

Weekly Commentary

21 December 2009

Turning the page

It was the week before Christmas, and all through the house, not a creature was stirring... except for the economics team, who had to deal with the last major data releases for the year.

The balance of payments (Tuesday) will see a continuation of the dramatic turnaround in the current account deficit. From a peak of 8.9% of GDP at the end of last year (though this will be revised lower), we estimate that the annual deficit narrowed to 3.5% of GDP in September. This is partly due to base effects, as last year's peak in oil prices drops out of the equation, and partly due to a significant narrowing in the deficit in recent quarters.

One of the notable features of the deficit for the September quarter will be a sharp drop in investment income outflows, as the major Australian-owned banks have made provisions for tax assessments on structured finance transactions. BNZ made a \$661m provision in the June quarter, after the High Court ruled in favour of the IRD in July, and in the September quarter the other banks made either partial or full provisions for their assessed liability (tax and accrued interest), which totalled \$1,366m.

This is the final *Weekly Commentary* for 2009. We wish you all a very Merry Christmas and a prosperous New Year. Publication of this document will resume on 11 January 2010.



These dollar amounts are large, but their significance to the current account can be overstated. The BNZ tax provision was widely cited as the reason behind the 'surprise' narrowing in the deficit in June. But it was equivalent to just 0.36% of GDP; most forecasts of the deficit overshoot by 1 to 2 percentage points. (We factored in the tax provision and were still too high by 0.7%). Similarly, the tax provisions in September add up to 0.73% of GDP – only a third of the narrowing in the deficit that we expect for this quarter.

Cyclical factors have been far more important in the narrowing of the deficit. The trade balance for goods has turned positive in the last year, as import spending has plunged while export receipts have held up relatively well. Aside from lower fuel prices, the fall in import spending was led by a sharp drop in volumes for vehicles, machinery, and intermediate goods such as fertiliser and ores. With the economy stabilising, there are signs import demand is finding its feet again.

Aside from the bank tax provisions, investment income outflows have continued to fall as a result of lower interest rates on overseas debt and weaker profits for overseas-owned firms. These are likely to be a feature for a few more quarters, given that there was a fairly long lag between the onset of the recession and the cuts to the OCR, and the decline in investment income.

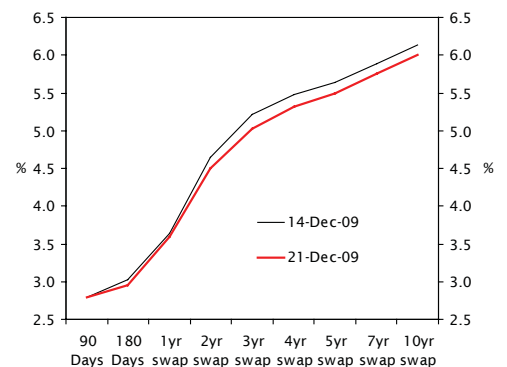
It's worth considering NZ's recent

trade performance, in light of claims by some policymakers and analysts that the recovery must be led by exports rather than consumption. Export volumes are up 9% on a year ago – a stunning result in the midst of a global recession. What's more, Kiwis have been able to do much of their belt-tightening via imports, with volumes down 14% on a year earlier. Net exports were a huge positive for the NZ economy during the recession; it's perfectly reasonable to expect consumption to pick up the baton during the recovery.

Turning to Wednesday's GDP figures, we estimate the economy was largely flat in the September quarter, expanding a mere 0.2%. This is in line with high-level gauges from business and consumer confidence surveys and the collection of various industry indicators, which suggest that a turning point in overall economic activity occurred around the middle of the year.

Even so, the economy was still sporting the

NZ Interest Rates



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

deep scars of the recession in Q3. Business conditions probably felt worse than at anytime during the recession, as the level of activity hit its lowest point relative to its trend. For the economy as a whole, this is the toughest part of the cycle – in economist-speak, the output gap was at its most negative.

