

# NEW ZEALAND ECONOMICS MARKET FOCUS

16 January 2012

**INSIDE**

Economic Overview	2
Key Themes for 2012	5
Interest Rate Strategy	20
Currency Strategy	22
Data Event Calendar	23
Local Data Watch	25
Key Forecasts	26

**NZ ECONOMICS TEAM**

**Cameron Bagrie**  
Chief Economist  
Telephone: +64 4 802 2212  
E-mail: Cameron.Bagrie@anz.com

**David Croy**  
Senior Interest Rate Strategist  
Telephone: +64 4 576 1022  
E-mail: David.Croy@anz.com

**Sharon Zöllner**  
Senior Economist  
Telephone: +64 4 576 1062  
E-mail: Sharon.Zollner@anz.com

**Mark Smith**  
Senior Economist  
Telephone: +64 4 802 2199  
E-mail: Mark.Smith2@anz.com

**Steve Edwards**  
Economist  
Telephone: +64 9 357 4065  
E-mail: Steve.Edwards@anz.com

**Con Williams**  
Rural Economist  
Telephone: +64 4 802 2361  
E-mail: Con.Williams@anz.com

## KEY THEMES FOR 2012

### ECONOMIC OVERVIEW

As we enter 2012 not much appears to have changed, with the global economy still facing enormous challenges. While the New Zealand economy has continued to display relative resilience, this will once again be put to the test this year. A bumpy road lies ahead. This week's local inflation data is expected to confirm a benign Q4 print, with the hurdle to future RBNZ moves remaining high. The QSBO is envisaged to show signs of global wobbles filtering through into domestic business sentiment but amidst general resilience in other survey measures.

### KEY THEMES FOR 2012

In this section, we outline some of the key themes that will play an influential role in determining New Zealand's economic prospects over the year ahead. They are: Deleveraging headwinds; Transitioning via differentiation; Sovereign risk; Economic tensions – the interaction of five shocks; Asia – with opportunity comes vulnerability; The grand finale – game theory at play; and Desynchronisation.

### INTEREST RATE STRATEGY

Familiar themes continue to dominate the outlook, and leave us circumspect. These include the European sovereign debt crisis, continued conjecture of QE3 amidst some signs of better data-flow, deleveraging, and heightened uncertainty. So although interest rates are close to multi year lows, with monetary policy on hold or easing across much of the world and slow growth set to be the norm, that yields are low is not a guarantee that they will rise. Expect NZGS to be well supported given the carry available, and distance from Europe. For borrowers, consider swaptions.

### CURRENCY STRATEGY

No surprise – France loses its AAA S&P rating, but the surprise is that the downgrade was only one notch. That together with the breakdown of Greek debt talks suggest that the FX markets should get ready for a disorderly default by Greece. US data continues to be stable with the passage of time working its magic. NZDUSD has delivered yet another positive year-end performance and we watch for the usual end of January correction.

### THE ANZ HEATMAP

Variable	12 mth view	Comment	Risk profile
GDP	2.5%	Respectable but grumpy growth. Downside risks.	
OCR	No change	OCR low for longer as opposed to outright lower	
CPI	2.6%	Benign but some medium-term inflation drivers remain sticky.	

## ECONOMIC OVERVIEW

### SUMMARY

As we enter 2012 not much appears to have changed, with the global economy still facing enormous challenges. While the New Zealand economy has continued to display relative resilience, this will once again be put to the test this year. A bumpy road lies ahead. This week's local inflation data is expected to confirm a benign Q4 print, with the hurdle to future RBNZ moves remaining high. The QSBO is envisaged to show signs of global wobbles filtering through into domestic business sentiment but amidst general resilience in other survey measures.

### FORTHCOMING EVENTS

**REINZ Housing Market Report - December** (Tuesday, 17 January, 10:00am). Sales volumes are expected to rise 2 percent, with prices to be underpinned by a low stock of properties on the market.

**NZIER QSBO – 2011Q4** (Tuesday, 17 January 10:00am). General Business Situation and Domestic Trading Activity metrics are expected to move lower. Pricing intentions and capacity-based measures should confirm a benign inflation environment.

**SNZ Electronic Card Transactions – December** (Tuesday, 17 January, 10:45am). A 0.2 percent increase in retail card spending is forecast, with core spending up 0.4 percent.

**GlobalDairyTrade auction** (Wednesday, 18 January, early am). A 0.5 to 1 percent fall in the average dairy price is forecast.

**ANZ Job Ads – December** (Thursday, January 19, 10:00am).

**SNZ Consumer Price Index – 2011Q4** (Thursday, January 19, 10:45am). We are forecasting a 0.2 percent quarterly increase (2.4 percent y/y).

**ANZ-Roy Morgan Consumer Confidence – January** (Thursday, January 19, 1:00pm).

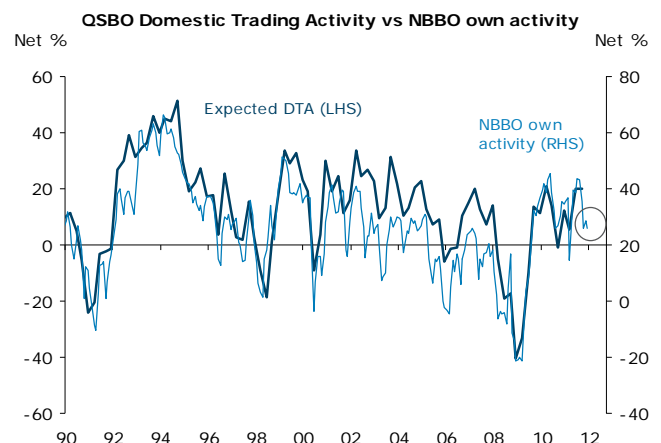
### WHAT'S THE VIEW

As we scour Christmas and New Year developments, the quick conclusion is that not much has changed. Yes we've seen the normal ups and downs across markets. But key planks and issues we wrote about heavily in 2011 such as sovereign risk remain in vogue. On one level it's encouraging for it doesn't force a rethink across our core macro views. On another level, recent developments underscore that the global economy faces significant challenges and suggests 2012 will be far from plain sailing.

Western society still faces a sustained period of penance following a leveraging super-cycle. The options to lower debt as a share of GDP: austerity or saving – a growth suppressant and politically difficult to implement; default – unpalatable; and growing your way out – requires huge structural reform in some key nations, all face challenges and yo-yo market movements over the recent weeks and the likes of Friday's credit downgrades in Europe merely highlight the journey ahead will be long and arduous. If there was a magic potion it would have been guzzled already. Ironically some are still looking for them when, if anything, one of the lessons of the past 20 years is surely that sugar-pill solutions have merely inflated problems down the track.

**New Zealand faces its own challenges being heavily indebted but we are equally mindful of the transmission from the global scene as well.** The former requires New Zealand to be "whiter than white", while the latter requires close monitoring of the 6 C's, namely contagion risks, confidence (growth), cost of credit, China, commodity prices and the currency. There are other channels but these cover most bases.

In our first *Market Focus* of the year, we introduce what we believe to be the key macro themes for 2012, and in some cases, beyond. This has become a regular feature at the start of each year where we focus on the bigger picture. Suffice to say, the picture remains largely the same as portrayed 12 months ago. The picture is dominated by global deleveraging imperatives and one where the best you can hope for is what we characterise as "grumpy growth" as structural headwinds dominate cyclical tailwinds. We've used the term "best we can hope for" with the best of intentions for addressing a huge pool of the global economy's challenges reside in the hands of politicians. In this situation it's obvious where the risk profile sits!



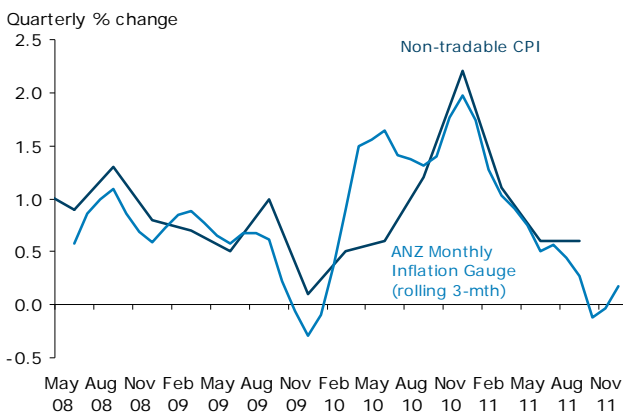
Sources: ANZ, National Bank, NZIER

# ECONOMIC OVERVIEW

Looking at the week ahead, the QSBO is expected to show the impact of the worsening European scene on domestic confidence. A softening tone had already been evident in late 2011 readings for the National Bank Business Outlook. Experienced domestic trading activity is expected to remain barely in positive territory in seasonally adjusted terms, which is consistent with a slightly above-trend print for Q4 GDP – pretty respectable all things considered. However, expected domestic trading activity, pricing and employment intentions are expected to head lower, signalling a benign pricing environment and a lull in quarterly activity from the first half of this year. Capacity based metrics are unlikely to provide inflation warning signs that will concern the RBNZ. **We don't think survey measures will be bad, merely more circumspect and considering the global scene, this will not be a bad outcome.**

We will be paying close attention to investment intentions, particularly those relating to the construction sector. Architects work in their own offices showed a welcome pick-up in residential work over the next 12 months, which is consistent with activity in the sector picking up from cyclical lows. The extent of additional impetus provided by earthquake reconstruction work remains a key unknown, with this weekend's Canterbury aftershocks a further reminder of the challenges facing the Canterbury rebuild.

**ANZ Monthly Inflation Gauge vs Non-tradable CPI**

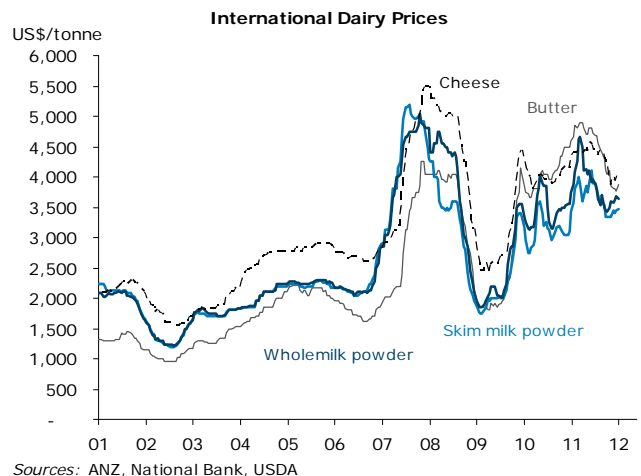


Sources: ANZ, Statistics NZ

We expect a 0.2 percent increase in the CPI, taking the annual headline inflation rate back inside the RBNZ's inflation target band. This morning's food price data was a touch weaker than we had expected, and suggests some marginal downside risk around our Q4 pick. The benign short-term inflation outlook provides the RBNZ with greater flexibility on OCR settings. Our Monthly Inflation Gauge has proved to be a good directional indicator for non-tradable inflation, with the modest 0.2 percent

December (month) reading coming on top of benign readings over the prior few months.

This week's GlobalDairyTrade auction is forecast to show a small fall in the average dairy price. A key has been the remarkable resilience of dairy prices considering the global backdrop and the increase in supply of all major producers over the last six months. Supply is forecast to continue to grow in 2012, but not at the rate seen in the last couple of years. Given the uncertainties faced in Europe in the first half of 2012 and better supply we expect an easing bias to continue for whole milk powder prices, with skim milk powder prices to remain around current levels. Prices for milkfat-based products look to have bottomed but we don't expect a lot of upside for butter and anhydrous milk fat, with Russia likely to be less active over the coming months.



Sources: ANZ, National Bank, USDA

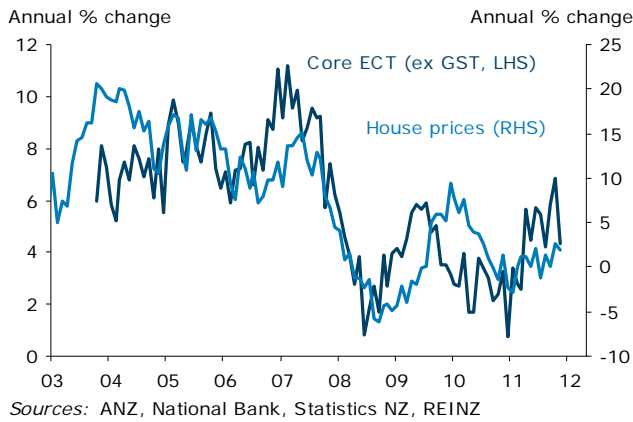
Housing market data for December 2012 is expected to confirm a strengthening in housing market activity from low levels. In the past a strengthening housing market would have flagged a RBNZ response, but times appear to have changed. The rebound is off lows. A December 2011 RBNZ bulletin article<sup>1</sup> sets out current thinking in household behaviour, where the role of income generation is given a much larger role in relation to asset prices. This explains in part the willingness of the RBNZ to assume modest income growth (rather than the improving housing market) will be the key influence behind their cautious consumption view. In this regard, this week's job ads will provide important insights as to whether the labour market is regaining some of the momentum lost over the past couple of months.

<sup>1</sup>See [www.rbnz.govt.nz/research/bulletin/2007\\_2011/2011dec744\\_deveirmanReddell.pdf](http://www.rbnz.govt.nz/research/bulletin/2007_2011/2011dec744_deveirmanReddell.pdf)



## ECONOMIC OVERVIEW

**Retail spending and house prices**



Electronic Card Transaction data for December will provide an important steer on the state of retail over the Christmas shopping season. **We expect a small increase for December with the Paymark data (up 0.1 percent m/m) confirming consumers' wallets were largely shut.** The last few monthly readings of consumer sentiment have been softening and point to moderate retail spending growth at best. This week's consumer confidence readings will provide updated insights on the degree of consumer caution.

### RECENT LOCAL DATA

**SNZ Food Price Index – December 2011.** Food prices rose 0.2 percent m/m (2.9 percent m/m).

**ANZ Commodity Price Index – December 2011.** The index fell 0.8 percent (3.1 percent y/y). The NZD index eased 0.6 percent (1.2 percent y/y).

**SNZ Building Consents – December 2011.** The number of residential consents fell 6.4 percent s.a. Non-residential consent values jumped 16 percent to \$341m s.a.

