



Surf break, Piha.

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Don't stop me now

New Zealand is on track for another year of solid growth. This week we take a look at what will underpin growth, and what the current softness in inflation may mean.

Shift in the drivers of growth

In recent years, growth was underpinned by strong increases in export commodity prices and the related gains in export earnings. However, prices for some of our key exports have since fallen sharply, and dry conditions are threatening to stymie agricultural production. Although dairy prices did pick up at the most recent auction, these developments will be a significant drag on export earnings over the coming year.

Despite these concerns, the New Zealand economy is still expected to grow at a robust pace over 2015. The drivers of growth are shifting away from the export sector and towards domestic demand. In large part, this is a result of a strong outlook for construction spending, which is expected to rise to levels above those seen during the mid-2000s construction boom.

Contributing to the expected strength in construction is ongoing reconstruction in Canterbury, with increases in residential and non-residential spending planned over the coming year. But the robust construction outlook isn't just a Canterbury story. Strong increases in residential construction are also expected in Auckland, where recent sales figures showed that housing market remains hot (house sales in Auckland were up 27% in the last two months and prices were up 13.5% on a year ago). This follows strong population growth and low building in recent years, which have added to demand and supply pressures. On top of this, solid increases in nationwide infrastructure and other non-residential investment spending are expected over the coming years, with continued firmness in the latest non-residential building consent figures.

Demand conditions are also looking positive in the economy more generally. In the household sector strong population growth, increases in employment and the boost to household purchasing power from both lower petrol prices and low interest rates are all supporting spending. In addition, businesses' investment and hiring intentions remained at firm levels in late-2014. Over the coming week we'll receive a number of

Don't stop me now continued

updates on how conditions in the business and households sections are faring as we enter 2015. These include the latest Quarterly Survey of Business Opinion and the manufacturing PMI, as well as Roy Morgan consumer confidence and the Westpac McDermott Miller survey of employment confidence.

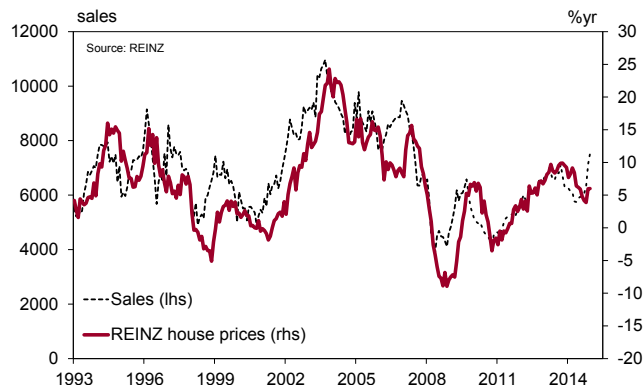
Good and bad deflation

While the growth outlook is looking firm, inflation remains soft. New Zealand has been experiencing an extended period of below average inflation, with headline inflation below the mid-point of the RBNZ's target band for three years now. Following recent sharp declines in petrol prices, it's likely that inflation will push even lower over the coming months. We expect the December quarter CPI (due 21 January) to show that annual inflation fell to 0.9% at the end 2014, and that it will remain below 1% percent for most of 2015.

New Zealand isn't the only economy currently confronting low inflation. But we are in a very different position from economies such as the euro area that are facing the spectre of deflation. In those economies, much of the weakness in inflation is a result of weakness in demand. This what economists colloquially refer to as 'bad' deflation. In contrast, what we're seeing in New Zealand is more of a 'good' deflation story. The New Zealand economy has been expanding at a solid pace, and is expected to remain robust over the coming year. Low inflation here has in large part been a result of softness in costs, particularly for imported goods. Most significantly, we've seen the price of petrol falling to its lowest level since 2010. Combined with increases in the economy's productive capacity, these conditions have meant the economy can continue growing without significant price increases.

Despite low inflation, rate cuts are off the table. The RBNZ looks through the effects of short-term movement in prices associated volatile items such as oil, and instead focuses on longer-term drivers of growth and inflation. And as discussed

REINZ house prices and sales



above, domestic demand is looking robust, particularly in the housing market. Consequently, the next move in interest rates is likely to be up. However, it's unlikely that the RBNZ will be hiking while inflation is below its target band. We're not factoring in any changes until early 2016. And if oil prices keep falling, this could be pushed out even further.

This doesn't mean that the Reserve Bank will be sitting on its hands for the next year. It will likely be looking into what other tools it could use to limit pressures in housing market, and it may be that we see further use of the Reserve Bank's macro-prudential tool kit over the coming year. On this front, December's REINZ house sales figures are notable. They showed a 24% increase in house sales in the year to December, confirming our view that the housing market would respond vigorously to lower mortgage rates and booming population growth. The seasonally adjusted level of sales is now 6% above the peak seen in September 2013 - just before the RBNZ introduced its limit on high-LVR mortgage lending.

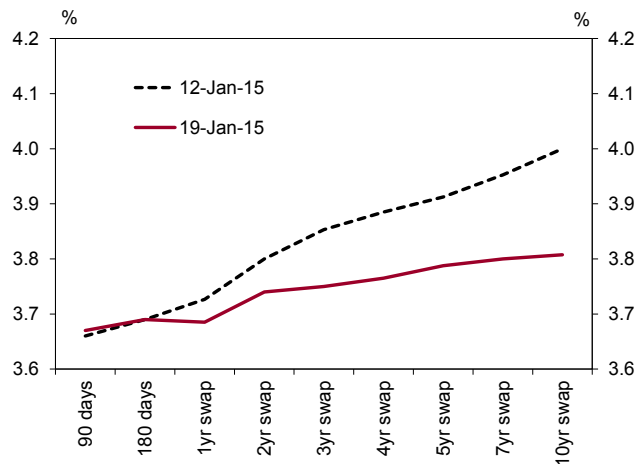
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though they do offer stability.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates

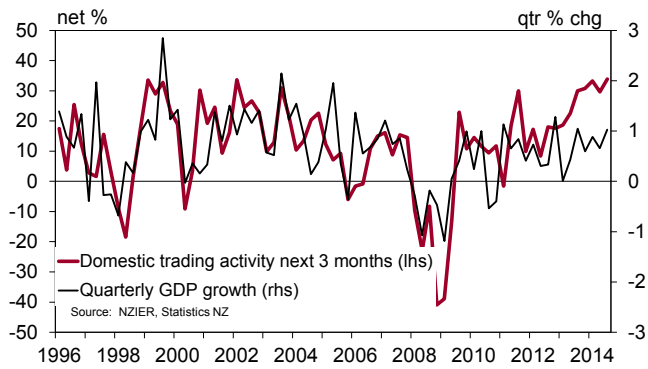


NZ Q4 Quarterly Survey of Business Opinion

20 Jan, last 20%

- Business confidence eased through the September quarter, although it remained at healthy levels. Confidence is expected to have remained firm through the final months of 2014, consistent with favourable indications for domestic demand.
- The survey's report of businesses' past own activity is an important early indicator of GDP growth for the quarter. Our current forecast is that GDP growth held steady at 0.8% in the December quarter.
- The survey's inflation gauges will be closely watched. Input costs have fallen sharply, and the survey will provide an early read on how this is passing through to final prices.

QSBO domestic trading activity and GDP

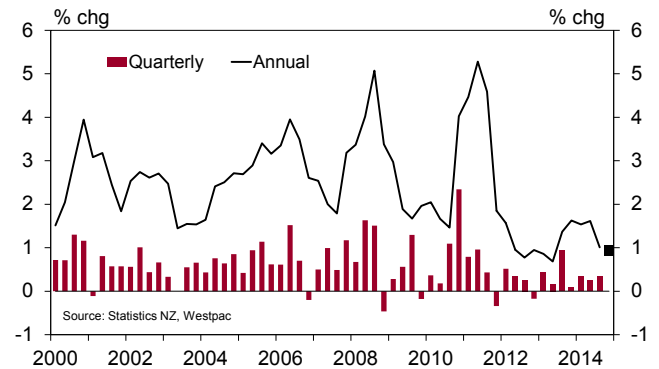


NZ Q4 CPI

Jan 21, Last: 0.3%/1% yr, Westpac f/c: 0.0%/0.9% yr, Mkt f/c: 0.0%/0.9%yr

- We expect another subdued inflation outturn for the December quarter, which would see annual inflation fall below 1% for the second time in the last few years. The legacy of a strong New Zealand dollar continues to depress tradables prices, and we are yet to see a significant lift in domestic inflation, despite accelerating growth in recent years.
- Quarterly movements in the CPI tend to be dominated by seasonal factors, in this case food (down) and airfares (up). The December quarter is typically the low point of the year for inflation, with Q4 often seeing a small decline.
- Petrol prices were 5% lower on average over the December quarter, though this was by no means a historical outlier. The real impact on headline inflation will come in the March quarter, with petrol prices tracking 16% lower to date.

NZ CPI inflation



Aus Jan Westpac-MI Consumer Sentiment

Jan 21 Last: 91.1

- The Westpac-Melbourne Institute Consumer Sentiment Index fell 5.7% in Dec from 96.6 to 91.1, taking the Index to its lowest level since August 2011.
- Respondents were clearly concerned about the outlook for the economy and job security; further, disillusionment over the May budget persisted, six months after it was announced.
- Since the December report, the oil price has continued to decline, boosting consumers' discretionary income. Also, the December labour force survey reported another robust job gain, taking annual employment growth to 1.9%yr. However, a number of potential offsets are apparent, notably: increased uncertainty over near-term global growth, particularly in Europe; further declines in key commodity prices; and an associated 2.0%+ fall in the ASX200 since the turn of the year.

Consumer Sentiment Index

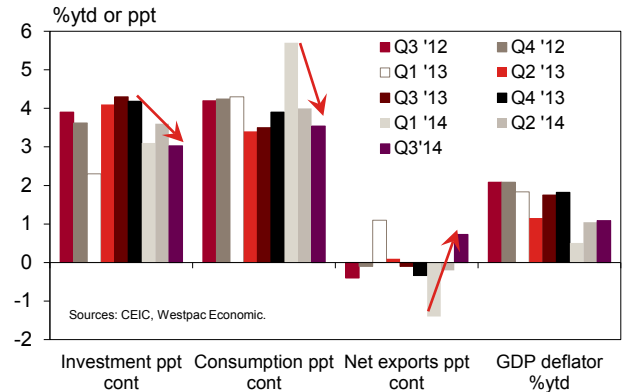


China Q4 real GDP

Jan 20, Last: 7.3%, WBC f/c: 7.2%, Mkt f/c 7.2%, Range: 6.9% to 7.5%.

- The NBS estimated that China grew at a real rate of 7.3%yr in Q3, with a seasonally adjusted change of 1.9%. Our forecasts for Q4 are a 0.1ppt decline in y/y rate, to 7.2%yr, although it is very close to rounding to a steady outcome (it incorporates a 1.64% sa quarterly assumption). Speaking of rounding, 7.2%yr could be consistent with either 7.3% or 7.4% for the full year, although with the official target at 7½%, 7.4% is more likely, depending upon what the leadership has decided to do with the 2015 target (lower it, abandon the concept, replace the point estimate with a range), which could influence NBS tactics.
- Nominal GDP tends to be more sensitive to swings in underlying demand conditions than the real estimate. The very weak price environment will weigh nominal activity down again.
- Net exports will support Q4, but the swing factor will be less than in Q3. The full year contribution will be around 0.9ppts.

Various elements of China's national accounts

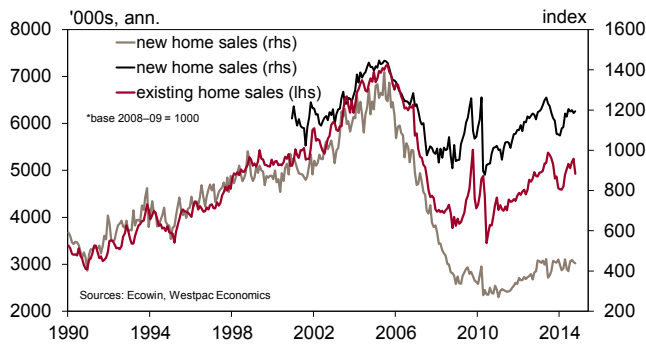


US housing starts, prices, sales & builder confidence

Jan 20–23

- The US housing recovery started at least two years after the broader economy emerged from recession in 2009. It lasted about two years, but since mid-2013 the sector has struggled to gain further traction.
- Sales of new and existing homes sales in November were down 4% and 8% respectively on their mid-2013 peaks, after growth of 70% and 30% respectively from their 2011 lows. Housing starts were down 7% in November from a year prior, after recovering 113% between 2011-2013; and homebuilder confidence fell 1pt after rising 45pts over similar timeframes. Less dramatically, annual house price inflation slowed from 14% in late 2013 to just above 4% a year later.
- None of this week's housing data are expected to materially alter this picture of a stalled recovery, which remains a source of concern for the FOMC, and a reason for policy "patience".

Various elements of China's national accounts

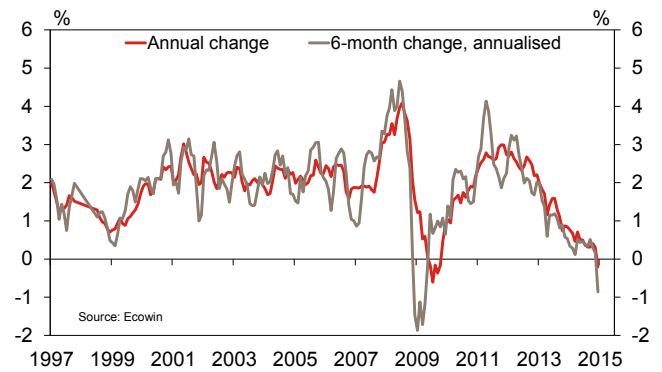


ECB policy decision: to QE or not to QE?

Jan 22

- More than 4 years ago, before the Portuguese/Irish bailouts, before the ECB rate hikes of mid 2011, and more than a year before Mario Draghi became ECB chief, we warned that that the emerging crisis in the Eurozone "could be severe enough to force the ECB into unsterilised purchases of ... sovereign debt off the banks - in other words QE from the ECB."
- That time has now come. Despite having exploited all other policy options, a sufficient majority on the ECB Governing Council now would agree that falling prices across the Eurozone and tumbling inflation expectations have increased the risks of "a downward spiral of stagnation, low inflation, or outright deflation." (ECB Council member Visco, 14/1/15)
- Impediments to QE have fallen by the wayside, most recently questions of legality. Draghi will announce a QE policy on Jan 22, although full details may be reserved till early March, with implementation to follow in Q2.

Euro area inflation trend a major concern



Data calendar

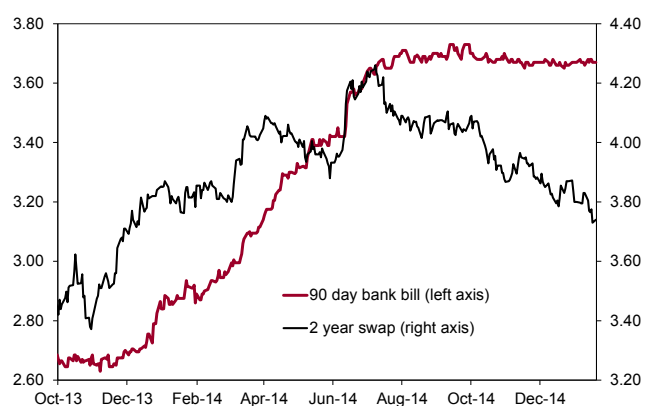
		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
Aus	Dec TD securities inflation gauge %yr	2.2%	–	–	Falling petrol; falling AUD; which will have bigger impact?
Eur	Nov current account balance €bn	20.5	–	–	Large surpluses providing little support for EUR as QE rolls in.
	Nov construction output %yr	1.4%	–	–	Growth to slump in Dec-Jan as weather effect drops out from year ago.
UK	Jan house prices %yr	7.0%	–	–	Rightmove index of asking prices.
Tue 20					
NZ	Q4 Quarterly Survey of Business Opinion	20.3	–	–	Business confidence is expected to have remained firm.
Chn	Q4 real GDP %yr	7.3%	7.2%	7.2%	Net exports strong, nominal activity and domestic demand weak.
	Dec fixed investment %ytd	15.8%	15.7%	–	Well established downtrend in real estate and heavy industry.
	Dec industrial production %yr	7.2%	7.4%	–	PMIs soft, but deepening PPI deflation will pull up real growth.
	Dec retail sales %yr	11.7%	11.8%	–	Consumer sentiment picked up in Dec, as did auto sales.
	Dec housing sales, sqm %ytd	–8.2%	–	–	Small improvement likely as sentiment towards housing turns - slowly.
	Dec housing starts, sqm %ytd	–9.0%	–	–	Developer finances stretched, starts will lag sales improvement in '15.
Ger	Dec producer prices %yr	–0.9%	–1.3%	–	Decelerating at –0.8%yr to –1.1%yr pace right through 2014.
	Jan ZEW analysts' survey	34.9	39.0	–	Expectations on the mend after slump through most of 2014.
US	Jan NAHB housing market index	57	58	58	2 year upswing stalled in mid-2013; housing headwinds persist.
Can	Nov manufacturing sales	–0.6%	–0.5%	–	Sales came off Sep record pace in Oct.
Wed 21					
NZ	Q4 CPI	0.3%	0.0%	0.0%	Annual inflation is expected to fall below the RBNZ target band.
	GlobalDairyTrade auction results	3.6%	–	–	Concerns about drought in NZ could boost prices in coming auctions.
Aus	Jan Westpac–MI Consumer Sentiment	91.1	–	–	Labour market data supportive; global backdrop not.
	Jan Westpac–MI unemp. expectations	4.4%	–	–	Has eased, but still at high level.
UK	Dec unemployment	–27k	–25k	–	Benefit claimant count.
	Jan BoE MPC meeting minutes, vote	7:2	–	–	Case for rate rise in near term has diminished significantly.
US	Dec housing starts	–1.6%	1.2%	–2.0%	Single family starts grew 7% in May-Nov ahead of permits up 4%, an unsustainable picture unless permits pick up smartly.
	Dec building permits	–3.7%	0.3%	2.0%	
Can	Nov wholesale trade	0.1%	–	–	Sales have not posted a fall since the end of 2013.
	BoC policy decision	1.0%	1.0%	1.0%	Policy firmly on hold. Monetary policy report to be issued.
Thu 22					
NZ	Dec PMI	55.2	–	–	Manufacturing and services surveys eased in Nov from very high levels.
	Jan consumer confidence	126.5	–	–	Consumer sentiment has eased, but remains elevated.
Aus	Jan MI inflation expectations %yr	3.4%	–	–	Outside of falling petrol, no other big surprises.
Chn	Jan MNI Business Indicator	56.2	–	–	Survey of mainly listed firms, both manufacturing and services.
Eur	ECB policy rate announcement	0.05	0.05	0.05	Draghi to pre-announce QE program with limited detail.
	Jan consumer confidence advance	–10.9	–10.5	–10.7	Confidence stabilising below May 2014 high at –7.1.
UK	Dec PSNCR £bn	6.7	–	–	Public sector net credit requirement. PSNB ex intv'ns £14.1bn in Nov.
	Jan CBI industrial trends survey	5	–	–	Total orders. Will also include quarterly business optimism index.
US	Initial jobless claims w/e 17/1	316k	–	290k	Claims may again be distorted by weekly seasonal adjustment issues.
	Jan Kansas City Fed factory index	8	–	10	Most sober of the regional surveys.
	Nov house prices	0.6%	0.3%	–	FHFA index.
Fri 23					
Chn	Jan HSBC manufacturing PMI – flash	49.6	–	–	Orders and prices fell sharply in December, stocks steady, bad combo.
Eur	Jan PMI factory, advanced	50.6	51.0	51.0	Showing tentative signs of recovery from late 2014.
	Jan PMI services, advanced	51.6	52.0	52.0	Composite PMI fact/ser was 51.4 in Dec.
UK	Dec retail sales volumes inc fuel	1.6%	–0.6%	0.2%	Discounting, lower fuel costs boosted Oct, Nov and continued in Dec.
US	Dec Chicago Fed nat'l activity index	0.73	–	–	Based on 80 or so data inputs, not a business survey.
	Dec leading index	0.6%	0.4%	–	Leading index has scarcely missed a beat for two years now.
	Dec existing home sales	–6.1%	2.4%	0.0%	Sales 8% down on recent peak of July 2013.
Can	Nov retail sales	0.0%	0.0%	–	Oct retail sales weighed down by autos and gasoline prices.
	Dec CPI % yr	2.0%	1.7%	–	BoC core rate 2.1%yr in Nov. Lower gasoline prices weighing on headline.

New Zealand forecasts

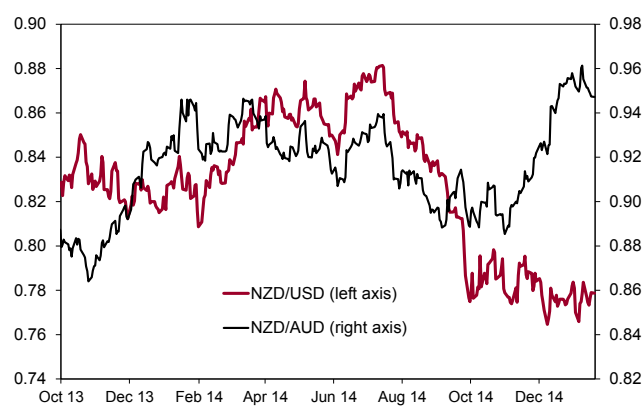
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	3.4	2.2	3.2	3.5	2.9
Employment	0.4	3.8	2.9	2.7	2.9	3.0	3.1	1.8
Unemployment Rate % s.a.	6.2	6.0	5.1	4.5	6.0	5.4	4.6	4.3
CPI	0.9	1.5	0.7	1.9	1.6	0.9	1.3	2.5
Current Account Balance % of GDP	-3.7	-2.6	-4.3	-5.1	-3.3	-3.3	-5.2	-4.3

Financial Forecasts	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Cash	3.50	3.50	3.50	3.50	3.75	4.00
90 Day bill	3.70	3.70	3.70	3.75	4.00	4.25
2 Year Swap	3.70	3.70	3.90	4.20	4.50	4.70
5 Year Swap	4.00	4.10	4.30	4.50	4.70	4.90
10 Year Bond	3.80	3.90	4.10	4.30	4.50	4.60
NZD/USD	0.76	0.74	0.77	0.79	0.81	0.81
NZD/AUD	0.93	0.93	0.93	0.93	0.93	0.91
NZD/JPY	89.7	89.2	93.9	98.0	100.2	101.3
NZD/EUR	0.66	0.66	0.67	0.68	0.69	0.69
NZD/GBP	0.50	0.49	0.50	0.50	0.50	0.49
TWI	78.0	77.5	79.3	80.8	81.9	81.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 19 January 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.63%	3.64%	3.64%
60 Days	3.65%	3.66%	3.65%
90 Days	3.67%	3.68%	3.65%
2 Year Swap	3.74%	3.80%	3.83%
5 Year Swap	3.79%	3.94%	4.02%

NZ foreign currency mid-rates as at Monday 19 January 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7787	0.7659	0.7760
NZD/EUR	0.6740	0.6425	0.6330
NZD/GBP	0.5142	0.5017	0.4967
NZD/JPY	91.50	92.18	92.94
NZD/AUD	0.9472	0.9496	0.9519
TWI	99.03	78.34	78.66

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014f	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.7	3.5
CPI inflation % annual	3.0	2.2	2.7	1.8	2.6	3.0
Unemployment %	5.2	5.3	5.8	6.3	6.4	6.1
Current Account % GDP	-2.8	-4.4	-3.3	-2.9	-3.2	-0.8
United States						
Real GDP %yr	1.6	2.3	2.2	2.2	2.5	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.8	1.8	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.6	5.1
Current Account %GDP	-2.9	-2.9	-2.4	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	-0.3	1.8	1.6	0.4	1.2	1.6
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.7	0.9	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	3.0	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.5	7.8
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.0	4.9	5.7
World						
Real GDP %yr	4.1	3.4	3.3	3.2	3.7	4.5
Forecasts finalised 8 December 2014						

Interest Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Australia						
Cash	2.50	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.72	2.20	2.20	2.20	2.22	2.25
10 Year Bond	2.52	3.10	3.30	3.35	3.35	3.60
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.500
US 10 Year Bond	1.71	2.40	2.60	2.70	2.75	2.90
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
AUD/USD	0.8240	0.82	0.80	0.83	0.85	0.87
USD/JPY	116.24	118	120	122	124	124
EUR/USD	1.1639	1.16	1.13	1.15	1.16	1.17
AUD/NZD	1.0494	1.08	1.08	1.08	1.08	1.08

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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