

# ASB Quarterly Economic Forecasts

## A year of progressive recovery



- The NZ economy will progressively recover over 2010 after shrinking more than 3%.
- Changed credit markets, high government and household debt will temper the global recovery.
- April is the earliest we to expect the RBNZ to start lifting the OCR.

Mark Twain reputedly said: “history never repeats itself, but sometimes it rhymes”. There are some key aspects to the current global environment that don’t rhyme with the typical recession and will act to restrain what would normally be a sharp bounce out of a deep hole.

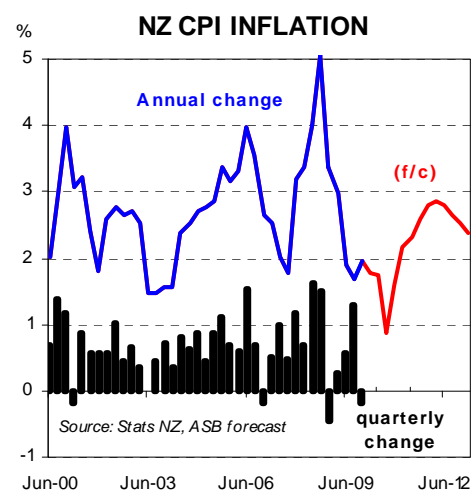
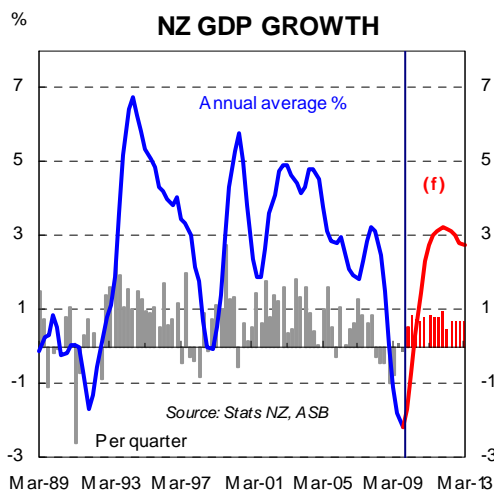
The first key change is that the global availability of credit will not be as easy as it was – but with greater competition for the funds available. NZ has large external borrowings which will increase as the Government increases its debt levels, so will need to compete to borrow its share of the pie. Financial regulation will be tightened up in many countries, an understandable response in countries that have suffered from the undesirable mix of incentives influencing lenders and borrowers. NZ will also see some of its own regulatory changes. One example is the RBNZ’s new liquidity policy, which places strong emphasis on banks funding their lending through retail deposits and through wholesale funding of greater than a year to maturity.

A second change is that households in a number of countries are demonstrating a preference to pay for purchases with money they have rather than money they borrow. That trend is likely to continue for some time. NZ is included in this group, with spending and borrowing habits conservative at present.

A third is the fiscal legacy of recession in many other Western economies. Governments will be focussing for years to come on restraining spending and repaying debt, a contractionary force on a number of economies. Fiscal constraints will also be a handbrake for NZ, though less so than in a number of countries.

In 2009 the NZ economy found its feet after being sideswiped by the escalation of the financial crisis. 2010 will be a period in which the economic recovery progressively broadens and picks up pace. The base for the initial (and weak) growth reported to 2009Q3 was narrow, with more industries going backwards than forwards. Domestic demand has been driven by improved housing activity, which has stimulated the services supporting real estate and a degree of housing-related retail spending. In 2010 we will see housing construction strengthen and some recovery in businesses’ expenditure. Positives for exporters include the robustness of the Australian economy (destination for nearly a quarter of NZ’s exports) and the strength of recovery in much of Asia. But, the overall pace of recovery in NZ is more likely to be progressive rather than sharp.

We expect the NZ economy will grow 2.5% over this calendar year, a respectable though not explosive pace. A recovery in inventory levels will do much for growth this year. But, with underlying demand picking up at a more modest pace, the rise out of recession will have a gradual feel about it for many. One sign that normality is getting closer will be when the RBNZ starts to lift the OCR from its current record low level. We expect the first move to come in April, but certainly no earlier than that.



### 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.

### Key trends beyond the Noughties

*Noughties start with dot.com bubble, end with financial crisis.*

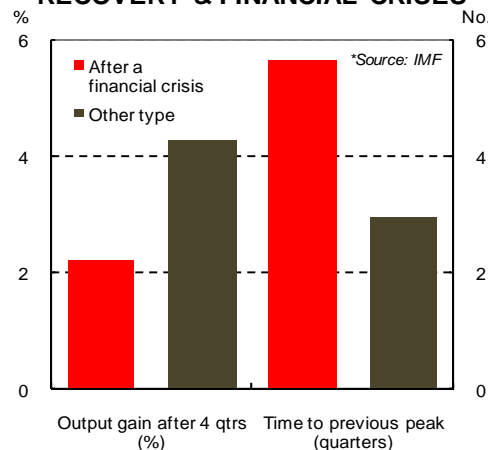
The decade of the Noughties was book ended by the bursting of the dot.com bubble and the Global Financial Crisis. In between we saw the emergence of China as a global economic power, strong lifts in commodity prices, a growing savings imbalance between emerging Asia and several Western economies (and plentiful supply of credit as a result). Locally, NZ had a very strong economic boom, driven primarily by the strongest housing boom for at least 40 years and strong household spending.

