ECONOMICS

25 May. 09

Business Weekly

Budget beauty pageant

This Week

The upcoming Budget, against the background of rapidly shrinking revenue expectations, could be described as a beauty pageant for the rating agencies. The potential for a sovereign credit rating downgrade is imposing a degree of fiscal discipline. A short-term spend-up to try and boost the economy not only has to be paid back in the future but could trigger a lift in NZ's debt-servicing costs. Furthermore, the quality of the short-term spending is important: other countries have resorted to writing households one-off windfall cheques, which may help stimulate spending for a month or so but have little lasting effect.

Ireland has demonstrated the importance of avoiding a sovereign downgrade. The Treasury head noted recently that Ireland's downgrade experience suggests a local downgrade could lift NZ interest rates by 1.5 percentage points. NZ's gross external borrowings currently amount to $250 billion: if the Treasury's extra 1.5 ppts was charged on that entire sum the nation's external debt servicing bill could rise by up to $3.75 billion a year. For those who think avoiding a ratings downgrade in the midst of a global credit crisis is the wrong priority for the Budget, there are a few billion reasons to think again! A lift in debt-servicing costs for households and businesses would hamper NZ's economic recovery and cost jobs. Ireland is a relatively extreme example, but other countries suffering downgrades now have higher risk premia (see chart).

To reduce the chance of a downgrade the Government will be highly focused on constraining expenditure growth and mitigating revenue impacts. The Government has signalled the 2010 and 2011 tax cuts will be pulled and in the short term contributions to the NZ Superannuation Fund will be curbed. It is putting emphasis on getting more value for money out of existing spending. In the past there has been a focus on inputs rather than outcomes. There is also the possibility of a rabbit being pulled out of a hat, such as the realised gains the RBNZ made from buying US dollars when it intervened in the foreign exchange market.

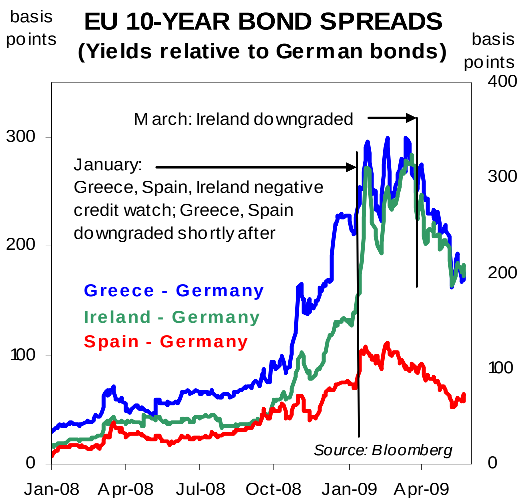
Rating agencies will want to see a credible path to fiscal health in the long term. A Standard and Poors analyst was quoted this morning as saying "it is hard to put a timing on it, but we would expect that over the cycle of the Government [it] would be recording operating surpluses within, I guess, the next three to five years", though did say there would be tolerance for modest operating deficits. The Government is stressing the importance of improving NZ's productivity growth, and it is possible that some initiatives are unveiled.

Last week we published our latest Quarterly Forecasts. Notwithstanding the recent run of 'green shoots', we expect the recovery is going to be slow given the amount of 'baggage' weighing on many economies.

Click here for:

Foreign Exchange	• NZD lifts on USD weakness.
Interest Rates	• Interest rates fall back, markets see RBNZ on hold in June.
Week Ahead	• All eyes on Budget 2009. Trade, Business Confidence, Credit, Building data due.
Week in Review	• Migration picks up, as less kiwis leave, and more come home.
Global Calendars	• US housing, consumer confidence in the spotlight. AU CAPEX due.

