Economic Overview

April 2011

Highlights

- **As the dust settles** – the February 22 Christchurch earthquake has rewritten New Zealand's economic outlook. All thoughts of recovery this year have been brushed aside. Next year, reconstruction activity in Christchurch will provide growth impetus. But rising interest rates will crimp activity in some parts of the economy *(see Economic Outlook, page 2)*.
- **Rebuild and repair** – The sector with the strongest outlook is construction, but there are other good news stories including high commodity prices and the Rugby World Cup. By contrast the squeeze on manufacturers will continue *(see Sectoral Trends, page 4)*.
- **In the face of adversity** – The New Zealand dollar has held firm in the face of recent events, with global demand for commodities continuing to underpin its fortunes. The RBNZ will be raising interest rates substantially once the reconstruction of Christchurch is into full swing, though the risk of an earlier move is low – raw material costs are rising, but in the wake of a drawn-out recession the pricing power simply isn't there *(see The Markets, page 6)*.
- **The turn of the screw** – Global commodity prices rose sharply in early 2011 and in many countries the monetary policy screws are tightening. It seems inevitable that global growth will moderate this year. Key risks include Chinese overheating, Middle Eastern politics, and European fiscal woes *(see International, page 8)*.
- **A matter of exchange** – A view has been gaining ground in policy circles that higher savings would bring about a lower exchange rate. In our special feature, we explain why we think that is wishful thinking *(see Feature article, page 10)*.

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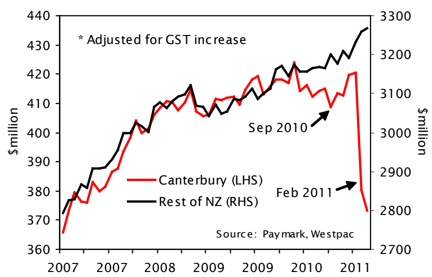
Text finalised 21 April 2011

As the dust settles

The February 22 Christchurch earthquake has rewritten New Zealand's economic outlook. All thoughts of recovery this year have been brushed aside. Next year, reconstruction activity in Christchurch will provide a surge in demand, at a time when the economy's productive capacity is damaged – a sure recipe for inflationary pressures and interest rate hikes.

After a disappointing year in 2010, the New Zealand economy began showing a few signs of improvement in early 2011. But this nascent recovery was derailed when the Christchurch earthquake struck on February 22. The quake wrought a tragic human toll. Now early post-quake economic data is revealing just how severe a blow has been dealt to the Canterbury economy. Electronic card transactions in Canterbury plunged in the months after the quake, and the chart below shows just how much harder the hit was this time compared to last September's earthquake. House sales in the Canterbury/Westland region have dropped to half their year-ago level, with very few sales in the hardest-hit parts of Christchurch city. We are currently costing the loss of NZ economic activity due to quake disruption at $4bn. That figure assumes Christchurch's annual economic output will shrink by 15% this year, and implies 2% will be wiped off New Zealand's GDP growth.

Figure 1: Paymark card transactions s.a.



The rest of the New Zealand economy is displaying surprising resilience. Granted, both consumer and business confidence did fall sharply across New Zealand. But that was mostly due to concern about the nation's future economic prospects. Consumers were actually fairly sanguine about their own prospects, and businesses outside of Christchurch reported little change in their own activity levels. Nationwide house sales rose 5% in March, as rising turnover in Auckland outweighed the disruption in Christchurch. And Figure 1 shows that card spending outside of Christchurch has been rising aggressively. Balancing the devastation in Christchurch against obvious growth in the rest of New Zealand, we are now forecasting zero GDP growth in the March quarter.

Figure 2: Domestic trading activity and consumer confidence

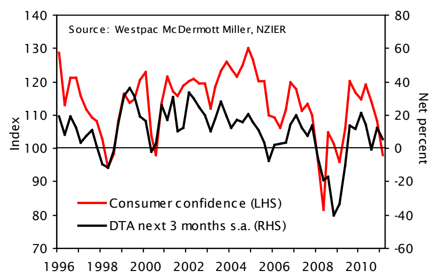
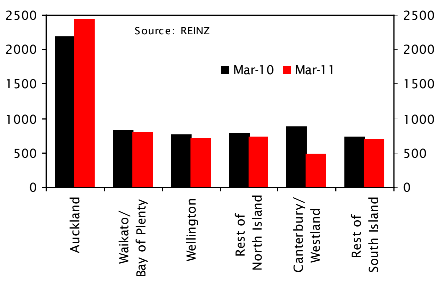


Figure 3: House sales in NZ regions



Can we bear the cost?

At this early stage we have no accurate gauge of what the final repair bill will be. Both the Reserve Bank and The Treasury are working with assumptions of $15bn worth of damage from the Christchurch earthquakes. We have adopted the same figure as the working assumption for our macroeconomic forecasts. We must stress that this is not an independent estimate.

Deferring to RBNZ analysis, we are assuming that the damage is broken down as follows:[1]

- $9bn in damage to residential housing and household contents. The capital value residential property in the Christchurch area is approximately $60bn.
- $3bn in damage to commercial and industrial buildings, compared to a total capital value of $15bn.
- $3bn of damage to government and council infrastructure assets, compared to the total value of Christchurch's infrastructure assets of $4.6bn.

New Zealand is well prepared to meet costs of this magnitude. The Earthquake Commission (EQC) spent sixty years building up $6.1bn reserves before last September's initial earthquake. EQC was also partially covered by reinsurance contracts for both the September and February temblors. EQC is liable to pay for the first $100,000 plus GST of damage to insured residential buildings, the first $20,000 plus GST for insured household contents, and any damage to residential land. We estimate that EQC's funds will be depleted but not exhausted after these liabilities are met (assuming no more severely damaging aftershocks).

New Zealand's private sector was well insured. Private insurance companies will be liable for about $7.5bn, mostly reinsured overseas. One major household insurer has used up its reinsurance cover and is in danger of exhausting its capital. It has received a capital injection from

[1] RBNZ's March 2011 *Monetary Policy Statement.*

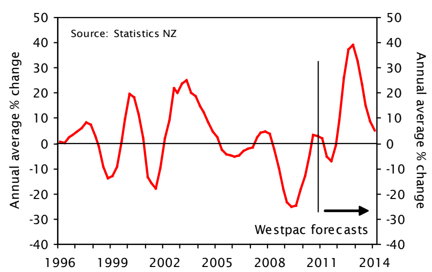
the government and, encouragingly, has been able to secure further reinsurance to cover it for future natural disasters. The insurance sector can still be described as stable. But we do expect a large hike in insurance premia that could become a permanent cost to the New Zealand economy.

