Offshore Overview

9 October 2008

Mission Statement

To help Kiwi exporters make informed financial decisions by discussing foreign economies and the NZ dollar in a language they can understand.

EXCHANGE RATES	**This week**	**Week ago**	**4 wks ago**	**3 months ago**	**Yr ago**	**10 yr average**
NZD/USD	0.61	0.672	0.667	0.753	0.76	.574
NZD/AUD	0.88	0.85	0.823	0.789	0.853	.858
NZD/JPY	61.6	71.3	72.1	80.9	89.3	66.8
NZD/GBP	0.353	0.38	0.381	0.382	0.374	.338
NZD/EUR	0.446	0.48	0.474	0.481	0.542	.51
NZD/CNY	4.16	4.61	4.56	5.16	5.71	4.68
USD/JPY	101.1	105.8	108.1	107.4	117.5	116.7
USD/GBP	1.728	1.77	1.75	1.97	2.03	1.687
USD/EUR	1.368	1.404	1.41	1.57	1.40	1.12
USD/CNY	6.8246	6.8451	6.8386	6.8546	7.5095	8.168
AUD/USD	0.693	0.793	0.81	0.954	0.89	0.67

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CURRENCY MOVEMENTS

There has been so much written about the worsening global financial crisis and the situation remains so precarious and uncertain that we don't think there are any particularly insightful comments we can make on the matter. But what we can do is give a run-through in summary form of what some of the key themes are.

- The crisis is continuing because no one believes banks in the northern hemisphere have revealed the full extent of their losses associated with bad lending into housing markets over the past few years. The general view is that interest rate cuts and rescue packages put together so far will prove insufficient to generate confidence that the losses have been revealed. So investors are preferring to hold their funds in cash, gold, and government securities rather than assets tied to the state of the economy and the state of the financial sector in particular. And as wholesale investors including managed funds see their previous loans to banks mature they are not reinvesting with those financial institutions.

- Worries about global inflation are going out the window as commodity prices collapse and forecasters cut growth expectations with many now predicting a global recession. http://www.bloomberg.com/apps/news?pid=20601068&sid=aZ19k8XSumeY&refer=economy

- Central banks in Europe, UK, Sweden, US, and Canada have reinforced moves to boost financial system liquidity with 0.5% cuts in interest rates. We expect New Zealand's official cash rate to be cut by 0.75% on October 23 and 0.5% on December 4. The Reserve Bank of Australia cut its cash rate 1% to 6.0% this week.

- The euro has been slammed lower recently in a continuation of general selling from 2 to 3 months ago based on a realisation that Europe's economy was slowing rapidly and probably entering recession. Now the currency has been slammed again as the realisation has hit that the credit crisis previously thought to mainly exist in the United States could be at least as bad in Europe. In addition with European interest rates expected to decline the differential against Japanese interest rates will fall. Plus there is a strong underlying belief that the ability of European leaders to get together and agree upon a comprehensive bailout package as has been passed in the United States is quite limited. Generally the expectation now is that it will take longer for Europe's financial crisis to end and longer for the European economy to recover than in the United States.

- The Japanese yen has soared as the final death blows have been applied to the carry trade. The carry trade involved borrowing cheaply in Japanese yen and investing in high yielding foreign currencies while running the risk that the Japanese yen would rise. Traders and investors have been cutting out their positions and this helps account for the sharp decline in the Kiwi dollar this week and the sharp rise in the Japanese yen.

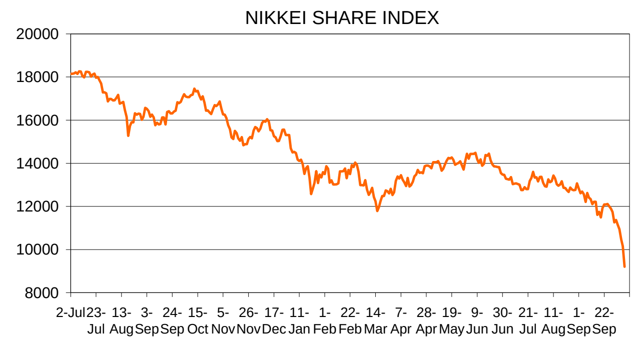
- The Kiwi dollar has been slammed lower not only by investors cutting carry trade positions but also by concern about New Zealand's status as one of the most indebted nations in the OECD, the movement of the government's fiscal accounts into deficit for the first time in 14 years, and plummeting commodity prices. We have also been dragged lower on the coattails of a collapsing Australian currency, but for a while rose above 90 cents against the AUD.

