

Weekly Commentary

31 January 2012

A tale of two policies

The market reception to the Reserve Bank's latest OCR review was swamped by the reaction to the US Federal Reserve's statement just a few hours earlier. Yet we can still find some interesting parallels with the two central banks' approaches: both have been helped by an easing in inflation pressures, both signalled a longer period of interest rates at record lows, but the tone of their messages reflected their very different circumstances. The RBNZ is still eyeing the resumption of rate hikes, though based on its latest statements we now think this will be in December, depending on developments in Europe and Canterbury.

As was widely expected, the RBNZ struck a more conciliatory tone in last week's OCR review. The key change was in the last line of the press release: while the December release noted that it remained prudent "for now" to keep the OCR on hold, those two words were absent this time. That communicated a later start to the projecting timing of rate hikes, without getting into the specifics – but certainly later than the June start that was implied in the December *Monetary Policy Statement*.

The Q4 inflation figures published the previous week were significantly lower than market and RBNZ expectations, and a stark change from the inflation pressures that seemed to be escalating in the first half of last year. Both headline inflation and the RBNZ's suite of 'core' measures now sit close to the middle of the 1-3% target range. It's notable that the RBNZ described the easing in inflation pressures as "reassuring" rather than concerning; with inflation now well within target, it has the freedom to wait and see how two of the biggest uncertainties around growth – Europe's debt woes and the pace of reconstruction in Canterbury – pan out.

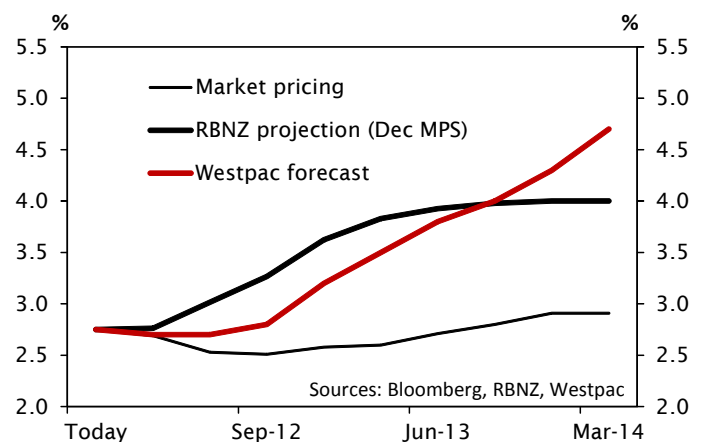
In contrast, the Fed made a sizeable and very explicit change to its stance on interest rates compared to its December review. With its key policy rate effectively at zero, the Fed has tried to influence market interest rates lower by signalling how long the policy rate is expected to remain at zero. That timing was changed from "at least through mid-2013" in the December review to "at least through late 2014" this time – more than an extra year of rates at rock-bottom

levels. Like the RBNZ, the Fed has been given some relief on the inflation front, which means that for now there is no real conflict between its dual mandate of low inflation and full employment – of which the latter remains a very distant prospect.

Interestingly, the Fed statement included for the first time the range of interest rate projections among the policy committee members, on top of the economic projections that are already published. This included projections for the policy rate over an undefined 'longer run', which we can take as being their estimates of the long-term neutral rate. These ranged from 3.75% to 4.50%, with a median of 4.25% – pretty much where the neutral rate was considered to be before the financial crisis. That's a stark difference from the debate in New Zealand, where there is a near-consensus (one we don't share) that the neutral level of the OCR has fallen sharply and permanently as a result of the crisis.

The prospect of easy money for longer in the US sent the US dollar lower, while boosting risk-sensitive assets like the New Zealand dollar, which was launched back to a three-month high after the statement. Consequently, it's hard to distinguish the market's read

90-day rate expectations



on the RBNZ's review, although the fact that interest rate pricing for the next year hardly budged suggests that the tone of the statement was broadly as expected.

