BNZ Weekly Overview

21 June 2012

ISSN 2253-3672

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.

Is Our Economy Getting Better?	**3**	**Housing Market Update**	**6**
What Do The Leading Indicators Say?	**4**	**Major Offshore Issues**	**6**
Interest Rates	**5**	**Foreign Exchange**	**8**

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 please click here.
http://feedback.bnz.co.nz/forms/Fx-I8ploskSGWgjN_7WOAw
To change your address or unsubscribe please click the link at the bottom of your email.

Long Rocky Road Ahead For Europe

The lesson of the Great Depression was that one must pay any price to make sure it doesn't happen again and help create the conditions which led to the Second World War. I recall noting almost four years ago that such a price could include spending two decades getting government finances back under control after using public balance sheets to their full extent to provide temporary insulation against the effects of the private sector cutbacks in spending.

That is, fighting a Depression scenario involves mutualising the problem away from important parts of the private sector to taxpayers. The thing is though that a couple of things need to happen during the period in which the fiscal stimulus is running through economies. First, governments need to address the problems which led to the private sector implosion in the first place. For some countries that may mean better supervision of the financial sector. For others it will mean addressing an economic structure not able to generate productivity growth and with insufficient flexibility to adapt to changing national and global circumstances.

Into that latter group one places the Mediterranean countries which partied up hard once they entered the Eurozone taking advantage of cheap interest rates delivered by market confidence in German membership of the group.

Second, the private sector needs to get its accounts in order to a sufficient extent that businesses once again are willing to hire and invest, while householders are willing to build and buy. In most countries around the world things have not reached that stage because the extent of the debt build up was so great, the depths to which house prices have fallen and wealth been decimated in some countries is immense, and rigid labour markets have prevented jobs growth.

The importance of this lack of enough public sector and regulatory reform and private sector rebuilding is that it has locked economies into a low growth high risk environment now that the short term artificial stimuli have been and gone. That is the stimulus to growth from countries slashing interest rates over 2008 - 09 has largely passed (except in the NZ housing market which was ripe for a rise anyway as we have long pointed out). The ability of governments to provide fiscal insulation and boosts to growth has ended because investors have reached the limits of their appetite for debt.

This is most evident currently in Spain where ten year government bond yields have now settled above the bailout-trigger level of 7%.

And then it gets worse. In Europe the Eurozone is an extremely poorly constructed currency union which cannot continue as it currently stands. But making changes along the lines of an overarching banking authority, mutualisation of banking debts through a European-wide deposit insurance scheme, and delivering fiscal control to a supranational body (controlled largely by the Germans?) is simply not going to happen in a smooth process as nationalism is once again on the rise.

Resentment within European countries against those they consider outsiders delivering negative impacts is growing. People either deplore the tax-dodging over-spending ways of Greeks, the controlling desires of the Germans, or the social impacts of Muslims, travellers, and even Chinese buying up increasingly cheap assets.

It is this rise in nationalism which is an outcome of the economic turmoil and unfortunately something increasingly likely to grow.

In the short term there appear to be no obvious solutions to Europe's woes, and in the long term the path toward greater integration may first of all require greater disintegration.

And then it gets worse again. In the United States the fiscal cutbacks have yet to seriously start. Last year politicians had only hours left to reach an agreement on raising the Federal debt ceiling or else Federal wages and bills would have started to go unpaid. The problem was solved by agreeing on a ceiling increase in exchange for putting in place automatic spending and taxation changes which will kick in from January 1 next year if no new package is agreed.

The trouble is that those tax increases and spending cuts from January will throw the US economy back into recession as they amount to about 4% of GDP. Yet it is difficult to see the relevant committees and politicians reaching agreement on another more spread out plan until after the Presidential election in November. Negotiations will once again go down to the wire and another period of major financial market turbulence could easily occur late this year.

And perhaps the worst thing of all is this. Politicians, with their limited understanding of what drives investor decisions in financial markets, business decision-making, and macroeconomics, think that just a wee bit more action from governments and central banks will be enough to solve the problem. But a key source of the current problem is a belief in the efficacy of government macroeconomic stabilisation measures, and a belief by investors, business and households (now less strong) that governments will always be there to act when times get tough.

