August 2018

Economic Overview

Falling into place

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Note from Dominick

The pieces of the puzzle that we laid out in past *Economic Overviews* are now falling into place. We have consistently warned that the economy would slow, businesses would feel the impact, the Treasury and Reserve Bank would revise their forecasts down, and the New Zealand dollar would fall. All of this has come to pass.

Our unchanged view is that the next phase for the New Zealand economy will be a modest and temporary pickup in growth on the back of government spending. Ironically, that view probably makes us optimists relative to the fickle winds of general sentiment, which have suddenly become very negative. From a personal perspective, that will be a nice change after being the relative pessimist for so long!

However, we view this pickup as temporary. Beyond 2019, we continue to expect a gradual cooling in economic growth.

The economic slowdown to date has been a domestic spending phenomenon. The flipside of lower spending is higher saving, as evidenced by New Zealand's shrinking overseas net debt position. What we are now witnessing is the long-awaited rebalancing in the New Zealand economy. The economy may be slower, but it is gradually moving onto a surer long-run footing.

Meanwhile, the strong global economy and falling exchange rate have left New Zealand exporters well positioned. The quiet achiever has been services exports such as software and tourism, as this quarter's *Special Topic* explains.

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

Anne Boniface
Senior Economist
T +64 9 336 5669

Paul Clark
Industry Economist
T +64 9 336 5656

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

New Zealand Economy

In the mix

The economic slowdown that we have long warned of is well in train, with earlier drivers of growth having now moved into new phases. Looking ahead, the coming year will see growth picking up, supported by firmness in export earnings and the large increases in fiscal spending being rolled out. This changing mix of activity should also see New Zealand's international debt position continuing to gradually improve.

Growth past the peak

The first half of 2018 has panned out very much as we expected, with GDP growth estimated to have slowed to around 2.7% in the year to June. We often hear the suggestion that what we are seeing is a 'normal' late cycle slowdown. It's true that in parts of the economy like the construction sector and labour market, spare capacity has been absorbed, and that is providing some brake on growth. However, that only explains a small portion of the slowdown that we have seen.

The more important piece of the puzzle is what's happening to the drivers of demand. Several of the factors that underpinned activity in previous years have now moved into new phases and are no longer providing the same boosts to growth that they once did. That includes significant contributors to recent economic activity such as the Canterbury rebuild, house prices, and net migration.

Figure 1: GDP growth

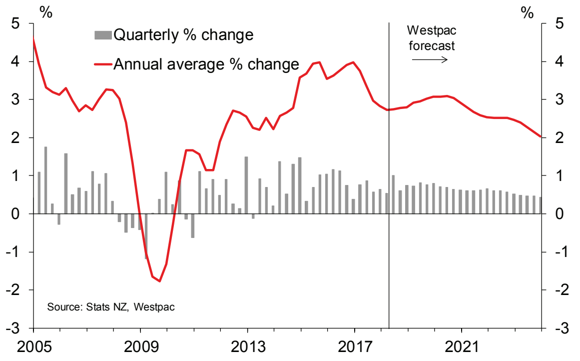
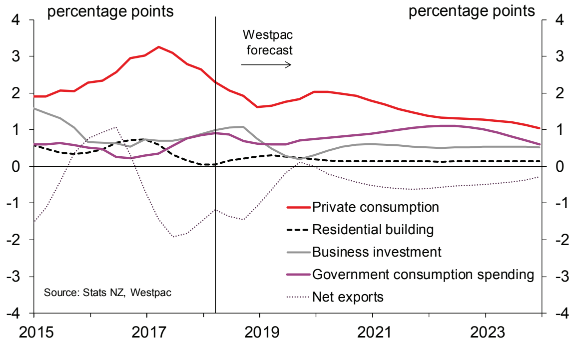


Figure 2: Contributions to annual GDP growth

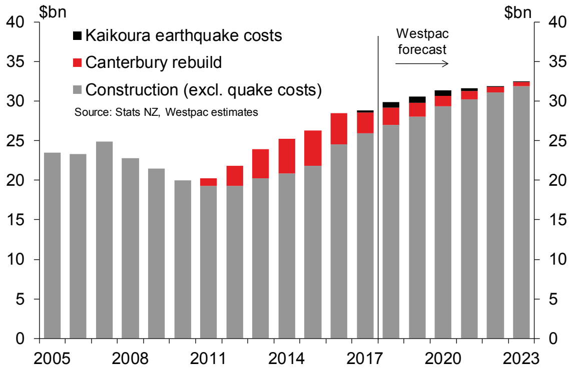


Reconstruction activity in Canterbury has slowed sharply since it peaked over 2015 and 2016. The resulting reductions in demand accounted for almost half of the slowdown in growth in 2017, shaving around half a percent off annual national GDP growth that year. The continuing wind-down in reconstruction work will be a drag on growth for several more years. And just as the boost to demand from reconstruction spending was not limited to Canterbury, the slowdown now in train will also be felt more widely.

Looking at construction activity more generally, we are seeing activity picking up again after stalling in late-2017. Recent months have seen renewed strength in Auckland, with regulatory changes supporting a significant lift in the construction of medium density homes. Dwelling consent issuance in most other parts of the country has also remained at firm levels. And on top of this, home building activity is now being boosted by the Government's KiwiBuild program which kicked off earlier this year, though its impact is fairly small at this stage.

There is also a large amount of non-residential construction work planned over the coming years. That includes numerous government related projects, as well as large amounts of work in the office, industrial and retail spaces.