Chart of the week



- Sovereign credit risk has flared up over the course of the year as various governments' borrowing requirements and contingent liabilities have lifted exponentially as a result of the credit crisis.
- The extent of divergence in credit risk is transparent within the Eurozone. With bonds all denominated in euros all currency risk and monetary policy factors are identical and yields closely represent credit risk.
- Bond yields in fiscally weak Eurozone countries have risen noticeably relative to German bonds (seen as the European benchmark). The increases in yield spread reflect higher risks of default being factored into the bonds of those countries.
- Ireland, both economically hard-hit and propping up a weak banking sector, has seen its risk premium soar.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6165	0.5859	0.5614	0.5319	0.7853	UP	0.6100	0.6300
NZD/AUD	0.7874	0.7827	0.7889	0.8482	0.8199	FLAT	0.7800	0.7950
NZD/JPY	58.33	55.53	54.54	50.63	81.76	FLAT	57.00	60.00
NZD/EUR	0.4397	0.4357	0.4273	0.4212	0.4993	FLAT	0.4350	0.4450
NZD/GBP	0.3873	0.3867	0.3833	0.3564	0.3968	FLAT	0.3850	0.3950
TWI	58.5	57.1	55.9	54.6	69.7	UP	57.00	59.50

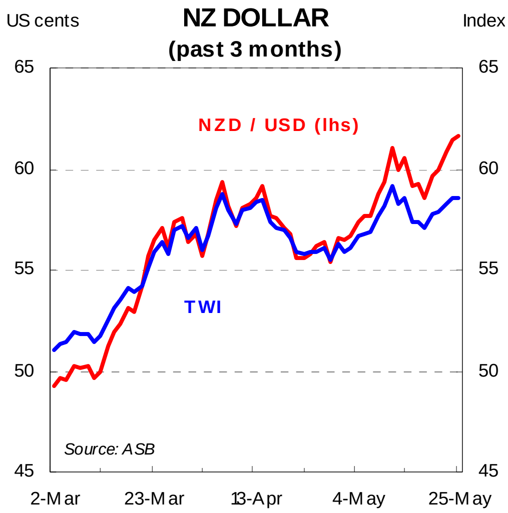
Weekly support and resistance levels * Current is as at 12pm Tuesday; week ago as at Monday 5pm

- The big news last week was **S&P changing the UK ratings** outlook from stable to negative on Thursday. The initial reaction was to be expected – GBP selling. However, by Friday morning, the GBP had more than recovered all the initial S&P announcement fall. The market focus was across the Atlantic. The thinking in the market was if the UK could get a downgrade, then so could the US. Traders pondered the scenario, which would be a huge blow to the reserve currency. Any downgrade is a long way off, but it kept the USD under huge pressure, trading near 2009 lows against the euro and the GBP.
- The **NZD lifted** at the end of last week due to these offshore themes rather than any local news. Memorial Day in the US today may have exacerbated things slightly on Friday night, as traders shut down for the long weekend.
- Now the focus really does shift onshore: **Dairy subsidy** talk out of the US has seen the NZD hit down from its high last week near USD 0.625. The real focus this week is the Budget on Thursday, and the ratings implications of the latest Treasury projections.
- **Standard & Poor's** said the group was looking for New Zealand to reach a stable position soon. The NZ Government needs to get its books out of the red within five years. Three S&P executives are in New Zealand this week. Thursday's Budget will be critical in influencing whether New Zealand's international credit rating gets downgraded. This has huge FX and interest rate implications.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
April Trade Balance	26/5	10.45 am	+$350 m
May NBNZ Business Confidence	27/5	3.00 pm	-
Budget 2009 (FY2010 OBEGAL)	28/5	2.00 pm	-$6.9b
April RBNZ Credit Aggregates	28/5	3.00 pm	-
April Building Consents	29/5	10.45 am	-

Potential currency movers from the US this week: S&P/CaseShiller Home Price Index, Consumer Confidence, Richmond, Dallas Fed Manufacturing Indices (27th), Existing Home Sales (28th), Durable Goods Orders, New Home Sales, mortgage delequencies (29th), Personal Consumption, GDP, Chicago PMI, Uni of Michigan Confidence (30th).



