

Gross Domestic Product – March 2008 quarter

Key points

- > Economic activity contracted in the first quarter of 2008, with a drought effect playing a part.
- > Composition suggests more underlying weakness than headline number implies.
- > Indicators to date suggest June quarter GDP looking no better.
- > September start to easing cycle still on track, but we would not rule out an earlier move in July.

Assessment

Headline production GDP contracted by 0.3 percent, in line with market expectations.

Drought conditions in the early part of this year had a noticeable impact, with activity in the agriculture industry declining 5.6 percent and shaving 0.3 percentage points off GDP growth. The drought impact was also noticeable in food manufacturing, which declined 4 percent and shaved 0.2 percentage points off growth.

The GDP mix had weaknesses in areas we had expected, but also surprising strength in some areas.

The 5.2 percent decline in the construction sector was as expected, and was foreshadowed by the weak building work put in place data released earlier. Following the sharp rise in oil production from the Tui oilfield, mining activity declined by 2.3 percent but activity remains at a very high level. Real estate and business services showed a 0.9 percent decline, which is not surprising given the sharp slowdown in the housing market. What was puzzling is the resilience in the retail and hospitality sector, which was flat despite a 1.2 percent decline in retail sales. Also puzzling is the ongoing strength in the finance and insurance sector (up 0.8 percent) despite slowing credit growth, and the 1.4 percent increase in personal and community services, which added 0.2 percentage points to growth. Government activity also provided support, up 1.6 percent in the quarter.

Growth was decidedly weaker on the expenditure side, and better reflects the state the economy is in.

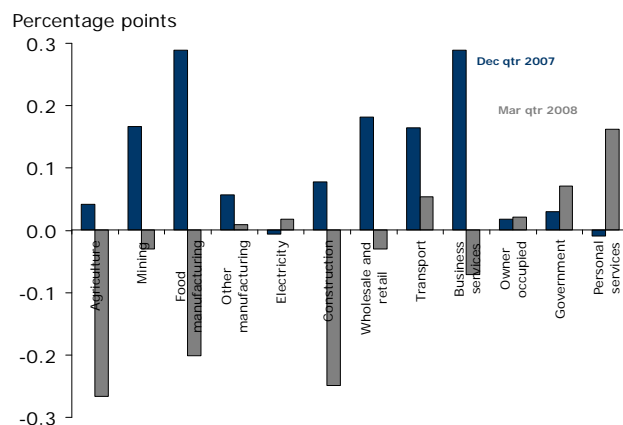
Despite inventories contributing 0.8 percentage points to growth, expenditure GDP still contracted by 0.6 percent. A rebound in inventories was on the cards given the previous quarter's rundown, but the rebuild was larger than we had anticipated. Most of the increase in inventories is in the distribution sector (wholesale and retail), which we suspect is of an involuntary nature given the slowdown in domestic demand. Given this, we can expect to see an inventory rundown in the coming quarters, which will be a drag on GDP growth. Final domestic demand was weak, declining 0.6 percent with only public consumption (up 1.1 percent) providing support to growth. Private consumption (down 0.4 percent) and

residential investment (down 5.4 percent) were major drags on growth. As foreshadowed by yesterday's Balance of Payments release, net exports shaved 1 percentage points off growth.

If there is one positive to be had in today's GDP report, it is that plant and machinery investment continues to grow, up 5.9 percent in the March quarter following a 4.4 percent rise in the December quarter. One hopes that such investment will eventually result in improved productivity performance that will help drive the next upswing in the business cycle.

	GDP (qtr % chg)	GDP (ann % chg)	GDP (ann ave % chg)
Mar-06	1.0	2.5	2.7
Jun-06	0.0	0.9	2.2
Sep-06	0.5	1.0	1.7
Dec-06	0.6	2.0	1.6
Mar-07	1.3	2.3	1.6
Jun-07	0.8	3.2	2.1
Sep-07	0.5	3.2	2.7
Dec-07	0.8	3.5	3.1
Mar-08	-0.3	1.9	2.9
ANZ	-0.6	1.8	3.0
RBNZ	-0.3	2.1	3.1
Market	-0.3	2.1	3.1

Contributions to quarterly GDP growth



Sources: ANZ National, Statistics NZ

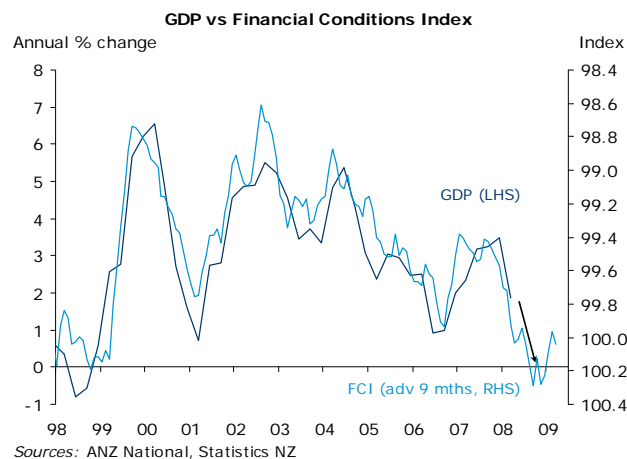
Looking at the GDP deflator, the broadest measure of overall price changes in the economy, the 1.1 percent increase was surprisingly soft given the 4.1 percent rise in the terms of trade. The consumption deflator rose 0.9 percent, reflecting higher food and energy related prices. The deflator for other fixed assets was the only one to show a decline (down 1.6 percent). For the year ended March 2008, the GDP deflator is up 4.9 percent.

While today's headline GDP print was not as weak as the market had feared, the composition provides little comfort. Not least is the fact that December quarter GDP growth has been revised lower to 0.8 percent from 1.0 percent previously. We also note that on an expenditure basis, growth has already gone backwards, albeit marginally, over the December and March quarters (up 0.5 percent and down 0.6 percent respectively).

The sectors that are still holding up well, such as finance and personal services, are expected to give way given the way the partial indicators such as credit growth and house sales are going. Recent troubles in the finance company sector also point to a period of de-leveraging in that sector, resulting in less activity. Retail sector resilience also cannot be expected to last, judging by the recent profit warnings issued by major listed retail companies. And when we consider that the drought impact will still be felt in the June quarter, particularly on agriculture production and electricity generation, it is difficult to see a June quarter GDP outcome which is better than the March quarter's.

Despite today's data coming in line with the RBNZ's forecasts, we expect the economy to slow by more than the Bank is projecting. For a start, downward historical revisions suggest the economy was not on as strong a footing as

originally thought. In addition, the headwinds facing the economy are getting stronger. To be sure, tax cuts and the strong dairy payout will no doubt provide a floor to growth, and we will still get a rebound once the drought effect dissipates. But the risks continue to point to a sharper slowdown in near-term growth, something our Financial Conditions Index has been alluding to for some time.



For now, a September start to the easing cycle remains on track, but we will not discount the possibility of a July move. We acknowledge that high near-term inflation remains a sticking point to an earlier easing, and the RBNZ will want to be sure that the slowdown in growth will translate into easing non-tradable inflation. While the NZIER's Quarterly Survey of Business Opinion on July 8 will likely confirm further weakness in the economy and evidence of easing resource pressure, the June quarter CPI release on July 15 is shaping up to be the critical release ahead of the OCR Review on July 24.

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