Weekly Commentary

23 November 2009

Workmen and their tools

New Zealand's monetary policy framework has been back in the spotlight recently – though you could say it's never been out of it for very long.

Concerns about monetary policy have generally revolved around two issues: the effectiveness of using short-term interest rates to manage inflation, and the impact on the volatility of the exchange rate. The first of these has attracted less attention recently, with annual inflation comfortably back within the target band. It's the latter that has been causing angst, as the NZ dollar has surged higher even though the economy is just barely emerging from recession.

We've written on these issues many times in the last few years, including in our submission to the Inquiry into the Future Monetary Policy Framework in 2007, which we'll quote from liberally here:

"The OCR has proven an extremely effective tool for implementing inflation targeting. Indeed, New Zealand's monetary policy arrangements are considered international best practice for monetary policy and have subsequently been adopted by over 30 countries worldwide. We feel that any deviation from this internationally accepted norm should be backed by solid research and evidence. We note that no rigorous evidence to substantiate some popular notions about monetary policy has been forthcoming."

In the current debate, one particularly bizarre notion seems to be gaining traction: that higher interest rates attract more capital from overseas, which then has to be lent out in the domestic economy, further inflating the housing market. This fails the basics of supply and demand: higher interest rates mean overseas investors will be more willing to lend (supply), but they can only lend as much as New Zealanders are willing to borrow (demand). This theory seems to suggest, at the very least, an upward-sloping demand curve, i.e. that people will demand more and more money as the cost of it rises.

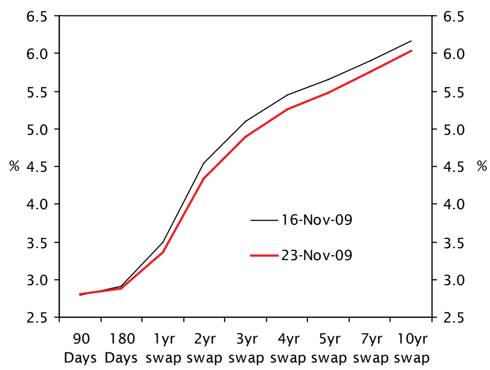
One way to judge this theory is whether its implications for policy pass the 'smell test'. If it were true, then the RBNZ has been doing precisely the wrong thing for the last year; they should have been raising interest rates in order to attract capital inflows that would reinvigorate the economy. And now that the economy is recovering, they should lower the OCR further in order to cut off funding to the resurgent housing market.

Turning to the influence of monetary policy on the exchange rate, we said in 2007 that "interest rates are not the only factor influencing the exchange rate, and may not even rank among the most important factors. The exchange rate is a relative price so what is happening in other countries is of paramount importance. Currency values are influenced amongst other things by: relative growth; relative inflation; commodity prices; and relative interest rates. We believe the current exchange rate is justified by the extraordinarily high level of commodity prices. We are concerned that the popular notion that the Reserve Bank is responsible for the high NZD is not backed by any real evidence."

There has been one significant policy development since our 2007 submission. The RBNZ has recently introduced prudential liquidity requirements for banks, which among other things will limit their ability to raise short-term funds from offshore. This restriction is most likely to bite during a cyclical upturn, which is why the RBNZ has mentioned it as a complement to the OCR in recent statements.

Some have interpreted the liquidity policy as an admission by the RBNZ that its conventional monetary policy tool is not working as well as it should. In our view

NZ Interest Rates



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

This publication has been prepared by the Wellington, Sydney and London Economic Departments

Published by Westpac, PO Box 691, Wellington, ph: (04) 381 1413. For further information contact Brendan O'Donovan, Michael Gordon, Doug Steel, Donna Purdue, Dominick Stephens or Sharon Zöllner. For email address changes contact natalie_denne@westpac.co.nz

this is a step too far: for one thing, the RBNZ drew up the policy while wearing its financial stability hat, not its monetary policy one. Nor is it intended as a 'tool' in the sense that it could be adjusted through the economic cycle. Loosening the rules in a downturn, letting banks become more exposed to the fickleness of international markets, would defeat the whole purpose from a stability point of view.

