Economic Overview

January 2011

Highlights

- **Tug of war** – the economy performed poorly during the middle of 2010. Most recent data has shown some improvement and the key pillars of growth (including historically high export prices and reconstruction activity) remain in place. The tension between higher income from the emerging-market led resource boom and the need to delever remains the key theme for 2011 *(see Economic Outlook, page 2)*.
- **Take two** – the two speed nature of NZ's recovery will remain this year. The income boost from high commodity prices will benefit some in the goods producing sectors, while other exporters will struggle because of the high dollar. Domestic focused sectors will get a fillip from Canterbury reconstruction and the Rugby World Cup. The housing market appears to be stabilizing, but the domestic consumer is likely to remain cautious in the first half of this year *(see Sectoral Trends, page 4)*.
- **Uneven keel** – world growth has been uneven and is likely to remain so, with rich world countries underperforming due to debt overhangs, developing economies booming, and commodity producers feeding the voracious appetite of the developing economies for food and raw materials *(see International, page 8)*.
- **Financial markets** – emerging market demand will keep commodity prices and the NZ dollar elevated. There's plenty of spare capacity in the economy, so medium term inflation pressures are currently benign. The RBNZ may restart a tentative tightening cycle in September. Experience of the past few years suggests that multiple shocks can be expected: whether they are international, local, mother-nature or financial related *(see The Markets, page 6)*.
- **Save our souls** – in our Feature article we outline a few considerations around the saving issue. We suggest that a lack of savings has not been NZ's 'problem', but has contributed to our vulnerability from high overseas debt. We'd prefer to see the emphasis on policies to raise the quality of investment, rather than saving *(see Feature article, page 10)*.

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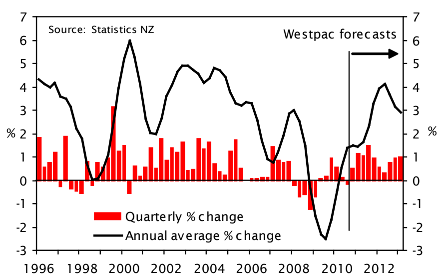
Tug of war

The New Zealand recovery stalled in mid 2010 – due to a run of bad luck, a weak housing market, and a crisis of confidence in the consumer. Year-end data showed some improvement, and the key pillars of growth – historically high export prices and the need for new building – remain in place. The tug of war between the emerging-market led resource boom and the need to delever remains the key theme for 2011, both in New Zealand and across the globe.

New Zealand's economic recovery ground to a halt in mid 2010. GDP posted zero growth over the June and September quarters, and business confidence fell sharply. There are a range of candidate causes for the slowdown. New Zealand experienced a short but sharp drought in the June quarter with lagged effects on manufacturing production and local economies. The global mid-cycle slowdown may have had an influence. The Canterbury Earthquake affected activity in Q3. And measurement issues are artificially reducing measured GDP growth (particularly in the communication sector). But the most important driver appears to be the weak housing market – weighed down by tax changes and lower population growth – and an associated weakness in consumer demand.

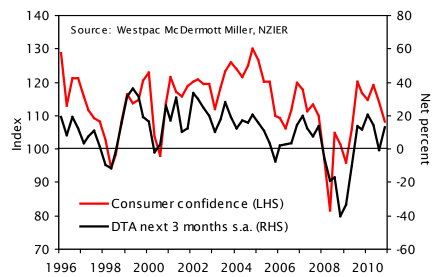
Recent economic and confidence data have been more positive, pointing to around 0.5% growth in the last quarter of 2010. Surveyed business activity appears to be emerging from its mid-year blues *(Figure 2)*. And the most recent data suggest some stabilisation in housing market turnover, albeit at low levels.

Figure 1: GDP production



But recent data also suggest that the New Zealand consumer remains caught in a crisis of confidence: surveyed consumer confidence softened further in the December quarter, and spending has been weaker overall than we might have thought. Electronic transactions data indicate a decidedly lacklustre Christmas shopping season, with rising petrol prices sapping shoppers' spending budgets, and there appears to have been less post-quake replacement spending in Canterbury to date than expected.

Figure 2: Domestic trading activity and consumer confidence



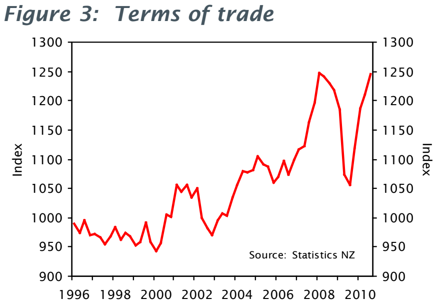
Opposing forces

The New Zealand economy is being pulled between two opposing forces – the positive income boost stemming mainly from high commodity prices, and the ongoing desire to repair balance sheets across the household, business and government sectors. To date, it seems that caution has won out to a disappointing degree. We now estimate GDP growth for calendar year 2010 to have been 1.5%, compared to the 3.7% growth we were forecasting this time last year, and growth in early 2011 is also likely to be weaker than forecast.

Looking further ahead, if anything the outlook for the external sector is even better now than a few months ago, as signs have strengthened that the global economy is emerging from its mid-cycle soft patch. Overall, 2010 has been a good, though uneven year for global growth, with demand surging in emerging economies, but debt concerns continuing to weigh on recoveries in major advanced economies. With a bit of luck we expect more of the same in 2011.

Against this global backdrop, export commodity prices remain near record highs, even taking into account the strong New Zealand dollar. The increase in export prices has led to an increase in the terms of trade, and hence New Zealanders' international purchasing power. New Zealand's terms of trade are now up 17.8% on a year earlier, the fastest annual increase since the early 1970s, and in the September quarter they regained their pre-crisis peak. Our view is that growing emerging market demand for our commodity exports will see New Zealand's terms of trade persist at higher levels than those seen in the last few decades.