*2010 global economic recovery likely to be gradual.*

Moving into the 2010s, the lingering impact of the Global Financial Crisis will influence the shape of the early years of the decade – and into the next decade when it comes to government debt levels. Economic recovery in countries directly affected by the financial crisis will be comparatively slow, based on past experience.

Even NZ will be affected by the crisis impact to a degree, notwithstanding how well the banking system fared during the crisis. NZ is highly dependent on external financing, and the crisis highlighted the potential vulnerability of being reliant on the unfailing goodwill of foreigners.

#### RECOVERY & FINANCIAL CRISES



Other changes will be afoot. Many vibrant developing economies have quickly come out of the crisis with less collateral damage and will be less encumbered going forward. Nevertheless, those countries heavily reliant on foreign consumer demand for their exports will need to adapt to slower growth in export demand.

The above are some broad-brush trends likely to develop. A few shifts are worth a close look at, as they will either affect NZ directly or indirectly via some of our larger developed nation trading partners: government fiscal positions; household debt levels (mainly in Anglo-Saxon countries); financial regulation.

#### Repairing government fiscal positions

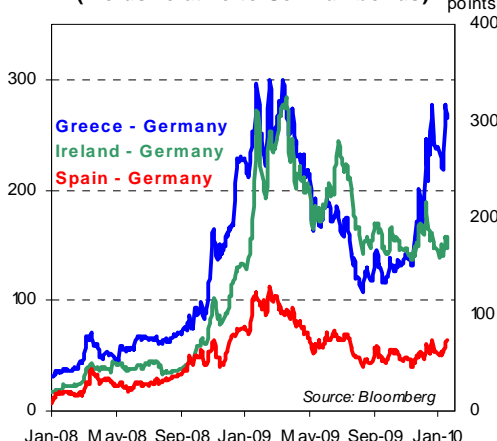
*Rise in government debt levels increasingly important.*

Some have observed that the world has attempted to solve a problem of excessive household borrowing through huge amounts of government borrowing. While that has been the result as far as government debt in many countries goes, governments effectively stepped in to spend and to prop up financial systems when no-one else was prepared to. Doing so prevented far more chaos in economies and people's lives from occurring. But the bill will take years to pay off, and debt repayment and servicing costs will constrain governments' abilities to increase spending and also prompt tax increases in some countries.

Some major economies are running budget deficits in excess of 10% of GDP, and it doesn't take much time for debt levels to increase considerably. In such cases the gap

between expenditure and revenue is so large that some governments will have to make some tough policy choices. There will also be a limit to how much governments can borrow before bond investors – the financiers of the ballooning debt – start to get nervous about their exposures. Bond markets are showing greater preparedness to discriminate between countries that appear to be taking their future debt levels seriously and those that aren't. Greece is a prime example of a country that, at least at present, does not appear to be fully facing up to its fiscal problems. In contrast, Ireland is already taking significant measures to stem its red ink.

#### EU 10-YEAR BOND SPREADS (Yields relative to German bonds)



*Investors will discriminate against countries without credible fiscal strategies.*

*Correction in household balance sheets will weigh on consumer spending.*

### Household balance sheet repair

Households in a number of countries took advantage of the period of cheap and easy credit to borrow to buy housing or finance spending. Anglo-Saxon countries were notable for this, but it also occurred in a number of European countries. Iceland is an extreme example of excessive borrowing.

Household balance sheet repair is a gradual process compared to the swift clean-out bankruptcies or receivership prompt in the business world. By and large the process involves affected households tightening their belts, either saving more or repaying debt faster. Households are swinging,

therefore, from a period of spending beyond their means to spending within their means. To date the pick-up in retail spending growth has been modest and the outstanding amount of consumer finance fell 5% over the 12 months to November 2009.

As this adjustment continues consumer demand growth will remain moderate, and it may be some time until the level of consumer spending returns to pre-crisis levels. In NZ's case the volume of consumer spending in the September 2009 quarter was 2% below its December 2007 peak and we don't expect it to exceed that pre-crisis level until mid-2010.

### Financial regulation

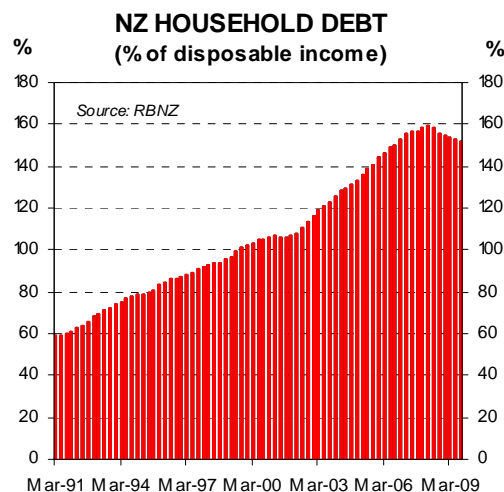
The global financial crisis exposed lax lending practices, financial innovation that was little understood by its creators, and highlighted poorly aligned incentives for lenders and borrowers. Deeply-affected countries include: the US, the UK, Ireland, Iceland, and a scattering of European countries from Spain eastwards to the Baltic states.

