

Turning point

Q3 GDP preview: released 23/12 10:45am NZT

- Revisions to substantially lift level of GDP.
- Recession probably shallower than previously thought.
- Economic activity was at a low level in Q2 and Q3, marking the toughest point in the cycle for business.
- Interest rates to rise in 2010 as output gap starts to close.

GDP expectations

	GDP q/q	GDP y/y	GDP ann avge
Q2 actual	0.1%	-2.1%	-1.8%
Q3 Westpac forecasts	0.2%	-1.5%	-2.1%
Q3 RBNZ forecasts	0.4%		-2.0%
Q3 Market forecasts	0.4%	-1.3%	-2.0%

Economists tend to focus a lot on growth, taking the starting point as a given. So with many lead indicators including business confidence surging higher through the third and fourth quarters – pointing to strong growth ahead – most commentary including ours has become decidedly more upbeat. Indeed, there is likely strong growth ahead.

But lest we forget, the economy was still sporting the deep scars of the recession in Q3. Despite our expectation of a small 0.2% gain in GDP over the quarter, economic and business conditions probably 'felt' worse than at anytime during the recession, as the level of activity hit its lowest point relative to its trend. For the economy as a whole, this is the toughest part of the cycle, or in economist tongue, the output gap was at its most negative in Q3 (although perhaps not as negative as previously feared, see note on revisions below). Forecasts of strong growth ahead need to be put in the context of a weak starting point.

We estimate the economy was largely flat in Q3, expanding a mere 0.2%. This is in line with high-level gauges from business and consumer confidence surveys and the collection of various industry indicators. An outcome close to our estimate would add to our view that a turning point in overall economic activity occurred around the middle of the year.

Figure 1: Production Based GDP

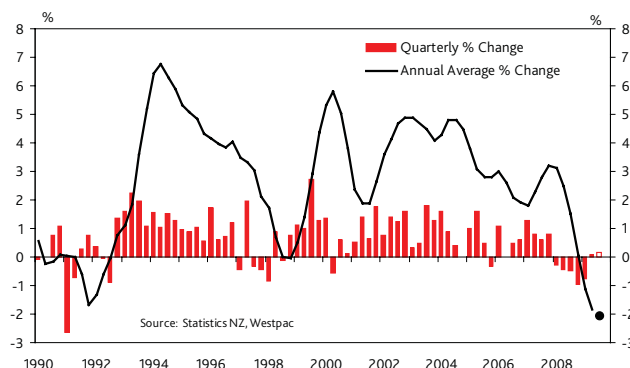
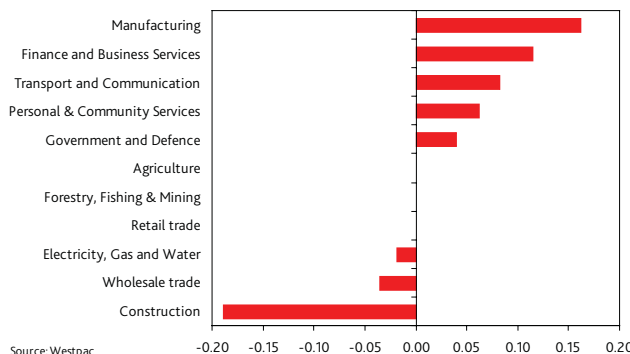


Figure 2: Percentage point contribution to Q3 GDP growth



Even so, there were still plenty of negatives around in Q3. Most notable of these is an anticipated 4.4% contraction in construction, as the frightful economic conditions of 12 months ago saw investment plans delayed or cancelled and a slump in building consents at the time. The resulting drop in both residential and non-residential building activity will show up in Q3.

We expect to see some positive signs in Q3 for the recovery ahead. A much improved outlook for our major trading partner economies and stabilization at home saw export and import volumes rise. Increased freight flow and a bounce back in both

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bodonovan@westpac.co.nz

For all clients: Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141, incorporated in Australia ("Westpac"). The information contained in this report: does not constitute an offer, or a solicitation of an offer, to subscribe for or purchase any securities or other financial instrument; does not constitute an offer, inducement or solicitation to enter a legally binding contract; and is not to be construed as an indication or prediction of future results. The information is general and preliminary information only and while Westpac has made every effort to ensure that information is free from error, Westpac does not warrant the accuracy, adequacy or completeness of the Information. The Information may contain material provided directly by third parties and while such material is published with necessary permission, Westpac accepts no responsibility for the accuracy or completeness of any such material. In preparing the Information, Westpac has not taken into consideration the financial situation, investment objectives or particular needs of any particular investor and recommends that investors seek independent advice before acting on the Information. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. Except where contrary to law, Westpac intends by this notice to exclude liability for the information. The information is subject to change without notice. Westpac expressly prohibits you from passing on this document to any third party. Westpac Banking Corporation is regulated for the conduct of investment business in the United Kingdom by the Financial Services Authority. © 2001
 For Australian clients: WARNING – This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

domestic and international air travel will see transport sector GDP post a solid gain. Meanwhile, real estate will lift on the back of more house sales.

We expect the manufacturing sector to make a strong contribution to quarterly growth, driven by strong growth in a few individual industries. In a similar tone to the wider economy, this growth should be viewed as a bounce off an extremely low base, rather than a pointer to buoyant conditions in the sector. The standout growth will come from metals, as production at the Tiwai Point aluminum smelter was restored after a transformer failed in November 2008. Wood and furniture manufacturing will also post strong gains from very low levels previously.

The consumer will again be notably absent as a material contributor to growth in Q3, extending the trend of the past two years. We expect overall consumer spending was flat during the quarter despite strong impulses from net migration and the lagged effect of interest rate cuts. Rising unemployment and debt repayment were no doubt key offsets, but we also harbor a view that Swine Flu had a suppressing effect on spending in Q3. In any event, real spending is likely to be stronger in Q4 if the rising trend in electronic transactions, soft price indicators and a ramping up of car registrations are anything to go by.

Revisions

Each year, Q3 brings more than the usual revision risks as new benchmarks (from the annual accounts released in November) and the accompanying updated chain weights are included into the quarterly national accounts. The table shows the difference between nominal GDE published last quarter and the new annual benchmarks.

Nominal Gross Domestic Expenditure

March years	Previous \$m	Revised \$m	Revision \$m	Previous %	Revised %	Revision %
2004	139,938	141,702	1,764			
2005	150,026	151,700	1,674	7.2	7.1	-0.2
2006	157,441	160,273	2,832	4.9	5.7	0.7
2007	166,121	168,328	2,207	5.5	5.0	-0.5
2008	177,939	180,827	2,888	7.1	7.4	0.3
2009	179,821	183,737	3,916	1.1	1.6	0.6

Key points from these revisions are:

- The level of nominal GDE will be close to \$4 billion (2.2%) higher than published in the Q2 accounts.
- Growth in nominal GDE was 0.6% stronger in March year 2009 than previously published in the quarterly accounts. Some of this is likely to flow through to real GDP growth, meaning that the recession to March 2009 was a little shallower than previously estimated.
- Less negative real growth means the output gap may not have been as negative as earlier estimated.

In addition, the updating of chain weights has the potential to mildly alter the quarterly profile of historical growth and adds to the error bounds around our Q3 estimate of 0.2% growth. Despite a wider error bound this quarter, the overall risks to our point estimate seem balanced.

Market implications

A key aspect for policy will come from the balance of any surprise in Q3 growth and the output gap implications from revisions. An outcome for Q3 growth on our forecast of 0.2% would be lower than the 0.4% published in the RBNZ's December *Monetary Policy Statement* and may generate some mild initial market reaction. However, we are wary that the general upward revision to the level of GDP and implicitly less negative output gap could well outweigh any negative surprise on the latest quarterly movement (or amplify any upside surprise). More generally, the pace of economic recovery from the turning point in the Q2 and Q3 period will be a critical factor behind the timing and speed of monetary tightening in 2010. Strong lead indicators to date suggest the first interest rate hike will be in the first part of the year.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250

Doug Steel, Senior Economist, Ph: (64-4) 470 8251