7 March 2014

Inflation to Breach RBNZ Band

- We add to our GDP projections
- Sending CPI inflation above 1.0 to 3.0% band
- RBNZ will be forced above neutral, to 5% OCR
- But the NZD still likely to trend lower
- Watch for a materially stronger March MPS too

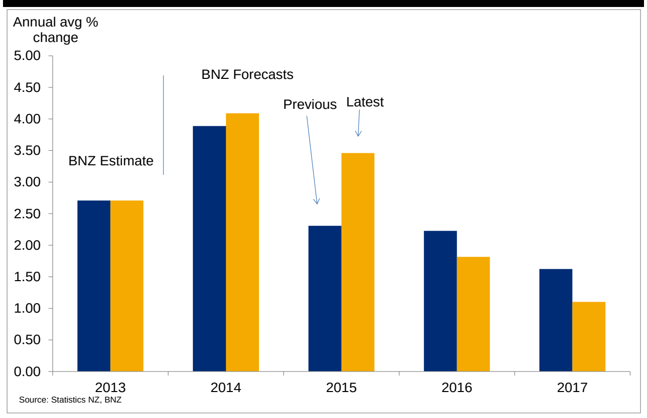
We have nudged up our economic forecasts for 2014 and bolstered them for 2015. While some of this is population driven, the overall consequence is greater excess demand than we previously envisaged. This, in turn, will drive CPI inflation above the Reserve Bank's 1.0 to 3.0% target band. To bring inflation under control, the Bank will be forced to lift its Official Cash Rate (OCR) through neutral, to a braking level of 5.00%. This process will likely be reinforced by the NZ dollar struggling to hold its already very high level.

If all of this sounds full on, it is supposed to.

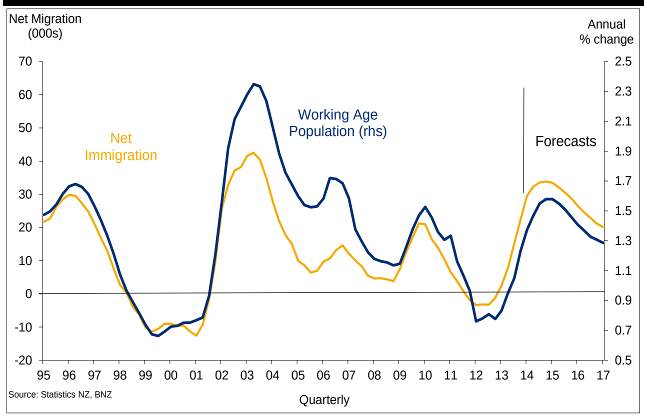
Of course, we might have waited to see what the national accounts have to say for themselves in a couple of weeks' time, before redoing our forecasts from a reset base. Indeed, there's a risk that these show Q4 GDP failing to live up to the solid 0.8% quarterly expansion we expect. However, we don't believe there's much point in waiting, when the issues we're concerned about are all about looking forward, not backwards.

In terms of numbers, we're now looking for real GDP growth of 4.1% for 2014 and 3.5% for 2015. This compares to the 3.9% and 2.3% we forecast previously. Our expectations for 2016 are down at 1.8%, from 2.2%. So we still have growth peaking this year, but at a slightly stronger pace and, more to the point, much less of a slowdown in 2015. Outright, this means sustained, above-trend, growth for a good couple of years.

Real GDP



Migration and Working Age Population



Why the upgrade? Well, some of it has to do with the fuller acceptance of the high level that net immigration has surged to and the way this has effectively doubled the rate of New Zealand's annual population growth, to approximately 1.4%. We can't see why this would turn tail anytime soon. While we had this substantively built into our labour market track, via working-age population assumptions, we felt we needed to do more to reflect this in GDP, via aggregate demand impacts.

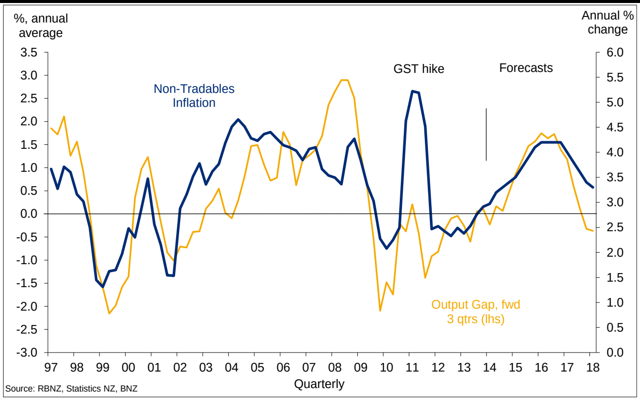
And so the greatest change we've made is actually to our private consumption track. While nudging its 2014 expansion to 3.5%, from 3.2%, we've lifted our expectations for 2015 to 3.5%, from 2.3%. This, by the way, stalls the recent improvement in the household savings rate.

However, we've also added a little more to our view on residential construction for 2014/15, while nudging up business spending on plant and machinery too, given the further surge in investment intentions we've witnessed in these realms. We have also taken the opportunity, in light of soaring staffing intentions, to strengthen our employment forecasts (although not as much as GDP, implying less of a squeeze on productivity growth, compared to what we had before).

The net impact of all the changes we've put through is to add to excess demand in our economic projections. This is reflected in a more persistent "output gap" rather than a clearly higher one. Also it means the unemployment rate falls to 4.9% by end-2015, compared to 5.1% in our prior set of forecasts.

With a stronger phase of excess demand in prospect, we now forecast the non-tradables component of the CPI to inflate to a 4.2% annual pace by early 2016, from last

Non-Tradables Inflation



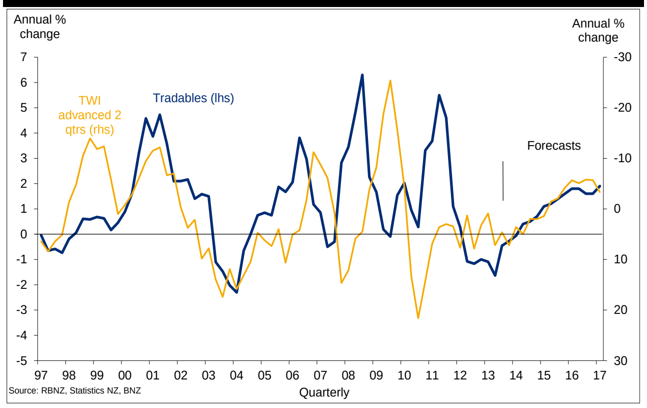
year's 2.9%. This is countered, to some extent, by slightly lower inflation in tradables inflation, given the slower retreat we now project in the NZ dollar (more on that later). Totting these two parts up, we have CPI inflation getting to 3.1% by early 2016.

While this is only 0.2 points higher than we saw before, it's symbolically (if not significantly) above the 1.0 to 3.0% target band. And, just as importantly, it's further away from the 2.0% mid-point that Governor Wheeler has said he is intently aiming to achieve.

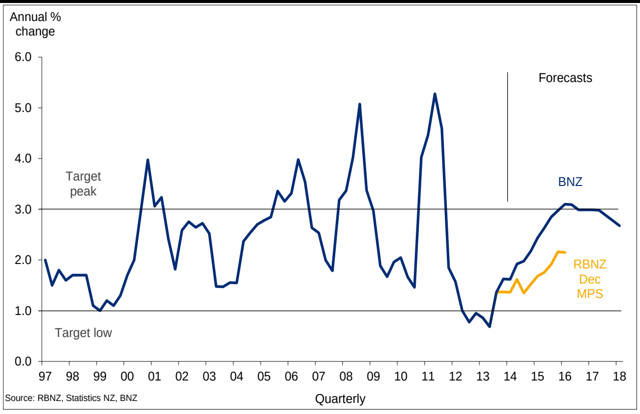
This reinforces our belief the Reserve Bank will be forced to not just neutralize its stimulus, but get the OCR to a point where it's actually having a braking effect on (excess) demand. We judge this level to be 5.00%. Pre GFC, of course, a 5.00% OCR was thought of as barely neutral. So, to be clear, we are accepting of the "new normal" notion that New Zealand's neutral cash rate is now more like 4.00-4.50% (assuming 2.0% inflation, that is). We previously projected the OCR peaking at 4.50%. But while we've since upped it, to 5.00%, we haven't changed the time at which it's achieved. That remains pitched at September 2015.

As for how we get there, we haven't altered our sequence of events for this year, meaning 25bp moves in March, April and June, to 3.25%, then two more in September and December for an end-year 3.75%. In this there is an assumption the RBNZ will continue to lag. But come

Tradables Inflation And TWI



Consumer Price Index



2015, and relentless growth, and persistence of inflation pressure, we anticipate the RBNZ will add rate hikes at the April and July OCR reviews, to complement those at the March, June and September MPS meetings, in order to get to 5.00%.

Regarding the impact of our upgraded economic outlook on the currency, our gut feel is that this will be of second order to the implications for interest rates. We think the exchange rate has been better at reflecting the hefty local data and economy's relative outlook than have central bank influenced interest rates. And so we suspect the recent robustness in the NZ dollar is well cottoned on to the GDP and CPI strength we are talking about. In any case, it might be asking too much for the NZ TWI to remain at such extreme highs, let alone go even higher, in order to sustain its inflation fighting role. In this regard, we still expect commodity export prices to drift lover over the coming 12-24 months.

Still, we feel we must make some adjustment to our currency track, given the non-trivial changes we've made to our GDP, CPI and interest rate projections. And so we have toned down its rate of decline for this year and next. We now expect NZD/USD to ease to 0.7800 by end-2014 (previously 0.7700) and the level for end-2015 to be 0.7150 (previously 0.7000). This is proportionately enforced for the TWI, given it's a change in the NZ story rather than anything US (dollar) specific.

What of the risks around our new central track? One of the motivations for us making all the changes was that we felt a bit exposed to being majorly wrong. And this was us being most conscious of the economic surveys telling us GDP growth could very well accelerate to 6% this year. If this was to transpire there would be a lot of egg on a lot of faces, especially the consensus view amongst economists, which presently expects 3.3% GDP growth for 2014 and 2.8% for 2015. There is a great danger here in the wolf arriving (which it always does, eventually, by the book).

Sure, the business surveys might still be stretching the truth, reflecting more the consensus for a pick up than the exactness on the extent of it. Then again, there are so many identifiable reasons for annual GDP growth to hit 6%, and soon, that we have to take it seriously. Population growth, dairy money and Canterbury's (re)construction alone could be enough to achieve this, this year.

And even if GDP growth in the order if 6% is not achieved in the statistics it could well be because supply simply cannot keep up with the acceleration in demand. So the pressure would be exacerbated in inflation. This is pretty much what happened over New Zealand's previous upswing, with GDP growth "slowing" but because of a severe lack of supply.

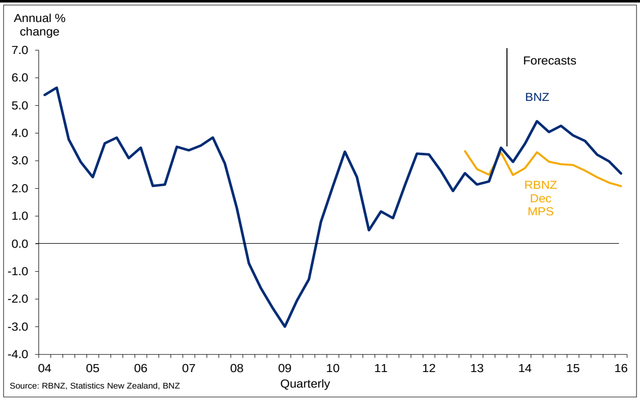
The main downside risks we see are international and, locally, related to housing and this year's election. The international risks are nothing new but, to repeat, involve commodity risk in relation to China's importance on the trading front, and funding issues with respect to Europe's ongoing banking uncertainties. The local housing market, particularly prices, will be a key test of how well, or otherwise, folk are prepared for rising rates (although we will also be monitoring reactions from businesses and farms, which also seem overly weighted to short-term debt and rates). The election, due by November, will be most important should it deliver a change to a left-leaning government. In the least, it may inject uncertainty.

Any of these things could interrupt the OCR getting to neutral, let alone the 5.00% we are projecting. Of course, nor can we ignore the currency response to a greater than expected tightening cycle, lest it proves more than we anticipate as a base case.

As for how our latest (central) view stacks up to the Reserve Bank's latest, ours is quite a bit stronger. Using the Bank's March-year basis, its December Monetary Policy Statement expected 2.8% GDP growth for 2013/14, 3.0% for 2014/15 and 2.3% for 2015/16. Our outlook is for 3.1%, 4.2% and 3.1% respectively. That's a cumulative premium of 2.3%. No wonder, then, we are forecasting CPI inflation to get to 3.1% by early 2016, while the December MPS saw a more middling 2.2%.

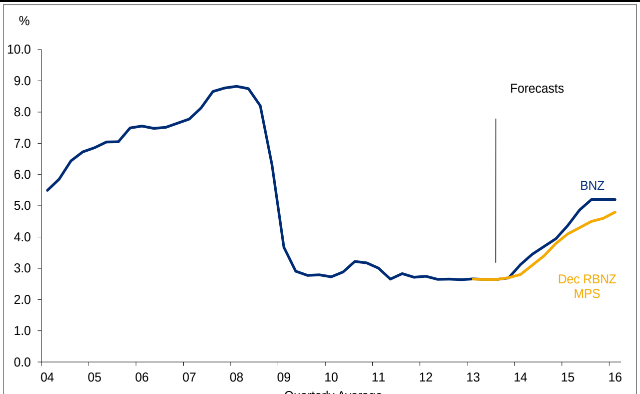
But it's also why we should probably expect the Bank to strengthen its macro-economic outlook in its Monetary Policy Statement of next Thursday. There certainly appears room and good reason for this to occur. And for the Bank to lift its (implied) OCR track in no small measure. Its December MPS, recall, inferred a 4.50% OCR by end-2015. Might this be lifted to 5.00%, even higher? It's worth thinking about, and preparing for.

Gross Domestic Product



Source: RBNZ, Statistics New Zealand, BNZ

90 Day Bank Bills



Source: RBNZ, BNZ

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Quarterly Forecasts

Forecasts as at 7 March 2014

Key Economic Forecasts

Quarterly % change unless otherwise specified

	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
GDP (production s.a.)	0.2	1.3	0.5	0.3	1.4	0.8	1.1	1.1	1.0	1.0
Retail trade (real s.a.)	0.0	1.8	0.8	1.5	0.2	1.2	0.8	0.9	1.0	0.9
Current account (ytd, % GDP)	-3.7	-4.1	-3.9	-3.9	-4.1	-3.3	-2.6	-2.2	-2.2	-3.0
CPI	0.3	-0.2	0.4	0.2	0.9	0.1	0.4	0.5	1.0	0.3
Employment	-0.4	0.5	0.2	0.4	1.2	1.1	0.6	0.7	0.8	0.8
Unemployment rate %	7.2	6.8	6.2	6.4	6.2	6.0	5.9	5.7	5.6	5.4
Avg hourly earnings (ann %)	3.0	2.6	2.3	2.4	2.6	3.2	3.2	3.6	3.1	3.6
Trading partner GDP (ann %)	3.2	3.4	2.9	3.3	3.5	3.8	3.9	3.7	3.7	3.8

Forecasts

Interest Rates

Historical data - qtr average Forecast data - end quarter	Cash	Government Stock 90 Day Bank Bills	5 Year	10 Year	Swaps 2 Year	5 Year	10 Year	US Rates Libor 3 month	US 10 yr	Spread NZ-US Ten year
2013 Mar	2.45	2.65	3.05	3.70	2.90	3.40	4.00	0.30	1.95	1.75
Jun	2.50	2.65	3.00	3.50	2.95	3.45	4.05	0.25	2.00	1.55
Sep	2.50	2.65	3.85	4.45	3.40	4.25	4.85	0.25	2.75	1.75
Dec	2.50	2.70	4.15	4.70	3.60	4.50	5.10	0.25	2.75	1.95
Forecasts										
2014 Mar	2.75	3.10	4.20	4.70	4.10	4.60	5.10	0.30	2.80	1.90
Jun	3.25	3.45	4.45	4.90	4.30	4.85	5.30	0.30	2.75	2.15
Sep	3.50	3.70	4.55	4.85	4.50	5.00	5.30	0.30	3.00	1.85
Dec	3.75	3.95	4.75	5.10	4.75	5.20	5.55	0.30	3.00	2.10
2015 Mar	4.00	4.35	4.75	5.10	5.00	5.25	5.60	0.50	3.25	1.85
Jun	4.50	4.85	4.95	5.25	5.20	5.50	5.80	0.75	3.50	1.75
Sep	5.00	5.20	5.35	5.70	5.20	5.75	6.10	0.90	3.75	1.95
Dec	5.00	5.20	5.40	5.85	4.90	5.65	6.10	1.20	4.00	1.85
2016 Mar	5.00	5.20	5.30	5.75	4.75	5.50	6.00	1.40	4.25	1.50
Jun	5.00	5.20	5.30	5.80	4.70	5.50	6.00	1.80	4.25	1.55

Exchange Rates (End Period)

USD Forecasts

	EUR/USD	USD/JPY	GBP/USD	NZD/USD	AUD/USD
Current	1.3859	102.98	1.6751	0.8491	0.9098
Mar-14	1.3800	105.00	1.6700	0.8300	0.8900
Jun-14	1.3200	107.00	1.6400	0.8200	0.8700
Sep-14	1.2900	109.00	1.5900	0.7900	0.8500
Dec-14	1.2700	111.00	1.5600	0.7800	0.8400
Mar-15	1.2600	112.00	1.5200	0.7700	0.8300
Jun-15	1.2500	116.00	1.4600	0.7500	0.8200
Sep-15	1.2500	117.00	1.4600	0.7250	0.8100
Dec-15	1.2400	120.00	1.4500	0.7150	0.8000
Mar-16	1.2400	120.00	1.3900	0.7000	0.8000
Jun-16	1.2400	120.00	1.3800	0.6800	0.8000

NZD Forecasts

	NZD/EUR	NZD/JPY	NZD/GBP	NZD/USD	NZD/AUD	TWI
Current	0.6127	87.44	0.5069	0.8491	0.9333	79.4
Mar-14	0.6014	87.15	0.4970	0.8300	0.9326	78.3
Jun-14	0.6212	87.74	0.5000	0.8200	0.9425	78.9
Sep-14	0.6124	86.11	0.4969	0.7900	0.9294	77.3
Dec-14	0.6142	86.58	0.5000	0.7800	0.9286	77.1
Mar-15	0.6111	86.24	0.5066	0.7700	0.9277	76.7
Jun-15	0.6000	87.00	0.5137	0.7500	0.9146	75.7
Sep-15	0.5800	84.83	0.4966	0.7250	0.8951	73.5
Dec-15	0.5766	85.80	0.4931	0.7150	0.8938	73.2
Mar-16	0.5645	84.00	0.5036	0.7000	0.8750	71.8
Jun-16	0.5484	81.60	0.4928	0.6800	0.8500	69.8
TWI Weights	0.2532	0.1510	0.0633	0.3123	0.2202	

Source for all tables: Statistics NZ, EcoWin, Bloomberg, Reuters, RBNZ, BNZ

Forecasts

Forecasts as at 7 March 2014	March Years					December Years				
	Actuals		Forecasts			Actuals		Forecasts		
	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015
GDP - annual average % change										
Private Consumption	3.1	2.5	3.4	3.6	3.1	2.5	2.9	3.2	3.5	3.5
Government Consumption	0.2	-0.6	1.1	0.4	0.8	0.9	-1.0	0.8	0.8	0.5
Total Investment	4.3	7.2	10.3	9.6	5.6	4.8	6.8	9.4	9.8	6.9
Stocks - ppts cont'n to growth	0.5	-0.4	0.2	0.2	-0.2	-0.2	0.3	0.1	-0.1	0.0
GNE	3.4	2.2	4.8	4.8	3.1	2.6	3.0	4.1	4.7	3.8
Exports	2.8	2.5	0.5	4.6	4.2	2.5	2.2	1.1	4.4	3.8
Imports	6.5	1.2	7.9	6.6	4.0	6.9	2.6	6.2	7.1	4.6
Real Expenditure GDP	2.3	2.6	2.8	4.1	3.1	1.2	2.9	2.7	3.9	3.5
GDP (production)	**2.4**	**2.3**	**3.1**	**4.2**	**3.1**	**1.9**	**2.6**	**2.7**	**4.1**	**3.4**
GDP - annual % change (q/q)	*3.2*	*2.1*	*3.6*	*3.9*	*2.5*	*3.3*	*2.6*	*3.0*	*4.3*	*3.0*
Output Gap (ann avg, % dev)	-0.3	-0.2	0.1	1.3	1.6	-0.5	-0.2	0.0	1.0	1.7
Household Savings (gross, % disp. income)	3.2	2.4	3.3	3.8	2.7					
Nominal Expenditure GDP - $bn	207.4	211.7	225.0	236.3	246.2	205.7	210.2	220.7	234.6	243.1
Prices and Employment - annual % change										
CPI	1.6	0.9	1.6	2.4	3.1	1.8	0.9	1.6	2.2	3.0
Employment	0.9	0.4	3.4	3.1	2.2	1.6	0.4	3.0	2.9	2.6
Unemployment Rate %	6.8	6.2	5.9	5.3	4.9	6.4	6.8	6.0	5.4	4.9
Wages - ahote	3.8	2.3	3.2	3.5	3.8	2.8	2.6	3.2	3.6	3.8
Productivity (ann av %)	1.3	1.9	0.4	0.9	0.4	0.4	2.3	0.6	0.9	0.5
Unit Labour Costs (ann av %)	2.3	1.0	2.2	2.5	3.4	3.3	0.8	2.0	2.5	3.2
External Balance										
Current Account - $bn	-6.3	-8.3	-5.9	-9.1	-11.0	-5.9	-8.6	-7.2	-7.0	-11.6
Current Account - % of GDP	-3.1	-3.9	-2.6	-3.9	-4.5	-2.9	-4.1	-3.3	-3.0	-4.8
Government Accounts - June Yr, % of GDP										
OBEGAL (core operating balance)	-4.4	-2.1	0.0	0.6	1.0					
Net Core Crown Debt (excl NZS Fund Assets)	24.3	26.3	27.5	27.2	25.9					
Bond Programme - $bn	15.0	14.0	10.0	8.0	7.0					
Bond Programme - % of GDP	7.4	6.6	4.5	3.5	2.9					
Financial Variables (1)										
NZD/USD	0.82	0.83	0.83	0.77	0.70	0.77	0.83	0.82	0.78	0.71
USD/JPY	82	95	105	112	117	78	84	98	111	117
EUR/USD	1.32	1.30	1.38	1.26	1.26	1.32	1.31	1.36	1.27	1.25
NZD/AUD	0.78	0.80	0.93	0.93	0.89	0.76	0.79	0.92	0.93	0.89
NZD/GBP	0.52	0.55	0.50	0.51	0.48	0.49	0.52	0.50	0.50	0.49
NZD/EUR	0.62	0.64	0.60	0.61	0.56	0.58	0.63	0.61	0.61	0.57
NZD/YEN	67.7	78.5	87.2	86.2	82.3	59.9	69.5	80.3	86.6	83.6
TWI	73.0	76.1	78.3	76.7	72.9	68.6	74.3	77.4	77.1	73.8
Overnight Cash Rate (end qtr)	2.50	2.50	2.75	4.00	5.00	2.50	2.50	2.50	3.75	5.00
90-day Bank Bill Rate	2.74	2.65	3.12	4.37	5.20	2.69	2.66	2.74	3.95	5.20
5-year Govt Bond	3.56	3.09	4.20	4.76	5.28	3.18	2.93	4.23	4.75	5.38
10-year Govt Bond	4.17	3.72	4.70	5.08	5.77	3.91	3.54	4.76	5.10	5.85
2-year Swap	3.07	2.92	4.10	5.00	4.75	2.74	2.70	3.79	4.75	4.90
5-year Swap	3.79	3.47	4.60	5.27	5.51	3.35	3.12	4.65	5.20	5.63
US 10-year Bonds	2.16	1.94	2.80	3.25	4.25	1.97	1.70	2.89	3.00	4.00
NZ-US 10-year Spread	2.01	1.78	1.90	1.83	1.52	1.94	1.84	1.87	2.10	1.85

(1) *Average for the last month in the quarter*

Source for all tables: Statistics NZ, EcoWin, Bloomberg, Reuters, RBNZ, NZ Treasury, BNZ

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