Medium term outlook: [Last Quarterly Economic Forecasts]

- As a consequence of the financial market turmoil centred in the United States, USD weakness was expected in early 2009. Although this weakness was initially offset in part by concerns about other regions, improved sentiment in financial markets has seen risk appetites improve and the USD weaken.
- Right now, the USD, which has shown countercyclical strength, is under pressure. USD is weakening for the following reasons;
  - US residents increase their offshore investment, encouraged by improvement in the global economy.
  - USD liquidity demand and safe-haven buying of the USD reverses is easing.
  - Diversification out of USD is expected to occur due to concerns about US government debt.
- The arguments for buying EUR, GBP and JPY are strong enough to engineer a reasonable depreciation in the USD, but we do not expect to revisit fresh US TWI lows).
- We are also comfortable with our current forecast that the NZD and AUD have bottomed and will begin a slow appreciation over the course of 2009, rather than revisit and break through the lows seen in early 2009.
- NZD/USD and AUD/USD will lift as the USD depreciates. But both the Australian dollar and the New Zealand dollar will remain weak vis-à-vis the major cross rates while global growth remains weak. Ratings concerns will weigh on the NZD over the coming months, and a rating downgrade is a key downside risk to our forecast.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	3.00	6.50	8.25	FLAT
90-day bank bill	2.77	2.77	3.05	5.85	8.71	FLAT
2-year swap	3.63	3.41	3.66	5.17	8.19	UP
5-year swap	5.07	4.69	4.77	5.59	7.75	UP
11/11 gov't stock	4.56	4.36	4.38	5.09	6.70	UP
NZSX 50	2765	2778	2656	2575	3589	DOWN

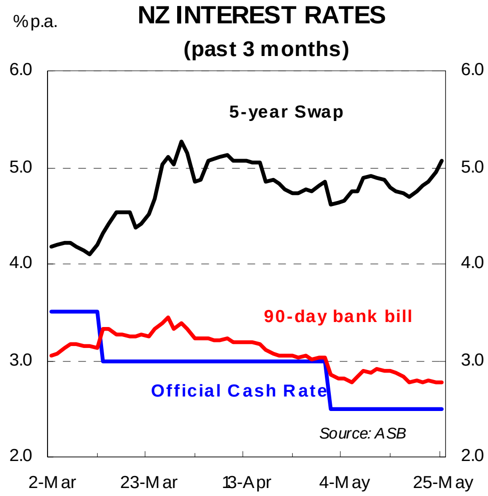
* Current is as at 12pm Monday; week ago as at Monday 5pm

- This week saw further steepening in the yield curve, with short rates remaining unchanged and longer-end swap rates lifting 30-40 basis points. The pick up in the longer end follows the global pick-up in government yields. Ongoing concerns on the large issuance of government debt expected over the next few years, coupled with talk of potential US downgrade, continues to put substantial pressure on the longer end.
- We have changed our call for the June RBNZ decision, now expecting the RBNZ to pause rather than deliver another 25bp cut. April's 50bp cut turned out relatively ineffective given the headwinds from market sentiment and now may not be the most opportune time for another 25bp cut. Nonetheless, we continue to expect two more 25bp cuts further down the track. The market has also moved towards the RBNZ keeping rates on hold in June, with only 8 basis points priced in.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
April Trade Balance	26/5	10.45 am	+$350 m
May NBNZ Business Confidence	27/5	3.00 pm	-
Budget 2009 (FY2010 OBEGAL)	28/5	2.00 pm	-$6.9b
April RBNZ Credit Aggregates	28/5	3.00 pm	-
April Building Consents	29/5	10.45 am	-

Comment: Thursday's Budget will be the focus of the week, although the large number of unknowns makes the ultimate figure difficult to forecast. Market expectations of the OBEGAL deficit range from $6b to $9.1b. The immediate threat of a ratings downgrade will be imposing a degree of fiscal discipline. The median expectation for the bond program sits at $10b over FY10 and $13b over FY11. It is a big week for US Treasury auctions too, with US$101b of new issuance.



Medium term outlook: [Last Quarterly Economic Forecasts]

- The RBNZ cut the OCR by 50 basis points to 2.5% at the April OCR review, and delivered a commitment to hold the cash rate at or below current levels until the latter part of 2010.
- April's statement was designed to combat the recent rise in monetary conditions, i.e. the rise in longer-term interest rates and the exchange rate. In particular, the RBNZ's expectation it will hold the OCR low until mid-2010 should help to anchor longer-term interest rate expectations. The message to borrowers is that there is no real hurry to fix rates, as there is still potential for further OCR cuts and longer-term interest rates will also remain low a little longer yet.
- The RBNZ's March MPS forecasts were optimistic, and the tone of April's statement suggests that the RBNZ has revised down its outlook somewhat. We expect economic output to continue to contract throughout much or all of 2009, although the recent NBNZ business outlook suggests we can expect the pace of decline to ease over the second half of 2009.
- The RBNZ's ability to deliver further monetary stimulus is facing multiple headwinds. The OCR is losing traction on retail interest rates (as deposit rates become sticky). In addition, financial conditions continue to tighten, with the NZ dollar remaining elevated and global yields continuing to push higher on debt issuance concerns.
- We expect the RBNZ will remain on hold in June, pausing to assess the impact of recent rate cuts. Current financial conditions are likely to limit the effectiveness of further rate cuts. Nonetheless, in our view further monetary policy stimulus is warranted and we continue to expect another 50 basis points of rate cuts to be delivered over the next 3-6 months.
- With the OCR losing traction, the RBNZ must more seriously consider alternative measures. Although the RBNZ has signalled it has been investigating different options, it remains very reluctant to implement these. Such measures may well be needed to put additional downward pressure on long-term rates and the NZ dollar.

NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
April Trade Balance	26/5	10.45 am	+325 m	+350 m	+250 m
May NBNZ Business Confidence	27/5	3.00 pm	-14.5	-	-
Budget 2009 (FY2010 OBEGAL)	28/5	2.00 pm	-$4.1 b	-$6.9 b	-$6.6 b
April RBNZ Credit Aggregates (household yoy)	28/5	3.00 pm	+2.8%	-	-
April Building Consents	29/5	10.45 am	-4.6%	-	+7.0%

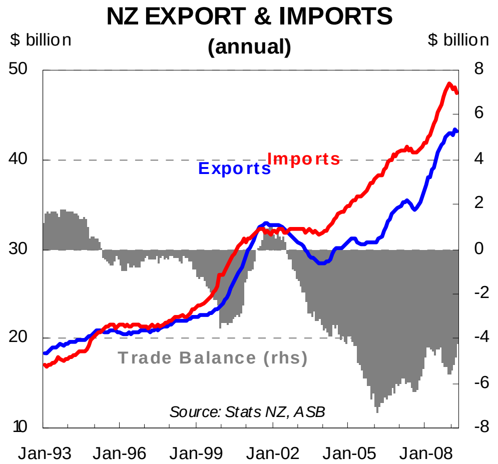
Trade balance - April

Previous: +324 Mill, Forecast +250 Mill

We expect a trade surplus of $250 million in April. Export values are expected to continue to reflect the underlying trend of weakening export volumes. We expect April export receipts to be down around 5% on year-ago levels.

Meat export prices are likely to remain reasonable, however volumes are expected to weaken, reflecting low lamb slaughter.

We expect a weak monthly import figure, partly driven by weak car imports to result in a surplus of $250 million for the month.

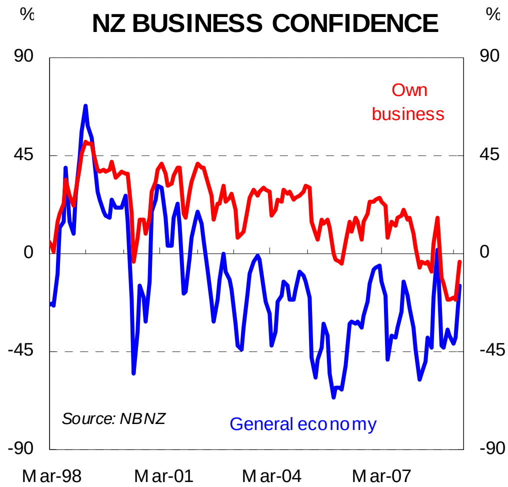


NBNZ Business Outlook Survey - May

Previous -14.5 (General) -3.8 (own activity)

The National Bank's last monthly outlook survey perked up in April. A net 14.5% expected deterioration in business conditions over the year ahead compared with a net 39% in March. Own activity expectations lifted noticeably in April from March. A net 21% were expecting tougher times for their own business over the year ahead in March, but only a net 3% had a negative outlook in April. The result is a decent lift off December's record low reading of -22. Other gauges generally lifted, but remain consistent with economic contraction – just a much milder one than implied by preceding surveys.

