Bank of New Zealand

# BNZ Weekly Overview

21 August 2008

## Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

**In this week's issue….**

- **Retailing has been confirmed as very weak in the June quarter. Page 2**
- **There are widespread expectations house prices will fall, but these views appear to be encouraging buyers out of their hidey holes. Page 6**

The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the WO and Offshore Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line. You do not have to be a BNZ customer to receive the WO. To get off the list email 'Unsubscribe".



## Weak Retail Spending but Migration Improving

We have learnt very little that is new about the New Zealand economy over the past week. On Friday we got confirmation of weakness in retail spending although the 0.7% decline in the seasonally adjusted volume of spending excluding the automotive sectors was slightly better than expected. But anyone who has had a habit of looking at the quarterly Household Labour Force Survey will realise that even on a quarterly basis economic data in New Zealand need to be treated extremely carefully. Any single piece of monthly data should always be distrusted. The labour market survey revealed a 1.7% seasonally adjusted decline in the number of hours worked during the March quarter which led to extreme worries about major weakness in New Zealand's labour market this cycle. Those worries have now pulled back substantially with the June report showing a 2.3% rise in hours worked. It's best to smooth even these quarterly numbers and doing so we get zero jobs growth over the first half of this year and just a small gain in the total number of hours worked.

But if we undertake the smoothing exercise for the retailing sector we find 0.4% shrinkage in spending over the first half of this year. Consumers have got their wallets closed and even though we have seen evidence of some improvement in sentiment recently worries about the economy remain high and retailers should anticipate continued tough conditions into at least early next year. Note however that one thing different this recession from the last one is that net annual migration inflows remain positive near 5,000. During the last recession the net gain was negative and sat at around 11,000 per annum from late 1998 into the middle of 2001.

Things will get interesting in mid-2009 however when interest rates will be lower and there will have been two rounds of tax cuts assuming a change in government at this year's general election. These positives will be acting against negatives of the additional weakness we expect to come in the labour market with a rise in the unemployment rate on its way towards just over 5%, and the continuing risks associated with world growth and especially the international credit crisis and its impact on bank funding costs.

Businesses should remain strongly focused on getting cash flows under control and keep reminding themselves that it's been a long time since we last had a recession. And the long-term fundamentals for the New Zealand economy not only look quite good with regard to growing demand offshore for our primary products, but have improved quite substantially in the past three years.

Just for the record, here are some comments by the Reserve Bank's head of Prudential Supervision speaking in Auckland today. What he spoke about was along the lines of that which we have mentioned recently regarding problems in New Zealand's financial sector being confined to a relatively small proportion of total lending largely associated with the property development sector. To whit

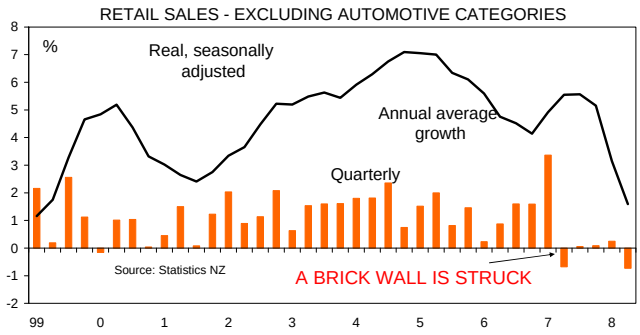
"The majority of institutions, accounting for over 90 percent of household financial assets, are not directly affected by these current events. These institutions are well capitalised businesses and give no apparent reason for concern." And …
"Our banks are navigating their way through the current turmoil well. Capital positions are well above the minimum levels required by regulation. Credit ratings remain strong. And loss provisioning is not abnormal for this point in the cycle"
http://www.rbnz.govt.nz/news/2008/3398112.html