For its part, the government is well placed to absorb the likely hit to its books. According to the Minister of Finance the earthquake could soak up $5.5bn in repairs, temporary housing, demolition work, support packages and the like (this figure excludes EQC's liability). $5.5bn amounts to 2.5% of New Zealand's GDP. Even if Government borrows to fund the entire earthquake bill, projections for government debt would still peak below 35% of GDP, which is very low by international standards. Not that government does need to borrow to fund all of its quake-related activity. Bear in mind that Government revenue will actually get a boost when Christchurch's reconstruction effort creates taxable incomes – essentially, Government will get a slice of the reinsurance money flowing into New Zealand. Ratings agencies have expressed comfort with government debt levels since the quake, and the fall in government bond yields indicates markets are similarly comfortable.

The reconstruction phase

When the insurance paperwork is done there will be a huge influx of money into the Canterbury region from overseas and central government, all earmarked for construction in Christchurch. This will be akin to a fiscal stimulus package worth 60% of pre-quake regional GDP,

Figure 4: Residential investment

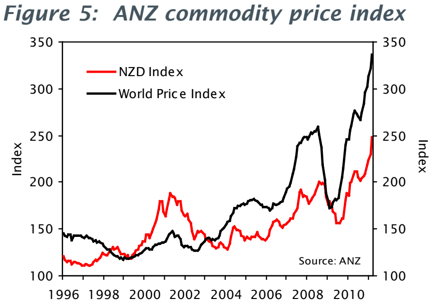


spread over many years. Once the aftershocks settle, a reconstruction boom is inevitable. This cannot be stymied by low regional confidence, because the money is coming from outside the region. Hawkes Bay certainly experienced a reconstruction boom following its devastating 1931 earthquake.

We expect the ramp up in Christchurch reconstruction activity will be a significant factor in pushing New Zealand's annual GDP growth rate to 4.6% in 2012. That's not to say that the earthquake was "good for the economy". Far from it – the earthquake has clearly harmed our long-run wellbeing. But GDP is not a measure of wellbeing, it simply gauges of the number of economic transactions that occur in a country. Earthquake reconstruction is an example of economic activity we would rather wasn't needed.

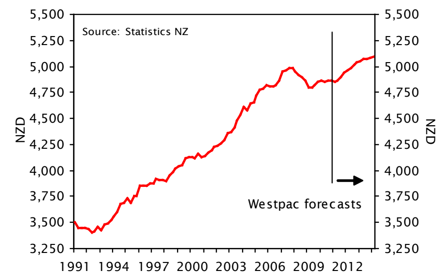
Reconstruction will not be the only source of growing domestic demand over the next year. NZ's export commodity prices have been hitting new record highs every month, and have now almost doubled since early-2009. During 2010 strong income growth in the agriculture sector went into repaying debt rather than downstream spending. But that cannot remain the case forever. We have already detected tentative signs of rural spending levels edging up, and with a record milk payout forecast for this year one can only expect there is more to come.

Figure 5: ANZ commodity price index



The pickup in the housing market is another reason to expect stronger domestic demand over the next year. House prices stopped falling around October last year, and have been stable since. The RBNZ's decision to cut the OCR in March may contribute to further housing market zing – we now expect 4% house price growth this year. House price growth should contribute to a slightly better consumer mood and some growth in retail sales, although nobody is talking about the helter-skelter of last decade.

Figure 6: Consumer spending volume per capita



And let's not forget the Word Cup, which is still expected to add significantly to tourist arrivals and retail spending.

The inflation consequences

All this growth in demand will be coming at a time when the economy's productive capacity has been damaged. The earthquake destroyed approximately 2.5% of New Zealand's capital stock, limiting the economy's capacity to supply goods and services. Limited supply combined with strong demand is a sure recipe for higher inflation. Prices rises are likely to occur first in the construction industry. But as wages for construction workers are driven up, the pressure will be on for inflation to rise in a more general sense, and the Reserve Bank will be forced to respond by hiking the OCR. Because there is currently a stack of spare capacity in the economy, and little pressure on underlying inflation, we expect the central bank will wait until early 2012 before kicking off the hiking cycle. But the hikes could be quite rapid once they start (see the *Markets* section for more detail).

Rising interest rates and the higher cost of construction will actually crimp consumption and investment outside of Christchurch. To some extent, we will end up with a two-speed economy, where the growth is concentrated in a single region.

Rebuild and repair

The scale of the reconstruction required in Canterbury means the construction sector will dominate New Zealand's economic growth profile over the next few years. But there are also other important drivers, in particular record high commodity prices which are providing a substantial boost to rural incomes. The arrival of the Rugby World Cup later in the year provides an excuse for the country to party and should benefit the retail and entertainment industries.

Overview

New Zealand's tepid economic recovery was kneecapped by the devastating February 22 Christchurch earthquake. The associated disruption will weigh heavily on economic growth over the first half of 2011. Beyond this, reconstruction in the region now dominates our forecasts.

Outside Canterbury, the key drivers of New Zealand's economic activity are little changed. In particular, demand for New Zealand's key commodity exports has remained robust, providing a substantial lift to farm incomes. High debt levels and lower rural land prices have slowed the pass-through from rural incomes to economic activity to date, but we don't expect this situation can last forever and we've already seen improving confidence in the sector. In the near term rising revenues should outpace costs – improving cash-flows and eventually spending. The Rugby World Cup in the second half of the year should provide a welcome boost to domestic and tourist spending alike.

Agriculture

The drought which hit parts of the country in late 2010 hampered agricultural production in the final quarter of the year. And while the dry weather didn't last long (current soil moisture levels are normal to above normal in much of the country) it capped off a disappointing production year for some farmers. Many had watched deteriorating conditions hamstrung, unable to fully capitalise on skyrocketing global prices. While we'd never claim to be able to pick droughts and storms (forecasting the economy is difficult enough!) more "normal" weather patterns over the next year should help production both in New Zealand and other parts of the globe.

