Weekly Overview

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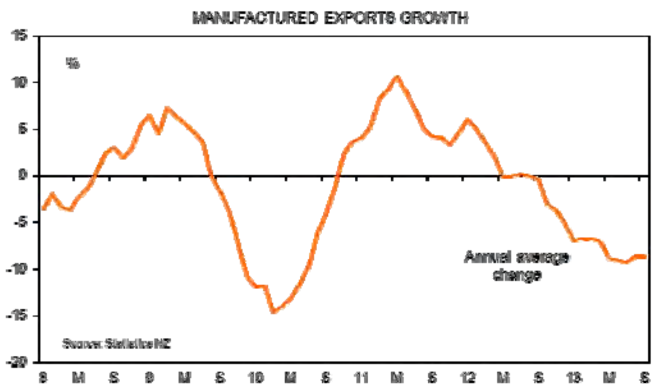
Mission Statement

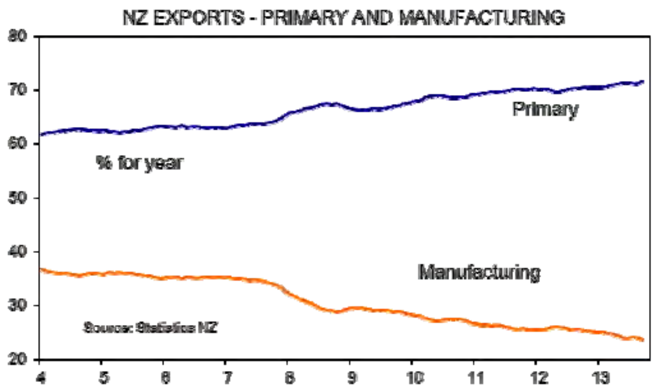
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

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/lFdYSs5FGEq4kAjP95uzTA

Primary Primacy

For your guide, every now and then I take a look at the export data broken down by the level of processing of goods. In the year to September the value of non-primary manufactured goods exported from New Zealand was down by 8.6% from a year earlier. Manufactures now make up just 23.6% of merchandise export receipts compared with 36.9% ten years ago. New Zealand is getting more and more dependent upon primary sector exports and the chances of this trend changing are very small given that what the rest of the world and China in particular wants from us is those primary goods. They might also want some of our manufactured goods. But when they really want them the offshore buyers or those who service them might simply buy the company and ship it offshore. One can't do that with a farm. Hence the importance of Kiwi ownership of our farm assets.



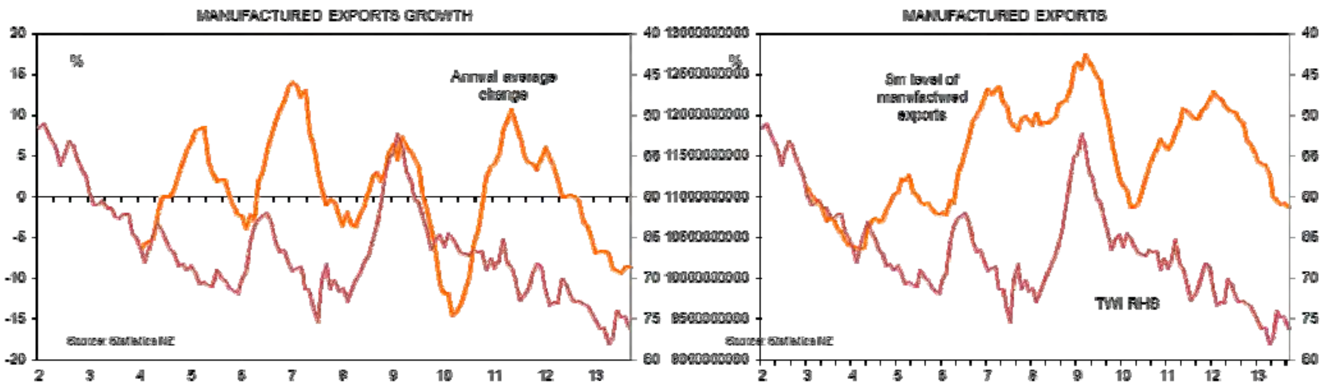


When we break the manufactured exports down into those that are simply transformed and those which are elaborately transformed there is no improvement in the picture. The former now make up 8.7% of all goods exports from 14.8% a decade ago. For elaborately transformed manufactured exports the change is to 14.9% from 22.1%.

