

Economic Update

One done and more to come

Preview of July 29th OCR Review

- We expect the RBNZ will increase the OCR 25 basis points to 3%.
- Offshore market sentiment has stabilised since June; NZ economic outlook remains firm.
- We continue to expect a steady stream of OCR increases over the coming year, to 5%.

We expect the RBNZ to deliver another 25 basis point rate increase at the July OCR announcement following the first increase in June, bringing the OCR to 3%. The accompanying statement is likely to retain a similar tone to June, weighing up the export-led economic recovery and growing inflation concerns against the risks remaining around the global outlook. The RBNZ is likely to keep an element of caution, sticking with the line that future hikes remain dependent on “economic and financial market developments”.

We expect that the in-house updated forecasts will have not changed significantly. There may be some slight downward revisions to growth, given the weaker than expected GDP outturn, recent decline in dairy prices and rapid slowing in net migration. Nonetheless, the outlook for an export-led recovery remains in place, albeit at a slightly more modest pace compared to the RBNZ’s optimistic forecasts in the June MPS. However, the slightly softer growth outlook does not allow for comfort on the inflation front. Headline inflation is still set to peak well over 5% due to a raft of Government related price spikes, and in our assessment the RBNZ was slightly underestimating medium-term inflation pressures in its last forecasts.

We expect the RBNZ will continue to withdraw monetary stimulus by steadily increasing the OCR in 25 basis point steps at each meeting until the OCR reaches 5%. Market pricing is currently more gradual than this, reflecting ongoing event risk posed by Europe’s sovereign debt difficulties.

Domestic outlook marginally softer

RBNZ growth outlook may be slightly weaker

The overall flow of data has been on the softer side of the June MPS forecasts and the RBNZ may be facing some downward revisions to its growth outlook. In contrast to the RBNZ, the recent flow of data has been less of a surprise to us. The Reserve Bank’s forecasts have been above the consensus average for some time, and any downward revisions would largely reflect the RBNZ moving closer to the consensus view.

To be clear, while we have long held the view that RBNZ growth forecasts on the strong side, this does not translate that inflation pressures are likely to be softer than the RBNZ is expecting. Indeed, for some time our inflation

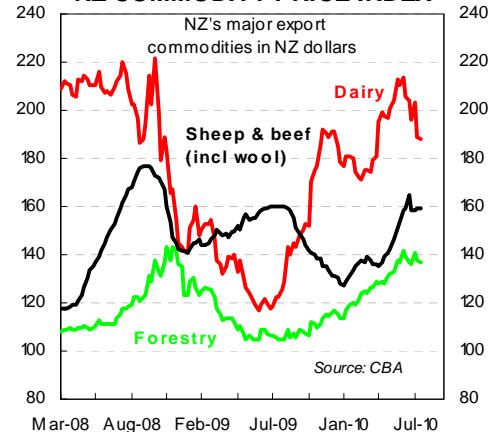
outlook has been similar to the RBNZ’s, despite a slightly softer paced recovery. As a result we have been concerned by the extent to which the RBNZ appears to be undercooking medium-term inflation pressures.

Dairy prices fall from peak

Dairy prices ease off peak

Dairy prices have eased over the past three months in the *global Dairy Trade* auctions, with the latest decline of 14% in July being particularly sharp. The tight supply issues in the dairy market have unwound relatively swiftly as US dairy production has increased. In addition, further increases in US production during the NZ winter may result in prices falling further, reducing the likelihood of the dairy payout exceeding the forecast previously flagged by Fonterra. The RBNZ’s forecasts for the Terms of Trade imply relatively strong export price outlook and the recent decline in dairy prices may suggest some downside risk to its forecasts. In addition to weaker dairy prices, a closer look at the RBNZ’s trading partner GDP forecasts reveals a relatively optimistic view compared to Consensus Economics’ survey.

COMPONENTS OF CBA
NZ COMMODITY PRICE INDEX



General Advice Warning

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

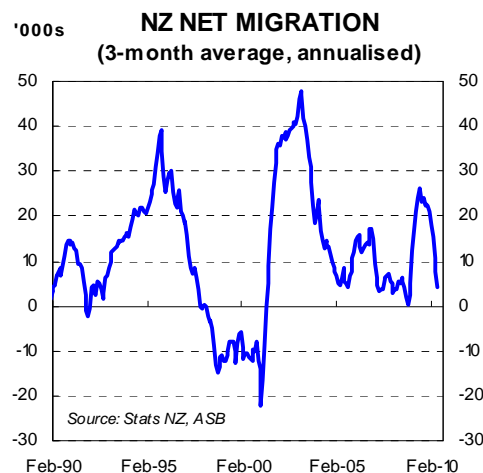
Some uncertainty over Chinese growth outlook

Recent offshore data flow has been slightly weaker than expected, and has raised doubts over the pace of the global economic recovery. Further, a more convincing effort by the Chinese authorities to slow growth could see 2011 growth in Asia and Australia weaker than the RBNZ is currently expecting. In light of recent developments, the RBNZ may be considering the relatively upbeat assessment more carefully.

Slowing net migration to reduce housing demand

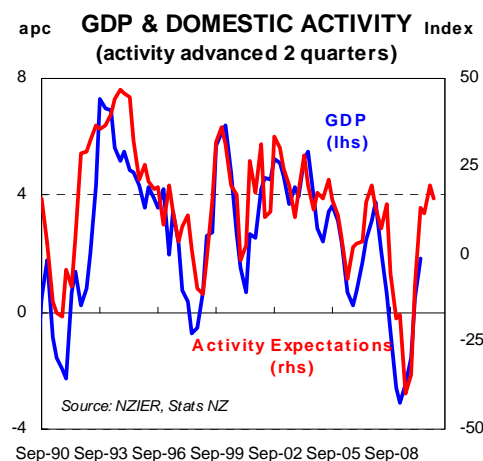
Weaker net migration reduces demand for housing

Net migration has also slowed much sharper than expected over recent months, which does add downside risks to the housing market outlook. The RBNZ has the strongest forecast for 2011 residential construction of all the economists surveyed by the NZIER. Nonetheless, although the RBNZ maybe facing a slightly weaker housing market than expected, it is like to be comfortable with recent developments. For a long time, the RBNZ has been looking for a rebalancing in growth away from the household sector, toward the export sector. Recent developments remain consistent with the recovery taking this form.



Business investment intentions ease

The key business confidence survey, the NZIER Quarterly Survey of Business Opinion, was more notable for some of the headlines it generated rather than the results themselves. In contrast to our more downbeat peers, we took a more neutral view of the survey results and generally found the survey to be very close to our own expectations. We also expect the RBNZ found the results reasonable close to their own expectations. We note that business own activity expectations, which has proved an excellent indicator of growth in the past, continues to point to a very healthy pace of growth of around 3.5-4% per annum, which is not far from the RBNZ's current forecasts. The only area of weakness was the slightly softer investment intentions reading, which may bring the RBNZ to question its relatively strong business investment outlook.



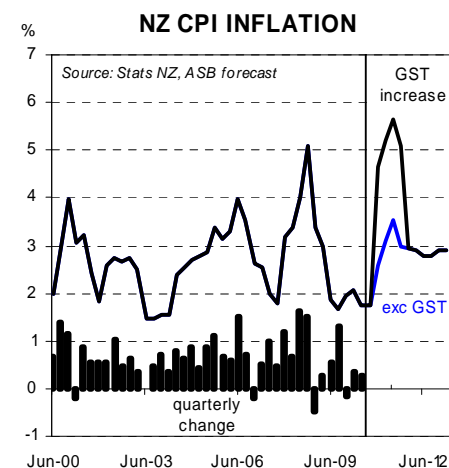
GDP growth slightly softer

The RBNZ may be facing a reality check on its previously optimistic forecasts. Q1 GDP grew at 0.6%, slightly softer than RBNZ expectations of 0.8%. From the detail of the report the RBNZ can still be confident of an export-led recovery taking shape, albeit at a slightly slower pace. While dairy prices maybe coming off slightly faster than expected, the outlook for other industries remains robust. In particular, manufacturing, forestry and oil production have been key contributors to recent growth. Strong demand in these sectors has been underpinned by the strength in Australia and Asia, and for the time being the outlook in for these economies remains buoyant.

Inflation starting point broadly unchanged

Lower CPI outturn provides comfort for now

The softer than expected 0.3% increase in Q2 CPI would be of some comfort to the RBNZ, if only for the fact that the starting point for inflation is close to its June MPS expectations. This will help to alleviate some concerns that inflation expectations will get out of control, at least in the near term. However, given our expectations that the GST increase, higher energy costs from the Emissions Trading Scheme, higher than usual increase in ACC levies and further substantial tobacco excise



Inflation expectations to test RBNZ's patience

taxes will boost headline annual CPI to well above 5% by mid-2011, there remains a clear risk that inflation expectations will become unanchored further down the track. Already, recent business surveys have shown a surge in pricing intentions and cost expectations. Although this is likely to partly reflect growing awareness of the high headline CPI over the coming year, it does highlight the key challenge the RBNZ face in ensuring price and wage setting behaviour will be unaffected.

Despite signs that economic growth will pan out below its June MPS forecasts, we do not expect much revision to its medium-term inflation outlook. To the extent that its June MPS

forecasts implied only a muted flow-through to non-tradable inflation from its projected rebound in economic activity, we expect any downward revision the RBNZ's growth forecasts will result in little change to the medium-term inflation outlook.

Monetary conditions slightly looser

Lower longer-term fixed interest rates offer some relief

Taking into account recent developments we see, on balance, a slightly looser set of monetary conditions than expected at the June MPS. There has been an increase in short-term interest rates, but this is in line with RBNZ expectations, given the OCR increase in June. Meanwhile, the NZ dollar TWI is slightly higher than the June MPS forecasts.

Offsetting the effects of the higher than expected NZ dollar TWI, the recent decline in longer-term interest rates means that monetary conditions are looser than expected at the June MPS. This unexpected decline in longer-term interest rates reflects continued concerns in financial markets about the sustainability of the recovery in the global economy. As yet, there has not been a rush from households to fix mortgage rates at the 2 and 3 year tenures. We expect the fall in longer-term interest rates to have a greater effect on businesses, rather than households. The fall in longer-term rates should encourage the recovery in business investment over the medium term – or at least make term cover cheaper.

Implications

RBNZ to increase OCR 25bp

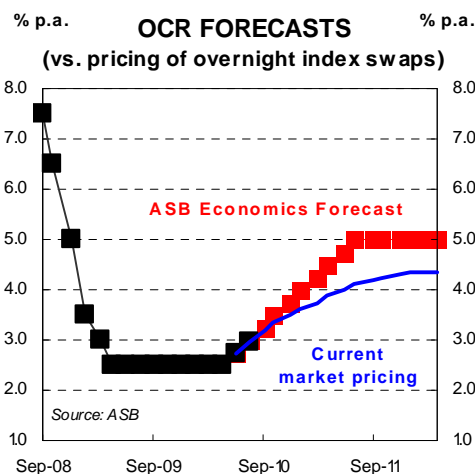
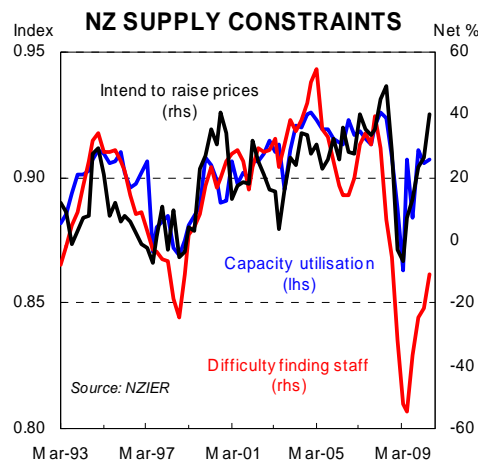
We expect the RBNZ to deliver another 25 basis point rate increase at the July OCR announcement. The accompanying statement is likely to retain the same caution as June, noting the risks remaining around the global outlook and that future hikes remain dependent on “economic and financial market developments”.

We expect that the in-house updated forecasts will not have significantly changed. Perhaps a slight downward revision to growth, but this is countered by the fact the RBNZ is facing slightly more stimulatory mix of monetary conditions than expected, given the fall in longer-term interest rates. With inflation set to spike well

over 5%, medium-term inflation pressures are likely to remain concerning. In our view, given the ongoing risks to the inflation outlook, the RBNZ will continue to remove monetary stimulus in a steady fashion. We expect the RBNZ will increase the OCR in 25 basis point steps at each meeting until the OCR reaches 5%.

Deterioration in Europe could present cause for pause later down the track

The market pricing implies a slower pace of rate hikes, reflecting the ongoing event risk posed by Europe. For now, Europe's financial system is pulling through and market sentiment has stabilised. Nonetheless, a severe deterioration in offshore funding costs or a substantial downside surprise to the domestic inflation outlook could warrant an extension of very stimulatory policy. In any case, whether the RBNZ is thinking about it or not, it is unlikely to give away any clues either way in the July statement. We expect a statement that keeps the RBNZ's options open to assess the data and financial market developments as they come.



OCR formally
reconsidered
every 6-7 weeks

Some background to the event

The Reserve Bank of New Zealand (RBNZ) releases a Monetary Policy Statement (MPS) each quarter outlining its thinking about the economy, especially future growth and inflation rates. At the Statements and at mid quarter Reviews the RBNZ take the opportunity to review the setting of the Official Cash Rate (OCR) target.

The OCR target effectively locks the level of wholesale overnight rates. Other wholesale short-term interest rates change to reflect anticipations of where the OCR might be in the ensuing weeks. In turn, the retail rates set by the banks will adjust to the level of wholesale rates.

Wholesale and retail rates need not adjust in the same direction and magnitude of any OCR change. The reaction will depend on the extent to which the RBNZ action has already been anticipated and built into rates.

While interest rates are a key factor in exchange rate determination, the exchange rate may or may not also respond to changes in the level of short-term rates. Other factors may also come into play at the time.

<http://reports.asb.co.nz/index.html>

ASB ECONOMICS & RESEARCH		PHONE	FAX
Economics			
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604
ASB Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185
ASB Economist	Christina Leung	christina.leung@asb.co.nz	(649) 369 4421
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819

DISCLAIMER

Views expressed in this report are those of the authors as at the date of this report and are based on information and sources believed but not warranted to be correct. Any views or information, while given in good faith, do not necessarily reflect the views of ASB and are subject to change without notice. Neither ASB Bank Limited nor any person involved in preparing this report accepts any liability for any loss or damage whatsoever that may directly or indirectly result from any views, information or omission contained in this report.