

ASB Quarterly Economic Forecasts

Running on empty



- Extreme belt-tightening and drought are pulling the economy backwards in 2008.
- More economic pain to come, but seeds are being sown for a gradual 2009 recovery.
- Oil price increases pose an additional challenge to the global economy and central banks.

As petrol prices have climbed this year there has been an increase in the number of motorists being stranded after running out of fuel. That development is in many ways very symbolic of what has happened to the economy this year.

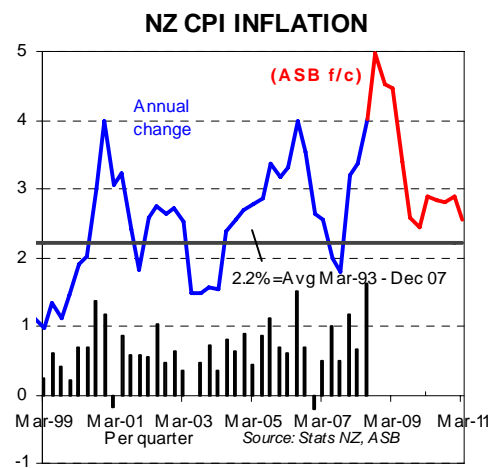
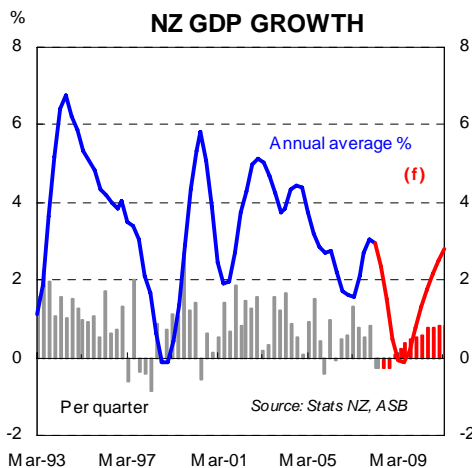
Household budgets are running on empty, having been drained by a number of financial shocks. In particular, fuel prices have pushed above \$2/litre. Even though there has (at the time of writing) been some relief relative to early July price levels, the fact of the matter is that high prices are biting hard in some households. Food prices have continued to increase: fresh vegetables are the latest part of the shopping basket to register price increases. Incrementally financial pressure has continued to mount, and in retail figures it is evident that households are concentrating on buying the necessities first and foremost. It will remain a challenging environment for retailers over the second half of the year.

The housing market will also continue to make its mark as it works through an overhang of homes for sale in a period of weak demand. Prices will fall slightly further as a consequence, though some houses will be pulled off the market and reduce some of the excess supply. An environment with a glut of listings, falling prices, household budgetary pressure and muted population growth is hardly conducive to spurring housing construction. Further woes amongst finance companies are also rippling through to affect property development, and some high-profile developments have been put on hold. Housing construction started falling towards the end of last year and will continue to do so this year.

In a nutshell the economy is in a household-led recession, with ripple effects still to be felt in the second half of the year. A 10-year economic expansion has most likely come to an end. After a number of economic reforms the economic cycle has not been eradicated but it has become longer and less volatile. The downside of an extended period of prosperity and relative stability is the tendency to expect that state of affairs to continue. This makes harder times much more of a surprise and an unfamiliar experience for some.

But even as the economy is weakening, the seeds are being sown for a gradual recovery over 2009. One of the crucial elements of recovery has officially arrived, with the RBNZ promptly cutting the Official Cash Rate. Mortgage rates actually began to come down in May in anticipation of RBNZ action, and further declines are likely into 2009. Over time lower mortgage rates will put a floor under the housing market and incrementally ease debt servicing pressure on a number of households. Along with lower interest rates is a weakening NZ dollar, which will aid export growth – though with the side effect of making imports more expensive.

More direct stimuli are heading for a wallet near you. Soaring dairy incomes are sending dollars coursing through dairy regions and are already starting to have a positive impact. And the first tranche of tax cuts is due after October 1st, which will provide some much-needed and long-anticipated relief.



Nick Tuffley – ASB Chief Economist – 649 374 8604 – nick.tuffley@asb.co.nz
Jane Turner – Economist – 649 374 8185 – jane.turner@asb.co.nz

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.

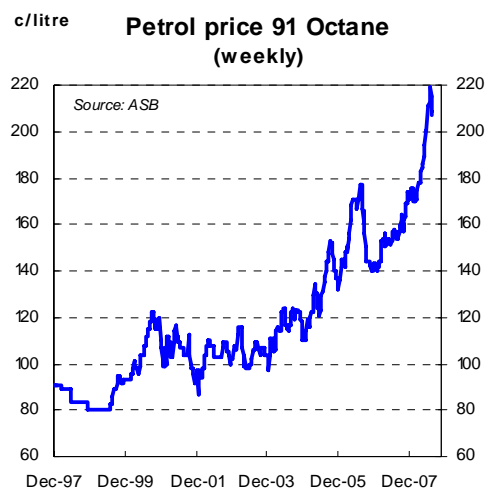
When oil prices fuel inflation, what's a central bank to do?

