Bank of New Zealand

BNZ Weekly Overview

18 May 2006

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 maths 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	7.51%	7.51	7.47	7.51	7.05	6.6
10 year govt. bond	5.87%	5.83	5.78	5.60	5.79	6.5
1 year swap	7.41%	7.39	7.29	7.36	7.03	6.7
5 year swap	6.85%	6.87	6.62	6.73	6.66	7.1
NZD/USD	0.623	0.622	0.626	0.669	0.706	.57
NZD/AUD	0.818	0.807	0.847	0.905	0.936	.86
NZD/JPY	69.0	69.2	73.7	78.7	75.8	66.0
NZD/GBP	0.331	0.335	0.353	0.38	0.385	.35
NZD/EURO	0.488	0.489	0.514	0.562	0.56	.509

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Budget Tax Cut Blind Spot Threatens Growth

As he has promised every year for a long time now the Minister of Finance Dr Cullen delivered a predictably boring Budget – helped this time around however by the leak of the Telecom deregulation papers a couple of weeks ago. In fact from a publicity point of view it looks like the government desperately needed the Telecom announcement to be confined to the Budget because all the Budget itself has is the actual numbers following up on the government's election commitments in areas like student loans and the Working the Families package, filling up the already identified hole in the land transport budget, an extra $425 million for roading projects, and a smattering of minor stuff spread across a range of portfolios. The financial markets were completely unmoved by the budget and its now back to business as normal.

The media generally will be well peppered with details of the budget so there seems little point in going over the minutia here. But here are a few numbers. Treasury's outlook for economic growth is similar to our own with a pick of growth in the economy for the year to March 2006 of 2.1%, versus 2% for us, 1.0% the year after (same for us) but then 3.3%% for the year to March 2008. We think this latter forecast is too optimistic with our own pick being 1.7%. They see the exchange rate trending down at a very gradual rate over the next couple of years while interest rates fall about 1.5% next year. Government spending as a proportion of the economy holds steady near 32.5% while net debt as a proportion of gross domestic product holds at 5.8% then starts creeping up to 6.1% over 2007/08 and 7.1% a year after that.

Delivering a boring budget was probably enough when the economy was growing strongly and things didn't look too bad. Now however that time has passed and the economy is facing some reasonably severe medium to long-term challenges which the government is not yet showing it either sufficiently understands or wishes to do enough about. One of the key issues facing the economy is poor infrastructure. Extra money has been allocated to improvements in the roading network but electricity remains a very worrying area and attacking it was a glaring omission In today's Budget. We don't believe businesses can have much confidence that electricity supply will be sufficient over the coming decade and that will tend to retard badly needed investment in plant and machinery.

This is extremely concerning because with New Zealand now heading back down the ladder of international competitiveness its probably not going to be long before a downward slide appears also in our OECD ranking of income per capita. The only way to get up the ladder is if we boost productivity levels and the only way to do that is with substantially greater levels of capital spending. But it is hard to imagine businesses jumping boots and all into a major capital expansion program if they are not confident the electricity is going to be there to run their new machines in a couple of years time. The dire need to do something about the electricity situation is one major problem we face. The other is the currently more pressing problem for the majority of businesses we have contact with which is the shortage of labour even with the economy's growth rate having more than halved over the past year.

The dynamics of the labour market have shifted and represent quite a threat to our economic growth in the short, medium, and long-term. One thing any student of New Zealand population studies will know is that we are highly mobile people. When we don't like it here we leave. Most of us can hop on a plane tomorrow and go to Australia. This can be seen in the net loss to our population of 156,000 people between 1976 and 1982, and the loss of a net 89,000 people between 1984 and 1989.

Over the next three years our expectation is that growth in the New Zealand economy will average approximately 1.8% per annum. Over the same period of time growth in Australia is likely to be close to 3%. We expect this difference in growth rates to reduce the number of migrants overseas choosing New Zealand over Australia, reduce the number of Australians willing to come here, and increase the number of Kiwis willing to move across the Tasman. This means low growth in the New Zealand labour force and this means a continuing problem for businesses growing their output, and increases even further the need to lift capital spending levels to boost productivity. This makes the electricity situation even more critical.

