

Weekly Commentary

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A weekly outlook for New Zealand, Australia and US markets

15 September 2008

The inflation targeter who wasn't

The RBNZ surprised the market again by delivering a 50bp rate cut, the first time under Dr Bollard's governorship. The RBNZ has decided to deliver some immediate relief to households, and last week's jumbo-sized move was aimed at ensuring that the cut would be passed on by lenders.

Credit conditions were the decisive factor in the RBNZ's surprise 25bp cut in July and again in this week's decision. Since the global credit crunch began a year ago, the cost of raising funds offshore has risen significantly. Combine that with 100bp of official rate tightening in the months before the credit crunch, and the lending rates faced by households and businesses rose sharply in a short space of time. More recently, average funding costs have remained high despite a substantial fall in swap rates. The RBNZ believes that aggressive OCR cuts are needed just to offset the rise in offshore funding costs.

The RBNZ also remains fixated on the idea that the 'effective' mortgage rate – the average rate paid on outstanding loans – matters most. Fixed-rate loans that are coming up for renewal in coming months are likely to be fixed at rates as much as 100bp higher than before, putting further pressure on some borrowers and pushing the effective rate higher. We think this effect is being overstated. Since the start of the year there has been a sharp rise in the number of borrowers 'fixing' for terms as short as six months, in the hope of

catching the bottom of the interest rate cycle. Rate cuts today will flow through to the average borrower much sooner than the RBNZ gives them credit for. That aside, we'd argue that the marginal cost of borrowing, not the average, is more influential – and marginal interest rates have been falling for months.

Even with the RBNZ easing harder and faster than previously signalled, they still expect consumers to be under the gun for a long time, as they are pumelled by falling house prices, higher food and energy costs, high mortgage rates and a weaker jobs market. The bleak outlook for the consumer is necessary because, to put it bluntly, the RBNZ is counting on weak growth to fix the inflation problem for them. Their view is that as consumer spending falls, excess supply will emerge in the economy, which will prevent workers from negotiating larger pay increases and businesses from passing on higher input costs.

We're not convinced: some of the blame for the slowdown has to fall on the supply-side 'shock' of higher food and energy prices that has hit New Zealand, and the rest of the world, in the last year or so. Weaker activity may not reduce inflation, if that weaker activity has been caused by inflation. The key is how inflation expectations and wages respond to high headline inflation.

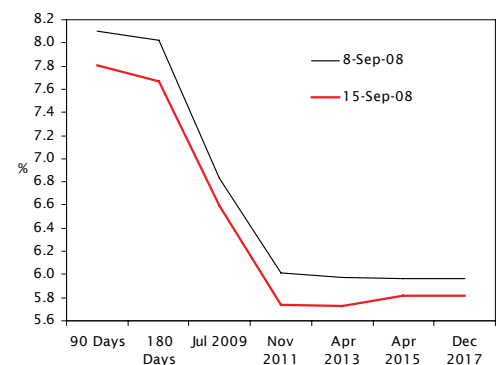
Our concern is that inflation will prove to be persistent. The

importance of the cost shock as a cause of the slowdown will only become apparent over time, and by the RBNZ's own admission, "it is likely to be early next year before we get a clear indication of the extent to which slower activity is translating into lower underlying inflation". But that won't stop them from delivering several rounds of interest rate cuts in the meantime.

In fact, reading the *Monetary Policy Statement*, you would be hard-pressed to believe that the RBNZ is an inflation targeter. Virtually all of the discussion was around weak domestic activity, slowing world growth and tight credit conditions. The possibility of upside risks to inflation didn't warrant a mention until the last paragraph of a 24-page document.

Any good news on the inflation front has been completely offset by a

NZ Interest Rates



*Yield curve is yields on bank bills to 180 days: yields on Government bonds for 2009 onwards.

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lower interest rate track, leaving their inflation forecasts nearly identical to the June *Statement*. Annual inflation is now expected to peak at 4.9% in Q3 (higher food prices in August suggest it could be more like 5.2%), and to average 3.4% over the next three years. Inflation expectation surveys show that businesses and the general public are becoming increasingly sceptical that inflation will remain within the 1-3% target band in the future, and you can hardly blame them when the RBNZ deliberately ‘tops up’ its inflation projections to the highest level it can get away with.

