Economic Overview

October 2010

Highlights

- **Keeping the faith** – economic momentum all but stalled in the second quarter and near-term indicators are weak. As such, we have revised down our forecasts for growth in the second half of 2010. However, we think extrapolating the current weakness through into 2011 would be a mistake. The key drivers of recovery remain in place and should support above-average GDP growth next year *(see Economic Outlook, page 2)*.
- **Shaken but not stirred** – rebuilding in the Canterbury region will be a key driver of overall growth in 2011 as it bolsters activity in the construction sector. Tax cuts and improving labour market conditions will support a modest improvement in retail trade and associated industries. Agricultural and manufacturing production are expected to improve from drought-stricken levels early in 2010, although severe spring snowstorms will dampen prospects in the near term *(see Sectoral Trends, page 4)*.
- **An emerging trend** – the world economy continues on its vigorous recovery path. We predict world GDP will expand by 4.4% in 2010. However, the growth will remain far from uniform *(see International, page 8)*.
- **Financial markets** – ‘currency wars’ are the talk of exchange rate markets, but we suggest the term overlooks the forces that are actually driving exchange rates at the moment. Meanwhile, the RBNZ dramatically altered its outlook for growth, inflation and interest rates in the September *Monetary Policy Statement*. We now expect the next OCR hike in March 2011 *(see The Markets, page 6)*.
- **Household habits** – in our *Feature* article this quarter we take a closer look at one key point of difference between our forecasts and the RBNZ’s – that of consumer spending behaviour. In particular, we aim to address the question, ‘will NZ households spend in line with income growth like we assume or, faced with very weak asset prices, will they become even more cautious as the RBNZ expects?’ *(see Feature article, page 10)*.

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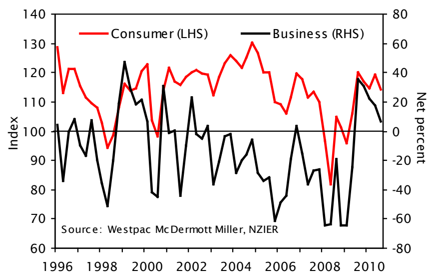
Keeping the faith

The economic recovery has slowed to a snail's pace and near-term indicators are soft. The good news is that the key pillars of growth heading into 2011 remain in place. Moreover, reconstruction following the Canterbury earthquakes, along with the prospect of low interest rates persisting for longer, have strengthened the case for above-average growth through 2011.

The economic recovery has been battered in recent months. More often than not, the economic data has disappointed, coming in at the lower end of (if not below) market expectations. A major blow came with the release of June quarter GDP figures, which showed that economic activity expanded by just 0.2% in the quarter, well below market expectations and a little too close to the 0% mark for comfort. And, the subdued forward-looking indicators are just as concerning.

Confidence is a key component of economic recoveries, because without it businesses are reticent to employ and invest and consumers remain till-shy. Unfortunately, business surveys show that confidence has fallen from the lofty heights reached earlier this year. The main activity indicators have fared a little better, with employment and investment intentions remaining slightly above their long-run averages. But we would expect to see them well above current levels at this stage of the recovery.

Figure 1: Business and consumer confidence



Confidence in the consumer sector has also declined, albeit to a lesser extent than amongst businesses. At current levels, confidence remains above long-run averages and is broadly suggestive of consumers still having a reasonable willingness to spend. Translating that willingness to spend into actual spending is the problem. We think the explanation is a moribund housing market, and – to date – slow income growth.

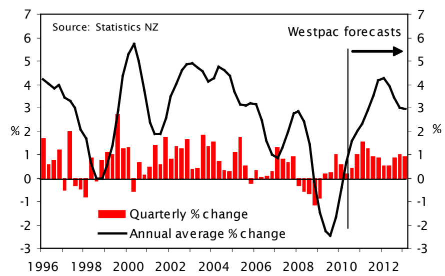
The New Zealand recovery story has also been hobbled by data problems. Communication sector activity has improbably fallen 7.5% in the last three quarters (even though employment in the sector has risen in the same period). We estimate that if the sector had grown at its trend growth rate in the last three quarters, annual GDP growth would have been closer to 3% than 2%.

Taking all this into account, we have shaved our forecasts for growth in the second half of 2010. We now expect GDP in the year ended December 2010 to grow by 2.0%, down from the 2.9% forecast in our last *Economic Overview*.

However, looking to 2011, we see little reason to dismiss the recovery story. The key drivers of recovery remain intact, including: ongoing global healing; strong commodity prices; continued monetary and fiscal stimulus; a better growing season; an improving labour market; and, population growth. These factors will sustain growth in our export sector and will drive an improvement in the domestic sectors of the economy. Our forecasts see GDP growth of 4.2% in 2011, which is at the top end of market expectations. From 2012, we expect GDP growth to return toward trend as reconstruction activity loses momentum, while tighter monetary and fiscal policy dampens overall spending growth.

As always, our forecasts need to be read in the context of widespread uncertainty. Globally, our forecasts assume a modest recovery in the US, an orderly resolution to sovereign debt concerns in Europe, and continued strength in emerging markets. Domestically, the future behaviour of the consumer remains a critical part of the recovery story.

Figure 2: GDP production



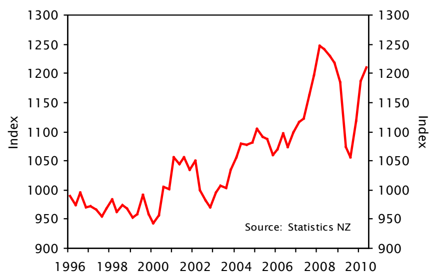
Export success to continue

The export sector is expected to remain at the forefront of NZ's recovery over the coming year. New Zealand's major trading partners are projected to grow at an above-trend 4.4% pace in 2010, and a respectable 3.6% in 2011. And, importantly, the growth remains focused on those areas where NZ has been growing its share of exports in recent years – emerging markets and Australia.

Indeed, growth in emerging markets will be key for our export sector going forward. Strong demand from countries like China and India, at a time when supply is constrained, will continue to support our commodity prices for some time to come. At present, export commodity prices remain near record highs, even taking account of the strong New Zealand dollar.

