BNZ Weekly Overview

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Mission Statement

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

The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please click here.
http://feedback.bnz.co.nz/forms/Fx-I8ploskSGWgjN_7WOAw
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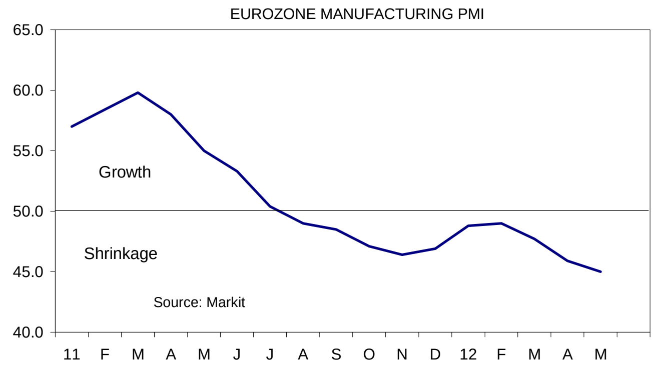
Deterioration Continuing

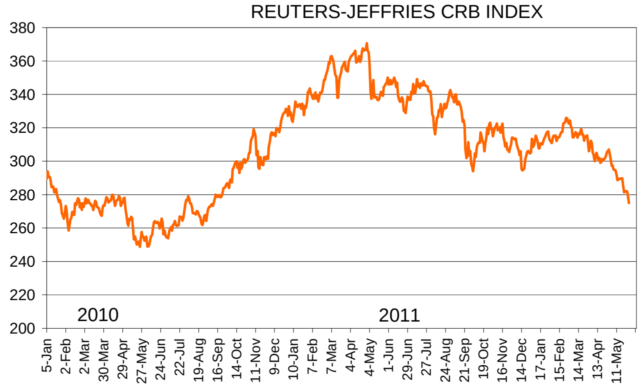
The name of the game now that we are a few weeks down the track from the Greek election and into soaring expectations of a break-up of the Euro as depositors take money out of banks in Greece, Spain, Portugal and to a lesser extent Italy, is finding evidence of what will clearly be a negative impact on global growth. As it arrives the evidence will be seen as bad for us with implications for the NZD, monetary policy, growth forecasts (cue Treasury's overly optimistic Budget numbers), commodity prices and sentiment.

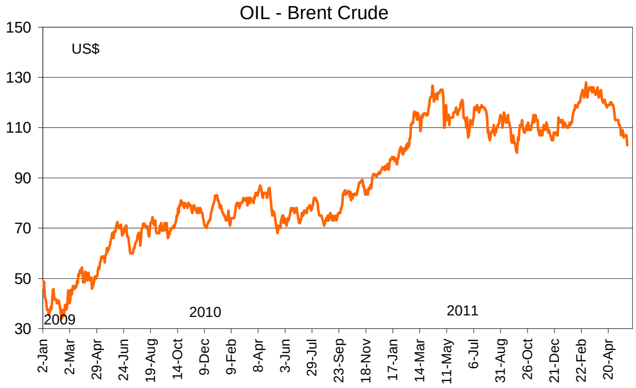
We shall look first to sentiment measures, then probably lending growth numbers, then short term spending and hiring indicators to get a feel for the extent of the damage – and damage there will be. It is overly optimistic to think that the huge unknowns surrounding how Greece will (almost certainly) quit the Euro and the flow-on effects will not affect the willingness of people to spend and of businesses to hire and invest.

Already the Eurozone is as good as in recession with 0.2% shrinkage over the December – March quarter period. The Markit Economics PMI manufacturing Index for the Eurozone fell in May to 45 from 45.9 in April and now sits at a 35 month low. Commenting on the data the Markit Chief Economist noted "The flash PMI indicated that the Eurozone downturn gathered further momentum in May, with business activity and new orders both falling at the fastest rates for just under three years. The survey is broadly consistent with gross domestic product falling by at least 0.5% across the region in the second quarter, as an increasingly steep downturn in the periphery infects both France and Germany." Yuk.



The weakness is evident in sharemarkets with one global index down more than 10% in recent weeks, and commodity prices of course pulling back. The much watched Reuters-Jeffries CRB index is back to levels of September 2010 and around 26% below its April 2011 peak. In Spain investors are so worried about debt levels that government ten year bond yields are approaching the 7% level generally considered as necessitating a bailout.





But making matters worse for the West is that oil prices are staying highish partly on the back of worries about the Middle East.

And there is no sign of any plan to stem the rot – mainly because as we pointed out in 2010, the dry powder has all but been used up, and that includes one would suggest the credibility of the policy makers. Last Wednesday night the meeting of Eurozone leaders came up with exactly the same set of proposals as the previous weekend's G8 meeting – words but no actionable items. As the New York Times noted this week "…it's increasingly evident that we are witnessing an institutional failure of monumental proportions."

Governments have already used their powers of taxation and spending to give insulation to their declining economies over 2008-10 and buy time for problems to be eased and natural growth to reassert itself. Now investors will not willingly finance newly large deficits without extracting a significant interest rate premium. Central banks have already slashed interest rates and apart from a very small number of exceptions have not been able to raise them again to build buffers in the past three years. Central banks have also printed money like there is no tomorrow – and yet just after a €1tn example of this by the European Central Bank in February we are into Europe's biggest crisis since WW2. Hang on. This is going to get worse, but NZ recession still looks like a very low probability scenario given the stability of our banking sector, government finances, commodity exports, and housing construction recovery.

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.

Go back and read the first line in the introductory section just above. Now think about it and you will realise that for a short time period we are going to need to water down the weight we place upon the real economic activity indicators which we analyse here. That is because the data we discuss here will be referring largely to a period when there were hopes of the world economy settling down courtesy of the Europeans' efforts earlier this year.

But now we have a whole new surge in worries (quite legitimate ones) regarding Europe and we know that those worries will lead to reduced growth in economic activity. It is simply a matter of how quickly, how much, for how long, and it which areas predominantly.

In other words, I shall continue the usual data analysis here but can see myself outright downplaying if not simply discounting the apparently positive picture some of the indicators might paint because of my expectation of Europe's negative feed-through into how we behave here.

Are householders opening their wallets more?
Nothing new.

Is business output rising?

Are businesses hiring more people?

This week we were expecting the monthly national Employment Indicator to be released by Statistics NZ. But they say that there are problems with the quality of the data so have cancelled the release.

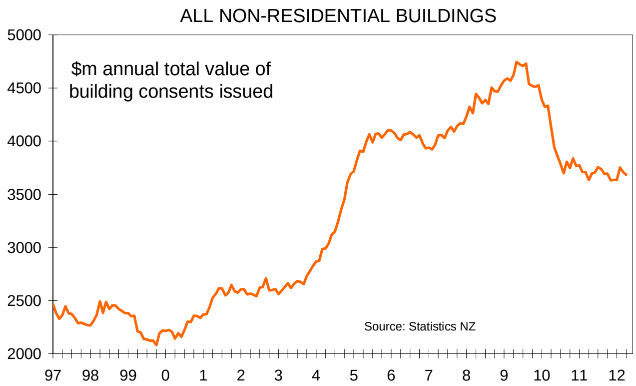
Are businesses boosting their capital spending?
For equipment no. Buildings = mixed.
To see how businesses are feeling right now one can read our monthly BNZ Confidence Survey here. http://tonyalexander.co.nz/bnz-confidence-survey/

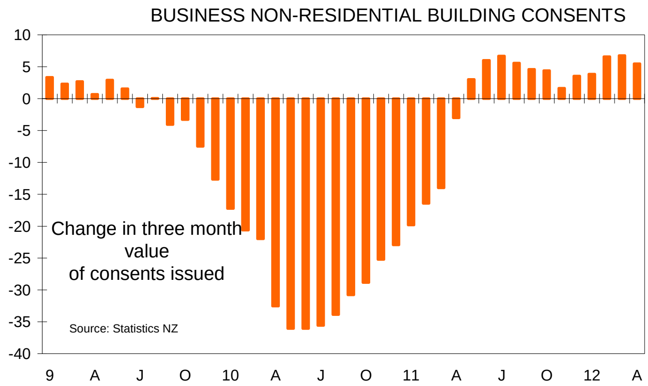
What Do The Leading Indicators Say?

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.

Almost nothing new apart from the 5.2 magnitude aftershock in Christchurch which clearly increases the risk that the rebuilding period occurs slightly later than would otherwise have been the case. Speaking of which…

The value of consents issued for the construction of non-residential buildings came in 10% lower in April than a year earlier at $228mn. This decline meant that in the six months to April consents were down 1% from a year earlier thus showing no underlying growth can be expected in non-residential construction in the coming year. Even if we do our best to strip out the public sector we get only 5% growth in business-type consents.





The data suggest a flat commercial construction outlook.

INTEREST RATES

Wholesale interest rates have crept higher this week in response to some borrowers taking advantage of low fixed rates to increase their cover and the markets now to pricing on average only 0.35% worth of official cash rate cuts this year rather than the 0.5% of last week. The yield on 90-day bank bills has crept up to 2.61% from 2.56% while the three year swap rate has moved to 2.75% from 2.62%.

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	2.50	5.4
90-day bank bill	2.61%	2.56	2.73	2.76	2.68	5.7
1 year swap	2.50%	2.37	2.66	2.92	2.88	5.8
3 year swap	2.75%	2.62	2.95	3.36	3.85	6.1
5 year swap	3.16%	3.06	3.41	3.82	4.49	6.3

If I Were a Borrower What Would I Do?

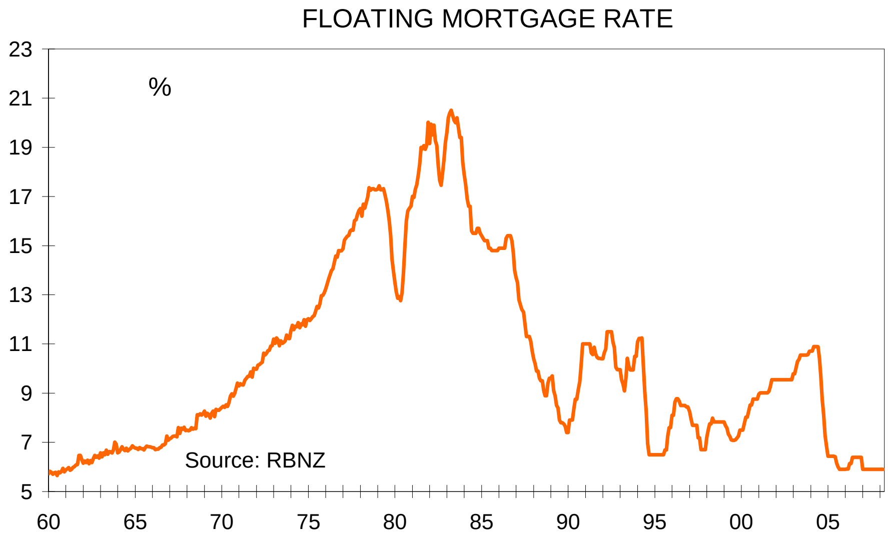
Personally I do not believe the Reserve Bank will cut interest rates when the housing market is already clearly moving upward with rising interest from investors, when the economy will be stimulated by the Christchurch rebuild over the next three years, when there is a small stimulus running through the economy also from the recent depreciation of the NZ dollar, and when interest rates have already just been cut by banks responding to falls in wholesale interest rates. The markets have however priced in cuts of 0.5% in the near future.

My expectation is that market pricing will eventually adjust to take away rate cut expectations and when that happens bank borrowing costs will rise again and fixed home lending rate cuts will be reversed.

Therefore I personally would fix three years currently at 5.75%. The rate is basically the same as floating and gives me good cheap rate certainty for a longer time period than the 5.1% 18 month rate which quite a few people are finding attractive. But note this important point. Just as I highlighted back in late-February when saying I would hop off floating and fix three years this is not based upon a view that floating rates are going to be increased anytime soon. It is looking very unlikely that the Reserve Bank will increase the official cash rate until the end of 2013 if not early 2014 given the clear lack of accelerating growth in the NZ economy, the low pricing power for businesses (witness the discounts retailers are offering), and the clearly troubling economic conditions offshore.

So if you choose to stay floating I think that is a very good strategy. I simply have a personal preference for some rate certainty in these uncertain times which are likely to be with us for many years.

And in particular I feel motivated to give a warning here directed at the many young people who are taking out a mortgage for the first time. Currently you are being courted aggressively by the banks and offered some very good interest rates which your parents could only dream of. But what you probably don't know is that here in little old New Zealand interest rates can move around quite a lot and just as we can all gape in wonder at the beauty of low interest rates, so too in the past have we looked in horror at skyrocketing rates.



For instance, while floating rates currently are near 5.8%, back in mid-2008 they were on average 10.9%. We do not see a return to such rates in the next few years – but then none of us picked the sharp decline in rates over 2008-09 or even this most recent round of cuts in fixed interest rates. So if you are making your home purchase decision on the basis of the current low level of interest rates continuing for many years you are gambling against the odds and should run a scenario of how you would be left if the floating rate went to 8.5% in say three or four years time.

There is little you can do about that possible scenario currently given that the cost of fixing five years is simply too high to digest at 6.5%. But it adds up to a very strong recommendation that you use the cash flow advantage provided by current low borrowing costs to reduce your principal as quickly as you can and put holiday and major appliance purchase plans on hold for the first five years of your mortgage. Your priority is putting yourself into a position where you will not lose your house in five years if interest rates jump up, your employment takes a hit, and house prices ease back. Like the government trying desperately to build a fiscal buffer ahead of the huge costs (and tax rises on young folk) to come as the Baby Boomers enter an Abe Simpson-like gimmee phase, you also need to build a buffer for your home. Unlike me, you don't need that 65 inch TV.

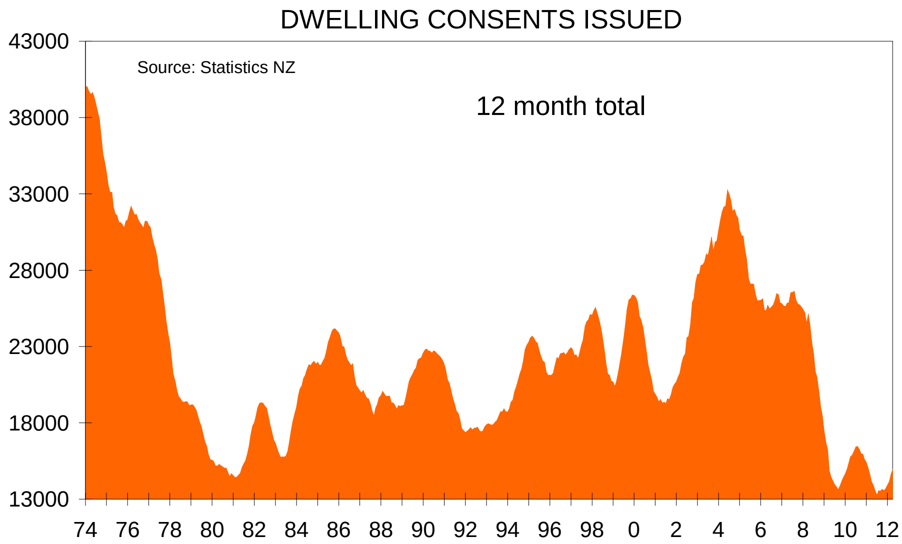
HOUSING MARKET UPDATE

- **To view the most recent results of our monthly BNZ-REINZ Residential Market Survey click here.** http://tonyalexander.co.nz/bnz-reinz-survey/
- **I also write a monthly column on the residential property market in NZ Property Investor magazine available at your bookshop or newsagent.**

Nothing Much New

Fresh news on the state of and prospects for the NZ housing market has been almost absent this week apart from consents data discussed below. So for insight I simply refer people to last week's commentary which fairly much sums up how I think things are currently – a rising market spurred by shortages, awareness of shortages, young buyers catching up after four years siting on their hands, investors following these buyers, and now a new wave of investors coming in as a result of interest rate cuts making property stack up very well in an otherwise low return uncertain investment climate.

In April there was a seasonally adjusted fall in the number of consents issued for the construction of new dwellings of 7.5% which followed a rise in March of 19.6%. But the March result and probably February's also, was biased upward by people getting in consents before a cost-raising increase in building standards. Therefore although in the three months to April consent numbers rose in seasonally adjusted terms by 10.2%, the true underlying rise will be somewhat less than that.



In the year to April consents totalled 14,932 compared with a four decade low of 13,269 in July last year and 14,138 a year ago. In the three months to April the number of consents issued for Canterbury was ahead 57% from a year earlier and Auckland was ahead 39%. The rest of the country excluding those two regions was ahead by 23.6%.

MAJOR OFFSHORE ISSUES

Europe

Things are so bad in Europe that investors are flooding so much money into Germany the German government is now able to sell its two year bonds at 0% interest rate.

Last week the OECD cut their forecasts for growth in the Eurozone. Shrinkage of 0.1% is forecast for this calendar year with growth of only 0.9% in 2013. The previous forecasts were near equally tepid rates of +0.2% and 1.4% respectively. They see the unemployment rate rising from the current 10% to over 11%. Reflecting my own warning here regarding the impact on financing costs should governments agree to boost deficits in the short term they warned “Given the persistent long term deterioration of public finances, there is no room for discretionary measures to offset the economic weakness without risking an upsurge in borrowing costs.”

In other words this is the horror scenario spoken about a lot in 2010 when things appeared to be improving. What we noted back then was that if some new big shock should come along the ability of many nations to fight it would be radically constrained by the inability to boost deficits without causing soaring interest rates, little scope to cut interest rates from already low levels, and the uselessness of printing money when people would not want to spend it anyway.

The OECD, like others, are left suggesting only the relatively extreme measures of having the ECB effectively print more money to support existing firewalls (ready to use bailout funds), and print money again by buying government bonds. If printing money is the only answer – then there is no solution. Pain will come because of loss of faith in the currency – which is almost the point reached with the Euro anyway. Current worries about its ability to remain the currency for all 17 Eurozone members can only be enhanced if it is deliberately debased by making more of it.

A run on Spanish banks appears to be slowly developing with more and more discussion of people and businesses shifting some of their €1tn in deposits in Spanish banks into pounds or into deposits with predominantly German banks. Greece has already lost one-third of its bank deposits and outflows are reported to be very high each day.

During the week Spain's fourth largest bank Bankia said it needs a €19bn capital injection. But one bright spot was the release of polls in Greece showing a shift in voter preference toward parties supporting the bailout conditions.

So much pain and so grave a threat to the Eurozone and even the European Union from a country accounting for only 2% of EU GDP. Astounding.

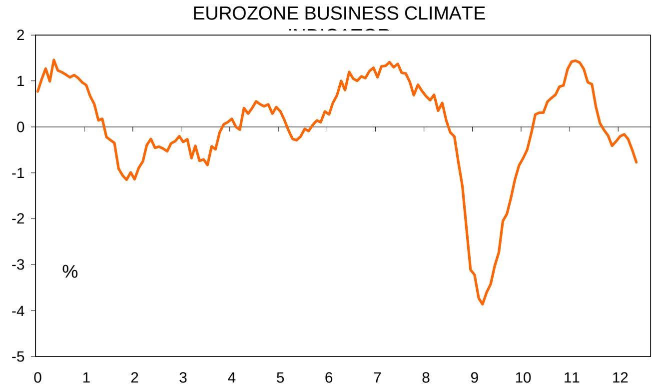
The Bank of Spain Governor (who I did not bump into when visiting said institution a month ago) resigned last night citing a campaign being run against him and his actions by politicians – thus throwing the Spanish banking crisis into an even deeper hole.

One of the reasons an exit of Greece from the Euro is becoming inevitable is that it is simply not possible to achieve the pain-spreading growth boosting benefits of a currency depreciation via falling wages. First it is hard to quickly cut wages by 40% - 60%. Second, if wages fall only those on wages feel the pain. Others may feel little and of course not all wages will decline equally. But most importantly, falling wages do not produce the incentive to purchase newly relatively cheaper domestically produced goods that a currency decline does.

That is, if one's currency falls 50% imports double in price and one will likely shift to buying a local product if available. If wages fall 50% then while the price of the locally produced product is likely to decline it will fall only by the extent wages make up the final price and that could be less than one-third of the shop counter price.

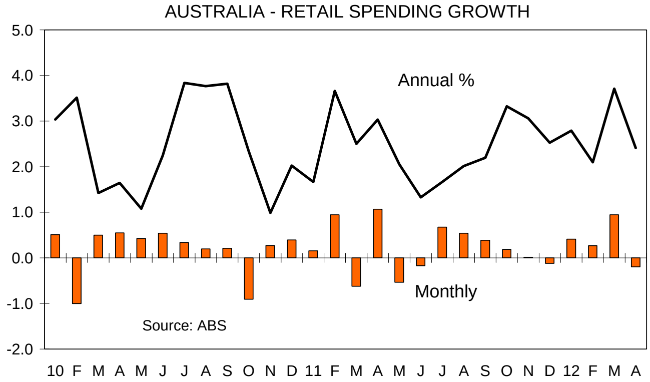
Cutting wages – internal devaluation – cannot achieve what a currency decline can and that is why if Greece remains in the Euro the vital economic adjustments necessary to achieve a more stable (but revealed poorer) economy will either not occur or take many years to appear. The longer the adjustment takes the more local businesses will close and industry knowledge and capital needed to start again will disappear.

Meanwhile sentiment in Europe continues to decline with one measure – the European Commission Business Climate Indicator falling away to a two and a half year low in May.



Australia

I had time to take a look at data coming out of Australia this week – but there was practically none apart from retail sales falling 0.2% in April rather than rising the expected 0.2% - thus showing the weakness in Australian household spending.



So I went looking for more data on the Australian Bureau of Statistics website. All I found of interest was this link through to statistics on Aussie rules games! As far as I know there are no strong Kiwi accents presenting the material so one is unlikely to be angered into punching anyone out – even though statistical analysis around the probabilistic payoff from sticking one on the face of an opponent on the field could be interesting. http://www.abs.gov.au/websitedbs/a3121120.nsf/51c9a3d36edfd0dfca256acb00118404/5b3657b0c50558a1ca25791a0080c50c!OpenDocument

United States

US average house prices across the 20 largest cities were down 0.1% in March after falling 0.2% in February and now sit 35% down from their peak and 2.6% lower than a year ago. The monthly rate of decline in house prices has clearly slowed but as yet there is no clear upward trend in prices in place. Other more up to date measures are however suggesting an improvement could be occurring and if that is true then it will go some way to bolstering household spending at a time when the improvement in the labour market has pulled back recently.

I'd put a graph here but am struggling to get monthly Case Shiller data now as they only publish quarterly numbers with a lag on their website and to date have not updated anything beyond June 2011. Some sort of pay for the privilege thing I guess.

China

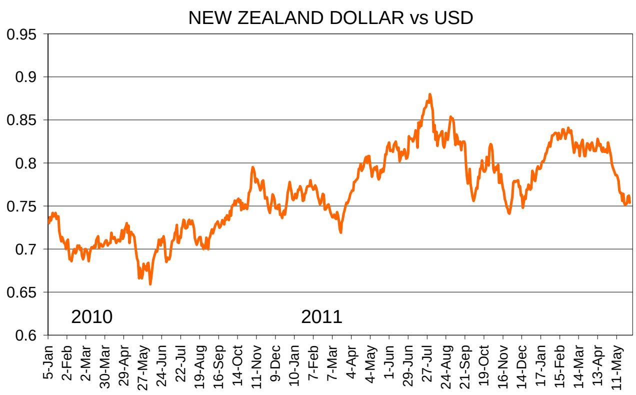
Chinese economic developments are now covered in our new publication "Growing With China", the last issue of which appeared on May 22. If you wish to receive this monthly then please email me specifying your name, company name, and connection with China. Tony.alexander@bnz.co.nz

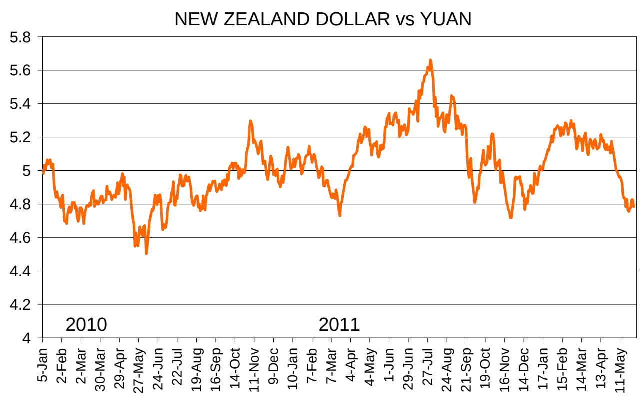
Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.754	0.751	0.824	0.836	0.821	0.67
NZD/AUD	0.776	0.770	0.787	0.778	0.764	0.85
NZD/JPY	59.600	59.700	66.100	67.200	66.4	69.6
NZD/GBP	0.487	0.479	0.506	0.526	0.497	0.388
NZD/EUR	0.609	0.597	0.622	0.621	0.571	0.52
NZDCNY	4.782	4.755	5.175	5.267	5.323	4.99
USD/JPY	79.045	79.494	80.218	80.383	80.877	105.7
USD/GBP	1.548	1.568	1.628	1.589	1.652	1.72
USD/EUR	1.238	1.258	1.325	1.346	1.438	1.28
AUD/USD	0.97	0.98	1.05	1.07	1.07	0.788
USD/RMB	6.3425	6.3318	6.2806	6.3003	6.4839	7.56

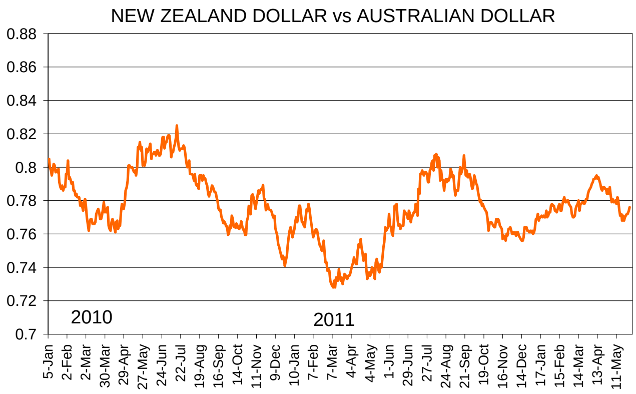
Worries Growing, Growing, and Growing

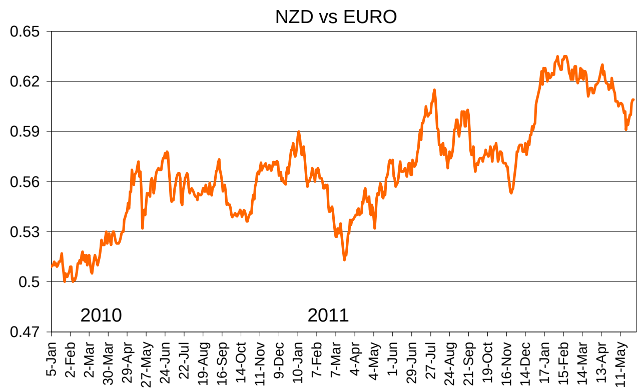
The Kiwi dollar fell this week. Reason = increased worries about Europe. This equation is so simple and has been in operation now for four years. When worries about some major part of the global economy go up the NZD and other risky volatile currencies such as the AUD go down. So our fall from US 82 cents last month to the current rate just over 75 cents reflects almost entirely the surge in worries about Europe. There is also some mild downward pressure from falling NZ commodity prices and our own weak data showing the NZ economy gathering no momentum outside of housing.



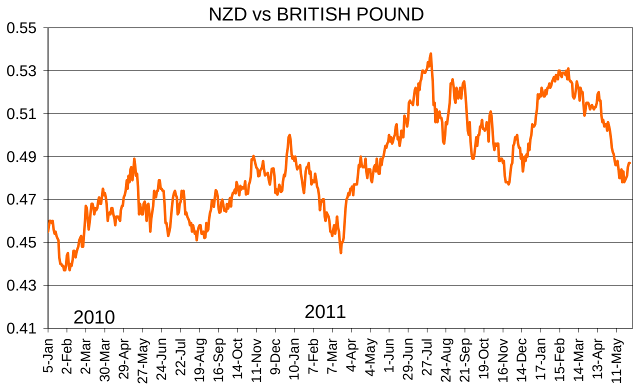


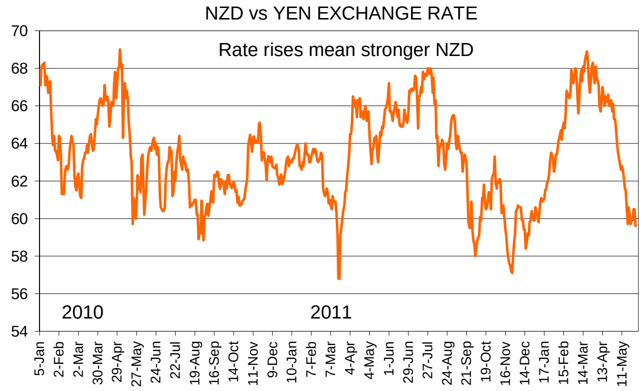
Ask yourself – is this how you want your economy to grow, on the back of a housing surge rather than escalating investment or exports? Not really. Hence watch for the coming year bringing discounting of the positiveness in our economy on the back of the rise being unsustainable because it is being led by yet another upward leg in our sometimes violent housing cycle.



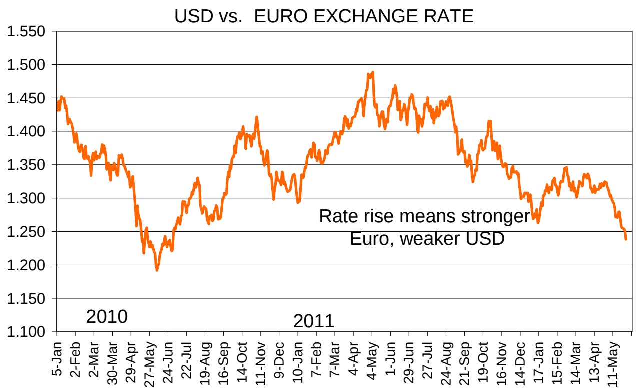


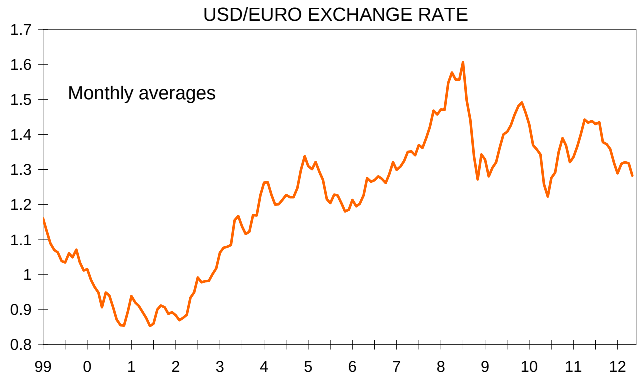
Still, having said that, I feel personally very relaxed about having my investments largely currently in NZDs plus in a mixture of cash and residential property rather than equities. Others may prefer equities but hopefully acknowledge that there will be some big ups and downs along the way. Facebook shares anyone?





As for the NZD's movement against other currencies during the week, we have changed by very little apart from a slight rise against the latest global dog currency – the Euro. The Euro is now at a near two year low against the greenback and highly likely to go lower in the near future as the markets now digest increasingly weak data to come out of the Eurozone.





Exchange Rate Assumptions

This table contains the latest NAB currency forecasts. In red I indicate where I believe the risk lies for these rates. You are welcome to toss your own coin and generate an equally valid table.

	2011	2012	Risk	2013	Risk
Year end					
NZD/USD	0.77	0.83	Higher	0.75	Higher
NZD/AUD	0.76	0.85		0.82	
NZD/YEN	60.0	71		60	Higher
NZD/GBP	0.50	0.52	Higher	0.49	Higher
NZD/EUR	0.60	0.61	Higher	0.54	Higher
USD/JPY	78	85	Lower	80	Lower
GBP/USD	1.54	1.58	Lower	1.56	Lower
EUR/USD	1.30	1.35	Lower	1.38	Lower
AUD/USD	1.01	1.00	Higher	0.95	Higher

Key Forecasts

Dec. year		**2010**	**2011**	**2012**	**2013**
GDP	annual average chg	1.2	1.1	1.5 – 2.2	2.5 – 3.5
CPI	on year ago	4.0	1.8	2.0 – 2.6	2.5 – 2.9
Official Cash rate	end year	3.0	2.5	2.50	3.00 – 3.75
Employment	on year ago	1.3	1.6	1.0 – 1.7	1.5 – 1.9
Unemployment Rate	end year	6.8	6.4	6.0 – 6.5	5.0 – 5.6

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 26,000 subscribers each week and is one of a stable of regular releases which include the

- monthly Growing With China publication, http://tonyalexander.co.nz/topics/china/
- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/ and the
- monthly BNZ-REINZ Residential Market Survey. http://tonyalexander.co.nz/topics/surveys/bnz-reinz-survey/ This latter survey provides information from a survey of over 10,000 licensed real estate agents on the current state of the residential property market in New Zealand.
- He has also written a weekly newspaper column since 1998, http://www.stuff.co.nz/business/opinion
- writes a column for the Farming Show posted at http://www.farmingshow.com/opinion/
- produces a monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.co.nz/ and
- writes a monthly column for the NZ China Trade Association. http://www.nzcta.co.nz/

Most of these publications plus research into impediments to NZ's economic growth are available on his website. www.tonyalexander.co.nz

Tony Alexander has been Chief Economist at the BNZ since 1994 and apart from publications and advising management spends considerable time on the road around New Zealand making presentations and speaking with the media. He travels to the UK and Europe twice a year to assess economic conditions and present at numerous functions, has five children, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com

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