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Economic Research note

Dark clouds forming over New Zealand's economy

- **RBNZ to embark on monetary easing cycle in 4Q**
- **Growth will slow as inflation remains above target**
- **GDP growth to slump to 1.4% in 2008 before recovering in 2009**

Economic momentum in New Zealand will slow significantly in 2008, owing mainly to weaker private consumption growth and a contraction in residential construction. Our forecast calls for GDP growth to dive from 3.1% in 2007 to a subpar 1.4% in 2008, with a contraction in economic growth anticipated for 2Q. The RBNZ probably will delay easing monetary policy until October; RBNZ officials will be searching for evidence of whether the recent weakness in employment and consumer spending will be sustained.

Upside pressure on inflation persists

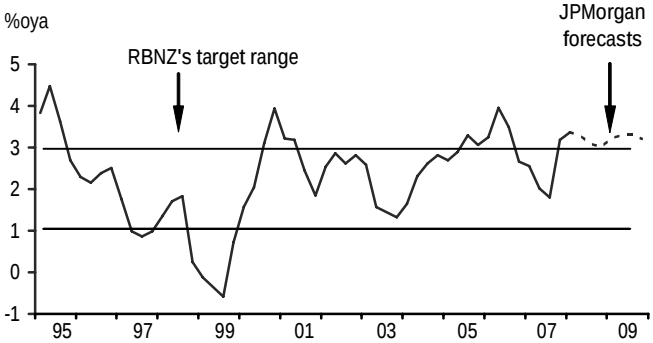
Also, upside inflation risks will prevent an interest rate cut before 4Q. Headline inflation rose to 3.4%oya in 1Q, hovering above the RBNZ's 1-3% target range for the second straight quarter. More importantly, nontradables inflation—generated domestically and not influenced by exchange rate fluctuations—held at 3.5%, even though domestic demand recently has slowed significantly.

There still appear to be price pressures building in the pipeline. Producer prices spiked in 1Q amid soaring crude oil costs, rising dairy prices, and increased demand for electricity. Prices paid by power companies surged 42%q/q as low hydro lake levels owing to the drought bolstered wholesale electricity costs. Both nontradable and producer price inflation will have to moderate before the RBNZ considers embarking on an easing cycle.

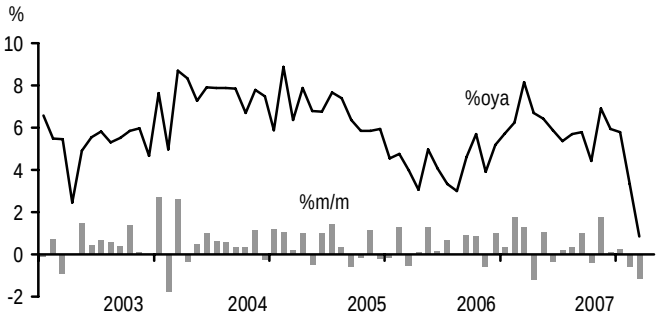
First cut to OCR in October

The RBNZ has left the official cash rate (OCR) at a record high of 8.25% since July 2007. According to our forecast, the RBNZ will cut the key rate 25bp in October, and again in December and 1Q next year. Our previous forecast that a rate cut would be delayed until 2009 was based mainly on the assumption that inflation would track above the RBNZ's target range for an extended period. But, signs that the economy will slow to a standstill midyear mean that the RBNZ now will be more inclined to tolerate what will be uncomfortably high CPI readings in coming quarters.

CPI growth to remain elevated



Downside risks for retail sales



Also, the government's decision to delay the introduction of the emissions trading scheme (ETS) will take some upside pressure off inflation. The government recently announced that the introduction of the ETS would be postponed for two years, protecting consumers against higher costs for gasoline and fuel until 2011. Estimates suggest that the ETS would add up to 8 cents a liter to the price of gasoline and fuel, which already are elevated and eating away at household budgets.

Private consumption growth tanking

The recent change in our rate call emerged amid a slew of weak economic data. In particular, labor market statistics indicated that labor market conditions loosened in 1Q, with employment contracting and wage growth easing unexpectedly. Being lagging indicators, these developments provided reason for concern about the health of the economy, especially since business confidence has recently plunged. Corporate profitability has dwindled amid soaring gasoline prices and tighter credit conditions, meaning that firms will become increasingly reluctant to hire workers, sending the jobless rate higher throughout 2008.

Household consumption will be dampened further throughout 2008. Consumer spending already is suffering, with retail sales volumes unexpectedly slumping 1.2%q/q in 1Q—the biggest quarterly drop since March 1997—under

the weight of record high interest rates, rising energy costs, a rapidly deteriorating housing market, and drought conditions in key dairy producing regions. There is additional downside risk now that a number of domestic banks have begun passing on higher funding costs resulting from credit market tightening. Domestic lending rates have increased even though the OCR has remained unchanged since July.

That said, the forecast 50bp cut to the OCR in 4Q, and the personal income tax relief recently announced in the May 22 Budget should cushion the downside for private consumption. The income tax cuts delivered by Finance Minister Michael Cullen this week were larger than expected, and will total NZ$10.6 billion over the next four years. Any further deterioration in the nation's fiscal position, however, may lead to credit rating downgrades, and significant tax cuts and increased spending run the risk that the RBNZ will not be able to start lowering interest rates this year.

Residential construction another key drag

The worst declines in employment in the March quarter were in industries related to the housing sector, conditions which have deteriorated sharply in recent months. House prices fell 1.2% in April, the medium number of days to sell a home rose from 40 to 44, and house sales are now down more than 45%oya—the lowest since 1991.

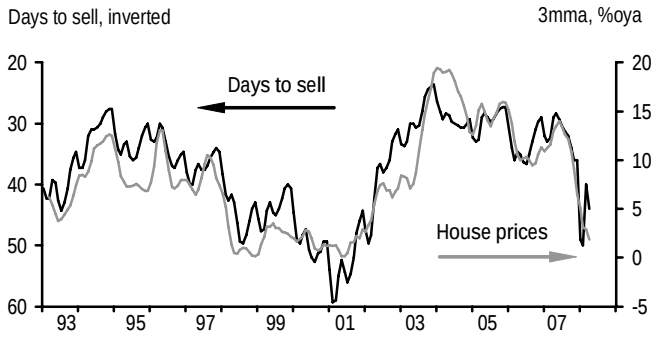
The house price boom in recent years has been fuelled by excessive household borrowing, with many households clearly taking on too much debt. Household debt as a percentage of nominal disposable income rose to 164% in the December quarter. Confidence in New Zealand's housing market now is at its lowest in 12 years, heightening the risk that house prices will fall more than the 5% we and the RNBZ forecast for 2008.

Recession should be avoided

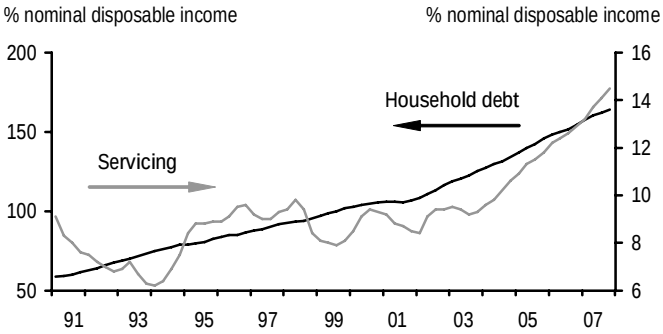
A recession in 2008 should be avoided, but the risks are skewed to the downside. Weaker NZD will help boost exports, which account for a significant 30% of the economy. Our forecast calls for the NZD—which recently sank to a four-month low—to be at $0.78 by year end, bearing in mind that NZD will retain upside support from higher commodity prices.

But the impact of the drought on exports will remain a drag. The dairy industry, the nation's largest exporter, has announced that it faces a NZ$500 million cut to its export income from production losses because of the drought. Furthermore, an unexpectedly sharp slowdown in global demand remains a key risk to the predicted export-led growth rotation away from households in 2008; this may develop if the credit crisis triggers a deeper global slowdown.

Housing market deteriorating rapidly



Household claims and debt servicing rising



The RBNZ has acknowledged that if credit conditions tighten significantly, the economic slowdown will be exacerbated, putting additional financial pressure on households already knee-deep in debt. The RBNZ recently announced, new liquidity measures, similar to those adopted by other central banks, aimed at ensuring sufficient liquidity in the banking system in the event of further global financial market volatility.

One other area for concern is the burgeoning current account gap. Any further deterioration of the current account deficit (now 8% of GDP), coupled with increased risk aversion and growing speculation that the RBNZ will soon start cutting interest rates, could send the NZD into a tailspin, adding upside risk to inflation.

Indeed, downside risks to growth have grown in recent months, but building inflation pressures mean that the OCR will remain at its current level until later in the year. Increased government spending on health, education and infrastructure, and the deliverance of personal income tax cuts should limit the extent of the economic slowdown, however, meaning that a recession should be avoided.