The strength in export commodity prices has seen our terms of trade soar, rising almost 13% over the past year, the fastest annual pace since 1979. The terms of trade reflect New Zealand's international purchasing power, so an increase unambiguously leaves the country better off, whether it's through higher export incomes, or cheaper imported goods and capital equipment. Right now we're benefiting from both.

Figure 3: Terms of trade



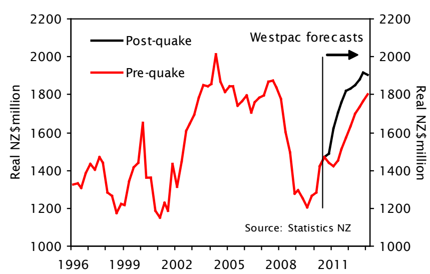
Investment: rescued by an earthquake

Both residential and business investment have been slow to pick up the growth baton in this recovery, although the latest GDP figures reveal some catch-up in the June quarter, with construction sector activity growing by 6.4%. However, indicators suggest that the growth momentum in the construction space has since slowed, with profitability down, building investment intentions falling, and residential and non-residential building consents collapsing. Import data suggest a more promising outlook for plant and machinery investment, with the value of plant and machinery imports having recovered about half of their 2008/09 peak-to-trough decline. Even so, prior to the Canterbury earthquake, the outlook for investment growth was looking pretty grim.

However, the 7.1 magnitude earthquake on September 4, while devastating in the near term, has essentially filled the growth hole that was beginning to emerge in the construction sector. The building and infrastructure cost of the earthquake has been estimated at around $4bn or 2.1% of national GDP. Previous work on the potential economic impact of a major earthquake in Wellington put the cost of interruption to business at around 15% of the capital loss. So if the final bill does come in around $4bn (ignoring damage to inventories) that would equate to a short term income loss of $600mn (or 0.3% of GDP).

Over the medium term, the local and national economies are likely to get a substantial boost from reconstruction activity – and one that will be much larger than the initial income loss. Our forecasts assume around $2bn of rebuilding in the residential space, with a further $2bn going toward non-residential buildings, and infrastructure. We also assume that the reconstruction work will extend outside our forecast horizon. However, the big boost to investment and hence GDP growth will come in the December 2010 and March 2011 quarters as construction activity steps up to a higher level. It is important to remember that the national balance sheet has been weakened by this event. A substantial boost to GDP is needed just to get the capital stock back to where it was before the earthquake.

Figure 4: Residential investment



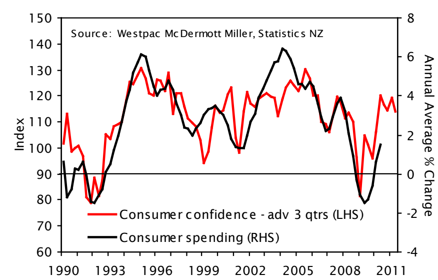
Consumers: savers or spenders?

After a splurge of activity in the second half of 2009, consumer spending has been stuck in the slow lane so far in 2010. We can attribute at least some of the consumer malaise to weakness in the housing market over the course of this year (partly due to the negative short-term impact of tax changes on property). After a strong pickup through to mid-2009, housing turnover has fallen back to near its 2008 lows. We expect some signs of improvement in the housing market by early next year. Mortgage rates and net migration trends have turned more favourable in recent months; in time, this will show up as stronger sales, and eventually in better prices. However, "improvement" in this context will probably mean a shift from gently falling to flat price growth. We are not going back to last decade's house price-fuelled consumer spending.

What consumer spending will respond positively to are incomes, tax cuts, and low interest rates. On the income score, recent developments have been disappointing, with the June quarter Household Labour Force Survey revealing a surprisingly sharp lift in the unemployment rate from 6.0% to 6.8%. While that needs to be put in the context of widespread scepticism about the previous quarter's plunge from 7.1% to 6.0%, it is clear that firms have been slow to hire additional staff. The upshot has been reduced pressure in the labour market and slow wage growth so far this year.

As the economy improves, we expect the unemployment rate to fall gradually, reaching 5.0% by the end of 2011. That should drive wage growth higher, with our forecasts putting annual wage growth at 2.7% in December 2011, from 1.6% currently. In addition, the increased cash from higher commodity prices is only just starting to flow. So, after a period of deleveraging by the household sector, we believe better income growth will unleash some demand. We expect consumer spending to grow broadly in line with income growth over the next few years.

Figure 5: Consumer spending and confidence



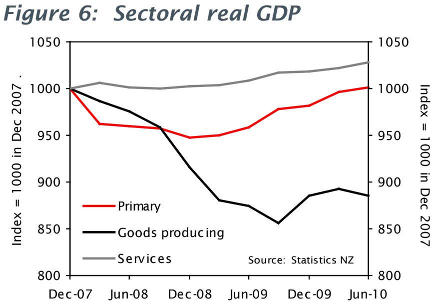
Shaken but not stirred

Over the coming year stronger income growth, supported by high commodity prices and a strengthening labour market, will see a modest improvement in retail trade and associated industries. Meanwhile, rebuilding in Canterbury will bolster activity in the construction sector, and recovery from drought will assist growth in the primary and manufacturing sectors.

Overview

The goods-producing sectors bore the brunt of the impact of the global financial crisis, and activity remains well below pre-GFC levels. In contrast, the primary and service sectors of the economy have recovered to pre-recession levels *(Figure 6)*. In the case of agriculture this has occurred despite the sharp drop in volumes following the 2010 autumn drought. Boosting the performance of this sector has been the strong rebound in commodity prices. In aggregate, world prices are up 59% and, despite an appreciating currency, New Zealand dollar prices are 31% above their 2009 lows *(Figure 7)*. With import prices remaining contained, this has driven an almost 13% improvement in New Zealand's terms of trade. Higher rural incomes will help bolster farm balance sheets, and eventually support a pickup in on-farm spending and investment.

Figure 6: Sectoral real GDP



The effects of the Canterbury earthquake will have a substantive impact on the shape of activity over the remainder of the year and into 2011. Forecasts of construction activity have been upgraded to reflect the significant rebuilding that will be undertaken in the region.

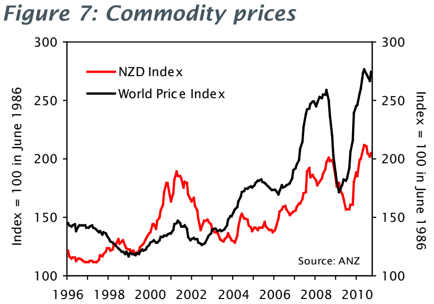
Agriculture

Agricultural production fell 2.1% in the June 2010 quarter, largely as a result of lower milk production as the late season drought took its toll. The severe spring snow storms in mid-late September are likely to hamper the recovery in production through the third quarter. However, growing conditions have improved dramatically in October and we are looking for the entire 2010/11 season to be substantially better than the last.

Price news is positive with world commodity price rises outpacing gains in the New Zealand dollar. September world commodity prices were 33% up on a year ago, while NZ dollar prices gained 27% over the same period. Strength has been broad based with dairy, meat, wool, forestry, seafood and aluminium prices all up.

The forestry sector continues to benefit from strong Chinese and, increasingly, Indian demand with activity increasing 1% in the June quarter. This sector has rebounded strongly over the last 18 months, and the June quarter outturn marked the sixth consecutive quarter of growth. Mining activity jumped 5% in the second quarter on the back of increased exploration activity.

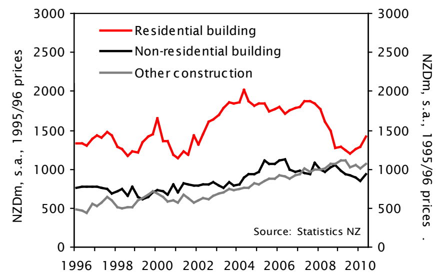
Figure 7: Commodity prices



Construction

Construction activity stepped up in the June quarter. Residential construction led the way, up a whopping 11.1% in the quarter, while non-residential construction posted a creditable 9% rise. We think this was a case of the statistics catching up with reality, and some of the growth may have actually occurred in late 2009. But as Figure 8 shows, even with the pickup, activity in both sectors remains well below pre-recession levels.

Figure 8: Construction activity by sector



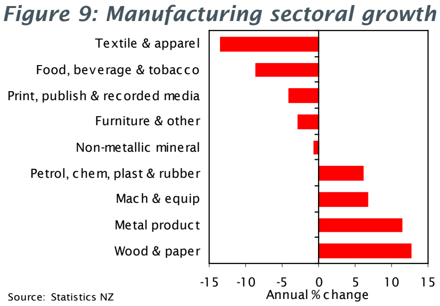
Going forward, construction activity will be dominated by the impact of the Canterbury earthquake – outside this, activity is likely to be weak. Residential consents fell 18% in August, reaching their lowest level since July 2009, while non-residential consents are around 22% below levels of a year ago. But this lack of activity beyond Canterbury is something of a silver lining for Cantabrians wanting repair work undertaken in a timely manner, as it should allow resources to be redirected into their region.

Manufacturing

Manufacturing activity in the June quarter was down 4%, depressed by the autumn drought that curtailed agricultural production and hit food-related manufacturing hard. We expect activity to rebound smartly in Q3, although the spring storm will temper prospects.

Manufacturers exporting to Australia have been benefiting from a cross rate hovering near ten-year lows and a buoyant Australian economy. In contrast, manufacturers exporting to US dollar markets are facing a NZ dollar that is expected to push back toward decade highs. Total exports into Australia for the year to August are up 13% on the same period last year, while exports to the US are down almost 10%.

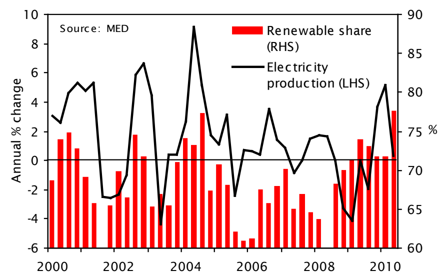
Figure 9: Manufacturing sectoral growth



Electricity, gas and water

Electricity generation edged lower in the June quarter (down 0.9% s.a.) as energy-intensive sectors such as manufacturing softened. The sector did, however, make a (very small) contribution to GDP growth due to a jump in the proportion of electricity generated by renewable energies. Hydro generation picked up as lake inflows returned to normal levels after drought and the Nga Awa Purua geothermal power station came online. Renewables energy production

Figure 10: Electricity generation, s.a.



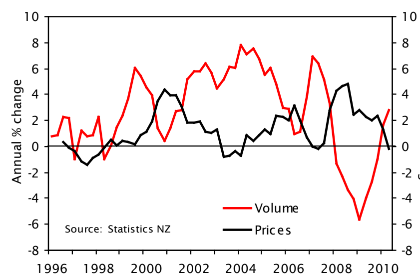
is set to rise over the next year with the growing availability of energy produced by wind farms. A number of wind farms are currently in the pipeline, either in construction or undergoing the resource consent process, with the potential to come online over the next 18 months.

Retail trade

Consumers remain circumspect and activity in the retail sector continues to be subdued. Housing market weakness, high unemployment and lacklustre wage growth have weighed on activity. We did see some spending brought forward to the final days of September to beat the GST hike, but much less than in 1989.

Looking ahead, we think improving after-tax wages, rural income growth and modest improvements in the outlook for the housing market should provide some support. However, consumption growth is still expected to underperform relative to GDP growth throughout 2011.

Figure 11: Retail sales growth

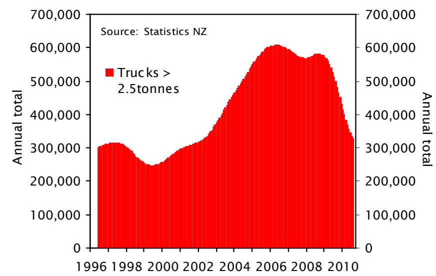


Transport and communication

Activity in the transport sector tends to move in sympathy with the broader economy, and soft GDP growth in the June quarter was reflected in weak transport activity. The transport and storage sector matched the 0.2% growth in the general economy. Activity levels in the sector are still 8% below where they were two years ago.

