

# Quarterly Forecasts

## Finding balance



- The likelihood of any growth surge in the next 12 months is low, both locally and internationally.
- The initial challenge is high global inflation.
- The longer-term challenge globally remains the large current account surpluses and deficits.

The likelihood of any growth surge in the next 12 months is low, both locally and internationally.

The global growth rate will likely remain high but it is now in a deceleration stage. Locally the deceleration happened a couple of years ago now but the process is far from complete and further deceleration – namely a recession – cannot be ruled out.

The backdrop to the global situation is the recessionary phase of 2000 and 2001 (and later in some parts), the subsequent huge fiscal and monetary stimulus, the huge surge in activity through 2003-2005 and culminating in the huge oil price surge over 2005-2006.

This brings us to mid-cycle and a period where some of the imbalances that have built up are now impacting. The initial challenge is high global inflation but this should not prove too troublesome, given global capacity is far from stretched at present (generally). The emerging challenge is how the US – and other economies – copes with a downturn in the US housing market. The downturn is taking on the proportions not seen since the 1980s and it could result in slow global growth. Fed Chairman Ben Bernanke recently commented that a “substantial correction” was taking place in the US housing market, which will be a drag on the economy’s growth. More likely it will cap the current rising global interest rate trend and may even lead to lower interest rates (this having already occurred for US fixed interest rates). The longer-term challenge remains the large current account surpluses and deficits that have emerged and the risk that creates should debtors fall out of favour with creditors.

This is not necessarily a global background likely to dampen local growth (unless the US housing downturn does prove more serious). However it is not a background likely to provide a stimulus to exporters either.

Furthermore, the combination of tight capacity in New Zealand and ongoing inflationary pressures leaves the RBNZ little option but to retain relatively high NZ interest rates until well into 2007. And hence the NZ dollar will remain high until at least early 2007.

And, to add to the pressures on exporters’ profits, local cost pressures are strong.

The result is a tough period for the NZ export sector in general, especially after the tantalising promise of the lower NZ dollar earlier this year. This will impact on the wider community and result in another 12 months – the third in a row – of low growth.

The risk in the very near-term is that demand, financed by borrowing, remains strong. This could force the RBNZ to tighten monetary policy further.

The risk over the next 12 months is that the slowdown could turn to recession should some shock (e.g. drought, lower commodity prices) or confidence loss occur.

Whether a recession or just low growth, the period does allow time for reallocation of resources and for investment to build up some spare capacity so that when inflation pressures do dissipate, the eventual monetary easing will result in a growth surge, probably around 2008.

Risk is always present. But the high debt levels run up in recent years in NZ and abroad suggest a period of heightened risk in the next few years. The run-down of spare capacity also suggests a more constrained growth phase. In average terms, this probably means that the NZ growth rate in the next five years will be around 3%, lower than the 3.6% average of the last five years. It also means the chance of a recession at some stage is high. It is an environment where productivity gains are the key to success.

This moderation of growth will eventually see NZ interest rates and exchange rates decline from above-average levels, probably the NZ dollar leading the way. But this unwinding remains that elusive six months away.

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### General Advice Warning

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### International economies

*The consensus is still for strong global growth.*

The consensus is still for strong global growth over the next few years, albeit with differing fortunes:

- slower US growth in the next 12 months, with slower housing activity a key dampening influence;
- slower German growth also, but resulting from tax increases early 2007;
- ongoing expansion in Japan;
- faster growth in Australia over 2007;
- and continued fast growth in the emerging countries.

The major risk is that the US slowdown is sharper than expected and that it spreads to other economies.

*Lower oil prices provide some comfort to consumers.*

Some comfort for global consumers, and indeed New Zealand consumers, is coming in the form of lower oil prices in recent weeks.

- Oil prices are now well below August peaks.
- Current pricing suggests no strong consensus on the future direction of prices.
- OPEC for one will endeavour to keep oil prices above \$50/barrel.
- And at \$50-60/barrel, the price is near the 2005 average and is still likely to have a contractionary influence.

*The upward global interest rate trend has been a key dampening influence.*

The other key dampening influence in recent quarters has been the upward global interest rate trend.

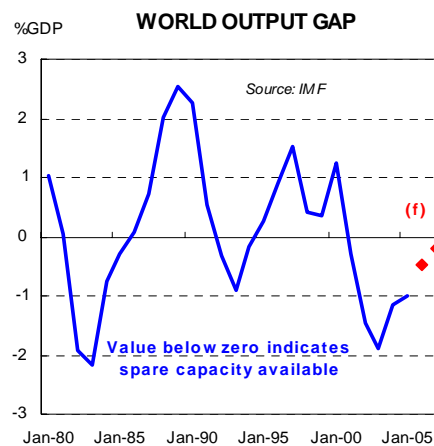
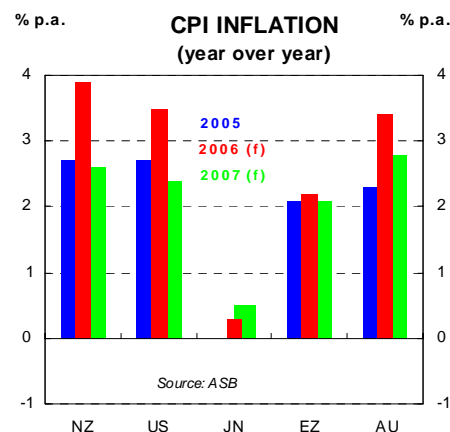
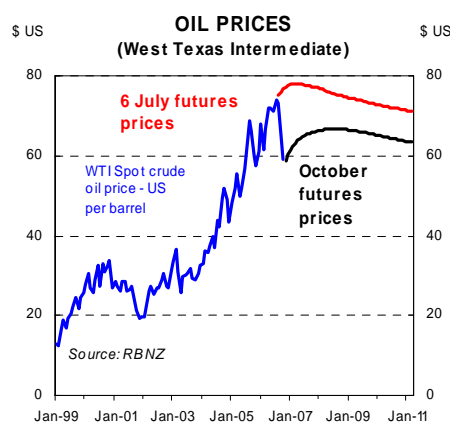
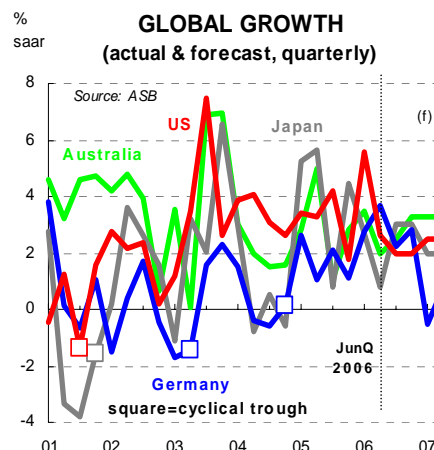
This process is one of rates returning to more 'normal' levels around the world after the very low rates of 2001.

And as a move against developing inflationary pressures. Inflation is expected to be high in many countries this year but is generally expected to moderate in 2007 (Japan being one exception).

Global interest rates are the dominant driver of long-term interest rates in New Zealand.

While there are a number of near-term risks – e.g. a global housing slowdown – the central banks around the world have some scope, in spite of high inflation rates at present, to ease monetary policy. There is still some spare capacity globally.

The potentially more disruptive risks still appear related to the rebalancing of global trade/investment flows. There is no major disruption caused by the large current account balances at present but it is generally agreed that the US imbalance (and others) cannot continue. The adjustment is very likely to require a lower US dollar at some stage.



## The New Zealand Economy

*The NZ economy has already entered its mid-cycle slowdown.*

The NZ economy has already entered its mid-cycle slowdown, GDP growth having averaged 0.5% per quarter since mid 2004. This slower pace is expected to be retained until a late 2007 pick-up.

This extended slow-growth phase is the result of stretched capacity and tight monetary policy settings, the latter coming more to the fore in next 12 months. Income growth generally is expected to be slow, leading to lesser investment and low consumption growth.

The impetus for the next growth phase is expected to come from easier monetary conditions emerging over 2007.

*The expected growth rate over the next 5 years is expected to be around 3% p.a.*

The average growth rate over the next 5 years is expected to be around 3% p.a., below the 3.2% average of the previous 10 years, and the 3.6% average of the last five years. This will still require a lift in national labour productivity, likely to eventuate from higher levels of investment and consolidation within industries.

The possibility of a slowdown after the initial growth rebound is included in these forecasts. This is highly speculative but it does serve to raise awareness that fiscal tightening may follow the 2008 election and/or the global rebalancing may prove disruptive over this horizon.

*The central scenario for 2007 is one of very slow consumption growth*

In the meantime, the risk of recession is high but the central scenario is one of very slow consumption growth in the next twelve months, largely due to two factors:

- lower company profitability, feeding through to lower retained earnings and low employment growth;
- and relatively flat-to-lower house prices in general.

Cushioning the economy – and hence averting recession – is relatively high wage increases and only moderately higher unemployment.

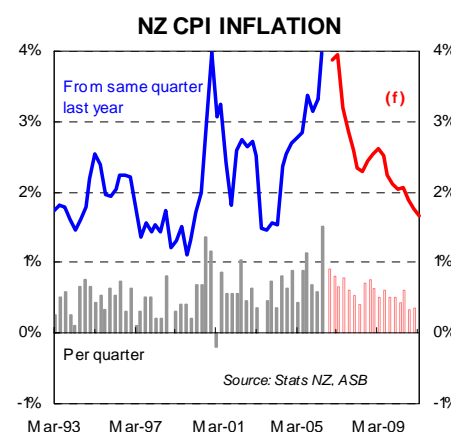
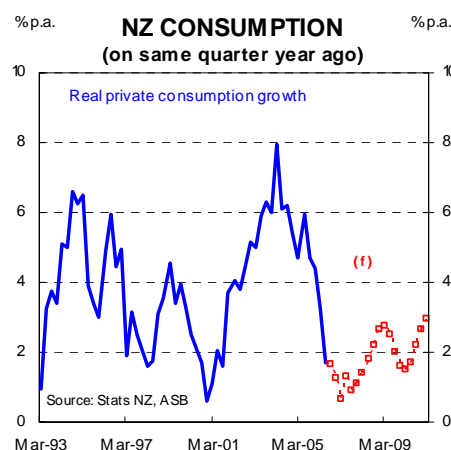
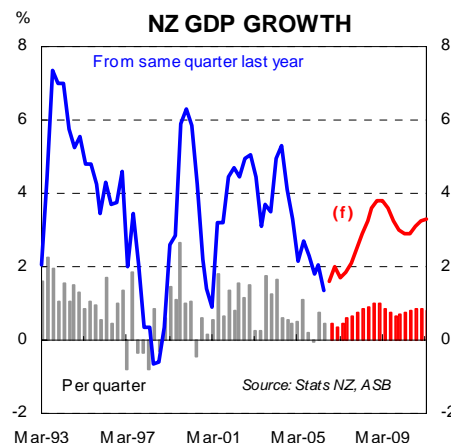
*The Reserve Bank will retain a firm stance.*

With inflation already high and still likely to be near 3% p.a. in twelve months, the Reserve Bank will retain a firm stance for some months yet and another tightening will remain a real and openly discussed option.

The gradual inflation decline is expected to come from less upward cost pressure:

- surrounding dwelling construction and occupation;
- and involving exported and imported goods and services;
- plus businesses facing difficulties passing on recent higher costs.

This mix of forces will require a deft hand by the Reserve Bank. In essence, the adjustment will largely come from (a) businesses finding alternative ways to cope with rising costs and tight capacity and (b) a housing slowdown reducing the household sector's propensity to borrow. A lack of evidence that these transformations are occurring could well prompt further tightening from the RBNZ, in spite of low growth.



*RBNZ retaining a firm stance until well into 2007*

### Interest rates and exchange rates

The continued inflation pressure in New Zealand – including high wage inflation – points to the RBNZ retaining a firm stance until well into 2007. The risk of a rate hike between now and March is high but the most likely scenario is that the RBNZ allows the rate hikes to date, the high NZ dollar and the generally slow growth rate to all gradually impact.

The slow growth phase that is envisaged should allow the RBNZ to begin the path towards neutral interest rates – a cash rate around 5.5-6% - around mid 2007.

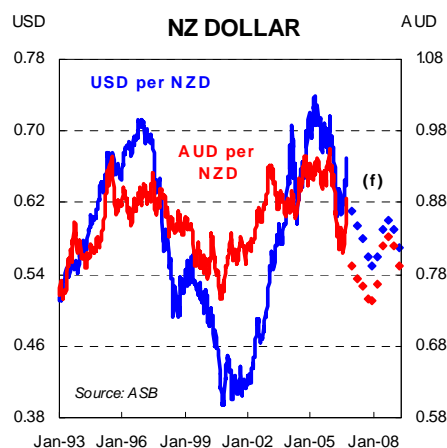
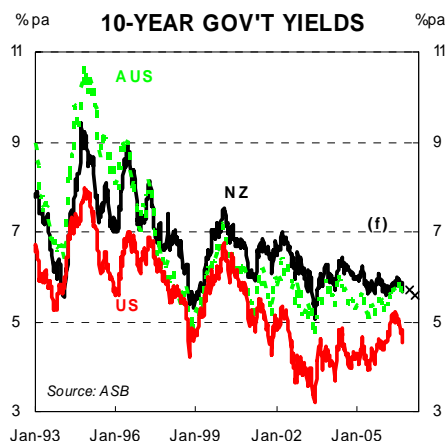
Local fixed interest rates have not increased to the extent of short-term rates, largely due to low fixed rates abroad and to continual anticipation that the RBNZ will overcome current inflation pressures soon.

Internationally the trend is likely to be largely sideways in the next few years. Locally the pressure is likely to be moderately downward as the slow growth phase gradually reduces inflation pressures and alternative high returns.

The following currency forecasts are predicated on two key assumptions:

- the slower US growth phase is mild, and the US maintains a significant interest rate advantage over Europe and Japan.
- and that the RBNZ retains a firm stance until mid-to-late 2007.

The mix of few rates hikes elsewhere and continued high NZ interest rates would bring upward pressure on the NZ dollar; the high debt burden already and a low local growth rate will likely cap the extent of any NZD rallies. Likewise, a slowdown in Europe or Japan would also be expected to translate into weakness in their currencies.



*Internationally the trend is likely to be largely sideways.*

ASB economic forecasts		Jun-06 << actual	Sep-06 forecast >>	Dec-06	Mar-07	Jun-07	Sep-07	Mar-08	Mar-09	Mar-10	Mar-11
NZ GDP nominal	AA%	4.2	3.8	4.0	3.8	4.1	4.2	4.7	5.9	5.5	5.4
NZ GDP real	AA%	1.9	1.7	1.8	1.7	1.8	1.9	2.3	3.6	3.2	3.1
private consumption	AA%	3.5	2.7	2.0	1.3	1.2	1.0	1.2	2.3	1.9	2.4
dwelling construction	AA%	-4.8	-4.5	-6.1	-8.0	-6.8	-5.8	-0.9	4.4	4.8	1.7
other investment	AA%	5.7	0.8	-3.6	-7.1	-7.1	-5.8	-1.5	5.1	3.0	5.6
exports	AA%	1.2	1.6	2.5	4.0	3.8	3.8	4.1	5.7	5.8	5.1
imports	AA%	1.7	-1.6	-2.2	-2.3	-0.8	0.5	1.2	4.3	3.8	5.1
NZ GDP real	A%	1.4	1.6	2.0	1.7	1.8	2.1	2.9	3.8	2.9	3.3
NZ GDP real	Q%	0.5	0.4	0.3	0.5	0.6	0.7	0.9	0.9	0.7	0.8
NZ CPI	Q%	1.5	0.7	0.6	0.6	0.7	0.5	0.4	0.5	0.4	0.3
NZ CPI	A%	4.0	3.5	3.3	3.3	3.2	2.9	2.3	2.6	2.0	1.7
NZ house prices (QV index)	A%	11.5	9.7	5.6	3.0	-1.0	-4.0	-3.5	3.5	3.5	2.0
NZ dwelling consents (no.)	A%	0.8	1.6	-6.5	-7.6	0.0	2.0	6.0	6.0	4.0	0.0
NZ non-residential consents (\$)	A%	3.9	-12.8	-18.9	-11.9	-7.6	-3.4	5.0	5.0	-5.0	5.0
NZ unemployment (sa%)	Qtr	3.6	3.7	3.8	3.9	4.0	4.1	4.3	4.1	4.4	4.1
NZ private sector wages (LCI)	A%	2.9	2.9	2.9	3.0	3.1	3.0	2.7	2.6	2.8	2.8
NZ current account (\$b)	Yr	-14.8	-15.5	-16.3	-15.2	-14.6	-14.7	-13.5	-11.8	-11.1	-11.8
as a % of GDP	Yr	-9.4	-9.8	-10.2	-9.4	-8.9	-8.9	-8.0	-6.6	-5.9	-5.9

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

AA% = percentage change since same quarter the previous year

Cash rate	9-Oct	Dec-06	Mar-07	Jun-07
US	5.25	5.25	5.25	5.25
Australia	6.00	6.00	6.00	6.00
New Zealand	7.25	7.25	7.25	7.25
Canada	4.25	4.25	4.25	4.25
Eurozone	3.25	3.25	3.25	3.25
Japan	0.25	0.50	0.75	1.00
10-yr bond yield	9-Oct	Dec-06	Mar-07	Jun-07
US	4.69	5.10	5.30	5.30
Australia	5.60	6.00	6.10	6.00
New Zealand	5.86	5.90	5.80	5.70
Canada	4.08	4.50	4.80	4.90
Eurozone	3.76	4.20	4.50	4.60
Japan	1.71	2.00	2.30	2.50
Exchange rate	9-Oct	Dec-06	Mar-07	Jun-07
AUD/USD	0.7435	0.7900	0.7700	0.7600
NZD/USD	0.6560	0.6680	0.6200	0.5800
USD/CAD	1.1264	1.0800	1.1300	1.1300
EUR/USD	1.2603	1.3000	1.2700	1.2500
USD/JPY	119.18	120.00	120.00	125.00
Cross rates	9-Oct	Dec-06	Mar-07	Jun-07
AUD/NZD	1.1334	1.1826	1.2419	1.3103
AUD/CAD	0.8374	0.8532	0.8701	0.8588
NZD/AUD	0.8824	0.8456	0.8052	0.7632
NZD/CAD	0.7388	0.7214	0.7006	0.6554

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