

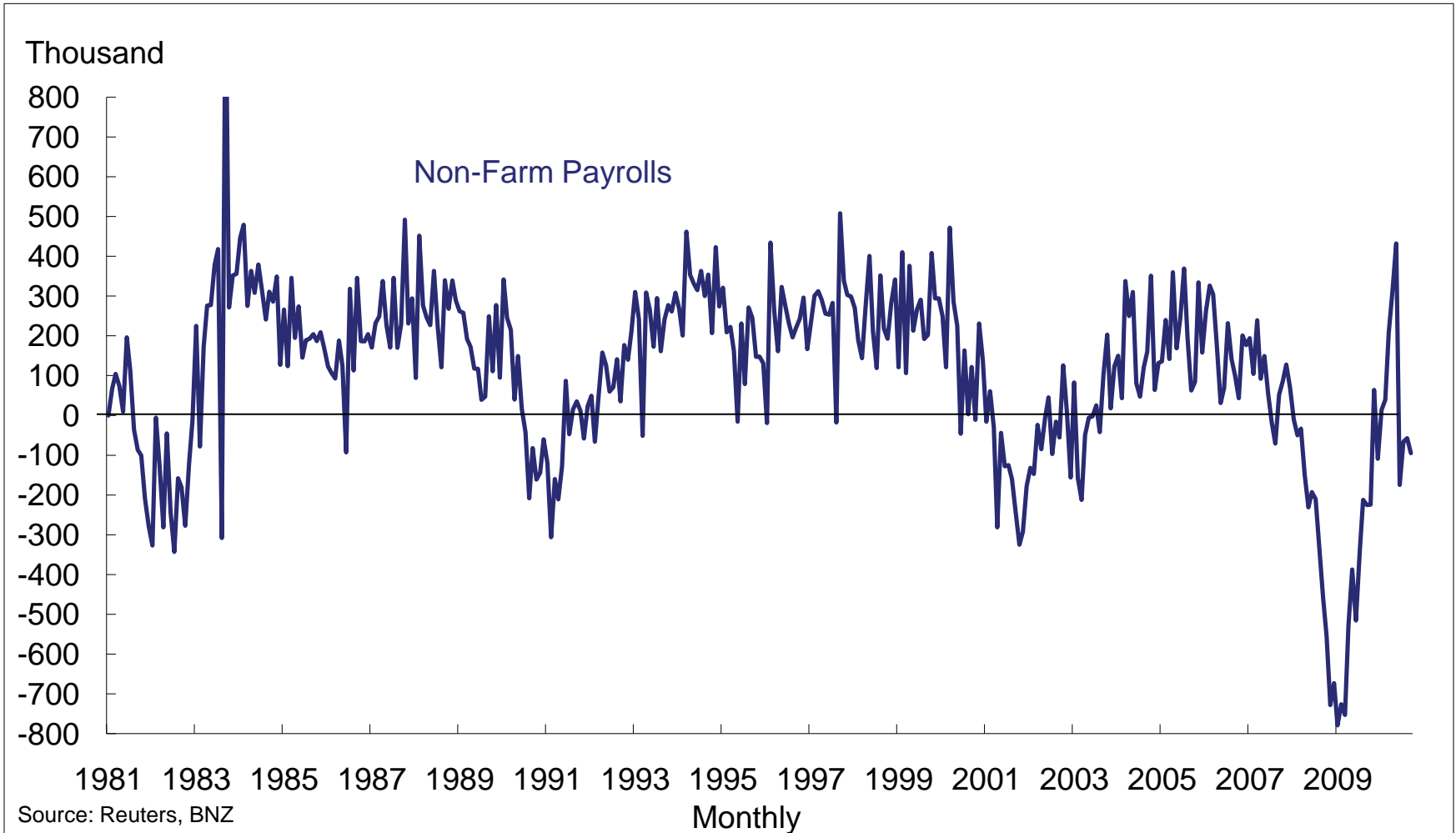
Economic Outlook

Doug Steel, Economist

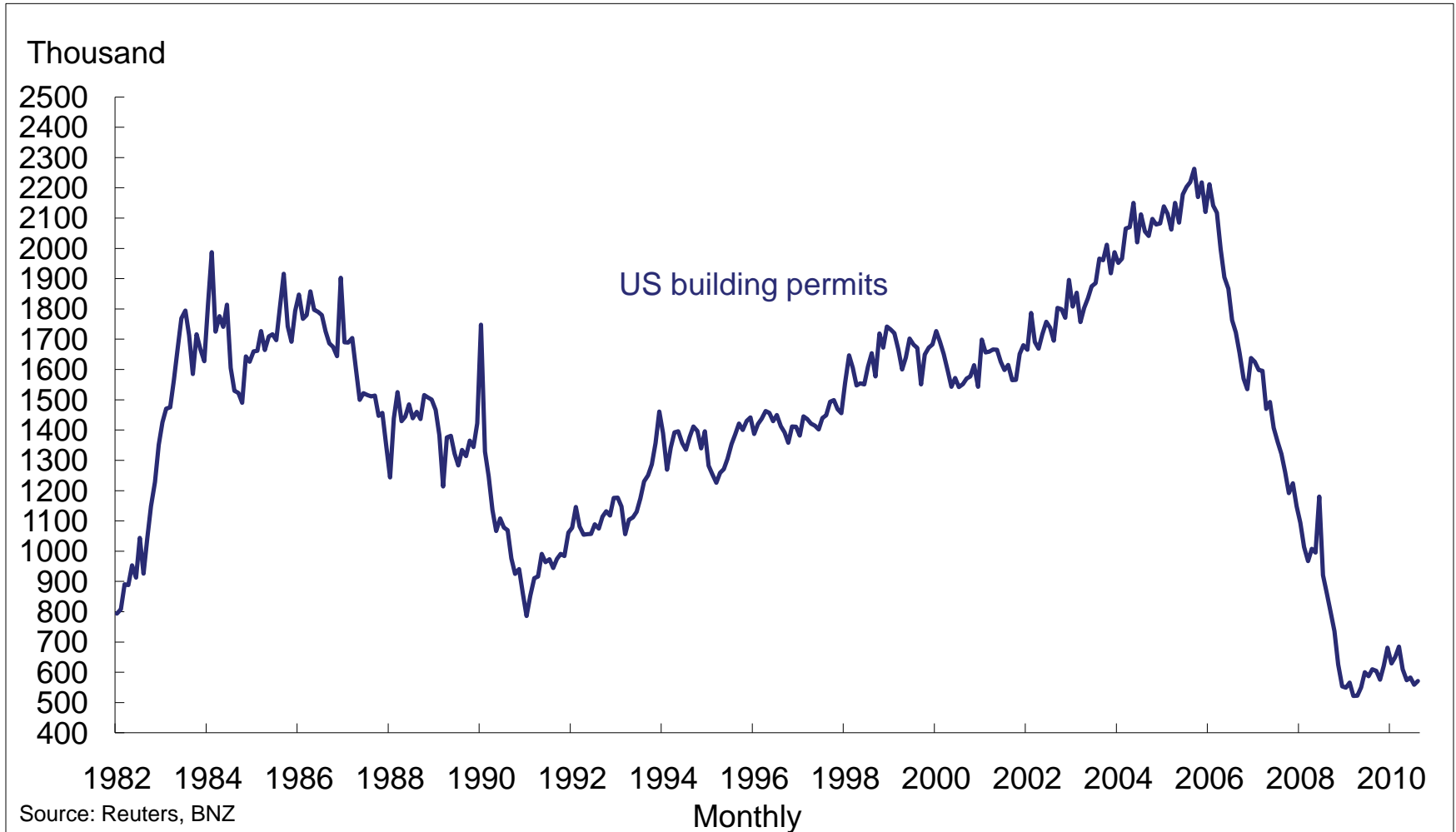
October 2010

The World

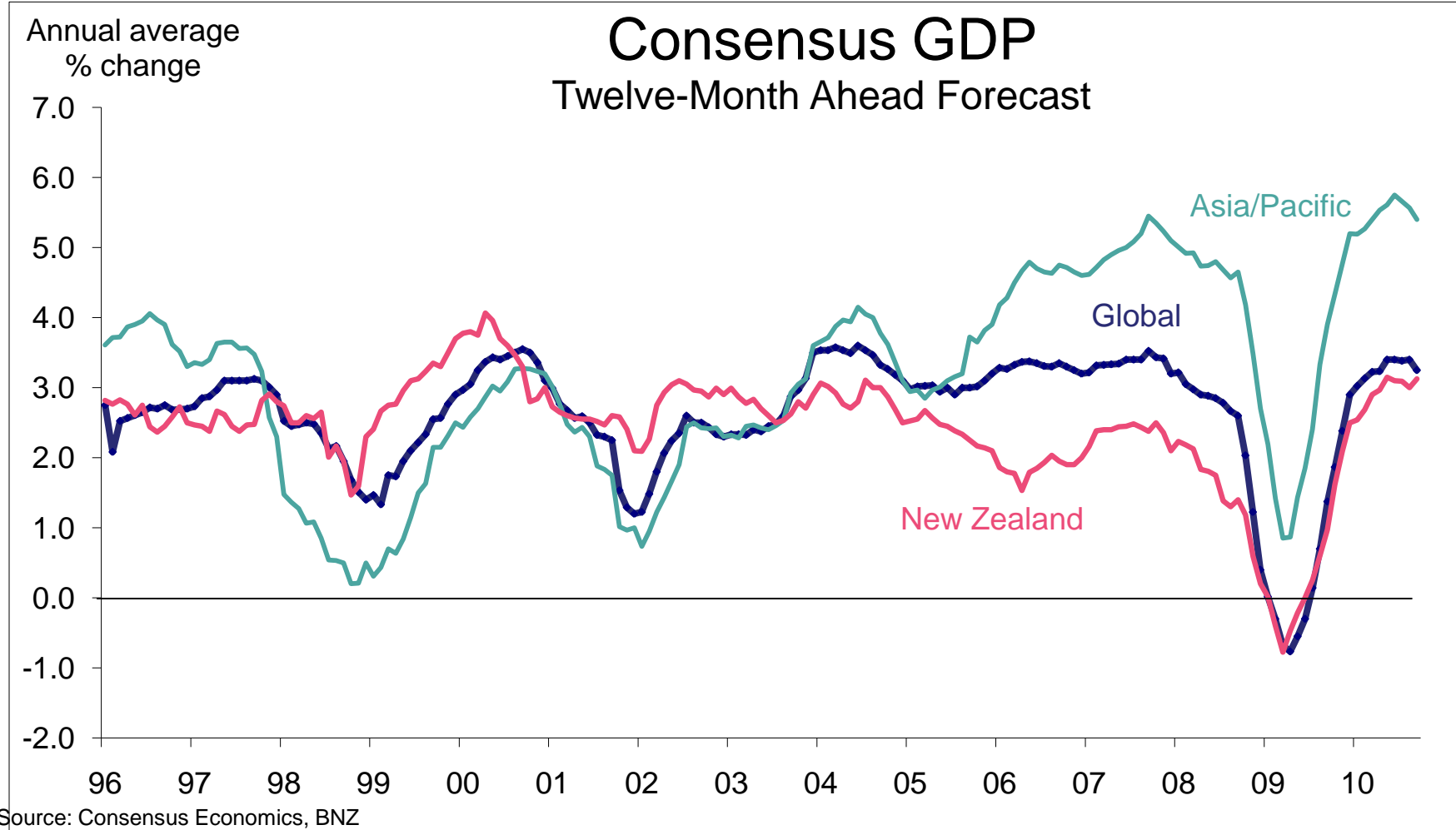
US Still Shedding Jobs – On Net



US Housing Remains Depressed



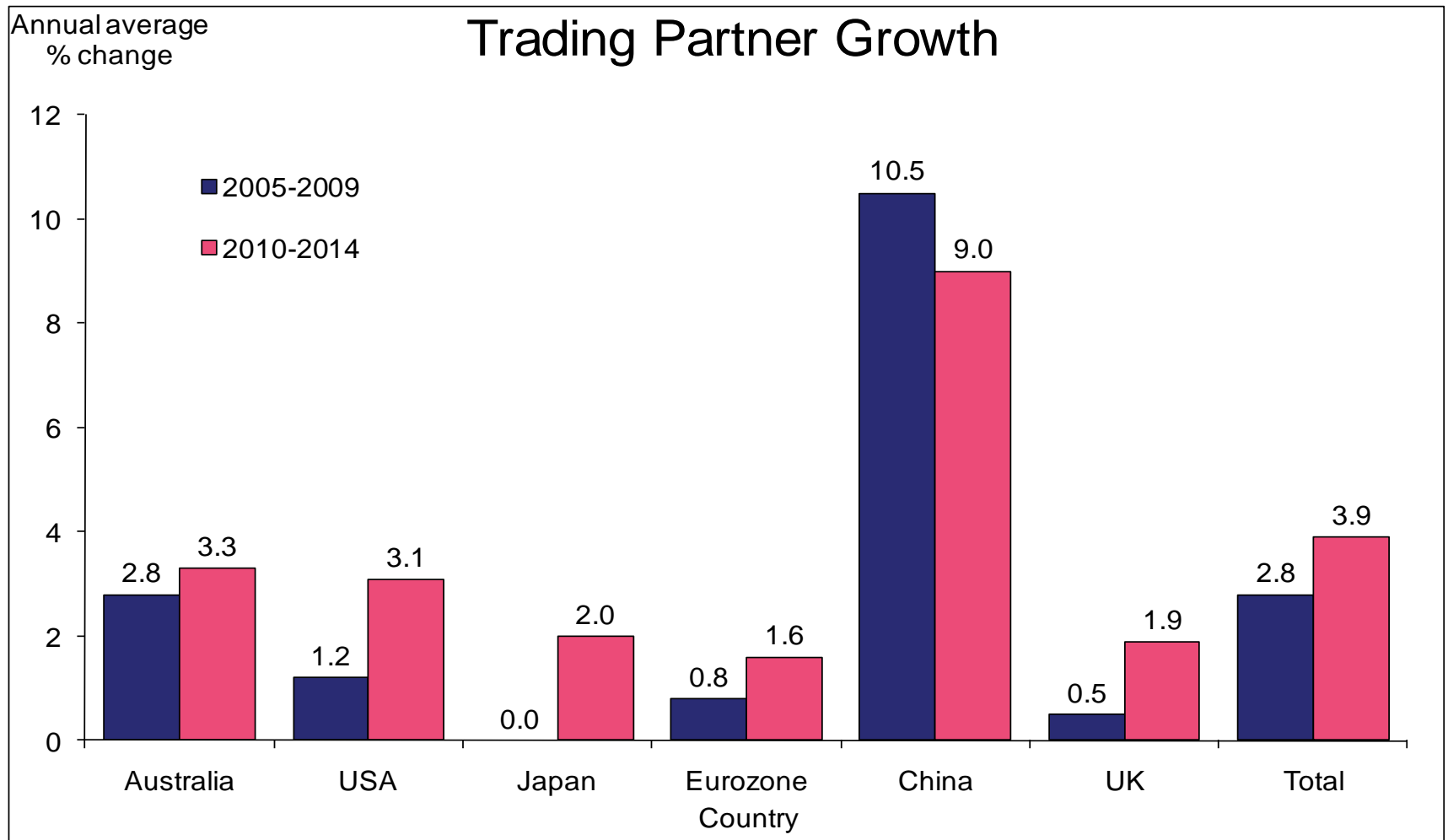
Global Outlook Solid Enough



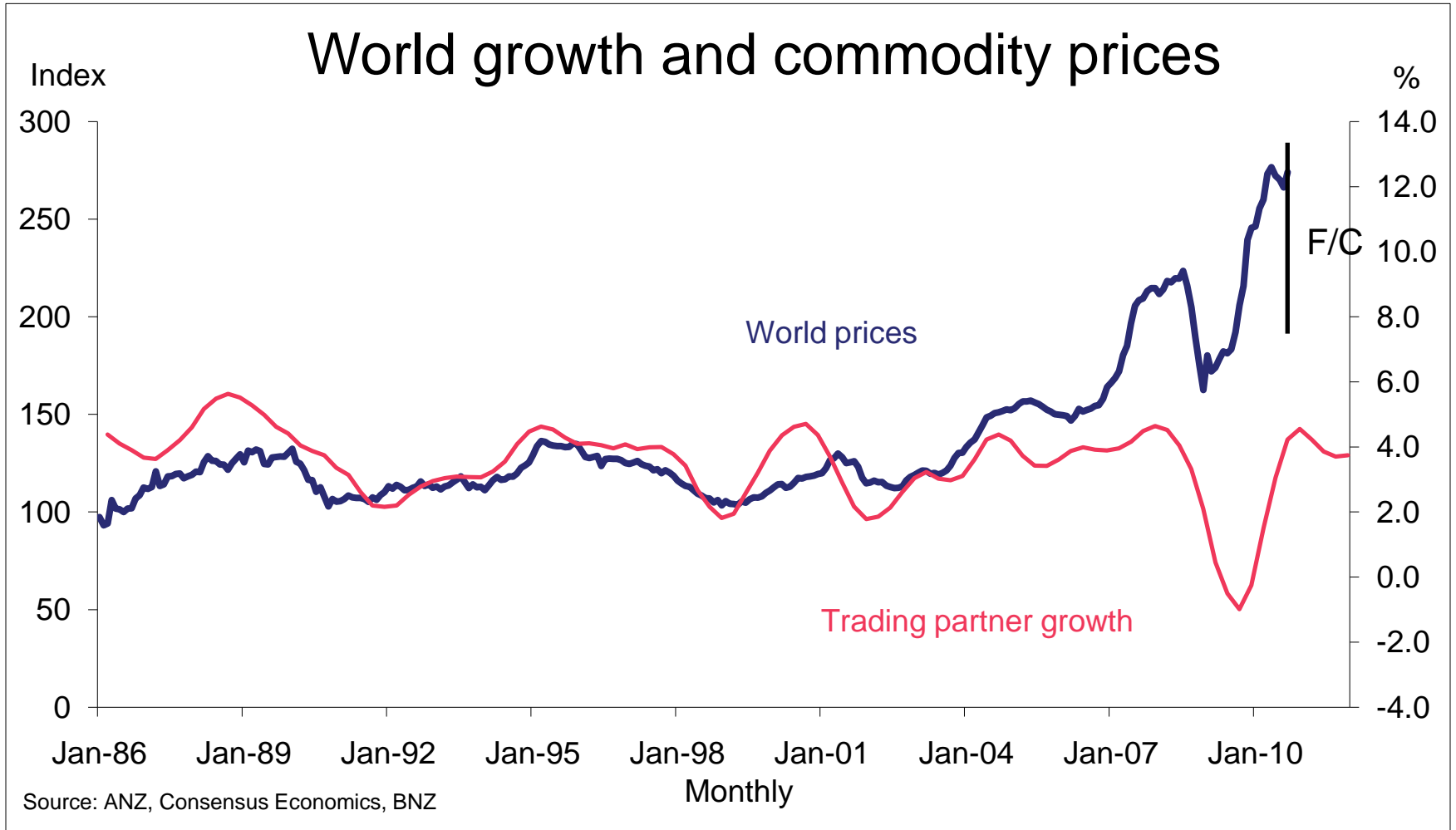
A 10-speed Recovery



Improving On Average



Commodity Prices Near Record



Diverging Fortunes

- Rich/Western economies hung over
- “Emerging markets” (over?) stimulated
- Deflation versus inflation
