BNZ Weekly Overview

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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.

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.
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Dry Gunpowder Gone

In a country the institutional and regulatory environment which a government imposes aims at reflecting what they perceive to be their people's desire for the extent of the trade-off between unfettered dog eat dog capitalism and social equity. The rule here is that no two countries are the same and a policy framework which works for one set of people and circumstances may not work in a different country where people hold different values, where economic strengths and weaknesses are different, and where linkages with other countries and peoples are not the same.

Thus, blind adoption in New Zealand of policies used over decades in Singapore would not be appropriate because we are unwilling to accept as much state paternalism having come to this country in the 1800s to escape those telling us what we could do and where. Copying Ireland's 10% corporate tax rate would not have been much good because we do not face a wall of companies looking to locate somewhere in our region to service near 400 million clients nearby, and because we think such a big difference between company and personal tax rates is unfair.

Adopting Chinese-like state dominance of all sectors except export manufacturing would not work for us (no sane person has of course proposed it) because easy rents to be earned on our development path disappeared a long long time ago. In contrast in China the Beijing government can corral the profits from its SOEs and ignore the building capital misallocations because numbers gaining from China's low-start growth path still hugely exceed losses.

But this week's front piece is not actually about the economics of growth and development. I just wanted to put those items in first of all to say that from here on when I write about government policies it will be about those aimed at insulation against shocks and not those aimed at promoting long term growth. They are not the same (though these is regulatory crossover).

Leading up to the 2008-09 global financial crisis central banks proved reasonably effective at curtailing periods of weakness through monetary policy easing and countering the risk of high inflation becoming locked in with policy easing. Governments would sometimes make good counter-cyclical use of fiscal policy to offset weakness though a rule of thumb developed over time that the chances were that by the time a government diagnosed a problem, developed strategies, implemented them, then had them working, the economy would probably already be lifting. That meant counter-cyclical fiscal policies developed a tendency to aggravate economic cycles rather than smooth them.

Such was not the case with the very strong policy responses to the GFC. Central banks slashed interest rates and where relevant eased asset ratio requirements, governments boosted spending, cut taxes and gave handouts, with the result that by the June quarter of 2009 it was clear that the feared repeat of the 1930s Great Depression had been avoided. So far so good.

But hopes that the private sector would be back on sound footing fairly quickly have proved continually misplaced since then and even central banks which raised interest rates when growth was strong have had to reverse those rises in part, whole, or more than whole in the cases of the Australia, New Zealand, and the Eurozone respectively. Governments have found growth insufficient to comfortably boost tax receipts and cut spending to the point where previous surpluses or small deficits re-established themselves.

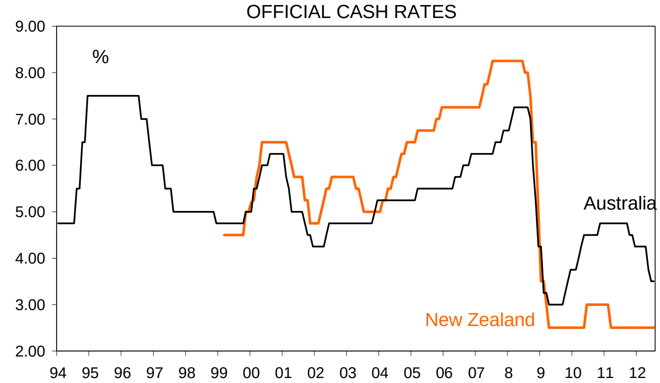
So now we face a situation where almost four years along from the Lehman Brothers investment bank collapsing and six years down from house prices in the United States starting to fall the deleveraging process which was initiated or accelerated by that event is continuing. That is, businesses, households and banks around the Western world are continuing to restrain themselves in order to get debt ratios down. Governments have tried but by and large their debt ratios continue to deteriorate and their deficits remain big though in most cases much less than immediately after late-2008.

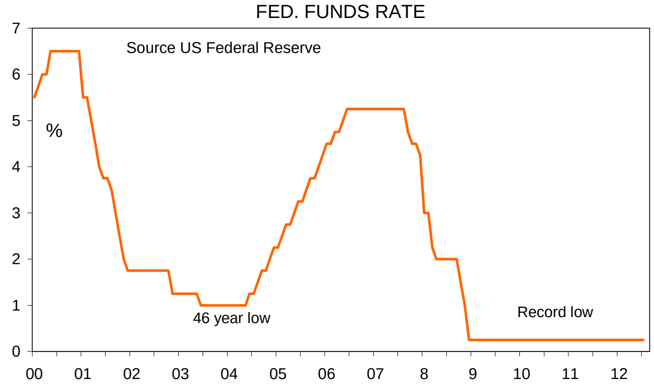
With growth not just weak but newly weakening in Europe and the United States, the IMF this week describing the Eurozone as being in “critical” danger, and with the risk of a new financial markets implosion growing in Europe we have to ask ourselves the following. What weapons are left for trying to buy a bit more time for the private sector deleveraging to finish – acknowledging that we have 100% no idea how much time is needed?

Interest Rate Cuts

One option is to push interest rates lower by cutting the overnight cash rate banks can earn by depositing spare cash with the central bank rather than lending it out to another bank or to customers. Lower interest rates tend to reduce the incentive for people to save and encourage borrowing to buy and invest while pushing up the prices of assets which can be funded through debt such as houses and shares.

Interest rate cuts proved quite effective over 2008-09 in reducing business and household debt servicing costs thus freeing up cash which could be used either to buy things or to reduce debt – thus shortening the period of time over which deleveraging would occur. In New Zealand the central bank took its cash rate from 8.25% to 2.5%. The Australian Reserve Bank cuts its rate from 7.25% to 3%. The US Federal Reserve funds rate went from 5.25% late in 2007 to 0.25% by the end of 2008. The Bank of England rate went from 5.75% at the end of 2007 to 0.5% in March 2009. The European Central Bank cut its rate from 4.25% in October 2008 to 1% in May 2009. Japan took their rate from 0.5% to 0.1%.





Can these weapons still be used to assist the world now? Not really. Japan still has a 0.1% rate so was not able to rebuild any interest rate buffer. The United States has similarly failed to create any dry gunpowder with their rate still only 0.25%. The Bank of England rate also remains at 0.5%. The strong growth in Australia allowed the RBA to take their rate from 3% to 4.75%. It has since been cut to 3.5% thus leaving a good buffer still for our biggest trading partner which is quite important for us.

The European Central Bank was able to raise its rate 0.5% to 1.5%. But they have since November last year cut it to a new low of 0.75%. Here in New Zealand our central bank was able to get its cash rate up to 3% but had to cut it back to the record low of 2.5% thus leaving a bigger buffer than in the major economies.

But the central point to note here is that there no longer exists a strong interest rates weapon with which to fight any new shock to the world economy or to accelerate by much the private sector deleveraging process.

Quantitative Easing

This is the technical name for printing money, which does not actually involve physically printing money as such. The way it happens is this using the United States as an example. The Federal government runs a deficit of say $100bn which it will finance by selling $100bn of bonds to private investors like pension funds. So an extra $100bn goes into the economy through paying salaries of public servants say, and $100bn goes out of the system from accounts in banks of the pension funds. Now say that instead of the funds buying the bonds the Federal Reserve gets in first and snaffles them up. In that case you have the $100bn of salaries in the system, but no withdrawal of $100bn from any private sector accounts. All that happens is that the Fed. records itself as owner of $100bn of bonds. The $100bn left in pension fund bank accounts is the printed money, the quantitative easing as it were.

