Bank of New Zealand

BNZ Weekly Overview

13 December 2007

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	8.25%	8.25	8.25	8.25	7.25	6.2
90-day bank bill	8.88%	8.88	8.68	8.85	7.65	6.4
10 year govt. bond	6.39%	6.28	6.38	6.07	5.73	6.5
1 year swap	8.90%	8.86	8.84	8.61	7.80	6.6
5 year swap	8.21%	8.19	8.27	7.78	7.22	7.0
NZD/USD	0.786	0.773	0.749	0.71	0.691	.567
NZD/AUD	0.889	0.886	0.848	0.845	0.879	.859
NZD/JPY	88.0	85.6	82.3	81.0	80.8	66.1
NZD/GBP	0.384	0.381	0.363	0.35	0.351	.342
NZD/EURO	0.534	0.528	0.515	0.511	0.521	.51

For addition to our emailing list for Thursday night receipt email "Subscribe WO" to tony.alexander@bnz.co.nz . To get off the list email 'Unsubscribe".

Last Issue For The Year

Over the past two issues you will hopefully have noticed a major expansion of the Exchange Rate section. More accurately, substantial extra information has been provided on what is happening in our top six trading partners – Australia, US, Japan, EU, UK and China. Over the holidays the way in which discussion is undertaken of developments overseas will be refined with the aim being to do in layman's terms to these economies what we have been doing here since 1999 for New Zealand.

Our objective in providing this extra information is to boost NZ exporters' knowledge about what is happening in our major markets. There is already a huge volume of material available on the internet regarding foreign economies but the focus tends to be on immediate implications for share prices, interest rates and exchange rates. These things are interesting but exporters need a more understandable short to medium term focus. For the longer term stuff regarding the structure of foreign economies there is good information available from the NZ Trade and Enterprise website at
http://www.nzte.govt.nz/

This extra work is increasing the size of the Weekly Overview so perhaps its best to remind readers that the best way to approach the WO is focus just on the bit that interests you. Read on your screen and don't contribute to global warming printing the whole thing out unless you really have to. Over the break we will consider creating a separate exporter focussed publication to make handling the information easier for readers – 21 pages is just too big.

At this stage we have no plans to scale back the Housing section which is of strong interest to home buyers, investors, builders, lenders and real estate agents. The Economic Developments section will also continue as of course will the Interest rates section.

Merry Christmas everyone and many thanks to those who have responded to our monthly survey during the year and otherwise let us know what they are seeing out there.

Hello Possum

One comment did not make it into our monthly Confidence Survey released this week but it is so relevant in a New Zealand context we have to put it somewhere. So here it is.

"The demand for possum fur is very strong at the moment as it has been for quite a while now. The price paid is around the $105 to $110 per kilo (on average about 20 possums hand plucked to make up a kilo of fur). In 2000 when a market for the fur was established the price was $45 per kilo. Looking at how the industry has developed and the fact that the fur buyers can not supply enough fur for the domestic market let alone overseas markets such as China I would expect the price to keep rising on a regular basis.

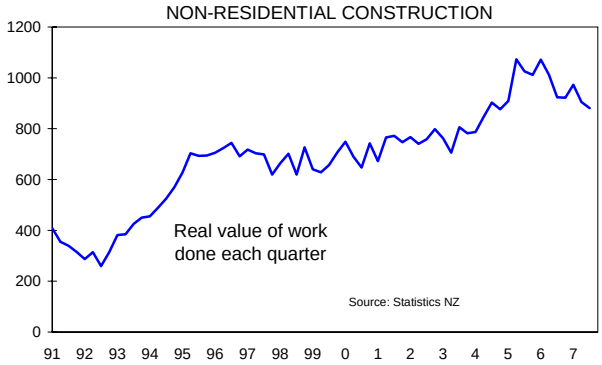
The skin market is still reasonably slow, it has moved in the last 6 months or so, although it has a long way to go before it gets back to the good old days of $20 for a 1st grade skin. Will be interesting to see what happens in the next 12 months."

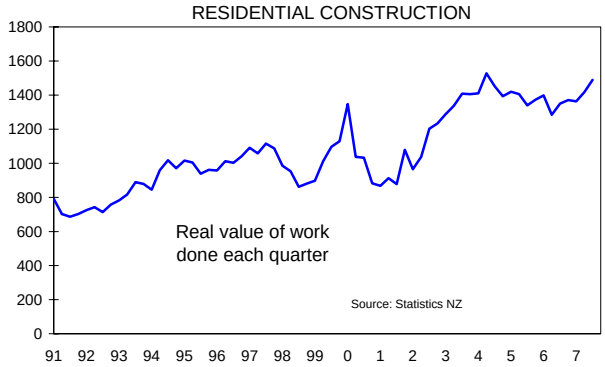
THE WEEK'S NZ ECONOMIC DEVELOPMENTS

Monday 11

Mixed Building Results

In seasonally adjusted terms the volume of non-residential construction work undertaken in the September quarter fell by 2.7% after falling 7% in the June quarter. Compared with a year earlier activity was down by 4.7%. Does this mean things are falling away strongly in this sector which accounts for about 3% of our country's GDP? Not necessarily because we know there are shortages of people in the construction sector plus the numbers can be easily moved around by the timing of major projects. Given our belief that businesses are highly aware they need to boost productivity in an environment of continuing labour shortages we believe non-residential construction activity is likely to recover going forward.





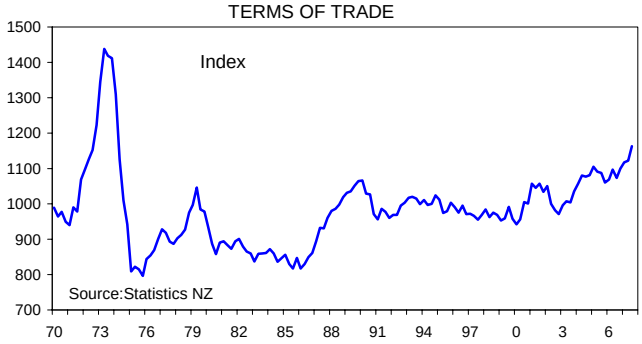
With regard to residential construction the decline in dwelling consent issuance underway has yet to show through with activity up 5% in the September quarter following 4% growth in the June quarter. Residential construction work was 10.2% ahead of a year earlier. In contrast to non-residential activity we think weakness in this area is likely over the next year or so commensurate with the pulling back of the New Zealand housing market. But as resources get freed up they are likely to get sucked up by non-residential construction plus infrastructure work.

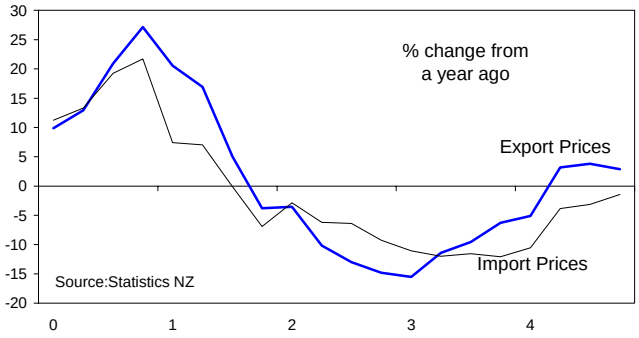
Tuesday 12

Terms of Trade Jump up

Exports make up just over 30% of GDP in New Zealand and the bulk of our export base comes from the primary sector. Therefore what happens with international commodity prices is particularly important and we can measure price changes relative to the price of what we pay for imports using the Terms of Trade.

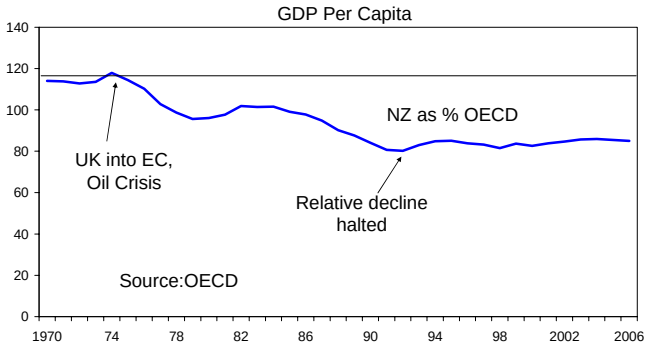
Significant periods of economic growth in New Zealand in the past have often been associated with a boom in our Terms of Trade. This included the 1950s wool price boom associated with the conflict on the Korean peninsular along with the boom in prices in the early 1970s before oil prices went through the roof and everything went to the pack here due to bad policy setting.





In the September quarter New Zealand's terms of trade improved by a relatively strong 3.7% with a 3.3% average gain in export prices swamping a 0.2% average fall in import prices. Compared with a year earlier the terms of trade were up by 8.4% and the overall index is now at its highest since a brief surge at the end of 1989.

Speaking of the 1970s bad policy setting period. You can see our relative decline in spades looking at the Ministry of Economic Development's just released Economic Development Indicators 2007 report. Page 3 of the summary report has a graph showing NZ per capita GDP relative to the OECD falling away from 1974 to 1991. Their graph is a more sophisticated version of our one just below.
http://www.med.govt.nz/



The report looks at many things but points which stand out include…

- The quality of much of New Zealand's infrastructure appears to be at or below the OECD average.
- New Zealand's information and communications technology (ICT) infrastructure quality appears to be below that of most OECD countries,
- As a percentage of GDP, New Zealand's share of exports and imports falls in the lower half of the OECD, which is unusual for a country of New Zealand's size.
- While the banking sector is very well developed, the venture capital and sharemarket are small compared with the better-performing OECD economies.
- Overall, New Zealand ranks low relative to other OECD countries on the formal measures of innovation activity – research and development (R&D) and patenting.
- The level of high and medium-technology products exported by New Zealand firms is also far behind the OECD average,

But

- New Zealand is second in the world for overall ease of doing business.
- New Zealand's total tax burden, measured by our tax to GDP ratio (35 per cent), is around the OECD median.

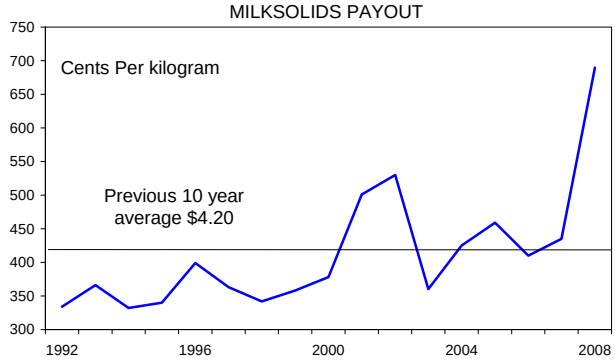
- The education level of New Zealand's workforce is above the OECD median and improving.

