

Business Weekly

'Subtle' change in tune

This Week

Last Thursday's *Monetary Policy Statement* showed the RBNZ is focussing on several expected issues: the housing market; household credit growth risks; the stubbornness of inflation. However, a "subtle" wording change (implying earlier OCR hikes) contributed to jumps in interest rates and the NZD. Rather than writing about the *Statement* itself (you can read our Review [here](#)), we have focussed on the market reaction.

The reaction was pronounced when considering that many of the issues the RBNZ highlighted were what many expected and given that markets already doubted the RBNZ would wait until the second half of 2010. The RBNZ has expressed surprise at the extent of the reaction to what it saw as a subtle change in wording.

Not many financial market participants have English degrees, but they are very sensitive to wording changes. In the past two announcements the RBNZ has moved from implying it will tighten in the "latter part of 2010" to the "second half of 2010" to "around the middle of 2010". Subtle, perhaps, but a clear trend – and accompanied by forecasts that again show the RBNZ sees a greater degree of inflation pressure ahead.

The reality is that markets have to think about not just what the RBNZ is thinking now but also how the RBNZ's view will change over time. There are plenty of past incidences of the RBNZ firmly saying one thing only to markedly change tack shortly afterwards. And only 6 weeks ago the RBNZ was berating markets for pricing in OCR hikes earlier than the RBNZ was then signalling. The vehemence of the RBNZ's rhetoric meant most people thought the RBNZ was unlikely to shift last week from its "second half of 2010" stance.

Sometimes it is not what is said but the context that carries the weight. It appears markets have reacted sharply to the RBNZ backing away so soon from its apparently firm stance. So the key wording change in the policy assessment may have been small but it carried a lot of significance for many. Extrapolation is not always a good forecasting tool. Nevertheless, the market is understandably wary that "around the middle of 2010" could easily morph into "the first half of 2010".

The challenge with giving an explicit timeframe for action is that as the facts change the timing is also likely to change. Ahead of the October OCR review we suggested the RBNZ would be better served in the longer term by moving away from an implied timeframe and make the eventual tightening cycle more conditional on economic events. Taking that path might reduce the bouts of tension between a central bank that feels some frustration with market pricing and a market that is all too aware from harsh experience that the RBNZ's tune can change quite quickly. We still expect the OCR to rise from next April – nearly around the middle of 2010.

Click here for:

[Foreign Exchange](#)

- NZD gains against all crosses after RBNZ surprisingly swift change in tone.

[Interest Rates](#)

- Rates rise sharply following surprisingly hawkish RBNZ Statement.

[Week Ahead](#)

- Treasury Half-Year Economic and Fiscal Update, RBNZ business outlook.

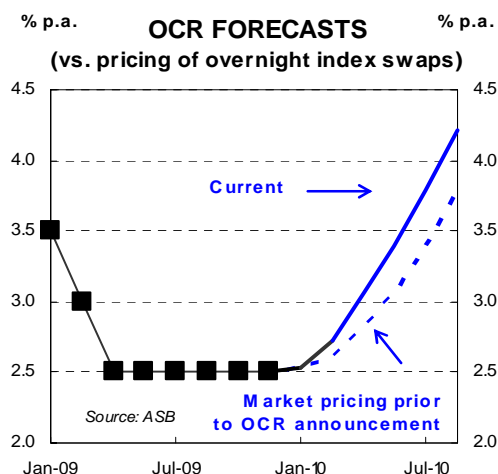
[Week in Review](#)

- RBNZ; manufacturing & construction weak; retail subdued house prices up.

[Global Calendars](#)

- RBA minutes, AU GDP, FOMC rate decision, inflation data (UK, EUR & US)

Chart of the week



- Prior to the announcement last Thursday, the market was expecting the RBNZ to stick with October's dovish stance. The hawkish tone of December's Statement took markets by surprise.
- The NZD dollar immediately spiked half a cent, and continued to make gains over the day peaking at 2 cents above pre-announcement levels.
- The 1-year swap rate lifted 20 points over the day as markets moved to bring forward its expectations of the first rate hike.
- The market now has a 25 basis point hike priced in for March (previously 5 basis points) and 50 basis points fully priced in by April. This broadly consistent with our view of a 50bp hike in April.

