

Economic Overview

November 2009

Highlights

- **NZ finally crawled out of recession** in the June 2009 quarter, although with growth confined to just a few specific sectors, it didn't feel like it. However, recent economic data paint a convincing story of recovery. We now expect above average GDP growth in calendar 2010 and 2011 (*see Economic Outlook, page 2*).
- **The high NZD is proving a challenge for many in the export sector, and is creating much angst over at the RBNZ.** However, the NZD has behaved the way it has for good reason – the ailing USD and strong growth in China are part of the story, but so too are rising commodity prices. So while such a strong currency rules out the traditional export volume-led recovery it won't preclude growth. The big income boost from our stronger terms of trade should provide significant impetus to households and businesses in the coming year (*see Feature Article, page 10*).
- **Cyclical industries are likely to outperform.** Booming house construction will be a key feature of the NZ growth story, along with consumer spending, as both benefit from very low interest rates, higher net migration and rising house prices. The outlook is also brighter for the manufacturing, agriculture and service sectors (*see Sectoral Trends, page 4*).
- **We now expect the RBNZ to begin lifting the OCR in March next year, with a gradual but steady tightening over the next couple of years.** The RBNZ remains more conservative about the case for tightening, reiterating in October its intent "to keep the OCR at the current level until the second half of 2010". We agree that the case for tightening isn't yet urgent, but we don't think that latitude extends to the second half of next year (*see The Markets, page 6*).
- **Globally, the rapid improvement in the economic outlook has continued.** Asian production is booming again, providing huge stimulus to the Australian economy. The US and Europe are experiencing more modest recoveries, the sustainability of which remain questionable (*see International, page 8*).

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Prepared by the NZ economics team:

Brendan O'Donovan, Chief Economist
Michael Gordon, Markets Economist
Donna Purdue, Senior Economist
Doug Steel, Senior Economist
Dominick Stephens, Research Economist
Sharon Zöllner, Senior Economist
email: economics@westpac.co.nz

For address changes contact:
Natalie Denne, ph: (04) 381-1413
natalie_denne@westpac.co.nz

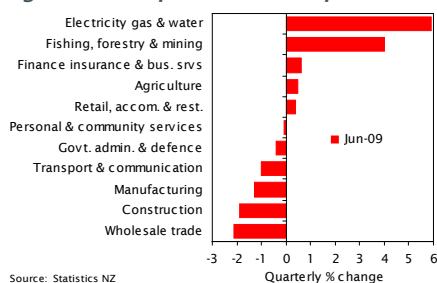
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Building our way back

New Zealand has crawled out of recession. Prospects for the next few years are looking good. Economic indicators now suggest that GDP growth will come in above average in calendar 2010 and 2011, with the domestic sectors of the economy leading the charge.

It's official! The recession is over and the New Zealand economy is growing again. Our latest GDP statistics revealed that the economy expanded in the June 2009 quarter, following 15 consecutive months of decline. The earlier-than-expected end to the recession is welcome news, but at just 0.1% growth in the quarter, we would hardly call it a convincing end. A few specific factors in the energy sector were responsible for getting growth over the line, while activity in many of our other major sectors – construction, manufacturing, wholesale trade and transport – all continued to contract. Indeed, for most of us, it probably didn't feel like the recession had ended.

Figure 1: GDP production components

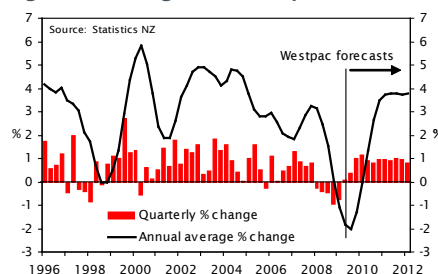


Nevertheless, it is hard to ignore the run of positive economic data in the past couple of months. Consumer and business confidence have surged, the labour market is showing signs of bottoming out, retail sales are a little more buoyant, and the housing market continues to find solid support from low interest rates and rising net migration.

The high NZD is proving a challenge for many in the export sector, but even so the news hasn't been all bad. The rapid improvement in the global economic outlook has continued, resulting in further upward revisions to Consensus Forecasts for our major trading partners. Commodity prices are also on the rise with dairy prices skyrocketing, to be up 88% in the last four months.

Taken together these factors tell a much more convincing story of recovery, and we have revised up our GDP forecasts accordingly. We now expect GDP to contract by 1.3% in calendar 2009 (previously 2.1%), before lifting to grow by 3.5% in calendar 2010.

Figure 2: GDP growth and forecasts



In the very near term, growth will be buoyed by a rebuilding of inventories following a sharp rundown through the first half of 2009. Thereafter, growth will be led by a swift upturn in residential investment as the sector responds to rising house prices and a housing shortage. Consumer spending will also strengthen, underpinned by strong net migration, low interest rates, recovering house prices and rising farm incomes, especially dairy. Business investment will be the laggard, as ample spare capacity keeps new spending at bay in the near term. However, come early 2010, we expect strong domestic demand, low interest rates and greater purchasing power from the high NZD to begin to

encourage an investment revival.

The export sector should also begin to make a small positive contribution to real GDP growth by early 2010. However, the more sustained contribution from exports is expected in the following year, allowing overall GDP growth to maintain an above average 3.8% pace in calendar 2011. On the whole though, the strongest contributions to growth over the next couple of years will come from a rebuilding of inventories, the housing market, and consumer spending.

Housing mini-boom

The rise in longer term mortgage interest rates from around May this year has dampened some of the previous enthusiasm in house sales, but there is little doubt that considerable momentum still exists. Sales are up 44% on a year ago, days to sell are falling, and listings are beginning to pick up (albeit slowly).

However, the momentum is no more apparent than in house prices, with the REINZ house price index showing prices up 4% in the four months to September. And, on our forecasts, there is still further to run.

The RBNZ is playing its part by recently re-iterating the commitment to keep the OCR at the current low level until the second half of 2010 (see our *Markets* section for more detail). That should help to anchor short-term interest rates over the next four months. The other major driver is net migration.

Annual net migration reached a five-year high of 17,000 in September 2009 primarily as fewer New Zealanders departed for Australia. Based on current flows, we expect the annual total to hit a peak of close to 23,000 in January 2010,

before easing back to more modest gains of around 10,000 per annum by the end of 2011. While that means the migration boost is largely a one-year wonder, it is sizeable nonetheless, and its impact on housing demand will be felt for some time to come.

The double-edged sword is that rising net migration is compounding the shortage of houses currently facing the NZ market. Even before our net migration flows began to pick up, the rate of new home building had fallen below what was needed to meet normal population growth. And even though dwelling consents are up around 25% since the beginning of the year, with only 13,600 consents issued in the past 12 months, it will be some time before supply is sufficient to meet demand. As such, we now expect a brief return to double-digit house price inflation in coming quarters.

Figure 3: Consents per 1000 population

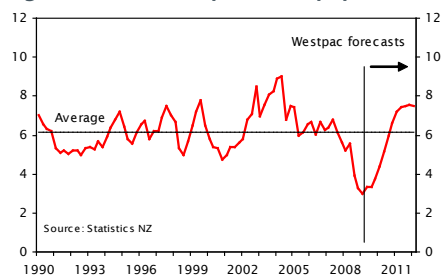
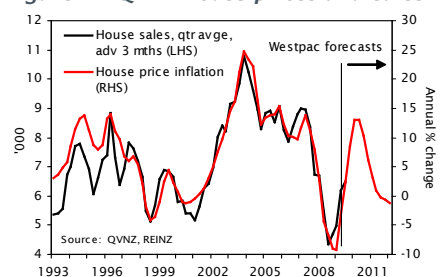


Figure 4: QVNZ house prices and sales



We say a brief return, as it is our expectation that double digit house price growth, combined with falling section prices, will be enough to kick-start builders into action from early 2010. Consent issuance has been surprisingly soft given the extent of improvement in the housing market and the obvious shortage that is developing. Some

of the weakness may be attributed to credit constraints. However, with credit conditions continuing to improve, this should become less of an issue by year-end. After contracting by an estimated 16% in calendar 2009, our forecasts see residential investment growing by close to 20% in calendar 2010 and a further 27% in calendar 2011. But even then, the level of activity does not get back to the 2007 peak until the end of 2011! Moreover, if this pace of home building doesn't occur and strong demand conditions persist, be prepared for a more potent and/or lengthy upturn in house prices.

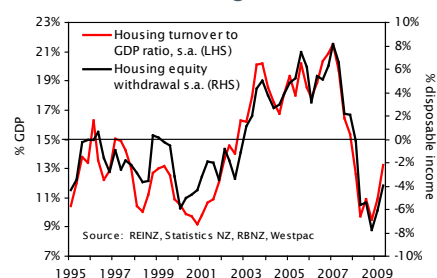
Consumers in a better place

Rising house prices will clearly be a boon to New Zealand consumers, not only through reduced housing equity injection (i.e., when households on average inject equity into the housing stock), but also more generally as the pick up in house sales spurs spending on items such as furnishings, whiteware, and hardware. Indeed, the signs are that these influences are already underway.

Figure 5 shows housing equity injection as a percent of disposable income and housing turnover as a percent of GDP. Our estimate for the June 2009 quarter suggests the degree of equity injection has reduced considerably, and will continue to do so for the foreseeable future.¹ That is significant when our research suggests around 25% of housing equity withdrawal is spent (as opposed to buying other non-housing assets or paying down debt). Moreover, retail sales figures for August suggest housing-related purchases are also beginning to pick up, with solid increases recorded in hardware sales, furniture and floorcoverings, and department stores through the month. We expect a continuation of this.

¹ Our previous research found a close connection between housing equity withdrawal (HEW) and housing turnover. That is, the majority of changes in overall HEW occur as a result of property transactions. The strong rise in house sales and rising house prices over recent months suggest the annual injections of equity into the housing stock will start to ease.

Figure 5: Housing equity withdrawal and housing turnover



Outside of the housing market, and the obvious support still coming from monetary and fiscal policy, there are plenty of other reasons to be upbeat about the outlook for consumer spending. For example the fallout in the labour market has been less severe than thought, and Fonterra has revised up their 2009/10 dairy payout from \$4.55/kg milksolids to \$6.05/kg (and a \$7.0/kg payout is possible next season if current commodity prices are maintained).

One hurdle that could stifle the recovery in consumer spending is the high level of household debt. But even that has reduced over the past year. Overall, we are optimistic that the worst of the downturn in consumer spending is behind us. We are looking for real consumer spending to grow by 2.5% in each of the next two years.

Toil and trouble

The very early stages of economic recovery are when the economy is at its most fragile and any number of events could easily spoil the recovery process we have outlined above. The risk of a second round of weakness in the global economy still lurks, and debate continues as to how sustainable the recovery will be (see our International section). Credit also remains a wildcard, with access and price likely to remain key hurdles for some businesses and households. Meanwhile, the risk of serious drought this summer has eased over the past couple of months, according to the Southern Oscillation Index, but it cannot be ruled out.

Cyclical sectors to outperform

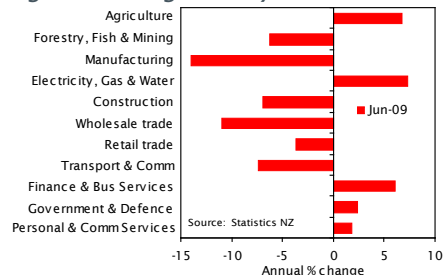
Confidence has returned to the business sector. Businesses expect better times ahead, despite the current low level of activity. House construction, retail and wholesale trade and the transport sectors look likely to outperform in 2010 as domestic demand strengthens. The outlook is also brighter, although still a little mixed, for the manufacturing, agriculture and service sectors.

Overview

A key ingredient to recovery is in place – a return of confidence. Optimism is broad-based, spanning across agriculture, construction, manufacturing, distribution and service sectors. Despite the expectation of better sales ahead, current sales and trading conditions generally remain difficult.

We expect solid growth off this low base in 2010. Cyclical industries are likely to outperform over the coming year. Construction, retail and wholesale trade, and transport look set to do well during the recovery. House construction in particular is expected to show strong growth off a very low base, benefiting substantially from low interest rates and higher net migration. Manufacturing will gain from stronger domestic and Australian demand, although ongoing competitive pressure from abroad

Figure 6: GDP growth by sector

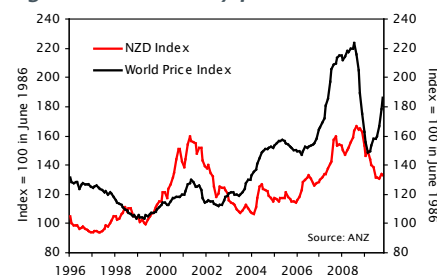


will restrict progress. The outlook for agriculture is mixed with overall on-farm discretionary spending likely to remain restricted. The dairy sector is shaping up as one of the stronger performers this season. The services sector should tap into the general economic recovery through 2010, with primary sector suppliers likely to be the underperformers.

Agriculture

The soaring NZ dollar is causing great concern among producers, as the new pastoral production season gets into full swing. Of course, actual prices received depend as much on world prices as they do on the value of the NZD. On average, world food prices have lifted and are around 12% above their 10 year average. But the situation varies by product. International dairy prices are rising strongly, more than offsetting the higher NZD and putting upward pressure on farmer payouts. Meanwhile, the higher NZD against the USD compounds the easing in international beef prices. In-market lamb prices are firm, but the strength of the NZD against the Euro and British pound is placing downward pressure on farmgate returns. Production is likely to be equally variable both across sectors and across regions with weather conditions through late winter and spring ranging from one extreme to the other. General weather conditions are consistent

Figure 7: Commodity prices

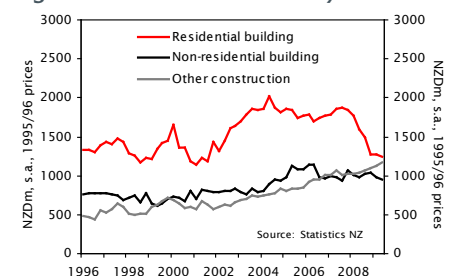


with an El Niño pattern, although the risk to production is waning. Overall, we expect farmers to continue to exhibit expenditure restraint.

Construction

The construction sector is poised to make a substantial contribution to economic growth through 2010. Residential investment is expected to post a strong performance, as it rebounds from low levels during 2009. Further government infrastructure investment is expected to see recent growth in other construction continue. Non-residential building construction is likely to be patchy. The strong 2010 growth forecast for the sector as a whole needs to be put in the context of a low starting point, with the value of construction activity in mid-2009 around 15% below its peak in late 2007.

Figure 8: Construction activity

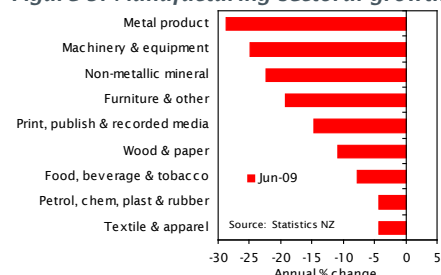


Manufacturing

The past year has been one to forget for the manufacturing industry. Profitability has been under pressure from a lack of sales, high inventory levels and squeezed margins. But there are signs of better times ahead. Despite the recent extremely tough trading conditions, confidence among manufacturers has hit its highest level in over 10 years. Indicators from the latest *Quarterly Survey of Business Opinion* show firms' expectations for both domestic and export sales have turned

strongly positive. Export sales should be aided by an expanding Australian housing market in 2010, with a supportive NZD/AUD cross rate helping bring better returns to the factory door. Inventory levels are becoming more comfortable, with firms looking to lift production to meet future demand. Profitability should improve as any lift in production is accommodated by existing spare capacity, keeping unit costs down.

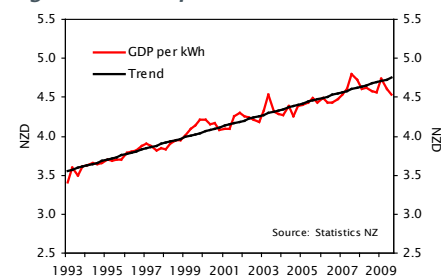
Figure 9: Manufacturing sectoral growth



Electricity, gas and water

Electricity generation rose around 2% in the September quarter, extending the strong gains in June (that were boosted by an exceptionally cold autumn and early winter). More generation in the third quarter indicates a robust pick-up in underlying electricity demand from the combined industrial and commercial sectors – a positive sign for economic growth over the period. The recession has brought a reduction in GDP per kWh against a generally rising trend in this ratio. After adjusting for the usual changes at this time of year, thermal generation met all the increase in demand with hydro easing back from its strong increase in the June quarter. This change in generation mix means the electricity sector will not directly contribute to

Figure 10: GDP per kilowatt hour

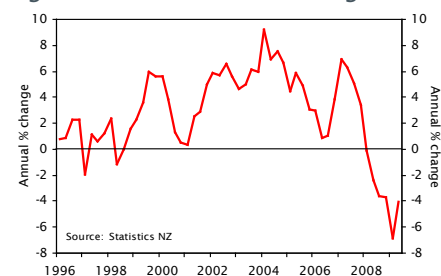


economic growth in the September quarter, despite the overall increase in electricity demand. A cold start to the fourth quarter points to more generation.

Retail trade

Optimism has returned to the retail sector following strong increases in consumer confidence. Substantial reductions in debt servicing costs as fixed mortgages roll onto lower interest rates, the related increase in house prices and the 1 April tax cut have significantly improved consumer sentiment. These factors, along with higher net migration, have helped drive a mild rise in retail sales over recent months. Despite this, the current level of sales remains low. The volume of retail sales are more than 6% below their early 2007 peak, with sales of big ticket items down the most. That said, retailers are reporting that they have got inventory to more comfortable levels and they expect a strong pick-up in new orders and domestic sales over coming months. We anticipate the dollar value of retail sales in 2010 to be around 5% higher than in 2009. Sales of durable goods including those associated with house construction are likely to outperform.

Figure 11: Retail sales volume growth

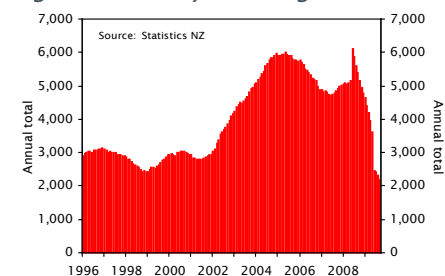


Transport

Transport activity tends to reflect the wider economic cycle but with larger amplitude. Still, it is abnormal that the 2% contraction in the economy over the year to June 2009 brought a 12% drop in transport activity over the same period. The lack of domestic demand and a hefty fall in import volumes reduced freight activity. A very sharp inventory rundown

amplified the movement. Annual heavy truck registrations have fallen to their lowest level in more than 15 years. We forecast transport activity to grow more strongly than the 3.5% growth forecast for the wider economy in 2010.

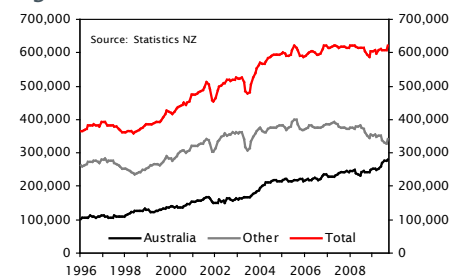
Figure 12: Heavy truck registrations



Tourism

The tourism sector keenly felt the downdraft from the global financial crisis. During the worst of the crisis, in the year to March 2009, international tourism expenditure fell 0.9% to \$9.3 billion. Meanwhile, domestic tourism expenditure rose 2.6% to \$12.4 billion, helping overall tourism expenditure eke out a 1.1% increase over the period. Since then, international visitor numbers have bounced back, with arrivals in the three months to September up 2.8% on the same period last year. This growth was driven by a 16% increase in the number of visitors from Australia. Ongoing economic growth in Australia, a favourable exchange rate and a good ski season have all encouraged visitors from across the Tasman. In contrast, the combined number of visitors from other countries fell 9% over the same period. More broad-based growth in visitor numbers is expected in 2010 as the global economic recovery takes hold.

Figure 13: Visitor numbers



Welcome to the new normal

The New Zealand dollar's 'normal' trading range has probably taken a permanent step higher. But its recent strength is also a product of sentiment, and the near-term outlook rests upon whether markets find reason to reassess their attitudes about the global economy. Structural changes will also put more upward pressure on some interest rates than in previous cycles, although the net impact will depend on the interaction with monetary policy.

Exchange rates

As we discuss in our Feature article, the New Zealand dollar's unusual bounciness through this cycle has some basis in fundamentals – fundamentals that weren't so apparent even a few months ago, like the resurgence in export commodity prices and the strength of demand from emerging markets such as China.

Even so, the speed of its rise has had at least as much to do with sentiment in global markets. Around the world, economic data has more often than not turned out better than expected – and certainly better than feared in the early part of this year. This has steered investors away from 'safe haven' investments and into those markets that are placed to benefit from the recovery. The result is that even though the US has been a key participant in the recovery, its currency has fallen out of favour.

So as uncomfortable as the NZ dollar's strength may be for some, the prospects for a correction in the near future seem to rest on a shift in global attitudes, particularly towards the US dollar, rather than local developments. We certainly see scope for such an adjustment – notwithstanding the US's relatively fragile outlook, we suspect the USD's slide has

been greatly exaggerated by rumours of its demise as the world's currency of choice. But there's no knowing when or where the catalyst for such a readjustment might emerge.

One possibility is that the Fed could begin to map out its exit strategy from near-zero interest rates and quantitative easing earlier than the market expects. This would help to restore the USD's yield appeal as longer-term interest rates rose in anticipation, even if an increase in the policy rate itself were some distance away.

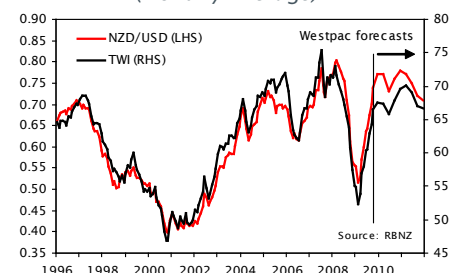
Another, less heartening, possibility is that investors could return to the 'safe haven' of the USD if they began to question the sustainability of the global recovery, beyond the easy gains from fiscal stimulus and a rebuilding of depleted inventories. Even so, it could be some time before these concerns are realised: much of the planned fiscal spending, such as infrastructure, is long-term, and restocking is a slow process that could continue well into next year.

In terms of sentiment closer to home, policymakers have expressed concern that the NZD has largely tracked the Australian dollar despite the two economies facing rather different conditions. However, the NZD/AUD cross rate is below its long-term average, and the close integration between the two economies means that this exchange rate rarely needs to stray far from average levels.

Finally, those hoping for investors to reassess the NZD based on New Zealand's economic imbalances won't have much to work with in the near term. We expect the current account deficit to narrow to 2.5% of GDP by early next year, admittedly for reasons that are both temporary and none too flattering: weak import demand, low interest rates and lower profits for

overseas-owned firms. But it's a better look than in recent years, when the deficit seemed to be mired around 8-9% of GDP regardless of economic conditions.

Figure 14: NZD/USD and TWI (Monthly Average)

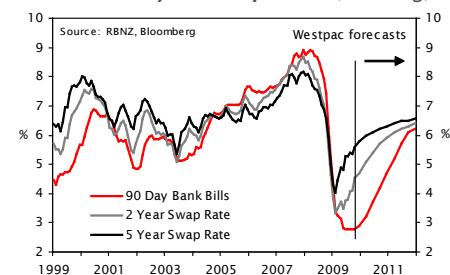


Interest rates

With the economy moving firmly into recovery mode, the market has turned its attention to when the RBNZ will begin returning the OCR to more normal levels. Our forecast – which is broadly in line with the market – is for the first increase in March, with a gradual but steady tightening over the next couple of years.

In contrast, the RBNZ has been more conservative about the case for tightening, and since April has maintained (aside from some minor wording changes) that it expects to keep the OCR unchanged at least until the second half of 2010. The RBNZ does have some time on its side: the economy is growing again but is running well below full capacity,

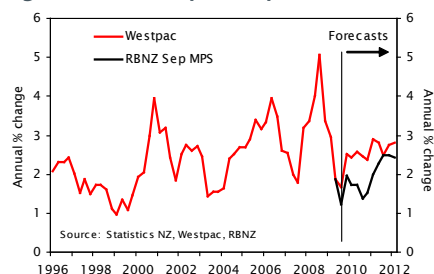
Figure 15: 90 day bank bills, 2 year and 5 year swap rates (mth avg)



and inflation is comfortably within the 1-3% target band for now.

But we don't think that latitude extends to the second half of next year. For one, the inflation outlook is not as benign as the RBNZ projected in its September *Monetary Policy Statement*. The 1.3% rise in consumer prices in Q3 was a hefty 0.5% above the RBNZ's forecast, and the fact that five quarters of recession have left annual inflation (1.7%) only just below the mid-point of the target range should be of concern. Looking ahead, we think that annual inflation has bottomed out and expect it to remain in the upper half of the target range for the next few years.

Figure 16: CPI inflation forecasts



Also, it's not just the timing of the first hike that is at stake. The key question is how quickly the RBNZ moves once it does start to return the cash rate to more normal levels. And what we've heard from the RBNZ so far suggests that it favours a policy of tightening late and hard. The September *MPS* projected a flat track for interest rates until late 2010 but a fairly steep rise beyond this, putting the 90-day

rate at 5%, and rising fast, by early 2012.

The danger for a central bank in this approach is that if it falls too far behind the curve, it could end up having to do more work than otherwise to catch up. At worst, that could mean higher interest rates on average in the following years, and to the extent that currency markets focus on expected interest rates, it could exacerbate the upward pressure on the NZD. Not to worry though – if local data continues to turn out positive as we expect over coming months, we suspect the RBNZ will come around to the case for an earlier and more gradual pace of tightening.

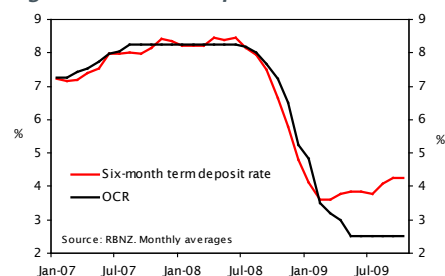
The process of 'normalising' the OCR is further complicated by the question of what constitutes a 'normal' cash rate in today's environment. We believe that two major developments have increased the wedge between the OCR and market interest rates, perhaps permanently. The first change is that the premium paid for wholesale funding has increased as a result of the global financial crisis. While it has eased back substantially over this year, it's unlikely to return to pre-crisis levels, which were unsustainably low.

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 regarded as more stable than short-term wholesale funding

– but are generally more expensive too. Higher funding costs across the industry will inevitably be passed through to higher lending rates.

The impact of this policy is already visible: 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. As a result, term deposit rates, which in the past have closely shadowed the OCR, are now substantially higher. As of today, banks have reached compliance with the policy, but further adjustments will be needed if the requirements are tightened in mid-2011 and mid-2012 as planned.

Figure 17: Term deposit rates vs OCR



One thing we haven't resolved is how these changes will manifest over the coming cycle. On the one hand, it could mean that the peak in lending rates is higher than otherwise; alternatively, it could mean a lower peak in the OCR, with the market doing some of the work for the RBNZ. Most likely, it will be some mix of the two.

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
Dec-09	2.50	2.90	4.70	5.80	0.77	0.80	67.8	67.5
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

Lucky for some, not so for others

The “decoupling” hypothesis, which suggested that developing Asia could continue growing strongly through a First World downturn, became unfashionable during Asia’s economic swoon of early-2009. But it is now obvious that the decline in Asian production was a vicious stock cycle compounded by panic. Asian production is booming again, led by Asian demand. The region is not hampered by credit constraints. Meanwhile, the US and Europe are experiencing more modest recoveries, the sustainability of which are questionable. Decoupling is now a fact.

USA

The United States economy is currently in recovery mode. The ECRI leading index of US economic activity is at its highest level since it began in January 1968. Consumer spending and confidence are soaring. Industrial production is growing, and forward looking indicators suggest robust growth for the remainder of 2009. Crucially, house prices are now rising, house sales are picking up, and house building is on the rise, although all are at pathetic levels compared to three years ago. Unemployment is still climbing, but the pace of job losses has fallen dramatically. We expect employment growth to resume soon.

The second half of 2009, and even the first quarter of 2010, could be periods of solid economic growth for the US. However, we have some reservations about the long-term outlook. Current activity is being flattered by an inventory rebuild and direct fiscal stimulus, both of which are necessarily temporary. Access to credit is still very difficult. Asset price declines have left household balance sheets in tatters, meaning more saving

and less spending. And high global commodity prices mean US consumers and businesses are not getting the relief they would historically expect following a recession. We expect a return to low growth in 2010, forcing the Fed to keep interest rates at their current near-zero setting throughout next year.

China

China is experiencing a solid economic recovery. Industrial production rose 12.4% in the third quarter, and is now 14.1% higher than a year ago. September quarter GDP advanced at a 9.1% annualised rate, and we expect a further acceleration to 11.3% annualised in the December quarter. Chinese consumers are playing a strong role in boosting final demand – retail sales are up 15.4% on a year ago. But the key driver of this recovery has been a stunning investment boom (investment spending is up 33% in nine months). Initially the investment growth came via direct government spending on infrastructure, especially transport. More recently, relaxed monetary policy and lending standards, combined with sharply rising property prices, have led to 39.1% annual growth in real estate investment. With consumer price inflation languishing at -0.8%, there is no urgency to revoke the stimulatory monetary policies that have helped create this environment. A recent surge in imports to high-tech trade zones, where componentry is assembled for re-export, strongly suggests that Chinese exports are about to pick up. China is clearly the engine of world growth right now.

Australia

The Australian economy is benefiting enormously from its status as a resource exporter to China, and is now growing strongly after narrowly avoiding

recession. However, a combination of loose fiscal and monetary policy may have overstimulated the economy. House prices are up 8.6% in six months (having barely fallen last year) due to a first home-buyer subsidy and low interest rates. Dwelling approvals data show Australia is on the cusp of a residential building boom. Consumer confidence is at a two-year high, and the September jobs report showed strong employment growth and a fall in the unemployment rate. All this comes at a time when underlying inflation is still bubbling along at 3.6%. The RBA became the first central bank to lift interest rates after the collapse of Lehman Brothers with its 25bp hike in October, and followed up with another 25bp in November. We anticipate further hikes will take the cash rate to 4.5%, at which point the RBA will pause to assess the impact.

Other Asia

The Japanese economy expanded in the June quarter and the Tankan survey suggests it grew again in the September quarter. But Japan faces a long climb out of the abyss, and considerations of balance sheets, workforces and production capacity remain worrisome. Excess capacity is once again generating deflation. Firms are overstocked with labour, creating a downbeat employment picture. And households are struggling with a reduction in incomes.

India’s GDP has expanded 6.1% in the year to June, and industrial production rallied strongly to be 6.8% higher than a year ago. Higher government spending, record-low interest rates and tax cuts have conspired to underpin strong demand for consumer goods, especially motor vehicles. Inflation pressures are gathering.

The smaller industrial Asian countries experienced extremely strong rallies in

economic activity in the second quarter. Industrial production has already recovered fully from the global financial crisis in Singapore and South Korea, and will soon have recovered fully in Taiwan. Forward-looking indicators show that regional production growth has maintained momentum into the third quarter, mainly thanks to Chinese and Asian demand rather than exports to other regions.

Europe and UK

Eurozone GDP contracted a further 0.2%

in the June quarter, although available data point to a probable moderate upswing in the September quarter, as industrial production benefited from the recent recovery in global trade. But the functioning of the European banking system remains severely impaired due to overstretched balance sheets and problem lending to emerging Europe. Growth in credit to the private sector has slowed to nothing, which is likely to prevent a self-sustaining broad-based economic recovery from taking hold. After shrinking 4% this year, the Eurozone economy is expected to post negligible growth in 2010.

The UK economy shrank 0.4% in the September quarter, making the UK's recession, at six quarters so far, longer than in the US, Europe and New Zealand. Fiscal and monetary stimulus is having only a muted impact on economic activity, and credit growth to both businesses and households has slowed alarmingly. With fiscal policy likely to be tightened sharply by an incoming Conservative government next year (elections due before mid 2010), any recovery will struggle to gain traction. We expect just 0.5% growth in 2010.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
New Zealand							
Real GDP % yr	4.5	2.8	1.9	3.2	0.0	-1.3	3.5
CPI inflation % annual	2.7	3.2	2.6	3.2	3.4	2.5	2.4
Unemployment %	3.8	3.8	3.8	3.5	4.7	6.7	6.3
Current Account % GDP	-6.3	-8.5	-8.6	-8.1	-8.9	-2.6	-4.0
Australia							
Real GDP % yr	3.8	2.8	2.9	4.0	2.4	1.0	2.8
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	2.0	2.2
Unemployment %	5.4	5.1	4.8	4.4	4.3	5.7	6.4
Current Account % GDP	-6.1	-5.8	-5.3	-6.3	-4.6	-4.1	-4.7
United States							
Real GDP %yr	3.6	3.1	2.7	2.1	0.4	-2.5	1.6
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-0.5	1.3
Unemployment Rate %	5.5	5.1	4.6	5.8	9.2	10.5	10.8
Current Account %GDP	-5.7	-6.1	-6.0	-5.3	-4.9	-2.9	-2.5
Japan							
Real GDP %yr	2.3	1.9	2.8	2.2	-1.0	-6.0	1.1
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-1.2	-0.6
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.2	5.9
Current Account %GDP	3.3	3.6	3.9	4.8	3.2	2.6	3.0
Euroland							
Real GDP %yr	2.2	1.7	2.9	2.7	0.6	-4.0	0.7
Consumer Prices %yr	2.1	2.5	2.0	3.1	1.6	0.3	0.7
Unemployment Rate %	9.0	8.8	7.9	7.3	7.8	10.0	11.5
Current Account %GDP	0.0	-0.2	-0.5	0.0	-0.2	0.0	0.4
United Kingdom							
Real GDP %yr	3.0	2.2	2.9	2.6	0.7	-4.7	0.3
Consumer Prices %yr	1.3	2.1	3.0	2.1	3.5	1.0	1.2
Unemployment Rate %	2.8	2.8	3.0	2.5	3.1	5.5	7.0
Current Account %GDP	-1.9	-2.6	-3.0	-2.8	-2.3	-3.0	-3.0

Forecasts finalised 6 November 2009

NZD: Reflecting or deflecting good times?

The New Zealand dollar has risen over 40% against the US dollar in the past eight months, at a time when the economy continued to struggle. There are good reasons for the NZD's performance, but it is causing angst at the RBNZ.

Introduction

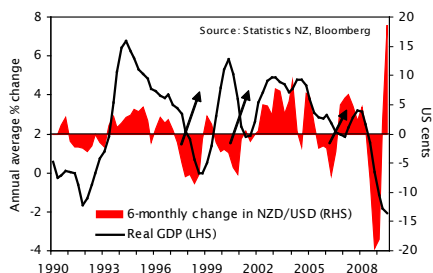
The rise of the NZ dollar has been nothing short of spectacular this year, particularly against the US dollar. During this time NZ's economic prospects have also improved considerably, but from the starting point of a deep hole, following a prolonged recession. At first glance, therefore, the NZD's rise appears unfathomable. The break with historical relationships is worth delving into, as clearly something unusual is going on. It also has major implications for how the NZ economic recovery is likely to play out.

The usual story

Typically, in NZ's recent history, the NZD has tended to fall when the NZ economy goes into recession (Figure 18). This easing in monetary conditions sparks exports, leading off the economic recovery. This was particularly true coming out of the 1998 Asian crisis.

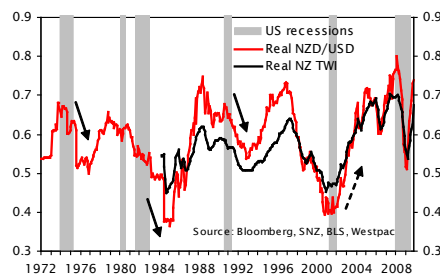
Looking at the NZD/USD from the other

Figure 18: NZ GDP growth versus the change in the NZD/USD



side of the fence, it typically keeps depreciating for 1-2 years after a US recession has ended, as the USD recovers (Figure 19). An exception was post-2001, when there was an exceptionally low starting point for NZ dollar and, unusually, New Zealand avoided recession even though the US was in it.

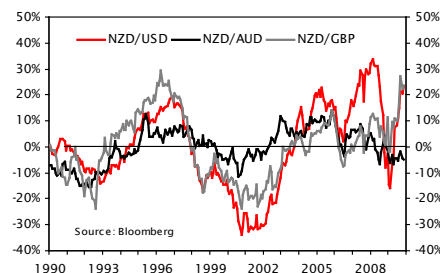
Figure 19: US recessions, real NZ TWI, real NZD/USD



What's happened this time?

Confounding most forecasts of a year ago, the NZ dollar has recovered sharply, particularly against the USD (recovering almost 80% of its fall to a 0.49USD trough) and the British pound Sterling, where the NZ dollar has just passed its mid-1990s high. But the NZD is still below its historical average against the Australian dollar (and even lower in real inflation-adjusted terms, since NZ has had lower inflation than Australia on average over this time) (Figure 20).

Figure 20: Deviation of NZD/USD, NZD/AUD, NZD/GBP from average



What's been driving the NZD up?

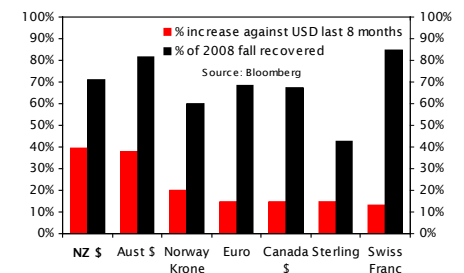
At first glance it seems absurd that our exchange rate is sitting near historic highs against major currencies at a time when the economy is only tentatively emerging from five consecutive quarters of recession and the official cash rate is at extreme lows. The RBNZ is also maintaining a very dovish stance. But it's not all about NZ: there are several good reasons why the exchange rate has behaved as it has.

1. The USD remains out of favour

The USD has weakened against a wide range of currencies, not just the NZD. One reason is pessimism about the outlook for the US economy compared to others, while another is the extremely low level of US interest rates. This means that the USD has become a funding currency for risk trades. In practice, therefore, we have seen stronger US data lead to a weaker USD as money flows out of the US into global risk trades (including buying the NZD). As the global economy has surprised observers with the speed of its recovery, the USD has suffered, driving up exchange rates such as the NZD/USD.

The rise in the NZD in the past eight months has been pretty spectacular (Figure 21), but this partly reflects that its fall was equally dramatic, due to its

Figure 21: Exchange rate increases against the USD



strong correlation with global attitudes to risk, which have swung massively during the financial crisis and its aftermath. Looking at how much of the fall has been recovered, rather than absolute increases, the NZD's rise is not such an outlier.

2. Commodity prices

But of course it must be noted that though the NZD has recovered about the same proportion of its fall against the USD as several other countries, it is returning to near historical highs, not to "normal" levels. And that's because NZ's global commodity prices are returning to levels that aren't "normal" for recent times either. World prices for NZ's commodity exports have recovered much more quickly than even the most optimistic forecasters could have hoped, and this is great news for NZ. Figure 22 below shows that world prices have recovered to above 2005 levels already, significantly off their 2002 lows – despite the world's largest economy only just emerging from recession. World dairy prices are up a staggering 88% in four months at Fonterra's online global auction.

The rapid rise in the NZD/USD looks quite reasonable when lined up against the equally impressive rise in NZ's world commodity prices (Figure 23).

3. China

The third factor explains why our commodity prices have recovered so pre-emptively, and why we think it will be enduring. In a word: China.

New Zealand and, particularly, Australia, are sitting in a sweet spot that is the envy

of developed countries around the world. Despite our deep and lengthy recession, NZ is a "good news" story at the moment, and that is because of our economy's exposure to China and other emerging Asia economies. These countries have bounced back impressively over the past six months, with their renewed demand pushing up commodity prices globally. For most developed nations this entails a drop in their terms of trade as they must pay more for the likes of oil, but don't get much benefit in terms of the prices of the goods they export. Australia and New Zealand, as net commodity exporters, are set to be winners in this equation.

Real prices for NZ's export commodities have been in long-term decline (see Figure 22). But we have argued for quite some time that the structural tide has turned, despite a cyclical sledgehammer hit.

The rebound in Asian economic growth and the related bounce in global commodity prices are not a flash in the pan. As well as the near-term improvement in the GDP outlook for developing Asian nations, there are long-run factors that haven't gone away. Both China and India are urbanising rapidly, and urban dwellers consume a great deal more meat and dairy than their rural counterparts. While there are still easy productivity gains to be made in modernising farming in many areas of the world, a counterbalancing factor is increasing shortages of fresh water for irrigation in many places. China, for example, is forecast to be close to the official definition of "water poor" by 2030.

The positive price story is even more

Figure 22: NZ's real world commodity prices versus US recessions

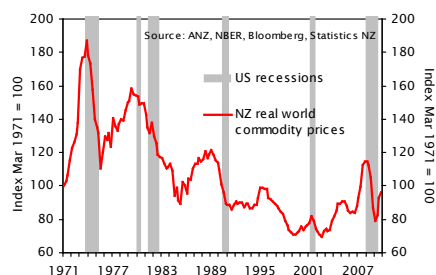
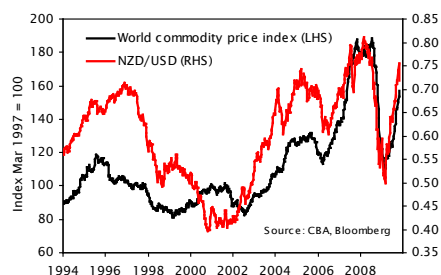


Figure 23: NZD/USD and world prices for NZ's export commodities



convincing for the hard commodities hawked by Australia, and the rapid recovery in their terms of trade goes a long way to explaining why their economy has avoided recession. New Zealand's exchange rate is being dragged up to some extent along with the neighbouring "wonder down under", and appropriately so, since they are our biggest trading partner. There are also other factors that cause Australasia to get a big tick in investors' minds: a financially sound banking sector, relatively respectable fiscal positions, and recent improvement in measures of structural imbalance such as the current account (NZ's current account deficit is now 5.9% of GDP, whereas only a month prior it was thought to be 8.5%).

What does the NZD's bounce mean for NZ's economic recovery?

Such a strong currency means the traditional export volume-led recovery is not going to happen. But the big income boost from the terms of trade jump is still there: consumers and businesses receive a fillip via cheaper prices for imported goods such as petrol. Hence we are still looking at an "export-led" recovery, but in prices rather than volumes. The impact on GDP will be slower, and will be in higher consumption and business investment than we'd have seen otherwise, particularly in the regions as dairy incomes jump, but also around the country as the high NZD makes all imports cheaper.

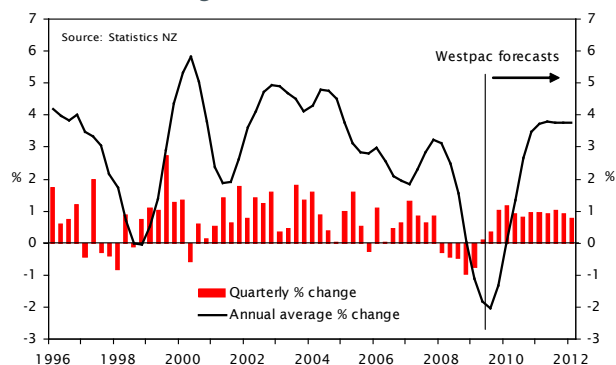
A vote of confidence

Exchange rates are a relative price and not everyone can depreciate at the same time, much as politicians worldwide would like to be able to. Though it might not feel much like it at the moment, New Zealand is considered one of the lucky ones, and the stronger NZD is a relative vote of confidence in our prospects.

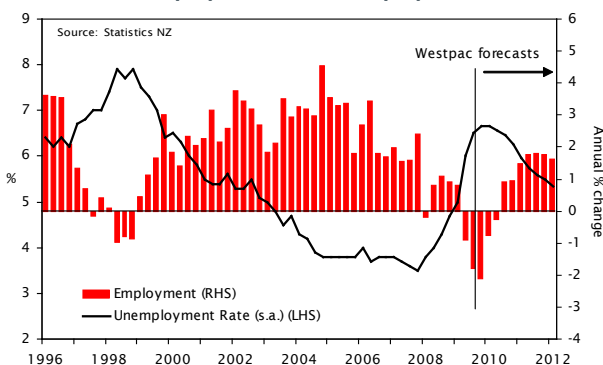
That said, the NZD is very closely tied to global risk sentiment, which could change at any time. Exchange rate forecasting remains, as always, a mug's game.

Annual Average	March years				Calendar years			
% change	2009	2010f	2011f	2012f	2008	2009f	2010f	2011f
Private consumption	-0.8	0.2	2.4	2.8	-0.1	-0.8	2.5	2.5
Government consumption	3.3	0.5	1.4	1.9	3.8	1.1	1.0	1.7
Residential Investment	-23.4	-8.2	24.0	26.5	-18.6	-15.6	18.7	27.0
Business Investment	-3.1	-10.9	6.8	6.4	0.0	-12.4	3.1	8.1
Stocks (% contribution)	-0.2	-1.3	1.9	0.8	0.5	-2.1	1.9	1.1
GNE	-2.0	-2.8	5.9	5.1	-0.1	-4.8	5.2	5.5
Exports	-3.3	1.7	4.9	4.3	-1.3	-0.7	4.5	4.4
Imports	-4.7	-13.3	11.3	8.3	2.0	-17.4	8.8	9.5
GDP (Production)	-1.1	0.0	3.7	3.8	0.0	-1.3	3.5	3.8
Employment (% annual)	0.7	-0.8	1.5	1.6	0.9	-2.1	1.0	1.8
Unemployment Rate (% s.a. end of period)	5.0	6.7	6.0	5.3	4.7	6.7	6.3	5.5
Average Hourly Earnings (% annual)	5.1	3.3	2.6	3.6	5.1	4.0	2.2	3.4
CPI (% annual)	3.0	2.4	2.9	2.8	3.4	2.5	2.4	2.8
Current Account Balance (% of GDP)	-8.1	-2.5	-4.2	-5.3	-8.9	-2.6	-4.0	-5.2
Terms of Trade	-5.0	-8.5	2.8	2.8	1.8	-11.0	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)	4.27	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	57.8	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

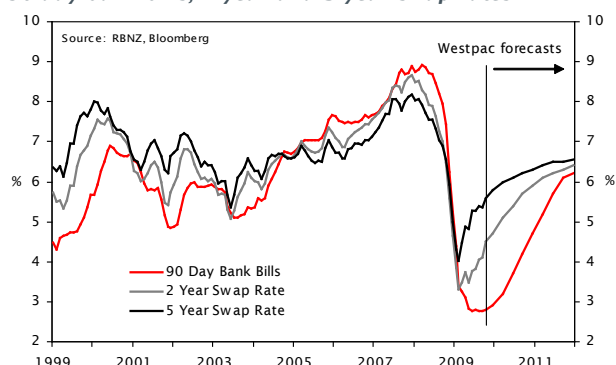
New Zealand GDP growth



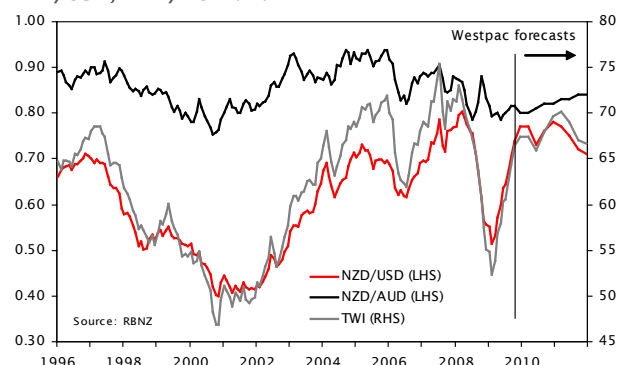
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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