A timely intervention

Since Graham Wheeler came to the helm, the Reserve Bank seems to have been operating a “no surprises” policy for OCR decisions. Last week was no exception. A 25 basis point hike at the July OCR Review was well-telegraphed and duly delivered, despite the recent run of weak data. This takes the OCR to 3.5%.

The accompanying press release was bang in line with our expectations. The RBNZ announced that, having hiked the OCR by one percentage point, it is now time for a pause:

“Encouragingly, the economy appears to be adjusting to the monetary policy tightening that has taken place since the start of the year. It is prudent that there now be a period of assessment before interest rates adjust further towards a more-neutral level.”

The first part of that statement is as good as a promise that the OCR will not rise at the September Monetary Policy Statement. But the second part was a reminder that the RBNZ still intends to hike the OCR over the coming years. Indeed, the description of the long-run OCR outlook was similar to previous releases:

“The speed and extent to which the OCR will need to rise will depend on the assessment of the impact of the tightening in monetary policy to date, and the implications of future economic and financial data for inflationary pressures.”

We have not changed our OCR forecast. We expect the current pause phase will last until January 2015. At that point, we expect the RBNZ will kick off another slug of three consecutive OCR hikes. And we anticipate a peak OCR of 5.25%.

This start-stop approach to the monetary tightening cycle is risky. Like the hare in the famous race against the tortoise, the RBNZ bolted out of the starting blocks with OCR hikes and is now preparing to take a snooze. The trouble with that strategy is that financial markets will probably overreact during the ‘pause’ phase. Whereas the RBNZ intends this to be a routine hiatus within a broader trend of a rising OCR, markets are starting to doubt the entire nature of the hiking cycle. If this doubt deepens,
fixed mortgage rates could fall to levels that make the RBNZ uncomfortable. The RBNZ would then have to “correct” market pricing with a hawkish speech or two.

Such interest rate volatility might throw up useful opportunities for borrowers to fix their interest rates. But it wouldn’t be ideal from the Reserve Bank’s perspective. In our view, tortoise-like behaviour would have been better. As we said prior to the June MPS, we think the RBNZ would have been better served by signalling a slower but steadier pace of hikes at that stage.

A risk of currency intervention
The OCR Review strengthened our conviction that the RBNZ could intervene in foreign exchange markets by selling New Zealand dollars any day now. The RBNZ railed against the inconsistency between tumbling export commodity prices and the very high exchange rate by saying “the level of the New Zealand dollar is unjustified and unsustainable and there is potential for a significant fall.”

This choice of words was significant. The RBNZ has four criteria for currency intervention: (1) The exchange rate must be extreme; (2) it must be unjustified; (3) intervention must be consistent with the aims of monetary policy; and (4) intervention must be opportune (i.e. it would work). The first three of these have long been satisfied, while the fourth has not. Over the first half of 2014, any RBNZ intervention would have been swamped by the inexorably rising tide of the New Zealand dollar carry trade. By saying there is now potential for a significant fall, the RBNZ is signalling that intervention is more appropriate.

While intervention itself may not have a huge effect, it does provide one among many reasons to expect the exchange rate to fall from here. The Kiwi has already dropped from 88.2 to 85.6, and we expect it will fall further over the weeks ahead. We are forecasting the NZD to average 83 cents against the USD over the remainder of this year.

A final word of caution
Last week’s more “dovish” tone from the Reserve Bank, and the sharp depreciation in the New Zealand dollar, are both fair reflections of a run of slightly weaker data in recent times. Global prices for two of New Zealand’s main export products are lower. Confidence has pulled back slightly from the twenty-year highs of early 2014. June quarter GDP growth was probably ‘only’ 0.7%, down from the 1% per quarter pace earlier on. And inflation remains subdued.

But this is all near-term detail – it is important not to lose sight of the big picture. The New Zealand economy is still in the grip of a massive construction boom that is propelling domestic demand (this week’s building consents data should provide a timely reminder on this front). House prices are still rising. The terms of trade are still very high. The economy is still growing at a faster rate than potential output, and inflation pressures are still building. Most importantly, inflation has long been suppressed by the stratospheric exchange rate. Should the New Zealand dollar suddenly tumble like the Australian dollar did in 2013, inflation would pop higher (inflation is currently 3% in Australia). The OCR is still much more likely to rise than to fall over the coming years.

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**Fixed vs Floating for mortgages**

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six month rate. However floating may still be the preferred option for those who require flexibility in their repayments.

Among the various fixed rates on offer, we have no clear favourite. Shorter-term fixed rates, such as the six month or one year rate, are currently low but are expected to rise over the coming two years. Opting for the three or four year rate would require higher payments up front, but would help insulate the borrower if the Reserve Bank does follow through with an extensive OCR hiking cycle. At this stage, it is not clear which option will result in lower average mortgage payments over the life of the loan.
NZ Jun building consents
Jul 30, Last: -4.6%, Westpac f/c: +2.0%
- Building consents in May were dragged down by a pullback to average levels in the volatile apartment units category. The underlying picture was a rebound in consents from a holiday-distorted April, though not recovering to their previous highs.
- We expect consents to continue their upward trend this year. The Canterbury post-quake rebuild is still picking up momentum, and construction in Auckland has room to expand much further, given population pressures and still rapidly-rising house prices. Interestingly, consents have started to pick up in the rest of the country as well this year, despite minimal evidence for housing shortages.

Aus Jun dwelling approvals
Jul 31, Last: 9.9%, WBC f/c: -4.0%
Mkt f/c: flat, Range: -7.1% to 4.0%
- Dwelling approvals jumped 9.9% in May driven by a spike in high-rise units approved in NSW and Qld. The May surge more than reversed a 5.8% fall in April although approvals remain 7.6% below their Jan peak. Some of the choppiness over April-May likely reflects the timing of public holidays in 2014 which reduced effective working days in April. Looking through the monthly volatility, approvals are seeing a moderate slowdown consistent with other housing market indicators.
- Approvals will clearly fall back again in June as the high-rise spike drops out. Previous sharp falls in high-rise approvals (from very high levels late last year) have exaggerated the pace of the underlying slowdown. On balance we expect June to show a 4% fall leaving a somewhat gentler downtrend in place (annualised –10% vs the –15-20% downtrend in February-May).

NZ Jun private sector credit
Jul 31, Last: 0.4%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.4% to 0.5%
- Credit growth is tracking a little higher in 2014 than 2013 as the business segment advances. Annual growth is now 4.7%, up from 3.0% a year ago.
- We expect credit to increase by 0.4% in June. This would match outcomes for the initial five months of this year and represent an uptick from average monthly gains of 0.28% over the first half of 2013 and from 0.35% over the second half of 2013.
- Business credit is expanding at a modest pace, up 1.8% over the past six months. New commitments are up strongly and point to further gains in credit near-term.
- Housing credit strengthened during 2013 on low and falling interest rates. This has given way to a consolidation over the first half of 2014. Housing rose 0.54% in the month of May and we would expect a similar outcome in June.

Aus Q2 import price index
Jul 31, Last: 3.2%, WBC f/c: -3.0%
Mkt f/c: –1.5%, Range: –5.0% to 1.2%
- Import goods prices are forecast to fall by around 3% in the June quarter, reversing a 3.2% rise in the March quarter.
- Currency fluctuations are central to quarterly movements in import prices. The AUD strengthened in Q2, up 3.8% on a TWI basis, following a 3.2% fall in Q1. This rebound in the currency placed downward pressure on import prices in Q2.
- Global oil prices strengthened a little in the quarter, up 1.6% in USD terms, thereby partially offsetting the impact of a higher AUD.

Import & export price index
The week ahead

Aus Q2 export price index
Jul 31, Last: 3.6%, WBC f/c: –8.0%
Mkt f/c: –4.0%, Range: –8.0% to –1.0%

- Export prices - as measured by the export goods price index - are likely to fall sharply in the June quarter on lower commodity prices and a higher currency.
- The export price index is forecast to decline by around 8% in the quarter, more than reversing a 3.6% rise in Q1.
- Global commodity prices slumped, down 6% in USD terms. The Australian dollar rose, up 4% against the USD. So, in AUD terms, commodity prices fell by almost 10%.
- The terms of trade for goods weakened by about 5% on these estimates, to be more than 7% lower than a year ago. (Note, the Balance of Payments estimates of import and export goods prices can differ from the trade price indexes.)

Fed funds target rate and balance sheet

US FOMC to taper a further $10bn
Jul 30, Last: 0-0.25%, WBC f/c: 0-0.25%

- The July meeting will see the usual press statement issued but there is no update of forecasts or press conference where the Chairman can nuance the message.
- The pick-up in payrolls growth makes a further $10bn reduction in monthly asset purchases assured, even though the 1.4mn new jobs delivered no extra economic activity in H1 2014.
- In recent testimony, Dr Yellen noted that the FOMC had been discussing “the many issues associated with the eventual normalization of the stance and conduct of monetary policy. These ongoing discussions are a matter of prudent planning and do not imply any imminent change in the stance of monetary policy.” There may be some further information along these lines in the statement.

Commodity prices and export price index

US Q2 GDP to not quite recover Q1 decline
Jul 30, Last: –2.9%, WBC f/c: 2.7%

- Net exports and inventories accounted for 1.8ppt of Q3’s 4.1% and 1.0ppt of Q4’s 2.6% (annualised) growth. Q1 saw all of that reversed, and then some: a 3.2ppt drag, 0.4ppt more than they had added in the previous two quarters, for a 2.9% slump. GDP excluding net exports and stocks (final sales to domestic purchasers) printed 2.1%, 2.3%, 1.6%, 0.3% ifry annualised from Q2 2013 to Q1 this year, but annual growth (compared to same qtr a year earlier) in FSDP was running a steady 1.6% yr pace in each quarter. That is a better guide to the underlying pace of growth in the US economy: it’s been stuck in second gear for at least a year now.
- Partial data show the biggest driver of the economy, consumer spending, remains constrained. Even with housing and business investment doing better, we see a 2.7% annualised rebound from Q1’s 2.9% fall. But annual revisions could rewrite recent history anyway.

US Jul ISM manufacturing to slip again
Aug 1, Last: 55.3, WBC f/c: 55.0

- The ISM factory index slipped from 55.4 to 55.3 in June, detail showing production down 1pt, orders up 2pts, and jobs flat. In the last 6 months of 2013 the ISM factory headline averaged 56.2 and ranged from 54.9 to 57.0; since then it has averaged just 54.0 in a range from 51.3 to 55.4. Well after the winter disruption, the ISM has only managed to rise above the lowest of the six readings in H2 2013, indicative of an ongoing slower pace of economic growth in 2014 compared to the temporary burst of growth in summer-fall last year.
- Separately, the factory PMI (Markit) fell from its all time high of 57.3 to 56.3 in July, its lowest since April, so two different survey pictures of the same sector of the US economy. ISM has the credibility that comes with longevity, the Markit new boy on the block has more survey participants. Our forecast is for ISM factory to slip further in July, mainly because the Richmond Fed factory index has been subdued, which in the recent past has been a signal not to be ignored.

US GDP growth

US ISMs

Sources: ABS, Westpac Economics

* AUD terms

Sources: BEA, Westpac Economics, Ecowin

% chg

-yr end % chg

qtr, ann%sd

ISM manufacturing

ISM non-manufacturing

% chg

Sources: Ecowin, Westpac Economics, ISM
US Jul non farm payrolls: much ado about nothing
Aug 1, Last: 288k, WBC f/c: 200k

- US non-farm payrolls posted a solid 288k gain in June for a 272k average pace of jobs growth through the last quarter, up from 189k in Q1 and 197k in Q4. For an apparently stalled economy to deliver jobs growth of 1.4mn in the first six months of this year is frankly unbelievable, but that’s what the data are telling us, at least until Q2 GDP is published, with annual revisions, as noted above.

- The eventual universe count (preliminary in Sep) and related revisions (in Feb next year) to payrolls may help explain what really went on in the labour market in the first half of this year. But until then we have to forecast this flawed but fervently followed number. If American bosses eventually get the 1.4mn they already hired to do something, they might ease back the hiring pace, to say 200k in July.

China Jul Westpac MNI Consumer Sentiment
July 30 Last: 112.6

- The headline index fell sharply to 112.6 in June from 121.2 in May, a −7.1% change over the month and −9.6% over the year. We noted that overall confidence and specifically the employment indicator had fallen to levels consistent with policy easing in prior cycles, which was duly forthcoming, although to be fair ‘unobservable’ fiscal easing began some months before.

- We will be looking for the following in July. 1. Whether forward looking responses are picking up to a greater degree than current conditions. 2. What consumers are now saying about the labour market, coming off a bad June reading. 3. The attitude of consumers towards the ongoing housing correction.

- New series covering the motivation for saving and the preferred avenues for investing these funds are being published for the first time this month. Once again, real estate related responses will be of particular interest.
Mon 28

Ger
Jun retail sales
-0.8% 1.0% – Tentative date, due by 31/7.

US
Jul PMI services
61.0 – – Tracks closer to ISM services than the factory surveys from ISM, Markit.

Jun pending home sales
6.1% 0.0% -1.0% Almost 9 pts of 15.4% in May-Feb decline recovered since March.

Jul Dallas Fed factory index
11.4 12.0 10.0 Philly/NY Fed booming since 2013; Dallas/Richmond not.

Tue 29

UK
Jun mortgage approvals. ‘000
61.7 63.0 63.5 BBA data point to renewed upswing.

Jun net mortgage lending £bn
2.0 – – BoE/Treasury FLS withdrawal for mortgages impacting at margin on

Jun net consumer credit £bn
0.7 – – outstanding, though demand for consumer credit remains weaker.

Jun M4 money supply ex IOFCs 3ma%
2.7% – – Down from 7.9%yr in Aug 12, partly a function of BoE APP suspension.

US
May house prices %yr
10.8% 9.9% – S&P-Case Shiller 20 city index.

Jun Conf Board consumer confidence
85.2 85.5 86.0 Weekly confidence has edged higher so far in July.

Wed 30

NZ
Jun building consents
-4.6% 2.0% – Trend growth across the country expected to continue.

Chn
Jul Westpac–MNI Consumer Sentiment
112.6 – – Confidence, job outlook at lows triggering policy easing in the past.

Eur
Jul business climate indicator
0.22 – 0.25 Surprise PMI gains suggest higher BCI.

Jul economic confidence
102.0 102.0 101.7 Eco conf may slip given lower consumer confidence in Jun-Jul.

Ger
Jul CPI prelim %yr (EU harm)
1.0% 0.8% 0.9% Recent volatility due to Easter distortions but trend sub 1%.

US
Jul ADP private payrolls
281k 228k 200k Q3 jobs growth to slow given stalled economy in H1 2014.

Q2 GDP advance % annualised
-2.9% 2.9% 2.7% Benchmark revisions due. As data stand, economy stalled in H1.

FOMC policy decision
0-0.25% 0-0.25% 0-0.25% No press conference. See text box.

Can
May industrial product prices
-0.5% 0.2% – Have not posted a rise since Mar.

Thu 31

NZ
Jun private sector credit %yr
4.4% – – Business lending started to show some life in May.

Aus
Jun dwelling approvals
9.9% flat -4.0% High-rise spike to unwind, moderate underlying downtrend to reassert.

May private sector credit
0.4% 0.4% 0.4% Growth tracking a little higher in 2014 on gains in business credit.

Q2 import price index
3.2% -1.5% -3.0% Import prices reverse, down in Q2 on a rebound in the currency.

Q2 export price index
3.6% -4.0% -6.0% Export prices hit by a higher AUD & by lower commodity prices.

Eur
Jul CPI flash %yr
0.5% 0.5% 0.4% Ger/Sp CPI due 30/7 will provide guidance. Euro Jun core was 0.8%.

Ger
Jul unemployment rate %
11.6% 11.6% 11.6% Steady German jobless rate, struggling France, some falls elsewhere.

Jul unemployment claim
9k –5k 12k Job loss payback after mild winter temporarily boosted employment.

UK
Jul house prices %yr
11.8% – – Asking prices have come off a bit, could received prices ease back?

Jul GfK consumer confidence
1 1 2 Commonwealth Games lift?

US
Q2 employment cost index
0.3% 0.5% 0.4% Still quite soft labour market keeping costs down.

Initial jobless claims, w/e 26/7
284k – 310k Recent downswing due shorter summer auto plant shutdowns.

Jul corporate layoffs %yr
-20.2% – – Challenger series.

Jul Chicago PMI
62.6 63.1 62.0 60 is the new 50 in Chicago, it seems.

Jul Milwaukee NAPM
60.6 – – Little watched.

Can
May GDP %yr
2.1% 2.2% – Partial data suggest GDP growth no longer decelerating.

May average weekly earnings %yr
3.3% – – May rate highest since Sep 2012.

Fri 1

Aus
Q2 Producer Price Index
0.9% – 0.5% Fuel & import prices a drag, construction costs rising.

Jul RP Data-Rismark home price index
1.4% – 1.6% Has recovered all of May’s 1.9% drop but 6mth pace of gains slowing.

Jul AIG PMI
48.9 – – Manuf’ng index a little below, but 50 past two months, down 0.3pts in June.

Chn
Jul HSBC manufacturing PMI - final
52.0 51.8 – Flash bounce larger than mkt f/c, but in line with MNI business survey.

Jul NBS manufacturing PMI
51.0 51.3 – Moderate strength in the detail implies it may lag flash PMI lead.

Eur
Jul PMI factory final
51.9 a 51.9 51.8 Final responses might be tarnished by sanctions talk post MH17.

UK
Jul factory PMI
57.5 57.3 57.0 Risks to downside from escalation of geopolitical tensions.

US
Jul non-farm payrolls ch’
288k 230k 200k Q3 jobs growth to slow after stalled economy in H1 2014.

Jul jobless rate
6.1% 6.1% 6.1% Higher participation to constrain jobless rate improvement.

Jun construction spending
0.1% 0.4% 0.4% Weak single-family starts in mid 2014 constraining residential.

Jun core PCE deflator
0.2% 0.2% 0.1% Core CPI was 0.1% in Jun. Q4rly data will be seen in Q2 GDP report.

Un personal income
0.4% 0.4% 0.3% Hourly earnings up 0.2% in June, hours worked also up 0.2%.

Un personal spending
0.2% 0.4% 0.4% Retail sales, auto unit sales modestly higher: suggest some savings dip.

Jul consumer sentiment final
81.3 a 81.4 81.5 Weekly confidence has edged higher so far in July.

Jul Markit PMI factory final
56.3 a – Has not had good fit with ISM factory survey over past year.

Jul ISM factory
55.3 56.0 56.0 Mixed Jul regional detail. NY/Philly Fed strong, Rich’d weak; see text box

Jul auto sales mn annualised
16.92 16.75 – Sales in uptrend, yet to fully recover from Govt shutdown, winter.

Can
Jul PMI factory
53.5 – – Less volatile than long-established Ivey survey.
Economic Growth Forecasts

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<thead>
<tr>
<th>% change</th>
<th>2013</th>
<th>2014</th>
<th>2015f</th>
<th>2016f</th>
<th>2012</th>
<th>2013</th>
<th>2014f</th>
<th>2015f</th>
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<tr>
<td>GDP (Production) ann avg</td>
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<td>Unemployment Rate % s.a.</td>
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Financial Forecasts

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<tr>
<th></th>
<th>Sep-14</th>
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<tr>
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<td>90 Day bill</td>
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<td>2 Year Swap</td>
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<td>5 Year Swap</td>
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<td>10 Year Bond</td>
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<td>NZD/USD</td>
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<td>NZD/AUD</td>
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NZ interest rates as at market open on Monday 28 July 2014

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<thead>
<tr>
<th>Interest Rates</th>
<th>Current</th>
<th>Two weeks ago</th>
<th>One month ago</th>
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<tbody>
<tr>
<td>Cash</td>
<td>3.50%</td>
<td>3.25%</td>
<td>3.25%</td>
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<tr>
<td>30 Days</td>
<td>3.63%</td>
<td>3.56%</td>
<td>3.43%</td>
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<td>60 Days</td>
<td>3.65%</td>
<td>3.62%</td>
<td>3.53%</td>
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<tr>
<td>90 Days</td>
<td>3.69%</td>
<td>3.67%</td>
<td>3.62%</td>
</tr>
<tr>
<td>2 Year Swap</td>
<td>4.09%</td>
<td>4.19%</td>
<td>4.21%</td>
</tr>
<tr>
<td>5 Year Swap</td>
<td>4.47%</td>
<td>4.61%</td>
<td>4.61%</td>
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NZ foreign currency mid-rates as at Monday 28 July 2014

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<tr>
<th>Exchange Rates</th>
<th>Current</th>
<th>Two weeks ago</th>
<th>One month ago</th>
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<tr>
<td>NZD/USD</td>
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### Economic and Financial Forecasts

<table>
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<tr>
<th>Economic Forecasts (Calendar Years)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014f</th>
<th>2015f</th>
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<tr>
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<td></td>
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<tr>
<td>Real GDP % yr</td>
<td>2.2</td>
<td>2.6</td>
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<td>CPI inflation % annual</td>
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<td>2.2</td>
<td>2.7</td>
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<tr>
<td>Unemployment %</td>
<td>5.2</td>
<td>5.2</td>
<td>5.3</td>
<td>5.8</td>
<td>6.2</td>
<td>5.9</td>
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<td>Current Account % GDP</td>
<td>-3.5</td>
<td>-2.8</td>
<td>-4.1</td>
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<td>-2.5</td>
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<tr>
<td>Real GDP % yr</td>
<td>2.5</td>
<td>1.8</td>
<td>2.8</td>
<td>1.9</td>
<td>1.3</td>
<td>2.5</td>
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<td>Consumer Prices %yr</td>
<td>1.6</td>
<td>3.1</td>
<td>2.1</td>
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<td>Unemployment Rate %</td>
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<td>8.1</td>
<td>7.4</td>
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<td>Current Account %GDP</td>
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<td>-2.4</td>
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<td>Real GDP %yr</td>
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<td>1.6</td>
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<td>1.3</td>
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<td>Real GDP %yr</td>
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<td>Forecasts finalised 4 July 2014</td>
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### Interest Rate Forecasts

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<tr>
<th>Interest Rate Forecasts</th>
<th>Latest</th>
<th>Sep-14</th>
<th>Dec-14</th>
<th>Mar-15</th>
<th>Jun-15</th>
<th>Sep-15</th>
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<td>Cash</td>
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<td>90 Day Bill</td>
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<td>10 Year Bond</td>
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<td>Fed Funds</td>
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<td>US 10 Year Bond</td>
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### Exchange Rate Forecasts

<table>
<thead>
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<th>Exchange Rate Forecasts</th>
<th>Latest</th>
<th>Sep-14</th>
<th>Dec-14</th>
<th>Mar-15</th>
<th>Jun-15</th>
<th>Sep-15</th>
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<tbody>
<tr>
<td>AUD/USD</td>
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<td>0.90</td>
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<td>1.08</td>
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<td>1.11</td>
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</table>
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