Bank of New Zealand

BNZ Weekly Overview

2 November 2006

The Week's Economic Developments	**2**	**Exchange Rates**	**8**
Interest Rates	**5**	**Economic Data/Forecasts**	**11**
Housing Market Update	**7**		

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	7.25%	7.25	7.25	7.25	7.00	6.2
90-day bank bill	7.58%	7.65	7.63	7.49	7.42	6.4
10 year govt. bond	5.76%	5.87	5.73	5.84	6.02	6.5
1 year swap	7.68%	7.60	7.66	7.50	7.49	6.6
5 year swap	7.08%	7.03	7.07	6.94	7.02	7.0
NZD/USD	0.671	0.656	0.651	0.618	0.688	.57
NZD/AUD	0.868	0.859	0.874	0.806	0.932	.86
NZD/JPY	78.6	77.9	76.9	70.6	81.0	66.0
NZD/GBP	0.352	0.349	0.347	0.329	0.389	.34
NZD/EURO	0.526	0.519	0.513	0.482	0.576	.51

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

Monthly Confidence Survey

As this is the first Thursday of the month we are running our monthly confidence survey. The response rate has dipped down over the past few months so will see how this survey and the one in December goes and decide whether we want to continue with the survey over 2007. If you have not already done so in the email used for sending the Weekly Overview out then please cut and paste the URL below into your browser, click on it, and let us know whether you believe the economy will get better or worse over the next of months. More importantly let us know how things are in your industry at the moment.

http://www.closer.co.nz/bnzeconomist.asp

This week we have seen the New Zealand dollar bounce back up again against the greenback and make gains against other currencies as well. This rebound after last week's sell off following the Reserve Bank's decision not to raise the official cash rate has been driven by a string of relatively strong NZ economic data releases and a weak USD. Business sentiment has improved once again and employment intentions are now running at above average levels. Seasonally adjusted dwelling consents numbers rose over 6% in September and 17% during the September quarter. Exports are running 19% ahead of a year earlier, and household debt continues to grow at a relatively firm pace. At the same time data in the United States have been weaker than expected so the greenback has fallen against other major currencies.

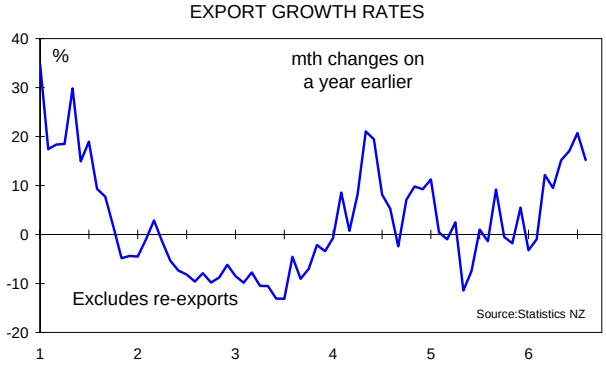
We have also seen wholesale interest rates edge up in response to a rally in the United States being offset by strong NZ data. The main focus in the markets at the moment is the United States labour market report due out on Friday night. As always it has capacity to move the US currency and interest rates depending upon whether it is better or weaker than expectations.

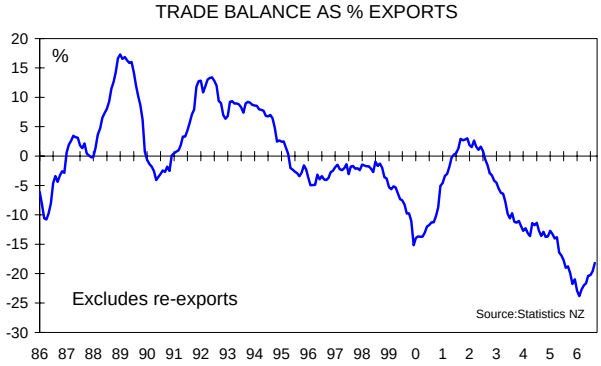
THE WEEK'S ECONOMIC DEVELOPMENTS

Friday 27

Foreign Trade Accounts Improving

The merchandise trade account recorded a deficit in September of $587 million. This was better than the expected deficit of about $800 million and is an improvement from $971 million in September 2005. As in the previous four months export growth was again strong with the value of export receipts up by 19.9% from a year earlier taking the total gain in the September quarter from a year ago to 19.9% from 16.1% in the June quarter and just 3.6% in the March quarter. The value of imports in September was up from a year earlier by just 2.6% and ahead 9.9% in the September quarter from a year ago. Allowing for the fall in the exchange rate there is no growth in the volume of imports and this is strongly suggestive of weakness in the domestic part of the New Zealand economy. A lot of this volume weakness is clearly coming through capital goods imports with the value of imports of machinery and plant in September down by 10% from a year earlier and off by 6% in the September quarter from a year ago. In contrast imports of consumer goods by value were up 8% from a year ago in September and ahead 9% in the September quarter from a year ago. The annual trade balance now stands at a deficit of $6.2 billion compared with a peak this cycle of $7.3 billion in February.