Figure 3: Annual construction activity



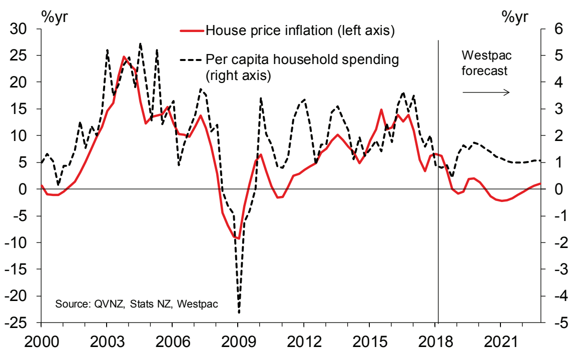
But while the level of construction activity is likely to remain elevated for some time, the sector is unlikely to be the driver of growth and employment that it was in earlier years. The construction sector is continuing to wrestle with a number of significant challenges including stretched capacity, rising costs, and difficulties accessing finance. These factors will provide a brake on how quickly building activity can ramp up to meet demand. In addition, the current strength in non-residential building is likely to give way to a period of softer activity heading into the middle part of the next decade. That's because currently scheduled projects are set to significantly boost available commercial space over the next few years.

One of the most significant changes in the economy in recent years has been the cooling in the housing market. On a nationwide basis, house price growth has taken a step down since 2017. And despite a brief flutter over the new year, prices have essentially been flat since February. That's a significant slowdown from previous years when prices were rising at double-digit rates. Softness in house prices has been centred squarely on Auckland and Canterbury, which together account for 40% of sales and where prices have been falling modestly in recent months. Prices are still rising in other areas, but at a more gradual pace than in previous years.

The slowdown in the housing market comes against a backdrop of significant policy changes targeting housing affordability and supply. We expect that these measures will result in modest house price declines over the next few years. However, compared to our forecasts from our June *Economic Overview*, weakness in the housing market is expected to be a little more moderate, especially over the coming year. Wholesale interest rates have fallen, and we expect that a related drop in mortgage rates will provide a counter-balance to the effect of the foreign buyer ban on price growth. We also expect the Reserve Bank will ease loan-to-value restrictions in January.

This still leaves us with a subdued outlook for house price growth. And with New Zealanders holding a large portion of their wealth in owner-occupied and investor housing, it's no surprise that we have seen consumer spending flatten off through the first half of the year. Looking ahead, we expect the ongoing softness in the housing market will weigh on household spending for some time (though as discussed below, this will be partially offset by increases in family support payments).

Figure 4: House price inflation and per capita spending



Over the coming years, spending growth will also be dampened by the slowdown in net migration that is already in train. While annual net migration remains elevated at just under 65,000, it has been gradually trending down since mid-2017. We expect that it will slow substantially more over the next few years. Many of those who arrived on temporary work and student visas in previous years are now departing. Improving job prospects in other countries are also making New Zealand relatively less attractive as a destination. Together, these developments will see population growth slowing from around 2% currently to around 1% in 2022, signalling a huge reduction in the economy's rate of potential GDP growth.

With a cooling in economic activity there has been a sharp decline in business confidence, and we expect this will weigh on both investment spending and hiring decisions. However, business surveys appear to be overstating the degree of weakness in activity, and the responses likely reflect some unease around the new Government's economic policies.

Changing drivers of demand

Quarterly GDP growth is expected to rebound to 1% in the June quarter. However, this is due in part to temporary factors, including a reversal of earlier softness in the primary sector. Consequently, we expect that there will be some payback in the form of a lower September quarter outturn. Smoothing through these quarter-to-quarter swings leaves us with a picture of soft activity in the year to date.

Looking ahead, we expect that the next phase of the economic cycle will be a pickup in GDP growth to just over 3% in 2019.

One of the key factors that will add to demand over the coming years is the large increase in Government spending that is now being rolled out. That includes around $1.5b of spending on the Government's families package and accommodation support payments, which will provide a significant boost to the disposable incomes of many households. The coming years will also see big spending increases in other areas, including health and education.

Strength in the export sector will also help to bolster New Zealand's economic performance. Although there has been a softening in the prices for some commodities recently (most notably dairy prices), the terms of trade remain elevated. We're also seeing continued firmness in services exports, underpinned by ongoing strength in tourism (we look at this more closely in our special topic this quarter). And going forward, export returns will be boosted by the depreciation of the New Zealand dollar, with the RBNZ set to remain on hold as interest rates offshore push higher. As discussed in the *Agricultural Outlook* section, it's certainly not all plain sailing for the export sector, with challenges including increased trade tensions abroad and the management of Mycoplasma bovis locally. However, the overall outlook for New Zealand's export sector is looking positive, with export earnings set to support the level of national income over the coming years.

Beyond 2019, we expect GDP growth to cool once again, as slowing population growth and weakness in the housing market offset increases in fiscal spending.

Labour market the laggard in the economic cycle

The unemployment rate rose slightly in the June quarter to 4.5%, up from 4.4% in March. That's not a significant change given the historic volatility of the unemployment rate, and the reasons behind it weren't alarming: employment grew by 0.5%, but was outstripped by a rise in labour force participation.

Looking ahead, we do expect to see a further modest rise in the unemployment rate to 4.7% next year, in a lagged response to the slowdown in GDP growth that has already taken place. However, this rise is expected to be short-lived with the unemployment rate to head lower again after GDP growth picks up.

Wage inflation increased to 1.9% in the year to June, and we expect it will rise to around 2.3% p.a. over the next few years. Although the unemployment rate is expected to increase modestly in the short term, it is still relatively low, and a firming in GDP growth is on the cards. Wage growth will also be boosted by increases in the minimum wage and collective bargaining agreements, especially in some public sector roles.

New Zealand's balance sheet gradually improving

The consequence of softening domestic demand and firming export earnings is an improvement in New Zealand's balance sheet (something that we think will continue for some time).

New Zealand's relatively small current account deficits in recent years mean that our overseas borrowing requirements have been much smaller than in the past. That's seen our net overseas financial liabilities declining from a horrendous peak of 84% of GDP in March 2009 to 54.5% of GDP in early 2018. Although our net debt position is still relatively large for a developed country, we're no longer an outlier. In fact, we're now more or less in line with Australia. We expect that the changing mix of economic activity now in train, and related continued low current account deficits, will result in ongoing gradual improvements in the nation's balance sheet over the coming years.

