

# ASB Quarterly Economic Forecasts

## Searching for the bottom



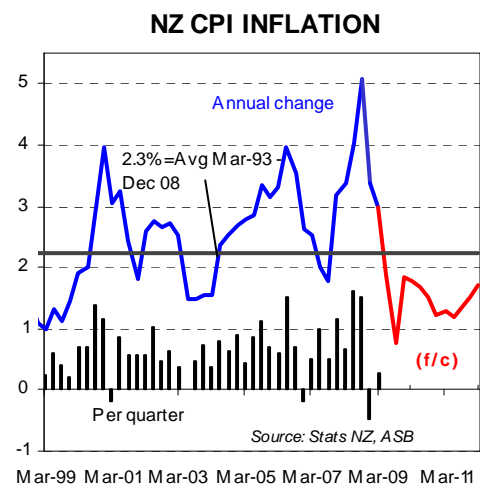
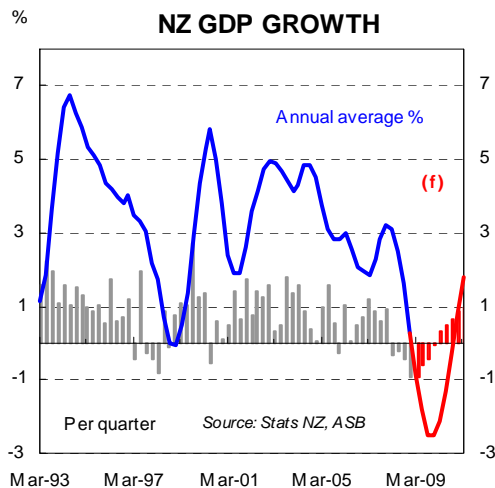
- Global economic data suggest the bottom of the downturn may be in sight.
- The vigorous global policy reaction is gaining some traction.
- However, the pace of the eventual recovery is likely to be modest compared to previous upturns.

In the midst of the deepest global recession since World War II we have a few positives to talk about. One is that our economic forecasts have 'only' been revised down modestly since our last Quarterly. On the face of it that might not sound like good news, but it makes a change (the second derivative of our forecasts has turned positive, to get overly technical). More importantly, economic data around the globe are now more mixed rather than the one-day traffic downwards: outright improvement, stabilisation, or slower rates of decline are increasingly commonplace. "Green shoots" has become the latest catch phrase as the positives get focused on. There is a growing sense of a glimmer of light at the end of a long, dark tunnel. Investors have taken the positive signs to heart and rising risk appetites have seen global equity markets recover from the January – February plunge.

Although the bottom appears in sight, the more sober message is that the economic recovery, in our judgment, is likely to be modest compared to what NZ normally experiences. Emphasising the more positive developments risks overlooking some more fundamental factors that will hamper the global economy. Global credit markets remain impaired and the banking systems of the US and the UK still face a long journey back to full health. Deleveraging in indebted countries, including NZ, still has some way to go and will constrain the extent to which global consumer demand can recover. The US, so long the consumer of last resort during times of economic slowdown, will not be filling that role and there are no other obvious contenders. Numerous governments, spending desperately in the short term, will then face years of fiscal austerity to pay down debt. And the bottom has yet to be reached, even if does appear to be in sight.

This year is going to remain a tough one for many businesses, notwithstanding the recent attention given to green shoots. Considerable uncertainty remains, but the road to recovery is likely to be long, rough and windy with a few stumbles along the way. The Economist magazine recently warned that "the worst thing for the world economy would be to assume the worst is over", which would risk complacency amongst policymakers when urgent action may still be required. We do need to be mindful of counting our chickens before the eggs are laid let alone hatching. It is barely 6 months since the credit crisis erupted and NZ has yet to feel much of the economic impact. Monetary conditions have actually tightened in recent months via the higher NZ dollar and long-term interest rates, despite continued Official Cash Rate cuts.

Contingency planning for businesses will remain important, as will being adept in dealing with change and taking advantage of opportunities that arise. We should be aiming for not just survival but for improvement in our collective lot: personal finances, business performance and national economic potential. That means focusing not just on the here and now but keeping an eye on where we envisage we should be moving to and acting accordingly.



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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.

## NZ's export vulnerability to the financial crisis

*Weak global demand*

The financial crisis has triggered a synchronised recession in the global economy and the widespread nature of the downturn limits New Zealand's ability to stage an export-led recovery. The export sector also faces additional headwinds, as the NZD dollar now appears to have bottomed out and has started a gradual appreciation.

*Some economies weaker than others*

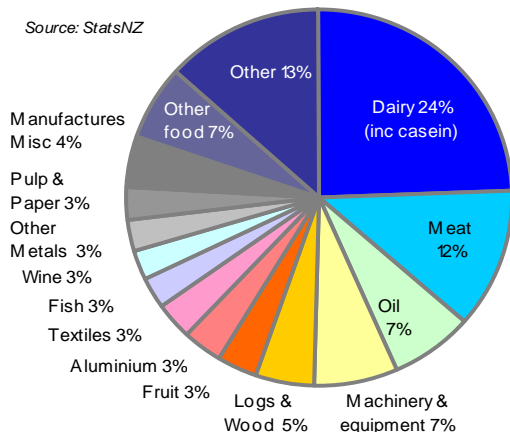
Nonetheless, some exports will fare better than others, as countries experience differing degrees of difficulty resulting from the financial crisis. The US, UK and Europe are ground-zero for the financial crisis, and exporters exposed to these regions are likely to face the largest challenges. Japan's economy is also struggling. In contrast, Australia's economy is expected to hold up comparatively well, with the recession forecast to be relatively mild.

Given the differences in markets, we have taken a closer look at NZ's export sector to evaluate how different industries can expect to fare through the next 12-18 months.

