Bank of New Zealand

BNZ Weekly Overview

23 March 2006

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 mths ago	Yr ago	10 yr average
Official Cash Rate	7.25%	7.25	7.25	7.25	6.75	6.3
90-day bank bill	7.49%	7.49	7.50	7.66	7.05	6.6
10 year govt. bond	5.77%	5.73	5.64	5.73	6.24	6.5
1 year swap	7.27%	7.31	7.34	7.52	7.15	6.7
5 year swap	6.56%	6.65	6.72	6.80	6.98	7.1
NZD/USD	0.627	0.645	0.658	0.673	0.73	.57
NZD/AUD	0.874	0.874	0.895	0.92	0.94	.86
NZD/JPY	73.3	75.9	77.9	78.5	76.8	66.0
NZD/GBP	0.359	0.369	0.377	0.387	0.387	.35
NZD/EURO	0.519	0.535	0.553	0.567	0.557	.509

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Currency Decline

Over the past week we have seen a continuation of the Kiwi dollar's decline from vastly over-valued levels with a loss of around 2 cents against the United States dollar but no change against the Australian dollar. Speculators and investors overseas have long known that the New Zealand dollar is overvalued and would eventually fall sharply. We are seeing some of that fall happen at the moment as these investors trim their long positions in our currency and generally move away from what has been called the carry trade. This is where one borrows in low interest rate countries like Japan and invests in high interest rate countries like New Zealand and Australia. One hopes to quit exposure to the overvalued currency before it declines sharply - hence the rush to get out the door now weakness has appeared.

This morning we learned that the country's current account deficit is equivalent to almost 9% the size of our economy and that this is the worst such ratio since 1975. This more than anything else shows that our currency has been trading at overvalued levels in the past two to three years but one would be unwise to expect that the current fall in the currency will cause the deficit to fall sharply in the near future. Imports certainly will pull back with businesses at the moment cutting their capital spending sharply and consumer spending growth looking like it has stalled. And we may see some extra investment to expand capacity in the exporting sector. But one has to remember that the bulk of New Zealand's exports still come from the primary sector where changes in capacity, the volume of production, tend not to happen quickly given constraints of available land.

A falling currency delivers an income boost to current exporters but by itself will not be enough to encouraging a whole swathe of new exporting industries. This is where we have failed over the past few years -- an inability to vastly grow and spread our export base. What's of great concern at the moment is the way in which businesses are pulling back on their capital expenditure.

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BNZ WEEKLY OVERVIEW

With productivity growth so poor in New Zealand at the moment and trending below levels in countries like Australia we have a strong need for a shift in the way businesses grow from trying to hire more people and lobbying the government for more skilled immigrants toward capital deepening. The opposite is happening and one can only hope that once businesses get their cash flows under control we will see a structural lift in capital spending from 2007 and 2008. If not then our current account deficit will continue to remain large, our currency will trend downward over time, income gains will remain good for commodity exporters, but more Kiwis will leave for countries like Australia to gain incomes which when converted into Kiwi dollars will be trending upward strongly over time relative to what can be earned here.

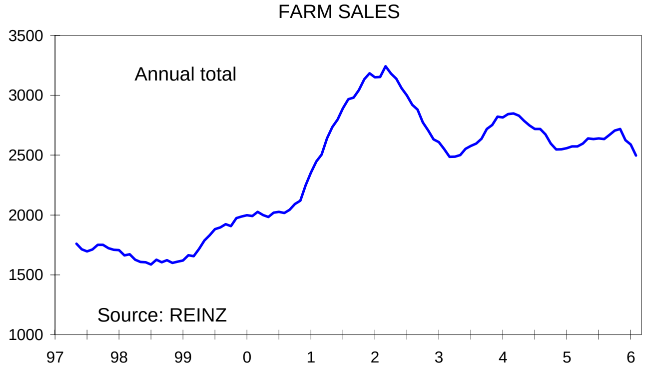
Tomorrow we will receive the December quarter gross domestic product numbers. We expect growth of 0.3% to be reported which will take the annual rate of growth in our economy from 2.6% down to 2.4%. We think we will scrape through this downturn without a recession -- which is defined as two quarters in a row of negative growth. But the absence of a sharp decline means the absence of a substantial easing in monetary policy which when combined with resource shortages, appalling productivity growth, and inflation already above 3%, means low growth near 1.5% is likely for the next couple of years.

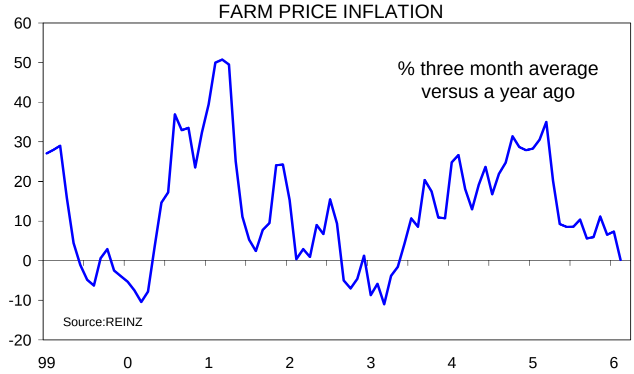
THE WEEK’S ECONOMIC DEVELOPMENTS

Monday 20

Rural real estate goes into reverse

Further confirmation of the pullback in farm spending has appeared with the number of farms being sold in February down 38% from a year earlier at 147. The decline means that in the three months to February the number of farm sales was down 30% from a year ago and 25% below the average number for this period of time over the past six years. For the year to February sales were down 3% from a year earlier. Monthly price data are too volatile to be useful so we average over three month periods before saying anything about farm prices. In the three months to February the average farm sale price was $1.1m. This was up from $947,000 three months ago but unchanged from a year earlier. It is hard to say anything definitive about farm prices but they appear to have plateaued.

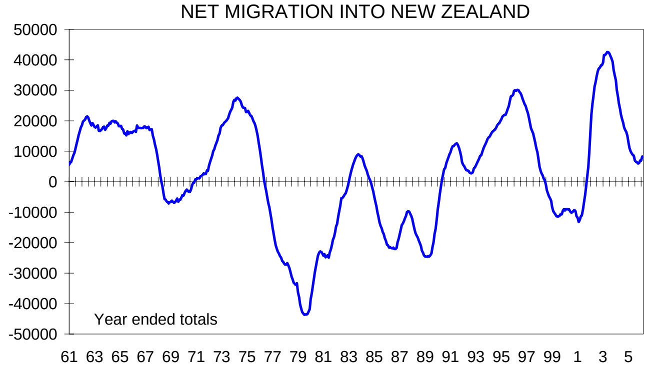


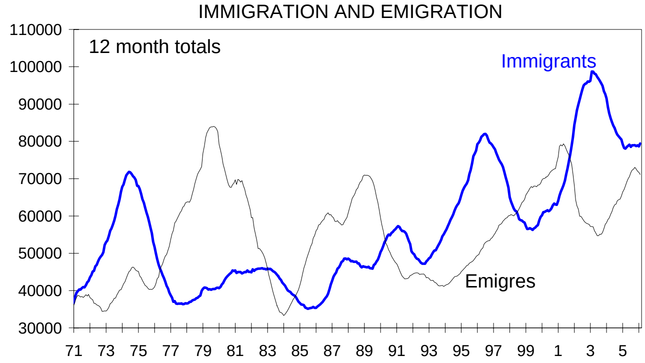


Tuesday 21

Migration gain improves

There was a net gain to New Zealand’s population from permanent and long-term migration flows in February of 3,090 people. This was 1,316 more than in February 2005 and takes the annual net migration gain up to 8,277 from 6,951 in January and a low of 5,987 in October last year. Considering the slowdown in the New Zealand economy this reversal of the decline in net migration flows is interesting. Our expectation remains that as the New Zealand economy deteriorates further over the coming year we will see an increase in the number of people leaving the country and a decrease in the numbers coming in. But this trend is not in place as yet and for the moment the slowdown in economic growth is being alleviated slightly by this small rebound in migration flows. In the three months to February the number of immigrants was up by 2.8% from a year earlier while the number of emigrants was down by 6.9%.

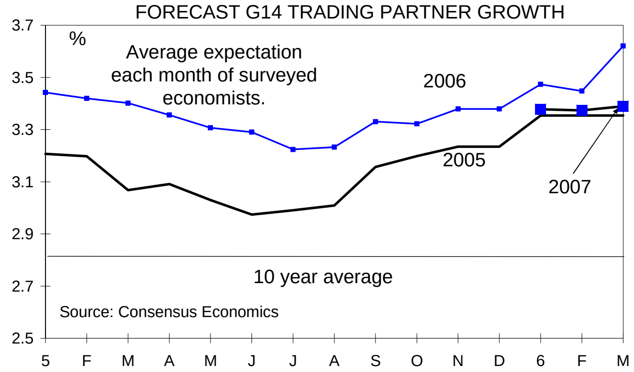




The number of visitors to New Zealand was up 0.9% from a year earlier in February but in the three months to February the number of visitors was down 0.4% from a year ago. Tourism growth is flat.

Trading partner growth prospects improve

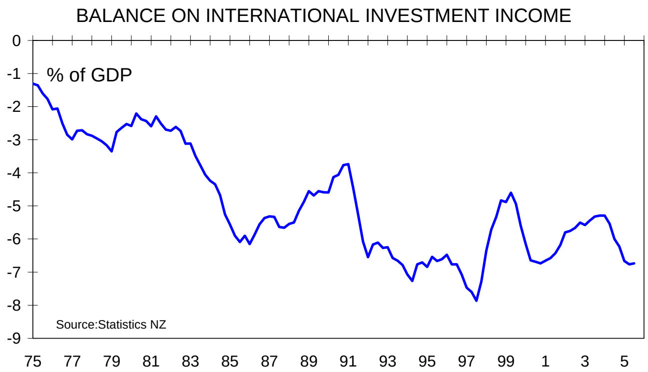
On average New Zealand's top 14 trading partners are expected to grow 3.6% this year and 3.4% over 2007. This year's expectation contained in the monthly Consensus Forecast publication was an increase from 3.4% last month and mainly reflects higher expectations for growth in Japan. The Japanese economy is expected to grow 2.9% this year and 2.1% of the 2007. Australia is seen growing 3.2% this year and 3.4% next, the United States 3.3% and 3%, Europe 2.2% and 2%, and the United Kingdom 2.2% then 2.5%.

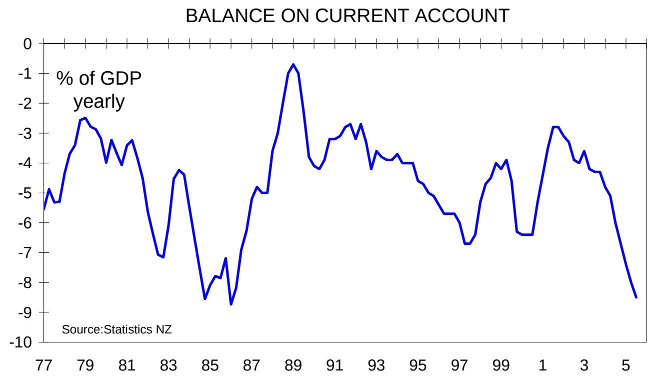


Thursday 23

External position worsens further

New Zealand ran a current account deficit last year of $13.7b. This was well up from $9.8b a year earlier and was equivalent to 8.9% of gross domestic product compared with 8.5% in the year to September and 6.7% over 2004. On average over the past twenty years the deficit has averaged 4.6% of GDP so the latest result is very large and in fact the largest such deficit relative to the size of our economy since 1975. The main cause of the deficit is a negative balance on net international investment income flows of $10.8b with $2.1b worth of credits from investments by New Zealanders overseas offset by $12.9b in payments for borrowed money and dividends flowing to the owners of companies operating in New Zealand. This deficit has worsened from $9.1b a year ago. But the big cause of the deterioration over the past one to three years has been a worsening balance on goods and services transactions. The goods and services balance was a deficit of $3.6b last year compared with $1b over 2004. Over 2005 exports of goods and services grew by only 0.9% while import payments were up by 6.6%.





Our expectation is that although the falling New Zealand dollar will eventually lead to improved export receipts and slow down the rate of growth in imports, before that happens the current account deficit will hit 9% of GDP. We see essentially no chance of a current account surplus being recorded in the next couple of decades with New Zealand continuing to be a long-term underperformer with regard to growth in the export sector.

INTEREST RATES

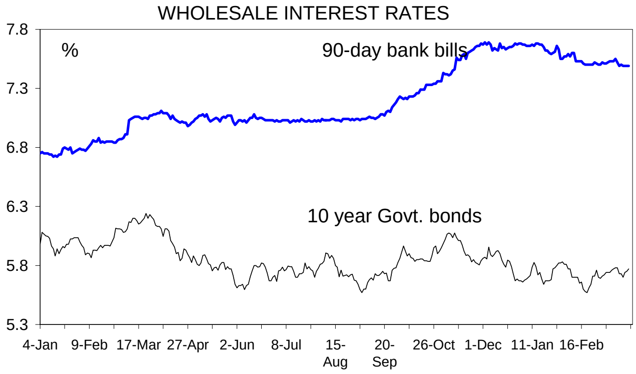
Wholesale interest rates have remained relatively static this week in spite of the large fall in the New Zealand dollar. To the extent that the fall in the currency is driven by expectations of much weaker growth in our economy one would not expect to see upward pressure on interest rates. However the New Zealand dollar has a tendency to undergo large shifts without a great swathe of data suggesting a significant change in our rate of economic growth. So on the face of it wholesale interest rates should have risen over the past week. But with the Reserve Bank recently having indicated they don't plan cutting the official cash rate until next year the markets have settled into a belief that there probably will be one or two cuts late this year but a lot more information is required before that expectation will need to be changed. The falling currency implies higher inflation but the experience of the currency's decline from 1997 through 2000 was that the impact on inflation was a lot less than had been expected.

The rule of thumb before then had been that a 10% fall in our currency would lead to a 3% rise in inflation over the following eighteen months. But what we learned back then was that this feed-through is a lot less. This seems to be because importers allow their margins to change quite a bit over the currency cycle and if it is not their margins which are moving then it may be the margins of foreign suppliers of goods into New Zealand.

This means that although we can certainly expect inflation to be lifted by this recent fall in the currency the hike in inflation may not be all that severe. Having said that, with shortages of capacity in our economy there is a new dynamic in play. We can see this already with transport companies warning that rising fuel prices will almost certainly be passed on relatively quickly into their charges.

For us what it adds up to is minimal scope for the Reserve Bank to cut its cash rate this year, especially now that the trade weighted index is sitting near 64.5 whereas the Reserve Bank had assumed a level of 68 for the first half of this year.

The yield on 90 day bank pills has finished this afternoon near 7.47% from 7.5% a week ago. The two year swap rate has finished near 6.88% from 6.93% last week, while the five year swap rate has ended near 6.56% from 6.65%.



If I were a borrower what would I do?

I like the look of the two year rate at 7.7%. Having said that the three and four year rates are also reasonably attractive. We don't have any strong view on where wholesale financing rates are likely to move over the next few months and that means we have no really strong justification for putting off fixing in expectation of fixed rates declining, or conversely fixing one's rate well ahead of time in case they bounce up.

Risks Facing Fixed Housing Rates

Just as the main determinant of the floating housing rate is the Reserve Bank's official cash rate and it's feed-through to the 90-day bank bill yield, the main determinant of fixed housing rates is the same term swap rate. This is roughly the wholesale market equivalent of the OCR. But whereas the OCR is determined by the Reserve Bank swap rates can move substantially without any change in monetary policy. The main things which influence swap rates are expectations of changes in the OCR and movements in overseas medium to long term interest rates. This latter influence can be particularly strong because we banks need to get about one-third of the money we lend out from offshore. This is because of the paucity of saving in New Zealand in relation to our borrowing to buy houses and such like.

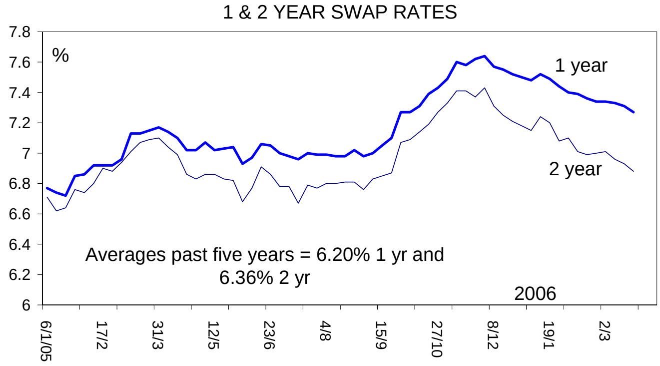
What this means is that if you want to take a view on where floating rate borrowing costs are going you need to get a view on the official cash rate. If you want to pick where fixed housing rates are going you need to track the relevant term's wholesale market swap rate and get a view on where that rate is going. The OCR bit is easy because the rate only occasionally moves, changes happen only at official reviews by the Reserve Bank, and the whole focus of the financial markets is on upcoming OCR movements. Tracking swap rate changes is more difficult and forecasting movements in swap rates is particularly hard. To do so one needs to allow for changes in NZ monetary policy and expectations of such, changes in United States monetary policy and fluctuations in marketplace policy expectations, changes in foreign flows (Asian particularly) into US long term securities and expectations of changes, and the same things to a lesser extent for other large economies.

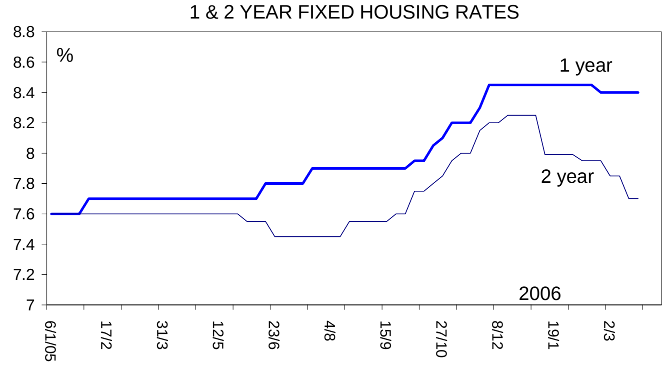
Plus one needs to take a view on the likely volume of Uridashi and Euro-Kiwi bond issues and in particular in the next year or so whether such issues will match maturities – probably not.

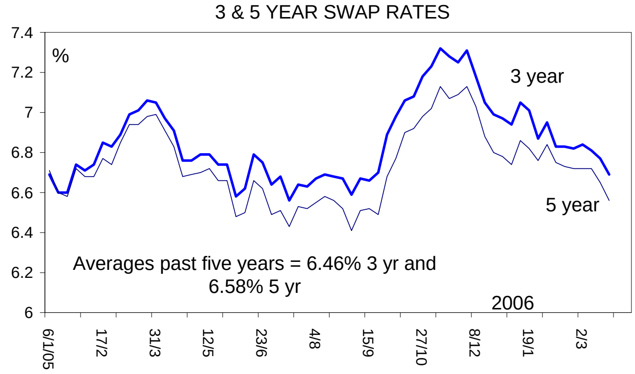
Add it all up and the process is quite difficult. The best bet for those wanting to take a view on whether there is broad upside or downside risk to housing fixed interest rates then is to simply track movements in the relevant swap rates. To that end we have published the one and five year swap rates in the table on page 1 since the Weekly Overview went public in 2000. But to help home owners wanting to make decisions about managing their interest rate exposure we'll flesh things out more now with extra graphical information in this Interest Rates section. As we do in the Exchange Rates section we'll run graphs starting just over a year ago showing movements in wholesale swap rates.

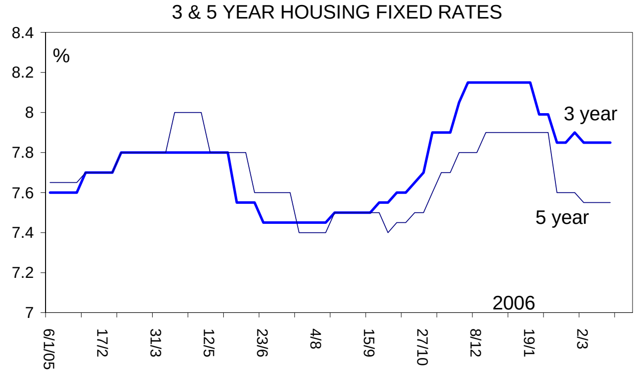
Over the past week swap rates have declined slightly in a continuation of the downward trend which has been in place broadly since the start of December last year. This trend reflects market expectations that the next change in monetary policy will be an easing. This expectation has actually been in the marketplace for a long time and has probably pulled back a bit recently in light of some strong comments from Reserve Bank and the decline in the exchange rate. The falling currency reduces scope for monetary policy to ease in the near future because of the mild boost inflation will get from higher import prices and better income prospects for exporters. But what the markets have been focusing on is the string of generally weak data on the New Zealand economy. This includes weakness in retail sales, the housing market, business and consumer confidence readings, employment intentions, and business capital expenditure.

While we admit that there are downside risks to the rate of growth in our economy over the next two years we still think the markets are getting a wee bit ahead of themselves in picking the timing for the easing of monetary policy. So we are wary about predicting further declines in swap rates in the near future.









BNZ Fixed Lending Interest Rates				
	Housing	**Average Past 5 yrs**	**Low Past**	**High 5 years**
Float	9.55%	8.00%	6.70%	9.55%
1 yr	8.40	7.16	5.95	8.45
2	7.70	7.28	5.99	8.25
3	7.85	7.49	6.30	8.30
4	7.85	7.62	6.40	8.40
5	7.55	7.65	6.50	8.60
7	7.55	7.83	6.75	8.80

Note: Conditions may apply to these rates.

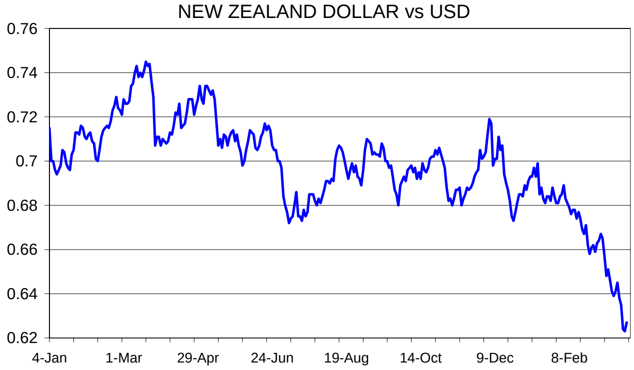
BNZ Term Deposit Rates			
Days	**$10-50K**	**$50-100K**	**$100-250k**
30	3.00	3.00	5.25
90	5.90	5.95	6.00
180	6.80	6.85	6.90
1 yr	7.00	7.05	7.10
5 yr	6.40	6.45	6.50

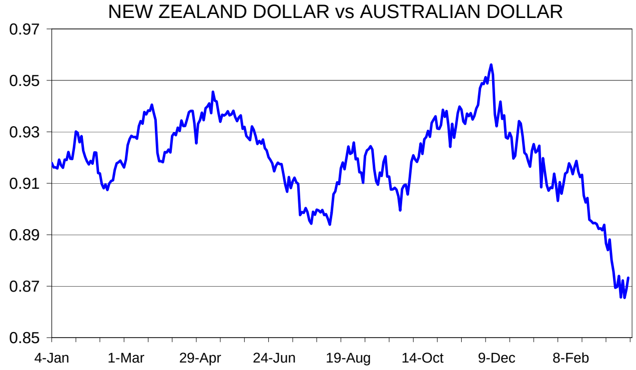
HOUSING MARKET UPDATE

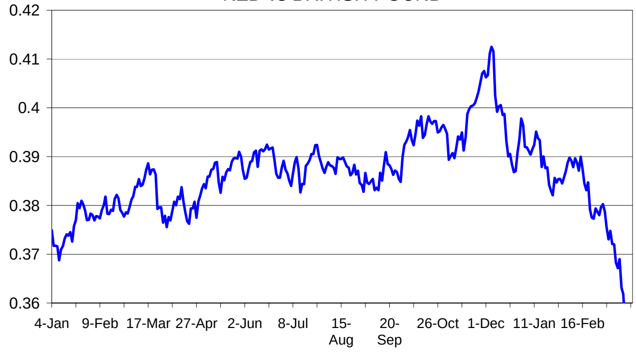
The only decent piece of information released over the past week of relevance to the housing market is the monthly data from Statistics New Zealand on migration flows in and out of New Zealand. The data show that the net migration gain in February was 3,090 people. This was 1,326 higher than the net inflow in February, 2005 and has taken the net annual migration gain up to 8,277 from a low of 5,987 in October. The faster the rate of growth in one's population generally the greater the upward pressure on housing construction, real estate turnover, and house prices. But we have a theory that the net migration flows will turn downward later this year so would not get too excited about the implications for housing of this recent small improvement in the migration flows.

EXCHANGE RATES

It's been another good week for exporters with the Kiwi dollar falling against most other currencies. At the end of trading today the New Zealand dollar was buying 62.5 U.S. cents from 64.5 the week ago. Against the Australian dollar we were unchanged near 87.4 cents, against the pound down one penny at 35.9, against the yen at 73.3 from 75.8, and against the euro at 51.9 cents from 53.4.







Causes of the decline have included weakness in the Australian dollar and worries about this morning's balance of payments data and tomorrow's gross domestic product numbers in an environment of increasing risk aversion overseas with some investors reducing exposure to countries with large current account deficits. But mainly it's a story of the Kiwi dollar being due for a decline after three years at overvalued levels. Investors in recent times have enjoyed high interest rates relative to the returns available in their home countries and have now decided that it is no longer as safe to hold high yielding currencies as it was a few months ago.

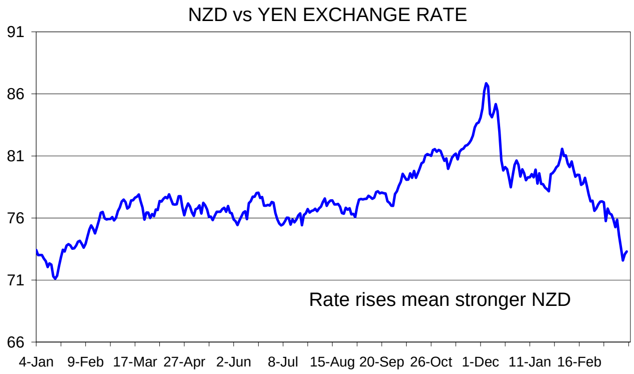
Our view for the past two and a half years has been that the New Zealand dollar would remain exceptionally strong until the end of 2005 by which time it would be due to decline. Our best guess was that the decline might happen in the middle of the year but it's really been a matter of not knowing exactly when foreign investors and speculators would decide it was time to sell the NZD. That time is at hand and now we have to ask ourselves how low the New Zealand dollar will go.

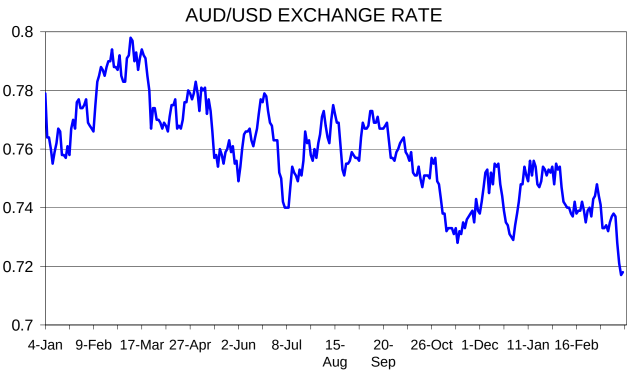
Our view is that we will trade below 60¢ by the end of the year but don't have a firm view on whether we hit that level in the next few weeks or in December. After that we see the Kiwi dollar settling in a range from 55 to 60¢. But history shows that picking where an exchange rate will settle is a mugs game. If the Kiwi dollar was to fall to levels that would bring balance to our current account then we'd be talking something down in the 30 to 40¢ area. But that is not going to happen given the high credit rating for our economy, low unemployment, strong government accounts, deregulated economy including unfettered capital flows, and glut of savings overseas looking for a home.

All one can do is note that when currencies are trending upward they often go through periods of substantial corrections down before resuming their upward trend and the same happens on the way down. We had an example of this overnight with the New Zealand dollar recovering about 1 cent against the United States dollar on short covering.

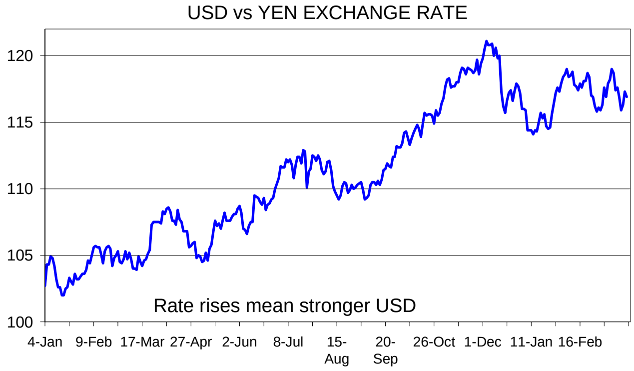
The Australian dollar has lost 2 cents against the greenback to finish near 71.8 cents this afternoon. Factors pushing the AUD lower this week have included

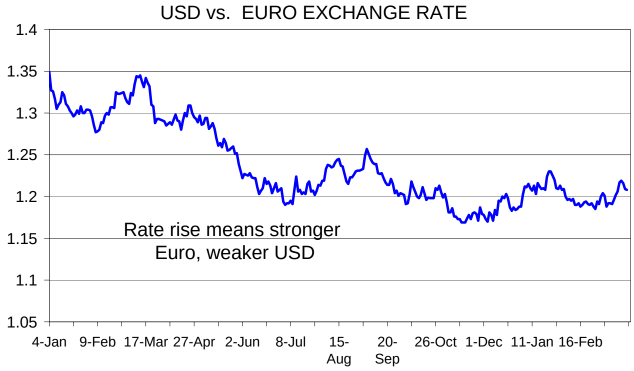
- falls in commodity prices over the past two months
- a general movement by investors away from currencies of countries with large current account deficits (risk aversion),
- reduced expectations of interest rate support for the Australian dollar as forecasts for the peak in United States interest rates are revised upward,
- a larger than expected fall in dwelling starts recently bringing some concern about the housing construction sector, and
- a greater than expected trade deficit for January.





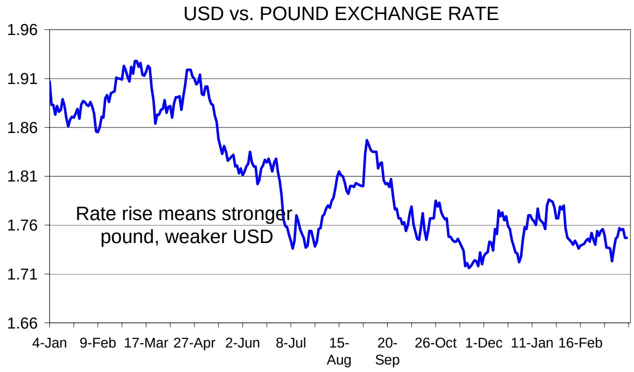
The U.S. dollar has ended the week unchanged in spite of some slightly better than expected economic data and comments from the Federal Reserve chairman. US industrial production rose 0.7% in February, following January's revised decline of -0.3%, while capacity utilisation rose to 81.2% in February from 80.8% in January. Of relevance to how much further interest rates will rise data showed the core producers price index for January rose by 0.3% whereas a rise of 0.1% had been expected. The Federal Reserve chairman made some general positive comments on the U.S. economy and said that the flatness of the U.S. yield curve implied that the Fed. may need to raise short term interest rates further than thought in order to get some extra increase in long-term interest rates. He also noted however that long-term interest rates have remained low in the United States in spite of tightening monetary policy due to a glut of savings around the world finding their way into U.S. government securities.





The USD has ended the week against the Japanese yen at 116.9 from 117.6, unchanged against the Euro near $1.207, and unchanged against the pound near $1.748.

This glut of savings also helps explain why the New Zealand dollar rose to record post-float levels last year with foreign investors keen to take advantage of our relatively high interest rates, and also explains why our long-term fixed interest rates have remained relatively low while the Reserve Bank have raised their cash rate by 2.25%.



BNZ WEEKLY OVERVIEW

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.7%	1.1	3.2	2.7	1.6
GDP growth	Average past 10 years = 3.3%	0.2	1.2	2.6	4.4	3.9
Unemployment rate	Average past 10 years = 5.7%	3.6	3.7	......	3.6	4.6
Jobs growth	Average past 10 years = 2.1%	0.0	1.5	1.6	4.4	2.6
Current a/c deficit	Average past 10 years = 4.9% of GDP	8.9	8.5	......	6.7	4.3
Terms of Trade		-2.3	-0.4	-1.8	4.4	6.6
Wages Growth	Stats NZ experimental series	1.3	1.7	5.3	5.1	4.9
Retail Sales ex-auto	Average past 9 years = 4.2%.	0.9	1.8	5.1	7.8	5.9
House Prices	Long term average rise 4.2% p.a.	2.6	2.7	14.0	16.4	21.2
Net migration gain	Av. gain past 10 years = 13,000	+8,277	6,145yr	......	11,131	30,075
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 8%. Colmar survey	-35	-34	8	17	1
Business activity exps	10 year average = 27%. NBNZ	-4	-2	14	31	29
Household debt	10 year average growth = 11.4%. RBNZ	15.1	15.3	15.0	15.1	15.7
Dwelling sales	10 year average growth = 4.6%. REINZ	-22	-10	4	3	3
Tourist numbers	10 year average growth = 6.1%. Stats NZ	0.9	0.2	-0.9	5.1	7.1
Floating Mort. Rate	10 year average = 8.5%	9.55	9.50	9.00	8.75	7.25
3 yr fixed hsg rate	10 year average = 8.2%	7.85	8.15	7.45	7.60	7.60

ECONOMIC FORECASTS

Forecasts at Mch 11 2006	March Years					December Years				
	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
GDP - annual average % change										
Private Consumption	5.8	4.3	1.6	0.5	1.1	6.5	4.9	1.9	0.7	0.8
Government Consumption	5.2	2.4	5.9	3.5	3.6	5.7	3.1	5.1	4.2	3.1
Investment	7.8	5.6	-0.2	1.8	3.6	13.2	4.5	0.5	1.4	3.1
GNE	6.5	4.4	1.5	1.4	2.3	8.2	4.8	1.6	1.5	1.9
Exports	3.9	1.4	2.5	3.2	4.6	5.6	0.0	2.8	2.9	4.2
Imports	13.7	7.0	2.5	2.5	3.2	16.6	7.6	3.0	2.6	2.9
GDP	3.7	2.4	1.5	1.6	2.7	4.4	2.5	1.7	1.6	2.2
Inflation – Consumers Price Index	2.8	3.5	3.0	3.2	2.1	2.7	3.2	3.2	3.3	2.2
Employment	3.4	1.7	0.5	0.5	1.1	4.4	1.6	0.6	0.4	0.9
Unemployment Rate %	3.9	3.7	4.1	4.2	4.1	3.6	3.6	3.9	4.3	4.3
Wages	2.9	5.0	4.6	3.5	2.6	1.9	5.1	4.9	3.7	2.8
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.73	0.65	0.57	0.59	0.6	0.71	0.7	0.58	0.58	0.6
USD/JPY	105	115	102	106	106	104	119	105	105	106
EUR/USD	1.32	1.19	1.15	1.18	1.16	1.34	1.19	1.16	1.17	1.17
NZD/AUD	0.93	0.88	0.85	0.86	0.89	0.93	0.94	0.85	0.85	0.89
NZD/GBP	0.38	0.37	0.34	0.35	0.36	0.37	0.4	0.34	0.34	0.36
NZD/EUR	0.55	0.55	0.5	0.5	0.53	0.53	0.59	0.5	0.50	0.52
NZD/YEN	76.8	74.8	58.1	62.5	64.8	74.2	82.7	60.9	60.9	64.6
TWI	70.7	66.8	59.2	60.9	63.5	69	71.9	60.2	60.1	62.9
Official Cash Rate	6.5	7.25	7	6	5.75	6.5	7.0	7.25	6.25	5.75
90 Day Bank Bill Rate	6.86	7.53	7.27	6.15	5.95	6.73	7.49	7.53	6.43	5.93
10 Year Govt Bond	6.04	5.80	5.95	5.6	5.7	6.03	5.89	6.00	5.65	5.65

All actual data excluding interest & exchange rates sourced from Statistics NZ.

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