Manufacturers often cite the high NZ dollar as the cause of their weakness. Is there a strong correlation between changes in the NZ dollar and manufacturing output (if not profit)?

The first following graph shows the monthly average level of the trade weighted index measured on the right hand side upside down and shown as the dark purplish line. The orange line measured on the right hand side shows the annual average change in non-primary manufacturing exports. If exchange rate movements were a big determinant of manufacturing exports then these lines would move broadly together though with the TWI line changing before the exports line.

With the manufacturing data starting in 2004 (annual average change calculations need two years of data) we see rising exports then falling in spite of a sustained rise in the TWI from 2002 until the end of 2005. The TWI then starts falling and exports soar. The currency then rises from 2006-2008 and exports fall away. The TWI then falls sharply but exports collapse clearly because of the GFC. Exports then recover from the slump but have been falling away since 2011 as the TWI has trended upward again as it did from 2002 – late-2005.



Personally I see a correlation there between currency strength and manufacturing export weakness. The second graph plots the TWI against the $ annual total of manufactured goods exports. Extreme TWI weakness shown as the high points for the TWI line tend to lead strength in exports.

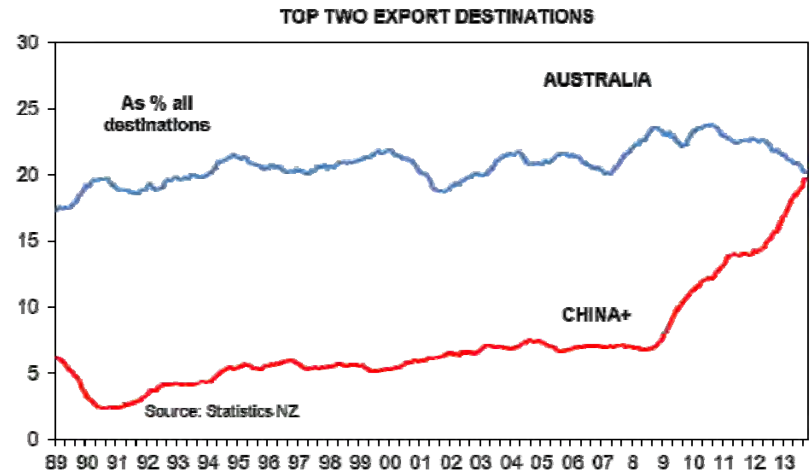
Yes, the high NZ dollar is negatively affecting New Zealand's manufacturing base. While good ground was recovered over 2010-11 frankly this looks like just a post-GFC return to normality with that normality being a fairly strong downward trend in our manufactured exports. Note the early-2012 peak being below that in eraly-2009.

Given the risk that the NZ dollar remains strong going forward against all currencies bar maybe the Aussie dollar and Chinese Yuan, we should expect this worsening trend to continue and therefore manufactured exports over time to fall from their current 23.6% of merchandise exports to below 20%.

New Zealand will become more and more dependent upon primary sector exports therefore policies in this area need to be world leading in order to mitigate the rising risks to our economy from some of the inherent characteristics of primary sector exports. These include their vulnerability to pests and diseases already here and those which could bypass biosecurity, trade rule changes, food safety and quality scares as seen on a number of occasions now with Fonterra, price vulnerability to supply shocks from overseas competitors, and disruptions to shipping zones in the event of regional security issues. Which leads into the following…..

Bye Bye Australia, Ni Hao China

Back in October 2008 when the Free Trade Agreement between NZ and China came into effect China including the Hong Kong Special Administrative Region (I call this China+) took 7.1% of our merchandise exports. One year ago that proportion had soared to 15.6%. Now it stands at 19.7%. Our exports to Australia account for 20.2% of export receipts from 21.8% one year ago and 23.6% five years ago. At this pace of change right now as you physically read this sentence China is passing Australia to become our most important export market. The relationship will never go back the other way.

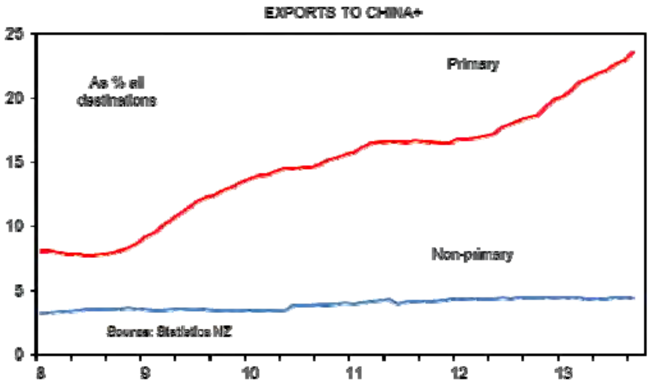


New Zealand is a primary exporting nation heavily dependent upon maintaining good relations with export destinations to ensure markets stay open, that phytosanitary rules do not unfairly penalise our products, and that we can quickly regain credibility when quality concerns arise. The focus of our trade relationship efforts has shifted more and more to China in recent years and from here on out the considerations of China in terms of end-buyers, distribution networks and arrangements, and the China Communist Party as current rulers has achieved paramountcy.

For which primary sectors is this market dependency the greatest? The following list shows the proportion of the products listed going to China+ and the rate of growth over the past year.

	% which Go to China+	Growth past year %
Live animals	45	-8
Meat	17	117
Seafood	33	5
Dairy	28	29
Fruit & Nuts	10	-14
Raw hides & Leather	39	-7
Logs	47	55
Wood Pulp	26	-14
Wool	53	4

Note that when it comes to analysing exports to China you'll now and then find an interesting article regarding non-primary products – but they are a rarity as these following two graphs show.



Just a thought. The Australian Attorney-General over the weekend announced that there would be no reconsideration of the previous Labour government's decision to ban large Chinese telecommunications firm Huawei from participation in Australia's National Broadband Network. There are fears that with Australia's close military involvement with the United States that Huawei would spy. But they may as well let them in given that the Americans are already spying on everyone everywhere bar perhaps inside China currently. And eventually someone like Julian Assange or Edward Snowden is going to post one's secrets online. It seems the default setting with regard to telecommunications these days is that we are being monitored – just like China's internet for which two million people are employed in a censorship role.

Speaking of censorship – in China this appears to mainly take the form of preventing outbreaks of bad-think spreading. Raising issues appears to be fine but it is their spread which the army of two million seems to knock on the head. The desire to stop potentially "destabilising" spreading of discontent which the internet facilitates so well means that maybe the authorities will be more willing to move in areas such as pollution and land seizures than was previously the case. Otherwise people will feel more disempowered than usual and four million censors might be needed.

With regard to land seizures, the China Data Centre under Tsinghua University this week released the results of a survey of 12,540 people in 31 provincial regions. The survey results apparently indicate that in China 64.3 million households have experienced either land acquisition or home demolition. Only 3.9% of

the farmers losing their land were offered job opportunities. Only 1.8% of those who lost their homes received such compensation. http://www.globaltimes.cn/content/820968.shtml
I assume the content is at this web address. My server won't let me access it – or just about any website from China actually, which is sort of ironic given censorship the other way around.

Urbanisation of some 10 – 15 million people a year in a very short period of time is causing major changes in China though in the West we tend to think mainly in terms of the opportunities to sell consumer goods such as quality food and services to the growing millions of urbanites and middle income households. Behind the huge success of China in raising its people from poverty lie many stories of loss which we tend to tut-tut about then push to the side as we seek higher sales.

In Australia a report just released by KPMG and the University of Sydney entitled "Demystifying Chinese Investment in Australian Agribusiness" finds that 11% of Australia's farmland is owned offshore including 1% owned by Chinese interests. The percentages are not complete given that they do not include holdings of below $5mn though the authors note that such blocks tend to be small farms of low economic value. http://www.theaustralian.com.au/national-affairs/policy/china-land-grab-hidden-by-corporate-veil/story-fn59nm2j-1226748527558

As a reminder, here are key results from my work earlier this year on foreign activity in the NZ residential real estate market.

Agents estimate that 3.6% of the vendors they represent are located offshore. They also estimate that a gross 9% of sales are to people offshore.

	May	**March**
First home buyers	23%	24%
Investors (all sources)	19%	19%
Offshore	8%	9%
Other	50%+	48%+

But given their estimate that many of the buyers offshore intend shifting here we get our estimate that about 3.5% of sales are to offshore investors if we run the assumption that half the Don't Know responses to the question are investors and half are not.

	% who intend shifting here	
	May	**March**
Australia	54	51
China	38	37
Europe excl. UK	38	39
India	32	30
Other Asia	30	23
South Africa	48	53
United Kingdom	65	69
United States	15	19
Other	10	6

Running these numbers gives the estimate that about 0.7% of all dwelling sales are to investors in Australia and 0.7% to investors in China. The first column in the table below shows the proportion of the vendors real estate agents represent in New Zealand who are located offshore. The second column shows where their foreign buyers tend to come from. This shows a similar spread of foreign buyers and vendors. The third column shows the percentage of all dwelling sales in New Zealand estimated as going to people in the countries listed who have not indicated that they plan shifting to new Zealand.

	Vendors %	**Buyers %**	**% All NZ Dwelling Sales To Offshore Investors**
Australia	22	22	0.7
China	16	20	0.7
Europe excl. UK	10	8	0.3
India	7	7	0.3
Other Asia	11	9	0.4
South Africa	6	7	0.2
United Kingdom	12	13	0.2
United States	11	6	0.3
Other	5	8	0.4

I am not certain but it is possible that someone in Auckland is looking at undertaking some more detailed work into finding out the proportion of sales going to overseas interests and this is a welcome development as the work I did in this area from February through to May is preliminary only in nature and needs refining.

Getting Ahead

Running with the theme that the best investment one can make is one's education, training and career rather than a financial portfolio, this week we offer a comment to younger readers. You have passed through a school system devoted to telling you as often as possible how great you are. You'll have received screeds of certificates saying exactly that and hopefully along the way the teachers stepped back from their focus on societal inclusiveness and your feelings to teaching you how to read, write, count and analyse in a critical manner.

Now you hit the real world after school or university and need to realise that New Zealand's culture is not one in which praise flows easily. In your workplace you will receive feedback, but it will almost exclusively be in the context of formalised annual and/or quarterly assessments. You will only rarely get casual positive feedback. That is dispiriting enough. But you will also not too often receive negative feedback. In this way you run the risk of getting locked into some bad behavioural and work performance patterns without anyone correcting you and pointing you in the right direction.

Why is this? The poor human resource management abilities of Kiwi employers arise partly because in our culture we are wary of relationships of superiority and inferiority. We don't like telling people they are doing poorly because those people might then think we are "up ourselves". We don't like giving positive feedback because the recipient then might get up themselves and feel superior to us. So we keep our mouths shut.

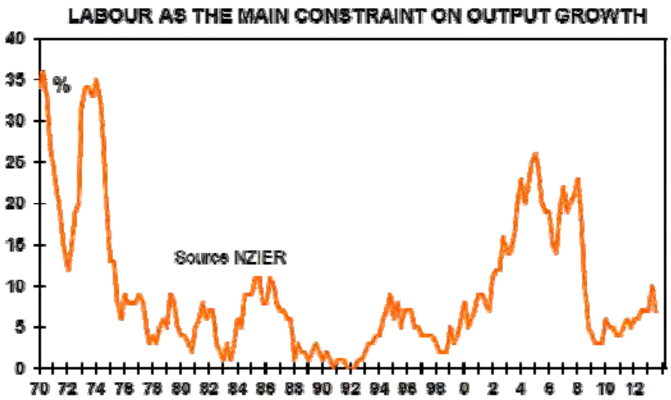
This tendency of lack of communication coupled with our general lack of emotiveness is very difficult for migrant employees to understand, some of whom we as employers steer well away from because those from some cultures may appear much too obsequious for us to feel comfortable with. Returned Kiwis are often baffled by our unwillingness to greet them with open arms and seek to make best use of the skills and connectivity which they bring. We don't do that because we already think repats are up themselves having gallivanted around the world for a few years while we did the hard yards back in NZ, and if we praise them they will get even bigger heads.

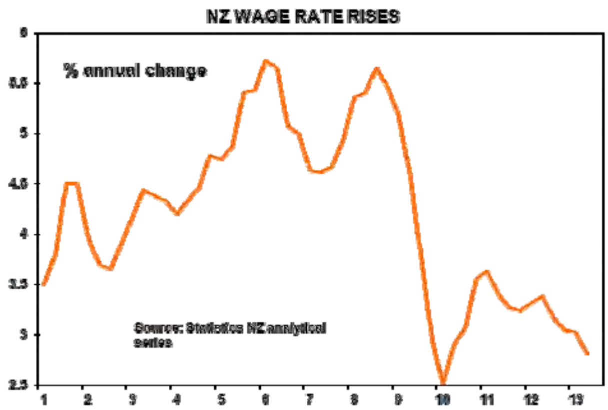
And as mentioned, for young Kiwis entering the workforce the situation is not much better. The message then to young people is not to sod off overseas where someone may praise you more and give better tips on how you can improve your performance. Instead recognise that there is a world of difference between the school system and the workplace. Keep your head down to avoid looking cocky, pay close attention to how others operate, and if you really want to get ahead then find someone with the knowledge you want and stick to them like glue.

IF I WERE A BORROWER WHAT WOULD I DO?

While people tend to believe that our central bank tightens monetary policy because of rising house prices that is only relevant to the extent that rising house prices are correlated with rising costs of home ownership and construction, and rising spending from increasing paper wealth. Inflation ultimately comes from the interaction between the rate of growth in demand for resources and the rate of growth in their supply plus improvements in productivity – plus lots of institutional factors thrown in. In that regard is there evidence of a good quantity of resources available to handle the strong growth we expect in the next few years?

The unemployment rate of 6.4% is above the ten year average of 4.6% so one might say wages pressure will be low. For the moment it is with one measure ahead just 2.8% in the year to June compared with an average rise of 4.2% the past ten years and a 3.4% rise a year ago. Plus just 7% of respondents in the recent NZIER QSBO said that labour is the main constraint on their ability to grow output. This is below the ten year average of 11.4% and well below rates between 20% and 30% from 2004 – 2007.

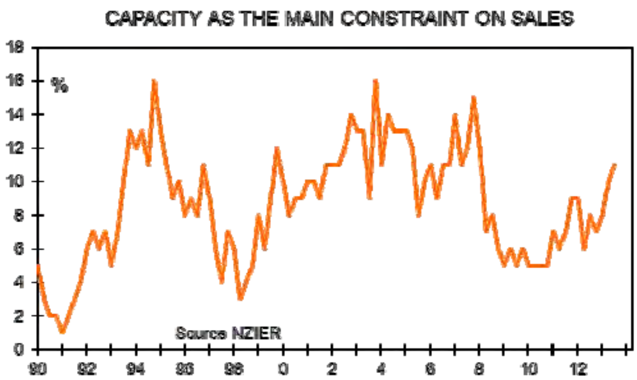


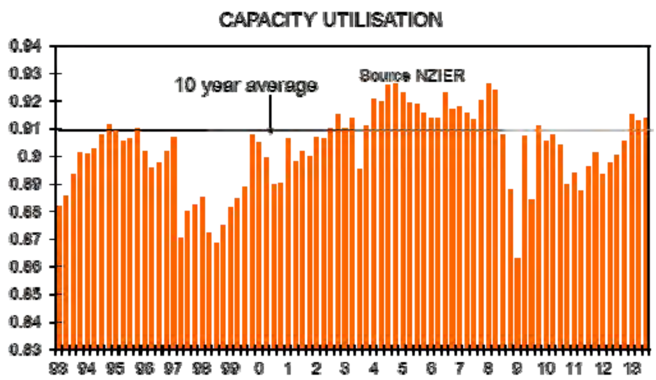


So the labour market looks loose. But there are two problems which will be occupying minds at the RB. First, the QSBO shows that a net 29% of businesses say they are finding it hard to source skilled labour. This is worse than the ten year average of 21%. And a net 5% say they are finding it hard to source unskilled labour compared with an average reading of 1% saying they find it easy.

Second, businesses have cut back substantially on their spending on training, apprenticeships etc. since 2008 so the chances are that the skills being sought by businesses as they respond to what we think will soon be rapidly surging demand, are not going to be there.

Labour shortages are likely to be quite bad within a year and that means a wages response sooner than the 6.4% unemployment rate would suggest. But can businesses respond to the coming labour shortages through substitution of capital – use machinery? Not really. The capacity utilisation rate has averaged 90.9% over the past decade and the QSBO showed that it was at 91.4% in the September quarter. This high capacity utilisation rate in spite of weak GDP growth averaging just 1.1% in the past six years arises because business investment has been weak.





Is business investment picking up? Investment in plant, machinery and equipment was 5.6% lower in the year to June than a year earlier, down 13% in the June quarter from a year before, and ahead only 1.5% in the June quarter itself after falling 5% in the March quarter. But we get a hint from a more up to date measure that business investment is picking up.

The value of imports of plant, machinery and equipment in the September quarter was 8.9% ahead of a year ago and up 14.6% from the June quarter seasonally adjusted. This sounds great. Unfortunately the September quarter boost came mainly from near $300mn worth of imports of aircraft and parts in July and excluding them growth was closer to just 2% for the quarter and negative 3% from a year earlier. Thus as yet we do not have evidence that a lovely productivity-enhancing business investment phase is underway. Note that there is little point trying to gauge whether this is happening or not by looking at investment intentions measures from opinion surveys as these have given a poor guide to such investment post-GFC. There is also no point looking at business credit growth data as past cycles tell us that businesses seem to finance early expansion through means other than recourse to bank debt.

Thus in New Zealand we find ourselves continuing to answer in the negative the same question which economists and especially central bankers are asking in Australia, the UK, Europe, Japan and the US. Seeing improving economic conditions, are businesses investing and hiring? This is very important because with easy monetary policies continuing and areas of spending such as housing and private consumption rising, there can be little other than a surge in inflation outside of that already occurring in asset markets (assisted by money printing) if there is no boost to either or both of the quantity and quality of resources in the economy.

Thus, while for the moment the comments which central bankers make regarding inflation are couched usually in terms of worries about escalating asset prices and implications should bubbles grow then burst, at heart their deepening but not yet much expressed concern is about the ability of economic resource bases to comfortably handle growth should their stimulatory policies actually work in boosting spending.

With regard to wholesale interest rate developments in NZ this week – the Reserve Bank met expectations this morning by leaving the cash rate unchanged at 2.5%. But wholesale rates have fallen mainly in response to lower rates in the United States on expectations of money printing continuing untouched there until well into 2014. Were I a borrower at the moment I might keep an eye out in case a lender cuts fixed interest rates. If they did then I'd look to shift some of my mortgage from floating to fixed.

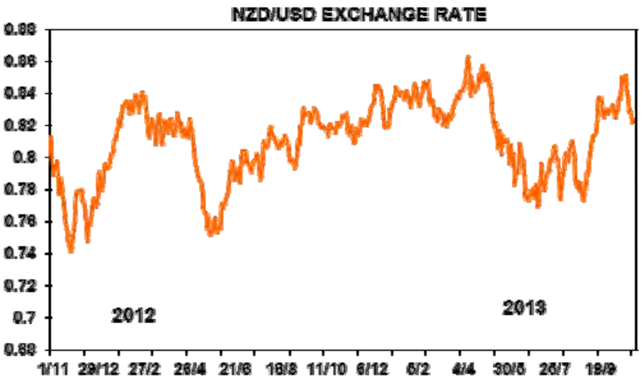
FINANCIAL MARKETS DATA

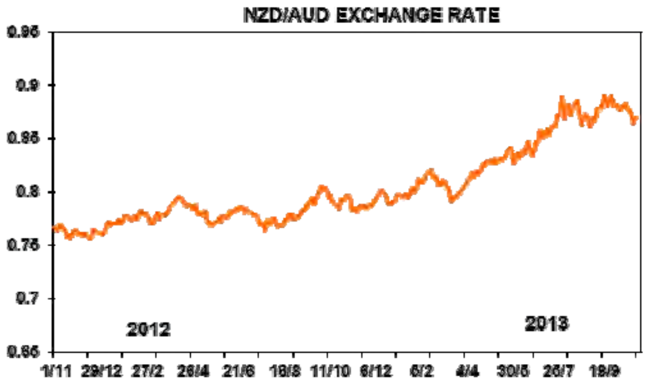
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.69%	2.71	2.68	2.67	2.76	5.7
1 year swap	3.02%	3.05	3.00	2.95	2.51	5.8
3 year swap	3.83%	3.92	3.92	3.75	2.73	6.1
5 year swap	4.32%	4.41	4.43	4.22	3.03	6.3
7 year swap	4.63%	4.72	4.72	4.50	3.32	

NZD Weakens

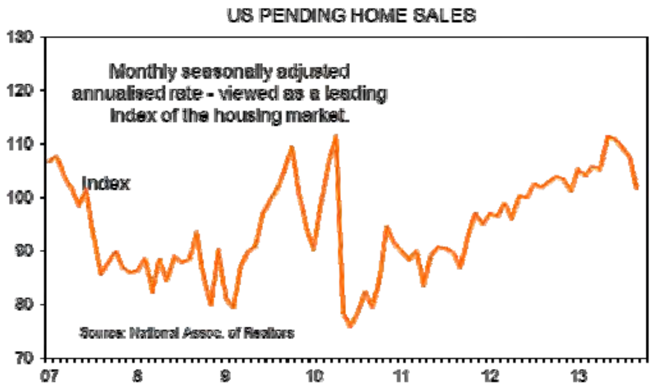
Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr Average
NZD/USD	0.825	0.841	0.827	0.798	0.821	0.67
NZD/AUD	0.869	0.874	0.887	0.88	0.792	0.85
NZD/JPY	81.2	81.8	80.9	78.2	65.3	69.6
NZD/GBP	0.515	0.52	0.513	0.524	0.51	0.388
NZD/EUR	0.601	0.61	0.613	0.602	0.633	0.52
NZDCNY	5.03	5.12	5.06	4.89	5.12	4.99
USD/JPY	98.42	97.27	97.82	97.99	79.54	105.7
GBP/USD	1.60	1.62	1.61	1.52	1.61	1.72
EUR/USD	1.37	1.38	1.35	1.33	1.30	1.28
AUD/USD	0.95	0.96	0.93	0.91	1.04	0.788
USD/RMB	6.0946	6.0859	6.1186	6.1315	6.2405	7.56

The past week has been a good one for NZ exporters with the NZ dollar shedding almost two cents against the greenback and declining marginally on the crosses. The decline has come about mainly in response to a sustained bout of profit-taking following the recent rise to 85 cents, a pullback in the Aussie dollar, and a lift in the greenback.





Data released in the past few days in the United States have been on the slightly weaker than expected side which means continuing easy US monetary policy. For instance, industrial production may have risen 0.6% in September following a 0.4% rise in August, but the September rise was due to a surge in utility output associated with a cold snap. Strip that out and factory/manufacturing output only gained a small 0.1%. Pending home sales also fell 5.6% in September to make four months in a row of decreases.



The Federal Reserve in fact this morning made explicit reference to the US housing market "having slowed in recent months", and that coupled with the effects of the government shutdown and slowing in labour market improvement led them to announce that the $85bn monthly bond purchase programme would continue. This outcome was almost universally expected in the financial markets so there has been little change in rates this morning even though the continued money printing means more USDs sloshing around and therefore weakness in the greenback.

This week however the USD has in fact strengthened against all the other major currencies on a sustained bout of short-covering following a few weeks of selling in response to worries about the government shutdown.

In the United Kingdom GDP rose by the expected 0.8% in the September quarter following a rise of 0.7% in the June quarter and 0.4% in the March quarter. The annual average growth rate now stands at 0.7% compared with 0.4% a year ago and 1.3% two years ago. Growth has averaged just 1.4% per annum over the past decade including shrinkage of 7.2% between the March quarter of 2008 and September quarter of 2009. In contrast the NZ economy shrank 3.5% during the GFC. Our economy is now 5.1% bigger than before the recession whereas the UK economy is still 1.6% smaller.

The UK economy is growing at a pace exceeding expectations and this is leading to some interesting speculation regarding bringing forward the expected timing of a tightening of monetary policy by the Bank of England. If this persists then some extra strength in the pound can be expected.

The AUD fell away by one US cent against the USD on Tuesday after some strong words from the RBA Governor where he expressed a view that the currency would be “materially lower” at some point. The RBA have clearly been getting frustrated at the AUD’s recovery over the past three months from levels just below 90 cents to over 97 cents last week. A lower AUD is considered to be an important component for insulating the Aussie economy against the effects of the easing resource sector investment boom. The RBA has seen the AUD decline following 2.25% worth of cash rate cuts in the past two years. But falling interest rates have ignited the housing market and another cut could create bubble conditions which would require the RBA to pursue the RBNZ policy of attaching for more weighting toward their second major task of maintaining financial sector stability.

The Euro received strength this week after one of the board members of the ECB said that the ECB would simply have to live with a strong Euro rather than cutting interest rates further.

Last week we learnt that China’s economy probably grew 7.8% in the September quarter compared with a year earlier if one believes the data are accurate. The result was marginally better than market expectations and feeds into a general picture that China’s pace of growth is holding up though it remains heavily dependent upon debt-funded investment which means ongoing worries about excess capacity, bad debts, and what happens when the building falls back to more sustainable levels if consumers have not accelerated their spending growth.

This week we got the HSBS Purchasing Managers Index covering mainly small to medium-sized companies and it showed some improvement in manufacturing activity with a reading of 50.9 from 50.2 in September.

But while this and other measures show strength there are deepening concerns about socially destabilising apartment price rises in the bigger cities and after some lending rules were relaxed earlier this year in many cities to spur construction there are now signs that the rules may be tightened again.

Housing Market Update

Housing Interest Piqued

Here is something interesting with regard to Australia’s residential property market – something I keep a closer eye on now that I have a holding over there. A few weeks ago the RBA expressed concern about an extra boost to house prices coming from Self-Managed Superannuation Funds gearing up and investing in residential property. Considering that there is over $1.5tn under management, just one-third of that in SMSFs, and in total just $18bn invested in residential property their worries may not yet be justified.

However, those in the managed fund and mortgage broking sector are now reporting that as a result of the publicity given to this investment angle provided by the RBA's warning enquiries for gearing up one's SMSF have risen substantially. Sometimes the thing we call 'Open Mouth Policy" does not have the desired result.

We have such open mouth policy here in New Zealand in the form of the RB Governor and Deputy Governor warning about the rising speed of house price rises, the risks for the financial sector, and their determination to get house price inflation down. One wonders if the extra attention they are inviting people to have on the capital gains in property will scare people away from the asset or encourage more to recognise that a ball is rolling and jump on it.

Just for your guide, in September the number of consents issued for the construction of new dwellings rose by only 1.4% seasonally adjusted after a 1.5% rise in August and 3.4% rise in July. The latest result means that for the September quarter as a whole consents fell 3.1%! This is most definitely not what anyone wants to see given the housing shortage in Auckland and Christchurch. It also helps illustrate why we feel that the price restraining effects of the LVR changes will be minor even if real estate turnover is hampered. Prices can rise strongly with little turnover.

The annual number of dwelling consents now sits at a still below average 19,785 (average = 21,568 the past ten years). In Auckland where there is a target of 13,000 houses per annum the number of consents has averaged 7,500 for the past two decades and was only 5,595 in the year to September. This is a 27% rise from a year ago but barely above the August year total of 5,564. Auckland house prices will continue to rise. The gains will spread to other parts of the country, starting with locations nearest Auckland.

Key Forecasts

Dec. year		**2011**	**2012**	**2013**	**2014**	**2015**
GDP	annual average chg	1.4	2.7%	2.5 – 3.0	3.0 – 3.5	2.0 – 3.0
CPI	on year ago	1.8	0.9	0.5 – 1.5	1.5 – 2.0	2.5 – 3.0
Official Cash rate	end year	2.5	2.5	2.5	3.5 – 4.25	3.5 – 4.5
Employment	on year ago	1.6	-1.3	2.5 – 3.5	2.0 – 3.0	1.0 – 2.0
Unemployment Rate	end year	6.3	6.8	5.5 – 6.5	5.0 – 6.0	5.0 – 6.0

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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 www.myece.co.nz