We used to talk a lot in earlier years about what was called the "Greenspan put". This referred to the actions of previous Federal Reserve Bank Chairman Alan Greenspan in successfully cutting interest rates quickly when US growth was slowing and generating a new rise in economic growth and new lift in the sharemarket. He was always there to keep the ball rolling, even taking the cash rate to 1% in 2003 amidst worries about SARS and the US invasion of Iraq.

Educating the politicians in Europe and America about the limitations of macroeconomic stabilisation tools has yet to commence going by the way Europeans are looking for more government spending as a solution for their high debt problems. Educating the private sector about the inability of governments and central banks to guarantee growth probably also has a long way to go.

The unfortunate combination of

- nations squandering the opportunities for reform provided by the past four years of breathing space,
- the absence of government and central bank ability to repeat the stimulatory measures of late-2008, and
- low growth or recession having returned already to some economies

means very rocky times lie ahead for many years. And take note that we are not fault free in all of this. We can take pride in the reforms implemented from 1984 – 92 and how they left us well positioned to handle the

current global crisis. Thanks again to all involved. But we feel little personal pressure from the events offshore and that means there is no great constituency for further reform of the NZ economy now. In fact reforms have been few and far between since the early-1990s.

This means that we can look forward to some reasonable insulation from the effects of a newly deteriorating global economic environment due to the rebuilding of Christchurch, catch-up house building in Auckland, infrastructure spending, and long-term focus on rising demand for our primary products out of China and some other emerging economies. But our productivity growth has all but stalled and this is manifesting itself in the failure of our incomes to keep pace with those in Australia. There is a migration cycle with Australia which may well have peaked. But the average underlying net outflow has probably permanently increased. Our challenge will be to attract immigrants to offset this ongoing net loss across the ditch of our best and brightest seeking proper recognition of their motivation and skills.

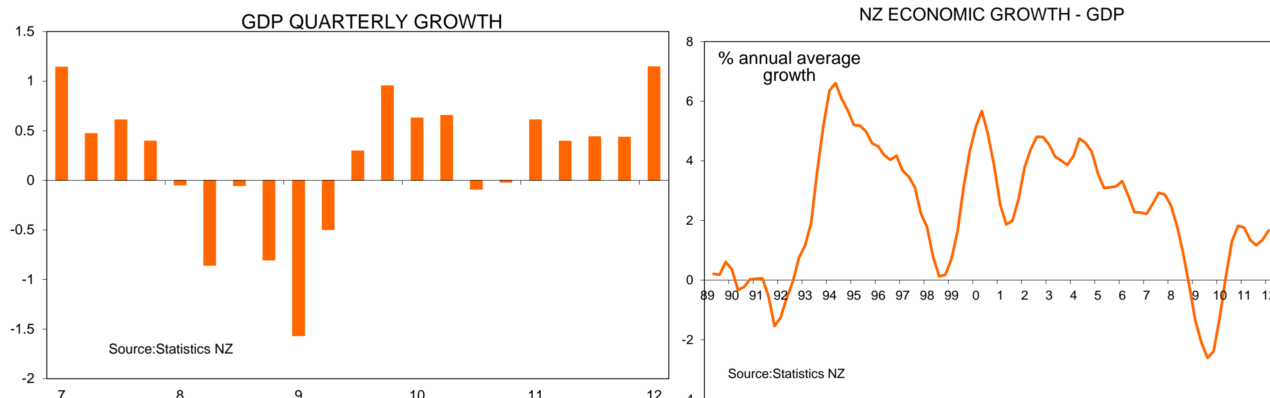
However we do not rank highly on the list of places people want to move to except ex-pats looking to settle down, accept less, shed some of their motivation, and raise a family.

Does this mean we are munted in the long term? Not at all. We will simply see a continued widening of the income gap with Australia, redirection of trade in goods and services plus capital flows away from Europe toward Asia and Australia (the United States as well – watch that space), and we will eventually supplant Tasmania as the bush-rich good rainfall farmlands nice place to live part of Australia's economy – but without the genocide.

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.

