BNZ Weekly Overview

14 July 2011

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 Weekly Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line.

What Chance Growth Policies?

Here is some simple analysis. New Zealand has a big problem with low productivity growth causing our income per capita to slide down the OECD ladder, and a culture in which we migrate here, come back here, or stay here to pursue what can be called a working retirement. We have wonderful access to beaches and mountains, clean air, great coffee and butter, beautiful rivers and lakes, good schools, detached dwellings, are distant from major ethnic and religious conflicts offshore, are of no strategic importance to practically anyone or country on the planet so get left alone, and have good weather absent the extremes seen overseas. So living here is good.

But the analysis we have presented regarding our culture at http://tonyalexander.co.nz/topics/what-we-lack/ concludes that our high gross inflows and outflows of migrants tend to reinforce our culture which is geared toward inventing things on the farm, on the porch, down the pub or in the shed, but reinforces also our unwillingness/inability to make much money if any from these inventions.

With our culture needing to be turned around toward more focus on profiting from our inventiveness, and with productivity enhancing investment weak, will some of the policy proposals appearing now make our economic and income growth prospects better or worse?

Raising the top personal tax rate to 39% does what? It discourages people from making extra income therefore this will tend to reinforce our culture of income distribution, cutting tall poppies, and disrespect for wealth and those who achieve. At the margin the policy change will reduce the incentive for high income earners to come here and encourage more get up and go people to leave. Additionally the difference with the company tax rate of 28% will lead to a hefty investment of people's time into restructuring their affairs to avoid the tax. The policy will worsen our long term growth prospects.

Introducing a capital gains tax on investment property does what? Over the long term reduced relative returns to property investment will divert some investment funds toward other assets – though keep in mind most housing investments are financed by debt so the amount available to be redirected toward more productive assets will be a lot less than people may be thinking. The move however will be positive for economic growth long term. However, by reducing the incentive for investors to build houses the current shortage of property will deepen and there will be extra upward pressure on rents. This will place extra pressure on governments to subsidise rents for low income earners and this will produce extra upward pressure for higher taxes on middle to upper income earners. The country's redistributive and tall poppy cultures will tend to be reinforced though with an offset from more efficient resource allocation over the long term.

Introducing a 0% income tax rate for the first few thousands of dollars of income does what? This will tend to encourage more people to get off welfare and into the workforce and increase incentives to get basic training. The effects will be positive for growth but must be offset against the negative effects of higher taxes elsewhere discouraging work effort which takes one into a higher tax bracket. The change in fact strongly reinforces our culture of not earning money vastly superior to those around us, not sticking out, not risking being scythed down, not risking looking superior. Basically the increased progressiveness of the tax system will retard long term economic growth by reinforcing our current culture.

Removing GST on fresh fruit and vegetables does what? We all benefit from that, those on lower incomes more so. But the door will be opened to other GST exemptions, it will be an administrative nightmare, and there will be a need for other taxes to compensate and if they are levied on those with upper incomes the tall poppy syndrome will again be reinforced and the country's long term growth prospects again retarded.

Selling stakes in electricity companies and Air New Zealand does what? No evidence is in hand to suggest these companies are poorly run currently or that partly selling them off would boost their efficiency. They return more to the government than would be saved by reduced bond issuance therefore the government deficit will be higher and the scope to alter our anti-work culture through reducing progressiveness in the tax system will be less. The sales do not seem likely to improve New Zealand's long term growth prospects.

The policies so far offered up by the two main political parties in New Zealand reflect their respective ideologies and if enacted would tend to retard our long term growth prospects rather than enhance them.

NZ Economy Performs Better Than Thought

On another matter, the world of economics is filled with surprises and we suspected there might be one this morning when last week Statistics NZ delayed the release of their March quarter national accounts until this morning. The trouble is we had no insight into whether the surprise might be a good or bad one though suspected that there was greater scope for a result above the common March quarter growth expectation of 0.4% than below – and we were right. Our economy grew by a healthy 0.8% during the March quarter and the December quarter growth was revised up from 0.2% to 0.5%.

These numbers make us feel slightly more comfortable with the strong 1.4% jobs growth recorded for the March quarter following 0.4% shrinkage during the December quarter. They were driven by good growth in the manufacturing sector and net exports offsetting weakness in construction and only mild 0.4% growth in private consumption. The country's annual average growth rate now sits at 1.5% from -0.7% in the year to March 2010and average growth of 2.3% pr annum over the past decade.

The result implies that the economy has a tad less spare capacity than we were thinking before 10.45am this morning, and that means a greater chance that the Reserve Bank will raise interest rates before December. Remember also the warning we shall probably be running with for some time here that at this point in the economic and interest rate cycle we forecasters tend to under-predict where interest rates will finish up. So while we pick a peak for the cash rate at 5% come early 2013, run your cash flow projections assuming 6% and see how you are left regarding comfort with your exposure to floating interest rates over the next three years.

The outlook of upside risk to interest rates fired the kiwi dollar through US 85 cents for a while this morning assisted also by weakness in the greenback overnight. We retain our warning that the NZD is headed higher and once the tightening cycle actually kicks off against the background of a long term decline in the greenback and challenging economic conditions in many other countries, we will head toward 55 – 60 British pence and US 90 cents.

It is probably safe to say also that we are headed higher also against the Aussie dollar especially considering that the bulk of their data releases recently have been weak and the markets are now factoring in a strong chance that the next Australian monetary policy change will be an easing.

This week the following material has been added to www.tonyalexander.co.nz

Weekly Newspaper Column http://tonyalexander.co.nz/newspaper-column/

This week we look at the results of our monthly BNZ Confidence Survey

BNZ Confidence Survey http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/

Net confidence about the economy in a year's time has eased slightly in this month's survey. But at a net 45% positive sentiment remains near record levels. Of note from the sectoral responses is a significant shortage of listings appearing in the residential real estate market, more balanced feedback from retailers than for many months, astoundingly mixed experiences reported by those in the construction sector, and improved sentiment from the legal sector.

