Weekly Commentary

11 December 2017

Slower growth, tougher choices

New Zealand's economic growth has slowed to a more modest pace this year, and it's increasingly likely that it will fall short of the quite optimistic official projections. This will have left the new Government with some difficult trade-offs as it prepared its first fiscal update, for release this week.

In recent days we've had the last of the major indicators for September quarter GDP, which will be published later this month. Overall, the results were solid but not spectacular. Residential building rose by 4.1% in the quarter, following two small declines that may have been affected by the unusually wet weather over the first half of the year. Non-residential building work rose by 0.6% nationwide, with the quake rebuild winding down in Canterbury but activity picking up elsewhere. Wholesale trade rose by 1.1%, in line with the growth in recent quarters, and manufacturing activity recorded solid gains outside of a drop in meat and dairy processing.

We'll finalise our GDP estimate this week, but the latest data releases are consistent with our forecast of just 0.4% growth for the quarter. We should emphasise that this is not a sign of broad-based weakness in the economy. Much of it is due to a drag from the primary sectors: wet weather weighed on milk production at the start of the new season, and oil and gas extraction continued its natural decline. There was also a pullback in accommodation and hospitality, after a strong June quarter that was boosted by sporting events such as the Lions rugby tour.

Nevertheless, it's fair to say that we're not seeing particularly strong growth in other areas that could offset the weak spots. That's even more apparent when you consider the rapid growth in the population, which is feeding demand for a range of goods and services. (Net migration started to turn down in the September quarter, but remains very high – population growth is still running at around 2% a year.) In per capita terms, the economy has barely grown at all so far this year.

What's more, there are some worrying signs for growth going into the early part of 2018. As we noted last week, business confidence has fallen sharply in recent months. Some of that could be put down to a knee-jerk reaction to the new Labour-led government, but the decline began even before then and has been larger than we've seen during previous changes of government. There is a risk that pessimism about the economy becomes self-fulfilling as businesses hold back on hiring and investment.

To top it off, there's a growing risk of drought this summer. The unusually wet weather through much of this year has abruptly turned into a hot and dry spell since November, thanks to a combination of a developing La Nina weather pattern and abnormally high sea temperatures in the south. Many parts of the country were unusually dry even before the official start of summer, and while there's plenty of grass at the moment after earlier rains, new pasture growth has dropped off sharply in the last month.

Agriculture accounts for a significant part of the variability in New Zealand's GDP, and past droughts have often led to 'technical' recessions (two straight quarters of negative GDP growth). The long-range weather forecasts don't point

Slower growth, tougher choices cont.

definitively to a drought at this point, but the fact that things are drying out so early marks this out as a risk to watch.

Lest we sound too gloomy, we should note that we still expect the economy to grow at a modest underlying pace, beneath the quarterly volatility in GDP. The September quarter is shaping up to be the weak spot for the year, but recent activity data points to a strong start to the December quarter. There are some challenges to the outlook for next year, but the economy seems to be coming from a stronger starting point than financial markets and business surveys are giving it credit for.

The outlook for economic growth will be particularly important for the Half-Year Economic and Fiscal Update (HYEFU), which will be released on Thursday. The HYEFU will incorporate both the expected costs of the new Government's policies and the changes to the economic outlook since the pre-election update (PREFU) in August.

In its pre-election fiscal plan, the Labour Party used the PREFU as its baseline to demonstrate that its planned policies were affordable. Labour's plan provided for more spending on social services, partly offset by additional revenue (mostly due to the cancellation of next year's income tax cuts). The effect on the fiscal projections was for lower (but still growing) surpluses, and an additional $7bn of net borrowing over the next four years. This would see net core Crown debt fall to 20% of GDP after five years, rather than three years as in the PREFU projections.

However, the PREFU forecasts assumed a strong acceleration in GDP growth from its recent pace of around 2.5%, peaking at 3.7% in the June 2019 year. We questioned that forecast at the time, and it's looks increasingly unlikely today. Even a continuation of the recent pace of growth – never mind a slowdown – would put substantial pressure on the fiscal projections. A lower than expected level of GDP in the near term has a compounding effect on the tax revenue forecasts in later years.

