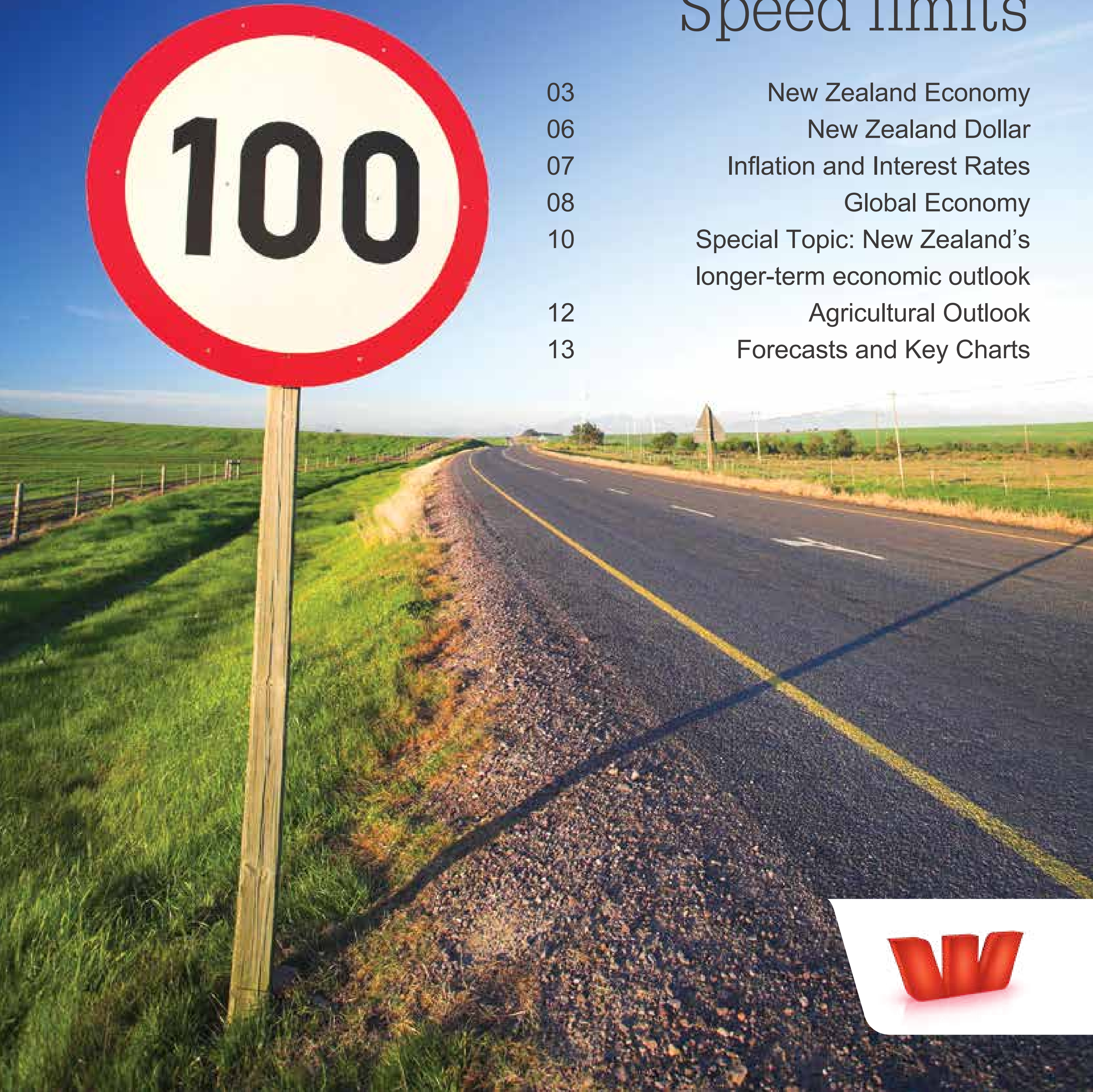
Economic Overview

November 2013

Speed limits



Dominick Stephens
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Note from Dominick

The “Speed Limits” referred to in the title of this *Economic Overview* are the economy’s deep fundamentals. Concepts such as the trend rate of GDP growth, the non-inflationary level of economic activity, and the neutral interest rate get a lot less air time than the economic cycle, but they are every bit as important for determining interest rates and exchange rates.

To give an example, the Special Topic outlines why we believe New Zealand’s trend rate of GDP growth is lower now than in decades past. That scepticism about New Zealand’s capacity for growth is the very foundation of our view that the upcoming economic cycle will generate significant inflation pressures. We just don’t believe that the New Zealand economy is capable of smoothly absorbing a construction boom, and rising house prices, and an export commodity price boom, and a surge in net migration, and a revival in business investment.

Similarly, we have long argued that New Zealand will experience quite an extensive OCR hiking cycle in the years ahead. That is founded on the principle that the OCR will need to rise above its neutral level to keep inflation in check. The Interest Rate section discusses why we believe the neutral OCR is currently about 4 ½%, but will rise to 5% by the time the cycle peaks.

Meanwhile, other parts of the world are still running well below their speed limits. As we have argued in previous *Economic Overviews,* we believe the United States will continue with quantitative easing (QE) for a long while. The US economy may be recovering, but the level of economic activity remains a long way below capacity, so deflation remains a bigger danger than inflation. And so long as the US continues with QE, the New Zealand dollar is likely to remain high.

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Text finalised 31 October 2013
ISSN 1176-1598 (Print)
ISSN 2253-2897 (Online)

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New Zealand Economy

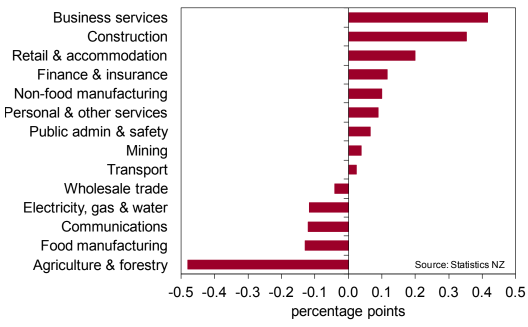
Growing pains

New Zealand's economic expansion is becoming apparent across a range of sectors and, increasingly, across regions. We expect that over the next year the economy will start to exhibit some of the stresses and strains that come with sustained growth, as it accommodates a migration-driven lift in population growth, diminishing spare capacity, and rising cost pressures.

