

Weekly Commentary

6 September 2010

Tipped over the edge

Note: this report was prepared before the 7.1 magnitude earthquake that struck the Canterbury region over the weekend. Please see our Bulletin "Shaky isles" for our assessment of the economic impact of this event.

We have shifted our forecast to no change in the OCR in September and October. Nearly all economists are now picking a pause next week, and interest rate markets are pricing only a one in four chance of a hike. But where our view differs – certainly from market pricing at least – is that we expect the September *Monetary Policy Statement* to continue to push the message that the OCR will need to move higher as the economy recovers.

As the RBNZ noted in its July statement, the tone of the recent data warrants a more moderate pace and extent of tightening than was projected in June. By our estimates, that could see the OCR peaking in mid-2012 around the 5.00-5.25% range, compared to a 5.75-6.00% range previously. But from a starting point of 3.00%, that still doesn't leave a lot of room for the RBNZ to drag its feet.

As a result, this represents a change to the expected timing of hikes, not a downgrade to our overall interest rate projections. We had already acknowledged that a pause in the tightening cycle was likely at some point in the next few months – previously we had it pencilled in for December. But

with the RBNZ facing a highly uncertain global environment, mixed signals on the domestic economy, and now the biggest financial sector failure in nearly two decades, bringing the pause forward to September is a low-risk option.

The failure of South Canterbury Finance, the largest non-bank-owned finance company (though still only accounting for around 0.5% of financial system assets), goes further towards making a pause the more tactful option for the RBNZ. However, in our view the net economic impact is likely to be close to zero. Bear in mind that the new development here is SCF's receivership (and the government's payout to depositors); any consequences should be weighed against the alternative of the firm continuing to limp on as before.

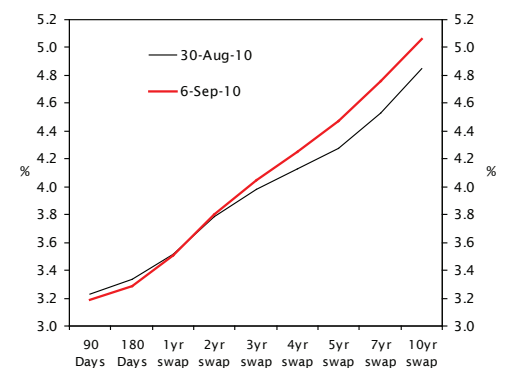
Under the Retail Deposit Guarantee, around \$1.6bn will be paid out to depositors in coming weeks. A large share of term deposits are held by retirees who rely on the regular interest income. So rather than being treated as a 'windfall' to be spent, we expect the vast majority of these funds will go towards similar investments – deposits at banks and building societies, and bonds from the higher-rated corporate issuers. It's possible that these funds could be recycled into new lending, thereby stimulating the economy. The key is whether

the main constraint on credit growth is supply or demand; the evidence seems weighted towards the latter.

Finally, access to finance is likely to be a sector-specific issue. While SCF has been portrayed as a major player in rural lending, this made up only 18% of its loan book as at the end of 2009 – about the same share as the major retail banks. Its greater exposure was to property development, a sector that is already under pressure to evolve towards new methods of financing.

On the data front, the news was mixed last week. Residential building consents rose 3.1% in July, but that was driven by a rise in the lumpy apartments component. Single-home consents fell by 5.3%, and are now below end-2009 levels. Tax changes, slower population

NZ Interest Rates



*Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1 year onwards.

growth and higher mortgage rates continue to have a cooling effect on the housing market compared to a year ago.

Business confidence fell in August, though only to levels more consistent with the pace of GDP growth seen to date. Confidence in housing construction was weaker, but export-oriented sectors remained positive. With the GST increase looming on 1 October, nearly 50% of retailers said they intend to raise prices in the next three months.

The trade balance slipped into deficit in July, with dairy volumes heading towards their seasonal low point, although prices remained firm. Imports were stronger than we expected, led by a substantial rise in capital goods (ex transport). We

estimate that after adjusting for large one-offs such as oil rigs, imports of plant and machinery have now recovered more than half of their peak-to-trough decline – not bad at a time when businesses are supposedly reluctant to invest.

