



# BERL Monthly Monitor

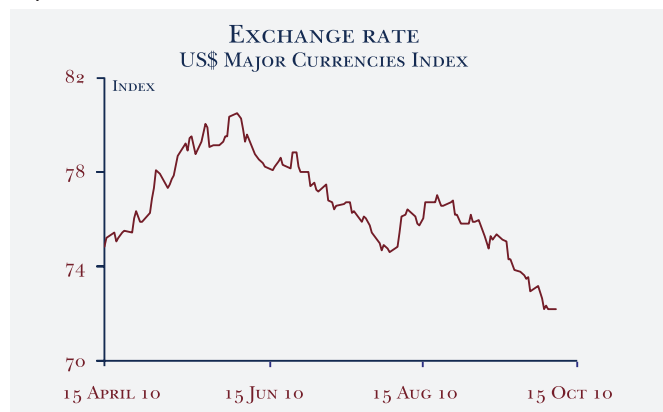
## October 2010

### Ho hum on the domestic front, but global currency turmoil

Domestically, it has been ho-hum over the past month with the 90-day interest rate and the Trade-Weighted Index (TWI) up only a few points at 3.20% and 66.8 as we go to press. Internationally however there has been abundant action as financial leaders wrestle with the basic imbalances in the financial system. Not since US President Nixon took the US\$ off gold, some 40 years ago, has there been so much turmoil.

Thus we see the emergence of “currency wars” in the form of strong pressure from the US on China to appreciate the Yuan significantly, direct intervention by Japan to depreciate the yen, and decisions by both the US Federal Reserve and the Bank of England to engage in further quantitative easing to partially depreciate their currencies.

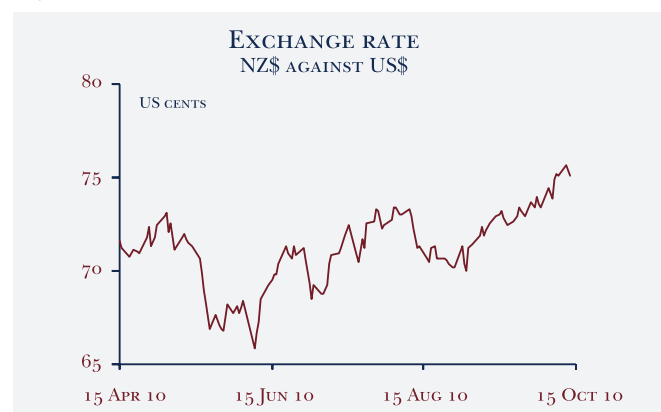
There is widespread recognition that a global approach is necessary, but meetings of the G20 and IMF have failed to agree on what measures to undertake. Realistically, it is everyone for themselves, and for New Zealand the question is stark: do we allow our dollar to appreciate as major players depreciate or do we take our own defensive action?



As we have for the past quarter century, BERL favours management of our dollar. Consequently, we welcome calls by other commentators for such or similar action. In the context of a personal epiphany, Bernard Hickey (Managing Editor of interest.co.nz) has recently written about the seriousness of the problem. The problem lays not only in the damage to the tradable goods industries, but also in the likely inflow of hot money at a time when our foreign debt to GDP ratio is already at dangerous levels.

On the grounds that New Zealand is too small to move “the market”, our authorities have traditionally opposed

intervention notwithstanding the fact that sterilized intervention is a long established concept in finance literature and widely implemented around the world. Of course, it can run into trouble when authorities are trying to maintain an over-valued exchange rate, without adequate foreign currency reserves with which to intervene. But when the intervention is to prevent over-valuation, the only limit is the supply of a central bank's own currency. This is not a problem for a truly independent central bank that is not facing inflationary pressures. When countries as small as Mauritius are intervening to stabilise their exchange rate and are being complimented on it by the IMF, one wonders why the New Zealand authorities think it is beyond them.



On the cross-rates a slightly different picture emerges from the relative stability of the TWI. For most export destinations the appreciation of the NZ\$ has been significant, while of course there are a few against which we have depreciated, notably against the AU\$ (now at parity with the US\$) the major destination for our manufacturing exports.

As to interest rates, while the 90-day rate is up only a few points, there has been quite a fall in the 10-year bond rate from 5.28% to 5.02%. This is pretty much where it was before speculation on a higher Official Cash Rate (OCR) began.

Latest data shows little change in retail bank interest rates at the end of September, and continuing tightness in credit availability. Some banks are now advertising near zero deposit for housing finance but only to high-income first homebuyers. We doubt there will be significant improvement in the housing market as a result of this and this will be of little value to business borrowers - where the problem is greatest. This data also shows lending growth to the productive sectors barely in positive territory, and we see no signs of improvement on the horizon.

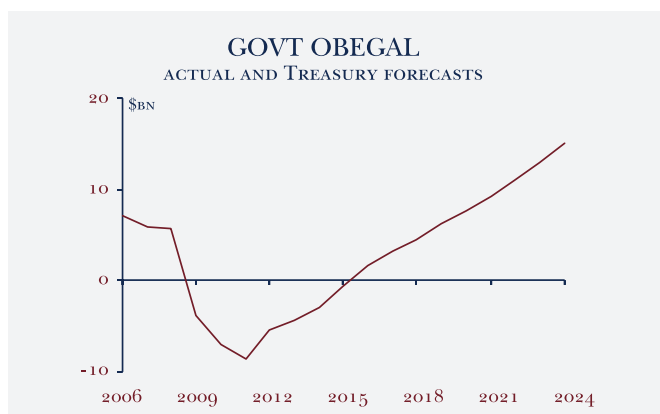
## Hole in government finances

The Government Financial Statements for the year to June 2010 were released in October and confirmed an operating balance excluding gains and losses (affectionately referred to as the OBEGAL) in deficit to the tune of \$6.3bn. This is a \$2.9bn deterioration on the \$3.4bn deficit recorded in the year to June 2009. On the bright side, the deficit is \$600m lower than the number forecast in this year's May Budget.

The reduction in revenue included a \$4bn decline in tax receipts. Of this decline, some \$2.4bn is estimated to have arisen from the impact of the recession reducing the profits and interest income of companies and individuals. A further \$1.5bn decline is attributed to the delayed impact of earlier tax cuts.

On the expenditure side, the reduction of \$2.4bn arose from reduced spending on State-owned Enterprises (SoEs) and other Crown Entities, while there was no change in overall spending on core Crown expense items. However, within the core Crown items, health and education spending rose \$1.1bn and benefit expenses increased \$1.5bn, including a \$500m rise in New Zealand Superannuation and a \$300m increase in unemployment benefit payments.

As shown, the deficit on the OBEGAL measure is expected to worsen this year then gradually improve before moving into surplus in the 2015/16 year.



However, with the stalling of New Zealand's recovery in recent months, the expected improvement may be in jeopardy and suggests ongoing spending restraint in the government sector.

Consequently, the net debt of the Government has risen to \$26.7bn, from the \$17.1bn recorded in June 2009. This represents a rise in net government debt to over 14% of GDP, having been only 5.6% of GDP two years ago. The results of the latest accounts are well within the Government's debt strategy of net debt remaining below 40% of GDP. However, the rapidity of the deterioration, along with the costs of the tax package just implemented and the weak economic growth picture now being forecast, suggests that this debt picture is set to worsen considerably, before getting any better.

## Inflation set to impact on household finances

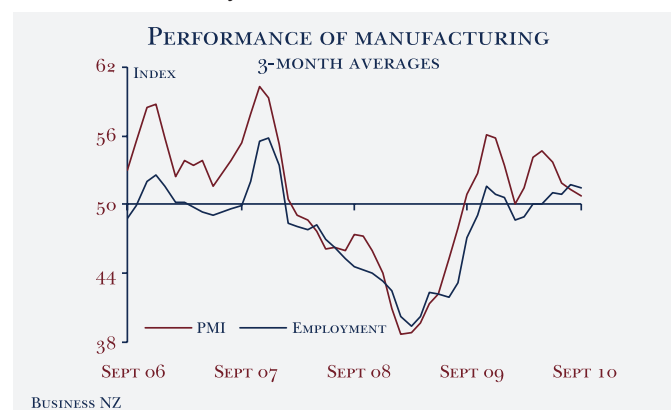
The Consumers Price Index (CPI) was up 1.1% in the September 2010 quarter, driven by higher food prices, local authority rates, and electricity. This is significantly higher than the increases of 0.2, 0.4 and a fall of -0.2 percentage points in the previous three quarters. Despite this, inflation was up 1.5% on the year, the smallest annual increase since the year to the March 2004 quarter.

In the current economic environment, there is little opportunity for businesses to raise prices, and increases are only occurring due to forces outside their control i.e. food prices up because of the weather. The high NZ\$ is also keeping the price of imports down.

The increase in GST will kick in from this (December) quarter, raising the annual CPI inflation measure to over 4.0% for the following four quarters. However, we expect to see the CPI settle back to between 2% and 2.5% from December 2011. This is slightly higher than the annual 1.5% to 2.0% range that we have seen over the last six quarters. This is because we expect to be past the immediate post-recession period by then and, also, the delayed impacts globally from the current monetary stimuli.

## Manufacturing remains becalmed

The surveys we monitor indicate that manufacturing activity continues to tread water. The Bank of New Zealand – Business New Zealand Performance of Manufacturing Index (PMI) stood at 49.2 in September. This is not much of a change from the 49.3 recorded in August, and 49.9 in July. Only two of the five seasonally adjusted sub-indices recorded expansion this month. Employment recorded the highest value – for a change – at 51.7, followed by new orders at 50.3.

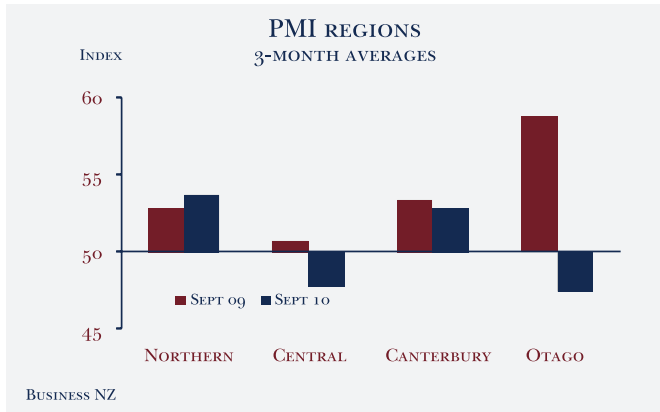


Earlier positive short-term indicators have now reverted to more reserved figures from this sector. Comments from survey participants have moved towards a 50:50 split in terms of positive and negative sentiment. Positive comments are generally focused on exports orders and the seasonal increase in orders as we move towards Christmas. Negative comments discuss a general lack of, or flat, customer demand as well as slow domestic sales and orders. These comments are supported by the latest GDP figures for the June quarter,

which indicate that household spending was flat during the quarter, after only a 0.4% increase in the March 2010 quarter.

The three-month average for the PMI dropped in September to sit at 50.7, down from the 51.4 recorded in August and 51.9 recorded in July. The three-month average indicator for production declined from 52.3 to 51.4, with the employment index also down – now averaging 49.5.

Last month, early indications were that the September 4 earthquake would not have an overly negative impact on manufacturing in the Canterbury region. This was based on larger manufacturers in the region remaining largely unscathed due to owning or occupying newer buildings, and most were only briefly interrupted in terms of their business operations. Looking at unadjusted figures for the Canterbury region this month, the PMI was up slightly, from 52.0 in August to 52.8 in September, indicating manufacturing activity in the region remains in expansion



Looking across the other regions, and comparing figures month-on-month each of the regions experienced a slight increase in manufacturing activity. However, caution is always advised when assessing one-off monthly indicators. Comparing three-month averages with figures from the previous year generally provides a more robust reflection of underlying strengths or weaknesses. The picture shows that by this measure manufacturing activity has declined considerably in the Central and Otago regions, although the Northern region is up on year-earlier levels.

GDP figures for the June 2010 quarter also supports this. Manufacturing activity was down 4.0% in the quarter, with household expenditure flat and inventories run down during this period. Exports from the food, beverage and tobacco manufacturing sector were up, but concerns remain as to whether export orders will keep manufacturing from remaining in the doldrums.

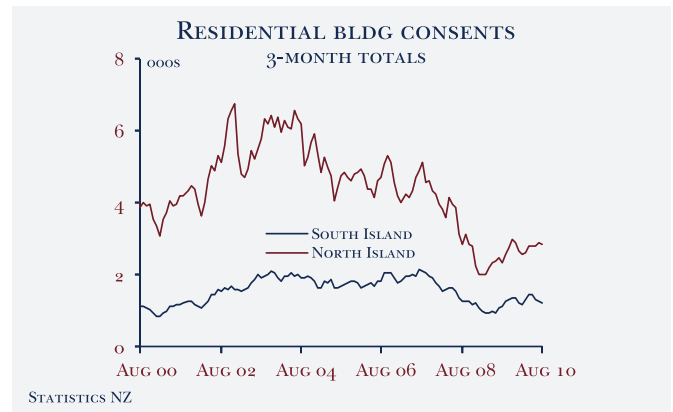
## Building activity also subdued

In August 2010, 1,229 new dwelling units were authorised. This is a decline from the 1,473 new dwelling units authorised in July 2010, but a slight improvement from the number authorised in August 2009 (1,195).

The annual total for new consents for dwelling units remains above 16,000 again this month (16,460), which is a 19% improvement from August 2009 when this annual total stood at 13,821. But it is well below the 25,000 considered to be the

level necessary to meet population growth. As we mentioned in our previous edition of BERL Forecasts, we have forecast a return to an annual rate of 20,000 consents for new dwelling units by the end of 2011. This is in line with our expectation of a continued easing in net migration inflows, and modest growth in employment and incomes.

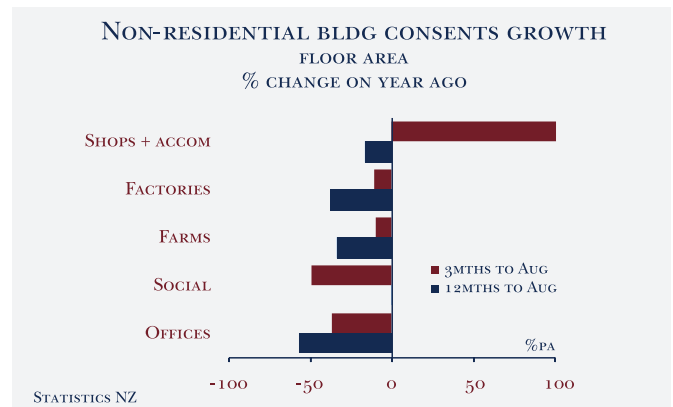
Looking at the regions, in the three months to August the number of new dwelling units authorised grew in 11 of the 16 regions (compared to year-earlier levels). Nelson had the largest increase in new dwelling units during this period, up 69%, followed by the Bay of Plenty (up 47%) and the Auckland region (up 45%).



For the 12 months to August, Southland and Marlborough were the only regions to experience a decline in the number of new dwelling units authorised. Nelson again was in the leading bunch, with the consents up 44%. The Taranaki region saw 41% growth over the last 12 months, while the number of consents issued in the Manawatu-Wanganui region was up 33% and in Canterbury consents were up 32%.

GDP figures for the June 2010 quarter indicate that construction activity was up 6.4%. The largest contributors to this growth were the construction trade services sector, and in particular residential building activity. This increase in construction activity can also be seen in increased investment in residential buildings, as measured on the expenditure side of the GDP accounts. However, again, we would caution that this increase in activity is off a very low base – longer-term trends are generally more informative than one-off quarterly numbers.

The number of non-residential building consents was up slightly in August 2010, to sit at 1,224 compared to 1,204 in July 2010 and 1,163 in June 2010.





Within the sectors, the largest decline was in the number of consents issued for farm buildings, with the latest three months 4% below year-earlier levels, and the latest year 20% below. For the year to August 2010, consents in the factories sub-sector and the office buildings sub-sector were down 11% and 10% respectively.

Figures for floor area are, arguably, more informative in that they overcome the problem in the raw numbers of measuring a range of projects of varying size and scale. However, the consent area numbers provide equally grim reading. Comparing year-on-year, the area of consents issued is down 28%. Four out of the five sub-categories well down on the year, with only the social sub-sector (including hospitals, education, social, cultural and religious buildings) flat on the previous year.

In value terms, total non-residential consents were down 22% on the year, with the latest 3 months down 23%. Within non-residential building, the value of consents for the latest 3 months for office buildings was 46% down on year earlier, while farm building consent values were down 39%.

### GDP numbers confirm recovery not going to plan

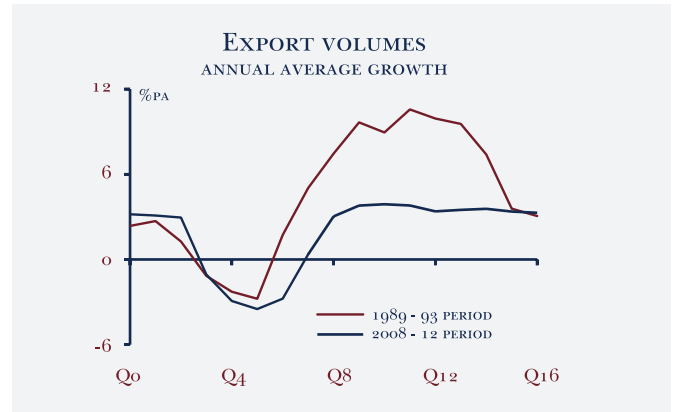
The release of GDP data for the June quarter provided further confirmation that the planned economic recovery is not going as many had hoped. The 0.2% quarterly growth figure highlighted the precarious nature of the present growth story, with the composition of this growth casting further doubt on the 'export-led' story. Received wisdom suggesting the economy is witnessing the much-needed re-balancing of the economy, with exports leading the growth picture and household's reverting to saving rather than spending.

Unfortunately, comparisons with previous post-recession periods do not support this argument.

The chart depicts export growth since the beginning of 2008 and forecast to 2012. This is compared with the export performance during and after the downturn of late-1980s – from the beginning of 1989 to 1993. Clearly, exports surged quickly to double-digit growth following that earlier recession. In contrast, the latest recession sees volume growth beginning to taper at about 4%.

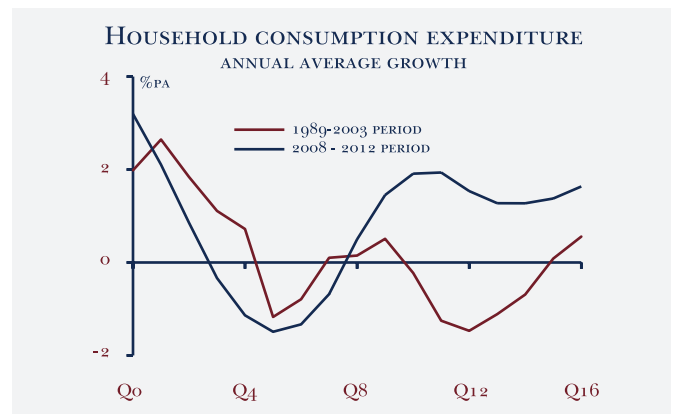
The difference this time around is the exchange rate track. During the earlier recession the TWI drifted down from a

value of 58 to reach 53 by the end of the period. However, the exchange rate is not as conducive to an export-led recovery, with the TWI above 66 and expected to remain high given the weakness of the US\$ in particular.



On the other side of the ledger, the numbers also call into question the argument that the household response is in line with a re-balancing of economic activity. Consumer spending is clearly subdued and is expected to remain so in light of employment and income expectations. However, real spending growth of 1.5% is already well above the experience of the early-1990s.

Of course, to suggest that the necessary re-balancing of NZ's economic structure could be achieved rapidly was, to put it politely, optimistic. More bluntly, a fundamental re-balancing towards an export-led economy requires significant changes in behaviour and appropriate policy settings. An export target as a counter-balance to the inflation target would be helpful, as would an export-friendly stable exchange rate.



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