BNZ-REINZ Residential Market Survey http://tonyalexander.co.nz/topics/surveys/bnz-reinz-survey/

Our fourth survey of licensed real estate agents has found a strong rise over the past month in the number of first home buyers looking for property (but a small decrease for investors), a jump in auction clearance rates, and much stronger perceptions that prices are now rising. However there are just as many agents reporting buyers being the most motivated to transact as report sellers more motivated, therefore we have a situation of neither a buyers nor a sellers market in place.

Other Website Material

- **Weekly syndicated newspaper column** http://tonyalexander.co.nz/newspaper-column/
- **State of the NZ Labour Market** Updated mid-month. http://tonyalexander.co.nz/nz-labour-market/
- **BNZ-REINZ Residential Market Survey** Released second week of each month. http://tonyalexander.co.nz/bnz-reinz-survey/
- **Real Estate Overview** Updated mid-late each month. http://tonyalexander.co.nz/bnz-reinz-survey/
- **Archived Weekly Overviews** www.bnz.co.nz/tonyalexander

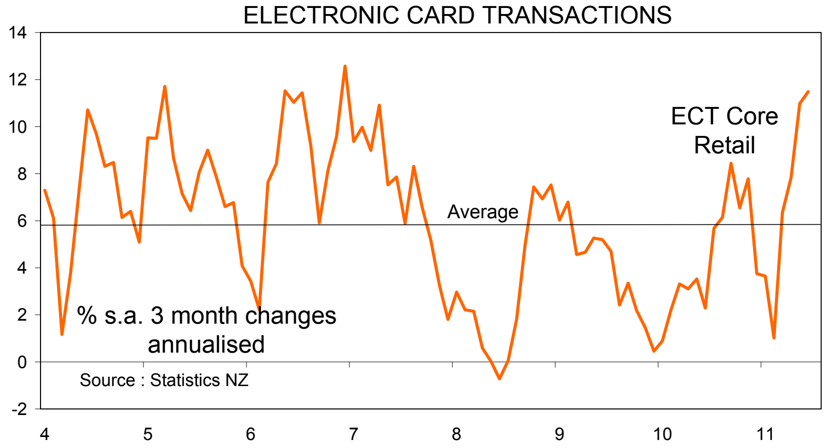
Is Our Economy Getting Better or Worse?

In this section we look only at what the data are actually telling us and pay no attention to forecasts or intentions measures.

There was a 2% surge in core retail spending using debit and credit cards in June and strong 11.5% annualised growth over the June quarter. Consumers appear to have opened up their wallets and because retailing forms about two-thirds of private consumption which makes up about two-thirds of GDP this suggests good GDP growth for the June quarter. And as noted above March quarter growth of 0.8% was twice expectations and the December quarter growth was revised up. Residential dwelling sales activity and prices also improved in the latest data. The week has been one of firm data releases.

Are householders opening their wallets more?

It would appear so according to the monthly Electronic Card Transactions data which in seasonally adjusted terms grew 0.8% overall in June and a strong 2% excluding non-core retail items. This latter measure is the one we focus on and the 2% rise followed a small 0.2% fall in May and large 1.6% rise in April, thus producing an annualised rate of growth over the June quarter of 11.5%. This is the strongest such rate of growth for this series since the end of 2006 and given that in that earlier quarter the official core retail measure rose 2.3% in real adjusted terms the latest ECT data suggest that the June quarter was a strong one for retailers.



Given that in this section we put aside sentiment surveys and focus just upon the data we have to conclude that there is good underlying growth in retail spending which a lot of retailers are not necessarily seeing and perhaps that should act as an indicator that they may need to take a fresh look at what they do and how.

This week we also learnt that people are buying more houses with what we estimate to be a seasonally adjusted rise in dwelling sales in June and prices creeping up 1.3%.

Is business output rising?

We have the March quarter GDP numbers in hand now and they tell us that in some, though definitely not all sectors, business output grew during that quarter. The table below ranks sectors by March quarter growth and shows manufacturing outperforming except for textiles and furniture, and the likes of finance and communication being weak. The second column of numbers shows growth for the entire year to March.

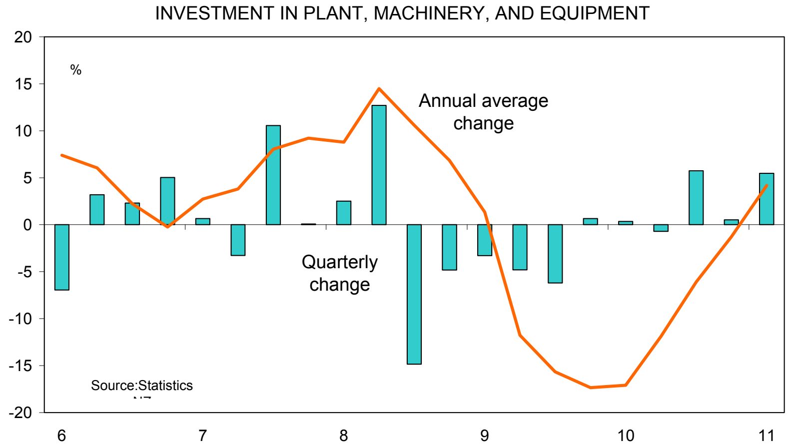
	March qtr % change	**Year to March 2011 vs. year to March 2010**
Machinery & equipment manufacturing	15.9	4.0
Metal product manufacturing	8.8	19.8
Non-metallic minerals product manu.	4.1	-2.5
Fishing	4.0	4.3
Wood & paper products manufacturing	3.5	1.3
Central Govt.	2.5	1.4
Petroleum, chemical plastics, rubber manu	2.2	2.1
Retail trade	2.1	1.7
Food, beverages & tobacco	2.0	-5.2
Wholesale Trade	1.6	5.0
Local Govt	1.3	2.0
Electricity, Gas and Water	1.2	1.3
Real estate & business Services	1.0	1.3
Agriculture	0.9	-1.6
GDP Total	**0.8**	**1.5**
Ownership of occupied dwellings	0.2	0.9
Transport and Storage	0.2	4.8
Forestry &Logging	-0.2	12.3
Finance & insurance	-0.3	0.9
Communications	-0.3	-2.9
Accom. Cafes & restaurants	-1.7	-1.3
Textiles & apparel Manufacturing	-2.9	-9.7
Construction	-4.3	2.7
Mining & Quarrying	-5.3	1.9
Furniture & other manufacturing	-9.0	-1.9
Printing, publishing	-11.1	-5.1

Are businesses hiring more people?
To view our latest monthly NZ Labour Market report click here. http://tonyalexander.co.nz/nz-labour-market/

Nothing new.

