



BERL Monthly Monitor

July 2011

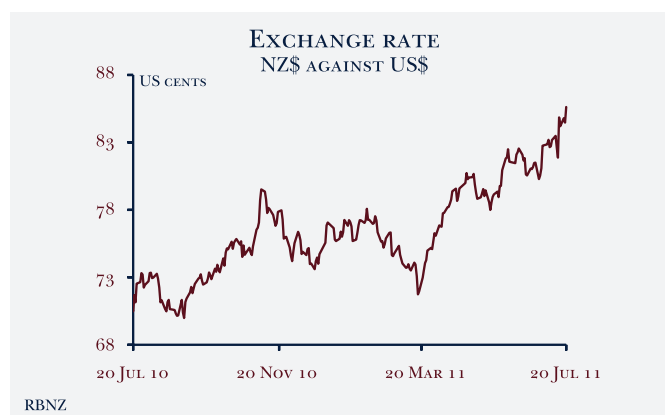
Exchange rate market failure

The last couple of weeks have seen a lemming-like rush towards an acceptance that higher interest rates are just around the corner. Higher than expected GDP growth and CPI inflation figures have been used to underpin calls for a monetary policy response. Despite little evidence of a fast-growing demand-fuelled over-heating of the New Zealand economy, there seems an almost universal acceptance that higher interest rates are the appropriate response to this inflation episode.

Consequently, we now have yet another factor pushing the NZ\$ exchange rate in a direction that is diametrically opposed to what is needed to re-balance the New Zealand economy – not to mention for the long-term development of the New Zealand economy. Amongst these factors are:

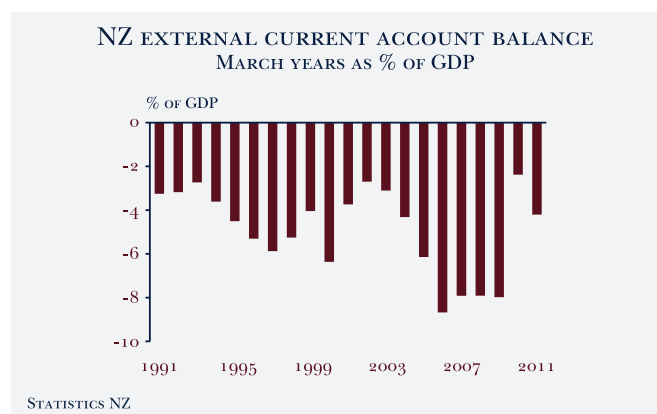
- increasing commodity prices fuelled by demand from Asia, magnified by climatic events hitting production capacity
- the continuing uncertainty as to the outcome of the Greece sovereign debt situation and its implications for European financial institutions and, indeed, national economies
- the weakness of the US\$, magnified by the ongoing political brinkmanship surrounding debt ceiling negotiations
- commentary that growth and inflation is on the rise here and so New Zealand interest rates will be higher sooner.

The combination of these influences and the direction in which they are sending the NZ\$ all point to a fundamental market failure of the exchange rate setting mechanism. There are several aspects to this market failure.



Firstly, take the argument that the NZ\$ is being pushed up in line with commodity prices. This perspective has its origins in the core role of an exchange rate to balance a nation's external payments position. Unfortunately, the market appears to interpret this perspective narrowly.

In particular, market players seem to be implying that an increase in commodity prices risks pushing NZ into a surplus position, so a higher NZ\$ is required to re-balance that effect. Such a perspective would only be true if the nation was close to being in an external balance situation in the first place (i.e. before the commodity price rises). Needless to add, New Zealand's annual external balance has varied from a deficit of about 2% to 9% of annual GDP over the past two decades. Translating this to a national debt position, New Zealand's indebtedness has ranged from approximately 74% to 90% of annual GDP. And official Treasury forecasts expect the level of indebtedness to worsen over the medium term out to 2015.



Consequently, to imply that we have been anywhere near to 'balance' beforehand, and so a stronger NZ\$ is justified due to higher commodity prices, is a curious interpretation of New Zealand's situation. At the very least, it is a clear market failure.