RBNZ Governor Bollard gave some elaboration on the policy outlook in a speech on Friday titled "A tale of two crises" – referring to the European sovereign debt crisis and the Canterbury earthquakes. On the first matter, we've been pointing out the implications for New Zealand for many months: weaker activity in Europe, spilling over into the Asia-Pacific region; weaker export prices (partly offset by a lower NZD); and upward pressure of bank funding costs, which could lead to higher retail interest rates independently of the OCR. The OCR review statement last week actually noted that conditions in Europe have improved slightly, though they remain fragile.

On the second matter, the most noteworthy point was that in light of the latest swarm of aftershocks in Canterbury just before Christmas, the RBNZ has pushed out its projections for the timing of reconstruction activity. However, the change in assumptions may not prove to be as dramatic as has been reported. The pace of acceleration in activity has been slowed relative to the previous forecast, but repairs and infrastructure work are now expected to reach a still chunky 0.75% of potential GDP by the end of this year, compared to 1% of GDP previously.

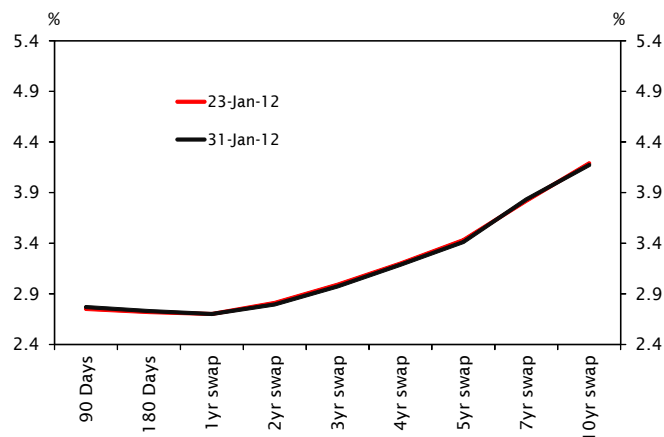
Outside of the official text of the speech, RBNZ Governor Bollard said that he was broadly comfortable with market pricing for no hikes or cuts in the next year. But assumptions about Canterbury's recovery are still very fluid at the moment, not just around the pace of rebuilding, but the degree of inflation pressure that it will generate. As Dr Bollard stated, "we will need to keep monitoring this to judge whether the level of the OCR continues to be appropriate" – hardly a signal that rate hikes have been taken off the table altogether.

However, based on the last week's developments, we now see December as the most likely start date for rate hikes. The RBNZ

has been given a lot of breathing room on inflation, and is broadly comfortable with market pricing for no hikes this year. In addition, Dr Bollard confirmed this week that he will not seek another term as Governor; his current term expires after the September MPS. We'll send out a note shortly with our thoughts on the matter, but suffice to say that the transition to a new governor (or possibly an OCR-setting committee) appears to make a September or October move less feasible at the margin.

Fixed versus floating: Fixed mortgage rates are currently good value given where we think floating rates are heading over the next several years. With no satisfactory resolution to the European debt crisis in the offing, there is no immediate pressure on fixed rates to rise, so borrowers can afford to wait a little longer. But the RBNZ's latest *Monetary Policy Statement* made clear that there is limited scope for fixed rates to fall further. A situation where the RBNZ saw fit to cut rates would also probably be one where banks' funding spreads are increasing sharply.

