7 March 2011

Shape of things to come

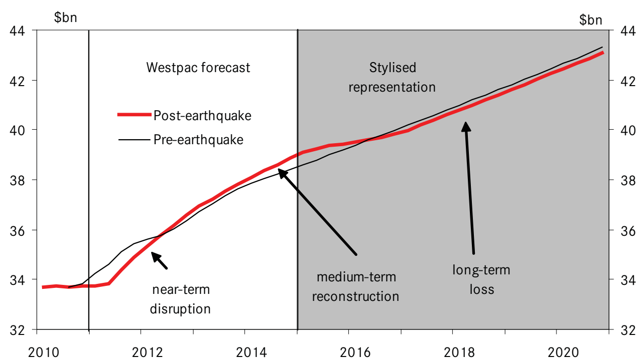
Post-earthquake macroeconomic forecasts

Christchurch's tragic earthquake on February 22 wrought a terrible human toll, and has dealt the economy a serious blow. This bulletin details our completely revised post-earthquake macroeconomic forecasts. As it is early days, these forecasts are subject to considerable uncertainty, particularly regarding the true extent of damage and the possibility of further aftershocks. We will continue to update as new information comes to light.

Our projections are based on early estimates of $15bn in new damage. This figure represents 20% of Canterbury's capital stock wiped out, or 2.7% of New Zealand's capital stock. We estimate the earthquake will knock 2% off national GDP this year.

After the initial drop in GDP, our new economic forecasts do include a period of rapid growth, and a temporary period of elevated economic activity. In no way does this imply that the earthquake was "good for the economy". There are two salient points here. First, the Christchurch economy is currently severely disrupted. Life will not be back to normal in a year, but it is reasonable to expect some improvement over the current state of affairs. For example, the CBD might go from completely closed to partly operational. This improvement constitutes economic growth.

Impact of earthquake on NZ gross domestic product



The second salient point is that gross domestic product (GDP) is not a measure of wellbeing. It simply measures the value of economic transactions that occur in a country. Many economic transactions are a drain on society's precious resources that we'd prefer were not needed. For example, we'd hardly jump for joy if a crime wave necessitated more police activity, even though police activity counts toward GDP. We'd be much better off if there was no crime and the police weren't needed. Exactly the same thing goes for this earthquake necessitating a huge reconstruction effort. Obviously we'd rather the earthquake never happened. But now that the earthquake has happened, the associated reconstruction effort will be duly recorded by the government statistician, and it will temporarily add to GDP.

The immediate aftermath

The sheer scale of disruption to people's lives in Christchurch has punched a serious hole in the local economy. There have been knock-on effects for the rest of New Zealand, as quake-affected Canterbury purchases less from other regions. There are also a few offsets to consider. For example, air travel increased sharply immediately after the quake, those who have left Christchurch are spending in other regions, and the drop in interest rates and the exchange rate will soften the blow.

It is too early to tell with any degree of accuracy, but at this stage our best estimate of the net loss of NZ economic activity over 2011 is $4bn.[1] That figure assumes Christchurch's annual economic output will shrink by 15%, and implies 2% will be wiped off New Zealand's annual GDP in the first year.[2]

Negative GDP growth in the March quarter is virtually assured, and there is little prospect of a better performance in the June quarter. Our annual GDP growth forecast for the year to June 2011 is now 0.5%. We expect job losses associated with the earthquake will cause the unemployment rate to rise to 7%, from 6.8% currently.

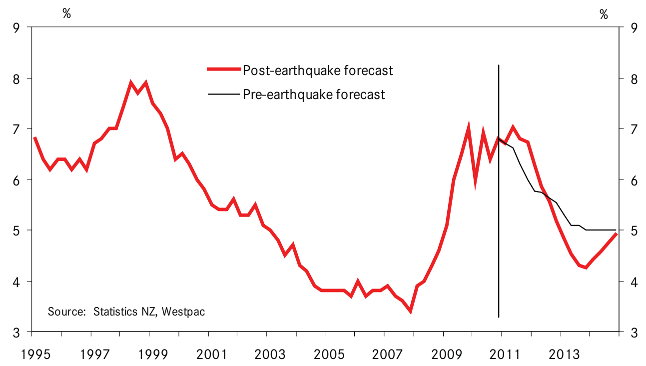
[1] Estimates of the likely disruption from a major earthquake are provided in Clarke M (1998), "The economic effects of a 1998 Wellington earthquake", NZIER working paper 98/17.

[2] Canterbury accounts for approximately 13% of the New Zealand economy.

For further information, questions or comments contact Dominick Stephens, telephone (04) 381 1414, email dominick_stephens@westpac.co.nz

For all clients: Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141, incorporated in Australia ("Westpac"). The information contained in this report: does not constitute an offer, or a solicitation of an offer, to subscribe for or purchase any securities or other financial instrument;· does not constitute an offer, inducement or solicitation to enter a legally binding contract; and is not to be construed as an indication or prediction of future results. The information is general and preliminary information only and while Westpac has made every effort to ensure that information is free from error, Westpac does not warrant the accuracy, adequacy or completeness of the Information. The Information may contain material provided directly by third parties and while such material is published with necessary permission, Westpac accepts no responsibility for the accuracy or completeness of any such material. In preparing the Information, Westpac has not taken into consideration the financial situation, investment objectives or particular needs of any particular investor and recommends that investors seek independent advice before acting on the Information. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. Except where contrary to law, Westpac intends by this notice to exclude liability for the information. The information is subject to change without notice. Westpac expressly prohibits you from passing on this document to any third party. Westpac Banking Corporation is registered in England as a branch (branch number BR000106) and is authorised and regulated by The Financial Services Authority. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised and regulated by The Financial Services Authority. © 2011
For Australian clients: WARNING – This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

Unemployment rate



Given the economy was already is such a weak state, we expect the Reserve Bank will respond by cutting the OCR by 50 basis points on Thursday 10 March. The proposed cut would do little to help Christchurch. But that is not the point. The point is to shore up confidence at a time when the economy's near-term prospects have been knee-capped, thereby stabilising the growth and inflation outlooks.

What's the cost and how do we pay?

At this early stage we have no accurate gauge of the value of damage to buildings and infrastructure in Christchurch. At the time of writing the figure most commonly cited by politicians and the media was $15bn of additional damage from the February 22 earthquake. We have adopted the same figure as the working assumption for these macroeconomic forecasts. We must stress that this is not an independent estimate.

We are assuming that the damage is broken down as follows:

- $9bn in damage to residential housing and household contents. The capital value residential property in the Christchurch area is approximately $60bn.[3]
- $3.5bn in damage to commercial and industrial buildings, compared to a total capital value of $15bn.
- $2.5bn of damage to government and council infrastructure assets, compared to the total value of Christchurch's infrastructure assets of $4.6bn.

New Zealand is well prepared to meet costs of this magnitude. After paying for last September's earthquake, the Earthquake Commission (EQC) will still have around $4.6bn in reserves, plus $2.5bn in reinsurance contracts, for a total of $7.1bn. EQC is liable to pay for the first $100,000 plus GST of damage to insured residential buildings, and the first $20,000 plus GST for insured household contents. Given that many houses in Christchurch have sustained more than $100,000 of damage, EQC will only be liable for a portion of the total damage to residential property. If our assumptions on the damage are correct, EQC's reserves will be depleted but not exhausted.

On our assumptions New Zealand's private insurance companies will be liable for about $7.5bn, but that will be almost entirely reinsured with overseas companies. Settlement of the private and EQC reinsurance contracts will count as a transfer in the balance of payments, and will accrue on the date of the earthquake (totalling $10bn on our assumptions). We expect the annual current account balance will rise to +2.8% of GDP for the year to March 2010 – New Zealand's first annual current account surplus since the 1970s.

The government is well placed to absorb the likely hit to its books. We estimate that the fiscal cost in the first year due to lost tax revenue and emergency assistance will be around $2bn to $3bn. In addition, our working assumption is that the government will pay $2.5bn towards rebuilding Christchurch's infrastructure, its own buildings, and the council's buildings. These costs will be partially offset by a boost to the government's tax take during the reconstruction phase, as the crown takes a slice of the $10bn in overseas reinsurance money.

If the government borrows to fund its entire earthquake bill, we estimate that the net debt to GDP ratio would rise to 32% by 2014, compared to the Treasury's last forecast of 28%. Ratings agencies have expressed comfort with government debt levels since the quake, and the fall in government bond yields indicates markets are similarly comfortable.

Given the one-off nature of this event, there is a strong case for government taking on debt to pay the bill. Spates of heavily damaging earthquake activity have occurred about once every 80 years in New Zealand. It makes sense to spread the cost of earthquakes across generations, rather than lumping the entire bill on those unlucky enough to be earning incomes when the quake strikes. We certainly do not advocate slapping the economy with tighter fiscal policy at a time of such vulnerability. Better would be a long-lasting or permanent tweak to government policy that ensures the projected fiscal balance is sustainable.

The biggest unknown is the extent of uninsured losses among businesses and households, and whether the government will choose to foot some of the bill.

