

New Zealand Economic Update

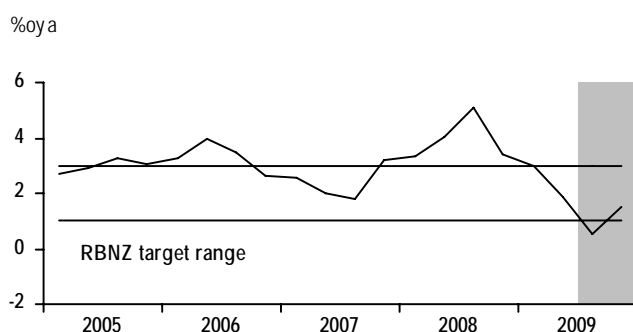
Consumer price index

- **Headline CPI back within RBNZ's target range**
- **Non-tradable inflation still elevated**
- **RBNZ's easing cycle over; OCR hike forecast for mid-2010**

Inflation in New Zealand accelerated in the second quarter. Consumer prices grew 0.6%q/q (J.P.Morgan 0.2%, consensus 0.5%), compared to 0.3% in 1Q. From a year ago, consumer price growth fell markedly, however, to 1.9%oya from 3.0%, marking the smallest rise since 3Q07 and falling comfortably back into the RBNZ's 1-3% target range. Statistics New Zealand said that if petrol and diesel prices had remained unchanged in the June quarter, the CPI would have increased 3%oya. With non-tradable inflation remaining elevated, however, we maintain our view that the RBNZ's easing cycle has ended.

Higher food prices were the major upward force on headline CPI, rising 0.9%q/q. Higher vegetable prices were partly offset by lower fruit prices over the quarter. The other main positive contribution came from the transport group, where prices rose 0.6%q/q in 2Q, owing to higher petrol prices..

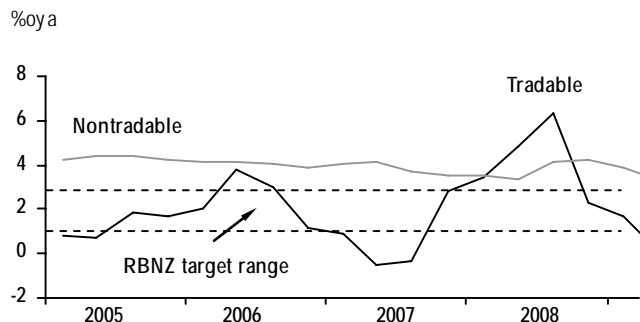
New Zealand: CPI



But, while the headline measure is back within the RBNZ's comfort zone, the non-tradable measure—inflation generated domestically and not influenced by the exchange rate—is not. Non-tradable inflation, at 3.3%oya, eased considerably in 2Q but still is hovering above the Bank's target, as it has done since early 2001. Significant upward contributions came from electricity, local authority rates and payments, rentals for housing, and beer. This strength in non-tradable inflation surprised on the upside, given the persistent weakness in the domestic economy, which was in a

home-grown recession before the worst of the international troubles unfolded. The tradables component increased just 0.2% oya.

New Zealand: nontradable and tradable inflation



With non-tradable inflation likely to hover at the upper end of the RBNZ's target range in the foreseeable future, we see little scope for the RBNZ to ease policy further, especially when the economic data (both domestic and offshore) recently has printed on the upside of expectations. We believe the OCR already has bottomed at 2.5% in the current easing cycle, with the next move to be a rate hike in mid-2010. The risk is, however, that an OCR hike may be delivered before then, if non-tradable inflation remains elevated throughout 2H09 and the global recovery continues to gather steam.

We believe the New Zealand economy will start to recover in 4Q, thanks to the significant monetary and fiscal policy easing delivered by policy-makers. The main risk to the recovery we forecast to commence later this year is the strengthening NZ dollar, which currently is dampening the chances of an export-led recovery as global demand picks up. Domestically, net migration and signs of stabilization in the housing market bode well for the resumption of growth later this year.

%q/q	1Q09	2Q09
Food	1.2	0.9
Alcoholic beverages and tobacco	1.8	0.5
Clothing and footwear	-0.4	1.8
Housing and household utilities	0.3	0.4
Household contents and services	0.2	1.5
Health	0.8	0.9
Transport	-1.5	0.6
Communication	-0.1	0.7
Recreation and culture	-0.6	-1.2
Education	4.2	0.0
Miscellaneous goods and services	0.9	1.0
Total	0.3	0.6

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