The decline of 2.6% in communications came hard on the heels of two consecutive quarters of 2.2% declines – a big surprise for a sector which has averaged 2% quarterly growth for the last 20 years. We think a partial explanation is found in the way activity in the sector is measured. Statistics NZ is counting fewer minutes spent on landline and mobile phone calls, but not adequately accounting for greater use of high-speed internet communication and alternatives such as Skype when it calculates GDP. Should this continue to be the case, the sector will likely weigh on GDP growth going forward.

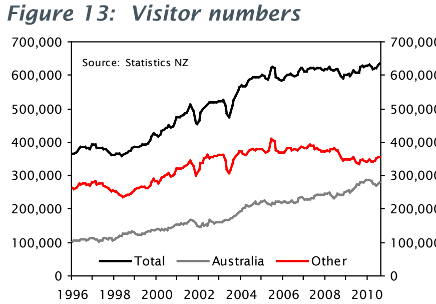
Figure 12: Truck registrations



Tourism

After partially running out of steam early in 2010, visitor arrivals have picked up, led by an increasing number of visitors from Australia. The strong labour market, generally buoyant economy, and a high Australian dollar are all likely to encourage Australians to take a holiday across the ditch. Conversely, a relatively weak pound and US dollar are likely to be reducing the attractiveness of New Zealand as a holiday destination for British and American tourists. Visitor arrivals from the UK and US are down on the levels of a year ago. Looking ahead, the 2011 Rugby World Cup will provide a boost, with growth in visitor arrivals to head toward double digits.

Figure 13: Visitor numbers



War! What is it good for?

Talk of a 'currency war' between nations overlooks the forces that are actually driving exchange rates at the moment. The US, and perhaps others, are expected to take steps that will weaken their currencies – but as a side-effect of expanding the money supply, a short-term response to an economy struggling with low growth. The RBNZ's dimmer view of household behaviour suggests that it will continue to favour a lower and slower tightening cycle.

Exchange rates

It has suddenly become fashionable to talk about a global 'currency war': the idea that nations are trying to manipulate their exchange rates lower, to benefit their own economy at the expense of others. But since an exchange rate is a relative price – a fall in one currency implies that another must rise – not everyone can do this at the same time. So the risks of a global currency war are, at best, a round of tit-for-tat devaluations that proves to be futile; at worst, it could lead to other forms of retaliation such as trade and capital controls, which ultimately harm both sides.

Tensions over exchange rate policies are nothing new – from time to time, political wrangling lures countries into attempting to subsidise exporters by lowering the exchange rate (while sometimes the politics leans the other way, where the temptation is to subsidise consumers by pushing the exchange rate up). Indeed, this has more of the aspect of a 'cold' war, with tensions simmering in the background for decades, flaring up occasionally as a result of domestic issues more often than not. In this case, the issue in the US is the slow pace of recovery and stubbornly high unemployment, which is now widely expected to prompt the Federal Reserve into another round of 'quantitative easing' of monetary policy. In Asia, the issue is a fear of destabilising capital inflows, after the experience of the 1998 Asian crisis.

While these tensions do have implications for exchange rates, neither part of the phrase 'currency war' really captures what financial markets are responding to at the moment. First, quantitative easing is aimed at stimulating US demand from what is perceived to be inadequate levels, to ease the risk of a slide into deflation. All else equal, an increase in the supply of US dollars relative to other countries will push down the price, so a lower exchange rate is one side-effect of monetary easing. But it's not the end goal, nor is it a particularly important channel for the US economy (where exports account for only 12% of GDP).

Second, it's easy to overstate the degree of conflict. The US is the only country that has shown any intention of taking substantial policy measures. The responses so far – some ineffectual intervention by Japan to weaken the yen; marginally stronger restrictions on capital inflows by developing economies such as Brazil – have generally been in keeping with past behaviour. Neither currency markets nor global share prices (which are nearing two-year highs) are conveying a fear of retaliation.

That said, each country will need to make its own choice about how to respond to money-printing in the US. In regions such as the UK and Europe, where demand is also weak, engaging in further easing of their own is a suitable response. In contrast, many parts of developing Asia are already at risk of overheating; while they may be reluctant to let their currencies rise against the US dollar, the only real alternative is a gradual loss of competitiveness through higher inflation.

Where does that leave New Zealand? Well, we need to be careful of overstating how much we've been caught up in the 'currency war'. The NZ dollar is at a one-year high against the US dollar, but is close to ten-year lows against the Australian dollar; it's gained against the euro and pound, but fallen against the yen. Overall, the NZD has been

***Figure 14: NZD/USD and TWI** (monthly average)*

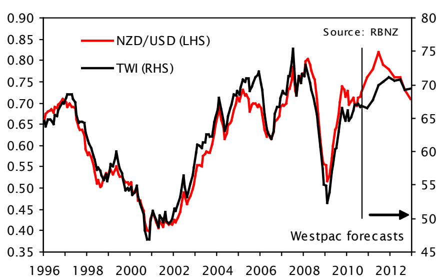


***Figure 15: NZD/AUD and NZD/JPY** (monthly average)*

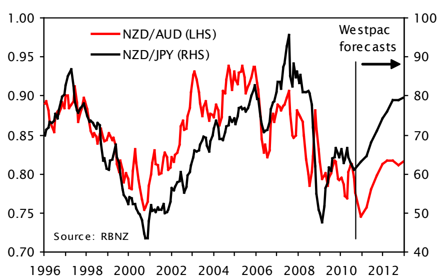
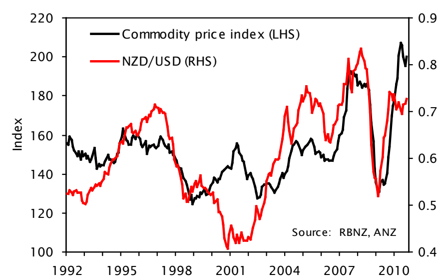


Figure 16: NZD/USD and commodity prices, adjusted for inflation



remarkably stable – in fact, the 8% range in the trade-weighted index over the last year marks this as one of the most stable periods since the currency was floated. Given the sustained strength of our commodity export prices, it's hard to say that the NZD has diverged from fundamentals in a way that would concern policy makers.

We emphasise that the key factors for the NZD are the strength of the market for our commodity exports and the outlook for the USD. New Zealand was relatively slow to engage with the fast-growing Chinese market, but has rapidly made up for this in the last few years. This is a major reason why the world prices for our commodity exports are near record highs, and why we expect these higher ranges to be sustained. The USD's fortunes will depend on the extent of quantitative easing, relative to what currency markets have already priced in. Our forecasts assume a more substantial easing programme that will drag down the USD through to the middle of 2011.

Interest rates

The RBNZ performed a dramatic about-face in the September *Monetary Policy Statement*, slashing its growth forecasts and projecting a significantly lower peak in the OCR. The spate of weaker data in recent months explains part of this change, but it appears that a large share of it was due to a sudden change in view on the behaviour of households and businesses. The RBNZ argues that households have become focused on saving and paying down debt, to a much greater extent than it had expected.

The RBNZ has also taken a much more sanguine view of inflation. Excluding various government policy-related charges, it now expects underlying inflation to settle right in the middle of the 1-3% target band. That forecast relies on households and firms not just looking through the upcoming spike in headline inflation, but actively downgrading their longer-term inflation expectations during this time.

Any such moderation in expectations has to be earned, and that clearly won't come from observed inflation (annual inflation is about to breach the upper end of the target band for the third time in five years) or any meaningful tightening in monetary conditions. The RBNZ has acknowledged that an upturn in expectations would require higher interest rates than in its central view, although at other times it has suggested that it will only respond once higher inflation expectations are already embedded in wages and prices.

While we disagree with some of the RBNZ's biggest assumptions – that households will further increase their savings, that inflation expectations will remain contained, and that the rise in the terms of trade will be temporary – these are the sort of things that would take a long time to disprove. In the meantime, that suggests the RBNZ is likely to err on the side of lower interest rates and inflation outcomes in the upper half of the target range. We now expect the OCR to reach 5.25% by late 2012 (previously peaking at 6.00%), with the next hike no earlier than March next year.

***Figure 17: 90 day bank bills, 2 year and 5 year swap rates** (monthly average)*

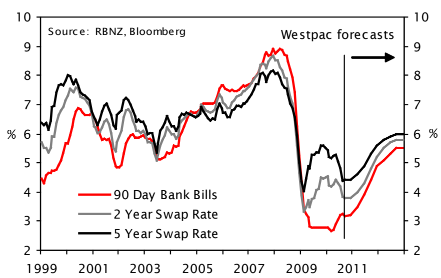
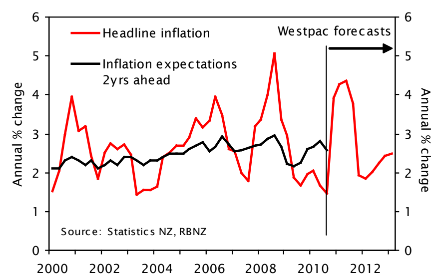


Figure 18: CPI and 2yr ahead inflation expectations



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-10	3.00	3.20	3.80	4.40	0.76	0.75	63.1	66.6
Mar-11	3.25	3.50	4.00	4.60	0.78	0.76	64.7	67.8
Jun-11	3.50	3.90	4.30	4.90	0.82	0.78	68.1	69.9
Sep-11	4.00	4.40	4.80	5.30	0.79	0.80	71.1	70.4
Dec-11	4.50	4.90	5.20	5.60	0.78	0.81	74.1	71.1
Mar-12	4.75	5.10	5.50	5.80	0.76	0.82	76.0	70.5
Jun-12	5.00	5.30	5.70	5.90	0.76	0.82	79.0	70.8
Sep-12	5.25	5.50	5.80	6.00	0.73	0.81	78.8	69.3
Dec-12	5.25	5.50	5.80	6.00	0.71	0.82	79.5	69.4
Mar-13	5.25	5.50	5.80	6.00	0.71	0.81	80.7	69.2
Jun-13	5.25	5.50	5.80	6.00	0.70	0.81	81.9	69.0
Sep-13	5.25	5.50	5.80	6.00	0.70	0.81	83.1	68.9

An emerging trend

This quarter we review the biggest economic theme of our times – rapid growth in emerging markets, combined with stagnation in the "old industrial" countries. These changes are ultimately good for global growth, but along the way they are generating financial imbalances and political tensions.

The big picture

The world economy continues on its vigorous recovery path. We predict world GDP will expand by 4.4% in 2010, while the IMF's forecast is 4.8%. However, in the ruthless and competitive hunting grounds of the global economy, some countries look like lions, while others play the part of gazelles. The United States is experiencing slow economic growth, stubbornly high unemployment, and very low inflation. Parts of Europe are still in recession or experiencing disappointing growth, as they deal with the legacy of excessive government debt and burst housing bubbles. Meanwhile, emerging economies like China, India, and Brazil are powering ahead.

Only to a limited extent can current slow growth in the West be "fixed" by stimulatory monetary and fiscal policies. Strong growth in the mid-2000s was a debt-fuelled exception, not the rule. The West is suffering as much from a structural lack of competitiveness as a cyclical downturn. Emerging world competition for raw materials is keeping commodity prices high, depriving the West of the cheap oil that has facilitated past recoveries. Improving productivity and cheap labour in Asia is leaving Western producers uncompetitive.

There is a long and not-so-proud history of over-using cyclical tools in futile attempts to "fix" economies that have just experienced a let-down after a period of unsustainable growth. The consequences have typically been disastrous. America (as well as New Zealand) generated rampant inflation in an attempt to maintain 1960s growth rates after the oil shocks fundamentally lowered potential growth in the 1970s. Japan's decades-long attempts to "stimulate" growth after the bursting of its epic bubble has only resulted in mind-boggling government debt levels.

We may now be entering another period of overused cyclical tools. The United States and other Western nations are running massive and unsustainable fiscal deficits to ward off recession. That would have been a great idea, if it weren't for the fact that they also ran deficits during the boom times, and the imminent retirement of the baby boomers is about to impose further fiscal costs. The theory of Keynesian fiscal policy only works if applied symmetrically. The reality of the current situation is that the US, UK and others now face a large and possibly involuntary fiscal tightening in the future, be it sooner or later. When it happens there will be a fresh round of economic pain.

Impediments to the free flow of capital mean that the highest-growth region of the world (Asia) is saving too much and exporting capital, while the US is still saving at an unsustainably low rate, and is importing capital. The long-run consequence of failing to allocate global capital efficiently is lower global growth. The immediate consequence of imbalanced capital flows has been even worse – dangerous instability in financial markets and banking systems. Fixing these imbalances requires a higher real exchange rate in China and other emerging economies. But a global row has erupted in which each country seeks to reduce the value of its own currency – a race that is costly to run and will produce no winners. In any case, a real appreciation of the Chinese exchange rate is inevitable. The only question being whether it comes via Chinese inflation consistently exceeding US inflation, or via direct nominal appreciation of the yuan. So far it's been a bit of both. In the meantime, there is a danger that political tension arising from the changing global economic order could cause a trade war, stalling or reversing the process of global trade liberalisation that has been so beneficial.

While we recognise these political risks to the global economy, it still seems that the big picture is one of a solid upward trajectory for global growth. The dividend from China's decision to engage in global trade and liberalise its economy has been, and will continue to be, simply enormous. China's emergence will go on boosting global growth, spurring higher commodity prices, and undermining US, European and Japanese growth for a long time to come.

Australia stands with a foot in each camp of this divided world economy, and has a distinctly two-speed economy to show for it. Mining investment is booming, creating jobs, wealth, and importantly, fiscal revenues. But consumers are being squeezed by rising interest rates that are necessary to prevent inflation, and non-commodity exporters suffering from the high exchange rate.

Recent details by region

China experienced a policy-induced slowdown through the middle months of 2010, after the authorities clamped down on runaway growth for fear of inflation. In recent months there have been signs that the slowdown has run its course and the economy is once again accelerating.

United States data has had a disappointing tone to it ever since the removal of housing subsidies sent the housing market back into the doldrums. Payrolls data shows job numbers are shrinking once again, and unemployment is failing to fall. Inflation is uncomfortably low at 1.2%.

Australia's economic data has gone from strength to strength. Second-quarter GDP exceeded expectations at 1.2% and we expect through the year growth of 3.9% for 2010. However, consumer reluctance is seen in building approvals dropping away over recent months, and retail sales are exhibiting slow growth.

Europe's GDP has grown 1.9% over the past year, but in a microcosm of the global economy, the growth has not been distributed evenly. The "periphery" is suffering from appalling declines in GDP, while Germany's value-add grew 2% in a single quarter.

Japan's economy has lost momentum, with growth slowing from 1.2% in the March quarter to 0.4% in the June quarter. With inflation remaining firmly below zero, the Bank of Japan has announced a further monetary easing that is bold in construction but meek in scale.

Emerging Asia ex China's rates of GDP growth defy belief – almost 9% in India, almost 19% in Singapore. Across the region inflation and asset bubbles threaten, prompting central banks to tighten monetary policy in those jurisdictions where it is possible.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
New Zealand							
Real GDP % yr	3.2	1.0	2.8	-0.2	-1.6	2.9	4.4
CPI inflation % annual	3.2	2.6	3.2	3.4	2.0	4.7	2.4
Unemployment %	3.7	3.8	3.5	4.6	7.1	5.7	5.2
Australia							
Real GDP % yr	2.8	2.9	4.0	2.2	1.2	3.5	4.0
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.2	3.2
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.2	4.8
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	–2.6	2.5	1.1
Consumer Prices %yr	3.4	3.2	2.9	3.8	–0.3	1.5	2.2
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.2
Japan							
Real GDP %yr	1.9	2.8	2.2	–1.5	–5.8	3.3	1.1
Consumer Prices %yr	–0.3	0.2	0.1	1.4	–1.3	–0.8	–0.4
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.1	5.0
Euroland							
Real GDP %yr	1.8	3.2	2.9	0.3	–4.0	1.6	1.4
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.5	1.4
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
United Kingdom							
Real GDP %yr	2.2	2.8	2.7	–0.1	–5.0	1.4	1.1
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.8	2.8
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	4.5	5.0
China							
Real GDP %yr	11.3	12.7	14.2	9.6	9.1	10.3	9.1
Consumer Prices %yr	1.8	1.5	4.8	5.9	–0.7	3.0	2.8

Forecasts finalised 8 October 2010

Household habits

The RBNZ has taken an axe to their forecasts of the economy, particularly because they expect household savings to step up.

It is not surprising that the RBNZ lost faith. The run of international data had been poor, with mid-cycle slowdowns evident in the US, China and Japan. And while the international data has taken on a more positive tone since the start of September, New Zealand's data has continued to lose altitude.

Differing views

Some of the main differences between our more optimistic forecasts for the economy and the RBNZ's pessimistic view are:

- the RBNZ has yet to incorporate the effects of the Canterbury earthquakes into their forecasts;
- the RBNZ expects a significant fall in commodity prices, whereas we think they will prove more persistent; and
- the RBNZ is forecasting 2.5% employment growth next year and only 0.5% real consumption growth. In effect they are anticipating a step change in household saving behaviour next year.

The purpose of this article is to take a closer look at the third point of difference (which is strongly influenced by the second – the terms of trade): will NZ households spend in line with income growth like we assume, or will they become even more cautious as the RBNZ expects?

A bad rap

First up, we take issue with the popular (mis)perception that the debt-funded splurge of the 2000s was all the fault of the household sector.

Undoubtedly, NZ Inc went on an unsustainable borrowing binge – but it was not limited to households. The table below highlights that the appetite for debt in the 'naughties' knew no sectoral bounds. Growth in agriculture debt led the pack, mortgages second, business a close third, and consumer debt lagged the field.