The hope is that this extra money will stimulate growth as banks seek to lend it out and people and businesses seek to borrow it to spend or invest in plant, machinery, systems and buildings. But after QE1 and QE2 all that has happened in the United States is that the banks haven't wanted to lend the extra money out, people haven't wanted to borrow it, so the banks have either put it on deposit with the Federal Reserve to earn 0.25%, (over $1tn worth versus near $4bn pre-crisis, yes that is trillion versus billion) or the pension funds look to buy assets other than the bonds they missed out on. Hence they buy shares, commodities, foreign currencies and so you get the US Dow Jones Index pushing upward while the economy's prospects get dimmer and dimmer. Ridiculous.

Europe is different in that the European Central Bank is reluctant to directly buy government debt (though it has purchased €212n worth since 2010) so its quantitative easing has come via giving banks essentially whatever amount of money they want, and that amounted to some €1.2tn earlier this year – to no effect because banks have also placed the money right back again with the ECB and even last week's introduction of 0% for those funds on deposit with the ECB is not expected to lead to a rash of bank lending to the private sector. European bank deleveraging looks like running for years.

So printing money is good for boosting asset markets and that is about that.

Fiscal Policy Loosening

Fiscal policy is all about how much a government spends and where, and how it gets money in order to undertake the spending. A key lesson of the Great Depression was that governments had an ability and a duty to counter the effects of a massive private sector contraction in activity by temporarily altering their spending and taxing in order to boost aggregate demand for a while and buy time for the private sector to get accounts back in order in a less weak environment than would otherwise be the case. Governments therefore rightly attacked the 2008-09 depression risk by increasing spending and cutting taxation.

But raising spending and cutting taxes means either running smaller surpluses or bigger deficits. If the latter (hardly any government but our own and Australia's entered 2008 in surplus) then the government needs to fund its increased deficit by selling bonds to savers. In a world where people felt that the private sector had become unsafe that funding did not present many problems over 2009 and into 2010. But a few months into 2010 with deficits still holding high, economies not as strong as hoped for, and government debt rising strongly with escalating liabilities often related to bank guarantees investors began backing away from buying bonds as willingly as previously.

This manifested itself mainly in Europe with the benchmark being 7% yields on ten year government bonds in Portugal, Ireland and Greece just before bailouts were agreed. These bailouts involve willing parties agreeing to buy the bonds of governments which private sector investors don't really want or which they will continue to buy/rollover only at rates (debt servicing costs) so high that shrinking the deficit becomes a near impossible task.

In Europe the message from investors is that they are not willing to keep raising their holdings of the debt of already heavily indebted and economically inefficient countries such as Italy and Spain in particular. Instead they have been shifting funds they want placed in government securities into bonds issued by northern European governments such as Germany, lowly affected countries with better fundamentals like New Zealand or Australia, or bonds issued by the US Federal government.

The message here is that the ability of European governments to buy more time for the private sector to get its accounts in order using fiscal policy has almost completely gone. Scope does still exist in Germany – hence there is pressure for the Germans to enact a stimulatory programme. In theory the United States could ease fiscal policy but in reality that cannot happen because while for the moment debt funding is no problem there is a crunch coming up. US Federal debt is near 100% of GDP compared with 87% on average through the European Union, the Federal deficit is near 8.5% of GDP, and the government only collects near 60 cents for every dollar it spends. There is a very difficult fiscal tightening ahead in the United States.

Here in New Zealand the deficit is running near 4% of GDP this year and a surplus is targeted for 2014/15 though highly unlikely to be achieved. Pressure to achieve a surplus is strong but driven not by investors demanding quick removal of deficits. Instead the driving force is a need to create fiscal buffers against future economic shocks (earthquakes, floods, foot and mouth), and build some assistance for the future fiscal burden of an aging population.

In China the fiscal policy weapon can still be used with central government debt only near 26% of GDP (44% including local government debt).

Outside of China and Germany the fiscal policy option to buy time for balance sheets to heal has fairly much disappeared.

Credibility

If citizens believe that their leaders have the answers to their problems they are less likely to make radical changes in their lifestyles. Even if times are tough and uncertainties high businesses will tend to maintain staff numbers, hiring and capital spending in anticipation of tough conditions proving short-lived. Householders will tend to cut back only slightly on their levels of expenditure believing that they will be earning enough not too far down the track in order to service debt and continue building reserve savings targets.

But if people believe their leaders are powerless, inept or uncaring they are more likely to retrench thus making an economic downturn even worse. In Australia the media commentary is generally anti-government because of business discontent with the introduction of the carbon tax and minerals rent tax and inability of the two main parties to agree on a solution to the refugees issue. This lack of leadership confidence may help explain why outside of mining and infrastructure Australia's economy is weak.

In New Zealand we have voted against strong leaders with plans for big changes since the early-1990s with few people wanting to repeat the turbulence associated with the economic changes of the 1980s. However we tend as people to give very strong benefit of the doubt at least to whoever is Prime Minister, and as a passionless people (John Mulgan, Man Alone) tend not to take to the streets and openly debate in fiery manner our political preferences and desires. Much as we like to take the proverbial out of them, I don't think we can rate any of our leaders over the past couple of decades as incompetent.

In Europe confidence in leadership appears extremely low. Voters have thrown out governments in charge when the crisis struck in 2008, in some countries they are opting for the political extremities, discontent with and mistrust of the north by the south and the south by the north is growing, and not a single person accords credibility to the European Parliament as a body for solving any of the current problems. The leaders appear not even to grasp the true nature of the problem – unwillingness of investors to fund deficits – believing that just a little bit more policy easing will buy enough time for things to cyclically turn right.

In the United States leadership credibility also appears low with President Obama losing support from the superstars and many normal constituents who lauded his victory in 2008, both houses of Congress having already failed to develop a credible deficit-reduction plan, both Presidential candidates refusing to produce detailed deficit-attacking strategies, and the economy failing to spark. This lack of leadership confidence and seemingly widespread business sector mistrust of the sometimes anti-wealth President Obama may explain why in spite of sitting on large cash reserves US corporates are refusing to hire, invest and gear up as they could. Analysts are also noting that uncertainty regarding the coming fiscal cliff may explain why for the past three months retail sales in the United States have fallen at an annualised pace of almost 1%.

In China there are no opinion polls upon which to gauge popular support for the CCP, (can one imagine such a thing!) and looking in from the West with a Western viewpoint it is impossible to gauge the true depth and potential follow-through of discontent popularly expressed via Sina Weibo, through mass disturbances, and petitioning in Beijing. But with the CCP having overseen in three decades the biggest eradication of poverty thus planet will ever see, having restored much national pride, with incomes rising around 14% per annum, and easy ability to rally people through the current South China Sea islands disputes it seems unlikely that leadership confidence will collapse in a way greatly detrimental to Chinese growth in the near future.

The important element in this discussion of leadership credibility is this. In the two parts of the world where it matters the most for getting out of the lingering after-effects of the 1990s-2000s debt binge – Europe and the United States – political capital of the leaders is low. That therefore acts to lengthen the adjustment period and renders weak any initial response to a new grand plan which might appear. In fact lack of credibility means few leaders are likely to even attempt presentation of such a plan.

State-Owned Enterprises

If governments own businesses they might choose to instruct them to boost hiring and investment during a period of economic weakness. Thankfully such practices are essentially illegal in the Western world as legislation focuses on the visibility of everything politicians do and for reasons of economic fairness and efficiency limits the activities of SOEs – be they wholly or partly state owned. This is not the case in China where SOEs dominate every sector in the economy except manufactured exports which is dominated by foreign-owned enterprises.

