

# Economic Overview

A quarterly overview of the New Zealand economy

May 2009

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## Highlights

- The NZ economic outlook has deteriorated further in the past three months as our trading partners implode. The only cold comfort in these times is schadenfreude that others have it worse than us. The lower NZD, NZ's export mix, robust banking sector and relatively modest wealth hit have provided some limited protection from the worst of it so far.
- Nonetheless we have revised down our forecasts for 2009 GDP growth to a grim -2.8%, with lower investment and net exports. The only growth bright spot in the near term is government spending. We have also revised down the outlook for 2010 to a mere 1.1%, with no decent recovery in GDP growth until 2011.
- With fiscal policy now rapidly running out of room in the face of a potential ratings downgrade, monetary policy must step up to the plate. And Dr Bollard has done that, cutting the OCR to 2.5% and promising rates "at or below" this level until late 2010. Despite some gyrations, the exchange rate is also on the whole doing its part to cushion the blow to NZ exporters, and we expect it to fall below US50c by the end of the year.
- We now see the unemployment rate rising to 7.7% by early next year, a key factor keeping consumption subdued for a long time.

## Cold comfort

*There are numerous factors that have helped to insulate the NZ economy from the worst of the international mayhem – to date. In this article, we discuss these factors, but also take a look at a couple of the major risks facing the economy.*

NZ is already over a year into a protracted recession. And make no bones about it, this recession is a ripshooter. When this down-turn has finally run its course, it will probably be at least as bad as our 'big 2'

recessions of the past 50 years (the early 90's, and late 70's). Desperate times require desperate measures to put a rosy tint on these events!

The only way that we can make

ourselves feel better is to compare NZ's experience to what is occurring in many other countries. It is cold comfort, but NZ has in fact come off relatively lightly compared to many other nations – so far.

### Remember others are not so fortunate

Times are tough in New Zealand. But they're worse elsewhere. Figures 1 to 4 show how NZ ranks on a range of economic indicators.

New Zealand has had the advantage of starting with a low unemployment rate and less of deterioration in employment than has occurred in other countries (see

Figure 1). Although New Zealand was in recession for all of 2008, employment increased by almost 1% in the year. While we fear that this is about to change

**Westpac**

dramatically for the worse, the flexibility of NZ's labour market is a key ally in absorbing economic shocks.

Exports receipts are where many of our main trading partners have been hammered relative to New Zealand (with most down by 20%+ and Japan by a mind-boggling 50%) and the consequent drop in industrial production.

Post the Lehman Brothers' collapse in September 2008, world activity "fell off a cliff". We suspect the downturn was exacerbated by severe frictions in the trade finance market and conglomerates pulling back on purchases and running down inventories. But in one of the huge ironies of the financial crisis, exports and production in the savings surplus economies (e.g., Japan, Germany, Taiwan, Singapore) have been hit harder than most.

### Being thankful for small mercies

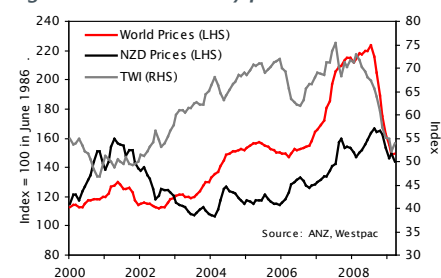
There are some factors working in our favour for which we should be grateful, and which so far have helped NZ avoid the extremes we've seen overseas.

#### Our volatile currency

The large swings our exchange rate goes through are often complained about by exporters. But in fact, our exchange rate is a crucial buffer for economic shocks.

While our commodity prices have fallen almost a third from their peak, so too has the exchange rate (at least up until mid March!). Undoubtedly some industries are struggling to sell product, but others (e.g., sheepmeat, venison, seafood, niche manufacturing) are getting substantial improvement in incomes from the lower currency.

Figure 5: NZ commodity prices



#### Not such a large wealth hit

Many countries in the world are reeling from three coincident shocks: an equities crunch; a housing crunch, and a credit crunch.

Figure 1: Current unemployment rates

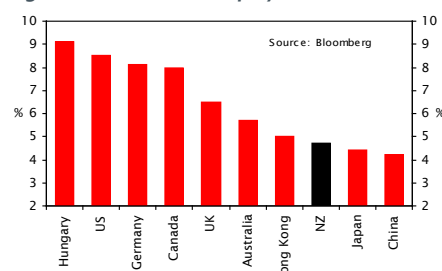


Figure 2: Export values

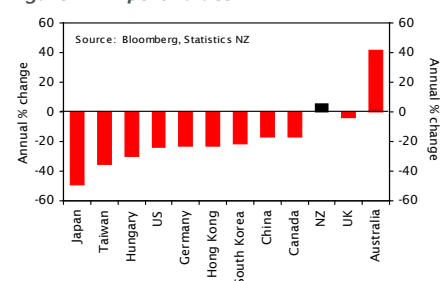


Figure 3: Industrial production

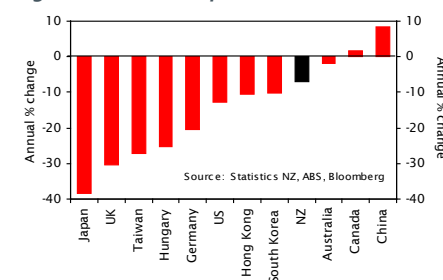
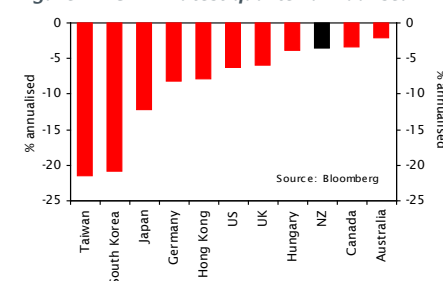


Figure 4: GDP - latest quarter annualised



So far New Zealand has experienced a full blown equities crunch (with a 44% peak to trough decline in the NZSE50 between May 2007 and March 2009). But household sector exposure to equities is low, the result of our collective love affair with property and long memories of the 1987 sharemarket crash. Direct holdings of equities is only around 2% of total household assets, and total holdings less than 5% of assets.

Housing comprises some 80% of household assets, and we'd classify NZ's housing downturn as a correction rather than crunch. If the 15% inflation-adjusted decline in house prices we've had to date were to double, then it would be a crunch.

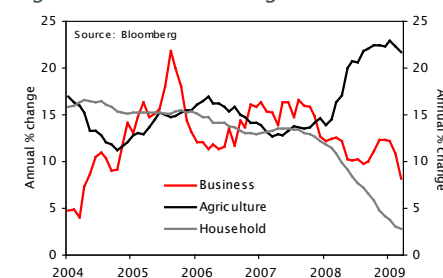
#### Robust banking sector and no credit crunch

In one survey rating the top 20 safest banks in the world, the Australasian banks occupied positions 11 through 16. The Australasian banks all have credit ratings of AA or higher, and they are amongst only 11 banks globally to have those ratings. In New Zealand, the banks basically "stuck to their knitting". There was none of the sub-prime lending or liars' loans, there was no indulgence in the jiggery-pokery of Collateralised Debt Obligations, virtually all assets written have been kept on balance sheet, bank profits and capital have been high, and the interbank market has remained

functional. This is in stark contrast to so many financial systems around the world which have been placed on life support by their governments.