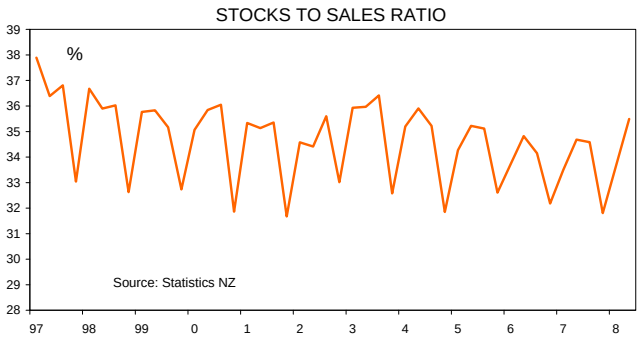
# NZ ECONOMIC DEVELOPMENTS

**Friday 15**

## Retail Spending Declines Again

In real seasonally adjusted terms retail spending fell 1.5% in the June quarter after declining 1.1% over the March quarter. This number perhaps more than any other shows the weakness in household spending in New Zealand and that this weakness, while greatest in the motor vehicle sector which was down 4.7% in the June quarter from 6% in the March quarter, has also spread into retail sales generally. Core retail spending excluding the motor vehicle related sectors declined 07% in the June quarter after rising just 0.3% in the March quarter. This measure was down 0.3% from a year earlier with a 23% decline in other food retailing, 8% fall in take-away sales, 8% for furniture, 2% for hardware, and 6% for recreation goods. Evidence that retailers have been caught out with the speed of cut back in consumer spending can be seen in an increase in the ratio of stocks to sales to 35.5% at the end of the June quarter from 34.7% a year earlier.



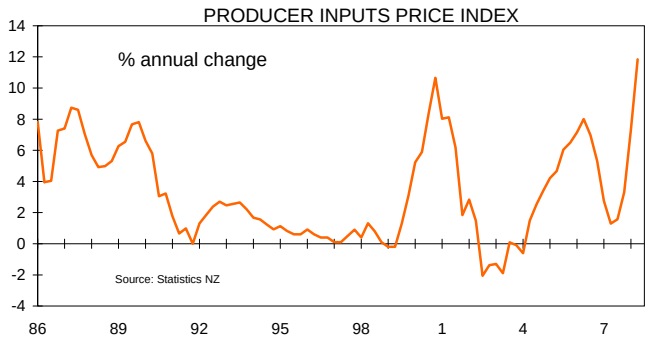

For each store type we can calculate what the average ratio is of stocks at the end of the quarter to sales over the past year with both numbers seasonally adjusted. We can then compare the latest result with the average over the past five years to get a feel for store types which may still be running excessive inventories. If they are the number will show up as a positive divergence. For instance in the table below the number for motor vehicles reads as 1.4. This means that the ratio of stocks to sales was 1.4 percentage points above the average for that store type category at the end of the June quarter. The table results suggest we may be getting near the end of the period when people can expect big discounts for clothing and furniture along with footwear but bargains should still be available for appliances, hardware, and most of all motor vehicles.

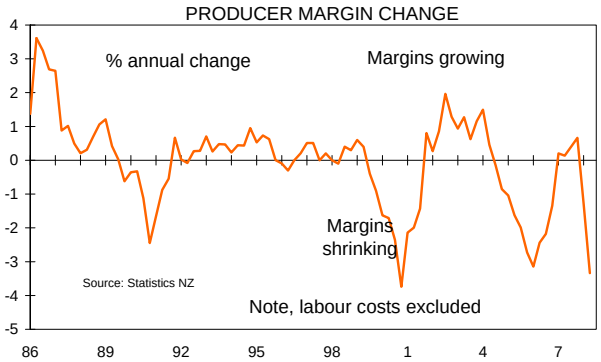
| | | | |
|---|---|---|---|
| Other retailing | 1.5 | Fuel | 0.0 |
| Motor Vehicles | 1.4 | Supermarkets | 0.0 |
| Other food | 1.4 | TOTAL ALL | -0.1 |
| Dept Stores | 1.3 | Other Personal | -0.1 |
| Pers & hshld gds hiring | 1.2 | Takeaways | -0.1 |
| Hardware | 1.2 | Accommodation | -0.2 |
| Liquor | 1.0 | Auto-electrical repair | -0.2 |
| Hshld Equip. Repair | 0.7 | Recreation | -0.2 |
| Appliances | 0.4 | Chemists | -0.4 |
| Fresh meat fruit & veges | 0.1 | Automotive repair | -0.6 |
| Bars | 0.0 | Footwear | -0.8 |
| Sub Total excl auto | 0.0 | Furniture | -1.6 |
| Cafes & Restaurants | 0.0 | Clothing | -2.0 |

