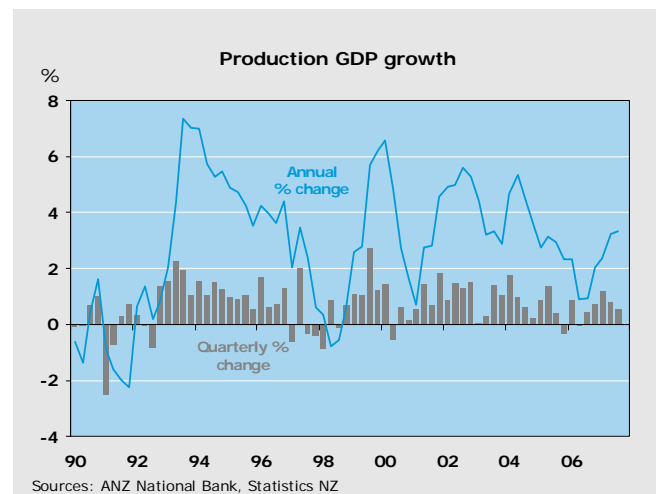


GROSS DOMESTIC PRODUCT – SEPTEMBER 2007 QUARTER

Key points

- **Headline GDP a tad stronger than expectations at 0.5 percent for the quarter.**
- **Stripping out the Tui oilfield impact (0.2 percentage points), the underlying picture is one of moderation with domestic demand easing. This needs to be sustained and extend into 2008, which is where the uncertainty resides.**
- **For now, the message remains one of rates remaining high for an extended period.**

	GDP (qtr % chg)	GDP (ann % chg)	GDP (ann ave % chg)
Sep-05	0.4	2.9	3.1
Dec-05	-0.3	2.4	2.8
Mar-06	0.9	2.3	2.7
Jun-06	0.0	0.9	2.1
Sep-06	0.4	0.9	1.6
Dec-06	0.7	2.0	1.6
Mar-07	1.2	2.4	1.6
Jun-07	0.8	3.2	2.1
Sep-07	0.5	3.3	2.7
ANZ	0.3	3.1	2.7
<i>RBNZ</i>	<i>0.6</i>	<i>3.4</i>	<i>2.8</i>
<i>Market</i>	<i>0.4</i>	<i>3.2</i>	<i>2.8</i>



Headline production GDP expanded by 0.5 percent in the quarter, stronger than market expectations of a 0.4 percent increase. Along with small upward historical revisions (with June quarter growth revised to 0.8 percent from 0.7 percent), this took annual growth to 3.3 percent (from 3.2 percent in June) and annual average growth to 2.7 percent (from 2.1 percent in June). Activity in the mining industry rose \$84 million in the September quarter, largely due to production from the Tui oil field coming on line, as well as increased exploration activity. We estimate that Tui added around 0.2 percentage points to growth in the quarter (or a contribution of just under half of the total increase in economic activity). The services industry again also made a large contribution to growth (up 0.7 percent), with the Finance, Insurance and Business Services industry (up 0.8 percent) dominating, although this is down on previous quarterly growth over the past 12 months. The stronger mining activity saw primary industries increase 3.9 percent, while weak manufacturing production (down 2.2 percent) saw the goods-producing industries fall 1.4 percent.

On an expenditure basis, GDP grew by a softer 0.3 percent. This follows solid growth of 0.9 percent and 0.7 percent in the March and June quarters respectively. Private consumption growth continues to moderate, increasing by 0.3 percent, following growth of 0.4 percent in the June quarter, and has taken a step-down from phenomenal growth of 2.1 percent in the March quarter. Total investment was also reasonably soft, with residential investment increasing 1.9 percent (we were expecting a much stronger increase), business investment falling 0.8 percent and inventories detracting 0.3 percentage points from growth. We note however, that if the impact of the commissioning of the HMNZS Canterbury in the June quarter is removed, business investment would have increased by more than 1 percent. Net exports continue to act as a drag on growth, with exports falling 0.6 percent and imports rising 0.2 percent. Bucking the trend, and clearly supporting growth in the September quarter, was a 2.3 percent increase in Government consumption spending. This contributed 0.4 percentage points to growth.

The implicit GDP deflator continues to increase courtesy of a surging terms of trade. The GDP deflator rose 0.9 percent in the September quarter, taking annual growth to 3.4 percent. Stripping out the impact of the terms of trade, the GNE deflator grew by a much more muted 0.2 percent, to be up 2.2 percent on a year ago.

Production GDP by Industries	Qtr % chg	%-pt contrib.	Ann % chg
Agriculture	0.2	-	1.7
Fishing, forestry & mining	15.5	0.3	28.3
Manufacturing	-2.2	-0.3	-0.6
Electricity, gas and water	-3.8	-0.1	-4.3
Construction	2.1	0.1	4.2
Wholesale	1.4	0.1	3.4
Retail	0.4	-	4.4
Transport	1.0	0.1	4.3
Finance, insurance and business	0.8	0.2	4.4
Government	1.6	0.1	4.7
Personal	-	-	2.2
Unallocated	...	-	...
GDP (P)	0.5	0.5	3.3

Expenditure GDP by Components	Qtr % chg	%-pt contrib.	Ann % chg
Private Consumption	0.3	0.2	4.2
Public Consumption	2.3	0.4	4.7
Residential Investment	1.9	0.1	6.8
Change in Inventories	...	-0.3	...
Other Investment	-0.8	0.3	2.3
Exports	-0.6	-0.2	-0.6
Imports	0.2	-0.3	8.6
Balancing item	...	0.1	...
GDP (E)	0.3	0.3	3.5

Assessment

The economy appears to be going through a slow-burn type of slowdown. The four OCR hikes this year, a higher currency and financial conditions that are at their tightest level since 1996 are certainly having an effect, but the economy has merely shifted from a gallop to a canter at this stage. Certainly, the Tui oilfield boosted the headline GDP number by around 0.2 percentage points. But this was well flagged and the markets, as well as the RBNZ, had already factored that in. We note that Tui also represents a one-off expansion in the supply side capacity of the economy (or production possibility frontier), and is therefore seen as non-inflationary (or that it will not generate much inflationary pressure) by the RBNZ.

When we look at the expenditure side, there is perhaps some cheer for the RBNZ. Domestic demand (GNE) has slowed markedly following strong prints over the past three quarters. Private consumption growth was soft and early indicators to date point to ongoing weakness in private consumption growth in Q4. Residential investment was also weaker than expected, and with the housing market still under some pressure, the RBNZ can have some confidence that residential investment will start to act as a drag on economic activity.

However, Government spending is looming as the biggest challenge for the RBNZ. Having now managed to tame the housing market and the consumer, Government spending is looking to be the biggest inflation threat next year. Public consumption was the largest contributor to Q3 expenditure growth, and given the projected surpluses contained in this week's *Half Year Economic and Fiscal Update*, public consumption will continue to hold growth up and put upward pressure on inflation. With tax cuts now looking very likely, the RBNZ will want to ensure that domestic demand continues to slow over the coming quarters in order to accommodate the tax cuts without putting further upward pressure on inflation. This sounds Scrooge-like, but the ugly inflation profile facing the RBNZ means it has little choice. **Fiscal policy remains a key inflation risk for the RBNZ next year.**

We also note that there were cumulative upward revisions to GDP of 0.4 percentage points over the past four years. While the headline result was a tad weaker than the RBNZ's forecasts, cumulative revisions may have brought the level of GDP more in line with their December *MPS* projections, or even potentially higher. This may have a small positive effect on the RBNZ's output gap estimates.

Looking forward, there are two major issues. Firstly, signs of moderation in Q3 need to extend into 2008, with fiscal policy and a booming dairy industry the key "moderation" challenges. We expect the downstream impact of a weakening housing market to progressively dominate. Secondly, softer growth needs to dampen inflation. We are sceptical of the fabled soft landing being sufficient. Changes in the global economy and commodity prices may well be the transmission mechanism needed for inflationary pressures to dissipate.

We doubt there is anything in today's number that will shift the Reserve Bank's thinking for now. The economy remains heavily capacity constrained despite growth now starting to slip below trend on a quarterly basis. The economy needs an extended period of the same. Domestic demand is slowing, albeit off a strong base. Early indicators relating to Q4 certainly point to further slowdown ahead. We also suspect that the level of inventory is still high despite a partial unwind in the stock contribution in Q3. This points to stocks acting as a further drag on growth over the coming quarters. Against this backdrop, inflationary pressure remains worrisome. **For now, the message remains one of rates remaining high for an extended period.**

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