

ASB Quarterly Economic Forecasts



Credit freeze chills global outlook

- Financial markets deteriorated as a loss in confidence saw global credit markets freeze up.
- The credit crisis is now starting to materially affect the global economic growth outlook.
- The NZ economy will be affected, but a number of buffers will dampen the impact.

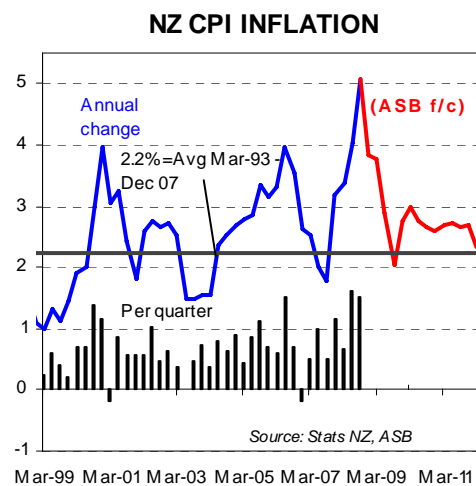
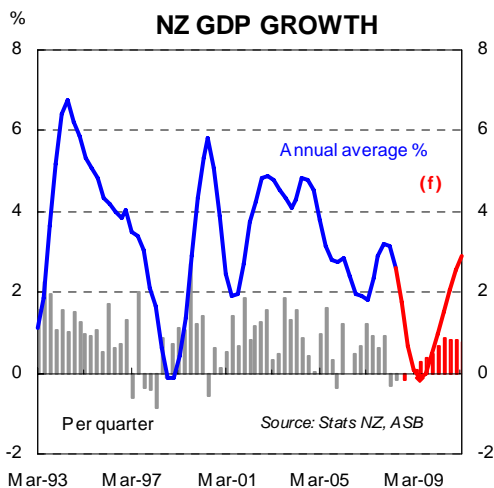
Over the past couple of months the global financial situation has taken a dramatic turn, evoking comparisons to the Great Depression. Certainly, the magnitude of the financial problem has become stunning. However, enough history books have been written about the events of 70-80 years ago to provide some stark lessons on how to stem the crisis. These lessons are now being applied with vigour. US and European governments and their central banks are injecting capital into needy banks, guaranteeing wholesale funding, making liquidity (cash) readily available, and in the case of the US buying up impaired assets to hasten the cleaning up of bank balance sheets.

These various measures have two primary objectives: keeping troubled entities on their feet and – most importantly – giving investors and banks confidence that they can lend to banks without fear of default. Restoring confidence is critical to the smooth functioning of credit markets. At the time of writing there are early encouraging signs that frozen US and European markets are starting to defrost, though it is still a little while before they will begin to function more normally.

NZ has not been directly caught up in the woes that have erupted out of the US. However, there have and will continue to be impacts locally. Financial transmission has been with us since early 2008 via higher global funding costs – and even once markets start functioning again these costs will likely be even higher. Globally credit is not going to be as easy to obtain. Over time weaker US and European consumer demand will flow through to demand for NZ's exports both directly and through third parties such as Australia and Asia. Developing economies themselves are also not immune to financial impacts.

Although NZ cannot escape these global impacts, it can and will put up some buffers to help absorb the impact. The NZ dollar has lost ground this year, which will provide insulation against weaker global demand. The RBNZ has also moved very swiftly to drop interest rates by 175bp to date in response, including an unprecedented 100bp drop on October 23rd. October's tax cuts have also arrived at an opportune time. There is good news on the price front as well: petrol prices have retreated noticeably and the more recent vegetable price increases are subsiding. Bit by bit we will have more money left over for discretionary spending. These factors will help to turn the NZ economy around next year, though expect a very slow recovery. There remain many challenges ahead on the global front that have yet to make their presence felt.

Life has been tough for much of this year, and will remain challenging over the next year. In times like these managing your cashflows and business relationships becomes even more important. Now is also a good opportunity to look at how you run your business or manage your personal financial affairs and ask yourself what you could do better to see you come out the other side fitter and stronger.



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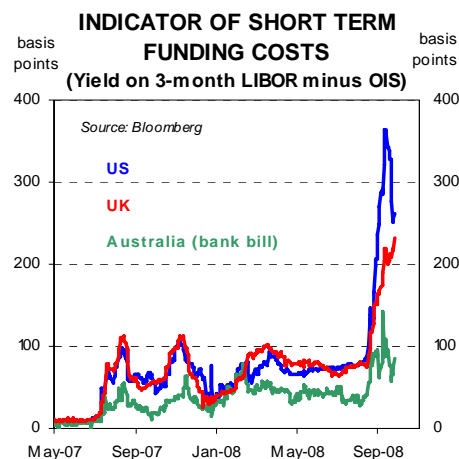
General Advice Warning

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.