Finally, dairy prices rose by 16.9% in Fonterra’s online auction. We suspect the magnitude of the increase reflects demand rather than supply, with buyers holding back on their purchases in recent months, in anticipation of a continued slide in prices as northern hemisphere production ramped up. However, the dramatic spike in wheat prices in Jul-Aug, due to drought in Russia, may have turned this sentiment around. We maintain our forecast for a total payout of around \$7/kg for this season. Along

with bumper growing conditions that could see production up by 8-10%, this would see cashflows to dairy farmers up almost \$1.5bn in the year to October 2011 (to \$10.3bn).

Fixed vs. floating: The gap between fixed and floating rates has narrowed significantly – partly because financial markets are questioning the RBNZ’s resolve to return the OCR to normal levels. Borrowers who believe that the economy is simply wobbling along the path to recovery, and therefore that the RBNZ will continue to normalise the OCR in the next few years, will find today’s 2-3 year fixed rates very attractive. Those who believe that markets are presaging a return to recession will be more attracted to floating rates.

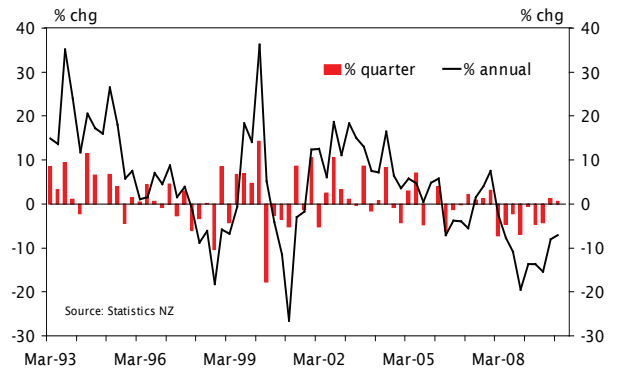
Key Data Previews

NZ Q2 real building work put in place

Sep 8, Last: +0.7%

- Total building work eked out only a small gain in the March quarter, as activity in the residential sector – which surprised on the downside (possibly finance-related, as consents indicated an increase of close to 6%) – only just offset a fourth consecutive decline in the non-residential sector.
- Consents suggest a modest gain in residential investment in the June quarter in the order of 3%. However, we see some potential for catch-up given the weak March quarter outturn.
- Private sector indicators of non-residential investment have maintained their usual volatility, but overall suggest a further decline in Q2. Government should provide some offset, given the increase in consents for hospitals and education buildings in the second half of 2009. However, we don’t expect it will be enough to push total activity in the non-residential sector into positive territory. Our forecast is for a decline of 1%.

NZ real building work put in place

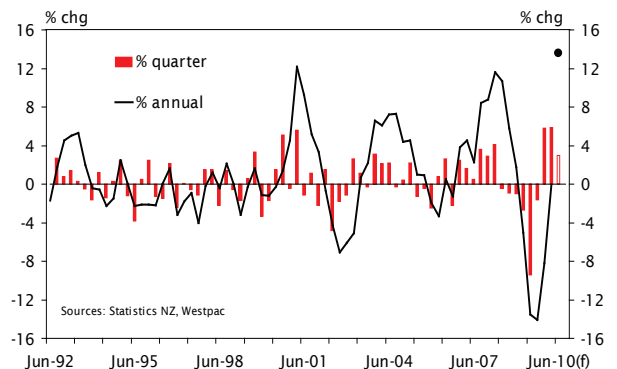


NZ Q2 terms of trade

Sep 10, Last: +5.9%, WBC f/c: +3.0%

- The terms of trade continues to claw its way back from the sharp decline seen during the global recession. Our forecast for the June quarter would put the index up 13.6% on a year earlier, and just 2% shy of its pre-crisis highs.
- We expect a 4.9% rise in export prices, with gains across the spectrum. Dairy exports continued to benefit from higher prices agreed earlier in the year, with an estimated 7% gain. Meanwhile, spot prices remained firm for the likes of meat, fish, logs and oil.
- Import prices are estimated to be up 1.8%, dominated by higher prices for petroleum products. The 2% rise in the exchange rate over the quarter is likely to have left prices broadly flat for manufactured goods.