Our big weaknesses appear to be lower than desirable engagement internationally, inadequate R&D, and weak venture capital and equity markets.

Thursday 13

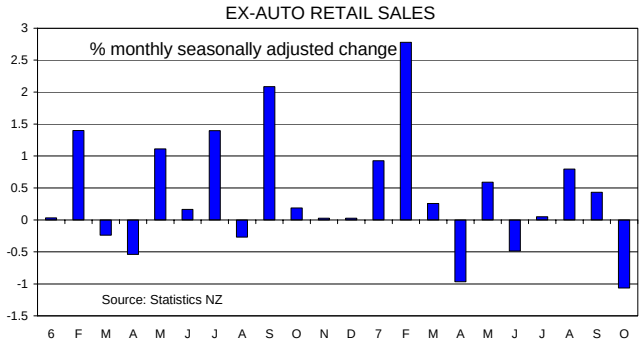
Milk Flowing Like Honey

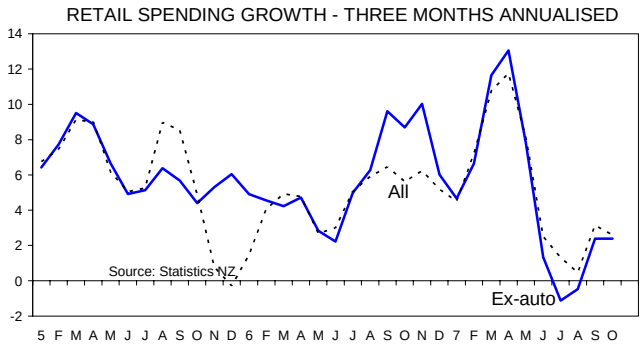
Fonterra announced an increase in their forecast milk solids payout this season to a record $6.90 from the previously estimated $6.40. The payout last season was $4.46 and the increase will inject around $3b more income into the pockets of dairy farmers. This is a significant boost in an economy with gross domestic product running just over $160b and is a key factor underpinning our forecast of acceptable growth in the NZ economy going forward. There is also however the obvious implication in a resource-constrained economy of extra upward pressure on inflation, interest rates, and the exchange.



Retail Spending Falls Away

Weakness in retail spending was revealed with the Statistics New Zealand retail trade series in nominal seasonally adjusted terms declining by a relatively firm 1.1% in October after removing the volatile automotives sector. Sales were just 3.4% ahead of a year earlier which was the lowest such annual rate of growth since the second half of 2000. Quite clearly consumers are reacting to the rise in interest rates perhaps along with uncertainty about the global financial environment and undoubtedly the absence of easy rises in house prices. The numbers will please the Reserve Bank however as they noted in their comments last week about inflationary risks there are many threats to inflation going forward. As we note in the Interest rates section, one of them is any weakness in the exchange rate. .

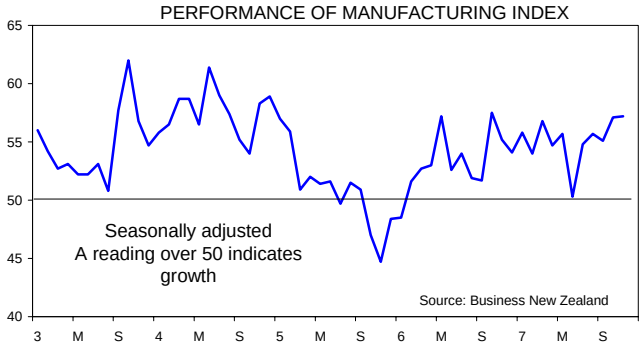




Manufacturing in Good Heart

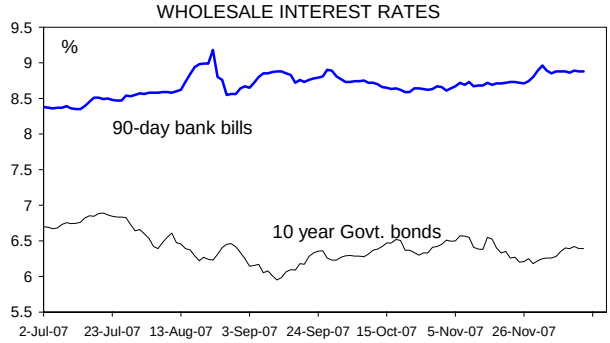
In contrast to the predictions of doom and gloom about the manufacturing sector traditionally coming from some of the more dinosaur-related business groups in the economy (like the groups in climate-change denial mode) the monthly Performance of Manufacturing index compiled by Business New Zealand shows a sector in good health. With 50 taken as neutral, in seasonally adjusted terms the index improved to 57.2 in

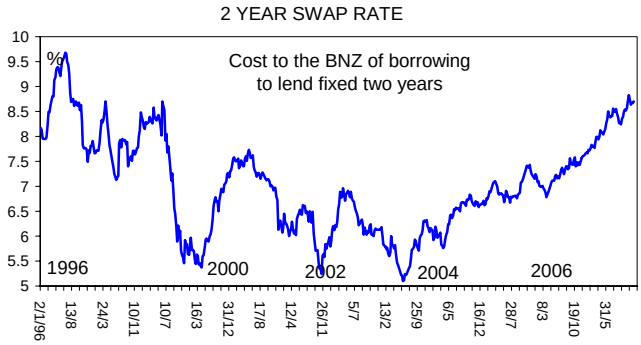
November from 57.1 in October. This is the best reading since May 2006 and lies above the average reading since the survey started of 54.6. There are definitely challenges for the New Zealand manufacturer as evidenced by the frequent reports of companies closing down and shifting offshore. But what people need to remember is that we have an economy which is short of resources and we desperately want those resources including people, buildings, and capital to go to the most productive areas. Producing manufactured goods that can far more cheaply be made in China is not a productive area so perverse as it may sound for each manufacturer that closes down in New Zealand and shifts offshore prospects for growth in our standard of living actually improve.



INTEREST RATES

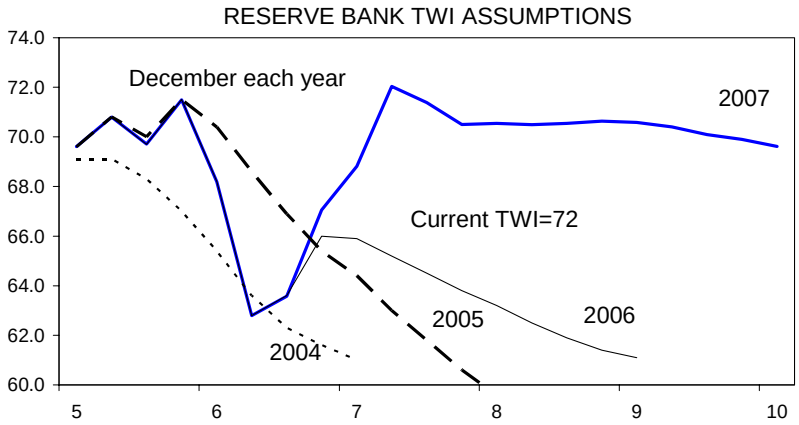
We have seen essentially no change in New Zealand wholesale interest rates over the past week with economic news items during the week tending to balance each other out. For instance although today's retail spending numbers were very weak the $.50 lift in the milksolids payout counters that to some degree. And although we have been reading about manufacturers shifting offshore the Business New Zealand Performance of Manufacturing index has improved in the past month. And although non-residential construction fell away by 2.7% of the September quarter residential construction grew by 5%.





Of course things are far more interesting if we do a comparison between interest rates today and what they were a year ago. Doing that we find the 90 day bank bill this Thursday at 8.88% compared with 7.65% a year ago. More significantly, the two year swap rate at which we banks borrow to lend fixed for two year periods has climbed to 8.71% from 7.57%. With fewer than 13% of people with mortgages sitting on a floating rate it is the fixed rate movement that matters and helps explain why we are seeing weak numbers on New Zealand's housing market at the moment.

For your guide, when making forecasts for the New Zealand economy the Reserve Bank have to include an assumption about what the exchange rate is going to do over the next few years. The graph below shows that starting in December 2004 they forecast the TWI would fall from its then level of 69 to near 61 two years later. That assumption of a TWI 8 decline increased to an assumed 11 TWI decline in their December 2005 forecasts. For their December 2006 forecasts the two year out assumed change was a decline of TWI 5, still to around the 61 area.



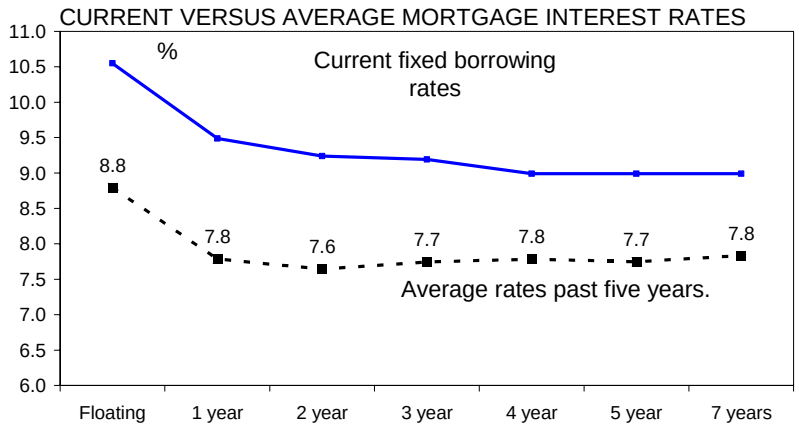
Well that has all gone out the window. From a starting level in December this year when they made their forecasts of around TWI 70, the assumed change two years out is now zero. No depreciation in other words.

Perhaps the RB believe that the long run average level for the NZ dollar has lifted. That seems a reasonable assumption to make and the Prime Minister has said as much. But assuming no change seems a bit much of an alteration in a one year period from previous behaviour even allowing for the lift in dairy prices. So one suspects the assumption is driven by a desire to avoid scary inflation forecasts. This reinforces our warning to borrowers not to factor in lower interest rates for the next two years if one adopts a conservative forecasting stance – though we still have an easing very tentatively pencilled in late next year. The RB has no scope in its inflation projections for any depreciation in the NZD not accompanied by something weakening NZ growth such as a collapse in commodity prices.