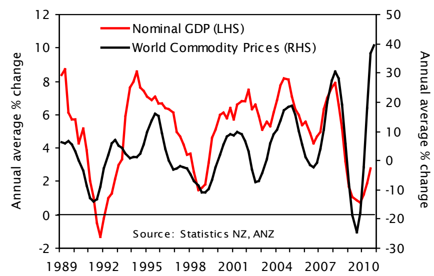
Figure 3: Terms of trade



The most visible illustration of the impact of higher commodity prices comes from the dairy payout. Fonterra has increased their expectation of the 2010 season milk payout to $6.90/kg milk solids, and further upwards revisions are likely in light of recent dairy auctions. This will mean cash in hand for farmers – particularly since fears that the dry weather we saw late last year would turn to drought have subsided. But an increase in the terms of trade unambiguously leaves the country better off, whether it's through higher export incomes, or cheaper imported consumer goods and capital equipment. Right now we're benefiting from both.

The big question facing forecasters is, how much of this income bonanza will be spent? Historically, the current level of commodity prices would have resulted in very strong economic growth *(see Figure 4)*. But households and farms are carrying historically high debt burdens from the previous boom, mortgaged against property which has taken a substantial hit.

Figure 4: GDP and commodity prices



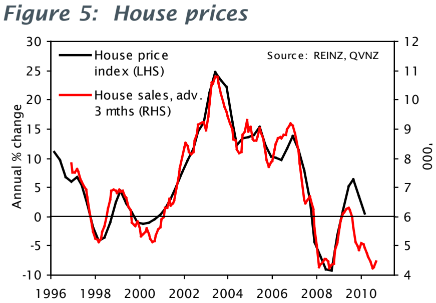
We think spending in 2011 will be soft by these historical standards, but not as soft as in 2010. It doesn't hurt that 2011 will see some positive one-offs replacing a string of bad news. Spending will receive a welcome fillip from the Rugby World Cup. And rebuilding from the Canterbury Earthquakes – while appearing to be proceeding a little more slowly than we anticipated – should go a long way in filling the current 'hole' in the construction sector.

But the underlying picture should also brighten. Job fears should diminish as actual employment conditions continue to improve over the coming year. The labour market data have been particularly volatile and hard to read in recent quarters, but taken together they suggest that an improvement is already under way: hours worked and employment have increased, unemployment has trended down, and underemployment (those with jobs but wanting more) falling 10%. We expect unemployment to approach 5% by the end of the year.

House prices (particularly at the lower end) are likely to have continued to slide modestly at the tail end of last year. Housing turnover is at very low levels, which might suggest some further downside risk to house prices *(Figure 5)*. But our fair value models suggest that house prices have already largely absorbed the impact of the tax changes, which we think were the major cause of both the slide in prices and the slump in sales last year. We expect house prices to end 2011 at about the same level as they begin the year. And the fact remains that current building levels are too low to meet population growth, which will support prices and construction over the longer term.

In New Zealand consumer spending is tightly tied to house and farm prices, because such a high proportion of wealth is held as property. Given a flat outlook for property prices, we certainly do not predict another credit-fuelled consumption boom, but growth in spending should be well set to move in line with growth in incomes. This remains a key difference between our view and that of the Reserve Bank, who expect house prices to slide further in 2011, and consumers to further ramp up their saving to bolster their balance sheets.

Figure 5: House prices



A shocker of a year

A striking feature of the past year has been the preponderance of shocks, whether they be local, international, weather or financial in origin. We've had finance company collapses, ongoing market jitters around Europe, the Canterbury earthquakes, and wild weather swings at home and abroad – all of which will have dented confidence and contributed to economic disruption, with the effect that economic growth in 2010 has turned out weaker than we would have predicted earlier last year.

Can we say anything about where the shocks might come from in 2011? While the timing and magnitude of shocks are by definition impossible to gauge, one obvious vulnerability continues to be in Europe, where governments are struggling to put together a coordinated and credible response to unsustainable debt build-ups in member states. A rescue fund has been set up to deal with the likes of Greece and Ireland, but should a bail-out of major European economies such as Spain or Italy start to look necessary, the impact on global financial prices could be much more severe than what we have seen to date.

Another risk to the outlook stems from the sheer breakneck pace of development that we have seen in emerging economies. Authorities in China, Indonesia and other fast-growing nations have struggled to rein in credit growth and inflation pressures using pretty much all methods at their disposal but with a reticence to allow significant interest rate and exchange rate rises. And rising food prices have raised the spectre of a return to the riots and unrest of the 2007-2008 food crisis. A major speed bump in the development path of the emerging world would make itself felt in global commodity prices, and certainly affect the balance of forces currently affecting New Zealand.

Take two

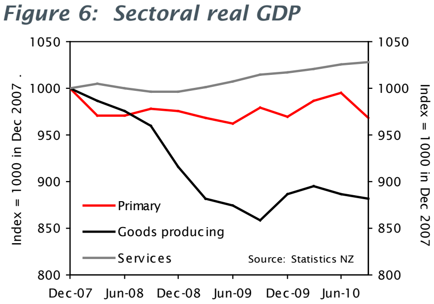
New Zealand's economic recovery faltered in 2010 but key pillars of growth remain in place. Export related sectors continued to benefit from strong demand growth in developing economies. Growth in the domestic focused sectors is likely to be more modest, boosted by reconstruction activity in Canterbury and the Rugby World Cup.

Overview

New Zealand's economic recovery in 2010 failed to live up to the promise hinted at early in the year. GDP growth for the year to September was a disappointing 1.4%, with the tepid pace of recovery through the middle part of the year underscored by the 0.2% contraction in the September quarter.

If anything, the two speed nature of New Zealand's recovery will be more pronounced this year. Export related sectors are again expected to lead the charge as foreign consumers demand for New Zealand products remains strong. We forecast a more modest pickup in domestic focused sectors with growth bolstered by Canterbury reconstruction spending, and the Rugby World Cup which should provide an all important boost to confidence. Add to this improving employment and wage growth and once again we are optimistic for a pickup in growth in 2011.

Figure 6: Sectoral real GDP



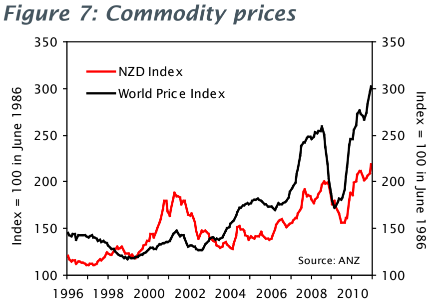
Agriculture

Weather has battered New Zealand farmers this season. September's spring storms were followed by unseasonably dry weather in early summer. Dairy production tumbled, dashing our hopes for a strong increase on last year's output. Rain since then has eased the situation somewhat, but farmers remain on edge. In an industry so exposed to unpredictable changes in weather, a strong finish to the growing season is never a certainty.

