# BNZ Weekly Overview

9 October 2008

## Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

**In this week's issue….**



The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the WO and Offshore Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line. You do not have to be a BNZ customer to receive the WO.

## Making Sense Of It All

We mainly cover the global credit crisis in the Offshore Overview. But for those who only read the Weekly Overview in a nutshell this is what is going on at the moment.

Banks in the northern hemisphere lent out a lot of money to people over the past few years that they should not have. These people now cannot service their mortgages so banks are having to write off losses. So far those loses total almost US$600 billion. US, UK and European banks traditionally raise a lot of their funds by selling securities to investors. These investors have also lost billions of dollars so are less willing to supply funds to banks generally. This means that predominately in the United States, United Kingdom and Europe banks cannot undertake normal lending to households and businesses because they cannot easily borrow money.

This is called a credit crunch and it only ends when investors become willing again to lend to major banks. But investors believe banks still have hundreds of billions of dollars worth of losses to report and are fearful that if they lend to a bank it may go bankrupt. Or if they do not necessarily believe that they believe other investors believe it so are unwilling to purchase bank securities.

Worries about the size of losses still to be revealed by banks have increased in light of deteriorating economic conditions in northern hemisphere economies and of course this generates a downward spiral effect as banks find it even more difficult to borrow, they cut their lending, and more businesses close down because they cannot even get an overdraft.

Central authorities around the world are being forced to take on management of the bad debts of these banks one way or the other. This may mean guaranteeing deposits of small depositors so they keep their money in banks, injecting capital directly into banks (nationalising them), lending increasing amounts of money to banks to supplant investors who are not there, or bypassing banks altogether and purchasing commercial paper issued by companies as is now happening with the Federal Reserve in the United States.

With so much uncertainty about how long it will take for the credit crisis to be resolved investors are selling any asset they consider risky and that means shares along with peripheral currencies like the Kiwi dollar.

The point will eventually be reached where investors sitting on increasing piles of cash and government securities decide downside risks are exceeded by upside risk for the prices of risky assets. When this happens falls in asset prices will cease, confidence will slowly improve, availability of funds to banks will improve, and the general commentary will turn towards continuing bad economic conditions for another 6 to 9 months but good light at the end of the tunnel probably at some point in late 2009 or 2010.

No-one knows when this point of equilibrium will be reached or at what level for indexes such as the Dow Jones Industrials. The longer it takes the worse the outlook for the world economy and therefore the outlook for the New Zealand economy. Governments and central banks are now holding meetings to agree on further actions which will get the markets to this new equilibrium point as quickly as possible.

Making any strong statements about what growth in the New Zealand economy over the next 12 months will look like in light of this huge uncertainty would be relatively silly. The best we can do is to give a reminder that over the past few weeks while confidence measures were going skyward in New Zealand (now they are falling) we kept emphasising growth prospects for 2009 still looked quite muted. We cited high food and petrol prices along with over 80% of mortgages being at fixed rates so most borrowers would not benefit from easing monetary policy for quite some time, along with worsening growth prospects in our trading partners and businesses attacking cash flows by cutting expenditure.

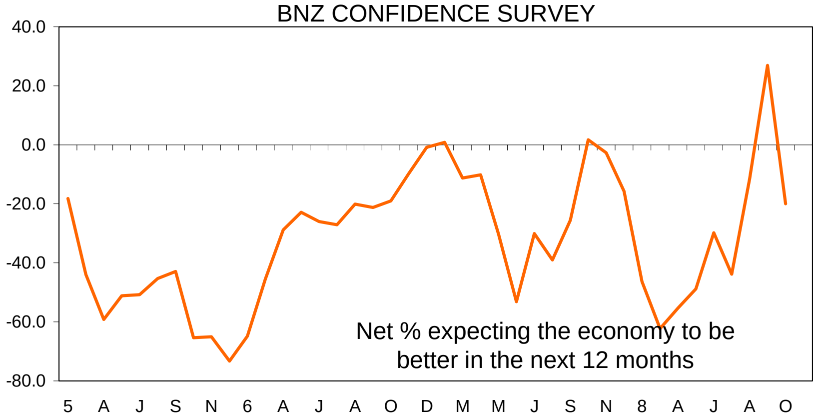
We say exactly the same thing now but with the extra warning that as each day goes past prospects for world growth seem to be getting worse and now the common expectation is of a global recession. This brings extra downside risks to our commodity prices, makes us more certain that visitor numbers into New Zealand will fall 5% and probably more in the next 12 months, and reduced demand for manufactured goods. There will be some good offset for exporters from the sharp decline in the Kiwi dollar but that will of course mean increased costs in some other areas.

