BNZ Weekly Overview

23 June 2011

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.

Farmers Confident But Cautious

Last week I spent three days speaking with farmers at the National Farm Fieldays near Hamilton and these are the main points to come through from those discussions.

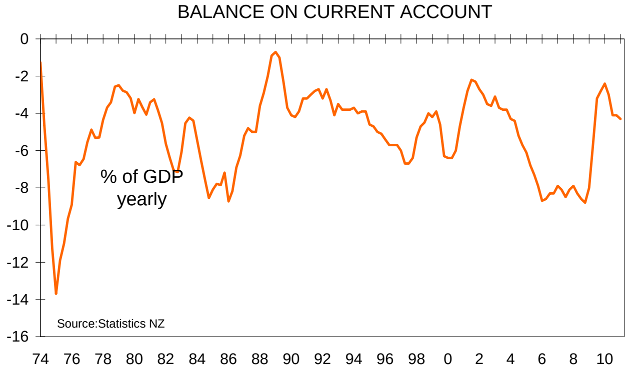
- Farmers are undergoing a period of catch-up maintenance and vital capital expenditure with the sheep and beef sector in particular reacting positively to the best returns in many years.
- The capex is concentrated on easily digestible items which might cost up to $100,000, but spending on new tractors simply for the sake of it as seemed to be happening a few years ago is not (yet) occurring.
- There was little evidence of a willingness to engage in a traditional cyclical household spending surge on the likes of new appliances, kitchens, bathrooms, family cars etc.
- A high number however have plans in place for overseas travel so it is not completely a situation of no treats for the family.
- The determination to pay debt down remains very strong.
- There is nonetheless increasing activity in the rural real estate market and farmers are once again thinking of strategic land purchases. Some spoke of having had their farms on the market for some time but planning to take them off if conditions improve further and they can make a better yield.

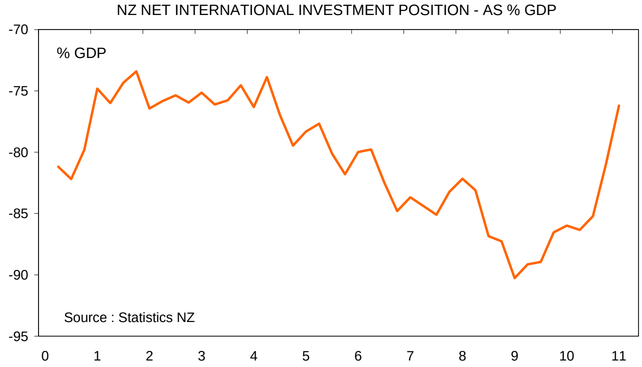
The fact that very recently farmers have seen returns soar then collapse means most are treating the current high level of export prices with caution, even though there is an overwhelming expectation that generally firm prices will continue due to demographic, income, and production developments overseas. For those of us in the city it is reasonable to expect that higher farm incomes will eventually lead to an activity boost. But the lag between farm incomes rising and city spending being affected is likely to be longer than in previous cycles.

Speaking of cycles, we are coming off the low point of one at the moment concerning our deficit with the rest of the world. The current account records income from goods and services purchased by non-residents and payments we make to non-residents for their goods and services – along with interest, dividend, and transfer flows. In the March quarter New Zealand's current account recorded a seasonally adjusted deficit of $1,753mn which was the best in four quarters and took the unadjusted annual deficit to $8.3bn from $8.0bn over calendar 2010 and $4.5bn a year earlier. Why the deterioration when commodity prices have boomed and domestic consumption and investment have been suppressed?

The balance on goods and services in the March year was almost exactly where it was a year ago near +$2.8bn. But the international investment income balance has worsened some $3bn mainly because in 2009 there were special payments by foreign owned banks to settle tax disputes with the IRD.

The annual deficit now sits at an estimated 4.3% of GDP from 2.4% a year ago and 8% two years ago. The average deficit for the past 10 years has been 5.5% of GDP so the latest result is better than average. However this situation will not persist. As global interest rates rise from low levels net interest outflows from New Zealand to service the large net international liability position will rise. In addition the recovering domestic NZ economy will boost imports while export growth will be as usual cyclically stifled by the high exchange rate. Therefore a deterioration in the current account deficit back toward 5% - 6% of GDP and maybe more is expected over 2012.





With regard to the country's net investment position with the rest of the world the earthquake has had a big impact. About $11bn of reinsurance has accrued to New Zealand as a result of the earthquakes up to the end of March and these flows count as credits. Therefore the nominal net international investment position has improved from $161bn in the March quarter of 2010 to $148bn at the end of March this year. This equates to a fall in the ratio of the debt to GDP from 86% to 76%. Perversely the earthquakes, while damaging infrastructure, businesses, the housing stock, employment, and peoples' lives have taken the net indebtedness of the country back to 2004 levels.

This week the following material has been added to www.tonyalexander.co.nz

What Businesses Want http://tonyalexander.co.nz/occasional-papers/

Our analysis of responses to our monthly survey question regarding what people would like the government to do reveal very strong support for welfare reform and reduced government spending. But there is also firm interest in increased training, tax changes aimed at boosting savings and investment but leaving KiwiSaver in a steady state, and keeping the exchange rate low.

On The Road 5 http://tonyalexander.co.nz/occasional-papers/

This final paper in this series contains comments from three days spent in Shanghai.

