ASB **Quarterly Economic Forecasts**

Watching for withdrawal symptoms

ECONOMICS

22 Jul. 10

- **The global economy is growing strongly – but the risks have grown strongly too.**
- **NZ's recovery is gradually continuing as manufacturing and export activity improves.**
- **The RBNZ will continue to lift the OCR though a pause along the way is possible.**

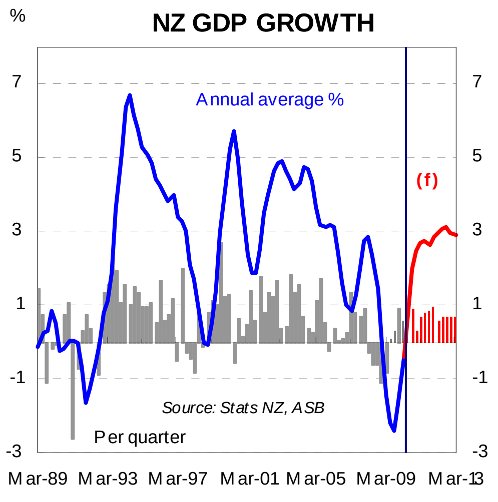
The initial recovery of many economies from their 2009 depths has been underway for a year or more. Rare is the economy that has not resumed growing in the face of the 'kitchen-sink' stimuli thrown at them.

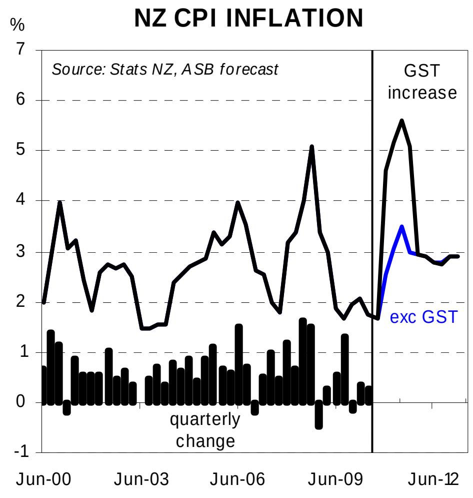
The next couple of years will see movement from full-on stimulus (fiscal and monetary) to self-sustaining forward momentum. There are several reasons for policy removal. First, economies in recovery mode will reach the point when they no longer need the aggressive support they have been getting. Second, and related, inflation pressures will start rising, rather than falling as they did when economies were weak. Third, there is a limit to the size investors will allow government debts and budget deficits to get.

This transition is starting to get underway, and by no means smoothly in some places. Several risks have intensified in recent months. Europe is the main focal point, where concerns over large government budget deficits and even larger debts triggered considerable wariness about exposures to European debt. Similarly, 3 years ago wariness over sub-prime mortgage debt flared up. Critically, the escalation of the crisis flowed through into rising inter-bank risk premiums in global markets to a similar degree seen during the early stages of the sub-prime crisis. Elsewhere, the US housing market has lost some federal support and is revealing that underlying housing demand is still weak. And China is putting the brakes on its economy after its efforts to stimulate its economy were so successful that inflation and asset bubbles have become the predominant concern. Chinese growth will inevitably slow this year, having hit 12%, but the issue will be whether or not China is too successful in engineering a slowdown. How all these risks play out will influence whether the global economy continues to gradually recover or has a major hiccup.

New Zealand has also started to move away from the extreme stimulus put in place. The RBNZ has now started to increase interest rates. The economy is growing once more and is less in need of the support given during the depths of the crisis. There are early warnings that inflation pressures will soon build – even putting aside the government-induced spike in inflation through factors such as GST and the Emissions Trading Scheme. Meanwhile, fiscal policy will remain modestly stimulatory in the short term before the Government works to stem its build-up of debt. As a substantially indebted nation NZ needs to work hard at maintaining investor confidence – as well as buttressing its defences to deal with any future shocks.

Our forecasts remain for continued gradual economic recovery, with the pace of growth building up to an average pace. However, the strength of the rebound will remain moderate compared to both the severity of this slowdown and the rebounds that followed the past two recessions. The next cycle will be a reverse of the last one: households will spend within their means and a disproportionate contribution to growth will come from export-focussed sectors. Meanwhile, short-term interest rates will continue to gradually rise. But with the skew of global risks, there is always the possibility the RBNZ pauses along the way.





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Europe brings debt risks back

Risks are now part of the background.

The world has been dealing with large bouts of risk ever since the words “sub-prime” became common usage outside the US. A number of risks hover in the background, but worries over growing government debts have leapt to the fore in recent months.

Risks from high government debt are double-edged.

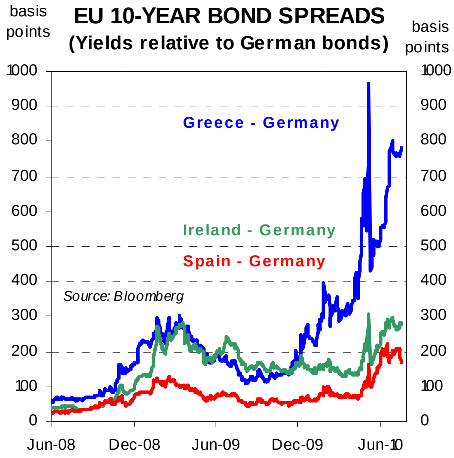
Government debts were always going to be slow to reduce. Government spending plugged a gap and stopped the global recession from being worse than it was. The balancing act with fiscal support is that left in place too long and there is the risk of debt levels becoming unmanageable – even more so if investor concerns further drive up the cost of debt servicing. But start removing the stimulus too soon and you risk pulling the rug out from under a fledging economic recovery. Sharp cutbacks in US public works as well as tightening of the monetary supply are cited as contributing factors to the US economy’s fall back into recession in 1937 following the initial revival from the Depression.