Price of petrol breaks \$2/litre

Oil's rapid rise

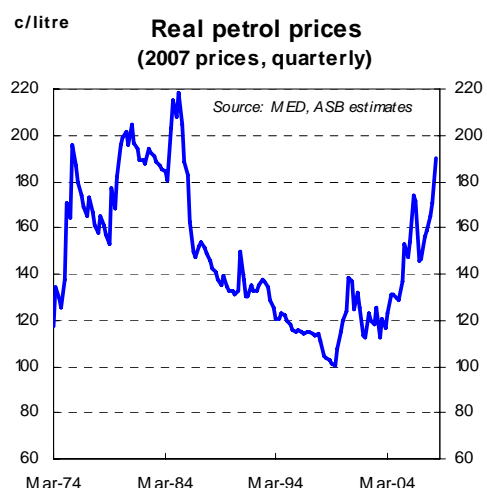
Over the past five months petrol prices have rapidly climbed to increasingly painful levels, at one stage setting a new record at \$2.19/litre in urban areas. Prices have since eased to \$2.07/litre, but remain considerably uncomfortable, up 32% on year-ago levels. This seemingly relentless climb has been going on for the past eight years, with prices roughly doubling since 2003.

The most recent increase in prices has been particularly sharp and swift. It has also come at a time when prices for basic food items are increasing sharply and high mortgage rates are pushing the housing market into a downturn. Household budgets are being squeezed and the economy is now tipping into recession.



But prices went up faster in the 1970s

But it's not the first time high oil prices have helped push New Zealand into an economic downturn. Many will remember the oil price shocks of the 1970s during which prices increased more suddenly (in the summer of 1974 oil prices doubled in less than two months). And while today's prices seem painful, once adjusting for general inflation retail petrol prices remain below the highs of the late 1970s and early 1980s (just).



and real prices were higher in the 1970s

New Zealand has been partly shielded from rising oil prices thanks to the high New Zealand dollar. However, in US dollar terms, real oil prices are already at all-time highs. Should the exchange rate fall (as many are expecting) New Zealand will end up paying even more to fill up the tank if international oil prices remain around current levels.

However, current prices could go higher if NZD falls

Estimated petrol price per litre (\$NZ)

		Dubai oil price \$US						
		60	80	100	120	130	140	160
NZD	0.79	1.48	1.66	1.84	2.02	2.11	2.20	2.38
	0.76	1.51	1.69	1.88	2.07	2.16	2.25	2.44
	0.73	1.54	1.73	1.93	2.12	2.22	2.31	2.51
	0.70	1.57	1.77	1.98	2.18	2.28	2.38	2.58
	0.67	1.61	1.82	2.03	2.24	2.35	2.45	2.66
	0.64	1.65	1.87	2.09	2.31	2.42	2.53	2.75
	0.61	1.69	1.92	2.15	2.39	2.50	2.62	2.85

Petrol prices directly contribute to inflation

Petrol prices fuel inflation

Higher petrol prices feed into inflation in two phases. During the first stage, petrol price increases impact inflation directly with petrol being part of the CPI 'shopping basket'. In addition, the increase in petrol prices also adds to inflation indirectly by affecting companies that use fuel intensively. Generally, these price increases are transparent and unavoidable.

.. but can also filter through to general prices...

Then there are the second-round effects, when the increase in fuel prices starts to generate price increases at a more general level. Increasingly more firms try to pass on the higher costs associated with rising fuel prices. Some will be more successful than

others at passing on these costs, depending on the level of industry competition and sensitivity of demand. But if too many of these firms are successful at passing on rising costs, the second round increases can start a feedback loop. Employees start to demand more compensation because of the higher prices they face. Employers respond by putting up their selling prices to cover rising labour costs. If the expectation of sustained price increases becomes embedded in wage and price setting behaviour on a sustained basis, there is a drift up in inflation expectations and the beginnings of a wage/price spiral.

...some offset through lower demand

However, higher oil prices also have a dampening effect on inflation through reducing demand for goods and services. Higher oil prices (for an oil importing economy) reduce the terms of trade, which in turn reduce the spending power of an economy. The extra money spent on petrol reduces the amount a household can spend on other goods. With petrol this effect is particularly pronounced, as there are not many other alternative options for transport. The fall in demand for all other goods helps to mitigate to upward impact of oil on inflation, as lower demand limits the scope businesses have to increase prices.

RBNZ will look through direct price increases

Central Bank considerations

An inflation-targeting central bank will not try to offset the direct effects of oil on inflation. These effects represent a change in relative prices and there's nothing a central bank can do to avoid them (after all, a shock is, by definition, a surprise). However, the Reserve Bank has stated it will act to offset any evidence that the second-round effects are spilling over into wage and price-setting behaviour.

But will try prevent widespread increases in prices

But knowing how much to offset can be tricky. To start, the magnitude of second-round effects can be hard to forecast and measure. A firm will change prices for a variety of reasons, and how much of an increase is due to higher oil prices is not obvious. Further, it's not straightforward to know in advance how much firms are able to pass on. Say, for a one-off oil price shock to an economy with a healthy level of competition, a central bank could expect the contractionary effect on spending power and demand will be enough to prevent general prices from rising too fast.

Frequently purchased items more risk to expectations

However, the current shock has not been a one-off. Oil prices have been rising steadily for a number of years. The national psyche is becoming sceptical that oil prices will fall back anytime soon and is starting to factor in rising energy costs as the status quo.

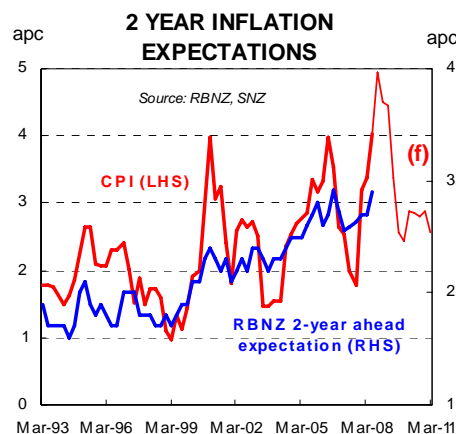
In addition, RBNZ research found that consumers are more aware of price increases in items that are purchased more frequently (i.e. food and fuel). The current environment of strong inflation in food and fuel are going to be highly influential in wage and price-setting behaviour.