High international commodity prices look set to remain a feature in 2011 as demand growth in developing economies remains strong and weather disruptions hamper supply in some sectors. Meat and dairy prices in particular appear well supported driven by accelerating global food demand. World commodity prices for New Zealand exports were up 23% in 2010, and are 16% higher in NZD terms. In a sector where income growth is expected to be strong (with the exception of viticulture and horticulture), confidence remains integral in determining how improved cash flows will be transmitted to the wider economy. Tractor registrations picked up in late 2010 – perhaps an early sign of the improved outlook translating to increased investment spending.

Growth in forestry exports has been dominated by unprocessed wood and logs. To date, Chinese demand for these products has remained robust with the volume of logs exported to China in November up 27% on a year ago. However, it is possible that a concerted effort by the People's Bank of China to slow down the domestic property market could dampen demand growth later in the year.

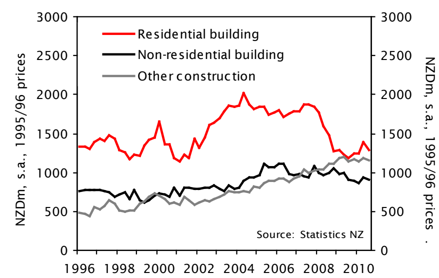
Figure 7: Commodity prices



Construction

The fortunes of New Zealand's construction sector remain firmly centred on Canterbury. Rebuilding in the aftermath of the September earthquake drives the profile of our forecasts for this sector over the next few years. Original estimates of $4bn reconstruction spending have now been upgraded to $5bn but the true cost of the disaster won't be known for years (if ever).We expect rebuilding activity to peak in Q4 2011 with the greatest impact on growth a little earlier. This reconstruction spending will go some way to filling empty order books elsewhere in the country where a more widespread rebound is unlikely to occur in the absence of a broader pick-up in housing market activity.

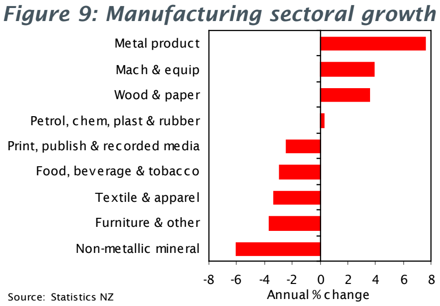
Figure 8: Construction activity by sector



Manufacturing

There continue to be divided fortunes in the manufacturing sector. Firms involved in food manufacturing have performed strongly, but non-food manufacturers are being squeezed on two fronts. High commodity prices are pushing up the value of the New Zealand dollar, leaving exporters faced with the choice of increasing prices or squeezed margins. Concurrently, increased competition from cheaper imports hits firms supplying domestic markets. Non-food manufacturing is now 16% lower than it was immediately before the 2008 recession. We are forecasting commodity prices and the NZD/USD to remain elevated going forward meaning the only possible relief in the near term for this sector is provided by the low NZD/AUD.

Figure 9: Manufacturing sectoral growth

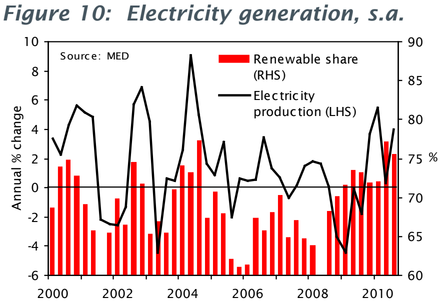


Electricity, gas and water

In September 2010, the largest ever quarterly generation reading was recorded, pushing electricity generation for the year over 3% above the previous 12 month period. This, combined with a slight decrease in the proportion of renewable generation in the quarter, ensured a 1.2% s.a. contribution to GDP growth.

Over the medium-term, much of the focus for New Zealand electricity generation developments is likely to be on wind and geothermal energy. Illustrating this, Contact Energy recently gained approval for a $1 billion geothermal power station near Taupo, while TrustPower has approval for two hydro power schemes in the South Island and two wind farm projects with a total project value of around $1.4 billion.

Figure 10: Electricity generation, s.a.

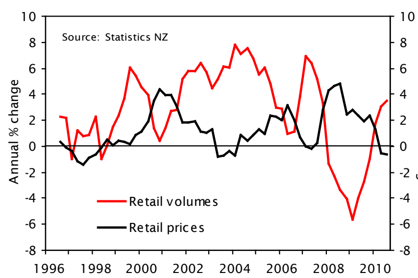


Retail trade

Growth plodded along in the retail sectors at an average rate of 2.5% in 2010 (annual, nominal, ex-autos, ex-GST). The timing of spending fluctuated as consumers grappled with the GST rise on the 1st October and though coincident tax cuts likely supported spending at the margin, cautious consumers have generally kept spending in check.

While consumers remain circumspect the outlook for the sector remains firmly intertwined with the fortunes of the housing market. We think there will be greater stability in house prices in 2011 as the immediate impact of tax changes dissipates, interest rates remain accommodative and wage and salary growth improves. This should provide a platform for consumer spending to gradually increase in line with income growth. In addition, the Rugby World Cup should provide further stimulus in the second half of the year.

Figure 11: Retail sales growth

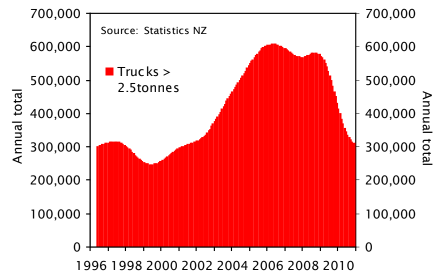


Transport and communication

Activity in the transport, storage and communication sector posted its strongest quarterly growth of the last year in the September quarter, expanding 2.1%.

