

ASB Quarterly Economic Forecasts

'B' is for Belt-tightening



- The NZ economy will grow only modestly over 2008 as household finances feel the pinch.
- Global economic and financial risks and a weak local housing market pose a challenge.
- Nevertheless, inflation will remain high, meaning lower interest rates are still some way off.

Global financial markets have continued their volatile ways. January brought renewed fears that the US economy was heading for recession and the consequent sharemarket slump and fragile market sentiment triggered a swift and sizable rescue effort from the Federal Reserve. And again, in March after investment bank Bear Stearns suddenly ran out of funding, the Federal Reserve stepped in to prop the bank up and make liquidity available on more generous terms to an ever-wider array of financial institutions. The dust is settling a touch, but it is clear the US financial system – and economy – are in a very fragile state.

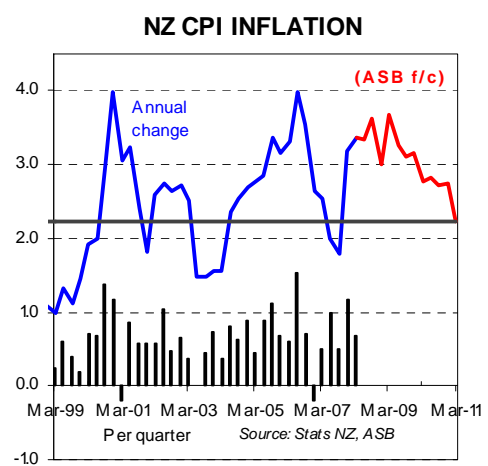
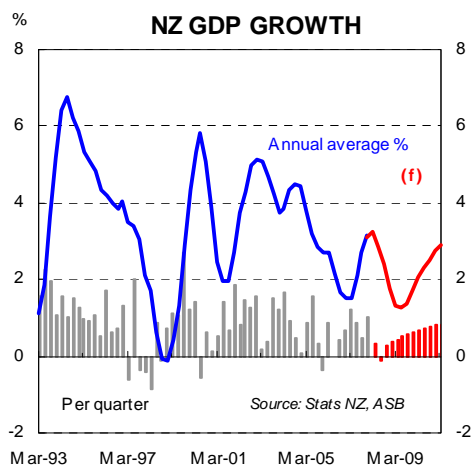
Closer to home, it is increasingly evident that the NZ economy will in turn experience a marked cooling of growth over 2008. A long hot summer may have been bliss for those of us at the beaches, but it has caused anguish on farms as drought conditions became widespread. The knock-on effect will reduce growth in the first half of the year after a flurry of livestock slaughtering and also reduce the pastoral sector's supply ability next season.

But more enduring than drought will be the growing financial pressures that households are facing. House prices are now falling – not that surprising given the extent of their rise, high interest rates and the extreme unaffordability many would-be first home-owners now face. Housing construction is following suit. Consumer spending growth is also weakening and will continue to do so as households feel the simultaneous squeeze on their finances from a number of directions.

To describe this year, we prefer to use a 'B' word: belt-tightening. To us that is an accurate description of what many New Zealanders will be doing this year. The brunt of the impact will continue to be borne by the mortgage belt (no pun intended) now that mortgage rates have reached high levels. But rising house rents and food, fuel and energy prices mean some degree of pain is being felt by most people. Effectively, our disposable incomes are shrinking – once we have fed ourselves, put a roof over our heads, and done the daily commute. Money will be spent on the 'must haves' but the 'nice to haves' will be trimmed back a touch if things have to give.

Nevertheless, the squeeze will not last forever. Positives remain, such as the cash windfall the dairy sector will receive despite the drought. And if you are heading into slower times, there is no better way to start than with a 20-year low in the unemployment rate and the associated strong wage growth. There is an election later this year and a Budget in May, with personal tax cut proposals to feature in both. However, inflation remains problematic for the RBNZ, so interest rates will remain high this year.

More than anything, 2008 is going to be a year of uncertainty. The US is experiencing a financial crisis that is very serious, and the US economy is buckling. Our own economy has proved astonishingly resilient in recent years, but is having its toughest test in some time.



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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.

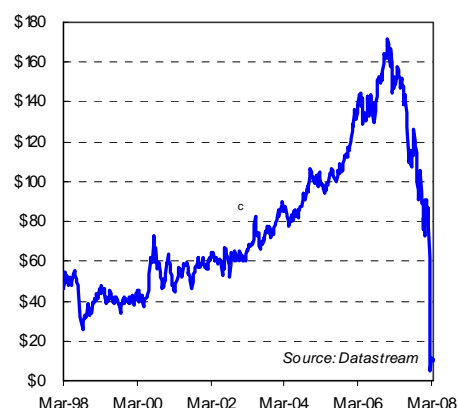
Credit indigestion

US credit markets still fragile

The US financial system remains in a parlous state as the fall-out of the sub-prime mortgage crisis continues to claim casualties and impair the efficient functioning of credit markets.

