Bank of New Zealand

BNZ Weekly Overview

25 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	7.49	7.50	7.05	6.6
10 year govt. bond	5.80%	5.87	5.67	5.71	5.77	6.5
1 year swap	7.41%	7.41	7.35	7.34	7.04	6.7
5 year swap	6.82%	6.85	6.77	6.72	6.66	7.1
NZD/USD	0.634	0.623	0.628	0.661	0.713	.57
NZD/AUD	0.842	0.818	0.844	0.894	0.938	.86
NZD/JPY	71.5	69.0	72.0	77.4	76.7	66.0
NZD/GBP	0.34	0.331	0.356	0.377	0.39	.35
NZD/EURO	0.496	0.488	0.507	0.555	0.567	.509

For addition to our emailing list for Thursday night receipt email "Subscribe WO" to tony.alexander@bnz.co.nz

Outlook for the New Zealand Economy

I spend a lot of time travelling around the country delivering talks to various audiences at Bank of New Zealand functions and for a few outside organisations. Over the next few weeks there are so many talks to be done that the time available for filling out the Weekly Overview is going to be less than normal. That means that unless we have some truly astounding data releases or events the Weekly Overview is likely to be slightly smaller than normal for a while. To compensate for that this week we are including the main points from the standard handout being taken along to talks at the moment. Enjoy.

The rate of growth in New Zealand's economy has slowed over the past year from 4.4% to 2.2%. We forecast growth near 1.2% over 2006 and 1.5% over 2007 with many risks. The main factors causing growth to slow include the following

- The high NZ dollar reducing export receipts
- Housing cycle downturn
- Capacity constraints in some sectors
- Commodity prices falling on average 15%
- Pre-NZD decline retail binge ending
- Above average interest rates
- Below average net immigration
- Farmers ending major capital spending catch-up
- Extremely tight business margins

But we are not forecasting a recession because of insulation from the following factors.

- Trading partner growth of 3.7% > the 10 year average
- Commodity prices still above average
- Non-residential construction backlog
- Accelerating wages growth
- Infrastructure investment around NZ
- Easing fiscal policy
- Good job security
- Low fixed interest rates & high uptake of such.

However downside risks to growth come from the following factors.

- High oil prices
- High household debt
- Liquidation by scared property investors
- Businesses slashing spending to rebuild margins

The pain so far has been felt in the exporting sector and businesses generally due to tight margins. But we are finally starting to see cutbacks in spending on retail goods and housing and in the second half of this year household spending is likely to be further restrained by flat to mildly falling house prices. These cutbacks in consumer spending reflect the lagged feed-through of the high exchange rate, worsened migration flows, interest rate worries, and a falling exchange rate. History shows that a falling currency and domestic woe tend to go hand in hand.

The New Zealand dollar is overvalued even after the recent decline toward 62 cents and will eventually fall toward 55-60¢ come the end of this year with further mild depreciation possible over 2007. However the speed of decline is unpredictable.

A key problem this economic cycle is shortages of resources and rising inflation expectations which will prevent the Reserve Bank from easing interest rates probably until December at the very earliest. This means the period of weak growth for the New Zealand economy is likely to extend through all of this year and 2007. Our key recommendations are as follows.

- Minimise floating rate debt and instead look for good one to three year fixed interest rates.
- Exporters should ease off currency hedging beyond three months. Importers in contrast should boost hedging for periods beyond three months.
- After six years of strong growth many business operators will not have experienced a downturn. Watch exposure to these people.