New Zealand's economic indicators have taken on a markedly stronger tone over the course of 2013, as the economy has moved beyond the recovery phase and into a solid expansion. That's not entirely apparent from the GDP figures: after a burst of 1.6% growth in the December quarter last year, a short but intense drought restrained growth to just 0.6% over the first half of this year. But that in itself is a mark of the resilience of the underlying economy, given the historic link between droughts and recessions in New Zealand.

With the effects of the drought now largely in the rear view mirror, and a continued upturn in the non-agricultural sectors, the New Zealand economy is set for a substantial acceleration in growth over the second half of this year and beyond. In particular, the remarkably swift rebound in milk production in the last few months means that GDP growth is shaping up well in excess of 1% for the September quarter.

Figure 1: Contributions to GDP growth over H1 2013

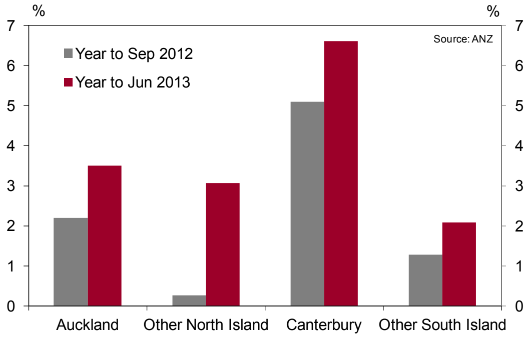


Broadening horizons

The breadth of this expansion is what gives us the most confidence that it will be sustained for another year or two. We've noted before that growth is occurring across a range of sectors, beyond the obvious suspects of construction and housing. Consumer spending is growing at an increasing pace – and spending on services was particularly strong over the June quarter, suggesting that it can't solely be pinned on consumers getting more bang for their buck as a result of the high exchange rate. The manufacturing and services activity surveys have put in consistently strong readings over this year. And export earnings are looking sunnier – China's demand for primary products remains rampant, and tourism earnings have picked up this year, helped by the gradual reopening of the Christchurch market.

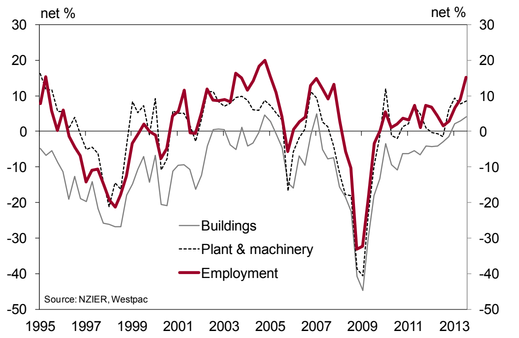
There are also signs that the expansion is becoming more consistent across regions. Although Canterbury remains the obvious standout as the quake rebuild progresses, surveys of confidence have turned substantially positive across many regions. And while the range of regional activity indicators is limited, there is a theme of widespread growth emerging there as well. Notably, the upturn in the regions doesn't seem to be reliant on housing market strength (which in any case remains fairly modest outside of Auckland and Canterbury). Rather, the improvement has come in forms such as building consents (both residential and commercial), vehicle sales and job advertisements, hinting at a more deeply-rooted upturn.

Figure 2: Regional growth indicators



Finally there's the time dimension. For several years now, businesses have been reporting that they expect better conditions over the quarter or year ahead. The more recent development of note has been that high levels of general confidence have been joined by a substantial lift in investment and hiring intentions. (Recent data on job advertisements and imports of capital equipment are consistent with those intentions.) Crucially, this suggests that firms are finally becoming confident enough about the future to make longer-term commitments.

Figure 3: Investment and employment intentions (s.a.)

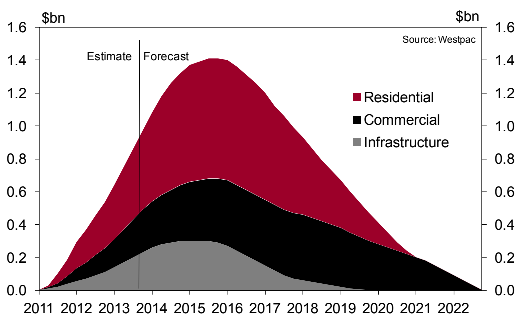


Growing pains

So far we've painted a fairly bright picture of New Zealand's growth prospects. But we'd caution that adapting to a period of stronger growth brings its own challenges. We expect that over the next year the New Zealand economy will move from below to above its non-inflationary "potential" level of activity.

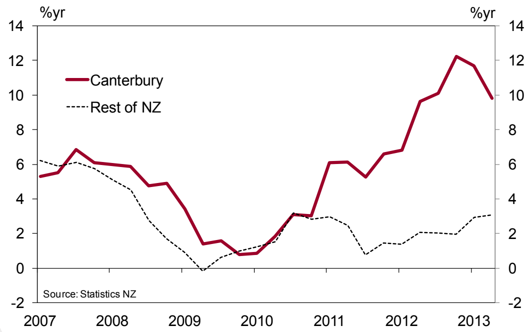
The single biggest challenge remains the Christchurch rebuild. Recent data suggest that the overall level of quake-related construction activity is more or less on track with the profile that we've assumed. The next year will see a shift in the make-up of that profile: under-cap repairs and infrastructure are now running at full tilt in order to meet their specified completion dates, and demolition in the CBD is largely complete. This means that growth from here on will be driven by major housing repairs/rebuilds and commercial construction.

