Bank of New Zealand

BNZ Weekly Overview

31 January 2008

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	8.75%	8.76	8.95	8.66	7.67	6.4
10 year govt. bond	6.25%	6.22	6.32	6.45	6.01	6.5
1 year swap	8.72%	8.74	8.83	8.85	7.89	6.6
5 year swap	8.04%	8.03	8.19	8.25	7.37	7.0

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Nothing Major Locally This Week

It has been a quiet week with respect to economic data releases in New Zealand. We have learned that residential construction is weakening off as is the rate of growth in lending to the household sector while growth in lending to farming is accelerating. Growth in lending to the business sector has fallen away relatively strongly although these numbers can be hard to interpret as they can often be distorted by large transactions.

Non-residential construction activity still looks reasonably firm, interest rates have hardly changed from a week ago, and as we have been warning the attractive interest rates being offered in New Zealand have contributed to a rise in the Kiwi dollar over the week. A good trade number boosted by record dairy receipts also helped the NZD to end this arvo near 78.0 cents from 76.3 last week.

During the week there was some minor debate about whether the tax cuts we expect the government to announce in the May budget will be inflationary. The answer is yes but whether that pushes the Reserve bank into another tightening and by how much the timing of the easing is delayed is impossible to say at this stage.

Any extra spending in an economy stretched for resources as we are (labour, electricity etc.) will boost inflation to some degree. So the extra $3b flowing to dairy farmers this season will boost inflation. And if the Reserve Bank is right about the $1.5b extra easing of fiscal policy they assumed in their last set of economic forecasts released in December then this too will stimulate inflation.

The Finance Minister has said that he does not believe the upcoming package will be inflationary. That means one of three things or a combination of all. First, the cuts could turn out to be extremely minor so their spending impact would be negligible. That seems very unlikely given what the polls are showing. Second, the cuts could be offset with increases in taxpayer charges elsewhere. This is what is happening in the business sector for instance with last year's announced cut in the company tax rate from 33% to 30% being offset by compulsory employer contributions to Kiwisaver schemes. And the government subsidy for Kiwisaver members announced last May was offset by the removal of inflation indexing of personal income tax brackets. So perhaps any tax cuts – whether via % reductions or increases in income thresholds – could be offset by new taxes somewhere else.

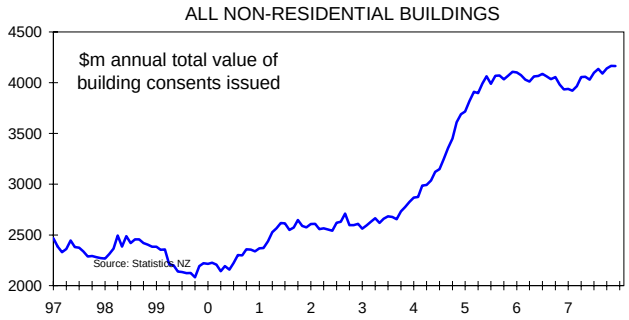
Third, the tax cuts could come in the form of compulsory contributions to Kiwisaver. That seems a risky move as people would view it as the government refusing to trust people with their own money and not acting at a time when many taxpayers are feeling the pinch from rising food and energy costs along with perhaps falling wealth if they think their house price is easing off. We'll have to wait and see in May. Then if we all whinge enough after May more voter-friendly stuff from the massive fiscal surplus is likely to be offered up.

