BNZ Weekly Overview

18 March 2010

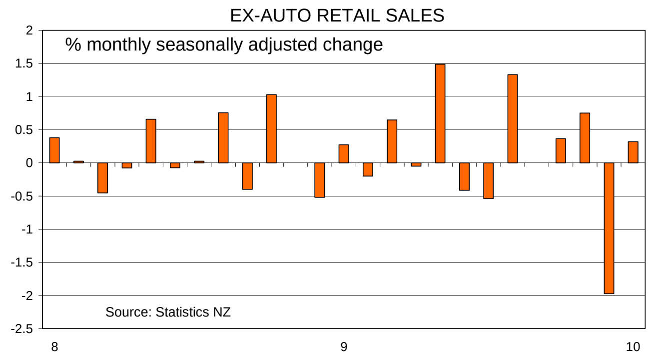
Mission Statement

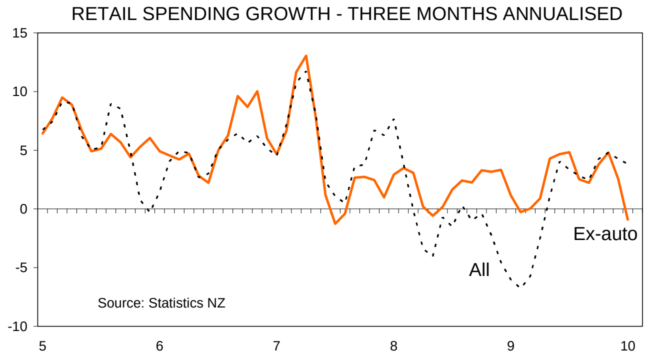
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

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.

Retail Spending Falls

There is little evidence that high levels of consumer confidence in New Zealand are feeding through to either new robustness in the housing market or strength in retail spending. The housing data from REINZ are discussed in our Housing section and here we note the continued weakness in January retail spending data published by Statistics NZ. After taking out the volatile automotive components to get core spending we see spending rose by a paltry 0.3% in January. We say paltry because this measure fell 2% in December (previously estimated as a 1.8% fall).

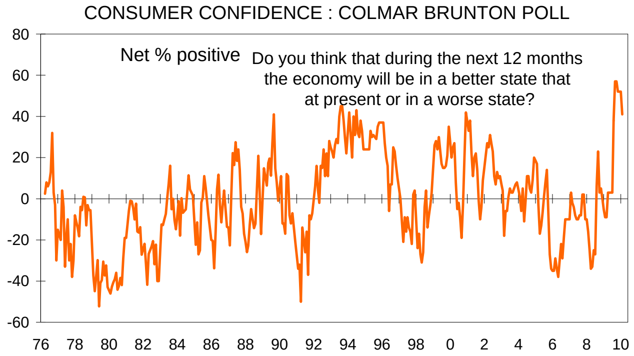


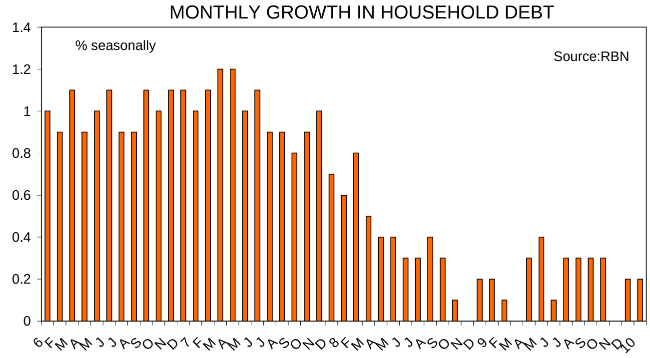


In annualised terms core retail spending has fallen 0.9% over the past three months. This is the worst result for this series since the middle of 2007 when the official cash rate hit 8.25%. Clearly there is more to consumer spending decisions than just confidence and we think a key element in play here is that although people expect the economy to improve they want to get their debt levels down.

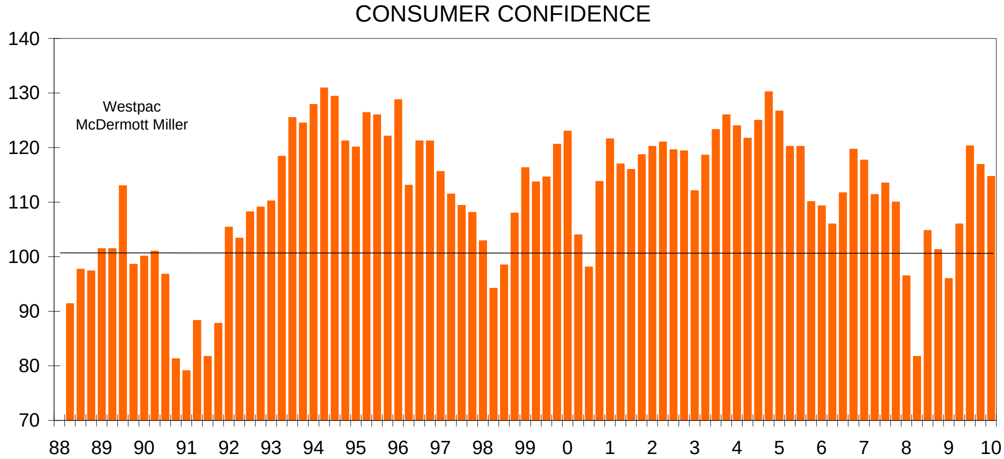
Whether this aversion to debt funded spending continues or not is guesswork at this stage – though it would be optimal if we spent less and financed more of the NZ economy ourselves rather than relying on the money of foreigners. But whatever the long term trend, the implication for the moment is that the strength we are expecting in retail spending for this year has yet to kick in.

This increases slightly the chances that the Reserve Bank will be able to delay its tightening of monetary policy until after our current favoured starting date of June 10 – though between now and then we will learn a lot more about how much the economy will improve this year.