Figure 4: Quake related construction forecasts



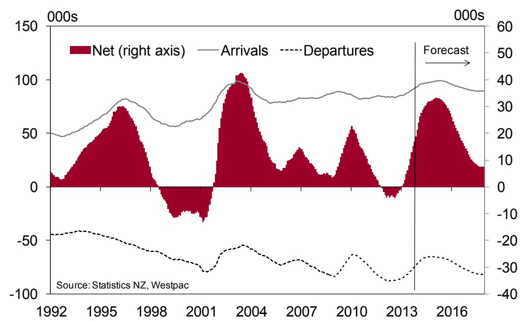
With less centralisation and resource co-ordination possible in these areas, constraining the upward pressure on costs will be even more challenging than it already has been. And with construction picking up in other regions as well – especially Auckland – competition for resources within the industry will become more intense. The Consumer Price Index shows that purchase prices for new dwellings in the Canterbury region have already risen by 28% since the first earthquake; the last few quarters have seen an acceleration in new house prices in the rest of the country too.

Figure 5: New dwelling prices, annual % change



The challenge of building enough houses has been amplified by a migration-led pickup in population growth. Net migrant inflows are on track to reach about 21,000 people this year (compared to a net outflow of 1,000 people in 2012), and we've upgraded our forecast to a peak inflow of 33,000 over 2014. Relative job prospects in New Zealand compared to Australia tend to be the most significant driver of migration trends, and with employment growth softening in Australia as the mining investment boom passes its peak, more Kiwis are coming home and fewer are leaving. In the short term at least, this implies more upward pressure on the housing market. We find that a net inflow of 10,000 migrants is associated with a 3% rise in house prices (although the relationship is not necessarily causal; net migration tends to pick up when New Zealand's economic conditions improve, a factor that in itself would boost house prices).

Figure 6: Annual migration flows to New Zealand



With house prices on the rise, the period of deleveraging following the Global Financial Crisis appears to have run its course, and households are making a return to housing equity withdrawal – that is, drawing down higher levels of debt against their housing wealth. This additional driver of spending – not matched by a rise in output or incomes – isn't a sustainable source of growth over the longer term, but it is likely to put further pressure on the economy's operating capacity over the next couple of years.

One final point is the record milk payout that Fonterra anticipates for the current season, which equates to an income boost for dairy farmers of more than 2% of annual GDP – the question being where the money will go. Anecdotally at least, the trend in recent years has been more towards on-farm investment in productive capacity, whereas prior to the Global Financial Crisis it was more commonplace for farmers to leverage up against the additional income and buy more land. Only time will tell which mood prevails.

Restraining orders

There are at least three notable factors that are working to restrain the pace of the economy's expansion. The first is in some sense a product of New Zealand's relative success – the persistent strength of the New Zealand dollar. A rising exchange rate allows the benefits of stronger export commodity prices to be channelled through to the consumer, but it also acts as a drag on non-commodity exporters and the tourism industry.

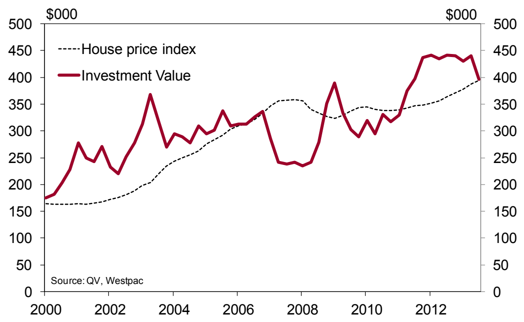
Secondly, fiscal restraint will remain a drag on the pace of growth compared to previous expansions. That said, the fiscal accounts have been better than forecast in recent months, which suggests there's scope for a bit more stimulus while staying on track for a return to surplus – especially bearing in mind that next year's election is shaping up to be a tight one. Under the current government, any loosening of the purse strings is likely to come in the form of reduced taxes or charges – leaving more money in the hands of households and businesses – rather than additional spending.

The third factor is the recently-announced restrictions on high loan-to-value ratio (LVR) mortgage lending, which took effect from 1 October. In our August *Economic Overview* we detailed how we thought the LVR restrictions would play out, and the response to date has been right in line with that assessment. Bifurcated pricing for high-LVR and low-LVR mortgages has emerged, and – at least anecdotally – investors are aiming to step into the gap left by first-home buyers. Aside from these factors, there's no evidence yet of the impact that the restrictions are having on the overall housing market, and nor would we expect there to be at this stage. The substantial pipeline of pre-approved loans means that we don't expect to see a significant drop in housing turnover until at least November, with the impact on prices coming through from early next year.

Taking these restraining factors into account, we've upgraded our GDP forecasts a fraction compared to the August *Overview,* to 2.8% growth this year and 3.8% next year, with the increase broadly in line with our stronger migration assumptions.

Our house price forecast is largely unchanged, with increases of 8.5% for this year and 6.5% next year. While stronger net migration will add further to housing demand in the short term, this will be balanced by the impact of the LVR restrictions (which are slightly tighter than we assumed in August) and the rise in fixed-term mortgage rates over the last few months. Indeed, it's worth noting that the latter has effectively closed the valuation "gap" that our Investment Value model of house prices has exhibited over the past two years.

Figure 7: Investment Value model of house prices



We expect the unemployment rate to fall to 5% by the end of next year. The slow pace of hiring, rather than layoffs, has been the main reason for the minimal improvement in the jobs figures to date, but surveys suggest that the former is starting to pick up. Firms are already reporting difficulty in finding skilled workers, and this squeeze is likely to intensify.

The upturn in domestic demand will eventually lead to home-grown inflation pressures, and with annual inflation now back within the 1-3% target band, that removes a potential psychological hurdle to OCR hikes. That said, the high New Zealand dollar is likely to keep a dampener on tradables inflation for a while longer, suggesting that the RBNZ can afford to delay interest rate hikes until next year, and to proceed gradually once they begin.

We maintain that the drivers of the economy's current expansion are largely temporary. Earthquake reconstruction is expected to peak and gradually wind down from 2016, at the same time that higher interest rates will be putting the squeeze on the housing market. We anticipate a modest drop in house prices over 2016-17, and an extended period of GDP growth below the economy's long-run potential rate.

New Zealand Dollar
A winning trifecta

The NZ dollar rose abruptly on the back of the US Federal Reserve's decision not to "taper" the pace of quantitative easing. Loose monetary policy in the US, combined with supportive domestic fundamentals, should see the NZ dollar remain high for a long while yet.

The base case we outlined for the NZD in the August *Economic Overview* has largely been borne out. The Federal Reserve's September decision not to taper the pace of quantitative easing surprised markets, but confirmed our own view that the conditions required for the Fed to start along the long path toward policy normalisation won't be met until well into 2014 (as detailed in our Global Economy section). As markets digested this news, US interest rates fell, dragging the US dollar with them. The NZD, along with other high yielding currencies hit hard by fears that US stimulus would start to be removed, rebounded sharply.

Against a backdrop of easy monetary policy and sub-par growth in the US, the NZD should remain well supported. On our forecasts it will linger above 80c against the USD until the middle of next year. But it is not just our US view underpinning this forecast. A trifecta of economic fundamentals also favour NZD strength.

Firstly, it is clear that the domestic economy is gathering momentum. The Canterbury rebuild and a broader pickup in construction activity, the strong housing market, a recovery from drought and a favourable terms of trade will all support a stronger pickup in GDP growth over the coming quarters.

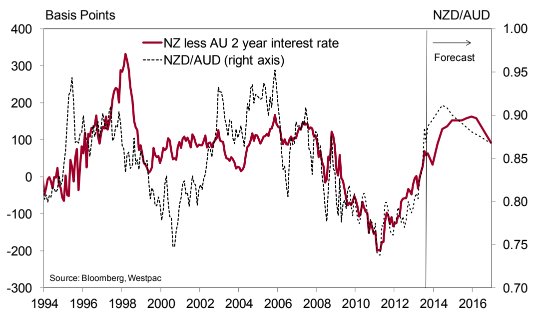
As we detail throughout this *Overview,* the RBNZ is likely to become the first OECD central bank to start raising interest rates. This increasing gap between interest rates in New Zealand and the rest of the world is the second important factor which favours NZ dollar strength.

The final leg of the trifecta is high prices for New Zealand's key commodity exports. Our Agricultural Outlook section explains that dairy prices in particular are at stellar levels but there have also been improvements in the likes of wool and meat prices. In aggregate, world prices for New Zealand's agricultural commodity exports are hovering near record levels.

Nowhere do these diverging fundamentals contrast more starkly than in a comparison with Australia. The Reserve Bank of Australia has aggressively cut its cash rate over the last two years and markets are underplaying the risk of further cuts (our own forecasts incorporate a further 50 basis points of rate cuts by May next year). Australian export commodity prices (dominated by hard commodities such as iron ore and coal) have shown some resilience to date, but remain vulnerable to slowing growth in China. Similarly growth prospects for 2014 will be tempered by a weak Australian labour market, and a sharp contraction in mining investment. We're forecasting the NZD to average above 90c against the AUD over next year.

But what goes up must (eventually) come down. As New Zealand export commodity prices ease in response to increasing global supply, domestic growth slows as interest rates rise, and central banks around the world edge ever closer to removing unprecedented stimulus measures, the NZD will fall.

Figure 8: NZD/AUD and 2 Year Interest Rate Differential



Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Dec-13	0.85	0.89	0.63	0.52	82.5	78.5
Mar-14	0.84	0.90	0.63	0.52	80.6	78.3
Jun-14	0.82	0.91	0.64	0.51	77.9	77.8
Sep-14	0.79	0.91	0.64	0.51	74.3	76.3
Dec-14	0.77	0.90	0.64	0.50	71.1	74.7
Mar-15	0.76	0.90	0.63	0.48	70.4	74.1
Jun-15	0.75	0.89	0.63	0.47	69.6	73.5
Sep-15	0.75	0.89	0.63	0.46	68.8	72.9
Dec-15	0.74	0.88	0.63	0.45	68.1	72.3
Mar-16	0.74	0.88	0.63	0.45	67.4	72.0

Inflation and Interest Rates

Moving feast

As the economy surpasses its non-inflationary "speed limit", the OCR will have to rise above its neutral level. But the neutral level itself is not static – we expect it will rise over the next few years.

As we've explained in previous *Economic Overviews,* we anticipate a period of rising interest rates from 2014 to 2016. The Canterbury rebuild, burgeoning construction activity elsewhere, an influx of migrants, rising house prices, and a burst of business investment will be more than enough to provoke inflation pressures, eventually requiring the Reserve Bank to hike the OCR.

The process we envisage is a slow one. The high New Zealand dollar is keeping inflation low. With inflation forecast to reach 2% in early 2015, the RBNZ truly has time on its side. Our thinking is that the OCR hiking cycle will not commence until April 2014.

But once the hiking cycle does get under way, we expect interest rates will need to rise above the "neutral" level. Of course, this begs the question – what is the neutral OCR? We shed some light on that question in a recent bulletin[1], and we'll summarise the main points here.

The neutral interest OCR is defined as the OCR that would neither increase nor decrease inflation if the economy were operating at its capacity. In the aftermath of the Global Financial Crisis (GFC), the neutral OCR fell – perhaps from 6 ½% to about 4 ½%. But there are three strong reasons to expect the neutral OCR to rise again over the coming five years. We are working on the assumption that it will reach 5%.

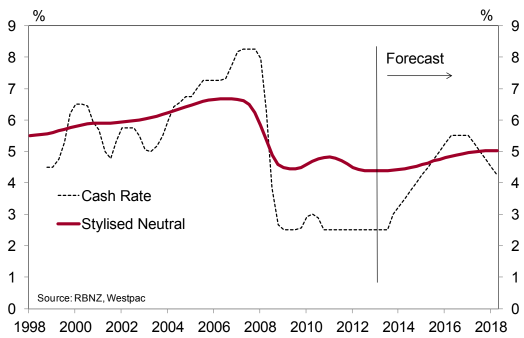
1. **Inflation expectations.** As headline inflation rises over the next few years, inflation expectations can be expected to rise in response – dragging the neutral OCR higher in the process. Inflation expectations might get an extra boost if the Reserve Bank's inflation target is loosened following a change of government.

