

FREE-FALLING

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- > International movements continue to dominate, with US recessionary fears percolating. Domestically, the growth and inflation picture remains dichotomised but consistent with a disturbing inflationary theme. Main antipodean attention for the week will reside in the tone of the RBNZ's OCR Review and whether Australia's CPI figures will force the RBA's hand in February.

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- > Financial conditions continued to tighten over December 2007, although our index has eased slightly in January. Our Financial Conditions Index is pointing towards annual GDP growth of around 1 percent by the end of the year, suggesting that economic activity will likely stall in one of the quarters in 2008.

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- > We present a table of global data outturns over the past week given the global economic significance at present. The past week was notable for weak data out of the US. Retail sales, housing and factory production (from the Philadelphia region) all came in well below expectations. This has intensified calls that the US will enter recession, or is already in recession. There was relatively little data out from Asia this week, with the most interesting probably an unexpected fall in Singaporean exports.

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ECONOMIC OVERVIEW

International movements continue to dominate, with US recessionary fears percolating. Domestically, the growth and inflation picture remains dichotomised but consistent with a disturbing inflationary theme. Main antipodean attention for the week will reside in the tone of the RBNZ's *OCR Review* and whether Australia's CPI figures will force the RBA's hand in February.

What's ahead?

- > **RBNZ OCR Review** (Thursday 0900 NZDT). Upside inflation pressure versus global dislocation. A no change decision is widely expected with a stern tone (see page 8 for a full preview).
- > **NZ Credit Card Spending** (Thursday 1500 NZDT). Monthly volatility is high. We expect a weak outturn after a 1.2 percent surge in November. The interest-bearing component of outstanding balances is an interesting gauge to monitor.
- > **Australian CPI** (Wednesday 1330 NZDT). Our Australian colleagues are expecting headline inflation to increase by 1.0 percent in the quarter. Core inflation is expected to rise 0.9 percent in the quarter an outturn we expect to force the RBA's hand.

What's the view?

New Zealand financial markets remain caught in the rip of fading US and global sentiment. Against this backdrop, the domestic economy continues to present dichotomised messages. But overall, it is consistent with intense capacity pressure and a strong inflationary under-current.

Firstly, the global backdrop. Recessionary fears continue to percolate in the US, with this week's sizeable fall in the Philly Fed survey to -20.9, a six year low. The US equity market (Dow Jones) has fallen 9 percent since the start of the year, and 4 percent in a week. While there has been the odd tit-bit of good news such as IBM's Q4 results, the remainder – including further credit write-offs, soft retailing, crashing US building permits and downward guidance from Intel (the worlds biggest chip-maker) – have been negative. US inflation was semi-contained, with the core up 0.2 percent in the month, but within a hair's breadth of being rounded to 0.3 percent, and a reminder that the aggressive rate cuts priced into the US yield curve are not risk free.

Elsewhere, Australia's growth pulse continues to pump strongly with unemployment falling to 4.3 percent. At the same time, the ASX has remained weak, as active debate continues to surround the broadening of the US slow-down into the Asian region, with flow-on risk to commodity prices. The Baltic Dry Freight Index has now fallen 40 percent, and daily moves were massive over the week. Commodity prices have eased somewhat, but remain generally in an oscillating pattern as the recoupling / decoupling debate continues. As noted last week, we remain coy over

the decoupling thesis holding. The global economy may be less reliant on the US consumer in a trade sense than in the past; however, financial linkages are now far stronger. International equity markets continue to get caught in the rip of fading US sentiment.

Baltic Dry Freight Index



Looking at soft commodity messages (a key transmission mechanism from the global economy to NZ), beef and venison are nudging up. The latest USDA figures show a further easing in international dairy prices, but report buyer interest re-emerging. It's an area we are closely watching. Equally, we'll be closely eyeing inbound tourism figures going forward, being a 'luxury service' that tend to respond more than 1 to 1 with the global growth cycle.

New Zealand financial markets (or the broad framework) have responded appropriately given the deteriorating risk profile to global prospects. The NZ dollar is down around percent on a TWI basis over the week. The 2-year swap has rallied 22 basis points. The latter was particularly noticeable once we moved beyond Thursday's CPI figures, although pre-CPI moves were already apparent.

The market response should be welcomed by, but also worry the Reserve Bank. On one hand, financial markets are moving to price growing global risks and the NZ market looks to be playing catch-up to a degree. Hence, such movements in the economy's natural shock absorbers are positive. Yet equally, the inflationary backdrop requires that financial conditions remain sufficiently tight to dampen inflationary pressure. Overall financial conditions are tight, although easing somewhat over January to date (refer page 5). But for the Reserve Bank it's a case of the old bird in the hand (inflationary pressure) versus two in the bush. Inflationary pressure is known, whereas others, including the global outlook and tight financial conditions being reflected in slower growth, are less certain. The latter is certainly portending of such, but this little New Zealand economy has surprised on numerous occasions with its resilience.

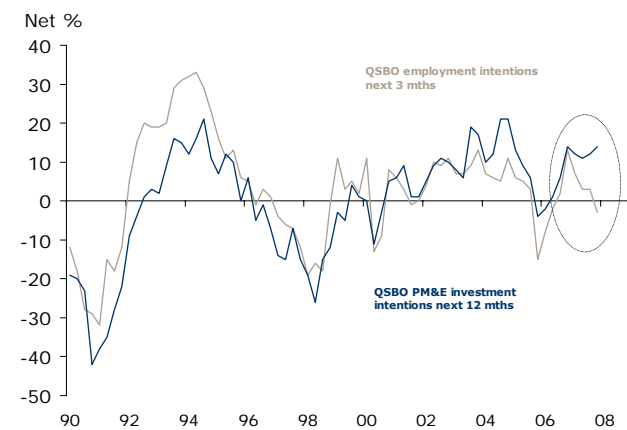
Such resilience was certainly the picture painted by the NZIER Quarterly Survey of Business Opinion. Sure sentiment was softer, but the overall nuances from the

survey were consistent with 2½ percent growth, a rate of growth that is broadly where we see the supply side capacity of the economy.

However, the real eye-popper in the survey was the extent of capacity pressures, despite growth in H2 2007 slipping below trend. Capacity utilisation leapt to a 15-month high, and the picture across labour indicators was one of exacerbated tightness. Pricing intentions remained high. We'd be tempted to discount the uplift in capacity utilisation (we've seen similar moves in the past such early as 1997 which was at odds with other indicators) if it wasn't for the similar message across labour inputs. Bottom line is that resource pressures remain intense.

