

- **Global imbalances should continue to unwind gradually in 2007.**
- **The US slowdown will see world growth moderate, but elsewhere growth prospects are positive.**
- **Geopolitical tensions, oil prices & the global housing market outlook are the key uncertainties.**
- **New Zealand growth in 2007 will be unspectacular due to ongoing capacity constraints.**

Key thoughts for 2007:

- The US economic slowdown will drive a moderation in global growth in 2007. But the firm outlook for other economies should mean that global growth slows only marginally from its high base.
- Global inflation expectations ease back moderately. Easing headline inflation pressures, driven largely by falling energy prices, should feed through into lower core inflation in 2007.
- Geopolitical tensions and uncertainty over the oil price remain key concerns.
- A key risk in 2007 is a larger than expected global house price correction, following the run up in house prices to unsustainably high levels in recent years.
- There is particular concern over the outlook for the US housing market, given the broader implications for the US, and indeed global, economic growth.
- US consumers have remained stubbornly and surprisingly resilient in the face of the housing downturn and we think there is good reason to expect this to continue.
- We don't see scope for Fed rate cuts until later in the year.
- European economic growth indicators are all around historical highs, suggesting solid economic growth will continue in 2007.
- Japan's leading index, which is helpful in picking turning points in the Japanese economy, is not yet signalling that Japan's economy has recovered from the recent consumption-led downturn.
- The global growth backdrop is overall supportive for New Zealand. Consensus forecasts point to reasonable growth for New Zealand's main export partners.
- This should aid the required economic rebalancing in New Zealand. The export sector should eventually take over from households as the key growth driver. However, this process is taking time, and the current mix of monetary conditions is restricting the process.
- 2007 should be a year of unspectacular growth and still high domestic inflation. This inflation pressure will keep the Reserve Bank hawkish.
- High interest rates and a strong NZ dollar also look set to be part of the mix for 2007.

Overall, the economic outlook for 2007 is reasonable but it is not without risks. High household debt leaves the kiwi consumer vulnerable during an economic slowdown. Ongoing tightness in the labour market and increasing costs pressure company profitability. Rebalancing is still required within the economy and this will require continued easing in consumption growth from households and a deft hand by the Reserve Bank during 2007.

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 – imbalances unravelling

World growth should slow, but only moderately.

The US economic slowdown will drive a moderation in global growth in 2007. But the firm outlook for other economies should mean that global growth slows only marginally from its high base. A composite index of *Consensus* GDP forecasts for world growth in 2007 points to robust growth of 4.3%, down from 5.0% in 2006. Meanwhile, *Consensus* 2007 GDP growth forecast for the world's "major base metal consuming economies" is 5.0%. These forecasts remain well above historical averages.

Inflation pressures should ease.

Global inflation expectations have eased back moderately. Easing headline inflation pressures, driven largely by falling energy prices, should feed through into lower core inflation in 2007. But concerns over tight resource markets remain, particularly on the labour market front, with related upside risks to wage inflation. The key risk is that core inflation measures will remain sticky. Central banks globally will remain wary about upside inflation risks.

But resource markets remain tight.

Geopolitical tensions and uncertainty over the oil price remain key concerns. Whether the mid-fifties to low-sixties oil price range that dominated through the last quarter of 2006 persists through 2007 depends how supply and demand evolve. We expect a little additional capacity in 2007, but not enough to have a marked impact on prices. Other factors that are more difficult to predict, such as weather and geopolitical issues, could well have more of an influence. We see little evidence to suggest that the fifties to low-sixties range will break down notably in 2007.

The oil price outlook is important.

A key risk in 2007 is a larger than expected global house price correction, following the run up in house prices to unsustainably high levels in recent years. There is particular concern over the outlook for the US housing market, given the broader implications for the US, and indeed global, economic growth. There is particular worry surrounding the large rise in US household debt and whether this has made the US household sector more vulnerable to rising interest rates and asset price declines.