NZ interest rates



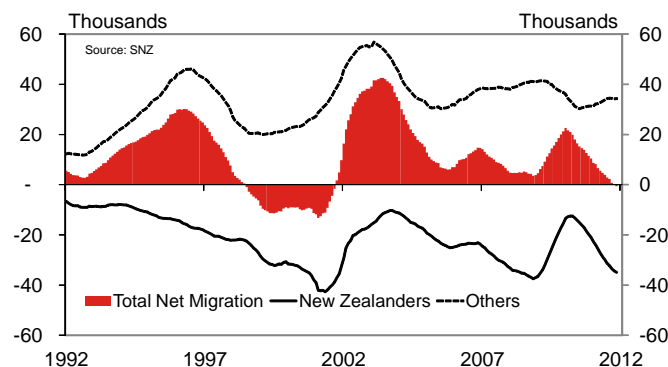
Key Data Previews

NZ Dec net migration

Feb 3, Last: -50, WBC f/c: -150

- Permanent and long-term net migration has been negative for 8 out of the past 9 months. The Christchurch earthquake has played a role, but the main factor has been the strong Australian economy attracting NZ workers.
- We expect another mildly negative net migration print in December. However, NZ departures have started to come off in the past few months, and over the coming year net migration should turn positive as the Australian labour market softens and New Zealand employment prospects improve.
- The latest Christchurch aftershocks may lead to another near-term spike in departures (this didn't happen after the June aftershocks) but we would expect the impact on the December figures to be limited.

NZ annual net migration



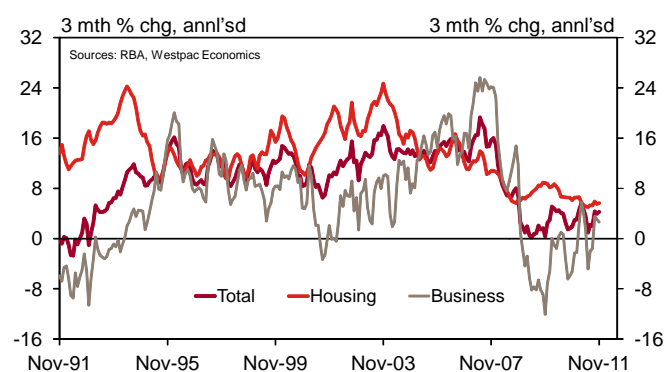
Aus Dec private credit

Jan 31 Last: 0.3%, WBC f/c: 0.3%

Mkt f/c: 0.3%, Range: 0.1% to 0.5%

- Credit to the private sector is expanding at a modest pace. The rise for the year was 3.5%, unchanged from the annual pace of a year-ago. We're forecasting credit to advance by 0.3% in December, a repeat of the November outcome.
- Note, the data should incorporate revisions to the housing figures (as was the case with the latest housing finance). This points to a slight downward revision.
- Business credit, following a modest decline through 2010, stabilised during 2011. We're anticipating a broadly flat result for December, following two flat months.
- Housing credit growth is subdued reflective of the headwinds facing the sector. Annual growth has slowed to 5.7%, down from 7.1% a year-ago.

Credit momentum



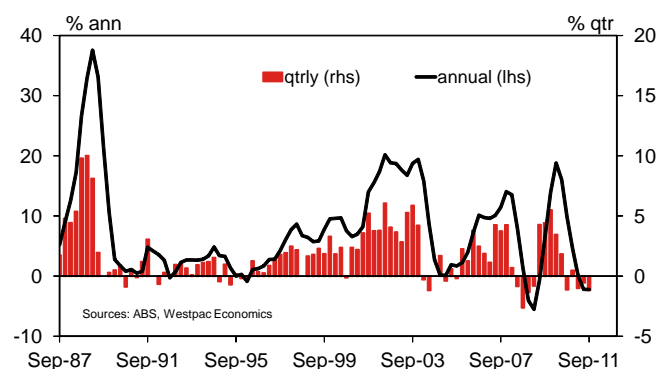
Aus Q4 house price index

Feb 1, Last: -1.2%, WBC f/c: -1.0%

Mkt f/c: -0.7%, Range: -1.2% to 0.1%

- The preliminary estimate of the ABS House Price Index showed a 1.2% fall in 2011Q3 to be down 2.2%yr and 3.3% from the indexes June 2010 peak.
- Private sector measures suggest this weakness extended into the December quarter albeit with some hints that conditions were starting to stabilise towards the end of the year. The ABS measure covers detached houses only (i.e. excluding townhouses, terraces and units). For Q3, our preferred private measures of this part of the market showed moves of -1.5%qtr, -3.5%yr (Residex); flat qtr, -3.5%yr (APM) and -1.0%qtr, -4.3%yr (RP Data-Rismark, figures for Oct-Nov).
- Overall, we expect the ABS series to show a 1% fall in Q4 bringing the annual decline to -3.7%yr. Revisions may see this come via a flatter Q4 result but weaker prior quarters.