IMPLICATIONS

- Property investors looking for bargains should focus strictly on rental yield as the probable absence of a slump in the housing market this cycle means the absence of strong capital gains three to four years out.
- Home buyers should be wary of forecasts that floating rates will decline sharply this cycle and instead look for good fixed rates in the two to three year area. Businesses should focus in the floating to three year area.
- Speculative building is now highly risky with migration easing off and the housing cycle turning down.
- With business profit margins being heavily constrained in an environment of resource shortages and uncertainty about the extent of our slowdown and events overseas, investors may want to consider running a greater than average cash component to their portfolio.
- The Kiwi dollar will fall further and this suggests investors may wish to increase the allocation of funds in foreign currencies.
- Importers may want to take advantage of periods of unusual NZD strength in the next few months to get longer term hedging in place.
- As the exchange rate falls prices for some imported goods and services may rise sharply. Businesses should budget for higher fuel costs.
- Historically growth in the New Zealand economy has been constrained by customer demand. Now the main constraint is resource availability. Business strategic plans should focus less on new customer acquisition and more on margin growth, resource quality and quantity, and investment which will boost productivity rather than boosting demand for other resources like electricity and labour.
- Retailers should prepare for much weaker conditions from later this year by quitting excess stock early.
- Businesses with labour shortages should watch for layoffs by other companies as an opportunity to improve staff numbers and/or quality.
- Farm capital spending jumped sharply from 1999 to 2001 and has remained at high levels until recently. With farm incomes now being constrained suppliers of rural services should allow for a potentially strong cyclical decline in farmer purchasing over the next 12 months.
- Businesses generally should watch their exposure to operators who have only been around since 1999 when growth has been unusually strong. They may be unable to handle weak economic growth let alone a recession should one happen to come along. Watch debtors ledgers in particular.

Buckleys

Continuing with our explanation of the term Buckleys and none we had the following e-mail sent this week. "Being a pedantic financial type and an Aussie I couldn't stand the lack of a complete answer to the critical "Buckleys" tale.

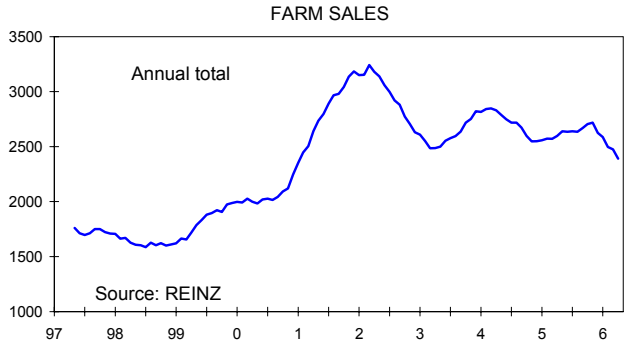
Buckley & Nunn was a very famous major department store chain in the early to mid 1900's. As a kid I can remember a big store in Bourke Street Melbourne with the Buckleys name carved in it. In the 19th Century there was also a convict by the name of Buckley. He became notable for repeatedly escaping from the authorities and on one occasion escaped and lived for several years in caves near the mouth of Port Philip Bay. He was searched for, shot etc etc – and the improbability of his survival came into the vernacular with typical Aussie rhyming slang – his chances were Buckley's & None."

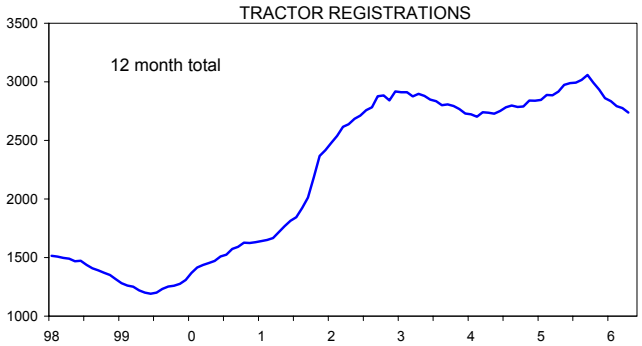
THE WEEK'S ECONOMIC DEVELOPMENTS

Friday 19

Farm Spending Easing Back

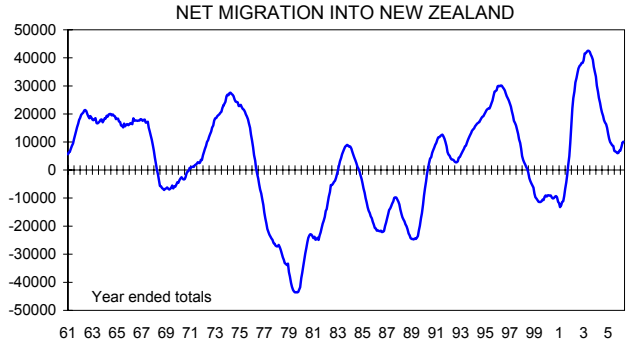
During April there were 177 farms sold around New Zealand. This was a relatively large 32% decline from a year earlier and means that in the three months to April farm sales were down 25% from a year earlier while in the year to April sales were down by 8% from a year earlier. These numbers and others showing for instance that tractor registrations were down 16% on a year ago in the three months to April indicate that capital spending in the farming sector is pulling back. Farmers are going through a period of consolidation in their finances after many years of expansion.

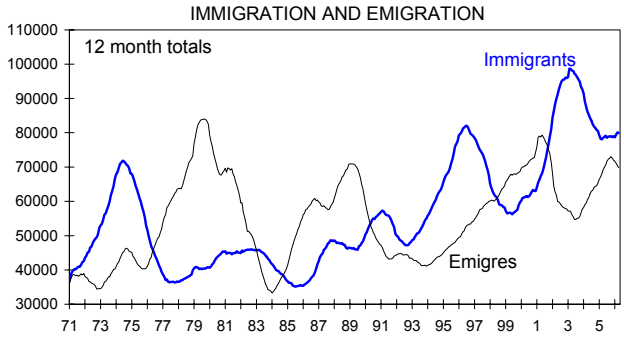




Migration Flows Improve Again

There was a net loss to the New Zealand population from permanent and long-term migration flows in April of 400 people. This was less than the 733 loss a year ago and means that in the year to April the net gain to our population from migration flows was 10,079. This was up from 9,349 a year ago and a low point for this cycle of 5,987 in October. In the three months to April the number of immigrants was up 6.7% from a year earlier while the number of people leaving New Zealand was down by 9.5% from a year ago. The turnaround in the migration numbers comes as a bit of a surprise considering the slowdown in growth in the New Zealand economy compared with accelerating growth in our trading partners. Because in the past relative growth rates appear to have influenced migration flows we suspect the migration numbers could dip down again later this year and through 2007. In particular of course with the raging debate about tax cuts in Australia versus the absence of such cuts in New Zealand we expect to see increasing numbers of people going across the Tasman. But for the moment the increase in migration flows implies a bit of extra support for the retail sector and the housing market and as such implies less scope for any easing of monetary policy by the Reserve Bank.



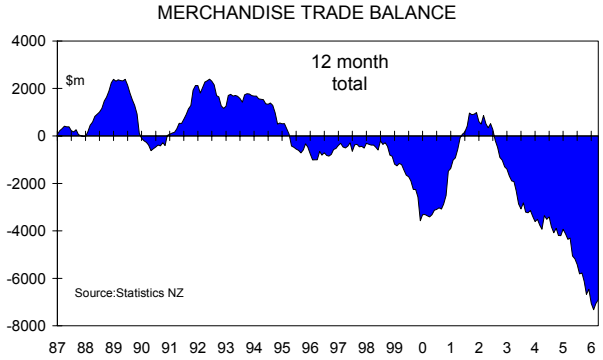


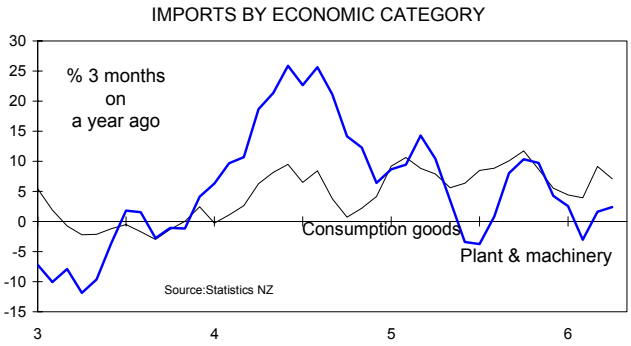
The tight labour market is an interesting dynamic to consider. On the face of it the low unemployment rate in New Zealand and hefty demand from businesses for skilled employees would dissuade people from going across the ditch to Australia and encourage more people to come here. For the moment this probably explains the recent improvement in net migration flows. But we have had a tight labour market for a few years now and one suspects that employees are close to taking it for granted. That is we must all just about have the frame of mind of thinking that there will always be a job for me. Once we are in that frame of mind then maybe we start to look for something else in order to improve our situation as employees. Most obviously this means higher wages and salaries hence the recent acceleration in wages growth. But maybe it means we also look for some greater respect for our position from the government through stronger means than just the extra week's annual holiday for those that were on three weeks for instance. Maybe we are becoming so used to job security that the government's continued determination not to give tax cuts is starting to be interpreted as an insult.

Thursday 25

Foreign Trade Account Improves

The merchandise trade account recorded a surplus in April of $19 million. This was considerably better than the deficit the markets had been expecting of $180 million and means that for the three months to April the value of export receipts was 6.8% ahead of a year earlier while import payments were up by only 4.7%. This means there is a slight reversal in the trend for export growth to be less than import growth in place broadly since the middle of 2002. In the year to April 2006 export receipts were up just 0.4% from a year earlier while import payments were up by 7.7%. The annual trade deficit now stands at $6.9 billion compared with $7.1 billion in March and $4.3 billion a year ago. As a proportion of exports the annual deficit now stands at 22%. This is down from the record 23.8% reached in February but still well up from 13.8% a year ago. Is the improving trend in exports likely to be sustained? We think it is probably a bit too early for the recent fall in the exchange rate to really be producing any solid results and changes in the timing of exports of dairy products may account for some of the recent export strength. However with growth in the New Zealand domestic economy slowing down and given the fall in the currency and above average growth in our trading partners we do believe the worst has been seen for the merchandise trade deficit and a slow improvement will now be under way.

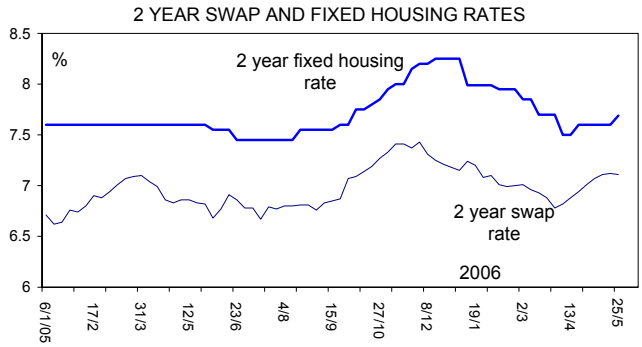


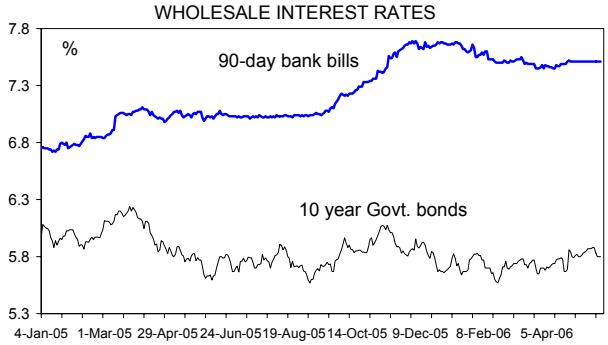


Reflecting the weakness in the domestic economy the value of imports of capital goods was just 2% ahead of the year earlier in the April quarter while the value of imports of consumer goods was ahead by 7%.

INTEREST RATES

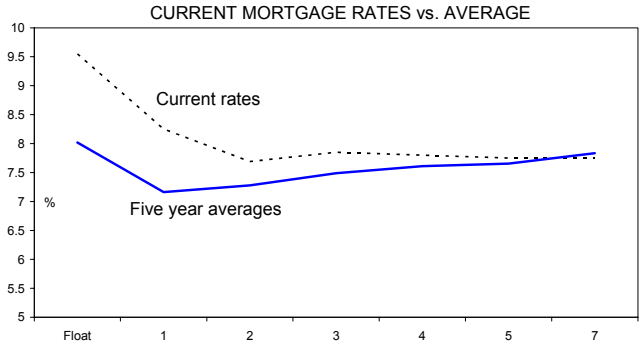
Wholesale interest rates have changed by very little over the past week in the absence of any earth shattering data releases in New Zealand or the United States. 90 day bank bill yields are unchanged from a week ago at 7.51% while the two year wholesale borrowing cost remains near 7.11%. Nothing major looms locally on the horison to get us excited about rate movements in the short term.





If I Were a Borrower What Would I Do?

The graph below compares current fixed interest rates with their average levels over the past five years. For borrowers simply wanting to get certainty for their interest costs locking in for three years or beyond doesn't look like a bad thing to do. Those having a view on the Reserve Bank easing monetary policy reasonably aggressively come late 2007 and 2008 might go for a two-year rate. The advantage is one gets an opportunity to re-fix at possibly a lower rate further out. The disadvantage is that one is paying above the average two-year rate in order to take this chance. Personally I still like the two year rate and see a risk of it moving up in the near future given the increase in wholesale two year borrowing costs in recent weeks.



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	8.25	7.16	5.95	8.45
2	7.69	7.28	5.99	8.25
3	7.85	7.49	6.30	8.30
4	7.80	7.62	6.40	8.40
5	7.75	7.65	6.50	8.60
7	7.75	7.83	6.75	8.80

Note: Conditions may apply to these rates.

BNZ Term Deposit Rates

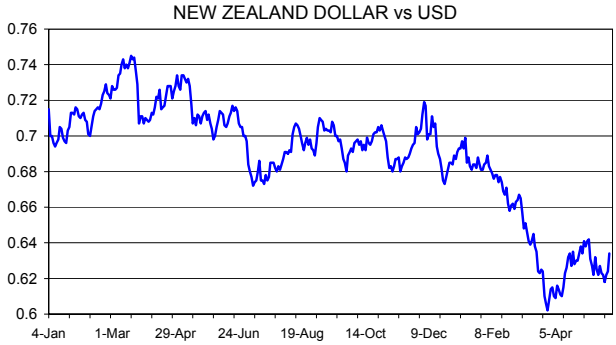
Days	$10-50K	$50-100K	$100-250k
30	3.00	3.00	5.25
90	6.20	6.25	6.30
180	6.80	6.85	6.90
1 yr	6.60	6.65	6.70
5 yr	6.10	6.15	6.20

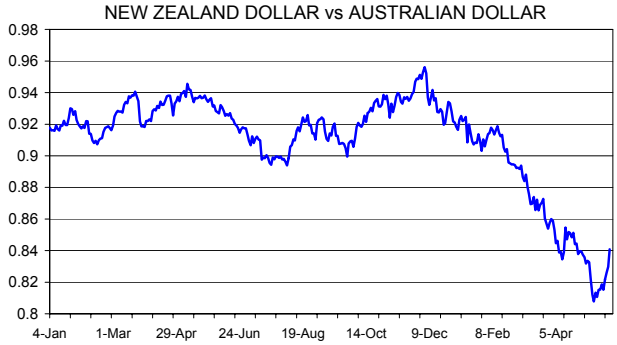
HOUSING MARKET UPDATE

We have not received any new data on the New Zealand housing market over the past week so have nothing to put in here.

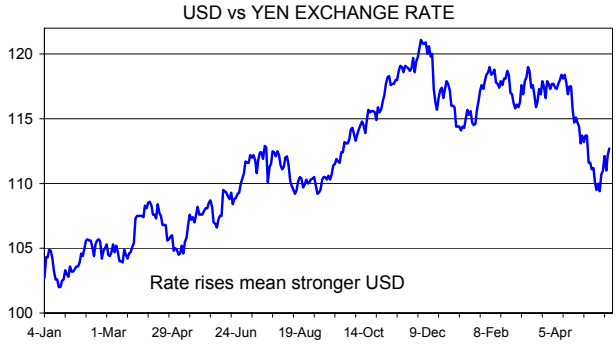
EXCHANGE RATES

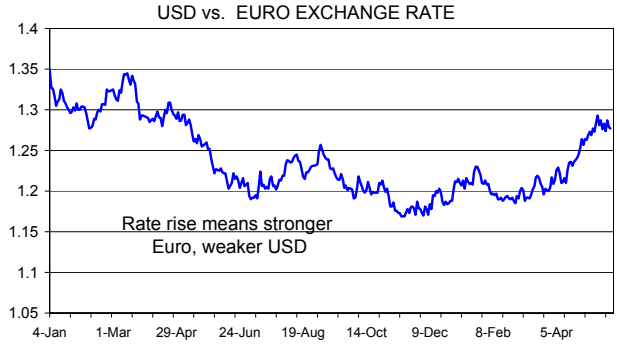
It's been a bad week for exporters with the New Zealand dollar climbing back to 63.4 US cents from 62.3 cents a week ago, while against the Australian dollar we have jumped to 84.2 cents from 81.9 cents last week. The rise against the greenback is mainly due to some independent strength in the Kiwi dollar rather than fresh weakness in the US dollar.



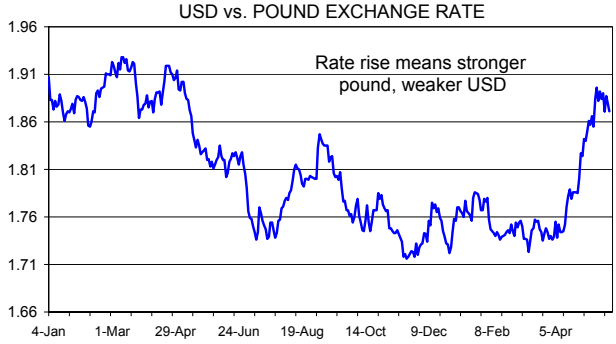


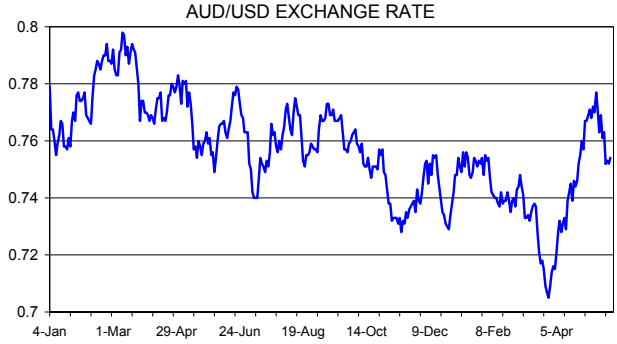
The US dollar itself has ended the week slightly better against the Japanese yen near 112.7 from 110.7 a week ago, but it has recorded only a slight improvement against the British pound to end near $1.868 from $1.884 last week. Against the euro the greenback is unchanged near $1.276.





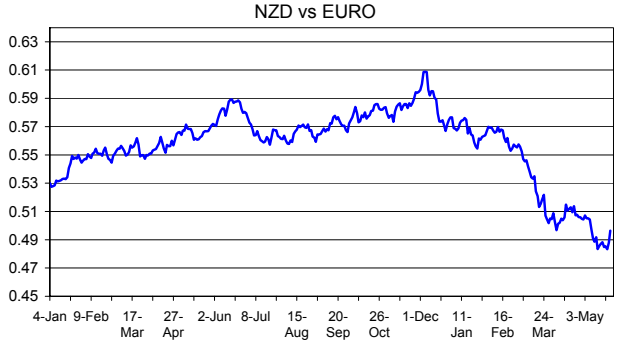
In the United States uncertainty remains about whether interest rates will be increasing again but we have seen the Bank of Canada raise their cash rate another 0.25% overnight to 4.25%. And in response to German business confidence remaining at very high levels in data released overnight there is a strong market expectation that the European Central Bank will be tightening monetary policy there in a few weeks time either by 0.25% or possibly 0.5%. In contrast in the United States the Federal Reserve have said they will judge whether it is necessary to increase interest rates further on the strength of economic data now being released. Those data are falling on both the positive and negative side so as yet there is no consensus view that there will or will not be a further increase in the Fed funds rate from the current 5%. If anything there is a slight expectation of another rate increase but high sensitivity to what each piece of data may show. In this sort of environment we expect continued volatility in the United States dollar and with commodity prices moving around reasonably sharply we are likely to see volatility continuing in many other currencies as well.