The RBNZ clearly intends to keep easing aggressively, and there is little on the horizon that could hold them back – inflation clearly won’t do it, activity indicators remain subdued, and global credit markets are still shaky. We expect a further 25bp cut at the 23 October review, but with Q2 GDP growth (published 26 Sep) likely to undershoot the RBNZ’s forecast of -0.2%, they may well feel that another 50bp move is justified. We still think that a pickup in activity and persistent inflation pressures will force the RBNZ to call a halt to the easing cycle by early next year, and by easing more aggressively now, they may

come to that realisation even sooner than we thought.

Fixed vs. floating: The easing cycle by the RBNZ is in full flight. With the RBNZ expressing a desire to ‘front load’ their interest rate cuts, it makes sense to be in floating, or only fix for a short term.

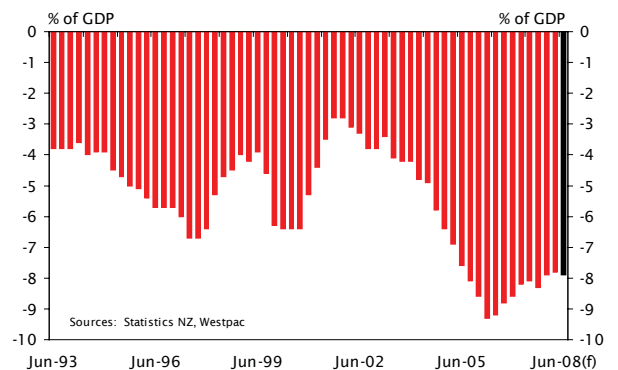
Key Data Previews

NZ Q2 Current account deficit NZDm s.a.

Sep 19, Last: -3,527, WBC f/c: -3,965

- The goods balance (s.a.) is expected to record a \$820m deficit, similar to a year ago. Drought conditions dampened what would have been a bumper year for dairy, and higher oil prices have worsened the net export position.
- Higher costs for offshore borrowing will add to investment income debits, by far the largest component of the deficit. Income credits in Q1 were pulled down by unusually low earnings of offshore subsidiaries of NZ firms. We’re not sure this was anything other than a one-off quirk, but it represents a downside risk to our forecast.

NZ annual current account deficit

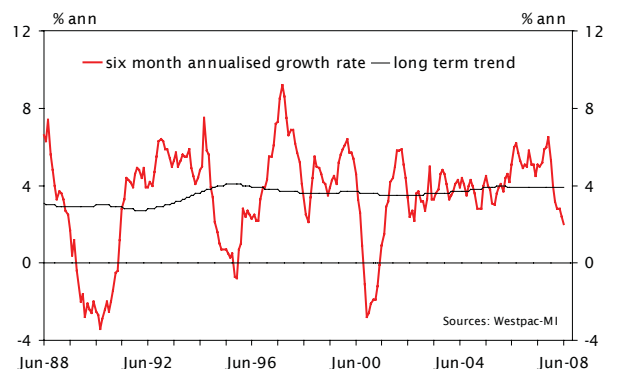


Aus Jul Westpac-MI Leading Index

Sep 17, Last: 2.0% annualised

- The annualised growth rate of the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, was 2.0% in June, well below its long term trend of 3.9%.
- Monthly components were mostly weaker in July: dwelling approvals fell 2.3% (albeit with historicals revised up significantly), money supply growth fell from 2.2% in Jun to 0.6% in July, and the sharemarket continued to slump, the All Ords falling 5.3% in July after a 7.6% drop in June. However, against this, the Q2 GDP figures showed a sharp rise in corporate gross operating surplus (+10.8%qtr vs +1.5%qtr in Q1), reflecting the boost from sharply higher commodity prices. On the international front, US industrial production rose 0.4% in July after falling 0.3% in June.

Westpac-MI Leading Index



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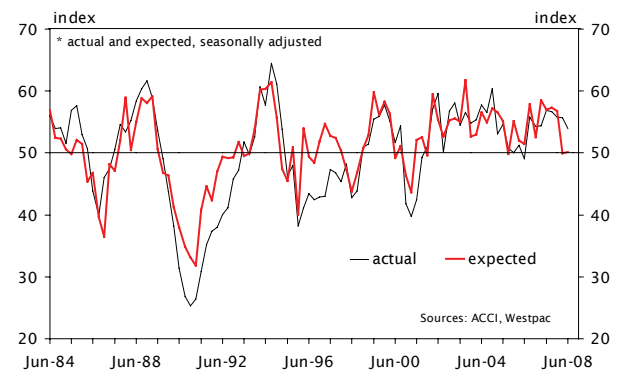