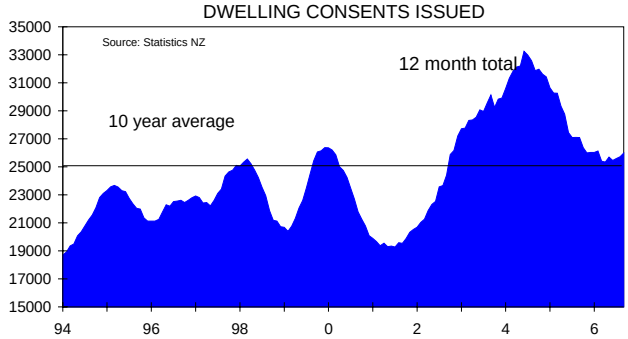


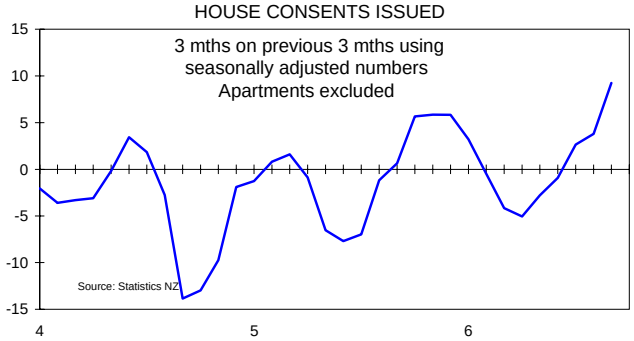


Monday 30

House Construction Upturn Seems To Be Underway

In September the number of consents issued for the construction of new dwellings was up from August in seasonally adjusted terms by 6.1%. This is the third monthly increase in a row and means that for the September quarter the seasonally adjusted number of consents issued was up by an extremely strong 16.9% from the June quarter after falling 8.4% in the June quarter compared with the March quarter. Even excluding the traditionally volatile apartment sector we still get a seasonally adjusted increase in house consents over the September quarter of 9.2%. The total number of dwelling consents issued in the year to September was 25,990. This was a 4.1% decline from the year to September 2005 but up from the recent cyclical low of 25,406 in March this year. The annual consents number was also 3.7% above the 10 year average. This upward trend in dwelling construction runs somewhat at odds with other indicators of the domestic economy such as declining business capital expenditure, falling dwelling sales and weakening retail spending. But it may reflect discontent with the cost of existing dwellings causing buyers to get their own place built. As long as net migration inflows remain around recent slightly above average levels this shouldn't cause too much of a problem. But it does still leave us with a small worry about a growing oversupply of properties and underlies our expectation that average house prices are soon going to start sitting at constant levels for an extended period of time.

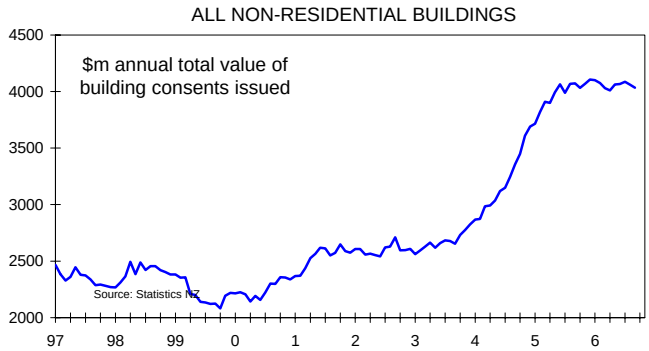


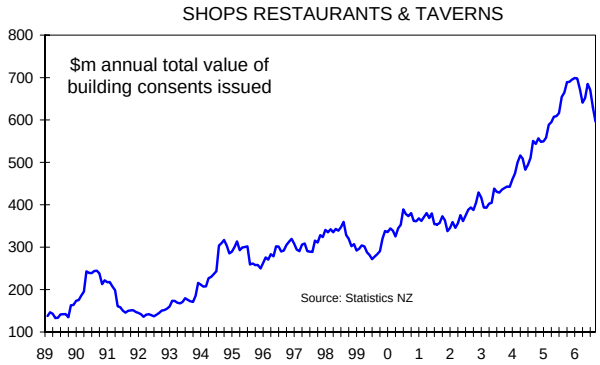


Note that the improving trend in dwelling consents issuance also backs up our view that New Zealand monetary policy is not going to be eased for a long period of time which also will act to limit the decline in the Kiwi dollar over the coming 12 months.

Non-Residential Construction Slowly Easing off

In September the value of consents issued for the construction of non-residential buildings was down by 7.3% from a year earlier at $343 million. For the year to September the decline in consent values was 0.9% while in the September quarter consent values were down from a year earlier by 3.2%. If we try and get around the inherent volatility in these monthly numbers by looking at six-month periods we see that in the half year ending September 2006 total consent issuance was up just 0.2% from a year earlier but with a 20% decline in the value of consents issued for construction of shops and restaurants, and 10% decline for education buildings. But there was 90% growth for hotels and motels, 47% growth for hospitals and nursing homes, 22% growth for office buildings, 16% growth for warehouses, 10% growth for factories but just 3% growth for farm buildings. We usually find it hard to draw any conclusions about underlying activity in particular sectors from these numbers and in fact one would have thought that with a high degree of pessimism in the farming sector consent issuance for farm buildings would be falling.



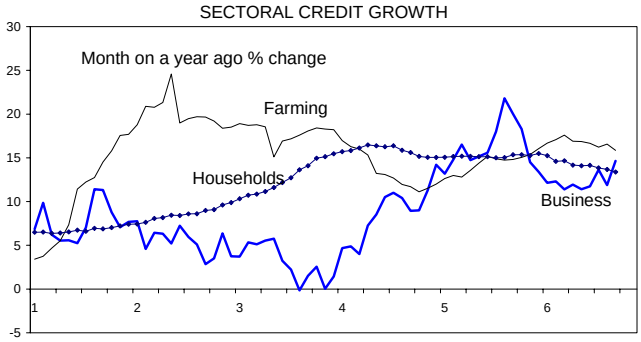


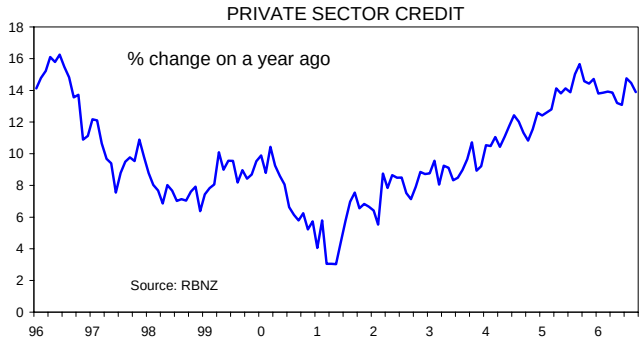
Lending Growth Remains Quite Strong

The annual rate of growth in lending to the household sector slowed to 13.4% in September from 13.7% in August and 15.4% a year ago. However in seasonally adjusted terms lending growth in the month was 1% compared with 0.9% in August and average monthly growth over the six months to August of 1%. This continued strong growth in household debt lends support to our soft landing scenario for the New Zealand economy with people likely feeling the environment is safe to continue raising funds on the basis of wage rises, talk about tax cuts, still slowly rising house prices, good net migration inflows, a tight labour market, and interest rates not rising as much as many may have been thinking.

