

# Economic Overview

August 2013

## Fork in the road

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## Note from Dominick

Welcome to the August 2013 *Economic Overview – Fork in the Road*.

New Zealand's economic upturn is now well-established, and is showing signs of becoming self-reinforcing. High confidence is contributing to consumer spending, business investment and rising house prices – all of which boosts confidence further. Better job prospects are drawing migrants into the country, fuelling demand. And an improved tax take has allowed the Government to ease up on austerity.

This virtuous circle is set to keep turning for a while yet, but not forever. This is a classic demand cycle, not a step-change in economic performance. Most of it derives from the Christchurch rebuild. Another chunk is driven by rising asset prices and debt. Both are temporary phenomena. It is worth reminding ourselves that an economic slowdown will eventually follow this construction and housing cycle – the charts on page 12 illustrate our thinking.

The upward trajectory of New Zealand's economy may be widely accepted, but in other respects we are at a fork in the road. The US economy has perked up enough for the Fed to propose "tapering" its quantitative easing program. We doubt tapering will happen any time soon, but the mere idea has already reverberated through markets all the way to the New Zealand dollar and interest rates. The *International Outlook* chapter discusses both the tapering and the non-tapering scenarios, and argues that New Zealand exporters would prefer the latter.

The other key fork in the road is the RBNZ's proposal to restrict mortgage lending. Nobody can be certain of the impact. Our tentative view is that the restrictions will hobble first home buyers but not investors, so house prices will keep marching higher.

Our views on interest rates are unchanged – we expect a substantial OCR hiking cycle. What has changed is market pricing, which now agrees.

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# New Zealand Economy

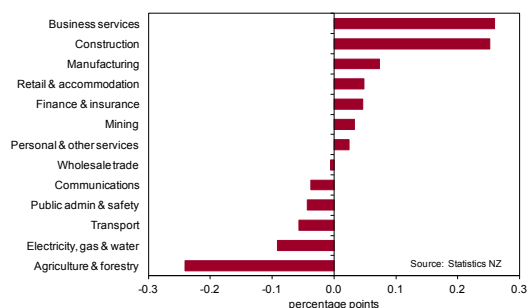
## A virtuous circle?

The economy is showing all the signs of a self-reinforcing upswing, led by a surging construction sector and fuelled by low interest rates. We don't expect the recent fall in the NZ dollar and the RBNZ's planned restrictions on mortgage lending to throw the economy off that course, but they may make the mix of growth just a bit more balanced.

The New Zealand economy has moved up another notch, from tentative recovery to solid expansion.

Granted, March quarter GDP growth – just 0.3% – was itself well short of spectacular. That largely reflects the recent drought, which has put a big, if temporary, dent in dairy production. Indeed, drought was probably an even bigger drag on economic growth in the June quarter. In March there was an offsetting boost to food manufacturing as sheep and cattle were sent to slaughter earlier than usual. As this unwinds, we expect another 0.3% GDP print in June.

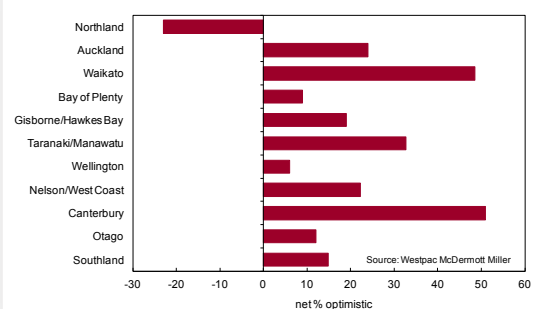
Figure 1: Contributions to March quarter GDP growth



However, most other recent economic data have ranged from encouraging to stunning, suggesting the wider economy has weathered the drought better than we feared three months ago. Business and consumer confidence are at or near three-year highs; retail spending is growing at the fastest annual pace since the Rugby World Cup in late 2011; manufacturing and services activity surveys are in healthy expansion mode; and the government's tax take keeps coming in ahead of plan.

What's been particularly striking is the extent to which optimism has spread. Households in 10 out of 11 regions are now optimistic for their local economy – indeed, some of the biggest lifts in confidence were in the rural North Island, where farmers were most affected by the drought. And business confidence has picked up across surveyed industries, though construction firms continue to lead the pack.

Figure 2: Regional economic confidence, June quarter



### Reasons for optimism

As we explain in the Agricultural Outlook chapter on page 10, one reason for this resilience is that lower New Zealand dairy production has itself contributed to an offsetting spike in global dairy prices. Combined with the recent fall in the NZ dollar, that's led us to revise up our forecast of Fonterra's milk price to \$7.40/kg.

A second reason is surging construction activity, which is increasingly an Auckland as well as a Canterbury story. Make no mistake, quake-related construction continues to race ahead – residential and non-residential building in Canterbury each posted gains above 20% in the March quarter. But residential building outside Canterbury rose 11%, a stellar result by any measure except Canterbury itself. Most of the improvement was in the Auckland region, which also saw the strongest growth in building consents in recent months.

The housing market continues to be a third, separate force for growth. House prices are 8.4% higher than a year ago, with prices in Auckland rising at more than twice that rate, and Canterbury prices also outstripping the rest of the country. Supplies on the market are undoubtedly tight: listings are near record lows compared to sales. However, physical shortages alone can't account for how far prices have risen. Notably, rent rises have been modest outside Canterbury, and indeed rents appear to be falling in Auckland. We have long argued that low mortgage



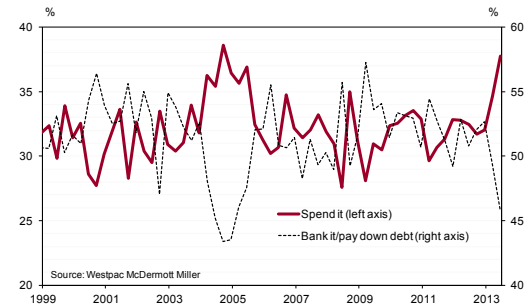
rates are an important reason why property investors are willing to accept falling rental yields. In Auckland, widespread expectations of capital gains may also be at play. Buyers are clearly desperate to get in the market, but owners are equally reluctant to sell.

### Spillovers

The lift in construction has predictably boosted demand for related industries such as engineering. But other sectors may now also be riding the construction wave. The ties between the manufacturing sector and domestic construction are stronger than is often acknowledged. While non-food manufacturing was a surprising area of weakness in the March quarter GDP data, the manufacturing PMI survey hit a 9-year high in May. Given the soggy state of equivalent surveys internationally, that suggests local factors are at play.

A reviving Christchurch economy may also be helping the long-suffering tourism industry, which was hurt by the Canterbury earthquakes as well as a high NZ dollar and weak traditional markets. Now that Christchurch is on the mend, tourists are starting to return, helped by a rapidly growing Chinese tourist market. May international guest nights were the second highest on record, with only the 2011 Rugby World Cup surge stronger.

Figure 3: 'How would you spend a \$10,000 windfall?'



As for the housing market, we have long expected rising house prices to stimulate consumer spending, much as in previous economic cycles. That view presumed that the 'deleveraging' dynamic that was such a feature of the post-2008 period would run its course. Recent developments keep pointing in that direction. Household debt is rising at a roughly 5% annual pace – comfortably faster than household income. And in the latest Westpac McDermott Miller consumer confidence survey, the share of respondents saying they would spend a windfall

(rather than bank it or use it to repay debt) was the highest since the mid-2000s. That is just the kind of scenario in which a rising housing market is likely to spill over to the wider economy.

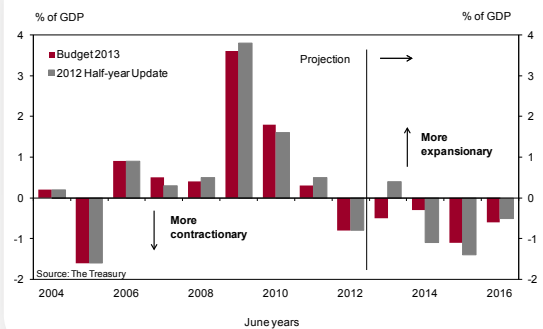
### Escape velocity

As an economic recovery strengthens, some economic headwinds naturally begin to weaken, and the upswing becomes even more established. We have recently seen several examples of this.

Most notably, the labour market is finally improving. The sharp fall in the unemployment rate reported for the March quarter, to 6.2%, may to some extent be statistical 'catch-up'. But the direction chimes with a lift in businesses' reported and expected hiring in recent surveys, and with a steady improvement in households' employment confidence.

Improving job opportunities (and fewer on the other side of the Tasman) have in turn led to a marked lift in net immigration, which will further boost housing market pressures. The year to June saw a net migrant inflow of nearly 8,000 people, compared to a net outflow of more than 3,000 the year before. By the end of the year net immigration easily looks set to surpass last decade's average of about 13,000. This turnaround has largely been about flows to and from Australia – fewer Kiwis leaving, and more coming back – though the Christchurch rebuild is now also clearly attracting migrants to the city.

Figure 4: Impact of fiscal policy on GDP growth



By boosting the fiscal outlook, a better than expected economy has also allowed the Government to become just a bit less austere, while sticking to its 2015 surplus target. In its May Budget, the Government was able to proceed with its previous spending plans and give some extra cash back in the form of lower ACC levies. That will mean a bit more money in consumers' pockets in coming years.

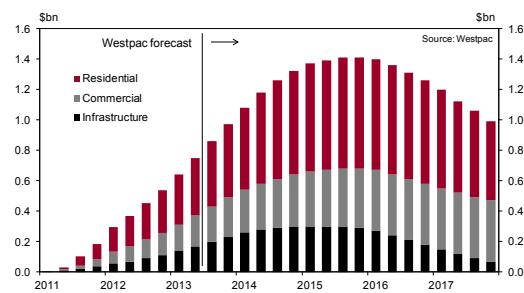
**The earthquake bill keeps rising**

Our view has long been that construction needs in Canterbury and Auckland, coupled with very low interest rates, would result in a sustained upturn in domestic demand. Drought aside, New Zealand's recent economic performance leaves us very comfortable with that expectation.

Indeed, estimates of the Canterbury rebuild continue to rise, and Auckland now also looks set to see even more building than we expected three months ago. Our updated forecasts for quake-related building incorporate the latest official estimates of the total spend, now around \$40bn, close to 20% of GDP. Some of this includes 'nice to haves', and our own forecasts are a bit more circumspect. We assume a total of \$33bn: \$16bn in residential reconstruction, \$12bn in commercial building, and \$5bn in infrastructure repairs.

That implies even greater demands on the construction sector over the next two years. Importantly, insurers have promised home-owners that work will be underway or complete by 2015, and our understanding is that there is considerable pressure from international reinsurers that these deadlines are met.

Figure 5: Quake-related construction forecasts



**The dark side of the virtuous circle**

We have also long cautioned that this economic upswing has a darker side. It mostly reflects stronger domestic spending rather than export revenues, and some of this spending is being funded by debt. That cannot go on forever, and nor will the Canterbury construction boom. Our long-held view has been that the eventual circuit-breaker would be inflation pressures and rising interest rates.

Could the cycle break sooner than we previously thought? After all, the NZ dollar has fallen sharply in the past few months. The high NZ dollar has played a

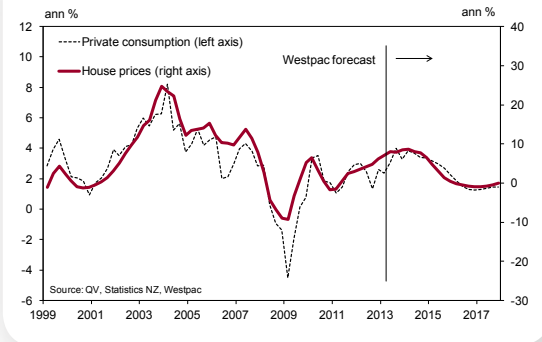
major role in keeping inflation low to date. That has allowed the Reserve Bank to keep interest rates low, stimulating asset prices and domestic spending. A lower exchange rate might imply a less benign inflation outlook and force the RBNZ to hike interest rates sooner.

Meanwhile, the RBNZ has made it increasingly clear that it plans to introduce restrictions on low-deposit mortgage lending. Those restrictions could work in the same direction as interest rate hikes, hitting the housing market and household borrowing directly, and dampening consumer spending.

As we explain in the rest of this *Economic Overview*, we think it is too soon to see either of these developments as game changers. First, we expect some of the recent fall in the NZ dollar will be unwound as the year progresses. If so, the implications for inflation and monetary policy will be limited. Secondly, our best guess at this stage is that the RBNZ's proposed lending restrictions will have only a small impact on the housing market.

Accordingly, while we now expect less momentum in the housing market and consumer spending than in our May forecasts, it's not that much less. We forecast house prices to rise 8.5% this year and 6.5% next. That is only slightly less exuberant than we thought three months ago. We continue to expect that substantial interest rate rises will eventually be needed to put New Zealand's economy back on a more sustainable track. And with all the recent signs that the upswing is developing a life of its own, we remain concerned about the potential for an eventual hard landing – particularly if the peak in interest rates coincides with the wind-down of the Canterbury rebuild.

Figure 6: House price inflation and consumer spending



# New Zealand Dollar

## Beginning of the end

The New Zealand dollar has been jolted lower in the last few months as the US central bank has signalled an end to its unconventional monetary policy measures. While we don't think this will proceed as smoothly as the market expects, we share the broad sentiment: only once the rest of the world starts returning to 'normal' monetary policy will we see a sustained fall in the NZD.

In previous reports we've made the case that the New Zealand dollar would remain high over 2013, reflecting a combination of the relatively favourable growth picture for the New Zealand economy and the prevalence of ultra-loose monetary policy around the world. The latter part of that story has been thrown for a loop in the last couple of months, as the US Federal Reserve has signalled that it expects to start winding down its quantitative easing (QE) programme later this year. While monetary policy will still be very stimulatory, it will be less so than markets previously thought.

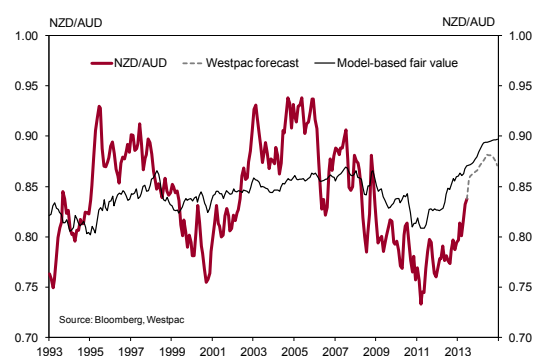
The result has been a sharp rise in US long-term interest rates (which has been transmitted around the world), and an abrupt fall in many high-yielding currencies. That shift in exchange rates will have meaningful implications for inflation and monetary policy in those countries – it's perhaps telling that Brazil, the country that coined the 'currency war' meme, is now raising interest rates to support its exchange rate. The outlook for currency markets seems to have passed a major turning point.

Or has it? The Fed has been clear that an end to quantitative easing will be dictated by the pace of the recovery. And our view remains that the US recovery is fragile and will continue to fall short of expectations, which implies that the unwinding of QE is unlikely to happen as quickly and smoothly as the market seems to be taking for granted.

Nevertheless, now that the Fed has opened the door to 'tapering', the issue is not going to go away. Our base case is that the NZD will reverse some of its recent decline against the US dollar by the end of this year, but will not return to the levels that we previously forecast. However, we recognise this as a key risk to our forecasts. If a stronger US economy does allow the Fed to plough ahead with tapering as intended, then what we have seen to date could be the start of a sustained downward leg in the NZD. That would change the picture for monetary policy in a meaningful way, as we detail in the Inflation and Interest Rates chapter.

We have a much higher level of conviction on our view of the NZ dollar against the Australian dollar. Indeed, the rise in the cross rate from 0.79 in December to 0.87 today is much in line with what we have been predicting this year. The Australian mining investment boom is likely to peak this year and will no longer be a force for growth, while New Zealand's own massive investment project – the Canterbury rebuild – is still revving up. Further interest rate cuts are on the way in Australia, while the next move in New Zealand interest rates will be up. Finally, a growth slowdown in China, as it attempts to rebalance towards private consumption over investment, will likely be seen as more favourable towards New Zealand's 'soft' commodity exports than Australia's 'hard' ones.

Figure 7: NZD/AUD, with model-based fair value



Exchange Rates Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-13	0.81	0.86	0.61	0.53	81.0	76.2
Dec-13	0.84	0.87	0.63	0.52	83.2	78.0
Mar-14	0.83	0.87	0.64	0.53	81.3	77.9
Jun-14	0.82	0.88	0.65	0.52	79.5	77.6
Sep-14	0.81	0.88	0.65	0.52	77.8	77.1
Dec-14	0.81	0.87	0.64	0.50	77.0	76.4
Mar-15	0.80	0.87	0.63	0.49	75.8	75.7
Jun-15	0.80	0.86	0.63	0.48	74.7	75.0
Sep-15	0.79	0.85	0.63	0.47	73.6	74.3
Dec-15	0.78	0.85	0.62	0.46	72.5	73.6

# Inflation and Interest Rates

## Go your own way

**Both markets and the RBNZ are coming around to our view that interest rates will be heading higher from early next year. While overseas conditions remain fragile, domestic forces – accelerating growth underpinned by a massive rebuilding project – point to higher inflation in coming years. That signal would be further amplified if the New Zealand dollar extends its recent fall.**

To date, the RBNZ's inflation-targeting duties have pulled it in two opposing directions. On one hand, inflation has fallen to as low as 0.7% in the last year, as a rising New Zealand dollar has put downward pressure on the prices of internationally-traded goods. On the other hand, the RBNZ has long been anticipating that inflation will return to the middle of the 1-3% target range over the medium term, as the domestic economy strengthens and the depressing effect of the high exchange rate wanes.

Conditions are now more convincingly turning in favour of higher inflation. Firstly, the NZ dollar is no longer persistently rising, which means that it's not the disinflationary force that it once was. And if the US economy does prove to be stronger and quantitative easing ends sooner than we expect, we could see a sustained leg lower in the NZD. That would take inflation back towards the top of the target band in fairly short order.

The second major factor is that housing-related inflation is now picking up. The June quarter CPI showed that new home prices have accelerated to over 4% annual growth, and perhaps more importantly, these increases are no longer contained to the Canterbury region.

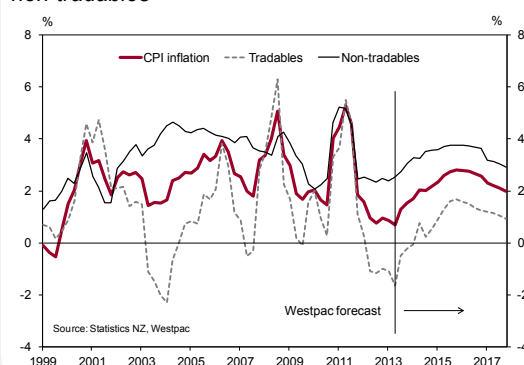
Our view has long been that the perkier housing market and the Canterbury rebuild would kick off a rise in domestic inflation pressures, much the same as in previous construction booms. The RBNZ had been assuming that the response would be more subdued this time, but the latest OCR review statement in July suggests that it is now coming around to our view. While we don't think the RBNZ will be budged from its prediction of an unchanged OCR this year, our view remains that the tightening cycle will kick off in early 2014.

The likely use of macroprudential tools in the near future is an additional complication around the timing, but ultimately doesn't change our view on the need for interest rate hikes. These tools, aimed primarily at reducing risk within the banking system, will matter for monetary policy only to the extent that they reduce the degree of housing-related inflation pressure. And as we explain in our special chapter "Lower the boom" on page 11, we think that any impact on house

prices will be modest. We expect that higher interest rates will play a far greater role in reining in house price inflation over 2014 and 2015.

Looking over the longer term, our view is that the pressure on the nation's resources generated by the Canterbury rebuild will require interest rates to rise beyond 'neutral' levels by the end of this cycle. But as the level of rebuilding activity peaks and starts to decline from around 2017, a period of below-neutral interest rates will then become appropriate – much like in Australia today, as their mining investment boom passes its peak.

**Figure 8: NZ inflation forecasts, tradables versus non-tradables**



**Annual Inflation and Interest Rate Forecasts**  
(end of quarter)

	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Sep-13	1.3	2.50	2.70	3.30	4.00
Dec-13	1.5	2.50	2.75	3.30	3.90
Mar-14	1.7	2.75	3.00	3.50	4.00
Jun-14	2.0	3.00	3.25	3.60	4.10
Sep-14	2.0	3.25	3.50	3.80	4.20
Dec-14	2.2	3.50	3.75	4.00	4.40
Mar-15	2.3	3.75	4.00	4.20	4.50
Jun-15	2.6	4.00	4.25	4.40	4.65
Sep-15	2.7	4.25	4.50	4.60	4.80
Dec-15	2.8	4.50	4.75	4.80	4.90

# International Outlook

## Fork in the road

**Markets are aflutter with the idea of a US recovery and tapering by the Federal Reserve. We are not so sure – we don't think the US economy is ready to stand on its own two feet. This section considers how the global economy would look in the scenario markets are painting versus our own scenario for lower US growth. Surprisingly, New Zealand exporters may prefer the latter.**

For now, the US is back on the growth horse. The economy is producing jobs. The housing market is on the road to recovery and the fiscal position is much healthier than anticipated. The Fed has signalled it will "taper" its bond purchases if strong economic data continue. The question is: can the economy kick on with less help from the Fed?

Markets think it can. This position has resulted in a sharp rise in US long-term interest rates, and an abrupt fall in many high-yielding currencies against the US dollar. Lower exchange rates will boost inflation, requiring tighter monetary policy that will depress growth in many of our trading partners, including Australia, Malaysia, Indonesia, and Korea. Others such as China and Hong Kong will import tighter monetary policy directly via exchange rate links to the US dollar.

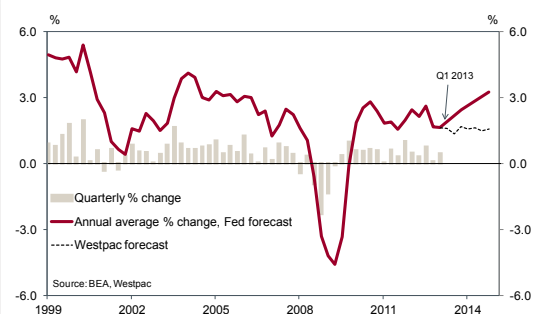
Another consideration for China is that stronger US growth would boost the price of oil and other commodities that are needed for its continued industrialisation. Of course, a stronger US economy will also have benefits for world growth via US consumer demand for Asian (and New Zealand) exports.

But the point is, it is unclear whether stronger US demand will offset the damage higher interest rates do to growth in the economies of New Zealand's trading partners. In fact, from a New Zealand perspective, higher US growth with potentially lower developing country growth may not suit our mix of exports, particularly with our emphasis on food.

That said, our base case is that the US economy won't quite measure up to the expectations that markets have factored in. The increase in long-term US interest rates has already flowed through to US mortgage rates, with one key market rate over 100 basis points higher than late 2012. This is likely to dampen the housing recovery, if recent falls in mortgage re-finance activity and mortgage approvals are anything to go by.

Moreover, we are not as bullish as the Fed on the prospects of the US labour market. With household consumption and investment by firms already weak, a

Figure 9: Divergent US growth forecasts



stalling housing market may slow jobs growth to a point where it doesn't make sense for the Fed to taper its bond purchases as rapidly as currently planned.

If our view pans out, peripheral currencies will strengthen again, and monetary policy will remain loose in Asia. This may suit New Zealand's mix of exports better.

As outlined in the New Zealand Dollar chapter we recognise our view on the US economy is a key risk to our forecasts.

### The China-Oz-NZ triangle

We have downgraded our forecasts for China. We now forecast 7.4% and 7.1% annual growth for 2013 and 2014, respectively. This represents a 0.6 and 0.7 percentage point downgrade on our previous forecasts, and leaves our expectations a little below the recently reaffirmed government target of 7.5%.

The main catalyst for the lowering of our growth forecasts has been the shake-out of the Chinese banking sector. These moves have served their purpose of clearing out some deadwood in the sector and thus facilitating financial reform. Nonetheless, confidence has taken a hit and activity has slowed.

Slowing Chinese growth hardly bodes well for New Zealand, but it is terrible for Australia. China is Australia's largest export market and Australia is particularly dependent on Chinese demand for minerals.



In addition, the slowing Chinese economy does not come at a good time for the Australian economy. We were already expecting Australia to endure below average growth and rising unemployment over 2013 and 2014.

The Australian economy is being held back by low global growth, peaking mining investment, tight fiscal policy and subdued household spending. An export upswing is underway as mining investment projects come online, but non-resource exports are still flat.

Low interest rates are gaining some traction, but it appears the Reserve Bank of Australia will need to do more. We expect three further rate cuts by the end of the March 2014 quarter.

For New Zealand, China is important both directly through its demand for our commodity exports, and indirectly via its impact on Australian export income and thus Australia's demand for our exports.

However, the nuances of this particular growth slowdown in China may not be all bad for New Zealand. Chinese authorities are trying to rebalance the economy towards household consumption over investment. This is likely to add to demand for New Zealand's food exports.

### Japan

Unusually, the Japanese economy is a positive outlier relative to the rest of the world. Japan is set to meet or exceed 1.7% growth (around its trend rate) for three consecutive years (2012-14). It has not achieved such a string since the bubble burst two decades or so ago.

The impetus is coming from three sources. The first is of course the boost to the export sector from the dramatic collapse in the yen since late last year. The yen has dropped by around 30% against the US dollar over this period.

Public investment and housing are providing the second boost. Spending associated with the natural disasters still features prominently. May housing starts exceeded one million annualised, the first outcome above that threshold since before the financial crisis.

Lastly, recovering trade with China, after the earlier export backlash following territorial disputes, is adding bounce to manufacturing over and above the boost from the low yen.

### Europe

Many European populations are fed up with continued austerity, coupled with still declining growth. Portugal is the latest government to come under pressure as the Portuguese public suffer from austerity fatigue. Meanwhile, Italian, Greek, Spanish and Cypriot issues continue to simmer – all having the potential to scare markets and move any recovery further out of sight.

While the European Central Bank has an easing bias, fiscal purse strings show no signs of loosening. Any prospect of easing austerity measures will have to wait until after the German election.

In the meantime, we expect the European economy to remain in recession over 2013 with little sign of respite in 2014.

### Economic forecasts (calendar years)

Real GDP % yr	2009	2010	2011	2012	2013f	2014f
New Zealand	-1.4	1.9	1.4	2.7	2.5	3.7
Australia	1.4	2.6	2.4	3.6	2.5	2.3
China	9.2	10.4	9.3	7.7	7.4	7.1
United States	-3.1	2.4	1.8	2.2	1.6	1.6
Japan	-5.5	4.7	-0.6	1.9	1.7	2.2
East Asia ex China	0.5	7.8	4.3	3.8	4.0	3.0
India	6.5	9.7	7.5	5.1	5.3	6.4
Euro zone	-4.3	1.9	1.5	-0.5	-0.9	-0.6
United Kingdom	-4.0	1.8	0.9	0.2	0.5	0.4
<b>NZ trading partners</b>	<b>-0.2</b>	<b>5.0</b>	<b>3.4</b>	<b>3.5</b>	<b>3.3</b>	<b>3.0</b>
<b>World</b>	<b>-0.6</b>	<b>5.2</b>	<b>4.0</b>	<b>3.2</b>	<b>3.1</b>	<b>2.9</b>

Forecasts finalised 29 July 2013



# Agricultural Outlook

## Dairy bounce, sheep stumble, dollar boost

**Overall, the agri sector's recovery from drought is on schedule. However this reflects the dominance of the dairy sector and its very high prices, more than it suggests a broad improvement. The sheepmeat sector is stuck in recession. Meanwhile, a weaker NZ dollar is giving all sectors a helping hand.**

2013/14 is shaping up as a bumper dairy season. World prices remain very high, while growing conditions have been generally very good since the drought broke. The icing on the cake is a lower currency.

World dairy prices have stayed at very high levels. To be frank, we are surprised by that. This time three months ago, we expected world prices would be around 7% lower by the end of July.

Tight world supply has contributed to the buoyant prices. However, we doubt that the market has gotten its head around prospects for growth in New Zealand production this season. We predict a rebound in production from drought of around 5% on last year's level. As a result, we still expect world prices to fall over 20% by the end of 2013 from their July levels.

The lower NZ dollar is also adding to returns. In recent years, a falling NZ dollar has usually been associated with heightened fears about the global economy, leading investors to rush back to the perceived safety of the US dollar. So a lower NZ dollar has tended to go hand in hand with lower export prices.

But this time, it's been a good news story – markets believe the US economy is out of its sick bed and walking around (see the International Outlook chapter).

The combination of a weak NZ dollar and strong global prices has prompted us to upgrade our 2013/14 milk price forecast to \$7.40 per kg of milk solids. This represents a massive 90 cent lift from our previous forecast. This price will allow the dairy sector to increasingly put the drought in the rear-view mirror.

**Table 1: Westpac forecasts of Fonterra's milk price**

	2012/13	2013/14	2014/15
<b>Milk Price (per kg)</b>	\$5.90	\$7.40	\$6.50

Similarly world beef prices have held up well, even as the drought led to the largest slaughter and export of New Zealand beef on record. Despite coming off record levels at the end of 2012, June world beef prices remain over 25% above the 10-year average for this time of the year.

Moreover, the lower NZ dollar has supported the price received by farmers; these prices are now just 3%

lower than at the end of 2012 and are effectively level with June 2012.

However, beef returns could weaken from here. First, we expect the currency to strengthen. Second, an influx of Australian beef following dry weather there has combined with sluggish US demand to put downward pressure on world prices.

We expect tough times in the sheepmeat sector this season. World lamb prices are mediocre at best, while the drought will hinder production this season as farmers rebuild their flocks. Sheep breeding numbers are likely to fall by more than one million this season, which in turn will see lamb production down around 10%.

With the supply of New Zealand lamb severely constrained world lamb prices have improved over recent months. The NZ dollar depreciation has added further to returns in NZD terms. However unlike beef and dairy, prices sit below their ten-year average.

From here, helped by Chinese demand and tight world supply, we expect world lamb prices to push higher. However, with demand in the key UK and European markets still weak, the improvement will be modest. Moreover, improving prices will be insufficient to offset lower production. Sheepmeat farmers will have to wait until the following season for a recovery in their returns.

**Table 2: World commodity price monitor**

Sector	Trend	Current Level vs. 10yr ave	Next 6 months
<b>Forestry</b>	Pulling back with the Chinese economy in a soft patch. US housing recovery may temper falls.	High	↓
<b>Wool</b>	Flat as growth in end product demand appears capped. Coarse wool may outperform as US housing improves further.	Above Average	→
<b>Dairy</b>	As per text	High	↓
<b>Lamb</b>	As per text	Below Average	↗
<b>Beef</b>	As per text	High	↓



# RBNZ Mortgage Restrictions

## Lower the boom

**The RBNZ is expected to restrict mortgage lending within a matter of weeks, on the grounds that rising house prices pose a risk to financial stability. This is a major fork in the road – nobody can be sure of the impact. Our tentative thinking is that mortgage restrictions will have only a small effect on the housing market.**

The restrictions will take the form of a speed limit on the share of new mortgages that have a high loan-to-value ratio (LVR), meaning low equity. For example, the Reserve Bank might stipulate that only 12% of new mortgages can be written at an LVR of 80% or higher. In practise this means some people will still be able to buy a house with a small deposit, but many will not.

We have reviewed the impact of comparable LVR restrictions overseas, and found a mixed picture.<sup>1</sup> In some cases there was no visible effect on house prices following the implementation of LVR restrictions. In other cases house price inflation did slow, although prices often accelerated again after six months or so. The common theme was that house price inflation tended to slow when high-LVR borrowers faced some kind of increase in the cost of borrowing. Simple bans on forms of borrowing tended to be less effective.

Of course New Zealand has its own peculiarities that must be considered.

Our thinking is that the LVR restrictions will result in a bifurcation of mortgage rate pricing. Interest rates for borrowers with low equity will go up as banks seek to ration high-LVR lending through price. This could take the form of “low equity premia”, or mortgage rate specials that don’t apply to borrowers with low equity.

Conversely, those with high equity may find that they enjoy lower mortgage rates than otherwise, because banks will compete more fiercely for those customers they are allowed to lend to. And the technicalities of the restrictions mean that the more low-LVR lending a bank does, the more that bank can lend out to high-LVR customers.

Some first home buyers will be excluded from the market by the higher mortgage rates they face. These people will rent instead. So the impact of LVR restrictions will be in the direction of lower house prices, higher rents, and a lower rate of home ownership than without the restrictions.

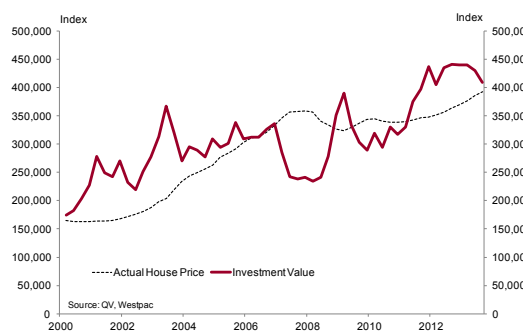
The analysis gets really interesting when we consider the perspective of a property investor. Investors normally

have higher equity stakes in their portfolios, so they will be among the people enjoying discount mortgage rates. Investors will also experience greater demand for rental accommodation, and less competition from first home buyers at auction. All up, the LVR restrictions could create great conditions for property investment.

So although LVR restrictions will severely dent first home buyer demand, we suspect that ongoing investor demand will ensure house prices continue their upward march. All up, we expect the LVR restrictions to slow the rate of house price growth only a little – we have knocked 1.5 percentage points off our house price forecast, over the next two years combined.

Our Investment Value framework suggests that house prices will continue rising until mortgage rates go up for everybody. The framework calculates the value of a median New Zealand house from an investor’s perspective, taking into account long-term interest rates, inflation, tax settings, and rent. A year ago we were among the first to predict a house price boom, based on a sudden leap in the Investment Value.<sup>2</sup> The model still suggests that there is value in buying property from an investor perspective, mainly because of low interest rates.

Figure 10: Investment value of houses

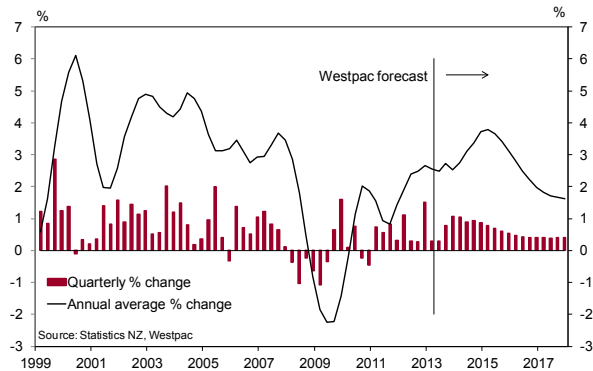


<sup>1</sup> The review will be published as a bulletin in the near future.  
<sup>2</sup> In the August 2012 *Economic Overview* we forecast house price inflation to reach 10%.

