

# Quarterly Forecasts

## Seeking balance



- **Global growth is strong and a NZ recession has been averted**
- **But risks do abound, both globally and locally**
- **The likely outcome is a slow NZ recovery and possibly a chequered few years**

New Zealand has shown that it can achieve a fast growth rate. It will likely resume strong growth again given its fast population growth, its close links with fast-growing economies and its relatively supportive policy framework. But there is a likely to be a drawn out period of adjustment ahead.

Already the growth rate is slow (an estimated average of 0.4% per quarter in the last four quarters). The high inflation rate and the large current account deficit suggest that monetary conditions will remain sufficiently tight to ensure that growth remains low until well into 2007. And even then, the subsequent recovery may be either muted or chequered, effectively due to a lack of spare capacity created in the current slowdown (although the triggers to any growth stall could be quite different).

There are risks surrounding this New Zealand adjustment: inflation may not decline next year; bad weather may constrain export growth; foreign investors may recoil from New Zealand. There are also risks around how the globe adjusts to the imbalances that have been created from strong global growth in recent years (global economy in fourth year of 4%-plus growth rate): there are the higher oil prices, the diminishing spare global capacity, the high household debts and high house prices, and the imbalanced current accounts that imply need for adjustment.

The general assumption here is that local and international adjustments happen smoothly, without undue disruption to global growth and without recession in NZ. This is the most likely scenario but it is by no means a certain scenario. Add in the potential for a bird flu pandemic and the risk and return trade-off of financial markets appears to be playing out in global economies at present.

The New Zealand slowdown is largely due to capacity constraints. It can also be traced to the lagged impact of a lower export incomes and the turnaround in the construction cycle. The second and third contractionary forces are cyclical and will be turned positive again by a lower NZ dollar now and by lower interest rates next year. It is the first factor that suggests the drawn out transition before the NZ economy embarks on another sustained growth phase.

This lack of capacity will show as only a gradual lowering of the inflation rate and as a gradual narrowing of the current account deficit. It will also show as continued high NZ interest rates this year and probably above-average interest rates for the next couple of years. In the scenario presented here, interest rates only revert to slightly below average levels due to an assumed shock in 2009 (maybe a global slowdown or maybe a tightening of NZ fiscal policy). Such an event is highly uncertain. It is presented here as a means of expressing one possible way that the current risks translate into reality.

Another key consequence of the imbalances that exist is that both the NZ dollar and US dollar will need to depreciate, both as part of the mechanism that leads to a reduction in respective current account balances. This points to relatively low cross-rates for the NZ dollar over the next couple of years, although not necessarily a low NZD/USD exchange rate.

The global pressures are such that global interest rates will probably also increase, especially those very low interest rates in Europe and Japan. An upward global interest rate trend reinforces the likelihood that the NZ dollar depreciates and also adds some upward pressure to local fixed interest rates. This later pressure is assumed to be moderate but it does add further weight to the argument that local rates across the yield curve will not decline this year, in spite of low growth, and that the yield curve turns from negative to positive in the next couple of years (probably 2008).

Inter-related with these forces, the local and international house price upswing is likely to be in the process of peaking. In New Zealand there are increasing difficulties selling a house but, at present, turnover remains above-average and the average house price appears to be still increasing. The delayed impact of prior interest rate increases and rising new housing/section supply, plus higher unemployment to come, suggest a flatter profile for the average house price over the next 2-3 years.

**Anthony Byett** – ASB Chief Economist – 649 374 8604 – [anthony.byett@asbbank.co.nz](mailto:anthony.byett@asbbank.co.nz)

### General Advice Warning

As this advice has been prepared without considering your objectives, financial situation or needs, and before acting on the advice, you should consider its appropriateness to your circumstances. The Bank as a provider of investment, borrowing and other financial services undertakes financial transactions with many local corporate entities. This may include any corporate issuer referred to in this report.