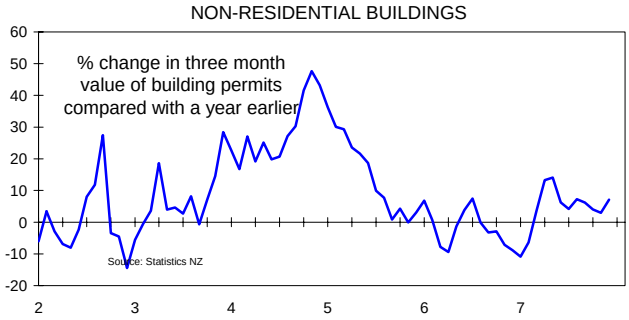
NZ ECONOMIC DEVELOPMENTS

Wednesday 30

Non-Residential Construction Activity Still Looks Firm

The value of consents issued for the construction of non-residential buildings came in at $331 million in December which was a decrease from a year earlier of just 0.6%. This followed increases from a year ago in the previous two months and means that during the December quarter the value of these commercial consents was ahead a healthy 7.1% from a year ago. For the entire calendar year of 2007 values grew by 5.9% to stand at $4.2 billion. As the graph below shows the annual value of these consents has remained at a relatively high level in spite of some worries about the state of the New Zealand economy and high interest rates.

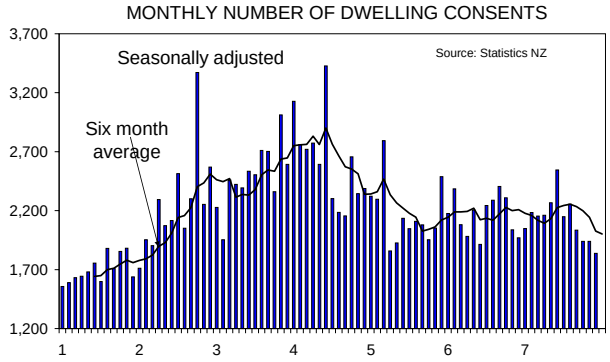


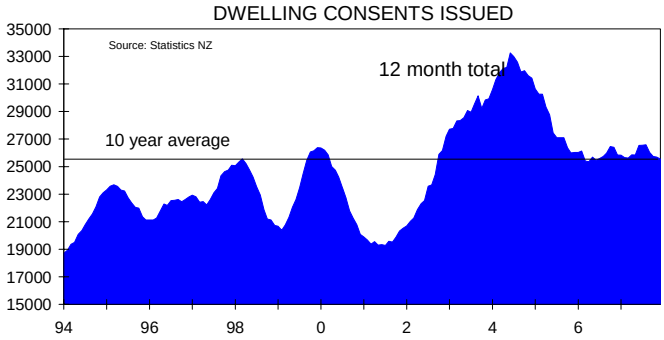


We expect non-residential construction activity to remain relatively firm going forward and not undertake the sort of cyclical decline we have often seen in the past when the economy has been slowing down. This continuation of activity at a high-level will partly reflect catching up on construction which could not be done in the past because of a shortage of builders. Maybe it's also taken a number of years for companies to get their consents through local authorities and the Environment Court and maybe only now they can start undertaking construction.

Dwelling Construction Heading Downward

But while non-residential construction activity may remain relatively firm that is not the case for residential building where things are definitely easing off. In seasonally adjusted terms the number of consents issued in December for new dwellings to be built was down by 5.1% from November. The decline for the entire December quarter was 11.2% and consent numbers unadjusted were down just over 7% from a year earlier. There is a clear downward trend in place here. For a while it was looking like the downward trend in house construction would be relatively mild because it has been apartment numbers which have been moving the total dwelling aggregate around. But what we saw in December was a jump in apartment consents from 66 to 214 and in seasonally adjusted terms the number of house building consents fell by 11.2%. House consents seasonally adjusted have fallen 6.8% over the December quarter though were only down 0.6% from a year earlier.

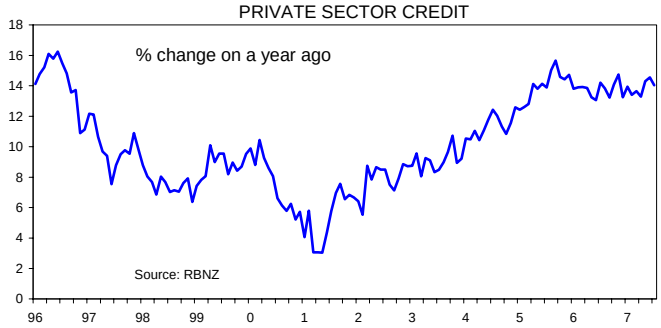




Residential construction activity is easing off and while one might normally begin to worry quite a bit about what this would mean for the overall economy frankly in many regards its good news. The freeing up of builders will allow productivity enhancing construction (hopefully) of factories and farm buildings to be undertaken. Note that at 25,544 the total number of dwelling consents issued over calendar 2007 was just ahead of the 10 year average of 25,415 though well down from 33,000 early in 2004.

