

Economic Overview

July 2010

Highlights

- **A traditional recovery** – our most recent GDP data confirmed that the recovery which ‘officially’ began in the June 2009 quarter, continued in the early stages of 2010. GDP has expanded by close to 2% in the last year, about average for the first year of recovery. The growth so far has been predominantly export-led. Consumer-related sectors have been slow to participate. However, we don’t think it will be long before they do (*see Economic Outlook, page 2*).
- **All dressed up, looking for somewhere to go** – we continue to expect the most pro-cyclical sectors to post the strongest growth rates over the next few years. These sectors include construction, its related industries (non-metallic minerals, wood, furniture), publishing and advertising, transport, and sectors supporting plant and machinery investment (*see Sectoral Trends, page 4*).
- **The “Greecey” road to recovery** – Asia remains firmly entrenched in a V-shaped recovery. Even Japan is enjoying robust growth, although not enough to end deflation. Meanwhile, the pace of recovery has clearly slowed in the US. Many European countries are facing fiscal cutbacks, and fears for the safety of banks that lent to governments on Europe’s periphery are casting a long shadow over the continent (*see International page 8*).
- **There and back again** – growing pressures on inflation over the next couple of years will keep the RBNZ working towards normalising monetary policy settings. Meanwhile, the recent turmoil in international markets has shed much heat but very little light on the outlook for currencies, leaving our New Zealand dollar forecasts little changed compared to three months ago (*see The Markets, page 6*).
- **Housing** – over the past three years house prices have fallen 3% against inflation of 9%. However, house prices have further to fall as tax changes have made property a less attractive investment. We expect the market to remain very subdued over the next few years as tax changes work through the system, interest rates rise, and the current shortage situation is gradually alleviated (*see Feature article, page 10*).

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A traditional recovery

NZ is in the midst of a traditional economic recovery led by income growth in the export sector. The domestic-focused sectors of the economy have been slow to participate, but we don't think it will be long before they do.

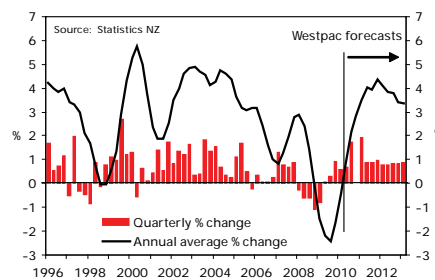
The recovery that 'officially' began in the June 2009 quarter pushed on in the early stages of 2010. GDP expanded by 0.6% in the March quarter, although that was softer than the 0.9% recorded in the December 2009 quarter, and a little weaker than we anticipated. A two-speed economy is now clearly evident, with the goods-producing (particularly export) sectors leading the growth charge while the consumer-related sectors of the economy lag behind.

Still, the economy has expanded by almost 2% in the first year of recovery. That is about average relative to previous economic upturns, at least in the post-war era. Moreover, NZ economic recoveries have always begun in the export sector. And, typically, it is not until the second year of recovery that growth accelerates as the recovery broadens to include the consumer and business investment. We think this time will be no different.

Indeed, despite the recent ructions in global markets and a soft patch in household spending, we believe that the economy is still on track to achieve respectable economic growth over the next few years. Our forecasts see GDP expanding by 2.9% in calendar 2010, with exports and residential investment leading the charge. In calendar 2011, we expect growth to accelerate to an above trend pace of 4.4%, as strong income growth brings consumers out of hibernation and a solid investment cycle (both residential and business) gets under way. Thereafter, we forecast GDP growth to ease back

toward 3.5%. That growth profile is slightly weaker than forecast in our April *Economic Overview*, but remains at the top end of market expectations.

Figure 1: GDP production



While we remain optimistic about NZ's prospects over the next few years, there is still plenty to worry about. A key development in recent months has been the escalation of concerns around sovereign debt in Europe and the emergence of fears over a double-dip in global growth. A renewed financial crisis would undermine global investor confidence, derail the global recovery, and hit our commodity prices hard. However, we put low odds on such an outcome (see our *International* section). Moreover, the changing composition of global growth and our key export destinations in recent years means that we are no longer as susceptible to shocks from Europe and the US as we used to be.¹

Back home, some sectors of the economy have been slower to respond to the improving economic conditions than we anticipated. Residential investment is an obvious example, with actual construction activity so far failing to live up to the sizeable increases we have seen in building consents. Big questions also remain around consumer spending. In particular, is the recent cautious spending by the consumer reflective of a temporary or more permanent shift in behaviour? For the moment, we continue to believe

activity in both sectors will pick up over the coming year. But only time will tell.

It is also worth bearing in mind that the upcoming changes to the tax system (announced in the Government's 2010 Budget) will complicate matters over the next few quarters. Specifically, the increase in GST on 1 October 2010 will bring a lot more noise into the quarterly inflation and consumption data, making the interpretation of underlying developments more difficult. We cover the inflation aspect in our *Financial Markets* section. However, in terms of consumer spending, history shows that consumers are likely to bring forward some purchases to beat the GST hike, thus boosting spending in the September quarter this year, but at the expense of spending in the December quarter. On our estimates, that will see quarterly GDP growth surge close to 2% in the third quarter this year, before dropping toward zero in the fourth quarter.

Export party central

As a trade-dependent nation, what's happening to our terms of trade (our export prices relative to our import prices) is crucial to our long-term economic outlook. Fortunately, right now it is through the roof. The terms of trade rose almost 6% in the first quarter of this year, the largest quarterly increase since 1976. And at current levels, the terms of trade is now just 5% shy of the pre-crisis high – a mark we think will be exceeded by the end of the year.

Thus, the resurgence of the terms of trade is a key part of our sustainable growth story. Over the coming year, we expect the higher export income to flow through to income growth in other sectors, supporting both balance sheet restoration and solid investment growth.

