

# BNZ Weekly Overview

27 July 2006

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## FINANCIAL MARKETS DATA

	<b>This week</b>	<b>Week ago</b>	<b>4 wks ago</b>	<b>3 months ago</b>	<b>Yr ago</b>	<b>10 yr average</b>
Official Cash Rate	7.25%	7.25	7.25	7.25	6.75	6.3
90-day bank bill	7.49%	7.50	7.47	7.52	7.02	6.6
10 year govt. bond	5.89%	5.94	5.92	5.83	5.77	6.5
1 year swap	7.53%	7.58	7.44	7.32	7.00	6.7
5 year swap	7.02%	7.05	6.89	6.71	6.52	7.1
NZD/USD	0.619	0.624	0.607	0.63	0.682	.57
NZD/AUD	0.813	0.832	0.828	0.838	0.90	.86
NZD/JPY	71.9	72.8	70.5	72.3	76.7	66.0
NZD/GBP	0.334	0.338	0.333	0.353	0.392	.35
NZD/EURO	0.486	0.495	0.482	0.506	0.567	.509

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## Soft Landing on Track

Over this past week nothing has happened to change our long-running view and assessment of the risks facing the New Zealand economy, inflation, interest rates, and the exchange rate. Yesterday's monthly merchandise trade numbers were surprisingly strong but support our view that the extent of a cyclical decline in the Kiwi dollar this time around will be relatively limited and a fall below 50 US cents is unlikely given the reasonable export outlook.

Earlier in the week the monthly National Bank Business Outlook survey showed further improvements in employment and investment intentions while revealing yet again high inflation risks as businesses look to put prices up when opportunities present themselves. The review of the official cash rate by the Reserve Bank this morning probably caught a few people by surprise because the RB stated explicitly that they do not expect to increase the official cash rate again this cycle. We have been cautious about the recent wave of bearishness sweeping through the markets following on from some recent stronger than expected inflation and growth data in New Zealand and the Reserve Bank's comments should now see things settle down.

Because the comments were slightly weaker than many were expecting we have seen the Kiwi dollar weaken marginally today to end up just below where it was a week ago against the greenback, but the main move this week has been a decline against the Australian dollar as the Australian currency has been boosted by a much higher than expected inflation report for the June quarter. Australian monetary policy is likely to be tightened next week and the reduction in the interest rate differential between New Zealand and Australia will eventually encourage further depreciation of the Kiwi against the Aussie currency.

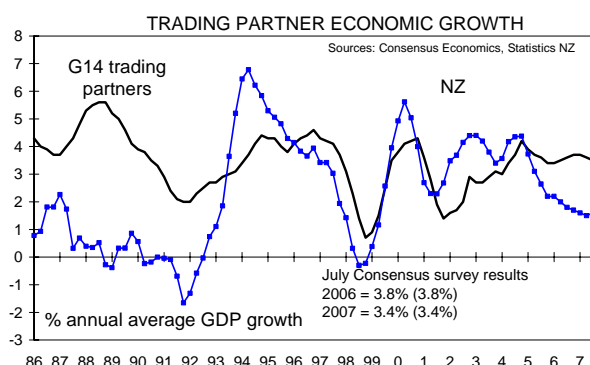
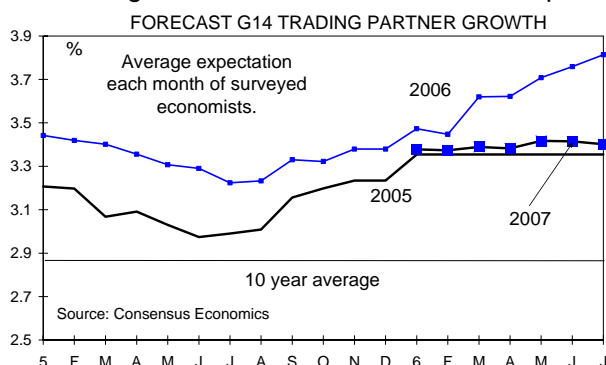
# BNZ WEEKLY OVERVIEW

## THE WEEK'S ECONOMIC DEVELOPMENTS

**Monday 24**

### Trading Partner Growth Okay

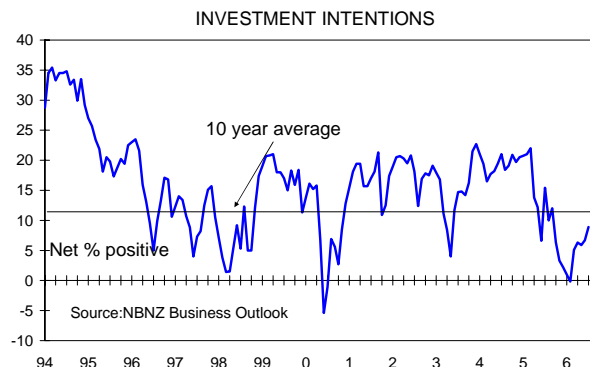
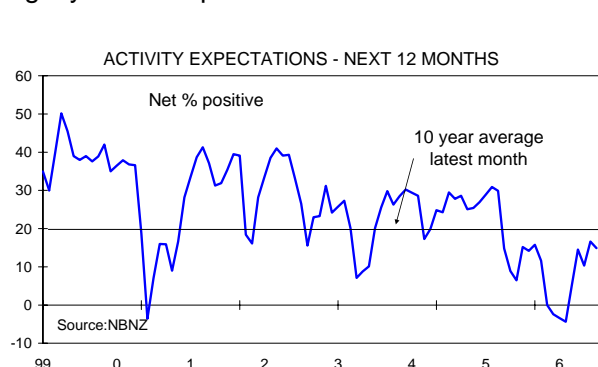
On average New Zealand's top 14 export destinations are forecast to grow by 3.8% this year and 3.4% next year according to the monthly consensus economics survey of economists around the world. These forecasts from July surveys were unchanged from June data from 3.5% and 3.37% respectively at the start of the year. The Australian economy is expected to grow 3.3% this year and 3.4% over 2007, the United States 3.5% then 2.8% with the slowdown attributable to higher interest rates, Japan 3% then 2.2%, the United Kingdom 2.4% in 2.5%, and the European Union 2.4% in 2.1%.



**Wednesday 26**

### Business Activity Outlook Okay

The monthly NBNZ Business Outlook survey for July showed a small improvement in business sentiment to a net 31% pessimistic from 32% pessimistic in June. However this measure has been sitting extremely close to 31% over the past four months so things appear relatively static at highly pessimistic levels. However, as we have noted many times in the past, you don't want to look at this confidence measure to get an indication for where the economy is going or what businesses are likely to do with their money in the near future. For that you need to look at the activity expectations number and indications of investment and employment intentions. Doing this we see that activity expectations for the coming 12 months were a net positive 14.9% in July which was down marginally from 16.6% in June. However this measure traditionally falls at this time of year and the average reading for July over the past 10 years was 19.7% versus 22.9% in June. Therefore one can in fact say that activity expectations on a seasonally adjusted basis have improved slightly over the past month.

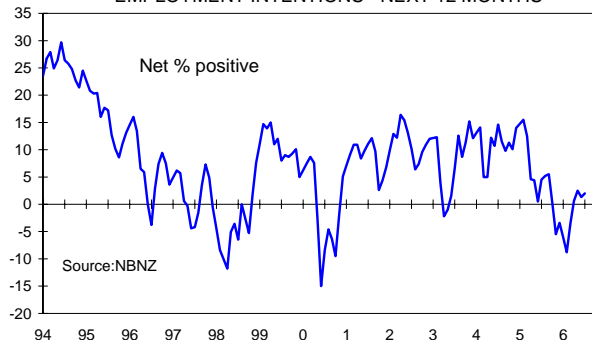


This conclusion of businesses having a reasonable outlook for their companies is reinforced by the improvement in employment intentions to a net 2% positive from 1.3% in June. The latest reading is only just below the 10 year average of 3.1% and reinforces our consistent message that the labour market

# BNZ WEEKLY OVERVIEW

remains relatively tight and this is not a downturn in the economy which is going to produce much of an increase in the unemployment rate. That means it is unreasonable to expect that this period of mild growth in the economy will cause much deceleration in the rate of increase in wages. Another indicator of business attitudes not being all that bad is investment intentions improving to a net 8.9% positive in July from 6.7% positive in June. The 10 year average reading for this measure in July is 11.8% therefore we are only just below average levels. This leaves us hopeful that next year we will see some reasonable growth in business capital spending.