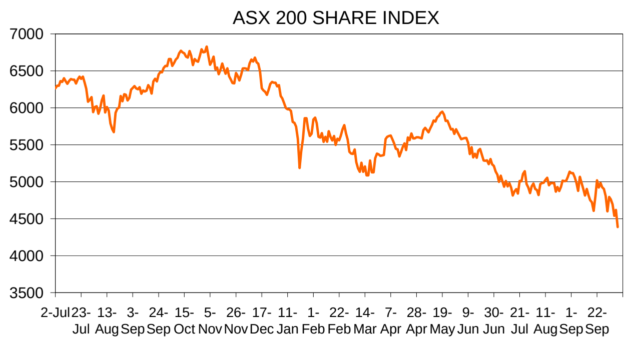
- The Australian dollar has plummeted mainly in response to sharp declines in commodity prices but also the 1% cut in the cash rate to 6.0% and ending of carry trades.

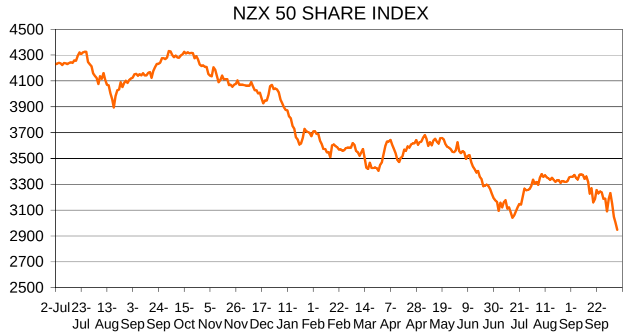
- There is a developing view that the final cost of bank bailouts in the northern hemisphere could greatly exceed current numbers. The IMF have upped their US$1bn estimate to US$1.4b. This implies stressed government balance sheets and higher debt servicing costs for businesses, consumers, and taxpayers.

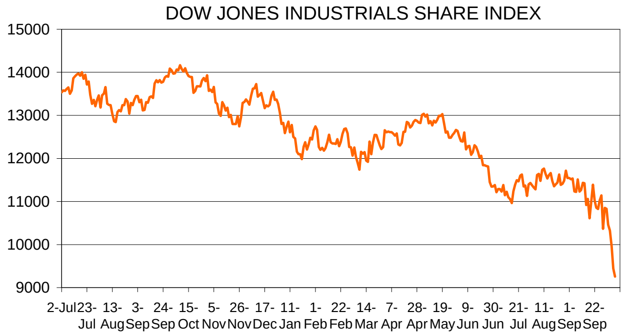
- Central banks and governments are being forced to come up with more and more measures to try and free up credit markets. In Europe governments are guaranteeing bank deposits, in the US the Federal Reserve this week agreed to purchase commercial paper – a key way in which US companies raise funds to keep operating. This practice is less common in NZ where generally companies fund through overdrafts. This weekend G7 Finance Ministers meet and further moves toward a global response to the crisis are likely.

So here are some of the numbers showing a massive rout in the markets over the past week and few months. The Dow Jones industrial index has fallen almost 15% over the past two weeks, is down 35% from October last year, and is at its lowest level since August 2003. Australia's main share index has fallen proximally 12% in the past fortnight, is 36% down from November last year, and is at its lowest level since July 2005. New Zealand's share index has fallen about 10% over the past fortnight, 32% since October last year, and is at its lowest level since May 2005.