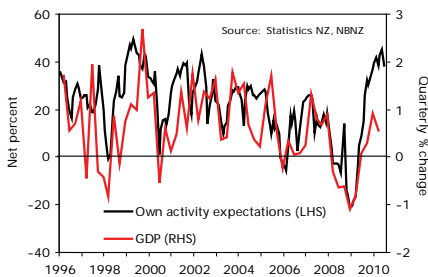
Primed for growth

Recent economic indicators give us confidence that the growth baton will eventually pass from the export sector to the domestic sectors of the economy:

- business and consumer confidence remain elevated;
- farmers will continue to benefit from the lagged effects of high commodity prices (Fonterra’s recent forecast of a near record payment for the 2010/11 season being a case in point);
- agricultural production will be bolstered by better growing conditions in the coming season as we recover from drought;
- government stimulus is forecast to continue with the 2010 Budget providing for an additional \$5.9bn in core crown operational spend in the 2011 June year alone;
- dwelling consents are up 40% from the lows reached in early 2009, and are 11% higher than a year ago, suggesting a solid pickup in residential construction later this year; and,
- bank credit constraints are easing.

Importantly, we are not concerned by the recent softer tone to business surveys. Although most of the confidence and activity indicators have eased back from the highs earlier in the year, they are still consistent with robust GDP growth. Moreover, there’s little to suggest that the post-recession economy has been left with an overhang of spare capacity. Measures of capacity utilisation are right on their average for the last decade. We expect business investment to rise as the recovery becomes more entrenched, business profitability improves, and the

Figure 2: Business activity and GDP



labour market tightens. Our forecasts see a solid business investment cycle kicking in from the end of this year, with growth of close to 15% in calendar 2011 and a further 8% in calendar 2012.

Sticking points

The notable exceptions in the domestic story at present are the housing market and consumer spending. Our *Feature* article discusses the outlook for housing in more detail, but suffice to say we expect house prices to remain soft for some time, although we do not expect that to preclude a sizeable residential investment recovery.

Retailers, meanwhile, are bearing the brunt of the weakness in the housing market. Indeed, growth in consumer spending slowed to barely a trickle in the first quarter of the year. The grim state of affairs in the housing market, combined with high levels of household debt, have left many people wondering how consumer spending could possibly pick up the pace over the coming year. But in our minds the key driver of consumer spending in this cycle was never going to be housing wealth or debt. Rather the key influence was always going to be the labour market or, in other words, jobs and income growth.

Tax changes will also be important. To date, consumers have almost solely focused on the increase in GST and not the sizeable cuts to marginal income tax rates. That appears to have added to their cautious mood so far this year. However, we suspect that once people actually experience the increase in their take-home pay, many could be pleasantly surprised.

Jobs critical

Jobs growth will be the key to a self-sustaining recovery over the next few years. With consumer spending such a large component of the economy, if people are concerned about their jobs and their incomes they will be reluctant

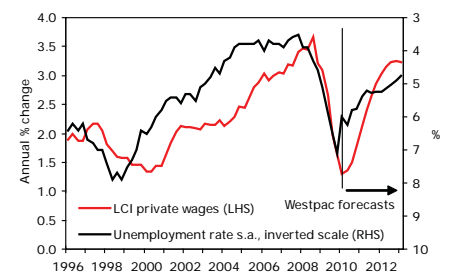
to spend. The good news for NZ is that even the labour market – the traditional laggard in the economic cycle – has now convincingly turned the corner.

The unemployment rate recorded a stunning (and we think overstated) drop in the first quarter of the year, falling from 7.1% in the December quarter to 6.0% currently. The number of employed rose by 25,000 in seasonally adjusted terms, resulting in a 15,000 drop in the number of unemployed. The detail of the survey was even more encouraging, with all of the employment growth coming from full-time jobs. That suggests that firms are confident that the increase in demand so far is permanent rather than temporary.

Our forecasts see surveyed employment being quite volatile over the course of 2010. However, we expect an improving underlying trend as firms initially look to the labour market as the fastest way to meet increased demand. That should see further declines in the unemployment rate from 6.0% currently to 5.7% by the end of 2010, and close to 5% by the end of 2011.

The current level of unemployment already suggests that there is less slack in the labour market than previously thought. That means wage pressure will likely rear its head earlier than anticipated, particularly as pent-up pressures from very slow wage growth through the recession combines with high and rising inflation later this year. We forecast annual wage growth to lift from 1.5% currently, to a peak of 3.6% in calendar 2011.

Figure 3: Unemployment and wages



¹ See our June 2010 *Agribiz* for a more detailed discussion.

All dressed up, looking for somewhere to go

The recovery so far has been predominantly export driven. The domestic consumer has been missing in action, mainly worried about a weak housing market. Improving jobs and wages will eventually see the consumer bolstering the recovery, but for now the recovery remains dominated by foreign consumers' demand for New Zealand's products.

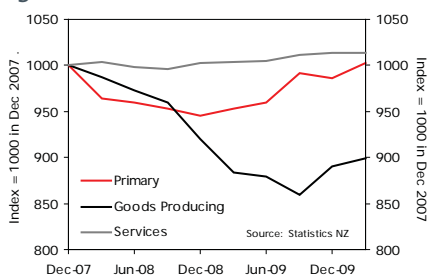
Overview

During the initial stages of New Zealand's recession, it was the primary and goods-producing sectors that were most severely affected. The service sectors, in aggregate, went sideways.

Once the Global Financial Crisis hit, the brunt of the production downturn was disproportionately borne by the goods-producing sectors (see Figure 4). However, both the primary and goods producing sectors were hit by marked falls in prices received for their products.

Interestingly, as at March quarter 2010, the production of both the service and primary sectors were above their pre-recession levels. In contrast, activity in the goods producing sectors was still 10% below.

Figure 4: Sectoral real GDP



The primary sector's recovery has been more spectacular than the production volumes indicate. Prices have been resurgent from their post-GFC low points (generally around September/October 2009). A higher NZD has taken away some of the gains, but even in NZD terms the increases have been impressive. As at June 2010, compared to their 2009 low, dairy prices were up 52%, meat, skins and wool 44%, forestry products 33%, seafood 17%, and horticulture 9.3%. It is this dramatic improvement in prices that is restoring primary firms' balance sheets, and will eventually feed through to stronger investment.

We continue to expect the typically most pro-cyclical sectors to post the strongest growth rates over the next couple of years. These sectors include construction, its related industries (non-metallic minerals, wood, furniture), publishing and advertising, transport, and sectors supporting plant and machinery investment.