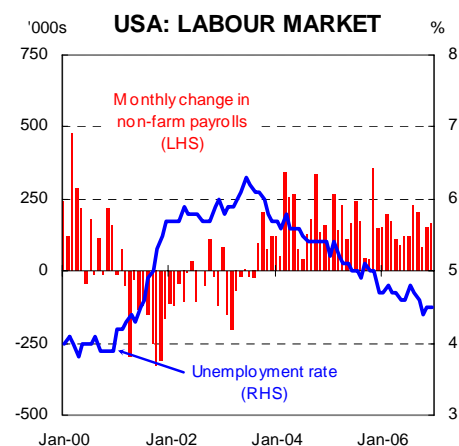
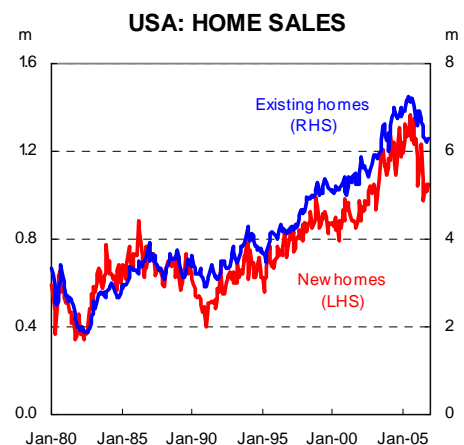
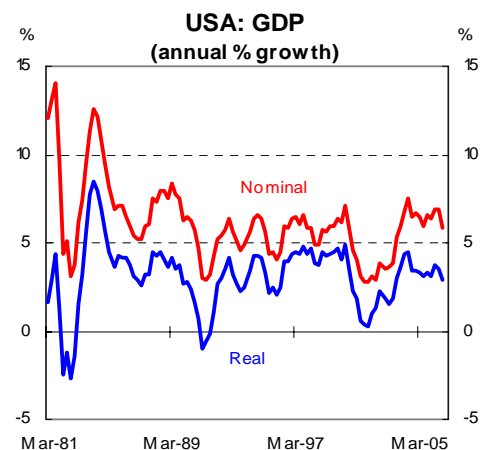
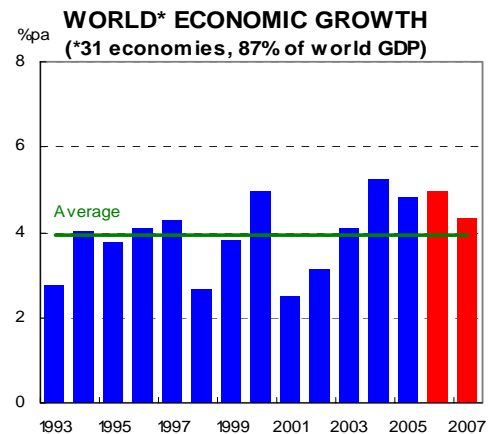
Concerns surround the US house price correction.

The US housing market slowdown in the second half of 2006 was more abrupt than most had anticipated. But at the margin, housing market indicators have recently pointed to stabilisation.

However, the risks are to the downside. Further adjustment may be needed in construction and prices in order to reduce the large inventory of unsold homes. Even if housing activity stabilises in the coming months, construction is still likely to weigh on US economic growth well into 2007.

Manufacturing has been softer.

Looking at the US economy on a broader scale, economic growth has decelerated to a below trend rate. There are signs that the housing slowdown is broadening into other sectors of the economy, with manufacturing growth softening in



the second half of 2006. Production was hindered by cuts in automobile output, but the drag from a correction in auto inventories may be coming to an end. Importantly, the manufacturing ISM rose back above 50 in December. This bodes well for the manufacturing sector in early 2007, pointing to moderate expansion. As opposed to a prolonged weakening in the sector, it appears likely that the recent softness may simply be an adjustment to a more moderate - and hence sustainable - expansion.

Consumer spending growth will be slower in 2007.

There is likely to be some further feed-through from the housing market downturn to US consumer spending. Indeed, consumer spending growth is unlikely to fare as well in 2007, with growth of 2.7% expected compared to 3.1% in 2006. US consumers have remained stubbornly and surprisingly resilient in the face of the housing downturn and we think there is good reason to expect this to continue. We foresee a soft-landing in US economic growth in 2007, given a raft of key positive factors that will provide a buffer in the face of the negatives in play.