Established house prices, ABS measure



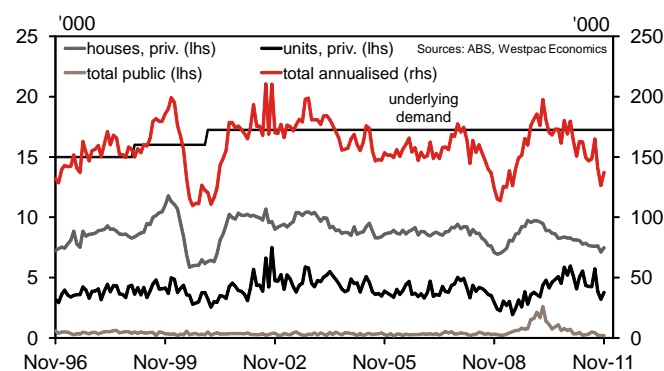
Aus Dec dwelling approvals

Feb 2, Last: 8.4%, WBC f/c: 2.0%

Mkt f/c: 2.0%, Range: -5% to 10%

- The 8.4% bounce in dwelling approvals in Nov was a welcome relief, removing much of the downside risk that had emerged from a very weak Oct read. The bounce reversed about half of the July-Oct decline with most of the detail positive as well. That said, the Nov gain still leaves a firm downtrend in place.
- Housing markets were starting to show some tentative signs of stabilising in late 2011 with auction clearance rates ticking up, prices steadying, finance approvals firming and consumer sentiment towards buying a dwelling improving. Despite this Dec is still too early for an unambiguously positive response to rate cuts. Even in interest rate sensitive sectors like housing these usually take several months to impact. Patchy sentiment and consumer caution will also tend to inhibit the response. Overall, we expect a 2% rise in Dec, another positive but only enough to lessen, not break, the downtrend.

Dwelling approvals



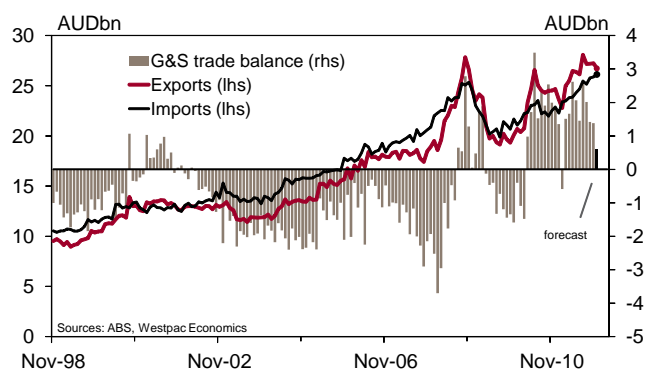
Aus Dec trade balance, AUDbn

Feb 2 Last: 1.4, WBC f/c: 0.6

Mkt f/c: 1.2, Range: 0.5 to 2.0

- The trade surplus most likely narrowed in December, potentially to the smallest balance since February, and before that since March 2010.
- We're forecasting a surplus of \$0.6bn, down from \$1.4bn.
- Exports were hit by weaker global commodity prices, as the world economy slowed further. Volumes were most likely mixed, with coal expected to be up but iron ore down due to weaker demand. On balance, we expect the value of exports to fall by around 2%.
- Imports, by contrast, are expected to rise, up a forecast 1%. Volumes are trending higher to meet rising domestic demand. This is reinforced by the high Aussie dollar, which is encouraging a switching towards imports.