Are businesses boosting their capital spending?
To see how businesses are feeling right now one can read our monthly BNZ Confidence Survey here. http://tonyalexander.co.nz/bnz-confidence-survey/

During the March quarter investment in plant, machinery and equipment improved by 5.5% which is a good healthy result that followed 0.5% growth in the December quarter and a 5.8% rise in the September quarter. So PME capital spending has risen for three quarters in a row. However based upon an easing observed in imports data until the past month or so we could see a negative result for the June quarter. Spending on non-residential buildings fell 15.5% in the quarter.



INTEREST RATES

Growth vs. Economic Slack

In a nutshell this is what drives inflation along with institutional arrangements, imported inflation, and exchange rate changes. If you want to forecast monetary policy you need to monitor these things. So we will, adding stuff here when we learn it. The current common view is rate tightening from December. Have we learnt anything this week which alters this outlook?

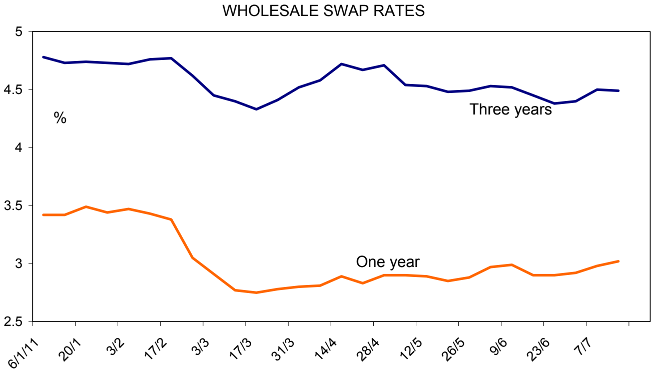
This week we have seen more evidence that consumers are spending in the stores, and in the housing market rising interest from first home buyers suggests it is reasonable to expect rising prices and a lift very soon in dwelling consent issuance and therefore construction. Most importantly however the March quarter GDP rate of growth at 0.8% was above 0.4% expectations and the December quarter 0.2% growth was revised up to 0.5%. That means the gap between resource availability and growth/use is less than thought, that implies extra inflationary pressure down the track, and that means enhanced upside risk to interest rates and hence rises recorded in wholesale rates this week.

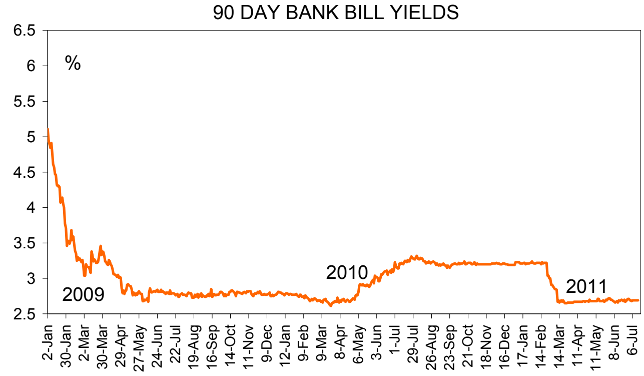
Other Inflation Influencers

Next week the June quarter inflation numbers will be released and we are expecting a 0.8% rise for the quarter and 5.1% rise for the year which is about what the Reserve Bank have pencilled in as well. It is extremely rare for the outcome to differ much from market expectations so the Monday release is unlikely to lead to much noticeable change in current wholesale interest rates. For the record NZ food prices rose by 1.4% in June to lie 7.5% ahead of a year ago. Food accounts for around 18% of the typical NZ household budget and we buy food items every week so these large price gains go a long way toward making people feel poorer and we would have thought such feelings would have been having a more depressing impact on broad retail spending than appears apparent in the monthly Electronic Card Transactions data discussed above.

Rate Movements This Week

Wholesale interest rates initially fell away this week in response to renewed worries about the European debt situation and the markets in Australia shifting to factor in a 100% chance that the RBA will cut its cash rate 0.25% over the coming year. But this morning's stronger than expected economic growth numbers have pushed rates back up. The one year swap rate has ended near a five month high of 3.02% from 2.98% last week, the three year rate at a five week high near 3.9% from 3.85%, and the five year rate essentially unchanged from last week at 4.49%. Bank bill yields are unchanged.



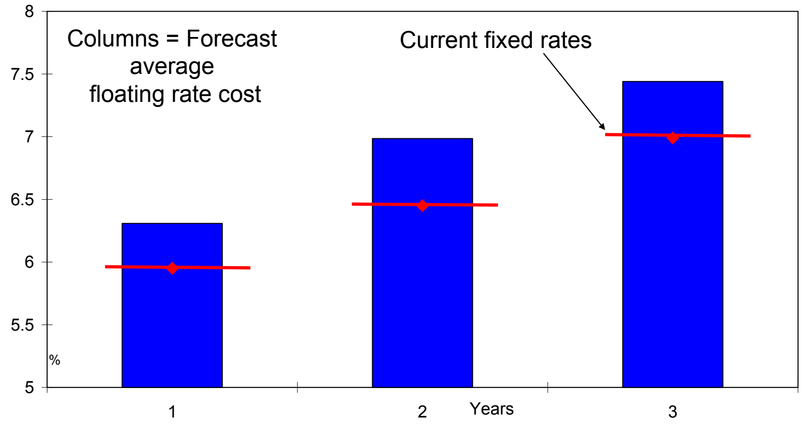


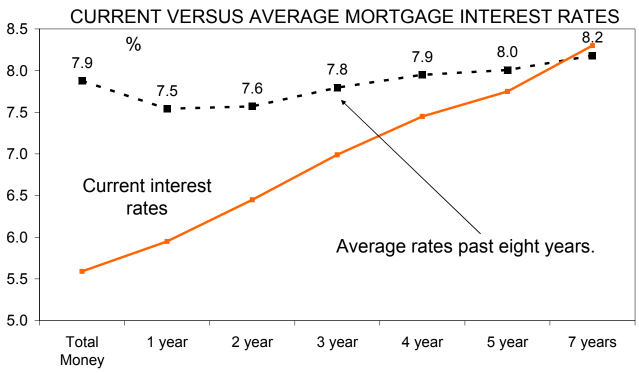
FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.75	5.9
90-day bank bill	2.69%	2.70	2.68	2.67	3.14	6.2
1 year swap	3.02%	2.98	2.90	2.89	3.87	6.3
5 year swap	4.49%	4.50	4.45	4.72	4.96	6.6
180-day term depo	4.30%	4.30	4.50	3.60	4.90	6.0
Five year term depo	6.00%	6.00	6.00	6.00	6.75	6.5

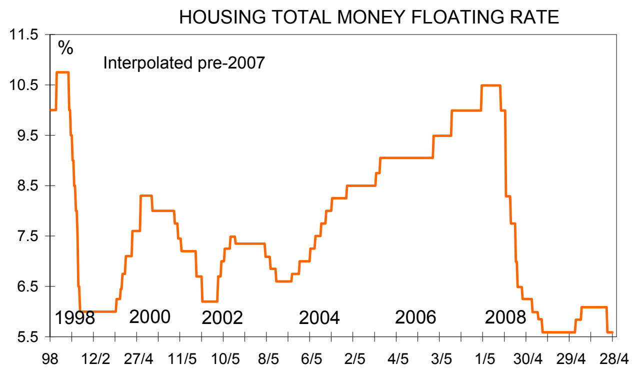
If I Were a Borrower What Would I Do?

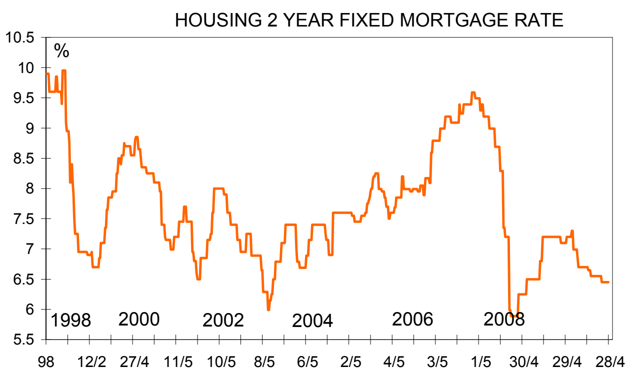
The weak US employment data for June, recently weak Australian data, continued low credit demand in New Zealand and the ongoing strength in the Kiwi dollar mean that as a borrower I would still personally feel disinclined to switch from floating to fixed for my mortgage. I reckon I have a few more months up my sleeve to keep paying principal down while taking advantage of the lowest floating mortgage rates in four decades.

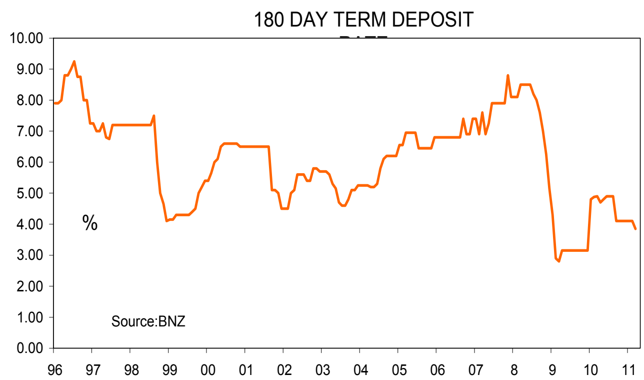
But in light of this morning's stronger than expected GDP growth numbers I'll be keeping an eye out for any decent fixed rate specials and as stated some months back would be willing to fix right now if I could get a two year rate for 6% or three rate for 6.25%. If I were a business borrower I would slowly be moving perhaps 20% - 40% of my core debt to a fixed rate near a three year term before the end of the year. I'd probably do this taking advantage of the occasional rallies we see in wholesale interest rate markets.











If I Were a Term Deposit Investor What Would I Do?

Stay short waiting for monetary policy to be tightened.

HOUSING MARKET UPDATE

To view the most recent results of our monthly BNZ-REINZ Market Survey and read our monthly Real Estate Overview click here. http://tonyalexander.co.nz/bnz-reinz-survey/

BNZ Confidence Survey Results

Our monthly survey of Weekly Overview readers produced quite a few responses from people involved in the residential real estate market. The general tone was increasing demand for rental accommodation with some shortages appearing, and widespread dearth of dwellings for sale listings throughout the country. Vendors were noted as being in no particular hurry to move with high unwillingness to meet the market. This has been the situation for quite some time and those forecasters consistently picking a substantial fall in house prices have to a large extent been relying upon vendors feeling the pinch and capitulating to buyer price offers.

But low mortgage interest rates have removed pressure for vendors to sell, and as we pointed out at the time, even when credit was quite loose in the mortgage market there were very few people who signed up at over 90% loan to value ratios for their investment properties.

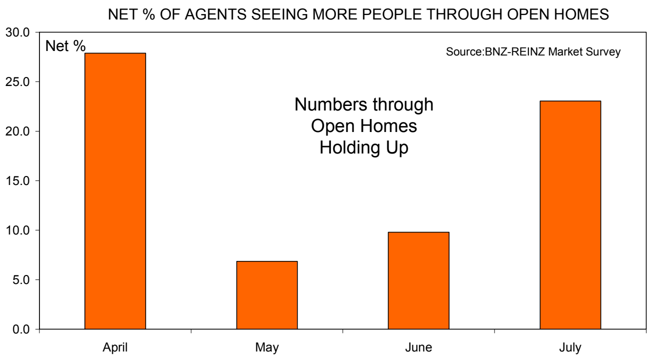
But what about when interest rates start rising? That will exert some cash flow pressure on investors, especially as most are now likely to be on floating rather than fixed interest rates. However at the same time as interest rates rise we expect the labour market to be performing strongly and tenants more aggressively bidding rents up. Rising gross yields for investors will work toward reducing the wave of properties we still think could hit the market in the next 12 months and cap the extent of average price rises.
http://tonyalexander.co.nz/topics/surveys/

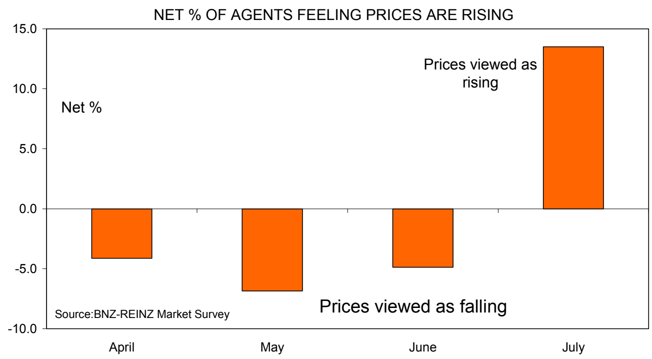
BNZ-REINZ Residential Market Survey Results

Our monthly survey of licensed real estate agents yielded responses from 742 of the over 10,000 surveyed which is a very good result that has allowed disaggregation of the results from the main eight questions to a large number of locations. The general themes coming through from the survey include the following.

- A rise in numbers going through Open Homes and higher auction clearance rates.
- A noticeable lift in interest from first home buyers but no change in interest from investors.
- A switch in agent perceptions of price changes form three months of declines to now feeling prices are rising.
- As many respondents feeling that it is a buyers market as feel it is a sellers market.
- Greatest strength in Auckland and in some regions still an overwhelming dominance of sellers.

The results show rising buyer demand and feed into our view that the side which will capitulate on price will be buyers and not sellers.





Central CGT Fallacy

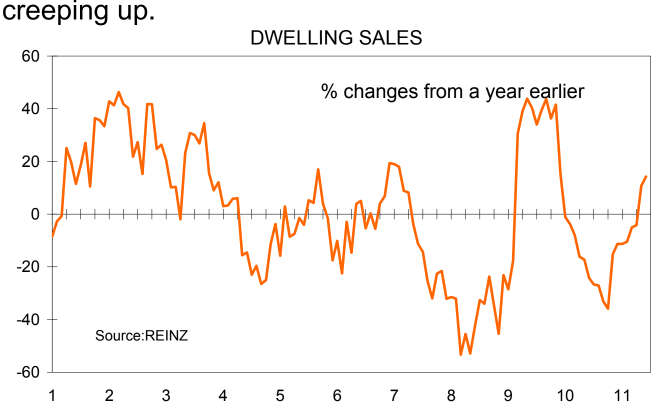
One of the key points put across by those proposing a capital gains tax is that it would lead to a reallocation of money toward productive assets. There is a problem with this view. Most of the money used to purchase investment properties is borrowed. That means the absence of buying a house does not free up something like the average house price of $350,000 for investment elsewhere. The amount may only be $50,000. Plus, this money can in fact only be “freed up” and made available for other investment in the case of a house which was going to be built not being built. If the freeing up simply involves an investor selling then of course someone else is buying so al that happens is debt shifts from one owner to another.

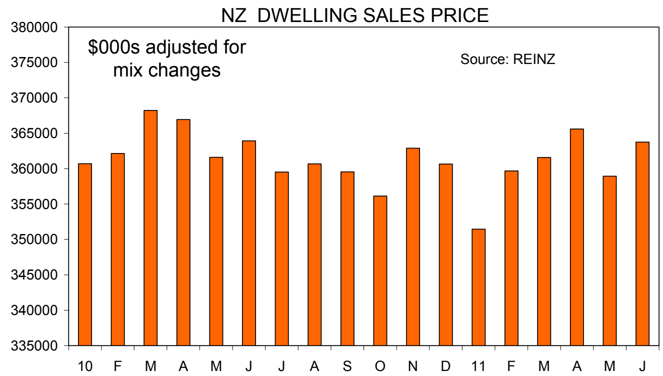
However, a reduced incentive to purchase a property to rent will mean less borrowing and that will mean interest rates lower than would otherwise be the case and that would mean a lower barrier to productive investment being undertaken. The problem there though is that although in theory this link sounds good, in practice the level of interest rates is rarely found to be a substantial determinant of business capital spending levels. It is confidence in the future which matters more.

Nevertheless, should there be a capital gains tax? Yes for purposes of equity. But those advocating a CGT should not fool themselves or others into believing the change will lead to the absence of boom/bust cycles, a large shift of investable funds into productive assets, or a decent rise in housing affordability. Any shift in where investment funds go will only happen slowly over a period of perhaps one to two decades. And to improve housing affordability would require a number of other stronger policies to be put in place including reducing the ability of local authorities to charge developers levies, opening up rural land for residential purposes, boosting competition in the building materials sector, and reducing the building code. None of these things are likely to happen and we remind people that very little happened as a result of the recommendations made in August 2008 by the Commerce Select Committee which examined the issue of housing affordability.

REINZ Data Show Activity Rising

Around New Zealand in June 5,288 dwellings were sold. This was a 14.3% rise from a year ago and although we do not have the latest REINZ seasonally adjusted data in hand would appear to be another month of a small seasonally adjusted rise by our rough estimates. Turnover appears to be improving. The stratified median dwelling sale price recovered 1.3% in the month after falling 1.8% in May and over the June quarter was ahead 1.5% from the March quarter showing annualised growth of about 5.8%. Prices are creeping up.





The days to sell gauge fell to 44 in June from 45 in May which was 6.7 days slower than average therefore not telling us that the market is especially strong – it is simply improving.

Are You Seeing Something We Are Not?

If so, email us at tony.alexander@bnz.co.nz with Housing Comment in the Subject line and let us know.

MAJOR OFFSHORE ISSUES

European Debt

The European Central Bank just made life a tad more difficult for debtor countries with a widely anticipated 0.25% increase in their cash rate to 1.5%. This makes the second increase in three months as the ECB reacts to inflation above their 2% target and anticipated pressures further down the track from strong growth in certain economies such as Germany. That means a further one or two rate rises are probable before the end of the year.

