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For immediate release

Downunder Digest

New Zealand's modest recovery continues, says HSBC

- **Commodity exports to Asia and the post-earthquake reconstruction will drive growth in 2012 and beyond**
- **At the same time, household deleveraging and the unwinding fiscal deficit will continue to keep the recovery modest**
- **Very low RBNZ rates will continue to support the economy, with hikes not expected until H2**

Recovery to continue

The recovery of New Zealand's economy from the global financial crisis of 2007-08 has been slow. Growth has been supported by ongoing trade with Asia and elevated commodity prices; however, much like the rest of the developed world, it has been held back by household deleveraging and financial retrenchment.

New Zealand has also been subject to significant negative shocks, in the form of the Canterbury earthquakes and the ongoing aftershocks, which have hindered progress on rebuilding and repair. Just to throw another spanner in the works, late 2011 saw the European financial crisis take a toll on local confidence and investment appetite.

In 2012, many of these themes will continue to resound. With Asia's growth expected to continue to outperform, commodity prices are expected to stay elevated, which will hold up local incomes. However, we still expect that in H1 the European financial crisis will dampen local growth, particularly via tightened financial conditions as it has increased the cost of bank funding. Households are expected to continue to deleverage, though we think continued low interest rates will see some support for the housing market this year.

A big factor that is expected to support growth is the rebuilding of Canterbury. The official estimates suggest that the value of claims from the earthquake is around NZD30bn, which is a substantial 15% of GDP. The RBNZ suggests that reconstruction could take five years to complete. This has been a far bigger event for New Zealand, as a share of the economy, than the natural disasters in Japan last year.

We expect that reconstruction will significantly boost the economy this year, though progress on reconstruction has been hampered by aftershocks, so the timing of the rebuild remains a key uncertainty.

The monetary policy setting is clearly expansionary, while fiscal policy is expected to continue to be contractionary. As growth picks up this year, supported by the Canterbury rebuild, we expect the RBNZ to lift rates, with 50bp of hikes still expected in H2 2012.

Nascent recovery so far

New Zealand's recovery since the global financial crisis has been slow, with GDP is still well below the level implied by the trend prior to 2007. This performance is more similar to the rest of the developed world than to Australia and the Asian economies, which are not far off previous trends (Chart 1).

Slow growth largely reflects the impact of continued household deleveraging and the effect of the Canterbury earthquakes. Household deleveraging is expected to continue in 2012, though low interest rates should see some support for the housing market in particular.

The Canterbury earthquakes have disrupted growth in demand, but the earthquakes have also reduced the supply capacity of the economy, by reducing the capital base, as infrastructure and housing have been destroyed, and by outward migration away from Canterbury and away from New Zealand in general (Chart 2). Nonetheless, the economy is still operating well below capacity, with the unemployment rate still in the sixes (Chart 3).

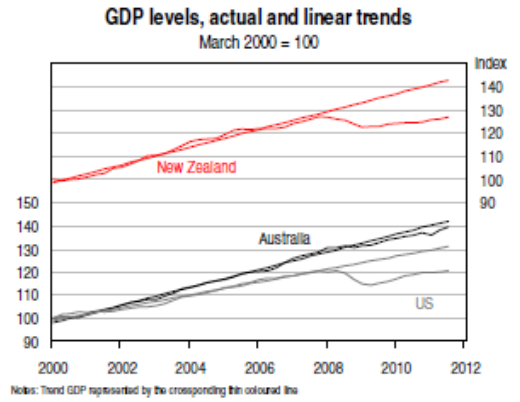
Reconstruction delays

Rebuilding and repair is expected to be a key driver of growth in 2012 and 2013. Official estimates suggest the repair bill could run to NZD30bn, which is c15% of annual nominal GDP. The RBNZ has recently stated that reconstruction could take five years to complete.

However, continued seismic activity has seen reconstruction delayed. While the ground is still shaking, households and businesses have been reluctant to commence reconstruction in earnest. It has also been difficult for building companies to attain insurance for reconstruction efforts, further hampering progress.

Importantly though, much of the reconstruction is forward-funded, so there should only be limited concern that it does not go ahead at all. The timing remains the uncertain part. Barring any further significant seismic events, we expect to see a significant rise in investment in 2012 and 2013 (Chart 4).

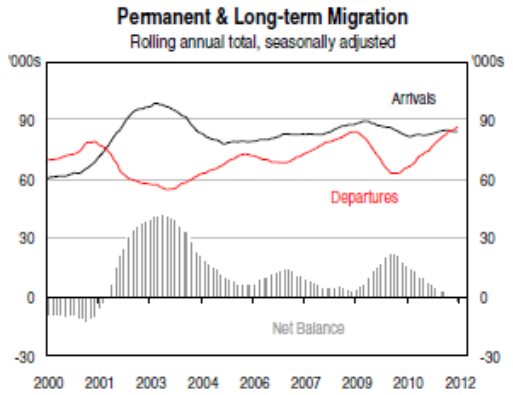
1. New Zealand GDP still well below previous trends



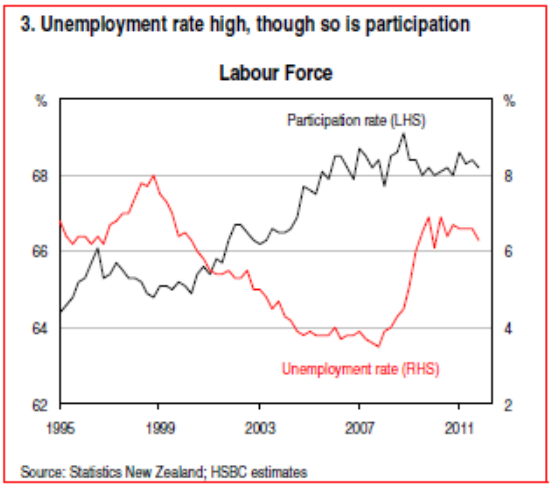
Notes: Trend GDP represented by the corresponding thin coloured line

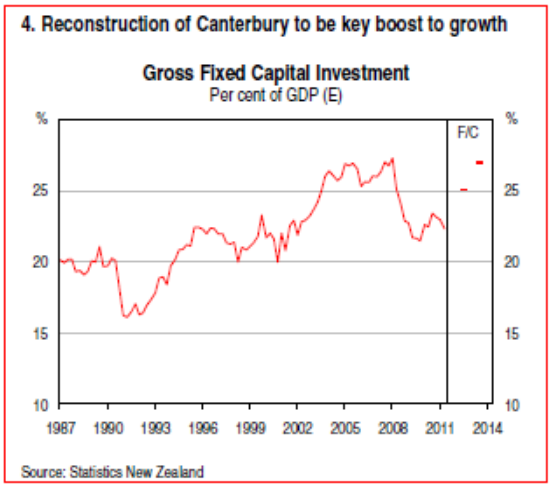
Source: ABS; Thomson Reuters Datastream; Statistics New Zealand

2. Outward migration relieving some pressure in Canterbury



Source: Statistics New Zealand

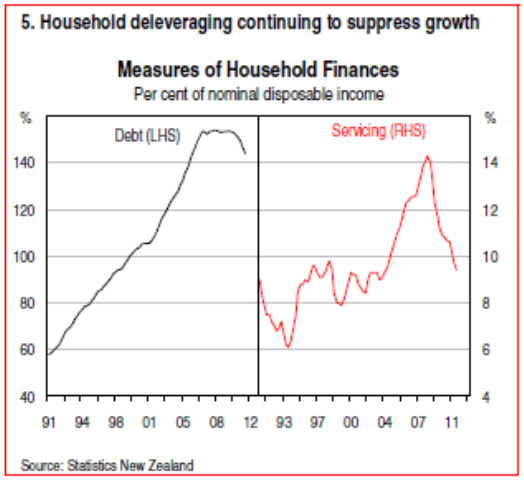


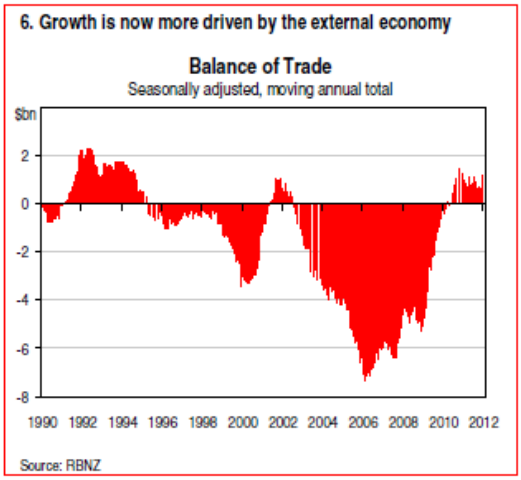


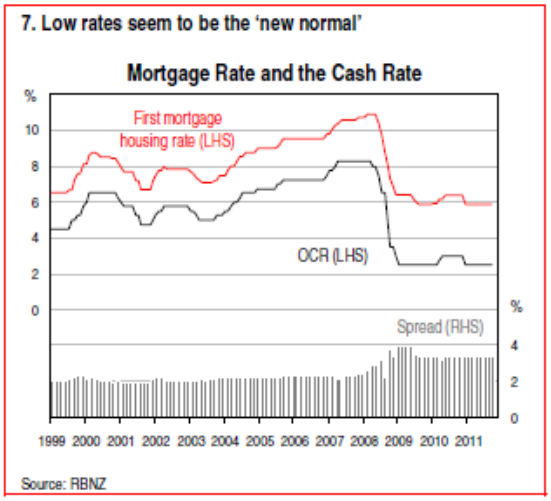
Commodities and Asia

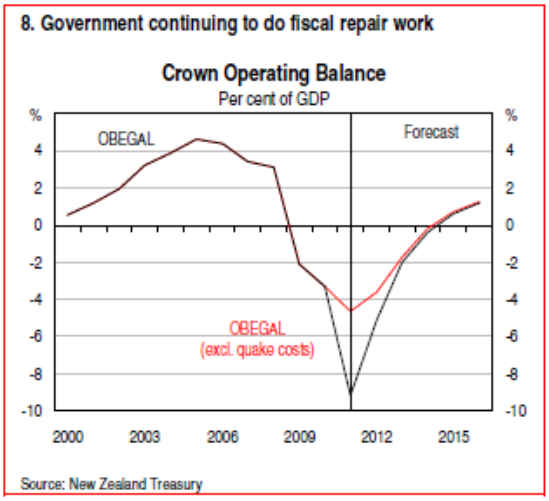
Another key theme in the outlook for New Zealand is that the economy has been shifting from internally driven growth to externally driven growth. As the period of increased household financial deepening has passed and households are now deleveraging, the growth impulse of the economy is being driven more by income from offshore (Chart 5 and 6). This is largely due to higher commodity prices (particularly meat and dairy), which have boosted export earnings. After having large trade deficits for much of the first decade of this century, New Zealand has now had a trade surplus for the past 18 months or so.

This makes New Zealand's growth prospects highly dependent on Asia and particularly demand for soft commodities. We remain of the view that the rapidly emerging middle class consumer in Asia will provide support for this source of growth. Growth in Asia this year will in part be supported by looser fiscal and monetary policy across the region. With significant capacity to adjust policy further if required, we still have a solid outlook for Asian growth, despite the expected slowdown in growth in the developed countries.









Policy settings and directions

Monetary policy remains very loose in New Zealand, with the cash rate still at a historically low of 2.50%. Mortgages rates are also low, though increased bank funding costs in recent years have seen a significant widening of the spread between the cash rate and mortgage rate (Chart 7). Increased funding costs due to the European financial crisis have also seen additional pressure on bank margins and may yet see some upward pressure on mortgage rates. New Zealand banks are still highly exposed to offshore markets, with around 30% of their funding from this source.

This has been one of the concerns flagged by the RBNZ and a reason why rates have been left on hold at very low rates. Indeed, the RBNZ has stopped referring to them as 'emergency lows' and it looks as though these very low rates will be with us for some time yet. We expect that as the reconstruction efforts in Canterbury kick up a notch, the RBNZ will start to lift rates modestly in H2 2012.

Fiscal policy is working in the other direction for the next few years as the government seeks to get back to surplus by the middle of this decade (Chart 8). While debt levels remain low by international standards (expected to peak at 29% of GDP in 2015), officials are aware that New Zealand's international funding requirement makes debt levels more vulnerable. Some part of the fiscal retrenchment is due to government asset sales, which will reduce the contractionary impact of the planned return to surplus.

Bottom line

We still expect growth to rise this year, supported by ongoing demand for rural commodities from Asia and post-earthquake rebuilding in Canterbury.

The global economy remains a key risk, particularly via its impact on the increasing cost of bank funding.

Loose monetary policy will continue to support growth, though we expect the RBNZ to start to withdraw some of its support later in the year, with 50bp of hikes pencilled in for H2 2012.

1. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2011e	2012e	2013e	Q311	Q411e	Q112e	Q212e	Q312e	Q412e	Q113e
%*										
AUSTRALIA										
GDP	2.0	3.4	3.5	2.5	2.6	4.0	3.3	3.2	3.3	3.5
Consumption	3.5	2.7	2.6	3.8	3.7	3.4	2.8	2.2	2.3	2.4
Govt consumption	1.6	1.9	2.8	0.9	1.0	1.1	0.8	2.7	2.8	2.8
Investment	6.8	9.2	6.9	9.2	9.6	9.1	11.9	7.8	7.9	7.7
- Dwelling	-1.6	1.0	6.1	-2.9	-1.1	-0.4	0.5	1.2	2.9	5.2
- Business	16.0	17.1	8.5	21.9	21.3	19.6	23.7	13.3	12.9	10.9
- Public	-7.4	-6.7	1.5	-10.2	-9.6	-10.0	-9.4	-3.5	-3.5	-1.0
Final domestic demand	4.0	4.3	3.9	4.6	4.8	4.5	4.9	3.8	4.0	4.0
Domestic demand	4.3	4.1	3.9	4.7	4.4	4.4	4.0	3.8	4.0	4.0
Exports	-1.5	10.3	10.6	0.8	1.1	10.4	9.9	10.5	10.3	10.6
Imports	11.4	12.8	10.8	13.8	13.3	13.9	13.4	12.0	12.0	11.5
GDP (% quarter sa)	-	-	-	1.0	0.9	0.6	0.7	0.9	1.0	0.8
CPI**	3.6	3.1	3.2	3.5	3.1	2.2	2.0	2.8	3.6	3.6
Trimmed mean	2.4	2.6	2.8	2.4	2.6	2.4	2.3	2.7	2.8	2.8
Unemployment rate	5.1	5.4	5.1	5.2	5.3	5.4	5.5	5.4	5.3	5.2
Labour price index	3.7	3.4	3.6	3.6	3.4	3.3	3.3	3.4	3.5	3.6
Current A/C (%GDP)	-2.2	-3.9	-4.8	-1.6	-2.2	-3.1	-3.8	-3.0	-3.3	-3.3
Terms of trade	14.2	-6.5	-4.8	13.2	8.8	1.1	-6.8	-10.5	-9.1	-6.6
Cash rate (end period)	4.25	3.75	4.25	4.75	4.25	4.00	3.75	3.75	3.75	4.00
NEW ZEALAND										
GDP	2.0	2.8	3.3	2.4	2.3	2.0	2.9	3.0	3.3	3.5
Consumption	2.2	2.1	2.1	2.6	2.6	2.2	2.4	1.9	1.9	2.6
Govt consumption	2.3	2.6	2.8	2.5	1.8	2.0	2.8	2.8	2.8	2.8
Investment	3.5	10.2	11.0	3.8	0.9	5.6	10.1	11.9	13.1	2.0
Final domestic demand	2.5	4.0	4.3	2.8	2.1	3.0	4.2	4.3	4.6	4.7
Domestic demand	2.3	4.2	4.3	2.2	0.9	3.7	4.2	4.3	4.6	4.6
Exports	2.1	2.8	5.7	3.3	1.8	1.6	2.7	2.9	3.9	1.5
Imports	6.0	6.6	8.3	6.8	1.3	5.9	6.0	6.8	7.6	2.0
GDP (% quarter sa)	-	-	-	0.8	0.6	0.6	0.9	0.9	0.9	0.8
CPI	4.3	2.0	3.0	4.6	1.8	1.8	1.5	2.8	2.9	2.9
Unemployment rate	6.5	6.0	5.5	6.6	6.3	6.2	6.1	5.9	5.7	5.6
Labour price index	1.9	2.7	3.2	2.0	2.0	2.3	2.6	2.8	3.0	3.1
Current A/C (%GDP)	-2.8	-5.5	-4.8	-3.7	-5.6	-5.5	-5.1	-5.6	-5.8	-5.6
Cash rate (end period)	2.50	3.00	4.00	2.50	2.50	2.50	2.50	2.75	3.00	3.25

Source: ABS; HSBC forecasts; RBA *unless otherwise specified **Includes the effect of the carbon tax from Q312

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10 February 2012

Disclosure appendix

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