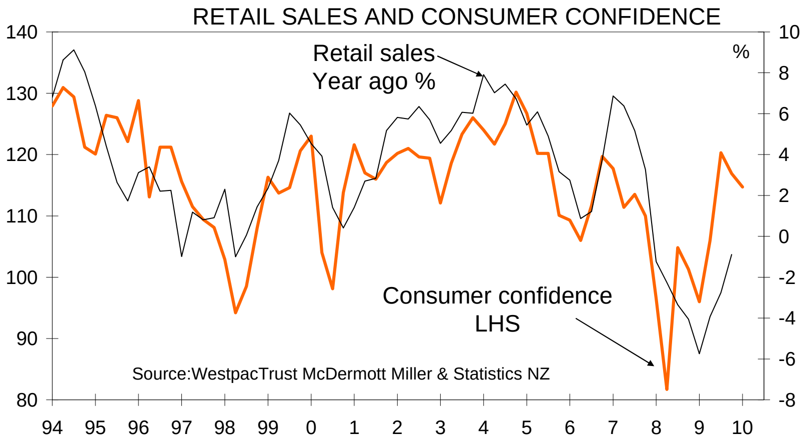




Speaking of learning more, this week the quarterly Westpac McDermott Miller Consumer Confidence Index eased marginally in the March quarter to a reading of 114.7 from 116.9 in the December quarter where a reading of 100 is neutral. Seasonally adjusted things actually improved marginally but the overall important thing is that people still feel confident generally about where things are going.



But as we have been noting for both businesses and consumers this confidence is not translating into higher borrowing and spending as has tended to be the case in the past.



The Next Recession

There will definitely be one but we don't know when. Forecasting when it will come is not actually what we are interested in here. What we think is worth discussing from a business management point of view is that no-one forecasts the next recession until a boom is underway. When we emerged from the 1997/98 Asian Crisis-driven recession (with drought) no-one put a stake in the ground forecasting when the next recession would come along. It took a decade as it turned out.

Why are none of us predicting the next recession? Partly it is because it would be such a truly horrible thing to do. Who wants to continually remind people that good times never persist and we will inevitably again see soaring unemployment, bankrupt businesses, old folk losing their retirement savings and so on? Mainly however it is because it is simply impossible to forecast such an event when one doesn't even know the nature of recovery from the most recent recession.

This time around it is not just that every downturn is different therefore every recovery will be unique, but the fact that we are recovering from the greatest downturn since the 1930s Great Depression for some economies or 1946 for many others. There is a lot we don't know. How quickly will governments be able to get their balance sheets and operating statements back in good condition? How quickly can central banks place dry powder in their kegs to fight the next downturn by raising interest rates from current very low levels. Are borrowers temporarily or permanently changing their debt-loving habits? Is there a collapse still looming in the United States commercial property market? Will Greece default on its debt and will this snowball into other governments defaulting?

There is more water to go under the bridge with regard to this global recovery from recession than any other in decades and it would be a very foolish person indeed who took a firm stance on when the next recession will come. All one can say is that one day it will, and because the recent one was so shocking businesses need to think about the recovery underway as representing not one opportunity but two.

The first is obviously more customers coming through the door bringing hopefully greater profits and opportunities to expand into new markets, invest in new machinery, processes, premises and people, pay higher wages and so on. The second is to prepare for the next shock in whatever way seems to best suit one's business. It might be low debt. It could be extra bank lines of credit. It might be diversifying one's product range and markets, altering inventory management policies, more outsourcing, and many other things.

This process is already explicitly underway in banking systems around the world including our own. All and sundry in the world of finance had the bejeebers scared out of them late in 2008 when global money markets froze up and banks could not refinance maturing borrowings. To help mitigate the impact the next time global markets freeze up (hopefully it won't be for decades) our central bank is requiring registered banks operating in New Zealand to hold greater levels of liquidity – the BS13 Liquidity Policy Framework. It would be confusing to go into the deep details but suffice to say that from April 1 this year we must hold term funding longer than one year along with capital and customer deposits at levels greater than 65% of lending. This rises to 70% on July 1 2011 then 75% on July 1 2012. The drive for higher customer deposits helps explain why in spite of the official cash rate sitting at 2.5% and 90-day bank bill yields near 2.7% term deposit rates are approaching 5%. In addition long term funding (often raised in foreign markets) costs more than short term funding.

The upshot is that bank funding costs in New Zealand are being pushed up over and above the increase caused by global investor reaction to the events of 2008. This means higher interest rates for borrowers in NZ than would otherwise be the case.

But before one gets apoplectic it pays to remember this. When the Reserve Bank implements monetary policy they want to influence inflation. To influence inflation they want to change the rate of growth in the economy – more or less borrowing and more or less spending (maybe some savings adjustments as well). To influence borrowing and spending behaviour they want to influence the cost of borrowing. To influence the cost of borrowing they change the official cash rate.

What this means very simply is that whereas in the past the average official cash rate used by the Reserve Bank sat at around 6%, now they will get customer borrowing rates fluctuating around the same levels as in the past but with the cash rate averaging 4.5% - 5.0%. Ceteris parebus the change in bank funding costs alters only the level of the official cash rate needed to implement monetary policy – except for one thing.

If the current high unwillingness of borrowers to raise funds is a long term structural change rather than a short term crisis response, customer borrowing costs will on average be lower than in the past. Only time will tell if current debt intolerance continues. Hopefully for householders it does. Hopefully for the sake of economic growth it does not with regard to businesses which the country needs investing in new machinery and so on. Exporters will hope the change by households is permanent because it implies a lower exchange rate on average – though there is no reason to believe it will be any less volatile than during the past couple of decades. And if householders overseas also permanently rein in their debt appetite then because it is relative interest rates which matter the currency will not in fact settle lower on average.