Real Estate Overview http://tonyalexander.co.nz/bnz-reinz-survey/

We have published our monthly overview of the NZ real estate market. After considering factors which influence where things are heading we conclude that a cyclical recovery in the market has started. Auckland is leading at this stage with not only some catch-up after under-performance during the previous cycle, but a greater shortage of housing than in most other parts of the country.

Weekly Newspaper Column http://tonyalexander.co.nz/newspaper-column/

We look at what farmers were indicating at this year's Fieldays. .

Other Website Material

- **Situation and Outlook for the NZ Economy** – eight pages of snippets and outlooks for specific variables and sectors. Updated early each month. http://tonyalexander.co.nz/nz-outlook/
- **Weekly syndicated newspaper column** http://tonyalexander.co.nz/newspaper-column/
- **State of the NZ Labour Market** Updated mid-month. http://tonyalexander.co.nz/nz-labour-market/
- **BNZ-REINZ Market Survey** Released second week of each month. http://tonyalexander.co.nz/bnz-reinz-survey/
- **Real Estate Overview** Updated mid-late each month. http://tonyalexander.co.nz/bnz-reinz-survey/
- **Archived Weekly Overviews** www.bnz.co.nz/tonyalexander

Is Our Economy Getting Better or Worse?

In this section we look only at what the data are actually telling us and pay no attention to forecasts or intentions measures.

This week we found out that manufacturing output rose by a good 1.9% in the March quarter which when combined with last week's news on retailing volumes all up rising 0.9% bodes well for a GDP growth rate of about 0.4% having been achieved in the quarter following 0.2% growth during the December quarter. But the tourism sector is going backwards with a small fall in visitor numbers in May and 5.5% decline all up in the past three months. In contrast 1.5% more Kiwis have travelled offshore in the past three months so some extra spending is being dragged out of the economy.

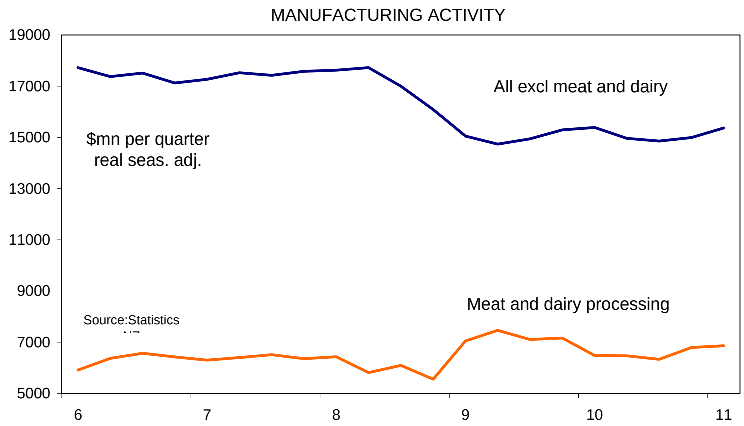
Are householders opening their wallets more?

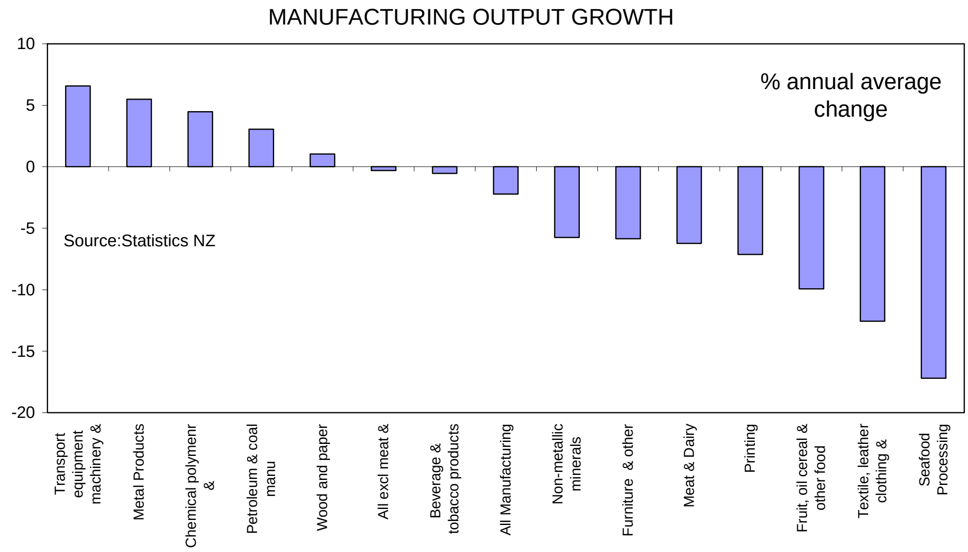
Again we note that with regard to travelling overseas the answer is yes. In the three months to May the number of Kiwis taking short trips out of the country was up by 1.5% from the three months to February and the gain in May alone was 1.7%. This might not even mean more business for travel agents given that booking online is so astoundingly simple these days. Speaking of buying online, once you've been overseas and seen the prices people pay for books compared with what we pay here in NZ you can understand why Kiwis are flocking to not just Amazon but the increasingly mentioned www.bookdepository.co.uk

Is business output rising?