NZ terms of trade

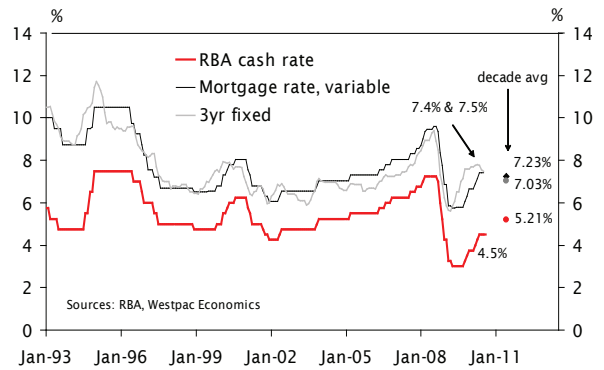


Aus RBA policy announcement

Sep 7, Last: 4.50%, WBC f/c: 4.50% Mkt f/c: 4.50%

- The RBA left the cash rate steady at 4.50% for the 3rd straight month in Aug, with the statement highlighting a more confident central bank in the forecasts with “growth likely to be close to trend” and “inflation close to target”, emboldened by the ‘low’ Q2 core CPI result. The current monetary policy setting was described as “appropriate” with loan rates near decade averages. The tone of the statement suggested preparation for an extended period of steady rates.
- With breathing room on inflation for now and the global outlook more uncertain (and waning US momentum), we see rates on hold for the rest of 2010. But with the SoMP GDP f/c’s above trend in 2011 and 2012, and core inflation f/c to rise to 3%, the resource investment boom is seen pressuring supply capacity, and we see the tightening cycle resuming in 2011H1. Recent CAPEX plan upgrades reinforce this view.

RBA: borrowing rates have normalised

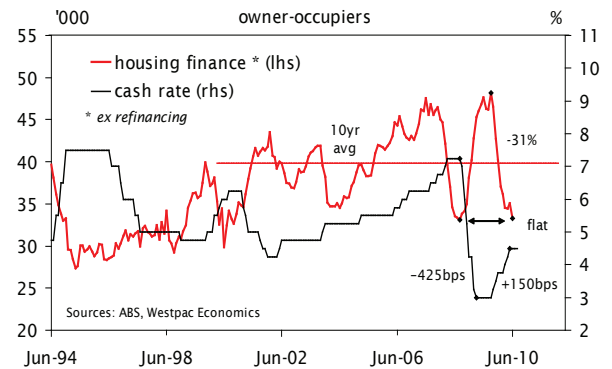


Aus Jul housing finance

Sep 8, Last: -3.8%, WBC f/c: 1.0%, Mkt f/c: 1.0%

- Demand for housing finance is likely to gain a second wind over the remainder of 2010, with the RBA on hold from June.
- Finance to owner-occupiers is forecast to rise by 1.0% in July, following a 3.9% fall in June and a 31% drop in new lending from the peak of last September.
- Supportive of a second wind is a brightening of the consumer mood. The Westpac-MI Consumer Sentiment Index rebounded from a low of just 102 in June to 113 in July and rose to 119 in August. This is as labour market strength boosts household incomes and thereby improves housing affordability.
- As for Investors, the upward trend in finance faltered in June, with a 3.6% fall - to still be up 29% from the start of 2009. We expect the upward trend to resume in coming months.

Owner-occupier finance & the rate cycle

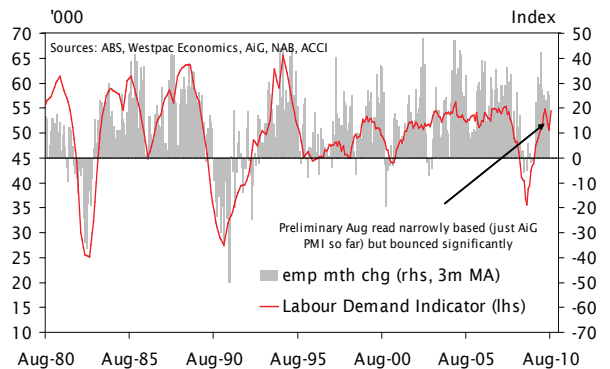


Aus Aug employment chg

Sep 9, Last: 23.5k, WBC f/c: 25k, Mkt f/c: 25k

- Jobs rose 23.5k in July, slowing trend growth to 16.7k mth from a Nov-09 peak of 33.5k as employers utilise more of the spare capacity in existing labour. Average hours worked have trended up for 5 months. The softer monthly trend has still seen annual trend growth rise to 2.7%yr (highest since Jul-08), with medium term leads implying a 3%yr pace in 2010H2.
- The election is a wild-card for Aug jobs, with the AEC said to have hired 70k for polling day. We expect minimal effect from this: the survey ran from 8th to 21st and relates to the week before the interview, so only 1/14th of the period could include polling day temps; temps on that day were not home to be surveyed; a large proportion of poll day temps are already otherwise employed; the same survey timing in Nov-07 saw a 50k PT jump, but that looked more like noise (followed -68k prev & no payback fall in Dec). Still, with our preliminary labour demand indicator up in Aug, we expect +25k, lifting annual trend growth to 2.8%yr.