However, that doesn't mechanically translate into smaller surpluses and more borrowing. Governments always have some leeway in their spending decisions. And it's notable that the Finance Minister has said that the Government is still committed to getting net debt down to 20% of GDP after five years. He also noted that in order to do so, and still fulfil the spending plans in the Government's coalition agreement, some other spending may have to be re-prioritised or reduced.

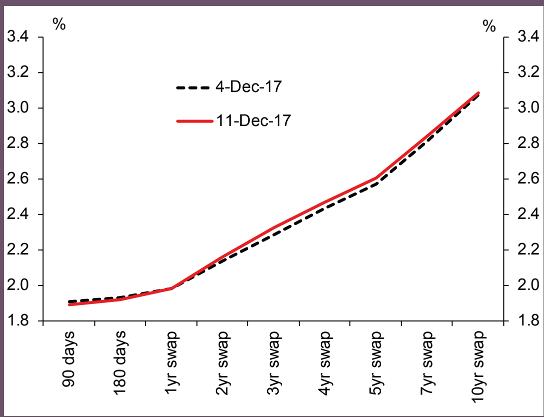
This is nothing new: the previous Government took the same approach in the years after the Global Financial Crisis, with some Budgets restricted to a zero net increase in new spending. But it does mean that this new Government may not be as much of a big-spender as some in the market have portrayed them to be. It's certainly an important issue for our GDP forecasts, where fiscal spending makes up a significant part of the lift in growth that we expect over 2019 and 2020.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Nov house sales and prices

Due in the week beginning 11 Dec, Sales last: 1.0%, Prices last: 1.6%yr

- The housing market slowed sharply over much of 2017, but recently there have been signs of a second wind. For example, prices have been rising in Auckland and nearby regions since August. Website data showed a surge of new listings over October and November, and one real estate agency reported a sharp rise in sales for November.
- The November REINZ data will clarify whether the surge of new listings has been matched by an increase in sales.
- We expect the positive trend in the housing market to continue for a few more months as buyers rush to beat looming regulatory and tax changes, as mortgage rates fall, and as banks loosen lending requirements following the RBNZ's LVR changes. However, over the course of 2018 we expect the market to slow again, and house prices to fall.

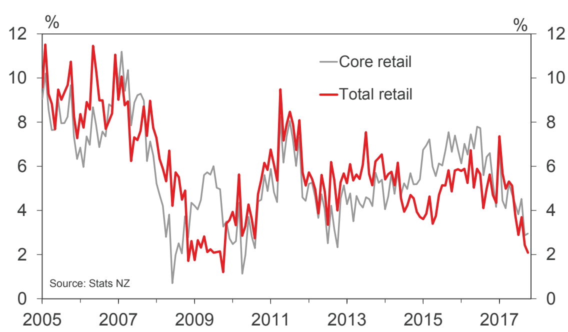
REINZ house prices and sales

NZ Nov retail card spending

11 Dec, Last: +0.3%, WBC f/c: 0.8%

- Despite eking out a small gain in October, the momentum in spending has faded over the past year, with monthly spending levels essentially flat since December. Much of the softness we have seen has been related to durables spending, which has been dampened by the earlier slowdown in the housing market.
- We expect that the November figures will show a solid 0.8% lift. New Zealand retailers, particularly sellers of durable goods, have latched on to the 'Black Friday' sales strategy. This appears to have given spending a temporary boost.
- Looking ahead, the recent second wind in the housing market will help to support spending levels going into the holiday season. However, the strength of spending over the coming year will be challenged by a range of policies that will dampen housing market conditions.

