BNZ Weekly Overview

18 June 2009

Mission Statement

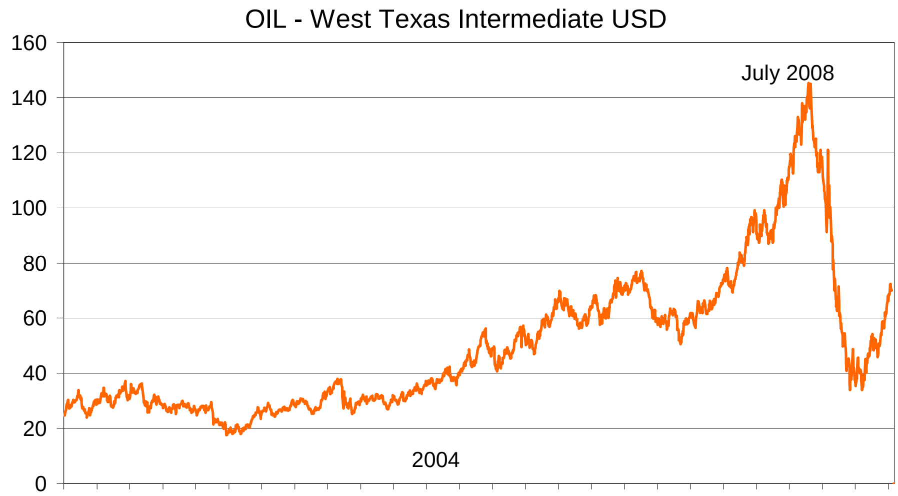
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

In this week's issue….

The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line.

Imagine How High Petrol Prices Will Go

Here is a thought which businesses and car owners should take notice of when considering their plans for the next few years. The global economy is currently undergoing its worst downturn since the Second World War. Yet oil prices are at US70 a barrel and at their low point in February only briefly got to US$35 before shooting back up.



Oil prices have risen in spite of consumption being down from a year ago partly because of anticipation that demand will start strengthening again before the end of the year, partly because investors have shifted back into the markets, and partly because of expectations that soon we will once again be asking ourselves where the oil will come from to feed China and other fast developing countries. There are some forecasters picking the price will be back at US$150 a barrel again by the end of 2010. That seems quite possible and in light of that we should all take advantage of this current breathing space to think about how we will adjust to that new surge in price which may be more sustained that last year's jump up. Car size and type, where to live, public transport capacity, efficient machinery etc.

Reserve Bank Clouds The Picture Again

Again this week the Reserve Bank Governor said "…, we are disappointed that banks have not passed on the April reduction in the OCR to short-term lending rates: they have an opportunity to help New Zealand's recovery by doing so,"

So lets explain the dynamics yet again. We do not fund a single loan to our customers by borrowing from the Reserve Bank at the official cash rate – whether that rate be last year's 8.25% or the current 2.5%. The only time the cash rate is relevant is when we need to borrow money from the RB to balance our account with them at the end of the day. The money gets paid back the next day usually.

We fund our lending by borrowing about 60% of the money we (you) need within New Zealand and the other 40% offshore. The cost to us of borrowing to make a five year fixed loan has risen from a swap rate of 4.1% plus risk premiums back in February to 5.3% plus premiums now.

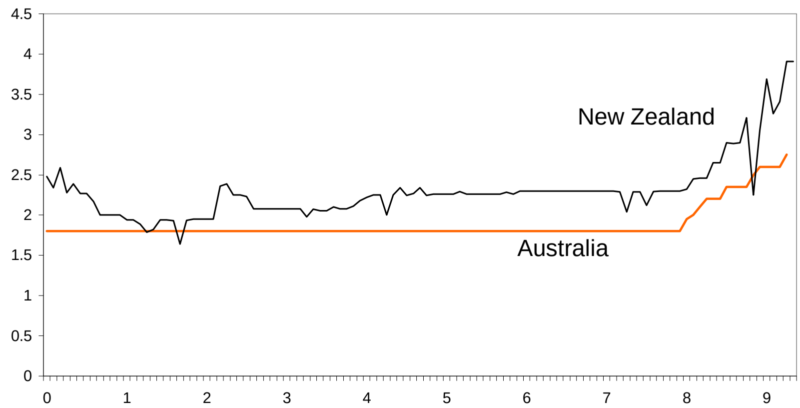
The cost to us of domestic funding as represented by the 90-day term deposit rate has risen from 3% back in early March to around 3.5% now. The current deposit rate is 1% above the official cash rate. A year ago it was over 1% below.

Interestingly, at the same time as the RB fails to point out that we banks fund at rates other than the OCR, they are also suggesting we boost our profits to ensure sufficient reserves are set aside to handle expected losses from the farming sector. And in fact the RB have circulated a proposal that would force us banks to charge farmers more than we currently do when we lend to them.

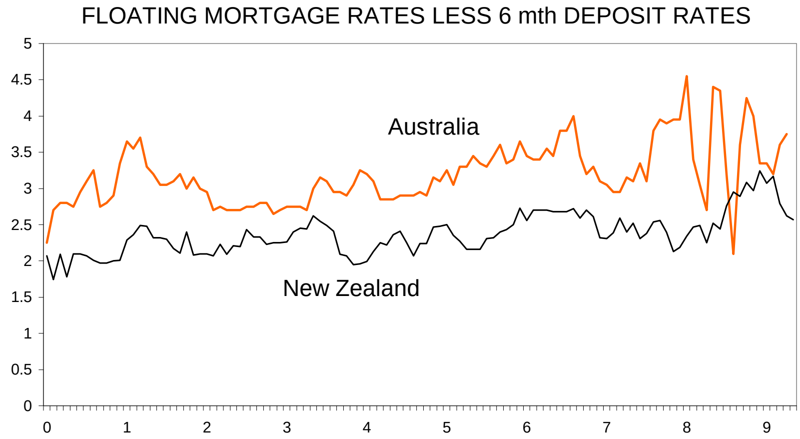
And perhaps the RB would do a better public service by pointing out that the pass-through of the official cash rate's cuts in New Zealand has been far greater than some countries offshore. US mortgage rates have fallen between 1% and 2% (now rising again though) over a period of time when the Fed.'s funds rate was reduced 5.25%. Cuts here amounted to around 4% for floating mortgage rates for 5.75% worth of cuts.