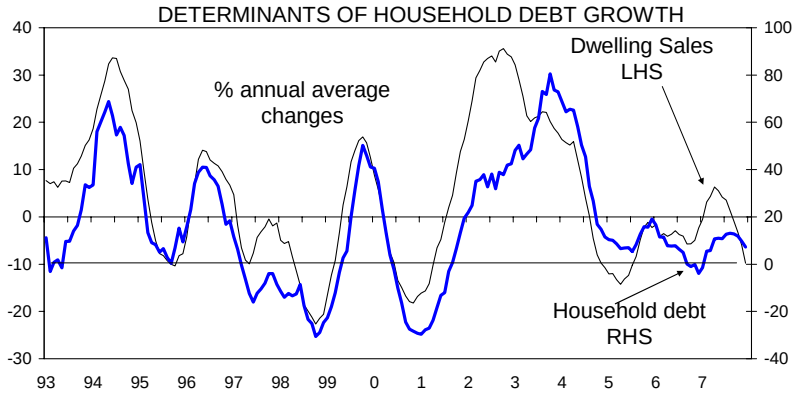
Lending Growth a Mixed Bag

The annual rate of growth in lending to the private sector accelerated in December to 14.0% from 13.5% in November. If our economy were truly munted then one would expect to see this rate of growth in private sector borrowing falling away relatively quickly. It isn't but we suspect there will be some weakening just down the track.

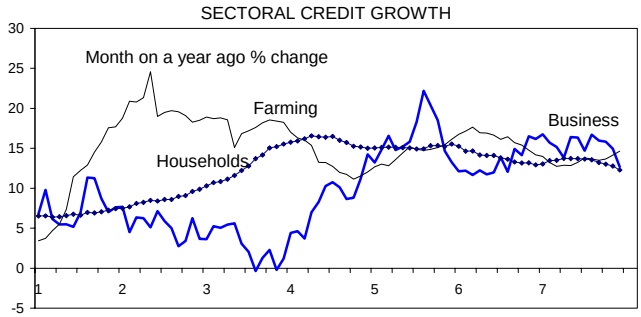


Speaking of being munted (for you overseas people this is a Kiwi way of saying something has had it, it's stuffed) the annual rate of growth in lending to the household sector declined in December to 12.3% from 12.8% in November. This is the lowest annual rate of growth in this measure since June 2003 and the slowing growth is hardly any surprise considering the 25% decline in dwelling sales in the December quarter compared with a year earlier. In seasonally adjusted terms household debt grew by just 0.7% in the month of December compared with 0.8% in November, and growth averaging 1.1% a month in the first six months of the year. December's growth was the lowest monthly improvement since October 2002 and the numbers show quite clearly that the Reserve Bank's high interest rates are having an impact on household debt growth.

Our expectation is that the annual rate of growth in household debt is going to fall to just below 10%. Note that the graph below measures the percentage annual average change in household debt growth not the change in the actual level of debt.



In contrast to the slowdown in household debt growth the annual rate of growth in lending to the farming sector improved to 14.6% in December from 14.1% in November and 14.2% a year earlier. This growth is hardly surprising considering that both farm sales and tractor registrations are running approximately 20% ahead of levels a year ago.



What is most interesting in the monthly credit growth release however is what is happening in the business sector. Interpreting the business lending numbers is extremely difficult because they can get moved around sometimes quite substantially by large transactions. So although what we are about to write here may look fairly horrible it may not reflect the true situation in the business sector. The annual rate of growth in lending to the business sector eased to 12.7% in December from 14.9% in November and 16.2% a year earlier. This doesn't sound bad but of course an annual growth number can reflect things that were happening a few months earlier in the one-year period. For a more accurate feel of what is happening with debt growth we can look at how debt has changed over the past three months and see how that change compares with the same three-month period a year earlier.

