

# Economics, interest rates and currencies chart pack

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## Charts prepared for ANZ Senior Management

23<sup>rd</sup> November 2007

[www.anz.com/go/economics](http://www.anz.com/go/economics)

Saul Eslake  
Chief Economist

*economics@*

# Summary of key economic forecasts

	2007	2008	2009
Oil prices (US\$ per barrel WTI)	72	82	75
World GDP growth (%)	5	4½ <sup>r</sup>	4½
Australian GDP growth (%)	4¼ <sup>r</sup>	4 <sup>r</sup>	3¼
Australian unemployment rate (%) <sup>a</sup>	4¼	4	3¾
Australian CPI inflation (%) <sup>a</sup>	3 <sup>r</sup>	2¾ <sup>r</sup>	2½
Aust current account deficit (% GDP)	5¾ <sup>r</sup>	5½ <sup>r</sup>	5
Australian credit growth (%) <sup>a</sup>	16 <sup>r</sup>	12 <sup>r</sup>	10½ <sup>r</sup>
NZ GDP growth (%)	2¾ <sup>r</sup>	1½	3
NZ unemployment rate (%) <sup>a</sup>	3½	4	4¼
NZ CPI inflation (%) <sup>a</sup>	3	2¾	2½
NZ current account deficit (% GDP)	8	6¾	6¾
NZ private sector credit growth (%) <sup>a</sup>	12¼	9	9¼

<sup>a</sup> Year to December quarter; all other forecasts are calendar year-average <sup>r</sup> Revised since last quarter; see slide 4

# Summary of key market forecasts

	Nov* 2007	Dec 2007	Jun 2008	Dec 2008	Dec 2009
US Fed funds rate (% pa)	4.50	4.50 <sup>r</sup>	4.25 <sup>r</sup>	4.50	5.75
US 10-year bond yield (% pa)	4.35	4.50 <sup>r</sup>	4.70	5.35	5.60
€ - US\$	1.42	1.45 <sup>r</sup>	1.47 <sup>r</sup>	1.40	1.26 <sup>r</sup>
US\$ - ¥	112	115 <sup>r</sup>	112 <sup>r</sup>	108 <sup>r</sup>	115
US\$ - Yuan	7.42	7.40 <sup>r</sup>	7.22	7.04	7.10
RBA cash rate (% pa)	6.75	6.75 <sup>r</sup>	7.25 <sup>r</sup>	7.25 <sup>r</sup>	7.25 <sup>r</sup>
Australian 10-year bond (% pa)	6.20	6.30 <sup>r</sup>	6.40 <sup>r</sup>	6.85 <sup>r</sup>	6.90 <sup>r</sup>
A\$ - US\$	0.89	0.95 <sup>r</sup>	0.96 <sup>r</sup>	0.91 <sup>r</sup>	0.80 <sup>r</sup>
RBNZ cash rate (% pa)	8.25	8.25	8.25 <sup>r</sup>	7.50	6.75 <sup>r</sup>
NZ 10-year bond yield (% pa)	6.50	6.60	6.70	6.70 <sup>r</sup>	6.70 <sup>r</sup>
NZ\$ - US\$	0.77	0.77 <sup>r</sup>	0.74 <sup>r</sup>	0.68 <sup>r</sup>	0.62 <sup>r</sup>
A\$ - NZ\$	118	122 <sup>r</sup>	130	132 <sup>r</sup>	130 <sup>r</sup>

\* actual <sup>r</sup> revised

# Key global themes

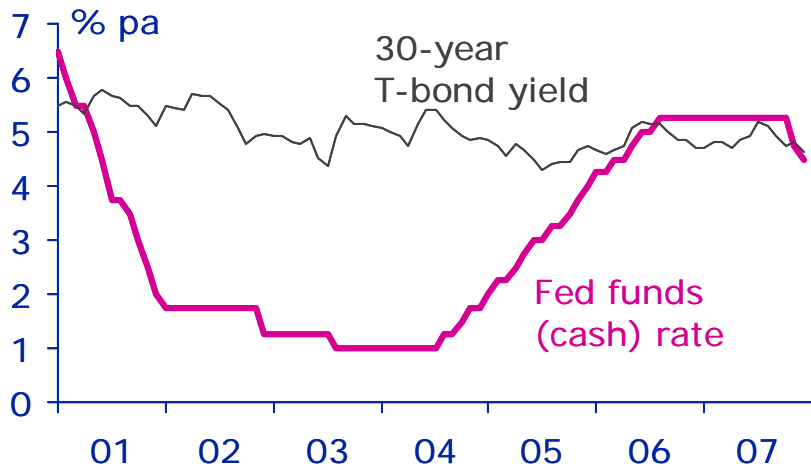
- Problems in credit markets are expected to continue for some months although (with apologies to Donald Rumsfeld) we are now largely dealing with 'known unknowns' rather than 'unknown unknowns'
- US economic growth is likely to remain below trend until H2 2008; but recession though not impossible is unlikely (house prices won't fall anything like as much as share prices did earlier this decade)
- Growth will also slow in Japan and Europe, but should remain relatively robust in developing economies
- Over the medium term (ie in 2009 and beyond) rising inflation is a bigger concern than weak growth
- The Fed will cut once more (though probably not in December), but will start raising rates again this time next year
- The BoE will probably cut rates twice over the next six months
- ECB and BoJ are on hold into the first half of 2008 but will then seek further gradual monetary tightening
- US\$ will decline further over the first half of 2008 but rise from then onwards as markets begin factoring in renewed Fed tightening

# Key Australian and NZ themes

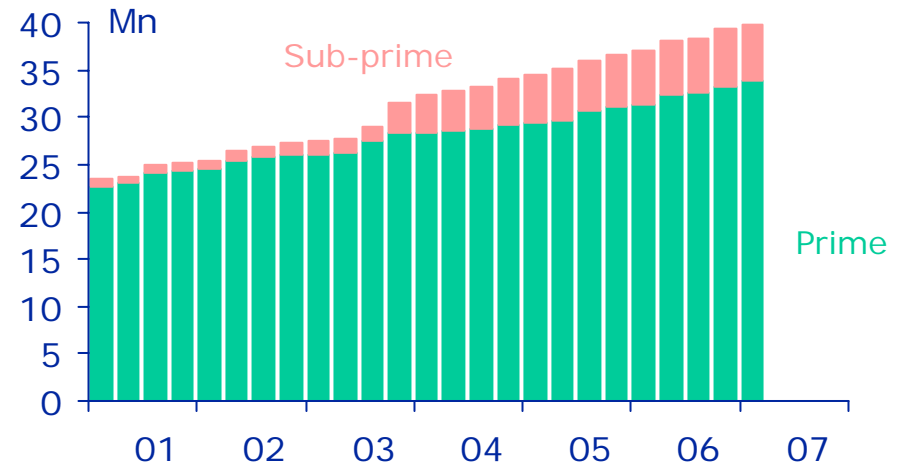
- Growth in Australian domestic spending is 'too rapid' given resource constraints within the Australian economy, and is thus adding to inflation risks
- Domestic spending growth is being fuelled by commodity-driven income growth and by fiscal policy (notwithstanding that the Budget is in surplus), something which seems likely to continue whatever the outcome of Saturday's election
- Monetary policy is thus likely to be tightened further – we expect two more increases in the cash rate over the first half of 2008
- The A\$ is likely to peak around US96¢ in mid-2008 given further US\$ weakness, commodity price gains and widening in the interest rate differential vs the US (but vulnerable to bouts of heightened risk aversion)
- NZ economy has also benefited from commodity price gains (especially dairy) – but there are also signs that tighter financial conditions are beginning to bite (as fixed-rate mortgages reset at higher rates)
- NZ interest rates have probably peaked for this cycle and will begin to come down from late 2008 onwards
- Narrowing interest rate differential vs Australia should see the NZ\$ fall sharply vs the A\$

# The US sub-prime mortgage crisis has its origins in sharp falls in interest rates earlier this decade

### US interest rates



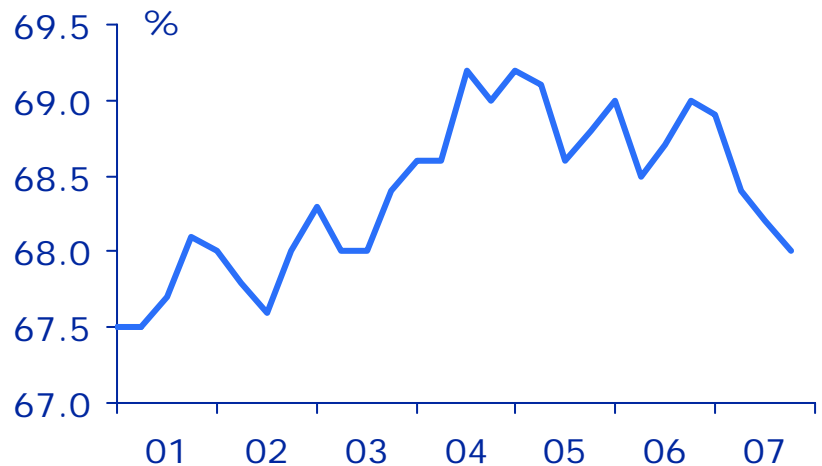
### Mortgages outstanding



### Mortgage rates



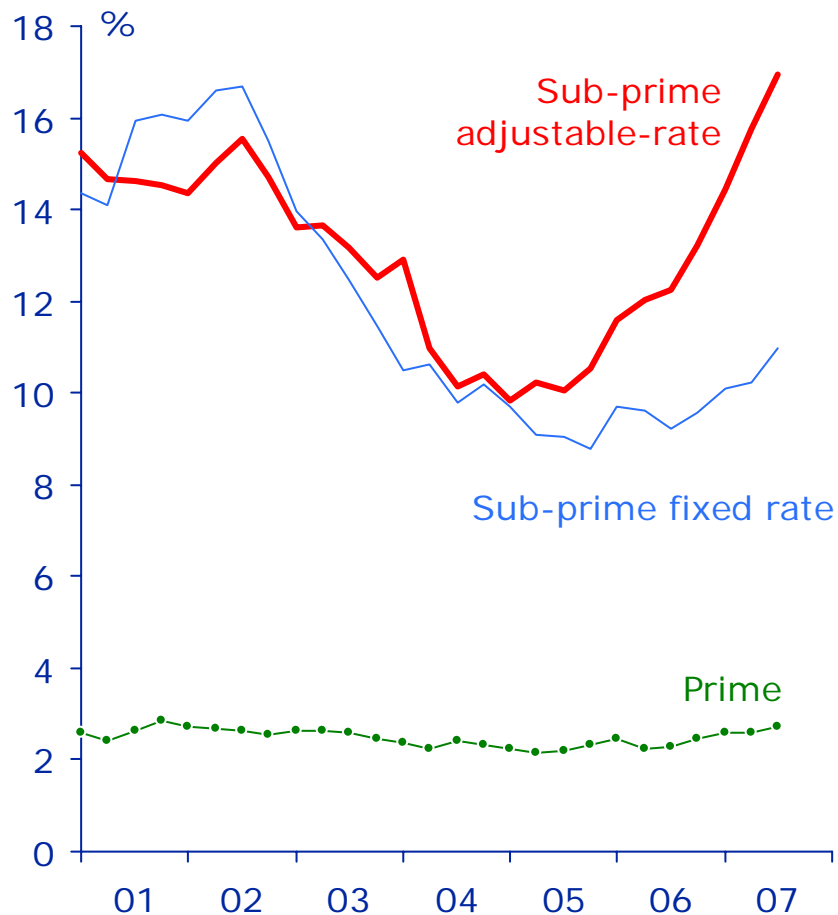
### Home ownership rate



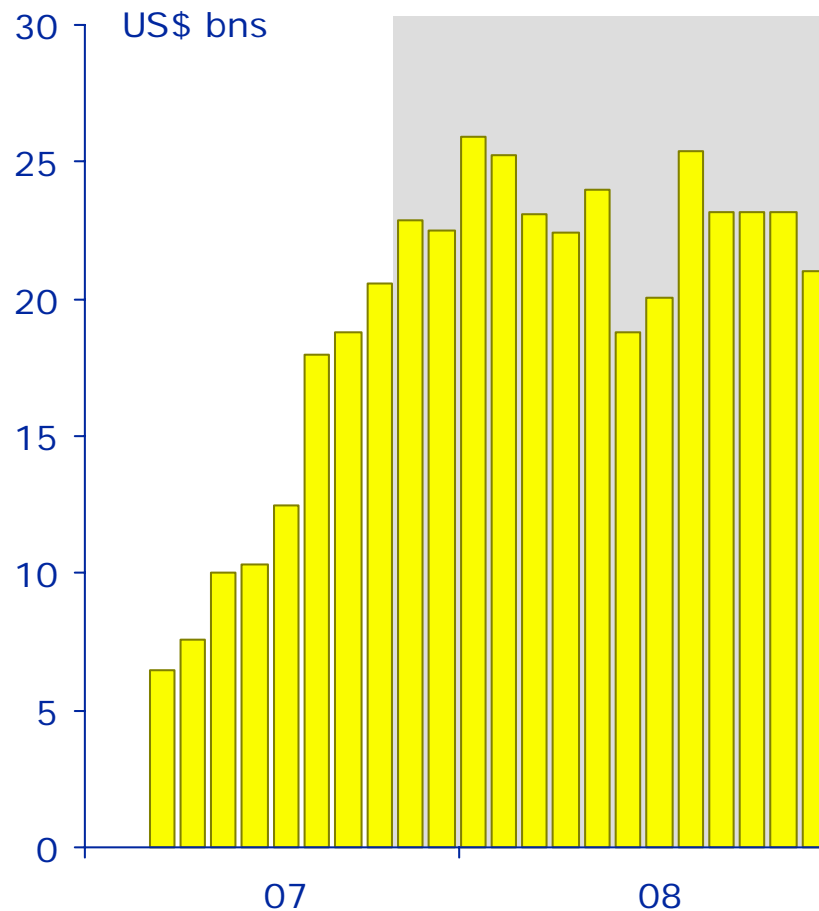
Sources: US Federal Reserve; Mortgage Bankers' Association; Commerce Department

# Sub-prime mortgage defaults have risen sharply as mortgages reset at higher rates

## Mortgage delinquencies (30 days or more overdue)



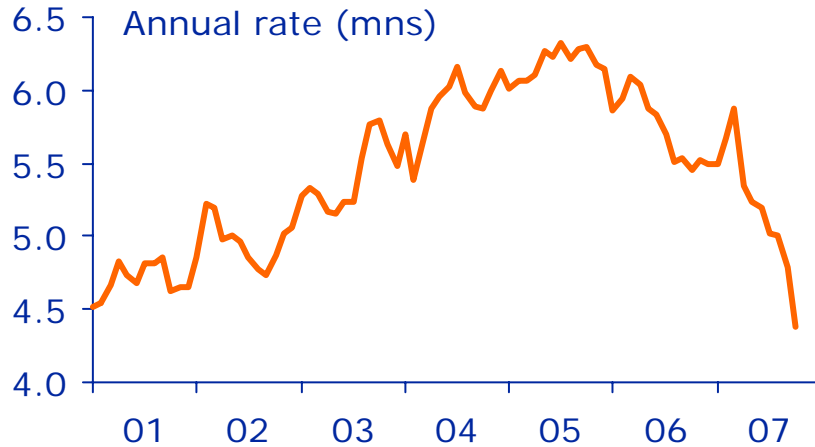
## Mortgages facing first interest rate 're-set'



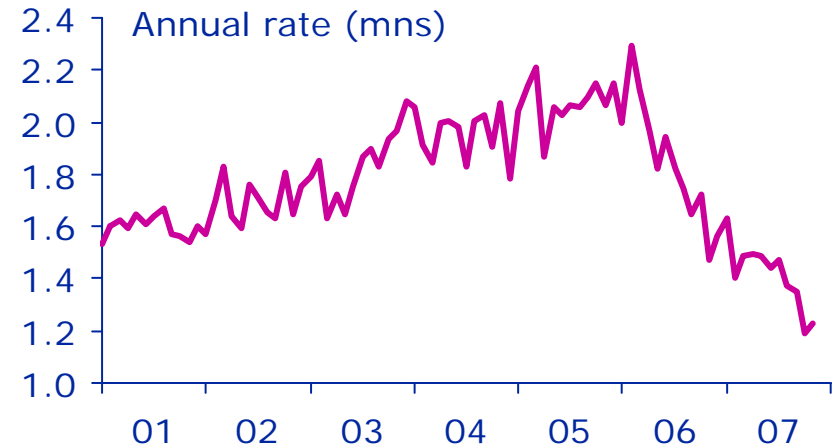
Sources: US Mortgage Bankers' Association; Institute of International Finance; JP Morgan

# Rising mortgagee sales have contributed to a sharp downturn in the US housing market

## Sales of established homes



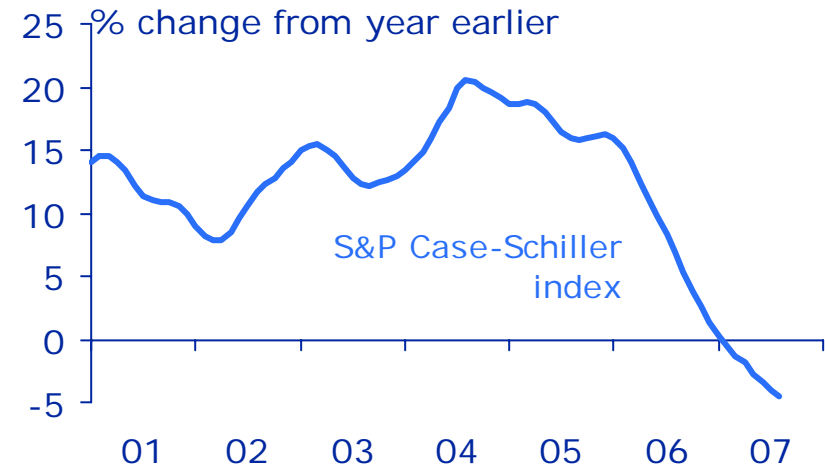
## New housing starts



## Unsold established homes



## House prices

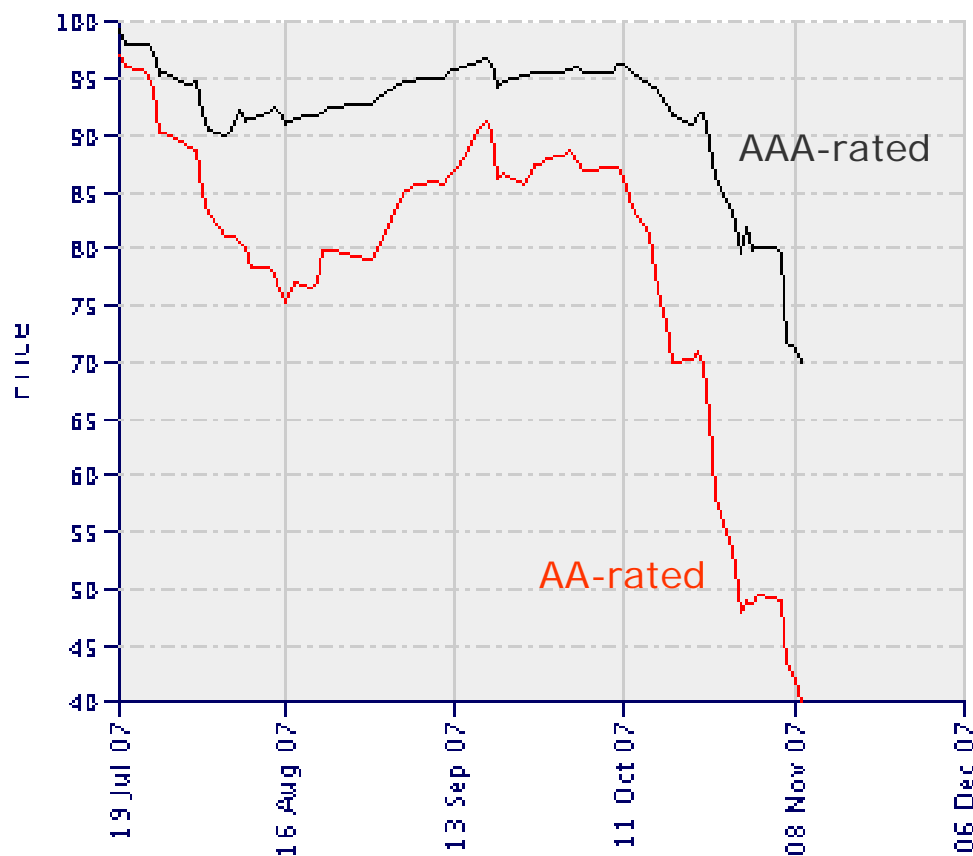


Sources: Federal National Mortgage Corporation; S&P; National Association of Realtors; Mortgage Bankers' Association



# Prices of CDOs have fallen substantially, causing substantial write-downs by banks

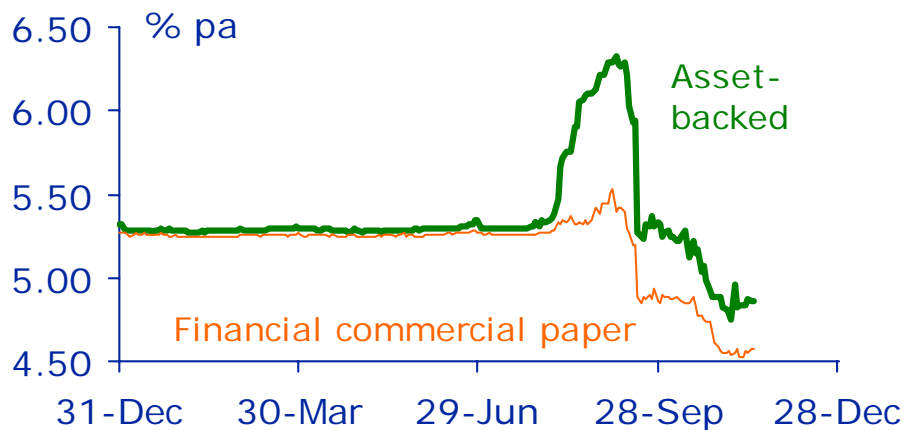
## ABX index of CDO prices



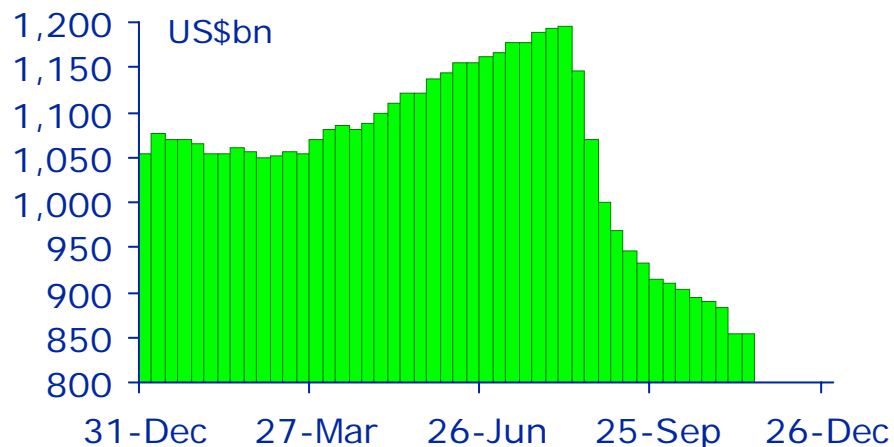
<i>Institution</i>	<i>Estimated write-down (US\$ bn)</i>
Citigroup	64.0
Merrill Lynch	10.2
UBS	7.2
Deutsche Bank	3.3
Goldman Sachs	4.3
Barclays	2.8
RBS	1.9

# Asset-backed commercial paper remains 'on the nose' despite lower yields

## 30 day commercial paper rates



## Asset-backed commercial paper outstanding

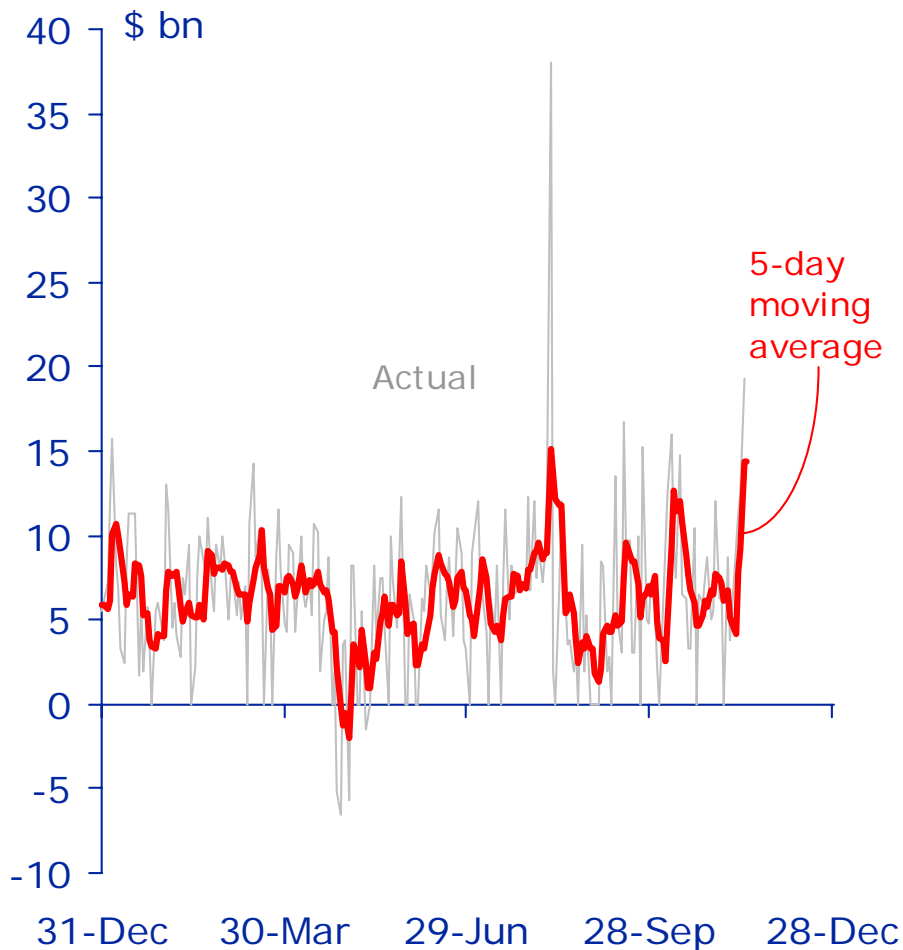


- Banks in the US (and other countries including Australia) had been making increasing use of off-balance sheet entities – 'conduits' and SIVs ('structured investment vehicles') – to finance lending activities
- These entities financed themselves by issuing asset-backed commercial paper
- As the sub-prime mortgage market crisis deepened, investors lost confidence in ABCP, forcing banks to take these assets back on to their balance sheets ...
- ... in turn greatly increasing their need for short-term funding ('cash')

Sources: Bloomberg; US Federal Reserve

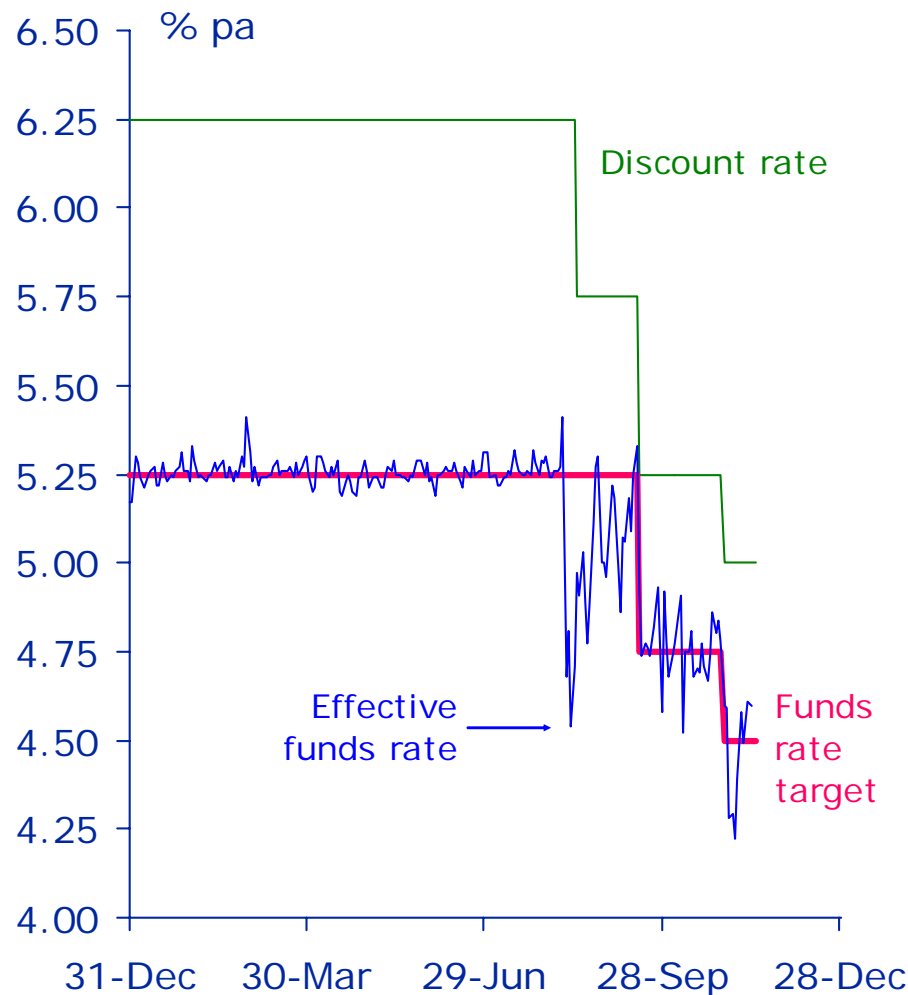
# The Fed is continuing to supply abnormal amounts of cash to the US markets