However, optimism in the transport sector may well have since been dented by recent rapid increases in fuel prices. Petrol prices increased 13.8% in the past four months, and diesel prices are up 12.6%. On the communications side of the ledger, there are ongoing issues around the measurement of communication activity, as technological innovation outpaces statisticians collection methods. However there was a reprieve from the recent downward trend in the September quarter with a 0.4% bounce.

Figure 12: Truck registrations

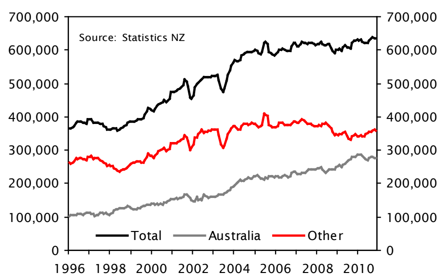


Tourism

The highlight of New Zealand's tourism calendar in 2011 will be the Rugby World Cup – a boost for both international and domestic tourism. A 70,000 increase in visitor arrivals is expected (excluding players and officials) with numbers of international tourists forecast to peak in October.

In 2010, a modest improvement in visitor arrivals (up 3.1% on the previous year in November) wasn't matched by growth in average tourist spend – the amount spent per tourist, per night, is still down 9% from a year ago. Interestingly, despite the changing composition of international arrivals (away from UK/Europe, toward Asia and Australia) the average length of visitor stay has remained fairly stable at around 22 days.

Figure 13: Visitor numbers



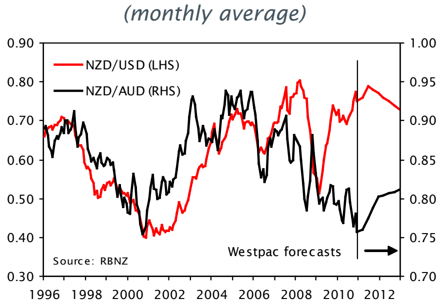
More of the same

Fundamental demand for commodities plays into New Zealand's favour, and will continue to be a decisive factor in keeping the NZ dollar elevated. Global currency tensions have eased back into 'cold war' mode, but downward pressure on the USD is likely to remain for as long as the Fed is alert to deflation risks. The RBNZ will regard domestic inflation pressures as benign, and is likely to carry through its plan for a very gradual policy tightening.

Exchange rates

For some time we've argued that high world commodity prices and trends in the US dollar would keep the New Zealand dollar at relatively elevated levels. Those themes kept our forecasts in good stead last year, with the NZD trading over a narrow range by its own standards, and ending the year slightly above where it began. We expect this year to bring more of the same *(Figure 14)*.

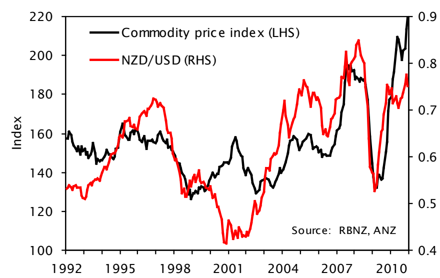
Figure 14: NZD/USD and NZD/AUD
(monthly average)



The ongoing strength of demand from rapidly-growing developing markets, 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. World food prices are now above their 2008 record levels, raising fears of a repeat of that year's global 'food crisis'. But while short-term supply constraints such as crop failures can certainly explain relative price strength in some cases, it's hard to deny that the surge in commodity prices across the spectrum is a product of demand.

New Zealand, as a high-quality food exporter, stands as a major beneficiary of this trend. The price index for our major commodity exports ended the year at a new record high, and world prices on average through 2010 were around 14% higher than the previous best year in 2008. Seen in that light, the NZD's gains through 2010 were actually fairly restrained *(Figure 15)*. Of course export prices don't tell the full story of the currency's purchasing power – New Zealand has largely avoided 'importing' inflation to date, aside from the resurgence in oil prices, but it is unlikely to dodge the bullet completely this year.

Figure 15: NZD/USD and commodity prices, adjusted for inflation



The US dollar is likely to remain under pressure for as long as the Federal Reserve retains an aggressive anti-deflation stance. Given the typical lag from economic activity to core inflation, that's likely to remain the case until at least the middle part of this year. But the better long-term growth prospects for the US – certainly compared to Europe and Japan – suggest that the USD should regain some ground over the course of the next few years.

Last year's global currency tensions have slipped back into 'cold war' mode. A few developing nations have taken further incremental steps to clamp down on capital inflows, but otherwise the rhetoric from the main players has noticeably eased. One reason is that the immediate source of those tensions last year – the slow pace of recovery in the US, which prompted the Fed into another round of 'quantitative easing' – is now seen as less pressing. The US economy regained some momentum in the last few months of 2010, with the result that, instead of the feared debauching of the currency, the USD actually rose more than 5% after the QE programme was announced.

Another factor is that China seems to have reached a stage where its competitiveness will be eroded one way or another. Annual inflation was close to 5% by the end of last year; the cost of food, raw materials and wages are all on the rise. Given China's need to contain inflation, as well as its broader goals for the economy, the policy mix in 2011 may well include a more substantial shift in the yuan than the gentle rise against the USD (and no real movement against a wider basket of currencies) that the authorities have allowed to date.

The rollercoaster ride in European financial markets last year proved two points: there is a significant political will to keep the euro project intact, but not so for actively getting on top of its problems. Reflecting this, we expect the euro to be choppy again over this year, marked by periodic dramas on the downside and occasional bouts of yield support from a hawkish-sounding ECB.

The NZD traded at ten-year lows against the AUD several times during 2010. Some underperformance was certainly warranted, given that NZ's economic recovery has lagged behind Australia's, and that we are in the unusual position where Australia's cash rate is significantly higher than ours. But the cross rate has been consistently weaker than those traditional relationships would suggest.

The answer may lie in a theme that we identified as far back as early 2009. In the post-financial crisis world, international lenders are much more cautious and more focused on their home markets. Countries with large external funding requirements – like Australia, and New Zealand even more so – would need to make their assets more attractive to investors, either through higher interest rates or a cheaper currency.

While this didn't lead to the outright weakness against the USD that we expected at the time, it's clear now that the relative performance story was on the mark. Accordingly, we've adapted our modelling of the cross rate to include a proxy for global investors' risk appetite. We still expect NZD/AUD to edge higher this year, but toward a 'fair value' in the low 80s rather than the mid 80s that our previous modelling suggested.