In the rural sector the annual rate of growth in debt slowed to 15.8% from 16.6% in August but was up from 14.8% year ago. In the three months to September farm debt grew by just under $1 billion. This was practically the same as nominal growth a year ago and is quite interesting because reports from companies involved in selling goods and services to the farming community indicate a relatively strong pullback in farm

spending. Tractor registrations are falling sharply and there is a small volume decline in farm building construction. One wonders if cash flow deficiencies are not leading farmers to boost debt levels. In the business sector excluding farming the annual rate of growth in debt lifted to 14.6% from 11.9% in August. A year ago this rate of growth was 20% but this particular monetary aggregate is exceedingly volatile and we don't tend to look at it as indicating what businesses are experiencing. In this regard we can see that there is a strong decline in the volume of capital goods being imported and investment intentions are running below average.



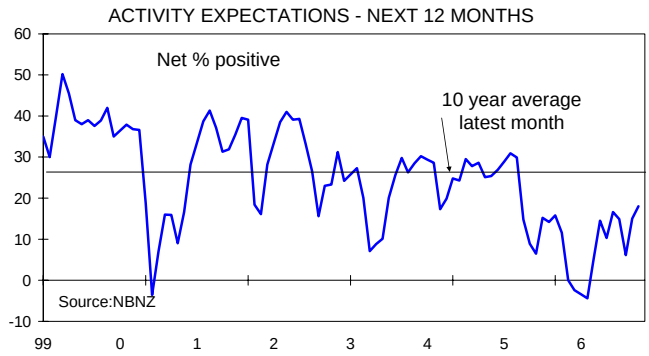


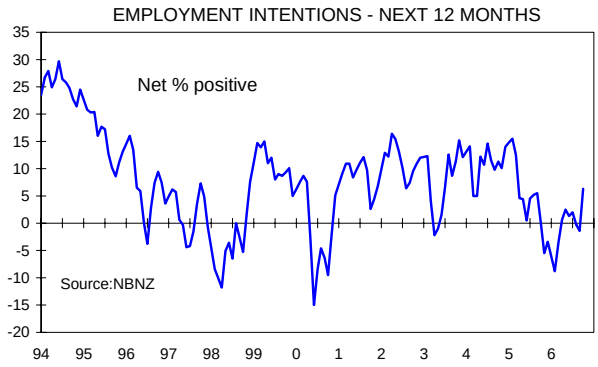
Overall, private sector credit growth slowed to 13.9% from 14.5% in August and 15.7% a year ago. However over the past five years the average rate of growth in this annual measure has been 10.8%. Therefore households and businesses in New Zealand are continuing to raise their debt at a very strong rate of growth that is certainly not consistent with any particularly bad weakness in the economy.

Tuesday 31

Business Sentiment Improves Slightly

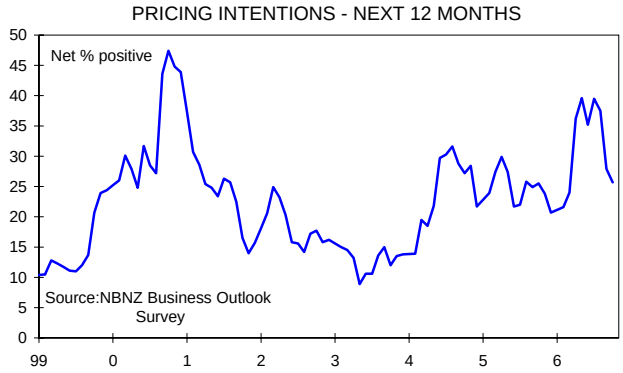
Business confidence measured in the monthly NBNZ Business Outlook survey improved to a net 22% pessimistic in October from 29% in September and an average reading for the past 10 years of a net 4% pessimistic. So things are well below average. But as we have noted many times in the past you don't want to gauge how businesses are really feeling and what their plans are by looking at this confidence measure. One first needs to look at the activity expectations indicator and then get down to the nitty-gritty of employment and investment intentions. Activity expectations improved to a net 18% positive in October from 15% in September, a low of -4% in February and a 10 year average reading of 26%. So things are below average but not aggressively so and the trend in this indicator is upward. This trend is validated by a sharp jump in employment intentions this month to a net 6% positive from 1% negative in September and a 10 year average reading of a positive 5%. In other words businesses have above average employment intentions and this backs up our view that the labour market will remain tight for the next few years, the unemployment rate low, wages growth high, and that the housing market correction will be very mild involving a flattening in prices rather than outright falls. Investment intentions eased slightly to a net 8% positive from 10% in September which is below the 10 year average of 13% but well above the reading of 0% in February.

