Australian weekly

week beginning 20 July 2009

- Australia: lucky timing on trade flows boosts confidence.
- New Zealand: the other 'R' word.
- Australian data: PPI and CPI to confirm subdued inflation picture.
- US: Fed's Monetary Policy Report and Bernanke testimony the focus.
- Key economic & financial forecasts.

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Economic Research Sydney +61 2 9284 8720 economics@westpac.com.au New Zealand +64 4 470 8255 London +44 20 7621 7061

Lucky timing on trade flows boosts confidence

Prospects for the economy have improved markedly in the last few months with the news that both consumer sentiment (Westpac Melbourne Institute – July survey) and business confidence (NAB–June Survey) have reached the highest levels we have seen since December 2007. Consumer and business Confidence tend to move closely together and while international factors would be important in influencing both measures it is reasonable to surmise that businesses are more optimistic when they see their customers more positive.

These readings have improved sharply over the last two months (consumer Sentiment is up by a record 23.2%) and the sheer pace of increase must signal that these levels remain fragile. One factor that in our opinion has been critical for restoring decent levels of Consumer sentiment has been the signal to consumers that Australia may avoid a recession. Of course, a recession is defined for purposes of the media as two consecutive negative quarters of GDP growth (although we favour a "negative growth over the year" definition).

Growth in the December quarter printed –0.6% and most economists were expecting a negative print for the March quarter heralding the official announcement of recession. The result was a 0.4% positive print which was hailed in the media as Australia avoiding recession. In response, the Westpac–MI Consumer Sentiment Index surged by 12.7% – the second largest increase since 1974.

The major source of this unexpected positive growth in Q1 was the 2.2ppt contributed to GDP(E) from net exports. That followed a 1.7ppt contribution in the December quarter. Over the two quarters combined, imports contracted by 14% while global trade was down by around 20%. The collapse in Australia's imports at a much faster pace than would normally have been expected given the 1% reduction in domestic demand must have been partly related to the collapse in global trade overall. As with other countries, financing difficulties and inventory rundown would have been key reasons. (nevertheless the credit constraint effect on trade would have been much less severe in Australia than offshore given the robust state of Australia's banks).

Over that same period, Australia's exports actually *increased,* by around 2%. The chart highlights the source of this extraordinary export performance: a sharp turnaround in rural exports. Nearly 2ppts of the 2.7% growth in exports in the March quarter came from rural exports. Non rural commodities were flat while manufactures were a significant drag on export growth.

While we would like to dig deeper into the net export story using data for export volumes by country we are unaware of such a data source. Consequently we have to talk in values which can obscure volumes when prices and exchange rates fluctuate as wildly as they have over the last year. However we expect that the fundamental messages set out below are probably still reliable even though the analysis focuses on values rather than volumes.

Japan was Australia's 'saviour' in the December quarter taking more than twice the level of exports taken by China (by value). Japan's imports from Australia were up 37% on the previous quarter whereas China's were down by 10%. A sharp reduction in resource exports to China was evidently offset by stronger exports to Japan (in value terms at least).

However there has since been a sharp turnaround. In the three months to May 2009, the value of exports to China is 30% higher than the value of exports to Japan. The value of exports to China has increased by 44% in the 3 months to May relative to the December quarter. This has coincided with a sharp swing in Chinese growth. On a quarterly annualised basis, GDP growth in China surged from 2% (December quarter); to 6% (March quarter) and 18% (June quarter).

Conclusion

Over a period when global trade collapsed by 20% Australia's export growth of 2% was truly extraordinary. With imports falling 14% and more closely reflecting global conditions, net exports contributed nearly 4ppts to GDP(E) growth allowing Australia to, for now, avoid a technical recession.

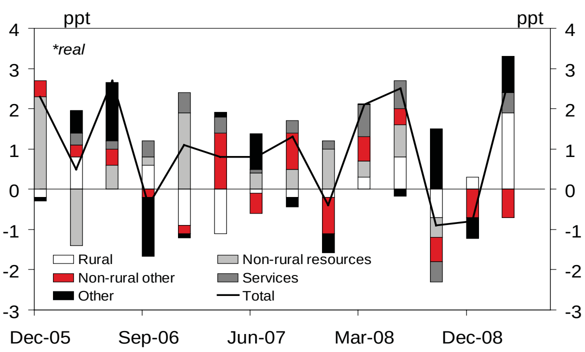
While there are many factors which can explain this, the main reasons seem to be: a surge in rural exports associated with the easing of the drought; the suprising strength of exports to Japan in Q4; and, since then, the more explicable surge in exports to China that have picked up the slack from weaker Japanese demand. Exports to China are now booming, directly reflecting the surge in domestic growth since the bulk of Australia's exports to China are not recycled back into exports to other countries but are instead absorbed by infrastructure investment which has been the dominant source of China's booming growth.

The recent resurgence in exports to China supports our current forecast of a further positive contribution to GDP growth from net exports in the June quarter. At this stage we estimate that net exports will add a further 0.3ppts to GDP growth in the June quarter – enough to keep growth positive despite sharp falls in business and housing investment. The June quarter national accounts are set to be announced on September 2 and another positive quarter of growth will, by silencing recession talk for another three months, help nurture the current fragile but vitally important rally in consumer and business confidence.

The timing of our various trade flows over the last nine months and prospects for China's demand going forward are true testament for why we can still call ourselves 'the Lucky Country'.

Bill Evans, Chief Economist

Contributions to export growth



Data wrap

Jun NAB business survey

- Business conditions became significantly less negative in June, with the index improving 12pts to –2.0pts – the strongest result since May 2008. Business confidence improved further, moving to +3.5pts, the first positive read since Dec 2007 and a far cry from the record low of Jan 2009. This suggests that annual domestic demand growth is beginning to stabilise. Stimulatory monetary and fiscal policies are clearly providing support to the domestic economy and globally, the strengthening of conditions in China, is a key positive for Australia.
- Confidence has returned to the optimistic zone, mirroring the rebound in consumer sentiment. This could suggest that while business is in the process of responding to the negative income shock from the global downturn (and associated decline in commodity prices) the cuts to investment, hiring and inventories may not be as aggressive as previously appeared likely.
- Given the volatility of monthly surveys it will be critical to see if these results are sustained. One concern is the downside risk from the removal of the temporary and substantial boost from the one-off cash payments by the Commonwealth Government.

May Westpac–MI Leading Index

- 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 –3.9% in May, well below its long term trend of 2.6%. The annualised growth rate of the Coincident Index was –0.1%, also below its long term trend of 3.0%.
- The revised data shows that the annualised growth rate in the Leading Index reached its lowpoint (–6.1%) in February and since then we have seen steady, albeit modest, improvement. While this suggests we have passed the worst, the Index is still contracting on a six month annualised basis. The annualised growth rate has now been negative for eight consecutive months but the lowpoint appears to have been reached after just five months. That compares with the last two recessions we have had in this country when the annualised growth rate remained negative for 20 months (1989/1991) and 16 months (1981/83). In those episodes it took 12 (1990/92) and 11 (1983/84) months before the growth rate reached its lowpoint. The more rapid recovery in the growth rate gives us some comfort that this economic downturn will be shorter than we saw in those previous cycles.