The relative strength of our banking system has been a huge bonus for our economy. It has meant we've had only a minor incarnation of the credit crunch. While maintaining funding has been a huge challenge for the banks, they have continued to expand their lending. Credit growth in the year to March 2009 was 3% for households, 22% for agriculture, and 9% for other businesses. While we expect a marked slowing in credit growth over the coming year, these numbers are remarkable given that they were delivered over a year into domestic recession and in the face of the global financial crisis.

Figure 6: Domestic credit growth



#### Monetary policy is still working

The US, UK, Australia and NZ have all cut their official cash rates by close to 5%. However, it took almost a year and a half after the Fed started cutting interest rates

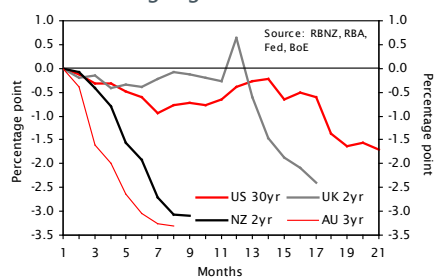
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before they got traction through lower mortgage rates (and then only when the Fed started down the track of quantitative easing and put mortgage backed securities and agency debt onto their balance sheet). For the UK it was a year.

NZ and Australia started cutting interest rates much later but have been able to deliver much greater drops in mortgage rates. UK and US fixed rate mortgages are down by around 1.5 and 2.5 percentage points respectively whereas New Zealand and Australian fixed mortgages are down 3.0 percentage points. Floating rates in NZ and Australia are down closer to 4.0 percentage points.

New Zealand also has the benefit of substantial pipeline interest rate relief to come. If interest rates were to only hold around current levels, as borrowers roll off existing fixed rate mortgages the cost to households of servicing existing debt

Figure 7: Change in mortgage rates since easing began



### Don't count your chickens

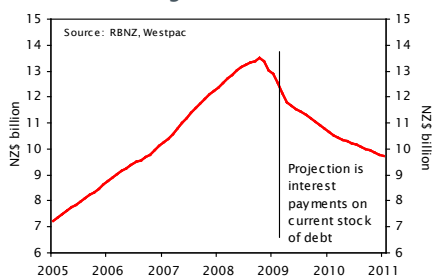
It would be foolish to be complacent about the impact that the biggest global economic downturn since the 1930s will have on the NZ economy. In this section we list some particular risks.

Through the month of March, a couple of the big buffers for the economy lost some of their padding. As risk appetite increased (we believe temporarily), the exchange rate and wholesale interest rates pushed dramatically in the wrong direction (higher). While extreme volatility is likely to remain to the fore, these episodes can undo a lot of the insulating work on the economy.

Also a risk is the potential for increasing protectionism. We see it as a minor risk at this stage because it makes no economic sense and politicians are well aware of the damage that rising protectionism wrought in the Great Depression. But one must always be wary, because while protectionism would

would drop by about \$3 billion over the next 2 years.

Figure 8: NZ households' mortgage debt servicing burden



### Fiscal policy

Last year all political parties came out proposing big stimulus packages. After all, there was an election to be won. That made for fortuitous timing, with the tax cuts and additional spending coming just as the wheels were falling off the international economy. New Zealand also had the benefit of a relatively healthy starting point for government finances, and the money hasn't had to go on bailouts - which means we are likely to get "more bang for the buck". However, the Government has run out of wriggle room. Government debt is projected to balloon, and a ratings downgrade threatens. There is no scope for additional fiscal stimulus from here on.

clearly have adverse economic impacts, it can make for good politics.

However, New Zealand's major vulnerability and challenge is the ability to fund its external liabilities (approximately a third of the financial systems funding comes from offshore). In a world that is shunning debt, New Zealand stands out. Our current account deficit has remained stubbornly large (8.9% of GDP), and net foreign liabilities are an enormous 93% of GDP. The large external liability situation encouraged S&P to place NZ on a negative ratings outlook. For now, the New Zealand financial system can get plentiful access to short-term funding. However, if for any reason the access to those funds were to dry up, New Zealand could be faced with an even more severe recession. The golden lining would be that any funding crisis would be accompanied by a currency crisis. The currency would fall to such a level that it looked ridiculously

### The nature of our exports

It's a great time to be selling necessities. It has long been a complaint that New Zealand needed to move up the value-add chain and get into technologically more advanced exports. But in times of global recession, it is demand for durable and luxury goods that get walloped (e.g., Japan's car exports are down 70%). For once, New Zealand's predominantly basic merchandise exports have held us in good stead: most of our exports are the table and goods to go on it (food and drink). People always have to eat, and in depressing times they like to get inebriated!

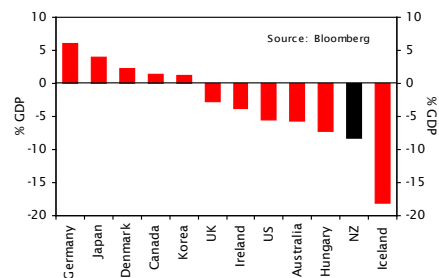
### Kiwis staying home

Net migration has a huge impact on the New Zealand economy, and is closely watched by the Reserve Bank for that reason. There are early signs that we may be getting a marked pickup in migration flows. A bit of that is expats returning from the carnage of the London financial sector, but most is fewer Kiwis heading across to Australia. With the commodities boom turning to bust, the job tap in Western Australia has been shut off. Net migration flows may increase from sub 5,000 last year to in excess of 15,000 this.

cheap and encouraged foreigners to lend to us again. The lower currency would also more quickly correct the large imbalances in the NZ economy.

And that is the beauty of the economic system. It tends to be self-equilibrating. The good times don't last for ever and, more importantly, neither do the bad. So far NZ has come through this global crisis relatively well. We pray that that does last.

Figure 9: Current account balance: 5 year average to 2008



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# Save the worst 'til last

*NZ has been in recession for more than a year, but for many the reality of the downturn is only just beginning to hit home. Indeed, the full brunt of the global recession has not yet been felt when it comes to investment and employment.*

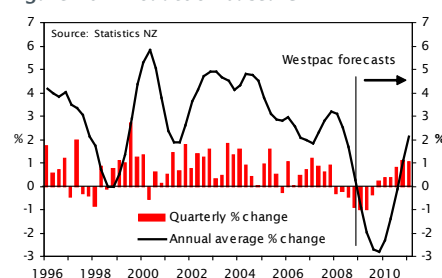
As outlined in our *Feature* article, New Zealand has, so far, got off relatively lightly in this global downturn. But as we move into our estimated sixth quarter of recession, the prospect of a turnaround still appears some way off. Confidence is dismal, job layoffs are becoming commonplace, and the Government is threatening to remove future tax cuts as it battles to avoid a credit downgrade.

However, in many ways these issues are not the key cause of concern. Rather, they are a manifestation of the major problem: the international outlook. The global financial crisis, in combination with a massive correction to wealth via lower house and equity prices, has wrecked havoc on confidence, destroying global demand in the process. In the first three months of this year alone, the US has lost 2.7 million jobs. And in the year to January 2009 Japanese exports contracted by 50% with similar rates of decline in other Asian economies like Taiwan and South Korea. Our International section goes into all the gory details but, put simply, the situation is grim. Even traditionally conservative forecasters such as the OECD and the IMF are predicting an ominous outlook for world growth in 2009. For example, the OECD's latest report forecast world GDP growth to fall by 2.75% this year and to recover by just 1.25% in 2010 – the average growth

rate since 1960 is 3.9%. If that eventuates, this will be the deepest and most synchronised recession in our lifetimes.

Against this backdrop, we have revised our growth forecasts down further this quarter. We now see the NZ economy contracting by 2.8% this calendar year (previously -1.3%), before registering still sub-par growth of 1.1% in calendar 2010 (previously 3.1%). A return to above potential growth (i.e. 2.75+%) is not anticipated until calendar 2011. See our *Sectoral Trends* section (pp., 6-7) for detail on performance by sector.

**Figure 10: Production-based GDP**

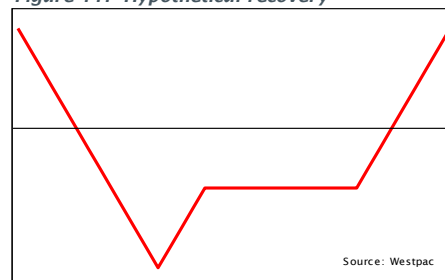


We caution, however, that making forecasts is a lottery at present. Though it's an overused claim, it seems reasonable to complain that we are "more than usually uncertain", given the unprecedented synchronisation of the global slowdown and the untraditional remedies being

dealt out by desperate policymakers around the world. In the alphabet soup of expectations, the markets are trying to pick whether it will be a V, W, U or L shaped recovery. We don't think any particular letter is appropriate: instead we are looking for the "shopping trolley" (see Figure 11). Recessions following financial crises tend to be particularly prolonged and painful.

Back home, the outlook for unemployment remains a key source of unease. Indeed, we have yet to feel the full brunt of the global downturn in terms of job losses. Moreover, business confidence remains mired at historically low levels, with savage cuts to business investment in the pipeline as profitability comes under pressure. Consumer confidence has held up better, but overall remains in pessimistic territory. Until confidence and related indicators improve, it will be hard to tell a convincing story of recovery.

**Figure 11: Hypothetical recovery**



## Bad vibes

The March *Quarterly Survey of Business Opinion (QSBO)* was, on balance, even weaker than the horrendous read of December 2008. A net 65% of businesses expect general business conditions to deteriorate over the next 6 months, the most on record. Firms are less pessimistic about their own activity, but again are extremely depressed. And the response to their miserable state is clear – firms intend to cut back heavily on investment and employment, with intentions for both falling to new lows.

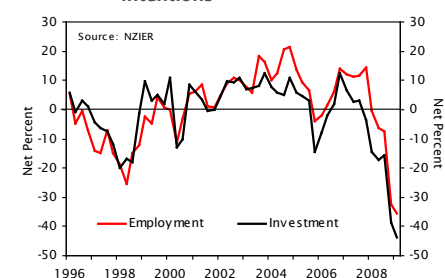
The main hurdle for firms continues to be poor demand, with 77% of businesses citing a lack of sales as the main constraint on expanding output. This weakness in demand is now being felt intensely in international markets – a record 54% of

manufacturers reported a fall in export orders in the last quarter. The collapse in global trade in recent months has been felt more keenly in industrialised sectors, but even as a producer of 'necessities' such as food, New Zealand is still clearly exposed. Merchandise export values have declined over 6% in the past year despite a lower currency, as commodity prices have fallen and global demand has dried up. Commodity prices have seen something of a revival in recent months as risk appetite has improved, but on balance we expect exports to remain under pressure through the remainder of 2009.

Overall, the investment picture is ugly and will be a key source of weakness for the domestic economy over the coming year. We anticipate a substantial

contraction through 2009 of close to 20%. With significant slack developing in the economy, and the weaker currency making imported goods more expensive, we don't expect a return to investment growth until mid 2010.

**Figure 12: Employment and investment intentions**



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## Jobs – the next casualty

One of the most disturbing features of recent business surveys has been the rapid deterioration in labour market indicators. In the QSBO, the ease of finding labour, both skilled and unskilled, is now the highest in more than 30 years. And finding labour looks set to become even easier in the near term, with a net 36% of firms intending to shed staff over the next three months, the highest ratio since September 1991. A net 31% of businesses reported a fall in labour turnover in the March 2009 quarter, suggesting that workers are becoming more appreciative of the jobs that they have.

Indeed, employees are acutely aware of the shift in the balance of power in the labour market. According to the Westpac McDermott Miller employment confidence survey, confidence fell from 104.0 in the December 2008 quarter, to 93.2 in the March 2009 quarter – the lowest read since the survey began in mid-2004. The fall in confidence was driven by a massive shift in sentiment regarding current job opportunities, with most employees saying

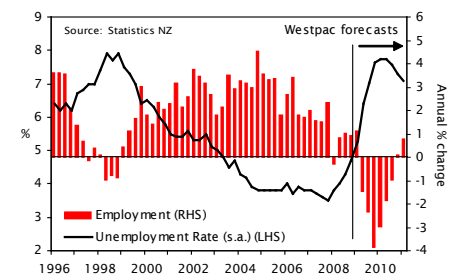
jobs are hard to find rather than plentiful, a situation that isn't expected to improve much over the coming year. That has taken its toll on job security and has seen earnings expectations plunge.

All up, the surveys reinforce our view that jobs growth will be the next victim of the current downturn. Our forecasts see employment growth contracting by close to 4% in 2009, a loss of around 85,000 jobs, and project virtually no recovery in 2010. That profile is expected to push the unemployment rate to a peak of 7.7% in early 2010, from 4.7% currently, with risks to the upside.

Our forecasts assume a fall in the participation rate from the current record high of 69.3% to 67.9% by the end of the year as discouraged workers move out of the labour force, particularly those in the under 25 and over 55 age groups.<sup>1</sup> However, these are unusual times, and as we have seen in other economies such as the US and Australia, participation is holding up. This is especially the case in the 55+ age group where workers have

seen their retirement funds slashed as asset prices have fallen. In many cases, these workers are finding themselves in a position where they either have to stay in or return to work – the so called 'desperate' worker effect. If participation holds up more than we expect, then we could easily envisage unemployment reaching 9+% over the next 18 months.

Figure 13: Household labour force survey



<sup>1</sup> Our research shows that participation is highly cyclical (i.e., as employment growth slows fewer people participate in the workforce as it becomes harder to find work – the discouraged worker effect). See our Bulletin "The Will to Work", 31 January 2007.

## Consumers retrenching

Consumers are now frantically saving their tax cuts, mortgage interest rate cuts and petrol savings, as they fret about their job security and indebtedness. But with debt at around 160% of household income versus less than 125% just five years ago, there is a long way to go.

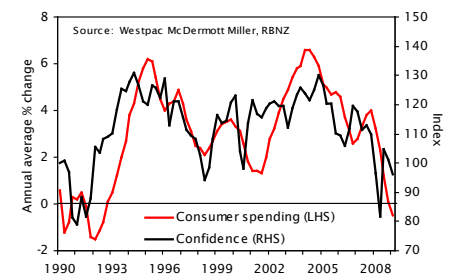
Consumer confidence slipped back below the 100 level in the March 2009 quarter, from 101.3 to 96.0, meaning that there are more pessimists than optimists. That still puts confidence at levels above the low reached in June last year (when the Index fell to 81.7), when high interest rates, petrol and other cost pressures were putting the squeeze on consumers. Nevertheless, at current levels, confidence hardly suggests consumers are set to change their new-found conservative

spending ways. In fact, when consumers were asked what they would do with a \$10,000 cash windfall, 58.3% said they would pay off debt or save it. That compares with 53.1% in the December quarter, and 50.5% at the same time last year.

Looking toward 2010, the Government has recently been making more noises about the possibility of taking future tax cuts off the table. Up until now, we have been banking on reasonable fiscal stimulus to support a recovery in consumer spending in 2010. If that is removed, it clearly puts that recovery at risk. Of course, on the other side is the strong possibility that net migration flows turn around faster than expected. In the year ended March 2009, net migration was

close to 7,500, up from a low of 3,500 in November last year. Should current trends persist, net migration could be upwards of 20,000 by the end of this year. That will provide a substantial boost to consumer spending, and demand generally, as well as providing support to house prices.

Figure 14: Confidence and consumer spending



## Housing showing signs of life

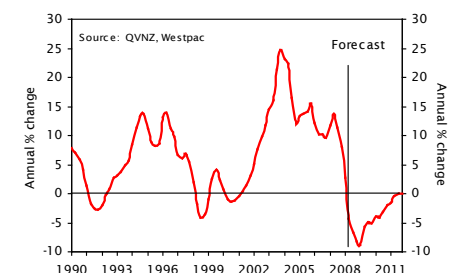
Sentiment toward the housing market has clearly turned and is now far more upbeat, largely courtesy of lower mortgage rates. House sales have lifted off their lows and it is now taking far less time to sell a house than it was in mid-2008. However, the outlook for house prices remains mixed. The positives include: lower mortgage rates; very low rates of new homes being built, meaning there is a strong possibility that a housing shortage is now developing;

and improving net migration.

However, these factors need to be weighed against the negatives: rising unemployment; tighter access to credit; and less valuable tax offsets.

Overall, we expect house prices to continue falling in 2009, but at a less vicious pace of -5%. That follows a 9% decline in 2008. We remain of the view that prices will not regain their 2007 level any time between now and 2012.

Figure 15: Westpac house price forecast



# Widespread contraction

*Few have been spared from the recession. Goods producing sectors have been hit hard by the slump in domestic and external demand. The short-term outlook remains weak. Retail and wholesale sales are likely to fall further as consumers remain cautious. Government spending and increased mining activity are among the few positives on the horizon.*

## Overview

Few, if any, sectors are avoiding the downdraft of recession. That is not to say all firms are in retreat. It is even likely that some firms in the worst hit sectors are seeing solid growth, while other firms in the least hit sectors are contracting. Overall though, on an aggregate sector basis, the latest set of national accounts does not make pretty reading.

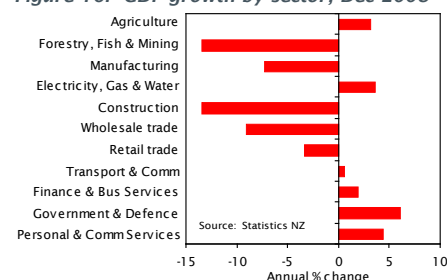
The goods producing sectors have been hit hardest by the more-than-a-year-long slump in domestic demand. The extreme weakness globally is now amplifying the domestic contraction. GDP in the manufacturing sector fell 7.3% in 2008, with all nine sub-sectors contracting. The

outlook for 2009 is for more weakness, given extremely weak new orders. This follows from the high stocking rates of retailers and wholesalers after a slump in sales. Meanwhile, construction activity has been slashed following the downturn in the housing market. While there are some shoots of recovery in housing appearing, forward indicators for non-residential building have turned down.

More rain during spring 2008 compared to the previous year helped boost agricultural production and value-added in electricity generation. Even these pockets of growth look likely to fade in 2009 as recovery from drought wanes and the weak economy reduces

demand for power. Increased mining activity and government appear to be the main prospects for growth in 2009, although these will not be enough to offset the negatives.

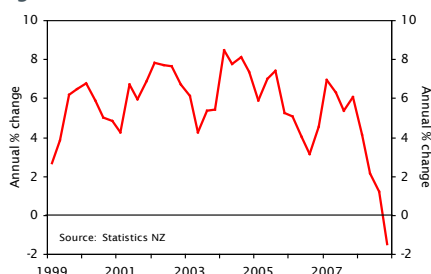
Figure 16: GDP growth by sector, Dec 2008



## Retail trade

Retailers are feeling the effect of cautious consumers. After adjusting for the leap day last year, trend sales in February were around 3.5% lower than a year ago. The outlook for 2009 is for tough times to continue. Dented household balance sheets and rising unemployment will see caution prevail. Tax cuts, lower fuel prices and lower interest rates are doing their best to encourage more spending. Rising net migration will also be a positive. On balance the negatives are expected to overwhelm the positives in 2009, but outcomes will differ by segment. Like 2008, sales of big ticket durable items will remain soft. Less income-sensitive sub-sectors like supermarkets, food, alcohol and repairs are likely to outperform in an overall weak retailing environment.

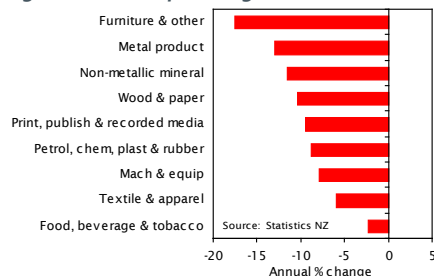
Figure 17: Nominal retail sales



## Manufacturing

Domestic and export sales have plunged, and official production figures show production followed suit in the final quarter of 2008. The results from the latest *QSBO* are alarming. Stocks are too high as a result of the slump in sales. Capacity is lying idle. A disturbing four in 10 manufacturing firms have more than 20% spare capacity. Firms do not see recovery in the short term, and new orders received have dropped to their lowest level since the survey began in the early 1960s! Little wonder more than half of manufacturing firms expect to shed staff over the coming three months, far outweighing the 5% of firms looking to expand staffing levels. If there is a positive side, those trying to find staff will find it easier and the calibre of applicants far higher.

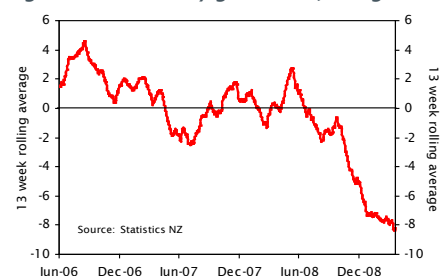
Figure 18: Manufacturing GDP



## Electricity, gas and water

Electricity generation fell by more than usual during summer. We estimate generation in Q1 fell by around 4% after adjusting for the normal summer effect. A widespread reduction in economic activity and especially in manufacturing production has pulled down demand for power, amplified by shutdowns at some major plants. Rising retail prices has also dampened electricity demand from households. The 4% decline in electricity generation will be a direct drag on Q1 GDP growth in its own right, the more worrying aspect is what the decline in power demand is telling us about the health of the overall economy. Electricity demand, outside of the usual seasonal variation, is not likely to strengthen substantially until economic recovery in 2010.

Figure 19: Electricity generation, ann growth

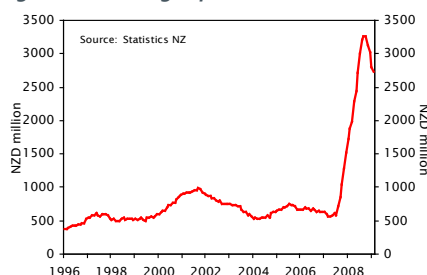


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## Mining

Production from the Tui oil field is easing. Combined with lower oil prices, this is reducing mining exports. After peaking at almost \$3.3 billion in the year to September 2008, annual mining exports have eased back to \$2.7 billion. The volume of mining exports is expected to rise through 2009, despite reduced Tui production. Production from the Maari oil field is now underway with Kupe gas and oil anticipated to come on-stream during Q3 2009 and Pike River coal mine expected to be in full production by Q4 2009. Across private sector dominated industries, the increase in mining output through the year will be one of the few positive contributors to GDP.