Chinese SOEs account for near half of GDP, the top three produce more profit than the top 500 private enterprises, they receive near 80% of all bank finance – and that is where China has a hugely effective though economically inefficient economic stabilisation tool which was deployed effectively (and inefficiently) from 2009-11 and may be employed again to counter slowing export growth in China.

Largely I have included reference to this SOE growth-insulating weapon not because it has any relevance to the current situations in the United States or Europe but because it is hugely relevant in China and discussed in this month's Growing With China issue which will appear on Monday to subscribers and at www.tonyalexander.co.nz

Regulatory Changes

You can't just legislate good times back again or force people to spend, invest wisely, and for businesses to hire and raise capital spending. But you can alter incentive structures and expected returns so that productivity growth is boosted. This revolves around removing distortions to prices of goods and services, capital and labour, removing privileges for selected groups, enforcing rule of law, minimising uptake of resources by government enterprises with their political motives, and promoting low cost movement of resources from one place to another. Thatcherism. Rogernomics, Reaganomics.

But in most instances the cost of removing privilege occurs before the benefits. Therefore when we look at countries like Italy, Spain, Greece and Portugal where barriers to efficient trade are being so remarkably unwillingly dismantled, we see layoffs and business closures. Only in the undefinable long run will the changes lead to new more entrepreneurial businesses starting up, more efficient allocation of capital etc.

The deregulation occurring in the Mediterranean countries is absolutely vital for their long term survival. But in the short term the changes make their economic condition worse. Not that all regulatory changes are negative in the short term. Taking away barriers which act to stop businesses hiring and expanding but do not afford privilege to any group can immediately help growth. Options include aggressively raising tax thresholds, slashing bureaucratic burdens on small businesses in particular, easing zoning restrictions and consent processes – basically stripping away measures put in place during stronger times when firm growth allowed such burdens to be imposed in the interests of pursuing goals in areas like social equity and environmental protection. Sometimes such things have to go out the window for a while to allow the strong economic base to be restored.

And if all of this were not bad enough, all we have done in this article is approach the topic of weak world growth as if the problem were cyclical in nature. In the United States that may not be the case with increasingly deeply entrenched unemployment, massive declines in household wealth, and falling real incomes for the middle class. An increasing number of articles are appearing in the likes of the Wall Street Journal considering the question of how much the current US weakness reflects a secular decline in productivity and therefore income growth.

In Europe while the leaders appear to believe the problem is simply cyclical, in truth a lot of it is to do with one of the key planks of the long term movement together of European economies and countries completely failing – the Eurozone. It was supposed to lead to convergence of the competitiveness of the included economies. Instead their competitiveness has diverged. There is increasing talk of the south of Europe being simply too different from the north, and of borders being thrown back up again to stop increasing economic refugee flight and flows of Muslims in particular.

Sorry Virginia, but sometimes there is not a Santa Claus. Or, for you other Alien movie fans (second film),
Newt: My mommy always said there were no monsters - no real ones - but there are.
Ripley: Yes, there are, aren't there?
Newt: Why do they tell little kids that?
Ripley: Most of the time it's true.

Most of the time governments and central banks in the western world have had the capacity to limit the duration of cyclical downturns in the private sector since the 1930s. Now they do not. This current situation of weak growth in the United States and Europe looks like continuing for many years. Get used to it. Build resilience into your business structure and investment portfolio, and ponder how to benefit from the Asian Century. Read my Growing With China publication!

Economist Bellwether Series Conference In Sydney

Last week I attended one of the Economist Bellwether conferences held in Sydney (you HAVE to get out of cosy laid back NZ to get a proper feel for the situation offshore) and the main things I picked up from it include the following.

- No-one had anything positive to offer regarding the short to medium term prospects for European Union growth and there was mainly scepticism regarding the ability of policy makers to do anything about it or even understand the true nature of the problem. That true nature involves investors from the north who previously were happy to have exposure to borrowers in the south now wanting their money back and forcing financing requirements onto either national governments, bailout funds, or the European Central Bank. So what Europe is suffering is largely a banking crisis which has highlighted other deep structural problems.

- The Eurozone was supposed to promote convergence among members' economies. Instead there has been divergence.
- Only recently have officials shown that they understand that the problem is more than just trying to offset a weak economic outlook through monetary and fiscal policy adjustments.
- European banks are undercapitalised compared with US banks. Europe needs a US TARP-like scheme rather than inflicting a death by a thousand cuts over a long period of time.
- Competitiveness of the southern economies needs to be lifted and as that will switch current account deficits to surpluses this will address the financing issue in conjunction with weakness in the Euro. It was these comments from a person dialling in from Brussels which caused despair in many quarters because it showed lack of understanding of the financing problem – especially rolling over existing debt, and lack of awareness that in this slow growth world exporting your way to greatness at the same time that others are trying it will not work.
- The Brussels person's comment regarding competitiveness gaps improving if Germans simply accepted inflation 1% higher each year was not considered a useful strategy as shrinking the 20% - 30% gap would take 20 – 30 years.
- A banking union involving a central overseer of Eurozone banks will take at least a year to set up and possibly longer because of the territorial disputes which will arise in the formation of an over-arching banking authority between bodies including the ECB, European Commission, national banking supervisors, and national finance ministers.
- It is likely that eventually the bailout fund (when set up and running) will be instructed to purchase government bonds on the secondary market. However the German constitution prevents mutualisation of national debts as such. Resolving the conflict will be difficult.
- It is not true that Germans don't want the Euro. Most polls show Germans still support Euro membership.
- There is probably a less than 50% chance that Greece will leave the Euro.
- In the 1930s deleveraging forces in the private sector were underestimated and that meant the crisis went on a lot longer than expected and stimulatory policies were less effective than anticipated. The ECB's $1.2tn LTRO is being swamped by this deleveraging.
- Such deleveraging includes European banks pulling loans out of Asia and Eastern Europe.
- Current negative interest rates in some countries are not sustainable. They reflect something being seriously wrong with the global financial system.
- Credit growth has stalled in Western countries and will remain weak but is about 15% p.a. in East Asia.
- More debt monetization by central banks (money printing, quantitative easing) is highly likely.
- Given low returns in the West capital is flowing into Asia. However the Asian authorities are worried about such flows quickly reversing at some stage down the track.
- Deposits in Greek banks have halved and ECB Target 2 lending to Greek and other southern European banks has soared. Basically money is flowing from Germany, the Netherlands and Finland into other Eurozone members.
- A coming problem will be that once private sector deleveraging has ended central bank deleveraging must commence. The movement of funds out of the financial system as this deleveraging occurs will undermine growth. (Maybe monetary policy tightening will come via this route rather than cash rate increases in the early stages of a sustained recovery – Ed note).
- EU banks have an exposure in Asia of about $1.3tn which is 3-4 times the size of US bank exposure.
- It is not possible to give a time line for when things will improve globally until the European banking problem is off the table.
- The Barclays rate-fixing scandal has anew slammed confidence in the banking system and in the regulatory authorities.

China

- Banks in China are highly liquid as citizens have nowhere else to put their money – except housing.
- The Chinese authorities are worried that financial scandals are impeding development of capital markets. Equity and bond markets are very undeveloped in China, most financing comes from banks and in a country where banks are state-owned and explicitly tasked with implementing state policy on financing state activities, most bank lending goes to SOEs.
- This year's political changes involve an aged Shanghai crowd moving out and a younger lot coming in.
- Inward FDI to China is decreasing and that is bad for productivity growth.