Q2 international trade price indexes

- Export prices plunged a record 20.6% in Q2 (weaker than expected) after –4.6% previously as falls in USD bulks export prices were reinforced by a 14.4%qtr AUD/USD appreciation. The fall was led by coal, coke and briquettes (–36.8%) and metalliferous ores and metal scrap (–23.5%), and broad-based valuation falls from the strong currency, with a partially offsetting rise in petroleum (+12.9%).
- Import prices fell 6.4% in Q2 (slightly weaker than expected) after a 2.8% fall previously, led by broad valuation effects of the strong AUD, as well as weakness in miscellaneous manufactures (–13.3%) and iron and steel (–22.8%). Food and beverage prices continued their recent retreat (–2.9%) while mineral fuels rose (+6.1%) in a partial offset. Abstracting from these non-core items, core import prices fell sharply as we expected, –7.9% as the import weighted AUD TWI jumped 10.2% in the quarter.
- The data has no implications for our Q2 CPI forecast – although the sharp fall in core import prices affirms our expectation for a less-than-usual seasonal rebound in discretionary items from New Year Sales price levels, the main reason behind our forecast for a much lower quarterly underlying CPI pace (0.7% vs 1.1% prev). However, the smaller than expected rise in petroleum has lowered our Q2 PPI forecast to –1.2%qtr and 1.8%yr (from –1.0%qtr, 1.9%yr forecast prior to the data). The sharp fall in export prices also supports our recent upward revision to Q2 export volumes growth, with the weakness in Q2 values all attributable to prices, allowing net exports to continue contributing positively to GDP growth in Q2.

Round-up of local data released last week

Date	Release	Previous	Latest	Mkt f/c
Tue 14	Jun NAB business survey	–14.2	–2.0	–
Wed 15	May Westpac–MI Leading Index	–4.1%	–3.9%	–
Thu 16	Jul RBA bulletin	–	–	–
Fri 17	Q2 export price index %qtr	–4.6%	–20.6%	–16%
	Q2 import price index %qtr	–2.8%	–6.4%	–6%

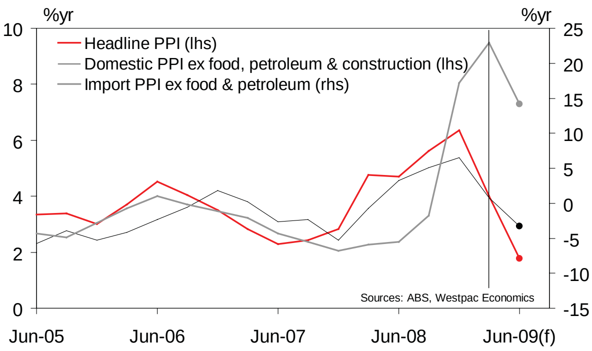
Data previews

Aus Q2 PPI

Jul 20, Last: –0.4%, WBC f/c: –1.2%
Mkt f/c: –0.1%, Range: –1.5% to 1.0%

- The Q1 PPI was –0.4%qtr, 4.0%yr. Non-core items subtracted 0.38ppts from the qtrly rate with food –0.9% & petroleum –9.0%. Core import prices rose 4.8% with latent pressures from AUD weakness in Q4, but the overall core PPI held flat (weakest since 2003Q4) with a fall in building construction (–1.6%) & the domestic core ex-construction and utilities –0.3%qtr (weakest since began this subset in 2002) & 3.0%yr.
- The core PPI is f/c to be weaker still in Q2, with a strong AUD cutting core import prices (f/c –8.5%), although firmer outcomes are expected in building construction (f/c flat) & the domestic core ex-construction & utilities (f/c flat), amidst improved demand. This gives –1.3% for the core PPI. Food prices are expected to fall another 0.9% but with petroleum up 3%, the total PPI is tempered to a 1.2%qtr fall. Still, this more than halves the annual rate to 1.8% (lowest since 2004Q1) from 4.0%.

