9 December 2011

Westpac Institutional Bank

Hold your horses

NZD/AUD model update

- **The NZD/AUD cross rate has stayed low over late-2011 because adverse global credit conditions affect New Zealand more than Australia.**
- **Our monthly model predicts that NZD/AUD will eventually normalise but not before global credit conditions improve.**
- **The model forecasts NZD/AUD will continue to register monthly averages below 77c until September 2012, rising to 83c by end-2013.**

The New Zealand dollar / Australian dollar cross rate (NZD/AUD) has remained persistently below its historical average (85 cents) for three years now. It isn't hard to understand why. Australian economic growth has vastly outperformed New Zealand's, Australian interest rates have been higher, Australia's terms of trade boom has been bigger, and New Zealanders have been migrating across the Tasman in droves.

But the relative situation is starting to change. Economists and markets seem to agree that the antipodean siblings will soon swap shoes, at least in relative terms. In Australia consumer spending is slowing, house prices are falling and the RBA is cutting rates. In New Zealand house prices are rising, earthquake reconstruction is about to boost economic activity, and the RBNZ has a hiking bias.

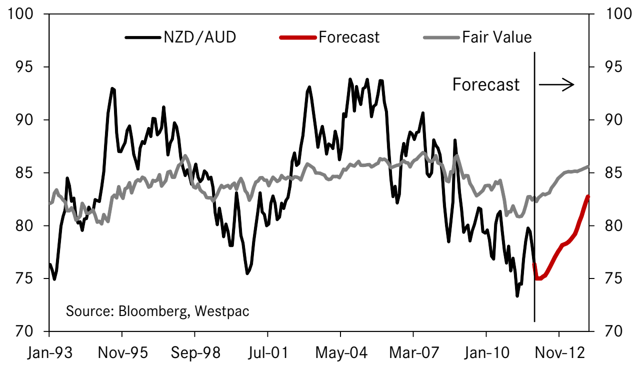
So the question is being asked: when will NZD/AUD rise?

Our monthly NZD/AUD model's answer is "not until late-2012." The model has a good (but not perfect) track record, and has successfully picked many major turning points in the cross over the four years we've been running it.[1] At the most recent update, the model did agree with the notion of an eventual rise in NZD/AUD... but not until mid-2012. The model predicts NZD/AUD will register monthly averages of below 77 cents in early-2012, only later normalising towards its long-run average of 85 cents.

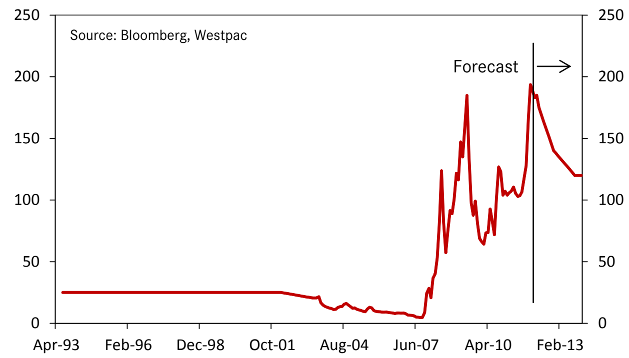
The reason the model prefers a tardy normalisation is down to global credit conditions. Research we published a year ago showed that NZD is more sensitive to global credit conditions than AUD.[2] During global credit events such as current European sovereign debt crisis, NZD can be expected to underperform relative to AUD. We measure the impact of global credit stress

1 See http://www.westpac.co.nz/olcontent/olcontent.nsf/content/FM_Occasional_Paper_20071019/$FILE/NZDAUD%20Occasional%20Paper.pdf for model documentation.
2 "Why so glum? Modelling and Forecasting the NZD/AUD exchange rate," Westpac bulletin 15 December 2010. Available on request.

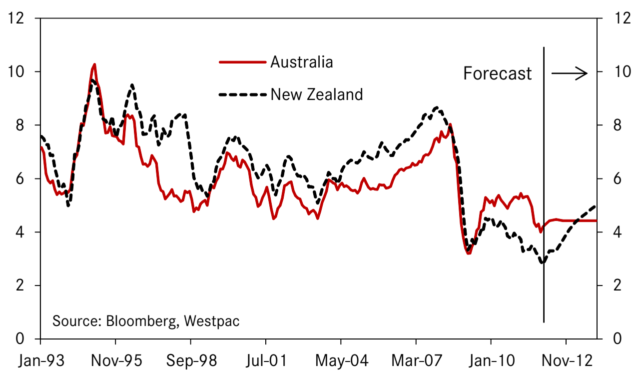
NZD/AUD cross rate forecast



Australian bank CDS spreads



Two-year swap rate forecasts



For further information, questions or comments contact Dominick Stephens, Chief Economist, Ph: (64-9) 336 5671, email dominick_stephens@westpac.co.nz

on our region by credit default swap spreads on the big-four Australian banks. These spiked up in August. While the future evolution of CDS spreads is wildly uncertain, we don't expect them to ease meaningfully until next year.

Meanwhile, the AUD is probably more sensitive to global economic growth, because Australia's commodity exports are more growth-sensitive. But we don't expect the fallout from the sovereign debt crisis to hit commodity prices in earnest until next year.

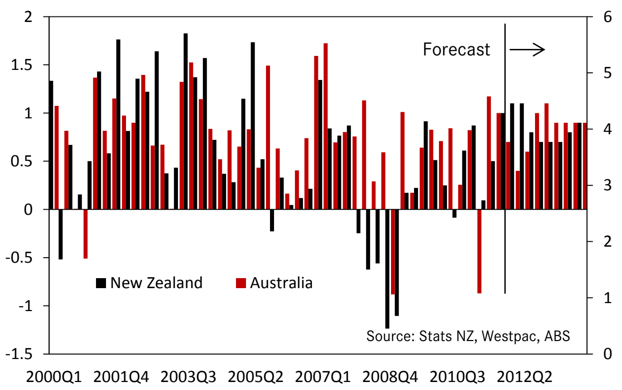
It is only at the point that financial conditions have eased and weak global growth is really upon us that the model is happy to predict an appreciation in NZD/AUD. So it is a case of "yes, but not yet".

Of course, the model is only as good as the projections we feed it. In addition to lower global commodity prices and falling CDS spreads, the other important assumptions are:

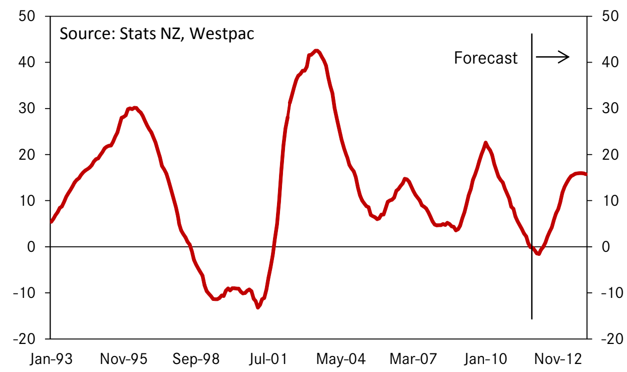
- New Zealand GDP growth is stronger than Australia's in early-2012, as Australia endures a consumer slowdown while post-quake reconstruction ramps up in New Zealand. We assume that Australia's higher trend growth rate reasserts itself over 2013.
- Australian 2-year swap rates linger around current levels, while NZ swap rates rise, consistent with the relative growth outlook. Our forecasts assume the spread between Australian and New Zealand swap rates eventually returns to its long-run average.
- The net number of New Zealanders emigrating to Australia falls over 2012 and 2013, again consistent with the relative growth outlook.

Dominick Stephens, Chief Economist, Ph: (64–9) 336 5671

GDP growth rates



New Zealand annual net migration forecast



Export commodity prices