



Cape Reinga lighthouse, North edge of New Zealand

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Cream of the Crop

Last week we published our latest *Quarterly Economic Overview*, our flagship publication for New Zealand. If you haven't already, it's well worth a read (you can download it from our website <http://www.westpac.co.nz/business/economic-updates/economic-research-and-market-strategy>). As well as an update of our economic forecasts it includes comprehensive discussion about the outlook for the NZ economy, interest rates and exchange rates.

In short, the story we tell in the February *Overview* remains a familiar one. As expected 2013 saw the New Zealand economy accelerate, boosted by a big lift in construction activity on the back of the Canterbury rebuild, a recovery from the effects of last summer's drought and strong house price growth which in turn supported a pickup in consumer spending. Meanwhile, the high exchange rate kept a lid on inflation pressure.

In many respects our forecasts for 2014 represent the next phase of the same narrative. GDP growth is forecast to accelerate to 4.2% this year. In addition to continued strength in construction activity, a key feature of the economy this year is likely to be the boost to national income from New Zealand's record high terms of trade. Strong export prices recently pushed New Zealand's terms of trade to a 40 year high, at a time when global growth has been fairly lacklustre. Importantly, while we think the terms of trade will fall over the next year, we have become increasingly convinced that the strength in demand from China for New Zealand's key export commodities will persist for some time yet.

If we're right, higher incomes are likely to flow through to economic activity in a range of ways. Our forecasts assume that around half the income boost will be used to pay down debt, with the other half translating to higher household spending, construction activity and business investment.

Strength in commodity prices will also help the NZD remain elevated. We're now forecasting the NZD to remain at 80c and above on average against the USD throughout

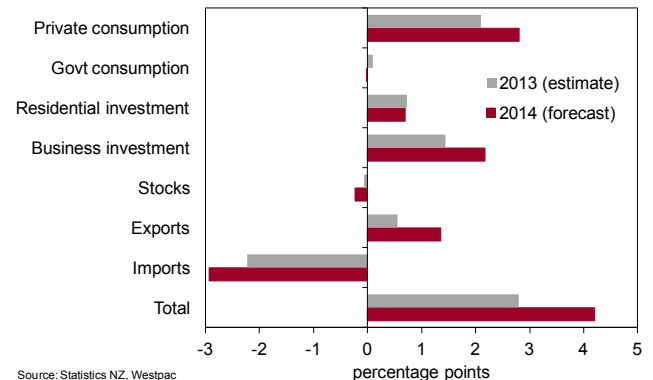
Cream of the Crop continued

this year and next. And against the Australian dollar, we expect the NZD to average at or above 91c over the same period. In addition to strong commodity prices the outlook for the NZ domestic economy is noticeably more upbeat than in many other parts of the world which should support the currency. The sustained strength in the exchange rate will dampen traded goods inflation, but this will be more than offset by stronger domestic inflation as the acceleration in the domestic economy forces sectors to compete for resources. Inflation is forecast to rise above the 2% mid-point of the RBNZ's target band by next year, even with the OCR expected to increase by 125 basis points this year.

Of course such sustained strength in the NZD will also have consequences for the economy. Export industries which are not benefitting from high commodity prices, such as tourism and manufacturing, will find the going tough for longer, while firms competing with imports will also face stiff competition. And it won't just be consumers looking to take advantage of relatively cheap imports. Businesses will find importing capital equipment an attractive option while the NZD is high. Although investment will tend to benefit the economy over the long run, in the near term, it may mean further improvements in the unemployment rate are more gradual than in past cycles. That said we're expecting the labour market to continue to steadily improve in 2014, with the unemployment rate forecast to fall to 5.1% by the year's end. And as it becomes more difficult for firms to find suitable workers and inflation picks up wage growth, which to date has remained rather muted, should eventually start to rise.

In the February *Quarterly Economic Overview* we also update our estimates of regional housing supply, which compare the estimated number of houses relative to population in each region of New Zealand except Canterbury. We first published this work last year and concluded that Auckland was building too few houses, Wellington was building slightly too few, and in

Contributions to GDP growth in 2013 and 2014



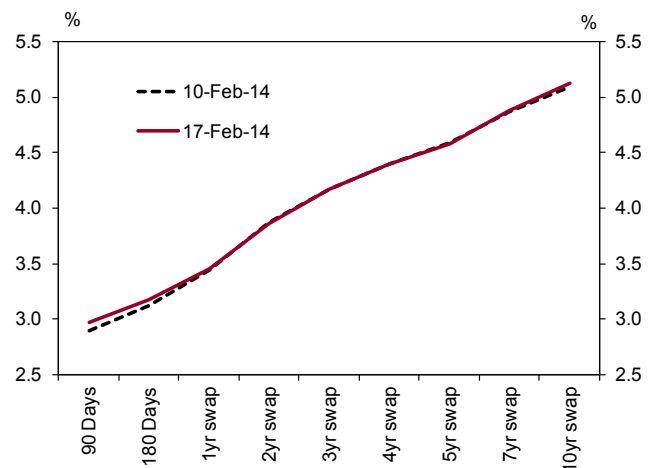
all other regions construction activity was roughly keeping pace with population growth. Consequently we expected construction activity to ramp up in Auckland, but not change very much in other regions.

By updating the analysis with the new information collected in the 2013 census, we find that Auckland's shortage of housing is not as severe as we thought a year ago. That's largely because Auckland's population is lower and there are more houses in the region than we had previously estimated. We also conclude that both Wellington and Nelson/Tasman are building too few houses for the 'people per house' ratio to continue to fall. Elsewhere in New Zealand building activity appears to be broadly commensurate with population growth, leaving us little reason to expect significant changes in residential constructions in these regions. The upshot is that while we continue to expect construction activity outside Canterbury to grow strongly, our view is now a little more moderate than we thought a year ago.

Fixed vs Floating for mortgages

We are indifferent between fixing and floating at present. Interest rates are currently higher for longer fixed terms. However, we expect floating rates and short-term fixed rates to rise substantially over the coming three years. In our view, floating and short-term fixed rates offer no better or worse value than longer-term fixed rates.

NZ interest rates

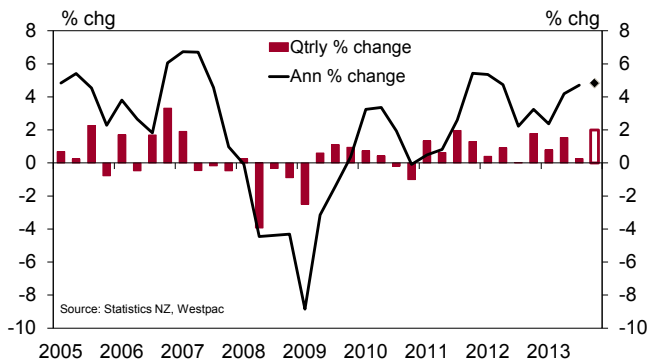


NZ Q4 real retail sales

Feb 17, Last: 0.3%, WBC f/c: 2.0%

- Strong growth in electronic card spending, rising consumer and retailer confidence, and subdued inflation in the December quarter all point to a big lift in retail volumes. We estimate that retail sales volumes rose 2% in the quarter, taking annual growth to 4.8%.
- Retail volumes had been surprisingly soft across a wide range of categories in the September quarter, but we suspect this was statistical payback for a very strong June quarter.
- As always, the wild card is vehicle sales – registrations data and a rise in the NZD/JPY are pointing to a solid lift, but this is only a loose indicator.

Real retail sales

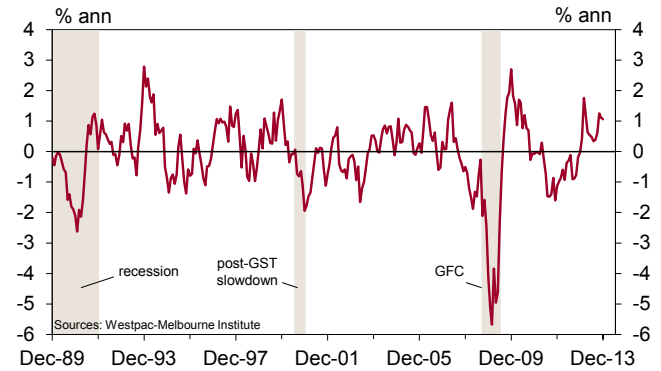


Aus Jan Westpac-MI Leading Index

Feb 19, Last: 1.1%

- The six month annualised deviation from trend growth rate of the Westpac Melbourne Institute Leading Index of Economic Activity edged down to 1.06% in Dec from 1.12% in Nov. Despite the slippage, the index growth rate remains comfortably above its long run average.
- Components have had a mixed start to 2014. The CSI Expectations Index fell 7.1% in Feb, with the Unemployment Expectations Index also less positive (up 2.3%, recalling that higher readings indicate a poorer outlook). The ASX sold off in Jan, declining 2.8% and AUD commodity prices were down 1.1%. Dwelling approvals edged another 1.6% lower in Dec but remained at a high level following a big spike in Sep. The yield gap also narrowed a touch. Against this, hours worked posted a surprisingly strong 1.3% gain in Jan despite an otherwise weak labour market report.

Westpac-MI Leading Index



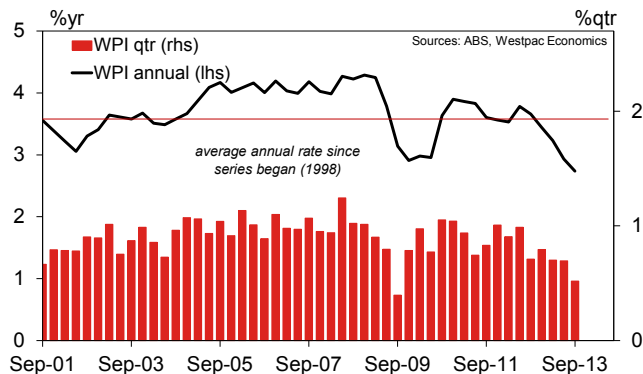
Aus Q4 Wage Price Index

Feb 19, Last: 0.5%, WBC f/c: 0.6%

Mkt f/c: 0.6%, Range: 0.5% to 0.8%

- Total hourly wage rates ex bonuses rose 0.5% in Q3, below Westpac's 0.6% forecast and given the relative stability of the series, surprisingly soft compared to the market forecast 0.7%.
- This was the second softest quarterly rise in the series, 0.4%qtr in Sep 2009 is the record low, while the annual pace of 2.7%yr is a record low (the series started in Sept 1997).
- The public and private sectors both saw a 0.5% wage gain in Q3. Over the year, public sector wage growth is a little weaker (2.6%yr) than in the private-sector (2.7%yr).
- The labour market continued to soften through 2013 so there is no reason to expect a pick-up in wage inflation, hence our 0.6%qtr which takes the annual pace down to 2.5%yr, a new record low.

Wage inflation continues to moderate



US housing starts/permits/sales in Jan: weather issues

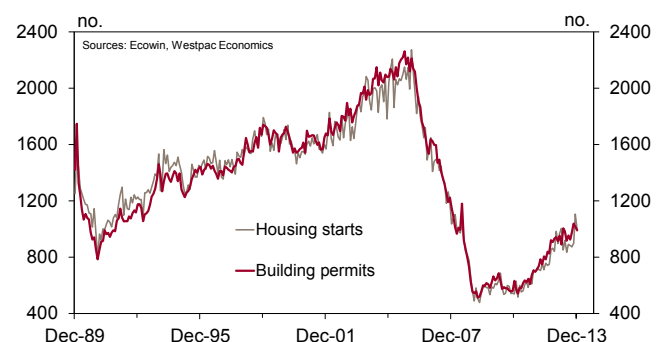
Feb 19, Housing starts: Last: -9.8%, WBC f/c: 4.0%

Feb 19, Housing permits: Last: -2.6%, WBC f/c: 2.5%

Feb 21, Existing home sales: Last 1.0%, WBC f/c: -4.5%

- Starts fell 9.8% in Dec, partially reversing Nov's 23% jump, weather turning from milder than usual to heavy snow a factor. Single family starts fell 7%. Permits to build were down 2.6% with singles down 5% in Dec. The annualised singles permits gain of 610k was lower than starts on 667k suggesting some sluggish activity in prospect. But construction jobs rose sharply in Jan after falling in Dec. Our forecast for a starts rise in Jan assumes Dec is revised sharply lower and usual multiples noise.
- Existing home sales rose 1% in Dec but had fallen 10% since July (subject to annual revisions). Pending home sales plunged 8.7% in Dec (the weather!), their seventh consecutive decline, to be down 17% since mid year. So closings in Jan as measured by existing sales should fall steeply again.

US housing starts & permits



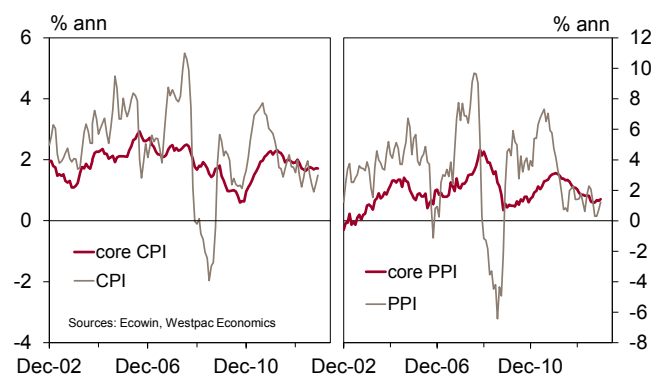
US Jan producer and consumer price indices

Feb 19, PPI Last: 0.4%, WBC f/c –

Feb 20, CPI Last: 0.3%, WBC f/c 0.0%

- Energy and some core pressures boosted the Dec PPI by 0.4%. With the January report, the BLS is introducing new methodology, coverage and reporting of producer prices. Under these arrangements, the “experimental” Dec PPI was up 0.1%. We expect that producer prices were subdued in Jan outside of food but will not attempt to forecast the new data series yet.
- CPI revisions incorporating new seasonal factors will be published 18/2 but they are unlikely to substantially alter the recent subdued inflation picture, consistent with the modest PCE deflator measure. After rising 0.3% in Dec on energy, we expect a flat Jan CPI, with lower, clothing to reverse part of Dec’s spike, food prices higher and rent and medical care gains insufficient to lift the core above 0.1%.

US price inflation



Data calendar

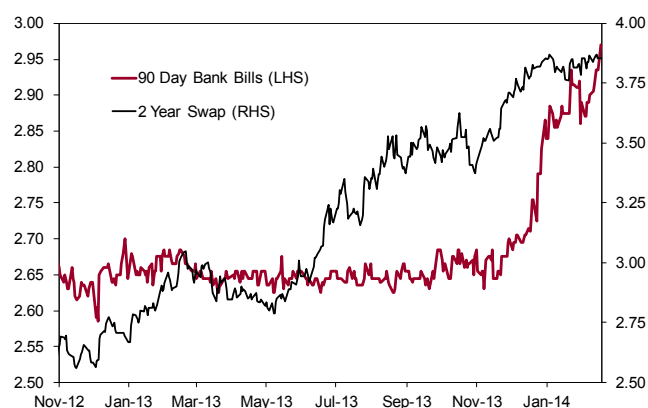
		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Q4 real retail sales	0.3%	-	2.0%	Rising confidence and strong card spending pointing to a big lift.
	Jan Performance of Services Index	57.5	-	-	Both manufng and services indices consistently strong over 2013.
Aus	Jan motor vehicle sales	1.7%	-	-3.5%	Industry figures showed a soft start to 2014, especially govt purchases.
UK	Feb house prices %yr	6.3%	-	-	Rightmove index of asking prices.
Tue 18					
Aus	Feb RBA meeting minutes	-	-	-	Additional detail surrounding decision to move to neutral bias.
UK	Jan CPI %yr	2.0%	2.0%	-	CPI hit 2% target in Dec. Core rate was just 1.7% yr in Dec
	Jan producer prices %yr	1.0%	1.0%	-	PPI core output measure.
	Dec house prices %yr	5.4%	-	-	ONS series
Ger	Feb ZEW analysts' expectations	61.7	60.8	-	Dec-Jan highest since 2006. Confidence in Draghi to offset EM?
US	Feb NAHB housing market index	56	56	55	Improvement in sentiment stalled for 6 months now.
	Feb NY Fed factory survey	12.5	9.8	2.0	These factory surveys showed no weather impact, unlike ISM.
	Dec TIC data, \$bn	-29.3	-	-	Net long term TIC flows.
Can	Jan existing home sales	-1.8%	0.0%	-1.0%	Down every month since Oct.
Wed 19					
NZ	GlobalDairyTrade auction	1.4%	-	-	Demand should remain robust.
Aus	Jan Westpac-MI leading index	1.1%	-	-	Slowed in late 2013 but still comfortably above trend.
	Q4 wage price index	0.5%	0.6%	0.6%	A slack labour market should see the annual pace ease back to 2.7%yr.
Eur	Dec construction output	-0.6%	-	0.3%	Construction rose 0.5% in Germany in Dec
UK	Feb BoE minutes	-	-	-	More detail behind how phase 2 of guidance was reached.
US	Jan housing starts	-9.8%	-4.9%	4.0%	Starts pace for (single family dwellings) has been running ahead of
	Jan building permits	-2.6%	-1.6%	2.5%	permits. Forecasts assume revisions. See text box.
	Jan PPI	0.4%	-	-	BLS is introducing new methodology, coverage and reporting
	Jan PPI core	0.3%	-	-	of producer prices.
	Jan 29 FOMC minutes	-	-	-	First meeting under the new rotation of district Fed presidents.
	Fedspeak	-	-	-	Lockhart on economy.
Can	Dec wholesale sales	0.0%	-0.7%	-	Sales at record high in Oct-Nov.
Thu 20					
NZ	Q4 producer prices (outputs)	2.4%	-	0.0%	Sharp lift in dairy payout in Q3; no change in Q4.
Chn	Feb HSBC manufacturing PMI - flash	49.5	-	-	Jan outcome ruffled a few feathers. Details points to a weak Feb read.
Eur	Feb PMI factory adv	54.0	54.0	52.0	Jan saw distance between French and German PMIs narrow again
	Feb PMI services adv	51.6	51.8	52.0	Composite PMI fact/ser was 52.9 in Jan.
	Feb consumer confidence advance	-11.7	-11.1	-12.0	Not far from high point reached between last two recessions of -9.7
Ger	Jan producer prices %yr	-0.5%	-0.8%	-	PPI has been deflating for most of the past year.
UK	Feb CBI industrial trends	-2	5	-	Total orders index
US	Initial jobless claims w/e 15/2	339k	330k	-	New year seasonality/weather swings that hit Jan data now over.
	Jan CPI	0.3%	0.1%	0.0%	Clothing to reverse part of Dec's spike, food prices higher and rent
	Jan CPI core	0.1%	0.1%	0.1%	and medical care gains benign.
	Jan leading indicators	0.1%	0.4%	-	Has not fallen since March.
	Feb Philadelphia Fed factory survey	9.4	10.0	7.0	Regional factory bosses not impacted by weather.
	Fedspeak	-	-	-	Williams on economy.
Fri 21					
UK	Jan retail sales incl autos	2.6%	-0.7%	-1.5%	Dec sales spurt to reverse but BRC strong in Jan, CBI weaker.
	Jan PSNCR £bn	9.0	-	-	Public sector net credit requirement.
US	Jan existing home sales	1.0%	-3.5%	-1.0%	Pending sales plunged 8.7% in Dec (the weather!).
Can	Jan CPI %yr	1.2%	1.3%	-	BoC core rate was just 1.3% yr in Dec
	Dec retail sales	0.6%	-0.8%	-	Nov sales supported by autos; ex auto were up 0.4%.

New Zealand forecasts

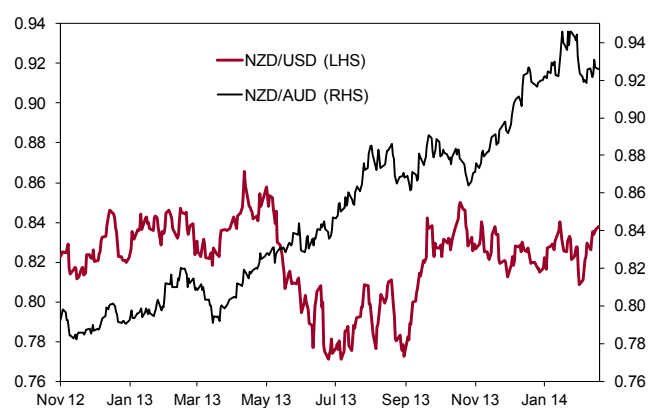
Economic Growth Forecasts	March years				Calendar years			
	2013	2014f	2015f	2016f	2012	2013e	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.2	4.2	3.0	2.6	2.8	4.2	3.2
Employment	0.4	3.3	2.8	1.5	0.4	2.9	3.0	1.7
Unemployment Rate % s.a.	6.2	5.8	5.1	4.8	6.8	6.0	5.1	4.7
CPI	0.9	1.4	1.8	2.3	0.9	1.6	1.7	2.2
Current Account Balance % of GDP	-3.9	-3.7	-5.7	-6.0	-4.1	-3.8	-5.0	-6.2

Financial Forecasts	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Cash	2.75	3.25	3.50	3.75	4.00	4.00
90 Day bill	3.10	3.50	3.75	4.00	4.20	4.30
2 Year Swap	3.90	4.10	4.30	4.50	4.65	4.80
5 Year Swap	4.60	4.70	4.80	4.90	5.05	5.20
10 Year Bond	4.70	4.80	5.00	5.10	5.20	5.30
NZD/USD	0.84	0.83	0.82	0.81	0.80	0.80
NZD/AUD	0.93	0.94	0.94	0.94	0.94	0.93
NZD/JPY	85.7	83.8	82.0	80.2	80.0	81.1
NZD/EUR	0.63	0.64	0.63	0.64	0.63	0.63
NZD/GBP	0.53	0.52	0.52	0.51	0.50	0.48
TWI	79.5	79.4	78.6	78.1	77.6	77.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 17 Feb 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.75%	2.72%	2.73%
60 Days	2.87%	2.77%	2.81%
90 Days	2.97%	2.91%	2.88%
2 Year Swap	3.86%	3.85%	3.77%
5 Year Swap	4.58%	4.56%	4.53%

NZ foreign currency mid-rates as at Monday 17 Feb 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8378	0.8098	0.8252
NZD/EUR	0.6113	0.6005	0.6094
NZD/GBP	0.4997	0.4929	0.5025
NZD/JPY	85.22	82.56	85.89
NZD/AUD	0.9255	0.9232	0.9402
TWI	78.50	76.85	78.47

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013f	2014f	2015f
Australia						
Real GDP % yr	2.3	2.6	3.6	2.4	2.6	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.3	2.5
Unemployment %	5.2	5.2	5.3	5.8	6.4	6.1
Current Account % GDP	-3.5	-2.8	-4.1	-3.1	-3.8	-2.7
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	2.2	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.7	1.7
Unemployment Rate %	9.6	8.9	8.1	7.4	7.1	6.6
Current Account %GDP	-3.0	-2.9	-2.7	-2.5	-2.5	-2.5
Japan						
Real GDP %yr	4.7	-0.6	2.0	1.8	1.8	1.4
Consumer Prices %yr	-0.7	-0.3	0.0	0.3	2.7	1.3
Unemployment Rate %	5.1	4.5	4.3	4.0	3.6	3.6
Current Account %GDP	3.6	2.0	1.1	0.9	0.9	1.9
Euroland						
Real GDP %yr	2.0	1.5	-0.6	-0.5	0.4	0.6
Consumer Prices %yr	1.7	2.7	2.2	1.4	1.2	
Unemployment Rate %	10.0	10.1	11.7	12.4	13.0	
Current Account %GDP	-0.1	0.0	0.9	1.0	1.0	
United Kingdom						
Real GDP %yr	1.7	1.1	0.2	1.9	2.6	1.9
Consumer Prices %yr	3.2	4.0	2.8	2.3	1.8	
Unemployment Rate %	7.8	8.4	8.0	8.5	8.5	
Current Account %GDP	-2.5	-1.9	-3.8	-2.5	-1.5	

Forecasts finalised 7 February 2014

Interest Rate Forecasts	Latest	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Australia						
Cash	2.50	2.50	2.50	2.25	2.00	2.00
90 Day Bill	2.61	2.55	2.30	2.10	2.10	2.10
10 Year Bond	4.15	4.10	3.90	3.70	4.00	4.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.73	2.70	2.60	2.60	2.80	3.00
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
AUD/USD	0.9000	0.90	0.88	0.87	0.86	0.85
USD/JPY	101.97	102	101	100	99	100
EUR/USD	1.3680	1.35	1.31	1.31	1.28	1.27
AUD/NZD	1.0795	1.07	1.06	1.06	1.06	1.06



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