**GlobalDairyTrade auction –January 4.** The average winning price was US \$3,654m per tonne, a 0.7 percent fall on the December 20 event.

**SNZ Merchandise Trade - November (Jan 9).** A monthly deficit of \$308m was registered, with the annual trade surplus narrowing to \$555m.

**National Bank Business Outlook – December.** A net 17 percent of firms expected better times for the economy over the year ahead (+18 previously). Firms' assessment of their own activity eased 3 points to +26. Employment intentions eased, whereas profit and investment expectations rose. Pricing intentions eased from +18 to +17, with firms' one-year-ahead inflation expectations easing to 3 percent.

**Gross Domestic Product – Q3.** Production-based GDP lifted 0.8 percent (+1.9 percent y/y), with the expenditure-based measure rising 1.0 percent (+1.8 percent y/y).

**Current Account Balance – Q3.** A quarterly deficit of \$4.6bn was registered, taking the annual current account deficit to 4.3 percent of GDP. The net international investment position rose to \$141.8bn (72.9 percent of GDP).

**International Travel and Migration – November.** Net permanent and long-term departures eased to 60 persons (568 persons in the November 2011 year). Visitor arrival numbers fell 1.6 percent s.a. (+1.6 percent y/y).

**Credit Card Billings – November.** The value of billings dropped 3.4 percent s.a. (3.2 percent y/y), driven by a 20.7 percent s.a. fall in billings on overseas cards. Spending on domestic cards fell 0.8 percent s.a.

**RBNZ Credit Aggregates - November (Friday, 23 December, 12:00pm).** Private sector credit (R) ex-repo rose 0.5 percent s.a. (1.4 percent y/y). Agricultural credit levels fell 0.9 percent y/y, while business (up 2.6 percent y/y) and household (up 1.0 percent y/y) credit rose.

## KEY THEMES FOR 2012

### SUMMARY

In this section, we outline some of the key themes that will play an influential role in determining New Zealand's economic prospects over the year ahead. They are: **Deleveraging headwinds; Transitioning via differentiation; Sovereign risk; Economic tensions – the interaction of five shocks; Asia – with opportunity comes vulnerability; The grand finale – game theory at play; and Desynchronisation.**

**Our key aim in writing this article is to alert our readers to some of the wider economic forces at work.** We want to highlight the inherent tensions that exist within the economic system, and to encourage readers to start thinking about the implications for their own businesses. Ultimately, it is the average rate of growth over a number of years (and volatility around that growth) that matters, as opposed to what GDP growth will be in any single year. The repercussions of the global financial crisis will continue to be felt for years. Therefore, we would encourage our readers to think about the macro themes we outline below within a five-year time horizon. The themes are:

- **Deleveraging (still).**
- **Transitioning via differentiation.**
- **Sovereign risk.**
- **Economic tensions: the interaction of numerous shocks.**
- **Asia – with opportunity comes vulnerability.**
- **Game theory at play – looking for a mandate to bite the bullet.**
- **Desynchronisation.**

**The process of financial system repair post the global financial crisis (GFC) in 2008 is ongoing and will take time.** Banking sector malaise has been usurped by fiscal challenges, with most governments now facing very tough decisions on the spending front. And that doesn't mean bank problems have disappeared, particularly in Europe! Significantly, we see the global economy embarking on not only a sustained period of stuttering growth, but also extensive structural change over 2012 and subsequent years. While growth remains a priority for policymakers, we must not lose sight of structural aspects to this cycle if we are to learn from lessons of the past. This means we are wary of sugar pill solutions. We see a lot of pending tensions between cyclical and structural forces over the year ahead, as many of our themes highlight.

### THEME 1: DELEVERAGING HEADWINDS

Call it "that old chestnut", call it what you will. But don't dismiss it. **Deleveraging is certainly a familiar theme, but it still remains at the top of our list of key considerations.** Of course, we have been deleveraging for three years now, but it's far from over (NB: we define deleveraging as a drop in debt to income ratios as opposed to falling nominal debt levels).

Our view is based on three simple considerations:

1. **We came to the end of a multi-decade leveraging super-cycle across Western society in 2008.** Appetite for debt didn't just grow over prior decades, it grew rapidly. Any economic model with credit growth running at 2 to 3 times the rate of nominal GDP for a sustained period was always on borrowed time. Excess consumption needs to be replaced by the reciprocal, and growth will be sacrificed for an extended period. The consequences and necessary "healing" include: bank deleveraging in Europe; fiscal austerity; negative feedback effects on the real economy; more regulation – without invoking unintended consequences; and social fallout. These consequences are only now starting to be felt.
2. **New Zealand was binging at the party** like a host of others and is now suffering from the hangover. The necessary adjustment is proving to be orderly, but it's an adjustment nonetheless.
3. **A sustained improvement in structural barometers is a precursor to sustained cyclical recovery,** or in other words above-trend growth taking hold in a sustained fashion.

**So where does NZ stand?** It is worth summing up what we have seen in the past three years.

- After a recession and a tepid recovery, **the New Zealand economy is the same size as it was in 2007 in real terms.** In real per capita terms we are almost 4.8 percent smaller. This represents a drop in living standards.
- **Commodity prices have lifted strongly since 2008,** giving a huge boost to rural incomes, and mitigating what could have been a nasty adjustment for heavily indebted parts of the rural sector. In short, this is helping to deflate the debt burden via income generation. It's a dynamic a host of nations would love to have.
- **House prices remain around 2½ percent below their peak** in nominal terms. They've

## KEY THEMES FOR 2012

fallen, recovered, fallen and moved sideways but not collapsed.

- **The annual household saving rate has improved** from -7.5 percent of disposable income in March 2007 to +2.8 percent in September 2011.
- **The current account deficit has** fallen from a peak of 8.9 percent of GDP at the end of 2008 to 4.3 percent as of September 2011.
- **Net external debt has fallen** from a peak of 84.7 percent of GDP in March 2009 to 72.9 percent of GDP as of September 2011.
- **Households have deleveraged**, but there's a catch. Household debt to income has fallen from a peak of 154 percent in mid 2008 to 144 percent in September last year. **But it is not because we are saving more – the improvement has come from rising incomes.** Other nations have made better progress, but more often than not this has been forced on them by collapsing house prices – not something we should wish for.
- **We've seen tax and regulatory changes.** Income taxes have been cut, aligning the top personal rate with the company rate, but GST had to be lifted in return. Depreciation rules for real estate have been tightened up, and along with tax changes, this has improved incentives to earn and lessened incentives to leverage into property.
- **The fiscal position has deteriorated markedly.** This is a combination of structural weakness, a weak economy, and the Canterbury earthquakes. The Government balance sheet has ample room to absorb this – for now.
- **Our credit rating has been downgraded** by both Fitch and Standard & Poor's. The lack of more concrete progress on private sector deleveraging was cited as a cause, as well as the impact of the earthquakes on the fiscal position. Standing back, it's a reminder to continue getting our house in order.

**Although we can take heart from the improvement in many of these balance sheet metrics, it has come at a cost.** The retailing environment has been poor and trading is still tough. While housing market volumes have stabilised, sales in the past 6 months remain around 37 percent lower than levels seen in 2005-07. These sectors will remain the sacrificial pawns in getting the economy back on its feet.

**Of course, the big question is, are we there yet? The short answer is no.** Structural indicators such

as the current account have improved but remain "in the red". We are still a deeply indebted nation. The lowering of our credit rating is a reminder that **we still face challenges, and are facing a sustained period of penance for past excesses.**

**So, where do we need to be to set the stage for the good times to roll again?**

- **The global scene needs to stabilise.** Unfortunately, it's hard to envisage this happening any time soon. If anything, things could get worse, especially for borrowers (be they governments, individuals or companies).
- **Net external debt needs to get below 60 percent of GDP** – a tough ask when there's an earthquake rebuild pending. This means we need to make trade-offs: in "share of GDP" terms we'll have to consume less so we can invest more.
- **The household saving rate probably needs to be north of 5 percent of income.** The last time this occurred was in the late 1980s. The household savings rate did improve over late 2010 and early 2011, but we estimate that it dropped in Q3 – not a good sign.
- **Fiscal deficits need to turn into surpluses.** As well as getting the all-important government debt-to-GDP ratio down, we need to stock up the pantry again, with the EQC fund now completely exhausted. Taxpayers and homeowners are on the hook here. A key challenge will be increasing government saving without creating too much of a drag on household incomes. There's only so much money to go round.
- **Housing affordability needs to improve further.** Low interest rates look locked in, which helps from a repayment point of view, but overall the house prices to income ratio still look stretched at a factor of 7.0 (down from 7.7 in 2007, with the post-1992 average being 5.6 times income).

There are a host of other dynamics that could assist. For instance a sustained lift in productivity growth would not go amiss. But turning the dial and trend here will take time.

**2011 was dominated by a deleveraging headwind and we expect the same dynamic to be influential in 2012.** The piper has not yet been paid. We are making progress but we are not there yet. As economists that means we're paying more attention to the structural indicators as opposed to the daily barrage of cyclical measures. It is progress in the former that will ultimately unlock a sustained lift in the latter. Until then, cyclical barometers will merely oscillate as opposed to trend upwards.

## KEY THEMES FOR 2012

What about the intensity of the deleveraging dynamic? **We expect the deleveraging headwind to be as intense as it was between 2009-2011, but with a couple of twists.**

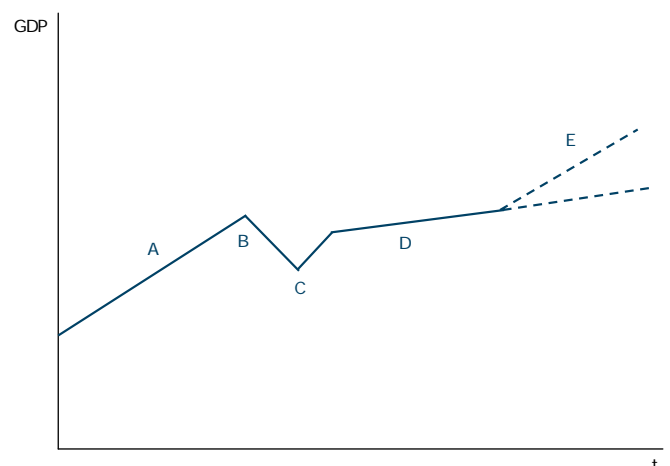
- **There will be a shift in the mix.** Rural sector deleveraging is ongoing but lessening in intensity as the commodity price boom filters through and rural land prices stabilise. Nominal business borrowing collapsed by more than 3 percent between April 2009 and July 2010, but has since recovered. Conversely, fiscal retrenchment is only beginning (there are huge lags) and households still need to get their finances in order.
- **The intensity of the deleveraging dynamic will be strongly influenced by the global scene** (as a driver of income generation). The fact that most other developed economies are deleveraging at the same time means we can't take obvious elixirs like export growth for granted. However, a stronger focus on exports, unlocking natural endowments, and a rise in import penetration to key trading nations will help mitigate the degree of required domestic restraint.
- **We have to acknowledge that income growth needs to exceed cost (spending) growth for a sustained period.** If income slips, so too will prospects for spending and the converse applies. Our working assumption is that we need to see something akin to "negative jaws" of 2 percent; which means spending growth 2 percentage points below income generation. That's a big gap.
- **We see "differentiation" (of New Zealand from other nations) playing a strong role in 2012.** This really links to theme 2. But suffice to say that these are all critical elements of keeping the adjustment the economy is going through orderly in nature. These include:
  - seeing more **leadership** than populism;
  - having a **strong banking sector**;
  - **utilising our huge natural endowment**; and
  - seeing society **increasingly receptive to change** (i.e. recognising the benefits of saving over spending despite the near-term growth loss);

These factors don't remove the adjustment imperative, they merely make it easier to navigate.

### THEME 2: TRANSITIONING VIA DIFFERENTIATION

Last year we identified **five stages in the current economic cycle** and they still apply. **The first stage (A)** was the "old normal", the 2002 (or even as far back as the early 1990s) to 2007 period, where growth **was driven by excessive borrowing** and risk-taking. This led to asset price bubbles and unsustainably high wealth-induced spending, or artificial wealth. Ironically, the 1990s-2007 period was also referred to as the "Great Moderation" in recognition of a period of relative economic stability. **Stage B over 2008-09 saw the inevitable initial purging** that followed such excesses. The "Great Moderation" was nothing of the sort; spending beyond one's means turned out to be unsustainable, surprise surprise. **Stage C** was the healing or recovery process that we saw in late 2009 and first six months of 2010, helped by aggressive policy action and an inventory rebuild. "Healing" or "recovery" is probably a bit optimistic: more like **stabilisation** following capitulation, and a recoil off lows.

**The New Zealand (and global) economy entered stage D – which we call "transition", around the middle of 2010.** Normal pro-cyclical forces and drivers of the business cycle, such as consumer spending, failed to kick on and take the inventory rebuild into something of substance. That's because there's a debt "supercycle" and payback dynamic that is overwhelming the usual cyclical forces. This period is where the economy transitions on a number of levels, including **altering the mix of growth (rebalancing)** and also paying penance for prior sins, i.e. **lowering debt** as a share of GDP across Western society. This entails **a period of stuttering and "grumpy" growth (D)** as stylised below. In the final stage (E), trend growth rates (the slope) will be at least partly a reflection of the choices made in the transition stage.



## KEY THEMES FOR 2012

**The economy is expected to remain in the transition stage for a number of years.** We are not talking booms to busts, but rather a period of sustained grumpy growth: there will be growth, but not at the rates we've become accustomed to, and we'll be working a lot harder to get it. Transition will involve a number of dynamics:

- **A capped rate of growth**, as a leveraging (borrowing) tailwind is replaced by a deleveraging headwind (refer theme 1). The slope of D is less than A.
- **A different mix to growth.** It is untenable to imagine a debt-laden nation borrowing and spending its way out of a debt-induced jam. So spending sides of the economy need to underperform.
- **The re-mobilisation of resources**, including labour and capital, across sectors, as a spend-centric model is replaced by a more balanced model for growth. Capital and labour does not respond instantaneously. It will be messy. Getting the basics right, such as a well functioning education system that responds to signals from the private sector will be key.
- **Economic wobbles.** Sustained fiscal deficits and low interest rates are untenable. Markets are looking for the central bank QE "bazooka". However, it is not the job of central banks to bail out irresponsible governments, and the track record of sugar pill solutions to economic crises in the past 20 years suggests they have merely inflated the problems down the track. Sometimes you just need to bite the bullet and deliver tough love. Time is the only true healer. We're in the hands of the politicians globally to make the tough decisions.

So what determines the rate of growth in the transition stage? **The weaker the balance sheet, the greater the deleveraging headwind** holding back near-term growth. NZ is somewhat saddled here by its sins of the past. Having more flexibility across your economy in areas such as the labour market and a floating currency can assist by allowing price signals and resources to adjust more readily. On this front, NZ stands strong. Those with limited flexibility and poor price signals stand ready to repeat NZ's experience of the 1980s – zero growth over 6 years, somewhat of a dire outcome. But even for those countries, the resulting performance will probably be better than the alternative of doing nothing.

Economists can probably point to 80-odd factors that determine growth. The problem is that it's difficult to disentangle the causality, for a lot of so-called growth

determinants (such as investment) are key components of GDP themselves. We know that traditional dynamics such as population and productivity will of course be influential.

**Depopulation in Christchurch, the allure of Australia and sub-par productivity performance are challenges for NZ.**

However, **there is also a strong behavioural aspect that operates and drives an economy**, particularly when you are witnessing a fundamental change in the DNA of society, and you need the confidence of investors. **Living standards are simply not what we had convinced ourselves they were**, and we can either drop them immediately or wait (hope) and strive for income-generating capacity to catch up. And while this goes on we need to be cognisant of the economic environment: it's all about maintaining confidence, credibility and showing competence as such changes are taking place. Nothing is a problem until markets think you are a problem, and as Ireland, Greece, Italy and other highly indebted countries will bear witness, problems can turn exponentially ugly in a very short time.

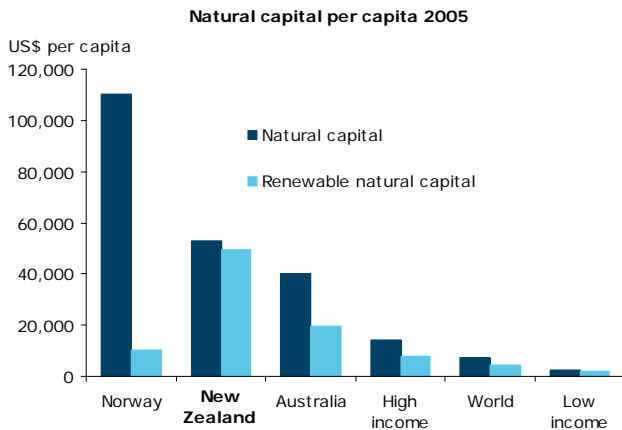
**Increasingly key for an indebted nation will be differentiation, i.e. convincing investors that you're on the right track.** We see this as a major factor determining both the rate of growth in the transition stage, and the volatility around it. Investors are eyeing the scene with confusion, and NZ is facing a marketing challenge of crucial importance.

We foresee differentiation occurring on a number of levels.

**Natural endowment.** It is easier to transition if you have strategic areas of excellence, or areas of comparative advantage. This makes it possible to get debt to GDP down by raising GDP, a far preferable adjustment path to scrimping. Structural reform agendas are easier to pursue if your endowment is high because the economic payback is quicker via avenues such as unemployment (which matters in a political sense). It is far more difficult to implement reform if the perceived payback is slow (which is one reason reform tends to be a consequence of a big-bang ex-post "accident" as opposed to being proactive). New Zealand has a lot to point to here: water and land (with Mother Nature) are clearly #1 and #2, but also energy, natural beauty (tourism), a huge economic exclusive zone, the brand NZ.Inc, food safety, minerals, potentially oil ... the list goes on. A host of these are complementary to structural changes around the globe, such as more consumption-centric growth in Asia and stronger demand for protein and fat.

## KEY THEMES FOR 2012

In fact **NZ ranks 8th in the per capita natural resources stakes globally, a few notches higher than Australia, who are often deemed the lucky country.** And in terms of per capita renewable natural capital, we lead the world.



Source: The World Bank "The Changing Wealth of Nations" 2010

**Yet there are also tensions between some of these endowments.** Unlocking them is not easy. You wouldn't want one area of strategic excellence such as mining to undermine another such as tourism, so sensible regulatory heads are required. **Moreover, having a large natural endowment does not guarantee success for a nation.** Indeed, it has historically tended to invite corruption and foreign exploitation. You need the legal/economic framework, attitudes and institutions to unlock them sensibly. Witness Congo and Switzerland. The latter has a lower natural resource endowment, but is far richer. Put simply, having the right stuff gives you a head-start. Just like successful businesses need something in their offering that is "different" (whether that be brand, relationships, or a better service proposition), the same applies for a nation. New Zealand has this in spades and it's critical, **for the more you pull an income-generating lever, the less pressure there is for austerity.**

**The political framework.** New Zealanders tend to take their lack of corruption and well-functioning political system as a given. But it matters. And while democracy may be "the worst system of governance except for all the others" in that it rewards short-term thinking, we are encouraged by the consistency being shown across the entire political spectrum towards fiscal savings and responsibility. Moreover, New Zealand has a political framework that is reasonably adaptive and receptive to change in a relative sense. Of course MMP has presented challenges. However, if you want evidence of political fragmentation and institutions that are conducive to gridlock, look no

further than the US and Europe. Our system is not perfect but it's far better than most.

**Evidence that society is "getting it".** Leadership can only take you so far – habits have to change on the ground. Our economic performance, after all, reflects the decisions of 4 million individuals, whether that's their borrowing, spending, or voting decisions. Japan's lost decade epitomises a refusal to bite the bullet. It appears in New Zealand the critical mass is now tilting towards the necessary structural change. Witness the continued uptake of KiwiSaver despite the smaller carrots, the focus on fiscal responsibility in the 2011 election, a refreshingly non-hysterical discussion of the possibility of raising the retirement age beyond the age of 65... such signals don't guarantee that society is willing to do the hard yards but they are reassuring that things are moving in the right direction.

**Microeconomic reform.** Microeconomic issues are often overlooked when assessing the macroeconomy, but as stated, the economy is the summation of its parts. It is crucial to get the right incentives in place. Tax policy is a biggie here, as well as welfare policy design, the ease of starting a business, property rights, balancing public and private interests, and avoiding corruption and rent-seeking (moulding one's economic activity around maximising returns from distortionary policies, rather than true economic profit). As a general rule New Zealand is pretty good in this area, whereas the real issue for a host of nations is microeconomic reform, and altering behaviour at the firm and individual level. Moreover, we're seeing continued tweaks. Over time, the benefits will accrue.

These factors do not deliver nirvana. Nothing does. But in a world that is "transitioning", differentiation through showing competency and maintaining confidence is key. **Such differentiation allows you to remain in control of your own destiny (and adjustment).** The alternative is the likes of Greece.

### THEME 3: SOVEREIGN RISK

**2008 was a credit crisis across the financial system, and unsustainable levels of debt to GDP were at the heart of the problem.** Between 2008 and 2011 the private sector began to improve balance sheets. However, **the ratio of debt to GDP in most Western societies is now higher than in 2008.** Private sector deleveraging has simply been replaced by sovereign and government leveraging. Some of this was a forced "socialisation" of the 2008 crisis. For example, the Irish government's net liabilities were actually zero at the end of 2007, but ballooned to over 70 percent of GDP as it nationalised some of its banks. And Ireland is not alone. The

## KEY THEMES FOR 2012

average level of net government debt across OECD countries rose from 43.9 to 62.5 percent of GDP between 2008 and 2011 and is expected to continue rising. In the US, the OECD projects that net government debt will have almost doubled from 43 to 81 percent of GDP between 2007 and 2012. A host of nations are approaching the 100 percent mark, while others such as Italy are now beyond that point.

**Fiscal solvency can quickly become problematic on five levels:** doing nothing actually makes the situation worse once confidence disappears (witness Greece's inaction), necessary fiscal retrenchment detracts from demand which makes the debt burden worse in the near-term, you have limited fiscal flexibility (which puts more pressure on monetary policy as a stabiliser, and risks undermining monetary policy independence), a huge portion of income is eaten up in debt servicing and you end up at the mercy of investors. Government's never go broke but there have been repeated times in history where investors didn't get all their money back, a dynamic that is somewhat problematic when Government bonds are characterised as risk free in some quarters!

**With attention now focused on sovereigns, we developed an indicator two years ago to assess sovereign debt vulnerability in an objective manner.** (Sovereign risk was one of our key themes at the start of 2011). Without having the massive resources of a rating agency, we simply assess each country on the basis of two broad criteria. First, we looked at "bad" or "worry" variables – things like government debt, the fiscal balance, the current account, net external debt and the unemployment rate. But we also recognised that there would be offsets, and looked at things that may buy you a bit of time – GDP per capita, population, the existence of a floating exchange rate, political stability, competitiveness etc. By comparing one set of criteria against the other, we arrived at a "net" score giving a simple metric of vulnerability for key nations.

**We collect comparable statistics across 38 countries,** comprising of the OECD and the major Asian economies. Where possible, we collect data from the same source for consistency. Negative unfavourable scores are added to positive favourable scores to arrive at an overall vulnerability score, with the most vulnerable countries having the lowest (generally negative) overall scores.

The two legs – negative and positive, are important. **Having a good favourable score doesn't eliminate challenges but they do buy you time to work issues out.** Witness the US losing its AAA status. It lived the dream for a long time, but the

market and rating agencies eventually called time. The rating is still high but rating agencies have sent a message via the downgrade.

The table below summarises the results. Nations are ranked according to the overall score, which is the net of the unfavourable and favourable numbers. But remember, this is a peer group comparison, so if everyone improves their lot, overall scores will improve. **Because investors have a choice as to where they invest, what matters most is a country's overall placing on the table.**

Country	Overall Score	Overall Rank	Prior Rank (mid 2011)
Norway	40%	1	1
Switzerland	30%	2	2
Australia	17%	3	3
Denmark	17%	4	5
Sweden	13%	5	6
Singapore	11%	6	4
Taiwan	11%	7	7
Luxembourg	10%	8	8
Canada	8%	9	9
NZ	2%	10	10
Korea	-1%	11	14
China	-1%	12	13
Czech Rep	-2%	13	15
Japan	-2%	14	12
Hong Kong	-3%	15	11
USA	-3%	16	16
Finland	-5%	17	17
Germany	-5%	18	18
Austria	-9%	19	19
Netherlands	-11%	20	20
Malaysia	-12%	21	22
Hungary	-12%	22	25
Thailand	-12%	23	24
Poland	-13%	24	21
Iceland	-15%	25	23
UK	-16%	26	26
India	-16%	27	27
Philippines	-18%	28	28
Vietnam	-21%	29	29
Indonesia	-22%	30	30
Belgium	-24%	31	32
Italy	-24%	32	31
France	-29%	33	33
Slovakia	-29%	34	34
Ireland	-30%	35	35
Spain	-38%	36	36
Portugal	-42%	37	37
Greece	-59%	38	38

Our rankings highlight several consistent points:

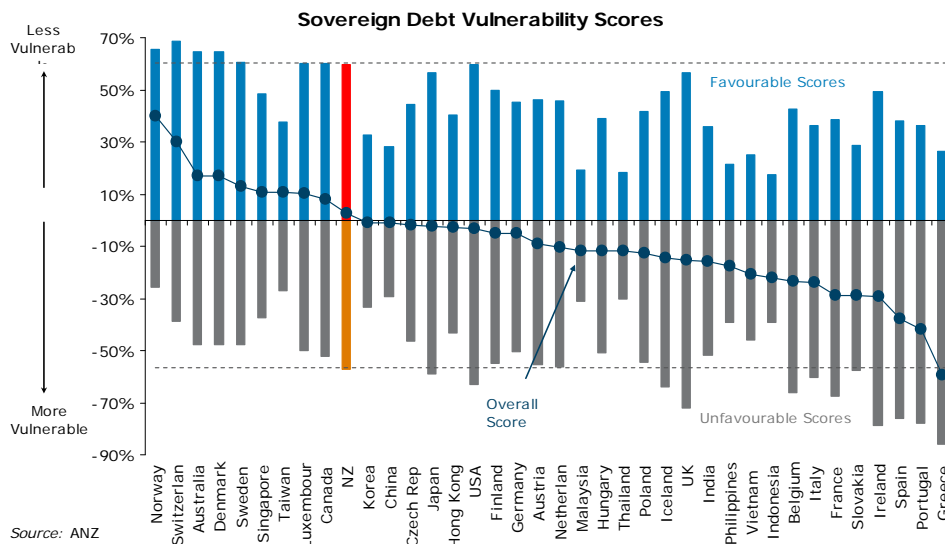
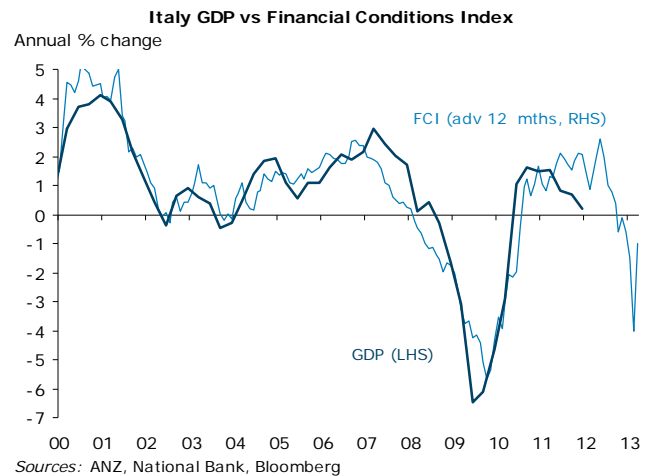
# KEY THEMES FOR 2012

- **Europe continues to dominate the problem end of the scale** and it's a reflection of both unfavourable and poor favourable characteristics. By contrast, Switzerland, Scandinavia, and the commodity countries dominate the top end. China and the more developed Asian economies are in the top half of the table;
- Big countries (like the US and UK) remain mid-table. They **have serious fiscal issues, but this is offset somewhat by positive factors** (for example, it pays to be rich);
- There has been some minor position shifting in terms of rankings in the middle of the table, but those at the top and bottom have tended to stay put. **Those in the hock are still in the hock, and those that were never in it have not been dragged in;**
- **NZ remains reasonably placed.** It ranks below average (26<sup>th</sup>) for unfavourable characteristics, a reflection of a high net external debt position and fiscal blowout in 2011, but has an above-average ranking (9<sup>th</sup>) for favourable characteristics. What is perhaps surprising is that NZ has maintained its position despite the Canterbury quakes dealing a devastating blow to public finances.