Random Tax Thoughts

Fiscal drag is the process whereby over time due to inflation and incomes growth the average wage and salary earner finds themselves pushed into higher and higher income tax brackets and a greater and greater proportion of their income goes to the government. If Finance Ministers exercise a modicum of restraint then every few years the fiscal numbers will allow them to appear generous by giving tax cuts in the form of higher income tax thresholds or maybe rate reductions. We think they are wonderful and consider voting for them again. But all that happens is if we are lucky our income tax burden simply goes back to where it was a few years earlier.

The coming round of income tax rate cuts is akin to a traditional fiscal drag adjustment with one exception. We pay for it with a hike in the rate of GST. Generous it is not and of course a dangerous precedent risks being set of accompanying income tax rate adjustments for fiscal drag further down the track with rate increases elsewhere.

And thinking in terms of the GST increase. All those who have saved money in recent years will have the purchasing power of their savings slashed 2.5% by the GST rise. GST was introduced in 1986, raised in 1989, will rise again this year. It seems reasonable to expect that before the bulk of people retire many years from now – maybe 40 years – GST will go up again. It would seem a good idea to have a good inflation hedging element in one's retirement savings portfolio.

And now thinking in terms of those retirement savings, it pays to remember that much as managed fund providers may try and scare you into saving more with stories of the pension not being affordable for the government down the track, the chances of the pension being slashed seem remote. The government can't even plug the rort in the Gold transport card given to old folk whereby they take free off-peak travel for a day's jaunt to Waiheke Island or to the Wairarapa. The voting power is with the old folk and they will get more of it over the next few years.

More and more budgetary resources are likely to be siphoned toward this agitative group and fewer and fewer to the young end of the taxpayer spectrum. Given budgetary constraints and political reality one worries therefore about the ability and willingness of the government to respond to the pressure soon to come on young families from rising rents caused by inadequate construction, landlords raising rents to compensate for coming tax changes, and a rising proportion of the rental stock which will be held by professional investors. These folk tend to pay more attention to rental returns than the small people just waiting for capital gain and a tax deduction.

Maybe the fact elderly folk with savings will not be compensated for the 2.5% cut to the purchasing power of their savings due to the GST increase is just after all. Best get as many free rides as they can.

INTEREST RATES

We have not learnt anything important enough over the past week to alter our view that the Reserve Bank will start their removal of the low 2.5% cash rate on June 10. We expect 0.25% increases after that through to early 2012 with the official cash rate getting to around 6%.

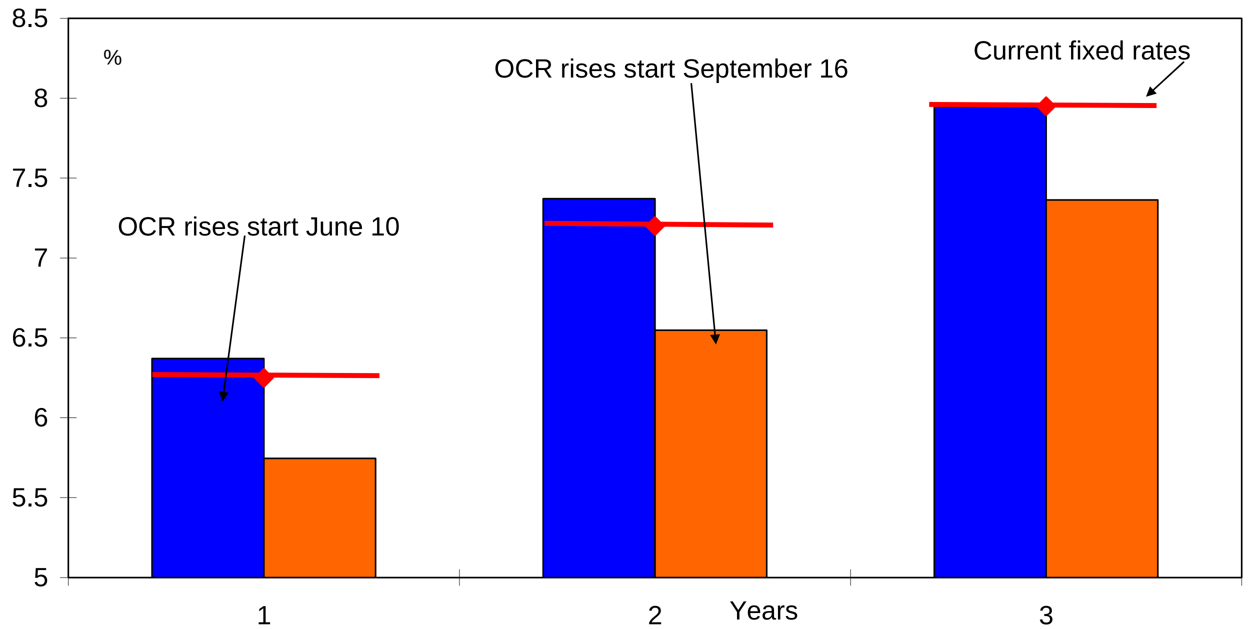
Key Forecasts

- Tightening mid-2010.
- Medium to long term housing rates to rise again in a few months.

