Bank of New Zealand

BNZ Weekly Overview

25 October 2007

FINANCIAL MARKETS DATA	**This week**	**Week ago**	**4 wks ago**	**3 months ago**	**Yr ago**	**10 yr average**
Official Cash Rate	8.25%	8.25	8.25	8.25	7.25	6.2
90-day bank bill	8.62%	8.64	8.80	8.47	7.73	6.4
10 year govt. bond	6.30%	6.48	6.32	6.84	5.92	6.5
1 year swap	8.71%	8.72	8.68	8.64	7.60	6.6
5 year swap	8.10%	8.09	7.93	8.14	7.03	7.0
NZD/USD	0.754	0.751	0.747	0.81	0.66	.567
NZD/AUD	0.836	0.843	0.86	0.91	0.87	.859
NZD/JPY	86.0	87.3	85.8	96.8	78.9	66.1
NZD/GBP	0.367	0.368	0.37	0.39	0.353	.342
NZD/EURO	0.528	0.528	0.531	0.583	0.53	.51

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Monetary Policy Steady

The main piece of news relevant to the New Zealand financial markets this week was the Reserve Bank's decision this morning - widely expected - to leave the official cash rate unchanged at 8.25%. But they issued some fairly explicit warnings about upside risks to inflation from the likes of the proposed emissions trading regime, rising global food prices, and any additional easing of fiscal policy. Given that it is a certainty fiscal policy is going to be eased in the coming year - especially in light of what the opinion polls are showing for the government - there is still a chance we could see the official cash rate increased again. But it is going to be a close call because we can see some clear evidence of weakness in the domestic economy and the housing market in particular.

Interestingly though having said that we got some data this week showing credit card spending up very strongly in seasonally adjusted terms in September and have recently seen an improvement in consumer confidence. Business investment and employment intentions are running at above average levels so prospects for economic growth overall still look reasonable though it would be wise to keep an eye on events overseas with the global liquidity crisis continuing to cause periodic jitters in the United States sharemarket and worries about the US economy.

Following are some of the things we think it is useful for various groups to take into account when they are considering prospects over the coming year or so.

Manufacturers
As with all other employers recognition of the structural tightening in New Zealand's labour market is required and must be factored into employment practices. Costs are likely to keep rising across the board and for this reason a very strong focus on boosting productivity is required. Over the next one to two years the Kiwi dollar is likely to be relatively strong and this will restrain the profitability of exporting manufacturers - except those sending goods to Australia. The Australian economy is booming and with Aussie commodity prices at their highest levels in over a century the rate of exchange between the New Zealand and Australian currencies is likely to favour New Zealand exporters. This is important because about 45% of New Zealand's manufactured exports go to Australia.

Farmers
Fortunes are very mixed in the agricultural sector with dairy incomes booming but horticulturalists and market gardeners as ever at the whim of whatever the season throws up this year both locally and overseas, while sheep and beef farmers are not seeing skyrocketing prices as has happened for dairy products. Costs are likely to keep increasing relatively firmly and one thing non-dairy farmers may want to keep an eye on is the way in which the good income prospects of dairy farmers lead to higher prices being bid for relatively scarce resources. For the moment this is manifesting itself as high prices for land with dairy potential but will also show through as upward pressure on wages of agricultural labourers along with contractors specialising in agricultural buildings etc.

Retailers
Growth until recently has been artificially stimulated by factors that won't in all probability be present over the next five years. Between 2002 and 2004 the net migration gain for New Zealand averaged about 30,000 people per annum. This is three times the average over the past 10 years. Net gains have been oscillating around the long-term average since late 2005 and are likely to continue to do so in the near future. New Zealand interest rates were at unusually low levels from late 2001 into early 2004 because of events overseas such as terrorist attacks, SARS and the Iraq war generating easy monetary policies in foreign economies which were copied by our Reserve Bank. Unless similar nasty things happen overseas in the next wee while unusually low borrowing costs in New Zealand are unlikely for quite some time. The unemployment rate has fallen from 7% around seven years ago to 3.6% now. A similar decline is not going to happen in the future therefore to the extent retail spending was artificially stimulated by extra jobs growth and a rise in job security in recent years these factors will be absent going forward. Since the middle of 2001 until the first half of this year house price inflation in New Zealand chugged along at unsustainable levels. Now with high levels of household debt and record ratios of house prices to incomes a similar surge in prices is unlikely going forward therefore there will be an absence of the house price wealth effect which has underpinned retail spending in recent years.

Having said that we are likely to see some probably very minor tax cuts for hard-working Kiwis in the next few years but this factor will be swamped by the absence of the factors above. Retailers should be aware that there is some downside risk to retail growth expectations for the next 12 months and over the medium-term out to three years there will be reasonable growth but perhaps not necessarily as much as one might be - thinking especially when the Reserve Bank does get around to cutting interest rates from late next year or perhaps over 2009 and 2010.

Real Estate Agents

Dwelling turnover in September was down 32% from a year earlier and while we think there might be a downward bias to some of the results recently activity is going to be much weaker than recently experienced over the next couple of years. Buyers already feel less urgency about making a purchase and will mainly be seeing negative headlines in newspapers. Having said that there will remain some good core demand for owner occupiers supported by a continued very strong labour market bringing wages growth and probably tax cuts over the next few years. In addition for the moment net migration inflows are travelling only just below medium-term average levels. There is of course a downside risk to population growth if we get no tax cuts in New Zealand but another large lump of tax cuts across the Tasman and this will bear watching. In the real estate sector it is likely we will see some hefty rationalisation of offices and franchises over the next couple of years.

Builders

Activity levels have been exceptionally strong over the past five years underpinned by a surge in residential construction which started easing somewhat three years ago but with a continued high level of non-residential construction activity. There is a fairly strong correlation between changes in dwelling turnover and changes in residential construction and therefore although we believe the tight labour market will underpin many areas of consumer spending the recent strong annual rate of decline in dwelling sales suggests downside risk to residential construction in the near future. This could be offset substantially however by a backlog of people wanting to get construction done along with fixing up leaky buildings. The overall level of construction is also going to be underpinned by continued firm non-residential building activity. This will be significantly underpinned by businesses looking to boost productivity through more efficient premises. In addition although retail spending growth will be relatively weak in the next couple of years it is likely we will continue to see ever larger malls being constructed, a continued movement towards mega-retailing, and provision of premises associated with regional population growth areas. Strong rural sector activity is also highly probable.

Building company operators would be well advised to continue keeping an eye out for skilled and semi-skilled employees and may want to increase their presence at employment shows in the United Kingdom.

Employees

It is reasonable to anticipate faster wages growth than in earlier years and potential for career advancement in a tight labour market is enhanced. However do not be surprised if in fact your advancement goes the other way because of the rising need for employers to retain people for training increasingly less skilled fresh employees. Your greatest value might be in undertaking that training. Also keep in mind that unless a company can find somebody to replace you it may not be possible for you to move onto the next higher position.

Businesses are experiencing rising costs across the board these days and if you make full use of your bargaining ability to get wage increases the employer may have no choice other than to restrict spending in other areas, perhaps shutting down divisions and cutting staff numbers, or in the worst-case scenario closing the company and perhaps relocating to Thailand.

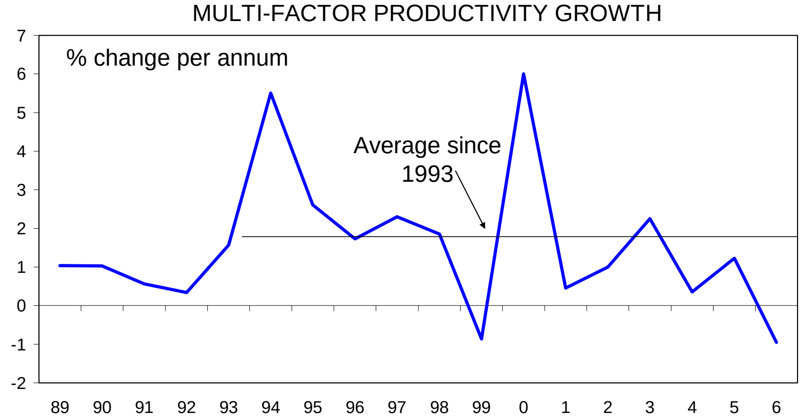
Employers

There has been a structural tightening in New Zealand's labour market over the past few years and while there is also a cyclical element it would take a substantial recession in the New Zealand economy to achieve something like the unemployment rate going back to 5.5%. The chances are the labour market will remain tight going forward and employers need to take this into account in a great variety of ways. One is that slightly higher average wages growth needs to be allowed for and perhaps the speed of promotion of employees will need to be increased. Consideration will need to be given to more flexible work arrangements. Increased investment will have to be undertaken in training of staff and it would pay to keep a very close eye on employee attitudes and morale generally. These days if people don't like the company they have plenty of other options available to them.

Capital deepening is going to be required - meaning investing more in information technology systems, more efficient buildings, and more efficient plant machinery and equipment. Strategically because of the shortage of resources and labour in particular it would pay to focus less on acquiring extra customers and a lot more on acquiring resources before acquiring those customers.

Productivity Growth Is Poor

Just for your guide, last week Statistics New Zealand revised and improved their annual release on productivity growth in New Zealand taking the series back to 1978 from 1988. We won't have any numbers for the year to March 2007 for a while but a quick glance at the graph below shows why we are dubious about the economy being able to sustain a strong growth rate going forward. Our economy is short of resources and once baby-boomers start retiring in droves in three years time the labour force constraint on the economy is going to become even worse. The annual rate of growth in productivity in our economy since 1993 has averaged 1.8% per annum. But as the graph below shows, the recent performance has been quite bad with productivity falling 0.9% in the year to March 2006.



Some of the decline in productivity growth recently can be put down to businesses having to take on increasingly less skilled people. But on the face of it it looks like capital expenditure in productivity enhancing equipment, information technology systems, and buildings would have to jump quite sharply to offset this effect.

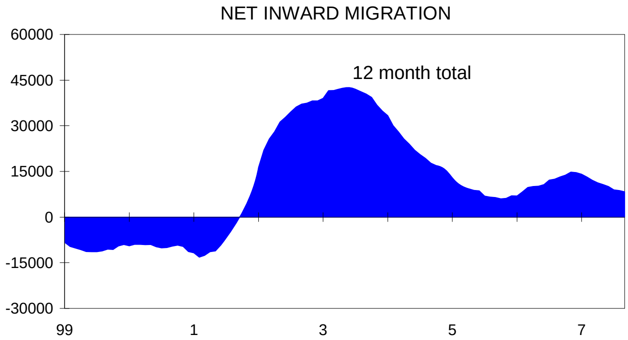
THE WEEK'S ECONOMIC DEVELOPMENTS

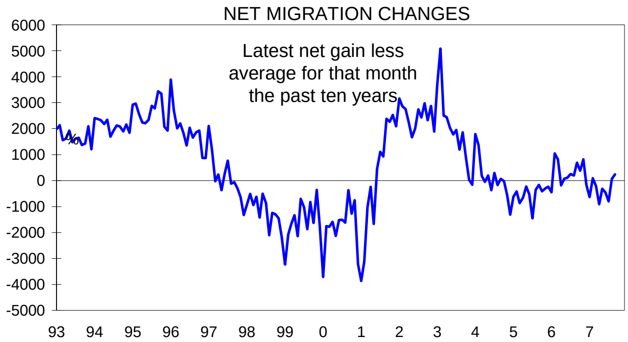
Friday 19

Migration Running Slightly below Average

There was a net addition to New Zealand's population from permanent and long-term migration flows in September of 2,241 people. This was 419 fewer than the addition in the same month a year earlier but it is interesting to look at these sort of numbers in seasonally adjusted monthly terms. Doing this we see that in September the net seasonally adjusted migration gain was 720 people. It was 760 in August and on average in the six months to July the net gain was 470 people a month. So the net flow has actually improved slightly recently and if we believe the monthly net gain is now running at around 730 people the annual net gain is chugging along just below 9,000. This is only just below the average net gain over the past 10 years of just below 10,000 people.

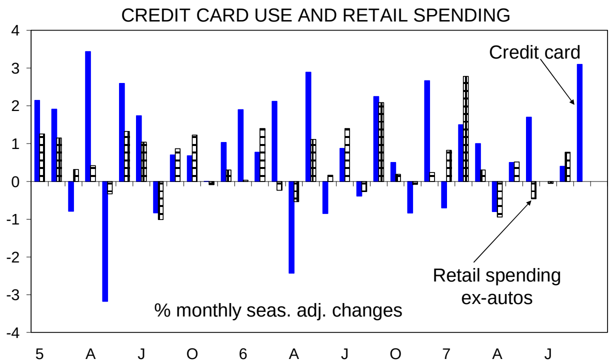
The annual net gain has been moving in a broad range from 5,000 people to 15,000 since the end of 2005 and perhaps the best interpretation to make of these most recent numbers is that we remain in a period when net migration flows appear to be neither stimulating or restricting activity in the New Zealand housing market.





Credit Card Spending up Strongly

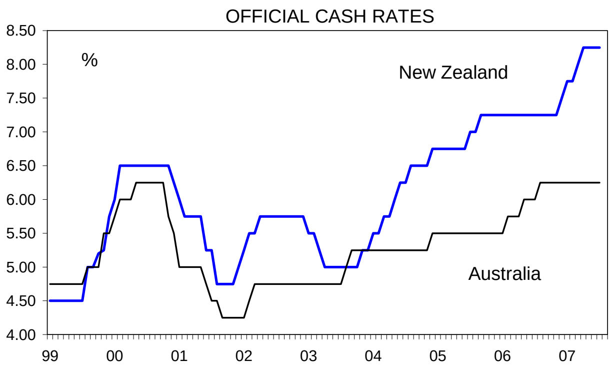
In seasonally adjusted terms spending on credit cards in New Zealand rose by a relatively strong 3.1% in September. This followed a 0.4% rise in August and as the graph shows there tends to be a directional correlation between the change in credit card spending and the actual change in ex-auto retail spending over the same month. The strong result for card spending in September therefore suggests the monthly retail spending number for that month when it eventually gets released will show a positive movement though not necessarily a large one.



Thursday 25

Monetary Policy Left Unchanged

As had been widely expected the Reserve Bank left the official cash rate unchanged at the 8.25% level it was taken to back in late July. However the Reserve Bank retained a tightening bias noting very strongly the implications of easing fiscal policy with such easing already applying inflationary pressures, but also warning about inflation risks from rising global food prices and the proposed emissions trading scheme. Their comments mean that one cannot rule out another tightening although we do assign a low probability on the basis of expected general weakness in the domestic economy going forward.



INTEREST RATES

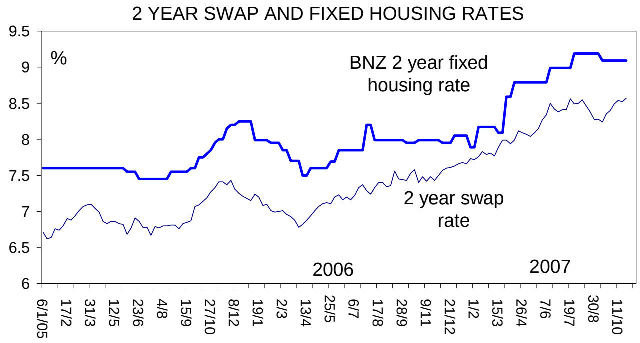
There have been only minor changes in wholesale interest rates over the past week with the two year swap rate at which we banks borrow to lend fixed for two years ending near 8.57% from 8.52% last week. The 90 day bank bill yield has ended near 8.62% from 8.64%. As had had been near universally expected the Reserve Bank this morning left their official cash rate unchanged at the 8.25% level they took it to late in July. In their commentary attached to the no change decision they noted that "…core inflationary pressures persist" and gave a relatively strong warning about fiscal policy.

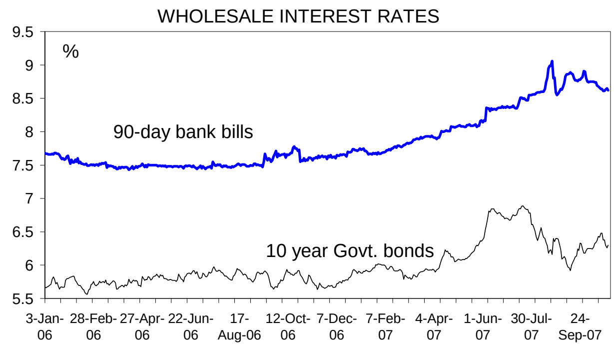
"Despite ongoing surpluses in the government's operating balance, fiscal policy is contributing to inflationary pressure. Any further easing in fiscal policy beyond that already announced will add further upside risks to medium-term inflation."

Not only that but they also warned about inflationary pressures from other policy changes.

"There are a number of other upside risks to inflation, including the direct effects of the proposed greenhouse emissions trading scheme…"

All up one would have to say that a tightening bias remains in the Reserve Bank's thinking so while we have tentatively penciled in a cut in the official cash rate late next year there does remain a risk they could raise the cash rate again with that risk correlated with the extent to which the government remains well behind the opposition in opinion polls. Oh, and the Reserve Bank also noted the inflationary risk from rising global food prices so further gains there could also prompt another tightening.





Over the next few weeks it is likely that wholesale interest rates will trade close to their current levels and in fact even in a year's time there may not be all that much change. A key influence however will be what happens with the United States economy and their monetary policy and this has capacity to eventually apply some extra downward pressure on medium to long-term fixed borrowing costs. But one has to be aware that although there are downside risks for the US economy that the rest of the world thinks still look okay so a general easing off in global concerns about inflation risks is not highly probable. In fact across the ditch it looks likely that interest rates will be raised in two weeks time and perhaps again early in 2008.

If I Were a Borrower What Would I Do?

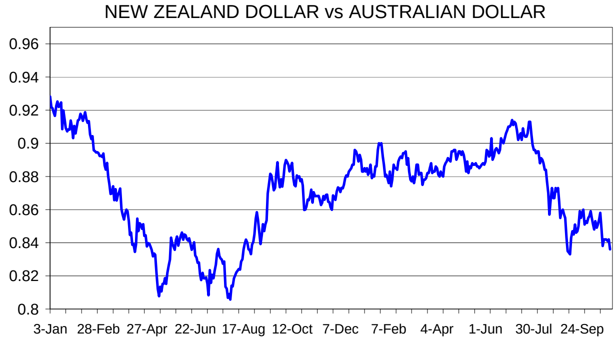
I'd look for a good rate in the two or three year area and would not be expecting any decent decline in interest rates over the coming year. There is a risk that the Reserve Bank might raise its cash rate again over the next 12 months but we assign this a very low probability and instead we think they are likely to start cutting interest rates from perhaps September next year. The risk is they don't start until 2009.

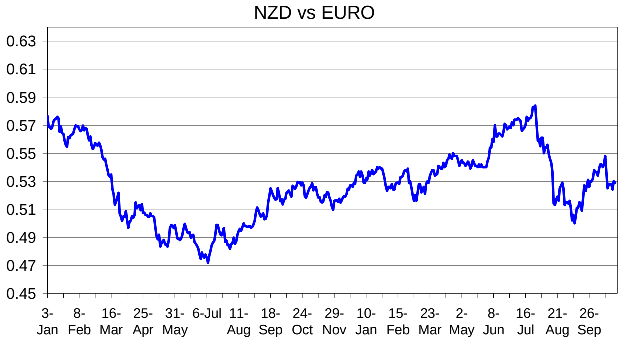
HOUSING MARKET UPDATE

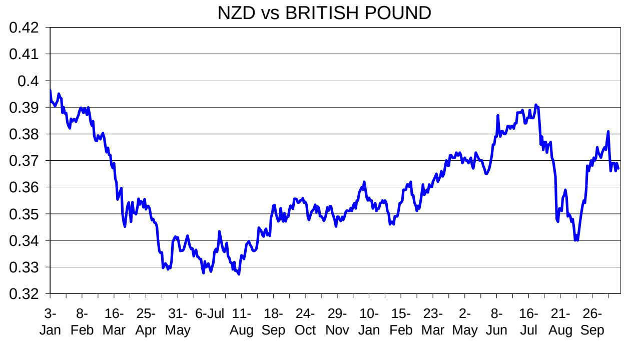
We have received no fresh news on the housing market this week apart from many articles about the weak state of the inner-city apartment market in Auckland. These articles are likely to continue for quite some time yet but it has to be kept in mind that they are not indicative of what is happening around the rest of the country.

EXCHANGE RATES

The Kiwi dollar has ended the week essentially unchanged against the greenback near 75.4 cents, unchanged against the British pound near 36.7 pence, unchanged against the Euro near 52.8 cents, but down against the Australian currency and the Japanese yen. Against the yen we have ended near 86.0 from 87.6 last Thursday while against the Aussie currency we have ended near 83.6 cents from 84.2.



