BNZ Weekly Overview

10 December 2008

Mission Statement

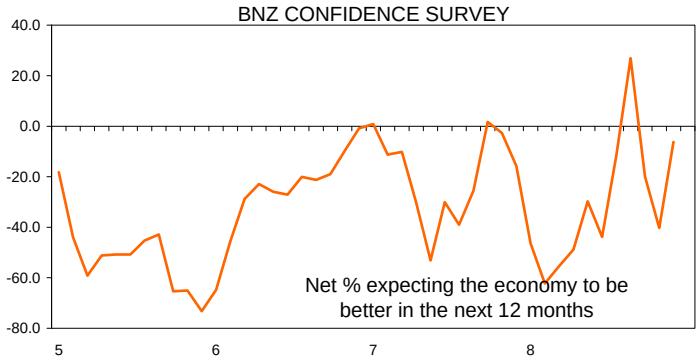
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

In this week's issue….

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.

Business Sentiment Improves Slightly

Many thanks to those people who contributed to our monthly survey last week. The main result was that a net 6% of people still believe the economy will get worse over the coming year but this was a relatively firm improvement from a net 40% feeling pessimistic in the early November survey. People appear to have reacted positive to large cuts in interest rates and falling petrol prices but there is also some feeling that surely things cannot get any worse. Unfortunately things are likely to get worse in some sectors of the economy and we have most concern about the tourism industry. It is about to be hit by a major drop in visitor numbers here as potential travellers offshore react to a loss of perhaps 50% of their equity wealth, losses of maybe 20% of their house value and potentially all of the equity they have in it, and potentially the loss of their job.



The house building sector is also undergoing a major decline with construction activity already down 22% from a year earlier and likely to fall further with consent numbers recently at their lowest level since the early 1990s. This weakness will spread to manufacturers and distributors of building materials along with manufacturers and distributors of home furnishings. The retail sector will also remain relatively constrained as the unemployment rate next year rises towards and perhaps above 6% from 4.2% in the September quarter this year. And there is a drought starting to set in over some parts of the country which will reinforce the worries in farmers minds associated with still rapidly falling commodity prices.

At the moment, and probably for the first part of next year, the key theme however is going to be continuing major uncertainty about the depth of the recessions in Northern Hemisphere economies and whether or not the large fiscal injection package announced recently in China will save that economy from weakening substantially. That means that even though we are going to finish this introductory section this week with a few positives keep in mind that we still have to warn about potential downside risks for our economy next year. At some stage those risks are going to turn towards the positive side but it is simply impossible to take a reasonable pick on when that is going to occur. At the moment the common assumption is that offshore things will look a lot better late in 2009.

Turning to the positives we have petrol prices which have fallen sharply and which are likely to continue to weaken, interest rates which have also fallen a long way and which probably have further to go. More importantly as each month goes by more and more people on fixed interest rates will roll onto lower interest rates and so cash flows into the household sector will slowly improve as 2009 advances.

There is another round of tax cuts due in April and we are likely soon to see food prices falling away in lagged response to some substantial declines in international food prices. Later in the year we think there will be growing awareness of the worsening shortage of accommodation in New Zealand especially as we are likely to see net migration numbers improving as expat Kiwis come back home and fewer of us leave to seek our fortunes overseas amongst the rubble left by those who have already lost theirs. Improving population growth and the worsening dwelling shortage will well before late next year place a floor under house prices and cause thoughts to turn at some point in 2009 to what could be a relatively firm lift in house building over the 2010 - 2011 period.

Perhaps more than that however we think that even as the unemployment rate rises businesses will remain highly aware of the structural shortage of employees in New Zealand. The first sign of light at the end of the economic tunnel is likely to lead to a cessation of widespread layoffs and employers will once again actively looking for good people. This is where the government's plan to quickly introduce the 90-day probation period of new employees at firms with fewer than 20 staff is hugely valuable at this point in the economic cycle.

If businesses think light is appearing for the economy they can hire on the off chance they are right and beat the rush to secure people. But if they are wrong and things deteriorate anew they can shed the staff and sit waiting again for the upturn. In other words, the legislation is likely to accelerate the speed of reduction in unemployment when the economy shows signs of turning. Quite useful and a far better contribution to the economy's wellbeing than the previous government's second policy change – a new 39% tax rate! Not that all changes foreshadowed by the new lot look good. Investing 40% of the Super Fund in little old NZ when all fund assets must be sold in a few decades to fund retirement and one should have a hedge against nasty events confined to NZ seems a less than optimal policy. Especially so when one considers how politicians over the years would likely try to direct "their" slush fund to preferred sectors.