One of the more puzzling aspects we found from the survey was strength across employment demand, but weakness in investment intentions. The latter is a worrying sign in terms of easing capacity pressures. Even more puzzling is why labour demand remains so resilient relative to capital, despite relative price signals moving strongly in capital's favour. To us, this reinforces the fact that a fair degree of the inflationary pressure we are seeing across the economy is coming from supply-side bottlenecks. If there is an area policy-makers (fiscal authorities) need to be assisting, it is on this front.

QSBO PM&E investment vs employment intentions



Looking at the coming week, the main attention will reside in the tenor of the Reserve Bank's *OCR Review*, with a no-change decision widely forecast. We expect a continued hawkish bent, as near-term inflation risks dominate and the Reserve Bank seeks to ensure they receive their pipeline tightening. However, the assessment will also maintain a degree of flexibility. Unless we see commodity prices start to plummet, the interest rate curve needs to remain anchored around current levels.

While there is a growing chorus in some areas for a further move upward in rates, it's something we are not buying into. Housing activity is slowing, and the global backdrop is fragile. Certainly, core inflation measures are still around 3 percent and require a vigilant stance. However, non-tradable inflation has started to trend lower, falling to 3.5 percent annually. And non-tradable ex-housing, a key measure of

inflationary expectations, was well below expectations in the fourth quarter. True, government related charges knocked 0.4 percentage points off non-tradable inflation in the third quarter and is responsible for the easing trend in the annual rate. But after being a steady upwards inflation influence, growing at an average 4.4 percent a year over the last five years, it was about time one (government charges) came the other way. In the meantime, the chorus for higher rates may well end up doing the Reserve Bank's work for it. After being told about the need for higher rates in 2007, when the headline inflation rate was falling but non-tradable inflation was tracking up, it would be an interesting P.R. exercise for the Reserve Bank to explain hiking in response to the reverse in 2008!

Certainly, a(nother) breach of the policy band is disconcerting with the headline inflation rate pushing through 3 percent. High average inflation outcomes over the past five years come with a reasonable risk that inflation expectations and wage and price setting behaviour continue to nudge up. In this environment it is entirely appropriate that the Reserve Bank maintains a tough line, with particular emphasis on banging the inflationary expectations drum.

The key issue remains whether the slow-down we are seeing in the housing market, with the December REINZ report continuing a subdued tone, diffuses into the broader economy. November retail sales rebounded sharply, and while three quarters of the rise can be put down to the price effect of petrol and food, there still look to be pockets of durable strength in areas such as motor vehicle retailing. Stepping back, the December quarter CPI was notable for the inflationary messages across core staples such as food and petrol. For consumers, real disposable income is being eaten up by the rising costs of core goods. With house prices flat-to-down, we expect consumer activity to become progressively restrained into 2008, despite receiving good income growth. It's a key judgement underpinning our sub-2 percent growth view, and as noted last week, behind what we suspect could be the buckling of the consumer.

In terms of the antipodean region, next week's Australian CPI figures are expected to cement whether the RBA hikes in February or not. Our Australian counterparts expect a 1.0 percent rise, and continue to have two rates hikes pencilled in for the first six months of the year. Elsewhere around the globe the Bank of Japan monetary policy committee will meet, although no change in interest rates is expected. The big data looks to be China-centric, with GDP, industrial production, retail sales and inflation all due to be released next week. Given China's reliance as a global growth engine, market's eyes will definitely be focussed there next week.

Recent data...

- > **NZ Building Consents Issued (November).** Residential dwelling consents fell 0.1 percent, while ex-apartment consent issuance rose 1.8 percent.

- > **NZIER QSBO (Dec qtr).** Seasonally adjusted headline confidence deteriorated. However, own activity expectations remained robust. All measures of capacity and resource pressures intensified.
- > **REINZ Housing Report (December).** Seasonally adjusted house sales fell 8.5 percent, median days to sell rose to 40 days (s.a.), and the median sale price fell \$7,000, to \$345,000.
- > **NZ CPI (Dec qtr).** Headline inflation rose 1.2 percent in the quarter, taking annual growth to 3.2 percent. Tradable inflation rose 1.8 percent (2.8 annually) and non-tradable inflation rose 0.7 percent (3.5 annually).
- > **NZ Retail Sales (November).** Headline sales rose 2.0 percent, while core sales (which exclude motor vehicle-related industries) rose a more modest 0.9 percent.

FINANCIAL CONDITIONS UPDATE

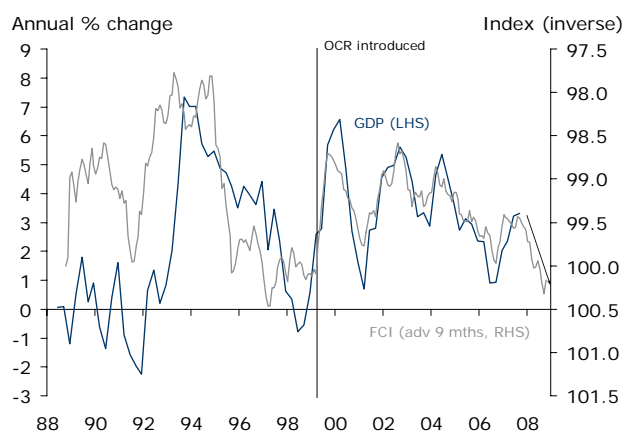
Financial conditions continued to tighten over December 2007, although our index has eased slightly in January. Our Financial Conditions Index is pointing towards annual GDP growth of around 1 percent by the end of the year, suggesting that economic activity will likely stall in one of the quarters in 2008.

Regular readers will be familiar with our Financial Conditions Index (FCI)¹, which we monitor and provide periodic updates in this publication. Unlike the conventional Monetary Conditions Index, our FCI includes a wider array of variables to recognise the different channels through which monetary policy influences the economy. Our FCI provides a timely gauge of economic activity 6 to 9 months into the future, and more importantly it has been successful in predicting key turning points in the growth cycle.

A rising TWI, higher NZ 90-day and 2-year swap rates, and a ballooning US swap spread, saw financial conditions reach its tightest level over December 2007 since the mid-1990s. Falling equity prices also contributed to a tightening in conditions, with only an abundance of liquidity providing some offset.

Over the first half of January, financial conditions eased slightly but remain extremely tight. The NZ equity market took its lead from Wall Street and sold off aggressively. However, domestic interest rates eased following falls in global interest rates and the US swap spreads narrowed from the highs seen over December. These helped to offset the TWI and equity impact and led to a small improvement in our Financial Conditions Index.

GDP vs Financial Conditions Index



Sources: ANZ National, Statistics NZ

Economic activity may have expanded at a modest pace over the second half of 2007, but financial conditions at current levels suggest a material slowdown in growth is ahead of us this year. Our Financial Conditions Index is pointing towards annual GDP growth of around 1 percent by the end of the

year, a marked slowing from the 3.2 percent rate currently for Q3 2007. This kind of slowdown implies that economic activity will likely stall in one of the quarters in 2008.

Indicators	Comment	Impact on activity
Currency, adjusted for the terms of trade	Higher terms of trade unable to offset increase in nominal TWI.	↓
Interest rates	Both the 90-day and 2-year swap eased over early January, but remain at restrictive levels.	↓
US 2-year swap spread	Spreads still wide due to global credit concerns.	↓
Equity market index as a proxy for corporate wealth and liquidity	NZ equity market taking a beating following the sell-off in the US.	↓
House prices as a proxy for household wealth	House prices continue to flatline.	↔
Private sector credit growth	Credit growth remains robust though is showing signs of slowing.	↔/↑
Liquidity	Liquidity remains abundant.	↔/↑
Overall conditions	Still very tight.	↓

The growth path implied by our Financial Conditions Index is at odds with recent business confidence measures, which show growth slowing more gradually towards 2½ percent this year. It remains to be seen which path will play out. Time will tell, but we note that the correlation coefficient between our Financial Conditions Index and annual GDP growth is very strong at -0.9 since 1999. Hence, we will be putting some weight on what financial conditions are telling us, particularly since our Index managed to pick the strong rebound in growth in late 2006.

Our own core economic forecast is for growth to slow towards 1½ percent this year. But high oil prices (which is not captured by our Index) and ongoing concerns over the health of the US economy add additional layers of downside risk to this forecast. Conversely, our Index does not pick up fiscal policy, and infrastructure spending, both strong positives to growth, and sentiment at present.

February's data on business confidence from the National Bank *Business Outlook* is likely to be a key read on how the economy is faring.

¹ Our index is calibrated so that there is a 4:1 ratio between the internal (e.g. interest rates) and external (e.g. currency) variables.

GLOBAL WATCH

A key theme emanating through our recent commentary has been prospects for the global economy, which we believe represent the most significant risk to the NZ economy at present. With this in mind, this table presents a weekly summary of data outturns, with a particular emphasis on the Asian region. The past week was notable for weak data out of the US. Retail sales, housing and factory production (from the Philadelphia region) all came well below expectations. This has intensified calls that the US will enter recession, or is already in recession. There was relatively little data out from Asia this week, with the most interesting probably an unexpected fall in Singaporean exports. However, we note that some big releases are out next week with Chinese GDP, industrial production, retail sales and inflation all due.

Country/ Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	Producer Price Index (Dec) – yoy	7.1%	6.3%	7.2%	Weaker
	Advance Retail Sales (Dec) – mom	0.0%	-0.4%	1.0%	Weaker
	CPI (Dec) – yoy	4.1%	4.1%	4.3%	In-line
	Industrial Production (Dec)	-0.2%	0.0%	0.3%	Stronger
	Housing Starts	1,145k	1,006k	1,173k	Weaker
	Building Permits	1,135k	1,068k	1,162k	Weaker
	Philadelphia Fed	-1.0	-20.9	-5.7	Weaker
	Europe	Industrial Production (Nov) – mom	-0.8%	-0.5%	0.5%
ZEW Survey (Econ. Sentiment) (Jan)		-38.0	-41.7	-35.7	Weaker
CPI (Dec) – yoy		3.1%	3.1%	3.1%	In-line
UK	PPI Input (Dec) – mom	0.8%	0.5%	2.0%	Weaker
	PPI Output (Dec) – mom	0.4%	0.5%	0.6%	Stronger
	CPI (Dec) – yoy	2.0%	2.1%	2.1%	Stronger
	Claimant Count Rate (Dec)	2.5%	2.5%	2.5%	In-line
	Jobless Claims Change (Dec)	-5.0k	-6.4k	-10.0k	Stronger
Asia Ex-Japan					
<i>Singapore</i>	Retail Sales (Nov) – yoy	3.5%	-0.3%	3.8%	Weaker
	Non-Oil Domestic Exports (Dec) - yoy	5.3%	-4.5%	-3.4%	Weaker
<i>Thailand</i>	Thai Central Bank Interest Rate Announcement	3.25%	3.25%	3.25%	In-line
<i>Indonesia</i>	Wholesale Price Index (Nov) – yoy	20.6%	20.6%	15.9%	In-line
<i>Philippines</i>	Bank Lending (Nov) – yoy	-	7.1%	3.2%	-
	Balance of Payments (Dec)	-	\$784m	-\$67m	-
<i>South Korea</i>	Export Price Index (Dec) – yoy	-	3.4%	1.8%	-
	Import Price Index (Dec) – yoy	-	15.6%	13.7%	-
	Department Store Sales (Dec) – yoy	-	-2.2%	8.5%	-
	Unemployment Rate (Dec)	-	3.1%	3.2%	-
<i>Malaysia</i>	Manufacturing Sales Value (Nov) – yoy	-	3.8%	-1.2%	-
Japan	Machine Orders (Nov) – mom	-4.0%	-2.8%	12.7%	Stronger
	Domestic CGPI (Dec) – mom	0.1%	0.4%	0.2%	Stronger
	Industrial Production (Nov F) – mom	-1.6%	-1.6%	-1.6%	In-line
	Capacity Utilisation (Nov F)	-	108.4	110.2	-
Australia	TD Securities Inflation (Dec) – mom	-	0.6%	0.3%	-
	Westpac Consumer Confidence (Jan)	-	-8.3%	1.8%	-
	Home Loans (Nov)	1.0%	4.0%	-0.5%	Stronger
	Employment Change (Dec)	20k	20.1k	47.6k	In-line
	Unemployment Rate (Dec)	4.4%	4.3%	4.5%	Stronger

INTEREST RATE STRATEGY

RBNZ takes centre, but they may have a tough time holding the curve up given deteriorating global sentiment and offshore receiving interest.

Market themes...

- > Weak US data and large investment bank write-offs saw global selloff in equities with rates rallying.
- > NZ dataflow largely ignored with offshore moves dominating.

Outlook...

It was a strange week in the NZ rates market. Who would have thought that a stronger than expected CPI print, taking annual inflation past the top of the RBNZ's target band, would cause rates to rally. But this is what happened on Thursday. To be fair, non-tradable inflation, which is the RBNZ's bugbear, printed much softer. But a much stronger than expected retail sales print today pretty much resulted in a similar reaction with a rally in rates.

It is a sign that the global environment is deteriorating to the point that people are buying into the recoupling theme. Collapsing equity markets are proving hard to ignore. And when you look around the globe at who is cheap, NZ stands out. On a risk reward basis, you are weighting up a possible 25bp hike in the near term vs potentially +100-200bps of cuts if the global economy turns pear shaped. Offshore participants seem to like these kinds of odds, and they have been piling in, sending the swap yields, in the sometimes illiquid kiwi market, sharply lower. The domestic dataflow, which relates to events prior to the recent deteriorating global outlook, is simply ignored. Uridashi issuance related receiving also compounded this effect.

With only the RBNZ OCR decision due next week, the NZ rates market is, once again, mainly in the hands of offshore sentiment. The RBNZ will have been unhappy at swap yields falling this much, potentially eroding their pipeline tightening effect, and will no doubt try to hold the curve up with some stern language. But they may be up against some aggressive offshore receiving.

We think the moves this week have been overdone, and continue to believe that the 2-year swap yield should be trading within a 8.5-8.65 percent range. Given that yields have moved below the bottom of our range, ordinarily we would be payers. But in the current environment, it is best not to stand in front of a runaway bus or try to catch a falling knife.

In offshore developments, US data on home sales will likely stoke recession fears. But it will be US corporate news that will see further bond market reaction, with the potential for further subprime and credit related write downs by financial institutions as well as more disappointing earnings outlook. Australia Q4 CPI data takes centre stage across the Tasman, which will have a large influence on the RBA's February cash rate decision. This may give the NZ market back a heavy

tone. The BoJ is expected to leave their rates unchanged.

Gauges for NZ interest rates yields

Gauge	Direction	Comment
RBNZ	↔	On hold but worried about inflation outlook.
NZ data	↔	Inflation at top of the band vs weak housing.
Fed Funds/front end	↓	50bp cut looks a done deal end of the month. More to come.
RBA	↔	Data printing strong over there. February move still on the cards.
US 10 year	↔/↓	Growth and recession fear overcoming inflation concern for now.
NZ swap spreads	↔/↓	Swap spreads should start to narrow from current high levels, but will meet some resistance given global sentiment.
Flow	↔/↓	Receiving interests should subside next week but offshore participants to have a big say.
Technicals	↔/↓	Bottom of ranges have been broken, but remains to be seen whether new ranges will develop.

Borrowing strategies we favour at present

Recent developments in the swaps curve reinforced the view that the NZ economy is not immune to offshore moves. Thursday's RBNZ *Review* will set the tone for future moves. We favour payers cautiously target the 4-5 year part of the curve as any dovish comments by the RBNZ will see further downside in the front end of the swap curve.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 24-Jan-08	6	4
Thu 6-Mar-08	12	8
Thu 24-Apr-08	18	22
Thu 5-Jun-08	23	28
Thu 24-Jul-08	23	8
Thu 11-Sep-08	-1	-12
Thu 23-Oct-08	-1	-12

Trading themes we favour at present

We favour paying the 2-year swap if the yield reaches 8.35 percent prior to the OCR *Review*, targeting a move back towards 45/50.

OCR REVIEW PREVIEW

(due 9.00am 24 January)

We expect the RBNZ to leave the OCR unchanged but maintain a stern tone, repeating December's "rates on hold for a longer period" mantra.

At the December Monetary Policy Statement, the RBNZ laid out their inflation concerns. Though the OCR was left on hold, the RBNZ pushed out any prospect of easings into late 2009. The focus then was purely on domestic developments, particularly on the inflation front.

The domestic dataflow since then has, by-and-large, been panning out as the RBNZ had forecast:

- > **Growth was in line with the Bank's forecast,** with the Q3 GDP print of 0.5 percent slightly lower than their 0.6 percent forecast. However, upward historical revisions were made to the GDP data.
- > **Q4 CPI was slightly stronger** printing at 1.2 percent compared to their 1.1 percent forecast, pushing the headline rate above 3 percent. But non-tradable inflation turned out much softer than the RBNZ had expected, and this softness was broader based than just housing.
- > **The housing market continues to weaken.** House prices are now starting to come under downward pressure, and look to be tracking in advance of the RBNZ's projections of flatness by late 2008.
- > **The size of the tax cuts is roughly what the RBNZ had factored in,** at around \$1.5b, though there is still a risk that this amount could turn out higher.
- > **Consumer spending has, volatility aside, been largely flat-lining,** with volume growth more subdued given higher petrol and food prices.
- > **Commodity prices look to have peaked.** Dairy prices in particular have eased, but remain high.
- > **The 90-day rate and the TWI are at the levels the RBNZ had forecast.**

Two areas that differ from the RBNZ's December assessment are:

- > **The QSBO portended of tighter capacity constraints and a generally resilient economy,** hence indicating more medium-term pressure on inflation.
- > **The global economic environment has deteriorated.** The RBNZ relied on the November *Consensus* forecasts when putting together their December forecasts, which at that stage were already lagging behind developments in the US. The global outlook has deteriorated since, with the US economy likely to be already in recession and UK, Japan and Euro Zone activity starting to slow. Equity markets are close to being in free-fall. At this stage, Asia continues to truck along, and

Australia is strong. NZ has been caught up in the rip of the subprime fiasco, raising wholesale funding costs to banks, which in turn have seen fixed lending rates increase – giving the RBNZ additional policy traction. However, with swap rates moving lower of late, it remains to be seen whether mortgage rates will remain at current levels.

Once again the RBNZ finds itself balancing upside inflation risks versus material downside growth risks. The science to monetary policy (read the RBNZ's model) will continue to err towards the former, while the art of policy will, and should, be mindful of the latter.

Indicators	Comment	Risk for rates
Inflation	No headroom at all with inflation above the target band, but softer non-tradable print provide some comfort.	↔/↑
Resource pressures	Intensified over Q4, pointing at further near-term inflation pressure.	↑
Commodity prices	Look to be coming off but still remain at high levels.	↔
Confidence	Consumer confidence down but business confidence remains resilient.	↔
Consumer spending	Volatile but still seems to be flat-lining. More subdued in volume terms. Need to see more.	↔
Housing market	Correction well underway, with prices coming under downward pressure.	↓
Global scene	All the risks pointing firmly to the downside.	↓↓
Exchange rate	TWI largely in line with RBNZ assumptions.	↔
Bottom line	Wait but keep your fingers crossed.	↔

A no-change decision is widely expected with most attention being paid to the tone of the statement, which is expected to be on the hawkish side. There will be reference to their unease over the inflation outlook, similar to their December rhetoric. While the global situation is disconcerting, the RBNZ needs to focus on managing inflation expectations and ensuring that they maintain the current pipeline tightening through the mortgage curve. This means reiterating that interest rates will remain high for a long time. In particular, the RBNZ will likely want to see the 2-year swap curve go back up to a 8.5-8.65 percent range, thereby ensuring recent increases in fixed mortgage rates are maintained.

We expect the RBNZ to conclude with "a rates on hold" message: *"We believe that the current level of the OCR remains consistent with future inflation outcomes of 1 to 3 percent on average over the medium term, based on the information to hand at present"*. Anything else is likely to be taken as opening the door on a move up in rates. The later part ("information at hand") still gives the Bank the capacity to respond if need be.

CURRENCY STRATEGY

The NZD has played catch-up to equity market sentiment, and looks hostage to equity gyrations from this point, with domestic factors taking a backseat. A strong Australian CPI may provide some antipodean support, but NZD/AUD looks vulnerable given recent prodding of 0.87 cents.

Market themes...

- > Recessionary fears intensify and commodities start to soften. Baltic Dry in free-fall.
- > US equities remain the key gauge to watch.
- > Weak AUD sides with global growth cycle, and ignores domestic influence. Kiwi the same.

Outlook...

The NZD has come under considerable pressure this week, falling by around 3 percent on a TWI basis. Tumbling equity markets around the globe – as a result of increased fears of a US recession and subsequent global growth concerns – are weighing heavily on the kiwi as risk aversion increases and the carry trade takes a breather. Although mixed messages still exist on whether the globe (particularly Asia) has decoupled or is recoupling to the US, with the Baltic Dry Freight Index (a global growth bellwether) off close to 40 percent and in free-fall over the week, the recessionary bears and believers in recoupling as opposed to decoupling look to have the upper paw, for now.

Even local data this week, which reaffirmed the extent of inflationary pressures within the economy (QSBO and CPI) and the likelihood that interest rates will remain elevated for some time, failed to lift the kiwi. Strong labour market figures failed to support the AUD, as both played catch-up to weak equity market sentiment. In saying this however, yield differentials are continuing to provide a solid base of support for the kiwi. The NZ-US 2-year swap differential is now close to 540 basis points, and we are also hearing talk of further Uridashi interest.

We expect the NZD to remain volatile, as the tussle between yield, risk and global growth continues. The whole decoupling / recoupling debate remains key, along with barometers of each. If US economic weakness spreads beyond its own shores then brace for further falls in the NZD. However, if global growth (particularly Asian growth) can weather the storm and commodity prices hold up, then the NZD could well be knocking on the door of US 80 cents once again. It is an environment where ranges are likely to remain large.

Moving to events this coming week, the RBNZ's *OCR Review* (Thursday 0900 NZDT) will be the major focal point locally. We are not expecting a major change in stance from the RBNZ with an underlying theme of rates remaining high for an extended period. Moving offshore, Australian Q4 CPI data will be important. A strong Australian CPI may provide some antipodean support, but NZD/AUD looks vulnerable, given

repeated prodding of the 0.87 level. Once again, we are at the mercy of equity market developments, and back to trading currency pygmies.

Technically, the NZD/USD has broken through the bottom of its recent trading band at 0.7620. In the absence of further information, the 200 day moving average at 0.7525 should be respected. A break of this opens the door for a test of 0.7380 and then 0.7230.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	Yield spreads stabilising. Data to give direction.
Commodities	↓	Gold up, milk down.
Partial indicators	↓	Better across the Tasman. Terms of trade shocks bigger there.
Technicals	↔	Range trade.
Sentiment	↓	AUD data is better.
Other	↑	Strangely, kiwi performs better when global sentiment fails.
On balance	↓	AUD simply better.

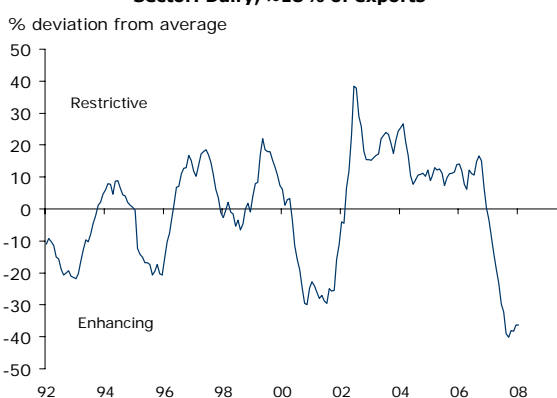
NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.65 (and rising) given a structural shift in commodity prices.
Fair value – short-term	↑	US data is woeful and spreads widening.
Yield	↑	Yield differentials at phenomenal levels.
Commodities	↔/↓	Off their highs.
Risk aversion	↓	Credit concerns and equity market jitters are weighing.
Partial indicators	↔	NZ domestic economy is soft, but US is softer.
Technicals	↑	Bottom of range
AUD	↔	Good fundamentals but a play on global cycle.
Sentiment	↔	Mixed messages.
Other	↔	USD disliked, but US weakness broadening = USD up by default.
On balance	↔	Looking for the tallest pygmy.

EFFECTIVE EXCHANGE RATES UPDATE

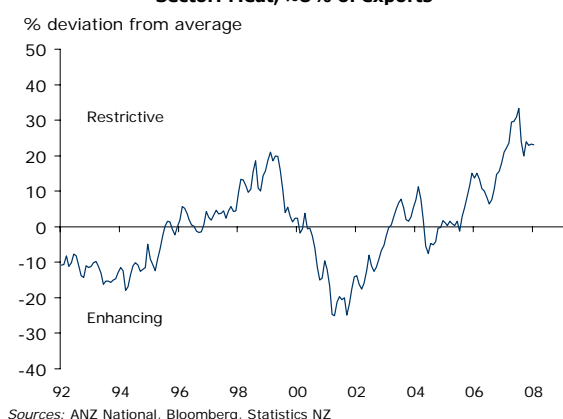
Regular readers will know that we track real effective exchange rate measures across various export industries. These measures adjust for the impact of commodity prices and are weighted by export destination. They highlight that the performance of the NZD has a contrasting impact on different sectors of the New Zealand export community.

With the exception of the crude sector, all the commodity adjusted real exchange rates we monitor were largely unchanged over the month. The ANZ World Commodity Price Index was flat in December, while the NZD was also broadly similar to the previous month's value. As a result, the picture remains the same and one where the dairy sector continues to experience near record enhancing conditions, albeit off their peak, but other sectors are struggling under the weight of the high NZD. Conditions for the meat, forestry, horticulture, manufacturing and services sectors remain restrictive. The seafood and now the crude sector are experiencing broadly neutral conditions.

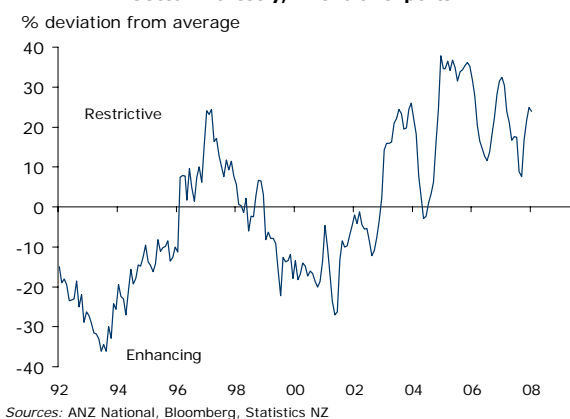
Sector: Dairy, ≈18% of exports



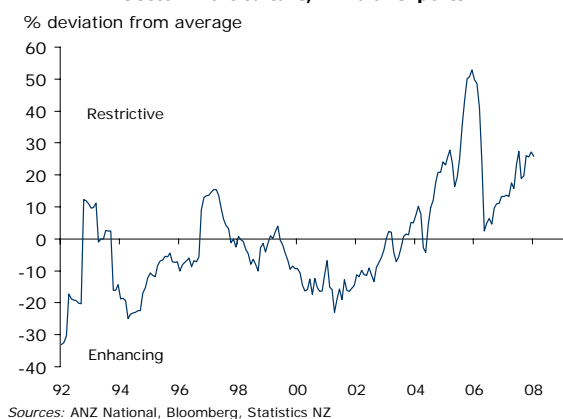
Sector: Meat, ≈8% of exports



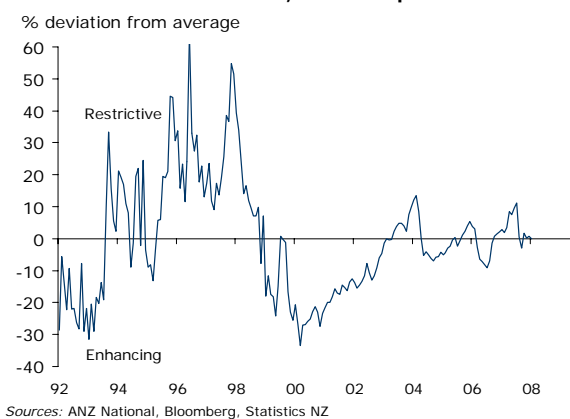
Sector: Forestry, ≈10% of exports



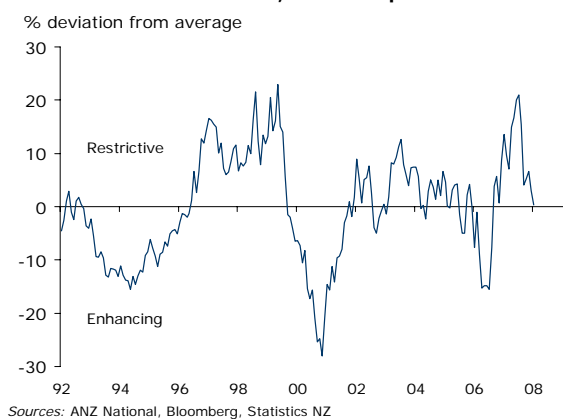
Sector: Horticulture, ≈4% of exports



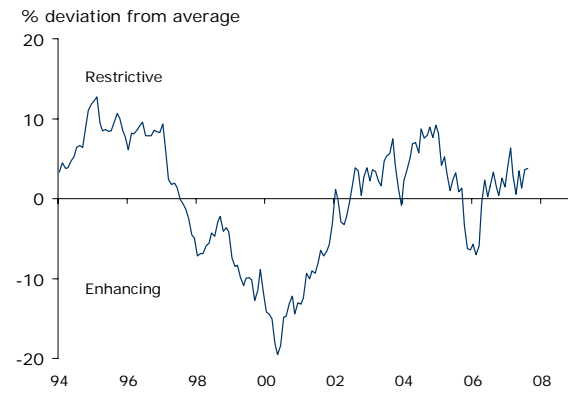
Sector: Seafood, ≈3% of exports



Sector: Crude, ≈5% of exports

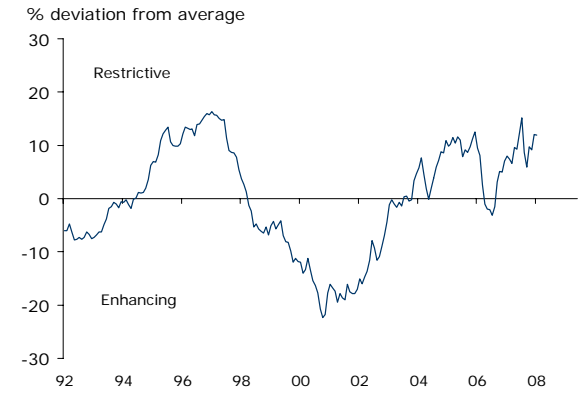


Sector: Manufacturing, ≈20% of exports



Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Services, ≈24% of exports



Sources: ANZ National, Bloomberg, Statistics NZ

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Jan 21	UK	Rightmove House Prices (Jan) – mom	-	-3.2%	13:01
		Public Finances (PSNCR) (Dec)	13.8B	8.9B	22:30
		Public Sector Net Borrowing (Dec)	6.8B	11.2B	22:30
		M4 Money Supply (Dec P) – mom	0.3%	0.5%	22:30
		M4 Sterling Lending (Dec P)	13.0B	16.5B	22:30
		BSA Mortgage Approvals (Dec)	-	£4,533m	22:30
	AU	Producer Price Index (4Q) – qoq	-	1.1%	13:30
	GE	Producer Prices (Dec) – mom	0.2%	0.8%	20:00
Jan 22	JN	BoJ Target Rate Announcement	0.5%	0.5%	-
		BoJ Monthly Report	-	-	19:00
Jan 23	US	Richmond Fed Manufacturing Index (Jan)	-	-4	04:00
	AU	Westpac Leading Index (Nov) – mom	-	0.5%	12:30
		Consumer Prices (4Q) - qoq	-	0.7%	13:30
		Consumer Prices (4Q) – yoy	-	1.9%	13:30
		RBA Trimmed Mean (4Q) - qoq	-	0.9%	13:30
		RBA Trimmed Mean (4Q) – yoy	-	2.9%	13:30
		RBA Weighted Median (4Q) – qoq	-	1.0%	13:30
		RBA Weighted Median (4Q) – yoy	-	3.1%	13:30
	EU	PMI Manufacturing (Jan A)	52.2	52.6	22:00
		PMI Services (Jan A)	52.8	53.1	22:00
		PMI Composite (Jan A)	52.8	53.3	22:00
		Industrial New Orders (Nov) – mom	1.5%	2.5%	
	UK	BoE Minutes	-	-	22:30
		GDP (4Q A) – qoq	0.5%	0.7%	22:30
		GDP (4Q A) – yoy	2.8%	3.3%	22:30
24 Jan	NZ	RBNZ Interest Rate Announcement	8.25%	8.25%	09:00
		Business NZ PMI (Dec)	-	57.2	12:00
		Credit Card Spending (Dec) – yoy	-	9.5%	15:00
	JN	Merchandise Trade Balance Total (Dec)	¥943.0B	¥791.7B	12:50
		All Industry Activity Index (Nov) – mom	-0.4%	1.2%	12:50
	GE	IFO – Business Climate (Jan)	102.2	103.0	22:00
		IFO – Current Assessment (Jan)	107.4	108.1	22:00
		IFO – Expectations (Jan)	97.7	98.2	22:00
25 Jan	NZ	RBNZ Governor Bollard speaks in Christchurch	-	-	-
	US	Existing Home Sales (Dec)	4.95m	5.00m	04:00
		Existing Homes Sales (Dec) – mom	-1.0%	0.4%	04:00
		US Treasury's Paulson and ECB's Trichet speak about risk	-	-	05:20

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
25 Jan cont.	US	Former Fed Chairman Greenspan speaks on Economy in Vancouver	-	-	08:30
	AU	Conference Board Leading Index (Nov)	-	0.9%	12:00
	JN	National CPI (Dec) – yoy	0.7%	0.6%	12:30
		National CPI Ex-Fresh Food (Dec) – yoy	0.6%	0.4%	12:30
		National CPI Ex Food & Energy (Dec) – yoy	-0.1%	-0.1%	12:30
		BoJ Releases Minutes from 19-20 Dec Meeting	-	-	12:50
	GE	Consumer Confidence Survey (Feb)	4.4	4.5	20:10

Key: AU: Australia, EU: Euro-zone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States.
Sources: Dow Jones, Reuters, Bloomberg, ANZ National Bank. All \$ values in local currency. (Note: all surveys are preliminary and subject to change).

NEW ZEALAND DATA WATCH

Key focus over the next four weeks: The RBNZ takes centre stage next week. Beyond that, it is data on how domestic demand is faring, as well as the extent of labour market tightness at the end of last year that will be key interest.

Date	Data/Event	Economic Signal	Comment
Thu 24 Jan (09.00)	RBNZ <i>OCR Review</i>	On hold	RBNZ to be on hold. Inflation concerns will continue to feature so expect the talk to be tough.
Thu 24 Jan (15.00)	Credit Card Spending (Dec)	Slowing	Monthly volatility is high. We expect a weak outturn after a 1.2 percent surge in November. The interest-bearing component of outstanding balances is an interesting gauge to monitor.
Wed 30 Jan (10.45)	Building Consents Issued (Dec)	Easing	Further declines in residential consent issuance are expected. But commercial consent issuance to hold up.
Wed 30 Jan (15.00)	Credit Growth (Dec)	Soft	Given that housing market activity remains subdued, credit growth is likely to remain soft.
Thu 31 Jan (10.45)	Overseas Merchandise Trade (Dec)	Gradually improving	High dairy prices and solid production from the Tui oil field continue to provide strong support to exports and are helping to contribute to an improving trade balance. However, high oil prices – adding to the import bill – will slow this improvement.
Mon 4 Feb (10.45)	External Migration (Dec)	Stabilising	We expect annual net migration to stabilise around its current level of 7,000, although the risks appear skewed to the downside. We'll be closely looking at US inbound tourist figures.
Tue 5 Feb (10.45)	QES and LCI (Dec qtr)	Elevated wage growth	The labour market remains tight and firms continue to report difficulty in finding staff. Wage measures are likely to remain elevated for some time.
Tue 5 Feb (15.00)	ANZ Commodity Price Index (Jan)	-	-
Thu 7 Feb (10.45)	Household Labour Force Survey (Dec qtr)	Still tight	Last quarter showed falling employment and a fall in the unemployment rate. This quarter may see the reverse. Volatility within the survey makes interpretation difficult. Suffice to say, the market will remain tight.
circa 11 Feb	REINZ Housing Report (Jan)	Down	A slight rebound in sales is possible after the big fall in December, but prices to remain under pressure.
Wed 13 Feb (10.45)	Producer Price Index (Dec qtr)	Margin squeeze	Business margins expected to remain under pressure, judging from the QSBO survey. This points to more potential cost-push inflation pressure.
Wed 13 Feb (10.45)	Capital Goods Price Index (Dec qtr)	Mixed on the price front	P&M prices to fall due to higher TWI, but residential and non-residential building prices to remain strong, though showing some signs of easing.
Thu 14 Feb (10.45)	Food Price Index (Jan)	On the up	January is usually a strong month for food prices, and this year will be no different. With world commodity prices still riding high, there is further agri-inflation in the works.
Fri 15 Feb (10.45)	Retail Trade Survey (Dec)	Flat-lining	After a strong surge in November, a pullback can be expected. We are penciling in a modest 0.5 percent rise, though a decline cannot be ruled out.
On Balance		Sub-trend growth	Inflationary pressures persist.

SUMMARY OF KEY ECONOMIC FORECASTS

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
GDP (% qoq)	0.7	1.2	0.8	0.5	0.3	0.3	0.4	0.4	0.6	0.7
GDP (% yoy)	2.0	2.4	3.2	3.3	2.9	1.9	1.5	1.4	1.7	2.1
CPI (% qoq)	-0.2	0.5	1.0	0.5	1.2	0.6	0.8	0.9	0.8	0.5
CPI (% yoy)	2.6	2.5	2.0	1.8	3.2	3.3	3.0	3.4	3.0	2.9
Employment (% qoq)	0.0	1.2	0.6	-0.3	0.4	0.4	0.2	0.2	0.2	0.1
Employment (% yoy)	1.4	1.7	1.6	1.5	1.9	1.1	0.7	1.2	1.0	0.6
Unemployment Rate (% sa)	3.7	3.7	3.6	3.5	3.6	3.7	3.8	3.9	4.0	4.2
Current Account (% GDP)	-8.6	-8.2	-8.1	-8.3	-8.1	-7.6	-7.0	-6.8	-6.8	-6.8
Terms of Trade (% qoq)	2.5	1.5	0.4	3.7	2.5	0.8	0.3	-0.1	-0.2	-0.6
Terms of Trade (% yoy)	3.8	4.5	2.3	8.4	8.4	7.5	7.4	3.5	0.8	-0.6

KEY ECONOMIC INDICATORS

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07
Retail Sales (% mom)	0.8	-1.2	1.1	-0.4	0.2	0.3	1.0	-0.6	2.0	..
Retail Sales (% yoy)	7.4	7.4	6.7	4.8	5.7	6.3	4.1	5.5	6.9	..
Credit Card Billings (% mom)	1.0	-1.0	0.8	1.8	0.1	0.3	2.6	-0.5	1.2	..
Credit Card Billings (% yoy)	7.2	7.9	5.8	9.0	7.8	8.6	9.4	7.8	9.5	..
Car Registrations (% mom)	1.2	-1.9	6.8	-4.6	7.0	1.0	-6.8	5.4	-3.9	-2.9
Car Registrations (% yoy)	-11.0	-4.8	-2.5	-1.5	7.0	10.9	0.1	4.7	2.3	1.4
Building Consents (% mom)	-1.2	0.7	5.2	12.7	-15.9	4.8	-10.1	-4.6	-0.2	..
Building Consents (% yoy)	3.4	9.1	2.8	33.1	-4.1	-1.4	-15.5	-16.0	-4.9	-3.0
REINZ House Price (% yoy)	13.7	14.4	14.8	12.1	10.4	12.9	12.3	8.0	6.7	4.5
Household Lending Growth (% mom)	1.2	1.1	1.1	1.1	0.9	0.9	0.8	0.9	0.8	..
Household Lending Growth (% yoy)	13.3	13.5	13.5	13.5	13.5	13.4	13.1	12.9	12.7	..
Roy Morgan Consumer Confidence	129.3	128.6	122.1	121.0	121.1	122.4	121.3	122.0	121.9	126.6
NBNZ Business Confidence	-12.5	-19.4	-48.3	-37.2	-38.5	-33.8	-26.5	-12.9	-19.6	-24.9
NBNZ Own Activity Outlook	24.1	22.5	7.8	14.8	12.4	16.7	17.2	20.3	15.7	18.2
Trade Balance (\$m)	60	-215	8	-518	-808	-947	-573	-717	-646	..
Trade Balance (\$m annual)	-5776	-6024	-5900	-6226	-6340	-6336	-6283	-5827	-5653	..
ANZ World Commodity Price Index (% mom)	2.0	4.9	2.6	6.3	4.6	1.4	0.4	1.8	0.8	0.0
ANZ World Commodity Price Index (% yoy)	17.1	20.9	21.1	29.8	35.1	36.3	35.7	37.8	35.9	30.9
Net Migration (sa)	630	240	430	620	490	740	680	280	530	..
Net Migration (annual)	12081	11222	10682	10078	8966	8730	8309	7517	6588	..

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

SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Nov 07	Dec 07	18 Jan 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
NZD/USD	0.763	0.768	0.760	0.760	0.740	0.710	0.680	0.660	0.640	0.630
NZD/AUD	0.851	0.881	0.871	0.835	0.822	0.807	0.791	0.786	0.780	0.788
NZD/EUR	0.520	0.528	0.519	0.510	0.493	0.486	0.479	0.478	0.478	0.485
NZD/JPY	84.8	86.3	81.2	83.6	79.9	75.3	70.7	69.3	69.1	69.3
NZD/GBP	0.368	0.380	0.386	0.386	0.379	0.368	0.358	0.351	0.344	0.342
NZ\$ TWI	70.3	71.6	70.3	69.7	67.8	65.6	63.5	62.5	61.7	61.7
NZ interest rates	Nov 07	Dec 07	18 Jan 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
OCR	8.33	8.40	8.25	8.25	8.25	8.00	7.50	7.00	6.75	6.75
90 day bill	8.74	8.90	8.71	8.70	8.60	8.00	7.50	7.00	7.00	7.00
10 year bond	6.39	6.39	6.29	6.60	6.70	6.40	6.10	6.10	6.00	6.40
International	Nov 07	Dec 07	18 Jan 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
US Fed funds	4.50	4.25	4.25	3.50	3.00	3.00	3.00	3.25	3.75	4.25
US 3-mth	5.13	4.70	3.93	3.40	3.25	3.15	3.25	3.65	4.15	4.50
AU cash	6.75	6.75	6.75	7.00	7.25	7.25	7.25	7.25	7.25	7.25
AU 3-mth	7.25	7.24	7.10	7.30	7.50	7.50	7.50	7.50	7.40	7.40

KEY RATES

	18 Dec	14 Jan	15 Jan	16 Jan	17 Jan	18 Jan
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
90 day bank bill	8.88	8.77	8.79	8.74	8.74	8.71
NZGB 07/09	7.43	7.27	7.31	7.30	7.30	7.23
NZGB 11/11	7.12	7.03	7.05	7.03	7.03	6.97
NZGB 04/13	6.96	6.96	6.96	6.94	6.94	9.89
NZGB 12/17	6.38	6.28	6.32	6.29	6.29	6.26
2 year swap	8.64	8.59	8.58	8.53	8.48	8.39
5 year swap	8.14	8.11	8.09	8.05	8.01	7.95
RBNZ TWI	70.9	72.3	72.6	71.7	71.1	70.30
NZD/USD	0.7558	0.7856	0.7911	0.7805	0.7695	0.7607
NZD/AUD	0.8782	0.8764	0.8797	0.8814	0.8734	0.8707
NZD/JPY	85.59	85.49	85.39	83.29	82.51	81.16
NZD/GBP	0.3739	0.4010	0.4042	0.3972	0.3918	0.3861
NZD/EUR	0.5246	0.5306	0.5319	0.5258	0.5250	0.5193
AUD/USD	0.8606	0.8964	0.8993	0.8855	0.8810	0.8730
EUR/USD	1.4407	1.4807	1.4873	1.4845	1.4656	1.4638
USD/JPY	113.25	108.82	107.94	106.71	107.23	106.83
GBP/USD	2.0215	1.9591	1.9570	1.9649	1.9642	1.9687
Oil	90.69	92.74	94.23	91.87	90.80	90.11
Gold	792.50	893.90	907.80	899.38	881.00	872.25
Electricity (Haywards)	6.14	8.30	7.06	8.48	n/a	n/a
Milk futures (US\$/contract)	166	152	151	150	150	n/a
Baltic Dry Freight Index	9751	7654	7336	6915	6472	n/a

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