

Weekly Commentary

20 December 2010

Wrapping up the year

As always, New Zealand's economic calendar is packed in the lead-up to Christmas, at a time when the market is looking to wind things down.

The Government's Half-Year Fiscal and Economic Update showed the expected deterioration in the fiscal accounts relative to the May Budget projections. Weaker than expected economic growth has led to a shortfall in tax revenue relative to forecasts, which is projected to continue over the next few years.

Expenses are still projected to rise, but not as rapidly. Much of this is down to good fortune rather than active management, reflecting lower inflation forecasts relative to Budget. But the devil is also in the details: while the Government retained the \$1.1bn allowance for operational spending increases, a greater share of this has been set aside to manage 'expense volatility' (i.e., expenses that arise as a result of fluctuating demand and/or cost pressures, such as Kiwisaver expenses).

This is the final *Weekly Commentary* for 2010. We wish you all a very Merry Christmas and a prosperous New Year. Publication of this document will resume on 17 January 2011.



In the past, these expenses have flowed directly through to the operating deficit, leaving the fiscal position exposed. So the decision to manage these risks more explicitly is a positive step, and potentially means less money will be available for 'new' spending.

The operating deficit, excluding gains and losses, is forecast to peak at \$11bn in the 2011 fiscal year (or 5.5% of GDP), before narrowing from 2012 onward. Importantly, the Government expects to achieve a small surplus in 2015, a year earlier than projected in the Budget.

Relative to the Budget, the fiscal position is expected to move from a slightly more expansionary stance in 2011 to a slightly less contractionary stance in subsequent years. On its own, this is unlikely to make a meaningful difference to monetary policy, despite the RBNZ's insistence that tighter fiscal policy would take some of the pressure off interest rates and the exchange rate.

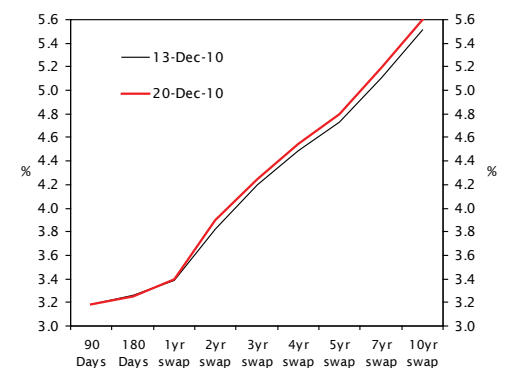
Last week's indicators of how households are faring were a very mixed bag. House sales bounced sharply in November - we estimate a 20% rise in seasonally adjusted terms - reversing most of the decline in the previous few months. Sales prices rose 1.9% for the month, though they were still 1.9% lower than this time last year. Activity in the housing market looks to be stabilising, albeit at very low levels - but even that puts

the acid on the RBNZ's expectation of a further 2% decline in house prices in the first half of 2011.

Retail sales fell by 2.5% in October, much more than we expected, although the details were less alarming. Purchases of big-ticket items such as furniture and appliances were brought forward into September to beat the 1 October GST hike, which meant that October should have been a below-trend month. In that light, the 1.6% fall in ex-auto sales, after a 1.7% rise in September, was actually fairly modest, and close to our forecasts. The real surprise was a 12% fall in car sales; however, a sharp rise in registrations in November suggests that this decline will be short-lived.

Finally, the Westpac-McDermott Miller consumer confidence survey fell in Q4,

NZ Interest Rates



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

to its lowest level since June 2009. The fall in confidence was spread fairly evenly across current and expected conditions, and across most regions. A number of events over the past few months are likely to have made people a little more edgy compared to September, including the early onset of drought in Northland and Waikato, the ongoing slump in the housing market (at least up to October), the increase in GST, and rising fuel prices. But it's clear that consumers have been becoming more cautious over the course of the last year.

We still hold the view that consumer caution won't be sustained through 2011. As the economy gathers momentum over the coming year, bringing more jobs and income growth, we expect growth in consumer spending to broadly match that of income, growing by around 2-3% per annum in real terms.

This week, on top of our employment confidence survey and net migration (Tues), we have the last of the major September quarter data. We expect the current account deficit (Wed) to widen slightly to 3.2% of GDP. The quarterly balance will be dominated by an inward transfer from overseas reinsurers, to cover claims from the Canterbury earthquake – the final amount won't be known for many months, but Statistics NZ has given an initial estimate of \$1.7bn.

We estimate that Q3 GDP (Thurs) rose by just 0.3% as the economy hit a mid-year soft patch. The autumn drought was a factor in the miserable 0.2% growth in Q2; we expect to see some elements of post-drought recovery in agricultural production and downstream manufacturing, despite the September storms. Retailing, wholesaling and transport should also show growth, in

part due to pre-GST spending.

But services have been the real laggard during the recovery, and that is likely to have continued in Q3. Government cutbacks are keeping a lid on growth in health and administration, real estate and finance have softened along with the housing market. And knock-on effects have curtailed growth in professional and personal services.

Fixed vs. floating: The RBNZ's more cautious stance suggests that floating rates will remain on hold for several more months. Fixed-term rates could rise in that time, but only if there is a substantial turnaround in sentiment on the global economy. As a result, there is no urgency to fix right now.

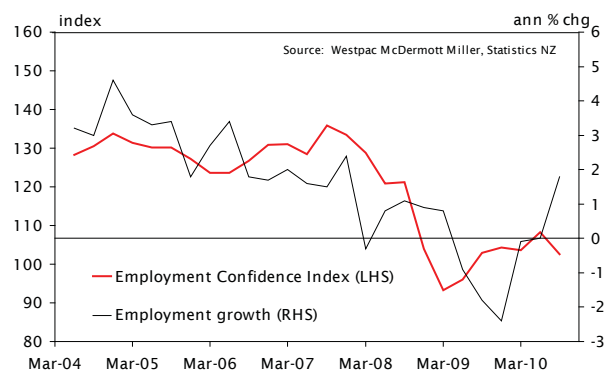
Key Data Previews

NZ Q4 employment confidence index

Dec 21, Last: 102.6

- Employment confidence fell in the September 2010 quarter as employees downgraded their assessment of both current and future employment conditions. However, at 102.6 the level of confidence remained consistent with continued recovery in the labour market.
- The tone of economic data has improved in recent months, and business surveys show that hiring intentions are on the rise again after a flat patch through the September quarter.
- We will be looking for further gains in employment confidence to support our view that consumer spending will continue to pick up pace in early 2011.

NZ employment and confidence

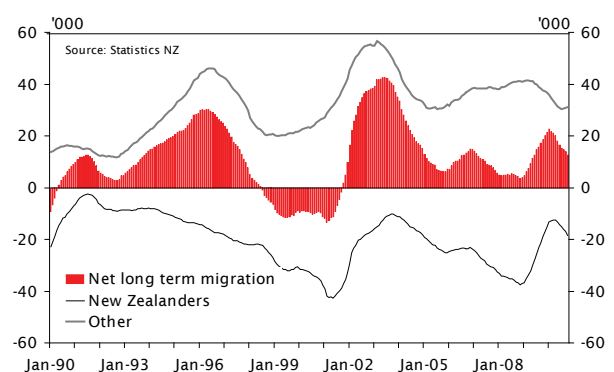


NZ Nov external migration s.a.

Dec 21, Last: 680, WBC f/c: 770

- Migration surged higher in July this year, as high numbers of overseas migrants began arriving in New Zealand, and as New Zealand departures remained below average. However, last month (October) there was a dip back to 680 on a monthly net seasonally adjusted basis. The dip was due to a sudden jump in the number of New Zealanders exiting the country.
- This month we will be watching closely to see whether NZer departures remain elevated. We are forecasting a middle ground.
- We are starting to see evidence of the housing market stabilising, at about the time we predicted when we observed the surge in net migration. Any change to the migration picture could generate a change in the housing market.

Net migration

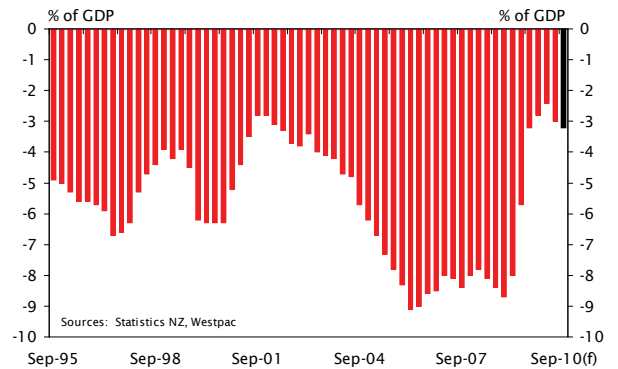


NZ Q3 current account deficit NZDm s.a.

Dec 22, Last: -1,814, WBC f/c: -330

- The trade surplus narrowed in the September quarter, as an improvement in the terms of trade was more than offset by a drought-induced fall in export volumes and a surge in imports of capital equipment. We expect the investment income balance to be similar to Q2, with profits of overseas-owned firms stabilising after a surprisingly rapid recovery in the last year.
- The Q3 balance will be dominated by a large inflow from overseas reinsurers to cover the costs of the Canterbury earthquake. Statistics NZ has given an initial estimate of \$1.7bn, which is likely to be revised up over time.
- That will see the annual deficit widen slightly to 3.2% of GDP on our forecasts, with the reinsurance inflow replacing another large positive one-off from last year – the major banks’ provisions for tax owed on structured finance transactions.

NZ annual current account deficit

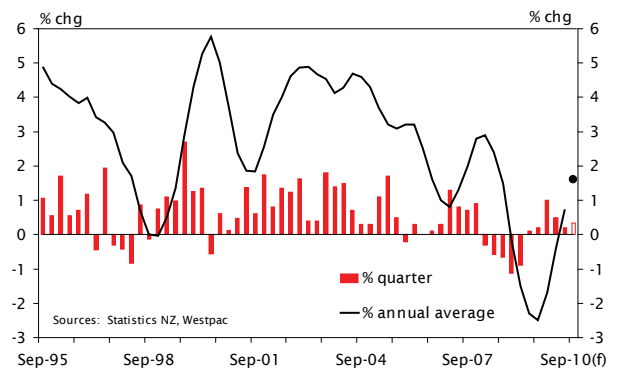


NZ Q3 GDP

Dec 23, Last: 0.2%, WBC f/c: 0.3%

- After a flurry in late-2009 and early-2010, GDP growth slowed to a snail’s pace of 0.2% in Q2 2010. Back then, the main problem was drought, which curtailed agricultural production and downstream processing.
- For Q3 we expect some rebound in agriculture-related sectors. However, offsetting that will be sharp declines in non-agricultural manufacturing and construction. Furthermore, service sectors are growing slowly as Government cuts back where it can, and as consumers remain cautious.
- We expect exports of goods will fall 4% in a delayed drought effect. Meanwhile, there was a massive amount of capital equipment imported in Q3, which we expect will show up as a 2.9% jump in imports of goods. Consumption expenditure is the critical sector to watch – we forecast 0.5% growth.

NZ GDP growth

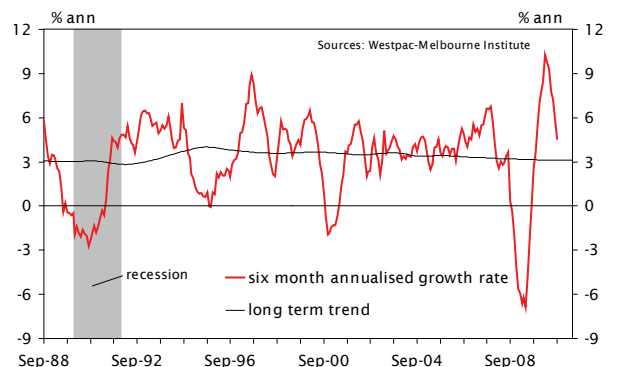


Aus Oct Westpac-MI Leading Index

Dec 22, Last: 4.6% annualised

- The Westpac-Melbourne Institute Leading Index continues to slow with the 6m annualised pace falling from 5.8% to 4.6% in Sep. That’s consistent with a solid expansion heading into early 2011 (above 3.1% long term trend), but the slowdown from March’s peak pace of 10.3% has been abrupt. The raw index has fallen the last two months and a continuation of this trend would see the 6m annualised growth pace drop below its long run trend in the near term.
- However, October Index monthly inputs were on balance more positive. The ASX rose a further 1.7% after a 4.1% bounce in September. Dwelling approvals rebounded 9.3% after a 5.3% fall previously and cumulative 26.4% drop from March to September. Money supply growth was 0.9%*mth* after averaging 0.6%*mth* over the prior six months. However, US IP saw its 1st fall since Jun-09 (-0.2%) and the subsequent Nov rebound won’t figure in the October Index.

Westpac-MI Leading Index

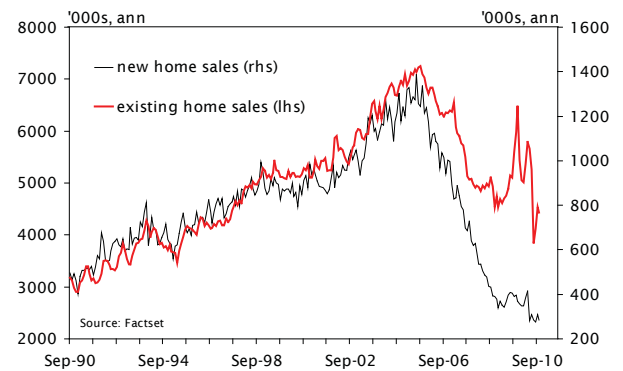


US Nov existing and new home sales

Dec 22, Existing home sales: Last: -2.2%, WBC f/c: 9.0%, Mkt f/c: 7.2%
 Dec 23, New home sales: Last: -8.1%, WBC f/c: 10.0%, Mkt f/c: 6.0%

- Housing activity (sales and construction) is bouncing along the bottom in the US, yet to clearly sustain a move higher after slumping on expiry of the homebuyer tax credit.
- Existing home sales fell 2.2% in Oct after gaining 17% from the post tax rebate sales slump. The level of sales in Oct was still the third lowest on record, after Jul and Aug. However pending home sales jumped 10% in Oct suggesting upside ahead for existing sale completions, even if only temporary.
- New home sales fell 8.1% in Oct, to a 283k annualised pace, almost back at Aug's 275k record low. Other housing data was soft in October but mostly positive in November, such as starts/permits, suggesting that sales of new homes may have picked up. As it's a volatile series, a double digit rise is possible.

US housing sales

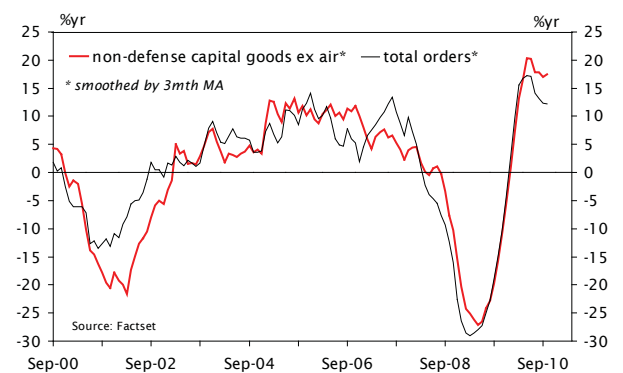


US Nov durable goods orders to fall further

Dec 23, Last: -3.4%, WBC f/c: -1.5%, Mkt f/c: -0.7%

- Durable goods orders fell 3.3% in Oct. A 4.5% fall in core capital goods orders (ex aircraft and defence) was the main source of weakness - defence also fell sharply, resuming its 2010 downtrend.
- In Nov, Boeing received just 16 aircraft orders, compared to 109 in Oct. These numbers don't match with the durables report, but the scale of that loss suggests aircraft will be a drag on the official data this month.
- The ISM factory new orders index dipped more than 2 pts in Nov - but its 8pt surge in Oct was a dud signal. Factory production rose just 0.3% in Nov, including a 6% fall in autos but a 1.2% rise in machinery.
- Together that suggests a subdued orders picture, although the headline could be pushed around by the aircraft orders story.

US durable goods orders

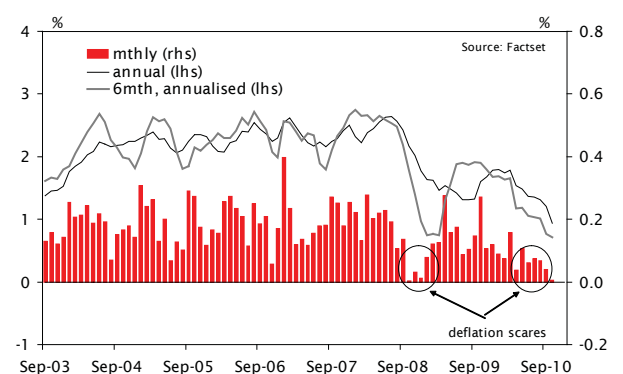


US Nov core PCE deflator: record low for annual pace

Dec 23, Last: 0.0%, WBC f/c: 0.0%, Mkt f/c: 0.1%

- Inflation has been drifting lower on most measures this year, driven by the wide output gap created by the deep recession of 2008 and 2009. The weak labour market, consumer resistance to price increases, discounting and otherwise intense competition in many retail sectors are also factors at play.
- The core PCE deflator rose by less than 0.1% in 8 of the first 10 months of 2010 and rounded down to flat on three occasions, including Sept and Oct.
- The core CPI fell slightly in Oct and bounced by just under 0.1% in Nov which suggests the core PCE should remain subdued; we expect another flat outcome though risks are skewed towards it rounding up to a still benign 0.1%. A flat result would complete the first consecutive triple flat outcomes since Q4 2008, and deliver a 0.8% yr annual pace - the lowest since the 1960s.

US core PCE deflator



Key Data and Events

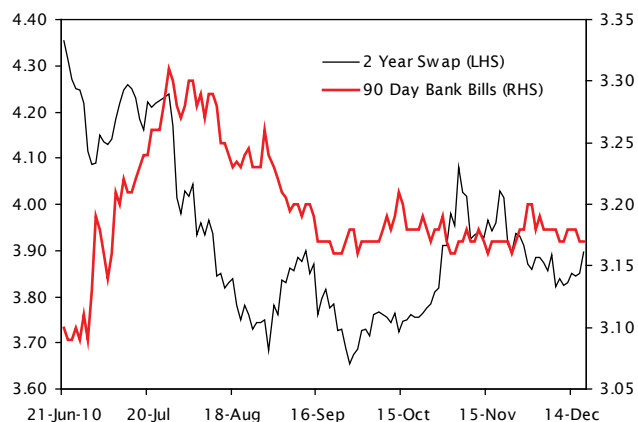
		Last	Market	Westpac	Comments
			Median	Forecast	
Mon 20 Dec					
US	Nov Chicago Fed Nat Activity Idx	-0.28	-	-	Index based on previously released data, not directly surveyed.
Eur	Oct Current Account €bn	-13.1	-	-	Solid export performance offset by income flows.
	Dec Consumer Confidence Advance	-9.4	-9.0	-	Still in uptrend despite sovereign debt crisis woes and 10% jobless rate.
Ger	Nov Producer Prices %yr	4.3%	4.5%	-	Higher commodity prices and recent euro depreciation pushing up PPI.
Can	Oct Wholesale Sales	0.4%	0.8%	-	Back to back gains in Aug-Sep after no rises since March.
Tue 21 Dec					
NZ	Q4 Employment Confidence Index	102.6	-	-	Business surveys portend improving labour market.
	Nov External Migration s.a.	680	-	770	Looking for confirmation or denial of last month's dip lower.
Aus	Dec RBA Board Meeting Minutes	-	-	-	On hold for now; detail to give guidance on comfort with outlook.
Jpn	Bank of Japan Decision	0.10%	0.10%	0.10%	Stable Fed policy takes away the defensive imperative to ease further.
	Oct All-Industry Activity Index	-0.8%	-0.2%	-	We expect GDP to contract in Q4, weakness should be evident here.
Ger	Jan GfK Consumer Confidence	5.5	5.7	-	Surveyed in Early Dec but labelled Jan.
UK	Dec GfK Consumer Confidence	-21	-22	-	Recent cold snap, tube strikes, student protests factors as well as economy
	Nov PSNB £bn	9.8	16.8	-	Public sector net borrowing.
Can	Nov Consumer Prices %yr	2.4%	2.2%	-	Core rate lower at 1.8% yr in Oct.
	Oct Retail Sales	0.6%	0.5%	-	Some support from autos likely in Oct.
Wed 22 Dec					
NZ	Q3 Current Acct Deficit NZDm s.a.	-1,814	-	-330	Smaller trade surplus, large inflow from reinsurance payments.
Aus	Oct Leading Index 6m ann'lsd	4.6%	-	-	Above trend but slowing abruptly, although mthly inputs more +ve in Oct.
US	Q3 GDP (F) % ann'lsd	2.5%	2.8%	2.7%	Revisions to partial data on inventories, trade, retail point upwards.
	Nov Existing Home Sales	-2.2%	7.2%	9.0%	Strength in pending home sales points to bounce.
	Oct House Prices	-0.7%	-0.2%	-	FHFA index.
Jpn	Nov Trade Balance ¥bn s.a	579	626	-	Exports have decelerated quite quickly, net X added just 0.1ppt in Q3.
UK	Dec BoE Minutes	1:7:1	-	1:7:1	Three way split still likely, though majority favour on hold policy.
	Q3 Business Investment (F)	-0.2%a	-0.2%	-	Sometimes a clue to GDP revisions but released same day this month.
	Q3 GDP (F)	0.8% a	0.8%	0.8%	Focus now on Q4 - some slowdown but pull-forward of spending from Q1.
	Q3 Current Account £bn	-7.4	-8.5	-	Volatile series but with trade deficits persistently offsetting income flows.
Thu 23 Dec					
NZ	Q3 GDP %qtr	0.2%	0.1%	0.3%	Falling non-ag manufacturing and construction, slow services.
US	Nov Durable Goods Orders	-3.4%	-0.7%	-1.5%	Durable goods orders to fall further.
	Nov Personal Income	0.5%	0.2%	0.2%	Hours worked and hourly earnings point to subdued income growth in
	Nov Personal Spending	0.4%	0.5%	0.8%	Nov but retail sales surged, suggesting solid personal spending growth.
	Nov Core PCE Deflator	0.0%	0.1%	0.0%	Core CPI 0.1% in Nov.
	Initial Jobless Claims w/e 18/12	420k	420k	425k	Recent claims trend shows renewed downside.
	Dec UoM Consumer Confidence (F)	74.2a	74.5	75.0	Recent equities upswing and extended tax cuts deal to boost final result
	Nov New Home Sales	-8.1%	6.0%	10.0%	Oct saw weakness across many hsing indicators; Nov is seeing the bounce.
UK	Nov Mortgage Lending '000	30.7	30.3	-	BBA data, not industry wide. Down from 45.6 peak in Dec '09.

New Zealand Economic and Financial Forecasts

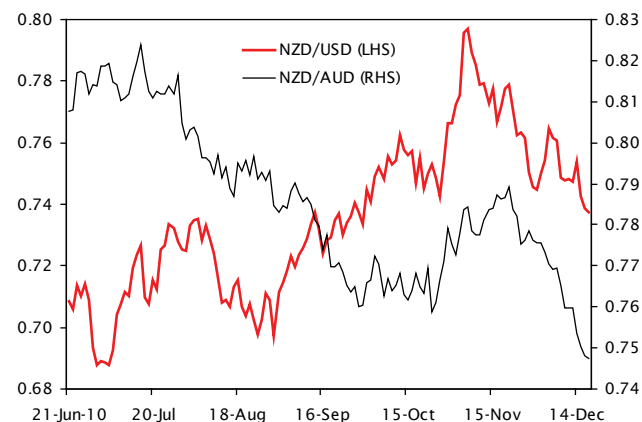
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	2.2	4.1	3.0	-1.7	2.0	3.9	3.0
Employment	-0.1	1.7	2.0	1.4	-2.4	2.2	2.2	1.2
Unemployment Rate % s.a.	6.0	6.0	5.1	5.0	7.1	6.3	5.2	5.0
CPI	2.0	4.5	1.9	2.5	2.0	4.2	2.1	2.3
Current Account Balance % of GDP	-2.4	-4.1	-5.3	-5.5	-2.8	-2.8	-5.2	-5.4

Financial Forecasts	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Cash	3.00	3.25	3.50	3.75	4.00	4.50	4.75
90 Day bill	3.20	3.50	3.80	4.00	4.30	4.80	5.10
2 Year Swap	4.30	4.60	4.90	5.10	5.30	5.50	5.60
5 Year Swap	5.00	5.20	5.40	5.60	5.80	5.90	6.00
10 Year Bond	5.60	5.70	5.70	5.80	5.90	6.00	6.00
NZD/USD	0.77	0.80	0.79	0.78	0.77	0.76	0.75
NZD/AUD	0.77	0.78	0.80	0.81	0.81	0.82	0.82
NZD/JPY	63.9	68.0	71.1	74.1	74.7	75.2	75.8
NZD/EUR	0.57	0.58	0.59	0.60	0.60	0.59	0.59
NZD/GBP	0.49	0.50	0.50	0.49	0.48	0.46	0.45
TWI	68.9	71.0	72.0	72.6	72.2	71.8	71.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 20 December 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.13%	3.11%	3.13%
60 Days	3.16%	3.12%	3.13%
90 Days	3.19%	3.18%	3.17%
2 Year Swap	3.90%	3.86%	4.02%
5 Year Swap	4.80%	4.73%	4.84%

NZ foreign currency midrates as at Monday 20 December 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7371	0.7616	0.7788
NZD/EUR	0.5597	0.5720	0.5695
NZD/GBP	0.4745	0.4848	0.4873
NZD/JPY	61.890	62.960	65.030
NZD/AUD	0.7461	0.7691	0.7891
TWI	66.750	68.550	69.640

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2006	2007	2008	2009	2010e	2011f	2012f
Australia							
Real GDP % yr	2.9	4.0	2.2	1.3	2.7	3.5	3.5
CPI inflation % annual	3.3	3.0	3.7	2.1	2.7	3.2	2.7
Unemployment %	4.8	4.4	4.3	5.6	5.3	4.9	4.9
Current Account % GDP	-5.3	-6.3	-4.5	-4.2	-2.9	-3.0	-3.2
United States							
Real GDP %yr	2.7	2.1	0.0	-2.6	2.7	1.1	2.4
Consumer Prices %yr	3.2	2.9	3.8	-0.3	1.6	2.3	3.3
Unemployment Rate %	4.6	5.8	5.8	9.3	9.7	10.0	10.2
Current Account %GDP	-6.0	-5.3	-4.7	-2.7	-3.3	-3.1	-2.4
Japan							
Real GDP %yr	2.8	2.2	-1.5	-6.6	4.5	1.8	2.3
Consumer Prices %yr	0.2	0.1	1.4	-1.3	-0.8	-0.4	-0.1
Unemployment Rate %	4.1	3.9	4.0	5.1	5.1	5.0	4.9
Current Account %GDP	3.9	4.8	3.3	2.8	3.3	3.4	3.6
Euroland							
Real GDP %yr	3.2	2.9	0.3	-4.0	1.7	1.3	1.5
Consumer Prices %yr	2.0	3.1	1.6	0.9	1.5	1.6	1.5
Unemployment Rate %	7.9	7.3	7.8	10.0	10.5	10.5	10.5
Current Account %GDP	-0.1	0.1	-1.1	-1.0	-0.5	0.0	0.0
United Kingdom							
Real GDP %yr	2.8	2.7	-0.1	-5.0	1.8	1.3	1.5
Consumer Prices %yr	3.0	2.1	3.5	2.9	3.0	2.8	1.5
Unemployment Rate %	3.0	2.5	3.1	5.0	4.5	5.0	5.5
Current Account %GDP	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5	-1.0

Forecasts finalised 10 December 2010

Interest Rate Forecasts	Latest (Dec 20)	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Australia						
Cash	4.75	4.75	5.00	5.00	5.00	5.25
90 Day Bill	5.01	5.10	5.25	5.25	5.25	5.40
10 Year Bond	5.57	5.70	5.60	5.60	5.60	6.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.33	3.30	3.00	2.80	3.00	3.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.9879	1.00	1.02	0.99	0.96	0.95
USD/JPY	83.97	83	83	90	95	97
EUR/USD	1.3169	1.35	1.38	1.33	1.30	1.29
AUD/NZD	1.3403	1.30	1.28	1.25	1.23	1.23

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