

## Eurozone crisis forms economic backdrop for 2012

- Europe remains the main source of risk to global prosperity for 2012.
- Ongoing financial market volatility will remain an issue for local businesses and investors to deal with.
- NZ will continue to be supported by interest rates and commodity prices – as long as a deep European crisis is averted.

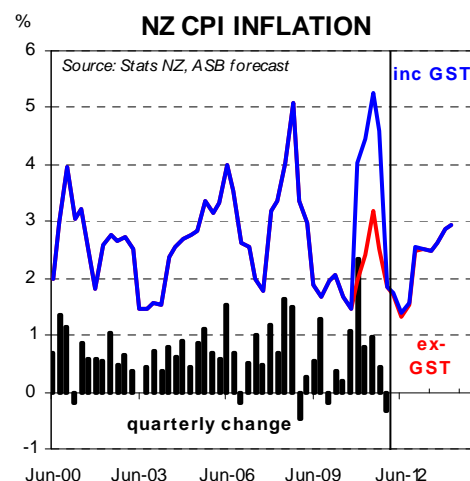
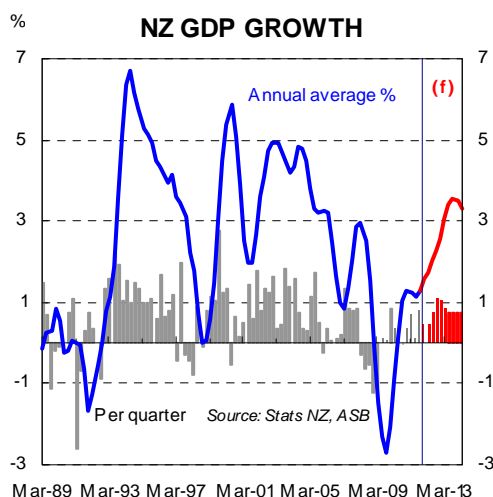
Our last quarterly talked about the global economy being at a crossroads. In the early stages of 2012 the global economy is edging towards the path of muddling through. But the path towards crisis is still only a miss-step away. Europe remains the main source of risk this year to global prosperity. We continue to expect that the most likely outcome is that Europe contains and defuses the crisis over time. But the risk of a fumble – unwittingly or otherwise – is significant given the potential consequences.

The challenges for Europe won't end with containing the current crisis. As we discuss in our feature article, for the euro to survive in its current form there will need to be not just greater fiscal integration but also closure of competitive gaps between countries. Otherwise, the current lack of safety valves in the group of differing economies will cause further strains in the future. At present the EU is focussing on fiscal oversight. But the competitive gaps are a critical issue for long-term balance within the currency union.

Our expectation is that NZ will continue with its gradual recovery – on the assumption that Europe avoids triggering a global financial meltdown. Europe is likely to remain in recession for parts of 2012 and the US will have another modest year. But NZ's trade fortunes are increasingly tied to Asia – a faster-growing region that has greater potential for emergency stimulus up its sleeve than developed economies. NZ is, to date, still benefitting from resilient commodity prices, notwithstanding some deceleration in global growth. Interest rates will remain low until the end of the year, if not longer, which will overall continue to provide the economy with support. The housing market should continue to gradually improve and prompt a greater amount of building. Rebuilding Canterbury will also inject some life into construction, even if the rebuild looks increasingly delayed until the second half of the year. The pace of consumer spending will also lift slightly, even though the general theme of living within means will remain.

But it is extremely likely that financial market volatility is going to remain an issue for businesses and investors to deal with. Europe's decision makers are progressing at a glacial pace and more focused on preventing the next crisis, rather than swiftly solving the current one. Consequently, the danger period in which something calamitous could happen will be drawn out.

Europe's woes mean that in New Zealand there are several things to be mindful of this year. Financial market volatility will remain a risk, though would show up mainly in foreign exchange and equity markets. For exporters, including the tourism industry, Europe's crisis and the long-term effects on its growth potential reinforce the importance of looking to Asia for sales opportunities. The trade prospects in Asia were always going to provide the stronger growth prospects over the long term, but Europe's problems and loss of purchasing power through its weaker currency are amplifying the need to shift focus. And, as was the case in 2008/09, alternative scenarios of how businesses could be affected if the global economy and financial system take a turn for the worse could be useful to help fine-tune responses – just in case the Europeans do stumble.



## No easy solutions to ongoing European crisis

**Markets have come to view the sovereign debt of several Eurozone nations as risky assets...**

**...but the crisis is about much more than just fiscal discipline.**

**Concerns over Greece have been rumbling on for over two years now.**

**Markets are now worried about the debt of other, larger nations, including Spain and Italy.**

**Investor fear can lead to a self-fulfilling cycle, driving solvent governments into default.**

Over the second half of 2011, concerns over the sustainability of the sovereign debt of several European nations escalated. This started with Greece, but soon spread to Italy and Spain. Previously sanguine investors have begun to view the sovereign debt of these countries as a risky asset and are therefore demanding higher interest rates on new debt. That in turn increases the cost of borrowing for these governments and further exacerbates their fiscal problems. Worries have also spread to the financial system, as many major European banks are large holders of sovereign debt.

However, what on the surface appears to be a crisis related to fiscal discipline, is in fact rooted in growing economic divides within the Eurozone. While policymakers may be able to contain the immediate crisis, the underlying problems will likely require a significant remodelling of the currency union if they are to be properly resolved.

### The immediate crisis

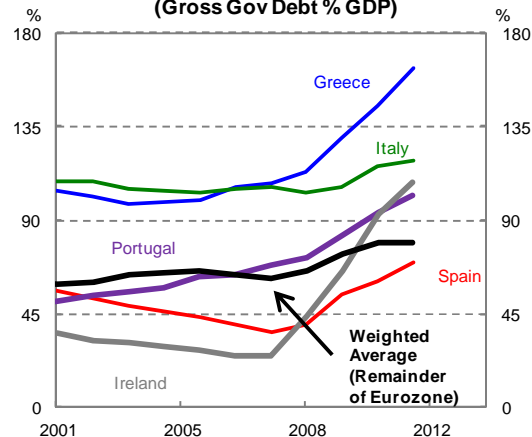
The catalyst for the current crisis can be traced back to late 2009, when the incoming Greek Government increased the estimate of that year's fiscal operating deficit to around 13% of GDP from the previous estimate of 6%. Its European neighbours have since provided two bailouts, but by mid-2011 it was becoming clear that Greece's fiscal position remained untenable.