Agriculture

The El Niño weather conditions that slammed agricultural production in March and April have passed. The weather boffins expect La Nina conditions to develop. If so, this is good news for the coming growing season – La Nina

conditions are generally associated with favourable pasture growth. Dairy production could be up around 8% in the coming season. High dairy prices have encouraged increased Northern Hemisphere supply, so we are starting to see prices ease. We expect prices to come off a further 20% or so over the coming year, particularly as Southern Hemisphere production is ramped up. Even with that, we expect a \$7.10 payout in the 2010/11 season followed by a circa \$6.00 payout subsequently.

Northern Hemisphere demand for meat has been adversely affected by weak economic growth in the region, but prices have held at high-ish levels due to short supply. We expect that mix to continue over the coming year.

Construction

Construction activity in March quarter 2010 was still 15% below its pre-recession levels. Residential building consents have generally been lifting for the past 16 months. In the three months to May 2010, consents were 25% above year earlier levels. However, it is taking longer than normal for the consents to show up in building work. Both nominal and real work put in place was down 2% in March quarter 2010 compared to the year before. We expect

Figure 5: Commodity prices

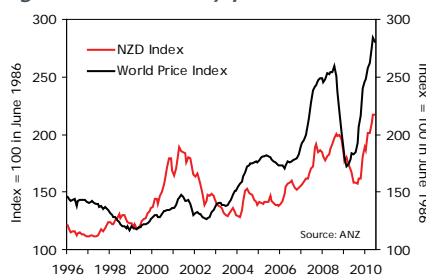
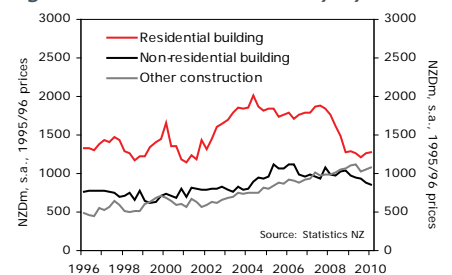


Figure 6: Construction activity by sector

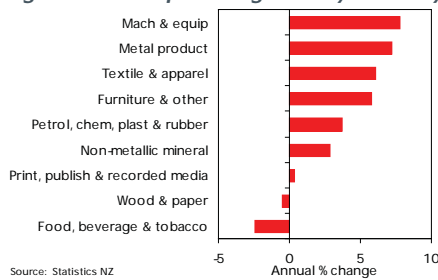


activity to significantly pick up from here on. In contrast, the prognosis for non-residential construction is weak. There is the standard post-recession overhang of capacity (particularly in the office market), and consents are around 20% below year earlier levels. Infrastructure activity will remain strong. Adding it all up, we expect the construction sector volumes to grow 10% in the coming year.

Manufacturing

After four years of virtually uninterrupted decline, the manufacturing sector has turned the corner. In the half year to March 2010, volume of activity lifted 7%. The bad news is that activity is still 15% below its peak levels. Nonetheless, strong growth in our Austral-Asian trading partners, a NZD/AUD exchange rate close to fair value, and a rebound in the primary and other goods producing sectors of the economy auger well for the recovery in manufacturing to be maintained. Food manufacturers will get a boost from an expected good growing season while a domestic economic recovery will particularly benefit manufacturers of non-metallic minerals, metal products, printing, machinery and equipment, and wood and paper.

Figure 7: Manufacturing GDP by industry

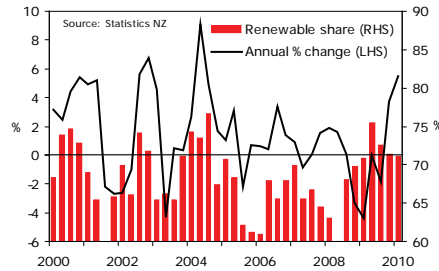


Electricity, gas and water

Electricity generation pegged back a touch in March quarter, falling 0.1% (seasonally adjusted). The sector's contribution to GDP declined by more (2.1%), mainly because the share of renewables generation was down in the quarter (thanks to a long dry summer). We expect the sector to run a bit ahead of growth in

the general economy over the next couple of years, as a result of our expectation that growth will be skewed toward the more energy-intensive goods-producing sectors.

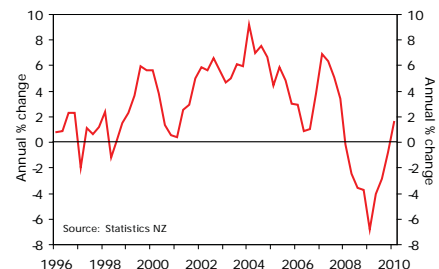
Figure 8: Electricity generation



Retail trade

Consumers have been very circumspect so far through 2010. Retail sales have pretty much gone sideways since the end of 2009. We expect that a downturn in the housing market (due to rising interest rates, slowing population growth and tax changes) has been to blame for the lacklustre retail performance. The GST hike and income tax cuts from 1 October will have a big impact on quarterly sales profiles. In a bid to beat GST, we expect sales of durable goods to be up 10% in the September quarter, non-durables to be up 3% and services unchanged. Most of that will be unwound in December quarter. Higher dairy cashflows in July-September will also boost retail sales in the September quarter. Sustained growth in retail sales will follow a pickup in employment and after-tax wages.

Figure 9: Retail sales volume growth

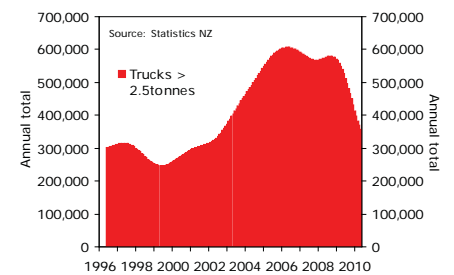


Transport

The pickup in the transport and storage sector has been gaining a bit of

momentum. Activity is now 4% above its June 2009 lows (but still 8% below its pre-recession peak). This increase has been mostly due to a lift in export volumes, and partly due to slightly higher international traveller movements. Higher primary production in the coming season will benefit this sector, as will a gradually improving consumer. We expect transport and storage to be one of the 'out-performers' in the next couple of years, but there is substantial existing capacity to meet that growth.