PPI: qtly domestic tame, core M weak (A$ up)

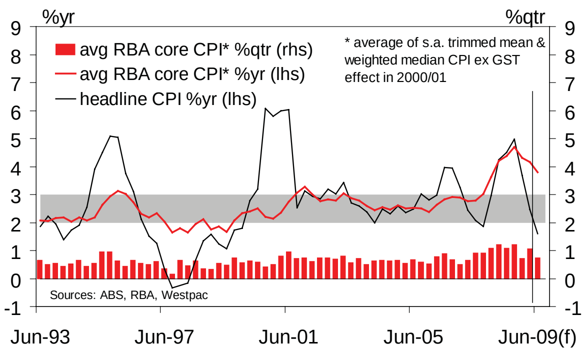


Aus Q2 CPI

Jul 22, Last: 0.1%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.1% to 0.8%

- While our Q2 headline CPI forecast is higher than Q1, it cuts the annual rate to 1.6% (lowest since 1999Q2). Drivers of the higher quarterly pace include seasonal rises in items from New Year sales levels, but less than usual with June discounting & talk of 'savaged' margins. This applies to clothing, h/hld & recreational goods. Stronger demand should see firmer house purchase costs (forecast 0.7%) after a surprise –0.5% prev, & transportation (forecast 1.6% vs –1.5% prev) will be pressured by petrol (+4% vs –8.1% prev). After their shock –14.1% fall in Q1, deposit & loan facilities are forecast to revert to –1.6%, more in line with movements in interest rate margins.
- Our avg RBA underlying CPI f/c is 0.7%qtr, 3.8%yr (vs 1.1%qtr, 4.2%yr prev), the lowest annual rate since 2007Q4. The lower qtly pace is largely courtesy of June dept store discounting & lower import prices. Base effects should drive the annual core rate sharply lower in Q3 (+1.2%qtr drops out from last year).

Inflation: annual headline & core CPI falling

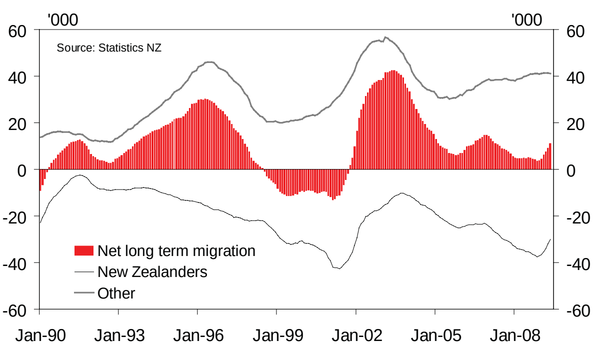


NZ Jun external migration ann.

Jul 21, Last: 11,200, WBC f/c: 13,000

- Net migration is surging, driven by fewer New Zealanders leaving and more coming home. In 2008 net migration was just above 3,000 for the year. Now net migration is running at closer to 3,000 people per month.
- We expect June seasonally adjusted monthly net migration of 3,300, stronger than May's 2,700. This would take annual net migration to 13,000. Annual net migration is heading for 25,000+ by year-end. The surge of people will be a huge swing factor for the economy, and has already contributed to a housing market turnaround. The RBNZ has become more hawkish on the back of this data, so markets should watch closely.
- Weekly data point to a large negative month for visitor arrivals, possibly –5% to –10% m/m. Possible swine flu impact?

NZ net migration



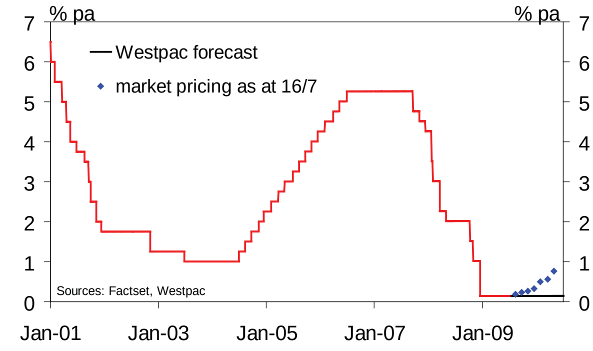
Data previews

US Fed monetary policy report and Bernanke testimony

Jul 21

- The mood in markets, banking and the economy has improved considerably since Chairman Bernanke delivered his previous his semi-annual testimony on February 24. The economy was in meltdown, and "overall, the downside risks probably outweigh those on the upside", though he expressed the view that if the wide range of measures taken by the Fed, Congress and Administration succeeded in restoring financial stability, "and only if that is the case, there is a reasonable prospect the current recession will end in 2009 and 2010 will be a year of recovery".
- Five months later, things seem to be on track. The June 24 FOMC meeting minutes revealed the Fed's upward revised central tendency forecasts, so focus will be on Bernanke's colouring of the risks, and also on any further communication/ transparency changes he might announce.

Fed funds target rate

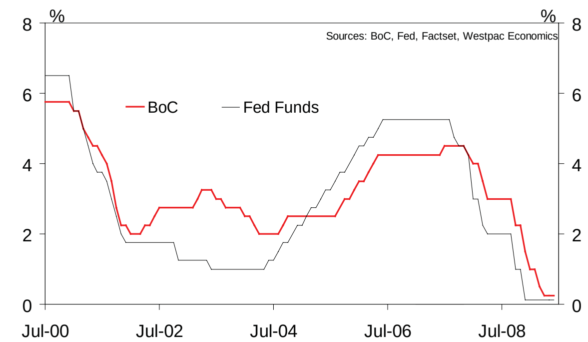


Bank of Canada rate decision

Jul 21, Last: 0.25%, WBC f/c: 0.25%

- In April, the BoC committed to hold rates steady at 0.25% till mid 2010, conditional on the outlook for inflation. At the early June window, the BoC reiterated that conditional commitment. Despite strong hints about a quantitative easing program back in March, BoC officials have since suggested that there is less need for QE than in other economies, and the latest credit conditions survey showed a marked improvement.
- Canadian data have revealed a considerably less weak economy thus far in 2009 relative to late 2008 (including jobs, housing, retail and business surveys). The rapid appreciation of the Canadian dollar up until early June has unwound some since then, helping ease the BoC's concerns in that area.
- The July statement should contain nothing new. We expect the conditional commitment re low rates to be retained.

Bank of Canada

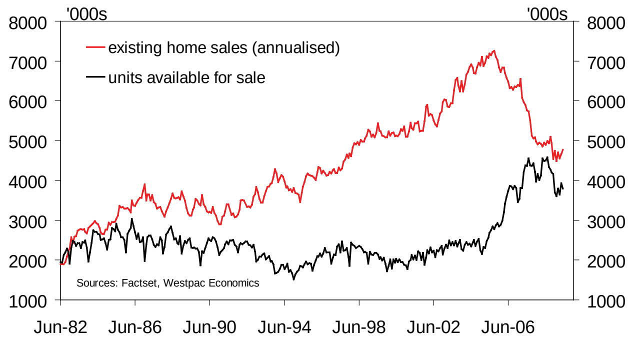


US June existing home sales to post further gain

Jul 23, Existing home sales: Last: 2.4%, WBC f/c: 2.0%

- Most housing indicators point to activity in the sector bottoming out at very weak levels. Existing home sales have see-sawed within a tight 4.49-4.94mn annualised range since October last year, about 35% below their 7.25mn peak in 2005; new home sales have also levelled off since the start of this year, about 75% below their 2005 peak.
- Pending sales of existing homes rose 13% in the four months to May, way stronger than the recent profile for finalised existing home sales, up 6% since the start of this year. Sharply lower prices, distressed sales of foreclosed homes and (temporarily) lower mortgage rates have all boosted sales, and June should see the existing sales report 'catch up' somewhat to pending sales, which purport to measure essentially the same thing, albeit at different stages of the sale process. There is upside risk around our 2% forecast gain.