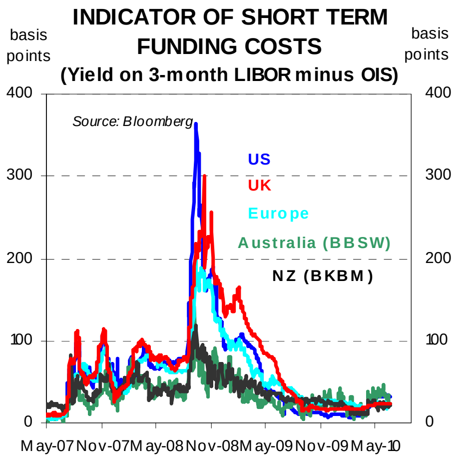
Slow European response has exacerbated the problem.

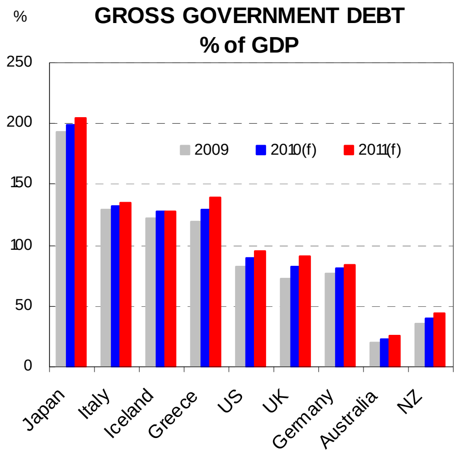
The failure of Greece and then Europe to promptly address Greece’s mounting problems led to a bigger crisis than there should have been. By waiting until investors – whom governments need to buy up future debt issuance – lost confidence, several governments have been forced to rein in budget deficits much quicker than is healthy for their economies. Other governments have voluntarily tightened their belts more than they would have otherwise.

Government debt a long-term issue.

As a source of risk, high government debt levels will persist for some time. Europe is the focus now, but the UK, US and Japan also need to bite the bullet at some point. The UK has started to, and the reaction to its June emergency Budget suggests it is keeping up the confidence of investors. The US has, perversely, benefited in the short term from the problems elsewhere, sending its bond yields down. Nevertheless, Europe’s experience has halted a proposal for a further US stimulus package. Japan, whose gross government debt is approaching 200% of GDP, risks hitting a point at which domestic savings are no longer sufficient to meet the government’s growing borrowing needs.







Financial contagion the biggest threat.

The main risk for NZ posed by the European debt crisis is the potential for financial contagion similar to that sparked by the US sub-prime crisis. Worries about US and European banks’ exposures to European government debt have put pressure on bank funding premiums, and some European banks have had difficult raising money. Resolving this blockage is important.

But other risks remain.

There are other risks. European growth will be stunted in countries putting the fiscal brakes on. Longer term, and more globally, is the potential for the sheer amount of government debt to crowd out the private sector’s ability to borrow. In the US the housing market is feeling the after effects of removal of support and the underlying employment growth has been muted. China is applying the brakes to its overheating economy.

Most of the ‘what-ifs’ at present are negative. But, in the absence of these ‘what-ifs’ becoming reality, the global economy is on track for a couple of years of robust growth.

International Outlook

Global outlook remains robust despite recent concerns.

The global economic recovery remains on track for 2010 and 2011. Despite recent concerns stemming from Europe, indicators continue to point to a healthy pace of growth over the next year. Nonetheless, the pace of recovery will remain uneven between different regions. The US, UK and Eurozone economies face ongoing challenges over the next year, including the potential for fiscal fade. Meanwhile, economic activity in Asia remains buoyant with authorities looking to slow growth to a more sustainable pace.

Fears of slower global growth exacerbated by slow US jobs data.

A run of weaker data over recent months has raised concerns on the US economy's ability to stage a self-sustaining recovery. Underpinning recent concerns has been a string of disappointing employment figures. Although US employment stabilised slightly earlier than initially expected, it appears that job growth has since failed to meet expectations as hiring appetite remains subdued. In addition, the recovery in retail spending remains patchy and there remains concern about the housing market now that it is receiving less fiscal support. Some Federal programmes for the housing market have recently expired and, in light of the Eurozone's current difficulties, there has been little political appetite to extend these programmes. Along with concerns around fiscal withdrawal, focus has also been on the economic impact of slower Eurozone growth. Indicators for US manufacturing activity eased in May, exacerbating these fears. However, indicators remain consistent with continued expansion.

Concern the US housing market may derail recovery as fiscal stimulus withdrawn.

European outlook fragile.

