May 2018

Economic Overview

Aging gracefully

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Note from Dominick

Welcome to our latest *Economic Overview.*

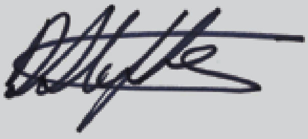
At seven years old, New Zealand's economic expansion is now entering its "mature" phase. Two years ago the economy was really in its prime. Economic growth was 4%, driven by rising house prices, burgeoning construction, population growth, and a strong terms of trade. But the economic cycle is now over the hill.

The drivers of demand are now mixed. The housing market has cooled, and consumer spending has slowed in response. The construction sector is also taking a breather, and population growth is slowing. But there are positives too – the terms of trade are strong and government spending is stimulatory. This mixture suggests the cycle will age gracefully rather than expire suddenly, with middling rates of GDP growth.

The economy is also experiencing aches and pains on the supply side, as capacity constraints start to bite. For example, firms are having great difficulty finding labour. As a consequence, we may see wage growth and non-tradables inflation slowly picking up. But low inflation has been the key feature of the current economic cycle, both in New Zealand and globally. The factors driving 'lowflation' have not gone away, so core inflation is likely to remain lower than the RBNZ would like for some time.

We still expect that the OCR will begin rising only at the end of 2019, and we are pleased to see that financial markets have largely come around to that view. There have been big changes at the RBNZ which could affect its behaviour in the future, but these have not affected the immediate OCR outlook.

Our Special Topic this quarter takes a closer look at forestry, New Zealand's third largest merchandise export. We often hear grumbling that New Zealand exports too many logs rather than value-added products, but we argue that New Zealand has positioned itself at the optimal part of the value chain.



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New Zealand Economy

The age of uncertainty

The New Zealand economy is on track for moderate growth over the next few years, but the path is riddled with uncertainties. Firms' caution towards the new Government may be having real consequences; the need for an extended period of homebuilding is hard to reconcile with a subdued housing market; and it's unclear if the tightening labour market has finally reached a turning point for wage growth and inflation.

The New Zealand economy has slowed, and we expect it to continue to grow at a moderate pace, reflecting the fact that it is now running near its full potential. Our forecasts of GDP growth over the next few years are slightly higher compared to our previous *Economic Overview,* given the prospect of an extended period of growth in government spending, though in time this will tend to crowd out private sector activity. In addition, the high level of the terms of trade and strong growth in tourism are set to provide an ongoing boost to national income.

However, there are several factors weighing against a pickup in growth. Net migration is coming off its highs, reducing one of the sources of easy growth for businesses in recent years. The housing market is likely to be weighed down by a range of government policies in the coming years. The Canterbury earthquake rebuild is winding down. And the construction sector in the rest of the country faces constraints from access to finance and skill shortages.

Perceptions and reality

The official statistics suggest that the economy has been losing momentum. GDP grew by 4% in 2016, the fastest pace in more than a decade, but slowed to 2.9% growth over 2017. Notably, the slowdown in growth dates as far back as late 2016, suggesting that the new government inherited an already-slowing economy.

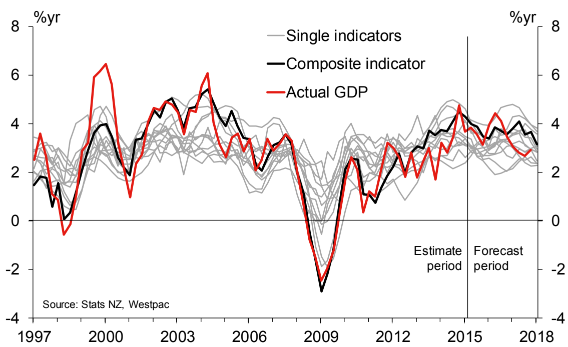
But as we detailed in our previous *Economic Overview,* the most recent GDP statistics are open to revisions that can substantially change the story. The initial reports for 2016 also pointed to a growth slowdown, which didn't seem to fit with other activity indicators at the time, and was subsequently revised away. Is there a risk that the same thing could happen with the 2017 figures?

To test this, we compiled a set of indicators that each cover a wide range of economic activity and have a positive relationship with quarterly GDP. The indicators include business and consumer confidence, retail spending, car sales, employment, electricity consumption and income tax collected.

None of these indicators on their own can capture all of the contours of growth over time. But when most of them are heading in the same direction, they provide a powerful signal about the state of the economy. Therefore, we also created a composite indicator, which captures a great deal of the variation in GDP growth. All of the indicators were estimated up to March 2015, so that they provide a 'forecast' of GDP for the last three years.

The composite indicator suggests that the extent of the slowdown in 2017 may have been overstated; the pace of growth in activity appears to have been reasonably consistent over the last few years. However, there is more support for the idea that growth has slowed from its peaks in the last few quarters.

Figure 1: GDP estimates based on activity indicators



To some degree, this slowdown is likely to be transitory. Business confidence has remained low since the election, which in part reflects nervousness about the impact of the new Government. We are expecting a hiatus in business hiring and investment over this year, with growth resuming in the following years.

But there is also some evidence that firms' perceptions of weaker prospects are matched by reality. The housing market has slowed significantly in the last year or two, and growth in homebuilding has stalled as the construction sector faces growing headwinds. Retail spending growth has slowed in line with the cooling in the housing market. And there are tentative signs of a slowdown in demand for construction workers.

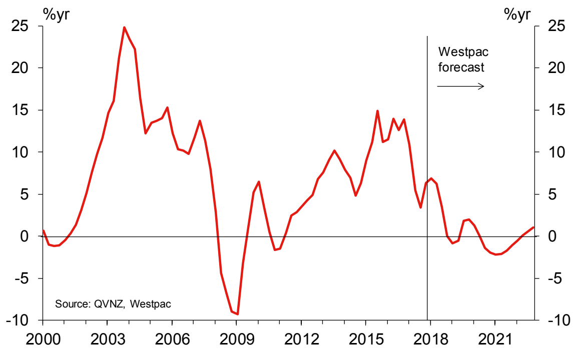
Headwinds for housing

The housing market has slowed significantly since late 2016, though there was a mild resurgence in late 2017 and early 2018 as mortgage rates fell and the Reserve Bank eased its loan-to-value ratio restrictions. In part, this may have also reflected buyers rushing in to beat a swathe of tax and regulatory changes aimed at dampening housing market speculation.