### International economies

*Strong global growth but some deceleration*

- The average global forecasts still point to:
- strong growth in total in the next few years (world GDP growth over 4% p.a.);
  - and consequently strong trade growth (volumes increasing over 7% p.a.);
  - growth still led by the US (due to size and growth >3% p.a.) & developing Asia (including China and India);
  - although with some deceleration in the US (after 12 quarters averaging 4% p.a.) and in Japan;
  - growth in Europe is forecast to continue, albeit with some volatility created by an expected German VAT hike.

*Oil price remains a major risk*

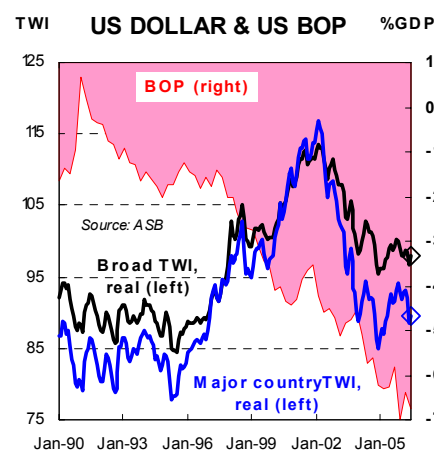
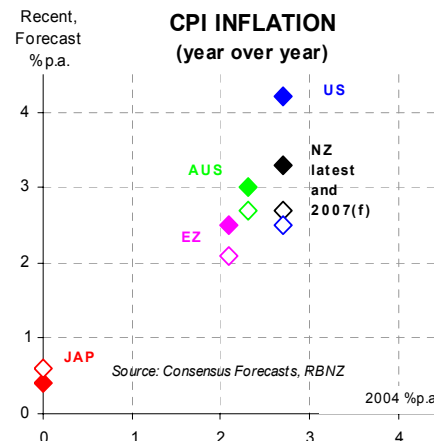
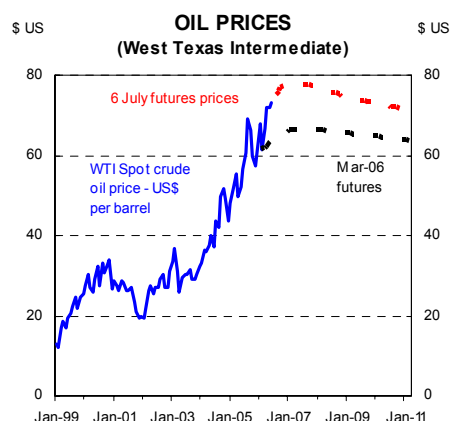
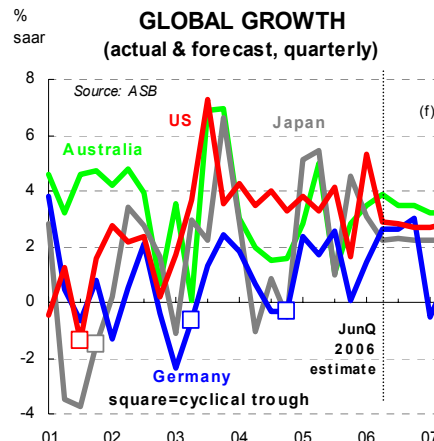
- The major near-term risk relates to oil:
- no major oil price rise is currently priced in futures contracts;
  - but continued tightness is being priced and there remains the risk of higher prices (futures prices have not been an accurate predictor);
  - plus there is yet to be the full impact of oil price rises to date;
  - the above forecasts are largely based on the assumption that each \$15/barrel reduces OECD growth by around 0.2% (prices recently around \$70/barrel, versus average below \$30 in 2003).

*Inflation rates generally are rising*

- The higher oil price is clearly showing at present in global inflation rates:
- CPI inflation is generally higher now than in 2004 and in 2005;
  - the latest US inflation rate of 4.2% is greater than the 3.9% peak recently predicted by the RBNZ for NZ;
  - Euro area inflation is now, and is expected to remain, above 2% p.a.;
  - the Japanese inflation is now above zero and is expected to remain so in 2006 and 2007.