Interest rates

The RBNZ took an axe to its interest rate projections through the second half of 2010 as the pace of the recovery fell short of expectations. The December *Monetary Policy Statement* implied a very weak tightening path over the next couple of years, with the OCR unlikely to rise before September, and peaking not far north of 4% – less than the trough of previous cycles. Since then, the contraction in September quarter GDP added insult to injury, leaving economic activity even further below potential than thought.

The extent of spare capacity to be mopped up means that the RBNZ is likely to regard the inflation environment as quite benign through the course of 2011. That might seem an odd thing to say when annual inflation will exceed 4% for most of the year, and could even briefly top 5% *(Figure 16)*. But the RBNZ has a great deal of scope to look through many of the immediate influences on inflation.

More than half of the 4% rise in prices last year was due to one-off government charges, particularly the increase in GST from 12.5% to 15%. The RBNZ has long stated that it will look through the initial impact of these charges, and would respond only if they were clearly starting to affect pricing behaviour and wage demands. Surveys to date suggest that people haven't been 'fooled' by the one-off nature of the GST hike, though this will continue to be monitored.

Rising commodity prices – reflecting global rather than domestic pressures – can also be looked through to some extent. In the past the RBNZ has treated higher fuel prices as a 'tax' on activity, draining consumers' purchasing power elsewhere, as much as a source of inflation. Rising food and raw material prices are more clearly inflationary, but to the extent that some prices may be a product of short-term supply constraints, the RBNZ may be willing to wait and see whether current prices are sustained.

If the recovery progresses as we expect, domestically-generated inflation is likely to become more prominent in 2012 and beyond. And given the usual lags on monetary policy, the RBNZ will still need to dictate settings this year with those future conditions in mind. However, we recognise that the RBNZ will probably not be pressured into resuming hikes any earlier than September *(Figure 17)*.

Figure 16: CPI and 2yr ahead inflation expectations

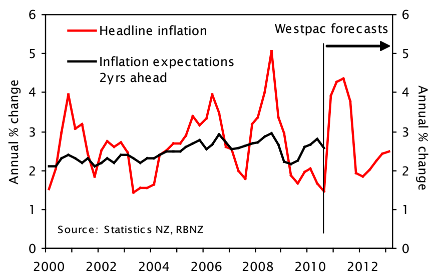
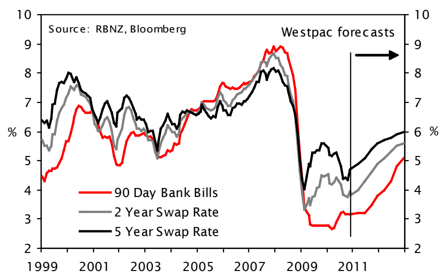


Figure 17: 90 day bank bills, 2 year and 5 year swap rates *(monthly average)*



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
Mar-11	3.00	3.20	4.00	4.90	0.76	0.76	0.56	0.48	63.1	68.0
Jun-11	3.00	3.20	4.30	5.10	0.79	0.77	0.57	0.49	65.6	69.9
Sep-11	3.25	3.50	4.60	5.40	0.78	0.79	0.59	0.49	70.2	71.0
Dec-11	3.50	3.80	4.90	5.60	0.77	0.80	0.59	0.48	73.2	71.6
Mar-12	3.75	4.00	5.10	5.70	0.76	0.80	0.59	0.47	73.7	71.2
Jun-12	4.00	4.30	5.30	5.80	0.75	0.81	0.59	0.45	74.3	70.8
Sep-12	4.50	4.80	5.50	5.90	0.74	0.81	0.58	0.44	74.7	70.2
Dec-12	4.75	5.10	5.60	6.00	0.73	0.81	0.57	0.43	74.5	69.6
Mar-13	5.00	5.30	5.70	6.00	0.73	0.81	0.57	0.42	74.7	69.5
Jun-13	5.25	5.50	5.80	6.10	0.72	0.81	0.57	0.41	74.9	69.3
Sep-13	5.25	5.50	5.80	6.10	0.72	0.81	0.57	0.41	75.1	69.1
Dec-13	5.25	5.50	5.80	6.10	0.71	0.82	0.57	0.40	75.3	68.9

Uneven keel

The global economy experienced above-average growth in 2010, and another good year seems likely. But growth will continue to be uneven, and disruptions are possible – fiscal problems in Europe and overheating in major emerging economies being the most obvious sources of stress.

The global economy experienced above-average growth in 2010 as it continued to emerge from the financial crisis. But the growth was far from even. The global economy can now broadly be divided into three groups. In the first group – led by China, but also including India, much of South-East Asia, and swathes of Latin America – are the erstwhile poor that are booming thanks to their low-cost production bases. Hundreds of millions of people are urbanising and obtaining the trappings of industrial life. The growth and sheer size of this group is creating intense competition for limited natural resources. In the second group are the countries that own the resources required by group one, and are benefiting from sky-high commodity prices. Russia, the Middle East and Australia come to mind. In the third group are many of the rich countries. They are being squeezed between the low production costs of group one and the high commodity prices charged by group two. Many are suffering from burst housing bubbles, damaged banking systems, unsustainable fiscal deficits (in some cases verging on default), and stagnant consumer demand.

This pattern is likely to continue over the next couple of years – strong growth in groups one and two, ongoing stagnation in group three. It is probable that financial instability in group three and overheating in group one will at some point disrupt the wider global growth story for a period – the most obvious pressure point right now being European sovereign debt, covered in the Europe section below. The main uncertainty is the severity and duration of such a disruption. On balance we predict 3.9% global growth in 2011, close to the post-WW2 average.

Australia

The Australian economy lost momentum in the third quarter of 2010, and retail sales and hours worked slowed further in the December quarter. The mining and resource boom is still progressing on an awesome scale. But the commodity super-cycle got the Reserve Bank of Australia concerned about inflation pressures, and it hiked the Cash Rate from 3.75% to 4.75% over the course of 2010, hammering consumer and business confidence in the process. A cooling housing market and a period of political uncertainty contributed to consumers' desire to save more and spend less.

Coming on top of this soft patch, the devastating Queensland floods are likely to cause substantial disruption to Australian activity as we head into 2011. While the impact is very uncertain at this stage, we think the hit to coal and agricultural exports could shave 1% off Australian GDP growth in Q1.

Looking beyond the near term, the economic outlook for 2011 remains positive. Activity will rebound as the clean-up and repair work from the floods gathers pace. And the late 2010 slowdown is best seen as a pause in the transition away from public spending towards private demand. Surveys indicate some recovery in consumer confidence, and the labour market has improved significantly over the past year. Australia is on the cusp of a renewed investment boom, which may not be good for everybody but will boost growth.

United States

There were some glimmers of hope in the US data towards the end of 2010. Q3 GDP growth was 2.6% annualised, and production and retail sales data picked up in the final months of the year. But improvement in the labour market is slow and the housing market remains extremely depressed. Inflation is worryingly low, with the core CPI at a record low on data going back to the 1950s.

In a bid to stave off the threat of deflation, the Federal Reserve is continuing to buy Federal debt as part of its quantitative easing programme. For its part, the Federal Government has agreed to extend Bush-era tax cuts and long-term unemployment benefits. The US faces an awful fiscal conundrum in the future – rein in the deficit and endure a further economic slowdown, or borrow until the debt burden becomes crushing. That, along with a very weak housing outlook, is a key reason why we are forecasting such slow US economic growth over the next few years.

China

China's latest five-year plan was signed off in October 2010, with an improvement in the "two ratios" of the consumption share of GDP and the household share of national income central to its structural goals. This may involve a higher exchange rate, greater taxes on firms, and a social security overhaul, as well as the givens of a tighter labour market and higher wages. The key question is how smoothly this economic transition can be achieved. The latest GDP data show a clear rebound after the mid-year slowdown, but surging food prices and inflation well above target have prompted more aggressive monetary policy tightening – mostly still in the form of credit controls.

Europe

The European sovereign debt crisis has deepened and widened. In mid-2010 things settled down for a period after Greece was bailed out, a rescue fund was set up, and governments embarked on austerity measures. But by November the Irish government was forced to agree to a bailout. Attention then turned to recession-bound Portugal, then Spain, and by early December Italian and Belgian yields began rising sharply. These economies should have less trouble servicing their public debts, but if trouble does emerge they may prove "too big to bail". This crisis is not just about government laxity, but about the structure of the euro area. It is euro membership that deprived these countries of the independent monetary policy and flexible exchange rate that could have prevented the boom, thereby avoiding the bust. The lack of a central authority prevented fiscal burden sharing. And market players are now testing the ability of euro area governments to come up with a coordinated crisis management strategy. At issue are both the scope and powers of the €440bn rescue fund and the regime to replace it once it expires in 2013.

Rest of Asia

Japan enjoyed relatively rapid growth in the September quarter as households rushed to take advantage of expiring government subsidies. Spending is likely to remain cautious in 2011, given a mountain of public debt and ongoing deflation, but a new fiscal stimulus package should keep the recovery going. Along with much of the rest of the world, Emerging Asia ex China saw economic growth take a breather from its earlier break-neck pace in Q3, but more recent export and manufacturing data show some re-acceleration in Q4.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2006	2007	2008	2009	2010e	2011f	2012f
New Zealand							
Real GDP % yr	0.9	2.9	-0.2	-1.7	1.5	3.3	3.1
CPI inflation % annual	2.6	3.2	3.4	2.0	4.0	2.3	2.1
Unemployment %	3.8	3.5	4.6	7.1	6.2	5.2	5.1
Australia							
Real GDP %yr	2.7	2.1	0.0	–2.6	2.7	1.1	2.4
Consumer Prices %yr	3.2	2.9	3.8	–0.3	1.6	2.3	3.3
Unemployment Rate %	4.6	5.8	5.8	9.3	9.7	10.0	10.2
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	2.8	2.2	–1.5	–6.6	4.5	1.8	2.3
Consumer Prices %yr	0.2	0.1	1.4	–1.3	–0.8	–0.4	–0.1
Unemployment Rate %	4.1	3.9	4.0	5.1	5.1	5.0	4.9
Euroland							
Real GDP %yr	3.2	2.9	0.3	–4.0	1.7	1.2	1.5
Consumer Prices %yr	2.0	3.1	1.6	0.9	1.5	1.6	1.5
Unemployment Rate %	7.9	7.3	7.8	10.0	10.5	10.5	10.5
United Kingdom							
Real GDP %yr	2.8	2.7	–0.1	–5.0	1.8	1.3	1.5
Consumer Prices %yr	3.0	2.1	3.5	2.9	3.0	2.8	1.5
Unemployment Rate %	3.0	2.5	3.1	5.0	4.5	5.0	5.5
China							
Real GDP %yr	12.7	14.2	9.6	9.1	10.3	9.1	9.9
Consumer Prices %yr	1.5	4.8	5.9	–0.7	3.3	3.0	3.0

Forecasts finalised 28 January 2011

Save Our Souls

A lack of savings has not been NZ's 'problem', but it has contributed to our vulnerability. There are simple ways to increase the national saving rate (but not necessarily the quantum of savings), but the cure can potentially be worse than the disease.

An independent Savings Working Group (SWG) has been formed to consider how NZ can improve its national savings. In this article we seek to outline a few considerations around the savings issue.[1]

Dodgy data

First up, there is considerable debate about what is the most appropriate measure of saving: is it the change in the stock of wealth, or the difference between income and expenditure? From an individual perspective the most relevant measure is changes in your net worth, which includes capital gains. From a national perspective it is probably the difference between income and expenditure ("the flow") that matters more. And the difference in measures can be significant: between 2004 and 2006 the household saving rate on a flow basis supposedly averaged -10% p.a. whereas when comparing individual's net worth over the same period the median real saving rate was +16% p.a (5% after stripping out house price appreciation).

And the data is fraught with difficulty. Savings flow is not measured directly, but rather as a residual between two very large numbers. A reasonable supposition is that income tends to be underreported more than expenditure. Also, investment components (e.g., education) are often included in consumption. And there is also omission (e.g., foreign assets are not fully captured). The sectoral split on saving is also problematic: net government saving is measured with accuracy but the split between household and business saving can be arbitrary. The issue of data is not just a curiosity. It can come at a real cost, as policy has, and may continue to be, set on the basis of perceived rather than actual problems.