The natural responses of governments are moves to tighten up financial regulation and beef up prudential policies. Changes will be pronounced in the US and UK, targeting lending practices and realigning banks' incentives.

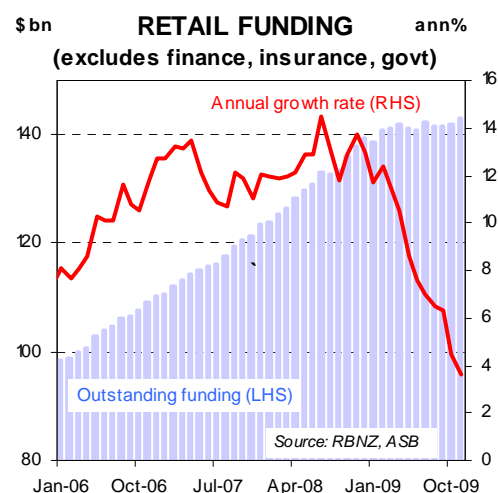
New Zealand, like Australia and Canada, benefited from a conservative and vanilla banking system. Nevertheless, the crisis has put a lot more focus on NZ's dependency on foreign funding. In response the RBNZ is this year implementing a liquidity policy for banks. The objective of the policy once fully implemented is, in very simplified terms, to ensure that at least 75% of each individual bank's funding comes from a combination of retail deposits and from wholesale funding of more than 1 year to maturity.

Capping the proportion of short-term wholesale funding reduces the risk of banks having a high proportion of their funding that needs refinancing at any given time. That will ensure a high degree of resilience should another financial shock trigger another freezing up of global credit markets, a positive and prudent policy objective. The side effect of the policy is that the funding sources deemed more secure are also currently more expensive sources, so the added systemic insurance will come at a cost. The 'retail deposit war' is also likely to remain in place in the short term as emphasis on stable, domestic funding continues.

However, this pool of funding is no longer growing rapidly at present. If NZ wants to rein in its dependence on foreign funding then stimulating the supply of local savings will be important. The challenge for NZ is that, even as household borrowing and savings habits appear to be changing, the rise in government debt will continue to increase NZ's overall dependence on foreign savings even more.



*Financial crisis highlights vulnerabilities in bank funding practices.*



*Increased regulation already starting to increase funding costs.*

*Stronger financial systems come at a slight cost.*

### International Economy

*World growth outlook improves.*

World growth prospects have improved dramatically in the past few months. A combination of very low interest rates, bank bail-outs and targeted fiscal expansion are driving economic recoveries around the globe. However, the strength and timing of these recoveries differs from region to region.

*US economy begins to turn corner, but fragilities remain.*

The US still has some issues to work through with bad debt problems in its financial and commercial property sectors. However, there are clear signs that house prices and new construction are turning up after recording 30% falls to mid-2009. The US unemployment rate looks to have peaked at 10% in the past few months. Industrial production is slowly reviving as producers and retailers re-stock in preparation for higher US and world growth in 2010.

*Europe, UK and Japan face fiscal limitations.*

Europe, the UK and Japan could have relatively weak recoveries in 2010. All are struggling with weak commercial property and finance sectors and high unemployment rates. Budget deficits have ballooned. It means there is limited fiscal flexibility to stimulate their economies further.

*Government debt levels under increased scrutiny.*

Rising government debt levels and fiscal positions will attract additional scrutiny over the next few years. Investors are more likely to discriminate between those governments demonstrating credible plans or actions to contain ballooning debt and those that don't. Being perceived as taking appropriate action will be important to contain the costs of servicing both government and private sector debts.

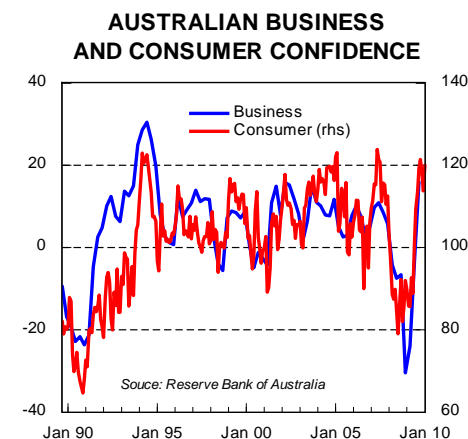
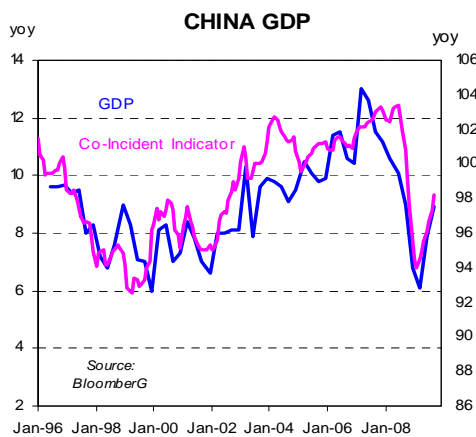
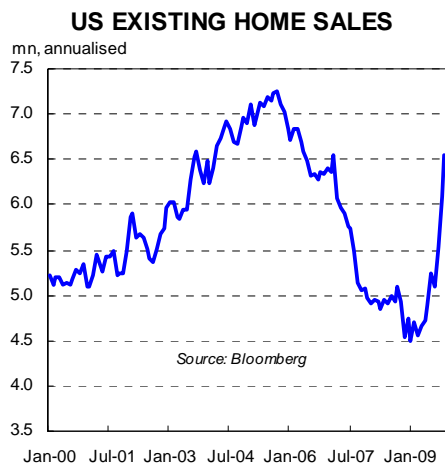
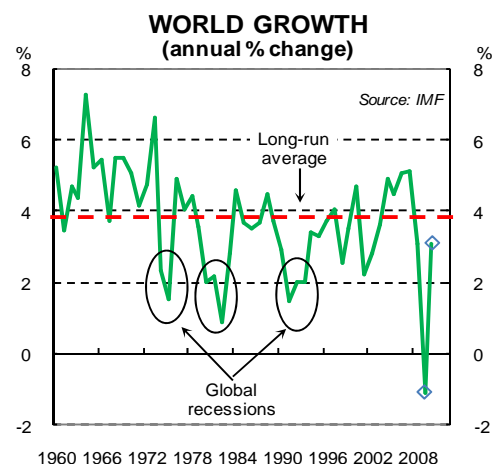
*China's rebound helpful for Australian economy.*