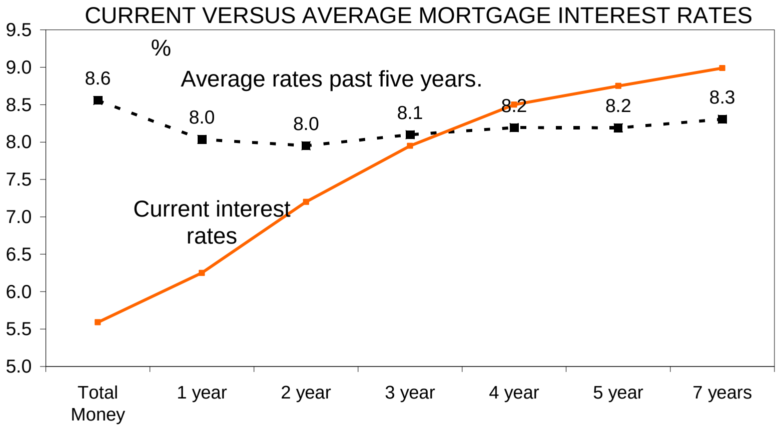
FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	3.00	6.2
90-day bank bill	2.71%	2.71	2.73	2.75	3.25	6.5
1 year swap	3.43%	3.48	3.47	3.63	3.14	6.7
5 year swap	5.21%	5.24	5.28	5.59	4.43	7.0

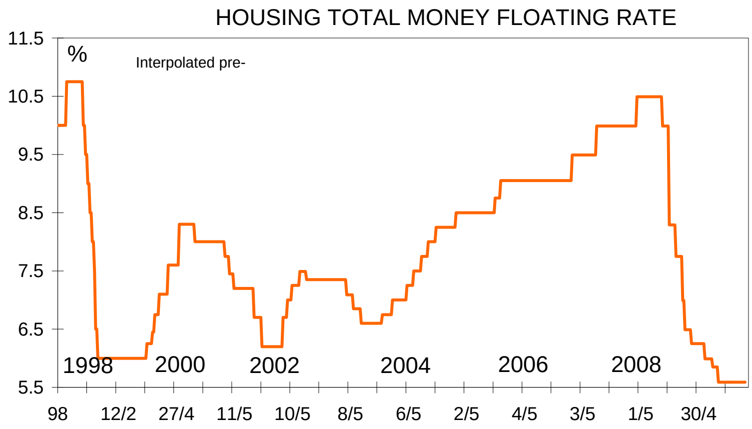
If I Were a Borrower What Would I Do?

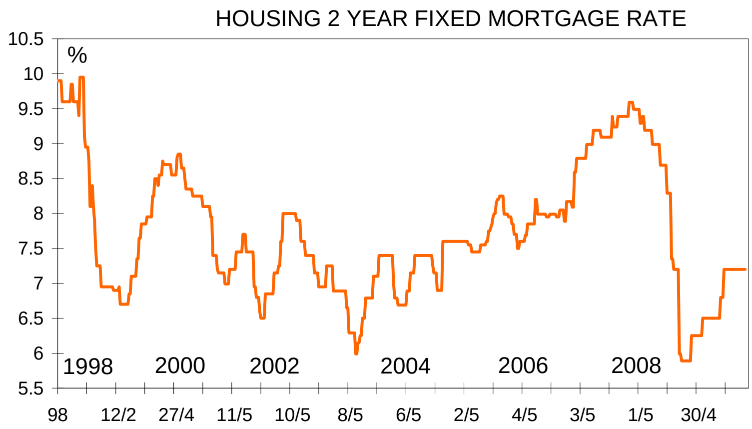
This graph has blue columns showing where the Total Money floating mortgage rate will average for the next one, two and three year periods if our forecasts prove correct and the rate rise cycle starts in June. The orange bars show average rates if tightening starts in September. The red lines show current fixed lending rates. The graph looks different this week from last week because we have cut the projected peak in our forecasts from 6.75% to 6%, advanced everything one month, and adjusted for a small rate error in the middle of 2010 (Doh).

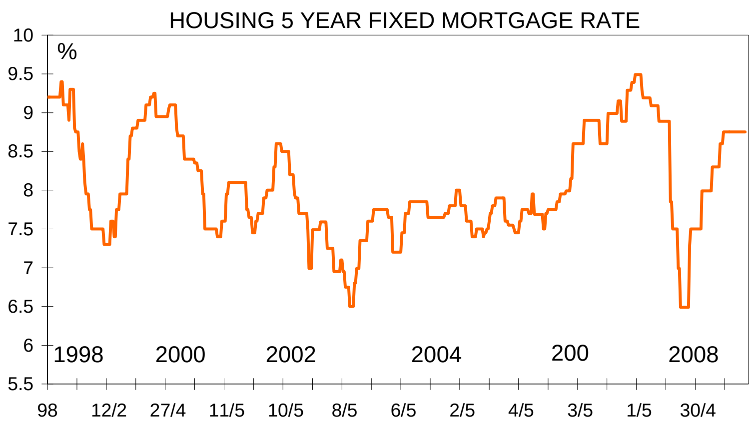


At the moment our central forecast of rate rises starting in June suggests fixing or floating involves tossing a coin. Personally I would stay floating. If the tightening starts a tad later then one definitely stays floating for now. Note that if you are on the standard floating rate –currently at 5.99% - then fixing becomes more attractive. But I would either switch to the Total Money rate and stay floating, or simply stay floating a bit longer anyway.


CURRENT VERSUS AVERAGE MORTGAGE INTEREST RATES
%
Average rates past five years.
Current interest rates
8.6
8.0
8.0
8.1
8.2
8.2
8.3
9.5
9.0
8.5
8.0
7.5
7.0
6.5
6.0
5.5
5.0
Total Money
1 year
2 year
3 year
4 year
5 year
7 years


HOUSING TOTAL MONEY FLOATING RATE
%
Interpolated pre-
11.5
10.5
9.5
8.5
7.5
6.5
5.5
1998
2000
2002
2004
2006
2008
98
12/2
27/4
11/5
10/5
8/5
6/5
2/5
4/5
3/5
1/5
30/4