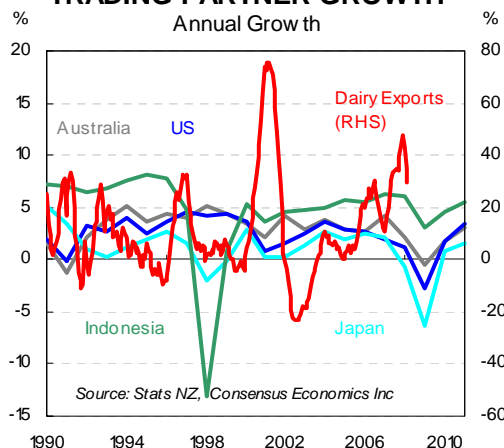
*How will different exports fare?*

Almost half of NZ merchandise exports are related to agriculture, where supply (in the short term) is more influenced by climatic factors. In these cases, the impact of the global recession will be felt mostly through lower prices than volumes. In addition, given agricultural exports' seasonal nature, prices are often negotiated in advance, resulting in a longer lag from weakening demand to weaker export receipts.

**EXPORT RECEIPTS 2008 BY TYPE**



**DAIRY EXPORTS AND KEY TRADING PARTNER GROWTH**



### NZ Dairy Exports

*Dairy has diverse range of export markets*

Dairy is our largest merchandise export earner, accounting for 24% of goods export receipts over 2008. Our dairy exports are sent to a wide variety of countries. 22 different countries account for 80% of dairy export receipts, and revenues are reasonably evenly spread between these markets.

US, Australia, Japan have traditionally been important markets. Emerging Asia-Pacific markets such as China, Indonesia, the Philippines and Malaysia have also become increasingly important. Over 2008 there was a prominent surge in dairy exports to oil-exporting countries such as Venezuela and Saudi Arabia. Strong oil prices over 2007 and early 2008 likely contributed to a strong increase in income, and in turn an increased demand for dairy products. The subsequent collapse in oil prices is likely to heavily weigh on income prospects for these countries, and the share of dairy exports to oil producers is likely to decline sharply over the next few years.

*Recent demand from oil exporters likely to go*

### Other Commodity Exports

*Meat exports concentrated, but prices holding up*

**Meat** was New Zealand's second largest merchandise export earner over 2008, accounting for 12% of export receipts. Meat exports are comparatively more highly concentrated, with 60% of exports sent to the Eurozone (mostly Germany, France and Belgium), UK and the US. Meat prices have held up well, despite the exposure to these markets.

*Fruit harvest strong, but export markets weak*

**Fruit exports** also have a large exposure to the European Market (40% of exports), as well as Japan (18%). Quality is a key determinant for price, which is dependent on growing conditions. Anecdotally, quality fruit has continued to command a premium in overseas markets despite the recession, although lower grade fruits have become difficult to sell. Apple growers are reporting a bumper season due to good autumn weather. Kiwifruit production is also well up on last year, recording strong exports early into the season. However, recent hail storms may have damaged some crops.

*Forestry related products vulnerable*

Asia Pacific is a key market for **log and wood exports** with 77% of export receipts coming from five key countries which include Japan, Australia, China, Korea and the US. The slowdown in global activity including housing construction, shipping and paper consumption has reduced demand for forestry products over the past year and these industries are likely to remain weak for some time.

*Oil production slowing, aluminium below capacity*

**Oil and Aluminium** are both important export earners, accounting for 7% and 3% of export receipts in 2008, respectively. Production from the Tui oil field in late 2007 accounts for oil's recent prominence. However, with production starting to slow and prices weak we do not expect oil to remain a key source of export earnings. Aluminium is produced at the Tiwai point smelter (owned by Rio Tinto) and the majority of exports are sent to Japan. The level of production is often affected by hydro-electricity supply. The plant is currently operating below capacity as international demand and prices remain weak.

*Wine exports sent to US and Australia*

**Wine** production dominates the beverages section of exports, which was 3% of 2008 export earnings. 40% of exports are sent to Australia, 23% to the UK and 19% sent to the US. Anecdotally, demand for high-end wines has fallen in the US, although demand remains for better-value products as consumers' preferences have changed. With much of NZ wine heading across to Australia, the vino industry should be relatively insulated by the lower NZD/AUD cross rate.

*Fish sent to Asia Pacific and EU*

**Fish exports** are sent all around the globe, with 6 key markets being Australia, Hong Kong, the US, EU, China and Japan. Like wine, fish exports are vulnerable to changing consumer preferences, and may be exposed should there be a material decline in demand for fine dining (particularly in Asian restaurants).

*Clothing and carpets sent to Australia*

**Wool** exports are a large portion of the textiles category and are mostly exported to China, EU and Australia. Prices have struggled against the large increase in global synthetic fibre production over recent years. The remainder of the textiles category mostly contains carpets and clothing, the bulk of which are sent to Australia.

*Manufactured exports mostly to Australia and US*

NZ's key **manufactured exports** are typically classed as Mechanical Machinery and Equipment, or Electrical Machinery equipment, and combined make up 7% of exports (miscellaneous other manufactures contribute another 3%). The bulk of manufactured exports are sent to Australia (40%) and the US (14%); the EU, UK and China are also important.

*Exports of services to fall on lower visitor arrivals*

**Tourism** is another very important foreign currency earner across a wide range of service sectors. Exports of services accounted for 25% of all exports over 2008 compared with 18% for dairy. Visitor arrival statistics can give an overview of key markets for NZ tourism, although a breakdown of total dollar spend by visitors' nationality is not available. Research suggests that travellers from longer-haul routes tend to stay longer and spend more per visit, although visitors from shorter routes are more likely to make frequent trips to NZ. That being the case, Australians accounted for 40% of all visitor arrivals over 2008 and we expect that visitor arrivals from Australia to remain reasonably firm. However, we expect to see a sharp decline in the number of visitors from the Asia, UK, Europe and US over the next 12 to 18 months. Tourists from these destinations tend to have a much higher spend and the decline in arrivals from these destinations is likely to have a larger impact on the tourism industry.

#### The economic outlook for our top 5 trading partners:

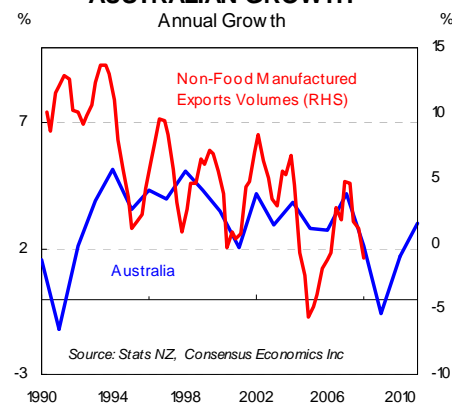
*Australia recession to be relatively mild*

**Australia** is our largest market for exports, and is forecast to experience a relatively mild recession. Australia benefits from a very strong fiscal position, allowing the government to act generously with fiscal stimulus. In addition, monetary policy has been very effective in Australia. The majority of Australian mortgages are on floating rates, such that rate cuts (425 basis points to date) have a very immediate effect on household disposable incomes.