Easing fiscal policy in the form of tax cuts will provide some assistance but the unemployment rate is likely to rise from 3.9% at the moment to above 5% late next year. And deteriorating credit conditions will only exacerbate what is already a horrible decline in residential construction.

Above trend growth in the New Zealand economy is not likely to come around again until 2010.

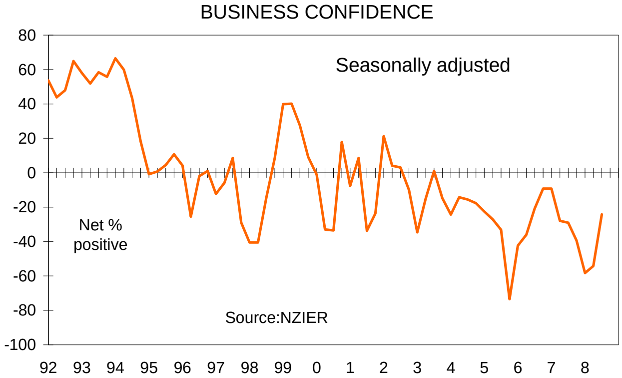
## Confidence In Retreat

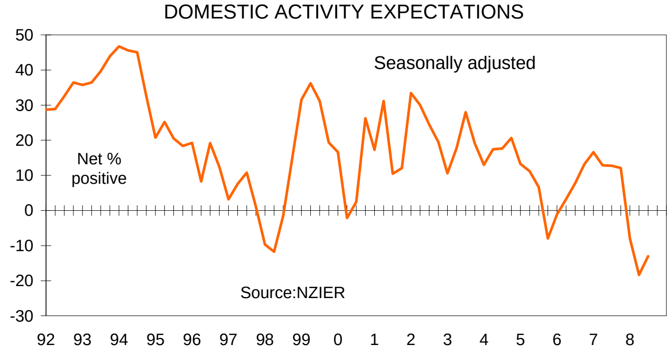
This week we have received confirmation that the surge in business and consumer sentiment seen during September was a blip and not the start of a new trend. Our monthly survey of Weekly Overview readers has revealed a net 20% expect the economy to get worse over the coming year. This is quite a turnaround from the net 27% positive recorded in September survey – but not surprising at all. Over the past four weeks we have been expressing caution about the sustainability of the confidence surge and pointing out our belief immediate prospects for NZ economic growth remain muted. That caution is proving justified and it's easy to understand why sentiment has deteriorated.



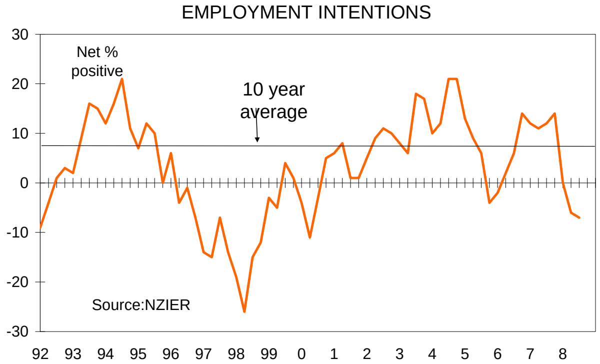
Global credit markets involving the financing of banks by wholesale investors have ceased up internationally. Sharemarkets are falling, commodity prices declining at their greatest rate in 50 years over the past week, and commentary about the world economy is becoming more and more pessimistic. The cost to banks of raising money has increased even further over the past week and this means even when our central bank cuts the official cash rate by at least 0.5% in two weeks time reductions in business and household borrowing costs will be less than that.

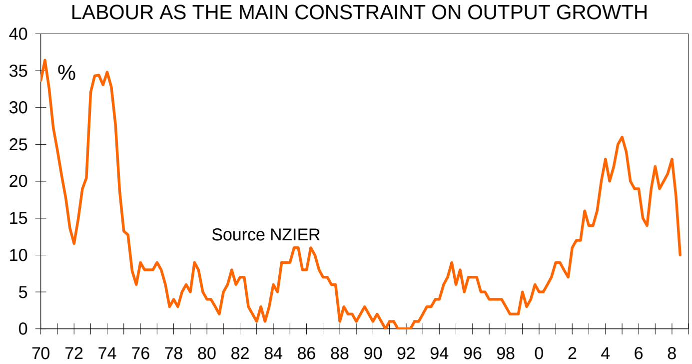
The chances of the Reserve Bank cutting 0.75% on October 23 have in fact increased strongly over the past week not just because of the global credit crisis or the fall in confidence recorded in our survey. The NZIER's highly detailed and long running Quarterly Survey of Business Opinion has shown that although business expectations about the economy over the next three months have improved to a net 24% pessimistic from 54% in the June quarter (seasonally adjusted) other indicators remain bad.