But we believe there is a new dynamic in the labour market now under way. Economies the world over are experiencing shortages of skilled people and governments are introducing policies and programmes aimed at making their country increasingly attractive to an internationally mobile workforce. For instance in one of this morning's newspapers it was reported that the Australian government is advertising for medical staff in Britain using pictures of people sunning themselves on Australian beaches. Various countries have eased their criteria when it comes to people having working holidays.

The goal these days is effectively to be a preferred employer - a place potential employees will choose to come and work. Australia appears well ahead of New Zealand in this regard as highlighted by the recent string of personal income-tax cuts. In contrast the government in New Zealand appears hell-bent upon dredging up any excuse imaginable to avoid giving tax cuts here. Instead the government's focus here is on increasing the number on welfare through the Working For Families assistance program. The message to the international workforce is go to Australia if you want to be rewarded for your own efforts but come to New Zealand if you want the government to take care of you.

So not only do we have concerns about growth in New Zealand's labour force as a result of low forecast growth rates for our economy over the next few years, plus concerns based upon the unwillingness of the New Zealand government to market itself effectively to the international workforce, we are also concerned that the rate at which the New Zealand labour force willingly upskills itself will be retarded compared with other countries going forward.

Dr Cullen correctly notes that if he was to give tax cuts this would prove stimulatory for the economy and could place upward pressure on interest rates. However it is difficult to imagine what circumstances would need to exist before the Finance Minister would give tax cuts and it seems clear that an ideological bias is the main reason behind the absence of tax cuts and a continued preference for middle income welfare delivered through the Working for Families package. It seems a fairly safe bet that ahead of the next general election we will see some further expansion in that welfare package.

Buckleys

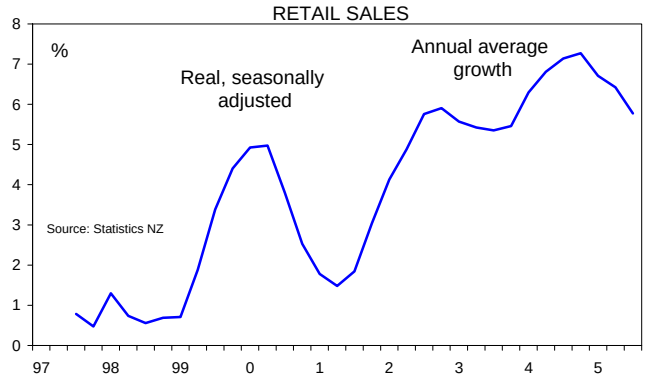
Many thanks to the gentleman from Palmerston North who gave us a call from Sydney last Thursday night to explain where the term nil and Buckleys comes from. Apparently there used to be a retail store in Sydney called Buckleys and Nunn. For some reason when people were discussing the chances of something happening the store name popped into the conversation and has stayed there ever since.

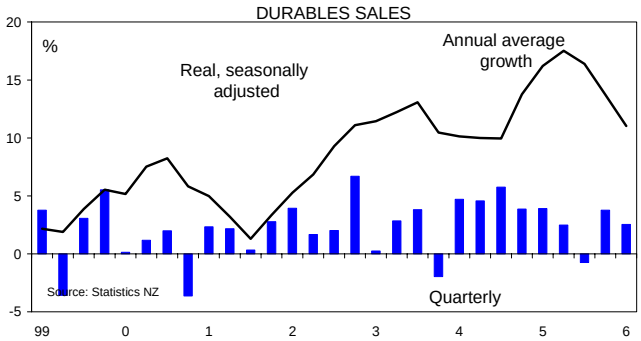
THE WEEK'S ECONOMIC DEVELOPMENTS

Monday 15

Retail Spending Grows But Below Trend

Retail spending in real seasonally adjusted terms rose by 1% during the March quarter. This followed a decline of 0.7% during the December quarter and means that the volume of sales was 3% ahead of a year earlier after being 2.9% ahead in the December quarter and 5.6% ahead in the March quarter of 2005 compared with March quarter of 2004. On average in the eight quarters ending in the September quarter of 2005 retail spending volumes grew by 1.5% a quarter. So the average growth over the past two quarters of just over 0.1% shows quite clearly that consumer spending growth has slowed down. However the fairly obvious implication of people putting their wallets in their pockets is somewhat challenged by continuing strength in the volume of sales of durable goods. These were up by 2.5% in the March quarter after rising 3.8% in the December quarter. The change from a year ago of 8.2% was well down from 19.4% a year early however and was the lowest such annual growth rate since December quarter 2003.



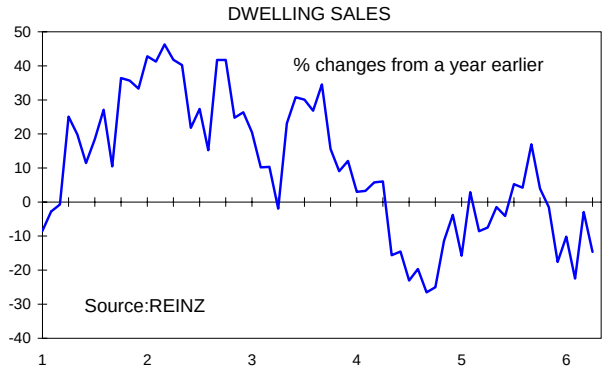


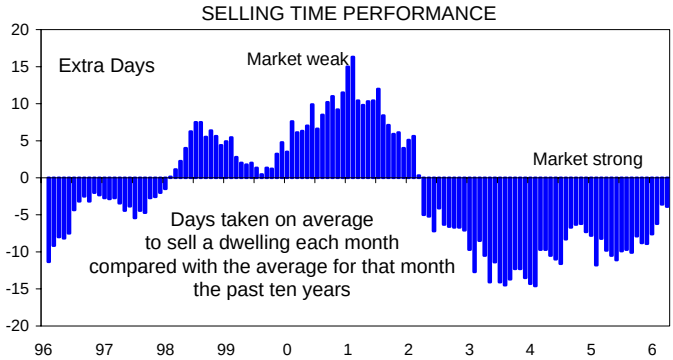
Our interpretation of the data is that they clearly show consumers have pulled their horns in slightly but that some spending growth does remain. In particular the 1% rise from the March quarter strongly suggests that the economy overall grew during the quarter and therefore will fail to meet the technical definition of a recession which is two quarters in a row of shrinkage.

Tuesday 16

Housing Market in a Soft Landing

The REINZ reported that in April there were 7,576 dwellings sold around New Zealand. This was a 14.6% decline from a year earlier which followed a 2.9% decline in March compared with March 2005. These annual rates of change has been distorted recently by Easter falling in March last year but April this year. Smoothing over the two months we can see that dwelling sales are falling at an annual rate of around about 8%. This is relatively gradual and does not in any way represent a hard landing for the sector - or for real estate agents specifically. The median dwelling sale price increased to a record $305,000 from $302,000 in March to sit 12.1% up from a year earlier. However this rate of change is misleading. Prices on average have increased just 0.8% over the past three months which equates to an annualised rate of about 3.3%. Prices therefore are still rising but at a rate only just matching inflation.

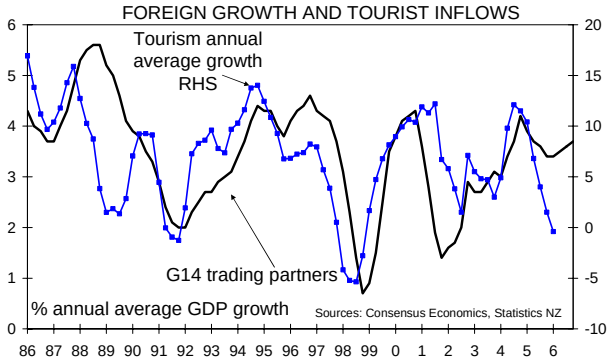


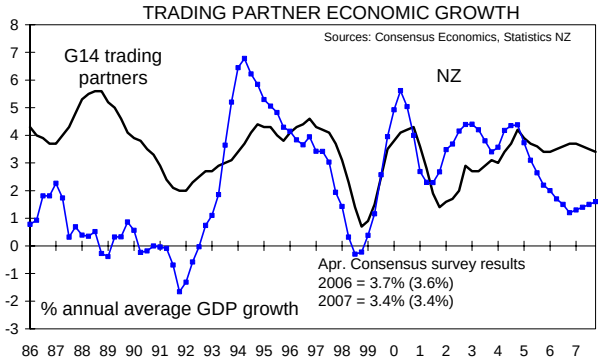


Perhaps the best indication that the housing market continues to slow down is the fact that in April it took 34 days on average to sell a dwelling. This was an increase of six days from a year earlier following a five-day increase in March and six day increase in February. Dwellings therefore are sitting on the market longer before selling and this is consistent with the anecdotal feedback in recent months of buyers taking their time feeling that the environment is now more in their favour than it has been since 2001. The second graph above compares the latest number of days on average taken to sell a dwelling with the average number taken for that particular month over the previous 10 years. An important point to note is that the speed of turnover is still running better than average. This reinforces our comment that the housing market is going through a soft landing.