But one needs to be fair and note that across the ditch over a period of time when the RBA cut its cash rate 4.25% down to 3%, average bank floating mortgage rates fell 3.85% to 5.75%. That sounds good, but it should be noted that in the five years ending December 2007 the average gap between the Aussie cash rate and floating mortgage rates was 1.8% and it is now 2.75%. The graph below shows the mortgage rate less cash rate margin rising for both NZ and Australia since early 2008 as the global credit crisis got cracking.

FLOATING MORTGAGE RATES LESS CASH RATES



Why has the NZ margin increased more? Because we don't fund using the official cash rate, we use things like retail deposits, and the relative gaps for NZ and Australia there have not ballooned out. The graph below shows the difference between floating mortgage rates and six month retail deposit rates for NZ and Australia. First, note that this margin is traditionally much less in NZ than Australia – thus wiping out anyone's contention that mortgage margins are bigger in NZ than Australia. Second, with NZ banks having to compete against government guaranteed finance companies for money and the RB and credit rating agencies telling us we need to fund more domestically, lending margins using this crude measure are not greatly out of line with the historical norm.



The Broad Outlook

We agree with the Reserve Bank that the NZ economy is likely to start recording growth again before the end of the year. And we also agree that there remains a huge degree of uncertainty and some clear downside risks surrounding things such as the extent to which banks offshore have yet to fully write off their losses. Swine Flu is also a clear risk (I've just been diagnosed this afternoon with pneumonia so one's desire to get Swine Flu early has diminished somewhat as having the two together does not seem like a very bright idea.)

The growth we expect to arrive before the end of the year is going to come from some parts of the export sector – mainly sheepmeat, venison, and gold kiwifruit. But, and this is going to greatly concern both the Finance Minister and RB Governor who this week expressed hope for the opposite, it is the domestic part of the economy which may make the greatest growth contribution in the short term.

There is a large monetary stimulus running through the economy on top of the easier fiscal policy and this is going to generate some life in the retailing and housing sectors. We have already seen housing turnover rise firmly while prices flatten out and there is evidence that the number of consents being issued for new houses is rising again. Retailing will benefit from slowly improving residential construction later this year with support from household cash flows improving as average effective interest rates decline each month. Net migration flows are also improving quite strongly.

But it would be wrong to use the word "strength" with regard to housing and retailing over the coming year given the impact of rising unemployment and slowing wages growth.

And we must remember that for at least three sectors conditions are going to worsen before they get better – dairying, tourism, and commercial property.

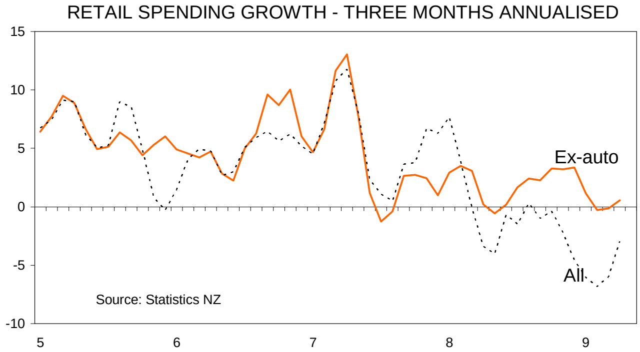
The road ahead remains very rocky and we would advise businesses to continue focussing very strongly on cash flow maintenance while reining in future plans for expansion funded by debt in a world where credit availability is going to permanently decline.

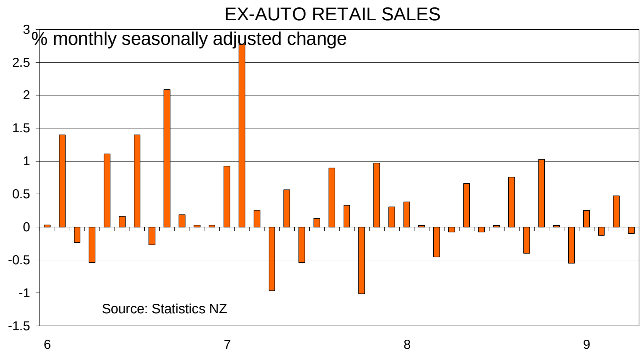
NZ ECONOMIC DEVELOPMENTS

Friday 12

Retail Spending Still Weak

Retail spending in seasonally adjusted terms rose by 0.5% in April after falling 0.2% in March. Is this growth a sign that consumers have started spending again? After all, confidence measures have improved recently. Actually, the result seems quite weak because we received tax cuts during April and the improved cash flow has clearly had little impact. Moreover, when we look at the core retail spending measure which strips out the automotive sectors including fuel we see that spending actually fell by 0.1% in the month and has produced growth at an annualised rate of only 0.6% in the past three months.



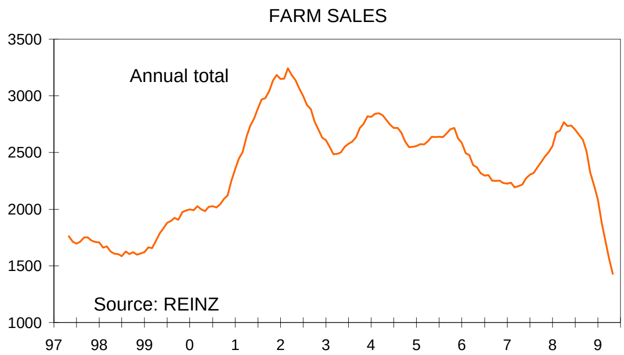


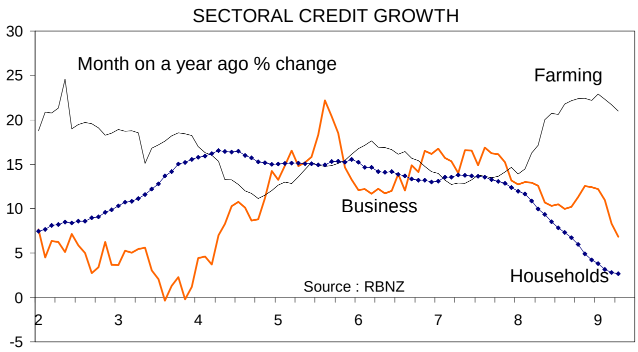
There is no sign yet that householders are opening up their wallets even though there are some factors supporting spending such as rising net immigration and low interest rates which every month leave more cash in borrowers' hands as they roll off fixed into lower rates. The problem is that unemployment is rising and there is a structural shift underway in the willingness of people to spend versus the willingness to save. It is impossible to know how big this shift is and the clear risk is people over-estimate the extent to which we Kiwis cut back on our over-spending because of major excess borrowing and banking sector problems overseas.

Our expectation is that as the year proceeds we will see some strength return to retailing. But it will be a very mild upturn which retailers in dairy areas probably won't see at all.

Farm Real Estate Turnover Crunched

During May there were only 97 farms sold around New Zealand. This was a massive 58% decline from a year earlier which followed annual falls of 59% in April, 66% in March, and 72% in February, Farm real estate turnover has been slammed by a combination of a sharp reduction in dairy income and tightening of bank lending criteria following many years in which funding has flowed too easily into the rural sector.

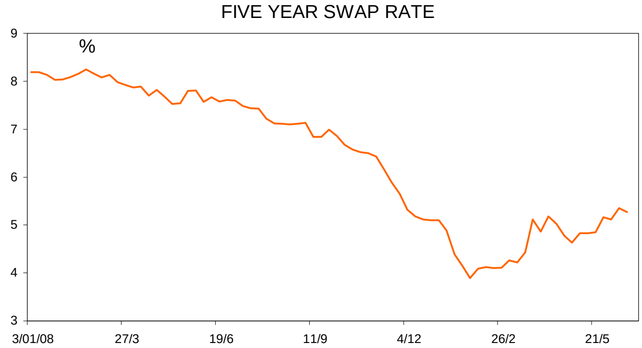


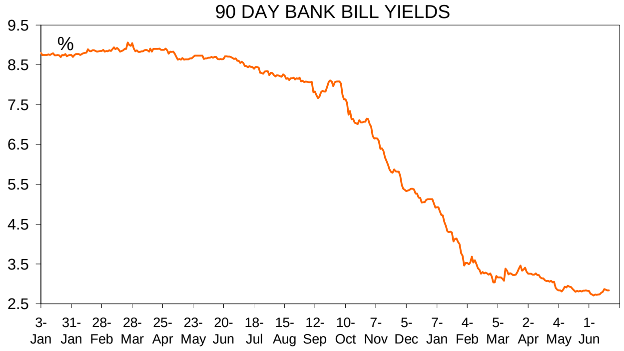


The Reserve Bank have expressed their concern about the level of farm debt in New Zealand and recent credit growth figures help show why. In an environment where the dairy payout fell from $7.90 to $5.20, the annual rate of growth in lending to the farming sector managed to stay ballistic at 21% in April. Annual growth in household debt was just 2.7% and business debt 6.8%.

INTEREST RATES

Wholesale fixed interest rates have edged down slightly over the past week in line with some reduction in United States long term interest rates as earlier excess euphoria about the extent of the likely recovery in US and global growth took a step back. But at 3.82% the two year swap rate is down only marginally from 3.88% and up from 3.6% a fortnight ago. The five year swap rate is now near 5.27% from 5.35% last week and 5.12% two weeks ago.





The yield on 90-day bank bills has ended up slightly at 2.84% from 2.78% last week with a small pullback in market expectations of any further policy easing from the Reserve Bank.

Our expectation is that the next change in the official cash rate is likely to be an increase and it will come toward the middle of next year – in other words earlier than the period the RB have indicated of the "latter" part of 2010. Our expectation also remains for further steepening of the yield curve as the world slowly starts to look less horrible and the markets increasingly solidify their expectations of central banks raising cash rates to remove current very stimulatory settings

Key Forecasts

- No more monetary policy easing with the this cycle.
- Medium to long term housing rates have seen their multi-year lows – stop-start rises now lie ahead. Speed unclear.

FINANCIAL MARKETS DATA						
	This week	**Week ago**	**4 wks ago**	**3 months ago**	**Yr ago**	**10 yr average**
Official Cash Rate	2.50%	2.50	2.50	3.00	8.25	6.2
90-day bank bill	2.84%	2.78	2.84	3.25	8.65	6.5
10 year govt. bond	5.90%	6.00	5.38	4.77	6.41	6.2
1 year swap	3.01%	3.05	2.96	3.14	8.28	6.7
5 year swap	5.27%	5.35	4.85	4.43	7.58	7.0

If I Were a Borrower What Would I Do?

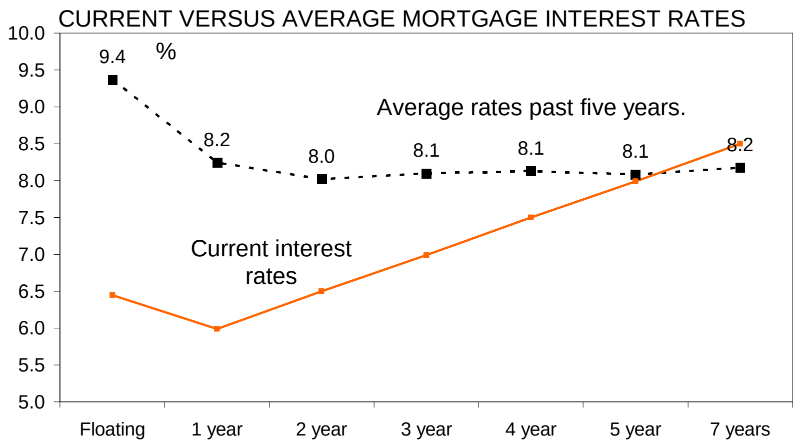
We have learnt nothing over the past week to alter our view on where interest rates are likely to go and what we think the best thing to do at the moment is for the average borrower. So if you read last week's WO then you'll gain nothing new this week. For those who did not read last week the guts of it is that if you are sitting floating waiting for the optimal time to fix – you missed it by three months!

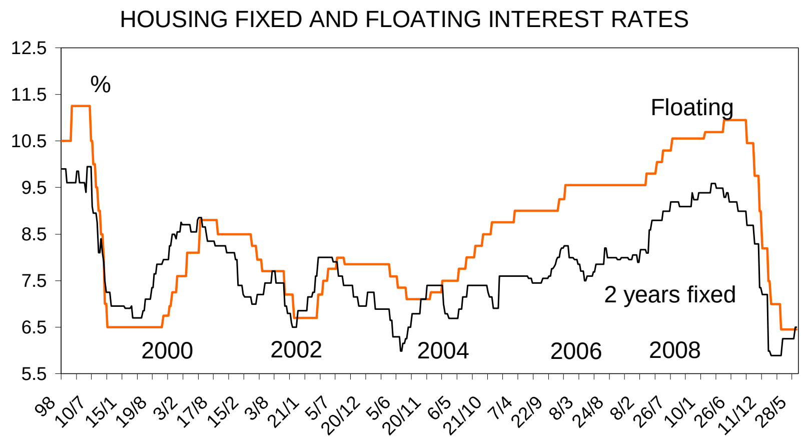
But seriously, it is quite unlikely that fixed rates will decline from current levels so there is little point in hanging off if fixing is your goal. But there is not anywhere near the same need to act quickly as there was in March and over April because the strong NZ dollar is going to limit the extent to which wholesale interest rates rise in the near future. Personally I would fix three years though for many people floating is optimal because it is the only way to get an affordable debt servicing cash flow at the moment. If you are in that position – then frankly you may be taking on more debt than you can really afford.

Interest rates are below average at the moment and if you are floating you should be budgeting for 2% - 3% rate rises a couple of years from now. Run your numbers on that basis and see if you can truly afford the debt you are planning to take on.

As we noted last week, for business borrowers the dynamics are a bit different because there is a larger gap between low floating and highish fixed rates than for home owners. This different yield curve situation mainly reflects the fact that we NZ banks have traditionally competed for mortgage business using fixed rates. Across the ditch the dynamics are different with competition mainly using floating rates. Don't know why.

For business and farming borrowers there are strong cash flow advantages from floating. But be sure to budget for 2% - 3% rate rises two or so years from now. If you work out your debt servicing costs based on current low floating rates then you are setting yourself up for a major problem 2-3 years from now.

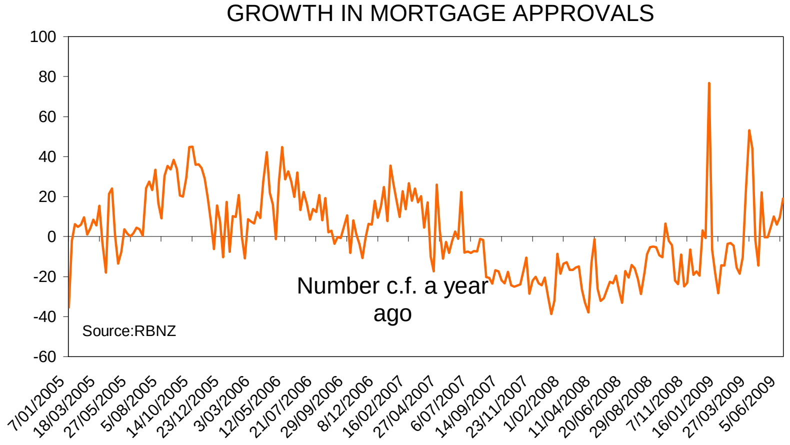


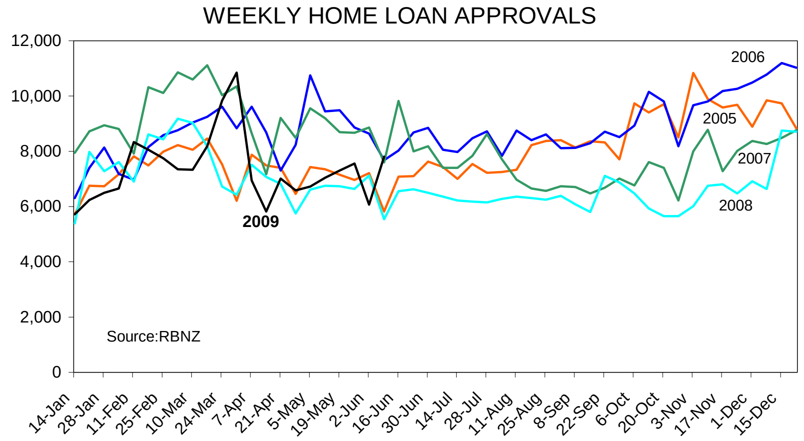


HOUSING MARKET UPDATE

Mortgage Approvals Growing

We have learnt nothing new with regard to the housing market this week, apart from Reserve Bank-gathered mortgage approval data showing a good lift in the most recent week. This indicates turnover remains good. The number of approvals in the past week was ahead 19% from a year ago after being 9% ahead in the previous week ending June 5.





Key Forecasts

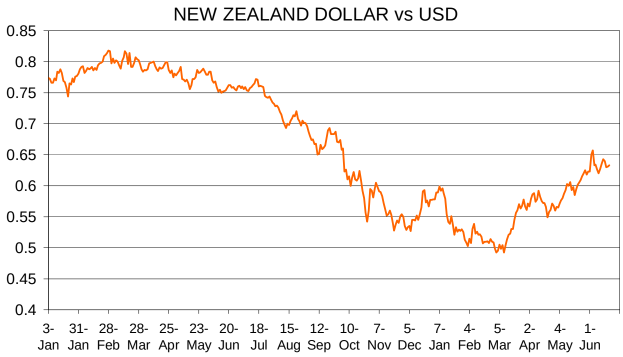
- Dwelling consent numbers to slowly recover from the middle of this year.
- Real estate sales have bottomed for this cycle. Activity is likely to fluctuate and begin a drift upward before year end with potentially firm activity over 2010.
- House prices stabilising, rising slightly over 2010.

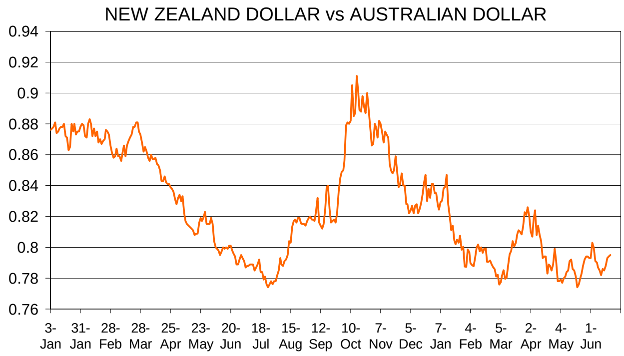
Exchange Rates & Foreign Economies

EXCHANGE RATES	This week	Week ago	4 wks ago	3 months ago	Yr ago	Consensus* Frcst Yr Ago	10 yr average
NZD/USD	0.633	0.636	0.585	0.53	0.754	0.693	.592
NZD/AUD	0.795	0.786	0.781	0.80	0.799	0.793	.856
NZD/JPY	60.6	62.3	55.7	52.3	81.4	73.3	66.8
NZD/GBP	0.386	0.388	0.386	0.377	0.385	0.371	.345
NZD/EUR	0.453	0.453	0.434	0.407	0.486	0.48	.51
USD/JPY	95.7	98.0	95.2	98.6	108.0	105.8	113.9
USD/GBP	1.64	1.64	1.516	1.40	1.96	1.867	1.709
USD/EUR	1.40	1.404	1.347	1.30	1.55	1.443	1.156
AUD/USD	0.796	0.81	0.75	0.662	0.9464	0.874	0.69

NZD Still Above US 63 cents

The NZD has maintained a firm bias all week now that the markets are convinced the monetary policy easing cycle in New Zealand is over and the next move is more likely to be an increase than a decrease. At this stage however there are few people anticipating a rate rise in the next few months and we are of the opinion rate rises won't commence until just before the middle of 2010. The timing is however going to be influenced by developments completely unforecastable at this stage – such as how quickly world growth recovers over 2010.

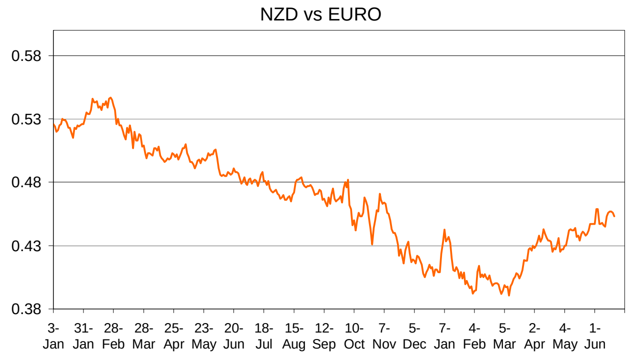


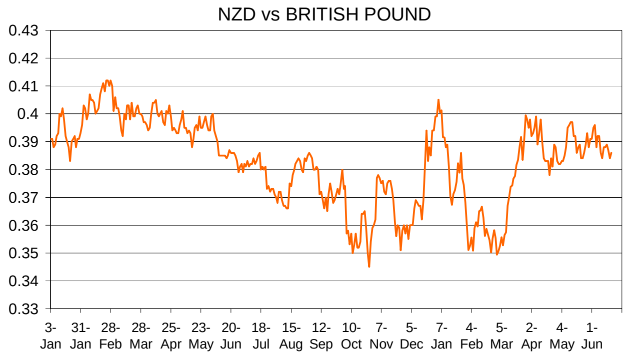


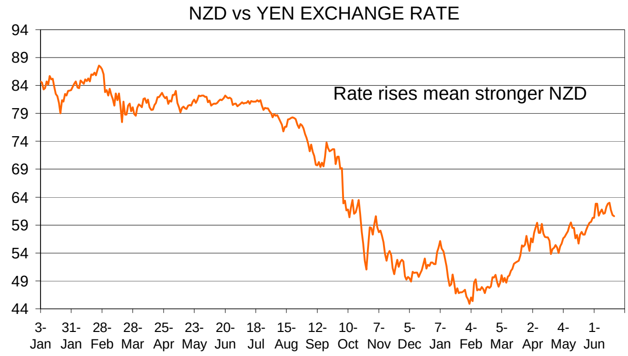
The NZD has ended this afternoon against the greenback near 63.3 cents from 63.6 cents last week. But we have risen against the Aussie dollar to near 79.5 cents from 78.6 cents with the Aussie dollar correcting downward from levels above 81 cents early this week to 79.6 cents this afternoon. The AUD suffered as the USD had a firm week – though one would have expected the switch back toward the USD would also have produced extra weakness in the NZD from a risk tolerance viewpoint.

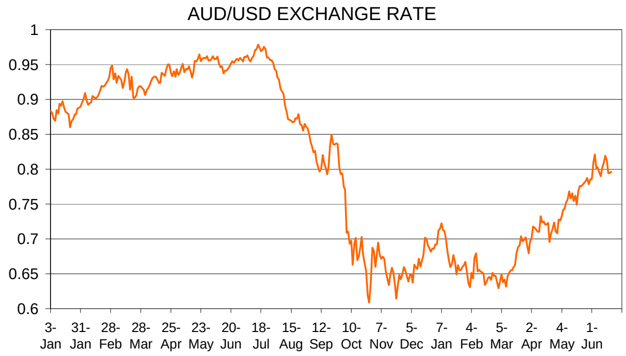
However, the NZD still remains well within its three month trading range against the AUD though the rise against the USD has stalled for the moment – thank goodness. As the Reserve Bank pointed out this week, a rising NZD is putting at risk the NZ upturn from later this year.

The NZD has ended slightly lower against the Japanese Yen near 60.6 from 62.3 last week, virtually unchanged against the British pound near 38.6 pence, and unchanged against the Euro at 45.3 centimes.

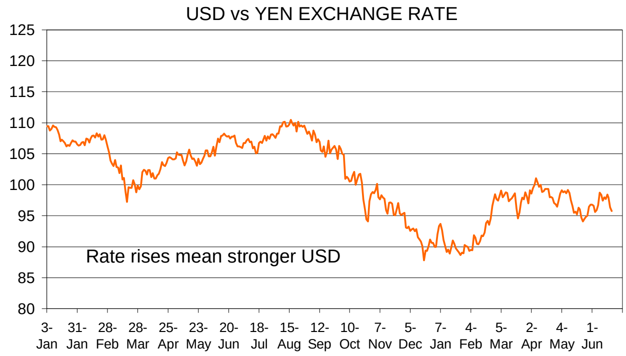


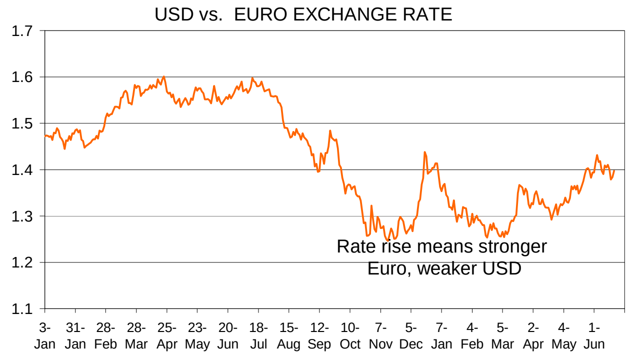


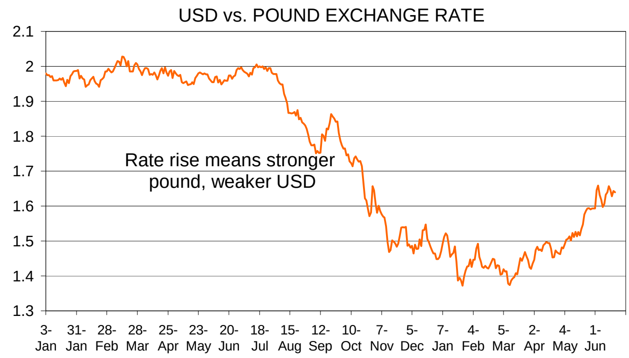




The greenback has ended the week stronger against the Yen at 95.7 from 98, but unchanged against the Pound and Euro near $1.64 and $1.40 respectively.

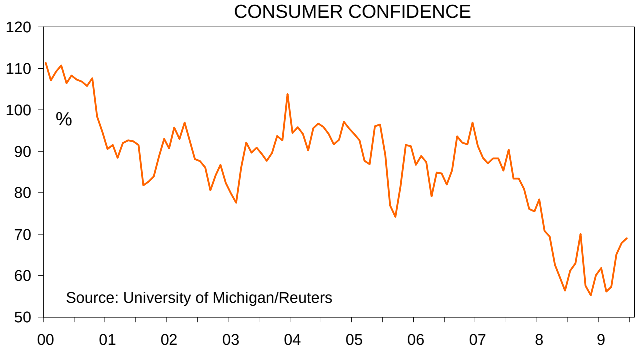


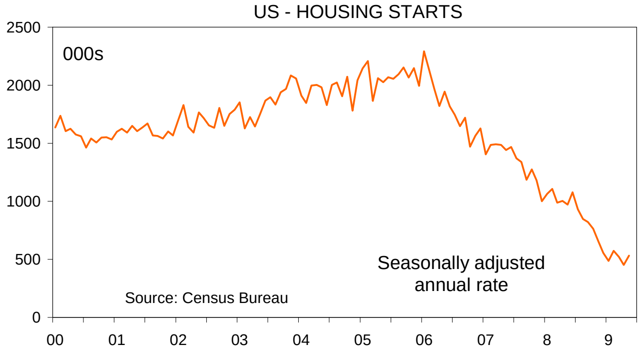




Mild support for the greenback came early in the week after the Japanese Finance Minister squashed some concerns about the ability of the US government to finance its deficit by saying his nation's confidence in US securities was "unshakeable". The Russian Finance Minister also said during the weekend – at the G8 meeting – that the USD's role as a reserve currency is unlikely to change in the near future. This is exactly what a number of other countries said a couple of weeks ago and highlights that although the BRIC economies may talk big when it comes to proposing some alternative, without support from some major economies no change in the USD's status is likely.

Consumer confidence continues to recover in the United States with the University of Michigan index improving to 69 in June from 68.7 in May. The result is however still well below the 100 neutral level (contrast that with one of Australia's indexes now just over 100).





Housing starts in the US improved to an annualised rate of 532,000 in May from 454,000 in April. This was a better than expected result but still a 46% decline from last year. House building remains extremely weak in the US.

But industrial production fell another 1.1% in the US in May to lie 13.4% down from a year earlier. The capacity utilisation rate fell to its lowest level since 1967 at 68.3% due significantly to the temporary closure of some motor vehicle plants in an effort to clear excess inventories.

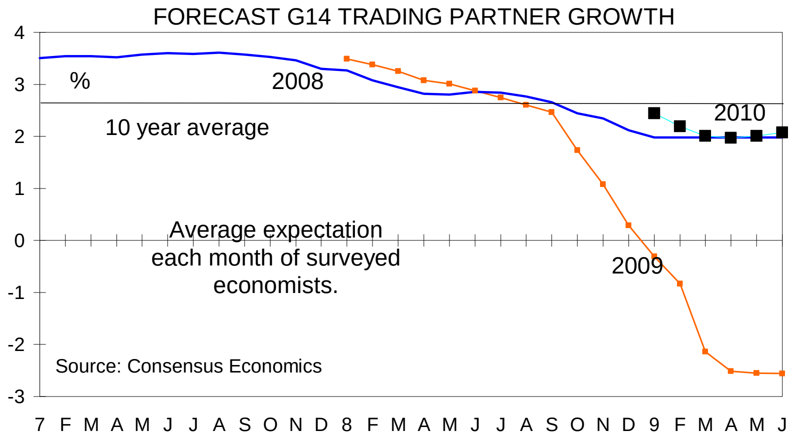
In Germany the monthly ZEW business sentiment index rose to 44.8 in June which was well above expectations of 35 and somewhat surprising considering the recent bad industrial production numbers out of the Eurozone.

China's industrial production in May was ahead 8.9% from a year ago compared with 7.3% growth in April. Retail sales were 15% above a year earlier – suggesting some feed-through from the large fiscal stimulus package.

Meanwhile, although there remain plenty of green shoots appearing offshore there are also plenty of data reminding us that we are still only talking about economies generally shrinking at a slowing rate rather than growing as such. Eurozone industrial production fell by a worse than expected 1.9% in April.

Consensus Survey Results

The monthly survey of economists around the world by Consensus Economics shows that on average our top 14 export destinations are expected to shrink 2.6% this year and grow 2.1% over 2010. These forecasts are essentially the same as back in April though remain well down from last September when this year growth of 2.5% had been expected. The average 2010 forecast in January was 2.4% so the broad profile for economic growth which forecasters have been working with has not changed as much as the actual magnitude of the economic decline expected this year.

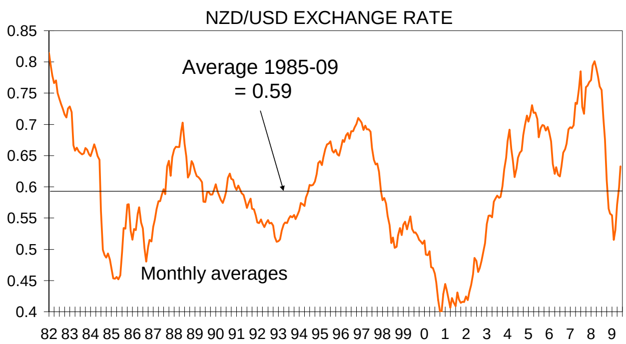


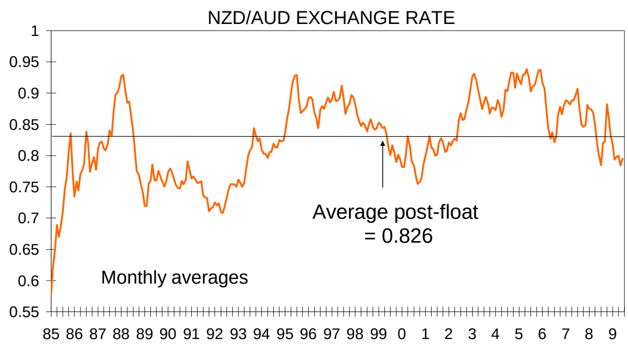
In the United States shrinkage of 2.8% is forecast this year to be followed by growth of 1.9% next year. In the EU a decline of 4.1% is forecast for 2009 with only a minor rebound next year of 0.3%. These forecasts support the general underlying theory that because they bite the bullet and lay off lots of people very quickly the US economy can recover from a shock earlier than the EU where things get drawn out over a longer period of time.

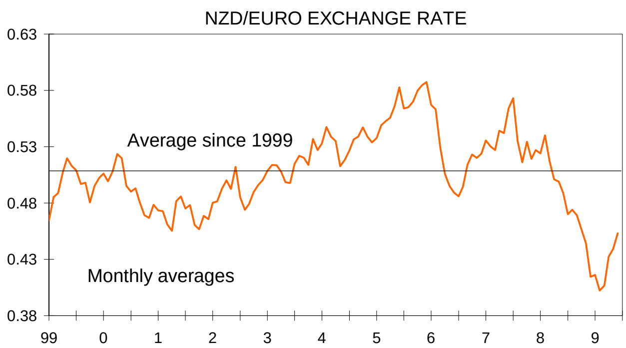
In Japan the economy is expected to shrink a horrible 6.6% this year then grow 1.3% over 2010. In Australia the forecasts are -0.2% (only) then +1.5% next year. In China growth of 7.5% this year is expected to be followed by growth of 8.4% over 2010.

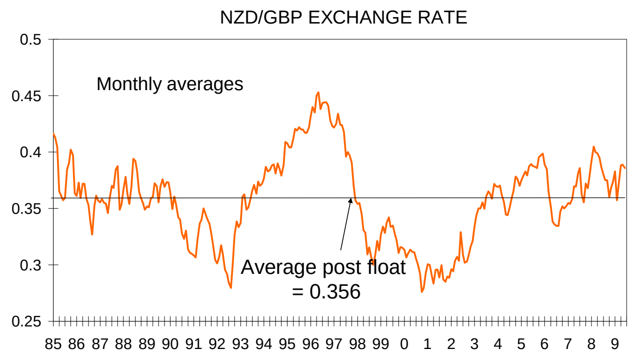
If I Were An FX Receiver What Would I Do?

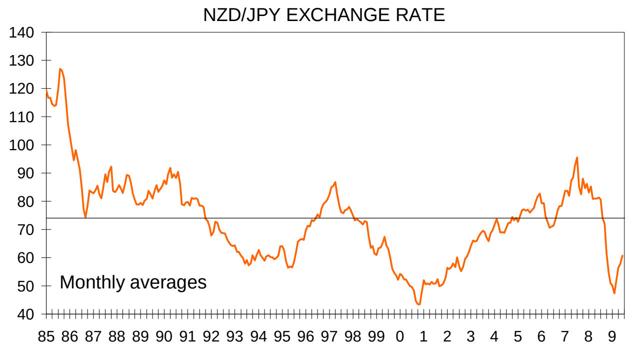
No change from recent weeks. Hold off for a pullback in the USD, load up against the Yen and AUD, but only take GBP coverage on decent dips.











*Sourced from Consensus Economics. http://www.consensuseconomics.com/

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	-0.5%	1.5	3.4	3.2	2.7
GDP growth	Average past 10 years = 3.0%	-0.9	-0.5	0.3	3.2	1.9
Unemployment rate	Average past 10 years = 5.3%	5.0	4.7	......	3.8	3.8
Jobs growth	Average past 10 years = 1.9%	-1.1	0.6	0.8	-0.2	2.1
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.9	8.6	......	8.2	9.0
Terms of Trade		-3.0	-1.0	-5.2	11.6	4.5
Wages Growth	Stats NZ analytical series	1.5	1.1	5.3	4.8	5.1
Retail Sales ex-auto	Average past 9 years = 3.8%.	-1.2	-0.0	-0.8	3.2	4.9
House Prices	Long term average rise 5% p.a. QVNZ	-2.0	-2.1	-8.9	8.0	9.7
Net migration gain	Av. gain past 10 years = 10,400	+9,176	4,538yr	......	4,667	11,230
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-2.7	-0.9	-2.7	1.5	2.1
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	3	-9	3	-34	-4
Business activity exps	10 year average = 26%. NBNZ	3.8	-3.8	-14.1	-4.4	7.8
Household debt	10 year average growth = 11.3%. RBNZ	2.7	2.8	6.0	10.0	13.8
Dwelling sales	10 year average growth = 3.5%. REINZ	43.9	-39.1	-45.4	-52.9	-3.7
Floating Mort. Rate	10 year average = 8.1%	6.49	6.49	9.75	10.95	10.05
3 yr fixed hsg rate	10 year average = 7.9%	6.99	6.75	8.49	9.49	8.80

ECONOMIC FORECASTS

Forecasts at May 14 2009	**March Years**					**December Years**				
	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010
GDP - annual average % change										
Private Consumption	2.8	3.2	-0.4	0.5	1.8	2.6	4	0.1	-0.1	1.8
Government Consumption	4	4.3	3.7	3.7	3.4	4.6	3.9	4	3.8	3.3
Investment	-0.6	4.3	-10.4	-16.2	5.9	-0.4	5	-5.7	-18.8	1.8
GNE	1.4	4.4	-2.1	-2.8	3.2	1.4	4.5	-0.3	-4	2.4
Exports	3.1	2.9	-3.7	-4.1	1.2	1.8	3.8	-1.8	-4.7	-0.6
Imports	-1.6	9.6	-2.5	-10.1	2.1	-2.6	8.6	2.5	-12	0.1
GDP	1.8	3.1	-0.9	-0.9	3	2	3.2	0.2	-1.7	2.3
Inflation – Consumers Price Index	2.5	3.4	3	1.9	1	2.6	3.2	3.4	2.3	1
Employment	2.1	-0.2	0.8	-3.2	2.9	1.7	2.3	0.9	-4	2.9
Unemployment Rate %	3.8	3.8	5	7.5	7.2	3.8	3.5	4.7	7	7.2
Wages	5.5	4.4	5.1	2.4	1.5	5.5	4	5.1	3.1	1.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.7	0.8	0.53	0.6	0.66	0.69	0.77	0.56	0.58	0.65
USD/JPY	117	101	98	105	115	117	112	91	103	113
EUR/USD	1.32	1.55	1.31	1.34	1.38	1.32	1.46	1.34	1.33	1.37
NZD/AUD	0.88	0.87	0.8	0.78	0.81	0.88	0.88	0.83	0.77	0.81
NZD/GBP	0.36	0.4	0.37	0.38	0.39	0.35	0.38	0.37	0.37	0.39
NZD/EUR	0.53	0.52	0.41	0.45	0.48	0.52	0.53	0.41	0.44	0.47
NZD/YEN	81.9	81.1	51.8	63	75.9	81	86.3	50.9	59.5	73.1
TWI	68.6	71.6	53.8	59.1	65.1	68	71.6	55.1	57.2	64
Official Cash Rate	7.50	8.25	3.00	2.25	4.25	7.50	8.25	5.00	2	3.75
90 Day Bank Bill Rate	7.78	8.82	3.24	2.62	4.62	7.64	8.77	5.23	2.2	4.12
10 year Govt. Bond	5.91	6.35	4.77	5.6	6.4	5.77	6.38	4.88	5.55	6

All actual data excluding interest & exchange rates sourced from Statistics NZ.

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.