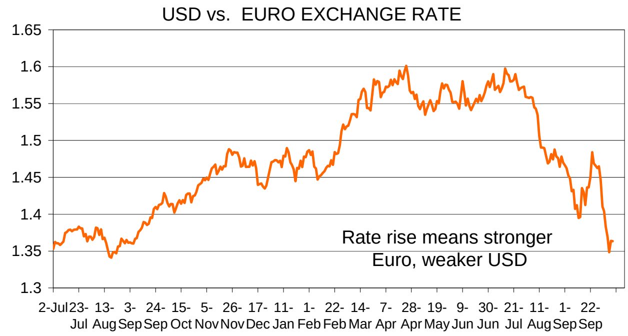


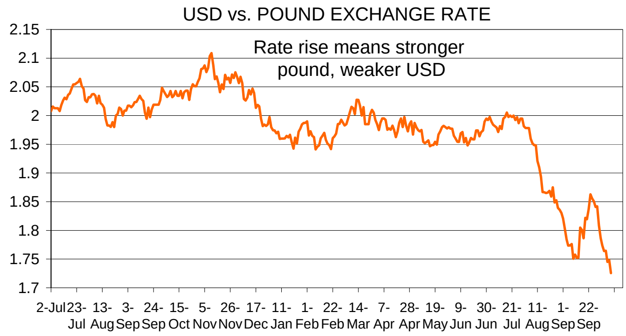




Why Is the US Dollar Rising?

At the time of writing the US dollar was trading near $1.728 against the British pound from $1.77 last week, and $1.85 a fortnight ago. Against the euro the greenback has also firmed to $1.368 to buy one euro from $1.40 last weekend $1.466 a fortnight ago.





With the financial crisis starting in the United States many people are quite rightly confused as to why the greenback has strengthened so much against other currencies in the past few weeks and months. Here is our version of the answer.

1. In times of massive uncertainty about the world economy and financial markets investors look to place their funds into what they believe others believe are safe assets. That means gold along with United States government bonds if not the greenback in physical form. It used to mean the German deutschemark and Swiss franc.

2. Ignoring the past fortnight the greenback had been appreciating against the euro and British pound because of a realisation that the economic problems deepening in the United States could easily be exceeded by deepening economic woe in these other major economies. Data released in the UK and Europe have been getting worse and worse and the quiet view starting to emerge has been that although bad times lie ahead the United States economy will probably recover before Europe and the United Kingdom. Hence extra selling of the pound and the euro.

3. With growing expectations that interest rates would be cut it has been perceived that scope for reductions in rates in Europe and the United Kingdom is greater than in the United States. That is, before tonight the Federal Reserve's funds rate was 2% compared with the European Central bank's main rate at 4.25% and 5% for the Bank of England. Numerically there is greater scope for reductions in Europe and the United Kingdom therefore a likely shrinking of the interest-rate differential between the United States and these two economies.

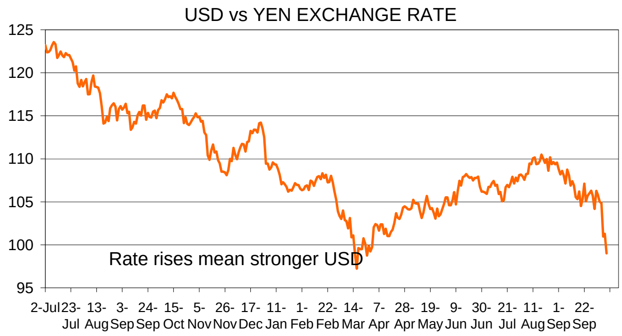
4. The fresh development over the past fortnight has been a realisation that the problems affecting financial institutions in the United States could be even worse for financial institutions in the United Kingdom and Europe. Therefore while ample reason exists for selling the greenback on the basis of worries about United

States banks greater scope exists for selling the pound and the euro because of worries about their financial institutions.

5. The Americans may make mistakes but they also make big decisions and bite the bullet went necessary. The Europeans on the other hand tend to dither and fight amongst themselves. They struggle to form a consensus about what should be done to regulate straight versus curved bananas through Europe and the collapse of financial institutions and seizing up of financial markets.

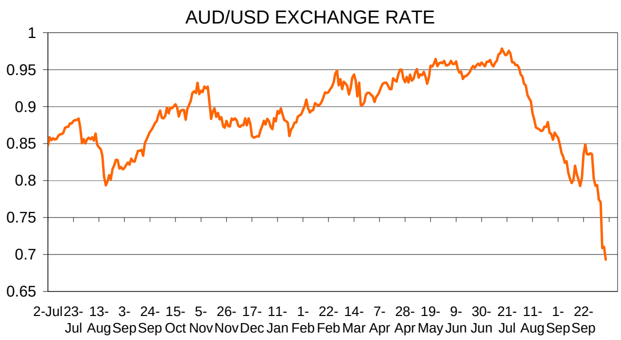
6. While everyone focuses upon the greenback measured against the euro or the pound or the yen there is also active direct trading in the Japanese yen against the euro and to a lesser extent the British pound. The closing out of the carry trade involving borrowing in Japanese yen and investing in high yielding currencies has led to extra selling of the euro and the pound against the yen to a greater degree than selling of the greenback against the yen. The selling has been greatest of all however for the Australian and New Zealand dollars against the yen.

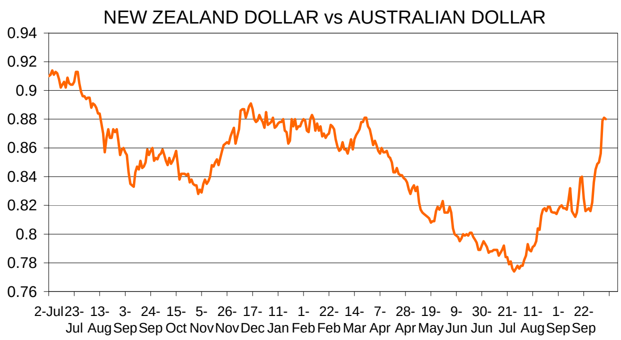
With the carry trade being closed out and the Japanese yen viewed as a low yielding but relatively safe currency because their financial institutions have not had involvement in the bad lending (this time) the greenback has fallen below 100 against the Japanese yen for the first time since March. It is currently trading near 101 compared with 105.8 last week and 106.0 a fortnight ago but traded below 99 early this morning.



Why Has the Australian Dollar Fallen so Sharply?

The Australian dollar has collapsed against the greenback over the past week. This morning it was buying around 67.0 cents compared with 79.0 cents a week ago, 83.0 cents two weeks ago, and 96.0 cents just over two months ago. The rate this afternoon has improved to 69.4 cents. The collapse in the Aussie currency has been so great that even our weakening dollar has risen against it to sit near 90.5 cents this morning and 88 cents now compared with 85.0 cents last week and 77.0 cents just over two months ago.





Why has the Aussie dollar fallen so much?

First of all the Australian currency has been slammed lower because it has been, like the Kiwi dollar, a high yielding currency which is the main beneficiary of the carry trade. With investors cutting out this trade which had involved borrowing cheaply in Japanese yen and investing in high yielding currencies the Australian dollar has been sold aggressively.

Second, like the Kiwi dollar the Aussie currency is viewed as a risky asset which tends to attract support when the outlook for the world economy and financial markets is good but gets sold when investors around the globe become risk averse and want their money in traditionally safe assets.

Third, and this is why the Australian dollar has fallen so sharply against the Kiwi dollar, Australia's export base involves minerals. The prices of things like coal and iron ore are heavily influenced by expectations for global growth and industrial output in particular. At the moment not only are forecasts for world growth being cut back but evidence is emerging of China reducing imports of fuel and other commodities. This is not so much leading to a reduction in expectations that over the next few decades Australia's economy will be underpinned by exports to China, but is leading to previous speculative support for the Australian dollar related to speculative support for minerals prices ending.

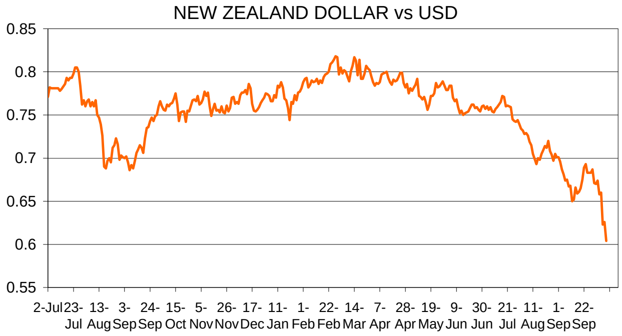
Why is the Kiwi dollar already where we thought it would be at the end of 2009?