Aus Q3 Westpac-ACCI Survey

Sep 18, Last: Actual Composite Index 53.9

- The Westpac-ACCI Survey of Industrial Trends for Q2 showed a slowing in manufacturing activity growth amidst signs of slowing domestic demand, continued financial market turmoil and uncertainty over the global outlook, and strong cost pressures, although the index remained consistent with above-trend growth (53.9 vs 53.3 decade avg). Q3 expectations were pessimistic with the Expected Composite Index at 49.9 (vs 53.9 decade avg) implying a slowing to below-trend growth.
- Business confidence (-16%) fell to its lowest since 2003Q1.
- The September quarter survey, concluded in the week ended 12 September, will give an important read as to whether actual conditions deteriorated to a sub-trend pace in Q3 as implied by prior weak expectations and the Expected Composite Index last quarter.

Westpac-ACCI composite indexes*



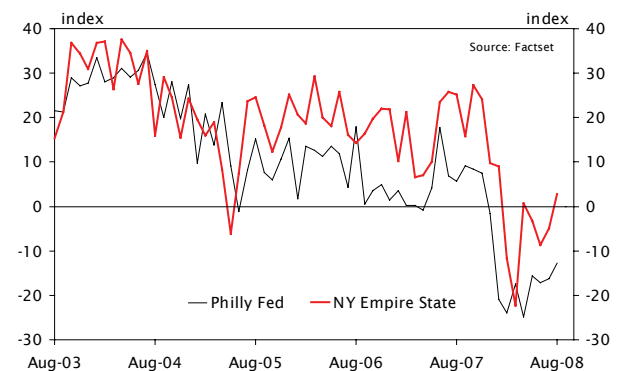
US Sep regional Fed factory surveys

Sep 15, NY Fed index Last: 2.8, WBC f/c: 0.0

Sep 18, Philly Fed index Last: -12.7, WBC f/c: -5.0

- These regional Fed surveys have been trending higher since the start of Q2, with NY actually back in positive territory in August, its strongest reading since January. Philly Fed has also improved, but continues to point to contraction in that region's factory sector.
- The national ISM factory survey has hovered very close to the neutral 50 level for four months running in May-Aug, and the regional surveys have tended to gravitate towards a similar reading (i.e. zero in the regionals' methodology).
- If that trend continues in September, we would expect to see a modest pull-back in the NY Fed index (a view supported by the fact that the detail in the Aug NY report was less robust than the headline), and a further up-trend in the Philly Fed (but still <0).

US regional manufacturing surveys

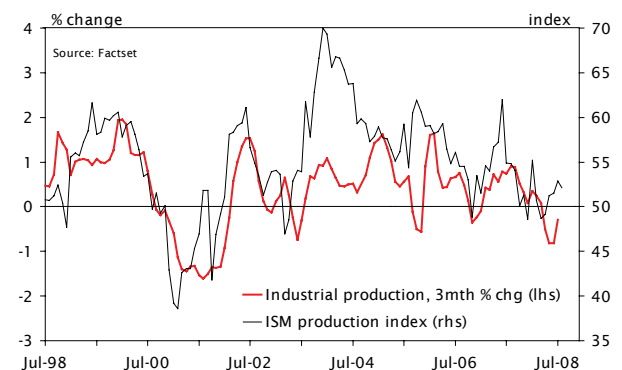


US Aug industrial production weighed down by autos

Sep 15, Last: 0.2%, WBC f/c: -0.2%

- Industrial production rose 0.2% in July and manufacturing was even stronger with a 0.4% rise, boosted by a further gain in auto output, probably related to the end of the strike that had impacted GM production up to late May.
- August hours worked data showed a 0.9% fall in manufacturing, mostly related to a 10% fall in hours worked in the auto industry, so clearly the auto sector support for manufacturing has been short-lived.
- Utility output fell in July but weekly electricity stats suggest at best a minimal bounce. However factory orders data were solid enough in July and the factory ISM report implied an increase in production.
- Tying these clues together, we expect a modest fall in IP in Sep, though risks to our -0.2% forecast are on the downside.

US industrial production



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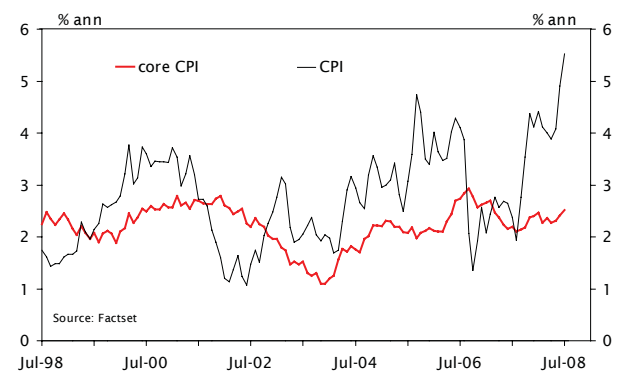
US Aug CPI – the decline begins

Sep 16, headline Last: 0.8%, WBC f/c: -0.2%

Sep 16, core Last: 0.3%, WBC f/c: 0.2%

- The CPI posted another sharp jump in July, mostly due to gasoline prices and an above trend rise in food prices, though the core posted a second consecutive solid 0.3% gain. The headline annual rate rose to 5.6% yr, its highest since 1990.
- Gasoline prices fell about 7% on average between July and August, and food price pressures are abating. These factors should weigh on the August CPI, and should also help pull the core rate back to 0.2% (as lower transport costs are passed on).
- A 0.2% fall in the headline CPI would only pull the annual rate back to 5.4% yr, because base effects are not especially favourable in August. But base effects will contribute to a significant fall in the headline rate over the remainder of 2008, and along with lower gasoline and food prices, should pull the CPI back to below 4% yr by December.

Heading

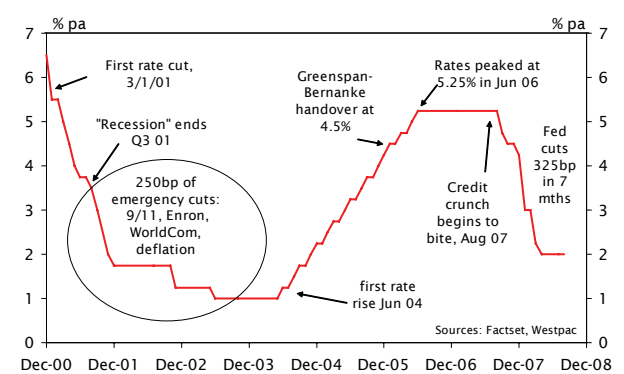


US FOMC rate decision – on hold again

Sep 16, Last: 2.0%, WBC f/c: 2.0%

- The Fed last cut rates by 25bp to 2.0% at the April 30 FOMC meeting, and has held steady since then, despite a regular dissenter for an immediate hike. The Aug 5 FOMC meeting statement dropped June 25's reference to "diminished" growth risks (i.e. those risks were beefed up again) and inflation risks were described as "significant" rather than "increased".
- The recent collapse in energy prices, the stronger US dollar, expectations of softer GDP growth in H2 2008 and the weaker job market argue against policy retightening, and could even see a slight downgrade in the inflation risk adjective in the statement.
- We are not ruling out ongoing dissent for a modest policy retightening, but do not expect rates to actually be lifted until late 2009.

8 yrs of Fed policy: the Fed funds target



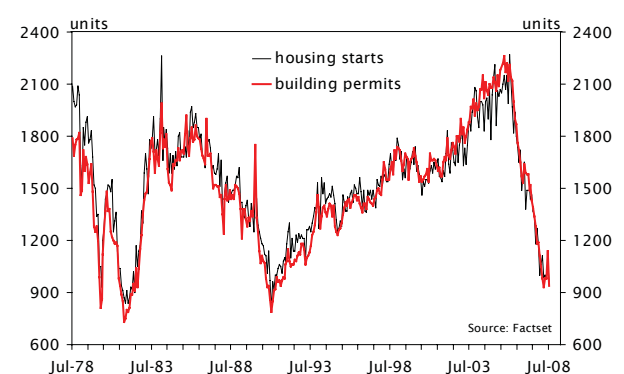
US Aug housing starts and permits

Sep 17, starts Last: -11.0%, WBC f/c: -3.5%

Sep 17, permits Last: -17.7%, WBC f/c: -5.0%

- Housing starts jumped 10% in June and permits surged 16%, as builders scrambled to beat the July 1 introduction of a new NY building code which boosted the multiples component in the northeast by 200+%. That was largely but not completely reversed in July when starts and permits both fell steeply. Single family starts/permits were not impacted by the building code change and continued to fall in both months.
- This distortion in the north-east will continue to see the multiples component unwind given the significant pull-forward of activity into late Q2. Also, with homebuilder sentiment still at an all-time low and falling existing home prices cannibalising new home sales, single family starts and permits are likely to drift a little lower. So we expect starts and permits to post further falls of between 3-5% in August.