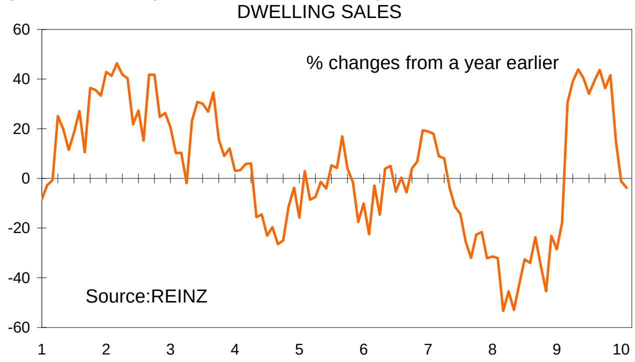

HOUSING 2 YEAR FIXED MORTGAGE RATE
%
10.5
10
9.5
9
8.5
8
7.5
7
6.5
6
5.5
1998
2000
2002
2004
2006
2008
98
12/2
27/4
11/5
10/5
8/5
6/5
2/5
4/5
3/5
1/5
30/4

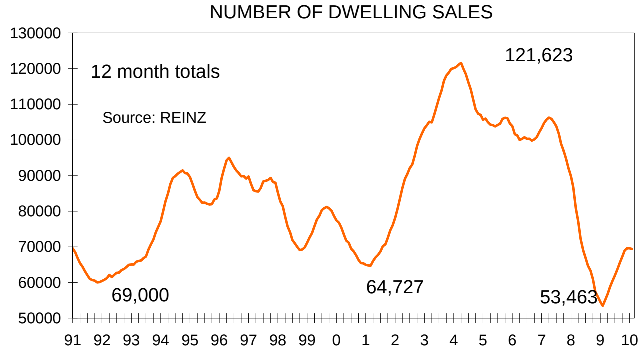

HOUSING 5 YEAR FIXED MORTGAGE RATE
%
10
9.5
9
8.5
8
7.5
7
6.5
6
5.5
1998
2000
2002
2004
200
2008
98
12/2
27/4
11/5
10/5
8/5
6/5
2/5
4/5
3/5
1/5
30/4

HOUSING MARKET UPDATE

February Not Flash

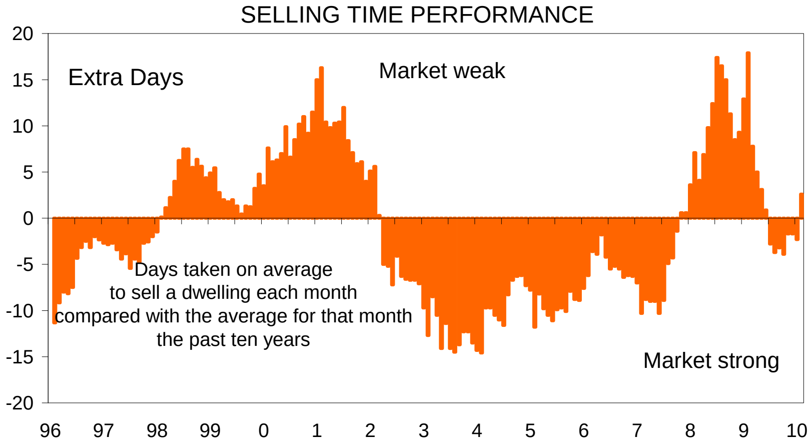
This week the REINZ reported that in February there were 5,029 dwellings sold around New Zealand. This was well up from 3,666 in January but that doesn't matter because January sales are always pushed down by the holidays and the January result was the lowest for any month on record.





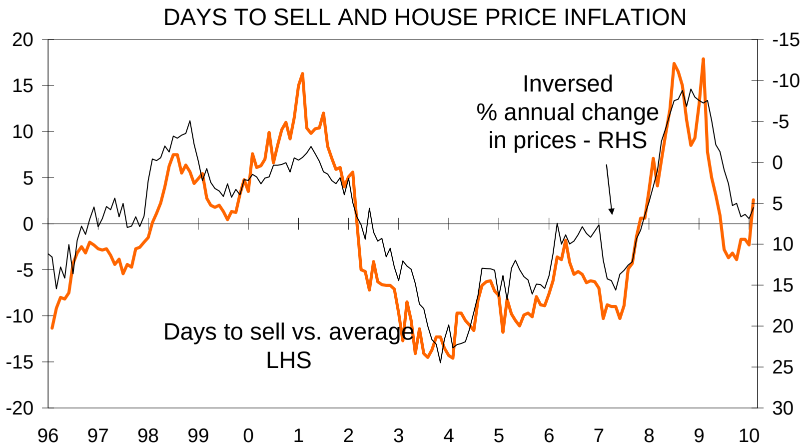
However, having said that, if we make a rough seasonal adjustment we see that sales did improve slightly in seasonally adjusted terms by about 8% in the month. This followed a 20% fall in January and means that for the past three months sales have eased about 18% from the three months to November. One can say that sales have eased off in recent months and the rebound in February was relatively mild considering the extent of January's weakness. In fact sales in February were the weakest for hat month since 1991.

The easing off of activity is probably best seen when we look at the days to sell indicator. In February it took on average 46 days to sell a dwelling. This was 2.6 days longer than on average in February for the past ten years whereas January was 2.3 days faster, November and December 1.7 days, and August, September and October all more than three days faster.



Properties are sitting on the market for a slightly above average length of time though not by all that much. For instance in February last year the days to sell measure was 18 days above average.

There is an inverse relationship between the average number of days taken to sell a house and annual house price inflation – shown in the graph on the next page. Given this relationship and the increase in days to sell recently it is unsurprising that house price movements have stalled. In February average house sale prices rose just 0.4% after falling 1.6% in January and 0.9% in December. They are therefore about 2.1% down from levels in November. But this is a relatively small change and still leaves prices on average 7.3% above the lows of January last year.



Overall the data are on the weak side but only mildly so. They certainly do not show the rapidly reversing market some commentators still seem to be praying for with their latest hope for salvation coming in the form of investor uncertainty about tax changes. The problem there is that while there is evidence of investors pulling back from purchasing there is little evidence of a wave of selling. If such a wave were to be ready to arrive one would expect to have already seen it a year ago when the biggest global financial crisis since the 1930s was underway, there was silly talk of house prices falling 40%, and there were predictions of soaring unemployment and huge numbers of mortgagee sales.