But the focus of attention with regard to Europe this week was increasing worries about Italy on top of deepening worries about Greece, with interest rates on Italian government debt shooting up to record levels above German bunds along with rises for Spanish debt. Partly the Italian debt selloff was driven by comments suggesting that the Prime Minister may have lost confidence in his Finance Minister. Then Moodys jumped in with a one notch downgrade of Irish government debt to junk status partly because of increasing signs that private holders of the sovereign debt of struggling euro-zone members will be asked to take some losses. Fair enough.

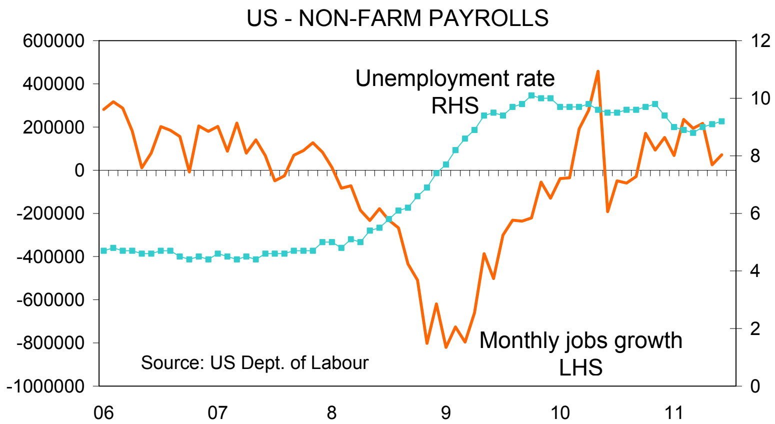
So for the moment things are getting worse. How much worse could they get? This Friday the results of the latest stress tests on European banks will be released and there are rumours that a number of German banks could be in trouble.

Chinese Inflation

Early news for the week out of China was that the annual rate of inflation rose to a slightly higher than expected 6.4% in June from 5.5% in May and 2.9% a year earlier. The large annual rise results mainly from a 14%+ rise in food prices (the rate was 3% without food) and it is expected that inflation will finish above the 4% target for this year. However prices rose only 0.3% in the month of June and 0.1% in May, while many other indicators for the economy show activity slowing well after surging over 2010 under pressure from loose bank lending conditions and a surge in infrastructure spending. Therefore, following the 0.25% rise in interest rates set by the People’s Bank of China last week it is likely that monetary policy will only be tightened another one or two times this cycle.

US Growth Momentum

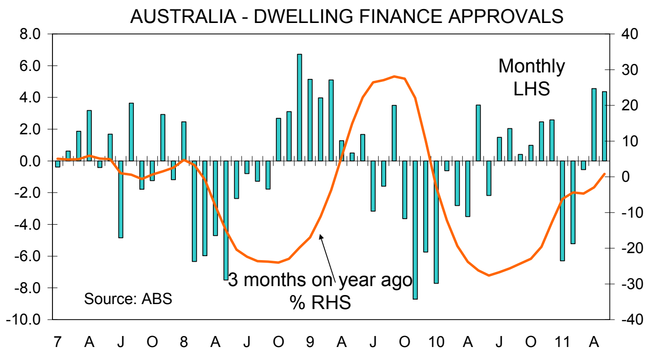
The tone of commentary on the US commentary has been getting more and more pessimistic over the past two months as economic data releases have generally turned out to be weaker than expected. This was the case in spades on Friday night when the monthly non-farm payrolls report appeared. It showed that rather than rising some 150,000 as expected job numbers improved only a miniscule 18,000 in June. More than that the increase reported in May was revised downward by 54,000 to only 25,000 and the April rise by 15,000. The unemployment rate has now clicked up to 9.2% from 8.9% three months ago.

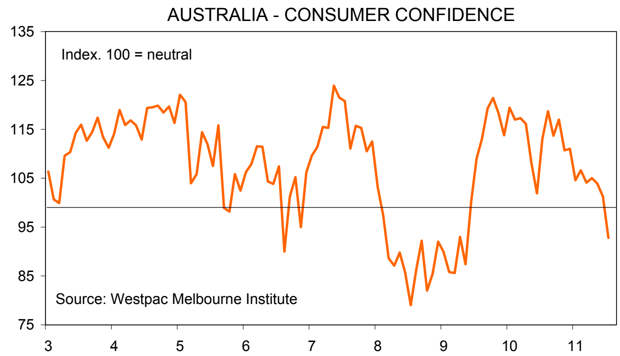


The result reinforces the fact that the US economy has yet to gain its own momentum even after huge monetary and fiscal stimuli since early 2008. The problem is that there is now no scope for lowering interest rates any further, printing of money over the past year has done nothing more than lower the greenback and boost some asset prices without encouraging businesses to hire or householders to purchases houses or goods, and fiscal policy now faces a tightening period stretching for many years. Hence talk last night about QE3 (quantitative easing episode three) is more a sign of desperation than anything.

Australian Growth

While most media attention during the week in Australia was on the plan to introduce a carbon tax and adjustments to income tax rates and zero tax threshold, there were some data releases as well. Approvals for housing finance excluding simple refinancing improved 1.1% seasonally adjusted in May after rising 3% in April and 1.1% in March. The slight upward trend in this series suggests that all is not bad in the Aussie housing sector and perhaps some people are getting used to interest rates having risen some 1.75% since the end of 2009.





But the more accurate underlying picture of the Australian economy outside areas directly linked into the mining and infrastructure booms is of slowing economic growth – especially with regards to household spending. This week we learnt that consumer confidence measured using the Westpac/Melbourne Institute survey fell sharply to its lowest reading since May 2009 at 92.8 from 101.2 in June where a reading of 100 is neutral. The result means that pessimists outnumber optimists and on that basis one has to expect weakness in both retail spending and the housing market over the remainder of this year.

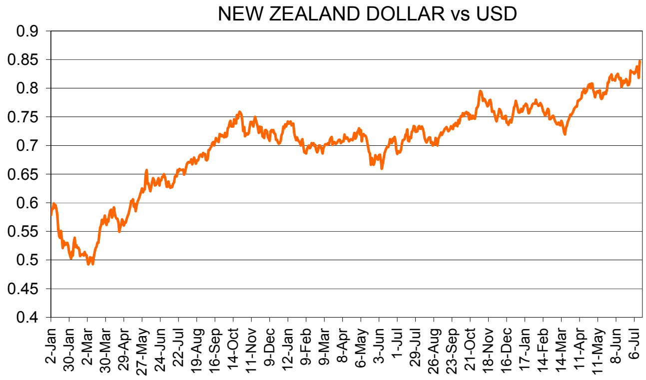
Exchange Rates

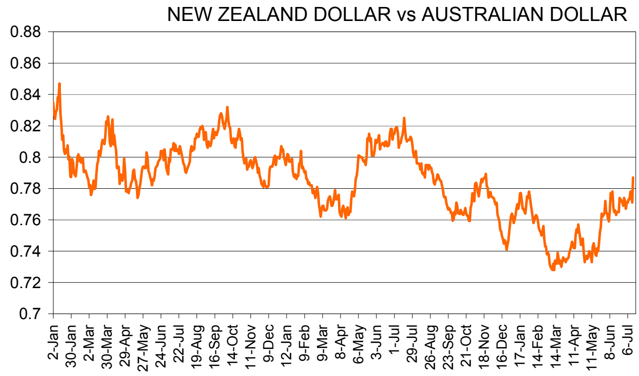
Exchange Rates	This Week	Week Ago	4 wks ago	mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.847	0.827	0.815	0.793	0.719	0.689	0.629
NZD/AUD	0.787	0.773	0.768	0.754	0.814	0.773	0.855
NZD/JPY	66.500	66.900	65.400	66.300	63.8	67.7	68.4
NZD/GBP	0.524	0.517	0.498	0.486	0.474	0.448	0.368
NZD/EUR	0.595	0.577	0.566	0.548	0.565	0.52	0.511
NZDCNY	5.478	5.348	5.284	5.181	4.869		4.83
USD/JPY	78.512	80.895	80.245	83.607	88.734	98.3	109.9
USD/GBP	1.616	1.600	1.637	1.632	1.517	1.54	1.705
USD/EUR	1.424	1.433	1.440	1.447	1.273	1.33	1.229
AUD/USD	1.08	1.07	1.06	1.05	0.88	0.891	0.737

*Sourced from Consensus Economics. http://www.consensuseconomics.com/

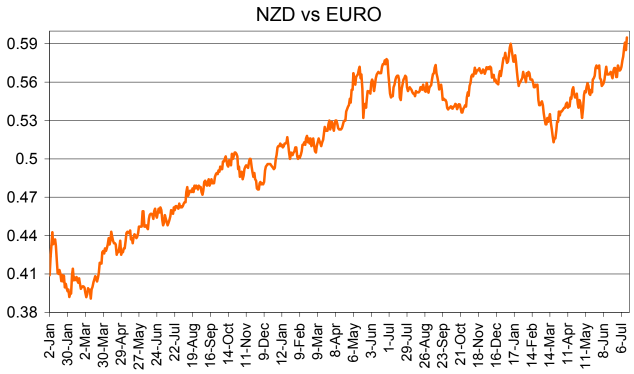
Kiwi At US 85 cents

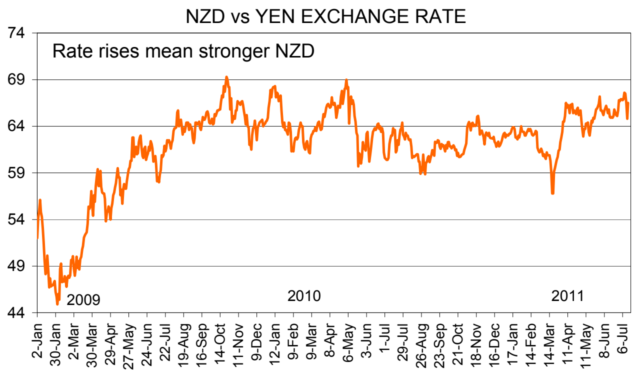
The Kiwi dollar traded above US 85 cents today after yesterday sitting near 81.8. The jump over the 24 hours was the result of weakness in the greenback associated with talk of more money printing, an easing off in some of the newly higher concerns about European debt, and this mornings far stronger than expected NZ GDP data. The data imply that NZ monetary policy may tighten earlier than thought and when set against the backdrop of rising expectations of rate cuts across the ditch help explain why the NZD is now near 78.7 Aussie cents from 77.3 last week.



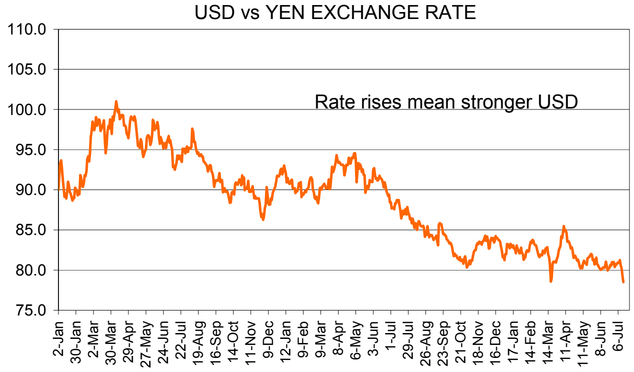


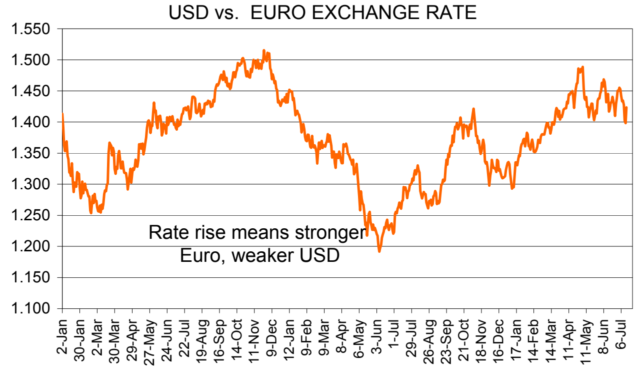
The Kiwi dollar has actually eased slightly against the yen over the week as the Japanese currency has benefitted from talk of US money printing (watch for the Bank of Japan intervening) and flight to quality out of the euro. The euro had fallen to a three month low against the greenback before the money printing talk shot the greenback downward.





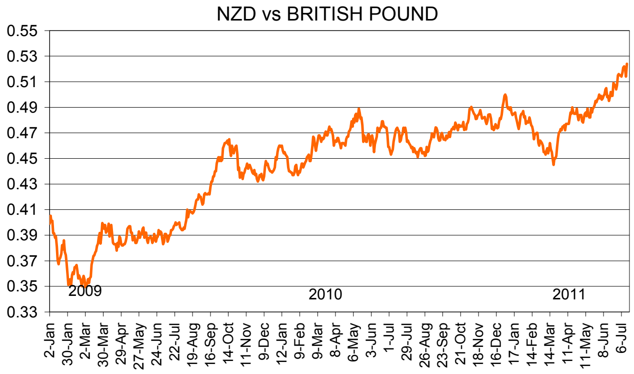
The FX markets continue to show high volatility and those engaged in it whether as exporters, importers, investors or travellers should be aware that all forecasts for rate movements need to be treated with a big sack of salt – even though the high volatility means most of the forecasts could actually prove correct for brief periods of time!

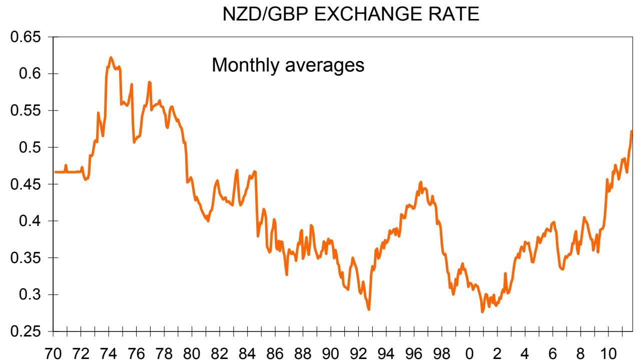




United Kingdom

In the UK this week we learnt that helped by deep discounting of retail goods the annual rate of inflation has crept down to 4.5% from 4.2% which coupled with weak data in recent weeks suggests the Bank of England is going to keep its hand off the 0.5% cash rate until sometime in the second half of next year. Given that by then we expect NZ's cash rate will have been lifted at least 1% it is not too hard to generate a forecast that the NZD will climb against the pound to 55 pence – unless commodity prices happen to collapse or the European debt crisis leads to a new banking crisis and threat of global depression. In fact 60 pence looks increasingly likely given this morning's NZ GDP numbers.





Exchange Rate Assumptions

Have I or have I not repeatedly pointed out how worthless exchange rate forecasts are? We call them assumptions but still people think they are forecasts. Consider how different the current level of the NZD is now compared with end-2011 numbers shown in the table below. Use any numbers indicating future currency scenarios at your peril. We shall update the table below one day but will note for the moment that we are happy with the risks indicated for 2011 except with regard to the NZD/AUD rate which has moved up rather than down.

	2010	2011	Risk	2012	Risk
Year end					
NZD/USD	0.73	0.75	Higher++	0.79	
NZD/AUD	0.74	0.77	Lower	0.86	
NZD/YEN	64.2	66		67.9	Lower
NZD/GBP	0.44	0.45	Higher	0.46	Lower
NZD/EUR	0.51	0.51	Higher	0.57	Lower
USD/JPY	88	88.0	Lower	85.9	Lower
GBP/USD	1.66	1.67		1.72	Higher
EUR/USD	1.43	1.47		1.39	Higher
AUD/USD	0.99	0.97	Higher++	0.92	Higher+

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.8%	2.3	4.5	2.0	3.0
GDP growth	Average past 10 years = 2.6%	0.2	-0.2	+1.5	-2.1	-0.2
Unemployment rate	Average past 10 years = 4.8%	6.6	6.7	......	6.1	5.2
Jobs growth	Average past 10 years = 1.9%	1.4	-0/4	1.8	-0.1	0.6
Current a/c deficit	Average past 10 years = 5.5% of GDP	2.3	2.2	......	2.8	8.8
Terms of Trade		0.9	0.8	6.8	0.1	-5.0
Wages Growth	Stats NZ analytical series	0.6	1.0	3.6	2.5	5.2
Retail Sales ex-auto	Average past 9 years = 3.9%.	0.7	0.0	1.4	1.0	-3.6
House Prices	REINZ Stratified Index	-0.7	-0.5	-0.7	5.5	-7.2
Net migration gain	Av. gain past 10 years = 13,900	+4,625	8,249yr	......	17,967	11,202
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	0.9	2.0	0.9	3.1	-2.6
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Business confidence	BNZ survey	57	42	18	26	18
Consumer confidence	ANZ-Roy Morgan 100=neutral	113	103	112	122	103
Household debt	10 year average growth = 10.3%. RBNZ	1.2	1.5	2.3	2.9	2.8
Dwelling sales	10 year average growth = 2.5%. REINZ	10.8	-4.2	-15.2	-17.2	43.9
Floating Mort. Rate	(TotalMoney) 10 year average = 7.9%*	5.59	6.09	6.09	5.59	6.49
3 yr fixed hsg rate	10 year average = 7.8%	6.99	7.15	7.15	7.95	5.99

All actual data excluding interest & exchange rates sourced from Statistics NZ.

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Key Forecasts

Dec. year		**2010**	**2011**	**2012**	**2013**
GDP	annual average chg	1.4	1.0 – 1.5	3.5 - 4.0	4.0 - 4.5
CPI	on year ago	4.0	3.0 – 3.5	2.5 – 3.0	2.5 – 3.0
Official Cash rate	end year	3.0	2.5 - 2.75	4.0 – 5.0	4.0 - 5.0
Employment	on year ago	1.3	2.0 – 2.5	2.0 – 2.5	2.0 - 2.5
Unemployment Rate	end year	6.8	6.0 - 6.5	5.0 - 5.5	<5.0

*extrapolated back in time as TotalMoney started in 2007