The was little reason for believing interest rates will be declining soon on the basis of this week's housing market data from the REINZ. Although the average number of days taken to sell a dwelling was one week longer than a year earlier and above average for the first time in over four years, in seasonally adjusted terms sales improved for the second month in a row and the median dwelling sale price even rose slightly by $2,000 in the month. So the housing market is weak but not doing anything remotely like what we are seeing in the United States and to some extent in the United Kingdom.

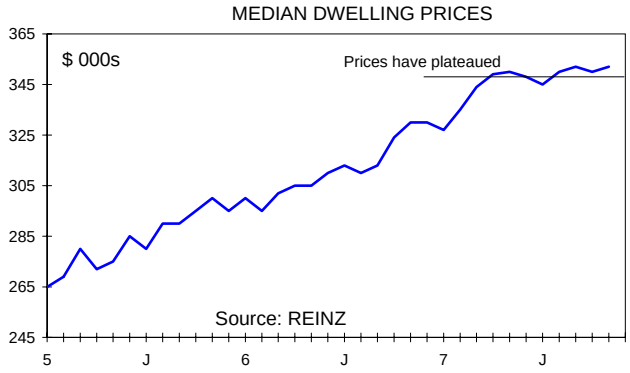
If I Were a Borrower What Would I Do?

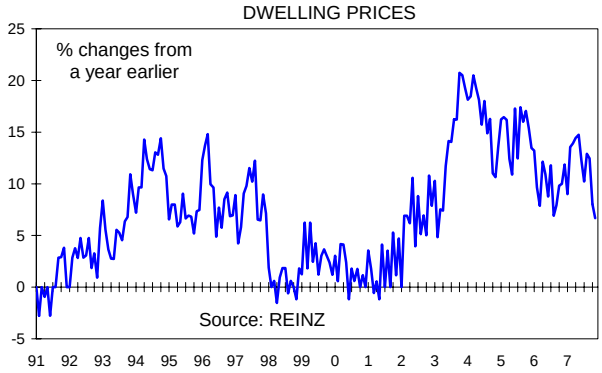
Fix two years and not get optimistic about interest rates falling in the near future unless we get a world recession.



HOUSING MARKET UPDATE

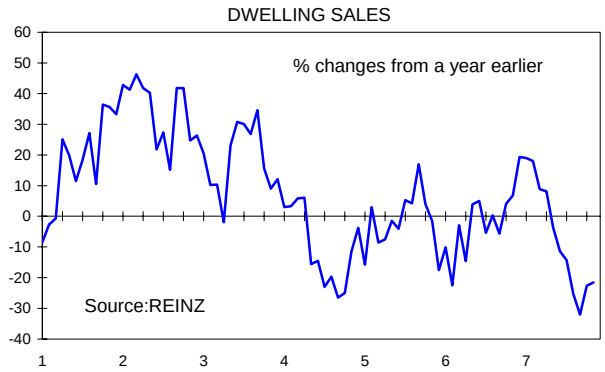
This week we received the main collection of data on the state of the New Zealand housing market in the form of the monthly REINZ release. In November the median dwelling sale price around New Zealand was $352,000 which was an increase from $350,000 in October. But when you look at the graph below it is fairly clear that house prices in New Zealand have essentially been flat since hitting $349,000 in April. The median dwelling sale price was 6.7% ahead of a year earlier so house price inflation is now running at its slowest pace in at least 4.5 years.

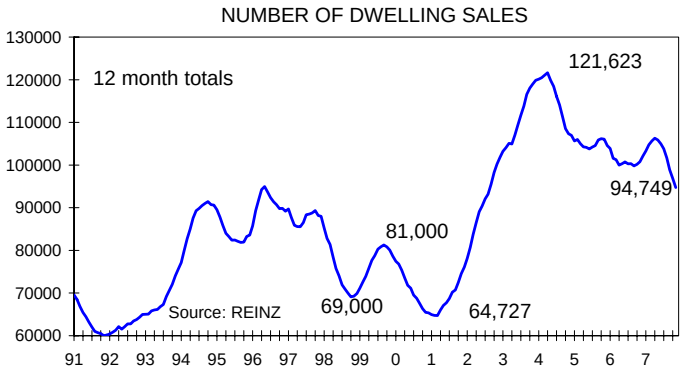




The total number of dwellings sold in November was 7,837. This was a 21.6% decrease from a year earlier and in rough seasonally adjusted terms was actually an improvement of about 3% from October following a near 9% gain in that month. It is these rough monthly seasonally adjusted calculations that can allow one to say there might be some evidence that the decline in turnover in the housing market is bottoming out. But these are very early days yet with regard to the cyclical easing in our housing market so it would be unwise to conclude that sales activity has stabilised although one can make reference to that argument.

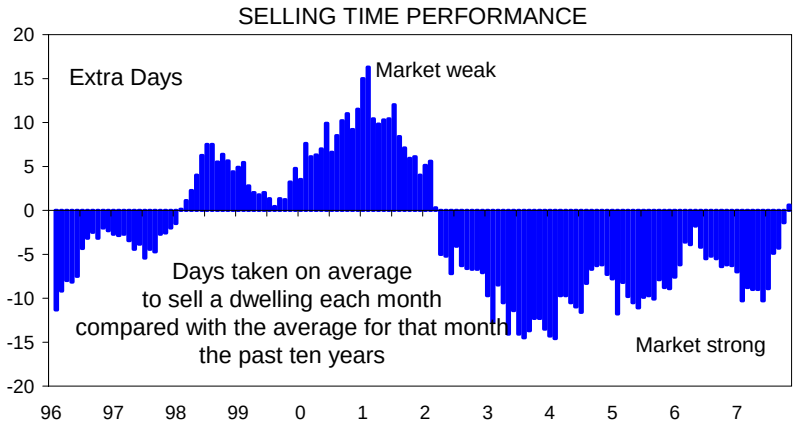
If one did want to make that argument then support for it can be found in some of the responses to our monthly survey of Weekly Overview readers. Some of the responses on the residential real estate market indicate there are many investors who are cashed up looking for bargains and supporting sales activity in some parts of the country.





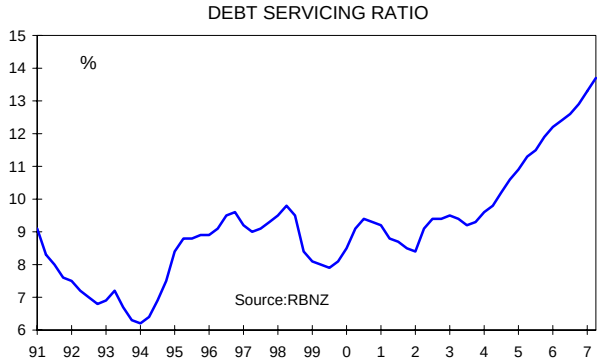
For the record sales in the three months to November were down by 21.5% from a year earlier, and sales in the year to November stood at 94,749 which was a decrease of 6% from a year earlier.

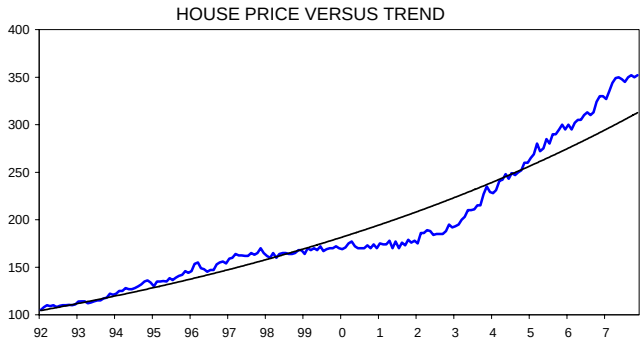
One figure we pay close attention to is the average number of days taken to sell a dwelling. This number for November was 36 days which was an increase from 34 days in October and seven days longer than November a year earlier. Most importantly, compared with the average number of days taken to sell a dwelling in November over the past 10 years there was an increase of 0.6 days. This is the first time this measure has been worse than average since March 2002 and it indicates quite clearly that properties are sitting on the market for - wait for it, by definition - longer. As the graph below shows we are moving into weak market territory. No surprise there.



The issue of course is where things are going to go to from here. At this stage we not placing a huge weight on the recent seasonally adjusted improvement in turnover because as some would say it could be just a dead cat bounce. After all, the outlook for the world economy is deteriorating and as each month goes by more and more people move from a low fixed interest rate onto a new fixed interest rate almost certainly above 9%.

At this stage it's a bit of a balancing act between some obvious supporting factors and some worrying factors. On the worrying side we have the record level of debt servicing in New Zealand and relatively high level of house prices according to whichever measure you feel like using - maybe versus incomes, maybe versus some concept of a trend.





Note that measures comparing a thing with some concept of fair value to get a feel for overvaluation or undervaluation sound interesting but are essentially worthless. If a thing is calculated to be 20% overvalued does that tell you where it is going to go in price and when? Definitely not. After all it was first of all 10% overvalued and the price kept on rising. Possibly the only reason the thing is 20% overvalued is because it is on its way to being 60% overvalued. This applies whether one is talking about house prices, share prices, exchange rates, and so on.

Why is it that house prices on average have doubled over the past six years? Because lots of people wanted to buy them and were prepared to pay increasingly high prices. Have the factors causing people to do this gone back the other way? Interest rates are certainly higher and one would suspect the confidence of investors in capital gains has diminished. We are also no longer seeing massively above average net migration inflows and jobs growth has slowed down from an average of 2.4% per annum to only an annualised 0.6% over the past half year. Commensurate with that the unemployment rate is no longer falling from a level near 7% to 3.5%. We are already there and we not now heading toward 0%.

Special factors driving our housing market upward have ended. But apart from interest rates which quite clearly are having negative traction in the housing market we have yet to see the appearance of other outright big negatives such as rising unemployment, rapidly slowing wages growth, declining job security, and net migration outflows.

This leaves us with a view that the housing market is probably going to be relatively flat for the next couple years and it is going to be an environment in which the skilled operator will do all right with their long-term focus as inexperienced people with high debt levels and low debt servicing ability get weeded out of the sector. Bargains will appear and there will be many examples of hefty price discounting. Newspapers will be able to run articles talking about the end of the boom but we don't think doom and gloom type articles will be warranted.

