

# Economic Overview

A quarterly overview of the New Zealand economy

November 2008

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## Highlights

- The world economy is centre stage at the moment. The credit crunch that has ravaged financial markets has now gone to work on real economies, and world growth forecasts for 2009 have been slashed.
- For New Zealand, the recent developments on international markets are bad news. Two of the biggest factors influencing our economic growth in recent years – soaring credit growth and high commodity prices – are now collapsing in spectacular fashion. Economic growth will suffer as a result.
- Aggressive action by the RBNZ will help to limit the losses, as will a lower exchange rate and increased government spending. Lower fuel prices are also providing some insulation for the consumer.
- However, any substantive recovery now looks unlikely before 2010. The housing correction has further to run and unemployment will rise further. But most importantly, the world is going through a massive deleveraging process. As one of the most indebted nations in the world, New Zealand will not be immune.
- We expect the OCR to trough at 5.0% in the first half of 2009, and a further decline in the New Zealand dollar over coming months. Trying to pick the bottom of the exchange rate cycle is a futile task in this environment. However, at this point it could get to somewhere in the mid 40's against the USD.

## Big bang vs creationism

*New Zealand will not be immune to the shockwaves emanating from overseas financial markets. The main effects will be lower prices for our commodity exports, more difficulty obtaining credit, and a lower exchange rate.*

### Implications of the credit crisis

Any number of adjectives can be applied to events occurring in global financial markets: jaw-dropping, unbelievable, spooky, unprecedented, meltdown, implosion, wild-fire, panic, capitulation, contagion, pant soiling, and plain old scary. The big bang in financial markets has meant credit creation in developed economies has slowed to a trickle.

Events of the past couple of months

have been revelational. It was telling that equity markets kept capitulating, and credit markets remained frozen, despite unprecedented and coordinated action taken by governments and central banks around the world to prevent a wholesale implosion of the global financial system. For example, in addition to the \$700bn US mega-bailout, six central banks, including the Federal Reserve, the Bank of

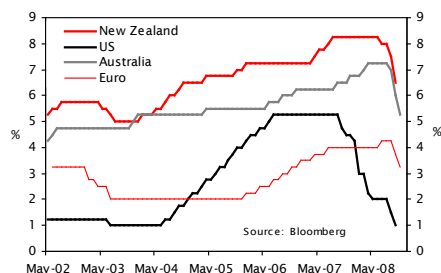
England and the European Central Bank announced co-ordinated cuts in lending rates on October 8, with most trimming them by 0.5%. All three have since lowered rates again. Furthermore, officials in Europe, America, and Asia, have introduced comprehensive plans to prop up failing banks (i.e., by injecting capital), guarantee their loans and flood the world with cash by providing unlimited dollar

**Westpac**

funds through central banks.

In fact, it is no exaggeration to say that the world financial system has come close to implosion on a couple of occasions over the past two months. However, we are much more comfortable that the risk of financial Armageddon has now reduced. In our view, the global authorities (with intellectual leadership from the UK) are now on the right track. They are making plentiful liquidity available, cutting interest rates, increasing fiscal stimulus, but most importantly injecting capital into banks and guaranteeing inter-bank deals. This mix of policy is getting on top of the liquidity

Figure 1: Central Bank Rates

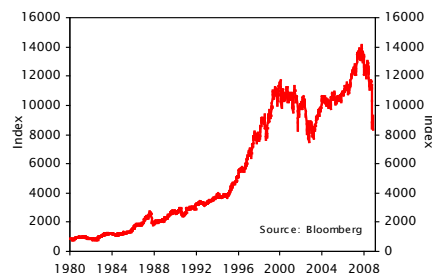


lock that was besetting credit markets.

Although international credit markets are beginning resume some semblance of function, problems will persist, as we are yet to see the impact of recession on consumer credit, credit cards, student loans, and business debt/defaults.

Sure, up until now, the world had been slowing in slow motion. A positive net export position and fiscal stimulus saw the US post robust economic growth in H1 2008 despite the woes in its housing, financial, consumer and automotive sectors. Growth in developing economies had proved resilient and commodity prices kept rising until early July. But no

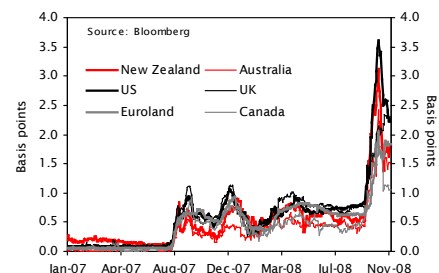
Figure 2: Dow Jones Industrial Average



longer. Credit creation in the developed world will be weak, sending the world's two biggest economic blocs into twin recessions. That is already undermining Asia's exporting base and causing a slowdown there. The Asian slowdown, while nasty, may be more moderate than the developed world's since Asia has no debt problem and could get a boost from falls in commodity prices.

Also, the injection of public money and guarantees into the financial system will be accompanied by strong demands from politicians and voters for greater regulation, less leverage, more simplicity, and greater transparency.

Figure 3: Interbank rate and OIS rate spread



## How long and how deep?

It's extremely hard to determine how long the global downturn/recession will last and how bad things will get. For one, we don't know what new regulations will ensue. Some of it will be good (e.g., possibly greater transparency around derivative exposures) and some will exacerbate problems or carry unintended consequences (e.g., post-Enron "mark-to-market" requirements have been fuel to the fire of this credit crunch, and government guarantees are already having some adverse effects on non-financial sector funding).

Also, we can't be sure how the collective psychology of the world will respond to the pummeling that equity markets have taken. Will it be akin to NZ's experience post-1987 when equities were shunned for a decade? Or will greed fairly quickly overcome fear? We presume the latter.

So far the world economy has

experienced the sub-prime earthquake, the credit markets tsunami that ensued, and is yet to live through the aftershocks. This crisis has had a habit of feeding itself. And we expect that to continue. For example, we think that the Emerging Markets (EM) economies and share prices have further to fall. After that, people's attention will turn to who has the most exposure to EM. Lending by US and Japanese banks to EM amounts to only 4% and 5% of their respective GDP. In contrast, lending by European banks to EM accounts for 21% of European GDP, and 24% for the UK.<sup>1</sup>

To get a grasp on the "how long" of this downturn, it's useful to look at history. Since the second world war, the average US recession (which is quite harsh) has lasted 10 months. Recent IMF work has examined recessions around the world and has highlighted that those preceded by financial crises are deeper

and longer lasting. Also, recessions that are centred on consumers restoring their balance sheets tend to be longer lasting. So this global downturn will in all likelihood be more pronounced than the norm. It may deliver around 3+ years of deeply sub-trend growth, akin to the 1982 global downturn where growth in the developed world was going backwards and developing economies were spluttering forward on one cylinder.

Equity prices and risk appetite tend to anticipate an economic recovery, rebounding on average around 4 months before the end of recession. This time around, we don't expect any sustained lift in risk appetite until economic recovery is within spitting distance. As the global economy is only just entering recession, that recovery is some way off.

<sup>1</sup> Source: Morgan Stanley

## Impact on New Zealand

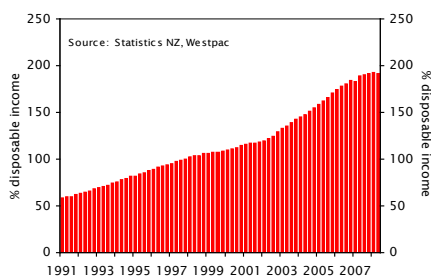
So far New Zealand has suffered falling share prices, falling house prices and failing finance companies. Previously high export commodity prices are now also starting to drop rapidly. And they will fall further.

