

Economic Overview

April 2010

Highlights

- **New Zealand is in the midst of a traditional economic recovery.** The New Zealand economy finished 2009 on a strong note. A vigorous stockbuilding cycle is underway, but we expect the baton of recovery to soon pass to residential construction and eventually a solid upswing in business investment (*see Economic Outlook, page 2*).
- **An economic rebalancing may finally be within NZ's grasp.** The goods producing sectors are leading the way out of recession, and NZ is currently enjoying the benefits of record commodity prices. At the same time, consumers seem to be circumspect (*see Sectoral Trends, page 4*).
- **Global healing is continuing but the recovery is not uniform.** The global recovery has become even more imbalanced. The US and Europe are working through structural difficulties including weak housing markets, wrecked banking systems, and fiscal unsustainability. Meanwhile, Asian and Australian economic growth is strengthening so rapidly that talk of the Asian bubble we have long worried about has become commonplace (*see International, page 8*).
- **Exchange rate and interest rates are headed north.** The NZD looks unusually strong for this stage of the recovery. But export commodity prices have also defied their usual cyclical pattern, recently reaching new highs. We see the NZD around current levels or higher by year-end, before easing back in 2011. Interest rates are going up from June – the market may be in two minds but we suspect the RBNZ is not. Inflation is forecast to remain uncomfortably close to the top of the 1-3% target band in coming years. The usual time lag between monetary policy and inflation outcomes dictates that the RBNZ should be taking action now (*see The Markets, page 6*).
- **A new neutral for the OCR?** There has been much hullabaloo around the neutral Official Cash Rate. Most market economists estimate the new neutral to be around 5%, 1% to 1.25% lower than what they think prevailed pre global financial crisis (GFC). While we think it is possible that the neutral OCR is lower (although we are not sure from where), we think that it is not nearly as low as other economists are asserting (*see Feature Article, page 10*).

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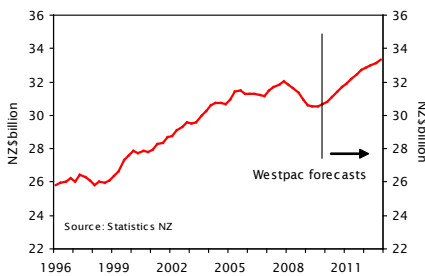
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Recovery on track

Consumer data has softened through the first quarter of 2010, fuelling the arguments of those already sceptical of the recovery and its durability. However, we remain convinced that the consensus view of a mild recovery will be proved wrong.

The New Zealand economy finished 2009 on a strong note, with GDP lifting 0.8% in the fourth quarter. However, in per capita terms GDP remains 4% lower than in 2007. On our forecasts, it will be mid 2011 before that gap is closed, so it's no wonder many people find it hard to believe the economy is growing. Still, the fact is, the economy is growing and the broad suite of recent data is supportive of an economy gaining momentum. Yes, household spending dipped in early 2010 and credit growth remains weak. But right now the main drivers of growth are elsewhere – exports, manufacturing, and house construction being key. Moreover, the economy is following the same well trodden path of past recoveries, giving us confidence that GDP growth will accelerate further through 2010.

Figure 1: GDP per capita



As a result, our GDP forecasts are little changed from our January *Economic Overview*. We expect GDP growth of 3½% for calendar 2010, 4½% in calendar 2011, and 3½% in calendar 2012. That is in line with the RBNZ's forecasts in the March *Monetary Policy Statement*, but remains at the top end of market forecasts.

As we have indicated for some time, residential investment will be the major driver of growth over the next couple of years. The good news is that recent developments, both global and domestic, point to business investment also returning to the fore. A recovery in consumer spending remains an essential part of our story, as does continued strong support from government spending.

Houses houses everywhere

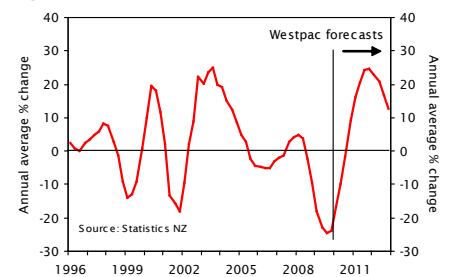
For the past year or so we have been arguing that the level of residential building activity has not been sufficient to meet population growth. In order to meet 'normal' population growth we estimate that we need around 18,000 new homes to be built every year. However, through 2009, a mere 14,400 homes were consented. When we combine that with the above average growth in population through the past year as net migration surged to 22,000, the conclusion is that a shortage of homes now exists. There are two plausible ways that this shortage will be resolved:

- supply will increase of its own accord – i.e., new home building will rise; or
- population pressures will ease (as Australia becomes attractive to jobseekers again).

In practice, we expect to see a mix of both factors. Indeed, momentum is already gathering in the residential sector, with confidence at an all time high and dwelling consents up 30% from a year ago. And, if you exclude the volatile apartment component (apartment building has been decimated by the credit crisis with just 13 apartments consented in the month of February – an all time low for the series), consents are up a massive 57%. On our calculations, that

will translate into residential investment growth of 16% in 2010 and a further 23% in 2011, even as the RBNZ continues to lift interest rates. That growth profile is not as steep as forecast back in January and largely reflects the slower than expected growth in residential construction to date, and our expectation of slower house price growth over the next couple of years (see below for detail). Credit remains a potential wildcard to our view, with anecdotes suggesting some developers are still finding conditions tough. If this continues, then the peak in the cycle is likely to be later.

Figure 2: Residential investment



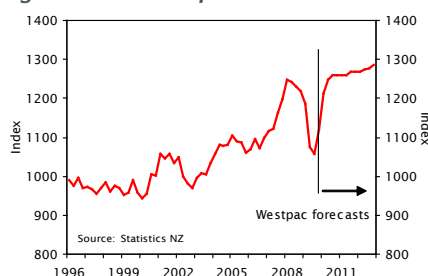
Investment, business that is

Business investment has been a drag on economic growth in the recovery to date, despite support coming from building work associated with the Rugby World Cup, government infrastructure investment, and mining exploration. However, we believe that situation is set to change over the course of this year. After contracting by close to 11% in calendar 2009, we expect business spending to gather pace through 2010. Several key factors support that view. Capacity utilisation has begun to rise as the economy has lifted out of recession, and in the March quarter was above its long run average. That suggests that as demand increases over the coming year, investment will rise. Certainly, business confidence is not an issue at the moment,

with confidence rising to its highest level since June 1999 according to the March *Quarterly Survey of Business Opinion*. That confidence is already translating into investment intentions, which rose through the March quarter.

Meanwhile, the export sector is going from strength to strength. The strong Australian economy and an NZD/AUD cross rate at ten-year lows are proving a boon to sectors such as manufacturing and tourism. Late season growing conditions have taken a turn for the worse in the upper North Island, but commodity prices have soared. In fact, the ANZ commodity price index set a new record high in March. Consequently, the terms of trade are on the rise again, increasing by 5.7% in the December 2009 quarter – the largest quarterly gain since March 1976.¹ The terms of trade are still around 10% below the previous peak, but are on track to surpass the 30-year high achieved during 2008. That will support both balance sheet restoration and solid investment growth in the export sector during the next couple of years.

Figure 3: Terms of trade

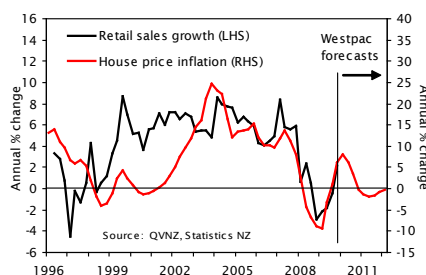


Consumer moderation will be short-lived

Not much went the consumer's way in late 2009 and early 2010. Petrol prices rose, unemployment worsened, and the housing market retreated. The prospect of changes to the taxation of property has weighed heavily on the housing market in the last few months – house sales have dropped sharply, listings have picked up, and house price growth has slowed. We now expect that house price growth will ease from a peak of 6% at the end of 2009 (based on QVNZ data) to flat

(i.e., 0%) by end 2010. House prices are expected to decline by 1% through 2011.

Figure 4: House price inflation and consumer spending



Against this backdrop consumer confidence faltered between the December and March quarters, dropping from 116.9 to 114.7. But although confidence has slipped from its peak, it remains comfortably above its long-run average. Indeed, the overall level of confidence is consistent with modest growth in consumer spending, just not as emphatic as in the latter part of 2009. The upshot is that we have pulled back our forecast for consumer spending in the first quarter of 2010.

However, we believe this soft patch will be short-lived. Durables spending is set to outperform through 2010 as a replacement cycle gets underway. Indeed, at the height of the recession, spending on durables fell 8% from the 2007 peak and at current levels remains 4% lower, suggesting there is plenty of room for catch up. Meanwhile, mortgagors are continuing to get more cash in hand as they roll off high fixed-term mortgage rates. We expect debt servicing costs to continue to fall over the next six months despite our expectation that the RBNZ will begin to lift rates from June this year.

In addition, a solid investment cycle and a strengthening export sector will spur job growth. That is consistent with recent labour market indicators which suggest firms, on balance, intend to hire over the coming year. Our forecasts see employment gradually gaining pace over the course of 2010, resulting in a

drop in the unemployment rate from an estimated peak of 7.4% in the March 2010 quarter to 6.2% by end 2010, and 5.5% by the end of 2011. Wages will come under pressure as the unemployment rate falls, meaning income growth should begin to gather momentum later this year.

Overall, though, we expect an average rather than spectacular outlook for the consumer. We forecast real spending growth of 2.5% in 2010 and 3.3% in 2011. That compares with a long-run average of 2.7% per annum. It seems the long-awaited rebalancing of growth from the domestic to the external sector is underway.

Taxman

Muddying the economic picture over the coming year will be the shift in tax policy anticipated in the 2010 Budget (due for release on May 20).² Of the tax changes mooted, we see the most likely to be a drop in income tax rates; an increase in GST from 12.5% to 15% with compensating increases in government transfers; and the removal of depreciation allowances (and subsequent claw backs) for buildings. While the overall gamut of tax changes will have positive effects on saving, investing, and the willingness to work, it is the potential impact on the housing market that has caused the greatest furore. We estimate the likely tax reforms would reduce the value of housing by around 10%, with most of the impact coming from the drop in the top income tax rate. This is not the same as forecasting that prices will fall by 10%: as we saw in the 2007-08 downturn, prices tend to be stickier on the downside, as most owners will avoid selling into a falling market. Most of the hit would come through lower turnover, and flat prices for a few years until incomes and rents close the valuation gap.

¹ The terms of trade reflect New Zealand's international purchasing power. An increase unambiguously leaves the country better off.

² For a detailed discussion of the potential reforms and their impact please see our Bulletin "The BigGST step", 12 February 2010.

It's good to be good

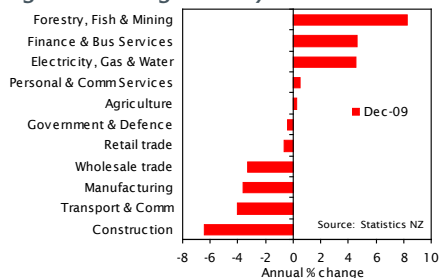
The will-o'-the-wisp of economic rebalancing, for which economists have been forlornly longing for the past couple of decades, may finally be within grasp. The goods producing sectors are leading the way out of recession, and NZ is currently enjoying the benefits of record commodity prices. At the same time, consumers seem to be circumspect.

Overview

Some of the goods producing sectors have begun to lead the economic recovery and we expect this to continue. Amongst the fastest growing sectors in the past year have been forestry (+12.5%), petroleum (9.2%), wood and wood products (7.2%), mining (7.0%), and electricity, gas and water (4.6%). Record high commodity prices are assisting the primary sector to initially deleverage and subsequently will help them self-fund a good portion of their investment. The manufacturing sector is beginning to turn around, benefiting from improved international growth, a decade low in the NZD/AUD exchange rate, and an end to a particularly severe process of destocking.

The most pro-cyclical sectors are likely to be amongst the best performers over the next couple of years. The 'winners' are likely to include construction, its related industries (non-metallic minerals, wood, furniture), and publishing and advertising.

Figure 5: GDP growth by sector

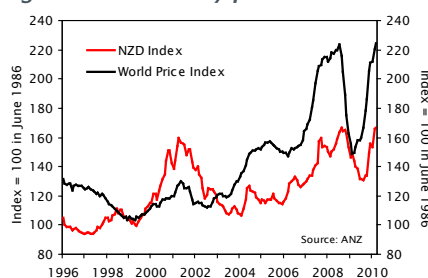


Sectors supporting plant and machinery investment are also likely to outperform. To these sectors we would add transport. Another general category of sectors that is likely to outperform is those associated with durables consumption (e.g., cars, whiteware, and other big ticket items).

Agriculture

It's been a rollercoaster production season. A slow start to the season was followed by a perpetual spring, delivering fantastic pasture growth and livestock weights to most districts in January and February. Then El Niño conditions caught up. Growing conditions have been terrible in March and April, with a drought zone declared north of Taupo in early April. Winter El Niño conditions tend to deliver a string of cold southerlies. The good news is that El Niño is abating, and computer weather models suggest it will continue to do so. Nonetheless, given the starting point, it's shaping up as a difficult winter on-farm. Foreign commodity prices are generally excellent but we're seeing mixed fortunes in how they are translating into NZD returns. For meat exporters to the UK, much of the strong commodity price is being robbed by a super weak Pound Sterling. We think soft commodity demand growth will be reasonably strong this year. We don't think we are at a peak in this commodity price boom, unless there is an outstanding Northern Hemisphere growing season.

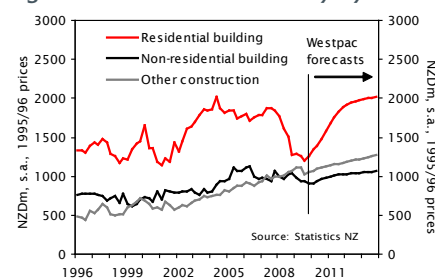
Figure 6: Commodity prices



Construction

Construction activity at the end of 2009 was a massive 17% below its pre-recession levels. Still, this was only around half the contraction that occurred in the early 1990s recession – one that was associated with carnage in the commercial property sector. The most recent downturn was more concentrated in residential investment. A marked shortage of residential properties is emerging and consents have begun to lift in response, up 26% in the 3 months to February compared to a year ago. Lags in the implementation of the government infrastructure surge will assist the sector, but it will take a couple of years of economic recovery before commercial property responds.

Figure 7: Construction activity by sector

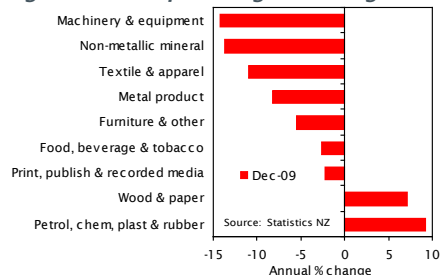


Manufacturing

A gap has appeared in the dark clouds that have overhung the manufacturing sector for the past four years. Manufacturing activity lifted 4.5% in Q4 2009, the largest quarter of growth since mid-2002. However, activity is still 11% below the level prevailing pre-recession. A rebound in global activity, a resurgent Australian economy, and a very favourable NZD/AUD exchange rate are supportive of the sector. Parts of the manufacturing sector are highly responsive to growth in the rest of the economy and we expect them to perform strongest in the next few years. Top performers should include

manufacturers of non-metallic minerals, metal products, printing; machinery and equipment, and wood and paper.

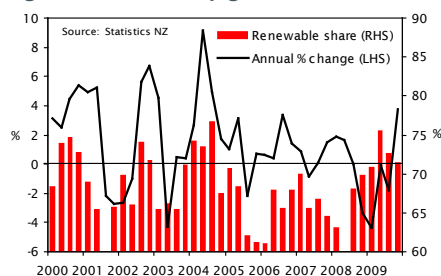
Figure 8: Manufacturing sectoral growth



Electricity, gas and water

Electricity generation rose a very strong 3.2% in Q4 2009. Partly this was due to the Tiwai Point Aluminium smelter resuming full production, but it also reflected that economic growth at the end of last year was concentrated on some of the more energy intensive goods producing sectors. The sector's growth for the full year (4.2%) was boosted by a higher than normal proportion of electricity being supplied by hydro and other renewables (which increases measured value add). Electricity, gas and water demand is likely to grow a bit in advance of general economic growth over the next couple of years, if we are correct in our expectation that growth continues to be skewed toward the goods producing sectors. Water will potentially see major regulatory and institutional changes in upcoming years, with tradable water rights likely to be introduced.

Figure 9: Electricity generation

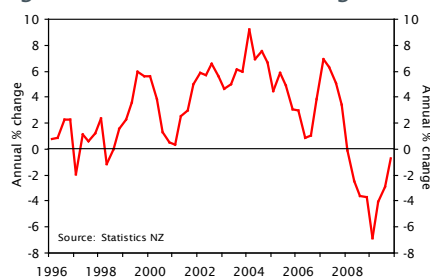


Retail trade

The retail sector is grinding out a gradual recovery. Sales volumes at the end of

2009 were 1.8% (2.3% for core) above those prevailing at the low point at the beginning of 2009. However, per capita sales volumes are still 8% below their 2007 peak. The recovery has been occurring despite real incomes of wage and salary earners going backwards. The turnaround coincided with an improvement in the housing market. The switch from housing equity withdrawal to injection between 2007 and 2009 'cost' the retail sector lost sales circa \$1.8bn. We are beginning to see some payback for that. Consumers went back into their shells at the beginning of 2010, as housing turnover slumped. Sustained retail growth awaits decent growth in employment and wages (which we think will occur in H2 2010). Durables consumption will continue to lead the rebound. A likely GST increase in October will see a temporary bounce, particularly in durables consumption, in Q3 2010 and an unwind in Q4.

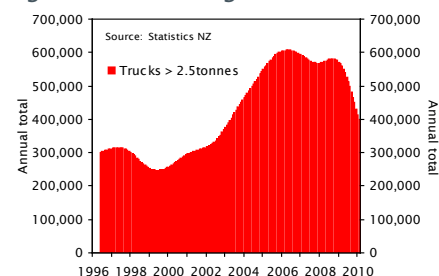
Figure 10: Retail sales volume growth



Transport

It is normal for transport activity to reflect the wider economic cycle, but with larger magnitude. But it was hit far, far harder than usual during the recent recession. While the economy contracted 3.4% during the recession, transport and storage retreated 10%. That probably reflected the extent to which global trade in manufactured goods was pummeled during the global financial crisis (GFC). Given that the downturn in transport was unusually large, we think the recovery in transport will also be outsized. However, there exists substantial excess capacity in the sector - with regards to all transport modes - so new investment will be slow.

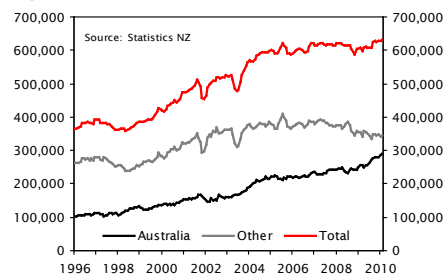
Figure 11: Truck registrations



Tourism

New Zealand visitor arrivals fell sharply in the midst of the GFC. At its worst, in early 2009, arrivals were close to 10% lower than in 2008. Still, New Zealand was one of the better performers worldwide and gained an increasing share of a declining international travel market. Tourism arrivals rebounded strongly during the winter, and a surge in visitors from Australia can take most of the credit. This momentum carried on in the summer season despite the long-haul market continuing to struggle. In the three months to February 2010, visitor arrivals to New Zealand increased by 4.5% compared to the same period a year ago and were up 2.4% in the full year. Growth from Australia was close to 12.2% in the full year. Australia now accounts for a whopping 44% of all visitor arrivals. We expect the recovery in visitor arrivals to continue through 2010 (with circa 5% growth forecast), as the recent improvement in global economic activity gains pace and a cheap NZD against the AUD assists in the continued penetration of the Australian tourism market. An influx of tourists for the Rugby World Cup should see even stronger growth (around 10%) in 2011.

Figure 12: Visitor numbers



A (re)balancing act

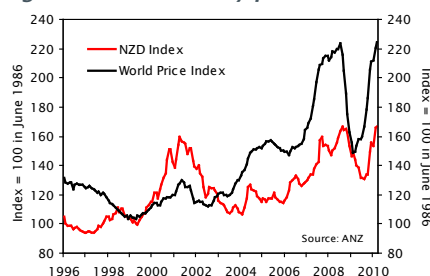
The New Zealand dollar looks unusually strong for this stage of the recovery. But export commodity prices have also defied their usual cyclical pattern and have reached new highs. We see the NZD around current levels or higher by year-end, by which time a revitalised US dollar could be more of a feature. Interest rates are going up from June – the market may be in two minds but we suspect the RBNZ is not.

Exchange rates

The strength of the New Zealand dollar remains a source of unease in some parts of the economy. The exchange rate is typically weak or still declining during the early stages of recovery, not at above-average levels. Analysts have stressed the need for more balanced growth – meaning more favourable conditions for exports – for the recovery to be sustainable. And the IMF has estimated that the NZ dollar is 10-25% above its long-term fair value.

Yet these observations don't even tell half the story. First, let's look at prices. A significant milestone was passed in March: the ANZ commodity price index reached a new record high, inching above the previous peak set in 2008 (Figure 13). And this is not just for international prices, but in NZ dollar terms as well – so even with the NZD/USD above 70c, we're receiving the best prices for our commodity exports in decades.

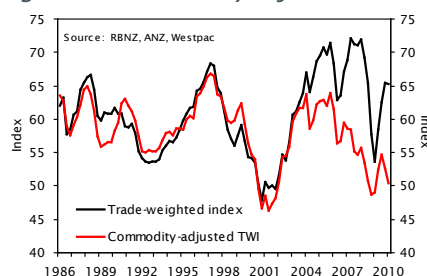
Figure 13: Commodity prices



Interestingly, not one of the components of the index is at its highs, at least not in NZ dollar terms. But while the 2008 peak was largely a dairy story, this time the gains have been more widespread.

To put it another way, commodity prices have roughly doubled since 2004, while the exchange rate hasn't. Acknowledging that commodities make up around half of our exports, our estimated commodity-adjusted NZ dollar index (Figure 14) is at one of the most favourable levels since the currency was floated.

Figure 14: Commodity-adjusted TWI



The NZD could be deemed 'overvalued' if you believe that current commodity prices are overdone and set for a fall. That could be brought about by, for example, an unexpected slowdown in China's economy. But the Australian dollar would surely be even more vulnerable in this instance; the strength of the AUD against the NZD and others suggests that the market doesn't have such an outcome in mind.

The other aspect of the story is the destination of exports. Australia's links into the fast-growing Asian economies are widely recognised. But what seems to have been overlooked is that New Zealand is not that far behind. Australia sends 54% of its exports to Asia (ex-Japan), plus another 4% to New Zealand. New Zealand's exports to the region – plus Australia, our gateway to Asian demand –

account for 54%. High commodity prices, and trade agreements with the important players in region, mean that this share is rising fast.

Between record prices and growing demand, the outlook for our commodity exports is encouraging. Combine that with a relatively subdued consumer in the early part of this year, and it seems that the much-vaunted rebalancing of the economy is happening – without the need for a weaker NZD.

Our forecasts see the New Zealand dollar rising through this year, then easing back slightly in 2011. As always, this is highly dependent on the US dollar's performance. As a rule of thumb, the US dollar tends to follow a non-linear path: it strengthens when the economy is weak, as investors look to the USD as a safe haven; weakens when the economy is doing moderately well, as investors look for more growth-sensitive markets; and strengthens again when the US economy

Figure 15: NZD/USD and TWI (Monthly Average)

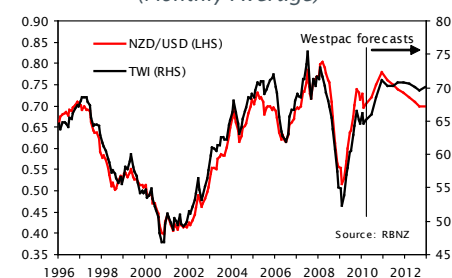
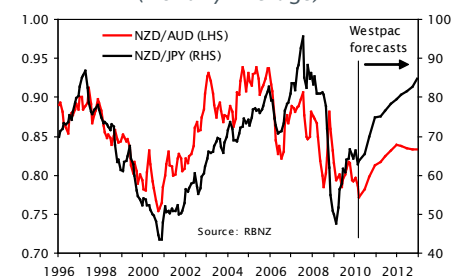


Figure 16: NZD/AUD and NZD/JPY (Monthly Average)



is outperforming and the world sees it as a genuine investment destination.

For the last year, the market has been in transition from the first scenario to the second, with the odd relapse when concerns such as European sovereign debt have come to the fore. We expect this to prevail through the rest of this year, meaning a further easing in the USD. But by next year, we expect a transition to the third scenario – a stronger US dollar – as the market comes to accept that the US will be the outperformer within the G3 (not that Europe and Japan are setting a high hurdle).

Interest rates

In the last few policy reviews, the RBNZ has reiterated that it expects to begin raising rates around the middle of this year. That phrase has become less conditional each time, as the economy has continued to recover in line with the RBNZ's forecasts. By the 29 April review, we suspect the statement will read less like a hint and more like a warning.

Despite the clear and consistent signal that the RBNZ has been giving the market, there's still some umm-ing and ahh-ing over the timing of the first rate hike. At the extreme, some have argued that there is no urgency to raise rates. This is little more than a strawman: the RBNZ devotes a lot of time and resources to anticipating where the economy is heading, precisely

so it doesn't end up having to act with "urgency". It is the outlook for inflation 1-2 years ahead that determines appropriate policy today.

The March *Monetary Policy Statement* forecasts (Figure 18) saw domestically driven (non-tradables) inflation returning above 3% by mid-2011 – and that's without the impact of the Emissions Trading Scheme, which is expected to add 0.4% to annual inflation for the first year after its introduction. More generally, the RBNZ expects inflation to remain uncomfortably close to the top of the 1-3% target band in coming years. The usual time lag between monetary policy and inflation outcomes dictates that the RBNZ should be taking action now – indeed, its inflation forecasts already incorporate the dampening effect of rising interest rates from mid-2010.

The more fruitful debate is around whether "the middle of 2010" means the 10 June MPS or the 29 July interim review.

One proposed reason for delaying until July is that the RBNZ should wait for more information before they act. There are no major data releases ahead of the MPS, whereas there are several key releases in the weeks before the July review: GDP, QSBO and inflation, as well as another monthly update on retail spending and house sales.

This would be a reasonable approach if the RBNZ was in the process of fine-tuning the level of rates. But it's not. It is about to embark on a tightening cycle that could see the cash rate rise by 3% or more over the next couple of years – far more tightening than it has ever anticipated before. This is not a course that will depend upon how the last data point turned out. Anyway, a single rate hike in June, followed by some weaker than expected data, would hardly be an irreparable error. In cricketing terms, the batsman wouldn't be committed to taking the run; he'd barely even be out of his crease.

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

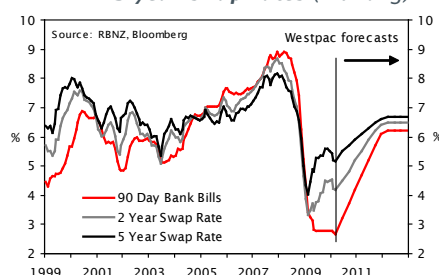
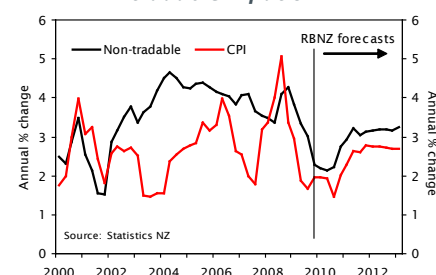


Figure 18: CPI, tradable and non-tradable inflation



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-10	2.75	3.20	4.50	5.50	0.72	0.78	65.5	66.1
Sep-10	3.25	3.70	4.80	5.70	0.75	0.80	69.8	68.5
Dec-10	3.75	4.20	5.20	5.90	0.78	0.81	74.9	71.1
Mar-11	4.25	4.70	5.50	6.10	0.76	0.82	75.2	70.3
Jun-11	4.75	5.20	5.90	6.30	0.75	0.82	76.5	70.4
Sep-11	5.25	5.70	6.20	6.50	0.74	0.83	78.4	70.8
Dec-11	5.75	6.10	6.40	6.60	0.73	0.84	79.6	70.8
Mar-12	6.00	6.20	6.50	6.70	0.72	0.84	80.6	70.6
Jun-12	6.00	6.20	6.50	6.70	0.71	0.84	81.7	70.1
Sep-12	6.00	6.20	6.50	6.70	0.70	0.83	82.6	69.7
Dec-12	6.00	6.20	6.50	6.70	0.70	0.83	84.7	70.0
Mar-13	6.00	6.20	6.50	6.70	0.70	0.83	84.6	69.9

Stuck in mud or high on froth

The global recovery remains imbalanced. The US and Europe are working through structural difficulties including weak housing markets, wrecked banking systems, and fiscal unsustainability. Meanwhile, Asian and Australian economic growth is strengthening so rapidly that talk of the Asian bubble we have long worried about has become commonplace.

USA

US economic activity found a firm footing in the last quarter of 2009, with GDP growing at an annualised pace of 6%, while surveys suggest growth remained rapid in early-2010. The key to the sudden bounce in economic activity is inventories. Through 2009 firms slowed production to clear unwanted stockpiles of product that had accumulated during the panic months of late-2008 and early-2009. The process of inventory reduction is now complete, so demand is once again being met by production. The sudden switch from inventory reduction to production is the key reason economic growth tends to be very rapid immediately after recessions. Of course, the sustainable rate of growth once the inventory cycle has settled down is another matter entirely. We suspect that America's deep financial and fiscal problems may be a drag on growth for years to come.

Unemployment remains distressingly high, but the labour market has passed its nadir. Unemployment has fallen from 10.1% to 9.7%, and the private sector has increased employment in four of the past five months. The employment gain in March was particularly encouraging because it was broad-based.

In contrast, the housing market has lost

momentum. Existing home sales have plunged 23% since November, proving that last year's improvement was just a tax-credit induced sugar-rush. The April 30 expiry of homebuyer tax credits and the end of the Fed's purchases of mortgage backed securities poses further downside risk for the housing sector.

After the early inventory-related boost to GDP growth, we expect US economic growth will settle down to around a 2½% annualised pace in the second half of 2010, and 3½% in 2011. That would still leave the economy operating well below potential, keeping inflation firmly at bay. Indeed, inflation has already slowed to a trickle, as highlighted by the first negative month for core inflation in almost 30 years in January. Therefore, we see little reason for the Federal Reserve to hike interest rates before 2011.

China

China's economic resurgence was the jewel in the global economy's crown in 2009, but it is now looking frothy. A late acceleration brought full-year 2009 growth to 10.7%, led by fixed asset investment (up around 30%). Now inflationary pressure is starting to emerge, and Chinese authorities are looking to take some of the heat out of the economy. The initial steps were to direct state-owned banks to reduce lending, increase interest rates slightly, and to increase the required reserve ratio. Now it seems the authorities may revalue the Yuan, which would slow the export sector. Our leading index suggests that Chinese growth is about to slow, possibly in response to the reduction in lending that has already occurred.

Australia

The Australian economy is roaring away. 215k jobs have been created in the

past seven months, after a loss of just 37k in the preceding twelve months. Employment is well ahead of pre-recession levels, although unemployment is a little higher because population growth has been so strong (2.1% per annum, twice the global rate). Combined with chronically low building activity and homebuyer subsidies, this has generated another round in Australia's seemingly endless housing boom. House prices are forging new highs, having risen 15% in the past year. Indeed, Australian house prices are now the most unaffordable in the world on price to income ratios. There was a 10% pickup in dwelling investment in the second half of 2009, and we anticipate another 15% in 2010. Even then, construction levels would be low relative to population growth.

The consumer is an emerging weak spot. Recent sales data suggests that consumers have responded to the RBA's decision to hike the cash rate at five of the past six opportunities. However, the RBA board believes that the rising terms of trade and frothy housing market trumps the consumer slowdown, so we expect another 25bps hike in either May or June.

Other Asia

The Japanese economy is on a recovery path led by the manufacturing sector. However, all parts of the economy remain below their pre-recession level, and the growth rate will be insufficient to make a substantial dent in the degree of surplus capacity that emerged during the recession. So consumer price deflation looks set to continue.

India and Indonesia are both relatively insular economies, and were less affected by the GFC than others. Both economies retained their pre-GFC level of activity

in 2009 Q2 and have been growing rapidly since. More export-oriented Korea, Malaysia and Singapore were all hit harder by the GFC, but have enjoyed exceedingly rapid recoveries and have all now surpassed pre-GFC levels of activity. Concerns about possible asset price bubbles or inflation are emerging. Central banks across Industrialising Asia have either already hiked or are on the cusp.

Europe and UK

While much of the globe enters economic recovery, the Eurozone has remained a laggard. GDP growth in the final quarter of last year was zero. Leading data suggest one more quarter of lacklustre

activity in Q1 before a resurgence finally takes place in Q2 2010. Even then, we expect modest household spending will limit the pace of growth, and keep the ECB on hold until 2011.

Greece's fiscal austerity measures were woefully inadequate to deal with its ballooning public debt, but were sufficient to convince the EU and the IMF to announce a rescue plan. The two institutions will act as emergency lenders in the event Greece is unable to finance its deficit through markets. Elsewhere, Portugal's sovereign debt was downgraded again in late March; ratings agencies are making noises about Italy; and the Irish government's estimate of its

exposure to failed banks was increased to 20% of GDP.

UK GDP growth was 0.4% in Q4 2009, however partial data to hand suggest that growth in Q1 this year probably stalled due to poor weather and a VAT increase. National elections have been called for Thursday May 6. Opinion polls currently suggest that a landslide victory by the opposition Conservative Party is no longer assured. Election uncertainty is likely to keep the BoE on hold in May. But with inflation now falling again we do expect Quantitative Easing will be extended again at some point, while there is little prospect of a BoE policy tightening before the middle of 2011.

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	3.4	4.4
CPI inflation % annual	3.2	2.6	3.2	3.4	2.0	2.3	2.7
Unemployment %	3.8	3.8	3.5	4.7	7.3	6.3	5.5
Australia							
Real GDP % yr	2.8	2.9	4.0	2.4	1.3	3.2	3.6
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	2.6	2.8
Unemployment %	5.1	4.8	4.4	4.2	5.6	5.1	4.8
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.4	3.0
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.4	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.5	9.2
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	2.3	1.8
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	1.3
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	0.7	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	0.3	1.3
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.0	1.5
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	10.9	9.5
Consumer Prices %yr	1.8	1.5	4.8	5.9	-0.7	2.9	2.9

Forecasts finalised 8 April 2010

Neutral about neutral

There are lots of moving parts in 'guestimating' a neutral cash rate. It is too simplistic to just subtract the increase in bank funding costs to calculate the new neutral. Rising inflation expectations and lower bank margins provide a counter. The new neutral OCR is possibly around 6%.

There has been much hullabaloo around what the neutral Official Cash Rate may now be. Other market economists estimate the new neutral to be around 5%, 1% to 1.25% lower than what they think prevailed pre global financial crisis (GFC). The RBNZ has been more circumspect; saying "it's possible that the neutral rate required to reach a neutral level (of lending rates) is lower than it used to be". We are more akin with the RBNZ: it's possible the neutral OCR is lower (although we are not sure from where), but we think that it is not nearly as low as other economists are asserting.

What is a neutral interest rate?

A neutral interest rate is one of the Yetis of monetary policy: unobservable but believed by some to be lurking in the background. But it gets worse – there is not just one type of unobservable Yeti that people are looking for.

First up, it is common to lop inflation expectations off interest rates so that we are talking 'real' rates. The mythical neutral real interest rate (NRR) is supposedly one where monetary policy is neither contractionary nor expansionary. But this means different things to different people. Is it neutral short-term interest rates in the short, medium, or long run context?¹ Is it effective borrowing rates, 90 day interest rates, or the OCR being referred to? At heart, it is also an equilibrium concept and in the real world other components

of the economy are rarely (OK, never) in equilibrium at the same time (e.g., exchange rate, fiscal balance, labour market, external accounts).

For this article, we take neutral to refer to the level of the real OCR that would deliver stable inflation and inflation expectations at the inflation target, and an output gap at zero and expected to remain zero over the medium run (i.e., the economy is operating at its full potential). This is where the Yeti meets Nessie. We now have two unobservables: neutral interest rates and the output gap. We can only infer the size of this Yeti's footprint and Nessie's tail from other data. And that comes down to an educated guess.

In search of Big Foot

The general approach taken by other economists to find the 'new neutral' has been to estimate what the neutral cash rate was pre GFC (purportedly somewhere in the vicinity of 6%), and take off the increase in bank funding costs that have resulted from the GFC (around 1%) to give a new neutral cash rate circa 5%.

Of course 5% could prove to be correct, because after all we are discussing who has the better imaginary friend. But there are a surprising number of aspects where the imaginary friends can look different.

1. Neutral rate in base period

It is not at all clear to us that the neutral rate in the base period (pre GFC) was circa 6%. The cash rate has averaged 6.3% since its introduction in 1999 through to 2008Q3 (i.e., just prior to the GFC), and 6.6% in the period 2003 through 2007. However, 2003 through 2007 was as much an aberrant period (but in mirror image) as what we have now. It was characterised by excessive

risk taking, dizzying credit growth and rampant asset price appreciation. Inflation averaging 3.0%² was well above the mid point of the target band, as were inflation expectations at 2.5%. The current account deficit reached an unsustainable 9% of GDP, credit growth was in excess of 2 times growth in nominal GDP, and property prices almost doubled. Counter to this, the real exchange rate (oops, another unobservable monetary leprechaun has just put in an appearance) was acting as a constraining influence, averaging around 18% above its long run level.³ A cash rate averaging 6.6% clearly did not deliver sustainable or equilibrium outcomes, and it could easily be argued (with the benefit of hindsight) that it should have been closer to 7.5%.

2. Inflating expectations

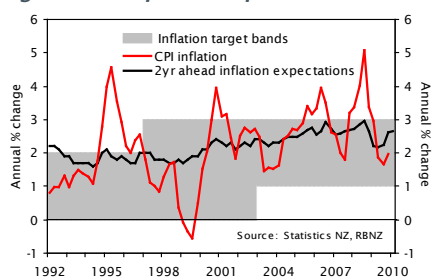
To get away from comparing to the equally aberrant period of 2003 – 2007, we can cast our eyes further back. Over a longer sweep of time (i.e., back to 1992, when inflation stability was achieved) the neutral cash rate has not been constant in reality or perception.⁴ For example, in 2001 the RBNZ calibrated an NRR for 90 day interest rates of 4.5% into their baseline economic model while in recent years the working assumption has been 4.0%.⁵

Even if the NRR had been constant, the nominal neutral rate most certainly wasn't. Between 1992 and 2002 there were 3 significant changes to the Policy Targets Agreement by which the RBNZ operates. At the beginning of the period, annual inflation in the range of 0 to 2 per cent was taken to represent the achievement of price stability. This was broadened to 0-3% in December 1996, and further raised to 1-3% in September 2002. All these changes led to an inexorable rise in inflation expectations

as did an apparent change in RBNZ policy approach from targeting the mid-point of the inflation range pre-2002, to the upper half of the range post 2002. Inflation expectations increased by a full percentage point between the early days of inflation targeting to just before the GFC. Half of that rise in inflation expectations was delivered during the period 2003-2007.

Even if the NRR were constant over the past 18 years, the effect of inflation expectations alone would have pushed the neutral nominal rate up by 1%. It is worth noting that 2-year-ahead inflation expectations are currently high at 2.7%, despite the economy only just emerging from a deep and protracted recession.

Figure 19: Inflation expectations



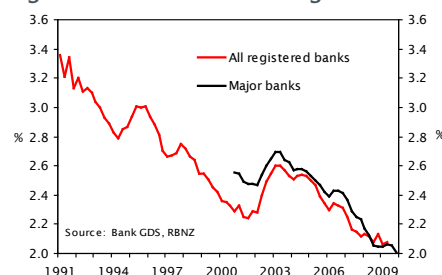
3. Funding costs

The RBNZ has estimated that bank funding costs are currently around 150bps above the OCR, whereas prior to the GFC they were closer to 30bps above the OCR. However, applying the full 120bps difference as a change in the NRR could potentially suffer from a couple of problems: the funding premium may be temporary, persistent, or permanent; the funding premium may vary with changes in the OCR; and there may be the same base period comparison problems as discussed in point 1 above. We think the funding premium will prove relatively persistent over the next few years, so monetary policy should look to accommodate some of it. However, as the NRR was not being revised up when funding costs were abnormally low during 2003-2007, we do not think it appropriate to revise down the NRR by the full 120bps of increase in funding costs now.

4. Banking at the margin

The analysis of others tends to focus predominantly on the change in bank funding costs. But similarly important has been the decline in bank margins over a long period. Bank margins are roughly 1% lower now than they were in the early 1990s. For the major banks, average net interest margins are currently 0.5% below their average of 2003 – 2007. When comparing NRRs, declining bank margins provide a substantial offset to higher funding costs over a broader sweep of history.

Figure 20: Net interest margins



Will the real NRR please stand up

We are not heroic enough to categorically state what the new neutral OCR is (oh alright, our measure of the footprint in the snow is 6%). For starters we don't know what shocks are going to beset the economy over the next few years, which themselves will influence the neutral rate. Relative caution on the part of (property) investors may persist for a few years, but this may reduce the magnitude of the next OCR cycle rather than the neutral rate.

What we can say is that there are multiple moving parts in estimating a neutral rate and it is dangerous to focus on only one. First, we don't think the 'old neutral' was around 6%. An OCR averaging 6.4% in the 2000s up to the GFC was clearly too low to deal with the shocks that were hitting the economy. Secondly, inflation expectations have been on a trend rise, and bank margins in trend decline. Both of these factors would serve to raise the neutral rate. Thirdly, we would be very reticent to apply the full 120bps increase in bank funding costs since pre-GFC to a decline in the neutral cash rate. The pre-

GFC period was aberrantly low in terms of funding costs, and the increase in funding costs may not be constant.

As an exercise, let's do a hypothetical on all the hypotheticals. What if the RBNZ was right in 2001 that the NRR for the 90 day rate was then 4.5% (or roughly equivalent to 4.25% on the OCR). Let's pretend the only changes since have been a rise in bank funding costs (let's generously say 100bps that will persist at that wedge for a few years and that it will show up as a fall in the OCR rather than a rise in retail rates), a decline in bank margins of 50bps, and inflation expectations moving from 2.2% to 2.7% (again generously assuming higher GST and emission trading scheme costs do not infect inflation expectations in coming years). Adding up all those changes would imply a neutral cash rate of 6.5% in 2001 and, surprisingly, an unchanged neutral cash rate of 6.5% now. So the new neutral would be equal to the old old neutral! Of course, other things have been changing in the economy which could independently have been impacting on neutral short rates but we don't think it is anywhere near the extent that would get neutral rates down to where other economists are suggesting.

Let's be clear, we are not saying the OCR should be near neutral now: there is a yawning amount of spare capacity in the economy and the OCR should continue to be low for a while. But whatever neutral is or isn't, we are a long way from it.

¹ For a comprehensive discussion of these issues, see Archibald and Hunter, "What is the neutral interest rate and how can we use it?" RBNZ Bulletin Vol. 64 No. 3, 2001.

² Reported inflation outcomes are taken as an 18 month lag on interest rates, to reflect the lags in the influence of monetary policy.

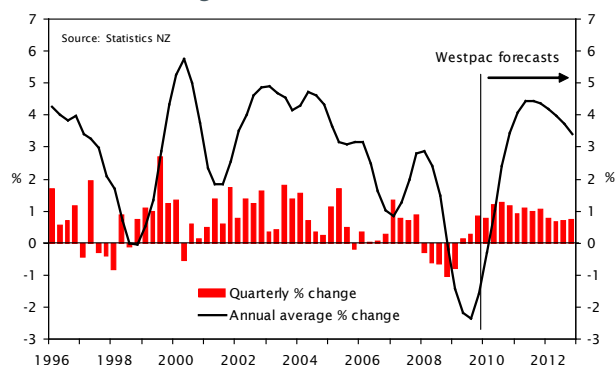
³ The Terms of Trade was also around 10% above its long-run level during this period, mitigating the degree of exchange rate 'overvaluation'.

⁴ Hunter and Archibald note that the neutral real rate can shift over time in response to temporary shocks to the economy, and in response to long lived changes such as demographics, technological change, industrial organisation, international relationships, and long-term government policies for health, education, social welfare etc.

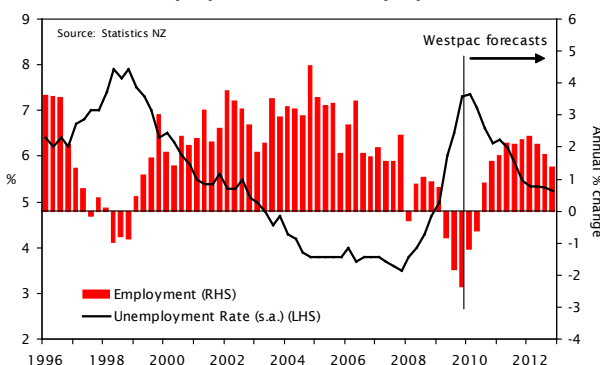
⁵ The RBNZ NRR refers to the 90 day rate, which averages around 25bps above the OCR although this wedge varies with the monetary policy cycle.

Annual Average % change	March years				Calendar years			
	2009	2010f	2011f	2012f	2009	2010f	2011f	2012f
Private consumption	-1.1	0.5	2.8	3.2	-0.6	2.5	3.3	2.5
Government consumption	4.2	0.9	2.1	1.9	1.4	2.0	1.7	2.0
Residential Investment	-22.8	-9.9	20.7	20.8	-16.8	16.1	23.1	9.0
Business Investment	-1.2	-8.7	9.9	10.6	-10.6	6.1	12.1	6.6
Stocks (% contribution)	0.0	-2.1	1.9	0.6	-2.6	1.6	0.9	0.1
GNE	-1.6	-3.3	7.2	5.7	-5.1	6.0	6.4	3.6
Exports	-3.4	2.8	4.7	4.1	0.0	4.9	4.0	4.1
Imports	-4.7	-10.0	11.4	8.5	-14.9	9.5	10.1	4.7
GDP (Production)	-1.4	-0.3	4.1	4.2	-1.6	3.4	4.4	3.4
Employment (% annual)	0.7	-1.2	1.7	2.3	-2.4	1.5	2.2	1.4
Unemployment Rate (% s.a. end of period)	5.0	7.4	6.4	5.3	7.3	6.3	5.5	5.2
Average Hourly Earnings (% annual)	5.1	2.4	2.6	3.6	3.2	2.2	3.4	4.1
CPI (% annual)	3.0	2.4	2.1	2.8	2.0	2.4	2.7	2.9
Current Account Balance (% of GDP)	-7.9	-2.6	-3.3	-4.4	-2.9	-3.0	-4.4	-4.4
Terms of Trade	-5.0	2.2	4.1	0.6	-8.2	12.8	0.5	1.4
90 Day Bank Bills (end of period)	3.67	2.73	4.70	6.20	2.79	4.20	6.10	6.20
5 year swap (end of period)	4.27	5.27	6.10	6.70	5.56	5.90	6.60	6.70
TWI (end of period)	53.7	65.3	70.3	70.6	65.5	71.1	70.8	70.0
NZD/USD (end of period)	0.53	0.71	0.76	0.72	0.73	0.78	0.73	0.70
NZD/AUD (end of period)	0.80	0.78	0.82	0.84	0.80	0.81	0.84	0.83
NZD/EUR (end of period)	0.41	0.51	0.55	0.56	0.49	0.56	0.56	0.56
NZD/GBP (end of period)	0.37	0.45	0.47	0.45	0.45	0.48	0.46	0.42

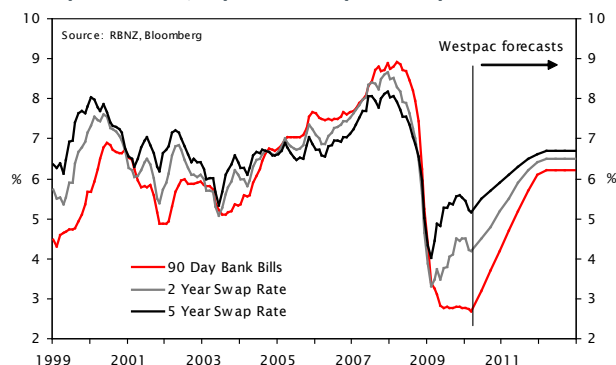
New Zealand GDP growth



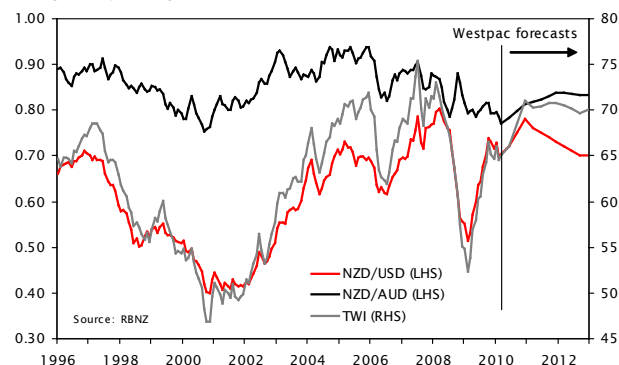
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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