What is the issue?

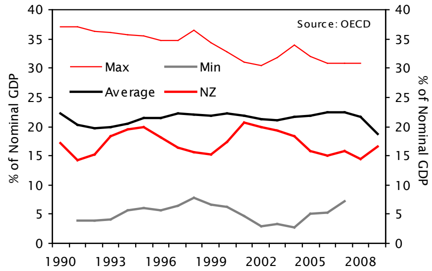
It is debatable what the issue is that NZ is trying to address: is it lack of saving perceived (and we think mistakenly) as limiting current growth; or low saving causing vulnerability through high external debt (and we think focus on saving alone would not necessarily address this issue); or adequacy of income and retirement; or lack of saving leading to lack of depth in domestic capital markets; or is it addressing a government budget problem with future high age related costs? The different issues have different policy implications.

How do we compare?

NZ's national saving rate is low compared to most other OECD countries. Our gross national saving has oscillated between 16 and 19% of GDP over the past 20 years. Our saving rate is the sixth lowest out of 28 countries, and is almost 5 percentage points below the OECD average.

However, saving is not of itself a very reliable indicator of economic growth (e.g., Japan has a high rate of saving and low economic growth). Nor is there a stable relationship between the wealth of a country and its rate of saving (e.g., the US is wealthy but not a particularly good saver, and poor developing countries tend to have high saving rates). And high saving rates haven't stopped asset price bubbles. Therein sits a warning that saving is not a panacea.

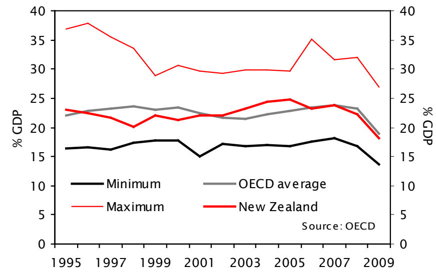
Figure 18: Gross national saving



Fingering the real culprit

NZ's low rate of saving has not necessarily restricted our potential economic growth. After all, there have been open capital markets and NZ has had access to plentiful foreign funds (this could of course change). In fact, NZ's gross investment rate has averaged close to the OECD mean (22.5% of GDP).

Figure 19: Gross investment



So our below OECD average savings have not (in the past) restricted our level of investment, but our relatively poor economic performance has seen us steadily sliding down the OECD ranking. It has been the poor quality of some of the investment undertaken that has been NZ's Achilles heal, not a shortage of saving. We have had relatively high residential and government investment, but relatively low business investment. In the 2000s NZ's productivity performance was woeful and we suffer from a lack of depth of our capital stock. It is our contention that a lack of savings is not the cause of these problems, but is itself a symptom of other ill-designed policies and misdirected incentives. Our most pressing need is to address the broad mix of policies that influence investment.

'Solutions'

The focus of the SWG is how to increase national saving. Rather unhelpfully, a number of studies prepared for the Group assume an autonomous (i.e. magical) lift in saving and analyse the consequences. Surely much of the interest should be in the process of getting higher national saving? Different measures to potentially increase the national saving rate could have dramatically different macroeconomic implications. Candidate measures could include: compulsion (although we are very dubious that this would have any impact on national saving, instead changing the form of saving – more into financial assets – and increasing household saving at the expense of other sectors); higher domestic interest rates (e.g., through capital controls); cuts in government social insurance programmes (forcing more self provision); hefty capital gains tax; or some even more radical means such as removal of freehold ownership of property, or engineering a financial sector crash.

Of course we are being facetious, but the point is that a number of policies that could increase the national saving rate are not palatable or desirable. And while they may increase the national saving rate, they could reduce the quantum of saving, and be good or bad for investment.

A difficult political reality is that the vast majority of savings in an economy is done by the wealthy minority. So any attempts to boost saving by using incentives is highly regressive – most of the benefits go to higher income earners. That makes them a very tough sell politically.

Vulnerability

NZ's large foreign debt and poor quality investment performance does leave the country vulnerable to an external funding shock. However, the country's best defence in the event of such a shock is a floating exchange rate. If foreigners reach the point that they think NZ looks like a bad risk, our interest bill will go up but the currency will act as a buffer – dropping (and boosting competitiveness) to a level low enough to make us look a better bet.

The usual candidates for causing a funding crisis are[2]: excessive debt; excessive interest payments; excessive reliance on foreign capital; economic weakness (reflected in low growth and low returns on private sector investment); political weakness (excessive expenditure and insufficient taxation are politically determined); and irrational exuberance (investors forget to learn from history).

As a country, NZ suffers to varying degree from all of these! Our only saving grace (pun intended) is that, to date, it has been private sector rather than public debt at exorbitant levels.

There are a number of ways for a country to get out of an excessive debt situation: cut spending to fit income; lower interest rates (but this has limits and country risk premia can negate it); a bailout; print money and deflate the debt away; default; or generate a higher growth rate of GDP. The only practical options for NZ are to cut (e.g., fiscal pain) or go for growth. And the two are not necessarily at odds: we think a significant part of NZ's recent abysmal economic performance has been because of a rapidly expanding size of general government. Too large government becomes like a boa constrictor: each time the private sector exhales, it squeezes tighter, taking the economic life away.

Contentious

The SWG has identified the key issue as NZ's vulnerability from high foreign debt. The SWG asserts that higher savings would reduce current account deficits, lower the interest rates New Zealanders pay foreigners, thus encouraging private investment, lowering the exchange rate and encouraging exports.

It sounds like the economic cure-all. But these assertions are actually contentious. The SWG does not say how higher savings will come about (it may take higher, not lower, interest rates to get them).

The current account is the difference between how much we save and invest as a nation. If higher saving resulted in lower interest rates and higher private investment as the SWG assert, the effect on the CA and foreign liabilities is ambiguous. We are also not at all convinced that higher saving (depending on how it is engineered) would result in a lower exchange rate (lower country risk generally results in a higher exchange rate).