The *Consensus* forecast for US GDP growth in 2007 is a below-trend rate of 2.3%. We think the risks are to upside given the resilience we expect in consumer spending. We see the prospect of US growth returning to a trend rate of around 3-3.5% by year end.

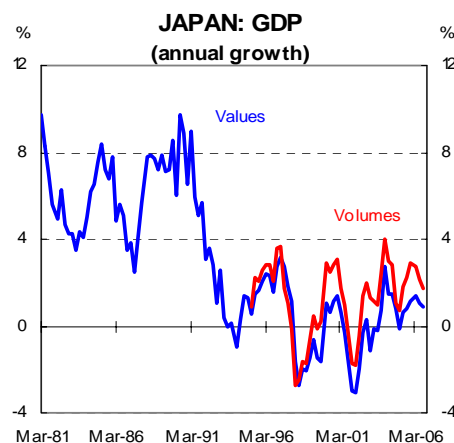
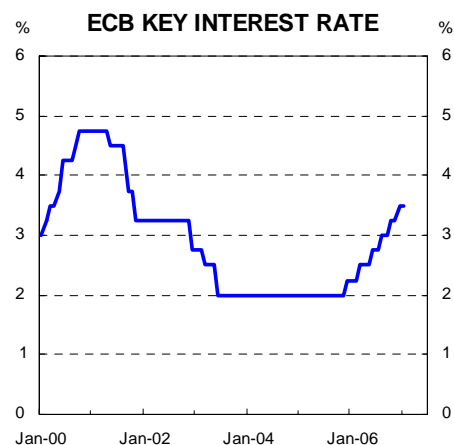
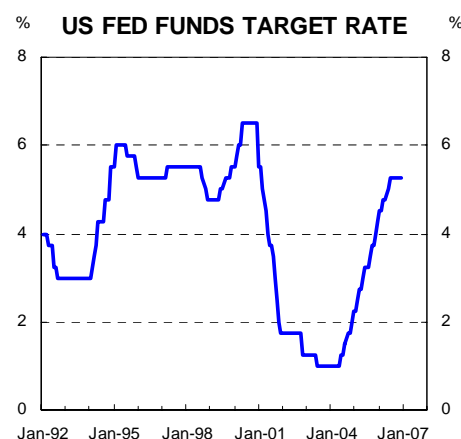
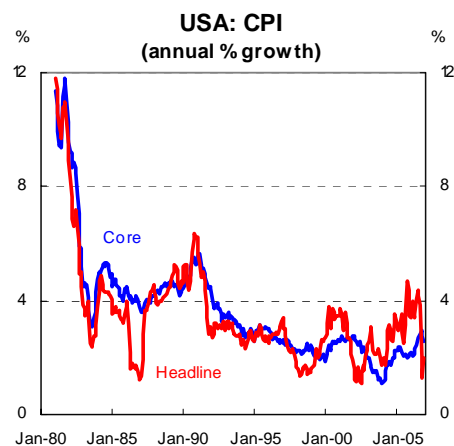
We don't see scope for Fed rate cuts until later in the year.

Current policy settings are assessed to be mildly restrictive. The period of below-trend growth, coupled with lower energy prices and less price pressure from the housing market, point to receding core inflation pressure in 2007. We think this will give the Fed room to cut the fed funds rate moderately in the latter half of the year. We are picking two 25 basis point rate cuts in H2 2007, bringing the fed funds rate to 4.75% by year end. But for the time being the Fed remains on a tightening bias. We think it will be firmly on inflation watch as long as core inflation measures remain elevated. Given the outlook for a soft-landing in growth, against the back drop of labour tightness, core inflation measures could prove sticky downwards in 2007. Labour related inflation pressures will linger as long as the unemployment rate remains below. Wage inflation pressures look set to persist for some time. The healthy US labour market is the key reason we expect the Fed to leave the fed funds rate on hold at 5.25% in H1 2007 and why we see scope for only moderate easing in H2 2007.

The labour market remains the key area of inflation risk

The Eurozone growth outlook is positive.