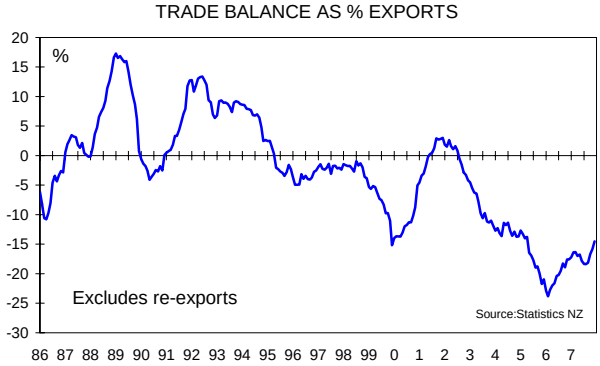
Doing that we see that business sector debt declined by $37 million in December compared with September whereas a year ago there was growth of $1.2 billion. The anecdotal feedback we are receiving from the business sector is that credit demand has eased off but nowhere near the degree to which these numbers suggest. So we suspect something is mucking the numbers up slightly. But it is worth keeping an eye on this aggregate.

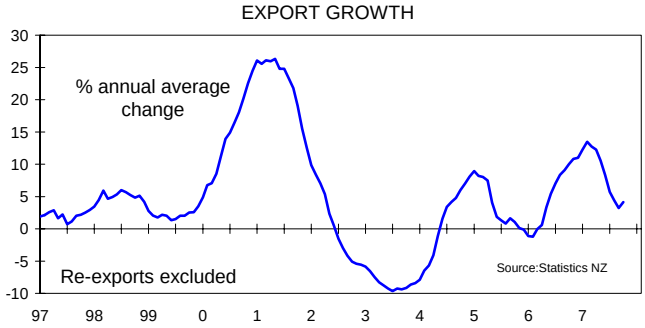
Thursday 31

Trade Accounts Improving

New Zealand recorded a merchandise trade surplus in December of $33 million which compares with a deficit a year earlier of $345 million. This is only the second time the December month outcome has been in surplus over the past 10 years and the result was driven by a massive surge in dairy exports which were two thirds higher than in December 2006 and worth over $1 billion in a month for the first time. The trade deficit for the year was $5.3 billion which was the lowest outcome since June 2005 and an improvement from $6.1 billion over 2006. Compared with a year ago the total value of exports was 25% ahead in December and up 5.6% for the entire calendar year. Imports were up 10.7% in December from a year earlier and ahead 2.8% for the whole year. Reflecting the slowdown in the domestic economy the value of consumer goods imports

in the three months to December was up just 5% from a year ago. Imports of machinery, plant and equipment were ahead 16%.



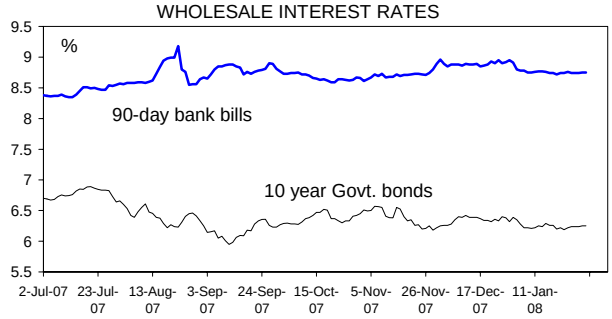


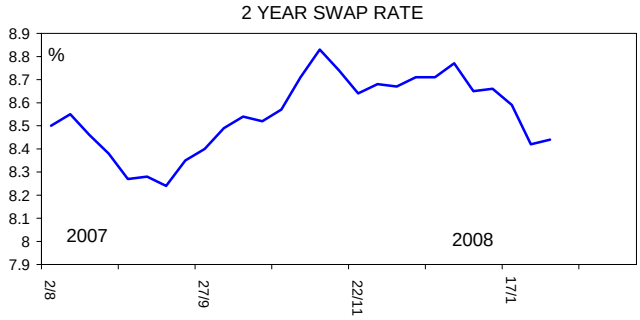
Government Accounts Good

The government recorded an operating balance in the first five months of this financial year of $1.3 billion. This was $0.5 billion less than expected due to losses suffered by the NZ Superannuation Fund caused by weakness in global share markets. However the true underlying measure of the government's financial position is the OBEGAL which strips out one-offs. This recorded a surplus of $2.2 billion which was $240 million more than forecast by Treasury. While Treasury, as always, say the result is temporary and delayed expenditure will put things back on track, they have been wrong about this an excessive number of times in the past and probably are this time around as well. The government's accounts are basically still in very good shape and help set the scene for what is likely to be a relatively large easing of fiscal policy as the year goes by. In fact the closer we get to the general election and the less the government claws back some of the gap in the opinion polls the more the lid of this large treasure chest will be opened up. Treasury are forecasting that the full-year surplus will be $6.6 billion compared.

INTEREST RATES

In the absence of any significant fresh news released in New Zealand this week we have seen essentially no change in wholesale interest rates from where they were a week ago. With regard to fixed interest rates this means we have broadly held at levels 0.2% to 0.3% lower than five or six weeks ago. Our expectation is that if we see any easing of monetary policy in New Zealand this year it won't come until December as our central bank grapples with relatively strong underlying inflationary pressures. Fixed interest rates are likely to decline slightly as the year goes by but borrowers shouldn't get all that optimistic about the extent of declines.





People might be looking across the Pacific at what is happening in the United States with their cash rate cut over a four-month period from 5.25% to 3.0%. Maybe you're thinking we will see a similar cut here. That is not remotely likely. Our economy's growth rate remains reasonably well insulated by our terms of trade

boom along with a very tight labour market. We have fiscal policy easing plus lots of infrastructure spending under way and a backlog of non-residential construction orders to be satisfied.

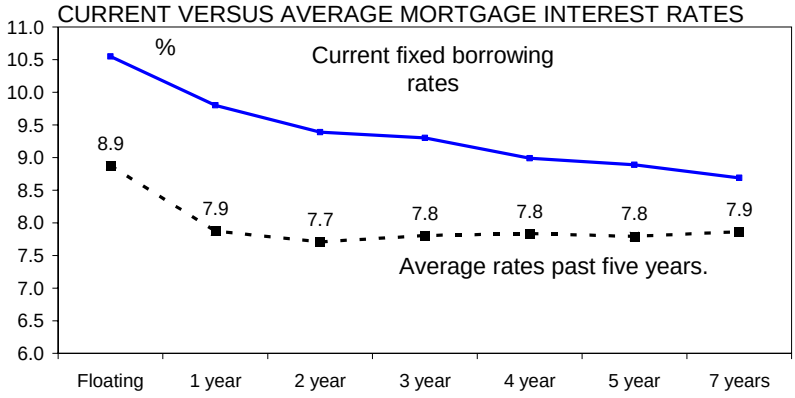
Our growth rate is likely to come in below 2% this year, however given a recent worsening of capacity availability including a tightening of the labour market on top of direct inflation pressure from rising energy and fuel costs our central bank will remain vigilant.

With regard specifically to fixed interest rates one might think that with these rates falling relatively strongly in the United States and some other countries we could see some decent falls here in New Zealand. We think some declines will occur. However one has to be aware that while in the United States the prime concern of the Federal Reserve and the markets for the moment is the current state of the US economy at some stage a view will build that the Fed's actions have got things under control. When that happens attention is likely to turn back very firmly to underlying inflationary pressures in the US economy. When that occurs we are likely to see their medium to long-term fixed interest rates rising and this will tend to place upward pressure on our own.

Picking when this will happen is essentially impossible and probably all this adds up to is the following. If we do see any substantial rally in New Zealand fixed borrowing costs over the next six months it could be a good opportunity to get on board some greater than normal two to three-year funding though still leaving some business debt in particular exposed to a likely fall in New Zealand floating borrowing rates over 2009 and 2010. Just don't get optimistic about the magnitude of those falls over that two-year period.