Most importantly, we don't think the RBNZ is in any doubt about the effectiveness of interest rates in managing inflation; their concern is how to achieve this without pushing the exchange rate to excessive levels at the same time. That probably can't be achieved by simply running interest rate policy in a different way; the RBNZ's research has shown that this would be prohibitively costly in terms of increased volatility in inflation and the real economy. Hence the notional appeal of supplementary policy tools.

But if the 'problem' is that higher interest rates are necessary for the domestic economy but will drive up the exchange rate by attracting capital inflows, then the 'solution' would be a tool that breaks the link between the rates paid by domestic borrowers and the rates received by offshore lenders. The prudential liquidity policy does nothing of the sort: banks will pay higher interest rates for longer-term funding, overseas investors will receive those higher rates, and the yield appeal of the NZ dollar remains undimmed.

So the search for a better mix of monetary conditions continues. Our view remains that monetary policy would be best complemented by some tough but necessary work on improving New Zealand's productivity and flexibility. There is much that can be done in terms of fiscal policy, as a Treasury memo released this week points out. Bold cuts to government spending, by reducing overall domestic demand, could allow a lower OCR and a lower exchange rate. This would only hold for a few years at best; in their words, "we can't permanently undervalue the exchange rate". But those few years could provide a suitable environment for more serious structural reforms.

Fixed vs. floating: Six-month fixed mortgage rates have now risen – until now the only fixed term left unscathed. Now that no point on the mortgage curve is 'safe', we could see borrowers seek to fix at whatever favourable rates are still on offer. 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.

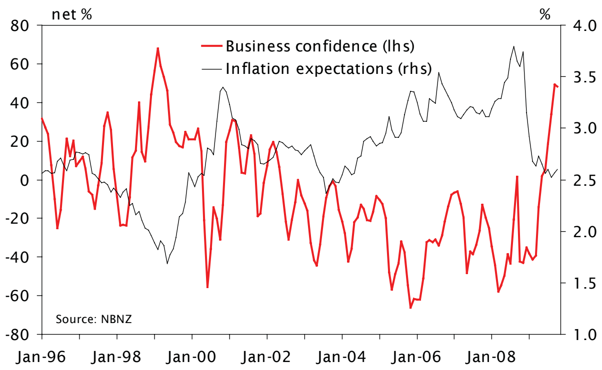
Key Data Previews

NZ Nov NBNZ business confidence

Nov 26, Last: 48.2

- Overall business confidence was steady in October, though with greater variation across sectors than in previous months. Expectations in the construction sector were particularly strong – questionably so for commercial – and it will be interesting to see whether this confidence can be maintained.
- Confidence in the agricultural sector is likely to have been boosted further in November by the increase in Fonterra's forecast payout for the 2009/10 season from $5.10/kg to $6.05/kg of milksolids.
- However, monthly indicators suggest that confidence in other sectors could be close to a top – perhaps a sign that the stronger currency and higher long-term interest rates are biting for some. The manufacturing and services PMIs were softer in October, and retail spending growth has remained timid.

NBNZ Business Confidence

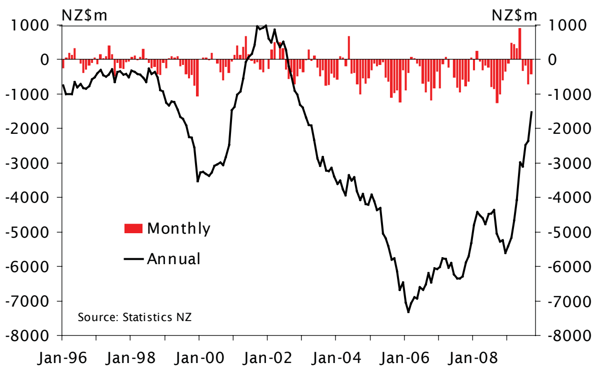


NZ Oct merchandise trade NZDm

Nov 27, Last: –424, WBC f/c: –460

- We expect both October exports and imports to be up around 3% on September levels, with a monthly trade balance of around –$460m versus –$424m in September. This would be less than half the trade deficit seen last October.
- Last month imports were weaker than we expected, given the degree of restocking we believe is required. There is a risk it may come through with a rush in October, though the strong NZD will be providing a price offset.
- Looking forward, the seasonal improvement in the trade balance should kick in from November. But over the next year we expect import growth to outpace the export recovery causing the trend trade balance to deteriorate, though improving global dairy prices will offset as product from the new dairy season heads off overseas.