International economies

Financial turmoil increases as investor confidence is lost

The global financial crisis escalated over September and October. The collapse of the investment bank Lehman Brothers and bailout of insurance company AIG highlighted the increasingly negative fall-out from the sub-prime crisis. As a result, global credit markets froze as US (and increasingly European) banks refused to lend to each other on fears of counterparty risk. The initial rejection of the Treasury's \$700 billion bail-out package exacerbated fears, although it was later passed. Meanwhile concerns spread to Europe, and resulted in a range of dramatic government action to revive confidence in the banking system.



Despite the flurry of various government announcements targeted to restore confidence, credit markets are only thawing out slowly as significant uncertainty remains.

Capital is Key

Underlying problem is lack of money

When assessing the various measures governments around the world are implementing, recall that the underlying cause of current turmoil is a crisis of confidence. The current market problems are about the lack of money in the system, not so much the price of money.

Increase liquidity in the short run

In the short-run (dealing with the day-to-day crisis) central banks can offer ample liquidity and governments can act to limit the financial contagion. However, this piecemeal reactive approach does not address the underlying systemic issues that now need to be resolved to facilitate the recovery.

Long run, capital injections needed to restore confidence

The road to recovery requires investor confidence to return. And for that, the key issue that needs to be addressed is that banks in affected countries remain undercapitalised through losses on their asset portfolios. Once markets stabilise, the deleveraging process – which could feasibly take years – will be able to make further headway.

The IMF estimates that a further US\$675 billion in capital will be needed by the major global banks over the next several years. As such, policy initiatives that target the root of the problem and help to strengthen banks' balance sheets, whether involving direct provision of government funds or measures to encourage private capital investment, will play an extremely important role in working through the crisis.

Co-ordinated action more effective than ad-hoc

Far-reaching plans that deal with numerous institutions at once will prove more successful than ad-hoc responses to individual bank failures, as will co-ordinated efforts from governments. Encouragingly, this approach is now being adopted.

So what is being done?

Govt officials aim to restore confidence

The measures announced to date by governments and central banks are targeted at restoring investor confidence. The measures are threefold: increasing liquidity; insuring deposits and wholesale funding of banks; and injecting capital into key banks.

Increased cash available in the system

To help ease inter-bank funding pressures, central banks have dramatically increased the quantity of term funds made available to banks. Meanwhile, to address the increased global demand for US dollar liquidity as a result of the risk aversion, the Fed has expanded its currency swap lines with foreign central banks (lending them US dollars to on-lend to local banks). In addition the Fed has set up a commercial paper funding facility as well as a money market investment funding facility that will increase liquidity and the ability of money market funds to sell assets to meet redemptions. They will also provide a back-stop for the commercial paper markets which have also been struggling to operate.

Deposit insurance schemes to boost confidence

To bolster confidence most Governments have introduced some form of guarantee on bank deposits (and in the US, the Treasury also has a temporary guarantee on money market mutual funds). In addition, to ensure banks are able to continue to raise funds on the wholesale markets many countries are guaranteeing banks' wholesale funding (although this is likely to be optional and the cost of doing so is likely to be sizable).

Capital injections

With credit markets frozen and investor confidence lost, banks have struggled to raise the capital required to absorb recent losses and prevent credit write downs. In markets where this has been most acute (US and UK) governments have stepped in and have

directly injected equity into key banks in return for preference shares.

Credit crunch impact on the economic Outlook

The ongoing financial crisis is resulting in a substantial deterioration in the global economic outlook and heightened downside risks. Shrinking bank balance sheets mean credit will remain tight and lending to households and businesses will remain very constrained on a global scale. The US and UK will be lucky to avoid recession, while Europe is in for a period of very soft economic growth. The IMF's October World Economic Outlook warned of "a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s". It marked its forecasts for global growth down substantially, and said they carry "significant downside risks".

The feedback loop from the real economy to the credit market is a key concern in the US and UK as it amplifies and prolongs the economic fallout. US consumption looks set to contract in Q3 for the first time since 1991, and to remain soft for a prolonged period. Weak consumption in turn flows through to falling profits, investment contraction, rising default rates and higher delinquencies – providing further pressure on house prices and exacerbating financial market problems. Given the extent to which some countries' growth of recent years has been dependent on US consumer demand (China, Japan), the prospect of a sustained period of soft US consumer spending has negative ramifications for the rest of the world.

Lower credit availability will reduce world growth

Weaker US consumer spending also key driver of weaker outlook

World growth forecasts revised down significantly

Global growth forecasts slashed

The IMF projects world GDP growth of 3.9% in 2008, slowing to 3.0% in 2009 - "a very low number for world growth" and down substantially from forecasts of 4.1% and 3.9% previously. In line with our view the IMF believes "the required deleveraging will continue to be a protracted process, implying that limits on the pace of credit creation – and on activity – will be present at least through 2009." It expects a gradual recovery to begin in late 2009, though we think the risk is that any recovery is more likely a story for 2010.

Much of the markdown in global growth forecasts is due to a substantial slowdown in

developed economies, which the IMF expects to be "in or close to recession in the second half of 2008 and early 2009". GDP forecasts for developed economies in 2009 are soft across the board: US +0.1%; Euro area +0.2%; Japan +0.5% and the UK -0.1%.