In addition, an Achilles Heel for New Zealand is our reliance on foreign lending. For many years we have spent far more than we earn and borrowed the difference from offshore. This was always unsustainable in the long run. A correction of some sort was long overdue, but we didn't know when it would come or what form it would take. We have a better idea now.

Over the past two months, US lending markets have been virtually closed. As those markets re-open, New Zealand banks may find that the terms for borrowing money from offshore will be much tighter, and the loans more expensive (even with the government guarantee). If so, the banks would increase interest rates and tighten credit standards for New Zealand customers. Firms would find it harder/more expensive to borrow money for investment. New home buyers and investors would find it tougher to borrow, which would cause house prices to decline more rapidly. Homeowners could find that their falling house price prevents them from topping up the mortgage to finance renovations. The resulting disruption to economic activity would cause job losses, which would further disrupt economic activity, and so forth. It is hard to imagine that in a world shunning leverage, one of the most indebted countries in the world – New Zealand – will not be forced to pare back on its debt appetite.

But fortunately for every action there

Figure 4: Household debt



is a reaction. The first consequence of foreigners' reluctance to lend to New Zealand will be a much lower New Zealand dollar (already in train). That's because a major source of demand for NZD – the "carry traders" who lend to us – will evaporate. We expect a further decline in the New Zealand dollar over coming months. Trying to pick the bottom is tough, but at this point it could get to somewhere in the mid 40's against the USD.

A lower NZD would go a long way towards effecting the inevitable rebalancing. It would make imports more expensive and encourage New Zealanders to consume less. It would protect agricultural exporters from falling world commodity prices and would be a comfort to other exporters. Fewer imports and more exports would repair the yawning current account deficit. Lack of access to credit is not something that can be directly addressed through the currency, but as part of the adjustment process, the currency can undershoot its long-run 'fair' value, to the point where lenders can be lured back by the prospect of an exchange rate re-appreciation as well as the usual yield pickup.

Reserve Bank liquidity measures and monetary policy will be the reaction to tighter overseas credit markets. The Reserve Bank of New Zealand made it clear in the September *Monetary Policy Statement* that they intend to reduce the OCR to offset banks' rising cost of funding and prevent increases in mortgage rates. With the OCR still high, the RBNZ has heaps of ammo.

The RBNZ has repeatedly expressed confidence in New Zealand's banking system. There is very little direct exposure to toxic mortgage-backed securities in the US. New Zealand's banks have been far more prudent than American or European ones. "Low-doc" and "sub-prime" loans are virtually non-existent, and the maximum loan-to-value ratios were 95% or 100%, whereas more was lent in the USA and Europe. Securitisation, where banks on-sell mortgages in order to free-up capital and lend more money out, and which caused so many problems in the

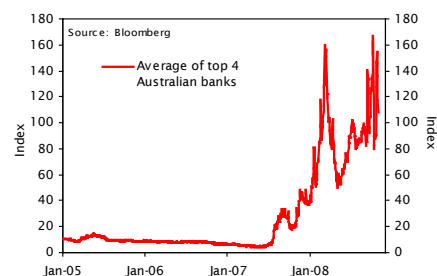
US, is rare in New Zealand (approximately 99.2% of bank-originated mortgages are held by the banks).

Falling house prices and a more cautious attitude toward risk have already encouraged less demand for borrowing in New Zealand, and more saving. A lower exchange rate will erode our purchasing power and further reduce spending so that demand for credit could remain subdued. New Zealand's "funding gap" (the shortfall of domestic saving relative to lending) is rapidly shrinking.

The worst case scenario for New Zealand would be a sustained shutdown of overseas lending before we are ready to balance our own saving and lending. This scenario is unlikely. The government guarantees of wholesale bank deposits will help keep the credit tap open. But in the unlikely event that the tap does remain closed, the RBNZ is very well prepared. Measures are in place for New Zealand's banks to borrow directly from the Reserve Bank, using supranational, corporate or bank bonds, or even mortgage backed securities as collateral. These amount to loans, not gifts for banks. The loans would eventually be repaid via mortgage repayments.

One way or another New Zealand faces a painful adjustment towards spending being more akin to what we earn. The mechanism for adjustment will be a lower exchange rate, tighter lending standards, and reduced credit creation. Possible long-term side effects will be greater banking sector regulation and more stringent capital requirements. This is the long-overdue cure to the economic ill of excessive borrowing. Like many cures, it will be painful but ultimately restorative to our long-term health.

Figure 5: CDS spread



# When bad turns ugly

*New Zealand's growth prospects have taken a turn for the worse following the dramatic events in global financial markets. We expect the economic hardships of 2008 to spill into 2009. Aggressive action by the RBNZ will help to limit the losses, as will increased government spending and a lower exchange rate. However, any substantive recovery now looks unlikely before 2010.*

For the average New Zealander, the recent run of international events may seem a world away. But they are nothing short of bad news for our economy. Two of the biggest factors influencing New Zealand's economic growth in recent years – soaring credit growth and high commodity prices – are now collapsing in spectacular fashion. Credit growth has come to a grinding halt as access to offshore funds has been severely crimped and the cost of those funds has surged. Meanwhile, commodity prices are heading south at a rate of knots as global demand for commodities dries up even faster than it took off. In fact, in

## Government to the rescue...

That said, we don't think the economy is on a slippery downward slope. Extraordinary times call for extraordinary measures, and fortunately New Zealand's key policy makers are coming to the party. Interest rates are falling rapidly, and government spending is expanding.

Our markets section covers the details of Westpac's outlook for interest rates, but briefly, the RBNZ has moved aggressively to cut interest rates in recent months. The Official Cash Rate (OCR) has dropped by a total of 1.75 percentage points since July this year. And, with the OCR currently at 6.5%, there is a long way to go before the RBNZ's powder runs dry.

There is also plenty of scope for greater

## ...with support from the NZD

The other major channel for softening the blow to the economy is the exchange rate. One of the benefits of a flexible exchange rate is that the currency can act as a shock absorber, dispersing the economic benefits

## Protection rather than stimulation

On balance, we still expect positive growth through 2009. However, in our minds the monetary and fiscal stimulus is more likely to 'stop the rot' rather than stimulate activity. Our forecasts see GDP growth of close to 1.0% for calendar 2009, similar to that estimated for 2008, and it is likely to

October the world price of New Zealand's key commodities experienced the biggest one-month decline since at least 1986, to be down almost 11% on a year ago.