NZ merchandise trade balance

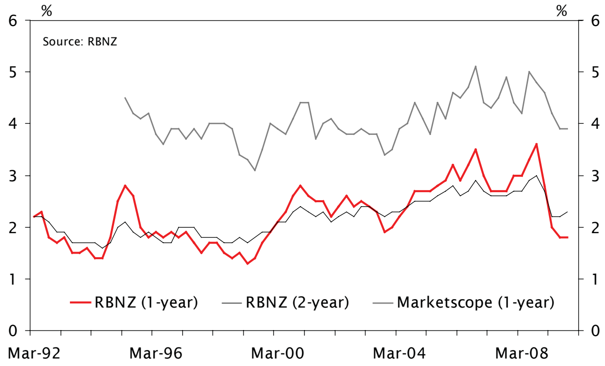


NZ Q4 RBNZ survey of inflation expectations

Nov 27, 2yr ahead – Last: 2.3%, WBC f/c: 2.4%

- Inflation expectations have been largely off the radar, but now warrant closer attention.
- The RBNZ is likely to be disappointed that the long recession has not done more to break the back of inflation expectations. After falling sharply from 3.0% in Q3 last year to 2.2% in Q1, the RBNZ's preferred measure of inflation expectations (analysts 2 years ahead) has started creeping up again.
- We expect 2.4% this quarter, though the lower than expected CPI outturn is a downside risk.

NZ inflation expectations

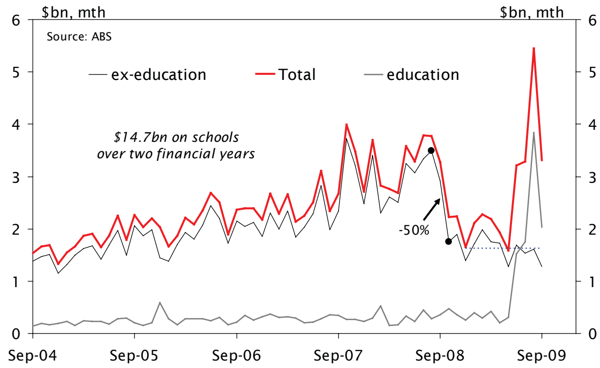


Aus Q3 construction work done

Nov 25, Last: -0.1%, WBC f/c: -1.4%, Mkt f/c: -0.5%, Range: -7.8% to 5.0%

- Construction activity was a mixed bag in the September quarter. Potentially large and conflicting movements in sub-sectors point to the risk of a surprise.
- We're forecasting a 1.4% decline in work in the period.
- Public construction (25% of the total) could jump by 8%, with upside risks. School building approvals rose $7.5bn in the four months to September. How quickly work progresses is unclear – we've allowed for a $0.5bn rise in such work, in this the initial quarter. Additional road works by S&L government (funded by the Fed's) will also boost public construction.
- However, private work most likely contracted, possibly by as much as 5%. This reflects the lagged impact of widespread weaker approvals over the second half of 2008, as earlier high interest rates, the global recession and the credit crisis hit.

Non-residential building approvals

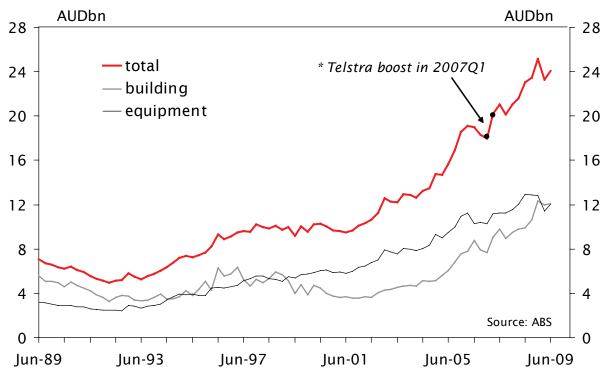


Aus Q3 CAPEX

Nov 26, Last: 3.3%, WBC f/c: -5.0%, Mkt f/c: 1.0%, Range: -5.0% to 4.5%

- CAPEX – a survey of private investment – is expected to pull-back after government tax incentives triggered a bring-forward in the June quarter.
- Our forecast is for a 5% fall.
- Equipment spend, after slumping 11% in Q1 in response to the global recession, rose 5.4% in Q2. We're allowing for a 4% fall in Q3 and anticipate a further decline in Q4. While imports of capital goods rose in Q3, we expect the domestic segment to fall sharply, thereby reversing the spike of last period.
- Building and structure spending is also expected to be down solidly, as weaker approvals result in a drop in activity.

Real capital expenditure *(CAPEX survey)*

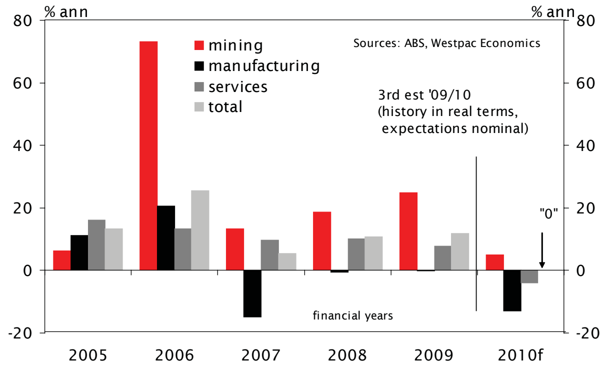


Aus CAPEX intentions

Nov 26, Last: Est 3 2009/10 AUD90.6bn

- With the return of confidence, firms are upgrading investment plans at a time of improving economic conditions.
- **The ABS is introducing changes to the CAPEX survey – thereby complicating interpretation of CAPEX intentions.** See ABS information paper for more details.
- The 3rd estimate for 2009/10 CAPEX plans was $90.6bn, 10.4% lower than est 3 for 2008/09.
- However, applying the average 10 year realisation ratio, the 3rd est implies that the value of investment this year would be the same as in 2008/09. Such plans are far more upbeat than we anticipated and than we are currently forecasting. In our judgement, the *average* 10yr RR is overstating the likely strength of investment this year.

CAPEX plans

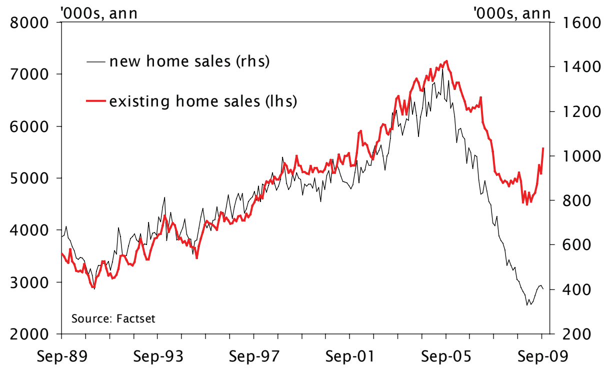


US Oct existing & new home sales to post gains

Nov 23, Existing home sales: Last: 9.4%, WBC f/c: 3.5%, Mkt f/c: 2.3%
Nov 25, New home sales: Last: -3.6%, WBC f/c: 5.5%, Mkt f/c: 0.8%

- For nearly six months up until late Q3, US housing was showing signs of strengthening on all indicators: starts, permits, prices, homebuilder sentiment and of course sales of both existing and new dwellings. However over the past month or so, some sector indicators have lost momentum, including sentiment, new sales, starts and permits.
- Existing home sales reflect transactions agreed months prior, so are unlikely to reflect the latest data "wobble". Indeed with pending home sales up 30% from their 2009 low, but existing sales up only 20% so far, there is upside risk to our 3.5% forecast.
- New home sales tend to be volatile, and we are forecasting an Oct bounce, but given the scale of the Oct slump in house starts, Sep new sales may need to be revised sharply lower for our Oct forecast sales jump of 5.5% to be realised.

US housing sales

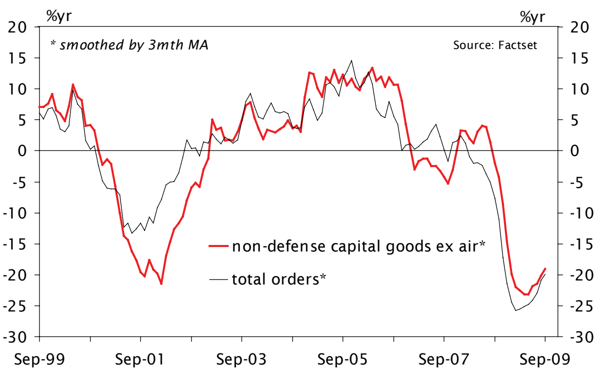


US Oct durable goods orders to rise again

Nov 25, Last: 1.0%, 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. In Sep, orders rose 1%, despite modest slippage in aircraft and also autos, thanks to a decent 2% rise in core capital goods orders and ongoing defence gains.
- Oct orders are forecast to post a further unimpressive gain. Oct ISM factory orders slipped for the second month running to a still solid 58.5: that suggests that core capital goods orders should post another rise (as their trend is still barely better than flat), and we expect defence to rise again.
- Other clues are softer: factory production fell 0.1%, with autos and business equipment output both down. Also, Boeing had fewer orders in Oct, though less than a handful of 737s shouldn't push the orders headline around too much.

US durable goods orders

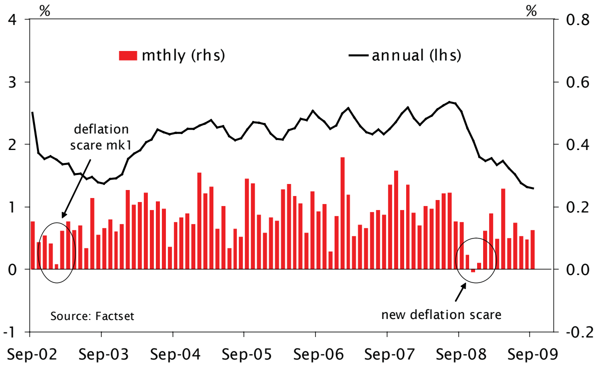


US Oct core PCE deflator – won't reach all time lows

Nov 25, Last: 0.1%, WBC f/c: 0.1%, 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, and not far above the 1.2% multi-decade low from 1998 before core PCE became the Fed's preferred inflation measure (and excluding a one-off post 9-11 distorted 1.1% read).
- The core CPI has been a little stronger of late, rounding up to 0.2% gains in Sep and Oct; its annual pace has risen from 1.4% in Aug to 1.7% in Oct. That means a sub 0.1% core PCE deflator is unlikely in Oct, and with a string of three flat core PCE outcomes through Q4 2008 dropping out of the annual calculation in the next few months, the annual core PCE deflator is likely to edge higher again from Oct. This should help further unwind US deflation concerns.

US core PCE deflator



Key Data and Events

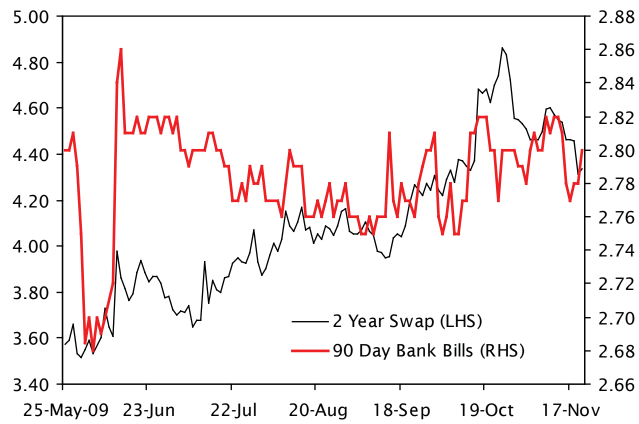
		Last	Market Median	Westpac Forecast	Comments
Mon 23 Nov					
Aus	Oct Motor Vehicle Sales	2.9%	–	4.0%	Clearer signs of a cyclical upturn starting to appear.
US	Oct Chicago Fed National Activity Index	–0.81	–	–	Index derived from 80+ national activity indicators.
	Oct Existing Home Sales	9.4%	2.3%	3.5%	Pending home sales up 30% since Feb, but existing up just 20%.
Eur	Nov PMI Factory Advance	50.7	51.2	50.5	Support for economy for car scrappage schemes waning.
	Nov PMI Services Advance	52.6	52.9	52.0	Services survey likely to correct from sharp Oct rise.
UK	Nov House Prices %yr	2.0%	2.4%	–	Tentative date for Nationwide index, due 23-30/11.
Can	Sep Retail Sales	0.8%	0.6%	0.8%	Auto sales known up 1.2%, gasoline prices higher.
Tue 24 Nov					
US	Q3 GDP Prelim	3.5%	2.9%	3.1%	Trade data suggest downward revision.
	Sep House Prices %yr	–11.3%	–9.1%	–8.3%	Preferred S&P-Case Shiller index. Base effects add 2 ppts to ann rate.
	Sep House Prices	–0.3%	0.1%	–	More volatile FHFA index.
	Nov CB Consumer Confidence	47.7	47.5	49.0	Signals mixed from weekly ABC and prelim Nov UoM.
Eur	Sep Industrial Orders	2.0%	1.0%	1.0%	Expecting fifth straight gain but Q4 may see some correction lower.
Ger	Q3 GDP (F)	0.7% a	0.7%	0.7%	Revision possible but more interest in detail driving Q3 growth.
	Nov IFO Business Climate Index	91.9	92.5	92.0	Slower improvement as Q4 eco growth loses some momentum.
UK	Q3 Business Investment	–10.2%	–5.0%	–	Very weak; sometimes a clue to direction of GDP revision.
	Oct BBA Mortgages	42k	44k	–	Banks currently about 75% of new home loan market.
Wed 25 Nov					
Aus	Q3 Construction Work Done	–0.1%	–0.5%	–1.4%	Private sector weak. Just how large offset from public sector unclear.
	RBA Deputy Governor Battellino Speech	–	–	–	Speaking to 6th National Housing Conference, Melbourne (9:20 AEDT).
US	Oct Personal Income	0.0%	0.2%	0.1%	Forecasts based on hours worked and earnings data from payrolls
	Oct Personal Spending	–0.5%	0.5%	0.7%	report (income), retail sales (spending) and consumer price index
	Oct Core PCE Deflator	0.1%	0.1%	0.1%	(core PCE) reports.
	Oct Durable Goods Orders	1.0%	0.5%	1.0%	Surveys suggest a moderate orders gain, despite Boeing softness.
	Initial Jobless Claims w/e 21/11	505k	500k	500k	Downtrend continues.
	Nov Uom Consumer Sentiment (F)	66.0 a	67.0	67.5	Weekly ABC data suggest upward revision risk.
	Oct New Home Sales	–3.6%	0.8%	5.5%	House sale recovery still has some legs, for now.
	Nov 4 FOMC Meeting Minutes	–	–	–	Some regional presidents agitating for early exit from current stance?
Jpn	Oct Corp. Services Prices %yr	–3.2%	–2.6%	–	Deflation spreading from traded to non-traded services.
	Oct Trade Balance ¥bn	59	300	–	Yen stability and export revival bode well for surplus.
	Nov Small Business Confidence	43.4	–	–	Conditions have improved, but still parlous.
Ger	Dec GfK Consumer Confidence	4.0	4.0	–	Labelled Dec but surveyed in early Nov.
UK	Q3 GDP 1st Rev	–0.4%a	–0.3%	–0.4%	Earlier expectation of upward revision now less likely.
Thu 26 Nov					
NZ	Oct NBNZ Business Confidence	48.2	–	–	Confidence improving for agri but may be topping out elsewhere.
Aus	Q3 Private CAPEX	3.3%	1.0%	–5.0%	Unwinding Q2 bring forward in response to tax incentives.
	2009/10 CAPEX Expectations AUDbn	90.6	–	–	Changes to CAPEX survey to complicate interpretation of intentions.
US	Thanksgiving Holiday	–	–	–	All markets closed.
Jpn	Bank of Japan Minutes	–	–	–	The BoJ will be the last major central bank to move rates this cycle.
Eur	Oct Money Supply M3 %yr	1.8%	0.7%	1.5%	Credit to private sector turned negative in Sep at –0.3% yr.
Ger	Nov CPI Prelim %yr	0.0%	0.5%	0.3%	Base effects to add 0.5 ppts to annual rate.
UK	Nov CBI Retail Survey	–	–	–	Early clue to official retail data, though has out-performed lately.
Fri 27 Nov					
NZ	Oct Merchandise Trade NZDm	–424	–480	–460	Seasonal upswing in monthly trade balance still a month away.
	Q4 RBNZ 2yr Inflation Expectations	2.3%	–	2.4%	Upward creep likely in line with economic recovery.
Jpn	Oct Unemployment Rate	5.3%	5.4%	–	Excess employment remains, weighing down firms' profitability.
	Oct National CPI %yr	–2.2%	–2.4%	–	Degree of slack across product and labour markets is immense.
	Nov Tokyo CPI %yr	–2.4%	–2.3%	–	Deflation pressures are very broad.
	Oct Retail Sales %yr	–1.3%	–1.6%	–	Former Govt's 4 supplementary budgets have had a narrow impact.
	Oct Household Spending %yr	1.0%	0.7%	–	Real measure. Stimulus measures divert spending from other areas.
Eur	Nov Business Climate Indicator	–1.78	–1.65	–1.75	Less steep improvement to be expected if GDP growth slows in Q4.
	Nov Consumer Confidence	–18	–17	–16	News that Euroland economy out of recession may boost confidence.
	Nov Economic Confidence	86.2	88.0	85.5	Less steep improvement to be expected if GDP growth slows in Q4.
Can	Q3 Current Account C$bn	–11.2	–13.3	–	C$ strength, weak trade have already delivered three qtrly deficits.

New Zealand Economic and Financial Forecasts

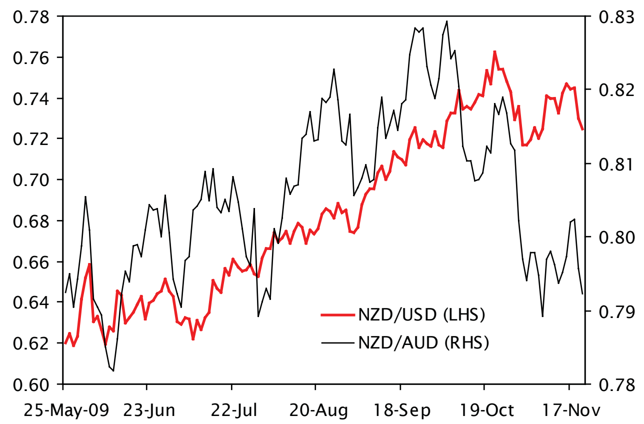
Economic Growth Forecasts		March years				Calendar years		
% change	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
GDP (Production) ann avg	3.1	-1.1	0.0	3.8	0.0	-1.3	3.5	3.8
Employment	-0.3	0.7	-0.8	1.6	0.9	-2.1	1.0	1.8
Unemployment Rate % s.a.	3.8	5.0	6.7	5.3	4.7	6.7	6.3	5.5
CPI	3.4	3.0	2.4	2.8	3.4	2.5	2.4	2.8
Current Account Balance % of GDP	-7.9	-8.1	-2.5	-5.3	-8.9	-2.6	-4.0	-5.2

Financial Forecasts	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Cash	2.50	2.75	3.25	3.75	4.25	4.75	5.25
90 Day bill	2.90	3.20	3.70	4.20	4.70	5.20	5.70
2 Year Swap	4.70	5.10	5.40	5.70	5.90	6.10	6.20
5 Year Swap	5.80	6.00	6.10	6.20	6.30	6.40	6.50
10 Year Bond	6.00	6.10	6.20	6.30	6.30	6.40	6.50
NZD/USD	0.77	0.77	0.73	0.76	0.78	0.77	0.75
NZD/AUD	0.80	0.80	0.81	0.82	0.82	0.83	0.83
NZD/JPY	67.8	67.8	67.9	73.0	78.0	81.6	81.8
NZD/EUR	0.51	0.51	0.50	0.51	0.52	0.52	0.51
NZD/GBP	0.44	0.43	0.42	0.42	0.43	0.43	0.40
TWI	67.5	67.4	65.9	67.9	69.6	70.2	69.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 November 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.77%	2.78%	2.77%
60 Days	2.77%	2.78%	2.78%
90 Days	2.80%	2.82%	2.80%
2 Year Swap	4.34%	4.60%	4.86%
5 Year Swap	5.48%	5.75%	5.87%

NZ foreign currency midrates as at Monday 23 November 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7239	0.7410	0.7540
NZD/EUR	0.4870	0.4938	0.5029
NZD/GBP	0.4385	0.4432	0.4628
NZD/JPY	64.300	66.670	69.480
NZD/AUD	0.7912	0.7969	0.8190
TWI	64.730	65.940	67.440

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
Australia							
Real GDP % yr	3.8	2.8	2.9	4.0	2.4	1.0	2.8
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	2.0	2.2
Unemployment %	5.4	5.1	4.8	4.4	4.3	5.7	6.4
Current Account % GDP	-6.1	-5.8	-5.3	-6.3	-4.6	-4.1	-4.7
United States							
Real GDP %yr	3.6	3.1	2.7	2.1	0.4	-2.5	1.6
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-0.5	1.3
Unemployment Rate %	5.5	5.1	4.6	5.8	9.2	10.5	10.8
Current Account %GDP	-5.7	-6.1	-6.0	-5.3	-4.9	-2.9	-2.5
Japan							
Real GDP %yr	2.3	1.9	2.8	2.2	-1.0	-6.0	1.1
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-1.2	-0.6
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.2	5.9
Current Account %GDP	3.3	3.6	3.9	4.8	3.2	2.6	3.0
Euroland							
Real GDP %yr	2.2	1.7	2.9	2.7	0.6	-4.0	0.7
Consumer Prices %yr	2.1	2.5	2.0	3.1	1.6	0.3	0.7
Unemployment Rate %	9.0	8.8	7.9	7.3	7.8	10.0	11.5
Current Account %GDP	0.0	-0.2	-0.5	0.0	-0.2	0.0	0.4
United Kingdom							
Real GDP %yr	3.0	2.2	2.9	2.6	0.7	-4.7	0.3
Consumer Prices %yr	1.3	2.1	3.0	2.1	3.5	1.0	1.2
Unemployment Rate %	2.8	2.8	3.0	2.5	3.1	5.5	7.0
Current Account %GDP	-1.9	-2.6	-3.0	-2.8	-2.3	-3.0	-3.0

Forecasts finalised 6 November 2009

Interest Rate Forecasts	Latest (Nov 23)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Australia						
Cash	3.50	3.75	4.00	4.50	4.50	4.50
90 Day Bill	3.92	4.00	4.30	4.70	4.60	4.75
10 Year Bond	5.39	6.00	5.70	6.20	6.50	6.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.37	3.50	3.20	3.75	4.25	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.25

Exchange Rate Forecasts	Latest (Nov 23)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
AUD/USD	0.9149	0.96	0.96	0.90	0.93	0.95
USD/JPY	88.83	88	88	93	96	100
EUR/USD	1.4866	1.51	1.51	1.47	1.50	1.51
AUD/NZD	1.2638	1.25	1.25	1.23	1.22	1.22