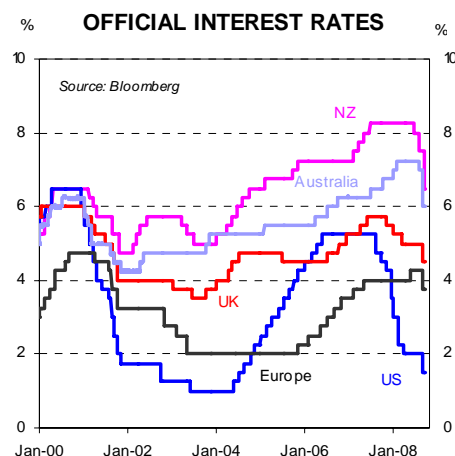
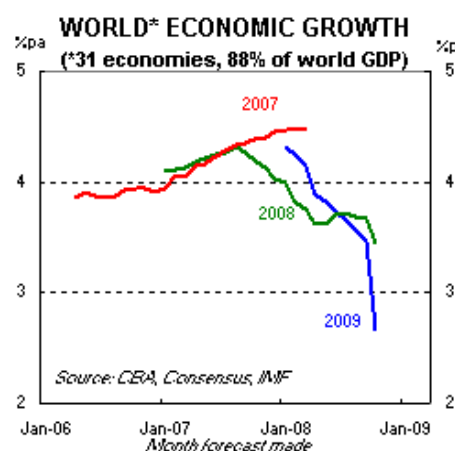
Emerging and developing economies are expected to perform somewhat better, though are still forecast to slow. 6.9% growth is expected in 2008, slowing to 6.1% in 2009 (vs. 6.7% in July). China's economic growth is expected to slow to 9.7% in 2008 and 9.3% in 2009, from 11.9% in 2007. Such growth is still exceptionally strong by Western standards but the forecasts nevertheless constitute a relatively solid step down in growth. The fact that China's central bank is easing along with the other global central banks is a sign that the economy isn't immune to what has become a global credit crisis.

Central banks lower interest rates

In reaction to the deteriorating economic outlook due to the credit crunch fall out central banks have been proactive in easing interest rates. In October the RBA cut by an aggressive 100 basis points. This was followed by a co-ordinated 50 basis point rate cuts by key central banks. We are expecting further rate cuts over the next few months, with the Fed expected to drop the Fed Funds rate to 1.0% at the time of writing. The ECB is expected to lower the policy rate to 3.0% (from 3.75% currently) and the BoE are expected cut another 200 basis points, to 2.5%, by mid-2009. The RBA is expected to cut rates another 100 basis points.

Developed countries bear brunt of slowdown

Central banks cut policy rates on deteriorating growth outlook



The New Zealand Economy

NZ economy in recession over 2008

2008 has, so far, been a challenging year for the New Zealand economy, slipping into a recession as a number of pressures mounted up. Rising mortgage rates over 2007 and early 2008 sent the housing market into a sharp slowdown. Drought cost dairy producers at least \$450 million, compared to the previous season. Rising prices for fuel and food over the first half of the year hit consumers where it hurt, squeezing out spending on more discretionary items.

Tax cuts may prevent a Q4 fall

Growth contracted 0.3% and 0.2% in the first and second quarters respectively, and we expect Q3 growth to register another 0.2% contraction. Tax cuts in October are likely to be the saving grace of 2008, preventing a fourth quarter of consecutive decline.

Slow recovery over 2009/10

The recovery over 2009 will be very slow. Easing monetary conditions will support the recovery in demand, although the on-going affects of the global credit crunch will reverberate on domestic demand for some time yet. Net export recovery and government spending will lead the way, while consumer spending, residential and business investment will remain weak.

NZD will boost export prices

Export prices strong

Export prices have climbed 19% over the past year, largely supported by rising international prices for dairy and, more recently, higher international prices for meat and the lower exchange rate. Exports of oil also enjoyed a strong increase in prices received over the first half of this year. Over the past few months, international commodity prices have moderated substantially, with the slowdown in global growth. As NZ commodity exports are predominantly food, the outlook for NZ export returns are more closely tied to growth prospects in developing Asia. In addition, declines in international commodity prices are likely to be cushioned by the weakening NZ exchange rate, continuing to provide some support for NZ export returns.

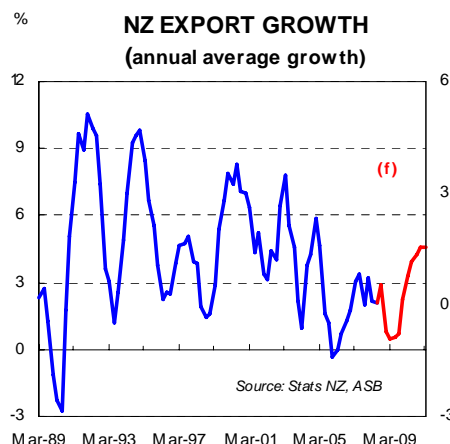
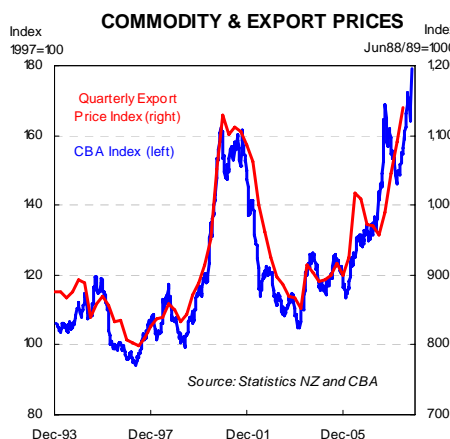
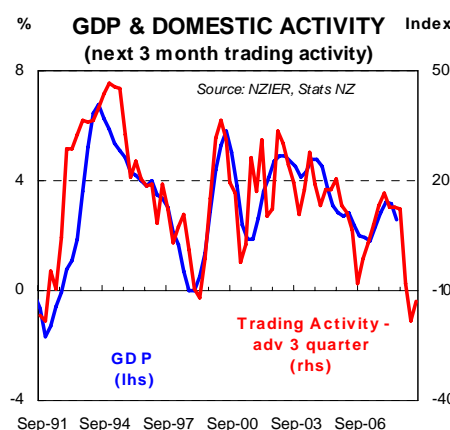
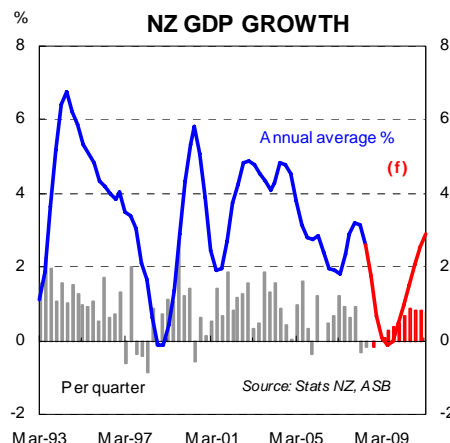
Asian growth key to NZ export prices

Export volumes remain lacklustre

Export volumes cut by drought...

By mid-2009 a recovery in dairy production from last summer's drought should become apparent. In addition, Fonterra expects volume growth to be lifted further by production from recent dairy conversions. While improved weather conditions will sustain a recovery in dairy output, forestry and non-commodity export volumes will struggle with weak global demand. Manufacturing performance is likely to be mixed, with those more exposed to the US markets struggling with weak demand in comparison to Australian and Asian markets. A recovery in tourist numbers is looking less likely, with

... weak world growth to limit recovery



lower income prospects overseas offsetting the lower exchange rate and increased attractiveness of NZ as a holiday destination. However, the lower exchange rate will encourage a higher spend per tourist.

Housing market remains very weak

Housing market weakness endures

Housing demand has weakened dramatically over the past year, with housing turnover down around 50% from early 2007. The fall in sales has seen the number of available listings steadily increase, creating a large oversupply on the market. Some would-be sellers, unwilling to accept lower house prices, have opted to turn to the rental market instead, creating a large supply of rental housing.

Weak demand to drive house prices lower

One fundamental factor behind lower housing demand is weak net migration inflows, influenced by strong outflows to Australia. In addition, mortgage rates (whilst down from their peaks earlier this year) remain above historical averages. With high food and fuel prices eating away at households' disposable incomes, and the labour market starting to weaken, potential home buyers have become more circumspect on prices they have been willing to pay. Already house prices have dropped around 6% on year-ago levels and we expect house price deflation to reach 10% by year-end. House prices have been fundamentally overvalued for sometime, and the correction will be slow and drawn out.

Residential investment to continue falling....

