February 2017

Economic Overview

In the zone

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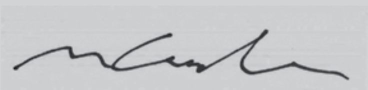
Note from Michael

New Zealand finds itself in something of a sweet spot right now. The economy has been growing at a steady pace for some time, and a strong pipeline of building work and an improvement in dairy prices will help to keep that momentum going. We're expecting above-trend GDP growth for the next couple of years. Inflation is no longer at rock bottom levels, and looks set to stay within the Reserve Bank's target range for the foreseeable future.

At the same time, the economy doesn't look at risk of overheating. New Zealand's growth rate is partly a reflection of unusually strong net migration. With both new arrivals and returning Kiwis being skewed towards those who are ready and able to work, these people add to the economy's growth potential as well as demand. That said, there are areas such as homebuilding where an adequate supply response clearly requires more than just more workers.

Another factor working against overheating is that longer-term interest rates are now on the rise, which may already be acting to cool the housing market. In some respects this is a positive development: economies are meant to have self-regulating mechanisms, even if in the past they've tended to work less well than they should in theory.

New Zealand also stands out as a strong performer within a difficult global environment, though we are by no means isolated from what happens elsewhere. Last year's events such as the Brexit vote and the election of President Trump were startling enough, but 2017 is the year in which the consequences of those choices will begin to be felt. The direction of US economic policy in particular remains largely unresolved.



Michael Gordon - Acting Chief Economist

Contributing authors

Michael Gordon
Acting Chief Economist
T +64 9 336 5670

Satish Ranchhod
Senior Economist
T +64 9 336 5668

Sarah Drought
Economist
T +64 9 336 5696

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

New Zealand Economy

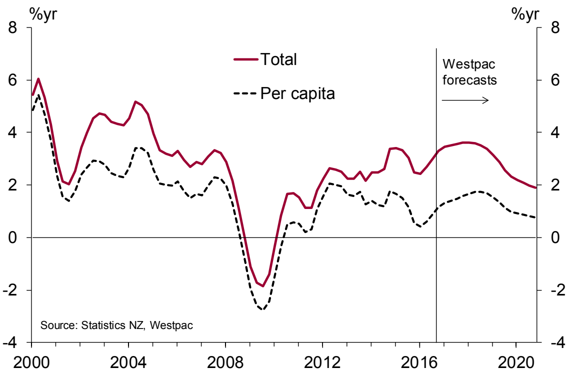
Finding the sweet spot

We expect annual GDP growth to top 3% over the next couple of years, as a wave of building work progresses and higher dairy prices provide some relief to rural regions. Population has boosted activity, and is likely to continue to do so as long as job prospects remain favourable here. Higher interest rates are likely to take the edge off house prices and consumer spending.

The New Zealand economy finished 2016 on a high note. We estimate that GDP growth reached 3.3% for the year, with standout contributions from building activity, consumer spending and business services. That would be the fastest pace of growth we've seen yet during this upturn – though that's partly because recent revisions to the GDP figures have shaved back the pace of growth over the last few years.

The country is now entering its seventh year of sustained growth. The damage wrought by the Global Financial Crisis is becoming more distant, and activity has now returned to around its non-inflationary potential. We wouldn't normally expect to see growth accelerating at this late stage of the economic cycle. But there is another atypical aspect of the current cycle: a record surge in net migration has lifted the population growth rate to above 2%, which is unusually high by the standards of a Western economy. In per capita terms, the pace of GDP growth has been more modest in recent years.

Figure 1: Total and per-capita GDP growth

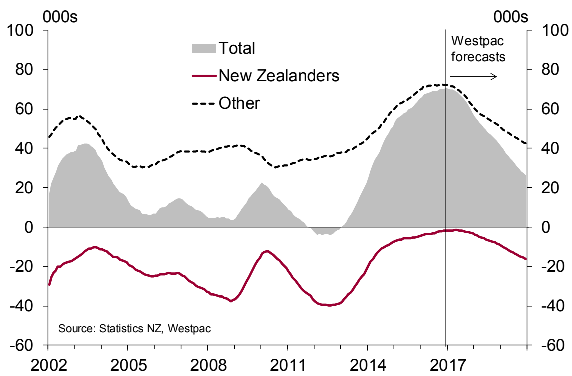


People power

For some businesses, this distinction may not matter: more people means more customers coming through the door. Adjusting for population growth is most relevant for thinking about the degree of spare capacity that's left in the economy. Inward migration adds to both the demand and supply sides, and the net effect is indeterminate. The evidence so far in this cycle suggests that it hasn't been much different from zero on the whole, with some obvious exceptions such as the housing market as we discuss later.

This result is partly due to the fact that the inflows have been skewed towards those who are work-ready. The growth in foreign arrivals over the last few years has been dominated by people coming on work visas; students were also a factor for a while, but they have slowed since late 2015 as the eligibility criteria have been more tightly enforced. Meanwhile, record numbers of New Zealanders are returning home from overseas, predominantly from Australia, and far fewer are heading there. Trans-Tasman flows tend to reflect relative job prospects in the two countries, and both the growth in the number of jobs and the types of jobs being created are strongly in New Zealand's favour.

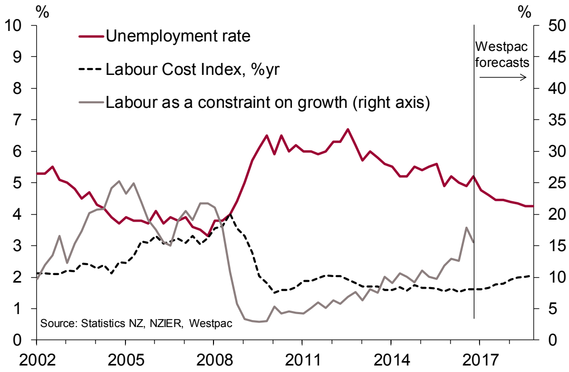
Figure 2: Net migration, annual



Consequently, strong demand by employers has been met by strong growth in the working-age population and record rates of participation in the labour force. The rise in the unemployment rate to 5.2% in the December quarter should be read with caution: it's well within the bounds of normal volatility for this series, and other indicators such as benefit numbers point to a more consistent decline. The broader picture is that the downtrend in unemployment over recent years has always been gradual, and wage growth has shown no signs of accelerating yet. That's consistent with an economy where per-capita GDP growth h as been steady but not rapid; it's not clear that the outcome would have been different if net migration had been zero.

We're forecasting GDP growth to be moderately above trend for the next couple of years, implying a further tightening of the economy's productive capacity. But on the whole, this doesn't look like an economy that is at risk of overheating, in the same way that it did in the mid-2000s. And as we detail in the Inflation and Interest Rates section, this implies that the risk of inflation breaking out is low.

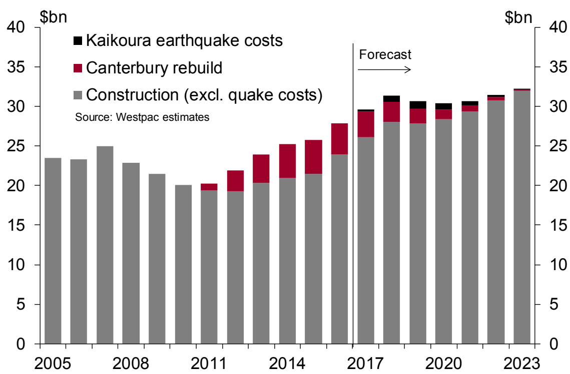
Figure 3: Labour market trends



Around the traps

Within the labour market figures there are some noteworthy differences across the country. The regions that have experienced the strongest population growth – namely, Auckland and the Bay of Plenty – have also seen the strongest improvement in their jobless rates. In contrast, unemployment has been flat or even rising in the last couple of years in the more dairy-focused regions such as the Waikato, Canterbury and Southland. Taranaki has suffered the most through the double hit of low milk prices and oil exploration drying up; the latter is unlikely to return any time soon if world oil prices linger around US$50 a barrel.

Figure 4: Annual construction activity



At a national level, the economy fared surprisingly well through the last two seasons of very low dairy prices. On a regional basis, however, the effects are more apparent: an insidious drag on activity in the dairying regions, rather than a sharp drop. That suggests some light at the end of the tunnel though. We expect farmgate milk prices to be slightly above-average for the next two seasons, which should encourage a lift in spending and improve job prospects in the rural regions compared to the main centres.

Canterbury has seen an uptick in unemployment from very low levels in recent quarters, as earthquake-related building work has passed its peak levels and moved gradually into its wind-down phase. New home building has slowed markedly, while commercial construction is still ramping up and will take several more years to complete.

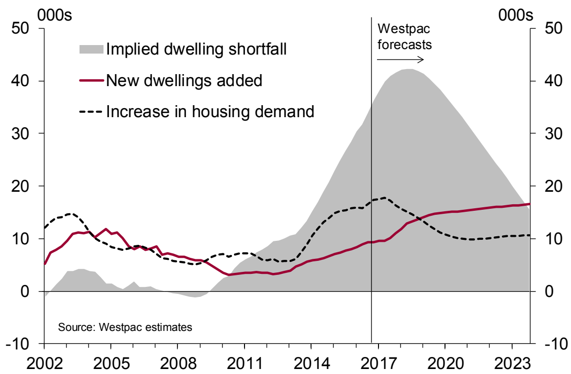
The extent to which things are normalising in Canterbury is also apparent in the housing market. As the housing stock has been restored, the scarcity 'premium' has faded: rents are now falling outright, while house price growth has slowed to near zero. With house prices rising strongly elsewhere, this means that prices in Canterbury relative to the rest of the country are rapidly converging on their pre-quake levels.

The Kaikoura earthquake last November has created a further need for repairs and rebuilding across North Canterbury, the upper South Island and central Wellington. We've assumed that the cost of the quake recovery will be in the order of $4.5bn (including inflation) spread over the next few years. This is a substantial sum, and will add to the capacity constraints on the building industry, but is unlikely to be a dominant macroeconomic theme in the way that the Canterbury earthquakes were.

More work to be done

The waning pipeline of building work in Canterbury has been more than offset by a strong lift in demand for more buildings in other parts of the country, particularly across the North Island. Nowhere is this more prominent than in Auckland. The slow rate of building in the years following the GFC, combined with an unexpected surge in population growth, has led to an estimated shortage of 35,000 homes in Auckland.

Figure 5: Housing supply and demand



Addressing this shortage will not be easy. The building industry is already running into capacity constraints; labour shortages and build quality are growing issues. While the pace of building has been picking up, it remains inadequate – in fact, building consents have actually fallen again in recent months. Now that the city's Unitary Plan, which allows for more and different kinds of homes to be built, has cleared its last legal hurdles, the pace of building should pick up again by mid-year. But as it currently stands, the housing shortage is likely to get worse before it gets better.

There's also a substantial pipeline of building work across the other main centres in the North Island, which have also seen strong population growth but have had the capacity to ramp up homebuilding. While this does offer a potential escape valve for Auckland's housing pressures, the relative size of Auckland means there is a limit to what the other main centres could reasonably absorb.

Putting it on the house

The housing market has clearly slowed down since the loan-to-value ratio (LVR) restrictions were tightened further last July. Sales are down more than 20% from their peak, and the national average sale price rose at a much slower pace in the last quarter of the year.

But there are again regional differences in the housing market's performance. In previous hotspots such as Auckland, Hamilton and Tauranga the rate of increase in house prices has slowed. But the majority of regions have actually seen an acceleration in house price growth since July; few regions in the North Island are running at below double-digit annual gains. This is somewhat at odds with the latest change to the LVR restrictions, which was to extend the limit on investor LVRs from Auckland to the rest of the country.

We have long argued that lending restrictions such as LVR limits have only a temporary effect on house prices; it's still too soon to say whether that will hold true this time. But the housing market is now facing what we see as a greater and more persistent challenge. Mortgage rates have risen in recent months, due to a combination of rising long-term interest rates globally and more expensive sources of funding for banks.

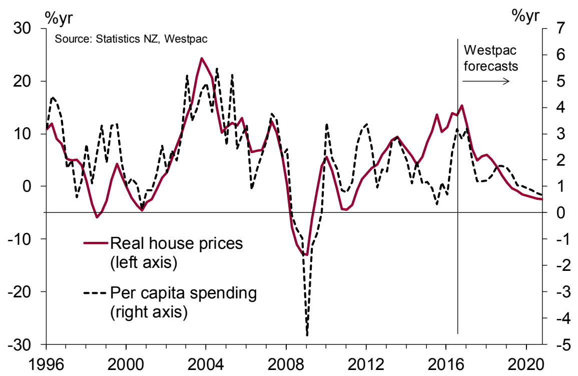
With the Reserve Bank standing pat for some time, we don't expect a further substantial ramp-up in mortgage rates this year. Nevertheless, this is a marked change of circumstances compared to the previous couple of years, where a steady decline in mortgage rates provided ongoing fuel for property values. House prices rose by 11% in 2015 and an estimated 15% in 2016.

The ongoing need to house a growing population makes it hard to justify forecasting an outright decline in house prices. But we suspect the higher cost of borrowing will weigh significantly on the market's momentum this year. We expect nationwide house price growth to slow to 7% this year, and to dwindle further in later years.

The change of fortunes for the housing market has an important implication for our economic forecasts. New Zealand has historically had a strong correlation between the rates of growth in house prices and household spending, reflecting the importance of housing as a major portion of household wealth. That linkage had appeared to soften in the last couple of years, with per-capita spending growing at a subdued pace even as the housing market accelerated. But the latest spending figures, along with substantial upward revisions to history, indicate that the relationship between the two is alive and well.

If our view on house prices is correct, the rate of growth in consumer spending is also set to slow from here. That leaves two implications for the Reserve Bank. The first is that slower house price growth, and a slower accumulation of household debt, will obviate the need for further lending restrictions. The RBNZ's aim of adding debt-to-income (DTI) limits to its macroprudential toolkit appears to have been stymied until after this year's election. But we suspect that by the end of this year there will be less of a case to be made for further restrictions anyway.

Figure 6: Household spending and house price growth



The second implication is that our forecasts of house price growth, and consumer spending are softer than the RBNZ's. If spending growth does slow as we expect, the upward pressure on domestic prices could fall short of the RBNZ's expectations too, making it that much harder to meet the overall inflation target. As we note in the Inflation and Interest Rates section, the RBNZ will have to tread carefully with the timing and pace of any interest rate hikes.

A matter of balance

New Zealand's economic growth is likely to remain weighted towards domestic factors for the next few years. The need to provide more homes and complete the earthquake rebuild will occupy the construction sector for a long time to come. A growing population also drives the need for more infrastructure, machinery and places of work. And as our Global Economy section notes, a potential escalation of trade protectionism risks hurting demand in some of New Zealand's key export markets.

On the positive side, we expect some mild relief from the exchange rate for exporters. As we note in the Exchange Rates section, forces are gathering behind a stronger US dollar this year, with the New Zealand dollar accordingly lower. Along with a moderately stronger outlook for world growth, this should provide some support for our commodity exports in particular this year.

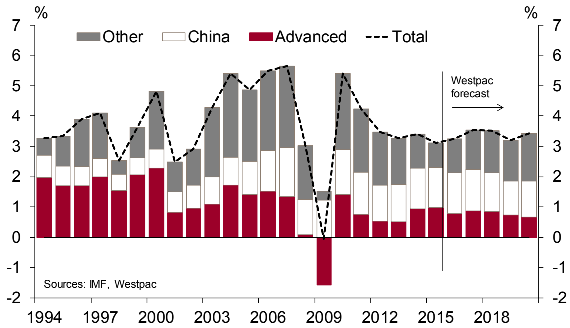
Global Economy

Shifting sands

The prospects for the global economy are looking a bit brighter in 2017, although the outlook is marred with uncertainty – especially the path of US fiscal and trade policy. While there are upsides if the Trump administration is successful in promoting growth, this is countered by the risk of potential deterioration in the global trade environment.

The outlook for the global economy is looking a bit brighter, with growth this year and next expected to pick up a touch to 3.5%. And with commodity prices and global inflation comfortably up from their troughs, central bankers around the world will be breathing a little easier as the strong disinflationary impulse has largely passed.

Figure 7: Contributions to world growth (annual)



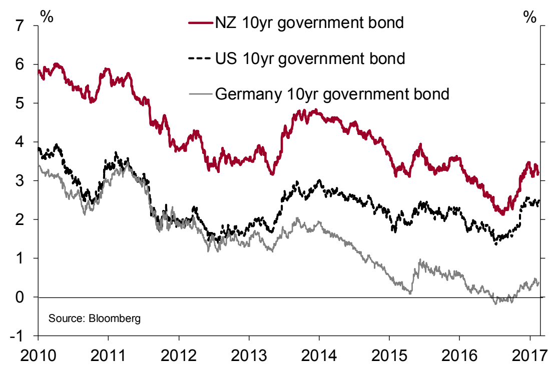
But the global economy is not out of the woods yet. In many countries, record levels of monetary stimulus continue to play an important role in propping up demand. And there's a lot clouding the outlook. At the forefront is the path for US fiscal and trade policy as the Trump administration gets its feet under the table, but simmering away in the background is political uncertainty in Europe, with elections this year in France, the Netherlands and Germany, while the United Kingdom is expected to formally begin negotiations to exit the European Union.

The Trump show

A wave of positivity washed over financial markets after November's US election, as talk of large-scale infrastructure spending and tax cuts saw markets rush to price in stronger US growth and inflation. But a few months on, we've seen some of this enthusiasm fade. Plans are still far from clear, and given typical lags putting domestic policies into action a boost to activity isn't imminent. What's more, the unpredictability of announcements and strong protectionist themes have made investors nervous about what lies ahead. But while the US dollar has lost some of its allure (for now), US term interest rates have largely held onto their post-election gains. And this has translated into higher term interest rates around the world, including in New Zealand.

On the US domestic policy front, there's clearly considerable enthusiasm from the Trump administration to reform taxes and boost infrastructure spending. However, in order to limit any deterioration in the government's debt position, there appears to be a push from Congress for revenue neutral tax cuts and offsetting measures to fund infrastructure, which would blunt the overall impulse on activity. The private sector is also expected to play a considerable role in the infrastructure plans, which may limit how much and how quickly infrastructure spending takes place.

Figure 8: Long-term interest rates



Trade policy has also been a key focus. Trump swiftly ended US involvement in the Trans-Pacific Partnership, and has maintained his intentions to introduce further trade barriers to protect US industries by encouraging firms to keep production onshore. Policy plans are murky, but much-touted options include large tariffs on imports from China and Mexico, or the Border Tax (which is effectively a tax on the US trade deficit). These types of policies would likely result in a stronger US dollar, and have important implications for US inflation and interest rates, with flow-on impacts for other regions. The policy responses of other countries will also be significant, whether it's retaliation with more trade barriers of their own, or instead fostering trade relationships with other countries. Protectionist measures globally have increased over the past decade, and a further push in that direction would be another headwind for the already-sluggish global trade environment.

Steady as she goes?

Despite the fanfare, our forecasts for the US economy have been little changed over the past six months. Households are expected to remain the stable force underpinning GDP growth, as strengthening employment prospects buoy spending, while higher oil prices have led to improved conditions in the industrial sector. However, business investment has continued to disappoint. And despite a recent lift in business confidence, it's hard to see the investment trend changing anytime soon given the significant uncertainty around the business environment (whether for trade, taxation or regulation).

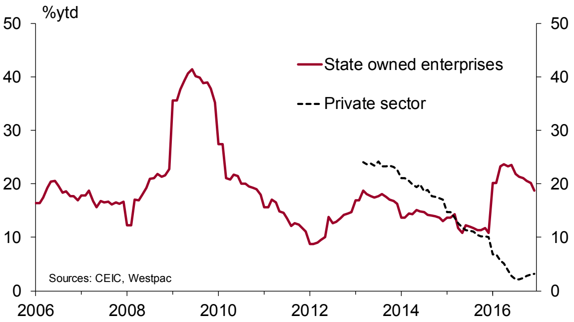
With a moderate outlook for growth, and inflation near 2%, the Federal Reserve is expected to continue on the path of gradual policy tightening. We're forecasting two rate hikes this year, which should see the US dollar and term interest rates push higher. Of course, there are upside risks to growth, inflation and interest rates if the administration is successful in its effort to promote growth. But this potential positive is countered by the chance that trade relationships are impaired, which in turn could slow growth.

China on the up (for now)

Momentum in the Chinese economy picked up through 2016, boosted by expansionary fiscal policy and ongoing strong growth in credit. Property construction rebounded, and growth in publicly-financed infrastructure spending remained strong. Meanwhile, growth in the services sector has remained relatively stable, as improving employment prospects and a turnaround in the housing market have led to better conditions for the household sector. In addition to the growing middle class, a better backdrop for Chinese households will support demand for New Zealand's consumer-orientated exports.

GDP growth is expected to hold up at 6.6% this year, as the Chinese authorities will be keen to maintain a strong economy in the lead up to the National Congress in November. But growth is forecast to step down to 6% in 2018 as fiscal stimulus is pared back, while private investment hasn't shown any signs yet of strengthening to fill the gap. The global trade environment presents risks for the Chinese economy, as any large tariff or Border Tax would pressure China's foreign reserves and growth outlook. That said, the rising share of services over time means that China is not as reliant on trade as it was a decade ago.

Figure 9: China investment projects growth



Sound but not stellar

After stumbling in 2016, the prospects for the Australian economy are looking much better this year. National income will receive a healthy boost from a sharp rise in iron-ore prices (off the back of improved conditions in China), export volumes are expected to record further strong gains, and the drag from mining investment will continue to wane.

The jobs market is expected to improve this year, supporting a recovery in household spending growth. But the recovery in employment growth is expected to fade in 2018, as a downturn in housing investment (from current elevated levels) weighs on activity. Given the relatively sluggish outlook for the labour market, we expect the RBA to keep its policy rate on hold this year and next. Conditions in Australia's labour market also have important implications for trans-Tasman migration flows. Without a sustained improvement in Australia's labour market, we may well see further upside surprises to net migration here in New Zealand.

Economic forecasts (calendar years)

Real GDP % yr	2013	2014	2015	2016e	2017f	2018f
New Zealand	2.2	3.4	2.5	3.3	3.6	3.4
Australia	2.0	2.7	2.4	2.2	2.1	2.8
China	7.7	7.3	6.9	6.7	6.6	6.0
United States	1.5	2.4	2.6	1.6	2.1	2.4
Japan	1.4	0.0	0.5	0.6	0.6	0.7
East Asia ex China	4.2	4.1	3.7	3.7	3.9	3.9
India	6.6	7.2	7.3	7.2	7.2	7.4
Euro zone	-0.3	0.9	1.6	1.6	1.4	1.3
United Kingdom	2.2	2.9	2.2	2.1	1.9	1.5
NZ trading partners	**3.5**	**3.8**	**3.6**	**3.2**	**3.3**	**3.3**
World	**3.3**	**3.4**	**3.1**	**3.2**	**3.5**	**3.5**

Forecasts finalised 17 February 2017

Agricultural Outlook

Sunny with clouds on the horizon

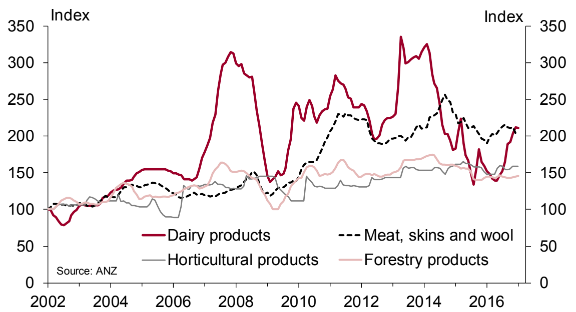
It's been a positive start to the year for many of New Zealand's commodity exporters, as steady demand and tight global supply have supported global prices. But the high NZ dollar remains a headwind for export returns, and looking ahead, the risk of a more protectionist trade environment clouds the outlook for global commodities demand. We expect prices to ease a little this year.

The outlook for the dairy sector is looking brighter, with global markets having finally found some balance. Global dairy prices rose 55% over the second half of last year, and have largely held those gains so far this year. We're now forecasting a milk price payout of $6.20/kgMS for the current season and $6.50/kgMS next season, slightly above the average of the past decade. While we expect farmers to initially focus on debt repayment and deferred maintenance, sentiment in the sector has improved. Dairy farm prices have recovered from a soft patch in early 2016 to be up around 9% over the past year, although turnover remains relatively light.

While global dairy demand has improved, led by a recovery in China, the real swing factor for dairy prices has been the turnaround in global supply. The largest adjustment in milk volumes has come from Europe, but other major exporters – New Zealand, Australia and Argentina – have also seen sharp declines. Locally, milk production was down 3.6% in the seven months to December, hampered by an unusually wet spring. With pasture conditions more favourable heading into 2017, milk production has begun to stabilise, although extremely dry conditions in some areas may see production tail off sharply for some.

The worst of the contraction in global milk supply is now behind us, and looking ahead, farmers will begin responding to higher prices on offer. Large stockpiles of European skim milk powder also need to be released onto the market at some stage. Against a demand backdrop that we'd characterise as steady rather than stellar, we expect global dairy prices to ease a little this year.

Figure 10: NZ export commodity prices (world prices)



Other commodity exporters are also enjoying better conditions. Chinese demand has strengthened, with log prices a notable beneficiary, while tightness in global beef and lamb supply continues to underpin meat prices. However, exchange rate movements have undermined NZ dollar returns, especially for lamb exports to the UK. Horticulture continues to perform strongly, with apple and kiwifruit exporters reaping the rewards of productivity growth and product innovation that has been particularly successful meeting preferences in the Asian market.

But despite the positive start, we expect commodity prices across the spectrum to lose a little steam this year. Tight supply conditions for some commodities are expected to ease, while the risk of more stringent trade barriers casts a cloud over demand. And moving into 2018, Chinese growth is expected to slow.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Recovery in Chinese demand has boosted log prices, but prices likely to come under pressure into 2018 as supply responds and demand moderates.	High	→
Wool	Synthetic substitutes to remain attractive while oil prices remain low.	Average	→
Dairy	Expected to ease a little as global supply stabilises.	Average	↘
Lamb	Tight supply supporting global prices. Chinese demand has improved, but Brexit clouds the outlook for UK demand.	Average	→
Beef	Global supply continues to recover and competition in Asian markets is rising, especially in China where beef imports from South America are growing rapidly.	High	↘
Horticulture	Benefitting from strong demand and productivity gains. Further improvement expected.	Above average	↗

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

Exchange Rates

Riding the waves

New Zealand's economic fundamentals look very attractive against the lacklustre global backdrop. That's seen the New Zealand dollar retrace its late-2016 decline against the US dollar. We expect it will remain well supported for the next few months. The kiwi is expected to lose some altitude over 2018 as growth here starts to ease off.

It's been a bumpy few months for the New Zealand dollar, with the Kiwi continuing to be buffeted by global forces. The strongest of these have emanated from the US. In the wake of Donald Trump's election to the presidency, his initial consolatory tone and plans to boost fiscal spending were greeted positively. We also saw the Fed hike the funds rate in December, and market expectations for future hikes being brought forward. These developments gave the US dollar a shot in the arm, and saw the NZD/USD fall by around 7% through late-2016.

However, since entering office, sentiment towards the new president has soured in some quarters. And combined with a lack of detail around policy, the US dollar has come under downwards pressure.

At the same time, the New Zealand economy has continued to look like a standout. GDP growth has been firm. Dairy prices have held on to most of their gains from the past year. And inflation has finally picked up. We still think it'll be some time before the Official Cash Rate starts to rise. But with New Zealand's economic fundamentals looking rosy against a still lacklustre global backdrop, the Kiwi has been well supported. In early 2017 the NZD/USD has picked up, retracing most of the decline we saw in late 2016. We expect that it will linger around 71 cents through the first half of 2017.

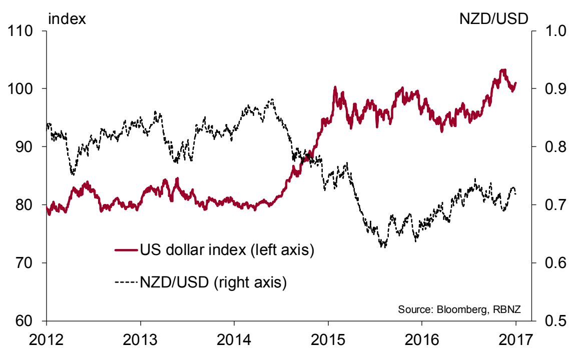
We expect the Fed to hike the funds rate twice this year, with a continued gradual tightening further ahead. At the same time, the RBNZ is expected to stand pat. These conditions should see the NZD/USD ease back through 2017, before heading down towards the mid-60s through 2018 as growth in New Zealand eases back.

While we have some degree of clarity around the economic outlook here in New Zealand, the outlook for the global economy is much more opaque. In particular, there's a lot of uncertainty around how US fiscal policy will evolve over the next few years, and what that will mean for the Fed. Depending on how things play out, we could see stronger upward or downward pressure on the US dollar, and by default the NZD/USD. President Trump's plans to ramp up infrastructure spending, if implemented, would boost US activity and would be supportive of the USD. However, there's still a lot of hurdles that need to be passed. And even then, it could take some time before spending plans are implemented.

On top of this, there are some big question marks around US trade policy and the more general increase in protectionist sentiment globally. Tightening trade restrictions could have negative impacts on many Asian economies, and would also weigh on the New Zealand dollar.

Closer to home, the New Zealand dollar has traded in a relatively tight range of around 94 to 96 cents against its Aussie counterpart. Both the RBNZ and RBA are likely to keep policy rates on hold for some time. Nevertheless, the NZD is expected to lose some ground against the AUD over 2017 due to strength in prices for Australia's commodity exports. These declines are expected to reverse through 2018, as prices for Australia's commodity exports pull back and building activity there slows.

Figure 11: US dollar exchange rates



Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-17	0.71	0.93	0.68	0.58	82.4	78.1
Jun-17	0.70	0.92	0.68	0.57	82.6	77.5
Sep-17	0.68	0.91	0.68	0.56	80.7	76.4
Dec-17	0.67	0.91	0.67	0.55	80.4	75.5
Mar-18	0.66	0.92	0.66	0.55	80.5	75.1
Jun-18	0.65	0.93	0.66	0.54	80.6	75.0
Sep-18	0.64	0.94	0.65	0.53	80.6	74.7
Dec-18	0.63	0.95	0.65	0.52	80.0	73.8
Mar-19	0.62	0.93	0.65	0.51	79.4	72.9
Jun-19	0.62	0.90	0.64	0.50	79.4	72.3

Inflation and Interest Rates

Back in the band

Inflation has picked up, but the OCR will need to remain low for some time yet in order to generate a sustained rise back to 2%. Nevertheless, the easing cycle looks like it's over, and the next move in rates is likely to be up (though that's still a long way off).

Inflation has picked up...

Since our last Economic Overview, inflation has picked up and is back inside the Reserve Bank's 1 to 3% target band for the first time in two years. In part, this rise in inflation reflects that earlier sharp falls in oil prices have dropped out of annual calculations. But that's not all that's going on. Smoothing through the volatility associated with oil prices, inflation bottomed out though 2015, and core inflation measures have been rising gradually for several quarters now.

Figure 12: Measures of core inflation

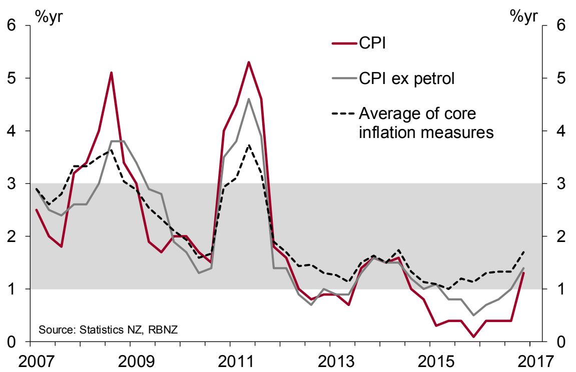
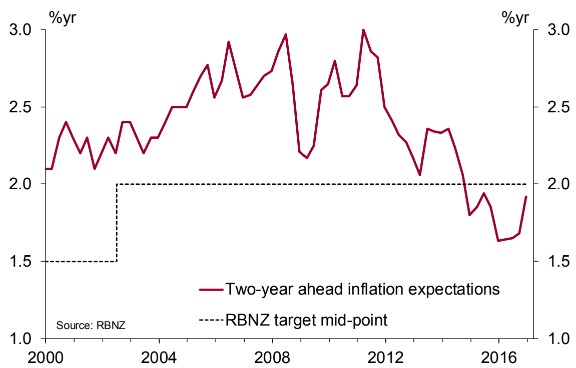


Figure 13: Inflation expectations



Perhaps even more important than the rise in inflation itself, businesses have shifted up their expectations of where inflation will be over the next few years. That will have come as a big relief for the Reserve Bank. Inflation expectations are a key determinant of how businesses adjust wages and prices, and low headline inflation in recent years had seen expectations also trending down. But with inflation having now recovered from its earlier lows, this key downside risk for the outlook looks to have abated.

...but future gains to be gradual

While inflation has picked up, it remains low at 1.3% in the year to December. And looking ahead, it will still be some time before it returns to the 2% midpoint of the Reserve Bank's target band – we don't expect this to occur until the latter part of 2018.

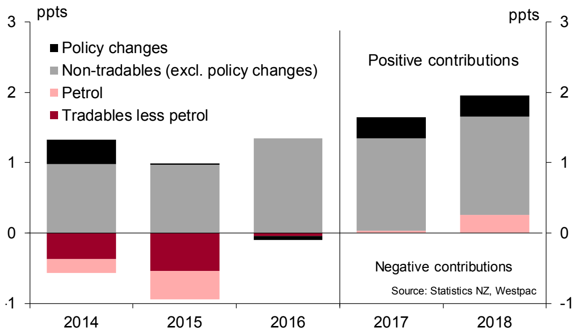
On the domestic front, robust growth over the coming years is expected to see inflation pressures rising, but at a gradual pace. As discussed in the New Zealand Economy section, there's a large pipeline of construction activity and spending has picked up. But this strength in domestic activity is coming on top of increases in the economy's productive capacity, underpinned by strong population growth. This is allowing the economy to grow with only relative modest increases in cost pressures.

To date, increases in domestic inflation have been squarely centred on the housing market, and we expect this to remain the case over the next few years. Residential construction costs in the CPI rose by 6.5% over the past year - the fastest pace in over a decade. And even with the construction cycle yet to hit its peak, firms are highlighting the emergence of resource constraints, particularly in terms of labour.

Building costs are, unsurprisingly, rising most rapidly in Auckland where we have seen the largest increase in construction activity. However, construction cost inflation has been rising across the country, with increases in house prices encouraging new building in many regions. The notable exception to this pattern is Canterbury, where home construction and cost inflation have slowed as housing damaged in the 2010 and 2011 earthquakes has been replaced.

While domestic inflation is gradually rising, softness in the prices of imported consumer goods is set to remain a major drag on inflation for some time. Although there was some lift in import prices in the latter part of 2016, that came on the back of a sharp fall in the New Zealand dollar in late 2015. The NZ dollar has clawed back all of its earlier losses, and more, in the last year. On top of this, the global trade environment remains subdued. Combined, these conditions point to continued downward pressure on the prices of many consumer goods over 2017.

Figure 14: Contributions to inflation



Note: Policy changes accounted for include GST, tobacco taxes, and ACC levies.

OCR to stay on hold for some time yet, but the next move is likely to be up

With inflation back in the target band and some downside risks abating, the RBNZ has shifted away from its earlier modest easing bias, and adopted a neutral stance at the time of the February Monetary Policy Statement. We still expect that the Official Cash Rate will remain on hold at the current record low of 1.75% for quite a while longer. To offset the weakness in imported prices and generate a rise in domestic inflation, the Reserve Bank needs domestic spending and investment to continue trucking along. And that will require continued support in the form of low borrowing rates.

But while the OCR is on hold for now, if the economy continues tracking the way it has recently, the next move in rates is likely to be up. We don't expect to that to happen quickly, with the first rate hike not pencilled in until early 2019. Even then, rate hikes are expected to be gradual. Inflation is expected to linger in the bottom part of the target band for much of the next two years even with the OCR at a record low, and GDP growth is expected to moderate through the latter part of the decade.

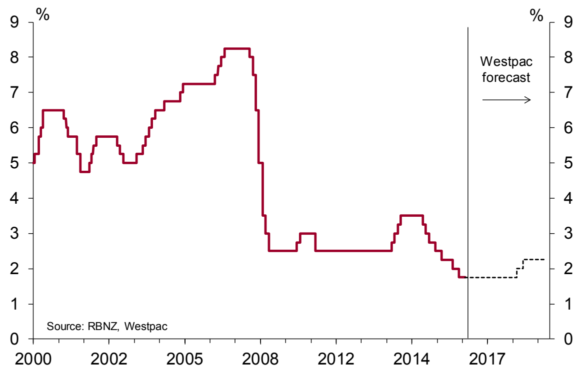
House prices to remain a perennial concern for the RBNZ

Although the OCR is likely to remain on hold for some time, we're unlikely to see the same stability in the interest rates faced by borrowers and savers. Global term interest rates have been rising in response to expectations of increased fiscal stimulus in the US and tightening by the Fed. At the same time, New Zealand banks are facing higher funding costs as borrowing outpaces deposit growth. Combined, these conditions have seen floating mortgage rates rise by around 10 basis points since November, with fixed-term rates up by around 25 to 50 basis points. On top of this, there is a risk that Fed tightens rates faster than expected, especially if fiscal spending results in a stronger than expected increase in US activity and inflation. This would likely put further upwards pressure on borrowing rates in New Zealand.

This creep higher in borrowing rates adds to the challenges the RBNZ faces in terms of balancing its overlapping goals of controlling inflation and ensuring the stability of the financial system. On the stability front, the cooling in the housing market that has followed recent interest rate rises and last year's tightening in borrowing restrictions will have been a welcome development from a financial stability perspective.

However, house prices are a key channel that monetary policy uses to affect domestic activity. And with house price growth having eased off, it won't provide the same boost to household spending or domestic inflation that it has over the past few years. Further more, we see the risks that house price inflation cools by even more than the RBNZ is assuming. This reinforces the likelihood that the RBNZ will need to keep OCR at a low level for some time yet.

Figure 15: Official Cash Rate



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-17	1.7	1.75	2.00	2.40	3.00
Jun-17	1.5	1.75	2.00	2.50	3.15
Sep-17	1.6	1.75	2.00	2.50	3.20
Dec-17	1.5	1.75	2.00	2.50	3.30
Mar-18	1.5	1.75	2.00	2.50	3.35
Jun-18	1.7	1.75	2.00	2.60	3.45
Sep-18	2.0	1.75	2.00	2.70	3.60
Dec-18	2.1	1.75	2.10	2.80	3.70
Mar-19	2.2	2.00	2.40	2.90	3.70
Jun-19	2.2	2.25	2.50	2.90	3.70

Special Topic

Policy considerations for 2017 and beyond

This year's general election is shaping up to be a close one, with a stronger economy providing more scope for campaign promises than we have seen for some time. In addition, the Reserve Bank Governor's departure could be used as an opportunity for some changes in the RBNZ's focus. In this special topic we highlight the areas where the policy mix could take on a different complexion by the end of this year.

Until a few months ago, New Zealand was comparatively free of the political uncertainties that abound across many parts of the world. That began to change in December when John Key unexpectedly resigned as Prime Minister. Bill English, the former Deputy PM and Minister of Finance, was chosen by his colleagues as PM and will lead the National Party into the general election on 23 September.

Mr Key's departure has added to the uncertainty around what was already shaping up to be a close election. New Zealand's system of proportional representation since 1996 has meant that successive governments have had to rely on support from other parties to secure a majority of votes in Parliament. While the National Party itself has remained popular, the number of seats held by its supporting parties has dwindled. Depending on the election results, National may need additional partners to reach a majority this time. That's also true of the main opposition Labour Party and its ally the Greens. This means that both sides could come under pressure to make larger campaign promises, and more concessions to the minor parties, to get enough votes to form a government.

In terms of economic policy, the areas where the current government appears most vulnerable are migration and housing affordability (and the extent to which the two are connected in voters' minds). There has already been some policy movement in these areas, but more could be forthcoming this year.

Fiscal policy

Fiscal policy could take a more stimulatory turn by the end of this year, regardless of who wins power. With the operating balance now back in surplus, the scope for additional spending promises is greater than it has been for the last decade. Labour has indicated it would favour more social spending, a position supported by the Greens; National has long favoured personal tax cuts, but has raised the possibility of a family assistance package.

The government also runs a sizeable capital expenditure budget, covering areas such as roading, hospitals, schools and defence. The capital spending allowance has already been increased twice in the last year, in recognition that the nation's infrastructure needs to keep up with its rapidly growing population. And with net migration (and hence population) running ahead of the Treasury's forecasts yet again, it's likely that a further boost to spending in this area will be needed.

Monetary policy

In the last two elections Labour campaigned on detailed changes to the monetary policy framework. This time around it has been less prominent, but they have indicated that they would add a focus on employment to the Reserve Bank's goals. It's also possible that if the NZ First party holds the balance of power after the election, it could demand changes to the monetary policy framework as part of any support agreement.

The election combines with a second source of uncertainty for monetary policy. RBNZ Governor Graeme Wheeler will be stepping down after his term expires on 25 September. Given the proximity to the election date, the RBNZ Board has opted to avoid any potential conflict by starting the search for a new Governor after the election. Grant Spencer, the current Assistant Governor and Head of Financial Stability, will serve as Acting Governor for six months after Mr Wheeler's term ends.

The RBNZ Governor is not, at least directly, a political appointment. But by delaying the search until after the election, the Board can select a candidate who is open to any changes that an incoming government may have in mind. That could include not just changes to the RBNZ's goals as defined in the Policy Targets Agreement, but also changes to the monetary policy framework itself, such as a formal shift to a committee decision-making structure.

Macroprudential policy

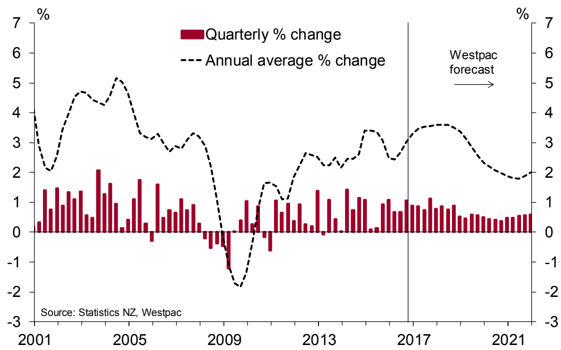
The RBNZ has been seeking to add debt-to-income (DTI) ratio limits to the list of macroprudential tools covered in its Memorandum of Understanding with the government. But there were already signs of wariness about such tools – Steven Joyce, the new Minister of Finance, has requested a full cost-benefit analysis of DTIs before adding them to the toolkit.

The vacancy at the top of the RBNZ – in fact two vacancies, as Mr Spencer will retire after his stint as Acting Governor – puts macroprudential policy even further into unclear waters. The next Governors could bring a different philosophical approach to this branch of policy, and perhaps a more critical view of the evidence for its effectiveness.

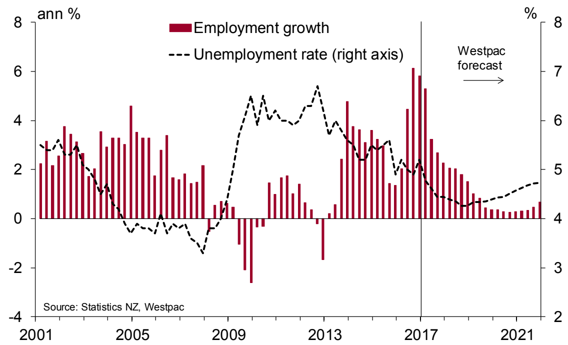
Forecasts and key charts

	Quarterly % change				Annual average % change			
	2016		2017		Calendar years			
	Sep (a)	Dec	Mar	Jun	2015 (a)	2016	2017	2018
GDP (production)	1.1	0.9	0.9	0.7	2.5	3.3	3.6	3.4
Private consumption	1.6	0.8	0.8	0.8	2.9	4.5	3.9	3.2
Government consumption	0.8	0.5	0.5	0.5	2.5	2.6	2.2	2.0
Residential investment	2.3	-1.0	2.0	-1.4	2.0	11.9	3.6	0.0
Business Investment	0.2	-1.2	1.4	1.3	2.2	2.5	3.8	7.4
Stocks (% contribution)	0.5	0.5	0.2	0.0	-0.3	-0.2	0.4	0.0
Exports	-0.7	-0.5	0.3	1.0	6.8	2.5	2.1	3.0
Imports	1.2	0.2	1.1	0.8	3.6	3.2	3.8	3.5
Consumer price index	0.3	0.4	0.5	0.2	0.1	1.3	1.5	2.1
Employment change	1.3	0.8	0.8	0.4	1.4	5.8	2.3	1.5
Unemployment rate	4.9	5.2	4.8	4.6	4.9	5.2	4.4	4.3
Labour cost index (all sectors)	0.4	0.4	0.4	0.4	1.5	1.6	1.8	2.1
Current account balance (% of GDP)	-2.9	-2.8	-2.8	-2.7	-3.4	-2.8	-2.7	-3.3
Terms of trade	-1.9	1.8	3.4	0.8	-3.2	1.5	3.7	-0.1
House price index	3.4	1.2	1.0	1.8	11.1	15.0	7.0	4.0
90 day bank bill (end of period)	2.19	2.00	2.00	2.00	2.80	2.00	2.00	2.10
5 year swap (end of period)	2.16	2.65	3.00	3.15	3.10	2.65	3.30	3.70
TWI (end of period)	77.0	77.6	78.1	77.5	72.1	77.6	75.5	73.8
NZD/USD (end of period)	0.72	0.71	0.71	0.70	0.67	0.71	0.67	0.63
NZD/AUD (end of period)	0.95	0.95	0.93	0.92	0.93	0.95	0.91	0.95
NZD/EUR (end of period)	0.65	0.66	0.68	0.68	0.61	0.66	0.67	0.65
NZD/GBP (end of period)	0.55	0.57	0.58	0.57	0.44	0.57	0.55	0.52

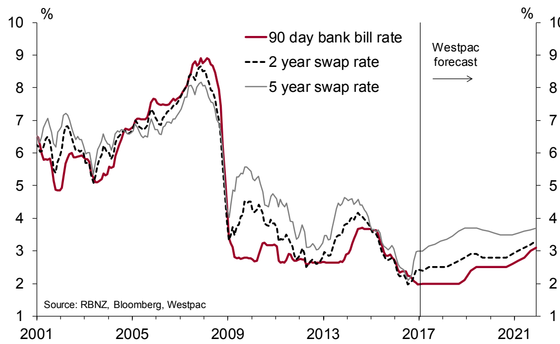
New Zealand GDP growth



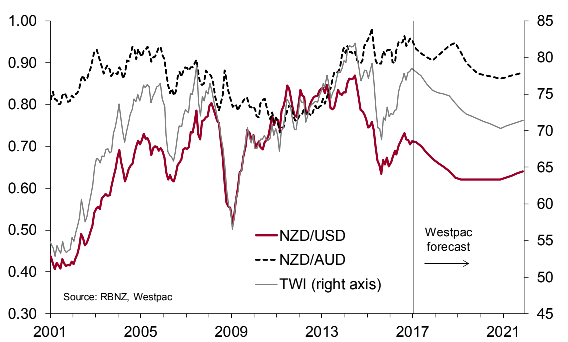
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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