- China is aware that if they let the Yuan rise strongly as Japan did with the Yen then they could precipitate an export collapse then economic stagnation as has gripped Japan. The Chinese authorities are determined to avoid this therefore currency reform will be gradual with a primary focus on stability.
- The Chinese focus on security when investing offshore and not yield maximisation. Therefore they are very unlikely to invest in European banks unless they become astoundingly cheap. This means that with China sitting on the bulk of the world's currency reserves global financial markets are not functioning as they normally would. This means the structural financing problem facing European banks is greater than if say the FX surpluses were held by the United States or Asian countries outside of China.

Australia

- Some 80% of Australia's government debt is held offshore.
- Low interest rates will be around for a long time and this is bringing problems for insurance companies and pension funds.
- Australia's cash rate is 1.5% lower than would otherwise be the case because of structural increases in bank funding costs domestically and offshore.
- The Australian dollar is not fundamentally over-valued and is about where one would expect it to be with the terms of trade only just down from the highest level in 150 years.
- Access to finance does not appear to be a constraint on growth in Australia.
- Credit growth is not necessarily sluggish currently – we just think it is because growth was so extraordinarily strong in the previous one and a half decades. Household credit is expected to grow at a similar pace to household income. This affects retailing and housing in particular but is the new normal.
- The European crisis has three main negative impacts on Australia. The first is financial via a higher cost for banks of funding in Europe and reduced availability of funding. The second is via reduced export demand. The third is a confidence and wealth effect due to media obsession with financial news.
- Australia's political relationship with China has not kept pace with its economic relationship.
- In 1994 5.4% of Australia's land was owned offshore. That proportion in 2010 was only 6%.
- The threshold for examination of Chinese FDI into Australia by the Foreign Investment Review Board is $244mn for private enterprises and $0mn for Chinese SOEs.
- Australian manufacturing is in a bad way and set to shrink but it is hard to produce a plan to address the situation without centralised wage-setting and without tariff policy available.
- There are five times as many people employed in manufacturing than mining and some 130,000 manufacturing jobs have been lost in Australia since 2008.

Is Our Economy Getting Better or Worse?

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

<u>Are householders opening their wallets more?</u>

No new data.

<u>Is business output rising?</u>

Nothing new.

<u>Are businesses hiring more people?</u>

Nothing new.

<u>Are businesses boosting their capital spending?</u>

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

Nothing new.

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.

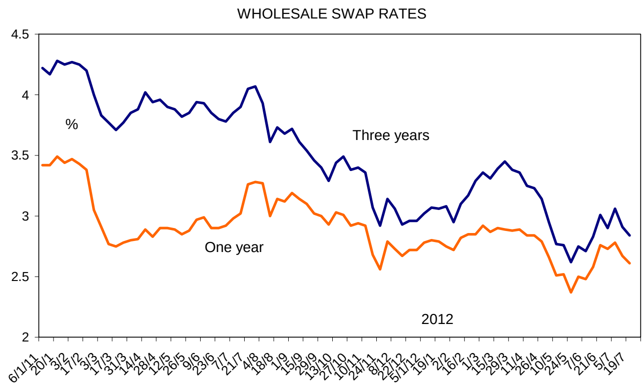
Nothing major.

INTEREST RATES

This week the June quarter Consumers Price Index was released and it showed that the price of a standard basket of over 600 consumer goods and services rose by 0.3% during the June quarter and by just 1% compared with a year ago. Another way of saying this is that the average Kiwi household cost of living has risen by 1% in the past year – well done if you are that average. The result was 0.2% lower than expected so applied a wee bit of downward pressure to wholesale interest rates this week especially as it shows that inflation is not any sort of a problem for the Reserve Bank at the moment.

Even measures like the 10% trimmed mean (take out the top and bottom 10% price changes) rose only 0.3% in the quarter and 1.2% from a year ago, though the effect of the exchange rate was apparent with the non-tradeables component rising 0.5% in the quarter and 2.4% from a year ago. What that tells us is that without the strong NZ dollar and falls in international commodity prices NZ inflation would be a lot higher.

Looking ahead then what do we think is going to happen? Inflation is unlikely to stay at this 13 year low for very long but any threat to the 3% upper end of the 1-3% range targeted by our central bank appears a long way off. As we noted last week cost and pricing expectations in the business sector have fallen away according to the NZIER's Quarterly Survey of Business Opinion, world growth forecasts are being cut, and our international commodity prices continue to fall. Thus wholesale interest rates have fallen slightly this week.



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	2.70%	2.70	2.68	2.77	2.70	5.7
1 year swap	2.61%	2.67	2.76	2.79	3.26	5.8
3 year swap	2.84%	2.91	3.01	3.14	4.05	6.1
5 year swap	3.13%	3.21	3.36	3.56	4.59	6.3

If I Were a Borrower What Would I Do?

Nothing new. Fix three years because I like certainty. But floating looks fine as well. Your call.

If I Were an Investor What Would I Do?

I only include this section every few months because whereas most borrowers are the same, as investors we are unique in terms of risk tolerance, risk understanding, income sources, time to needing investment assets, reliance upon investment returns, and frankly intelligence. Personally I find that when it comes to investing, 80% of the people I speak with lack an adequate grasp of the variables in play – and they show it when they ask the simple question 'Where should I invest my money?" To which I like to reply these days, 'How much are you prepared to lose?" Some are shocked by that question because they haven't really thought about losing their money. Instead their focus is return maximisation with an assumption that capital is secure. Big mistake. Assumption is the mother of all …

I also tend to assume lack of thinking on the part of many investors because of the easy way so many have been sucked in previously by advertisements using people seen previously in the media. They played rugby therefore they must surely know the company is a good one. They used to read the six o'clock news therefore they also must know what they are doing.

You may find these comments harsh (actually I have watered them down three times), but they are necessary because of two key forces coming together to produce a big new crop of uninformed not PhD-holding people looking for somewhere to put their money other than a bank account – which is where all my money is outside of a residential investment and five kids who hopefully one day will pay off big time.

First we have people now hitting 65 and getting their Kiwisaver money out. Having some years ago come into some money I know full well that when you are presented with a lump sum it very quickly changes from a great bonus to a pain in the butt. You don't know what to do with it and spend so much time wondering if you should lock it away, chase high returns, keep it liquid etc. that in the end you just want some nice person to take the problem off your hands. That is what those lovely people who fronted ads for finance companies offered people in the 1990s and 2000s – removal of a problem.

The rule here is this. If this is the first time you have been in the position of choosing what to do with a lump of money as opposed to either regularly paying off a mortgage or regularly salting away space cash, then you should get some professional advice. If you don't – well, good luck. At least lock the maturing Kiwisaver cash away for 90 days in a term deposit while you mull your options. And don't just do something with it just because your neighbour, best friend, relative, or club member has done it.

Second, we have entered into an environment where interest rates will be low not for a few more months but for YEARS. This is because the world is a wobbly place which will keep central banks from raising interest rates for a long time, and because as the Western world focuses on deleveraging for many more years credit demand and credit growth will naturally be low. This means that much as we banks look to pay as much as we can to try and switch our funding from unreliable offshore wholesale markets to the domestic retail (term deposit) market, the rates to be on offer for the next few years are going to be low.

That means many people are going to conclude they have not saved enough for retirement and they will either keep working (good, employers take note, you will need these people) or they will look for higher yield elsewhere. That is fine, but if you go for higher yield you lock yourself into higher risk and the experience of the 1990s and 2000s when people flooded into finance companies and geared themselves up in residential property investment companies shows risk analysis by your typical Kiwi gets a C minus.