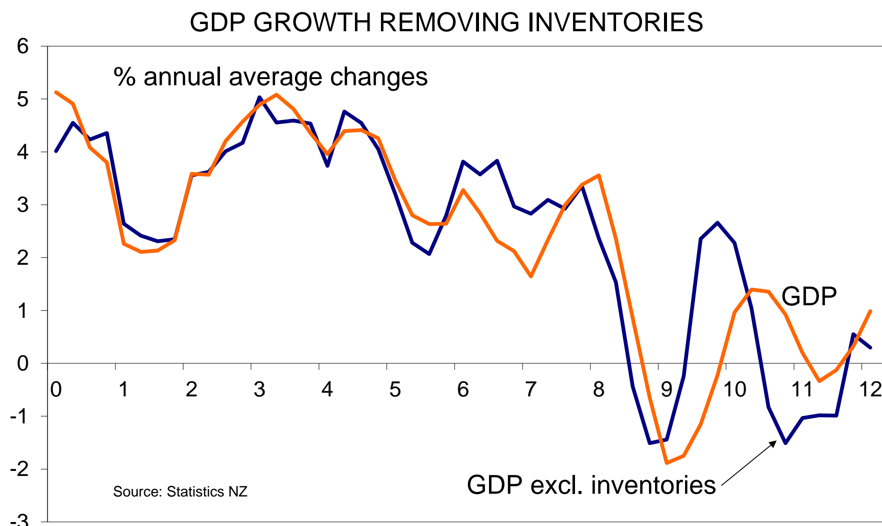
The data show that our economy rocketed ahead by 1.1% during the March quarter. This result was more than twice market expectations for a 0.5% rise in GDP and on the face of it says that our economy boomed. But all is not as it seems.



First, household spending rose by a miserly 0.1% following 0.1% growth also in the December quarter. The retail trade numbers may suggest good spending strength over the turn of the year, but these data show part of that growth was made possible by cutbacks in non-retail areas of household spending.

Second, exports fell 1.7% and that is hardly a signal that things are going right in the economy. But imports rose 4.1%. So what gives?

Third, all of the 1.1% growth and then some can be explained by a build-up in inventories. That is, stuff was produced or imported but went into warehouses and was not consumed. If we remove the stocks build-up GDP did not rise 1.1% in the March quarter. Instead it fell by 0.5%. And GDP did not rise 1.7% for the year ending March, it grew only 0.3%.



Therefore, while the GDP news was greeted by the markets reacting positively with the NZD rising above US 80 cents for a while and swap rates jumping, the actual underlying story is one of weakness in our economy. It will be interesting to see the stories over the next few days regarding GDP growth of 1.1% not being seen by the unemployed or retailers – or house builders as yet because residential construction fell 0.5% in the quarter.

Are householders opening their wallets more?

Nope. Private consumption rose only 0.1% in the March quarter.

Is business output rising?

Yes, but the production has gone into inventories.

Are businesses hiring more people?

Also nothing new.

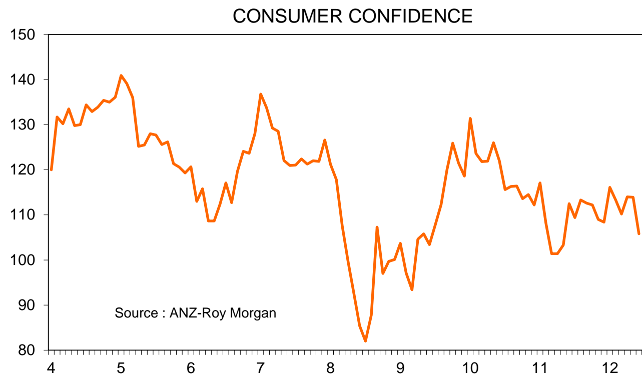
Are businesses boosting their capital spending?
For equipment no. Buildings = mixed.
To see how businesses are feeling right now one can read our monthly BNZ Confidence Survey here. http://tonyalexander.co.nz/bnz-confidence-survey/

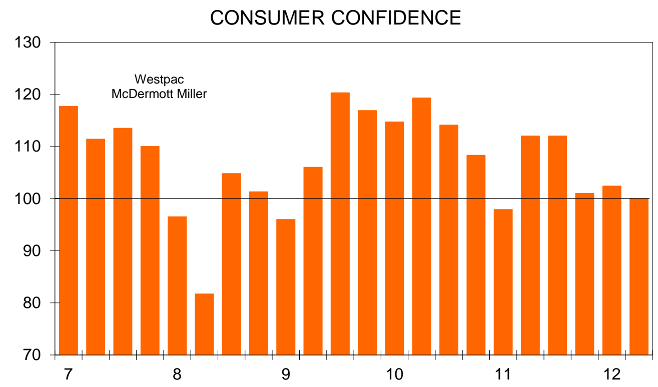
In stocks yes.

What Do The Leading Indicators Say?

In this section we look only at the factors which can at times give insight into where the economy is headed. Generally we will only cover newly released information.

Consumer sentiment has finally shown some reaction to developments offshore with the monthly Roy Morgan measure falling to a reading of 105.8 in June from 113.9 in May. This result is below the average for the past ten years of 1117 and one suspects the fall would have been much greater were it not for the falls in interest rates which have just occurred.





The less up to date quarterly version put out by Westpac also showed a decline – coming in at 99.9 from 102.4 in the March quarter.

In the short term there is no reliable correlation between changes in consumer sentiment and changes in consumer spending – so we await to see whether a downward trend is developing. The chances are that it is and that will be bad news for retailers who have been discounting sock simply to get turnover.

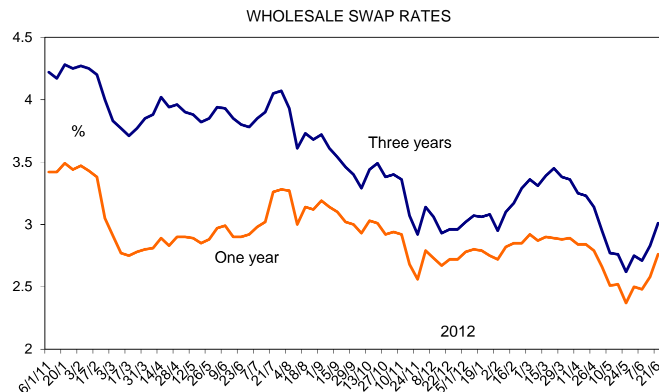
INTEREST RATES

Wholesale interest rates have bumped up this week in response to reduced worries about an imminent collapse in the Eurozone, European economy, and world economy following the Greek election outcome, plus this morning's seemingly good NZ GDP numbers. Does the rise in the likes of the three year swap rate to near a two month high near 3% from 2.83% last week mean that we have seen the lows in the fixed interest rate cycle? That is impossible to know. No-one predicted the sharp drop in borrowing costs a few weeks ago so it would seem unreasonable to expect that one can take a strong believable view on where rates are likely to go in the very near future.

We will see rates dip back again if the European situation deteriorates anew. It will at some stage but it is impossible to know if that new deterioration will happen tomorrow or in six months. We will see rates rise if things settle down in Europe and everyone makes nice.

As we have long pointed out here, interest rate predictability in this newly uncertain world is low and a person would be foolish to base interest rate risk management decisions on a particular set of interest rate forecasts. It is better to work out one's tolerance to completely unpredictable movements in rates and base hedging decisions on that tolerance.

That means that if you are a conservative borrower like me you will give high weighting to taking advantage of still unusually low fixed rate borrowing costs to reduce uncertainty about cash outflows. If you are comfortable taking a punt and can handle things if it goes completely wrong then sitting largely on floating rates may be optimal for you.



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	2.50	5.4
90-day bank bill	2.68%	2.63	2.73	2.76	2.68	5.7
1 year swap	2.76%	2.58	2.37	2.89	2.90	5.8
3 year swap	3.01%	2.83	2.62	3.45	3.80	6.1
5 year swap	3.36%	3.18	3.06	3.96	4.38	6.3

If I Were a Borrower What Would I Do?

I personally still like the three year fixed housing rate at 5.75% though most people will simply go for a floating rate given the lack of general comment about rates potentially rising in the near future. Choose whatever suits your risk profile. I fix.

HOUSING MARKET UPDATE

- **To view the most recent results of our monthly BNZ-REINZ Residential Market Survey click here.** http://tonyalexander.co.nz/bnz-reinz-survey/
- **I also write a monthly column on the residential property market in NZ Property Investor magazine available at your bookshop or newsagent.**

Nada

This week we have received no fresh information on the state of the housing market – but we wrote a lot last week so if you are hungry for commentary and analysis simply look up last week's Overview.

MAJOR OFFSHORE ISSUES

Europe

- In Germany investor sentiment has essentially collapsed with the ZEW monthly survey falling by the greatest amount in 13 years to a reading of -16.9 in June from 10.8 in May.
- Not only has Germany recently sold government bonds at negative interest rates as investors seek to escape exposure to dodgy European economies, so too have non-Eurozone members Switzerland and Denmark also recently sold bonds at below 0% yield.
- A new Government has been formed in Greece – now they will be off visiting European partners to see if they can beg more money having blown it all in the past decade or so.
- Spain is on the cusp of a bailout as government bond yields rise above 7%.

How did Europe get to this sorry state?

- Poor supervision of banks leading to over-construction of dwellings and massive bad debts which have been covered by governments raising debt to give or lend to the affected banks.
- Governments running deficits and building higher and higher debt levels.
- Investors failing to adequately gauge European debt risks and extending credit to governments at too low a level of interest rates.
- Banks in Europe being permitted to count sovereign debt as capital thus making financing of government deficits even easier while linking banking performance and balance sheet strength to government finances.
- A growing gap between German productivity and productivity elsewhere caused by Germany undertaking reform and wage restraint while others increased government intervention including labour market restrictiveness and welfare system expansion.

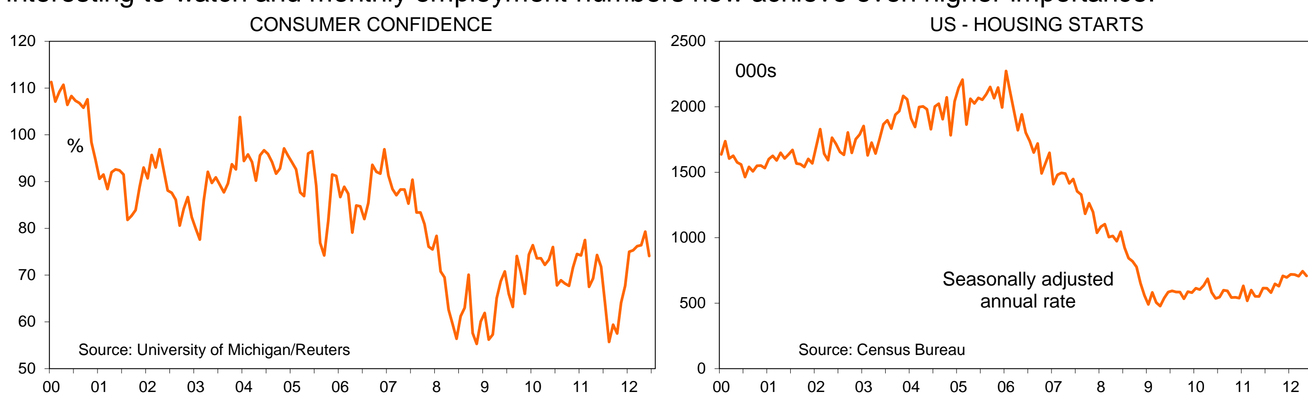
- Downplaying of the risks of Euro membership and discipline needed by smaller less competitive countries by Germany and France as they encouraged as many countries as possible to join the Euro.
- Poor economic management reflected in decades-long beliefs that fiscal stimuli could permanently boost growth rates and employment.

Australia

Nothing new worth writing about beyond lots of journalists losing their jobs as people switch to reading electronically (do it through www.pressdisplay.com)

United States

US consumer confidence measured by the University of Michigan monthly survey has fallen to a six month low with a June reading of 74.1 from 79.3. This level is still well above those seen just after the middle of last year when there were worries about the US economy re-entering recession. However the trend will be interesting to watch and monthly employment numbers now achieve even higher importance.



Speaking of important things, US housing starts fell 4.8% seasonally adjusted in May which was a weaker than expected result. The fall means that although the number of new house building jobs started was 28.5% ahead of a year ago, over the past three months growth has been only 1.1% compared with 7.6% three months earlier and 9.7% another three months before that. The upturn in house building appears to be stalling for the moment.