Of course, improved output in New Zealand and elsewhere will eventually put downward pressure on key commodity prices, and combined with an expected second half 2011 slowdown in the juggernaut Chinese economy, will likely see commodity prices soften later in the year. Indeed, lower dairy prices have already been recorded. But even if we do see some moderation in export commodity prices in the near term, it doesn't mean that we're retreating from our bullish outlook for the world's demand for food over the coming decade. Rather, it is an acknowledgement that for a while at least, increased production and slower demand growth may see a period of modestly lower prices.

Construction

The Canterbury (and New Zealand) construction industry had little chance to get into repair mode following the September earthquake before the February 22 quake struck. Consequently, our forecasts now incorporate a period of subdued activity before a substantial reconstruction boom to repair the damage caused by both events.

Yet while a substantial reconstruction boom centred in Canterbury is a certainty, less clear is just how quickly the rebuilding can take place. Our own forecasts have residential building activity peaking in late 2012 (with the greatest impact on growth a little earlier), while the more involved non-residential building work isn't expected to peak until 2013. Indicators of construction activity beyond Canterbury remain very weak leaving a significant degree of spare capacity in the sector. As Canterbury rebuilding gets underway, this capacity will be eaten up and eventually exceeded, generating inflation pressures in the sector which are expected to spill over to the wider economy.

Figure 7: Sectoral real GDP

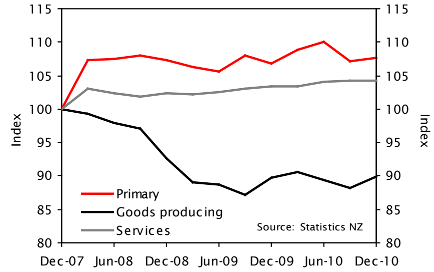


Figure 8: Commodity prices

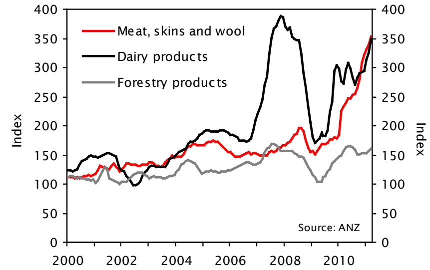
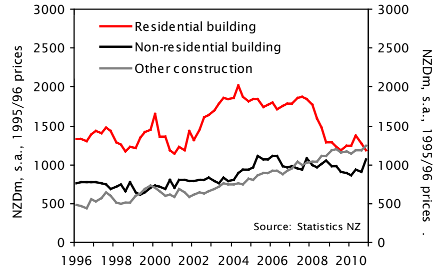


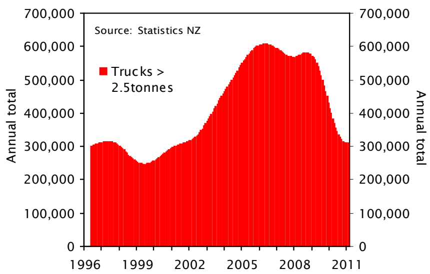
Figure 9: Construction activity by sector



Transport and communication

Rapidly rising fuel costs have weighed on the transport sector. Petrol prices rose almost 10% in the March quarter, while diesel prices were up close to 15%. Add to this weak retail sales and manufacturing activity and it was little surprise to see the transport, storage and communication sector contract by 0.2% in the December quarter. Because the fortunes of the sector are closely entwined with the economy as a whole, despite high fuel costs, there should be some improvement as wider economic activity picks up.

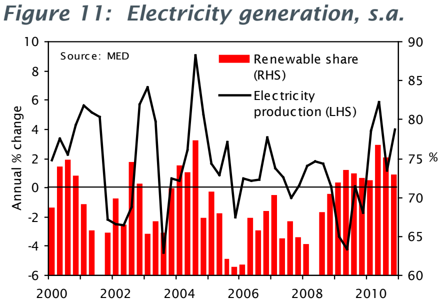
Figure 10: Truck registrations



Electricity, gas and water

Electricity generation in the December quarter was up around 2% on a year ago, with a slight reduction of the contribution from non-renewable resources during the quarter. The medium-term focus for electricity generation is very much on renewable resources. This is illustrated by looking at power generation projects in the pipeline. Over 50% of mooted generation projects (according to a February Electricity Authority report) harness wind energy. In comparison, gas and diesel projects comprise just 18%. Overall, there are a large number of consented electricity generation projects which could possibly be constructed in the next few years – to the tune of 2900 MW. This dwarfs the 42 MW of generation capacity currently under construction.

Figure 11: Electricity generation, s.a.

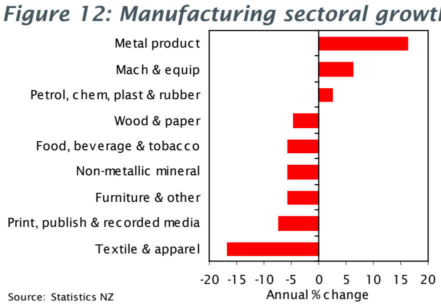


Manufacturing

The manufacturing sector has been hard hit by the double whammy of a high exchange rate and subdued domestic activity. Add to that weak agricultural production volumes during 2010 and the sector has found the last year tough going. A return to more "normal" weather conditions should provide some relief to food manufacturers.

But other manufacturers are likely to continue to be squeezed on two fronts: via increased competition from cheaper imports and through reduced competitiveness of New Zealand manufactured exports in offshore markets. While the weak AUD/NZD is currently providing something of a release valve, we expect this relief to moderate over the next year as the kiwi appreciates against the Australian dollar.

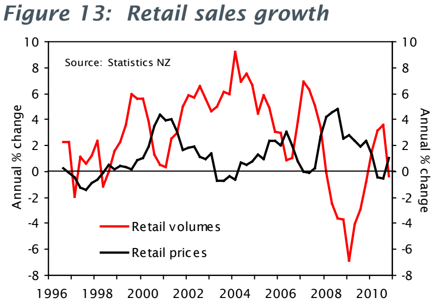
Figure 12: Manufacturing sectoral growth



Retail trade

The retail sector has clearly been an area of weakness during the recovery to date. House prices declined by 2% during the course of 2010 and dragged consumers' spending appetite with them. Indeed, the retail sector was the weakest sector in the December quarter, with sales contracting by 2.1%.