The sub-prime crisis blew up in earnest last August, in part as the demise of two hedge funds linked to investment bank Bear Stearns made people realise the sub-prime problem was starting to infect financial markets. Fear has periodically flared up ever since. March saw another jolt as Bear Stearns rapidly ran out of funding to be hurriedly bailed out by the Federal Reserve. Bear Stearns is subsequently to be bought up by a rival bank for a fraction of its book value.

BEAR STEARNS SHARE PRICE

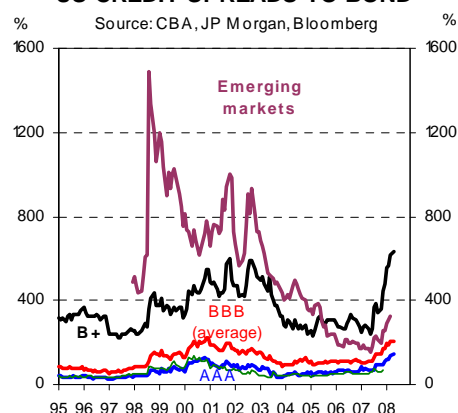


Wariness remains

Credit markets in the US remain considerably gummed up by ongoing wariness of financial institutions to lend to each other. Most large commercial and investment banks have reported write-downs on their holdings of mortgage-backed securities, and a number have sought capital injections to bolster their balance sheets. However, suspicions remain over exactly how great the eventual losses will be.

While that distrust continues global credit markets will remain affected, spreading the pain. US households and hedge funds alike are finding that fresh funds are now less forthcoming.

US CREDIT SPREADS TO BOND

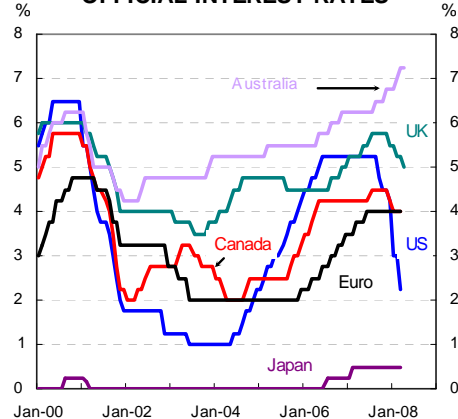


Fed taking concerted action

To date the Federal Reserve has taken considerable action to try and unglue US credit markets. It has cut interest rates dramatically, though the impact on Main Street lending rates has been limited.

Progressively it has moved to providing liquidity on ever-widening terms: relaxing the conditions for lending money to banks and extending loans beyond institutions classed as 'primary dealers' (essentially the largest commercial and investment banks). Such efforts to get liquidity to where it is most needed are likely to continue in the short term, accompanied by further interest rate cuts.

OFFICIAL INTEREST RATES

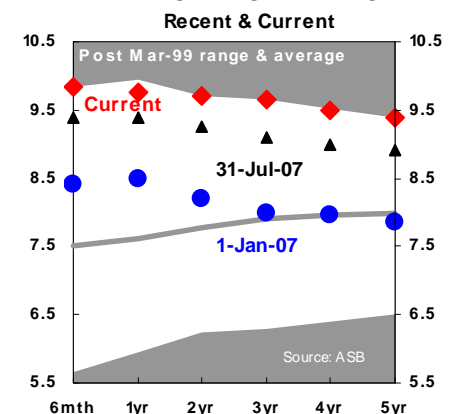


NZ rates have been affected moderately

NZ banks and corporates have not been immune from the higher risk premiums lenders are now charging in global markets as compensation for the added perceived risk: local mortgage rates have risen 40-50bp since the sub-prime crisis blew up last August. However, the impact has been mild in comparison to those countries whose institutions are embroiled in the sub-prime fallout.

There remains the possibility that excessive global risk aversion puts even further pressure on bank funding costs in 2008, so further rises in NZ lending rates can't be ruled out.

NZ HOME LOAN RATES % p.a.



US economic slowdowns

1980s and early 1990s US slowdowns were broadbased

With the US economy in the news so much in the early parts of this year – and set to stay that way – it is worth having a quick look at past US economic slowdowns.

The US has gone through 3 slowdowns since 1980, and is entering a 4th. Every economic cycle is different, but it is interesting to look at the respective similarities and differences.

The early 1980s and early 1990s slowdowns were fairly similar in that they were broadbased. Consumer spending growth slowed noticeably and total fixed investment (including residential construction) contracted. Those components of GDP rebounded in tandem.

2001 slowdown concentrated in business investment

The 2001 slowdown followed the strong dotcom economic boom and 10 years of robust growth. Much of the fallout was confined to equipment investment, which was very strong during that 1990s IT revolution.

Job losses and reduced equity wealth did dent consumer spending growth. However, the policy responses were large: US official interest rates eventually dropped to 1% and the Federal Government cut taxes. Consumers were able to continue spending by refinancing their mortgages at very low mortgage rates and extract equity as well.

As a result, consumer spending growth held up comparatively well – helping support the shaky global economy at the same time.

Current slowdown led by housing construction

However, those low interest rates did help sow the seeds for the current slowdown, through effectively transferring the asset price bubble from equities to the housing market.

As interest rates rose from very low levels some households faced large proportionate increases in debt servicing costs. The housing market slowed quite quickly, and construction has contracted markedly in response to the build-up of unsold homes.

Until recently the rest of the economy appeared largely unaffected. But more recent signs show buckling consumers, slower fixed investment and job losses. A silver lining is a weaker USD is stimulating export growth.

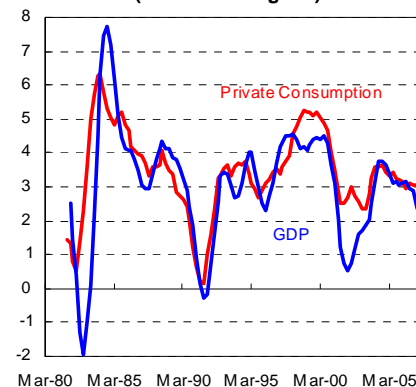
US 2008 outlook has been progressively cut

The housing market woes and rising defaults that originated in the sub-prime mortgage market have permeated through to trigger a widespread credit crisis. And the tentacles have reached beyond the US.

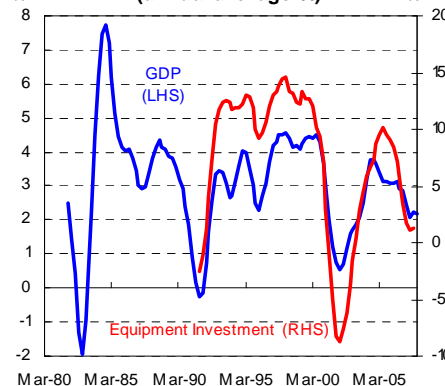
It is still unclear how far the US economy will slow, and whether or not it will go into recession – some commentators believe the economy is already in recession. But it looks increasingly difficult for the US to avoid recession, with housing and credit markets yet to turn the corner.

Further downward revisions to the US outlook are likely as forecasters factor in recent weak data.

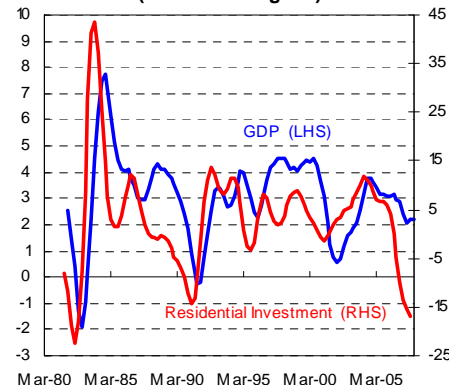
US GDP, CONSUMPTION
(annual average %)



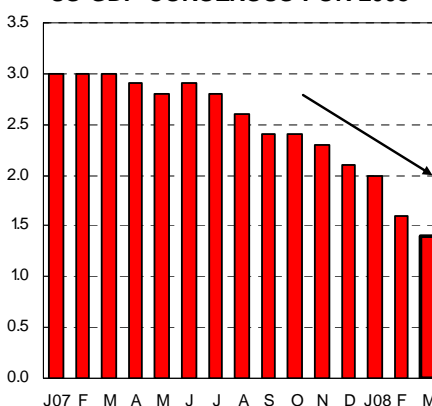
US GDP, EQUIPMENT INVESTMENT
(annual average %)



US GDP, RESIDENTIAL INVESTMENT
(annual average %)



US GDP CONSENSUS FOR 2008



International economies

Impact of US on global growth matters

The weakening of the US economy is a Damocles Sword hanging over the global economy. Ongoing weakness in the US housing market and the financial pressures households are facing will inevitably flow on to affect US demand for imported consumer goods.

Beyond the credit market impact, which we have already touched on, the other main transmission of US woes to NZ will come through its impact on trade. Arguably the impact slower US demand has on NZ's other key trading partners will prove to be more important than the direct impact on NZ's trade with the US.

Key trading partner growth a little slower ahead

The surveys conducted by Consensus Economics Inc. indicate that growth in NZ's main trading partners (including the US) will be below average over 2008 and 2009, akin to the growth seen when the global economy was recovering from the impact of the dotcom bust. The risks remain further downward revisions in the short term, particularly to the US outlook.

How Asia and Australia hold up in the face of US weakness will be very important for NZ. Non-Japan Asia accounts for 34% of NZ merchandise exports and Australia makes up 22% - together approaching 50% of exports. In contrast, the US accounts for 11%.

China still robust

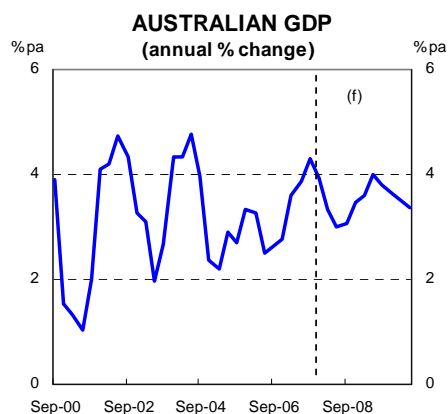
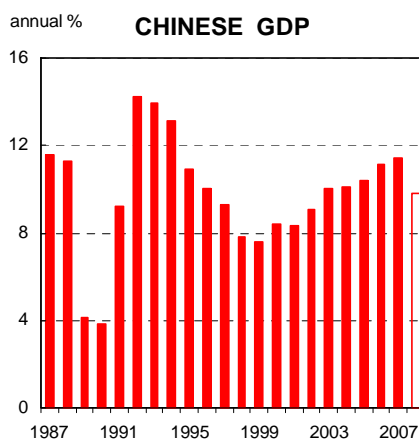
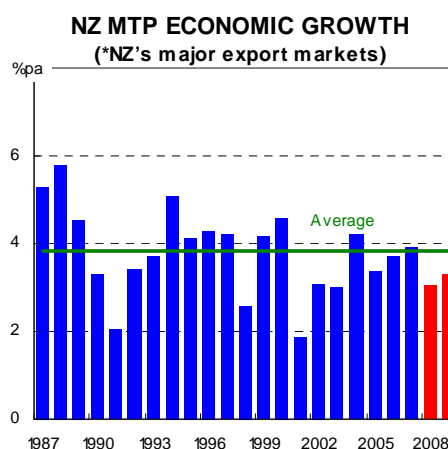
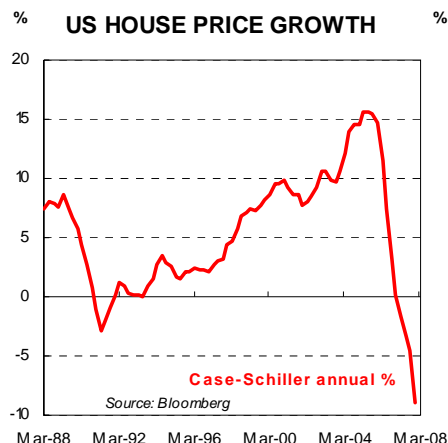
China has been a significant driver of global economic growth, not to mention commodity prices. How well it holds up in the face of weaker US demand growth will be influential. However, its export earnings are coming from more diverse sources, and other developing countries are becoming increasingly important markets. China is also continuing to modernise itself, so investment expansion is likely to continue apace.

Chinese growth is likely to slow a touch from its recent red-hot 11% pace, but even growth in the vicinity of 9% would still represent a considerable source of demand.

Australian economy holding up

The outlook for the Australian economy remains very positive. The resource boom continues to give the economy a strong boost, stimulating spending, employment and investment. The terms of trade are at their highest level since the early 1950s, thanks to the strength of demand for hard commodities, with further price increases for key exports (such as coal and iron ore) tipped when supply contracts are renewed this year.

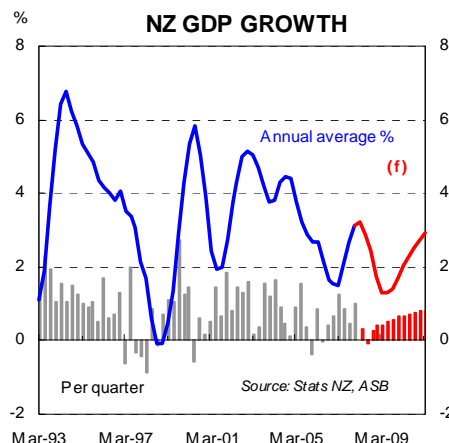
Consumers are facing higher mortgage rates and food and fuel price increases. But a further round of tax cuts is on the cards, which will put some income back into consumers' pockets. House prices are rising strongly.



The New Zealand Economy

NZ growth to slow

The NZ economy proved quite resilient over 2007, growing at a very respectable 3.1% annual average pace - not at all bad given the high levels interest rates and the NZ dollar climbed to over the year. But now there are growing signs that the economy will be considerably weaker over 2008. Durable though the NZ economy has seemed to be in recent years, those tight monetary conditions are starting to bite hard. There are also a few other headwinds that are starting to blow: drought has knocked the pastoral sector and the clouds forming over the global economy have got darker.

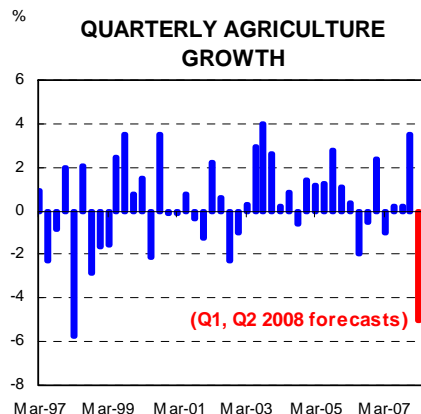


Drought impacting in short term

Last year's relatively fast pace of growth is likely to give way to 1.7% annual average in calendar 2008 and 2009. At its trough growth is likely to be 1% to 1.5%.

Drought conditions have been widespread this summer, including hitting the Waikato and Taranaki – key dairy areas that usually enjoy relatively lush conditions and are less prepared to endure protracted dry weather.

Largely as a consequence of the drought we expect GDP growth in the first half of 2008 to be markedly slower. Our provisional forecasts are 0.3% qoq for Q1 and -0.1% qoq for Q2. The exact timing of the drought impact on the GDP statistics is still uncertain.

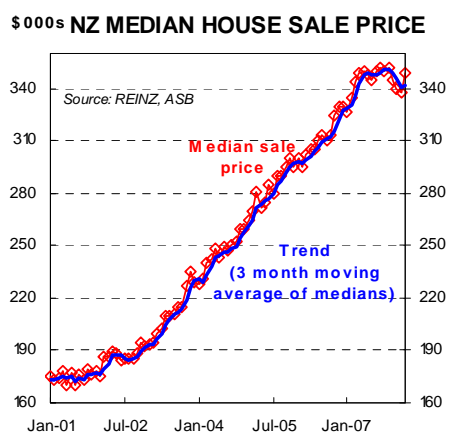


Slower household spending a drag

The more enduring impact on the economy is the pressure households are facing. Mortgage rates are very high and rising fuel and food prices are putting extra pressure on effective disposable incomes.

Pressure is very evident in the housing market. Sales turnover is down more than a third relative to a year ago. And house prices, which had been flat in dollar terms since last April, have recently started to trend down.

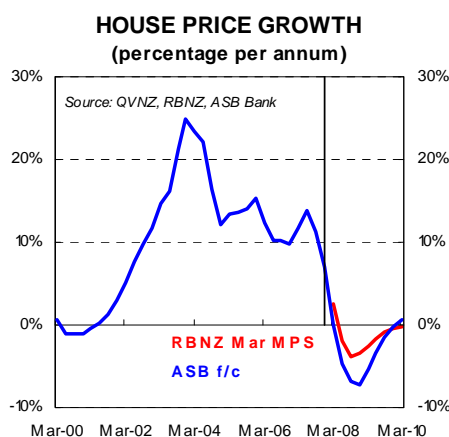
We expect house prices to fall around 7% to 8% over 2008.¹ It is increasingly evident that there has been a rapid rise in houses for sale on the market.



Housing market to weaken further

House prices will be under a lot of pressure in 2008 until the overhang is reduced. The overhang in the housing market is also flowing onto housing construction, which will continue to contract over the next year.

¹ Our forecast of a fall in house prices should not be taken as suggesting that you sell the family home and wait for a bargain. Economists are wrong occasionally, and there is no guarantee that you will be able to accurately pick the bottom of the market. On a practical front, you likely will be paying an agent 4-5% in sales commission to start with. Other considerations are: the number of weekends you can look forward to spending going to open homes; finding somewhere to live in the meantime, and; that you may like your current house and neighbourhood!



The New Zealand Economy (cont'd)

Debt servicing and consumer staples all cost more

On top of losing the feel-good factor of rising wealth via higher house prices, consumer spending is also feeling the pinch. As more and more people refix their mortgage at higher interest rates, increasingly less money is left over to spend. Higher petrol and food prices are compounding the squeeze on household budgets. Over the second half of 2007 spending growth evidently slowed, and the squeeze has continued into 2008. Unsurprisingly, consumer sentiment is at a low ebb. Consumer spending growth, in volumes terms, is likely to be around a mere 1% annual average in the March 2009 year.

Little impact – so far – from slower global growth

Two other key influences on the economy are intertwined, and stem from the spreading tentacles of the US sub-prime mortgage market meltdown. The first leg is the impact on demand for NZ's exports. Inevitably there will be some fallout, but much will depend on the extent to which key export markets Asia and Australia hold up and how export commodity prices fare. So far the signs are encouraging, though it is a little too early to tell. The second leg is the continued fragility of global credit markets and potential impact on NZ lending rates.

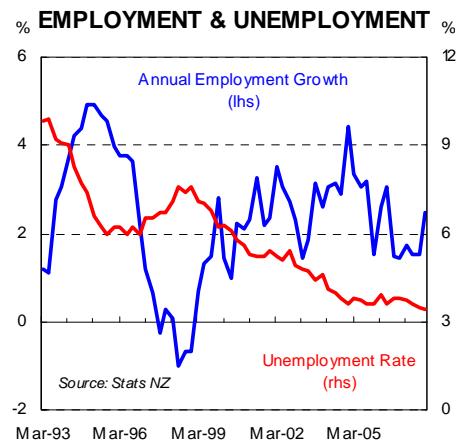
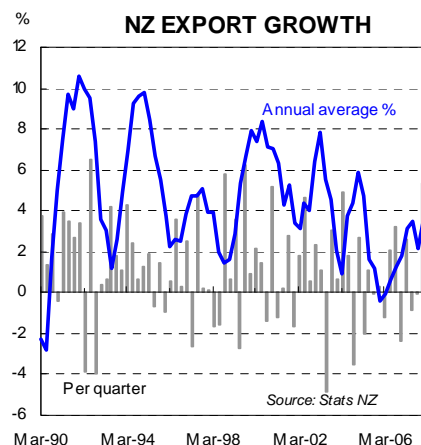
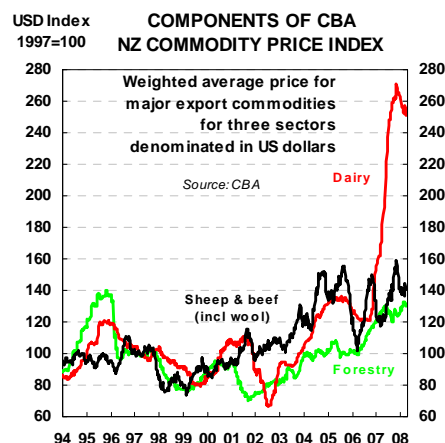
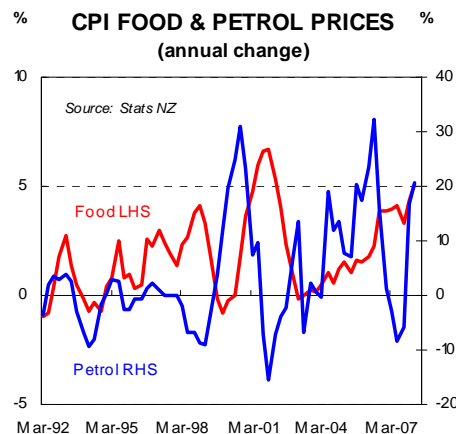
Economy rebalancing in two separate phases

A rebalancing of the economy is slowly taking place after an economic expansion that has been driven by domestic demand. Household spending is moderating and residential construction is easing. Parts of the export sector have made a strong contribution to growth. However, that export contribution has been narrow in its base: broader and sustained export growth will require a lower NZ dollar (beyond just the NZD/AUD) and a relatively healthy global economic environment. The export part to the rebalancing will be slower in coming than the first (household demand), and in the interim overall growth will be comparatively muted.

Some positive stimuli are on the horizon

Although it is clear the thumbscrews are being tightened, it is important to remember that some stimuli are on the horizon. The dairy payout, even if drought has taken some of the froth off, will stimulate the economy (there are signs it has already started to). Moreover, personal tax cuts are on the agenda for early 2009 – and October 2008 is always a possibility. The labour market remains tight, which means a relatively greater degree of job security and wage growth than seen in past slowdowns.

In these more uncertain times it probably pays to err on the cautious side rather than risking over-committing yourself financially.



Inflation problematic

Inflation to remain high

Even though the economy will slow markedly over 2008, inflation will nevertheless remain high and problematic to the RBNZ. Resource constraints within the economy remain considerable, meaning the economy has little scope to sustain rapid growth.

On top of capacity constraints a number of other factors are conspiring to push inflation higher, notably commodity prices and the Emissions Trading Scheme.

We expect inflation will be well over 3% in 2008 and around/above 3% in 2009 as well. Subsequently it should ease back towards the mid-point of the 1% to 3% target band.

Capacity constraints persist

On the capacity front the extent of the constraints are highlighted by the two-decade low in the unemployment rate, continued reported skill shortages, and high reported rates of capacity utilisation. The economic boom of the past 5 years has exhausted the economy's effective spare capacity, resulting in high non-tradables (i.e. domestically-generated) inflation.

Slower economic growth over the next couple of years will reduce some of the stretch in the economy. Even so, the labour market is likely to remain tight and skill shortages will continue.

Economy's speed limit is slow

The RBNZ's efforts since 2004 have been aimed at reducing demand growth in the economy to the point where a degree of excess capacity appears. However, whilst the RBNZ has indeed slowed overall economic growth, underlying inflation pressures have been slow to dissipate.

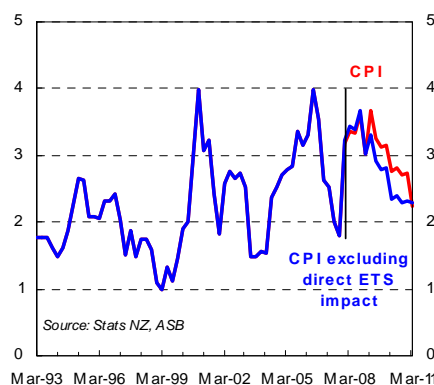
Part of the problem appears to be that the economy's potential growth rate has also slipped. Official productivity figures indicate overall productivity growth has been declining. In a nutshell the economy's sustainable speed limit appears to have fallen, which would help explain why inflation pressures have been slow to abate.

Inflation expectations will concern RBNZ

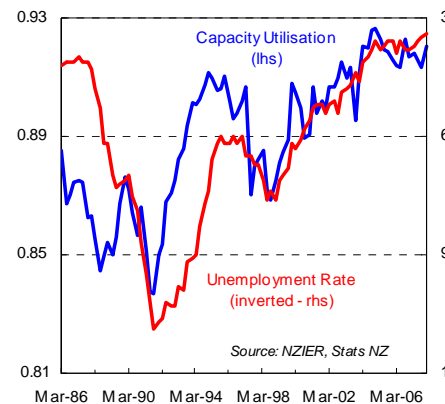
The Emissions Trading Scheme will add to inflation over 2009 and 2010 as fuel and electricity prices are lifted by the cost of buying carbon credits.

Over the course of this year we expect the RBNZ to pay very close attention to inflation expectations. A period of high headline inflation and sharp price increases in staples such as fuel and food mean a greater risk that perceptions of future inflation lift. And perception often has a habit of becoming reality, which in this case would make the RBNZ's job of reducing inflation even tougher.

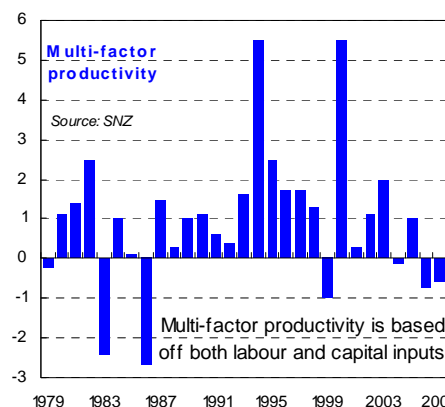
% NZ INFLATION: WITH ETS SCHEME



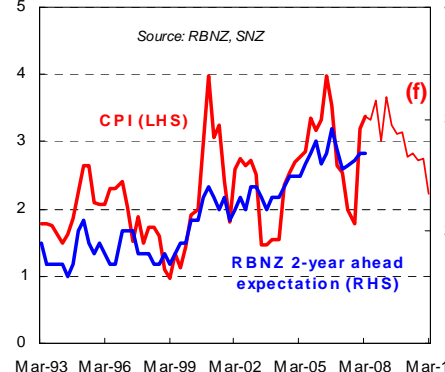
Index RESOURCE STRAIN MEASURES



% NZ PRODUCTIVITY GROWTH



2 YEAR INFLATION EXPECTATIONS



Interest rates and exchange rates

Interest rates to remain high in 2008

The inflation outlook – at or above the top of the RBNZ’s inflation target for most of 2008 and 2009 – gives the RBNZ very little headroom.

Consequently we expect the Official Cash Rate (OCR) to remain high until early 2009. The RBNZ will want to be very sure that it has got inflation under control before loosening monetary policy. It is also mindful that future stimuli, such as dairy incomes and tax cuts, have yet to feed through the economy.

Moreover, the early stages of monetary loosening are likely to come via the NZ dollar once the RBNZ starts signalling a softer stance.

But outlook more uncertain than usual

That interest rate forecast comes with two ‘health’ warnings. First, the current economic environment is highly uncertain and could change very quickly. 1998, 2001 and 2006 are all examples of rapid shifts in the perceived outlook for the economy.

Second, if global credit markets deteriorate there is always the chance the RBNZ tries to counter the local impact, through either a lower OCR or some form of liquidity injection.

Even so, a response to global credit market problems would still leave lending rates high. Rather, it would be action intended to stop lending rates from rising further.

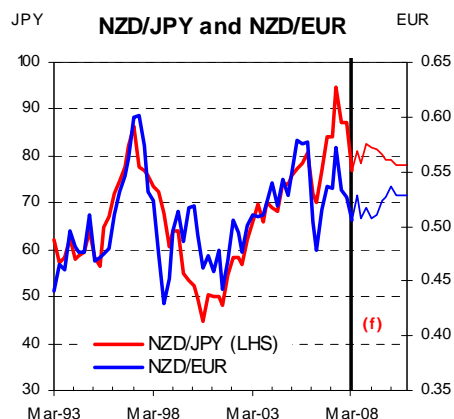
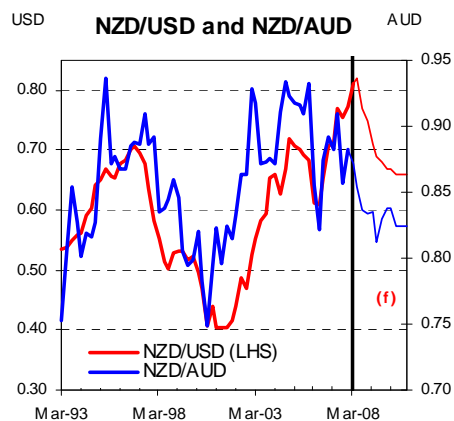
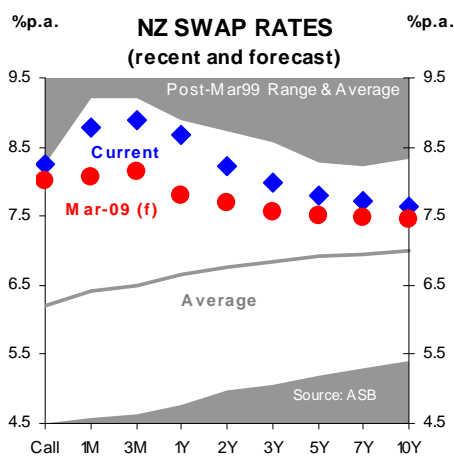
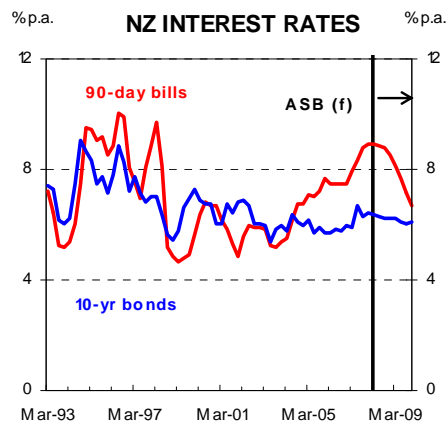
NZD high, largely on weak USD

The NZ dollar has remained fairly high, particularly against the battered USD. But it has been a wild ride in foreign exchange markets. Bouts of risk aversion continue to pop up. During those episodes the NZD tends to get sold down, often gradually recovering once the dust settles. Hence, the NZD has from day-to-day been linked to the fortunes of global equity markets and commodity prices.

In the short term volatility and unpredictability are likely to remain. However, our bias is that there is potential for the NZD to hold around USD0.80 through to mid-2008.

Will depreciate on a sustained basis once RBNZ changes its stance

Later in 2008 the NZD is likely to soften as it becomes increasingly apparent that the local economy is slowing considerably and likelihood of the RBNZ cutting interest rates grows. The plunge in early 2006 is an example of what the NZD can do when the growth outlook and interest rate outlook change markedly in a short space of time. We expect the NZD to weaken most noticeably against the USD (as the USD itself starts to recover once light at the end of the tunnel appears) and the AUD (as the Australian economy continues to steam along and interest rates remain high there).



ECONOMIC FORECASTS

ASB economic forecasts		Dec-07 << actual	Mar-08 forecast >>	Jun-08	Sep-08	Dec-08	Mar-09	Mar-10	Mar-11
NZ GDP real	AA%	3.1	3.2	2.8	2.4	1.7	1.3	2.0	2.9
private consumption	AA%	4.3	3.6	2.6	1.8	1.1	1.1	2.0	2.7
dwelling construction	AA%	4.3	4.7	1.1	-3.1	-6.7	-9.2	-4.1	2.9
other investment	AA%	4.6	5.0	5.3	6.1	4.0	3.4	2.0	4.0
exports	AA%	3.5	3.5	4.2	5.8	4.0	2.6	2.6	4.6
imports	AA%	8.8	9.7	8.7	2.4	3.4	2.8	2.5	4.8
NZ GDP real	A%	3.6	2.7	1.7	1.5	1.0	1.0	2.4	3.1
NZ GDP real	Q%	1.0	0.3	-0.1	0.3	0.4			
NZ CPI	Q%	1.2	0.7	1.0	0.8	0.6			
NZ CPI	A%	3.2	3.4	3.3	3.6	3.0	3.7	2.8	2.2
NZ house prices (QV index)	A%	7.0	0.0	-4.8	-7.0	-7.5	-5.6	0.6	2.3
NZ unemployment (sa%)	Qtr	3.4	3.5	3.7	3.8	3.9	4.2	4.2	4.2
NZ private sector wages (LCI)	A%	3.4	3.6	3.5	3.5	3.1	3.1	2.8	2.8
NZ current account (\$b)	Yr	-13.8	-13.2	-12.3	-11.4	-11.5	-11.6	-12.2	-13.0
as a % of GDP	Yr	-7.9	-7.5	-6.9	-6.3	-6.3	-6.3	-6.4	-6.5

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)	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Mar-10
		<< actual	forecast >>				
NZ cash rate target	8.25	8.25	8.25	8.25	8.25	8.00	6.00
NZ 90-day bank bill	8.9	8.9	8.9	8.8	8.6	8.2	6.2
NZ 3-year swap rate	8.5	8.3	8.2	8.1	7.8	7.6	6.8
NZ 10-year gov't stock	6.4	6.4	6.3	6.3	6.3	6.3	6.1
 ASB foreign exchange forecasts (end of quarter)	 Dec-07	 Mar-08	 Jun-08	 Sep-08	 Dec-08	 Mar-09	 Mar-10
		<< actual	forecast >>				
USD per NZD	0.774	0.794	0.82	0.77	0.75	0.71	0.67
GBP per NZD	0.388	0.398	0.41	0.39	0.38	0.37	0.36
AUD per NZD	0.882	0.866	0.85	0.84	0.83	0.84	0.84
JPY per NZD	87.1	78.5	81	79	83	82	79
EUR per NZD	0.526	0.502	0.53	0.51	0.51	0.51	0.54
TWI	71.9	70.4	72.5	69.3	69.6	67.9	67.1

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