But while there is obviously a lot of attention on the usual data releases in the United States, the main point of focus this week has been on potential Federal Reserve actions. There was growing speculation that the Fed. will ease monetary policy again with some version of either a “twisting” exercise involving issuing short-term debt to limit long term debt issuance and get long term yields down, or outright buying of long term debt.

But if these exercises were going to work one suspects they would have done so by now. Plus the more ammunition the Fed. uses now the less it will have available for later this year or early in 2013 when debate about raising the debt ceiling once again almost certainly goes down to the wire and causes a selloff of risky assets and dent to confidence levels.

In the event, this morning we learnt that all that the Fed. will be doing is extending the time period of its existing twist operation until the end of the year. A damp squib but probably a realistic assessment of the uselessness of simply printing money which banks don’t want to lend and people either don’t want to borrow or cannot because their credit ratings make them untouchable. The Fed. have cut their growth forecast for this year from a range of 2.4% - 2.9% to 1.9% - 2.4%.

China

Chinese economic developments are now covered in our new publication “Growing With China”, the June issue of which was released today, June 21. If you wish to receive this monthly then please email me specifying your name, company name, and connection with China. Tony.alexander@bnz.co.nz

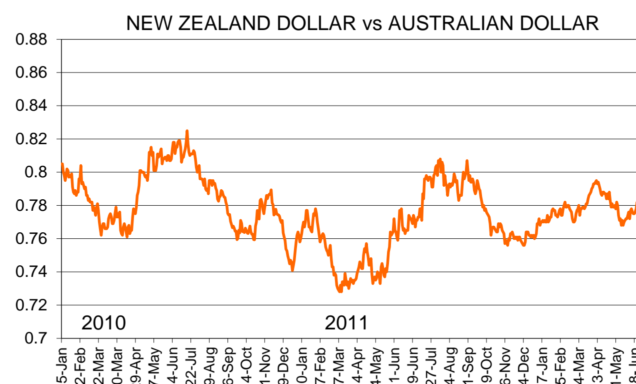
Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.797	0.778	0.756	0.817	0.809	0.67
NZD/AUD	0.784	0.780	0.768	0.779	0.765	0.85
NZD/JPY	63.400	61.700	59.700	68.400	64.9	69.6
NZD/GBP	0.508	0.500	0.478	0.515	0.499	0.388
NZD/EUR	0.628	0.618	0.591	0.618	0.565	0.52
NZDCNY	5.070	4.941	4.782	5.163	5.240	4.99
USD/JPY	79.548	79.306	78.968	83.721	80.222	105.7
USD/GBP	1.569	1.556	1.582	1.586	1.621	1.72
USD/EUR	1.269	1.259	1.279	1.322	1.432	1.28
AUD/USD	1.02	1.00	0.98	1.05	1.06	0.788
USD/RMB	6.3609	6.3507	6.3259	6.3189	6.4768	7.56

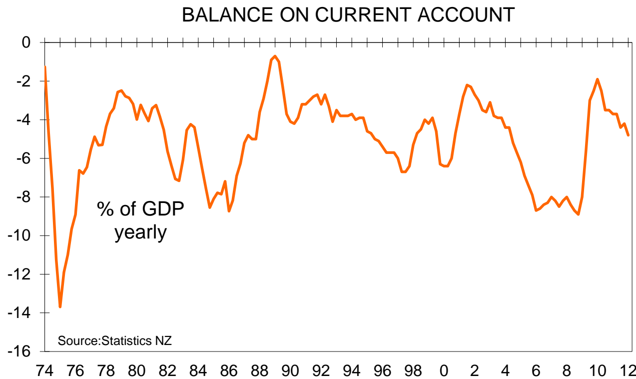
Back Near 80 cents

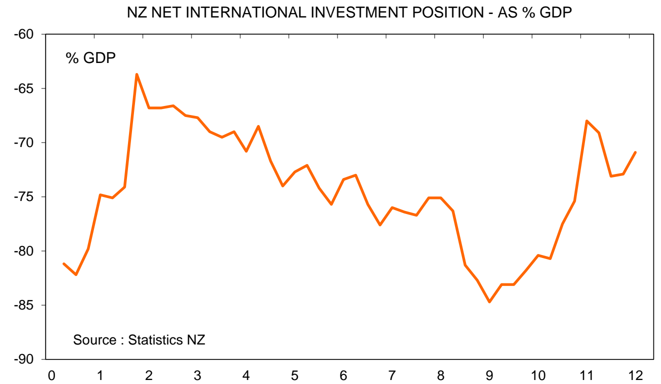
The Kiwi dollar has risen almost two cents against the greenback this week supported by the following factors.