US existing housing sales



Key data & event risk for the week ahead

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
Aus	Q2 producer price index %qtr	–0.4%	–0.1%	–1.2%	Stable domestic core, weak M core (A$ up) = –1.3%qtr core PPI; fuel up.
Ger	Jun producer prices %yr	–3.6%	–4.2%	–4.8%	Base effects still hugely favourable, but not after July.
UK	Jul house prices %yr	–5.5%	–	–3.5%	Rightmove index. Base effects will drive sharp gain in annual rate.
	Jun M4 money supply %yr	16.6%	14.6%	–	Still waiting for evidence in this indicator that QE is working.
US	Jun leading index	1.2%	0.5%	0.4%	Heading for strongest quarter of gains since at least 2004.
	Fedspeak	–	–	–	Lockhart on economic outlook.
Can	May wholesale sales	–0.6%	–	–	Has not posted a gain since Aug last year.
Tue 21					
Aus	Jul RBA meeting minutes	–	–	–	Adding colour to the more upbeat rhetoric in July statement's.
	Jun new motor vehicle sales	5.4%	–	10.0%	Industry figs showed big jump on tax break boosted business spend.
NZ	Jun external migration ann.	11,200	–	13,000	Strong migration is dragging NZ out of recession.
	Jun credit card transactions	–0.4%	–	–	Highly volatile of late; expect flat billings in June.
Jpn	Bank of Japan minutes (May)	–	–	–	Commentary should reflect the advanced nature of inventory cycle.
UK	Jun PSNCR £bn	18.8	21.5	–	The black hole that is UK public finances...
US	Jun Chicago Fed national activity index	–2.30	–	–	Compiled from 80 previously released economic indicators.
	Fed Monetary Policy Report	–	–	–	Presented by Fed chair Bernanke during testimony to House panel.
Can	BoC rate decision	0.25%	0.25%	0.25%	No new information expected; commitment to low rates reiterated.
Wed 22					
Aus	Q2 headline CPI %qtr	0.1%	0.6%	0.6%	Seasonal rises after NY sales; petrol & housing up; lesser d&l facil. fall.
	Q2 avg RBA underlying CPI %qtr	1.1%	0.7%	0.7%	June discounting & lower M prices to temper seasonal rises; 3.8%yr.
	RBA Assistant Governor Debelle speaking	–	–	–	On panel at a Mortgage Finance Industry Assoc forum (12.00 pm AEST).
Eur	May industrial orders	–1.0%	1.9%	2.5%	German orders jumped 4.4% in May.
UK	Jul BoE minutes	–	–	–	Decision to wait until Aug for further QE decision probably unanimous.
	Jul industrial trends survey	–	–	–	Expanded quarterly version of monthly survey.
US	May house prices	–0.1%	–0.2%	–	Lesser watched FHFA index.
Can	May retail sales	–0.8%	–	0.5%	To be boosted by auto sales (known up 1%) and higher gasoline prices.
Thu 23					
Aus	RBA Assistant Governor Debelle speaking	–	–	–	To Whitlam Institute Forum (5.00 pm AEST).
Jpn	Jun trade balance ¥bn sa	222	514	–	Current slim surplus should widen in trend terms from here.
Twn	Jun export orders %yr	–20.1%	–18.7%	–	Nothing good about %yr pace, but improvement is there.
	Jun industrial production %yr	–18.3%	–16.0%	–	Inventory adjustment has advanced from tech to basic materials.
Eur	May current account balance €bn sa	–5.9	–	–	In deficit since March last year.
UK	Jun retail sales	–0.6%	0.4%	0.5%	Surveys point to June weather-related bounce.
	Jun bank mortgage lending £bn	31.2	–	–	Guide to large chunk of the home lending market.
US	Initial jobless claims, w/e 18/7	522k	558k	545k	Ongoing distortion from summer auto sector layoffs.
	Jun existing home sales	2.4%	0.6%	2.0%	Boosted by distressed sale of foreclosed properties at knockdown prices.
Can	BoC Monetary Policy Report	–	–	–	More detail underpinning Tuesday's rate decision.
Fri 24					
Kor	Q2 GDP %yr	–4.2%	–2.4%	–	Momentum has improved significantly through the quarter.
Sing	Jun industrial production %yr	2.0%	–6.42%	–	Hanging on to a large portion of the pharma bounce.
Eur	Jul PMI factory advance	42.6	43.5	43.0	Both these surveys are expect to show that the pace of contraction
	Jul PMI services advance	44.7	45.1	45.0	in the Euroland economy was moderating heading into Q3.
Ger	Jul IFO business climate index	85.9	86.5	87.0	Current index still stalled, but expectations are on the rise.
UK	Q2 GDP advance	–2.4%	–0.3%	–0.5%	Still contracting, but at a much slower pace.
US	Jul UoM consumer sentiment final	64.6 a	65.0	65.5	Upward revision as stocks improve, gasoline prices level off.

