

IT ISN'T BROKE SO DON'T CHANGE IT

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Page 2: Economic overview

- > The local data continues to paint a very weak economic picture. Brace for more of the same this week. Last week saw speculation of changes to the monetary policy framework. Our view is simple: it isn't broke so don't tinker with it!

Page 5: Economic comment – defending the front line

- > Governments and associated spending have a clear role in a modern society. The international literature is generally indeterminate in defining how strong this role should be, and the relationship between government spending and economic growth. However, the literature is clear in the view that some areas of spending are more “valuable” and productive than others. Looking at a range of gauges we find that the “mix” to current government spending is being directed into back office and less productive areas. This does not mean the mix is wrong per se, and we need to be wary of making sweeping assessments. But certainly more attention needs to be paid to where money is ending up.

Page 9: Economic comment – global watch

- > US economic weakness is now clearly broadening. Data for the UK was weak across the board last week as a housing-led slowdown filters through the rest of the economy. The Euro-zone is also slowing, with PMI data showing contractions for the services and manufacturing sectors.

Page 10: Interest rate strategy

- > QSBO expected to reinforce weakness in the economy, and may get the market more attuned to the possibility of a July move. Expect the swaps market to range trade ahead of next week's CPI data.

Page 11: Currency strategy

- > The NZD remains stuck in its well established range against the USD as both economies remain very weak. Uncertainty remains high across currency markets as tensions across credit, commodities and equity markets continue.

Page 12: Currency comment – NZD/AUD and commodity risk

- > We continue to hold a very bearish view towards the NZD/AUD (bullish AUD/NZD), which we expect to hit 0.72 (1.38) based on economic divergence. An Achilles heel to this view is a potential turn in the commodity cycle with negative implications for the AUD. While there seems an inevitability about something changing on the commodity front over the coming months as central banks move towards more alert inflation modes, the fundamental case for further NZD/AUD weakness remains compelling.

Page 14: Data and event calendar

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ECONOMIC OVERVIEW

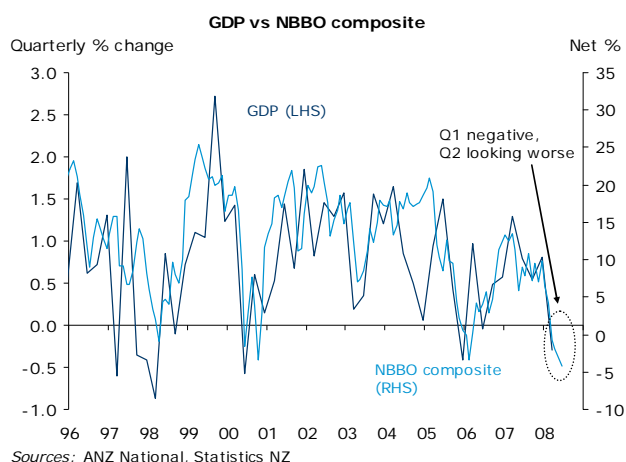
The local data continues to paint a very weak economic picture. Brace for more of the same this week. Last week saw speculation of changes to the monetary policy framework. Our view is simple: it isn't broke so don't tinker with it!

What's ahead?

- > **NZIER Q2 Quarterly Survey of Business Opinion** (Tuesday 1000 NZST). In similar themes presented in the NBNZ *Business Outlook*, headline confidence may improve slightly. However, activity indicators such as employment and investment intentions should continue to deteriorate. Resource pressure gauges are also expected to soften, although pricing and cost measures will remain elevated, if not push higher.
- > **REINZ June Housing report** (circa 10 June). A bounce in sales volumes in line with the Barfoot & Thompson data is possible. However, we expect median days to sell to increase and house prices to fall.

What's the view?

Last week was relatively quiet on the domestic front. The major new piece of information (well the picture it is painting is not new) was the National Bank *Business Outlook* for June. Headline business confidence once again nudged higher, with a net 39 percent of firms expecting the economy to deteriorate over the coming 12 months, up from a net 50 percent in May. However, the detail of the survey shows that the underlying economy remains very weak. Own activity expectations, which provide a better indication of actual economic activity, remain in negative territory – the fourth consecutive month this has been the case. Not since 1988 have we seen firms' own activity expectations remain so consistently weak. We've said it before and we'll say it again. When this indicator is negative, the economy is moving backwards.



Other indicators within the survey also make for pretty grim reading. Employment intentions continue to fall, with a net 12 percent expecting labour market

conditions to worsen. This is a pretty clear sign of where the unemployment rate is likely to head over this year and next. Investment intentions also fell. Profit expectations did improve slightly, but remain well in negative territory, with a net 19 percent expecting a deterioration over the coming year. Collectively, our composite growth indicator from the survey remains in negative territory. Growth in Q2 now looks to have been weaker than Q1, and we struggle to see where momentum for Q3 will emerge from.

The other data released last week were the Barfoot & Thompson house sales for June and building consents issued for May. The former reported house sales for the Auckland region rising by a seasonally adjusted 15 percent for the month, following a 5 percent fall in May. Given the considerable falls in sales activity over the past year, with sales volumes still down 44 percent on a year ago, a rebound was likely at some stage. However, it is still far too early to say whether the trough has been and gone. The average house price fell 2 percent in the month and is down 2 percent from a year ago. House prices from the Barfoot data show that they are now 7 percent off the early 2007 peak. The more comprehensive REINZ data is expected to be released later this week and we will be looking for similar themes.

The consent data showed a large 45 percent fall in residential consent issuance following the massive 83 percent surge in the previous month. Looking through the volatility, which has been exacerbated by the early Easter this year and a couple of large apartment complexes receiving consent approval in April, consent issuance continues to soften, with the number down 27 percent on a year ago. Further weakness is expected given the thin activity in the housing market at present, suggesting that the construction sector will remain a considerable drag on economic activity for the remainder of this year.

In one positive development, there are some signs that this reduced activity is resulting in less inflation pressure from this sector. Growth in the value of dwelling consents issued per floor area (a proxy for construction costs) has slowed to just 1 percent (on a three month average basis) compared with a year ago. This is well down from over 10 percent early last year. We will be looking closely at whether this is being reflected in the CPI data to be released next week. Slowing housing-related inflation is required to offset the significant cost-push inflationary forces of high oil and food prices.

Another key area we are watching at present is the rising cost of international credit. Remember, NZ runs a large current account deficit so this carries an explicit cost. Credit gauges have been steadily deteriorating over the past month. The Australian iTraxx series – a cost of credit measure – rose over 40 percent in June alone (although we admit it is still well off its March peak). If international credit markets do not improve (or worse still, deteriorate further) this means financial conditions within the NZ economy will

continue to tighten, and at a time when the economy is already heading backwards.

Australian 5-year iTraxx



Sources: ANZ National, Bloomberg

It is one major reason why we have sympathy for the RBNZ beginning to cut rates as soon as the end of this month in order to offset the tightening in financial conditions coming from other areas. However, each day we also glance at oil prices, and when we see prices close to US\$145/bbl (up another 3.6 percent this week) and the inflation rate set to push through 5 percent, it's a hard environment to envisage monetary policy relief. The NZD/AUD is also now firmly in a downtrend, which is great news for manufacturers. No doubt we'll soon be seeing a big boost in the number of holidaymakers from Australia. For now we remain in the September rate cut camp, but as noted last week we believe the odds on a July move are as high as 50 percent. Such is our wariness over areas like the rising cost of credit. The situation on a number of fronts is moving fast.

Last week also included some speculation and discussion from politicians that the monetary policy framework and potentially the Reserve Bank Act could be reviewed. We literally winced when we heard it.

For one, the monetary policy framework has served the economy well. Average GDP growth has been higher, inflation rate lower, and volatility has been substantially reduced – all testament to the framework's success. The average quarterly percentage increase in real GDP has not only been higher over the 1990s and in the first part of this decade compared to the 1970s and 1980s, but the volatility (as measured by the standard deviation of the quarterly growth rate) has also been greatly reduced. For inflation, the average quarterly percent change in the CPI index has reduced substantially from the 2.9 percent (almost 12 percent annualised) averaged over the 1970s to an average of 0.68 percent (2.7 percent annualised) since 2000.

Second, monetary policy is a convenient scapegoat for other evils. Fix the productivity problem we have and we wouldn't have an inflation problem. New Zealanders being New Zealanders, we tend to focus on the negative aspects of higher food and oil prices, not realising that net on net the country is actually

relatively better off from the factors driving them higher. Clearly there is some wealth redistribution going on between Auckland and urban centres to Southland and the Waikato. But as a net commodity exporter we are still better off in aggregate. Let's not forget that the Reserve Bank told everyone three years ago to stop investing in property, so it's a bit rich to blame them when house prices start to fall.

