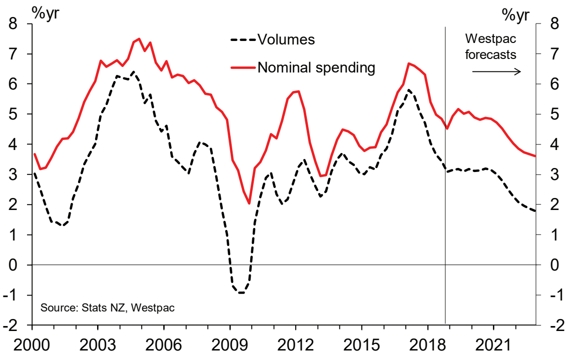
Shopping around

The outlook for household and retail spending

- After rapid increases in previous years, household spending growth shifted down a gear over 2018.
- The early part of this year is likely to see a modest pickup in spending growth, with low mortgage rates and a firming in the housing market helping to bolster spending appetites.
- Looking at the longer-term trends in spending, we expect to see moderate growth of around 5% per annum through 2019 and 2020. However, this is set to give way to a period of softer spending growth in the following years as slower population growth and a weakening in the housing market crimp demand.
- Competitive pressures in the retail sector remain strong, and costs (including wages) are rising. Combined with slowing household spending growth, this signals ongoing pressure on margins for many retailers.

Figure 1: Household spending growth



Household spending growth has taken a step down, slowing to an estimated pace of 4.5% over the past year. That's down from a peak of 6.7% per annum in late-2016. This slowdown has come against a backdrop of a softening housing market and a fall in consumer confidence, which together saw many households putting away their wallets.

Spending growth is set to pick up a little through the first half of 2019. Increases in disposable incomes and falls in petrol prices are adding to households' purchasing power. At the same time, low interest rates and a firming in the housing market will bolster spending appetites.

Looking at the longer-term trends in spending, we expect to see moderate growth of around 5% per annum through 2019 and 2020. But that's likely to give way to a period of softer spending growth in the following years as the housing market softens again and population growth slows.

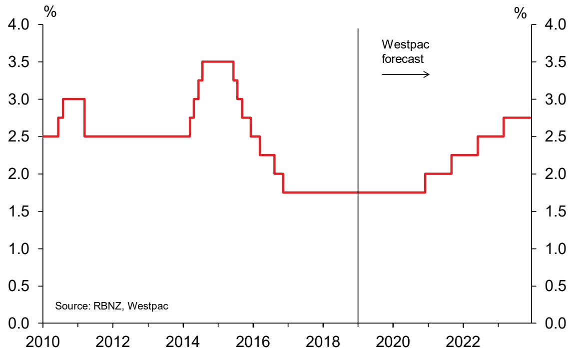
What factors are supporting spending?

Among the factors that will continue to support spending is the low level of borrowing rates. The back half of 2018 saw

Author:
Satish Ranchhod
Senior Economist
Phone: +64 9 336 5668
Email: satish.ranchhod@westpac.co.nz

the Reserve Bank signal that, under its new dual mandate, it's willing to tolerate a bit more of a pickup in inflation (at least temporarily) in order to shore up economic growth. Consistent with that change, we expect the RBNZ will keep the Official Cash Rate on hold through to November 2020, with only gradual increases beyond that time. We expect the resulting low level of mortgage rates will flow through to a stronger housing market, and that's likely to support stronger household spending over the next few months.

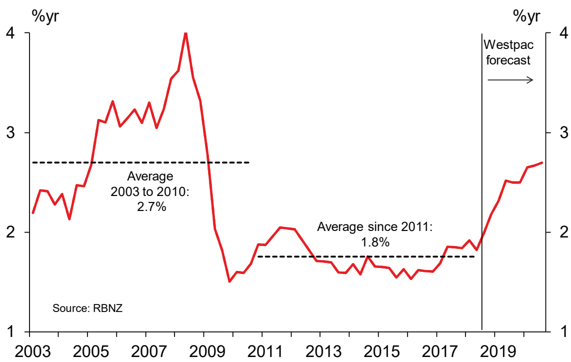
Figure 2: Official Cash Rate



A strengthening outlook for household incomes is also helping to support spending. With the economy in good shape, employment has been rising. And looking to the next few years, we expect that unemployment will remain low, at rates close to 4%. At the same time, wage growth has started to pick up, and it's set to rise even further over the next few years. That will be reinforced by large planned increases in the minimum wage and gains associated with increased collective bargaining. Together, these conditions will see wage growth rising from rates of around 1.8% in recent years to around 2.7% per annum in 2020/21 – the fastest pace in more than a decade.

Gains in households' disposable incomes and spending will also be supported by the large increases in Government spending now being rolled out. That includes around $1.5b per year of spending on the Government's Families Package and accommodation support payments. Recent falls in petrol prices will also provide a boost to households' spending power in early-2019.

Figure 3: Wage inflation (Labour Cost Index)



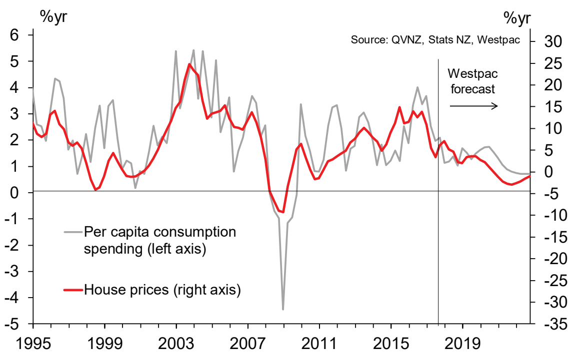
What's weighing on spending?

While the above factors will help to bolster households' spending appetites through the early part of 2019, increases in spending levels are likely to be more moderate going forward. That's due to changes in two of the major factors that supported demand in recent years - the housing market and population growth.

New Zealanders hold a large proportion of their wealth in housing assets, be it the family home or some form of investment property. As a result, it's no surprise that changes in house prices have a big impact on spending appetites (this can be seen from figure 4 below).

While the housing market is set to pick up in the early part of this year, this is likely to be a temporary lift. Looking to the back half of 2019 and into the early-2020s, house price growth is set to take a sizeable step down. That's due to the raft of policy changes the government is rolling out with the aims of improving housing affordability and limiting the financial risks that can be associated with rapid house price growth. Measures introduced thus far include restrictions on foreign buyers and the extension to the 'bright line' test for taxing capital gains on investment properties. Looking ahead, ring-fencing restrictions will be enacted later this year (i.e. removing the ability to use losses on rental properties to offset other tax obligations) and we're likely to see the introduction of a capital gains tax for investment properties ahead of the 2020 election. Such changes will be particularly important for major urban areas like Auckland where there are a larger proportion of property investors, but the impacts will be felt widely. The resulting softness in house price growth signals a significant drag on household spending.

Figure 4: House prices and household spending



The coming years will also see a slowdown in population growth. Through 2016 and 2017, the combination of strong inflows from other countries and low departures of New Zealand citizens saw net migration rising to an annual rate of over 70,000. That sent population growth soaring to rates of over 2% per annum – its fastest pace since the 1970s. This provided a powerful boost to demand, and helped to offset some of the slowing in per-capita spending growth (as shown in figure 6). It's also played an important role in helping businesses source skilled labour.

While net migration is still elevated, it's now down 16% from its peak as new arrivals into the country have levelled off and many of those who arrived in recent years have begun returning home. We expect that net migration will continue falling over the next few years. And just as the earlier run up in migration provided a boost to demand, the slowdown now in train will be a drag, moderating an 'easy' source of demand growth that many businesses have been enjoying.