## Net additions of cash to US banking system by Fed



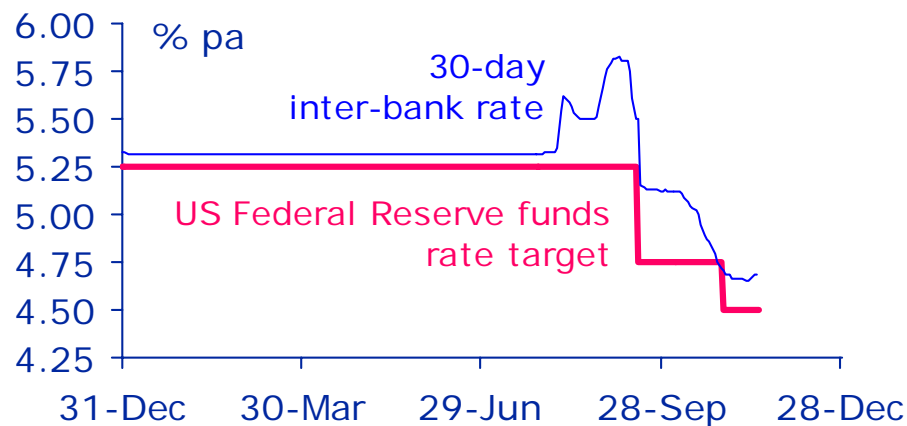
Source: US Federal Reserve

## Fed interest rates

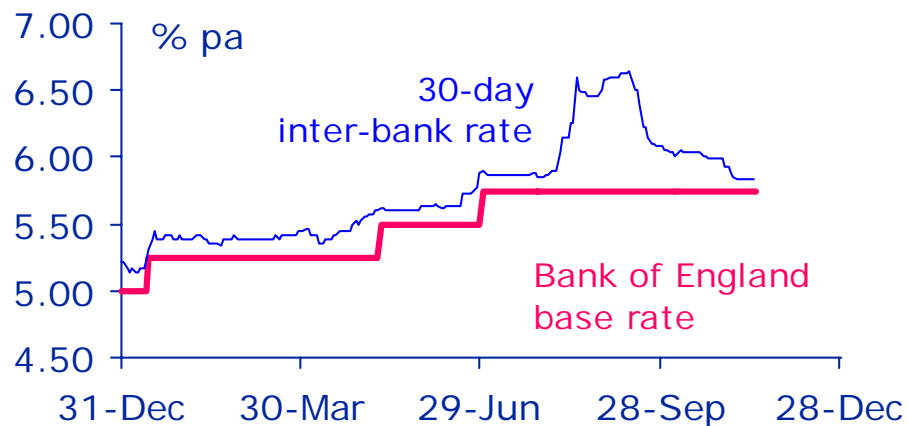


# Spreads over cash in the short-term inter-bank market remain wide despite the US rate cuts

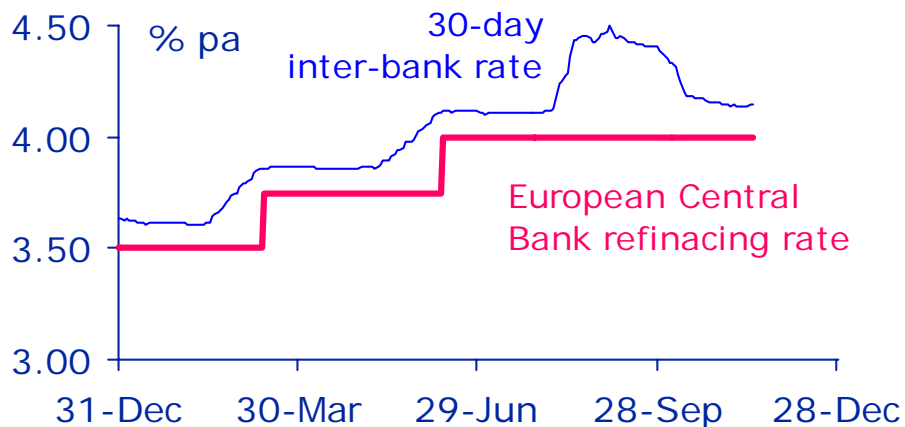
## United States



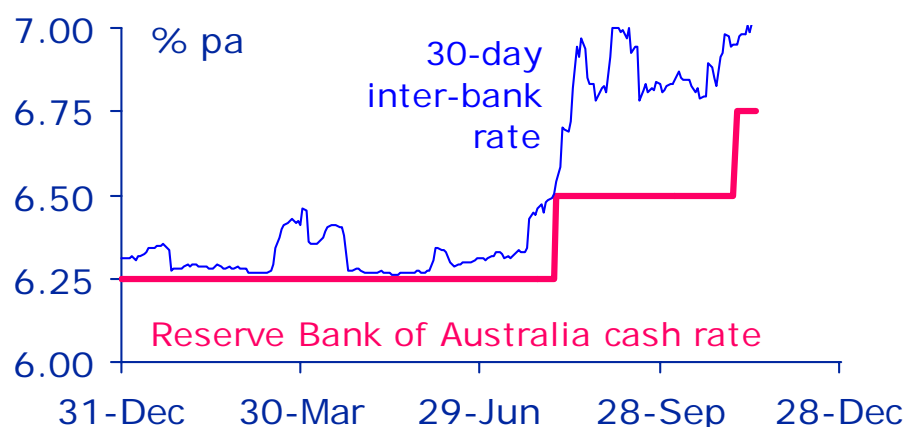
## United Kingdom



## Euro area

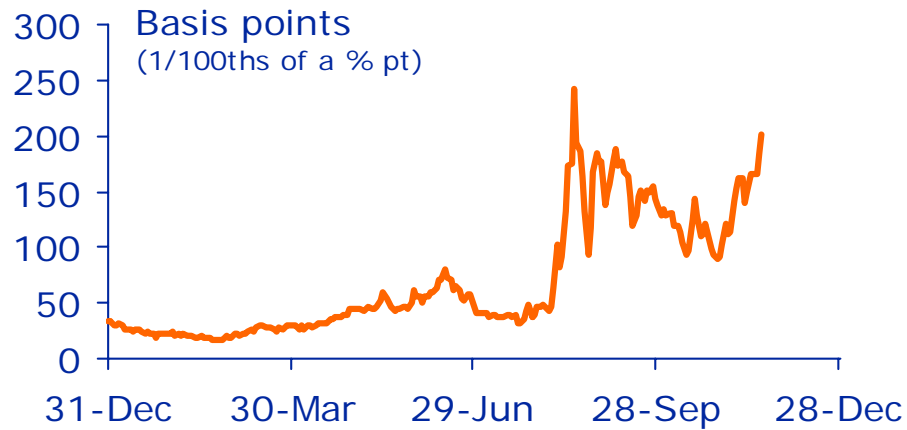


## Australia

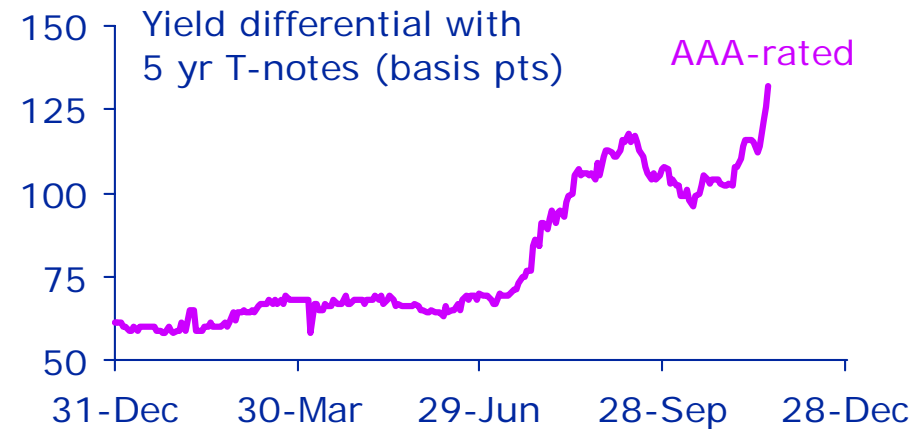


# Spreads between bank or corporate and government instruments have blown out again

## 'TED' spread between 3-mth inter-bank deposits and T-bill yields



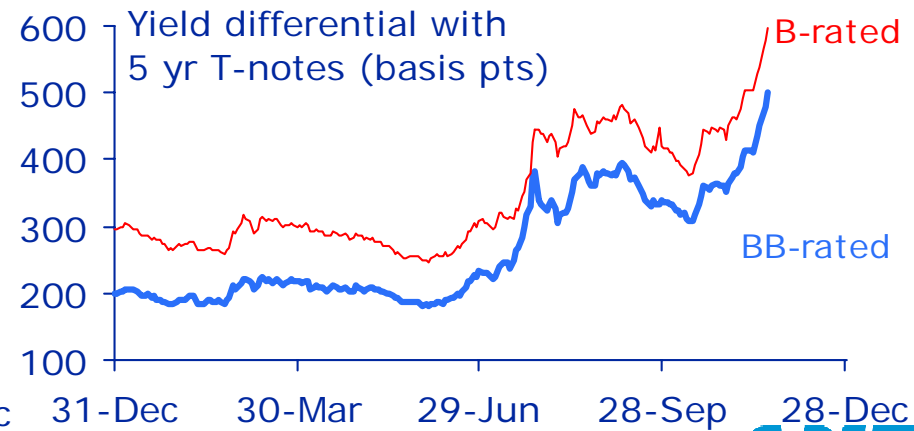
## Spread between AAA-rated corporate and T-bond yields



## 'Swap spread' between US bank and US Government bond yields



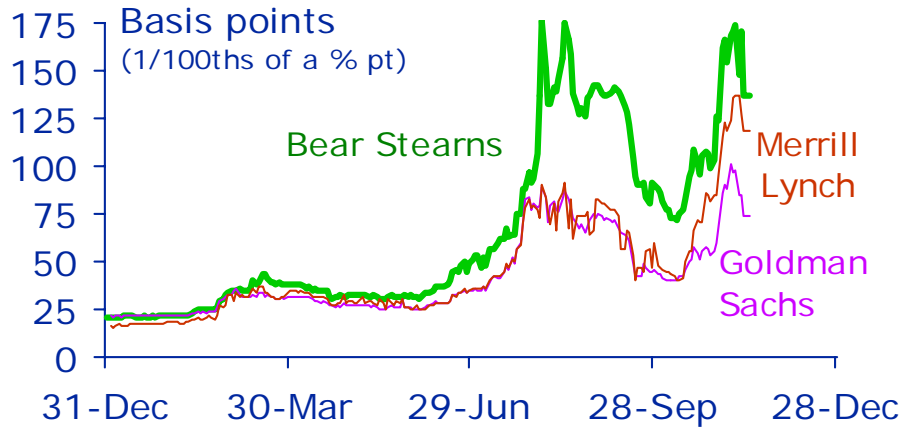
## Spread between BB- and B-rated corporate and T-bond yields



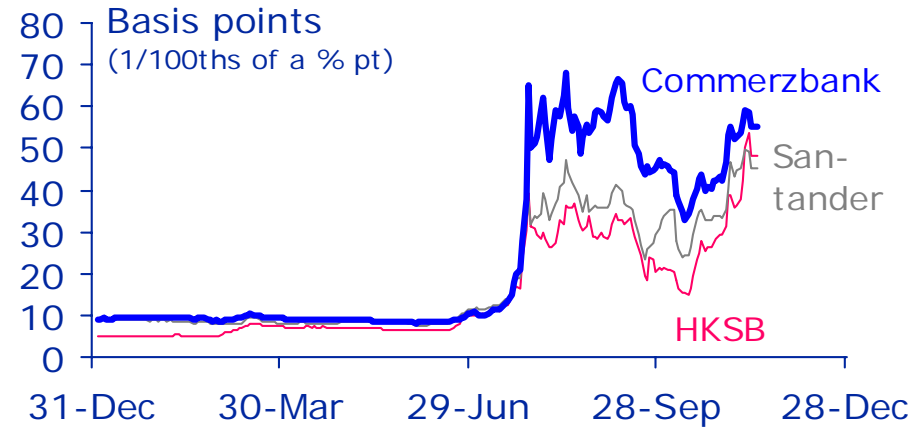
Sources: Bloomberg, Datastream

# Credit default swap spreads for banks and brokers have blown out again

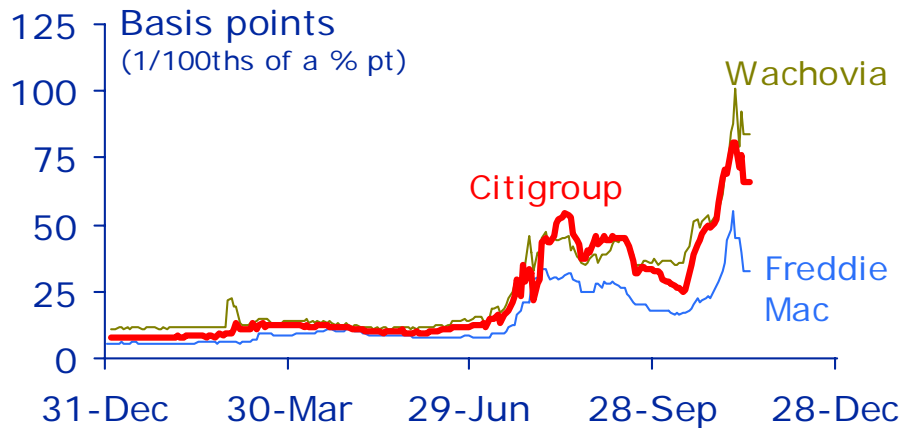
## US broker credit default swap (CDS) spreads



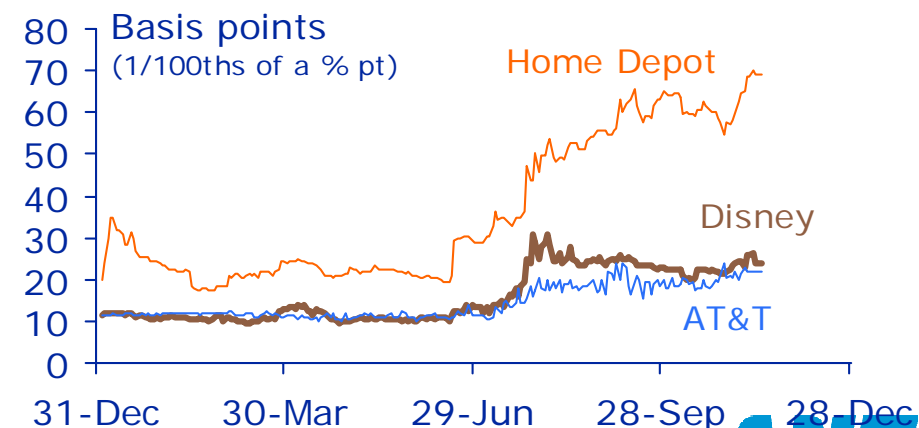
## European banks CDS spreads



## US lender CDS spreads



## US corporate CDS spreads



Sources: Bloomberg, Datastream

# Equity markets have been hit by a 'second wave' of risk aversion

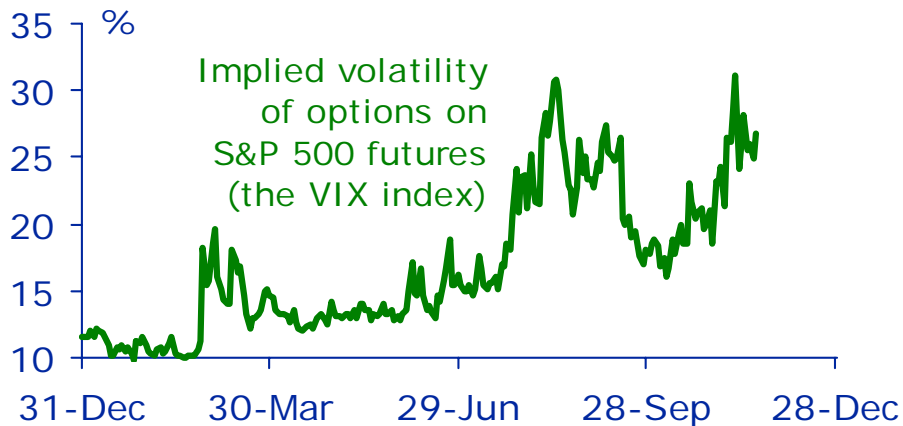
## US stock market



## UK stock market



## US stock market volatility

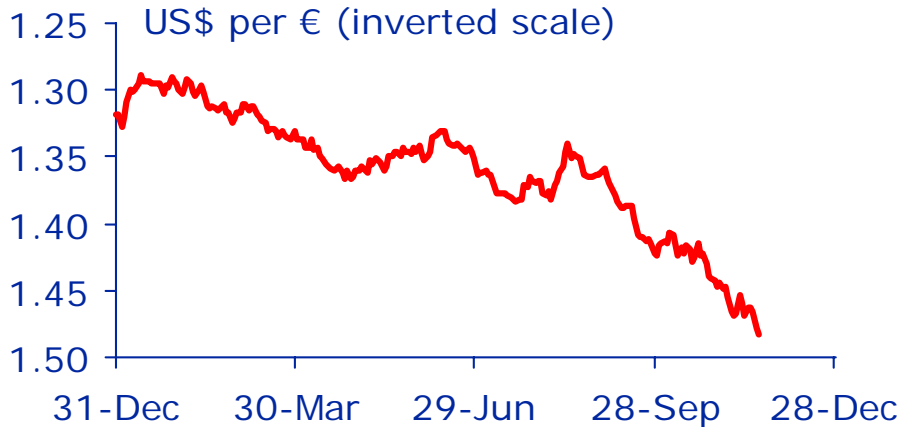


## Japanese stock market



# The US dollar has continued to fall, while risk aversion has also returned to currency markets

## US dollar vs Euro



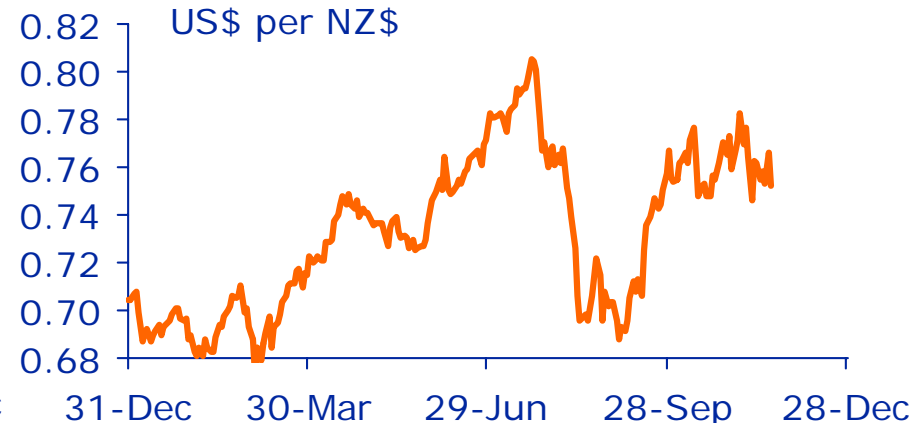
## Australian dollar vs US dollar



## Japanese yen vs US\$



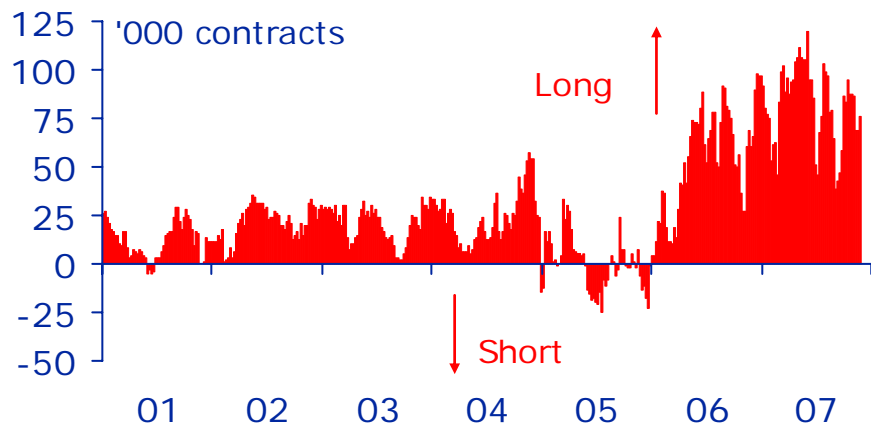
## New Zealand dollar vs US dollar



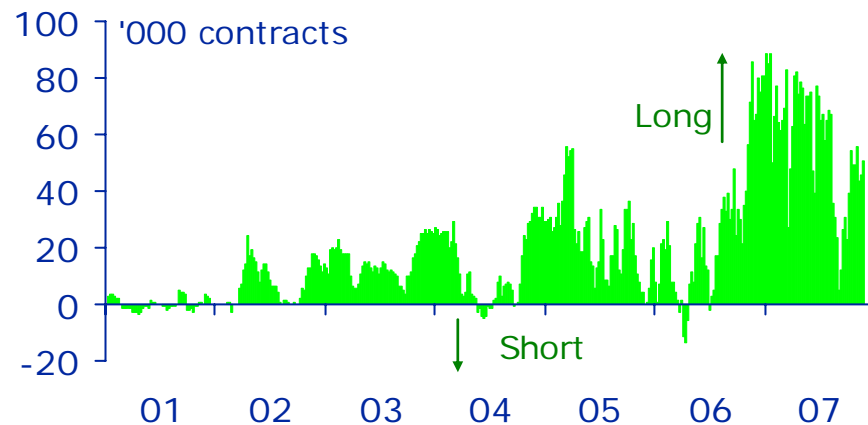


# Swings in risk aversion evident in net positions in Chicago currency futures

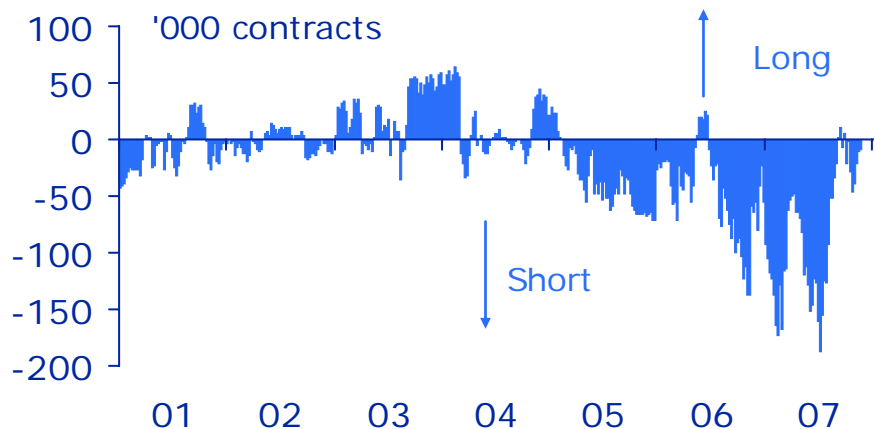
## Euro



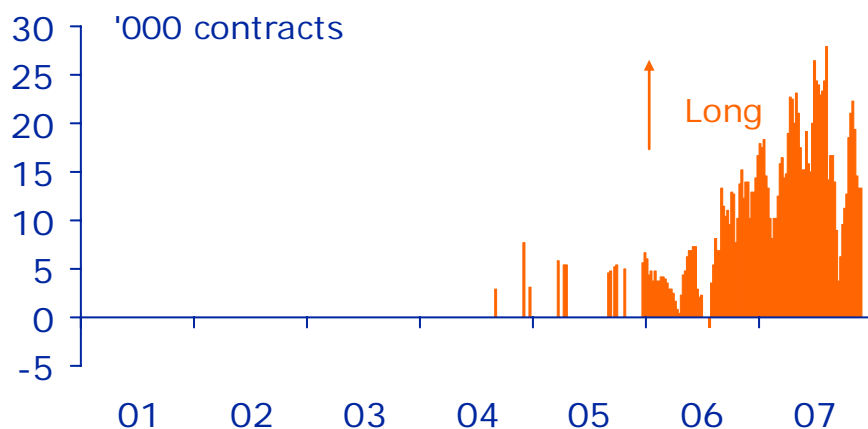
## Australian dollar



## Japanese yen

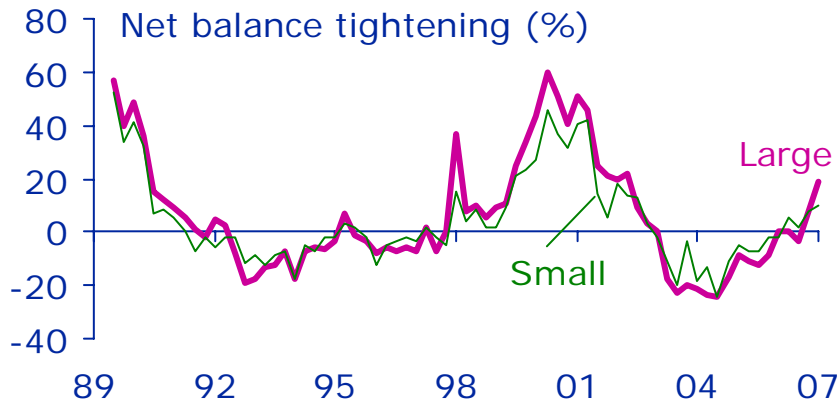


## New Zealand dollar

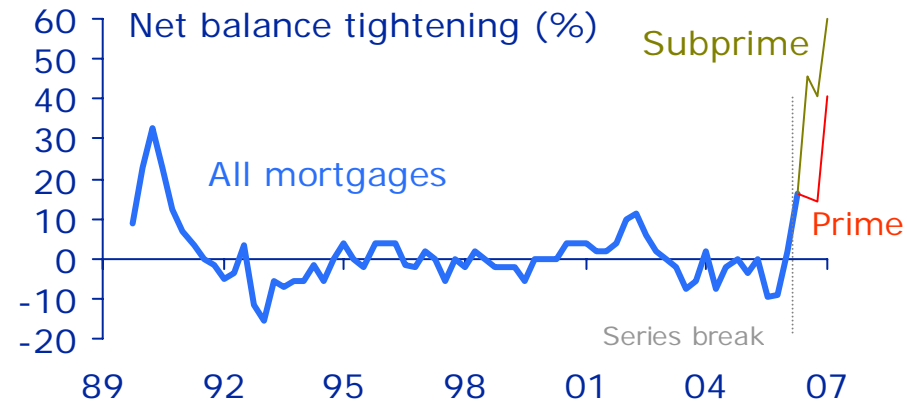


# US banks are tightening credit standards and widening spreads on loans

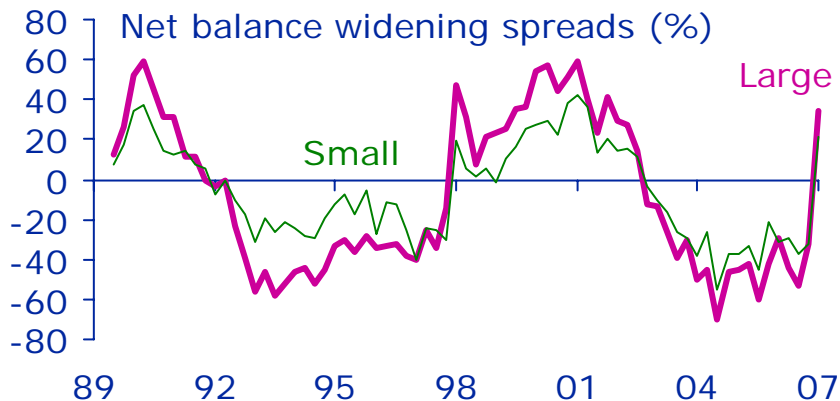
## Banks tightening credit standards on commercial & industrial loans



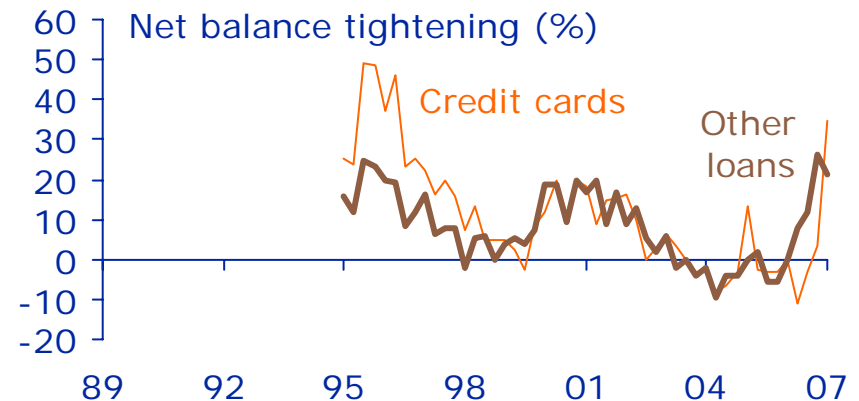
## Banks tightening credit standards on mortgages



## Banks widening spreads on commercial & industrial loans



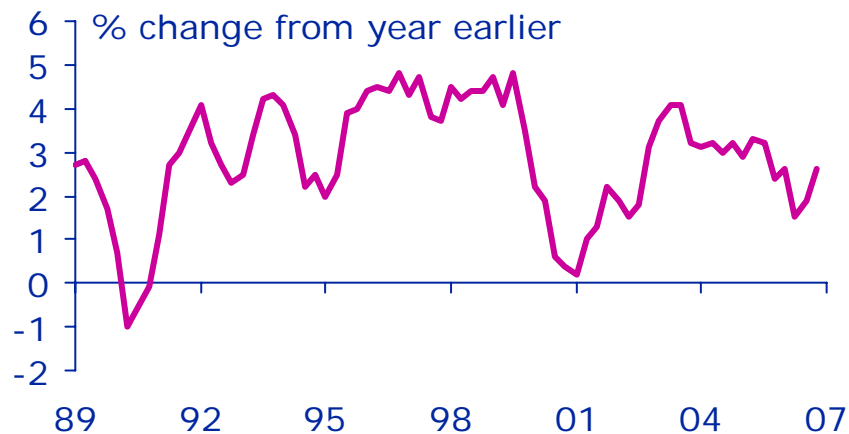
## Banks tightening credit standards on other consumer loans



Sources: US Federal Reserve Senior Loan Officer Survey

# The US economy is slowing, but so far at least does not appear headed for recession

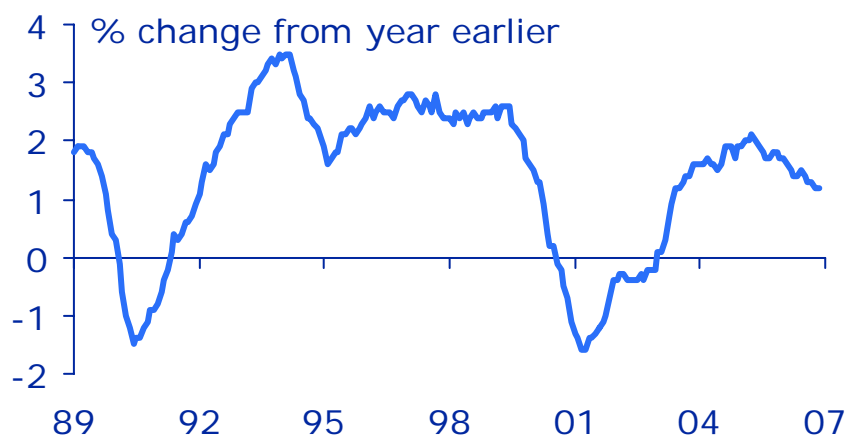
## Real GDP growth



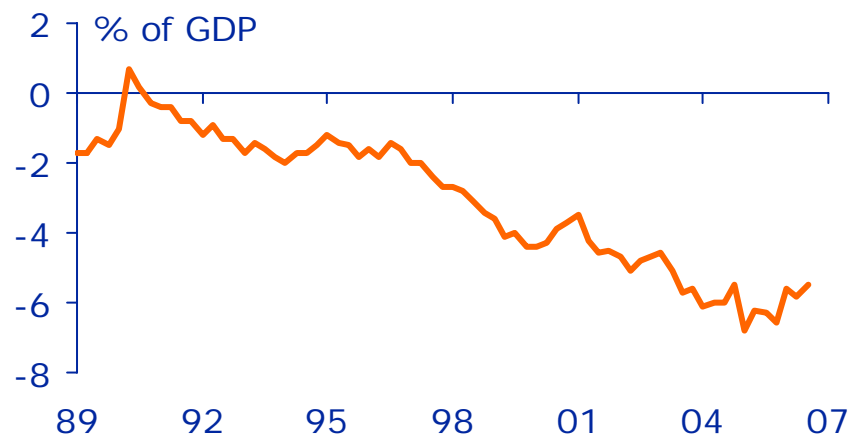
## Unemployment rate



## Employment growth



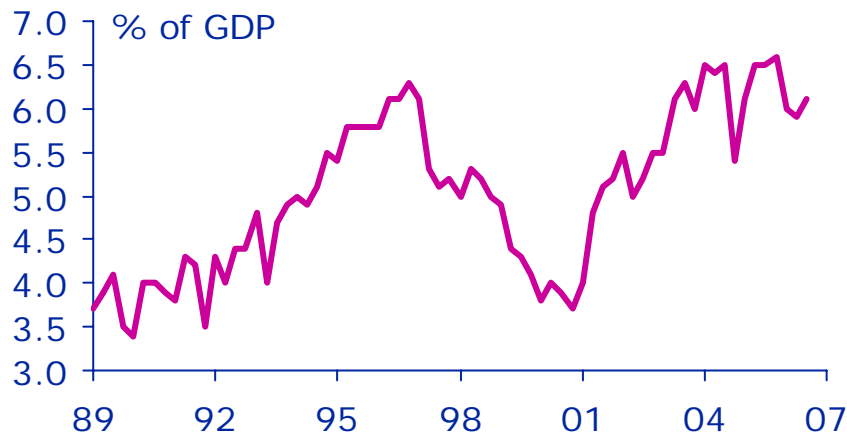
## Current account deficit



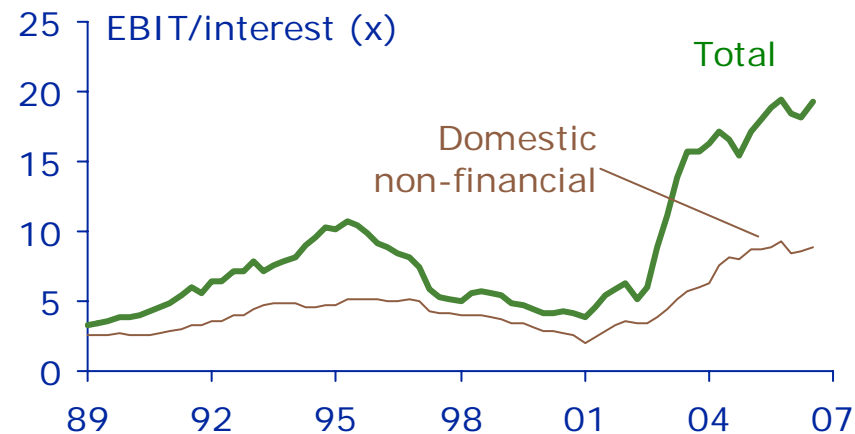
Sources: US Bureau of Economic Analysis; Bureau of Labor Statistics; Economics@ANZ