2. **Bank funding costs and mortgage margins.** The margin between the OCR and actual lending rates widened considerably after the GFC, as overseas lenders demanded larger risk premiums. In the short run, the RBNZ has been able to offset this by reducing the OCR – this amounts to a lower neutral OCR. But in the future, bank funding costs could fall again, reversing the process. And if wider margins between the OCR and actual lending rates were to persist indefinitely, eventually the economy would transition to a new equilibrium that accounts for the fact that foreigners are less willing to lend to us. This would involve higher average interest rates, more saving, and less borrowing. In other words, foreigners' reluctance to lend to us would eventually manifest as higher neutral lending rates, not a lower neutral OCR.

3. **Global savings preferences.** Following the GFC there was a shift in global preferences in favour of saving. This reduced neutral policy rates around the world, including New Zealand. We suspect that some, but not all, of the preference to save will prove persistent. Correspondingly, we are assuming that some, but not all, of the drop in New Zealand's neutral OCR will prove persistent.

[1] http://www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins-2013/Primer-on-neutral-rates-October-2013.pdf

Figure 9: Westpac forecast of neutral cash rate and actual cash rate



Annual Inflation and Interest Rate Forecasts
(end of quarter)

	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Dec-13	1.5	2.50	2.65	3.50	4.50
Mar-14	1.3	2.50	2.90	3.70	4.60
Jun-14	1.6	3.00	3.25	3.90	4.70
Sep-14	1.5	3.25	3.50	4.10	4.80
Dec-14	1.9	3.50	3.75	4.40	4.90
Mar-15	2.2	3.75	4.00	4.60	5.00
Jun-15	2.4	4.00	4.25	4.80	5.10
Sep-15	2.6	4.25	4.50	5.00	5.20
Dec-15	2.6	4.50	4.75	5.20	5.30
Mar-16	2.5	4.75	5.00	5.30	5.35

Global Economy

Hold your horses

The biggest news of the past three months was surely the decision by the US Federal Reserve not to "taper" its asset purchasing programme. With US fiscal politics in deep dysfunction, tapering looks unlikely until late 2014 at the earliest. While there are signs that monetary policy is gaining traction elsewhere, we expect central banks to keep policy settings loose for some time yet.

Three months ago, the world economy was at a crossroads. Financial markets were convinced that the US economy was finally on the mend, and that the US Federal Reserve would start winding down its bond-buying programme as soon as September.

We were sceptical. When we looked through the US data we struggled to see how the US would achieve the kind of growth that the Fed was expecting for this year. More fundamentally, we simply weren't convinced that the US economy was ready to withstand the rises in mortgage rates that the threat of tapering had brought about.

In the event, the Fed's monetary policy makers decided the time was not ripe for tapering, sending shock-waves through global financial markets (see our New Zealand Dollar section).

But if the case for tapering seemed doubtful in September, it looks doubly inappropriate after the US government shutdown and debt ceiling debacle. We estimate that the government shutdown will subtract about 0.5 percentage points (annualised) from US growth in the December quarter, meaning the Fed is likely to downgrade its growth forecasts yet again in its December meeting.

More seriously, the debt ceiling/government funding debate has not been resolved; it has only been pushed out a few months. That means another round of political brinkmanship and associated economic uncertainty looms early next year, which will continue to weigh on businesses' willingness to hire and invest. This is exactly the kind of situation we warned about three months ago.

In this environment, financial markets no longer expect "tapering" to occur until about March next year. We would go further: given the anaemic pace of US jobs growth even before the government shutdown, we think tapering is unlikely before late 2014 at the earliest. That will keep interest rates low for longer in many other economies that have seen their exchange rates rebound since September, including Australia, New Zealand and many emerging markets.

The broader lesson from the US experience is that while monetary stimulus does work, it needs to be assessed against the broader economic context. As we detail below, evidence is now accumulating that monetary policy is gaining traction in a number of economies. However this does not mean that "exit" from monetary stimulus is anywhere close. In Australia, Europe, and the UK, just as in the US, monetary policy is currently the only force counterweighing headwinds that will continue to buffet those economies in 2014. New Zealand, buoyed along by a post-quake building boom and a post-drought export recovery, is set to remain an international outlier for a while.

Australia

Confidence in Australia is picking up. The Sydney housing market is gathering steam, with signs that stronger demand is translating into firmer price action. And business and consumer confidence surveys have both ticked up since the Coalition win in the September elections.

The Reserve Bank of Australia is now taking a "wait and see" approach before cutting rates further. Markets are pricing in less than a 50% chance of another rate cut, and believe rate hikes could begin late next year.

We think this is premature. First, outside Sydney, the housing data have been less strong. Secondly, post-election confidence rebounds haven't always lasted in the past, and may not do so this time. Australian businesses are still facing the combination of a post-mining boom let-down in Australia itself, and a sluggish global economy. If we are right about a renewed global slowdown next year, it is hard to see the recent pickup in business sentiment being sustained.

So we still expect two more RBA rate cuts by early next year. Importantly for New Zealanders working in Australia or considering doing so, our forecasts imply that a turnaround in Australian job prospects is some way off yet. Indeed, we expect Australia's unemployment rate to keep rising next year, to around 6.5% - the highest since the early 2000s.

China

In another apparent piece of good news for Australia, iron ore prices have held up surprisingly well through a seasonal soft patch. Is this a sign that the Chinese economy is picking up again? Certainly, the Chinese housing market has been surprisingly strong of late.

Again, we would caution against extrapolating too soon. Other parts of the economy are still in consolidation mode, with property developers remaining cautious despite the pickup in housing demand. But the deeper issue in this case is the ongoing tension between the Chinese government's growth targets and financial stability concerns.

A few months ago, GDP growth threatened to dip below 7% by year-end, and it seems the reins on housing were loosened somewhat as a result. But now that the Government's 7.5% growth target for this year looks within closer reach, we wouldn't be surprised to see financial controls being more tightly enforced – and Chinese growth slowing again by early next year.

Europe and the UK

The euro zone has now enjoyed six months of relative calm. Markets were remarkably unfazed when Silvio Berlusconi threatened to bring down the Italian government, only to cave one hour before the European Central Bank's October press conference.