But back to the labour market. We already know of some companies currently in reasonable financial shape which are taking the opportunity of a loosening label market to shed some of their less valuable people and replace them with better folk appearing in the labour market.

And this awareness of the tight labour market is likely to be reinforced at some point as businesses remember that New Zealand's economy almost always gets dragged out of recession by a lift in the export sector on the back of a combination of a low Kiwi dollar and improving economic conditions offshore. As noted above, it is difficult to know exactly when conditions will improve offshore and it is impossible to know when the Kiwi dollar is going to reach its low point in the cycle. It seems reasonable however to assume late next year for want of anything offering insight suggesting an alternative time.

The interesting thing is that this export growth when it comes is going to coincide with a potential resurgence in our domestic economy as well and that is where things get very interesting for monetary policy. It is likely the Reserve Bank will be raising interest rates again over 2010 and this, along with a probable recovery in commodity prices, could see the Kiwi dollar rise quite firmly of 2010 and 2011.

But people properly shouldn't be looking too much at canny investment opportunities based on financial markets movements over 2010. At the moment the goal is to get through 2009 and if one is lucky perhaps undertake a transaction when fixed interest rates and the Kiwi dollar are near their cyclical lows at some point between January and December.

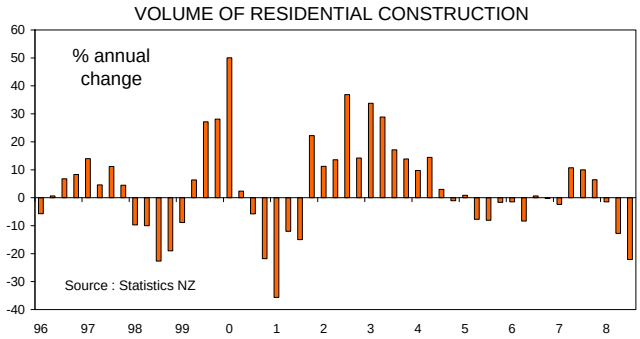
NB. This probably will not be the last Weekly Overview for 2008. There will most likely be one on Thursday 18 however if there is it won't be large as one will only just be back from a few days with family members down on Stewart Island and one will hardly be wanting to jump back into deep financial and economic matters before once again turning the brain off for official Christmas holidays.

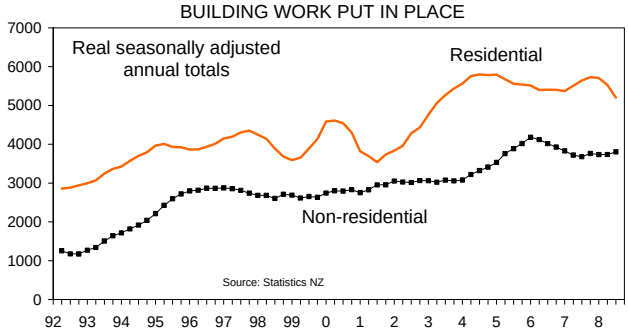
NZ ECONOMIC DEVELOPMENTS

Monday 8

Construction Weakening Off

This week we learnt that during the September quarter the seasonally adjusted volume of residential building work in New Zealand fell by a rather large 7.9% to be 22.1% down from a year earlier. Work undertaken during the quarter was the weakest for any quarter since June 2002. Given the still deteriorating trend in dwelling consent issuance it's likely that this number will fall further and layoffs already occurring in the building sector are likely to increase in magnitude.



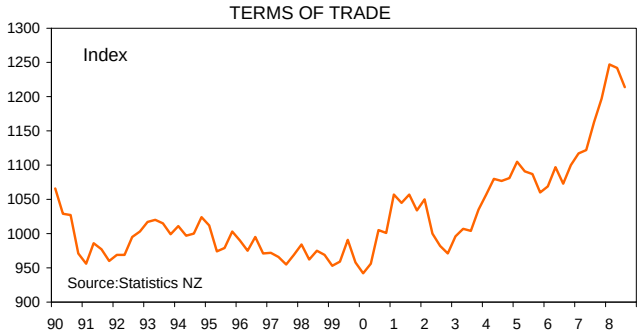


There will however be at least some offset from continuing strength in non-residential construction. This grew 5.7% during the September quarter to be 7.6% up from a year earlier. Non-residential consent issuance is still holding up reasonably well though is likely to decline given business sector worries about the economy over 2009 and cash flow constraints. But then again there will also be some offset from continuing firm infrastructure activity.