Trade surplus: to narrow



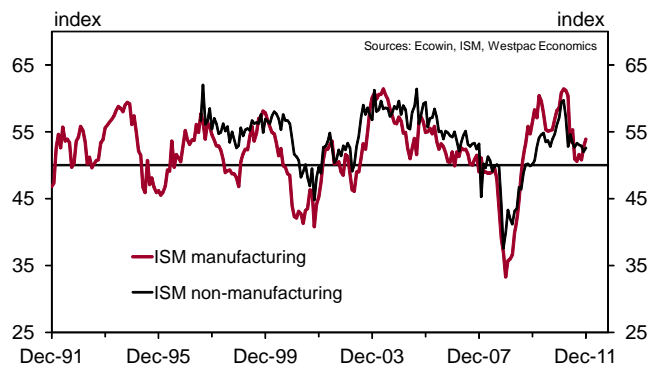
US Jan ISM manufng/non-manufng reports

Feb 1, Man Last: 53.9, WBC f/c: 54.5

Feb 3, Non-man Last: 52.6, WBC f/c: 52.5

- The factory ISM hit 61.4 in Feb last year, close to three decade highs. By Jul it had plunged to 50.9, and it hovered around there until rising 3.1pts in Nov-Dec, indicating some renewed life in the industrial sector, reflected also in late 2011 factory output. The regional factory surveys for Jan included mostly favourable orders, shipments and jobs detail so the composite ISM factory index is likely to post a further gain.
- The non-manufacturing ISM in Dec at 52.6 was in the middle of its 52.0 to 53.3 range recorded since June last year. This index just hasn't captured the renewed optimism showing up in other surveys since Q4 last year. That's a reason to question the sustainability of those other survey rises, especially if Jan comes in little changed at 52.5 as we forecast.

US ISMs

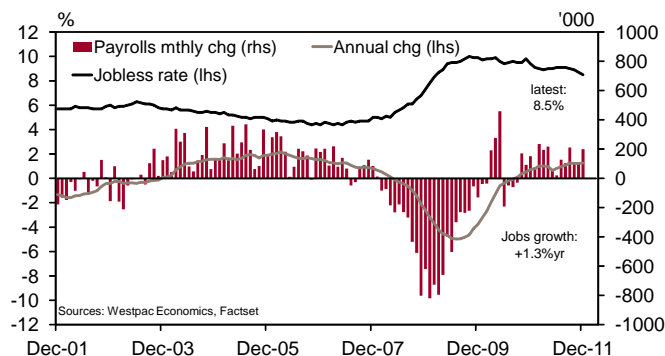


US Jan non-farm payrolls to rise 150k

Feb 3, Payroll employment: Last: 200k, WBC f/c: 150k

- Payrolls rose 200k in Dec, although there was an 8k downward revision to the first two months of Q4, after solid upward revisions in the previous 3 reports. That took the monthly average gain in Q4 to 137k, softer than Q3's 147k but still a little better than the 131k average through H1 2011.
- Forecasting Jan payrolls is always difficult because of the annual seasonal adjustment revision which rewrites history. Dec was boosted by a 42k surge in courier jobs; last year a similar rise dropped out in Jan but the new seasonals may better account for increased internet shopping courier jobs in Dec. The economy accelerated in Q4 which suggests jobs growth; initial claims have been noisy but hint at less layoffs since late 2011.
- Our Jan forecast: 150k payrolls gain and a moderate (30k) downward revision to the Dec outcome.