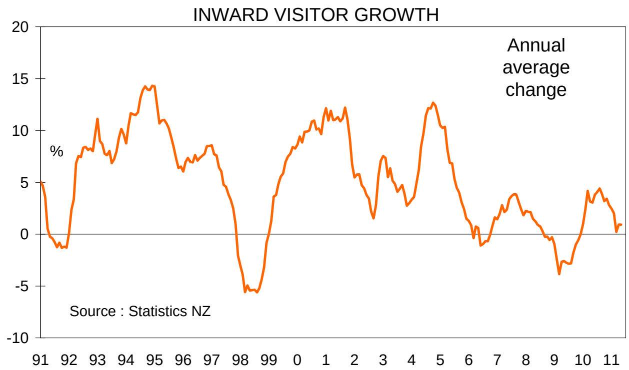
This week we learnt that output of the manufacturing sector increased in real seasonally adjusted terms by 1.9% in the March quarter which is a healthy result following the 3.7% rise over the December quarter. Activity was however only 1.9% up from a year earlier and 7.4% below mid-2006 levels so the strength over the past two quarters is an aberration around what appears to be a long term trend. The annual average change was a fall of 2.2% with transport manufacturing rising 6.6% and seafood processing down 17.2%.

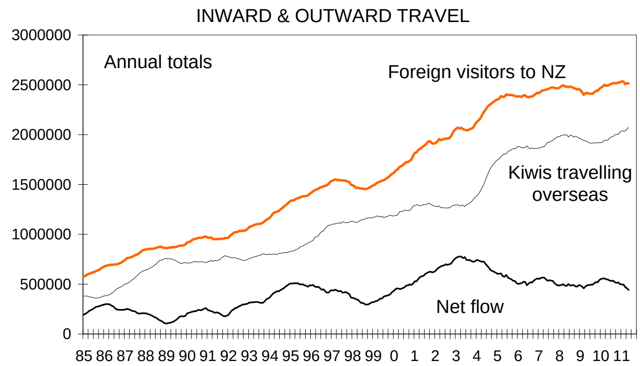
But when it comes to writing about manufacturing in NZ one really wants to strip out the dairy and meat processing sectors which account for some 30% of all manufacturing activity. Doing this we find that underlying manufacturing gained 2.5% in the quarter, but was down 0.1% from a year ago and 13.3% below the early 2006 peak. In other words, manufacturing activity as people overseas tend to understand it is on a strong downward trend in New Zealand and one would be exceptionally brave to conclude that the latest quarter's 2.5% gain is a sign of a secular upturn.





We also found out this week that the number of people visiting NZ was down 0.4% from a year ago in May, and down 3.2% in the three months to May from a year ago. In seasonally adjusted terms visitor numbers have fallen 5.5% over the past three months with the Christchurch earthquakes probably explaining the 8% fall in the March month. The number of people coming our way is falling and with the snow late in arriving the early-Winter flow looks like being below average while the fact that Christchurch has largely been taken out of the picture tourism-wise for the next few months will also clearly dent inflows.





The tourism sector is in recession and going deeper.

Are businesses hiring more people?

To view our latest monthly NZ Labour Market report click here. http://tonyalexander.co.nz/nz-labour-market/

Are businesses boosting their capital spending?
To see how businesses are feeling right now one can read our monthly BNZ Confidence Survey here. http://tonyalexander.co.nz/bnz-confidence-survey/

Nothing new this week.

INTEREST RATES

Growth vs. Economic Slack

In a nutshell this is what drives inflation along with institutional arrangements, imported inflation, and exchange rate changes. If you want to forecast monetary policy you need to monitor these things. So we will, adding stuff here when we learn it. The current common view is rate tightening from December. Have we learnt anything this week which alters this outlook?

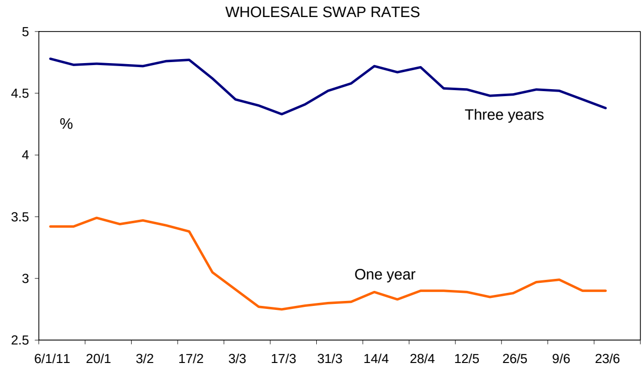
This week we learnt of growth in the manufacturing sector but worsening tourism and rising outflows of Kiwis for overseas holidays, so on balance the aggregate demand picture does not look much different.

Other Inflation Influencers

Nothing worth mentioning.

Rate Movements This Week

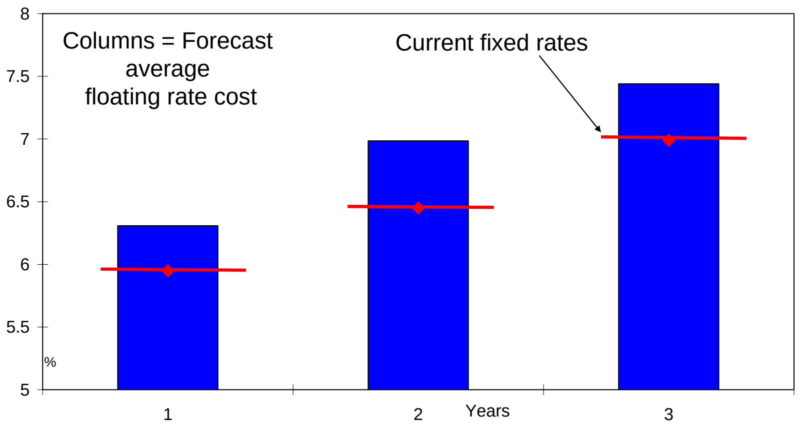
Some swap rates have crept down very slightly this week in response to a general mixture of worries about Greece, reduced monetary policy tightening expectations in Australia and to a lesser extent the UK, and weak monthly data on migration flows and tourism. But realistically speaking there has been no sizeable change in NZ wholesale interest rates since the first half of March.

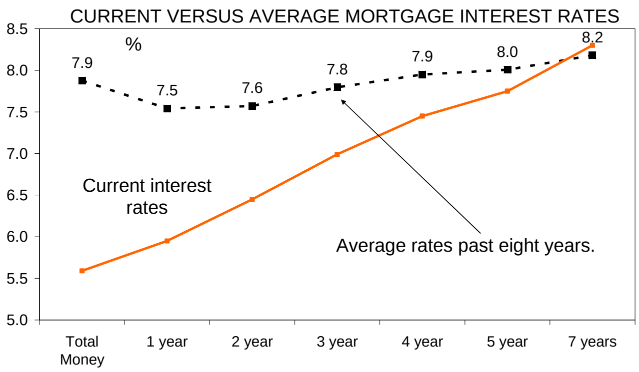


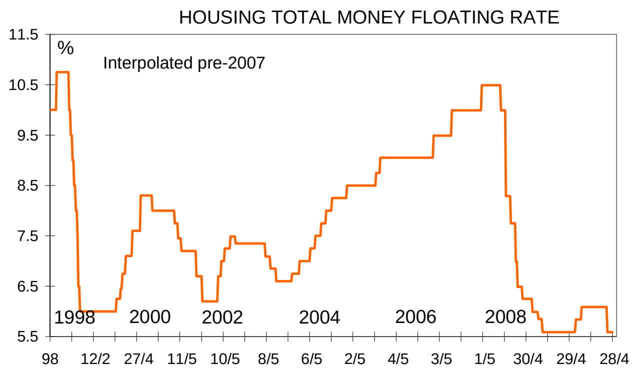
FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.75	5.9
90-day bank bill	2.70%	2.68	2.71	2.69	3.10	6.2
1 year swap	2.90%	2.90	2.88	2.78	3.80	6.3
5 year swap	4.38%	4.45	4.49	4.41	5.09	6.6
180-day term depo	4.30%	4.30	4.60	4.10	4.80	6.0
Five year term depo	6.00%	6.00	6.00	6.50	6.75	6.5

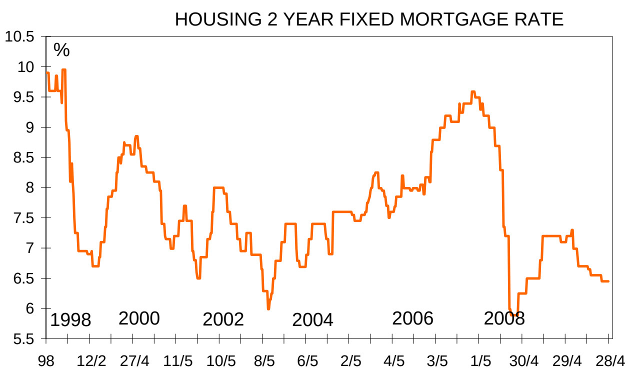
If I Were a Borrower What Would I Do?

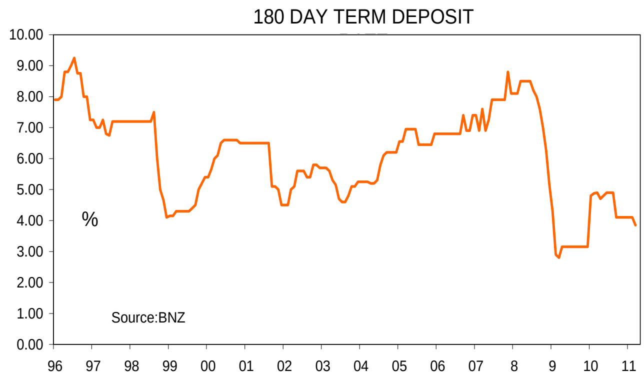
Nothing has changed this week with regard to our view on likely interest rates. The name of the game is staying floating as long as one can in order to get a lovely low rate, paying down principal, but before the end of the year flicking maybe up to half the rate into fixed to get some insulation against the policy tightening cycle over 2012-13. The risk is that at this point ahead of the tightening we underestimate how high rates eventually go and how long they stay high, hence the strategy of floating all the way through could be dangerous – with you being in danger of hitting the panic button when forecasts for the official cash rate hit the top extreme at some point well down the track.











If I Were a Term Deposit Investor What Would I Do?

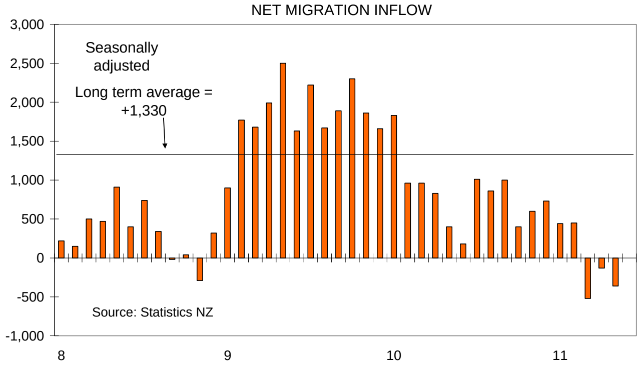
I am still investing short planning to one day ride the short rates up as the RB tightens then face the challenge when they are near their peaks of either switching long or hopping out of the NZ dollar completely before it turns cyclically downward.

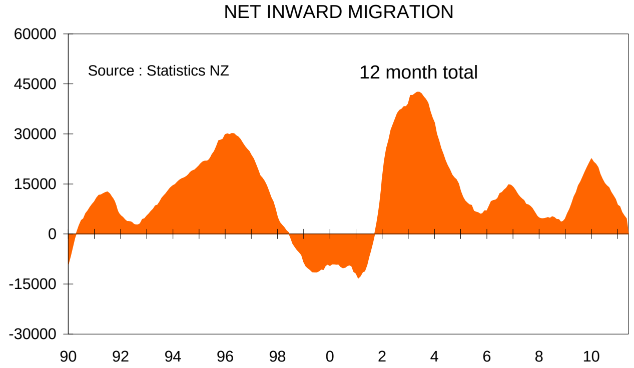
HOUSING MARKET UPDATE

To view the most recent results of our monthly BNZ-REINZ Market Survey and read our monthly Real Estate Overview click here. http://tonyalexander.co.nz/bnz-reinz-survey/

Migration Becoming A Drag

During May the NZ population was reduced as a result of migration flows by a relatively high 2,143 people. This was 883 more than the net loss in May 2010 and well away from the usual net loss for May (the month is usually negative) of 689. In fact in seasonally adjusted terms the flow for the month was a loss according to Statistics NZ of 360 which is worse than 130 in April and not too far away from March's net 520 loss which was boosted by outflows from Christchurch. The annual net migration flow now stands at +4,625 from a peak of 22,588 in January 2010 and an average gain for the past ten years of 16,000 people.





The numbers basically show reducing upward pressure on the housing market from population growth and it looks likely that with the earthquakes in Christchurch continuing the annual net migration flow will turn slightly negative. But we don't think the deterioration is or will be remotely great enough to offset the fundamental shortage of houses when compared with the population.

In fact that shortage is now close to 45,000 dwellings by our calculations given that the bandied about figure for outright destruction of houses in Christchurch has now lifted to 12,000 from the earlier 10,000.

For your guide this week we published our monthly summary of the state of the residential real estate sector in New Zealand at http://tonyalexander.co.nz/bnz-reinz-survey/

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.

MAJOR OFFSHORE ISSUES

European Debt

The first piece of big news with regard to the continuing Greek debt saga this week was the back down by German Chancellor Angela Merkle from her demand that any further aid to Greece be conditional on private sector bond holders taking some of the losses. This sounds logical on the face of it but the problem as we have long pointed out here is that so much of the government debt is held by banks in France and Germany in particular that the losses they suffer would threaten their capital bases and confidence of investors in their sustainability. That would have the capacity then to create a repeat of the September 2008 Lehmans bank collapse where worries about collapses led to the global credit markets seizing up and the likes of banks in NZ not being able to refinance maturing foreign debt for a period of six or so weeks.

Therefore the back down by Ms Merkle is important and has generated relief rallies in the likes of sharemarkets and risky currencies like the Kiwi and Aussie dollars. However there is increasing concern that the deepening Greek crisis and increasing market expectations of eventual default will dominate Europe's immediate economic prospects and forestall the good recoveries which have been occurring in the likes of Germany and France.

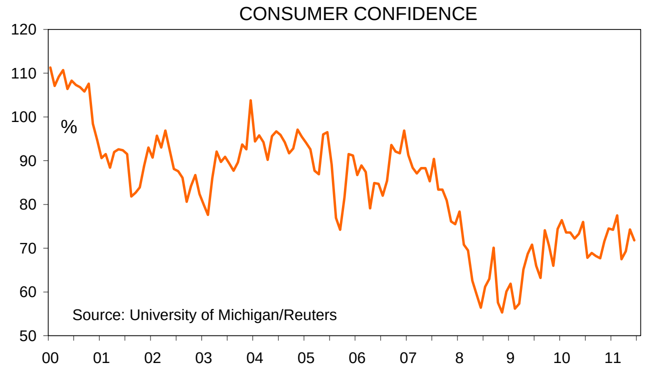
Moody's announced during the week that it has placed Italy's AA2 credit rating on negative watch because of concerns about economic growth prospects and debt levels.

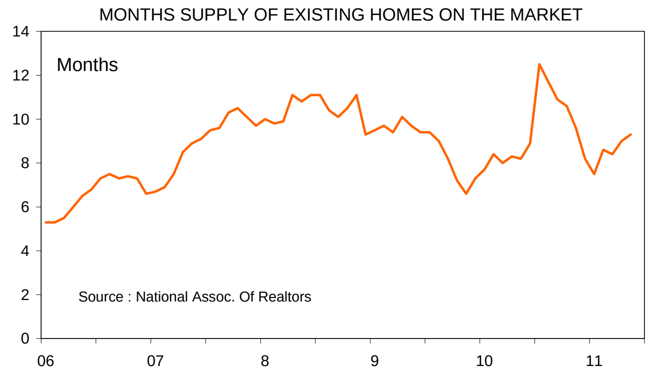
Chinese Inflation

With time lost this week to Fieldays (Friday) and an economics conference (today) this section is empty.

US Growth Momentum

This week in the US we learnt that yet another measure of consumer sentiment has deteriorated more than expected. The monthly University of Michigan Index fell to 71.8 in June form 74.3 in May. The reading suggests continuing weakness in retail spending and as we noted last week over the past couple of months retail spending has been relatively flat in the United States.





And we saw yet again the release of some disappointing housing market measures, this week in the form of existing home sales falling 3.8% in May to lie 15.3% down from a year ago at an annualised sales rate of just 4.81mn. This is the lowest such rate in six months and was accompanied by a rise in the months worth of supply on the market to 9.3 from 9 months n April and 8.2 months a year ago.

For your guide, the latest Consensus Economics survey shows that the average forecaster in the United States expects the US economy to grow 2.5% this year and 3.1% over 2012.

Australian Growth

One of the market processes underway currently in Australia is a pullback in expectations of another monetary policy tightening this year following recent weak data on the labour market and some partial economic indicators. The RBA validated this process this week when the minutes of their monthly board meeting held earlier this month indicated they feel it is “prudent” to wait for more information on developments in Europe’s debt crisis and the domestic Australian economy. As a result the markets have almost entirely priced out another rate rise this year though we still leave open the possibility later this year as does the RBA. The last rate rise was in November last year, taking the cash rate to 4.75%.

The consensus view is that the Australian economy will grow by 2% this year then 4% next year with this year’s low growth attributable to the Queensland floods near the start of the year which caused GDP to fall by 1.2% during the March quarter.

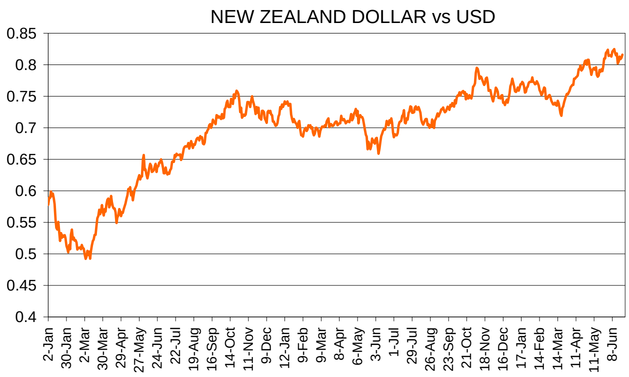
Exchange Rates

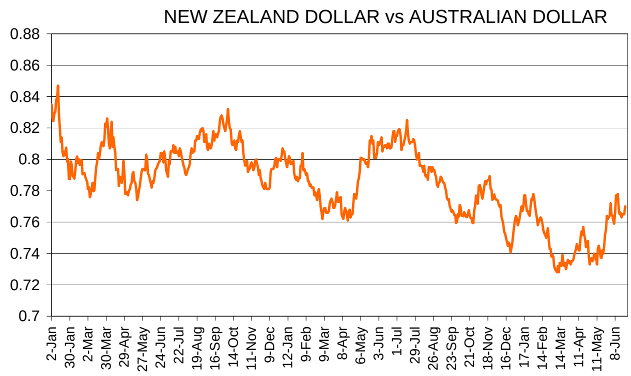
Exchange Rates	This Week	Week Ago	4 wks ago	mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.816	0.802	0.793	0.741	0.704	0.689	0.629
NZD/AUD	0.774	0.766	0.745	0.733	0.808	0.773	0.855
NZD/JPY	65.800	65.000	64.900	60.000	63.7	67.7	68.4
NZD/GBP	0.509	0.495	0.489	0.452	0.475	0.448	0.368
NZD/EUR	0.509	0.566	0.562	0.522	0.574	0.52	0.511
NZDCNY	5.274	5.199	5.153	4.858	4.796		4.83
USD/JPY	80.637	81.047	81.841	80.972	90.483	98.3	109.9
USD/GBP	1.603	1.620	1.622	1.639	1.482	1.54	1.705
USD/EUR	1.603	1.417	1.411	1.420	1.226	1.33	1.229
AUD/USD	1.05	1.05	1.06	1.01	0.87	0.891	0.737

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

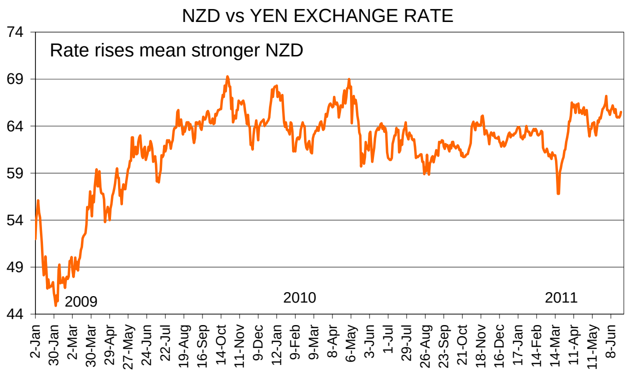
Kiwi Recovers

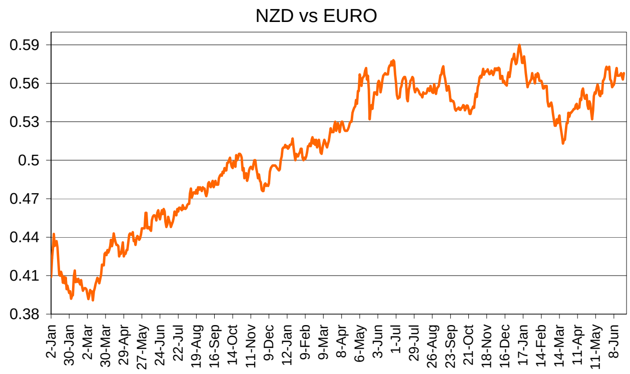
The Kiwi dollar has moved back up this week supported largely by an improved global risk appetite following the Greek PM winning his government's confidence vote and the increased chance that the Greek debt situation will not degenerate into default in the near future. The vote also produced some movement up in the euro against the dollar but the pound was sold off following some more dovish than expected comments form the Bank of England.





The first graph above shows an upward trend in the Kiwi dollar against the greenback since exactly a year ago and provided one buys into a view that commodity prices will not be falling sharply in the near future or the European debt situation reach a collapse point then it seems reasonable to expect that the NZD will keep moving upward.

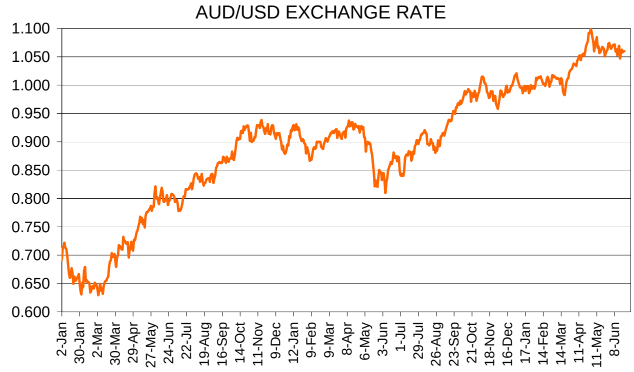


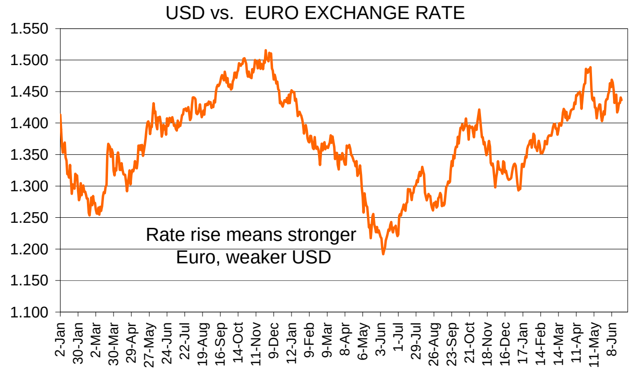


What exporters need to look for are periods of pullbacks, such as we saw last week, for getting some extra cover on board. In particular, it pays to keep in mind that once the Reserve Bank starts tightening monetary policy from most probably December this year the Kiwi dollar will likely receive a potentially large level of support from the carry trade getting back into full swing. That will mean upward movement for our currency against not just the greenback which has been on a downward trend on average against other currencies since 2002, but against the Japanese Yen as well.

Movement against the Euro over the coming couple of years is less clear given that the European Central Bank have already shown themselves willing to raise interest rates even in the midst of debt worries and poor economic performance for some euro-zone members.

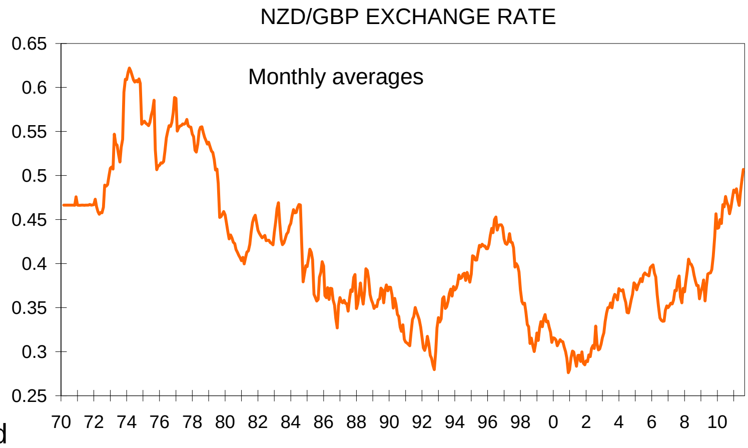
The chances of the NZD having a decent kick back down against the AUD have lessened this week following the RBA's board minutes showing they feel it is prudent to wait to see how things develop domestically and offshore before contemplating another cash rate rise. What this means is that when their next increase comes along it will be much closer in time to the rate rise cycle starting in New Zealand therefore the movement of the interest rate differential against the NZD will be all that much less. Over the week the Aussie dollar has still managed to rise against the USD as Greek worries have eased slightly – for now.