Debt owing to M3 Financial Institutions, compound annual growth

	End 2000 – End 2007
Agri	15.1%
Business ex Agri	10.0%
Housing	12.6%
Consumer	9.0%
Total	12.0%

Source: RBNZ

** Through this period nominal GDP was growing at a compound rate of 6.4% p.a.*

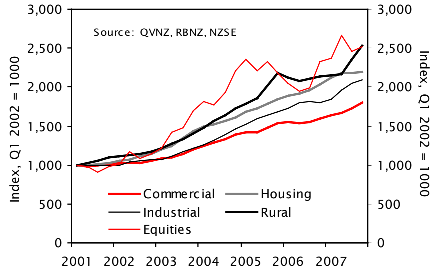
In the past two years, compound growth of business (including agriculture) debt was only 0.4% and total household 2.3%, at a time of nominal GDP growth of 3.8% p.a. So deleveraging has been occurring across the economy, and to date has been stronger in the business than the household sector.

The asset price surge that the torrent of borrowing unleashed was also not restricted to housing. Between the beginning of 2001 and end 2007, rural land values and equities increased by more than housing. And the increase in industrial land values was almost on a par with housing *(see Figure 19)*.

Rural, commercial and industrial real estate, and equity values, all subsequently underwent larger corrections than house values.

It is clear that the debt binge occurred across all broad sectors and fed all asset prices. The adjustment to this period of excess has, and will continue, to occur across the entire economy. The household sector has no need to bear a disproportionate share of the load.

Figure 19: NZ asset prices



Character assassination

The household sector has also fallen victim to bad data. Everyone 'knows' that the household sector has been dissaving – after all, that was the basis on which a bevy of distortionary pro-savings policies were sold to us. Actual analysis of household saving shoots this 'knowledge' down in flames.

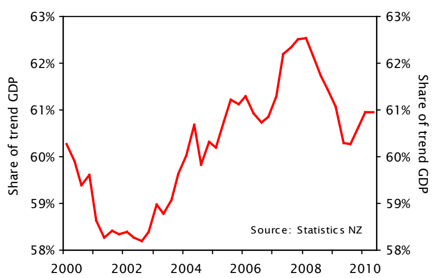
In a recent study of household wealth and saving in New Zealand[1], Motu found "even the most conservative estimate of household saving was at least 14% of gross income during this time period (2004-2006). On the other hand, the indirectly derived Household Income and Outlay Accounts (HIOA) indicate (net) household saving was -12.5% per year over the same period. We also find no evidence that capital gains in housing during this time period crowded out saving". But the household dissaving fallacy must have the spirit of the Phoenix rather than Icarus, as it refuses to die.

Of the deleveraging that has occurred in the household sector to date, Westpac's experience is that is has largely been of the "lazy" kind. As mortgage interest rates dropped markedly post the GFC, and as borrowers rolled off previous high rates, many kept their debt payments the same (and hence increased their principal payments). We don't think it likely that a significant number of borrowers will be ringing their banks next year and asking for their debt payments to be increased.

A matter of perspective

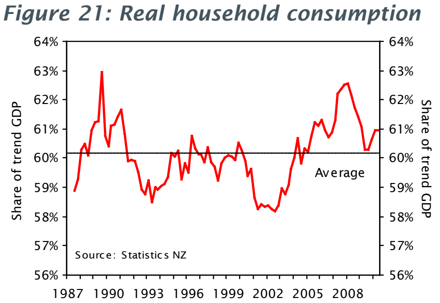
We often see a variant of Figure 20 being presented in official publications. It shows the size of household consumption relative to trend activity in the rest of the economy, in real terms.[2] The inference is that debt fuelled an unsustainable consumption splurge, with real consumption's share of the economy catapulting from 57% to 62.5% in just 5 years. The prognosis is that the consumer is set for numerous years of belt-tightening – more so than the rest of the economy – as payback for the years of gluttony.

Figure 20: Real household consumption



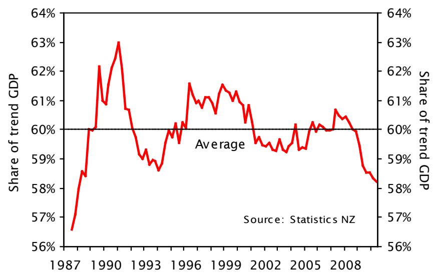
But a comparison with a larger slice of history sheds a different light. Real consumption's share of the economy is currently only just above its long-run average, and the implied degree of required correction is substantially less.

Figure 21: Real household consumption



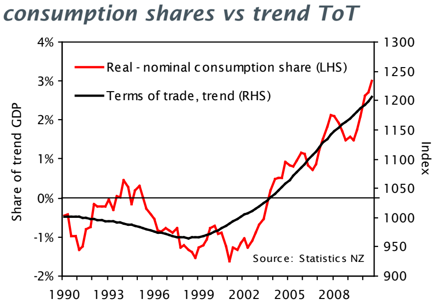
A fairer way of expressing consumption's share of the economy is to simply do it in nominal terms. Recasting the data in this manner *(see Figure 22)*, leaves one with an entirely different perception. The relative consumption boom of 2002 – 2007 was modest by historical standards and, as a share of the economy, is now a long way below its historic average.

Figure 22: Nominal household consumption



So why the massive divergence between consumption's share in nominal and real terms? The explanation lies with the deflators. Inflation of consumer goods prices was less than average inflation in the rest of the economy – particularly from 2002 to 2007. But the reason is the terms of trade (ToT). In Figure 23 we overlay the gap between real and nominal consumption shares (i.e., Figure 21 minus Figure 22) against the ToT.

Figure 23: Real minus nominal consumption shares vs trend ToT



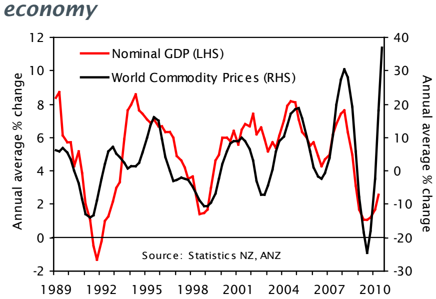
The terms of trade is the ratio of export prices to import prices, both expressed in New Zealand dollars. For a given volume of exports, the ToT measures how much by way of imports we can afford. A rise in the ToT basically means New Zealand gets more for what it produces. So we can consume more, without producing more. Between 2000 and June 2010, New Zealand's trend ToT rose around 22% (and is still rising). That has represented a massive relative price shock to the benefit of the New Zealand economy. A big part of the story has been the China factor: China's rapid growth has helped push up New Zealand's commodity prices, and the integration of their manufacturing capacity into the global economy lowered the price we pay for many imported consumer goods.

Different strokes

We expect NZ Inc to go through a continued period of deleveraging. That is why we are expecting growth in the economy to be far less than what the surge in commodity prices would historically suggest *(see Figure 24)*. However, we don't think that caution to be peculiar to the household sector (it hasn't so far). Rather, the load will be shared more broadly by business, government, and households.

To get such an aggressive adjustment in the household sector as the RBNZ is assuming requires a precipitous drop in commodity prices and/or a marked fall in house prices. We don't expect either to happen over the next couple of years, but only time will tell.

Figure 24: Commodity prices and the economy

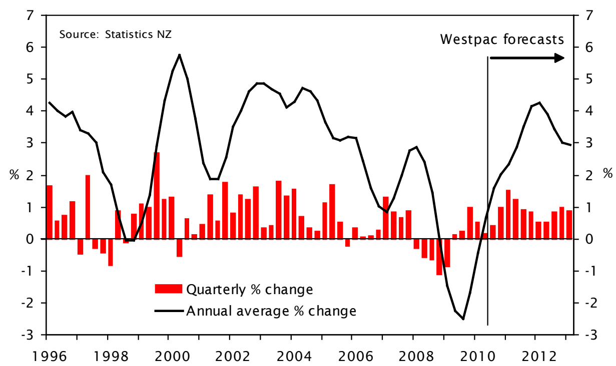


[1] Household Wealth and Saving in New Zealand: Evidence from the Longitudinal Survey of Family, Income and Employment. Trinh Le, John Gibson, Steven Stillman. Motu working paper 2010.

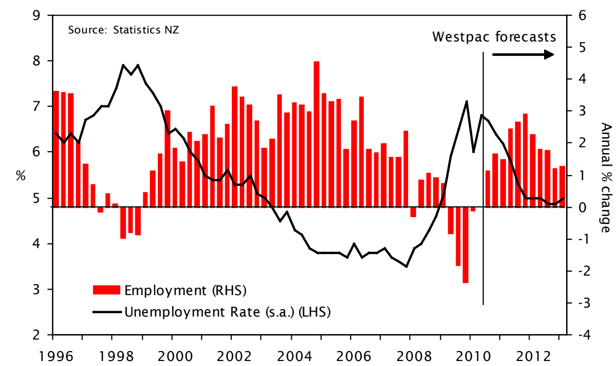
[2] We have an issue with comparing actual consumption with trend GDP, as it imparts an implied cyclical behaviour to consumption that isn't necessarily there in reality.

Annual Average	March years				Calendar years			
% change	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
Private consumption	0.6	1.9	2.4	2.3	-0.6	2.1	2.3	2.3
Government consumption	1.1	3.3	1.7	2.0	1.4	3.4	1.8	1.9
Residential Investment	-11.5	14.5	17.2	6.4	-16.8	9.4	18.7	8.4
Business Investment	-9.2	6.0	12.6	10.5	-10.2	1.6	13.6	10.5
Stocks (% contribution)	-1.9	0.7	1.2	-0.2	-2.7	1.1	1.0	0.0
GNE	-3.3	4.7	6.1	3.9	-5.1	4.1	6.2	4.2
Exports	3.2	1.5	4.5	3.7	0.4	2.6	3.7	3.9
Imports	-9.5	9.0	9.2	6.4	-14.8	8.6	9.2	7.2
GDP (Production)	**-0.4**	**2.3**	**4.3**	**3.0**	**-1.7**	**2.0**	**4.2**	**3.0**
Employment (% annual)	-0.1	1.5	2.3	1.3	-2.4	1.7	2.9	1.2
Unemployment Rate (% s.a. end of period)	6.0	6.2	5.0	5.0	7.1	6.4	5.0	4.9
Average Hourly Earnings (% annual)	1.6	2.2	2.8	3.4	3.1	1.3	2.5	3.3
CPI (% annual)	2.0	4.3	1.8	2.5	2.0	3.9	1.9	2.4
Current Account Balance (% of GDP)	-2.4	-4.0	-5.2	-5.3	-2.8	-3.6	-5.0	-5.5
Terms of Trade	0.1	5.8	0.8	1.4	-8.2	12.2	0.5	1.3
90 Day Bank Bills (end of period)	2.73	3.50	5.10	5.50	2.79	3.20	4.90	5.50
5 year swap (end of period)	5.27	4.60	5.80	6.00	5.56	4.40	5.60	6.00
TWI (end of period)	65.3	67.8	70.5	69.2	65.5	66.6	71.1	69.4
NZD/USD (end of period)	0.71	0.78	0.76	0.71	0.73	0.76	0.78	0.71
NZD/AUD (end of period)	0.78	0.76	0.82	0.81	0.80	0.75	0.81	0.82
NZD/EUR (end of period)	0.51	0.54	0.56	0.56	0.49	0.53	0.57	0.56
NZD/GBP (end of period)	0.45	0.47	0.45	0.41	0.45	0.47	0.46	0.42

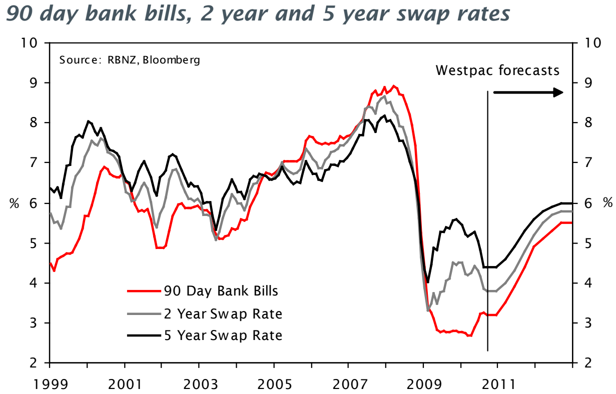
New Zealand GDP growth



New Zealand employment and unemployment



90 day bank bills, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI