

Weekly Commentary

15 February 2010

Taxman

Last week the Government signalled a range of economic reforms, including changes to tax policy (income, GST, and property), with details to be provided in the May Budget.

The economic agenda is wide-ranging, with the main pillars being: a more growth-friendly mix to the tax system; better regulation of resources; deepening and improving access to capital markets; a greater emphasis on practical skills in education; investment in key infrastructure; support for science and innovation; and better delivery of public services.

Of these areas, tax reform has understandably received the most attention. This is where there was the most uncertainty about which direction the Government would take, after several working groups made their recommendations last December; it's also where there is the greatest potential to create winners and losers. The sharp drop in house sales in January (down 16% s.a.) suggests that buyers have become concerned about potential tax changes.

The most likely outcomes are a drop in the top income tax rate from 38% to 33%; an increase in GST from 12.5% to 15%, with compensating increases in government transfers; the removal of depreciation allowances (and subsequent clawbacks) for buildings; and the ring-fencing of losses on rental properties. New taxes aimed specifically at property were ruled out, though there may be greater enforcement of the existing capital gains tax for 'active' traders.

The overall thrust of the reforms is clearly beneficial for potential economic growth, albeit difficult to quantify. Lower marginal tax rates and reduced abatement rates for family tax credits will increase the responsiveness of the labour supply. Productivity will be enhanced by improving firms' access to capital, and by encouraging more innovation for commercial uses. Removing barriers to industries such as mining and aquaculture would generate export income and jobs. The payoff to growth could have been larger if inroads were made into the size of government, but projections of deficits for years to come meant that the tax package had to be designed to be revenue-neutral.

As to the specific effects, a shift in emphasis from income to consumption taxes would encourage more household saving at the margin. As it stands, saving is taxed twice – first when the income is earned, and again on accrued interest (and of course a third time if you count future consumption taxes). Cutting the top income tax rate reduces this penalty on saving.

The interaction of the various reforms makes it difficult to untangle the net impact on the housing market, but the general direction is clear: lower house values, higher rents, and some investors exiting the market while owner-occupiers enter. Ironically, the measure that would be most effective in taking the heat out of the housing market is the one that's not intended for that purpose: cutting the top tax rate will reduce the rebate that

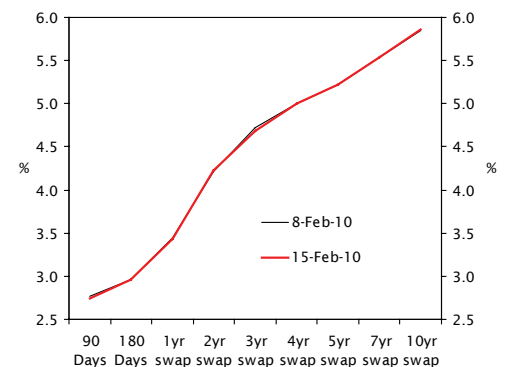
landlords receive for losses on their rental properties (and the implicit value of tax-free accommodation for owner-occupiers).

Ring-fencing of losses on property, and removing depreciation allowances, would largely affect investors through the timing of cash flows. So while the impact on the fundamental value of housing is unclear, house prices would be put under pressure initially as highly leveraged, cash-constrained investors exited the market.

An increase in GST would have a positive, though relatively small, impact on house values. Since GST is applied to the construction of new houses, an increase would push up the replacement cost of housing, setting the benchmark for existing house prices and reducing the supply of new homes – which is already running at unsustainably low levels.

Furthermore, GST isn't applied to the 'flow' of housing services – whether rented or

NZ Interest Rates



*Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1 year onwards.

owned – making them more attractive compared to other types of consumption.

We estimate the 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 catch up.

The proposed tax changes will also create some volatility in the economic data around the time they are implemented. The GST increase would add 2% to the CPI, which on our forecasts would see annual inflation peak at around 4.8% between December 2010 and September 2011. Consumers will bring forward some purchases to beat

the price hike. Based on the experience of the last GST increase (from 10% to 12.5%) in 1989, we would expect a 10% lift in real spending on durable goods and a 1% lift in non-durables, which would be fully unwound in the following quarter. This will require the RBNZ to interpret the data carefully, but it shouldn't materially disrupt their plans to normalise the OCR from extremely low levels.

On that subject, the recent data (housing, employment, and retail) have generally fallen short of forecasts, prompting us to shift our forecast for the first OCR hike from April to June. The retail figures were still strong in outright terms – the 1% growth in volumes was the largest quarterly increase since March 2007 – but even this is a double-edged sword. To date, consumers have been more responsive to the housing market upturn than the RBNZ assumed; but if this relationship holds, the potential tax changes could indeed do

some of the tightening work that the RBNZ would have to otherwise.

Fixed vs. floating: The growing prospect of OCR hikes in the first half of the year will eventually flow through to short-term fixed rates, which have only seen small increases to date and remain at historically low levels. As a result, we could see more borrowers moving to fix at the favourable rates still on offer – and the experience of March/April last year shows that these types of flows can put a great deal of upward pressure on mortgage rates. With floating and one-year fixed rates around similar levels, there may not seem to be much advantage in fixing right now, but those who wait until they see the whites of the RBNZ's eyes before fixing are likely to face much less attractive options. Repaying more than the minimum amount and spreading the loan over a mix of terms can help to reduce overall risk regarding uncertain future interest rate changes.

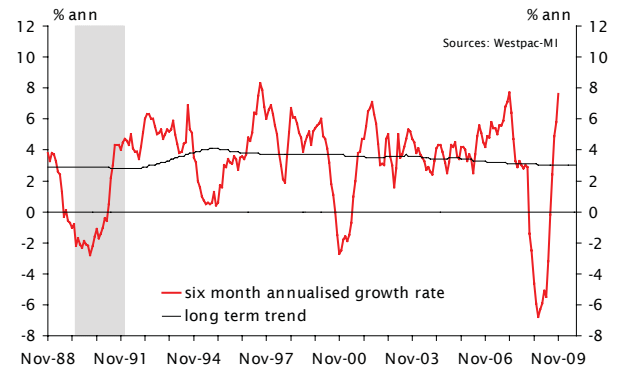
Key Data Previews

Aus Dec Westpac-MI Leading Index

Feb 17, Last: 7.6% annualised

- The *Westpac-Melbourne Institute Leading Index* surged strongly over 2009H2. The Index's annualised growth rate, a guide to the likely pace of economic activity three to nine months ahead, hit 7.6% in Nov, on a par with previous peaks and well above its long term trend of 3%. The turnaround remains extraordinary – the index was contracting at a -5.5% annual pace in May – easily the fastest turn since the mid 1970's.
- Monthly components were somewhat mixed in Dec. Equity markets posted more strong gains, the ASX rising another 3.6%; as did dwelling approvals, up 2.2% after an upwardly revised 10.4% jump in Nov. However, the money supply continued to contract and at a slightly faster pace in Dec (0.6%*mth* vs 0.2%*mth* previously). US industrial production posted another solid 0.6% rise, in line with Nov. The Dec index will also incorporate quarterly data from the Q3 GDP.

Westpac-MI Leading Index

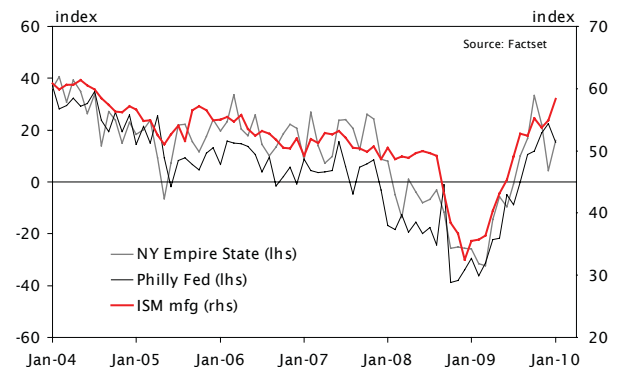


US Feb NY and Philly Fed surveys

Feb 16, New York Fed: Last: 15.9, WBC f/c: 20.0, Mkt f/c: 18.0
 Feb 18, Philadelphia Fed: Last: 15.2, WBC f/c: 20.0, Mkt f/c: 17.0

- Both these regional Fed surveys surged in the second half of 2009, the NY index peaking at 33 (highest since 2006) in Oct and Philly at 23 (highest since 2005) in Dec. Since peaking, they have pulled back somewhat, but both are still at levels consistent with a rapid pace of industrial expansion.
- These elevated readings will persist while government policies continue to support the housing market (via production of construction materials and household goods) and while firms are rebuilding their inventory levels.
- Without local agents on the ground it is difficult to forecast these small surveys of factory boss sentiment but given the Feb survey period overlaps with the Jan factory ISM which was much stronger, it seems reasonable to expect both to post a decent gain in Feb.

US manufacturing surveys



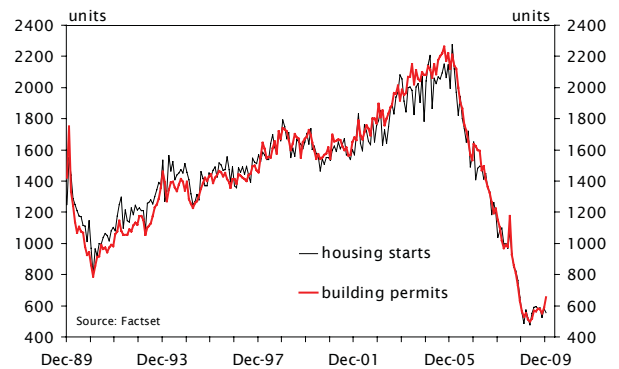
US Jan housing starts and permits

Feb 17, Starts: Last: -4.0%, WBC f/c: 0.0%, Mkt f/c: 4.1%

Feb 17, Permits: Last: 10.9%, WBC f/c: -2.0%, Mkt f/c: -5.8%

- Housing starts fell 4% in Dec, despite a further gain in the usually volatile multiples component. Single family starts posted their second 7% fall in three months, sufficient to leave a modest downtrend in place since mid-year, following six months of gains for single family starts from February to July. Poor weather was probably a factor in Dec.
- With permits now running at a 653k annualised pace compared to starts on just 557k, we should see a significant run-up in starts in coming months, especially given that the tax credit for homebuyers has been extended from Nov to April.
- However the Jan snow-storms were more severe than normal and construction jobs fell sharply, so we doubt starts bounced in Jan. Permits are due a multiples led decline.

US housing starts and permits

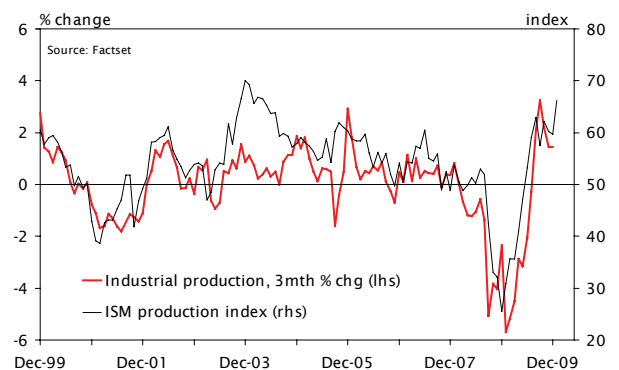


US Jan industrial production to post solid rise

Feb 17, Last: 0.6%, WBC f/c: 1.4%, Mkt f/c: 0.8%

- Industrial production posted a 0.6% gain in December, its sixth consecutive gain. It was largely due to a near 6% surge in utility output as the weather turned unseasonably cold. Excluding that and a 0.2% rise in mining output, factory output actually fell slightly, down 0.1%, a little surprising given generally solid business surveys and firms' renewed inventory building.
- Even more so this time around, the business survey evidence, such as the five year high for the factory ISM, points to a solid Jan IP result. Also, factory hours worked surged 1% in Jan, and utility output should have held up given the colder than usual weather mid month.
- Hence we are forecasting a solid 1.4% gain in industrial production, including a decent 1+% rise in the manufacturing component.

US industrial production rebounds



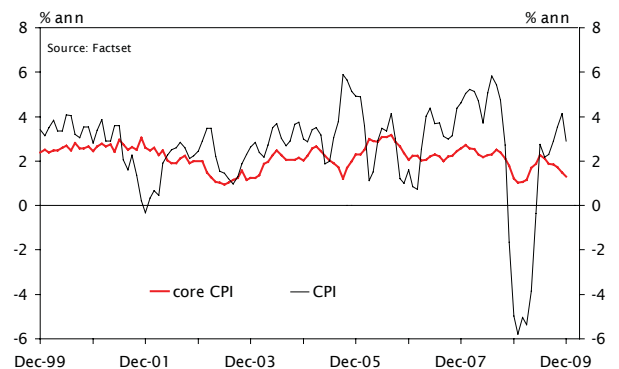
US Jan PPI and CPI

Feb 18, PPI headline Last: 0.2%, WBC f/c: 1.0%, Mkt f/c: 0.8%

Feb 19, CPI headline Last: 0.1%, WBC f/c: 0.4%, Mkt f/c: 0.3%

- The PPI rose 0.2% in Dec, driven mainly by a 1.6% jump in food prices. The core rate was flat, constrained by the volatile light truck component which fell 1.2%. The Jan PPI will be lifted by sharply higher oil prices (when the survey was taken in early Jan) and a bounce in vehicle prices could lift the core rate 0.2%.
- The CPI posted subdued 0.1% gains for both the headline and core rates in Dec. Food and energy both posted 0.2% gains but these were partially offset by flat housing costs, a fall in recreation and subdued medical care prices. Base effects continued to drive the headline annual rate higher but the core annual rate rose just a tick to 1.8% yr. In Jan, we expect recent PPI food price hikes to impact in CPI, and somewhat higher gasoline prices. That means a 0.4% headline CPI in Jan, but the core rate should remain subdued at 0.1%.

US CPI inflation



Key Data and Events

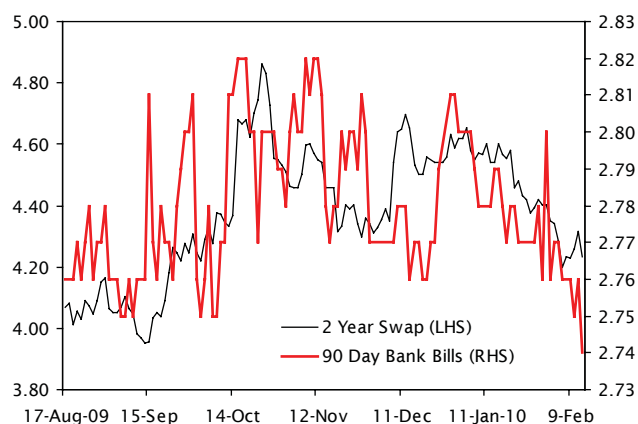
		Last	Market Median	Westpac Forecast	Comments
Mon 15 Feb					
US	Presidents' Day Holiday	-	-	-	Markets closed.
Jpn	Q4 GDP %saar	1.3%	3.5%	2.5%	Huge stat. discrepancy in Q3 offers downside risk in Q4.
Eur	Finance Minister Summit	-	-	-	Detail on assistance for Greece to be announced on 15/2 or 16/2.
UK	Feb House Prices %yr	4.1%	-	-	Rightmove index of asking prices (i.e. not actually selling prices).
Tue 16 Feb					
NZ	Q4 Producer Input Prices	-1.1%	-	-1.2%	Rising exchange rate still driving input costs down and keeping
	Q4 Producer Output Prices	-1.4%	-	-0.1%	output prices in check.
Aus	RBA Minutes, Feb Meeting	-	-	-	Markets looking for any hints on timing of next hike.
	RBA Assist. Gov (Financial Mkts) Debelle	-	-	-	Women in Finance luncheon, Sydney, 12:45pm
	Jan NAB Business Survey	10	-	-	Conditions Index steady in Dec at an above trend level.
US	Feb NY Fed Empire State Index	15.9	18.0	20.0	NY factory bosses experience larger mood swings than other regionals.
	Dec Net Long Term TIC Flows \$bn	126.8	50	-	Measure of appetite for US financial assets.
	Feb NAHB Housing Market Index	15	16	16	Builder confidence still low but may edge higher in Feb.
	Fedspeak	-	-	-	Hoenig, Lockhart and Kocherlakota.
Ger	Feb ZEW Analysts' Survey	47.2	41.0	40.0	Latest PIGS budget deficit concerns to extend recent decline.
UK	Jan CPI %yr	2.9%	3.5%	3.6%	VAT hike back to 17.5% main factor at play.
	Dec House Prices %yr	0.6%	1.2%	-	Less watched DCLG (govt) index.
Can	Dec Manufacturing Sales	0.1%	1.9%	-	Up three months running in Sep-Nov.
Wed 17 Feb					
Aus	Dec Westpac-MI Leading Index	7.6%	-	-	Posted a dramatic turnaround over the second half of 2009.
US	Jan Import Prices	0.0%	1.0%	1.2%	Oil prices on the rise again.
	Jan House Starts	-4.0%	4.1%	0.0%	Starts were weather affected in Dec but probably more so in Jan.
	Jan House Permits	10.9%	-5.8%	-2.0%	Permits less weather affected but 18% rise in Nov-Dec unsustainable.
	Jan Industrial Production	0.6%	0.8%	1.4%	Factory hours up 1.0% in Jan, plus utilities likely boosted by snow.
	Jan 27 FOMC Meeting Minutes	-	-	-	How much support for dissenter re "extended period" language?
	Jan Federal Budget Statement \$bn	-63.5	-46.0	-	A hot topic now.
	Fedspeak	-	-	-	Plosser on financial crisis.
Eur	Dec Trade Balance €bn sa	3.9	3.9	-	Back in surplus for eight months running now.
UK	Feb BoE Meeting Minutes	-	-	-	A minority vote in favour of extended QE is quite possible.
	Jan Unemployment chg	-15k	-10k	-15k	Few benefit claimants but employment growth not yet restored.
Can	Dec Wholesale Sales	2.5%	0.5%	-	Up three months running in Sep-Nov.
Thu 18 Feb					
Aus	RBA Assist. Gov (Economic) Lowe	-	-	-	CEDA Economic & Political Overview, Sydney, 9:20am
	Q4 NAB Survey	-	-	-	Already have the Jan monthly survey - out Tue.
	Jan Merchandise Imports, nsa AUDbn	17.7	-	-	+0.6% in Dec = +7.1% sa in further vol driven surge, led by K goods.
US	Jan Producer Prices	0.2%	0.8%	1.0%	Oil prices sharply higher in early Jan when survey taken.
	Jan PPI Core	0.0%	0.1%	0.2%	Big swings in vehicle prices have pushed the core rate around lately.
	Initial Jobless Claims w/e 13/2	440k	430k	440k	Administrative backlog now cleared, claims at "normal level".
	Feb Philadelphia Fed Index	15.2	17.0	20.0	Stronger ISM in Jan has some overlap with Feb Philly Fed.
	Jan Leading Index	1.1%	0.5%	0.5%	Looking for 10th consecutive gain in the leading index.
	Fedspeak	-	-	-	Bullard to Eco Club of Memphis.
Jpn	Bank of Japan Meeting	0.10%	0.10%	0.10%	The least likely major CB to begin normalisation process in 2010.
Eur	Feb Consumer Confidence Advance	-16	-16	-	Advance release of EC confidence report usually issued end month.
UK	Jan Mortgage Approvals	62k	63k	-	Major bank data. Industry wide figs due 1/3.
	Jan PSNCR £bn	23.6	-20.0	-	Budget deficits around Europe are hot topics now.
	Jan Money Supply Prelim %yr	6.4%	4.6%	-	Slowed from 18.8% yr peak just ten months prior.
	Feb CBI Industrial Trends Survey	-39	-	-	Orders measure less negative since Oct.
Can	Dec CPI %yr	1.3%	1.9%	-	Base effects to drive step up in both headline and core CPI but the
	Dec CP BoC Core %yr	1.5%	1.9%	-	latter to remain below the 1-3% target mid-point.
Fri 19 Feb					
NZ	Jan Credit Card Transactions	-1.1%	-	-	Expect evidence of continued consumer recovery.
Aus	RBA Gov Stevens Parliamentary Testimony	-	-	-	Canberra, 9:30am. To repeat themes in the Statement on MP.
US	Jan CPI	0.1%	0.1%	0.4%	Recent solid food prices gains in PPI to impact CPI. Also gasoline
	Jan CPI Core	0.1%	0.3%	0.1%	prices higher in Jan. Core CPI still subdued.
	Fedspeak	-	-	-	Lockhart and Dudley.
Eur	Dec Current Account €bn sa	0.1	-	-	Nov saw first surplus for four months, albeit very small.
	Feb PMI Factory Advance	52.4	52.7	52.0	Recent hard data from factory sector suggest PMIs overstating extent
	Feb PMI Services Advance	52.5	52.5	52.5	of recovery; services PMI fell in Jan and we don't expect Feb recovery.
Ger	Jan PPI %yr	-5.2%	-4.0%	-3.6%	Base effects add 1.2ppts; plus weaker euro, higher oil prices.
UK	Jan Retail Sales	0.3%	-0.5%	-1.0%	Weather disruption and VAT rise to dampen sales.
Can	Jan Leading Index	1.5%	1.1%	-	Has not posted a fall since April last year.
	Dec Retail Sales	-0.3%	0.5%	0.5%	Auto sales to lead retail gain.

New Zealand Economic and Financial Forecasts

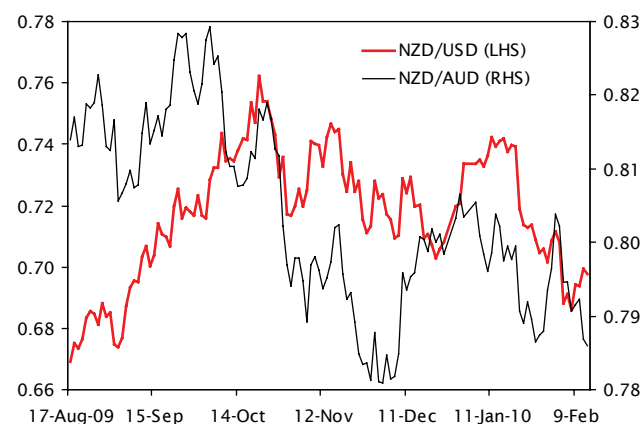
Economic Growth Forecasts	March years				Calendar years			
	2008	2009	2010f	2011f	2008	2009e	2010f	2011f
% change								
GDP (Production) ann avg	2.9	-1.4	-0.1	4.2	-0.1	-1.4	3.7	4.3
Employment	-0.3	0.7	-1.3	1.8	0.9	-2.4	1.2	2.1
Unemployment Rate % s.a.	3.8	5.0	7.1	6.3	4.7	7.3	6.5	5.7
CPI	3.4	3.0	2.3	2.8	3.4	2.0	2.7	2.8
Current Account Balance % of GDP	-7.8	-7.9	-2.1	-4.9	-8.7	-2.1	-4.7	-5.1

Financial Forecasts	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Cash	2.50	2.75	3.25	3.75	4.25	4.75	5.25
90 Day bill	2.80	3.20	3.70	4.20	4.70	5.20	5.70
2 Year Swap	4.40	4.70	5.00	5.30	5.60	6.20	5.90
5 Year Swap	5.40	5.60	5.70	5.90	6.10	6.30	6.45
10 Year Bond	5.80	5.90	5.90	6.00	6.10	6.20	6.20
NZD/USD	0.68	0.68	0.74	0.79	0.78	0.75	0.72
NZD/AUD	0.79	0.80	0.82	0.83	0.84	0.83	0.84
NZD/JPY	59.8	61.9	71.0	79.0	82.7	81.8	80.6
NZD/EUR	0.49	0.50	0.53	0.55	0.53	0.51	0.49
NZD/GBP	0.43	0.42	0.44	0.46	0.43	0.40	0.38
TWI	63.0	63.6	68.2	71.9	71.3	69.0	67.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 February 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.74%	2.73%	2.75%
60 Days	2.76%	2.76%	2.75%
90 Days	2.75%	2.80%	2.78%
2 Year Swap	4.22%	4.40%	4.57%
5 Year Swap	5.22%	5.33%	5.43%

NZ foreign currency midrates as at Monday 15 February 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6959	0.7084	0.7377
NZD/EUR	0.5114	0.5091	0.5128
NZD/GBP	0.4440	0.4443	0.4538
NZD/JPY	62.660	64.290	66.960
NZD/AUD	0.7838	0.7964	0.7994
TWI	64.470	65.250	66.710

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009e	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.3	1.0	3.0	3.2
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	2.5	2.7
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.5	5.3
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.2	-5.3	-4.7
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	1.8	3.0
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.5	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	10.7	10.6
Current Account %GDP	-6.1	-6.0	-5.3	-4.9	-3.0	-3.0	-2.2
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.6	1.5	1.8
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.2	-0.7	0.3
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.2	5.1
Current Account %GDP	3.6	3.9	4.8	3.2	2.9	4.0	4.8
Euroland							
Real GDP %yr	1.7	2.9	2.7	0.6	-4.0	0.7	1.1
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	11.5	10.8
Current Account %GDP	-0.2	-0.1	0.1	-1.1	-1.0	-0.5	0.0
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.7	-4.7	0.4	1.2
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	5.5	7.0	7.3
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 5 February 2010

Interest Rate Forecasts	Latest (Feb 15)	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Australia						
Cash	3.75	4.00	4.25	4.50	4.50	4.50
90 Day Bill	4.22	4.20	4.50	4.60	4.75	4.75
10 Year Bond	5.51	5.60	5.90	6.00	6.00	6.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.69	3.60	3.40	3.75	4.00	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.25	2.00
Exchange Rate Forecasts						
AUD/USD	0.8878	0.86	0.85	0.90	0.95	0.93
USD/JPY	90.05	88	91	96	100	106
EUR/USD	1.3608	1.38	1.36	1.40	1.43	1.46
AUD/NZD	1.2758	1.26	1.25	1.22	1.20	1.19

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