Underneath the current chaotic uncertainty regarding the tax changes there are the same very deep fundamentals at work which will limit short term price declines and cause prices to head back up again next year in spite of rising floating mortgage rates from sometime near the middle of this year.

- Construction of dwellings is running at 14,500 per annum and we need at least 23,000.
- Net migration inflows are running at 23,000 and not the ten year average of 13,000.
- Investors are reacting to tax worries by pulling out of construction deals involving leasing newly built properties back to Housing NZ.
- Finance to build new subdivisions is extremely tight now that the traditional finance company business model has been shattered.
- While net migration flows are expected to ease off from late this year, a high proportion of those leaving are likely to be skilled tradespeople and this will also reduce the ability of house construction to recover.
- The rise in GST will boost construction costs 2.5%.
- The recovering global economy and rising commodity prices means rising prices for house construction materials – as seen recently with price hikes for steel and timber products.

And to top it all off, the anecdotal evidence suggests rents are finally showing some decent increases as landlords realise they should be pricing their houses like they were running a business and not just squatting for capital gain.

Are You Seeing Something We Are Not?

If so, email us at tony.alexander@bnz.co.nz with Housing Comment in the Subject line and let us know.

Key Forecasts

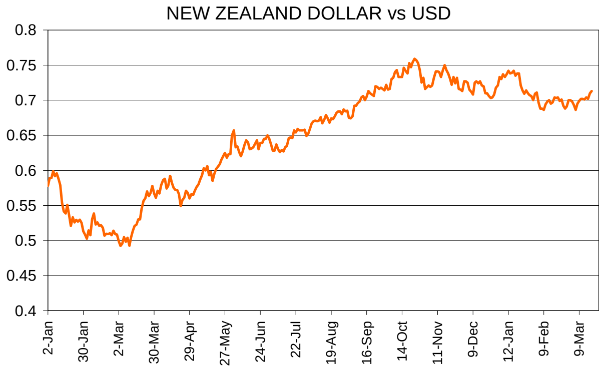
- Dwelling consent numbers to recover now with potentially good activity from late-2010.
- House prices edging higher after tax change effects wend their way through.
- Sales recovering later this year.

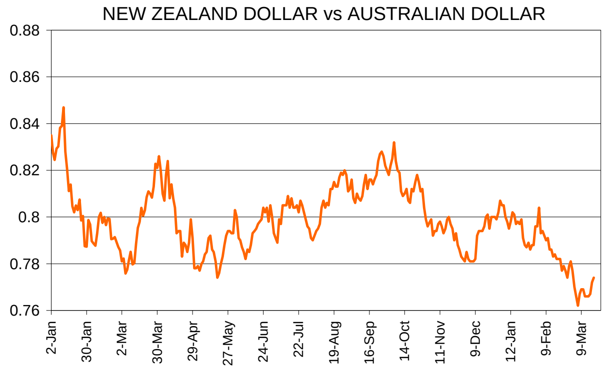
Exchange Rates & Foreign Economies

Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.713	0.702	0.703	0.710	0.5303	0.573	0.592
NZD/AUD	0.774	0.766	0.782	0.801	0.8006	0.848	0.856
NZD/JPY	64.40	63.50	64.00	64.00	52.31	59.0	66.8
NZD/GBP	0.466	0.468	0.448	0.440	0.3776	0.358	0.345
NZD/EUR	0.520	0.514	0.516	0.496	0.4073	0.448	0.51
USD/JPY	90.32	90.45	91.03	90.14	98.64	103.0	113.9
USD/GBP	1.530	1.500	1.569	1.614	1.404	1.601	1.709
USD/EUR	1.371	1.366	1.362	1.431	1.302	1.278	1.156
AUD/USD	0.921	0.916	0.899	0.886	0.662	0.676	0.69

Kiwi Dollar Recovers Some Ground

The NZD has risen over the past week to sit this afternoon near US 71.3 cents from 70.2 cents a week ago. This takes it back to where it was in late-January but still well short of the 76 cent high back in October.

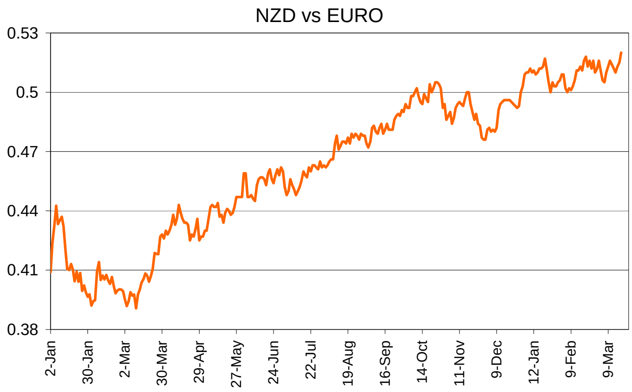


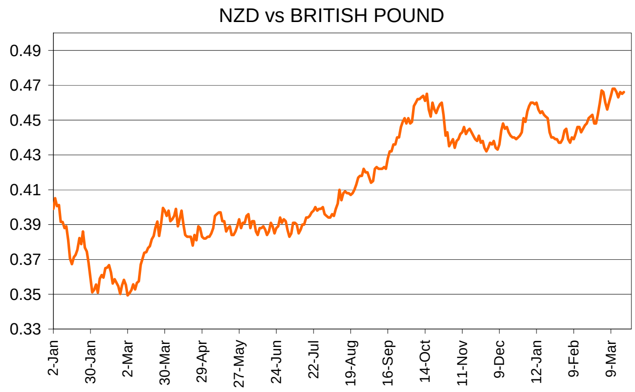


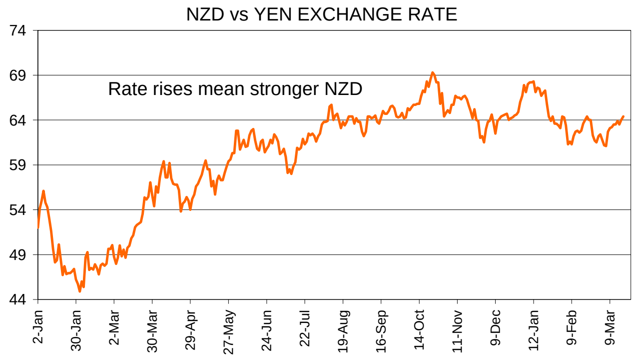
The firming of the Kiwi dollar over the week largely reflects the following factors.

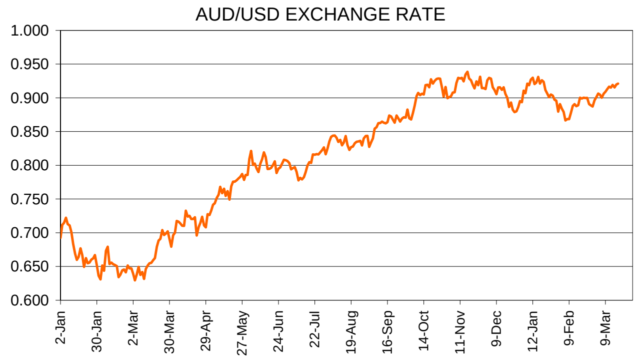
- Upgraded global growth forecasts from the IMF improving risk tolerance.
- An official bail-out deal on the way to being organised for Greece.
- Comments on Tuesday from the Reserve Bank of Australia which were less hawkish than expected. This meant traders scaled back their expectations for when the RBA next hikes its cash rate from April to June and as a result some profit-taking occurred in the NZD/AUD cross rate – selling of AUD and buying of the NZD.
- There was also a mild pullback in the greenback after the Federal Reserve indicated they still intend maintaining exceptionally low interest rates “for an extended period.”
- Monetary policy was eased in Japan via extra short term lending to banks.

Our expectation remains the same as it has been for some time. As global risk tolerance improves and as our interest rates start rising in advance of rate rises in the US, Europe, UK and Japan, the NZD will move upward. We expect a rate above US 75 cents later this year, near 75 Yen, near 0.54 against the Euro, but some eventual easing against a currently very weak British pound.





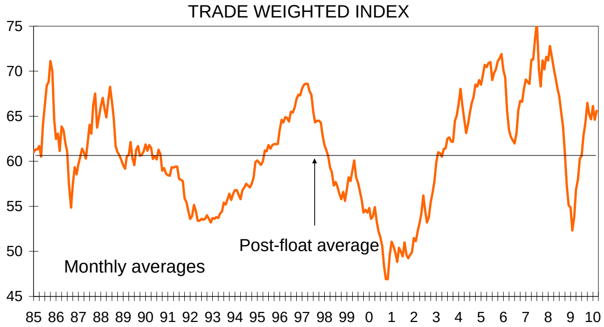


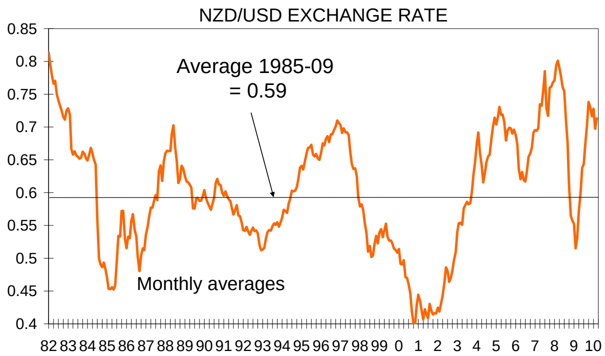


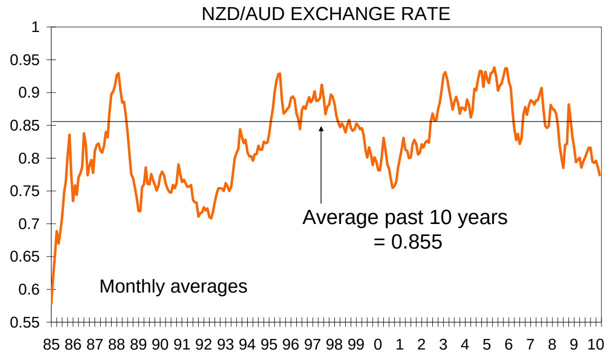
For more in depth currency comment – frankly the sky is the limit as there is no shortage of it on a daily basis. Your best starting point would be the Daily FX Wrap & Strategy at https://research.bnz.co.nz/Research/NewZealand/Pages/Foreignexchange.aspx

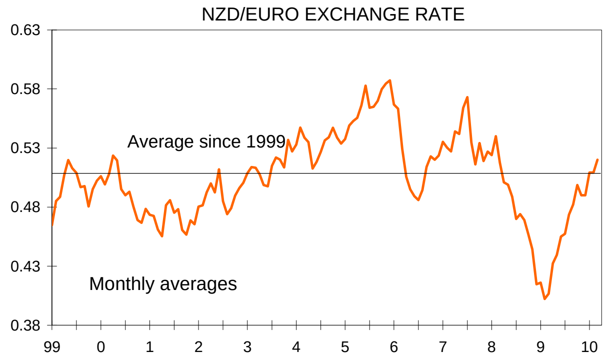
If I Were An FX Receiver What Would I Do?