On a final note consider the following. In an environment where the availability of rental accommodation is worsening and there are forecasts of strong increases in rents how reasonable is it to expect falling house prices? Normally if the housing market were in such bad shape that prices were falling away there would surely be an oversupply of rental property. That is not the case. It's worth thinking about.

According to the Consumers Price Index average rents have risen by 3.1% over the past year. While house prices have doubled from six years ago average rents have risen approximately 18%.

Monthly Survey Residential Real Estate Responses

Hopefully all of you will have already received and read the results of our monthly survey of Weekly Overview readers. If you have not here are the responses we received regarding the residential real estate market.

- High end real estate - positive, although better once the NZD declines
- Property Valuation and Advisory ChCh strong slowing up in activity and now real evidence of price weakening although not across all bands of property. High interest rates for many more months to come may exacerbate what is becoming a potentially fragile situation. Tax cuts maybe the panacea
- Property Development, Tauranga: Has been busy again here since Labour Weekend. Renewed interest in property since the collapse of finance companies, the uncertain dollar and the unpredictable stock exchange. Waikato farmers making noises about property investments during 2008. Outlook is rosy.
- Real Estate Advisory Quite!
- Residential Real estate sales east Auckland. Slow at open homes. buyers generally unmotivated with the gap seller to buyer expectations big. However against the grain we had 3 offers on one property (good location) the other day which sold unconditionally as a result.
- Property development - residential decline on high interest rates and poor returns on rents and capital gains.
- We are a Real Estate company operating in Whakatane, Ohope Beach & Districts. September & October were very good months in terms of property sales however November was slow. December has really got away to a great start with lots of activity by the salespeople which are resulting in house sales. If the rest of December is as good as this first week we will come close to a record December. Sales People are having to work much harder than they needed to 12 – 18 months ago, but their efforts are showing good results. Our property management department is still very short of properties to rent as there is strong demand from quality Tenants. Properties sold to investors are quickly tenanted at the moment. We really really need rental properties to manage.
- Property. Outlook is good for my sector - Apartments - rising rents, finite amount of new builds within CBD, population changes all work for us.
- Property development: new sections still selling well in Hawkes Bay. We do not see a slowing down in the market yet.
- Auckland residential property sales: I am seeing some very scary registered valuations held by second tier lenders. Some are well beyond current realisable value.
- Valuation - still busy
- Residential Property Investment: Interest rates are having a big impact and is causing tremendous cash-flow problems. Added to this is the tightening up a lending criteria. However, there are many wealthy investors with low gearing who have been waiting for this moment for 3+ years. So much so, that

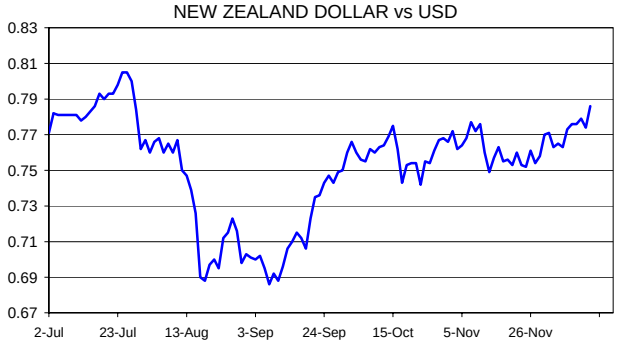
the downward pressures on pricing caused by possible over supply may to a large degree be absorbed by the number of potential buyers waiting in the wings.

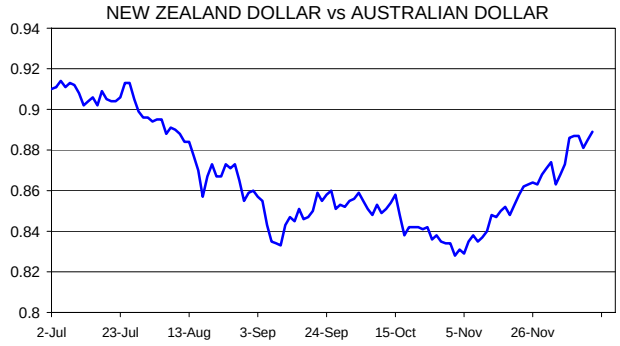
- Property Development. The market has gone completely quiet. The Bollard message has come through load and clear and buyers are choosing to sit tight rather than commit. Add to this the Christchurch City Council has ground to a complete halt and is adding significant costs to the system through financing the delays.
- Residential Real Estate, Auckland Eastern Suburbs. After fairly mediocre results in September and October, November was our second best month of the year. Auctions have been attracting multiple buyers and many have sold above reserve with spirited bidding. Days on market for the Eastern Suburbs crept out to 39 in October. November stats are not yet available. Listing activity was strong during the month. Vendors who are motivated and listening to the market are achieving sales, but many vendors are hanging out for unrealistic expectations. Property sales were across all price ranges with $1m plus properties making up over a third of settled sales. Several leasehold sales were also made. December 2006 was an exceptional month but we would expect sales this year to be at a lower level. Rental activity was also strong and if anything there is a shortage of good stock to satisfy demand.
- Property - valuer Hamilton/Cambridge. We have been a lot busier than at anytime last year with a lot of new properties being bought by investors particularly in the last 2 months. There seems to be a good number of investors with cash and equity available to purchase good quality properties.
- Residential real estate Pakuranga/Howick. Sale numbers down on last year, prices seem to be holding at last years; actually reasonably busy, possibly vendors accepting that to move on they need to get real with price expectations. Many buyers say they are waiting for huge drops next year, but others who are buying suggest that perhaps we are at the low point.
- Property investing and land development/low end of market/middle end of market. (Mangere/Waiuku) 1), the low end of the market stuffed, only vultures circling Waiuku: new brick & tile homes lying empty for some time now. not even any vultures to be seen. 3)1910 circa Villa ,Remuera, more than 50%burnt, 1020 m steep site sold for just on 1.8ml within eight weeks, land value only (one dwelling per 1000m). Three competing purchases. Amazing! There seems to be a new benchmark for high-quality homes in the best Remuera streets, starting at 3.5 upwards. Amazing :) a lot more "for sale" real estate signs springing up across the board
- Real estate. Good inquiry, especially from overseas, harder to get buyers to commit, some vendors still over pricing.
- I am a US mortgage broker and we are surviving the mortgage crisis, but had seen the meltdown coming and were prepared. I have property holdings in Kaikoura and am pleased with the strength and appreciation. Not thrilled with the New Zealand mortgage rates or current exchange rate, but do like the interest rates paid on term investments. So, overall no real reason to complain!
- Open Homes are like "Waiting for Godot" after the initial two weeks showings when the left over bargain hunters check out any new listing
- Residential in Christchurch: The market has suddenly gone very quiet. No properties in last week's auction at …. in Christchurch reached their reserves. It would appear that the long awaited correction in the residential market is about to happen.
- Property Industry poor sales already evident
- Real Estate - Eastern Beaches, Auckland We are at a full-stop across all price ranges. There are lots of excellent buys out there for the astute investors and expect this to continue for quite some time.
- Residential Real Estate Auckland Central - Sales volume is down from a year ago about 20%. Some prices being achieved seem low, but others high. An open home today of a just-listed family home in the $1mil plus bracket was attended by 25 groups or about 65 people. Several buyers were cashed up but more-so than last year, many were not.
- Rental properties. Rents are rising and the future looks better as housing costs prevent first home owners buying, and investors bide their time for expansion.
- Residential property investor House values are now confirmed to have stopped rising. Tenant demand for property is very strong. Locally, residential property managers are complaining to me that they need more houses from investors to lease to tenants. I believe long-term property investors will see large increases in rents over the next two years. The media is starting to run "pity the poor renter" type headlines.

- In the Property and Investment sector we note that high interest rates are leading to a steady decline in investment as people are becoming more cautious about where they place their funds. Pessimism in overseas markets is also being reflected in increasing uncertainty by our clients.
- Real Estate Christchurch, things are definitely picking up after a couple of pretty flat months Vendors need to be well priced to the market, but the stock is flowing onto the market .Surprised by the number of sellers asking about auction as a marketing initiative .
- Real estate. feels like the tap has been turned off.

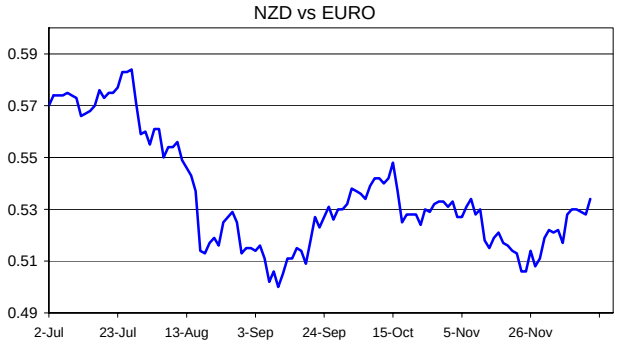
EXCHANGE RATES & FOREIGN ECONOMIES

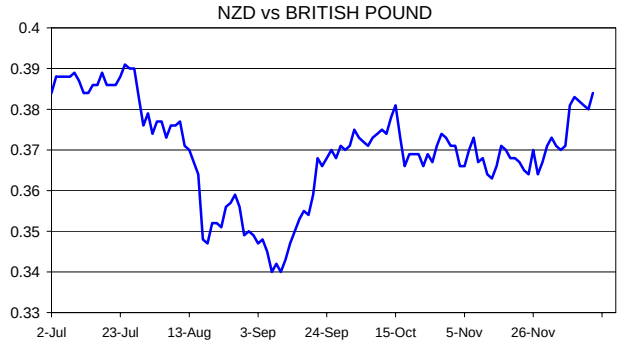
It's been a strong week for the Kiwi dollar with gains against all our major trading currencies. Against the greenback we have ended at a 4 ½ month high near 78.6 US cents from 77.3 last week. Upward pressure on the Kiwi dollar has come from some very mild recovery in world sharemarkets over the past week associated with anticipation of easier monetary policy in the United States and capital injections to banks reporting losses slightly increasing risk tolerance by investors. The Kiwi dollar has also been supported by this week's reporting of a sharp jump in our terms of trade during the September quarter and Fonterra's announcement of a higher payout this morning.





Against the Australian currency we have ended this afternoon just below 89.0 cents from 87.3 cents last week. This has happened in spite of the Australian dollar itself gaining against the greenback.





Against the British pound we have ended near 38.4 pence from 38.1 last week, against the Japanese yen near 88.0 from 85.6, and against the euro near 53.4 cents from 52.8 last week.

