

# New Zealand Outlook

## Monetary easing started



- **Slow NZ growth over 2007.**
- **Monetary easing has started via the exchange rate.**
- **But lack of spare capacity likely to constrain growth over 2008 and 2009.**

The NZ economy has slowed down, the growth rate having declined quicker and further than expected. Output was down in the December quarter, albeit slightly, with GDP contracting 0.1% over the quarter. Although the March quarter appears to have been slightly stronger, the economy is growing far slower than the 3-5% per annum growth rate observed between 2001-2004. This realisation begs three questions:

- is the slowdown 'only' cyclical?
- how slow will the economy be in the near-term?
- when will the RBNZ react to this slowdown?

The answer to the first question remains yes. There are at least three reasons to believe that the NZ economy will do well over the next 5-10 years: the generally appropriate policy mix, laid down by the reforms of the 1980s and 1990s; the strong population growth rate likely to accompany 45,000-odd immigrants per year; and the proximity of NZ to the fast-growing economies of Australia and Asia.

The usual lead into the next growth phase typically comes from lower interest rates and exchange rates. This process has started already. The latest exchange rate depreciation is extreme (-16% since late 2005, only matched by a similar depreciation in mid 1988). The interest rate part of the equation is more complicated. Inflation pressures within the economy are intense, and made worse by the falling exchange rate boosting the price of imports. These pressures have meant the RBNZ have kept the Official Cash Rate at 7.25% since December 2005, and at this stage look set to keep it there for all of 2006. And with inflation pressures globally on the rise, other central banks are also raising rates. Long-term global rates are the dominant driver for local long-term rates. Global rates have been rising, and this is putting upward pressure on our interest long-term rates, despite the local slow-down. When the RBNZ begins their easing cycle will depend on how deeply the economic slowdown becomes. At this stage it is mild. Reasons to believe it remains mild include: there is a fiscal expansion underway; a large part of the slowdown to date has been a stock adjustment; the global growth rate remains strong; net migration remains an inflow; the labour markets are still tight and hence job losses are few; and wage rates are still rising rapidly.

It is this later factor, plus the lower exchange rate, that will slow any consumer price deceleration. And hence slow the RBNZ response to any output decline.

Our forecasts can be loosely summarised as:

**2006** – Continued low growth with declining exchange rates and eventually interest rates.

**2007** – The initial recovery year, probably only moderate at first given a slow RBNZ response in 2007 but gathering pace as the RBNZ continues to ease.

These forecasts are based on judgements about the current forces at play and the likely policy response.

Beyond that it is more a matter of portraying a scenario that captures some of the major pressures – a constrained NZ economy, a possible NZ fiscal adjustment and some global rebalancing beyond the current growth momentum – rather than simply show a reversion to mean (the common forecast but one that rarely happens). The following scenario captures these forces:

**2008** – a growth spurt, normal after a slowdown and also coming to be expected in election years;

**2009** – if a fiscal tightening does not take hold then a global recession might (it would now be eight years since the last US recession and far enough ahead to question whether the current global growth momentum can be sustained), plus it will be difficult to sustain above-average NZ growth if the current slowdown does prove moderate (and hence less spare capacity is created).

**2010** – the start of the next growth wave.

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In other words, envisaged is a moderate slowdown in the near term, followed by a 'false' recovery; the latter a reflection that, first, global shocks happen around 1-in-6 years and, second, that the local economy is unlikely to make any sharp adjustment to free resources in the next 12 months.

### International economies

*Global growth momentum intact*

The global growth momentum remains intact, a remarkable feat given the global imbalances evident in the US current account deficit, the large US interest rate adjustment of recent years and the sharp oil price shock that has occurred. Growth rates amongst the major economies are expected to be similar this year to those of 2005.

*Australian growth also moving to above 3% p.a. again*

Importantly for NZ, the Australian economy is expected to accelerate another notch this year after the slowdown of 2004.

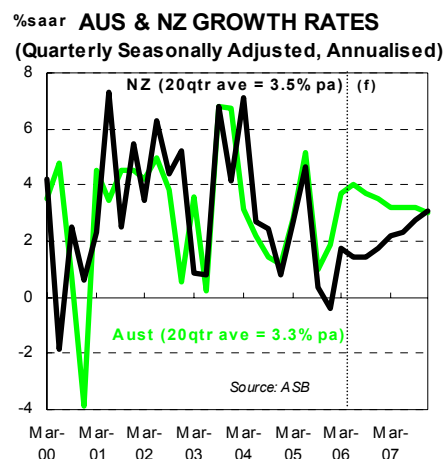
The driving force for Australian growth is the strong global economy and, in particular, stronger commodity prices, in turn encouraging business investment.

Some consumption pickup is also likely given increasing jobs and rising wages.

The 2.7% average Australian inflation rate of the last four years is expected to be repeated in 2006 and 2007.

*Strong global growth removes one major NZ risk*

This strong global economy – and stronger Australian economy – is important in the context of slowing NZ growth.

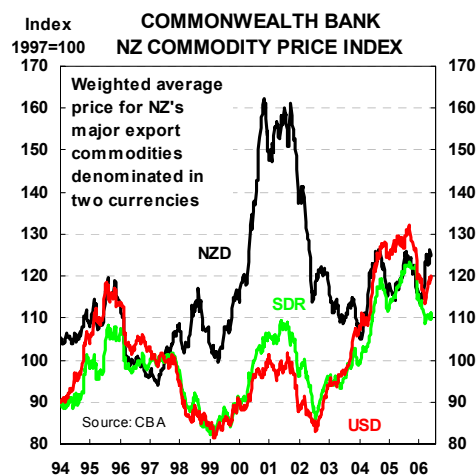


Research shows that global shocks play a key role in the NZ business cycle. In particular, global recessions or difficulties can quickly translate into local problems. Recent examples include the Asian crisis of 1997-1998 and the global recessions around 2001. In the Asian crisis the local slowdown was worse due to a number of local factors including two droughts and tight monetary policy. Conversely, the effects of the 2001 global slowdown were mitigated by favourable weather, strong export prices and accommodative monetary policy.

*Allows lower NZ dollar to feed through to higher prices and/or volumes for most exporters*

At present there is no global slowdown; global growth is high. A slowdown will probably reoccur during the 5-year forecast horizon – the IMF puts the average cycle at 6 years including 1 year of recession – but that is not a major near-term risk.

Hence, export demand, in general terms, should remain strong, allowing NZ exporters to benefit from the recent NZ dollar depreciation. Although that does not prevent some slippage in international prices for some commodities (e.g. dairy and lamb recently).



### The New Zealand Economy

*NZ growth rate has slowed. Three cyclical factors impacting.*

In contrast to the global trend, the NZ economic growth rate is low. The bigger picture remains one of a moderate slowdown, rather than a recession. There are three major elements to the current slowdown: lower export income and/or export profitability, largely due to the high NZ dollar of recent years; some peaking in the investment cycle (cars, plant and equipment); and a move to a less frenzied state of construction.

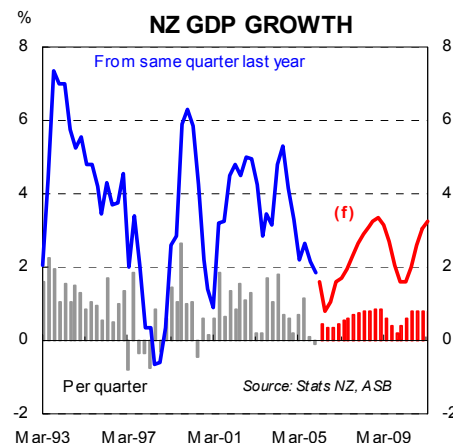
*But also a number of positive driving forces*

This is yet to show as a major loss of jobs. And is unlikely to short of a further shock given the widespread shortage of labour still being reported. Meanwhile the exchange rate depreciation to date provides some stimulus. And a sizeable fiscal impulse is also underway (estimated equivalent to 1% p.a. of GDP in the current and next three years).

*Suggests moderate slowdown*

These are reasons to believe that output growth will occur in the next few quarters and that, given an expected RBNZ easing in early 2007, output growth will accelerate through next year.

However, two intertwined factors suggest that the eventual recovery will be moderate also, and possibly chequered: first, a moderate slowdown is unlikely to free many resources for subsequent use in future production; and, second, the recent history of productivity growth in NZ is poor. Combined these factors point to limited growth potential for NZ in the next 2-3 years.

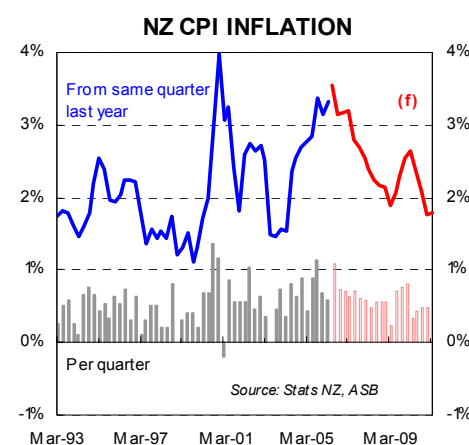


*But also a moderate pickup in 2007-2009*

The same constraints, especially in the face of an eventual demand push and higher export/import prices, imply a persistent inflation pressure also, possibly reduced significantly only after 2 years of sub-3% growth (to mid 2007) and an eventual NZ dollar rebound (2008).

The same forces also imply a sustained large current account deficit.

The implied average growth rate over 2005-2007 of 2% – and the coincident fiscal loosening – does raise the probability of some change in government policy after the 2008 election. This is one of several reasons to suggest another period of slow growth around 2009.



*Short-term growth prospects low...*

In sum, in the short-term, the correction of the imbalances within the economy will most likely lead to a period of modest growth over 2006. The usual lead into the next growth phase typically comes from easing monetary conditions, from lower interest rates and exchange rates. This process has started already, via the exchange rate. Interest rates should likewise ease over the next 18 months as inflationary pressures start to reduce.

*...but the long-term prospects remain healthy.*

An adjustment process is now taking place, and the long-term outlook for the New Zealand economy remains healthy.

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