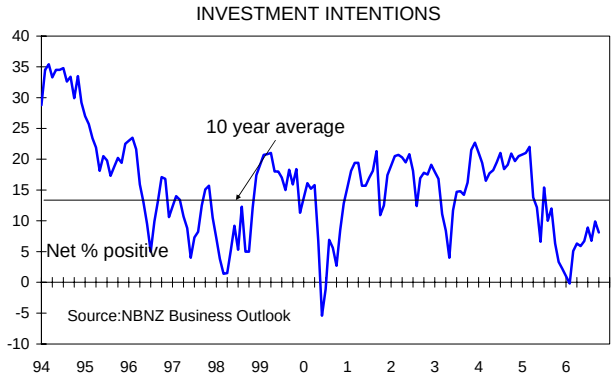




Last month we noted that in spite of the sharp bounce back up in the Kiwi dollar against the Australian currency manufacturers' export intentions remained relatively strong. This month manufacturers have had

time to factor in the rise in the Kiwi dollar and this undoubtedly explains why only a net 14% expect better exports in the coming year compared with a net 32% last month and 10 year average of 36%. The Reserve Bank will be pleased that for the third month in a row pricing intentions have fallen this month declining to a net 25.7% positive from 27.9% in September and 39.5% in July. But the 10 year average reading for this measure is a net 21.7% positive so the result is still consistent with above average inflation.

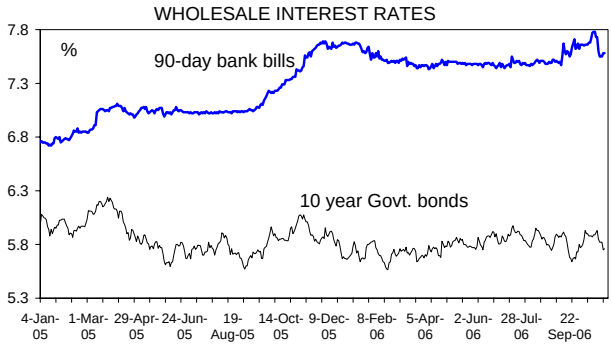


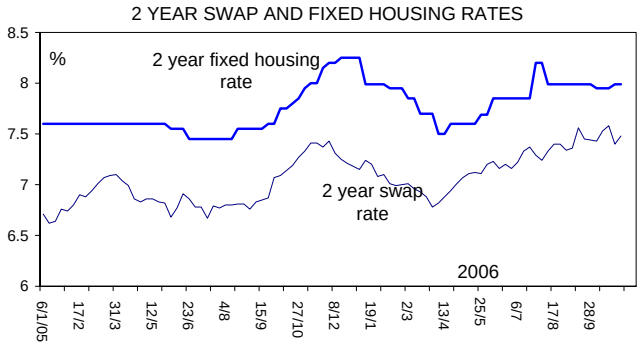


Overall this survey is 100% consistent with a soft landing for the economy and backs up our warning to businesses that resource availability will remain poor going forward and this will maintain relatively strong cost pressure which by keeping up the rate of inflation greatly limits the ability of the Reserve Bank to cut interest rates in the next couple of years while tending to keep the currency well supported in the immediate future.

INTEREST RATES

Wholesale interest rates have been pulled in two directions over the past week. Economic data releases in the United States have surprised on the weak side and this has applied some downward pressure to long-term interest rates. Offsetting this, especially at the short end, has been a string of very strong data releases in New Zealand. The upshot is that the chances of a further tightening of monetary policy in New Zealand remain relatively strong and regardless of what happens with the United States labour market report this Friday night we are unlikely to see any decent rally in the New Zealand markets for quite some time. Having said that we do feel the yield curve will adopt an increasingly inverse shape over the next six or so months.





90-day bank bill yields have finished this afternoon near 7.58% compared with 7.6% a week ago. The two year swap rate at which we banks borrow to lend fixed for two years has ended near 7.48% from 7.4% last week and 7.58% a fortnight ago before the Reserve Bank announced they would not be raising the official cash rate.

Next Thursday the September quarter Household Labour Force Survey will be released and give us an update on New Zealand's unemployment rate and jobs growth. The risk is that the unemployment rate remains low while jobs growth is relatively strong especially in light of businesses continuing to report labour shortages and a recent increase in employment intentions to above average levels in one survey. A strong labour market has been an important factor keeping the housing market firm in New Zealand and is likely to

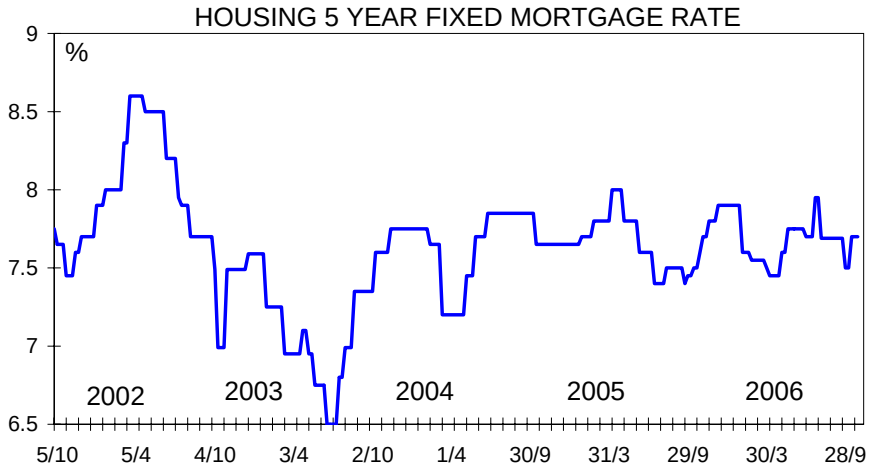
continue to do so going forward though we still expect house price inflation will head towards zero in the next 12 months.

If I Were a Borrower What Would I Do?

You may have noticed over the past week that the Kiwi dollar has risen strongly against the greenback. This has come about mainly because of a fall in the United States dollar on the back of some weaker than expected economic data leading to increased expectations that next year the Federal Reserve will be cutting interest rates. Our expectation is that the funds rate will be cut from its current level three times in the second half of next year. As the markets switch around to this view we expect to see medium to long-term interest rates in the United States decline. This is what has happened to a small degree over the past week. As the process continues next year we are likely to see the re-emergence of 7.5% five-year fixed housing rates in New Zealand and toward the end of 2007 rates may go below that level while the one and two-year fixed interest rates might be only marginally below current levels.