EMPLOYMENT INTENTIONS - NEXT 12 MONTHS



PRICING INTENTIONS - NEXT 12 MONTHS



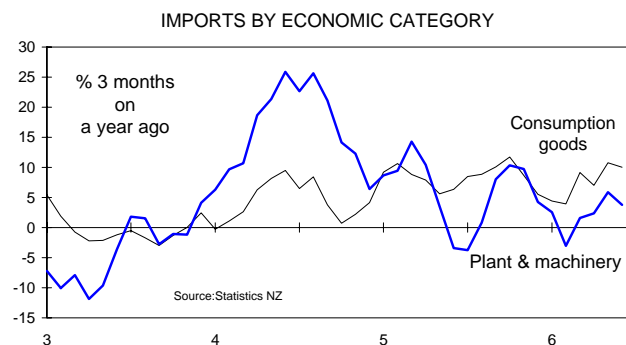
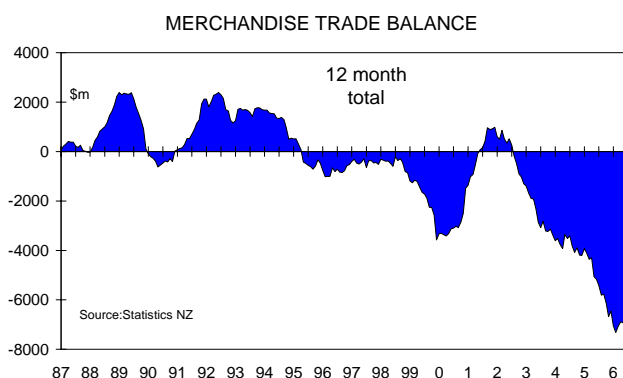
Given that inflation is at 4% the Reserve Bank needs a period of weak growth to make you and I believe that inflation will one day consolidate back below 3%. This survey so far will not be pleasing them all that much because it shows an economy in reasonable shape. They are likely to be quite scared by the pricing intentions measure this month. In July a net 39.5% of businesses said they expect to increase their selling prices over the coming 12 months. This is an increase from 35.2% in June and shows that the June decline from 39.6% in May was not the start of a downward trend. We think little solace can be taken from year ahead inflation expectations easing marginally to 3.24% from 3.26% in June.

All up the survey reinforces our expectation of a soft landing but it also leaves us convinced that for the next two to three years growth in our economy will be relatively mild with restraint from the Reserve Bank maintaining tight monetary policy primarily because they have misjudged the strength in the economy and the inflationary pressures coming along from resource shortages. Yet again the evidence suggests they mucked it up in 2004 and 2005 by not tightening monetary policy properly.

## Trade Deficit Improves

The merchandise trade account recorded a deficit in June of \$214 million which was better than the deficit of \$370 million expected by the markets. The difference mainly reflects unusually strong dairy exports. The annual trade deficit now sits at 6.6 billion compared with 6.9 billion in May and 5.2 billion a year earlier. In the year to June export receipts improved 6% while import payments grew 9.2%. Over the June quarter export receipts were up by 16.2% while import payments were up by 10.1% with exports boosted by some late strength in the dairy sector. Given that export growth continues to run slower than import growth but allowing fall in the event will feature of the recent decline in the currency and further depreciation which we expect it seems fair to say that the annual trade deficit has peaked and will slowly improve from here. If today's number had been unusually large the maybe one could have run a case for the Kiwi dollar facing extra strong depreciation pressures in the near future. But that is not the case therefore we retain in our view that further falls in the Kiwi dollar will be relatively mild and still struggle to see you eventually falling below the 50 US in level.

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Just above we noted that business investment intentions are running at just below average levels and that we are hopeful capital expenditure will improve at a reasonable rate over 2007. Up-to-date data on capital expenditure is hard to find and our recent comments about spending being quite weak as businesses improve cash rise through capital expenditure cutbacks rather than laying people off can be hard to back up. We mainly rely on anecdotal feedback from businesses we have contact with and the monthly capital goods imports data. In June the value of imports of capital goods was up just 2% from a year earlier with June quarter import values ahead by just 4%. These numbers are relatively weak and support our conclusion of currently poor business capital spending levels.

The Reserve Bank is likely to be concerned by the value of consumer goods imports being 11% higher than a year earlier in June and 10% ahead in the June quarter from a year earlier. However allowing for the currency decline this does indicate reduced growth in the volume of consumer goods imports - and understandably so because consumer sentiment is relatively weak and we feel retail spending will be a poorly performing part of the economy over the next couple of years. We think retailers are aware of this probability and since late last year have been making attempts to reduce their inventories.

## Thursday 27 Monetary Policy Unchanged

As had been widely anticipated the Reserve Bank left the official cash rate unchanged at 7.25% at their regular six weekly review. But in a relatively wordy statement the Reserve Bank Governor noted "Indicators of both consumer demand and business activity have not softened to the degree anticipated. We are also seeing slightly more short term inflation pressure as a result of the continued upward trend in world oil prices." Commenting on inflation hitting 4% he noted "We remain wary of the risks to inflation expectations presented by these high headline inflation rates."

"We maintain our view that the current level of the OCR is consistent with returning inflation to the target range." And "... it will be some time before an easing in the OCR can be considered."

In other words there will be no cuts in floating interest rates for a long period of time and the Reserve Bank continues to hope that their tightening will have the desired effect while noting yet again that inflationary pressures have turned out to be stronger than they anticipated. The risk is that they are going to still be making such comments in 2007.

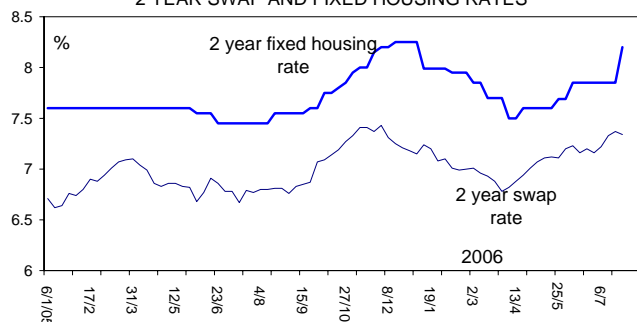
# BNZ WEEKLY OVERVIEW

## INTEREST RATES

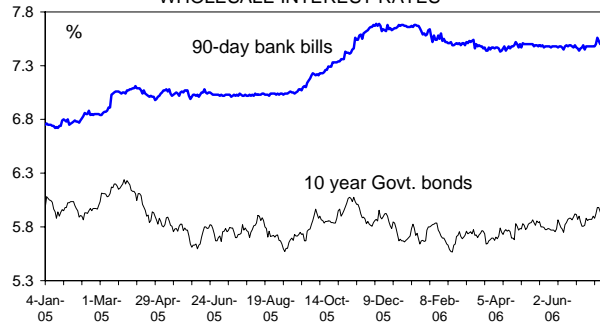
Wholesale interest rates have edged marginally lower over the past week with the Reserve Bank's official cash rate review this morning coming in as we expected and in the absence of any significant data. The monthly National Bank Business Outlook survey showed that the economy remains on track for a soft landing but that inflation risks are persisting, and the soft landing scenario was also supported by the June merchandise trade numbers which showed some strength in exports. In the United States the markets are waiting for the next review of the Federal Reserve's funds rate and this week no major data releases occurred to change the prevailing view that there is only a slight chance of one more rate increase in their cycle.

There was greater action across the Tasman however where the June quarter consumers price index increased by 1.6% whereas a rise of 1.2% had been expected. Annual inflation in Australia is now 4%. This makes near certain that the Reserve Bank of Australia will be raising their cash rate to 6% next week and this news added some mild upward pressure to New Zealand swap rates.

2 YEAR SWAP AND FIXED HOUSING RATES



WHOLESALE INTEREST RATES

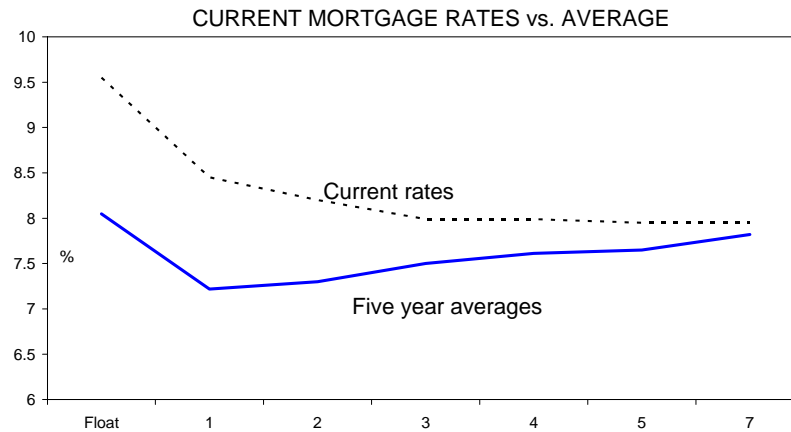


Our view remains that floating interest rates are not going to be cut until well into 2007 and before that we may see some mild downward pressure on fixed interest rates. We don't believe the recent upward movement in wholesale fixed borrowing costs is the start of a new trend and when one looks at the likes of the two year swap rate at 7.29% it seems clear that a wholesale shift in market opinion towards expecting another rate rise or two by the Reserve Bank of New Zealand would be required for this rate to move substantially higher. That means the current round of increases in fixed housing rates is unlikely to be repeated in the near future. But we also don't expect to see these rates coming down for quite some time given the inflation worries that abound.