United States

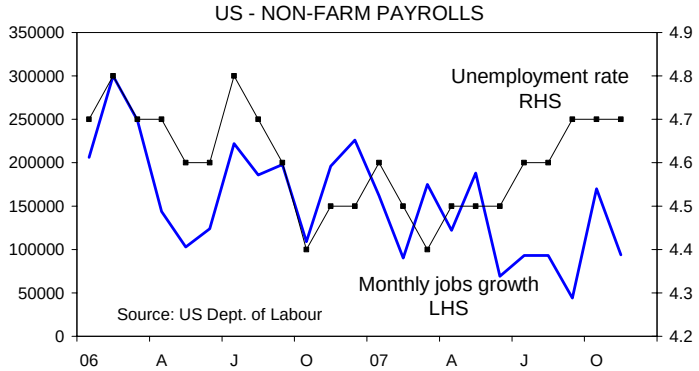
GDP +4.9%, CPI +3.5%, funds rate 4.50%, 9% of NZ visitors & 12% of exports, $10.5b FDI in NZ

The question we seek to answer here is whether we have learnt anything over the past week that decreases or increases the chances of recession in the US economy next year. The recession worry arises because of the sharp decline in the housing market with construction at a 16 year low, average prices down almost 5% from a year earlier, and builders discounting new house prices to 13% down from a year ago. Plus –

excluding the Hurricane Katrina period – consumer confidence is at a 16 year low. During the week recession worries were boosted when Morgan Stanley released a recession prediction. http://www.telegraph.co.uk/money/main.jhtml?view=DETAILS&grid=A1YourView&xml=/money/2007/12/11/cnusa111.xml

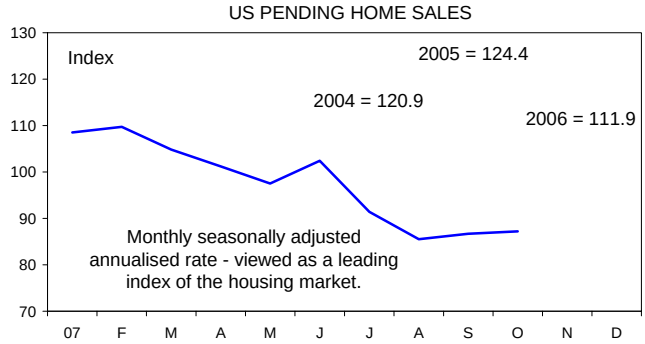
What we are looking for is evidence about whether the woe in the housing market is spreading to other sectors such as household spending on consumer goods, business investment and employment. Last Friday night the monthly non-farm payrolls report was released and the good news as far as the recession probability goes is that the report was okay. Job numbers rose by 94,000 a month which was slightly above market expectations. So far this year job numbers have increased 1.3 million giving an average monthly rise of 113,000 people. What was important in Friday night's result was that the outcome was not very weak. This meant scope still existed for the Fed to cut interest rates as they did last night with further cuts likely next year.

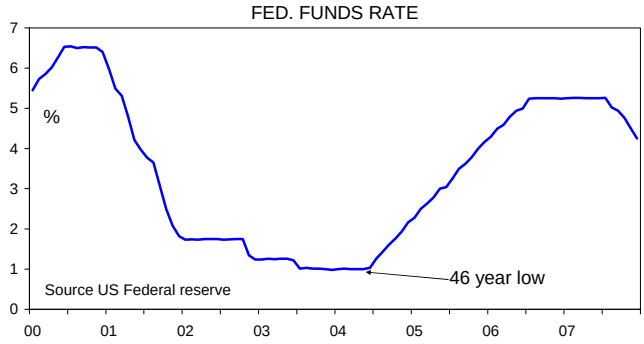
However the fact that businesses are still hiring diminishes the chances that the housing collapse will lead to a major decline in wider consumer spending. And importantly it signals that businesses still have some confidence in the economy going forward. It impossible to be optimistic however considering consumer confidence sitting at a 16 year low in one of the major monthly surveys.



Interestingly, while the jobs report was acceptable, because it was not bad US bond yields jumped up. But because it was not great oil prices fell almost $3 on the news. It is interesting to see the way in which a single number can produce quite divergent responses in different markets.

In a somewhat surprising tone that there was some positive news released on the United States housing market last week. The National Association of Realtors said that in October the number of people signing up to buy a previously owned home was down 18% from a year earlier. This sounds bad but there was an improvement of 0.6% from September and in September the number was an improvement of 1.4%. This is leading to a view that the bottom of the barrel may be getting scraped with regard to turnover in the housing market. But this is still very much a fluctuating beastie and optimism does not yet seem warranted.





For your guide about 5.5 million used homes are sold in the United States each year. Add in about another 700,000 new homes being sold and total sales are about 6.2 million. This works out at about 2% equivalent of the population of just over 300 million people. The New Zealand the equivalent ratio is about 2.9%.

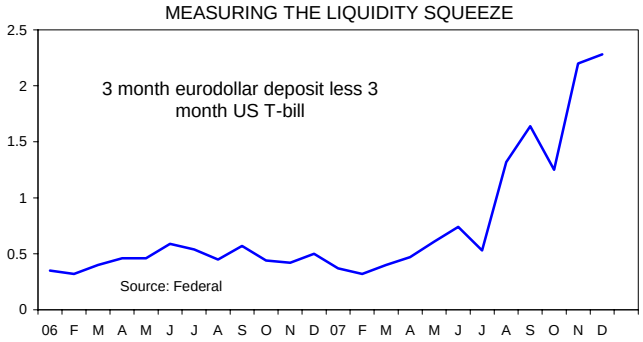
The housing rescue package announced by the US President last week will go a small way to alleviating pressures in the housing market but things have to be kept in perspective. One estimate suggests that of the 2 million people having their adjustable rate mortgage roll onto a new rate over 2008 only about 240,000 will be eligible for the five year rate freeze. A really good article describing how the sub-prime mortgage crisis has come about can be found at the following link.
http://news.bbc.co.uk/2/hi/business/7073131.stm

This Wednesday morning the Federal Reserve disappointed those hoping for an aggressive easing in monetary policy by cutting their funds rate 0.25% to 4.25%, and also reducing the discount rate at which banks can access liquidity direct from the Federal Reserve just 0.25% (to 4.75%) as well. A number of market participants had been hoping for 0.5% cuts in both rates and on Wall Street the reaction was a fall in the Dow Jones index of over 200 points. In addition, the Fed did not adopt any unusually strong easing bias with comments such as "some inflation risks remain" and the Fed "will continue to monitor inflation developments carefully."

Their comments reinforce a key problem for central banks in many parts of the world. They would like to cut interest rates because of concerns about growth and illiquid conditions in their money markets. However they are worried about stoking inflation further out. In addition central banks want to make sure the financial markets and institutions don't believe they will always stand behind them when asset price corrections occur and capital bases of institutions are threatened.

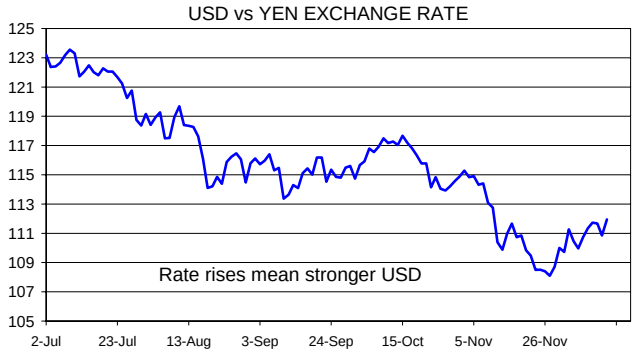
But last night the Federal Reserve along with the Bank of Canada, Bank of England, European Central bank, and Swiss National Bank got in the good books of the market by undertaking the most coordinated central bank action since after the 2001 terrorist attacks. The central banks announced that they would each hold a series of auctions over the next month or so at which settlement banks can bid for money directly from the central bank. This is to address the concern of central banks that private sector banks do not seem to be making adequate use of the discount windows available to them. This is possibly because of worries about the signal it may send to the marketplace if other participants find out they are seeking liquidity from the central bank. The Federal Reserve will hold four auctions with the first two for $20 billion each and successful tenderers will not be revealed.
http://money.cnn.com/2007/12/12/news/economy/fed_liquidity/index.htm?postversion=2007121213

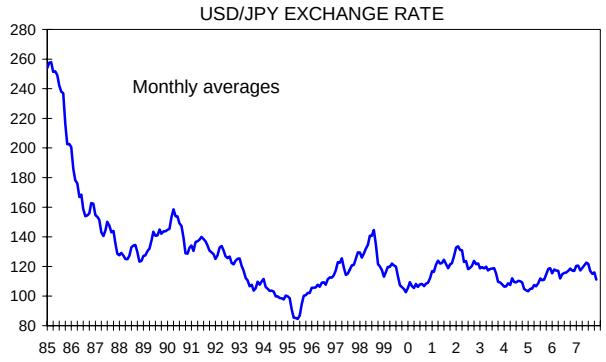
These relatively unprecedented actions come in response to the return of amazingly tight conditions in money markets as evidenced by a huge blow-out in the spread between the likes of the three-month Treasury bill and the three-month interbank lending rate to around 2.2% compared with the more normal 0.5%. The graph below refers to the United States but similar blowouts have occurred in other markets.



Three weeks ago shares in the United States bounced off low levels following news that the Abu Dhabi Investment Fund was taking a 4.9% stake in Citigroup. This reduced worries about a major reduction in the capital bases of US banks which could translate through into a major reduction in willingness to lend. This past week we have seen some further capital injections into Swiss bank UBS plus discussions of cooperation between JP Morgan Chase and the Investment Corporation of Dubai. But after all of that the Dow Jones index has finished practically unchanged from a week ago at a reading last night of 13,474 from

13,456 last week. The greenback has weakened slightly against the pound during the week commenced near $2.047 from $2.029 last week, has gained against the Japanese yen to end near 112.0 from 110.7, and has weakened just slightly against the euro to $1.472 from $1.464 last week.