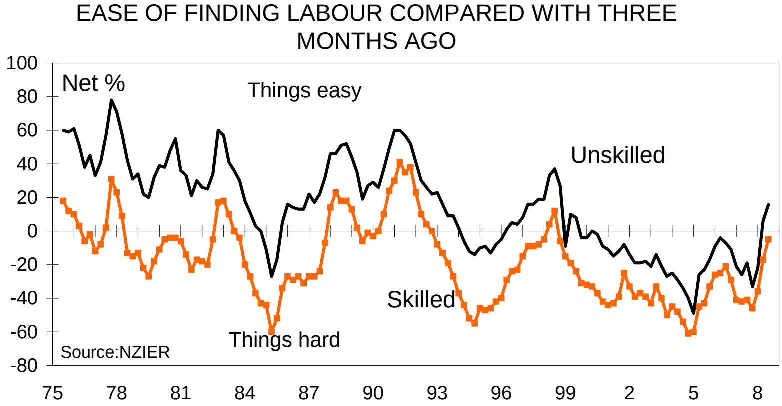




A net 16% of businesses say they plan cutting back investment in plant and equipment. This is barely changed from 17% in the June quarter and in line with our long-running comment that in an environment of constrained cash flows businesses will be delaying capital expenditure. We have also noted that businesses will be looking to lay off people and we can see this in a number of ways in the survey. Employment intentions have worsened to a net 7% negative from 6% negative in the June quarter, and a net 11% said they laid people off in the September quarter from 3% in the June quarter.



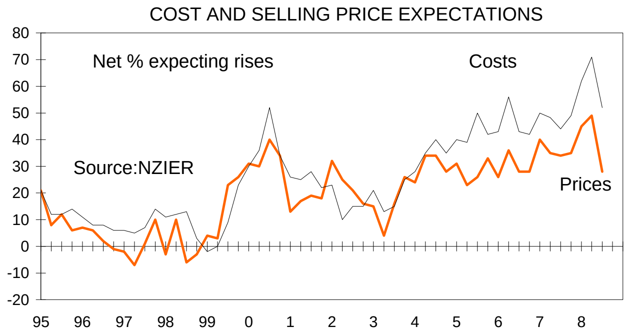



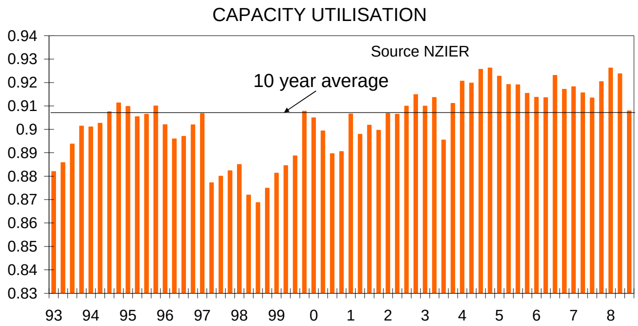

Only a net 5% of respondents said they now find it difficult to get skilled labour compared with 17% in the June quarter and 36% in the March quarter with the 10 year average reading for this measure sitting at 34%. A net 16% say they now find it easy to get unskilled labour from 6% in the June quarter, 22% finding it hard in the March quarter, and an average reading of 11% finding it difficult.




And now only 10% of businesses say that a shortage of labour is the main constraint on their ability to boost output. In the June quarter this was 18% but given that the 10 year average reading is 13% one could not actually say the New Zealand labour market is necessarily unusually loose. It is on the loose side of neutral now but one suspects businesses are still aware of the structural shortage of employees in New Zealand and that is why we still don't think unemployment will be shooting up all that strongly this cycle.