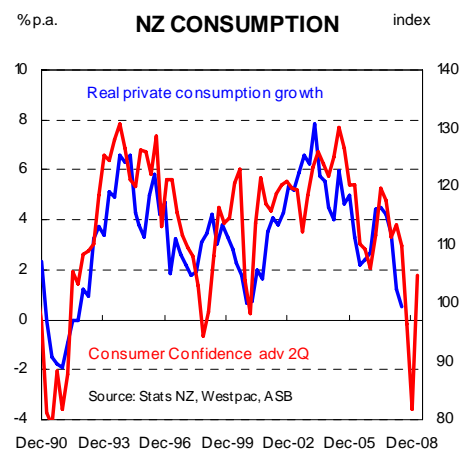
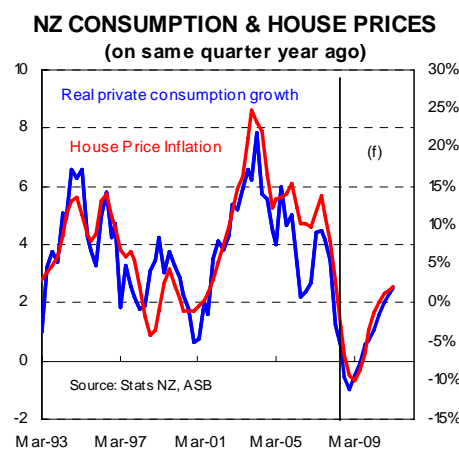
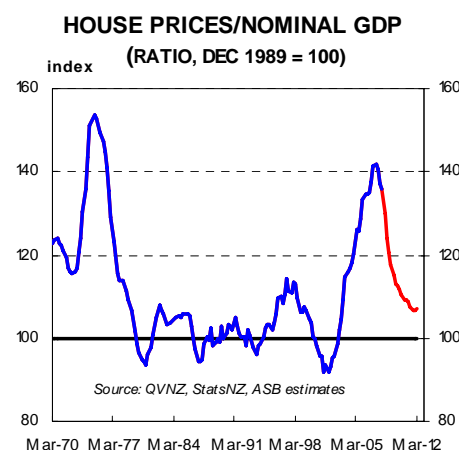
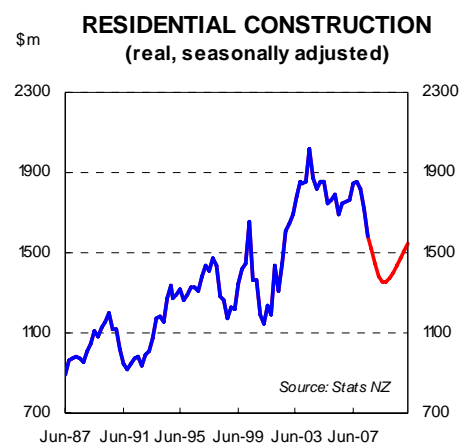
Waning demand for housing and falling house prices have reduced the incentives to build new houses, and by the June quarter residential investment had already fallen 15% from year-ago levels. We expect residential construction to continue declining for at least another year. Lower credit availability and low income growth will keep house prices and construction demand weak. However, ongoing population growth will lead to a situation of pent-up demand for new housing, and along with lower interest rates, will encourage a recovery in residential construction over 2010.

...population growth drives recovery 2010

Consumers run out of steam

Consumer spending weak, outlook remains challenging

Consumer spending slowed rapidly over 2008, with households grappling with slower income growth, falling net wealth and rising cost of living. However, consumers are optimistic the worst is over. Consumer confidence recently staged a recovery following declines in mortgage rates and fuel prices along with the anticipation of tax cuts in October. Nonetheless, the outlook for consumer spending will remain weak. Borrowing costs and fuel prices, although easing, remain relatively high and the labour market is likely to deteriorate further and, in the short term, consumer sentiment is likely to be more sombre.



Falling profitability weighs on investment outlook

Business investment plans cancelled

The trading environment was challenging over 2008, and businesses' margins came under significant pressure as the low demand environment muted the ability to pass on rising costs. Most areas of business investment were scaled back over 2008, although there was some offset with imports of large items (such as oil platforms) and ongoing government investment in infrastructure. Looking ahead we expect to see more broad-based declines in business investment. On top of falling profitability, reduced capacity constraints have lessened the need for expansion while the depreciation in the exchange rate will increase the cost of imported capital investment. The credit crunch is also likely to exacerbate the fall in business investment, with risk aversion increasing the cost of borrowing and reducing the availability of credit. The current climate of uncertainty is likely to be further weighing on investment decisions. Ongoing infrastructure investment by government is likely to provide some offset to falling investment in the business sector.

Global credit crunch will also reduce investment

Labour market softens

Employment growth stalled over the first half of 2008. Sectors exposed to real estate and retail have been the hardest hit, with these industries starting to shed jobs. Employment growth has stalled in construction and the number of hours paid cut back, suggesting less overtime being worked in an industry that has been operating at full stretch over the past few years.

Employment growth stalls in 2008

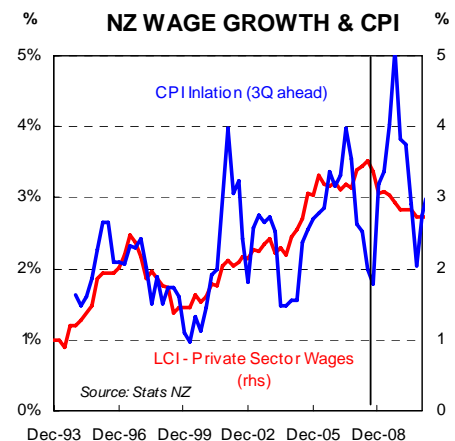
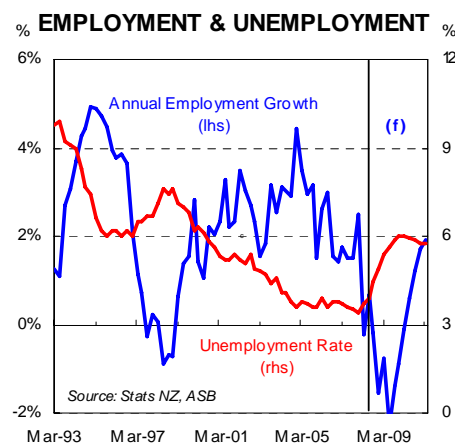
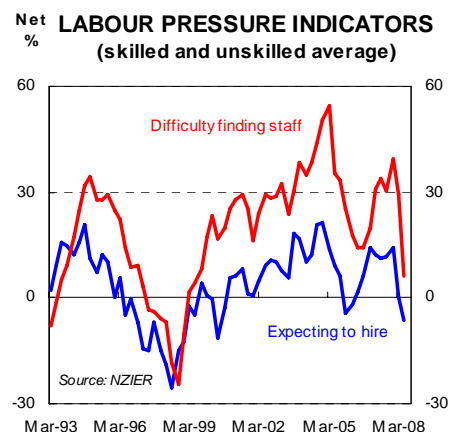
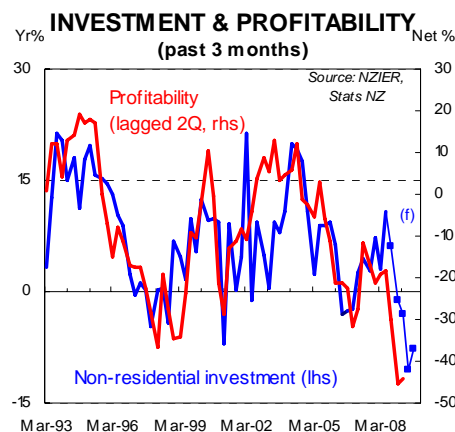
Labour market to weaken further...

