November 2018

Economic Overview

Different strokes

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Note from Dominick

New Zealand's economy at present really is a case of different strokes for different folks. Auckland and Canterbury are experiencing lacklustre economies and flat or falling house prices. There is a completely different feel in some other parts of the country, where local economies are at their most buoyant in years.

For the national economy, our last *Economic Overview* predicted a near-term economic pickup. That call was against the grain of sentiment at the time, but it is now clear that the economy is indeed improving. We expect the economy will continue to improve for a while yet, before a renewed slowdown sets in for the early-2020s.

On the inflation front, we are hearing increasing concerns about costs, and wage inflation is clearly picking up. This and other signs of burgeoning inflation pressures have seen us lift our inflation forecast. But competition in the retail sector and falling prices in areas the government controls, such as tertiary education, are large offsetting forces. Overall we expect inflation to remain fairly contained at around two percent for the coming few years.

Compared to our previous forecasts, we've made an unusual set of changes – we have increased our GDP growth and inflation forecasts, while at the same time reducing our OCR and exchange rate forecasts. The changes to the Reserve Bank Act square the circle. It is becoming clearer that the central bank's behaviour has changed – it will keep the OCR low for longer than the RBNZ of old, even as inflation rises to 2%. If the OCR stays low for longer, inflation and growth will rise higher in the short run. But if the central bank zigs now, it will have to zag later – over the long run, this will lead to higher inflation and higher interest rates.

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

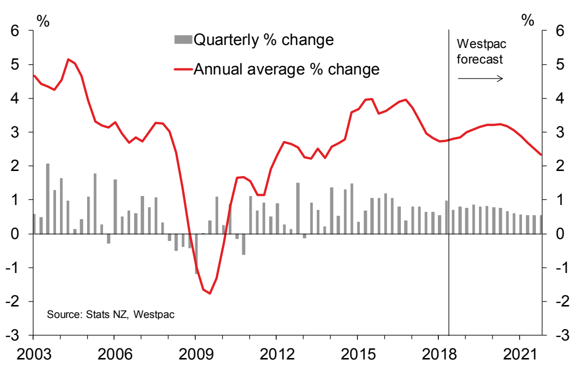
Second wind

New Zealand is on track for a stronger, albeit temporary, patch of growth over the next couple of years, supported by house prices, building activity and government spending. However, some differences in regional performance are becoming apparent, in part due to shifting patterns of population growth. One consistent theme across the country is a tightening labour market, with stronger wage growth expected to follow.

The New Zealand economy has continued to grow steadily over the last year, defying the crisis of confidence that has been portrayed in business surveys. Recent GDP figures have been somewhat choppy – the details suggest that growth was temporarily soft in the first quarter of this year and temporarily strong in the second. But the underlying picture has been one of moderate growth, though down from the heights reached a couple of years ago.

Compared to our last *Economic Overview*, we have slightly upgraded our GDP forecasts for the next couple of years. Our view remains that the next phase for the local economy will be a pickup in the pace of growth, aided by government spending, low interest rates and renewed growth in homebuilding. But we also see this upturn as short-lived, with slower population growth and a weaker housing market to weigh on spending as we head into the next decade.

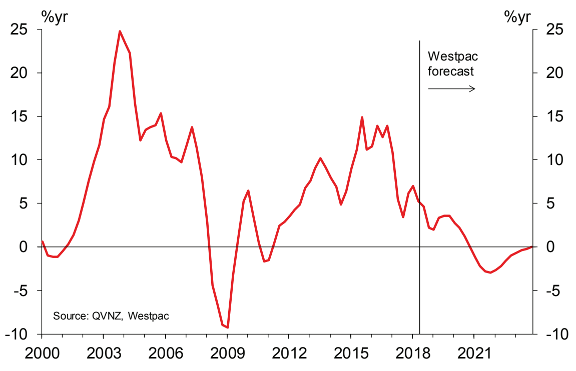
Figure 1: GDP growth forecasts



Stronger growth next year

The more positive outlook for near-term growth reflects a number of factors. Firstly, we have raised our forecast of house price growth, which will help to support consumer spending. There are still a range of headwinds for the housing market in place and on the horizon. Investors are facing a battery of policy changes, including the extension of the 'bright-line' test, restrictions on foreign buyers, the removal of negative gearing, and the possibility of a broader capital gains tax. On top of this, banking regulation and practice are both tending towards tighter lending conditions than in the past. We expect house price growth to remain modest over the coming years, turning to declines by 2020 as interest rates gradually rise.

Figure 2: House prices



But for now, the housing market outlook has turned more positive. Wholesale interest rates have fallen sharply in the last few months, spurred by the Reserve Bank's softer stance. Mortgage rates have followed suit, with some fixed-term rates now back to or below the previous record lows seen in 2016. We expect that this will temporarily revitalise house price growth over the coming months.

We also expect that the Reserve Bank will further ease the loan-to-value ratio (LVR) restrictions on mortgage lending, perhaps as soon as the November *Financial Stability Report*. House prices and credit growth have remained in check in recent months, and a modest loosening of the LVR limits, on its own, is unlikely to send the housing market out of control. However, an easing of the LVR limits would provide some more momentum to the housing market in the early part of next year.

Another major factor supporting the near-term GDP growth outlook is a planned acceleration in government spending. The May Budget included a sizeable funding boost for health and education over the coming years, much of which is likely to go towards hiring and pay increases. The Budget also included the Families Package, a range of transfers to low-income households, which took effect in July. This means that a portion of the extra fiscal stimulus will show up in GDP data as household consumption rather than government spending.

The latest fiscal accounts suggest that the Government has plenty of room to manoeuvre. The tax take has continued to run ahead of forecasts, even if the economy itself hasn't. Net core Crown debt has dropped below 20% of GDP years sooner than expected, though this is partly due to persistent delays in capital spending. Our view is that the Government will continue to struggle to ramp up capital spending by as much as planned, but that this will leave even more room to increase operational spending – and there will no doubt be many demands on the public purse in the coming years.

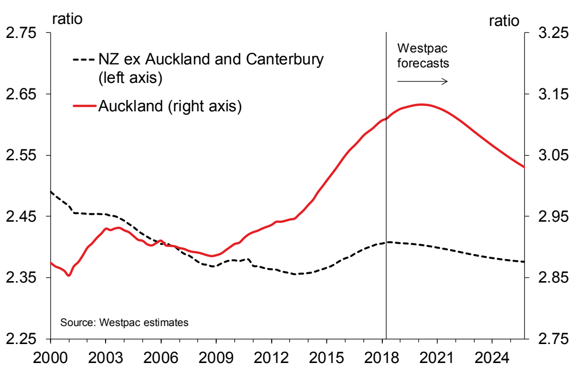
Construction activity is set to take another leg up over the next year. Housing construction rose rapidly up until 2016, but growth subsequently stalled due to difficulty accessing finance and falling house prices, which reduced the attractiveness of property development. However, recent consents figures indicate that building in Auckland is gaining a second wind. Almost 13,000 homes were consented in the last year, compared to just over 10,000 in the previous year, with the rise skewed towards apartments and townhouses. Given the usual lag between consent and construction, this is a clear indication that building activity will increase next year.

Auckland was previously building too few houses relative to population growth, leading to a worsening housing shortage as indicated by a rise in the estimated number of people per dwelling. But we are now roughly at the point at where construction activity is commensurate with population growth, which has slowed. We expect the housing shortage will stabilise soon, and begin to ease in the early 2020s. At that point, Auckland construction will be less of a driver of economic growth.

In Canterbury, homebuilding has been slowing as the post-earthquake rebuild is completed, and we expect that to continue. In regions other than Auckland and Canterbury, homebuilding has been steady at a high level, and is expected to remain so for a while yet.

Altogether, we are forecasting a 5% lift in housing construction next year. However, we expect low growth in subsequent years as population pressures ease and the housing market cools.

Figure 3: People per dwelling



Non-residential building is also set to pick up, though the timelines for this tend to be longer and more variable than for housing. Recent building consents and project announcements confirm that there are a large number of commercial and infrastructure projects in the pipeline. This activity will be spread across the country, but with Auckland accounting for a large share.

We're more circumspect on the outlook for business investment. Surveys have shown a sharp drop in business confidence and investment intentions in the last year. These responses are probably a poor guide to the economy's overall trajectory, but they could signal a period of caution on business investment. The lower New Zealand dollar could also dampen investment in plant and machinery, which tends to have a high import share.

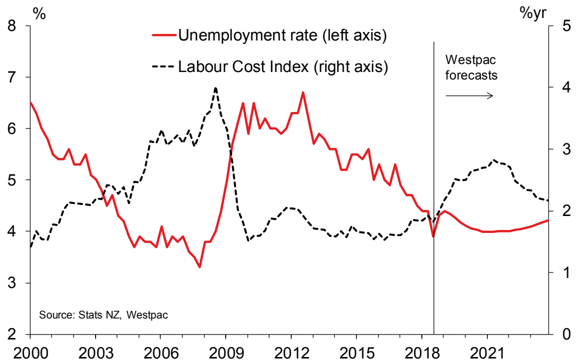
In contrast to the domestic drivers, overseas trade is likely to play less of a part in the pick-up in growth next year. As we note in the *Agricultural Outlook* section, export commodity prices have softened, which will offset any growth in volumes and the lower New Zealand dollar. Growth in international tourism is now slowing, as airfares increase in response to the recent rise in oil prices. On the other hand, higher airfares and a lower exchange rate make it relatively more attractive for New Zealanders to holiday at home rather than overseas.

A sea change for the labour market

There's now a more convincing case that the labour market has entered 'tight' territory. The difficulty of finding workers has been a long-running refrain in business surveys and anecdotes. But it's only more recently that there has been evidence of rising cost pressures for businesses, as they are forced to increase pay rates to attract or retain workers.

The unemployment rate fell sharply in the September quarter, from 4.4% to a ten-year low of 3.9%. We're wary of this result, given the volatility of the survey – movements of this size are not unprecedented, and are often reversed the next time. Nevertheless, the positive trend in employment appears to be intact. And with GDP growth set to pick up a little in the near term, we expect that unemployment will be below its neutral, or non-inflationary, level over the next few years.

Figure 4: Unemployment and wage growth



With a more positive outlook for employment, we also anticipate a more substantial pickup in wage growth in the coming years. Private sector wage growth has seen little acceleration to date, at least according to the Labour Cost

Index. But this tends to evolve very slowly anyway, and recent readings have seen a bit more upward momentum.

Government policy will add to the upward pressure on wages, with public sector pay settlements and larger minimum wage increases on the horizon. The planned changes to employment law will place more weight on collective agreements, giving workers more bargaining power. It's hard to quantify what this will mean for wage growth, but we note that the impact is likely to be greater when the labour market is already tight.

Different strokes

While the economic picture is turning more positive at the national level, some distinct regional differences are becoming apparent. In part, these differences are the consequence of a pattern of regional population growth that is very different today compared to a few years ago.

Auckland still has the fastest growing population, but the pace has slowed substantially from its peak in 2015. Canterbury's population growth rate has also slowed following an influx of construction workers and returning residents after the earthquakes. In contrast, population growth stepped up sharply across the central and lower North Island and in Otago between 2015 and 2017, and has slowed only slightly in the past year.

Anecdotally, some of these population patterns are due to Aucklanders leaving for greener pastures in smaller towns. However, changing patterns of overseas migration are probably playing a bigger role. Foreign arrivals are slowing, and a growing number of those who arrived in recent years on temporary visas are now leaving. Since migrants tend to be concentrated in Auckland, this partly explains why population growth has slowed more in Auckland. Meanwhile, the number of New Zealanders heading to Australia is lower today than it was in the mid-2010s, an effect that is spread more evenly across the country.

The regional pattern of population growth rates neatly matches the regional patterns we are seeing in housing markets and economic performance. In Auckland and Canterbury, growth in rents has cooled, house prices until recently were flat or falling, and measures of regional economic activity are weaker than elsewhere. But in other parts of New Zealand, it feels as though there has not been an economic slowdown at all. These regions are still experiencing accelerating rents, rising house prices, strong economic activity and high confidence.

The pattern of demand for workers has also notably shifted. Growth in job vacancies has slowed in Auckland and Canterbury, but has picked up strongly in other regions. In the short term at least, this could result in a regional mismatch between jobs and available workers, which would exacerbate the tightness in the labour market at the national level, and add to the upward pressure on wages.

While the strength outside Auckland and Canterbury may last for a while yet, it won't persist indefinitely. The current strong momentum has partly been driven by strong population growth. When this unwinds, house price growth and construction activity in these regions will cool and consumer spending will take a breather.

What if oil prices stay high?

Economic conditions can be quite sensitive to shifts in world oil prices, which are notoriously difficult to predict. Our base case is that oil prices will decline gradually over the coming years, settling at around US$60/barrel for Brent crude.

But there's a risk that ongoing supply disruptions could see oil prices hold up for longer. In the charts below we show how our forecasts would change if oil instead settled at its recent peak of $85/barrel.

The first effect would be higher inflation, due to both the direct impact on fuel prices and the ongoing impact on transport costs for a broader range of industries. Secondly, fuel prices effectively act as a tax on households, reducing their spending power elsewhere. Higher oil prices would lower our GDP growth forecasts, largely through softer consumption.

An oil price shock of this scale wouldn't fundamentally change our outlook – the economy would continue to grow broadly in line with its potential, and inflation would remain within the target range. Higher inflation and lower growth would have mixed implications for the Reserve Bank, but probably wouldn't require a different monetary policy response. However, a larger and more sustained oil price shock could well require higher interest rates to keep inflation in check, despite the negative impact this would have on activity.

Figure 5: Inflation forecasts

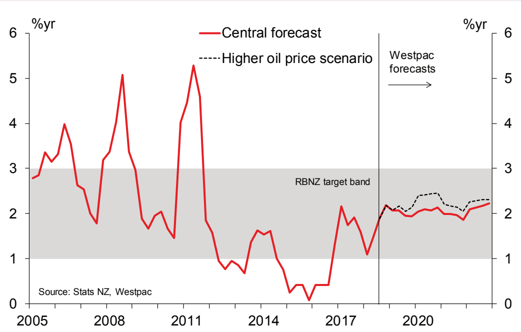
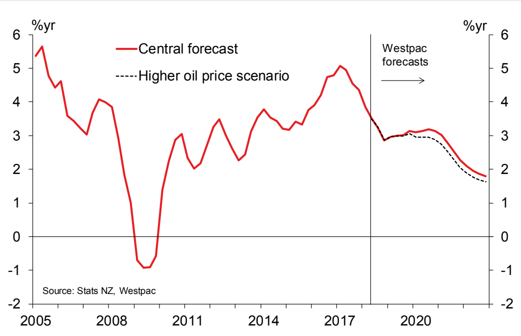


Figure 6: Consumption forecasts



The Reserve Bank and Interest Rates

Cutting a new path

The ‘new’ Reserve Bank is much less hawkish than the old. Despite recent strong data, the RBNZ is not entertaining the idea of lifting the Official Cash Rate (OCR) any time soon – it would rather run the risk of inflation and employment rising above target. This approach will work fine for the next few years – inflation remains well contained. But eventually it may mean higher interest rates and higher inflation on a sustained basis.

Over the past few months it has become clearer that the Reserve Bank’s shift to a dual mandate and a new Governor has profoundly affected its approach to monetary policy. To put it simply, the ‘new’ Reserve Bank is less hawkish than the old. This means it will be quick to shore up growth and slow to choke off inflation.

The November *Monetary Policy Statement* was a perfect illustration. In the lead-up we saw a near-perfect storm of inflationary data prints, including high GDP and inflation numbers as well as a lower-than-expected exchange rate. The Reserve Bank acknowledged these burgeoning signs of inflation pressure, but chose not to forecast earlier OCR hikes. Instead, the RBNZ forecast that inflation would rise above 2% in the medium term, and employment would exceed the maximum sustainable level.

The RBNZ is saying that it is not going to lift the OCR any time soon, and if that means that both inflation and employment overshoot their targets, then so be it. Admittedly, the size of the target miss on inflation is small. But this still marks a sharp departure from the approach the RBNZ would have taken under the previous Governor. We suspect that the shift to a committee for monetary policy decisions (due to begin in April next year) will only reinforce the dovish shift in the Reserve Bank’s behaviour.

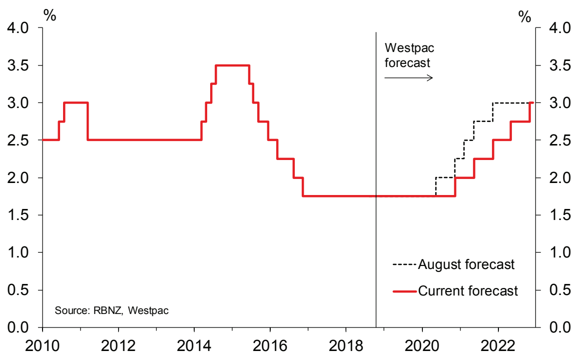
Bearing all of this in mind, we have altered our OCR forecast in this *Economic Overview*. We now expect the OCR to start rising in November 2020 (previously May 2020), and to rise more slowly than previously forecast. Financial markets recently marked the two year swap rate sharply higher in reaction to strong economic data. That is a mistake. The Reserve Bank has no intention of hiking in 2019, even if the data is strong.

OCR cuts are not off the table. However, our central view is that the data will be strong enough over the coming year to prevent cuts. If we are wrong about that and the data unexpectedly weaken, an OCR cut is possible.

Running with a low OCR despite a strengthening economy and falling exchange rate will inevitably boost inflation. However, as mentioned in the *Inflation* section, we think there are plenty of other factors that will continue to suppress inflation over the coming few years. Consequently, the more dovish approach being taken by the Reserve Bank is going to work out well for the time being. We expect inflation to sit around 2% for the coming few years, whereas previously we were worried that inflation would remain too low.

But if a central bank zigs now, it has to zag later. When inflation eventually does start to lift, the Reserve Bank under its new dual mandate will be slow to respond. That could cause inflation to linger at a higher level than otherwise, and a self-fulfilling rise in inflation expectations could set in. This would then oblige the Reserve Bank to maintain nominal interest rates at a higher level, just to achieve the same real interest rate and keep inflation steady. It is ironic that more dovish monetary policy eventually leads to higher nominal interest rates.

Figure 7: Official Cash Rate forecasts



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Dec-18	2.2	1.75	1.90	2.15	2.60
Mar-19	2.1	1.75	1.90	2.10	2.60
Jun-19	2.1	1.75	1.90	2.10	2.60
Sep-19	2.0	1.75	1.90	2.15	2.65
Dec-19	1.9	1.75	1.90	2.20	2.70
Mar-20	2.0	1.75	1.90	2.25	2.75
Jun-20	2.1	1.75	1.95	2.30	2.80
Sep-20	2.1	1.75	2.10	2.40	2.85
Dec-20	2.1	2.00	2.20	2.50	2.90
Mar-21	2.0	2.00	2.35	2.60	3.00

Inflation

Up...up...but not away

Inflation has picked up and is set to rise to a bit above 2% in the near term. However, it is still expected to remain well contained within the RBNZ's 1% to 3% target band over the next couple of years, with softness in retail prices a continuing drag.

After an extended period of weakness in recent years, the September quarter saw a larger than expected increase in consumer prices, with annual inflation rising to 1.9%. Recent months have also seen a growing number of businesses highlighting increased cost pressures, particularly with regards to wages. These developments have raised questions about whether we will see a further near-term acceleration in inflation to levels that could prompt a period of rising interest rates. Looking at the details of the inflation environment, we have our doubts.

It's true that the inflation backdrop is now looking firmer than we or the RBNZ had expected, with headline inflation set to rise to 2.2% over the coming quarters. However, much of that increase is due to earlier increases in petrol prices, which will only provide a temporary lift in inflation. We've already seen fuel prices easing back in recent weeks. And as discussed in the *Global Economy* section, we expect that international oil prices will ease further over the coming year, dampening headline inflation in the process.

Looking through the short-term volatility associated with fuel prices, underlying inflation is trending higher, but only slowly. We expect it will rise from around 1.7% now to a little over 2% in 2020. That's being underpinned by a further decline in the NZ dollar, firmness in domestic demand and some rise in inflation expectations.

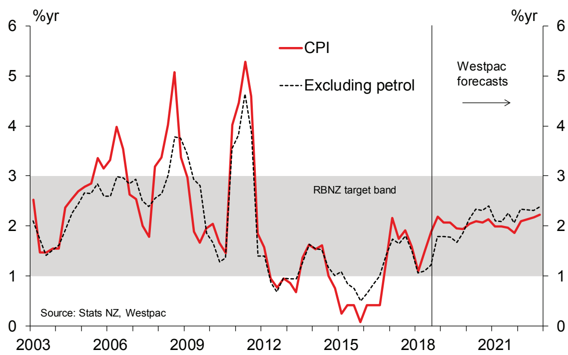
There are also clear signs that the labour market is tightening, and we expect to see wage inflation rising from rates of around 1.8% per annum in recent years to around 2.7% through 2020/21. That's in part due to large planned increases in the minimum wage and increases associated with collective bargaining agreements. However, while wage increases will add to costs in some industries, the impact on the Consumers Price Index (CPI) is likely to be more modest. Competitive pressures are keeping a lid on price increases in many industries. Furthermore, in some sectors where we expect to see wages rising (such as health and education), there is not a strong relationship between wage costs and the prices that consumers face.

Although these conditions will push inflation higher over the next few years, it is not likely to rise to levels that will spook the RBNZ into hiking the Official Cash Rate. The key reason for this is the continuing softness in the retail prices of imported consumer goods, which (excluding fuel) account for around 40% of the CPI. In part, the lingering softness in these prices is due to offshore factors: global inflation is still below the levels that prevailed prior to the financial crisis, and GDP growth is now cooling in many economies that are key producers of consumer goods. We're also seeing ongoing strong competitive pressures in the domestic retail sector, including the continuing growth in online trading. The resulting squeeze on margins has been the key reason for the weakness in consumer price inflation in recent years. We expect that such forces will continue to weigh on retail prices for some time yet, offsetting some of the impact of the lower NZ dollar.

Also limiting the rise in overall inflation are charges for many government related services, which have been rising at a more gradual pace than in the previous decade. We expect that pattern will continue for some time, supported by lower prices for some services such as tertiary education and doctors visits.

Putting this all together, we expect inflation will remain well contained within the RBNZ's 1% to 3% target band over the next few years, albeit at rates that are a little above 2%. However, as discussed in the *Reserve Bank and Interest Rates* section, we expect that a less-hawkish stance from the RBNZ will lead to higher inflation over time.

Figure 8: CPI Inflation



Global Economy

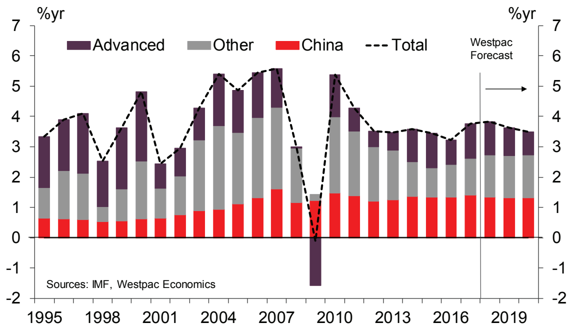
At the peak

Global economic growth is now reaching a peak, with conditions in the US and other major economies expected to cool over the next few years. However, given the current momentum in US activity, we still expect the Federal Reserve will hike rates through 2019, the effects of which will be felt widely.

With the close of 2018 rapidly approaching, the global economy is on track to expand by 3.8%, unchanged from the solid pace of growth seen over 2017. But while overall global growth has held up, beneath the surface conditions in a number of major economies have started to cool.

We expect global growth will ease over the next few years, with softening growth in the US and other major developed economies, along with a more modest easing elsewhere. Against this backdrop, global inflation pressures are expected to remain moderate.

Figure 9: Contributions to world GDP growth



The **US** economy has built up a head of steam in recent years thanks to the combination of tax cuts, a jump in government spending, and low interest rates. Those conditions have seen US GDP growth rise to an annualised rate of 3.5% in mid-2018, with strength in both the jobs market and household spending. This momentum in the household sector is expected to continue into the new year.

But while US growth has been robust recently, going forward the strength of activity will be challenged by the unwinding of fiscal stimulus, as well as increases in the federal funds rate aimed at limiting inflation. Those changes are expected to see US economic growth slow to 1.7% through 2020. However, there are some big questions about how the changing mix of US monetary and fiscal policy will play out.

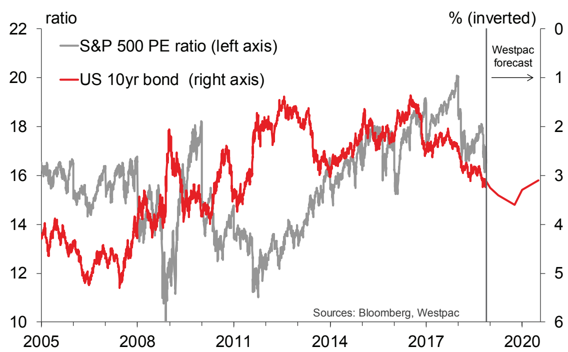
In the case of fiscal policy, some of the current stimulus package is set to be wound back over 2019. However, there is a chance that stimulus could be extended, particularly with the 2020 elections coming onto the horizon. That would see growth holding up for longer, but would also leave the US with a large fiscal hole at a later date.

With regards to monetary policy, the key question is how much further do rates need to rise to keep inflation in check? We expect that the Fed will hike rates four more times over the coming 12 months, with the last increase coming in September 2019. That will take the funds rate to 3.125% – 25bps, higher than we previously assumed. However, there is a risk that rates may need to rise further, especially if fiscal stimulus is extended.

The tightening of US monetary policy and related appreciation of the US dollar is already reverberating through the global economy. Low interest rates have been the key driver of rising asset prices in recent years, including US share prices. But as interest rates have risen, there has been increased nervousness in financial markets and sharp falls in equity prices through October. We expect downward pressure on equity prices to continue as interest rates rise, and that this will weigh on households' spending appetites.

Policy tightening by the Fed will also have important implications for those economies that have large amounts of US dollar denominated debt or that are reliant on US dollar funding. In response we've already seen central banks in a number of Asian and emerging market economies (such as India) increasing policy rates to limit currency outflows.

Figure 10: S&P 500 PE ratio and US 10yr bond



Outside of the US, growth in many of our key trading partner economies has been cooling. That includes **China**, where GDP growth slowed to 6.5% in the year to September – its slowest pace since 2009. This slowdown is primarily a result of domestic political factors, with Chinese authorities continuing to pursue a reform agenda that puts financial stability and long-term growth ahead of current momentum. The consequence has been a substantial tightening of credit conditions and a marked slowing in investment both by state-owned enterprises and local government authorities.

This ongoing reorientation in demand will see Chinese GDP growth continuing to slow over the coming years, the impacts of which will be felt more widely through the Asia-Pacific region. The related cooling in areas like manufacturing and construction will dampen the demand for intermediate goods, including 'hard' commodities like those that are key exports for Australia. And while consumer demand is likely to be more resilient, it won't be fully insulated from these changes. Consequently, we expect demand for the 'soft' commodities that New Zealand exports to China will also slow (though not to the same extent as demand for hard commodities).

Across the Tasman, **Australian** GDP growth picked up to 3.4% in mid-2018, and momentum heading into the back half of the year remains firm. But looking further ahead, a marked slowdown remains on the cards, with annual GDP growth expected to fall to 2.7% over 2019. Underlying this slowdown is an expected downturn in residential construction, with tighter lending conditions and reduced demand from both domestic and offshore investors. As banks have tightened credit conditions, house prices have fallen. Combined with high debt and low wage growth, this is weighing on consumer confidence and spending. A further cloud on the horizon is the looming Federal election, with a likely change in government adding to the uncertainties for businesses.

Global inflation

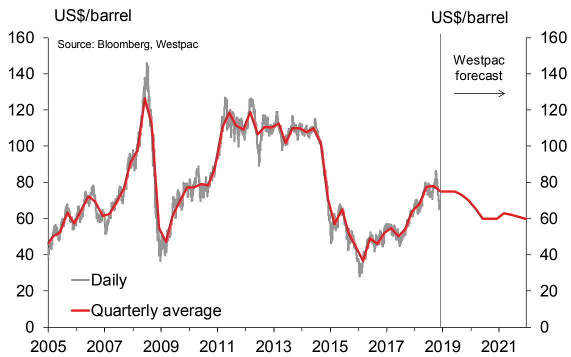
With strengthening economic activity in recent years, we have also seen a firming in global inflation. However, in many regions, increases in prices have been gradual, and that will be reinforced by cooling GDP growth over the coming years. For New Zealand, this means we are likely to see ongoing softness in the prices of imported consumer goods.

While the broader inflation backdrop has remained contained, the past month has seen some large swings in global oil prices, with the price of Brent oil rising above $85/barrel in early October. This recent pop higher in oil prices was largely related to supply concerns stemming from heightened geopolitical tensions. That included concerns about US sanctions on Iran, falling production from Venezuela and tensions between the US and Saudi Arabia. Production bottlenecks in the US have also added to upward pressure on prices.

Those supply concerns have eased more recently, with a rise in US inventories and increasing global supply adding to the downward pressure on prices. This has seen Brent oil prices dropping to below $70/barrel at the time of writing – back around the levels we saw at the start of this year.

Despite recent falls, we expect that the current level of oil prices will still support further increases in production over the coming year. That includes a lift in shale production, which tends to be more responsive to changes in oil prices than conventional oil wells. These conditions will see prices gradually easing back to around $60/barrel in 2020. Slowing economic growth in a number of regions, including China, will also weigh on oil demand over time. But while the longer-term trend for prices is downward, in the near term there is the risk of another flare up in geopolitical tensions, and related supply concerns could see oil prices popping higher from time to time.

Figure 11: Brent oil prices



Economic forecasts (calendar years)

Real GDP annual average % change	2015	2016	2017	2018f	2019f	2020f
New Zealand	3.6	4.0	2.8	2.9	3.2	3.1
Australia	2.5	2.6	2.2	3.3	2.7	2.8
China	6.9	6.7	6.9	6.4	6.1	6.0
United States	2.9	1.5	2.3	2.9	2.5	1.7
Japan	1.4	0.9	1.7	0.9	0.8	0.7
East Asia ex China	3.8	3.9	4.5	4.3	4.1	4.1
India	8.2	7.1	6.7	7.2	7.0	7.0
Euro zone	2.1	1.8	2.5	1.9	1.5	1.5
United Kingdom	2.3	1.9	1.8	1.2	1.2	1.4
NZ trading partners	**3.8**	**3.5**	**4.0**	**4.0**	**3.6**	**3.5**
World	**3.5**	**3.2**	**3.8**	**3.8**	**3.6**	**3.5**

Agricultural Outlook

Not all one way traffic

As expected, commodity prices have continued their gradual retreat in recent months. Demand has cooled as China's economy has slowed, and for some commodities global supply has increased. The risk of being caught in the crossfire of an escalating trade war between the US and China remains. But there has also been good news. New Zealand exporters will soon be reaping the benefits of the much-debated Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

Export prices for New Zealand's key commodity exports have continued to slide since our last *Economic Overview*, particularly dairy. Our farm gate milk price forecast for this season has fallen to $6.25, and even that is contingent on prices improving in 2019 as global supply growth slows. International beef prices have fallen sharply from recent peaks in the all-important US market. As China has slowed and the yuan has weakened, log prices have also weakened.

The deteriorating trade relationship between the US and China continues to be the key risk, but it is not the only development on the trade front. Brexit negotiations are coming to a head as the March deadline for the UK's exit from the European Union draws closer. Details about how New Zealand's trading relationship with the region will look post-Brexit remain scarce. Presently, New Zealand has an annual quota of sheepmeat exports to the EU of 228,000 tonnes. It has been proposed that this is simply split between the UK and Europe roughly 50/50. This would deny New Zealand the flexibility to respond to changes in the market, so the Government is protesting at the WTO.

While trade news from the US and Europe is discouraging, much of the rest of the world continues to pursue trade liberalisation. The ratification of the multiparty CPTPP by 6 of the 11 signatories starts the clock ticking on the removal of trade barriers for New Zealand exporters. The deal will be New Zealand's first free trade agreement with Japan, Mexico, and Canada. In addition it opens the door wider to trade with ten economies that account for around 13.5% of world GDP and are already the destination for almost 30% of New Zealand's goods exports. Importantly, the deal will eventually put New Zealand exports to Japan on a level playing field with key competitors such as Australia, Chile and the EU who have already negotiated bilateral free trade agreements. A wide variety of agricultural exporters will benefit including kiwifruit, onions, squash, wine, beef, lamb, fish and dairy.

It's estimated that when fully implemented, the CPTPP has the potential to deliver around $220 million of savings on tariffs. But that's probably just the tip of the iceberg. The bigger benefits of the deal for New Zealand exporters stem from greater access to some of the world's biggest economies. It remains to be seen how New Zealand exporters will make the most of these opportunities, but the Ministry of Foreign Affairs and Trade estimates it could lift New Zealand GDP by somewhere between 0.3% and 1% ($1.2 billion to $4 billion).

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	We expect slower growth in China and the weaker yuan to weigh on export log prices. There have been glimmers of this happening in recent months. Domestic demand for sawn timber remains firm.	High	↘
Wool	Coarse wool prices remain low, especially compared to finer grades of wool. While we don't anticipate further deterioration, any improvement in prices is likely to be only gradual.	Average	→
Dairy	Strong growth in New Zealand milk production has weighed on prices. Looking ahead, we expect slower growth in milk production in other regions will see prices stabilise around current levels before gradually grinding higher in 2019.	Average	→
Lamb	Prices have remained well supported in the face of increased supply out of Australia. However, slower growth in China is expected to lead to some moderation in international prices from here.	High	↘
Beef	International prices have fallen on the back of a lift in domestic supply in the US. We think prices are likely to ease further in the months ahead.	Above Average	↘
Horticulture	Some moderation in prices from high levels expected. This should be at least partly offset by further improvements in productivity.	High	↘

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

Exchange Rates

Lower for longer

We expect the New Zealand dollar to lose further ground against the US dollar over the next year. New Zealand's interest rates are now lower than US rates across the board, and that gap is likely to turn even more negative while the two countries' central banks remain out of sync. We expect more modest declines against the other major currencies.

The New Zealand dollar has put in a mixed performance over the last few months. Stronger economic data has given it a boost recently, but prior to that, traders were shying away from the currency as its yield advantage disappeared. Yields on New Zealand government bonds are now lower than their US counterparts for the first time since 1994.

We've been surprised by the extent of the fall in relative interest rates. Longer-term interest rates have been rising in the US as its economy has accelerated and the Federal Reserve has continued to increase its policy rate. But rather than being dragged along by overseas trends, New Zealand interest rates have remained stubbornly low. It seems that the market expects monetary policy in the two countries to be out of sync for a long time.

We agree with this view to an extent. We are forecasting the Fed to continue raising rates until late next year, while the RBNZ will still be firmly on hold by that time. This would see the spread on longer-term interest rates go even more negative, dragging the New Zealand dollar down further. We expect the New Zealand dollar to fall to a low of 61 cents against the US dollar in the September quarter next year. Beyond that, we expect a gradual rebound as the US dollar cools off and RBNZ rate hikes draw nearer.

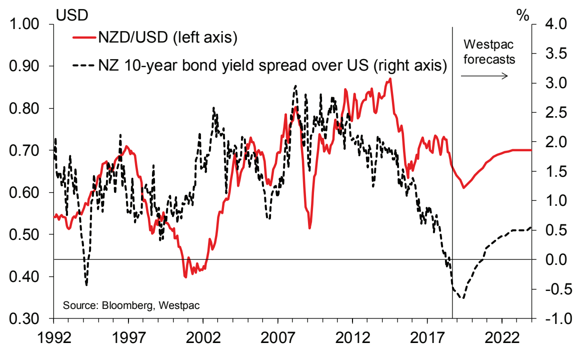
Interest rates are by no means the dominant driver of the exchange rate, and even with yield spreads falling to historic lows, there is good reason to believe that the New Zealand dollar won't follow suit. New Zealand's terms of trade is at an all-time high, and we expect it to remain close to current levels in the coming years. In addition, perceptions of country risk have become more favourable towards New Zealand (and less favourable to the US) over time.

The New Zealand dollar is above its long-run fair value against the Australian dollar, but we are forecasting only a modest decline. The outlook for domestic growth and export commodity prices is more favourable for New Zealand over the next year, and the Reserve Bank of Australia is in a similar boat to the RBNZ – with inflation lingering on the lower side of the target, we don't expect rate hikes there until 2021.

The Chinese yuan has fallen sharply this year as the trade war with the US has escalated. However, we think the Chinese authorities will be reluctant to see further declines, due to concerns that this could prompt a flood of capital out of the country. Consequently, we expect the New Zealand dollar to lose ground against the yuan, matching its decline against the US dollar.

Other major economies have either started hiking interest rates (such as the UK and Canada) or are likely to start down that path before New Zealand does (such as Europe). We expect that the New Zealand dollar will face a less acute but more drawn-out underperformance against these currencies.

Figure 12: NZD/USD and relative interest rates



Exchange rate forecasts (quarter average)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Dec-18	0.66	0.92	0.58	0.52	75.2	72.6
Mar-19	0.64	0.90	0.58	0.52	73.0	70.9
Jun-19	0.63	0.90	0.57	0.51	72.5	70.2
Sep-19	0.61	0.90	0.56	0.49	69.5	68.3
Dec-19	0.62	0.89	0.56	0.49	69.4	68.5
Mar-20	0.63	0.88	0.56	0.49	69.3	68.6
Jun-20	0.64	0.86	0.55	0.49	69.8	68.8
Sep-20	0.65	0.88	0.55	0.49	70.2	69.2
Dec-20	0.66	0.89	0.54	0.50	69.6	69.4
Mar-21	0.67	0.87	0.54	0.51	71.0	69.8

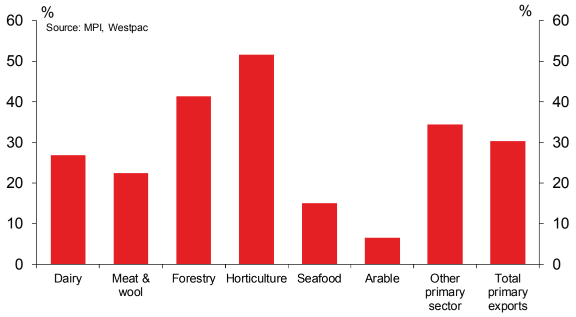
Special Topic

The rise of horticulture

The rising star of New Zealand's agricultural sector of late has been horticulture.[1] Alongside traditional headline acts of kiwifruit and apples, a wide variety of emerging talents are jostling to become the next big thing. A relatively favourable environmental footprint and improved productivity in the sector are just two of the reasons the sector looks set to enjoy further success. This will have important implications for both the shape of the agricultural sector and the broader New Zealand economy.

Increases in New Zealand's primary exports have outstripped total merchandise export growth over the last five years, and are up around 30%. And while a number of sectors have contributed to this strong performance, the horticulture sector has been a clear standout with horticultural exports increasing by over 50% over this period. Key to this success has been improved returns on the back of increased intensification and a lift in productivity. The benefits have been felt particularly acutely in the Bay of Plenty, Hawke's Bay and Nelson/Marlborough. More generally, the strength of the horticulture sector has played a part in the relative outperformance of regional New Zealand in recent years.

Figure 13: Growth in exports, 2013 - 2018



Within the horticulture sector, kiwifruit has been at the forefront. Since being rocked by the discovery of the vine killing disease Psa in the Bay of Plenty in 2010, the sector has made an impressive recovery. Export volumes are up over 50% on five years ago, while export values have grown almost 150%. Some of the factors that have supported the recovery in the kiwifruit sector are the same elements that will support strength in the horticulture sector more broadly in the coming years. Most notably, Zespri developed a new variety of gold kiwifruit. Not only has this variety proven to be resistant to disease, but it also has better yields and commands premium prices. Consequently while output has grown strongly, the area of land used for kiwifruit production is little changed over the last decade.

Looking beyond kiwifruit, there's no shortage of products vying for the title of 'next big thing'. Relative to five years ago the value of avocado exports is up over 200%. A tier below this, hemp, hops and blueberries are among those products hoping to expand beyond niche status.

But while the horticulture sector is relatively heterogeneous, a common theme is that operations tend to have less of a negative environmental impact than pastoral farming. Most notably, operations tend to be less carbon intensive, emitting fewer greenhouse gasses. That's going to be a serious advantage as industries' social licence to operate comes under increasing scrutiny and as New Zealand pushes to reduce its carbon emissions.

Higher relative returns and productivity improvements in the horticulture industry have pushed up horticultural land values. At a time when the value of other agricultural land (particularly dairy) has been under downward pressure, the price paid for horticultural land has been bucking the trend. Over time, we expect this will lead to changes in land use as, at the margin, some land currently being used for other activities is converted into horticulture. We saw this happen in the dairy industry. High product prices and increased productivity drove a 34% lift in the area of land used for dairying between 2007 and 2016.

While the outlook for New Zealand's horticulture sector is bright, risks remain. Exports in some markets are highly concentrated. For example, more than 80% of avocado exports are to Australia, while the vast bulk of New Zealand's squash exports are to Japan. Progress on the CPTPP and other trade agreements could help efforts to diversify markets. But for now the risk remains that should these countries close the door on New Zealand exports for any reason (or even open the door more widely to imports from other countries) there could be significant impacts. Another challenge faced by the horticulture sector in recent years has been finding seasonal workers – a challenge exacerbated during the recent period of a tight labour market. Over time, this is likely to encourage growers and processors to invest in productivity-improving technology and increase automation in order to reduce picking and processing costs.

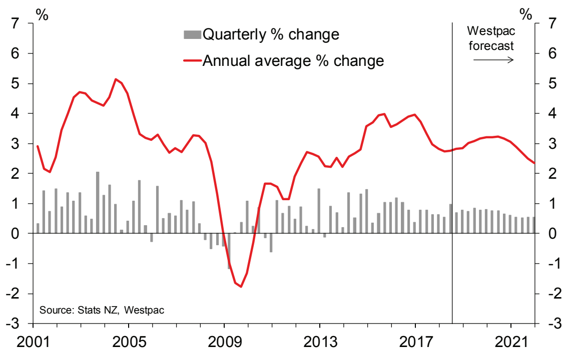
For the New Zealand economy more broadly, benefits from the rise of the horticulture means a more diversified export base, an opportunity to mitigate some of the negative environmental consequences of pastoral farming, and a chance to export higher value products.

1. For more on the risks and challenges facing the horticulture sector see our 2016 Industry insights report *https://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Industry-Insights-Horticulture-July-2016.pdf*

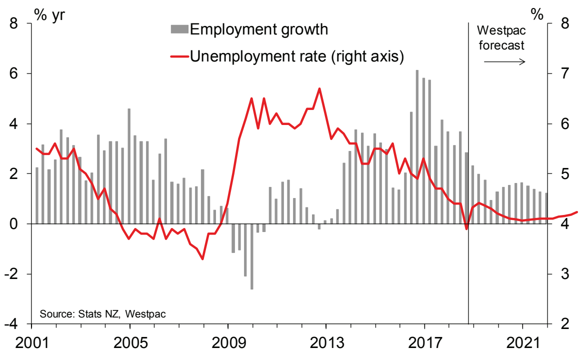
Forecasts and key charts

	Quarterly % change				Annual average % change			
	Jun-18	Sep-18	Dec-18	Mar-19	2017	2018	2019	2020
GDP (production)	1.0	0.7	0.8	0.7	2.8	2.9	3.2	3.1
Private consumption	1.0	0.9	0.7	0.7	4.4	2.9	3.1	3.1
Government consumption	2.2	0.0	1.0	1.0	4.5	4.2	3.9	4.7
Residential investment	0.5	2.0	2.5	1.0	0.7	2.8	5.1	1.9
Business investment	-0.2	1.0	-1.1	0.5	4.7	4.2	1.7	3.7
Stocks (% contribution)	-0.7	-0.2	0.4	0.0	-0.1	0.3	-0.1	0.0
Exports	2.4	1.8	0.1	0.6	1.8	3.9	3.2	2.3
Imports	1.5	-0.4	0.5	0.4	7.0	6.3	2.0	3.5
	Quarterly % change				Annual % change			
Consumer price index	0.4	0.9	0.4	0.4	1.6	2.2	1.9	2.1
Employment change	0.6	1.1	0.0	0.2	3.7	2.3	1.3	1.6
Unemployment rate (end of period)	4.4	3.9	4.3	4.4	4.5	4.3	4.2	4.1
Labour cost index (all sectors)	0.5	0.5	0.6	0.5	1.8	2.0	2.5	2.7
Current account balance (% of GDP)	-3.3	-3.4	-3.4	-3.1	-2.9	-3.4	-3.5	-3.0
Terms of trade	0.7	-0.4	-2.4	-1.7	7.9	-4.0	-0.1	2.8
House price index	-0.6	0.6	0.7	1.3	6.2	2.2	3.5	0.0
90 day bank bill (end of period)	1.88	1.81	1.90	1.90	1.79	1.90	1.90	2.20
5 year swap (end of period)	2.69	2.43	2.60	2.60	2.66	2.60	2.70	2.90
TWI (end of period)	73.8	72.4	72.6	70.9	73.8	72.6	68.5	69.4
NZD/USD (end of period)	0.71	0.67	0.66	0.64	0.70	0.66	0.62	0.66
NZD/AUD (end of period)	0.93	0.91	0.92	0.90	0.91	0.92	0.89	0.89
NZD/EUR (end of period)	0.59	0.57	0.58	0.58	0.59	0.58	0.56	0.54
NZD/GBP (end of period)	0.52	0.51	0.52	0.52	0.52	0.52	0.49	0.50

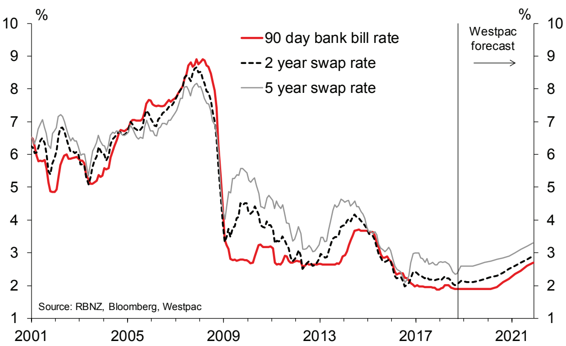
New Zealand GDP growth



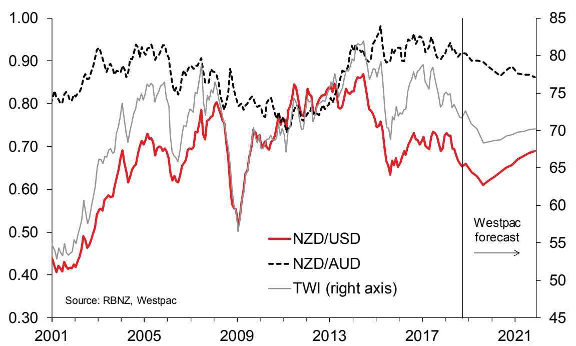
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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