To make matters worse, New Zealand is already in the midst of recession. GDP contracted 0.5% in the first half of 2008 as drought, a housing slump, an oil price spike, and tight monetary conditions destroyed growth in many sectors. There had been signs that consumers and businesses were starting to feel a little chirpier through the July-September period: lower fuel prices, falling interest rates and pending tax cuts, clearly provided some cause for relief. But

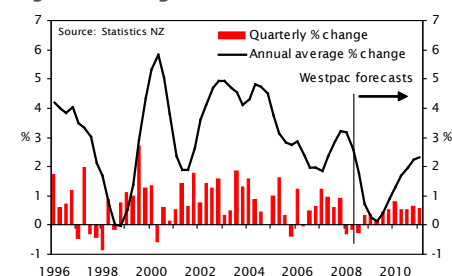
fiscal stimulus. The newly elected National-led government has pledged to provide additional support to the economy in short order. Some of their priorities include additional tax cuts from 1 April, more infrastructure spending, and a transitional relief package for workers made redundant. The Pre-Election Economic and Fiscal Update (PREFU) estimated the fiscal stimulus for the year ended June 2009 at 2.8% of GDP. It is now likely to be substantially stronger than that, implying an even greater deterioration in the government accounts (the PREFU forecast a return to operating deficits next year). However, we see further fiscal stimulus as appropriate given the current circumstances. Now is not the

in the good times and providing insulation to the economy in the downtimes. Already the currency is providing some offset to lower commodity prices – in New Zealand dollar terms commodity prices actually lifted

be 'grumpy' growth. That is, much of it will be appearing in areas that don't materially benefit the average consumer – agriculture, mining and electricity. From 2010, we expect the massive stimulus coming from monetary and fiscal policy will gradually start to kick in, lifting year-end growth to

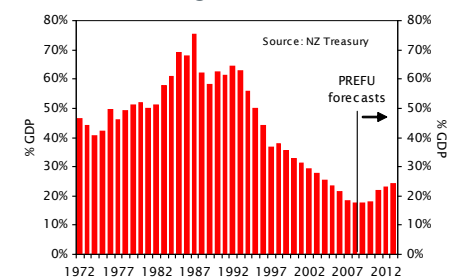
that was then! The latest developments offshore will be a difficult load for the economy to bear, and economic growth will suffer as a result.

Figure 6: GDP growth



time for the government to be tightening its belt. Remember also that New Zealand has a fiscal position that many other OECD economies are envious of – debt levels remain low by international standards.

Figure 7: Gross sovereign issued debt (excluding settlement cash)



0.7% in the month of October, and were 8.2% higher than a year ago. And we expect a further substantial decline in the New Zealand dollar over coming months (see our *Markets* section for more detail).

2.2%. Yet, that is a far cry from the 3.6% average we have become accustomed to in recent years.

Moreover, our forecasts assume that some form of 'normality' returns to credit and financial markets. But access to credit remains one of the key unknowns and on

that basis we cannot rule out a deeper or more protracted slowdown through 2009. Moreover, the real economic impact of the crisis is only just beginning, and NZ, like most other countries, is beholden to how

## Investments on hold

Until recently, part of our optimistic growth story for 2009 was predicated on strong growth in business investment. But that was before the latest freeze in global credit markets. And even though the freeze is now beginning to thaw, access to credit will remain a major headwind, not to mention much weaker demand and plunging sentiment. As such, it seems inevitable that many investment projects will now be delayed. Short term indicators suggest that business investment activity is likely to be abysmal in the first half of 2009. The nascent recovery in business confidence stopped dead in its tracks in October. The headline measure plunged from a six-year

the global economy (and particularly Asia) is affected by the current mayhem on financial markets. Our forecasts assume global growth slows from 3.7% in 2008 to 2.25% in 2009, but risks are to the downside. We

high in September to a balance of -42%. A net 11% of firms expected their own activity to deteriorate over the next year, the second worst reading in the history of this survey (the low of -19.8 was in April 1988, the first time this question was included). The details were just as ugly: profit expectations, employment and investment intentions were also the lowest on record.

Of course, there is no way to say how much of this latest survey reflects fears of global catastrophe, and how much it reflects a genuine softening in domestic activity. Having said that, there isn't much reason to expect these results to be reversed next month – the risk of financial Armageddon

## Employment outlook is critical

The labour market holds the key to how severe and protracted the NZ downturn will be. To date, the drop-off in employment growth has been mild, and the labour market is still in very good shape with the unemployment rate relatively low at 4.2%. Part of that reflects the fact that most disaffected workers have found alternative employment, quit the labour force, or emigrated, and as such the rise in unemployment has been slow but steady. But our forecasts are a case of 'you ain't seen nothing yet' – our core view is that unemployment will continue rising over the

next year (with layoffs most prominent in the retail, construction, and finance industries), to a peak in early-2010 of around 5.6%. That equates to 33,000 additional people out of work. However, given the weight of events to date, the risks are clearly for a sharper upturn in unemployment, the consequences of which could be nasty for the housing market and consumer spending.

For those that remain in work, we are of the view that wage growth will be solid – around 3.5% - 4% – until mid-2009, as inflation compensation continues to dominate higher unemployment. Thereafter,

## Housing correction not over yet

The housing market entered a serious slowdown in late-2007 and by April 2008 market turnover was down 53% on year-ago levels. So far, falling mortgage rates have provided only a little relief: sales have risen slightly since April, but they are still a third lower than a year ago. On a like-for-like basis, house prices on average across NZ

had dropped close to 7% by October.

We expect the annual pace of decline to reach 10% for 2008, with a peak-to-trough price decline in the vicinity of 15%. We do not expect prices to return to their 2007 levels until 2012. House prices are still around 15% overvalued, based on current interest rates, inflation, rents and

## Excesses unwinding

Global recession is nothing new. We have experienced them before, and we will again. But this time the feeling is that the downturn will be a lot deeper and more protracted than anything we have seen since the Great Depression in the 1930s. After the build up of excesses over the past decade, the world is going through a massive deleveraging, or unwinding of debt. That is a process that

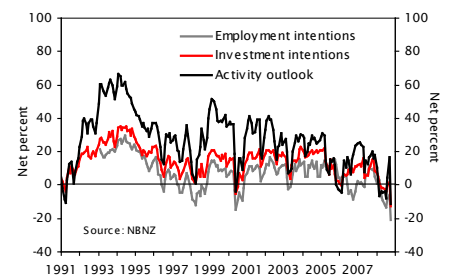
will take time and, while officials are doing everything in their power to limit the losses, unfortunately there is no quick fix.

The deleveraging theme is a key part of our view that NZ's economic growth will be down and out for at least the next 18 months. NZ remains one of the most indebted nations in the world, as evidenced by our large current account

have little doubt that the first half of 2009 will present some testing times for many. Some of the key risk areas include business investment, employment, and the housing market.

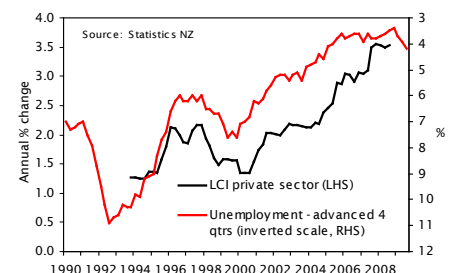
has now been replaced by the very real prospect of a global recession. In that sense, investment paralysis remains a key risk over the coming year.

Figure 8: Business indicators



with inflation expected to be dissipating rapidly in 2009, and growth weak, wage growth will slow.

Figure 9: Unemployment and wages



tax treatment. The risk is for even bigger house price declines if access to credit is tightened further. Some offset could come from a rebound in migration in 2009, as disaffected New Zealanders start returning home from the financially bruised UK. The weaker Australian economy is also likely to attract fewer Kiwis across the Tasman.

deficit (currently 8.4% of GDP). Since 2003, household debt alone has risen from around 120% of household disposable income to 190% currently. As such, it was inevitable that at some point households would begin to cut back on the excesses of recent years, and would start spending in line with what they earn. Given the current environment, we think that time has come.

# World woes to hit home

*Trading conditions will be far from uniform across and within sectors over the coming year, with performance by sector shaped by the large market and policy responses. A falling NZD will help cushion the primary and manufacturing sectors from the worst of the global economic slump. Meanwhile, domestic demand is expected to contract in 2009, restricting growth across the service sector. Government spending will be a lonely light.*

## Overview

The prospect of much weaker global growth has seen us mark down the outlook for growth in the New Zealand economy over the next couple of years. Yet, trading conditions are and will continue to be far from uniform in New Zealand, even within sectors.

For the primary sector, weak foreign demand has pulled down world commodity prices, and further falls are expected over the coming year. But the considerably weaker outlook for commodities has also seen the market take the NZ dollar sharply lower. That is helping to shield exporters, and in particular farm incomes, from the worst of the plunging product prices on world markets. On top of that, reasonable spring grass growing conditions will aid recovery in agricultural production from last year's drought. Mining will also make another strong contribution to growth over the coming year as new projects come on-stream.

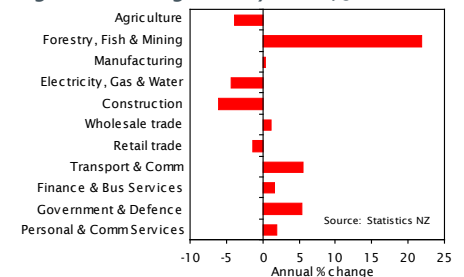
And value added will be boosted late in 2008 by electricity generation as recent rain allows lower cost hydro generation to take more of the national load.

Exporting manufacturers will also embrace the weaker NZD to help fend off some of the negative demand influences from overseas. However, weaker growth in Australia coupled with a higher cross-rate is an illustration of the difficult trading conditions within sectors. Despite the lower NZD, tourism will feel the fallout more than most other exports, as the credit crunch, falling asset prices, and weak income growth overseas strongly discourages luxury expenditure like holidays to New Zealand.

Meanwhile, at home, domestic demand is expected to contract in 2009 led by residential construction and business investment. Retail sales growth will also remain low in response to rising

unemployment and the soft housing market. An overall decline in domestic demand will restrict growth across the service sector in 2009, from real estate agents and business services, to warehousing, distribution and transport. Some offset will come from increased government spending, with the most obvious winners being non-residential building and infrastructure projects.

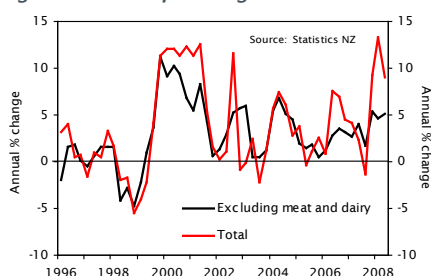
Figure 10: GDP growth by sector, June 2008



## Manufacturing

The manufacturing sector has had a strong lift in sales. Total sales revenue in the first half of 2008 was up 11% on the same period a year earlier, or 5% if the dairy and meat-processing sector is excluded. But higher costs have continued to suppress profitability. There has been considerable variation in performance within the sector. Textile and apparel, wood and paper, and furniture manufacturers have shown the largest falls in activity, while food processing has been a standout on the positive side. The sales outlook is mixed across the sector given the expected decline in domestic demand in 2009, and the much lower NZD against the major currencies, but not against the AUD.

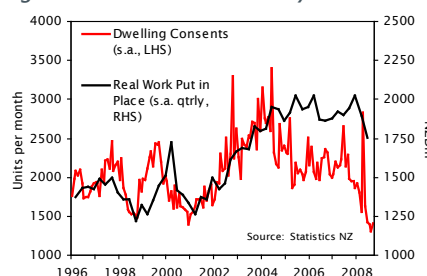
Figure 11: Manufacturing sales



## Construction

The real value of building work put in place slumped 12% in the first half of 2008 from its peak in the final quarter of 2007. Residential led the decline, falling 14% over the period as high interest rates, credit tightening, and low net migration crushed demand for new houses. Rising construction costs, especially relative to falling prices for existing houses, also dampened house building. Construction employment fell 5% in the 12 months to June. Overall conditions for house building are expected to remain negative until well into 2009. Non-residential building is expected to show positive growth, although some projects risk being delayed in the short term given current sentiment. Infrastructure spending will remain strong.

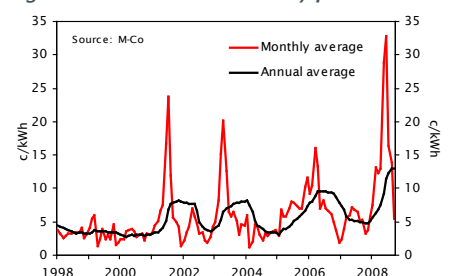
Figure 12: Construction activity



## Electricity, gas and water

Hydro electricity generation was wound back and wholesale electricity prices spiked sharply higher as hydro lakes dropped below 50% of average in June. Wholesale prices averaged almost 33c per kilowatt hour in June, compared to 7c a year earlier. A public electricity saving campaign was launched and some major electricity users cut back production. Since then the rains (and snow) have arrived. This has fully replenished water levels in the hydro lakes. The return of hydro generation will see valued-added lift in Q3, despite a small decline in total generation. The short term outlook will be a battle between rapid snow melt and only average to below average rainfall in the major hydro catchments.

Figure 13: Wholesale electricity price

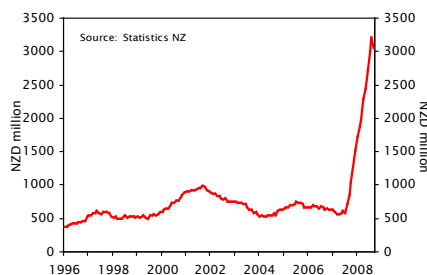


Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

## Mining

Mining exports in the year to September 2008 surpassed \$3.2 billion to be \$2.4 billion higher than a year ago, with oil production from Tui a key contributor. Further growth in mining is expected over coming years, despite production from Tui easing back. Previous extremely high energy prices encouraged more activity and, despite the recent price drop on world markets, more extraction is just around the corner. For example, production from the Maari oil field and Pike River coal mine is expected to start soon, while Kupe gas and oil is anticipated to come on-stream around mid-2009. The additional mining activity is expected to boost GDP by around 0.3% over the next 12 months.

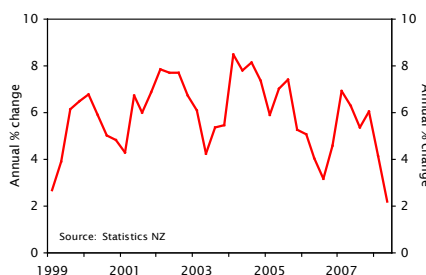
Figure 14: Mining exports



## Retail trade

Retailers have faced difficult trading conditions through 2008 with the twin evils of falling sales and rising costs. Sales volumes in the second quarter of 2008 were 2.4% lower than a year ago, as consumers reacted to higher food and fuel prices, high debt servicing costs and falling asset prices. Indicators suggest Q3 was even worse. While some have been able to lift prices over the past year, this has not been enough to offset the 6.4% increase in operating costs on average across the industry. Consumer spending will receive a short-term fillip from tax cuts and lower petrol prices and interest rates. However, trend sales growth is expected to remain weak through 2009.

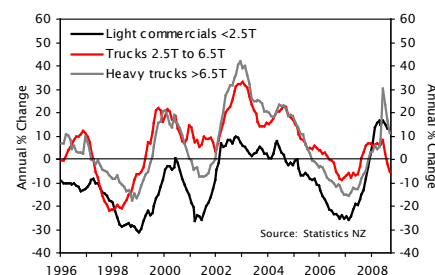
Figure 15: Nominal retail sales



## Transport

A contraction in overall economic growth in early 2008 has dented freight volumes. Contracting domestic demand and the lower New Zealand dollar are expected to reduce imports and distribution activity over the coming year. Export volumes will show some growth helped by primary production, but weak foreign demand will prevent strong broad-based export growth. These conditions are likely to continue into 2009. One positive, amidst the weak outlook, is the sharp fall in fuel prices. On the passenger side, the strong train and bus patronage growth over the past year is likely to slow following recent fare increases and reduction in fuel prices.

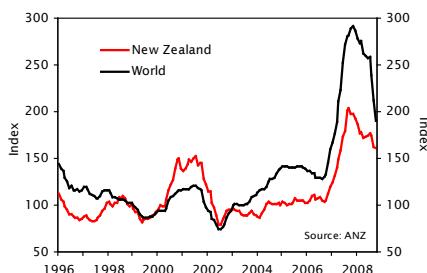
Figure 16: New commercial registrations



## Agriculture

Fonterra's revised payout forecast for the 2008/09 season, from \$7 per kilogram of milksolids to \$6.60, hit optimism across the dairy sector in September. Further declines in world dairy prices are not helping. Lamb prices remain firm on short supply, while beef has fallen sharply from its highs as demand in the US eases and more US product enters Asia. To date, the NZD has offset the weighted average decline in primary product prices on world markets. But costs remain a major concern. The good news is the grass is growing again. We expect a 9% lift in milk production this season, with dry stock farmers also benefiting from better growing conditions. Average to below average rainfall over the summer is a key risk.

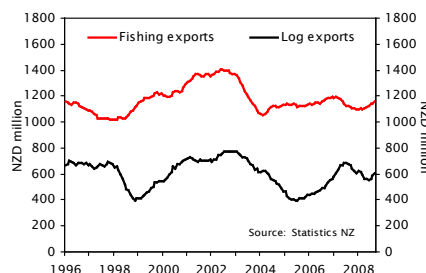
Figure 17: Dairy commodity prices



## Forestry and fishing

Lumber markets remain constrained by the downturn in the US housing market. There has been weak demand for logs in Asia, China the exception. The value of log exports in the year to September was down \$63m or 9%. However, there are positives despite concern around the world economy. Shipping costs have fallen dramatically. And a lower NZD is helping lift log returns. The Agri-fax Log Price index, which measures the return from the whole forest, stood at \$76.8 per tonne in October. This is up from \$68.6 per tonne a year ago with prices now 5.1% above their 10-year average. Lower shipping and transport costs, a lower NZD, and a further increase in Russian log export tariffs that is likely to lift demand for NZ product are positives for 2009. A sharp slowdown in economic growth in Asia is a key risk.

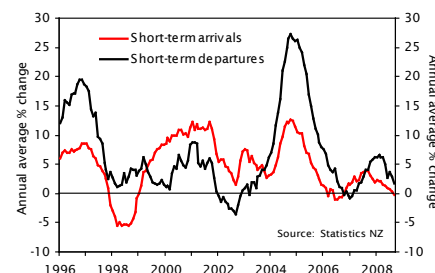
Figure 18: Non-agriculture primary exports



## Tourism

Total visitor numbers in the year to September have held up remarkably well, thanks mainly to a 2.9% lift in visitors from Australia. Visitor numbers from the US were down 1.3%, UK down 4.1%, Japan down 11.0%, and Korea down 19.6%. Some offset has come from emerging markets including India, Brazil and South Africa. A sharp drop in visitors from China over the past four months is concerning. Looking ahead, the international credit crunch is bad news for tourism. As the financial implosion starts to affect jobs and incomes, would-be international travelers are likely to hunker down and delay travel until some sort of financial stability returns. Lower oil prices and lower NZD will help at the margin, but will not be enough to offset the negative income and wealth effects. We expect fewer visitors in the coming 12 months.

Figure 19: Tourism growth



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# Bearing the burden

*The New Zealand dollar has been quick to absorb the impact of the global financial crisis. However, we believe that it has further to fall. The impact of lower commodity prices, weaker world demand and tighter access to offshore funding will become apparent with time. The RBNZ will continue to front-load rate cuts, but importantly, they are getting the traction on mortgage rates that they desired. Inflation pressures have peaked and are now easing rapidly.*

For an indication of what the credit crisis means for the New Zealand economy, we need only look to the exchange rate. Since peaking at around 0.82 in February, the New Zealand dollar has been in steady decline, accelerating in July and plunging to a five-year low in October as the global picture worsened. Such moves may be terrifying to watch, but it's important to remember the role that the exchange rate serves as a buffer against external shocks.

With such extreme volatility, any forecasts of the exchange rate will inevitably have a wide margin of error. So it's useful to have a framework for understanding why the currency could deviate from forecast. We have identified three outcomes from the credit crisis that will drive currencies:

**Lower commodity prices:** Commodities tend to be highly sensitive to world demand, and have already fallen sharply in response to recession fears – in some cases, at the same time that additional supply is coming on tap in response to previous high prices. Net exporters of commodities will suffer more, but a weaker exchange rate can offset the impact of lower world prices.

**Weaker demand for exports:** World GDP growth is expected to slow next year, to a pace last seen in the 1991 recession. Demand for exports will be an inevitable casualty of this slowdown. For exporting countries, weaker volumes can be partially offset by higher prices in local currency terms.

**Access to credit:** Countries that run current account deficits and rely on offshore funding will be most vulnerable to a tightening of credit – they will have to either reduce their reliance on borrowing,

or somehow make themselves more attractive to foreign investors. One quick, albeit imperfect, way to achieve this is for the currency to 'undershoot' its fair value in the near term. Firstly this restricts import demand, and secondly it may lure investors back with the prospect of an exchange rate appreciation on top of the usual yield pickup.

These forces will affect every country to varying degrees. But exchange rates are a zero-sum game; if one currency goes down, another one has to rise. In this environment, exchange rates are best described as an 'ugly contest', with the strongest currency being the one with the least worst outlook. In terms of how the major economies fare:

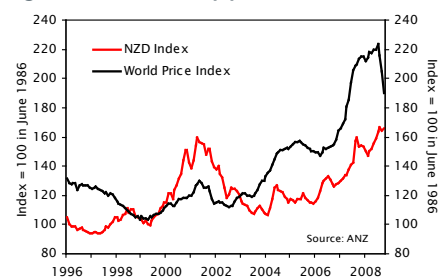
- The US is the epicentre of the crisis, and the real economy will be hit hard by tighter credit conditions. Yet it is also seen as the furthest advanced in resolving the problems in its financial sector. Exports account for a relatively low share of GDP, and as a net importer of oil, the US will probably benefit on balance from falling commodity prices. Consequently, USD strength is expected to remain a feature over coming months.
- Europe is also heavily exposed to credit crunch, a fact that has only gradually come to light. But like the US, the euro zone is not highly dependent on external trade, and on balance will benefit from lower commodity prices. The euro is expected to lose further ground against the USD.
- Asia will be hit hard by the drop in export demand. On the positive side, most countries run current account surpluses and are not reliant on inflows

of foreign funds, and they will benefit from lower fuel and food prices.

That leaves New Zealand in the unenviable position of being both a net exporter of commodities, and a net borrower for consumption purposes. World prices for New Zealand's key commodities have fallen by 15% in the last three months, though the weaker currency has maintained them at record highs in NZD terms (*Figure 20*). Evidence of weaker exports has so far been limited to certain areas such as tourism, but we expect it to broaden over time. And with one of the highest current account deficit-to-GDP ratios in the developed world, New Zealand looks particularly vulnerable to a loss of appetite by foreign investors. We have 'won' the ugly contest, hands down.

To be fair, this has already been reflected in a sharp fall in the NZD against the other major currencies. But we believe that the currency has further to fall. The main source of uncertainty around our view is the credit channel: funding markets around the world are starting to thaw out, but it is unclear when they will return to normal – or even what the 'new normal' will be.

**Figure 20: Commodity price index**



## Interest rates outlook

Along with the weaker currency, lower interest rates are now doing their part as well. In the September *Monetary Policy Statement*, the RBNZ said that they now intend to front-load their easing – and they certainly delivered on that promise, cutting the OCR by 50bp in September

and a whopping 100bp in October, while signalling more to come. It seems that the RBNZ now intends to bring interest rates below neutral levels into genuinely 'loose' territory, in order to buffer the domestic economy from the global slowdown.

The RBNZ was initially concerned that

official rate cuts would not be fully passed on to retail borrowing rates, as the credit crunch had increased the cost of raising funds offshore. That hasn't proven to be the case though, and mortgage rates have fallen substantially since the easing cycle began (*Figure 21*). This is an important

contrast with countries such as the UK, where some mortgage rates are higher now than they were before the credit crunch began, despite aggressive easing by the central bank.

We expect the RBNZ to continue to ease rapidly. The flow of bad news on the global economy is likely to continue for several more months, which will encourage the RBNZ to keep providing

### Inflation outlook

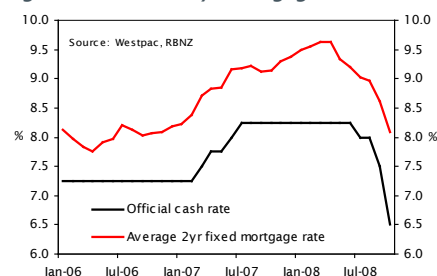
The inflation outlook has swung from one extreme to the other. Annual inflation hit 5.1% in the September quarter, its highest rate in 18 years. Sharp increases in fuel and food prices were the most prominent factors, but domestically-generated inflation has remained stubbornly high as well, posting its biggest quarterly rise in more than a decade. Ordinarily, this would leave the RBNZ extremely nervous, but recent international events have rapidly overtaken any concern about past inflation. The collapse of international crude oil prices over recent months will drive headline CPI sharply lower over coming quarters (Figure 22). Falling petrol prices and flow-on effects could see headline CPI inflation test the 1% bottom

stimulus. Our forecasts assume 50bp cuts at the December and January OCR reviews, followed by two smaller cuts to bring the OCR to a low of 5.00% by the middle of next year. We expect the market to continue to price in an even more aggressive easing cycle than this, egged on by large rate cuts from other central banks.

of the RBNZ target band by Q3 2009. From a policy perspective, of more importance is the weaker domestic growth outlook and the expected creation of economic slack. This significantly reduces concerns about the persistence of non-tradable inflation, despite currently high inflation expectations feeding through to wage and salary agreements. A previously tight labour market is already showing signs of loosening. Firms are reporting labour is easier to find as unemployment starts to rise. We expect inflation to be within the RBNZ target band in 2010 and 2011.

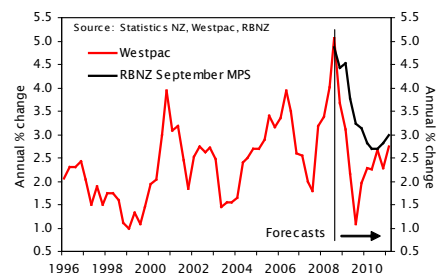
A further fall in the NZD will add to the upward pressure on tradable inflation that is already in train from the lower currency.

Figure 21: OCR vs 2yr mortgage rate



We think the pass-through effect will be strong in its own right. But much lower international commodity prices will give an impression of a muted pass-through effect from a lower NZD to inflation. Food and fuel will be prime examples of this.

Figure 22: CPI inflation forecasts



### Financial Markets Forecasts (end of qtr)

	Official Cash Rate	90 Day Bill	2 Year Swap	5 Year Swap	NZD/USD	NZD/AUD	NZD/JPY	TWI
Dec-08	6.00	6.30	5.80	6.00	0.55	0.82	52.8	55.8
Mar-09	5.25	5.40	5.35	5.50	0.52	0.81	48.9	53.2
Jun-09	5.00	5.30	5.40	5.55	0.48	0.80	42.7	49.6
Sep-09	5.00	5.30	5.45	5.60	0.51	0.80	46.9	52.1
Dec-09	5.00	5.30	5.50	5.65	0.56	0.81	54.9	56.3
Mar-10	5.00	5.30	5.55	5.70	0.58	0.82	58.6	57.9
Jun-10	5.00	5.50	5.65	5.80	0.61	0.82	63.4	60.2
Sep-10	5.25	5.70	5.80	5.95	0.62	0.85	66.3	61.2
Dec-10	5.50	5.90	6.00	6.10	0.62	0.86	67.6	61.1
Mar-11	5.75	6.20	6.20	6.25	0.62	0.86	68.5	61.6
Jun-11	6.00	6.50	6.45	6.45	0.62	0.86	69.4	62.0

Figure 23: 90 day bank bills, 2 year and 5 year swap rates (Monthly Average)

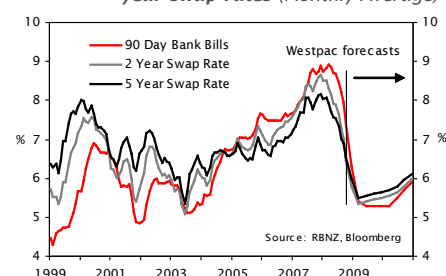


Figure 24: NZD/USD and TWI (Monthly Average)

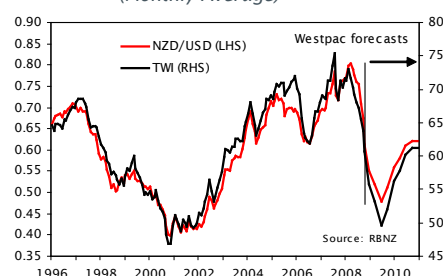
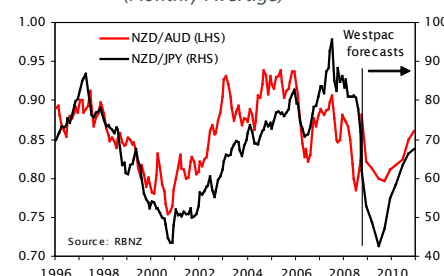


Figure 25: NZD/AUD and NZD/JPY (Monthly Average)