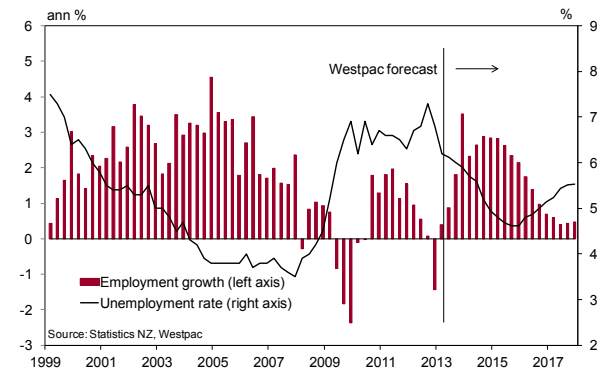


Annual Average % change	March years				Calendar years			
	2013	2014f	2015f	2016f	2012	2013f	2014f	2015f
Private consumption	2.2	3.5	3.4	2.4	2.3	3.2	3.6	2.8
Government consumption	0.6	0.1	0.5	0.7	0.6	0.1	0.6	0.6
Residential investment	19.2	20.9	17.0	8.4	12.1	23.1	17.5	10.9
Business investment	3.7	6.4	7.2	3.9	5.0	3.3	8.8	4.3
Stocks (% contribution)	-0.4	0.7	-0.3	0.1	0.3	0.5	-0.2	0.0
GNE	2.3	4.8	3.9	2.8	3.1	3.7	4.3	3.1
Exports	3.4	2.0	4.3	3.0	2.0	4.0	3.1	3.3
Imports	0.5	6.0	4.5	2.8	1.9	4.8	4.9	3.2
<b>GDP (production)</b>	<b>2.5</b>	<b>2.7</b>	<b>3.8</b>	<b>2.8</b>	<b>2.7</b>	<b>2.5</b>	<b>3.7</b>	<b>3.1</b>
Employment (% annual)	0.4	2.3	2.8	1.7	-1.4	3.5	2.8	2.2
Unemployment rate (% s.a. end of period)	6.2	5.7	4.8	4.8	6.8	5.9	4.9	4.6
Labour cost index (all sectors, % annual)	1.7	1.8	2.1	2.6	1.8	1.7	1.9	2.5
Inflation (% annual)	0.9	1.7	2.3	2.8	0.9	1.5	2.2	2.8
Current account balance (% of GDP)	-4.8	-5.0	-5.9	-5.3	-5.0	-4.7	-5.8	-5.5
Terms of trade (% annual)	-2.9	3.6	0.8	3.3	-8.9	10.1	-2.5	3.9
90 day bank bill (end of period)	2.65	3.00	4.00	5.00	2.65	2.75	3.75	4.75
5 year swap (end of period)	3.40	4.00	4.50	5.00	3.07	3.90	4.40	4.90
TWI (end of period)	75.9	77.9	75.7	73.2	73.6	78.0	76.4	73.6
NZD/USD (end of period)	0.83	0.83	0.80	0.78	0.82	0.84	0.81	0.78
NZD/AUD (end of period)	0.80	0.87	0.87	0.85	0.79	0.87	0.87	0.85
NZD/EUR (end of period)	0.63	0.64	0.63	0.62	0.64	0.63	0.64	0.62
NZD/GBP (end of period)	0.54	0.53	0.49	0.45	0.51	0.52	0.50	0.46

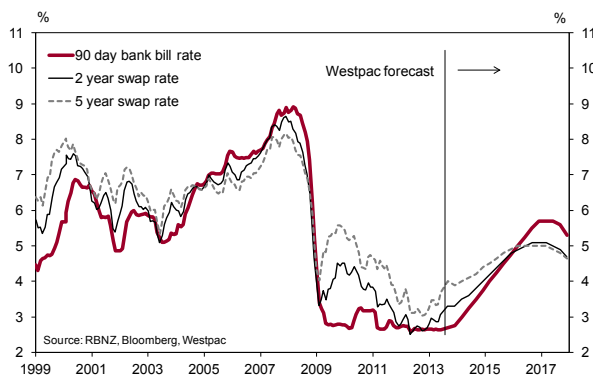
**New Zealand GDP growth**



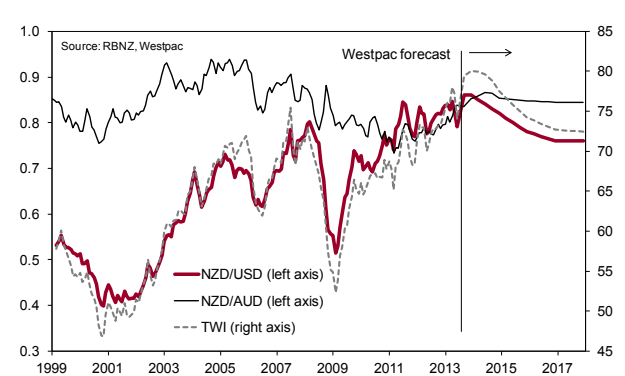
**New Zealand employment and unemployment**



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



**NZD/USD, NZD/AUD and TWI**



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