US payrolls



Key Data and Events

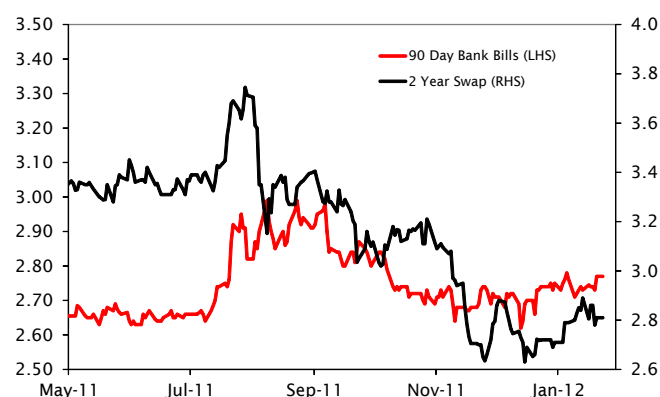
		Last	Market median	Westpac forecast	Risk/Comment
Tue 31					
Aus	Dec private sector credit	0.3%	0.3%	0.3%	Modest growth. Housing subdued, business flat.
	Dec RP Data-Rismark home px index	0.1%	-	-	Registered its only monthly gain in 2011 in Nov, but only just.
	Dec NAB business survey	1	-	-	Conditions index up a touch to +1 in Nov, in line with historic avg.
Jpn	Jan Markit PMI manufacturing	50.2	-	-	Thai disruptions may be a factor this month.
	Dec overall household spending %yr	-3.2%	-	-	Real measure. Very weak, below income growth (greater contraction).
	Dec jobless rate	4.5%	4.5%	-	Job-to-applicants ratio at 0.69. Participation trending lower.
	Dec industrial production	-2.7%	3.0%	-	Consensus f/c would put output back around June levels.
	Dec construction orders %yr	21.0%	-	-	Fiscal impetus hitting in early 2012.
	Dec housing starts %yr	-0.3%	-1.5%	-	854k annualised level - reconstruction in train
Eur	Dec unemployment rate %	10.3%	10.4%	10.3%	German jobless rate fell to 6.8% offsetting rises elsewhere.
Ger	Jan unemployment change	-22k	-5K	-	Offsetting rising joblessness elsewhere in Europe.
UK	Jan GfK consumer confidence	-33	-32	-	Back at the level when the 2008 recession started.
	Dec net consumer credit £bn	0.4	-	-	Credit to households grows most months - at a very slow pace and
	Dec net mortgage lending £bn	0.6	-	-	may turn negative again as recession bites.
	Dec M4 money supply %yr	-2.6%	-	-	M4 ex OFC is at 3.7% yr.
US	Q4 employment cost index	0.3%	0.4%	0.6%	Stalled benefits growth in Q3 unlikely to persist in Q4.
	Nov house prices %yr	-3.4%	-3.2%	-	S&P Case Shiller 20 city index.
	Jan Chicago PMI	62.5	63.0	60.0	Chicago seems to always read strong these days while Milwaukee is in
	Jan Milwaukee NAPM	57.8	-	60.0	an uptrend after stumbling earlier in 2011.
	Jan consumer confidence	64.5	68.0	67.5	UoM index suggests another rise likely - risk on jobs mkt sentiment.
Can	Dec industrial product prices	0.2%	-	-	Energy prices the driver in Nov.
	Nov GDP	0.0%	0.2%	-	Q4 had soft start in Oct but Nov looks stronger.
Wed 01					
Aus	Q4 house price index	-1.2%	-0.7%	-1.0%	Despite the 'official' badge, monthly private measures: a better guide.
	Jan AiG PMI manufacturing	50.2	-	-	Index surprised, up 2.4pts in Dec (avg'd 45.7 over 2011H2).
Chn	Jan PMI manufacturing	50.3	49.6	-	Our s/adj estimate of Dec was 50.9. Seasonality a big issue in Jan.
	Jan HSBC manufacturing PMI	48.8	-	-	Less optimistic than official PMI in Dec, no bounce in flash estimate.
Jpn	Dec labour cash earnings %yr	-0.2%	-	-	Not supportive of consumption growth.
Eur	Jan PMI factory final	48.7	48.7	-	Indicating mild recession so far.
	Jan CPI flash %yr	2.8%	2.7%	-	Downtrend emerging.
UK	Jan PMI factory	49.6	49.8	-	Contracting for five of the past six months.
	Jan house prices %yr	-1.3%	-	-	Tentative date for Halifax index due 1-8/2
US	Jan ADP private payrolls ch	325k	185K	150k	Strongest ever but probably distorted by seasonal factors as in 2010.
	Dec construction spending	1.2%	0.7%	1.0%	Housing the driver, looking up from a very low base it seems.
	Jan ISM manufacturing	53.9	54.5	54.5	Regional surveys suggest some strength.
	Jan auto sales mn annualised	13.5	13.6	-	Late 2011 sales pick-up may dissipate in 2012.
	Fedspeak	-	-	-	Plosser on the economy.
Thu 02					
NZ	Jan ANZ commodity price index	-0.8%	-	-	High Kiwi to depress NZD export prices this month.
Aus	Dec dwelling approvals	8.4%	2.0%	2.0%	Nov bounce reversed half of Jul-Oct slump - but downtrend remains.
	Dec trade balance, AUDbn	1.4	1.2	0.6	Exports -2% (hit by global downturn), imports +1%.
Eur	Dec PPI %yr	5.3%	4.4%	-	Decelerating.
UK	Jan PMI construction	53.2	-	-	Still growing at a modest pace.
US	Jan layoff announcements %yr	30.6%	-	-	Uptrend has slowed.
	Q4 productivity % annualised	2.3%	1.0%	-	Has been patchy over 2011 with Q3's outcome offset H1's weakness.
	Q4 unit labour costs	-2.5%	0.8%	-	Expect modest rebound after sizeable Q3 decline.
	Initial jobless claims w/e 28/1	377	-	-	Erratic in recent months; has made this indicator less useful.
	Jan chain store sales %yr	3.5%	-	-	Guide to official retail data.
Fri 03					
NZ	Dec net migration	-50	-	-150	New Zealand departures to Australia high for now.
Eur	Jan PMI services final	50.5	50.5	-	Indicating mild recession so far.
	Dec retail sales	-0.8%	-	-	Annual pace of contraction -2.5%, weakest since 2009 recession.
UK	Jan PMI services	54.0	53.0	52.0	If UK is in recession this should be lower.
US	Jan non-farm payrolls change	200k	150K	150k	Annual benchmark revisions; seasonal courier hiring; noisy claims;
	Jan unemployment rate %	8.5%	8.5%	8.6%	generally upbeat surveys: factors at play. See text box.
	Jan ISM non-manufacturing	52.6	53.3	52.5	Never reflected the more upbeat economic vibe in late 2011.
	Dec factory orders	1.8%	1.2%	-	Durables known +3.0%; ex transport, durables rose +2.1%.
Can	Jan employment change	18k	22.3k	-	Jobs growth trend stalled to 1k per month in H2 from 33k in H1 2011.