Foreign Growth Prospects Look Good

On average New Zealand's top 14 export destinations are expected to grow by 3.7% this year and 3.4% over 2007. These forecasts were largely unchanged in the monthly Consensus Economics survey of economists around the world but were up from 3.5% and 3.4% for this year and next year respectively in the January survey. There is a strong correlation between growth in our trading partners and growth in the number of visitors to New Zealand. Given the reasonable outlook for the next couple of years for growth overseas this suggests later this year we will see growth improve in the number of inward tourists.





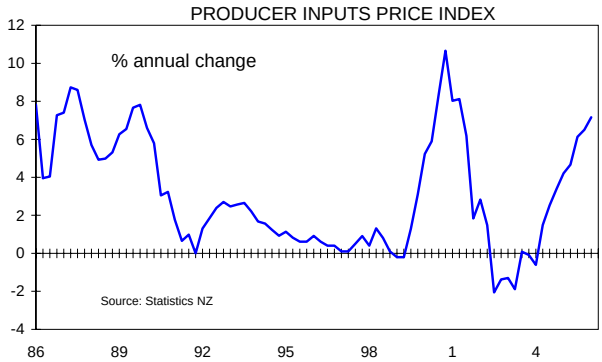
There is also some correlation between overseas growth and growth in the New Zealand economy but as the second graph above shows the correlation is not perfect. In particular for the next couple of years we expect relatively weak growth in New Zealand while our trading partners grow at above average rates.

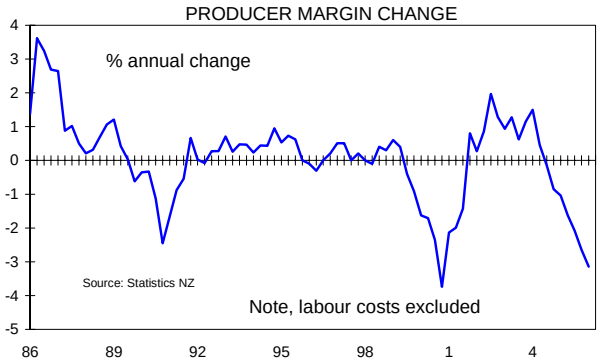
Wednesday 17

Business Margins Contracting

During the March quarter on average business non-labour costs rose by 0.9%. This was a lower increase than expected but still means that on average such costs were 7.2% greater than a year earlier. In contrast output prices on average rose just 0.7% during the quarter to be 4% ahead of a year ago. This means margins for businesses on average have been squeezed over the past year and in fact on an annual basis have been falling since September 2004. This is the only approximate measure we have of the margin squeeze on businesses and because such a squeeze is continuing with more to come as the falling

exchange rate feeds through we expect strong efforts to be made by the business sector to improve cash flows over the coming quarters. What that has meant over the past six months has been businesses cutting capital expenditure while holding on to staff in expectation of the very tight labour market continuing. This is good for job security but bad for productivity growth going forward. Probably the saving grace in all of this is that business balance sheets are generally in very good condition and this means the period of capital expenditure reduction may not be all that long lasted and we expect to see business investment picking up again over 2007 concentrated in the export sector which will be benefiting from some slight further depreciation in the New Zealand dollar.