Wednesday 10

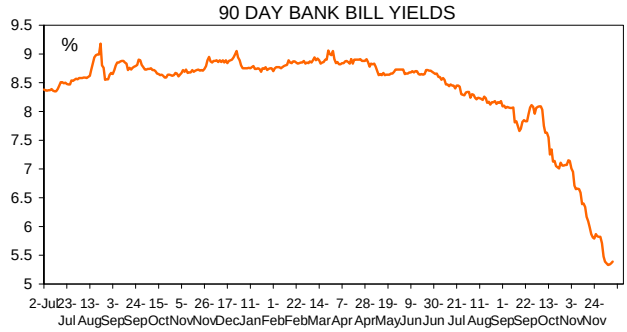
Terms of Trade Heading Down

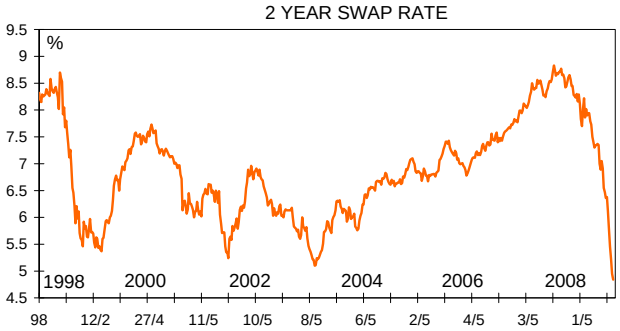
With our export commodity prices falling it is no surprise that New Zealand's terms of trade deteriorated for the second quarter in a row during the September quarter with a decrease of 2.3%. The index is still 4.4% ahead of a year earlier. But with a relatively large decline likely to be recorded for either the December quarter or the March quarter a sizeable decline in the nicely upward moving terms of trade graph below is probable.



INTEREST RATES

Following last week's large 1.5% cut in the official cash rate by the Reserve Bank and in the absence of any earth shattering data releases we have seen little change in wholesale interest rates from where they were last Thursday. There were some small upward movements today in response to the Reserve Bank Governor's warning that domestic inflationary pressures are still relatively firm especially in areas like local authorities and electricity companies. He also explicitly called for various companies to pass on cost increases they are now recording and cited transport and building firms.





The yield on 90 day bank bills has ended near 5.4% from 5.35% last week while the two-year swap rate has backed up a bit too today to end at just below 4.9% from just above 4.95% last week. For your guide, and as a reminder to the Reserve Bank that banks do not fund themselves at the official cash rate, the old steady relationship between the likes of bank bill yields & swap rates and bank lending rates has gone out the window as a result of the global credit crisis.

Whereas just over a year ago banks used to pay in the order of 0.1% risk premium above New Zealand level interest rates to borrow funds internationally one more commonly these days will pay something along the lines of 2.5% to 3%. That is a massive boost in cost for the over 30% of funding gained offshore by New Zealand banks and is not something one can see in the domestic interest rates we talk about here. Plus one other thing. Although there has been some flow of money to banks as a result of the collapse in many finance companies there is now also a flow back to finance companies because of the capital guarantees which around 20 have been able to receive from the government.

For the record our expectation remains that the official cash rate will be cut to somewhere between 3.5% and 4% in the middle of next year as the Reserve Bank reacts to further weakness in the global economy. Our challenge for probably the first half of next year but potentially the second half is to be able to recognise at the time it is happening when fixed interest rates have reached their cyclical lows. Often one does not know a thing has reached its cyclical low until one has moved well beyond it. This can easily happen with exchange rates and sharemarkets and it is quite possible we won't conclude a cyclical low for interest rates has been reached until we get a decent enough string of data to conclude the worst of the economy has passed by which time the markets will probably have pushed rates off their lows by over 0.5%. Still it's good to have a goal each year.

Key Forecasts

- Monetary policy easing with the official cash rate between 3.5% and 4.0% come mid 2009.
- The two year fixed housing rate reaching 7.0% in mid-2009 or earlier, with minor downside possible after that assuming easing of the credit crisis. Falling to the 6.5% low of 1999, 2001 and 2003 is now more possible this cycle than previously thought for the past few months because of the worsened global outlook.