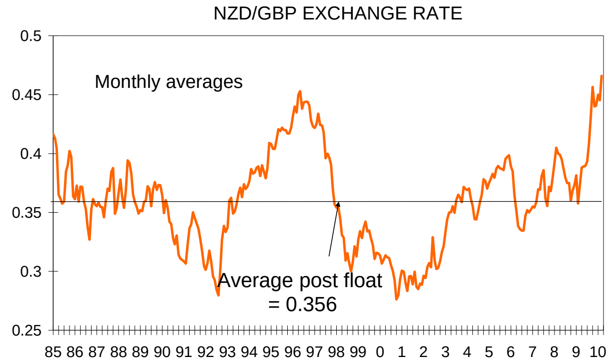
Nothing new. We expect a rising currency so I would boost hedging – especially against the AUD but not at all beyond three months against the pound. Don't forget to look at options and don't base hedging decisions on currency forecasts.

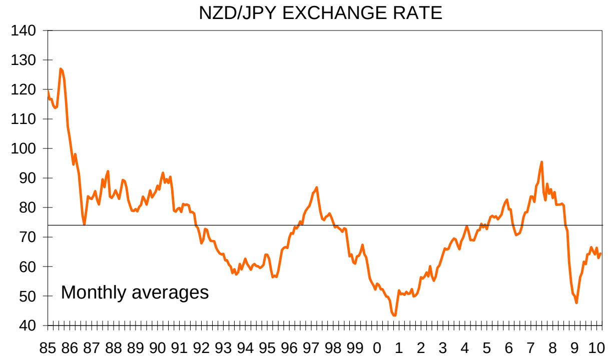












*Sourced from Consensus Economics. http://www.consensuseconomics.com/

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	-0.2%	1.3	2.0	3.4	3.2
GDP growth	Average past 10 years = 3.0%	+0.2	0.2	-2.2	1.5	2.1
Unemployment rate	Average past 10 years = 5.3%	7.3	6.5	......	4.7	3.5
Jobs growth	Average past 10 years = 1.9%	-0.1	-0.8	-2.4	0.9	2.1
Current a/c deficit	Average past 10 years = 5.5% of GDP	5.9	8.1	......	8.3	8.2
Terms of Trade		5.8	-1.6	-8.2	1.8	8.8
Wages Growth	Stats NZ analytical series	0.4	0.8	2.7	5.4	5.0
Retail Sales ex-auto	Average past 9 years = 3.8%.	1.3	0.7	1.3	-0.6	2.8
House Prices	REINZ Stratified Index	2.8	2.5	6.0	-7.9	8.0
Net migration gain	Av. gain past 10 years = 11,700	+22,588	18,560yr	......	4,538	4,804
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	1.0	-1.0	1.0	-0.9	2.3
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	52	57	3	5	2
Business activity exps	10 year average = 26%. NBNZ	41	37	26	-20	2
Household debt	10 year average growth = 11.3%. RBNZ	2.7	2.7	2.4	4.2	12.4
Dwelling sales	10 year average growth = 3.5%. REINZ	-3.8	-1.1	39.3	-17.7	-32.1
Floating Mort. Rate	(Total Money) 10 year average = 7.6%*	5.59	5.59	5.99	7.75	9.99
3 yr fixed hsg rate	10 year average = 7.9%	7.95	7.45	6.99	6.99	9.40

ECONOMIC FORECASTS

Forecasts at Mch 11 2010	**March Years**					**December Years**				
	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
GDP - annual average % change										
Private Consumption	3.2	-1.1	0.4	2.8	2.5	3.9	-0.3	-0.7	2.6	2.7
Government Consumption	4.9	4.2	0.2	2	2	4.4	4.8	1.1	1.4	2.2
Investment	5.5	-7.2	-10.3	4.8	8.7	5.5	-3.6	-12.5	1.5	9.3
GNE	4.6	-1.7	-3.6	5.2	3.6	4.7	0.2	-5.2	4.4	4.1
Exports	3.1	-3.3	2	0.7	5	3.9	-1.3	-0.1	0.3	4.8
Imports	10	-4.7	-12.2	5.1	6.7	8.9	1.9	-16.2	3.7	6.7
GDP	2.9	-1.4	-0.3	3.7	3.1	2.9	-0.1	-1.5	3.1	3.5
Inflation – Consumers Price Index	3.4	3	2.3	2.6	2.6	3.2	3.4	2	2.8	2.3
Employment	-0.2	0.8	-1.3	2.6	3.2	2.3	0.9	-2.4	1.7	3.4
Unemployment Rate %	3.8	5	7.2	6.9	6.1	3.5	4.7	7.3	7.1	6.3
Wages	4.3	5.1	2.7	1.6	3.6	4	5	3.1	1.7	3.1
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.8	0.53	0.7	0.72	0.66	0.77	0.56	0.72	0.73	0.68
USD/JPY	101	98	90	104	108	112	91	90	100	106
EUR/USD	1.55	1.31	1.36	1.34	1.28	1.46	1.34	1.46	1.36	1.29
NZD/AUD	0.87	0.8	0.77	0.81	0.81	0.88	0.83	0.79	0.8	0.82
NZD/GBP	0.4	0.37	0.47	0.41	0.37	0.38	0.37	0.44	0.42	0.38
NZD/EUR	0.52	0.41	0.51	0.53	0.52	0.53	0.41	0.49	0.54	0.52
NZD/YEN	81.1	51.8	63.3	74.4	71.3	86.3	50.9	64.2	73	71.6
TWI	71.6	53.8	64.8	68.2	65.1	71.6	55.1	64.7	68.4	66
Official Cash Rate	8.25	3	2.5	4.25	6	8.25	5	2.5	3.75	5.75
90 Day Bank Bill Rate	8.91	3.24	2.8	4.62	6.2	8.9	5.23	2.78	4.17	6.12
10 year Govt. Bond	6.36	4.77	5.8	6.3	7	6.4	4.88	6.02	6.1	6.8

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.

*extrapolated back in time as Total Money started in 2007