Thursday 18

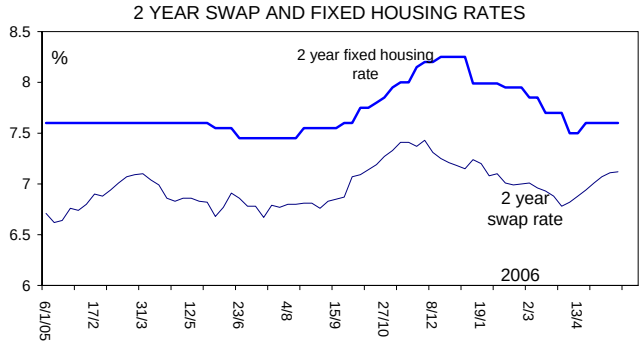
Boring Budget

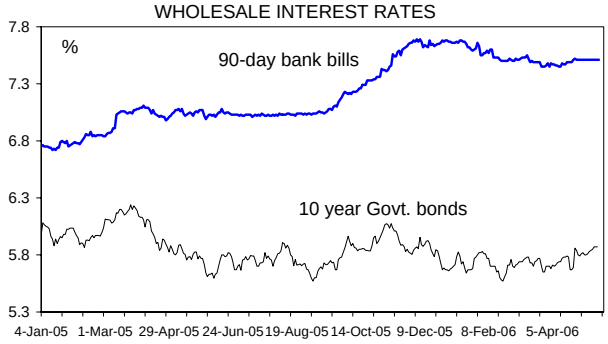
The Minister of Finance delivered the annual budget showing the operating surplus easing from an estimated $7b this current financial year to $3.6b come 2008/09. Government spending as a proportion of gross domestic product is seen changing from 32.3% this year to 32.7% over 2006/07, then 32.6% after that. Net debt as a proportion of gross domestic product is seen rising from 5.8% this year to 7.1% come 2008/09. The budget contained an extra $1.3 billion worth of spending on the roading network but failed to address problems in the electricity sector. Other big spending announcements were simply accounting numbers following on from election commitments plus a smattering of extra money here and there across a wide range of portfolios.

INTEREST RATES

Today's budget release had zero impact in the financial markets and we have seen 90-day bank bill yields finish unchanged from a week ago at 7.51% while the two-year wholesale borrowing cost has ended near 7.12% which has also unchanged from a week ago. There has been greater excitement in the overseas markets with some initially weak data in the United States on the likes of consumer confidence and producer price increases causing medium to long term wholesale fixed interest rates to edge down a bit. But last night data were Released showing consumer prices on average rose 0.6% in April rather than an expected increase of 0.4%. The core rate of inflation - which excludes food and energy -was 0.3% in the month and 2.3% over the year . Given that the Federal Reserve prefers this core inflation measure to sit near 2% worries have appeared in the financial markets regarding future tightening of monetary policy. This is especially so as the Federal Reserve has said any further tightening will depend upon what the data show.

BNZ WEEKLY OVERVIEW





If I Were a Borrower What Would I Do?

All the rates from two years and beyond look acceptable at the moment and for those wanting to simply lock in a rate near the average level over the past few years fixing for three years or beyond looks good. In two years time we expect interest rates in the United States to be creeping downward and this will tend to place some downward pressure on fixed interest rates. But at the same time we expect to see expectations for growth in the New Zealand economy looking a lot stronger and while the Reserve Bank might still be easing monetary policy in the first half of 2008 the markets will be turning their attention to when they start tightening. Overall it looks like rates will be lower in a couple of years time and for that reason we can't find any especially strong reason for avoiding the two-year fixed interest rate currently.

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	8.15	7.16	5.95	8.45
2	7.60	7.28	5.99	8.25
3	7.70	7.49	6.30	8.30
4	7.65	7.62	6.40	8.40
5	7.60	7.65	6.50	8.60
7	7.60	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	6.20	6.25	6.30
180	6.80	6.85	6.90
1 yr	6.60	6.65	6.70
5 yr	6.10	6.15	6.20

HOUSING MARKET UPDATE

Time is tight at the moment with analysis of this afternoon's Budget and plenty of media interviews so we have nothing to put into this section this week.