Looking ahead, hiring intentions are falling, with many businesses who had been looking to expand are now considering cutting back on numbers employed via attrition. Difficulties in finding skilled labour have eased considerably, while unskilled labour is now easier to find. The labour market is now unwinding the considerable amount of stretch that has built up over recent years. The return to a more balanced position between demand and supply will moderate the considerable pressure on wage inflation and labour costs.

... reduce pressures on labour costs

Housing related and retail industries most exposed

Overall, we expect to see some further declines in employment over the next 12 months, with those industries that are most exposed to the slowdown in housing and consumer spending continuing to feel the most pressure. However, job losses will be spread wider across sectors over time.



Inflation: Here today, gone tomorrow?

Food and fuel prices push inflation to 5.1%

Annual inflation rose to 5.1% in the September quarter, fuelled by rising food and fuel inflation.

Bad weather during August caused vegetable prices to jump 20%. Meanwhile, the large run-up in oil prices during July pushed petrol prices up 4.6% and transport prices rose another 2% in Q3. However, since late July oil prices have been in rapid retreat, with further large declines as the credit crisis fall-out escalated. International oil prices have fallen 60% from its peak; however, the depreciation in the NZ dollar has muted the pass through to consumers, with petrol prices only down 21%.

Administrated inflation also strong

The timing of various taxes and levies also contributed to the 1.5% qoq spike. Reviews for council rates (up 4.7%) and alcohol excise duty (up 3.5%), as well as increased vehicle licensing fees (up 16.1%) and hospital service charges (5.6%).

Surprisingly little offset from retail

Along with rising administered inflation, there was surprisingly little offset coming from weakening domestic demand. In particular, pricing in retail areas remained fairly stable in contrast to anecdotes of widespread discounting. Construction costs also continued to grow strongly, despite the slowdown in the housing market now being well entrenched.

Underlying inflation accelerates in Q3...

With the diverse range of fee increases and continued domestic inflation pressure, underlying inflation accelerated in Q3. In normal times, this pick up would be triggering alarm bells at the RBNZ. However, these are not normal times. As outlined above, the outlook for both global and NZ growth has deteriorated significantly. Sub-trend economic growth over the next few years will help alleviate inflation pressures built up over the past few years.

... but weak economic outlook to unwind inflation pressures

Falling oil prices reduces cost pressures

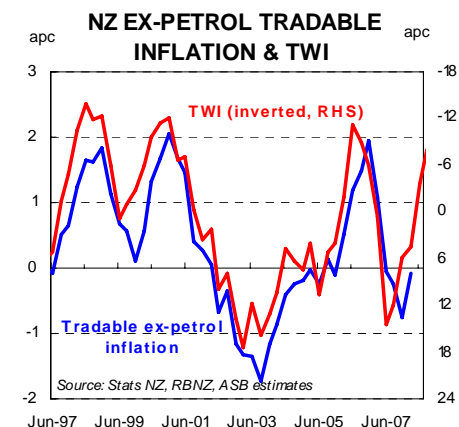
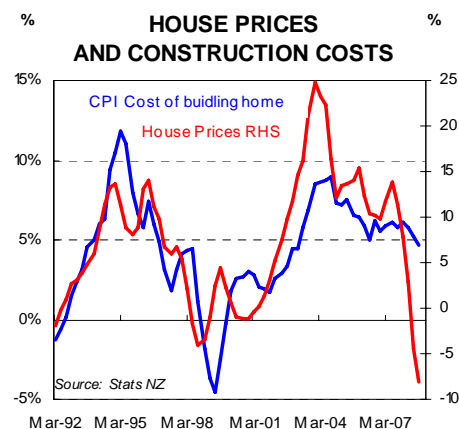
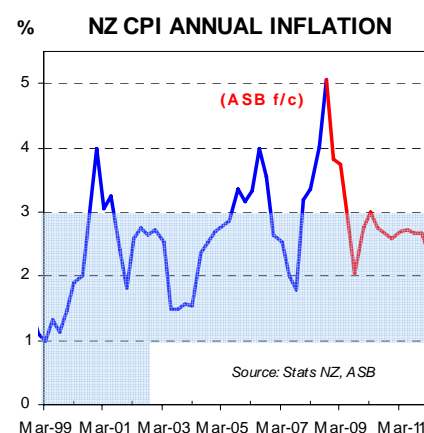
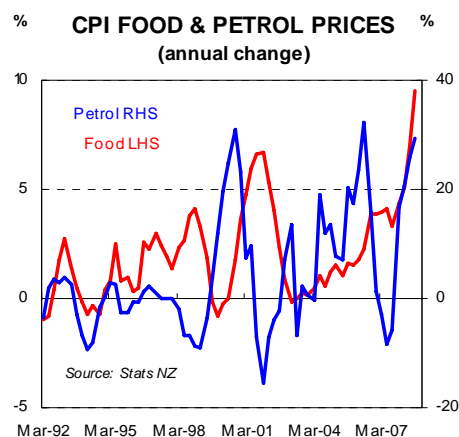
Already international commodity prices have fallen dramatically in response to the weaker growth outlook. The fall in oil prices in particular has removed much of the cost pressure that has prevailed.

Supply constraints easing

Weaker demand and output has seen capacity pressures ease significantly, with firms reporting lower levels of capacity utilisation and less difficulties finding skilled labour.

Falling NZD adds tradable inflation near term

While domestically-sourced inflation is set to slow, the decline in overall inflation will be moderated by rising import price inflation. The Trade Weighted Index is down over 15% on year-ago levels and, while the depreciation has generally been orderly, it will add to inflation pressures in the near term.



Interest rates and exchange rates

RBNZ cuts rates aggressively, OCR 175bp lower

The RBNZ has aggressively cut 175 basis points off the Official Cash Rate over the past 4½ months. The risk aversion associated with increased uncertainty and reduced investor confidence has seen the cost of offshore funding increase dramatically, contributing to the RBNZ cutting rates by 50bp in September in order to bring borrowing costs lower. By October, the financial crisis had escalated, international credit markets had stopped functioning and the economic outlook had deteriorated rapidly, prompting the RBNZ to bring anticipated rate cuts even further forward, cutting 100bp.

More cuts to come, but timing increasingly data dependent

We expect the RBNZ to cut another 50 basis points in December, then 25 basis points in both January and March, bringing the cash rate to 5.5%.

With the majority of planned interest rate reductions undertaken by the end of 2008, rate cuts in early 2009 will be more data dependent. Failure to see more definitive evidence of easing inflation expectations and easing in domestic and underlying inflation (the RBNZ will look through tradable inflation) may see the RBNZ start to slow rate cuts. On the other hand, further deterioration in the global financial crisis and failure for credit markets to unfreeze will increase the likelihood of further rate cuts.

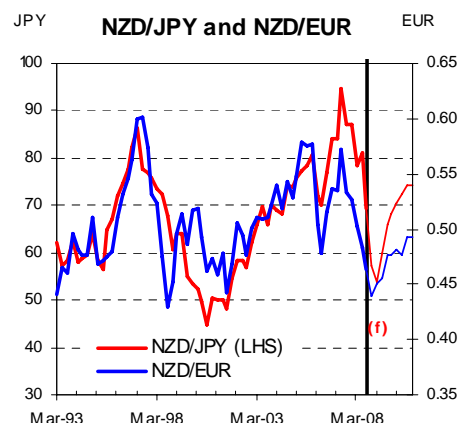
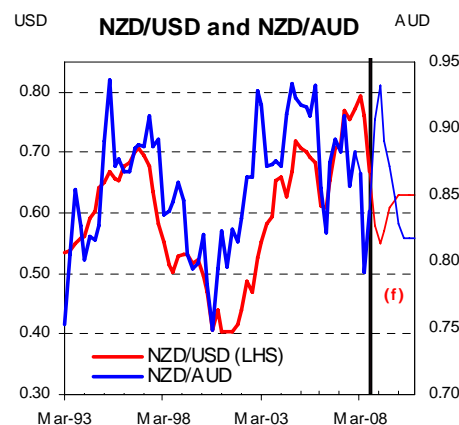
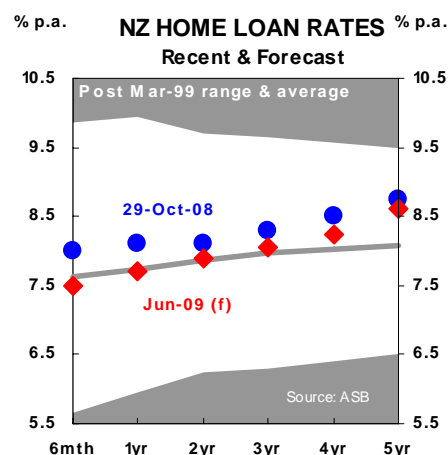
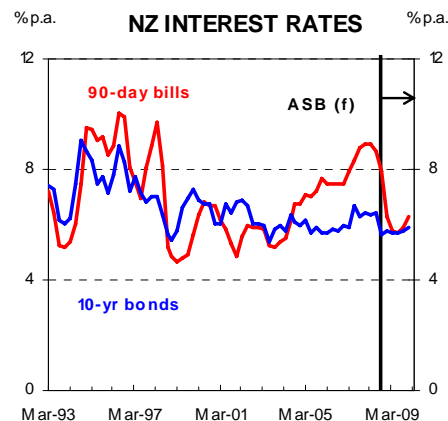
NZD weakens on global risk aversion

Over the past few months, the NZD has now undergone a significant correction. The escalation of the global credit crisis, triggered by the unexpected failure and rescue of various large financial institutions, saw investor confidence collapse. Increased risk aversion saw positions in peripheral currencies unwound, driving the NZD and AUD down. As the financial crisis dragged on, attention turned to the deteriorating global outlook, in turn putting pressure on commodity currencies. Over this period the AUD has experienced more pressure than NZD, driving a lift in the NZD/AUD cross. We do not see this lift as sustainable in the medium term, as the RBNZ is likely to cut rates to a greater extent than the RBA, narrowing the interest differential between the two countries. Furthermore, Australia's economy is likely to hold up better than New Zealand's.

NZD outperforms AUD – but not sustainable

The USD is likely to remain firm in the short-term as risk aversion sees USD hoarding continue. However, by mid-2009 concerns regarding the US debt obligations will start to re-emerge as a driver of a softening USD. Such a backdrop may see the NZD/USD remain under pressure in the short term, but with the potential for slight recovery as 2009 unfolds.

USD weakness returns mid-2009 on debt concerns



ECONOMIC FORECASTS

ASB economic forecasts		Mar-08	Jun-08 << actual	Sep-08 forecast >>	Dec-08	Mar-09	Mar-10	Mar-11	Mar-12
NZ GDP real	AA%	3.2	2.6	1.8	0.7	0.1	1.0	2.9	3.3
private consumption	AA%	3.3	2.3	1.1	0.0	-0.4	0.6	2.1	2.9
dwelling construction	AA%	4.1	-2.0	-8.3	-14.2	-18.4	-7.8	8.5	9.4
other investment	AA%	4.4	6.0	6.8	4.5	2.8	-7.1	2.5	5.6
exports	AA%	2.2	2.1	2.9	0.8	0.5	3.3	4.6	4.5
imports	AA%	9.6	9.8	9.5	7.0	4.8	-1.8	3.1	5.5
NZ GDP real	A%	2.2	1.1	0.2	-0.7	-0.3	1.8	3.3	3.2
NZ GDP real	Q%	-0.3	-0.2	-0.2	0.0				
NZ CPI	Q%	0.7	1.6	1.5	0.0	0.6			
NZ CPI	A%	3.4	4.0	5.1	3.8	3.8	3.0	2.7	2.3
NZ house prices (QV index)	A%	2.8	-4.4	-8.1	-10.7	-11.4	-1.3	2.1	3.1
NZ unemployment (sa%)	Qtr	3.7	3.9	4.4	4.9	5.4	6.0	5.7	5.5
NZ private sector wages (LCI)	A%	3.5	3.4	3.4	3.1	3.1	2.8	2.7	2.8
NZ current account (\$b)	Yr	-14.2	-15.0	-15.6	-16.3	-16.6	-14.7	-14.1	-14.3
as a % of GDP	Yr	-8.0	-8.4	-8.6	-8.8	-9.0	-7.7	-7.0	-6.7

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 (end of quarter)	Jun-08	Sep-08 << actual	Dec-08 forecast >>	Mar-09	Jun-09	Mar-10	Mar-11
NZ cash rate target	8.25	7.50	6.00	5.50	5.50	6.00	6.50
NZ 90-day bank bill	8.68	7.96	6.3	5.8	5.7	6.4	6.7
NZ 3-year swap rate	7.65	6.92	6.3	6.2	6.2	6.6	6.8
NZ 10-year gov't stock	6.42	5.65	5.8	5.7	5.7	5.9	6.0
ASB foreign exchange forecasts (end of quarter)	Jun-08	Sep-08 << actual	Dec-08 forecast >>	Mar-09	Jun-09	Mar-10	Mar-11
USD per NZD	0.762	0.668	0.58	0.55	0.57	0.63	0.63
GBP per NZD	0.382	0.371	0.34	0.34	0.37	0.38	0.37
AUD per NZD	0.792	0.837	0.91	0.93	0.89	0.83	0.82
JPY per NZD	81.0	69.5	57	54	60	71	75
EUR per NZD	0.483	0.464	0.44	0.45	0.46	0.48	0.49
TWI	67.7	63.3	58.5	57.6	59.4	63.3	64.1

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

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