Primary objective: stable inflation expectations

What's a central bank to do?

The primary objective should be to avoid a sustained increase in inflation expectations.

Looking back to the 1970s, in most developed economies monetary policy was too slow to react when inflation pressures first picked up. By the mid-1970s inflation was rampant and out of control. To get inflation expectations back under control, policy had to be more aggressive during the late 1970s, which then exacerbated the subsequent recession.



Lesson from 1970s is to act early

With the economy potentially already in recession, the RBNZ will be very conscious not to exacerbate the downturn. On the other hand, allowing inflation to get out of control in the first place was also a mistake of the 1970s (which is why aggressive policy was required later). Getting inflation expectations back under control is always much more costly to an economy than preventing the rise in the first place.

RBNZ softened stance on inflation expectations in July...

In the June *Monetary Policy Statement* and the July *Official Cash Rate Review*, the RBNZ appeared comfortable that the current slowdown underway in activity will be sufficient to offset the flow-on inflation impact of rising food and fuel prices. The RBNZ has to balance a stuttering economy on one hand with keeping inflation in check and maintaining its inflation-fighting credibility on the other. By cutting the OCR in July, the

Bank shifted its emphasis away from inflation expectations towards weaker medium-term inflation pressures.

with more consideration to growth....

Essentially the RBNZ is taking a calculated gamble inflation expectations will remain sufficiently contained given costs are harder to pass on in today's competitive environment. The RBNZ is also taking note of additional considerations built into the Policy Targets Agreement, i.e. to avoid unnecessary instability in growth. But at the end of the day inflation is the Bank's primary objective, and keeping inflation expectations under control is key. With inflation expected to climb to 5%, this is a very precarious time to be cutting rates. Let's hope the Bank has got the balance right.

But, be warned, inflation not tamed yet.

Lessons from the past

Lessons from the 1970s (RBNZ does its homework)

Recent RBNZ work by Reddell and Sleeman¹ provides a very accessible overview of New Zealand's past economic recessions including the Great Depression of the 1930s and the all the major downturns since the mid-1960s. Their overall conclusion is that NZ recessions have generally been triggered by an international event, but often exacerbated by domestic pressures or imbalances.

1970s similar situation

In this article, we only focus on the 1970s oil shocks, for which we have summarised the key facts from these episodes and made a quick comparison of similarities and differences between then and now. For more detail and a more in-depth discussion we suggest you refer to the [full Bulletin article](#), from which we have drawn heavily.

Early-70s strong growth and inflation pressures

Time line of key economic events during the 1970s oil shock

Early 1970s – Boom times

1971-73 – Commodity boom underpins a terms of trade increase of 53%

1970-73 – Net immigration increases sharply

1970-74 – Real house prices increase 62%

1974 – Inflation reaches 10%

Mid-70s oil shock and drought

Mid 1970s Economy falters

1972/73 – Drought arrives

1973/74 – Oil prices double in 2 months (December 1973 – January 1974)

1975 – The terms of trade fall 38% as oil prices double and export prices fall 12%

Late-70s Recession

1975-1978 Recession

1975 – Per capita GDP contracts by 9%

1975 – Real house price inflation drops to -10% per annum (and prices continue to fall in every quarter for the following 5 years)

1976 – Annual CPI inflation reaches 17.8%

1976 – Newly-elected government introduces measures to dampen inflation

1978 – Annual GDP growth falls -2.6% in 1978

Eerie similarities between then and now...

History never repeats?

The oil shock of the early 1970s has some eerie resemblance to current economic events. Oil prices have increased sharply at a time when monetary policy is already trying to reduce inflation. While it can be useful to look at similarities and predict what might happen in the future, it's also important to keep in mind the differences between then and now. In particular, the management of the economic cycle has improved dramatically in the past 30-odd years. The credibility of the central bank plays an important role in how well we can weather the storm, allowing us to minimise the rise in inflation and loss on output from an oil price shock. Other important features are that the current increase in oil prices was not as sudden and oil intensity of production is now lower. Export prices are not expected to fall as far as they did in the 1970s, which should help support export earnings.

...but also key economic differences

Late 1970s shows credit important

While there are currently fewer similarities with the second oil price shock (1979-1982), there are still some interesting lessons. In particular, bad economic policies and limited access to credit during the period probably exacerbated the deterioration in activity and rise in unemployment, a sobering warning given the current credit environment.

¹ "Some perspectives on past recessions" by Michael Reddell and Cath Sleeman, Reserve Bank of New Zealand: Bulletin, Vol.71 No. 2, June 2008

A comparison of 2008 and the early 1970s

Setting the scene:

Similarities in the economic backdrop before the oil price shock

<i>Pre-crisis economic growth</i>	Both episodes were <u>preceded by an economic expansion</u> that was fuelled by a commodity boom, easy access to credit (low real interest rates) and strong migration inflows.
<i>Monetary policy</i>	<u>Monetary policy</u> was in the midst of trying to rein in inflation pressures that had built up as a result of the preceding economic expansion. However, before the 1970s oil price shock hit <u>inflation was already much higher</u> , around 10 percent and monetary policy settings were too soft. Policy was not operated independently of government (like it is now) and there was a reluctance to tighten policy sufficiently and a preference to use unorthodox (and ineffective) measures.
<i>Oil shock</i>	Against a back drop of increasingly tight oil supply, oil prices increase. <u>The increase was far more sudden in the 1970s</u> and the shortage was far more severe. Prices doubled in 2 months as exports were actually restricted. In comparison, it has taken 4 - 5 years for petrol prices to double this time. In addition, oil intensity of production is now much lower than during the 1970s, which has resulted in a less severe hit on production costs.

