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RODNEY'S RAVINGS

Positive news for economic growth in 2009

EXECUTIVE SUMMARY

The international financial crisis is hurting the NZ economy especially via the direct impact it has had on local banks. Overseas funding dried up soon after the escalation of the crisis in September caused by Lehman Brothers' bankruptcy in the US, with this resulting in banks rationing credit which appears to be the major reason for the extremely pessimistic business sector surveys. The crisis has also been impacting on the NZ economy via the traditional mechanisms of lower international commodity prices and reduced demand for exports including lower tourist visitor numbers.

The super-sized cut in the OCR from 5% to 3.5% on 29 January was largely based on the expectation that the unfolding negative international economic shock will weigh heavily on the NZ economy. Most bank economists expect the fallout from the crisis to result in NZ economic activity contracting by around 1% this year (see http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10553340 for a survey of bank economists' predictions). And on the back of the dire predictions for economic growth this year many bank economists are predicting further significant OCR cuts.

We initially underestimated how badly the financial crisis would impact on NZ but after being slow off the blocks we have spent the last several months analysing the mechanisms by which the crisis will impact on NZ and advising clients of our pay-to-view reports on developments and likely prospects. And now seems like a timely moment to point out that NZ economic growth could be significantly better this year than implied by the headless-chook analysis being done by some of the doomsayers.

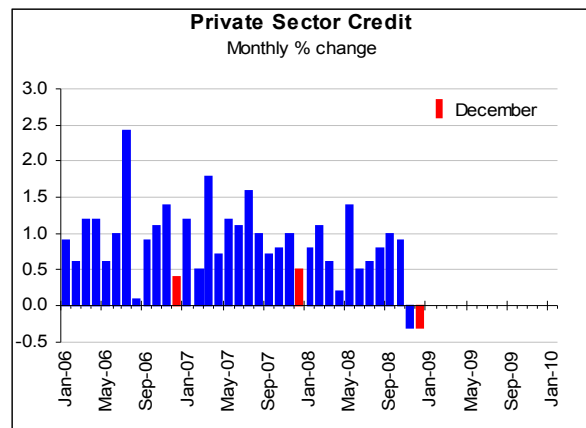
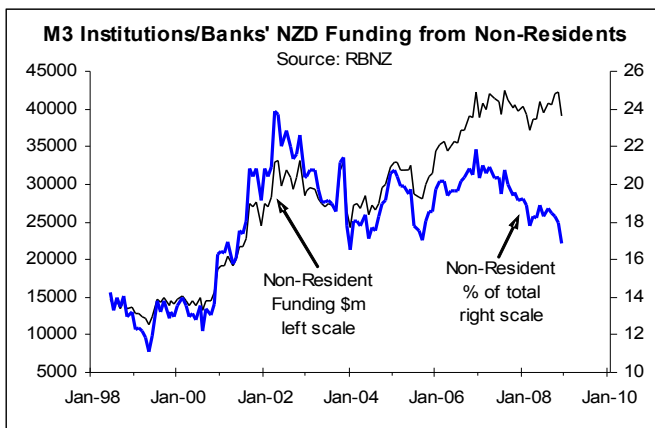


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NZ's credit crunch could soon be in the rear-view mirror

A key part of the impact of the financial crisis on NZ has been because since September banks have not raised funds overseas. The left chart shows one perspective on the overseas funding story for banks with the black line showing what the RBNZ reports as the outstanding level of non-resident funding of the NZ banking system. The blue line shows non-resident funding as a % of total funding, which has fallen from a recent peak of close to 22% in early-2007 to around 17% in December. A consequence of this has been that the stock of bank lending to the private sector fell mildly in both November and December (the right chart below) based on one of the measures the RBNZ supplies of bank lending to the private sector. The right chart below gives evidence of the credit crunch. Not only have many firms in the last few months struggled to get funding from banks for new projects and in some cases for working capital, banks have reduced the total stock of lending to the private sector. The business sector appears to have born the brunt of this, which may be because banks have to hold a higher level of capital reserves for every dollar lent to the business sector than for every dollar lent on housing mortgages. The credit crunch is still with us but by mid-year it could be yesterday's story for most would-be borrowers.