In Australia, the major favourable development in the world economy is China's relatively buoyant growth outlook. Chinese policy makers have boosted commodity-intensive infrastructure spending and bank lending. Domestic growth drivers are helping offset some of the contraction in Chinese export markets.

*Strength of economy prompts RBA to lift interest rates.*

The Australian economy managed to avoid recession, aided by aggressive rate cuts by the Reserve Bank of Australia (RBA) and aggressive fiscal stimulus by the Federal government. The Australian economy was in strong shape before the crisis, with a low jobless rate and under-supplied housing market. These factors, combined with a rebounding Chinese economy, will underpin growth over 2010. Stronger housing and education construction will drive economic momentum, supported by increased mining output and firmer consumer and business spending.

In light of the improving growth outlook, the RBA has become increasingly concerned about leaving interest rates at emergency settings for too long. The RBA has moved to gradually withdraw stimulus with three 25 basis point rate increases in the three months to December.



## The New Zealand Economy

*NZ economy exits recession, recovery to become more broad-based.*

The New Zealand economy stabilised over the middle of 2009, exiting recession during the second quarter of 2009. During the 5 quarters of recession the economy contracted 3.3%, with the manufacturing, building and wholesale sectors bearing the brunt of the decline. To date, the recovery has been led by a pick up in housing-related areas, underpinned by an increase in population growth and low interest rates. Over the next six months, we expect the recovery to become more broad-based across different sectors of the economy. To the extent there was a large running down of inventories through the recession, a recovery in the inventory cycle should help provide an additional growth boost over the next few quarters.

### Export commodity prices improve

Improving global prospects have underpinned a recovery in New Zealand export commodity prices: in particular, dairy prices have lifted substantially off their lows. The lift in the NZ dollar has taken some of the shine off the recovery in dairy prices, and has also pushed returns on sheep and beef meat prices lower. NZ dollar returns for forestry products also remain subdued.

### Agricultural exports supported volumes

NZ export volumes performed surprisingly well during the global downturn, mostly due to strong gains in agricultural output. Over 2010, dairy and meat volumes are likely to weaken, although falls will be offset by a recovery in volumes of manufactured goods. In particular, exporters focused on Australian markets will be receiving the dual benefit of comparatively stronger demand and the low exchange rate against the Australian dollar.

Exports of services remained weak over 2009, following substantial declines in 2008. Declines in tourist numbers, particularly from Japan and Korea, have reduced revenue from tourism over the period. However, a surge in Australian visitors over the second half of 2009 provided some offset to the decline.

Demand for travel is likely to improve as the global economy recovers. We also anticipate an additional boost to tourism spending during the Rugby World Cup in 2011.

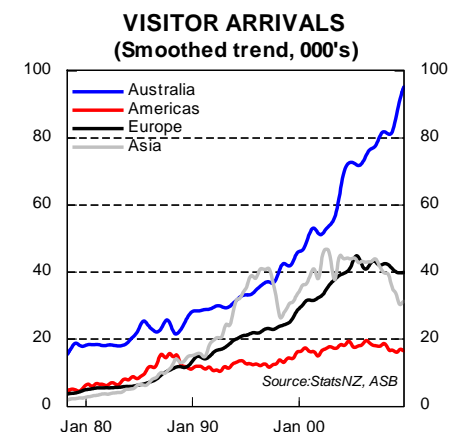
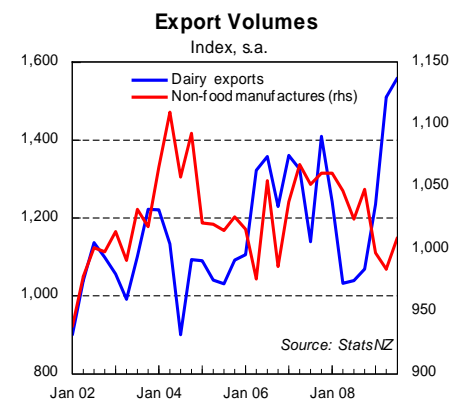
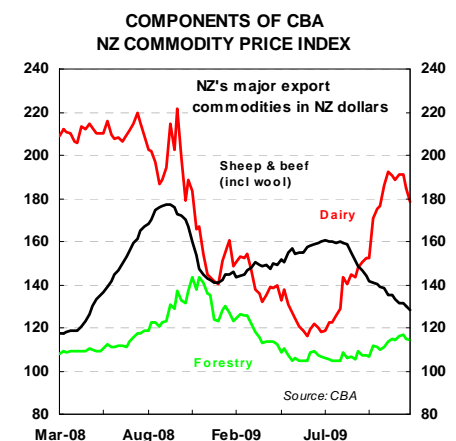
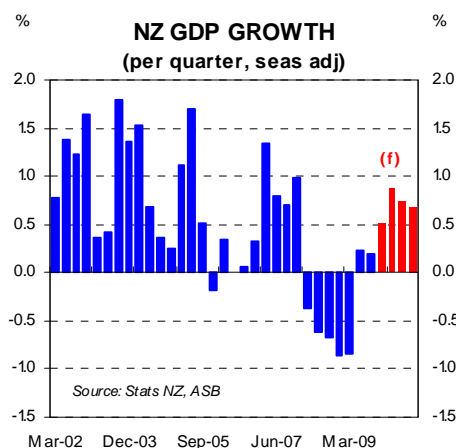
### Households focus on balance sheets

The household sector will continue to focus on improving balance sheets over 2010. Following a sharp decline in housing and equity asset values and an abrupt change in job security, households' focus has turned towards living within their means, confirmed by a decline in consumer debt levels. We expect households to remain cautious, despite the recent recovery.

*Recovery in dairy prices underpins lift in export commodity prices.*

*Recovery in manufactured exports to offset flagging agricultural production.*

*Tourism receipts remain weak, although pick up in Australian visitor arrivals promising.*



*Consumer spending picks up, but caution remains.*

**Retail spending improving**

While consumer confidence has lifted off lows, employment confidence and households' views on their financial circumstances remain below average. These concerns are likely to weigh on consumer spending, particularly on big-ticket items. Nonetheless, stronger population growth and an increased rate of household formation have led to an increase in housing-related consumer spending. Per-capita spending has started to make small improvements after contracting almost 4% during the recession.

**House prices rebound**

House prices have been one area to surprise over the past year. After contracting 10% in nominal terms, house prices have now recovered roughly half of this decline. While the lift in demand has been reasonably modest, the low supply of houses for sale has contributed to a mini-boom that has been particularly evident in the larger cities.

Over 2010 we expect the momentum in house prices to slow. An increase in dwelling construction and a resumption in permanent migration to Australia will increase the number of houses available for sale. In addition, rising mortgage rates and confirmation from the RBNZ of interest rate increases in the first half of 2010 will temper demand.

**Investment cut back**

Investment contracted sharply during 2009 as firms' profitability and confidence declined. While business confidence has improved, investment intentions have been slower to bounce back due to still-low levels of experienced activity and low profitability. Nonetheless, as confidence continues to build, we expect investment spending to recover over the second half of 2010.

**Labour demand improves**

There has been increasing evidence that the labour market has turned, with the unemployment rate close to its peak. Any further declines in the level of employment are likely to be limited, although the outlook for job growth still remains subdued. Already firms have noted it is not as easy as it was to find labour. Many firms were able to hoard labour throughout the recession and manage costs via wage freezes, thus underpinning a sharp decline in wage inflation. The higher level of unemployment is likely to keep wage growth below average into 2011.

While the NZ labour market can be described as stabilising, prospects in the Australian labour market have improved considerably. Given the relative strength in the Australian job market, it's a matter of time before permanent departures of New Zealanders to Australia recover towards pre-crisis levels.

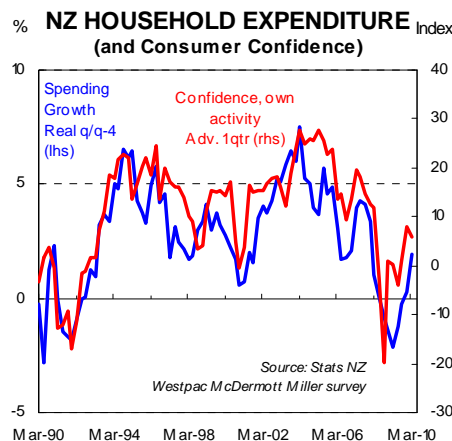
*House prices start to recover.*

*Increased supply and slowing demand should help balance housing market.*

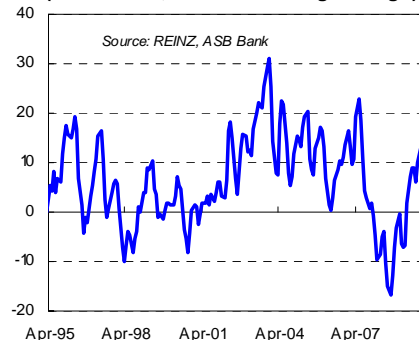
*Investment intentions point to investment recovery latter half of 2010.*

*Labour market set to improve, although recovery to remain gradual.*

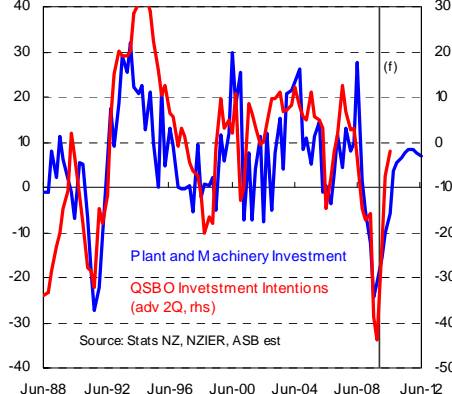
*Job growth in Australia likely to attract Kiwis.*



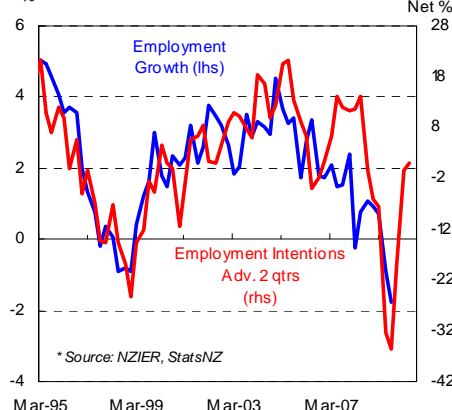
**REINZ STRATIFIED MEDIAN HOUSE PRICE INFLATION (Annualised, 3 month moving average)**



**PLANT AND MACHINERY INVESTMENT & QSBO INVESTMENT INTENTIONS**



**NZ EMPLOYMENT & INTENTIONS**



*Inflation pressures tame for now.*

*But inflation pressures to pick up as economy recovers.*

*Non-inflationary growth rate likely to be lower than previously thought.*

*Central banks to start lifting rates in 2010.*

*RBNZ may have a lower neutral cash rate.*

*Funding costs likely to remain a wedge between retail rates and the OCR.*

### Inflation pressures will build over 2011

Inflation at present is where the RBNZ would ideally want it to sit: precisely at the 2% mid-point of the 1% to 3% target band. But tame as inflation looks at present, the early warnings are appearing that disinflationary pressures are starting to abate. Capacity utilisation has started to creep back up already. Construction cost inflation, much moderated somewhat during the recession, is set to start lifting as housing construction picks up. Businesses constrained labour costs during the recession as an alternative to cutting jobs. But improved prospects and greater competition for workers from both NZ and Australian businesses will see labour costs start to lift.

Despite the worst recession since the 1970s, inflation did little more than drop briefly below the target mid-point. Downward revisions to historic growth rates, combined with weak business investment in the downturn, point to a lower non-inflationary speed limit for the economy. Once the economy has largely recovered to its pre-recession size (which will occur around the end of 2010), inflation pressures are likely to emerge more noticeably.

### Interest Rates and Exchange Rates

#### OCR increases loom

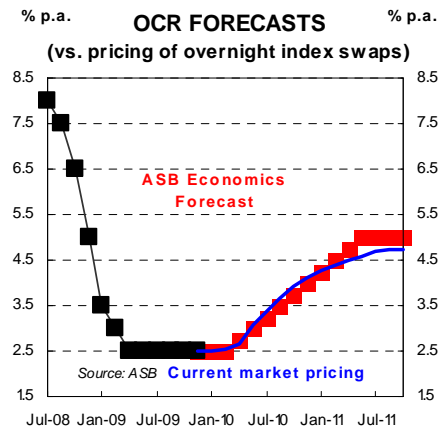
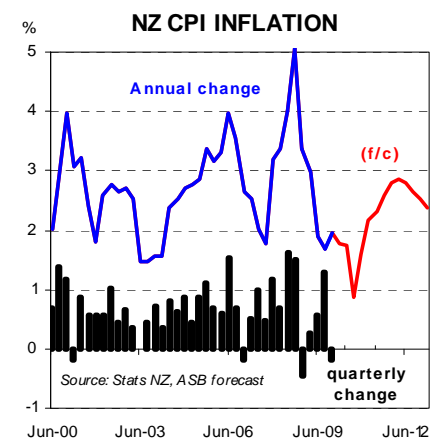
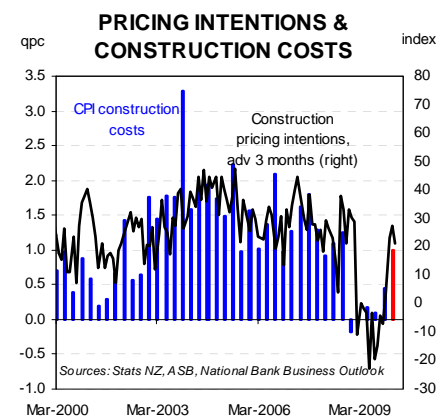
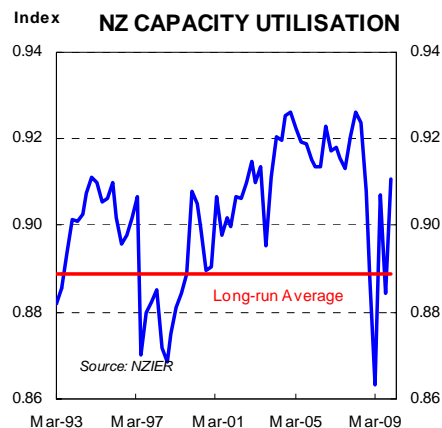
Last year short-term interest rates dropped dramatically in the first half of the year. Declines in long-term rates were short-lived, however, as the global environment turned the corner and as global bond issuance was set to lift rapidly over coming years.