Figure 13: Retail sales growth



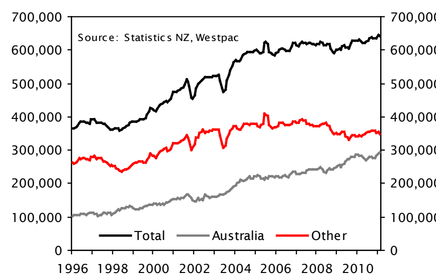
Looking ahead, a modest improvement in the outlook for the housing market should provide a more stable backdrop for the sector. Increased housing turnover in recent months (albeit off a low base) has coincided with some improvement in retail spending indicators ex-Canterbury in the early months of 2011.

Tourism

More Australian visitors crossed the Tasman in recent months as the Australian dollar remained strong against the kiwi (and most other currencies), making overseas travel attractive. But despite the Aussie-led pickup in tourist arrivals, tourist spending remains weak and is likely being hampered by the high New Zealand dollar. Consumer caution evident in many countries at the moment appears to be remaining firmly in place when on holiday.

February's earthquake is also likely a negative for the tourism sector in the short term. Although the Christchurch airport was shut only briefly, the extent of damage in the region may have led to people cancelling or cutting short travel in New Zealand or even reconsidering the country as a holiday destination. In contrast, the approaching Rugby World Cup later in the year will provide a boost for the sector with 70,000 visitors expected to arrive for the tournament.

Figure 14: Visitor numbers



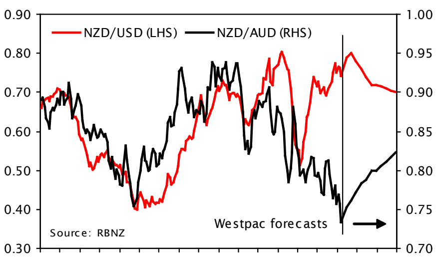
In the face of adversity

The New Zealand dollar has held firm in the face of recent events, with global demand for commodities continuing to underpin its fortunes. That said, we expect a cooling in China's rapid rate of growth this year – a risk to markets that seem priced for perfection. The RBNZ will be raising interest rates substantially once the reconstruction of Christchurch is into full swing, though the risk of an earlier move is low – raw material costs are rising, but in the wake of a drawn-out recession the pricing power simply isn't there yet.

Exchange rates

A number of forces conspired against the New Zealand dollar in the early part of this year: growing turmoil in the Middle East, a second devastating earthquake in Christchurch and a subsequent cut in interest rates, and an even larger quake in Japan that sparked a crisis at the Fukushima nuclear reactor. Yet after a short-lived dip, the NZD has returned to elevated levels, even briefly visiting a three-year high of USD80c *(Figure 15)*.

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

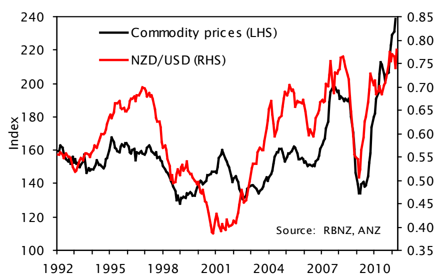


We can credit some of this rebound to the fact that the market has been able to discount the worst-case scenarios. Middle East tensions remain, but fears of oil shipments to the Western world being cut off have faded. Similarly, while the Japanese nuclear crisis is far from a resolution, the initial fears of a Chernobyl-type scenario (in a much richer and more densely populated country) have at least been allayed. And the Christchurch earthquake has dislocated a lot of local activity, but has not really disrupted goods exports.

Some other factors behind the currency's strength have been more foreseeable. Post-quake claims on overseas insurers and reinsurers will generate a significant inflow of NZ dollars – claims from the September quake are currently estimated at $3.6bn, and we think claims from the February event could be as much as $10bn in the final cut. The actual timing of these flows is a moot point; it's been clear from day one that they would need to happen, and smart traders will have been buying the NZD in advance.

Last and not least, the fundamental support for commodity prices, which has underpinned our exchange rate forecasts for some time, remains intact. The basket of our main export commodities has far surpassed its 2008 highs *(Figure 16)*, although prices for dairy products, our largest export group, have lagged the broader food complex in the last month.

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



The rapid rise in demand from developing economies, especially China, makes it likely that we've seen a step-change in commodity prices to levels above what we've been used to in past decades. With greater wealth and urbanisation has come a demand for a higher-calorie diet, and New Zealand – the world's biggest net exporter of food relative to its GDP – is well-placed to benefit from this.

Notably, a recent article by the RBNZ espoused this view more confidently than we've seen in recent times. Until now the RBNZ has assumed that the rise in the terms of trade would be temporary, so that consumers and businesses would treat the export income boost as a windfall and save rather than spend it. Viewing the terms of trade boost as a permanent one will have implications for monetary policy, but also for the RBNZ's tolerance for a stronger exchange rate, which can – and should – play a role in containing the inflation pressures that arise from a commodity boom.

While it's important to recognise the structural aspect of China's rise, they are still subject to the business cycle as much as anyone else. We see growing evidence for a slowing in China's rapid growth in the second half of this year, as past monetary tightening comes to bear (see the International section). While we expect this to amount to no more than a soft landing, there's a risk it could roil markets that seem to be priced for perfection in all matters Chinese. The AUD and to a lesser extent the NZD, which are highly leveraged into the Chinese growth story, could be hit particularly hard in this scenario.

The reason we're not forecasting a larger or more timely decline in these currencies is that the near-term outlook for the US dollar remains poor. Despite the recent manufacturing-led pickup in growth, unemployment remains uncomfortably high, core inflation is low, and the housing market has yet to find a bottom after more than five years of decline.

The Federal Reserve will remain under pressure to keep conditions growth-friendly, and if the early-year momentum fades – as it did last year – then a third round of quantitative easing could be on the cards before year-end.

Interest rates and inflation

The February earthquake was doubly disruptive to the interest rate outlook. Not only did it come at a time when the fragile domestic economy was only just regaining momentum, but it quashed the most important source of expected growth for this year – namely, the rebuild from last September's quake.