All of this leaves us with a strong feeling that the situation has not improved. There has been much talk, and arguably more "muddling through". But at some stage, push will come to shove, and tough decisions will need to be made.

The experience of Italy is demonstrative of how quickly a tailspin can develop. Once confidence is lost, borrowing costs rise, financial conditions tighten, and recessions beckon. This only lifts the debt burden further, forcing politicians to implement

austerity measures, potentially plunging the country into a deeper recession, and confidence deteriorates further, and **before you know it the downward spiral is in motion.** Remember, Italy is the 8th biggest economy around the globe and at last count the third largest borrower in the bond market. Italy runs a primary surplus but net government debt is 100.2 percent of GDP, so it has to be in primary balance just to stand still. **The problem is, in the last 6 months, Italian 10yr government bond yields have increased by around 2 percent.** Although it will take a while for rising yields to affect financing costs (the whole debt portfolio isn't rolled over every year), it tends to set off the earlier mentioned downward spiral. **Italy has certainly felt the brunt of market anger,** and as the chart below shows, although financial conditions have eased in the past few weeks as Italian bond yields have fallen, they have tightened considerably relative to where things stood in 2010 and 2011. It certainly casts a shadow over the growth outlook which exacerbates the debt problem.



## KEY THEMES FOR 2012

Italy is then, a clear example when market calls time; the game is up, hence the importance of policymakers. **In practice, this means putting our fate in the hands of politicians. Even with the best intentions, they may not be able to deliver the credible outcomes the market so desperately craves. It's not easy balancing the demands of the populous (who vote you in and out) with the market (which you depend on for financing).**

**Although New Zealand ranks fairly well overall, we are not above scrutiny by global markets and can't be complacent.** We are more "plugged in" to the global economy through trade and financial markets than ever. **Recall the "Six C's" from page 2 which we saw as crucial barometers for New Zealand – namely contagion risks, confidence (growth), cost of credit, China, commodity prices and the currency.** Witness, for example, swings in sentiment and pricing on all six of the C's that have occurred over the past year as financial markets have swung from optimism to pessimism regarding Europe. **We are simply dreaming if we think a significant shock in Europe won't cause shock waves here. The six C's are metrics that bear watching closely.**

**The past year has also taught us that we need to recognise that the politics are as (or more) important than economics. Most analysts (ourselves included) concluded long ago that the economics simply didn't stack up – once you reach a certain level of debt (and that level varies from country to country) you simply can't balance the books without negotiating with your lenders. The message here – we are reliant on politicians to deliver the goods.** Markets know this, and have tended to factor in better outcomes than the economics alone suggest is likely. **But if the politicians disappoint, we end up pricing on the back of economics, which tends paint a substantially darker picture.**

### THEME 4: ECONOMIC TENSIONS – THE INTERACTION OF FIVE SHOCKS

**The economic outlook is arguably more complicated than any time in New Zealand's economic history.** Theme 1 detailed the **structural headwinds** the economy is facing. Restoring a modicum of health to the national balance sheet is a prerequisite to any sort of cyclical upturn taking hold. This is shock 1. That means any talk of a supply-demand imbalance, housing-led upturn, or borrowing and spending our way to nirvana is premature. On top of this we have a **weak and volatile global scene** to

contend with (shock 2). We can add to that three other material shocks and tensions.

- **Rebalancing.** The economy remains lopsided, with excessive concentration in spendthrift activity, and this is at the expense of earning. Since 2004 activity in the tradable sector has gone backwards, and income growth has not kept up with spending. It will take years for resources (i.e. labour and capital) to respond to different price signals, for opportunities to be unlocked, and the DNA of society to change. Basic supply-side aspects such as the education system need to adapt: prospects for more tradable sector growth tomorrow need to be matched by fostering supply-side responses today. A failure to do so will see resource bottlenecks. We are set to see some job displacement in certain sectors over the coming year in response to structural and cyclical challenges. These resources will inevitably be remobilised to other sectors, but the transition will not be smooth.
- **A positive income shock.** We're seeing structurally higher demand for commodities, which has seen our goods terms of trade hit a 37 year high. Asia is increasingly relevant for New Zealand as an export market, with Asia ex-Japan now accounting for a third of merchandise exports, versus a quarter a decade ago. We're getting better connected in regard to the Asian region, with a free trade agreement with India currently under negotiation. But we must add a note of caution here: with exposure to the upside of Asia's potential comes vulnerability to adverse turns. And there are plenty of pundits picking an adverse turn for China in the next 12 months (see Theme 5).
- **The Canterbury earthquakes.** The impact channels are endless. Relative to the size of the economy, the estimated cost (more than 10 percent of GDP) is unrivalled globally. A lot of wealth has been destroyed and we see it as accentuating the structural change in households' savings behaviour. Canterbury's population will not be the same but the South Island needs it as a hub. We expect a net migration outflow from the region in 2012 but an inflow once the rebuild starts. There will be a massive construction response, but the ground needs to stop shaking first and Christchurch's events will alter building and insurance standards nationally. And in reality, much of what was lost cannot or will not be rebuilt, at least not in Christchurch. Nonetheless, we need to rebuild a lot of destroyed domestic capital at a time resources need to be deployed to

## KEY THEMES FOR 2012

tradable-centric areas (refer above). This risks blowing out the current account deficit unless consumption as share of GDP drops. Over time the costs of Canterbury will hit consumers' pockets via increased levies, higher insurance premiums and reduced government spending in other areas.

**These shocks are complementary in some facets but opposing in others.** Deleveraging is deflationary. Commodity income shocks and natural disasters are not (indeed, we'd put some of the current Auckland housing inflation down to earthquake migration). The income shock is helping New Zealand get its balance sheet back in order via income generation (by getting the debt to GDP ratio, the current account deficit, and the consumption to income ratio down). Conversely, rebuilding Canterbury will involve dedicating huge amounts of resources to rebuilding domestic capital (i.e. housing and infrastructure) at a time when we're also supposed to be investing in other regions and sectors to address our national indebtedness.

**To put these shocks in perspective in terms of their significance,** issues such as the leaky home/building crisis, which hasn't gone away and is hugely relevant, doesn't make our top five (deleveraging, the global scene and the three above). And if we were ranking economic developments by national significance, PSA – which is decimating the gold kiwifruit industry – would not even make the top ten. That is not to belittle the kiwifruit industry or those facing large leaky building repair bills. It's to underline **the mammoth scale of the forces buffeting the New Zealand economy** at present.

As if navigating a collection of shocks and opposing forces is not enough, there is a time limit in terms of the policy responses. New Zealand society, like many around the world, is ageing rapidly. The current superannuation system is fiscally unsustainable, and **the window of opportunity for voluntary reform,** as opposed to painful reform forced upon us with its associated "unfair" intergenerational transfers, **is rapidly closing.**

**Markets cannot focus on five major macroeconomic themes at once. They will lurch around** as focus shifts from one to the other. We can therefore expect a period of heightened volatility in financial variables. We can expect this in the real economy too. We saw it in 2011 and we expect a repeat in 2012. Various themes will dominate individually from month to month, which will make underlying assessments of the true state of affairs difficult. Just because a theme is not dominating the data-flow over 3 months does not mean it will have become irrelevant.

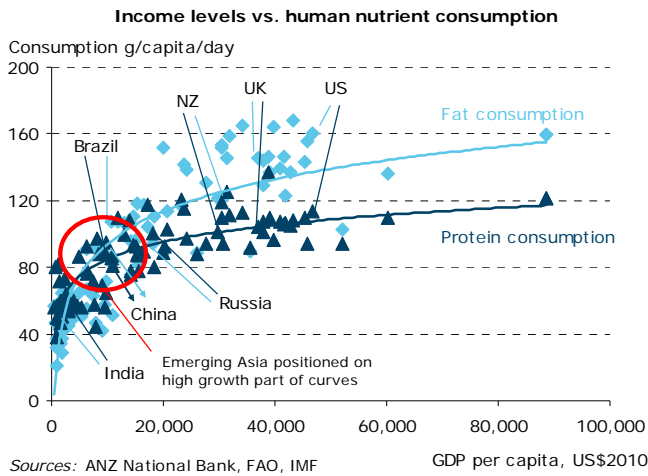
The interaction of these shocks will see **more volatility across the New Zealand business cycle than is normal, amidst a lower trend growth rate.** It will be difficult to get a steer on the true state of affairs. Data will be murky. A lot will have to be taken on faith.

**This also portends of challenges for policymakers** as they face off against voters with expectations based on a debt-accumulating world that no longer exists. Fine-tuning the supply-side capacity of the economy will take on particular importance. Things like rebuilding Christchurch and rebalancing require at their core the remobilisation of resources, and getting the right incentives in place in areas such as education will be critical. There will be trade-offs in dealing appropriately with these shocks, and **a long-term view will be key to achieving the best outcomes.** Navigating numerous shocks simultaneously ups the ante on true leadership to prevail over populism. We hope cool heads prevail and that enough of society grasps the big picture.

### THEME 5: ASIA – WITH OPPORTUNITY COMES VULNERABILITY

**The economic opportunities in Asia and even a little further up the silk route in the Middle East are unprecedented for a number of sectors that New Zealand excels in.** The "food story" of large populations increasing their protein and fat consumption with limited key natural endowments to meet these needs, has been well documented. This is further energised by rising incomes in the middle class, urbanisation and the modernisation of their food industry. This has already manifested itself in the trade statistics and a big jump in export and farm-gate prices for a number of key primary sectors such as dairy, forestry and seafood. In fact, total New Zealand trade to the Asia-Pacific region has near doubled over the last 10 years to \$26 billion per year. The region now makes up 55 percent of New Zealand's total merchandise trade, up from 42 percent 10 years ago.

# KEY THEMES FOR 2012



The opportunities do not stop there, with **New Zealand already starting to sell other products and services in farming, primary production and manufacturing to help modernise Asia’s food supply chain.** Fonterra’s investments in three dairy farms in China to supply fresh and liquid milk to the local marketplace, as well as the establishment of a scholarship fund for university education in animal husbandry and food science, are recent examples.

**Tourism is another benefactor.** Total tourism numbers from Asia (excluding Japan) have increased by 23 percent over the last 10 years. This has been led by Chinese visitors, whose numbers have tripled during this period. While total expenditure and length of stay per person is less for Asian tourists (excluding Japanese) compared with their Anglo-Saxon counterparts, this may change as time progresses. Overseas students coming to study also boost the local economy, as well as fostering longer-term business links as students return to their homeland after completing their studies, or find a job in New Zealand.

**Things such as rising connectivity, our close geographical position and the rise of e-commerce will continue to facilitate these prospects.** An increasing number of bilateral agreements with key countries such as China have opened the door for New Zealand’s wares. The countries with which New Zealand has a FTA cover 2 billion people (29 percent of global population), 16 percent of global GDP (in current prices), account for almost half of New Zealand’s merchandise trade, and importantly have been growing at a much faster rate than global growth. The FTAs under negotiation cover 1.8 billion people (26 percent of global population), 31 percent of global GDP and currently account for around 18 percent of New Zealand’s trade. If all of them prove successful, then New Zealand will have free access to 56 percent of the world’s population accounting for close to half of global GDP. This

represents a big playground for a country of just 4.4 million people.

In many cases, we have been the first across the line, or in the lead, which allows us to establish a beachhead versus our competitors. The rise of e-commerce is another mega-trend directly linking trade in a low cost manner, creating cheaper imported goods such as flat screen televisions and an even larger playground for our clean, green and safe primary exports. An example is the success of GlobalDairyTrade in accessing a broader range of customers at a low cost.

Country	GDP US\$b in current prices	Population (millions)	Average real GDP growth past 10-years	% of NZ exports	% of NZ imports
<b>FTA in force or about to be in force</b>					
Australia	1,507	22.5	3.0	22.6	16.3
Singapore	266	5.3	6.3	1.7	4.8
Thailand	339	64.3	4.5	1.6	3.0
Brunei	16	0.4	1.4	0.0	0.9
Chile	243	17.4	4.1	0.1	0.1
China	6,988	1348.1	10.6	12.4	15.8
Myanmar	50	62.4	9.8	0.0	0.0
Philippines	216	95.8	5.0	1.6	0.3
Vietnam	122	89.3	7.2	0.9	0.6
Cambodia	13	14.4	7.7	0.0	0.0
Indonesia	834	240.5	5.5	1.9	1.3
Laos	8	6.6	7.5	0.0	0.0
Malaysia	248	28.7	5.1	1.8	3.3
Hong Kong	247	7.2	4.6	1.6	0.4
<b>Total</b>				<b>46.3</b>	<b>46.8</b>
<b>FTA under negotiation</b>					
Bahrain	26	1.1	5.6	0.1	0.1
Oman	67	3.1	4.5	0.1	0.8
Kuwait	171	3.7	6.0	0.2	1.2
Saudi Arabia	560	28.2	3.9	1.5	1.4
UAE	358	5.4	5.8	1.1	1.6
Qatar	173	1.8	14.4	0.1	1.8
Korea	1,164	49.0	4.2	3.5	3.2
India	1,843	1206.9	7.8	2.1	0.8
Russia	1,885	142.4	4.8	0.7	2.6
Belarus	58	9.4	7.5	0.0	0.0
Kazakhstan	180	16.5	7.6	0.0	0.0
Peru	168	30.0	6.3	0.2	0.1
US	15,065	312.9	1.6	8.3	11.1
<b>Total</b>				<b>17.9</b>	<b>24.7</b>

Sources: ANZ, IMF, Statistics NZ

**However, while Asia has been a strong focus opportunity wise for investors, particularly since 2008 and there are further opportunities to exploit, Asia is not immune to what is happening elsewhere in the world.** It is subject to business cycles, and countries such as China have their own unique structural economic issues that need to be addressed. With New Zealand more reliant on Asia, we are also increasingly susceptible to what happens there.