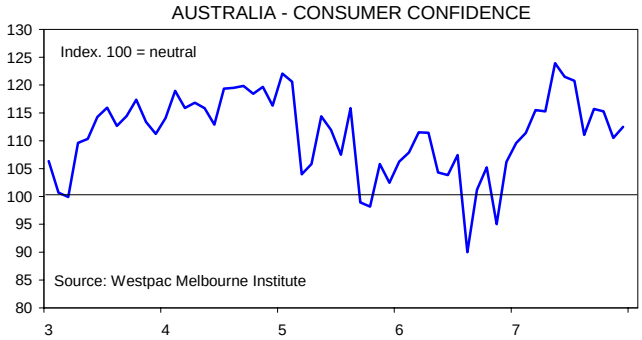


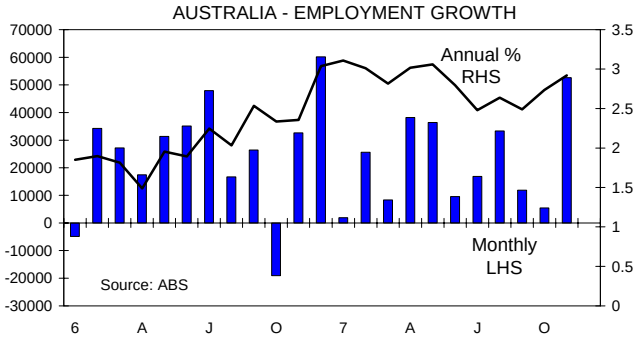


Australia

GDP +4.3%, CPI +1.9%, cash rate 6.75%, 38% of NZ visitors & 22% of exports, $47b FDI in NZ

During the past week in Australia there were two interesting data releases. The first was consumer confidence which improved slightly early this month to a reading of 112.5 from 110.5 in November. A reading above 100 indicates net confidence about the economy going forward. The index is about equal to its average reading over the past five years of 111.2 and as such is suggestive of reasonable growth in consumer spending. This is important because it says that the Reserve Bank of Australia's increase in its cash rate just over a month ago has not had a sustained negative impact on households and for New Zealand this is important because Australia takes almost half of our manufactured exports and a lot of them end up in the household sector.

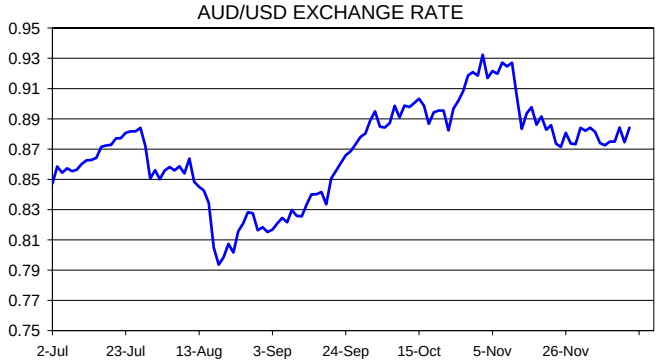


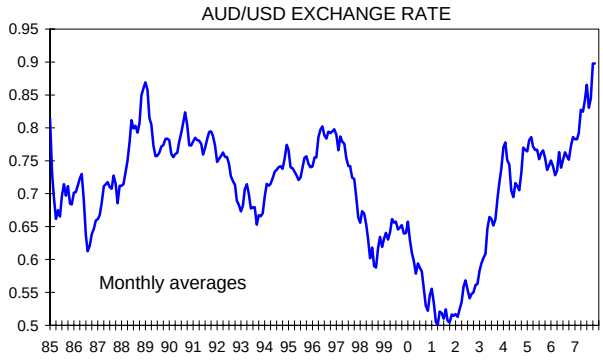


The other very important piece of news was the monthly employment report. This showed a far greater than expected increase in job numbers during the month of 53,000 people although this didn't stop the unemployment rate rising slightly from 4.4% to 4.5% due to growth in the labour force. With a boom continuing in Australia jobs growth is strong and this helps explain why consumer confidence is also continuing at above average levels and prospects for household spending remain reasonable. Contrast that with the situation in New Zealand where we have seen weakness in retail spending and you would think on the face of it this might mean easing monetary policy in New Zealand while tightening continues in Australia. We do believe another tightening is coming from the Reserve Bank of Australia in February but prospects of easing here in New Zealand still seem very remote given inflationary pressure from resource shortages continuing.

The big risk for Australia is if the Chinese economy falls over and there are plenty of people who believe that is going to happen at some point down the track. This is because of worsening inflationary pressures and excessive money supply growth likely associated with extremely unwise lending. Such a decline thankfully does not seem likely in the near future.

For the week the Aussie dollar has gained against the greenback to end this afternoon there 88.4 cents from 87.2 cents last week.

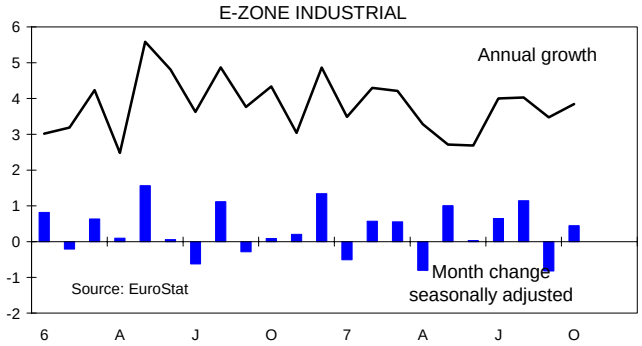




Euro-Zone

GDP +2.6%, CPI +3.0%, cash rate 4%, EU ex-UK=9% NZ visitors & 10% exports, $11.2b FDI in NZ

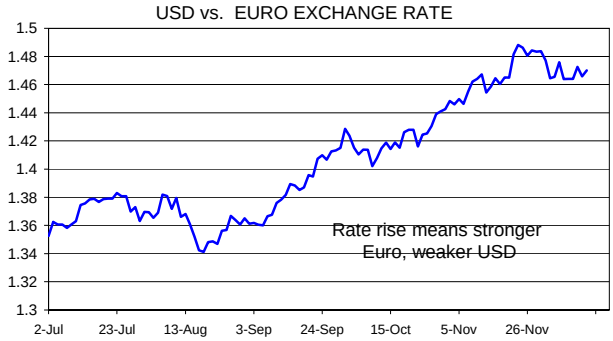
The week has been quiet with regard to data releases in Europe. In seasonally adjusted terms industrial production across the Euro zone improved by a nice 0.4% in October. However this followed a 0.8% decline in September and production was just 3.8% ahead of October last year. So factories are increasing their output. But in the context of declining consumer confidence around the world, central banks having to inject extra liquidity because of banks becoming unwilling to lend to each other, and high energy prices, October data are viewed as too out of date. All one can probably usefully say about this release is that it shows the e-zone entering this current very worrying period with reasonable momentum in the manufacturing sector. This is in spite of the sharp rise in the Euro against practically all but the high yielding currencies since 2002. Interesting. Maybe things are being helped by all those nuclear reactors the French are selling around the world with a couple being sold to Libya this week following last week's announcement of a couple off to China. Plus orders for the Airbus planes seem to keep coming in thick and fast.

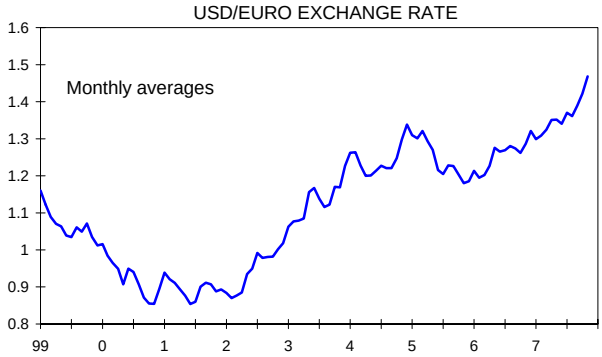


With inflation already at 3% and facing upward pressure from rising food and energy prices it is unsurprising that last week the ECB left their cash rate unchanged at 4% with the ECB President warning "… there are upside risks to price stability over the medium term". In fact he warned that if fuel price rises lead to higher pay claims he will raise interest rates.
http://www.bloomberg.com/apps/news?pid=20601068&sid=aBqSNrlo_nsc&refer=economy

One of the interesting things about Europe at the moment is that the German economy, after many years of pain partly associated with integrating East Germany, has performed well recently with a strong rise in productivity. This week news was released showing that in spite of the high Euro German exports have improved strongly recently. This is relevant for NZ companies as it suggests even if the high euro suppresses European growth as expected next year exposure to Germany could see one's exports relatively well insulated.
http://www.bloomberg.com/apps/news?pid=20601068&sid=adV48geQYl7M&refer=economy
http://www.eurointelligence.com/Article.599+M51d20a20a40.0.html

Over the week the euro currency has moved in a relatively tight range against the greenback to end near $1.47 from $1.464 last week. But it has risen to a one month high against the Japanese yen to near 165 from 162 as the yen has generally edged lower this week.

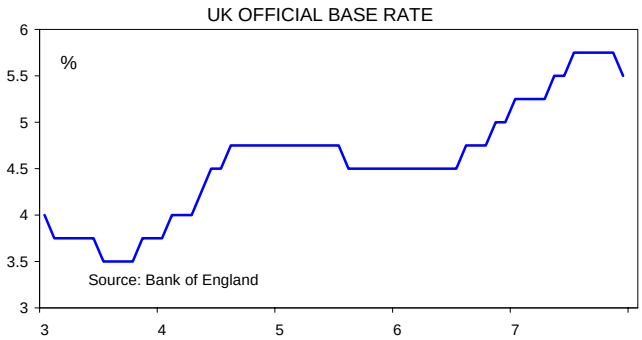


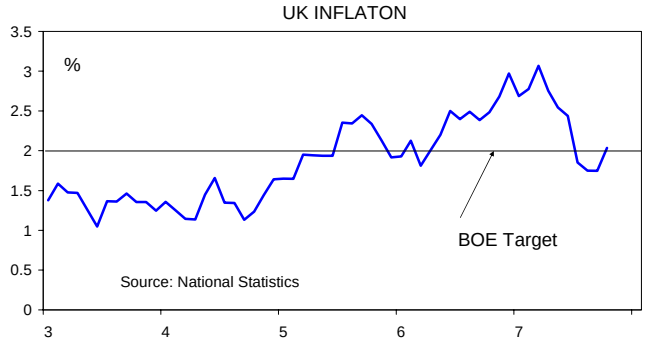


United Kingdom

GDP +3.2%, CPI 2.1%, base rate 5.50%, 12% of NZ visitors & 5% of exports, $4b FDI in NZ

The highlight for the week in the UK was the decision by the Bank of England to cut its base rate 0.25% to 5.5% last Thursday night. The cut starts to reverse rises of 0.75% earlier in the year when the BOE was moving in line with most other central banks around the world and tightening monetary policy. The cut was clearly driven by some recent very weak data on the UK housing market and concerns about the return of liquidity problems between banks boosting worries about a credit crunch. A credit crunch involves banks decreasing their willingness to lend to the business and household sectors. At the moment they are mainly unwilling to lend to each other.



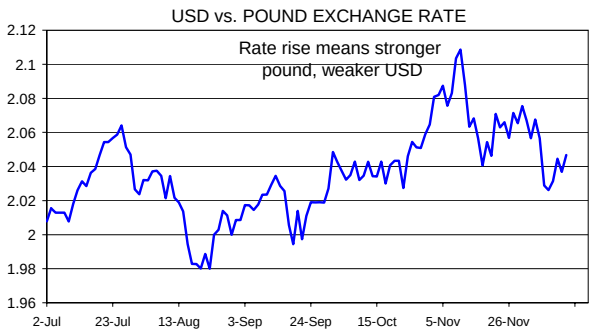


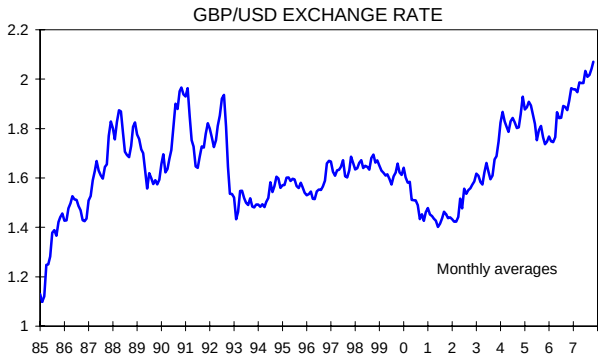
The Bank of England then reinforced their interest-rate cut last night by joining the Federal Reserve and three other central banks in boosting Interbank liquidity conditions, causing a positive reaction in the sharemarket.

On Monday night the pound received some support from a reminder that although there are worries about the global economy and the liquidity squeeze turning into a credit crunch, inflation remains a problem in the UK. UK manufacturing output prices rose on average by 0.5% in November after rising 0.5% in October and were ahead 4.5% from a year ago from a 3.8% increase in October. The result was higher than the markets were expecting.

And just as employment data released in the United States last Friday night showed that as yet the housing market woes have not spread to the labour market so too did data released last night in the United Kingdom show a still robust employment situation with declining jobless numbers.

For the week the British pound has managed to recover slightly against the USD following last week's five cent decline. It has ended near $2.047 from $2.029 last week.

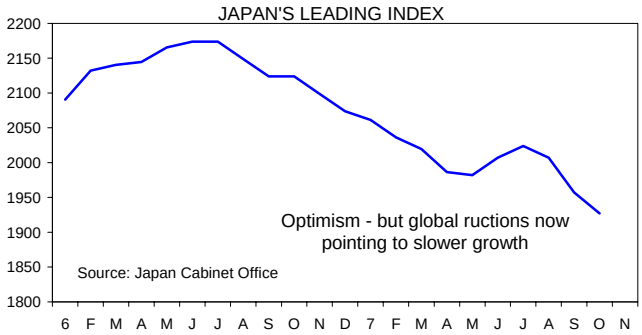


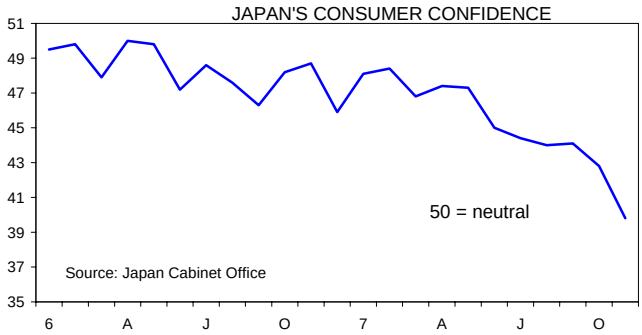


Japan

GDP +1.5%, CPI -0.2%, cash rate 0.5%, 5% of NZ visitors & 10% of exports, $1.8b FDI in NZ

Expectations for a slowing in growth from the annualised rate of 2.6% (see below) recorded in the September quarter have been enhanced this week by Japan's leading index falling for the third month in a row. This leading index comes out with a bit of a lag as it is compiled – in this case – from 12 indexes so the month referred to now is only October. But it fleshes out the picture of waning growth nonetheless.
http://www.bloomberg.com/apps/news?pid=20601101&sid=a3yFPqO7Uhkc&refer=japan

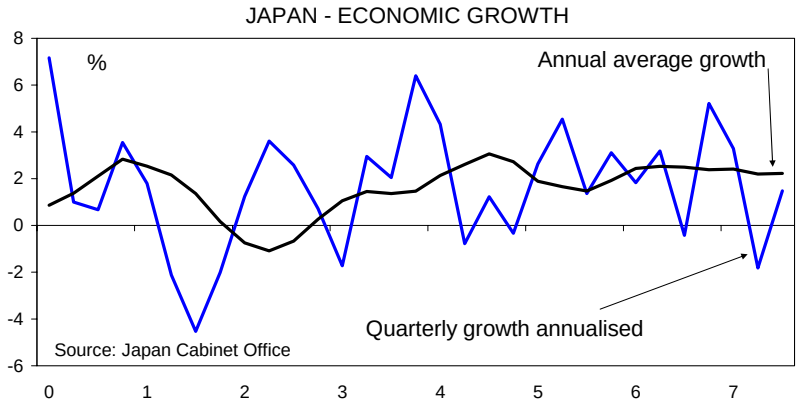




A further indication of likely slowing in growth came from something called the Economy Watchers index which surveys the confidence of merchants such as barbers and shopkeepers. The index fell to its lowest level since March 2003 with a reading of 38.8 in November from 43.1 in October - officially described by the Cabinet Office as " very weak". 50 is neutral. Nasty.
http://www.bloomberg.com/apps/news?pid=20601101&sid=aT3VY17FutQ0&refer=japan

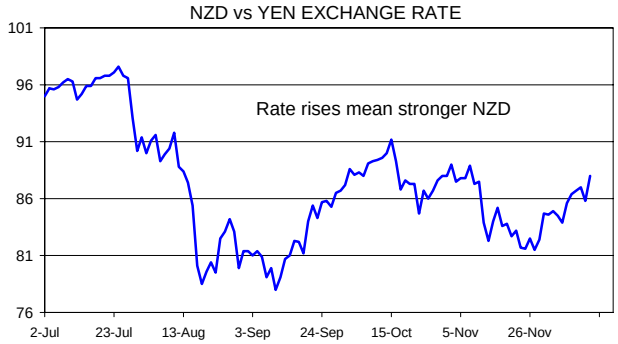
And the Japan-wide official consumer confidence measure fell to a four-year low in the middle of November with a reading of 39.8 from 42.8 in October where 50 is neutral. This series is actually extremely interesting because it gives valuable insight into a key problem facing Japan - people are not confident. The last time the reading in this survey was above the neutral level of 50 was in the June quarter of 1990. Hence the extreme reluctance from the Bank of Japan to raise interest rates because of the risk that consumer spending which, for one a half decades has been so tentative, could collapse.

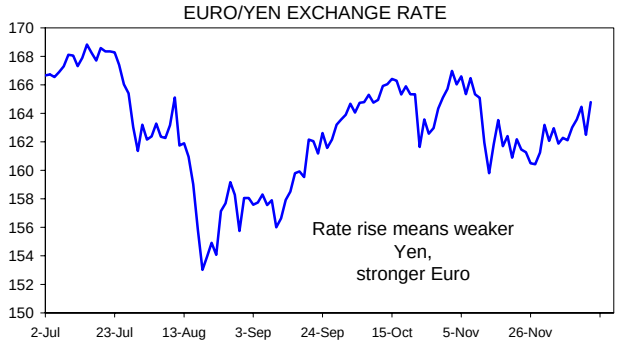
Actually economic growth referred to above for the third quarter is now not even a healthy 2.6%! The number was revised down this week and now stands at 1.5% (following an annualised decline of 1.8% in the June quarter) due mainly to weaker than earlier estimated business investment. This is relevant to NZ exporters not because it implies slower Japanese economic growth than previously thought – that is not relevant with regard to future orders. Instead it implies more spare capacity in the economy than previously thought therefore a reduced probability that the Bank of Japan will be raising interest rates in the near future.



That means continuing very strong support for the NZD from our interest rate differential against Japan. And this even applies without any lift in the carry trade involving anyone in the world borrowing in yen and investing in NZD denominated securities. All it takes is the average Japanese housewife choosing an 8.5% yield on an NZ investment over 0.21% at the Japanese Post Office. A no-brainer really.

These things plus a few other factors help explain why the NZD has ended today against the yen near 88.6 from 85.6 last week – a five week high. The yen has itself edged lower against other major currencies over the week to end near 112.0 to buy one US dollar from 110.7 last week.





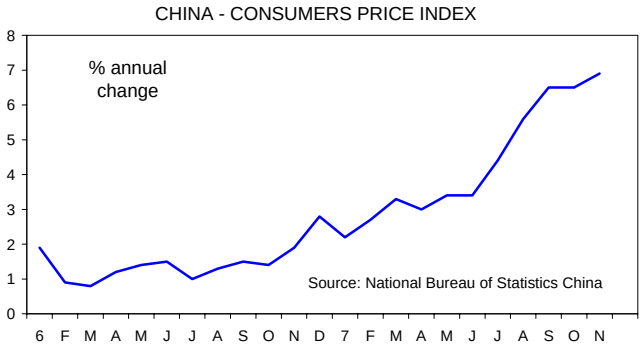
Want to export to Japan? Info on Japan in the first link. Export assistance the next one.
http://www.marketnewzealand.com/MNZ/services/14431.aspx
http://www.nzte.govt.nz/section/11728.aspx

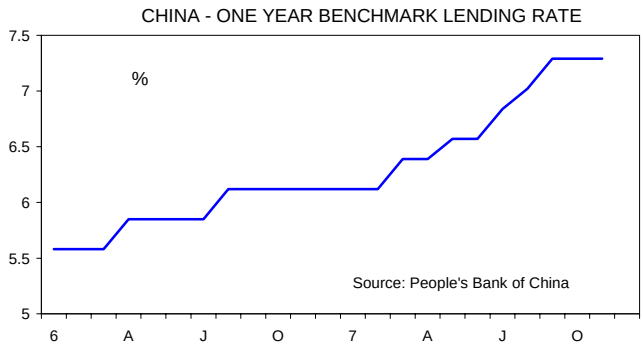
China

CPI +6.9%, 5% of visitors & 5% of exports.

