August 2017

Economic Overview

Throttle back

New Zealand Economy	01
Global Economy	04
Agricultural Outlook	06
Exchange Rates	07
Inflation and Interest Rates	08
Special Topic – Election Preview	10
Forecasts and Key Charts	11

August 2017 Economic Overview

Note from Dominick

Welcome to our latest *Economic Overview.*

The New Zealand economy is now into its seventh year of expansion. While we do expect the growth to roll on, there are a number of areas in which the economy is throttling back.

First, the housing market slowdown has intensified. Prices are down 4% in Auckland since the January peak, and prices have flattened elsewhere. And second, residential construction activity has surprised us by levelling off at a time when further rapid growth was anticipated.

The connecting thread between the two is credit – both its price and its availability. The global environment is one of rising interest rates, and that has dragged New Zealand's fixed mortgage rates higher. Meanwhile, difficulty attracting deposits has made New Zealand banks choosier about who they will lend to. When credit is tight, both property development and property purchases are more difficult. We expect that the housing market will remain subdued, and that will have the usual flow on to consumer spending and the wider economy.

The positive counterbalance to all of this is the smiles that have appeared on farmers' faces as global soft commodity prices have risen over the course of this year, which is good news for rural regions and will boost the wider economy.

But with export success comes a higher exchange rate. That is one of many factors that will tend to keep inflation quiescent over the coming two years. This quarter we have reduced our GDP growth and inflation forecasts, meaning we see even less scope for the RBNZ to hike the OCR. Financial markets are priced for OCR hikes in the second half of 2018, but we view that as quite a distant prospect.

Of course, the big uncertainty will be the September election – this quarter's special topic covers how various election outcomes might affect our forecasts.

Dominick Stephens - Chief Economist

Contributing authors

Dominick Stephens
Chief Economist
T +64 9 336 5671

Michael Gordon
Senior Economist
T +64 9 336 5670

Satish Ranchhod
Senior Economist
T +64 9 336 5668

Shyamal Maharaj
Economist
T +64 9 336 5669

Text finalised 11th August 2017

ISSN 1176-1598 (Print)
ISSN 2253-2897 (Online)

For address changes contact:
WNZResearch@westpac.co.nz

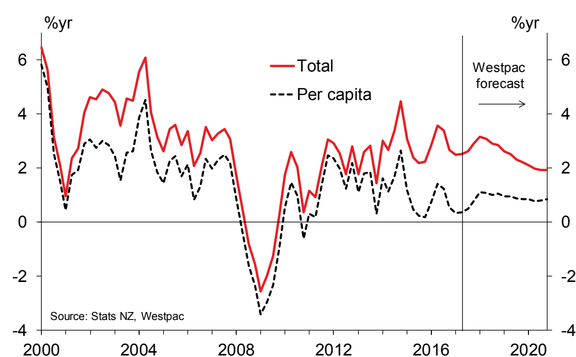
New Zealand Economy

Clouds on the horizons

The New Zealand economy is set to continue growing at a firm pace over the coming year. However, some of the big drivers of activity in recent years have started to dissipate, and we expect that growth will slow to low rates before the decade is out. This will bring some of the key challenges in the economy, including our high household debt levels, into much sharper focus.

The New Zealand economy is now into its seventh year of expansion, and we expect that economic growth will remain firm over the coming year. Activity has long been supported by strong population growth, increases in construction spending, and accommodative monetary policy. On top of those factors, we're now also seeing firmer conditions in exports sectors, and fiscal policy is set to adopt a more stimulatory stance.

Figure 1: Total and per-capita annual GDP growth



But while overall economic conditions have been firm, we're still wrestling with some big challenges. On a per capita basis, economic growth has actually been quite modest. In addition, much of the increase in domestic demand in recent years has come on the back of rising household debt, which is not a sustainable source of growth. The economy is also facing ongoing issues in relation to the provision of housing and infrastructure, which have been compounded by growing headwinds in the construction sector.

Reinforcing the above challenges have been some important changes in the economic landscape. Most notably, borrowing rates have been creeping higher, and the housing market has slowed. We've also seen reconstruction activity in Canterbury continuing to gradually wind down. Softening conditions on these fronts is already weighing on economic growth, and these downdrafts are set to become more pronounced over the coming years. Combined with an eventual turn in the migration cycle, this will see the current period of firm economic activity give way to a period sluggish GDP growth before the close of the decade.

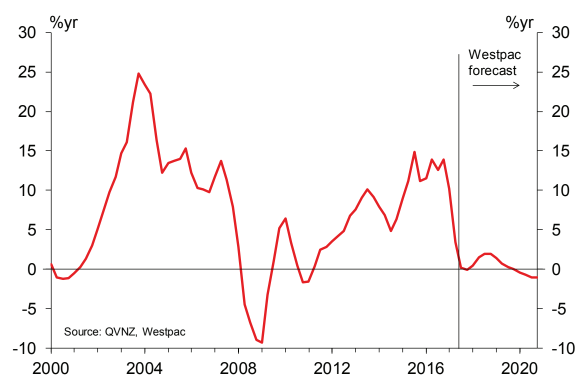
As GDP growth slows, some of the other challenges that the economy has been wrestling with will become even more pressing. In particular, the run up in household debt in recent years poses downside risks for domestic demand.

Housing market momentum continues to fade…

Among the biggest changes in the economic environment over the past year has been the rise in borrowing rates and a related slowdown in the housing market. Borrowing rates are still at low levels. However, increases in both domestic and offshore funding costs have seen mortgage rates creeping higher, and further increases are likely over the coming year. This has been a significant change in New Zealand's lending environment after several years when mortgage rates were either flat or falling.

Combined with last year's tightening in lending restrictions and uncertainty ahead of September's election, rising borrowing rates have seen annual house price inflation slow to just 1%. That's a far cry from the double-digit rates of house price growth we saw over the past few years. We've also seen the number of house sales fall 25% over the past year, and the number of unsold homes has been creeping higher. This suggests that there is more housing market weakness to come.

Figure 2: New Zealand house price growth



The slowdown in the housing market has been sharpest in Auckland, where prices have fallen 4% since January. That follows very large gains in recent years that eroded housing affordability and left house prices in our largest city significantly overvalued on a number of metrics. Housing

markets have also slowed in other parts of the country, but to a lesser degree.

In the near term, there's a chance that there will be a modest rebound in house price inflation following September's election and as the impact of last year's tightening in lending restrictions fades.

But the main driver of the housing market slowdown is not about to change. If anything, borrowing rates could push higher. For existing and prospective owner occupiers, this will weigh on housing affordability (which is already stretched in some parts of the country). For investors, increases in interest rates mean that the financial returns on housing assets – especially the potential capital gains – will look at lot less attractive over the next few years.

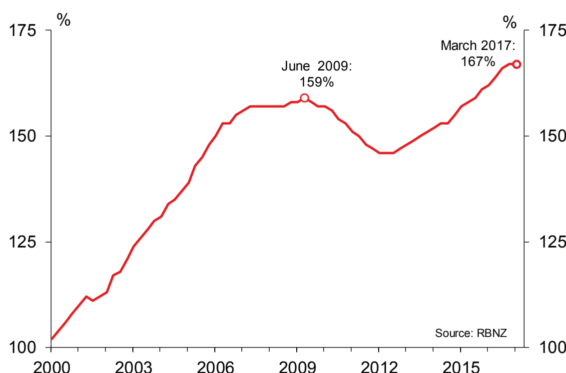
Putting all this together, we expect house price inflation will remain weak for some time yet. In fact, we expect that house prices will be flat over 2017 as a whole, and that we'll see only muted rises over the next few years.

...and combined with a run up in debt levels, this will dampen household spending

New Zealanders hold a large proportion of their wealth in housing assets, and the combination of low borrowing rates and strong house price inflation in recent years gave household spending a powerful shot in the arm. But now, with borrowing rates pushing higher and momentum in the housing market fading, a period of softness in household spending is on the cards.

Importantly, the low interest rates and associated gains in house prices that boosted households spending in recent years also encouraged a large run-up in household debt. Low borrowing rates made it very attractive for investors to purchase residential property using debt, especially given the potential for capital gains. At the same time increases in house prices meant that owner-occupiers have had to borrow more to purchase housing, while existing owners have spent some of their perceived windfall as house values have risen.

Figure 3: Household debt (% of disposable income)



The above conditions saw household debt levels rising by more than 30% between 2012 and 2017. New Zealand households now carrying $264 billion of debt, a level that's equivalent to 167% of disposable incomes. These high levels of household debt will be a brake on spending growth over the coming years. Debt eventually needs to be repaid, and the large increases in recent years mean that households will now have to commit a greater proportion of their future income to debt repayment. In addition, while debt servicing costs are currently low, they are set to increase over time.

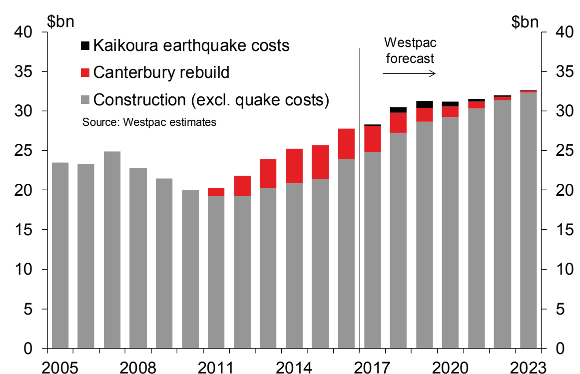
Strong gains in house prices in recent years have flattered households' debt-to-asset positions, while also encouraging borrowers to take on additional debt. But with the housing market now slowing, debt-to-asset positions may start to look less heathy, especially in Auckland where house prices are falling. More indebted borrowers are likely to find their access to credit curtailed, while rising debt servicing requirements result in their disposable incomes being squeezed.

A related concern is that many borrowers have used debt to purchase investment properties. Rising borrowing rates will further erode rental yields (which are already at relatively low levels), while also limiting the scope for capital gains. These conditions could reinforce the housing slowdown, as well as weighing on spending.

Construction rising, though headwinds have increased

Construction is set to remain a key driver of growth and employment over the coming years, with a large pipeline of work planned. Much of this is centred on Auckland, where around a decade of strong building is required to address the existing shortfall of housing and keep up with surging population growth. Residential construction has also been increasing strongly in areas such as Northland, Taranaki, Manawatu and Wellington (though with population growth likely to slow over the coming years, home building in smaller regions is also likely to ease back). On top of this, there is a large amount of non-residential work planned nationwide, including a substantial amount of infrastructure spending.

Figure 4: Annual construction activity



However, while there is a large amount of work planned, the construction sector is encountering a number of challenges. Capacity in the sector has become stretched and firms are reporting increasing difficulties finding staff. These conditions have seen building costs rising rapidly, especially in Auckland. At the same time, many developers

have found it harder to access credit, which is providing a brake on building activity. This has been reinforced by the slowdown in house price inflation, with developers cautious about building in a softening market.

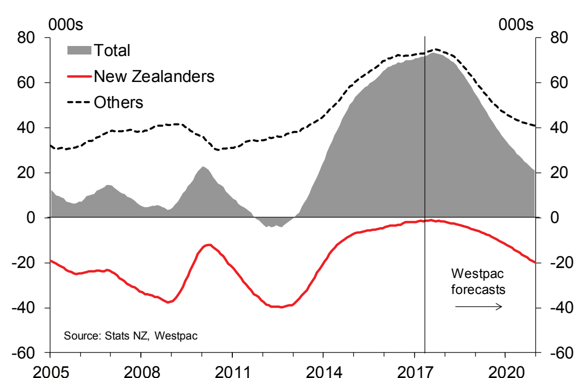
While we continue to expect construction levels will continue to rise over the coming years, the above headwinds mean that the pick-up may be quite gradual, especially in the near term. This means that the existing shortfall of housing and pressure on infrastructure will persist for some time yet.

In addition to the above work streams, reconstruction activity following the Canterbury and Kaikoura earthquakes will continue for several more years. However, in the case of the Canterbury rebuild, around two-thirds of planned work is now complete and spending has been gradually winding down. This has important implications for the nationwide growth outlook. The Canterbury rebuild has been a massive undertaking, and spending on reconstruction work has provided a significant boost to activity and employment in recent years. But just as the ramp up in rebuild spending was a boon for economic activity and employment, the gradual wind down that is now occurring is resulting in some drag on growth.

Net migration continues to push higher

Underpinning much of the growth in demand in recent years has been strong population growth on the back of record net migration. Our relatively positive economic conditions have encouraged large numbers of new arrivals, including those on work and residency visas. We've also seen higher than usual numbers of New Zealanders choosing to stay onshore, as well as increased numbers coming back from overseas (particularly from Australia). We expect these factors will keep net migration at high levels over the coming year.

Figure 5: Net migration, annual



For businesses, strong population growth has been a boon. Increases in the economy's demand base have meant more bodies in stores, and have helped to offset some of the other headwinds that the economy is facing. But for many households, the economic environment is likely to feel a lot more sluggish. Population increases have masked what's actually been quite muted growth in per-capita GDP. In addition, it also has added to pressures in the housing market and strains on infrastructure.

However, migration isn't just affecting demand. With inflows weighted towards those of working age, migration has added to our productive capacity and is helping to address skill shortages in areas like construction.

Net migration and population growth are expected to ease back over time. As global economic conditions slowly improve, increasing numbers of New Zealanders will begin venturing abroad. We'll also see the departure of many of those who arrived on temporary visas in recent years. The resulting slowdown in population growth will reinforce the more general softening in demand late in the decade.

An additional overlay to the current migration cycle is the growing political appetite for a tightening in migration settings. If we don't see a 'natural' easing back, it is much more likely that we will see a policy change to limit inflows over the coming years.

Export outlook continues to improve

Helping to offset some of the softening in parts of the domestic economy are improved conditions in export sectors. As discussed in the Agricultural Outlook section, tightness in global supply and firm international demand have continued to support prices for some of our key exports, including dairy, beef and lamb. This is boosting incomes and confidence in rural regions, and over time will flow through to increases in downstream spending (though, least for now, many farmers are focused on paying down debt).

Tourism also continues been a bright spot for the economy, with a record 3.6 million international visitors over the past year. This has boosted demand in a range of areas like hospitality and accommodation, with increases in spending spread across the country. Growing airline and hotel capacity will support continued growth in the sector over the coming years.

Monetary and fiscal policy to remain supportive

With some of the key drivers of domestic activity easing off, monetary policy is likely to remain very accommodative for some time. As discussed in the Inflation and Interest Rates section, the Reserve Bank needs a period of strong economic activity to fully ward off the low inflation that has dogged it in recent years. And that requires support from low interest rates. We're not forecasting any change in the Official Cash Rate until late-2019.

Fiscal policy is also set to adopt a more expansionary stance over the coming year, though the precise details of spending will depend on the makeup of government after September's election. Our forecasts are based on plans the current National-led government has announced. These include sizeable increases in infrastructure spending over the coming years, as well as a package of family income support measures (including tax cuts). Our special topic looks at possible election outcomes, and what a change in government might mean for our forecasts.

Global Economy

The Newer Normal

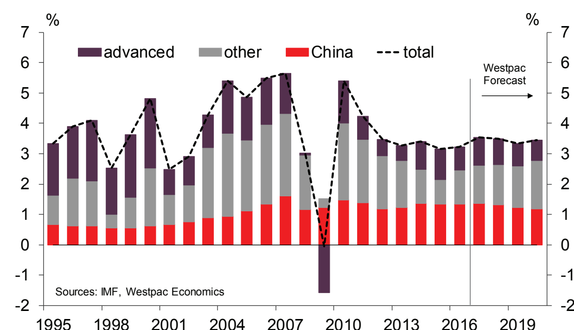
Global economic fundamentals continue to firm with growth and inflation outcomes fostering broad based confidence. There is a shift in tone coming from central banks, based on improving labour market conditions and economic outlooks. However, this is uncharted territory, and we are in the early days of normalising monetary policy.

Global growth is becoming more broad based and sustainable. The resilience we have seen in the recent past appears to be here to stay and this bodes well for many countries. We maintain our growth projections at 3.5% for this year and the next. China remains the leader in global growth contributions, but as the gears shift up in other advanced economies, this composition could change.

The strong US economy has formed a basis for the change in tone coming out of the Federal Reserve, in their decision to normalise monetary policy. We expect the Fed will begin the process of shrinking their balance sheet in December.

Uncertainties remain as to the implications monetary policy changes will have on the global economy and financial markets. This will especially influence policy directions in the UK and Europe as they closely observe the markets' response to normalisation.

Figure 6: Contributions to world growth



Normalisation of policy and the US economy

The economies of the US and Europe are starting to look a bit better, with growth, inflation, labour markets and confidence firming. Since our May *Economic Overview*, there have been interesting developments on the monetary policy front. In particular, the tone in central banking circles has tilted toward support for normalisation. Central banks have recognised that their economies are growing at a pace that can sufficiently operate with less monetary stimulus than before.

The US economy grew a solid 2.3% in Q2, following a soft start to 2017. This has supported the view that the US economy may be able to handle another rate hike this year. Inflation pressures within the US will continue to shape the case for further rate hikes going forward. Our view is that the Fed will hike rates in December this year and twice more in 2018.

On the quantitative easing front, the Fed has taken the lead and signalled its intention to run down the asset side of their $4.5 trillion balance sheet. This is unchartered territory not only the Fed, but also global financial markets.

The quantitative easing program involved buying a wide range of bonds to reduce long-term interest rates as a means to boost liquidity and investment following the financial crisis. The effect of this stimulus notably exceeded the impact of changes to the Fed Funds rate. Conversely, unwinding QE is likely to have a greater impact on financial markets than the schedule of planned rate hikes.

The process of unwinding QE is signalled to start by the end of 2017. It will be introduced at a gradual pace. The Fed has been very transparent about its plans, which is a crucial ingredient for successful monetary policy. Although the effects of the running down of central bank balance sheets are uncertain, markets' rhetoric suggests that long-term interest rates are likely to rise once normalisation commences.

One thing is for certain, many central banks will be closely interested in how monetary policy normalisation plays out for the US.

Europe and UK: Throttling along

As mentioned the EU and UK are also experiencing better economic conditions which, within the context of an improving global economy, looks sustainable.

A change in tone from both the ECB and BOE suggests that these economies have the potential to support a gradual removal of monetary stimulus. This has sparked a strengthening in the Euro and Pound, but we think that markets are overplaying the case.

Economic growth may be strengthening, but it is clear that, in the absence of policy changes, there still remains a great deal of spare capacity in the European economy. This leaves further potential for GDP growth without causing undue inflation. So in our view, any significant tightening of monetary policy in Europe is not in the cards any time soon.

Figure 7: European investor confidence has rallied

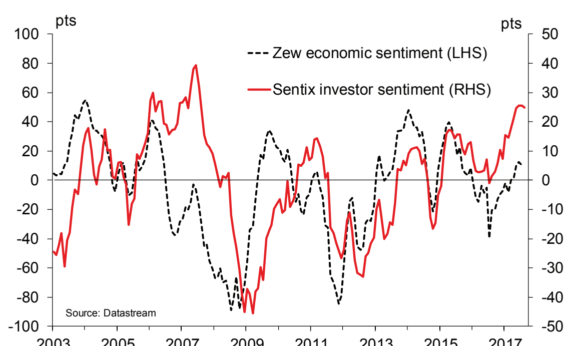
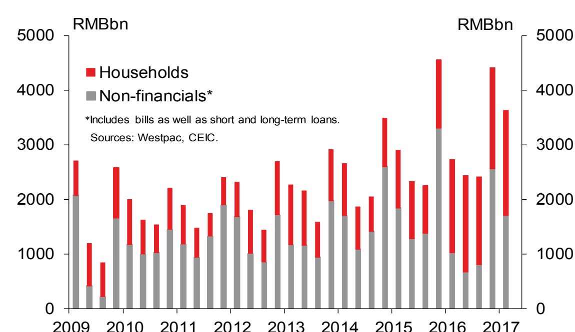


Figure 8: Chinese new bank loans



In addition, continued uncertainty around Brexit negotiations has added to the downside risks for investment spending. Putting everything together, we maintain that the ECB will keep rates on hold for now. Furthermore, we expect the BOE will keep the rates on hold for longer than markets expect.

China: Firing on all cylinders

The Chinese economy continues to fire on all cylinders, confounding market expectations of an imminent slowdown. Although concerns remain as to the strength of growth, the current evidence is in support of continued upside to the Chinese economy.

Even with financial regulation cracking down hard on credit and liquidity markets, China is doing well. However, the housing market remains a concern, as such a great portion of growth relies on middle class wealth and household consumption. Property prices have risen to such an extent that a greater amount of credit is required for households to sustain purchases.

Constraints on credit availability might threaten the housing market and limit the scope for further consumption growth going forward. Chinese trade data from Q3 already suggests that tighter credit conditions are weighing on investment spending.

Dropping a gear

Australian economic conditions have rebounded from the softness of early 2017. However, we're still expecting the economy to grow at a moderate rate of 2.8% over the coming year. Weighing on growth is a subdued outlook for household spending and softer business investment.

Given the expectation of modest growth rates, inflation is expected to remain at the bottom end of the RBA's target inflation rate. Strong competition in the retail sector and lower rents due to greater housing supply are expected to further suppress overall inflation.

While the labour market is tightening, wage growth has remained subdued. This is likely to limit any upside in consumption and is expected to soften GDP growth to 2.5% in 2018. Sluggish consumption is likely to dissuade businesses from expanding or increasing wages, further dampening economic growth.

Against this backdrop we expect the RBA to keep rates on hold for quite some time. However, the RBA itself is more optimistic, on the expectation that the global growth story will have more positive effects on the Australian economy over time.

Economic forecasts (calendar years)

Real GDP % yr	2013	2014	2015	2016f	2017f	2018f
New Zealand	2.2	3.4	2.5	3.1	2.6	3.0
Australia	2.1	2.8	2.4	2.5	2.3	3.0
China	7.7	7.3	6.9	6.7	6.7	6.2
United States	1.5	2.4	2.9	1.5	2.1	2.1
Japan	1.4	0.0	0.5	0.6	1.1	1.0
East Asia ex China	4.2	4.1	3.7	3.7	3.8	3.8
India	6.6	7.2	7.3	7.2	7.1	7.3
Euro zone	-0.3	0.9	1.6	1.7	1.8	1.5
United Kingdom	2.2	2.9	2.2	2.0	1.8	1.6
NZ trading partners	**3.5**	**3.9**	**3.6**	**3.3**	**3.4**	**3.4**
World	**3.3**	**3.4**	**3.2**	**3.2**	**3.5**	**3.5**

Forecasts finalised 11 August 2017

Agricultural Outlook

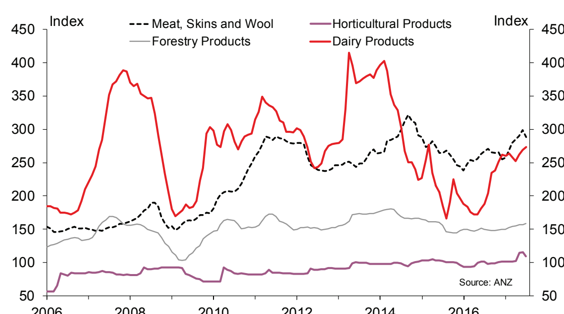
Gearing up

New Zealand's agricultural sector is in good shape, with many farm products enjoying high prices. The global growth outlook is expected to support demand for New Zealand exports, especially for soft commodities like dairy and meat. Certainly the ongoing tightness in supply has played a role in higher prices, but we think there is room for supply to pick up and reverse some of these price gains.

New Zealand export commodity prices are demonstrating broad based gains that are boosting confidence among farmers. The anticipated improvements to global economic conditions are expected to bode well going forward. However, the story remains anchored to supply side developments.

Optimism across the industry is well and truly warranted, with the aggregate commodity price index up over 17% compared to this time last year. The outlook for the New Zealand dairy and meat industries is looking in good shape, with forestry and horticulture also playing a role in the broad based optimism we are seeing.

Figure 9 : NZ commodity prices index (world terms)



New Zealand milk collections were down by 0.6% last season, but this was due to very poor weather conditions. That being said, our dairy industry continues to play a significant role in the international markets. So changes in New Zealand's milk volumes – more precisely, unexpected changes – will have a significant impact on prices in the international market.

We see the risks as being towards a strong lift in milk volumes, from both New Zealand and from Europe. Higher dairy prices will incentivise profit seeking producers to boost milk volumes on global markets. On balance, we think we could see some downward pressure on world dairy prices over the coming year. Putting this together, we have maintained our forecast milk price at $6.50/kgMS for this season, compared to Fonterra's forecast of $6.75/kgMS.

Meat: Coasting Along

The lamb market has been the backbone of the meat market outlook. Prices are up 21% on average from this time last year. Low slaughter numbers from Oceania have restricted global supply, mainly due to unfavourable weather conditions. However, the inevitable supply response to high prices is likely to edge prices down from here. Notably, we are already seeing a rise in lamb exports out of Australia and this is unlikely to slow going into the peak season.

On the other side of the meat market, beef prices have risen mainly due to the large herd building across Australia and New Zealand. However, the US is expected to ramp up production in response to high prices and this may pull back some of the gains we have seen in the recent past.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Strong Chinese demand underpinning log prices, and strong revenues to boost productivity and sustain current trends.	High	→
Wool	Coarse wool demand is continuing to soften. Synthetic substitutes and rising demand for finer wools are keeping prices flat.	Average	→
Dairy	Prices have continued to firm, but as southern hemisphere production rises, gains could moderate.	Average	↘
Lamb	Low slaughter numbers and strong demand continues to push prices up. Australian supply to put downward pressure on prices for the year ahead.	Above Average	↘
Beef	Demand is firm, but competing Free Trade Agreements and rising production from US may pose risks going forward.	Above Average	↘
Horticulture	Product innovation and firm demand are expected to boost prices. Weather conditions still pose a risk.	Average	↗

1 NZD prices adjusted for inflation, deviation from 10 year average.

Exchange Rates

Healthy scepticism

The US dollar lost ground over the past three months, pushing all comers higher, including the New Zealand dollar. We are sceptical this will be sustained. We expect the US dollar will reverse course, helping to push the NZD/USD lower over the coming year. Meanwhile, there is scope for the Kiwi to gain ground against its Australian counterpart.

After our May Economic Overview the NZD/USD exchange rate went from strength to strength, rising steadily from 69 cents to a peak of 75 cents in late-July, although it has subsequently lost some ground. Looking ahead, we expect that both global and domestic factors will see the exchange rate fall further into the 60s by next year.

The rising NZD/USD over June and July was chiefly a US dollar story. President Trump's reform agenda ran into political roadblocks, and looming political battles about healthcare and the debt ceiling spooked financial markets. A spate of softer US economic data reinforced the trend.

Against this recent reality, we expect that the US dollar will re-enter a sustained uptrend over the remainder of 2017 and into 2018. That's based on the views expressed in the Global Economy section – the US economy has reached full employment, is capable of sustaining economic growth, and will require tighter monetary policy. There has been an overshoot in negativity around the US dollar, and we expect that to reverse in due course.

Meanwhile, there are also strong New Zealand-specific reasons to expect the New Zealand dollar to weaken against the USD. Financial markets remain convinced that the RBNZ will lift the OCR in 2018. We have long been sceptical. With the housing market looking weaker by the month, a flush of soft economic data coming through, and headline inflation set to fall over the coming year, we expect that financial markets will increasingly come around to our view that RBNZ rate hikes in 2018 are unlikely. As they do so, they will tend to drag the New Zealand dollar lower.

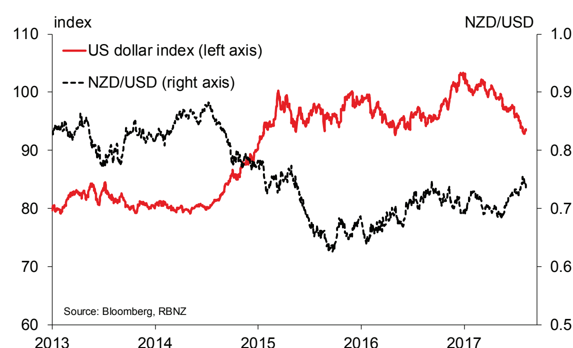
While our views on the NZD/USD are all one-way, the forecasts for the cross rates are more mixed. We expect that the Australian dollar, euro, British pound and yen will all decline relative to the US dollar – our cross rate forecasts are a matter of who falls fastest.

Against the Australian dollar there is scope for the Kiwi to ride higher over 2018. The interest rate situation in the two countries is similar, but the relative commodity price outlook is clearly in New Zealand's favour. We are expecting Australia's key exports to fall 20% in price over 2018. Meanwhile, the commodity price outlook for New Zealand is stable.

The euro is currently benefitting from economic optimism on the Continent, but we think markets are overplaying the case. European unemployment is still high and inflation quiescent, so we do not expect European interest rates to move for some time. As US interest rates inexorably rise, we would expect to see the euro weaken against the US dollar. However, we expect the NZD will fall faster than the euro, meaning NZD/EUR is forecast to decline a little.

On the British pound and the Japanese yen we are more circumspect. We expect both currencies to weaken relative to the rising US dollar, but how they perform relative to the NZD is more uncertain.

Figure 10: US dollar exchange rates



Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-17	0.72	0.92	0.62	0.57	79.2	76.4
Dec-17	0.70	0.92	0.60	0.56	77.7	75.0
Mar-18	0.69	0.92	0.59	0.56	77.3	74.3
Jun-18	0.68	0.92	0.59	0.55	76.8	73.8
Sep-18	0.67	0.93	0.59	0.55	76.4	73.4
Dec-18	0.66	0.94	0.58	0.55	75.9	72.9
Mar-19	0.66	0.94	0.58	0.55	75.4	72.6
Jun-19	0.65	0.93	0.57	0.54	75.7	72.3
Sep-19	0.65	0.93	0.57	0.54	76.1	72.1
Dec-19	0.65	0.93	0.57	0.54	76.7	72.0

Inflation and Interest Rates

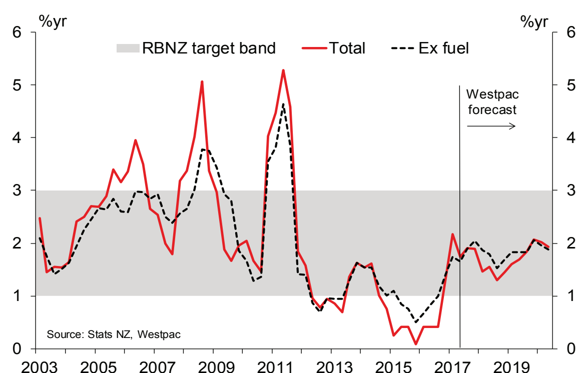
A matter of time

Inflation pressures in New Zealand are past their lowest ebb, but some temporary price movements and the gradual pace of economic growth will keep inflation on the softer side of the Reserve Bank's target for a while longer. We expect the Official Cash Rate to remain on hold for a long time, but longer-term interest rates are likely to be pressured higher by market forces.

The RBNZ, like many other central banks, has been grappling with persistently and unexpectedly low inflation in recent years. The response has been to keep interest rates at very low levels, in order to stimulate growth and use up the economy's spare capacity. That response is now producing results: underlying inflation, based on a range of measures, appears to have bottomed out in around 2015 and has been lifting gradually since.

The headline inflation rate overstates this turnaround to some degree. Annual inflation remained below 1% through 2015 and much of 2016, but by early this year it had jumped up to 2.2%, before easing back to 1.7% in the June quarter. However, recent readings have been affected by gyrations in fuel and food prices, which are known to be volatile and are typically excluded from calculations of core inflation.

Figure 11: Inflation forecast



The first factor, the price of fuel, has had a strong influence on the inflation in both directions in recent years. A plunge in world oil prices was responsible for some of the weakness in inflation worldwide over 2015 and 2016. Oil prices have since rebounded from unsustainably low levels, with the peak impact on inflation occurring in early 2017. However, prices are unlikely to repeat this rate of increase, and in fact we see room for them to drift lower over the next year, as oil production remains high and extraction costs fall.

The second temporary factor, this one specific to New Zealand, was a jump in fruit and vegetable prices in the early part of this year, after flooding delayed harvests and wiped out some crops. This has boosted the annual inflation rate so far this year, but if conditions return to normal next season, food prices are likely to be a temporary drag on the inflation rate over coming year.

The lingering effects of a strong New Zealand dollar over 2016 has also played a role in keeping inflation pressures contained. Exchange rate movements typically flow through into consumer prices with a lag of up to a year. That may be why we saw large price falls for items such as home furnishings and electronics in the June quarter.

We expect the strong currency to continue to weigh on inflation over the coming year, though this won't be a permanent factor. As we noted in the Exchange Rates section, economic conditions are ripe for a stronger US dollar over the next couple of years, which implies a fall in the New Zealand dollar and higher prices for imported goods over time.

Non-tradables inflation, while up from its lows, is still running substantially below where it was in the years before the Global Financial Crisis. This group includes government charges and other non-market prices, which on balance have actually been less of an inflationary factor in recent years. But for the most part, non-tradables inflation reflects the strength of domestic demand and the extent of capacity constraints.

As we noted in the New Zealand Economy section, the economy is not growing substantially faster than its potential pace, and the labour market has not to date been sufficiently tight to drive an acceleration in wage growth. We do expect the economy to grow and generate more inflation pressure over time, but it will be at a gradual pace – and interest rates will need to remain to low support this growth.

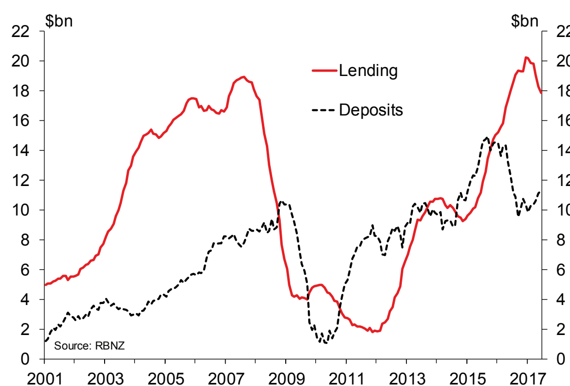
We expect inflation to remain below the 2% midpoint of the RBNZ's target range until late 2019, with underlying inflation picking up only slowly, and with some temporary factors weighing down headline inflation in the near term. This outcome would not be a surprise to the RBNZ, which has been forecasting a similar inflation path for some time.

However, this view of inflation has important implications for interest rates and the exchange rate. Financial markets continue to expect OCR increases by next year; current market pricing implies a hike in the September quarter of 2018, but at times it has been priced for as early as the March quarter. We have long argued that this is far too soon. The RBNZ will be reluctant to consider any policy tightening at a time when inflation is still lingering on the lower side of the target.

One good reason for the RBNZ to hold off on rate hikes is that financial conditions are already tightening through market forces. Longer-term interest rates in New Zealand have been heading higher since late 2016, in line with overseas trends. As we noted in the *Global Economy* section, the world economy is looking in better shape, and thoughts are turning to the 'normalisation' of interest rates. So while local conditions will still determine the OCR and other short-term interest rates, longer-term rates in New Zealand are unlikely to buck the global trend.

Another factor driving New Zealand's interest rates higher is that the mix of funding for banks has become relatively more expensive over the last year. For several years after the Global Financial Crisis, the growth in bank balance sheets was fairly well matched – loans and deposits were growing at about the same pace. But from mid-2016 a gap emerged: lending growth remained strong, but deposit growth slowed substantially, as investors became more willing to accept the higher risk associated with higher-return assets such as equities and bonds.

Figure 12: Housing lending and deposits, 12m growth

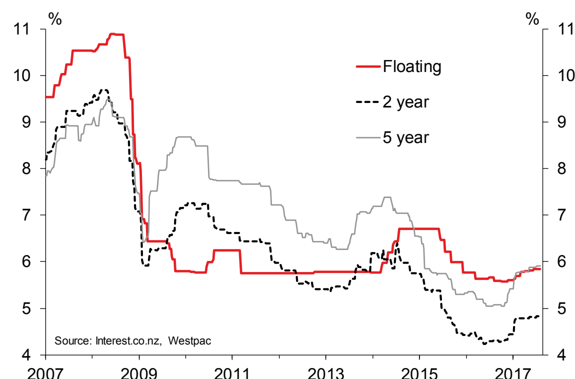


The shortfall in deposit growth has had some interaction with banking regulations. Since 2010 the RBNZ has imposed a minimum core funding ratio for banks. This limits the extent to which banks can draw on short-term wholesale funding, which is typically available at low interest rates but proved to be flighty during the GFC. The result is that banks have had to either bid up to attract more deposits, or turn to more stable but more expensive sources of funding. The more expensive mix of funding has in turn been passed on into higher interest rates for loans.

It's important to note that these steps are helping to close the banks' funding gap: deposit growth is picking up again, and loan growth is slowing. However, there is still some way to go, and it seems unlikely that there will be scope for lending and deposit rates to drop back again any time soon. This also suggests that there may be an effective floor for short-term interest rates – notably, the last OCR cut in November 2016 wasn't passed on to deposit or lending rates at all.

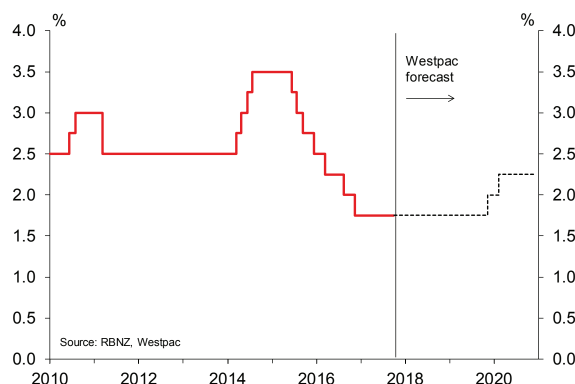
Our view is that the RBNZ will need to keep interest rates low for a long period of time. We were already on the latter side of the market in forecasting OCR hikes to be delayed until early 2019; we have now pushed out the expected timing of the first hike to the end of 2019. Even when the OCR does start to rise, we expect it to be at a gradual pace, given our outlook for modest economic growth and a subdued housing market.

Figure 13: Average advertised mortgage rates



We can't rule out a situation where more stimulus may be needed. However, such a scenario would most likely be one where the housing market is cooling faster than the RBNZ intended. In that case, the first policy step might be to ease the loan-to-value restrictions on housing loans, which the RBNZ had always intended to be temporary. A weaker economy would also likely be accompanied by a fall in the exchange rate, which would both help to support the economy and directly add to inflation pressures.

Figure 14: Official Cash Rate



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Sep-17	1.9	1.75	1.95	2.10	2.65
Dec-17	1.9	1.75	1.95	2.10	2.70
Mar-18	1.5	1.75	1.95	2.15	2.80
Jun-18	1.5	1.75	1.95	2.20	2.90
Sep-18	1.3	1.75	1.95	2.30	3.00
Dec-18	1.5	1.75	1.95	2.40	3.10
Mar-19	1.6	1.75	1.95	2.50	3.20
Jun-19	1.7	1.75	1.95	2.60	3.30
Sep-19	1.8	1.75	2.10	2.70	3.35
Dec-19	2.1	2.00	2.20	2.80	3.40

Special Topic

Election considerations for our forecasts

In our February *Economic Overview* we noted that uncertainty around government policy would be more of a feature this year. That now seems like an understatement. In this section we look at the potential configurations of the government after the 23 September election, and how they might affect our economic and financial forecasts.

Since November 2008 the centre-right National Party has governed with the aid of confidence and supply agreements with the ACT, Maori and United Future parties. However, the number of seats held by these minor parties has dwindled with each term, and recent polling suggests that this configuration may not win enough seats to form a majority this time.

The other significant players are the Labour, Green and NZ First parties. Labour is a centre-left party with social democratic roots and strong ties to unions. The Green Party is further left on the economic spectrum, and focuses on environmental and social justice issues. Labour and the Greens have long been seen as natural coalition partners, but it is very unlikely that they could form a government without the support of NZ First.

NZ First favours tighter controls on immigration and foreign investment, retaining the retirement age at 65, and changes to the Reserve Bank Act. NZ First has worked with both Labour and National governments in the past, and may end up holding the balance of power after this election.

The three most likely post-election scenarios, and their implications for our forecasts, are below.

Scenario 1: National + minor parties

Maintenance of the status quo would have the least impact on our forecasts, which are based on current government policy. That said, the policy agenda could still change in the face of changing public sentiment. For example, the National government could well react to voter disquiet about high levels of net migration by tightening residency requirements, though a recent attempt to do so faced pushback from employers.

Scenario 2: National + NZ First

This outcome could result in similar fiscal settings to scenario 1. While NZ First has a number of big spending policies, National would be likely to try to accommodate any policy concessions broadly within existing fiscal settings. A significant point of difference would most likely be net migration, where some sort of concession seems likely. NZ First aims to bring this down to a net 10,000 a year, from the current level of over 70,000. Our forecasts already assume a drop in migration over the coming years, so the impact of a change in migration policy would depend on how binding it is. A substantial reduction in our migration forecast would see us lower the forecasts for GDP growth, the rate of home building, house prices, and interest rates.

NZ First favours reforming the Reserve Bank Act while National broadly favours the status quo, so it is unclear where a coalition would land. If the Reserve Bank's inflation target were raised, or if the focus on inflation was reduced, we would expect lower interest rates, higher GDP growth and higher inflation in the short term, but higher interest rates and higher inflation over the longer term.

Scenario 3: Labour + Greens + NZ First

This outcome would have the biggest implications for our economic forecasts, though it also has the greatest degree of uncertainty about the policy mix. A three-party coalition is inherently more unpredictable, and there are areas where the parties' policy positions may be incompatible. The strongest point of agreement is on migration, with each party favouring a reduction to various degrees. Second, this coalition grouping would almost certainly run with higher income taxes and higher government spending.