- US bond market vs Shares/Commodities
- NZ, Australia, in safer (commodity) space
- Early November: RBA hike, Fed QE II ??

Global – many risks remain

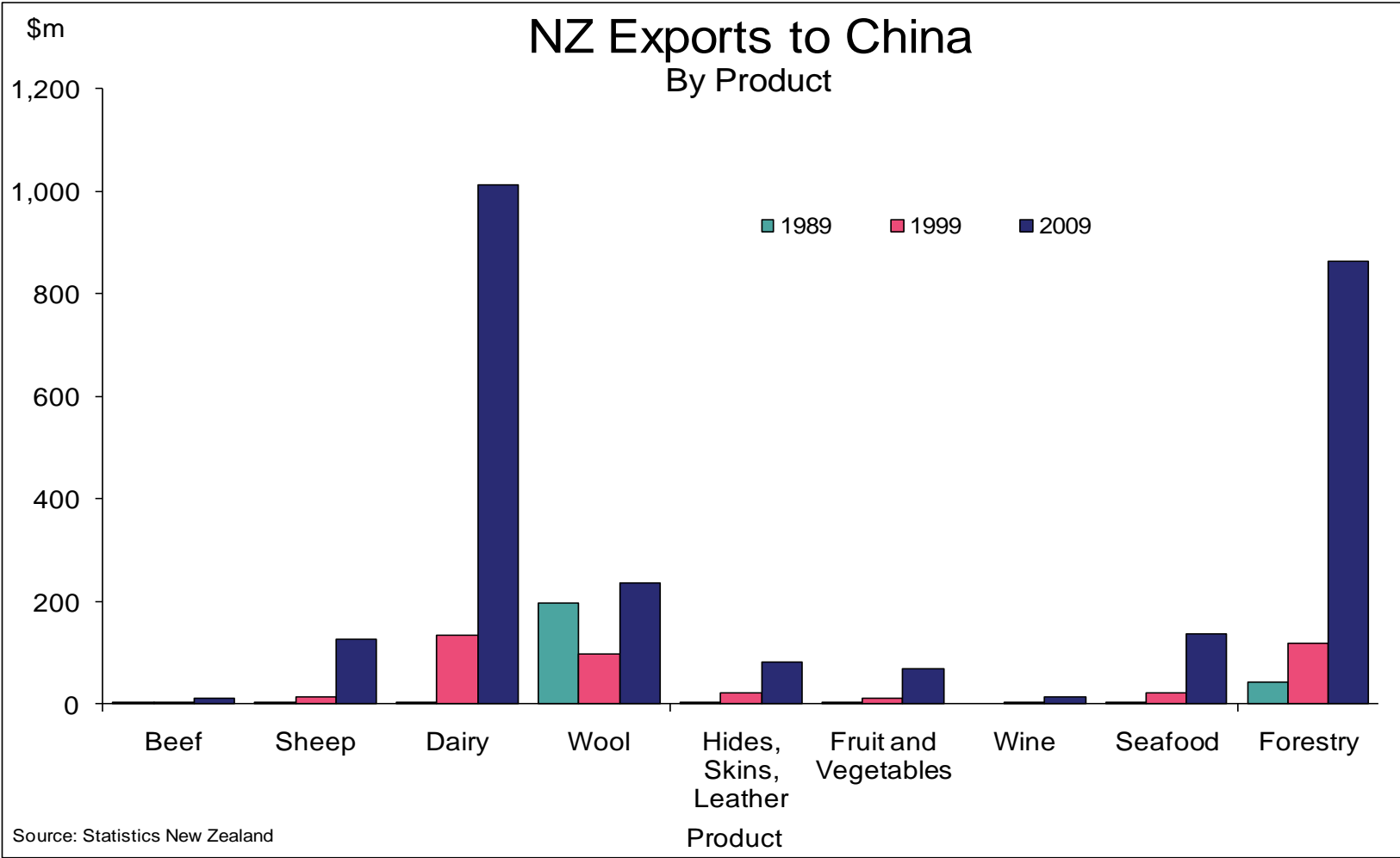
- QE (and its eventual removal) and its impacts (esp in the US)
- The possible emergence of asset bubbles
- The removal of fiscal stimulus
- The timing and extent of future monetary tightening
- The realignment of emerging market currencies
- Banking sector re-regulation (Basel III, already watered down)
- High demand for long dated paper – fiscal deficits
- Global dependence on the emerging market of China

China Increasingly Important to NZ

China's Share of NZ Exports



NZ Primary Exports To China



The China Story

China's achievements to date

China's economic growth model has delivered exceptional results to date:

- Average annual real GDP growth of 9.8% over the past three decades.
- World's 2nd largest economy
- Just become world's largest merchandise exporter (from 1% of global trade in 1980 to 9% in 2008)
- World's largest current account surplus (US\$426bn) and holder of foreign exchange reserves (US\$2.3tr)

Reason for China's rapid growth

The model is based on an exceptionally high level of investment with an increasing reliance on exports:

- Fixed asset investment (FAI) makes up almost half of China's GDP (world's highest share)
- High productivity growth (from labour & capital)
- China has run this high investment model long and hard

Limitations of China's model

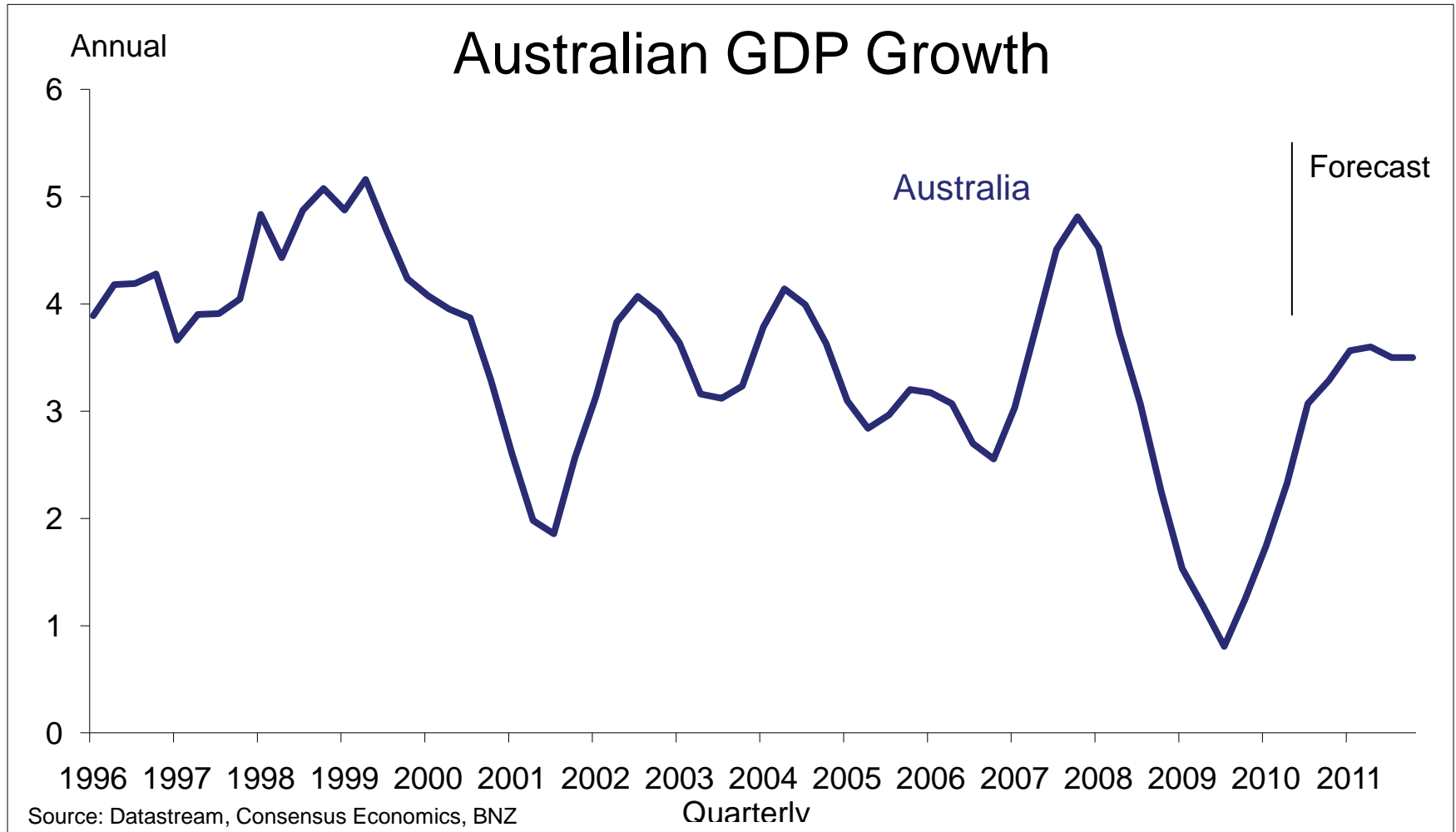
- The need to maintain rapid economic growth and its exceptional degree of dependence on investment spending is the Achilles heel of the model
- This means the growth model is circular, like a cat chasing its tail
- Over the longer term, the model is unsustainable and will eventually need to be reformed, but this involves structural changes over many years
- Poorly directed investment spending usually weighs on long term growth rather than precipitating a sudden economic slump.

Drivers of China's growth model

A unique set of characteristics has allowed China to pursue an investment driven, export led growth model:

- High savings rates by both households and corporate sector provide a cheap funding base for investment.
- Government influenced financial and regulatory system where interest rates, capital movement, and currency are all controlled.
- State owned enterprises (SOE) dominate many strategic sectors of the economy (especially heavy industry)
- Export promotion policies (i.e. "mercantilist" approach)
- Abundant, cheap labour supply

Australia Up On China's Coat Tails



Domestic

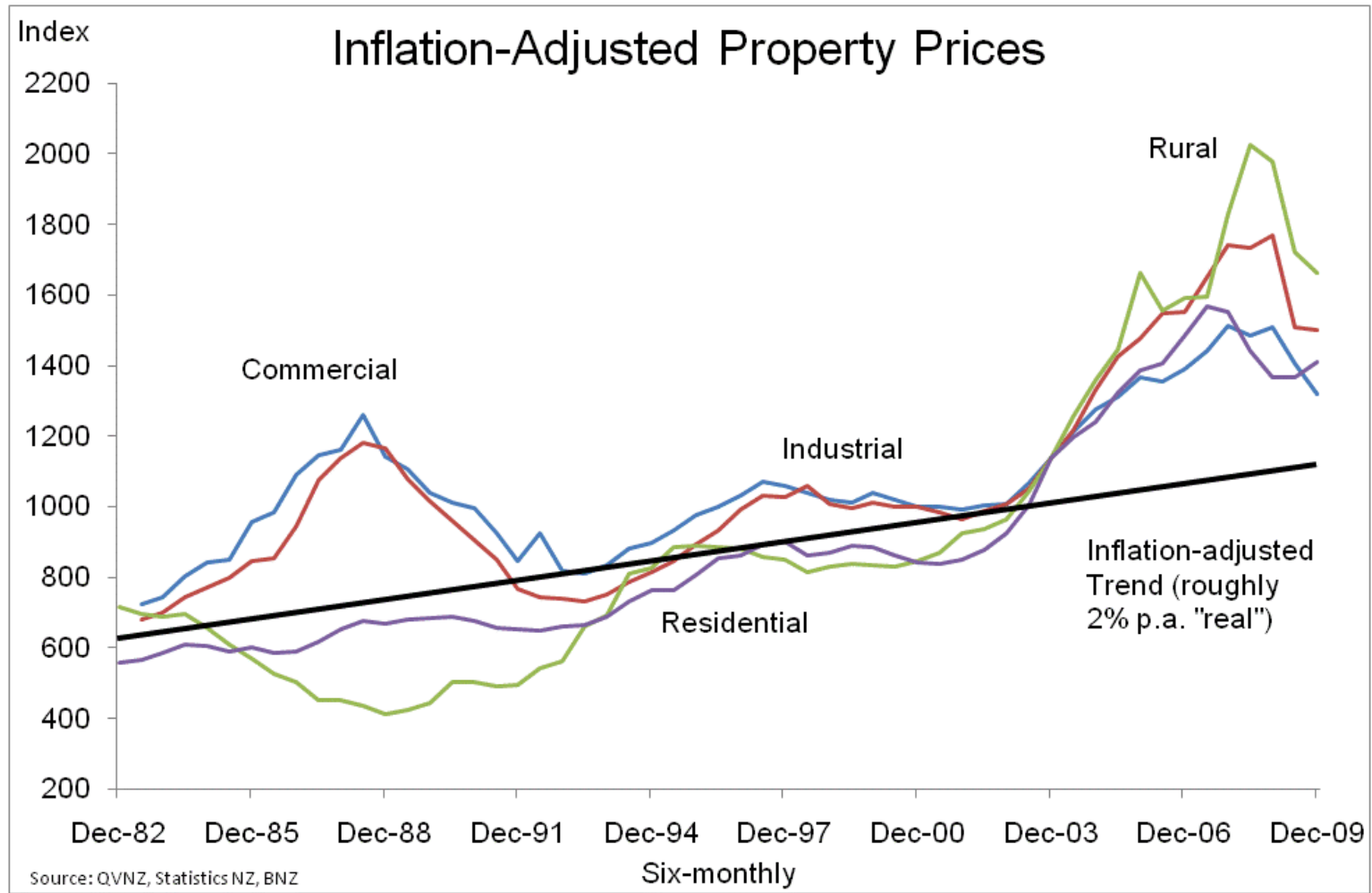
NZ: Reality Check



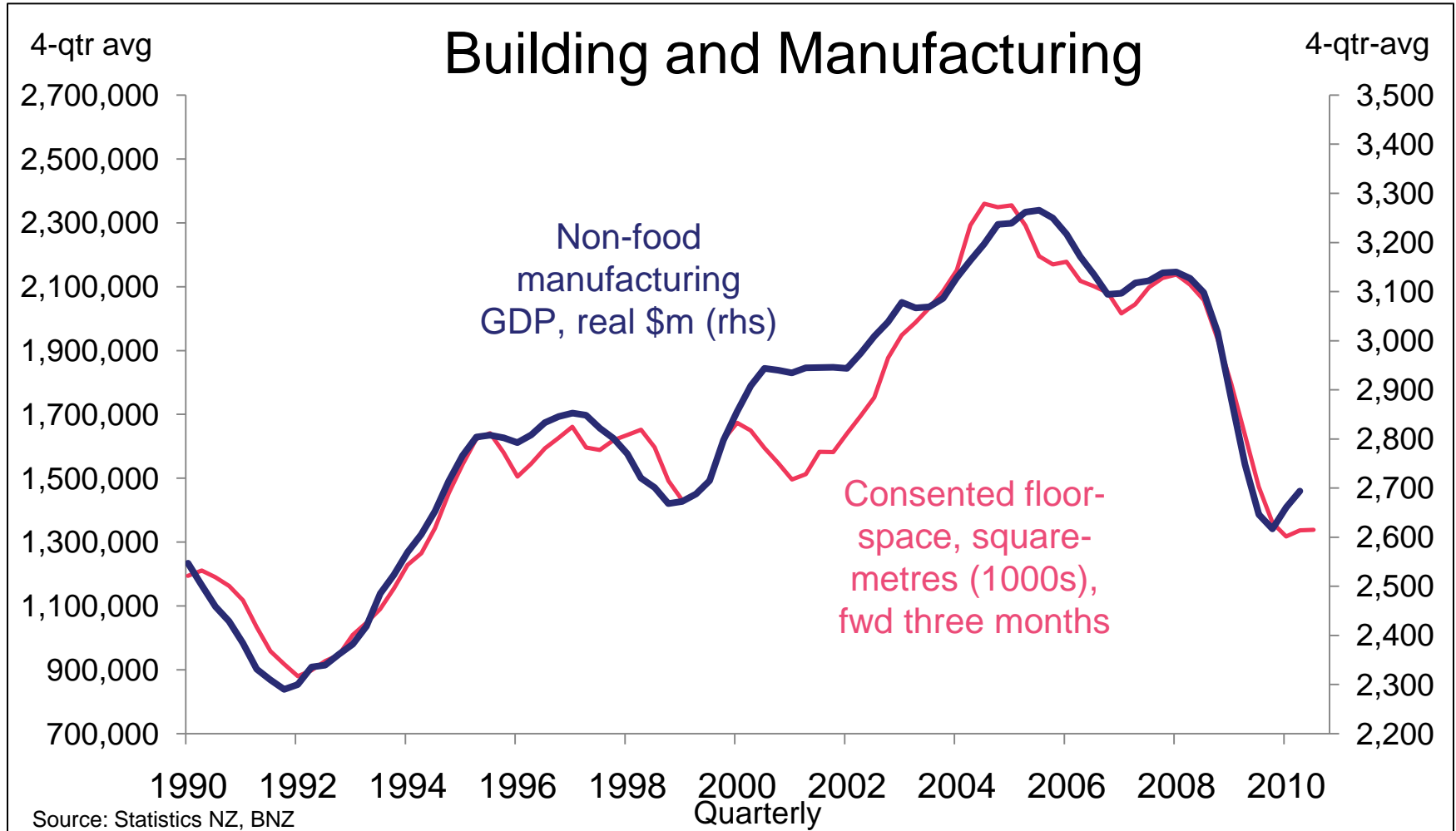
NZ Property (Prices)



From the Clouds



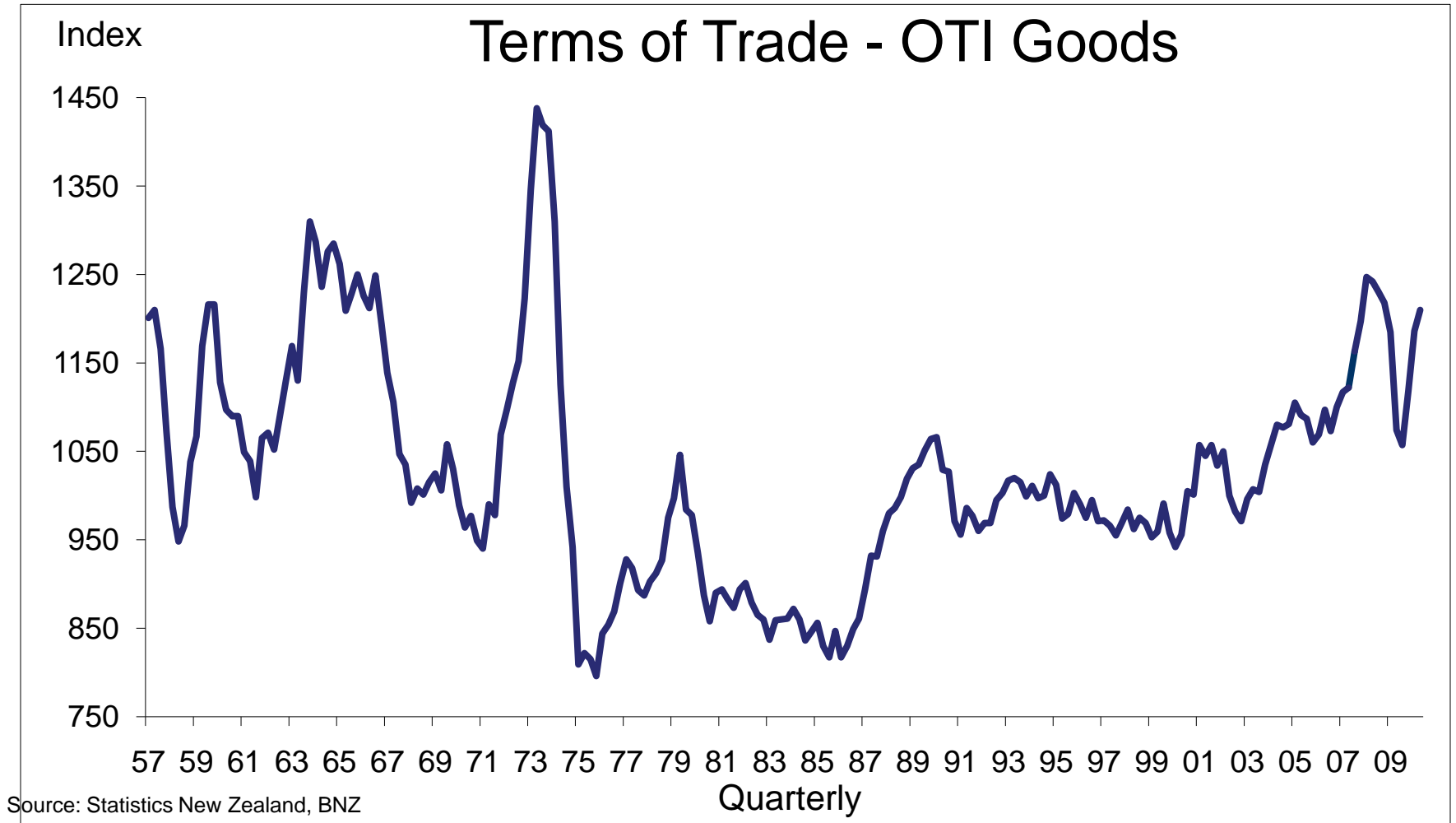
Building and Non-Food Manufacturing



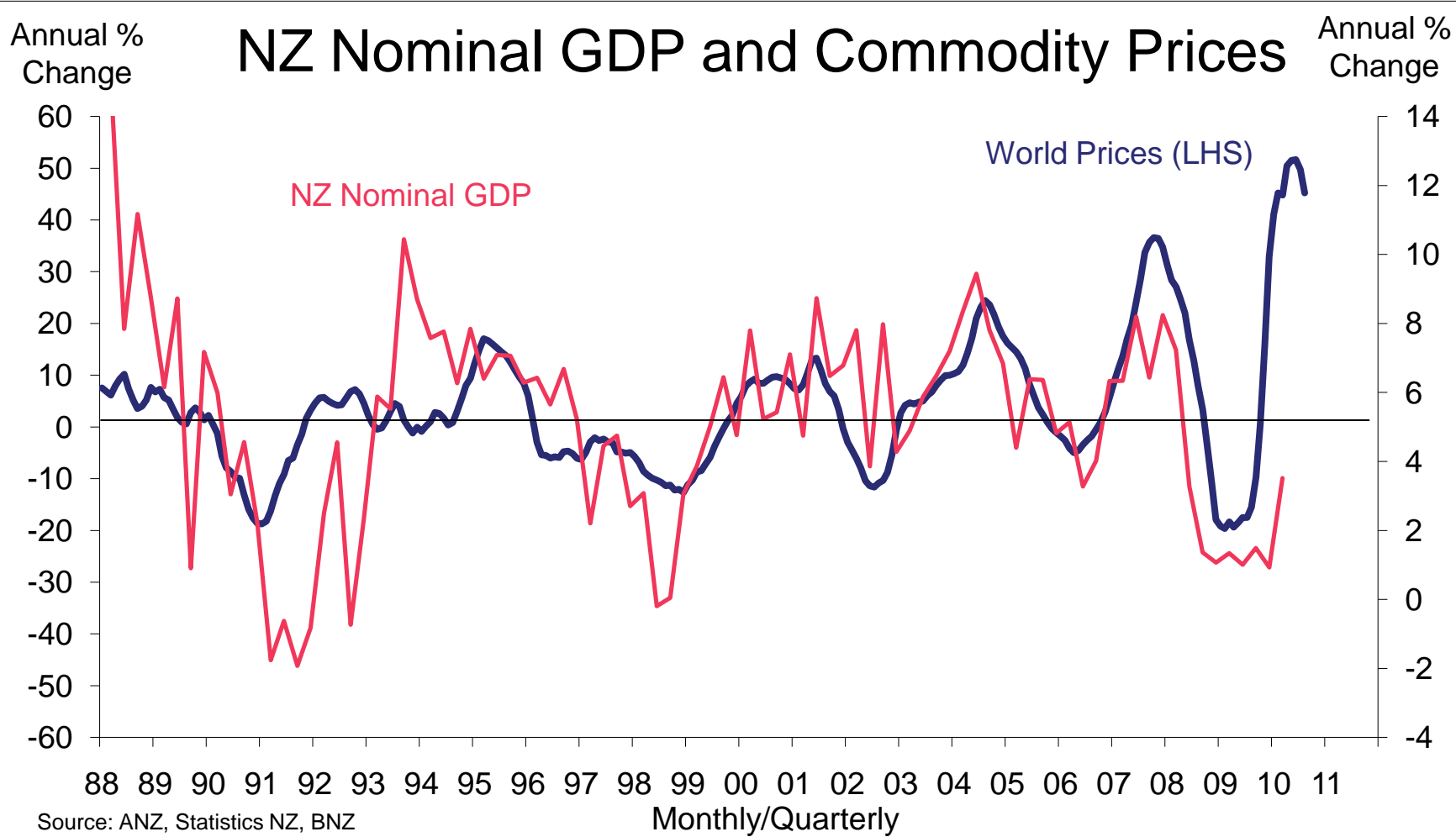
Enough To Sustain NZ Upswing

- Commodity exports, Aussie/China demand
- Last-gasp fiscal stimulus (income tax cuts)
- Inventory cycle (after painful adjustment)
- Robust, functioning, banking system
- Canterbury rebuild, Rugby World Cup
- Consumer/business confidence
- Supportive monetary policy (still)

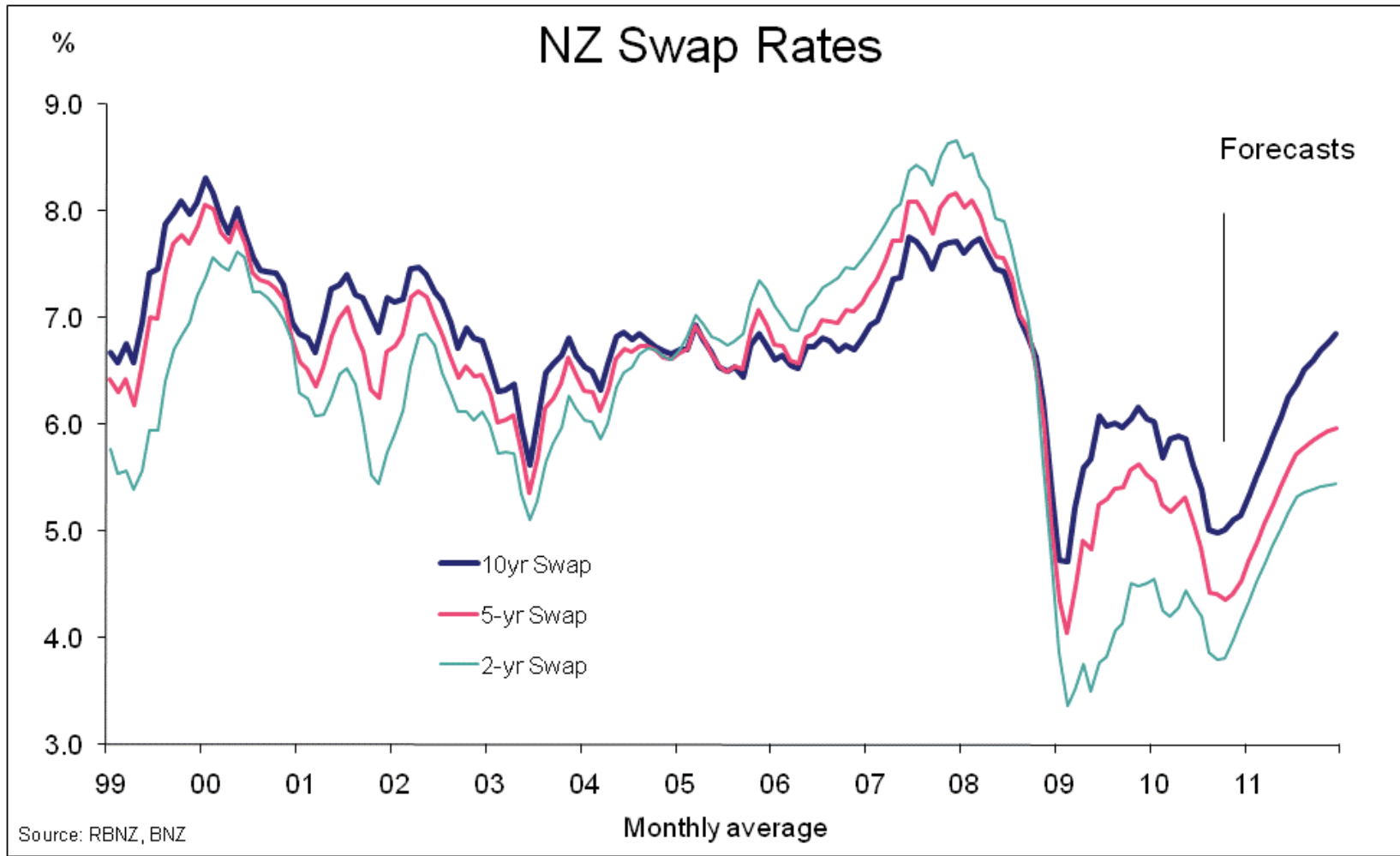
Terms of Trade The Positive Story



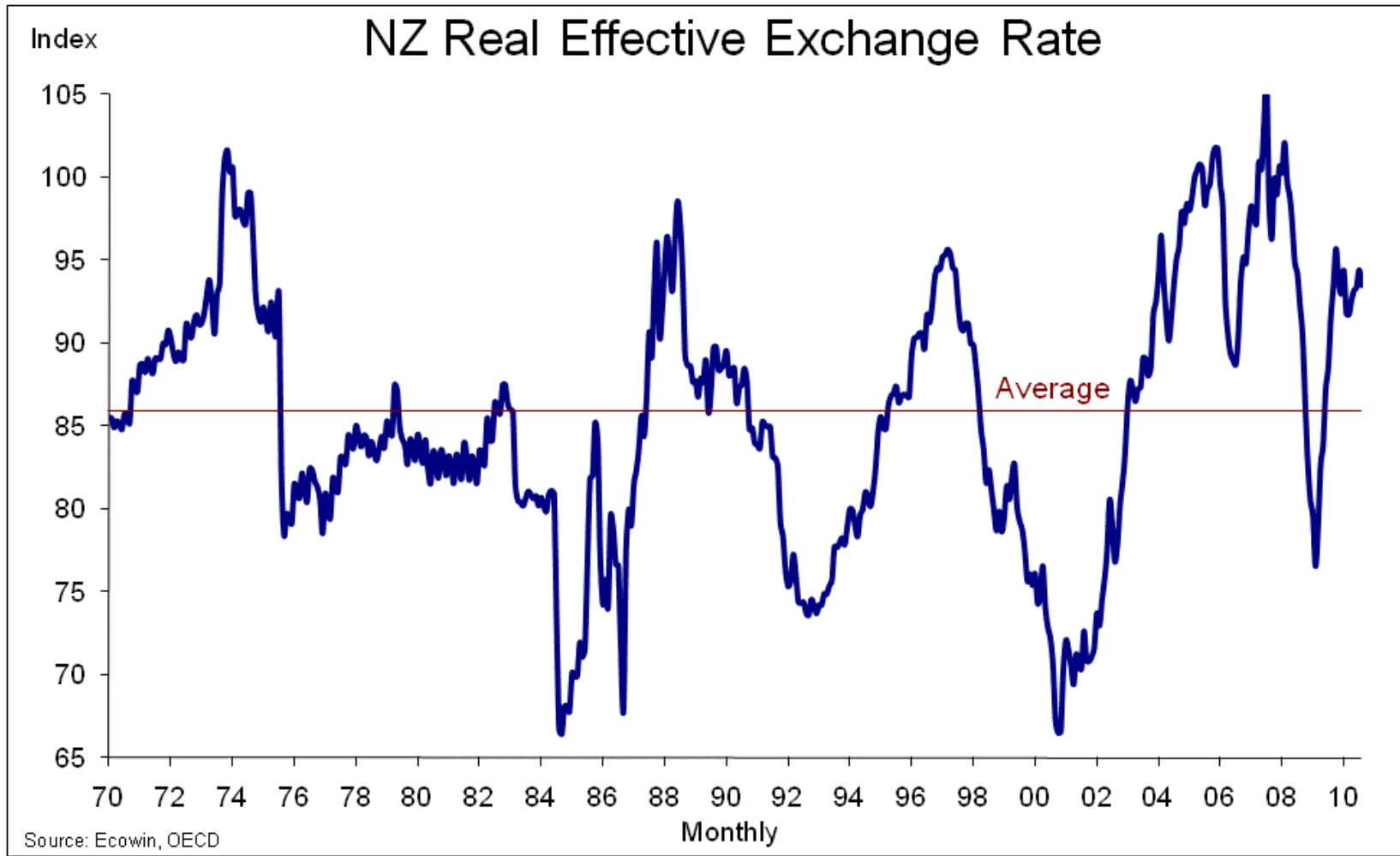
Commodity Prices Matter A Lot!



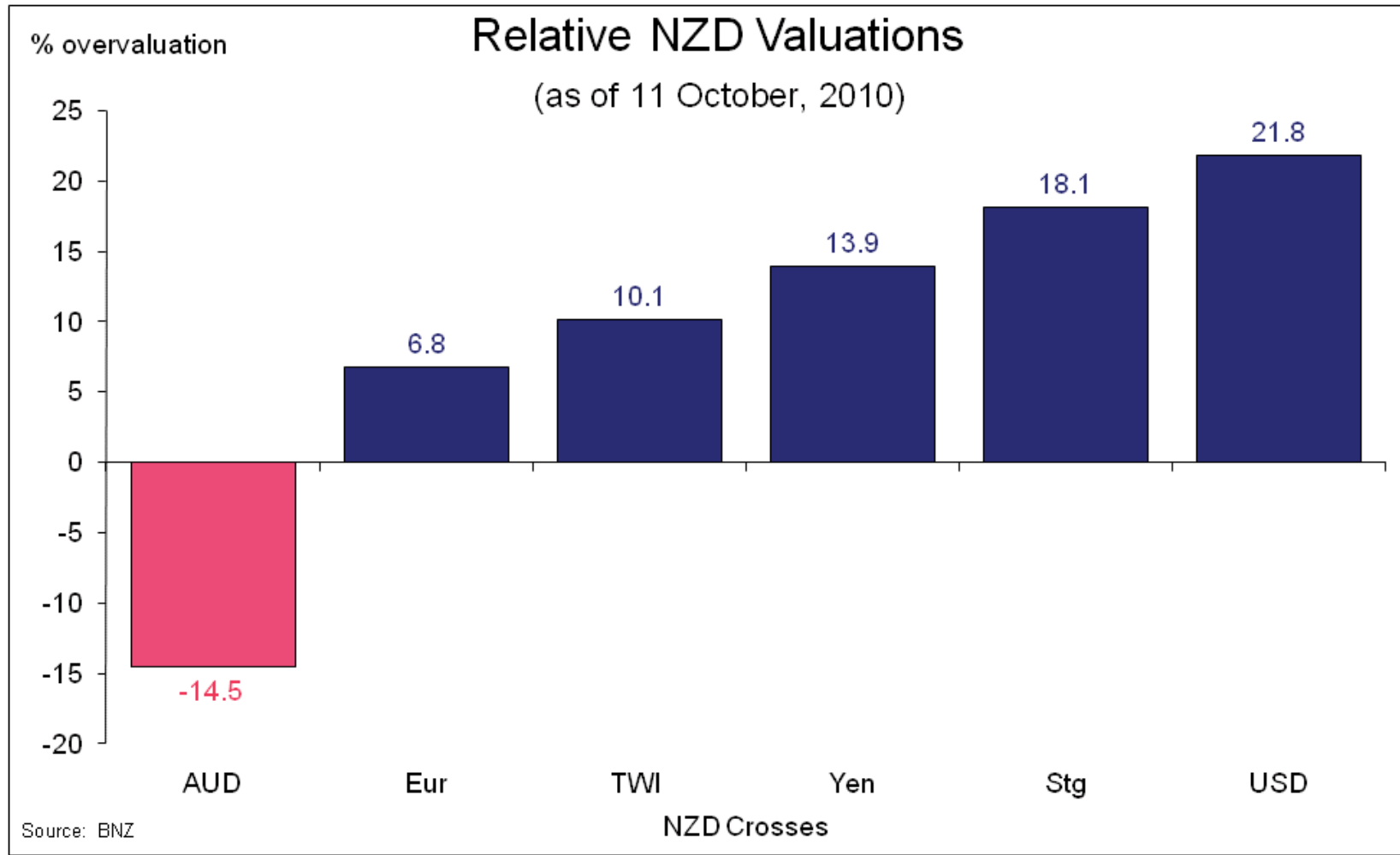
Interest Rate Lows Passing



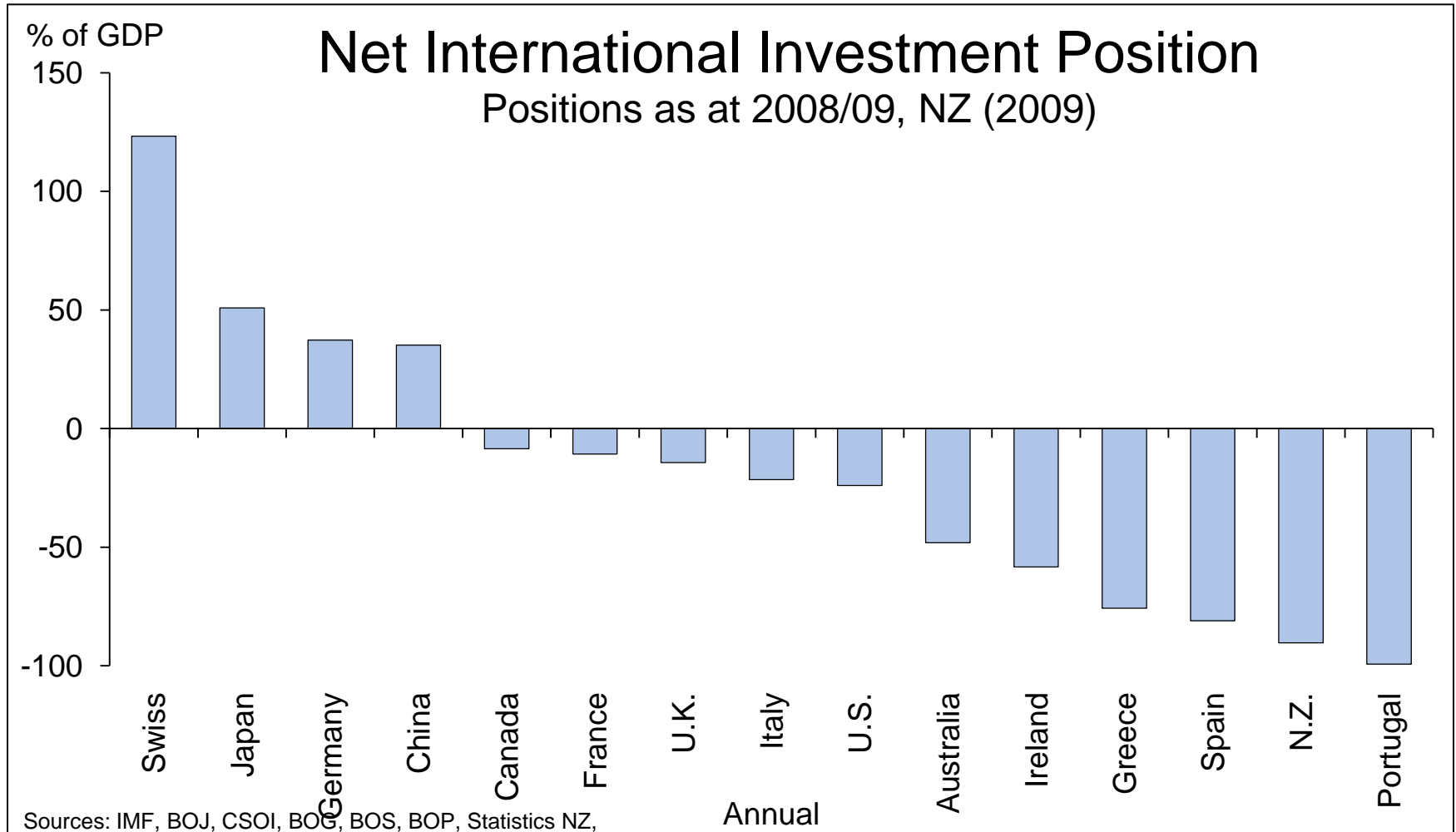
NZ Dollar's Relative Success



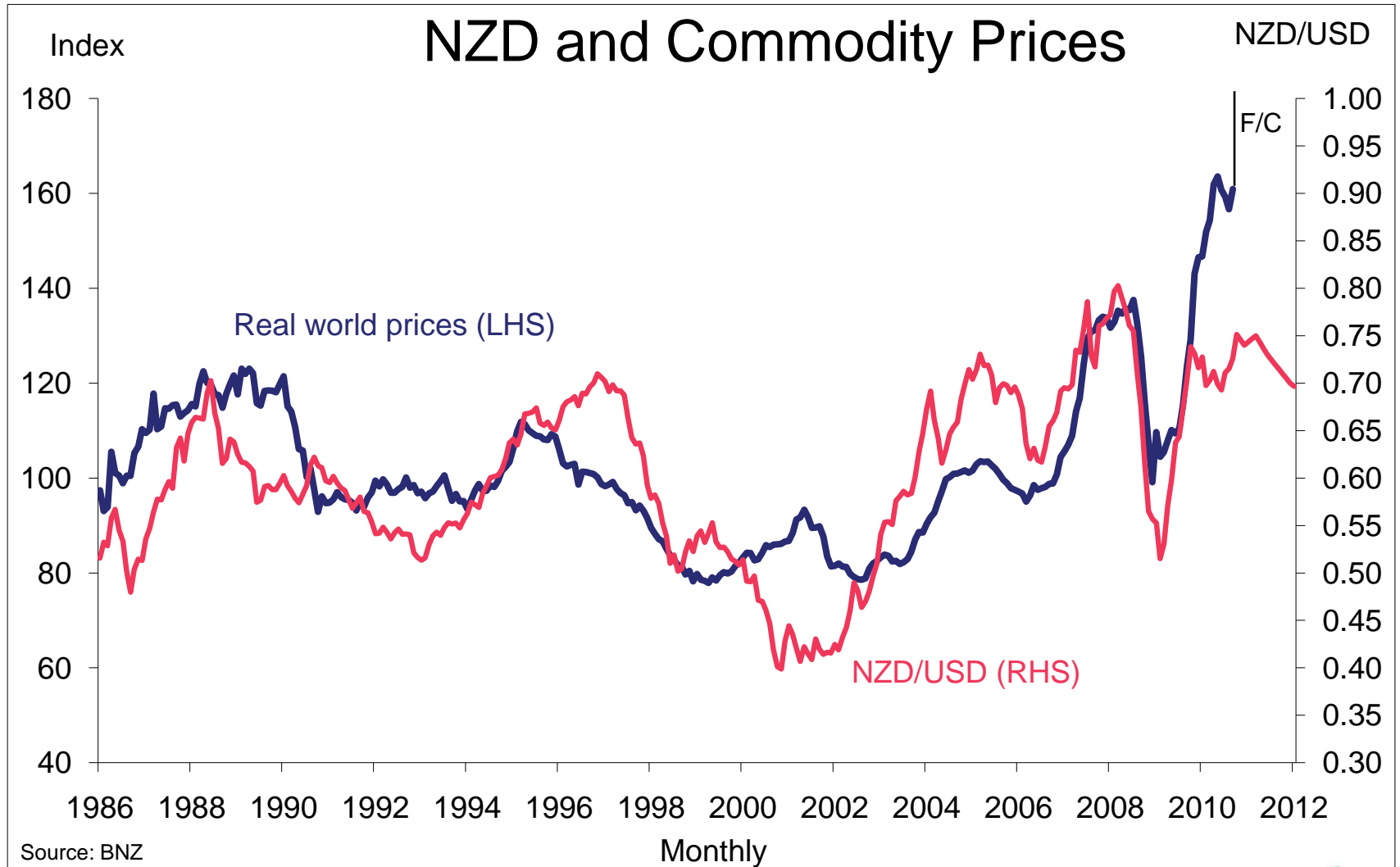
Versus Strong AUD, Weak USD



International Position Vulnerable



NZD Linked to Commodity Prices



Summary Points

- After the party
- A difficult 10-speed recovery
- Here and abroad
- As world faces big challenges

Challenges In Store

- Consumers/Housing still vulnerable
- Fiscal ammunition exhausted, deficits/debt
- Interest rates passing lows, domestically
- Financial reforms crimping credit
- NZ dollar stout despite sluggish growth
- A gradual, bumpy, recovery

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