**Tuesday 19**

## Business Inflation High

Business non-labour input costs rose by 5.6% in the June quarter to sit 11.8% ahead of a year earlier. This is the greatest quarterly increase since March 1980 and was driven by sharp increases in fuel and electricity prices. While the fuel price increases may not reverse to a huge degree the electricity price increases probably will but this doesn't mean there won't be any feed through from the higher costs into business selling prices. In fact the outputs price index rose by 3.5% in the quarter to sit 8.5% ahead of a year earlier. Though again there is an upward bias here because of increases in prices of primary products

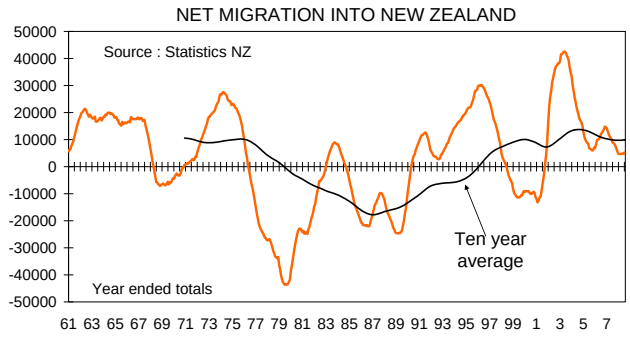


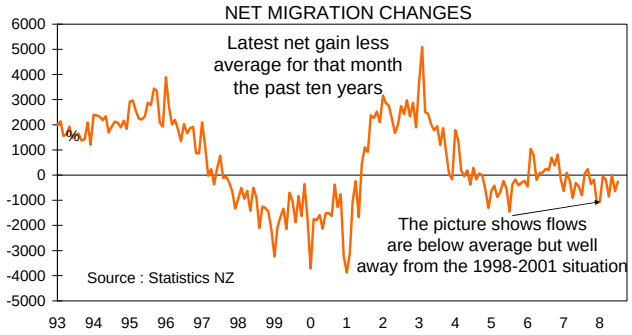




**Thursday 21**

## Migration Flows Below Average But Improving Marginally

There was a net addition to New Zealand's population from permanent and long-term migration flows in July of 696 people. This was an improvement from a net gain of 230 a year earlier and in seasonally adjusted terms the net gain for the month was 850 compared with 480 in June and an average gain of 473 for each of the first six months of 2008. In other words there is a small upward drift in net migration inflows and we think it is this which people need to keep an eye on rather than the media headlines about a net loss to Australia of around 32,000 people over the past year. New Zealand continues to receive strong net migration inflows amounting over the past year to some 16,000 from Asia, 11,000 from Europe including 7,558 from the United Kingdom, and 6,000 from the Americas.




For the year to July the net gain from permanent and long-term migration flows was 5,201 people. This was up from a low point of 4,644 in February but down from 8,970 a year earlier and the average net gain over the past 10 years of just under 10,000 people. The net migration inflow on an annual basis has broadly been moving in a range from 5,000 to 15,000 people since the end of 2004. Directionless in other words and certainly nothing like the net migration outflows of around 11,000 per annum from late 1998 into the middle of 2001 which made the last recession that much worse.

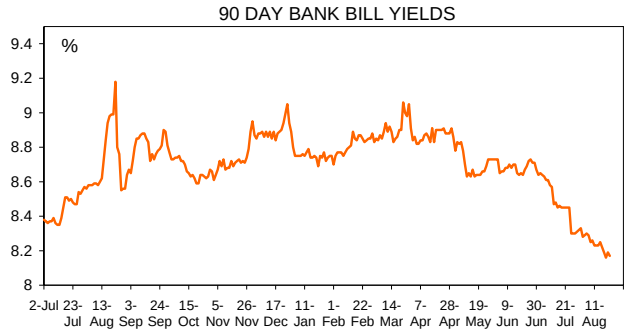
## Feedback & Queries

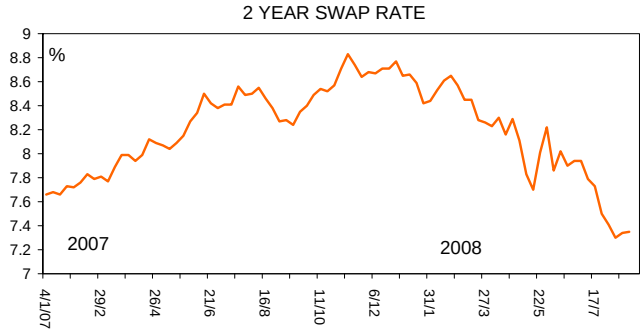
If there are any issues in the Weekly Overview you wish to comment on or you have a query about the economy, send me an email at tony.alexander@bnz.co.nz Useful issues will be discussed in the WO.

# INTEREST RATES

In the absence of any major news items we have seen wholesale interest rates and the week practically unchanged from where they were a week ago. The yield on 90-day bank bills has finished at around 8.17% from 8.25% last week with the decrease mainly driven by the passage of time bringing closer the widely expected string of cuts in the official cash rate over the next 12 months. The two year swap rate has ended unchanged near 7.35%.

The next review of monetary policy in New Zealand occurs on September 11 and it is our expectation and the expectation of practically everybody in the markets that the Reserve Bank will cut the official cash rate by 0.25% taking it down to 7.75%. After that we expect a string of cuts which will see the cash rate ended up somewhere in the vicinity of 6% late next year. Where exactly it will land is too difficult to say at this stage as along the way we will learn what the response is of the household sector to falling interest rates, how quickly those interest rates in fact fall given the impact of the international credit crisis, the extent to which the exchange rate will fall and therefore feed back into interest rate changes, and things like unpredictable movements in petrol prices and so on.




**Key Forecasts**

- Monetary policy easing with the official cash rate near 6% come late 2009.
- The two year fixed housing rate falling below 8.50% at a stretch late 2008, hitting the five year average of 7.8% in mid-2009 optimistically, but going lower will require weaker data on the NZ economy and decent easing of global credit tensions – possible late in 2009. Falling to the 6.5% low of 1999, 2001 and 2003 is very unlikely this cycle.

**FINANCIAL MARKETS DATA**

| | This week | Week ago | 4 wks ago | 3 months ago | Yr ago | 10 yr average |
|---|---|---|---|---|---|---|
| Official Cash Rate | 8.00% | 8.00 | 8.25 | 8.25 | 8.25 | 6.2 |
| 90-day bank bill | 8.17% | 8.25 | 8.45 | 8.66 | 8.99 | 6.4 |
| 10 year govt. bond | 6.14% | 6.15 | 6.00 | 6.38 | 6.24 | 6.5 |
| 1 year swap | 7.70% | 7.69 | 7.99 | 8.44 | 8.68 | 6.6 |
| 5 year swap | 7.10% | 7.11 | 7.43 | 7.80 | 8.08 | 7.0 |

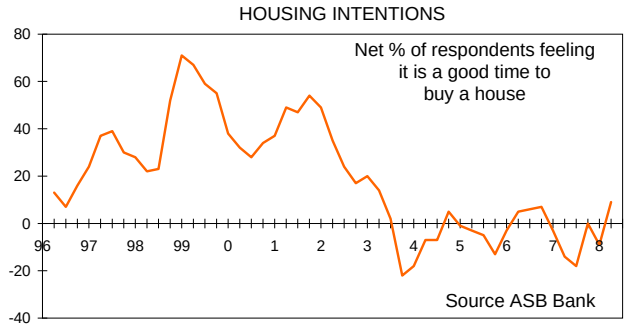
## If I Were a Borrower What Would I Do?

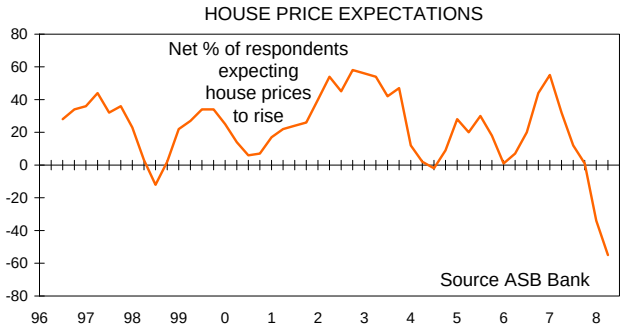
I would still fix one year and not get optimistic about interest rates this cycle falling anywhere near the low levels we saw back in 2003 when there were major declines on the back of worries about deflation in the United States. The main worry now is about high inflation getting entrenched and as our interest rates fall over 2009 US interest rates will be rising and in doing so offsetting some of the reduction in our funding costs which we assume will occur as the international credit crisis surely eases off over 2009. Surely?

# HOUSING MARKET UPDATE

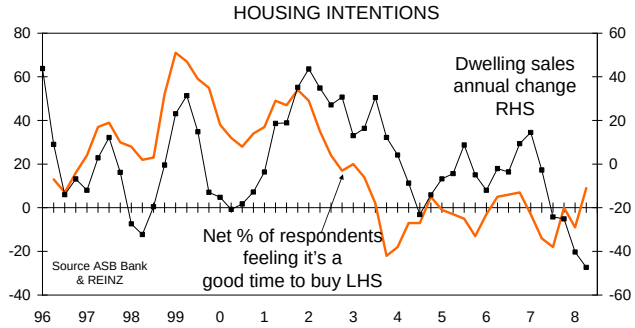
## Widespread Expectations of Price Declines

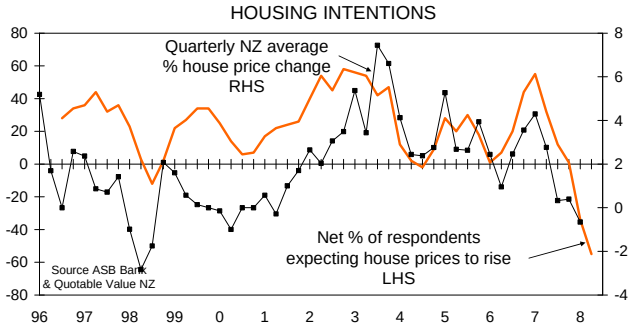
This week the quarterly Housing Intentions survey by ASB indicated that more people are starting to feel it is a good time to buy a house but it seems only because they believe there could be lots of bargains out there. This survey shows that a net 9% of people feel it is a good time to buy a house which is an improvement from a net 9% feeling it was a bad time in the previous quarter and the best result since 2003. However a record net 55% of people expect house prices will fall compared with 34% in the previous quarter.



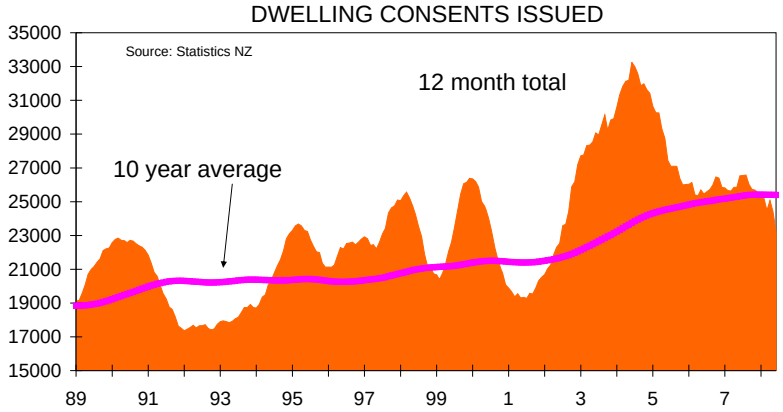

Based on the past correlation between changes in housing intentions and changes in dwelling sales annual growth there is a hint that the decline in turnover may be coming to an end. This is something we have already seen in the monthly dwelling sales numbers which have improved in seasonally adjusted terms around 15% in each of the past two months. But if we look at the correlation between house price expectations and actual house price annual changes then there would appear to be some further slight downside in prices to come.




Does this mean one should give credence to one commentator's "forecast" that house prices will fall 30%? No. The gentleman in question makes money by getting people to click on his web site and his actions are probably best stored in the same box as that containing the freedom of speech argument by another gentleman promoting visits to his commercial site with a parade of half naked people down Queen Street. (Getting media exposure as a commentator is relatively easy in New Zealand. The reporters are simply looking to fill up some space and all you have to do is say something interesting and leave the phone on.)

To put things into context consider this. In the United States house prices so far have fallen 19% in an environment where some commentators estimate there could be between 1 million and 2 million excess numbers of houses sitting around the country as a result of the earlier construction boom largely caused by extremely lax bank lending to unworthy borrowers at interest rates around 2%. In contrast, here in New Zealand on average over the past 10 years dwelling consent numbers have been 25,000 per annum and this is where they sat between 2005 and 2007.




We have not had a recent excessive building boom and nothing remotely approaching the bad US lending practices has occurred in New Zealand. The only credit crisis in New Zealand has been for property developers whose business model depends upon easy money from finance companies whose business model in turn depends upon naive Kiwi investors either unable to understand the trade-off between risk and reward or unwilling to act on that understanding – a "willing suspension of disbelief" as they call it in the movie industry.

New Zealand's fundamental housing problem is one of an undersupply of accommodation as evidenced by the recent report from the select committee investigating housing affordability in New Zealand. The committee was not created to try and figure out how to get more people into thousands of empty houses sitting around the country or how to encourage local authorities to demolish houses to prevent neighbourhoods sinking into empty ghetto status. The outcome of that long-running investigation by the Commerce Committee was a 10 point list of, well, essentially nothing going to make any measurable impact on housing availability in the near future.
http://www.parliament.nz/en-NZ/SC/Reports/c/7/9/48DBSCH_SCR4170_1-Inquiry-into-housing-affordability-in-New-Zealand.htm

People appear highly aware that interest rates are falling and are likely to fall further and that lower interest rates have a positive impact on the housing market. Over the coming year the likes of two year fixed housing rates currently commonly just below 9% are likely to fall below 8% and perhaps as low as 7.5% depending on competitive pressures. Household budgets are likely to be improved by two rounds of tax cuts assuming a change in government, and plummeting residential construction is likely to generate renewed debate in a years time about housing shortages.

House construction costs also continue to rise and this week we learnt for instance in the Capital Goods Price Index that the cost of residential construction rose 0.8% in the June quarter to be 4.4% ahead of a year earlier and 36% up from five years ago. Further increases appear certain with rising costs of raw materials and increasing building code requirements such as for insulation.

The big area of uncertainty however is how weak the labour market may get. We are forecasting that the unemployment rate will reach 5.2% early in 2010 from 3.9% in the June quarter of this year. The risk is the rate does not go that high because businesses appear highly aware of the structural shortage of labour in New Zealand and its possible the cash flow-driven layoffs we are seeing at the moment may not continue into general structural downsizing of businesses over 2009. Basically we will just have to take developments in the labour market as they come along acknowledging that for the immediate future weakness is the most likely outcome and that this weakness will easily cap bouts of optimism in the housing market.

**Key Forecasts**

- Dwelling consent numbers to fall from 24,500 in the year to March 2008 to below 18,000 in the year to March 2009 with a slight recovery to March 2010 then above average activity after that as attention turns to a shortage of dwellings late in 2009.

- Real estate sales falling from 77,130 in the year to April 2008 to between 55,000 and 65,000 come the end of this year then recovering back over 65,000 in calendar 2009 with further growth over 2010.
- House prices down 5%-10% by the end of 2008, flat over 2009, rising slightly over 2010, possibly earlier.

# 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 |

## ECONOMIC DATA

| All % | | Latest qtr only | Previous qtr only | Latest year | Year ago | 2 Yrs ago |
|---|---|---|---|---|---|---|
| Inflation | RBNZ target is 1% - 3% on average | 1.6% | 0.7 | 4.0 | 2.0 | 4.0 |
| GDP growth | Average past 10 years = 3.0% | -0.3 | 0.8 | 2.9 | 1.6 | 2.7 |
| Unemployment rate | Average past 10 years = 5.3% | 3.9 | 3.7 | ..... | 3.6 | 3.6 |
| Jobs growth | Average past 10 years = 1.9% | 1.3 | -1.3 | 0.7 | 1.5 | 3.0 |
| Current a/c deficit | Average past 10 years = 5.5% of GDP | 7.8 | 7.9 | ..... | 8.5 | 9.6 |
| Terms of Trade | | 2.9 | 3.7 | 8.8 | 3.8 | -1.9 |
| Wages Growth | Stats NZ analytical series | 1.2 | 1.3 | 5.5 | 4.5 | 5.5 |
| Retail Sales ex-auto | Average past 9 years = 3.8%. | 0.2 | 0.1 | 3.1 | 4.9 | 5.6 |
| House Prices | Long term average rise 5% p.a. | -0.7 | 0.4 | 2.8 | 11.7 | 12.2 |
| Net migration gain | Av. gain past 10 years = 10,400 | +5,201 | 4,667yr | ..... | 8,970 | 12,150 |
| Tourism – an. av grth | 10 year average growth = 5.0%. Stats NZ | 0.8 | 1.5 | 0.8 | 3.7 | -0.9 |
| | | Latest year rate | Prev mth year rate | 6 mths ago | Year ago | 2 yrs ago |
| Consumer conf. | 10 year average = 2%. Colmar survey | -28 | -25 | -10 | -10 | -22 |
| Business activity exps | 10 year average = 26%. NBNZ | -8.2 | -4.0 | 10.3 | 12.4 | 14.9 |
| Household debt | 10 year average growth = 11.3%. RBNZ | 8.4 | 9.3 | 12.3 | 13.7 | 14.1 |
| Dwelling sales | 10 year average growth = 3.5%. REINZ | -42.4 | -52.9 | -32.1 | -1.3 | 5.0 |
| Floating Mort. Rate | 10 year average = 8.1% | 10.95 | 10.95 | 10.55 | 10.30 | 9.55 |
| 3 yr fixed hsg rate | 10 year average = 7.9% | 9.09 | 9.49 | 9.19 | 9.15 | 7.75 |

## ECONOMIC FORECASTS

| **Forecasts at July 31 2008** | **March Years** | | | | | **December Years** | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2011 | 2006 | 2007 | 2008 | 2009 | 2010 |
| ***GDP - annual average % change*** | | | | | | | | | | |
| Private Consumption | 2.8 | 3.3 | -1.1 | 1.4 | 2.3 | 2.6 | 4.1 | -0.6 | 0.6 | 2.3 |
| Government Consumption | 4.4 | 4.2 | 3.7 | 3.2 | 3.3 | 4.7 | 4.2 | 3.8 | 3.3 | 3.2 |
| Investment | -1.9 | 4.2 | -0.2 | -0.4 | 7.6 | -1.5 | 4.7 | 0.6 | -2 | 6.7 |
| GNE | 1.2 | 4.5 | -0.4 | 1.4 | 3.8 | 1.1 | 4.7 | 0.4 | 0.5 | 3.5 |
| Exports | 3.1 | 2.3 | 0.6 | 4.6 | 3.1 | 1.7 | 3.4 | 0.5 | 4 | 3.2 |
| Imports | -1.7 | 9.7 | 1.8 | 0.5 | 3.6 | -2.8 | 8.8 | 4.1 | -0.1 | 2.7 |
| GDP | 1.6 | 3 | 0 | 2.6 | 3.7 | 1.6 | 3.1 | 0.4 | 1.7 | 3.8 |
| Inflation – Consumers Price Index | 2.5 | 3.4 | 4.1 | 2.4 | 2.2 | 2.6 | 3.2 | 4.4 | 2.7 | 2 |
| Employment | 1.8 | -0.2 | -0.3 | 0.4 | 1.8 | 1.4 | 2.5 | -1.4 | -0.1 | 1.8 |
| Unemployment Rate % | 3.7 | 3.6 | 4.7 | 5.2 | 5 | 3.8 | 3.4 | 4.5 | 5.1 | 5 |
| Wages | 5.5 | 4.4 | 4.3 | 3 | 2.4 | 5.5 | 4 | 4.5 | 3.4 | 2.4 |
| **EXCHANGE RATE ASSUMPTIONS** | | | | | | | | | | |
| NZD/USD | 0.7 | 0.8 | 0.68 | 0.63 | 0.61 | 0.69 | 0.77 | 0.7 | 0.64 | 0.62 |
| USD/JPY | 117 | 101 | 108 | 116 | 120 | 117 | 112 | 107 | 114 | 120 |
| EUR/USD | 1.32 | 1.55 | 1.47 | 1.34 | 1.3 | 1.32 | 1.46 | 1.5 | 1.37 | 1.34 |
| NZD/AUD | 0.88 | 0.87 | 0.77 | 0.76 | 0.77 | 0.88 | 0.88 | 0.78 | 0.76 | 0.76 |
| NZD/GBP | 0.36 | 0.4 | 0.37 | 0.36 | 0.36 | 0.35 | 0.38 | 0.37 | 0.36 | 0.36 |
| NZD/EUR | 0.53 | 0.52 | 0.46 | 0.47 | 0.47 | 0.52 | 0.53 | 0.47 | 0.47 | 0.46 |
| NZD/YEN | 81.9 | 81.1 | 73.4 | 73.1 | 73.3 | 81 | 86.3 | 74.9 | 73 | 74.4 |
| TWI | 68.6 | 71.6 | 63.1 | 61.5 | 61.1 | 68 | 71.6 | 64.1 | 61.7 | 61.2 |
| Official Cash Rate | 7.47 | 8.15 | 6.75 | 5.5 | 6 | 7.44 | 8.19 | 7.25 | 5.5 | 6 |
| 90 Day Bank Bill Rate | 7.78 | 8.83 | 6.81 | 5.73 | 6.23 | 7.64 | 8.77 | 7.46 | 5.73 | 6.23 |
| 10 year Govt. Bond | 5.91 | 6.35 | 6.1 | 6.1 | 6.3 | 5.77 | 6.38 | 6.1 | 6.1 | 6.25 |

**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.**