The RBNZ cut the cash rate by 50bp in March, as a precaution against a fall in confidence and activity that could extend beyond those directly affected by the quake. The March *Monetary Policy Statement* also indicated that the post-quake timeline will dictate the path of policy: interest rates will remain low until the reconstruction gets under way (expected to be from early 2012), after which they will need to be raised quickly as the economy's spare capacity is soaked up.

We think the RBNZ can stick to that timeline, despite some resilience in the post-quake data, and the complication of a return to the high headline inflation rates and soaring commodity prices of 2007/08. The crucial difference between then and now is the degree of slack in the economy, in the wake of a drawn-out recession. Firms are increasingly reporting higher costs, but they simply lack the ability to pass these on *(Figure 17)*. The relatively strong exchange rate

Figure 17: Firms reporting cost and price increases (last 3 months)

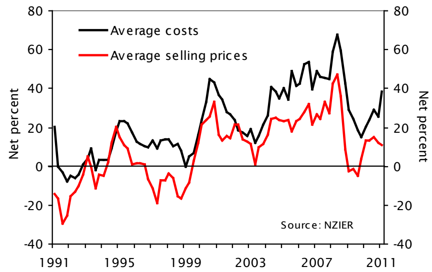
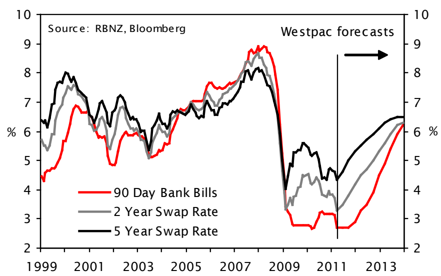


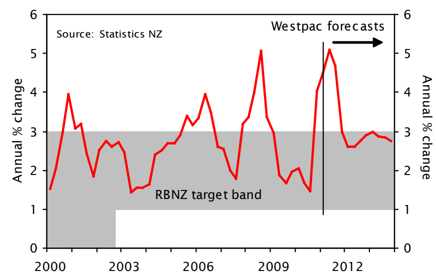
***Figure 18: 90 day bank bills, 2 year and 5 year swap rates** (monthly average)*



will further help to contain inflation, as well as keeping the RBNZ wary about near-term growth prospects.

The RBNZ expects to lift the OCR to around 4% by the end of next year – much the same as before the quake, but from a lower and later starting point. Both we and the market broadly agree with that track; where we differ is in what happens beyond 2012 *(Figure 18)*. Firstly, we've long been sceptical of the idea that the 'neutral' level of the OCR has fallen as low as 4% in the wake of the global financial crisis (or at least we're sceptical of how that conclusion has been reached). Secondly, on our forecasts, the reconstruction will see the NZ economy running above potential for an extended period. That implies some monetary rigour will be needed just to keep average inflation near the upper bound of the 1-3% target *(Figure 19)*.

Figure 19: CPI inflation forecasts



Financial Markets Forecasts (end of qtr)

	OCR	90 Day Bill	2 Year Swap	5 Year Swap	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Jun-11	2.50	2.70	3.50	4.60	0.79	0.75	0.56	0.49	65.6	69.2
Sep-11	2.50	2.70	3.80	5.00	0.80	0.76	0.57	0.48	68.0	70.2
Dec-11	2.50	2.90	4.20	5.30	0.78	0.77	0.57	0.47	69.4	70.0
Mar-12	3.00	3.30	4.50	5.50	0.76	0.78	0.57	0.47	69.2	69.5
Jun-12	3.25	3.50	4.70	5.70	0.74	0.79	0.56	0.45	68.8	68.4
Sep-12	3.50	4.00	5.00	5.90	0.72	0.80	0.55	0.43	68.4	67.6
Dec-12	4.00	4.50	5.30	6.10	0.72	0.80	0.56	0.42	69.1	67.8
Mar-13	4.50	4.80	5.60	6.20	0.72	0.81	0.56	0.41	69.4	67.7
Jun-13	4.75	5.20	5.80	6.40	0.71	0.81	0.56	0.41	69.6	67.6
Sep-13	5.25	5.70	6.10	6.50	0.71	0.82	0.56	0.40	69.8	67.5
Dec-13	5.75	6.10	6.20	6.50	0.70	0.82	0.56	0.39	70.0	67.3
Mar-14	6.00	6.20	6.30	6.50	0.71	0.83	0.55	0.39	71.5	67.7

The turn of the screw

Global commodity prices rose sharply in early 2011 and in many countries the monetary policy screws are tightening. It seems inevitable that global growth will moderate this year. Key risks include Chinese overheating, Middle Eastern politics, and European fiscal woes.

For two years after the global financial crisis, the focus of governments was on promoting the fragile and uneven global recovery. That focus has begun to shift. Firming demand in the United States, continuing breakneck growth in China and other emerging economies, and revolution in the Middle East have conspired to push oil prices above US$120/barrel and food prices well above their 2008 peaks. With core inflation also rising off its lows, inflation is back on the policy table: the hawkish ECB has raised its repo rate, and the punditry is expecting the US Fed to wind up its quantitative easing programme in June (a policy tightening, in our view). Meanwhile, the Chinese government continues its battle against a rampant property market and is increasingly serious about 'decoupling' its monetary policy from the United States.

Some of this removal of stimulus is well overdue, some arguably premature. Notably the US housing market continues to be in terrible shape, and economic confidence there has started to buckle under high oil prices. And in Europe, a reviving Germany is surrounded by a periphery on very thin ice. With luck – an orderly slowdown in the Chinese property market later this year, Spain maintaining the faith of the markets, and no major Middle Eastern ructions – we expect the global economy to slow to a more moderate 4.2% this year and next.

Australia

Late last year the Australian economy entered a soft patch, which the January floods and February cyclone have prolonged. Domestic final demand grew just 0.3% in the December quarter, and an economic contraction looks increasingly likely in the March quarter. Looking through disruption from weather events, Australian household spending is clearly much more subdued than one would expect in an economy basking in the sunshine of the highest terms of trade in 60 years. The business sector looks more positive, and we expect those stellar external prospects, coupled with an RBA on hold, to boost domestic spending by the second half of this year. The consumer remains the major swing factor for the near-term Australian outlook.