If you are in the position of retiring soon with a lump sum and bemoaning the low level of term deposit rates, sit back and say to yourself 'I have this lump sum. Many of those who chased returns in the 1990s and 2000s have nothing left. I am fortunate. I will cut my cloth to suit" Do this, and remember that right now circling out there are people who want your money to punt on their projects – and haven't we just seen in the news one investment company engaging in alleged related party lending with those charged with overseeing such things waving it through with best wishes and no documentation? History in the field of personal investment does repeat itself.

So just in case you missed it, as an investor what am I doing? I am cashed up because I am fearful of what I see happening offshore and the lack of policy weapons to radically change the situation, and because I do not feel I need to maximise the return on my investment. The occasional 200 point overnight rally in the Dow Jones Index does not assuage my concerns.

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.**

Summary Of The Situation

No fresh data have been released this week – and even if they had there is not much chance that I would be writing anything different here to what I have been writing in one form or another since the second half of 2004.

New Zealand's key housing fundamental is a shortage of supply caused by a combination at some times of builder shortages (2005-07 and 2013-), high costs imposed by councils, an inefficient building materials sector, a Kiwi preference for individually designed houses rather than cookie cutter premises, increasing building standards (water-tightness, insulation, earthquake), and resident unwillingness to allow either more in-fill housing, low level multi-storey accommodation, or further urban sprawl.

This lack of supply kept house prices rising as predicted from 2005-07 in spite of sharp interest rate increases, limited price falls to only 11% on average during the global financial crisis, and has seen prices now rise above their late-2007 record levels.

The only really interesting dynamic in all of this for those of us who look at the housing sector with a purview extending over decades rather than a few years is two things. First is the way Auckland is once again leading the cycle. Auckland led the housing cycle during the 1990s in terms of turnover, prices and construction because of the surge in net inward migration from the early 1990s. Then Auckland lagged during the 2000s as investors sought better yield in the regions and rural incomes received a strong boost from five years of a below average exchange rate.

This time around Auckland is once again leading largely because of the weak 2000s construction whereas in the regions there is generally an over-supply still.

The second interesting thing is that during the period from 2008 to the end of the last year the majority of young buyers and one suggests investors had the view that house prices would probably fall and that it would be a good idea to hold off buying. Coupled with that delayed purchasing effect were worries about obtaining finance, the uncertainty created by water tightness issues and of course above average unemployment and low wages growth. Investors worried that other investors might sell because of LAQC and depreciation changes.

But now those fears of house price falls have completely gone out the window as four years of delayed buyers have rushed into the market to be followed, accompanied and soon perhaps (sorry young folks) led by the more cash rich investors. This frenzy of catch-up buying explains the articles in the NZ Herald in Auckland regarding aggressive bidding at auctions and people describing the easy tax free money they have made from purchasing a year ago and selling now. The balloon has gone up.

Those stories of wealth gains carry a lot of traction and will be bringing even more buyers into the market only this time they won't so much be those catching up on a purchase they could have made from 2008 – 2011 but those who were thinking about buying from 2013-17. This is where cycles come from. Sentiment changes cause people to catch up on delayed buying, bring forward planned buying so this causes a surge in prices and activity. Construction can follow. Then something causes sentiment to shift (maybe high interest rates) and people put off their buying so the cycle turns.

We are very much into the early stages of a particularly strong cyclical upturn occasioned by the delayed purchasing noted above, bring-forward buying, and the investor element I started writing about a few weeks ago. This is the one where investors have dropped their expectations for interest rate returns over the next few years so are searching for better yields and will be gearing themselves once more into property. Watch for people now spruiking property investment ventures to those who have retired without enough saved up in a new low interest rate environment and to those receiving their Kiwisaver lump sums. Its all on again folks.

This leads to a number of questions. First, if the world economy implodes anew because no matter how low interest rates are people won't borrow money and spend, can our housing market keep rising? In the absence of Depression scenario I would say yes simply because we do not personally feel the intensity of the globe's problems here in New Zealand, the worse it gets offshore the lower our interest rates go, the catch-up buying effect noted above, and the simply under-supply of property. But the worse things get offshore the slower will be the pace of housing market gains here.

Second, will house prices not rise because they are already very high when compared with incomes whether one undertakes an international static comparison or looks back in time in New Zealand? No. If there was to be a correction then the biggest global financial shock since the 1930s would have caused it.

Third, is it likely that something massive will be done to boost supply because we are starting to see one of the housing elements I have warned will come – a crisis for low income earners? The answer is no. The issue of poor housing affordability is not new in New Zealand and we have chosen as a populace to do little about it. Not much has been done to act on the recommendations of the Commerce Select Committee investigation into housing affordability released in August 2008 www.parliament.nz/NR/...2DF3.../DBSCH_SCR_4170_61892.pdf or the Productivity Commission report released last year. http://www.productivity.govt.nz/inquiry-content/1509

MAJOR OFFSHORE ISSUES

Europe

- The Spanish government has continued with its strong austerity push by introducing a range of measures including tax rises, accelerated raising of the retirement age to 67 (see John, everyone but the French are doing it, and their policies are not really the ones to copy), cutting public servant bonuses and days off, abolishing tax deductions for home owners, cutting the duration of the full unemployment benefit, reducing funding of unions and political groups etc. The aim is to cut the deficit by €65bn over the next two and a half years.
- Moodys cut Italy's credit rating two notches.
- Germany's highest court said it will not make a decision until September 12 regarding whether Germany's constitution will allow the country to support the new bailout fund.
- Spain's central bank the Bank of Spain announced that bad loans sitting on the books of Spanish banks at risk of not being repaid amount to €156bn. That is more than the €100bn Spanish bank bailout package offered by Spain's European partners a few weeks ago with worse likely to come as the economy continues to deteriorate and house prices fall. So far prices have fallen only about 25% in spite of an ongoing and worsening oversupply of property.

If you were a struggling manufacturer in Europe (France say), and your processes were semi-labour intensive but not requiring degree-level skills, wouldn't you just be praying for Greece to leave the Euro so you could shift your factory down there! Hence one reason why northern European governments will try their utmost not to let Greece out. They fear the quick loss of jobs.

I wrote an article on the European debt situation which was posted a week ago at http://www.farmingshow.com/opinion/ I reckon it is a good one so here it is.

"This week I have attended a conference put on by the Economist magazine people in Sydney looking at the Asian Finance scene but in which much discussion was undertaken of the situation in Europe. One strong point needs to be made right here – not a single person expressed confidence that Europe is close to solving its debt problems. All spoke in terms of the difficulties getting worse, that they will last for many years, that there is a risk to Chinese growth from Europe's woes, and that a weak China would slow Australia's growth. The same goes for us.

The nature of the European debt crisis essentially comes down to this. Investors in the north channeled money to the south for many years feeling secure within the Eurozone and a belief that the superior yields offered by southern European borrowers were of little risk because inclusion in the Eurozone would bring convergence of the member economies in terms of output per person, incomes, living standards etc.

Instead what happened is that the divergence in productivity between northern and southern countries has increased, and southern banks lent money into a property construction boom which has now turned into collapse. The northern investors want their money back. This is starving southern European banks and therefore southern European economies of cash. Growth has disappeared and the ability of southern governments to offset the credit crunch, construction crunch, and confidence collapse through stimulatory policies is near non-existent.

They do not have their own currencies which can depreciate and boost exports. They have no interest rate control and official interest rates are already very low anyway. Their government finances are shot through either bad 2000s practices then GFC-induced fresh deterioration, or simply the latter (Spain). Their economies are in major need of reform but citizens are tired of pain and voting for weirdoes promising relief.