Looking at the household sector, although debt levels remain elevated, debt accumulation has been slowing and the ratio of household debt to income has been steady since the start of 2017. We're also seeing signs that households are starting to save more. In 2010, local deposits at banks were 70% as large as loans. Now that figure is close to 85%. This means that while New Zealanders are continuing to take on debt, more of this is borrowed from other New Zealanders, rather than from offshore.

Going forward, we expect that the softness in the housing market will put a brake on household spending growth and further dampen the appetite for credit (particularly with regards to mortgage debt). This should see households' debt to income ratios remaining relatively stable, or potentially improving. That would have important implications for the Reserve Bank's choice of policy settings, potentially allowing for a further loosening of loan-to-value lending restrictions.

Businesses have also been more cautious about their spending since the financial crisis. This has seen their contribution to the current account balance shifting from a drag prior to 2010 to a small positive. However, as business borrowing is typically related to investment spending, the corollary of this focus on debt consolidation has been that investment has accounted for a smaller share of economic activity in recent years.

Finally, a focus on debt consolidation has seen the Government's balance sheet improving in recent years. And although it's likely that GDP (and hence tax revenue) will fall short of the Government's forecasts, we expect its net debt position will continue to improve. That's because much of the Government's borrowing requirements relate to its capital spending program, and we doubt that the budgeted ramp up in infrastructure spending will occur as quickly as expected.

Although our national debt position is looking a lot healthier than it did a decade ago, there are still some risks. One of the most important is the composition of our assets, which is weighted heavily towards housing and land. In recent years, low interest rates saw households taking on increasing amounts of debt secured against housing assets, while the related gains in land and house prices flattered their debt-to-asset positions. Over the life of a housing loan borrowing rates could rise. And in the past there have been substantial increases. If this occurs, it could have a dramatic impact on both asset prices and debt servicing costs, resulting in significant deterioration in the nation's balance sheet.

Figure 5: Annual current account balance

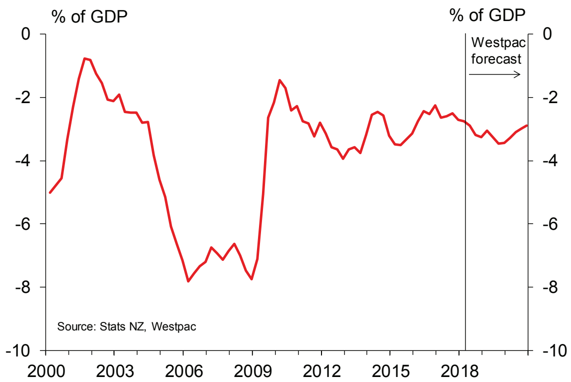


Figure 6: Net international investment position

Agricultural Outlook

Signs of a slowdown

There have been a few jitters for New Zealand's commodity prices in recent months, including slowing growth in China and heightened concerns about the ongoing trade spat between China and the US. For some commodities, stronger global supply is also causing prices to ease. We expect commodity prices to retreat a little further in the coming months. Yet despite this, the terms of trade are still expected to remain historically high.

For some time now we've been expecting global prices for New Zealand's key export products to ease in response to slowing growth in China. And in the last few months we have started to see signs of this happening. Softer demand has been most apparent in dairy prices which fell almost 7% in July and are down 9% since the start of the dairy season. This leaves Fonterra's opening season milk price forecast of $7 looking optimistic. Our own forecast is for a $6.50 milk price, with this view predicated on auction prices hovering around current levels, before improving a little heading into 2019.

If we're right, this would mean a third consecutive cash flow-positive season for most dairy farmers. Yet despite this outlook, sentiment in the sector remains subdued. This, combined with increasing environmental regulations, Fonterra's new rules aimed at discouraging PKE use, and ongoing efforts to eradicate Mycoplasma bovis are all likely to cap growth in milk production at around 2% this season. That said, much will depend on how the weather pans out, and farmers will be wary of the possibility of El Niño conditions developing in the coming months.

We still view global dairy markets as broadly balanced at current prices. However, that's not the case for all of New Zealand's export commodities. Increasing global supply, particularly in the US, is expected to weigh on beef prices and translate to softer demand for New Zealand beef exports. In sheep meat markets increasing supply from Australia on the back of dry conditions in south-eastern parts of the country has lifted global supplies in recent months (though this will lead to tighter supplies when conditions eventually improve and flocks are rebuilt).

There may also be mixed impacts from the tit for tat tariff hikes between the US and China. While not directly in President Donald Trump's crosshairs, New Zealand's commodity exporters risk getting caught in the crossfire between these two giants of global growth. China has slapped retaliatory tariffs on a range of US imports including agricultural products such as dairy and beef. This is likely to lead to weaker demand for US products, and could leave opportunities for New Zealand exporters to fill the gaps (with New Zealand already a much larger exporter of both beef and dairy products into China). But as one door opens, others may close. Product initially destined for China may now head elsewhere, or be redirected within the US, squeezing demand for New Zealand exports. Other effects are less direct. Lower US corn and soybean prices on the back of tariffs could mean lower cattle feed costs for US producers, potentially leading to an increase in dairy or beef production.

For now, we expect the impacts on New Zealand commodity exporters to be relatively minor. But perhaps the biggest threat to this view is that these trade tensions broaden, slowing trade and becoming a major drag on global growth. That would be an unambiguously negative development for New Zealand exporters.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Whispers of softer demand from China. We expect further signs of slowing demand to be reflected in lower prices in the coming months.	High	↘
Wool	Tentative signs of improved demand for coarse wool, though prices continue to linger at low levels. Demand for merino still strong.	High	→
Dairy	Prices fell sharply in July but have since stabilised. We expect prices to linger near current levels before improving again in 2019.	Above Average	→
Lamb	Prices have held up relatively well in the face of increased supply from Australia. However, pressure likely to increase in the coming months.	High	↘
Beef	We expect prices to ease further in the coming months as the US cattle supply continues to grow.	High	↘
Horticulture	Demand likely to remain firm. However, increasing supply on the back of increased plantings could see prices slip a little.	High	↘

[1] NZ dollar prices adjusted for inflation, deviation from 10 year average.