Some version of Labour's proposed Kiwibuild programme, which aims to provide 100,000 affordable homes over the next decade, would probably be palatable to all parties in this coalition scenario. It's unclear to what extent this might crowd out private sector building, given that the industry is already running into capacity constraints, but a state-sponsored building programme on that scale would probably see us lift our residential investment forecasts to some degree.

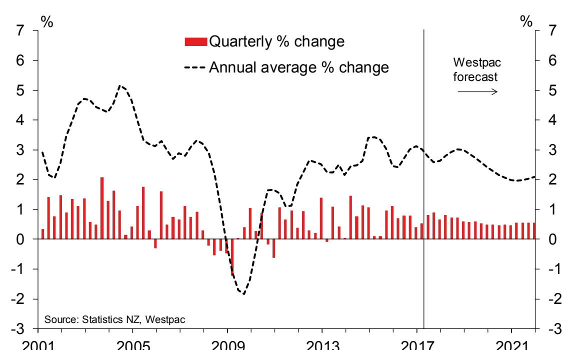
The Greens favour a capital gains tax on rental properties, Labour favours taxing capital gains only on rental properties resold within five years (currently two), and as far as we are aware NZ First does not favour such taxes. It is very difficult to say what would happen to house prices under a centre-left government, but we would probably lower our house price forecast in the first instance.

All three parties favour change to the Reserve Bank Act. Labour favours adding employment alongside the RBNZ's existing price stability mandate, along the lines of the US Federal Reserve and the Reserve Bank of Australia. If worded in a similar way, it would probably not lead to a significant change in the way that the RBNZ operates. However, a numerical unemployment target may have a similar effect to the higher inflation target already described under scenario 2.

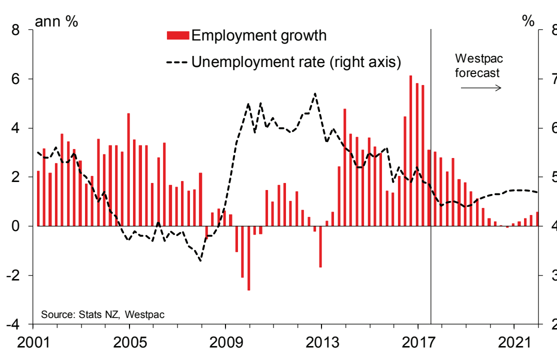
Forecasts and key charts

	Quarterly % change				Annual average % change			
	2017				Calendar years			
	Mar (a)	Jun	Sep	Dec	2016 (a)	2017	2018	2019
GDP (production)	0.5	0.8	0.9	0.7	3.1	2.6	3.0	2.4
Private consumption	1.2	1.0	0.6	0.8	4.1	4.0	3.5	2.7
Government consumption	1.0	0.5	0.5	0.5	2.4	3.2	2.0	2.1
Residential investment	-1.6	3.0	2.4	0.0	11.1	3.5	2.1	-1.8
Business Investment	2.3	0.0	1.9	1.9	3.2	5.8	6.0	3.7
Stocks (% contribution)	-0.7	-0.8	-0.1	0.1	0.0	-0.2	0.0	0.2
Exports	-0.4	4.0	1.5	0.5	1.9	0.9	4.5	2.4
Imports	1.3	1.9	1.4	1.5	3.4	6.6	5.7	3.1
Consumer price index	1.0	0.0	0.4	0.5	1.3	1.9	1.5	2.1
Employment change	1.1	-0.1	1.3	0.5	5.8	2.8	1.8	0.3
Unemployment rate	4.9	4.8	4.5	4.5	5.2	4.5	4.5	4.8
Labour cost index (all sectors)	0.4	0.4	1.0	0.5	1.6	2.3	2.2	2.0
Current account balance (% of GDP)	-3.1	-2.9	-2.9	-3.0	-2.8	-3.0	-3.3	-3.4
Terms of trade	5.1	3.0	0.7	-0.4	6.7	8.6	-0.3	0.7
House price index	0.2	-0.3	-0.1	0.2	13.9	0.0	2.0	0.0
90 day bank bill (end of period)	1.84	1.85	1.95	1.95	2.00	1.95	1.95	2.20
5 year swap (end of period)	3.00	2.79	2.65	2.70	2.65	2.70	3.10	3.40
TWI (end of period)	78.0	76.5	76.4	75.0	77.6	75.0	72.9	72.0
NZD/USD (end of period)	0.71	0.70	0.72	0.70	0.71	0.70	0.66	0.65
NZD/AUD (end of period)	0.94	0.94	0.92	0.92	0.95	0.92	0.94	0.93
NZD/EUR (end of period)	0.67	0.64	0.62	0.60	0.66	0.60	0.58	0.57
NZD/GBP (end of period)	0.57	0.55	0.57	0.56	0.57	0.56	0.55	0.54

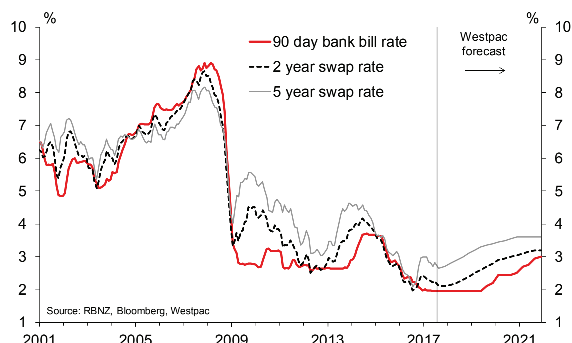
New Zealand GDP growth



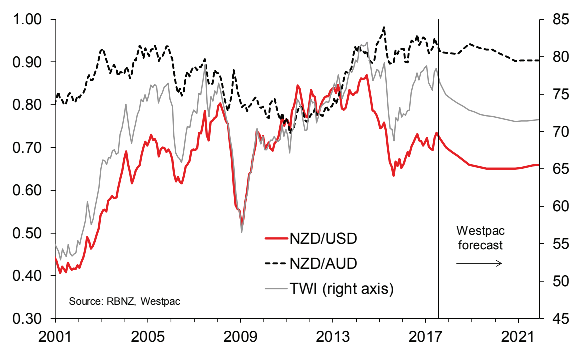
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. 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. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should

Disclaimer continued

not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(ii) physical separation of various Business/Support Units;

(iii) and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.