2010 will see central banks move to unwind some of the stimulus put in place, and a few central banks have already started the process. It is becoming increasingly clear that NZ's OCR is at an unsustainably low level. Although inflation will be benign over 2010 it will be back in the top half of the 1% to 3% target band from the first half of 2011 – even assuming interest rates will shortly lift from their current low levels. Given the long lags from monetary policy changes to full impact on inflation the RBNZ will lift interest rates sooner rather than later.

#### Neutral cash rate lower

There a number of issues the RBNZ will have to negotiate when considering its exit strategy. One of these issues is what level of the OCR is appropriate in order to have a neutral effect on the economy, i.e. not stimulatory and not contractionary. In normal 'pre-crisis' times, we estimate the neutral to be close to 6.25%-6.5%. However, it has become clear that the financial crisis is likely to have a lingering effect on funding costs.

Bank funding costs have been pushed significantly higher via retail deposit rates and the credit spread on long-term wholesale bank funding and retail funding.



*Neutral cash rate around 5%*

These funding costs have placed a wedge between the OCR and retail interest rates. In a global environment where competition for funds is likely to remain tight, we expect these funding pressures to persist. To get retail borrowing rates back to neutral/average levels, we estimate an OCR of only 5% is necessary.

**Small rate hikes likely to be powerful**

Even then, the RBNZ has a large gap to close, with 250 basis points of tightening to return the OCR roughly to neutral. However, relatively small increases in the OCR are likely to have a surprisingly powerful effect on lending rates and household behaviour. The relatively steep normal-shaped yield curve has helped increase sensitivity to interest rates increases. Borrowers have become more attracted to shorter-term interest rates and this dynamic will be helpful for the RBNZ as it reduces the lag between OCR increases and higher effective interest rates.

*Early OCR increases likely to have strong bite*

*We expect the first increase in April 2010*

We expect the RBNZ will start removing stimulus in April, steadily increasing the OCR in 25 basis point moves. The eventual OCR peak of around 5% will be very low by past standards. However, the RBNZ is increasingly looking to other tools to help reduce the work the OCR needs to do. Tighter fiscal purse-strings will impact on economic demand and there is potential for tax policy changes to dampen the housing market. The RBNZ are also hoping the new prudential liquidity policy will act as an automatic stabiliser and reduce the required hikes in the OCR during the recovery phase.

*Potential for fiscal policy to do some of the tightening for the RBNZ.*

*Earlier start by RBNZ will put pressure on NZD first half 2010.*

**NZD: upside risk still in the short term**

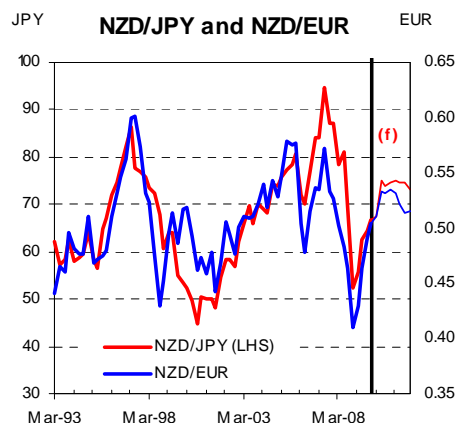
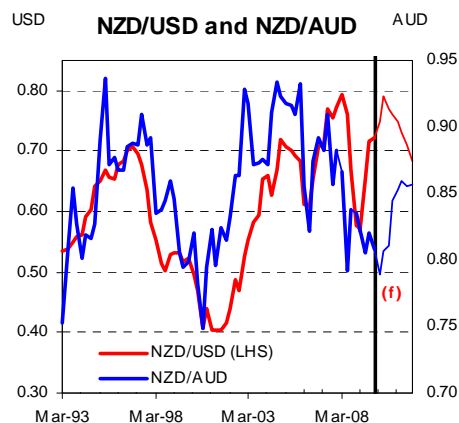
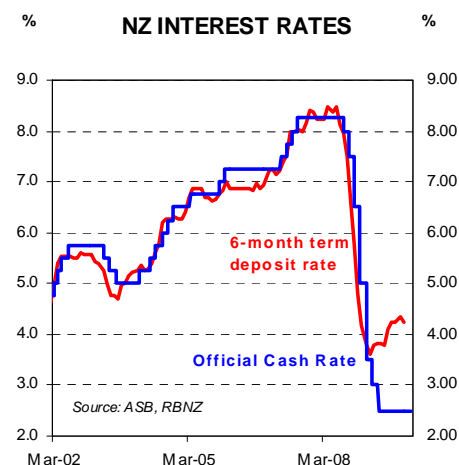
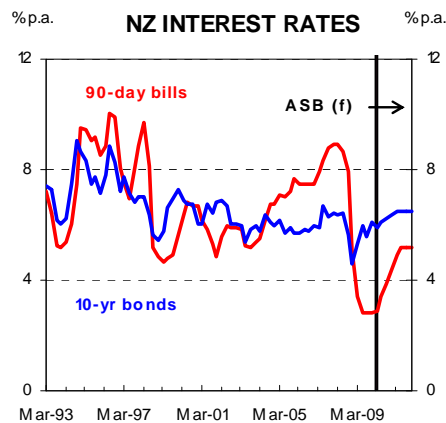
Over the first half of the year the NZD will be influenced by the timing of NZ interest rate increases relative to what happens in the US. Our expectation is that the RBNZ will start to lift rates earlier than the Federal Reserve (Q2 vs. Q3), and ahead of the main European central banks. Assuming the RBNZ beats the Fed (and other central banks) to the punch, a further short-term lift in the NZD is likely. Just how much of a lift (and when it comes to an end) will partly depend on the lead time the RBNZ has.