In the Eurozone, the current policy rate of 3.5% is assessed to be at the lower end of neutral. With the Eurozone growth outlook still robust and the risks to price stability still firmly to the upside, further tightening looks probable in the near-term. The European Central Bank (ECB) retained a largely hawkish rhetoric, saying that "monetary policy is still accommodative", that the key ECB interest rate remains at low levels, money and



Further near-term tightening from the ECB looks likely.

credit growth is strong and liquidity ample. Inflation risks are still clearly assessed to be to the upside.

Importantly, European economic growth indicators are all around historical highs, suggesting solid economic growth will continue in 2007. Pressure on resources and thus on inflation will remain. Further into 2007, the ECB will be wary of hiking too far for fear of crimping economic growth. The ECB will want to assess the impact of the past year's interest rate increases before hiking too far into restrictive territory. This is likely to mean that rate decisions in 2007 will become increasingly data-dependent.

Japan has undergone a consumption-led slowdown.

Confusing signals continue to emanate from the Bank of Japan. The Bank's on-hold decision in December suggested the MPC assessed the cost of a re-emergence of deflation as more dire than the prospect that inflation pressures would intensify in the absence of tightening.

But prospects remain positive.

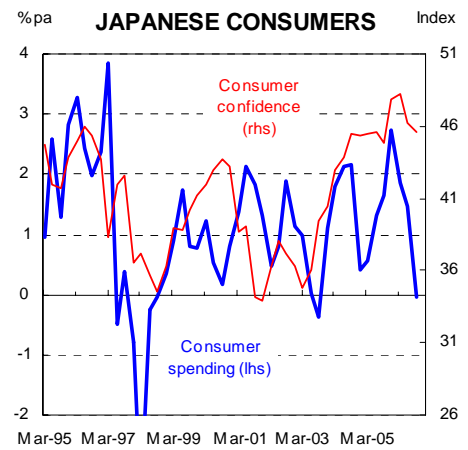
Japan's leading index, which is helpful in picking turning points in the Japanese economy, is not yet signalling that Japan's economy has recovered from the recent consumption-led downturn. In fact there has been no data since the December decision that has changed the picture markedly enough to convince us that the Bank of Japan will hike in early 2007. Consumer prices are rising, but only just.

The BoJ looks set to tighten policy gradually in 2007.

Labour market developments have been positive but Japanese wage growth remains contained. If the BoJ remains focussed on short-term developments, it will be difficult to justify a near-term rate hike. But a switch in focus towards the longer-term inflation risks should eventually see the BoJ raise rates.

The prospect that labour market tightness will lead to stronger wages growth, stronger consumption, and GDP growth appears case enough for policy tightening. In spite of the recent slowdown, the Japanese recovery appears self-sustaining and domestically driven and the BoJ will be wary about inflation risks. Beyond the near-term rate debate, we think the BoJ will undertake moderate, gradual tightening in 2007.

We expect the call rate to end 2007 at 1.0%, still well below neutral, from its current level of 0.25%.



The New Zealand Economy

All Blacks finally win the World Cup?

Many New Zealanders are hoping that 2007 will be the year that New Zealand finally manages to win the rugby world cup. It has been 20 years since the first and only time the All Blacks won the tournament.

Positive, but modest growth.

Economically speaking, it should be a year of unspectacular growth and still high domestic inflation. This inflation pressure will keep the Reserve Bank hawkish. High interest rates and a strong NZ dollar also look set to be part of the mix for 2007. The global growth backdrop is supportive. Consensus forecasts point to robust growth for New Zealand's main export partners. This should aid the required economic rebalancing in New Zealand. The export sector should eventually take over from households as the key growth driver.

High interest rates, strong exchange rate.

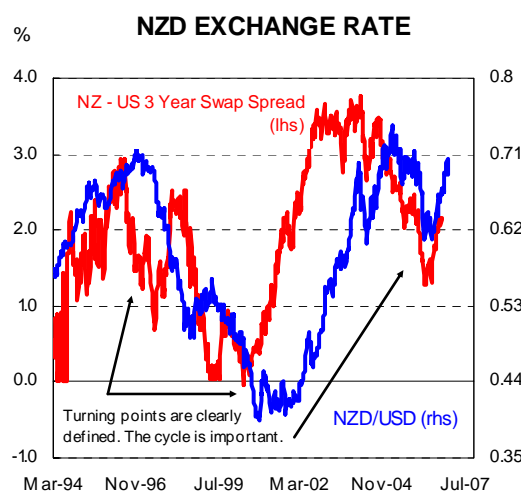
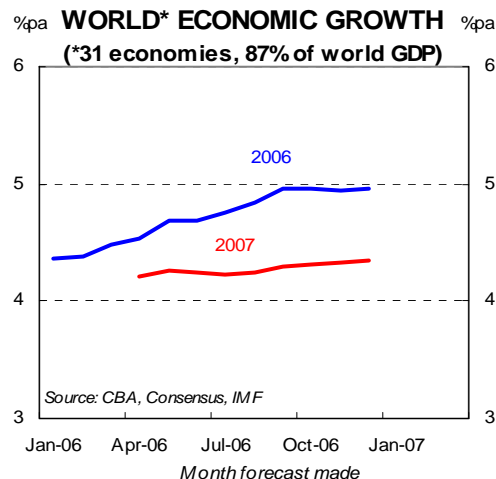
The New Zealand dollar strengthened in the second half of 2006 we expect this to continue in 2007. The local currency is extremely interest rate sensitive. Ongoing domestic inflation pressures will keep New Zealand's interest rates high this year. Accordingly, our currency forecasts include a strong kiwi dollar, peaking at US\$ 0.73 in mid 2007. A resurgent NZ dollar is not helping the export sector, but strong global commodity prices are providing an offset. Global prices for New Zealand's main exports will be important to monitor this year. Dairy is New Zealand's biggest export sector. Dairy prices were very strong in 2006. Prices are high because of regional supply issues and strong global demand.

Terms of trade expected to stay strong.

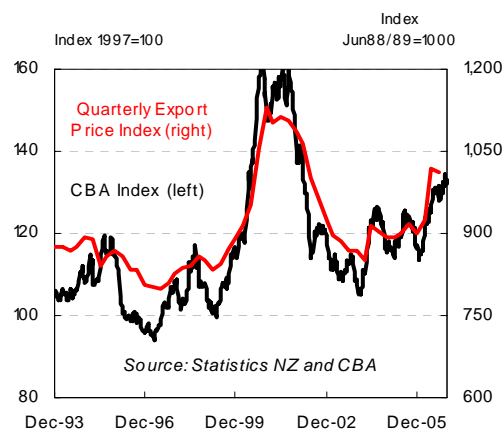
Dairy prices may well be peaking now and will be under downward pressure as the northern hemisphere season begins. Meat prices are reasonable, but the industry is feeling the effects of a strong currency, as is the forestry sector. Our overall expectation is for continued strength in commodity prices in 2007.

New Zealand is a net importer of energy.

The current lower level in global oil prices will contribute to lower import costs and continued strength in New Zealand's terms of trade in 2007. A strong trade position is necessary to reduce New Zealand's large current account deficit which stands at 9.1% of GDP.



COMMODITY & EXPORT PRICES



Current account deficit is large.

Over 75% of the current account deficit in New Zealand results from investment income outflows. This in part reflects the poor savings rate and debt accumulation of New Zealand households. A narrowing in New Zealand's current account requires improved savings and lower level of consumption growth from households. This improvement is part of the rebalancing away from households as the key driver of economic growth.

Oil to the rescue for inflation.

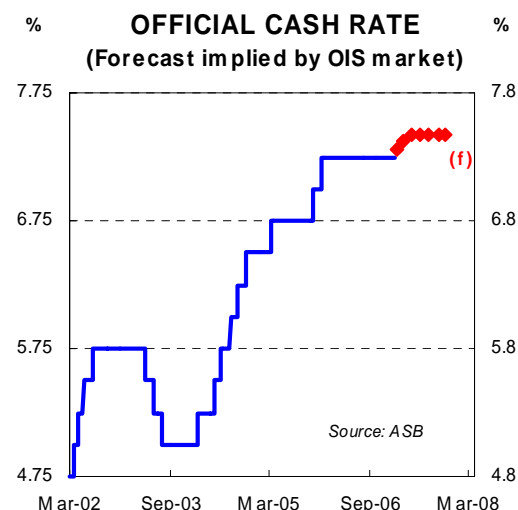
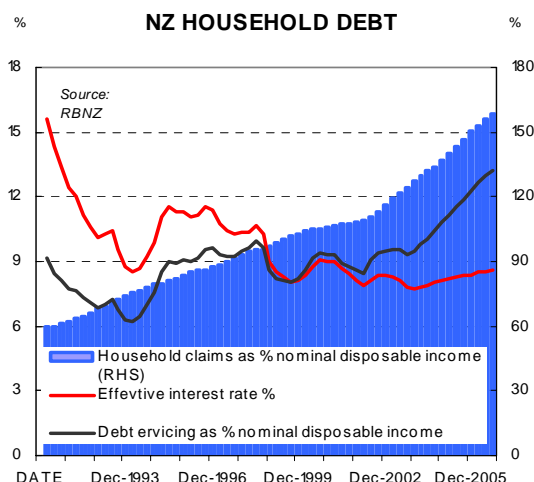
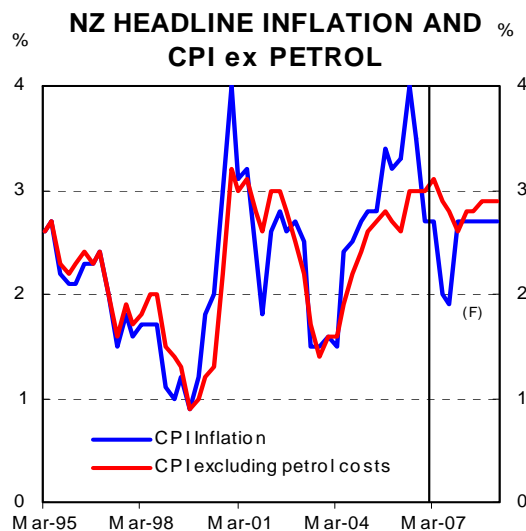
Annual consumption growth has fallen since 2005, but still remains high. And given the ongoing strength in the housing market, and the tight labour market, New Zealand households look set to continue their borrowing and spending ways in 2007.

RBNZ to retain tightening bias.

The RBNZ have the task of keeping CPI inflation between 1–3%pa over the medium term. Strong wage inflation, and strong domestic demand have contributed to the CPI remaining outside the target range for the last 5 quarters.

Falling global oil prices will contribute to the CPI falling quite quickly back into the target range in 2007. But the petrol effect disguises the ongoing inflation pressure that remains within the economy. The Reserve Bank will not cut interest rates any time soon despite a fall in headline inflation. In fact the risks are skewed towards further tightening. Activity data indicates that household consumption and the housing market both accelerated in Q4 2006 and this has put the risk of further RBNZ tightening firmly back on the table.

Market pricing currently implies a 25 basis point rate hike over the current quarter, and no easing in 2007. In contrast, we think that the RBNZ will retain the current 7.25% cash rate, but the risks are firmly skewed to the upside in the near-term, and any chance of easing is several quarters away. Even without further RBNZ action, New Zealand's interest rates are high on a global basis. There was renewed interest in high yielding currencies like the New Zealand dollar in the second half of 2006 and this looks set to continue in early 2007.



Offshore NZ bond issuance important.

Over the last few years, a huge amount of New Zealand dollar denominated investments such as Uridashi and Eurokiwi bonds have been purchased by offshore investors.

A significant number of these investments mature in the second half of 2007 and if maturing funds are repatriated by investors, the New Zealand dollar will experience significant downward pressure. Whilst it cannot be said that the current maturity profile of Uridashi bonds will cause depreciation in the New Zealand dollar exchange rate with the yen, the developments in the New Zealand Uridashi market over the next 12 months should be front of mind for anyone interested in this cross rate.

Business outlook improves....

Both own activity and general business outlook continues to improve, with headline confidence at a 4 year high in the December Quarter NZIER Quarterly Survey.

Business confidence is expected to continue to recover to more average levels in the opening months of 2007. Sectors previously hurting from the shallow NZ growth slowdown – construction and retail sectors in particular – recovered slightly towards the end of 2006 as activity consolidated somewhat. Stronger domestic activity leading indicators suggest this will continue into 2007. Furthermore, still solid exporter confidence suggests that high global commodity prices are helping to offset the high NZD to some extent.

...but the resource stretch remains.

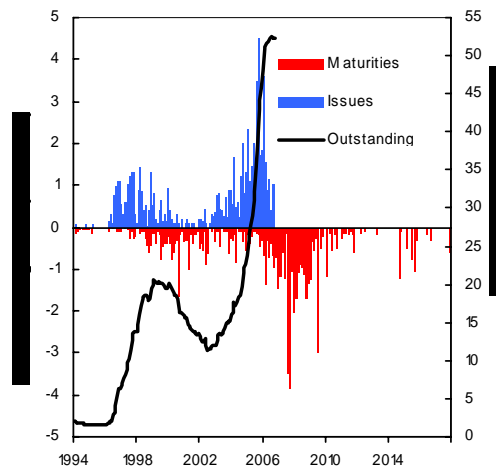
Business costs have retreated slightly in the wake of lower oil prices, and combined with a generally better trading outlook, profit expectations have also hit positive territory for the first time in 2 years. This generally better backdrop has put firms back in hiring mode, with employment expectations back up to levels last seen in early 2005.

Note that business trading activity, and profit expectations, are unlikely to push higher further into 2007. Domestic cost pressures remain pervasive, reflecting still acute resource stretch. And in the absence of significant productivity gains near term, capacity constraints will likely limit domestic growth to the 2-3% p.a. range. This should continue to prove a competitive revenue environment.

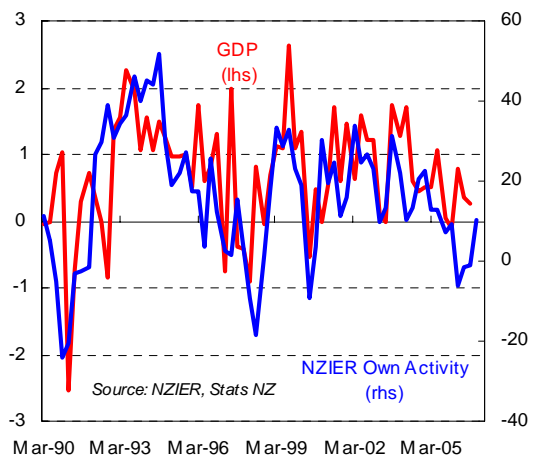
Running with more risk.

Overall, the economic outlook for 2007 is reasonable but it is not without risks. High household debt leaves the consumer vulnerable during an economic slowdown. Ongoing tightness in the labour market and increasing costs pressure company profitability. Rebalancing is still required within the economy and this will require continued easing in consumption growth from households and a deft hand by the Reserve Bank during 2007.

OFFSHORE NZD BOND ISSUANCE
(Eurokiwi and Uridashi bonds)



GDP & NZIER OWN ACTIVITY



Exchange rates

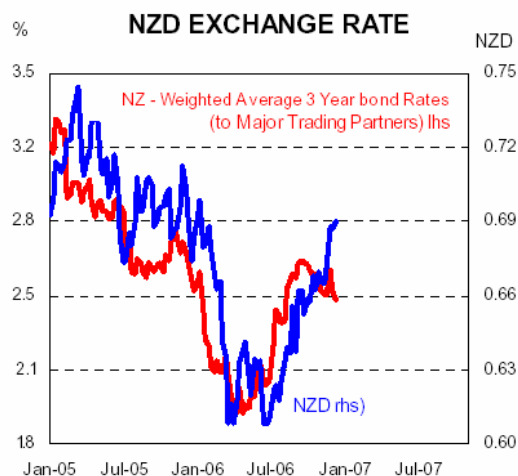
In late 2006 we revised up our NZD forecasts. The solid growth momentum in the New Zealand economy is generating upside risks to inflation and interest rates. Despite our ‘rates on hold’ view, there is a strong risk the RBNZ will raise interest rates. RBNZ have stated their concern *“there is an increased chance that some further increase in interest rates may be required to ensure that medium-term inflation pressures abate”*.

Housing (and house prices) are strong, net migration continues to increase, the service sector is expanding. Agriculture commodity prices (in SDR terms) have accelerated and New Zealand’s export volumes have picked up despite the high exchange rate.

New Zealand’s high interest rates compared to New Zealand’s major trading partners are keeping the NZD well-supported. A slowing US economy and Fed rate cuts will cause USD depreciation. The NZD can appreciate despite a slowing US economy, as above average global growth, driven from other economies, will help ensure New Zealand economic growth remains solid.

Annual average forecasts are shown to the right.

A 2007 summary of key statistics in on the following page.



	USD Averages			
	2007	2008	2009	2010
AUD	0.785	0.760	0.760	0.760
EUR	1.325	1.250	1.250	1.250
JPY	125.3	120.0	112.0	112.0
GBP	1.963	1.800	1.800	1.800
CAD	1.150	1.150	1.150	1.150
NZD	0.708	0.640	0.650	0.650
NZD/AUD	0.901	0.842	0.855	0.855
NZD/GBP	0.361	0.356	0.361	0.361
NZD/JPY	89	77	73	73

GDP (annual % chg)	2004	2005	2006	2007
US	4.2	3.2	3.3	2.5
Australia	3.5	2.7	2.7	3.2
New Zealand	4.3	2.2	1.9	1.9
Canada	3.3	2.9	2.8	2.6
Eurozone	1.8	1.5	2.6	1.9
Japan	2.3	2.7	2.7	2.0
CPI (annual % chg)	2004	2005	2006	2007
US	2.7	3.4	3.4	2.3
Australia	2.3	2.7	3.6	2.7
New Zealand	2.3	3.0	3.5	2.7
Canada	1.8	2.2	2.1	1.8
Eurozone	2.1	2.2	2.2	2.1
Japan	0.0	-0.3	0.2	0.4
C/A bal (% of GDP)	2004	2005	2006	2007
US	-5.7	-6.4	-6.7	-6.0
Australia	-6.3	-6.0	-5.2	-5.2
New Zealand	-6.3	-8.9	-8.5	-7.8
Canada	2.2	1.8	1.9	1.9
Eurozone	0.6	-0.4	-0.1	0.0
Japan	3.8	3.6	3.2	2.9
Cash rate	19-Jan	Dec-06	Mar-07	Jun-07
US	5.25	5.25	5.25	5.25
Australia	6.25	6.25	6.25	6.25
New Zealand	7.36	7.25	7.25	7.25
Canada	4.25	4.25	4.25	4.25
Eurozone	3.50	3.50	3.75	3.75
Japan	0.27	0.25	0.50	0.75
10yr Bond Yield	19-Jan	Dec-06	Mar-07	Jun-07
US	4.74	4.60	4.50	4.00
Australia	5.87	5.75	5.70	5.40
New Zealand	5.91	5.80	5.70	5.50
Canada	4.13	4.00	4.00	3.70
Eurozone	4.06	3.75	4.00	3.80
Japan	1.72	1.70	1.80	1.90
Exchange Rates	19-Jan	Dec-06	Mar-07	Jun-07
AUD/USD	0.7899	0.7886	0.7900	0.8000
NZD/USD	0.6952	0.7039	0.7200	0.7300
USD/CAD	1.1744	1.1659	1.1600	1.1600
EUR/USD	1.2961	1.3199	1.3200	1.3600
USD/JPY	121.21	119.07	120.00	123.00
Cross Rates				
AUD/NZD	1.1360	1.1203	1.0972	1.0959
AUD/CAD	0.9276	0.9194	0.9164	0.9280
NZD/AUD	0.8803	0.8926	0.9114	0.9125
NZD/CAD	0.8164	0.8207	0.8352	0.8468

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