Therefore the investors want even more of their money out and southern European banks are on the verge of collapsing and bringing down their northern neighbours. There is no over-arching European body which supervises European banks, there is no mutual bailout fund, there is no deposit guarantee scheme. The June 28-29 summit made good noises about the first item, but progress will take a long time and is barely relevant to the current situation.

So investors still want their money out of those countries and out of the bonds of those countries' governments. No circuit-breaker to assuage investors appears likely, and the speaker on video link from Brussels spoke of cures no-one back in the conference room in Sydney expressed confidence in thus showing that still the bureaucrats in Europe do not yet even understand the nature of what they are dealing with. Hearing his comments, were I an investor in southern Europe, I would want my money out faster.

The relevance to New Zealand farmers is this. One, Europe's economy is in recession and likely to go deeper. This will directly lower commodity prices. Two, China's exports to Europe are falling, Chinese growth is slowing, this will depress our export prices. Three, the world's capital markets are not functioning properly and that means suppressed growth over a period of years – which will depress commodity prices."

On the same topic, the Wall Street Journal of Wednesday 11 contained a short piece where the President of the St Louis Federal Reserve Bank reported on his trip to Europe. The gentleman Mr. Bullard said he had "marked down the probability" that a solution can be found. "One of the things I am most concerned about right now is this crisis has pitted a fast-moving financial market against a very slow-moving political process."

To that I would like to add that even when it comes to the long term formation of an over-arching fiscal union there is a major problem with France, Italy and Spain unwilling to give away budgetary control and Germany unwilling to countenance either jointly issued Euro bonds or centralised budgetary funding without such Eurozone-wide control.

Oh, and the German High Court has given no date for when it will say whether the proposed new bailout fund – the European Stability Mechanism – is compatible with Germanys constitution.

And lets keep going on Europe's woes. Because Europe's left-leaning parties and unions have been so strong for so long European labour markets are very rigid. That means that first of all there is entrenched high unemployment concentrated amongst young people because it is very hard to lay someone off if you hire them and find they are not up to scratch. Second, because it is hard for employers to cut wages labour market adjustment during times of weakness occurs through layoffs rather than sharing the burden through reducing wages for all, cutting back on work hours etc. This means that unemployment in Europe has risen sharply and currently sits at a Eurozone record of 11.5% and set to higher as the crisis drags on. That means a growing cohort of predominantly young people but also people over 50 who are losing connectivity to the workforce, losing skills, losing motivation, and dropping out of normal civil society. That is a disaster and huge social failing which we tend not to experience these days in new Zealand for three reasons.

First, with a flexible exchange rate and exposure to well growing Asia we have economic growth underway. Second we have a quite flexible labour market. Third, we bugger off across the ditch when times are tough.

I write this having just read a summary of the OECD’s annual employment report. Whereas at the end of 2007 there were 33 million people unemployed throughout the OECD now there are 45 million. The average unemployment rate has risen to 7.9%. In May last year the OECD thought that the unemployment rate would be 7.1% at the end of 2012. Now they think it will rise to 8%.

Australia

The Aussie economy is growing at about a 3% pace and expected to continue to do so because of the strong mining and infrastructure sectors. But manufacturing, retailing, housing and tourism are struggling and are likely to continue to d so this year and next due partly to the high Aussie dollar.

United States

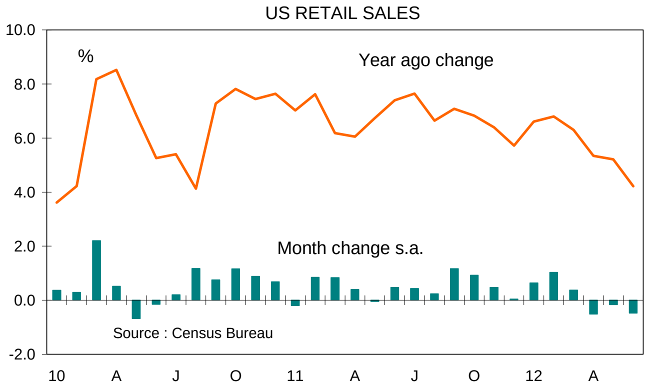
If you are not worried about where things are heading on this planet then you are at odds with the bulk of those sitting on the US Federal Reserve Board according to the minutes of their June meeting released last Thursday night. They expressed concern about the impact on the US economy from the European debt crisis, the risk of a “significant slowing” in China’s economy, and the prospect of a severe tightening of US fiscal policy. All this and the yield on ten year government bonds is already at a record low below 1.5% even though the United States faces an ongoing massive debt financing requirement.

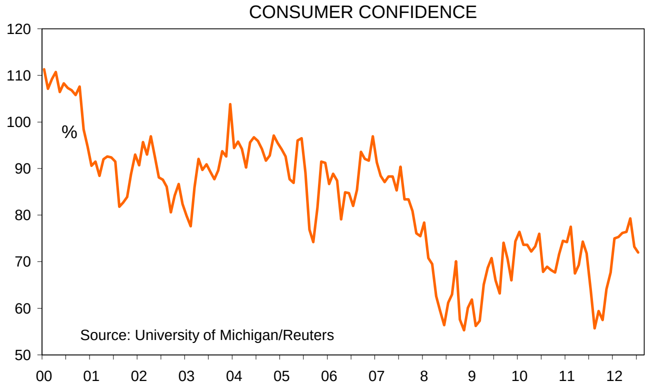
While the globe’s attention currently or at least their actions on the basis of their attention are on Europe, the US fiscal issue worsens in the background. The US Federal government is running a deficit near 8.5% of GDP, has a debt level near 100%, and because Federal spending makes up just 24% of GDP compared with Europe’s 45%+ getting a deficit of any set GDP proportion lower in the United States involves almost twice the proportional tax and spending changes as in Europe.

At the moment if no-one touches any buttons there will be an automatic tightening of US fiscal policy from the start of next year equal to about 4% of GDP. That would throw the less than 2% growing US economy into a new deep recession and is not going to occur. The debate currently is focussing on extending Bush-era tax cuts with the Republicans wanting to extend the cuts for all and the Democrats wanting to extend only those for middle income earners.

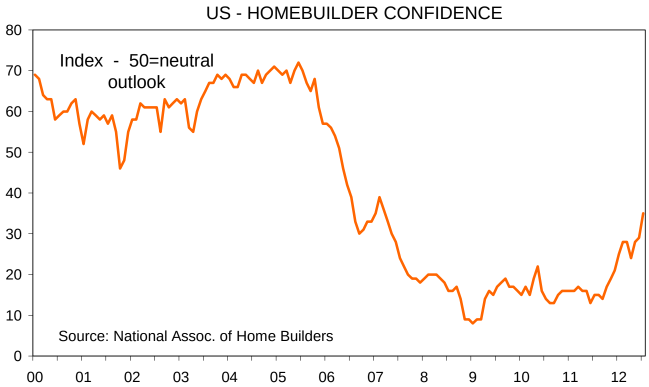
So if you sit back and think about it you’ll realise that the fiscal debate currently in the United States is less about how to tighten fiscal policy and more about how to loosen a tightening already programmed in. This is quite concerning, especially in an environment where the labour market appears to have stalled and growth risks coming in less than previously expected. That means more upward pressure on Federal spending, downward pressure on tax receipts, and upward movement in the Federal budget deficit. This then is a version of the problem in Europe where fiscal tightening is occurring in a weak economic environment.

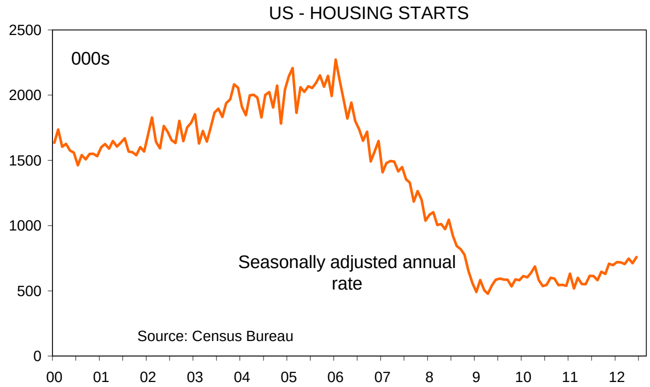
Speaking of economic weakness. The retail trade numbers in the US this week came in much weaker than expected for June and numbers for the previous two months were also revised downward. Excluding motor vehicles retail spending fell by 0.4% in June after falling 0.4% also in May and 0.6% in April. That makes for an exceptionally weak quarter and means sales were 4.2% ahead of a year ago compared with a 6.5% rise in the March quarter on a year earlier and 7.1% gain in the December quarter.





In addition, the monthly University of Michigan consumer confidence index fell to 72 in July from 73.2 in June. This is the lowest reading since December last year and does not bode well for much consumer spending strength over the second half of 2012. However with regard to housing the developing view is that the worst has passed and improvement is occurring. This week we learnt that the Wells Fargo National Association of House Builders sentiment index rose to 35 in July from 29 in June to sit at its highest level since March 2007.





Additionally there was a better than expected seasonally adjusted rise in the number of housing starts in June. Starts amounted to an annualised 760,000 compared with 711,000 in May. This was the strongest result since October 2008.

Over the past two nights the US sharemarket has risen on the back of hopes that the Federal Reserve will initiate another round of quantitative easing. Obviously the first two rounds did not work to cement in good economic growth and a third is also unlikely to do much in an environment where people do not want to borrow. So why does the US sharemarket go up when thoughts turn to more money printing? Because the extra cash sloshing around tends to end up in financial assets.

China

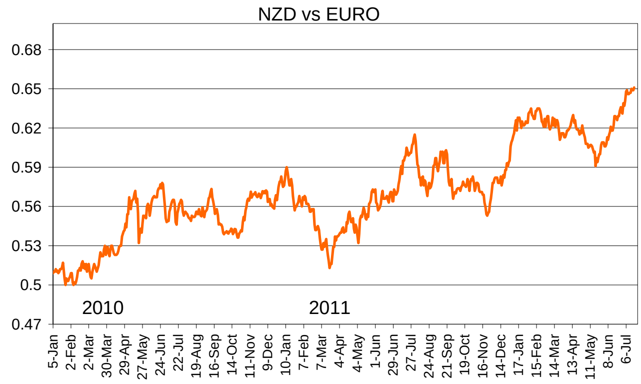
Chinese economic developments are now covered in our new publication “Growing With China”, the July issue of which will be released in the 23rd. If you wish to receive this monthly then please email me at Tony.alexander@bnz.co.nz

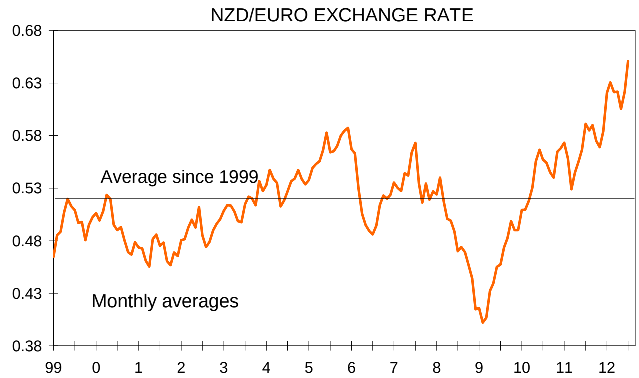
Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.799	0.792	0.791	0.815	0.843	0.67
NZD/AUD	0.771	0.778	0.781	0.787	0.796	0.85
NZD/JPY	63.000	62.900	62.600	66.200	66.7	69.6
NZD/GBP	0.511	0.511	0.505	0.509	0.526	0.388
NZD/EUR	0.651	0.647	0.629	0.621	0.599	0.52
NZDCNY	5.090	5.045	5.030	5.135	5.453	4.99
USD/JPY	78.849	79.419	79.140	81.227	79.122	105.7
USD/GBP	1.564	1.550	1.566	1.601	1.603	1.72
USD/EUR	1.227	1.224	1.258	1.312	1.407	1.28
AUD/USD	1.04	1.02	1.01	1.04	1.06	0.788
USD/RMB	6.3705	6.3694	6.3585	6.3003	6.469	7.56

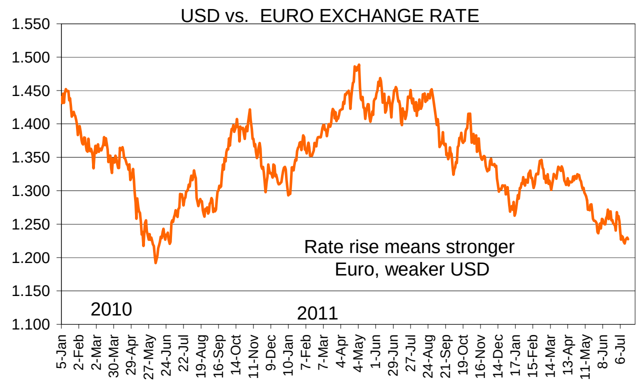
Only Clear NZD Pattern = Up Vs. The Euro

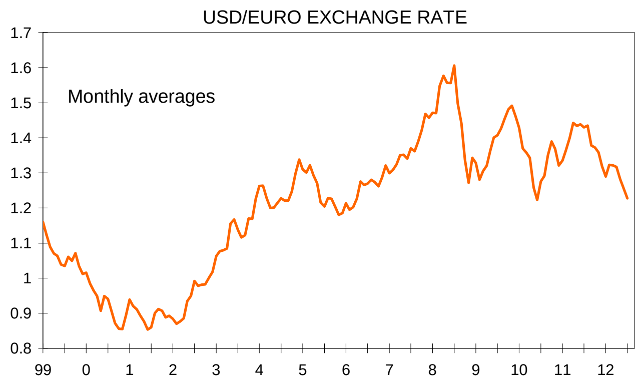
The Kiwi dollar rose to another record high against an increasingly dead dog-looking Euro which also fell to an almost a five and a half year low against the greenback.





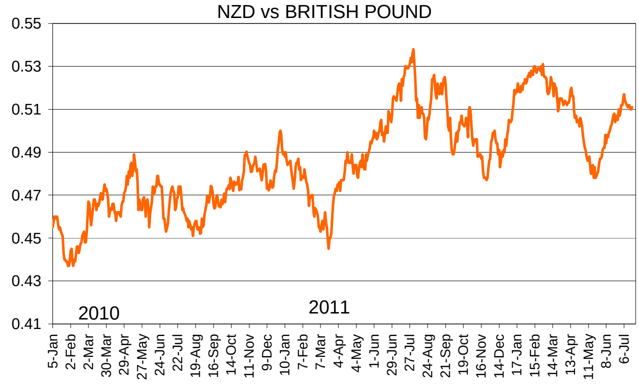
The driving force for this weakness in the Euro is deepening worries that the immediate outlook for European growth is poor, that the process of deleveraging may leave growth poor for quite a number of years, and that there remain non-zero probabilities assigned to a break-up of the Euro and the need for another bailout for one of the heavily indebted southern economies.

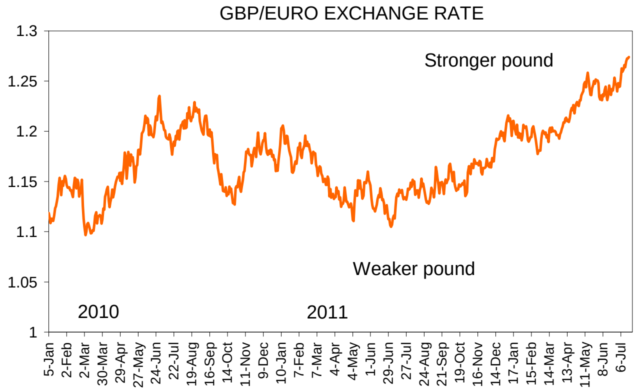


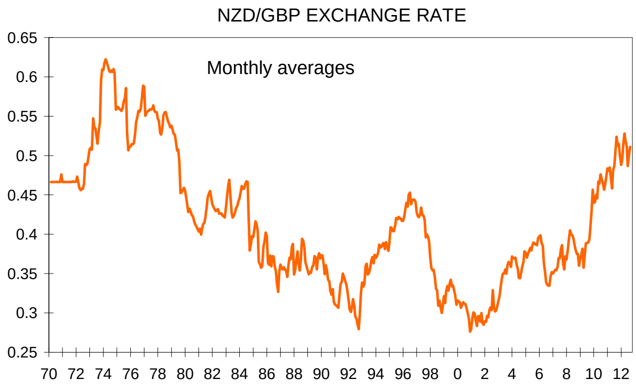


One point worth noting is that these worries about Europe are clearly outweighing the downward pressure implied on the greenback by the possibility of further quantitative easing by the Federal Reserve.

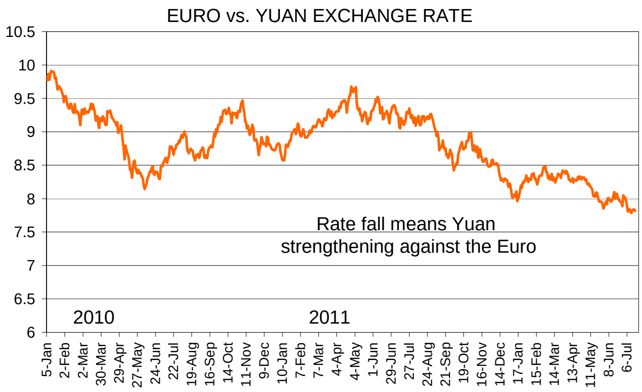
With regard to the British Pound which is tarnished by the UK's close trade and investment association with the Continent and its Eurozone members the week has brought some improvement against the Euro and the greenback but no change against our currency which has gained almost one cent against the USD from a week ago.

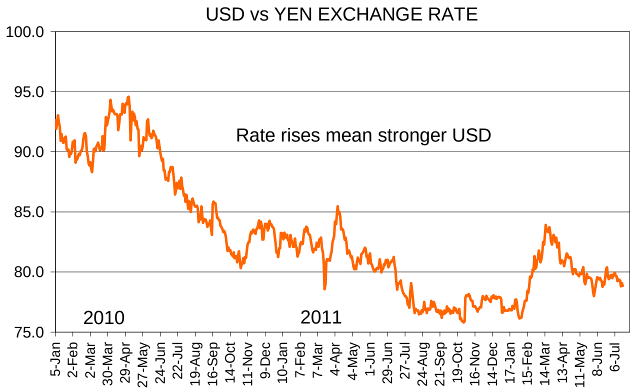




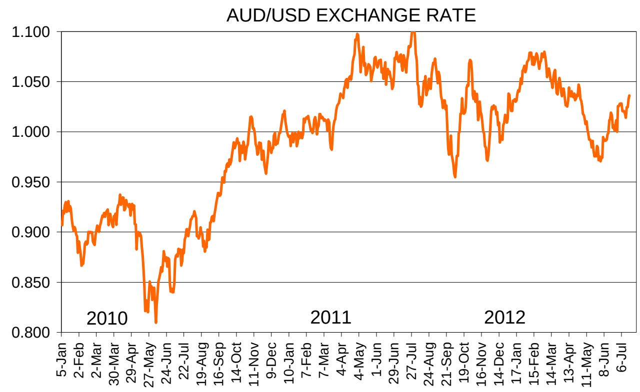


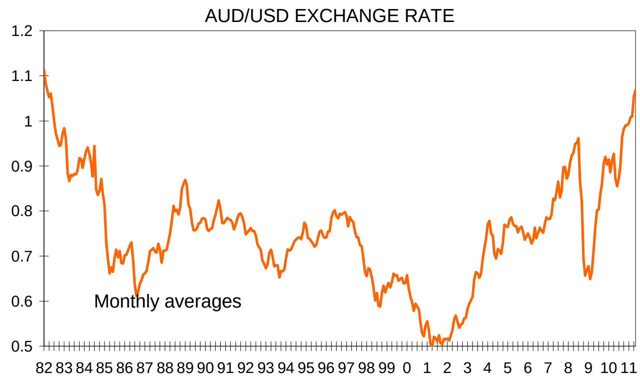
The USD is not the main currency benefiting from investor flows out of the Euro. Instead that honour appears to go to the Japanese Yen which while rising against the Euro has also gained against the greenback as shown in the following two graphs.



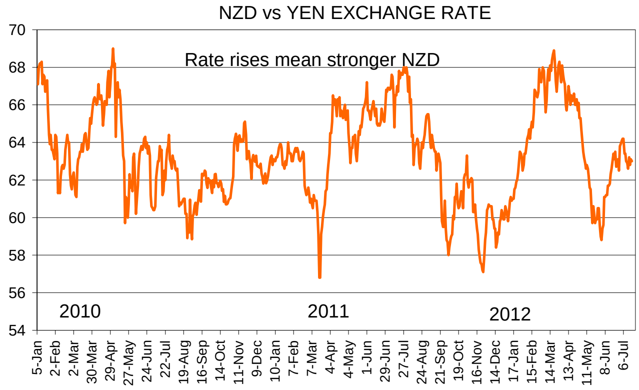


The Aussie dollar has had a strong week rising to over $1.035 from $1.018 last week as worries about Europe have spurred investors also into our Tasman partner's currency. In addition some AUD support has come from expectations of more policy easing in China amidst signs in China's monthly data of some stabilising of the economy's slowdown in growth.





Where does everything go from here? I am running broadly on this scenario. Europe gets much much worse so the Euro goes down and we head over 70 centimes. Funds flowing out of the Euro keep the Yen, USD and AUD up and we gain some as well. Out of that I believe we rise further against the British Pound possibly back toward the 55 pence area. I have no view on where we go against the Japanese Yen. The graph here shows there has been no clear pattern for a long time.



I worry about the state of the US economy and the approaching fiscal cliff which risks weakening the greenback. However I also see downward movement in commodity prices which will tend to weaken the NZD. Therefore my broad view of the NZD against the USD is that we move in a range from 75 – 85 cents. Against the Aussie dollar I feel that the risk is we weaken further given that they are going to be accorded more safe-haven status than ourselves as the global environment deteriorates further.

Key Forecasts

Dec. year		**2010**	**2011**	**2012**	**2013**
GDP	annual average chg	1.8	1.4	2.0 – 2.7	2.5 – 3.5
CPI	on year ago	4.0	1.8	1.5 – 2.0	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	1.5 – 2.0	1.0 – 1.5
Unemployment Rate	end year	6.8	6.4	6.0 – 6.5	5.0 – 5.8

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, search www.stuff.co.nz
- 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, tramps, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com

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