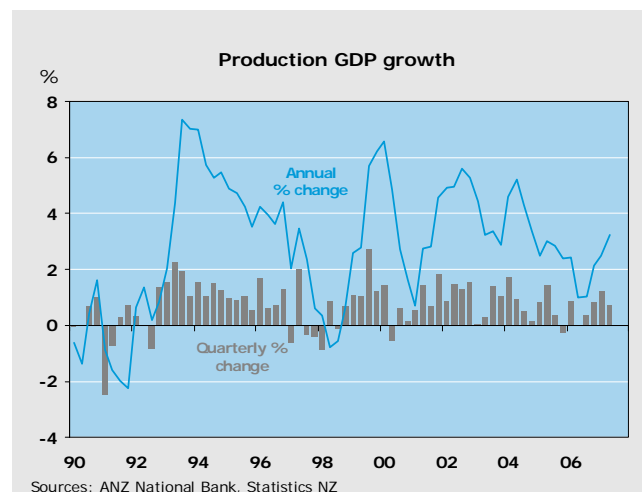


GROSS DOMESTIC PRODUCT – JUNE 2007 QUARTER

Key points

- A stronger June outturn and upward historical revisions mean economic activity, and therefore pressures on the economy, are more intense than what the Reserve Bank was expecting.
- Domestic demand was strong with consumer spending more robust than expected, although (distribution) stocks also made a strong contribution to growth. The latter portends of an unwind down the track given more timely indicators of domestic demand.
- Today's data, in combination with burgeoning food-related inflation and subsiding credit fears, have raised the bar for the OCR moving lower. Our March call is looking tenuous in this environment although we'll hold it for now until we see how certain credit dynamics – both domestic and offshore – unfold over the coming month. We do not see much point sitting on the crowded fence.

	GDP (qtr % chg)	GDP (ann % chg)	GDP (ann ave % chg)
Jun-05	1.4	3.0	3.3
Sep-05	0.4	2.9	2.9
Dec-05	-0.3	2.4	2.7
Mar-06	0.9	2.4	2.7
Jun-06	0	1.0	2.2
Sep-06	0.4	1.0	1.7
Dec-06	0.8	2.1	1.7
Mar-07	1.2	2.5	1.7
Jun-07	0.7	3.2	2.2
ANZ	0.5	2.6	2.1
RBNZ	0.5	2.6	2.1
Market	0.5	2.5	2.1



Headline production GDP grew by 0.7 percent in the quarter, stronger than expectations of a 0.5 percent increase. This, along with upward historical revisions (March quarter growth was revised up from 1.0 percent to 1.2 percent), took annual growth to 3.2 percent and annual average growth to 2.2 percent. As has been the theme for the majority of the past two years, services industries – led by Finance, Insurance, and Business Services – made the largest contribution to growth in the quarter, rising 0.9 percent. Primary industries grew 0.2 percent, while goods-producing industries fell 0.1 percent.

On an expenditure basis, GDP grew by 0.8 percent. After recording growth of 1.4 percent in the March quarter, gross national expenditure (GNE or domestic demand) expanded by 1.5 percent in the June quarter. Although private consumption growth, at 0.6 percent, was a step down from the 2.1 percent growth in March, it was still stronger than our expectations given the fall in June quarter retail sales. Other strength in the quarter came from a solid contribution from general government consumption (up 1.2 percent), residential investment (up 3.8 percent), and a 0.7 percentage point contribution from inventories. The major offsetting factor to domestic demand growth was a 2.9 percent fall in other fixed asset investment – largely due to a fall in plant and machinery equipment investment. Net exports were also a drag on growth in the quarter, with exports rising by 0.5 percent, compared with the 2.5 percent growth in imports.

The implicit price deflators are showing a faster rate of increase for the GDP deflator compared to GNE on an annual basis for the first time since 2005. This is most likely a consequence of the strong terms of trade impact the economy is beginning to experience, with the price of exports increasing at a faster rate than the price of imports. The GDP deflator increased by 1.1 percent in the June quarter, taking annual

growth to 3.1 percent. This compares with quarterly and annual growth of 0.6 percent and 2.4 percent for the GNE deflator respectively.

Production GDP by Industries	Qtr % chg	%-pt contrib.	Ann % chg
Agriculture	-0.8	-	1.4
Fishing, forestry & mining	3.3	0.1	8.7
Manufacturing	0.5	0.1	0.3
Electricity, gas and water	-1.8	-	-2
Construction	-0.8	-	1.8
Wholesale	0.9	0.1	2.9
Retail	-0.9	-0.1	5.2
Transport	1.3	0.1	5.5
Finance, insurance and business	1.5	0.4	4.7
Government	-	-	3.6
Personal	1.0	0.1	2.9
Unallocated	...	-0.1	...
GDP (P)	0.7	0.7	3.2

Expenditure GDP by Components	Qtr % chg	%-pt contrib.	Ann % chg
Private Consumption	0.6	0.4	4.8
Public Consumption	1.2	0.2	3.1
Residential Investment	3.8	0.2	9.2
Change in Inventories	...	0.7	...
Other Investment	-2.9	-0.9	3.6
Exports	0.5	0.2	2.6
Imports	2.5	-0.4	9.1
Balancing item	...	0.4	...
GDP (E)	0.8	0.8	3.8

Assessment

Economic activity over the first half of this year proved to be much stronger than expected, growing at an annualised pace of 4 percent. The June quarter GDP growth remains unbalanced, with domestic demand dominating and net exports subtracting from growth. The composition to growth was not as strong as what the headline implied with a change in inventories and the balancing item both contributing 1.1 percentage points. Nonetheless, the combination of upward historical revisions, still remarkably robust consumer spending, and stronger headline print means the economy is more stretched than what the Reserve Bank thought at their September *Monetary Policy Statement*.

The historical revisions were reputedly made to bring the production and expenditure measures, which had been diverging lately, into line. Nonetheless, this has important implications for the Reserve Bank's assessment of the starting point of their output gap position, which is now higher than their September projections. This implies further near-term inflation pressure in their forecasting framework. Given their lack of inflation headroom, this will reinforce their wariness.

With June quarter GDP data out of the way, the focus will now turn to how economic activity fared over the September quarter. The partial data to date shows a soft start to the September quarter, with weak retail sales and falling house sales pointing to a weakening in domestic demand. The finance and business services sectors (which added 0.4 percentage points to growth in the June quarter and represent 20 percent of GDP) are likely to be a major drag in the September quarter, going by a strong slowing in housing and lending activity. Merchandise trade data to date suggests net exports will again subtract from growth. And the build-up in inventories in the June quarter will likely partially unwind, acting as a further drag on growth. However, support will come in the form of production from the Tui oilfield, which the Reserve Bank estimates will contribute 0.2 percentage points to September quarter GDP growth, and government spending. From a monetary policy perspective, the addition to growth from Tui should be of little consequence as it raises both demand and supply (new capacity).

Given the still tight financial conditions facing the economy, we continue to expect economic growth to slow over the second half of this year. The partial data in the coming months should reflect this as the "ripple" effects from easing housing demand filter through to other sectors. However, the more inflationary opening position for the economy means it is now essential that the Reserve Bank sees such a slow-down. How dislocation across credit markets play out remains the wild-card at present. The September quarter CPI print on 15 October is shaping up to be a key read. Another strong non-tradable print coming on top of today's stronger-than-expected GDP outturn will put the Reserve Bank in a difficult position given the lack of inflation headroom.

Today's data, in combination with burgeoning food-related inflation and subsiding credit fears, have raised the bar for the OCR moving lower. Our March call is looking tenuous in this environment although we'll hold it for now until we see how certain credit dynamics – both domestic and offshore – unfold over the coming month. We do not see much point sitting on the crowded fence.

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