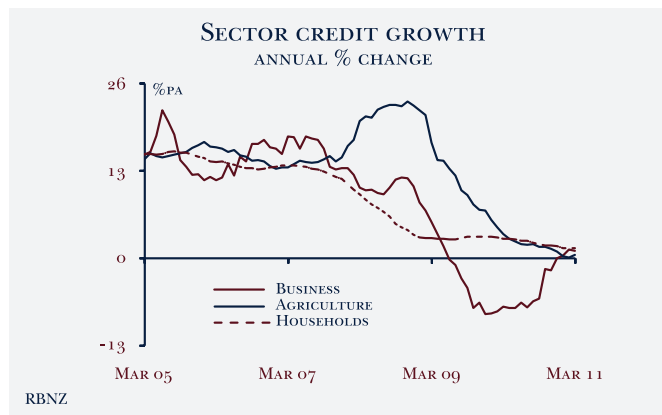
Secondly, take the argument that the sovereign debt crisis in Europe and the US debt situation is making investors look elsewhere. This suggests that New Zealand's sovereign debt position is not as bad as some New Zealand commentators, officials and political spokespeople make it out to be. The market failure here is that the focus is on sovereign debt, without regard to a nation's debt situation or its external balance position. That NZ\$ is in demand because of its potentially favourable yield, despite an external indebtedness position that is amongst the highest in the developed world, indicates that market players are making decisions on less than full information – yet another market failure.

Thirdly, take the argument that New Zealand's economic growth situation is fuelling expectations of higher interest rates here and so encouraging investors in search of higher yielding assets. This argument, takes the exchange rate mechanism noticeably away from its core role to balance a nation's external payments position. That is, the exchange rate is being influenced by investors looking to re-balance their asset portfolios, rather than need to balance a nation's external payments.

In other words, influences from capital flows are dominating the influences required from the perspective of current trade (exports, imports and other current payments) flows. This is a market failure, which left unaddressed means we need another mechanism to re-balance our external payments position. If we do not, we risk our payments position being re-balanced over the longer term by means that may be significantly more unpalatable than an exchange rate depreciation.

Credit growth remains minimal

Despite the acceleration in inflation, there are no signs of an unsustainable expansion in credit that would justify a tightening of monetary conditions. As illustrated by the chart, credit to agriculture, non-agriculture businesses and to households have hardly grown over the past 12 months. Indeed, credit to agriculture is at 0.2% above year-earlier levels; to non-agriculture business is 0.8% up on year-earlier, having been below year-earlier levels for most of the past 18 months; and to households is 1.2% higher than that of a year ago. As noted in the GDP article below, the turnaround in business investment is promising (and, indeed, remarkable) given this context of relatively restrictive credit conditions.



Jeopardising the turnaround in business investment during the initial stages of the recovery by a pre-emptive interest rate rise, and so a further tightening of monetary conditions, would seem inappropriate.

Despite the incessant calls by market players for interest rate rises, we need to remember that monetary policy is only supposed to be used in the face of demand-driven inflationary pressures. As the chart illustrates, there can be no suggestion that credit conditions are fuelling a demand-driven expansion.

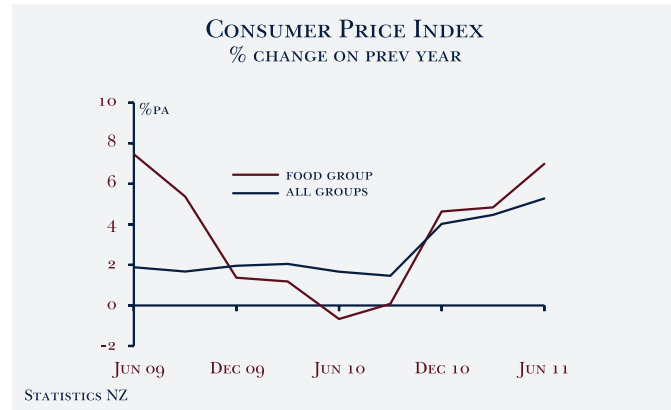
In the current situation, much of the inflation (domestically at least) is caused by supply, regulatory (tax) and/or external influences, as noted below. In such a case a monetary policy response is not only inappropriate, it can lead to significant long-term 'collateral damage'.

Inflation returns to haunt recovery

The Consumer Price Index (CPI) measure of inflation rose by 5.3% for the year to June 2011. Statistics New Zealand has estimated that approximately 2.3% of this rise is due to the GST increase in October last year. Excluding the GST increase, this puts the CPI annual rate of inflation at 3%, which is only just within the Reserve Bank's target range of between 0% to 3%. Consequently, the latest CPI results will be weighing heavily

on the minds of the Reserve Bank officials as they considers their next OCR announcement on July 28 and the following September Monetary Policy Statement.

With the effects of GST still working its way through since its rise in October, along with influences from higher global prices, the Reserve Bank's interest rate statements will be closely scrutinised.

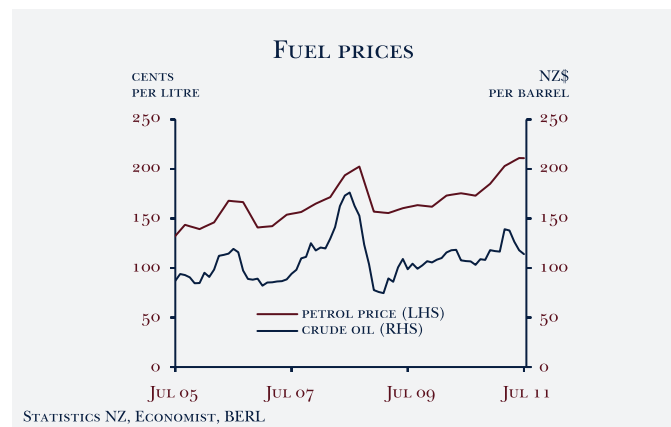


Overall, prices for nine of the eleven subgroups of the CPI increased over the year to June. Most of the CPI rise came from prices in the transport group, which were up 11% from a year ago. This was followed by prices in the alcohol and tobacco and food groups, up 7.1% and 7% respectively.

Price rises in the transport group were no surprise given that petrol prices have increased. Despite an appreciating NZ\$ exchange rate, petrol prices have risen from around 175 cents/litre in July last year to be around 207 cents/litre now. It is revealing to note that crude oil prices have actually been declining since April this year, with the average price of crude oil (translated into NZ\$ terms) dropping from an average of \$140 per barrel, to \$114 per barrel in July.

Noticeably, up until April this year rises or declines in crude oil and petrol prices have been in line with each other. With the NZ\$ now above 85 US cents, many would have expected petrol prices to have declined in recent months. However, the apparent breakdown in the relationship between crude prices and petrol prices in the latest few months suggests another influence at play. Industry sources suggest timing lags, as well as effects from the Emissions Trading Scheme (ETS). No doubt, the ongoing development of this relationship will continue to be closely monitored.

Also contributing to the 11% rise in transport group prices, were domestic and international aviation transport services,



up 8% and 6.8% respectively. Of course, these are also likely to be influenced heavily by costs arising from higher global fuel prices.

Alcohol and tobacco prices, despite being up 7% from June last year, have declined by 0.6% over the latest quarter. The annual change in prices in this group is mostly influenced by tax changes – both GST and excise duty rises.

Food prices are still rising, increasing 1.1% over the June quarter. The increase in prices of grocery food has mainly been driven by the increased price of bread and cereals, up 3.1%. Bread and cereal prices have been pushed up with the price of wheat increasing, due to plantations being destroyed in Canada, Australia and Russia. Prices of non-alcoholic beverages are also up, with coffee and tea up 5.9% over the June quarter, due to severe weather again reducing supplies from two of the main coffee making countries of Colombia and Indonesia.

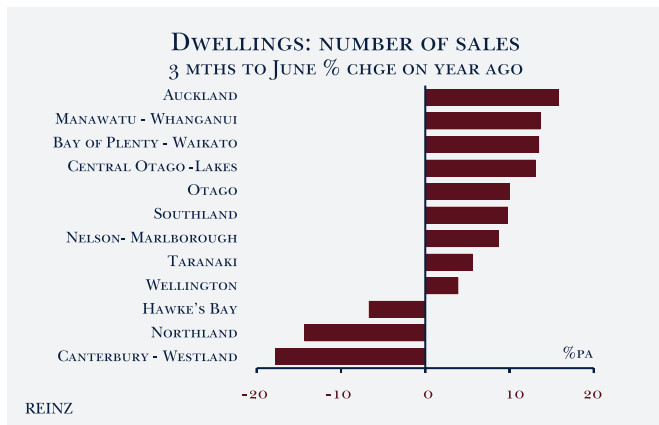
On a positive note for consumers, prices in the clothing and footwear and the communications groups decreased over the June quarter. Prices in the clothing and footwear group are heavily influenced by import prices, and the strengthening NZ\$ is undoubtedly playing a role here. The largest drop in prices over the June quarter was in the communication group with the price of telecommunications equipment (predominantly televisions) declining by more than 20% over the past year. Again, this will be closely related to the rising value of the NZ\$.

Tentative signs in housing market

With the Reserve Bank not changing the OCR in May, floating mortgage rates have stayed still at around 6-6.5%. However, this scene is complicated by much commentary and speculation that suggests interest rates will rise towards the end of this year. Consequently, the residential housing market remains in a situation probably aptly described as ‘treading water’.

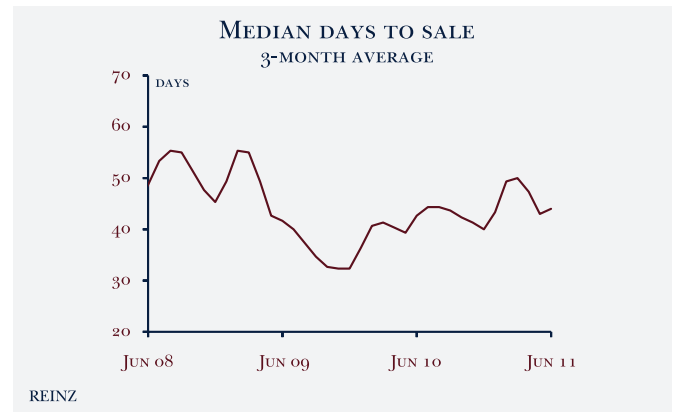
The Real Estate Institute of New Zealand (REINZ) reported a spike in median house prices in March when median house prices skyrocketed to \$365,000, well up on previous months. Prices had a brief decline over April and May, but have recently increased again with the national median price in June of \$360,000 up 2.1% from year earlier.

The number of sales has started to pick up, with total national sales for the three months ending June up 6.6% on year-earlier figures. Interestingly, regional differences are also beginning to emerge.



Compared to year-earlier levels, nine of the twelve regions had an increase in sales for the three months to June. The stand-out region was Auckland, recording sales up 16%. Also registering noticeable positives are the export-dominated regions of Manawatu-Whanganui, Bay of Plenty-Waikato, and Central Otago-Lakes, which all recorded increases in sales of above 13% over the latest three months. Other export dominated regions, such as Otago, Southland, Taranaki and Nelson-Marlborough also recorded noticeable increases in the volume of sales.

Clearly, the Canterbury-Westland result is dominated by the effects of the earthquakes, with large decline in house sales for the three months to June of 18%. What is of concern also, is that the decline in house sales in Northland is of a similar magnitude to that of the Canterbury-Westland region, down 14%. The Hawke's Bay also had a decline in the number of house sales, which is somewhat of a surprise given the performance of exports this year.



A further tentative positive sign for the housing market is the decline in the number of days to sale. From a national peak of over 50 days, this figure plummeted to just over 30 days in late 2009. This premature optimism was short-lived, as days to sale rose again to be well over 45 days for most of the past 12 months, reaching close to 50 days earlier this year. The latest figures, though, suggest a tentative reversal towards the 45 day mark.

GDP growth surprising – or incredulous?

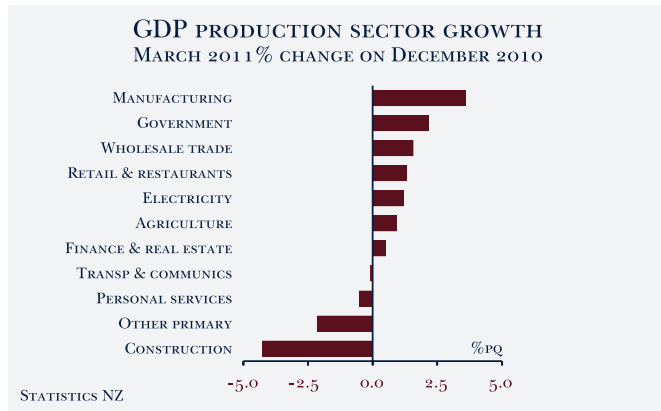
The New Zealand economy managed to show surprising resilience, with the latest GDP figures reporting a 0.8% growth in the March 2011 quarter. This unexpectedly high growth rate has been a ray of sunshine to some, while a surprise to others. Reasons for the surprise were the expected negative effect of the Canterbury earthquake along with generally subdued domestic spending nationwide. Indeed, estimates that the ‘excluding Canterbury earthquake’ GDP figures suggest an economy growing by a remarkable 1.3% during the quarter (or, an annual rate in excess of 5%) add to our suspicions around this set of data. However, a strongly performing export sector – and in manufacturing in particular – appears to have underpinned this result.

Production numbers confirm that the gain in GDP is dominated by a revival in the manufacturing sector, which increased activity by 3.6% over the March quarter. This figure was driven within manufacturing by a phenomenal 16% increase in machinery and equipment manufacturing, and an equally impressive 9% growth in metal product manufacturing. These two industries contribute nearly 30% of total manufacturing sector production.



Unlike the manufacturing sector, activity in the construction (down 4.3%) and the mining (down 5.3%) sectors contracted during the March quarter. The former remains subdued as house building activity continues to be in the doldrums, while the latter will have been affected by the closure of the Pike River mine. On an annual basis, production increased in most sectors, with the mining, forestry, and wholesale trade sectors showing the strongest growth whilst the agriculture sector had a setback.

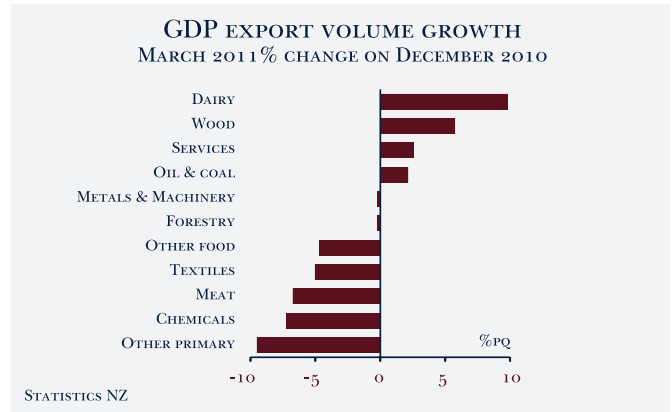
On the expenditure side, GDP grew 0.6% during the March quarter. Increases came mainly from the government consumption (up 1.2%), exports (up 0.8%) and household consumption (up 0.4%) categories.



Compared to year-earlier levels, GDP expenditure was up 1.1%, with continuous improvement in business confidence translated into growth in business investment (up 11.5%). Though there was a slight dip during the latest quarter, business investment reached over \$5bn, approximating its pre-recession level on the same quarter in 2007.

Such growth is expected to be translated to income terms for the household sector as jobs are expected to be created. However, household spending numbers remained tentative. And housing investment declined again (down 2.1% compared to the previous quarter), meaning this component has contracted in ten out of the last 12 quarters.

Interestingly, its stated emphasis on trimming spending and reducing its deficit, government spending continues to grow significantly according to these numbers. The latest quarter recorded spending in real volume terms up 3.2% on year-earlier levels, with the latest quarter some 1.2% up on the previous quarter.



And the export engine of growth remained dominated by the dairy and forestry performance during the March quarter. According to the GDP data, the 0.8% quarterly increase in export volumes was led by a nearly 10% rise in dairy product volumes, followed by a nearly 6% rise in wood and paper products.

However, there was a 0.3% fall in metal products and machinery export volumes during the March quarter, as well as a 0.3% contraction in forestry primary product export volumes. The former figure clearly contradicts the 16% quarterly rise in machinery and equipment manufacturing and the 9% increase in metal product manufacturing recorded on the production side of the GDP accounts. Further, the forestry figure contradicts the data on logs export volumes from trade data. This reinforces our suspicions as to the veracity of the latest GDP data.

Recorded GDP growth of twice analysts' expectations is encouraging, but we contend the recovery remains fragile. Flat consumer spending and the strengthening of the NZ\$ remain causes for concern. And, now, calls for increases in interest rates in response to rising inflation do not augur well for the recovery in business investment. Further, the likely re-direction of resources to the Christchurch re-building effort is also set to impact (negatively) on prospects for a broader recovery taking hold.

On the plus side, those reconstruction efforts in Christchurch and the Rugby World Cup should bolster activity in the immediate short term.

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