Westpac Institutional Bank

19 December 2013

Firing on (almost) all cylinders

Q3 GDP rose 1.4%, boosted by post-drought recovery

- GDP rose by 1.4% in the September 2013 quarter, in line with our view and stronger than market expectations.
- Agricultural production more than fully rebounded from the effects of the drought over the first half of this year.
- Ex-agricultural production has also seen solid growth in the last few quarters, although the pace of growth over 2012 was revised lower.
- The New Zealand economy has entered a robust and sustainable upturn, even more so than the Reserve Bank assumed. Higher interest rates will be appropriate next year; we expect the first OCR increase in March, with four further hikes over 2014.

Key results

	Actual		Q3 expectations		
	Q2	Q3	Westpac	Mkt	RBNZ
GDP q/q	0.3	1.4	1.4	1.1	1.1
GDP ann % chg	2.3	3.5	3.8	3.3	3.3
GDP ann avg % chg	2.2	2.6	3.4	-	-

The New Zealand economy roared ahead in the September 2013 quarter, with a remarkably swift post-drought rebound in agricultural conditions coming on top of an ongoing and broad-based lift in momentum. While forecasters were already braced for a strong quarter, the outturn beat all market expectations except for our spot-on forecast of 1.4% growth.

The much-awaited revisions to the recent track record of GDP were surprisingly mixed – although as we noted in our preview, these kinds of changes shouldn't greatly affect our understanding of where the economy sits relative to its potential. The economy has been growing steadily over the last few years but has yet to crack the 3% growth mark on a full-year basis.

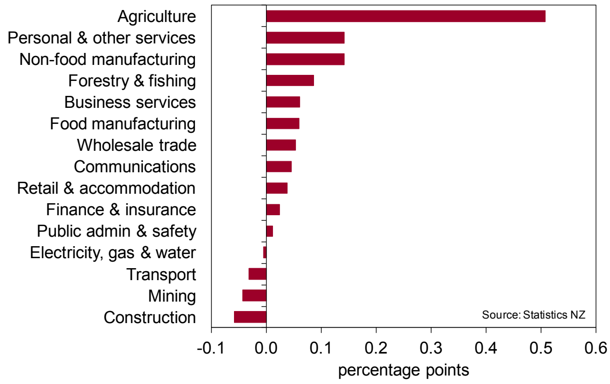
The economy's momentum over 2013 has been stronger than was assumed in last week's *Monetary Policy Statement,* and will leave the Reserve Bank more confident about raising the OCR from next year. While markets are probably justified in placing reasonable odds on a January hike, our view is that tactical considerations favour a March start date. We have, however, lifted our forecast to 125 basis points of hikes over 2014 (previously 100bps), with three consecutive 25bp hikes between March and June.

Details

Production GDP rose by 1.4% in the September quarter, the largest quarterly increase since a 1.5% rise in December 2009 when the economy was starting to exit a deep recession. Growth in the first two quarters of the year was also revised higher by 0.1ppt each, to 0.5% and 0.3%.

Agriculture was by far the greatest contributor to growth in the September quarter, having been a sizeable drag over the first half of the year. Agricultural production rose by 17%, more than unwinding the hit to production from a short but severe drought early this year. Combined with the lift in dairy and meat processing, the post-drought recovery contributed around 0.6ppts to GDP growth for the quarter.

Percentage point contribution to Q3 GDP growth



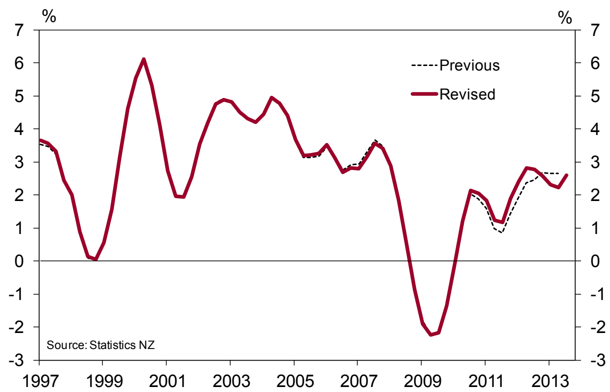
That still leaves a solid 0.8ppt contribution from the rest of the economy – indeed, stripping out the drought impact suggests that ex-agri growth has been running consistently around this pace so far this year. In a symptom of the self-sustaining nature of this upswing, growth was spread across a broad range of sectors, with standout contributions from manufacturing (up 1.5%), healthcare (up 2.0%), forestry (up 8.2%) and rental, hiring and real estate services (up 1.1%).

There were a few disappointments relative to our forecasts, particularly in construction (down 1.0%). Previous surveys had already flagged a rise in residential building (up 8.5%) and a drop in non-residential building (down 6.0%); the new information was a sharp drop in infrastructure work. We don't have a lot of visibility around this series and it tends to be very volatile, so today's figures don't change our view that there is a substantial amount of construction work in the pipeline, both quake-related and business as usual.

Revisions

Today's release included substantial revisions to the history of GDP over the last few years. In addition to the usual annual update of sectoral benchmarks, there were improved estimates of quake-related construction in Canterbury and a new methodology for the chronically under-reported communications sector.

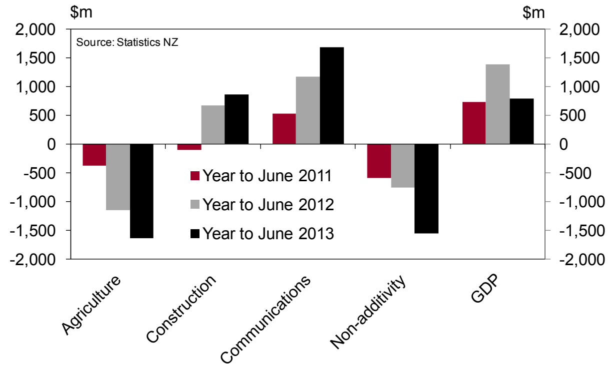
Annual average GDP growth



In our preview we indicated that the last two of those revisions would substantially lift the reported rate of GDP growth over the last couple of years. It turns out we were only half-right: growth over 2011, when the adjustments started to kick in, was certainly revised higher. But the annual changes to the benchmarks actually lowered the rate of growth over 2012. Consequently, annual growth in the year to June 2013, previously reported as 2.7%, was actually revised down to 2.2%. The latest quarter has boosted annual growth to 2.6%, but that's still slower than we previously thought.

So where did the growth go over 2012? There are two major stories. The first is that the value-added from the agricultural sector has been revised down heavily over the last few years – output has grown strongly, but new information shows that the inputs needed to produce that output were greater than assumed. The second story is rather less enlightening. Due to a technical quirk in the way GDP is compiled, total GDP can be greater than the sum of the sectors – that gap had become large in recent years but was effectively erased during these revisions.

Major revisions to GDP components



Implications

The New Zealand dollar and interest rates rose slightly after the GDP release, although the NZD has subsequently moved lower as the market has digested the US Federal Reserve's surprise decision this morning to slow the pace of its bond purchase programme. Financial markets appear to be well-versed already with the story of the strengthening New Zealand economy; interest rate markets are more than fully pricing a 25bp OCR hike in March and around 125bp of hikes over 2014.

The drought and the subsequent recovery has left an uneven GDP growth profile over the course of this year, but today's figures reinforce that the New Zealand economy is firmly in the grip of a widespread upturn. Underlying activity has been running at around 0.8% in the first three quarters of this year, and high-level indicators such as business confidence suggest that momentum may have even picked up further in the current quarter. We have revised our forecast for December quarter GDP growth from 0.7% to 1.0%.

With September quarter GDP stronger than the RBNZ's forecast of 1.1%, and upward revisions to the previous two quarters, the economy's momentum so far this year has been quite a bit stronger than the RBNZ assumed. That should give the central bank more reassurance that it will be appropriate to start raising interest rates early next year, as it signalled in last week's *Monetary Policy Statement.*

Our view remains that the first OCR hike will come in March next year – while the tone of the recent data could support a hike as soon as the next review in January, we suspect the RBNZ will prefer to use a full *MPS* to launch such a significant move. However, we believe that recent developments – stronger than expected near-term growth, the Fed's early 'tapering', and the reduced risk of rate cuts by the Australian central bank in the near future – could encourage the RBNZ to move faster than previously signalled. We now expect three consecutive OCR hikes from March to June (previously we expected the RBNZ to pause at the April review), with further hikes in September and December, bringing the cash rate to 3.75% by the end of next year.

Michael Gordon
Senior Economist

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

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website 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.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.