The Chinese economy has been growing strongly for a number of years and is one of the factors behind the recent strong rise in New Zealand commodity prices. This is good. But the Chinese authorities are concerned about a number of things. One is that the inflation rate this week hit an 11 year high of 6.9% for November and this is clearly too high (the target is 3%).

With average food prices up about 18% in the past year (pork 56%) people on low incomes are starting to feel disaffected. The authorities would like lower inflation in order to avoid the possibility of social unrest. Worries about food prices were one of the factors in play ahead of the Tiananmen Square protests of 1989.
http://www.chinadaily.com.cn/china/2007-12/11/content_6312736.htm





The authorities are also concerned about excessive growth in capital expenditure. There are worries that too many buildings and capital works generally are going up and that if the economy's growth rate slowed even slightly an excess supply of capital structures may be revealed. With generally lax lending standards by Chinese banks there is concern this may produce a collapse in the financial system.

Apart from rising food and energy prices what is causing the high rate of inflation in Japan is the fixed currency regime whereby the authorities offset the upward pressure on the Yuan from an increasing trade surplus – so far US$238b this year - by injecting extra currency into the market. The trade surplus with the US so far amounts to US$149b this year and the total trade surplus is running 52% ahead of a year earlier!
http://english.mofcom.gov.cn/aarticle/newsrelease/commonnews/200712/20071205278147.html

two weeks the Europeans tried and filed and this week the US treasury Secretary was also turned down in his request for the Chinese to allow their currency to appreciate. The authorities are concerned that if the Yuan is allowed to rise – and it would almost certainly soar if traded freely - the resulting weakness in exports may not be compensated by strength in private consumption. Although inflation worries would reduce the risk of a sharp slowing in economic growth is concerning.

This week, to try and curb inflation the reserve asset ratio for banks was raised 1% to 14.5% - the 10th such increase this year. The second graph just above shows interest rate rises since the start of 2006.

FURTHER READING

Sovereign Wealth Funds

In order to shore up it's balance sheet this week we saw Swiss Bank UBS sell a 9% stake to the Government of Singapore Investment Corporation with further money coming from an undisclosed Middle East investor rumoured to be either the huge Abu Dhabi Investment Authority or the Government of Oman – with assets possibly as high as US$1tn.
http://www.businessweek.com/globalbiz/content/dec2007/gb20071210_736856.htm?chan=top+news_top+news+index_global+business

Brazil – an oil exporting country running large current account surpluses – is now getting in on the SWF act. (They might find better places to put their money than the regional development bank for South America launched by Venezuela's President Chavas this week.)
http://brazileconomy.blogspot.com/

The Libyans are also getting in on the act.
http://www.bloomberg.com/apps/news?pid=20601116&sid=aGoff5ffhkLw&refer=africa

And there was a rumour during the week that the Japanese – with about US$1 tn in FX reserves of which about half is in US government securities – may look at setting up a US$100b wealth fund.

And a fortnight ago the Chinese SWF, China Investment Corp. said it would be a "stabilizing force" in markets affected by credit losses – hinting maybe some investment in banks from this source as well.
http://www.chinapost.com.tw/business/2007/12/01/133070/China's-wealth.htm

All of this is important in the context of the current global financial crisis because the SWFs are being viewed in some ways as "buyers of last resort". That is, they stand ready with sacks of cash ready to buy financial institutions having temporary capital adequacy problems because of their exposure to the US sub-prime home loan sector. As long as every now and then something gets bought the recent strength in the US sharemarket may continue and the resulting association with reduced risk aversion will see the NZD remain strong. But should a view develop that they will not buy (unlikely as they are buying and the 28 funds don't coordinate their activities) then one could see substantial sharemarket weakness, further blow-out in credit spreads around the world, a worsening of the credit crunch, and a much weaker NZD.

Good background article.
http://www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm

Here's a question. If Fonterra was placed on the open market, how long would it take SWFs to buy it?

Climate Change

One thing we need is some sort of tree with very few leaves to mess up the place but a large squat type of trunk, high CO2 mass proportion and non-invasive roots that people could plant in their suburban garden to help soak up CO2. If the government ran a coordinated and monitored programme to do this it could count as carbon credits under the Kyoto Protocol and reduce the upcoming burden on us taxpayers.

One deep greenie doctor has proposed taxing parents who have more than two children. On that basis he presumably is a big fan of emissions control in China with their one child policy!
http://www.cnsnews.com/ViewForeignBureaus.asp?Page=/ForeignBureaus/archive/200712/INT20071210a.html

NZ ranks 50th when it comes to CO2 emissions per capita. Australia is double our emissions – probably because most of their electricity is generated from coal fired stations whereas renewables supply about 75% of our electricity. Plus they have higher income/spending per capita. More money, more carbon emissions – hence the age old credibility problem for greenies. Too many for too many years used green issues merely as a front for their anti-capitalist views. One suspects those people may be getting completely swamped by normal people realising the need to address environmental issues.
http://en.wikipedia.org/wiki/List_of_countries_by_carbon_dioxide_emissions_per_capita

Data Sources

Interest rates & exchange rates RBNZ at	http://www.rbnz.govt.nz/statistics/
Housing fixed interest rates – our data from 1991 email	tony.alexander@bnz.co.nz
House mortgage data – RBNZ	http://www.rbnz.govt.nz/statistics/monfin/rbssr/rbssrpartE/data.html
House price information - REINZ	http://www.reinz.org.nz/reinz/public/market-information/market-information_home.cfm
NZ economic data, most from Statistics NZ	http://www.stats.govt.nz
Government accounts, NZ Treasury at	http://www.treasury.govt.nz/financialstatements/
Australian data	http://www.abs.gov.au/ and http://www.rba.gov.au/
European data	http://epp.eurostat.ec.europa.eu
United States data	http://www.economagic.com/
Parliament, select committees, publications etc.	http://www.parliament.nz/en-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	0.5%	0.7	1.8	3.5	3.4
GDP growth	Average past 10 years = 3.0%	0.7	1.2	2.2	2.2	3.3
Unemployment rate	Average past 10 years = 5.3%	3.5	3.6	.....	3.8	3.7
Jobs growth	Average past 10 years = 1.9%	-0.3	0.6	1.5	1.5	3.3
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.2	8.5	.....	9.7	8.0
Terms of Trade		3.7	0.4	8.4	-1.3	0.9
Wages Growth	Stats NZ experimental series	1.6	1.2	4.9	4.9	5.1
Retail Sales ex-auto	Average past 9 years = 3.8%.	0.2	-0.9	5.6	4.5	6.3
House Prices	Long term average rise 5% p.a.	2.8	4.3	13.7	10.3	13.7
Net migration gain	Av. gain past 10 years = 10,400	+7,520	8,970yr	.....	13,780	5,987
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	3.1	3.7	3.1	-0.0	3.1
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	2	-8	-4	-10	-7
Business activity exps	10 year average = 26%. NBNZ	15.7	20.3	7.8	23.7	0.0
Household debt	10 year average growth = 11.3%. RBNZ	13.3	13.6	13.5	13.3	15.3
Dwelling sales	10 year average growth = 3.5%. REINZ	-21.6	-22.6	-3.7	6.8	-1.5
Floating Mort. Rate	10 year average = 8.1%	10.55	10.55	10.05	9.55	9.00
3 yr fixed hsg rate	10 year average = 7.9%	9.19	8.80	8.70	7.99	7.90

ECONOMIC FORECASTS

Forecasts at Nov. 22 2007	**March Years**					**December Years**				
	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009
GDP - annual average % change										
Private Consumption	4.4	2.4	3.7	1.3	0.5	4.8	2.1	4.3	1.5	0.7
Government Consumption	5.3	4.1	3.7	3.9	4	4.5	4.6	3.6	4	3.9
Investment	4.2	-3.1	4.2	2	2.9	3.1	-2.7	4.4	2	2.2
GNE	4	0.7	4.8	1.9	1.7	4.1	0.6	4.9	2.2	1.7
Exports	-0.1	3	1	2.6	3.9	-0.4	1.8	1.9	1.9	3.8
Imports	4.1	-1.4	6.8	4.1	3.1	5.4	-2.6	7	4.3	3.2
GDP	2.7	1.7	3.1	1.6	1.9	2.7	1.7	3.1	1.8	1.8
Inflation – Consumers Price Index	3.3	2.5	3.1	3.2	3.1	3.2	2.6	2.9	3.2	3
Employment	2.6	1.7	0.9	0.8	1	1.6	1.4	1.8	0.9	0.9
Unemployment Rate %	3.9	3.7	3.6	3.8	4.2	3.6	3.7	3.6	3.7	4.1
Wages	4.6	5.5	4.8	4.2	3.3	5.1	5.5	4.3	4.6	3.5
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.64	0.7	0.77	0.67	0.59	0.7	0.69	0.76	0.69	0.61
USD/JPY	117	117	108	111	109	119	117	109	112	110
EUR/USD	1.2	1.32	1.5	1.38	1.3	1.19	1.32	1.5	1.41	1.32
NZD/AUD	0.87	0.88	0.82	0.77	0.76	0.94	0.88	0.83	0.77	0.76
NZD/GBP	0.36	0.36	0.39	0.36	0.34	0.4	0.35	0.38	0.37	0.35
NZD/EUR	0.53	0.53	0.51	0.49	0.45	0.59	0.52	0.51	0.49	0.46
NZD/YEN	74.6	81.9	83.2	74.4	64.3	82.7	81	82.5	76.9	66.8
TWI	65.6	68.6	70	63.8	58.4	71.9	68	69.4	64.8	59.8
Official Cash Rate	7.25	7.50	8.25	7.5	6.5	7.0	7.50	8.25	7.75	6.75
90 Day Bank Bill Rate	7.55	7.78	8.68	7.7	6.73	7.49	7.64	8.74	7.95	6.98
10 year Govt. Bond	5.71	5.91	6.35	6.05	5.9	5.89	5.77	6.4	6.1	5.9
2 Year Swap	6.99	7.76	8.18	7.02	6.56	7.24	7.48	8.51	7.22	6.59

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.