The reconstruction phase

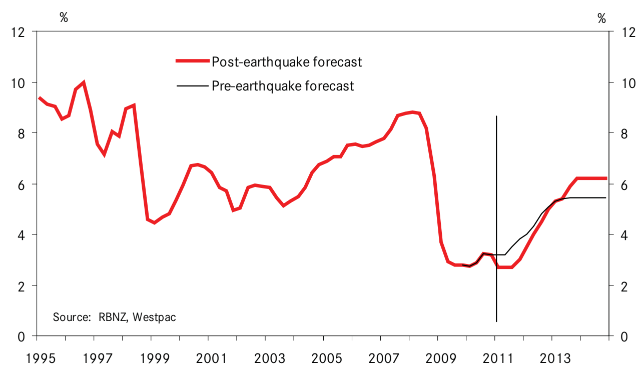
When the insurance paperwork is done there will be a huge influx of money into the Canterbury region from overseas and central government, all earmarked for construction in Christchurch. This will be akin to a fiscal stimulus package worth 60% of pre-quake regional GDP, spread over many years. Once the aftershocks settle, a reconstruction boom is inevitable. This cannot be stymied by low regional confidence, because the money is coming from outside the region. Hawkes Bay certainly experienced a reconstruction boom following its devastating 1931 earthquake.

[3] Estimates of capital stocks and infrastructure sourced from RBNZ, September 2010 Monetary Policy Statement.

Some parts of the wider New Zealand economy will feel a positive "trickle-down effect" from Christchurch's reconstruction boom. For others, Christchurch's call on scarce resources will make life more difficult. In particular, the price of construction could rise across the nation, prompting some businesses outside Christchurch to cancel projects. Government infrastructure projects in other regions may be delayed.

We expect Christchurch reconstruction activity will help propel New Zealand's annual GDP growth to 5.7% through the year to June 2012. Other factors will be the flow-on effect of bumper farmer payouts, the World Cup, and low interest rates. This growth in demand will come at a time when New Zealand's capacity to supply goods and services is damaged. Constrained supply plus rising demand is a recipe for rising inflation.[4] The enormity of the reconstruction task implies these inflationary pressures will be present for many years, and therefore cannot be ignored by the Reserve Bank. To be sure, the central bank will try its best to give growth a chance, and will err in the direction of keeping the OCR low for as long as possible. But eventually the inflation outlook will become so onerous that the Reserve Bank will be forced to return the OCR to more normal levels. We are now forecasting a steep series of OCR hikes through 2012 and 2013. Unlike our pre-quake forecasts, we are now forecasting an eventual period of "tight" monetary policy, during which the OCR is above neutral.

90-day bill rate



Longer-term interest rates have fallen since the quake, in anticipation of the OCR cut. Markets are pricing in a monetary policy normalisation over 2012, but the implied rate of OCR hikes seems too slow given the likely medium-term inflationary consequences of the earthquake. We expect that the 2-year swap rate will rise sharply in 2012 as inflation pressures become evident.

The exchange rate dropped after the earthquake, but we doubt it will stay down for long. Reinsurance payments could create flows that favour the NZD later this year. Rising interest rates in 2012 will support the NZD. And in the background, global food prices are rising, New Zealand's terms of trade is at a 35-year high, and most of the country is still open for business.

The housing market

In Christchurch, rents for undamaged residential houses are likely to rise – media reports suggest commercial and industrial rents have already increased in undamaged areas. The rental squeeze could flow through to other parts of New Zealand as those who have left Christchurch secure temporary accommodation.

Christchurch house sales are likely to drop substantially as buyers become wary of hidden damage. In hard-hit suburbs economic circumstance might force sales, dragging down the median selling price. In less damaged areas prices could go either way, as uncertainty about the city's long-term future is balanced against the short-term need to secure scarce accommodation.

For the rest of New Zealand the impact on house prices is uncertain, as it depends on the balance of contradictory factors. We've shaded our price forecast slightly higher for this year, as the drop in mortgage rates plus demand from Christchurch emigrants marginally outweighs the drop in economic confidence. However, for 2012 and 2013 we are building in a return to flat house prices amid rising mortgage rates.

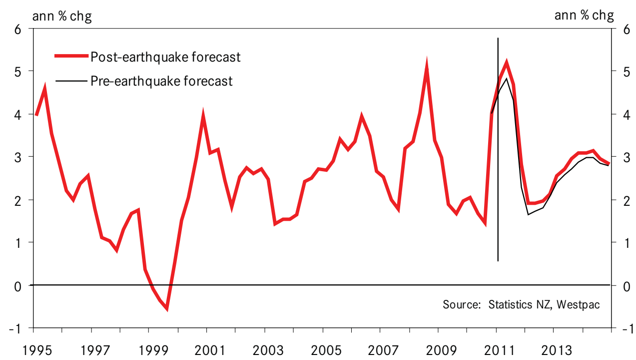
See next page for complete forecasts.

Contact:
Dominick Stephens, Senior Economist, Ph: (64–4) 381 1414

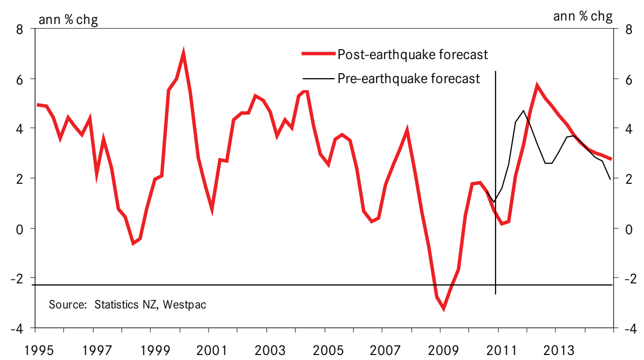
[4] Consider commercial and industrial rents in Christchurch, which skyrocketed immediately after the quake due to reduced supply.

Annual Average % change	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010e	2011f	2012f
Private consumption	0.4	1.0	1.4	3.2	–0.7	1.7	0.6	3.2
Government consumption	0.2	1.9	1.4	2.0	0.6	2.1	1.2	1.9
Residential Investment	–13.0	6.8	11.4	29.9	–18.1	5.3	4.7	34.3
Business Investment	–8.5	4.1	9.9	13.8	–7.5	0.2	7.9	15.4
Stocks (% contribution)	–2.1	0.8	0.7	0.3	–2.8	1.2	0.5	0.4
GNE	–3.6	3.5	4.0	6.6	–4.9	3.4	2.8	6.9
Exports	4.6	1.9	5.8	3.5	1.7	3.1	4.8	3.9
Imports	–9.4	8.5	8.8	7.9	–14.6	8.5	7.8	9.1
GDP (Production)	–0.5	1.0	2.6	5.1	–1.7	1.4	1.5	5.1
Employment (% annual)	–0.1	1.2	1.0	4.1	–2.4	1.3	0.7	4.5
Unemployment Rate (% s.a. end of period)	6.0	6.7	6.3	4.8	7.0	6.8	6.7	5.2
Average Hourly Earnings (% annual)	0.6	3.1	4.4	4.1	2.2	1.8	4.2	4.3
CPI (% annual)	2.0	4.8	2.3	2.6	2.0	4.0	3.2	2.3
Current Account Balance (% of GDP)	–2.4	2.8	–4.1	–5.3	–2.8	–2.3	1.2	–5.2
Terms of Trade	0.1	5.7	0.0	1.6	–8.2	12.2	0.0	0.9
90 Day Bank Bills (end of period)	2.73	2.70	3.20	4.90	2.79	3.18	2.90	4.40
5 year swap (end of period)	5.27	4.40	5.50	6.30	5.56	4.60	5.30	6.10
TWI (end of period)	65.3	66.0	68.0	67.7	65.5	67.8	68.0	67.8
NZD/USD (end of period)	0.71	0.74	0.74	0.72	0.73	0.76	0.75	0.72
NZD/AUD (end of period)	0.78	0.73	0.77	0.80	0.80	0.77	0.76	0.80
NZD/EUR (end of period)	0.51	0.55	0.56	0.56	0.49	0.56	0.56	0.56
NZD/GBP (end of period)	0.45	0.46	0.44	0.41	0.45	0.48	0.45	0.41

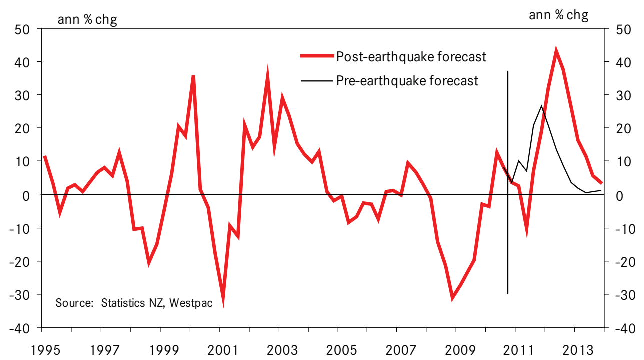
Inflation



GDP



Residential investment



Other investment