The first of these changes was the extension of the 'bright line' test, introduced at the end of March. Property investors must now hold a property for five years before selling if they want to avoid being taxed on capital gains. Later this year, a ban on foreign purchases of residential property is likely to come into force, and from next year property investors' ability to claim tax deductions on rental property losses will be phased out.

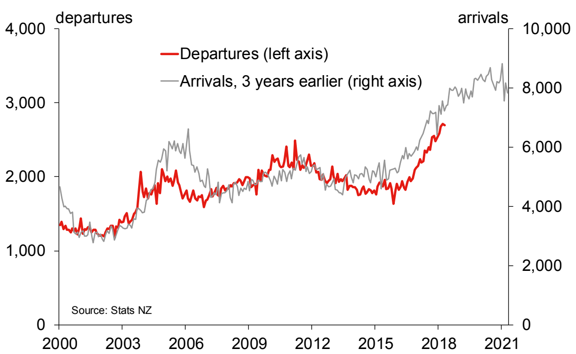
We expect that this combination of policies will soon subdue the housing market – indeed, the sales figures for April suggest that the slowdown is already under way. We continue to expect a total 2% decline in nationwide house prices over the next four years. We're not inclined to forecast a more dramatic fall, for a few reasons: the jobs market and household incomes are expected to stay in pretty good shape, the RBNZ is ready and able to relax its lending restrictions as the housing market cools, and the Government could soften its policy changes if the market slows too quickly for comfort.

Figure 2: House price inflation



Housing makes up a significant part of household wealth in New Zealand, and consumer spending tends to wax and wane in line with house price inflation. We expect a slower housing market over the next few years to be matched by a slower rate of growth in spending, relative to household incomes.

Figure 3: Migrant flows of foreign citizens



Growth in household spending is also likely to be weighed down by the slowdown in net migration that is now under way. The annual net inflow has so far slowed to around 67,000 people, compared to a peak of over 72,000 last year. Much of this is due to a jump in the departures of non-New Zealand citizens – an echo of the large numbers that had arrived on temporary visas in previous years.

We expect the slowdown in net migration to continue as job prospects in the rest of the world improve relative to New Zealand. Government policy plays an uncertain role in this – the Government's campaign pledge to reduce migrant inflows has not led to any firm policy prescriptions yet, and more recently the talk has been about refocusing migration on areas of skill shortages.

Construction: bracing needed

The second factor behind a sustained slowdown in growth is the construction sector, and particularly homebuilding. Construction was a significant driver of GDP and employment growth in past years, but the pace of growth has stalled more recently. To some extent a slowdown was inevitable, as the era of easy growth from low levels of activity has now passed. But the industry is also facing a growing number of headwinds.

It's becoming more apparent that access to finance is an issue for developers and builders alike. Lenders are wary of the industry's thin margins, rising costs, and weak balance sheets that have little scope to absorb any surprises. Skill shortages are an ongoing issue, but they may no longer be the binding constraint on growth; indeed, there are signs that demand for construction workers has slowed recently as projects are delayed or cancelled.

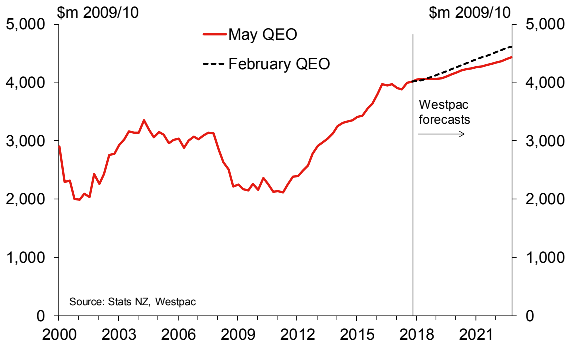
We recognise that this leaves us with a growing tension in our outlook for the housing market. There is clearly a need for an extended period of strong construction activity – we estimate that Auckland alone will need to build 130,000 homes over the next decade to fill the existing shortfall and meet future population growth. But a period of flat to falling house prices doesn't provide a financial incentive to ramp up construction.

In this situation, the government's KiwiBuild programme could play a useful role. A large share of the programme's targets will be met by buying houses off the plan from private developers. We've noted previously that, as one more buyer in a crowded market, this will do little to relieve the industry's physical constraints such as skill shortages. But if access to finance is the main barrier, KiwiBuild could help to ensure that more developments are greenlit by providing some certainty around pre-sales – provided that a portion of the development is devoted to 'affordable' homes.

However, this only goes part of the way towards resolving the tension. The initial allocation for KiwiBuild is just $2bn, and requires the Government to find private buyers for the completed homes so that the funds can be recycled into future developments. And since the Government is proposing an extensive ban on foreign purchases of residential land, the scope for an injection of offshore financing is limited.

It's likely that a greater share of housing construction over the coming years will need to be financed out of households' savings. That squares with our forecast of slower growth in household spending relative to income growth. Higher savings by some households can then be recycled into loans for those who buy the completed KiwiBuild homes.

Figure 4: Residential investment forecasts



Our forecast remains for a lift in homebuilding activity over the coming years, but at an even more gradual pace than before. We expect building activity to be close to flat over the next year, as it will take some time for KiwiBuild to ramp up and make a meaningful difference to the financing constraint.

Full steam ahead?

Government spending will help to 'fill the gap' in our growth forecasts in a broader sense as well. The new Government is planning a substantial lift in operating spending in coming years, with a focus on health, education and the public service. These plans have been assisted by a stronger than expected tax take, which means that the Government can lift spending and still maintain surpluses, in keeping with its self-imposed Budget Responsibility Rules. A large increase in infrastructure spending is also planned, though we think this will proceed more slowly than the Government's projections due to capacity constraints in the construction sector.

Our view remains that the balance of new policies, particularly those aimed at the housing market, is likely to dampen growth in the near term, while increased government spending will help to lift GDP growth in 2019 and 2020. Over time, there is likely to be an element of 'crowding out' of the private sector, with government spending accounting for a rising share of the economy, but without lifting the overall growth rate on a sustained basis.

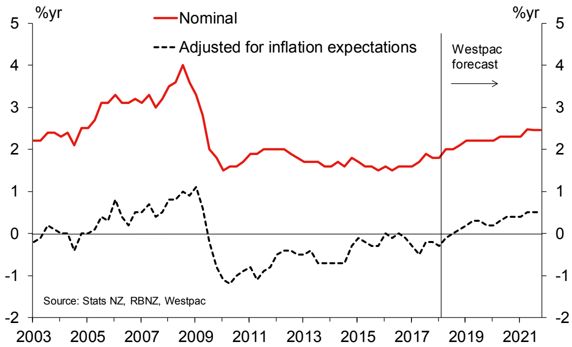
The labour market has taken on a particular resonance under the new Government, which has expressed the aim of bringing the unemployment rate below 4%. It has also tasked the Reserve Bank with contributing to 'maximum sustainable employment', which means that labour market analysis will play a greater role in future interest rate decisions.

The unemployment rate fell to 4.4% in the March quarter, putting it broadly in line with our assessment of the sustainable non-inflationary rate. Crucially, it has not been below that mark at any point in the current cycle, which partly explains the lack of a pickup in wage growth to date.

The other important aspect of low wage growth is that inflation – both actual and expected – has been substantially lower than it was during the previous upturn in the mid-2000s. Consequently, cost-of-living wage increases have tended to be smaller in recent years. After adjusting for expected inflation, wage growth looks closer to where it was in 2004, the last time that the unemployment rate was around 4.5% and falling.

The crucial question is whether the labour market has finally reached a turning point – that is, whether future economic growth will push it into inflationary territory for wages, and ultimately for consumer prices. We are expecting some pickup in wage pressures over the coming years. But with the prospect of slower economic growth and a hiring hiatus this year, in response to the uncertain impact of the new Government's policies, we actually expect unemployment to pick up a little by the end of this year, before improving again in the following years. As a result, we expect only a gradual lift in real wage growth, even with the impact of policies such as minimum wage hikes and increased collective bargaining.

Figure 5: Labour Cost Index, annual change



Trade a highlight

New Zealand's international trade performance remains a bright spot. The terms of trade reached an all-time high last year, with price gains spread widely across our commodity exports. While we may see some headwinds for export prices this year, we expect them to remain at relatively high levels over the coming years. Tourism has also been a useful source of growth, with visitor numbers reaching new highs. A lower New Zealand dollar will help to boost export returns and make New Zealand a relatively more attractive tourist destination.

Strong export earnings are providing the income required for New Zealand to grow without ramping up debt further. This squares our expectation of reasonable economic growth with our observation that the household savings rate will rise. The corollary is that New Zealand will be able to maintain low current account deficits compared to past periods of growth.

Inflation

Not there just yet

Higher oil prices and a lower NZ dollar will see inflation briefly rise above 2% over the coming year. Changes in government policy and continued low interest rates will also boost inflation over time. Nevertheless, inflation is likely to linger in the lower part of the RBNZ's target band for most of the next few years.

Consumer price inflation fell to 1.1% in the March quarter, down from 1.6% at the end of 2017. Over the coming year, we expect headline inflation will push higher, and will briefly reach the 2% mid-point of the RBNZ's target band. This is largely a result of the recent drop in the NZ dollar and a sharp rise in oil prices. Core inflation, in contrast, is expected to linger below 2% for some time.

Smoothing through short-term volatility associated with commodity prices, we expect inflation will gradually trend higher over the next few years. A further decline in the NZ dollar will add to imported inflation. In addition, economic growth is expected to be strong enough to generate some lift in non-tradables inflation (although this rise is likely to be more moderate than the RBNZ is expecting).

On top of those underlying drivers, some specific factors are shaping the outlook for inflation. On the upside are several significant changes in government policy that will directly affect consumer prices, such as increases in petrol taxes.

Changes in government policy will also see a lift in wage growth over the next few years as a result of increases in the minimum wage and collective bargaining agreements. While wage increases will add to costs in some industries, on their own they are not expected to result in significantly higher inflation. Competitive pressures are keeping a lid on prices in many industries. In addition, in some areas where we expect to see wages rising, such as health services, there is not a strong relationship between wage costs and the prices that consumers face. Nevertheless, increases in spending associated with higher wages will result in some lift in inflation.

While the above factors will push inflation higher, several long lasting factors are likely to limit price increases. As a result, inflation is still expected to linger in the lower half of the RBNZ's target band for most of the next few years.

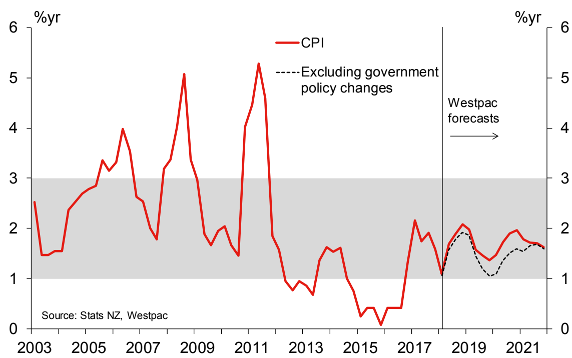
In the retail sector, strong competitive pressures are continuing to dampen prices and squeeze margins. An expected easing in consumption spending growth over the next few years as the housing market cools will reinforce such softness.

Domestically sourced inflation is expected to rise only gradually from its current below average levels. Although capacity pressures have firmed in recent years, the economy as a whole is not highly stretched in terms of resource pressures. In part, this is because much of the strength in economic growth in recent years came on the back of record net migration that boosted not only demand, but also supply capacity.

The domestic components of inflation also include many 'non-market' or administered prices. These prices have been rising at a much more modest pace in recent years, and we expect this pattern will continue for some time. In addition, we will see reductions in the prices for some government charges, including tertiary education fees and doctors visits.

Finally, there has been a decline in inflation expectations in recent years. Expectations are a significant influence on wage and price setting decisions, and their step-down is likely to continue weighing on inflation for some time yet.

Figure 6: CPI inflation



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Jun-18	1.7	1.75	2.00	2.20	2.70
Sep-18	1.9	1.75	2.00	2.20	2.75
Dec-18	2.1	1.75	2.00	2.30	2.90
Mar-19	2.0	1.75	2.00	2.40	3.05
Jun-19	1.6	1.75	2.00	2.55	3.15
Sep-19	1.5	1.75	2.10	2.70	3.25
Dec-19	1.4	2.00	2.20	2.80	3.30
Mar-20	1.5	2.25	2.45	2.90	3.40
Jun-20	1.7	2.25	2.45	2.95	3.45
Sep-20	1.9	2.25	2.50	3.00	3.50

The Reserve Bank and the OCR

The more things change, the more they stay the same

The Reserve Bank has a new Governor and a new Policy Targets Agreement that instructs it to contribute to supporting ‘maximum sustainable employment’. Next year a law change will formalise the RBNZ’s dual mandate to target both employment and inflation, as well as shifting to a committee structure for making monetary policy decisions. We discuss what all of this might mean for the OCR.

The first thing we noticed about the Reserve Bank’s new Policy Targets Agreement (PTA) was that the inflation target was broadly unchanged – the RBNZ is still responsible for keeping inflation between 1% and 3%, with a focus on the two percent midpoint. That focus on two percent was critical for the RBNZ’s credibility, and has been repeatedly emphasised by Adrian Orr, the new Governor.

The new labour market directive for the RBNZ is quite different. It is not numerical, and it casts the RBNZ as a supporting actor rather than the responsible party – the RBNZ only needs to “**contribute** to **supporting** maximum sustainable employment” (our emphasis).

So how is this rather vague labour market directive going to affect the RBNZ’s behaviour? The long run average level of the OCR will not change, and neither will the long-run focus on inflation. As the RBNZ said in the May *Monetary Policy Statement (MPS),* the best long-run contribution monetary policy can make to employment is to keep inflation generally low and stable – it is simply not possible to do better than that by the labour market. The RBNZ has also emphasised that the labour market target is symmetrical – employment rising above the maximum sustainable level should be avoided just as much as below.

The labour market target will affect the speed and vigour with which the RBNZ attempts to correct any deviation from the inflation target. But that is functionally similar to the RBNZ’s existing directive to avoid unnecessary instability in output, interest rates and exchange rates. For example, the RBNZ previously eschewed cutting the OCR below 1.75% on the basis that doing so would cause unnecessary volatility, even though inflation is below target. After the change of PTA, the RBNZ issued almost exactly the same OCR outlook. But it switched the justification for not cutting the OCR to include the labour market – cutting the OCR would push employment beyond the maximum sustainable level.

Where the dual mandate will make a difference is in the assessment of the economy. The RBNZ has now shifted its attention more towards labour market indicators, and will place less emphasis on economy-wide concepts like the output gap. The two are not always in line – for example, from 2014 to 2016 employment was clearly below the maximum sustainable level while the output gap implied that the overall economy was operating above its sustainable capacity. A dual mandate might have made the RBNZ a little more dovish over that period.

In the May *MPS,* the RBNZ discussed a range of metrics that could be used to ascertain where employment is relative to the maximum sustainable level, and was at pains to emphasise that unemployment is not the only measure. The RBNZ’s conclusion was that employment is currently close to the maximum sustainable level.

The paucity of wage growth, however, might belie the RBNZ’s judgement. Surely if the labour market was tight, wage growth would be higher? The RBNZ’s response seems to be that wage growth is just around the corner. We will be watching wage growth very closely, because if it falls short of the RBNZ’s expectations, the RBNZ may become more dovish.

The other big change at the RBNZ over the coming year will be a shift to a committee structure for monetary policy, rather than legal responsibility for the decisions being vested solely in the Governor. This will be a voting committee, with non-attributed vote counts published and non-attributed records of the meetings published. However, the RBNZ Governor will still be in a more powerful position than many overseas central bank chiefs. The committee will always have a majority of RBNZ staff who report to the Governor, the Governor will chair the committee, and the Governor will be its sole spokesperson.

It is difficult to say how the shift to a committee will affect actual OCR decisions. The external members will not be monetary economists, and in our experience that means they may be more loath to increase interest rates. And a committee may be less likely to move the OCR rapidly or set it far from historical average levels – whether that caution is an advantage or a disadvantage remains to be seen.

Our OCR call for the coming couple of years has not changed – we still expect the OCR to remain unchanged until late 2019. Rising oil prices and the Government’s expansionary Budget have tilted the balance of risks away from OCR cuts. But our long-held view remains that a slowing housing market will put a lid on economic growth and core inflation, and that will prevent the RBNZ from hiking. The slowing housing market will probably also prompt the Reserve Bank to loosen macroprudential policy this year and next year.

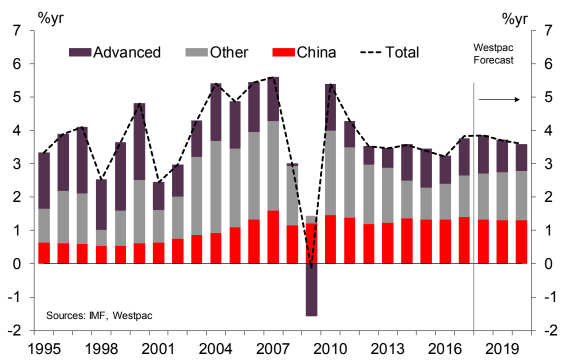
Global Economy

Uneven outlook

The overall pace of global economic activity is set to remain firm over the next few years. However, conditions are likely to be uneven across regions, with slowing growth in Asia-Pacific economies that are key trading partners for New Zealand. Recent months have also seen rising trade tensions, pressure in global funding markets, and a sharp lift in oil prices.

Global economic activity picked up steam over the past year, with global GDP growth accelerating to 3.8%. That's the fastest pace since 2011. We expect that overall global economic activity will continue to expand at a brisk pace over the next few years. However, conditions are likely to be uneven across regions.

Figure 7: Contributions to world growth (annual)



At the head of the pack is the US, which is expected to continue growing at a healthy clip, supported by a substantial increase in fiscal stimulus. The resulting lift in US interest rates will also drag interest rates higher in other regions.

In contrast, momentum in some of New Zealand's other major trading partners is expected to be subdued. Most notably, we expect that Chinese GDP growth will slow from around 7% as seen in recent years to about 6% as credit conditions continue to tighten.

Softening demand in China will also dampen growth in many other economies. This is particularly important for Australia as it comes atop softness in domestic activity. We expect Australian GDP growth will remain below trend for the next few years.

Trade tensions

There are some dark clouds on the global economic horizon. First is an increase in trade protectionism. Earlier this year, President Trump threatened to impose tariffs on imports to support US manufacturing, with US trade with China a particular focus. The resulting tit-for-tat retaliatory measures have raised concerns about a potential trade war.

Threatened trade restrictions have not yet been put into effect, and it's looking increasingly likely that a diplomatic solution will be found. Nevertheless, recent developments have contributed to increased uncertainty around the economic outlook, and associated volatility in financial markets.

For New Zealand exporters, the rise in protectionist sentiment, evident not only in the US but also elsewhere, signals an uncertain environment. While we have not been directly targeted with restrictions thus far, we can't entirely rule this out in the future. For instance, the US has taken issue with Canadian dairy exports, and this could spill over to affect New Zealand. Furthermore, if trade restrictions were put in place targeting other regions, these could slow global economic activity, with knock-on effects for New Zealand's exports.

The rise in funding spreads

Recent months saw a widening in the spread between US dollar LIBOR interest rates (which reflect how much it costs banks to borrow from each other) and OIS rates (which reflect expectations of the Fed Funds rate). In mid-April, the gap between these two interest rates reached its highest levels since the Global Financial Crisis.

This increase in spreads has prompted concerns about funding pressures in financial markets, which could be an early indicator of downside risk for economic and financial conditions. However, there are a number of additional factors that may be contributing to the widening in spreads. These include:

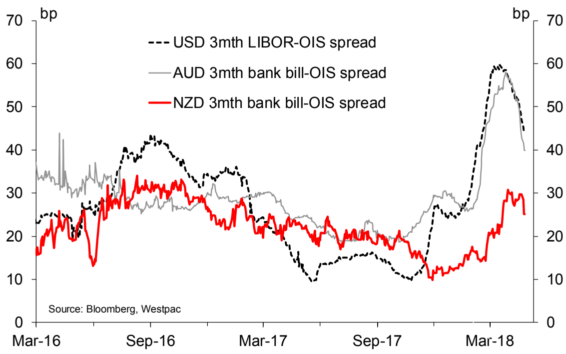
- The reversal of Quantitative Easing by the US Federal Reserve.
- Recent tax changes that have encouraged US corporates to repatriate funds on-shore.
- Concerns about the funding of US fiscal debt.

This issue has also spilled over into Australian and, to a lesser extent, New Zealand markets, with interest rates rising independently of central bank policy rate expectations.

Recently, the widening of spreads across Australia, New Zealand and US markets has been arrested, with spreads in all three markets easing back a little since mid-April. Nevertheless, spreads remain elevated relative to recent history.

The longer the spread between Bank Bill and OIS interest rates remains elevated, the more likely it will move further out the curve to longer dated maturities. And if sustained, it is also more likely that higher interest rates will be passed on to consumers via higher mortgage and deposit rates.

Figure 8: Spread between bank borrowing rates and central bank rate



Oil prices up, other prices rising gradually

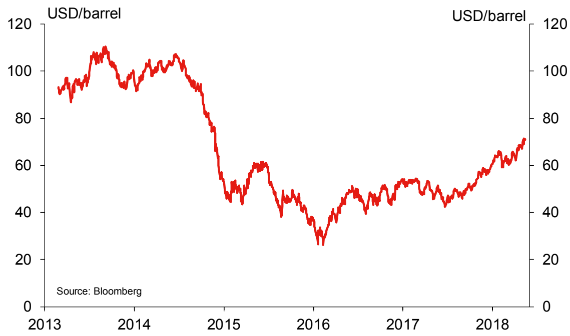
Along with a strengthening in global activity, the past year also saw a lift in global inflation. Much of this was related to oil prices, with West Texas Intermediate rising by around 40% over the past year, from below US$50/barrel in May 2017 to over US$70/barrel at the time of writing. As well as increases in global demand and production cuts, oil prices have been boosted in recent weeks by tensions in the Middle East, including the recent US decision to exit the Iran nuclear deal.

In New Zealand, the rise in oil prices has already resulted in higher prices at the pump, and is likely to pass through into higher prices for other goods and services.

We expect that global oil prices will remain elevated through 2018. OPEC production curbs are likely to persist for some time. In addition, there is increased concern about economic stability in key exporting nations such as Venezuela, which could significantly affect supply.

However, over time current high prices are likely to encourage an increase in global oil production. We also expect that slowing economic growth in China will weigh on oil demand over time. These conditions are expected to result in oil prices easing back again over 2019.

Figure 9: West Texas Intermediate crude oil price



Outside of oil prices, there has also been a more general firming in global inflation as economic growth has strengthened. Some further increase in inflation is expected over the next few years. However, this will still only see global inflation rising back to moderate levels after an extended period of weakness.

Several key factors are limiting the extent of the pick-up in global inflation. In most regions, wage growth has not significantly accelerated, even as GDP growth has firmed. On top of this, competitive pressures, in part related to the continued growth in online retail spending, are weighing on the prices of consumer goods in many regions. Finally, decelerating economic activity in China and other regions will dampen prices for many commodities over the coming years. This combination of conditions reinforces our expectations for continued softness in imported consumer price inflation in New Zealand.

Economic forecasts (calendar years)

Real GDP % yr	2014	2015	2016	2017	2018f	2019f
New Zealand	3.6	3.5	4.0	2.9	2.7	3.0
Australia	2.6	2.5	2.6	2.3	2.7	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	2.8	2.5
Japan	0.4	1.4	0.9	1.7	1.3	1.0
East Asia ex China	4.2	3.8	3.9	4.5	4.3	4.3
India	7.4	8.2	7.1	6.7	7.0	7.0
Euro zone	1.3	2.1	1.8	2.3	2.1	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**	**3.8**	**3.7**
World	**3.6**	**3.5**	**3.2**	**3.8**	**3.8**	**3.7**

Forecasts finalised 18 May 2018

Agricultural Outlook

Prices not the problem

New Zealand's commodity prices remain in a sweet spot. With the odd exception, commodity prices are at very healthy levels and have generally been stronger than we expected in recent months. Even dairy prices are at levels that should leave most dairy farmers comfortably in positive cash flow territory. However, growth has slowed in China and is set to slow further. We expect this will become an increasing headwind for commodity prices as we move through this year.

In the main, New Zealand commodity prices have continued to defy gravity over the past three months. Lamb prices have been buoyant, supported by tight supplies. Robust demand has supported international beef prices even as supply has grown. In the horticulture sector, apple and kiwifruit prices remain favourable. The main challenge for growers is finding enough workers to pick the fruit.

While dairy prices are sitting near the middle of the pack, if our forecast of a $6.40 milk price for the 2018/19 season proves to be correct, it would mark a period of unusual stability in dairy prices with three consecutive seasons of a $6-plus milk price. This might come as a welcome relief to dairy farmers facing big changes on other fronts. Nutrient caps, the possible inclusion of agricultural emissions in the Emissions Trading Scheme (ETS), higher hurdles for foreign purchases of rural land, the simmering debate around water rights and the review of the 17-year-old Dairy Industry Restructuring Act are just some of the issues the sector is currently grappling with.

In addition, the impact of the Mycoplasma bovis outbreak is becoming more widespread. The disease, which can cause a range of quite serious conditions in cattle, was discovered in New Zealand last year. The disease has the potential to impact on farm productivity and animal welfare, but the biggest effect might be on already fragile confidence. For now, the sector is waiting for an official decision on whether efforts will focus on phased eradication, which would be expensive and not guaranteed to succeed, or long-term management of the disease, which would pose ongoing costs to the sector – a position other dairy producing countries are already in.

Mycoplasma bovis adds to the growing list of biosecurity incursions the New Zealand agriculture sector has faced recently. Queensland fruit fly, Psa and the pea weevil have all been unwelcome arrivals on New Zealand shores and have hit New Zealand's agricultural production to varying degrees.

Our small island nation has benefitted from becoming more interconnected with the rest of the world via trade and tourism. But at the same time, the risk of damage to our agricultural sector from some kind of foreign invader has become more acute. The lesson for both industry and the Government is that they need to cooperate to deal with incursions quickly, effectively and efficiently when they inevitably happen. The kiwifruit industry eventually managed to make lemonade out of lemons, and there is the potential for other industries to do the same. If not, New Zealand faces the prospect of an erosion of one of the important advantages it currently holds over other food producing countries.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Demand for logs has remained strong to date, but is expected to slow going forward as Chinese demand cools.	High	↘
Wool	Fine wool prices benefitting from strong demand for merino wool, but coarse wool prices still weak. We are watching the development of new wool trading platform with interest.	Above Average	→
Dairy	Period of relative stability in dairy prices expected to continue. Within this trend prices are expected to soften a little over the remainder of this year before improving again in 2019.	Above Average	↘
Lamb	Firm local prices supported by tight global supplies. Demand for high value cuts exported to traditional markets expected to come under the most pressure.	High	↘
Beef	Prices have eased a little and expected to ease further in line with increased production, particularly in US. This trend likely to continue in the coming months, putting downward pressure on prices.	High	↘
Horticulture	Some regions facing labour shortages during harvest, likely amplified by increased plantings. Solid demand underpinning firm prices in the sector.	High	↘

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

Exchange Rates

Falling into line

There has been a compelling case for a higher US dollar for some time on the back of rising US interest rates and a firmer growth outlook. It's taken a while for markets to come to the same view, but in recent weeks they have fallen into line and the US dollar has appreciated sharply. We expect the NZD/USD to fall further over the course of the year.

At the time of the February Economic Overview we were scratching our heads about the strength of the NZD/USD. We struggled to make sense of market pricing, and in the end we put it partially down to a market overreaction that would iron itself out over time.

This has proven to be the case. After defying gravity over the first few months of 2018, the NZD/USD has fallen sharply in recent weeks on the back of a stronger US dollar. Once again, what triggered this shift in sentiment is up for debate. The list of possible catalysts includes increased confidence in the US rate hike cycle, reduced optimism about the outlook for European and UK growth, and greater certainty about improved growth prospects in the June quarter after softer data in Q1. In addition, the gradual grind higher in interest rates has also seen rates rise to levels that have currency markets sitting up and taking notice.

Whatever the case, fundamentals are now back in the driver's seat in currency markets – which brings markets in line with our own thinking. We firmly expect the NZ dollar to depreciate over the year ahead.