*But once the Fed starts to lift rates, this pressure will abate.*

But, once the Federal Reserve starts lifting interest rates, some recovery in the broad USD will see the NZD taper off, particularly against the USD and Pound. Our interest rate forecasts suggest the middle of the year is the likely turning point for the NZD.

*Australia's economic outperformance to keep NZD/AUD cross low*

We expect that the NZD/AUD will remain at levels that provide some comfort to exporters. The Australian economy is outperforming NZ's and in the short term its interest rates will continue to pull away from NZ's. However, we expect the NZD/AUD to lift modestly back to a roughly average level as NZ interest rates also start rising.



**ECONOMIC FORECASTS**

ASB economic forecasts		Sep-09 << actual	Dec-09 forecast >>	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Mar-12	Mar-13
<b>NZ GDP real</b>	AA%	<b>-2.2</b>	<b>-1.6</b>	<b>-0.4</b>	<b>0.7</b>	<b>1.7</b>	<b>2.5</b>	<b>2.8</b>	<b>3.2</b>	<b>2.7</b>
private consumption	AA%	-1.3	-0.8	0.2	1.0	1.5	1.9	1.8	2.0	2.0
dwelling construction	AA%	-25.3	-19.7	-13.2	-6.1	2.8	7.4	10.1	2.6	2.0
other investment	AA%	-10.1	-11.5	-9.9	-6.1	-3.0	1.4	4.4	8.9	6.5
exports	AA%	-3.2	0.0	2.2	2.1	1.6	1.3	1.5	5.0	4.3
imports	AA%	-16.5	-16.5	-11.9	-4.5	1.8	6.4	8.0	6.0	4.6
NZ GDP real	A%	-1.3	0.1	1.8	2.3	2.8	3.1	3.1	3.0	2.7
NZ GDP real	Q%	0.2	0.5	0.9						
NZ CPI	Q%	1.3	-0.2	0.1	0.5					
<b>NZ CPI</b>	<b>A%</b>	<b>1.7</b>	<b>2.0</b>	<b>1.8</b>	<b>1.7</b>	<b>0.9</b>	<b>1.6</b>	<b>2.2</b>	<b>2.9</b>	<b>2.4</b>
NZ house prices (QV index)	A%	1.1	5.0	7.5	5.0	2.4	1.2	1.1	2.3	2.8
NZ unemployment (sa%)	Qtr	6.5	6.7	6.9	7.0	7.0	7.0	7.0	6.7	5.9
NZ private sector wages (LCI)	A%	2.0	1.6	1.3	1.4	1.5	1.7	1.9	2.3	2.4
NZ current account (\$b)	Yr	-5.7	-3.9	-4.1	-5.8	-8.4	-9.2	-9.9	-11.2	-15.1
as a % of GDP	Yr	-3.2	-2.1	-2.2	-3.1	-4.5	-4.9	-5.1	-5.6	-7.1

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)	Sep-09	Dec-09 << actual	Mar-10 forecast >>	Jun-10	Sep-10	Dec-10	Mar-11	Mar-12
NZ cash rate target	2.50	2.50	2.50	3.00	3.50	4.00	4.50	5.00
NZ 90-day bank bill	2.81	2.80	2.9	3.4	3.9	4.4	4.9	5.2
NZ 3-year swap rate	4.61	5.19	4.9	5.3	5.8	5.8	5.9	5.7
NZ 10-year gov't stock	5.60	6.11	5.9	6.1	6.3	6.4	6.5	6.5
ASB foreign exchange forecasts (end of quarter)	Sep-09	Dec-09 << actual	Mar-10 forecast >>	Jun-10	Sep-10	Dec-10	Mar-11	Mar-12
USD per NZD	0.715	0.755	0.79	0.82	0.80	0.76	0.72	0.65
GBP per NZD	0.448	0.449	0.45	0.46	0.44	0.44	0.44	0.41
AUD per NZD	0.821	0.808	0.79	0.81	0.81	0.84	0.85	0.84
JPY per NZD	64.5	66.8	68	75	74	74	75	72
EUR per NZD	0.490	0.504	0.51	0.53	0.53	0.54	0.53	0.50
TWI	65.2	66.1	66.9	70.5	69.6	70.0	69.8	65.5

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

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