This then raises an interesting possibility. If cash flow is not a problem would be a good idea if your rate is coming up for renewal at the moment to refix for one year then fix at a nice low five or seven-year rate late next year? We estimate that a policy of fixing strictly at the two year period will deliver an average interest rate over the next five years of close to 7.3% - if our forecasts are correct. With a five-year interest rate currently at 7.7% this suggests that if cash flow is not a problem you'd be better off fixing two years at the moment than going five years. If cash flow is a problem - and it looks like it is for an increasing number of property investors - then fixing five years at 7.7% is a quite acceptable thing to do especially considering that this interest rate has averaged 7.6% over the past five years.

If you fix one-year at the moment you'll start with a cost of 8.4%. To do better than the expected 7.3% average rate from the simple two-year fixing method you'll need a four or five year interest-rate in a year's time of 7%. Is that very likely? The graph below shows movements in the five-year fixed housing rate over the past five years. The only time the rate fell for anything longer than one week below 7% was in the middle of 2003 when there were major worries about deflation in the United States. We do not see that environment returning. Therefore it is pretty unlikely that in a year's time the likes of a five-year fixed housing rate will be as low as 7%. If in fact the rate is 7.3% your average borrowing cost for the next five years after taking an 8.4% one-year fixed interest rate at the moment would be 7.5%.



So it was worth a thought but fixing one-year at the moment with a view of taking advantage of a lowish longer-term rate in a year's time doesn't appear like a canny thing to do. We still think the best bet for most people is fixing two years if cash flow is not a problem but if things are looking tight then one can fix five years and sleep easy knowing that you will have locked in a quite acceptable interest-rate.

BNZ Fixed Lending Interest Rates

	Housing	Average Past 5 yrs	Low Past	High 5 years
Float	9.55%	8.18%	6.70%	9.55%
1 yr	8.40	7.32	5.95	8.45
2	7.99	7.34	5.99	8.25
3	7.89	7.51	6.30	8.30
4	7.79	7.61	6.40	8.40
5	7.70	7.63	6.50	8.60
7	7.70	7.78	6.75	8.80

Note: Conditions may apply to these rates.

BNZ Term Deposit Rates

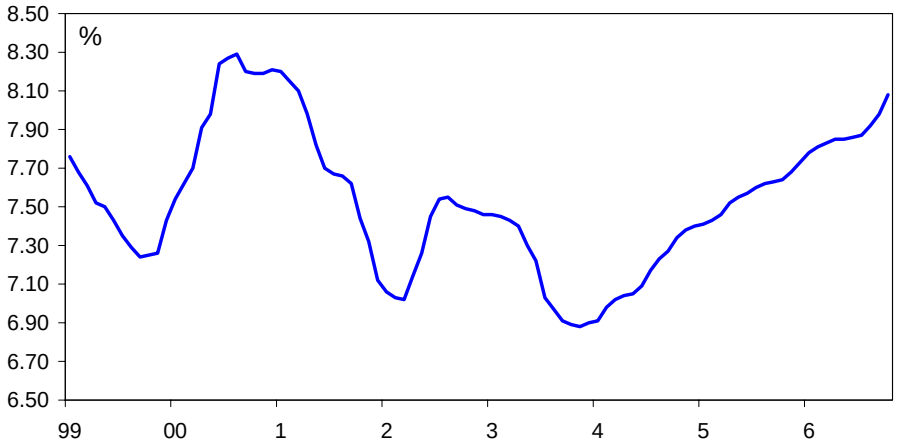
Days	$10-50K	$50-100K	$100-250k
30	3.00	3.00	5.25
90	6.20	6.25	6.30
180	6.90	6.95	7.00
1 yr	7.10	7.15	7.20
5 yr	6.20	6.25	6.30

HOUSING MARKET UPDATE

The only fresh piece of news on the housing market this week came in the form of the monthly dwelling consents data. The numbers show that an upturn in construction appears to be underway with the seasonally adjusted number of dwelling consents up by over 6% in September and 17% in the September quarter. This growth probably reflects the continuing positive impact of the tight labour market, upturn in net migration inflows since October, and sheer weight of money looking for a home – as it were. But for those thinking that a fresh upturn in the housing market is at hand we would suggest pausing. The negatives are still likely to dominate the positives when it comes to price movements over the coming two to four years causing price growth to slow to a rate close to zero in the near future.

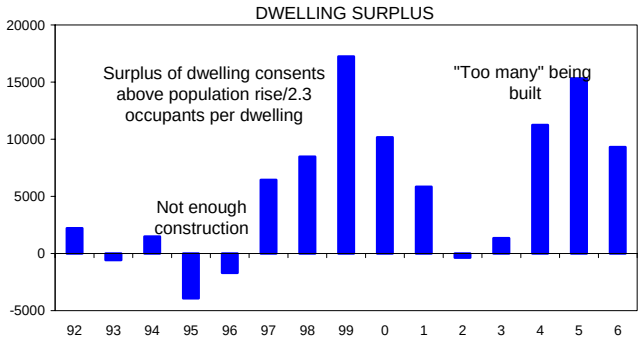
With regard to these negatives we are talking about the average mortgage interest rate rising from about 6.9% at the end of 2003 to near 8.1% at the moment with a further small rise towards 8.3% expected in the next few months as people roll from an average fixed interest rate near 7.5% to something closer to 8%.