A few recommendations

Incentives and compulsion will change the form of saving but generally do not increase national saving. The best chance of having any impact on national saving (and keeping the country's credit rating) would probably come from getting on top of the government deficit more quickly, and ultimately shrinking the size of government. The age of eligibility for superannuation needs to be extended. The tax treatment of different forms of saving needs to be addressed so that financial assets are not penalised in comparison to property. Examination of an Exempt-Exempt-Tax regime on financial assets would also be worthwhile, although we fear that the current state of the government accounts means that this was an opportunity for the past decade which was lost. The list can go on in terms of reducing compliance costs, flattening tax scales, etc. Improved financial literacy is also necessary (understanding of two areas would be a good start: the effects of compounding, and the risk reward trade-off).

For us, policies specifically targeting higher savings are at high risk of failure. We'd prefer to see the emphasis on raising the quality of NZ's investment. A good test is whether a policy will enhance or diminish the quality of investment, not whether it might or might not increase saving with unknown effects.

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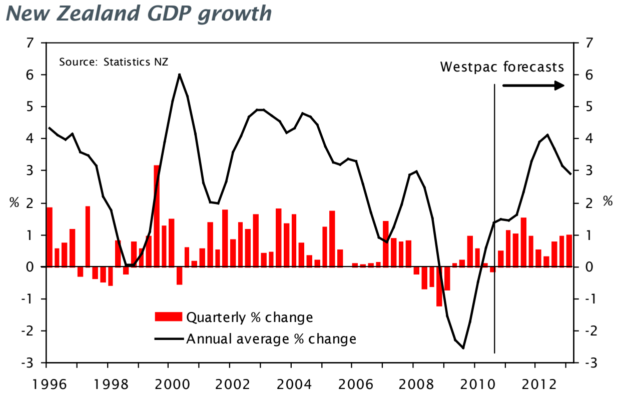
[1] These are the views of Westpac Economics and do not necessarily coincide with those of Westpac.

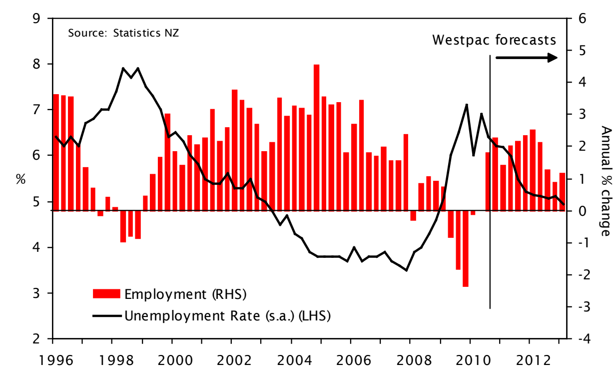
[2] This list is taken from "Fiscal Crises and Imperial Collapses: Historical Perspectives on Current Predicaments", Niall Ferguson, Harvard University Niarchos Lecture, May 13, 2010

Annual Average		March years				Calendar years		
% change	2010	2011f	2012f	2013f	2009	2010e	2011f	2012f
Private consumption	0.4	1.6	1.8	2.4	-0.7	2.0	1.5	2.3
Government consumption	0.2	1.9	1.4	2.0	0.6	2.1	1.2	1.9
Residential Investment	-13.0	8.6	18.7	6.8	-18.1	5.3	16.3	11.0
Business Investment	-8.5	4.9	10.8	10.5	-7.5	0.2	10.9	10.5
Stocks (% contribution)	-2.1	0.7	1.2	-0.1	-2.8	1.1	0.9	0.2
GNE	-3.6	3.9	5.3	4.1	-4.9	3.5	4.8	4.5
Exports	4.6	1.9	5.7	3.2	1.7	2.9	5.0	3.6
Imports	-9.4	8.9	9.3	6.6	-14.6	8.5	9.1	7.4
GDP (Production)	**-0.5**	**1.5**	**3.9**	**2.9**	**-1.7**	**1.5**	**3.3**	**3.1**
Employment (% annual)	-0.1	1.4	2.5	1.1	-2.4	2.3	2.3	0.9
Unemployment Rate (% s.a. end of period)	6.0	6.2	5.1	4.9	7.1	6.2	5.2	5.1
Average Hourly Earnings (% annual)	1.6	2.1	2.8	3.4	3.1	1.2	2.5	3.3
CPI (% annual)	2.0	4.6	1.7	2.4	2.0	4.0	2.3	2.1
Current Account Balance (% of GDP)	-2.4	-2.7	-4.1	-5.0	-2.8	-2.6	-3.9	-4.9
Terms of Trade	0.1	6.6	0.0	1.6	-8.2	12.0	1.0	0.9
90 Day Bank Bills (end of period)	2.73	3.20	4.00	5.30	2.79	3.18	3.80	5.10
5 year swap (end of period)	5.27	4.90	5.70	6.00	5.56	4.60	5.60	6.00
TWI (end of period)	65.3	68.0	71.2	69.5	65.5	67.8	71.6	69.6
NZD/USD (end of period)	0.71	0.76	0.76	0.73	0.73	0.76	0.77	0.73
NZD/AUD (end of period)	0.78	0.76	0.80	0.81	0.80	0.77	0.80	0.81
NZD/EUR (end of period)	0.51	0.56	0.59	0.57	0.49	0.56	0.59	0.57
NZD/GBP (end of period)	0.45	0.48	0.47	0.42	0.45	0.48	0.48	0.43

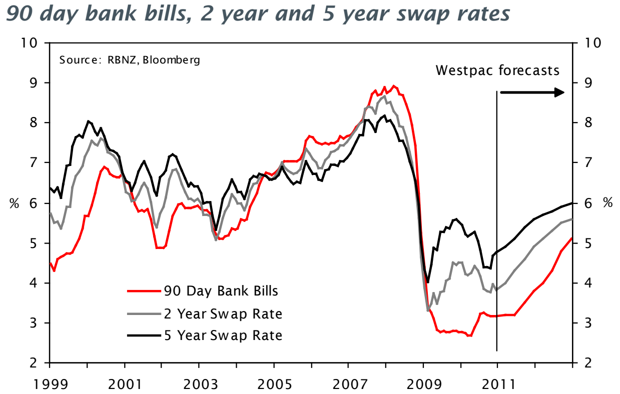
New Zealand GDP growth



New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI