Economic Weekly

28 February 2011

One of our darkest moments

- **The Christchurch earthquake has dealt residents a cruel blow.**
- **From an economic point of view, the disruption will be significant and will last far longer than the September 4 earthquake.**
- **We believe a 50bp OCR cut is warranted by the blow to Christchurch and the flow-on risks to the wider, and weak, economy.**

Christchurch has been dealt another – and far crueller – blow with last Tuesday's deadly 6.3 magnitude earthquake. The thoughts of all of us are with those affected.

Cantabrians – and New Zealand – face a massive challenge in restoring the region following February's earthquake. The Christchurch CBD faces destruction far beyond that experienced in the September earthquake, with nearly a third of CBD buildings deemed too dangerous to enter. Many of these will likely be demolished. Meanwhile, the CBD may be blocked off and unusable for months. The damage to the city's wider infrastructure has been much greater than the September 4th earthquake. As a result, the level of disruption to economic activity will be significant. Although a number of businesses will be able to relocate to alternative premises, many will be unable to reopen in the short term and some may never do so. This earthquake has traumatised people in a way last year's quake never did: some people are leaving the city, others face weeks of focusing solely on looking after their loved ones in trying conditions. The human dimension to recovery shouldn't be underestimated, either.

Various government agencies, NGOs, corporates and banks are providing targeted support for Christchurch, and that will be the most effective way of financially helping Christchurch people and businesses. But this earthquake has come at a time when the economy is clearly vulnerable and domestic demand is weak. By Thursday last week we were convinced that a 50bp OCR cut would be the prudent course of action (and our central view) for the RBNZ. What we have seen since then convinces us even more that the potential economic consequences warrant a large cut. If the economic impact turns out to be mild the RBNZ can always reverse it after a few months time – but we suspect rates would remain low for most of this year.

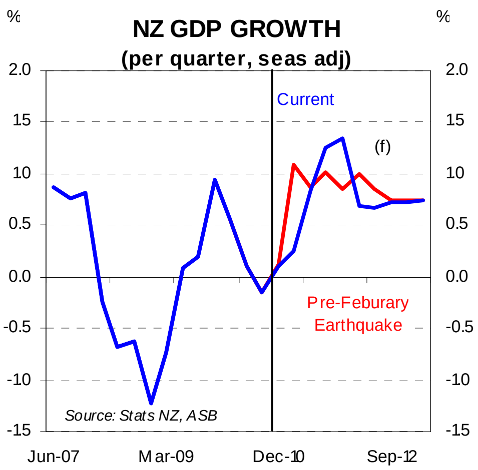
Markets are already pricing in 30bp of OCR cuts for the March Monetary Policy Statement announcement i.e. a significant chance of a 50bp cut. Wholesale rates have fallen substantially. There is high potential for market volatility by the end of March 10, so if you are transacting in financial markets over the next 2 weeks be aware of the risks – particularly of the RBNZ not cutting rates.

For ASB customers in Christchurch, you can find out information about special assistance, insurance, ATM and branch availability here . For other readers who would like to help earthquake victims, ASB has set up the following account to accept donations for the Red Cross: 12-3205-0146808-00.

Click here for:

Foreign Exchange	• NZD declines against all major crosses following Tuesday's earthquake.
Interest Rates	• Domestic rates fall sharply as markets contemplate 50 basis point OCR cut following earthquake.
Week Ahead	• Q4 Terms of Trade, other releases delayed due to the earthquake.
Week in Review	• Inflation expectations remain subdued, trade balance registers surplus in January.
Global Calendars	• Australia Q4 GDP and rate announcement, Eurozone inflation, US ISM survey and non-farm payrolls.

Chart of the Week



It is difficult to isolate the impact of the earthquake on GDP. The September quake likely detracted 0.1-0.2 percentage points from Q3 GDP. The sheer scale of destruction and disruption of last week's earthquake suggests the impact on Q1 GDP will be much greater.

The CBD is likely to remain shut down for some time, while businesses outside of the CBD will find it challenging to resume operations with the city's infrastructure badly damaged. Retailing, manufacturing, business services and tourism are likely to be key areas badly affected. Although there will be some offsets, with increased activity in transport and emergency repairs to infrastructure.