Economic & financial forecasts

Interest rate forecasts

	Latest (Jul 17)	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
Cash	3.00	3.00	3.00	3.00	3.00	3.00
90 Day Bill	3.11	3.20	3.20	3.20	3.20	3.30
3 Year Swap	4.67	4.60	4.40	4.25	4.75	5.50
10 Year Bond	5.45	5.50	5.20	5.50	5.60	5.75
10 Year Spread to US (bps)	190	210	195	175	135	125
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.55	3.50	3.25	3.75	4.25	4.75
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
New Zealand						
Cash	2.50	2.50	2.50	2.50	2.50	3.00
90 day bill	2.80	2.80	2.80	2.80	2.80	3.60
2 year swap	3.81	3.90	4.10	4.30	4.30	5.00
10 Year Bond	5.75	5.80	5.90	6.00	6.00	6.20
10 Year spread to US	216	230	265	225	225	145

Exchange rate forecasts

	Latest (Jul 17)	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
AUD/USD	0.7995	0.76	0.74	0.77	0.80	0.82
NZD/USD	0.6437	0.60	0.59	0.62	0.65	0.68
USD/JPY	93.66	92	90	93	96	99
EUR/USD	1.4084	1.38	1.36	1.39	1.42	1.45
AUD/NZD	1.2414	1.27	1.25	1.24	1.23	1.21

Australian economic growth forecasts

	2008		2009				2010	Calendar years			
% change	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**2007**	**2008**	**2009f**	**2010f**
GDP	0.2	–0.6	0.4	0.2	–0.3	0.3	0.3	4.0	2.3	0.2	1.8
ann chg	2.2	0.8	0.4	0.2	–0.2	0.6	0.6	–	–	–	–
Unemployment rate	4.2	4.5	5.3	5.7	6.6	7.3	7.7	4.4	4.3	6.2	7.9
CPI headline	1.2	–0.3	0.1	0.6	0.4	0.6	0.6	–	–	–	–
ann chg	5.0	3.7	2.5	1.6	0.8	1.8	2.2	3.0	3.7	1.8	2.4
CPI core	1.2	0.7	1.1	0.7	0.7	0.6	0.5	–	–	–	–
ann chg	4.7	4.3	4.2	3.8	3.3	3.1	2.6	3.6	4.3	3.1	2.0

New Zealand economic growth forecasts

	2008			2009				Calendar years			
	Q2	**Q3**	**Q4**	**Q1**	**Q2e**	**Q3f**	**Q4f**	**2007**	**2008**	**2009f**	**2010f**
GDP % qtr	–0.2	–0.5	–1.0	–1.0	–0.4	0.2	0.1	–	–	–	–
Annual avg change	2.5	1.6	0.2	–1.0	–2.0	–2.4	–2.1	3.2	0.2	–2.1	2.6
Unemployment rate %	4.0	4.3	4.7	5.0	5.7	6.3	6.7	3.5	4.7	6.7	6.5
CPI %qtr	1.6	1.5	–0.5	0.3	0.6	0.7	0.6	–	–	–	–
Annual change	4.0	5.1	3.4	3.0	1.9	1.1	2.1	3.2	3.4	2.0	1.2