US housing starts and permits



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Key Data and Events

	Last	Market Median	Westpac Forecast	Comments	
Mon 15 Sep					
Aus	Q2 Dwelling Starts	-3.6%	-2.0%	-2.0%	Weakness starting to show: approvals 4% in Q1, -2.8% in Q2.
US	Sep NY Fed Factory Index	2.8	1.0	0.0	A 0 reading would be consistent with recent national ISM readings.
	Aug Industrial Production	0.2%	-0.3%	-0.2%	Hours worked data point to slump in auto sector output.
Eur	Q2 Labour Costs %yr	3.3%	3.5%	-	Have been trending higher since early 2007.
Can	Jul Auto Sales	-1.0%	-0.2%	flat	"Relatively unchanged" in July according to StatCan.
Tue 16 Sep					
Aus	Sep RBA Board Meeting Minutes	-	-	-	Superseded by Parl testimony but policy considrs may incl some insights.
US	Aug Consumer Price Index	0.8%	-0.1%	-0.2%	Energy prices to fall and food prices to soften. Core rate should
	Aug CPI Core	0.3%	0.2%	0.2%	slow but not reverse recent solid 0.3% gains. See text box.
	Jul TIC Data \$bn	51.1	40.0	-	Guide to extent/way current account deficit is being funded.
	Sep NAHB Housing Market Index	16	17	15	Collapsing existing home sales cannibalising new house market.
	FOMC Meeting	2.00%	2.00%	2.00%	Fed firmly on hold despite probable lone vote for rate hike.
Eur	Aug CPI %yr (F)	3.8%a	3.8%	3.8%	Mild risk of downward revision. Core rate was 1.7% in July.
Ger	Sep ZEW Analysts' Survey	-55.5	-53.0	-53.0	Weaker euro, lower oil price to boost analyst confidence again.
UK	Aug CPI %yr	4.4%	4.6%	4.8%	Energy bills still hitting, but CPI approaching its peak.
	Jul DCLG house prices %yr	0.6%	-2.1%	-	Little watched govt series that lags banks' series by 6 months.
Can	Jul Manufacturing Shipments	2.1%	0.8%	-	Very solid during Q2.
Wed 17 Sep					
Aus	RBA Governor Speaks	-	-	-	Sydney (1.30 pm AEST), no topic given.
	Jul Westpac-MI Leading Index	2.0%	-	-	This earliest economy-wide barometer has plunged well below trend.
	Aug Merchandise Imports AUDbn	19.7	-	-	Raw data; guide for goods M, which bounced 4.5% in July (fuel-led).
US	Q2 Current Account \$bn	-176.4	-180.0	-175.0	Well past its peak with trade deficits narrowing.
	Aug Housing Starts	-11.0%	-1.5%	-3.5%	June spike in starts/permits still unwinding. Should see cumulative
	Aug Housing Permits	-17.7%	-1.0%	-5.0%	fall of up to 15% in starts and 25% in permits in Q3. See text box.
Jpn	Bank of Japan Meeting	0.50%	0.50%	0.50%	Shirakawa's Sep 2 speech balanced. No move anticipated this year.
Eur	Jul Trade Balance €bn s.a.	-3.0	-3.5	-	Too early for lower oil price to materially impact on trade balance.
UK	Sep BoE MPC Minutes	-	-	-	If increased vote for a rate cut, then we might get one in Oct.
	Aug Unemployment ch'	20.1	22.5	20.0	Jun-Jul saw steepest rise since early 1990s recession.
Thu 18 Sep					
Aus	Q3 WBC-ACCI Survey of Indust Trends	53.9	-	-	-2.1pts in Q2, but > decade avg (53.3) = slowing, but still above-trend.
	Sep RBA Bulletin	-	-	-	Can include recent RBA research articles.
US	Initial Jobless Claims w/e 13/9	445k	440k	450k	Data still distorted but underlying job market weakness still apparent.
	Sep Philadelphia Fed Index	-12.7	-10.0	-5.0	Should be closer to 0.0 if national ISM as any guide. See text box.
	Aug Leading Index	-0.7%	-0.2%	-0.4%	Permits a big negative still, also initial jobless claims.
Jpn	Jul Tertiary Activity Index	-0.8%	0.4%	-	Consumer indicators improved a little in July, but volumes still falling.
UK	Aug Retail Sales	0.8%	-0.5%	-1.0%	CBI and BRC surveys both very weak.
	Aug Public Sector Net Borrowing £bn	-4.8	9.0	-	Govt revenues are falling as economy slows, housing collapses.
	Aug M4 Money Supply %yr	11.2%	10.5%	-	Mild downtrend in annual growth now in place.
Can	Aug Leading Index	flat	flat	flat	Flat.
	Jul Wholesale Sales	2.0%	-	-	Solid during Q2.
Fri 19 Sep					
NZ	Q2 Current Account NZDmn s.a.	-3,527	-3,500	-3,965	Softer exports, higher borrowing costs to halt the improvement.
	Aug External Migration ann.	5,200	-	4,800	A strong month, but the annual total will fall due to base effect.
	Aug Credit Card Transactions	0.4%	-	-	Expect decline as consumers retrench.
US	Fedspeak	-	-	-	Chicago Fed's Evans on economic outlook.