It's clear from this episode that conditions in Europe remain highly vulnerable to political risk. If Berlusconi had not backed down, the ECB might have had to make good on its promise to "do whatever it takes" to keep the euro zone intact. But for now that promise remains untested, markets continue to believe in the ECB, and judging from the European business surveys, greater financial stability is starting to bear fruit. In recognition of that fact we now expect mere stagnation in Europe over next year, rather than outright recession.

One immediate beneficiary of greater European stability is the UK. With the Funding for Lending scheme boosting the housing market, the UK economy may finally be on the recovery path. But ongoing fiscal austerity means it's a long road ahead, and our on-hold policy forecast for the Bank of England is unchanged.

Japan

Japan, like New Zealand, is a positive economic outlier in the global mix. As with New Zealand, one reason is post-disaster reconstruction activity. But Japan may also be one economy that has been successfully jump-started by a combination of aggressive monetary and fiscal stimulus. The biggest factor here has been the plunge in the yen earlier this year, which has boosted the export sector and has lifted inflation to 0.9% - the highest since 2008.

The challenge will be to maintain this momentum and use it to implement much-needed reforms. In the last three months, the major development has been the announcement of a consumption tax – a crucial step on the path to Japan's long-term fiscal sustainability. More immediately, the tax may act as a further stimulus as consumers rush in to beat it (while the pill has been sweetened by another mini-stimulus package worth 1% of GDP).

Economic forecasts (calendar years)

Real GDP % yr	2009	2010	2011	2012	2013f	2014f
New Zealand	-1.4	1.9	1.4	2.7	2.8	3.8
Australia	1.4	2.6	2.4	3.7	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	2.8	1.5	1.7
Japan	-5.5	4.7	-0.6	1.9	1.9	2.4
East Asia ex China	0.5	7.8	4.3	3.8	3.9	3.0
India	6.5	9.7	7.5	5.1	4.3	5.2
Euro zone	-4.4	1.9	1.6	-0.6	-0.5	-0.1
United Kingdom	-4.0	1.8	0.9	0.2	1.1	0.9
NZ trading partners	**-0.3**	**5.0**	**3.4**	**3.6**	**3.3**	**3.2**
World	**-0.6**	**5.2**	**4.0**	**3.2**	**3.1**	**3.0**

Forecasts finalised 31 October 2013

Eye on the Horizon

New Zealand's longer-term economic outlook

In this section, we set out our forecasts for the New Zealand economy for the next ten years.

Our main motivation for extending our forecasts is to trace the current economic cycle out to its full conclusion. We have long argued that the Canterbury rebuild and rising house prices would create an economic upswing. Our long-term forecasts make the additional point that the drivers of this upswing are temporary. The Canterbury rebuild will wind down in the second half of the decade, at the same time as house prices are likely to be slowing or even falling as the Reserve Bank raises interest rates. That adds up to a slowing economy, and by 2017 we expect to see the Reserve Bank embarking on a new easing cycle.

Issuing long-run forecasts is also a way of outlining our assumptions for the future "average" state of the economy. Our forecasts for 2023 are not meant to be precise predictions – in reality the economy will be buffeted in one direction or the other by as yet unforeseen economic shocks. But long-run forecasts provide a reasonable basis for planning, given what we do know today. Our key assumptions[2] are that:

- New Zealand's average economic growth rate will be slower than in past decades. The main reason is slower growth in the work force. Slower population growth combined with aging suggests that by 2023 New Zealand's labour force will be growing less than 1% a year. We are sceptical that faster productivity growth will compensate. Productivity growth has remained elusive through a range of policy changes and we struggle to see where a quantum leap will come from in the next decade, particularly in a global context of population aging and natural resource constraints. We've conservatively assumed that productivity growth will continue at its historical average of about 1.2% a year. That implies trend GDP growth of just 2.1% - over the past two decades the average was closer to 3%.

- Inflation will average 2.5% as governments tinker with the Reserve Bank's targets. New Zealand has a history of "inflation creep", where inflation has averaged in the top half of the RBNZ's target band and the target itself has been relaxed over time. Governor Wheeler has broken with that trend, refocusing the RBNZ on the 2% mid-point of the target range. But in 10 years' time we will be dealing with a different Governor and a different Government. In our view higher average inflation has few long-run benefits and large potential costs, but the temptation to "buy" just a bit more short-term growth with a bit more inflation is powerful.

- The NZ dollar will average 71 cents against the US dollar and 87 cents against the Australian dollar. We are bullish on global food prices, given the rapid growth of Asian demand and New Zealand's competitive strength as a food exporter. That is likely to keep the NZ dollar historically high against the US dollar. For the NZD/AUD the situation is less clear-cut. We

Key long-term forecasts and historical averages

	1993-2002	2003-2012	2013-2017	2018-2022	2023
GDP (% annual ave)	3.6	2.3	2.8	1.9	2.1
Employment (% annual)	2.3	1.5	1.8	0.8	0.9
Labour productivity (% annual ave)	1.2	1.1	0.8	1.1	1.2
CPI (% annual)	1.9	2.6	1.9	2.2	2.5
Wages (% annual)	2.5	3.5	3.1	3.1	3.5
Nominal GDP (% annual ave)	5.5	4.9	5.1	4.1	4.6
Current account (% of GDP)	-4.5%	-5.6%	-4.5%	-3.9%	-3.8%
NZD/USD (end of period)	0.56	0.70	0.76	0.70	0.71
NZD/AUD (end of period)	0.84	0.84	0.88	0.85	0.87
90-day interest rate (end of period)	6.9	5.4	4.3	5.0	5.2
2-year mortgage rate (end of period)	-	7.3	6.7	6.7	6.9
House prices (% annual)	5.3	7.6	3.3	3.5	4.6

suspect that over the long haul, “soft” commodity exporters like New Zealand will do better out of the rise of Asia than “hard” commodity exporters like Australia. But New Zealand also has a worse track record on productivity. On balance we expect the NZD/AUD to settle around its historical inflation-adjusted average.

- The Official Cash Rate will average 5%. As we explain in the Inflation and Interest Rates section, the “neutral” OCR is likely to rise as the economy recovers, though not all the way back to where it was before the Global Financial Crisis.

Figure 10: GDP growth (annual average % change)

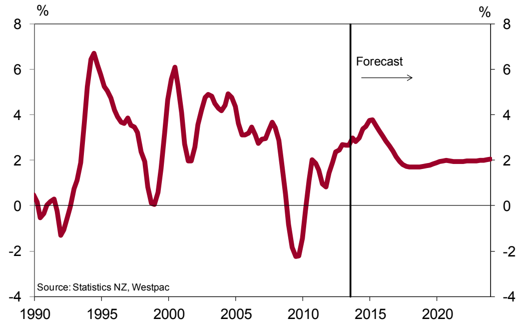


Figure 11: Inflation

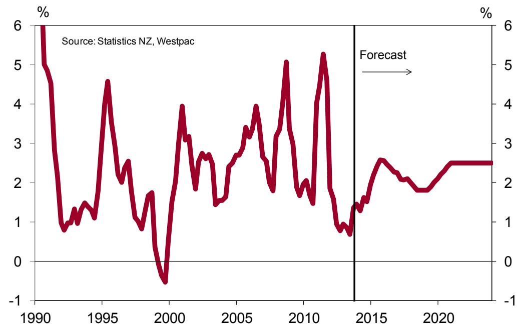


Figure 12: 90-day interest rate

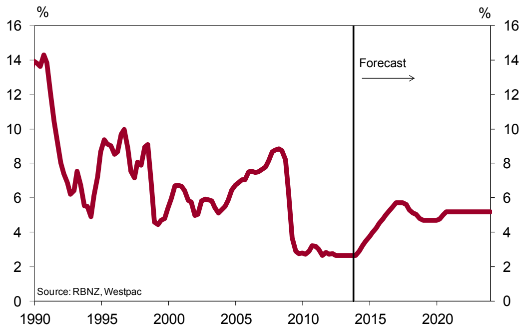


Figure 13: Unemployment Rate

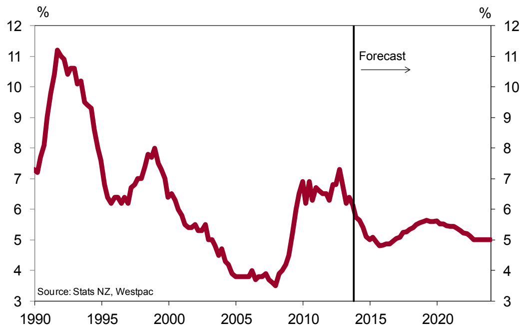


Figure 14: House price inflation (annual % change)

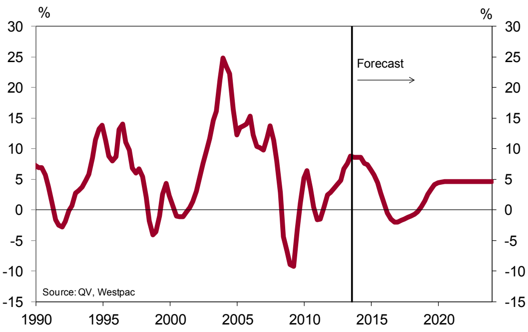
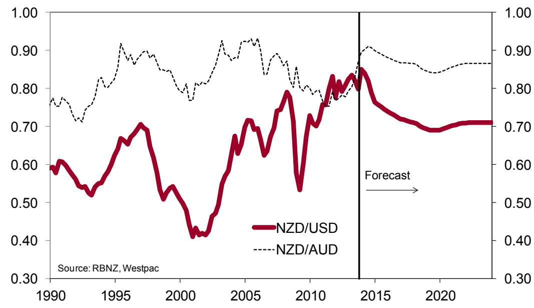


Figure 15: NZD/USD and NZD/AUD exchange rates



[2] For more detail see our recent bulletin http://www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins-2013/Eye-on-the-horizon-October-2013.pdf

Agricultural Outlook

Greener pastures

The agricultural sector is recovering strongly from the recent drought. Excellent spring conditions and high international prices are adding a bounce to the step of many in the rural sector. But the good times won't last forever. We expect commodity prices to soften in 2014.

Agricultural production was hit hard by one of the worst droughts on record over the summer of 2012/13. Indeed looking back now, the effects of the drought were even more dramatic than we anticipated. Milk production in the first 6 months of the year was 13% lower than the year before. In aggregate, there was a 10% fall in agricultural production which flowed through into a sharp contraction in food manufacturing and processing and a large fall in exports in the June quarter.

But while the view through the rear-view mirror is rather depressing, the good news is that since the August *Economic Outlook,* conditions have improved much more rapidly than expected. Good rainfall, a mild winter, and superb spring growing conditions across large swathes of the country have seen milk production in particular rebound strongly. Nationwide milk production is running 5% ahead of last season's levels. Indeed in some regions processing capacity is struggling to keep up as supply approaches its seasonal peak. In comparison, the effect of the drought will linger for sheep and beef farmers. Lack of feed forced some farmers to cull breeding stock which will take time to replace. And for sheep farmers the relatively poor condition of remaining stock ahead of lambing will contribute to an expected 7.7% fall in the lambing crop (according to estimates by NZ Beef and Lamb). Beef cattle numbers are expected to be down around 1.3% this year.

Adding to the good news for farmers, prices for key export commodities have also proved more robust than expected in recent months. Dairy prices in particular have been the star performer. GlobalDairyTrade auction prices have persisted at high levels, even as domestic supply prospects brightened, and are 44% higher than a year ago. With 27% of New Zealand's dairy exports now destined for China, part of the reason for this is the strength of Chinese demand. The ongoing benefits of the Free Trade Agreement, China's decision to break an alleged oligopoly in milk powder retailing, and the inability of growth in Chinese supply to keep pace with increased dairy consumption have all pushed prices to within a whisker of record highs. We (and Fonterra) are now forecasting a record milk price for farmers of $8.30/KgMs for the current season – compared to last season, this is a boost to revenues in the sector equivalent to about 2% of GDP.

But while dairy farmers may be wearing the biggest smiles there have also been improvements in wool, lamb, beef and even forestry prices (see the table below for further detail).

This backdrop of tight global supplies for New Zealand's key commodity exports won't last forever. Markets are dynamic, and the high international prices on offer provide a strong incentive for producers worldwide to lift production to the extent they are able. For example, US dairy producers with their well developed infrastructure and supply chains are likely to respond to the improved margins relatively quickly. However we remain firmly of the view that the fundamental strength in demand for food from consumers in emerging market economies will limit the downside.

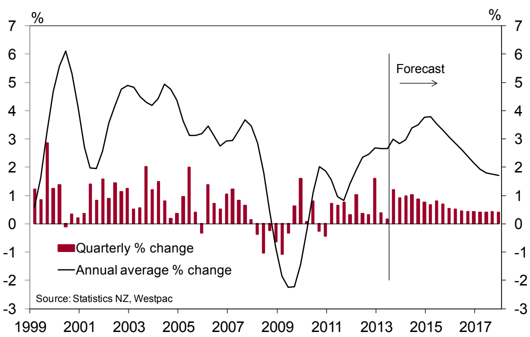
Commodity price monitor

Sector	Trend	Current NZD level[3]	Next 6 months
Forestry	Forestry prices have defied expectations of weakness, but this is unlikely to continue indefinitely. Slower growth in China will eventually weigh on prices.	High	↘
Wool	Fine wool prices have been weighed down by weakness in Europe. Coarse wool prices to benefit from recovery in US housing market.	Above Average	→
Dairy	Sky-high prices are likely to come under increasing pressure in 2014 as global supply increases.	High	↘
Lamb	Prices are holding up well. While European markets remain soft, tight supplies globally should support prices.	Average	↗
Beef	Solid demand for imported beef in the US and Asia to benefit NZ producers.	Average	→

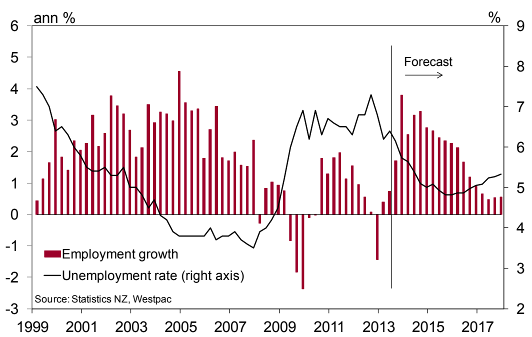
[3] NZD prices adjusted for inflation, deviation from 10yr average.

Annual Average % change	March years				Calendar years			
	2013	2014f	2015f	2016f	2012	2013f	2014f	2015f
GDP (production)	2.7	3.0	3.8	2.9	2.7	2.8	3.8	3.1
Private consumption	2.3	4.0	3.4	2.8	2.4	3.6	3.6	3.1
Government consumption	0.4	0.1	0.5	0.9	0.5	-0.1	0.5	0.8
Residential investment	18.9	14.6	17.9	9.2	12.1	17.4	17.2	11.9
Business Investment	4.2	8.4	7.3	5.0	5.0	6.1	8.3	5.6
Stocks (% contribution)	-0.4	0.3	0.0	0.1	0.2	0.2	-0.3	0.2
Exports	3.0	-0.7	4.6	1.9	2.6	0.5	4.5	1.3
Imports	0.7	5.6	5.5	3.3	2.1	4.3	6.0	3.7
Inflation (% annual)	0.9	1.3	2.2	2.5	0.9	1.5	1.9	2.6
Employment (% annual)	0.4	2.6	2.7	2.1	-1.4	3.8	2.8	2.3
Unemployment rate (% s.a. end of period)	6.2	5.6	5.1	4.9	6.8	5.7	5.0	4.8
Labour cost index (all sectors, % annual)	1.7	1.7	2.2	2.4	1.8	1.7	2.0	2.4
Current account balance (% of GDP)	-4.5	-3.8	-4.9	-5.0	-4.7	-3.9	-4.4	-5.2
Terms of trade (% annual)	-2.8	10.7	-3.4	3.3	-8.9	15.4	-4.6	3.9
House prices (% annual)	7.6	8.6	5.7	-0.5	6.7	8.6	6.5	1.0
90 day bank bill (end of period)	2.65	2.90	4.00	5.00	2.65	2.65	3.75	4.75
5 year swap (end of period)	3.40	4.60	5.00	5.35	3.07	4.50	4.90	5.30
TWI (end of period)	75.9	78.3	74.1	72.0	73.6	78.5	74.7	72.3
NZD/USD (end of period)	0.83	0.84	0.76	0.74	0.82	0.85	0.77	0.74
NZD/AUD (end of period)	0.80	0.90	0.90	0.88	0.79	0.89	0.90	0.88
NZD/EUR (end of period)	0.63	0.63	0.63	0.63	0.64	0.63	0.64	0.63
NZD/GBP (end of period)	0.54	0.52	0.48	0.45	0.51	0.52	0.50	0.45

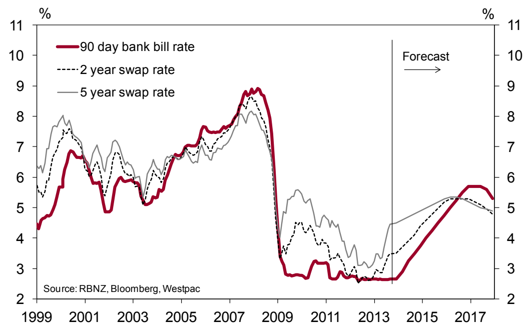
New Zealand GDP growth



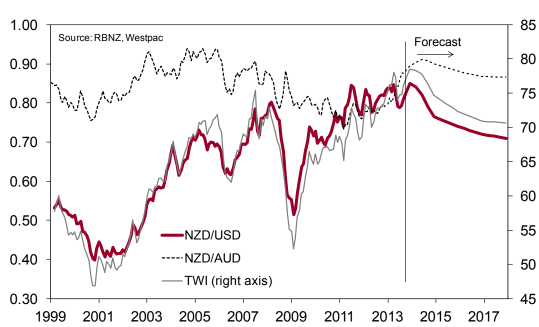
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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