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.

Some Learnings

Here are some thoughts on NZ fundamentals developed over the past couple of decades analysing and commenting on our little economy.

Shocks keep coming and it is impossible to pick what, when, how long, how bad, and when recovery occurs. Consider the 1987 sharemarket and property market crashes, Asian Crisis and drought of 1997/98, the 2001 terrorist attacks, SARs and Iraq War of 2003, global financial crisis of 2008,earthquakes, the weakness of the post-GFC recovery. More shocks will come and businesses need to build resilience to cost and revenue shocks.

Exchange rates cannot be reasonably predicted. The NZD has floated for 27 years and in spite of a persistent current account deficit and implications of the interest rate parity theory (high rate countries eventually see their currencies fall) the NZD has remained strong. In fact even our long term assumptions of a decline are now challenged as Asian middle income growth means we see rising NZ terms of trade long term and are happy about our primary sector export base whereas from the 1970s we expected falling prices and hoped for manufacturing export dominance.

The NZ lifestyle is attractive to many in the world but to enjoy it you need to live here and that means trying to own a house and investing in other houses in expectation others will be wanting to live in them. We do not support policies which undermine our wealth by cutting house prices. Our house prices therefore will stay high. Similarly farm prices will stay up and trend upward under most scenarios except a foot and mouth outbreak as limited supply means better returns get captured in asset prices.

Our lifestyle choice embraces not just the outdoors and standalone houses but full blown consumerism as well which we can only afford to pursue by raising debt. Therefore it is unsurprising that the NZ household savings rate has turned negative again, our dependence upon foreign financing will remain, and NZ interest rates will on average sit above those in most other countries.

We only embrace radical change when we feel collapse is imminent. Given that we congratulate ourselves on having undertaken reforms in the 1980s which other countries are struggling now to emulate, and feel we have weathered the GFC well, there is no NZ appetite for big policy changes. The broad policy status quo will continue until our next truly large crisis which to generate policy change will need a financing element – offshore savers no longer willing to fund our over-spending. It may take a couple of decades to reach that point.

No investment is truly safe and history does repeat itself in the form of people chasing returns too good to be true (Ross Asset Management, some finance companies), and investing in things with elements of risk they do not fully understand – commercial and residential property investment schemes, forestry (a personal experience).

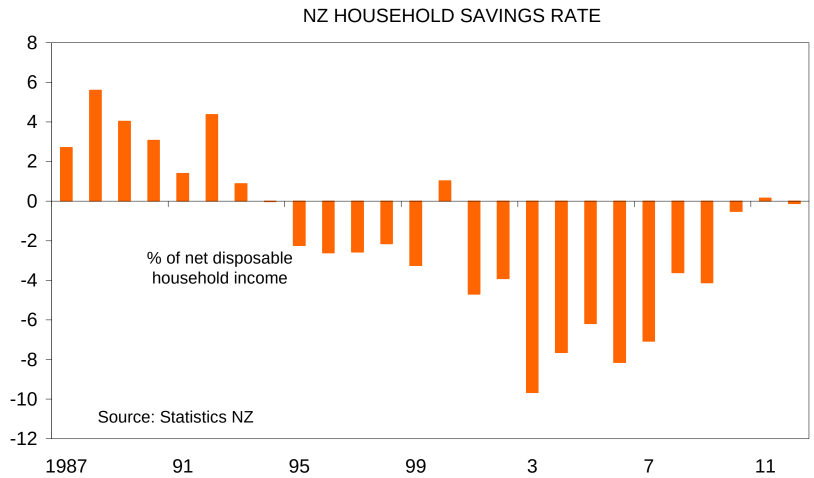
Restraint on our ability to raise productivity and therefore income per capita comes no longer from the regulatory environment (though red tape is still excessive and the RMA a growth killer) or institutional framework, but from our poor managerial skills, Kiwi business culture, and lack of connectivity (interaction of people) with the rest of the world. Getting up the income ladder therefore requires efforts to be focussed in these areas rather than the likes of the taxation framework, monetary policy, or fiscal policy.

Middle income growth in China and Asia more generally and the permanent shifting of the planet's economic centre to our doorstep presents the growth opportunity we have been waiting for since the end of the 1950s Korean War wool boom. History however says we won't grasp the opportunities presented – but this will always be a good place to live – so long as our children retain the option of shifting to Australia.

INTEREST RATES

No significant data releases have occurred in New Zealand over the past week and the news offshore has not led to any substantive changes in interest rate expectations. Therefore wholesale interest rates today sit largely where they were a week ago and our outlook remains the same – the next change in the Reserve Bank's official cash rate is more likely to be upward than downward and that move may not come until 2014 given some of the recently weaker than expected NZ data on retail spending and the labour market. A key factor staying the hand of the Reserve Bank is the rising housing market represented by rising prices which will spread out of Auckland, rising construction soon set to boom, and accelerating growth in not just household borrowing but for businesses as well.

In fact yesterday we received the National Accounts for the year to March 2012. Among many things they show that the household savings rate which improved from -8.2% in the year to March 2006 to a wonderful +0.2% in the year to March 2011 is now back into negative territory again at -0.1%. Kiwis may have sat watching the biggest global financial crisis since the 1930s, may have felt some of it, and may have altered their spending behaviour in response to it. But as warned over the past four years, one would be bold to conclude at this early stage that the shock has been big enough to cause a substantial sustained change in the household savings rate. And with house prices rising again and people asking their investment advisors more and more about how to get property exposure, more gearing up lies just around the corner. That means faster household debt growth, a rising household dissaving rate, and eventually extra upward pressure on interest rates, extra upward pressure on the exchange rate, more deterioration in the current account deficit, rising net external indebtedness, and eventually another credit rating downgrade 2 – 4 years from year. 9That latter view started a year ago with a 3-5 year timeframe.)



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	2.67%	2.67	2.66	2.67	2.76	5.7
1 year swap	2.60%	2.55	2.51	2.69	2.56	5.8
3 year swap	2.83%	2.76	2.73	2.92	2.92	6.1
5 year swap	3.12%	3.05	3.03	3.28	3.44	6.3

HOUSING MARKET UPDATE

This week we have not received any fresh data on the state of the housing market in New Zealand and our views remain the same. There is a shortage of housing concentrated in Auckland and although construction will rise this shortage will continue for a very long time. This will bring rising prices, rising rents, deepening social problems, and a shifting of both older and younger people out of Auckland to other parts of the country as happened in the 1990s.

If I Were A Borrower What Would I Do?

Sit floating or fix for one year at 5.25%. But one would also keep an eye open for a discounted long term fixed interest rate in order to get some certainty about cash flows during these continuing uncertain times and because at some stage interest rates will blip up. But we do not appear remotely near that point yet so borrowers look like facing good conditions well into 2013.

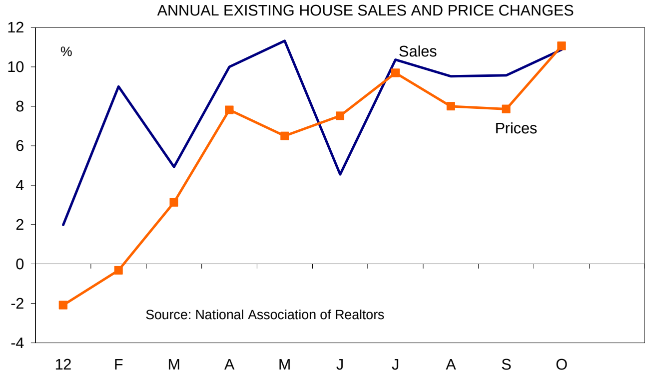
OFFSHORE

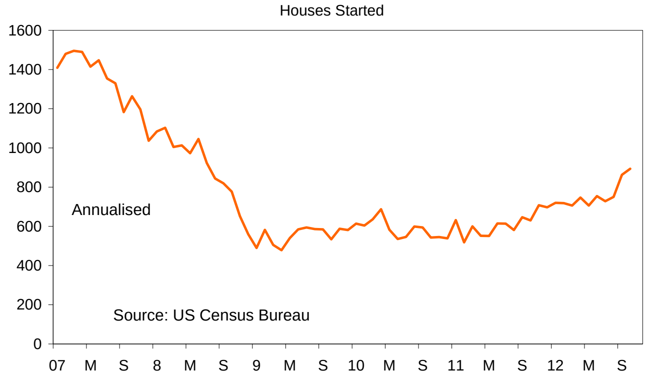
Europe is officially back in recession with Euro-zone GDP falling by 0.1% during the September quarter after declining by 0.2% in the June quarter. The relevance of this development to ourselves is that easy growth opportunities for NZ businesses in Europe remain limited, the Euro will remain weak against a Kiwi dollar supported by good commodity price expectations and a few other factors, and European interest rates will remain low for potentially a great number of years. This will tend to keep NZ interest rates low as well which perversely means extra support for the NZ housing market.