Card transactions, annual % change

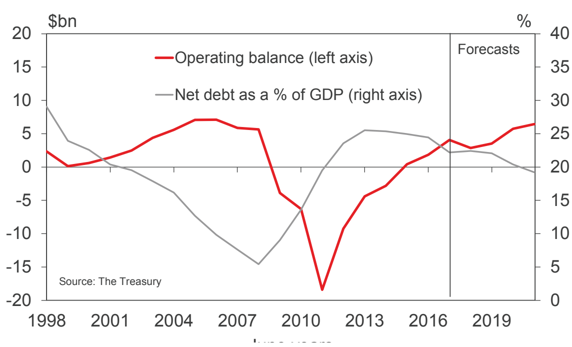


NZ Half-Year Fiscal and Economic Update

Dec 14

- The Pre-Election Economic and Fiscal Update (PREFU) in August projected growing surpluses and falling debt over the next few years. However, the HYEFU will need to incorporate two significant changes.
- The first is the new Labour-led Government, which has promised additional spending in areas such as health, education, regional development and infrastructure.
- The second is that the Treasury is likely to revise down its very optimistic forecasts of economic growth, which means a lower expected tax take.
- With the Government still aiming to reduce net debt to 20% of GDP, it may have to meet its election promises through spending cuts elsewhere or additional sources of revenue.

NZ fiscal projections (pre-election update)

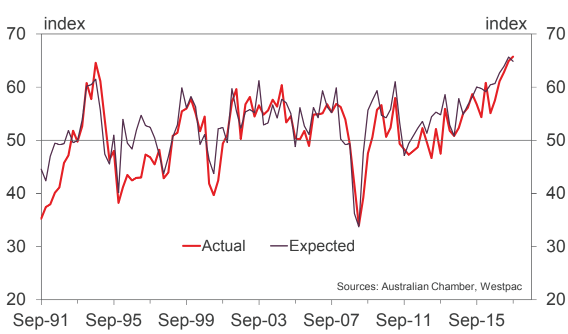


Aus Q4 AusChamber-Westpac survey of Industrial Trends

Dec 12, Last: 66.1

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Actual Composite tracks a range of demand related measures including investment and employment. The Q4 survey was conducted during November and the start of December. In Q3, the Actual Composite rose to 66.1 from 65.0 in Q2, continuing the rebound from a dip in June 2015 to 55.1. Strength is centred on a lift in new orders and output as well as increased overtime and an uplift in employment.
- Manufacturing is benefitting from a rise in public infrastructure, non-mining business investment, and stronger world growth combined with a relatively low AUD. However, weaker consumption constrained by low wage growth is a significant headwind.

Composite indexes, Actual & expected, sa



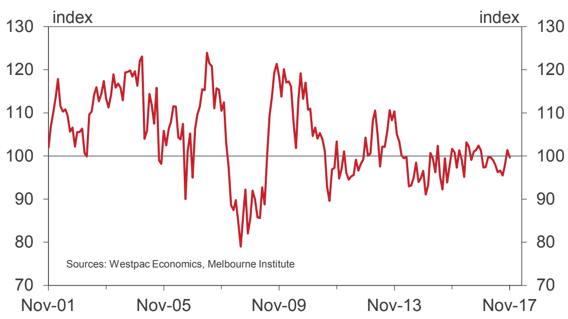
The week ahead

Aus Dec Westpac-MI Consumer Sentiment

Dec 13 Last: 99.7

- The Westpac-Melbourne Institute Consumer Sentiment Index declined 1.7% to 99.7 in Nov from 101.4 in Oct. The consumer mood has been mostly downbeat in 2017 with clear pressures on family finances and an uncertain economic outlook.
- The Dec survey is in the field over the week ended Dec 9. Factors that may influence confidence include: a firm signal from the RBA that rates are likely to remain on hold; but more signs of cooling across Australia's major housing markets and a disappointing Q3 GDP result. Sentiment may also be influenced by political developments – the ongoing citizenship saga and the passing of same sex marriage legislation. The Amazon launch may also influence 'time to buy' assessments.