	GDP (quarterly % change)		CPI (quarterly % change)	
	Average	Std Dev	Average	Std Dev
1970s	0.54	0.84	2.90	1.08
1980s	0.44	1.24	2.75	1.63
1990s	0.69	1.00	0.46	0.48
2000-now	0.76	0.63	0.68	0.38

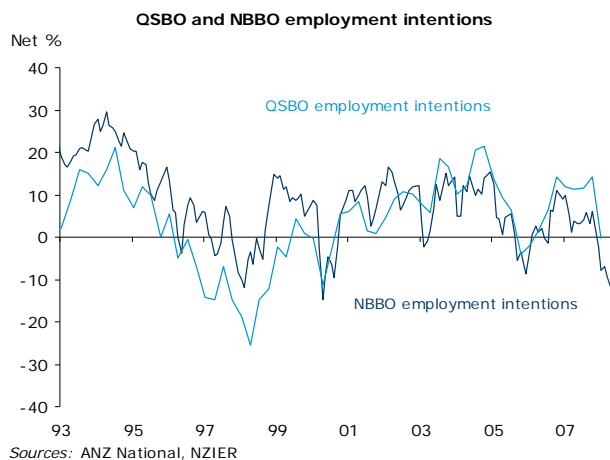
Moreover, NZ is critically reliant on offshore capital and credit markets remain fickle. Global investors' decisions are in part determined by the overall macroeconomic framework within an economy. This is completely the wrong time to be looking at fiddling with a fundamental component of the macroeconomic framework.

Finally, the heart of the monetary policy framework resides in its credibility to deliver low and stable inflation. Such credibility was hard to win over in the 1980s and early 1990s. Making noises in regard to changing the framework risks undermining the central bank's credibility, and the endgame to restoring it could be higher, as opposed to lower, interest rates.

We hope the comments were mere politicking and it ends there. If there is an area that should be reviewed, it is regarding the interaction between monetary and fiscal policy. We'll repeat our message from three weeks ago: monetary policy needs mates in a globalised world and fiscal policy is not impotent. This is where the government's primary focus should be.

Now that we've got that off our chest, we can look towards the events of this week. The big one will be the NZIER's Quarterly Survey of Business Opinion released on Tuesday. Although it is expected to mirror the themes present in the timelier NBNZ *Business Outlook* (NBBO), the resource and employment gauges in the survey will be important. For completeness, we expect headline confidence to improve slightly, but for the domestic trading activity measure to remain weak and consistent with no growth. Employment intentions are expected to fall sharply, a sign of where the unemployment rate is expected to head over this year and next. We also expect resource pressure gauges to improve. Difficulty in finding skilled and unskilled labour should reduce, and the key capacity utilisation measure could potentially fall sharply after last quarter's surprising surge. We put this down to the dry weather conditions resulting in farmers sending livestock to slaughter early causing a bottleneck at slaughterhouses earlier this year. All these nuances should be welcomed by the Reserve Bank. However,

we also expect to see cost and pricing intention measures push ever higher, which will only reinforce the challenging dynamic present for the Reserve Bank as they weigh up the risk of second round effects from a near-term blip in inflation versus more favourable medium-term forces.



The international calendar is reasonably quiet this week. The big events will be the BoE's interest rate announcement where they are expected to leave rates unchanged, and the release of June labour market data for Australia. Seeing as the May Australian employment data showed large contraction of close to 20,000, this week's number will be closely watched. Our Australian colleagues are looking for a strong rebound of 25,000.

To finish off, we thought it was about time to give an update on our monthly inflation gauge. We believe someone should take the lead in preparing one as the lack of monthly inflation data is a major gap in our statistical armoury, and while no easy task, it's simply a case of doing as best you can. The series remains a work in progress and it will be a while before we can accurately assess its value or usefulness relative to the official statistics. Moreover, we need to make sure it is reasonably stable and not inclined to give 'off the wall' reads. It should be noted that our monthly inflation gauge, while designed to be as comparable as possible to the official Statistics NZ series, will not exactly mirror the official series due to coverage issues. However, the original intention was never to duplicate the official statistics. Rather, our main priority is to come up with a gauge that is timely and able to provide an indication of domestic inflation trends, to assess the extent to which inflation pressures remain, or whether they are starting to ease.

Our gauge covers a host of non-tradable inflation areas ranging from construction costs, real estate agent fees, rents, dental visits, paramedical charges, rest homes, accountancy charges, newspapers, hairdresser, insurance, credit services, postal, telecommunications, energy.....the list goes on. Basically, a very broad spectrum of non-tradable prices, which is the pocket of inflation the Reserve Bank can influence.

Our monthly inflation gauge rose by 0.5 percent in the month of June, following a 0.7 percent rise in May.

Interestingly the housing components were the main source for the increase, with the purchase of housing and property maintenance services the main drivers. This surprised us a little and on the face of it this suggests the weakness we are seeing in the housing market has not yet reached sufficient critical mass to dent pricing. Rent increases appear well contained, after showing strong growth earlier in the year. Domestic airfares were the other major source of price increases, as airlines pass on the higher fuel costs onto consumers. Comments from some of our respondents indicate that due to higher input costs, they were attempting to push through price increases, though whether those price increases will stick given the soft demand environment remains to be seen. While the series is not long enough to draw any firm conclusions, it does suggest that the official Statistics NZ non-tradable CPI series will print reasonably solid for Q2. It also suggests there might be a bit of 'get the price hikes in now' attitude around.

	Monthly inflation gauge (m/m%)
Mar-2008	0.4
Apr-2008	0.2
May-2008	0.7
Jun-2008	0.5

We've pencilled in a 1.0 percent rise for Q2 non-tradable (the same as the RBNZ), but the indications from our monthly gauge suggest it has more upside risk. Obviously, it is hard to imagine the RBNZ cutting rates in July if the gauge is correct (although of course we know the Reserve Bank's attention should be on inflation tomorrow as opposed to today).

We'll continue to track our gauge over the coming months and make a decision before the end of the year as to whether to continue.

Recent data...

NZ Building Consents (May): Total residential dwelling consents fell 45 percent, following a 83 percent surge in April.

NBNZ Business Outlook (June): Headline confidence improved from a net 50 percent expecting worse times over the year ahead in May to a net 39 percent in June. Own activity expectations remain in negative territory and employment intentions continue to fall. Pricing intentions rose again.

Barfoot and Thompson Auckland House Sales (June): Seasonally adjusted house sales rose by 15 percent. The average house price fell to \$525,316 and is 7 percent off its early 2007 peak.

ANZ Commodity Price Index (Jun): The world price index was unchanged over the month, although the NZD index was up by 2.1 percent.

DEFENDING THE FRONT LINE

Governments and associated spending have a clear role in a modern society. The international literature is generally indeterminate in defining how strong this role should be, and the relationship between government spending and economic growth. However, the literature is clear in the view that some areas of spending are more “valuable” and productive than others. Looking at a range of gauges we find that the “mix” to current government spending is being directed into back office and less productive areas. This does not mean the mix is wrong per se, and we need to be wary of making sweeping assessments. But certainly more attention needs to be paid to where money is ending up.

Government spending and paying tax; it is a combination that is seen to be as certain as death, if the famous quote from Benjamin Franklin is anything to go by.¹ Yet most people will accept (even if begrudgingly) the important role that governments play in any modern economy. The legislative and economic framework that they ultimately instil provides the basic foundation for the effective functioning of the economy. A key feature of our society is the ability to provide a leg-up to those that are less fortunate. Yet a leg-up is distinct from a hand-out. In a just and fair society, it goes without saying that peoples’ hard earned dollars should be spent wisely.

Governments and their associated spending have a clear role in modern economies:

- > They provide core public goods that, due to their non-rivalry and non-excludability, will not have been produced by the private sector. National defence is an example.
- > They set out a legal and social framework within which the economy operates in.
- > They address market failure by spending and investing in areas where the social rate of return exceeds the private rate of return.
- > They provide a basic social safety net.

