

Quarterly Forecasts

Monetary easing started



- **Slow NZ growth into 2007**
- **Interest rates and exchange rates to trend lower**
- **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. It may even be that NZ is in recession at present: output was down in the December quarter, albeit slightly, and the March quarter appears to have also been weak. 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 (-14% within 4 months, only matched by a similar depreciation in mid 1988). The monetary policy easing built into fixed rates is now large (-1% within 12 months). Whether the RBNZ delivers on the market cue will depend on how deeply the 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.

The following forecasts can be loosely summarised as:

2006 – continued low growth with declining interest rates and exchange rates, albeit with the RBNZ lagging the market;

2007 – the initial recovery year, probably only moderate at first given a slow RBNZ response in 2006 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.

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.

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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.

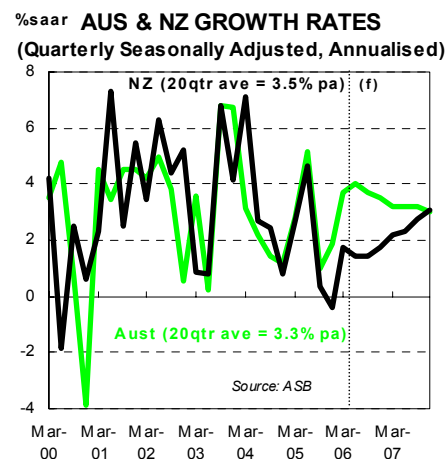
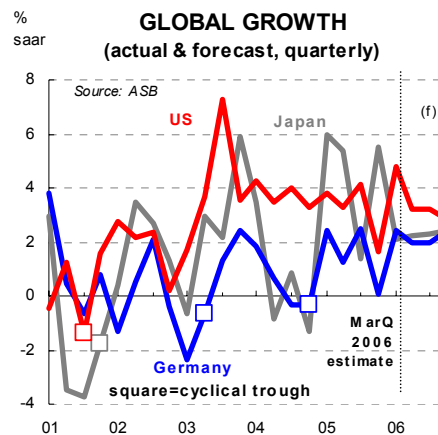
US growth rate above 3% p.a.

The recent growth forecasts by the OECD, IMF and surveys by The Economist and Consensus Forecasts centre on:

- US, now in the fifth year of growth, growing fast but with the rate gradually declining to 3.3% p.a. (2006) and 3.0% (2007);
- Japan growing at around 2% after the sharp spurt during 2005, a big turnaround from the low growth of 1991-2001;
- The EU also maintaining a growth rate around 2% p.a.;
- Asian growth rates remaining high this year and next.

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.



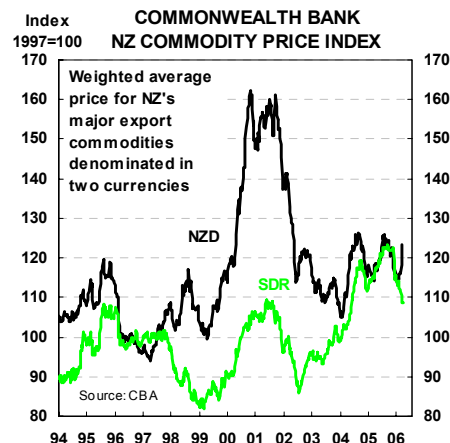
Strong global growth removes one major NZ risk

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

In contrast to the global trend, the NZ economic growth rate is low. It may well be that NZ is in recession at present should output in the March quarter be shown to have declined (following a slight decline in the previous December quarter); this will not be known until late June.

Three cyclical factors impacting

Whether or not a mild recession has already occurred, the bigger picture remains one of a moderate slowdown. 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 and the wholesale non-cash interest rate declines to date provide some stimulus. While 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 rate will occur in the next few quarters and that, given an RBNZ easing later in 2006, output growth will accelerate over 2007.

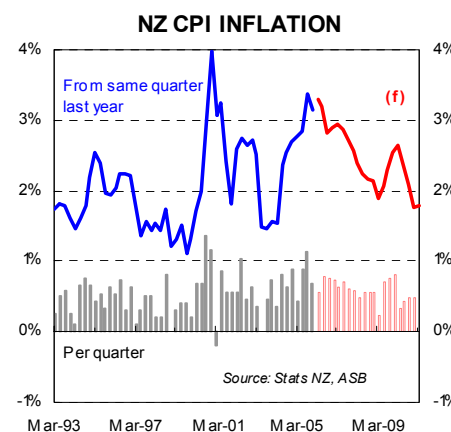
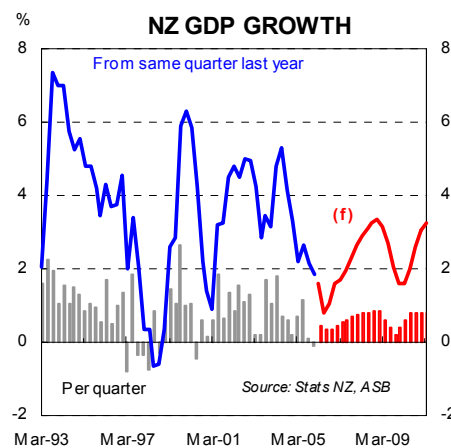
However, two intertwined factors suggest that the eventual recovery will be moderate also, and possibly chequered: first, a moderate slowdown is unlikely to free many resources for subsequent use in future production; and, second, the recent history of productivity growth in NZ is poor. Combined these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



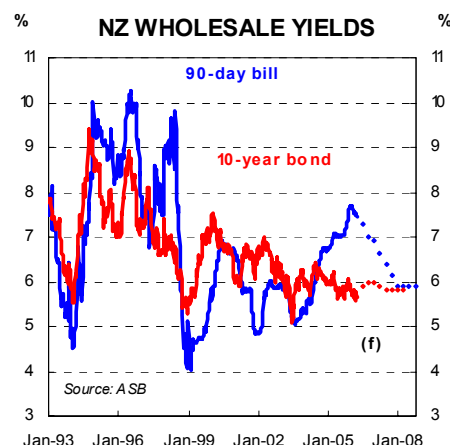
ASB economic forecasts		Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
NZ GDP	Q%	-0.1	0.4	0.4	0.4	0.4	0.6	0.8	0.6	0.6	0.8
NZ GDP	A%	1.8	1.6	0.8	1.1	1.6	1.7	2.9	3.2	1.6	3.2
NZ GDP	AA%	2.2	2.1	1.6	1.3	1.3	1.3	2.4	3.2	2.0	2.7
NZ Current Account (%GDP)	Yr	-8.9	-9.0	-8.9	-8.7	-8.5	-8.1	-7.7	-7.8	-7.5	-7.6
NZ Unemployment (sa%)	Q	3.6	3.8	4.0	4.2	4.4	4.6	5.0	4.7	5.0	4.6
NZ CPI	Q%	0.7	0.6	0.8	0.8	0.7	0.6	0.5	0.2	0.3	0.4
NZ CPI	A%	3.2	3.3	3.2	2.8	2.9	3.0	2.4	1.9	2.6	1.8
NZ Dwelling consents (no.)	A%	-13.9	-8.4	2.4	-1.5	-0.7	0.0	5.0	5.0	-5.0	5.0
NZ Non-res. building consents	A%	3.0	-20.2	-7.4	-18.9	-18.9	-5.0	5.0	5.0	-5.0	5.0

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

Interest rates and exchange rates

RBNZ to lag market with easing

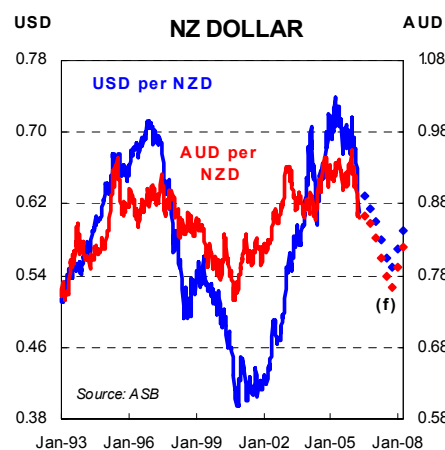
The slow growth of late ensures that the RBNZ will lower the OCR. The issue, as always, is one of timing. The RBNZ had warned of no rate cuts this year but this assessment has probably changed. But so too has market pricing. Likely the RBNZ will continue to lag the market, delivering 1-2 OCR cuts during Sep-Dec rather than the 2-3 currently priced. The moderate nature of the 2007 recovery should allow further cuts next year. Conversely longer-term yields should be relatively stable, given a likely upward international rate trend and the level of anticipation in NZ long-term rates already.



NZD movement dependent on USD trends

Likewise the NZ dollar fall so far appears based off strong anticipation of OCR cuts. As above, these will be delivered eventually but a near-term NZD rebound is likely as a slower RBNZ reaction is taken into account.

The currency forecasts below are based off the assumption of a stable EUR/USD, an unrealistic assumption but one that reflects the dual nature of risk. That said, the average forecast for the EUR/USD was recently put at -5% in the next 12 months. Should that come to fruition, the NZ dollar depreciation envisaged below would be less against the USD and greater against the JPY and EUR.



ASB financial forecasts	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
NZ cash rate target	7.25	7.25	7.25	7.00	6.75	6.50	5.75	5.50	5.00	6.25
NZ 90-day bank bill	7.7	7.5	7.3	7.0	6.9	6.7	5.9	5.7	5.2	6.4
NZ 3-year swap rate	7.0	6.7	6.7	6.8	6.7	6.5	6.3	5.9	5.5	6.4
NZ 10-year gov't stock	5.7	5.7	5.9	6.0	6.0	5.9	5.8	5.4	5.0	5.8
USD per NZD	0.684	0.612	0.630	0.615	0.600	0.580	0.590	0.570	0.570	0.650
GBP per NZD	0.397	0.351	0.361	0.352	0.344	0.332	0.338	0.326	0.326	0.372
AUD per NZD	0.932	0.855	0.863	0.854	0.833	0.806	0.819	0.792	0.792	0.903
JPY per NZD	80.6	71.9	73.1	71.0	69.0	66.4	66.4	63.0	61.8	69.6
EUR per NZD	0.576	0.504	0.516	0.504	0.492	0.475	0.484	0.467	0.467	0.533
TWI	70.8	63.1	64.5	63.1	61.5	59.4	60.3	58.1	57.9	65.8
Based on JPY per USD	118	117	116	116	115	115	113	111	109	107

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