China and non-Japan Asia

China grew at a blistering pace in the year to March 2010, expanding 9.7% over a year earlier. The Chinese government is clearly serious about achieving more sustainable economic growth and getting inflation (5.4% in March) under control: in April the People's Bank raised benchmark lending and deposit rates for the 4th time in 5 months, reserve requirements are sitting at over 20% for most banks, and a myriad of administrative controls has been introduced. There are questions around how effective these levers are, and how much liquidity is simply being channelled into a growing shadow financial system – but make no mistake, the government will continue to act to tame the Chinese property boom. We reckon the slowdown will come later this year as an increasing number of housing completions come on the market.

China's decision to raise interest rates will have been made easier by similar moves in other Asian economies, including Korea, Thailand, Taiwan and the Philippines. Across the region, central banks are slowly responding to strong local growth and rising food and fuel prices. We forecast more moderate growth in the region this year and next.

United States

The US recovery firmed in early 2011. GDP growth quickened to 3.1% (annualised) in the December quarter, and business surveys heralded further gains in the new year. Core inflation finally bottomed out, and the labour market continued to improve, raising expectations for an end to the Fed's asset purchases in June. But the US economy continues to face major headwinds. The state of the housing market is abysmal, with 39% of house sales in January distressed sales. Fiscally crippled state and local governments are sucking demand out of the economy, and at federal level politicians are playing brinkmanship over the mix of spending cuts and tax increases. And high oil prices have dented consumer and small business confidence. We continue to expect the US to grow below trend, and below Consensus, in the next two years.

Europe

While the dichotomy between a buoyant German economy and a deeply troubled periphery continues, the Euro area has managed to muddle through its sovereign debt crisis for another quarter. Portugal has joined Greece and Ireland in applying for a Europe/IMF bailout, following the downfall of the Portuguese government over austerity measures. The existing European rescue fund is big enough to absorb the costs and market reaction was limited. But there are clouds on the horizon: the European

Stability Mechanism (the 2013 successor to current arrangements) agreed to in March 'bails in' creditors, and also leaves important questions of funding open. Meanwhile, the ECB's 25bps rate hike in April will not help countries like Spain, where the housing market is in a slump and most borrowers are on short-term mortgages. So far, financial markets have continued to trust that Spain can maintain fiscal sustainability via austerity and structural reform.

Japan

At the start of the year, Japan was sharing in some of the rebound in global momentum, with manufacturing activity having resumed growth and the unemployment rate falling to a 2-year low. That growth has been dealt a blow by March's devastating earthquake and tsunami. The disaster has crippled the Japanese north-west and fractured global production chains. Provided nuclear fears subside, however, the economic disruption should be short-lived. Activity will rebound as power is restored (helped by Japan going into the disaster with substantial generating capacity), and the reconstruction effort – assessed by the Japanese Cabinet Office as between 3% and 5.5% of GDP – will further boost growth over the next several years. We expect the level of activity in Japan to be only a little below our pre-earthquake forecast by end 2012.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2006	2007	2008	2009	2010	2011f	2012f
New Zealand							
Real GDP % yr	1.0	2.9	-0.2	-2.1	1.5	1.3	4.6
CPI inflation % annual	2.6	3.2	3.4	2.0	4.0	3.0	2.9
Unemployment %	3.8	3.4	4.6	7.0	6.8	6.3	5.0
Australia							
Real GDP % yr	2.9	4.0	2.2	1.3	2.7	2.0	4.0
CPI inflation % annual	3.3	3.0	3.7	2.1	2.7	2.6	2.6
Unemployment %	4.8	4.4	4.3	5.6	5.2	4.8	4.5
United States							
Real GDP %yr	2.7	2.1	0.0	–2.6	2.9	2.2	2.1
Consumer Prices %yr	3.2	2.9	3.8	–0.3	1.6	2.7	2.1
Unemployment Rate %	4.6	5.8	5.8	9.3	9.6	8.9	8.8
Japan							
Real GDP %yr	2.8	2.2	–1.5	–6.6	4.3	1.2	2.9
Consumer Prices %yr	0.2	0.1	1.4	–1.3	–0.7	–0.3	–0.1
Unemployment Rate %	4.1	3.9	4.0	5.1	5.1	5.0	4.9
Euroland							
Real GDP %yr	3.2	2.8	0.3	-4.1	1.7	1.4	1.4
Consumer Prices %yr	2.2	2.1	3.3	0.3	1.7	2.4	1.6
Unemployment Rate %	8.4	7.5	7.5	9.5	10.0	10.3	10.5
United Kingdom							
Real GDP %yr	2.8	2.7	–0.1	–4.9	1.3	1.1	1.3
Consumer Prices %yr	2.3	2.3	3.6	2.2	3.2	3.5	2.8
Unemployment Rate %	5.4	5.3	5.6	7.6	7.8	8.0	8.2
China							
Real GDP %yr	12.7	14.2	9.6	9.1	10.3	9.2	8.2
Consumer Prices %yr	1.5	4.8	5.9	–0.7	3.3	3.8	3.0

Forecasts finalised 8 April 2011

A matter of exchange

A view has been gaining ground in policy circles that low savings have been responsible both for New Zealand's high interest rates and its high exchange rate. The implication is that an increase in saving would provide relief for the export sector and allow lower interest rates. As seductive as this view is for monetary policy, we think it is largely wishful thinking, and should have no bearing on savings policy.

In our previous Feature Article (*'Save our Souls'*, January 2010), we discussed New Zealand's saving rate, taking a critical look at the recommendations coming out of the Savings Working Group. We argued that New Zealand's problem is not the quantum of saving, but the quality of investment, and that measures to engineer higher savings could well cause more trouble than they are worth.

One particular bone of contention we had with the SWG's report was over the view that a higher saving rate would lead to a lower exchange rate, taking pressure off the beleaguered tradable sector (and, by implication, some of the angst out of monetary policy). The logic underlying that claim (set out most cogently in a recent Treasury working paper[1]) is gaining increasing favour in New Zealand policy discussions. It has implications not just for the exchange rate, but for interest rates and the monetary policy outlook. We disagree with it, and in what follows we explain why.