Westpac Australian Labour Demand Indicator

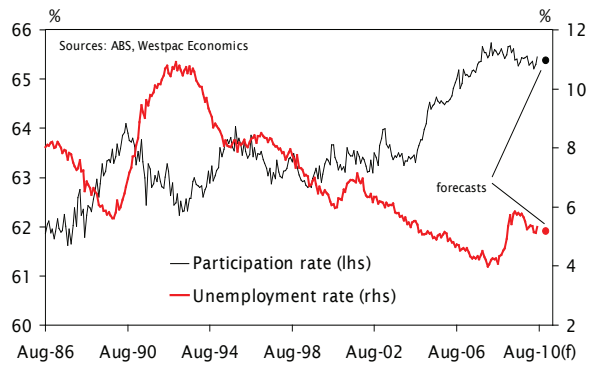


Aus Aug unemployment rate

Sep 9, Last: 5.3%, WBC f/c: 5.2%, Mkt f/c: 5.2%

- With the recent rise in consumer sentiment, the participation rate rose 0.2ppts to 65.5%. That drove strong labour force growth of 48.1k, more than offsetting the jobs rise to lift the unemployment rate 0.2ppts to 5.3%. The trend unemployment rate continued to edge gradually lower (5.2% vs 5.8% a year ago), consistent with our view that continued strong labour force growth will leave the unemployment rate downtrend slow.
- Months of jobs growth around 25k following 0.2ppt rises in unemployment and participation rates have seen pullbacks in participation. But with a possible Election offset from temp workers, we f/c a small 0.1ppt dip to 65.4%. That sees weak labour force growth of around 7k, allowing a 25k rise in jobs to take the unemployment rate back to 5.2% from 5.3%. That could show as a 0.2ppt fall, as our two-decimal f/c is 5.17% vs 5.32% previously = a fall of 0.15ppts.

Unemployment and participation rates



US trade deficit on widening trend

Sep 9, Last: \$49.9bn, WBC f/c: \$50.1bn

- The US trade deficit widened \$7.9bn to \$49.9bn in June on a broad-based 1.3% exports fall and a 3.0% imports jump that was constrained by lower oil prices; ex-oil, imports rose 4.7%.
- Although industrial production and durable goods shipments posted solid growth in July, much of this was auto related (which is not a US export strength). However aircraft exports should be a positive. But elsewhere, there is not much evidence of renewed exports growth with June's softer ISM export reading maintained in July-August.
- Imports should not repeat June's gain in July given the economy has lost momentum, and US dollar appreciation has pushed import prices lower (but a bounce in the oil component is likely).
- A 0.5% rise in both exports and imports would lift the deficit to just over \$50bn in July.

US trade balance



Key Data and Events

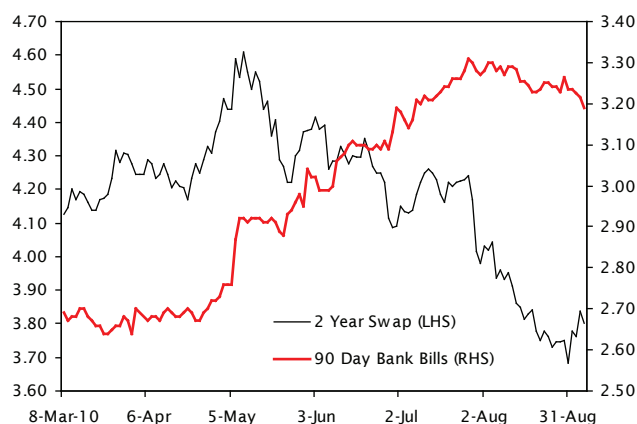
	Last	Market Median	Westpac Forecast	Comments	
Mon 6					
Eur	Sep Sentix investor confidence	8.2	10.0	7.5	Investors starting to question euro growth with US clearly slowing.
UK	Aug house prices %yr	4.9%	4.4%	-	Tentative date for Halifax series, due 6-10/9.
US	US Labor Day holiday	-	-	-	Last chance for the ladies to wear their white shoes; markets closed.
Tue 7					
NZ	Q2 wholesale trade survey	2.3%	-	-	Further recovery expected, though may not match last quarter's pace.
Aus	RBA policy decision	4.50%	4.50%	4.50%	CPI room = rates "appropriate" & on hold; further hikes likely 2011H1.
Jpn	Bank of Japan decision	0.1%	0.1%	0.1%	Fizzer of an emergency meeting makes this a non-event we suspect.
Ger	Jul factory orders	3.2%	0.5%	2.0%	Still benefiting from weaker euro and global trade recovery.
UK	Aug BRC retail sales monitor %yr	0.5%	-	-	Same store sales were weaker in July, contrasting solid official data.
Wed 8					
NZ	Q2 building work put in place	0.7%	-	-	Potential for some catch-up in residential sector, meaning upside risk.
	Q2 real manufacturing sales s.a.	-2.7%	-	-	Dairy manufacturing affected by drought; non-agri still recovering.
Aus	Jul housing finance (no.)	-3.8%	1.0%	1.0%	RBA now on hold + labour mkt strength points to a 2nd wind.
Jpn	Jul machinery orders	1.6%	2.0%	-	Still adjusting to a major decline in May. Private core +17% from low.
	Aug bank lending %yr	-1.8%	-	-	Lack of demand for credit is the key problem here.
Ger	Jul industrial production	-0.6%	1.0%	1.0%	Still some momentum from recent solid orders growth.
UK	Aug BRC shop prices index %yr	1.5%	-	-	Guide to part of CPI basket; often picks direction of annual CPI change.
	Jul industrial production	-0.5%	0.4%	0.9%	Bounce back in mining and oil likely due to seasonality issues.
US	Fed beige book	-	-	-	Fed's regional assessment of economic conditions.
	Jul consumer credit \$bn	-1.3	-5.4	-	Credit in decline as spending dwindles post fiscal stimulus.
Can	Jul building permits	6.5%	-6.0%	-	Canadian housing market is losing momentum on many indicators.
	BoC rate decision	0.75%	1.0%	1.0%	Further modest tightening but sluggish US means BoC to pause soon.
	Aug Ivey PMI nsa	54.0	55.5	55.0	Index typically rises in August for seasonal reasons.
Thu 9					
NZ	Aug electronic card transactions	-0.2%	-	-	No hint of a pre-GST spending rush just yet.
Aus	Aug employment chg	23.5k	25k	25k	Survey timing implies no big Election boost.
	Aug unemployment rate	5.3%	5.2%	5.2%	Jobs rise reinforced by dip in participation rate to 65.4%.
UK	Jul visible trade balance GBPbn	-7.4	-7.6	-	Will June's export jump be sustained?
	BoE MPC policy decision	0.50%	0.50%	0.50%	Rates on hold and no QE adjustment still the majority view.
US	Jul trade balance \$bn	-49.9	-47.8	-50.1	Nothing particularly unsustainable about Jun imports surge.
	US initial jobless claims w/e 4/9	472k	470k	475k	Holding below recent 500k peak but still indicating weak jobs mkt.
Can	Aug housing starts	-1.6%	-2.4%	-	Urban single family home starts down by around a third since March.
	Jul new house prices	0.1%	0.1%	-	Have been rising for the past year but may soon lose momentum.
	Jul trade balance C\$bn	-1.1	-1.0	-	Deficits in three of last four months.
Fri 10					
NZ	Q2 terms of trade	5.9%	-	3.0%	Moderate gains in commodity export prices across the board.
Chn	Aug trade balance USDbn	28.7	26.7	-	Imports soft in PMI, possible source of upside surprise.
	Jul NDRC house prices %yr (tentative date)	10.3%	9.3%	-	On a reasonably benign downward path with high regional diversity.
UK	Aug producer prices %yr	4.7%	-	-	Core output measure.
US	Jul wholesale inventories	0.1%	0.4%	0.2%	Another early clue to extent of inventory contribution to Q3 GDP.
Can	Aug employment chg	-9k	17.8k	25k	Trend still positive but slowing as economic growth moderates.