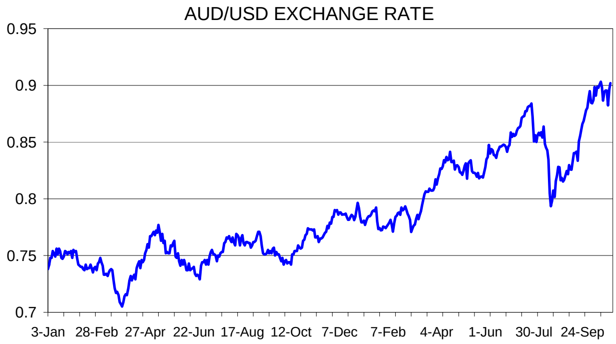


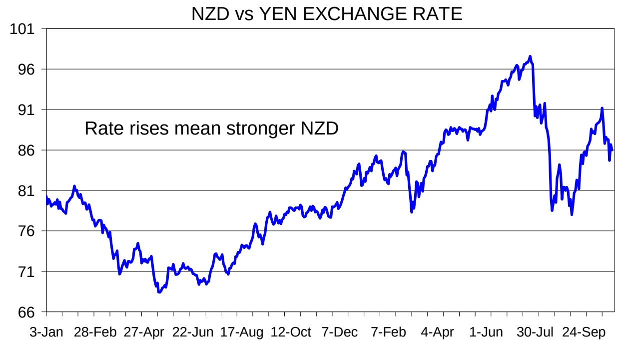


Because the markets had been expecting no change in the official cash rate this morning and the retention of a tightening bias the statement from the Reserve Bank had no impact on trading today.

Across the ditch the Aussie currency has had a firm week ending this afternoon near 90.2 cents from 89.4 against the greenback last week. The Aussie dollar has risen this week not only because some weakness in the greenback but also because the inflation number for the September quarter released on Wednesday showed a higher than expected rise in the underlying measure. We now expect that because of greater inflation worries the Reserve Bank of Australia will raise their cash rate 0.25% on November 7 taking it to 6.75%. Another rise is then highly likely early next year.

Because of these expected hikes at a the time when the Reserve Bank of New Zealand are less likely to raise rates further the narrowing interest rate differential between the Australasian currencies has seen the Kiwi dollar fall over the week against its Tasman cousin.





It's worth noting that over the past 22 years the NZD/AUD exchange rate has averaged 83.0 cents. Therefore at the current rate of 83.6 cents if there are companies sending goods to Australia and finding the exchange rate difficult it would be best to think about changing business.

The greenback has weakened against all other major currencies over the week apart from the Euro where it has ended unchanged at $1.426. Against the Japanese yen the greenback has ended near a six-week low of 114.0 from 116.3 last week, while against British pound it has ended near $2.054 from $2.04 last week.

The US dollar has been depressed by worries about the impact on United States financial institutions of the sub prime mortgage market collapse, and the absence of any strong statements from the meeting of Group of Seven finance ministers and central bankers over the weekend suggesting that the US dollar should be stronger.

Looking ahead, the next piece of economic data which might have some reasonable impact on the Kiwi currency because of implications for monetary policy is the Household Labour Force Survey due out on November 8. But it may also pay to keep an eye out for comments from senior government ministers regarding the extent to which they will be throwing open the fiscal treasure chest in the coming year to try and reverse their poor showing in opinion polls.

Data Sources

Interest rates & exchange rates RBNZ at	http://www.rbnz.govt.nz/statistics/
Housing fixed interest rates – our data from 1991 email	tony.alexander@bnz.co.nz
House mortgage data – RBNZ	http://www.rbnz.govt.nz/statistics/monfin/rbssr/rbssrpartE/data.html
House price information - REINZ	http://www.reinz.org.nz/reinz/public/market-information/market-information_home.cfm
NZ economic data, most from Statistics NZ	http://www.stats.govt.nz
Government accounts, NZ Treasury at	http://www.treasury.govt.nz/financialstatements/
Australian data	http://www.abs.gov.au/ and http://www.rba.gov.au/
European data	http://epp.eurostat.ec.europa.eu
United States data	http://www.economagic.com/
Parliament, select committees, publications etc.	http://www.parliament.nz/en-nz

BNZ WEEKLY OVERVIEW

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.5%	0.7	1.8	3.5	3.4
GDP growth	Average past 10 years = 3.0%	0.8	0.3	1.5	2.2	4.5
Unemployment rate	Average past 10 years = 5.3%	3.6	3.7	......	3.6	3.7
Jobs growth	Average past 10 years = 1.9%	0.7	1.2	1.5	3.1	3.0
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.2	8.5	......	9.7	8.0
Terms of Trade		0.6	1.5	2.5	0.5	1.0
Wages Growth	Stats NZ experimental series	1.3	1.4	4.9	5.3	4.9
Retail Sales ex-auto	Average past 9 years = 3.8%.	-0.8	3.6	5.5	4.8	7.0
House Prices	Long term average rise 5% p.a.	2.8	4.3	13.7	10.3	13.7
Net migration gain	Av. gain past 10 years = 10,400	+8,319	10,080yr	......	13,210	6,398
Tourism - yr ago grth	10 year average growth = 5.0%. Stats NZ	5.8	4.1	3.9	-0.7	4.5
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	2	-8	-4	-10	-7
Business activity exps	10 year average = 26%. NBNZ	17.2	16.7	24.1	15.0	15.8
Household debt	10 year average growth = 11.3%. RBNZ	13.7	13.7	13.5	13.6	15.1
Dwelling sales	10 year average growth = 3.5%. REINZ	-32.0	-25.3	8.9	-5.6	17.0
Floating Mort. Rate	10 year average = 8.1%	10.55	10.55	9.80	9.55	9.00
3 yr fixed hsg rate	10 year average = 7.9%	8.95	9.10	8.80	7.89	7.60

ECONOMIC FORECASTS

Forecasts at Sept. 13 2007	March Years					December Years				
	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009
GDP - annual average % change										
Private Consumption	4.5	2.4	2.7	1.4	0.5	4.7	2.3	3.4	1.3	0.7
Government Consumption	5.1	4.2	3.7	3.4	3	4.3	4.5	3.8	3.5	3.2
Investment	4.2	-3.2	8.5	2.3	3.9	3.5	-2.7	7.6	3	3.2
GNE	4	0.7	4.5	2.2	1.8	4.1	0.7	4.4	2.5	1.8
Exports	-0.3	3.2	2.2	3	3.6	-0.6	1.9	2.9	2.6	3.7
Imports	4.1	-1.3	7.2	4.1	3.1	5.5	-2.5	7.5	4.3	3.2
GDP	2	1.7	2.8	1.8	1.9	2.2	1.5	2.9	1.9	1.8
Inflation – Consumers Price Index	3.3	2.5	2.8	316	3.1	3.2	2.6	2.7	3.1	3.1
Employment	2.6	1.7	1.5	0.9	1	1.6	1.4	2.4	1	0.9
Unemployment Rate %	3.9	3.7	3.4	3.6	3.9	3.6	3.7	3.4	3.5	3.8
Wages	4.6	5.5	4.8	4.2	3.3	5.1	5.5	4.6	4.5	3.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.64	0.7	0.76	0.67	0.61	0.7	0.69	0.76	0.69	0.61
USD/JPY	117	117	114	111	110	119	117	115	112	110
EUR/USD	1.2	1.32	1.43	1.38	1.32	1.19	1.32	1.42	1.40	1.32
NZD/AUD	0.87	0.88	0.84	0.78	0.74	0.94	0.88	0.85	0.78	0.74
NZD/GBP	0.36	0.36	0.38	0.36	0.35	0.4	0.35	0.38	0.37	0.35
NZD/EUR	0.53	0.53	0.53	0.49	0.46	0.59	0.52	0.53	0.49	0.46
NZD/YEN	74.6	81.9	87	77	67	82.7	81	87	77	67
TWI	65.6	68.6	71	64	59	71.9	68	71	65	59
Official Cash Rate	7.25	7.50	8.25	7.5	6.5	7.00	7.50	8.25	7.75	6.75
90 Day Bank Bill Rate	7.55	7.78	8.45	7.72	6.76	7.49	7.64	8.53	7.95	7.01
10 year Govt. Bond	5.71	5.91	6.4	6.2	5.9	5.89	5.77	6.5	6.25	5.9
2 Year Swap	6.99	7.76	7.95	7.05	6.59	7.24	7.48	8.24	7.25	6.62

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

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.