One of the most notable points of weakness is an anticipated 4.4% contraction in construction, as the frightful economic conditions of 12 months ago saw investment plans delayed or cancelled and a slump in building consents at the time. The resulting drop in both residential and non-residential building activity will show up in Q3.

A strong contribution to quarterly growth from the manufacturing sector should be viewed as a bounce off an extremely low base, rather than a pointer to buoyant conditions in the sector. The standout growth will come from metals, as production at the Tiwai Point

aluminium smelter was restored after a transformer failed in November 2008. Wood and furniture manufacturing will also post strong gains from very low levels previously.

The consumer will again be notably absent as a material contributor to growth, extending the trend of the past two years. We expect overall consumer spending was flat during the quarter, despite strong impulses from net migration and the lagged effect of interest rate cuts. Rising unemployment and debt repayment were no doubt key offsets, but we also harbour a view that Swine Flu had a suppressing effect on spending. Real spending is likely to be stronger in Q4 if the rise in electronic transactions, soft price indicators and a ramping-up of car registrations are anything to go by.

The pace of economic recovery from the turning point in the Q2-Q3 period will be a critical factor behind the timing and speed of monetary tightening in 2010. Strong

lead indicators to date support our view that the first interest rate hikes will come in the first part of the year.

Fixed vs. floating: The growing prospect of OCR hikes in the first half of next year will soon 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 this 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.

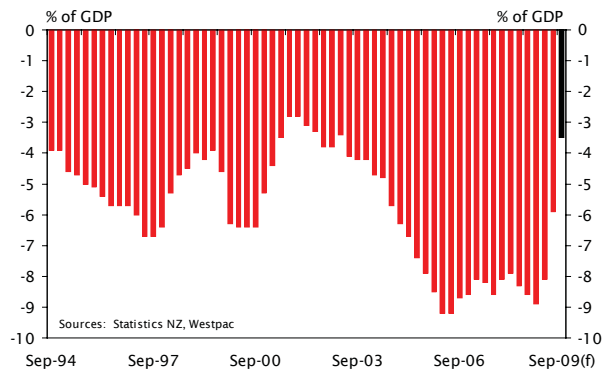
Key Data Previews

NZ Q3 current account deficit NZDm s.a.

Dec 22, Last: -612, WBC f/c: -270

- We estimate that the annual deficit narrowed to 3.5% of GDP in the year to September. This would be the smallest deficit since March 2003.
- The narrowing in the deficit has been driven by cyclical factors: lower import spending (while export receipts have held up relatively well), lower interest rates on overseas borrowing, and weaker profitability for overseas-owned firms.
- Investment income debits will be unusually low for this quarter, due to provisions by the major Australian-owned banks for tax owing on structured finance transactions. These provisions are worth 0.7% of nominal GDP.

NZ annual current account deficit

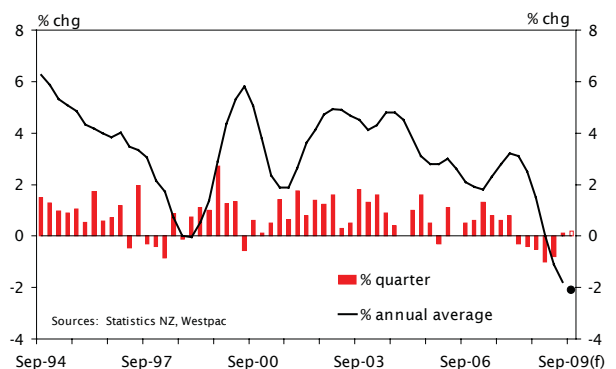


NZ Q3 GDP

Dec 23, Last: 0.1%, WBC f/c: 0.2%, Mkt f/c: 0.4%

- The economy was still sporting the deep scars of recession in Q3, despite our expectation of a small 0.2% gain in GDP over the quarter. The level of activity is still low relative to its trend.
- Historical revisions to the level of GDP will be significant. We suspect the level of GDP will be lifted by around \$4 billion (2.2%) and historical growth will likely be lifted a little.
- A key aspect for RBNZ policy will come from the balance of any surprise in Q3 growth and the output gap implications from revisions. We are wary that the general upward revision to the level of GDP and implicitly less negative output gap could well outweigh any negative surprise on the latest quarterly movement (or amplify any upside surprise).

NZ GDP growth

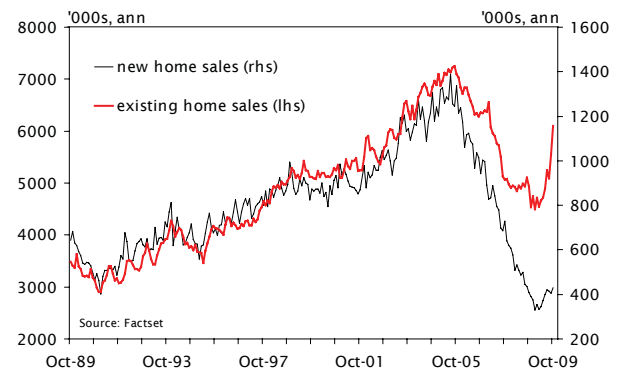


US Nov existing/new home sales to post modest gains

Dec 22, Existing home sales: Last: 10.1%, WBC f/c: 2.0%, Mkt f/c: 2.5%
 Dec 23, New home sales: Last: 6.2%, WBC f/c: 1.0%, Mkt f/c: 1.9%

- For nearly six months until late Q3, US housing was showing signs of strengthening across the board. However since early Q4, some sector indicators have lost momentum, including homebuilder sentiment and starts, perhaps due to wet Oct weather and uncertainty about the tax credit for first home-buyers (which has since been extended).
- Existing home sales reflect transactions agreed months prior, so the Nov report may not yet reflect this housing data "wobble". Indeed with pending home sales up 42% from their 2009 low, but existing sales up only 36% so far, there is upside risk to our 2.0% forecast.
- New home sales jumped 6.2% in Oct but declines in Aug-Sep mean the sales trend has slowed, and reflecting that, we expect just a mild 1.0% gain in Nov.

US housing sales

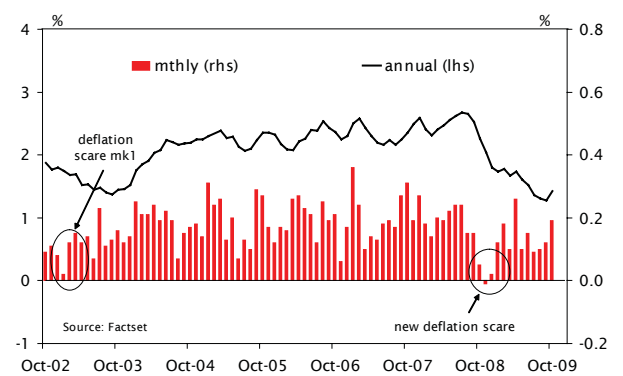


US Nov core PCE deflator

Dec 23, Last: 0.2%, WBC f/c: 0.0%, Mkt f/c: 0.1%

- The core PCE deflator slowed from a 0.3% gain in April to a string of 0.1% rises since then, pulling the annual rate down to just below 1.3%, a pace even lower than in late 2003 during that year's relatively short-lived bout of deflation concern. However a stronger 0.2% core rate in Oct (and unfavourable base effects) lifted the annual core PCE back to 1.4% yr.
- The core CPI was a little stronger in Sep-Oct, rising 0.2% twice in succession; its annual pace rose from 1.4% in Aug to 1.7% in Oct. But in Nov soft shelter costs pulled the CPI back to flat, holding the annual rate at 1.7% yr.
- Shelter is not weighted as highly in the core PCE deflator but given its above trend 0.2% rise in Oct, we expect a flat Nov outcome, holding the annual pace at 1.4% yr.

US core PCE deflator

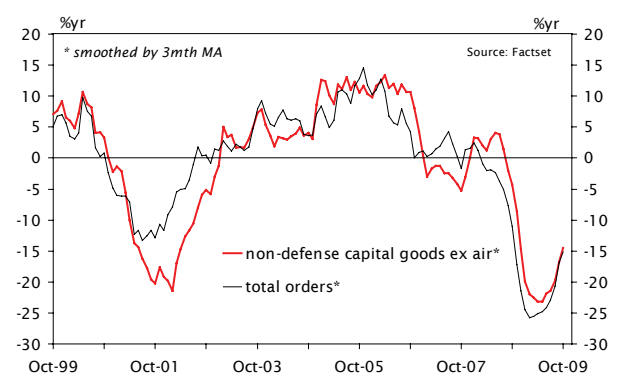


US Nov durable goods orders to rise modestly

Dec 24, Last: -0.6%, WBC f/c: 1.0%, Mkt f/c: 0.5%

- Durable goods orders have see-sawed of late, with the dips in June and August mostly due to volatility in the lumpy civilian aircraft component. However Oct's 0.6% fall was despite a 51% jump in aircraft orders, and reflected a 2.9% fall in core capital goods orders and an 18% decline in defence.
- Nov orders are forecast to post an unimpressive gain, continuing the see-saw pattern. Nov ISM factory orders rose back above 60; strength on this measure has been misleading recently, but it does suggest at least that core capital goods orders should bounce (their trend is barely flat), and we expect defence to rise again.
- Other clues are mixed: factory production rose 1.1% in Nov, with autos and business equipment output both higher. But Boeing had fewer orders in Nov.

US durable goods orders



Key Data and Events

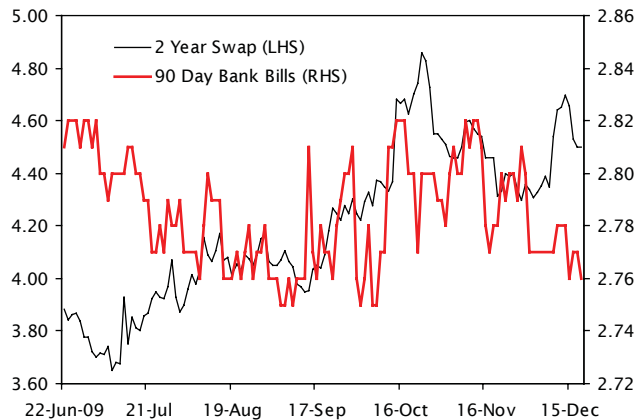
		Last	Market Median	Westpac Forecast	Comments
Mon 21 Dec					
NZ	Nov Credit Card Transactions	-1.0%	-	-	Likely to be broadly flat for the month.
Aus	Nov Motor Vehicle Sales	3.7%	-	3.5%	Industry figures showed another strong month, sales up 20%yr.
US	Nov Chicago Fed National Activity Idx	-1.08	-	-	Derived from 80+ previously published statistics.
Jpn	Nov Trade Balance ¥bn sa	419	268	-	Exports in repair phase, but strong yen doesn't help matters.
	Oct All-Industry Index	-0.6%	1.0%	-	Watch for divergence between public and private construction.
Can	Oct Retail Sales	1.0%	0.8%	1.0%	Auto sales known up 3.5%.
Tue 22 Dec					
NZ	Q3 Current Account Balance NZDm s.a.	-612	-	-270	Deficit narrowing on trade surplus and falling income outflows.
US	Q3 GDP (F) % annualised	2.8%	2.8%	2.8%	Revisions to monthly data could see slight downward revision to Q3.
	Dec Richmond Fed Factory Index	1	4	5	Regional surveys have eased off their 2009 highs in recent months.
	Oct House Prices	0.0%	0.2%	-	Lesser watched FHFA index.
	Nov Existing Home Sales	10.1%	2.5%	2.0%	Pending home sales data point to further gain.
Ger	Jan GfK Consumer Confidence	3.7	3.5	-	Labelled Jan but surveyed in early Dec.
UK	Q3 GDP (F)	-0.3%a	-0.1%	-0.3%	More interest now in Q4 GDP, probably up 0.2%.
	Q3 Current Account £bn	-11.4	-8.2	-	Q2 saw widest deficit since Q3 07.
Wed 23 Dec					
NZ	Q3 GDP %qtr	0.1%	0.4%	0.2%	Mild growth expected, watch for historical revisions.
US	Nov Personal Income	0.2%	0.5%	0.4%	Hours worked higher though hourly earnings gain minimal.
	Nov Personal Spending	0.7%	0.7%	0.9%	Strong retail sales point to healthy personal spending gain.
	Nov Core PCE Deflator	0.2%	0.1%	0.0%	Soft core CPI suggests flat core PCE likely.
	Dec UoM Consumer Sentiment (F)	73.4 a	73.7	73.5	Prelim result was strong 6pt rise.
	Nov New Home Sales	6.2%	1.9%	1.0%	Recent flatter starts trend suggests sales might be slowing.
UK	Dec BoE Policy Meeting Minutes	-	-	-	On hold policy and unadjusted QE likely unanimous.
	Nov BBA New Mortgages	42k	-	-	More house lending is taking place, but at reduced loan:valuation ratios.
Can	Oct GDP	0.4%	0.3%	-	Sep saw strongest monthly gain since Jul 08.
Thu 24 Dec					
US	Nov Durable Goods Orders	-0.6%	0.5%	1.0%	ISM orders higher, IP solid in Nov, but Boeing orders softer.
	Initial Jobless Claims w/e 19/12	480k	470k	470k	Claims downtrend consistent with diminished pace of job shedding.
Jpn	Bank of Japan Minutes	-	-	-	DPJ government are impinging on independence in a good way.
	Q4 BSI Large Firms Conditions %qtr	0.3%	-	-	Very deep survey sample; quality information on corporate sector.
Fri 25 Dec					
Int'l	Christmas Day	-	-	-	Public holiday in many countries (Aus, NZ, Eur, Ger, UK, US, Can).
Jpn	Nov Nationwide CPI %yr	-2.5%	-2.0%	-	Huge resource slack & strong yen against firming raw materials prices.
	Dec Tokyo CPI %yr	-2.2%	-2.0%	-	One month ahead of the nationwide measure, higher shelter weight.
	Nov Unemployment Rate	5.1%	5.2%	-	Falling as participation falls faster than employment levels.
	Nov Household Spending %yr	1.6%	0.4%	-	Real measure: nominal outlays still down on a year ago.
	Nov Corp. Services Prices %yr	-2.2%	-2.0%	-	Deflation has moved from durable goods to non-traded markets.
	Nov Housing Starts %yr	-27.1%	-23.0%	-	Spectacular implosion over the last year.
	Nov Construction Orders %yr	-40.1%	-	-	Public works can only do so much.

New Zealand Economic and Financial Forecasts

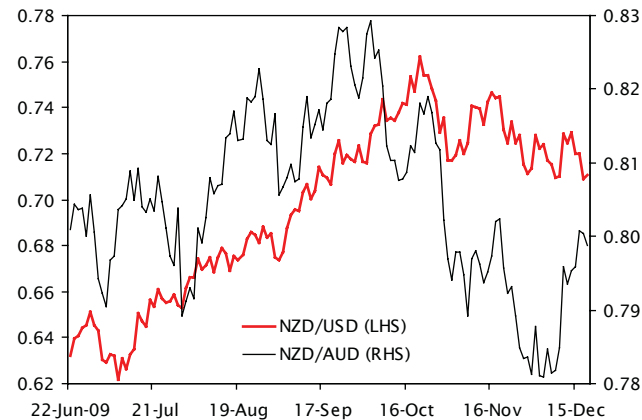
Economic Growth Forecasts	March years				Calendar years			
	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
% change								
GDP (Production) ann avg	3.1	-1.1	-0.1	4.1	0.0	-1.4	3.7	4.0
Employment	-0.3	0.7	-0.8	1.6	0.9	-2.1	1.0	1.8
Unemployment Rate % s.a.	3.8	5.0	6.7	5.3	4.7	6.7	6.3	5.5
CPI	3.4	3.0	2.1	3.1	3.4	2.2	2.2	2.9
Current Account Balance % of GDP	-7.9	-8.1	-2.5	-4.7	-8.9	-2.5	-4.6	-5.4

Financial Forecasts	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Cash	2.75	3.25	3.75	4.25	4.75	5.25	5.75
90 Day bill	3.20	3.70	4.20	4.70	5.20	5.70	6.10
2 Year Swap	5.10	5.40	5.70	5.90	6.10	6.30	6.20
5 Year Swap	6.00	6.10	6.20	6.30	6.40	6.50	6.50
10 Year Bond	6.10	6.20	6.30	6.30	6.40	6.50	6.50
NZD/USD	0.77	0.73	0.76	0.78	0.77	0.75	0.72
NZD/AUD	0.80	0.81	0.82	0.82	0.83	0.83	0.84
NZD/JPY	67.8	67.9	73.0	78.0	81.6	81.8	80.6
NZD/EUR	0.51	0.50	0.51	0.52	0.52	0.51	0.49
NZD/GBP	0.43	0.42	0.42	0.43	0.43	0.40	0.38
TWI	67.4	65.9	67.9	69.6	70.2	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 21 December 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.76%	2.77%	2.77%
60 Days	2.76%	2.77%	2.77%
90 Days	2.77%	2.77%	2.80%
2 Year Swap	4.50%	4.39%	4.34%
5 Year Swap	5.49%	5.49%	5.48%

NZ foreign currency midrates as at Monday 21 December 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7114	0.7155	0.7247
NZD/EUR	0.4975	0.4816	0.4875
NZD/GBP	0.4414	0.4347	0.4391
NZD/JPY	64.190	63.970	64.380
NZD/AUD	0.7982	0.7814	0.7923
TWI	64.900	64.050	64.800

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	2.4	1.0	3.0	3.2
CPI inflation % annual	2.8	3.3	3.0	3.7	2.0	2.2	2.7
Unemployment %	5.1	4.8	4.4	4.3	5.6	6.0	5.9
Current Account % GDP	-5.8	-5.3	-6.3	-4.6	-4.1	-5.1	-5.4
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.5	1.5	3.1
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	-2.6	-1.8
Japan							
Real GDP %yr	1.9	2.8	2.2	-0.9	-5.8	1.6	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	5.3	5.2
Current Account %GDP	3.6	3.9	4.8	3.2	2.6	3.1	3.9
Euroland							
Real GDP %yr	1.7	2.9	2.7	0.6	-4.0	0.6	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.3	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	-0.5	0.0	-0.2	0.0	0.4	0.4
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	1.5	2.8	1.5
Unemployment Rate %	2.8	3.0	2.5	3.1	5.5	7.0	7.3
Current Account %GDP	-2.6	-3.0	-2.8	-2.3	-3.0	-3.0	-2.0

Forecasts finalised 9 December 2009

Interest Rate Forecasts	Latest (Dec 21)	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Australia						
Cash	3.75	4.00	4.50	4.50	4.50	4.75
90 Day Bill	4.14	4.30	4.70	4.60	4.75	5.00
10 Year Bond	5.35	5.70	6.20	6.50	6.50	6.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.54	3.50	3.20	3.75	4.25	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.25	2.00
Exchange Rate Forecasts						
AUD/USD	0.8913	0.96	0.90	0.93	0.95	0.93
USD/JPY	90.23	88	93	96	100	106
EUR/USD	1.4300	1.51	1.47	1.50	1.51	1.47
AUD/NZD	1.2529	1.25	1.23	1.22	1.22	1.21

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