*US economy centre of financial crisis*

The **US** is NZ's second largest export destination and has been at the centre of the financial crisis. GDP is forecast to contract 2.7% over 2009, with consumer spending falling 1.5%. 5.7 million workers have lost their jobs since December 2007 and the unemployment rate is likely to exceed 10%. Consumer demand is not expected to make a strong recovery over the next few years, as households rebuild balance sheets and increase savings.

#### NON FOOD MANUFACTURES AND AUSTRALIAN GROWTH



*Eurozone demand weak unemployment 10%+*

**The Eurozone** is another key trading partner at the centre of the financial crisis fall-out. 2009 GDP is forecast to contract 3.4%, followed by a very weak recovery over 2010 (+0.3%). The unemployment rate is expected to rise from 7.6% to 10.2%. Consumer confidence remains weak as household wealth has fallen and the labour market continues to deteriorate.

*Japan badly effected by global weakness*

**Japan** has been hit hard by the global recession, in particular industrial production and exports have dropped dramatically as global demand for Japan's products has retrenched. 2009 GDP is expected to contract 6.3% (effectively wiping out the past 5 years of growth), and 2010 GDP is forecast to grow a mild 0.8%. Unemployment is expected to rise from 4% at the end of 2008 to 5.6% by the end of 2010. Japan's fragile domestic economy and government debt burden has left it vulnerable to the external demand shock.

*China vulnerable as exports decline*

**China's** rapid integration into the global economy has seen strong economic growth and rising incomes. In turn, China's growing middle class has made it an increasingly important trading partner and a key market for many of our commodity exports such as dairy, fish, logs and wool, as well as some electrical machinery. China's industrial sector and exports have been exposed to the fall in demand from US and Europe. China's future growth prospects depend on the ability for domestic demand to remain firm without the support of the export industry. Chinese growth is expected to slow rapidly, from 11.2% per annum in 2007 to just 6.1% in Q1 2009. Although this pace of growth seems high, in reality it reflects a sizable demand shock which threatens ongoing urbanisation and the rising number of middle-class households, which have been a key driver of rising demand for NZ commodities, particularly dairy.

*Outlook for oil exporters very weak*

**Oil exporting nations:** Venezuela's economy is heavily dependent on oil. Since oil prices have fallen, export earnings, private consumption and investment have collapsed. The pace of annual GDP growth slowed to 3.2% in 2008 (from 8.5% a year earlier). The Economist Intelligence Unit predicts GDP will decline 5% in 2009 and 5.4% in 2010. Saudi Arabia is expected to fare slightly more favourably: 2009 GDP is forecast to remain flat (but risks remain to the downside) with 3.3% growth over 2010 (Source: Economist Intelligence Unit).

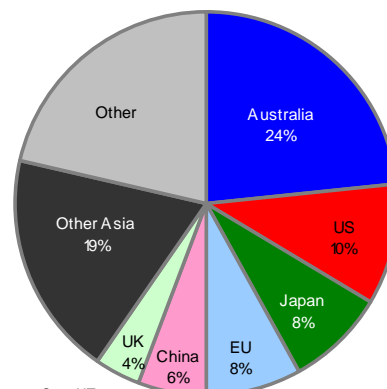
**Summary**

Despite dairy exports to a diverse range of trading partners, the global nature of the financial shock has affected dairy prices severely, with global supply dynamics exacerbating the impact of weakening demand. Forestry-related products also stand out as one of the most exposed industries, with global residential construction likely to remain weak for some time.

Meat and Fruit exports are exposed to the European and UK markets. However, prices have fared comparably well, suggesting demand for these products in these particular markets has been less sensitive to weakening income prospects. For other products, such as wine and seafood, the outlook for the industry depends on its flexibility and ability to react to changing consumer preferences.

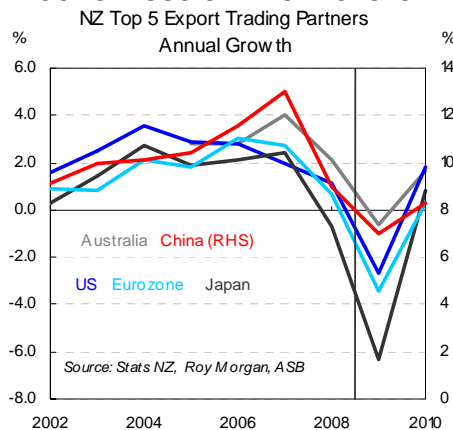
Meanwhile, although we still expect manufactured exports to decline, the fall will be reasonably modest given the concentration of manufactured exports sent to Australia.

**EXPORT RECEIPTS 2008 BY DESTINATION**



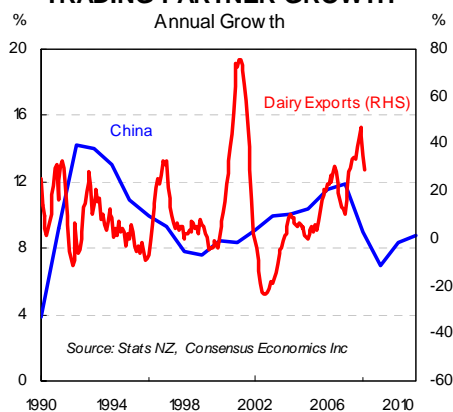
Source: StatsNZ

**CONSENSUS GDP FORECASTS**



Source: Stats NZ, Roy Morgan, ASB

**DAIRY EXPORTS AND KEY TRADING PARTNER GROWTH**



Source: Stats NZ, Consensus Economics Inc

### International policy response

*The worst recession since the 1930's*

The link between financial markets and economic performance – fuelled by the dual crises of credit and confidence – has ensured the downturn is the worst global recession experienced since the Great Depression. The Federal Reserve Chairman Ben Bernanke was a pioneer on research on such matters in the early 1980s when he proposed the idea that financial markets could significantly amplify booms and busts. He found that widespread failures by banks could aggravate a downturn, as could a decline in creditworthiness by consumers or businesses, leaving them unable to borrow. Bernanke used this “financial accelerator” theory to explain the severity of the Great Depression. Against this background, and taking heed of the astounding scope of initiatives the Fed has implemented in the past year to support the function of financial markets, it is entirely clear that Bernanke and his colleagues have been more than wary of the beast they are dealing with for some time.

*US problems permeate in 2008.*

Developments from mid-2008 confirmed once and for all that the global credit problems had expanded out of the US housing market and financial sector, and permeated into the global economy. The global growth outlook deteriorated substantially. Central banks went into crisis control, slashing interest rates and providing liquidity to an extremely stressed financial system. The strain caused several high profile international banking collapses and government rescue packages have been implemented to keep other banks operating. In early October 2008 central banks and governments took the ultimate step to reassure savers by providing guarantees for bank deposits.

*Central banks in crisis control.*

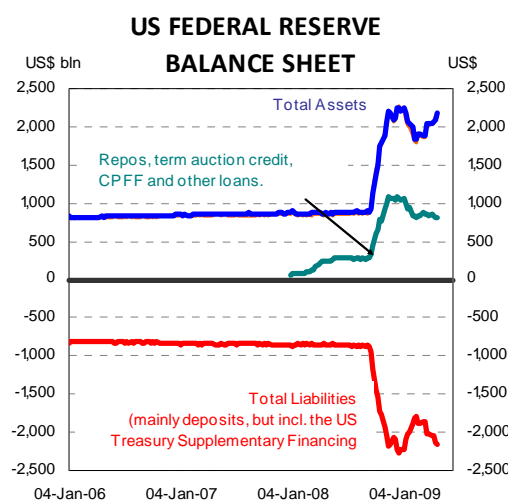
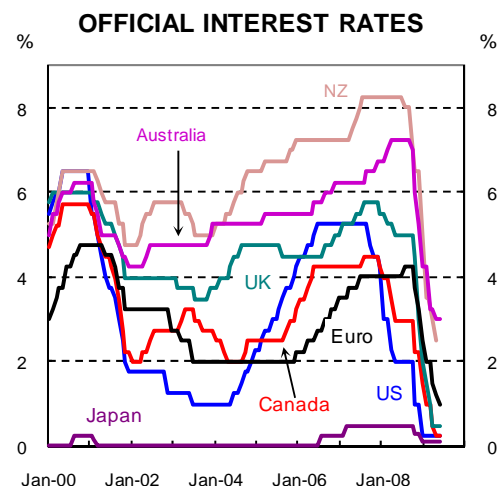
Sharemarkets around the world plummeted over 2008, triggering comparisons to the Great Depression. The comparison is valid when talking about the magnitude of share price falls to date, but not when comparing the state of the global economy or the response from policymakers. It is widely acknowledged that key policy responses in the 1930s were in hindsight inappropriate. As a consequence, unemployment rates exceeded 25% in many economies during the Great Depression, international trade halved and the contraction in global economic activity was huge. The policy responses to the current crisis have on the whole been timely, positive and appropriate. Unemployment is nowhere near as bad as in the 1930s and the economic contraction to date is mild in comparison.

### Quantitative easing: what are central banks actually doing?

*Central banks employ new measures.*

Having cut key interest rates as low as practically possible, central banks need to use alternative policies to stimulate economies. Quantitative easing is the expansion of a central bank's balance sheet. The aim is to improve credit conditions, increase the money supply, and stimulate the economy. The central bank provides more cash into circulation by exchanging cash for securities such as bonds or mortgage-backed securities, which are then held by the central bank. The aim of the asset purchases is to drive down long-term bond yields and influence (lower) the cost of private sector debt raising. To date quantitative easing is being used in UK and US. The ECB has also decided to purchase certain euro-denominated bonds later in 2009. The measures have had some success, including lowering US long-term mortgage rates, but are now battling against pressures being put on long-term interest rates by the accelerated pace of government bond issuance.

*Quantitative easing occurring in UK and US, and in Europe soon.*



In New Zealand, the RBNZ still has room to move the OCR lower, but in April tried to influence long-term rates. By both cutting 50bp and implicitly committing to keep the OCR low into the "latter part of 2010" the RBNZ aimed to shape interest rate expectations held by businesses, households and market participants alike.

### **Governments open the cheque books**

*Keynesian  
policy  
responses.*

With monetary policy reaching conventional limits, a lot of hope rests on old-fashioned Keynesian fiscal policy. Obama's government delivered an \$825 billion economic recovery package, constituting a whopping 6% of GDP – unprecedented on every scale and blowing the Bush \$168 billion package out of the water. Obama's plan involved \$550 billion in new spending and \$275 billion in tax cuts. Other governments also delivered combinations of tax cuts and spending initiatives to stimulate activity (one exception being an increase in the top UK personal tax rate). There is one constraint on how much governments can do: they have to pay for it. Governments need to find a balance between providing more fiscal help in an attempt to lift economies from recession in the short term, against the need for medium to longer-term fiscal sustainability. The borrowing and debt numbers for the UK and US governments are somewhat disturbing, particularly if the recovery process is more drawn out than currently forecast. In New Zealand, the Government's ability to spend has been curbed somewhat by the possibility of a sovereign credit rating downgrade.

*PPIP plan to  
buy toxic  
assets.*

### **Toxic Assets**

"Toxic assets" entered our vocabulary as a financial term during the latest crisis. Some complex financial assets held on bank balance sheets have become difficult or impossible to value as there is no longer a functioning market for these assets. Holding "toxic" assets has been the downfall of several financial institutions during the crisis. In March 2009 U.S. Treasury Secretary Geithner announced a plan to buy toxic assets from banks' balance sheets. The Public-Private Investment Program has around \$500 billion – with the potential to expand to \$1 trillion – to buy the toxic assets from banks in conjunction with private investors, in order to help the banks function more normally again.

*US Banks pass  
stress tests.*

### **Stress tests**

The Supervisory Capital Assessment Program, commonly referred to as the Bank Stress Tests was a three-month assessment of the largest US banks. The program revealed a \$75 billion shortfall of capital to be recouped by 10 of America's 19 biggest banks that were under scrutiny. The number doesn't sound like much given the IMF's estimate that write-downs from US loans and securities will total \$2.7 trillion before the crisis is over (though that includes those to date). Unsurprisingly, questions are being raised over some of the loss assumptions and whether they are too optimistic.

*Searching for a  
new growth  
driver.*

### **Where are we now? Households deleveraging**

RBA Governor Glenn Stevens delivered a key speech in April entitled "The Road to Recovery".

*"So to the extent that strong global growth relied on advanced country consumers lowering their saving rates, absorbing the export surpluses of the emerging world, and accepting higher debt burdens, the model is broken. Of course, the most important matter in the immediate term is for the US economy to resume growth. But even when it does, the reality is that for some time ahead, advanced country households will be looking to lower their debt burdens and save more of their income. They will not be the same spur to consumption growth as they were."* RBA Governor Glenn Stevens.

The recovery process for western economies will be long and arduous. After the recent excesses it will take a long time for the associated imbalances to unwind. An increased propensity of households to save means that we are probably years away from a return to pre-crisis consumer spending growth rates. Furthermore, the global nature of the current recession makes it difficult for countries to break out of recession through higher exports or to smooth consumption through foreign borrowing. Nevertheless, signs that the free-fall in economic activity seen in 2008 may be nearing an end are reassuring and provide the groundwork for an eventual, gradual recovery. But downside risks to growth and heightened uncertainty remain, and mean the widespread and unorthodox policy measures in place will be maintained for some time, and measures will be stepped up where possible if deemed necessary.

## The New Zealand Economy

*NZ economy to remain in recession over much of 2009.*

2009 marks the second year of recession for New Zealand. The recession remained relatively mild over 2008 until the last quarter, which saw GDP contract sharply. We expect further sizable declines in the first half of 2009, and then mild falls over the second part as the NZ and the world economies begin to find their feet. Growth will slowly resume over 2010, as the world continues to work through its financial issues. Recessions triggered by financial crises tend to have slower recoveries, reflecting the shift in behaviour by consumers and investors.

### Global recession hits export sector

*Global demand to remain very weak*

Export volumes are expected to continue to struggle against the weakening global demand backdrop. We expect the GDP of our main trading partners to contract by 2.5% over 2009 and we expect the recovery over 2010 to be very modest. The global nature of the shock will make it difficult for NZ to stage an export-led recovery. In addition, the NZD has lifted off its lows and can no longer be relied to enhance the competitiveness of NZ exports (although the rate against Australia does remain favourable).

*NZD off lows*

*Export volumes to continue falling*

Export volumes have fallen steadily over the past year, with the weakness centred in manufacturing and services. Tourism revenues have declined as the composition of arrivals shifts away from Asian, US and European visitors towards Australian visitors (who tend to have shorter trips). We expect further weakness in manufacturing and tourism, although note that agricultural-related exports have remained reasonably robust due to solid production volume growth.

### Housing market shows signs of life

*Housing market stabilises*

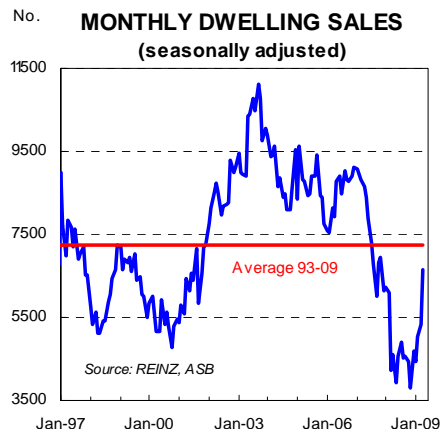
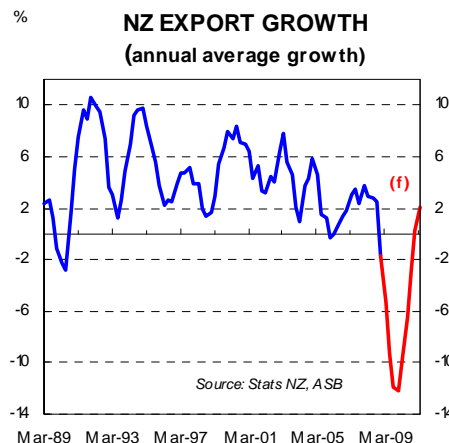
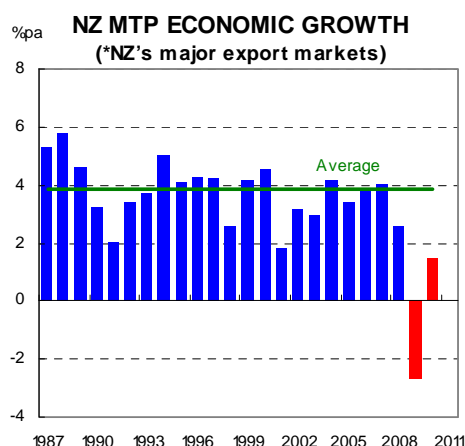
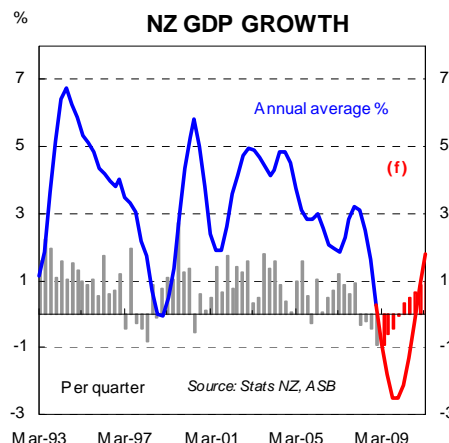
Low mortgage rates have finally helped the housing market stabilise, with house sales bottoming out earlier this year. A rush to lock in low rates in late March/early April has provided a boost to house sales over this period. Mortgage approvals have since slowed; nonetheless we expect demand to improve.

*Prices close to the bottom?*

Housing turnover typically leads house prices by 6 months, so the recent stabilisation suggests house prices may be close to the bottom. Nonetheless, the fundamentals for the housing market remain soft. Population growth, although picking up, remains relatively subdued. In addition, house prices remain high relative to incomes and rents.

*Construction activity to remain low in 2009*

The lags to housing construction are longer and residential building is likely to continue to contract over the short term. However, the recovery in population growth, pick-up in housing demand and stabilisation in house prices should help housing construction activity



find a floor by the second half of 2009.

**Consumers cautious**

*Consumer change spending patterns*

Over the past six months households have started to change shopping patterns. Household finances have been propped up by falling mortgage rates, lower petrol prices and tax cuts. However, offsetting the positive cash flow is the increased uncertainty on the employment outlook. The labour market has deteriorated noticeably, with unemployment rising and income growth prospects weakening. Combined with a weakened asset position (falls in house and equity prices), consumers have become more cautious with large purchase decisions, particularly vehicles. We expect this behaviour to continue and that consumer spending growth will remain subdued over 2009 and recover only gradually in 2010.

*Households more cautious, big purchase decisions put on hold*

**Business investment still on hold**

*Investment intentions continue to fall*

Slowing activity, falling profitability and increased uncertainty have seen business investment plans put on hold. In addition, the fall in the NZ dollar makes imported equipment less affordable. Non-residential investment has already started to slow noticeably over the past two quarters, led by declines in transport and plant and machinery. Going forward we expect these declines to be added to by declining non-residential building investment (although consents have held up relatively well to date). The long lags in business planning will see business investment continue to decline through out 2009 and early 2010, despite the recovery in business sentiment expected over the second half of this year.

*Plant & machinery and transport investment already falling*

Providing some offset to the decline in business investment will be government investment through a range of infrastructure projects.

**Labour market lags**

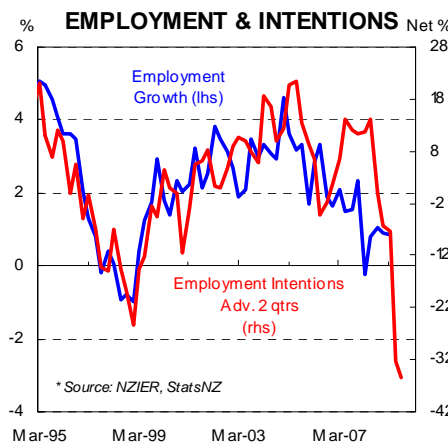
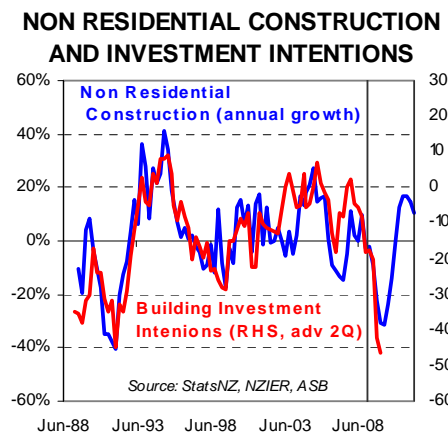
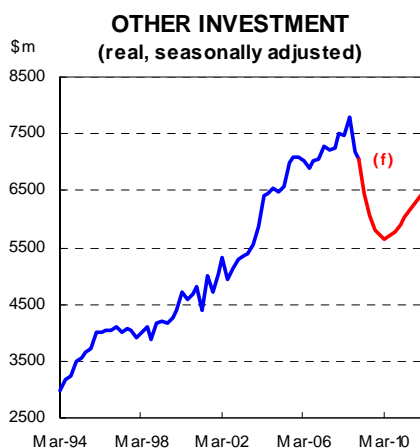
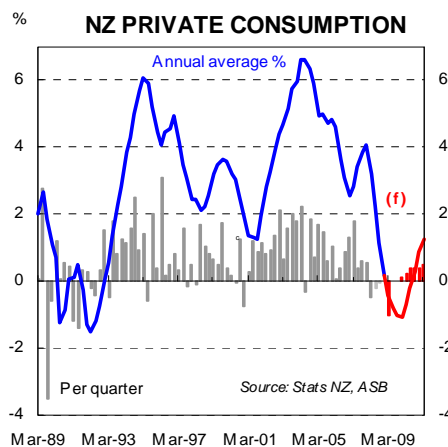
*Labour market lags economic activity*

The labour market is traditionally a lagging indicator to economic growth. Firms tend to hoard labour in the early stages of a downturn, only reducing the size of the workforce as a last resort. But on the up cycle, firms tend to be more cautious with hiring plans when activity recovers. Firms often extract additional productivity from the existing work force, waiting to confirm the pick-up in activity will be sustained to warrant additional hires.

*Unemployment continues to rise, even as economy stabilises*

This inherent lag means that NZ's labour market will remain weak and unemployment will continue to rise, despite signs of 'green shoots' emerging. The work force contracted 1.1% percent over the first quarter of 2009, lifting the unemployment rate to 5.0%. We expect the unemployment rate will approach 8% by the end of 2010.

The weakening in labour demand and falling inflationary pressure will contain wage inflation over the foreseeable future.



### OCR low for an extended period

*Inflation to settle in bottom half of target band*

The subdued economic environment will contain inflation pressures over the next couple of years. Inflation is likely to sit in the bottom half of the 1% to 3% target band for an extended period, aided by considerable falls in non-tradable inflation under the pressure of a weak economy. That environment gives the RBNZ ample scope to keep interest rates low.

*RBNZ implicitly committing to long period of low OCR*

The RBNZ has increasingly realised the need to keep interest rates low. At its April Official Cash Rate Review it implicitly committed to keeping the OCR at a low level until "the latter part of 2010". That commitment has been made to influence interest rate expectations held by businesses, households and market participants alike. If people are more convinced that short-term interest rates will remain low for a long period that will help to cap or reduce long-term rates. One, borrowers will be less likely to chase long-term fixed rates in the immediate future, reducing demand for them. Two, term rates are in part influenced by expectations of where shorter-term rates are likely to average over time.

*After triggering a stampede to fix rates in March*

The move is a change in tack after the RBNZ's March statement, in which the RBNZ attempted to rein in expectations of further rate cuts. In an environment in which long-term interest rates were already rising, the RBNZ's March actions spurred a stampede of borrowers wanting to fix their debt for long terms. As a result, long-term rates lifted dramatically and have struggled to retreat since. That tightening in monetary conditions was compounded by the lift in the NZ dollar on improved global sentiment.

*RBNZ still likely to need to cut the OCR to help contain interest rates*

Over time the RBNZ's commitment should help contain long-term interest rates, though other influences also matter. We do expect the RBNZ will supplement its commitment by eventually reducing the OCR to 2%. However, it is increasingly likely to pause in June and any further cuts will depend heavily on events.

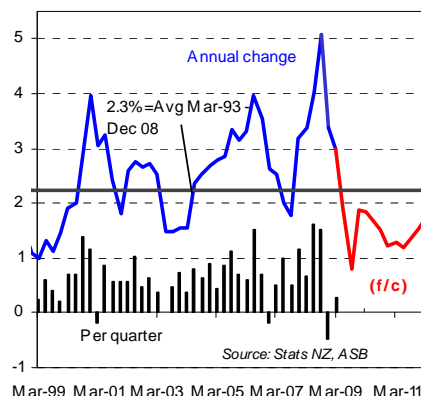
*Choice of fixing vs. floating involves a clear trade-off*

The message for borrowers is there is no real hurry to fix rates since the door on very low long-term rates slammed firmly shut at the end of March. The choice of fixing vs floating will remain a trade-off between the low debt-servicing costs in the immediate future of floating rates against the certainty of (higher) fixed rates. The RBNZ has given a little more certainty over how long the benefits of floating rate debt will be sustained. More detailed considerations for borrowers are contained in our [Home loan rate report](#).

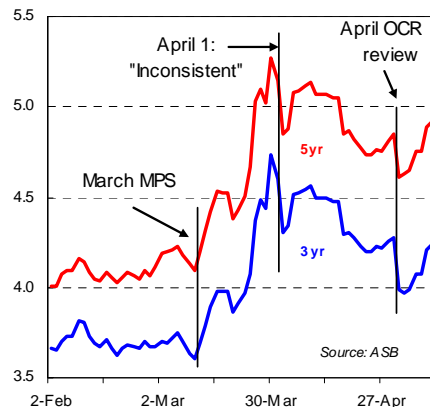
*Deposit rates may not fully reflect any further OCR cuts*

Deposit rates will remain subdued until the RBNZ starts reversing the extraordinary degree of interest rate cuts. However, deposit rates may not fully reflect the impact of any further OCR cuts as rates will need to remain sufficiently competitive relative to other riskier investment alternatives.

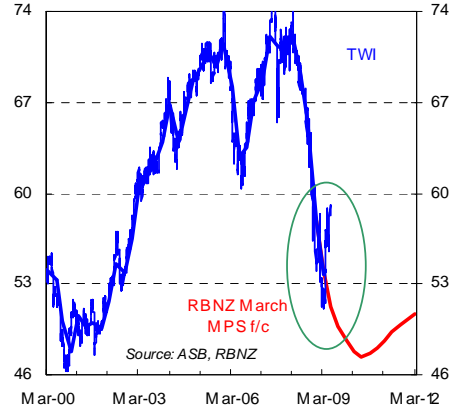
**NZ CPI INFLATION**



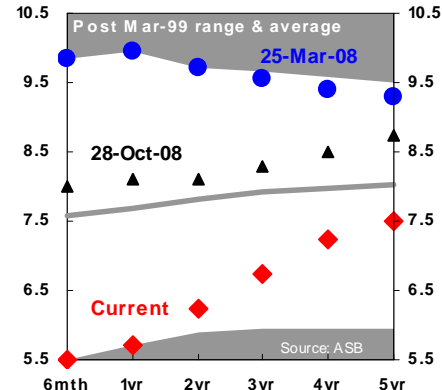
**NZ SWAP RATES**



**NZ TRADE WEIGHTED EXCHANGE RATE**



**NZ HOME LOAN RATES**



**Other measures might be needed**

*RBNZ faces dilemma as OCR loses potency*

The RBNZ does face a quandary: if it wants to deliver more stimulus, how will it do it? The OCR is losing its ability to directly influence short-term rates, with retail deposit rates starting to get sticky.

Other options include intervention to push down the NZ dollar, purchasing of long-term bonds (financed either by issuing short-term debt or creating additional money), or transacting in the interest rate swaps market. But all of these alternatives carry economic risk (e.g. inflation in the case of creating money) or expose the RBNZ to financial risk (there is no guarantee the RBNZ could extricate itself without loss).

As of May the RBNZ still has some scope to move on the OCR, and the traditional central bankers' tool will remain the first port of call.

**An eventual reversal**

Interest rates will not remain low indefinitely: at some point the RBNZ will want to reverse the considerable stimulus put in place. The RBNZ's commitment to keeping interest rates low is not cast in stone, made more for influence than from intent. The exact words were "we expect to keep the OCR at or below the current level [2.5%] through until the latter part of 2010". Ultimately, the time for higher interest rates will come when the economy is clearly on the mend and the inflation outlook is no longer benign.

**NZD: wax and wane, higher by year-end**

The NZD lifted over March on the "green shoots" optimism that saw equity markets swiftly reverse their February plunge. The reasons for the recent lift were similar to some of those underpinning our expectation that the NZD/USD would rise over the second half of the year.

Over the next few months the NZD will likely wax and wane in line with sentiment shifts: the path to global economic recovery is unlikely to remain smooth sailing the whole way. The risk of a sovereign credit rating downgrade in coming months is low, but does exist.

The challenge for the exchange rate outlook is that structurally NZ would benefit from a low exchange rate to assist rebalancing to more exporting and less domestic consumption. However, that argument goes equally for other countries such as the UK, Australia and the US. Moreover, the USD may lose some of its gloss as a safe haven and reserve currency.

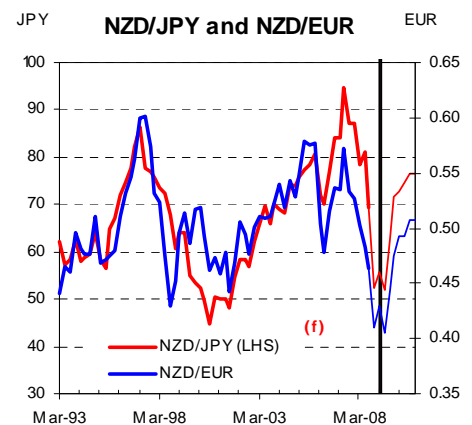
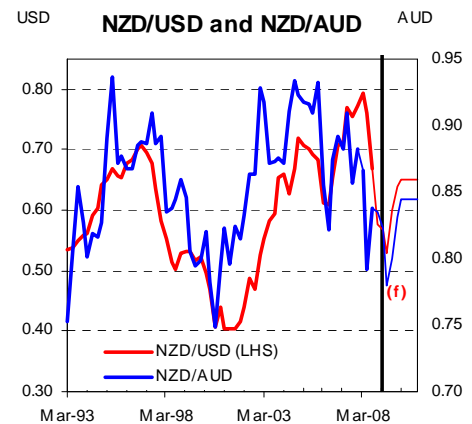
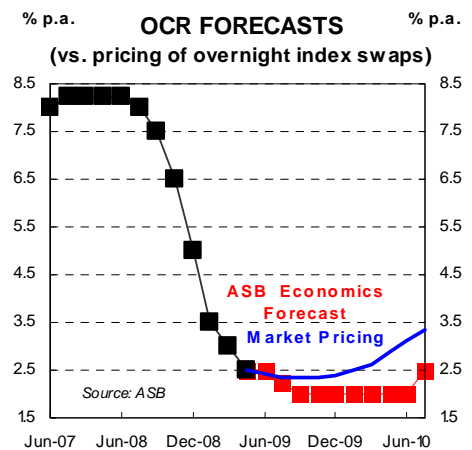
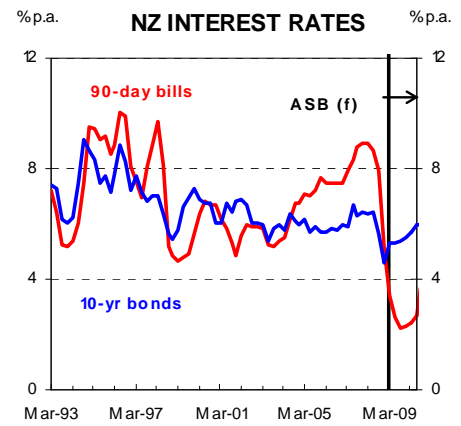
Weighing up various influences, we see a greater likelihood that the NZD/USD does appreciate further later in 2009, as the global economy does start to turn around. Against other key currencies the NZD is likely to appreciate but to a more modest extent: the NZD will leverage off the global recovery and NZ is in a relatively good position compared to a number of major economies.

*OCR will eventually rise: economic background will dictate timing*

*NZD buoyant on global "green shoots" optimism*

*Structurally NZ would benefit from a low NZD*

*NZD likely to trend up later in 2009*



**ECONOMIC FORECASTS**

ASB economic forecasts		Sep-08	Dec-08 << actual	Mar-09 forecast >>	Jun-09	Sep-09	Dec-09	Mar-10	Mar-11	Mar-12
<b>NZ GDP real</b>	AA%	<b>1.7</b>	<b>0.2</b>	<b>-0.9</b>	<b>-1.8</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.1</b>	<b>1.8</b>	<b>3.6</b>
private consumption	AA%	1.2	0.2	-0.4	-0.8	-1.0	-1.1	-0.7	1.2	2.1
dwelling construction	AA%	-8.7	-17.3	-25.2	-30.1	-32.5	-30.0	-23.6	7.9	11.8
other investment	AA%	4.0	0.9	-3.3	-11.1	-15.4	-18.6	-18.5	0.9	8.6
exports	AA%	2.5	-1.7	-5.3	-9.3	-11.9	-12.1	-9.8	2.1	5.0
imports	AA%	7.8	2.6	-3.8	-11.6	-16.0	-16.9	-14.1	1.4	4.6
NZ GDP real	A%	-0.1	-1.9	-2.5	-2.8	-2.8	-2.0	-0.8	3.0	3.6
NZ GDP real	Q%	-0.5	-0.9	-0.9	-0.6	-0.4	-0.1			
NZ CPI	Q%	1.5	-0.5	0.3	0.5	0.4	0.6			
<b>NZ CPI</b>	<b>A%</b>	<b>5.1</b>	<b>3.4</b>	<b>3.0</b>	<b>1.9</b>	<b>0.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.3</b>	<b>1.7</b>
NZ house prices (QV index)	A%	-6.7	-8.9	-10.0	-7.5	-5.9	-3.5	-0.8	1.7	2.4
NZ unemployment (sa%)	Qtr	4.3	4.7	5.0	5.6	6.0	6.6	7.0	7.8	7.4
NZ private sector wages (LCI)	A%	3.7	3.2	3.1	2.9	2.4	2.2	2.0	1.6	2.2
NZ current account (\$b)	Yr	-15.5	-16.1	-15.1	-13.5	-12.3	-11.6	-11.0	-9.2	-8.6
as a % of GDP	Yr	-8.6	-8.9	-8.6	-7.7	-7.1	-6.7	-6.3	-5.2	-4.6

A% = percentage change since same quarter the previous year

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

**FINANCIAL FORECASTS**

ASB interest rate forecasts (end of quarter)	Sep-08	Dec-08	Mar-09 << actual	Jun-09 forecast >>	Sep-09	Dec-09	Mar-10	Mar-11
NZ cash rate target	7.50	5.00	3.00	2.50	2.00	2.00	2.00	4.50
NZ 90-day bank bill	7.96	5.11	3.38	2.7	2.3	2.3	2.4	5.0
NZ 3-year swap rate	6.76	4.92	4.52	3.8	3.9	4.4	4.8	6.1
NZ 10-year gov't stock	5.65	4.62	5.32	5.3	5.4	5.5	5.7	6.0
ASB foreign exchange forecasts (end of quarter)	Sep-08	Dec-08	Mar-09 << actual	Jun-09 forecast >>	Sep-09	Dec-09	Mar-10	Mar-11
USD per NZD	0.668	0.578	0.568	0.53	0.60	0.64	0.65	0.65
GBP per NZD	0.371	0.401	0.399	0.37	0.39	0.41	0.41	0.41
AUD per NZD	0.837	0.835	0.823	0.78	0.80	0.83	0.84	0.84
JPY per NZD	69.5	52.2	55.7	52	63	72	73	77
EUR per NZD	0.464	0.411	0.429	0.40	0.44	0.47	0.49	0.51
TWI	63.3	56.3	57.0	53.4	59.5	63.8	65.1	66.2

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

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