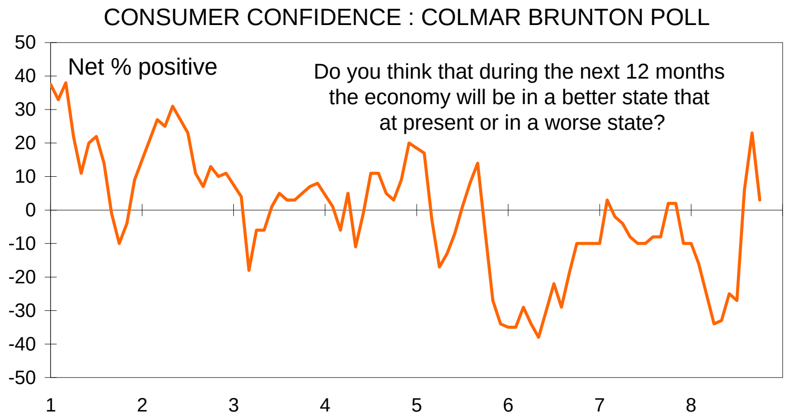
The thing which will especially please the Reserve Bank is that weakness in the economy and the market facing businesses is resulting in quite a decrease in inflationary pressures. Although still well above the average 33% the net 52% of businesses that expect costs will go up in the coming quarter is down from 71% in the June quarter. And most significant of all the net percentage of businesses planning to raise their prices has declined to 28% from 49% in the June quarter which is practically equal to the 10 year average reading of 27%.




When one adds in a fall in the capacity utilisation rate to 90.8% from 92.4% in the June quarter and a 10 year average reading of 90.7%, the green light is clearly given for the Reserve Bank to cut interest rates further. For the moment we are still of the opinion that the low point for the cash rate will be close to 6% - increasingly likely to be 5.5% rather than 6% - but the speed with which they get there now looks like being relatively rapid in light of the deteriorating credit conditions offshore and the 1% rate cut across the Tasman this week.

For the record, the reduction in business confidence recorded in our survey has been mirrored in a reduction of consumer confidence recorded in the One News Colmar Brunton poll released this week. Only a net 3% of consumers now expect the economy will get better over the coming year whereas the survey last month revealed a net 23% feeling optimistic. Neutral is roughly 0%.

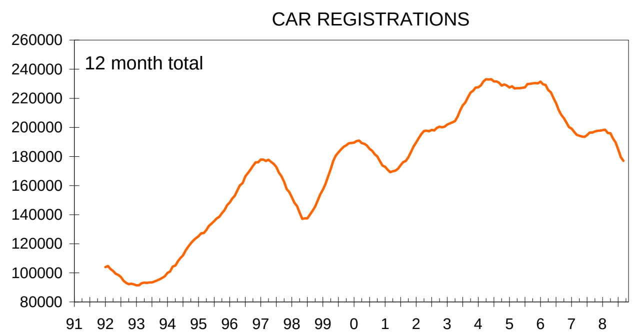


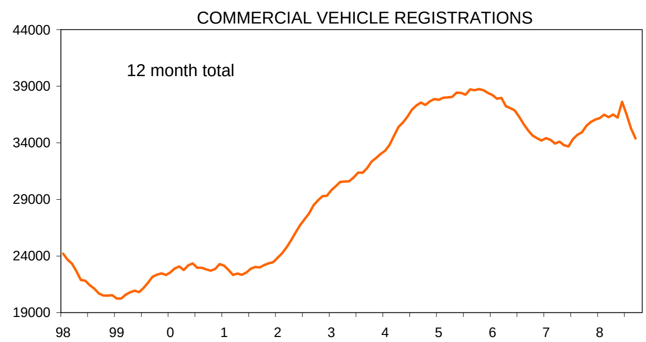

# NZ ECONOMIC DEVELOPMENTS

**Friday 2**

## Car Purchases Still Falling

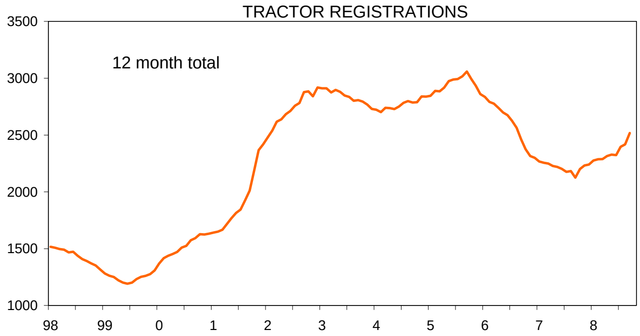
in September there were 13,829 cars registered around New Zealand. This was a decrease from a year earlier 15.6% meaning that for the September quarter registrations were down almost 25% from eight year earlier. This is clearly quite a weak result which is also reflected in the seasonally adjusted decline for the quarter of almost 8% which follows a decline of 10% over the June quarter and 3% in the March quarter. Consumers have pulled back aggressively in their motor vehicle purchases in the face of declining house prices, low consumer sentiment, rising unemployment, high debt servicing costs, and rising petrol prices.




But an even worse decline in expenditure is underway for commercial vehicles. In September there were 2,115 commercial vehicles registered around New Zealand which was a decrease from a year earlier of a relatively strong 29%. This followed a 39% decrease in August and means that over the September quarter registrations were down from a year earlier by approximately by 33%. There is a small downward bias to this number however as a result of some changes in braking requirements introduced at the start of the September quarter but the fact that the monthly numbers for August and September continued to fall strongly after the pullback in July from an unusual 41% annual surge in June shows that businesses are pulling back quite aggressively on their capital expenditure. This is something we have been writing about four quite some time in terms of businesses having to respond to a deficiency of cash flows by laying off spare employees, cutting inventories, rationalising product lines, and delaying capital expenditure.

Meanwhile down on the farm spending on tractors continues to boom. In September there were 331 tractors registered around New Zealand which was a 44% increase from a year earlier. The September quarter rise from a year ago was 33% and the seasonally adjusted gain from the June quarter was 10%. Maybe the strong spending however will slow down in the near future following the cut in Fonterra's forecast dairy payout this year and further falls recorded recently for international dairy prices.




**Monday 5**

## Fiscal Outlook Deteriorates

In their Pre-Election Economic and Fiscal Update Treasury have painted a picture of some severe deterioration in New Zealand's fiscal accounts over the next few years. The OBEGAL - or operating balance excluding gains and losses as well as revenue from the New Zealand superannuation fund - is expected to record a tiny deficit this year before increasing to $3.2 billion by the year ending June 2013.

| Year ending March | Budget | PEFU |
|---|---|---|
| 2009 | +$1.4b | -$31m |
| 2010 | +$1.0b | -$1.7b |
| 2011 | +$0.5b | -$2.4b |
| 2012 | +$0.2b | -$3.0b |

The deterioration results from a combination of higher expenses related to weaker economic growth causing high benefit payments, along with greater than expected uptake of the Kiwisaver scheme and 20 hours free childcare plus greater debt servicing costs. In addition projected tax revenue has fallen almost $1 billion per annum as result of lower growth in the economy.

Where the numbers get quite scary is looking at the cash balances that the Finance Minister has highlighted in recent years with an emphasis on the need to keep these in surplus.

| Year ending March | Budget | PEFU |
|---|---|---|
| 2009 | -$3.5b | -$5.9b |
| 2010 | -$3.3b | -$5.3b |
| 2011 | -$3.4b | -$6.6b |
| 2012 | -$3.6b | -$6.8b |

And that then leads to a much worse outlook for government debt.

| Year ending March | Budget | PEFU |
|---|---|---|
| 2009 | -$3.5b | -$5.9b |
| 2010 | -$3.3b | -$5.3b |
| 2011 | -$3.4b | -$6.6b |
| 2012 | -$3.6b | -$6.8b |

And that means that whereas previously the ratio of gross debt to GDP had been expected to peak near 22% it is now expected to reach over 24% come 2013. The ratio of net debt to GDP was previously seen going negative but it is now expected to increase to 13% of GDP come 2013.

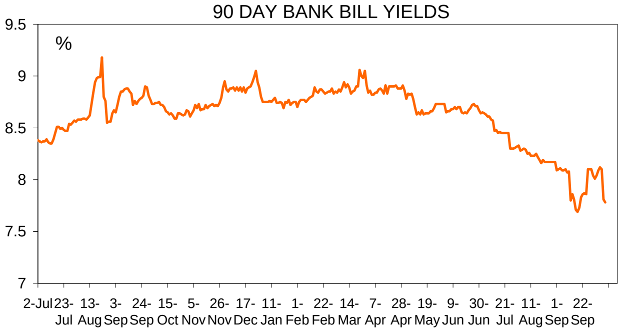
While the turnaround from an expected series of continuing small budget surpluses into deficits may seem quite severe it's probably best to put things into perspective. As a proportion of GDP the deficit only reaches approximately 1.5% which is extremely small and is unlikely to greatly concern international investors or credit rating agencies. But it does apply pressure to politicians who were thinking about either large spending programs or large tax cuts.

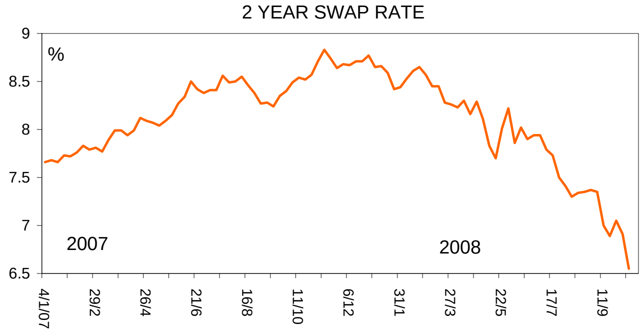
# INTEREST RATES

Wholesale interest rates have fallen solidly this week on expectations that a surprising 1% cut in Australia's official cash rate and coordinated 0.5% cuts in other economies overnight will be copied here in New Zealand with possibly at least a 0.75% cut at the next review on October 23 if not a matching 1% reduction.

