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Economic Research note

RBNZ grounded amid rising tide of inflation

- **New Zealand's GDP growth to slow in 2008, owing to cooling housing activity and weaker household spending**
- **Inflation, though, will stay near the top of the RBNZ's 1-3%oya target range**
- **RBNZ to remain on hold as it balances elevated inflation against weakness offshore**

New Zealand will enjoy a welcome rotation in the sources of economic growth this year, away from domestic demand toward exports. Export volumes are likely to drive GDP growth in coming quarters as global demand expands and surging food prices stimulate supply. In particular, the dairy industry, New Zealand's largest export sector, is experiencing a huge windfall of income thanks to milk solids prices more than doubling in the past year. Household spending probably will be weaker, partly because house price inflation and construction activity have turned south. The rotation away from households as the main driver of growth, though, will be cushioned by the government's expansionary fiscal policy ahead of this year's election.

New Zealand's experience in 2008 also hinges on the performance of the corporate sector. Business conditions are likely to remain robust on the surface, but there will be patches of weakness. The agricultural sector and nonresidential construction, for example, are likely to outperform other areas of the economy on the back of rising farm incomes and increased public investment. Firms in residential construction and retailing will struggle in relative terms owing to record-high interest rates, surging oil prices, reduced immigration flows, and weaker housing activity.

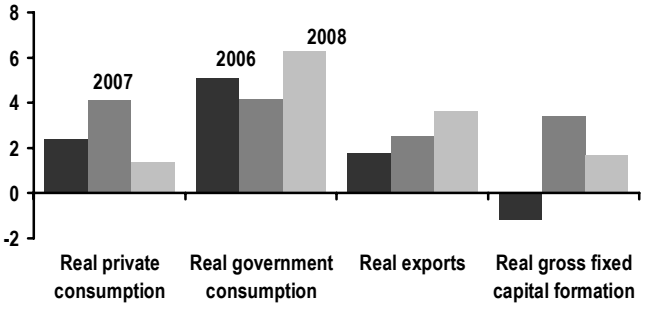
Slow and steady as she goes

New Zealand's economic ship has bumped into some icebergs of late—a big slowdown in housing activity, surging gasoline prices, and some high-profile financial market collapses—but the outlook is for continued growth, albeit at reduced speed. The economy should expand 2.5%y/y in 2008, after growth of 3.0% in 2007. The recent financial market dysfunction claimed a few scalps in the nonbank financial sector, but not enough to alter the economic outlook in a material way. The corporate sector remains in good shape and the labor market is tight.

The outlook depends on developments in three key areas:

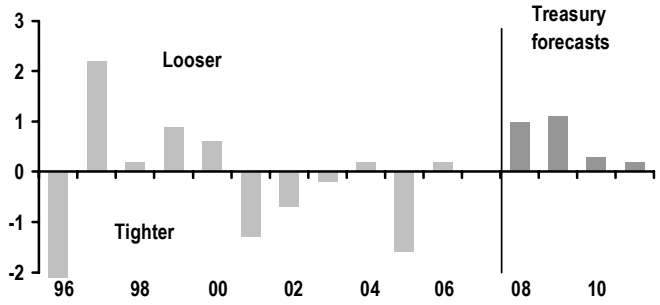
Contributions to real GDP growth

%-pt contribution to oya GDP growth



Treasury fiscal impulse forecasts

% of GDP



- First, house prices, at best, are likely to track sideways in annual terms through 3Q08 (chart), and the risk of a contraction is rising. Home sales have plummeted and the number of days to sell a property has steadily increased, pointing to lower house prices. A severe correction could push confidence and consumption down sharply.
- Second, the government's fiscal policy largesse is set to hit in the 2008 fiscal year and aggravate RBNZ officials (chart). The government is flush with cash and is trailing in opinion polls heading into this year's election. The government is likely to announce tax cuts ahead of this year's poll, which probably will be held in October. The fiscal impulse from spending plans already announced looms large on the RBNZ's list of inflation concerns.
- Third, surging soft commodity prices, especially for dairy produce, which accounts for 20% of exports, are providing a revenue windfall to Kiwi farmers (chart). The outlook for the meat industry is also prosperous, thanks to growing appetites in Asia. The commodity price boom will likely add pressure to inflation through higher rural land prices and farm spending. As a result, the risk to the inflation trajectory remains to the upside. RBNZ concern about agricultural-industry-generated inflation was a conspicuous reason for the 25bp rate hike in July 2007.

On top of a weakening housing market, though, households face a number of gusty headwinds. Elevated and rising market interest rates, higher residential rents, and surging energy and food prices will contribute to reduced growth in consumer spending. Also, the jobless rate is likely to increase in 2H08 owing to the lagged effects of slower GDP growth in the second half of 2007, coupled with rising labor costs and an elevated NZD that have squeezed corporate profitability. That said, the windfall of cash coming into the system through Fonterra's (New Zealand's largest dairy cooperative) record payout to farmers, and the government's desire to "buy" its way back into power, will provide a cushion for consumption growth.

Business investment outside the agricultural sector is likely to expand at a slow rate, following significant capital deepening in 2002 -05. Material investment, though, will occur in the dairy industry. The earlier investment in additional capacity, strong global demand, record prices, and favorable weather conditions mean that export volumes will improve. In fact, the 4%y/y increase in export volumes forecast for 2008 will be the highest since 2004.

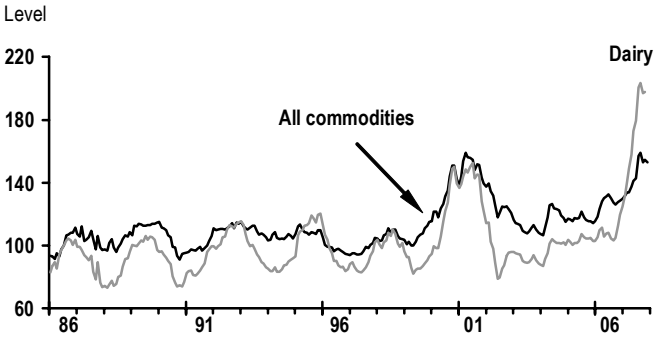
RBNZ in the red corner, PM in the blue

The shaky marriage between fiscal and monetary policy in New Zealand has been through a bitter divorce in recent years; the government's economic stabilizers have worked against the RBNZ's attempts to slow the pace of domestic demand growth. Key to watch over the course of 2008 is the evolution of the government's expansionary fiscal policy heading into the election, and the RBNZ's response.

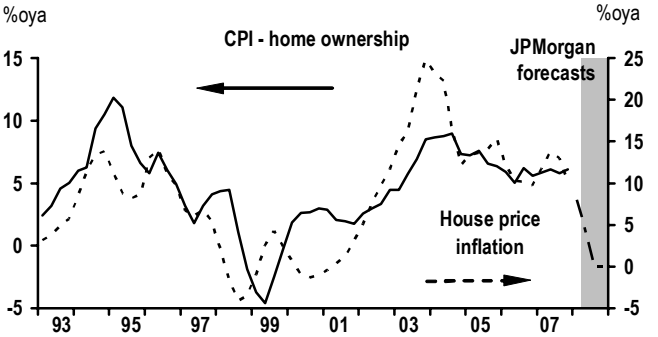
Prime Minister Helen Clark's government would be wise to heed the lessons learned in Australia, where fiscal policy largesse leading into last November's election contributed to the RBA tightening policy during the election campaign, which had adverse effects for the government on election day. The RBNZ will continue to focus on fiscal developments, and lock horns with the government over the extent of fiscal stimulus being unleashed ahead of the election. Our forecast is that the RBNZ is on hold from here, but another tightening could result if RBNZ officials believe that the government is overly stimulating the economy.

The government's promised personal tax cut package, rising oil and food prices, and higher prices from the new emissions trading scheme, which will boost inflation from 2009, mean that interest rates are likely to remain at current elevated levels for the foreseeable future. The RBNZ has been at war with inflation since early 2004, and will be keen not to surrender recent gains, so the first rate cut remains a long way off, most likely in 2009. Furthermore, given the RBNZ's assertive action to date, and the weakening housing market, the hurdle for another tightening remains high.

ANZ commodity price index - in NZD



QVNZ house prices and home ownership component of CPI basket



Usual suspects: three risks to the view

The three wildcards for the New Zealand economy in 2008 are the path of global growth, (with growth in Australia, New Zealand's largest trading partner, critical), net permanent immigration, and NZD. First, should the current financial market turbulence and subprime mortgage crisis deliver unexpectedly weak global GDP growth, growth in New Zealand's key trading partners inevitably will be affected. The predicted export-led growth rotation away from households, therefore, would be inhibited.

Second, net permanent immigration defied most market forecasts (including our own) in 2006 and early 2007 and placed a floor under housing activity and consumption growth. Surprises on the upside or downside to net permanent immigration, however, could generate substantial swings in domestic demand. Given the slowdown globally, fewer Kiwis are likely to depart in 2008. Finally, a stronger for longer NZD will curb exporters' competitiveness while, on the flipside, a big NZD fall would boost exports, but add to imported inflation. The risk is that the NZD holds strong in the near term but then drops sharply into year end.