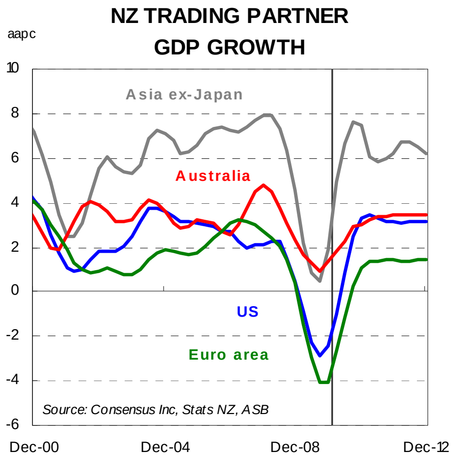
The outlook for Europe remains more fragile. Fiscal austerity measures required over the next year in some Eurozone countries are expected to drag on the region's growth. However, Eurozone-based exporters with wider export markets (for example Germany) are set to benefit from the weaker currency.

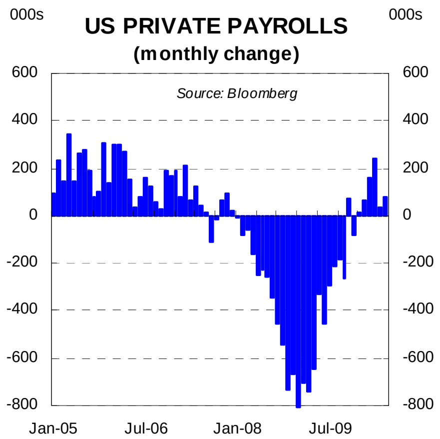
Australian outlook robust, strong demand from Asia underpins high commodity prices.

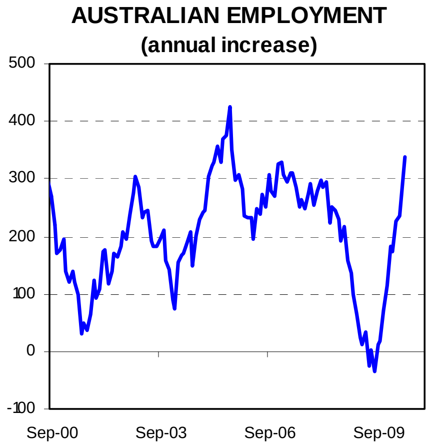
Australia's economic outlook remains upbeat. Given China's robust growth over the past year and continued demand for minerals, Australian commodity prices have pushed to new highs. Recent global growth concerns stemming from Europe have barely dented Australia's commodity prices. Indeed, the ability for China, rather than Europe, to continue growing is much more critical for this part of the world.

Strong employment growth triggers inflation concerns.

Australian employment growth continues at a robust rate. The unemployment rate is down to 5.1%, and spare capacity has diminished significantly over the past six months. The export-led recovery in Australia has quickly pushed the economy back up towards capacity constraints.







NZ Housing market

House prices to ease modestly this year.

The outlook for the housing market remains very subdued and we expect modest declines in house prices over this year of around 3-4%.

House prices declined 10% during the early stages of recession in 2008. However, following aggressive OCR cuts and very low interest rates, demand for housing started to recover. During this time supply remained low, creating a tight housing market. As a result house prices recovered with surprising gusto during the spring of 2009.

Housing demand cooled early 2010 on proposed tax changes.

Demand has since cooled over the first half of 2010, due to the combination of rising interest rates and changes to tax policy.

The tax system has been partly blamed for house prices being elevated compared to average income levels and rental yields. The Tax Working Group noted in January "there is a major hole in the tax base… which is manifest in high investment and low returns in the property market". Changes in the 2010 Budget were designed to go some way to address this issue. The removal of building depreciation deductions means rental property will be less attractive as a 'borrow and hold' investment strategy.

Slower population growth and rising interest rates also to reduce housing demand.

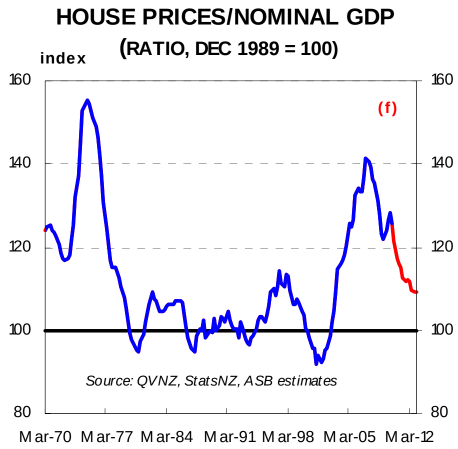
Along with the change in tax policy, the fundamentals for housing demand remain weak. Longer-term borrowing rates are now above average levels, and short-term borrowing rates are likely to move toward average levels over the next year as the OCR is increased. Further to this, the support from net migration is now waning. Indeed net migration is slowing more rapidly than expected, due to fewer employment opportunities in New Zealand (reducing arrivals) as well as a stronger labour market in Australia attracting New Zealanders across the Tasman. Just as very strong net migration can put pressure on the housing stock, past experiences have shown that weak or negative net migration can create states of oversupply and downward pressure on house prices.

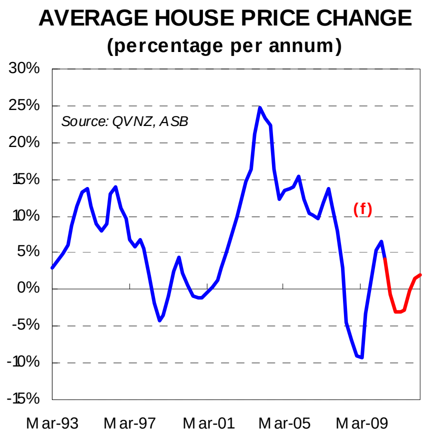
Weak building demand and consent issuance points to mild under building.

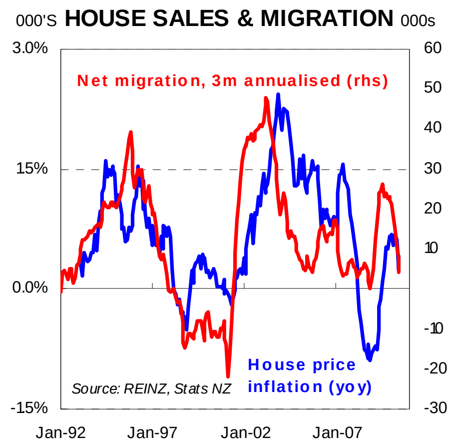
However, our concerns for oversupply are mitigated by the very weak outlook for building activity. We estimate that NZ's housing requirements will increase by 15,000 over the year to June 2011, which is only just being met by current annual consent issuance (also around 15,000 per annum). Further, given the weakness in housing demand, we expect the pace of consent issuance will ease back to 14,000 per annum, potentially causing a situation of mild under supply.

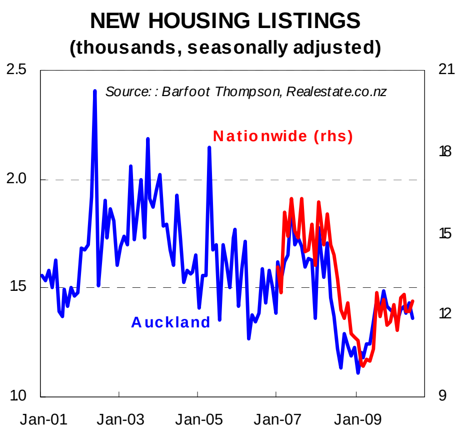
Lower supply to offset weak demand, mitigate downside pressure on house prices.

The number of new sales listings on the housing market remains at very low levels, with the changes in the tax policy failing to trigger a landslide of listings to date. The low level of listings has kept the balance of supply and demand in check, with total listings around average levels. To the extent that housing supply remains tight, it will limit any declines in house prices over the next year.









The New Zealand Economy

NZ economic recovery now export led.

The economy has entered its second year of recovery. Since the latter part of 2009 the recovery has become more broad-based throughout the economy, although some pockets of weakness remain. Initially, the recovery was led by early signs of life in the housing market and some stabilisation in consumer spending, supported by lower interest rates and strong population growth. However, momentum in these sectors has since waned. More recent growth has been led by exporters, in particular non-food manufacturing, forestry and mining (as well as the associated support industries such as wholesale trade and transport). Business confidence has improved and is consistent with levels of healthy economic growth. Further, there have been promising signs of an early recovery in business investment and employment. We expect momentum will continue to build over 2010 and 2011, although the recovery is likely to remain somewhat uneven. The recovery is likely to remain export-led, propped up by strong demand from key trading partners such as Australia and China. In contrast to previous cycles, the household sector will be less of a force driving this recovery. In particular, the housing market is likely to remain fairly subdued, with the recovery in construction muted by historical standards. In addition, consumer spending has been slow to recover, with consumers continuing to display relatively cautious behaviour. Nonetheless, ongoing improvement in the labour market and tax cuts in October this year will likely support a modest recovery in spending going forward.

Business confidence points to healthy pace of growth.

Household sector outlook more subdued.

Export outlook robust

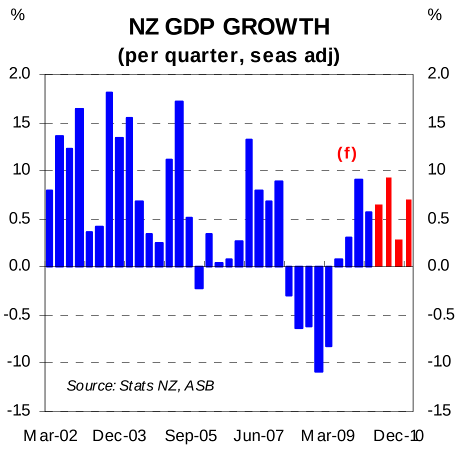
Manufacturing export performance strong.

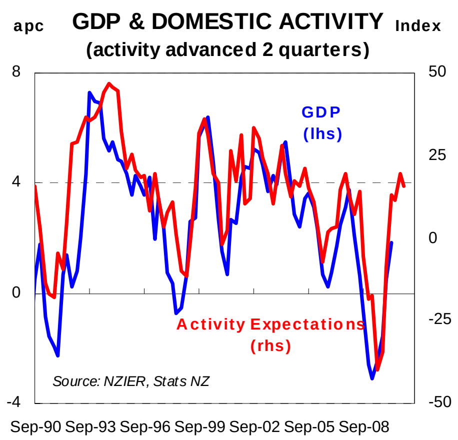
The export sector has started 2010 with a hiss and a roar. Non-food manufacturing has grown strongly for two consecutive quarters. Strong demand in Australia and the relatively low NZD/AUD have been key factors supporting manufacturing confidence. In addition, the global recovery has underpinned an impressive recovery in New Zealand's export commodity prices. Given the relative exposure to Asia and Australia, recent growth wobbles emanating from Europe and the US have as yet barely dented NZ's export commodity prices. Adding to the positive commodity outlook, the recent spike in dairy prices, albeit unsustainable, has provided a boost to export incomes. While we expect further moderation in dairy prices over the year, we remain upbeat on the medium-term prospects and expect dairy prices to remain at above-average levels.

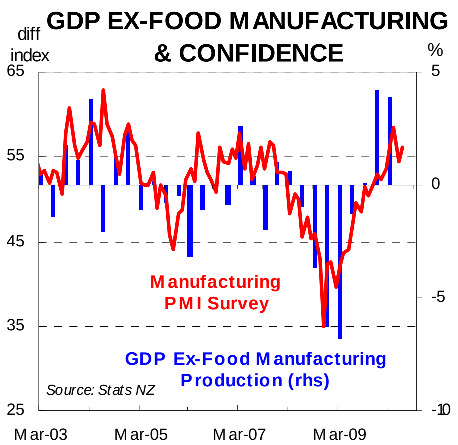
Commodity prices up on strong trading partner demand.

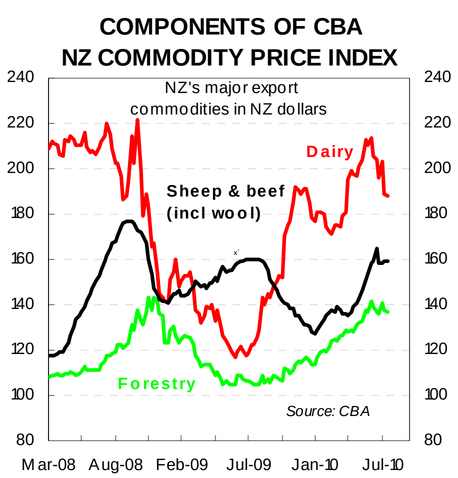
Tourism sector performance more patchy.

The recovery in the tourism industry has been more patchy. Services exports surged over late 2009 as hordes of Australians arrived to spend their "Rudd Cheques", although recently the









momentum from Australian visitors has stalled. It has been encouraging to see a recovery in visitor numbers from Asia (including Japan, China and Korea), although the pick-up has been from low levels.

Consumers remain cautious.

Households remain cautious

Consumer spending stabilised early in 2009 and over the year continued to gradually recover, buoyed by both stronger population growth and a small pick-up in spending on a per-person basis. While consumer confidence has improved, households have retained a degree of caution when it comes to spending on big-ticket items and consumer finance. Contributing to this, households still feel financially worse off compared to a year ago, likely a result of weak wage growth over the past few years. As labour demand is set to recover over 2010, we expect wage growth to improve. Combined with this year's tax cuts, we expect a modest recovery in spending to continue over 2010/11.

Labour demand starting to recover.

Employment starts to recover

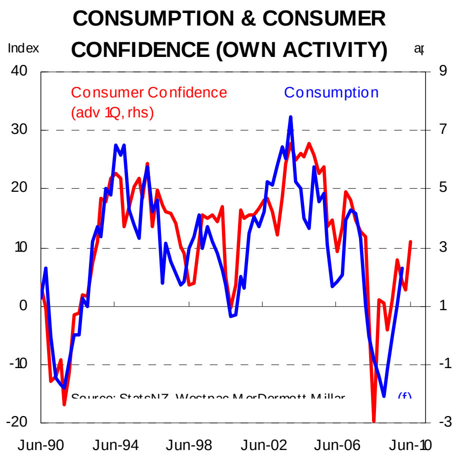
The labour market showed clear signs of turning in the early part of 2010. Employment grew strongly for the first time in a year during the March 2010 quarter, along with a substantial lift in hours worked. We expect the recovery in employment demand to continue over the second half of 2010.

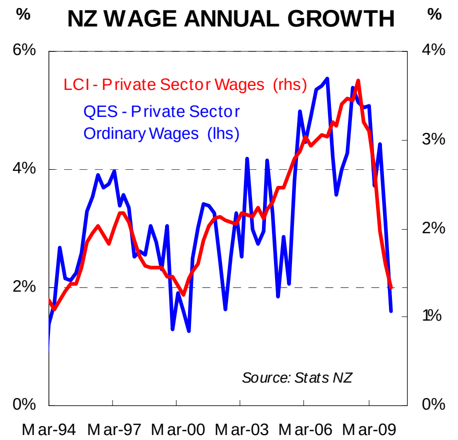
With labour demand improving, there have been early indications that conditions in the labour market are beginning to tighten. Firms reported that finding skilled labour was "difficult to find" for the first time in 18 months. As demand continues to strengthen, profitability recovers and competition for labour heats up, wage growth is also set to recover from a muted pace.

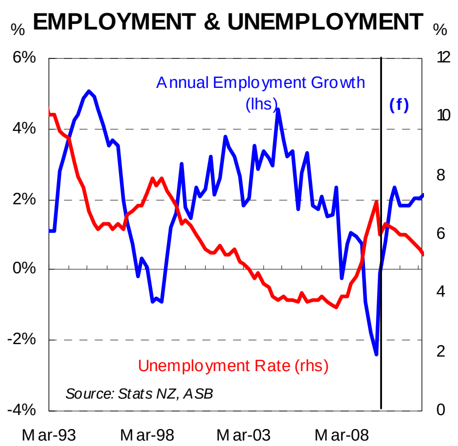
Businesses preparing for future growth.

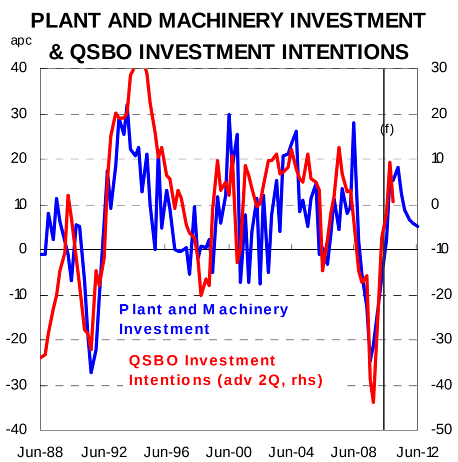
Business investment slowly improving

Businesses confidence has improved over the past year, with encouraging signs firms are increasingly willing to prepare for expansion. In the December 2009 quarter there was evidence of firms both rebuilding stock levels and increasing investment in plant and machinery equipment. Import data point to further recovery in this area of investment. However, the recovery in investment is likely to be mixed as the non-residential building construction outlook remains more subdued. Consent issuance for non-residential construction projects has started to decline, after holding up well through the recession (in part propped up by an increase in government related activity). Anecdotes of high vacancy rates with CBD offices suggest this area of construction will remain subdued for sometime yet. Nonetheless, the majority of firms are upbeat on the future outlook and appear increasingly willing to expand capacity to meet future demand.









Government charges will boost inflation

Concerning inflation developments in the pipeline.

A raft of Government policy changes is expected to boost headline annual CPI inflation well above 5% by the middle of 2011. These Government policy changes include higher energy prices as a result of the Emissions Trading Scheme (ETS), higher ACC levies, tobacco excise taxes, and an increase in GST to 15%. While the Policy Targets Agreement allows the RBNZ to look through the first round effects of these changes, there is the risk that these higher costs will spill over to generalised inflation. Indeed, the RBNZ acknowledged in its June Monetary Policy Statement the "risk the coming spike in headline inflation causes consumers and businesses to reassess their expectation of medium term inflation".

Administrative inflation will boost annual CPI to well above 5%.

The ETS is boosting petrol and electricity prices from 1st July, with several petrol and electricity retailers already having announced price increases. Meanwhile, the higher ACC levies will mean a larger increase in vehicle licensing fees than is typical for Q3. Added to that, the 10% increase in tobacco excise tax in late April, with further 10% increases planned for 2011 and 2012 will provide a further boost to non-tradable inflation. The increase in GST on 1st October will increase the CPI by around 2%. We expect the combination of these Government policy changes will push headline CPI inflation to well over 5% by June 2011.

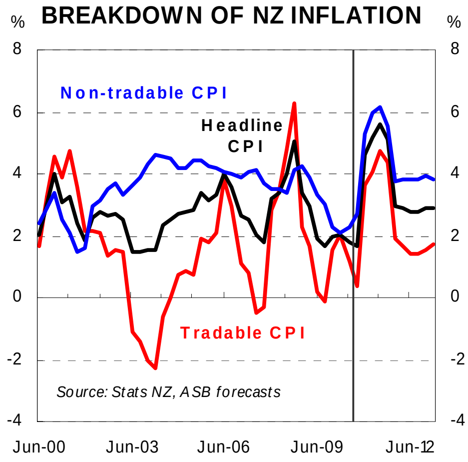
Risks that high headline inflation will spill over to changes in price and wage setting behaviour.

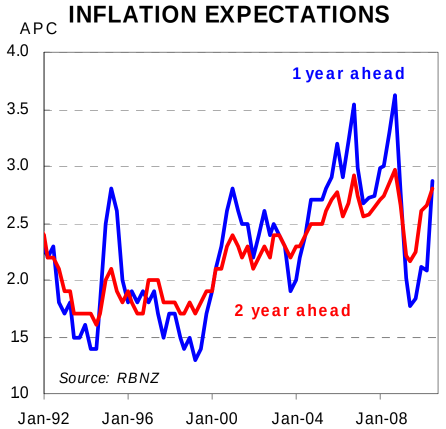
The RBNZ has stated that while it will look through the first round effects of the Government policy changes it will respond to any changes to price and wage setting behaviour. The surge in pricing intentions in recent business surveys likely reflects increased awareness that inflation will be higher as a result of these Government policy changes. Nonetheless, the high level of pricing intentions is in line with our expectations that headline inflation will rise to well over 5% by the middle of next year. Future readings on pricing intentions and cost expectations will be key to determining whether the Government charges have led to second-round effects.

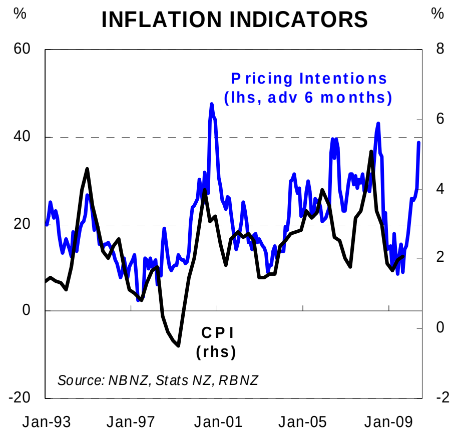
Given the recovery in economic activity will see a lift in underlying inflation pressures, the sharp increase in headline inflation poses a very real risk that price and wage setting behaviour will be affected. With medium-term inflation expectations already approaching close to the top of the RBNZ's target band there is little room for the RBNZ to absorb upside inflation risks.

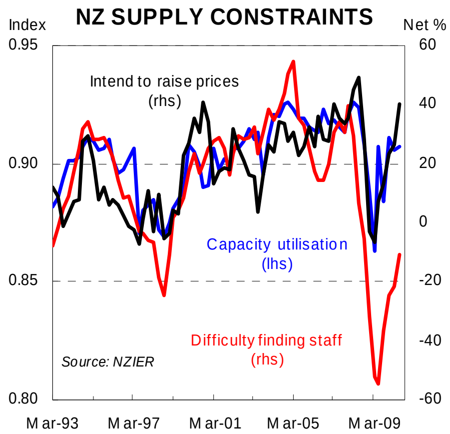
Growing signs of capacity pressures in the economy.

The June quarter NZIER Quarterly Survey of Business Opinion also points to capacity pressures building up in the NZ economy. Capacity utilisation remains elevated, and businesses report increased difficulty in finding skilled staff thus pointing to an increase in wage pressures from subdued levels.









Interest Rates and Exchange Rates

OCR will continue to rise over 2010

Continue to expect monetary policy stimulus to be removed over coming year.

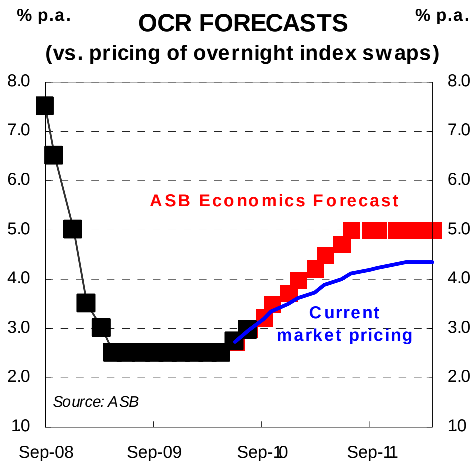
The RBNZ has reiterated its expectation that monetary policy stimulus will be steadily unwound over the coming year as the domestic economy recovers.

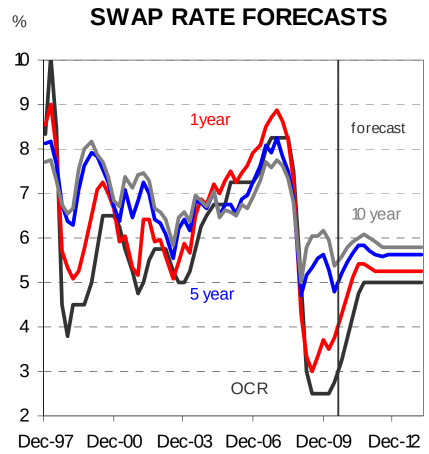
With growing inflation pressures in the NZ economy, we expect the RBNZ will continue to increase the OCR in 25 basis point increments to an eventual peak of 5%. This peak of 5% implies some narrowing in the term funding premium over the coming year as financial market conditions improve. If this improvement in funding conditions did not eventuate the OCR would not have to be increased by as much to achieve the same mix of financial conditions.

Domestic interest rates expected to rebound in line with the recovery in economic activity.

Our judgement is the RBNZ is slightly underestimating future inflation. Nevertheless, the skew of global risks means there is a possibility the RBNZ pauses at some point. Market pricing is currently consistent with the RBNZ only lifting the OCR at every scend meeting over 2011.

Heightened concern in the financial markets over the global growth outlook has seen a decline in longer term interest rates in recent months. We expect wholesale domestic interest rates will rise across all tenures in line with the recovery in economic activity.





NZD to remain firm

NZD likely to remain at relatively high levels.

Reflecting the diverging fortunes of the different economies and changing risk appetite, the NZ dollar is expected to depreciate slightly against the US dollar and the British pound, but appreciate against the Euro and Japanese yen. Overall, we expect an appreciation in the NZ dollar TWI over the coming year.

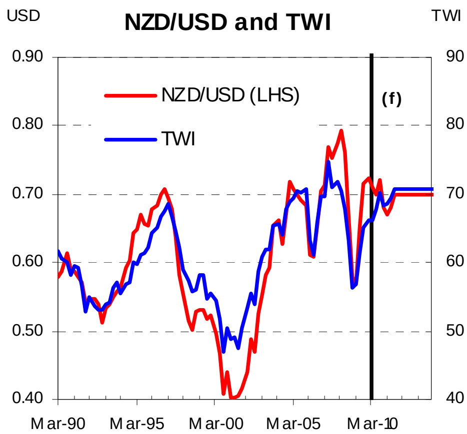
USD supported on risk aversion...