Consumer Sentiment Index

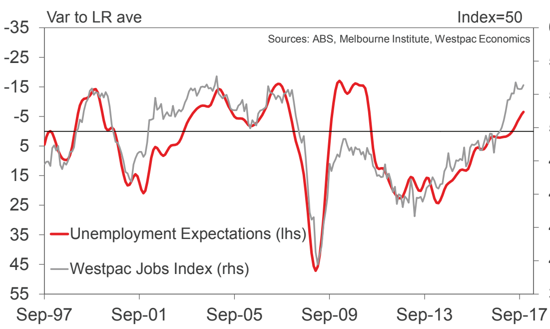


Aus Nov Labour Force Survey - total employm.'000

Dec 14, Last: 3.7k WBC f/c: 25.0k,
Mkt f/c: 19.0k, Range: 5.0k to 30.0k

- Total employment was softer than expected in October lifting just 3.7k, below Westpac and the market's expectation of +20k and +18.0k respectively. September's result was revised up to 26.6k from 19.8k. In the month total hours worked rose by a more reasonable 0.3%. This relates to a 24.3k increase in full-time employment, which was mostly offset by a 20.7k decrease in part-time employment. Over the past year, total employment is up 3.0%yr with full-time employment increasing 3.7%yr and part-time employment increasing 1.5%yr.
- The business and consumer surveys remain quite robust suggesting a continuation of the near term momentum at least into early 2018. Our forecast 25k lift in employment will see the annual pace ease back to 2.8%yr from 3.0%yr.

Near term labour indicators are robust

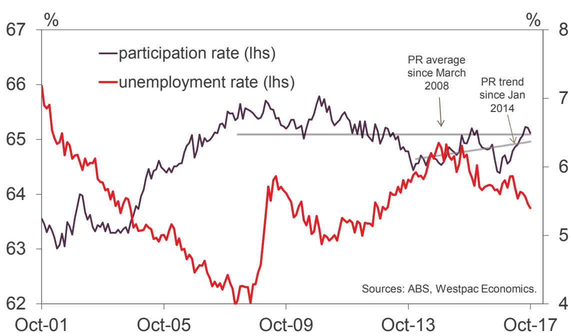


Aus Nov Labour Force Survey - unemployment %

Dec 14, Last: 5.4% WBC f/c: 5.4%
Mkt f/c: 5.4%, Range: 5.3% to 5.5%

- In October, the unemployment rate fell to 5.4% the lowest seen since February 2013 but is still above most estimates of full employment of around 5.0%.
- The October drop in unemployment was due to a drop in the participation rate to 65.1% from 65.2%; male participation was down from 70.7% to 70.5%. The overall participation rate drop appears to be concentrated in Vic, down to 65.7% from 66.3%, back to near the level seen in February this year.
- We are expecting to see a small 0.1ppt bump up in the participation rate with the robust employment number. This will be enough to offset the employment gains thus holding the unemployment rate flat at 5.4%.

Unemployment and participation rates

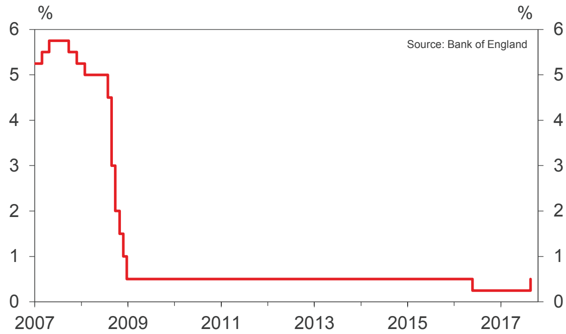


UK Bank of England Bank Rate decision

14 Dec, Last: 0.5%, Mkt: 0.5% WBC f/c: 0.5%

- November saw the BOE increase the Bank Rate for the first time in ten years. The 25 basis point increase removed the 'emergency' stimulus that had been introduced in the wake of last year's Brexit referendum, and still leaves the Bank Rate at the very accommodative level of 0.50%.
- With reduced spare capacity, the scope for the BOE to look though the current period of high inflation has diminished. Hence, the reversal of last year's emergency rate reduction.
- Nevertheless, given lingering uncertainty around the economic outlook, and the looming downside risks posed by Brexit, we expect that the BOE will keep the Bank Rate at low levels for some time yet in order to support demand. However, the risks are tilted towards later rate hikes, rather than sooner.

Bank of England Bank Rate



The week ahead

US Dec FOMC meeting

Dec 12–13, Fed Funds mid rate, Last: 1.125%, WBC f/c: 1.375%

- A rate hike at this meeting is the expectation of all in the market, having been well telegraphed by the FOMC since the decision to begin balance sheet normalisation back in September.
- Justification for the decision can be found in continued above-trend GDP growth, led by the consumer, as well as a labour market that has well and truly achieved full employment. Wages growth continues to lag, but the FOMC remain expectant. Confidence and financial conditions are also very supportive for the economy, hence the downside risks of a rate hike are negligible.
- Inflation on a PCE basis is expected to firm slowly to target over the coming two to three years. If this occurs and we see two additional hikes in 2018, then the Fed Funds rate will remain neutral to the economy, sustaining growth.

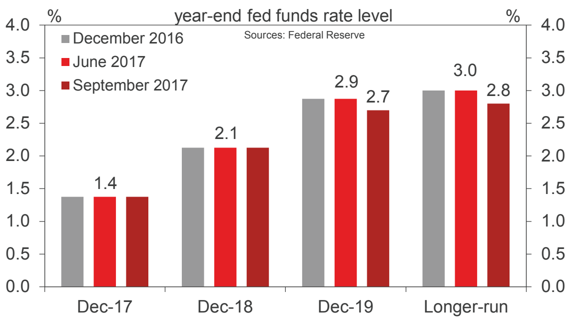
US Nov CPI and retail sales

Dec 13, CPI, last 0.1%, WBC 0.3%

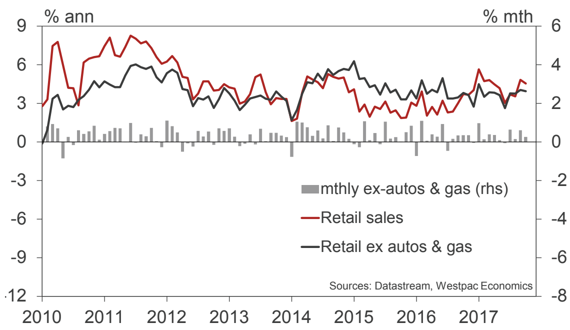
Dec 14, retail sales, last 0.2%, WBC 0.4%

- August and September saw strong gains in the CPI owing to the effect of hurricane season. Gains of 0.4% and 0.5% in these two months were subsequently followed by a 0.1% rise in October. The November outcome is likely to be somewhere in the middle, around 0.3%, as energy again supports headline inflation. Throughout the period, core inflation has remained stable, averaging a little below 0.2% per month. This will remain the case in November.
- Retail sales were also heavily affected by the weather. Particularly notable was the surge in auto sales in September as written-off vehicles were replaced. In October, demand for new vehicles remained strong, but some of this transitory demand will fall away in November, resulting in a subdued gain for headline sales of 0.3%. Core retail sales are likely to print at a similar level.

FOMC plans to keep raising interest rates



Retail sales volatile owing to weather



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Nov card spending	0.3%	–	0.8%	'Black Friday' boost to durables spending.
	Nov REINZ house sales	1%	–	–	Due this week. Concerns around policy changes a drag...
	Nov REINZ house prices, %yr	1.6%	–	–	... but easing back in mortgage rates has provided a boost.
US	Oct JOLTS job openings	6093	–	–	Hires; fires; quits; and job openings.
Tue 12					
Aus	Nov NAB business survey	21	–	–	Conditions jumped 7pts in Oct, reversal likely.
	Q4 Westpac–AusChamber survey	66.1	–	–	Manufacturing in an upswing led by food & beverages.
	Q3 ABS house price index	1.9%	0.5%	–1.0%	Limited relevance given more timely measures available.
Eur	Dec ZEW survey of expectations	30.9	–	–	Very strong.
UK	Nov CPI	0.1%	–	–	Annual rate elevated, but boost from GBP fall to fade.
	Oct house price index, %yr	5.4%	–	–	Economic uncertainty continues to dampen housing.
US	Nov NFIB small business optimism	103.8	–	–	Small business believes in trickle–down economics.
	Nov PPI	0.4%	0.4%	–	Commodity prices supportive, but passthrough negligible.
	Nov monthly budget statement $bn	–63.2	–135.0	–	Budget contained at present, thanks to labour market.
Wed 13					
NZ	Nov food price index	–1.1%	–	–0.2%	Produce prices largely reversed their weather–driven spike.
Aus	RBA Governor Lowe speaks	–	–	–	On "An eAUD?", Australian Payment Summit, Syd 9:15 am.
	Dec Westpac–MI Consumer Sent.	99.7	–	–	Consumer mood has been mostly downbeat in 2017.
	RBA Assistant Gov. Kent speaks	–	–	–	On "The Availability of Business Finance", Syd 11:00 am
	RBA Head of Payments Richards	–	–	–	On panel at the Australian Payment Summit, Syd 1:00 pm.
Eur	Oct industrial production	–0.6%	–	–	Fell in September after strong August.
UK	Oct ILO unemployment rate	4.3%	–	–	Soft GDP growth weighing on labour demand.
US	Nov CPI	0.1%	0.4%	0.3%	Energy boost of Aug/Sep dropped out in Nov.
	FOMC policy decision, midpoint	1.125%	1.375%	1.375%	December rate hike a known known.
Thu 14					
NZ	Half–year economic/fiscal update	–	–	–	More spending by new Govt, but softer economic backdrop.
Aus	Dec MI inflation expectations	3.7%	–	–	Inflationary expectations remain well below average.
	Nov employment	3.7k	19k	25k	Employment growth is set to remain robust int 2018...
	Nov unemployment rate	5.4%	5.4%	5.4%	... but rising participation prevents a fall in unemployment.
Chn	Nov retail sales YTD %yr	10.3%	10.3%	–	Consumer demand held back by subdued jobs growth.
	Nov fixed asset investment ytd %yr	7.3%	7.2%	–	In a clear downtrend.
	Nov industrial production	6.7%	6.6%	–	PMIs surprised to the upside in Nov; momentum to persist.
Eur	Dec Markit manufacturing PMI flash	60.1	–	–	Near record highs...
	Dec Markit services PMI flash	56.2	–	–	... and showing strong momentum.
	ECB policy decision	–0.4%	–	–	Euro Area rates on hold, for a long time to come.
UK	Nov RICS house price balance	1.0%	–	–	Increase in rates and uncertainty key drags, esp. in London.
	Nov retail sales	0.3%	–	–	Inflation lift has eroded households purchasing power.
	Bank of England Bank Rate decision	0.5%	0.5%	0.5%	Inflation remains elevated, but activity risks are to downside.
US	Initial jobless claims	236k	–	–	At historic lows.
	Nov import price index	0.2%	0.8%	–	Have remained subdued recently.
	Nov retail sales	0.2%	0.3%	0.4%	Hurricane effects have run their course; autos a –'ve in Nov.
	Oct business inventories	0.0%	–0.1%	–	A key driver of GDP volatility.
Fri 15					
NZ	Nov BusinessNZ manufacturing PMI	57.2	–	–	Businesses are increasingly nervous about the outlook.
Eur	Oct trade balance €bn	25.0	–	–	Euro less supportive of late, but not a major headwind.
US	Dec Fed Empire state index	19.4	18.0	–	Regional indexes continue to hold at elevated levels.
	Nov industrial production	0.9%	0.2%	–	Underwhelming versus PMI strength.
Sat 16					
US	Oct total net TIC flows $bn	–51.3	–	–	Long–term bond flows.

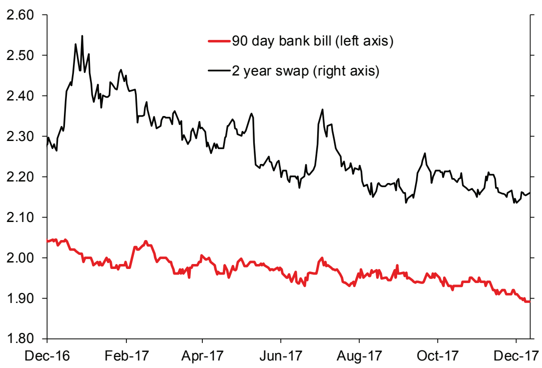
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017			2018	Calendar years			
% change	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production)	0.8	0.4	0.7	0.5	2.5	3.0	2.4	2.4[1]
Employment	-0.1	2.2	-0.2	0.6	1.4	5.8	3.1	1.6
Unemployment Rate % s.a.	4.8	4.6	4.5	4.5	5.0	5.3	4.5	4.7
CPI	0.0	0.5	0.5	0.4	0.1	1.3	2.0	1.5
Current Account Balance % of GDP	-2.8	-2.5	-2.4	-2.0	-3.2	-2.5	-2.4	-2.5

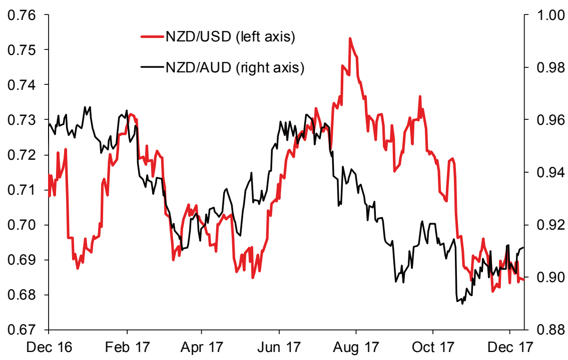
[1] Annual average % change

Financial Forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.95	1.95	1.95	1.95	1.95	1.95
2 Year Swap	2.10	2.10	2.20	2.30	2.40	2.50
5 Year Swap	2.60	2.70	2.80	2.95	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.66	0.64	0.63	0.63
NZD/AUD	0.89	0.89	0.89	0.89	0.90	0.91
NZD/JPY	77.5	76.4	75.9	74.5	73.1	73.7
NZD/EUR	0.59	0.58	0.58	0.57	0.56	0.57
NZD/GBP	0.52	0.51	0.51	0.51	0.50	0.50
TWI	72.6	71.8	71.2	69.9	69.2	69.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 11 December 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.77%	1.77%	1.78%
60 Days	1.83%	1.84%	1.86%
90 Days	1.89%	1.91%	1.94%
2 Year Swap	2.16%	2.17%	2.21%
5 Year Swap	2.60%	2.61%	2.72%

NZ foreign currency mid-rates as at 11 December 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6844	0.6885	0.6935
NZD/EUR	0.5818	0.5768	0.5947
NZD/GBP	0.5112	0.5161	0.5257
NZD/JPY	77.71	76.71	78.71
NZD/AUD	0.9113	0.9033	0.9061
TWI	72.78	72.65	73.73

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.5	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	1.7	2.0	2.0
Unemployment %	6.2	5.8	5.7	5.5	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.2	-2.6
United States						
Real GDP %yr	2.6	2.9	1.5	2.2	2.1	2.0
Consumer Prices %yr	1.6	0.1	1.3	2.0	1.8	1.8
Unemployment Rate %	6.2	5.3	4.9	4.4	4.1	4.1
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.3	1.1	0.9
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.2	1.8	1.7
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.6	1.6	1.5
China						
Real GDP %yr	7.3	6.9	6.7	6.8	6.2	5.9
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.1	4.1	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.7	3.6	3.6
Forecasts finalised 10 November 2017						

Interest Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.75	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.53	2.65	2.85	2.85	2.95	3.00	3.00	3.00
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.37	2.40	2.60	2.75	2.90	3.00	3.00	3.00
ECB Deposit Rate	–0.40	–0.40	–0.40	–0.40	–0.40	–0.40	–0.30	–0.30

Exchange Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
AUD/USD	0.7514	0.76	0.75	0.74	0.72	0.70	0.69	0.68
USD/JPY	113.35	114	114	115	116	116	117	118
EUR/USD	1.1767	1.15	1.15	1.14	1.13	1.12	1.11	1.10
AUD/NZD	1.0991	1.12	1.12	1.12	1.12	1.11	1.10	1.08

Contact the Westpac economics team

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