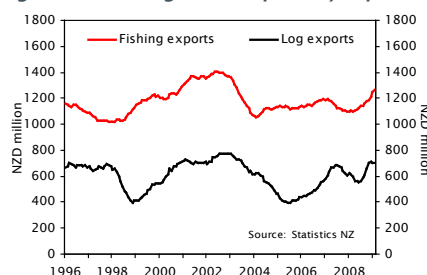
Figure 20: Mining exports



## Forestry and fishing

Lumber markets remain very weak, constrained by the downturn in many housing markets around the world. A sustained global recovery in the short term seems highly unlikely, although, importantly, some recovery is anticipated in Australia. In the log market, glimpses of improvement in China are encouraging, but extreme weakness remains elsewhere including in Korea and Japan. A markedly lower NZD has helped lift the value of log exports in the year to February to \$705m, 15% up on the previous year. However, underlying volume growth over the year has been subdued and has weakened in the first few months of 2009.

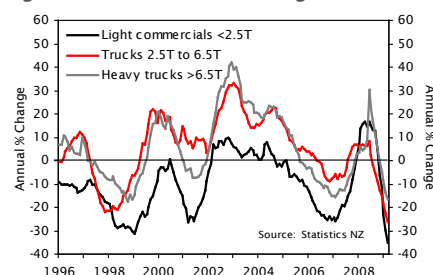
Figure 21: Non-agriculture primary exports



## Transport

The recession is showing up in reduced transport activity. Freight volumes have fallen on the back of a slump in both domestic and external demand. The short-term outlook is bleak. Ongoing weakness in domestic demand is expected to result in a 20% drop in import volumes in 2009, while export volumes are expected to contract 8.5%. Moreover, no significant recovery in trade volumes is forecast until the second half of 2010. This outlook has businesses severely paring back investment. Truck registrations in the first three months of 2009 are down 50% on the same period last year.

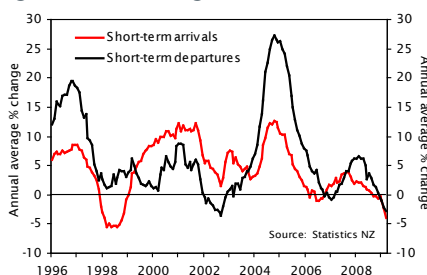
Figure 22: New commercial registrations



## Tourism

Visitor arrivals are down on a year ago as the severe destruction of wealth and now rising unemployment around the world discourages travel. Visitor numbers were down about 3.5% in March, after adjusting for the early timing of Easter last year. Weakness was widespread with fewer travellers from North America, Europe and much of Asia. There has been some encouraging growth from the Chinese and Indian markets over recent months – the latter boosted by the touring Indian cricket team. Increased marketing in Australia should help boost visitors from Australia later in 2009, especially if winter delivers decent snow. Lower oil prices, international airfares and NZD will all help. Just as well; there are some very large negatives to offset.

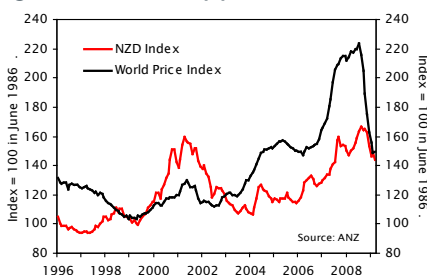
Figure 23: Tourism growth



## Agriculture

Supply side responses in various key markets will help dampen the hit to prices from the international economic crisis. Encouragingly, world dairy prices have stabilised in recent months on expectations of slowing supply growth. This has led to an upward revision to payout forecasts. We expect a final payout of \$5.30/kgMS for 2008/09 and \$4.90 for 2009/10, the latter an increase from our previous view of \$4.50. International lamb prices are expected to remain high thanks to limited global supply while US beef prices are expected to remain volatile reflecting variable demand conditions, heightened dairy cow culling and uncertainty around recovering trade with Asia.

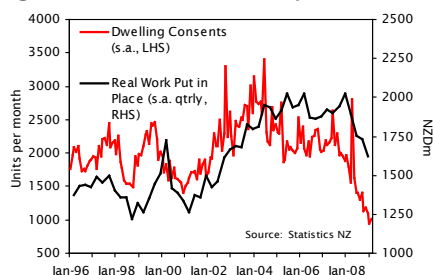
Figure 24: Commodity prices



## Construction

A 31% slump in residential building saw the real value of total building work put in place drop 20% through 2008. Despite the already very low level of activity, indicators suggest further declines are likely in the short term. The downtrend in dwelling consents extended to 20 consecutive months in February 2009, with trend consents 45% below year ago levels. We expect some recovery in house building in 2010 helped by rising net migration (there are signs this is turning already) and lower interest rates. Meanwhile, non-residential building continued at a brisk pace through 2008, but forward indicators like building consents and firms' building intentions suggest activity will pull back in 2009.

Figure 25: Construction activity



Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

# All guns blazing

*The deepening global recession and the absence of inflation pressures mean that more should be done to stimulate the economy. Fiscal policy is hamstrung by the need to maintain the confidence of rating agencies and international investors; monetary policy must step up to the plate. The RBNZ has done that, cutting the OCR to 2.5% and committing to keep it low for a very long time. We believe them, and also see further modest cuts to come.*

## Inflation outlook

The clamour for policymakers to provide more economic stimulus is usually framed in terms of 'rescuing' growth, in the face of the worst recession that the world has seen in decades. In practice, it's not that straightforward for central banks, and especially for the RBNZ – their sole mandate is to maintain low and stable inflation over the medium term (subject to clauses about avoiding excess volatility). So any further interest rate cuts, below what are already record-low levels, would have to be justified in terms of the medium-term outlook for inflation.

That outlook has changed dramatically in recent months. In fact, there is now a greater chance that the RBNZ finds itself forecasting a breach of the lower edge of its 1-3% target band over the medium term, in the absence of a further policy response – a reversal of the problem they have faced in recent years (Figure 26).

The most widely recognised driver of inflation over the medium term is the 'output gap' – a measure of the degree of slack in the economy, relative to its 'potential', or sustainable long-run growth rate. In recent years the RBNZ has been faced with a persistently positive output gap (i.e. the economy has been running ahead of potential), which has put upward

pressure on prices and wages. But with the global economy expected to contract sharply this year, and to claw back only a fraction of its losses in 2010, it looks as though there will be a huge degree of slack in the global economy for years to come. Capacity utilisation is falling, and unemployment is set to rise sharply – the OECD's prediction for the unemployment rate in its member economies to reach 10% next year doesn't seem much of a stretch, given that it's already 8.5% and rising in the US and Eurozone.

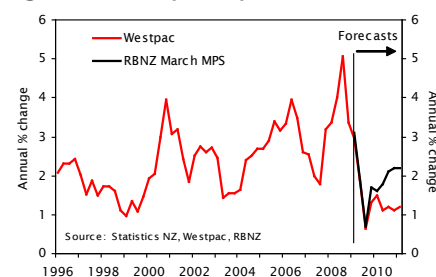
This affects NZ in two ways: firstly through our own negative output gap, which will ease domestically generated inflation pressures, and secondly through the global output gap, which will weigh on prices for traded goods. The latter could be offset by a continued fall in the exchange rate, but the net effect would depend on firms' ability to pass any currency-driven inflation on to their customers – and in a recession, that kind of pricing power tends to be limited.

There was already evidence of weaker inflation pressures in the March quarter CPI data. Prices rose just 0.3% in the quarter, bringing annual inflation down to 3.0%. Food price inflation remains stubbornly high, and a rise in petrol prices since the

start of the year meant less disinflation than we previously expected, but the rest of the details were generally soft. Housing-related inflation, previously one of the RBNZ's biggest bugbears, was particularly weak, with rents up just 0.3%, purchase prices for new homes flat, and real estate services down 1.1%.

Disinflation will become a more prominent theme through 2009. Business surveys point to weak activity, increasing spare capacity and falling pricing intentions, reflecting a lack of pricing power. The unemployment rate is set to rise sharply over the next year, which will remove the upward pressure on wages. Even with our forecast for the RBNZ to cut rates further and keep them low for a long time, we still expect inflation to average not much more than 1% for the foreseeable future.

Figure 26: CPI inflation forecasts



## Interest rates outlook

Fiscal policy has provided a significant boost to the economy so far during this recession. But there is growing concern about the Government's projections for a sharp rise in outstanding debt in coming years – and as the growth outlook deteriorates, that debt profile just looks worse and worse. Standard and Poor's have already stated that this could threaten New Zealand's AA+ sovereign credit rating, and a downgrade would make it even more costly for New Zealanders to borrow offshore. Officials have stressed that there is no room for fiscal policy to do more than is already planned – and it may end up doing less, if the personal tax

cuts pencilled in for 2010 and 2011 are cancelled, as is looking increasingly likely. Monetary policy is therefore in the hot seat.

In the March *Monetary Policy Statement*, the RBNZ cut the cash rate by 50bp to 3% but indicated that any further cuts would be more modest than those seen recently. Their central forecast implied a low in the OCR of 2.5%, although they noted that it could go as low as 2% if the economy failed to recover as quickly as hoped. However, they expressed concern about taking the OCR any lower than this, noting that "New Zealand needs to retain competitiveness in the international capital markets".

The tenor of the *Statement* saw

long-term rates rise substantially, after borrowers read the *MPS* as a signal that the interest rate cycle had bottomed, and rushed to lock in what were historically low fixed-term rates. In addition, the NZ dollar rose about 10% above the RBNZ's projections, further tightening monetary conditions.

These developments were of such concern to the RBNZ that on 1 April they issued a statement that "the rise in longer-term interest rates is unwarranted and inconsistent with the monetary policy outlook". And, even more importantly, the message was far more accommodating in the OCR review on 30 April than it

had been in March. The OCR was cut by 50 basis points to 2.50%, and possible further modest cuts were foreshadowed. Gone was any reference to the need for internationally competitive rates, and added was a comment that they “expect to keep the OCR at or below the current level through until the latter part of 2010”. Long interest rates and the NZD both fell sharply in response to such a bold statement, exactly the response for which

the RBNZ would have been hoping.

We expect the OCR to fall to 2% in the third quarter of this year and to remain there for a long time (Figure 27). Central banks around the world are still mulling over how to deliver more stimulus, with a growing number resorting to quantitative easing now that they have cut rates to near-zero. It will be a long time before NZ needs to worry about keeping its rates “competitive”.

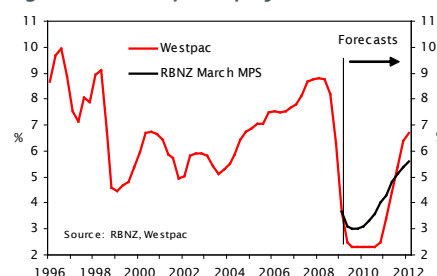
## Exchange rates outlook

The rebound in the NZ dollar since mid-March can be ascribed to several factors: the rise in interest rates after the MPS, signs of a pickup in dairy export prices, an improvement in investor sentiment, and concerns that other central banks will debase their currencies by resorting to ‘printing money’. We suspect some of these factors will be fleeting, particularly the change in market sentiment – investors may have become acclimatised to weak data in the short term, but we doubt they’re prepared for the mediocre rebound and sustained period of weak activity implied by our ‘shopping trolley’ growth scenario. Other factors could be more

enduring: the quantitative easing measures undertaken in the US and elsewhere won’t be reversed for some time. NZ may be one of the few developed economies that doesn’t resort to such measures – though we can never say never!

Notwithstanding the recent bounce, we still see a weaker currency as a necessary part of the economy’s adjustment process. The collapse in global activity will continue to weigh on export demand, even though the impact on the relatively basic items that New Zealand produces has been more gradual. The exchange rate has been an important buffer so far, but there is more work to be done.

Figure 27: 90 day rate projections



Perhaps more significant is NZ’s heavy reliance on external funding, in a world where a ‘home bias’ for lenders is becoming more apparent. Borrowing from overseas is one thing; being able to borrow in your own currency is another matter entirely, and NZ is fortunate in that it has been able to either borrow directly in NZD or hedge the vast majority of its foreign currency risk through derivatives. But to keep this up over time, we suspect that the NZD will need to get much cheaper, and stay there for an extended period, to entice investors into accepting this much exposure to NZ. The recent much more dovish tenor from the RBNZ will help.

## 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
Jun-09	2.25	2.50	3.20	4.10	0.52	0.76	54.6	53.2
Sep-09	2.00	2.30	3.30	4.20	0.50	0.77	52.5	52.7
Dec-09	2.00	2.30	3.40	4.30	0.47	0.76	48.4	50.7
Mar-10	2.00	2.30	3.50	4.40	0.45	0.75	45.9	49.2
Jun-10	2.00	2.30	3.60	4.50	0.48	0.75	48.0	50.9
Sep-10	2.00	2.30	3.80	4.60	0.52	0.76	51.0	54.0
Dec-10	2.00	2.50	4.00	4.80	0.55	0.79	55.0	56.4
Mar-11	3.00	3.40	4.40	5.10	0.56	0.80	58.4	57.7
Jun-11	4.00	4.40	4.95	5.55	0.58	0.81	61.8	58.9
Sep-11	5.00	5.40	5.75	6.10	0.59	0.82	65.4	60.1
Dec-11	6.00	6.40	6.50	6.60	0.60	0.83	69.0	61.3

Figure 28: 90 day bank bills, 2 year and 5 year swap rates (Monthly Average)

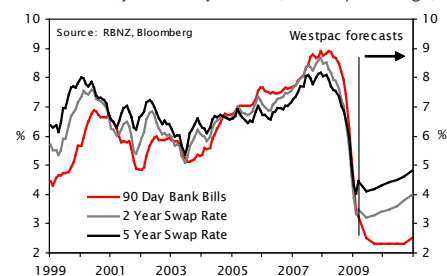


Figure 29: NZD/USD and TWI (Monthly Average)

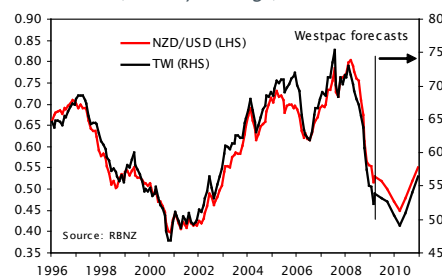
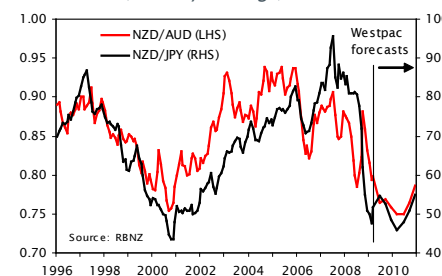


Figure 30: NZD/AUD and NZD/JPY (Monthly Average)



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# Green shoots or noxious weeds?

*Recent data out of the US suggests that the prevailing bad mood may be shifting. Indeed, if equity markets are anything to go by, one may be forgiven for thinking that the worst is over. The consensus view is that growth should start to turn by late 2009, but we caution that it is still very early days.*

In the major northern hemisphere developed economies, banking systems have largely failed making traditional policy responses (cutting interest rates and fiscal measures) to the recession less effective, but governments have committed to "do what it takes" to get things moving again. Evidence that enough has already

been done is still scant but at this stage we expect policy responses to get some traction by 2010. Developing economies, initially seemingly resilient to the western slowdown, are now reeling from the collapse in global trade that emerged late last year and continues this year. China (and India) is still growing but at a far

slower pace. We are hopeful that the global situation will improve in 2010 but risks around our 2% growth forecast for next year are to the downside and a return to the 4-5% global growth pace seen earlier this decade is unlikely in the foreseeable future.

## Australia

The Australian economy weakened sharply through 2008, with the non-farm economy in recession in the second half of the year and overall GDP falling 0.5% in Q4. The economy is expected to contract 1% this year, its first year of decline since 1991. Last year's slowdown was initially in response to aggressive monetary policy tightening by the Reserve Bank but more recently the global credit crisis and

consequent global recession have weighed heavily on the economy.

Policy response has been swift with official interest rates cut 425bp in seven months and several rounds of fiscal stimulus already implemented since December last year. This has led to some tentative signs of activity picking up in retail and housing although sharply higher household saving, slashed business

investment and hiring intentions and weaker exports will be the dominant economic drivers this year. Unemployment is already rising sharply and any recovery in economic growth in 2010 will be modest. But it needs to be stressed that, unlike in previous global downturns, the Australian economy is likely to fair relatively less badly thanks to the still robust and profitable banking sector.

## USA

The US recession began gently in early 2008 but entered a new phase late last year when the economy dived at a pace not seen since the early 1980s, as the collapse of Lehman Bros prompted a fresh round of risk aversion, financial market instability and consumer and business retrenchment. The numbers are stark: new home sales have fallen from the mid decade peak of 1.2mn per year to less than 400k currently; auto sales are down from

typically 17mn per year to below 10mn; jobs growth of 200k per month mid decade is now being reversed by as much as three quarters of a million per month in early 2009. We expect the economy to shrink 3% this year and minimal if any recovery in 2010, as substantial fiscal, monetary and quantitative easing struggle to gain traction while the banking system remains broken. The so-called "green shoots" of recovery apparent in some housing and factory

indicators are tentative at best.

US policy-makers will "do what it takes" to stabilise the crippled banking sector but it is not yet clear that the latest iteration of the Geithner bailout plan will be sufficient. Indeed it may be the case that US banks are still sitting on undisclosed substantial losses, in which case a renewed bout of risk aversion in markets would be a big near-term risk.

## China

The Chinese economy reportedly expanded at a 6.1% annual pace in Q1, its slowest in a decade, and well down on the 13% growth rate reported for 2007. The collapse in global trade has hit hard, with exports down by a quarter in February compared to a year earlier. However a range of industrial production, electricity use, construction

and retail indicators have recently provided some evidence that the economy might be stabilising, perhaps in response to the fiscal stimulus announced late last year.

An ongoing concern, however, is that a range of factors including an undervalued currency, rising unemployment, lack of measures in the fiscal package aimed

directly at households and a high propensity to save will constrain the development of private domestic demand as an alternative to crippled exports. Hence we expect only modest GDP growth acceleration in 2010, well short of the double digit growth pace that was the norm prior to last year.

## UK and Europe

The European economic black hole is deeper than policy-makers believed just a few months ago. Unemployment is rising sharply across Europe and household

spending is falling for the first time in fifteen years. The ECB has cut rates by 300bp to just over 1% and in early May will detail "unconventional measures" to

provide further stimulus. Fiscal stimulus has been limited and largely ineffective.

European banks are heavily exposed to crumbling emerging markets and that is

likely to mean, for some institutions, that crippling losses will need to be revealed later this year. Euroland is expected to suffer a GDP contraction of over 3% this year and will not return to significant growth before 2011.

The financial services melt-down continues to hit the UK economy hard, but the factory sector is now also contracting

at its fastest pace in decades, and the monthly unemployment gains beat anything seen during the Thatcher years or the winter of discontent in the 1970s. House prices are down nearly 20% yr despite an underlying shortage because the broken banking system, now about half nationalized, has not been lending. That said, there is some tentative evidence

that the pace of contraction might be stabilizing, but with monetary policy now exhausted, fiscal policy constrained by already excessive government borrowing and the BoE still feeling its way with its quantitative easing program, the UK economy will shrink by up to 4% this year with minimal growth in prospect next year.

## Japan and rest of world

Saving the worst to last, the Japanese economy is conservatively expected to shrink by 5% this year, demonstrating that excessive saving can hurt your economy even more than profligate borrowing. With no domestic demand growth to speak of, Japanese reliance on other countries' spending to support the export

and industrial sectors has left her over-exposed to the collapse in global trade. Exports have halved over the past year, industrial production is down around 40% and machinery orders have imploded by a staggering 85%, meaning exports and production will shrink even further this year.

The story is similar across the region with the orders, exports and production meltdown pummelling the likes of South Korea, Singapore, Hong Kong, Taiwan, Singapore and others, with economic contractions in the vicinity of 4% expected this year.

## Economic and Financial Forecasts

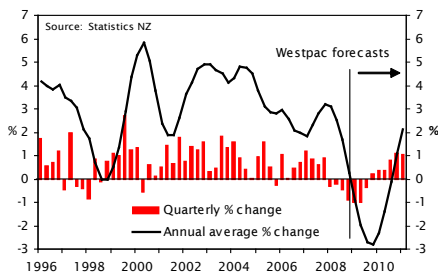
Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
<b>New Zealand</b>							
Real GDP % yr	4.5	2.8	2.0	3.2	0.2	-2.8	1.1
CPI inflation % annual	2.7	3.2	2.6	3.2	3.4	1.3	1.1
Unemployment %	3.8	3.8	3.8	3.5	4.7	7.6	7.3
Current Account % GDP	-6.4	-8.5	-8.7	-8.2	-8.9	-6.2	-5.5
<b>Australia</b>							
Real GDP % yr	3.8	2.8	2.9	4.0	2.1	-1.0	1.5
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	2.6	2.4
Unemployment %	5.4	5.1	4.8	4.4	4.2	5.8	7.6
Current Account % GDP	-6.1	-5.8	-5.3	-6.3	-4.3	-5.7	-7.5
<b>United States</b>							
Real GDP %yr	3.9	3.1	2.8	2.0	1.1	-3.0	0.5
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-1.8	1.2
Unemployment Rate %	5.5	5.1	4.6	4.6	5.8	9.2	10.6
Current Account %GDP	-5.7	-6.1	-6.0	-5.3	-4.7	-3.4	-3.7
<b>Japan</b>							
Real GDP %yr	2.3	1.9	2.2	0.3	1.1	-5.0	0.2
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-0.9	0.1
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.5	7.0
Current Account %GDP	3.3	3.6	3.9	4.8	3.0	2.8	2.6
<b>Euroland</b>							
Real GDP %yr	1.9	1.8	3.0	2.6	0.7	-3.1	0.3
Consumer Prices %yr	2.1	2.5	2.0	3.1	1.6	0.5	0.7
Unemployment Rate %	9.0	8.8	7.9	7.3	7.8	9.0	9.5
Current Account %GDP	0.0	-0.2	-0.5	0.0	-0.2	0.0	0.4
<b>United Kingdom</b>							
Real GDP %yr	2.8	2.1	2.8	3.0	0.7	-3.4	0.4
Consumer Prices %yr	1.3	2.1	3.0	2.1	3.5	1.0	1.3
Unemployment Rate %	2.8	2.8	3.0	2.5	3.1	4.5	5.5
Current Account %GDP	-1.9	-2.6	-3.0	-2.8	-2.3	-6.0	-5.5

Forecasts finalised 22 April 2009

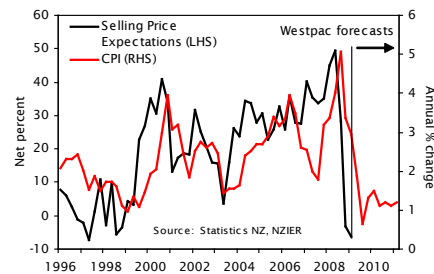
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Annual Average % change	March years				Calendar years			
	2008	2009f	2010f	2011f	2008	2009f	2010f	2011f
Private consumption	3.2	-0.3	-0.2	0.7	0.1	-0.2	0.3	2.4
Government consumption	4.3	3.4	3.8	3.3	3.8	3.7	3.4	2.9
Residential Investment	4.3	-25.0	-15.5	5.6	-18.6	-22.7	3.4	10.5
Business Investment	4.2	-4.4	-19.4	0.8	-0.6	-19.0	-5.1	8.9
Stocks (% Contribution)	0.8	-0.5	-1.2	1.6	0.2	-1.8	1.4	1.0
GNE	4.4	-2.1	-4.3	3.0	-0.3	-5.1	1.5	4.9
Exports	2.9	-4.8	-7.6	2.0	-1.8	-9.0	-0.4	4.8
Imports	9.6	-3.5	-17.0	4.8	2.5	-18.8	0.9	8.6
<b>GDP (Production)</b>	<b>3.1</b>	<b>-0.9</b>	<b>-2.3</b>	<b>2.1</b>	<b>0.2</b>	<b>-2.8</b>	<b>1.1</b>	<b>3.7</b>
Employment annual %	-0.3	1.1	-3.0	0.8	0.9	-3.8	0.1	1.4
Unemployment Rate % s.a.	3.8	5.3	7.7	7.1	4.7	7.6	7.3	6.7
Average Hourly Earnings annual %	4.4	4.7	1.5	2.6	5.1	1.8	2.2	3.4
CPI annual %	3.4	3.0	1.5	1.2	3.4	1.3	1.1	1.2
Current Account Balance % of GDP	-8.0	-8.9	-5.9	-5.3	-8.9	-6.2	-5.5	-5.9
Terms of Trade	11.6	-7.5	-3.2	4.9	1.8	-8.8	4.8	0.5
90 Day Bank Bills (end of period)	8.82	3.67	2.30	3.40	6.30	2.30	2.50	6.40
5 year swap (end of period)	8.01	4.27	4.40	5.10	5.83	4.30	4.80	6.60
TWI (end of period)	71.9	53.7	49.2	57.7	57.8	50.7	56.4	61.3
NZD/USD (end of period)	0.79	0.53	0.45	0.56	0.58	0.47	0.55	0.60
NZD/AUD (end of period)	0.87	0.80	0.75	0.80	0.86	0.76	0.79	0.83
NZD/EUR (end of period)	0.53	0.41	0.41	0.46	0.44	0.42	0.46	0.48
NZD/GBP (end of period)	0.40	0.37	0.34	0.37	0.37	0.34	0.37	0.36

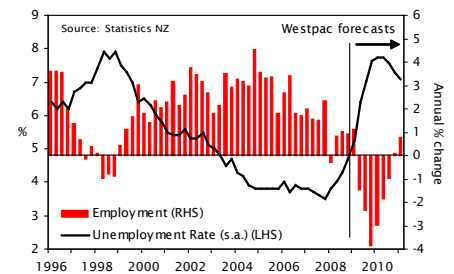
Production-based GDP



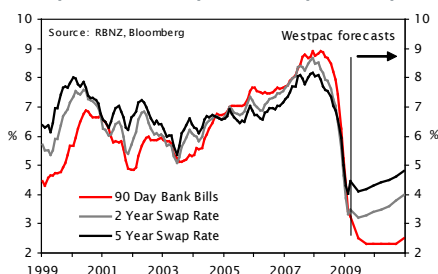
CPI and selling price expectations



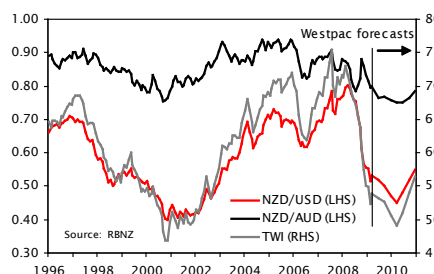
Household labour force survey



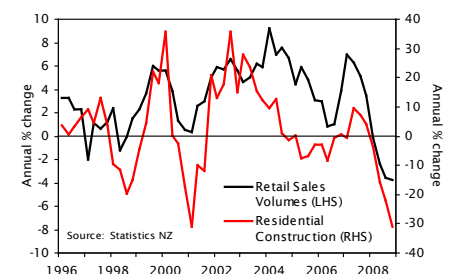
90 day bank bills, 2 year and 5 year swap



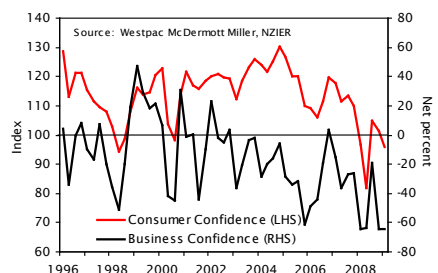
NZD/USD, NZD/AUD and TWI



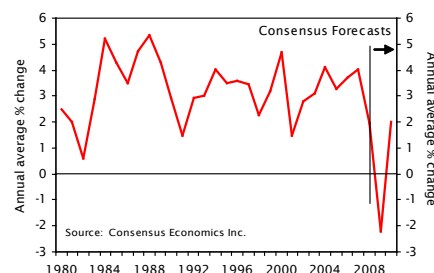
Retail sales and residential construction



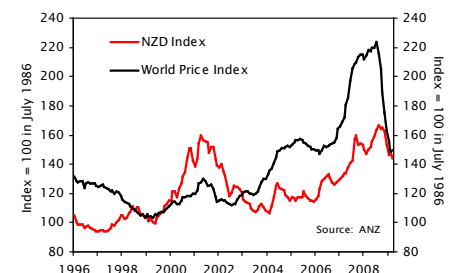
Consumer and business confidence



World GDP - trading partner weighted average



Commodity prices



Prepared by the Economics Department, Westpac, PO Box 691, Wellington, email [economics@westpac.co.nz](mailto:economics@westpac.co.nz).  
 For further information contact Brendan O'Donovan, Donna Purdue, Doug Steel, Michael Gordon, Dominick Stephens or Sharon Zollner.  
 For address changes contact Natalie Denne, ph: (04) 381-1413 or [natalie.denne@westpac.co.nz](mailto:natalie.denne@westpac.co.nz). Text finalised 30 April 2009



Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.