Economic Overview.

Signs of spring?

November 2019

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Having endured the chill winds of a slowdown, it is nice to see signs of spring emerging in the New Zealand economy. The slowdown intensified in the September quarter, but recent data tentatively suggests we are past the worst of it.

Things have played out very much as we expected, so you will find very few changes in our forecasts since August. We have long expected the economy to get a lift from government spending, low interest rates, and rising house prices, and that's how things are playing out. The biggest call we have made this year was that house price inflation would lift from 1% to 7% by the end of 2020. No other major forecaster shared that view back in April, but evidence of a housing market pickup is now clear.

This putative economic improvement won't be felt by everybody. Businesses will remain under siege from a rising cost base, a limited ability to lift prices, and more difficulty accessing finance. That's why we are forecasting a pretty modest 2.6% GDP growth next year.

The Reserve Bank is seeing the same signs of spring as us, so it has kept the OCR on hold. We still think there will be one more cut before the OCR reaches its low point of 0.75%. This is based on our global forecasts. Global economic sentiment has calmed recently, but we expect it to worsen as signs of a slowdown in the US become more prevalent – or if another presidential tweet sets off palpitations.

I'll close with a surprising fact mentioned in the *New Zealand Economy* section. Due to immigration the median age of New Zealand's population has *fallen* over the past five years. Our demographic future will look different to other Western countries.

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New Zealand Economy.

Spring is in the air.

The local economy has lost momentum over the course of this year. Our long-held view has been that fiscal spending and accommodative monetary policy would help to lift the economy out of the mire, and recent data is starting to support that view. However, some persistent headwinds to growth remain in place, and the recovery will not be felt evenly across the economy.

New Zealand's economic slowdown intensified over the first three quarters of 2019. On an annual basis, we are expecting GDP growth to slow to 2.2% for this year, compared to 2.8% last year and a peak of 3.9% in 2016.

There has been a range of factors behind the slowdown in growth. Business confidence has remained weak this year, and firms have been more hesitant about hiring and investing. A source of easy growth for businesses is waning as net migration has come off its highs. And a softer housing market over recent years has weighed on households' willingness to spend.

The September quarter was clearly weak, but we suspect that will mark the low point for growth.

GDP for the September quarter, which will be released towards the end of this year, is shaping up to be particularly weak – we expect an increase of just 0.3%. It's not an entirely gloomy picture, with agriculture and retail set to record solid gains. But the indicators to date point to weak growth in services and a contraction in manufacturing.

Our long-held view has been that the economy will be dragged out of the mire by increased government spending and accommodative monetary policy. Admittedly, the turnaround has been slower to emerge than we expected. But there have been some more encouraging signs over the last few months, suggesting that the September quarter marked the low point for growth. It is starting to look like the economy has passed a turning point.

A crucial part of our view was that house price inflation would pick up on the back of lower mortgage rates. That part is now undeniable. Since the steep slide in mortgage rates that began in April, along with the shelving of the proposed capital gains tax, house sales have lifted by 14% from their lows, and house prices have risen by 3.2% in the last three months (having risen just 1.5% in the year before that). There are also tentative signs that the housing market is helping to support consumer spending, with electronic card transactions and car registrations picking up a little in the last few months after a soft patch in the first half of this year.

Businesses are still very downbeat, but they may be seeing some light at the end of the tunnel. Surveyed business sentiment for the September quarter was very weak, but expectations for the quarter ahead rose slightly. Similarly, job advertisements have recovered a little after falling sharply mid-year.

Figure 1: GDP growth

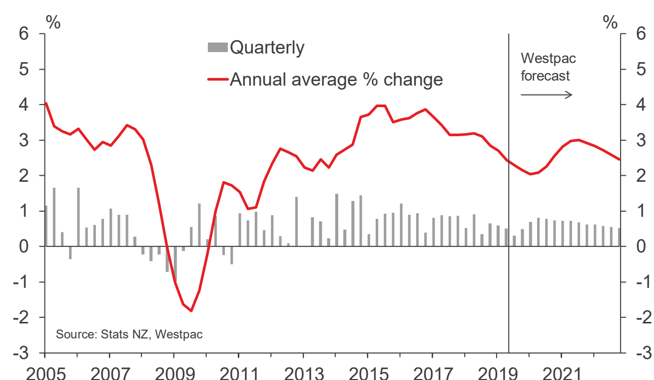
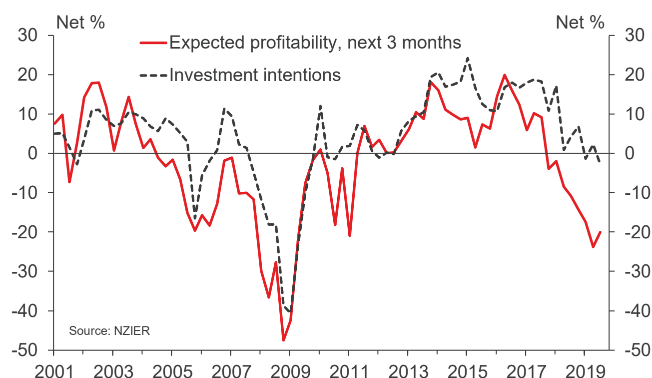
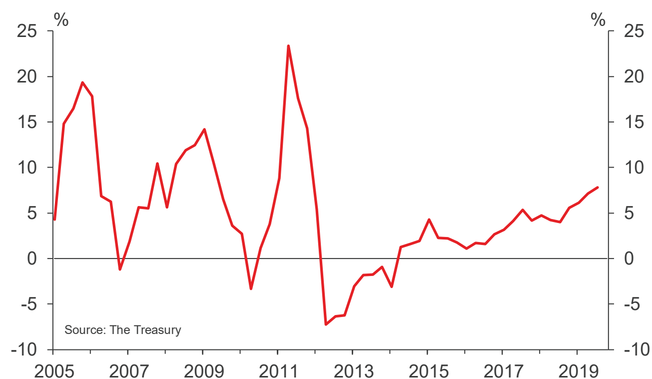


Figure 2: Surveyed profitability and investment intentions



The Government is now meeting its spending plans, having underspent in previous years. Total operating spending was up by 7.8% in the year to September, compared to 4% in the previous year. Much of that increase is likely to have boosted incomes rather than activity in the first instance – for example, transfers to households and higher pay rates for public sector employees. But that translates to more money in people's pockets, which will provide further support for growth in consumer spending.

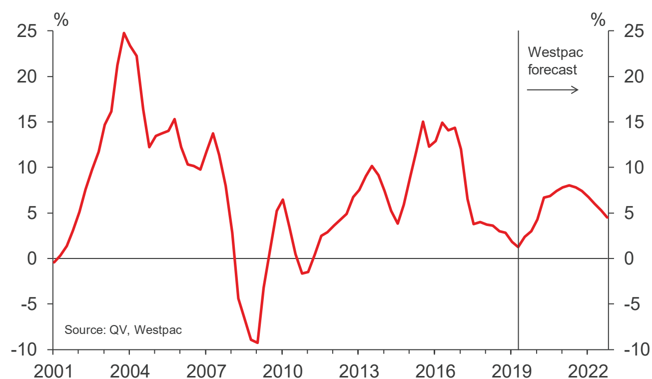
Figure 3: Total government spending, annual growth



We expect to see a more convincing lift in the economy's momentum over the next two years, with the pace of annual growth peaking at around 3%. That's some way short of the growth rates reached in previous years, in recognition of the fact that there are both supportive factors and substantial headwinds to growth.

The first positive is that record low mortgage rates will continue to support house price gains, and consequently household spending, for some time to come. We're forecasting house prices to rise by around 7% in both 2020 and 2021, a fairly modest rate of increase compared to previous periods of housing market strength. Indeed, our forecast is intentionally conservative, reflecting the unclear impacts of the foreign buyer ban, the ringfencing of investment properties for tax purposes, and the tightening in bank capital requirements over the coming years.

Figure 4: House prices



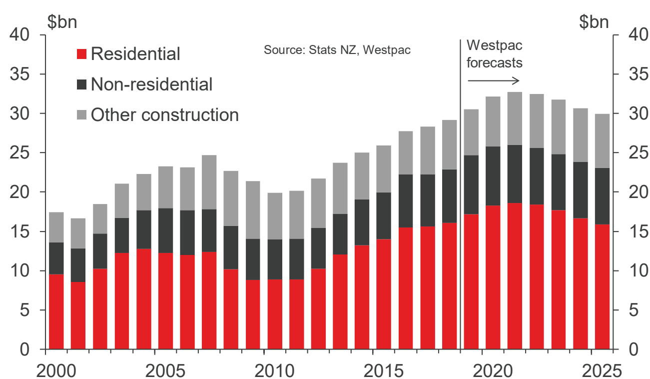
Higher house price inflation, on the back of lower mortgage rates, is key to our view.

Fiscal stimulus is also likely to remain a feature over the next few years. Tax revenue has been persistently surprising to the upside, which has allowed the Government to increase its planned spending while still running modest surpluses. Our forecasts already incorporated an increase in spending allowances beyond what was signalled in the May 2019 Budget, and we've bumped up that assumption further this time. We expect next year's Budget to feature a substantial increase in projected spending – not least because it will be an election year.

Construction, and particularly housing, has been a notable bright spot. We were previously expecting homebuilding to stabilise at a high level, but instead building consents have lifted another 12% over the past year. Population growth, via net migration, has also held up better than we expected, adding to the demand for housing.

We expect further growth in construction over the coming year, with the level of activity peaking in 2021. After that, though, we see the cycle turning. Earthquake reconstruction work is still winding back, and at the current pace we'll soon be building enough homes to keep up with population growth – particularly in Auckland, in light of recent revisions to population estimates (see box on facing page). Indeed, it's conceivable that Auckland could even move into overbuilding, with the risk of a sharper construction slowdown further down the track.

Figure 5: Construction forecasts



The trade outlook for the next year or so is mixed. High world commodity prices and a lower exchange rate will support exporters' returns, particularly in the agricultural sector. However, low confidence among farmers and a softer world economy mean that volume growth is likely to be muted. Tourist numbers have slowed this year, and we expect them to be broadly flat over 2020. A number of events over 2021 should give tourist spending a temporary boost.

Low business confidence and tighter access to credit present stubborn headwinds to growth.

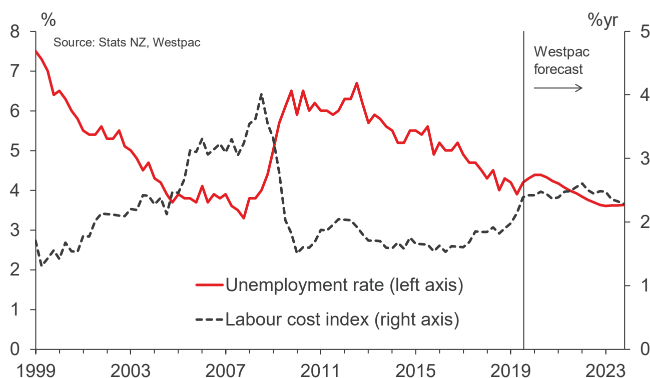
There are still some stubborn headwinds to a pickup in economic growth. The causes of low business confidence are multifaceted, reflecting concerns about government policies, rising costs of doing business, and the difficulty of raising prices in the face of local and global competition. None of these issues will be directly alleviated by lower interest rates or fiscal stimulus. We think that businesses will remain reluctant to hire and invest for a while yet.

Access to credit has tightened significantly for some sectors such as agriculture and commercial property. This issue will become more pressing as the Reserve Bank's proposed increase in bank capital requirements is phased in over the coming years. We've already made some allowance in our forecasts for the expected impact on the economy, and we'll review this after the final decisions on the policy settings are announced in early December.

In recognition of these headwinds, our forecasts imply a relatively modest lift in growth over the next couple of years. But with population growth expected to slow further as net migration slows, the economy's potential growth rate is falling as well. GDP growth peaking at around 3% would still be consistent with a further tightening in the labour market, and a gradual build-up in inflation pressures.

The labour market appears to have tightened over 2019, but it tends to lag the broader economic cycle. Given the slowdown in growth to date, we expect the unemployment rate to worsen in the near term, rising to 4.4% early next year. However, as economic growth strengthens in the next couple of years, we expect unemployment to gradually drop below the 4% mark again, helping to underpin wage growth. Government-mandated increases such as minimum wage hikes and public sector pay agreements have accounted for part of the rise in wage growth to date, and they will make further contributions over the next few years.

Figure 6: Unemployment rate and wage growth



New insights on population.

Recent data suggests that the median age of New Zealand's population has fallen, and its growth has been less concentrated in Auckland than previously thought. Recently we've seen two significant updates to the population estimates: a change in the measurement of permanent and long-term migration, and the first batch of data from the 2018 Census.

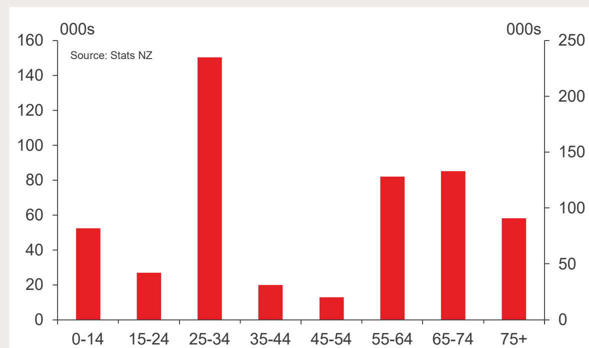
The first change is that we've seen less migration-led population growth over the last few years than previously thought – about 1% less since 2013. Even so, that leaves a major trend intact: New Zealand's workforce has seen significant growth in the 25-34 age group, which is where migrants (both inward and outward) tend to be concentrated. Indeed, the median age in New Zealand has fallen slightly in the last five years, counter to the global trend of an ageing population.

If a high proportion of these people remain in the country for the long haul, there will be some significant distributional impacts. First, these people will bolster the workforce for decades to come – participation rates remain consistently high up to around the age of 55. Another issue is that many of them will be looking to enter the housing market at this stage of their lives, so will find themselves in competition with each other for a limited pool of housing.

The second change to the population estimates is a substantially different mix of growth across the regions. In particular, Auckland has grown by much less than previously thought, due to a combination of the downward revisions to net migration and the movement of people to other regions.

Consequently, the housing shortage in Auckland is much smaller than previously estimated, and at the current pace of building would be eliminated much sooner. This reinforces our view that construction activity will start declining after 2021. The flipside is that the smaller regions have seen much stronger population growth than was previously estimated, suggesting that some of them may see a more prolonged building cycle.

Figure 7: Estimated population growth, 2013-2018



Global Economy.

A break in the weather.

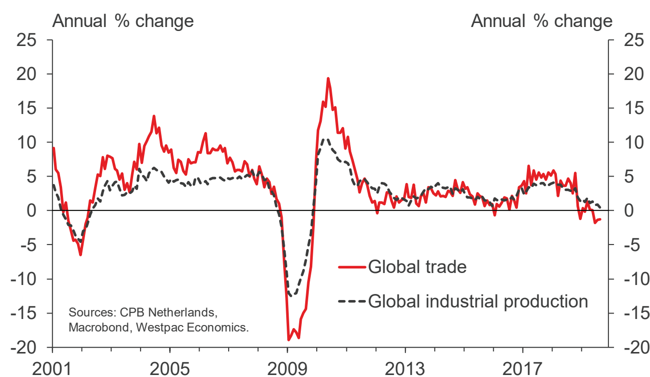
Financial markets have become more optimistic about the outlook for the global economy as central banks have loosened policy and concerns about geopolitical risks have eased. However, we expect that this recent lift in sentiment will be short lived, with global growth and inflation to remain subdued over 2020 and 2021. As a result, major central banks are likely to loosen policy settings again over the coming year.

The global economy has continued to weaken, with global GDP growth likely to slow to a below trend pace of just 3% by the end of 2019. That would be the slowest pace in ten years. The downturn in growth has been widespread, with many of New Zealand's major trading partner economies experiencing weaker conditions, including Australia, the United States and China.

Underlying this slowdown has been a combination of political uncertainty and increased trade protectionism, including the protracted tit-for-tat trade war between the US and China. That's come atop other factors that are weighing on economic growth, including the managed slowdown in the Chinese economy.

The combination of those factors has resulted in a deepening downturn in global manufacturing and international trade. Importantly, weakness in these areas is now spilling over into economic conditions more broadly. Many countries have seen activity in their service sectors slowing, and nervousness around the global backdrop has prompted businesses to scale back plans for investment spending.

Figure 8: Global trade and industrial production



But while economic activity has been weak through much of 2019, there are signs that the geopolitical tensions that have been weighing on economic activity are starting to ease. That's been seen on two key fronts:

- First, in terms of trade policies, recent rhetoric from both the US and China has been encouraging, with indications that an agreement is close, which could avoid the introduction of further tariffs. If the two countries do reach an agreement, that might also pave the way for some rolling back of tariffs that have been introduced in recent years.
- The other area where uncertainty has eased is in relation to Brexit. After a turbulent three years and several extensions to negotiations, the UK has reached an agreement on the terms of their withdrawal from the EU. That's seen the chances of a no-deal exit recede in recent months. Nevertheless, it's likely that economic activity in the UK will remain weak over the next few years.

Those developments, along with support from monetary and fiscal policy, have soothed nerves in financial markets and seen renewed optimism about the outlook for economic activity. However, we're sceptical that this optimism will last. As we look ahead to 2020, there is a very real likelihood that nervousness around the global economic outlook will flare up again. On the geopolitical front, negotiations between the US and China remain in flux, with a number of contentious issues yet to be resolved. There is also a risk that President Trump may attempt to introduce new restrictions on trade with major economies other than China, such as increased tariffs on US imports of European cars. And on top of that, the US election is coming onto the horizon, and that will no doubt raise a number of questions about the direction of US economic policy.

Importantly, a range of indicators are pointing to weaker GDP growth in the world's two largest economies – the US and China. In the US, the global manufacturing recession is now clearly affecting domestic producers, with the manufacturing ISM slumping to a decade low in September. There are also signs US activity more generally is cooling, with the non-manufacturing ISM dropping to a three-year low, a downturn in investment spending, and a fall in hiring intentions. We expect that these headwinds will see US GDP growth slowing from 2.3% over 2019 to 1.6% over 2020, and the related softness in US demand will be a drag on global growth more generally.

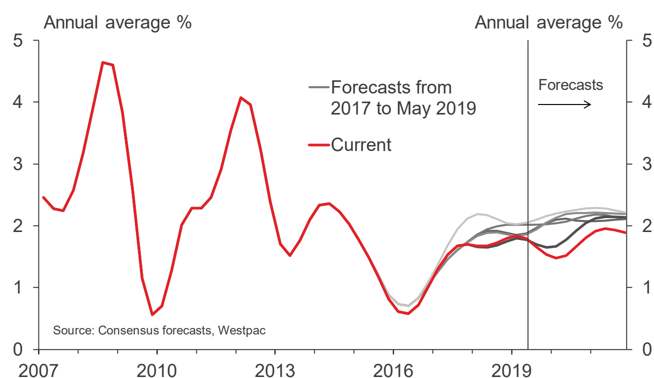
In China, GDP growth surprised to the downside earlier this year, leaving annual growth at the threshold of the authorities' target 6.0% to 6.5% range for 2019. Global factors have clearly been a drag. However, domestic factors are also at play with authorities continuing to pursue a reform agenda that puts financial stability and long-term growth ahead of current momentum. The consequence has been a marked slowing in investment by both state-owned enterprises and local government authorities. Looking ahead, Chinese GDP growth is expected to slow to 5.8% in 2020 and 2021. And as we've highlighted before, that softness will have spillover effects for other economies in the Asia-Pacific region, including Australia and New Zealand.

Putting all that together, an enduring reacceleration in global economic activity still looks some way off. We expect that overall global GDP growth will remain sluggish over 2020 and 2021.

Global economic sentiment has improved, but an enduring reacceleration in activity still looks some way off.

In addition to the slowdown in growth, global inflation has remained muted. As we've previously highlighted, that's in part due to the softening in activity in economies that are major producers of internationally traded consumer goods. However, there have also been significant structural changes in the retail environment, including the continuing growth of e-commerce and related changes in logistics. That's resulted in an increasingly competitive global marketplace for many consumer goods. Combined, these conditions have meant inflation has been rising more gradually than central banks in many countries have been expecting, and forecasts for inflation over the coming years have continued to be revised down.

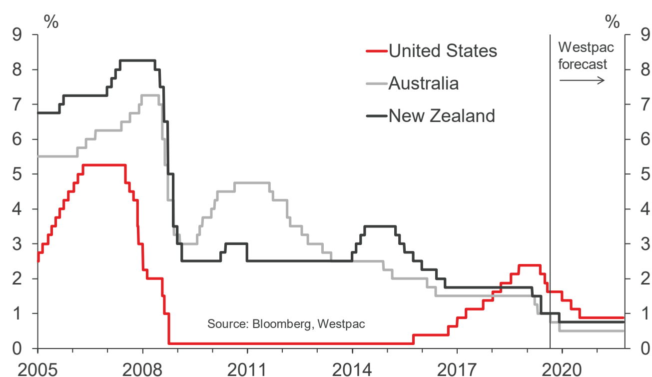
Figure 9: Revisions to global inflation forecasts



With subdued economic activity and lingering softness in inflation, central banks have been active over the past couple of months. The US Federal Reserve cut rates at its July, September and October meetings. The ECB cut rates and announced the restarting of quantitative easing. And the RBA has slashed its cash rate by a total of 75bps over the past year, taking it to a fresh historic low of 0.75%.

Central banks have now hit the "pause" button as they watch to see how their economies respond to recent stimulus. But while policy makers are equivocal about the need for additional stimulus, we think that weakness in economic activity will see them coming back to the party in 2020. In particular, we expect a further three cuts from the Fed. We also expect that the RBA will cut again in February, taking the Australian cash rate to a new low of 0.50%.

Figure 10: Central bank policy rates



New Zealand has not been immune from the downturn in global activity. Weaker conditions in our trading partner economies have already dampened the demand for several of our key commodity exports like wool and forestry products that are used in manufacturing. It's also weighing on the demand for services exports, like tourism and education services.

Nevertheless, New Zealand may be better positioned than many other countries to weather the slowdown in the global economy. As discussed in the *Agricultural Outlook* section, the continued uptrend in the demand for food in China and other parts of Asia is helping to support prices for some of our key commodity exports like dairy and meat. In addition, as we import a large proportion of our consumer goods, price competition in this space is boosting many households' spending power.

New Zealand has not been immune from the downturn in the global economy, but we may better positioned than many other economies.

Inflation.

Stirring slowly.

Domestic inflation pressures have firmed and are set to continue strengthening over the coming year. However, there's still lingering softness in import prices and continued strong competition in the retail sector. That means the Reserve Bank still faces a protracted battle to get inflation back to 2% and keep it there on a sustained basis.

Inflation slipped back to 1.5% in the September quarter, down from 1.7% earlier in the year. That easing in the headline inflation rate was mainly due to last year's sharp rise in oil prices dropping out of the annual calculations. Digging beneath the surface, we're seeing signs that inflation pressures in the economy are at long last starting to firm.

This strengthening in inflation has been centred on the domestically oriented non-tradables components of the Consumers Price Index. Prices in this group rose by 3.2% in the year to September – the fastest pace of increase since 2011. It's true that some idiosyncratic factors added to inflation in September, like a sharp rise in domestic airline prices. But even looking beneath the surface, a more general firming in domestic inflation is occurring.

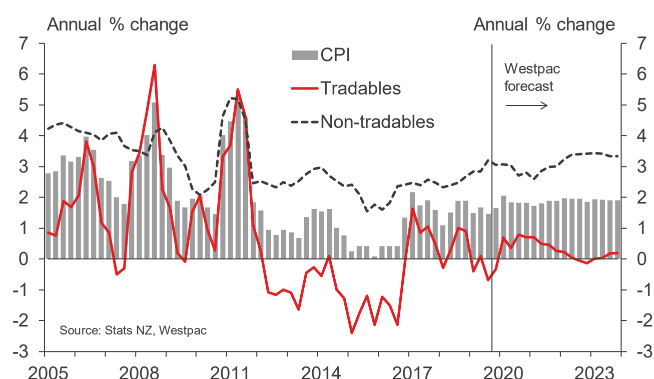
That strengthening in domestic inflation comes atop other signs that inflation pressures are building, with a growing number of businesses reporting increases in operating costs and wage growth climbing to a 10-year high in September. We expect that domestic inflation will continue to gradually trend higher over the coming year as the combination of low interest rates and increases in fiscal spending supports a strengthening in domestic demand.

But while the domestic inflation backdrop is firming, it's a very different story when we look at more import intensive areas of the economy. Recent months have seen continuing softness in the prices of many globally traded consumer goods, and that's being exacerbated by sluggish global economic activity. At the same time, competitive pressures in the retail sector remain fierce. That's being reinforced by the continuing shift to e-commerce, which has effectively increased the presence of large global retailers with significant pricing power in the New Zealand marketplace. The combination of these factors has seen the prices for tradable consumer goods (excluding petrol) falling by 0.4% over the past year, and they're down nearly 5% since 2011.

Putting all this together, we think that inflation is going to continue pushing higher over the next few years. However, that rise is likely to be gradual, and the Reserve Bank will still be fighting a protracted battle to get inflation back to 2% on a sustained basis for some time yet.

With lingering softness in inflation in recent years, we've also seen shorter-term measures of inflation expectations slipping back. Longer-term expectations, in contrast, have remained close to 2%. With inflation struggling to reach 2%, the RBNZ will be keeping a close eye on expectations over the coming year. If they continue to slip, it would be a big concern for the central bank, making it harder for them to generate a sustained lift in inflation back to target.

Figure 11: New Zealand inflation



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Dec-19	1.7	1.00	1.10	1.10	1.20
Mar-20	2.0	0.75	0.90	1.00	1.10
Jun-20	1.8	0.75	0.90	1.00	1.15
Sep-20	1.8	0.75	0.90	1.00	1.20
Dec-20	1.8	0.75	0.90	1.00	1.25
Mar-21	1.7	0.75	0.90	1.00	1.30
Jun-21	1.8	0.75	0.90	1.05	1.35
Sep-21	1.9	0.75	0.90	1.10	1.40
Dec-21	1.9	0.75	0.90	1.15	1.45
Mar-22	2.0	0.75	0.90	1.20	1.55

The Reserve Bank and Interest Rates.

Rematch.

The Reserve Bank is still 50/50 on whether one more OCR reduction will be required this cycle, so the February decision is a close call and data dependent. We still expect a February cut and that 0.75% will be the low in the OCR. While OCR hikes are a long way off, lending rates will be rising in the early 2020s because of the RBNZ's bank capital requirements.

When it cut the OCR 50 basis points in August, the Reserve Bank indicated that there was a 50/50 chance that a further OCR cut would be required. Initially, we thought that downside surprises would prompt the RBNZ to cut the OCR in November. That is not the way the game played out – it was actually a tie, with upside and downside developments scoring evenly. Although the economy was weaker than anticipated, this was balanced out by an upside surprise on inflation, a lower exchange rate, strong export commodity prices, and a general calming in global financial market sentiment. Accordingly, the RBNZ left the OCR unchanged.

If the August to November monetary policy round was a tie, November to February is shaping up as the rematch. Once again, we start the quarter with the RBNZ indicating that there is a 50/50 chance of an OCR cut, to be decided by how the data evolves relative to the RBNZ's expectations.

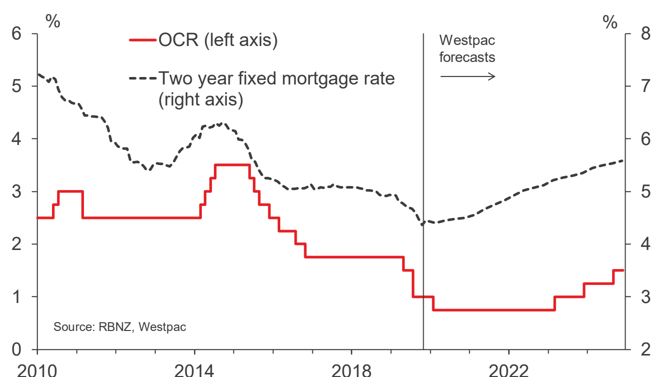
At this stage, our view is that downside surprises will predominate, and therefore we are forecasting a February OCR cut. It's not that we expect the RBNZ will be surprised on the trajectory of the domestic economy – their GDP forecasts are very similar to ours. If anything, we expect that the RBNZ will be surprised on the *upside* by ongoing increases in house prices. However, our view is that global factors could tip the balance in favour of an OCR cut. The recent period of calm on global financial markets has been influential for the RBNZ. However, a single presidential tweet or a renewal of the trade wars could easily prompt renewed nervousness, as could signs of a slowdown in the US economy.

The second downside development will be the RBNZ's final decision on its bank capital requirements, which will be announced in early December.[1] To date, the monetary policy arm of the RBNZ has not formally factored the capital requirements into its forecasts, but it will do so once the requirements are finalised. Based on views the RBNZ has already published, the capital requirements will have only a small downward impact on the RBNZ's OCR forecast. This will be a consideration for the February MPS, albeit minor.

Our own view is that the capital requirements will eventually have more impact on the economy, and therefore the OCR, than the RBNZ expects. If the RBNZ's initial proposal was implemented in full, we estimate that bank lending rates would rise by about 50 basis points relative to the OCR. However, the RBNZ may water down its original proposal a little, so the working assumption we have adopted in this *Economic Overview* is 40 basis points. This impact will not be spread evenly – mortgage rates will rise by less while business and agricultural lending rates rise by more, meaning the capital requirements will crimp investment in the economy.

The full lift in interest rates consequent on the capital requirements will take place over a timeframe of years rather than months. Therefore, we think of the capital requirements as something that will delay the eventual OCR hikes from the Reserve Bank, rather than having a huge bearing on how low the OCR goes in the short run. We still expect mortgage and other lending rates to rise during the 2020s, but this is likely to be due to the capital requirements before it is due to OCR hikes.

Figure 12: Official Cash Rate and two year mortgage rate forecasts



1 For background on the capital requirements, see the February 2019 Economic Overview.

Agricultural Outlook.

Standing firm.

In the face of a slowing Chinese economy, demand for New Zealand's food exports has held up well, but logs and wool have struggled. We have maintained our cautious view on the strength of the Chinese consumer, but continued strong demand for protein and a lower exchange rate should mean that meat and dairy farmers are set for some solid returns this season.

New Zealand's key agricultural exports have faced diverging fortunes this year. Demand for consumer-oriented products such as meat, dairy and fruit has been steady, and prices have held up better than we expected. In contrast, products that go into further manufacturing such as logs and wool have been relatively weak and are expected to remain so.

This matches what we're seeing in the global economy, especially China. As discussed in the *Global Economy* section, China's economic growth has continued to slow this year, though the effects have fallen unevenly. The manufacturing sector has been directly in the firing line of the US-China trade war; consumers have been less affected, but there have been knock-on effects in terms of softer employment and wages.

In the case of meat, the strength of Chinese consumer demand has been amplified by the outbreak of African Swine Fever (ASF), which has spurred demand for other proteins. Beef has been the biggest beneficiary, with a strong lift in prices and a sharp rise in the share of New Zealand's exports going to China. Lamb has benefited to a lesser extent, particularly the lower-value cuts that were already popular in China. We think that meat prices have further to run in the short term, though we expect prices to ease back over the course of 2020 as both global demand and supply adjust.

World dairy prices have ticked up in the last couple of months, unwinding some of their mid-year decline. Demand from China has remained solid, and indeed has been almost the sole source of growth for New Zealand's exports. We have revised up our farmgate milk price forecasts to $7.10/kg for the current season and $7.30/kg for the following season. Even then, we've maintained our caution on the strength of the Chinese consumer, and our forecasts allow for a modest pullback in world dairy prices over the first half of 2020.

In the past, milk payments at these levels would have incentivised dairy farmers to ramp up production. However, rising on-farm costs, concerns about regulatory changes such as the proposed freshwater standards, and tighter bank credit are expected to restrain farmers' expansion plans this time.

Log export prices plunged in mid-2019 on a combination of weaker Chinese demand and oversupply from Europe, and we had expected that prices would fall further. Instead, they have stabilised and risen a little in the last couple of months, as New Zealand and other exporting countries have slowed their harvesting. We expect prices to go sideways rather than rising further over the next year, as any improvement in demand is likely to be met by a resumption of supply.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	World dairy prices are around their long-term averages, but a lower effective exchange rate points to a relatively high $7.10/kg milk price for this season. We continue to expect some easing in world prices in the near term.	Average	↘
Beef	Limited supply means that the price lift from the ASF outbreak in China probably has further to play out.	High	↗
Lamb	ASF has boosted Chinese demand for some cuts, but lamb is playing second fiddle to beef. UK buyers are tentatively returning as Brexit uncertainty lifts.	High	→
Forestry	Log prices appear to have fallen far enough to achieve the necessary rebalancing in the Chinese market. However, we think that both prices and volumes will be slow to recover.	Above average	→
Wool	US-China trade tensions expected to continue to weigh on demand for wool products.	Below average	↘
Horticulture	Both prices and volumes have remained firm, as the sector has reaped the rewards of investment in new varieties of fruit.	High	→

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

Exchange Rates.

Nearing the bottom mark.

The New Zealand dollar may drop a little further in the near term against the US dollar, but we think the exchange rate's long downtrend will come to a close next year. The falling exchange rate was driven by a strong US dollar and New Zealand's economic slowdown, both of which are going to turn soon. Our foreign exchange forecasts are more stable against most other currencies, except the Brexit-affected pound sterling.

Since early 2018 we have consistently predicted that the New Zealand dollar / US dollar exchange rate would fall to around 64 cents by late-2019, and that is broadly the way things have panned out. There have been two key drivers. First and foremost, the US dollar has strengthened, mainly on safe haven flows as global risk sentiment has soured. Secondly, the New Zealand economy has lost its rockstar status with a notable slowdown. Both trends may soon start to turn around, so the long downtrend in the exchange rate may be drawing to a close.

We are content to forecast one last leg lower in NZD/USD to 62 cents by March, mainly because sentiment around the New Zealand economy may yet worsen when key pieces of data such as September quarter GDP are published. However, that may be as low as the kiwi dollar goes.

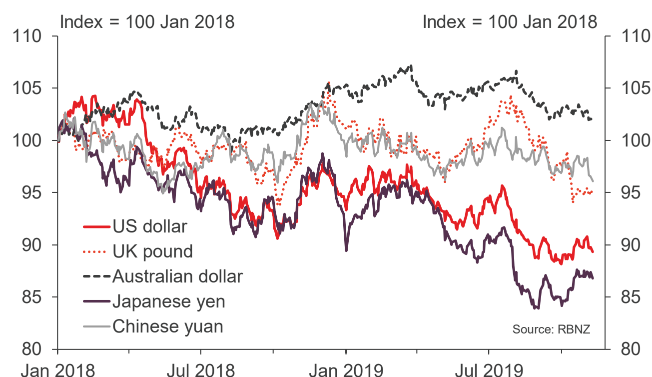
Global foreign exchange markets are gradually pivoting away from the strong US dollar trend. Over the course of 2020 we expect that a new downward trend for the US dollar will be in place, causing NZD/USD to gradually trend higher.

Safe haven flows into the US dollar may wane as tensions on trade fade to a 'slow burn' risk. Meanwhile, we expect the US economy to weaken more than others. Correspondingly, we anticipate a further 75 basis points of monetary easing from the US Federal Reserve, but only a fraction of that from other central banks. For Australia, New Zealand and the UK we forecast only one 25 basis point cut each, and for the eurozone and Japan we expect even less monetary easing.

While we expect the New Zealand dollar to strengthen relative to the US dollar, our forecasts against other currencies are more stable. We don't have strong cause to predict any major change in the NZD/AUD. Both countries are currently experiencing weak economic conditions, but are showing signs that monetary policy is boosting asset prices. New Zealand's commodity price outlook is the stronger of the two, but that probably only justifies the NZD/AUD staying above its long-run average, rather than suggesting another leg higher. Similarly, our forecasts are fairly stable for the New Zealand dollar against the euro and yen, as all boats are affected by the outgoing US dollar tide.

The UK pound has strengthened recently on optimism about a Brexit deal eventually being struck. This market optimism may persist into early-2020, hence we forecast NZD/GBP down to 0.47 in the near term. However, over the longer term we have reservations about what Brexit will mean for the UK economy, so we expect sterling to weaken over time.

Figure 13: NZ dollar exchange rate vs major countries



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Dec-19	0.63	0.94	0.58	0.48	68.0	70.4
Mar-20	0.62	0.94	0.57	0.47	66.3	69.5
Jun-20	0.62	0.94	0.56	0.47	65.7	69.2
Sep-20	0.63	0.94	0.57	0.48	66.2	69.6
Dec-20	0.63	0.94	0.56	0.48	66.2	69.3
Mar-21	0.64	0.94	0.57	0.49	67.8	69.9
Jun-21	0.65	0.93	0.57	0.49	69.0	70.0
Sep-21	0.66	0.93	0.57	0.50	71.3	70.9
Dec-21	0.67	0.92	0.58	0.50	72.5	71.0
Mar-22	0.67	0.92	0.58	0.51	73.6	71.2

Special Topic.

New Zealand's commercial property outlook.

In recent years, the combination of firm economic activity and very low interest rates has boosted both occupier and investor demand for commercial property. Some of that positive momentum in the economy has eased back over 2019. However, with interest rates likely to remain low for an extended period, we think that commercial property prices will rise from here.

New Zealand's commercial property sector has enjoyed a solid run in recent years, with strength in both occupier and investor demand.

For occupiers, an extended period of economic growth and rapid increases in the population have fuelled the demand for commercial space. Over the past five years, economic activity has increased by 17%. During that time we've seen solid jobs growth in industries that occupy commercial space: around 48,000 more jobs have been added in occupations that traditionally occupy office space (up 10%); 38,000 jobs have been added in the retail and hospitality sectors (up 12%); and 21,000 jobs have been added in businesses that occupy industrial space (up 5%).

Strength in occupier demand has supported related increases in non-residential building activity. However, construction has not kept up with demand. That's seen vacancy rates falling to low levels, especially in Auckland and Wellington. There have also been related increases in rents.

Against this backdrop, there's also been strong investor interest in commercial property. Very low interest rates in New Zealand and abroad have seen investors hunting for assets that can provide higher returns. And with solid GDP growth and positive trends in occupier demand, investing in commercial space has been seen as an attractive option. Looking across the range of commercial property categories, gross rental yields in Auckland are currently averaging around 5.4% to 5.9% per annum, while in Wellington and Christchurch yields are averaging around 6.7% to 7.1%. Those returns are well above what's on offer from standard bank deposits. They also look attractive compared to the yields on residential property.

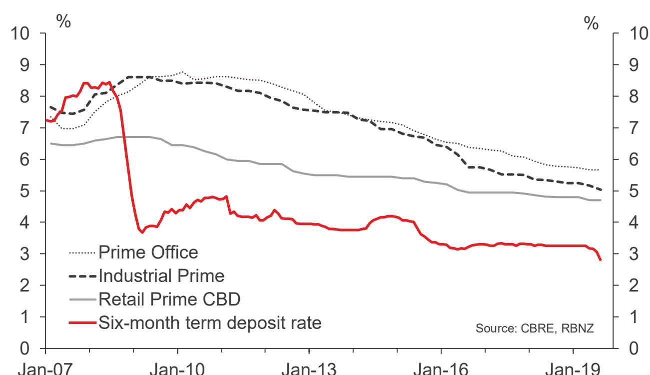
While the commercial property sector has enjoyed a solid run in recent years, the underlying economic conditions that have supported demand have been changing. GDP growth has slowed, population growth has dropped back, and the global backdrop has been rocky. These conditions have seen business confidence slumping across all sectors.

We expect that these conditions will dampen occupier demand for new space over the coming year and will result in some increase in vacancy rates from current low levels. Those conditions could also limit rent increases.

The softening in economic conditions will also raise some flags for investors. Nevertheless, we expect that investor demand will remain strong over the next few years. That's because interest rates here and abroad have dropped sharply, and they are likely to remain low for an extended period. As a result, yields on commercial property will continue to look attractive relative to other investments. This also means the price of commercial property could rise faster than the underlying rents.

A key risk to the outlook for commercial property is the potential for a continued deterioration in economic conditions. Our forecast is for economic growth to pick up from here, but there are downside risks, particularly given the lingering softness in global economic conditions. Moreover, even as the economy picks up we expect businesses will remain under pressure, limiting demand to lease commercial space.

Figure 14: Indicative yields on commercial property and term deposits



Economic and financial forecasts.

New Zealand forecasts

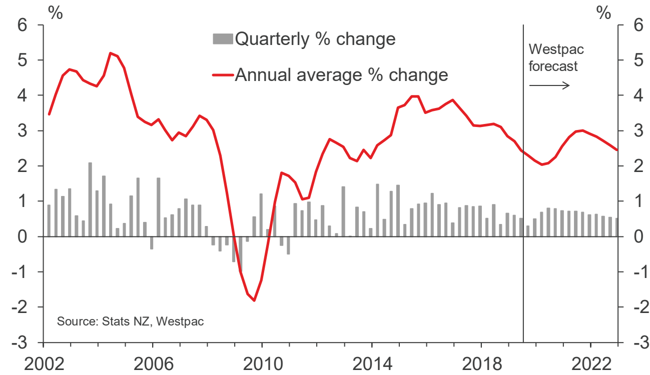
GDP components	Quarterly % change				Annual average % change			
	Jun-19	Sep-19	Dec-19	Mar-20	2018	2019	2020	2021
GDP (production)	0.5	0.3	0.5	0.7	2.8	2.2	2.6	2.9
Private consumption	0.5	0.9	0.8	0.8	3.3	2.9	3.6	4.0
Government consumption	0.6	1.0	1.1	1.1	2.2	3.2	4.2	3.7
Residential investment	-0.2	2.5	2.0	1.8	2.6	6.8	6.4	2.1
Business investment	-0.9	-1.3	0.9	0.2	4.0	0.7	0.6	2.1
Stocks (% contribution)	0.4	0.8	-0.5	-0.1	0.4	-0.4	0.0	0.0
Exports	-1.8	-2.9	0.7	0.7	2.6	1.3	-0.3	2.0
Imports	-0.3	0.9	0.6	0.7	5.8	0.8	3.1	3.9
Economic indicators	**Quarterly % change**				**Annual % change**			
	Jun-19	Sep-19	Dec-19	Mar-20	2018	2019	2020	2021
Consumer price index	0.6	0.7	0.3	0.5	1.9	1.7	1.8	1.9
Employment change	0.6	0.2	0.4	0.3	1.9	1.2	1.8	2.0
Unemployment rate (end of period)	3.9	4.2	4.3	4.4	4.3	4.3	4.2	3.9
Labour cost index (all sectors)	0.7	0.8	0.5	0.4	1.9	2.4	2.4	2.5
Current account balance (% of GDP)	-3.4	-3.3	-3.1	-3.0	-3.9	-3.1	-3.2	-3.6
Terms of trade	1.6	1.5	-0.6	-0.6	-4.8	3.5	-0.9	-0.1
House price index	-0.6	1.7	1.5	1.6	2.8	3.0	7.4	7.4
Financial forecasts	**End of quarter**				**End of year**			
	Jun-19	Sep-19	Dec-19	Mar-20	2018	2019	2020	2021
90 day bank bill	1.73	1.32	1.10	0.90	1.87	1.10	0.90	0.90
5 year swap	1.66	1.14	1.20	1.10	2.40	1.20	1.25	1.45
TWI	72.7	72.0	70.4	69.5	73.5	70.4	69.3	71.0
NZD/USD	0.66	0.65	0.63	0.62	0.67	0.63	0.63	0.67
NZD/AUD	0.95	0.95	0.94	0.94	0.93	0.94	0.94	0.92
NZD/EUR	0.59	0.58	0.58	0.57	0.59	0.58	0.56	0.58
NZD/GBP	0.52	0.53	0.48	0.47	0.52	0.48	0.48	0.50

International economic forecasts

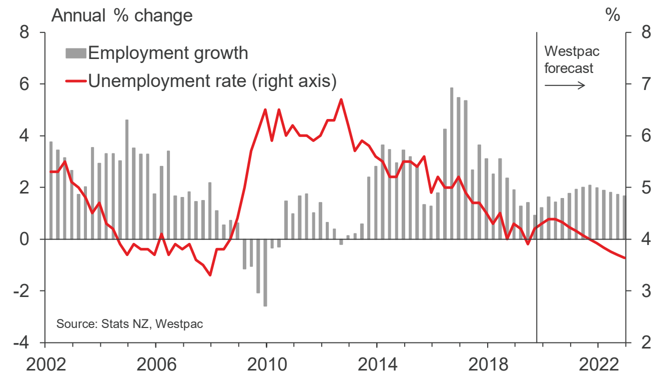
Real GDP (calendar years)	Annual average % change					
	2016	2017	2018	2019f	2020f	2021f
New Zealand	3.9	3.1	2.8	2.2	2.6	2.9
Australia	2.8	2.4	2.7	1.8	2.4	2.7
China	6.7	6.8	6.6	6.1	5.8	5.8
United States	1.6	2.4	2.9	2.3	1.6	1.5
Japan	0.6	1.9	0.8	0.8	0.2	0.4
East Asia ex China	4.0	4.5	4.3	3.6	3.7	3.9
India	8.2	7.2	6.8	6.0	6.1	6.3
Euro Zone	1.9	2.5	1.9	1.2	1.0	1.2
United Kingdom	1.8	1.8	1.4	1.3	0.8	1.1
NZ trading partners	3.6	4.0	4.0	3.4	3.3	3.4
World	3.4	3.8	3.6	3.0	3.0	3.2

The economy in six charts.

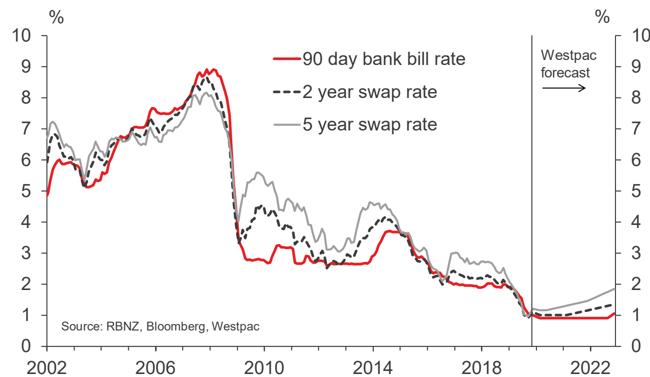
New Zealand GDP growth



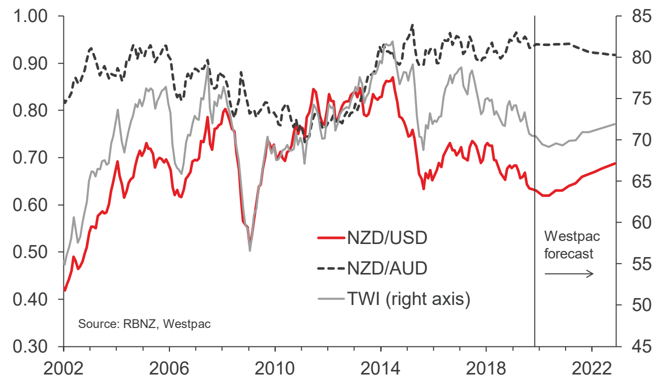
New Zealand employment and unemployment



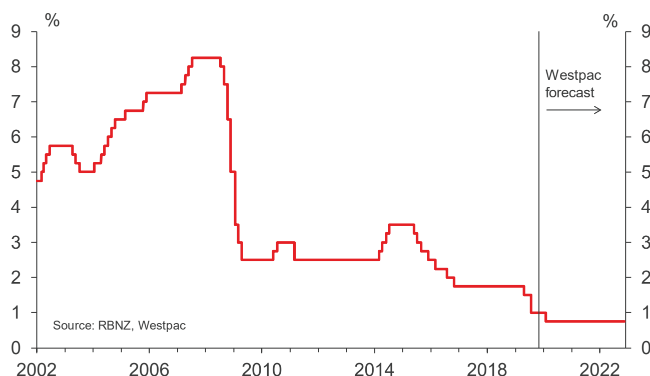
90 day bank bills, 2 year swap and 5 year swap rates



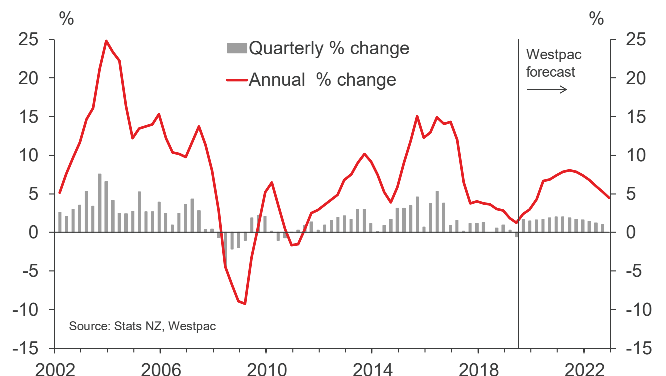
Exchange rates



Official Cash Rate



New Zealand house prices



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