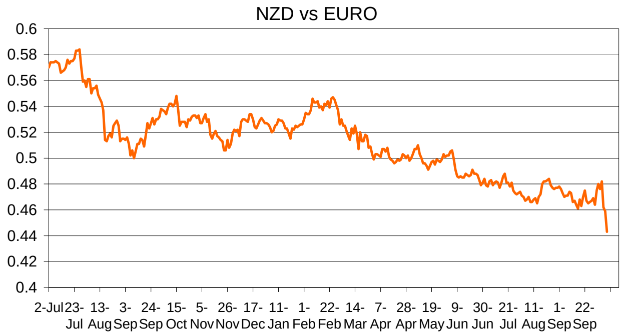
As we have tried very hard to point out a number of times in the Overview, exchange rates cannot be reasonably predicted. Recent events show that anything is possible so the fact that we are 10.0 cents lower at the moment than we thought we would be is surprising but not ridiculous.

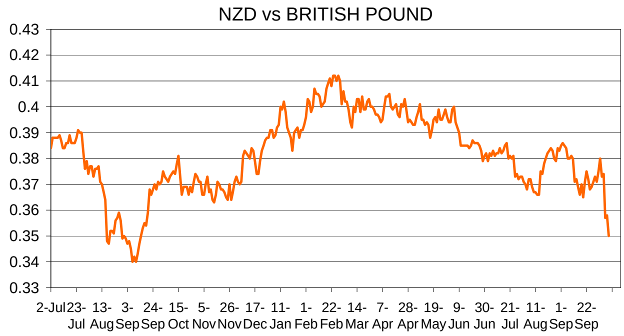
The Kiwi dollar has fallen against a stronger greenback - discussed above - and because of selling related to reduced expectations for our commodity export prices in the near future. Expectations for greater nominal cuts in interest rates in New Zealand than Japan, the United Kingdom, United States and Europe help explain some of the fall as well. In addition because we are viewed as a risky currency the surge in investor risk aversion around the world has led to selling of the Kiwi dollar and purchasing of what are traditionally viewed as safe assets.

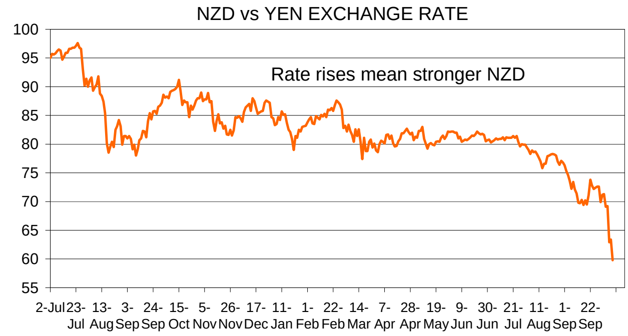
No financial variable can be reasonably predicted in this current extreme global environment and all we can say is that the fall in the currency will eventually be good for our export sector but for the moment exporters should be extremely cautious heading into a global recession.

We have ended today against the greenback near 61 cents compared with 67.4 cents last week, 35.3 pence from 38.0 last week, 61.6 Japanese yen from 71.3 last week, and 44.6 cents against the euro from 48.0 cents. We have risen against the Australian currency to just over 88.0 cents from 85.0 cents last week.







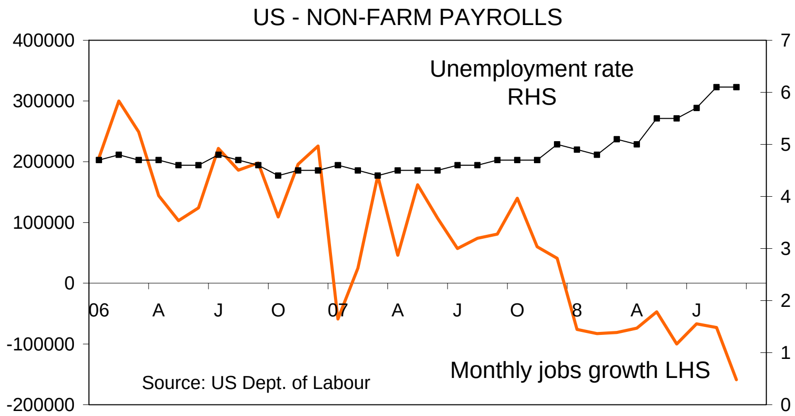


THE WEEK'S MAIN OFFSHORE EVENTS

United States Data

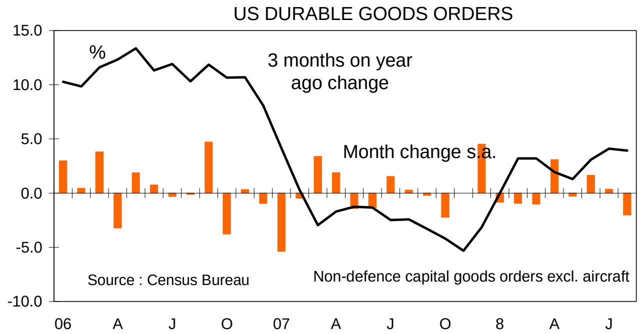
GDP +1.0%, CPI +5.4%, funds rate 2.0%, 9% of NZ visitors & 12% of exports, $10.5b FDI in NZ, 21% global GDP. NZ exports to US -12.7% year to May, tourists -2.2%.

The main piece of economic data out of the United States this week was the non-farm payrolls report for September. It came in weaker than expected with job numbers falling 159,000 whereas a decline of 105,000 had been expected. The unemployment rate at least remained unchanged at 6.1% but is likely to go higher in the near future. Business employment intentions are very weak and one can't help but think the recent ructions in the financial sector will encourage a few more companies to lay off employees as a precautionary measure.



In fact the labour market tends to lag what is happening with the economy and because forecasters are expecting additional weakness in output in the near future the unemployment rate could easily go substantially higher than it is at the moment. This means continued weakness in demand for retail goods and services and backs up the warning we have been giving that New Zealand exporters selling goods to the United States retail sector or who rely upon people visiting here should budget for weak sales over the coming year.

In a sign that the outlook for the manufacturing sector is quite poor the value of orders placed for durable goods fell in August fell by a relatively large 4.5% from July in seasonally adjusted terms. Over the three months to August the value of orders was down by 3.4% from a year earlier. The graph shows the change in durable goods orders when the defence sector and aircraft orders are stripped out to get a better feel for what is happening underneath. Their is still some mild growth under way supported by the low greenback assisting exporters.



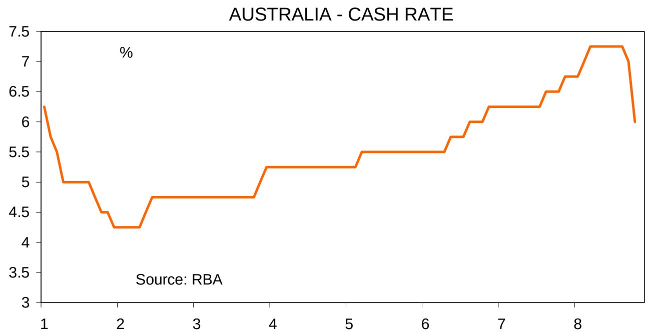
Want to find out about exporting to the US? Start here.
http://www.nzte.govt.nz/section/11728.aspx
http://www.mfat.govt.nz/Countries/North-America/United-States.php

Australian Data

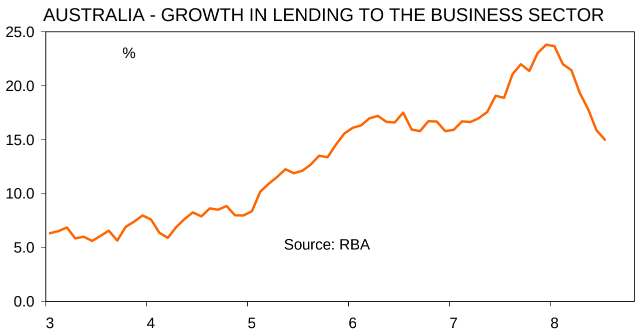
GDP +3.7%, CPI +4.5%, cash rate 7.0%, 39% of NZ visitors (but 16% spending) & 22% of exports, $47b FDI in NZ, 1.2% global GDP. NZ exports to Australia 23.4% (oil) year to May, tourists 5.5%.

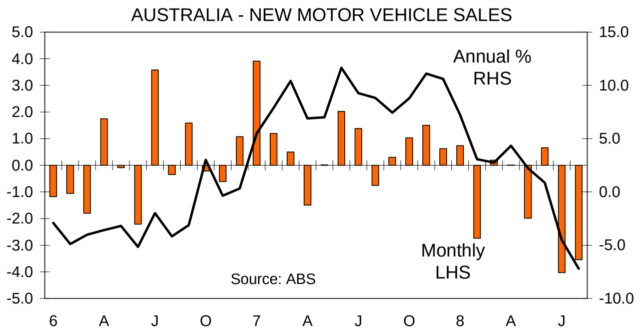
In Australia the week started being all about massive weakness in the sharemarket and the Australian currency associated with the deepening credit crisis in the northern hemisphere. Then on Tuesday afternoon the Reserve Bank surprised everybody by cutting its cash rate 1% to 6.0%. This is the greatest reduction since 1992 and gives a clear signal to the markets that the RBA is taking the current situation quite seriously both in terms of potential weakness in the economy and stress in the financial markets.

In the words of the RBA Governor "An unusually large movement in the cash rate was appropriate in order to bring about a significant reduction in costs to borrowers,"



What this means is that because the cost to Australian banks of borrowing money has increased tremendously the RBA feels it needs to slash wholesale interest rates to which rising risk premiums are applied in order to get some sort of feed-through into lower interest rates facing Australian households and businesses. This is the same rationale which the RBNZ used four weeks ago when it cut our official cash rate by 0.5% to 7.5%, and it is likely to be the same rationale they will use on October 23 when they cut probably 0.75% if not 1%.

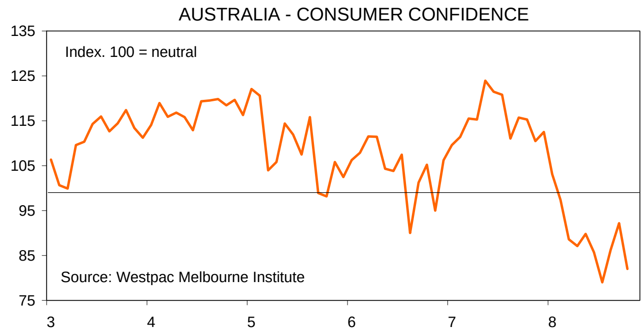


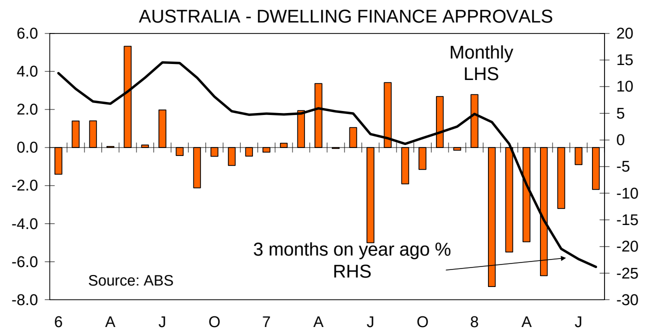


The cut in the cash rate comes after it had earlier been pushed to its highest level in 12 years amidst concerns about rising inflation, and following more recent data showing the economy grew at its slowest quarterly pace in four years over the June quarter. Credit growth on a monthly basis has decelerated to its slowest pace in 22 years, residential construction is falling away and car purchases are declining.

Our expectation is that the cash rate will be cut by another 0.5% in November and that further cuts in the March quarter will see the rate reach 5% which is considered just below the neutral level for Australia. In other words even at the current level of 6% the official cash rate in Australia is viewed as acting as a brake on the economy.

Helping to justify the 1% interest rate cut was the sharp 11% decline in consumer sentiment recorded during September in the Westpac monthly index. The monthly fall was the greatest in two years and suggests remaining strength in retail spending could easily evaporate in the near future. It will be interesting to see the impact on confidence and spending of the interest-rate reduction but one suspects it could be minor given the widespread concerns about financial stability offshore.





There was even more justification in weak lending approval numbers. Seasonally adjusted dwelling finance approvals fell for the seventh month in a row in August to lie 25.5% down from a year earlier. Construction is falling away strongly and even more so for investment properties – in a country where there are already dwelling shortages.

Want to find out about exporting to Australia? Start here.
http://www.nzte.govt.nz/section/11728.aspx
http://www.mfat.govt.nz/Countries/Australia/Australia.php

OTHER ECONOMIES

Data releases have received little attention in Japan, UK, Europe and China with all attention on the ructions in the financial markets.

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