New Zealand Economic and Financial Forecasts

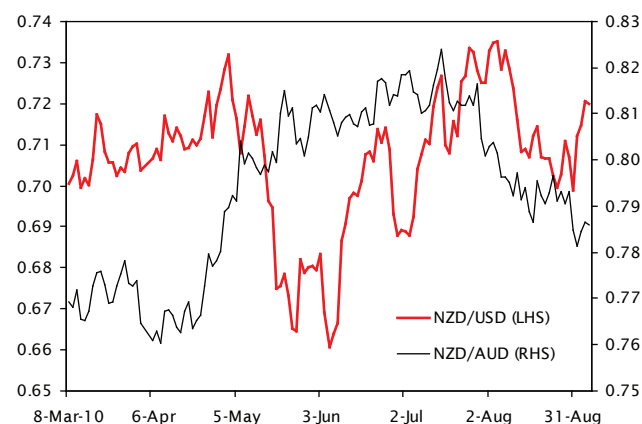
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	3.5	4.1	3.3	-1.6	2.9	4.4	3.4
Employment	-0.1	1.7	1.5	1.7	-2.4	1.9	1.9	1.6
Unemployment Rate % s.a.	6.0	5.8	5.6	5.1	7.1	6.2	5.6	5.2
CPI	2.0	4.7	2.7	3.2	2.0	4.7	2.4	3.3
Current Account Balance % of GDP	-2.4	-3.3	-4.8	-4.9	-2.9	-3.0	-4.6	-5.0

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.00	3.25	3.75	4.25	4.75	5.25	5.75
90 Day bill	3.30	3.70	4.20	4.70	5.20	5.70	6.10
2 Year Swap	3.90	4.20	4.70	5.20	5.60	6.00	6.30
5 Year Swap	4.50	4.80	5.20	5.60	5.90	6.20	6.40
10 Year Bond	5.30	5.40	5.70	5.90	6.00	6.20	6.30
NZD/USD	0.70	0.72	0.75	0.75	0.74	0.73	0.72
NZD/AUD	0.80	0.80	0.82	0.83	0.84	0.84	0.84
NZD/JPY	61.6	65.5	70.5	72.8	74.0	75.2	76.3
NZD/EUR	0.53	0.54	0.56	0.58	0.59	0.59	0.59
NZD/GBP	0.45	0.46	0.47	0.48	0.48	0.47	0.46
TWI	65.6	67.1	69.7	71.1	71.4	71.2	71.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 6 September 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.11%	3.13%	3.12%
60 Days	3.20%	3.22%	3.20%
90 Days	3.19%	3.24%	3.29%
2 Year Swap	3.80%	3.75%	3.96%
5 Year Swap	4.43%	4.20%	4.58%

NZ foreign currency midrates as at Monday 6 September 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7199	0.7050	0.7329
NZD/EUR	0.5588	0.5549	0.5517
NZD/GBP	0.4659	0.4544	0.4582
NZD/JPY	60.830	60.320	62.760
NZD/AUD	0.7861	0.7958	0.7964
TWI	66.760	66.190	67.280

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.3	1.3	3.3	3.5
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.2	3.2
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.1	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-2.9	-2.1
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.6	2.5
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.1	1.1	2.2
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.0
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.2	-2.7
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.5	1.1
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-0.7	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.1	4.8
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	3.3	3.4
Euroland							
Real GDP %yr	1.7	3.0	2.8	0.6	-4.1	0.8	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.0	1.2
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
Current Account %GDP	-0.2	-0.1	0.1	-1.1	-1.0	-0.5	0.0
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.5	-4.9	1.1	1.0
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	3.0
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	5.0	5.0
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 6 August 2010

Interest Rate Forecasts	Latest (Sep 6)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.50	4.50	4.75	5.00	5.00
90 Day Bill	4.74	4.75	4.75	5.00	5.25	5.50
10 Year Bond	4.91	5.20	5.30	5.30	5.30	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	2.70	3.20	3.40	3.50	3.60	3.80
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.9159	0.88	0.90	0.92	0.90	0.88
USD/JPY	84.49	88	91	94	97	100
EUR/USD	1.2884	1.31	1.33	1.34	1.30	1.26
AUD/NZD	1.2724	1.22	1.22	1.21	1.20	1.19

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