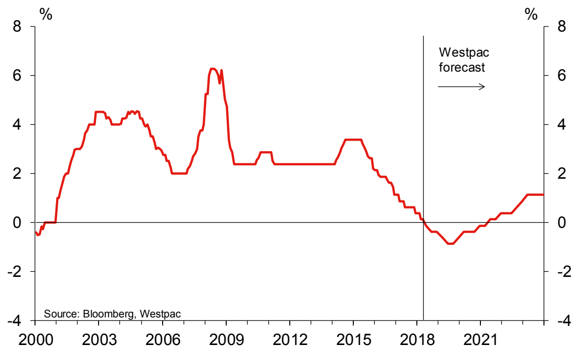
New Zealand's yield advantage is fast disappearing. The RBNZ is set to remain firmly on hold this year and most of next as the near-term lift in inflation proves transitory. Meanwhile, the Federal Reserve looks set to continue to tighten monetary policy settings. Adding further weight to our view is a forecast weakening of New Zealand's export commodity prices on the back of growing global supply and slower growth in China. Any further bouts of volatility in global markets, which we've seen a few of this year, would also tend to favour a lower NZD/USD. We expect the NZD/USD to fall to around 64 cents by September 2019.

It wasn't only against the USD dollar where the NZD displayed surprising strength. We were surprised to see the NZD/AUD rise as high as 95 cents in April – well above our estimates of fair value. However, in recent weeks the NZD/AUD has depreciated, falling to a more sensible level around 92 cents. In the near-term momentum could see it fall a little further yet.

That said, fundamentals argue in favour of the NZD/AUD not falling much further after that. Our view remains that the RBA won't be raising interest rates until early 2020. That's much later than market pricing, which is consistent with more than a 50% chance of a rate hike by March next year. In addition, we expect slower growth in China to weigh on Australian commodity export prices more than New Zealand's soft commodity dominated export basket.

That leaves us forecasting the NZD/AUD to broadly track sideways from here, hovering a little above the 90 cent mark throughout the forecast horizon.

Figure 10: Difference between US Fed Funds rate and OCR



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Jun-18	0.70	0.92	0.58	0.52	77.0	73.0
Sep-18	0.68	0.91	0.57	0.52	75.5	71.4
Dec-18	0.67	0.91	0.57	0.53	75.0	70.9
Mar-19	0.66	0.92	0.56	0.54	75.2	70.6
Jun-19	0.65	0.92	0.55	0.53	73.5	69.8
Sep-19	0.64	0.91	0.53	0.52	71.7	68.9
Dec-19	0.65	0.93	0.53	0.53	71.5	69.7
Mar-20	0.66	0.92	0.54	0.54	71.9	70.1
Jun-20	0.66	0.90	0.53	0.53	71.3	69.7
Sep-20	0.67	0.91	0.53	0.53	71.7	70.1

Special Topic

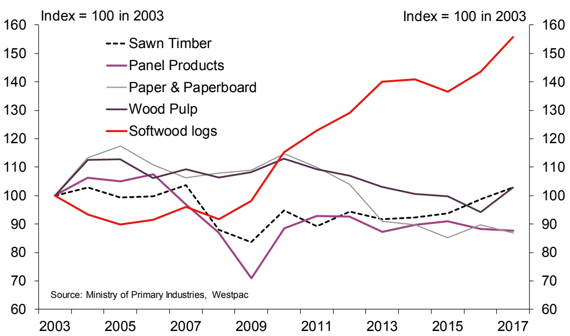
Turning the tables – forestry and wood processing

New Zealand is able to produce logs quicker and faster than most countries. However, these competitive advantages are largely eroded by downstream wood processors, who do not have the scale required to compete head-on with large producers in key export markets. While cyclical factors suggest that the fortunes of these industries could reverse in the near term, structural drivers are likely to underpin log production in the long term, which could prove challenging for downstream wood processing.

The forestry sector, which produces softwood logs, sawn timber, wood panel products and pulp and paper, generated export earnings of $5.4bn in 2017, making it our third biggest merchandise export after dairy and meat. The sector also employs about 24,000 people, mostly in deprived rural areas where employment prospects are often limited.

Softwood logs have been the standout performer. Production volumes have grown strongly in recent years, mostly because of demand out of China and elevated log prices. Sawn timber production has also grown, although at a more measured pace, mainly because its fortunes are more closely linked to what happens domestically. The manufacture of most wood panel and pulp and paper products has trended downwards in recent years.

Figure 11: Forestry sector production



The forestry sector exports a significant proportion of its production. But most of this is low value logs rather than higher value structural sawn timber and wood panel products. By contrast, the world's largest wood product producers typically focus on high value processed products.

Wood processors argue that the industry should follow suit. They suggest that focusing on higher value added products will provide a bigger boost to regional economic growth and will create more jobs than at present. However, this argument doesn't take into account the limitations of a small domestic market or whether downstream wood processors have the scale to compete in geographically distant markets where there are already well entrenched competitors. All things considered, log production is probably the most profitable segment for the industry to operate in.

That said, log production is not without its challenges. Not least of these is the sustainability of forestry given the maturity profile of the forests in New Zealand and evidence that some small log producers, looking to maximise revenues at higher prices, have been harvesting trees before they mature. The fear is that by cutting down less mature trees now to cash in on higher prices, harvesting over the next five years or so may exceed tree growth and forestry could end up adding to New Zealand's carbon emissions in coming years. This could drive up the price of carbon, which would be important if New Zealand were to adopt a comprehensive Emissions Trading Scheme.

The near-term prospects for log producers are less favourable than they have been. Chinese demand for logs is set to slow as economic activity eases and structural reforms impact on residential building activity. In the absence of another country picking up the slack, log prices can be expected to ease from current levels. A forecast weakening of the New Zealand dollar could provide some offset.

By contrast, the wood processing industry should benefit from lower prices and increased availability of logs. Whether they can absorb this increase will depend largely on domestic conditions and residential building activity. With the Christchurch rebuild now winding down, the fortunes of the industry will become more closely linked to what happens in Auckland, where acute housing shortages are expected to remain. Demand will also be supported by a lift in homebuilding in other parts of the country, including Wellington and Otago.

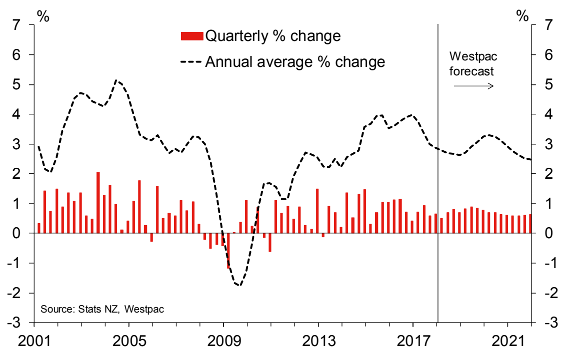
Looking further ahead, the structural drivers of demand are likely to come to the fore and support log production. As the world's population expands, so too will the demand for logs. China will continue to be a major source of demand, but other countries are likely to join the fray. Among them is India, where demand is expected to follow a similar growth trajectory to China.

The same cannot be said for the wood processing industry, which is likely to find itself in much the same situation that it is in today. With more logs going overseas to feed offshore demand, there are likely to be fewer logs available to the local processors, most of whom will still lack the scale needed to compete in global markets. This competitive disadvantage will continue to be exaggerated by New Zealand's distance from key markets.

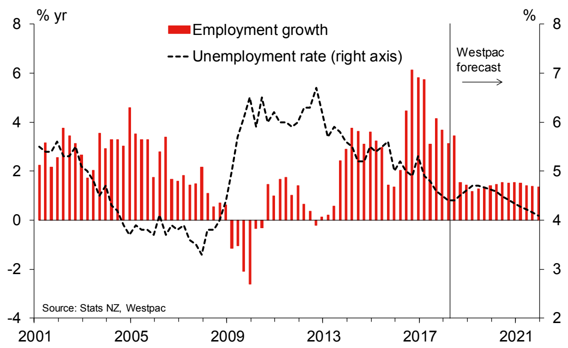
Forecasts and key charts

	Quarterly % change				Annual average % change			
	2017	2018			Calendar years			
	Dec (a)	Mar	Jun	Sep	2017 (a)	2018	2019	2020
GDP (production)	0.6	0.5	0.7	0.8	2.9	2.6	3.2	2.9
Private consumption	1.2	0.2	0.8	0.9	4.5	3.1	3.1	2.9
Government consumption	-0.1	0.7	0.8	0.9	4.7	3.6	4.0	4.7
Residential investment	0.5	0.7	0.3	0.1	0.6	2.7	1.0	2.9
Business investment	3.8	-0.3	0.0	-0.1	4.5	3.0	2.7	3.7
Stocks (% contribution)	1.3	0.2	-0.5	0.0	0.0	0.2	-0.1	0.0
Exports	0.0	-1.0	1.2	1.2	2.5	2.5	4.4	2.6
Imports	3.9	0.7	-0.6	0.6	6.6	4.9	3.2	4.0
Consumer price index	0.1	0.5	0.6	0.7	1.6	2.1	1.4	2.0
Employment change	0.4	0.6	0.2	0.3	3.7	1.4	1.4	1.5
Unemployment rate	4.5	4.4	4.4	4.5	4.5	4.6	4.6	4.3
Labour cost index (all sectors)	0.4	0.3	0.6	0.7	1.8	2.1	2.2	2.3
Current account balance (% of GDP)	-2.7	-2.7	-3.1	-3.5	-2.7	-3.6	-3.7	-3.3
Terms of trade	0.8	-2.0	-0.1	-0.7	7.3	-4.0	-0.2	2.3
House price index	3.3	1.2	0.5	-1.5	6.3	0.0	2.0	-2.0
90 day bank bill (end of period)	1.79	1.80	2.00	2.00	1.79	2.00	2.20	2.70
5 year swap (end of period)	2.66	2.71	2.70	2.75	2.66	2.90	3.30	3.55
TWI (end of period)	73.8	74.9	73.0	71.4	73.8	70.9	69.7	70.8
NZD/USD (end of period)	0.70	0.73	0.70	0.68	0.70	0.67	0.65	0.68
NZD/AUD (end of period)	0.91	0.92	0.92	0.91	0.91	0.91	0.93	0.91
NZD/EUR (end of period)	0.59	0.59	0.58	0.57	0.59	0.57	0.53	0.53
NZD/GBP (end of period)	0.52	0.52	0.52	0.52	0.52	0.53	0.53	0.54

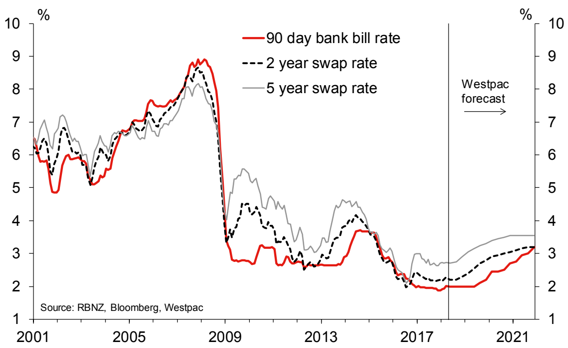
New Zealand GDP growth



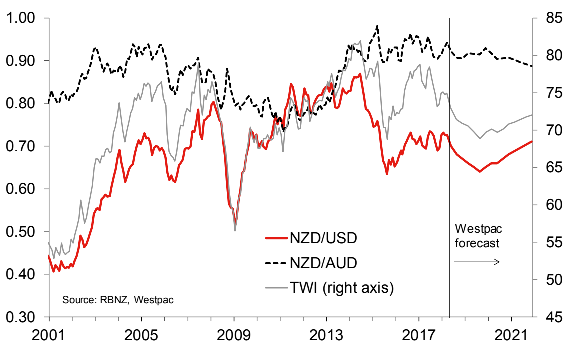
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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