EXCHANGE RATES

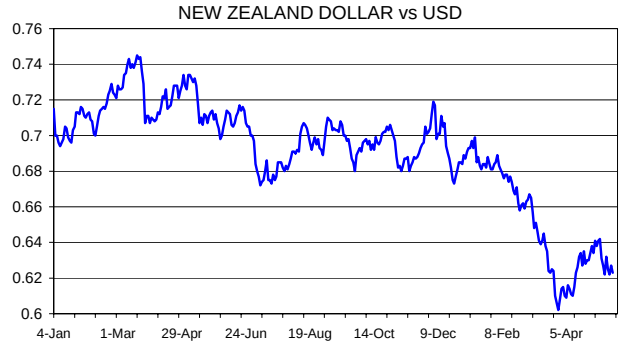
As has been the case over the past two to three years the most common exchange rate question we are receiving at the moment is about the New Zealand dollar against the British pound. The current exchange rate of close to 33 pence is well down from 35.5 a month ago and 39 pence four months ago. There are many people who have shifted to New Zealand over the past few years who have been waiting for the exchange rate to fall so they can bring their valuable British pounds over. Some have decided to bring the money over in the past couple of years and just get on with life here while others have either held off buying a property waiting until they can get a better exchange rate to pay cash for what they want or have bought a property, taken out a mortgage, and intend paying the mortgage down once they bring their cash over.

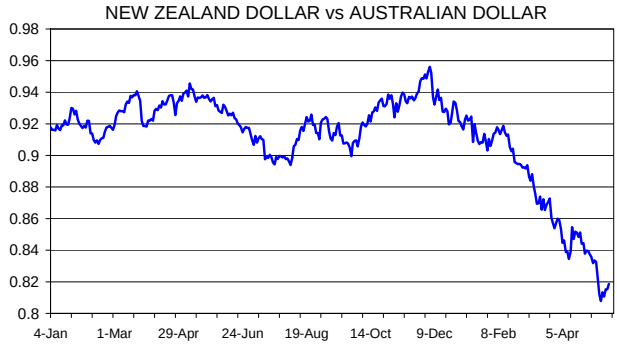
One interesting thing with regard to British citizens who have shifted to New Zealand is that many appear to have made bad house purchase decisions over the past two to three years. We don't know why but many find themselves relatively unsatisfied with their first purchase and need to sell and buy again perhaps in a different suburb. We have come across one family who are on to their third property in two years. This is great for real estate agents but perhaps indicates that the picture some immigrants have of New Zealand from afar isn't detailed enough when it comes to realising there can be substantial differences in the quality of schools, access to public transport, quality of employers etc. it will be interesting to see if some of these negative experiences of migrants cause a pullback in migration here in the same way that the bad experiences of many Chinese students studying in New Zealand have contributed to a sharp decline in the foreign education sector over the past two to three years.

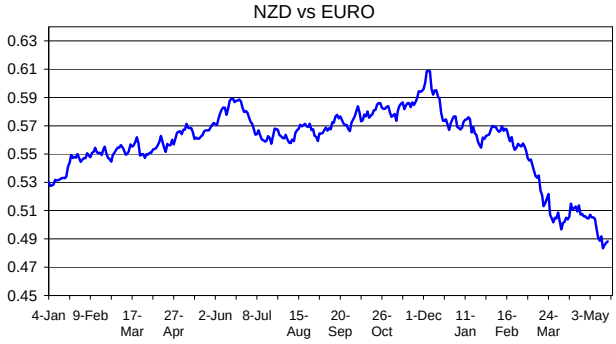
Never mind. Back on the exchange rate again. The Kiwi dollar has come down a long way over the past few months and on the face of it one would expect to see some stability over the remainder of this year given evidence that the economy is having a soft landing and the Reserve Bank will unlikely to cut their official cash rate for a long time yet. However the fact that we are going to go through a relatively slow growth period over the next two to three years while our trading partners are chugging along at 3% to 3.5% suggests strongly that there is further downside left in the Kiwi dollar. Similarly when we consider the large volume of maturing Euro Kiwi and Uridashi issues in the coming two years one gets a picture of downside risk. Throw in divergent interest rate movements over 2007 and our conclusion is further downside beckons.

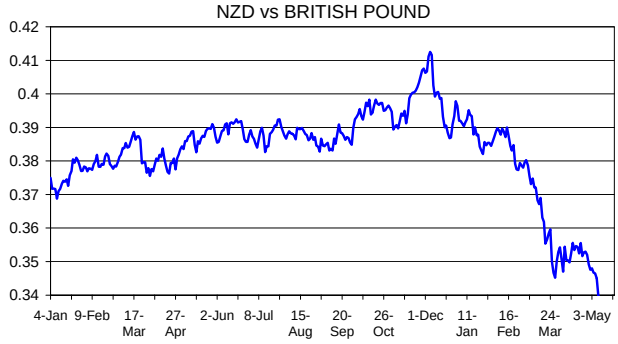
Having said that we think people should be wary about expecting a lot of extra further downside for the Kiwi dollar when measured against the Australian currency. The Australian dollar has been strangely strong in recent months on the back of an interest-rate increase from the Reserve Bank of Australia, a positive budget a couple of weeks ago, some good economic data, and strong rises in commodity prices. But we have a concern about the sustainability of these commodity prices and believe there could be a bubble in the commodity markets. If this bubble bursts commodity influenced currencies will decline. We are one of those currencies but our soft commodity prices have not risen as the metals and minerals commodity prices have in recent times. That means that for those interested in the New Zealand dollar against the Australian dollar we caution against expecting too much extra depreciation in the near future. To justify a move below 80 cents we will need to see some new information come out suggesting either extra sustainability of commodity prices or extra weakness in the New Zealand economy.

This afternoon the New Zealand dollar has ended against the greenback near 62.3 cents compared with 62.2 cents a week ago. Against the Australian dollar we have risen one cent however from 80.8 cents to 81.8 cents. Against the British pound we have edged down lower to 33.1 pence from 33.5, against the Japanese yen we are hardly changed near 69, while against the euro we are similarly unchanged near 48.9 cents.



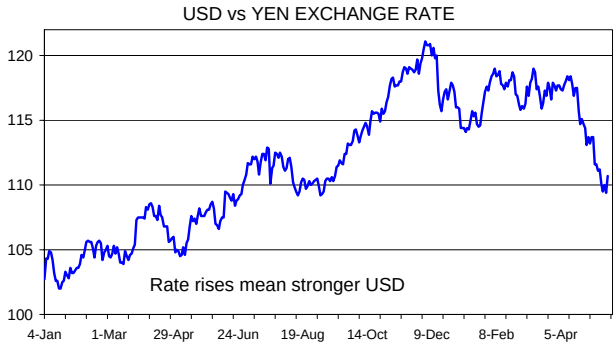


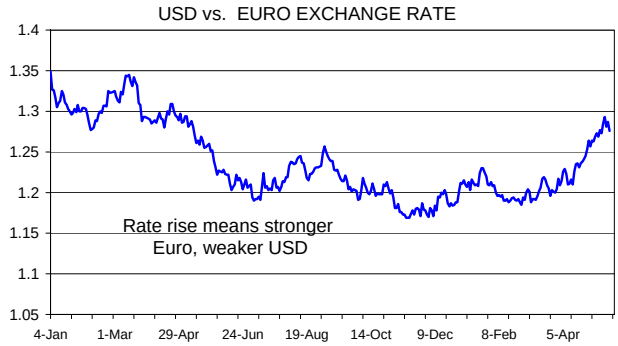




The Australian dollar has lost ground against the greenback over the week to end near 76.1 cents from 77 cents on the back of profit-taking following the strong rise in recent weeks along with falls in commodity prices overnight and a few worries starting to appear regarding the sustainability of current commodity price levels. During the week in Australia data were released showing consumer confidence weakening after the budget of a couple of weeks ago while one business confidence measure rose to a record high.

The United States dollar has weakened over the past week in spite of the resurfacing of worries about inflation last night. The selling started early in the week when the April retail sales report came in slightly weaker than expected showing sales up 0.5% rather than the anticipated growth rate of 0.8%. The USD has ended against the Japanese yen near 110.7 from 111.2, against the pound at $1.884 from $1.855, and against the euro near $1.276 from $1.273.





Last week someone send an e-mail asking for average exchange rates for the New Zealand dollar against a number of currencies over the past few years. Each Thursday night when I send out the Weekly Overview I get over 600 error messages which then need to be deleted and any emails sent on the night can easily get deleted and that is what happened. So for the interest of all the following table shows the average exchange rate for the New Zealand dollar against the major currencies for each year since 2000.

	2000	2001	2002	2003	2004	2005
USD	**0.46**	**0.42**	**0.46**	**0.58**	**0.66**	**0.70**
AUD	**0.78**	**0.81**	**0.85**	**0.89**	**0.90**	**0.92**
GBP	**0.30**	**0.29**	**0.31**	**0.36**	**0.36**	**0.39**
EUR	**0.49**	**0.47**	**0.49**	**0.51**	**0.53**	**0.57**
JPY	**49.26**	**51.08**	**57.86**	**67.37**	**71.76**	**77.50**

If anyone is interested in further historical information on exchange rates then you will get full information since the Kiwi dollar was floated in March 1985 by going to the Reserve Bank's web site at www.rbnz.govt.nz

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	0.6%	0.7	3.3	2.8	1.5
GDP growth	Average past 10 years = 3.3%	-0.1	0.1	2.2	4.4	3.4
Unemployment rate	Average past 10 years = 5.7%	3.9	3.6	.....	3.8	4.2
Jobs growth	Average past 10 years = 2.1%	1.1	0.0	2.6	3.4	3.2
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	1.2	5.6	7.1	5.9
House Prices	Long term average rise 4.2% p.a.	3.9	2.6	15.3	12.2	24.8
Net migration gain	Av. gain past 10 years = 13,000	+9,746	6,960yr	.....	10,013	27,978
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 8%. Colmar survey	-29	-35	14	-3	-6
Business activity exps	10 year average = 27%. NBNZ	15	5	12	15	20
Household debt	10 year average growth = 11.4%. RBNZ	14.7	14.7	15.3	15.2	16.1
Dwelling sales	10 year average growth = 4.6%. REINZ	-14.6	-2.9	3.9	-7.5	6.0
Tourist numbers	10 year average growth = 6.1%. Stats NZ	-3.0	0.9	1.6	10.6	9.2
Floating Mort. Rate	10 year average = 8.5%	9.55	9.55	9.00	9.00	7.50
3 yr fixed hsg rate	10 year average = 8.2%	7.70	7.85	7.70	7.80	6.90

ECONOMIC FORECASTS

Forecasts at Apr 6 2006	**March Years**					**December Years**				
	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
GDP - annual average % change										
Private Consumption	5.8	3.7	0.8	0.4	1.1	6.5	4.6	1.0	0.5	0.8
Government Consumption	5.2	5.2	4.3	3.2	3.6	5.7	5.3	4.4	3.6	3.1
Investment	7.8	5.6	-0.1	1.8	3.6	13.2	4.3	0.7	1.4	3.1
GNE	6.5	4.1	1.0	1.3	2.3	8.2	4.5	1.2	1.4	1.9
Exports	3.9	0.9	1.8	3.7	4.8	5.6	-0.3	1.9	3.2	4.5
Imports	13.7	5.1	1.0	2.4	3.2	16.6	6.4	0.9	2.4	2.9
GDP	3.7	2.0	1.0	1.7	2.8	4.3	2.2	1.1	1.6	2.4
Inflation – Consumers Price Index	2.8	3.3	3.3	3.3	2.1	2.7	3.2	3.3	3.5	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	0.64	0.54	0.59	0.62	0.71	0.70	0.55	0.57	0.61
USD/JPY	105	117	108	106	107	104	119	108	105	108
EUR/USD	1.32	1.20	1.21	1.24	1.23	1.34	1.19	1.21	1.23	1.24
NZD/AUD	0.93	0.88	0.79	0.82	0.84	0.93	0.94	0.81	0.80	0.83
NZD/GBP	0.38	0.36	0.31	0.34	0.36	0.37	0.40	0.32	0.33	0.35
NZD/EUR	0.55	0.53	0.45	0.48	0.50	0.53	0.59	0.46	0.46	0.50
NZD/YEN	76.8	74.6	58.3	62.5	66.3	74.2	82.7	59.4	59.9	66.1
TWI	70.7	65.6	55.6	59.5	62.4	69	71.9	56.7	57.6	61.8
Official Cash Rate	6.5	7.25	6.75	5.75	5.75	6.5	7.0	7.00	6.0	5.75
90 Day Bank Bill Rate	6.86	7.55	6.98	5.88	6.12	6.73	7.49	7.24	6.14	5.95
2 Year swap	6.82	7.0	6.20	6.06	6.20	6.61	7.24	6.35	6.04	6.17
10 Year Govt Bond	6.04	5.71	5.95	5.6	5.7	6.03	5.89	5.95	5.65	5.65

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

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