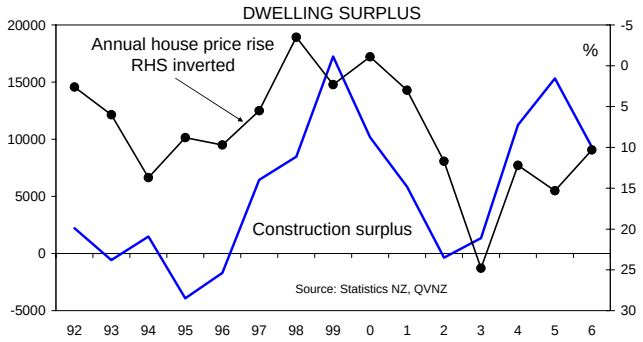
AVERAGE EFFECTIVE MORTGAGE RATE



Employment growth is also going to slow down. This will partly reflect employers wanting to contain costs (though not to the extent of laying people off in large numbers and causing a large jump in the unemployment rate). But the slowdown in jobs growth will mainly reflect the unavailability of suitable labour with the unemployment rate at 3.6% now compared with 7.3% seven years ago.

Dwelling supply is also growing relatively strongly and although we cannot ignore the anecdotal feedback from the real estate industry that there is a shortage of listings in many areas, compared with population growth the growing dwelling supply suggests a lift in house price inflation does not seem very likely.

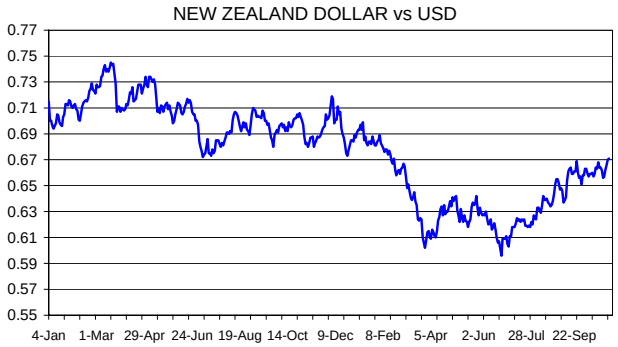


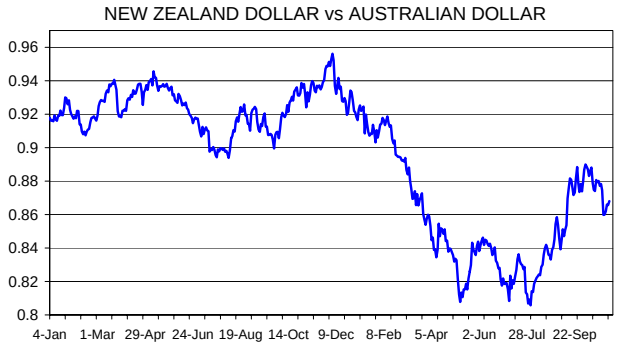


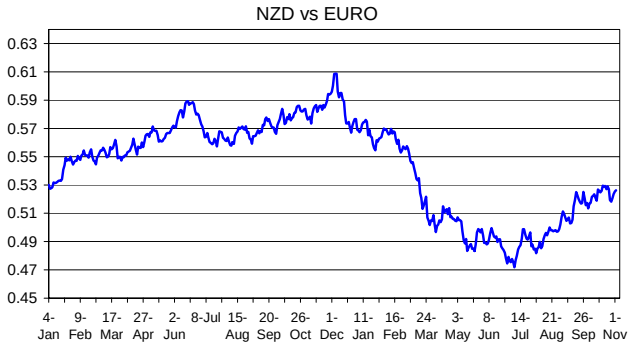
We certainly don't have a negative outlook as such for house prices or the concept of investing in residential property. It's simply a change toward capital gains being harder to come by. People entering the investment market with high debt, low experience, and a typical Kiwi expectation of flogging the place off within three years could get caught out in a cash-flow bind. The more experienced investor with a few years of experience and a focus on yield enhancement will probably welcome the silly money edging back from the market.

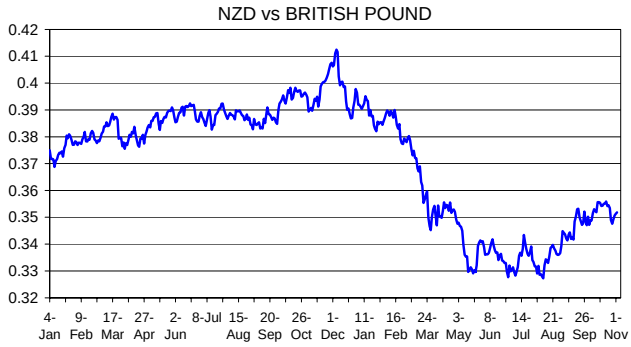
EXCHANGE RATES

It's been a week in which there has not been the appearance of any information upon which a person would make a fresh decision to sell the New Zealand dollar. In fact basically all the pieces of data this week have been supportive of the Kiwi dollar and this helps explain why our currency has strengthened over the past week. Against the United States dollar we have ended this afternoon near 67.1 cents compared with 65.6 cents a week ago. Against the Australian currency we have ended near 86.8 cents from 86, against the Japanese yen near 78.6 from 77.9, against the British pound near 35.2 pence from 34.9, and against the euro near 52.6 cents from 51.9.









Of some importance this week was the September merchandise trade outcome which was better than expected with exports up strongly from a year earlier by 19.9%. This trend towards growth in exports

suggests the Kiwi dollar is not is overvalued as one may have been thinking and that the current account deficit has probably peaked at 9.7% of GDP. But this is a long way from saying export prospects look good!

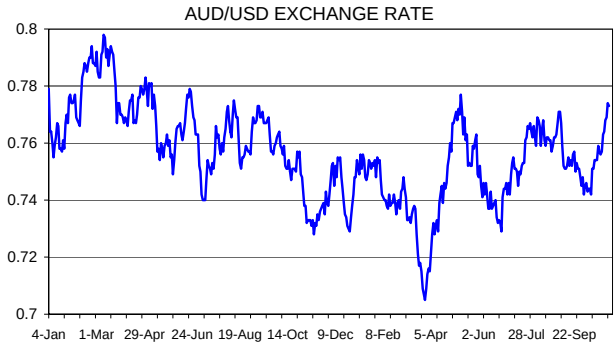
Data showing that in seasonally adjusted terms the number of dwelling consents issued around the country jumped by 6.1% to give a 17% gain for the September quarter indicates the Reserve Bank remains unsuccessful at containing the housing sector. This means the chances of a rate increase remain firm and we are way off any interest-rate cut in New Zealand. In fact the chances are we will still have interest rates risking being increased in New Zealand while they are starting to fall in the United States. This is a scenario the Reserve Bank could have avoided if they had not taken such an optimistic view on inflation in New Zealand in 2004 and tightened monetary policy properly. Perhaps also we would not be in this position if the Reserve Bank had given serious thought to the way in which movements in its official cash rate are near useless at influencing the domestic market now and they need some other way of achieving low inflation other than crunching the export sector. That is hardly helpful in an economy where we need much stronger growth on a trend basis in exports and investment in that sector.

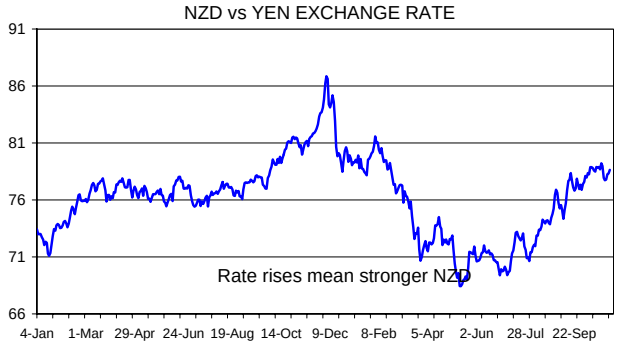
The currency was also assisted higher during the week by data showing that debt growth remained relatively strong for all sectors in September with the seasonally adjusted monthly rate of growth in household debt equal to the average rate for the previous six months. In addition, business confidence and activity expectations improved in September leading to a lift in employment intentions to above average levels and continued acceptable levels of investment intentions.

Next week the September quarter labour market numbers will be released in New Zealand and the chances are the report will be strong and continue to support the case for a firm Kiwi dollar.

And just for your guide, you may recall that a week ago we thought that following the Reserve Bank's decision to leave the cash rate unchanged the Kiwi dollar had probably at least another week's worth of declining in it. The fact that the Kiwi dollar rose by 1.5 cents should just go to reinforce our strongly stated opinion that forecasting exchange rates for short periods of time is impossible for us economists.

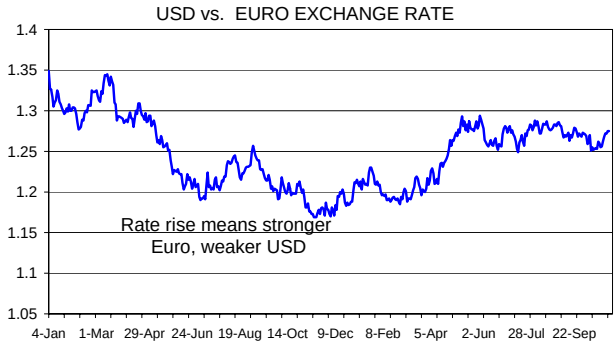
Over the week we have seen the Australian currency rise against a weaker greenback underpinned by very strong expectations that next week the Reserve Bank of Australia will increase their cash rate by 0.25% to 6.25%. However with data on the United States economy proving to be on the weak side there have been some concerns that commodity prices may ease off in coming months and this has limited the gains in the Australian dollar. It has ended this afternoon against the greenback near 77.3 US cents from 76.3 US cents last week.

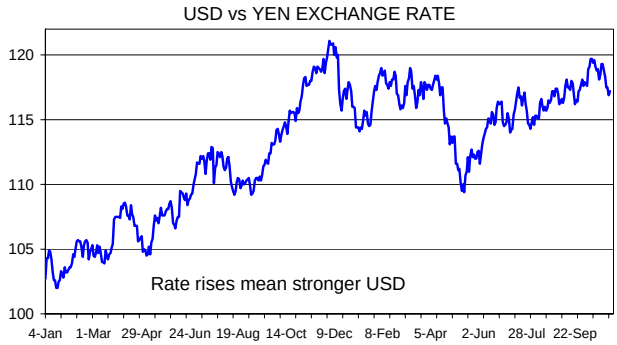




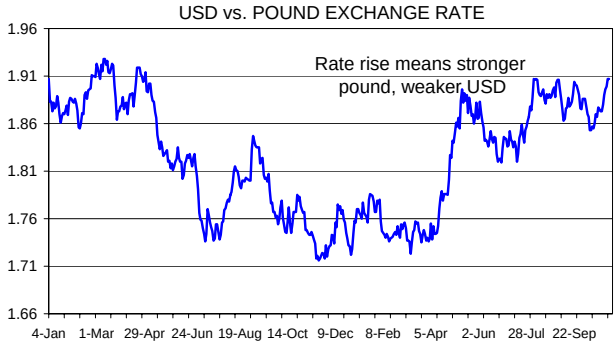
The greenback has entered this afternoon against the Japanese yen near 117.2 from 118.2 last week, against the British pound near $1.907 from $1.88 last week, and against the euro near $1.275 from $1.263. Weak data releases during the week have included the following. US GDP rose at an annualised rate of 1.6% in the September quarter. This was less than the expected rate of 2% due mainly to weakness in exports and residential construction in particular – down 17.4% in the quarter. The annual rate of growth has now slipped to a three year low. This was followed on Tuesday night by a weaker than expected consumer confidence reading in the monthly Conference Board measure (still acceptable however at 105.4 in October from 105.9 in September). The Chicago Purchasing Managers Index which gives insight into manufacturing sector strength fell to 53.5 from 62.1 where a reading over 50 indicates growth. Last night the ISM

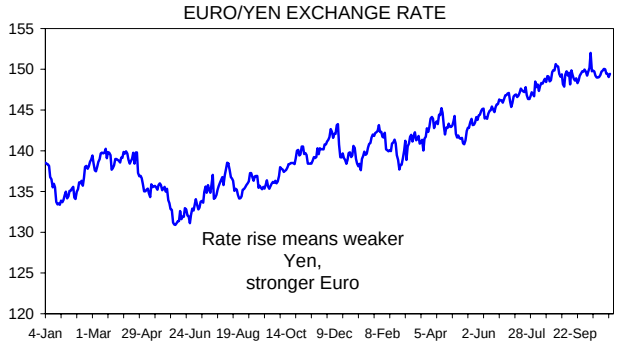
manufacturing survey also came in weaker than expected with a reading of 51.2 - the lowest since June 2003.





This Friday night the October non-farm payrolls number will be released and as always it has capacity to cause movement in the US dollar and US interest rates. The markets have switched around over the past week back into the hard lending scenario for the United States economy over 2007 so we would probably have to see a fairly weak number to cause any substantial extra weakness in the US dollar in the short term.





This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. BNZ strongly recommends that readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither the Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever that may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

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%	1.5	3.5	3.4	2.5
GDP growth	Average past 10 years = 3.3%	0.5	0.8	1.9	3.0	4.4
Unemployment rate	Average past 10 years = 5.7%	3.6	3.9	.....	3.6	4.0
Jobs growth	Average past 10 years = 2.1%	1.0	1.1	3.0	3.0	3.1
Current a/c deficit	Average past 10 years = 4.9% of GDP	9.7	9.5	.....	8.0	5.1
Terms of Trade		0.7	0.8	-1.3	1.0	7.2
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%.	0.7	0.8	4.8	7.0	6.3
House Prices	Long term average rise 5% p.a.	0.9	2.5	10.3	11.3	25.9
Net migration gain	Av. gain past 10 years = 13,000	+13,210	12,500yr	.....	6,398	17,757
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 8%. Colmar survey	-10	-19	-34	-7	3
Business activity exps	10 year average = 27%. NBNZ	18	15	15	12	25
Household debt	10 year average growth = 11.4%. RBNZ	13.4	13.7	14.7	13.4	15.6
Dwelling sales	10 year average growth = 4.6%. REINZ	-5.6	0.3	-2.9	17.0	-26.5
Tourist numbers	10 year average growth = 6.1%. Stats NZ	1.7	3.3	-3.0	1.6	8.6
Floating Mort. Rate	10 year average = 8.5%	9.55	9.55	9.55	9.00	8.50
3 yr fixed hsg rate	10 year average = 8.2%	7.89	7.89	7.60	7.60	7.65

ECONOMIC FORECASTS

Forecasts at Oct. 19 2006	**March Years**					**December Years**				
	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
GDP - annual average % change										
Private Consumption	5.7	4.5	1.2	0.4	0.9	6.4	4.9	1.9	0.5	0.6
Government Consumption	4.5	5.4	4.4	2.2	3.9	5.7	4.6	4.6	3.0	3.1
Investment	8.1	5.6	-5.3	1.3	3.7	13.4	4.2	-3.0	-0.5	3.1
GNE	6.3	4.5	-0.3	1.2	2.3	8.1	4.5	0.4	1.0	1.9
Exports	3.8	-0.1	4.3	3.8	4.9	5.4	-0.5	2.5	4.2	4.8
Imports	12.8	5.0	-2.2	2.3	3.0	16.4	6.2	-2.3	1.9	2.7
GDP	3.7	2.2	2.0	1.6	3.0	4.4	2.2	1.8	1.5	2.6
Inflation – Consumers Price Index	2.8	3.3	3.4	3.2	1.9	2.7	3.2	3.2	3.6	1.9
Employment	3.4	2.6	1.3	0.7	1.4	4.4	1.5	2.3	0.6	1.1
Unemployment Rate %	3.8	3.9	3.9	4.1	4.0	3.7	3.6	3.7	4.0	4.1
Wages	2.9	4.6	5.1	3.5	2.6	1.9	5.1	5.0	3.7	2.8
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.73	0.64	0.61	0.54	0.57	0.71	0.70	0.63	0.54	0.57
USD/JPY	105	117	107	103	105	104	119	112	103	105
EUR/USD	1.32	1.20	1.29	1.29	1.24	1.34	1.19	1.28	1.30	1.24
NZD/AUD	0.93	0.87	0.85	0.76	0.78	0.93	0.94	0.85	0.76	0.78
NZD/GBP	0.38	0.36	0.33	0.30	0.32	0.37	0.40	0.34	0.29	0.32
NZD/EUR	0.55	0.53	0.47	0.42	0.46	0.53	0.59	0.49	0.42	0.46
NZD/YEN	76.8	74.6	65.3	55.6	59.9	74.2	82.7	70.6	55.6	59.9
TWI	70.7	65.6	60.7	53.6	57.2	69	71.9	62.9	53.5	57.2
Official Cash Rate	6.5	7.25	7.25	6.50	6.00	6.5	7.0	7.25	6.75	6.00
90 Day Bank Bill Rate	6.86	7.55	7.39	6.56	6.08	6.73	7.49	7.42	6.81	6.06
2 Year swap	6.82	7.0	6.75	6.26	6.22	6.61	7.24	7.17	6.34	6.21
10 Year Govt Bond	6.04	5.71	6.00	5.85	5.70	6.03	5.89	5.90	5.90	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.