Looking forward, the sheer scale of damage and clean up required suggests it may be 2012 and 2013 when rebuilding really starts to provide a boost to economic growth. The process will be slow, with Canterbury residents keen to wait for aftershocks to stop and the damage assessment process alone taking many months.

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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7494	0.7633	0.7729	0.7099	0.6937	DOWN	0.7400	0.7600
NZD/AUD	0.7386	0.7537	0.7814	0.7900	0.7795	DOWN	0.7300	0.7500
NZD/JPY	61.24	63.41	63.93	60.60	61.95	DOWN	60.00	62.00
NZD/EUR	0.5465	0.5580	0.5639	0.5575	0.5106	DOWN	0.5400	0.5500
NZD/GBP	0.4654	0.4702	0.4865	0.4571	0.4541	DOWN	0.4600	0.4700
TWI	66.4	67.8	69.0	66.5	64.4	DOWN	66.0	67.0

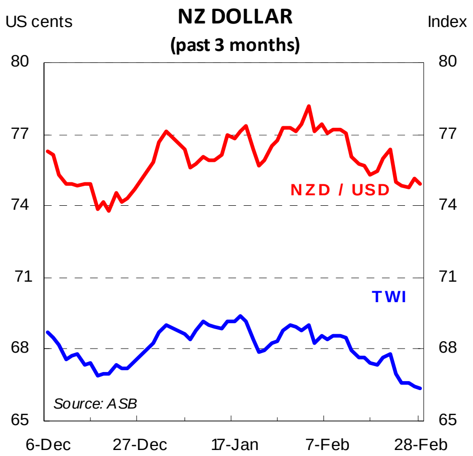
^Weekly support and resistance levels * Current is as at 11.30 am Monday; week ago as at Monday 5pm.

Following Tuesdays severe earthquake, the NZ dollar fell against all the major crosses and languished at low levels for the rest of the week. The decline followed the fall in interest rates and concerns on the fiscal outlook (although S&P and Moody's both noted that NZ's sovereign credit rating is unaffected by the earthquake). The NZ dollar has received buying support from exporters, with the commodity prices remaining very strong. Nonetheless, on balance we continue to see downside risks to the NZD in the short-term.

Aside from the Canterbury earthquake, markets are focusing on tensions in the Middle East and North Africa. As a result, safe-have flows have driven support for the Yen this week.

Looking ahead, along with the downside risk to the NZD we see upside support to the AUD and euro. The Australian dollar is likely to benefit from a more upbeat tone from the RBA and better local economic data. Meanwhile, strong Eurozone inflation data and further hawkish comments from ECB members are likely to provide support to the euro this week. We expect last week's downward pressure on the US dollar to continue, with Ben Bernanke likely to continue with relatively dovish comments.

Short-term outlook:



Key data	Date	Time (NZT)	Market
Q4 Terms of Trade	1/3	10.45am	-
RBA Rate Announcement	1/3	4.30pm	4.75%
Australian Q4 GDP qoq	2/3	1.30pm	+0.6%
ECB Rate Announcement	4/3	1.45am	1.00%
US Non-Farm Payrolls – change in February	4/3	2.30am	+175

Key events in offshore markets this week: EU CPI, US Personal consumption expenditure (28th); AU current account, AU retail sales, RBA policy meeting, UK and EU purchasing managers indices, US ISM indices (1st); AU GDP, EU PPI, Federal Reserve Beige Book (2nd); AU building approvals, EU GDP, EU retail sales, ECB policy meeting, US jobless claims (3rd); payrolls (4th).

Speakers: Fed's Dudley (28th); Bernanke (1st); Bernanke, (2nd); Bernanke, ECB's Trichet, ECB's Mersch (3rd); Fed's Kocherlakota, Fed's Lockhart (3rd); ECB's Weber, ECB's Smaghi, ECB's Draghi (4th); Fed's Yellen (5th).

Medium-term outlook:

Last Quarterly Economic Forecasts

Our forecast strength in the NZD in early 2011 is due to a strong New Zealand Terms of Trade and USD weakness, rather than the broader New Zealand economy's performance, which has been very patchy. The earthquake adds to the uncertainty.

We forecast the NZD to ease over the course of 2011 against the main cross rates, but remain strong when compared to long-run average levels.

The Australian and Canadian economies continue to benefit from strong Terms of Trade and upward pressure on local interest rate settings. The AUD in particular is likely to out-perform over the coming months, and has already traded above parity with the USD.

We anticipate that the USD will remain weak over H1 2011. The FOMC appears extremely cautious in its assessment of a clearly improving US economy. It appears the threshold for the FOMC to pre-maturely end the quantitative easing program is high. Accordingly, we are unlikely to see near-term USD strength, but expect the Greenback will lift in the latter part of 2011.

We have revised up our near-term currency forecasts for the EUR, GBP and CHF forecasts. Behind the revision is an improvement in sentiment: "crisis management" by the European authorities is being perceived as satisfactory. Accordingly, exchange rate direction is now being driven by traditional interest rate, growth and inflation, differentials.

GBP is forecast to out-perform EUR, reflecting a more rapidly improving UK economy and a healthier banking system.

Interest Rate Market

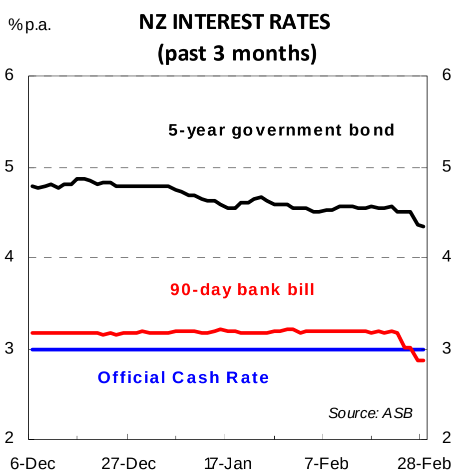
Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	3.00	3.00	3.00	3.00	2.50	DOWN
90-day bank bill	2.86	3.19	3.21	3.26	2.71	FLAT/DOWN
2-year swap	3.41	3.85	3.90	3.82	4.18	FLAT/DOWN
5-year swap	4.43	4.73	4.68	4.32	5.18	FLAT/DOWN
5-year benchmark gov't stock	4.34	4.57	4.58	4.46	5.05	FLAT
NZSX 50	3359	3382	3353	3037	3154	DOWN

* Current is as at 10.30 am Monday; week ago is as at Monday at 5pm. Please note we changed the NZ govt 5-year benchmark bond to the April 2015 maturity (from April 2013), which causes some distortion in the comparison against the previous levels (i.e. 6 months ago).

Domestic interest rates fell sharply across the curve over the week, as market expectations grew of a 50 basis point cut to the OCR following the Christchurch earthquake. The domestic yield curve steepened with the declines in interest rates being concentrated in the short end. 2-year swap rates fell 25 basis points in the hours following the earthquake on Tuesday afternoon, and continued to steadily decline over the week to end the week almost 45 basis points lower. Interest rate movements were very choppy over the week reflecting the large degree of uncertainty in the markets. Markets have now priced in at least 25 basis points of rate cuts by the March meeting, with speculation that the cut would be larger.

Offshore, interest rates were also lower reflecting continued risk aversion as political unrest continued in the MENA (Middle East North Africa) region. With Libya having the largest oil reserve in Africa and daily crude oil production of 1.6 million barrels per day, the escalating violence in the country has heightened oil supply concerns and boosted crude oil prices to above US$100 per barrel. This has weighed on global growth prospects.

Short-term outlook:



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Comment: Domestic markets will remain focused on the Christchurch earthquake, with growing calls for a 50 basis point OCR cut. Data-wise, NZ Q4 terms of trade is likely to reflect the boost to NZ export commodity prices from strong global demand recently.

Geopolitical developments in the Middle East will likely continue to dominate market attention offshore. US Non-Farm Payrolls data will provide useful insight into whether the recovery in the US labour market is still on track after severe weather disruptions in January.

Medium-term outlook:

Last Quarterly Economic Forecasts

The personal, economic and financial ramifications for the entire economy from the February 22nd earthquake are becoming increasingly severe as more information comes to hand. At a time of national crisis, when the underlying economy is already proving frustratingly weak, a rate cut would potentially be very helpful to the recovery of the economy. We expect the RBNZ to deliver a 50 basis point rate cut at the March 10 meeting, if not sooner.

Prior to the earthquake, the RBNZ had already flagged the possibility of an OCR decrease over this cycle should domestic conditions continue to deteriorate. This followed a raft of underwhelming data, which indicated economic activity stalled over the second half of 2010. GDP data showed the NZ economy contracted in Q3, and the recovery in the labour market show signs of slowing more recently. The continued weakness in credit growth is also of concern, as households and businesses remain focused on paying down debt.

In addition, inflation indicators point to inflation pressures being contained for now, suggesting the RBNZ still have breathing space on the inflation front at the moment.

We expect the RBNZ will then wait until at least December to raise the OCR. We continue to expect the initial phases of tightening will be gradual, with the first 25 basis point OCR increases occurring at the December 2011, March and June 2012 Monetary Policy Statement releases. Beyond that, we expect the tightening cycle to pick up pace as the NZ recovery gets underway and inflation concerns eventually lift.

Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Q4 Terms of Trade	1/3	10.45am	+3.0%	-	-0.5%
RBA Rate Announcement	1/3	4.30pm	4.75%	4.75%	4.75%
Australian Q4 GDP qoq	2/3	1.30pm	+0.2%	+0.6%	+0.7%
ECB Rate Announcement	4/3	1.45am	1.00%	1.00%	1.00%
US non-farm payrolls – change in February (000)	4/3	2.30am	+36	+175	-

New Zealand Data Previews

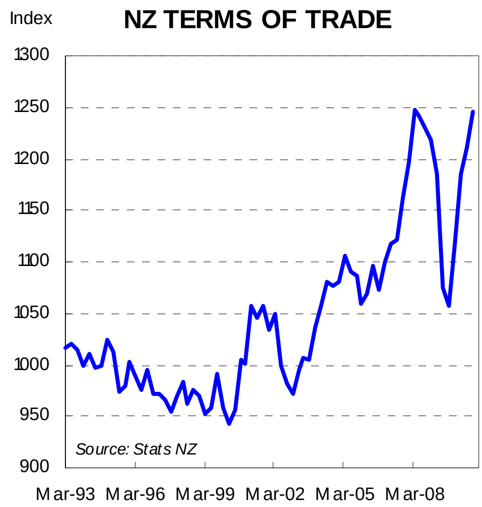
Tuesday 1 March

Q4 Terms of Trade

Previous: +3.0%, ASB forecast: -0.5%

The Terms of Trade increased 3% over Q3, largely on the back of lower import prices. However, much of the decline in import prices was due to the exchange rate methodology used by NZ Customs Services. As a result, we may be some "pay back" this quarter with import prices lifting. As a result, the Terms of Trade is likely to fall slightly (-0.5%) over Q4.

New Zealand's Terms of Trade were up 18% on year-ago levels in Q3 and back to 2008 peak levels, largely reflecting the strong recovery in NZ export commodity prices. We expect export prices remained firm in Q4, edging higher by 1.5%. We see scope for export prices to lift further over Q1 following the recent lift in food commodity prices, including dairy prices.



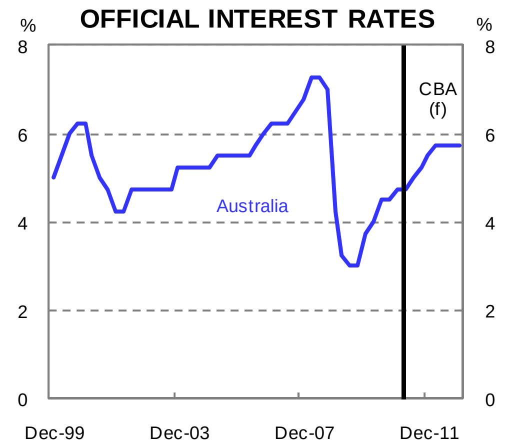
International Data Previews

Tuesday 1 March

AU RBA cash rate

Previous: 4.75%, ASB forecast: 4.75%

We are not expecting the RBA to lift the cash rate at its March policy meeting. But, we continue to forecast a further 75bpts worth of rate hikes in 2011, which would lift the cash rate to 5.5%. The minutes of the February meeting and testimony by Governor Stevens to the House Economic Committee identified that the RBA is comfortable with the current monetary policy setting. But, the framework for further rate hikes remains. The domestic labour market continues to outperform, while the international economic outlook has improved. According to the RBA, stronger global demand and adverse weather is likely to push up Australia's Terms of Trade more than previously forecast, which would lead to higher profits, investment and incomes. The RBA also stressed that while the events in Queensland were tragic, it is likely to look through the short-term effects as the focus of monetary policy is the medium-term outlook.

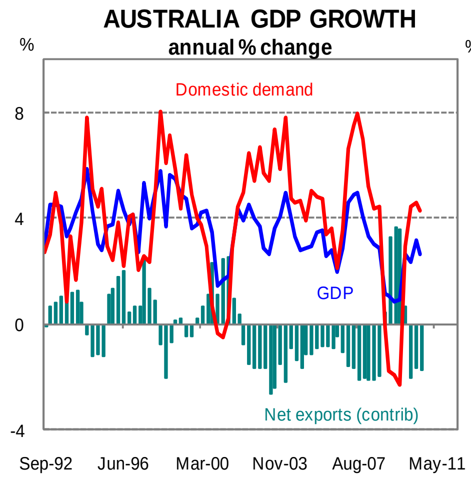


Wednesday 2 March

AU Q4 GDP

Previous: +0.2% qoq, ASB forecast +0.7%

Real GDP rose less than expected in Q3, up only 0.2%, with annual growth at 2.7%. The Q3 result was underpinned by modest growth in private (+0.6%) and public (+0.9%) spending. Exports declined by 2.4% in the September quarter. Significantly, non-farm GDP fell by 0.2% in Q3, the first decline since the end of 2008. In contrast, the nominal economy continues to grow robustly, up 9.6% in the year to September. The beneficiaries from the strong nominal economy continue to be: (a) the government. Revenues are strongly correlated with nominal GDP; and (b) the corporate sector. Company profits are highly correlated with nominal growth. Relatively subdued consumption in late 2010 and the disruption to Queensland coal production are likely to have been headwinds to GDP growth in Q4. Additionally, there appears to be a tendency to quell sales demand by running down inventories rather than by new production. But, we are forecasting a 0.7% lift in Q4. The Q3 GDP result was likely a "pothole" in an otherwise favourable growth path.

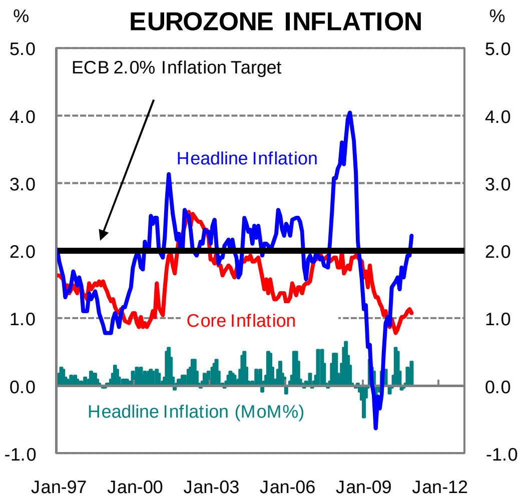


Thursday 3 March

ECB Rate Announcement

Previous: 1.00%, ASB forecast: 1.00%

The ECB is expected to keep official interest rates at 1%, for the 23rd consecutive month in March. At its February policy meeting, the ECB moderated the hawkish tone that emanated from the January meeting. But, over the course of the past month various ECB policy makers have reiterated that the central bank cannot ignore possible second round effects brought on by sustained elevated inflation. In the year to December, annual Eurozone inflation accelerated to 2.4%. The ECB's headline inflation target is 2%. Importantly, price stability remains the sole mandate of the ECB. Although market expectations for an earlier than anticipated ECB rate hike continue to be priced in, we do not expect the next ECB rate hike until Q4 2011. Uncertainty over the Eurozone peripheral sovereign debt situation is likely to remain a hurdle for any ECB policy tightening in the short to medium term.

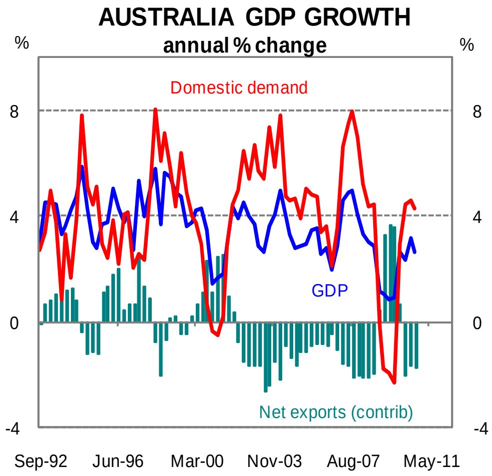


Friday 4 March

US February Non-Farm Payrolls – change (000)

Previous: +36

According to the Labour Department, bad weather prevented 886,000 people from going to work in the January survey week. Payroll growth was understandably depressed by the adverse winter weather. Non-farm payrolls increased by only 36,000, while private payrolls lifted by 50,000 in the month. The US labour market continues to show slow signs of improvement. Despite the unemployment rate declining to 9% in January, its lowest level in 21 months, it remains uncomfortably high for policy makers. Historically, 200-300,000 jobs have been created per month during economic recoveries. In contrast, recoveries from financial crisis induced downturns have typically required a longer timeframe to return to pre-crisis levels. Over the past ten months an average 111,000 private jobs have been added per month.

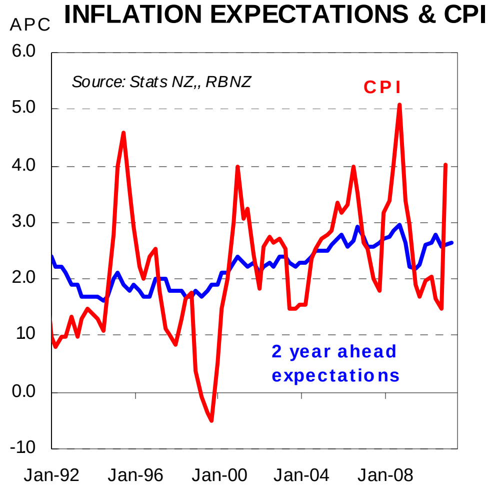


Data Recap: weekly recap

Q1 RBNZ Inflation Expectations

Two year ahead inflation expectations remained steady at 2.6% in Q1, despite the spike in Q4 CPI. Combined with the recent easing in pricing intentions and cost expectations, this result suggests inflation pressures remain contained for now. The annual rate of CPI had spiked to 4.0% in Q4, boosted by the GST increase in October. The RBNZ had indicated it would be vigilant against any flow-on effects to changes in price and wage setting behaviour.

The Q1 result suggests the effects on medium-term inflation expectations have been muted to date. Meanwhile, one year ahead inflation expectations fell to 2.9%, from 3.4% in the previous quarter.

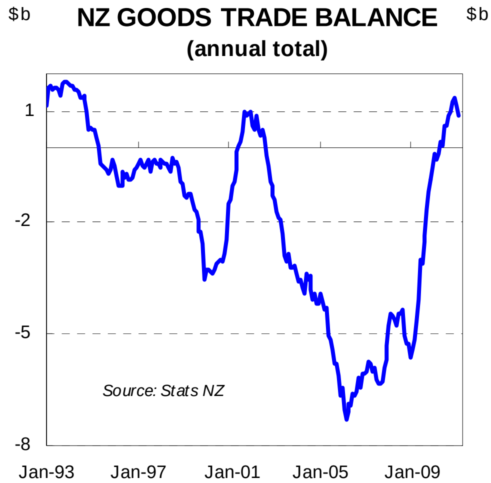


January Trade Balance

The trade balance for January was close to market expectations, with an $11 million surplus. Adjusting for seasonal patterns, the balance registered a surplus of $71 million in January (StatsNZ are reporting seasonally-adjusted figures for the first time this month).

Exports increased 5.9% over January (seasonally adjusted) underpinned by a 2.7% increase in dairy product (higher prices) and a 12% increase in fish (higher volumes).

Imports fell 1.8% seasonally adjusted over January, and down 1.9% excluding oil imports. This follows an 11% increase in the previous month. This volatility may be a result of the new AirNZ 777 aircraft imported in December.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Tue 1 Mar	10.45	NZ	Terms of trade index	QIV	q%ch	3.0	~	-0.5
	11.30	AU	AiG PMI	Feb	Index	46.7	~	~
	12.30	JP	Jobless rate	Jan	%	4.9	4.9	~
	13.30	AU	Current account balance	QIV	A$bn	-7.83	~	-7.5
	13.30	AU	Australia net exports of GDP	QIV	q%ch	-0.4	~	0.1
	13.30	AU	Retail sales	Jan	m%ch	0.2	~	0.3
	14.00	CH	PMI manufacturing	Feb	Index	52.9	52.1	~
	15.30	CH	HSBC manufacturing PMI	Feb	Index	54.5	~	~
	16.30	AU	RBA cash target	Mar	%	4.75	4.75	4.75
Wed 2 Mar	12.50	JP	Monetary base	Feb	y%ch	5.5	~	~
	13.30	AU	GDP	Jan	q%ch	0.2	~	0.7
Thu 3 Mar	10.45	NZ	Net migration	Jan	mth	750.0	~	~
	11.30	AU	AiG PSI	Feb	Index	45.5	~	~
	12.50	JP	Capital spending	QIV	%	5.0	~	~
	13.30	AU	Building approvals	Jan	m%ch	8.7	~	3.0
	13.30	AU	Trade balance	Jan	A$bn	1.98	~	1.5
	14.00	CH	Non-manufacturing PMI	Feb	Index	56.4	~	~

Calendar - North America & Europe

Please note all days and times are UK time. Add 13 hours for NZ times.

Date	Time (UK)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Tue 1 Mar	11.00	EZ	PMI manufacturing	Feb	Index	59.0	59.0	~
	11.30	UK	PMI manufacturing	Feb	Index	62.0	61.5	~
	11.30	UK	Net consumer credit	Jan	£bn	0.2	0.1	~
	12.00	EZ	Unemployment rate	Jan	%	10.0	10.0	~
	16.00	CA	Bank of Canada rate	Mar	%	1.0	1.0	1.0
	17.00	US	ISM manufacturing	Feb	Index	60.8	60.5	~
	17.00	US	ISM prices Paid	Feb	Index	81.5	81.5	~
	24.00	US	Domestic vehicle sales	Feb	mn	9.6	9.7	~
Wed 2 Mar	07.00	US	Federal Reserve Beige book	Feb	~	~	~	~
	11.30	UK	PMI construction	Feb	Index	53.7	~	~
	12.00	EZ	PPI	Jan	y%ch	5.3	5.6	~
	13.15	US	ADP employment change	Feb	'000	187	185	~
Thu 3 Mar	11.00	EZ	PMI composite	Feb	Index	58.4	~	~
	11.00	EZ	PMI services	Feb	Index	57.2	57.2	~
	11.30	UK	PMI services	Feb	Index	54.5	53.9	~
	12.00	EZ	GDP	QIV	q%ch	0.3	0.3	~
	12.00	EZ	Retail sales	Jan	q%ch	-0.6	0.3	~
	14.45	EZ	ECB announces interest rates	Mar	%	1.0	1.0	1.0
	15.30	US	Initial jobless	26 Feb	'000	391	~	~
	15.30	US	Continuing claims	19 Feb	'000	3790	~	~
	15.30	US	Non-farm productivity	QIV	%	2.6	2.6	~
	17.00	US	ISM non-manufacturing composite	Feb	Index	59.4	59.7	~
Fri 4 Mar	15.30	US	Change in non-farm payrolls	Feb	'000	36.0	175	~
	15.30	US	Change in private payrolls	Feb	'000	50.0	175	~
	15.30	US	Unemployment rate	Feb	%	9.0	9.1	~
	17.00	CA	Ivey purchasing managers index	Feb	Index	41.4	~	~
	17.00	US	Factory orders	Jan	%	0.2	2.2	~

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