Inflation

Maybe not today. Maybe not tomorrow...

Core inflation has firmed and is set to rise further over the coming year, underpinned by continued growth in domestic activity and a fall in the NZ dollar. Nevertheless, a sustained return to 2% inflation is still some way off, with the factors that have dampened tradable prices set to persist for some time.

Consumer price inflation rose to 1.5% in the year to June, up from 1.1% in March. Much of the increase in inflation over the past year was related to increases in international oil prices, with Dubai oil rising from around US$50/barrel this time last year to over US$70/barrel at the time of writing. That's pushed up prices at the pump for consumers, and also added to operating costs for many businesses.

Oil prices have now levelled off, and we expect they will ease over the coming years as global supply comes online. Nevertheless, earlier increases in global prices, combined with increases in domestic fuel taxes, will see headline inflation approaching 2% by the end of this year, before easing again over 2019.

The extent of the near-term lift in inflation will likely come as a surprise to the RBNZ. However, from a monetary policy perspective, swings in inflation associated with gyrations in international oil prices are 'look through' events. What's more important for monetary policy are changes in 'core' inflation, which are more closely related to the underlying health of the economy. On this front, we have seen a firming in recent months, with core inflation rising to 1.7% in June (based on the RBNZ's preferred measure of core inflation). That's the highest level since 2011 and has been underpinned by increases in the more persistent domestic components of inflation.

This picture of firming inflation pressures is also evident when we look at the economic backdrop more broadly. Annual wage inflation has risen to 1.9% - its highest level since 2012. And while some of that was due to the recent large increase in the minimum wage, there has also been a more general increase in private sector wage growth. At the same time, businesses in many parts of the economy are reporting increasing cost pressures.

We expect to see a further strengthening in the economy's underlying inflation pulse over the next few years. With spare capacity having been eroded and the economy continuing to expand, both wages and non-tradable inflation are set to continue gradually trending higher. At the same time, a further decline in the NZ dollar will add to imported inflation.

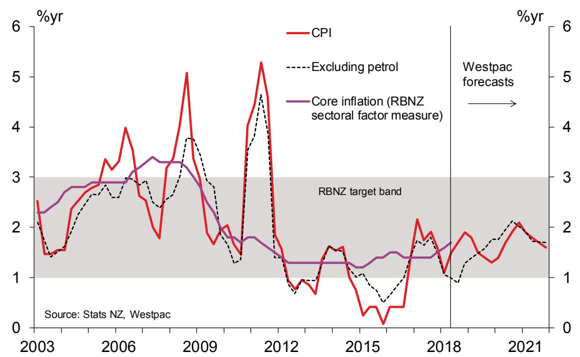
The above conditions will still only take inflation back to levels close to the RBNZ's 2% target midpoint. However, we're certainly not headed into an environment where inflation will threaten the upper half of the RBNZ's target band or which would signal the need for higher interest rates any time soon.

As we've been highlighting for some time, there have been significant structural changes in the New Zealand economy in recent years that are limiting any rise in inflation. One of the most important developments has been the ongoing softness in the retail prices of imported goods. In part, this has been due to earlier weakness in the global economic backdrop, which is now fading. However, prices for many goods have also been affected by structural changes affecting competitive pressures in the retail environment, the most significant of which has been the increasing prevalence of online trading.

This softness in the retail pricing backdrop has seen tradables inflation surprising forecasters, including ourselves and the RBNZ, on the downside for several years now. Importantly, there is no sign that these factors are dissipating, with tradables inflation surprising to the downside again in the June quarter. We've assumed that competitive pressures will continue to weigh on retail prices and will restrain the rise in overall inflation.

Domestic factors are also weighing on inflation. Prices for many government related services (which account for around 10% of domestic prices) have been rising at a more gradual pace than in the previous decade. In addition, there has also been a sizeable step-down in inflation expectations in recent years, which is dampening wage growth and weighing on price setting decisions.

Figure 7: Inflation forecasts



The Reserve Bank and Interest Rates

Panning out

Our consistently dovish OCR expectations have come good. The RBNZ has acknowledged the economic slowdown and has adjusted its OCR expectations. But the RBNZ has gone further than even we were expecting. The question now is whether the RBNZ will cut the OCR. The best answer we can give at this stage to that question is no, but there is always a chance that data surprises could change that answer.

In November 2017, we said: "Our view is that the RBNZ will be disappointed by the state of GDP growth over 2018, and surprised by the weakness of the housing market... Under these conditions the exchange rate would probably fall, providing some offset for the RBNZ. But overall, we expect that the RBNZ will have to become more dovish over the course of 2018."

That is exactly how things have panned out. In the August *Monetary Policy Statement*, the Reserve Bank finally accepted that the economy was just not matching their bullish expectations. They pushed out the date of forecast OCR hikes, and emphasised in subsequent media interviews that they are "nearer to the trigger point" for cutting the OCR.

Financial markets went into a tailspin following those comments. Two year swap rates are now 20 basis points lower than they were in June, and a chance of OCR cuts has been priced into markets.

The change of rhetoric from the RBNZ is more than can be explained by data surprises alone. It seems there has been a systemic change of approach at the central bank since Adrian Orr took over as Governor. Reading between the lines, we have come to believe that the new regime will prove keener to shore up GDP growth when it flags, and more willing to take a risk when inflation shows signs of rising. They may also be keener on a low exchange rate, and more averse to rising unemployment than the RBNZ under the previous Governor. In the parlance of financial markets, we suspect that the Reserve Bank has become more dovish.

Even though the economy, inflation and the exchange rate are performing very much as we expected, the dovishness of the current Reserve Bank leadership has prompted us to change our OCR call. We are now forecasting that the OCR will remain on hold until May 2020 and will rise slowly thereafter, whereas we previously predicted that the OCR would begin rising in November 2019.

But the real question is whether or not the RBNZ will cut the OCR in the foreseeable future. We certainly take seriously the possibility – we put the odds of a cut at around one in three.

But it is more likely that the flow of data this year will not support an OCR cut.

Strike one against cuts is the exchange rate, which has plunged in recent times and now sits well below the RBNZ's forecasts.

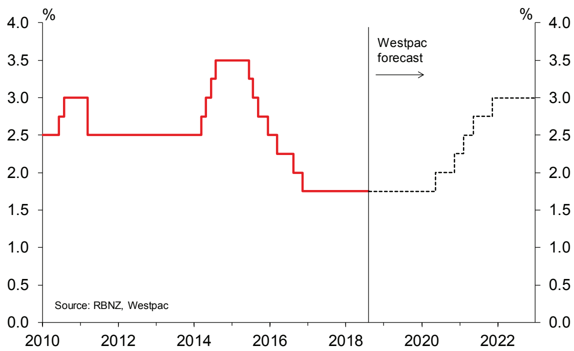
Strike two is June quarter GDP, which is released in mid-September. The RBNZ is forecasting 0.5%, but our read is that we'll get a monster print of around 1%. This may just be due to the quarterly vagaries of agricultural production and the like, but such a number would still forestall any OCR cut. And as the *Domestic Economy* section outlines, we also expect a genuine improvement in the economy later this year and into next.

Strike three is September quarter inflation, which the RBNZ predicts will be low at 1.4%. Our own forecast is 1.7%.

The Reserve Bank's newfound dovishness raises the question of whether it is setting itself up for a future inflation problem, and ultimately, higher interest rates. If markets start to fret about that, longer-term interest rates will rise and the yield curve will steepen. However, as explained in the *Inflation* section, we expect inflation to remain well contained. Consequently, although we do expect longer-term swap rates to rise, our long-term interest rate forecasts are no higher than in previous *Overviews*, and are not high by the standards of history.

The other facet that the Reserve Bank has hinted at in its recent communications is a willingness to loosen its loan-to-value ratio restrictions. The Governor has repeatedly stated that he is pleased with the housing market slowdown and "will need to look at the LVRs". We continue to anticipate a loosening of the LVR restrictions will be announced in November and implemented in January.

Figure 8: Official Cash Rate forecast



Exchange Rates

Falling into step

We have been beating the drum of a lower exchange rate forecast for well over a year. The exchange rate has certainly fallen into step with that view. Most recently, the Kiwi took an extra leg down on the back of a dovish RBNZ statement and financial market jitters about growing risks in emerging markets. While the NZ dollar is expected to weaken further in the near term, a run of stronger than expected data could see recent downward momentum stall, or even cause a pop higher, in the coming months.

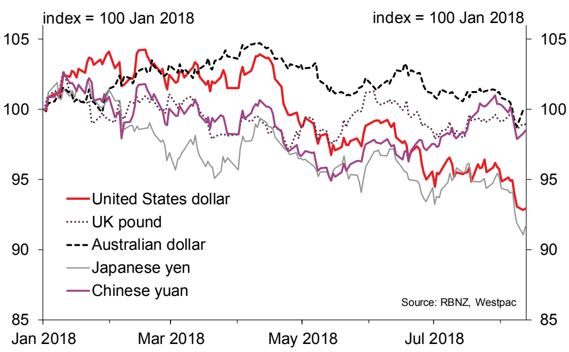
The New Zealand dollar has continued to fall in recent months in line with the forecasts we laid out last year. Fundamentals continue to be a key driver in currency markets. The Federal Reserve remains on the path toward tighter monetary policy settings, raising rates twice this year and signalling more to come. In addition, as we outline in the *Reserve Bank and Interest Rates* section, the RBNZ is now likely to remain in "watch and wait" mode for even longer than we anticipated three months ago, and is minded to cut the OCR if the data warrants.

In financial markets, this news of a more dovish outlook by the RBNZ has collided with a wave of global risk aversion. The catalyst for this latest shift in sentiment is concerns that recent turmoil in Turkey could spill over into other emerging market economies. This sentiment has led to further support for the US dollar, adding to the downward pressure on the NZD/USD.

Yet with the NZD/USD falling so far and so fast in recent weeks, we remain wary that markets could be surprised by a more positive tone in New Zealand economic data over the next few months as discussed in the *New Zealand Economy* and *Inflation* sections. These positive surprises could arrest the downward momentum in the NZD/USD, or even cause a pop higher, albeit temporarily. We still expect the NZD/USD to fall to around 64 cents by September 2019, lingering around these levels for a time before interest rate differentials once again start moving in favour of a firmer NZD/USD.

The NZ dollar has depreciated more modestly against the Chinese yuan. That's partly because Chinese policy makers have allowed the yuan to depreciate as one way to offset higher tariffs on Chinese imports into the US. Similarly, the depreciation in the NZD/AUD has also been relatively modest, briefly moving below 90 cents in August. Looking ahead we expect the NZD/CNY to weaken further, while the NZD/AUD is forecast to broadly track sideways from here, hovering near the 90 cent mark throughout the forecast horizon.

Figure 9: NZdollar exchange rates vs major countries



End of quarter forecasts

	CPI	Interest rates				Exchange rates					
	Annual %	OCR	90-day bill	2 year swap	5 year swap	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/JPY	TWI
Sep-18	1.7	1.75	1.90	2.00	2.50	0.67	0.91	0.58	0.52	74.4	72.5
Dec-18	1.9	1.75	1.90	2.10	2.65	0.66	0.89	0.57	0.52	73.9	71.5
Mar-19	1.8	1.75	1.90	2.20	2.80	0.65	0.90	0.57	0.53	73.5	71.0
Jun-19	1.5	1.75	1.90	2.30	2.90	0.65	0.90	0.56	0.53	73.1	70.5
Sep-19	1.4	1.75	1.95	2.45	3.05	0.64	0.91	0.55	0.52	71.7	69.8
Dec-19	1.3	1.75	2.00	2.60	3.15	0.64	0.91	0.53	0.52	70.4	69.4
Mar-20	1.4	1.75	2.10	2.75	3.25	0.65	0.90	0.54	0.53	70.9	69.8
Jun-20	1.7	2.00	2.20	2.90	3.35	0.66	0.89	0.54	0.53	71.3	70.1
Sep-20	1.9	2.00	2.35	3.00	3.40	0.67	0.90	0.54	0.53	71.5	70.6
Dec-20	2.1	2.25	2.60	3.05	3.45	0.68	0.90	0.55	0.53	71.8	71.0

Global Economy

Parting ways

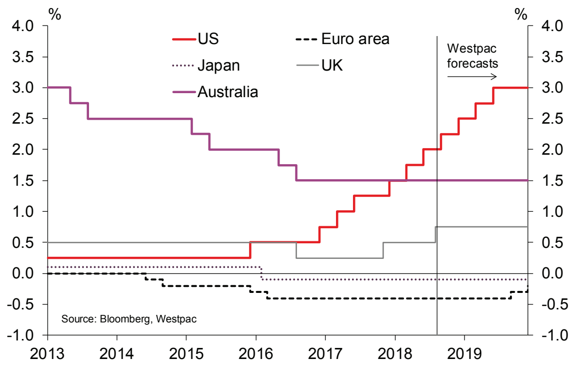
The world economy is continuing to grow at a solid pace. But there are some differences emerging across regions that are setting the stage for a slower pace of growth next year. Rising US interest rates, growing trade protectionism and China's economic rebalancing are notable risk factors for New Zealand.

After several years of subdued growth in the wake of the Global Financial Crisis, the world economy began to accelerate from around mid-2016. Notably, this upturn was synchronised across the major economies, and was accompanied by a rebound in international trade that helped to share the benefits of growth more widely.

Global growth on the whole has remained strong this year, but there are growing signs that the upturn is becoming more fragmented. Part of that reflects emerging differences in domestic conditions across the major economies. But policy choices are also playing a significant role.

The US economy has been at the forefront of the global upswing in the last couple of years. What's been noteworthy is the breadth of recent growth, with support from rising net exports, investment in the oil and gas industry, strong consumer spending, and last year's tax cuts. Household incomes are benefiting from strong employment growth and, as the labour market has tightened, an acceleration in wage growth at last.

Figure 10: Central bank policy rates



All of this has left the US Federal Reserve more confident that the economy is running at capacity and that inflation pressures are picking up. The Fed has increased its policy rate six times in the last two years, and we expect four more rate hikes over the next 12 months. As higher interest rates dampen consumption and housing investment, we expect US growth to slow from its current above-trend pace to around trend by the middle of next year.

Notably, the US is the only major economy where monetary policy is tightening to a significant degree. The UK and Canada have raised their policy rates tentatively, while Europe and Japan are still in the midst of unconventional easing programmes and interest rate hikes are a distant prospect.

For the developed economies, rising US interest rates have largely played out as a fall in their exchange rates against the US dollar. But there are signs that higher US interest rates are putting some strain on emerging market economies, particularly those with trade and fiscal deficits who have relied on access to cheap US dollar funding in the past. That in turn has put global markets on a more risk-averse footing, and further reinforced the US dollar's appeal as a 'safe haven' asset.

Another policy-driven risk for global growth is the US's escalating trade war with the rest of the world, particularly China. Diplomacy appears to have fallen by the wayside, as the US has announced a significant increase in tariffs on Chinese imports and China has responded in kind.

A full-blown trade war, with all countries turning against each other, would be a major threat to the world economy. However, we don't get the sense that's where things are heading; the disputes so far have remained between the US and the rest.

In this situation, the economic impact could be softened as the global trade system adjusts. For example, China has placed retaliatory tariffs on imports of US grains. But China still needs to buy grain, and the US needs somewhere to sell its grain. It's possible that a third grain-producing country such as Brazil could accommodate both sides, although these 'roundabout' trade flows are inefficient and come at a cost.

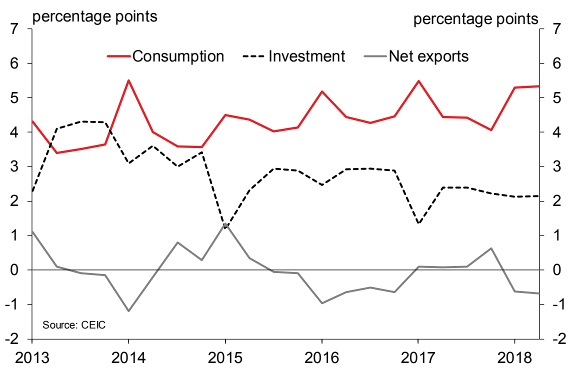
The greater concern is that the trade war is likely to have a chilling effect on business investment. There are already anecdotes that tariffs on imports of intermediate goods have raised costs for some US businesses and threatened their viability. In the longer term, firms can relocate their production to minimise the impact of tariffs, but they will be reluctant to do so without knowing whether the tariffs will last.

The Chinese economy is also facing policy-driven challenges from within, as the government tries to engineer a shift towards more sustainable sources of growth. Lending and investment are being shifted away from unprofitable state-owned enterprises, infrastructure projects by local governments are being assessed more closely, and banks are looking to improve the quality of both their loan books and their sources of funding.

China's GDP grew by 6.4% annualised in the first half of this year, tracking a little below the government's full-year target of 6.5%, but above our forecast of 6.3%. We expect growth to slow further to 6.1% next year. But on the whole, the clampdown on low-quality investment appears to have achieved its aims, and the government is now turning towards providing support to the economy around the margins.

In terms of New Zealand's trade with China, this economic rebalancing has been relatively favourable. Growth in consumer spending and housing construction have remained strong, even as industrial investment has cooled. Household debt is low, and has been identified as one of the up-and-coming areas where banks are being encouraged to lend. That said, indicators of employment growth have been soft, and we expect consumer spending growth to slow in the second half of this year. But the risk of a deeper drop in China's demand for our exports is now fading.

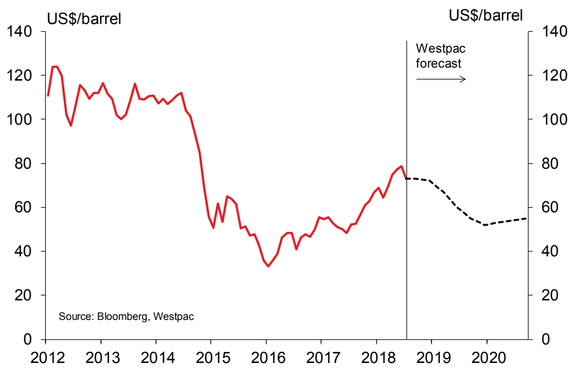
Figure 11: Contributions to Chinese growth



Australia, New Zealand's biggest trading partner, has benefited from the stronger world economy in recent years, and has largely remained out of the firing line on matters such as the US trade war and rising interest rates. We expect the Australian economy to grow at an about-trend pace this year, but slowing to below trend next year. The wind-down in mining investment has run its course, and there is a very large pipeline of planned infrastructure projects in the coming years. However, consumers are facing headwinds from slow wage growth and a drop in property prices in most of the main centres.

The overall picture for global trade is one of growing demand, but still subdued inflation pressures. As we note in the *Agricultural Outlook* section, trade disputes and the slowing Chinese economy are likely to weigh on global commodity prices. For oil, the pressure will be compounded by a surge in supply. With the growth in infrastructure investment in the US oil industry, we're expecting a strong lift in US oil production over the next year, pushing prices back down towards the cost of production again.

Figure 12: Brent crude oil prices



Economic forecasts (calendar years)

Real GDP % yr	2014	2015	2016	2017	2018f	2019f
New Zealand	3.6	3.5	4.0	2.8	2.8	3.1
Australia	2.6	2.5	2.6	2.2	2.8	2.5
China	7.3	6.9	6.7	6.9	6.3	6.1
United States	2.6	2.9	1.5	2.3	2.9	2.5
Japan	0.4	1.4	0.9	1.7	1.1	1.0
East Asia ex China	4.2	3.8	3.9	4.5	4.4	4.3
India	7.4	8.2	7.1	6.7	7.2	7.2
Euro zone	1.3	2.1	1.8	2.3	2.0	1.6
United Kingdom	3.1	2.3	1.9	1.8	1.2	1.5
NZ trading partners	**4.0**	**3.8**	**3.5**	**4.0**	**3.9**	**3.7**
World	**3.6**	**3.5**	**3.2**	**3.8**	**3.8**	**3.7**

Special Topic

Quiet achievers - the rise of services exports

Services exports have been a star performer in recent years, easily outperforming services imports, resulting in a much needed boost to New Zealand's external balances. There is more to come, with most categories of services exports expected to grow in the future, including some that typically don't make the headlines.

Services exports are a big earner in New Zealand. For the year ending March 2018, they amounted to about $23bn, contributing 30% to total exports. They are also fast growing, having risen by an impressive 44% over the past five years.

About $14.5bn of services exports were generated from spending by people visiting New Zealand for different purposes. Of this, about $9.5bn came from tourists, i.e. people visiting New Zealand for a holiday or to see friends and family here. Growth in spending by tourists has been strong in recent years, spurred on by developments in fast growing markets like China and the availability of cheaper flights to New Zealand.

And there is likely to be more to come. Conducive economic conditions in key markets and a weaker New Zealand dollar, in particular, are likely to ensure a steady flow of tourists to New Zealand over the next few years, although the pace of growth in arrivals may slow as elevated crude oil prices and higher airfares make it more expensive to get here.

A further $4bn came from international students studying and living in New Zealand. Spending by this group has grown strongly in recent years, mainly because of an acceleration in the number of students from abroad enrolled with private training establishments in New Zealand. However, with the Government having recently tightened entry rules into New Zealand, the likelihood is that there will be fewer international students and less spending in the future.

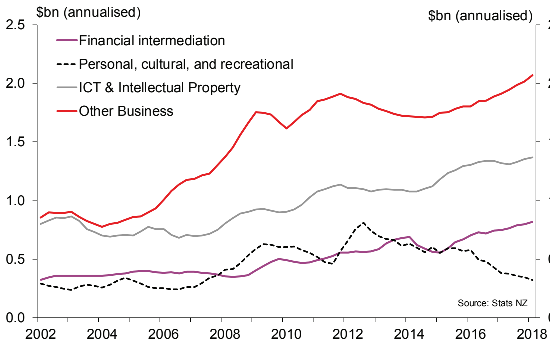
Business travellers spend about $1bn annually when visiting New Zealand, and this has generally shown a positive trend in line with improvements in global economic conditions and increased trade and investment activity. A continuation of these factors should result in more business people travelling to New Zealand in the future.

In addition to travel services, New Zealand based carriers (and their foreign affiliates) as well as port operators earn about $3bn from transporting people and freight to and from New Zealand. Demand for transportation services is closely tied to trade and tourism activity, so is likely to follow the same growth pattern in the future.

Services exports also include a large number of business services, which typically don't capture the headlines, but when put together earn as much as that generated from both international students and business travellers.

The largest of these are "other business" services and ICT and intellectual property services, which contribute $2bn and $1.4bn respectively to services exports. Financial intermediation services are also significant.

Figure 13: Selected services exports by type



Each of these has grown strongly in recent years, as new technologies have helped to reduce the disadvantage of being geographically distant from key markets. This has enabled New Zealand to compete on a more level playing field.

And New Zealand firms have taken advantage. For example, firms operating in New Zealand have been able to dramatically increase the revenues they generate from providing management services to offshore subsidiaries and parent companies. The same is true for firms that provide software design and development services as well as IT infrastructure services. More growth is likely, especially if the global economy continues to perform well.

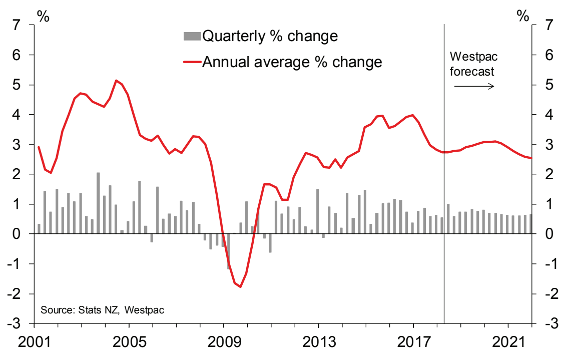
However, not all services have done well. Revenues from personal, cultural and recreational services, for example, have fallen sharply in recent years because of a drop in demand for services relating to the production and distribution of films, radio, and television programmes. This may have something to do with the absence of large-scale productions following the release of the "The Hobbit" films between 2012 and 2014. That said, a lack of big blockbusters is likely to have less of a drag on growth in services exports in the future.

In conclusion, most services exports will grow in the future, although the pace of growth could initially be a bit slower than in the past. This should pick up over time as an expected decline in spending due to fewer international students becomes less of a drag on growth.

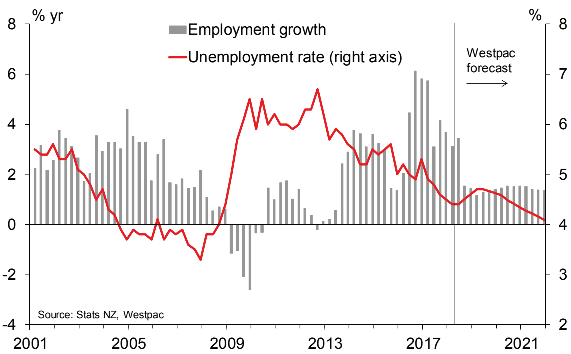
Forecasts and key charts

	Quarterly % change				Annual average % change			
	2018				Calendar years			
	Mar (a)	Jun	Sep	Dec	2017 (a)	2018	2019	2020
GDP (production)	0.5	1.0	0.6	0.7	2.8	2.8	3.1	2.9
Private consumption	0.0	0.6	1.0	0.6	4.4	2.6	3.3	2.9
Government consumption	0.5	0.8	0.9	1.0	4.6	3.3	4.0	4.7
Residential investment	-0.2	2.0	2.0	0.4	0.7	4.1	3.0	2.3
Business investment	0.6	-0.2	0.0	0.1	4.8	4.1	1.6	3.3
Stocks (% contribution)	0.5	-0.4	-0.3	0.1	0.0	0.4	-0.3	0.0
Exports	-0.1	1.2	1.0	0.7	2.3	2.6	3.1	2.4
Imports	1.2	-0.4	0.7	0.6	6.7	5.4	2.6	3.5
Consumer price index	0.5	0.4	0.7	0.3	1.6	1.9	1.3	2.1
Employment change	0.6	0.5	0.4	0.3	3.7	1.8	1.4	1.7
Unemployment rate	4.4	4.5	4.5	4.6	4.5	4.6	4.6	4.4
Labour cost index (all sectors)	0.3	0.5	0.7	0.5	1.8	2.1	2.3	2.3
Current account balance (% of GDP)	-2.8	-2.9	-3.2	-3.3	-2.7	-3.3	-3.4	-2.9
Terms of trade	-1.8	2.0	-1.4	-2.0	7.9	-3.2	0.7	2.9
House price index	1.1	0.0	0.0	-0.2	6.2	0.9	2.5	-2.7
90 day bank bill (end of period)	1.80	1.88	1.90	1.90	1.79	1.90	2.00	2.60
5 year swap (end of period)	2.71	2.69	2.50	2.65	2.66	2.65	3.15	3.45
TWI (end of period)	74.9	73.8	72.5	71.5	73.8	71.5	69.4	71.0
NZD/USD (end of period)	0.73	0.71	0.67	0.66	0.70	0.66	0.64	0.68
NZD/AUD (end of period)	0.92	0.93	0.91	0.89	0.91	0.89	0.91	0.90
NZD/EUR (end of period)	0.59	0.59	0.58	0.57	0.59	0.57	0.53	0.55
NZD/GBP (end of period)	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.53

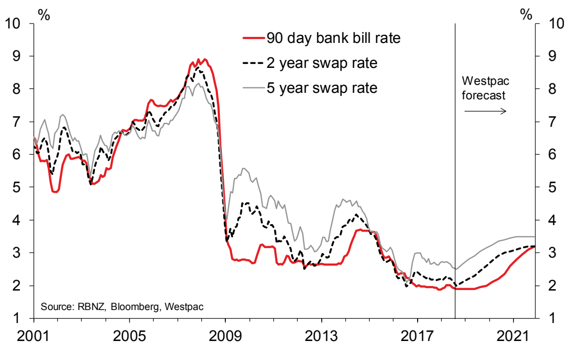
New Zealand GDP growth



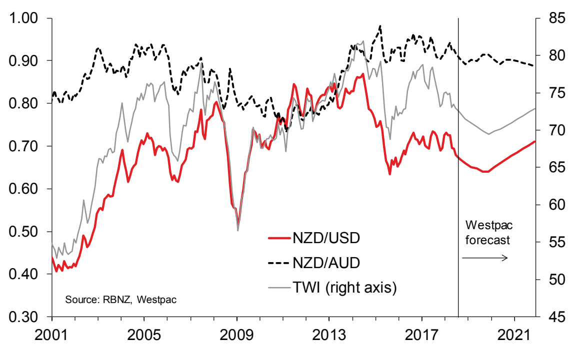
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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