Putting the above factors together leaves us with a picture of continuing, but moderate household spending growth over 2019 and 2020. However, this is set to give way to a period of soft spending growth in the following years as slower population growth and a softer housing market crimp demand.

Figure 5: Net migration

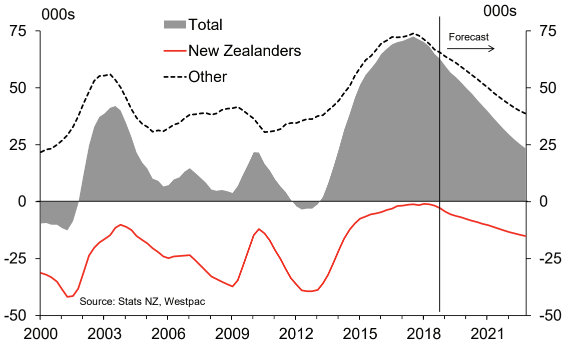
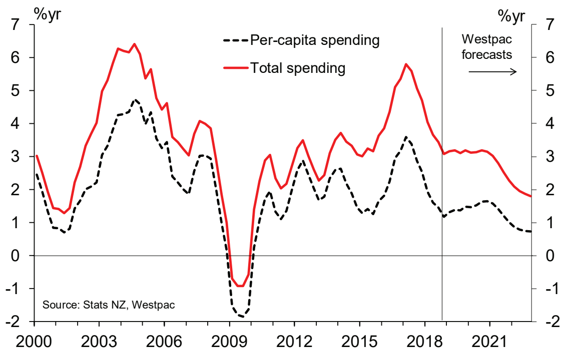


Figure 6: Total and per capita household spending growth (volumes)



Tourism spending

Strong growth in tourist numbers also boosted spending levels in recent years, particularly in sectors like hospitality and accommodation. Overseas visitor numbers rose by around 10% in 2016 and 2017, with a record 3,800,000 visitors last year. That was underpinned by gains in fast growing markets like China and the availability of cheaper flights to New Zealand, with annual tourist spending rising to $9.5bn.

Going forward, tourist spending is set to remain elevated, but gains are likely to be more modest than in recent years. Visitor arrivals growth has already slowed to around 3% per annum. And looking to the next few years, slowing economic growth in many major economies - including the key markets of Australia and China - will put a dampener on many travellers' plans. We're expecting nominal exports of services to grow by around 2 to 3% per annum over the next few years, with limited growth in volumes[1].

Rising costs, but muted price growth

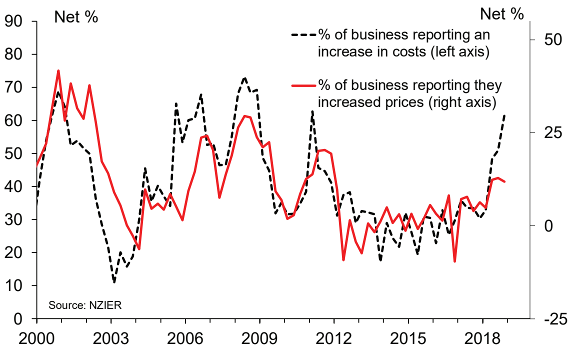
In addition to a cooling in demand growth, the coming years will see many retailers wrestling with rising operating costs, particularly with regards to wages. Base wage rates in the retail sector rose by 2.2% over the past year - their fastest rate of increase since the financial crisis. We expect that wage inflation in the retail sector will continue to push higher over the next few years. An important reason for that is the large planned increases in the minimum wage. From April this year, the minimum wage will rise by $1.20 to $17.70/hour (an increase of around 7%), and the Government is aiming to lift it to $20/hour by April 2021.

New Zealand already has a relatively high minimum wage rate compared to the average wage. And as it increases, not only will it cover more workers, we'll also see related increases in other wages to ensure performance related relativities. Overall, we estimate that minimum wage increases will add a total of 1% to wage inflation between 2018 and 2021, with pay rates for around 25% of the workforce affected.

Wage growth is also being boosted by increases associated with collective bargaining agreements, and by initiatives such as the push towards paying a 'living wage'. Combined with a fall in unemployment and continued growth in economic activity, these developments are expected to see a sizeable lift in wage growth over the coming years.

But at the same time, competitive pressures in the retail sector – both domestically and from abroad – remain strong, with continued growth in online trading and other e-commerce developments driving changes in business models. That's limiting the ability of retailers to push up prices and means that scope to expand margins is likely to remain limited for some time.

Figure 7: Retailers' costs and prices



[1] In addition to tourism and transport, exports of services also includes activity such as education services and financial services.

Regional split[2]

- **Auckland** has seen a particularly sharp slowdown in spending growth in recent years, down from rates of over 10% per annum in 2016 to around 4% now. That's come on the back of a marked slowdown in the region's housing market which has offset the effects of continued rapid population growth.

  Over the next few years, changes in housing market policy will have a stark impact on Auckland, signalling a significant drag on spending. However, population gains will provide some buffer – even though nationwide population growth is set to slow, Auckland still tends to attract large numbers of people.

- Spending growth in **Wellington** has been rising a little more gradually than in most other regions. However, Wellington is benefiting from increases in Government spending, which will provide some buffer from changes in broader economic conditions.

- Spending growth in **Canterbury** continues to lag the rest of the country, and that's likely to remain the case over the coming year. The region's economy, including its housing market, is continuing to adjust to the winddown in rebuild spending and related impacts on demand more generally. While the drivers of demand are shifting away from construction over time, growth in the region's output and employment is likely to remain modest for some time.

- **Regional centres in both the North and South Islands** have seen solid gains in spending. Population growth has picked up in a number of regions, solid demand for commodity exports is boosting incomes, and in several regions house price inflation is running at rates of around 10% per annum.

  Regional economies will feel the brunt of slowing population growth over the next few years, and they won't be immune from the slowdown in the housing market (though the coming policy changes aren't likely to be felt as acutely as they will be in Auckland). Nevertheless, in those areas that are still benefitting from strong commodities demand, spending levels are likely to be more resilient. Regions such as Northland will also receive a boost from Government spending as part of the Provincial Growth Fund.

Figure 8: Retail spending by region

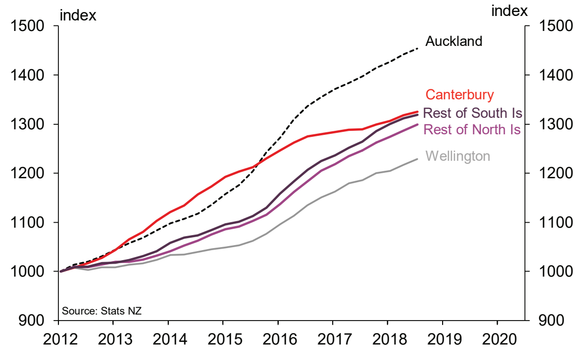
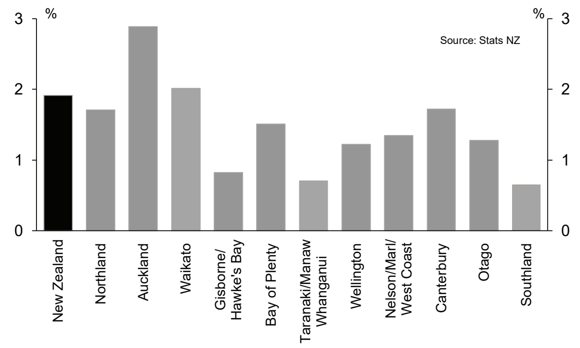


Figure 9: Regional population growth



Satish Ranchhod
Senior Economist

[2] Our recent Regional Roundup provides a closer look at economic trends across New Zealand's regions. It's available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Regional-Roundup-December-2018.pdf

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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