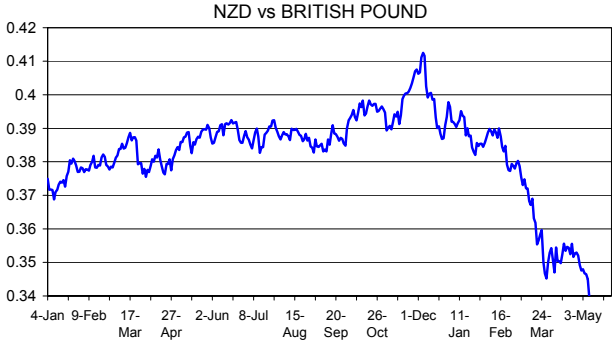


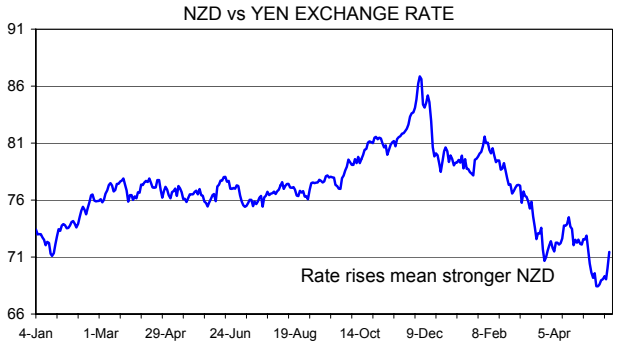


For instance the Australian dollar has weakened over the past week on the back of a reasonably sharp pullback in commodity prices as the markets have grown weary about rising interest rates and inflation, and some speculators who have been pushing prices up in the commodities markets have been taking profit. Against the greenback the Australian currency has ended this afternoon near 75.2 cents from 76.1 cents a week ago.

The Kiwi dollar over the past week has been lifted by a number of factors. One has been this morning's better than expected merchandise trade numbers bringing export growth compared with a year earlier to levels faster than import growth and causing some hope that the current account deficit will soon be cyclically improving. The New Zealand dollar has also benefited by the rumour of one trader unwinding a large position where they were long Australian dollars and short Kiwi dollars.







Our expectation is that the New Zealand dollar will resume its cyclical decline at some point this year. However it is not a surprise to us that the Kiwi dollar is going through a period of strength at the moment and this strength could continue for quite some time as we see better than expected export numbers being released here and a number of other indicators such as confidence measures also improving.

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	+10,079	6,951yr	.....	9,349	25,712
		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	9.7	-3.0	-2.8	5.2	22.6
Floating Mort. Rate	10 year average = 8.5%	9.55	9.55	9.55	9.00	7.75
3 yr fixed hsg rate	10 year average = 8.2%	7.85	7.60	8.15	7.80	7.20

ECONOMIC FORECASTS

Forecasts at May 18 2006	**March Years**					**December Years**				
	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
GDP - annual average % change										
Private Consumption	5.8	3.9	1.4	0.4	1.1	6.5	4.6	1.7	0.5	0.8
Government Consumption	5.2	5.2	3.8	3.1	3.6	5.7	5.3	4.0	3.4	3.1
Investment	7.8	5.4	-1.2	1.4	3.6	13.2	4.3	-0.3	0.7	3.1
GNE	6.5	4.1	1.0	1.2	2.3	8.2	4.5	1.2	1.2	1.9
Exports	3.9	0.6	1.6	3.8	4.9	5.6	-0.3	1.2	3.4	4.6
Imports	13.7	4.9	0.1	2.2	3.3	16.6	6.4	-0.2	2.2	3.0
GDP	3.7	2.1	1.1	1.7	2.7	4.3	2.2	1.2	1.5	2.4
Inflation – Consumers Price Index	2.8	3.3	3.4	3.3	2.1	2.7	3.2	3.3	3.5	2.2
Employment	3.4	2.6	0.5	0.7	1.1	4.4	1.5	1.5	0.6	1.0
Unemployment Rate %	3.8	3.9	4.3	4.5	4.4	3.7	3.6	4.1	4.4	4.4
Wages	2.9	4.6	4.6	3.5	2.6	1.9	5.1	4.4	3.7	2.8
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.73	0.64	0.59	0.57	0.59	0.71	0.70	0.60	0.56	0.59
USD/JPY	105	117	103	105	104	104	119	105	105	105
EUR/USD	1.32	1.20	1.23	1.23	1.21	1.34	1.19	1.24	1.22	1.23
NZD/AUD	0.93	0.87	0.80	0.81	0.84	0.93	0.94	0.80	0.80	0.83
NZD/GBP	0.38	0.36	0.33	0.32	0.34	0.37	0.40	0.33	0.32	0.34
NZD/EUR	0.55	0.53	0.48	0.46	0.49	0.53	0.59	0.48	0.46	0.48
NZD/YEN	76.8	74.6	60.8	59.9	61.6	74.2	82.7	63.0	58.8	61.8
TWI	70.7	65.6	58.9	57.7	62.1	69	71.9	59.7	56.9	62.1
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	6.10	6.73	7.49	7.22	6.12	5.93
2 Year swap	6.82	7.0	6.18	6.04	6.18	6.61	7.24	6.33	6.02	6.15
10 Year Govt Bond	6.04	5.71	5.90	5.6	5.7	6.03	5.89	6.05	5.65	5.65

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

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.