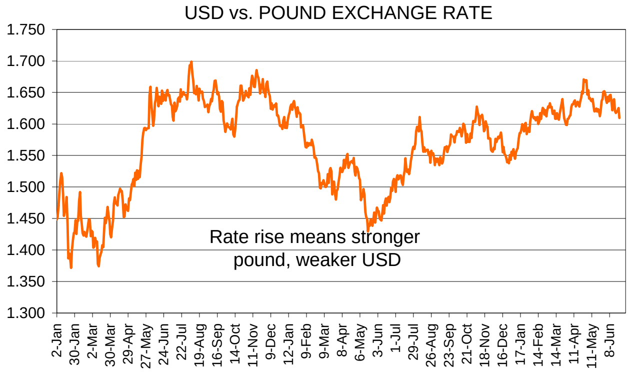


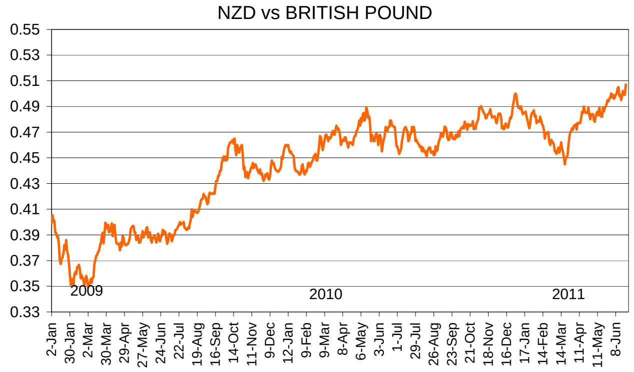
United Kingdom

One of the numerous monthly house price measures released in the UK improved a tad in June. The Rightmove index which measures vendor asking prices as opposed to actual sales prices improved by 0.6% after rising 1.3% in May and 1.7% in April. I'd plot a graph here but back issues are still not available on their website to allow the time series to be filled in. The data suggest at a minimum some stabilising in the UK housing market. However the feedback received whilst over there a month ago is that conditions are still very tough and many people are put off migrating because of concern about their ability to sell their house and the price they might get for it.



This week the main event of interest for the pound was the release of BOE board minutes which showed a 7-2 vote against raising rates at the moment, and some policymakers suggesting that additional bond purchases might be necessary in light of the still struggling UK economy. Hence the pound has fallen against the greenback over the week though to a level still well within trading ranges. This is not however the case with the NZD where the combination of the newly falling pound and risk-driven recovery in the NZD has pushed the NZD/GBP cross rate to near 50.7 pence. This is the highest level for the NZD versus the pound since 1979. Our view is that the rate is headed toward 55 pence. Maybe by the time we get there the recovery in the NZ housing market and very strong NZD will coincide with a more solid recovery in the UK economy and a few of us Kiwis may migrate the other way. But could those of us with families easily change from wide open spaces to much smaller accommodation and by all accounts a worse school system unless one pays up for a top school?





The consensus view is that the UK economy will grow just 1.6% this year then 2.1% over 2012 whereas for the European Union the expectations are 1.9% and 1.8% respectively. The differences are clearly fairly small.

Exchange Rate Assumptions

The following table contains year end assumptions for exchange rates in 2011 and 2012. It also contains a column beside each rate for each year indicating where the risk lies – that the outcome will be higher than shown or lower.

	2010	2011	Risk	2012	Risk
Year end					
NZD/USD	0.73	0.75	Higher++	0.79	
NZD/AUD	0.74	0.77	Lower	0.86	
NZD/YEN	64.2	66		67.9	Lower
NZD/GBP	0.44	0.45	Higher	0.46	Lower
NZD/EUR	0.51	0.51	Higher	0.57	Lower
USD/JPY	88	88.0	Lower	85.9	Lower
GBP/USD	1.66	1.67		1.72	Higher
EUR/USD	1.43	1.47		1.39	Higher
AUD/USD	0.99	0.97	Higher++	0.92	Higher+

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.8%	2.3	4.5	2.0	3.0
GDP growth	Average past 10 years = 2.6%	0.2	-0.2	+1.5	-2.1	-0.2
Unemployment rate	Average past 10 years = 4.8%	6.6	6.7	......	6.1	5.2
Jobs growth	Average past 10 years = 1.9%	1.4	-0/4	1.8	-0.1	0.6
Current a/c deficit	Average past 10 years = 5.5% of GDP	2.3	2.2	......	2.8	8.8
Terms of Trade		0.9	0.8	6.8	0.1	-5.0
Wages Growth	Stats NZ analytical series	0.6	1.0	3.6	2.5	5.2
Retail Sales ex-auto	Average past 9 years = 3.9%.	0.7	0.0	1.4	1.0	-3.6
House Prices	REINZ Stratified Index	-0.7	-0.5	-0.7	5.5	-7.2
Net migration gain	Av. gain past 10 years = 13,900	+4,625	8,249yr	......	17,967	11,202
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	0.9	2.0	0.9	3.1	-2.6
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Business confidence	BNZ survey	57	42	18	26	18
Consumer confidence	ANZ-Roy Morgan 100=neutral	113	103	112	122	103
Household debt	10 year average growth = 10.3%. RBNZ	1.2	1.5	2.3	2.9	2.8
Dwelling sales	10 year average growth = 2.5%. REINZ	10.8	-4.2	-15.2	-17.2	43.9
Floating Mort. Rate	(TotalMoney) 10 year average = 7.9%*	5.59	6.09	6.09	5.59	6.49
3 yr fixed hsg rate	10 year average = 7.8%	6.99	7.15	7.15	7.95	5.99

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 tony.alexander@bnz.co.nz www.tonyalexander.co.nz

Key Forecasts

Dec. year		2010	2011	2012	2013
GDP	annual average chg	1.4	1.0 – 1.5	3.5 - 4.0	4.0 - 4.5
CPI	on year ago	4.0	3.0 – 3.5	2.5 – 3.0	2.5 – 3.0
Official Cash rate	end year	3.0	2.5 - 2.75	4.0 – 5.0	4.0 - 5.0
Employment	on year ago	1.3	2.0 – 2.5	2.0 – 2.5	2.0 - 2.5
Unemployment Rate	end year	6.8	6.0 - 6.5	5.0 - 5.5	<5.0

*extrapolated back in time as TotalMoney started in 2007