Downside risks to growth in New Zealand are increasing and for that reason whereas just a few weeks ago we were backtracking from thinking the low point in the official cash rate cycle could be 5.5% we are back now to expecting that to be the level the Reserve Bank eventually cuts to. And the cuts are going to happen sooner rather than later with the next large cut coming on two weeks - probably at least 0.75%.

The yield on 90 day bank bills has ended the week near 7.75% from 8.04% last week. The one-year swap rate has ended near 6.75% from 7.23% and the two-year swap rate has ended near 6.55% from just over 6.9%. Further falls are likely in coming months as monetary policy gets eased potentially quite aggressively.




**Key Forecasts**

- Monetary policy easing with the official cash rate near 6% come late 2009.
- The two year fixed housing rate falling below 8.50% at a stretch late 2008, hitting the five year average of 7.8% in mid-2009 optimistically, but going lower will require weaker data on the NZ economy and decent easing of global credit tensions – possible late in 2009. Falling to the 6.5% low of 1999, 2001 and 2003 is very unlikely this cycle.

| FINANCIAL MARKETS DATA | This week | Week ago | 4 wks ago | 3 months ago | Yr ago | 10 yr average |
|---|---|---|---|---|---|---|
| Official Cash Rate | 7.50% | 7.50 | 7.50 | 8.25 | 8.25 | 6.2 |
| 90-day bank bill | 7.81% | 8.04 | 8.10 | 8.58 | 8.72 | 6.5 |
| 10 year govt. bond | 5.66% | 5.74 | 5.88 | 6.24 | 6.32 | 6.2 |
| 1 year swap | 6.75% | 7.23 | 7.33 | 8.24 | 8.77 | 6.7 |
| 5 year swap | 6.67% | 6.86 | 6.84 | 7.48 | 8.09 | 7.0 |

## If I Were a Borrower What Would I Do?

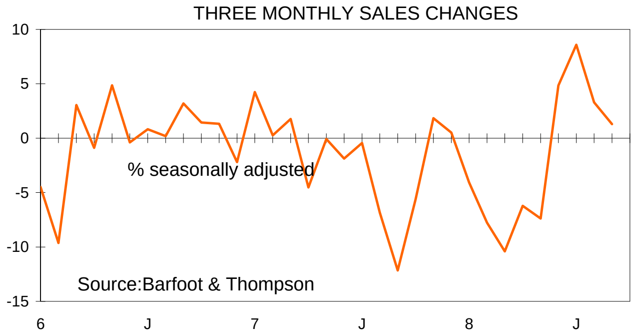
Given the high chances that the RBNZ will cut its cash rate sharply in the near future I would now be inclined to float and ride down the fall in fixed rates.

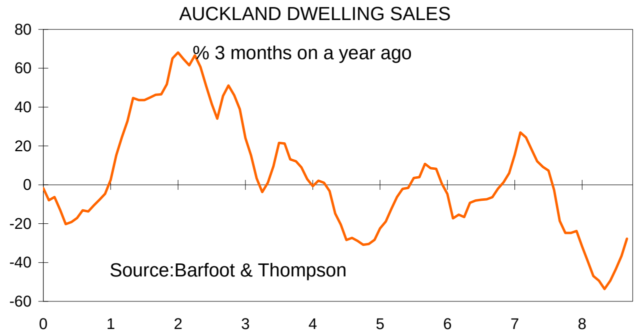
# HOUSING MARKET UPDATE

Treasury's central scenario for house prices presented in this week's Pre-Election Economic and Fiscal Update is that they fall 11.3% from their peak in 2007 to mid-2009 before flattening out for a couple of years. We think that forecast seems reasonable though if the credit situation internationally continues to get worse then the worst case scenario of house price falls more than double that does come into play both here and overseas.