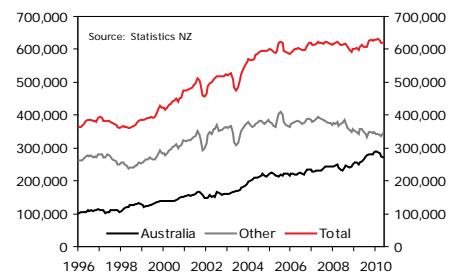
Figure 10: Truck registrations



Tourism

The recovery in New Zealand visitor arrivals is temporarily running out of steam. The huge influx of Australian visitors that were the saviour of the industry in 2009 has begun to wane. Meanwhile, there are early signs that visitor numbers from other countries are slowly beginning to pick up. In the three months to June 2010, visitor arrivals to NZ increased by 2.2% compared to the same period a year ago. This is slower than we were anticipating and growth in visitor arrivals in calendar 2010 may be just 3%. An influx of tourists for the Rugby World Cup, and the global economic recovery, should see visitor arrival growth approaching double digits in 2011.

Figure 11: Visitor numbers



There and back again

The recent turmoil in international markets has shed much heat but very little light on the outlook for currencies, leaving our New Zealand dollar forecasts little changed compared to three months ago. High export commodity prices and a directionless US dollar support our view of a higher NZD by year-end. Growing pressures on inflation over the next couple of years will keep the RBNZ working towards normalising monetary policy settings.

Exchange rates

Compared with some of the wild swings in foreign exchange markets in recent months, the New Zealand dollar has looked like a beacon of stability. Since late January it has traded slightly either side of 0.70 against the US dollar, aside from a brief round-trip to 0.66 when European sovereign debt concerns came to the fore in May-June.

That stability is probably by accident more than anything, when you consider the range of opposing forces arrayed against the currency – few of which have much to do with the state of the New Zealand economy. Indeed, there's been little on the domestic front that might influence market views on the NZD: recent data has generally been a bit softer than expected, but nothing to suggest

that the economy isn't on track for activity to be stronger and interest rates to be higher in a year's time.

Instead, day-to-day movements in the exchange rate have generally been – and will likely continue to be – dictated by the fickle sentiment of global markets. For instance, the NZD has shown an unusually high correlation with the S&P 500 index – which helps to explain changes in hindsight, but in terms of forecasting it merely shifts the burden from one volatile and erratic market to another.

Having said that, we note that credit markets have put in several weeks of solid improvements, and turning points in this segment of the market tend to lead government bond yields, then share prices, then exchange rates. Our best guess is that in time investors will become more comfortable with Europe's debt situation and the hysteria about a US double-dip recession will die down, both of which favour a stronger NZD.

Going beyond these short-term movements, we continue to emphasise that the key factors for the NZD are the strength of the market for our commodity exports, and the outlook for the USD. World prices for our commodities remain close to record highs, and even after adjusting for general inflation, they're still at their most favourable in over two

decades. The upturn has been fairly broad-based as well, reflecting ongoing Asian demand for dairy, meat, logs and so on.

The NZD hasn't matched the most recent surge in commodity prices – which on the face of it would suggest that the currency is actually cheap, not overvalued, at these levels. However, rather than a harbinger of further gains in the NZD, it may well reflect market expectations of a softening in commodity prices in coming months. There are already signs of this happening: milk powder prices were close to 'limit down' in Fonterra's latest online auction, thanks to uncertainty about global demand and increasing supply from the Northern Hemisphere. But the general upward shift in the level of commodity prices still provides support for our forecast of a stronger NZD by year-end.

As for the USD, the market has been caught between evidence of slower US growth and its appeal as a safe haven as European financial markets have wobbled. Our view remains that a sustained rise in the USD (and hence a sustained drop in the NZD) depends on a shift to the other side of the 'dollar smile' – that is, demand for the USD as an investment destination in the context of a strong global economy, rather than as a safe haven in the context of a weak world economy. That increasingly looks like a

Figure 12: NZD/USD and commodity prices, adjusted for inflation

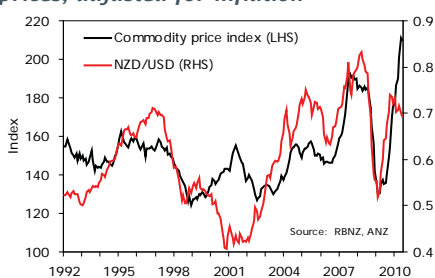


Figure 13: NZD/USD and TWI (monthly average)

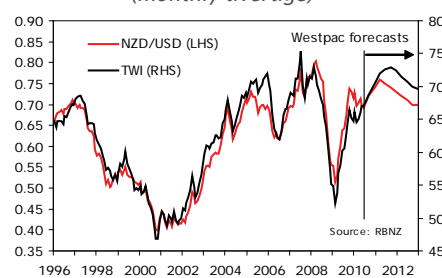
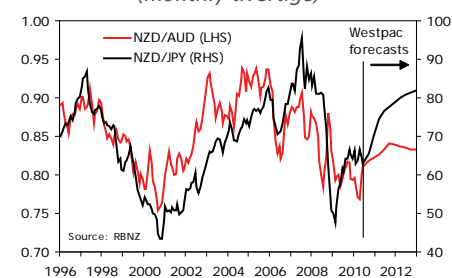


Figure 14: NZD/AUD and NZD/JPY (monthly average)



story for next year and beyond, not this year.

Interest rates

Little change in the outlook for interest rates, apart from the fact that the RBNZ has now started to turn expectations into action. The June *Monetary Policy Statement* made it clear that the 25bps increase in the OCR should be seen as the first in an extended series of hikes, with the 90-day rate projected to reach a more 'neutral' level of around 6% by the end of 2012. That's not quite consistent with a 25bps hike at every review date for the next couple of years – but it's not far off.

There are two related reasons for going through with this. First, the RBNZ is now sufficiently confident that the economy is returning to normal, which suggests that monetary policy settings should be doing the same. The process of rebalancing means that the recovery isn't being felt everywhere at once: household spending

and credit growth are still subdued, and stronger export earnings will take some time to filter through to other parts of the economy. But there's no indication that the recovery is proceeding more slowly than usual, or that it is at any greater risk of faltering.

The second reason is that inflation in 1-2 years time will be a much more pressing issue than it is today. With the economy on the mend, underlying inflation is projected to return to the upper half of the 1-3% target range, even with the dampening effect of rising interest rates over the next few years. Add to that a raft of government charges – the GST increase, the ETS, and several rounds of tobacco excise hikes – and annual inflation is set to reach about 5% by the middle of next year. The RBNZ can look through the direct effects, but a third breach of the target band in five years will raise some tough questions about whether medium-term inflation expectations will remain in check.

Our forecasts are consistent with a 25bps hike at every review date up to early 2012, but don't take this literally – think of it instead as a weighted average of the likely outcomes. There's a good chance that the RBNZ will pause somewhere along the way, to assess the impact of the hikes to date. But there's also a good chance that it could be carried into larger moves, if inflation doesn't behave as hoped.

After all, the OCR will be abnormally low for a while yet – a year of uninterrupted hikes would only bring it back to 4.50%, its previous record low. And we argue that many of the proposed reasons why the RBNZ won't need to do as much work in this cycle don't really stack up: the share of borrowers on floating rates is much the same as at the start of previous tightening cycles, the yield curve is no longer unusually steep, and the push for banks to secure more long-term funding could actually blunt the effectiveness of OCR moves in isolation.

Figure 15: CPI inflation forecasts

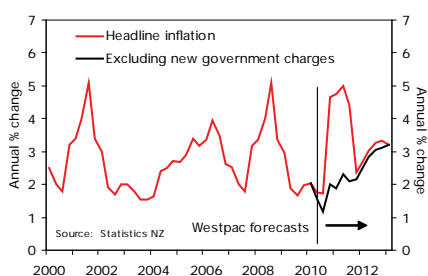


Figure 16: Proportion of mortgages on floating rates

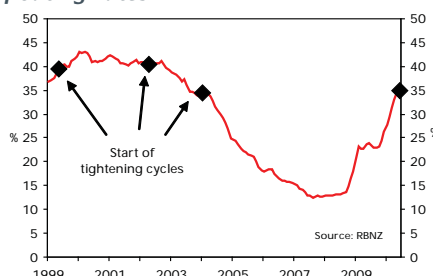
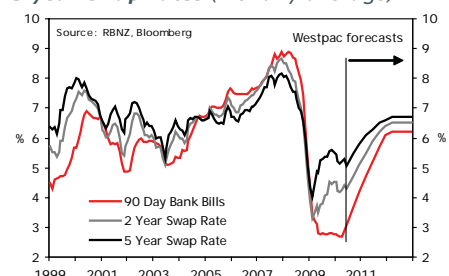


Figure 17: 90 day bank bills, 2 year and 5 year swap rates (monthly average)



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
Sep-10	3.25	3.70	4.70	5.50	0.72	0.82	65.5	68.7
Dec-10	3.75	4.20	5.10	5.80	0.74	0.82	70.3	70.4
Mar-11	4.25	4.70	5.50	6.10	0.76	0.83	74.5	71.9
Jun-11	4.75	5.20	5.90	6.30	0.75	0.83	76.5	72.5
Sep-11	5.25	5.70	6.20	6.50	0.74	0.84	77.7	72.9
Dec-11	5.75	6.10	6.40	6.60	0.73	0.84	78.8	72.4
Mar-12	6.00	6.20	6.50	6.70	0.72	0.84	79.9	71.5
Jun-12	6.00	6.20	6.50	6.70	0.71	0.84	80.9	70.7
Sep-12	6.00	6.20	6.50	6.70	0.70	0.83	81.2	69.9
Dec-12	6.00	6.20	6.50	6.70	0.70	0.83	81.9	69.7
Mar-13	6.00	6.20	6.50	6.70	0.70	0.83	82.3	69.5
Jun-13	6.00	6.20	6.50	6.70	0.69	0.83	82.8	69.3

The “Greecey” road to recovery

Asia remains firmly entrenched in a V-shaped recovery, led by China. Even Japan is enjoying robust growth, although not enough to end deflation. Meanwhile, the pace of recovery has clearly slowed in the US. Many European countries are facing fiscal cutbacks, and fears for the safety of banks that lent to governments on Europe’s periphery are casting a long shadow over the continent. Overall, the globe is on track to record trend growth of around 4% in 2010 and 2011.

USA

The US economic recovery rolled on in the first quarter of 2010, with GDP growing at an annualised pace of 2.7%. There has been a modicum of improvement for the labour market, with non-farm payrolls registering jobs growth of just over one million between January and May (although some were temporary Census workers), and the unemployment rate dropping to 9.5% – still very high, but better than last year’s peak of 10.1%.

But the most recent data has exhibited a decidedly softer tone. Regional Fed surveys, the venerable ISM surveys of manufacturing and non-manufacturing enterprises, initial jobless claims and the ECRI leading indicator all worsened in June. The evidence so far suggests slower growth through the middle of this year, perhaps around the 1.5% pace, rather than anything as dramatic as a second recession.

As the beneficial effects of inventory rebuilding and fiscal stimulus wear off, America is entering its post-GFC reality. Households are in balance-sheet repair mode, so consumers won’t party like they did last decade. There is a glut of

houses for sale, so no need for much construction. And the fragile banking system is making it difficult to get credit, especially for small businesses and start-ups. Government has picked up the baton of unsustainable spending, held by consumers last decade, but fiscal stimulus cannot prop up the economy forever. The fiscal war-chest was empty even before the recession began, and the deficit is now epic. A painful fiscal tightening will be forced at some point in the future.

China

China’s growth can still be described as spectacular, but the pace has slowed a little after measures aimed at preventing an inflationary bubble were taken in April. Annual growth in industrial production has slowed to 13.7%, from a peak of 18.1%, and growth in bank lending over the past year was down to 21.5% from 34% last year. However, it’s not clear that the cooling measures have been enough. Retail sales are still rising at 18.3% per annum, inflation is 3%, and annual property price inflation is 12.8%. One difficulty is that China must keep interest rates comparable to rock-bottom US rates to support its exchange rate regime. The People’s Bank of China has announced that it will allow the exchange rate to appreciate slowly against a basket of currencies. We expect nominal appreciation of about 2% to 4% per annum, depending on how Chinese inflation compares to that of the US.

Australia

The pace of the Australian recovery has peeled off a bit as the interest rate sensitive sectors such as housing and retailing react to the RBA’s six cash rate hikes. However, the mining sector is back in full swing, and employment growth has been outstanding – 327,000 jobs

have been created in ten months, helping to reduce unemployment to 5.1%. We anticipate annual GDP growth of 3.7% over the next year. Core inflation is still higher than the RBA would like, so we anticipate 50bps more of cash rate hikes this year.

Other Asia

Even outside of China, Asia’s economy is roaring. Singapore’s GDP rose 19.1% in the year to June 2010 – an indication of the strength of Asian regional trade activity. Rampant inflation pressures in India’s 9%-growth economy prompted a rare inter-meeting hike from the central bank. Industrial production in Korea, Taiwan and Singapore is up 22%, 31% and 59% respectively over the year. Even stately old Japan is having a better time of it. The most recent Tankan survey revealed surprising strength in manufacturing activity and employment, on top of the 4.2% GDP growth experienced in the year to March 2010. However, there is no end in sight for Japan’s deflation.

Europe and UK

Europe is not a happy place to be this year, as serious doubts emerge about the ability of some Eurozone governments to service, refinance or repay their debts. For peripheral countries, entering the common currency meant the lowest interest rates in generations. The resulting housing booms and consumer spending sprees boosted tax revenues, temporarily. But Governments put in place new spending that was permanent. After the GFC hit, the debt- and housing-fuelled peripheral economies crashed hard, tax revenues plunged, and Governments found themselves spending grossly more than they earned with hard-currency debts and no option of devaluation to ease the burden.

Ireland has opted for fiscal austerity, slashing public sector pay, benefits, and Government spending. Contrary to fears that austerity would worsen recession, March quarter GDP expanded 2.7% in Ireland. The Greek Government's austerity measures have been woefully inadequate, and widespread civil unrest is hampering further efforts. Recent debt rollovers did progress thanks to EU and IMF support, but Greece still faces the very real prospect of default or bailout. Portugal, Spain and even Italy will eventually have to choose between the devil of default or the deep-blue sea of austerity.

The practical implication of default would be to further weaken shaky European banks, which in turn would forestall the European economic recovery and could curtail credit availability around the globe. And, of course, financial markets' fear that this *might* happen has already sent equity prices lower. However, we don't expect credit markets to freeze like they did during the sub-prime mortgage collapse. Back then the main problem was lack of information – about who held the toxic debt, and about what the various individual holdings were worth. In the case of European sovereign debt there

is a better sense of who holds the debt, and a much better sense of the range of possible outcomes.

The UK has recently announced savage budget cuts to address the massive fiscal deficit there. Counter-cyclical policy has, rightly in our view, been handed back to the Bank of England, while the Exchequer puts its house in order for the long term. The immediate pain of the budget cuts confirms our view that there is no prospect of Bank of England monetary policy tightening this year.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
New Zealand							
Real GDP % yr	3.2	1.0	2.8	-0.2	-1.6	2.9	4.4
CPI inflation % annual	3.2	2.6	3.2	3.4	2.0	4.7	2.4
Unemployment %	3.7	3.8	3.5	4.6	7.1	5.7	5.2
Australia							
Real GDP % yr	2.8	2.9	4.0	2.3	1.3	3.0	3.5
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.4	3.1
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.1	4.9
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.7	2.8
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.2	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.0
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.1	1.4
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-1.1	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	4.8	4.5
Euroland							
Real GDP %yr	1.8	3.1	2.8	0.5	-4.0	0.6	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.0	1.2
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.5	-4.9	0.5	1.3
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	2.0
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	5.0	5.0
China							
Real GDP %yr	10.4	11.6	13.0	9.0	8.7	10.6	9.1
Consumer Prices %yr	1.8	1.5	4.8	5.9	-0.7	2.9	2.9

Forecasts finalised 9 July 2010

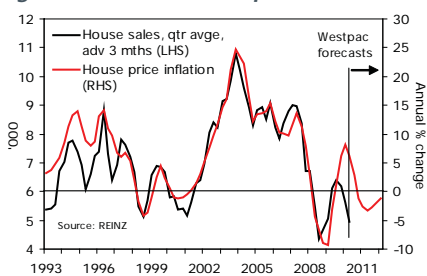
Tax and housing

Over the past three years house prices have fallen 3% against inflation of 9%. However, house prices have further to fall as tax changes have made property a less attractive investment. We expect the market to remain very subdued over the next few years as tax changes work through the system, interest rates rise, and a pent up shortage of housing is gradually alleviated.

Market activity

It has been a slow year for the housing market. Sales have been subdued all year. Inevitably, the time taken to sell a house has lengthened. The REINZ's House Price Index indicates that prices are now trending lower. And the slow pace of house sales right now is a solid indication that prices will continue declining gently through to about September. As we predicted last year, the mid-2009 market resurgence turned out to be a "flash in the pan."

Figure 18: REINZ house prices and sales

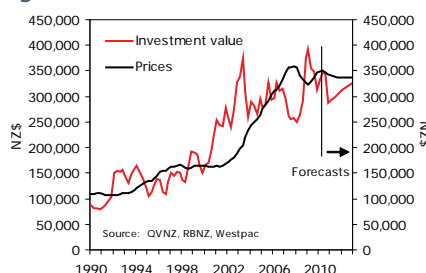


Bugging the market over 2010 have been rising interest rates, impending tax changes, and slowing population growth. The positive vibe of an improving economy has not been enough to counterbalance these negatives. We foresee more of the same. Interest rates will rise further, tax changes are now an unfavourable reality for property prices, and population growth is still slowing. So we are forecasting modest house price

declines over the period ahead.

In late-2007 we noted that houses were 15% overvalued, and predicted house price inflation would "...allow a few points either side of zero, with prices in five years' time similar to today." Almost three years on, prices are 3% lower than they were back then. Over the same period inflation has been 8.8%, so the real house price decline has been almost 12%. We are "almost there" in terms of the adjustments necessary to correct the mid-2000s house price overvaluation. However, impending tax changes will reduce the fundamental value of houses, creating a renewed reason to expect ongoing price weakness.

Figure 19: Prices vs investment value



Tax changes and house prices

The income tax cuts will reduce the tax-shelter value of property ownership. The link between income tax and house prices is slightly obtuse, but very real. The link exists because New Zealand's tax system allows property owners to avoid income tax while enjoying tax-free capital gain. Landlords receive tax rebates for cash losses on their properties, but their capital gains are usually untaxed. The recent tax cut will make landlords' annual rebates smaller, thus increasing the cost of owning an investment property. Freehold owner-occupiers avoid income tax in the sense that any other investment would incur tax on the flow of benefits, while owner-occupied housing does not.¹

The tax cut will improve the return on alternative investments relative to buying a bigger/better house.

Other tax changes have smaller implications for house prices. Much has been made of the removal of depreciation allowances, but that's actually a minnow. It will seriously harm cash flow for a few highly-leveraged property investors, but it will only slightly reduce the overall attractiveness of property investment by removing what was, in effect, an interest-free loan (investors were required to pay back any depreciation claims upon sale, if the property had not actually depreciated). It is difficult to determine the net effect of GST on house prices. GST is price-positive on two fronts – it drives up the price of building new houses, and it makes housing (which is exempt from GST) a more preferred form of consumption. But for investors, GST will drive up the cost of maintaining and managing the property, which is a negative for house prices. The one thing that is certain is that the GST hike will drive rents higher than they would otherwise have been, as some of landlords' increased costs are passed on.

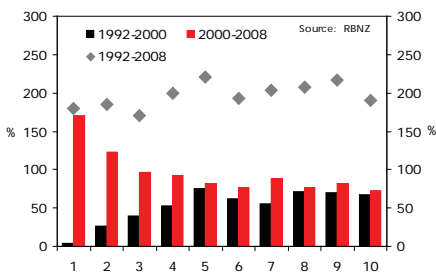
We estimate that the tax changes will knock 14% off the fundamental value of residential property in the short term. However, we expect prices to fall by less than a third of that amount. House prices are sticky on the downside. Owners will hold out (i.e. sales turnover will remain low) until income growth in the economy is sufficient to close the valuation gap. Perversely, if the tax changes 'work' and raise NZ's medium-term growth potential this well help close the valuation gap.

¹ Bank deposits incur income tax on interest. Shares incur income tax on dividends. Owning a business or a farm incurs income tax on profit. Even investing in education incurs tax on the higher income one hopes to receive as a payoff. Little wonder New Zealanders choose to invest in property above all else.

With landlords now receiving a smaller tax subsidy, the yield in rental properties will have to rise. Our calculations suggest rents will end up about 7% higher than they would have been if the tax system had remained unchanged. Higher rents and lower house prices will tend to increase the rate of home ownership, relative to what would have occurred in the absence of tax change. It will take a number of years for these changes to work through. Most likely, we'll experience years of higher rent growth and flat house prices, rather than big-bang adjustment.

We expect lower-end property prices will be hit hardest by the reduction in income tax. Landlords will be more sensitive to tax, and they are most active in the cheaper market segments. Furthermore, the potential buyers of top-end properties will get the biggest after-tax income boosts, so prices in that bracket should outperform. We expect an element of "price dispersion" in the market over the next few years, similar to the experience of the 1990s when tax changes were unfavourable to landlords and favourable to the higher income groups. The opposite occurred in the 2000s (see Figure 20), after the introduction of the 39 cent income tax rate.

Figure 20: Growth in property values by price decile of suburb



Interest rates

The 2009 burst of housing market activity may have been partly caused by buyers rushing in while mortgage rates were low. Now that rates are rising, buyers seem more reluctant. We expect floating mortgage rates to steadily rise. Bank

funding costs are much higher than they were last decade, and the RBNZ cannot shelter us from that forever. The longest-term fixed mortgage rates have already risen in anticipation of higher floating rates. Higher average mortgage rates over the coming years will curtail affordability and reduce demand for housing – yet another reason to anticipate subdued prices.

Economy

The improving economy is the lone positive for house prices, in a sea of negatives. As we've said elsewhere, the NZ economy is well into the recovery phase that normally follows recession. Unemployment is falling, and job security is much improved. The situation is expected to improve further over the next couple of years as wage growth eventually accelerates from its current snail's pace. Better job prospects should encourage more youngsters to fly the coop and enter the rental market – yet another reason to anticipate higher rents.

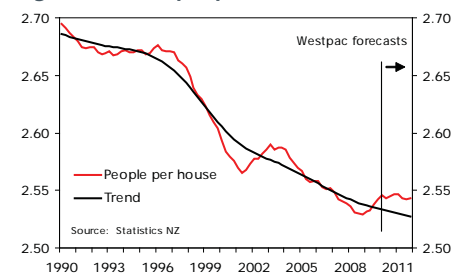
Supply/demand balance

The final reason to expect subdued house prices over the next few years is that the housing shortage situation that developed in 2009 is now stabilising and will probably improve over the next couple of years. In 2009 the number of houses built in NZ plunged to less than half the 2007 level. At the same time, population growth accelerated from 0.9% to 1.3%. That may have helped to keep house prices and rents from falling as they normally would have in such a recessionary environment.

The rate of house building has picked up over the first half of 2010, and building consents data suggests a further acceleration over the second half. We predict that the residential construction industry will ramp up construction of new houses by 23% in 2011, as builders and developers are incentivised by fatter developers' margins. Meanwhile, population growth is slowing because fewer foreigners are migrating to NZ.

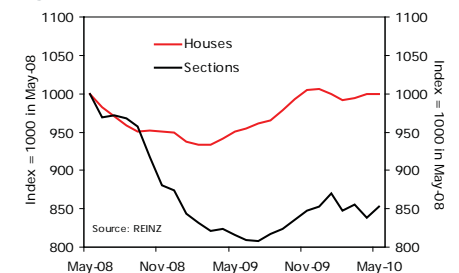
The number of people per house was rising sharply in 2009, flying in the face of the centuries-long trend towards smaller household sizes. Our calculations suggest that the pickup in construction and decline in migration will see the number of people per house stabilise this year and next, before returning to its declining trend in 2012. This will gradually ease the squeeze, taking the "shortage premium" out of the market.

Figure 21: People per house



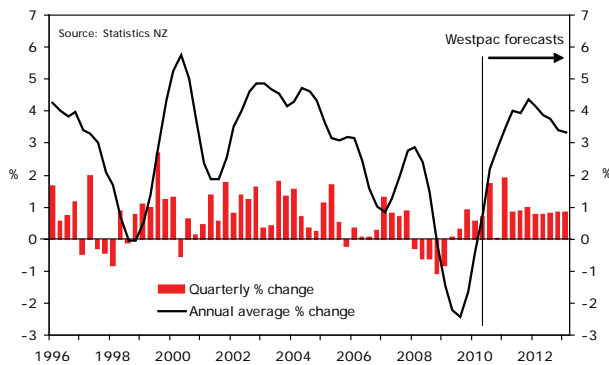
Finance is difficult for property developers at present, but that cannot act as a roadblock forever. Market economies tend to find ways of getting around obstacles, normally by throwing up new price signals. In this case, developers who relied on cheap finance have been forced to sell land, pushing the price of undeveloped residential sections down by 15% since 2008. Over the same period, house prices have remained unchanged. So the margin on offer for successful property development is now much wider than it was during the boom. There is a profit opportunity on offer for larger firms that are less reliant on finance to get involved in residential property development. Which is precisely what we think will happen.

Figure 22: Section and house prices

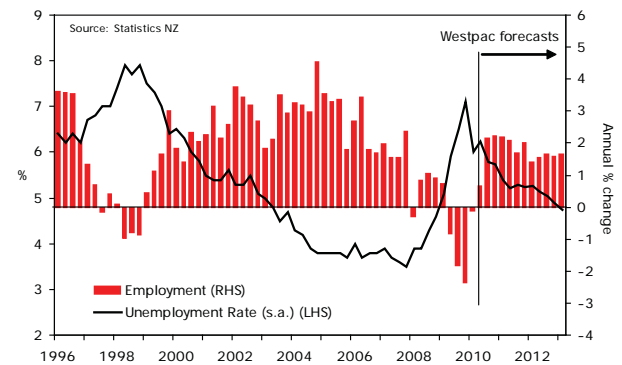


Annual Average % change	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
Private consumption	0.6	2.5	2.8	2.5	-0.5	2.5	2.7	2.5
Government consumption	1.4	1.5	1.9	2.0	1.6	2.1	1.4	2.0
Residential Investment	-11.5	15.9	20.5	6.5	-16.8	9.5	22.9	9.0
Business Investment	-8.9	7.3	12.9	8.2	-10.3	2.8	14.5	8.5
Stocks (% contribution)	-2.0	2.2	0.5	0.0	-2.7	2.2	0.7	0.1
GNE	-3.1	6.4	5.7	3.8	-5.0	5.6	6.1	4.0
Exports	2.9	2.3	4.6	3.7	0.0	3.1	4.2	3.8
Imports	-9.6	9.1	9.2	5.0	-14.9	8.7	9.5	5.5
GDP (Production)	-0.4	3.5	4.1	3.3	-1.6	2.9	4.4	3.4
Employment (% annual)	-0.1	2.2	1.4	1.7	-2.4	2.2	2.0	1.6
Unemployment Rate (% s.a. end of period)	6.0	5.4	5.3	4.7	7.1	5.7	5.2	4.9
Average Hourly Earnings (% annual)	-0.5	2.7	3.6	4.1	3.2	-0.6	3.4	4.1
CPI (% annual)	2.0	4.7	2.7	3.2	2.0	4.7	2.4	3.3
Current Account Balance (% of GDP)	-2.4	-3.3	-4.8	-4.9	-2.9	-3.0	-4.6	-5.0
Terms of Trade	-0.1	5.3	0.0	2.8	-8.2	12.1	-1.0	2.6
90 Day Bank Bills (end of period)	2.73	4.70	6.20	6.20	2.79	4.20	6.10	6.20
5 year swap (end of period)	5.27	6.10	6.70	6.70	5.56	5.90	6.60	6.70
TWI (end of period)	65.3	71.9	71.5	69.5	65.5	70.4	72.4	69.7
NZD/USD (end of period)	0.71	0.76	0.72	0.70	0.73	0.74	0.73	0.70
NZD/AUD (end of period)	0.78	0.83	0.84	0.83	0.80	0.82	0.84	0.83
NZD/EUR (end of period)	0.51	0.59	0.59	0.56	0.49	0.58	0.60	0.56
NZD/GBP (end of period)	0.45	0.49	0.46	0.40	0.45	0.49	0.49	0.41

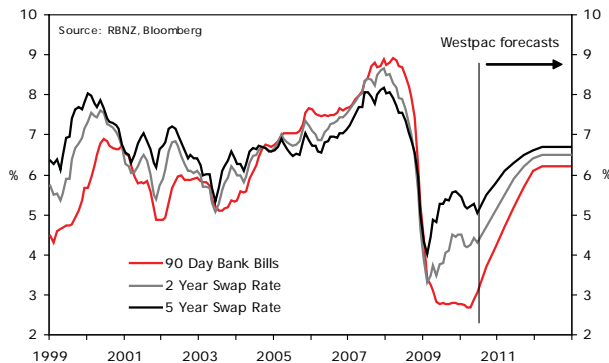
New Zealand GDP growth



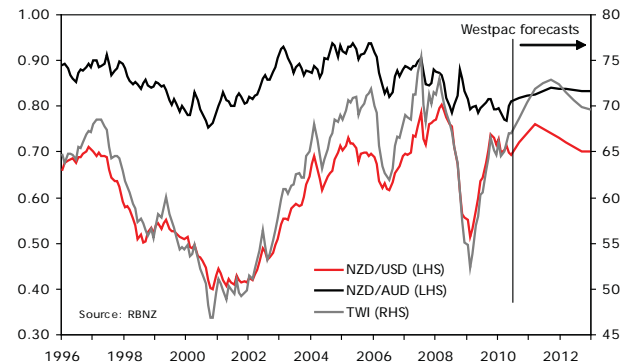
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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