

Economic Overview

January 2010

Highlights

- **Our positive outlook for the economy over the next few years remains unchanged from November.** If anything, we have gained more confidence in our view. We expect GDP to grow by an above average 3.7% pace in calendar 2010, and 4.3% in calendar 2011. That puts us at the top end of current market forecasts, with the Consensus picking growth of just 2.7% in 2010 (*see Economic Outlook, page 2*).
- **New Zealand economic recoveries tend to be relatively robust.** History shows that New Zealand typically averages 6% GDP growth per annum nine quarters after recession. Weighing it all up, we feel the risks to our forecast growth over the next two years are to the upside, not the downside as indicated by Consensus Forecasts (*see Feature Article, page 10*).
- **Pro-cyclical sectors to outperform.** We expect the best performing sectors to include: construction and its related industries (non-metallic minerals, wood, furniture); publishing and advertising; transport; and sectors supporting plant and machinery investment, and durables consumption (*see Sectoral Trends, page 4*).
- **Global economic healing continues.** The global economy is staging a convincing recovery after its first year of contraction since 1946. China is doing more than its fair share, and is bolstering activity in South-East Asia, Australia and the resource economies. That is great news for New Zealand. Overall, we expect world GDP growth to expand by 3%+ in 2010 following an estimated 0.8% contraction in 2009 (*see International, page 8*).
- **Official cash rate to begin rising.** The clear improvement in economic conditions means that the RBNZ will need to begin normalising interest rate settings sooner rather than later to avoid inflation getting away on them. The RBNZ has pencilled in a kick-off date of mid-2010. We are picking an earlier start, with March or April the most likely (*see The Markets, page 6*).

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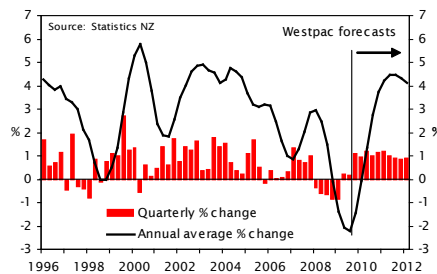
Just getting started

The New Zealand economy has seen a modest recovery from the recession that dominated the scene in 2008 and early 2009. However, conditions are in place for a stronger rebound this year.

As we head into 2010, our positive view for economic growth over the next three years remains unchanged from our November *Economic Overview*. If anything, we have gained more confidence in our view over the past few months. The global economic environment has continued to improve, with the Consensus view of growth in our major trading partners reporting the eighth consecutive upward revision in December. The domestic economy has also proved more resilient than many commentators gave it credit for. Business and consumer confidence has soared, net migration continues to rise, house prices are almost back to the peak levels reached in late 2007, and indicators suggest that the labour market (traditionally the laggard in the economic recovery process) has already turned. We also estimate that H1N1 influenza (aka Swine Flu) took around 0.4 percentage points off growth in the September quarter, as a result of higher rates of absenteeism and less spending. That means some growth payback is likely in the December quarter.

We expect that GDP growth accelerated to a 1.0%+ pace in the fourth quarter of 2009. Moreover, we see activity maintaining that solid quarterly growth pace through 2010, supported by a resurgent construction sector, a recovery in consumer spending, and a stronger global economy. GDP growth of 3.7% is forecast for calendar 2010, following an estimated 1.4% contraction in calendar 2009. In calendar 2011, growth is projected to reach 4.3%, as the supporting factors above continue to play out.

Figure 1: GDP growth



Risks around our forecasts continue to exist on both the global and domestic fronts. Globally, a second wave of weakness in financial markets would take a heavy toll on the New Zealand economy, not only in terms of the access and availability of credit, but also the obvious follow on effects to the demand for our exports. But, that said, the risks domestically are not as one-sided as you might think. Indeed, as we highlight in our Feature Article, history suggests the risks are weighted toward stronger, not weaker, international and domestic economic recoveries over the next two years. We see the strongest growth coming from construction and consumer spending, while the export sector (dairy in particular) will also play a significant role. Inventories seldom rate a mention as a key influence on growth, but at this stage in the cycle they deserve some attention. Inventories were run down massively through the recession, and in the June 2009 quarter recorded the largest unwind since the GDP series began in 1987. As demand continues to pick up, depleted stock piles will need to be replenished, meaning inventories will shift from being a substantial drag on growth through 2009, to being a sizeable contributor in 2010.

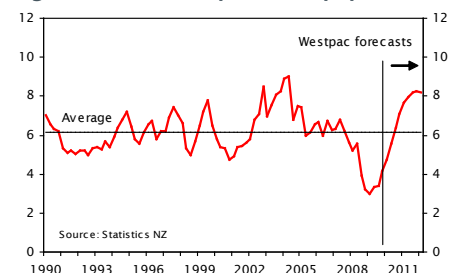
Investment set to boom

One of the major growth stories for 2010 will be residential construction. Building activity has been in decline

since house prices peaked in 2007. New home construction has declined by a massive 36% in that time, contributing to the housing shortage we estimate now exists. The surge in net migration through 2009 has added to the housing shortage, with annual net migration rising from a low of 3,500 in November 2008 to just over 20,000 a year later. But even before the trend in net migration began to turn higher in 2008, the rate of new home building had fallen below what was needed to meet normal population growth. Figure 2 shows that the number of consents issued per population dropped well below average in 2008, and through 2009 remained close to the lowest levels seen since the 1970s. On its own, that suggests a substantial pick up in residential building activity is imminent.

The rise in dwelling consents over the past year reinforces that view, as do rising house prices and improved access to credit. Since January 2009 dwelling consents have lifted a whopping 45% (albeit off an extremely low base), suggesting that new home construction should begin to add to growth from the final quarter of 2009. Meanwhile, the impending return to double-digit house price inflation, albeit temporary, should encourage developers and builders to dive back in (we expect double digit house price inflation in early 2010). The continued freeing up of credit markets will also gradually assist by providing developers with easier access to the

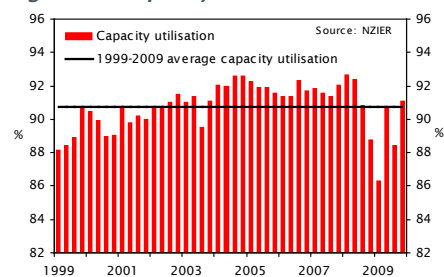
Figure 2: Consents per 1000 population



funds they need to pursue new building projects.

Business investment is also expected to help promote overall GDP growth through 2010, although the growth will be likely be later and more muted than in the residential sector. The recession has resulted in spare capacity emerging in the manufacturing sector and parts of the commercial property sector. Meanwhile, the sharp rise in the unemployment rate through the early part of 2009 (from 4.7% in December 2008 to 6.5% by September 2009) means that labour resources are also underutilised at present. As such, early gains are likely to come via increased hours worked and growth in employment. But, by mid-2010 we expect businesses to begin dusting off shelved investment plans as domestic and global economic conditions improve and the labour market begins to tighten up.

Figure 3: Capacity utilisation

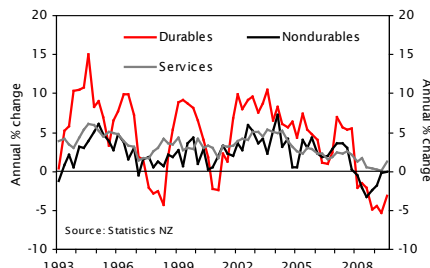


Consumer back in spend mode

Consumer spending is also set for a more convincing recovery in 2010. Confidence remains high, despite easing back a little through the December quarter. Moreover, the rebound in the housing market will help to make homeowners feel wealthier and, to a degree, will spur spending on housing-related durables. As Figure 4 shows, durable spend was hit the hardest through the downturn. Non-durable spending also suffered, although to a lesser extent than durables, while services-related spending managed to hold its own, eking out small gains through most of 2009. Overall we expect durable spending to outperform through 2010 as a replacement cycle gets underway, and more importantly as

spending on cars begins to normalise (real spending on motor vehicles fell 23% y/y at the height of the recession).

Figure 4: Spending by type



Mortgagors are also continuing to get more cash in hand as they roll off high fixed-term mortgage rates (and contrary to a popular belief, they are no more vulnerable than usual to interest rate hikes; the fraction of loans on floating rates is actually less than at the start of previous tightening cycles). We estimate that debt servicing costs will continue to fall through 2010, despite our expectation that the RBNZ will begin lifting the OCR from March or April. Debt servicing costs fell from around 17% of household disposable income in October 2008, to 13.3% in October 2009. We estimate a further fall to 13% by September 2010.

Finally, job prospects are starting to look healthier, with recent surveys indicating that the healing process in the labour market has already begun. Business surveys reveal that hiring intentions are on the rise, while the Westpac McDermott Miller Employment Confidence Index rose further in December as employees assessment of current conditions improved for the first time in two years. Our forecasts see the unemployment rate peaking at 6.7% in March 2010 before easing back gradually over the remainder of the year.

Exports strong but imports stronger

Export volumes have held up surprisingly well through the global recession, lifting 2.3% in the September 2009 quarter when compared the same period in 2008.

Strong demand from Asia has been a big help, with the dairy sector in particular a key benefactor of the strong growth out of China. World prices for milk powder are currently 81% higher than they were back in July 2009, meaning that Fonterra’s payout forecast of \$6.05/kg milk solids for the current season should be easily achieved. That puts the dairy sector in a far more comfortable position as we head into 2010 than it was a year ago.

As the global healing process continues through 2010, we expect the recent healthy demand for New Zealand’s exports to continue. However, for the tradable sector as a whole, the recent favourable net export position (i.e. exports minus imports) is set to reverse as stronger domestic demand and an elevated currency sees import growth pick up faster than growth in our exports. This will eventually result in an unwinding of the cyclical improvement we have seen in the current account. We expect the annual current account deficit to trough at around 2% of GDP early this year, before widening to reach around 4.5% of GDP by end 2010.

Watch this space

Government policy/spending remains a potential wildcard. The Government has indicated that the withdrawal of fiscal stimulus will begin in this year’s Budget, although the composition of that stimulus makes it difficult to see where the reductions will occur – income tax cuts won’t be reversed, and much of the planned infrastructure spending has yet to be put in place. One possibility is that allowances for future spending increases could be tightened further – certainly we thought they could have been cut by more in last year’s Budget, given the need to demonstrate a plan for bringing public debt levels under control. Potential changes to the tax system will complicate the fiscal picture, although the intention is for the sum of any changes to be revenue-neutral. For the housing market though, the consequences of future recommended tax changes could be material.

Cyclical winners

Pro-cyclical sectors will be the relative winners. We expect the best performing sectors to include: construction and its related industries (non-metallic minerals, wood, furniture); publishing and advertising; transport; and sectors supporting plant and machinery investment, and durables consumption.

Introduction

We have chosen a different approach for the Sectoral Trends section this quarter. Rather than discuss prospects for individual sectors, we take a look at some broader relationships between 25 sectors and the general economy. We examine which sectors have been hit hardest in the recession, discuss which sectors are most sensitive to growth in the rest of the NZ economy, and estimate which sectors are most pro-cyclical. For those that yearn for our usual sectoral write-up, normal transmission will resume next quarter.

Destitution

To give an indication of which sectors have had the most miserable time during the recession, we have taken the weakest 2 quarters of activity (as measured by real GDP) for each sector in 2008/09 and compared it with the average level of activity over 2006-07. The results are in Figure 5. It's only indicative of misery as volume of activity is only one component of profit. You have to mind both your P's (prices) and Q's (quantity and quality) for bottom line performance. Also, the method understates the degree of peak to trough contraction but we chose this to smooth out inherent volatility in some sectors. In addition, it is not always a short-fall in demand that led to a sectors production decline (e.g., a pot-line outage

at the Tiwai Point Aluminium smelter in Q4 2008 restricted production in Metal Product Manufacturing).

The results are sobering. Similar to the international experience during the Global Financial Crisis, top end manufacturing was hardest hit. In general, the goods producing sectors were severely impacted in the recession, while the government and service sectors sailed through relatively unscathed.

Determination

Prospects for each sector will substantially be determined by prospects for their end consumers. Figure 6 highlights the ultimate destination of each sectors output, whether directly through its own end sales or indirectly via intermediate sales to other sectors. Sectors at the top of the chart are heavily reliant on foreign demand, whereas sectors at the bottom are influenced most by domestic trading conditions. Not surprisingly, the primary sectors, mining, and transport are most influenced by demand in our trading partners.

Another crude way of getting at the influences on each sector is to compare the correlation of the annual growth in each sector with the contemporaneous growth in the rest of the economy. We show the results of this in Figure 7. We can see the sectors that move most in sync with the rest of the economy. They include retail, accommodation, restaurants and bars, construction and housing related sectors, those providing plant and machinery investment, and publishing and advertising. Of course correlation does not necessarily equate with causation, but the inference is that a rising tide in the rest of the economy is particularly good for these sectors.

To get a feel for just how responsive each sector is to developments in the rest of the economy, we ran simple regressions of each sectors contemporaneous annual growth with growth in the rest of NZ. These results are shown in Figure 8. The most pro-cyclical sectors (i.e., they move in the same direction but by much more than changes in the rest of the economy) are construction and its related industries, and publishing and advertising. Countercyclical sectors are fishing and forestry, no doubt via the exchange rate channel (as the economy improves, the exchange rate tends to appreciate, tending to harm these relatively 'pure' exporters).

Restoration

An important influence on a sector's performance is the situation facing their end consumers. With New Zealand in only the early stages of an economic recovery, the most pro-cyclical sectors are likely to be amongst the best performers over the next couple of years. The above analysis suggests that the 'winners' are likely to include construction, its related industries (non-metallic minerals, wood, furniture), and publishing and advertising. Sectors supporting plant and machinery investment are also likely to outperform. To these sectors we would add transport. The downturn in the transport and storage industry (peak to trough decline of 12%) was far greater than in a standard recession, no doubt exacerbated by the severe down-turn in global trade and tourism. As trade and tourism normalize, so too will transport sector activity.

Another general category of sectors that is likely to outperform is those associated with durables consumption (e.g., cars, white-ware, and other big ticket items). Most of the down-turn in consumption in the recession was in the durable goods

category. Improvement in the housing market and household incomes will see the durables consumption category rebound by more than non-durables and services.

For many of our export intensive sectors, it is even harder to generalize. For exporters it depends who you export to. We expect economic activity in Europe,

the UK, and Japan to be subdued in the coming year. In contrast, we see the US producing reasonable growth, the emerging markets going gangbusters, and Australia continuing to perform strongly. The exchange rate will be OK for manufacturers exporting to Australia, but third country competitiveness (e.g., developing Asia) will still be stifling for low-end manufactures. However,

commodity exporters will tend to get good end-market prices because of recovering global demand while supply is generally skinny.

With a much improved domestic economic outlook, and prospects for reasonably strong global growth, we think the sectoral economic outlook (in terms of growth) is at its best for many a year.

Figure 5: Change in activity by sector
Worst 2 quarters of 2008/09 compared to average of 2006-07

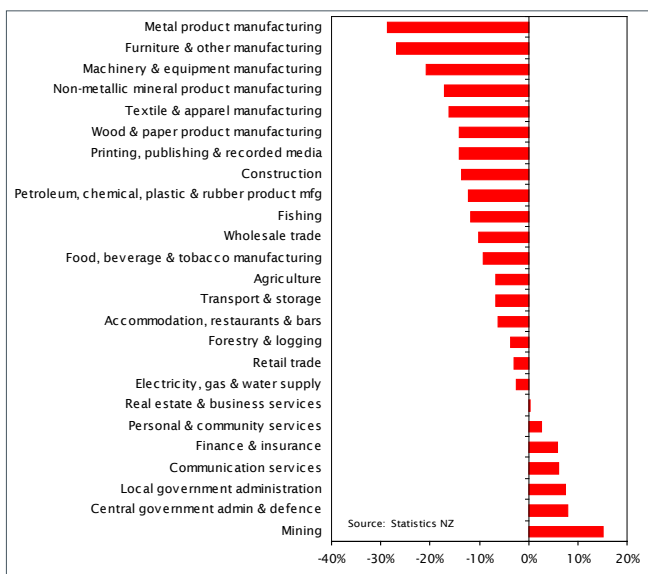


Figure 7: Correlation of sectoral growth with growth in rest of the economy

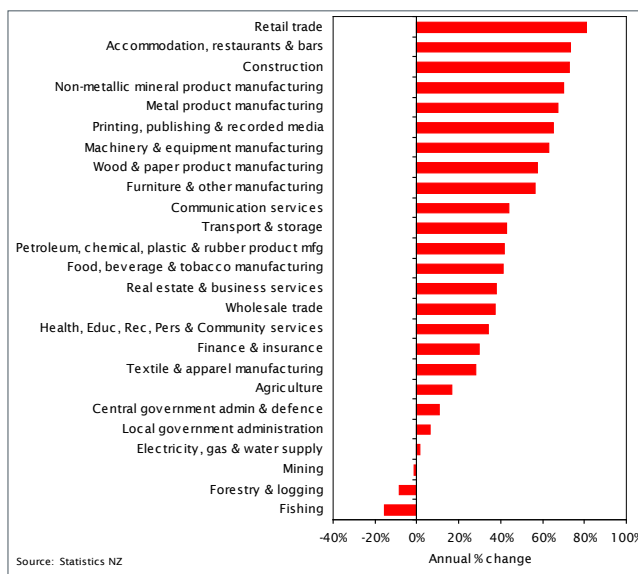


Figure 6: Ultimate destination of output

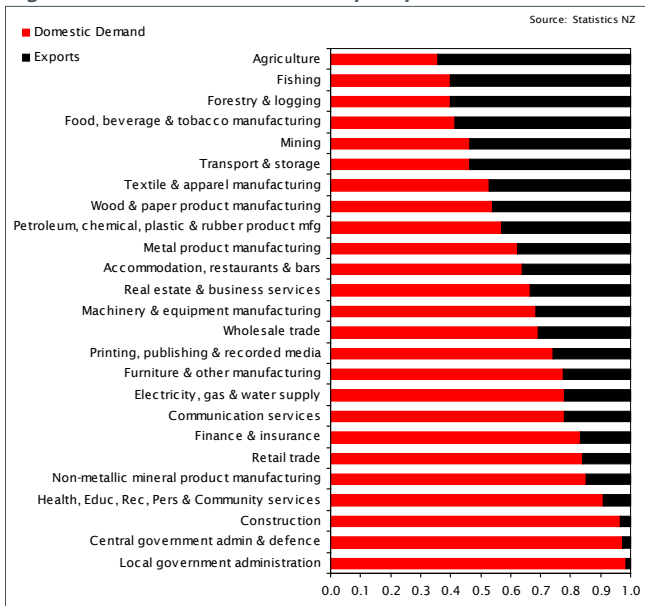
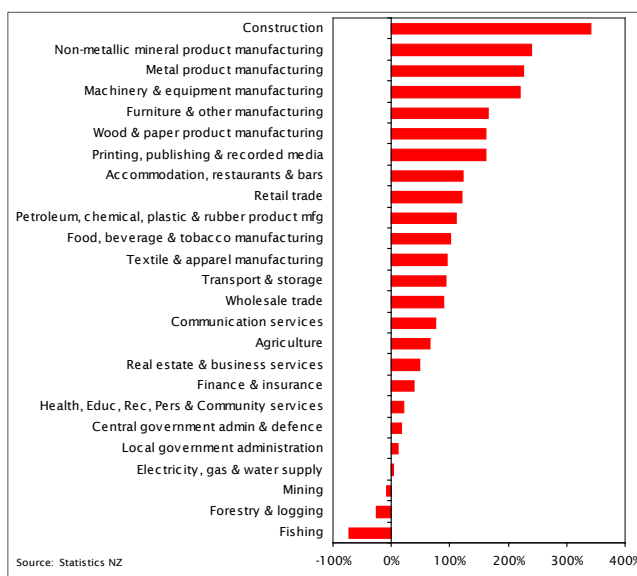


Figure 8: Responsiveness of sectoral growth to growth in rest of the economy



Are you ready for rising interest rates?

The Reserve Bank of New Zealand expects to normalise the OCR with rapid hikes over the next few years, with a flexible kick-off date pencilled in for mid-2010. We expect strong data will prompt earlier action from the central bank, with a March or April hike. Retail interest rates, for both deposits and lending, are likely to rise independent of the OCR as banks adapt to the RBNZ's new liquidity policy.

Interest rates

At its December review the RBNZ left the cash rate on hold at 2.50%, as widely expected. But in the accompanying statement the RBNZ announced that it expected to begin removing monetary stimulus "around the middle of 2010", and was quite flexible to changing that timing as circumstances demanded. This was a change from earlier statements, when the RBNZ's determination to maintain a low OCR was couched almost as a commitment. The market was taken by surprise, and two-year swap rates rose 25 basis points.

The RBNZ is signalling a series of rapid hikes once they begin – roughly 275 basis points over seven quarters to March 2012. That date is as far as the Bank's forecasts go, but judging

by the trajectory of projected interest rates, further hikes are forecast for the remainder of 2012.

We agree that interest rate settings need to be normalised. Inflation has been surprisingly resilient, falling only to the middle of the RBNZ's target range despite the severity of the recession and the appreciating exchange rate. As the economy recovers and the exchange rate stabilises, only decisive action from the RBNZ will prevent inflation from rising to an unacceptable level. In addition, the Emissions Trading Scheme recently passed into law will add more than half a percentage point to inflation in 2011 by our reckoning, so that even with a series of quick-fire OCR hikes we still expect inflation to poke its head above 3% in 2012.

If anything, we expect the hiking cycle to kick-off earlier than currently planned, at the March *Monetary Policy Statement* (or at the latest, in April). The RBNZ's downbeat economic forecasts may have been replaced with a more conventional degree of optimism, but its communiqué remained full of references to downside risks. It was as if the RBNZ is still not quite convinced about the recovery. Another couple of months of data that is officially "on expectations" may therefore be enough to dispel the Banks lingering

doubts, leaving it more comfortable adopting a more hawkish stance.

Furthermore, the RBNZ's key argument against immediate hikes could soon be challenged. The RBNZ argues that rapidly rising house prices will not feed through to consumer spending, which would be a major departure from historical norms. Sure, recent electronic transactions data has shown only mediocre growth, but that may be because most of the growth in consumption is coming through cars, which are rarely paid for using cards. We see no reason to doubt that this upswing is proceeding in normal fashion, with house price growth soon feeding through to stronger consumer spending. And we expect evidence supporting a consumer resurgence will soon become apparent.

The interest rates actually being paid in the New Zealand economy are considerably higher than an OCR of 2.5% would historically have presaged. Two factors have increased the wedge between the OCR and market interest rates, perhaps permanently. The first change is that the risk premium paid for wholesale funding has increased as a result of the global financial crisis. While the premium has eased back substantially over this year, it is unlikely to return to pre-crisis levels, which were unsustainably low.

Figure 9: 90 day bank bills, 2 year and 5 year swap rates (mth avg)

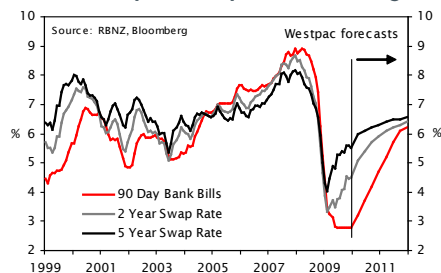


Figure 10: 90-day forecasts

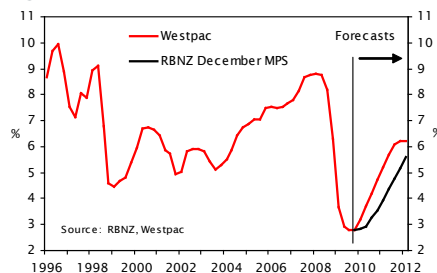
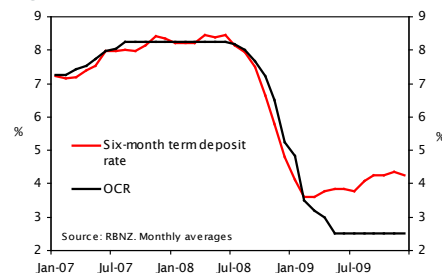


Figure 11: Term deposit rates vs OCR



The second change is the introduction of the RBNZ’s prudential liquidity policy. The upshot is that banks will have to get a greater share of their funding from either retail deposits or long-term wholesale funding, which are both regarded as more stable than short-term wholesale funding – but are generally more expensive. Since last October, when the thrust of the policy was first made known, banks have been competing harder for retail deposits in anticipation of the new requirements. Consequently, term deposit rates have risen independent of the OCR. They may rise even further if banks are to source sufficient funds under the planned tightening of the requirements over 2011 and 2012. More expensive funding has already led to higher lending rates relative to the OCR. Again, this phenomenon could prove permanent, so expect more increases in lending rates independent of the OCR.

Exchange rates

The New Zealand dollar went through a roller-coaster ride in 2009, but the volatility did have a basis in fundamentals – namely the equally tumultuous fortunes of global soft commodity prices. At the start of 2009 the dairy industry was in despair following a global price collapse, but we were pleasantly surprised to see a near-doubling in global prices through the year.

The high exchange rate is also the flip-side of USD weakness, a general theme that was only briefly interrupted by the release of surprisingly strong US labour market data in early December. Back then markets moved to price in early interest rate hikes from the Fed, and the US dollar rose accordingly. Since then, the Federal Reserve has reiterated its determination to keep monetary policy accommodative in order to avoid strangling the nascent recovery, dismissing the market’s inflation worries. Fed Chairman Ben Bernanke said in a recent speech that he does not believe that low interest rates caused the 2000s housing bubble, and neither does he believe monetary policy should be used to pre-empt asset price bubbles. Markets have already begun to realise that a gradual recovery will not have the Fed scrambling to hike, moving the timing of the first hike out to August.

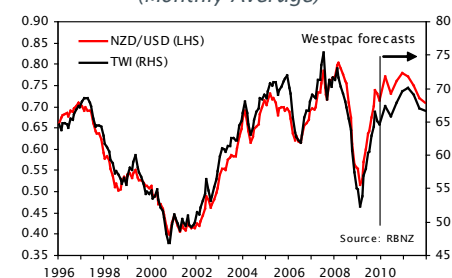
We believe a further reassessment of the Fed’s stance is due. Combined with strong short-term data in New Zealand, that could propel the NZD up to 77 cents in the short term as part of a wider move in favour of risk currencies.

Eventually the Fed will map out its exit strategy from near-zero interest rates and quantitative easing, and will reassure markets that it will not tolerate high inflation. This will restore the US dollar’s appeal as a long-term store of value, as well as improving its yield via higher

long-term interest rates, and will cause USD appreciation well before the Fed Funds Rate is actually increased. Although we expect the NZD/USD to fall at that time, we expect it will remain above its historical average owing to New Zealand’s high terms of trade.

The current exchange rate environment is unusual because the NZD is low against the AUD at the same time as it is high against the USD. The AUD’s strength relative to the NZD is certainly warranted in light of Australia’s extraordinary outperformance. Australia enjoyed an earlier and slightly larger improvement in commodity prices than New Zealand, it endured no recession, and Australian interest rates are, unusually, higher than New Zealand rates. We expect the NZD to remain below average against the AUD, but to slowly gain ground as the degree of NZ economic underperformance diminishes, and as the interest rate differential normalises.

Figure 12: NZD/USD and TWI (Monthly Average)



Financial Markets Forecasts (end of qtr)

	Official Cash Rate	90 Day Bill	2 Year Swap	5 Year Swap	NZD/USD	NZD/AUD	NZD/JPY	TWI
Mar-10	2.75	3.20	5.10	6.00	0.77	0.80	67.8	67.4
Jun-10	3.25	3.70	5.40	6.10	0.73	0.81	67.9	65.9
Sep-10	3.75	4.20	5.70	6.20	0.76	0.82	73.0	67.9
Dec-10	4.25	4.70	5.90	6.30	0.78	0.82	78.0	69.6
Mar-11	4.75	5.20	6.10	6.40	0.77	0.83	81.6	70.2
Jun-11	5.25	5.70	6.20	6.50	0.75	0.83	81.8	69.0
Sep-11	5.75	6.10	6.30	6.50	0.72	0.84	80.6	67.0
Dec-11	6.00	6.20	6.40	6.55	0.71	0.84	81.7	66.7
Mar-12	6.00	6.20	6.40	6.55	0.70	0.84	81.9	66.5
Jun-12	6.00	6.20	6.40	6.55	0.69	0.84	82.1	66.3
Sep-12	6.00	6.20	6.40	6.55	0.68	0.84	82.3	66.1
Dec-12	6.00	6.20	6.40	6.55	0.67	0.84	82.4	65.8

The great devolution

The global economy is staging a convincing recovery after its first year of contraction since 1946, but the good news is not distributed evenly. China is the global growth powerhouse, pulling South-East Asia, Australia and the resource economies with it. The US recovery looks anaemic by comparison, Japan remains mired in deflation, and Europe is the worst laggard of all. As the smoke of crisis clears, the underlying economic power shift from West to East is back in plain view.

USA

Official data has confirmed that the US economy grew by 0.7% in the third quarter of 2009, and indicators suggest similar growth over the fourth quarter of last year and the first quarter of this year. A modest but sustained recovery is taking place, based principally on recovering sales in consumer durables and inventory rebuilding. Manufacturing surveys point to steady growth, consumer sentiment has swung into very optimistic territory, house prices are rising, and share prices are still rising sharply.

The labour market is turning more slowly. Payrolls data has shown the pace of monthly job losses slowing from around 700k early in 2009 to just south of zero more recently. Similarly, the unemployment rate has stabilised at 10%, but is yet to fall materially. The labour market is the quintessential lagging indicator. It normally turns only well after economic recovery has begun, but when it turns it stays turned. Since the US labour market rarely throws false signals we interpret the improvement seen over the past six months as useful confirmation that a sustained economic recovery is in train. (The idea that high

unemployment will prevent recovery is reverse logic in its purest form – low unemployment did not prevent recession!)

The current recovery is being supported by extremely stimulatory monetary and fiscal policy. Neither can last forever. Eventually the US must face up to its long-standing structural problems of excessive household debt and waning international competitiveness, as well as the newer, but equally vexatious issue of an unsustainable fiscal deficit. Beyond the inevitable period of post-recession growth, we have deep reservations about the long-term growth outlook for the US.

China

In stark contrast to the US, China is apparently in an economic sweet spot. Economic growth is expected to clock 9.6% for 2009, propelled not only by stimulatory policy and massive public works projects, but also by private investment and, most importantly, burgeoning consumer demand. Retail sales rose 16% in the year to October, investment was up 33%, and bank lending was 34% higher, to name just a few of the usual round of mind-boggling statistics that chart China's economic rise. We forecast growth rates of 9.4% and 9.0% for 2010 and 2011 respectively.

Despite strong growth, there are no indications of rising inflation, which was running at -0.5% in October. The People's Bank of China has announced that it aims to continue supporting steady growth while managing inflation expectations by targeting credit growth of 17% this year, compared the last year's exceptionally high 33%. Lending growth is being curtailed partly by requiring banks to hold greater reserve ratios, partly with a modest interest rate increase, and partly by direct guidance to state-owned

banks. However, Yuan appreciation does not feature among the policy tightening plans, and fiscal policy can well afford to remain stimulatory. Overall policy remains very stimulatory, and there seems little chance that the minor tightening planned so far will derail growth this year. The bigger risk is a new bubble.

Australia

The Australian economy rode through the global downturn with remarkably little damage in 2009, and it seems to be weathering higher interest rates and the removal of fiscal stimulus handouts with equal alacrity. By late in the year both consumer and business confidence had recovered to very optimistic levels, employment was growing again, and retail trade was surprisingly resilient. Unfortunately for the RBA, the recession-that-never-was failed to materially reduce underlying inflation. The cash rate rose by 75 basis points in late-2009, and we expect the RBA has more work to do starting in February.

For 2010 we expect Australia to notch up its 19th consecutive year of economic expansion, led by three varieties of investment. The severe housing shortage will be resolved through a boom in housing investment. The long-term trend of rising investment in mining is expected to resume after a brief interruption last year. And the public investment program designed in early-2009 to prevent recession will really ramp up over 2010 to further boost economic activity (an example of the perils of using fiscal policy as a counter-cyclical tool).

Other Asia

The Japanese economy has re-entered the deflationary twilight zone, with prices down 2.2% yr. The price-depressing

effect of Japan's 8.4% GDP contraction was exacerbated by the strong Yen, and now deflationary expectations are compounding the problem. The economy did sputter back to life with tepid growth of 0.6% per quarter through the middle of 2009, but we expect only slow growth over the next two years – not enough to truly escape the omnipresent grip of deflation. To make matters worse, Japan's massive and pervasive fiscal deficits are once again raising questions at the ratings agencies.

The export-oriented countries in Asia are experiencing a particularly elastic bounce after their deep recessions. GDP in South Korea, Taiwan and Singapore has now fully recovered the pre-crisis level. India was more resilient last year, as it relied on home-grown consumer demand, and is expected to rack up 7% growth in 2010.

Europe and UK

Europe's five-quarter-long 5.1% GDP contraction was more severe than America's, and now its recovery looks more feeble. The Euroland economy expanded just 0.4% in the third quarter of this year, and may have stalled again since then. Such weak growth means ECB interest rate hikes remain a long way off. The suffering is at its most acute on the periphery of the Eurozone, where weak economies are shackled to the strong euro. Ireland has dealt with extreme pressure on the public purse by slashing public sector pay and benefits. By contrast Greece's fiscal deficit has ballooned to 12.7% of GDP, sparking off ratings downgrades and spiralling bond spreads. Greece may eventually require a bailout from the ECB, which is sure to impose harsh conditions. Ratings agencies are warning Portugal of a similar

fate, and even Spain's fiscal viability is questionable.

The UK is still officially in recession, as third quarter GDP growth was negative, but prospects for 2010 are slightly better as loose monetary policy along with the sharply weaker pound and emerging growth elsewhere prevent further contraction in economic output. However, with both the financial services industry and the housing market subdued, UK growth will be anaemic for the foreseeable future. The weakening of the tax base has rendered government expenditure levels unsustainable. Fiscal tightening is inevitable, and when it comes the UK will experience a fresh round of economic pain.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009e	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.4	1.0	3.0	3.2
CPI inflation % annual	2.8	3.3	3.0	3.7	2.0	2.2	2.7
Unemployment %	5.1	4.8	4.4	4.3	5.6	6.0	5.9
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.5	1.5	3.1
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.5	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	10.7	10.6
Japan							
Real GDP %yr	1.9	2.8	2.2	-0.9	-5.8	1.6	1.8
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.2	-0.7	0.3
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.3	5.2
Euroland							
Real GDP %yr	1.7	2.9	2.7	0.6	-4.0	0.6	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.3	0.7	1.2
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	11.5	10.8
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.7	-4.7	0.4	1.2
Consumer Prices %yr	2.1	3.0	2.1	3.5	1.5	2.8	1.5
Unemployment Rate %	2.8	3.0	2.5	3.1	5.5	7.0	7.3
China							
Real GDP %yr	10.4	11.6	13.0	9.0	8.5	9.4	9.0
Consumer Prices %yr	1.8	1.5	4.8	5.9	-1.0	1.5	3.3

Forecasts finalised 9 December 2009

Economic recovery: Will this time be different?

Most forecasters are anticipating only a mild economic recovery. This is at odds with history. On average, NZ GDP growth peaks at 6% per annum nine quarters after recession.

Consensus forecasts are for only a tepid 2.7% recovery in US economic growth in 2010 and there is even talk of the possibility of a “double dip”. This relatively despondent attitude has infected NZ economic forecasters. Westpac is forecasting 3.7% NZ economic growth in calendar 2010. This is the highest of 16 economic forecasters by some margin. The next highest forecast is 3.0%, the mean is 2.4% and the lowest is a measly 1.3%. A valid question is whether we are being realistic or delusional.

In this article, we cast our eyes to the past to see what happened during previous economic recoveries. Each recession and recovery has their own peculiarities, so history is not necessarily a reliable guide – but it is the best we’ve got. We examine the speed of recovery from past NZ, US and Australian recessions. Recoveries from past recessions have tended to be very strong, so an equally valid question is why those forecasting a timid recovery think this time is going to be different.

Previous recoveries

We have used quarterly GDP series for each of NZ, Australia and the US (back to 1947, 1959 and 1947 respectively). During this period, each country has had the remarkable average run rate of around 1 recession every 5½ years.

Table 1 shows the average peak growth rate during recovery, and the number of

quarters taken to reach the proximate peak.

From the post World War 2 (WW2) quarterly data series we find that:

- In the US year on year growth peaks at an average of 6%, eight quarters after the end of recession. Since the mid 1980s, recoveries (and their preceding recessions) have been more moderate (closer to 4%) and more elongated. The only ‘false start’ recovery was in 1981. But then the Fed was concerned with the legacy of high inflation and pushed up the effective fed funds rate by 8% to nearly 18% at the first signs of recovery, tipping the economy back into recession.
- In Australia, peak growth averages 5% in the economic recovery, 6 quarters after the recession has ended. The only instances when growth didn’t get above 4% in the initial stages of recovery was in the mid 1970s (post oil shock), and early 1990s (post banking sector crisis).
- NZ economic recoveries are robust with the exception of the negative supply shocks of the 1970s and the banking crisis of the late 1980s / early 1990s. On average, NZ GDP growth peaks at 6% per annum nine quarters after recession has ended.

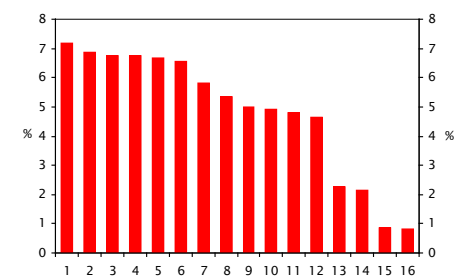
Table 1: Peak growth rate in recovery

	Ann % chg	Qtrs after	Ann avg % chg	Qtrs after
US	7.4	6.5	6.1	8.1
Australia	6.4	4.9	5.0	6.3
New Zealand	8.3	7.0	7.2	8.9
Ex '48, '75, '88	7.2	7.3	6.1	8.8

Instead of looking only at recoveries from recession, we also examined recoveries

from any significant slowdown. On this basis, for New Zealand, there are 17 periods of ‘recovery’ post WW2. The average peak year-on-year growth rate across all the recoveries (excluding the immediate post war whopper) is 4.8% and the median 5.2%. Excluding the periods of severe supply shock and banking crisis, the average is 5.7% and the median 5.8%. In fact, excluding those periods, the peak growth rate in every other instance of recovery was above 4.5% (see Figure 13). Whichever way you cut it, the standard economic recovery is fairly strong, and much greater than what nearly all forecasters are picking for the current rebound.

Figure 13: Peak growth rates in post 1950 NZ economic recoveries



We also examined annual GDP back to 1870 from the database developed by British academic Angus Maddison. The general lessons from this data are:

- The deeper the recession, the more robust the recovery.
- Robust recoveries – once they take hold – have been the norm.
- Tepid or false start recoveries have been associated with severe terms of trade shocks (NZ in the 1970s), banking crises (e.g., NZ and Australia in the late 1880s / early 1890s and in the late 1980s / early 1990s), and monetary policy ‘mistakes’ (US in the early 1980s).

For the US, the peak (Q4 2007) to trough (Q2 2009) contraction in activity was 3.7%. This is the sharpest pullback in activity since the 1957/58 recession (also 3.7%) although the twin recessions of 1980 and 1982 would have driven activity further below potential. NZ's peak to trough contraction in activity in the latest recession was 3.3%. This is a similar order of magnitude to the 1991, 1982/83, 1975-78 recessions but less than half the contraction experienced in the 1951-52 and 1948 recessions. The 2008-09 recessions for both NZ and the US were deep, and the simple arithmetic of history would suggest a stronger than average rebound.

Same, same but different

The story of subdued growth and potential relapse in the US generally goes along the lines of: the consumer is reeling from an \$11 trillion hit to net wealth so will be saving, not spending; there is a massive overhang of unsold housing stock, so the recovery will not be supported by increased residential construction; there is lots of spare capacity, so firms will not be investing; continued high default rates will keep bank capital under pressure, so they won't be lending; and if there is a relapse, there are precious few policy options left with the fed funds rate effectively zero and the government running a deficit of around 13% of GDP. It all sounds plausible and grim.

But history provides some counter-examples. US economic growth was on steroids after the 1893-94, 1907-08, 1920-21, and 1929-33 depressions, posting double digit rates in the year or two after the depressions ended. And in the 1920-21 slump the policy response was higher interest rates and running a government surplus! The policy response this time around couldn't be more different: the biggest fiscal and monetary stimulus ever. And the Fed has expressed a desire to keep easy money available until the recovery is well entrenched. So even in the US, we'd rate it a good chance that growth surprises on

the upside.

In Australia, their avoidance of, or relatively mild, recession probably constrains the potential amount of upside surprise.

In NZ we had a deep contraction, avoided a banking crisis, the Terms of Trade remained above its historic average, and the net worth of the household sector is now back to its previous peak level.

For NZ, there are a number of aspects of this economic cycle that people could point to as being different and thereby constraining the rebound.

1. The exchange rate (TWI) didn't stay low for long.
2. We've experienced a dramatic global financial crisis (GFC) and are yet to see the full regulatory response.
3. NZ Inc has a record level of indebtedness.
4. The secondary finance sector has been decimated, limiting availability of property and equipment finance.

However, there have been a number of offsetting factors. The exchange rate is higher because commodity prices have rebounded much more quickly than they normally do after a global downturn. The world is no longer so US-centric, with strong growth in demand from emerging markets (and we expect this to continue in 2010, as policy settings in emerging economies remain super stimulatory). NZ has been in a period of substantial trade liberalisation, with numerous free trade agreements being signed. The response to the GFC has been extraordinary fiscal and monetary policy stimulus around the world (and a record low OCR in NZ and strong fiscal/infrastructure stimulus). And lack of mezzanine finance may be a temporary problem: history repeatedly shows that where there is a will (and more particularly, a dollar), there is a way.

What is startling is how many factors are currently behaving similarly to precursors of past strong recoveries.

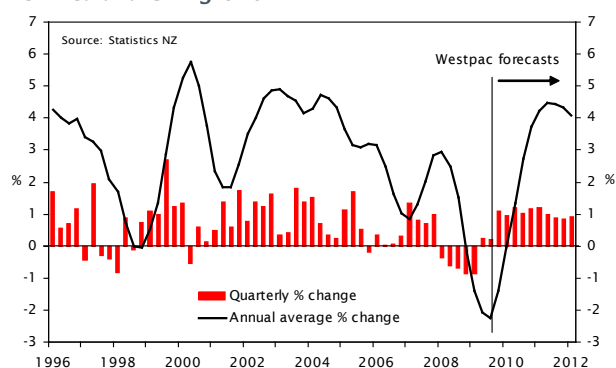
1. A deep recession.
2. Asset prices (particularly housing and equities) have rebounded strongly.
3. We are experiencing a mini migration boom.
4. Forecasts of global activity continue to be revised upward.
5. There is a dramatic shortfall of houses being built (which will be a multi-year source of economic growth in the nascent recovery).
6. The inventory cycle is at an extremely low ebb, and restocking will reinforce the economic recovery.
7. Most of the consumption hit was on durables, and car import and registration data has turned strongly.
8. Leading indicators (e.g., yield curve, business and consumer confidence) are, if anything, stronger than in most other economic recoveries.

Those looking at credit, employment, mortgagee sales, and business defaults will find that they miss the first year of economic recovery: these are all classic lagging indicators. It is one of the quirks that default rates (consumer and business) tend to keep rising during an economic recovery. The reasons are two-fold: time and the level of activity. Time is the enemy in a downturn – some firms and individuals can hang on for only so long. And even when economic growth returns, the level of economic activity can still be very weak (e.g., in the September quarter, the volume of construction activity was 19% below the cycle peak, manufacturing was 20% down, and wholesale trade 15% lower). Acute financial pain tends to continue to be experienced by many through the preliminary stages of economic recovery.

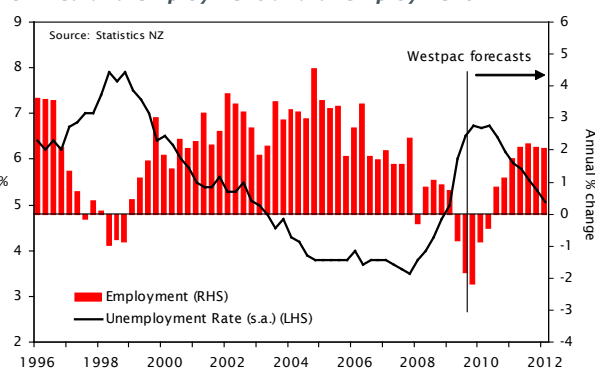
In all recessions and economic recoveries, people tend to say this time is different. In the absence of 1970s style supply shocks or late 1980s / early 1990s systemic banking problem, we'd hazard to say that this time will not be different! Weighing it all up, we feel the risks to our forecast growth over the next two years are to the upside, not the downside as indicated by Consensus Forecasts.

Annual Average	March years				Calendar years			
% change	2009	2010f	2011f	2012f	2008	2009f	2010f	2011f
Private consumption	-1.1	0.7	3.6	2.9	-0.3	-0.6	3.6	3.0
Government consumption	3.3	0.5	1.4	1.9	3.8	1.1	1.0	1.7
Residential Investment	-22.8	-12.3	21.9	25.6	-18.2	-17.8	14.7	26.7
Business Investment	-1.2	-8.3	8.3	6.4	2.0	-10.3	5.4	8.1
Stocks (% contribution)	-0.3	-1.6	2.0	0.1	0.4	-2.4	2.1	0.4
GNE	-1.7	-2.7	6.9	4.4	0.2	-4.8	6.2	5.1
Exports	-3.3	3.3	5.6	4.3	-1.3	0.3	5.9	4.4
Imports	-4.7	-10.3	12.7	5.1	1.9	-15.6	11.9	6.4
GDP (Production)	-1.4	-0.1	4.2	4.1	-0.1	-1.4	3.7	4.3
Employment (% annual)	0.7	-0.9	1.7	2.1	0.9	-2.2	1.1	2.1
Unemployment Rate (% s.a. end of period)	5.0	6.7	5.9	5.1	4.7	6.7	6.1	5.3
Average Hourly Earnings (% annual)	5.1	3.3	2.6	3.6	5.1	4.0	2.2	3.4
CPI (% annual)	3.0	2.5	2.7	3.0	3.4	2.1	2.6	2.8
Current Account Balance (% of GDP)	-7.9	-1.9	-4.8	-5.0	-8.7	-1.9	-4.7	-5.1
Terms of Trade	-5.0	-9.5	2.8	2.8	1.8	-12.0	2.3	2.8
90 Day Bank Bills (end of period)	3.67	3.20	5.20	6.20	6.30	2.90	4.70	6.20
5 year swap (end of period)	4.26	6.00	6.40	6.55	5.83	5.80	6.30	6.55
TWI (end of period)	53.7	67.4	70.2	66.5	57.7	67.5	69.6	66.7
NZD/USD (end of period)	0.53	0.77	0.77	0.70	0.58	0.77	0.78	0.71
NZD/AUD (end of period)	0.80	0.80	0.83	0.84	0.86	0.80	0.82	0.84
NZD/EUR (end of period)	0.41	0.51	0.52	0.49	0.44	0.51	0.52	0.49
NZD/GBP (end of period)	0.37	0.43	0.43	0.37	0.37	0.44	0.43	0.37

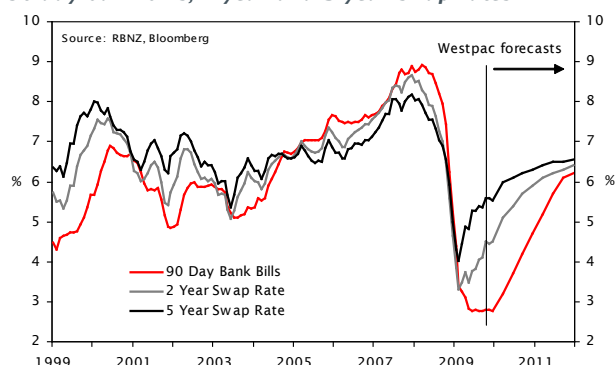
New Zealand GDP growth



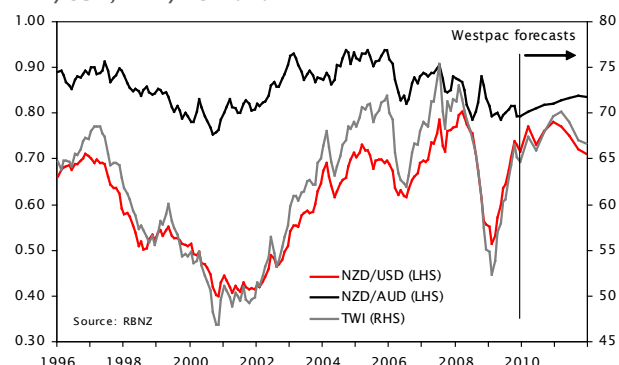
New Zealand employment and unemployment



90 day bank bills, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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