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# Riches to rags

*The credit crunch that ravaged the banking industry has gone to work on real economies. The US and UK have long been spiralling towards severe slowdowns. Now Europe is staring into an abyss that could end up deeper than America's. And worst of all, there are straws in the wind suggesting a severe economic slowdown in Asia too. Slower economic growth has sent commodity prices plunging, which has removed the threat of inflation and given central banks greater license to reduce interest rates.*

## Australia

The Australian economy is already experiencing a consumer-led slowdown, and now faces the prospect of an export slowdown. House prices are falling in all of the major state capitals. House building, credit growth and consumer confidence have all slowed in tandem, and unemployment has edged up from

4% to 4.3%. Australia is probably more vulnerable to the global commodity price declines than any other OECD country, so foreign exchange markets have marked the AUD down by a brutal 30% in just one month. Like other countries, high oil and food prices sent inflation to 5% p.a. in September. Unlike elsewhere, Australian

core inflation has accelerated markedly to 4.7% p.a. Despite high inflation the RBA has reduced interest rates by 2.25%, such is the severity of the potential economic downturn. The government has announced a fiscal package including \$1000+ cheques mailed out direct to pensioners and low-income households.

## USA

USA is the epicentre of the global credit crunch and is well along the road towards a painful economic recession. House prices are still falling at 10% p.a., and are more than 20% below peak levels. The mortgage delinquency rate is 5%, the highest since records began in 1990. Mortgage foreclosures reached 2.75%

2008Q2, the highest rate since records began in 1980. There are nearly 5 million houses for sale, so prices clearly have further to fall. With asset prices falling so fast, US households are forced to borrow less and spend less. Car sales have fallen 25% yr, and total retail sales are falling. Employment is falling by 100k per month,

and we expect that to accelerate to 140k per month in H1 2009. This would be enough to take the unemployment rate to 7.75%. By comparison, unemployment reached 7.6% during the 1991 recession. We now expect an outright GDP contraction in 2009 and a Fed Funds Rate trough of 0.5%.

## China

Inflation is fast receding and fears of an economic slowdown have come to the fore. At the time of writing China's official data to hand related to August and September, and was quite upbeat: industrial production up 12.8% yr, retail sales up 21.9% yr, and fixed asset investment up 27.4% yr. But anecdotes, news reports, and perspectives gained on a visit to China by a Westpac economist all suggest that October has

been horrendous. There are reports that toy makers have very few orders for Christmas, thousands of factories are closing (including some where owners simply walk away leaving huge debts), mass layoffs are occurring, and iron ore is piling up at Chinese wharves for lack of demand from steel mills. The declines we have witnessed in commodity prices and shipping rates (which have fallen 93%) is certainly consistent with

a Chinese slowdown, since China was the key force that drove commodities up in the first place. Chinese authorities have announced a huge fiscal stimulus package equivalent to half a trillion US dollars, as well as cutting interest rates and slowing the pace of exchange rate appreciation. We still expect Chinese growth to slow to 8.5% before these policy measures gain traction and growth reaccelerates.

## UK and Europe

The UK economy is deteriorating sharply. House prices have fallen 14% in the past year, and credit is extremely difficult to obtain. UK banks have been among the world's hardest-hit in the credit crunch, prompting a Government offer to partially nationalise all of the big banks. GDP growth was zero in Q2 and the manufacturing and service purchasing managers indices (key leading indicators)

have fallen to record lows. We now expect an outright contraction of 0.2% annual GDP in 2009.

Eurozone GDP contracted by 0.2% in 2008 Q2. Ireland and Spain are in similar predicaments to the UK, but the rest of the Eurozone had been faring somewhat better until recently. France and Germany are suffering contagion, with export demand well down and indicators

pointing to recession. The situation could soon get worse if European banks that suffered from exposure to America's toxic mortgage-backed securities have to deal with losses in Eastern Europe (see below).

Following the collapse of its three huge banks, Iceland's sharemarket has plunged 93%, inflation and interest rates have raged upwards, and the exchange rate has collapsed. Trading in the Icelandic

Krona actually ceased altogether for a period. Iceland was forced to borrow emergency funds from the IMF and others to allow limited sales of foreign exchange for purchasing essentials such as food and medicine. Icelandic economists think GDP will contract by 10% and inflation will

rise to 75% in the next year. Iceland is tiny, but worth illustrating because other economies could follow. Eastern Europe is particularly vulnerable because of huge mortgage debts denominated in euros, Swiss Francs or yen. Eastern European exchange rates have dropped, making

those debts much larger and potentially unserviceable. Add to that a serious economic slowdown due to lower export demand, and Eastern Europe could be in for a very nasty recession. Hungary and Belarus have already appealed for IMF help.

## Rest of the world

The Japanese economy contracted by a surprisingly steep 0.6% in 2008 Q2, due to a fall in the terms of trade. Japan's terms of trade have since improved, but the stronger Yen will do little to help the vulnerable export sector. Surveys have revealed declining confidence. We are

forecasting -0.1% GDP growth in 2009.

Most of Industrial South East Asia is suffering an economic slowdown associated with reduced export demand. India is faring better, as it is less exposed from a trade perspective and is benefiting from lower oil prices, but funding the

current account deficit could become difficult. It is too early to assess the impact of falling commodity prices on the commodity exporting nations, but if share markets are any gauge, Russia and Brazil have been hit hard.

## Economic and Financial Forecasts

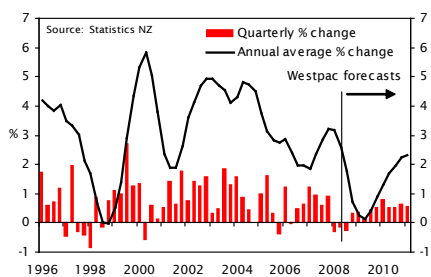
Economic Forecasts (Calendar Years)	2003	2004	2005	2006	2007	2008f	2009f
<b>New Zealand</b>							
Real GDP % yr	4.1	4.5	2.7	2.0	3.2	0.7	0.9
CPI inflation % annual	1.5	2.7	3.2	2.6	3.2	3.7	2.0
Unemployment %	4.6	3.6	3.6	3.8	3.4	4.4	5.6
Current Account % GDP	-4.3	-6.4	-8.5	-8.8	-8.2	-8.9	-5.3
<b>Australia</b>							
Real GDP % yr	3.1	3.6	2.8	2.7	4.2	2.5	2.0
CPI inflation % annual	2.4	2.6	2.8	3.3	3.0	4.9	3.1
Unemployment %	6.1	5.5	5.1	4.8	4.4	4.3	5.2
Current Account % GDP	-5.6	-6.2	-5.8	-5.3	-6.2	-4.4	-4.4
<b>United States</b>							
Real GDP %yr	2.5	3.9	3.1	2.8	2.0	1.4	-0.3
Consumer Prices %yr	2.3	2.6	3.4	3.2	2.9	4.3	1.5
Unemployment Rate %	6.0	5.5	5.1	4.6	4.6	5.6	7.3
Current Account %GDP	-4.8	-5.7	-6.1	-6.0	-5.3	-4.9	-4.5
<b>Japan</b>							
Real GDP %yr	1.8	2.3	1.9	2.8	1.9	0.3	-0.2
Consumer Prices %yr	-0.4	-0.1	-0.3	0.2	0.1	1.4	0.5
Unemployment Rate %	5.0	4.5	4.4	4.1	3.9	4.1	4.6
Current Account %GDP	3.1	3.3	3.6	3.9	4.8	3.8	3.9
<b>Euroland</b>							
Real GDP %yr	0.8	2.0	1.5	2.8	2.6	1.1	0.0
Consumer Prices %yr	2.1	2.1	2.5	2.0	3.1	3.5	1.4
Unemployment Rate %	8.8	9.0	8.8	7.9	7.3	7.8	8.8
Current Account %GDP	0.6	0.0	-0.2	-0.5	0.0	-0.2	0.4
<b>United Kingdom</b>							
Real GDP %yr	2.6	3.2	1.9	2.8	3.0	0.8	-0.8
Consumer Prices %yr	1.4	1.3	2.1	3.0	2.1	4.0	1.5
Unemployment Rate %	3.1	2.8	2.8	3.0	2.5	3.1	4.5
Current Account %GDP	-1.8	-1.9	-2.6	-3.0	-3.5	-3.5	-3.5

Forecasts finalised 7 November 2008

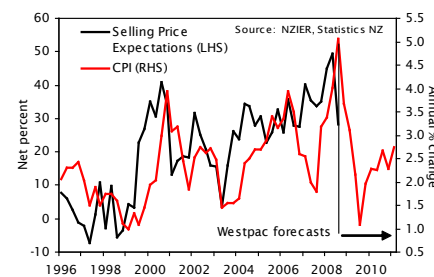
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Annual Average % change	March years				Calendar years			
	2008	2009f	2010f	2011f	2007	2008f	2009f	2010f
Private consumption	3.3	-0.1	-0.1	1.1	4.1	0.2	-0.1	0.7
Government consumption	4.1	5.0	4.1	4.1	3.6	5.0	4.3	4.1
Residential Investment	3.8	-18.2	-5.2	6.9	4.5	-15.1	-9.9	5.2
Business Investment	4.4	4.5	-6.9	8.0	4.7	5.5	-7.1	6.2
Stocks (% Contribution)	0.9	-0.8	0.0	0.5	0.4	-0.1	-0.7	0.7
GNE	4.5	0.4	-0.8	3.7	4.5	1.4	-1.4	3.2
Exports	2.3	1.0	1.0	3.5	3.3	1.5	0.6	2.8
Imports	9.7	1.1	-5.9	7.5	8.7	4.7	-7.4	5.7
<b>GDP (Production)</b>	<b>3.2</b>	<b>0.3</b>	<b>1.3</b>	<b>2.3</b>	<b>3.2</b>	<b>0.7</b>	<b>0.9</b>	<b>2.2</b>
Employment annual %	-0.2	-0.1	-1.1	1.1	2.4	-0.5	-2.1	0.9
Unemployment Rate % s.a.	3.7	4.6	5.4	5.1	3.4	4.4	5.6	5.2
Average Hourly Earnings annual %	4.4	5.4	3.6	3.2	4.0	5.4	4.0	3.2
CPI annual %	3.4	3.1	2.3	2.7	3.2	3.7	2.0	2.3
Current Account Balance % of GDP	-8.0	-8.6	-4.9	-5.0	-8.2	-8.9	-5.3	-5.0
Terms of Trade	11.6	-1.0	-1.5	2.0	8.8	0.7	0.9	1.5
90 Day Bank Bills (end of period)	8.82	5.40	5.30	6.20	8.77	6.30	5.30	5.90
5 year swap (end of period)	8.01	5.50	5.70	6.25	8.10	6.00	5.65	6.10
TWI (end of period)	71.9	53.2	57.9	61.6	71.0	55.8	56.3	61.1
NZD/USD (end of period)	0.79	0.52	0.58	0.62	0.76	0.55	0.56	0.62
NZD/AUD (end of period)	0.87	0.81	0.82	0.86	0.86	0.82	0.81	0.86
NZD/EUR (end of period)	0.53	0.42	0.45	0.46	0.53	0.44	0.44	0.46
NZD/GBP (end of period)	0.40	0.35	0.36	0.34	0.37	0.35	0.36	0.34

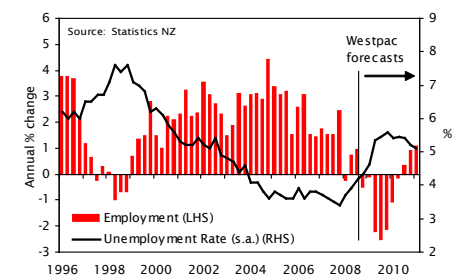
Production-based GDP



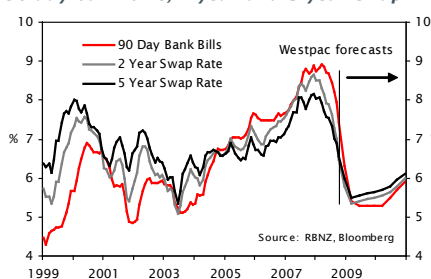
CPI and selling price expectations



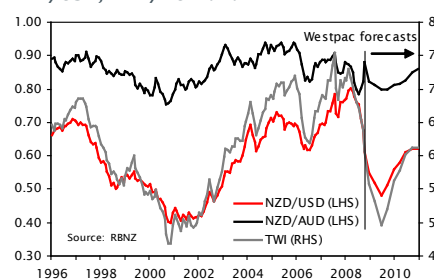
Household labour force survey



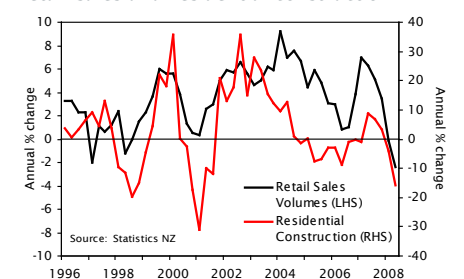
90 day bank bills, 2 year and 5 year swap



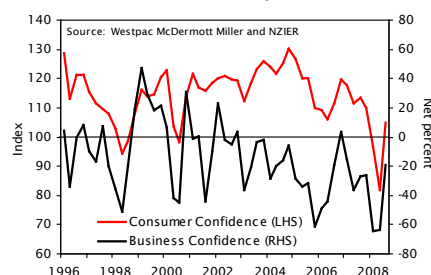
NZD/USD, NZD/AUD and TWI



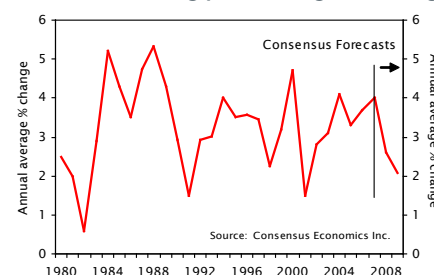
Retail sales and residential construction



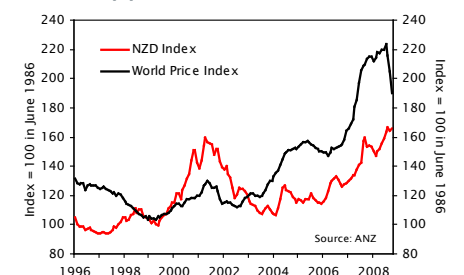
Consumer and business confidence



World GDP - trading partner weighted average



Commodity prices



Prepared by the Economics Department, Westpac, PO Box 691, Wellington, email economics@westpac.co.nz.

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