The wary eyes of investors began to look with doubt upon other Eurozone nations with large amounts of government debt. Initially they focused on small peripheral countries like Ireland and Portugal but towards the end of last year attention turned to Italy and Spain. These two economies are among the largest in Europe - a government default by one of them would have disastrous consequences for world financial markets. The huge quantities of Spanish and Italian debt are too widely held and the institutions that hold this debt often rely on its valuation (i.e. the perception that it will be paid back) for their own solvency.

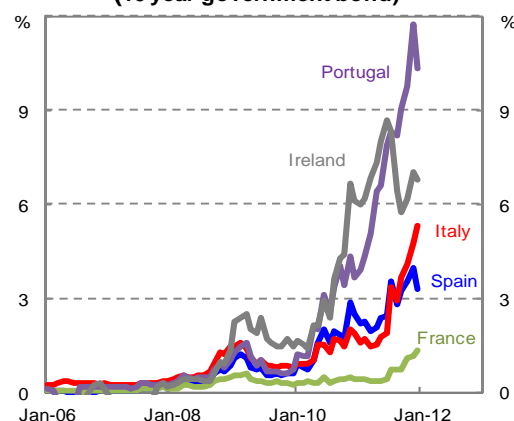
This factor – perception – is at the heart of the Eurozone debt crisis. If investors fear a government will not be able to pay back its debts they will demand higher interest rates on new debt. This makes the cost of servicing that debt higher for the embattled government. Higher debt servicing costs worsen the government's fiscal position even further, which in turn heightens the concerns of investors. The danger is that this becomes a self-fulfilling cycle whereby the fears of investors drive an otherwise solvent government into default. In all likelihood, the peripheral Eurozone governments (with the exception of Greece) are solvent and, given a sustainable cost of borrowing, would be able to reduce their deficits and eventually their overall level of debt over time.

The perception that this crisis has been brought on by fiscal irresponsibility is not completely accurate. Before the global financial crisis of 2008/09 Italy's high level of historical government debt had been falling as a proportion of GDP. Additionally, the likes of Spain and Ireland were being praised as examples of low debt, low deficit government (in fact, Ireland's fiscal position bore a striking resemblance to New Zealand's). Countries, such as Italy and Belgium, that had high levels of outstanding debt had done so for many years without defaulting or investors panicking that they may do so.

**SELECTED EUROZONE NATIONS  
(Gross Gov Debt % GDP)**



**SPREAD TO GERMAN BONDS  
(10 year government bond)**

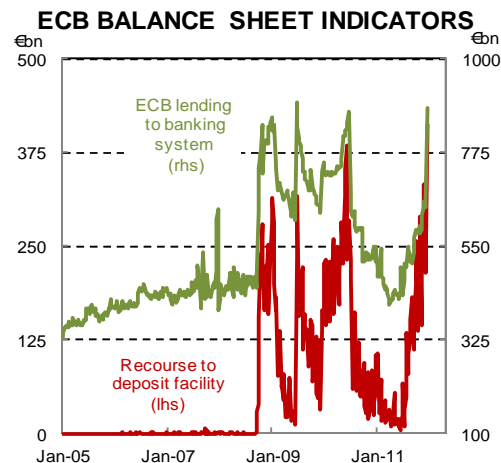


**Given sustainable borrowing rates, most Eurozone governments would be able to stabilise their finances.**

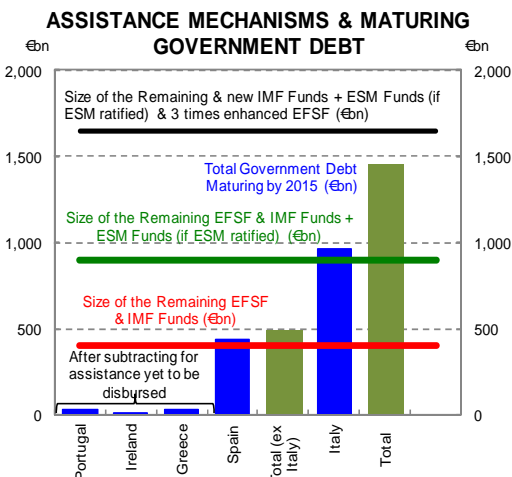
So in the short term at least, it would seem that the disaster of a sovereign default can be avoided as long as borrowing rates for these countries are kept at sustainable levels. The simplest way to guarantee that this happens would be for a third party to effectively guarantee the sovereign debt of troubled nations, thereby restoring confidence amongst investors. This could be done by either the Eurozone nations collectively or by the European Central Bank (ECB), but so far both have been reluctant to do so. The powerful 'core' nations of the Eurozone, led by Germany, are reluctant to guarantee or subsidise their southern neighbours, who they see as wasteful spenders. The ECB insists that it is prevented by the European treaties from directly monetising sovereign debts (printing money to fund deficits directly). But the ECB has certainly not been a bystander in the crisis.

**Policy responses, though slow coming, have been large and should contain the immediate crisis.**

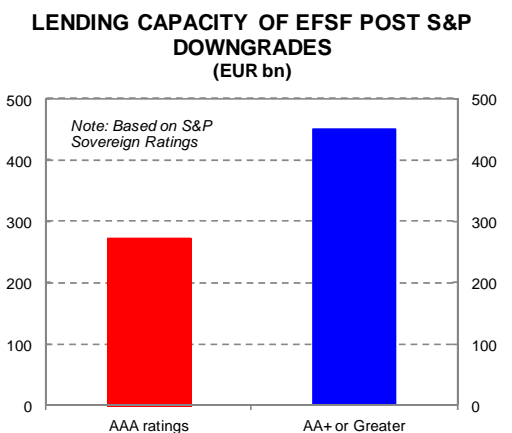
The ECB has been buying up European government bonds in the secondary market - €141bn since the crisis spread to Spain and Italy in mid-August 2011. This has helped to keep a lid on interest rates. Also, in December the ECB initiated a three-year Long-Term Refinancing Operation (LTRO), in which it lent €489bn to European banks. The goal of the LTRO is to provide cheap long-term funding to banks to help them (a) refinance their own balance sheets, meet their own debt repayment obligations and ease credit conditions in the economy, and (b) to encourage banks to buy more sovereign debt. A second LTRO is scheduled for February 2012.



Alongside these ECB measures the Eurozone countries and the IMF have together set up their own assistance measures. Together, the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and the committed IMF funds total €1.64 trillion (assuming the EFSF can be leveraged). The total Greek, Irish, Portuguese, Spanish and Italian debt maturing by 2015, after subtracting any already committed assistance, stands at around €1.46 trillion.



To be sure, there are several potential risks and roadblocks to overcome. The necessary treaty changes need to be implemented and the capital contributions must still be provided by the respective nations. Assuming all this goes smoothly it would seem then that these measures will be able to prevent any default in the near term. This may be a courageous assumption, but even if the crisis came to a sudden head and a government lost market access and was on the verge of default, one would imagine policymakers would stop dragging their feet and do whatever was necessary to prevent default and the associated financial contagion. This could potentially include emergency bailouts or other action on the part of the IMF or ECB.



**Longer-term challenges are even greater**  
In the longer term, though, more substantive measures will be needed to ensure the survival of the Eurozone in anything like its current form. To understand the full extent of this crisis we must look beyond fears over government debt, to the underlying economic imbalances that have developed since the establishment of the Euro.

**Implications for EFSF:** (1) Increased interest costs, (2) possible need to lift guarantee commitments, (3) risk of further downgrades

**Sharing a single currency prevents economic imbalances between Eurozone nations from being corrected through currency revaluations.**

The fact that all Eurozone nations share the same currency robs them of a valuable economic 'release valve'. Under normal circumstances imbalances such as differing unit labour costs between countries would often be offset by a natural revaluation of their respective currencies. So for instance, a rise in unit labour costs in Spain would lead to the Spanish currency falling in value, thereby restoring some of Spain's lost competitiveness against other nations. Under a 'one-size-fits-all' currency system like the euro, though, these types of imbalances between countries cannot be corrected by currency revaluation. The result has been a currency that is too strong for the likes of Spain and Greece, and too weak for exporting powerhouse Germany. Therefore, strong increases in the unit labour costs of the peripheral European nations have left them burdened with significant competitive disadvantages.

**Lack of integration adds to inflexibility.**

In some circumstances these imbalances can be worked out by other means. The USA is a prime example of how imbalances between the states are offset by labour market flexibility; workers will often move from, say, an uncompetitive state with high unemployment to a state with low unemployment. In Europe this type of movement is much more limited due to natural cultural and language barriers – not many Greeks would consider moving to Germany, no matter how bad things get in their homeland.

**These imbalances will likely lead to many years of economic underperformance.**

The US also has a common fiscal policy, which naturally leads to some transfers from 'successful' states (which will pay more in federal taxes) to 'unsuccessful' states (which will receive more in federal government transfers). Of course, the Eurozone is a purely monetary union with no fiscal transfers between countries. The German taxpayer would have little interest in paying for permanent transfers to other Eurozone members.

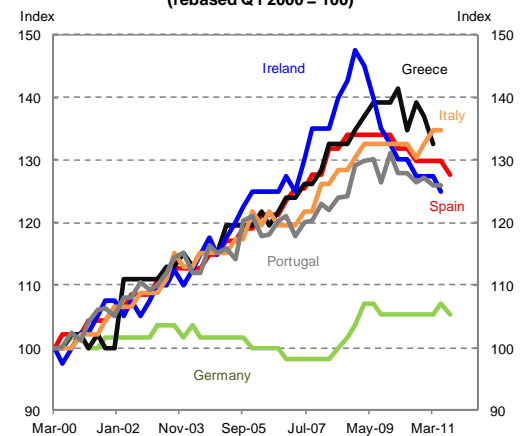
**Reducing government debt will be all but impossible in the absence of economic growth.**

The imbalances that have built up within the Eurozone are likely to lead to many years (potentially decades) of economic underperformance and stagnant wages in the peripheral nations. The uncompetitiveness of these economies has been largely obscured in recent times by generous government spending (in the cases of Portugal and Greece), and property market bubbles (in the cases of Spain and Ireland) that have provided an economic boost. But no longer – these economies need to restore some degree of fundamental competitiveness, and the only way to achieve that within the straitjacket of the Euro is to undergo a long period of low inflation relative to the stronger economies of Europe.

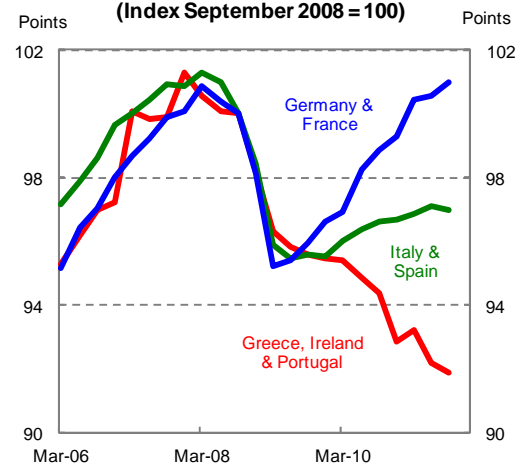
However, the economic situation of peripheral European nations is inextricably linked to their fiscal position. To satisfy investors (not to mention some of their more powerful European neighbours) these countries are instituting significant fiscal austerity measures – cuts to government spending and tax increases. This will inevitably lower economic growth further and may even prove counter-productive, as reducing government debts and deficits will prove virtually impossible in the absence of economic growth. Lower growth means greater welfare expenses, lower tax revenues and a smaller denominator in the standard measure of debt to GDP.

So, while we have argued above that the immediate 'debt crisis' should be containable, the longer-term sustainability of these countries' fiscal positions may well prove more problematic. To ensure sustainability, some form of greater fiscal union may prove necessary, whether in the form of direct fiscal transfers or collectively-backed 'Eurobonds'.

**EUROZONE UNIT LABOUR COSTS**  
(rebased Q1 2000 = 100)



**ECONOMIC ACTIVITY**  
(Index September 2008 = 100)



**Greater fiscal union may prove necessary to counteract economic imbalances.**

Economic reform to boost productivity will also be necessary. While radical, and sure to be opposed by many, all these fiscal and productivity measures would assist the peripheral nations in achieving the long-term goals of restoring economic competitiveness and growth and reducing high government debt. Without such measures, the struggle is likely to rumble on amidst growing unrest in the markets and on the streets.

**Exiting the euro and adopting a naturally weaker national currency would restore competitiveness...**

#### **Staying together is hard – but breaking up is even harder**

There is another alternative for peripheral European nations – exiting the euro altogether and adopting a naturally weaker national currency. Milton Friedman once likened a devaluation of this nature to the resetting of clocks to daylight saving time. Rather than every person altering their behaviour by one hour, the same result can be achieved by simply changing the one time that all people use as a reference. Likewise, rather than all the prices and wages in an economy adjusting downwards over time, a devaluation of the exchange rate would adjust the prices and production costs of the entire economy relative to the rest of the Eurozone. In addition, the adjustment would happen overnight.

**...but not without significant economic and political costs.**

Of course, exiting the euro would come with significant upheaval, as well as economic and political costs. A country that exited would be further removed from the rest of the single market, and its government would likely lose the backing, whether real or perceived, of the ECB and other Eurozone nations, which may damage their fiscal credibility even further. A significantly weaker currency would also mean there may be a risk of higher inflation.

**Euro exit would only be a realistic option for the truly desperate, and would likely mean public and private default on external debt.**

One significant barrier to exit would be external debt, both public and private, most of which will be denominated in euros. Therefore following the move to a new, weaker currency the external debt burden would rise significantly. The only ways to avoid this would be to default on all or part of the debt or to revalue the debt into the new currency (if legally possible) – in itself a partial default as the holders of the debt would take a loss. A likely consequence of such

actions would be isolation from international capital markets, imposing huge austerity as a cost for swift restoration of international competitiveness. Another huge hurdle for departing peripheral countries is that the banking sector would be deeply affected, causing further harm to the economy. For these reasons the costs of leaving the euro would be very high for a peripheral country. For the 'core' countries the costs of exiting would be milder but still significant: they would face a loss of competitiveness through a higher exchange rate and some capital loss on debts to the weaker countries. Currently, the popular mood within all Eurozone nations is in favour of remaining in the euro, even in beleaguered Greece. This suggests that any breakup is likely to be a result of crisis mismanagement rather than a voluntary decision.

	% OF RESPONDENTS WANTING TO STAY IN THE EUROZONE		
	For	Against	Don't know
Greece	75	20	5
Portugal	54	32	14
Ireland	78	14	8
Spain	63	30	7
Italy	57	29	14
UK	15	80	5
Sweden	23	74	3
<b>EU27 average</b>	<b>53</b>	<b>40</b>	<b>7</b>

Source: Euro-Barometer Survey (November 2011)

#### **Muddling through**

In summary, we still assume that European policymakers will do enough to avert disorderly financial disruption – though it could be that only a dramatic turn for the worse prompts decisive rather than incremental action.

However, the long-term survival of the Eurozone in its current form would not be assured simply by averting a financial crisis. Economic imbalances have built up, and to eliminate them will likely require greater fiscal integration and economic reform. The likelihood is that adjustment will take many years, possibly decades, and will necessitate prolonged economic underperformance and stagnant wages in the peripheral Eurozone nations – eventually restoring their competitiveness. This is harsh medicine, but the alternative of exiting the Euro would almost certainly prove more costly still.

#### **What does this mean for New Zealand?**

**Volatility will continue and downside risks remain for NZ.**

- The likelihood is we will have another year of volatility in global financial markets.
- 'What if' risks to the downside will linger, so scenario planning may be beneficial for businesses.
- The crisis emphasises that New Zealand needs to work hard to integrate into Asia and focus strongly on the trade opportunities there.

## International outlook

**Events in Europe dominate global outlook.**

Developments in Europe remain pivotal to the global growth outlook. Although downside risks of a severe financial crisis remain, even our core assumption of a mild recession in Europe will likely have some ripple effects through the global economy.

**Europe is expected to dip into mild recession.**

While several of the peripheral Eurozone economies are already experiencing deep recessions, it is now widely expected that several core nations, along with the UK, will dip into recession too over the first half of 2012. The debt crisis has unsurprisingly shaken confidence of businesses and consumers alike. Eurozone unemployment stood at 10.3% in November, up from 10.0% in the middle of the year.

**Chinese growth is holding up reasonably well.**

Turning to China, economic growth seems to be holding up quite well despite talk of an imminent 'hard landing'. Q4 GDP was announced at an annualised rate of 8.9%. Domestic demand has held up well despite a concurrent withdrawal of fiscal and monetary stimulus and intensified measures to cool the property market. Net exports have started to become a drag on the economy, and there is a risk that this will continue as external demand would shrink in the event of a global slowdown. Importantly, though, the authorities would seem to have plenty of policy 'ammunition', both fiscal and monetary, with which to support growth if necessary.

**Asian economies continue to power along.**

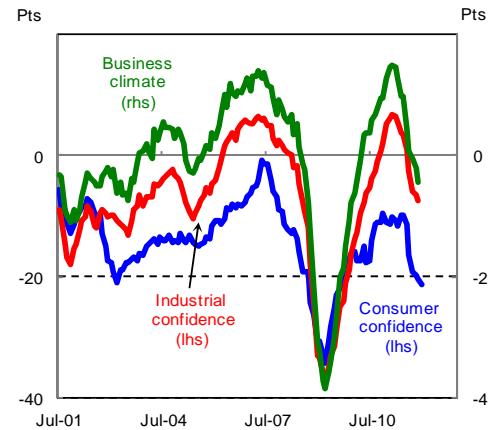
In the rest of Asia, growth continues at quite a strong pace. Japan's economy has bounced back from the slight contraction following the tsunami; Q3 real GDP growth was 1.4% qoq.

**US economy seems to have avoided sliding into recession. Still not much cause for outright optimism though.**

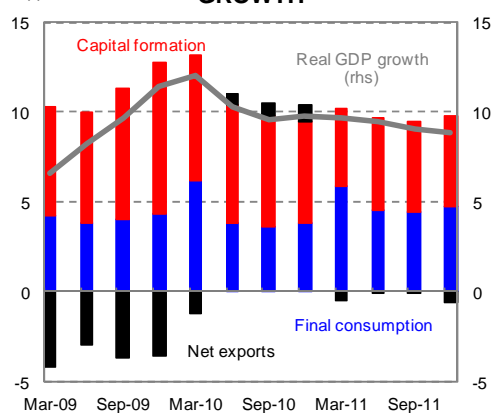
Recent economic data from the US have been surprisingly upbeat, suggesting that the economy has avoided slipping back into recession (as was feared six months ago). Employment growth has been encouraging if not exceptional in the last few months and most indicators suggest a moderate pace of growth. December retail sales did disappoint though. Looking ahead to 2012 it is difficult to see anything other than below-trend growth for the US economy, with political paralysis and a troubled housing market unlikely to offer much help.

Overall, then, trading-partner growth is holding up at around the long-term average. Obviously, much of this is driven by emerging Asia and, to some extent, Australia. Significant downside risks remain, and a European implosion would likely lead to significantly slower growth in most regions of the world.

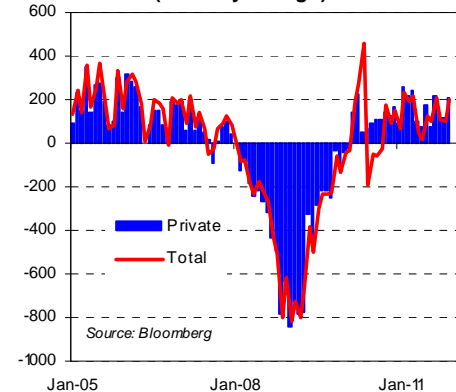
**EZ CONFIDENCE INDICATORS**



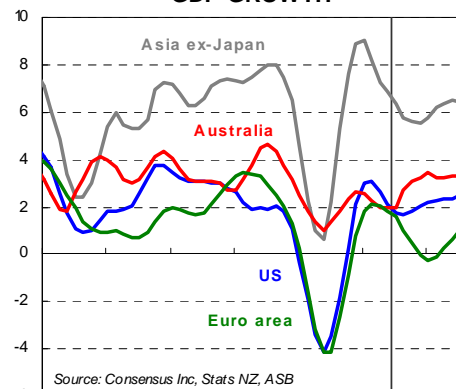
**CONTRIBUTION TO CHINA GDP GROWTH**



**US Payrolls (monthly change)**



**NZ TRADING PARTNER GDP GROWTH**



Source: Consensus Inc, Stats NZ, ASB

# The New Zealand Economy

**Gradual recovery threatened by Eurozone debt crisis.**

The economic recovery in New Zealand over the past year has remained very gradual, and has been largely underpinned by improved export incomes. NZ commodity prices have surged, pushing NZ's Terms of Trade to their highest level since 1974. We currently expect the economy to gradually build more momentum over 2012, with annual average GDP growth lifting to 2% by year-end 2012 and 3.4% year-end 2013. This acceleration is underpinned by ongoing support from export incomes, increased household demand and reconstruction activity. However, the current concerns and uncertainties around the global growth outlook threaten the momentum in NZ's export-led recovery.

**Dairy and meat export prices remain strong.**

The export outlook is mixed, as the Eurozone debt crisis continues to present large downside risk.

New Zealand's food-export commodity prices have held up well over recent months, despite recent turmoil offshore which has weighed on other commodity prices. Dairy prices, while having eased over most of 2011, remain at strong levels. Global dairy demand remains firm and, along with elevated feed prices, will continue to provide support to prices over the coming year. Meat prices remain at very high levels, with the global outlook favourable. However, recent strength in the NZD against the EUR and GBP is starting to erode farm-gate returns.

**Weakening demand for forestry and manufactured exports.**

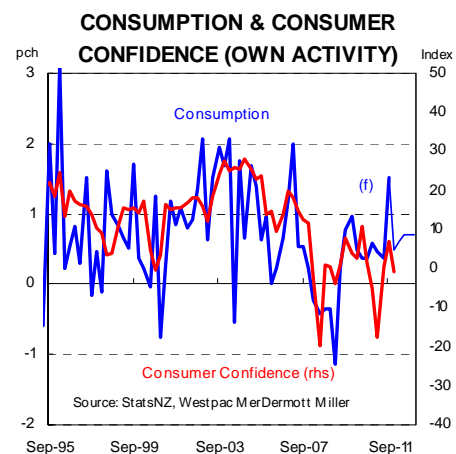
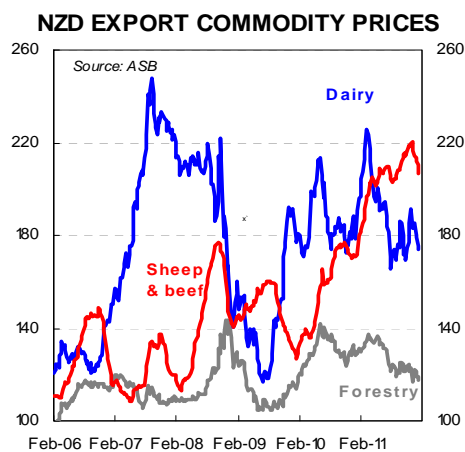
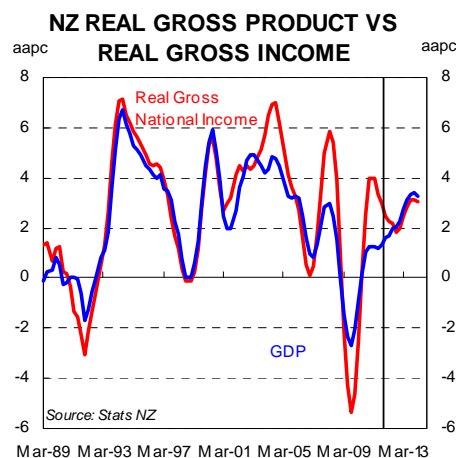
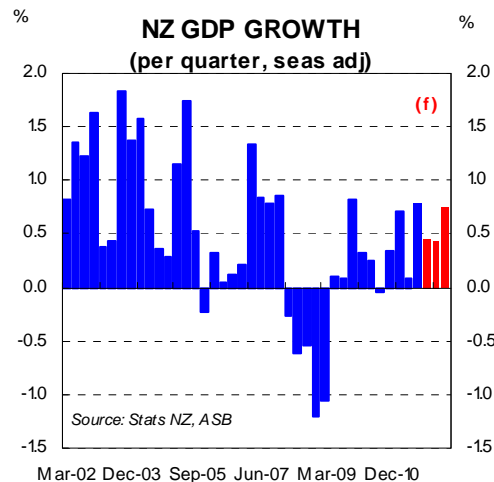
While dairy and meat prices have remained elevated, demand and prices have eased for more growth-sensitive commodities. Forestry prices have eased off as the Chinese market digests excess supply. Meanwhile, manufactured exports started to decline over Q3, and the steady deterioration in recent manufacturing PMI surveys points to further declines in production as trading partner demand weakens.

**RWC generates temporary lift to tourism activity.**

The Rugby World Cup provided a temporary boost to tourism, with a lift in visitor arrivals and tourist spending over the year. However, the stimulatory impact was not as pronounced or as widespread as expected. As the RWC boost fades, the outlook for tourism remains challenging. Tough global economic conditions, particularly in the UK and Europe, will continue to weigh on demand for long-haul travel. In addition, the elevated NZD will also provide a further headwind to visitor spending. China, meanwhile, has been a growth market.

**Household sector remains cautious.**

Underlying household demand continues to gradually improve. Retail spending has consistently recovered over the past year, although the overall level of demand remains quite subdued.



A degree of cautiousness remains in the household sector, with a continued focus on paying down debt. We expect the gradual recovery to continue over 2012, underpinned by increasing support from improved labour incomes.

**Housing market starts to pick up.**

The NZ housing market has become increasingly tight over 2011, particularly in Auckland. While the overall level of demand remains subdued the market is also very supply constrained. This has provided support to house prices over 2011, and we expect small increases to continue over 2012.

There has been volatility in Canterbury housing turnover since late 2010, reflecting the many disruptions in the wake of the earthquakes. We expect Government and insurance payouts will support a continued recovery in house sales in the region as households relocate over the coming year.

**Construction currently weak, expect earthquake rebuilding from mid-2012.**

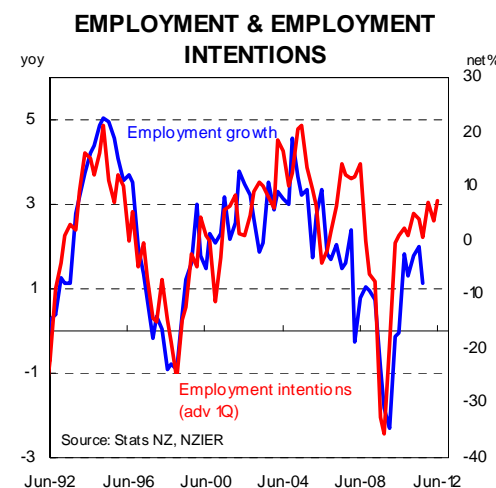
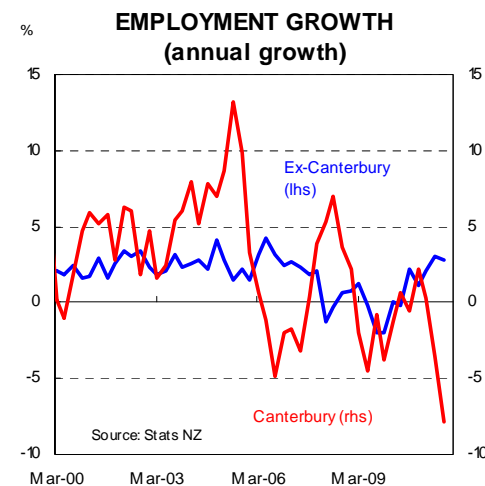
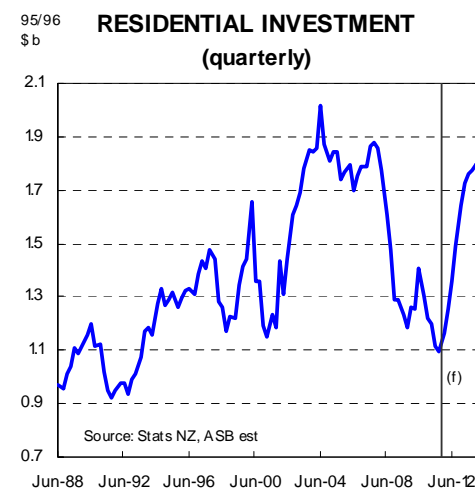
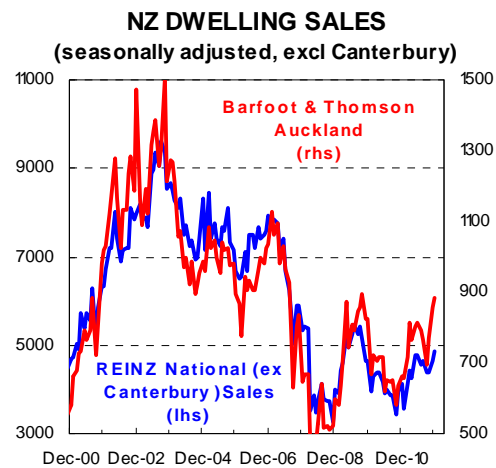
Residential dwelling consent issuance remains very subdued and points to ongoing weakness in construction activity in early 2012. Over the coming year we expect underlying demand for housing construction to pick up, reflecting the current tightness in the housing market (particularly in Auckland). From mid-2012 earthquake reconstruction is likely to build momentum and lift construction activity from current lows back towards levels which prevailed over 2003-2008. However, there remain many uncertainties around the reconstruction process and risks are skewed towards a later start.

**Businesses cautiously optimistic.**

Over 2011 business have demonstrated increased confidence in the economic outlook, evidenced by a recovery in employment (outside of Christchurch) and plant and machinery investment. The recent flare up in the Eurozone debt crisis has added uncertainty to the outlook, and is currently weighing on confidence. Nonetheless, the lift in activity over 2011 is an encouraging sign of improvement in underlying domestic confidence.

**Unemployment elevated, although employment demand improving.**

The unemployment rate remained elevated over 2011. Nationwide employment was weighed by declines in Canterbury following the February earthquake. Declines were largely centred in the retail and hospitality sector, which is consistent with the ongoing closure of the Christchurch CBD and extensive damage sustained by some of the major hotels. Looking beyond Canterbury, employment growth throughout the rest of the country proved surprisingly robust and indicates underlying employment demand has recovered robustly. We expect employment will continue to gradually recover over the coming year. We expect that skill shortages will emerge relatively quickly through the economic recovery, and will underpin a lift in wage growth from 2013.



## Inflation outlook

**CPI reflects subdued inflation pressures in the NZ economy.**

The CPI increased 1.8% for the year to December 2011. This subdued annual rate of inflation reflects weak demand in the NZ economy, as well as the effects of the high NZ dollar on the price of imported goods.

**Expect strength in NZ dollar will continue to place downward pressure on import prices.**

We expect annual inflation will continue to fall over the coming year, as the high NZ dollar places downward pressure on tradable inflation. In particular, there have been some sharp declines in the price of electronic goods in recent quarters, reflecting both subdued household demand and the high NZ dollar which has given retailers increased scope for discounting. We expect some further declines in the price of imported household items over the coming year.

**Food price inflation moderating as global commodity prices ease.**

Meanwhile, the easing in international commodity prices has seen a moderation in food price inflation. Annual food price inflation is currently well below the double-digit growth seen over late 2008.

**Rebuilding activity to underpin lift in inflation pressures later in 2012.**

In regards to non-tradable inflation, we expect post-earthquake rebuilding activity from mid-2012 will see inflation pressures lift over the coming years. Recent business surveys have indicated there are already some signs of capacity pressures in the Christchurch building sector. We expect this will flow through to a pick-up in construction cost inflation nationwide later in 2012 as rebuilding activity gathers momentum. This acceleration in construction cost inflation is expected to contribute to the rise in non-tradable inflation over the coming years.

**Potential for delay in lift in inflation pressures.**

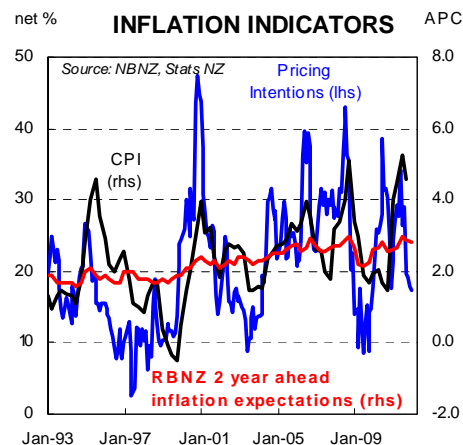
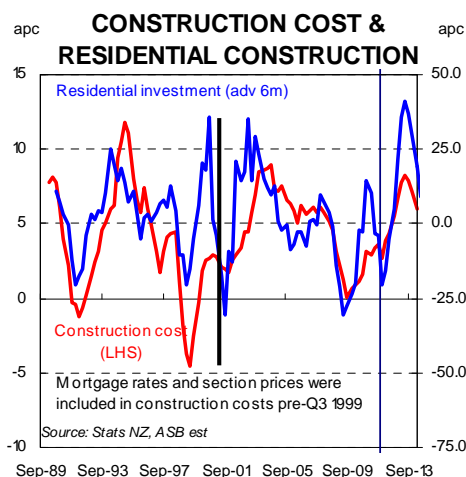
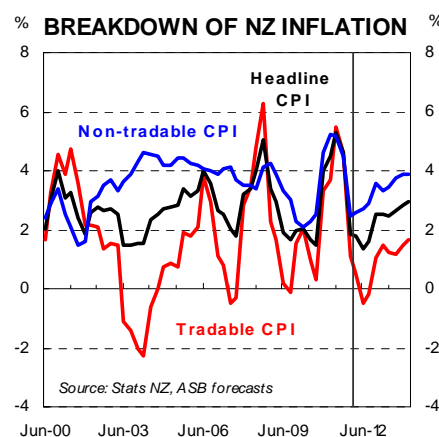
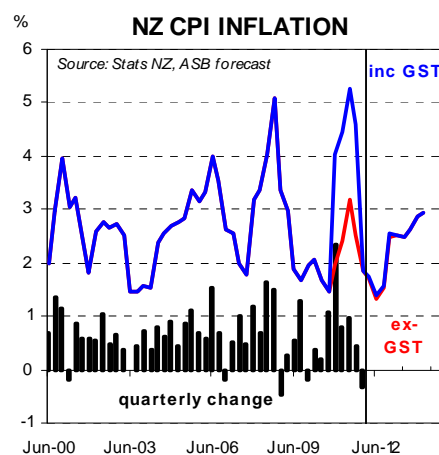
Reflecting this lift in underlying inflation pressures in the NZ economy, we expect annual headline inflation to rise towards the top of the RBNZ's target band next year. To the extent that we see the risk of a later start to the reconstruction process, there is also the potential for the rise in inflation pressures to occur later.

**Inflation pressures contained for now.**

For now though, recent inflation indicators point to inflation pressures remaining contained. The Q4 CPI data showed construction cost inflation remains subdued. Business confidence surveys point to a continued decline in pricing intentions in recent months. In addition, businesses' cost expectations have also eased.

**RBNZ will be comfortable with current inflation environment.**

Meanwhile, there has also been an easing in medium-term inflation expectations in recent quarters. The RBNZ had been concerned the boost to headline inflation from the GST increase in October 2010 would lead to a change in price and wage setting behaviour. The recent easing in inflation indicators suggests there is breathing space on the inflation front, which should be of some comfort to the RBNZ.



## Interest Rates and Exchange Rates

**RBNZ reiterates global uncertainty the dominant factor in its monetary policy outlook.**

The RBNZ left the OCR on hold at 2.5% at the December MPS, as widely expected. The accompanying Statement reiterated that the ongoing uncertainty in global markets remained the dominant factor in its monetary policy outlook. Reflecting its view of a sharper downturn in Europe, the RBNZ revised down its forecasts for global growth. In addition, it notes the downside risks to NZ export growth from slowing activity in our key Asian trading partners.

**Financial difficulties in Europe also expected to flow through to higher funding costs.**

The RBNZ also expects higher funding costs as a result of the financial difficulties in Europe, although for the time being the effects are expected to be mild. Nonetheless, this implicit tightening in financial conditions reduces the extent to which the OCR has to be increased.

**Little urgency for the OCR to increase.**

A resolution to the European debt crisis looks some way away. In addition, recent domestic developments also point to little urgency for the RBNZ to raise the OCR. Hence we expect the RBNZ will remain on hold until the end of this year. We also expect some pauses in the tightening cycle such that the OCR is not expected to reach its peak of 4% until late 2013. This reflects the cautious approach likely to be taken by the RBNZ in light of the ongoing uncertainty.

**NZ dollar driven by market sentiment.**

Rising risk aversion placed downward pressure on the NZ dollar over much of November. Although the financial woes in the European economies look far from resolved, a general improvement in market sentiment has underpinned some recovery in the NZ dollar since then.

**Expect NZD/USD to ease over 2012.**

We expect the NZ dollar will ease against the US dollar over the first half of 2012: this period will remain a challenging one for Europe and we expect the USD will be well supported by risk aversion. Once the crisis materially recedes the USD will lose some of its safe-haven support.

**Ongoing uncertainty in Eurozone likely to keep NZD/EUR elevated.**

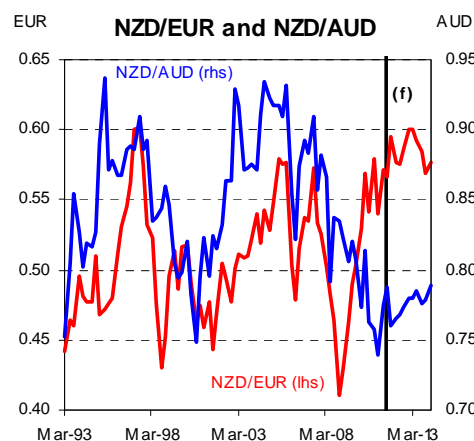
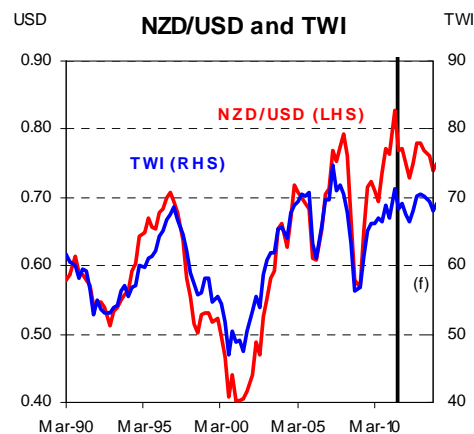
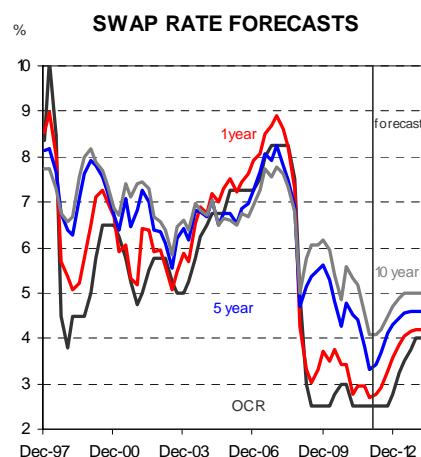
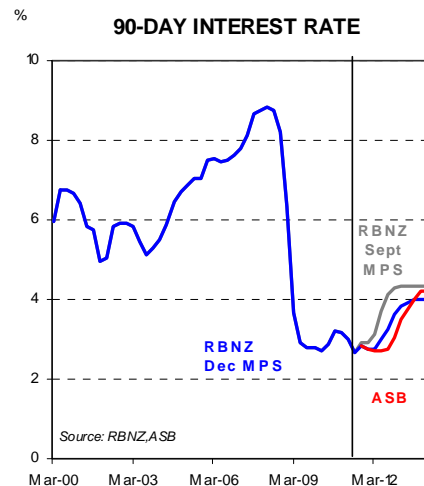
Meanwhile, the ongoing focus on the European debt crisis has seen a steady depreciation in the euro since November. This saw the NZD/EUR rise to record highs in January. We expect the NZD/EUR will remain elevated in light of the continued uncertainty in the Eurozone.

**Some recovery in NZD/AUD expected over the coming years.**

We expect the NZD to recover slightly against the AUD over the coming years, particularly as the OCR is raised here in NZ. Nonetheless, the NZD is likely to remain below average against the AUD over the next few years.

**NZD to remain elevated.**

Overall, we expect the NZD to remain elevated against most of the major crosses, reflecting the better relative performance of the NZ economy.



## Economic Forecasts

ASB economic forecasts		Sep-11 << actual	Dec-11 forecast >>	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Mar-14
<b>NZ GDP real</b>	AA%	<b>1.3</b>	<b>1.6</b>	<b>1.7</b>	<b>2.0</b>	<b>2.3</b>	<b>2.6</b>	<b>3.1</b>	<b>3.3</b>
private consumption	AA%	2.1	2.4	2.7	3.1	2.9	2.9	2.9	2.8
dwelling construction	AA%	-11.3	-11.7	-9.8	0.6	13.6	25.6	34.1	14.9
other investment	AA%	10.8	7.3	5.0	4.2	5.7	8.8	10.5	6.9
exports	AA%	2.1	2.2	1.7	1.6	1.3	0.8	1.5	3.7
imports	AA%	9.8	6.8	6.3	5.4	4.1	5.0	5.2	4.7
NZ GDP real	A%	1.9	2.0	1.8	2.4	2.8	3.4	3.8	3.0
NZ GDP real	Q%	0.8	0.4	0.4					
<b>NZ CPI</b>	<b>A%</b>	<b>4.6</b>	<b>1.8</b>	<b>1.8</b>	<b>1.4</b>	<b>1.6</b>	<b>2.5</b>	<b>2.5</b>	<b>2.9</b>
NZ house prices (QV index)	A%	2.3	3.5	4.0	3.7	3.4	3.4	3.2	2.0
NZ unemployment (sa%)	Qtr	6.6	6.3	6.2	6.1	5.9	5.7	5.4	4.6
NZ private sector wages (LCI)	A%	2.0	1.9	2.0	2.0	2.0	2.0	2.1	2.4
NZ current account (\$b)	Yr	-8.7	-8.5	-9.7	-10.5	-11.1	-12.0	-12.5	-13.6
as a % of GDP	Yr	-4.3	-4.2	-4.7	-5.0	-5.3	-5.7	-5.8	-6.0

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

## Financial Forecasts

ASB interest rate forecasts (end of quarter)	Sep-11	Dec-11 << actual	Mar-12 forecast >>	Jun-12	Sep-12	Dec-12	Mar-13	Mar-14
NZ cash rate target	2.50	2.50	2.50	2.50	2.50	2.75	3.25	4.00
NZ 90-day bank bill	2.86	2.7	2.7	2.7	2.8	3.1	3.5	4.2
NZ 3-year swap rate	3.38	2.9	3.2	3.5	3.8	4.0	4.2	4.3
NZ 10-year gov't stock	4.39	3.8	4.1	4.2	4.5	4.7	4.9	5.0
<b>ASB foreign exchange forecasts (end of quarter)</b>	Sep-11	Dec-11 << actual	Mar-12 forecast >>	Jun-12	Sep-12	Dec-12	Mar-13	Mar-14
USD per NZD	0.77	0.77	0.75	0.73	0.75	0.78	0.78	0.75
GBP per NZD	0.49	0.50	0.50	0.49	0.50	0.52	0.51	0.49
AUD per NZD	0.79	0.76	0.77	0.77	0.77	0.78	0.78	0.79
JPY per NZD	59.2	59.9	57	55	58	61	62	64
EUR per NZD	0.57	0.60	0.58	0.57	0.59	0.60	0.60	0.58
TWI	68.4	69.1	67.6	66.6	68.2	70.2	70.5	69.2

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