- Riding the coat-tails of an Aussie dollar which broke through the parity level once again above the greenback and raced higher.
- Dairy prices falling only 0.5% at the fortnightly Global Dairy trade auction after rising 14% two weeks earlier.
- The victory for conservatives in Greece's second general election in six weeks reducing worries about imminent departure of Greece from the Eurozone.
- In their Monetary Policy Statement last week the Reserve Bank of NZ indicated they do not plan cutting the official cash rate again this cycle – though would if conditions became bad enough offshore.
- Lower than expected inflation data in the UK (2.8%) have raised expectations of additional UK easing measures. Hence the NZD back near 51 pence.
- This morning's much stronger than expected headline GDP growth number of +1.1%.



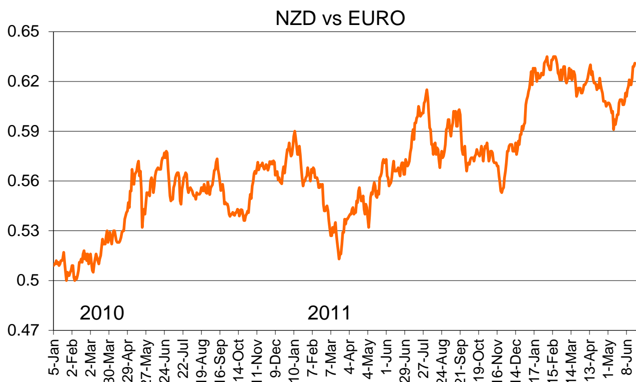
The Kiwi dollar has risen in spite of the release of worse than expected data on the state of New Zealand's current account deficit this week. The deficit in the year to March came in at $9.7bn or 4.8% of GDP compared with 3.7% a year earlier. A return of the deficit to levels above 8% of GDP last seen in early 2009 seems inevitable given the coming weakness for exports which will arrive courtesy of a deteriorating global economy, at the same time as imports are boosted by a sharp rise in NZ house building.

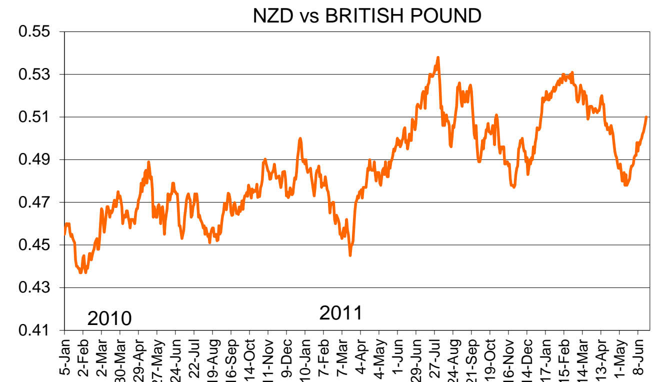




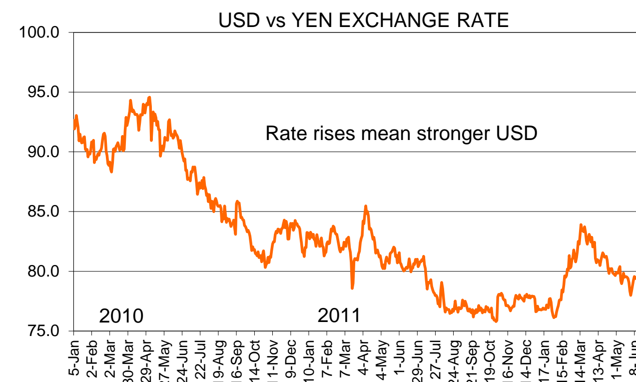
The question is when will this renewed deficit blowout lead to international investors aggressively selling the NZD lower? The answer is that the NZD has rarely if ever had its short, medium, or long term movements driven by changes in the current account deficit and the international investment balance which measures how much we "owe" to the rest of the world. The trend is completely unsustainable but there is no way of knowing when investor attitudes will change. In fact the NZD's trend is more upward than downward now on the back of bad currency alternatives overseas, good export mix to take advantage of Asia's rise, and avoidance of the problems which have beset many other western economies.

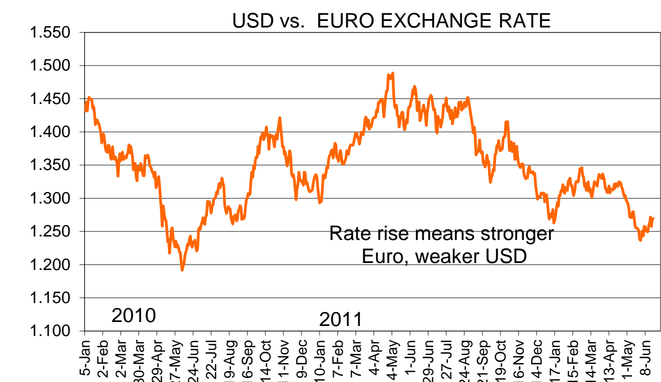
Sorry exporters, but much as current trends suggest the country will see another credit rating cut within 3 – 5 years, it would be unwise to bank on a substantial NZD decline either ahead of or even because of such a cut. All those punting on NZD depreciation on the back of our inability to pay our way internationally have been wrong for the past 27 years.

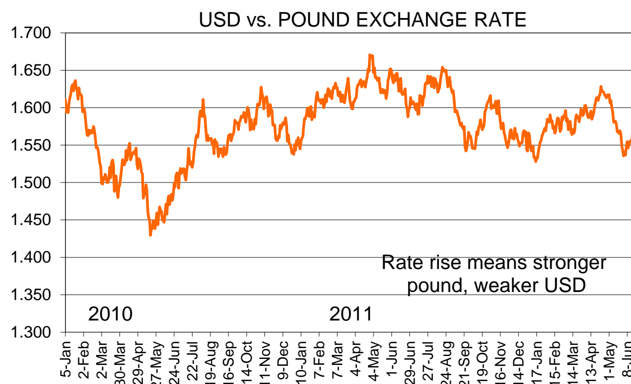




The USD itself has shed minor ground against the Euro and Pound this week because of a slight reduction in safe-haven demand.







If Europe looks worse in the coming week the USD will firm along with the yen while the NZD will weaken. If Europe looks better the opposite will happen – probably.

Key Forecasts

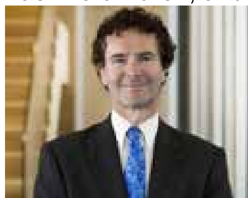
Dec. year		2010	2011	2012	2013
GDP	annual average chg	1.8	1.3	1.5 – 2.2	2.5 – 3.5
CPI	on year ago	4.0	1.8	2.0 – 2.6	2.5 – 2.9
Official Cash rate	end year	3.0	2.5	2.50	3.00 – 3.75
Employment	on year ago	1.3	1.6	1.0 – 1.7	1.5 – 1.9
Unemployment Rate	end year	6.8	6.4	6.0 – 6.5	5.0 – 5.6

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 26,000 subscribers each week and is one of a stable of regular releases which include the

- monthly Growing With China publication, http://tonyalexander.co.nz/topics/china/
- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/ and the
- monthly BNZ-REINZ Residential Market Survey. http://tonyalexander.co.nz/topics/surveys/bnz-reinz-survey/ This latter survey provides information from a survey of over 10,000 licensed real estate agents on the current state of the residential property market in New Zealand.
- He has also written a weekly newspaper column since 1998, http://www.stuff.co.nz/business/opinion
- writes a column for the Farming Show posted at http://www.farmingshow.com/opinion/
- produces a monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.co.nz/ and
- writes a monthly column for the NZ China Trade Association. http://www.nzcta.co.nz/

Most of these publications plus research into impediments to NZ's economic growth are available on his website. www.tonyalexander.co.nz

Tony Alexander has been Chief Economist at the BNZ since 1994 and apart from publications and advising management spends considerable time on the road around New Zealand making presentations and speaking with the media. He travels to the UK and Europe twice a year to assess economic conditions and present at numerous functions, has five children, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com



Tony.alexander@bnz.co.nz Ph 00644 474-6744

This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.