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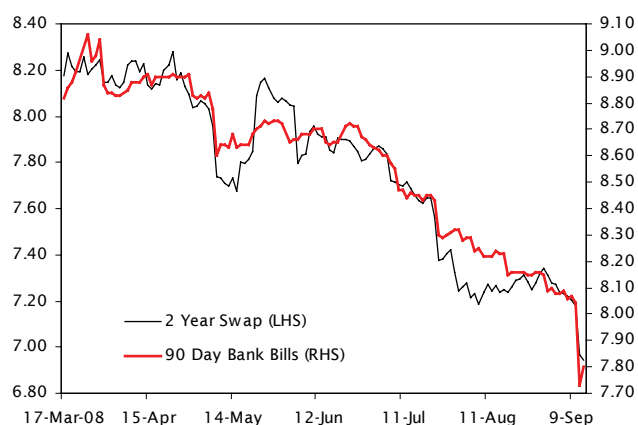
New Zealand Economic and Financial Forecasts

Economic Growth Forecasts	March years				Calendar years			
	2008	2009f	2010f	2011f	2007	2008f	2009f	2010f
% change								
GDP (Production) ann avg	3.0	0.5	3.4	3.6	3.1	0.6	2.8	3.6
Employment annual %	-0.2	-0.9	0.5	1.0	2.4	-2.0	-0.1	1.1
Unemployment Rate % s.a.	3.6	4.9	4.8	4.1	3.4	4.6	5.0	4.3
CPI annual %	3.4	4.7	2.4	3.6	3.2	5.1	1.7	3.6
Current Account Balance % of GDP	-7.8	-7.4	-6.7	-7.8	-7.9	-7.7	-6.5	-7.7

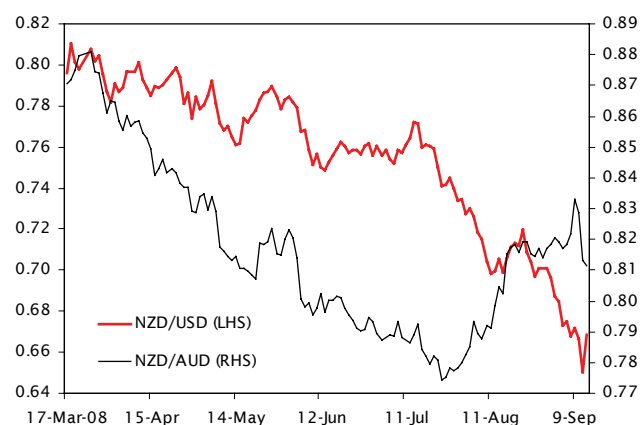
Economic forecasts finalised 8 July 2008