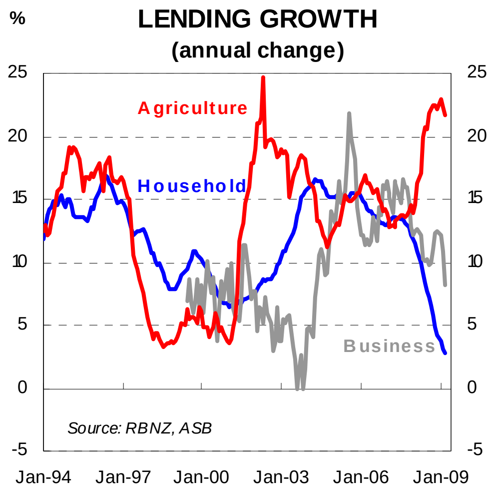
We expect that the bulk of economic contraction will be behind us by mid-year, and the survey certainly suggests that growth figures will make for better reading after sizable contractions in Q1/Q2. Nonetheless, with demand remaining weak business confidence is likely to remain very low for much of this year.



March RBNZ Credit Aggregates

Mortgage lending growth had a stronger month in March in dollar terms, but is typically the strongest month of the year for the housing market. Nevertheless, annual growth continued to decline slightly, even though March 2008 lending may have been dampened by the early fall of Easter. Annual growth is likely to edge down slightly further over coming months, though April may prove to be a respectable month. Mortgage approvals spiked in late March/early April and house sales were robust over the month. Consumer lending growth will remain flat on year-ago levels as households concentrate more on savings and as purchases of big-ticket items often financed remain weak.

Annual growth in business lending is edging down again after picking up in late 2008. Annual growth in agricultural lending remains high but is likely to ease over 2009.



NZ Government Budget

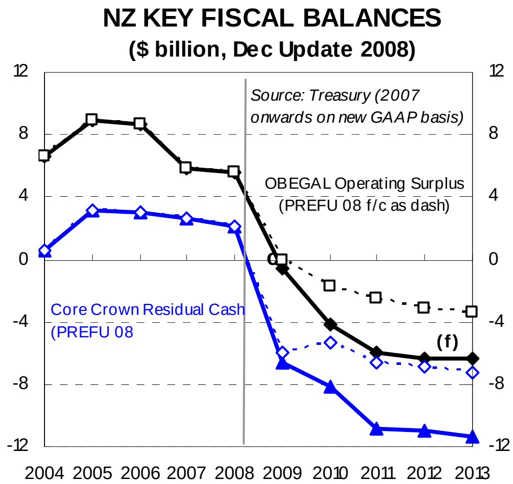
The upcoming Budget, against the background of rapidly shrinking revenue expectations, could be described as a beauty pageant for the rating agencies. The potential for a sovereign credit rating downgrade is imposing a degree of fiscal discipline. An additional short-term spend-up to try and boost the economy not only has to be paid back in the future but could trigger a lift in NZ's debt-servicing costs – and hamper NZ's economic recovery.

The Government will be highly focused on constraining expenditure growth and mitigating revenue impacts. The Government has signalled the 2010 and 2011 tax cuts will be pulled and in the short term contributions to the NZ Superannuation Fund will be curbed. It is putting emphasis on getting more value for money out of existing spending.

Substantial red ink in the short term is unavoidable with potential for the 2010 fiscal year deficit to exceed $6bn and an even bigger deficit in 2011.

However, much attention will go on the longer-term fiscal forecasts, particularly the 2012/13 to 2022/23 period. Rating agencies will want to see a credible path to fiscal health in the long term. The Government is stressing the importance of improving NZ's productivity growth, and it is possible that some (largely costless) initiatives are included in this Budget.

The Treasury appears relatively pessimistic on the economic outlook, which suggests its growth forecasts will be closer to our own than the RBNZ's (2010 March year: ASB -2.1%, RBNZ March MPS +0.2%; 2011 ASB 1.8%, RBNZ 4.8%).



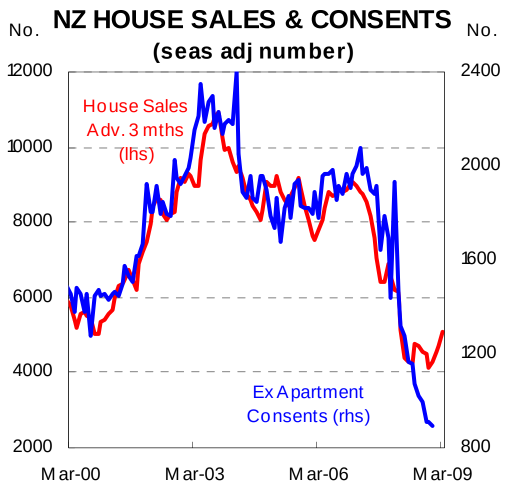
Building consents - April

ASB f/c total consents +7%mom (sa)

Dwelling consent issuance remained weak in early 2009. We expect more of the same in the coming months, notwithstanding the possibility of a slight bounce in April. A reasonable period of housing sales in Autumn provides a glimmer of hope, but we do not expect the sales lift to spur a pick-up in construction just yet. Apartment consent issuance is volatile, and was weak in March, with consents for 104 units issued. In February, 193 consents were issued, which compares poorly with average since 2000 of 310.

Ex-apartment consent issuance is also very weak, with 896 consents issued in March and 908 in February far below the average since 2000 of 1750. Recent dwelling consent issuance points to another sizable contraction in housing construction in early 2009.

Non-residential consent values peaked in Q3, and there has been some weakness since, signalling that this sector is also likely to start registering weak construction. However, declines will be mild compared to the residential side.



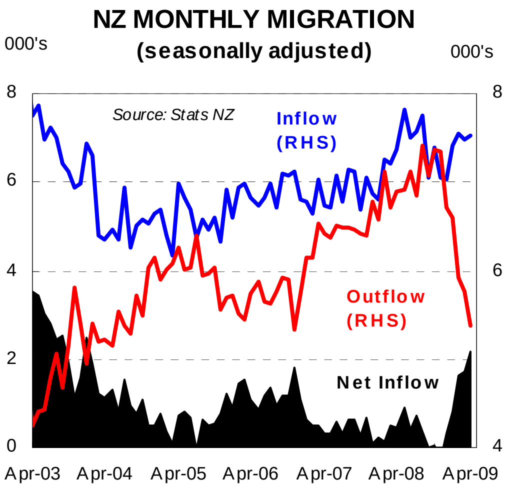
NZ Data Review: weekly recap

April International Travel and Migration

Net migration continued to recover over April on the back of another sizable drop in departures. Over the past 12 months NZ has recorded an additional 9,176 net migrants. The turn around in net migration over the past few months has been swift, and net migration is likely to continue to rise. The 2,160 net inflow per month (seasonally adjusted) equates to an annualised inflow of almost 26,000 per annum.

The rapid pick-up comes as departures have fallen dramatically, in particular, departures to Australia. Australia has not been immune to the global economic downturn and has seen unemployment pick up roughly in line with NZ. Arrivals remain roughly steady, up 0.5% and 2.3% on year-ago levels. One interesting development to note was a pick up in PLT arrivals from Australia over April, most likely to be Kiwis returning home.

Short-term visitor arrivals remained surprising firm over April, up 2.4% on March and 1.2% on year-ago levels. Visitor arrivals remain reasonably buoyant compared to expectations for steeper declines, partly due to visitor arrivals from Australia remaining firm.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 11 hours for NZ times.

Calendar – Australasia, Japan and China

Date	Time NZT	Econ	Event	Period	Unit	Last	Forecast Market	Forecast ASB/CBA
Mon 25 May	~	JP	Cabinet office monthly economic report					
	11.50	JP	All industry activity index	Mar	m%ch	-2.0	~	~
Tue 26 May	10.45	NZ	Trade balance	Apr	$mn	324.0	~	~
	11.50	JP	Corp service price	Apr	y%ch	-2.1	~	~
	15.00	NZ	RBNZ 2yr inflation expect.	QII	%	2.3	~	~
Wed 27 May	11.50	JP	BoJ Monetary Policy Meeting Minutes for April 28 Meeting					
	11.50	JP	Trade balance (adjusted)	Apr	¥bn	97.1	~	~
	11.50	JP	Small business confidence	May	Index	30.8	~	~
	12.30	AU	Westpac leading index	Mar	m%ch	-0.3	~	~
	13.00	AU	DEWR skilled vacancies	May	m%ch	-8.9	~	~
	15.00	NZ	NBNZ business confidence	May	Index	-14.5	~	~
Thu 28 May	11.50	JP	Large retailers' sales	Apr	%	-8.1	~	~
	11.50	JP	Retail trade	Apr	m%ch	-1.1	~	~
					y%ch	-3.9	~	~
	13.00	AU	HIA new home sales	Apr	m%ch	4.2	~	~
	13.10	AU	RBA Deputy Governor Battellino Speaks in Sydney					
	13.30	AU	Private capital expenditure	QI	%	6.0	~	-8.0
	13.30	AU	Construction work done	QI	%	1.7	~	-4.0
	14.00	NZ	Annual Budget					
Fri 29 May	10.45	NZ	Building permits	Apr	m%ch	-4.6	~	~
	11.30	JP	Jobless rate	Apr	%	4.8	~	~
	11.30	JP	Household spending	Apr	y%ch	-0.4	~	~
	11.30	JP	CPI	Apr	y%ch	-0.3	~	~
	11.30	JP	CPI food, energy	Apr	y%ch	-0.3	~	~
	11.30	JP	Industrial production	Apr	m%ch	1.6	~	~
	16.00	JP	Vehicle production	Apr	y%ch	-50.0	~	~
	17.00	JP	Housing starts	Apr	y%ch	-20.7	~	~
	17.00	JP	Construction orders	Apr	y%ch	-37.8	~	~
	13.30	AU	Private sector credit	Apr	m%ch	0.1	~	0.3
					y%ch	4.9	~	4.7

Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK time	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Mon 25 May	09.00	GE	IFO – business climate	May	Index	83.7	~	~
Tue 26 May	07.00	GE	GDP	QI	q%ch	-3.8	~	~
	07.10	GE	GfK cons.confidence survey	Jun	Index	2.5	~	~
	09.00	EZ	Current account	Mar	€bn	-2.3	~	~
	10.00	EZ	Industrial new orders	Mar	y%ch	-34.5	~	~
	14.00	US	S&P/CaseShiller Comp.-20	Mar	y%ch	-18.6	-18.4	~
	15.00	US	Consumer confidence	May	Index	39.2	42.0	~
	15.00	US	Richmond Fed manuf. index	May	Index	-9.0	-7.0	~
	15.00	US	Dallas Fed manuf. activity	May	Index	-31.6	-24.0	~
Wed 27 May	~	GE	CPI	May	m%ch	0.0	~	~
	15.00	US	House price index	Mar	%	0.7	0.2	~
	15.00	US	Existing home sales	Apr	mn	4.6	4.7	~
Thu 28 May	07.00	GE	ILO Unemployment rate	Apr	%	7.6	~	~
	08.55	GE	Unemployment change	May	'000	58.0	~	~
	10.00	EZ	Business climate indicator	May	Index	-3.3	~	~
	13.30	US	Durable goods orders	Apr	%	-0.8	0.4	~
	13.30	US	Initial jobless and continuing claims					
	15.00	US	New home sales	Apr	'000	356	364	~
Fri 29 May	10.00	EZ	CPI estimate	May	y%ch	0.6	~	~
	10.00	EZ	Unemployment rate	Apr	%	8.9	~	~
	13.30	CA	Current account (BOP)	QI	$bn	-7.5	10.5	~
	13.30	US	GDP (annualised)	QI	q%ch	-6.1	-5.5	~
	14.45	US	Chicago purchasing manager	May	Index	40.1	42.0	~
	15.00	US	Uni of Michigan confidence	May	Index	67.9	68.0	~
	15.00	US	NAPM-Milwaukee	May	Index	39.0	~	~
Sat 30 May	06.05	GE	Retail sales	Apr	m%ch	-0.4	~	~
					y%ch	-1.5	~	~

ASB ECONOMICS
Level 9, 135 Albert Street, Auckland

ASB ECONOMICS			PHONE	FAX
Economics				
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374-8604	(649) 302 0992
ASB Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374-8185	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	