### If I Were a Borrower What Would I Do?

First of all I would want to fix my mortgage interest rate because the floating interest rate is relatively high at 9.55%, I don't expect to see it coming down until perhaps the middle of 2007 at the earliest, and when it reaches its low point for the easing cycle is only likely to fall just below 8% and not hit the 6.5% low we have often seen in the past. The 8.2% two year fixed housing rate is almost 1% above its average level for the past five years and therefore is relatively expensive. The three-year rate is just 0.5% above its average for the past five years at 7.99%. In an uncertain world with rising global inflation if I was fixing my mortgage at the moment I would probably fix three years at 7.99% partly because I don't have a view that in two years time interest rates will be unusually low. If I did however, perhaps because my view of the economy was poor, then I would favour the two-year rate.

# BNZ WEEKLY OVERVIEW



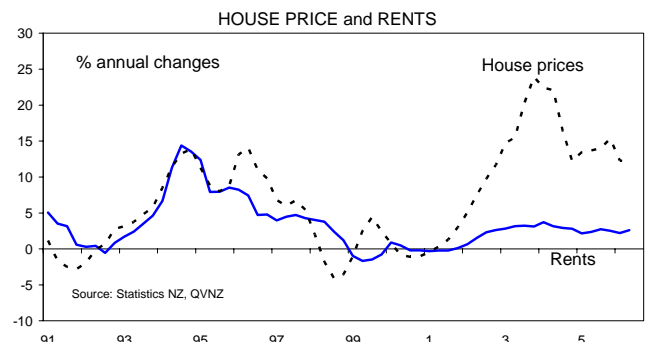
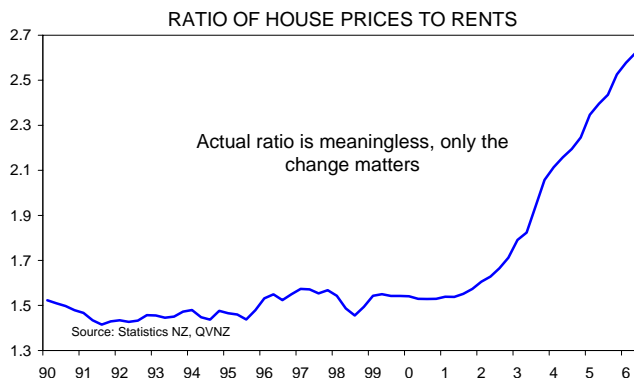
BNZ Fixed Lending Interest Rates					BNZ Term Deposit Rates			
	Housing	Average Past 5 yrs	Low Past 5 years	High Past 5 years	Days	\$10-50K	\$50-100K	\$100-250k
Float	9.55%	8.00%	6.70%	9.55%	30	3.00	3.00	5.25
1 yr	8.45	7.16	5.95	8.45	90	6.20	6.25	6.30
2	8.20	7.28	5.99	8.25	180	6.80	6.85	6.90
3	7.99	7.49	6.30	8.30	1 yr	6.60	6.65	6.70
4	7.99	7.62	6.40	8.40	5 yr	6.10	6.15	6.20
5	7.95	7.65	6.50	8.60				
7	7.95	7.83	6.75	8.80				

Note: Conditions may apply to these rates.

## HOUSING MARKET UPDATE

### Rents Lagging Behind – Won't Catch Up

On average during the June quarter the median dwelling sale price reported by the REINZ rose by a relatively strong 2.6% from the March quarter. Over the same period of time average rents captured in the Consumers Price Index rose by just 1%. This story of house price growth well outstripping rental growth is also seen over the past year with house prices up about 12.2% while rents were up just 2.6%. And compared with five years ago while house prices are up 93% rents have risen just 13.5%.

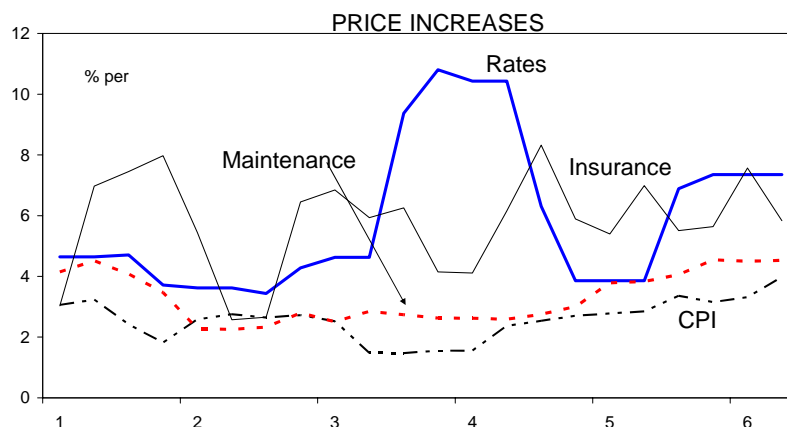


At what point does the low yield worry outweigh capital gain expectations and scare the buyers away? That is what one can never forecast and helps explain why predicting house prices is such a difficult business. All one can say at the moment is that this relationship between rents and prices shows another way in which house prices are well away from fundamentals. Note that we do not for a minute buy into the argument some punters are pushing that there is a massive rental catch-up to occur.