Potential for the European growth path to change by much in the near future is limited with “temporary” fiscal policy stimuli having been applied for decades since the 1930s – leading to the current situation where misplaced faith in the ability of governments to stimulate growth has retarded and continues to retard the implementation of market-freeing changes which can boost growth. Greece, Spain, Portugal and Ireland are not actually the worst examples of this phenomena. That prize would go to France. The former countries suffer less from blind faith in the ability of governments to deliver growth while pursuing egalitarianism than corruption, protection of elites, and a European partner-embracing dependency mindset. France however believes government can deliver.

A day after writing this Moodys gave their view on France and the direction of government policies with a one notch credit rating downgrade to Aa1 which followed the same cut by Standard and Poors back at the start of this year. Meanwhile European Finance Ministers have failed to agree on a plan to (yet again) reduce Greece’s debt, and couldn’t reach agreement either in negotiations for the European budget.

In the **United States** the data continue to fall in a pattern suggesting that the labour and housing markets are turning for the better with consumer spending showing some life. Existing home sales for instance rose by a better than expected 2.1% in October, the median sales price rose at its fastest annual pace in seven years with a gain of 11.1% from a year earlier, and the inventory of unsold dwellings fell to the lowest level in almost a decade at 5.4 months worth of sales.





Additionally the annualised number of dwelling starts rose to the highest level since 2008 in October to lie 42% ahead of a year earlier.

But businesses remain cautious in their investment plans and willingness to raise debt and capital, and all eyes are on negotiations aimed at smoothing a deeply necessary tightening of fiscal policy rather than having a brutal 5% of GDP fiscal restraint applied from January 1 next year – just six weeks away. In that regard this week we have seen a wave of optimism sweep over the markets associated with a developing view that agreement to slowly phase in a fiscal tightening may be easier to reach and implement than thought. One certainly hopes so as having the US economy slip back into recession would not be very positive for world growth.

Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.814	0.811	0.818	0.806	0.778	0.67
NZD/AUD	0.785	0.781	0.788	0.768	0.763	0.85
NZD/JPY	67	65	64.9	63.4	60	69.6
NZD/GBP	51	0.511	0.508	0.514	0.489	0.388
NZD/EUR	0.634	0.636	0.626	0.654	0.571	0.52
NZDCNY	5.07	5.05	5.11	5.13	4.94	4.99
USD/JPY	82.31	80.15	79.34	78.66	77.12	105.7
USD/GBP	0.02	1.59	1.61	1.57	1.59	1.72
USD/EUR	1.28	1.28	1.31	1.23	1.36	1.28
AUD/USD	1.04	1.04	1.04	1.05	1.02	0.788
USD/RMB	6.2258	6.23	6.248	6.36	6.3552	7.56

Other Currencies Bad

For the past few years we have usually expressed a view for where the Kiwi is likely to go against the USD, GBP, Euro, and AUD – but not against the Japanese Yen. That reflected uncertainty about balancing the positives of low inflation (deflation) and trade surpluses against essentially zero interest rates, limited growth, and political sclerosis. However the balance of factors is shifting more now toward weakness in the Yen – meaning appreciation of the NZD against the Japanese currency. The political situation is as dysfunctional as ever and a new general election has been called for the middle of December, growth remains bad (the economy shrank by 0.9% during the September quarter and is expected to shrink 0.1% this quarter), but the trade surplus has gone and with a possible change in Bank of Japan Governor soon a boost in money printing may be on the way.

So the NZD/JPY exchange rate could undergo some interesting upward movement in the near future. As for currency movements this past week – nothing worth reporting.

Key Forecasts

Dec. year		**2011**	**2012**	**2013**	**2014**
GDP	annual average chg	1.3	2.0-3.0%	2.0 – 2.5	1.0 – 2.0
CPI	on year ago	1.8	1.3	2.2 - 2.9	2.5 – 3.5
Official Cash rate	end year	2.5	2.5	2.5 – 2.75	2.75 – 4.25
Employment	on year ago	1.6	0.0 – 0.5	1.0 – 2.0	0.5 – 1.5
Unemployment Rate	end year	6.4	6.5 – 7.0	5.5 – 6.0	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 27,000 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, search www.stuff.co.nz
- 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
- Discussion of New Zealand's relationship with China can be found here. www.facebook.com/TonyAlexanderNZ

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, tramps, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com

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