However, poorly-conceived and ill-directed government spending can lead to poor economic outcomes. High levels of government spending can crowd out more productive private enterprises (displacement costs). There are also deadweight costs of taxation associated with raising the revenue to fund government spending, arising from distortions and the burden placed on households and businesses. In addition, the public sector is often thought to be less efficient than the private sector, leading to inefficiencies and lost productivity.² Another potential cost comes in the form of negative multiplier costs, where activities that are funded by only a small

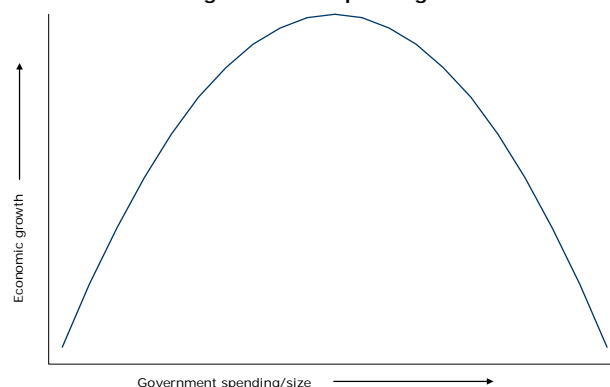
portion of the government's budget actually create large costs in terms of economic growth.

Identifying and quantifying the economic costs of poor government spending is difficult because no one really knows the counterfactual. The actual nature of a government's role within an economy also adds to the difficulty. Government spending can raise the marginal product of capital, yet the funding of such expenditure – via taxes – creates disincentives.

The relationship between economic growth and government spending has long been the subject of much intense debate. Economic theory widely acknowledges the positive role that the provision of certain public goods has, such as education, law and order, and infrastructure spending, along with negative externalities that can be overcome via government intervention. Conversely, funding such programmes can reduce the incentives to work and innovate, and government involvement can easily crowd out more productive private suppliers.

The stylised relationship between economic growth and government spending is typically expressed as a “humped” relationship, where government spending is seen to be positively correlated with economic outcomes up to a point, and turn negative thereafter as decreasing returns and distortionary effects set in.

“Humped” relationship between economic growth and government spending



This “humped” relationship is illustrated in Barro (1990).³ In his famous paper, government spending increases the marginal product of capital, therefore providing an incentive for increased private investment and hence higher long-run economic growth. However, the means to fund this government spending requires distortionary taxes, which reduce the incentive to invest. As a result of this, and as described in Dowrick (1995), a country faces a “hump-shaped” relationship between economic growth and government spending (or in this case, the size of government relative to GDP).⁴ When the size of government is small, the positive growth effects of government on private sector productivity are greater than the negative effects from distortionary taxes.

¹ The actual quote was “*Certainty? In this world nothing is certain but death and taxes.*”

² To be fair, there are no official estimates of public sector productivity growth in New Zealand.

³ Barro, R. J. (1990), “Government Spending in a Simple Model of Endogenous Growth” *The Journal of Political Economy* 98 (5).

⁴ Dowrick, S. (1995), “The Determinants of Long-Run Growth” RBA 1995 Productivity and Growth conference.

However, there is a point, as the size of government increases, where the distortionary tax effect dominates and the net marginal effect of government is negative.

But a wider review of the empirical literature reveals some very contrasting results. Cross country studies, in particular, appear to show the most divergent views, with results ranging from government spending having a significant positive effect on growth to a significant negative effect, or no effect at all. Difficulties with data, which countries to include or to exclude (rich or poor), and what empirical frameworks with which to test hypothesis have all been found to influence the results. Economic theory states that the level of government spending has an important effect on economic growth, yet the empirical evidence of this is mixed. It makes drawing broad conclusions about government spending very difficult.

However, some key themes are still apparent within the literature.

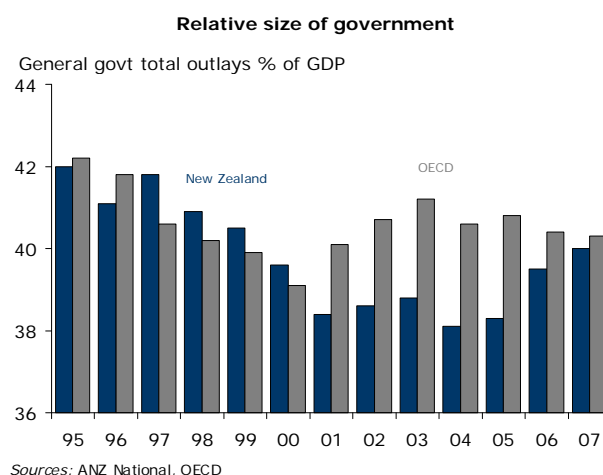
- > Government spending is both necessary and optimal for growth up to a point, with no consensus on where that inflection or the optimal point resides. So we would be inclined to agree with Dr Cullen when he refers to ideological burps in relation to the overall level of government spending or size of government. It's impossible to tell and we suspect is critically dependent on a range of economic and institutional factors that will vary across countries.
- > The weight of literature appears more skewed towards a negative relationship between government spending and growth, although once again, it is open to a fair degree of debate.
- > The mix to spending is more important than the level itself. Identifying the appropriate mix to spending is equally difficult. While some of the examples of productive spending are education, R&D subsidies, transport and communication spending, how far this extends is uncertain. Formal analysis suffers from data limitations in this area, with each country's government spending data heavily aggregated.

So what can we say about NZ? Government spending as a share of GDP peaked in 1990, fell over the subsequent 10 years, but is now rising again. Relative to the OECD, general government spending as a percentage of GDP is currently around 40 percent, compared with an OECD average of 40.3 percent.⁵

Can we read anything into this? While tempting to be headline grabbing by stating that the government is taking a larger share of the economic pie, crowding out private sector involvement and imposing additional deadweight and distortionary costs; the truth is that we need to be wary of making such sweeping assessments given the evidence from the literature. Certainly, we know from microeconomic theory (i.e. at the individual level) that disincentive effects associated with a larger

⁵ General government spending includes central and local government spending as well as current and capital outlays.

role for government are pronounced. But it is a different proposition to marshal this into formal microeconomic and top-down macroeconomic evidence.



This difficulty has led us to pursue a different route, focusing on the mix to spending as opposed to the level, and using benchmarks that we believe are more easily understood. What follows are four indicators, derived from the government's fiscal accounts.

The back-office to the front-line.

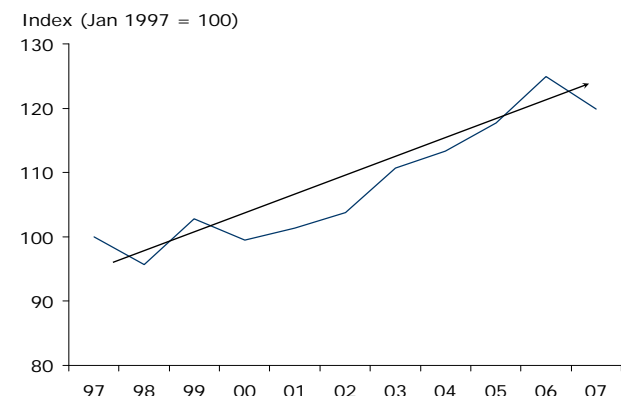
Talk to any private enterprise, and the focus is on devoting as much resources as possible to the customer facing (i.e. front-line) part of the business to enhance their service proposition. It is how enterprises directly (financially) or intangibly (i.e. through the provision of a service such as medical care) add value. Just think about the expectation of the typical taxpayer. It is not that they are opposed to paying tax (the vast majority anyway!), but rather it is the feeling (knowing) that their taxpayer dollars are being well spent on appropriate service delivery.

The "back-office to front-line" barometer is derived by using the ratio of aggregate spending on departmental outputs (what departments spend on goods and services) to what we consider front-line purchases, the latter being those services taxpayers generally expect their money to be used for, and where the literature assesses governments generally get a better bang for their buck or fulfil public good criteria. It is based on the assumption that higher priority and "value" spending or the delivery of the social safety net should ultimately find its way into front-line services that are closer to the public. Front-line purchases includes welfare benefits, health service purchasing, early childhood, primary, secondary and tertiary funding, science expenses, overseas development expenses, law and order, defence, land transport spending, employment initiatives, and housing subsidies.

While we acknowledge that there may be a degree of overlap between front-line purchase and spending on departmental outputs (or swapping with non-departmental outputs), ultimately it is the trends within the data that is important. As a broad principle, we would expect the indicator to provide a sound gauge as to where money is being *relatively* directed. The notion is simple: *relatively* more money should

always find its way into front-line services. The emphasis on **relativity** is important. We are not talking about the amount of money spent, but rather where it is being directed.

Back office vs front-line

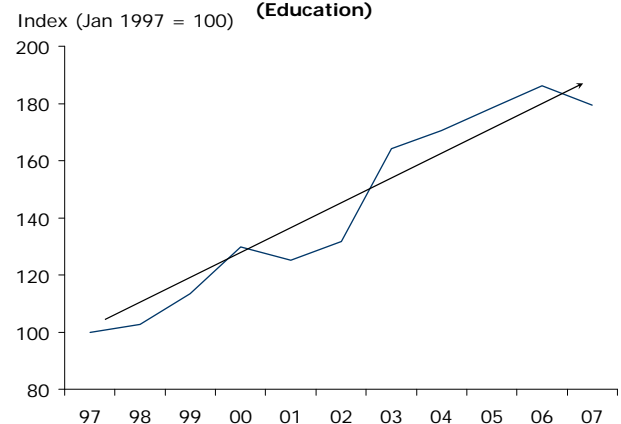


Sources: ANZ National

What we find is that back-office (departmental) expenses have exceeded our definition of front-line spending, resulting in an upward trend. Growth in total departmental outputs has averaged close to 7 percent per year since 1997, while front-line spending has averaged 5 percent per year. Nominal GDP growth within the economy has averaged 5.5 percent so departmental output spending has even outgrown the average enterprise. If the ratio of back-office to front-line spending had remained constant since 1997, then there would have been close to an extra \$1 billion free for other initiatives in 2007. The cumulative saving since 1997 is over \$3 billion.

While we present an aggregate indicator for the amount of spending on back-office versus the front-line, we can also present this gauge for different components of government spending (i.e. the ratio of departmental output spending in social welfare relative to benefits paid, the ratio of departmental output spending on education relative to front-line education purchases).

**Back office vs front-line
(Education)**



Sources: ANZ National

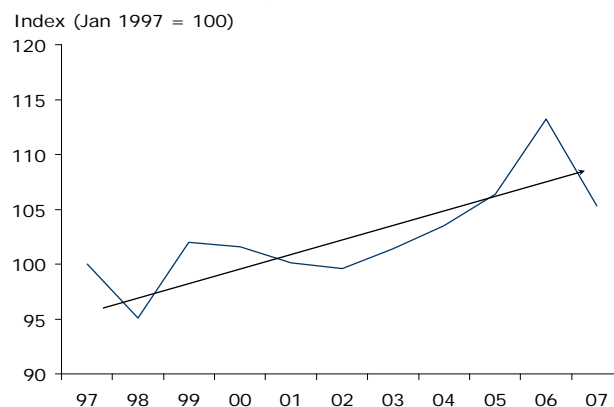
Interestingly, if we look at the trend in back office versus front line spending for education, departmental spending (which has averaged 12 percent per year since 1997) has massively outstripped education

purchases for early childhood, primary, secondary and tertiary funding. Likewise for spending purely on benefits, which has increased by an average of 3 percent per year, while benefit department expenditure growth has averaged 7½ percent per year. Conversely, health has seen an improvement. Now, there might be some classification issues here, but nonetheless it is an interesting trend to note over more than a decade.

Investment for tomorrow versus spending for today.

We define this barometer as front-line investment in education and transport (investment in human capital and infrastructure which clearly give tangible benefits) relative to spending on total departmental output spending. Investment in education and infrastructure is not expected to get immediate returns, but instead the benefits accrue over time (hence the reference to "tomorrow").

Today vs tomorrow



Sources: ANZ National

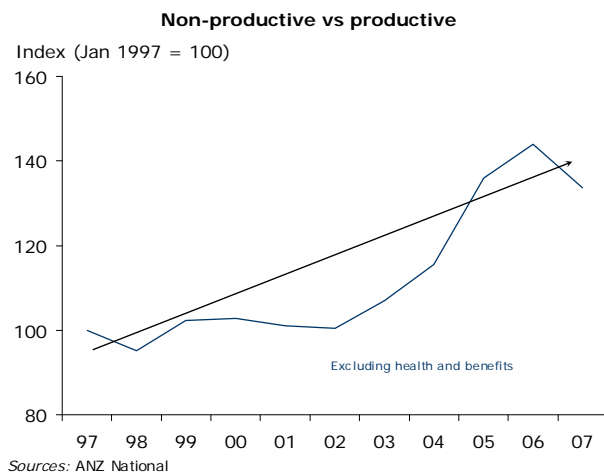
Education and transport funding have both grown strongly over the past decade, averaging 6.2 percent per annum. On the face of it, this is encouraging from a pure investment point of view, although investment quantity does not necessarily mean quality. However, **relatively** more money has been going into departmental spending. This is the puzzling aspect.

More productive versus non (less) productive.

We define productive spending as (front-line) funding for education, law and order, science, housing, defence, employment initiatives, and transport. Non-(or less) productive expenditure includes departmental outputs, non-departmental outputs, heritage culture and recreation, and economic and industrial services.⁶

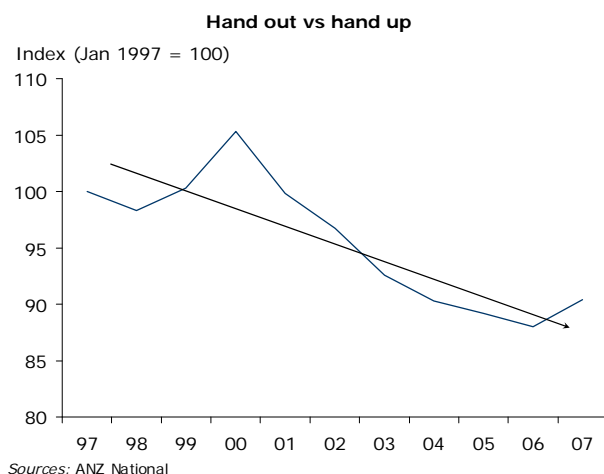
Non-productive spending has far outpaced our definition of productive spending. Growth in non-(or less) productive spending (excluding benefits) has averaged 8.4 percent per year since 1997. The average growth in more productive spending was only 5.2 percent over the same period.

⁶ We exclude health as to be honest we were unsure where to classify it. We also remove welfare benefits as they have shown subdued growth owing to favourable demographics and a lower unemployment rate.



Hand up versus hand out.

This indicator is based on the idea that a hand up is better than a hand out, and policy-makers' primary goal should always be directed towards giving the incentives and assistance that allow people to get ahead. "Hand out" is defined as benefit spending, while "hand up" is the sum of front-line education funding (excluding student loan funding) and employment initiatives.



Encouraging, relatively more money is going towards "hand up" initiatives than benefit spending. Hand up spending has averaged 4.4 percent per year since 1997, compared with average growth in benefit spending of 3.3 percent per year.

The picture is not quite so rosy if we focus solely on tertiary funding and employment initiatives (i.e. removing primary, secondary and early childhood education). However, the gauge is at least not falling and has effectively been flat-lining for the past decade. Neither is it so rosy if we exclude the unemployment benefit, which has fallen dramatically as a consequence of an extended period of economic expansion.

Shortcomings

We acknowledge that care must be taken in interpreting the barometers we have presented. Not all education spending will be "productive", nor cultural spending "less productive". There will "blurred" lines so we highlight the need to focus on trends.

- > We may be playing catch-up. It could be that some aspects of government spending and services were run-down in past years, and the changes we have seen since 1997 were catch-up. While certainly a fair point and "catch-up" may have biased some measures, the length of the trend across the gauges indicates this factor should not be dominating.
- > Data limitations mean international comparisons are impossible so there is no best-practice to benchmark the barometers against.
- > The mix to spending is not necessarily wrong. We live in a democratic society and need to be cognisant of the political economy of spending decisions made on constituents' behalf.
- > Our barometers say nothing about what is the optimal level of government spending (which, going by the literature discussed earlier, is impossible to define anyway).
- > Our indicators say nothing about the individual quality of the components to spending, which is where the primary focus should reside, nor deadweight cost associated with funding it.

Nonetheless, we believe the trend across our gauges is sufficiently clear: more government spending is being directed at areas that are not going to the front-line, and for consumption today relative to tomorrow.

The upshot

Where to from here? There are endless possibilities but we'll just leave readers with a few suggestions. First, the spending value chain needs to be re-assessed, as on the face of it money is not going to the front line. Greater quality aspects to spending and measurable benchmarks need to be introduced into the Government's stated objectives such as the Fiscal Strategy Report, and it may well be time to review the Public Finance Act.

While fiscal transparency and rigorous analysis of government spending decisions is to be applauded, we also need to be mindful of another aspect. We appear to be attempting to run a Rolls Royce style framework when a Toyota will suffice (no offence meant to the car manufacturers). As last week's focus on the form filling required to get approval for basic maintenance in the education sector alluded to, it seems resources are tied up in approval and monitoring as opposed to getting the job done. There is a fine line between transparency and bureaucracy.

It may well be time for another QUANGO or equivalent hunt (for those that remember the 1980s). Do we really need 41 government departments and 65 crown entities, not to mention the 21 DHBs and 9 CRIs for a population of four million?

Finally here's a challenge to Treasury, as guardians of the public purse. Develop a set of fiscal indicators that will allow independent assessments as to the mix and quality of government spending. We've started the ball rolling.

GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. US economic weakness is now clearly broadening. Data for the UK was weak across the board last week as a housing-led slowdown filters through the rest of the economy. The Euro-zone is also slowing, with PMI data showing contractions for the services and manufacturing sectors.

Country/ Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	ISM Manufacturing (Jun)	48.5	50.2	49.6	Stronger
	ISM Prices Paid (Jun)	87.0	91.5	87.0	Stronger
	Construction Spending (May) – mom	-0.6%	-0.4%	-0.1%	Stronger
	Factory Orders (May)	0.5%	0.6%	1.3%	Stronger
	Change in Non-Farm Payrolls	-60k	-62k	-62k	In-line
	Unemployment Rate (Jun)	5.4%	5.5%	5.5%	Weaker
	ISM Non-Manufacturing (Jun)	51.0	48.2	51.7	Weaker
	Europe	CPI Estimate (Jun) – yoy	3.9%	4.0%	3.7%
PMI Manufacturing (Jun F)		49.1	49.2	49.1	In-line
Unemployment Rate (May)		7.1%	7.2%	7.2%	Weaker
PPI (May) – mom		0.9%	1.2%	0.9%	Stronger
PMI Services (Jun F)		49.5	49.3	49.5	Weaker
Retail Sales (May) – mom		0.6%	1.2%	-0.6%	Stronger
ECB Interest Rate Announcement		4.25%	4.25%	4.00%	In-line
UK		GfK Consumer Confidence (Jun)	-31	-34	-29
	Mortgage Approvals (May)	51K	42K	58K	Weaker
	Nationwide House Prices (Jun) – yoy	-6.4%	-6.3%	-4.4%	In-line
	PMI Manufacturing (Jun)	49.8	45.8	49.5	Weaker
	PMI Construction (Jun)	43.1	38.8	43.9	Weaker
	PMI Services (Jun)	49.5	47.1	49.8	Weaker
Asia Ex-Japan					
<i>China</i>	PMI Manufacturing (Jun)	-	52.0	53.3	-
<i>Singapore</i>	Purchasing Managers Index (Jun)	48.7	50.6	49.0	Stronger
	Electronics Sector Index (Jun)	49.2	51.7	49.4	Stronger
<i>India</i>	Exports (May) – yoy	-	13.0%	31.5%	-
	Imports (May) – yoy	-	27.0%	36.6%	-
<i>Malaysia</i>	Unemployment Rate (1Q)	-	3.6%	3.0%	-
	M3 Money Supply (May) – yoy	-	12.4%	12.2%	-
<i>Vietnam</i>	GDP (2Q)	-	6.5%	7.4%	-
	Retail Sales (Jun) – yoy	-	30.0%	29.7%	-
<i>Indonesia</i>	Inflation (Jun) – yoy	12.58%	11.03%	10.38%	Weaker
	Exports (May) – yoy	18.5%	31.4%	23.1%	Stronger
	Imports (Ex Trade Zones) (May) – yoy	47.0%	50.1%	66.2%	Stronger
Japan	Housing Starts (May) – yoy	-3.7%	-6.5%	-8.7%	Weaker
	Tankan Large Manufacturers Index (2Q)	3	5	11	Stronger
	Labour Cash Earnings (May) – yoy	0.7%	0.2%	0.8%	Weaker
Australia	Private Sector Credit (May) – mom	0.6%	0.6%	0.4%	In-line
	RBA Interest Rate Announcement	7.25%	7.25%	7.25%	In-line
	Building Approvals (May) – mom	-3.4%	-6.5%	5.4%	Weaker
	Retail Sales (May) – mom	0.1%	0.7%	-0.1%	Stronger

INTEREST RATE STRATEGY

QSBO expected to reinforce weakness in the economy, and may get the market more attuned to the possibility of a July move. Expect the swaps market to range trade ahead of next week's CPI data.

Market themes...

- > RBNZ governor "disappointed" by Q1 GDP data.
- > RBA on hold suggesting it is comfortable with the inflation outlook.
- > US equity selloff continues.

Review and outlook...

A lack of major domestic data saw the rates market drift on largely light volumes. A long US weekend did not help. The week started with RBNZ Governor Bollard reported as saying that he was disappointed with the Q1 GDP release, and that he expects Q2 to be flat followed by a soft pick up later in the year. The National Bank *Business Outlook* survey showed own activity remaining in negative territory, pointing to an economy still going backwards. The ANZ Commodity Price Index may have held up at high levels, but the Roy Morgan consumer confidence index continues to plumb to new lows.

Overall, we remain on track for a September start to the easing cycle. But on balance, we are coming to a view that growth is set to undershoot even the RBNZ's weak growth projections, necessitating less tight monetary policy. Tomorrow's QSBO is expected to show broad-based weakness, with indicators or resource pressures easing. But pricing intentions will jump higher – reinforcing the difficult balancing act facing the RBNZ.

While a September move is our core view (the markets are fully priced for it as well), we continue to put a 50-50 chance on July. This is based on our view of weaker domestic growth, the implications of recent finance company difficulties, and increased global credit spreads resulting in higher wholesale funding costs. Of course, inflation remains a sticking point and higher oil prices pose near-term upside risks to inflation. But they also pose a material downside risk to growth as well.

We expect the market to become more attuned to the possibility of a July move following tomorrow's QSBO. But the market will be unlikely to push it too far as it remains fearful of a strong Q2 CPI print next week. With over four rate cuts already priced in over the next 12 months, there will be reluctance for participants to drive swap yields too much lower from current levels. We expect the 2-year swap yield to remain in the 7.8 to 7.95 percent range. We continue to favour receiving the belly of the curve, and to go long the September bank bill futures as a play on a July move.

In offshore events, the BoE interest rate decision is expected to yield a no change. The dataflow is light in the US and Europe, but fairly busy in Australia with labour force data, NAB business confidence, housing

finance, consumer confidence and consumer inflation expectations. The data will provide a check against the RBA's judgement that the domestic economy will continue to slow, eventually helping ease inflation pressures.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↓	Market looking for September easing but July still a real possibility.
NZ data	↓	QSBO tomorrow to be soft across the board.
Fed Funds/front end	↔	On hold with markets paring back rate hike expectations.
RBA	↔	RBA on hold for now provided domestic economy continue to slow.
US 10 year	↔/↓	Yields drifting lower on weak economy but inflation still a worry.
NZ swap curve	↔	Need to see a July move by the RBNZ to see curve steepen.
Flow	↔	Payside flows more dominant which is unwinding of existing positions.
Technicals	↔/↓	Technically the picture is primed for a downward move given soft NZ data. Q2 CPI remains key.

Borrowing strategies we favour at present

A September start to the easing cycle remains on track. Hence, we stick to our preferred strategy which is for borrowers to target the 1-year space, which benefits from positive pick-up. If borrowers are still worried about inflation (oil prices) delaying the easing cycle, they can consider borrowing in the 2-year space.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 24-Jul-08	-32	-38
Thu 11-Sep-08	-104	-106
Thu 23-Oct-08	-188	-192
Thu 4-Dec-08	-268	-260
Thu 22-Jan-09	-336	-340
Thu 5-Mar-09	-400	-388
Thu 23-Apr-09	-444	-430

Trading themes we favour at present

Stick with core strategy of receiving the belly of the curve (3-5 year), and buy September bank bill futures as a play on a July move.

CURRENCY STRATEGY

The NZD remains stuck in its well established range against the USD as both economies remain very weak. Uncertainty remains high across currency markets as tensions across credit, commodities and equity markets continue.

Market themes...

- > Weaker on a TWI basis, but stuck in its recent range against the USD until the RBNZ acts.
- > A number of tensions across markets leading to high uncertainty.
- > QSBO of interest this week, but Q2 CPI (next week) likely to be more important.

Review and outlook...

The broad themes remain unchanged for the NZD; a very weak domestic economy leaving the bias clearly downward (which should increasingly be seen on a TWI basis), but uncertainty surrounding the USD – and particularly the EUR/USD – that is clouding the picture. The NZD remains under pressure against the AUD, but is stuck in its established range against the greenback.

Although the ECB lifted interest rates last week, comments from President Trichet that he now has “no bias” in terms of the monetary policy outlook saw the EUR weaken as markets pared back expectations of further interest rate hikes. This came on top of data that confirms that the Euro-zone region is slowing. The manufacturing and services sectors contracted in June according to PMI surveys. Denmark is now in recession, Spain is weak and the Irish economy also contracted in Q1. The weakness that began in the US is now clearly broadening, although the big bellwether German economy still looks to be holding up relatively well. After breaking through the key 1.58 level earlier in the week, the EUR has now retreated back below this level to remain within the 1.53 to 1.58 channel.

However, the trouble at present is that the US also remains very weak and interest rates have rallied some 40bps in the space of two weeks. The housing market is yet to trough, the unemployment rate is trending higher and equity markets are under considerable pressure. In this environment it is hard to turn bullish the greenback nor expect the EUR/USD to break the bottom (1.53) of the channel.

We have consistently said that if US weakness broadens to other countries, we will see the USD strengthen by default, and this is a view we stick by. However, in the near-term it remains a case of uncertainty remaining high and a number of tensions across markets (credit, equities, and commodities). Until a clear theme begins to develop, we suspect that ranges, albeit large ones, will continue to pan out.

Datawise this week, the major local piece of information is the NZIER QSBO (Tuesday). It is likely to reinforce the messages present within the economy – sharply weaker growth, but still intense cost and inflation pressure. As such it is unlikely to be too

directional for the kiwi. Instead, the Q2 CPI next week is shaping as the critical read prior to the RBNZ’s *OCR Review* near the end of the month. Internationally, the BoE interest rate decision (although no change is expected) and Australian labour market data are the most important developments. The G8 leaders meeting may be of interest. However, without the central bank heads present, there is unlikely to be any concerted comments on currencies. If there is an area to watch it may well be over the political aspect to rising food and commodity prices such as oil. Hence, we’ll be keeping a close eye on commodities this week.

Technically, the NZD has solid support at 0.7540 and we prefer a test of top side resistance at 0.7660 this week. Volatility has decreased, and in periods of low volatility the carry trade out performs. The NZD/AUD trade feels very mature at the moment and with waning momentum we recommend profits should be booked. A move as high as 0.8150 is possible before a top is seen.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	RBA possible hike.
Commodities	↔	Same picture for both.
Partial indicators	↓	Better across the Tasman.
Technicals	↔	Oversold at present?
Sentiment	↓	Terms of trade says it all.
Other	↔	AUD could be vulnerable to turn in commodities.
On balance	↓	Trend is clear.

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	↔	Yield and commodity story factored.
Yield	↔	Watch US data this week.
Commodities	↔	The big one to watch.
Risk aversion	↔/↓	Credit again an issue.
Partial indicators	↓	NZ data now looking weaker than US.
Technicals	↔/↓	Still stuck in range.
AUD	↔/↑	RBA to hike again?
Sentiment	↔	Kiwi on peoples watch list but not pulling the trigger
Other	↔	Inflation all round. EUR/USD direction key.
On balance	↔/↓	RBNZ will need to cut to break range.

NZD/AUD AND COMMODITY RISK

We continue to hold a very bearish view towards the NZD/AUD (bullish AUD/NZD), which we expect to hit 0.72 (1.38) based on economic divergence. An Achilles heel to this view is a potential turn in the commodity cycle with negative implications for the AUD. While there seems an inevitability about something changing on the commodity front over the coming months as central banks move towards more alert inflation modes, the fundamental case for further NZD/AUD weakness remains compelling.

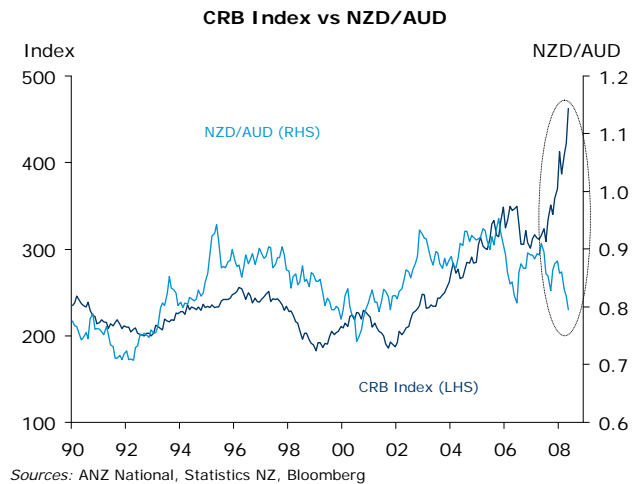
From a fundamental perspective, divergences in productivity growth and the terms of trade between New Zealand and Australia have materially lowered our estimate of fair value for the NZD/AUD. Previous estimates put fair value in the 0.85-0.87 range. Updated structural specifications suggest it has fallen significantly closer to 80 cents. Based on a standard 10 cent overshoot – which has been the historical norm – a movement to the lower 70's remains our strategic target. Ironically, the NZD/AUD was around these levels the last time NZ entered a period of considerable household consolidation and elongated period of weakness.

Given cyclical aspects, including prospects for lower interest rates in New Zealand and positive carry in the belly of the curve currently being achieved by holding AUD, we remain happy to retain a bearish bias, and let the market duck and dive around from week to week in terms of positioning.

However, an often quoted challenge or risk to our view is a potential turn in the commodity cycle. The link between the AUD and commodity prices is well-known. While supply-demand aspects are of course hard to pin down at present, there seems an inevitability about where commodity prices must head in order for global inflation pressure to ease. We'd view it as a cyclical correction within an upward secular trend. The real uncertainty at present is isolating the trigger. But in a world where central banks are mandated to control inflation, the endgame at some stage seems clear enough.

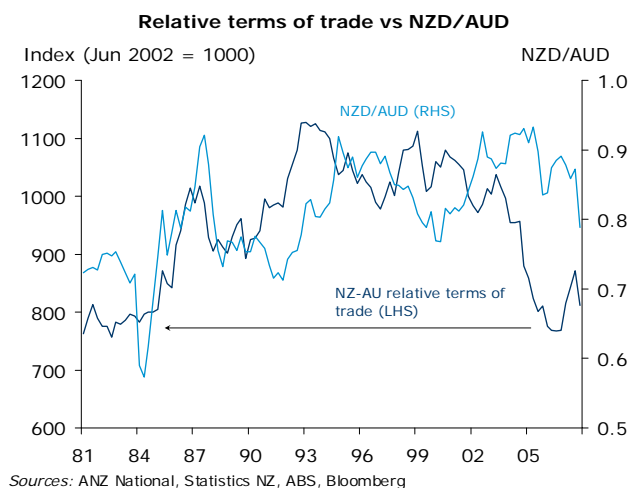
Conventional wisdom is that the NZD/AUD could be vulnerable to an upside cleanout, particularly given general speculation the market is very short. (As an aside, we suspect this is more talk than extreme substance). However, abstracting from this we would also make the following observations:

Observation 1: Correlations between traditional commodity benchmarks and the NZD/AUD are far from determinate. Longer-term, the NZD/AUD has shown a tendency to move positively with hard commodity price benchmarks of the global growth cycle. However, the correlations for the past two (and five) years have turned negative, although this does not extend across all, with zinc and nickel remaining positive (refer table overpage).



Observation 2: Irrespective of the change in commodity prices and correlations, it is hard to go past the level of the respective terms of trade. Australia's terms of trade has risen close to 40 percent in four years, a three-fold increase on the NZ equivalent. Rising prices for bulks including iron ore and coal imply another 10 to 15 percent movement for Australia is "in the bag". Indeed, it would take a massive rout in commodity prices for this gap to close materially, and we need to remember that while demand linked commodity prices may be vulnerable to a turn, various bulks still contain significant capacity constraints, which are maintaining prices.

Observation 3: It's an inputs story as well. When we eye the commodity correlations over the past two years, they signify that the market is in many ways onto the divergent story. Yet the respective terms of trade levels relative to where the NZD/AUD sits portends of a market that has not yet fully captured the net or aggregate story. Remember, NZ is a huge importer of commodities such as oil (a net 0.9 percent of GDP) and commodities such as fertiliser (with prices more than doubling in two years) are a significant input into the rural production process. Such forces heavily dilute the income boost. While the correlation between terms of trade movements and the currency is not strong, it is interesting to note that the last time the relative terms of trade was at its current level, the NZD/AUD was sub 0.70 cents.



payout has risen to above \$7/kg ms, farm prices jumped significantly (forty percent over the past year) and stock (cow) prices more than doubled, and the benefit was quickly capitalised into farm values. This dynamic has important implications for the respective business cycles in terms of expecting continued trickle down from the initial income boost.

The upshot

We're happy to maintain a very negative bias towards the NZD/AUD despite obvious risks of a sudden turn in the commodity cycle, particularly given other volatility we are seeing at present. While this may lead to a short-term bout of position squaring, the fundamental picture between the two economies suggests continued NZD/AUD weakness.

Observation 4: The terms of trade story is also one of ownership. Established corporates with governance structures such as boards have been the initial benefactor of the terms of trade boost in Australia. The response has been to increase capital investment, PM&E, pay down debt, some M&A, but within a framework of medium-term decision making. Hence the trickle down effect of the income boost is not only more substantial (the terms of trade gap) but also more elongated as the benefits slowly diffuse through into the broader economy. We also need to remember that the ASX is already pricing in a weaker outlook for commodities, which ironically is at odds with the commodities market itself. Compare the ownership dynamic to NZ where upon news the dairy

Correlations with NZD/AUD							
Period	CRB Index	WTI	Gold	Copper	Zinc	Aluminium	Nickel
Last 2 years	-0.65	-0.63	-0.35	-0.42	0.49	-0.08	0.60
Last 5 years	-0.47	-0.50	-0.57	-0.57	-0.43	-0.50	-0.33
Last 10 years	0.41	0.26	0.30	0.22	0.14	0.21	0.30
Last 15 years	0.37	0.20	0.24	0.20	0.13	0.22	0.25

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
7 Jul	AU	AiG Perf of Construction Index (Jun)	-	36.9	11:30
		ANZ Job Advertisements (Jun) – mom	-	-1.7%	13:30
		Foreign Reserves (Jun)	-	A\$35.3B	18:30
	JN	Official Reserve Assets (Jun)	-	\$997.0B	11:50
	UK	Industrial Production (May) - mom	-0.8%	0.2%	20:30
		Manufacturing Production (May) - mom	0.0%	0.1%	20:30
	EU	Sentix Investor Confidence (Jul)	2.5	5.2	20:30
	GE	Industrial Production May) - mom	0.3%	-0.8%	22:00
8 Jul	US	Fed's Yellen Speaks in San Diego on U.S. Economic Outlook	-	-	03:00
	NZ	NZIER Business Opinion Survey (2Q)	-	-64	10:00
	UK	NIESR GDP Estimate (Jun)	-	0.2%	11:01
	JN	Japan Money Stock M3 (Jun) – yoy	0.7%	0.7%	11:50
		Bank Lending incl Trusts (Jun) – yoy	-	1.5%	11:50
		Bankruptcies (Jun) – yoy	-	-1.5%	16:30
		Eco Watchers Survey: Current (Jun)	-	32.1	17:00
		Eco Watchers Survey: Outlook (Jun)	-	35.1	17:00
	AU	NAB Business Confidence (Jun)	-	-4	13:30
		NAB Business Conditions (Jun)	-	7	13:30
	UK	DCLG UK House Prices (May) – yoy	3.3%	4.9%	20:30
9 Jul	US	Bernanke Speaks at FDIC Forum on Mortgage Lending	-	-	00:30
		Pending Home Sales (May) – mom	-2.5%	6.3%	02:00
		Wholesale Inventories (May)	0.7%	1.3%	02:00
		Richmond Fed's Lacker Speaks on Economic Outlook in Washington	-	-	04:30
		Consumer Credit (May)	\$7.5B	\$8.9B	07:00
	UK	Nationwide Consumer Confidence (Jun)	65	69	11:01
		Total Trade Balance (GBP/Mln) (May)	-£4200	-£4325	20:30
	JN	Machine Orders (May) – mom	-	5.5%	11:50
		Machine Tool Orders (YoY)	-	1.4%	18:00
	AU	Westpac Consumer Confidence (Jul)	-	-5.6%	12:30
		Home Loans (May)	-2.0%	-3.0%	13:30
		Investment Lending (May)	-	1.4%	13:30
	GE	Trade Balance (May)	17.3B	18.7B	18:00
		Current Account (May)	12.5B	14.5B	18:00
	EU	ECB's Trichet Presents Annual Report to European Parliament	-	-	19:00
		ECB's Gonzalez-Paramo Speaks at Event in San Sebastian	-	-	19:15
		Euro-Zone GDP (1Q F) - qoq	0.8%	0.8%	21:00
		Euro-Zone GDP (1Q F) - yoy	2.2%	2.2%	21:00

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
10 Jul	JN	Domestic CGPI (Jun) – mom	0.6%	1.1%	11:50
		Current Account Total (May)	¥1,934.8B	¥1380.9B	11:50
		Trade Balance - BOP Basis (May)	¥500.0B	¥634.7B	11:50
	NZ	Business NZ PMI (Jun)	-	49.3	12:00
	AU	Consumer Inflation Expectation (Jul)	-	5.9%	13:00
		Unemployment Rate (Jun)	4.3%	4.3%	13:30
		Participation Rate (Jun)	65.3%	65.2%	13:30
		Employment Change (Jun)	10.0k	-19.7K	13:30
	EC	ECB Publishes July Monthly Report	-	-	20:00
	UK	BoE Interest Rate Announcement	5.00%	5.00%	23:00
11 Jul	US	Initial Jobless Claims (w/e Jul 6)	395k	404k	00:30
		Continuing Claims (w/e Jun 29)	3,140k	3,116k	00:30
		Bernanke, Paulson Testify on Markets Before House Committee	-	-	02:00
		ICSC Chain Store Sales (Jun) - yoy	-	3.0%	05:30
	EU	ECB's Trichet Speaks at Event in Munich	-	-	05:45
	US	Fed's Yellen Speaks in Portland	-	-	07:30
	JN	Industrial Production (May F) - mom	-	2.9%	16:30
		Capacity Utilization (May F)	-	-0.7%	16:30
		Consumer Confidence (Jun)	33.0	34.1	17:00
	GE	Wholesale Price Index (Jun) – mom	0.9%	1.4%	18:00
12 Jul	US	Trade Balance (May)	-\$62.5B	-\$60.9B	00:30
		Import Price Index (Jun) - mom	2.0%	2.3%	00:30
		University of Michigan Confidence (Jul P)	55.5	56.4	02:00
		Monthly Budget Statement (Jun)	\$30.0B	\$27.5B	06:00
	AU	CBA/HIA House Affordability (2Q)	-	103.1	13:30

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 economy is heading backwards, but with inflation - a nasty mix for the RBNZ. Upcoming data is likely to confirm that the domestic economy remains weak. However, the key release on the horizon, prior to the RBNZ's *OCR Review*, is the June quarter CPI. The headline will be nasty, but the most important component will be non-tradable inflation and whether the weaker economy is feeding into reduced inflation pressure.

Date	Data/Event	Economic Signal	Comment
Tue 8 Jul (10.00)	NZIER Quarterly Survey of Business Opinion (Jun qtr)	Weak growth, high inflation	We expect headline confidence to improve, but activity gauges to continue to deteriorate in line with the National Bank <i>Business Outlook</i> . Capacity utilisation is also expected to fall following last quarter's surprising surge. Employment gauges are expected to weaken considerably. However, pricing intentions should remain elevated.
circa 11 Jul	REINZ Housing Report (Jun)	Weak	A bounce in sales volumes in line with the Barfoot & Thompson data looks likely. However, we expect median days to sell to increase and house prices to fall.
Mon 14 Jul (10.45)	Retail Sales (May)	Small rebound	Core retail sales are likely to rebound slightly following two soft months. However, headline sales are likely to be weak driven by a fall in motor vehicle sales.
Tue 15 Jul (10.45)	Consumers Price Index (Jun qtr)	High inflation	Petrol and food prices are likely to contribute close to 1 percentage point alone to the CPI increase in the quarter. The mix will be equally important as the headline and we will be closely watching housing-related components to see if any softening is occurring and an early sign weak demand is capping pricing pressure.
Mon 21 Jul (10.45)	Electronic Card Transactions (Jun)	Weak trend	Given cost of living pressures, the underlying trend in retail spending is likely to be weak.
Mon 21 Jul (10.45)	External Migration (Jun)	Base forming	Recent monthly net migration inflows have improved. We expect a base to form around the current annual net inflow of 5,000.
Thu 24 Jul (09.00)	RBNZ <i>OCR Review</i>	50-50	Evidence is mounting that the economy is slowing even sharper than the RBNZ's June assessment. But at the same time near-term inflation pressure is more intense. Looks to be a 50-50 call at this stage. Q2 CPI will be key.
Mon 28 Jul (10.45)	Overseas Merchandise Trade (Jun)	Another deficit	Another monthly trade deficit is expected as the high oil prices continue to add to the import bill.
Tue 29 Jul (10.45)	Building Consents (Jun)	Weak	An early Easter and some large apartment approvals have led to incredibly volatility in consent issuance of late. However, we expect it now to settle back down into its weakening trend.
Wed 30 Jul (15.00)	Credit Growth (Jun)	Weak	Housing lending will remain soft.
Thu 31 Jul (15.00)	NBNZ <i>Business Outlook</i> (Jul)	-	-
On Balance		An economy heading backwards, but with inflation	Growth indicators are awful. But inflation needs to be watched.

SUMMARY OF KEY ECONOMIC FORECASTS

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Mar-10
GDP (% qoq)	0.8	0.5	0.8	-0.3	-0.4	0.1	0.3	0.3	0.5	0.5
GDP (% yoy)	3.2	3.3	3.5	1.9	0.7	0.2	-0.3	0.3	1.2	1.6
CPI (% qoq)	1.0	0.5	1.2	0.7	1.4	1.2	0.9	0.5	0.7	0.7
CPI (% yoy)	2.0	1.8	3.2	3.4	3.8	4.6	4.3	4.1	3.4	2.9
Employment (% qoq)	0.5	-0.3	0.9	-1.3	0.2	-0.2	0.0	0.1	0.1	0.2
Employment (% yoy)	1.5	1.6	2.5	-0.2	-0.6	-0.4	-1.3	0.1	0.0	0.4
Unemployment Rate (% sa)	3.6	3.5	3.4	3.6	3.8	4.0	4.2	4.3	4.5	4.7
Current Account (% GDP)	-8.1	-8.3	-7.9	-7.8	-7.5	-7.5	-7.5	-7.4	-7.2	-7.0
Terms of Trade (% qoq)	0.4	3.7	2.7	4.1	0.0	-1.0	-0.1	-1.5	-1.2	-1.0
Terms of Trade (% yoy)	2.3	8.4	8.5	11.3	10.8	5.8	2.9	-2.6	-3.8	-3.7

KEY ECONOMIC INDICATORS

	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Retail Sales (% mom)	1.1	-0.4	1.8	0.0	0.2	-0.6	-1.2	1.0
Retail Sales (% yoy)	4.1	5.8	7.2	5.4	6.3	7.7	-1.0	4.1
Credit Card Billings (% mom)	2.2	-0.4	1.1	0.5	-	0.8	-3.4	4.0	-1.1	..
Credit Card Billings (% yoy)	9.3	7.7	9.5	7.6	8.6	8.0	3.3	8.2	5.9	..
Car Registrations (% mom)	-6.6	5.7	-3.5	-2.6	5.2	-4.3	-13.3	11.7	-14.7	3.3
Car Registrations (% yoy)	0.1	4.7	2.3	1.4	1.7	1.9	-13.2	-1.0	-20.6	-15.9
Building Consents (% mom)	-11.0	-4.2	0.4	-4.3	3.6	-5.7	-14.3	83.0	-45.0	..
Building Consents (% yoy)	-15.7	-16.0	-4.6	-6.6	-5.3	-17.6	-27.3	30.8	-27.1	..
REINZ House Price (% yoy)	12.3	8.0	6.7	4.5	4.0	0.7	1.6	-1.1	-1.4	..
Household Lending Growth (% mom)	0.8	0.8	0.8	0.7	0.7	0.8	0.4	0.4	0.5	..
Household Lending Growth (% yoy)	13.2	13.0	12.8	12.3	11.9	11.6	10.8	9.9	9.3	..
Roy Morgan Consumer Confidence	121.3	122.0	121.9	126.6	121.2	116.0	111.7	99.9	89.2	86.5
NBNZ Business Confidence	-26.5	-12.9	-19.6	-24.9	..	-43.9	-57.9	-54.8	-49.7	-38.7
NBNZ Own Activity Outlook	17.2	20.3	15.7	18.2	..	2.4	-6.4	-3.8	-4.4	-4.0
Trade Balance (\$m)	-572	-774	-628	39	-311	243	-44	-296	-196	..
Trade Balance (\$m annual)	-6282	-5883	-5691	-5307	-4793	-4422	-4527	-4609	-4813	..
ANZ World Commodity Price Index (% mom)	0.4	1.8	0.8	0.0	-1.4	1.1	2.0	-0.3	0.9	0.0
ANZ World Commodity Price Index (% yoy)	35.7	37.8	35.9	30.9	27.4	26.9	26.9	20.7	18.7	11.6
Net Migration (sa)	630	220	440	0	90	250	530	510	1010	..
Net Migration (annual)	8309	7517	6588	5491	4799	4643	4678	4666	4931	..

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)						
	May-08	Jun-08	7-Jul-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
NZD/USD	0.778	0.762	0.759	0.770	0.750	0.720	0.680	0.640	0.630	0.620
NZD/AUD	0.819	0.801	0.788	0.762	0.721	0.720	0.723	0.719	0.724	0.738
NZD/EUR	0.500	0.489	0.483	0.494	0.484	0.468	0.453	0.441	0.450	0.456
NZD/JPY	81.1	81.4	81.0	80.1	78.0	75.6	73.4	70.4	69.3	69.4
NZD/GBP	0.395	0.387	0.383	0.393	0.389	0.379	0.364	0.346	0.346	0.344
NZ\$ TWI	69.4	68.2	67.6	67.8	65.9	64.0	61.9	59.6	59.6	59.7
NZ interest rates	May-08	Jun-08	7-Jul-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
OCR	8.25	8.25	8.25	8.00	7.50	7.00	6.50	6.00	6.00	6.00
90 day bill	8.72	8.76	8.56	8.20	7.70	7.10	6.60	6.20	6.20	6.20
10 year bond	6.43	6.44	6.35	6.30	5.70	5.60	5.60	5.40	5.30	5.40
International	May-08	Jun-08	7-Jul-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
US Fed funds	2.00	2.00	2.00	2.00	1.75	1.75	1.75	2.25	2.75	3.25
US 3-mth	2.68	2.80	2.79	2.50	2.00	1.75	2.00	2.50	3.00	3.50
AU cash	7.25	7.25	7.25	7.50	7.75	7.75	7.75	7.75	7.25	6.75
AU 3-mth	7.79	7.73	7.77	7.90	8.10	8.10	8.10	7.80	7.20	6.70

KEY RATES

	4 Jun	30 Jun	1 Jul	2 Jul	3 Jul	4 Jul
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
90 day bank bill	8.66	8.66	8.64	8.63	8.62	8.60
NZGB 07/09	7.07	6.95	6.99	7.01	6.99	6.97
NZGB 11/11	6.72	6.35	6.33	6.30	6.30	6.28
NZGB 04/13	6.54	6.32	6.32	6.31	6.30	6.28
NZGB 12/17	6.44	6.34	6.34	6.34	6.34	6.33
2 year swap	8.05	7.81	7.84	7.88	7.87	7.86
5 year swap	7.65	7.45	7.47	7.52	7.51	7.49
RBNZ TWI	69.7	67.8	67.6	67.4	67.5	67.4
NZD/USD	0.7798	0.7632	0.7605	0.7592	0.7606	0.7564
NZD/AUD	0.8157	0.7929	0.7939	0.7908	0.7905	0.7867
NZD/JPY	82.00	81.01	80.67	80.47	80.71	80.75
NZD/GBP	0.3972	0.3829	0.3819	0.3805	0.3820	0.3813
NZD/EUR	0.5045	0.4834	0.4827	0.4803	0.4789	0.4812
AUD/USD	0.9560	0.9625	0.9579	0.9601	0.9622	0.9615
EUR/USD	1.5458	1.5787	1.5754	1.5808	1.5883	1.5718
USD/JPY	105.16	106.15	106.07	105.99	106.11	106.75
GBP/USD	1.9632	1.9933	1.9911	1.9951	1.9912	1.9839
Oil	124.33	139.69	139.96	141.06	143.74	145.31
Gold	880.45	927.05	923.70	940.45	943.35	936.00
Electricity (Haywards)	39.21	33.76	33.03	25.62	23.15	17.81
Milk futures (US\$/contract)	144	145	144	144	144	n/a
Baltic Dry Freight Index	11623	9589	9379	9139	8925	n/a

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