If I Were a Borrower What Would I Do?

As expected we have seen some cuts in fixed housing rates over the past week but the extent to which we will see further cuts depends as ever on what is going to happen with wholesale interest rates and the degree of competition in the marketplace. Over the year we expect fixed interest rates will creep lower but in a global environment of banks being cautious about undertaking a lot of new lending scope for any sizable falls seems small. It is very unlikely we will see fixed housing rates in New Zealand moving below their five-year average levels until some point perhaps late in 2009. For that reason there is probably no great need to sit floating in the hope of a much lower fixed rate in the near future. If I were borrowing at the moment I would probably do the usual thing and fix two years.



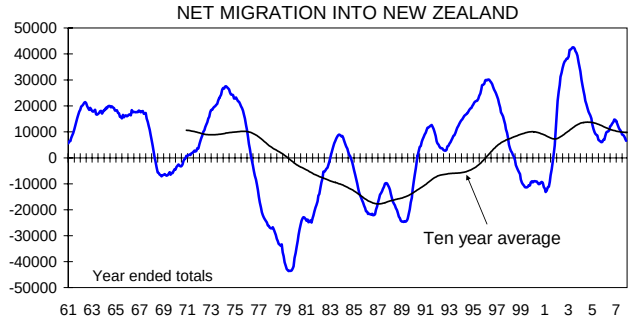
HOUSING MARKET UPDATE

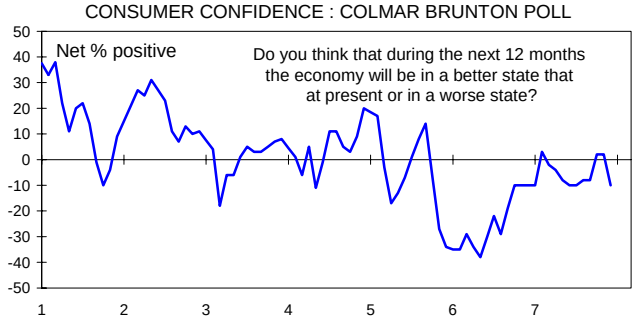
Nothing New Really

The data at hand show clearly that the NZ housing market has turned down. Sales in the December quarter were off 25% from a year ago, prices have been flat since April and could be falling, and consent issuance was down 11% seasonally adjusted over the December quarter we learnt this week. Its difficult to know how bad the downturn will become because of the relatively firm factors on each side of the fence.

On the negative side we have high interest rates with the two year fixed rate for instance currently sitting about 1.7% above its average level over the past five years. People rolling off fixed rates are currently coming off at about 8.1% and rolling onto maybe 9.5%. So there will be pain that will manifest itself in the retailing sector.

Other negatives include the loss of faith amongst investors that there will be good capital gains in the near future. Net migration inflows are also running at slightly below average levels. Consumer sentiment is poor and likely to deteriorate with worries about the world economy growing by the week.





But on the positive side we have the extremely tight labour market which has even tightened over the past three months. That means great job security which will tend to limit the number of people who feel they have no choice other than to sell their investment or owner-occupied property. Strong wages growth is likely to continue and there are tax cuts coming by the looks of the polls. We also think there may be a queue of ready and willing first home buyers looking for signs of market weakness, plus a few cashed up investors.

This year is likely to be one in which real estate turnover continues to decline and the sector undergoes a period of rationalisation. Well capitalised agencies may be able to pick up some bargains out there plus sort the wheat from the chaff with regard to their staff. In fact real estate could be almost the only sector in the economy in which there is not a great undersupply of potential employees.

Prices could fall though this is always a difficult thing to predict. How will we know completely subjectively when the market is munted? Probably when the dreadful voyeuristically entrancing property upgrade programmes disappear from our screens.

Exchange Rates & Foreign Economies

See the Offshore Overview

Data Sources

Interest rates & exchange rates RBNZ at	http://www.rbnz.govt.nz/statistics/
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/
Parliament, select committees, publications etc. http://www.parliament.nz/en-nz

Want more detailed background information on the NZ economy? Start in these places.
http://www.treasury.govt.nz/economy/overview
http://www.oecd.org/country/0,3377,en_33873108_33873658_1_1_1_1_1,00.html
http://www.rbnz.govt.nz/monpol/statements/

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	1.2%	0.5	3.2	2.7	3.2
GDP growth	Average past 10 years = 3.0%	0.5	0.8	2.7	1.6	3.1
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	8.3	8.2	.....	9.2	8.5
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.	0.3	2.8	11.4	10.1	14.0
Net migration gain	Av. gain past 10 years = 10,400	+6,590	8,738yr	.....	14,780	6,145
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	2.4	3.9	2.4	0.9	2.4
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	-10	2	-10	-10	-34
Business activity exps	10 year average = 26%. NBNZ	18.2	15.7	14.8	24.0	-2.4
Household debt	10 year average growth = 11.3%. RBNZ	12.3	12.8	13.7	12.9	15.5
Dwelling sales	10 year average growth = 3.5%. REINZ	-32.1	-21.6	-11.3	19.4	-17.6
Floating Mort. Rate	10 year average = 8.1%	10.69	10.55	10.30	9.55	9.55
3 yr fixed hsg rate	10 year average = 7.9%	9.30	9.19	9.00	8.15	8.15

ECONOMIC FORECASTS

Forecasts at Jan 24 2008	**March Years**					**December Years**				
	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009
GDP - annual average % change										
Private Consumption	4.6	2.6	3.3	0.5	1.7	4.9	2.4	4.1	0.7	1.2
Government Consumption	5	4.4	3.7	3.6	4.2	4.1	4.7	3.9	3.4	4.2
Investment	5.2	-2.3	4.1	1.5	2.7	3.9	-1.6	4.2	1.7	1.9
GNE	4.1	1	4.7	1	2.4	4.2	1	4.9	1.4	1.8
Exports	-0.1	3.1	2.1	3.7	3.8	-0.4	1.7	2.9	3.5	3.7
Imports	4.1	-1.7	8.3	3.4	3.1	5.4	-2.8	8.1	4	3
GDP	2.7	1.6	2.9	1.1	2.5	2.8	1.6	3	1.4	2
Inflation – Consumers Price Index	3.3	2.5	3.4	3.1	2.9	3.2	2.6	3.2	3	3
Employment	2.6	1.7	0.8	0.7	1.8	1.6	1.4	1.8	0.7	1.4
Unemployment Rate %	3.9	3.7	3.8	4.4	4.4	3.6	3.7	3.7	4.3	4.4
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	0.76	0.67	0.61	0.7	0.69	0.77	0.69	0.62
USD/JPY	117	117	107	112	119	119	117	112	110	118
EUR/USD	1.2	1.32	1.47	1.38	1.31	1.19	1.32	1.46	1.4	1.32
NZD/AUD	0.87	0.88	0.87	0.82	0.79	0.94	0.88	0.88	0.83	0.79
NZD/GBP	0.36	0.36	0.39	0.37	0.34	0.4	0.35	0.38	0.37	0.35
NZD/EUR	0.53	0.53	0.52	0.49	0.47	0.59	0.52	0.53	0.49	0.47
NZD/YEN	74.6	81.9	81.3	75	72.6	82.7	81	86.3	75.9	73.2
TWI	65.6	68.6	70.4	64.6	61	71.9	68	71.6	65.8	61.7
Official Cash Rate	7.25	7.47	8.25	7.75	6.75	6.99	7.44	8.19	8	7
90 Day Bank Bill Rate	7.55	7.78	8.73	7.95	6.98	7.49	7.64	8.77	8.2	7.23
10 year Govt. Bond	5.71	5.91	6.3	6.1	6.3	5.89	5.77	6.38	6.1	6.25
2 Year Swap	6.99	7.76	8.29	7.23	6.65	7.24	7.48	8.58	7.46	6.7

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.