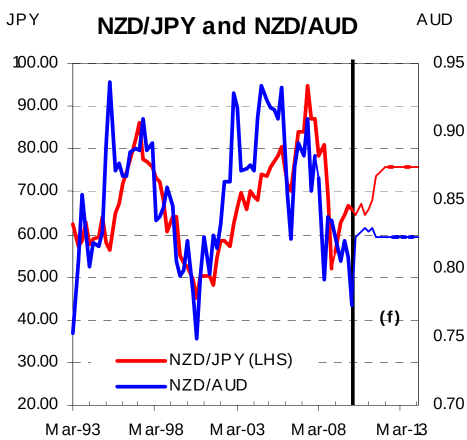
Continued concerns over European sovereign debt contagion have seen investors continuing to favour the relative safety of US dollar denominated assets, thus supporting the level of the US dollar during periods of risk aversion. Meanwhile, the NZ dollar is expected to depreciate against the British Pound, partly reflecting some retracement of the rise in the cross over the past year. Continued concerns over the sustainability of the fiscal deficits of some European countries are expected to weigh on the euro over the coming year.

...with euro weighed down by debt worries.

NZD to recover slightly more against the AUD.

The NZ dollar has fallen sharply against the Australian dollar over the past year. This depreciation has supported a recovery in NZ's core manufacturing activity. More recently, the RBA has signalled it intends to pause to assess the effects of its earlier rate increases. This is in contrast to the RBNZ beginning its removal of monetary policy stimulus in June. We expect a small lift in the NZD/AUD as the interest rate differential between Australia and New Zealand continues to narrow.





ECONOMIC FORECASTS

ASB economic forecasts		Mar-10 << actual	Jun-10 forecast >>	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Mar-13
NZ GDP real	**AA%**	**-0.4**	**0.8**	**1.9**	**2.4**	**2.6**	**2.6**	**2.5**	**2.8**	**2.9**	**2.9**
private consumption	AA%	0.5	1.4	2.6	2.6	2.5	2.3	1.0	1.3	1.5	2.4
dwelling construction	AA%	-11.8	-5.1	2.6	4.3	6.0	6.2	4.4	3.5	2.6	2.0
other investment	AA%	-9.5	-6.2	-2.3	3.2	6.9	9.6	10.4	9.4	8.0	5.4
exports	AA%	2.8	3.6	4.0	4.4	4.5	5.0	5.3	5.3	5.2	4.4
imports	AA%	-9.6	-0.9	7.5	10.6	10.9	9.5	6.2	5.4	4.6	4.0
NZ GDP real	A%	1.8	2.5	3.0	2.4	2.5	2.6	2.7	3.3	3.2	2.8
NZ GDP real	Q%	0.6	0.6	0.8	0.3						
NZ CPI	Q%	0.4	0.3	1.2	2.7						
NZ CPI	**A%**	**2.0**	**1.8**	**1.7**	**4.6**	**5.2**	**5.6**	**5.1**	**2.9**	**2.9**	**2.9**
NZ house prices (QV index)	A%	6.4	4.0	-0.5	-3.1	-3.0	-2.7	-0.2	1.4	1.9	2.9
NZ unemployment (sa%)	Qtr	6.0	6.4	6.2	6.2	6.0	6.0	5.9	5.7	5.5	4.9
NZ private sector wages (LCI)	A%	1.3	1.4	1.5	1.8	2.1	2.3	2.5	2.6	2.7	2.4
NZ current account ($b)	Yr	-4.5	-4.8	-7.0	-6.4	-7.3	-8.4	-8.7	-8.9	-8.9	-8.7
as a % of GDP	Yr	-2.4	-2.5	-3.6	-3.3	-3.6	-4.1	-4.3	-4.3	-4.2	-3.9

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

FINANCIAL FORECASTS

ASB interest rate forecasts (end of quarter)	Mar-10	Jun-10 << actual	Sep-10 forecast >>	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
NZ cash rate target	2.50	2.75	3.25	3.75	4.25	4.75	5.00	5.00	5.00
NZ 90-day bank bill	2.67	3.13	3.7	4.2	4.7	5.1	5.2	5.2	5.2
NZ 3-year swap rate	4.77	4.40	4.9	5.2	5.5	5.7	5.7	5.5	5.4
NZ 10-year gov't stock	6.02	5.37	5.3	5.4	5.5	5.6	5.7	5.8	5.8

ASB foreign exchange forecasts (end of quarter)	Mar-10	Jun-10 << actual	Sep-10 forecast >>	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
USD per NZD	0.710	0.693	0.72	0.68	0.67	0.68	0.70	0.70	0.70
GBP per NZD	0.471	0.460	0.50	0.47	0.47	0.47	0.47	0.47	0.45
AUD per NZD	0.773	0.814	0.83	0.83	0.83	0.83	0.82	0.82	0.82
JPY per NZD	65.8	61.5	67	65	66	68	74	75	76
EUR per NZD	0.529	0.568	0.60	0.59	0.61	0.61	0.61	0.61	0.61
TWI	66.1	66.9	70.2	68.2	68.6	69.2	70.6	70.8	70.7

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

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