In our view, key issues to keep an eye on in Asia in 2012 will be:

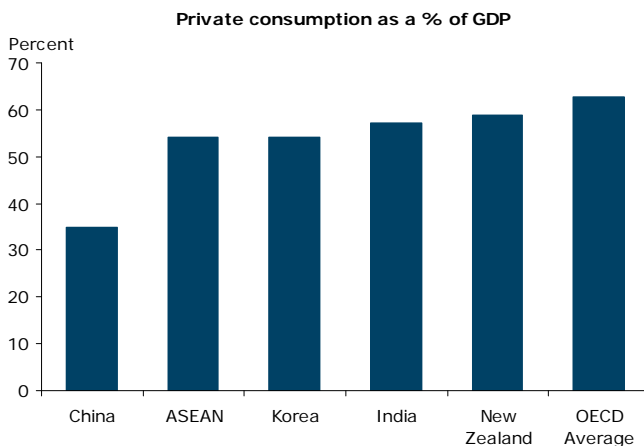
1. **Growth and trade.** The more open economies are more sensitive to changes in global growth and have higher downside risks. This means we can’t divorce China *et al* from European



## KEY THEMES FOR 2012

developments, and remember our largest trading partner Australia is also strongly Asia dependent.

2. **Private consumption.** Asia must progress towards more economic growth coming from private consumption instead of being reliant on the traditional export and investment model. Much has been penned about the challenges in getting Western society to alter its behaviour. Asia has challenges here too. Change is a slow moving beast.
3. **Financial tail wags real dog.** Market turbulence lowers asset values, confidence and growth. Our financial conditions measures for Asia have a high weight on asset prices; in some cases they are extreme. This high correlation in itself leaves us uneasy regarding how much of the Asia growth story may have gotten ahead of itself.
4. **Bank funding.** Financial systems that rely on wholesale funding (loan/deposit > 100 percent) are at risk if inter-bank flows dry up.

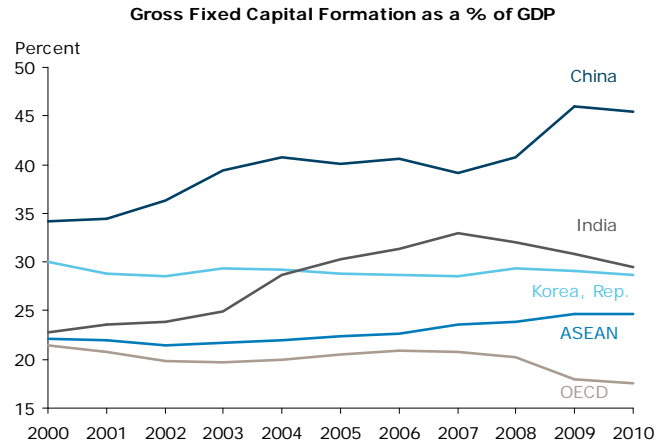


Sources: ANZ, National Bank, The World Bank

Many of the economies in Asia have been through a tightening of macro and fiscal policy over the last 12 months to dampen down inflationary flames. In many countries, monetary policy was "behind the curve" in 2011. **With growth in a cyclical downturn, inflation still persistent in some economies, and a deterioration in Europe's economic prospects (Asia's largest trade partner), walking the tight-rope of keeping inflation under control but not over-shooting the mark and choking off economic growth will be tricky.**

**This is especially the case where the traditional model for growth in many cases has been export-led industrialisation, supported by weak currencies. It has produced high net export and fixed capital investment shares and a lower consumption share of GDP.** The squeeze could come on very

quickly should trading partner demand dry up, especially for those economies that are more open.



Sources: ANZ, National Bank, World Bank

**Longer-term, net exports, fixed capital investment and saving needs to fall as a share of GDP, while private consumption needs to sharply rise.** This is a particular issue for China but also a familiar theme for many other ASEAN countries where private consumption as a percentage of GDP is well below the OECD average. The challenge of increasing private consumption before the investment boom turns into a bust cannot be overstated in countries such as China that are still heavily controlled by the State. **High saving rates and low private consumption are structural issues that will take years of politically difficult reform to change.**

**If financial market turbulence and policy responses hit capital investment growth, this would have a disproportionate effect on growth in countries such as China and India.** The lead indicator of such a change will be international prices for key hard commodities such as copper, iron ore, nickel and the like, with China now consuming 40-50 percent of global trade in these products. Late 2011 falls in these metals may be telling.

**The other challenge that could possibly hurt the credit cycle and growth in some Asian economies is European banks massively contracting their balance sheets by calling in, or not rolling over, loans.** In general European banks' gross assets in Asian economies rarely exceed 10 percent of total outstanding domestic credit. Loan-to-deposit ratios in most of Asia are well under 100, implying low reliance on offshore wholesale funding. However, India, Vietnam, Korea and Australia, despite recent improvements, are the most vulnerable if this were to occur.

## KEY THEMES FOR 2012

### THEME 6: THE GRAND FINALE – GAME THEORY AT PLAY

**The challenges for the global economy are well documented.** There is simply too much debt. A host of governments face solvency challenges. The global economy is unbalanced: excessive saving in the East is financing consumption largesse in the West. Governments have been on a borrowing bender. Illustrating the scale of the global economy's challenges is the fact that Middle East tensions barely rate a mention from night to night. At any other time in the past century, it would have had us on tenterhooks. This is not to downplay the significance of it; it is a reflection of the attention being paid to other challenges and issues.

**Ask any economist and they can offer a host of solutions:** we need more consistent global oversight of the financial system; government spending needs to be reduced or at least better contained; protectionist barriers need to be broken down; tax systems should be simplified; relative price signals, including currencies, need to be allowed to adjust; to name but a few.

**Solutions are easy to identify; it is implementation that is difficult, for we are in the realm of politics and there is a group dynamic to it, as well as a host of considerations that go beyond pure economics.** Witness trade tensions between the US and China; the furore over a financial transactions tax between the UK and France/Germany; uncertainty over pending bank regulation and the likes of Basel; street protests against austerity measures; the rise of nationalist parties in Europe *et al.* These are non-trivial tensions that illustrate the difficulty getting a truly unified response.

**The global economy is desperately looking for leadership.** Probably the most important aspect of the leadership challenge is achieving significant fiscal austerity to demonstrate solvency. While this is an immediate drag on growth (and Keynesian economists would argue for more as opposed to less fiscal stimulus at this juncture), businesses and markets also need certainty that the medium to long-term picture is sustainable. Lacking such certainty, hiring and investment decisions go on hold. While providing certainty is not without challenge (i.e. less government spending or higher taxes detract from aggregate demand) it leaves the business sector and markets with greater confidence over the medium term, an essential driver of investment and hiring decisions.

**Will politicians make the hard decisions?** They have avoided them, as much as possible, so far. If monetary policy is typically behind the 8 ball, fiscal

policy typically hasn't turned up at the venue yet. Standard & Poor's downgraded nine nations' sovereign debt ratings last week, commenting that "the policy initiatives taken... may be insufficient to fully address ongoing system stresses". The Eurozone crisis unfolding at present, if left unchecked, could quickly engulf the US next. Doing nothing is not an option. But this does not necessarily mean the "right" thing will be done. **Rather than go into the ins and outs of the various challenges in a political sense – which are huge – we turn to game theory,** and in particular the prisoners' dilemma, which illustrates the **tension between group and self interest.** This dynamic is played out time and time again around the globe. Remember, global problems require truly global solutions.

This is how it works. Two men are arrested on suspicion of robbing a bank, but the police do not have enough evidence for a conviction. Following the separation of the two men, the police offer both the same deal – if one testifies against his partner (defects), and the other stays quiet (co-operates with his partner), the betrayer goes free and the co-operator receives the full 5 year sentence. If both remain silent, both are sentenced to only 6 months in jail on a minor charge. If each 'rats out' the other, each receives a 2 year sentence. Each prisoner must choose to either betray or remain silent; the decision of each is kept quiet. What should they do?

	Prisoner 2 stays silent (co-operates)	Prisoner 2 confesses (defects)
Prisoner 1 stays silent (co-operates)	Each serves 6 months in jail	Prisoner 1: 5 years Prisoner 2: goes free
Prisoner 1 confesses (defects)	Prisoner 1: goes free Prisoner 2: 5 years	Each serves 2 years

The best outcome for the prisoners is that they both stay silent or "co-operate" with each other, as this minimises their jail time. However, a closer look at the payoff matrix reveals a range of possible outcomes. Consider prisoner 2. They don't know what prisoner 1 will decide. If prisoner 1 stays silent, they are best to confess, going free rather than serving 6 months. If prisoner 1 confesses, they are still best to confess (2 years rather than 5 years). Individually, the optimal strategy for both prisoners is therefore to confess, even though this leads to a worse outcome for the group than staying silent.

**Politicians face a similar situation when trying to agree on solutions to the global problems.** Where

## KEY THEMES FOR 2012

tension exists between a country's own best interest and the group's best interest, a less than optimal solution is highly likely. This is especially the case in Europe where the monetary union exacerbates the situation, limits the available solutions, and heightens the trade-offs between the optimal and actual outcomes of decisions. Each country is looking out for its own banking sector, its own export sector, and its own credit rating. Worse still, each politician is looking out for their own re-election chances. The UK's recent decision to opt out of the EU-wide negotiations on a new fiscal treaty was a case where self-interest (avoiding curbs on London as a financial hub) trounced group interest (a unified front).

**So how does the grand finale look?** We are not sure. The *hope* is that enough will be done to head off problems before they arise. The *fear* is that a) the later you leave it the more exponentially difficult the decisions become (and for politicians there are no easy choices in 2012), and b) individual interest will dominate group interest, and the combination will lead to **an accident of sorts before mandates are given to make the hard choices – whether that's a true political mandate, or sheer will forcing through the tough leadership solutions regardless of the damage it does to politicians' re-election chances.** For an example of this in New Zealand, think back to 1984 and 1990 when incoming Governments were forced to make wholesale changes to avert otherwise disastrous consequences. We envisage this dynamic playing out for a host of nations. Upcoming elections (Finland, Greece, Russia, Slovakia, and France in the first half of this year alone) may be preventing politicians from making the tough calls now, but they are also an opportunity. It's easier for a new Government to implement unpopular measures and blame their predecessors for making it necessary.

**Can an accident be averted? Yes.** Theme 2 – "Transitioning via differentiation" applies. It's about showing competency, confidence and credibility. Going back to our Prisoners' Dilemma example and application of game theory, if the game is played repeatedly, players can ultimately end up with the "Pareto Optimal Solution". Oil cartels succeed, even though everyone at any given time has an incentive to cheat by increasing their production, because everyone is in it for the long haul. Arguably, the 2008 GFC should serve as the "lesson" regarding short versus long-term thinking. **Yet when we consider the cultural and attitude differences in the West and the East,** and prospects for Europe corralling 17 euro member nations (and 27 in the EU) into some sort of fiscal union, which is required

for the euro to survive, well, **it just seems a bit of a stretch.**

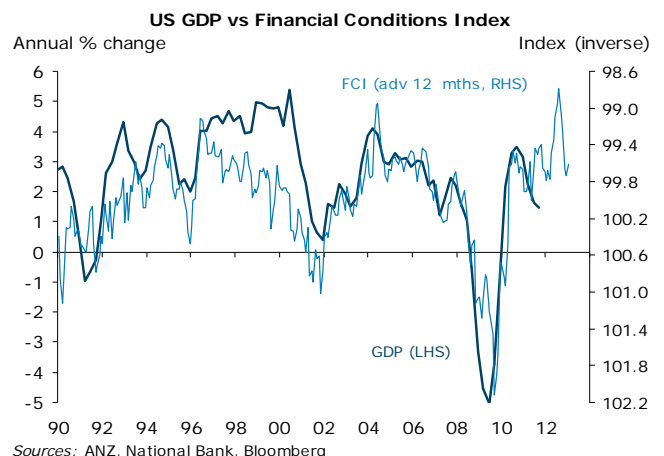
### THEME 7: DESYNCHRONISATION

**As a baseline assumption we view the world as "coupled" in a growth sense,** such is the strength of trade and financial linkages. Historically, Western economy business cycles have tended to be well correlated. The emergence of China as an economic powerhouse has added a twist to this – they were a key source of global stabilisation in 2009 – but has not fundamentally altered the core proposition of coupling.

However, we are also mindful of growing disparities in terms of growth prospects across key regions that point to the possibility of decoupling. **To give us a steer, we track financial conditions across an array of countries.<sup>1</sup>** While they do not track perfectly, we generally find that financial conditions give a good lead on GDP, with lead times ranging from 3 – 12 months depending on which country we're looking at. They also tend to give a reasonable lead on turning points in the cycle. An added advantage of our approach is that it is not a black box approach, and can help quantify the impact of each potential channel on base momentum.

A quick look at our financial conditions measures across key regions highlights the disparities.

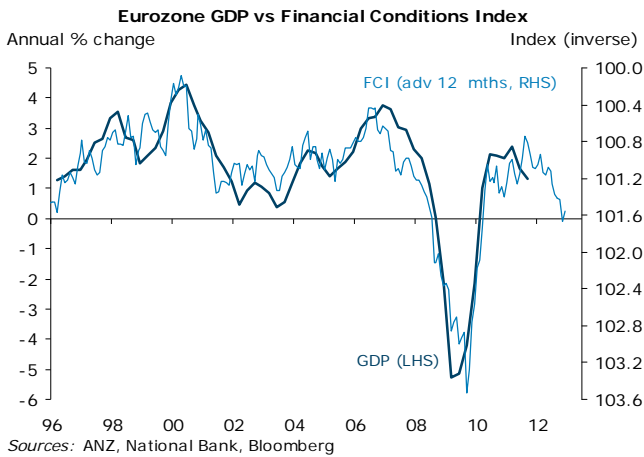
- **Prospects for the US look fairly solid.** The "level" of conditions has come back thanks to an unwind of the surge in M2 money supply (i.e. QE2), but they still point to growth of around 3 percent.



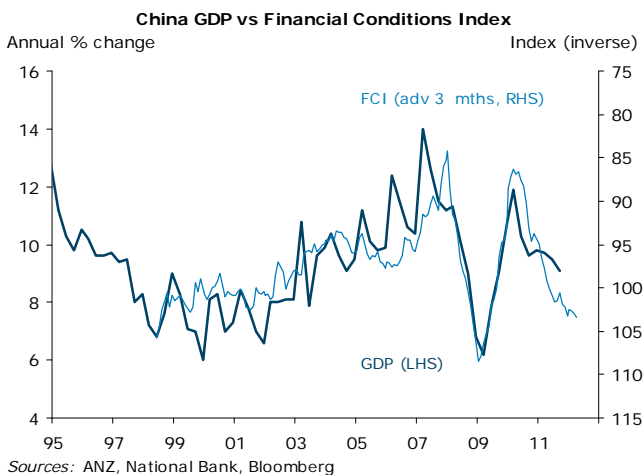
<sup>1</sup> Our financial conditions index summarises a range of financial variables into a single series that can be used to predict the future path of the economy. Where available, our FCI includes the currency adjusted for commodity prices or terms of trade movements, interest rates, asset prices, credit growth and proxies for the cost and availability of credit.

# KEY THEMES FOR 2012

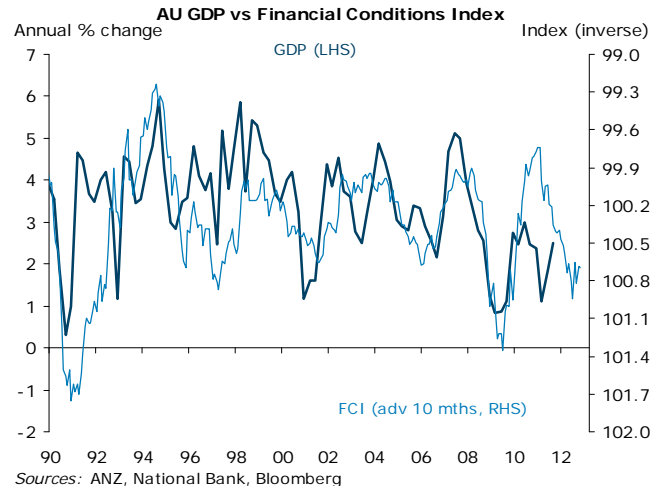
- By contrast, **our Eurozone FCI is pointing to a sharp slowing in European growth**, and the possibility (we would say inevitability) of recession. Of course, conditions vary markedly across Europe, and remain upbeat in Germany. But Italy, Spain and Greece muddy the waters.



- Our FCIs are flagging a slowdown in China** too, adding weight to fears that some moderation lies ahead. Monetary policy can help, but with China potentially slowing, the onus is on some other larger country (like the US) to take up the slack. Positive as the outlook is for the US, a rebound is by no means guaranteed.



- Our FCIs also point to some moderation in Australia.** If one were to be optimistic, one would say that our FCIs point to a soft landing in Australia. If one were to be pessimistic, one might say that such an outcome would still be a shock to an economy used to uninterrupted growth.



**Does this mean we should reject the coupling thesis? Not necessarily.** But we need to acknowledge the barrage of structural forces that are relevant and influencing a greater than normal amount of de-synchronisation in the near-term growth stakes. Such forces include:

- Your opening position, including your national balance sheet. The bigger the pickle and balance sheet headwind, the larger the sacrificial payback.
- The rebalancing of the global economy is presenting challenges. A need for more consumer-centric growth in the East (which is supporting commodity demand and prices) is being countered by deleveraging headwinds in the West.
- It's a confidence game, far more so than normal. As we noted in our sovereign risk theme, the economics ceased stacking up for some countries a long time ago. Markets will be prepared to give politicians some benefit of the doubt, but only if there is confidence in the system.
- Differing policymaker reaction functions. Most notable here is the divergence between the Fed and the ECB, with the former putting a higher weight on growth (or unemployment) relative to inflation.
- Relative price signals such as currencies will ebb and flow, altering relative growth prospects. Some have the ability to ebb and flow more widely than others.

**We admit that indicators such as financial conditions have limitations.** Our FCIs are a reduced form and do not capture all of the many influences on growth, but then again, what approach could, especially when confidence and risk appetite are such key drivers, and we are in the midst of a once in a generation structural realignment! The world



## KEY THEMES FOR 2012

economy is undergoing a period of considerable change, and with the financial system playing an increasingly important role in the economy, our approach has advantages over traditional macroeconomic modelling approaches. We have been careful not to over-fit our FCIs, and have continued to use them to identify trends in momentum and potential turning points rather than as a forecasting tool. **As such, our FCI measures should be interpreted as an indicator as to the direction for base momentum within an economy, as opposed to the general rate of growth itself.**

**The messages across our financial conditions measures are simple.**

- **Regions face divergent prospects.** Financial market variables – including currencies – will ultimately realign financial conditions somewhat. For instance, it is difficult to imagine recession-bound nations having their currencies bid up in a sustained fashion, providing a natural counter.
- **Diverging prospects means more uncertainty.** It also gives rise to more “key man risk”. That is, it is crucial that we see a recovery in the US. Indeed, if we assume our FCIs are good predictors, the US is the only major economic area expected to recover this year. If it doesn’t, we’ll be wrong, because things will synchronise again, only it will be a synchronous slowing.
- **Beware nations that can’t achieve 2 percent growth, a debt spiral may beckon.** Debt and deleveraging will be a significant determinant of growth prospects. But you need sufficient growth (the denominator in debt/GDP) to keep the debt burden in check. If we see downward debt spirals start to emerge, then the hurdle for growth only increases. That is, it’s not good enough for our FCIs to just flag growth, they need to flag enough growth for a country to be able to turn a primary surplus, so as to keep overall debt levels in check. If net debt stands at 100 percent of GDP, as it does in Italy, every 1 percent rise in funding costs means you either need to grow 1 percent faster, or run a 1 percent bigger surplus. Yet as we know, the more one tightens the fiscal belt, the harder it is to grow. Ironically, when it’s funding costs that are doing all the tightening, the tighter FCIs get, the higher the required growth hurdle. We don’t know exactly what the magic growth number is, but with funding costs up across the globe, and debt rising quickly, 2 percent growth would seem to be a minimum aspiration. Beware countries where prospects for nominal GDP are below borrowing costs.

### THE UPSHOT

**So what do all these themes in aggregate mean for the NZ economy?**

- A bumpy year, particularly for the domestic economy (themes 1, 2, 3, 4). We’ve pencilled in 2 percent growth. It’s enough to get by and help slowly push the unemployment rate lower.
- NZ will still perform better than most across the OECD (theme 2, 3 and 5). Two percent growth is not stellar but relative to others NZ will look solid.
- There is still more downside risk than up (theme 3 and 6). Where the world goes, NZ follows. We’re in the hands of the European politicians.
- Fiscal policy (number 2 the Terrace) to supercede monetary policy (number 1 the Terrace) in importance (themes 2, 3 and 5). We can remain masters of our own destiny to a degree. The NZ Treasury need to take a stronger role in the leadership space.
- A lack of clear trends across financial market variables (themes 2, 4 and 7).

# INTEREST RATE STRATEGY

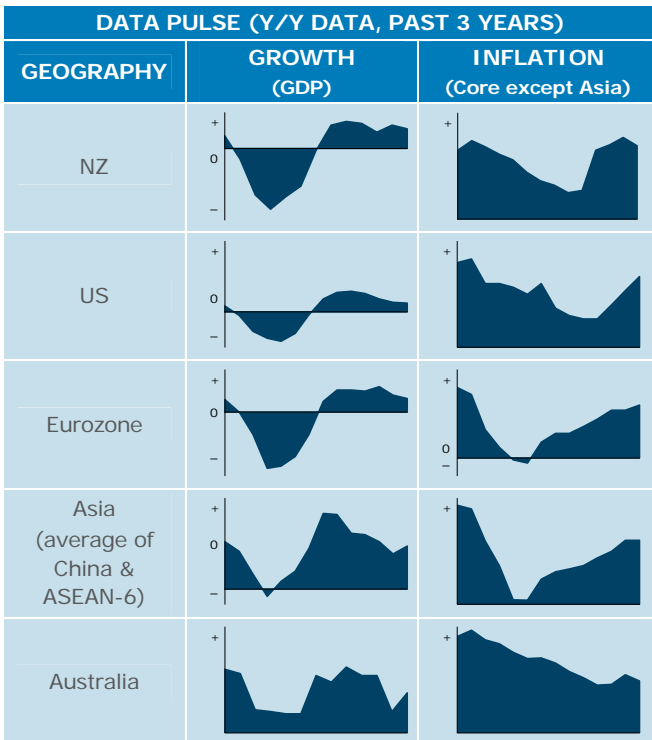
## SUMMARY

Familiar themes continue to dominate the outlook, and leave us circumspect. These include the European sovereign debt crisis, continued conjecture of QE3 amidst some signs of better data-flow, deleveraging, and heightened uncertainty. So although interest rates are close to multi year lows, with monetary policy on hold or easing across much of the world and slow growth set to be the norm, that yields are low is not a guarantee that they will rise. Expect NZGS to be well supported given the carry available, and distance from Europe. For borrowers, consider swaptions.

## THEMES

- The big issues that dominated in 2011 will also dominate 2012. But they have intensified, raising the stakes. This is a supportive environment for NZGS bond yields.
- With risk appetite crumbling, expect a focus on safety and carry – which favours New Zealand.

## DATA PULSE



## PREFERRED STRATEGIES – INVESTORS

With yields near historic lows and signs of a seasonal improvement in sentiment often seen at the start of the year, it is not surprising that many analysts are calling for a trend rise in bond yields. This notion is further supported by the improving tone of US data. However, the outlook is also clouded by heightened uncertainty in several key areas. Indeed, the

sovereign debt crisis remains far from resolved, and in fact, developments over the weekend have raised the stakes. The US housing market remains in disarray, the Fed may yet opt for QE3, and the RBNZ is months (if not over a year) away from tightening. This is hardly a bearish environment for bonds, and as such our bias is to be long, and to benefit from significant positive carry in both swaps and bonds.

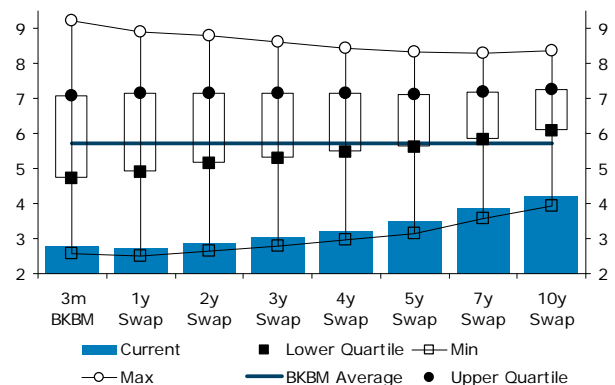
KEY VIEWS – FOR INVESTORS		
GAUGE	DIRECTION	COMMENT
Duration	Long	Yields are low, but the case for higher yields is unclear.
Curve	Neutral/ flatter	Biased towards flatteners on account of huge +ve carry.
NZ-US 10y spread	Narrower	Spreads have edged out in recent days
Swap spreads	Wider	At recent wides, but biased to continue widening over time.

## PREFERRED STRATEGIES – BORROWERS

With the RBNZ on hold for the foreseeable future (and that could be for more than a year) it doesn't seem like there is any great urgency to hedge. However, it would be irresponsible not to have some cover in place and we need to acknowledge inflation risks not from demand or from contestable pockets but via non-contestable areas and supply shocks. Swaptions look attractive here. They have lower implied volatility than caps and are arguably a better way to get term protection on while still enjoying low floating rates. If you buy a cap you're paying for upside protection from day one, which is of no value.

KEY VIEWS – FOR BORROWERS		
GAUGE	DIRECTION	COMMENT
Hedge ratio	Mostly floating	Swaptions look more attractive than caps/collars.
Value	Good	Still historically cheap.
Uncertainty	High	Optionality makes sense here.

NZ Swap Rate History (since the OCR introduction)



Sources: ANZ, National Bank, Bloomberg



# INTEREST RATE STRATEGY

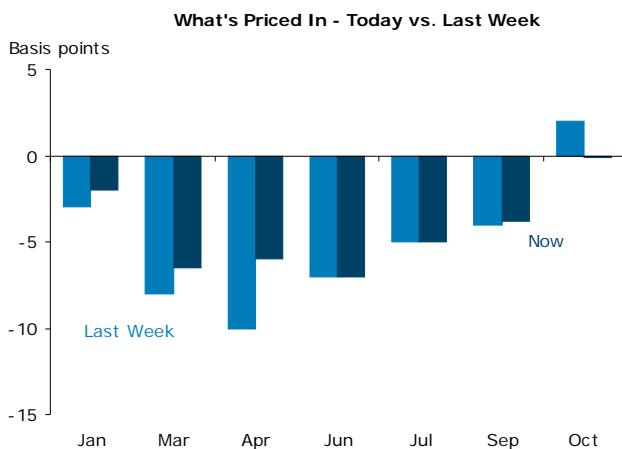
## GLOBAL SCENE

Europe remains the key focus, and news on Friday that S&P had downgraded 9 Eurozone sovereigns (including France and Italy) and placed a further three on negative watch has done nothing to calm rattled nerves. Market reaction to the news has so far been muted (at least in comparison to some of the swings seen in the past). We suspect this is due to the fact that a) the announcement came out after the European market had closed, and b) because it had been rumoured for some time. Nonetheless, the stakes have now been raised a notch, and we are now at the mercy of politicians. This adds enormously to the risk profile, and we'll be watching funding markets closely as this is where the links to NZ are critical. We're certainly left with the feeling that if you wanted the year to start on a sour note, it doesn't get much more sour than this.

## DOMESTIC

This is a big week for data, with CPI and the QSBO particularly key. Although it is well expected, the fact that headline CPI will drop from 4.6 percent to around 2.5 percent courtesy of GST falling out of the calculation may catch some (positively) by surprise. Even so, local considerations will play second fiddle to global issues. Or perhaps put another way, if we're going to see a 20bp move in yields, it won't be because of domestic news, it will be on the back of something offshore. News that Christchurch could see tremors for a decade to come certainly put plans for rebuilding at risk, and remove what many had been expecting to be a major source of new activity.

## MONETARY POLICY AND MARKET PRICING

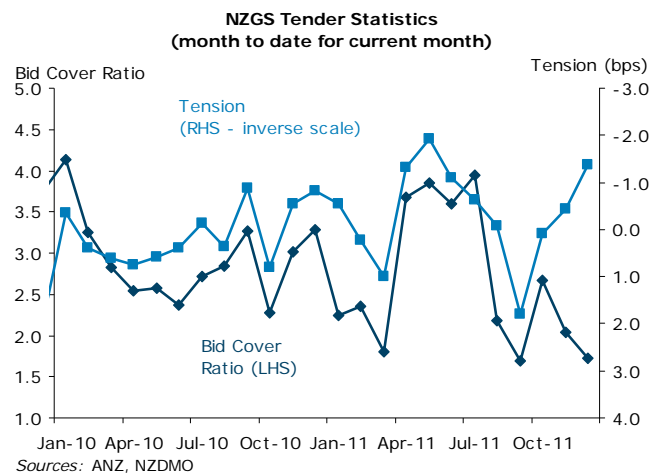


Market pricing remains somewhat in limbo, in that the market is pricing in the risk of something it doesn't really believe will happen. We believe it is appropriate for the market to be pricing in cuts (rather than hikes) given the risk profile. After all, it is easier to imagine

some offshore crisis forcing an OCR cut than it is imagining a domestic rebound necessitating a hike. Whatever the case (whether or not the RBNZ cuts), we prefer to be long the long dated OIS and short the near dates on the basis that if we do see a cut, it will be later rather than sooner, and the market will gun for more. But if we don't (as we expect), then what is priced in by March will eventually be ironed out. Of course, it is likely that markets move in the near term to price in more cuts.

## BONDS

With risk appetite much-reduced, investors are likely to be focussed on yield and stability, and few markets are as far away from Europe or offer the carry NZ has to offer. This should add support to local yields, especially in the middle of the curve, where butterfly spreads have widened. Although we do like bonds, bond supply at the weekly tenders has been limited, as the chart below shows. While this has helped preserve price tension, at some stage issuance will need to be ramped up to meet annual targets, and it remains to be seen whether there will be sufficient demand. We think the European crisis will play into New Zealand's hands, but we can't be complacent.



## SWAPS AND SWAP SPREADS

We have seen nothing but pay side pressure since year end, taking bellwethers like the 2yr to the top of trading ranges. Given the "risk off" tone, outright swap yields are biased lower, with corporates reluctant to pay and investors chasing yield in a risky environment. Swap spreads tend to widen in a credit stressed environment, but what makes the current situation difficult is that it is a sovereign debt crisis!

## RELATIVE VALUE

NZGS 5/21s look cheap versus Treasuries at around +200bps, especially in light of European concerns.

# CURRENCY STRATEGY

## SUMMARY

No surprise – France loses its AAA S&P rating, but the surprise is that the downgrade was only one notch. That together with the breakdown of Greek debt talks suggest that the FX markets should get ready for a disorderly default by Greece. US data continues to be stable with the passage of time working its magic. NZDUSD has delivered yet another positive year-end performance and we watch for the usual end of January correction.

## MARKET THEMES

- No good news from Europe and none on the horizon.
- NZDUSD seasonality suggests downside potential for the rest of January.
- 2012 could be the year of the USD. NZD tends to perform well against other currencies in a rising USD environment. Caveat here is positioning that is extremely short the EUR vis-à-vis the USD.

## REVIEW AND OUTLOOK

**There continues to be no good news out of Europe hence the EUR still looks vulnerable.** The downgrade of France and Austria should not be a surprise being mooted by many for some time now. Together with the breakdown in talks to organise an orderly restructure (read semi-default) of Greece's debt, a Eurozone breakdown of some description seems inevitable. Greece is now at a point of no choice and cynics might say the current delaying tactics are buying time to print Drachmas. A disorderly Greek default seems only a matter of weeks away. It will be a significant event, but also a purging that allows Europe to finally move forward. The FX market is divided on what this will mean for EUR direction but in our view the EUR is not the only game in town so a lower EUR seems the most likely course.

**The NZD end of year seasonal rally came again for the 20<sup>th</sup> year in a row.** The same evidence shows that the NZD has fallen in the last 2 weeks of January every year as well by an average of 4.3% so statistics have us wary of a NZD fall in the short term. Looking further out, if 2012 is indeed the year of the USD we can expect some NZD weakness vs the USD but may see strength against other currencies (particularly the AUD).

**The NZDAUD broke through resistance at 0.7660 last week and now looks set to move higher.** The price action refocused the FX market on this cross but risk/volatility intolerance has seen players cut positions at any hint of a change in direction. This will make further progress up a slow grind but we remain

confident that the conditions are in place for a NZDAUD in the low 80 cent zone during this year.

### **The USD has the potential to stage a rebound in 2012 if policymakers don't lose their nerve.**

Evidence suggests that the US is in recovery mode, just not to the degree that we are used to experiencing. The passage of time is working its magic in gradually healing the impact of the GFC train wreck but a lot more time is required. Absent a QE3 the USD has the potential to look the "least worst" of the major free floating developed markets currencies in 2012. (If we include the NZD, it may well experience some safe-haven status with good growth prospects, stable frugal government and good quality banks).

NZD VS AUD: MONTHLY DIRECTIONAL GAUGES		
GAUGE	DIRECTION	COMMENT
Fair value	↔/↑	Undervalued on a near-term cyclical basis.
Yield	↔	RBA narrows interest rate differential but still large.
Commodities	↔	Commodities lower.
Partial indicators	↔	Leading indicators are slowing.
Technicals	↑	Turned up, positive outlook.
Sentiment	↑	See NZD undervalued vs. AUD.
Other	↔	Global sentiment big driver.
<b>On balance</b>	↑	<b>NZDAUD specific interest has re-entered the market.</b>

NZD VS USD: MONTHLY DIRECTIONAL GAUGES		
GAUGE	DIRECTION	COMMENT
Fair value – long-term	↓	Above revised structural fair value estimate of 0.70.
Fair value – short-term	↔	Closer to short-term FV.
Yield	↑	Official rates to stay low but investable yields support.
Commodities	↔	Softs not bad.
Risk aversion	↔	Positive US data and short covering leads to risk on.
Partial indicators	↔	NZ data now mixed. US data improving.
Technicals	↔↓	Technical bounce done.
AUD	↔↓	Bullish correction has run its course?
Sentiment	↔	Seasonal sell-off possible.
Other	↔	Nothing apparent.
<b>On balance</b>	↔↓	<b>Holiday hangover possible.</b>

## DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
16-Jan	NZ	Food Prices (MoM) - DEC	--	0.2%(a)	10:45
	AU	TD Securities Inflation MoM% - DEC	--	0.5%(a)	12:30
	AU	TD Securities Inflation YoY% - DEC	--	2.4%(a)	12:30
	UK	Rightmove House Prices (MoM) - JAN	--	-0.8%(a)	13:01
	UK	Rightmove House Prices (YoY) - JAN	--	0.4%(a)	13:01
	AU	Home Loans MoM - NOV	--	1.4%(a)	13:30
	AU	Investment Lending - NOV	--	1.8%(a)	13:30
	AU	Owner-Occupied Home Loan Value MoM - NOV	--	2.2%(a)	13:30
	AU	ANZ Job Advertisements (MoM) - DEC	--	-0.9%(a)	13:30
	GE	Wholesale Price Index (MoM) - DEC	--	0.7%	20:00
	GE	Wholesale price Index (YoY) - DEC	--	4.9%	20:00
	CH	Actual FDI (YoY) - DEC	--	-9.8%	16-18 Jan
	NZ	REINZ Housing Price Index MoM% - DEC	--	1.1%	16-18 Jan
	NZ	REINZ House Sales YoY% - DEC	--	16.9%	16-18 Jan
17-Jan	NZ	NZIER Business Opinion Survey - 4Q	--	25	10:00
	NZ	NZ Card Spending - Retail MoM - DEC	0.2%	-0.5%	10:45
	NZ	NZ Card Spending - Total MoM - DEC	-0.2%	-0.2%	10:45
	CH	Industrial Production YTD YoY - DEC	13.8%	14.0%	15:00
	CH	Industrial Production (YoY) - DEC	12.3%	12.4%	15:00
	CH	Real GDP YTD (YoY) - 4Q	9.2%	9.4%	15:00
	CH	Real GDP (QoQ) - 4Q	--	2.3%	15:00
	CH	Real GDP (YoY) - 4Q	8.7%	9.1%	15:00
	CH	Retail Sales YTD YoY - DEC	17.0%	17.0%	15:00
	CH	Retail Sales (YoY) - DEC	17.2%	17.3%	15:00
	NZ	Non Resident Bond Holdings - DEC	--	60.2%	15:00
	UK	DCLG UK House Prices (YoY) - NOV	--	-0.4%	22:30
	UK	CPI (MoM) - DEC	0.4%	0.2%	22:30
	UK	CPI (YoY) - DEC	4.2%	4.8%	22:30
	UK	Core CPI YOY - DEC	3.0%	3.2%	22:30
	UK	Retail Price Index - DEC	239.1	238.5	22:30
	UK	RPI (MoM) - DEC	0.3%	0.2%	22:30
	UK	RPI (YoY) - DEC	4.7%	5.2%	22:30
	UK	RPI Ex Mort Int.Payments (YoY) - DEC	4.9%	5.3%	22:30
	EC	Eurozone CPI - Core (YoY) - DEC	1.6%	1.6%	23:00
	EC	Eurozone CPI (MoM) - DEC	0.4%	0.1%	23:00
	EC	Eurozone CPI (YoY) - DEC	2.8%	3.0%	23:00
	GE	Zew Survey (Current Situation) - JAN	24.0	26.8	23:00
	EC	ZEW Survey (Econ. Sentiment) - JAN	--	-54.1	23:00
	GE	ZEW Survey (Econ. Sentiment) - JAN	-49.2	-53.8	23:00
18-Jan	US	Empire Manufacturing - JAN	11.0	9.5	02:30
	AU	Westpac Consumer Confidence s.a. (MoM) - JAN	--	-8.3%	12:30
	AU	Westpac Consumer Confidence Index - JAN	--	94.7	12:30
	AU	New Motor Vehicle Sales MoM - DEC	--	-0.7%	13:30
	AU	New Motor Vehicle Sales YoY - DEC	--	2.9%	13:30
	UK	Claimant Count Rate - DEC	5.0%	5.0%	22:30
	UK	Jobless Claims Change - DEC	7.0K	3.0K	22:30
	UK	Average Weekly Earnings 3M/YoY - NOV	2.0%	2.0%	22:30
	UK	Weekly Earnings exBonus 3M/YoY - NOV	1.9%	1.8%	22:30

Continued on following page

## DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
18-Jan	UK	ILO Unemployment Rate (3mths) - NOV	8.3%	8.3%	22:30
	EC	Construction Output SA MoM - NOV	- -	-1.4%	23:00
	EC	Construction Output WDA YoY - NOV	- -	-2.8%	23:00
19-Jan	US	MBA Mortgage Applications - 13-Jan	- -	4.5%	01:00
	US	Producer Price Index (MoM) - DEC	0.1%	0.3%	02:30
	US	PPI Ex Food & Energy (MoM) - DEC	0.1%	0.1%	02:30
	US	PPI Ex Food & Energy (YoY) - DEC	2.8%	2.9%	02:30
	US	Producer Price Index (YoY) - DEC	5.1%	5.7%	02:30
	US	Total Net TIC Flows - NOV	\$50.0B	-\$48.8B	03:00
	US	Net Long-term TIC Flows - NOV	\$40.0B	\$4.8B	03:00
	US	Industrial Production - DEC	0.5%	-0.2%	03:15
	US	Capacity Utilization - DEC	78.1%	77.8%	03:15
	US	NAHB Housing Market Index - JAN	22	21	04:00
	NZ	ANZ NZ Job Ads (MoM) - DEC	- -	0.9%	10:00
	NZ	Consumer Prices (QoQ) - 4Q	0.4%	0.4%	10:45
	NZ	Consumer Prices (YoY) - 4Q	2.6%	4.6%	10:45
	NZ	ANZ Consumer Confidence Index - JAN	- -	108.4	13:00
	UK	Nationwide Consumer Confidence - DEC	38	40	13:01
	AU	RBA Foreign Exchange Transactn - DEC	- -	A\$330M	13:30
	AU	Employment Change - DEC	10.0K	-6.3K	13:30
	AU	Unemployment Rate - DEC	5.3%	5.3%	13:30
	AU	Full Time Employment Change - DEC	18.8K	-39.9K	13:30
	AU	Part Time Employment Change - DEC	-8.8K	33.6K	13:30
	AU	Participation Rate - DEC	65.5%	65.5%	13:30
	EC	Eurozone Current Account nsa - NOV	- -	€1.7B	22:00
	EC	ECB Eurozone Current Account SA - NOV	- -	-€7.5B	22:00
20-Jan	US	Consumer Price Index (MoM) - DEC	0.1%	0.0%	02:30
	US	CPI Ex Food & Energy (MoM) - DEC	0.1%	0.2%	02:30
	US	Consumer Price Index (YoY) - DEC	3.0%	3.4%	02:30
	US	CPI Ex Food & Energy (YoY) - DEC	2.2%	2.2%	02:30
	US	Housing Starts - DEC	680K	685K	02:30
	US	Building Permits MOM% - DEC	-0.7%	5.7%	02:30
	US	Building Permits - DEC	675K	680K	02:30
	US	Housing Starts MOM% - DEC	-0.7%	9.3%	02:30
	US	Initial Jobless Claims - 14-Jan	385K	399K	02:30
	US	Continuing Claims - 7-Jan	3590K	3628K	02:30
	US	Philadelphia Fed Index - JAN	10.7	6.8	04:00
	AU	Import price index (QoQ) - 4Q	0.6%	0.0%	13:30
	AU	Export price index (QoQ) - 4Q	-2.0%	4.0%	13:30
	GE	Producer Prices (MoM) - DEC	0.1%	0.1%	20:00
	GE	Producer Prices (YoY) - DEC	4.6%	5.2%	20:00
	UK	Retail Sales Ex Auto Fuel(MoM) - DEC	0.7%	-0.7%	22:30
	UK	Retail Sales Ex Auto Fuel(YoY) - DEC	1.7%	0.5%	22:30
	UK	Retail Sales w/Auto Fuel (MoM) - DEC	0.6%	-0.4%	22:30
	UK	Retail Sales w/Auto Fuel (YoY) - DEC	2.4%	0.7%	22:30
21-Jan	US	Existing Home Sales MoM - DEC	5.2%	4.0%	04:00
	US	Existing Home Sales - DEC	4.65M	4.42M	04:00

Key: AU: Australia, EC: Eurozone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States, CH: China.

Sources: Dow Jones, Reuters, Bloomberg, ANZ, National Bank. All \$ values in local currency

Note: All surveys are preliminary and subject to change



## LOCAL DATA WATCH

**Key focus over the next few weeks:** The Q3 GDP data confirmed a Rugby World Cup boost, but also highlighted the likelihood of a post- RWC lull in activity. With the current account deficit edging closer to the more problematic 5 percent plus zone, ongoing private and public sector deleveraging is expected to place a structural cap on future deficits. This week's inflation data is expected to support the benign CPI inflation message, providing the Bank with the luxury of staying on the sidelines. Other consumer-centric data will help shed more light on how the retail sector will start this year, although with the journey towards households' improving their saving performance only two-thirds complete, the outlook for 2012 remains downbeat. Global developments continue to dominate local markets, and will be a key focus for the OCR review later this month. With a fickle global backdrop, and with ongoing uncertainty over the timing of the Canterbury rebuild, the upshot is likely to be the OCR on hold for most of 2012. The spirit of our assessment is a low OCR endpoint this cycle.

DATE	DATA/EVENT	ECONOMIC SIGNAL	COMMENT
Tue 17 Jan (10:00am)	REINZ housing market report – Dec	Rising	Sales volumes are expected to rise 2 percent, with prices to be underpinned by a low stock of properties on the market.
Tue 17 Jan (10:45am)	Electronic Card Transactions – Dec	Crunch time	A 0.5 percent increase in retail card spending is forecast, with core spending up 0.7 percent.
Wed 18 Jan (early am)	GlobalDairyTrade auction	Holding	Strong Chinese demand will support prices, with only a small fall expected.
Thur 19 Jan (10:00am)	ANZ Job Ads – December	- -	- -
Thur 19 Jan (10:45am)	Consumers Price Index – Q4	Benign	A 0.2 quarterly increase is expected, with annual CPI inflation falling to 2.5 percent.
Thur 19 Jan (1:00pm)	ANZ Roy Morgan Consumer Confidence – January	- -	- -
Thur 26 Jan	RBNZ OCR Review	On hold	Global concerns and a benign short-term inflation environment dictate the RBNZ remaining on hold until December.
Fri 27 Jan (1:00pm)	Overseas Merchandise Trade - Dec	In the red	A trade deficit of around \$100m is forecast, with the annual trade deficit widening to \$670m.
Tue 31 Jan (10:45am)	Building Consents – Dec	Rebounding	A 10 percent increase in residential issuance is expected, with non-residential issuance of around \$300m forecast.
Tue 31 Jan (10:45am)	National Employment Indicator – Oct	No change	The lead provided by internet job advertising suggests flat employment over the next few months.
Wed 1 Feb (early am)	GlobalDairyTrade auction	High levels	Strong Chinese demand will support prices, with no change in the average price expected.
Thur 2 Feb (1:00pm)	ANZ Commodity Price Index – Jan	- -	- -
Fri 3 Feb (10:45am)	International Travel and Migration - Dec	Improving	A net permanent and long term inflow of 100 persons is expected. Visitor arrivals are likely to rise 2-3 percent.
Tue 7 Feb (10:45am)	Labour Cost Index – 2011Q4	Contained	A 0.5 percent increase in private sector ordinary time earnings (1.9 percent y/y) is forecast.
Tue 7 Feb (10:45am)	Quarterly Employment Survey - Q4	Stalling	No change in filled jobs expected. Average hourly earnings are expected to rise 0.5 percent (3.2 percent y/y).
Thur 9 Feb (10:45am)	Household Labour Force Survey – Q4	Creeping forward	A 0.2 percent quarterly increase in employment is forecast, with the unemployment rate easing to 6.5 percent.
Fri 10 Feb (10:45am)	Electronic Card Transactions - Jan	Time for a rest	No change in seasonally adjusted retail and core ECT spending is forecast.
<b>On Balance</b>		<b>Local vs global</b>	<b>Domestic gauges for Q4 2011 should remain positive but global concerns suggest caution for early 2012.</b>

## KEY FORECASTS AND RATES

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
GDP (% qoq)	0.8	<b>0.6</b>	<b>0.2</b>	<b>0.5</b>	<b>0.7</b>	<b>1.0</b>	<b>0.9</b>	<b>0.7</b>	<b>0.7</b>	<b>0.6</b>
GDP (% yoy)	1.9	<b>2.2</b>	<b>1.7</b>	<b>2.1</b>	<b>2.0</b>	<b>2.4</b>	<b>3.1</b>	<b>3.3</b>	<b>3.3</b>	<b>2.9</b>
CPI (% qoq)	0.4	<b>0.2</b>	<b>0.6</b>	<b>0.7</b>	<b>0.9</b>	<b>0.4</b>	<b>0.6</b>	<b>0.7</b>	<b>0.9</b>	<b>0.4</b>
CPI (% yoy)	4.6	<b>2.4</b>	<b>2.2</b>	<b>2.0</b>	<b>2.4</b>	<b>2.6</b>	<b>2.6</b>	<b>2.6</b>	<b>2.7</b>	<b>2.7</b>
Employment (% qoq)	0.2	<b>0.2</b>	<b>0.2</b>	<b>0.5</b>	<b>0.4</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>
Employment (% yoy)	1.1	<b>1.7</b>	<b>0.7</b>	<b>1.2</b>	<b>1.4</b>	<b>1.4</b>	<b>1.5</b>	<b>1.3</b>	<b>1.2</b>	<b>1.2</b>
Unemployment Rate (% sa)	6.6	<b>6.5</b>	<b>6.5</b>	<b>6.2</b>	<b>6.1</b>	<b>6.1</b>	<b>6.1</b>	<b>6.1</b>	<b>6.1</b>	<b>6.0</b>
Current Account (% GDP)	-4.3	<b>-3.8</b>	<b>-4.2</b>	<b>-4.4</b>	<b>-4.7</b>	<b>-5.0</b>	<b>-5.2</b>	<b>-5.4</b>	<b>-5.7</b>	<b>-5.9</b>
Terms of Trade (% qoq)	-0.6	<b>-0.4</b>	<b>-0.9</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.7</b>	<b>-0.7</b>
Terms of Trade (% yoy)	3.4	<b>2.1</b>	<b>0.5</b>	<b>-2.7</b>	<b>-2.9</b>	<b>-3.3</b>	<b>-3.2</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-2.8</b>

	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11
Retail ECT (% mom)	1.5	1.4	-0.7	1.1	0.3	-0.5	0.5	1.6	-0.5	..
Retail ECT (% yoy)	6.6	10.0	6.8	9.0	8.0	8.4	7.5	7.4	6.0	..
Credit Card Billings (% mom)	-0.9	1.7	0.4	0.5	1.0	-1.1	1.1	2.6	-3.4	..
Credit Card Billings (% yoy)	2.2	6.5	5.6	4.5	7.4	4.7	5.1	7.8	3.2	..
Car Registrations (% mom)	-0.8	-5.4	3.4	-2.3	-1.8	8.6	-11.1	1.1	7.4	..
Car Registrations (% yoy)	-1.0	-10.5	-3.7	-9.5	-6.0	1.9	-12.2	-8.8	-7.9	..
Building Consents (% mom)	2.7	-1.2	3.2	-1.0	11.2	19.5	-17.7	10.7	-6.4	..
Building Consents (% yoy)	-25.7	-32.5	-21.6	-25.3	-17.6	18.5	-3.7	11.4	-5.0	..
REINZ House Price Index (% yoy)	-1.8	-0.4	-0.7	0.0	0.5	0.7	2.7	3.4	2.6	..
Household Lending Growth (% mom)	-0.1	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.0	..
Household Lending Growth (% yoy)	1.3	1.3	1.2	1.2	1.2	1.2	1.1	1.1	1.0	..
ANZ Roy Morgan Consumer Confidence	101.4	101.4	103.3	112.5	109.4	113.3	112.6	112.2	109.0	108.4
NBNZ Business Confidence	-8.7	14.2	38.3	46.5	47.6	34.4	30.3	13.2	18.3	16.9
NBNZ Own Activity Outlook	14.7	29.5	39.7	38.7	43.7	43.3	35.4	26.1	28.8	25.7
Trade Balance (\$m)	583	1158	550	201	103	-690	-789	-228	-308	..
Trade Balance (\$m ann)	741	1238	1019	999	1288	1028	694	687	555	..
ANZ World Commodity Price Index (% mom)	4.7	1.6	0.4	-1.2	-0.2	-1.4	-2.0	-3.6	-1.1	..
ANZ World Commodity Price Index (% yoy)	23.5	19.8	19.6	20.6	22.2	22.0	16.5	9.0	5.5	..
Net Migration (sa)	-510	-60	-240	-240	-190	130	-660	-650	-60	..
Net Migration (annual)	6554	5508	4625	3867	2867	2257	773	-103	-568	..

Figures in bold are forecasts. mom: Month-on-Month qoq: Quarter-on-Quarter yoy: Year-on-Year

## KEY MARKET FORECASTS AND RATES

	ACTUAL			Forecast (end month)						
FX RATES	Nov-11	Dec-11	Today	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
NZD/USD	0.810	0.770	0.794	0.80	0.83	0.86	0.89	0.90	0.90	0.90
NZD/AUD	0.768	0.794	0.771	0.80	0.79	0.78	0.81	0.82	0.82	0.82
NZD/EUR	0.583	0.570	0.627	0.58	0.59	0.61	0.61	0.62	0.62	0.62
NZD/JPY	62.73	57.75	61.06	60.0	59.8	61.9	64.1	63.0	63.0	63.0
NZD/GBP	0.504	0.497	0.519	0.51	0.52	0.53	0.55	0.55	0.55	0.55
NZ\$ TWI	70.3	68.4	71.3	70.3	71.3	72.8	74.8	75.4	75.4	75.4
INTEREST RATES	Nov-11	Dec-11	Today	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.25	3.50	3.75
NZ 90 day bill	2.73	2.72	2.71	2.70	2.80	2.80	3.20	3.70	3.80	4.20
NZ 10-yr bond	4.02	4.10	3.85	4.10	4.10	4.20	4.40	4.40	4.60	4.80
US Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
US 3-mth	0.53	0.35	0.57	0.35	0.35	0.35	0.35	0.35	0.35	0.60
AU Cash Rate	4.50	4.25	4.25	4.00	4.00	4.00	4.00	4.00	4.00	4.00
AU 3-mth	4.60	4.60	4.39	4.20	4.20	4.20	4.20	4.20	4.20	4.20

Forecasts finalised as at 28 November 2011

	13 Dec	9 Jan	10 Jan	11 Jan	12 Jan	13 Jan
Official Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill	2.70	2.71	2.73	2.73	2.76	2.74
NZGB 04/13	2.42	2.47	2.48	2.49	2.50	2.50
NZGB 04/15	2.76	2.71	2.74	2.77	2.74	2.79
NZGB 03/19	3.61	3.55	3.57	3.60	3.58	3.63
NZGB 05/21	3.87	3.80	3.83	3.86	3.84	3.89
2 year swap	2.73	2.80	2.83	2.85	2.84	2.89
5 year swap	3.31	3.39	3.44	3.47	3.45	3.52
RBNZ TWI	68.1	70.1	71.0	71.1	71.4	70.7
NZD/USD	0.7635	0.7798	0.7931	0.7933	0.7963	0.7905
NZD/AUD	0.7579	0.7671	0.7706	0.7715	0.7731	0.7670
NZD/JPY	59.48	60.01	60.93	61.01	61.20	60.71
NZD/GBP	0.4892	0.5062	0.5126	0.5132	0.5197	0.5153
NZD/EUR	0.5789	0.6145	0.6211	0.6226	0.6262	0.6167
AUD/USD	1.0074	1.0166	1.0292	1.0282	1.0300	1.0306
EUR/USD	1.3189	1.2689	1.2770	1.2741	1.2717	1.2819
USD/JPY	77.90	76.96	76.83	76.91	76.86	76.80
GBP/USD	1.5608	1.5406	1.5471	1.5457	1.5322	1.5340
Oil (US\$/bbl)	97.77	101.62	101.22	102.12	100.89	99.03
Gold (US\$/oz)	1654.75	1608.30	1616.35	1637.90	1642.65	1639.25
Electricity (Haywards)	6.60	6.70	8.73	7.97	7.37	8.64
Baltic Dry Freight Index	1922	1308	1258	1193	1105	1053
Milk futures (USD)	141	140	140	140	140	140

## IMPORTANT NOTICE

### NEW ZEALAND DISCLAIMER

This publication is for information purposes only. Its content is intended to be of general nature, does not take into account your financial situation or goals, and is not a personalised adviser service under the Financial Advisers Act 2008. It is recommended you seek advice from a financial adviser which takes into account your individual circumstances before you acquire a financial product. This publication does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this publication can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of ANZ National Bank Limited (the "Bank").

This publication is a necessarily brief and general summary of the subjects covered. The information contained in this publication is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this publication. To the extent permitted by law, neither the Bank nor any other person involved in the preparation of this publication accepts any liability for the content of this publication (including the accuracy or completeness thereof) or for any consequences flowing from its use.

### UNITED STATES DISCLAIMER

This publication is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [[www.finra.org](http://www.finra.org)] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this publication and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This publication is issued on the basis that it is only for the information of the particular person to whom it is provided. This publication may not be reproduced, distributed or published by any recipient for any purpose. This publication does not take into account your personal needs and financial circumstances. Under no circumstances is this publication to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this publication (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this publication. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this publication accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this publication and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this publication. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

This document has been prepared by ANZ National Bank Limited. ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2217 Fax 64-4-496 8639 <http://www.anz.co.nz> email [nzeconomics@anz.com](mailto:nzeconomics@anz.com)