# The US corporate sector is in much better shape than prior to the last two recessions

## Corporate profits



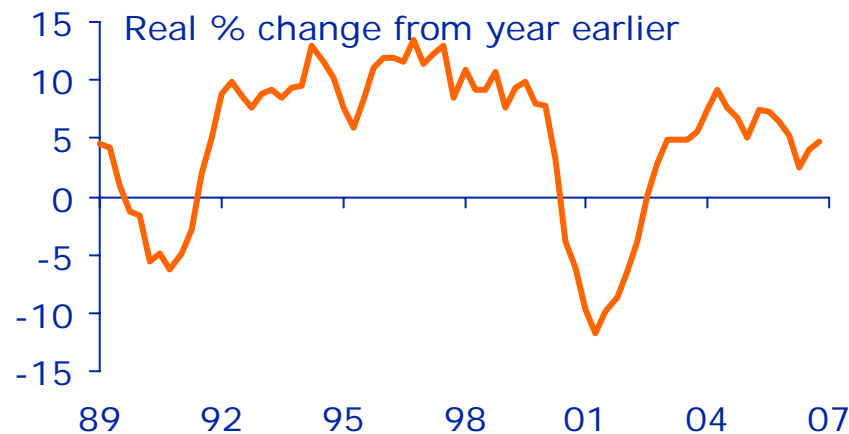
## Interest cover ratio



## Debt-equity ratio



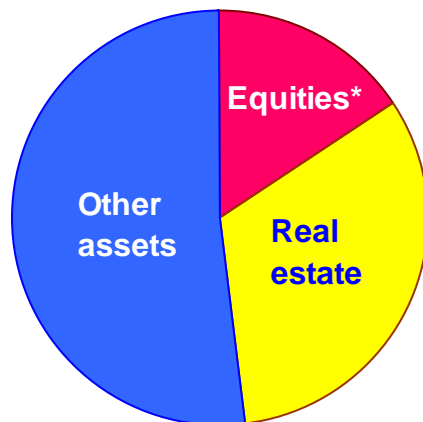
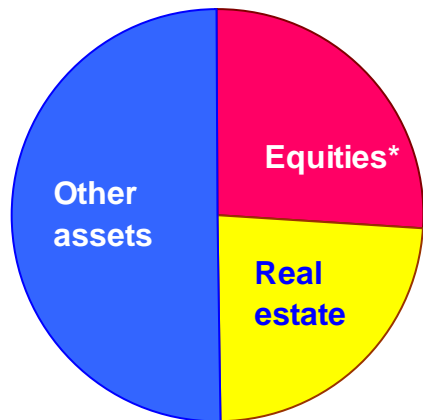
## Business capital expenditure



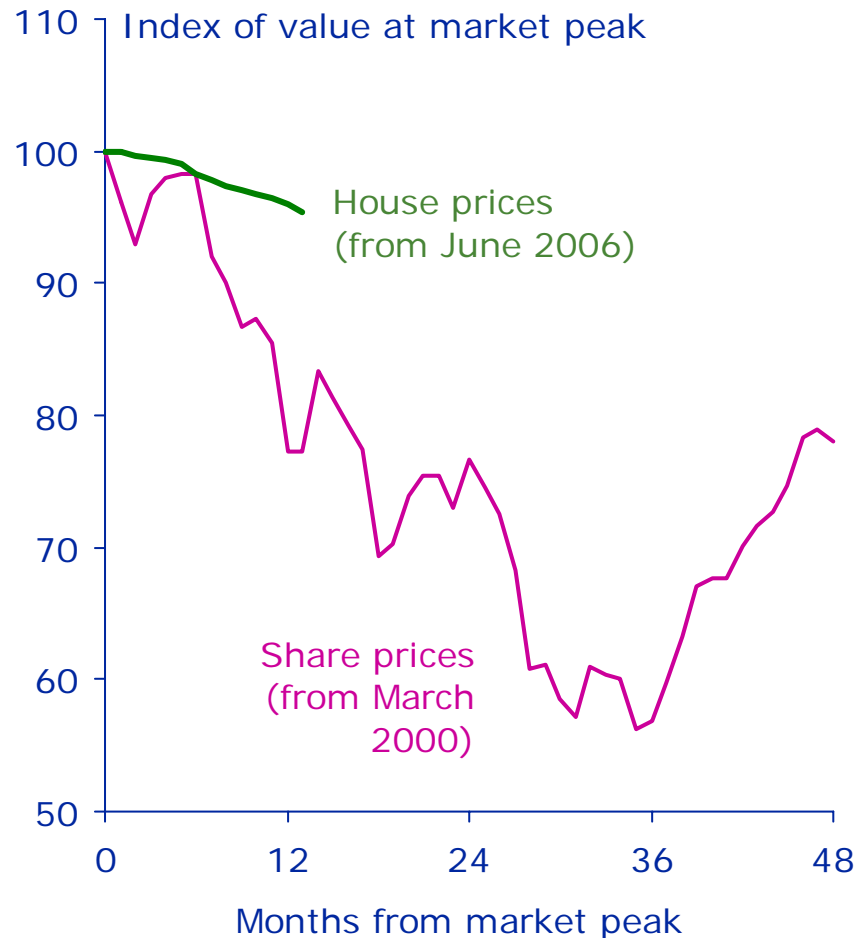
Sources: US Bureau of Economic Analysis; Federal Reserve; Bureau of Labor Statistics; Economics@ANZ

# House prices are unlikely to fall by anything like as much as share prices did earlier this decade

## Composition of US household assets



## Share and housing bear markets compared



\* Directly-held and through mutual funds  
Sources: Federal Reserve; S&P; Datastream

# US household net worth, income and spending should hold up better than in 2001-03

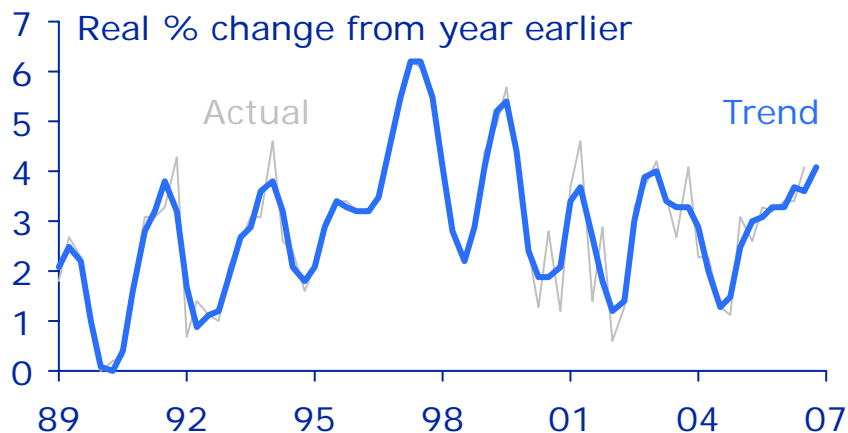
## Household net worth



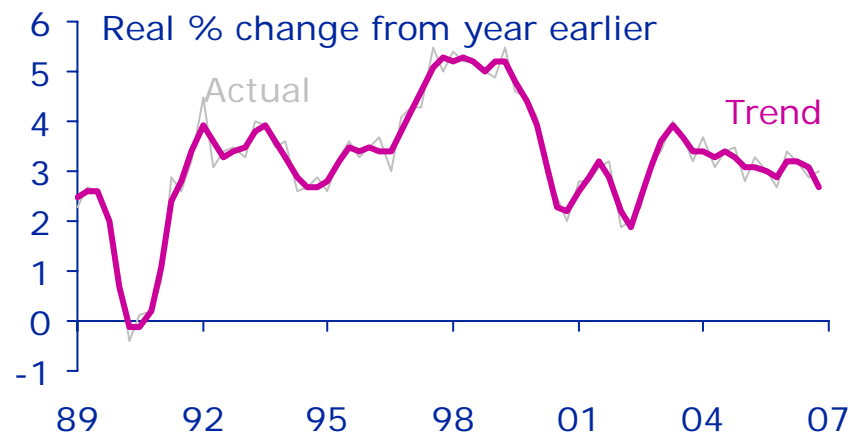
## Consumer sentiment



## Personal disposable income



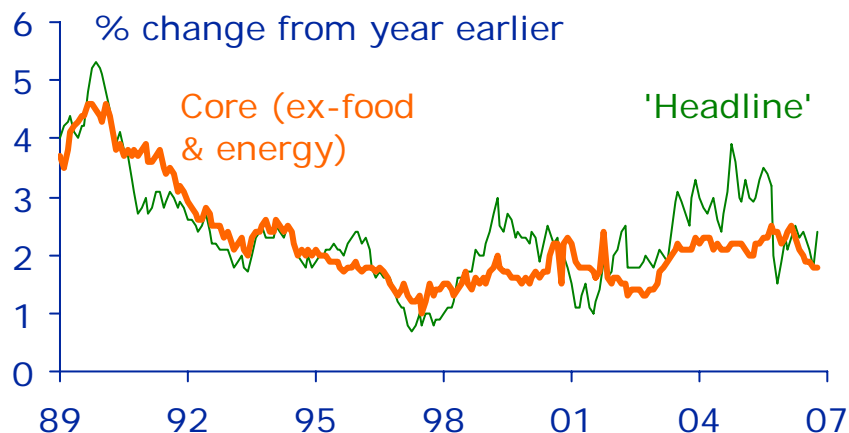
## Personal consumption spending



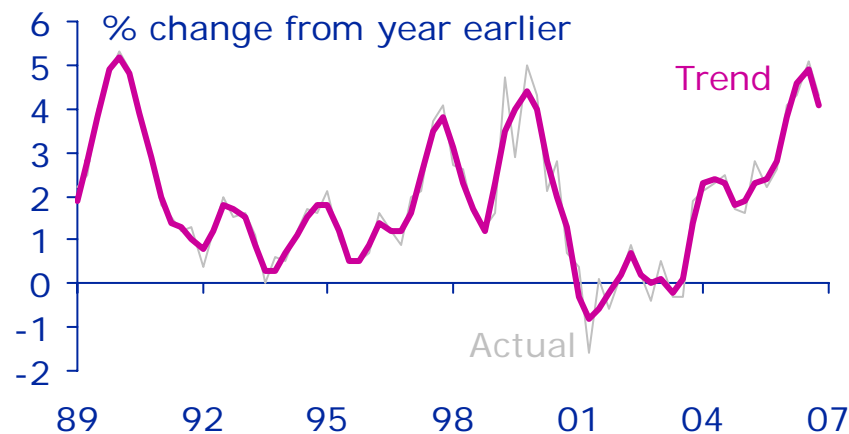
Sources: US Federal Reserve; US Bureau of Economic Analysis; Michigan University Survey Research Center

# Meanwhile there are some grounds for concern about the inflation outlook beyond the near term

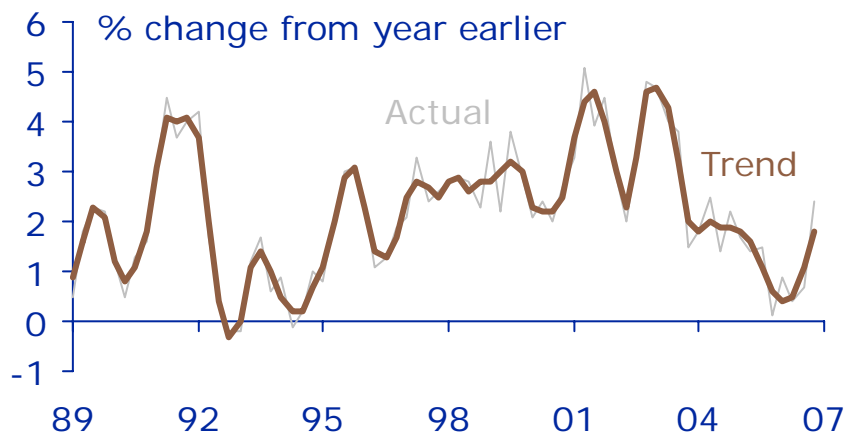
## Personal consumption deflator



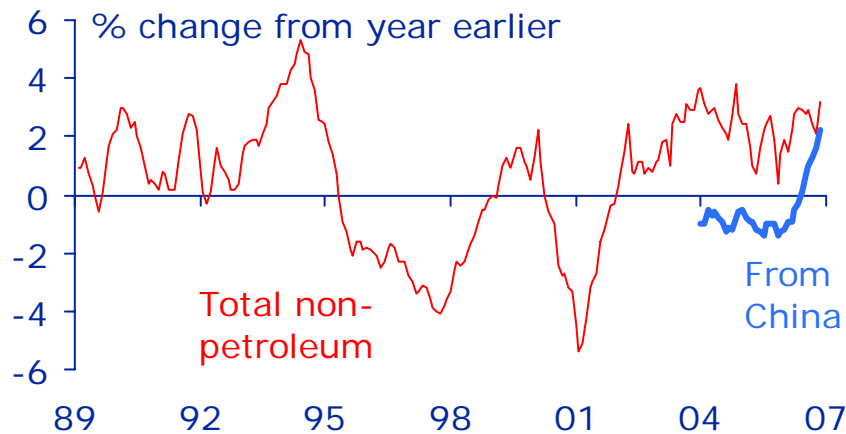
## Unit labour costs\*



## Labour productivity\*



## Import prices

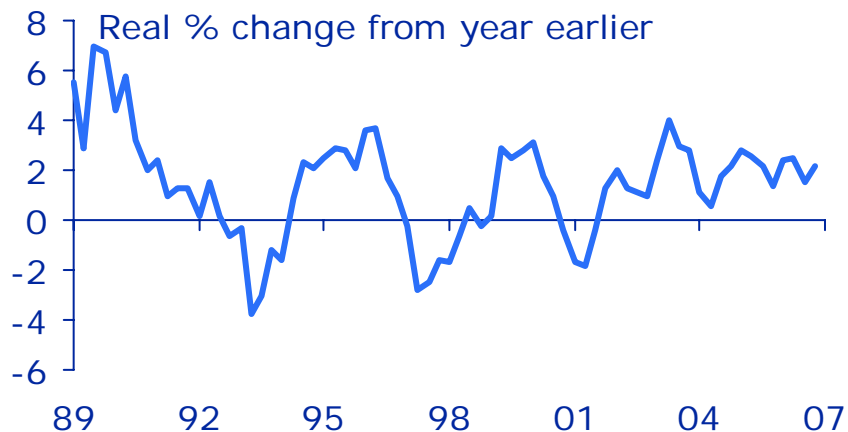


\* Non-farm business sector

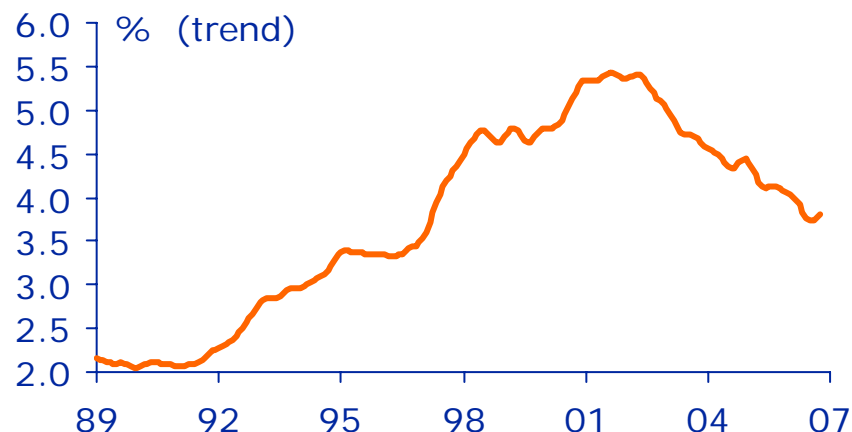
Sources: US Bureau of Economic Analysis; Commerce Department

# Japan's economy has been doing much better than in the 1990s, but negative inflation persists

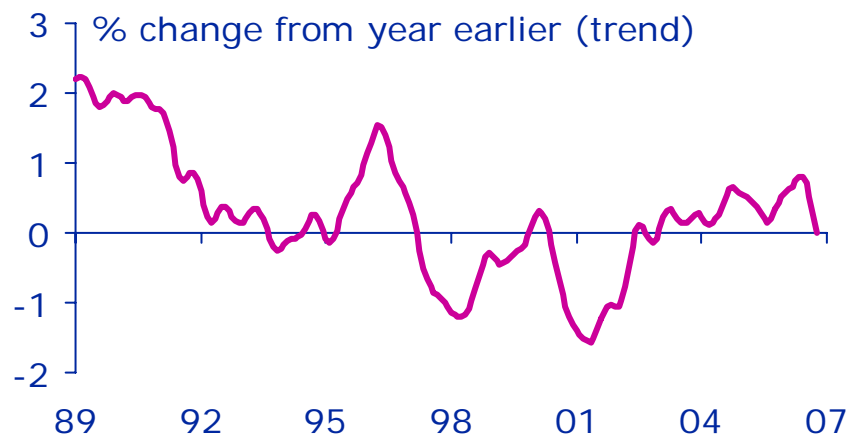
## Real GDP growth



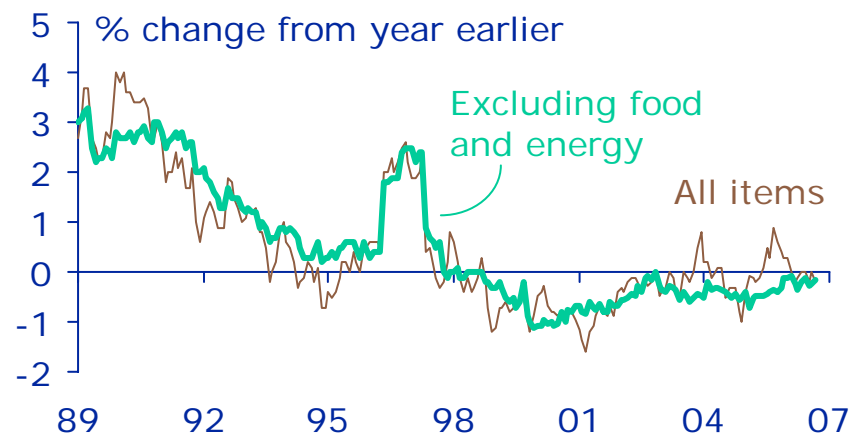
## Unemployment rate



## Employment growth



## Inflation

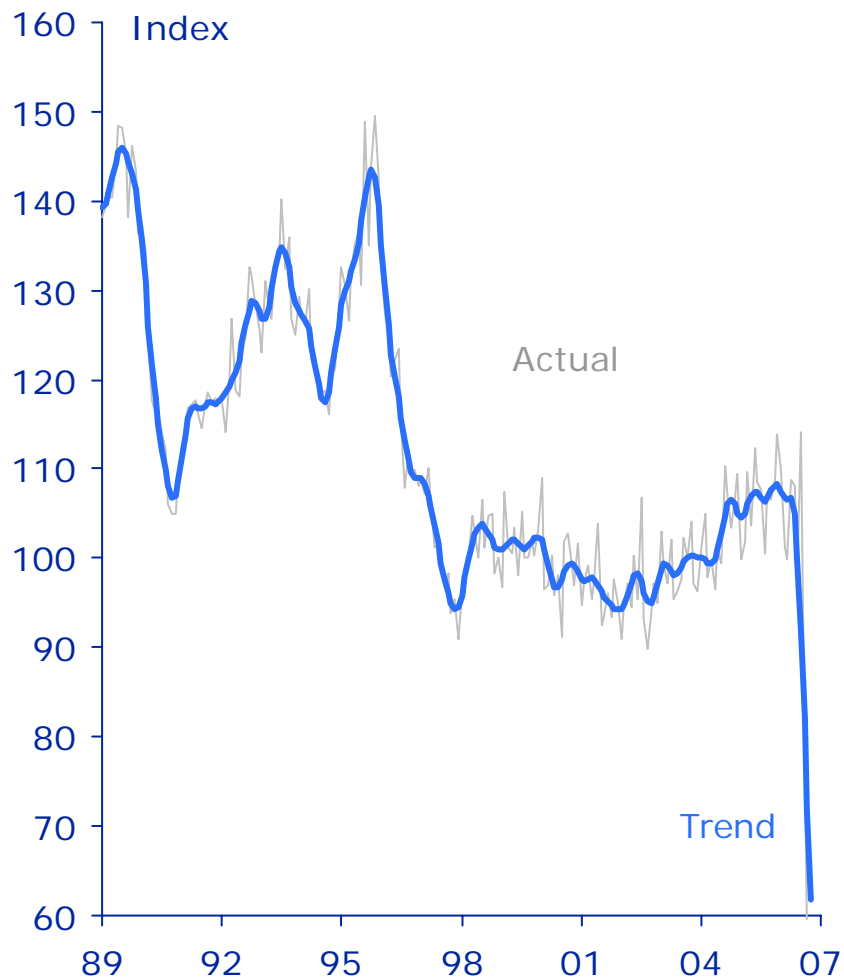


Sources: Japan Economic & Social Research Institute; Home Ministry; Economics@ANZ

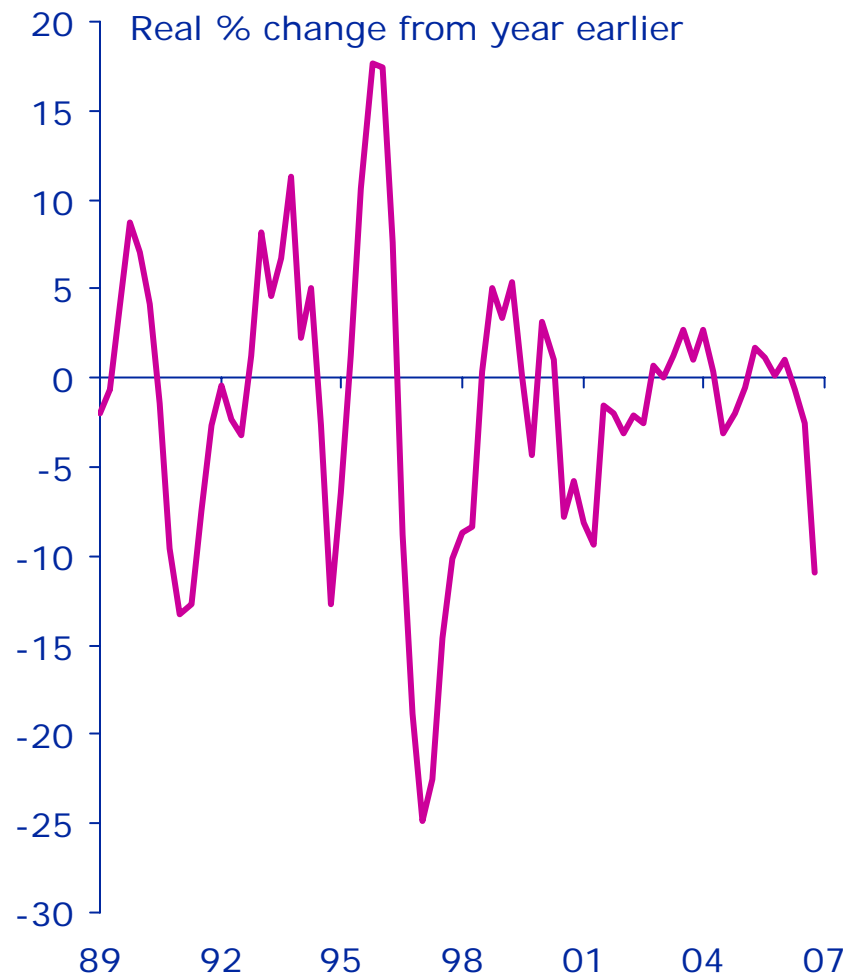


# Recent changes to building regulations have caused a slump in Japanese housing activity

## Housing starts



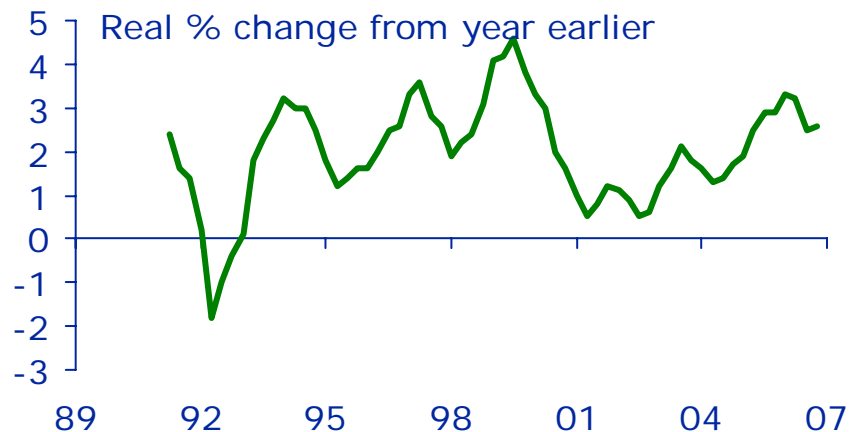
## Dwelling investment



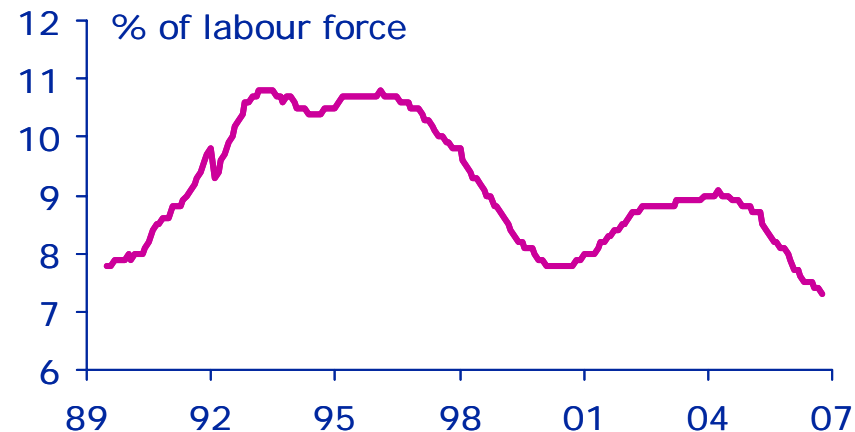
Sources: Japan Land Ministry; ESRI

# Euro area economy has recorded strong growth, falling unemployment and rising inflation

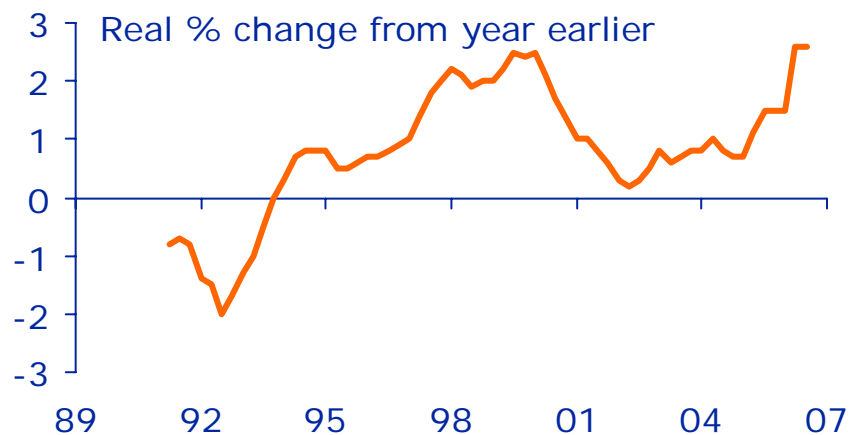
## Real GDP growth



## Unemployment



## Employment growth



## Inflation

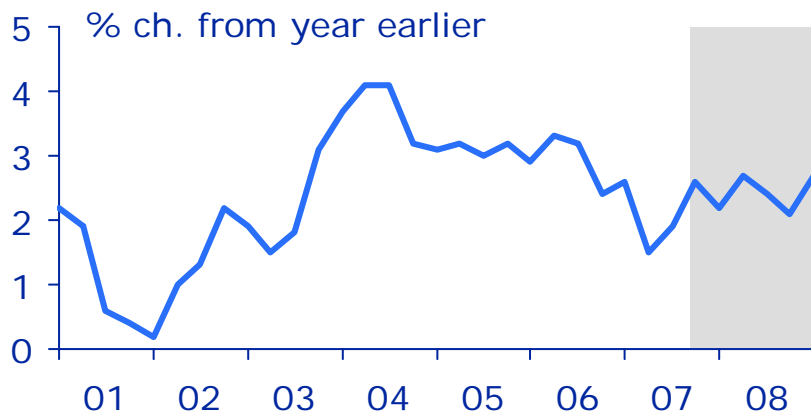


Source: Eurostat

# Growth in the US and major advanced economies will slow, although outright recession is unlikely

## Real GDP growth – major industrialized economies

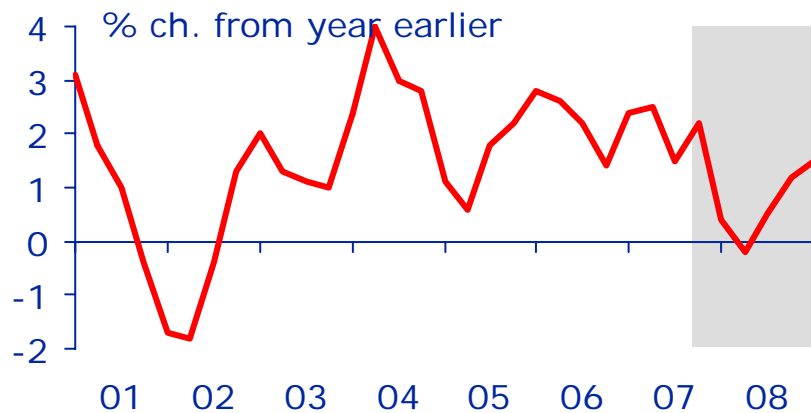
### United States



### Euro area



### Japan



### United Kingdom

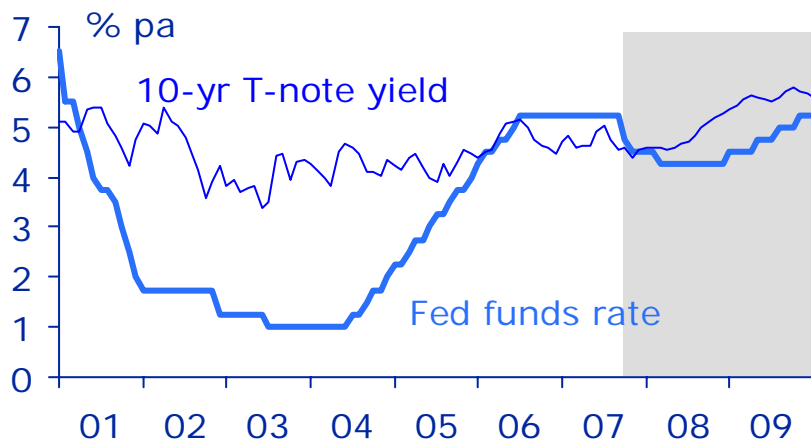


Sources: National statistical agencies; Economics@ANZ

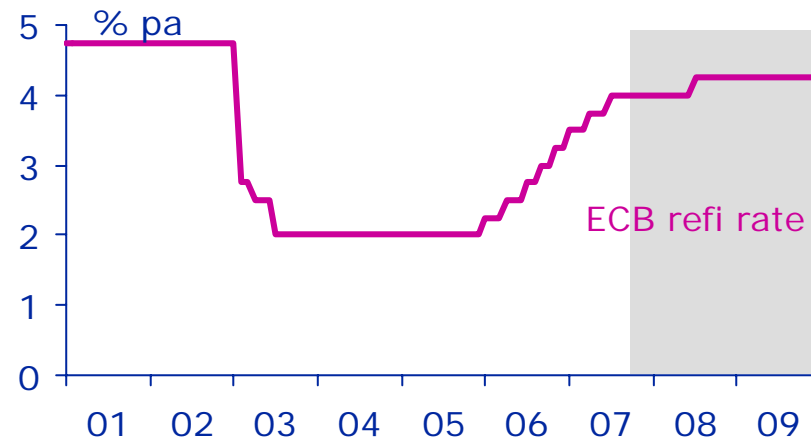
# US Fed will cut rates again, as will BoE, but ECB and BoJ have deferred proposed rises till 2008

## Monetary policy indicator rates – major industrial countries

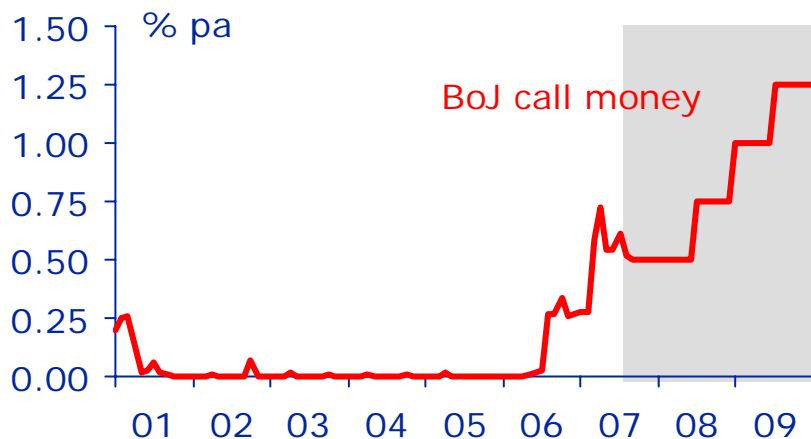
### United States



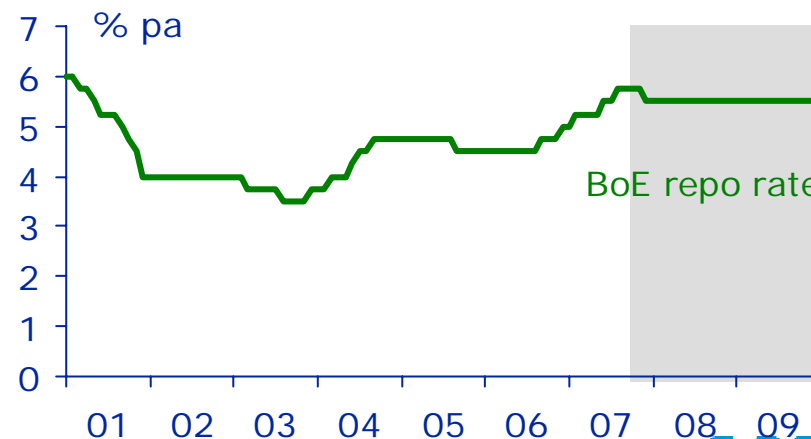
### Euro area



### Japan



### UK

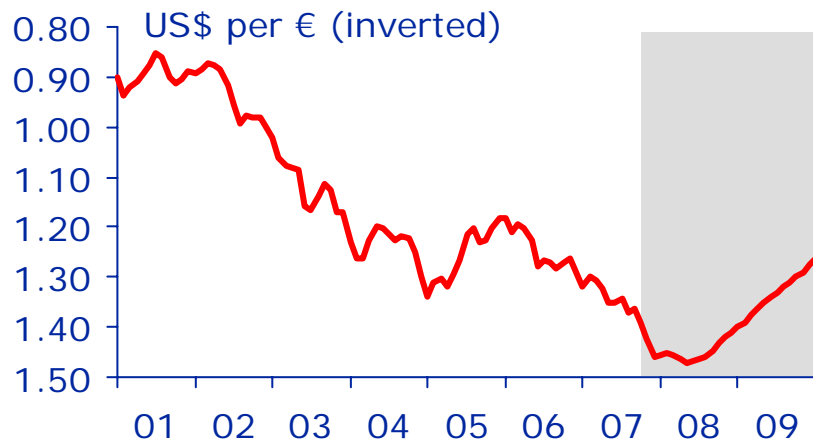


Sources: Bloomberg; Economics@ANZ

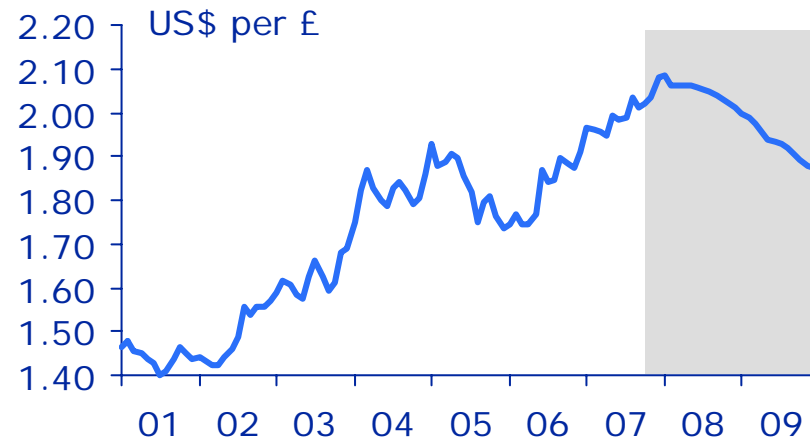
# US dollar will continue weakening until mid-2008, before recovering as US rates start rising

## Major currency pairs

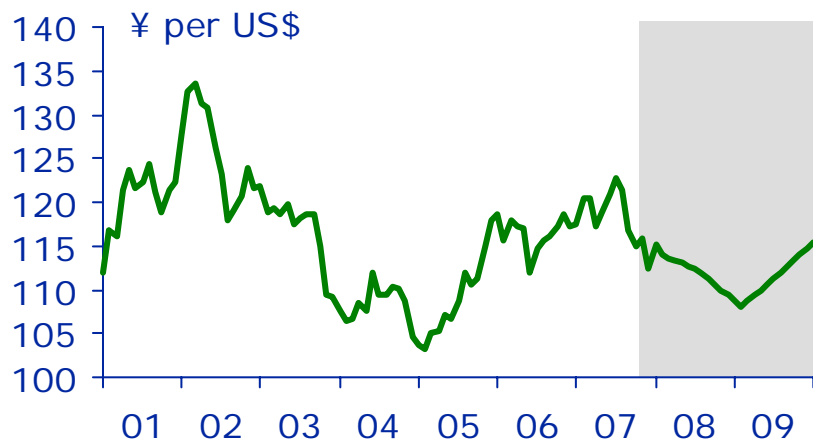
### US dollar vs euro



### Sterling vs US dollar



### US dollar vs yen



### Sterling vs euro

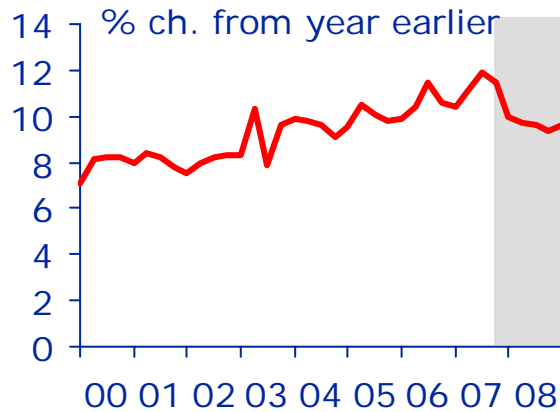


Sources: Bloomberg; Economics@ANZ

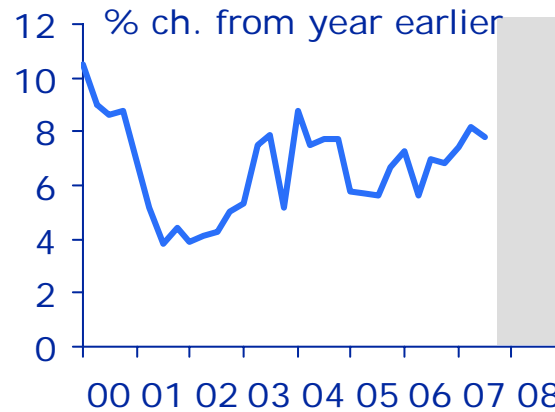
# Major developing economies should continue to record strong growth

## Real GDP – large developing economies

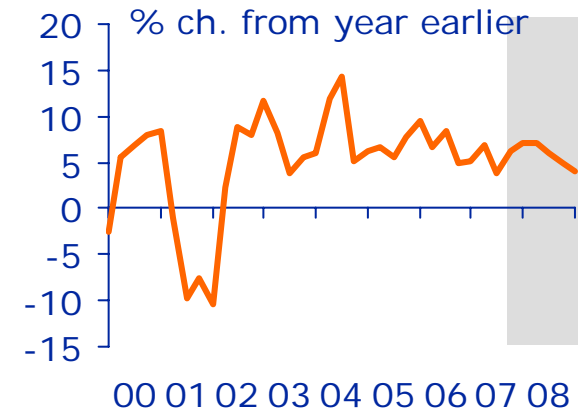
### China



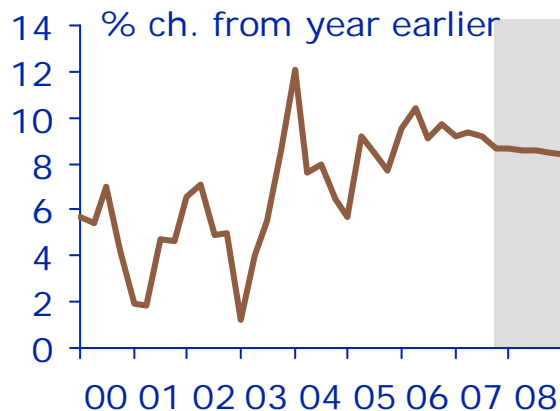
### Russia



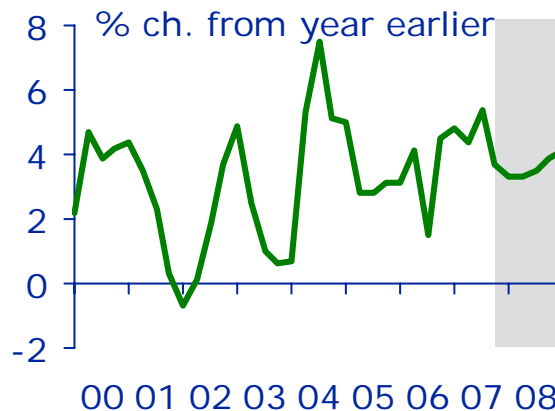
### Turkey



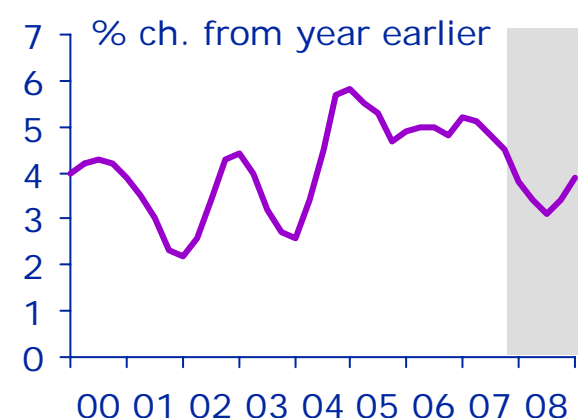
### India



### Brazil



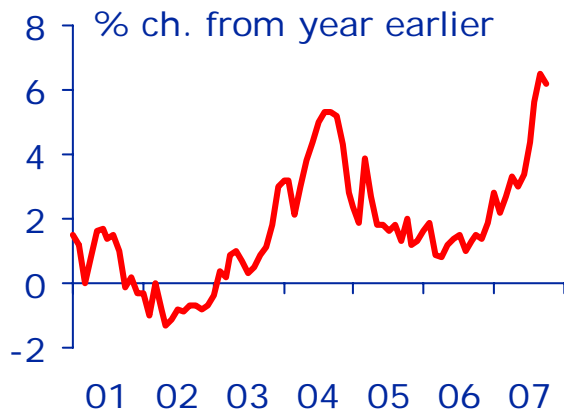
### South Africa



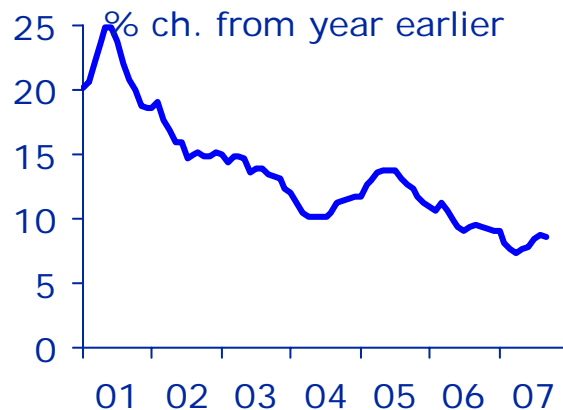
# Developing countries are increasingly more worried about rising inflation

## Inflation – large developing economies

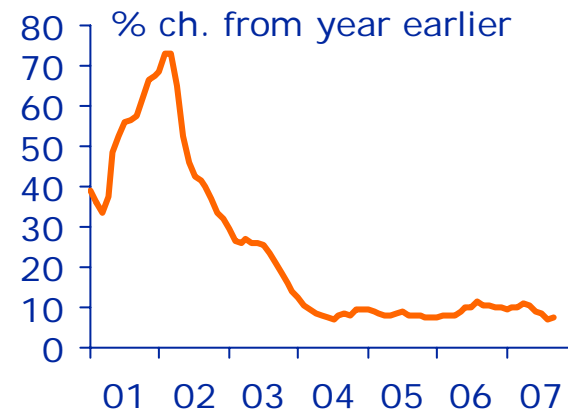
### China



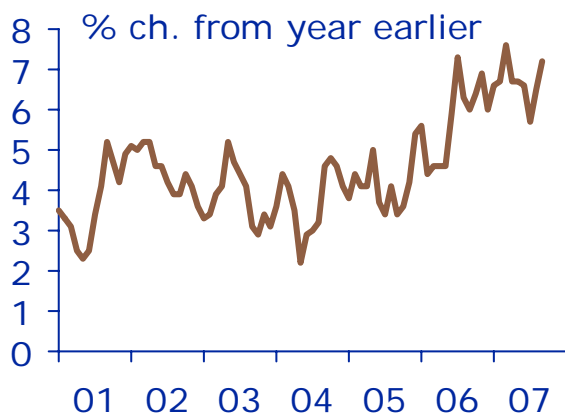
### Russia



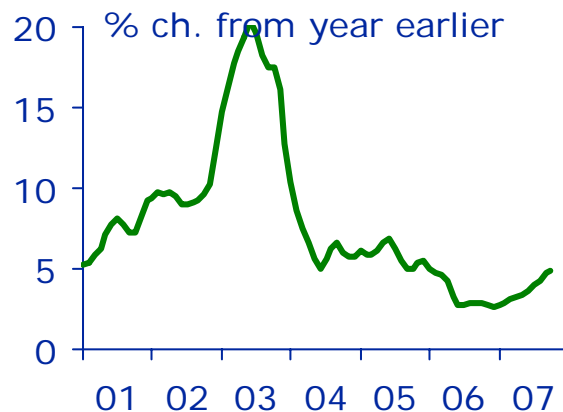
### Turkey



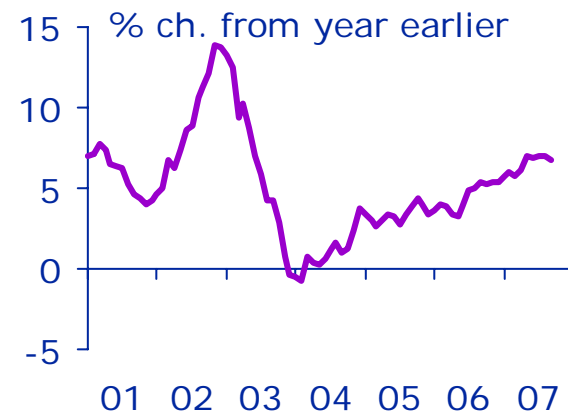
### India



### Brazil



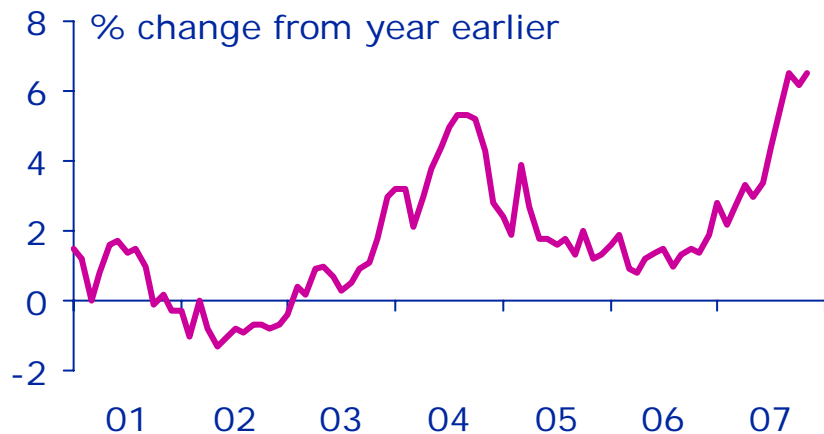
### South Africa



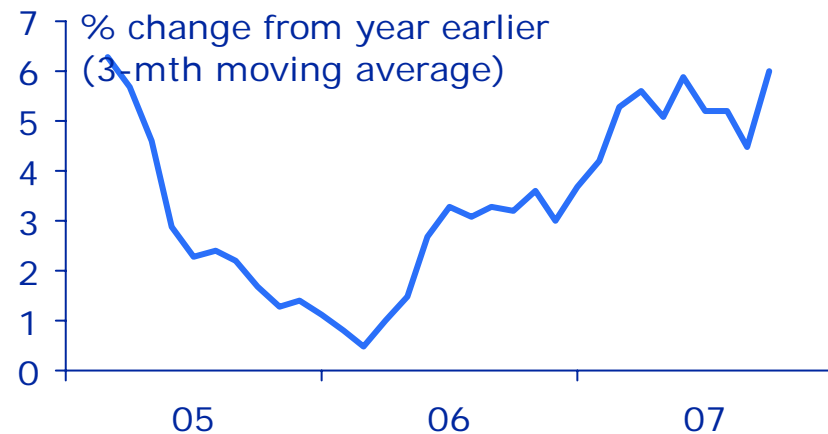
Sources: National statistical agencies; OECD; Datastream

# Rising inflation is a particular concern in China, for political as well as economic reasons

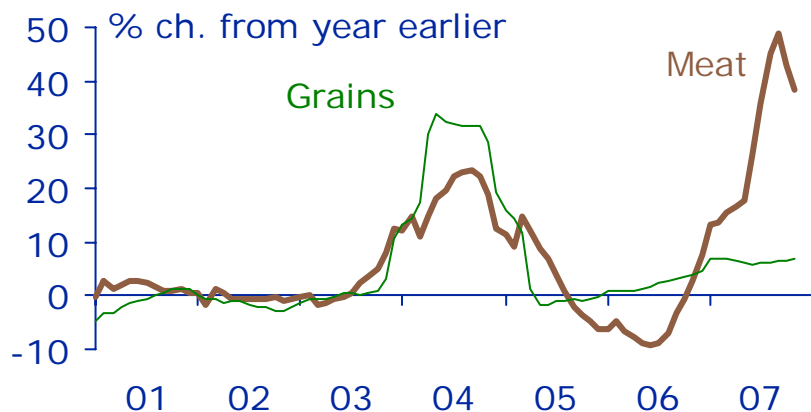
## Consumer prices



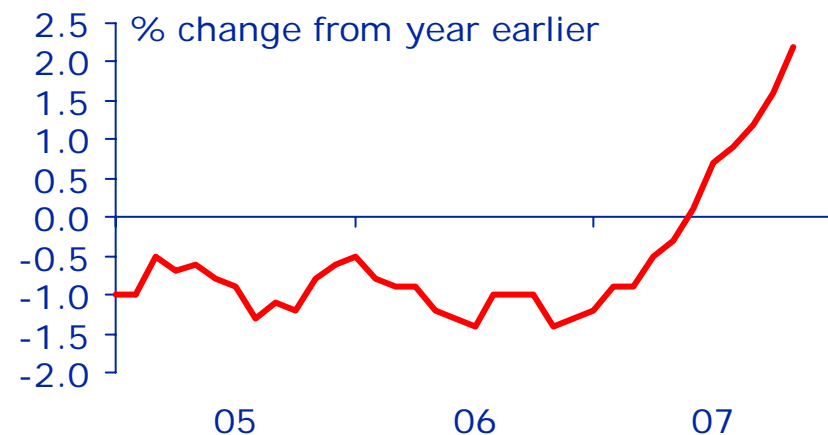
## Export prices



## Food prices



## US imports from China prices

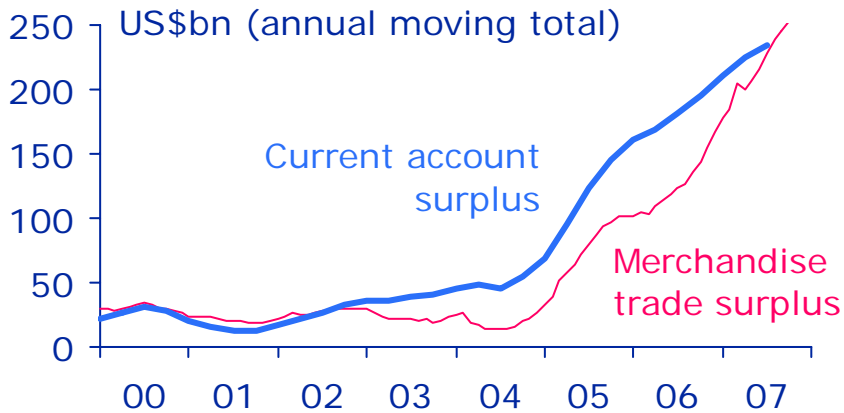


Sources: China National Statistics Bureau; US Commerce Department

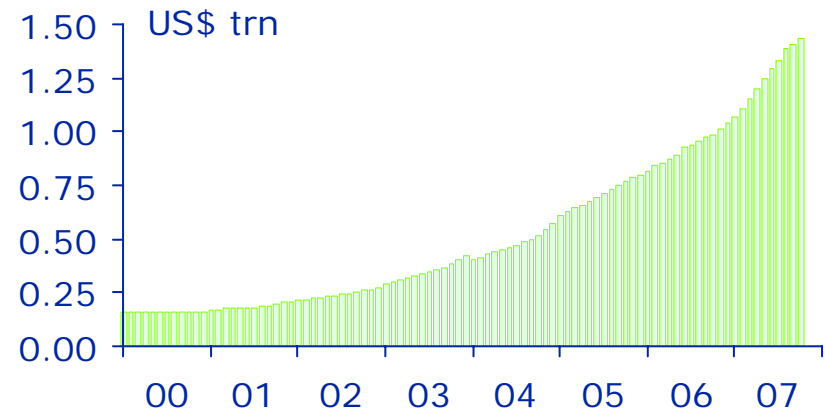


# China's external accounts continue to be a major source of liquidity generation

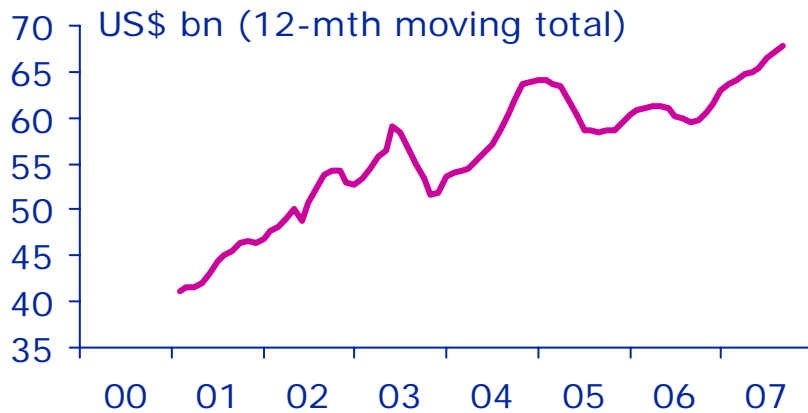
## Current account surplus



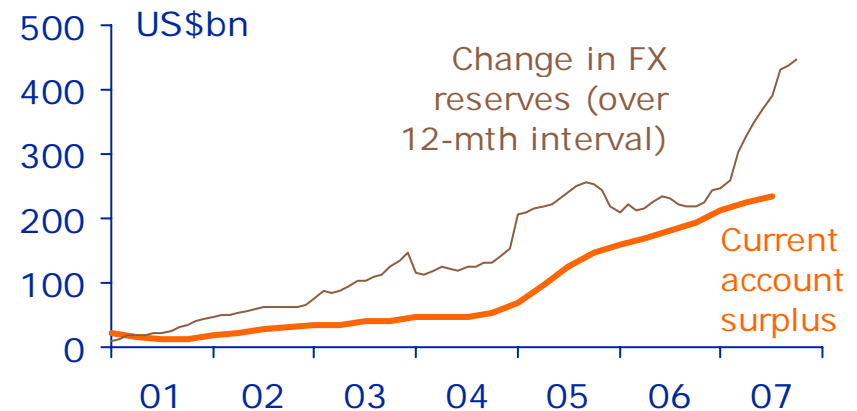
## Foreign exchange reserves



## Foreign direct investment



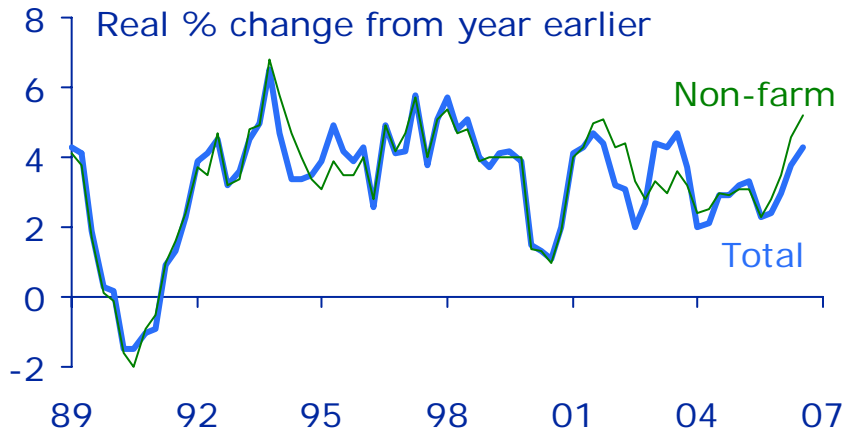
## Increase in FX reserves



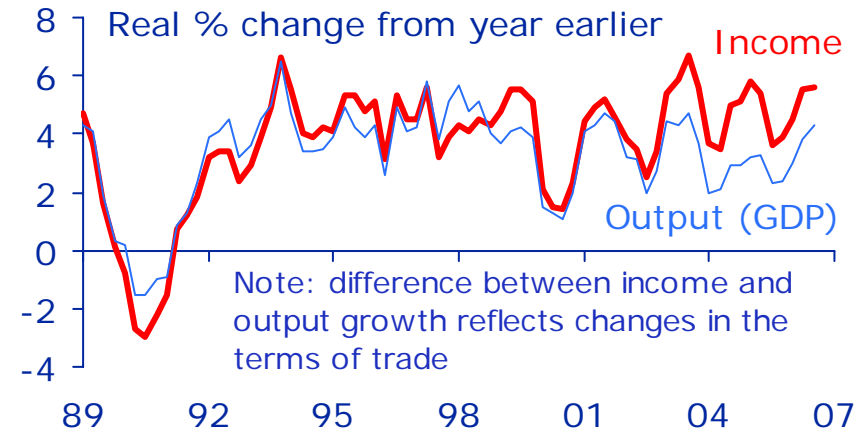
Sources: China National Statistics Bureau;  
OECD; People's Bank of China

# Australia's above-trend growth has been fuelled by spending of commodity-related income gains

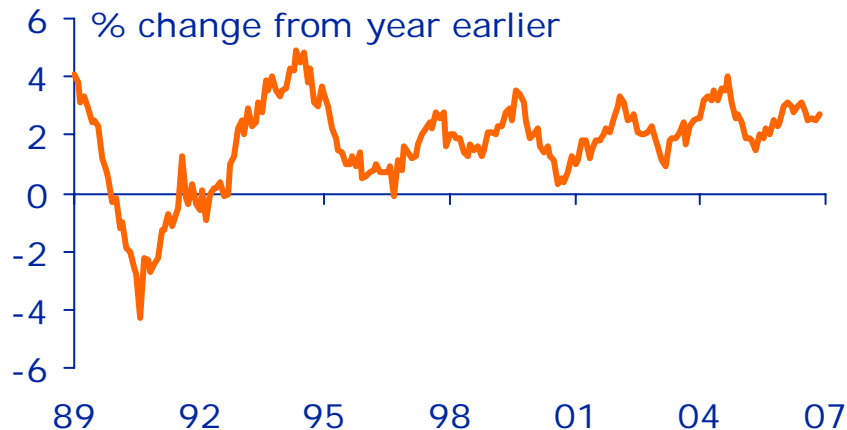
## Real GDP growth



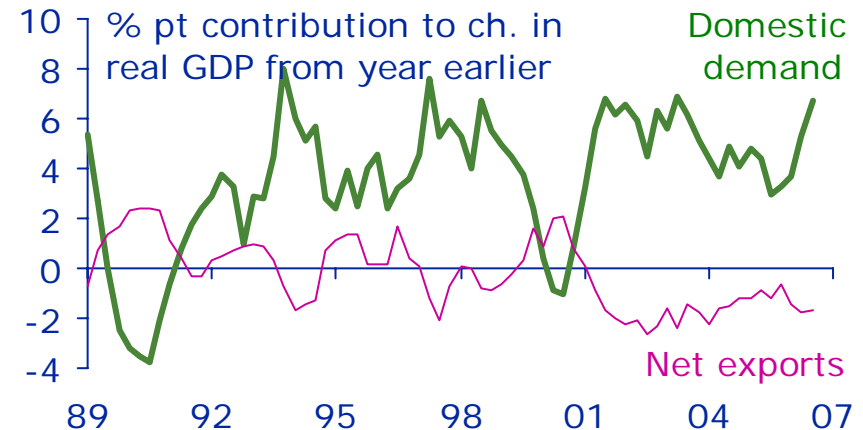
## Real gross domestic income



## Employment growth

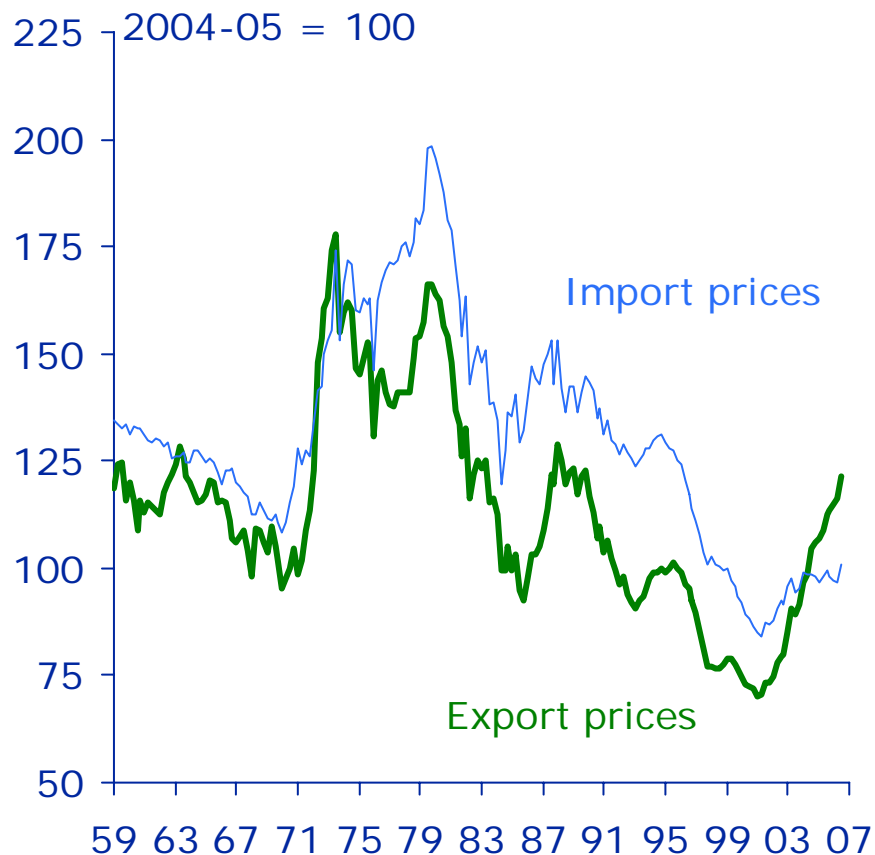


## Composition of GDP growth

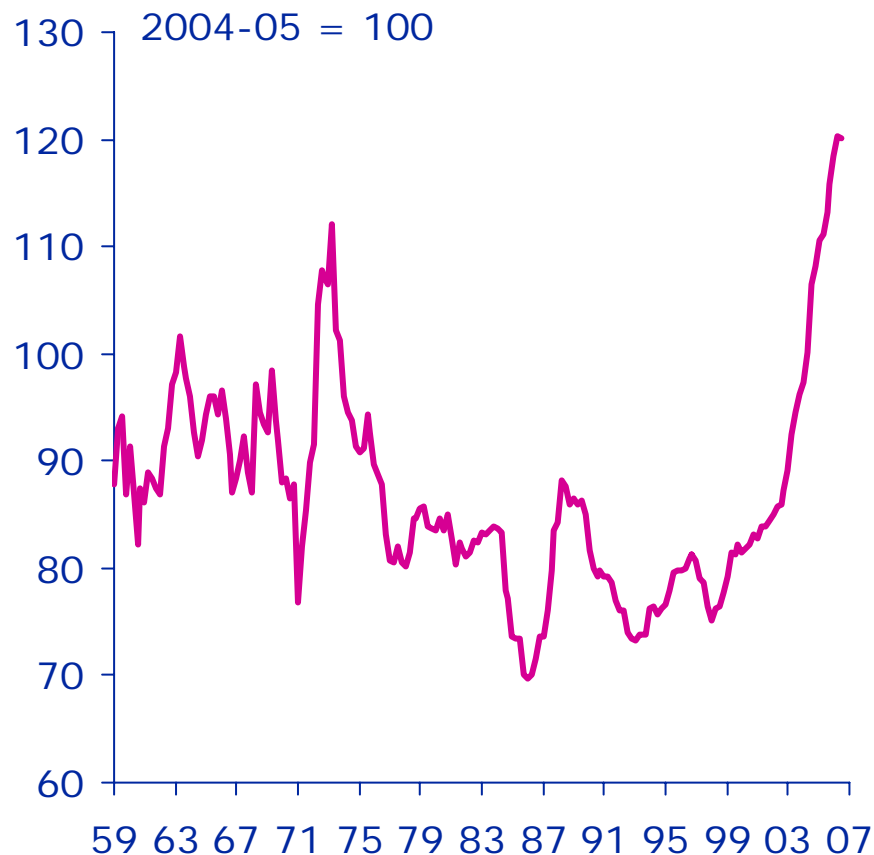


# The commodity boom has dramatically reversed the long-term decline in Australia's terms of trade

## Australian export and import prices in real US\$ terms



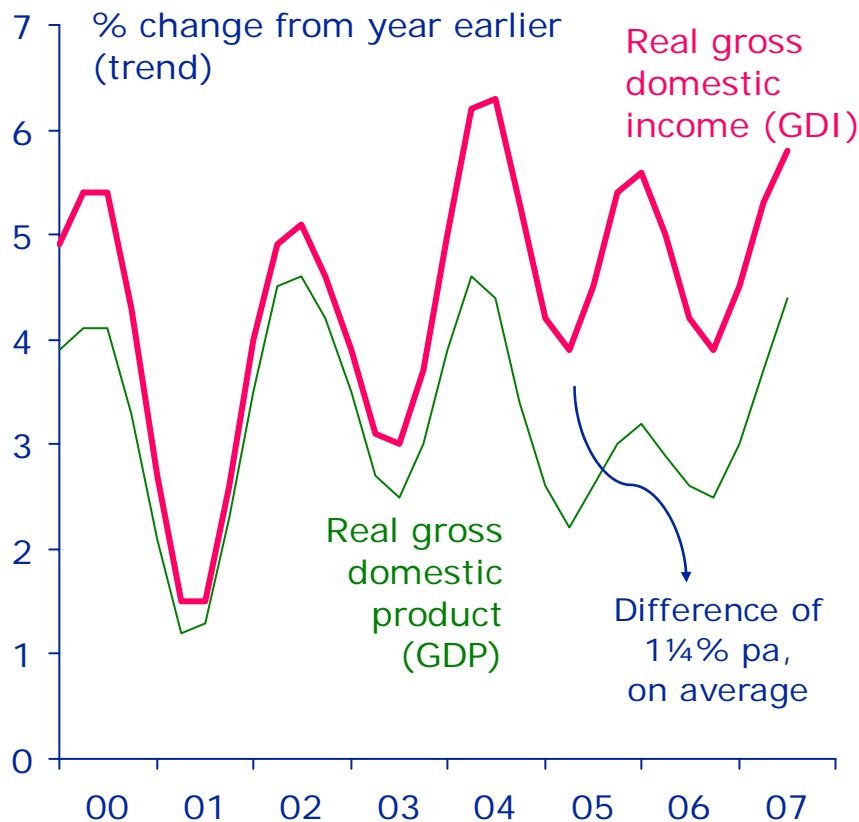
## Australia's 'terms of trade'



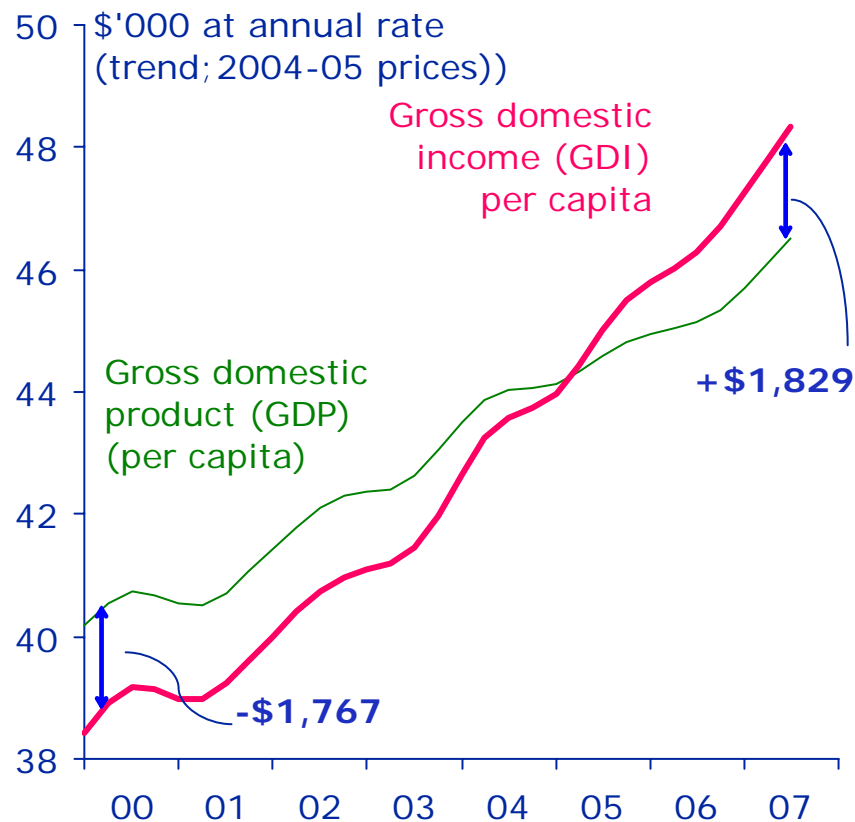
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ

# 'Terms of trade' gains since 1999 have been worth \$3,600 pa to each Australian, on average

## Real gross domestic product and income



## Real gross domestic product and income per capita

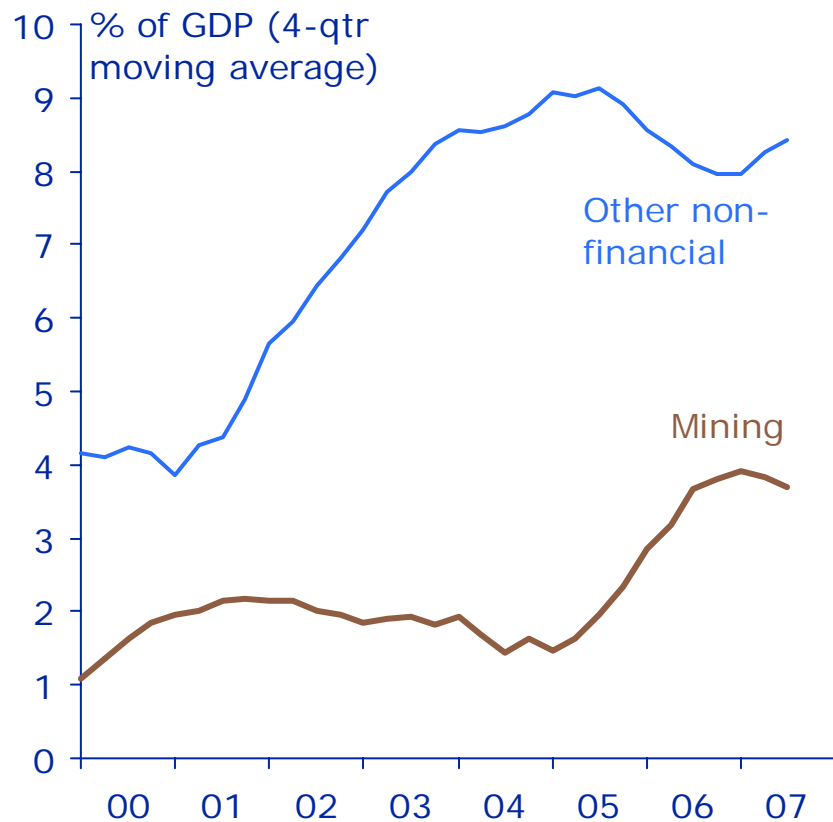


Note: Gross domestic income (GDI) is GDP adjusted for changes in the terms of trade (ratio of export to import prices)

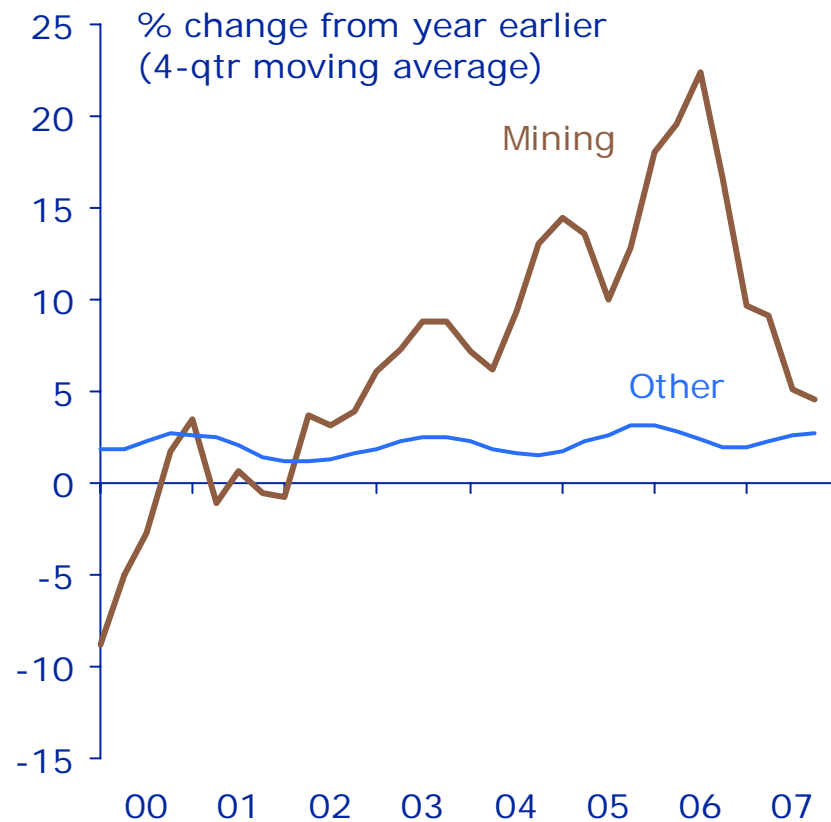
Sources: ABS; Economics@ANZ

# Although much of these gains accrue initially to the mining sector, others have benefited as well

**Pre-tax corporate profits  
as a pc of GDP**

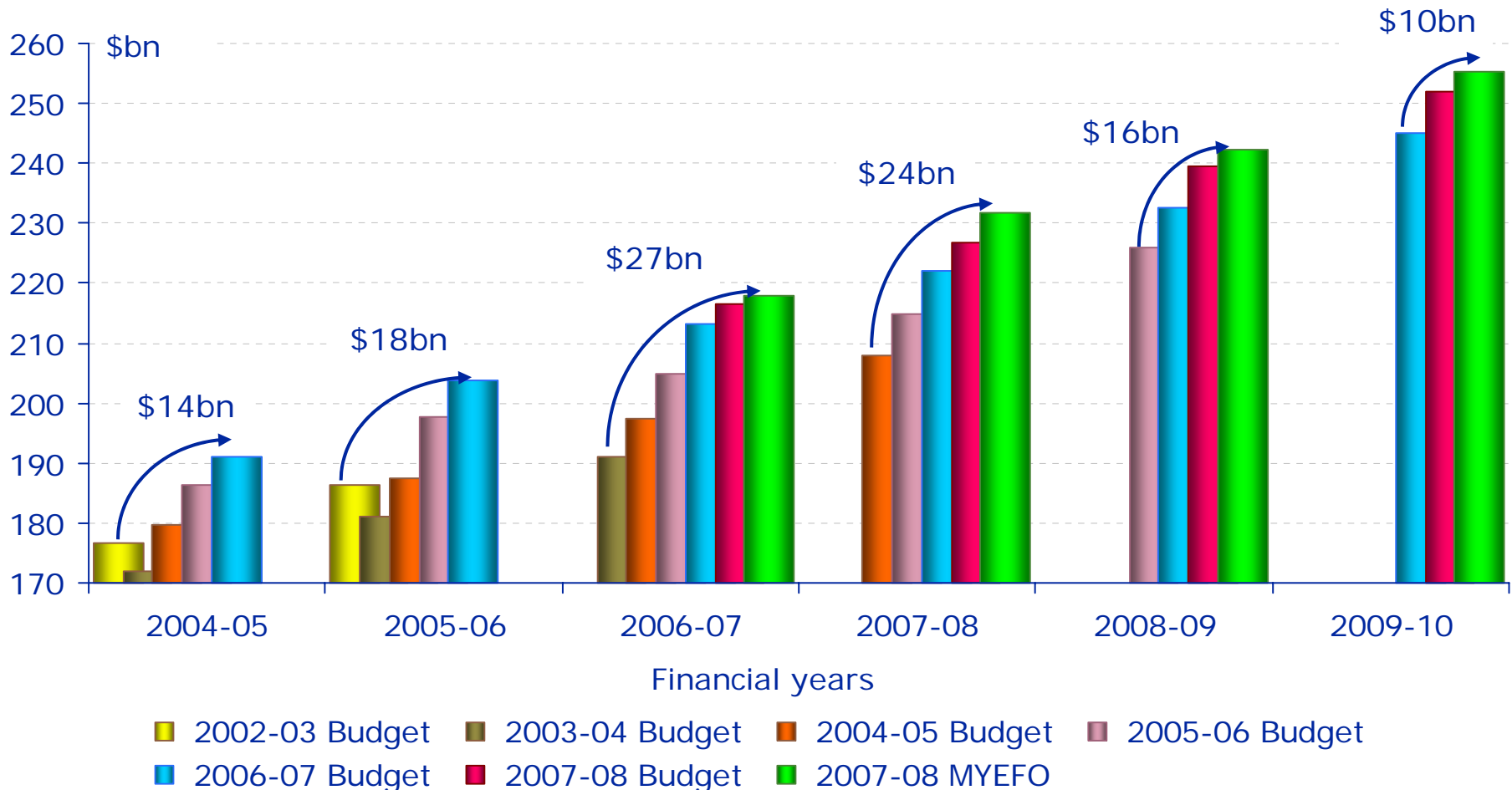


**Employment**



# Every year, tax revenue projections are revised up – despite successive tax cuts

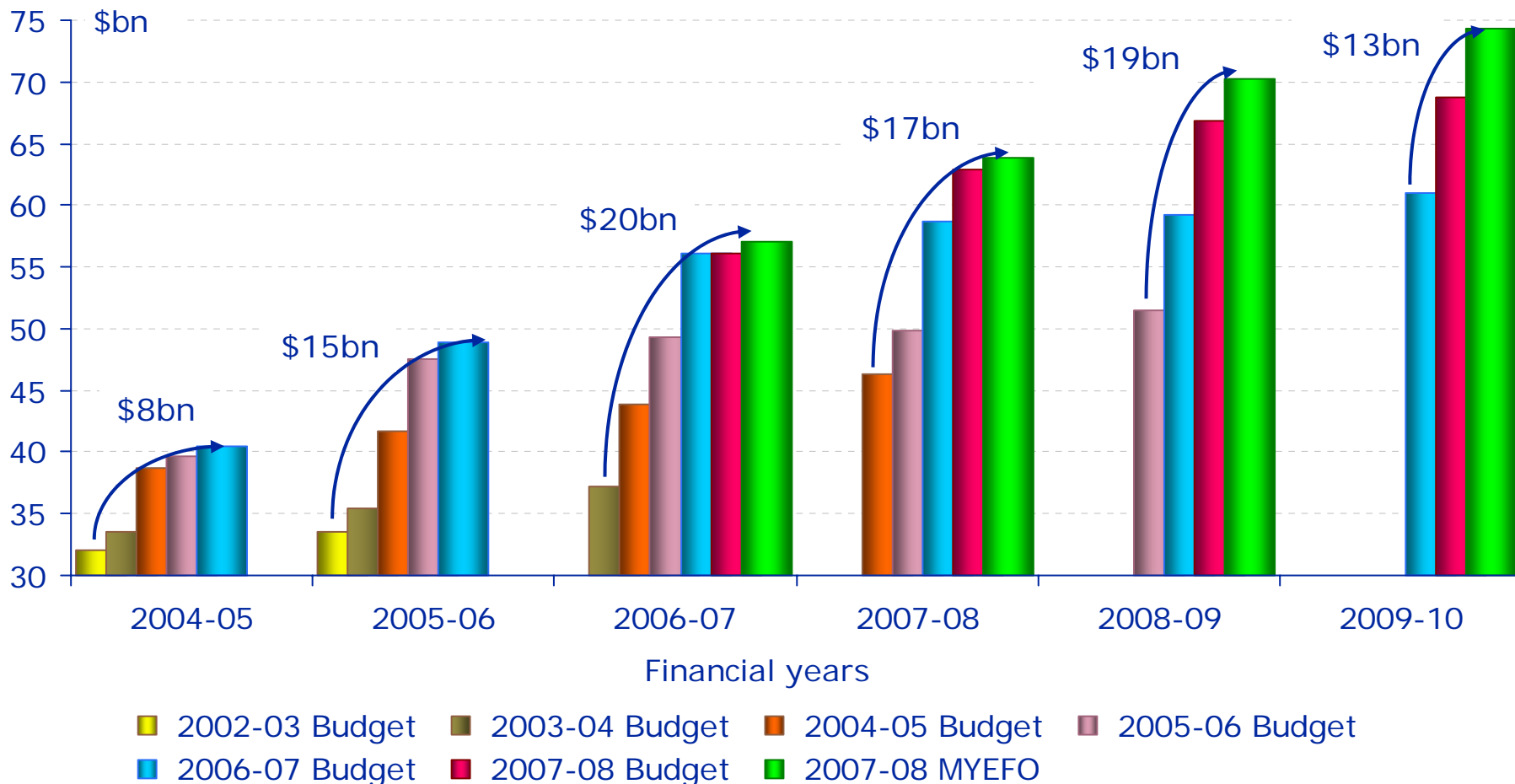
## Successive (cash) estimates of total taxation receipts



Source: Table C4: Statement No 5, *Budget Paper No 1* (various years) and MYEFO Table F7; Economics@ANZ

# Most of these windfall revenue gains have come from company tax

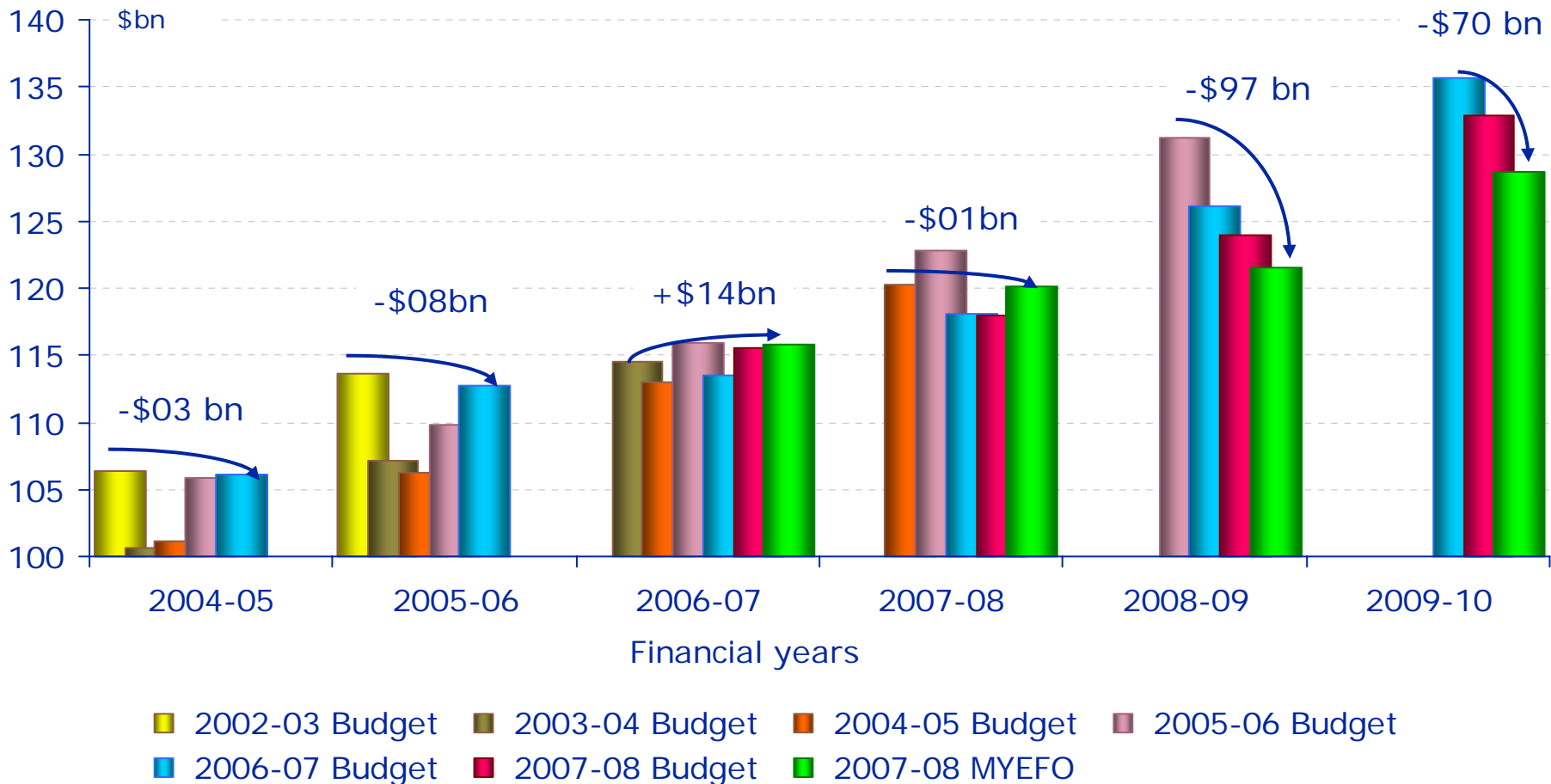
## Successive estimates of company tax receipts



Source: Table C4: Statement No 5, *Budget Paper No 1* (various years) and MYEFO Table F7; Economics@ANZ

# By contrast, personal income tax revenues have been revised downwards – due to tax cuts

## Successive estimates of personal income tax receipts

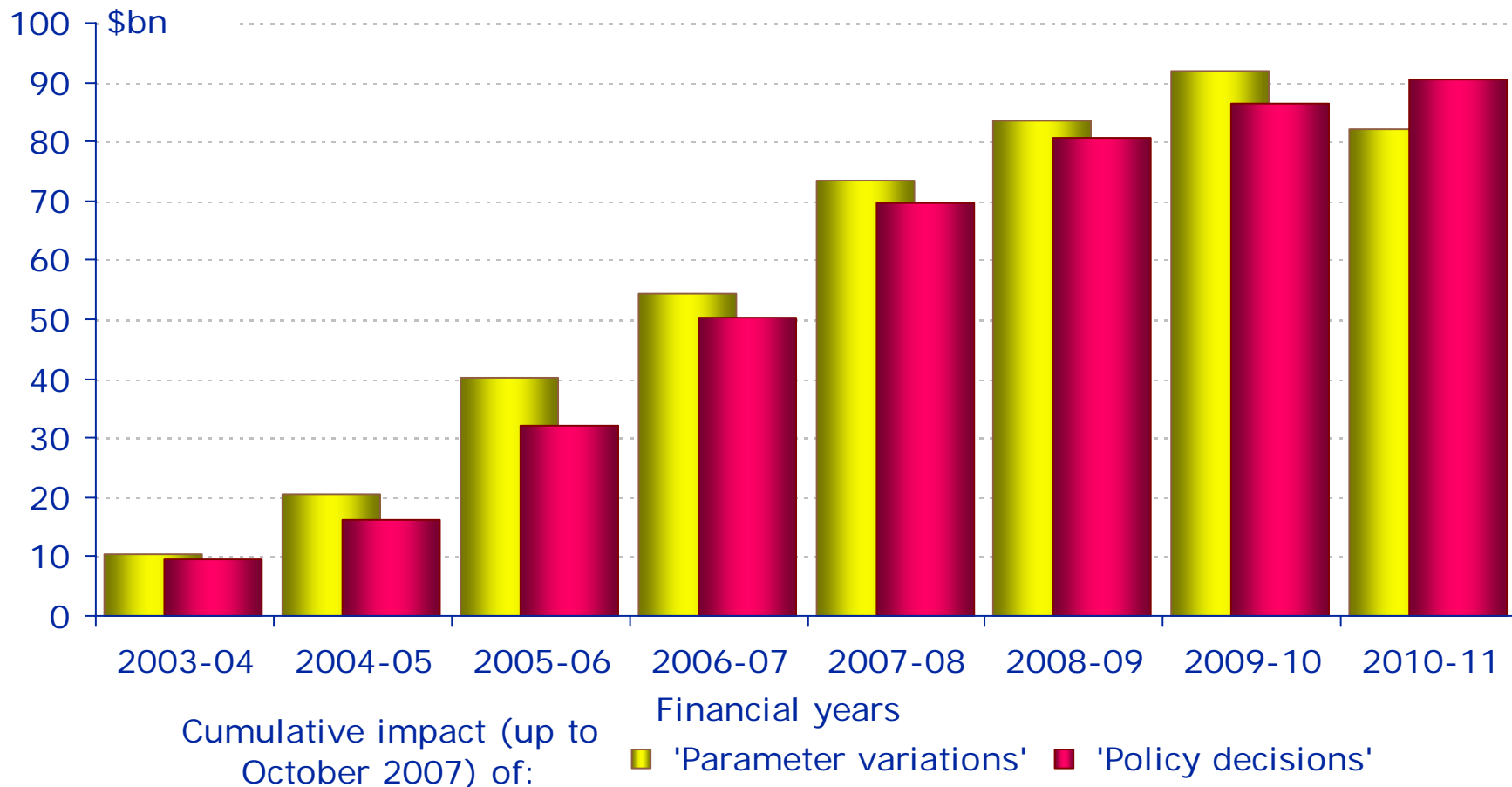


Source: Table C4: Statement No 5, *Budget Paper No 1* (various years) and MYEFO Table F7; Economics@ANZ



# Of at least \$457bn in 'parameter variations' since 2003-04, 'policy decisions' have absorbed \$435bn

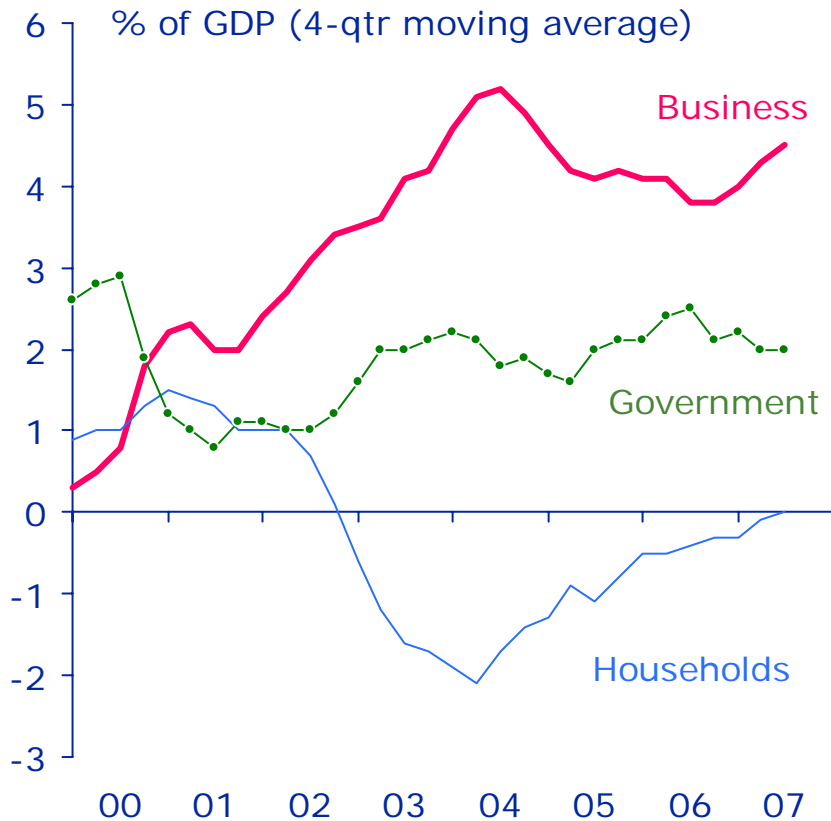
Cumulative net impact on the 'underlying' cash balance of 'parameter variations' and 'policy decisions' since 2003-04



Note: impact of 'parameter variations' and 'policy decisions' beyond published 4<sup>th</sup> year assumed to remain constant at 4<sup>th</sup> year value Sources: Economics@ANZ estimates Based on Statement No 1, Budget Paper No 1 (various years); 2007 MYEFO & PEFO

# By transferring income from business to households, fiscal policy has been boosting demand ...

## Components of national saving

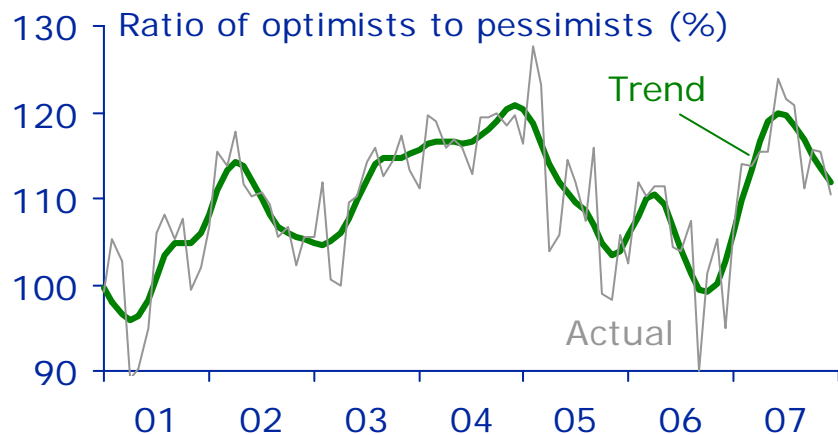


Sources: ABS; Economics@ANZ

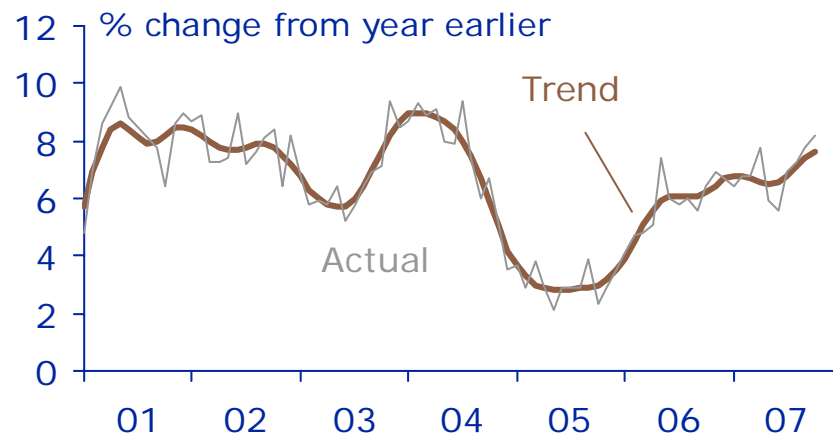
- In each of the past four budgets, the Government has redistributed windfall gains accruing to it from higher-than-expected company tax collections to households via tax cuts and cash handouts, leaving its surplus essentially unchanged
- In so doing the government transfers income from a sector which saves 4-4½% of GDP to one which dis-saves ¼-½% of GDP
- Hence fiscal policy is, at the margin, boosting demand – and thus putting upward pressure on interest rates – even though the Budget remains in surplus

# ... which helps explain why higher interest rates have so far had little tangible impact

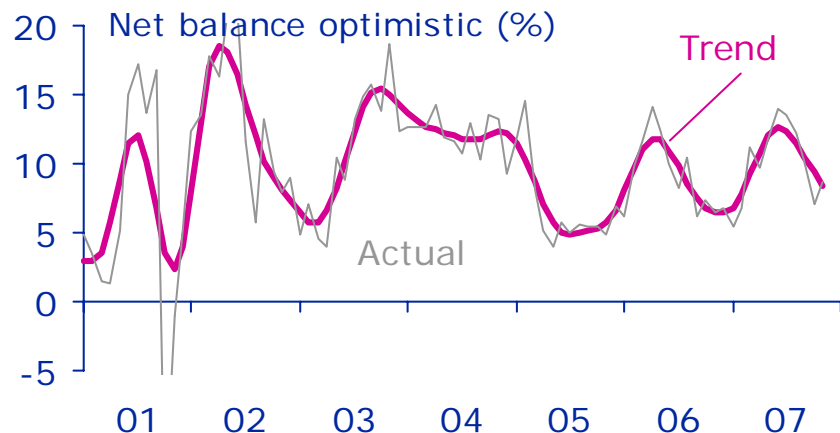
## Consumer confidence



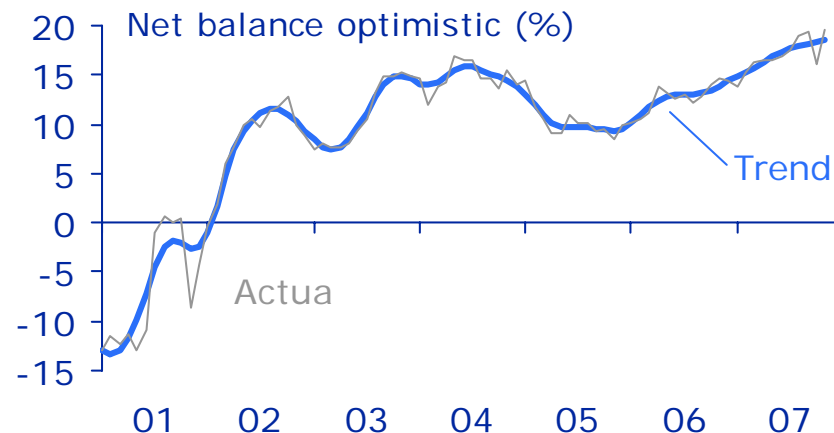
## Retail sales



## Business confidence



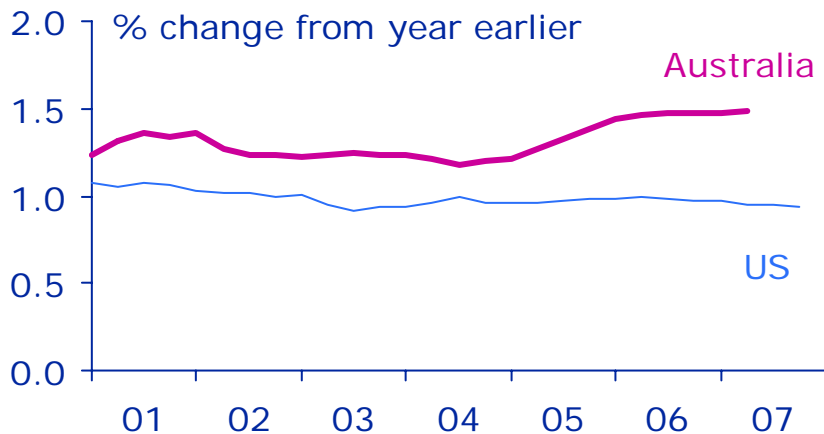
## Business conditions



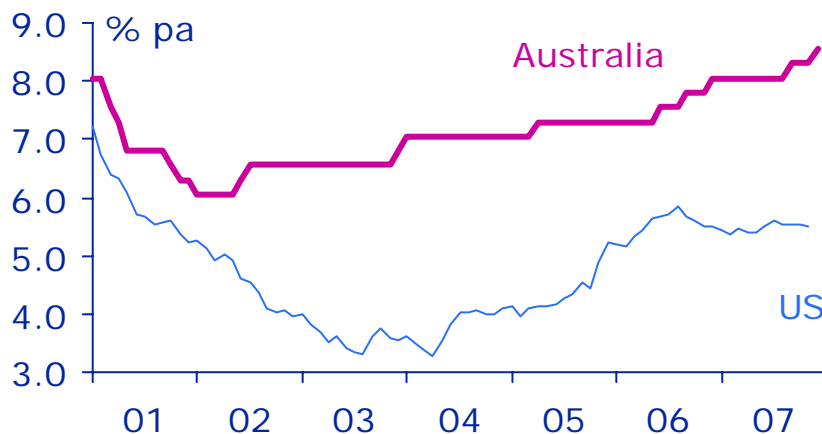
Sources: Westpac-Melbourne Institute; National Australia Bank; ABS

# Housing is not a drag on the Australian economy in the way it has been in the US

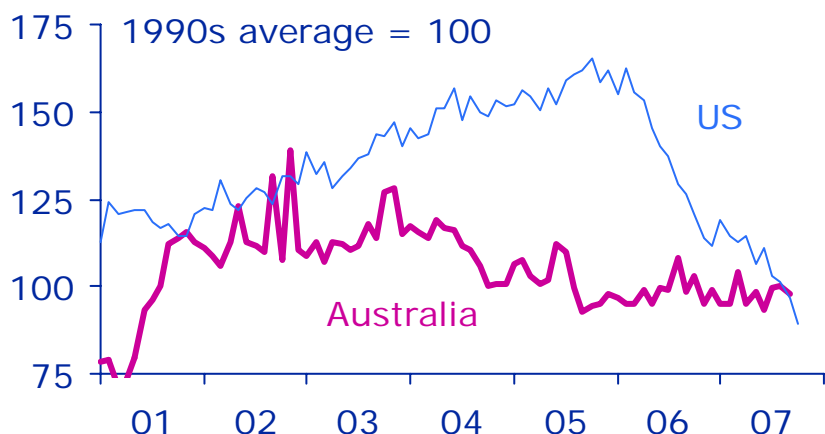
## Population growth



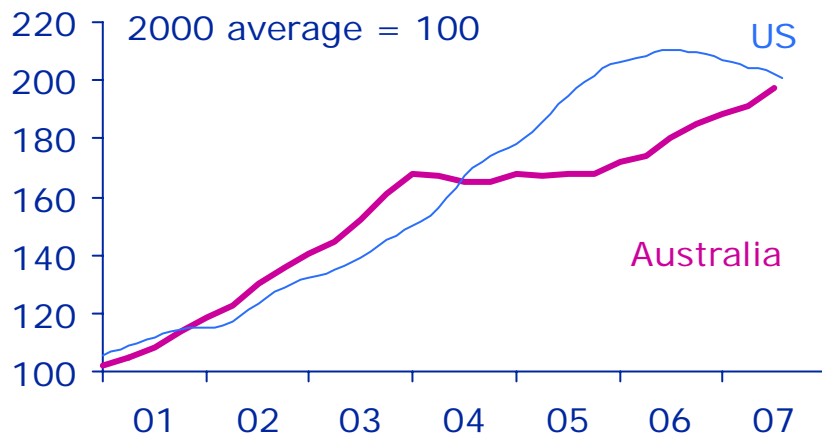
## Variable mortgage rates



## Housing starts

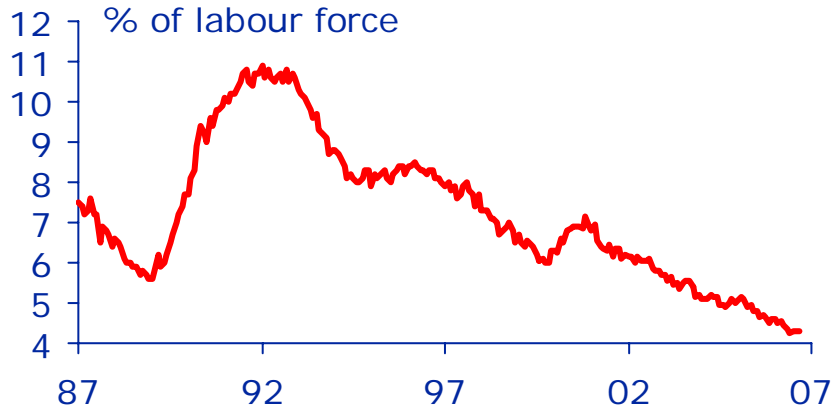


## House prices

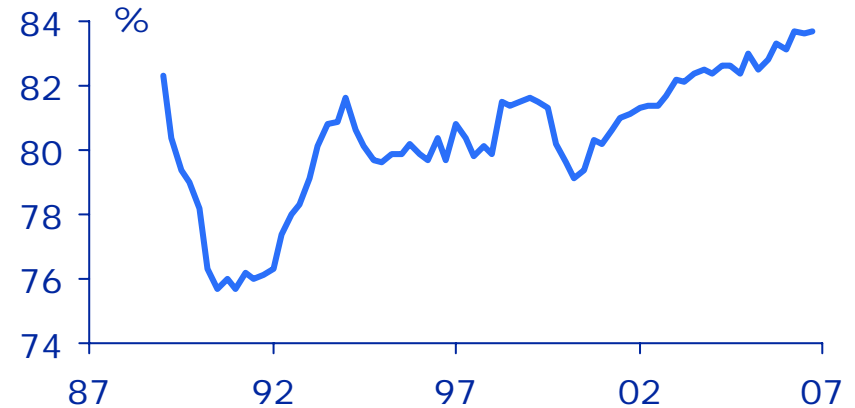


# After over 16 years' continuous growth Australia's economy is running into capacity constraints

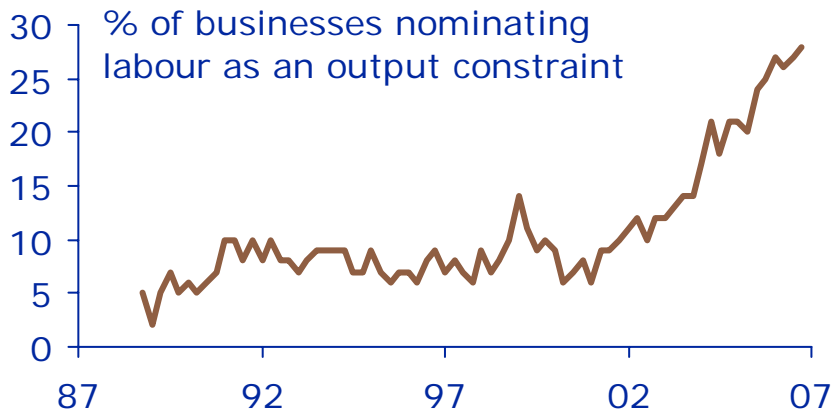
## Unemployment rates



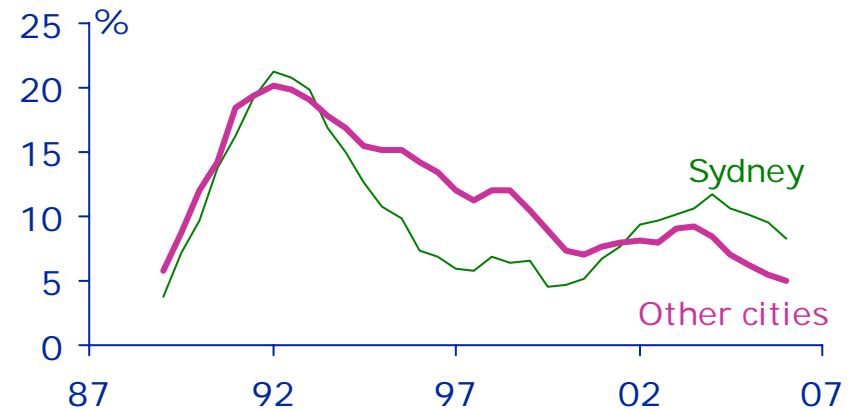
## Capacity utilization



## Labour shortages



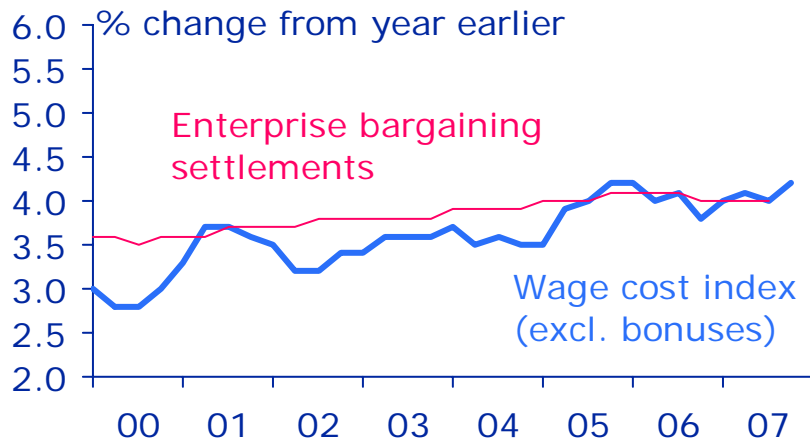
## Office vacancy rates



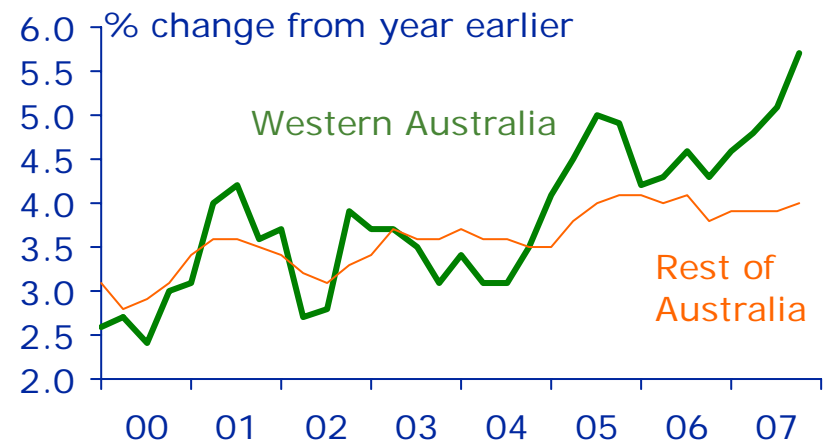
Sources: Australian Bureau of Statistics; National Australia Bank; Property Council of Australia

# Wage pressures have been much better contained than in previous periods of strong labour demand

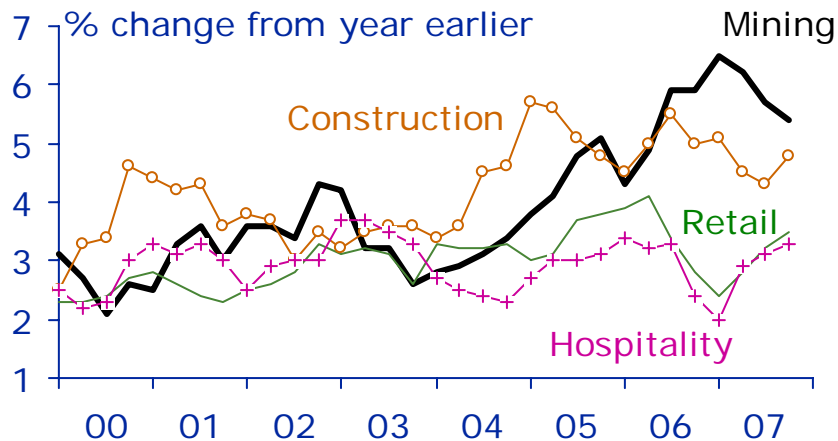
## Wage cost measures



## Wage costs by geography



## Wage costs by industry

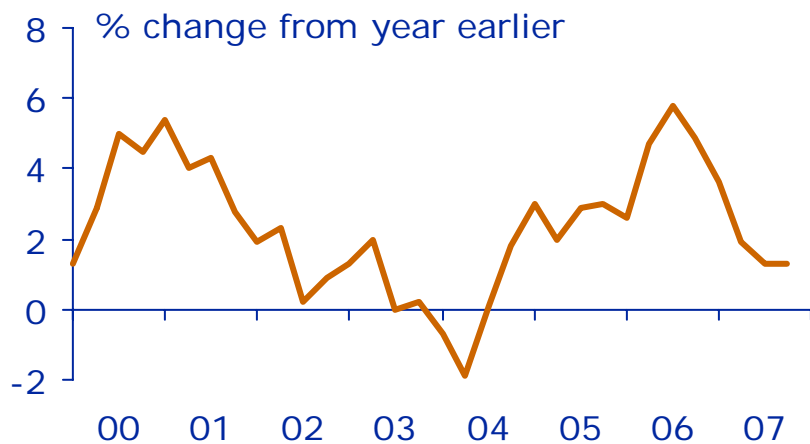


- During previous commodity booms and periods of low unemployment, double-digit wage gains in industries such as mining or metal manufacturing have 'spilled over' into the rest of the economy
- That hasn't happened in this cycle, thanks in part to the weakened bargaining power of unions, and the diminished role of industrial tribunals awarding pay rises on the basis of 'comparative wage justice'

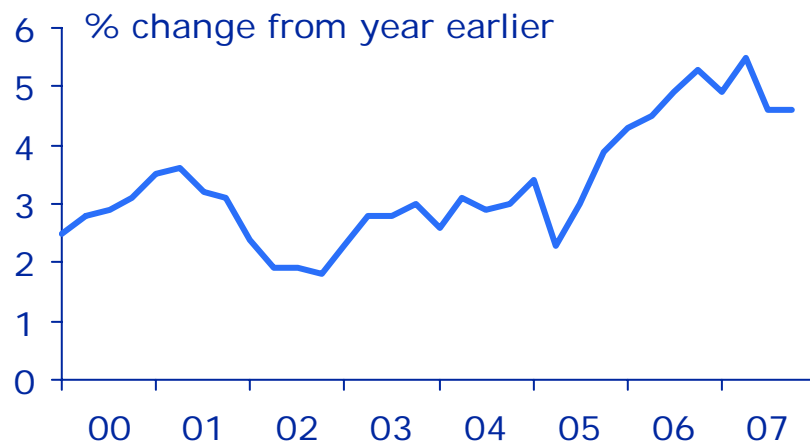
Sources: ABS; Dept of Workplace Relations

# Inflation pressures have been more marked in services sectors than for goods

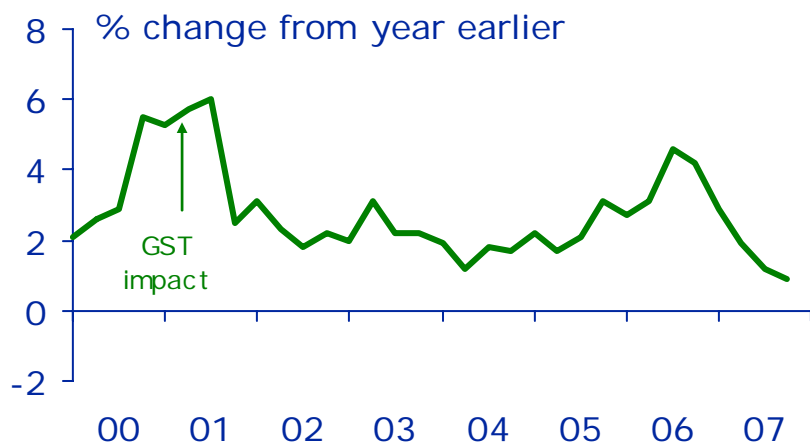
## Producer prices - goods



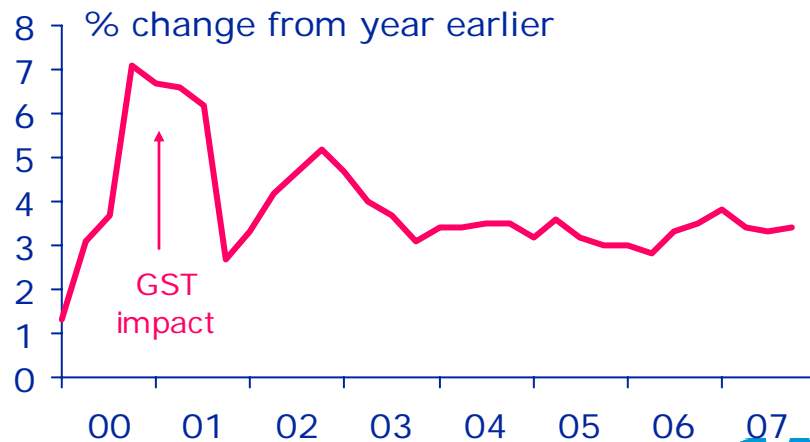
## Producer prices - services



## Consumer prices - goods



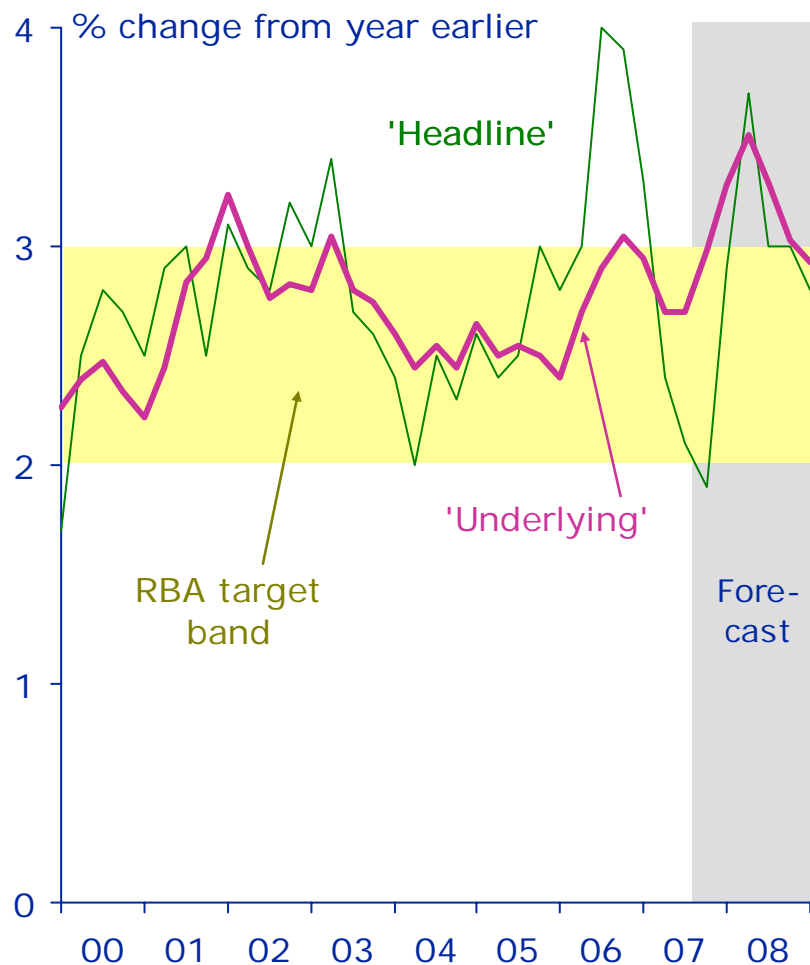
## Consumer prices - services



Sources: ABS; Dept of Workplace Relations

# Most of the risks to the Australian inflation outlook seem tilted to the upside

## Consumer prices



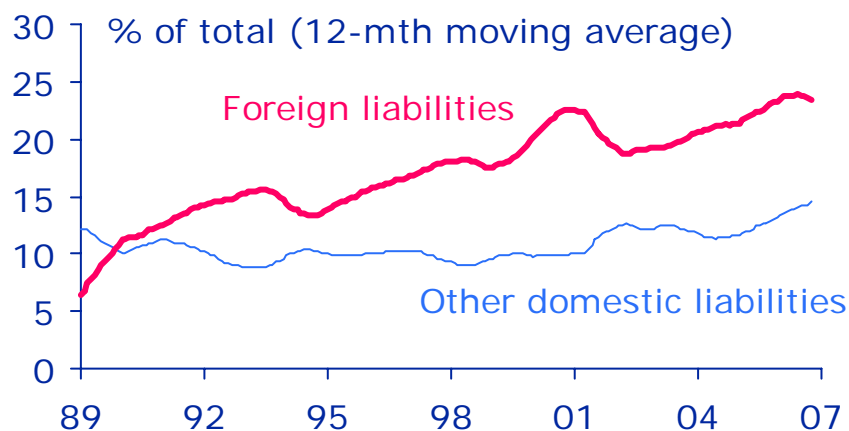
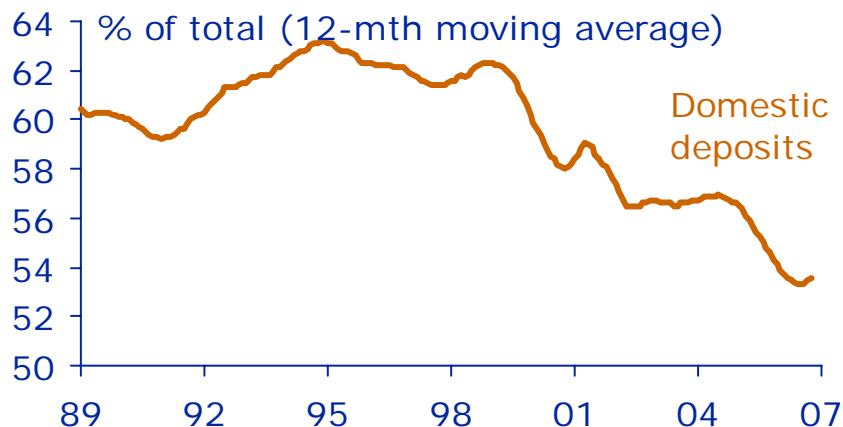
Sources: ABS; RBA

- The sharp fall in the 'headline' inflation rate over the year to the September quarter reflects the 'washing out' of last year's spikes in petrol and banana prices, and the impact of changes to the child care rebate in the most recent Federal Budget
- The RBA's preferred measures of 'underlying' inflation have risen by 0.9-1.0% in each of the past two quarters, bringing the annual 'underlying' rate to 3%
- Strong growth in household spending has allowed price rises to 'stick' more readily
- Rising prices for food, water, electricity, petrol and rents will also add to inflation during 2008
- Underlying inflation will likely peak at 3½% in mid-2008



# Australian banks have become increasingly dependent on wholesale and offshore funding

## Components of bank liabilities



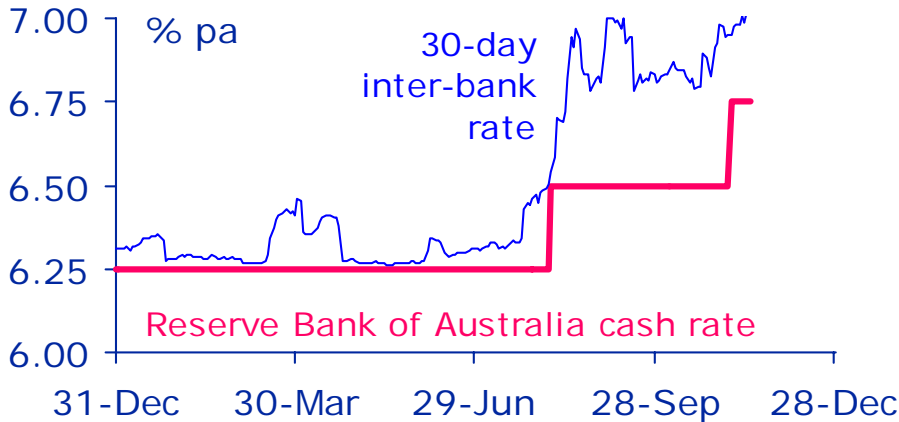
## 'Financial corporations' net foreign debt



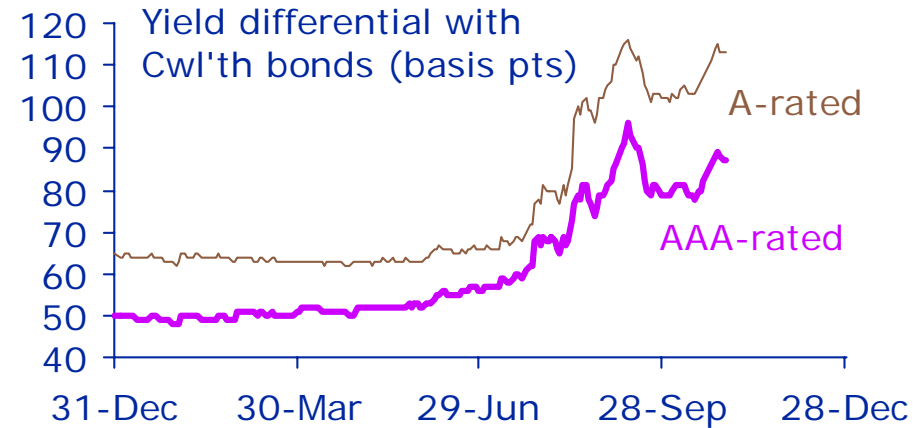
- Banks have become the principal intermediary through which Australia's current account deficit is financed
- Offshore borrowings now account for just under  $\frac{1}{4}$  of Australian banks' total liabilities, while domestic deposits account for just over  $\frac{1}{2}$
- Increases in wholesale funding costs globally have been transmitted directly to the Australian banking system

# Australian interest rate spreads remain much wider than prior to mid-July

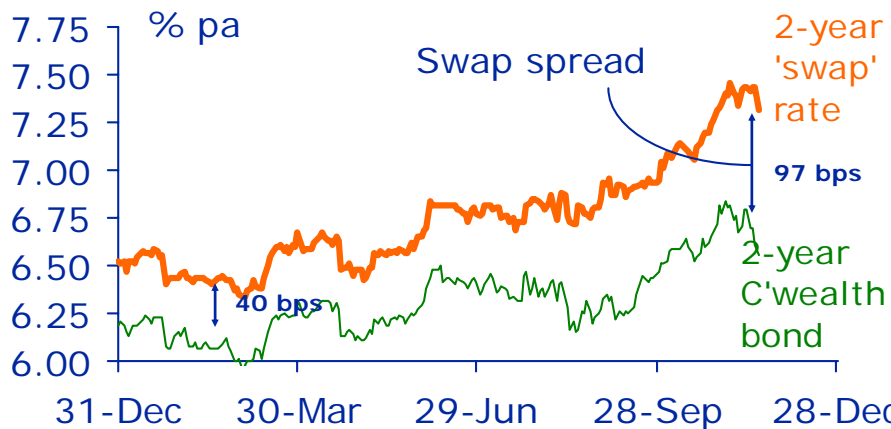
## Short-term money market rates



## Corporate bond yield spreads



## 2-year rates

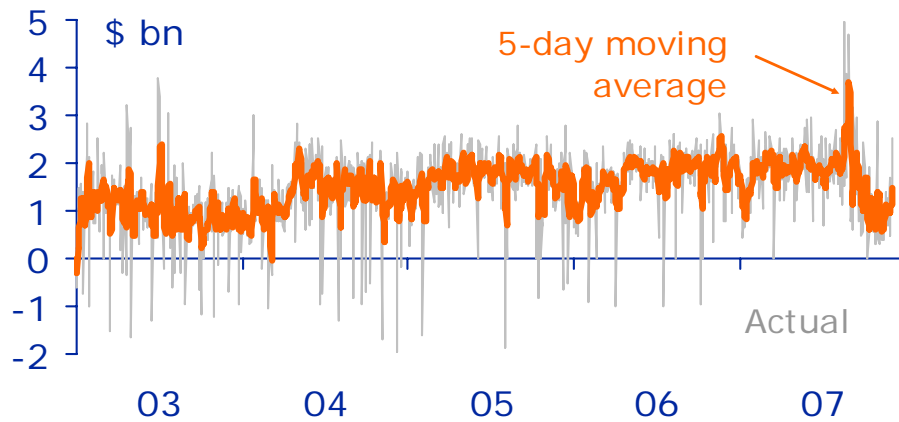


## Credit default swap spread

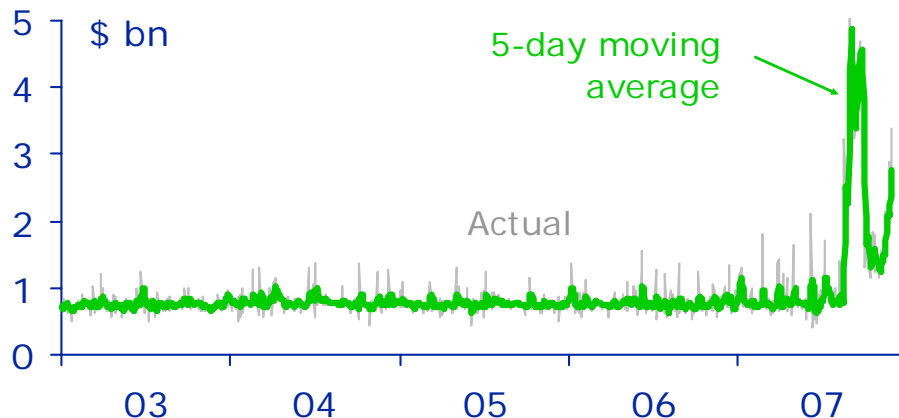


# Like other central banks the RBA has stepped up its market operations to add additional liquidity

## RBA open market operations



## Exchange settlement account (ESA) balances with the RBA

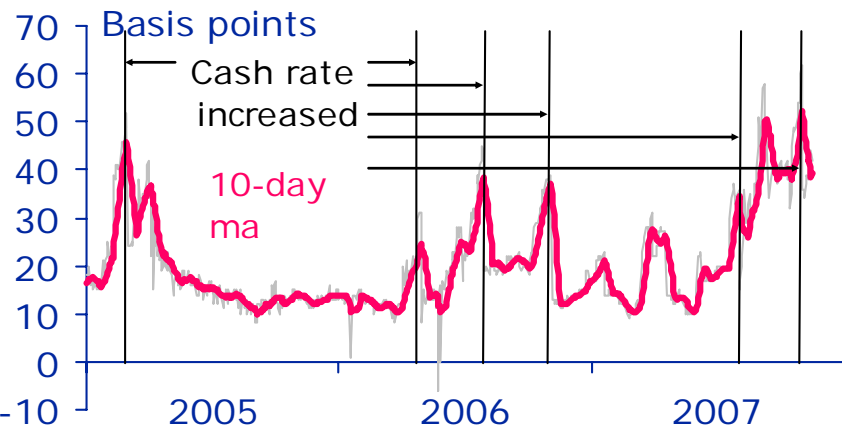


Source: RBA

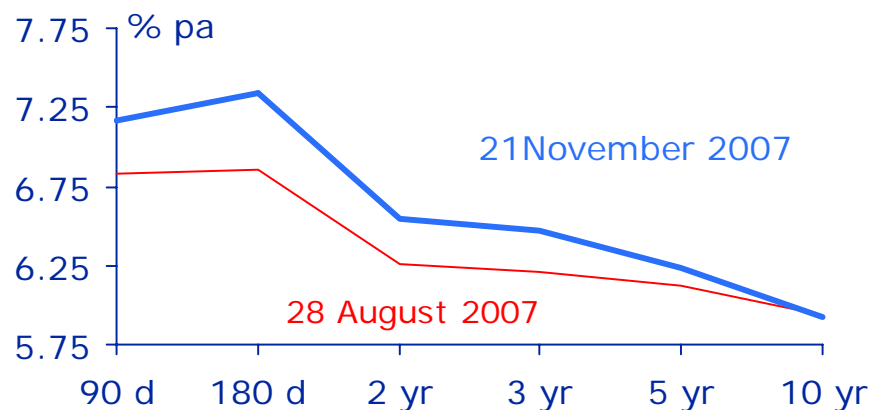
- The RBA typically supplies around A\$700-800mn of exchange settlement funds ('cash') to the commercial banks each day
- In response to heightened demands for cash from the banking system since early August the RBA significantly increased and broadened the scale of its open market operations
- ESA balances peaked at over \$4½bn in mid-September
- The scale of RBA liquidity support eased back significantly since then, but has stepped up again in early November in response to renewed funding pressures

# Markets have priced in at least one more increase in the cash rate

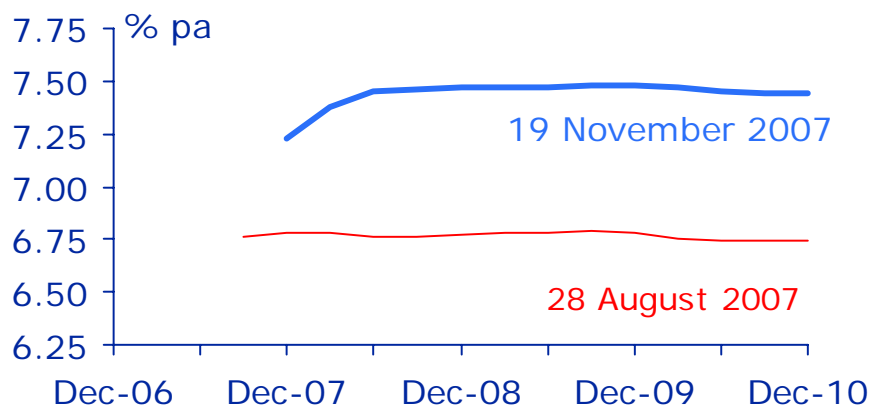
## 90-day bill funding spread



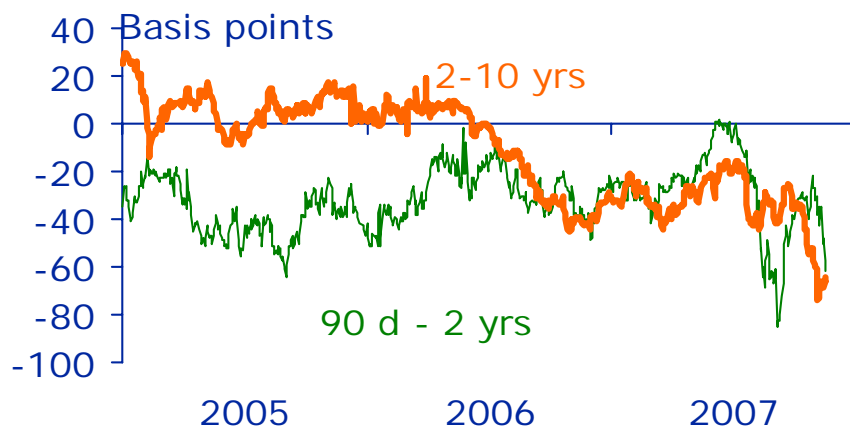
## Yield curves



## 90-day bank bill futures



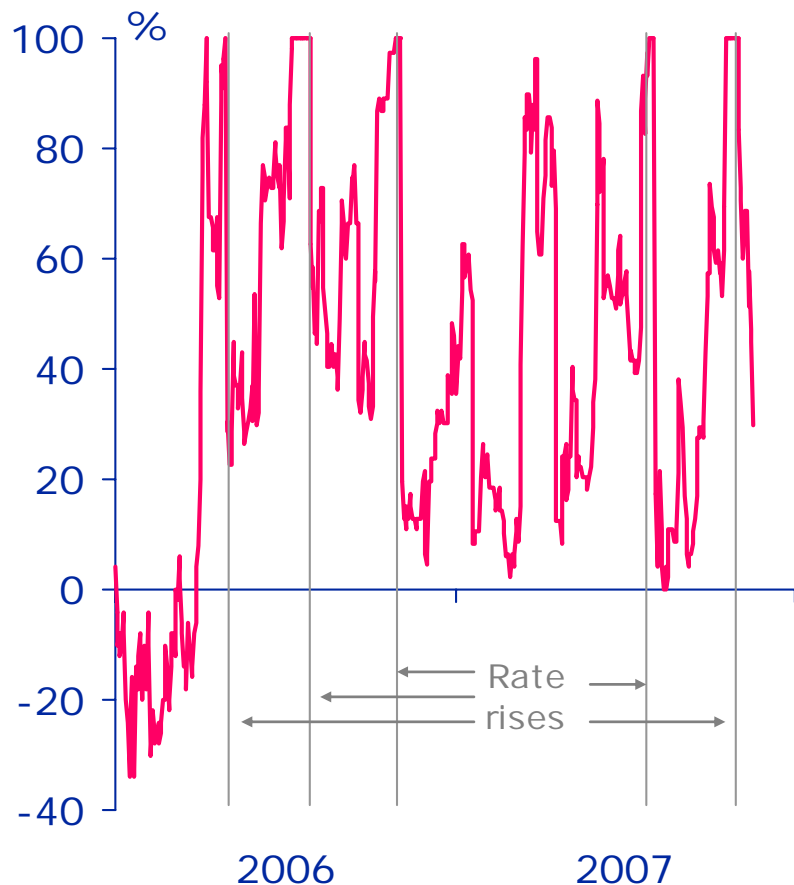
## Yield curves



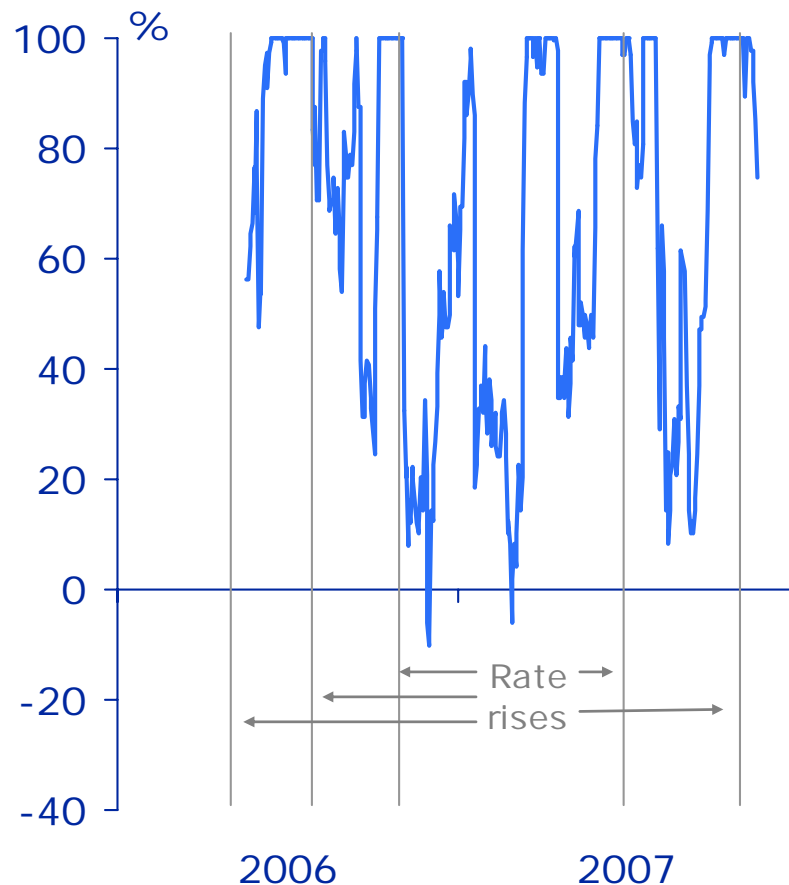
# Markets have become less certain of further rate hikes over the past week or so

Market implied probability of a 25 bp rate increase

within 3 months



within 6 months

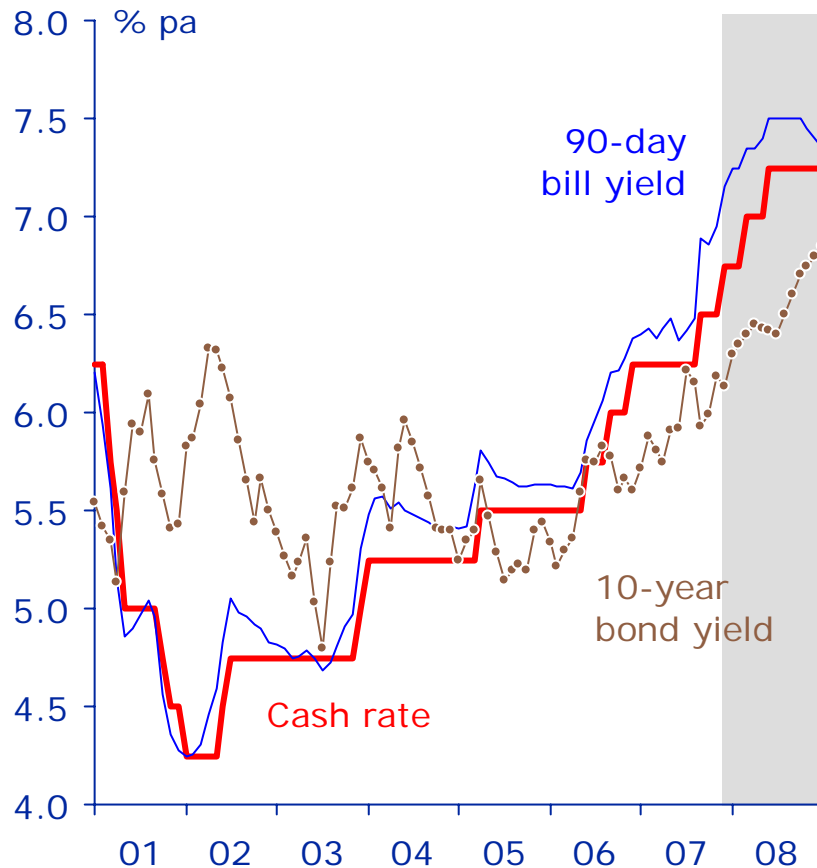


Note: vertical lines indicate date of increases in the cash rate

Sources: Bloomberg; Economics@ANZ (based on 30-day futures contracts)

# The RBA has now raised rates twice in an election year – and there will likely be more next year

## Australian interest rates



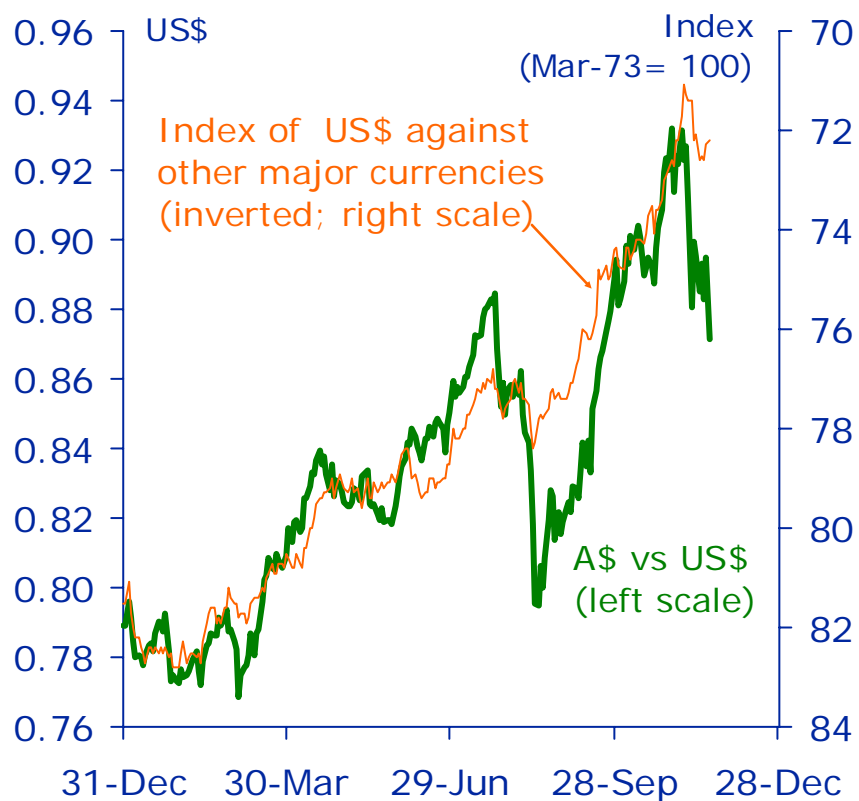
Shaded areas denote forecasts

Sources: RBA; Datastream; Economics@ANZ

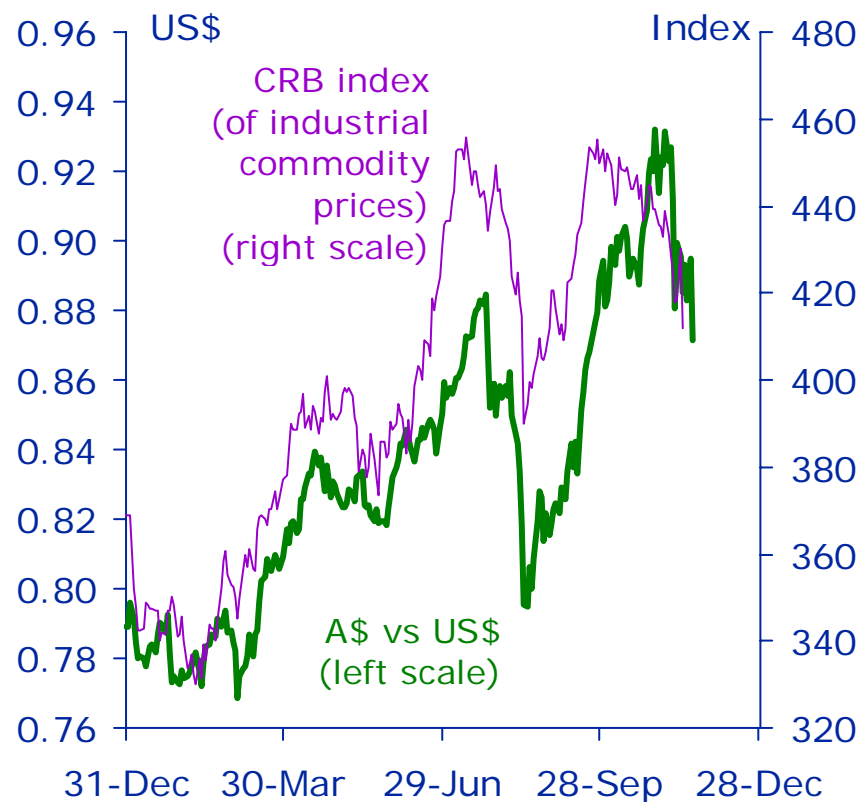
- The August rate increase, the first in an election year in living memory, was prompted by the higher-than-expected June quarter inflation figure
- The Reserve Bank has now lifted rates again, during the election campaign itself, for the first time ever
- The RBA Board really had no choice, given that its preferred measures of 'underlying' inflation were already at the top of its target range, and likely to rise further
- Interest rates are likely to rise again, to 7¼%, during 2008 – no matter who wins the election – given that both major parties have promised substantial additional fiscal stimulus

# A\$ movements have been driven by a combination of US\$ weakness, commodity price fluctuations ...

## A\$-US\$ and US\$ vs other major currencies

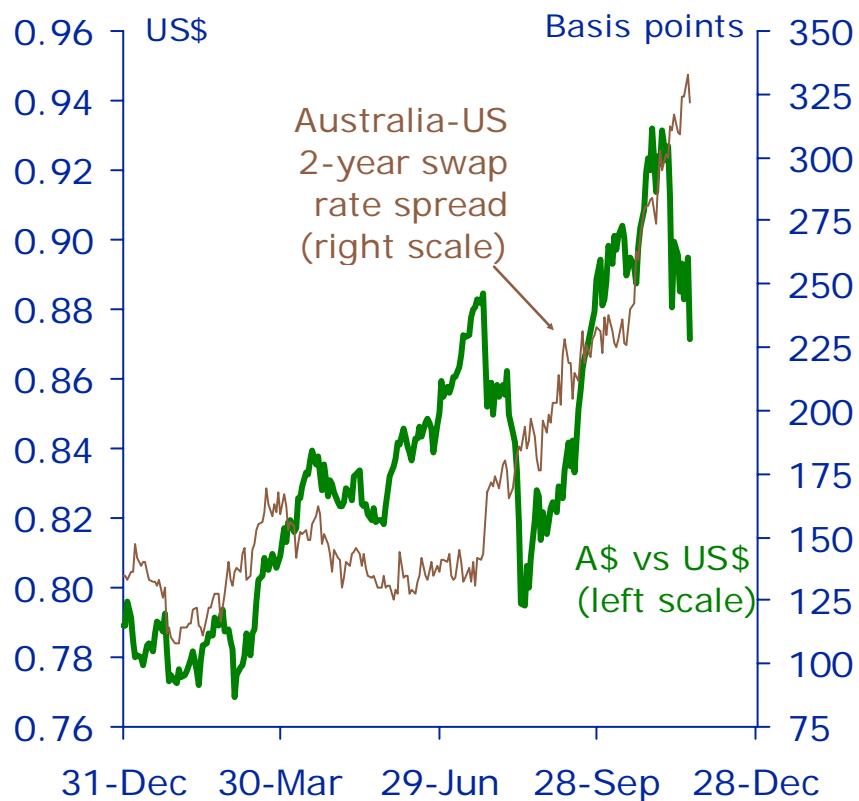


## A\$-US\$ and industrial commodity prices

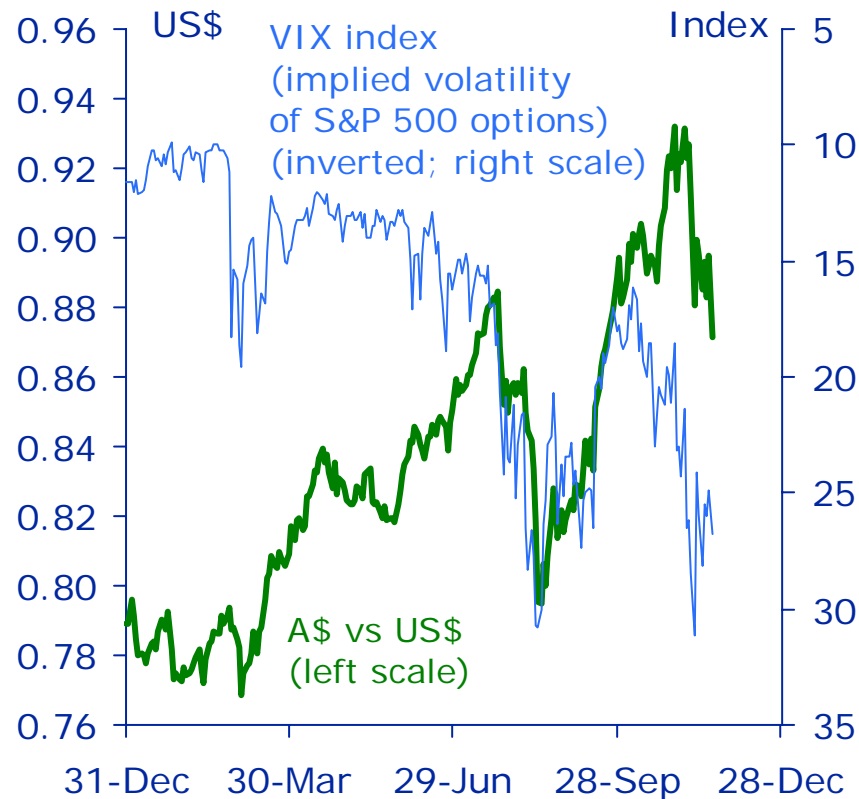


# ... a rising interest rate spread against the US, and (on two occasions) spikes in risk aversion

## A\$-US\$ and Australia-US 2-year interest rate spread



## A\$-US\$ and the VIX index of stock market volatility

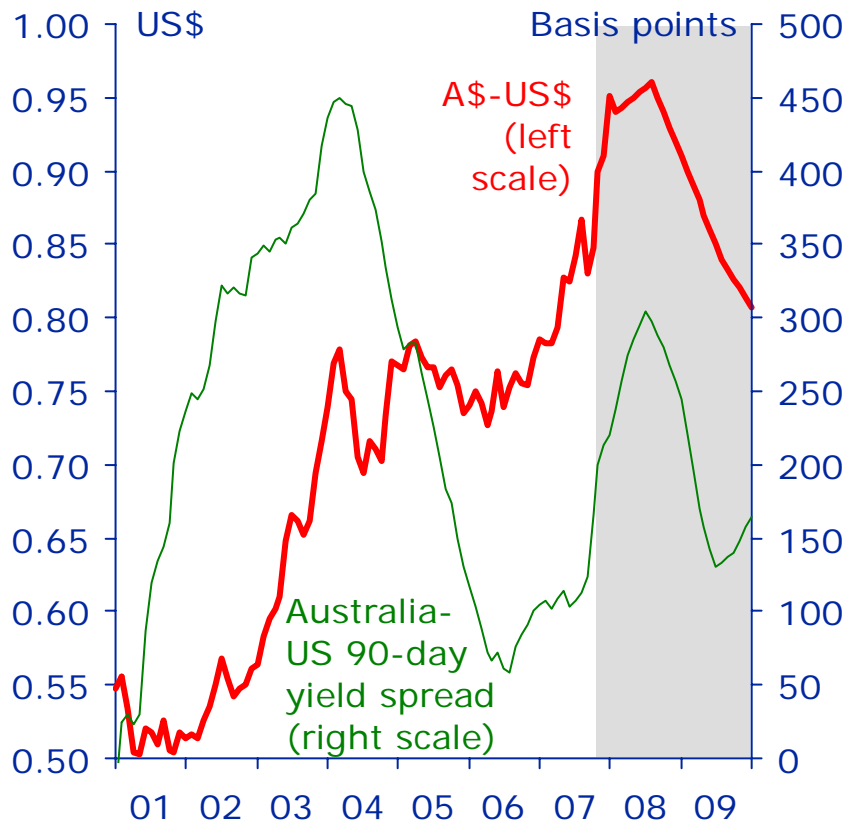




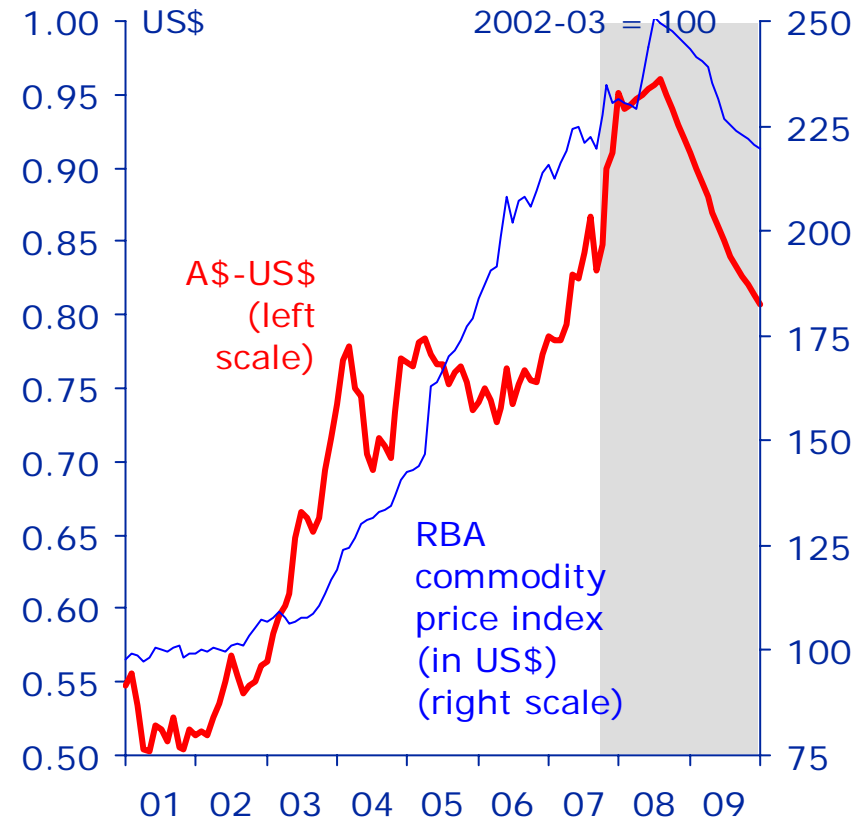
# A\$ will remain at elevated levels until 2009 when a US\$ recovery and narrowing spreads pull it back

## Economic influences on the value of the A\$

### Interest rate spreads



### Commodity prices

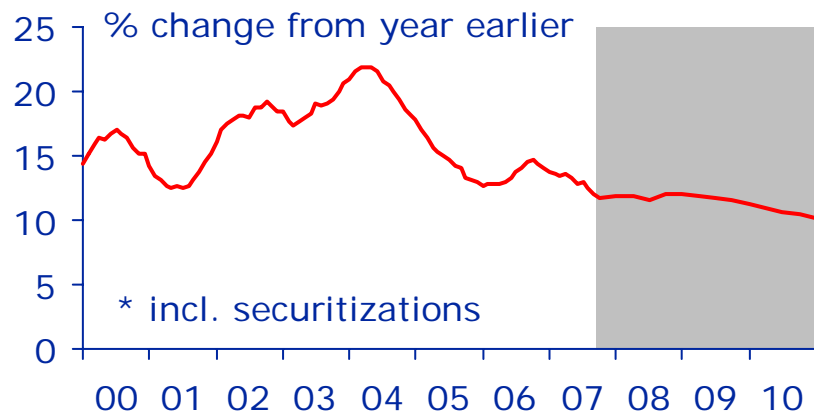


Shaded areas denote forecasts

Sources: Datastream; RBA; Economics@ANZ

# Credit growth stronger than expected this year but likely to slow with higher rates

## Housing credit\*



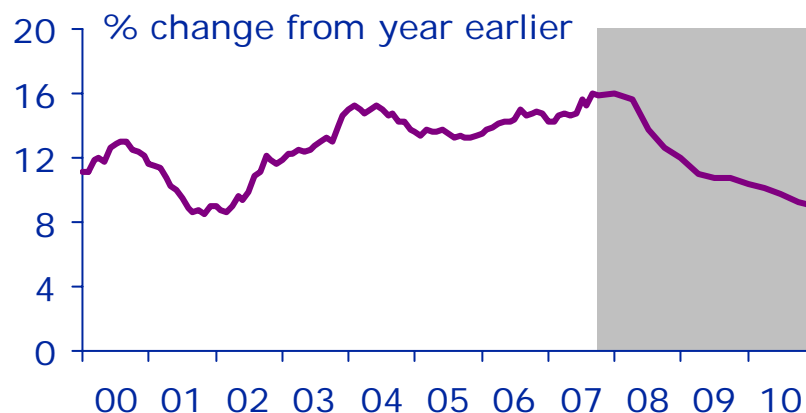
## Business credit



## Other personal credit



## Total credit



Source: Reserve Bank of Australia;  
Economics@ANZ forecasts

# The New Zealand economy has shown remarkable resilience to rising interest rates and a strong NZ\$

## Real GDP growth



## Unemployment rate



## Employment



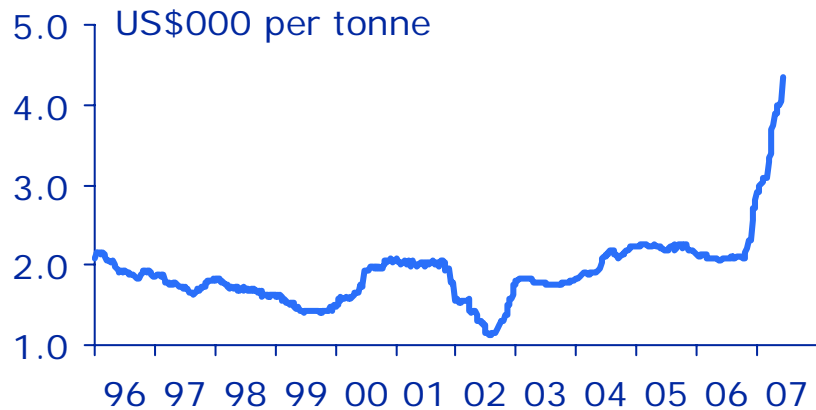
## Capacity utilization



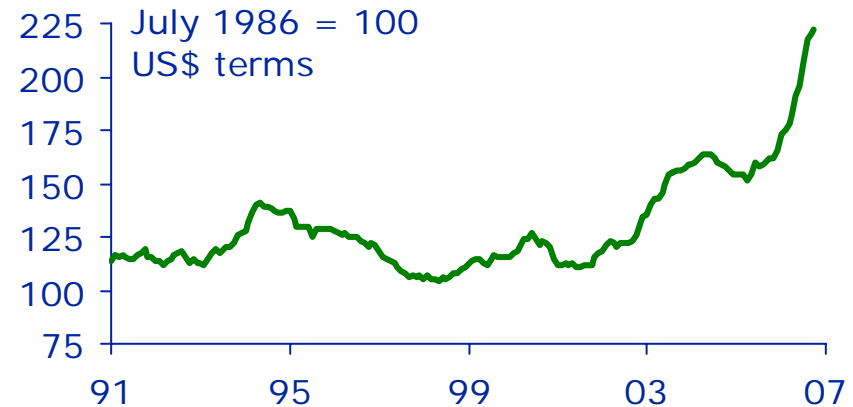
Sources: Statistics NZ; NZ Institute of Economic Research.

# NZ is also benefiting from higher commodity prices, especially for dairy products

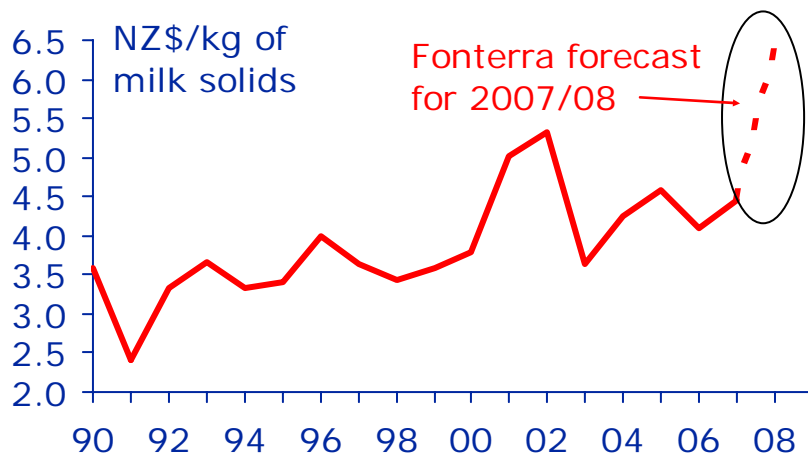
## World milk prices



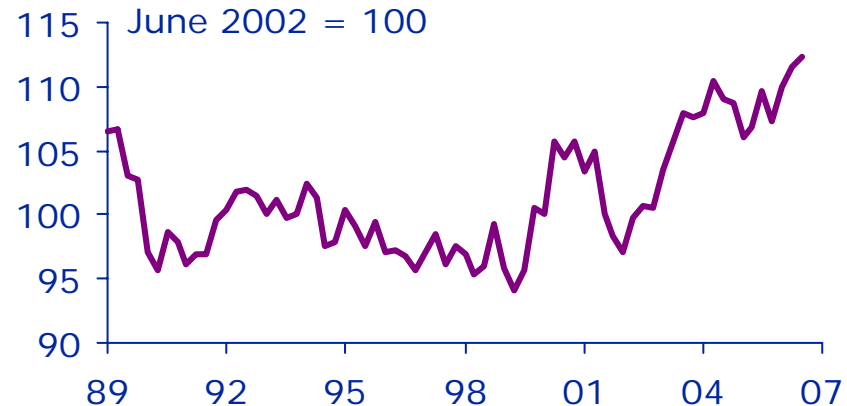
## Total export commodity prices



## Fonterra dairy payout



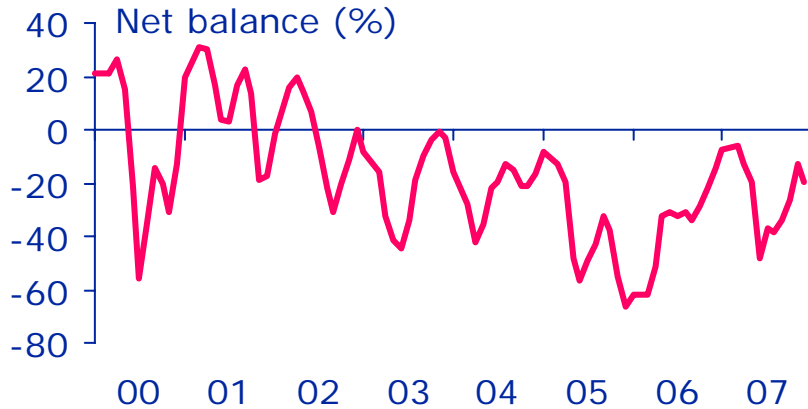
## NZ terms of trade



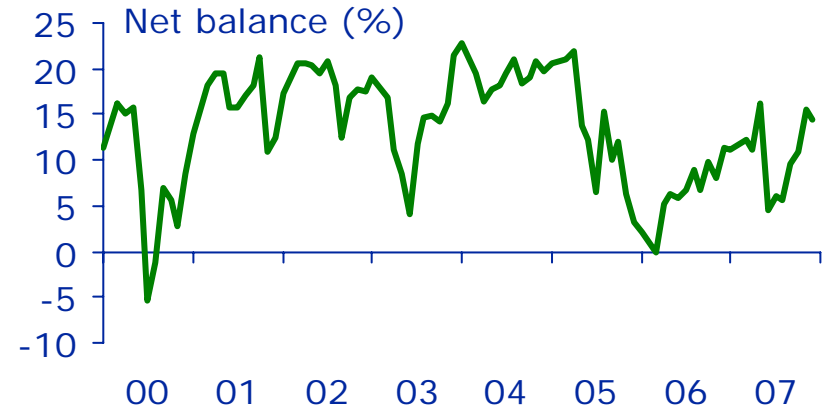
Sources: ANZ National Bank; REINZ; Statistics NZ; NZ Treasury.

# Business expectations have improved modestly since mid-2007

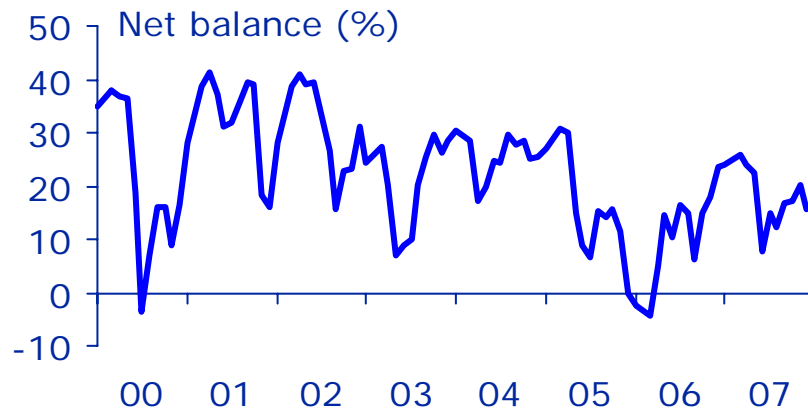
## Business confidence



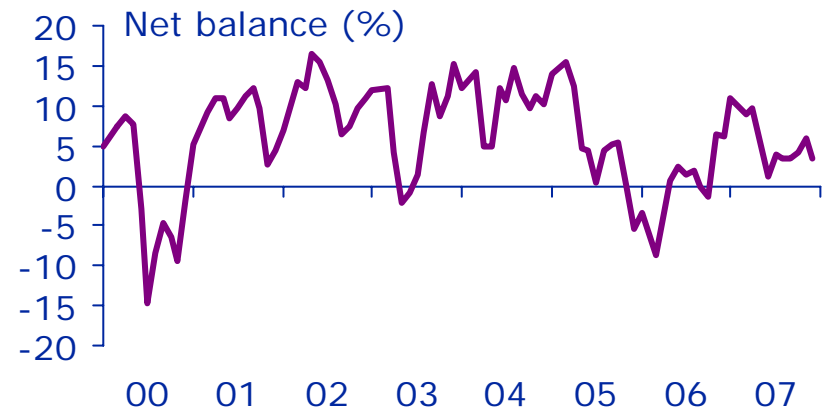
## Investment expectations



## Firms' own activity outlook



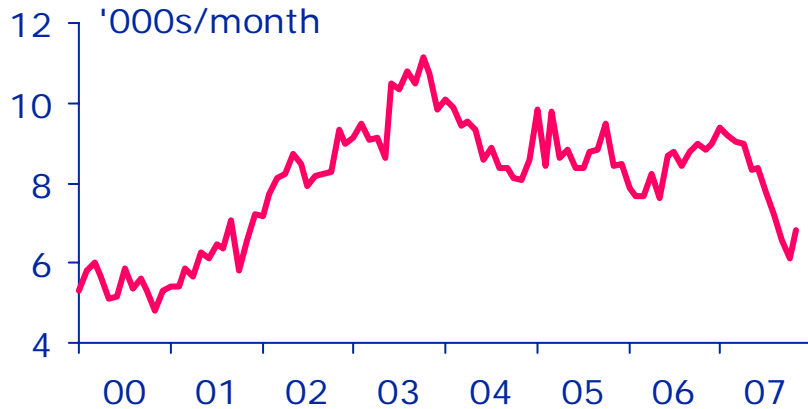
## Employment expectations



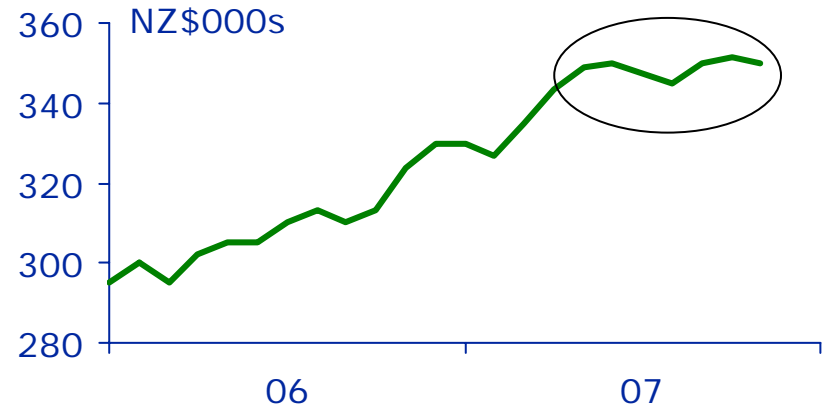
Source: ANZ National Bank

# However some pockets of softness are emerging in housing, consumer spending and migration

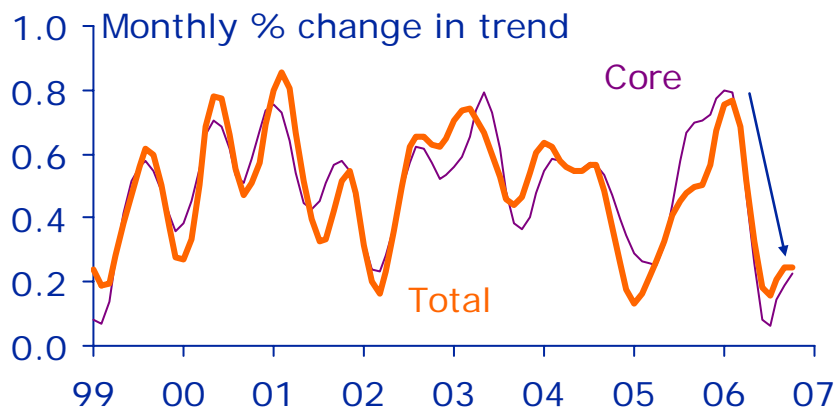
## House sales



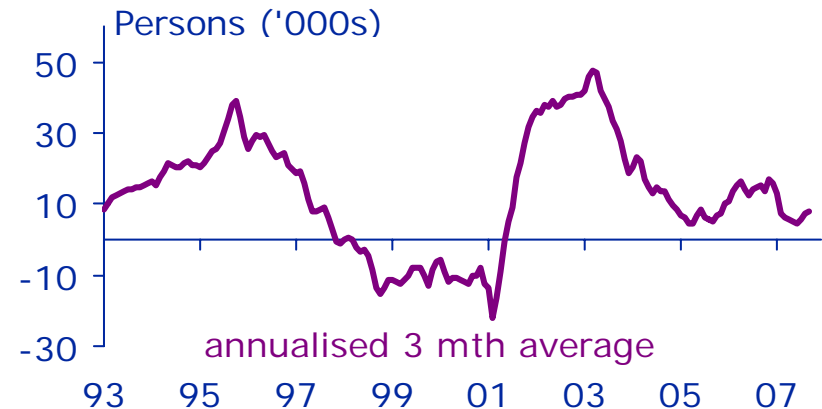
## Median house prices



## Retail spending

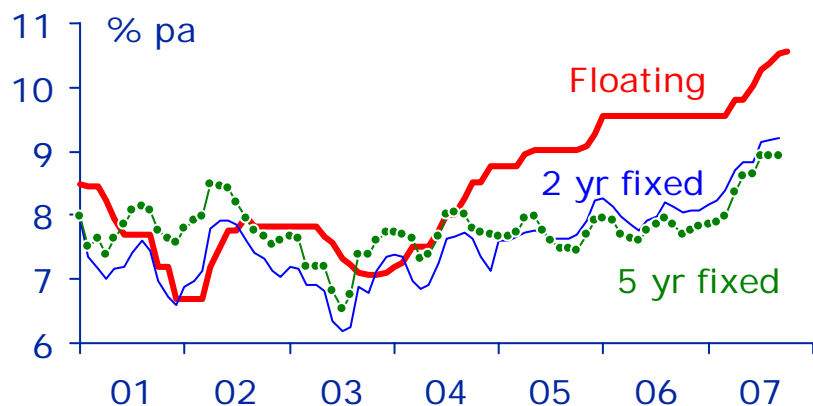


## Net migration

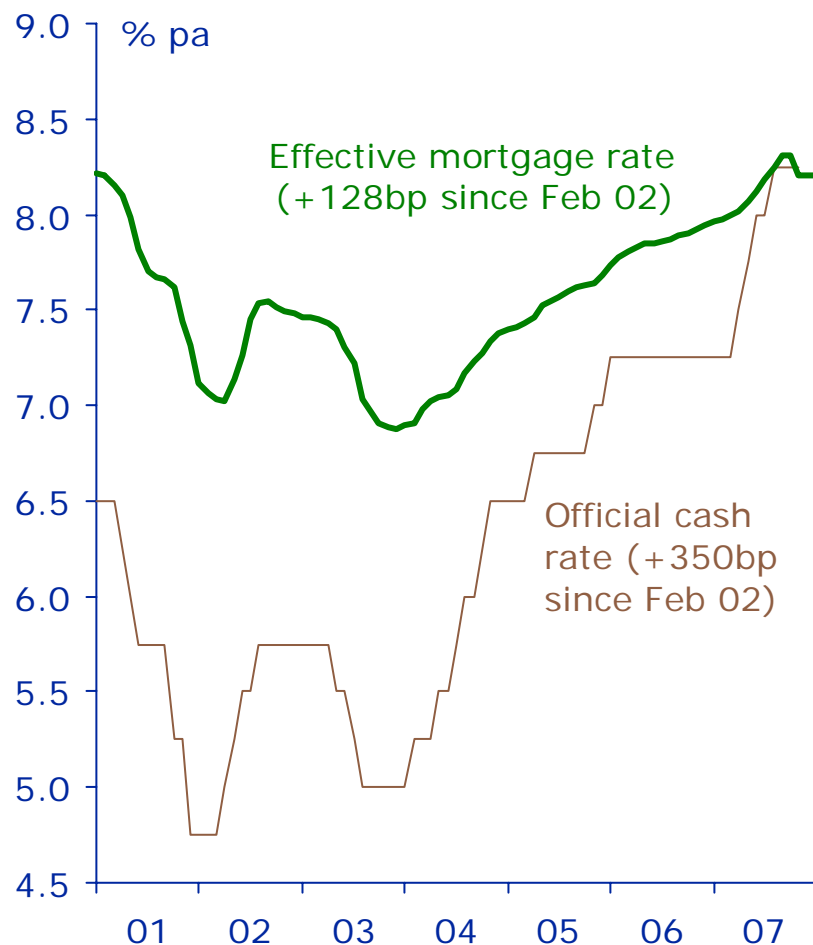


# The shift to fixed rate mortgages has delayed the impact of RBNZ monetary policy tightening

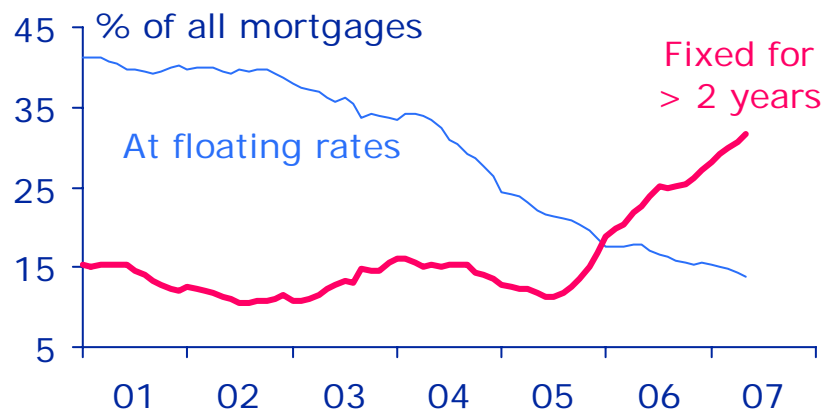
## Mortgage rates



## Cash vs mortgage rates



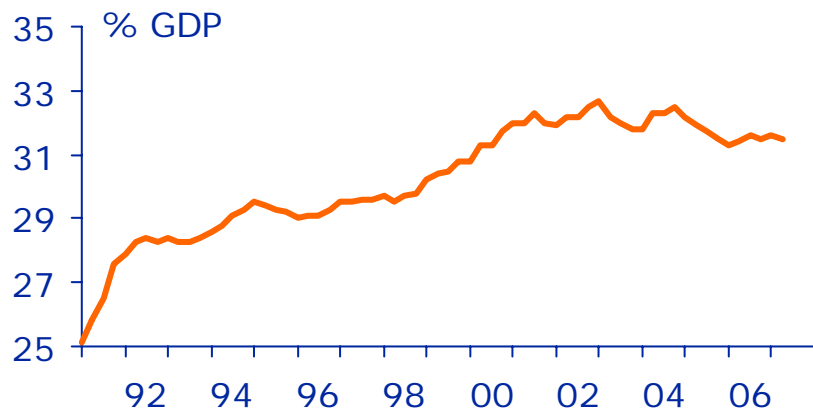
## Floating vs fixed rate mortgages



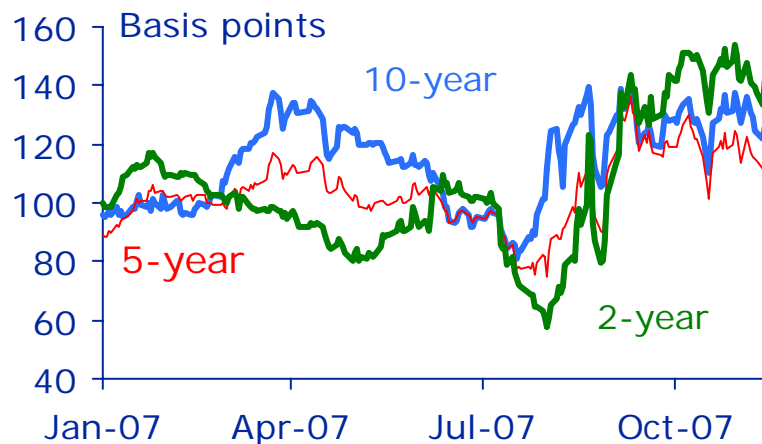
Source: Reserve Bank of New Zealand

# Global credit developments may have an important bearing on NZ economic fortunes

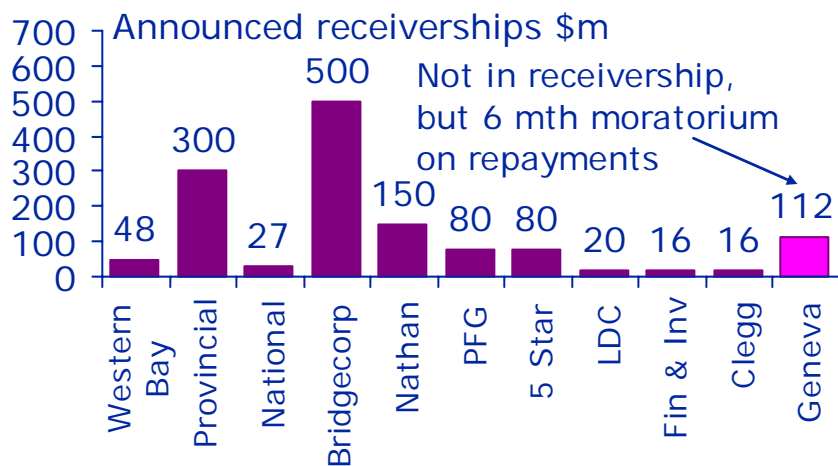
## Real exports % of GDP



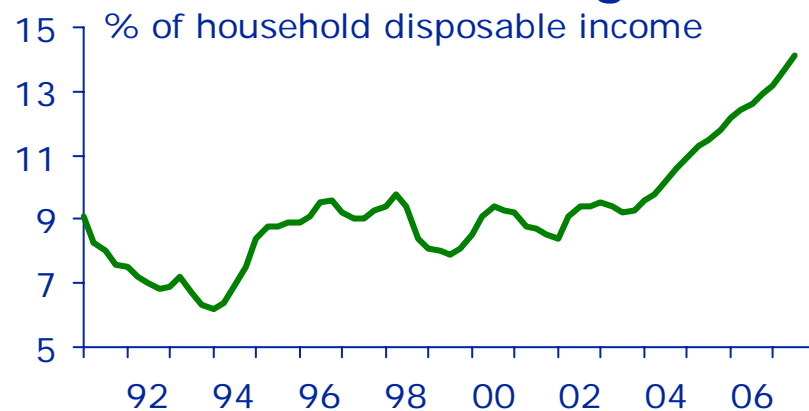
## Swap spreads



## Non-bank finance companies



## Debt servicing

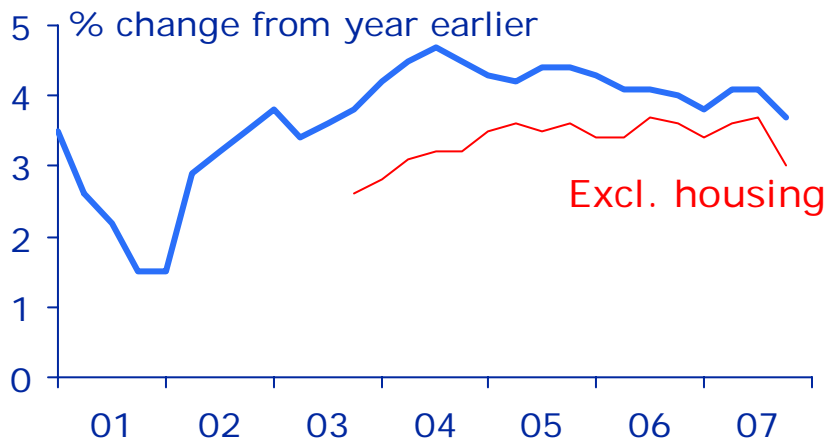


Sources: REINZ; Reserve Bank of NZ; ANZ National Bank

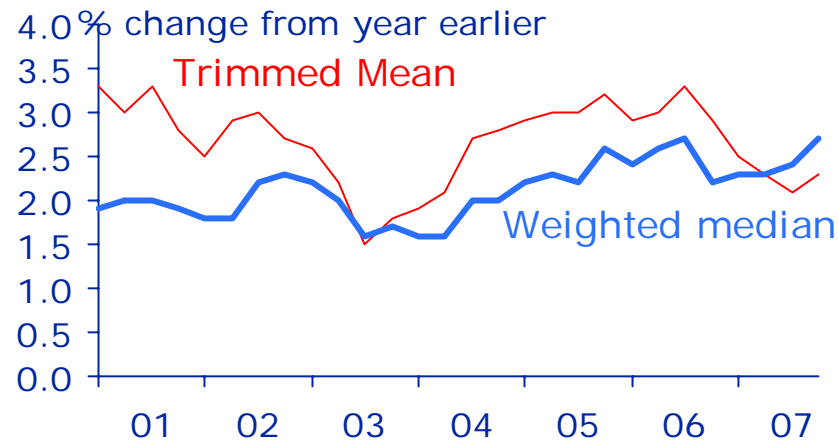


# Inflation remains of concern to the RBNZ despite a lower-than-expected September quarter outcome

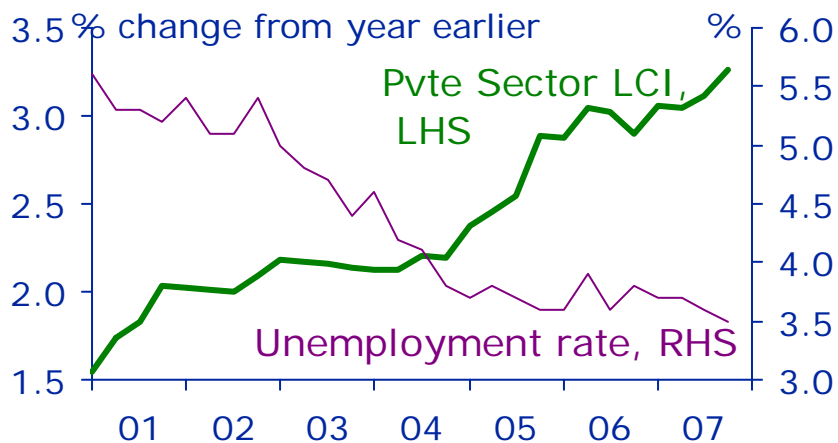
## 'Non-tradable' prices



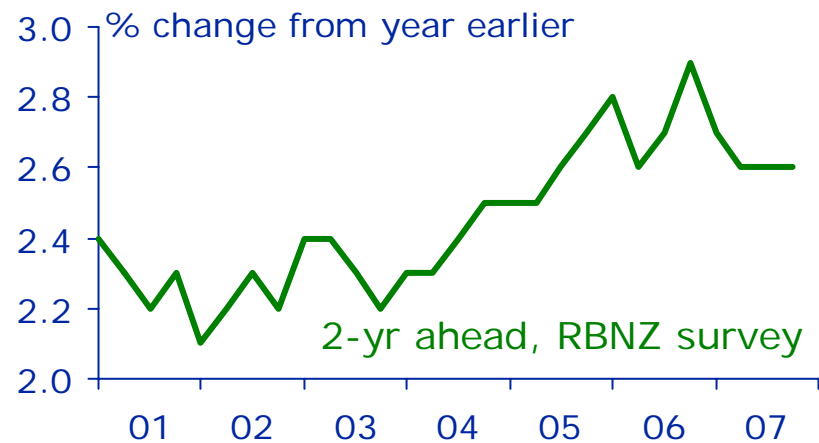
## 'Core' prices



## Labour market



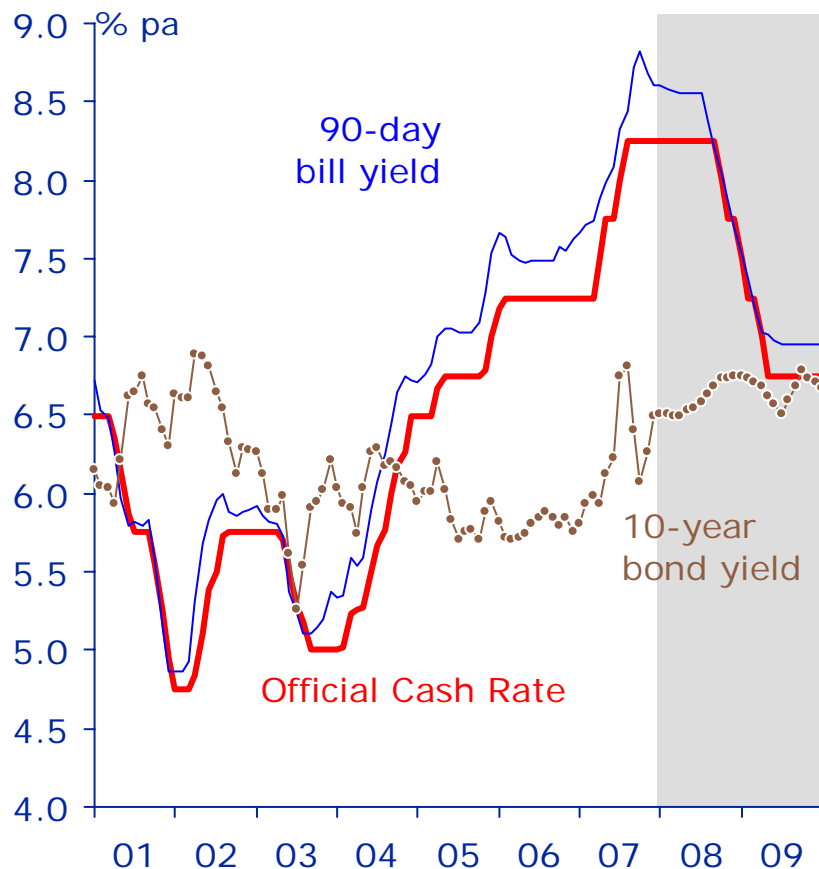
## Inflation expectations



Sources: Statistics NZ; Reserve Bank of NZ

# Despite ambiguous signals from the RBNZ, rates have probably peaked for this cycle

## NZ interest rates

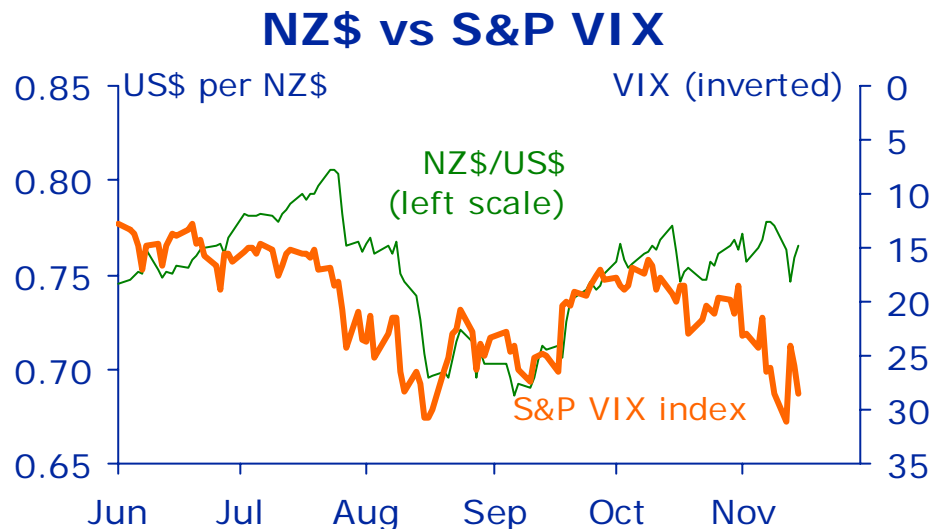
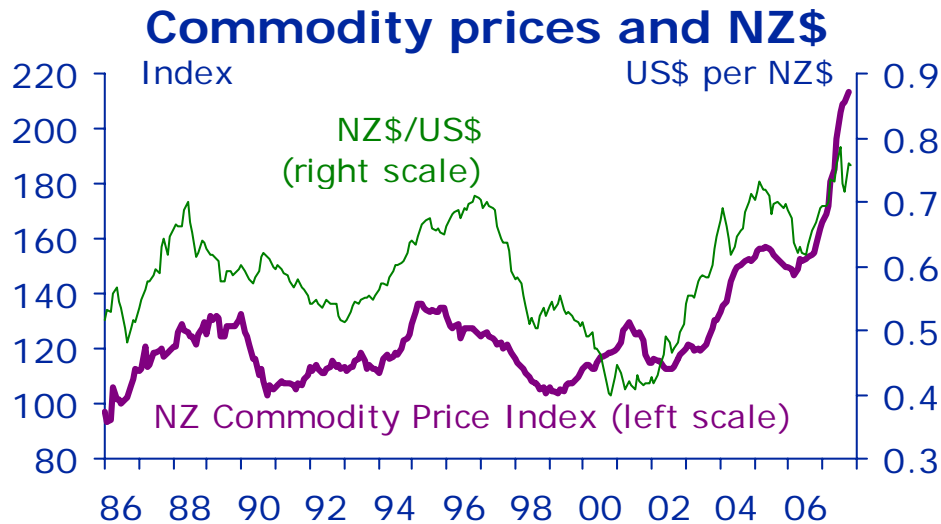


Shaded areas denote forecasts

Sources: Reuters; ANZ National Bank

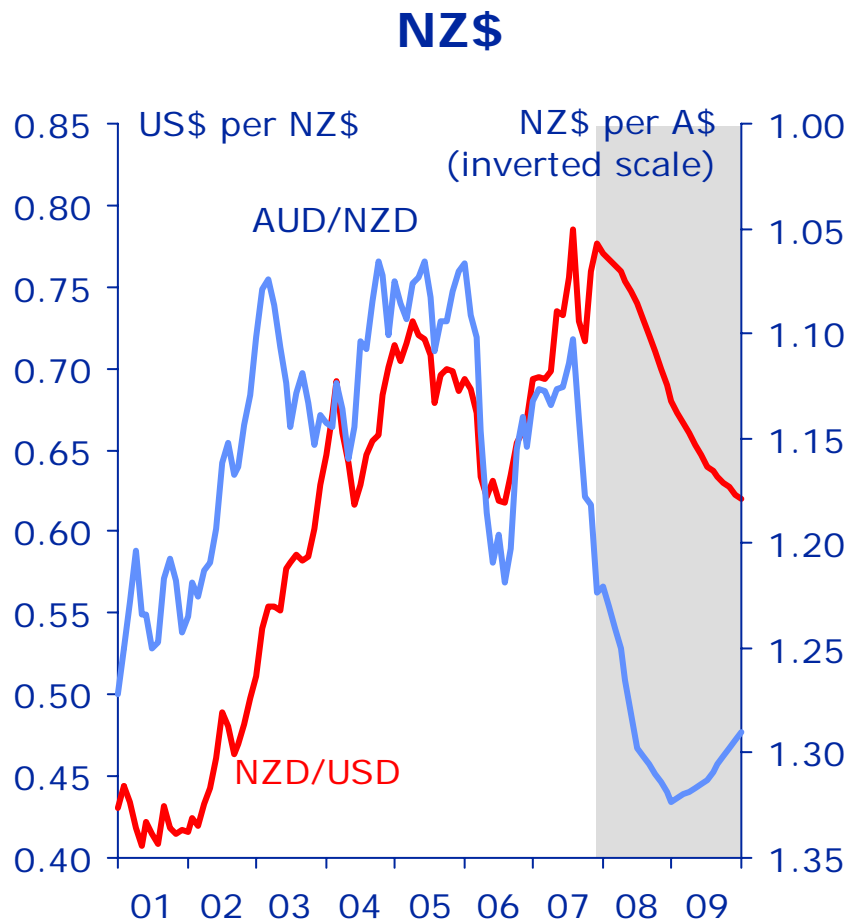
- The RBNZ is likely to maintain the 'wait and see' stance set out in last month's Monetary Policy Statement, with concerns about the potential inflationary risks arising from continued resource constraints and fiscal easing balanced against signs that tight financial conditions are biting and heightened global uncertainty
- Rates are likely to remain at present levels until late 2008, by which time inflationary pressures may have eased enough to allow the RBNZ to begin cutting rates

# NZ\$ remains caught in the tussle between global liquidity concerns/risk aversion and yield



- The NZ\$ is caught in the rip of contrasting themes Yield, a strong A\$, and weak US\$ sentiment remain supportive Against this backdrop, sentiment remains fickle, risk appetites flaky, and the NZ\$ is overvalued looking at traditional valuation metrics
- We expect this tug-of-war to continue and markets to remain volatile
- From a fundamental perspective, high commodity prices are supporting notions of a structural shift higher in the NZ\$, although the extent of this has been eroded by weak productivity growth We view structural fair value as remaining around US65¢

# Uncertainty is high and ranges are likely to be wide over the next 6 months



Shaded areas denote forecasts

Sources: Reuters; ANZ National Bank

- The outlook for the NZ\$ remains highly uncertain while the implications of US economic weakness are unclear
- If recent unease remains US-centric, the NZ\$/US\$ could be dragged higher via a weak US\$. Conversely, if traditional trade linkages hold and decoupling does not hold, the NZ\$/US\$ could move sharply lower
- In light of the uncertainty, our forecasts portray a flat trajectory for the NZ\$/US\$ over the next six months, and receding profile thereafter towards fair value
- Stronger relative commodity prices, growth, productivity, and a narrower yield gap point to further moves higher in the A\$/NZ\$

# Credit growth in New Zealand is expected to slow over the next 18 months

- The slowdown in housing lending growth gathered pace in September, to record growth of 137% for the 2007 financial year
- However, a seasonal upturn has been evident in October and into November, indicating a gradual slowing in mortgage lending growth moving into 2008, rather than anything more dramatic
- Banks have been the recipients of household deposits, as investors seek the relative safety they offer over Non-Bank Financial Institutions. However, household deposit growth had been exceptionally strong in 2006-07, even prior to the latest round of finance company collapses starting with Bridgecorp in July

Sources: RBNZ; ANZ National Bank