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	5.00%	5.00	6.50	8.00	8.25	6.2
90-day bank bill	5.39%	5.35	6.65	8.07	8.89	6.5
10 year govt. bond	4.74%	4.80	5.98	5.87	6.47	6.2
1 year swap	4.70%	4.80	5.94	7.33	8.90	6.7
5 year swap	5.18%	5.35	6.16	6.84	8.21	7.0

If I Were a Borrower What Would I Do?

Would I break my fixed interest rate? Here is the first rule. You only break your mortgage if you are planning to re-fix for a period substantially longer than the term left on your existing mortgage. The second rule is that the breakee is not going to get a free ride. The documentation one signs states that breaking the contracted agreement fixing one's interest rate will attract a cost recovery penalty. This is because if the bank lends to a person at a fixed rate then the bank has also borrowed from someone at a fixed rate. That other person is probably not going to be too keen to have us give them back their money and break the contract we have with them if a customer on the other side chooses to break their contract with us.

The third rule is that you have to openly acknowledge you are taking a gamble. You, and perhaps we, have already proved inability to forecast quick changes in fixed interest rates because of the original fixing now looking relatively expensive. One might legitimately ask what miracle has occurred to suddenly improve one's forecasting ability!

We are probably not at the bottom of the fixed interest rate cycle so if you break now and refix the chances are in a few weeks time you could be regretting the decision. It may only be best to break when it looks like interest rates are at their lows. Of course one way around that is to break now and go floating or to take a six month fixed interest rate. Personally speaking if I was borrowing at the moment I would fix six months and if I had a high fixed interest rate locked in for two years earlier this year I would keep it and look to break them refix for seven years at a nice low level at some stage next year. It is impossible at this stage to know whether the cyclical low for interest rates will occur in January or December 2009 and frankly you can't even guarantee that at the time we will know rates are at their lowest levels. We may only know in hindsight - such is the nature of things

HOUSING MARKET UPDATE

What is it that generates hate mail at the moment? Saying something other than that house prices will fall by between another 30% and 40%. It is quite amazing the number of people who seem to believe we should be predicting massive price declines in the face of fundamentals which suggest otherwise. They seem personally insulted by one having a view differing from theirs and they often resort to some fairly impolite language. Still, that’s life in the big city.

But putting criticising emails aside we also receive a few notes from people questioning the accuracy of data we use when discussing the housing market. For instance one person (thankfully this persons’ emails were well thought out and well written) operating in Auckland's eastern suburbs, used their internal data to show that averaged dwelling sale prices over the past four months are down 20% from a year earlier. They claim the housing market is a lot weaker than we have been writing about

The first point to make here is that the data may not represent all of activity in the area. The second point is that not all areas are the same and it is nationwide averages we economists deal with.

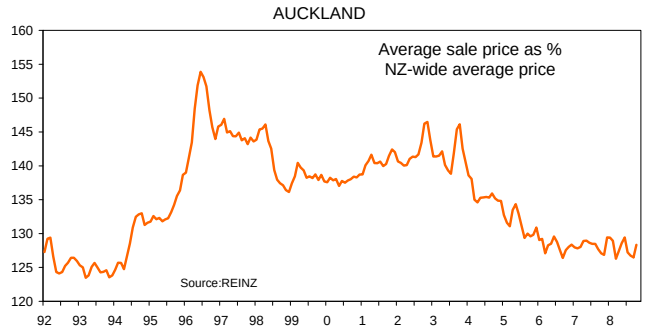
For instance, although using REINZ data one can see median dwelling sale prices down 16% in the Auckland Milford/Takapuna area from a year ago, the decrease was only 10% for the Eastern Suburbs REINZ classification, 6.5% for Ellerslie Panmure. For Invercargill the decrease was only 2.3%. For the Hutt Valley there was a rise of 0.1%.

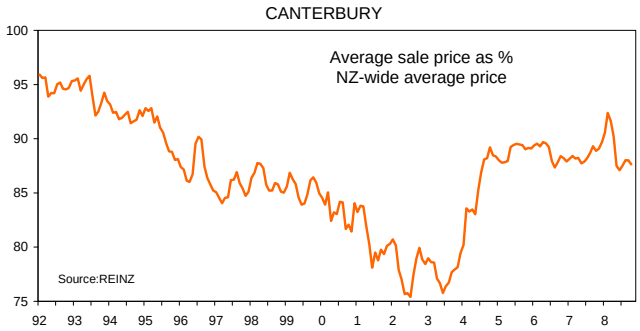
So which of these limited data recordings are we to base our nationwide housing comments on? Obviously none of them. We focus on the big kahuna and not the details which people on the ground get too enmeshed in and which blind them to what economics is about – the big picture as a sum of all the little pictures.

Go to the link below if you want to do this exercise for yourself. The data are quite detailed.
http://www.reinz.co.nz/reportingapp/?RFOPTION=Report&RFCODE=R100

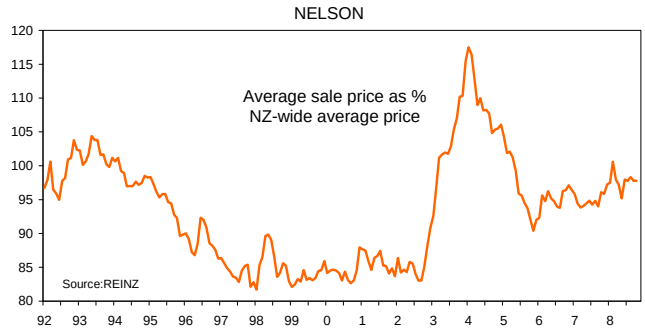
In fact here is an exercise you can do for yourself to get a feel for whether the area you live in might be due for a potentially larger than average fall in price, or maybe could outperform once house prices start creeping up again over 2010. Based on the general view that if prices soar elsewhere one's area will eventually pick up as people find it more affordable, one can compare median dwelling sale prices with either another area or some broad average concept to get a feel for whether an area looks over or under-priced.

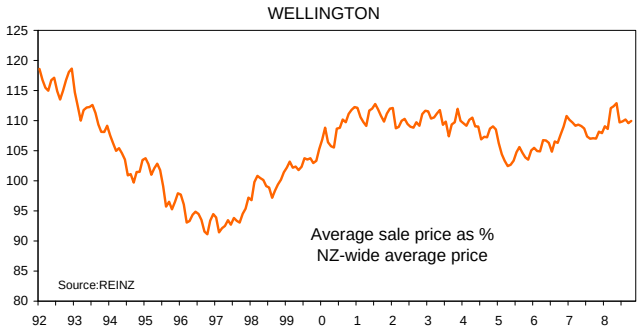
The first two graphs for instance take a look at Auckland and Canterbury. Keeping in mind that the NZ average price used includes Auckland (which makes up 1/3 of all NZ sales activity) one can say the following.



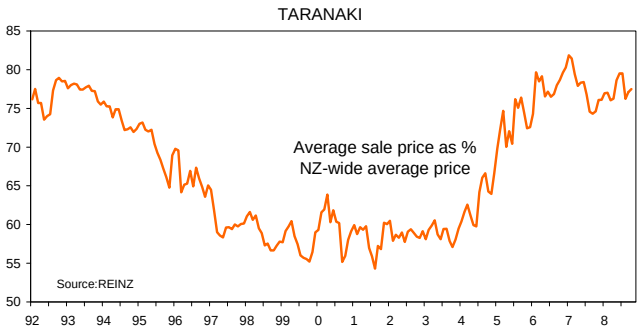


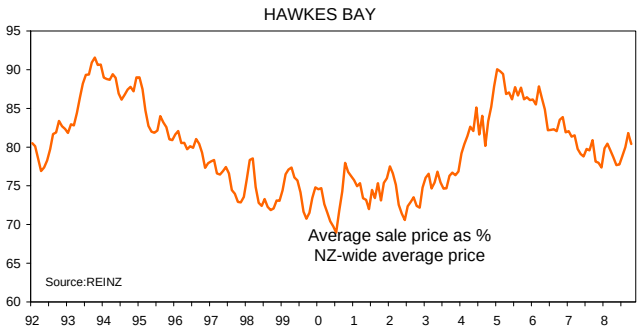
Completely ignoring pressures from different population growth rates, zoning pressures and so on one might say Auckland is looking cheap by the standards of the past 16 years. Canterbury does not look cheap. Nelson and Wellington seem neither here nor there.





Taranaki seems fully priced, the Hawkes Bay graph tells us little.





To do this exercise for yourself go to the website address noted above.

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 (annual low point near 16,000 now likely) 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.

Exchange Rates & Foreign Economies

See the Offshore Overview.

Blanket apology for any strange words or phrases resulting from not doing enough proof-reading after using the Dragon Naturally Speaking voice recognition software.

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	1.5%	1.6	5.1	1.8	3.5
GDP growth	Average past 10 years = 3.0%	-0.2	-0.3	2.6	2.4	2.4
Unemployment rate	Average past 10 years = 5.3%	4.2	3.9	.....	3.5	3.8
Jobs growth	Average past 10 years = 1.9%	0.1	1.3	1.0	1.5	1.5
Current a/c deficit	Average past 10 years = 5.5% of GDP	7.8	7.9	.....	8.5	9.6
Terms of Trade		-2.3	-0.4	4.4	8.4	-1.3
Wages Growth	Stats NZ analytical series	1.5	1.1	5.3	4.8	5.1
Retail Sales ex-auto	Average past 9 years = 3.8%.	-0.2	-0.6	0.4	5.5	4.5
House Prices	Long term average rise 5% p.a.	-4.5	-0.7	-4.4	13.7	10.3
Net migration gain	Av. gain past 10 years = 10,400	+4,403	4,938yr	.....	8,319	13,210
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-0.2	0.8	-0.2	3.1	-0.0
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	5	3	-33	2	-10
Business activity exps	10 year average = 26%. NBNZ	-14.1	-11.4	-4.4	15.7	23.7
Household debt	10 year average growth = 11.3%. RBNZ	6.0	6.8	10.0	13.1	13.2
Dwelling sales	10 year average growth = 3.5%. REINZ	-34.8	-23.7	-45.5	-22.6	4.0
Floating Mort. Rate	10 year average = 8.1%	8.19	9.75	10.95	10.55	9.55
3 yr fixed hsg rate	10 year average = 7.9%	7.40	8.49	9.09	9.19	7.99

ECONOMIC FORECASTS

Forecasts at Nov. 20 2008	**March Years**					**December Years**				
	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010
GDP - annual average % change										
Private Consumption	2.9	3.3	-0.4	1.6	2.3	2.7	4.1	0	0.9	2.3
Government Consumption	4	4.1	3.6	3.2	3.3	4.7	3.6	4	3.2	3.2
Investment	-1.9	4.3	-4	-5.1	6.6	-1.5	4.7	-1.7	-7.4	5.1
GNE	1.1	4.5	-0.9	0	3.8	1.2	4.5	0.4	-1.1	3.4
Exports	3.1	2.3	0.5	0.2	2.2	1.7	3.3	0.9	-0.1	1.5
Imports	-1.6	9.7	2.9	-2.7	2.2	-2.6	8.7	5.4	-2.9	0.8
GDP	1.8	3.2	-0.4	1.3	3.9	2	3.2	0.4	0.3	3.8
Inflation – Consumers Price Index	2.5	3.4	3	2.4	2.3	2.6	3.2	3.8	1.7	1.9
Employment	1.8	-0.2	0.6	-0.5	2.1	1.4	2.5	-0.3	-1.1	2.1
Unemployment Rate %	3.7	3.7	4.9	6	6.1	3.8	3.4	4.6	5.8	6.1
Wages	5.5	4.4	4.8	3.2	2	5.5	4	4.9	3.5	2.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.7	0.8	0.53	0.56	0.64	0.69	0.77	0.54	0.54	0.62
USD/JPY	117	101	93	98	110	117	112	94	95	107
EUR/USD	1.32	1.55	1.24	1.24	1.32	1.32	1.46	1.25	1.22	1.3
NZD/AUD	0.88	0.87	0.85	0.9	0.9	0.88	0.88	0.86	0.9	0.9
NZD/GBP	0.36	0.4	0.36	0.37	0.4	0.35	0.38	0.36	0.36	0.39
NZD/EUR	0.53	0.52	0.43	0.45	0.48	0.52	0.53	0.43	0.44	0.48
NZD/YEN	81.9	81.1	49.3	54.9	70.4	81	86.3	50.8	51.3	66.3
TWI	68.6	71.6	54.6	58.1	65.4	68	71.6	55.5	56.3	63.5
Official Cash Rate	7.47	8.25	4.75	5	6	7.50	8.25	5.5	4.75	5.75
90 Day Bank Bill Rate	7.78	8.83	5	5.2	6.2	7.64	8.77	5.55	5	5.95
10 year Govt. Bond	5.91	6.35	5.3	6.4	6.5	5.77	6.38	5.5	6.2	6.5

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.