New Zealand Economic and Financial Forecasts

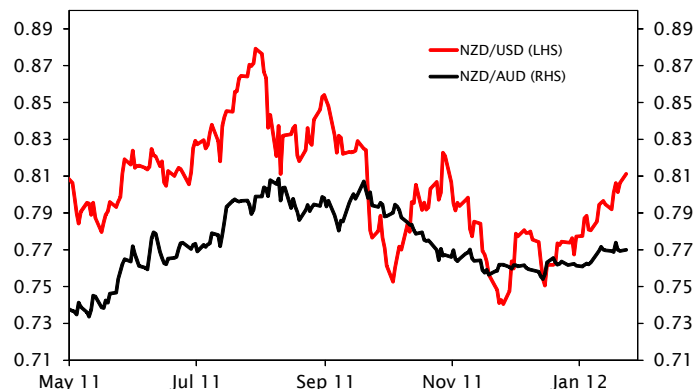
Economic Growth Forecasts	March years				Calendar years			
	2010	2011e	2012f	2013f	2010	2011f	2012f	2013f
% change								
GDP (Production) ann avg	-0.9	1.2	1.8	3.2	1.3	1.6	2.8	3.8
Employment	-0.1	1.8	1.0	2.1	1.3	2.0	1.7	2.8
Unemployment Rate % s.a.	6.1	6.5	6.3	5.9	6.7	6.6	5.9	5.1
CPI	2.0	4.5	1.7	2.2	4.0	1.8	2.2	2.4
Current Account Balance % of GDP	-1.9	-3.6	-4.4	-6.1	-3.5	-4.0	-5.7	-5.9