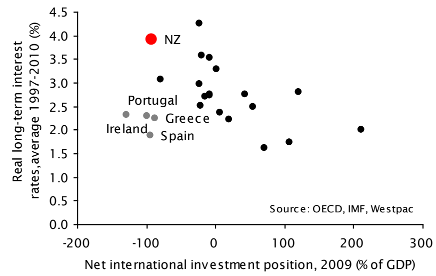
Global vs local

The aim of the Treasury paper by Labuschagne and Vowles (L&V) is to explain why New Zealand's interest rates have been consistently higher than in most other OECD countries. Textbook economics says that the only way in which interest rates in different countries can diverge over the long haul is through different perceptions of risk or different rates of inflation. For countries with the same riskiness and the same inflation trends, interest rates should converge to the same global level – otherwise financial market participants could make riskless profits forever. (Global interest rates are themselves determined by global saving and investment patterns – essentially by factors such as global growth prospects and global risk appetite.)

As L&V explain, for New Zealand the standout risk is credit risk – we aren't that different from other countries (notably Australia) in terms of our inflation rates or the volatility of our exchange rate. What we do have is an unusually high national debt. While our government debt is relatively low by international standards, the net foreign liabilities of New Zealand as a whole, at over 80% of GDP, put us within reach of some euro area basket cases. This would tend to push our interest rates higher than for countries with lower debt (by making us a riskier investment proposition), while also pushing the exchange rate lower than it would otherwise be (because we have a higher debt burden to service). Figure 20, which plots average inflation-adjusted interest rates against net foreign debt for a range of countries, suggests that this broadly holds true (the aforementioned euro area countries are a notable exception, highlighting the extent to which their riskiness was mispriced before the Global Financial Crisis).

We'll call the standard economics explanation of New Zealand's high interest rates the 'risk premium' view. Over short periods, of course, interest rates in different countries diverge all the time: higher interest rates in one country can drive up the exchange rate, as investors chase yields. This is called the carry trade. Economic theory says that there is a limit to this carry trade – investors will pile into higher-yielding currencies only up to the point where the exchange rate has become sufficiently 'overvalued' for its expected depreciation to offset the prospective interest rate gains.

Figure 20: Average inflation-adjusted interest rates and net foreign debt



L&V propose an alternative account of New Zealand's high interest rate history, building on the carry trade idea. Their explanation – which we will call the 'excess demand' view – essentially says that a very long-lived aggregate demand boom specific to New Zealand has kept the exchange rate high. The story goes like this: for a host of reasons (explored, inter alia, by the Savings Working Group), New Zealand has suffered from a chronically low level of saving relative to investment, and persistently strong domestic demand. This has forced the Reserve Bank to keep interest rates above those seen in countries with higher saving rates. A side effect has been the large current account deficit, and our high level of foreign debt. What has allowed these current account deficits and high interest rates to persist over time is a chronically overvalued exchange rate. Essentially, investors have been expecting the currency to come crashing down for 20 years. It won't happen overnight, but it will happen!

Forever overvalued

Both theories explain the coincidence of high debt and high interest rates in New Zealand – so we need to look to other evidence to decide between them. L&V argue that their theory accounts for the fact that the NZD *has* been overvalued, whereas the risk premium story would, if anything, imply a lower exchange rate. They also assert that the risk premium story implies that New Zealanders should have been deleveraging (because higher risk premia imply higher borrowing costs) – whereas debt levels have been rising until very recently.

We're not so sure how overvalued the New Zealand dollar really is. The Treasury point to research by the IMF and others concluding that the dollar is still up to 25% above its long run value.[2] But what you consider fair value depends crucially on the outlook for the terms of trade – higher terms of trade provide an income boost that allows a country to service its debts at a higher exchange rate. For New Zealand, rising global commodity prices have seen the terms of trade reaching record highs, and our view is that they are likely to stay high for a long time to come. In that kind of world, we would also expect the exchange rate to stay above historical averages. There is no question that an exchange rate at those levels is painfully high for non-commodity exporters and import-competing manufacturers. But for the country as a whole, it reflects that we are able to consume more for what we produce. That is the blessing and the curse of Lucky Countries, also known as Dutch Disease.

Not only do we have doubts about how overvalued the exchange rate is right now – we find it very hard to believe that the exchange rate has been overvalued, on average, for decades at a stretch. Over that sort of time span markets adjust and 'long-run' drivers look increasingly relevant. It does seem to be true that, as L&V note, the 'carry trade' can be profitable for extended periods before the exchange rate comes back to earth.[3] But there are really only three ways in which this could happen. One is that financial markets are 'irrationally exuberant', expecting an overvalued exchange rate to stay overvalued. This is reasonable over an economic cycle, but not over 20 years. The second, as L&V appear to suggest, would be for investors to continually expect an exchange rate depreciation which never comes. This is just not plausible. The final way would require a whole series of surprise boosts to aggregate demand over that period. One candidate source of these positive demand shocks that we have heard mentioned is migration. But New Zealand's net immigration rate has, on average, been less than that experienced in the US, Australia and the UK in the past 20 years. Overall, it's this aspect of the L&V story that just doesn't pass the sniff test.

We also don't think the increase in leverage seen in New Zealand in recent decades is evidence in favour of the 'excess demand' story. A lot of things have been going on over that time to drive borrowing costs down at home and abroad, encouraging a ramp-up in debt. Financial deregulation and lower and more stable inflation have led to lower wholesale interest rates and lower credit costs for borrowers. And global risk appetite exploded in the years preceding the Global Financial Crisis – to the particular benefit of relatively risky countries like New Zealand.

Having your cake and eating it

The 'excess demand' account of New Zealand's high interest rates has seductive implications for monetary policy. If we could only find a way of getting New Zealanders to save more, we could have both lower interest rates and a lower exchange rate. On our preferred 'risk premium' view, higher savings would also be rewarded with lower borrowing costs – but the exchange rate would be higher because of a lower foreign debt servicing burden and reduced country credit risk.

But the implications of the two views of the financial world go beyond the exchange rate. As we have set out in our previous work on the post-financial crisis interest rate landscape , they also potentially lead to very different predictions for future monetary policy. Under the 'excess demand' view, borrowing rates might in future be permanently lower, whereas under our 'risk premium' view, interest rates should eventually return to levels seen over the past couple of decades, and could even rise higher. Specifically, what if the required compensation for risk globally is permanently higher since the bursting of the 2000s credit bubble? On our view, this inevitably means that NZ lending and deposit rates will be higher, on average, than in the past decade. There will be nothing the RBNZ can do to *persistently* offset the reduced willingness of foreigners to lend to us, without causing higher inflation. Under the logic of the 'excess demand' view, the RBNZ could offset higher international funding costs with a lower OCR for decades (implying, presumably, an undervalued exchange rate over the next 10-20 years)!

Overall, we feel that there is a reluctance on the part of some in the policy world and in the press to accept the implications of a tighter global funding environment for New Zealanders' standard of living. There also seems to be a widespread desire to search for ways of tightening monetary policy without raising the exchange rate. We suspect a lot of this is wishful thinking. We agree that higher savings have the potential to drive New Zealand's real interest rate premium down. But it is higher interest rates – via a more realistic global pricing of risk – which may help achieve those higher savings rates in the first place.

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[1] Labuschagne, N and P Vowles (2010), *'Why are Real Interest Rates in New Zealand so High? Evidence and Drivers'*, Treasury Working Paper 10/09.

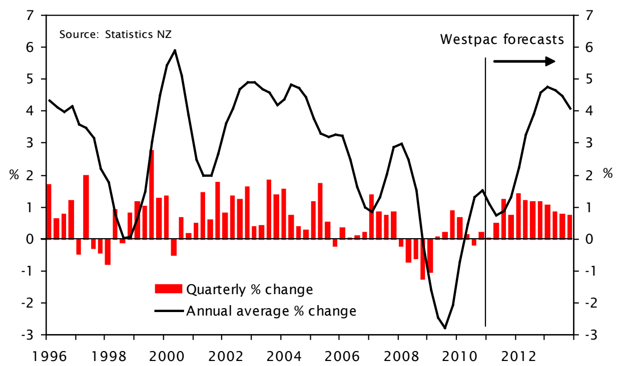
[2] Mabin, G. (2010) *'New Zealand's Exchange Rate Cycles: Evidence and Drivers'*, Treasury Working Paper 10/10, p. 26.

[3] See, for example, Burnside, C, M Eichenbaum, and S Rebelo (2008) *'Carry Trade: The Gains of Diversification'* Journal of the European Economic Association, 6(2-3): 581 – 588.

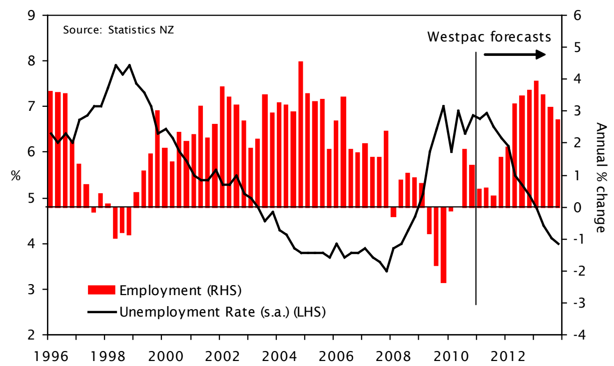
[4] *'A matter of interest'*, Westpac Bulletin, 12 August 2010.

Annual Average	March years				Calendar years			
% change	2010	2011f	2012f	2013f	2010	2011f	2012f	2013f
Private consumption	0.4	1.6	2.4	3.6	2.0	1.8	3.6	2.8
Government consumption	0.2	2.3	4.0	-0.8	2.3	3.9	-0.3	0.9
Residential Investment	-13.0	2.1	9.4	32.9	2.8	-0.7	39.1	9.0
Business Investment	-8.3	6.6	12.9	12.6	2.2	11.8	13.7	8.7
Stocks (% contribution)	-2.2	1.9	-0.1	0.1	2.0	0.4	-0.2	0.1
GNE	-3.6	4.9	5.2	5.8	4.2	5.0	5.9	4.2
Exports	4.6	2.3	7.1	3.5	3.0	6.5	4.0	3.9
Imports	-9.4	11.4	11.5	6.8	10.2	11.7	7.9	4.1
GDP (Production)	**-0.7**	**1.1**	**2.2**	**4.8**	**1.5**	**1.3**	**4.6**	**4.1**
Employment (% annual)	-0.1	0.6	1.9	4.0	1.3	1.6	3.7	2.7
Unemployment Rate (% s.a. end of period)	6.0	6.7	6.1	4.8	6.8	6.3	5.0	4.0
Average Hourly Earnings (% annual)	0.6	3.1	4.6	4.5	1.8	4.3	4.7	4.2
CPI (% annual)	2.0	4.5	2.6	3.0	4.0	3.0	2.9	2.7
Current Account Balance (% of GDP)	-2.4	2.5	-4.6	-5.9	-2.2	0.5	-5.8	-5.8
Terms of Trade	0.1	6.3	0.0	-0.3	12.2	1.5	-1.6	1.4
90 Day Bank Bills (end of period)	2.73	3.00	3.30	4.90	3.18	2.90	4.50	6.20
5 year swap (end of period)	5.27	4.54	5.50	6.30	4.60	5.30	6.10	6.50
TWI (end of period)	65.3	67.2	69.5	67.7	67.8	70.0	67.8	67.3
NZD/USD (end of period)	0.71	0.76	0.76	0.72	0.76	0.78	0.72	0.70
NZD/AUD (end of period)	0.78	0.75	0.78	0.81	0.77	0.77	0.80	0.82
NZD/EUR (end of period)	0.51	0.55	0.57	0.56	0.56	0.57	0.56	0.56
NZD/GBP (end of period)	0.45	0.47	0.47	0.41	0.48	0.47	0.42	0.39

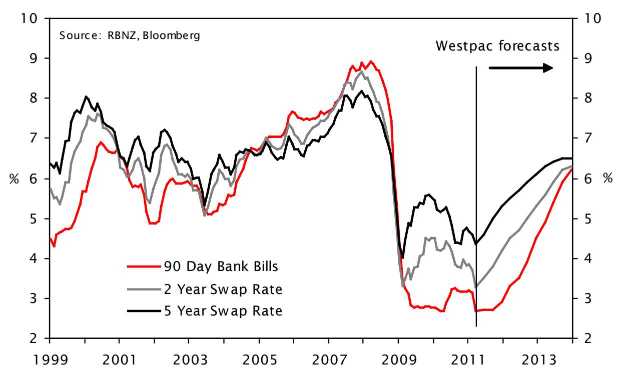
New Zealand GDP growth



New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI