# Economic Overview

November 2012

## Two speed ahead


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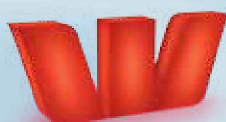

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# Note from Dominick

The New Zealand economy accelerated over the first half of 2012, but momentum has waned and it looks as though slower growth will persist until year-end. This reinforces a key theme – patchiness. The economy is currently subject to strong but opposing forces – the Canterbury rebuild, good agricultural growing conditions, and a buoyant housing market on the upside; the slow global economy, high New Zealand dollar, and fiscal austerity on the downside. We should expect a lumpy timeline for growth as well as divergences across regions. Indeed, Canterbury is now surging while parts of the North Island are struggling. But lumps and bumps aside, the big picture remains the same – a construction-led upturn in economic growth.

The global economic slowdown has spawned policy responses around the world, from infrastructure projects in China, to interest rate cuts in Australia, to quantitative easing in the big rich countries. As policy stimulus takes effect, we expect global growth will pick up, albeit modestly (see page 9).

In my travels around New Zealand I have noticed a bit of angst about the possible effects of quantitative easing (QE) in the United States. The most common concern is that QE is "debasing the US dollar", which could spark inflation in the US and push up New Zealand's exchange rate in the process. The financial markets section (page 6) explains why we don't necessarily share those concerns. It is worth bearing in mind that Japan has been engaged in quantitative easing since 2001, and has been locked in *deflation* for most of that time.

We've rounded out this *Economic Overview* with our impressions of how Reserve Bank policy might evolve under the new Policy Targets Agreement and new Governor (page 8). It is early days yet, but communications so far indicate a firm focus on medium-term inflation.

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# New Zealand Economy

## Speed wobbles

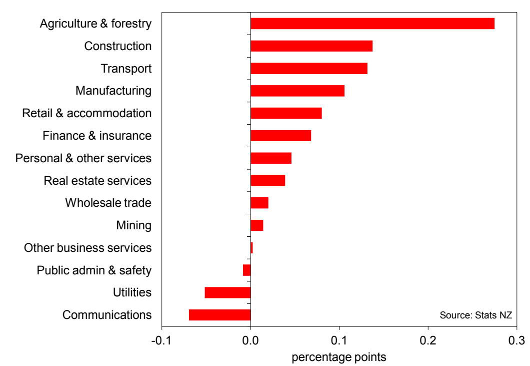
**After a solid performance in the first half of the year, the New Zealand economy has lost momentum. While post-quake recovery and reconstruction in Canterbury have continued to gain strength, the global downturn and high NZ dollar have taken their toll elsewhere. For now, this mix means slower growth and low inflation. However, we regard this as a speed wobble in an ongoing construction-led upturn.**

Over the first half of the year, New Zealand continued to see modest but improving economic growth. GDP expanded 0.6% in the June quarter, to be 2.6% higher than a year earlier – the highest annual pace of growth since way back in 2007. Good growing conditions for farmers can take much of the credit: the single biggest contribution to growth in the quarter came from agriculture, and food manufacturing also had a strong showing.

But the GDP report showed domestically-focussed parts of the economy picking up as well. There were big increases in residential building and civil construction, as well as professional and technical services, as post-earthquake repair and construction activity in Canterbury gathered pace. In the first 'clean' read since the Rugby World Cup, retail trade was 4.8% higher than a year earlier, as households responded to low import prices and a recovering housing market. We were particularly heartened by a 12.8% surge in investment by businesses in plant and machinery. That adds to the economy's productive capacity and is a vote of confidence in future growth prospects.

Since June, it seems that the economy has once again lost momentum. Conditions have become more challenging for exporters and import-competing manufacturers, as a deepening global economic downturn has coincided with a persistently high NZ dollar. And while the high exchange rate has helped make consumer durables and imported investment goods cheaper, households and businesses have also been hit by some hefty cost increases, including a renewed rise in petrol prices and steep hikes in insurance premia and earthquake strengthening costs. These stresses have left their mark on a broad range of domestic indicators. Business confidence has soured, and we've seen imports of capital goods and registrations of commercial vehicles fall back. Net immigration has turned negative again, and retail spending has slowed. And building approvals still suggest no sign of an uptrend in construction activity outside Canterbury.

*Figure 1: Contributions to Q2 GDP growth*




There have also been some positives in the second half of 2012. Most notably, the Canterbury economy continues to go from strength to strength. In contrast to the rest of the country, building approvals in the region have continued to rise, and job openings have grown faster there than elsewhere. Net international migration to Canterbury has been positive since mid-2012, after more than a year of outflows. And retail spending in the region is now back above its pre-quake level and showing no signs of slowing.

The agricultural sector, especially dairy, has also enjoyed some good fortune lately, thanks to poor growing conditions for offshore competitors and what is shaping up to be another good growing season at home. Fonterra dairy production numbers are up 5.6% on the same time last year, and global dairy prices have risen more than 25% from their mid-year lows, as drought in the US and other parts of the Northern Hemisphere has pushed up feed cost for grain-fed cattle farmers. Conditions for beef farmers have been relatively favourable as well, with global stocks low and prices close to historic highs.

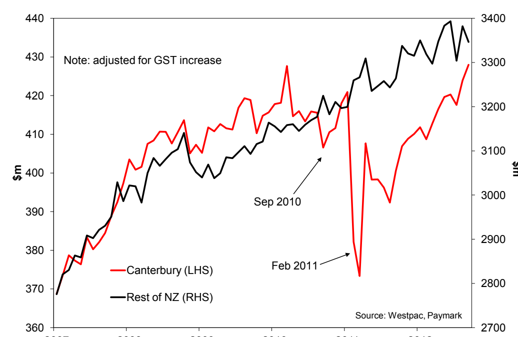
The housing market has also tightened further, with sales trucking along at decent levels and prices continuing to rise. Price increases have been

particularly large in Auckland and Canterbury (where supply shortages have been greatest), but haven't been confined to those regions: smaller centres such as Hamilton and Dunedin have recently seen prices rise as well.

## The near-term outlook

On balance, it does seem that economic growth has slowed in the second half of the year, with the Canterbury rebuild not yet sufficiently advanced to make up for weakness in the other parts of the economy. We have downgraded our 2012 GDP growth forecasts accordingly. In particular, the near-term prospects for business investment are looking decidedly weaker than in the first half of the year, and the recent slowing in retail spending suggests that we will also see slower growth in consumption spending.

*Figure 2: Paymark electronic card transactions*




One factor weighing on the near-term economic outlook is the sustained weakness in the New Zealand labour market. The unemployment rate has sat well above 6% for most of the past three years, and we anticipate that it will remain high well into next year.

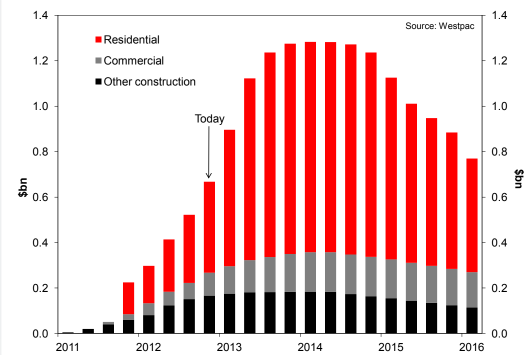
There has been growing concern that New Zealand is experiencing a 'jobless recovery'. That is only partly accurate. It's certainly true that unemployment has stayed higher than firms' reported skill shortages would suggest. We suspect that the increasingly 'two-speed' nature of the economy since the Canterbury earthquakes has caused a similarly divided labour market, with specific jobs related to the Canterbury rebuild in high demand while workers in other regions and industries languish unemployed. But we'd also note that by the standards of previous recessions, the hit to employment following the 2008/2009 recession and 2011 Canterbury earthquake was actually rather mild. The result is that firms have sufficient workers on their books to accommodate a modest increase in production without hiring new staff. The lack of new employment will dampen household income growth and weigh on consumer confidence for a while yet.

## 2013 and beyond

While the near-term outlook has softened, the balance of evidence continues to point to the economy accelerating rapidly through next year and 2014. The major force for growth will come from a further ramp-up in the construction industry – we expect nationwide residential construction to grow more than 30% next year.

Much of this growth directly reflects the Canterbury rebuild, which is still in its very early stages. With no signs of fresh roadblocks, our expectations on that score are broadly unchanged from three months ago (see figure 3). Best estimates of the overall size of the repair bill continue to be around $20bn (in 2011 prices), or around 10% of New Zealand's annual GDP. The vast bulk of this (around $13bn) is residential, and we assume that this repair work will take about 7 years. Commercial repair and rebuilding will take a decade or more.

*Figure 3: Quake-related construction forecasts*

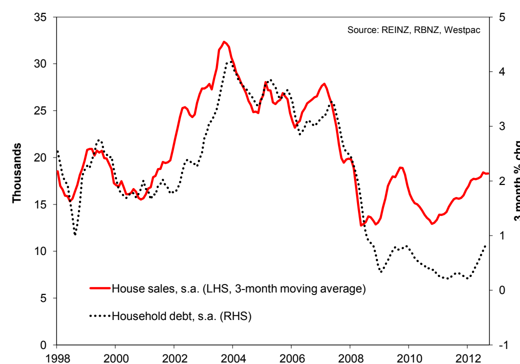



We also continue to expect construction outside Canterbury to pick up gradually, despite the sluggishness we've seen to date. The case for more residential building in Auckland remains very strong: Auckland was the only New Zealand region to see a net positive migrant inflow in the year to June 2012, and over the four years since June 2008 the city's population has increased by 90,000 people – about seven times the number of new houses built over that time. With Auckland house prices now 8% above their 2007 peak and likely to rise further, the market is sending a clear signal to builders as well.

A second positive for the economic outlook is low interest rates. Inflation is already at rock bottom – the lowest since the late 1990s. And with global and local growth weak and the exchange rate high, inflation is likely to stay low for some time yet. As we explain in the Financial Markets section, that gives the RBNZ scope to keep the OCR on hold well into the second half of next year. Low interest rates for longer will boost housing markets – indeed, fixed-term mortgages have already fallen further in the past three months. We now expect house prices to continue rising through 2014. That in turn will support an upswing in consumer spending: rising house prices tend to boost household borrowing and encourage spending, and we expect this time to be no different.

Even so, the growth that we expect – 3.2% next year, and 3.1% in 2014, falling back to 2.2% in 2015 – is still fairly modest by the standards of the 4%-plus growth rates seen in the early 2000s. One reason, as we've noted in previous *Economic Overviews*, is that low interest rates are pushing against a greater tendency to save. The Government is firmly committed to achieving a budget surplus by 2015, and while the government's books have come in a little better than forecast, we still expect government spending to actively detract from growth next year. And overall household attitudes to debt remain more cautious than before the 2008/2009 recession (figure 4). Even with a stronger housing market, consumption growth is likely to stay more subdued than in past construction booms.

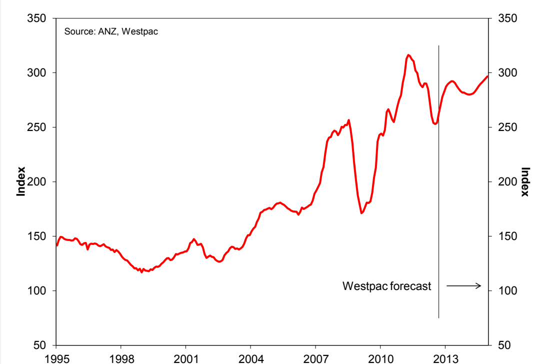
*Figure 4: House sales and household credit growth*




While we expect the global backdrop to improve modestly over the coming year, conditions for export-dependent sectors are also likely to remain challenging for a while yet. As we detail in the International Outlook section, central banks in our key trading partners have eased monetary policy aggressively, setting the stage for stronger global growth. However, the world won't come right overnight, and in the interim the NZ dollar is likely to stay high.

The export outlook also continues to be very uneven. For example, prospects look significantly brighter for dairy and beef farmers (selling to growing Asian markets, and benefiting from the US drought) than for lamb producers (exposed to depressed European markets, and facing competition from good growing conditions in Australia). Forestry prices will be dependent on an upturn in the Chinese industrial cycle, which looks some months away yet. And for New Zealand manufacturing and tourism, it's the beleaguered non-mining parts of the Australian economy that matter – though recent interest rate cuts by the Reserve Bank of Australia leave us cautiously optimistic on that front.

*Figure 5: World prices of NZ export commodities*




Finally, as remote as the prospect may seem now, inflation will eventually become a constraint on growth. There have already been substantial increases in construction costs in the Canterbury region, and as we explain in the Financial Markets section, we don't believe that a project the size of the Canterbury rebuild can be accommodated without substantial increases in cost pressures. The RBNZ will also be wary of a return to old imbalances as the housing market heats up. From late 2013, we expect a steady series of interest rate hikes from the RBNZ. That will make a continued upswing in the housing market and consumer spending increasingly difficult to sustain.



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# Financial Markets

## Loosey goosey

**Financial markets are as beholden to policymakers as they have ever been, with perceptions about the latest quantitative easing measures by central banks perhaps having more impact than the reality. Our view is that global policy won't be a sustained driver of the New Zealand dollar; relative growth prospects are a more important factor. The strong NZD has kept inflation subdued so far, but the Christchurch rebuild remains a challenge and will eventually require higher interest rates.**

### International markets

In recent months a number of central banks have restarted or extended their unconventional policy easing measures – often labelled as quantitative easing (QE), although not every program fits that definition precisely. These efforts are variously seen as countries 'debasing' their money supply, driving down their exchange rates, creating undesirable inflows of capital into other countries, and generating inflation. Those perceptions are currently driving investors towards assets that are seen as inflation-proofed – gold, shares, property – or that benefit from greater monetary discipline elsewhere – namely, higher-yielding currencies such as the NZ dollar.

Perceptions are one thing; the experience of QE to date has been less straightforward. Firstly, the motives for easing vary across regions. The US Federal Reserve has justified QE in terms of asset prices and wealth effects that encourage people to spend more; there's been little suggestion of weakening the exchange rate. The European Central Bank is more concerned with ensuring that there is a euro in the future, and to the extent that its rescue efforts have worked they have tended to push the shared currency up, not down. Japan and Switzerland are more obviously targeting their currencies; at great expense, it seems they have been able to halt further gains, but they have not managed to weaken them.

**Broad money growth, year to Sep 2012**

| Region | M3 growth % | Unconventional easing |
|---|---|---|
| US | ~4* | yes |
| Euro zone | 3.0 | yes |
| Japan | 0.7 | yes |
| UK | -3.4 | yes |
| Switzerland | 8.9 | yes |
| Canada | 6.8 | no |
| Australia | 7.1 | no |
| New Zealand | 6.4 | no |

* Unofficial estimates; publication of official data ceased in 2006.

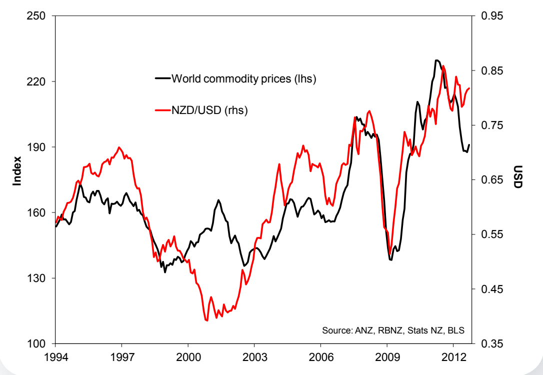
The inflationary effects of QE have also been more scattered than market perceptions would imply. Inflation can arise from rapid growth in the money supply, and it is true that on narrow measures – namely, reserves held at central banks – the money supply has expanded significantly as a result of QE. But by and large this money has not been recirculated by the private sector, a crucial step if it is to have a sustained impact on either inflation or growth. Rather, as the table below shows, those countries engaging in QE have had the least success in expanding the broader money supply – which is precisely why they have persisted with QE. (The notable exception is Switzerland, which is now grappling with concerns about an overheated housing market, and like Canada has recently tightened loan limits.)

### Exchange rates

The QE efforts of the previous couple of years seem to have had little sustained impact on growth, inflation, and hence on exchange rates. The question for our forecasts is whether this time will be different – and we recognise that the latest QE programmes are somewhat different in substance, with a greater focus on where credit markets are impaired. We view this as a necessary, but not sufficient, step to returning the major economies to sustained growth. New Zealand's relatively favourable growth prospects remain the key factor in our forecast for the currency to hold around the 80c mark over the next year.

That said, one of the notable features of the NZD over this year is that it has not respected what we'd regard as the 'fundamentals'. In particular, it has failed to perform its usual buffering role as world prices for our commodity exports have fallen. The lack of relief from a lower currency is one plausible factor behind the softening in the short-term economic data since the first half of this year. We expect the valuation gap to narrow over the coming year via higher commodity prices, as the Chinese economy recovers and poor Northern Hemisphere growing conditions boost food prices.

*Figure 6: Inflation-adjusted commodity prices and the exchange rate*




## Interest rates

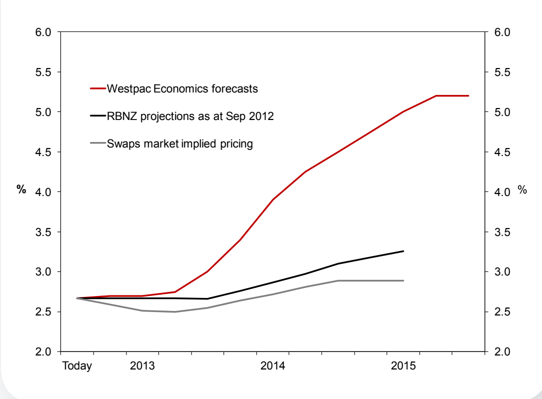
The persistent strength of the NZD has reinvigorated calls for lower interest rates, following the Australian example. In one sense this is already happening: unconventional easing overseas, aimed at depressing long-term interest rates in the host country, tends to influence long-term rates lower in New Zealand too – fixed-term mortgage rates have fallen to new record lows over the last year, without any direction from the central bank.

That aside, we should at least be aware of the conditions for more direct action. Inflation has persistently surprised on the downside over the last year, with annual inflation plumbing a 13-year low of 0.8% in the year to September. Much of the surprise has been on the tradables side, suggesting a higher than expected degree of passthrough from the strong NZD. In light of these forecast misses, we suspect the RBNZ will be thoroughly testing the robustness of its forecast that annual inflation will return to the 2% midpoint of its target over the period 1-3 years ahead.

But the dampening effect of the exchange rate will need to be weighed against the uncertain inflationary impact of the Christchurch rebuild. The inflation figures suggest that central co-ordination of small to moderate repairs – the bulk of the activity to date – has been effective in limiting construction cost inflation. This is unlikely to remain the case as major repairs and complete rebuilds take over as the main form of activity – the price of new housing in the Canterbury region has already risen nearly 10% in the last year.

The rebuilding programme will make a demand on the nation's resources that will be very difficult to accommodate without substantial price pressures. With near-term inflation still subdued, we expect the OCR to remain on hold until September next year. But our view remains that over the following years there will be a need for higher interest rates than markets or the RBNZ are currently signalling.

*Figure 7: 90-day interest rate forecasts*




**Financial Markets Forecasts** (end of quarter)

| | OCR | 90 day bill | 2 year swap | 5 year swap | NZD/ USD | NZD/ AUD | NZD/ EUR | NZD/ GBP | NZD/JPY | TWI |
|---|---|---|---|---|---|---|---|---|---|---|
| Dec-12 | 2.50 | 2.70 | 2.70 | 3.20 | 0.80 | 0.79 | 0.63 | 0.51 | 62.4 | 72.1 |
| Mar-13 | 2.50 | 2.70 | 2.80 | 3.30 | 0.82 | 0.77 | 0.66 | 0.53 | 68.1 | 74.2 |
| Jun-13 | 2.50 | 2.75 | 2.90 | 3.50 | 0.81 | 0.77 | 0.66 | 0.53 | 66.4 | 73.7 |
| Sep-13 | 2.75 | 3.00 | 3.10 | 3.70 | 0.80 | 0.78 | 0.67 | 0.53 | 64.8 | 73.4 |
| Dec-13 | 3.00 | 3.40 | 3.40 | 3.90 | 0.79 | 0.78 | 0.67 | 0.54 | 64.8 | 73.3 |
| Mar-14 | 3.50 | 3.90 | 3.70 | 4.10 | 0.79 | 0.79 | 0.68 | 0.54 | 65.2 | 73.7 |
| Jun-14 | 4.00 | 4.25 | 4.00 | 4.35 | 0.77 | 0.79 | 0.68 | 0.53 | 64.7 | 73.1 |
| Sep-14 | 4.25 | 4.50 | 4.30 | 4.60 | 0.76 | 0.79 | 0.67 | 0.52 | 64.2 | 72.5 |
| Dec-14 | 4.50 | 4.75 | 4.50 | 4.80 | 0.74 | 0.80 | 0.67 | 0.52 | 63.6 | 71.7 |
| Mar-15 | 4.75 | 5.00 | 4.70 | 5.00 | 0.74 | 0.80 | 0.66 | 0.51 | 63.9 | 71.3 |

# The RBNZ's new Governor
## A solid start

**Markets are intensely interested in the attitude and approach to monetary policy of Graeme Wheeler, the new Governor of the Reserve Bank. Until recently, speculation swirled in a virtual vacuum of reliable information. The gap has been amply filled in recent weeks, following three substantive public statements by Mr Wheeler. Our tentative assessment is that the new Governor is firmly focussed on medium-term inflation, is realistic about what central banks can and cannot achieve, and is mindful of the lessons from the Global Financial Crisis.**

The first hint that Mr Wheeler would be firm on inflation came when the new Policy Targets Agreement (PTA), which is signed jointly by the Governor and the Minister of Finance, significantly tightened the definition of price stability. Under Mr Wheeler the Reserve Bank will be required to keep inflation close to 2%. Allowing average inflation and inflation expectations to hover closer to 3%, as they have for most of the past decade, is no longer permissible.

We got further confirmation of the Governor's focus at his first OCR review, which emphasised the medium-term outlook for inflation over the low level of current inflation.

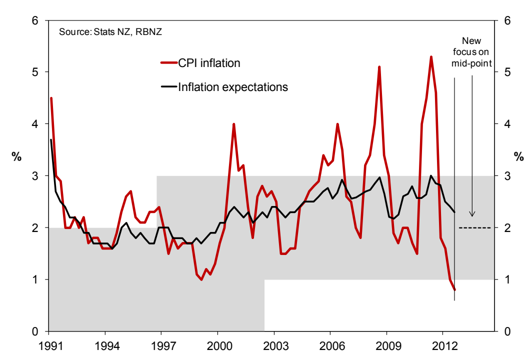
The day after the OCR review, Mr Wheeler gave his first speech as Governor. The general thrust was that price stability and a sound financial system were the best contributions that central banks could make to society's wellbeing. Much of the speech was spent batting down a hotchpotch of alternative ideas about monetary policy. Mr Wheeler explained that central banks cannot engineer higher economic growth on a sustained basis, and that quantitative easing is unnecessary in New Zealand's case.

Mr Wheeler was sympathetic but firm on the high exchange rate. He took the view that central banks can do little to sustain a lower New Zealand dollar without some loss of price stability or financial stability. OCR cuts have had little effect on the exchange rate in the past, perhaps because markets understand that today's OCR reductions are tomorrow's inflation problem. Capital controls would imperil financial stability. Currency intervention was largely dismissed as ineffective. On a constructive note, Mr Wheeler did suggest that policies designed to boost savings could sustainably reduce the real exchange rate.

The mistakes and lessons of the past decade have been taken on board. Asset prices oscillated dangerously last decade but were thought to be outside the remit of central banks. The new PTA includes a requirement to "monitor" asset prices. This may allow the Reserve Bank to raise interest rates earlier if an asset price bubble were forming, or to lower rates earlier during an asset price bust. The PTA also requires the Reserve Bank to have regard to financial stability – a clear reference to the mess that unchecked credit growth can create. In his speech, Mr Wheeler talked about the possible use of macroprudential tools (such as applying loan to value limits to bank lending) to combat excessive growth in debt, if necessary. He envisaged using such tools infrequently "for the purpose of maintaining a sound and efficient financial system" – not as a substitute for the OCR.

Broadly speaking, we support the new PTA and the new Governor's approach. The experience of last decade taught us that asset price cycles can be dangerous and central banks should combat them early. The extra focus on the middle of the Reserve Bank's numerical inflation target will provide certainty. Over the course of the full economic cycle, the result should be lower average interest rates and lower inflation.

*Figure 8: CPI inflation and target range*



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# International Outlook

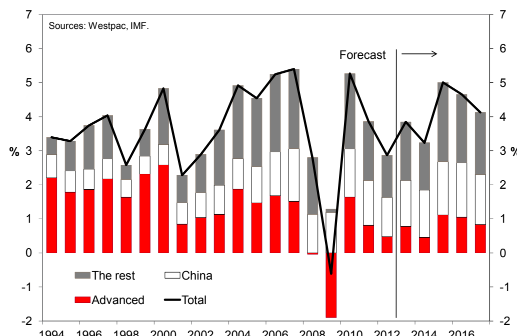
## A sigh of relief

**Reflecting stuttering economic growth – and in the case of Europe, outright recession – policy-makers have eased monetary policy in an attempt to get economies back on the growth horse. Their actions have stopped the rot, with 2012 set to be the low-point in the global growth cycle. From this low-point, we expect growth to pick up over 2013, but our forecast is not what fortunes are made on.**

We expect the major contributions to 2013 global growth will come via China and other emerging economies as well as Australia in our part of the world. However, the imperative to reduce debt in major advanced economies will limit overall global growth.

The prognosis is rather mediocre, but still better than the one we reported in August, as the probability of a full-blown catastrophe in Europe is lower now than it was then. The EU has put the European Stability Mechanism (ESM: code for bailout fund) in place to stabilise the currency union, giving the European Central Bank (ECB) the ability to support sovereign bond yields, if necessary. These actions have calmed global financial markets for now.

*Figure 9: Contributions to world growth*




Official interest rates are near zero in Europe, Japan and the US, forcing monetary policy makers to resort to their second or third string policy tools. By contrast, policy makers in China, emerging economies and Australia still have plenty of policy first teamers in reserve. And they are putting them to good use. The RBA lowered its cash rate by 25 basis points (bps) to 3.25% on top of the earlier cuts while Chinese authorities have unwound tight monetary policy and allowed their budget deficit to widen.

We expect these measures to gain traction over the remainder of 2012, and for activity to accelerate, as a result, modestly over 2013. Already, September quarter Chinese GDP data beat market expectations and October's flash Purchasing Managers Index (PMI) improved from September. Overall, we forecast the world economy to grow by 2.9% in 2012 before accelerating modestly to 3.6% in 2013.

For New Zealand, global growth is centred in the hungry part of the world, China and emerging Asia. Moreover, drought has hit parts of the Northern Hemisphere, particularly the US. World grain prices have risen, contributing to higher feed costs for US dairy producers in particular. For example, US non-fat dry milk production fell 7.8% in July and August compared to the same period a year ago. As a result, world dairy prices have increased with the Global Dairy Trade trade-weighted index rising 27.3% from the May 2012 lows. We expect that the combination of drought and the underlying growth in China and emerging Asia will support further price increases of New Zealand export (food) commodities over the remainder of 2012 and into 2013. At the same time, a modest pick up in the non-mining sector of the Australian economy will support the otherwise struggling manufacturing and tourism sectors.

### Australia

Australia is struggling not with low growth, but uneven growth. On one side of the coin is the mining sector – the mining investment boom that has followed the terms of trade boom will peak next year. As this capacity comes online, an upswing in exports of coal, iron ore, and in particular, gas are forecast to take export volumes growth from 8.5% last year to 11% for the to the June 2013 quarter. On the other side, the non-mining part of the economy remains subdued with a rising household savings rate and ongoing debt repayment indicative of the caution that prevails.

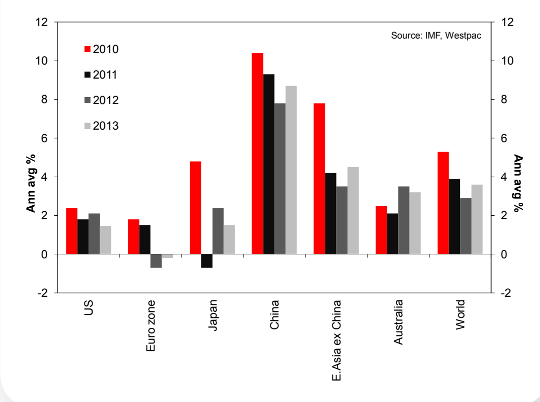
In an effort to even things up the Reserve Bank of Australia cut interest rates by 25bps to 3.25% in October. In cutting rates, the RBA cited deepening global growth concerns, a higher than expected Australian dollar, a softer labour market and

recognised the need for other components of demand to regain some strength because the peak in the resources investment cycle will be in 2013. To achieve this balancing act, we expect the RBA to cut again in November and once more in the first quarter of 2013, leaving the low point for interest rates in this cycle at 2.75%.

In terms of growth, lower rates will go some way to boosting the non-mining sector. While growth will be more even, the mining sector will remain the dominant growth driver. We expect the economy to expand by 3.5% in 2012 and by slightly less at 3.2% in 2013.

## China

*Figure 10: Key trading partner GDP growth*




In contrast to the policy stimulus package of 2008/09, Chinese officials have been more cautious in their efforts to boost growth this time around. Infrastructure projects have been brought forward and the central government's deficit has been allowed to widen with expenditure growing at 20% while revenue has been allowed to lag at 12%. Importantly, monetary policy settings have gradually moved from tight to normal rather than to outright loose.

The cautious loosening of policy combined with high stock levels have meant that Chinese growth has taken until the September quarter to gain traction, later than our original estimates. September quarter growth came in at 2.2% from 2.0% in the previous quarter and exceeded our pick of 1.8%. We expect momentum to build from here.

China's potential growth rate has slowed, but because the economy is now so much bigger, China's contribution to global growth is now more important than ever. We estimate that China's potential growth rate lies between 7% and 8% compared to the 10% average over the 2000s. But, the Chinese economy is nearly 270% bigger than 10 years ago. Thus Chinese growth of 7.5% will contribute more to global growth than the 10% growth rates of old.

## United States

The US economy remains stuck in the mud. Four out of four regional factory surveys turned negative in October. And while the unemployment rate fell below 8% in September, most of the post-Global Financial Crisis improvement in the unemployment rate can be explained by falling labour force participation.

For its part, the Federal Reserve remains singularly focused on jumpstarting the economy, kicking off the third round of quantitative easing in September. The latest round of money printing extends the type of securities that the Fed purchases to promote lending by financial institutions. The thrust of all this is designed to stimulate asset markets – housing and equities – in the hope that increases in wealth will increase confidence and then activity. (See the Financial Markets section for more discussion of the effects of quantitative easing).

The incoming US president (the election result was unknown at the time of writing) will face economic challenges in every direction. The 'fiscal cliff', a swathe of automatic tax increases and spending cuts that take effect if no agreement is reached on how to balance the budget, has the potential to unnerve financial markets temporarily. The way ahead for fiscal policy is the more formidable challenge as trimming the $16 trillion deficit without derailing the economy will be a delicate balancing act.

Housing market data are offering some hope, however a long slow deleveraging slog remains in front of both households and the government. This culminates in our US growth forecast slowing from 2.1% in 2012 to 1.7% in 2013.

## Japan

Japan is normally well-placed to benefit from Chinese-led growth with around 18% of exports heading across the Sea of Japan to China. However, its recent squabble with China over pieces of rock (known as the Senkakus in Japanese and the Diaoyus in Chinese) has led to boycotts of Japanese-made goods in mainland China. This issue adds to the long list of challenges plaguing the Japanese economy. Some are enduring – deflation, demographic pressures, political inertia – while others are more recent – the proposed shutdown of nuclear power plants by 2040 following the Fukushima nuclear crisis.

The earthquake and tsunami rebuild had boosted our forecast for 2012 to 2.4% growth. But with exports to China hurting, this number and our 1.5% growth forecast for 2013 may be under threat.

## Europe

The ECB's outright monetary transactions (OMT) bond buying plans announced in September helped reassure financial markets. In the week following the ECB's introduction of OMT, Spanish bond yields fell 75bps to just over 5.5%. Combined with ECB chief Draghi's earlier tough talk, yields were around 200bps lower than in late July.

While the ground work is being laid to support the euro as a going concern, the politics remain volatile and the economic reform and fiscal consolidation process ahead of many European governments is as daunting as ever. Spain is reluctant to take up the ECB's bailout offer in the first place. German, Dutch and Finnish officials have publicly questioned the earlier agreement to bail out Spanish banks. France wants a banking union sooner rather than later, while Germany wants to take the time to get it right. Politicians are increasingly coming to the table, but the road ahead will remain long and bumpy.

Recent developments are by and large positive, and have reduced the probability of a full-blown catastrophe. But they have come too late to save the euro zone from recession. Moreover, recent business surveys suggest that German growth will no longer offset wider European weakness.

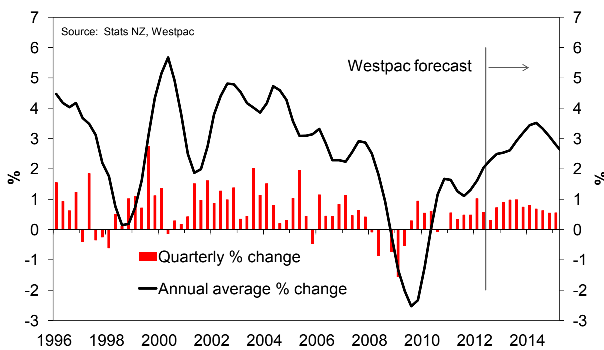
## Economic and Financial Forecasts

| Economic Forecasts (Calendar Years) | 2008 | 2009 | 2010 | 2011 | 2012f | 2013f |
|---|---|---|---|---|---|---|
| **New Zealand** | | | | | | |
| Real GDP % yr | -0.2 | -2.3 | 1.7 | 1.3 | 2.5 | 3.2 |
| CPI inflation % annual | 3.4 | 2.0 | 4.0 | 1.8 | 1.3 | 2.5 |
| Unemployment % | 4.5 | 6.9 | 6.7 | 6.4 | 6.4 | 5.5 |
| **Australia** | | | | | | |
| Real GDP % yr | 2.5 | 1.4 | 2.5 | 2.1 | 3.5 | 3.2 |
| CPI inflation % annual | 3.7 | 2.1 | 2.7 | 3.1 | 2.3 | 2.2 |
| Unemployment % | 4.3 | 5.6 | 5.2 | 5.1 | 5.3 | 5.5 |
| **China** | | | | | | |
| Real GDP %yr | 9.6 | 9.2 | 10.4 | 9.3 | 7.8 | 8.7 |
| Consumer Prices %yr | 5.9 | -0.7 | 3.3 | 5.4 | 2.7 | 3.4 |
| **United States** | | | | | | |
| Real GDP %yr | -0.3 | -3.1 | 2.4 | 1.8 | 2.1 | 1.7 |
| Consumer Prices %yr | 3.8 | -0.3 | 1.6 | 3.1 | 2.0 | 2.0 |
| Unemployment Rate % | 5.8 | 9.3 | 9.6 | 9.0 | 8.2 | 8.2 |
| **Japan** | | | | | | |
| Real GDP %yr | -1.7 | -5.7 | 4.8 | -0.7 | 2.4 | 1.5 |
| Consumer Prices %yr | 1.4 | -1.3 | -0.7 | -0.3 | -0.1 | -0.4 |
| Unemployment Rate % | 4.1 | 5.2 | 5.1 | 4.5 | 4.3 | 4.3 |
| **Euroland** | | | | | | |
| Real GDP %yr | 0.3 | -4.2 | 1.8 | 1.5 | -0.7 | -0.2 |
| Consumer Prices %yr | 3.3 | 0.3 | 1.7 | 2.7 | 2.4 | 1.4 |
| Unemployment Rate % | 7.5 | 9.5 | 10.0 | 10.4 | 11.4 | 12.0 |
| **United Kingdom** | | | | | | |
| Real GDP %yr | -1.1 | -4.4 | 2.1 | 0.8 | -0.2 | 0.7 |
| Consumer Prices %yr | 3.6 | 2.2 | 3.2 | 4.0 | 2.3 | 1.5 |
| Unemployment Rate % | 5.6 | 7.6 | 7.8 | 8.4 | 8.0 | 8.5 |

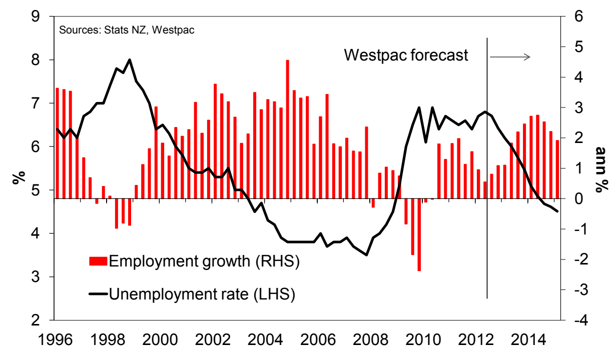
Forecasts finalised 1 November 2012

| Annual Average % change | March years | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013f | 2014f | 2011 | 2012f | 2013f | 2014f |
| Private consumption | 1.5 | 2.0 | 1.5 | 3.1 | 1.4 | 1.6 | 2.7 | 3.4 |
| Government consumption | 0.3 | 0.5 | 0.2 | -0.3 | 0.5 | 0.1 | -0.3 | 0.6 |
| Residential investment | 3.8 | -11.8 | 18.6 | 32.0 | -11.7 | 10.5 | 33.8 | 15.0 |
| Business investment | 6.9 | 2.2 | 4.7 | 6.7 | 5.7 | 3.2 | 6.3 | 5.1 |
| Stocks (% contribution) | 1.2 | 0.7 | -0.5 | 0.3 | -0.2 | 0.1 | 0.1 | 0.2 |
| GNE | 2.6 | 2.1 | 2.8 | 4.5 | 1.8 | 2.8 | 4.1 | 3.9 |
| Exports | 2.8 | 2.6 | 2.3 | 3.4 | 2.7 | 2.2 | 3.3 | 3.4 |
| Imports | 11.6 | 6.2 | 0.2 | 6.2 | 6.7 | 1.8 | 4.7 | 5.6 |
| **GDP (production)** | **1.6** | **1.6** | **2.5** | **3.4** | **1.3** | **2.5** | **3.2** | **3.1** |
| Employment (% annual) | 1.8 | 1.0 | 1.1 | 2.7 | 1.5 | 1.1 | 2.5 | 2.2 |
| Unemployment rate (% s.a. end of period) | 6.6 | 6.7 | 6.2 | 5.1 | 6.4 | 6.4 | 5.5 | 4.6 |
| Labour cost index (all sectors, % annual) | 1.9 | 2.0 | 1.6 | 1.7 | 2.0 | 1.8 | 1.6 | 2.2 |
| Inflation (% annual) | 4.5 | 1.6 | 1.4 | 2.5 | 1.8 | 1.3 | 2.5 | 2.4 |
| Current account balance (% of GDP) | -3.7 | -4.5 | -5.9 | -6.5 | -4.1 | -5.6 | -6.5 | -6.1 |
| Terms of trade (% annual) | 6.7 | -2.1 | 0.3 | -1.2 | 1.0 | -3.0 | 0.7 | -0.4 |
| 90 day bank bill (end of period) | 3.00 | 2.74 | 2.70 | 3.90 | 2.71 | 2.70 | 3.40 | 4.75 |
| 5 year swap (end of period) | 4.54 | 3.59 | 3.30 | 4.10 | 3.62 | 3.20 | 3.90 | 4.80 |
| TWI (end of period) | 67.2 | 72.5 | 74.2 | 73.7 | 68.7 | 72.1 | 73.3 | 71.7 |
| NZD/USD (end of period) | 0.76 | 0.82 | 0.82 | 0.79 | 0.78 | 0.80 | 0.79 | 0.74 |
| NZD/AUD (end of period) | 0.75 | 0.78 | 0.77 | 0.79 | 0.77 | 0.79 | 0.78 | 0.80 |
| NZD/EUR (end of period) | 0.55 | 0.62 | 0.66 | 0.68 | 0.58 | 0.63 | 0.67 | 0.67 |
| NZD/GBP (end of period) | 0.47 | 0.52 | 0.53 | 0.54 | 0.49 | 0.51 | 0.54 | 0.52 |

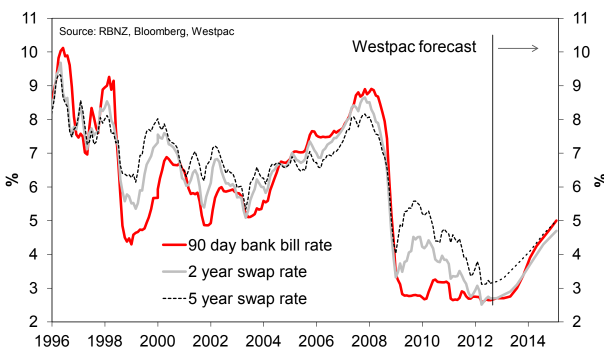
### *New Zealand GDP growth*



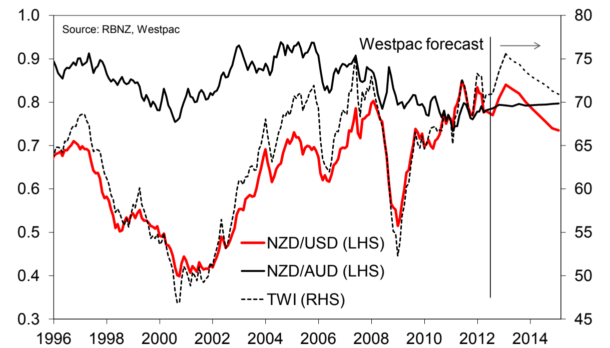

### *New Zealand employment and unemployment*




### *90 day bank bill, 2 year and 5 year swap rates*




### *NZD/USD, NZD/AUD and TWI*

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