*Large US current account deficit likely to lead to lower US dollar*

- The other major global risk, probably more of a medium-term nature, is the large global imbalance between trade and capital flows:
- the US current account deficit was 6.3% of GDP in 2005, equivalent to around 75% of the sum of surplus countries;
  - the deficit is expected to 6.7% this year;
  - it is widely believed that the level of capital inflow required to fund deficits of this level cannot be sustained;
  - part of the adjustment process is likely to require a lower US dollar, especially against the major currencies given the inflexible currencies of some US trading partners.



### The New Zealand Economy

*NZ current account implies adjustments within NZ*

The NZ economy is fully stretched at present. It shows in a number of measures such as the unemployment rate (low), the inflation rate (high) and the current account deficit (large). This mix of conditions is unsustainable. The issue is not whether these tensions are resolved but how they are resolved.

The scenario presented here – and broadly provided by the RBNZ – implies a relatively smooth adjustment. Key assumptions are:

- that a lower exchange rate stimulates exports;
- that investment declines in the near-term due to over-investment in last year;
- that consumption slows as the housing upswing ends;
- and that businesses absorb significant cost increases during 2006.

Any of these assumptions could be tested.

In particular, a low growth rate for consumption spending is a pivotal link that both reduces imports and reduces the opportunity for businesses to pass on the many cost increases that are occurring at present. This, in turn, will turn on whether the current housing cycle comes to an end. Hence, the RBNZ will remain sensitive to housing statistics in the months ahead.

*Consumption growth to be low*

*Cyclical slowdown to be followed by moderate pickup in 2007-2008*

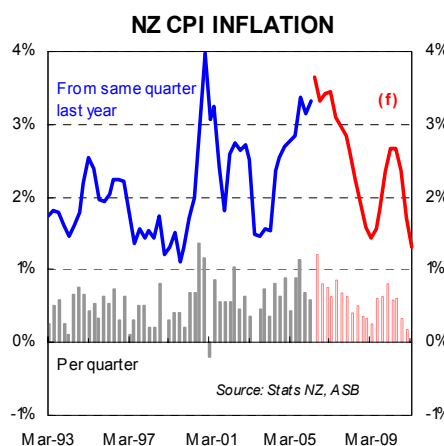
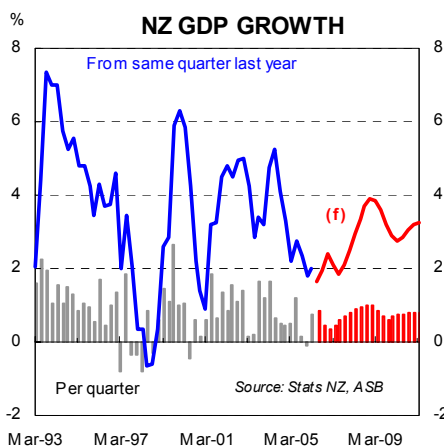
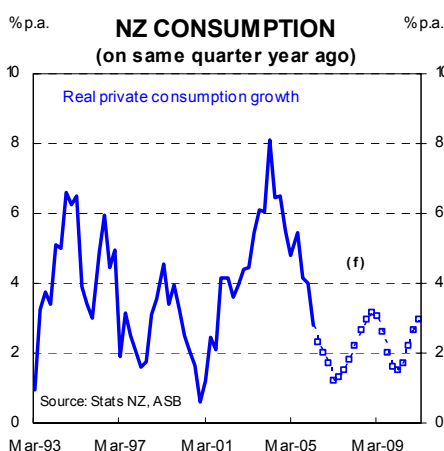
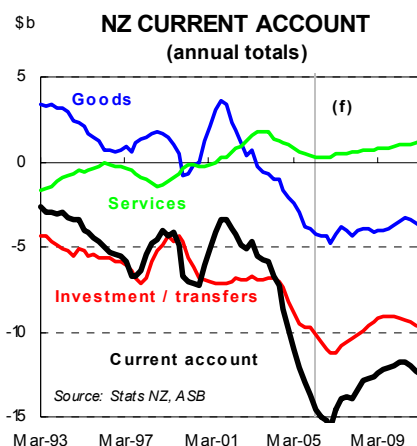
Based on house prices peaking without further cash rate hikes, the NZ growth rate:

- will remain positive and thus a recession will be averted;
- but growth will be low until mid 2007;
- due to both low consumption growth and less dwelling and business investment;
- all three contingent on continued high interest rates in 2006 and lower profits;
- the 2007-2008 recovery is based largely on higher export incomes;
- but only gathers pace once interest rates decline.

*The current inflation risk will require tight monetary policy this year*

A pre-requisite for the lower interest rates will be the CPI inflation rate heading back below 3% p.a.

- This will also depend closely on future oil prices movements;
- even without higher oil prices, business cost increases will be large and a quick return to sub-3% inflation will require widespread cost absorption;
- one consequence of dealing quickly with a lower NZ dollar is that a NZ dollar rebound will likely occur within the next 2-3 years, raising the possibility of low inflation rates for a brief period.

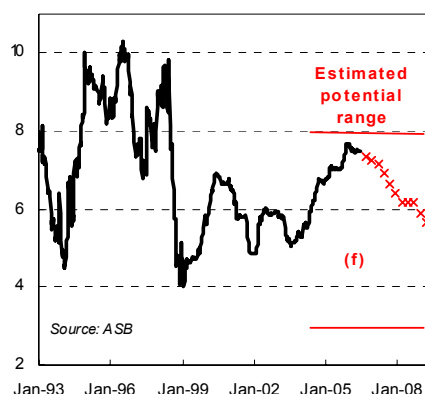


## Interest rates and exchange rates

*Short-term rates peaking but falls will have to wait until 2007*

It has been thought for some time that the future range for 90-day bank bills is around 3% to 8%, centred on 5.5-6.0% p.a. This hypothesis will be put to the test in the near-term given the extent of current inflationary pressure. The current peak is expected to hold. But the cash rate itself will unlikely fall until 2007. Once the easing cycle starts a decline of around 1% is forecast over 12 months. Short-term interest rates are not expect to spend much time in the lower half of the potential range in the next 2-3 years (unless an unexpected and large contractionary shock were to occur in 2007).

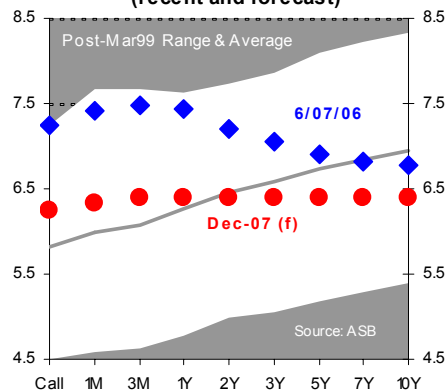
% p.a. **NZ 90-DAY BANK BILL YIELDS**



*Flattening of the yield curve forecast over 2007*

Longer-term rates, on the other hand, appear to have limited scope for decline in the next 1-2 years. A combination of OCR anticipation, low global rates and low global risk premium has longer-term swap yields already below average.

%p.a. **NZ SWAP RATES (recent and forecast)** %p.a.

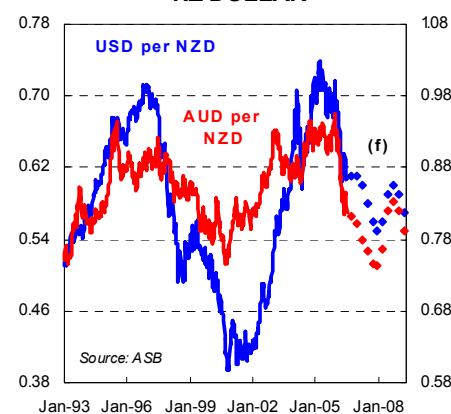


Rising offshore fixed rates and ongoing concern about NZ inflation rates and exchange rate risk are likely to prevent sharply lower longer-term rates. Hence the yield curve is expected to pivot from negative to moderately positive over the next couple of years.

*NZ dollar downtrend intact*

A number of forces are shaping to push the NZ dollar further downward including low NZ growth, a large NZ current account deficit, the likelihood of investors quitting NZD Uridashi bonds and the narrowing interest rate differential.

USD **NZ DOLLAR** AUD



And even though NZ interest rates will probably remain relatively high, the extent of the Uridashi maturity over the next couple of years suggests the NZ dollar could reach previous cyclical lows – with one major exception. A weaker US dollar is also expected and thus the NZD/USD may not decline below 50 US cents.

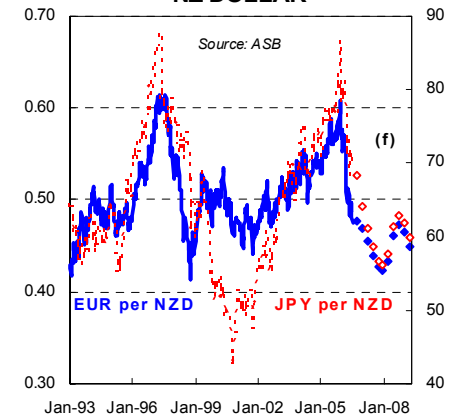
*Declines greatest against non-USD currencies*

Rather the low exchange rates are probable against other currencies, for example:

- 56 Japanese yen (20% below recent levels);
- 42 euros and 29 pence (-12%).

The consequence of such rapid and large depreciation is likely to be a significant growth stimulus, in turn putting a floor on local interest rate declines and eventually creating the conditions for a moderate currency rebound (possibly in 2008).

EUR **NZ DOLLAR** JPY



**ECONOMIC FORECASTS**

ASB economic forecasts		Dec-05	Mar-06 << actual	Jun-06 forecast >>	Sep-06	Dec-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
NZ GDP nominal	AA%	4.6	4.5	4.2	4.0	4.3	4.3	4.7	6.0	5.4	5.4
NZ GDP real	AA%	2.3	2.2	1.9	1.8	1.9	1.9	2.4	3.7	3.1	3.1
private consumption	AA%	4.6	4.1	3.3	2.8	2.2	1.8	1.7	2.9	1.9	2.4
dwelling construction	AA%	-4.5	-5.4	-4.0	-2.1	-2.4	-2.4	-4.2	4.1	4.8	1.7
other investment	AA%	7.4	9.1	6.5	2.4	-1.3	-4.0	-1.5	5.1	3.0	5.6
exports	AA%	-0.2	0.1	-0.1	-0.7	-0.6	0.4	4.9	5.7	5.8	5.1
imports	AA%	6.6	4.6	2.0	-1.2	-1.2	-0.9	1.0	5.0	4.0	5.2
NZ GDP real	A%	1.8	2.0	1.4	1.8	2.3	2.0	3.0	3.8	2.8	3.3
NZ GDP real	Q%	-0.1	0.7	0.6	0.5	0.4	0.4	0.9	0.8	0.7	0.8
NZ CPI	Q%	0.7	0.6	1.2	0.8	0.8	0.6	0.4	0.3	0.6	0.2
NZ CPI	A%	3.2	3.3	3.7	3.3	3.4	3.5	2.6	1.4	2.7	1.3
NZ house prices (QV index)	A%	15.3	11.8	8.8	6.0	2.0	0.0	-3.5	3.5	3.5	2.0
NZ dwelling consents (no.)	A%	-13.9	-9.0	2.8	-9.1	-9.5	-7.3	6.0	6.0	4.0	0.0
NZ non-residential consents (\$)	A%	3.0	-7.7	-6.7	-18.9	-18.9	-12.0	5.0	5.0	-5.0	5.0
NZ unemployment (sa%)	Qtr	3.6	3.9	3.9	4.1	4.3	4.6	4.9	4.6	4.9	4.6
NZ private sector wages (LCI)	A%	2.9	3.0	3.1	3.1	3.1	3.2	2.7	2.6	2.8	2.8
NZ current account (\$b)	Yr	-13.7	-14.5	-15.0	-15.3	-15.7	-14.5	-13.3	-12.4	-11.8	-12.6
as a % of GDP	Yr	-8.9	-9.3	-9.5	-9.6	-9.8	-9.0	-7.8	-6.9	-6.2	-6.3

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

AA% = percentage change since same quarter the previous year

**FINANCIAL FORECASTS**

ASB financial forecasts		Dec-05	Mar-06 << actual end of quarter	Jun-06 forecast >>	Sep-06	Dec-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
NZ cash rate target		7.25	7.25	7.25	7.25	7.25	7.00	6.00	5.50	5.00	6.00
NZ 90-day bank bill		7.7	7.5	7.5	7.4	7.3	7.2	6.2	5.7	5.2	6.2
NZ 3-year swap rate		7.0	6.7	7.0	6.9	7.0	6.8	6.3	5.9	5.5	6.3
NZ 10-year gov't stock		5.7	5.7	5.8	6.1	6.3	6.1	5.8	5.4	5.0	5.8
based on US 10-year bond		4.4	4.9	5.2	5.3	5.5	5.3	5.0	4.6	4.2	5.0
USD per NZD		0.684	0.612	0.609	0.61	0.61	0.60	0.56	0.57	0.57	0.61
GBP per NZD		0.397	0.351	0.332	0.33	0.33	0.32	0.30	0.31	0.31	0.34
AUD per NZD		0.932	0.855	0.821	0.81	0.80	0.78	0.77	0.79	0.79	0.85
JPY per NZD		80.6	71.9	70.0	68	64	61	58	60	60	64
EUR per NZD		0.576	0.504	0.479	0.48	0.47	0.45	0.43	0.45	0.45	0.48
TWI		70.8	63.1	61.3	60.9	59.8	58.1	55.2	56.8	56.8	60.8
based on JPY per USD		118	117	115	112	105	102	103	105	105	105

<http://www1.asbbank.co.nz/reports>

<http://www.research.comsec.com.au>

**ASB ECONOMICS**

Level 9, 135 Albert Street, Auckland

**ASB GROUP ECONOMICS & RESEARCH** PHONE FAX

**Economics**

Chief Economist	Anthony Byett	<a href="mailto:anthony.byett@asb.co.nz">anthony.byett@asb.co.nz</a>	(649) 374 8604	(649) 302 0992
Treasury Economist	Daniel Wills	<a href="mailto:daniel.wills@asb.co.nz">daniel.wills@asb.co.nz</a>	(649) 374 8185	
CBA NZ Economist	Chris Tennent-Brown	<a href="mailto:chris.tennent-brown@asb.co.nz">chris.tennent-brown@asb.co.nz</a>	(649) 374 8819	

**Research**

Head of Research	Rodney Dickens	<a href="mailto:rodney.dickens@asb.co.nz">rodney.dickens@asb.co.nz</a>	(649) 374 8300
------------------	----------------	--	----------------

**DISCLAIMER**

The views expressed herein are those of the authors and are based on information believed but not warranted to be correct. Any views or information, whilst given in good faith, are not necessarily the views of the bank and are given without responsibility and no right of action shall arise against any of the authors, the bank or its employees either directly or indirectly out of any views, advice or information.