Financial Forecasts	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
Cash	7.00	6.75	6.75	6.75	6.75	6.75	6.75
90 Day bill	7.20	7.00	7.00	7.00	7.00	7.00	7.00
2 Year Swap	6.70	6.80	6.95	6.95	6.95	6.95	6.90
5 Year Swap	6.60	6.70	6.75	6.75	6.75	6.75	6.75
10 Year Bond	5.70	5.80	5.85	5.85	5.90	5.90	5.95
NZD/USD	0.69	0.71	0.74	0.75	0.74	0.74	0.73
NZD/AUD	0.80	0.81	0.80	0.81	0.81	0.82	0.82
NZD/JPY	74.5	74.6	76.2	76.5	77.0	77.9	78.1
NZD/EUR	0.47	0.48	0.50	0.51	0.51	0.51	0.52
NZD/GBP	0.39	0.40	0.41	0.42	0.42	0.41	0.40
TWI	64.7	65.8	67.6	68.4	68.3	68.4	68.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 September 2008

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	7.50%	8.00%	8.00%
30 Days	7.91%	8.23%	8.28%
60 Days	7.90%	8.19%	8.30%
90 Days	7.81%	8.09%	8.23%
2 Year Swap	6.92%	7.31%	7.25%
5 Year Swap	6.82%	7.06%	7.00%

NZ foreign currency midrates as at Monday 15 September 2008

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6672	0.6962	0.7062
NZD/EUR	0.4664	0.4768	0.4808
NZD/GBP	0.3700	0.3864	0.3783
NZD/JPY	70.800	75.310	78.040
NZD/AUD	0.8156	0.8184	0.8153
TWI	63.180	65.260	65.940

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Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2003	2004	2005	2006	2007	2008f	2009f
Australia							
Real GDP % yr	3.1	3.6	2.8	2.7	4.2	2.5	3.0
CPI inflation % annual	2.4	2.6	2.8	3.3	3.0	4.4	3.0
Unemployment %	6.1	5.5	5.1	4.8	4.4	4.3	5.0
Current Account % GDP	-5.6	-6.2	-5.8	-5.3	-6.2	-4.5	-1.5
United States							
Real GDP %yr	2.5	3.9	3.1	2.8	2.0	1.9	1.7
Consumer Prices %yr	2.3	2.6	3.4	3.2	2.9	4.0	2.4
Unemployment Rate %	6.0	5.5	5.1	4.6	4.6	5.5	6.4
Current Account %GDP	-4.8	-5.7	-6.1	-6.0	-5.3	-4.3	-3.3
Japan							
Real GDP %yr	1.8	2.3	1.9	2.8	1.9	0.7	1.9
Consumer Prices %yr	-0.4	-0.1	-0.3	0.2	0.1	1.4	0.9
Unemployment Rate %	5.0	4.5	4.4	4.1	3.9	4.1	4.3
Current Account %GDP	3.1	3.3	3.6	3.9	4.8	3.8	4.5
Euroland							
Real GDP %yr	0.8	2.0	1.5	2.9	2.6	1.3	0.9
Consumer Prices %yr	2.1	2.1	2.5	2.0	3.1	3.5	1.8
Unemployment Rate %	8.8	9.0	8.8	7.9	7.3	7.5	8.0
Current Account %GDP	0.6	0.0	-0.2	-0.5	0.0	-0.1	0.2
United Kingdom							
Real GDP %yr	2.6	3.2	1.9	2.8	3.0	1.3	0.3
Consumer Prices %yr	1.4	1.3	2.1	3.0	2.1	4.0	1.8
Unemployment Rate %	3.1	2.8	2.8	3.0	2.5	2.9	3.6
Current Account %GDP	-1.8	-1.9	-2.6	-3.0	-3.5	-3.5	-2.5

Forecasts finalised 5 September 2008

Interest Rate Forecasts	Latest (Sep 15)	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
Australia						
Cash	7.00	6.50	6.25	6.25	6.25	6.25
90 Day Bill	7.25	6.75	6.50	6.20	6.00	5.70
10 Year Bond	5.68	5.60	5.60	5.80	5.60	5.45
International						
Fed Funds	2.00	2.00	2.00	2.00	2.00	2.25
US 10 Year Bond	3.72	3.60	3.50	3.70	4.00	4.40
ECB Repo Rate	4.25	4.25	4.00	3.75	3.75	3.50
Exchange Rate Forecasts						
AUD/USD	0.8180	0.86	0.88	0.92	0.93	0.91
USD/JPY	106.11	108	105	103	102	104
EUR/USD	1.4305	1.46	1.47	1.48	1.47	1.45
AUD/NZD	1.2260	1.25	1.24	1.24	1.24	1.23

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