General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7241	0.7176	0.7328	0.6369	0.5501	FLAT	0.7150	0.7350
NZD/AUD	0.7934	0.7835	0.7916	0.7888	0.8287	FLAT	0.7850	0.8000
NZD/JPY	64.42	64.45	66.11	62.67	49.94	FLAT	64.00	65.25
NZD/EUR	0.4950	0.4817	0.4929	0.4566	0.4109	FLAT	0.4900	0.5000
NZD/GBP	0.4455	0.4353	0.4416	0.3889	0.3649	FLAT	0.4400	0.4500
TWI	65.2	64.3	65.5	60.4	54.6	FLAT	64.75	65.75

^Weekly support and resistance levels * Current is as at 10.30 am Monday; week ago as at Monday 5pm

- The RBNZ surprised us and the market with its swift change of tone at last week's meeting, bringing forward the timing of rate rises to mid-2010 from the second half of 2010. The NZD picked up on all the main cross rates on Thursday following the RBNZ announcement, and has remained strong over the subsequent trading sessions.
- The USD rallied following Friday's better-than-expected US November retail sales report extending gains since the previous week's November non-farm payrolls. With a plethora of US economic data due for release this week, the USD could continue to lift as the data indicate improving economic conditions in the US economy and annual inflation turns positive after 8 months of year-on-year deflation.
- The Federal Reserve makes an interest rate announcement this week, and is likely to reiterate its expectation that interest rates should remain on hold for an 'extended' period. But the Fed could sound more confident about the US economic recovery, which would support the USD later in the week.

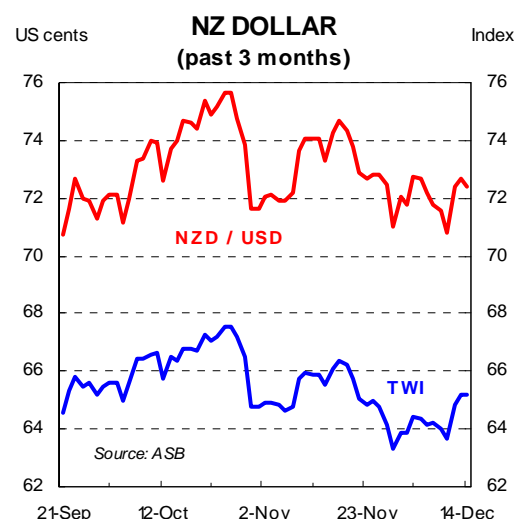
Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Half Year Economic and Fiscal update	15/12	2.00 pm	-
National Bank Business Outlook	17/12	3.00 pm	-
International Travel and Net Migration	21/12	10.45 am	-

Potential currency movers from overseas this week: Eurozone industrial production (14th); US Empire manufacturing, net long-term TIC flows, industrial production, UK CPI, Eurozone ZEW (15th); US inflation, current account, housing starts, building permits, FOMC interest rate decision, Eurozone Inflation (16th); Bernanke confirmation vote, Eurozone Current Account, UK inflation (18th). Speakers: none.

Medium-term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- We continue to expect the NZD to appreciate further against the USD over the next 6-9 months. We have revised up our expected peak to USD 0.82.
- The story remains primarily one of USD weakness, also overlaid by some Downunder strength. We expect the USD to remain under pressure until the Federal Reserve starts to unwind its policy stimulus: the earlier that starts the sooner the NZD's rise is likely to be capped.
- The reasons for the expected USD weakness remain similar to the drivers in place since mid-March, namely:
 - US residents increase their offshore investment, encouraged by improvement in the global economy, with USD liquidity demand and safe-haven buying also no longer boosting the USD.
 - Diversification out of USD is expected to occur due to concerns about US government debt.
 - And, related, concern about the USD's future role as a reserve currency.
- Very recently, the USD has responded positively to strong US data, a change from the pattern of the past 8 months. There is a risk that the USD troughs a lower level than our current forecasts imply.
- The NZD is also likely to mildly outperform other major currencies in the ongoing environment of improving global growth prospects and rising commodity prices. Outright weakness in the Pound will continue to hold the NZD/GBP rate at very elevated levels. The Pound, like the USD, is being weighed down by debt concerns and the state of its financial sector – both of which have ramifications for the future growth rate of the economy.
- The buoyant Australian dollar is also likely to contribute to an overall strengthening of the NZD. The RBA is likely to continue lifting its cash rate back to a less stimulatory level. Rising interest rates there will lift the AUD. The NZD will be caught in the middle: weakening slightly against the AUD but up against other currencies.



Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	2.50	2.50	5.00	FLAT
90-day bank bill	2.77	2.77	2.79	2.81	5.24	FLAT
2-year swap	4.73	4.45	4.58	3.87	4.74	UP
5-year swap	5.68	5.54	5.70	5.31	5.08	UP
5-year benchmark gov't stock	5.51	5.42	5.55	4.84	4.67	UP
NZSX 50	3128	3139	3157	2821	2684	UP

* Current is as at 10.30 am Monday; week ago as at Monday 5pm. Please note that we have recently changed the NZ govt 5-year benchmark bond to April 2015 maturity (from April 2013). This does cause some distortion in the comparison against the previous levels (i.e. month ago).

- The RBNZ delivered a much more hawkish than expected statement. The tone of the statement was in stark contrast to the very dovish statement in October, and the message was not quite as subtle as the RBNZ may have intended. The Bank has moved forward its expected timing of interest rate hikes to the middle of 2010 (from second half) and has brought forward the lift in the 90-day interest rate track to Q3 (from Q4 in the September MPS).
- Interest rates rose sharply in response to the hawkish statement, and continue to rise over the rest of the week. The considerably stronger than expected increase in Australian jobs and strong retail data in the US added to momentum in markets. Over the week, the 1-year swap is up 25 basis points (bps), 2-year is up 28bps and 5 year up 15bps.
- The RBNZ made direct comments on the linkages between fiscal and monetary policy settings. In particular, fiscal restraint beyond that described in Budget 2009 would allow lower interest rates than otherwise be the case. An indication of an imminent change to the tax treatment of housing is also a wild card, as this could take out some of the heat in the housing market for the RBNZ.

Short-term outlook:

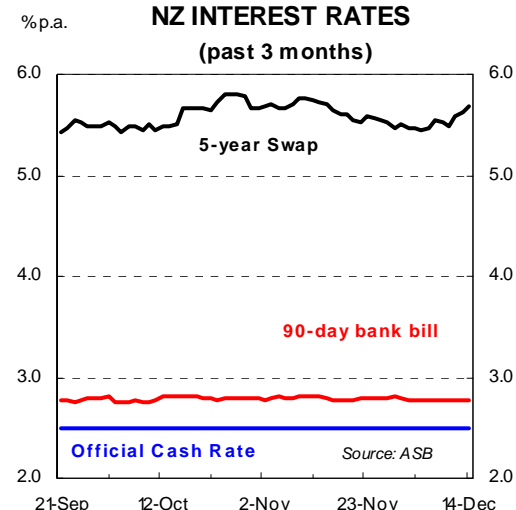
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International Travel and Net Migration	21/12	10.45 am	-

Comment: The Fiscal Update on Tuesday will be the focus in local markets. The RBA minutes later Tuesday afternoon could also be influential. Other key events include Australian GDP on Wednesday and the FOMC rate announcement Thursday morning. The tone of the statement could be market sensitive given the recent strength in US data.

Medium term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- The RBNZ continues to hold the cash rate at 2.5%. The RBNZ adopted a more hawkish tone at the December Monetary Policy Statement. The RBNZ now recognises the stronger economic outlook at the risks to inflation moving toward the upside. The RBNZ has moved forward its expected tightening to the middle of 2010, with the 90-day interest rate track now increasing from Q3 2010.
- The RBNZ has revised up its view on the economic outlook, with the composition of growth is now more household led. The move acknowledges the recent strength in house prices as well as the improvement in consumer and business confidence. The RBNZ notes there is upside risk to spending growth given the strength of house prices, although points the weakness in housing credit growth as indicating cautious consumer behaviour.
- The RBNZ has become more concerned on future inflation pressures, noting it has been surprised by the extent non-tradable prices have help up. The recession has not triggered a period of muted inflation; it merely appeared to wipe out the excess inflation pressure from the economy. There is no longer much scope for the RBNZ to absorb upside surprises to the inflation outlook other than to lift rates earlier than currently intended.
- The next move in the OCR is up, it's just a matter of when. We continue to expect the RBNZ will hike by April next year, as the strength in the housing market continues to test the RBNZ's patience. The RBNZ has a substantial amount of policy stimulus to unwind, the first steps are likely to be bigger (i.e. 50 basis point moves).

NZ INTEREST RATES
(past 3 months)



NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
Half-Year Economic and Fiscal update (OBEGAL)	15/12	2.00 pm	-\$7.7b	-	-\$6.9b
National Bank Business Outlook (Own Activity)	17/12	3.00 pm	+33.7	-	-
International Travel and Net Migration	21/12	10.45 am	+18,560	-	-

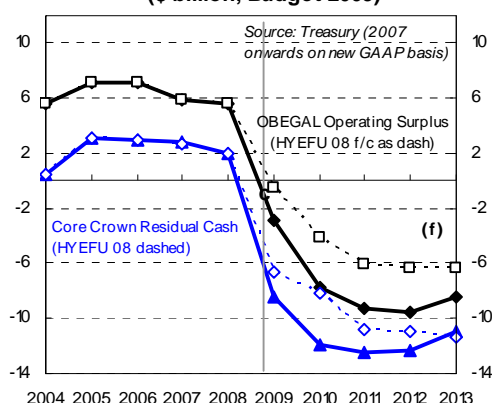
Tuesday 15 December

Half Year Economic and Fiscal Update

OBEGAL: Previous 2010(f) -\$7.7 billion

The fiscal position for the 4 months to October 2009 showed that the Operating Balance Excluding Gains and Losses (OBEGAL) was weaker than the May Budget running forecasts, suggesting that the Crown's fiscal position for the year-end June 2010 may improve little from Budget forecast of a \$7.7 billion deficit. However, we expect the 2010 OBEGAL forecast will look slightly better than the Budget forecast, around a \$6.9 billion deficit. Beyond 2010 we expect the forecast deficits to be closer to \$5 billion through to 2013 rather than the \$8.4 - \$9.6 billion forecasts of the Budget. The economic outlook is now substantially better than what underpinned the Budget fiscal outlook, with the longer-term debt outlook likely to look slightly less mountainous. One aspect to look out for is any legislative changes aimed at reining in the housing market. From a narrow monetary policy perspective, if any changes are to reduce the need for monetary policy action they need to be announced soon and have a fairly immediate impact. If the housing market continues to experience excess demand leading into the next Budget then housing-related changes are likely to come too late to do the work for the RBNZ.

NZ KEY FISCAL BALANCES
(\$ billion, Budget 2009)



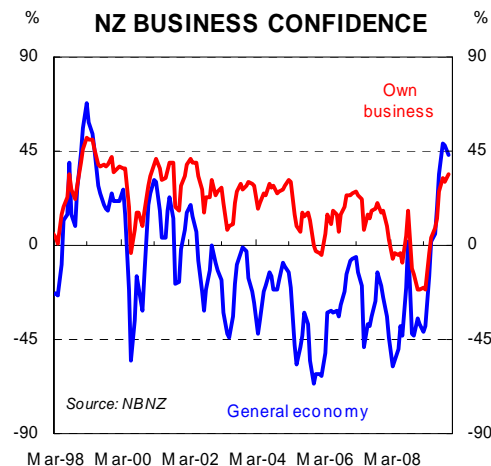
Thursday 17 December

December National Bank Business Outlook

In November, while businesses' view of the general economy dipped their expectations of own activity continued to rise. More encouragingly, profitability of firms continued to hold on to recent highs, thus underpinning employment and investment intentions. We expect December business confidence to remain at recent highs. In line with this, other business surveys also continue to show improvement in sentiment.

Of interest will be the extent the increases in consumer and business confidence flow through to real activity. So far the effects have been muted.

NZ BUSINESS CONFIDENCE



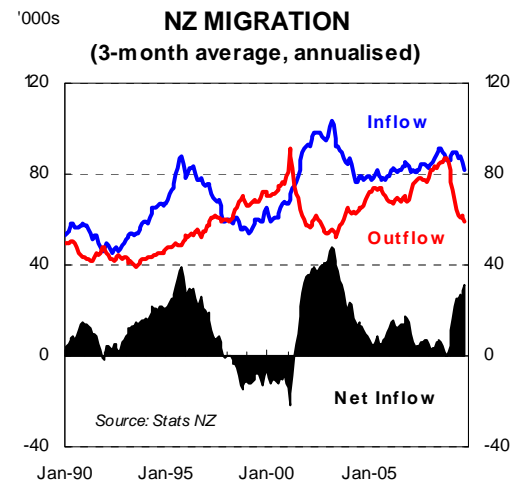
Monday 21 December

November International Travel and Migration

Previous: 18,560 net migrants (in 12 months to October)

Net migration inflows have picked up strongly over the past few months, mostly owing to a dramatic fall in the number of departures, particularly to Australia. The deterioration in the world economy is likely to be behind the decline in departures as a weaker labour market in Australia deterred New Zealanders from heading across the Tasman. We expect these trends to continue into early 2010, supporting a modest pick up in net migration over the year, to over 20,000 net new migrants per annum. A boost to net migration will provide some underlying support to NZ's flagging housing construction sector.

Overseas short-term visitor arrivals are also expected to slow over the next year as weakened world growth reduces demand for international travel.



NZ Data Review: weekly recap

Economic Survey of Manufacturing

The Economic Survey of Manufacturing revealed another weak quarter for the manufacturing sector. The volume of sales fell 1.4%, with the weakness stemming from meat and dairy manufacturing (down 7.1%). These declines are likely to reflect the weakness in meat exports as slaughter levels have fallen dramatically over the past few months.

Excluding meat and dairy, manufacturing sales volumes ticked up 1%, consistent with the steady improvement in manufacturing confidence over the second half of 2009. With NZ and global demand starting to stabilise and renewed momentum in growth in Australia, the outlook for manufacturing is improving. Nonetheless, the level of activity is likely to remain subdued for sometime.

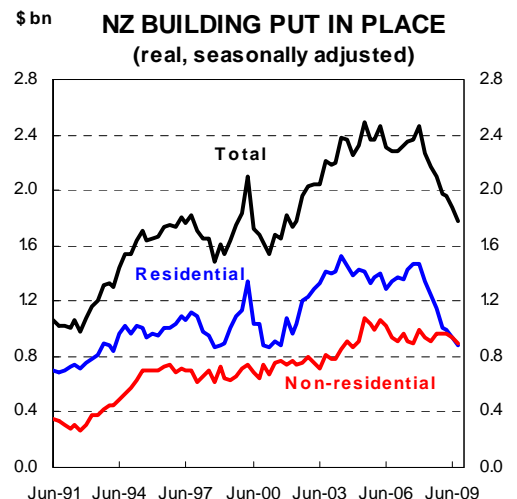
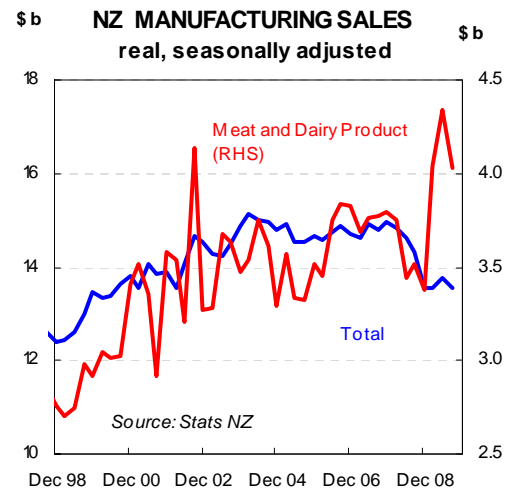
We estimate that seasonally-adjusted stocks also declined, suggesting that manufacturing production further than we had expected.

Value of Building Work Put in Place

Weak construction activity continued in the third quarter, with real building work put in place declining 4.9%.

Residential building work fell 5.4% in the September 2009 quarter. Activity has been declining for two years, with volume of work done now down 39.8% on the peak level recorded in the September 2007 quarter. To date the recovery in the housing market has yet to flow through into a recovery in housing construction. However, we expect housing construction will contribute strongly to growth in the first half of next year.

Non-residential building work has held up slightly better, but was still weak. The seasonally adjusted volume of non-residential building work fell 4.3% in the September 2009 quarter. Volumes are also down 17% from the peak level of activity in June Quarter 2005.



RBNZ December Monetary Policy Statement

The RBNZ left the OCR unchanged at 2.5%, as widely expected. However, the RBNZ delivered a surprisingly hawkish statement. The RBNZ has made key change in its nuance, signalling it will start to lift rates “around the middle of 2010”, instead of the “second half” or “latter half” of 2010.

The RBNZ have revised up its growth outlook with consumer spending stronger, underpinned by the lift in confidence and stronger than expected house price inflation. Higher than expected dairy prices also added to the stronger outlook. The RBNZ has become more concerned on the inflation outlook, as non-tradable inflation has remained surprisingly strong.

The RBNZ noted that the higher exchange rate, increased long-term interest rates and widening gap between the OCR and bank funding costs was doing some of the tightening in financial conditions for it, reducing “the need for more immediate action”.

Terms of Trade

The Q3 Terms of Trade fell 1.3%, weaker than our forecast of a 0.5% increase. The weaker result was largely due to the 5.2% decline in export prices, compared to our expectations of a 2.5% fall. Import prices fell by 3.9%.

The decline in export prices was largely driven by falls in prices for dairy (-10.4%) and meat exports (-3.2%). The declines in dairy prices reflect the lagged effects of weak prices on spot markets earlier this year. However, recent gains made in dairy prices on spot markets are likely to flow through into export receipts over the next couple of quarters.

Import prices fell 3.9% in Q3, following modest declines in the previous 2 quarters. The decline in import prices was also broad-based, in most cases reflecting the appreciation in the exchange rate.

The decline in the Terms of Trade follows large declines of 11.9% and 7.9% in Q2 and Q1 respectively. The Terms of Trade are now starting to stabilise, and may possibly lift in coming quarters as recent strength in dairy prices start to flow into export receipts.

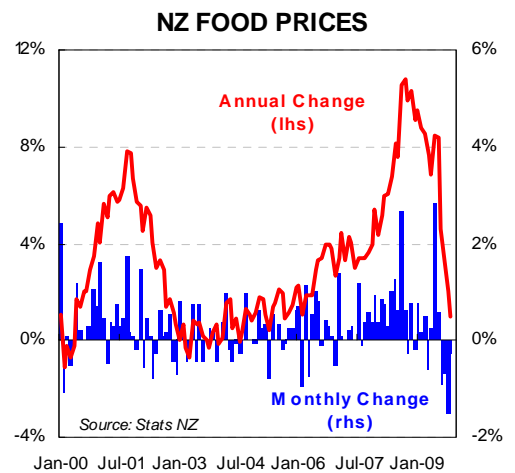
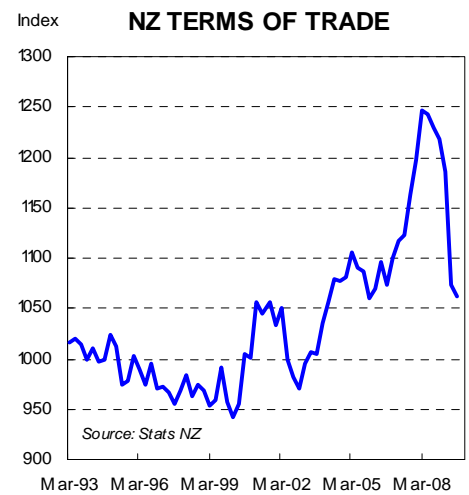
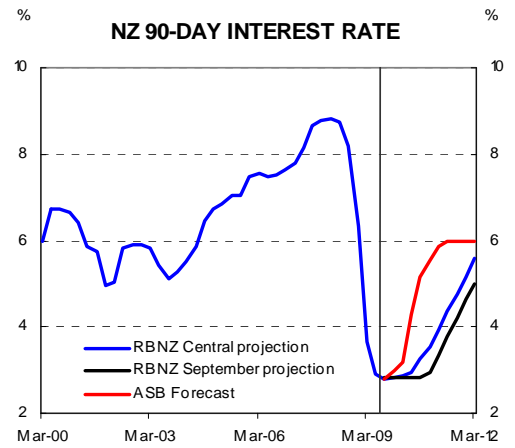
November Food Price Index

Food prices fell 0.3% in November, the fourth consecutive monthly fall in food prices. Most of the November decline came from further falls in the fruit and vegetable group. Fruit and vegetable prices typically decline over the spring months, and are now 17.2% below their winter peak.

General grocery prices fell 0.2%, the fourth consecutive fall in this group. These falls follow substantial increases over 2007 and 2008 (largely due to rising global food prices, i.e. dairy and grains). Prices remain 1.5% above year-ago levels.

Non-alcoholic beverages fell 0.8%, the second consecutive fall. However, prices in this group have increased strongly over the past year, and prices remain 6.9% above year-ago levels.

Ready to eat and restaurant meal prices increased 0.6%, following the unusual 0.3% fall in the previous month. Inflation in this group is slowing, likely to be reflecting weaker wage inflation pressures and some reduction in ingredient cost inflation.



REINZ Housing Data

Over November, the median number of days to sell increased to 35.1 from 33.9 (seasonally adjusted), while seasonally-adjusted house sales fell 8.7% in October. Nonetheless, the low number in days to sell and relatively low turnover support the view that prices are being supported by tight supply rather than surging demand.

Over the past 3 months the REINZ Monthly Housing Price Index has increased by 4.1%, and is up 6.6% on year-ago levels.

Supply has been sluggish to respond to the recent pick-up in demand. November's housing data paint a picture of strength in prices, but modest activity levels. There were also some very tentative signs that the momentum is slowing, with days to sell lifting fractionally as turnover slowed. One month does not make a trend – particularly when closing in on the holiday-distorted months of December and January. Whether this pattern continues in the first few months of 2010 will be something to watch for, in particular the trend in days to sell.

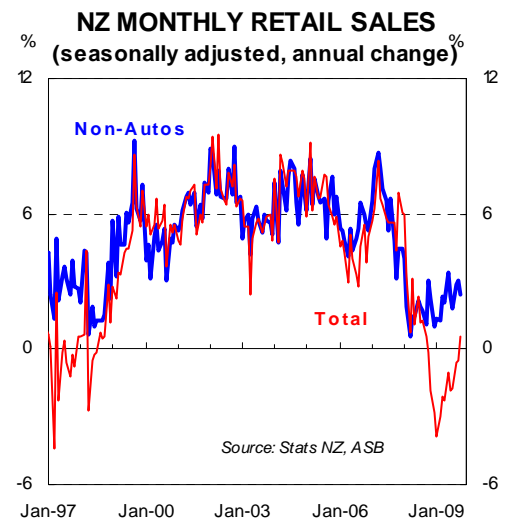
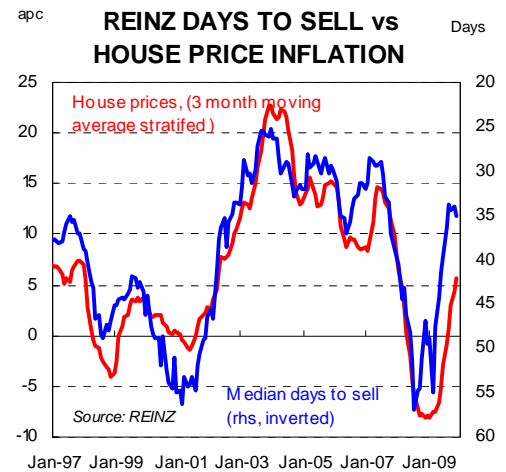
Retail Trade Survey

Total retailing remained flat in October, while core retailing lifted slightly by 0.5%. The retail trade survey appears to be affected by volatility this month, with a couple of technical anomalies (such as October having 5 Saturdays) potentially distorting monthly movements in some categories. Overall, the growth in spending remains very subdued, despite the recent pick up in confidence.

Supermarket sales, the largest category in the retail trade survey, fell 1.1%. This section has been unusually volatile in recent months, although weaker food prices may have also contributed to the decline in sales. Clothing sales were very weak, falling 6.7% to unwind the strength seen in August and September. Clothing sales have been whipped around by unseasonal weather this year.

The key areas of strength in October came from areas typically associated with tourism, such as cafes and restaurants (+10%), bars and clubs (+3.5%) and accommodation (+4.2%). However, given the volatility in the monthly survey we are reluctant to put too much weight on a monthly increase in these categories. Trend growth in cafes and restaurants and accommodation remain subdued, although sales at bars and clubs have been growing strongly in recent months.

In addition, there were five Saturdays in October, which could have boosted spending on weekend entertainment.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 13 hours for NZ times.

Calendar – Australasia, Japan and China

Date	Time		Econ Event	Period	Unit	Last	Forecast	
	NZT						Market	ASB/CBA
Mon 14 Dec	12.50	JP	Tankan Large Manuf. Index	QIV	Index	-33.0	-27.0	~
	12.50	JP	Tankan Non-Manufacturing	QIV	Index	-24.0	-24.0	~
	13.30	AU	Lending finance	Oct	m%ch	6.7	~	~
	17.00	JP	Tokyo Condominium Sales	Nov	y%ch	-20.0	~	~
	17.30	JP	Industrial Production	Oct	m%ch	0.50%	~	~
					y%ch	-15.1	~	~
17.30	JP	Capacity Utilization	Oct	m%ch	1.6	~	~	
Tue 15 Dec	13.30	AU	Dwelling starts	QIII	q%ch	-3.7	~	14.0
	13.30	AU	RBA Board December minutes					
Wed 16 Dec	12.50	JP	Tertiary Industry Index	Oct	m%ch	-0.5	~	~
	13.00	AU	DEWR skilled vacancies	Dec	m%ch	2.4	~	~
	13.30	AU	GDP	QIII	q%ch	0.6	~	0.3
					y%ch	0.6	~	0.6
	14.15	AU	RBA Deputy Bank Governor Battellino speaks in Sydney					
19.00	JP	Machine tool orders	Nov	y%ch	-8.6	~	~	
Thu 17 Dec	13.00	AU	HIA New Home Sales	Nov	m%ch	-6.0	~	~
	13.00	AU	Westpac-ACCI 4th-Qtr Survey of Industrial Trends					
	13.30	AU	RBA Bulletin	Dec	~	~	~	~
	13.30	AU	Labour force	QIII	~	~	~	~
	15.00	NZ	NBNZ Business Confidence	Dec	Index	43.4	~	~
	17.00	JP	BoJ Monetary Policy Meeting	Dec	~	~	~	~
	18.00	JP	Leading Index CI	Oct	Index	89.7	~	~
	18.00	JP	Coincident Index CI	Oct	Index	94.3	~	~
	Fri 18 Dec	~	JP	BOJ Target Rate	Dec	%	0.1	~

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Calendar – North America & Europe

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

Date	UK		Period	Unit	Last	Forecast	
	time	Econ Event				Market	CBA
Mon 14 Dec	00.01	UK Rightmove House Prices	Dec	y%ch	1.6	~	~
	10.00	EZ Employment	QIII	q%ch	-0.5	~	~
	10.00	EZ Industrial production	Oct	m%ch	0.3	~	~
				y%ch	-12.9	~	~
13.30	CA Capacity Utilization Rate	QIII	%	67.4	~	~	
Tue 15 Dec	00.01	UK RICS House Price Balance	Nov	%	34.0	38.0	~
	09.30	UK CPI	Nov	m%ch	0.2	~	~
	09.30	UK PMI Manufacturing	Nov	%	0.3	~	~
	10.00	EZ Labour Costs	QIII	y%ch	4.0	~	~
	10.00	EZ ZEW Survey (Econ. Sent.)	Dec	Index	51.8	~	~
	13.30	CA Leading Indicators	Nov	m%ch	0.7	~	~
				q%ch	0.0	~	~
	13.30	US Producer Price Index	Nov	m%ch	0.3	0.8	~
				y%ch	-1.9	1.7	~
	13.30	US Empire Manufacturing	Dec	Index	23.5	25.0	~
	14.15	US Industrial Production	Nov	%	0.1	0.6	~
	18.00	US NAHB Housing Market Index	Dec	Index	17.0	18.0	~
Wed 16 Dec	09.00	EZ CPI	Nov	m%ch	0.2	~	~
				y%ch	-0.1	~	~
	09.30	UK Construction Output	Oct	m%ch	1.2	~	~
	13.30	US Consumer Price Index	Nov	m%ch	0.3	0.4	~
				y%ch	-0.2	1.8	~
	13.30	US Housing Starts	Nov	'000	529.0	575.0	~
13.30	US Building Permits	Nov	'000	551.0	570.0	~	
19.15	US FOMC rate decision	Dec	%	0.25	0.25	0.25	
Thu 17 Dec	09.30	UK Retail Sales	Nov	y%ch	3.4	~	~
	10.00	EZ Construction Output	Oct	y%ch	--8.0	~	~
	12.00	CA CPI	Nov	m%ch	-0.1	~	~
				y%ch	0.1	~	~
	13.30	US Initial jobless and continuing claims					
	15.00	US Leading Indicators	Nov	%	0.3	0.7	~
15.00	US Philadelphia Fed.	Dec	Index	16.7	16.0	~	
Fri 18 Dec	09.00	EZ Current Account	Oct	€bn	-5.0	~	~
	09.30	UK Labor Productivity	QIII	£bn	11.4	~	~
	09.30	UK Consumer Price Index	Nov	m%ch	10.8	~	~
	10.00	EZ Trade Balance	Oct	€bn	6.8	~	~
	13.30	CA Wholesale Sales	Oct	m%ch	0.2	~	~