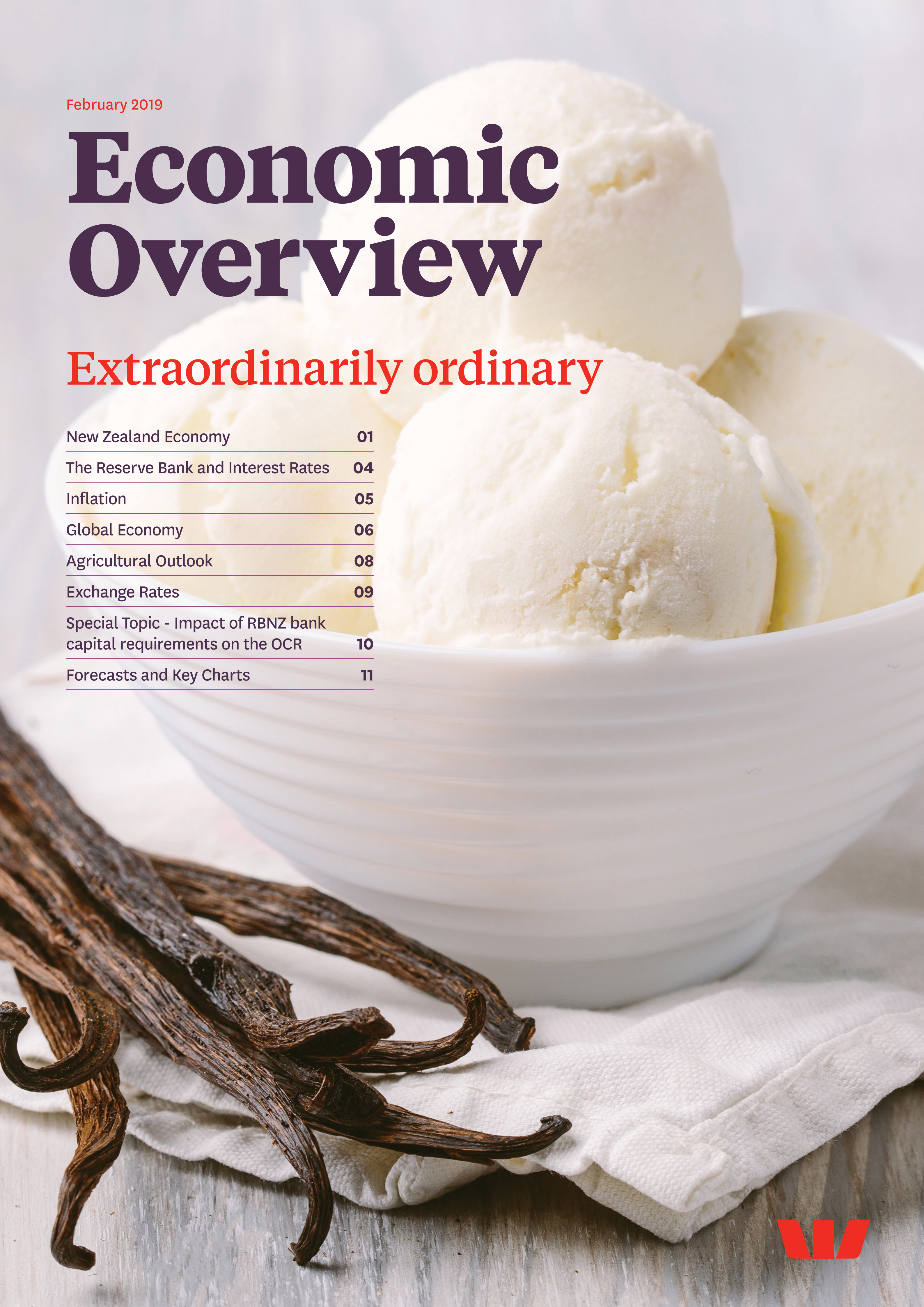
February 2019

Economic Overview

Extraordinarily ordinary



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Economic Overview

Note from Dominick

Right now the New Zealand economy is in an extraordinarily ordinary position. Unemployment, inflation and the exchange rate are all close to average or neutral levels. And the output gap tells us the economy is running neither above nor below its capacity 'speed limit'. Such a balanced situation is something normally seen in economics textbooks, not real life.

The big question is whether the next phase for the economy is up, down or sideways from here.

The global economy is slowing, but we think financial markets and newswires are overplaying the downside risks. The slowdown to date has been very consistent with our earlier forecasts. We expect global growth will keep ticking over, just not as vigorously as the 2017 peak. Crucially, we still expect the US Federal Reserve will lift interest rates this year, whereas financial markets have gone off the idea. If we are right, the New Zealand dollar / US dollar exchange rate will fall.

In New Zealand there was a clear economic slowdown in late 2018, and it was deeper than we expected. But we expect momentum will be regained this year. Petrol prices have unwound most of their previous spike, which will allow bruised household wallets to heal. Government spending and a successful farm sector will be the other key drivers.

That said, we retain our long-held view that the economy will slow again in the early 2020s. One major reason is that we are about to hit peak construction. Population growth is slowing more sharply than previously understood, and earthquake reconstruction is winding down. We expect residential construction to peak in 2019 and fall slightly from there. That will be a real change from the 2010s, when homebuilding activity more than doubled.

Tying it all together, we expect the economy to remain in a fairly neutral position overall, so we are forecasting no change in the OCR for the coming three years.

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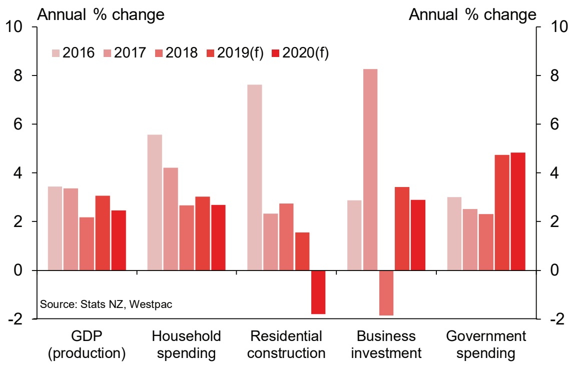
New Zealand Economy

Perfectly balanced (for now)

The economy clearly lost steam in late 2018, but we expect that it will regain some momentum over the coming year. However, that reacceleration is likely to be temporary. Growth is set to slow again through the early 2020s for a range of reasons including a slowdown in population growth and the rapidly approaching peak in the construction cycle. Compared to our previous forecasts, the outlook for growth is now looking softer than we had anticipated.

Figure 1: Components of GDP growth



The New Zealand economy slowed by more than expected through the second half of 2018. GDP growth in the September quarter was just 0.3%, and recent data points to a similarly modest pace of expansion through the December quarter.

Some of the recent soft reads on economic conditions may have been more noise than signal. For instance, late 2018 saw a sharp 2.3% drop in retail spending that was subsequently reversed in early 2019. But looking beneath that sort of short-term data volatility, we also saw a more fundamental softening in some of the major factors that have underpinned demand in recent years. That includes a slowdown in migration and population growth, a softening in the housing market, and the continuing wind-down in post-earthquake reconstruction in Christchurch and Kaikoura.

While that was all largely as expected, two unanticipated developments also reinforced the recent slowdown in growth. First was the low level of business confidence which saw many businesses defer investment spending. The other was the rise in petrol prices to record levels of over $2.40/ltr in October. That syphoned at least $130 million out of households' wallets between July and October, offsetting a good chunk of the boost to demand from the Government's Families Package.

Putting that all together, we estimate that annual GDP growth slowed to 2.2% at the end of 2018 - its slowest pace in five years.

Having lost some momentum over the past year, the New Zealand economy has started the new year in a broadly neutral position. The output gap is currently close to zero, indicating that demand conditions are broadly in line with the economy's productive capacity. Similarly, while there are pockets of pressure in the labour market, the current 4.3% unemployment rate points to a labour market that is neither unusually loose nor tight.

A temporary pickup in growth is in train...

We expect that the New Zealand economy will regain some of its earlier momentum over 2019, with annual GDP growth set to reaccelerate to 3.1% by year's end. In part, that's due to the roughly 20% fall in petrol prices since October, which has put money back into households' wallets.

Household spending will also be buoyed by a lift in labour incomes. Employment in the economy has been rising, and we expect that unemployment will remain low, at rates close to 4%. At the same time, wage growth has started to lift, and it's set to continue rising over the coming years, reinforced by large planned increases in the minimum wage and gains associated with 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.

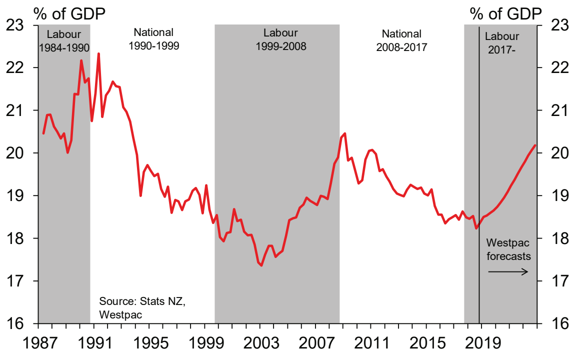
A further factor that will boost households' spending appetites over the next few months is a modest reacceleration of house price inflation. That's in response to the easing in loan-to-value restrictions in early January. We've also seen mortgage rates pushing lower in recent weeks as financial markets have priced out the chance of a rate increase from the Reserve Bank.

The construction sector is also set to take one last leg higher in 2019. Over the past year we saw a sharp lift in the number of new dwellings consented in Auckland, as well as strong consent numbers in other regions including the Waikato, Wellington and Otago. That points to a solid lift in home building activity over the coming months. On top of that, a significant number of commercial and infrastructure projects are in the pipeline.

Strength in farm incomes will help to support the rural economy. As discussed in the *Agricultural Outlook* section, prices for some of our key exports like dairy have risen, growing conditions have (until recently) been excellent, and the exchange rate is relatively low. That's a relatively rare combination of conditions.

And as we've previously highlighted, a major factor that will support GDP growth over the coming years is the large increase in fiscal spending that is now hitting the economy. That includes around $1.5bn of spending per annum on transfers to low and middle-income households as part of the Families Package. It also includes around $8.5bn of spending over the coming four years in areas like health, education and infrastructure. These increases in fiscal expenditure will see Government consumption spending growing by around 4% per annum through 2019 and the early 2020s. That's roughly double the pace seen over the previous decade, and will see the Government's share of economic activity rising from around 18% at present to over 20% in the early 2020s. The impact of this spending will be seen across the economy and will help to support employment growth.

Figure 2: Government consumption share of GDP

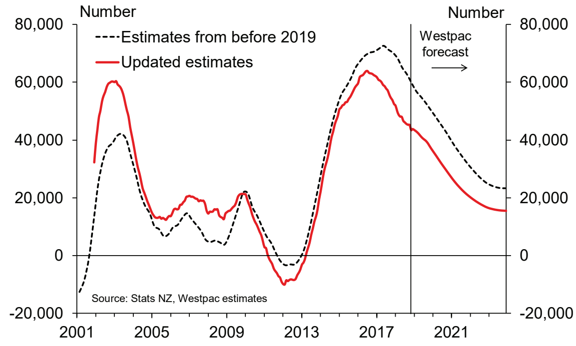


...however growth is set to slow through the early 2020s

Despite the continuing boost to demand from increases in government spending and growth in household incomes, the firming in economic growth currently in train will be temporary. Several of the other factors that have supported growth in recent years are now moving into new phases, and going forward they won't provide the same support for demand that they once did. As we head into the early 2020s this will see growth slowing to low levels. And compared to our forecasts from November, it looks like that slowdown will be starker than had previously been anticipated.

A major reason for the softer outlook for GDP growth is a downward revision to the outlooks for migration and population growth. Stats NZ's recent examination of movements in and out of the country has revealed that a greater proportion of recent arrivals were on a temporary basis than had been assumed. That's left us with a picture of much slower population growth in recent years. In fact, while previous estimates indicated that the population was still growing at rates of around 2% per annum, it now looks like population growth peaked back in 2016 and has already slowed to 1.5%. Importantly, with many of those who enter the country only staying for a temporary period, we now expect slower population growth over the coming years as well. We expect population growth will slow to around 1% in 2021, which signals a substantial reduction in the economy's rate of potential GDP growth.

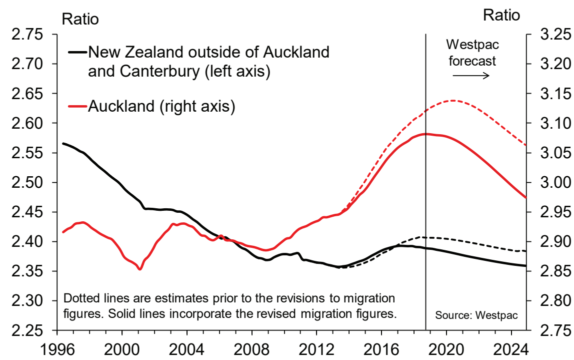
Figure 3: Net permanent and long-term migration



A lower population growth forecast is especially important for the construction sector, because it implies less need to build houses than previously thought. Rapid population increases in recent years left New Zealand with a shortage of homes. The construction sector responded by ramping up the rate of home building, and now construction activity is broadly commensurate with population growth. We'll still need a large number of new homes over the coming years. But with fewer migrants settling here on a long-term basis, the number of homes required is lower than previously thought, meaning the construction boom will peak sooner.

The number of people per dwelling (figure 4) illustrates how the need to build houses has changed. A higher number of people per dwelling indicates a greater shortage of housing. The new population estimates imply that the number of people per dwelling is lower than previously thought, and will drop away faster. In other words, the shortage of housing is less severe and will diminish more rapidly than previously estimated.

Figure 4: People per dwelling estimates

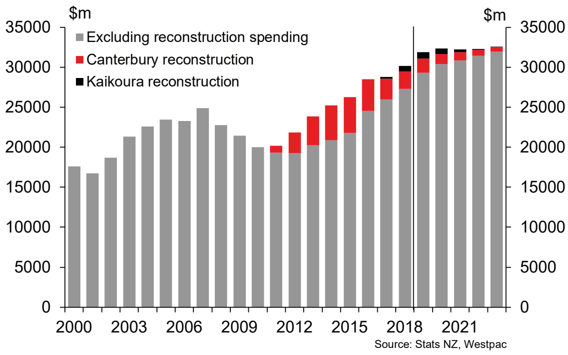


Two other important factors are also providing a brake on construction activity. The first is the continuing wind-down of post-earthquake reconstruction work in Christchurch and Kaikoura. At its peak in 2015, more than a billion dollars was being spent each quarter on reconstruction, with much of that funded by offshore insurance payments. Planned reconstruction spending is now around 80% complete, and spending levels have fallen back to around $700 million per quarter. Over the coming years, that number is set to get even smaller.

The other factor weighing on the outlook for construction and home building is the changing outlook for house prices. While the housing market is set to pick up in the early part of this year, we expect that this will give way to a period of modest house price falls in late 2019 and early 2020. That's in response to the raft of policy changes the Government is rolling out including already announced tax changes, the foreign buyer ban, and the likely introduction of a capital gains tax for investment properties ahead of the 2020 election. These changes will significantly erode the attractiveness of residential property, leading to house price declines. That's important for the construction outlook, as when house prices are weak there tends to be less interest in home building.

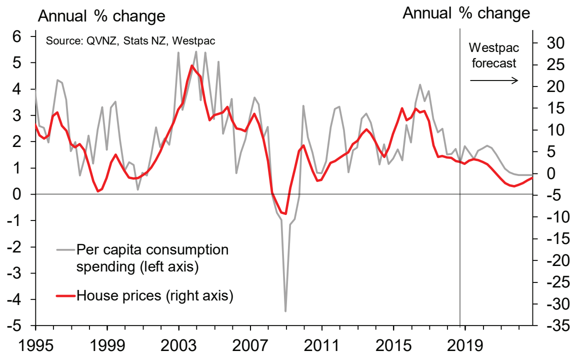
The combination of slowing population growth, falling house prices and slowing quake reconstruction means the peak in the construction cycle is now clearly in sight. Beyond 2019 we're likely to see residential construction activity flattening off or even declining slightly. That will be a drag on the demand for workers and income growth, and will also flow through to softer spending and activity in other sectors.

Figure 5: Construction activity



The coming years will also see much slower growth in household spending (which accounts for around 60% of GDP). After solid gains of 5% to 6% per annum in recent years, household spending growth has already slowed to around 3% at the end of 2018. We expect that spending growth will slow further over the coming years, dropping below 2% per annum in the early part of next decade. In part, that's because of the slowdown in population growth discussed above, which signals slower growth in the demand base. In addition, with New Zealanders holding a significant proportion of their wealth in housing assets, the weak outlook for house prices over the coming years also signals a significant drag on spending.

Figure 6: House prices and household spending



On the export front, we expect that prices for our key commodity exports, including dairy, will remain at relatively high levels compared to history. However, it's a more downbeat story for New Zealand's tourism industry. While this sector has seen strong growth in recent years, growth in visitor arrivals from nearly all our key markets has slowed over the past year. And combined with a softer global backdrop, we expect only muted growth in tourism over the next few years. It's a similar story for the international education sector, with arrivals of international students easing off in recent years, and earlier arrivals now departing.

Against this backdrop of slowing demand growth, we are also likely to see softness in business investment. Business confidence remains at low levels, and there is particular concern about how changes in labour market policies and environmental regulations will affect operating costs. Combined with a cooling in activity, this is likely to see some investment plans shelved.

Reinforcing the downside for business investment and the housing market will be tighter credit conditions over the early 2020s. On both sides of the Tasman banks' lending practices are being more tightly scrutinised, banks are being encouraged to ensure their loan portfolios are safe, and they will be required to hold more capital. The immediate impact is that it will become harder or more expensive for mortgage borrowers, farmers and businesses to get a loan. That will tend to crimp GDP growth directly as more investment opportunities fall through due to lack of finance, and indirectly if tight credit conditions impact house prices (as is happening in Australia).

The Reserve Bank and Interest Rates

Flat as far as the eye can see

We now expect the OCR to remain on hold over 2019, 2020, and 2021. That's as far as the proverbial eye can see – what we are really saying is that the OCR outlook is evenly balanced for the foreseeable future. The economy and wage growth are expected to pick up over 2019. This will be enough to prevent OCR cuts, but not enough to provoke hikes.

For a number of years now, we have consistently been of the view that the OCR would remain low for a very long time, because New Zealand inflation was going to struggle to rise to two percent. That view has proved correct – indeed, things have gone even further in that direction than expected.

Back in November our best estimate was that gradual OCR hikes would begin in late 2020. Now we are forecasting no change in the OCR over 2019, 2020 and 2021. The key catalysts for this change of view have been a reduction in the outlook for residential construction, a higher exchange rate outlook, and the Reserve Bank's proposal to lift bank capital requirements.

The New Zealand economy is in an extraordinarily ordinary position – pretty much everything that matters for monetary policy is neutral. Core inflation is only a touch below two percent; the output gap, which measures inflationary pressure by comparing demand and supply in the economy, is roughly zero; employment is roughly at the "maximum sustainable level"; the exchange rate is close to fair value; and house price inflation is moderate. Current conditions require neither a cut nor a hike in the OCR.

Over 2019, we do expect economic growth to lift a little, wage growth to accelerate, and the exchange rate to fall. Together, these forces will be enough to push core inflation from slightly below two percent to bang on. But they won't generate pressures on inflation or the labour market that are so intense that the Reserve Bank feels the need to lift the OCR.

Then from 2020 onwards we expect to see economic growth gradually cool, causing inflationary pressures to remain moderate. Overall, we expect the output gap to remain only a little above zero for a long time, hence core inflation will remain close to 2% and employment close to the RBNZ's maximum sustainable level. Under these conditions, there is no obvious reason for the OCR to be changed over the coming three years.

The biggest risk to our 2019 OCR view is the housing market. If the foreign buyer ban or one of the Government's tax changes causes a really disruptive drop in house prices, the Reserve Bank would almost certainly have to cut the OCR. Alternatively, if today's low mortgage rates cause nationwide house price inflation to take off again, the RBNZ would have to hike.

Beyond 2021, the best forecast is that the OCR will rise. We estimate that the neutral OCR is currently around 3%. Holding the OCR so far below neutral will eventually lead to inflationary pressures emerging, requiring an eventual Reserve Bank response. However, the pace of this expected OCR normalisation is highly uncertain (as is any forecast more than three years into the future).

Figure 7: Official Cash Rate forecast

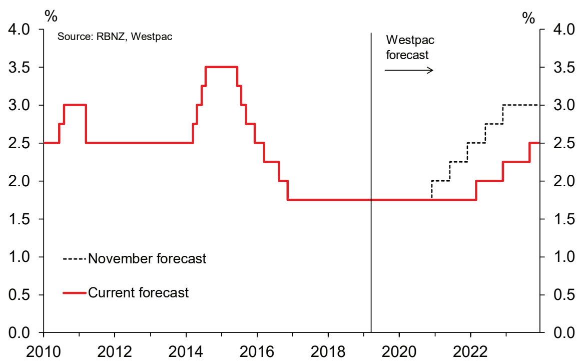
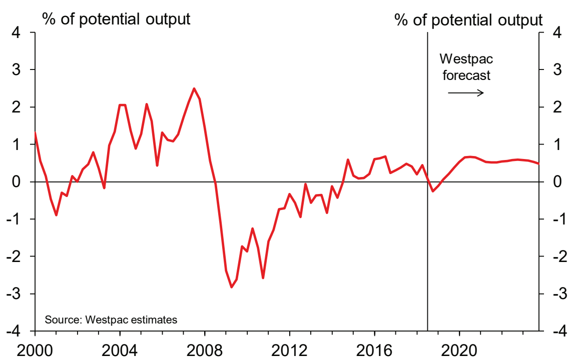


Figure 8: Output gap



Note: The output gap measures GDP compared to its non-inflationary potential. Negative numbers imply spare capacity in the economy. Positive numbers indicate excess demand.

Inflation

Gradual progress

Inflation is now running slightly below the mid-point of the Reserve Bank's target. We expect a temporary dip in inflation this year as a result of the pull-back in petrol prices. Beyond that, tight labour markets and rising business costs will lead to a gradual rise in domestic inflation, though not enough to prompt an RBNZ response. Indeed, the RBNZ's new mandate means that it may be more tolerant of higher inflation outcomes once they do arise.

Consumer price inflation held steady at 1.9% at the end of 2018, right in line with our forecast. The lower New Zealand dollar over the last year led to some price increases (or smaller price declines) for imported goods, while domestic inflation pressures continued to pick up gradually. Movements in volatile prices such as fuel can often throw around the headline inflation rate, but this wasn't an issue for the latest figures. Nearly all of the various measures of 'core' inflation currently sit at or a little below 2%, confirming the story that inflation has now returned firmly within the Reserve Bank's 1-3% target range, though still leaning towards the lower half.

In our November *Economic Overview* we expected inflation to briefly rise above 2% in 2019; it now looks likely that inflation will dip lower again in the near term. The key reason for the change in outlook is oil prices, which soared above US$80 a barrel in late 2018 but have since dropped sharply to around $60 a barrel.

We weren't surprised by the price fall itself. Our view has long been that surging output from US fracking operations will eventually push prices back down to around the cost of production. However, oil prices reached this point much sooner than we anticipated. As a result, we now expect fuel prices to act as more of a drag on inflation over 2019 – but less of a drag in 2020 – compared to our previous forecasts.

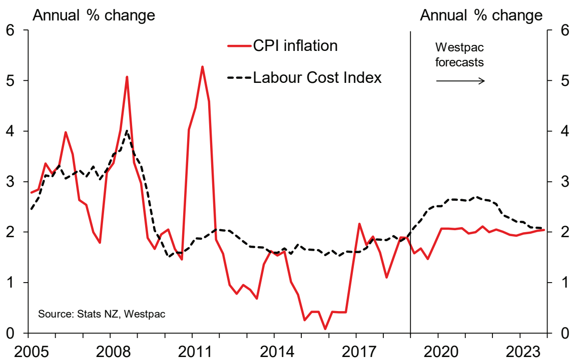
Excluding fuel, we expect a mild lift in inflation over 2019. We're forecasting a further modest drop in the New Zealand dollar in the coming months that will boost import prices. However, long-running competitive pressures will limit the extent to which firms can pass these higher prices on to consumers.

The more significant developments to watch will be in the non-tradable components of the CPI. Non-tradables inflation tends to evolve relatively slowly, so even the mild pick-up seen over the last couple of years is meaningful. The tight labour market is putting pressure on businesses to bid up wages in order to attract and retain workers. Indeed, a growing number of firms report that they are feeling the pinch from rising costs.

The economy is expected to pick up over 2019, spurring a further drop in unemployment and adding to the upward pressure on wages. Government policies such as minimum wage hikes, public sector pay agreements and a shift towards collective bargaining will also play an increasing role in lifting wage growth over the next few years. But with economic growth set to slow again in the new decade, the resulting pick-up in domestic inflation pressures won't be significant enough to prompt an RBNZ response.

That said, we believe that inflation will head higher in the very long run. The RBNZ's new mandate requires a focus on maximum sustainable employment as well as inflation, suggesting that the RBNZ will be more tolerant of higher inflation outcomes when they do occur. That could cause inflation to linger at a higher level than otherwise, and in turn lead to a self-fulfilling rise in inflation expectations for businesses and consumers. In the very long term, we see inflation settling at closer to 2.5% than 2%.

Figure 9: Inflation and wage growth



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-19	1.6	1.75	1.90	1.90	2.10
Jun-19	1.7	1.75	1.90	2.00	2.20
Sep-19	1.5	1.75	1.90	2.00	2.25
Dec-19	1.8	1.75	1.90	2.00	2.30
Mar-20	2.1	1.75	1.90	2.00	2.35
Jun-20	2.1	1.75	1.90	2.05	2.40
Sep-20	2.1	1.75	1.90	2.10	2.45
Dec-20	2.1	1.75	1.90	2.15	2.50
Mar-21	2.0	1.75	1.90	2.20	2.60
Jun-21	2.0	1.75	1.90	2.25	2.70

Global Economy

Rougher terrain

Over the past year, the synchronised upturn in the global economy has given way to more uneven terrain. But we think that financial markets have overplayed the downside risks and that global growth will keep ticking over, albeit at a slower pace. The US economy remains fundamentally strong, and China's growth slowdown was foreseeable and has been a managed process. Closer to home, the Australian economy is heading into a period of below-trend growth.

Sentiment towards the global economy has turned markedly more downbeat in the last few months, especially in financial markets. Share prices and bond yields fell sharply in December and interest rate markets have all but eliminated any thought of further policy rate hikes by central banks. As is often the case, markets have self-corrected to some degree, with lower interest rates helping to lift share prices again in the new year.

The slowdown in growth to date has been much in line with our forecasts. While 2017 saw a synchronised upswing in growth across the major economies, the past year has seen a return to patchier growth, with the US surging ahead while Europe has slowed. Meanwhile, China has continued to focus on improving the 'quality' of its growth, which has weighed on some sectors while supporting others. We expect overall world growth to decelerate to 3.5% over the next two years, from last year's peak of 3.7%.

Figure 10: US interest rates and share prices

The extent of the shift in market sentiment is most surprising in the US, given that the activity indicators have generally remained strong. Ongoing growth has eliminated much of the spare capacity in the labour market, and significantly, wage growth is now clearly accelerating. Both of these factors are set to put consumers in the front seat, driving above-trend growth over 2019. Stronger wage growth will also help to support a sustained return to the Fed's inflation target.

To be sure, the outlook for US growth this year is more challenging. First, the economy benefited from fiscal stimulus last year in the form of tax cuts and increased government spending, and we expect some (but not all) of this stimulus to be clawed back over the coming years. That said, it's possible that the stimulus could be extended, particularly as the focus turns to the 2020 elections.

Second, the US trade war with China looms as a source of uncertainty. The US has applied a 10% tariff to a range of Chinese imports, and has threatened to raise it to 25% and extend it to a wider range of products unless China agrees to changes to its industrial and trade policies. The evidence to date suggests that the tariffs may be hurting the US more than China, by raising the prices of inputs for many US businesses. Negotiations between the two countries will prove difficult, but our central case is that the tariffs won't be extended beyond current levels.

We think that the market has gone too far in dismissing the idea of further interest rate hikes by the Federal Reserve. Uncertainty over the impact of the government shutdown – not fully resolved at the time of writing – will preclude any moves by the Fed in the near term. But we still expect two further rate hikes in June and September, taking the cash rate towards the middle of the Fed's estimate of neutral. There is a risk that rates will need to rise further, if stronger wage growth carries through into consumer price inflation.

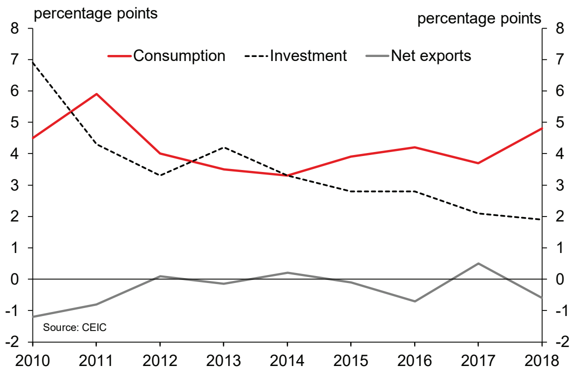
Other major economies have seen more obvious signs of softening. There are growing pressure points within Europe, as Italy has slipped back into recession and political tensions in France have dragged on. Meanwhile, the uncertainty around Brexit is clearly weighing on business activity and investment in the UK. We expect that a 'soft' exit deal will eventually be negotiated, although there's a good chance that the date will have to be pushed out beyond 29 March.

The Chinese economy grew by a solid 6.6% over 2018, although by the last quarter of the year it had slowed to a 6% annualised pace. This pace is comparable to the GFC lows seen in 2009, so it's not surprising that it has caused some alarm in financial markets. But our view remains that the slowdown has been a managed process, as the central government has pursued a reform agenda that puts financial stability and long-term growth ahead of current momentum.

Recent anecdotes and policy actions suggest that the authorities may now be satisfied with the extent of re-orientation in the economy, and are prepared to start underpinning growth again. We expect growth to stabilise at around 6% over the next couple of years. However, the changing mix of growth is likely to continue to be disruptive for some sectors. Previous areas of overinvestment such as infrastructure and construction will be disciplined by a greater need to attract private sector funding.

In contrast, consumer spending is playing an increasing role in China's growth, and saw a substantial pickup over 2018. The economy's re-orientation towards a consumer-led economy remains a work in progress, however, and households are unlikely to be immune from the disruptions in other sectors.

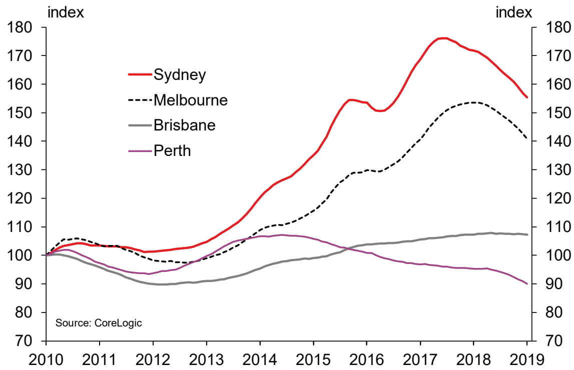
Figure 11: Contributions to Chinese GDP growth



The outlook has become notably more challenging for Australia, New Zealand's largest trade partner. Growth surged in the first half of 2018 but slowed sharply in the second half, as a growing downturn in the housing market weighed on household spending. House prices in Sydney and Melbourne are down by around 10% from their peaks, and we expect further declines over this year.

The downturn in house prices has been for reasons specific to the Australian market. First, there has been a rise in bank funding costs and mortgage rates, independent of changes in the central bank's policy rate. Second, regulatory pressure and the Royal Commission inquiry into the banking sector have prompted a tightening in lending standards. Finally, a wave of building, particularly high-rise apartments, appears to have led to an oversupply in the main centres.

Figure 12: Australian house prices



The main impact on New Zealand is likely to come from softer consumer demand, via the housing wealth effect. In particular, discretionary spending such as overseas travel is likely to be first on the chopping block; Australia accounts for almost a quarter of spending by overseas tourists in New Zealand.

As house prices have retreated, there has also been a sharp fall in the number of new homes consented. While the pipeline of already-consented work meant that building activity remained solid over 2018, we expect it to decline by around 10% over the next two years. At the margin, this will weigh on demand for building materials exported from New Zealand.

The weaker outlook for consumption and housing is offset to some degree by a strong lift in planned infrastructure spending in the public sector. The Federal election, which is due by May, will add to the uncertainty for businesses. But it could also prompt a wave of further spending promises; stronger than expected commodity prices have seen an improvement in the Government's books.

Economic forecasts (calendar years)

Real GDP annual average % change	2015	2016	2017	2018f	2019f	2020f
New Zealand	3.5	3.9	3.1	2.7	2.6	2.8
Australia	2.5	2.8	2.4	2.9	2.2	2.6
China	6.9	6.7	6.9	6.6	6.1	6.0
United States	2.9	1.6	2.2	2.9	2.5	2.1
Japan	1.4	1.0	1.7	1.1	0.8	0.7
East Asia ex China	3.8	4.0	4.5	4.4	4.2	4.3
India	8.2	7.1	6.7	7.2	7.0	7.0
Euro zone	2.1	1.9	2.4	1.8	1.4	1.5
United Kingdom	2.3	1.8	1.7	1.3	1.4	1.4
NZ trading partners	**3.8**	**3.6**	**4.0**	**4.1**	**3.7**	**3.7**
World	**3.5**	**3.3**	**3.7**	**3.7**	**3.5**	**3.5**

Agricultural Outlook

A double double

Global prices for key New Zealand agricultural products have started 2019 on the front foot. What's more, many sectors are benefitting from the relatively rare combination of firm prices and strong production. In aggregate, prices look set to broadly track sideways through 2019. The threat of a further escalation of the trade war between the US and China is casting a shadow over the outlook.

Global dairy prices drifted lower over much of 2018, but rebounded in the first couple of months of this year. We had long been expecting prices to lift on the back of tighter international supply conditions. In reality they lifted more quickly than anticipated due to slower growth in northern hemisphere production, firm demand from China and most recently, hot dry weather in New Zealand.

On-farm conditions have been very good for much of the current dairy season with around three quarters of this season's milk already in the tin. However, recent hot dry weather has seen parts of the North Island and top of the South getting very dry. While favourable conditions earlier in the season should provide a partial buffer, farmers and growers will be hoping for some relief from the dry weather soon.

Excellent pasture conditions have also benefited sheep and beef farmers. Livestock are in good condition and although meat prices have moderated from recent record highs they remain at very healthy levels. While we expect a lift in global supplies to weigh modestly on prices in 2019, to date China has been a key source of demand. Around 27% of New Zealand meat exports are now destined for China. In traditional European markets, ongoing Brexit uncertainty is still clouding the outlook. While the New Zealand Government has secured an agreement promising trade continuity post-Brexit, there remain more questions than answers on the details.

Favourable climatic conditions have also aided horticulture. With the apple picking season starting to swing into gear and grape harvesting to follow suit in the coming months, many in the industry are relatively upbeat about crop prospects. However, seasonal labour is in very short supply, with the industry lobbying for foreign workers to be allowed to fill the gaps in local availability.

After taking a step down in the second half of 2018, New Zealand's export commodity prices are broadly expected to track sideways in 2019. For some time we have warned about an economic slowdown in China. But as we explain in the *Global Economy* section, the pace of growth in China has already eased and we are not expecting a further step down in quarterly growth from here. This should help provide a floor under commodity prices. If we're wrong, and escalating trade disputes have a bigger impact on global growth than we're currently projecting, then commodity prices would take another leg lower. On the flipside, a greater role for consumer spending in Chinese economic growth could boost demand for New Zealand food exports by more than we're currently forecasting.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Strong log prices were a feature of 2018. Looking ahead we expect some moderation as Chinese demand slows. However, New Zealand exporters are benefiting from disruptions to US log supplies to China.	High	↘
Wool	Coarse wool prices remain low because the price of synthetic substitutes has benefited from lower oil prices. Any improvement in prices will be only gradual.	Average	→
Dairy	Prices have improved more quickly than expected. If sustained, this could encourage a lift in production and moderation in prices further down the track. We expect next season's milk price to be up on this season (forecasting $6.30 and $6.75 respectively).	Average	→
Lamb	International prices are expected to soften modestly but are likely to remain underpinned by tight international supplies. Brexit uncertainty continues to weigh on demand in traditional markets.	High	↘
Beef	International prices trended lower over most of 2018 but have lifted again in recent months. We expect this improvement will be temporary as growing US supplies weigh on markets over 2019.	Above average	↘
Horticulture	Volume growth to weigh on prices. Sentiment in the sector remains positive but labour shortages a key concern.	High	→

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

Exchange Rates

Overs and unders

We expect the NZ dollar will head south over the coming months against the US dollar. That's because, in contrast to markets, we think the US Federal Reserve is set to raise interest rates further in 2019. This will surprise markets and push yield differentials in favour of the US dollar. We expect the Kiwi to be steadier against the Australian dollar and the euro.

The New Zealand dollar has had its ups and downs over the last few months and has generally been stronger than we were expecting. Most recently that strength has continued, despite the softer tone of local economic data that has suggested a more subdued growth outlook for the New Zealand economy.

Two key developments have supported the NZ dollar. First, and most important, is the shift in the market's view around the outlook for the US Federal Funds Rate. Markets now suggest that there is little prospect of a change for the next year and are even considering the prospect of a cut beyond this. That's a sharp turnaround from where we sat at the time of our last *Economic Overview*, when markets were tossing up the likelihood of two or even three further rate hikes. This turnaround, combined with ongoing concern about the risks to US-China trade, has weighed heavily on the US dollar, in turn pushing the NZD/USD higher.

The second development supporting the stronger Kiwi of late has been the sharp lift in dairy prices. Against a backdrop of increasing jitters about global growth prospects, this improvement has helped the NZ dollar stand out from the crowd.

Our view is that both of these factors will prove temporary. The recent momentum in commodity prices is unlikely to continue in the coming months if weather conditions normalise and global growth cools modestly, as we expect. As we explain in our *Agricultural Outlook* section, New Zealand's export commodity prices in aggregate are expected to broadly track sideways over 2019.

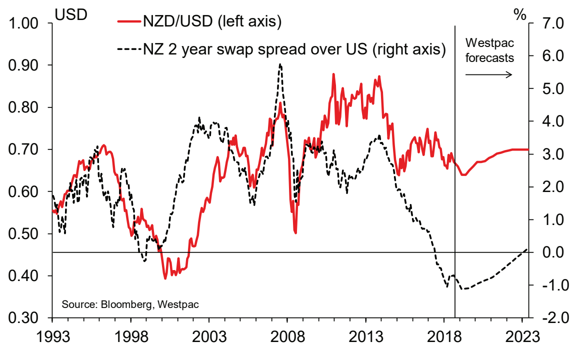
Crucially, we also take a different view to markets on the outlook for US monetary policy, and therefore interest rate differentials. While both NZ and US short term interest rates are expected to rise from current levels, the lift in US rates is likely to be larger if the Federal Reserve hikes rates twice more in 2019 as we expect.

If we're right, this is likely to see the NZD/USD head lower in the coming year. We're forecasting a fall to around 64 cents by the middle of the year (a little higher than we forecast in November).

The NZD/AUD has continued to track higher in recent months, and remains above its long run fair value. We think it will remain at these levels for a while yet. The outlook for both growth and export commodity prices continues to favour New Zealand over Australia and both central banks are expected to keep interest rates on hold for a long time.

In Europe, dwindling confidence in the region's ability to sustain growth over 2019 is set to weigh on the euro. However, beyond this the ECB is expected to deliver a long awaited tightening in monetary policy which should see the NZD/EUR gradually move lower. Brexit uncertainty continues to cloud the outlook for the British pound in the near term. Our central view is that the worst case scenario of a 'no deal' Brexit will ultimately be avoided and this should see the pound gradually strengthen against the NZ dollar from the middle of the year.

Figure 13: NZD/USD and relative interest rates



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-19	0.67	0.94	0.59	0.53	73.7	73.4
Jun-19	0.66	0.94	0.59	0.52	73.3	73.0
Sep-19	0.64	0.94	0.58	0.49	72.3	71.3
Dec-19	0.64	0.93	0.58	0.48	71.7	70.7
Mar-20	0.65	0.93	0.59	0.49	72.2	71.0
Jun-20	0.66	0.93	0.58	0.49	72.6	71.3
Sep-20	0.67	0.93	0.57	0.50	72.4	71.6
Dec-20	0.67	0.93	0.56	0.50	71.0	71.0
Mar-21	0.67	0.93	0.55	0.49	71.2	70.9
Jun-21	0.68	0.93	0.55	0.50	71.4	71.1

Special Topic

Impact of RBNZ bank capital requirements on the OCR

In December the Reserve Bank proposed that New Zealand banks should be required to hold more capital. This will lead to a lower OCR than otherwise, mainly due to tighter credit conditions crimping GDP growth. But this OCR impact will be transitional. We disagree with the widespread idea that higher bank capital will also lead to a permanently lower neutral OCR.

Banks fund their lending activities in two ways: through capital (mainly shareholders' equity), or debt (deposits from the public and wholesale debt issuance). Currently, banks are required to hold capital equal to at least 8.5% of risk-weighted assets, but the big four banks actually hold 13.4% on average.

The Reserve Bank's first proposal is to change the calculation of banks' risk weighted assets. This would reduce the big banks' current capital ratio from 13.4% to 11.6%. Second, the Reserve Bank proposes that the minimum capital ratio be lifted to 16%. Assuming that banks would choose a safety buffer of two percentage points, the big four banks would have to lift their capital ratio from 11.6% to 18%, a dollar amount in the order of $19bn. Smaller banks would also have to raise about a billion dollars of additional capital.

The RBNZ proposes that the increase in capital would take place gradually over five years, and envisages that banks would build up capital by retaining earnings rather than paying dividends.

Capital is more costly for banks than debt, so requiring banks to hold more capital will increase their cost of doing business. Banks might absorb some of this as a lower return on equity. But to at least some extent, higher costs will be passed on to customers in the form of a wider margin between deposit rates and lending rates.

This wider interest margin will partly take the form of higher lending rates, which would tend to slow GDP growth. But we should also expect bank deposit rates and interest rates on wholesale bank debt to fall. With higher lending rates, New Zealanders will choose to borrow less. In turn, that would reduce banks' need to take deposits or find funding from offshore, leading to lower interest rates paid. The very act of holding more capital would also reduce banks' requirement to source deposits. Finally, if banks are perceived as safer then wholesale lenders would, in theory, demand a lower interest rate (although this effect will be vanishingly small for the main banks, because the interest rate on their debt reflects the fact that they are subsidiaries of larger Australian parent banks.)

The RBNZ's calculations implied roughly a 40 basis point widening of the spread between bank deposit and lending rates. Our own reading emphasises that the impact is highly uncertain, with estimates varying wildly between studies.

The second key impact could be a tightening in credit conditions. Banks can build the ratio of capital to risk-weighted assets in two ways – increasing capital, or restricting risk-weighted assets. Opting for the latter would mean banks becoming more restrictive on lending, with business and agricultural loans affected most.

Impacts on the OCR temporary, not permanent

The transition to higher capital ratios will tend to crimp GDP growth via higher lending rates and (possibly) restricted credit growth. The monetary policy arm of the Reserve Bank could react to this lower GDP outlook by keeping the OCR at a lower level than otherwise, at least until the economy has adjusted. We lowered our OCR forecast by around 25 basis points, over a five year period starting in early 2021, to reflect this.

We have seen widespread suggestions that higher bank capital requirements will also lead to a lower neutral OCR. The idea is that the RBNZ can offset the impact of the bank capital requirements by lowering the OCR permanently, resulting in unchanged lending rates on average across cycles. We disagree, because this unrealistically implies permanently lower interest rates for bank deposits and wholesale loans.

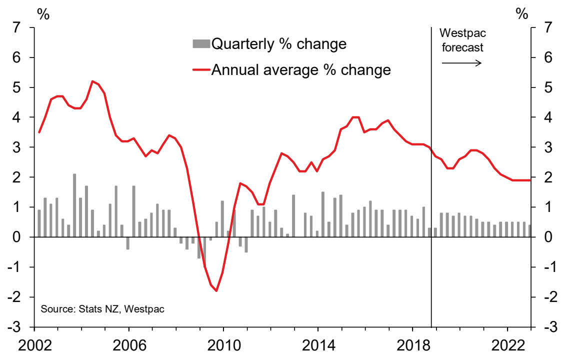
As established above, higher bank capital requirements would lead to a wider margin between bank deposit and lending rates. If lending rates are the same as today while interest margins are wider, deposit rates must be permanently lower. That is unrealistic – savers and wholesale lenders would react to lower interest rates by depositing or lending less, leaving banks with a funding shortfall.

Our view is that the capital requirements will lead to higher lending rates, lower deposit rates and no change in the neutral OCR. It is not obvious why the neutral OCR would change when deposit rates and lending rates are moving in two different directions. Our view implies that depositors and savers would each bear some of the cost of the bank capital requirements, whereas the lower-neutral-OCR theory unrealistically implies that savers would bear the entire cost via lower deposit rates.

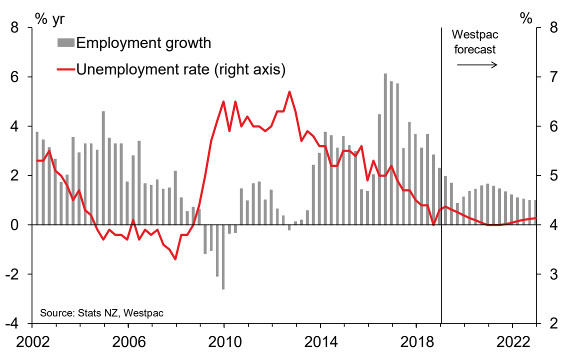
Forecasts and key charts

	Quarterly % change				Annual average % change			
	Sep-18	Dec-18	Mar-19	Jun-19	2018	2019	2020	2021
GDP (production)	0.3	0.3	0.8	0.8	2.7	2.6	2.8	2.0
Private consumption	1.0	0.6	0.7	0.8	3.0	3.0	3.0	2.0
Government consumption	-1.1	1.5	1.5	1.0	2.2	4.0	4.6	4.9
Residential investment	1.3	1.0	0.8	0.5	3.0	2.9	-0.5	-2.1
Business investment	-2.1	-0.4	0.3	1.0	3.7	0.4	3.4	2.0
Stocks (% contribution)	-0.3	0.2	-0.1	0.0	0.4	-0.2	0.0	0.0
Exports	0.3	0.8	0.6	0.6	3.5	2.8	2.1	2.0
Imports	-0.2	1.1	0.5	0.6	6.3	2.6	3.2	2.9
	Quarterly % change				Annual % change			
Consumer price index	0.9	0.1	0.2	0.5	1.9	1.8	2.1	2.0
Employment change	1.1	0.1	0.2	0.3	2.3	1.1	1.7	1.2
Unemployment rate (end of period)	4.0	4.3	4.4	4.3	4.3	4.2	4.0	4.0
Labour cost index (all sectors)	0.5	0.5	0.5	0.7	1.9	2.5	2.6	2.6
Current account balance (% of GDP)	-3.6	-3.7	-3.3	-3.0	-3.7	-2.9	-2.8	-2.8
Terms of trade	-0.3	-0.5	-1.2	0.2	-2.4	-1.1	2.2	0.0
House price index	0.4	0.9	0.9	0.7	2.6	3.0	0.0	-3.0
90 day bank bill (end of period)	1.81	1.87	1.90	1.90	1.87	1.90	1.90	2.10
5 year swap (end of period)	2.44	2.40	2.10	2.20	2.40	2.30	2.50	2.90
TWI (end of period)	72.4	73.5	73.4	73.0	73.5	70.7	71.0	71.3
NZD/USD (end of period)	0.67	0.67	0.67	0.66	0.67	0.64	0.67	0.69
NZD/AUD (end of period)	0.91	0.93	0.94	0.94	0.93	0.93	0.93	0.93
NZD/EUR (end of period)	0.57	0.59	0.59	0.59	0.59	0.58	0.56	0.54
NZD/GBP (end of period)	0.51	0.52	0.53	0.52	0.52	0.48	0.50	0.50

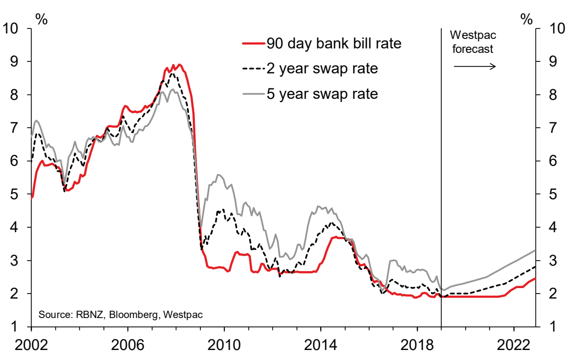
New Zealand GDP growth



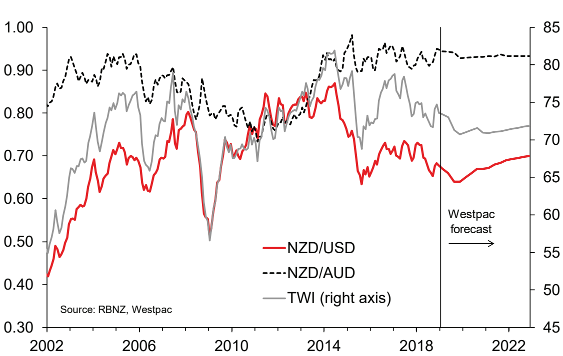
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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