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How does the 13.5% increase in rents over the past five years compare with inflation? The consumers price index has increased by 14.2% over this period of time therefore in real, inflation-adjusted, terms rents have fallen. In fact it's going to be a lot worse than that. The Consumers Price index is a basket of about 700 goods and services consumed by the average household. But the expenses for a landlord will not remotely match this basket. Instead the expenses will be weighted toward local authority rates, insurance and maintenance. How have these three areas of costs changed in recent years?

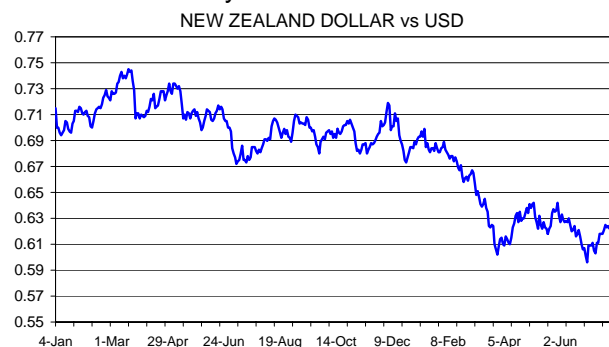
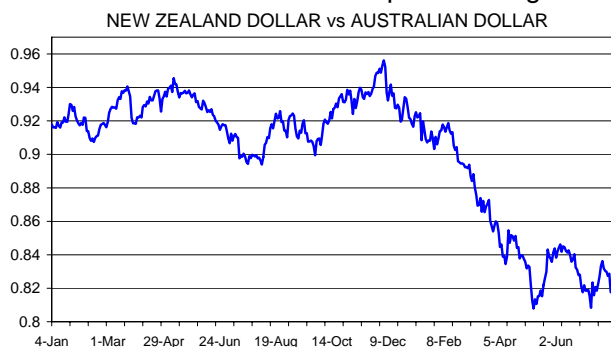
In total over the past five years the local authority rates index included in the Consumers Price index basket has increased by 33.5%. Another index measuring maintenance materials and services has increased by 17.1%. Dwelling insurance has increased by 30.6%. If you put in the effort you could construct an index measuring changes in the costs of owning a rental property - and apologies if someone is already doing this but we haven't made the effort to suss out if anybody has already done this exercise.



It seems fairly likely that landlord costs have increased a lot more than consumer costs in general over the past five years. This means that in real terms property rents have almost certainly fallen in the past five years by a lot more than the 0.7% difference between the Consumers Price index and the rents index.

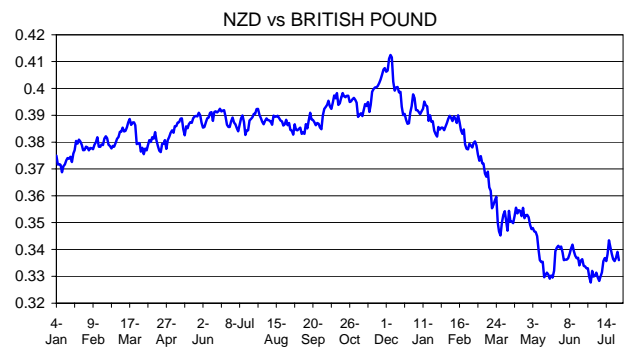
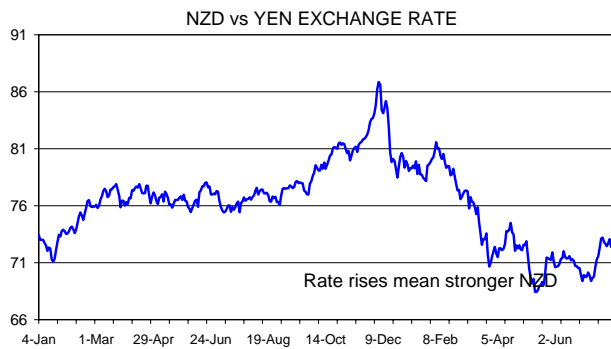
## EXCHANGE RATES

The Kiwi dollar started the week against the greenback near 62.4 US cents and has ended lower near 61.9 US cents. The US dollar itself has generally weakened over the week however and this means that we have fallen on the cross rates and in particular against the Australian currency.

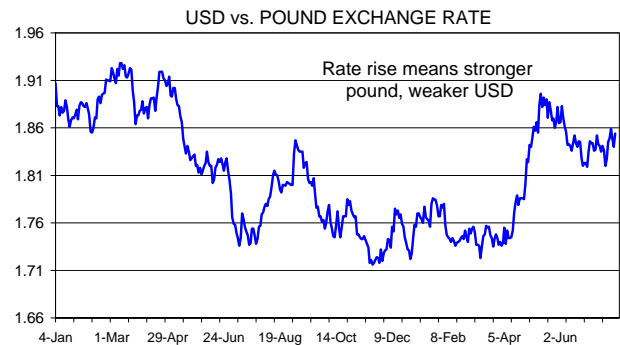
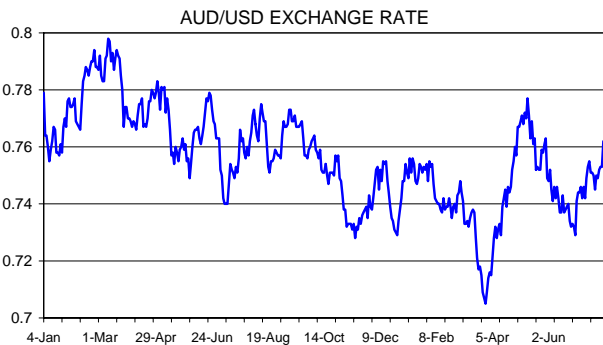




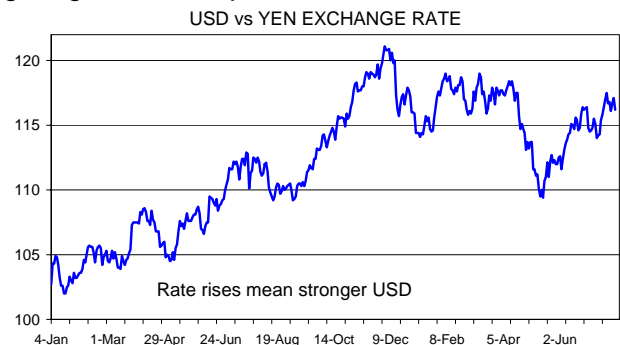
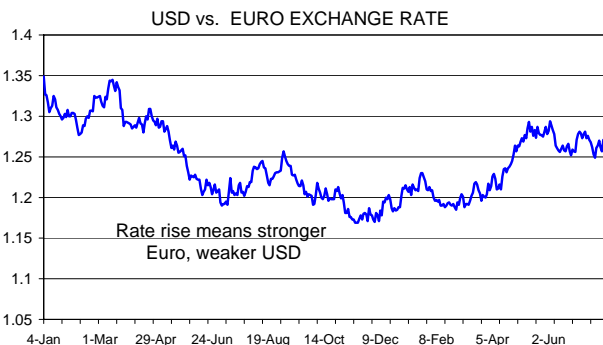
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The Australian dollar received a strong boost yesterday when it was reported that the Australian Consumers Price Index rose by 1.6% during the June quarter to take the annual inflation rate to a 10 year high of 4%. Stripping out various one-off effects the underlying rate of inflation is between 2.8% and 3%. But the problem for the Reserve Bank of Australia is that with the unemployment rate at a 30 year low a 4% headline rate of inflation is highly likely to feed through to wage claims. To try and limit the second-round effects of high headline inflation we expect the RBA will increase their cash rate next Wednesday morning by 0.25%. This will take it to 6%.



Anticipation of higher interest rates, with the markets starting to talk about two rather than just one more rate hike, has seen the Australian dollar end this afternoon against the greenback near 76.1 US cents compared with 75 US cents a week ago. The Kiwi dollar has ended against the Australian dollar near a two-month low of 81.3 cents from 83.2 cents last Thursday. Against the British pound we have ended at 33.4 pence from 33.8 pence a week ago, against the Japanese yen at 71.9 from 72.8, and against the euro at 48.7 cents from 49.5 cents. These rates are all well within trading ranges over the past two to four months.



The US dollar has been in a stuttering upward trend against the other major currencies over the past few months and although it has weakened slightly this week still appears relatively well supported by a reasonable outlook for the United States economy and limited chances for any cut in US interest rates until well into next year. Last night the US dollar weakened on the back of some downbeat comments about the economy in the Federal Reserve's six weekly Beige Book. This book summarises views on the economy from the 12 Federal Reserve districts with these views being taken into consideration for the next Federal Open Market Committee meeting which is going to be held on August 8. The weaker than expected



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comments about the economy generated weakness in the US dollar and a further pulling back in expectations of another tightening of US monetary policy.

With regard to the New Zealand dollar our expectation remains that there is further depreciation to occur but that the extent of this depreciation will be limited by the absence of a commodity price collapse due to above average world growth, and the absence of any major slashing of New Zealand interest rates given persistent inflationary pressures. Exporters may want to take advantage of periodic periods of weakness in the Kiwi dollar to get on board very short term covering out to the six-month area, but for anything longer may want to hold off waiting for whenever a 5 cent to 10 cent fall eventually comes along.

There is zero way of forecasting when the remainder of the cyclical decline in the Kiwi dollar will occur.

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## ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	1.5%	0.6	4.0	2.8	2.4
GDP growth	Average past 10 years = 3.3%	0.7	-0.1	2.2	3.7	3.6
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	9.3	8.9	.....	7.4	4.8
Terms of Trade		1.1	-2.5	-3.0	4.5	6.1
Wages Growth	Stats NZ experimental series	1.1	1.3	5.5	4.8	4.3
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.	2.5	3.9	12.3	13.4	23.3
Net migration gain	Av. gain past 10 years = 13,000	+10,690	10,200yr	.....	8,599	22,008
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 8%. Colmar survey	-22	-38	-35	1	-1
Business activity exps	10 year average = 27%. NBZ	15	17	-3	15	30
Household debt	10 year average growth = 11.4%. RBNZ	14.1	14.2	15.2	15.1	16.3
Dwelling sales	10 year average growth = 4.6%. REINZ	5.0	3.9	-17.6	-4.1	-14.5
Tourist numbers	10 year average growth = 6.1%. Stats NZ	-11.2	-0.3	-1.9	16.9	20.4
Floating Mort. Rate	10 year average = 8.5%	9.55	9.55	9.55	9.00	8.00
3 yr fixed hsg rate	10 year average = 8.2%	7.99	7.75	7.99	7.45	7.65

## ECONOMIC FORECASTS

Forecasts at June 29 2006

March Years

December Years

	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
<b>GDP - annual average % change</b>										
Private Consumption	5.8	4.1	1.6	0.6	1.1	6.5	4.7	2.1	0.7	0.8
Government Consumption	5.2	5.6	4.6	2.7	3.9	5.6	5.7	4.5	3.5	3.1
Investment	8.0	5.9	-3.1	0.8	3.7	13.5	4.5	-1.4	0.4	3.1
GNE	6.4	4.2	0.7	1.1	2.5	8.1	4.5	1.1	1.0	2.0
Exports	3.9	0.0	3.6	4.3	5.0	5.6	-0.2	1.7	4.8	4.8
Imports	13.7	4.6	-0.4	2.3	3.0	16.6	6.5	-1.1	2.4	2.7
GDP	3.7	2.2	1.6	1.6	3.1	4.3	1.9	1.9	1.8	2.7
Inflation – Consumers Price Index	2.8	3.3	3.3	3.0	2.6	2.7	3.2	3.3	3.1	2.7
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
<b>EXCHANGE RATE ASSUMPTIONS</b>										
NZD/USD	0.73	0.64	0.57	0.55	0.58	0.71	0.70	0.58	0.55	0.58
USD/JPY	105	117	103	105	103	104	119	105	105	104
EUR/USD	1.32	1.20	1.23	1.23	1.24	1.34	1.19	1.24	1.22	1.24
NZD/AUD	0.93	0.87	0.78	0.79	0.81	0.93	0.94	0.79	0.79	0.80
NZD/GBP	0.38	0.36	0.32	0.31	0.33	0.37	0.40	0.33	0.31	0.33
NZD/EUR	0.55	0.53	0.46	0.45	0.47	0.53	0.59	0.47	0.45	0.46
NZD/YEN	76.8	74.6	58.7	57.8	59.5	74.2	82.7	60.9	57.8	59.7
TWI	70.7	65.6	57.2	55.8	58.3	69	71.9	58.1	55.9	57.8
Official Cash Rate	6.5	7.25	7.00	6.00	5.75	6.5	7.0	7.25	6.25	5.75
90 Day Bank Bill Rate	6.86	7.55	7.23	6.13	6.12	6.73	7.49	7.49	6.39	5.95
2 Year swap	6.82	7.0	6.35	6.08	6.20	6.61	7.24	6.52	6.10	6.17
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.

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