NZ banks haven't yet followed the lead of the Australian banks back into the overseas funding markets. One reason for this seems to be that the NZ government was charging significantly higher fees than the Aussie government is charging its banks for the wholesale guarantees relevant to overseas investors. But the NZ Treasury announced on 27 January that it was cutting the fees by between 15 and 50 basis points (see <http://www.treasury.govt.nz/publications/media-speeches/media/27jan09>). However, we understand that the NZ margins are still around 20 basis points higher than are being charged in Aussie for AA-rated borrowers for terms longer than one year. Maybe the cut in margins will start the ball rolling with Governor Bollard indicating on 29 January that he expected NZ banks to re-enter the international funding markets "in the next couple of months".

If NZ banks resume overseas funding over the next few months the credit crunch that has plagued the business sector since September should start to abate provided the banks don't play ostrich. However, we will not return to the easy money days that existed prior to the crisis, some property-related companies that are over-gearred may get a call from the receiver before they get the OK from their financiers, while this may not fully address the problems some large companies are facing trying to raise money overseas. The latter problem is seen as being sufficiently large in Australia that the government has proposed setting up a special fund or lending vehicle in conjunction with the major banks to provide loans to major companies (see <http://www.theaustralian.news.com.au/story/0,25197,24945791-643,00.html>). Some NZ companies face the same problem with the Prime Minister recently recognising this and asking Treasury to investigate the matter. So there is more to the impact of the financial crisis than the ability of banks to raise funds overseas, but we believe the bank funding issue is the most important. The cost of funding is another issue but the RBNZ has cut the OCR aggressively meaning banks' funding costs in the local market, where they raise the majority of their funding, have fallen dramatically with significant scope for further cuts if needed.

It is also interesting to note that the demise of many major international banks will probably make it easier for Australian banks and by association possibly also NZ banks to raise money in the international market. As reported in The Australian on 26 January, "The crisis in the financial system catapulted all four majors into the ranks of the top 20 global banks for the first time. As a result Australia's big banks expect to grab new business opportunities and draw the attention of more international investors. Despite pressure on



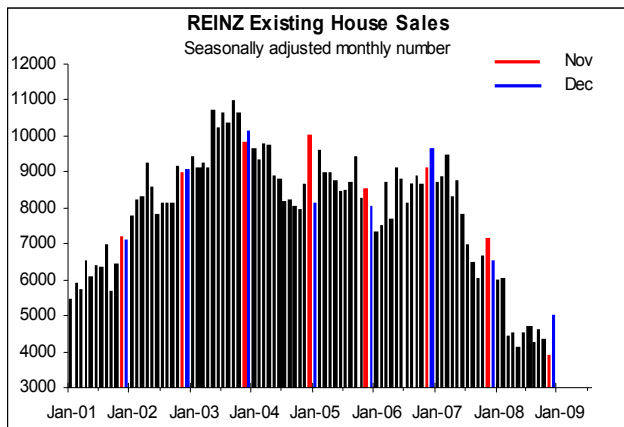
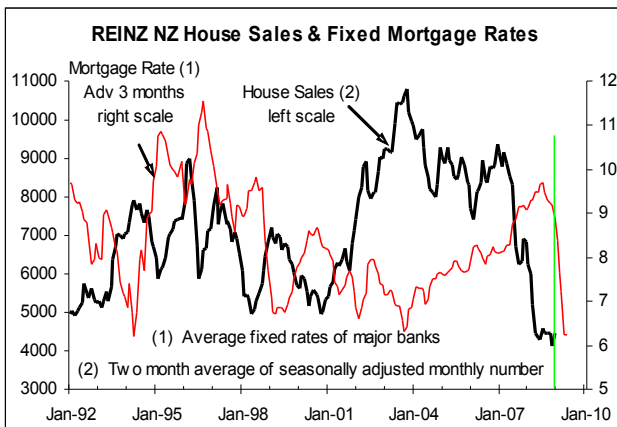
their funding and bad-loan books, they remain highly profitable while banks overseas seek government handouts, are nationalised or allowed to collapse. In the US alone, the global shake-up means Australia's four largest banks, which have retained their AA rating, are now considered some of the biggest in the world. The banks believe their newfound status will increase their participation in markets such as foreign exchange trading, where opportunities in the past have been limited because of the presence of bigger global players." (Source: <http://www.theaustralian.news.com.au/story/0,25197,24961870-643,00.html>)

As we see it NZ doesn't have a fundamental banking sector problem it has an access to funds problem and to a lesser extent a cost of funds problem, but the government has provided a wholesale guarantee for banks to help them solve the overseas funding problem while the RBNZ has been slashing the OCR to get down funding costs and is offering alternative sources of liquidity for the banking sector. So we struggle to see why the banking sector should stand in the way of a recovery in the NZ economy this year even if the banking crisis continues to plague the likes of the US and Europe. The proviso is that the international crisis doesn't escalate further and mean the door to overseas funding doesn't open or opens then gets closed again, but even if this happens the RBNZ has options to deal with funding shortfalls and still has significant latitude to cut the OCR if needed.

So if individuals respond to the interest rate cuts and start fuelling house sector activity and demand for mortgages, with this demand stimulus filtering through to many other industries, and if banks are able to borrow overseas again to fund increased demand for credit, then why can't there be an economic recovery this year? Especially when the government is chipping in with tax cuts and increase infrastructure spending, while the major fall in the exchange rate has largely insulated commodity exporters on average from falling international commodity prices and has dramatically improved the international competitiveness of NZ firms vis-à-vis overseas competitors.

The left chart below shows the major roll interest rates normally play in driving cycles in housing demand as reflected in the number of dwelling or house sales reported each month by RENZ. The red line is the average fixed mortgage interest rate charged by the major banks and is advanced or shifted to the right by three months as a leading indicator of the number house sales (the black line, which is a two month average of the monthly number of sales after they have been adjusted to remove the seasonal pattern). We use a two month average to remove the volatility in the monthly numbers and we seasonally adjust the monthly numbers to remove the regular seasonal pattern in sales, especially the tendency for the number of sales to be below average in December and January.

The green line in the left chart is a marker line to show how much of the fall in mortgage interest rates had occurred in time to be relevant to house sales up to December. Based on the fall in the average fixed mortgage interest rate from a peak of 9.7% in April to 8.9% in September there should already have been some increase in house sales in the December quarter allowing for the three months it generally takes for changes in interest rates to impact on the number of house sales. The escalation of the international crisis in September and the subsequent tightening of bank lending criteria appear to have offset the stimulus from falling interest rates so far. But the fall in the average mortgage rate from 8.9% in September to 6.2% now is what is relevant to house sales over the next several months. This represents a massive improvement in the affordability of debt for would-be mortgage borrowers so provided banks don't further tighten lending criteria we struggle to see how this can't fuel a significant albeit less than normal upturn in house sales over the next several months.





The right chart on the previous page shows the seasonally adjusted monthly number of REINZ house sales. The chart shows a hint of a recovery in December (the right hand blue bar in the chart). And if the interest rate cuts are only half as powerful as normal in fuelling an upturn in the number of house sales over the next several months the seasonally adjusted monthly number of sales could increase from recent lows of just above 4,000 to maybe as high as 6,500 per month by mid-year. Our fall back position is that if there isn't much of a recovery in the next few months the RBNZ will continue to deliver super-sized OCR cuts until there is one. The RBNZ and the government are determined to underwrite and economic recovery. With interest rates being the RBNZ's primary tool and the housing sector being the most interest-sensitive sector then an upturn in the number of house sales this year looks like a certain bet.

But don't interest rates become impotent when they get below a certain level?

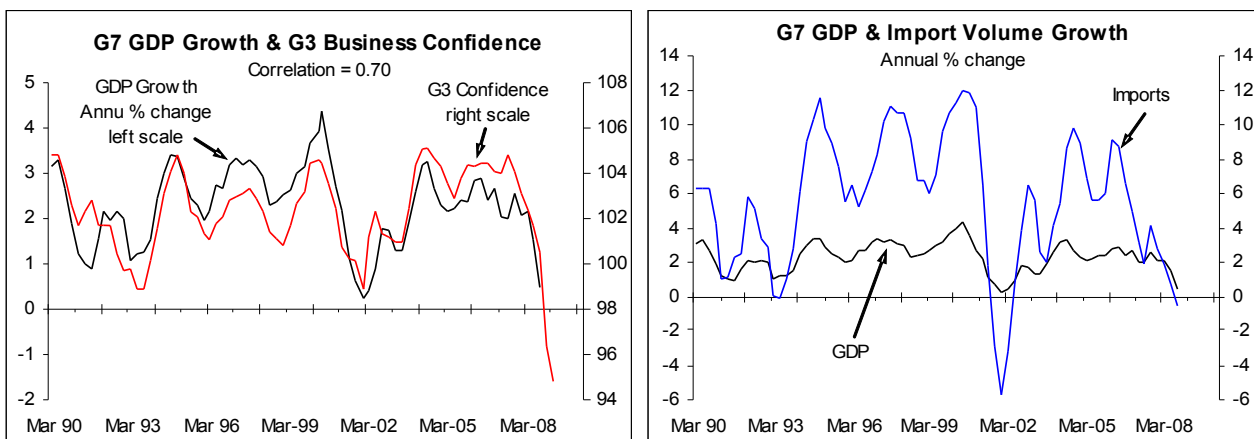
We occasionally hear people suggest that interest rates become impotent once they get below a certain level. No doubt the Japanese experience, where the official interest rate has been below 1% since July 1995, and signs that the near-zero official interest rate in the US (the Fed Funds Rate) aren't helping much will be behind such views. In economic theory such a situation is called a liquidity trap and if the forces at work on an economy are sufficiently horrendous then liquidity traps can exist. But with the RBNZ in recent times indicating that local banks don't have a capital adequacy problem and consumer confidence well above trough levels we struggle to see why NZ could be in a liquidity trap. NZ has been experiencing a credit crunch but we are hopefully not being naïve in assuming that this will be resolved for the vast majority of would-be borrowers once the banks have confidence in accessing overseas funds again.

There is always the possibility that the crisis delivers another Lehman-sized pothole, sending nuclear bombs showering down on Chicken Licken's fallout shelter. But if this doesn't happen what should matter for NZ's economic growth prospects this year is that as interest rates get cut each successive cut is more powerful. An example helps show this.

If the mortgage interest rate falls from 9% to 8% borrowers experience an 11.1% drop in interest costs, but a fall from 8% to 7% delivers a 12.5% drop and a fall from 7% to 6% delivers a 14.3% cut in interest costs which gets us close to where things are now. If the RBNZ delivers another significant OCR cut on 12 March we will see mortgage rates fall from around 6% to around 5% which will deliver a 16.7% further drop in interest costs. All up the fall from 9% to 5% will deliver a 44.4% drop in interest costs which should be more than enough to fire up a decent upturn in housing demand. This will have implications for house prices as well as for the number of sales although being good capitalists we reserve the best insights for subscribers to our **Housing Prospects** reports.

The international economy could also deliver a positive surprise this year

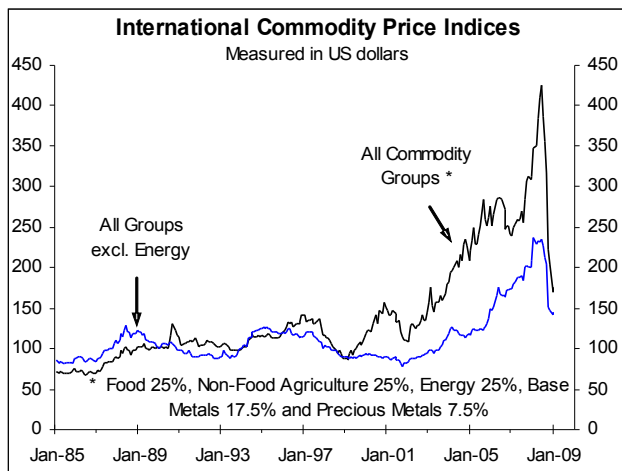
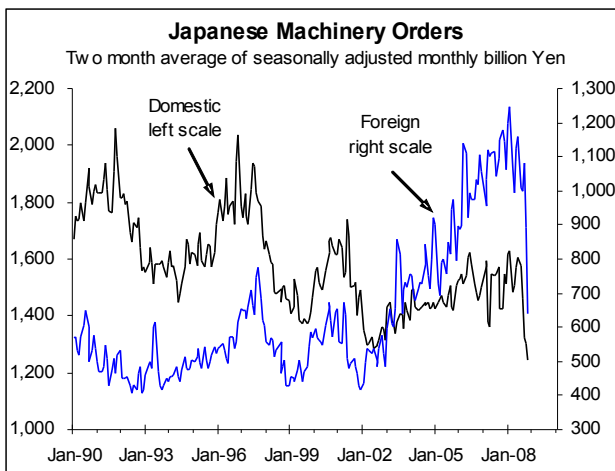
The stock or inventory cycle plays a key roll in global economic growth cycles which is why when GDP growth in the major G7 economies threatens to turn negative, as it last did in late-2001, G7 import volume growth can turn hugely negative (see the right chart below). The left chart shows a measure of business confidence in the G3 as a leading indicator of economic growth in the G7 and predicts annual GDP growth heading to around -1.5% in the current quarter. This implies that import volumes by the G7 could be in the process of falling as much as 10%, which is why there is a massive negative economic shock filtering around the world hurting export nations including China, India, Japan, Korea, Australia and NZ.



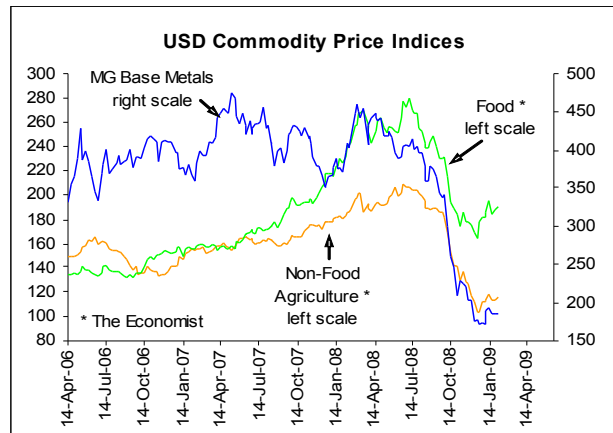
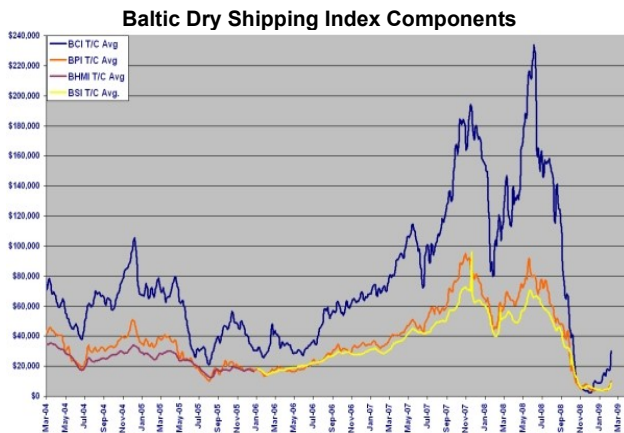
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An example demonstrates the roll of the stock cycle. If the representative US retailer is selling 100 gadgets a month and experiences a 2% fall in demand so sales fall to 98 the retailer will in the first instance cut the monthly orders to his/her suppliers from 100 units to 98 units but the retailer will, especially if he/she is under financial stress also run down inventories. Faced with a fall in sales from 100 to 98 units a month the retailer will respond by meeting some sales in the next few months out of inventories (e.g. 8 units per month). This means orders to his/her suppliers get cut from 100 per month to 90 per month so the 2% drop in sales experienced by the retail filters back down the supply chain and around the world to a 10% cut in demand for suppliers and manufacturers. And if distributors, importers and manufacturers in turn decide to meet some of the lower level of sales by running down their inventories, including inventories of raw materials in the case of the manufacturers, then demand for raw materials will fall much more than 10%. That is what has been happening globally over the last few months and in many industries will continue for a while longer. Manufacturers will also respond by cutting spending on new plant and equipment which will send another shockwave around the global economy and is why a shock that started in the US housing market has ended up being reflected in tumbling orders for Japanese machinery and collapsing international commodity prices (the two charts below).



But the stock cycle is equally important in underwriting the early stages of a recovery as it is in multiplying the downturn or recession as our example can demonstrate. After a few months of running down inventory the retail gets them down to a level below which cutting further will only occur if he/she goes out of business, and some of this will occur but even then the inventory will eventually be sold or scrapped. Once the representative retailer stops running down inventory to meet a portion of his/her sales all of the 98 units sold per month will be matched by orders to his/her suppliers. So even if the retailer experiences no increase in sales his/her suppliers will experience a rebound in orders from 90 units a month to 98 units.



Source: <http://www.dryships.com/pages/report.asp>

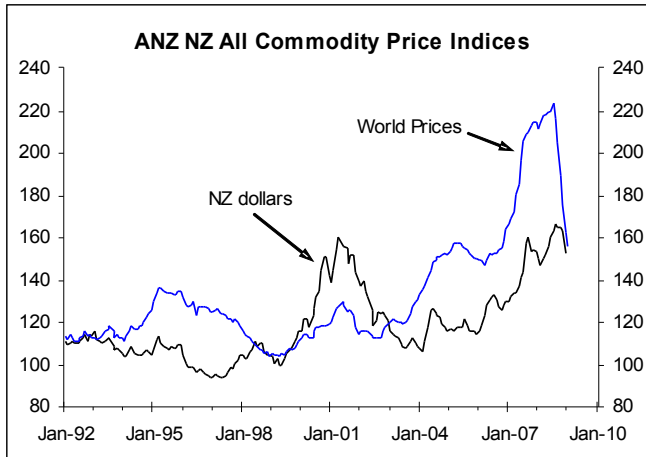
Concern about deteriorating global growth and the associated downside risk for NZ was central to the RBNZ justifying the latest super-sized OCR cut and for expectations by most bank economists that further large cuts would follow. However, the global stock cycle is starting to turn with a report on 4 February that

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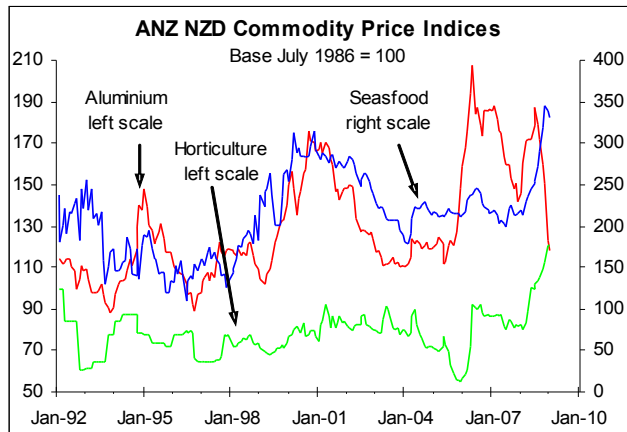
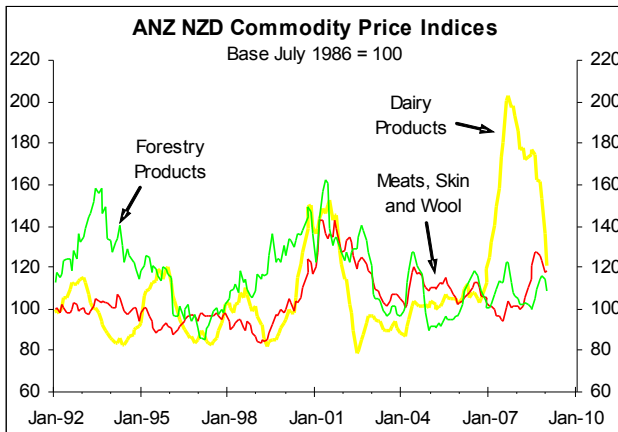
demand for iron ore has increased because Chinese steel makers have finished de-stocking and associated with this a global shipping cost index that relates to bulk commodity shipping has been rising again (see <http://www.bloomberg.com/apps/news?pid=20601085&sid=ah6n4sxikADs&refer=europe>). The bottom left chart on the previous page shows the components of the shipping cost index while there are signs that international commodity prices may be bottoming out (bottom right chart on the previous page).

What the doomsayers forgot to tell you about commodity export prices



Another factor seemingly overlooked in the frenzy over falling dairy commodity prices and Fonterra stockpiling product in response to tumbling prices is that for the average NZ commodity exporter the fall in the exchange rate has to a large extent insulated him/her from falling international commodity prices. The adjacent chart shows that ANZ's monthly measure of a basket of NZ export commodity prices has fallen 28% in world prices terms since November 2007 (the blue line). Over the same period the same basket of commodity prices has fallen only 5% in NZ dollar terms which is the measure relevant to local producers (the black line). In NZD terms commodity prices are still not far below recent peak levels.

In the current environment different commodity groups are experiencing divergent price performance as the two charts below show with the ANZ price indices for the six commodity groups measured in NZD terms. The dairy commodity price index has fallen 39% since November 2007 and the aluminium index is down 22% while the forestry index is up only 0.4%. But the meat, skin and wool price index is up 17% over the same period, the horticultural index is up 46% and the seafood index is up a staggering 55%. Dairy is at the top of the heap when it comes to commodity exports but assuming ANZ has the commodity group weights right in its overall commodity price indices – the chart above – then the media headlines should be focused on the fantastic roll the falling NZD is playing in insulating the average NZ commodity exporter from the full wrath of the financial crisis.



There are still some negative economic multipliers working their way around the global economy and the international banking system still has an over-gearing problem that could take several more years to resolve and there could be more potholes in the road ahead for the global economy. But provided a fresh batch of nuclear bombs aren't delivered to the door of Chicken Licken's bomb shelter as a result of the crisis, like a rush to protectionism by our trading partners or another Lehman-sized pothole, then there could be some positive surprises in store for NZ economic growth in 2009 which we suspect the doomsayers are overlooking. This includes the stimulus from the massive interest rate cuts, the potential that NZ's credit crunch could abate and the potential that the global stock cycle could produce a positive surprise before the end of the year. The monthly **Interesting Times** and six-weekly **Monetary Policy Briefing** reports update our views on these and other relevant topics.

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Confessing is said to be good for the soul

It turns out that bank economists can serve a useful purpose other than getting their employers cheap brand-name exposure in the national media. The unfolding financial crisis is a case in point. In the rare occasion that the biggest economic issue is a banking sector crisis then the bank economists will have the inside running for picking the scale of the crisis and in picking that larger than normal interest rate cuts by the RBNZ will follow. In the Raving **Banking Lunacy of Unimaginable Proportions** written soon after the bankruptcy of Lehman's but before it was obvious that this event would almost bring the international banking sector to its knees I chastised ANZ-National chief economists Cameron Bagrie for calling for massive interest rate cuts. In the Raving I wrote, "unless I am materially under-estimating the consequences of the latest round of fallout in the US-international financial sector on the NZ economy I believe massive interest rate cuts would only perpetuate the destructive roller coaster ride the economy has been too often subjected to by the RBNZ".

History has shown that I was materially under-estimating the fallout and subsequent OCR cuts have been even larger than Cameron was calling for. So three cheers for Cameron, well done. In my defence both consumer confidence and business confidence were in the process of improving significantly when I wrote the Raving, while it is still likely that the RBNZ will cut excessively and fuel a roller coaster ride, but it was a good lesson that even an old dog can make new mistakes (and learn from them). While being slow out of the blocks it didn't take long for our clients to benefit from quality analysis of the mechanisms by which the crisis would filter around the world economy and impact on NZ. Now somewhat older but hopefully wiser it seems timely to air some of my thoughts on the financial crisis at the same time as apologising to Cameron for suggesting he might be Chicken Licken.