

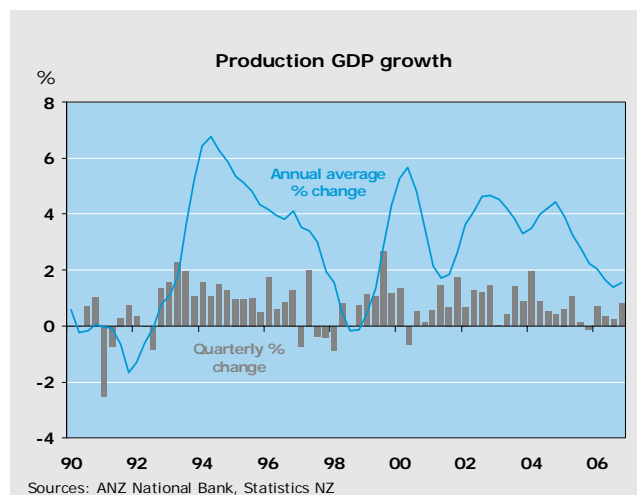
GROSS DOMESTIC PRODUCT – DECEMBER 2006 QUARTER

Key points

- **Headline GDP came in weaker than expected at 0.8 percent (compared with our and market expectations of a 1.0 percent increase).**
- **On an expenditure basis, GDP came in at 1.2 percent, driven by domestic demand. Part of the strength was a rebound in inventories, but the interest rate sensitive sectors (private consumption and residential investment) posted strong growth in the quarter.**
- **The net external sector was a huge drag on growth, subtracting 1 percentage points, though this should be seen as a pullback from previous quarters of strong export performance.**
- **The GDP figures confirmed that the economy slowed to 1.5 percent in calendar 2006, from 2.2 percent in 2005 and 4.5 percent in 2004.**
- **We maintain our view that the Reserve Bank will not increase the OCR in April. The composition of today's GDP still highlights strength in domestic demand, which the Reserve Bank wants to see moderate. However, we believe the recent rises in fixed lending rates - if sustained – will be a material influence on April's decision.**

The headlines

	Actual	ANZ-National	RBNZ	Market
Gross Domestic Product	0.8% qoq 2.1% yoy 1.5% ann.	1.0% qoq 2.4% yoy 1.7% ann.	1.0% qoq 2.4% yoy 1.6% ann.	1.0% qoq 2.4% yoy 1.7% ann.



Production GDP expanded by a weaker than expected 0.8 percent in the December quarter compared to our and market expectations of a 1.0 percent increase. This took annual growth to 2.1 percent and annual average growth to 1.5 percent. Growth was again driven by the services industries, which grew by 0.9 percent in the quarter and is the seventeenth consecutive quarterly increase. Industries exposed to the housing market (Finance, real estate and business services) contributed half of the GDP growth in the December quarter. The major downside surprise to our 1.0 percent estimate was due to falls in manufacturing production and wholesale trade (we were expecting increases).

The expenditure-based GDP measure recorded a 1.2 percent increase. Domestic demand rebounded strongly, up 2.5 percent, after contracting over the previous two quarters. This rebound was driven by a reversal in the inventory drawdown of the previous quarter, with stocks contributing 1.4 percentage points to GDP growth. However, even abstracting from stocks, domestic demand was strong in the quarter, up 1.3

percent. All components of GNE rose, with private consumption up 1.1 percent, public consumption up 0.8 percent, residential investment up 2.3 percent and other investment up 1.4 percent. The external sector was a huge drag on growth with exports down 2.7 percent and imports up 1.4 percent. The fall in exports is partly an unwinding of the previous two quarters of strong export growth (dairy related).

The GDP implicit price deflator, the broadest measure of overall price changes in the economy, was up 0.5 percent in the December quarter and is up 2.3 percent for the year. The GNE deflator fell 0.5 percent in the quarter, driven by slower private consumption inflation (petrol related) and falling prices for transport, plant and machinery investment. However, on an annual basis, the GNE deflator remains elevated at 3.1 percent, which will continue to remain a concern for the Reserve Bank.

Expenditure GDP Components – September 2006 quarter	Percentage change from previous quarter	Percentage point contribution to change	Percentage change in annual values
Private Consumption	1.1	0.6	2.0
Public Consumption	0.8	0.2	4.2
Residential Investment	2.3	0.1	-2.4
Other Investment	1.4	0.2	-3.7
Exports	-2.7	-0.8	1.9
Imports	1.4	-0.2	-2.5
Change in Inventories and Balancing Item
Gross Domestic Product (Expenditure)	1.2		1.7
Gross Domestic Product (Production)	0.8		1.5

Assessment and implications

We saw upside risks to Q4 GDP, though this came through on the more volatile expenditure measure. The headline GDP number was weaker than expected, and will give the Reserve Bank a slightly lower starting point in their output gap estimate. However, the expenditure component showed a strong rebound in domestic demand and continues to paint a picture of resilience in the interest rate sensitive sectors.

The Reserve Bank will be focusing more on the expenditure measure, which is still showing domestic demand growing at a pace the Reserve Bank deems to be unsustainable. The inventory rundown and rebuild over the September and December quarters may have added volatility into the numbers, but the quarterly expenditure GDP track shows an acceleration in the quarterly growth rates over 2006. The composition of growth showed that the rebalancing of growth away from domestic demand towards the external sector, which the Reserve Bank wants to see, is yet to occur. The fall in exports in the December quarter is partly an unwind following previous strong quarterly growth, but the current level of the exchange rate will continue to hamper export performance. The manufacturing remains in recession, with production contracting for the third consecutive quarter. In annual terms, manufacturing production is 1.5 percent below the level 12 months ago. Five of the nine manufacturing industries recorded declines in the December quarter, with the biggest fall coming from metal product manufacturing. The NZD will also continue to make imports attractive, particularly if domestic demand remains resilient.

We continue to maintain our view that the Reserve Bank will not increase the OCR in April. The GDP data confirms that the economy rebounded strongly at the end of last year, and that the dichotomy between the domestic and external sector remains. Part of last year's momentum may have spilled over into early this year. However, we remain wary whether this will be sustained. Capacity constraints are curtailing the ability of the economy to rebound, and financial conditions have tightened considerably of late. Today's data – while showing strong domestic demand – lacks a trigger to take us across the line and call a hike.

We believe the recent rises in fixed lending rates - if sustained – will be a material influence on April's decision. Given March's hike, the threshold to a second move will undoubtedly be lower, and resilience across the economy leaves the risk towards a further move. While the Reserve Bank will remain mindful of signs of sustained strength and capacity pressure, we expect the recent bout of increases in household borrowing rates to give them some comfort that housing related activity will return to a moderating trend. While one of the reasons behind higher fixed lending rates is expectations of higher rates (and hence no move risks a rally in the curve), it also reflects a market belief of sustained higher interest rates for sometime, and less aggressive mortgage discounting across financial intermediaries.

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