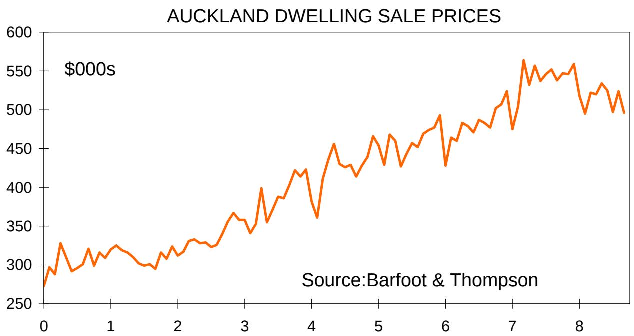
## Auckland Real Estate Data

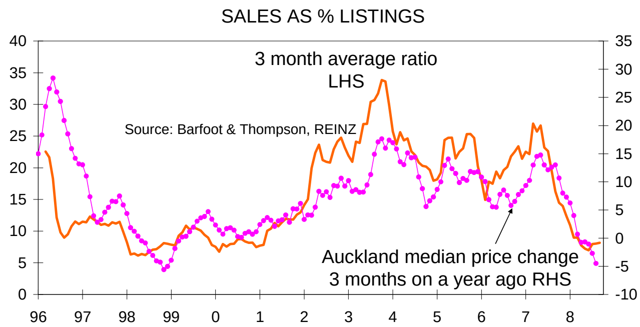
During the week we learnt there was a small recovery in dwelling sales activity in Auckland over September according to the monthly data from Barfoot and Thompson. During the month they sold 559 properties which was a 17% decrease from a year earlier and a seasonally adjusted improvement from sales in August of about 7%. The overall level of activity remains exceedingly low but there is no longer a decline as such in turnover under way. The median dwelling sale price pulled back to where it was two months ago at $496,000 which was a decrease from a year earlier of 7.8%.




The total number of listings remained relatively high at 6,802 which was a rise from a year earlier of 33%. But in contrast with the previous three or four months when we have been noting vendors taking their properties off the market over September it looks like a few more felt encouraged to put them on - or were forced to by financial circumstances. There were 1,263 new listings received by Barfoot and Thompson during September which was an increase from 1,078 in August. This is the first rise between these two months since 2004 when the gain was just seven extra listings.



**Key Forecasts**

- Dwelling consent numbers to fall from 24,500 in the year to March 2008 to below 18,000 in the year to March 2009 with a slight recovery to March 2010 then above average activity after that as attention turns to a shortage of dwellings late in 2009.
- Real estate sales falling from 77,130 in the year to April 2008 to between 55,000 and 65,000 come the end of this year then recovering back over 65,000 in calendar 2009 with further growth over 2010.
- House prices down 5%-10% by the end of 2008, flat over 2009, rising slightly over 2010.

# Exchange Rates & Foreign Economies

See the Offshore Overview.



Blanket apology for any strange words or phrases resulting from not doing enough proof-reading after using the Dragon Naturally Speaking voice recognition software.

## ECONOMIC DATA

| All % | | Latest qtr only | Previous qtr only | Latest year | Year ago | 2 Yrs ago |
|---|---|---|---|---|---|---|
| Inflation | RBNZ target is 1% - 3% on average | 1.6% | 0.7 | 4.0 | 2.0 | 4.0 |
| GDP growth | Average past 10 years = 3.0% | -0.2 | -0.3 | 2.6 | 2.4 | 2.4 |
| Unemployment rate | Average past 10 years = 5.3% | 3.9 | 3.7 | ...... | 3.6 | 3.6 |
| Jobs growth | Average past 10 years = 1.9% | 1.3 | -1.3 | 0.7 | 1.5 | 3.0 |
| Current a/c deficit | Average past 10 years = 5.5% of GDP | 7.8 | 7.9 | ...... | 8.5 | 9.6 |
| Terms of Trade | | 2.9 | 3.7 | 8.8 | 3.8 | -1.9 |
| Wages Growth | Stats NZ analytical series | 1.2 | 1.3 | 5.5 | 4.5 | 5.5 |
| Retail Sales ex-auto | Average past 9 years = 3.8%. | 0.2 | 0.1 | 3.1 | 4.9 | 5.6 |
| House Prices | Long term average rise 5% p.a. | -0.7 | 0.4 | 2.8 | 11.7 | 12.2 |
| Net migration gain | Av. gain past 10 years = 10,400 | +4,938 | 4,938yr | ...... | 8,738 | 12,500 |
| Tourism – an. av grth | 10 year average growth = 5.0%. Stats NZ | 0.8 | 1.5 | 0.8 | 3.7 | -0.9 |
| | | Latest year rate | Prev mth year rate | 6 mths ago | Year ago | 2 yrs ago |
| Consumer conf. | 10 year average = 2%. Colmar survey | 3 | 23 | -34 | 2 | -10 |
| Business activity exps | 10 year average = 26%. NBNZ | 4.7 | -8.2 | 2.4 | 16.7 | 6.1 |
| Household debt | 10 year average growth = 11.3%. RBNZ | 7.7 | 8.4 | 11.9 | 13.7 | 13.8 |
| Dwelling sales | 10 year average growth = 3.5%. REINZ | -42.4 | -52.9 | -32.1 | -1.3 | 5.0 |
| Floating Mort. Rate | 10 year average = 8.1% | 10.45 | 10.95 | 10.69 | 10.55 | 9.55 |
| 3 yr fixed hsg rate | 10 year average = 7.9% | 8.69 | 9.09 | 9.54 | 8.75 | 7.89 |

## ECONOMIC FORECASTS

| Forecasts at August 28 2008 | March Years | | | | | December Years | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Will update next week | 2007 | 2008 | 2009 | 2010 | 2011 | 2006 | 2007 | 2008 | 2009 | 2010 |
| ***GDP - annual average % change*** | | | | | | | | | | |
| Private Consumption | 2.8 | 3.3 | -1.1 | 1.4 | 2.3 | 2.6 | 4.1 | -0.6 | 0.6 | 2.3 |
| Government Consumption | 4.4 | 4.2 | 3.7 | 3.2 | 3.3 | 4.7 | 4.2 | 3.8 | 3.3 | 3.2 |
| Investment | -1.9 | 4.2 | -0.2 | -0.4 | 7.6 | -1.5 | 4.7 | 0.6 | -2 | 6.7 |
| GNE | 1.2 | 4.5 | -0.4 | 1.4 | 3.8 | 1.1 | 4.7 | 0.4 | 0.5 | 3.5 |
| Exports | 3.1 | 2.3 | 0.6 | 4.6 | 3.1 | 1.7 | 3.4 | 0.5 | 4 | 3.2 |
| Imports | -1.7 | 9.7 | 1.8 | 0.5 | 3.6 | -2.8 | 8.8 | 4.1 | -0.1 | 2.7 |
| GDP | 1.6 | 3 | 0 | 2.6 | 3.6 | 1.6 | 3.1 | 0.4 | 1.7 | 3.6 |
| Inflation – Consumers Price Index | 2.5 | 3.4 | 4 | 2.4 | 2.2 | 2.6 | 3.2 | 4.3 | 2.7 | 2 |
| Employment | 1.8 | -0.2 | 0.4 | 0.7 | 1.9 | 1.4 | 2.5 | -0.6 | 0 | 1.9 |
| Unemployment Rate % | 3.7 | 3.7 | 4.7 | 5 | 4.8 | 3.8 | 3.4 | 4.5 | 5 | 4.8 |
| Wages | 5.5 | 4.4 | 5 | 3 | 2.4 | 5.5 | 4 | 5.3 | 3.4 | 2.4 |
| **EXCHANGE RATE ASSUMPTIONS** | | | | | | | | | | |
| NZD/USD | 0.7 | 0.8 | 0.66 | 0.63 | 0.65 | 0.69 | 0.77 | 0.68 | 0.62 | 0.66 |
| USD/JPY | 117 | 101 | 111 | 116 | 120 | 117 | 112 | 110 | 114 | 120 |
| EUR/USD | 1.32 | 1.55 | 1.46 | 1.36 | 1.3 | 1.32 | 1.46 | 1.47 | 1.37 | 1.34 |
| NZD/AUD | 0.88 | 0.87 | 0.79 | 0.77 | 0.81 | 0.88 | 0.88 | 0.8 | 0.76 | 0.8 |
| NZD/GBP | 0.36 | 0.4 | 0.36 | 0.36 | 0.39 | 0.35 | 0.38 | 0.37 | 0.35 | 0.38 |
| NZD/EUR | 0.53 | 0.52 | 0.45 | 0.46 | 0.5 | 0.52 | 0.53 | 0.46 | 0.45 | 0.49 |
| NZD/YEN | 81.9 | 81.1 | 72.9 | 73.1 | 78 | 81 | 86.3 | 74.8 | 70.7 | 79.2 |
| TWI | 68.6 | 71.6 | 62.2 | 61.4 | 64.9 | 68 | 71.6 | 63.8 | 60.1 | 65 |
| Official Cash Rate | 7.50 | 8.25 | 6.75 | 5.5 | 6 | 7.50 | 8.25 | 7.25 | 5.5 | 6 |
| 90 Day Bank Bill Rate | 7.78 | 8.83 | 6.78 | 5.73 | 6.23 | 7.64 | 8.77 | 7.41 | 5.73 | 6.23 |
| 10 year Govt. Bond | 5.91 | 6.35 | 6.1 | 6.1 | 6.3 | 5.77 | 6.38 | 6.1 | 6.1 | 6.25 |

**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.**