BNZ Weekly Overview

29 September 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.

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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 please click here.
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No Decoupling – We're All In This Together

It would be great to say that after a week in the sand and warmth of the Gold Coast one returns to work in a relaxed mood with good prospects for our economy as we head into the end of the year and enjoy the rugby and rugby league games. But things have deteriorated internationally, our economy is going to be affected next year by the worsening global outlook and already slightly falling commodity prices, and it would be wise to consider the downside risks when contemplating business and borrowing plans for the next three years. In fact there has been no shortage recently of people and organisations warning about such risks.

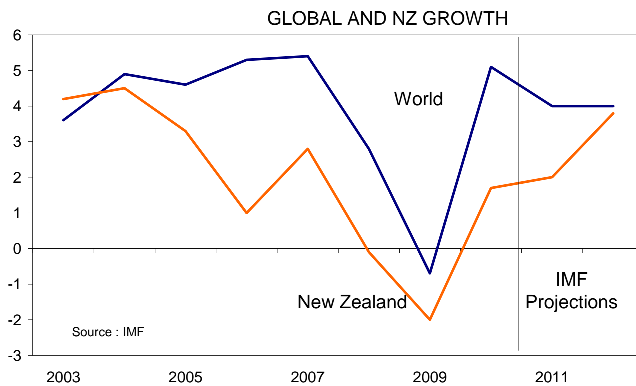
- The US Federal Reserve has noted that there are "considerable downside risks to growth."
- The IMF says that "The global economy is in a dangerous new phase."
- The British PM has said "Growth in Europe has stalled. Growth in America has stalled." "The problems in the Euro-zone are now so big that they have begun to threaten the stability of the world economy."
- The World Bank President has said "The world is in a danger zone."
- Management at both BHP-Billiton and Rio Tinto have both recently warned of slowing demand for commodities.
- The US Treasury Secretary has warned that failure to tackle Greece decisively risks "…cascading default, bank runs and catastrophic risk."

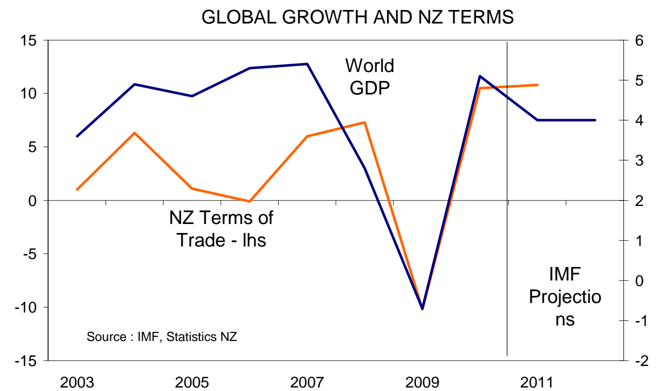
The markets have begun building in these higher risks with weakness in asset prices. Oil prices have fallen to seven month lows, share prices have fallen sharply with the likes of the ASX200 now down near 18% from mid-April levels, the FT100 and Dow Jones Industrials Indices down 13% from early-July levels.

This week the Overview is devoted to explaining in as simple language as possible what is happening offshore. Why? Because what happens offshore is highly relevant to us.

- About 30% of what gets spent in New Zealand comes from overseas. If people don't want our stuff our economy will suffer. Australia's proportion is 20%, US 11%, Japan 13%, China 29%.
- Just under 40% of all NZ bank lending is financed from offshore. If investors grow weary of banks interest rates will rise and credit become less available.
- Our gross migration flows are the largest percentage wise of any OECD country. If people are faced with falling house prices offshore fewer will shift here, but then fewer of us will leave.

- Our capital markets are shallow and we need offshore foreign direct investment.
- If global capital markets seize up as investors seek low risk assets, our companies will also be starved for new funds.
- Over 25% of us were born offshore, we travel extensively, and our awareness of global issues would put most Americans at least to shame. If we see worrying things happening offshore it will affect our confidence and our willingness to invest, spend, and hire people.





Therefore, if the world is heading into either another recession such as the 0.7% shrinkage of 2009, or simply growth below the average 4% around something like 2%, we will feel the effects here and our growth outcomes for 2012 and 2013 won't be in the order of 3% - 4% but closer to the average annualised quarterly growth rate since mid-2009 of 1.6%.

Our sharemarket will be weak, our monetary policy unchanged through into 2013, our currency will fall, retail spending will be moribund even if recent hefty discounting continues, farmers will not spend their current largess but will continue to pay down debt as will the household and business sectors, the government will struggle to meet its projection of a surplus come 2014/15 and will think about spending cuts and tax increases, our house prices will stay flat, and our productivity record will worsen through lack of investment.

So, what is likely to happen? That of course is the question no-one has an answer to but is why we have since January devoted a special section in the Weekly Overview to our biggest trading partner Australia, the extent to which China is being successful in lowering inflation without crunching growth, developments in the US economy, and progress in the Euro-zone's waltz toward debt restructuring.

All we can hope to do here is give a clearer understanding of what the issues are offshore, and why the optimal approach remains one of high conservatism with one eye toward planning to benefit from NZ-specific factors, and another to building reserves and strengths for the possibility of a severe dip in world growth and financial markets.

We start with what is wrong in Europe and point out that the inevitable Greek debt default is not the issue, it is whether investors believe other indebted countries like Spain, Portugal, Ireland and Italy go the same way. So far the politicians have proved themselves unable to garner investor confidence and with

- German voters dead set against sharing debt obligations,
- fiscal policies tightening,
- a string of failed minimalist bailouts,
- banks at risk,
- Euro-zone growth now stalled,
- Politicians unable to speed up decision-making, and
- the Euro's future increasingly questioned

more market turmoil beckons.

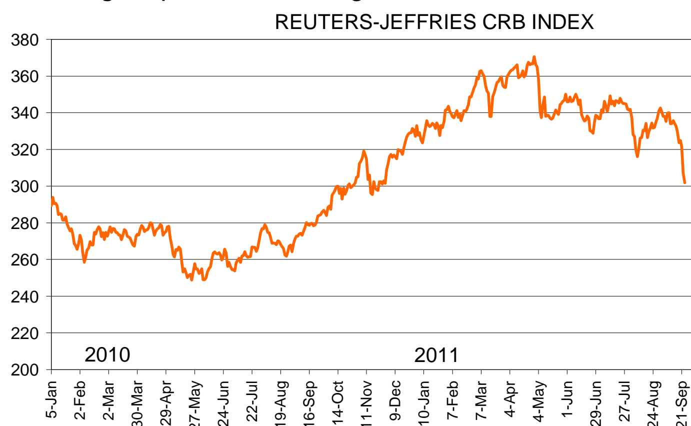
Next we look at the US where the problems are

- consumers not wanting to spend for fear of job loss and reduced housing wealth,
- businesses not wanting to hire and invest for fear of weak household spending,
- an impotent Federal Reserve which has used up all its useful ammunition,
- a Federal deficit and debt blow-out,
- inability of the politicians to reasonably debate the issues and agree on a cohesive course of action, and
- a President increasingly viewed as ineffective.

Then we look at the country of most significance to us, Australia, and note that some sectors like housing, retailing, tourism and manufacturing are effectively in recession, and that although near AU$500bn of mining and infrastructure projects are on the way, there is encroaching weakness as China slows and export prices fall. The Aussie debate has rapidly shifted from continuing references to a “two-speed” economy to how much China and commodity prices will weaken.

Which brings us to the fourth area we shall look at – China. Both ourselves and Australia as commodity-driven countries have always had a tendency toward a cargo-cult mentality. That is one where a person sits waiting for a big airplane to drop goodness from the skies. In this context we and our Aussie cousins sit smugly assuring ourselves that she’ll be right because the Chinese will keep buying everything we produce.

But China’s growth rate is slowing and may have to slow further in order to contain socially divisive inflation, and scope for a repeat of the stimulatory fiscal and lending policies of 2009 – 10 is very limited this time around. Already commodity markets are easing as realisation of this Chinese risk kicks through with the much watched Reuters/Jeffries CRB Index of commodity prices down 11% from where it was three weeks ago. Copper, platinum, silver and even gold prices are falling.



After canvassing these negative offshore developments we look at the ways in which we get affected by these things in New Zealand. The main transmission routes are confidence, export incomes, and bank funding. Then we look at some specific factors which will generate a bit of insulation for our economy and which explain why recession for NZ next year is highly unlikely. After that we produce a simple list of the implications of the environment we have discussed with a continuing huge emphasis on the massive uncertainties involved. The situation warrants high caution with emphasis needed on debt reduction, floating rate funding, low inventories, flexible hiring contracts, and allowance for extreme exchange rate changes.

The Mess In Europe

Euro Possibly Unsustainable

Some countries in the Euro-zone should not be there. They have no hope of matching German incomes and productivity growth because their work cultures are poor. But they were encouraged to join the Euro and willingly did so with the benefit of low interest rates and partners willing to turn a blind eye to fiscal infractions and deteriorating economic structures. German voters and others in the Northern European area accepted entry of the traditionally inefficient Southern countries as they were promised that the currency union was not

and never would be a liabilities union. That is, they would never be called upon to share the debts of their layabout cousins.

Now, with years of ignoring the rules, running large deficits and becoming less and less competitive with the likes of Germany, recalcitrant economies – the PIIGS of Portugal, Ireland, Italy, Greece and Spain – have had their economies shattered and debt burdens magnified by events surrounding the collapse of Lehman Brothers investment bank in September 2008 and the resulting sharp decline in economic activity. Their debt blowouts have naturally scared investors who have come to realise that the absence of unique depreciable currencies combined with rigid labour and product markets means these increasingly indebted countries do not have adjustment mechanisms available to more independent countries such as the UK or NZ many years ago. Note that Ireland does not necessarily fit into the PIIGS group in terms of economic inefficiencies and the economy has already returned to growth with booming exports following quick cuts in labour costs.

Growing worries that Greece may default have led to worries that if they do other countries may follow. These worries in turn have spurred concern about which European banks holding previously highly regarded European government bonds would go bankrupt. To try and stem these worries and buy time for the troubled economies to get deficits down, debt falling, and their economies restructured northern taxpayers in the Euro-zone have had to transfer funds to their southern neighbours with EU/IMF bailouts (debt purchase assistance packages) so far for Greece, Ireland and Portugal. But the slow speed of reform in troubled economies has renewed investor concern that they may default and two months ago these concerns and market sell offs prompted agreement on a second bailout package for Greece with expansion of the overall sovereign support fund from €250bn to €440bn. The hope is that by stopping Greece defaulting worries about other economies will settle down and the precious time needed for Greek to restructure will be bought. Those hopes however have been dashed.

The reform processes in Greece and Italy in particular have been begrudging and slow, economic data have weakened so budget deficit projections have worsened, and individual governments are proving hesitant to sign up to the new support package. Finland and Austria are demanding collateral. Slovenia have said they won't even consider legislation allowing the bailout until all other Euro-zone members have already agreed. Their view naturally is that having worked hard to meet criteria for joining the zone they are reluctant to channel funds to those who flipped the bird at the same rules.

These new concerns have prompted renewed investor caution and backing away from bonds. Rising yields and therefore rising risks of new budget deficit deterioration a few weeks ago prompted the ECB to renew buying bonds issued by the Italian and Spanish governments. But they have failed and yields are now above where they were before the new buying started – buying which exposes member countries of the ECB to increasing losses as yields rise and probable Greek default approaches. Greece now devotes one quarter of tax revenue simply to making interest payments on its debt.

Rising yields means rising risks of Greek default and rising risks of another country going the same way and this spirals into further unwillingness of investors to fund continuing deficits and renew bonds when they mature. Rising default worries have led to rising concern about banks failing because of their debt holdings and that has prompted rising fears of a new credit crunch manifesting itself as funding costs for banks in Europe are once again on the rise and few banks are able to borrow foe periods longer than 12 months.

Throwing in concern about the negative blowback to European growth and debt servicing ability of possible renewed recession in the United States we unsurprisingly now are seeing selling not just of bad country bonds issued by Greece, Portugal, Italy etc., but risky assets in general such as shares and far flung currencies like the NZD. Investors have also been cutting speculative commodity positions so prices in those markets have also been falling.

As these things have been happening investors have continued looking toward the politicians and policy-makers to see if they are coming up with any grand believable plans to stop the rot. But few official plans have been forthcoming and belief in the effectiveness of European politicians and institutions is quickly eroding. This is especially so as they have shown themselves only willing to act when pushed by the markets, unable to get ahead of market concerns, and this time around appearing in complete disarray. If agreement cannot be

reached to stem the collapse of Greece, what possible hope is therefore stopping rot in the likes of Spain and Italy – hence the worrying comments from very senior people noted at the start of this week's Overview.

And to make matters worse, there is now growing awareness that without the likes of German taxpayers being prepared to pay taxes to help other countries but without any representation with regard to how the money is spent (remember the Boston tea party), the entire Euro framework may not be sustainable. Former British Chancellor of the Exchequer put it in the following terms with regard to the Germans 'Cough up or break up."

With worries about Greek default growing by the day, and concern about Spain and Italy increasing, the next cab off the rank with regard to investor withdrawal may well be wholesale withdrawal by retail depositors of their funds in Greek, Italian and Spanish banks for depositing (in the same currency) in German banks. Already 12% of Greek deposits have shifted out this year.

In fact the IMF have said they do not have enough funds to draw on to stop the crisis if it keeps spreading, and have estimated that Europe's banks need a capital infusion of €200bn straight away. Barclays Capital estimate €230bn. There is discussion of giving the European Financial Stability Fund the ability to borrow as much as €2tn to fund purchases of Euro-zone government bonds but this would require the ECB lending it the money and it is against doing that. Plus, as noted above, expansion of the EFSF has not yet been agreed upon by all 17 member countries.

With all these problems swirling around each other and escalating it is highly unlikely that the IMF cut their Euro-zone growth forecasts by enough last week. They took their 2011 pick from 2.0% to 1.7% and their 2012 pick from 1.7% to 1.1%.

United States

Faith in Leaders Gone, Economy Weak

The IMF predict that the US economy will grow 1.5% this year and just 1.8% next – assuming things work out okay with regard to Europe. The risk is they do not and US growth turns out even weaker than the near 0.7% annualised rate recorded over the first half of this year.

Over the past three months confidence in US growth has been decimated by a number of events.

- Data were released showing the 2009 recession was over 1% worse than previously estimated and that March quarter growth this year was an annualised 0.4% rather than the previous estimate of 1.9%. Second quarter growth was also revised down to an annualised 1% from 1.3%.
- Monthly non-farm payroll reports have shown weakening jobs growth with employment numbers in fact unchanged in August and the unemployment rate at 9.1% from 8.8% in March.
- Housing measures have deteriorated anew in terms of sales, construction, and prices.
- Various other measures such as for the manufacturing and services sectors, consumer confidence and retail spending have also weakened away recently.
- Standard and Poors cut the US credit rating for the first time in history.
- The Federal Government avoided defaulting on its debt by only a matter of hours early in August and the public's perception that politicians are unable to grasp the seriousness of the situation and act quickly with a credible long term plan has shattered confidence that leaders will be able to either address growth worries or comfortably control a deficit and debt blow-out.

The Federal Reserve has responded to renewed signs of economic weakness with a "twist" operation involving switching over US$400bn of their bond holdings from terms less than six years to longer than that with the aim of keeping down long term borrowing costs. The policy was less than expected and with the Fed. funds rate already almost zero and two bouts of quantitative easing having failed to boost growth, hopes have diminished that in the face of slowing economic activity the Fed. Is able to provide any cushion this time around.

The President has responded with a $447bn jobs and infrastructure package but funding it requires Congress voting in favour of tax increases already rejected by Republicans. The long term deficit reduction package

proposed by the President of some $1.3tn also requires tax increase likely to be rejected. Therefore at a time when people are disappointed in their leaders because of the worsening economy, the deficit reduction debacle, the credit rating cut, and the President appearing more made of strong speeches than action confidence in the country's leadership during a potential time of extended economic crisis has plummeted.

It is highly likely that US consumers will continue to pay down debt rather than spend, that the housing market will weaken further (1/4 of houses with mortgages are worth less than the mortgage), that businesses will remain reluctant to hire and invest, and that the US economy may therefore already have in fact fallen back close to recession after one the weakest post-recession recoveries on record. Note however that business vulnerability to a bank funding and therefore lending crisis is far less than in 2008-09 with US businesses holding a record 7.1% of their assets in cash.

Australia

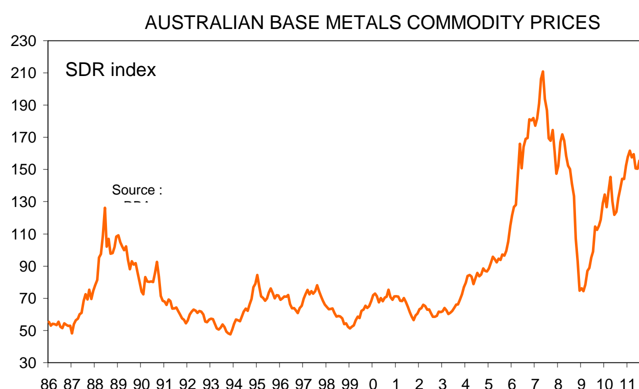
Outlook Worrying But Assisted by Pipeline of Projects and Queensland Rebuilding

The IMF have recently downgraded their forecasts for growth in the Australian economy and now pick 1.8% for 2011 from 3% six months ago, and 3.3% for 2012 from a 3.5% forecast previously. Australia's main underlying economic fundamental at the moment is that it is enjoying the biggest commodity price-driven boom in history with almost AUD500bn worth of minerals and energy projects in the pipeline. In order to ensure resources (staff) are available for these projects to advance without generating surging inflation the Reserve Bank raised their cash rate 1.75% to 4.75% between late-2009 and late-2010. But high interest rates, a high exchange rate, and high labour costs have depressed sectors such as manufacturing, tourism, retailing and housing and before the booming sectors can hire people layoffs from those sectors have caused the unemployment rate this year to rise from 4.9% to 5.3%. The common expectation is that it will go higher.

Australia is described as having a two-speed low productivity growth economy with the low speed part mentioned above made slower by interest rates and the exchange rate being pushed higher than otherwise would be the case because the Federal Government is still running budget deficits.

If China continues to grow firmly and commodity prices hold up, then the Australian economy will grow at the 3.3% picked by the IMF for 2012. After all, when the global economy shrank 0.7% in 2009 Australia kept growing by 1.4% courtesy of the continuing strong growth in China of 9.2% that year. This growth occurred even though between September 2008 and May 2009 all Aussie export prices declined 35% and base metals prices fell 53% between June 2008 and February 2009. The RBA estimate that some 75% of the changes in Australia's growth rate can be explained by changes in China.

But this time around the situation would be different.



First, as already noted, there are some sectors of the Australian economy already in or close to recession.

Second, back then the RBA had few inflation worries and cut their cash rate to 3.0% very quickly starting from 7.25%. This time around the cash rate is 4.75% and cuts would be tempered by some underlying (though obviously weakening) concerns about inflation.

Third, the Federal government would be unlikely to repeat its fiscal stimulus package which amounted to some 1% of GDP though capacity does exist to do so with the budget deficit projected at just 3.6% of GDP for the year just ended.

But offsetting these factors there is the rebuilding of Queensland roads and buildings following the January floods with a cost over AUD11bn currently projected. Also there is almost AUD500bn worth of mining and infrastructure spending in the pipeline and while a global crisis would inevitably delay some projects not least through financing difficulties, the net impact over the next two years may not be substantial given that labour availability is already a restraint on the number of projects which will go ahead.

It seems reasonable to assume that if Europe and the US tank and China slows down then Australia's economy will not grow 3.3% next year as the IMF predict. But on the face of it it seems reasonable to assume growth would exceed 2009's 1.4% as the US and Europe are unlikely to shrink near 4% as they did that year. Plus the RBA can quickly cut interest rates if needed and bank funding vulnerabilities are less than they were then.

China

Optimism in Asian 'Decoupling" Insulating NZ and Australia Needs Tempering

This is the cargo cult mentality great hope - that even as Europe and the US economies slow and possibly go into reverse China will continue to grow strongly and carry a number of other economies along with it including Australia's and ours. This mentality was most recently seen with the short-lived rally in financial markets following news that the Chinese were talking with the Italians and that the talks might have included Chinese purchases of Italian government bonds. The Chinese had their hands burnt investing in US investment banks early in 2008 and will be worried about losses already suffered on Western government bond investments and the internet discussions surrounding discontent that such exposures exist. A Chinese bailout is highly unlikely.

Current hopes of us and Australia decoupling from European and US woes are based on what happened in 2009. Back then the world economy shrank 0.7% (it usually grows 4%) with advanced economies falling 3.7% including a 3.5% decline in the United States, 4.3% decline in the Euro-zone, and 6.3% fall in Japan. But China grew by 9.2% and developing Asia all-up 7.2%. We shrank 2%, Australia kept growing 1.4%.

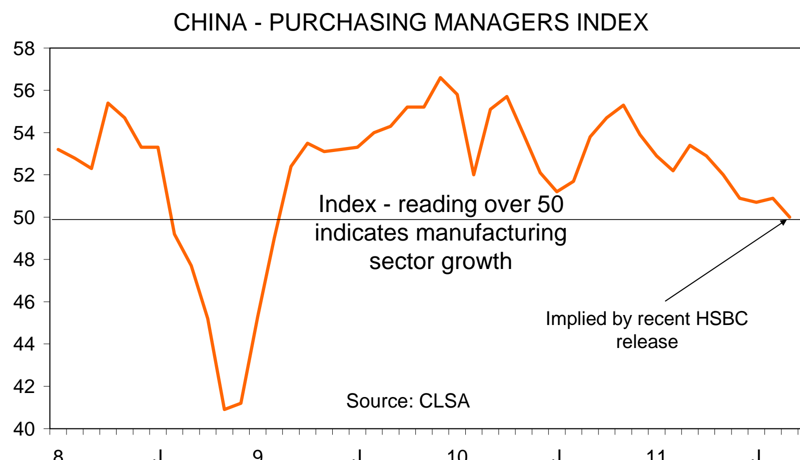
But there are problems. The first is that the IMF have already cut their growth forecasts for China this year and next from 9.6% and 9.5% respectively to 9.5% and 9.0%. But these forecasts explicitly assume that things will turn out okay in Europe and the US. They probably will not.

The second worry is that should the EU and US fall over there is not capacity for China to repeat the near US$1.5tn stimulus package it implemented over 2009-10. The package was accompanied by massive bank lending of some US$2.8tn (near 30% of two year GDP) of which some is likely to never be repaid with about US$1.7tn now lent to some 6,000 borrowing companies especially created by local authorities to get around rules restricting their borrowing. These companies bought land from the local governments thus giving those governments a strong revenue flow, and the developers built many residential and non-residential buildings. Some may never be occupied. Plus extreme social discontent has been stirred with regard to the compulsory seizure of land. Local government finances have been artificially boosted and spending will need to be reined in. In addition it is estimated that at least 23% of such loans can only be serviced with land sales by the borrowing entities. The much highlighted risk is that much of the debt will never be repaid and many Chinese banks will fail.

Strong bank lending has also caused soaring property prices and it is quite likely that a bust of some sort will occur. The impact however is hard to gauge as mortgages tend to be a quite small proportion of property valuations.

China's growth is still heavily dependent upon exports and the commonly cited timeframe is that it will be five years before domestic consumption will be enough to allow growth to remain strong even if exports slump. The manufacturing sector is vulnerable to reduced orders from foreign companies and one of the factors

which caused recent global turbulence was a monthly manufacturing report showing the sector may have officially started shrinking.



Inflation has retreated from a three year high of 6.5% but at 6.2% is still high and causing widening social disparities which the Communist Party is extremely concerned about because of the tension it creates. If inflation does not quickly get back to the targeted 4% any easing of monetary policy aimed at bolstering the economy against Western world weakness will be delayed. Think of it this way. The challenge for the Chinese rulers is how to hold their society in its current form but in increasingly urban locations as incomes rise. Which is the bigger threat? Slow export growth leading to rising unemployment or high inflation? The former is in some regards controllable as rising unemployment hits migrants hardest (people without city residency cards in eastern seaboard metropolises) and they go back home for a while. Such people are always on the move and the work interruption while unwelcome is part and parcel of the life they have chosen by their internal migration.

High inflation on the other hand including a 13.4% rise in food prices in the past year and 52.3% jump for pork threatens the very ability of people to feed themselves and calls into question the current development/political model. Food prices were rising strongly ahead of the 1989 events. Inflation risks higher social discontent and displays of such than unemployment for migrant workers. As such therefore, at a time when the authorities desperately want growth to slow down so price rises can ease, a falling away of export demand from Western countries will in some regard be a welcome development – especially as it will be accompanied by falling food prices. Few commentators have yet picked up on this point.

China's growth risks lie on the downside, and their demand for some commodities has already weakened. Senior people from both BHP-Billiton and Rio Tinto have recently noted they see commodity prices weakening. Log prices have recently fallen sharply. Much commentary we shall see with regard to China now will be the extent to which they are slowing or may slow and this will generate a lot of headlines regarding further downward pressure on the commodity prices important to ourselves and our biggest trading partner.

Our 12% of export receipt direct exposure to China and our 23% exposure to Australia which receives 26% of its export receipts from China is not going to adequately insulate us against our 12% exposure to Europe and 9% exposure to the United States if commodity prices fall and Chinese growth slows.

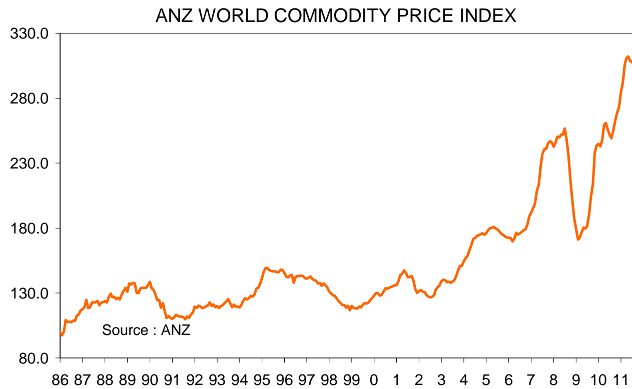
How This Affects Us

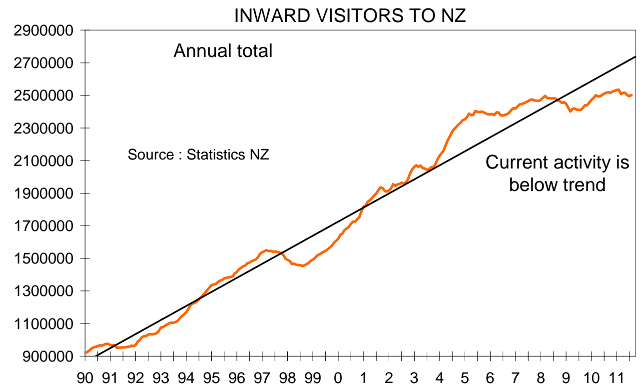
There are a number of routes by which the gathering and probable extra offshore weakness can affect us.

Export receipts

Commodity prices already appear to be easing with dairy prices generally falling since early this year, log prices declining, and the ANZ Commodity Price Index in world price terms now falling for three months in a row. So far the decline only amounts to 2.5% and the index sat 22.1% ahead of a year earlier in August. But between mid-2008 and early-2009 it declined 33% as the world headed into recession and with the index

currently sitting just below a record high some 56% above the ten year average and 19% above the mid-2008 peak scope for declines is ample.





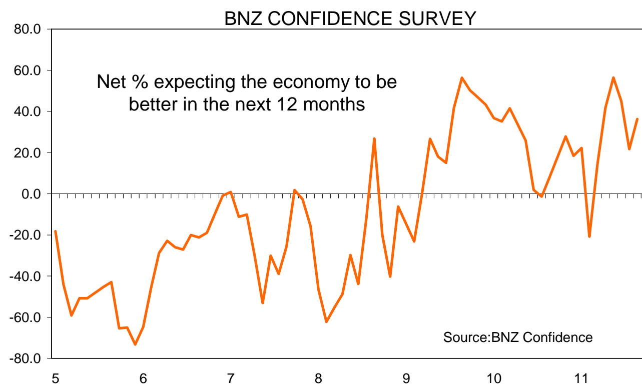
Given that farmers have to date been more focussed on reducing debt than undertaking a traditional income-driven spending boom, it is highly likely that the fresh ructions offshore will further erode whatever willingness to spend was building.

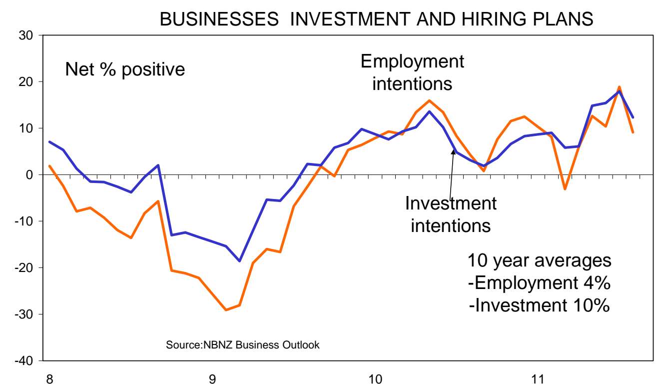
Tourism

Visitor numbers have shown healthy growth above 8% seasonally adjusted in each of the past two months and there will obviously be strong growth associated with the Rugby World Cup over September and October. But after that the high NZD and worsening economic weakness offshore will likely cause a return to declining numbers.

Confidence

We are an exporting country highly attuned to developments overseas (except maybe at the moment as our attention is instead on rugby and rugby league). If the world economy once again tanks we can expect a sharp decline in the confidence of NZ businesspeople much as happened between September and October 2008 when the reading in our BNZ Confidence Survey when from +27% to -20%. The second graph here shows how a collapse in confidence can translate through to reduced willingness of businesses to hire and invest.





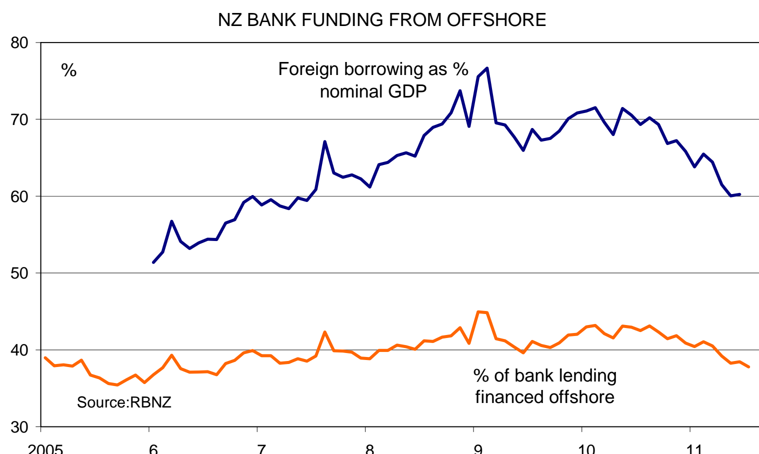
Already we are receiving signs of a pullback in business willingness to hire, though up to date indicators of capital spending plans are near impossible to find.

Bank Funding

Because Kiwis are such appalling savers but like borrowing there is not enough money available in New Zealand to fund the debt people want to raise. So we banks have to source the difference overseas and in spite of lending growth to the private sector falling to near 1%, just under 40% of the stock of private sector debt in NZ is still sourced from abroad. As long as we banks have the confidence of foreign savers this does not represent a problem. But for a period of about six weeks after Lehman Brothers investment bank collapsed we could not replace maturing deposits overseas let alone raise new funds. The result was a sharp reduction in credit availability in New Zealand and the effects are still being felt as old debt matures and is replaced by

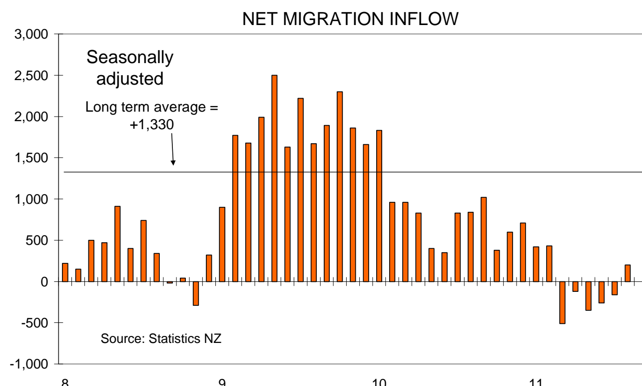
new money raised from offshore which costs more (versus NZ interest rates) than was the case before late-2008.

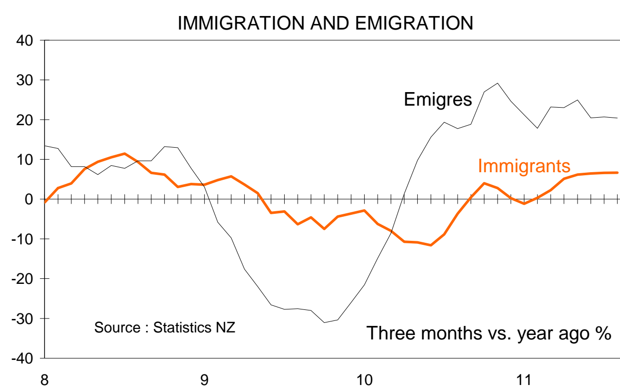
If fears of European and US banks arise again we Australasian banks will once again be caught in the backwash and credit availability in NZ will once again be impeded. So far there have been only slight increases in bank borrowing costs overseas and as the graph below shows our dependence upon offshore funding is slowly declining.



Migration

Although we received a population boost following the September 11 2001 terrorist attacks our migration patterns have been different following the Lehman's Bank collapse. Very briefly the numbers worsened, but then a sharp decline in the number of people leaving New Zealand caused the annual net migration inflow to move from 3,569 in November 2008 to a peak of 22,588 in January 2010. Since late-2010 although numbers coming here have improved, the gross outflow of Kiwis to Australia has risen sharply to reach a net loss of 32,067 in August this year from a loss of just 14,791 in April 2010. The turnaround, as we discussed much earlier this year, has been caused by the low level of the NZD against the AUD, lower unemployment in Australia than NZ, and catch-up departures.





In the event of a fresh severe downturn in the world economy it seems reasonable to expect a repeat of the post-Lehman's collapse and this would accelerate the improvement in net migration inflows we are broadly expecting from mid-2012 anyway. That is, migration flows will likely mildly cushion the NZ economy in the event of a global downturn.

Interest rates and Exchange Rate

Weak growth offshore will stay the hand of the Reserve Bank for longer and tend to keep medium to long term borrowing costs down. The NZD is known as a commodity-dependent and risky currency therefore the greater the worries about world growth the greater the selling of our currency by investors.

So Why Will Our Economy Still Grow?

Taking the strong downside risks to world growth and sentiment into account, why do we still think that our economy will grow next year by close to 3.5? The IMF forecast is for 3.8% growth. That is, what are the things likely to lead on average to a rise in our output? In no particular order of importance here is a list of factors which suggest that for the average business planning for a bit of growth rather than shrinkage remains valid – acknowledging that there is no average business as such.

Population growth is expected to be about 0.9% with 0.5% growth in the working age population. More people generally means more spending.

Rebuilding Christchurch. Some 100,000 dwellings need repairs or replacement and although lack of insurance is slowing the process down it seems reasonable to assume that activity will begin in earnest next year. This will provide more work for a wide range of businesses including builders, civil engineers, building material producers and distributors, architects, financiers, and so on.

Farmers spending higher incomes. Wobbles and weakness offshore suggest farmers will exercise restraint in their spending and more especially their borrowing. But history tells what farmers will do with their higher incomes. Already we can see higher spending starting up with farm sales in August almost double last year's levels and rising values of consents being issued for farm buildings. Tractor registrations are also growing. Higher spending will provide more employment in the rural real estate sector, stock and station agents, fertilizer producers, transport companies, chemical producers, installers of dairy sheds and other buildings, fencing contractors, gravel merchants, top dressers, travel agents (holidays overseas), retailers of cars and household appliances and furniture etc.

House building in Auckland. There is a housing shortage in Auckland which we expect will lead to rising construction over 2012 and 2013 though the volume of growth is hard to pick given the difficulties we think people will face finding builders and people baulking at rising construction costs.

Energy sector growth, driven by increasing activity from offshore investors, geothermal generation expansion, investments by companies to boost efficiency/cogeneration.

Film production related to the two Hobbit movies principally.

Forestry, timber processing, driven by rising NZ house construction, rebuilding after Queensland's floods, rebuilding in Japan, continuing growth in China.

The **aging population** will produce growth in the health services sector, fitness classes and equipment, home redesign to accommodate an aging population in their own homes rather than aged care residences, pharmaceuticals, domestic travel (in campervans), property management…

Telecommunications involving the rollout of broadband and the continuing stream of technological developments.

Recruitment because of the slow labour force growth combined with loss of skills and motivation by many increasingly long-term unemployed.

Residential real estate as continued low interest rates, improving employment, population growth and the simple passage of time bring more buyers to the market.

NZ long term strategic value. We have water, can efficiently produce quality food, and may have large energy reserves. Businesses and investors with an eye to the long term are already increasing their NZ exposure and may take the opportunity presented by an easing in the NZD, low funding costs, and low confidence to boost holdings of the likes of farmland.

There is also some capacity for stimulatory policies to be applied. The official cash rate is at 2.5% and could be cut as low as the 0% - 0.25% currently in place in the United States though we feel the Reserve Bank would be extremely reluctant to take such a move.

Implications

The most important to point to note is that no-one knows how bad the situation offshore will get. The worries could pass quickly and we will be back on the road for 4% growth next year. Or things might collapse and the world goes back into a 2009-like 0.7% recession. Or things worsen but not by that much and world growth comes in closer to 2% - 3% than the IMF's pick of 4% - and that seems an increasingly likely scenario.

Because of these uncertainties it is not possible to develop a business management or financial hedging strategy based upon a set scenario. Instead we would suggest one focussed around planning for growth but with ability to adjust quickly if downside risks materialise. So here are some suggestions.

Keep inventories low as negative growth shocks make cutting stock levels difficult and expensive and assumptions/forecasts of rising demand upon which some stocks have been rebuilt since 2009 have usually proved too optimistic.

Keep deleveraging. The global availability of credit has changed and whereas the period from the 1980s up to 2007 was one of increasingly easy access to credit, the situation for the next two decades is likely to be the opposite.

Pursue flexibility in hiring and leasing contracts to allow easy downsizing in the event of negative growth shocks.

Maintain extremely tight debtor control as the structural decline in credit availability will continue to catch some companies short.

Just as the 0.5% increase in the official cash rate over a year ago was reversed in March and the timing for a fresh rise has moved from September to December and now March, the risk is a rise gets pushed out a tad further. **Floating rate funding** may deliver the minimum cost for the next two to three years. However in an extremely uncertain world it pays to seek some cash flow certainty where possible and with long term fixed borrowing costs having rallied recently some borrowers may find it optimal to fix a portion of their interest rate exposure.

There is little chance of anything other than continuing **extreme currency volatility** over the next two to three years. Exchange rate risk management decisions must be based around vulnerability to up and down shocks rather than any currency view.

Having cut back on training and with a structural shift down in labour force growth, once solid growth does return, and probably even before then given loss of people to Australia, **shortages of skilled people** will appear. Keep an eye out for skilled and motivated people and consider long term staff training programmes and offshore recruitment strategies.

With regard to a few specific industries we offer the following brief comments which spring to mind.

Rural servicing – very good prospects based upon the structural lift in farm returns associated with weather changes offshore and income/quality food demand out of China.
Financial services – structural changes in funding ability combined with business and household deleveraging mean sustained weak credit growth for coming years.
Retailing – mild growth likely with an eventual period of "catch-up" spending in durable goods beyond simply more TVs to watch rugby. Sectoral rationalisation to continue.
Commercial property – good underpinning for industrial with manufacturing sector export growth to Australia, CBD in Wellington to struggle due to public sector downsizing, CBD in Auckland mild support to slowly

appear, retailing to experience strong stratification between high foot count and out of the way locations. Investor demand likely to improve due to low interest rates and search for assets other than volatile equities.

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

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

This week we yet look again at how things are worsening offshore.

Other Website Material

- **Weekly syndicated newspaper column** http://tonyalexander.co.nz/newspaper-column/
- **BNZ-REINZ Residential 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've done a summary of the solid measures of what the economy is doing and retain our conclusion that the economy is not performing all that well and therefore it is a lot more vulnerable to weakness offshore than many people are thinking..

- The economy grew only 0.1% over the June quarter.
- The value of core Electronic Card Transactions fell 1% in August after rising only 0.4% in July.
- Car registrations in seasonally adjusted terms have fallen recently.
- Export receipts fell by -2% seasonally adjusted in the three months to August
- Commercial vehicle registrations have fallen near 7% in the past three months.
- Job numbers are ahead 1% on a year ago with 0.4% growth over the past three months. But they fell 0.3% in July and grew only 0.2% in June so growth may have stalled. Plus online skilled job advertisements have fallen by 0.4% in the three months to July.
- Lending to households for non-housing purposes have fallen in each of the past three months.

However…

- Dwelling consent numbers have improved 7% s.a. over the past three months.
- Dwelling sales have gained near 6%.
- Approvals for the construction of non-public sector buildings were ahead 7% in the six months to August from a year ago with farm buildings ahead 26%.
- Imports of plant and machinery have improved near 6% s.a. over the past three months.

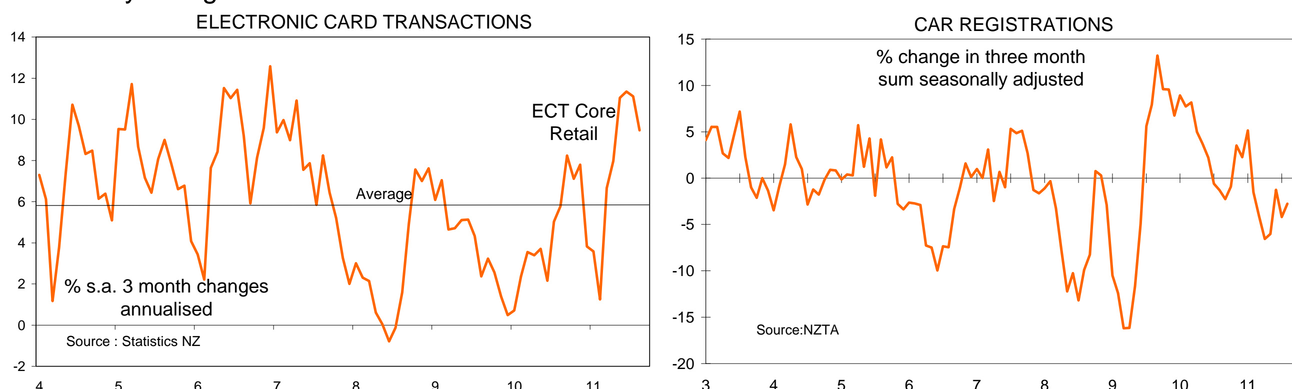
So growth essentially stalled in the June quarter and data covering July and August hints at more weakness except maybe with regard to business investment – though the evidence is quite mixed there. The data show an economy not performing all that well.

In this interests of conserving space we discuss only a smattering of indicators which have been released over the past two weeks.

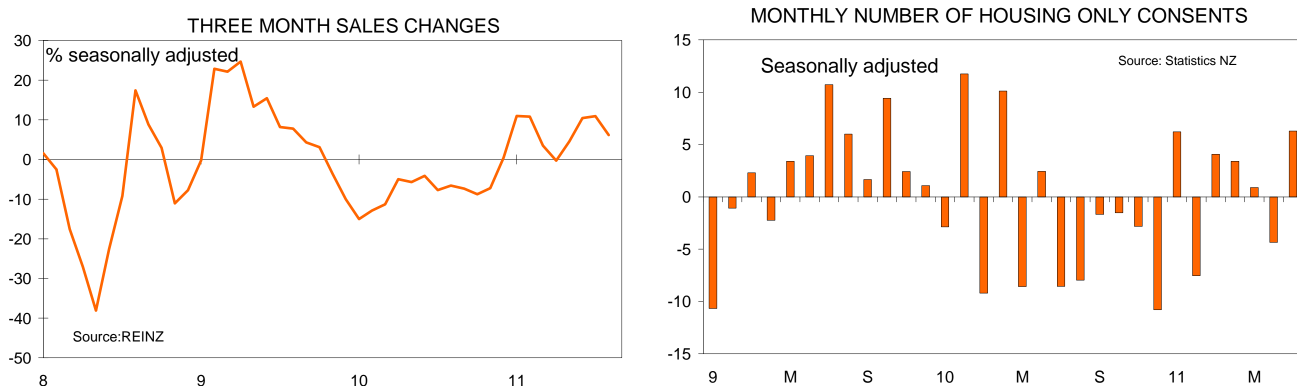
Are householders opening their wallets more?

Not really. While in real seasonally adjusted terms ex-auto retail spending rose by a healthy 1% in both the March and June quarters, once one strips out electrical goods (we have been snapping up heavily

discounted TVs ahead of the rugby) growth rates fall to 0.7% and 0.5%. Plus more recent data are weak. Electronic card spending rose only 0.4% in July then weakened a full 1% in August. Also, car registrations in seasonally adjusted terms recorded a small decline in the three months to August and were 10% below levels of a year ago.



There is however evidence of rising dwelling purchases with sales up in seasonally adjusted terms by near 6% in the three months to August following 5% growth three months earlier. Consents for new houses may be starting to turn up with seasonally adjusted growth of 6.2% in August and 3.6% in the three months to August. But numbers were down 3.8% in the three months to May and 9.5% in the three months to February so one cannot dismiss the possibility that the recent growth is simply the appearance of the absence of weakness as opposed to the commencement of strength.

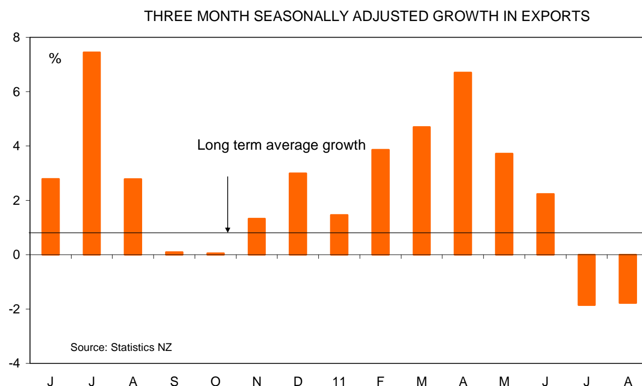


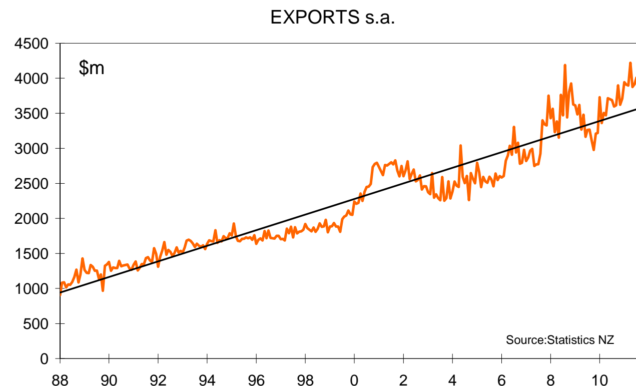
Is business output rising?

Our discussions in this section have shown that a lot of partial indicators of the NZ economy have been poor in recent months, so it is no great surprise that the economy officially only managed growth of a paltry 0.1% in the June quarter. Growth essentially stalled after a 0.9% rise during the March quarter.

In the tourism sector things are clearly going through a good patch with regard to the Rugby World Cup, but also just ahead of it there were some positive developments. In seasonally adjusted terms visitor numbers rose by 8% in August after rising 8.8% in July so the three month change has shifted to +2.3% from -5.2% in May.

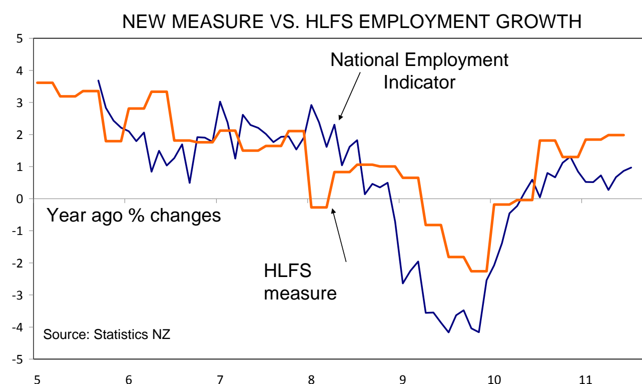
The rate of growth in exports has slowed down with a 1.8% fall in seasonally adjusted receipts over the three months to August. This is shown in the first graph. The second shows that the level of monthly exports is still above trend but clearly the extent is easing.

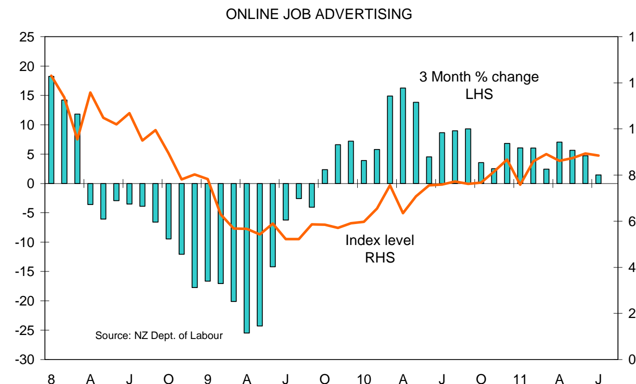




Are businesses hiring more people?

Ignoring the Household Labour Force Survey from which we derive the unemployment rate because frankly it goes all over the place and Statistics NZ cannot explain why, we can see acceptable growth in the new (experimental) National Employment Indicator. This series is derived from data submitted to IRD on all wage or salary paying jobs and shows job numbers up a seasonally adjusted 0.4% in the three months to July and 1.0% from a year ago. There is jobs growth which is exceeding labour force growth so we expect to see the unemployment rate trending lower. But note that the latest observation in hand for this new series is only July, so where we stand now, two months beyond that month things could quite easily be different. In the monthly of July itself job numbers actually fell 0.3% after rising 0.2% in June so underlying jobs growth could easily be less than the 1.6% annualised rate derived from the past three months in total.

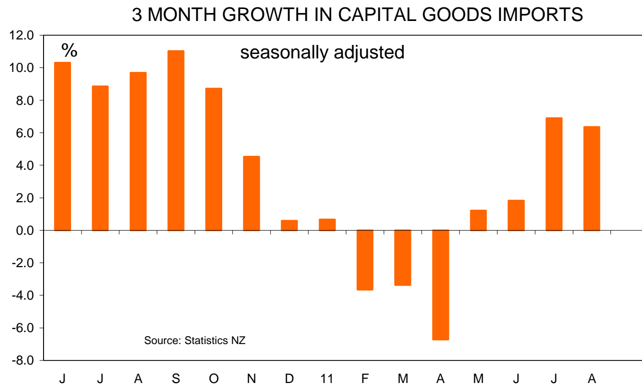


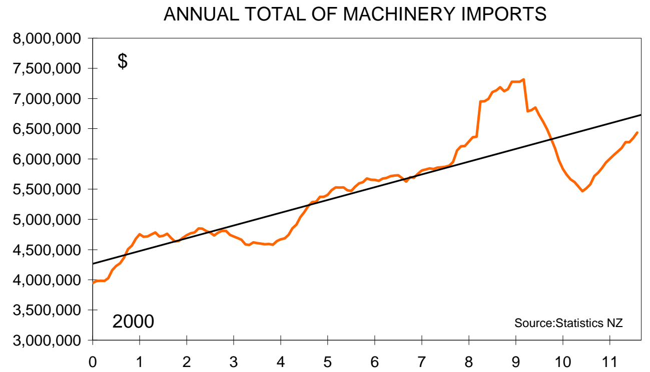


Are businesses boosting their capital spending?

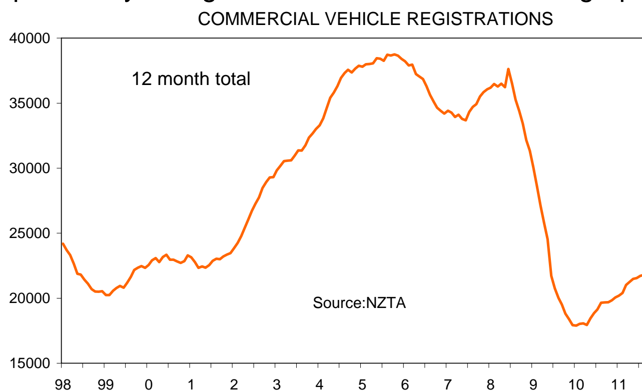
To see how businesses are feeling right now one can read our monthly BNZ Confidence Survey here. http://tonyalexander.co.nz/bnz-confidence-survey/

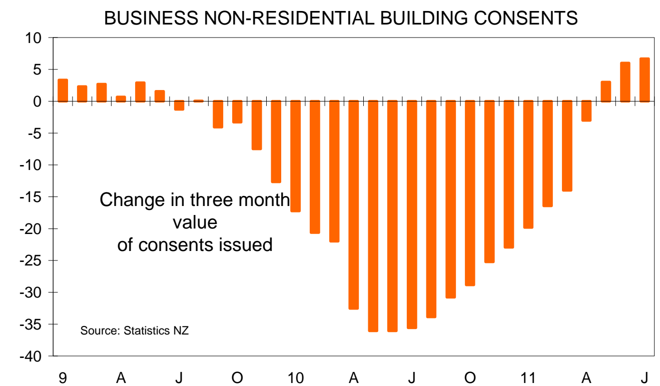
We can only play at guessing what is really happening with business capital spending in New Zealand because the data simply are not available. One proxy is imports. In the three months to August the value of imports of plant and machinery was ahead 6.4% from the three months to May and 15.5% from a year ago adjusting for exchange rate changes. Three months earlier however the short term rate of change was 1.2% so the most recent growth could simply be the absence of earlier weakness. Nevertheless there does appear to be an upward trend in place.



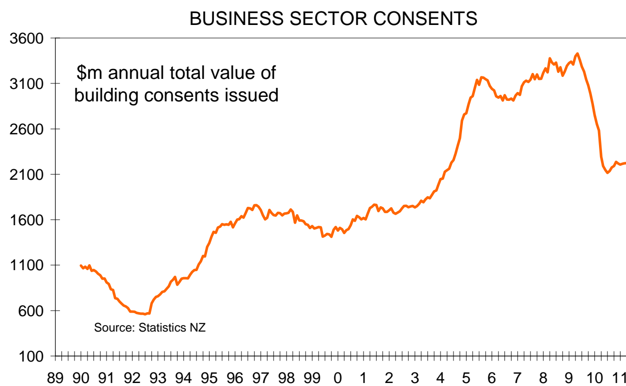


Another indicator we use is vehicle registrations. In the three months to August the number of commercial vehicle regos was down by 7% from the three months to May. But this fall followed 10% growth three months earlier so maybe it simply reflects the absence of a surge rather than a fall as such. Regos were 5% up from a year ago and the trend shown in the graph below is upward.





We think there is also an upward trend in the value of largely non-public sector building consents. Values in the three months to July were ahead 7% from a year ago after being 3% ahead in the previous three months.



All up we think the fact that these three inferior suggestors of capital spending are rising is good enough to allow one to say that there is growth underway in business investment.

What Do The Leading Indicators Say?

In this section we look only at the factors which can at times give insight into where the economy is headed. Generally we will only cover newly released information.

They say we should be worried about what is happening offshore and not get too smug speaking about how our economy will be boosted by rebuilding of Christchurch and farmer spending next year. We still receive

30% of national income from exports and if the Western world tanks Asia will slow and commodity prices fall which will further sap the willingness of companies to hire and invest and of consumers to spend.

We've written nothing more here this week as the WO is already long enough. We'll populate this section with what we can find next 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 March. Have we learnt anything this week which alters this outlook?

The chances of NZ monetary policy tightening anytime soon have eased even further now that the world looks a more worrying place. The markets are only pricing in 0.2% worth of cash rate rises in the coming year. They could easily be right though the risk is they are too dovish and therefore business borrowers might want to not look a gift horse in the mouth and consider locking in some long term debt at current rates.

Other Inflation Influencers

The NZD has fallen away but not by enough to radically alter the inflation outlook.

Rate Movements This Week

Over the past fortnight wholesale interest rates have understandably rallied as global growth worries have grown. If those worries increase further rates will rally again. If the worries back off then rates will rise. All one has to do is forecast changes in global risk changes.

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	5.9
90-day bank bill	2.87%	2.83	2.93	2.71	3.20	6.2
1 year swap	3.00%	3.02	3.19	2.92	3.44	6.0
3 year swap	3.40%	3.45	3.72	3.78	3.96	6.2
5 year swap	3.84%	3.91	4.24	4.40	4.34	6.4
180-day term depo	4.00%	4.30	4.50	3.60	4.90	6.0
Five year term depo	6.00%	6.00	6.00	6.00	6.75	6.5

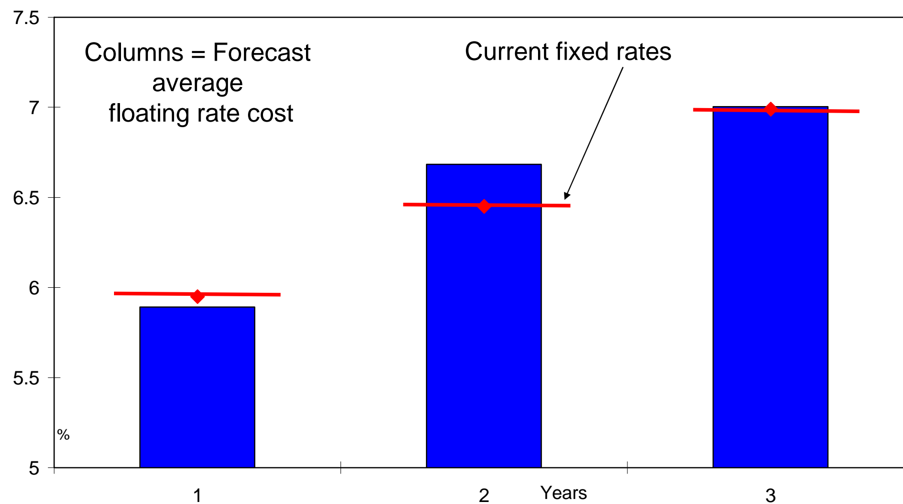
If I Were a Borrower What Would I Do?

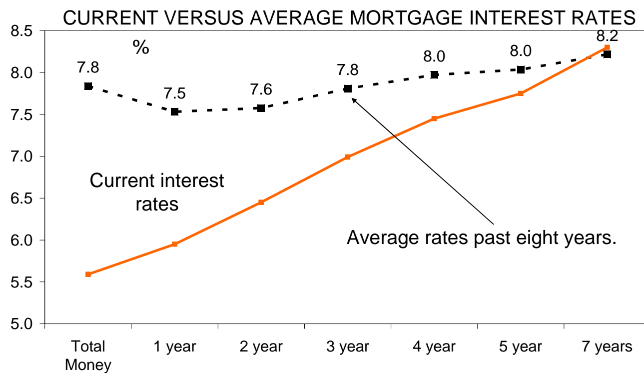
I float, end of story, stop reading for probably a year. As we have highlighted over and again here, apart from three short periods since June-2009 (bugger), the chances are that floating interest rates are going to remain low for a very long time as the world grinds its way through a period of debt reduction and we get caught in the backwash. Plus lets not forget that hardly any country has a higher household debt to income ratio than we do and even after all the travails of the past three year's it is a matter of statistical error whether or not our household savings rate has moved into positive territory once one strips out the earthquake insurance effect.

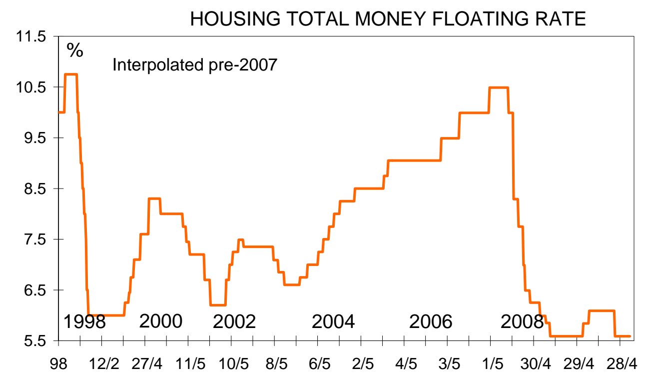
We suck as savers and in a world where the markets will reward savers and punish the spendthrifts we are in dangerous territory that eventually will attract greater offshore attention. The transmission mechanism of this concern will be bank borrowing problems feeding through to higher NZ interest rates even with no change in growth or inflation prospects, plus tightening of lending criteria. It is impossible to know when attention will turn our way and this adjustment will occur.

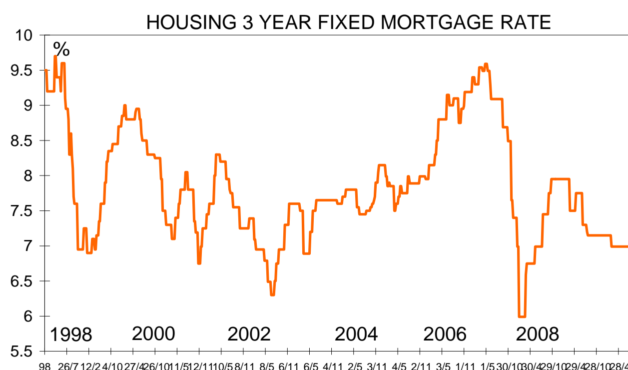
The risk is that our current pencilled in forecast of a cash rate rise in March will be pushed out further, if the world economy's growth rate drops away as looks increasingly likely. If I were a borrower I would sit floating and not expect to be thinking about fixing for a very very long period of time.

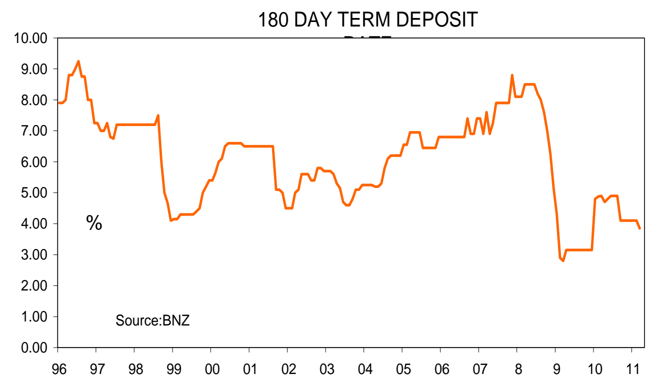
However, there are many business borrowers who favour certainty and for whom the recent fall in fixed wholesale borrowing costs represents an opportunity to get some long term fixed rate hedging in place. So just as we suggested that travellers take the bird in the hand when the NZD was at US 86 cents we would suggest these types of business borrowers increase their interest rate hedging at the moment – not because we think fixed rates are about to rise, but simply because the bird in the hand is always worth something. Greed is not good.











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/

Nothing

Enough written elsewhere this week.

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

See this week's lead article.

European Debt

Chinese Inflation

US Growth Momentum

Australian Growth

Exchange Rates

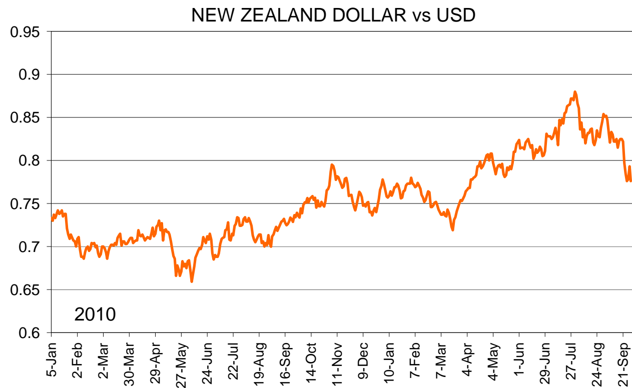
Exchange Rates	This Week	Week Ago	4 wks ago	mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.776	0.797	0.838	0.811	0.7393	0.689	0.629
NZD/AUD	0.794	0.795	0.792	0.769	0.7646	0.773	0.855
NZD/JPY	59.400	61.200	64.400	65.700	61.98	67.7	68.4
NZD/GBP	0.497	0.515	0.512	0.507	0.4679	0.448	0.368
NZD/EUR	0.572	0.589	0.578	0.564	0.5445	0.52	0.511
NZDCNY	4.962	5.093	5.353	5.244	4.946		4.83
USD/JPY	76.546	76.788	76.850	81.011	83.836	98.3	109.9
USD/GBP	1.561	1.548	1.637	1.600	1.580	1.54	1.705
USD/EUR	1.357	1.353	1.450	1.438	1.358	1.33	1.229
AUD/USD	0.98	1.00	1.06	1.05	0.97	0.891	0.737

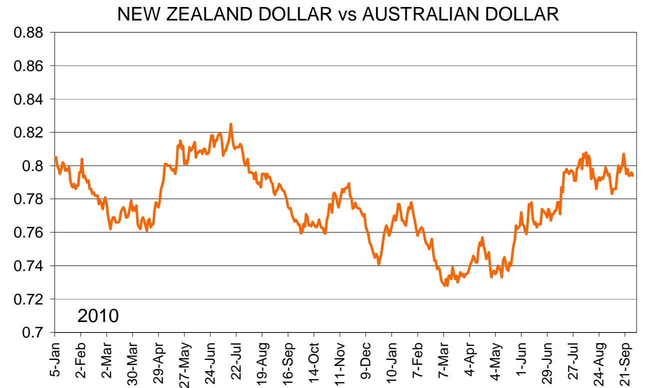
*Sourced from Consensus Economics. http://www.consensuseconomics.com/

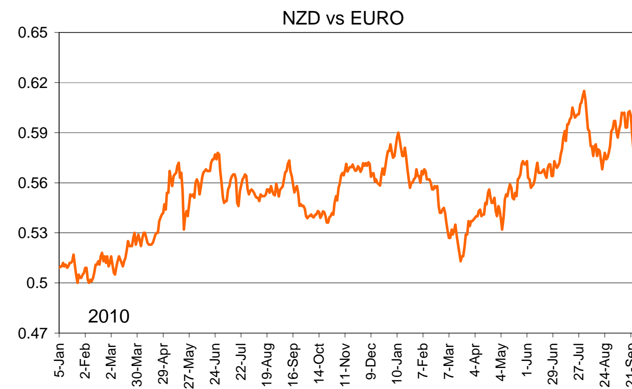
Worries Wear Away The NZD

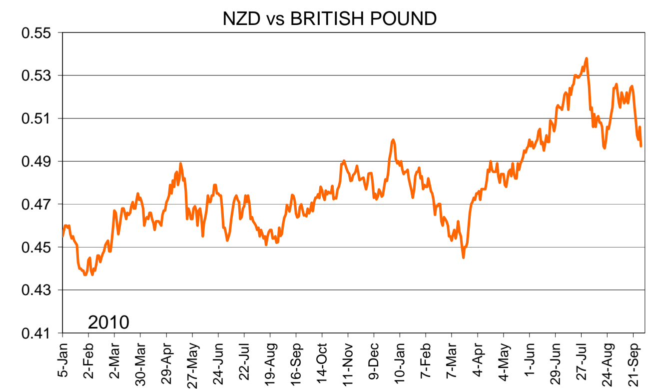
Its quite simple really. Worries about the world have grown so investors have sold risky currencies like the NZD and AUD and moved funds into the currently perceived safe havens of the Yen and USD. Apart from that the currency movements are just fluffery at the edges about which we can add nothing of value. If worries grow the NZD will fall further. If they ease the NZD will rise. Both will happen probably dozens of

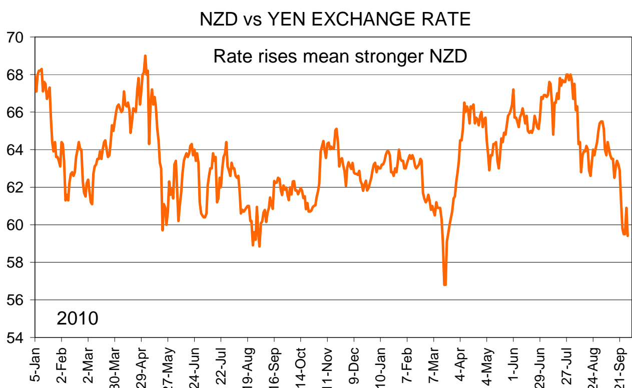
times over the next 1-3 years and range traders with good stop-loss and profit-taking management will have a field day. Good luck.

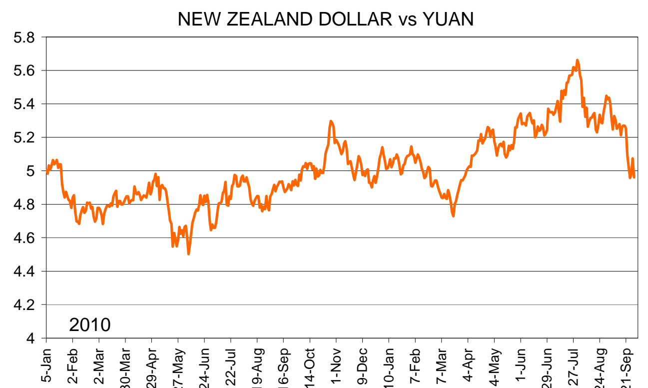


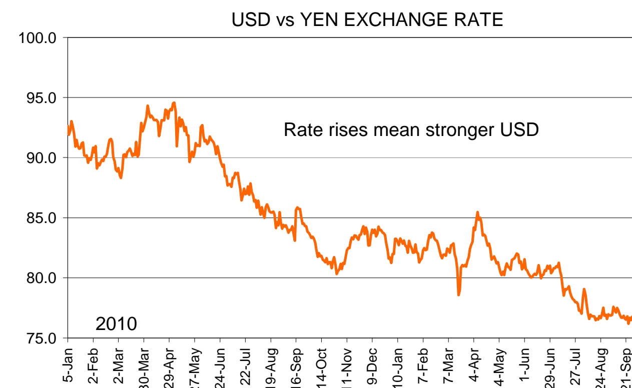


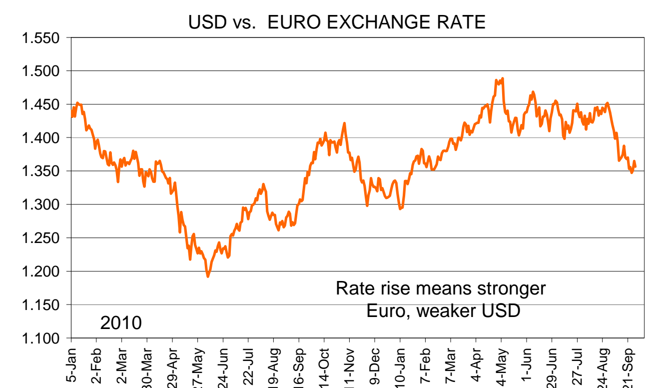












United Kingdom

Not this week.

Exchange Rate Assumptions

	2010	2011	Risk	2012	Risk
Year end					
NZD/USD	0.73	0.87		0.84	Higher
NZD/AUD	0.74	0.81		0.85	
NZD/YEN	64.2	68		72.0	
NZD/GBP	0.44	0.53		0.52	
NZD/EUR	0.51	0.60		0.60	
USD/JPY	88	78	Lower	86	Lower
GBP/USD	1.66	1.64		1.62	Higher
EUR/USD	1.43	1.45	Higher	1.40	Higher
AUD/USD	0.99	1.07		0.99	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	1.0%	0.8	5.3	1.7	1.9
GDP growth	Average past 10 years = 2.6%	0.1	0.9	+1.5	0.5	-2.4
Unemployment rate	Average past 10 years = 4.8%	6.5	6.5	......	6.9	6.0
Jobs growth	Average past 10 years = 1.9%	0.0	1.3	2.0	0.0	-0.8
Current a/c deficit	Average past 10 years = 5.5% of GDP	3.7	3.6	......	2.5	5.6
Terms of Trade		2.3	0.8	7.0	12.7	-13.5
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%.	1.0	1.0	1.3	1.9	-3.1
House Prices	REINZ Stratified Index	-0.2	1.1	-0.1	2.8	-0.9
Net migration gain	Av. gain past 10 years = 13,900	+2,257	4,625yr	......	14,507	15,642
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	-0.6	0.9	-0.6	4.4	-2.8
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Business confidence	BNZ survey	36	22	-21	8	56
Consumer confidence	ANZ-Roy Morgan 100=neutral	113	113	101	116	120
Household debt	10 year average growth = 10.3%. RBNZ	1.2	1.2	1.5	2.4	2.6
Dwelling sales	10 year average growth = 2.5%. REINZ	21.1	11.7	-10.5	-27.1	39.3
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.

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Key Forecasts

Dec. year		2010	2011	2012	2013
GDP	annual average chg	1.4	2.0 – 2.5	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	4.0 – 4.5	4.25 – 4.75
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

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