Financial Forecasts	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Cash	2.50	2.50	2.50	2.75	3.25	3.50
90 Day bill	2.70	2.70	2.80	3.20	3.50	3.80
2 Year Swap	2.90	3.20	3.50	3.90	4.20	4.50
5 Year Swap	3.60	3.90	4.20	4.50	4.80	5.00
10 Year Bond	4.00	4.10	4.20	4.50	4.70	4.90
NZD/USD	0.76	0.72	0.75	0.78	0.80	0.79
NZD/AUD	0.77	0.77	0.77	0.77	0.78	0.79
NZD/JPY	58.5	55.4	58.5	63.2	67.2	64.8
NZD/EUR	0.60	0.60	0.61	0.61	0.63	0.63
NZD/GBP	0.51	0.49	0.50	0.51	0.50	0.49
TWI	68.9	67.2	68.9	70.7	72.5	71.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 31 January 2012

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.69%	2.66%	2.74%
60 Days	2.71%	2.68%	2.70%
90 Days	2.77%	2.76%	2.74%
2 Year Swap	2.97%	2.89%	2.71%
5 Year Swap	3.41%	3.52%	3.27%

NZ foreign currency mid-rates as at Tuesday 31 January 2012

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8194	0.7924	0.7775
NZD/EUR	0.6246	0.6272	0.6005
NZD/GBP	0.5224	0.5184	0.5016
NZD/JPY	62.52	60.989	59.790
NZD/AUD	0.7745	0.7699	0.7609
TWI	72.200	71.110	69.400

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2008	2009	2010	2011f	2012f	2013f
Australia						
Real GDP % yr	2.5	1.4	-2.6	2.0	3.0	3.5
CPI inflation % annual	3.7	2.1	2.7	3.5	3.3	1.9
Unemployment %	4.3	5.6	5.2	5.1	5.6	5.4
Current Account % GDP	-4.5	-4.2	-2.9	-2.2	-4.5	-3.3
United States						
Real GDP %yr	-0.3	-3.5	3.0	1.7	1.7	2.1
Consumer Prices %yr	3.8	-0.3	1.6	3.2	2.0	2.0
Unemployment Rate %	5.8	9.3	9.6	9.0	9.1	9.1
Current Account %GDP	-4.7	-2.7	-3.2	-3.3	-2.9	-1.8
Japan						
Real GDP %yr	-1.5	-6.7	4.4	0.1	2.0	1.9
Consumer Prices %yr	1.4	-1.3	-0.7	-0.2	-0.5	-0.3
Unemployment Rate %	4.0	5.1	5.1	4.4	4.2	4.5
Current Account %GDP	3.3	2.8	3.6	2.2	2.7	3.4
Euroland						
Real GDP %yr	0.3	-4.0	1.7	1.6	-1.0	0.4
Consumer Prices %yr	3.3	0.3	1.7	2.5	1.0	0.8
Unemployment Rate %	7.5	9.5	10.0	10.3	11.0	11.5
Current Account %GDP	-0.8	-0.7	-0.5	-0.5	0.0	0.0
United Kingdom						
Real GDP %yr	-0.1	-4.9	1.4	0.9	-0.0	0.6
Consumer Prices %yr	3.6	2.2	3.2	4.0	2.2	1.5
Unemployment Rate %	5.6	7.6	7.8	8.3	9.0	9.2
Current Account %GDP	-1.6	-1.3	-2.4	-2.0	-1.5	-1.5

Forecasts finalised 16 December 2011

Interest Rate Forecasts	Latest (Jan 31)	Mar-12	Jun-12	Sep 12	Dec 12	Mar 13
Australia						
Cash	4.25	4.00	3.75	3.75	3.75	3.75
90 Day Bill	4.40	4.25	4.00	4.00	3.90	3.90
10 Year Bond	3.87	4.20	4.40	4.50	4.70	4.90
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	1.93	2.20	2.40	2.50	2.60	2.70
ECB Repo Rate	1.00	0.75	0.75	0.75	0.75	0.75

Exchange Rate Forecasts	Latest (Jan 31)	Mar-12	Jun-12	Sep 12	Dec 12	Mar 13
AUD/USD	1.0579	0.99	0.93	0.97	1.01	1.02
USD/JPY	76.305	77	77	78	81	84
EUR/USD	1.3118	1.26	1.20	1.23	1.27	1.28
AUD/NZD	1.2911	1.30	1.29	1.29	1.29	1.28

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