Common exacerbating features

<i>Drought</i>	<u>Drought</u> hits agricultural production as inflation fighting measures intensify, <u>exacerbating the subsequent economic downturn</u>
<i>Export prices</i>	Export prices fell 12 percent over 1974/75, and likewise, are expected to decline over the next year. However, <u>export prices are expected to only decline very modestly this time around</u> . Nonetheless, there is risk that the global downturn could turn more severe and widespread, which could see the terms of trade fall by more.
<i>Monetary policy</i>	<u>Developed economies' responses to the 1970s rise in inflation were too slow, which in turn exacerbated the eventual severity of downturns</u> . In New Zealand, attempts to control inflation were not taken seriously until 1976 (2 years after the initial the oil price shock). By this time inflation was well and truly out of control at 17.8 percent. Reacting to inflation so late in the game made it harder to bring inflation expectations down and also increased the severity of the downturn. In contrast, the Reserve Bank has now built credibility with its inflation-targeting framework over the past 20 years. As a result, <u>inflation expectations remain better anchored than the 1970s episode</u> . Credibility allows the Bank to have lower monetary settings to achieve given inflation outcome than would have been required in the 1970s when credibility was low.
<i>Access to credit</i>	Globally, credit remained easily available in the 1970s. In contrast, global credit conditions are currently in a more fragile state. <u>A sudden increase in global risk aversion would be an addition negative as New Zealand is heavily reliant of foreign funds</u> .

International economies

Key trading partner growth to slow

Weakening growth prospects but stronger inflation pressures is a theme New Zealand is currently sharing with the rest of the world. Growth of our main trading partners is expected to slow over 2008 and 2009 to below-average rates, according to the Consensus Economics Inc survey. But growth is expected to remain more buoyant compared to other major global slowdowns (1990 and 2001). Key to this outlook is growth in Asia and Australia holding up comparatively well. Meanwhile, rising commodity prices have caused a global inflation headache, with most countries experiencing a pick-up in inflation pressures.

US growth outlook fragile

The US housing market woes continue to drag down US economic prospects. The housing market correction still has some way to go before stabilising, with massive overhangs in the housing supply. In addition, households are struggling to cope with the rising cost of living associated with food and fuel inflation. Much of the earlier cuts in Federal Reserve interest rates have not filtered through to retail mortgage rates. Meanwhile, the effect of late April's tax rebates appears to be short-lived. While the Federal Reserve has become more concerned about inflation pressures, the weak growth outlook leaves little room to lift rates.

China's outlook robust

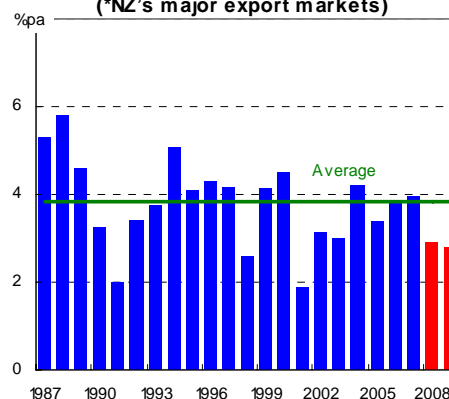
China, a key driver of global economic growth over the past few years, is expected to ride out recent global turmoil with relative ease. Increased diversification should moderate the slowing in export growth associated with weaker US demand. Meanwhile, any post-Olympic slump in construction should be tempered by continued heavy spending on other infrastructure. Slowing growth will come as a relief to authorities, who have struggled against rising inflation pressures. Recent declines in property prices have been noted with some trepidation, as commercial banks could be exposed if property prices weaken.

Australian demand slowing, but to remain solid

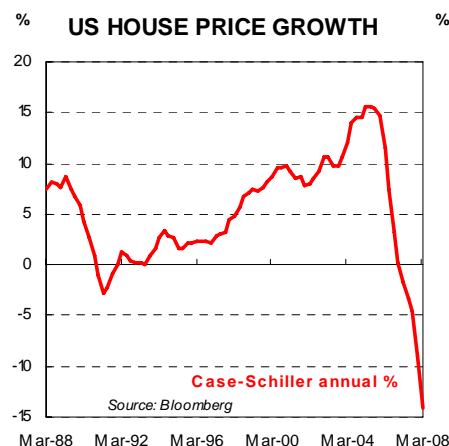
Australia's growth outlook has fared comparatively well against a backdrop of slowing world demand. China's insatiable demand for hard commodities has underpinned Australia's stellar terms of trade, and has helped sustain domestic demand. However, rising inflation pressures saw the RBA hike rates 100bp over the past year, the effects of which are starting to filter through the economy. Signs of easing domestic demand have become more concrete, and growth is expected to ease, but only by just enough to keep rising inflation pressures at bay.

Inflation pressures remain strong

NZ MTP ECONOMIC GROWTH
(*NZ's major export markets)

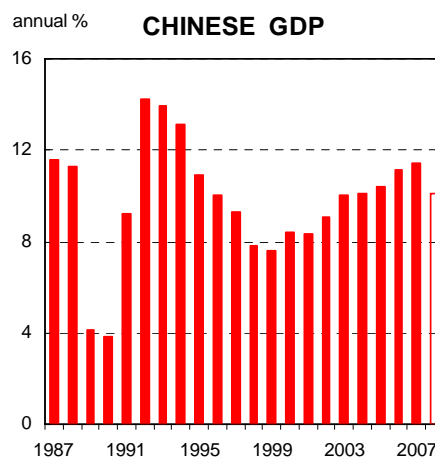


US HOUSE PRICE GROWTH

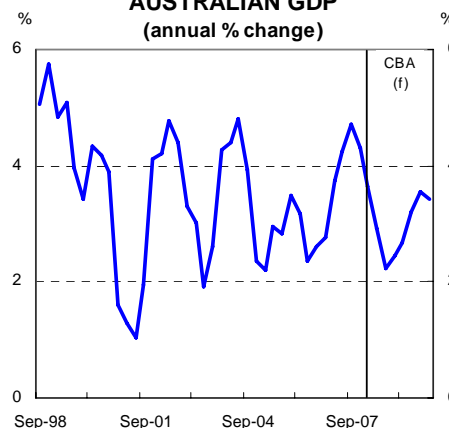


Source: Bloomberg

CHINESE GDP



AUSTRALIAN GDP
(annual % change)



CBA (f)

The New Zealand Economy

NZ growth enters recession

The New Zealand economy may already be in the midst of a recession, but it follows a year of pretty good growth and 10 years of expansion. 2007 ended on a high note, registering 3.0% growth. 2008 is off to a weak start, with a 0.3% fall in Q1 GDP, brought on by a number of factors, including the weakening housing market, falling consumer confidence, early Easter and drought. With both consumer and business confidence slipping further in Q2, it's now likely GDP will register a couple more negative quarters. High interest rates and rising petrol prices have brought the economy to its knees.

Households haven't felt this much pressure since 1991. However, we expect the economy to fare considerably better than it did back then, when the economy contracted 2.5% in one quarter alone.

Near-term outlook grim but growth will recover

The outlook for 2009 is more upbeat. Absent a rebound in oil prices, the combination of tax cuts and lower interest rates later this year will bring some relief. Also, export incomes should continue to improve as the exchange rate moderates.

Export growth to recover

Export outlook positive on lower exchange rate and strong dairy prices

The doubling in dairy prices over the past year has resulted in an improvement in export earnings. However, this summer's drought limited farmers' ability to take advantage of strong prices. A recovery in production over the new dairy season will see export volumes improve, although meat exports may languish as livestock numbers need to be rebuilt. The decline in the exchange rate, particularly against the Australian dollar, will benefit the manufacturing sector. While demand from the US and Europe markets will remain soft, demand in Australia and Asia should remain at comparatively robust levels.

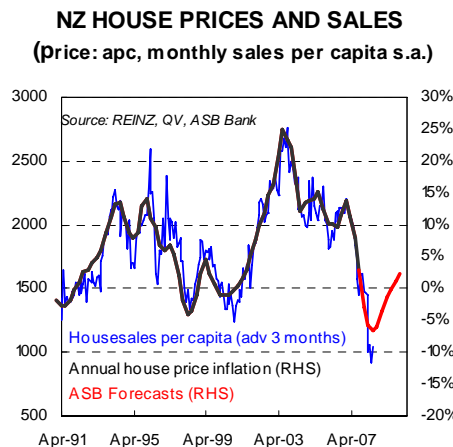
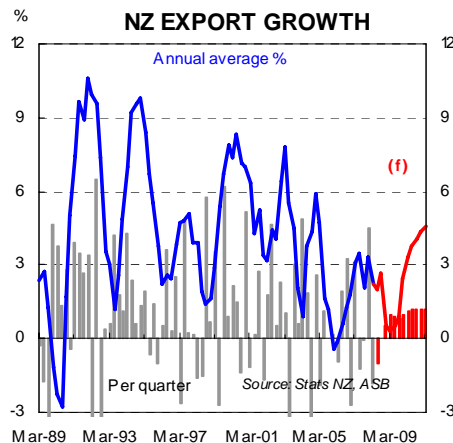
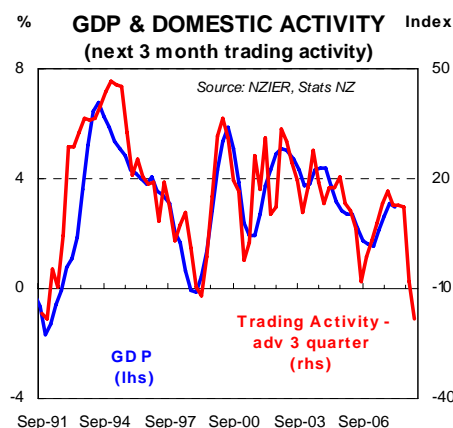
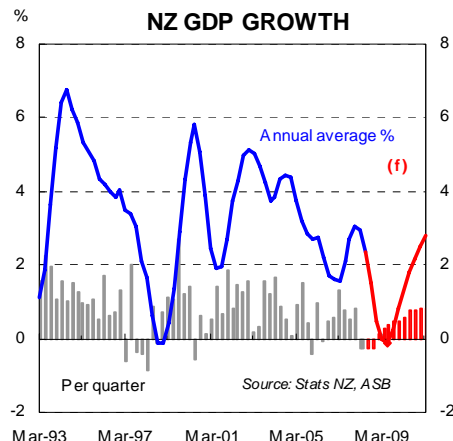
House prices will fall

House sales fall, house prices following

High interest rates have finally, well and truly, knocked the housing market down. Over the past year, the number of house sales has halved. With demand dropping off, the amount of unsold housing stock has soared over the past few months. While some price adjustment has already begun, with median house prices down 2.2% from last year's sales prices, we anticipate there is more to come over the remainder of the year. Prospective home buyers are limited to how much they are willing/able to pay due to high mortgage rates, falling job security and rising food and fuel costs. We expect house prices to fall over 5% this year. Residential construction will also suffer with the drop in demand for housing. With house prices falling, it has become more attractive to buy an existing house versus building a new dwelling. Also, with net migration inflows very muted at

Buyers just can't afford to pay

Residential construction suffers



present the need to increase the housing supply has waned. Finance company failures will also contribute to a fall in residential construction over the next year, as funding for large-scale projects has dried up.

Consumers feel the pinch

With the combination of high mortgage rates, rising petrol and food prices, falling housing wealth and the prospect of lower wage increases, the consumer has reached breaking point. Not surprising then to see consumer confidence plunge to recessionary levels. Total retail spending growth has essentially stalled as increased spending on essentials, such as food and petrol, has squeezed out spending on more discretionary items. Purchases of big-ticket items have been put on hold: in particular spending on motor vehicles has been cut back. Absent any immediate and substantial relief on petrol prices, this contraction on consumer spending has further to go before recovery starts.

Labour market

The labour market has softened considerably in the first quarter of this year. The fall in the housing market and the slowdown in consumer spending clearly took its toll, with employment noticeably down in the property/business sector, construction and retail. Many firms have noticed less difficulty in finding labour and the workforce are now feeling less confident about the job market.

Employment growth is likely to remain very weak for the next 18 months or so. With slowing demand, firms will no longer need to be increasing their labour force and in some cases will choose not to replace those leaving. With fewer firms likely to hire, but continued growth in population, the unemployment rate is likely to rise.

However, it is not likely to be a situation of mass layoffs. Acute labour shortages have persisted for a number of years, limiting firms' production capacity. To the extent possible, firms will want to retain the people they have put so much effort into finding. It was hard finding people the first time around, and firms will be conscious that they will need them when the next upswing gets underway.

Light at the end of the tunnel

By mid-2009 the NZ economy should be able to climb out of its lull. The effect of interest rate and tax cuts should be filtering through the economy. The housing market will be on the road to recovery and improved business confidence should see the labour market firm up. Additional stimulus will come via a recovery in export earnings, owing to a more palatable exchange rate. Dairy-intensive regions also stand to fare comparatively well over the next couple of years.

Consumers facing multiple headwinds

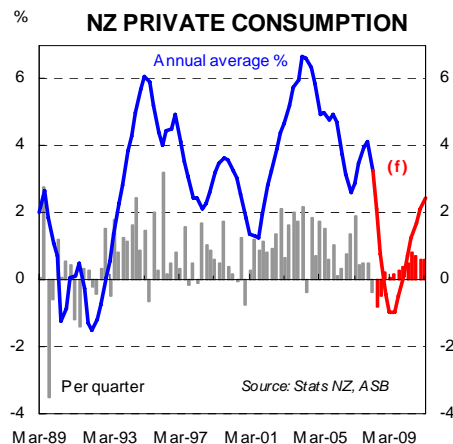
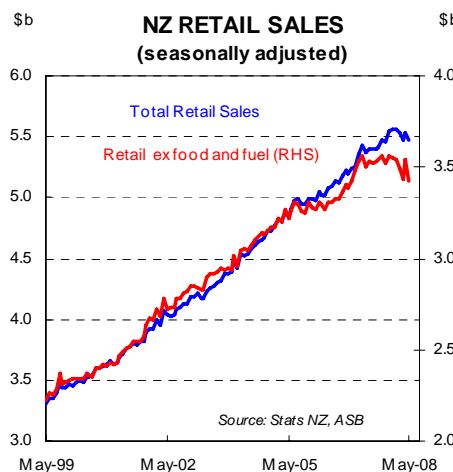
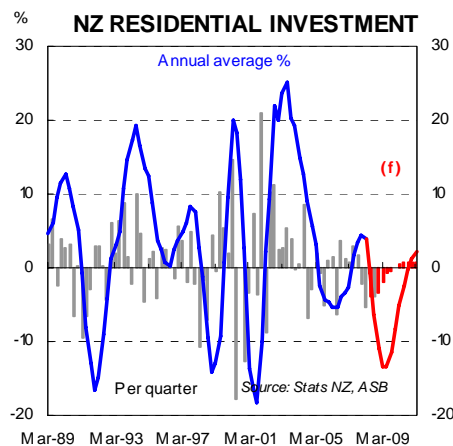
Discretionary spending axed

Labour market softens

Employment growth likely to remain soft...

...alleviating inflation pressures in the labour market

Tax cuts and lower interest rates will bring relief



Inflation: what goes up must come down (over the medium term)

Core inflation pressures remain elevated

When it comes to inflation the RBNZ finds itself in a very difficult position. Even as the economy has ground to a halt, inflation has accelerated. Long-standing capacity pressures have yet to abate appreciably, leaving current underlying inflation on the high side. Meanwhile, the sharp surge in commodity prices over the past year has boosted inflation significantly.

Annual inflation hit 4% in the year ending June 2008, and in the year to September is likely to reach 5%. Yet, the RBNZ is charged with keeping inflation between 1% and 3% on average over the medium term.

Cost shocks exacerbate inflation outlook

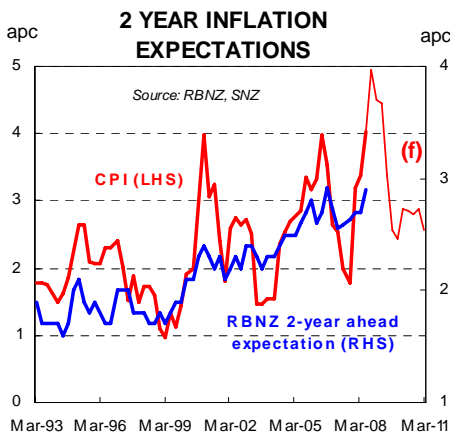
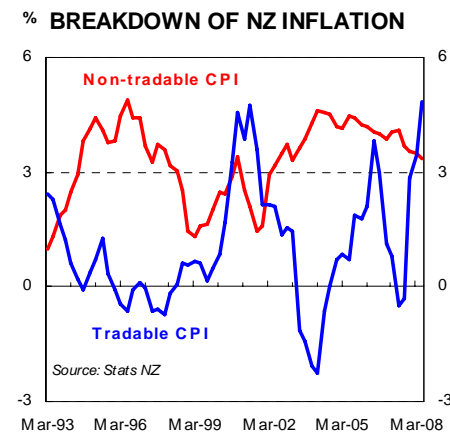
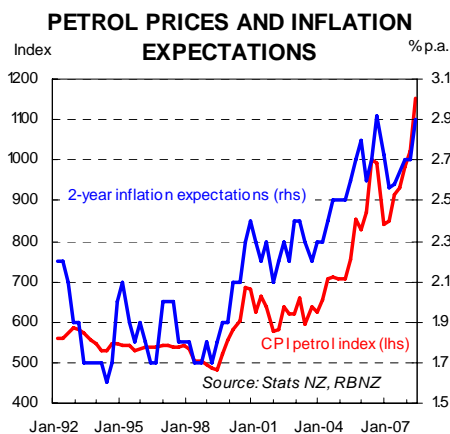
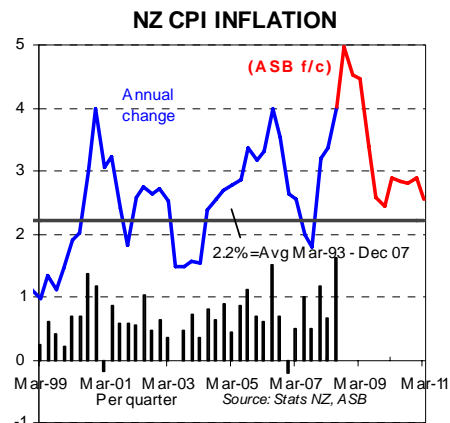
Aside from the fact that persistently-high inflation is stretching the definition of “medium term”, the extent of the inflation spike is a source of concern for the RBNZ. Increases in prices for frequently purchased items, like food and fuel, are more likely to alter perceptions of inflation and wage and price-setting behaviour. This isn't any old temporary spike in inflation; it has got the potential to substantially lift inflation expectations. However, on the other hand, cost shocks, such as higher food and fuel prices, also reduce purchasing power, reduce profitability and ultimately reduce demand.

Slower growth will alleviate built up inflation pressures

Consequently, growth is set to slow dramatically through 2008, providing scope for domestic inflation pressures to unwind more rapidly. The silver lining in the dark cloud of a stalled economy is reduced pressure on resources. The highly-regarded Quarterly Survey of Business Opinion recently indicated that businesses are finding that capacity constraints have already started to ease. In particular, the very tight labour market has started to show signs of easing up. This should help contain wage increases and prevent a wage/price spiral from developing.

Monetary policy forward looking

The RBNZ needs to be forward looking. Their most recent statement suggests they have become much less concerned about inflation expectations being carried away and more focused on the weaker medium-term price pressures. Monetary policy works with long lags, typically 18 months from the time interest rates are changed until when inflation outcomes are affected. Monetary settings have been tight for some time, and even with some OCR cuts, are likely to remain above neutral levels i.e. still contractionary. Being proactive about medium-term inflation and unwinding policy settings now, requires a gamble on inflation expectations remaining well anchored.



Interest rates and exchange rates

RBNZ started OCR cuts in July

The RBNZ's stance became surprisingly 'dovish' in July, with a marked shift in focus away from inflation expectations risks towards weaker medium-term pressures on inflation. In addition, the RBNZ appeared more concerned about the deterioration in global credit market conditions as consequent higher international funding costs may reduce the potency of OCR cuts. The easing cycle was commenced with the OCR being cut to 8% in the July review. We expect the RBNZ to undertake a cautious easing cycle, with 25 basis point cuts in consecutive meetings, finishing with the OCR at 6.75% in March 2009.

We expect a modestly paced easing cycle

The RBNZ sees future OCR cuts as contingent on an inflation outlook that continues to improve, and that the exchange rate does not excessively depreciate. A weaker NZD would make the near-term inflation outlook higher still and the RBNZ may consider a pause. In saying this, now they have started, we see the threshold to make them stop as being very high.

Global financial market developments appear to be the new wild card. Just like the RBNZ battled cheap money sloshing round the globe in its tightening cycle, they now risk facing expensive money on the way down. Deterioration in global credit markets could see the RBNZ cut rates in 50bp moves.

Exchange rate falls on weaker economic outlook and OCR cut

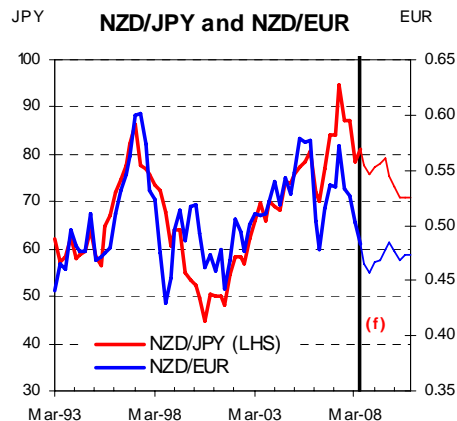
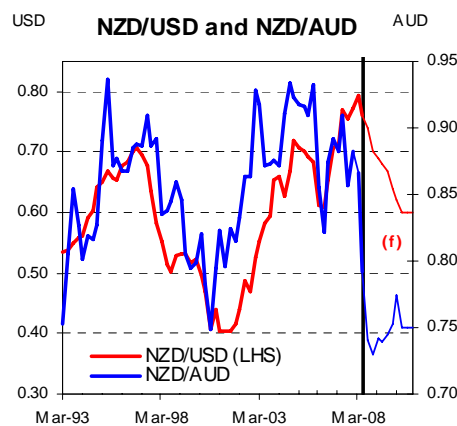
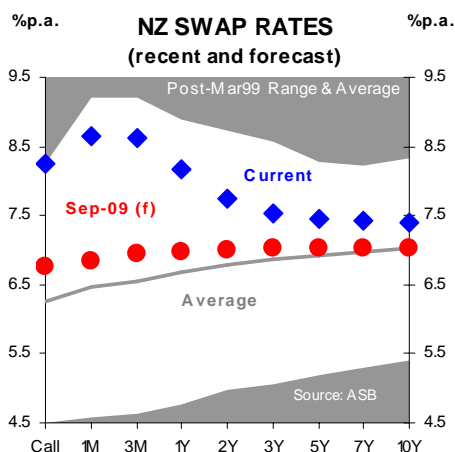
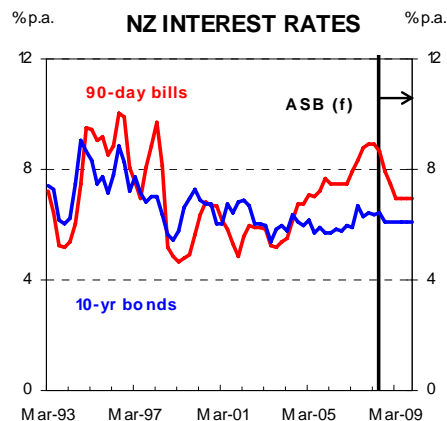
The NZ dollar has started to depreciate with increased recognition of New Zealand's faltering economy, along with confirmation that interest rates are now on the way down. Reflecting the deterioration in the fundamental outlook, the underperformance has been broad-based across a range of currencies.

Expect continued underperformance NZD/AUD

The NZD has lost considerable ground against the AUD, down to around AUD0.77 to 0.78, with respective fundamental outlooks now in stark contrast. Australian growth is expected to remain relatively robust and will benefit from far more favourable terms of trade. In addition, Australia's cash rate is likely to remain elevated. In contrast, the RBNZ has already commenced its easing cycle. Given the outlook, we expect the NZD/AUD underperformance to continue to below the AUD0.75 mark.

USD weakness behind NZ dollar holding up

The NZD has held up comparatively well against the USD, as both economies have been plagued by a slew of disappointing data. An eventual recovery in the USD will see the NZD/USD ease, though lingering USD weakness means the NZD is likely to stabilise around USD0.60 rather than plumb the sub-USD0.40 depths seen early in the new millennium when the USD reigned supreme.



ECONOMIC FORECASTS

ASB economic forecasts		Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Mar-10	Mar-11
			<< actual	forecast >>					
NZ GDP real	AA%	3.1	3.0	2.3	1.5	0.4	-0.1	1.3	2.8
private consumption	AA%	4.1	3.3	2.1	0.8	-0.4	-1.0	0.7	2.4
dwelling construction	AA%	4.4	3.9	-0.8	-6.3	-11.1	-13.7	-6.1	2.2
other investment	AA%	4.3	4.3	4.2	4.0	1.1	-0.6	-2.4	2.9
exports	AA%	3.3	2.2	2.0	2.7	0.5	0.3	3.3	4.6
imports	AA%	8.6	9.6	8.7	2.4	3.4	1.8	0.2	3.6
NZ GDP real	A%	3.5	1.9	0.8	0.0	-0.8	-0.2	1.9	3.2
NZ GDP real	Q%	0.8	-0.3	-0.3	-0.3	0.1			
NZ CPI	Q%	1.2	0.7	1.6	1.4	0.7			
NZ CPI	A%	3.2	3.4	4.0	5.0	4.5	4.5	2.9	2.6
NZ house prices (QV index)	A%	8.0	2.8	-2.9	-5.7	-6.5	-5.9	1.3	2.7
NZ unemployment (sa%)	Qtr	3.4	3.6	4.3	4.7	5.0	5.2	5.7	5.6
NZ private sector wages (LCI)	A%	3.4	3.5	3.5	3.4	3.1	3.1	2.7	2.8
NZ current account (\$b)	Yr	-13.8	-13.8	-13.2	-12.6	-12.5	-12.4	-11.5	-11.6
as a % of GDP	Yr	-7.9	-7.8	-7.3	-6.9	-6.8	-6.7	-6.0	-5.7

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	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Mar-10
(end of quarter)			<< actual	forecast >>			
NZ cash rate target	8.25	8.25	8.25	7.75	7.25	6.75	6.75
NZ 90-day bank bill	8.9	8.9	8.7	8.0	7.5	7.0	7.0
NZ 3-year swap rate	8.5	8.3	8.0	7.3	7.2	7.0	7.0
NZ 10-year gov't stock	6.4	6.4	6.4	6.1	6.1	6.1	6.1
ASB foreign exchange forecasts	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Mar-10
(end of quarter)			<< actual	forecast >>			
USD per NZD	0.774	0.794	0.762	0.74	0.70	0.69	0.62
GBP per NZD	0.388	0.398	0.382	0.38	0.37	0.37	0.34
AUD per NZD	0.882	0.866	0.792	0.74	0.73	0.74	0.78
JPY per NZD	87.1	78.5	81.0	78	76	77	73
EUR per NZD	0.526	0.502	0.483	0.47	0.47	0.47	0.48
TWI	71.9	70.4	67.7	65.1	63.1	63.6	61.4

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ASB ECONOMICS
Level 9, 135 Albert Street, Auckland

ASB GROUP ECONOMICS & RESEARCH **PHONE** **FAX**

Economics				
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604	(649) 302 0992
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	

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