# Economic Overview

August 2015

## The tide has turned


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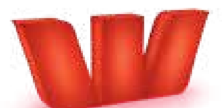

**Dominick Stephens**
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# Note from Dominick

In our last *Economic Overview* we argued that the outlook had changed, economic growth had peaked, and the OCR hiking cycle was over.

With the passage of three more months it is obvious that we did not go far enough in that document. We have subsequently experienced a ferocious unexpected decline in global dairy prices. It is also now apparent that the Canterbury rebuild has levelled off nine months earlier than anticipated and is no longer boosting economic growth. Business and consumer confidence have already plunged.

Such a significant change in backdrop requires a significant change in our forecasts – which is exactly what we deliver in this *Economic Overview.* We now expect GDP growth to drop from 3.3% to below 2% in short order, unemployment to rise to around 6.5%, and the housing market to slow. We expect the OCR to fall to 2.0% and the exchange rate to remain under downward pressure. That should provide some relief, so we have been able to forecast a modest recovery in GDP growth from mid-2016 onwards.

When we put our revised forecasts together we found ourselves referring frequently to international parallels – especially Australia's recent economic history. Since 2011, Australia has endured a 28% decline in its terms of trade, and its huge mining construction boom is fading. Australia's exchange rate has fallen 30%, and its cash rate has dropped from 4.75% to a record low of 2.0%. There have been bright spots in the Australian economy – notably rising house prices in the biggest cities and robust urban construction activity. But overall, Australia has struggled to stimulate the non-mining sector. GDP growth has remained below trend and unemployment has risen, albeit not catastrophically.

The reader will find that our forecasts for New Zealand follow this Australian template very closely.

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# New Zealand Economy

## Double whammy

After expanding at a robust pace over 2014, the economy showed signs of coming off the boil in early 2015. With the dairy sector taking a dramatic turn for the worse, we anticipate a further slowdown in GDP growth and a lift in unemployment. The falling exchange rate and lower interest rates will cushion the blow, but any recovery will soon run into headwinds from the waning Canterbury rebuild.

Economic growth accelerated to 3.3% in 2014, on the back of a forty-year high in the terms of trade, the Canterbury rebuild, and burgeoning population growth. But cracks in the façade emerged in early 2015. The economy grew a surprisingly paltry 0.2% in the March quarter. Some of this can be chalked up to drought and the temporary shutdown of a major oil field. But there were genuine disappointments in lacklustre personal consumption and very weak business investment spending. We will probably see June quarter GDP figures tick higher as temporary factors from March unwind, but that will be just a blip.

### From bad to worse

We expect the economic situation to deteriorate markedly over the second half of 2015 and early 2016, following two major headwinds that have struck the economy. As we explain in the *Agricultural Outlook* section, developments in dairy markets have prompted us to radically lower our forecast for this season's farm gate milk price, to just $3.70 from $5.70 three months ago. That implies that annual dairy export revenues will be more than $3.5bn lower – about 1.5% of annual GDP – than we assumed in our last *Economic Overview.*

That statistic doesn't capture the full extent to which conditions in the dairy industry have deteriorated. A milk price of $3.70 will be well below break-even levels for many dairy farmers. A second consecutive season of very low returns will inevitably force much more wrenching on-farm spending adjustments than a one-year downturn might have. And downstream investment activity is also likely to slow.

Meanwhile, the Canterbury rebuild – which we have long highlighted as a key driver of national economic growth – is peaking early, about nine months sooner than we had expected. On the residential side, the pipeline of work has already slowed, with residential building consents in Canterbury down about 25% since late last year. Consents for commercial buildings have continued to ramp up, but these more complex projects will require more coordination and specialist skills, and are likely to proceed more gradually. Overall, we expect rebuild activity to plateau for the coming year. That will come as a shock to an economy accustomed to accelerating rebuild activity underwriting growth. And by early 2017 the vast bulk of residential work will be done, and by our estimates commercial construction will be well-advanced. At that point the waning rebuild will become an outright drag on GDP.

Available data suggest that these developments are already affecting consumer confidence, business confidence, hiring and investment. Indicators of actual business activity in the June quarter, such as the PMI surveys, were fairly resilient. However, employment growth has slowed, imports of capital equipment have flattened out, and commercial vehicle registrations have come off sharply.

*Figure 1: Business confidence*

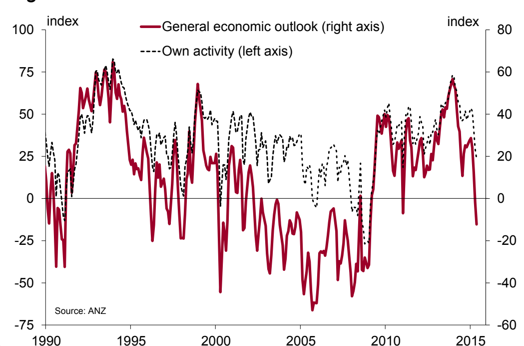
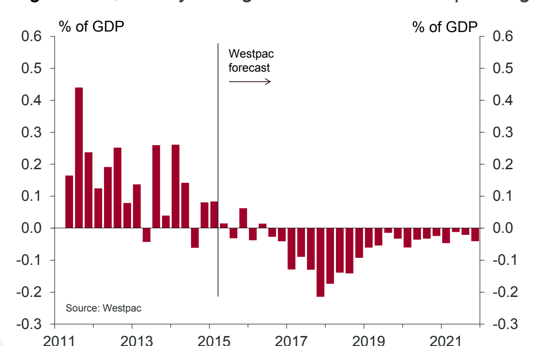



*Figure 2: Quarterly changes in reconstruction spending*



A shockingly weak business confidence survey in July suggests worse is yet to come. Unsurprisingly, confidence in the agriculture industry has taken the hardest knock. We suspect it will fall further from here – dairy farmers' cash flows will continue to tighten in coming months, and anecdotes are only starting to emerge that rural land values are coming under pressure. But declining confidence hasn't been restricted to the farm sector. Concerningly, sentiment also plunged among construction firms. This seems at odds with actual building activity levels at present, but adds to the sense that the building pipeline is weaker than previously anticipated.

Plunging business confidence will likely translate into a further retrenchment of businesses' investment and employment decisions. Over the coming December and March quarters we expect to see outright declines in plant, machinery and transport investment; zero employment growth; and low rates of quarterly GDP growth. We expect annual GDP growth will drop to 1.8%, while unemployment will rise to 6.5% and wage growth will slow even further.

Such a deterioration in the labour market will seriously knock consumer confidence – although actual consumer spending is likely to slow more modestly owing to strong population growth.

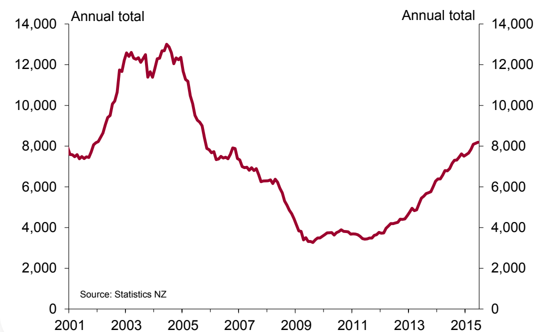
## Bright spots

Of course, not all drivers of economic growth have disappeared. In Auckland, the need for new housing and infrastructure to accommodate the city's rapidly growing population remains pressing. Net immigration has shown very little sign of slowing to date – probably a reflection of the ongoing malaise in Australia's labour market. We expect some moderation in population growth over the coming year, but it is unlikely to turn decisively until Australia becomes a more compelling alternative destination for New Zealand and international migrants.

How quickly Auckland construction can and will ramp up to meet demand is uncertain. Issuance of residential building consents has doubled in recent years, but given the recent downturn in confidence it would be optimistic to expect a sudden further leg higher. However, with development rules slowly being relaxed and interest rates falling, we do expect building activity in the region to continue rising over time.

The other key bright spots are export industries such as kiwifruit, wool and beef. As we detail in the *Agricultural Outlook* section, international prices for these products have generally fared better than dairy, and for these exporters the lower exchange rate will provide a welcome windfall. The lower exchange rate is also likely to be a boon for tourism

*Figure 3: Auckland residential building consents*




and the foreign education sector, which were already enjoying a very strong year on the back of a recovering global economy, and have now become more price-competitive.

## Million dollar question

A decisive factor will be what happens to the housing market – particularly in Auckland, where house prices have continued to defy gravity. House price inflation in other regions has been relatively modest, though prices in Tauranga and Hamilton are now rising more rapidly, suggesting some spill-over from the Auckland market to those nearby centres.

It is tempting to conclude that OCR cuts by the Reserve Bank will further inflame Auckland house prices, but we are sceptical. The market has clearly been driven by expectations of capital gain, with prices running well ahead of existing rents or incomes. Our preferred interpretation is that investors are betting on Auckland's housing needs being met by denser development, which has driven up the perceived value of land. This leaves the market highly vulnerable to a shift in sentiment. We expect investor optimism to be increasingly challenged in the coming months as the economic climate continues to darken.

Adding to our concerns are the recently announced policy changes around investor lending and tax. From 1 October, the Reserve Bank plans to tighten its lending restrictions for Auckland property investors (while loosening them in other parts of New Zealand), and the Government plans to tax any capital gain on investment properties sold within two years of purchase. While these policy changes are incremental on paper, they could create further cracks in investors' confidence that prices will keep marching higher.

So while lower interest rates will provide some support for the housing market, we are not confident they will prevent it from slowing. We expect Auckland house price inflation to slow later this year. The flow-on effects of the dairy downturn could cause house prices

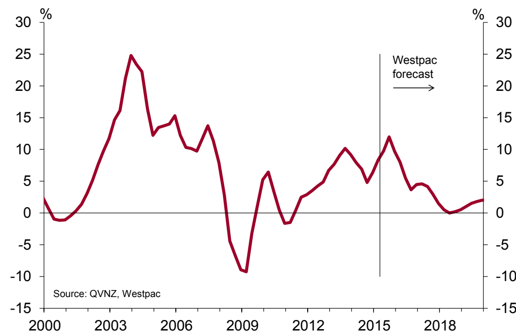



*Figure 4: House price inflation*

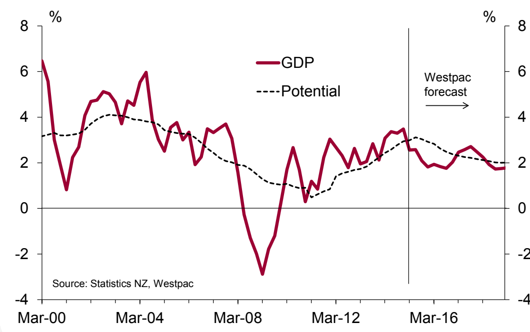



*Figure 5: GDP growth – actual and potential*

to fall in dairying regions such as Taranaki and Southland, while Christchurch prices are likely to fall as the housing stock is replenished. But housing markets in other parts of New Zealand could well experience a boost from falling interest rates and looser lending restrictions. On balance, we forecast national house price inflation of 4.5% next year, compared to 10% this year.

## Beyond the initial shock

Looking beyond the coming economic downturn, there are reasons to expect a modicum of recovery from mid-2016 onwards. We do expect some recovery in dairy prices by that time, which will buoy confidence and spending in rural parts of New Zealand. But the real circuit-breakers will be lower interest rates and a lower exchange rate.

The economic downturn we expect needs to be seen in the context of very strong recent growth in the economy's supply-side potential. In the last few years strong business investment, rapid population growth, and good progress on productivity combined to boost the New Zealand economy's ability to supply goods and services. We estimate that New Zealand's rate of potential GDP growth – the speed at which it can grow without adding to inflation – increased from less than 1% in 2011 to 3% last year. This meant that even when economic growth was at its peak, inflation was low.

The coming economic downturn will see economic growth fall a long way short of its now-elevated potential. For the labour market, this translates to slow employment growth amid rapid population growth – the consequence will be rising unemployment and low wage growth. For the wider economy, below-potential GDP growth could cause non-tradables inflation to trend down further, from an already-low starting point.

As later sections explain, we expect all of this will force the Reserve Bank to cut the OCR to 2.0%. Lower interest rates will support housing markets to some degree, ease budgets among indebted households, and encourage spending over saving. The lower OCR will also contribute to a drop in the exchange rate, supporting export industries such as tourism and import-competing industries such as furniture manufacturing.

That said, we would expect any recovery in 2016 to be modest and short-lived, especially since the headwind of the waning Canterbury rebuild will be gathering force by late 2016 and into 2017. Our GDP forecasts are generally pretty modest until the end of the decade.

There is a remarkably close parallel between the challenges New Zealand is currently facing and Australia's recent experience with an unwinding mining construction boom amid tumbling iron ore prices. Since late 2011 the RBA has reduced the cash rate from 4.75% to 2.0% and the Australian dollar has fallen about 30%. There have certainly been bright spots in the Australian economy – notably rising house prices in the biggest cities and robust urban construction activity. Still, Australia's economic performance has not been strong enough to prevent stubbornly high unemployment, sagging wage growth, and persistently low business and consumer confidence. In our view, this provides a template for what New Zealand can expect over the next few years.

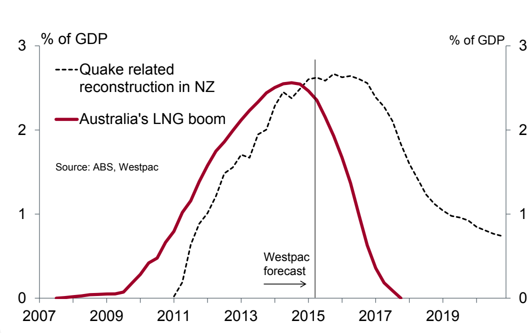



*Figure 6: A tale of two booms – Australia vs New Zealand*

# Global Economy

## Waters remain choppy

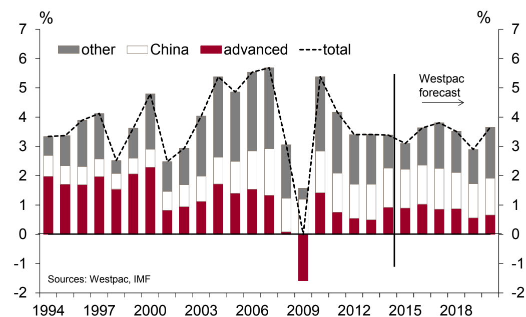
Global growth is expected to remain moderate over 2015 and 2016, but with significant divergences across regions. The composition of growth is resulting in challenging conditions for commodity exporters, with weakness expected in both New Zealand's and Australia's terms of trade.

### Global growth to remain moderate

Since our previous *Economic Overview,* we've seen increased volatility in financial markets and challenging conditions in some economies, particularly China and Greece. These developments have provided a timely reminder of the lingering downside risks for global activity. But recent developments haven't all been negative. There are signs that recoveries in a number of economies, including the US, are on an increasingly stable footing.

Looking at the global economy as a whole, we're forecasting growth of around 3% to 3.5% over 2015 and 2016. However, growth is expected to remain uneven, and in many regions it will continue to be dependent on policy support.

*Figure 7: Contributions to world growth*




### Conditions in China are expected to remain sluggish…

While overall global growth is expected to remain only a little below average, the current mix of activity isn't favourable for Australasian commodity exporters. In large part, this is due to conditions in China.

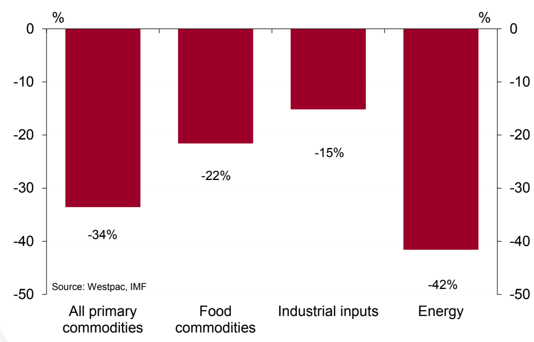
Through June and July, Chinese equity markets plunged by more than 30%, with declines only arrested after significant policy support was introduced. At this stage, the impact of this volatility on the wider economy is expected to be limited. Nevertheless, it does raise some concerns about the downside risks for growth.

Of greater concern is that momentum in Chinese economic activity remains subdued. Confidence in the corporate and household sectors remains low, fixed asset investment continues be dampened by weakness in the real estate and industrial sectors, and export growth continues to be weighed down by lingering softness in global trade. In light of these conditions, we expect Chinese GDP growth to slip below 7% in coming years.

### …which is dampening the outlook for commodity exporters…

Subdued demand in China, as well as softness in a number of other economies, is weighing on demand for many globally traded commodities. Combined with increases in global supply in recent years, this has resulted in significant downward pressure on a range of commodity prices. These developments will have a pronounced impact on income growth and investment decisions in many countries including China itself.

*Figure 8: Changes in commodity prices – year to June 2015*




### …including Australia and New Zealand

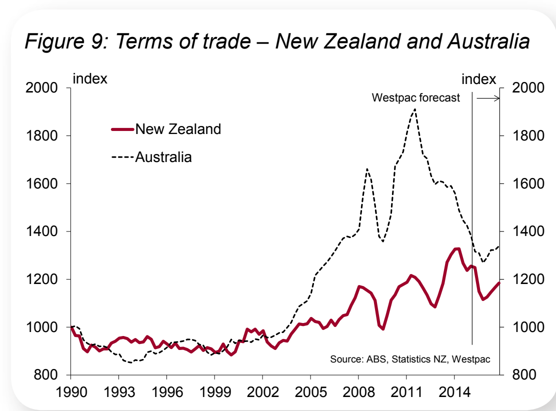
Weakness in commodity prices will have a particularly marked impact on the Australian economy. Prices for a number of Australia's key exports have plunged in recent years, pulling its terms of trade down by 28% since 2011. This weakness in commodity prices, combined with subdued public demand and business

investment spending (particularly in the mining sector), means that Australian GDP growth is expected to remain below trend through 2015. There are some bright spots, however, with a strong upswing in home building, as well as increases in both resource and service exports.

Australian GDP growth is expected to pick up through 2016 as the drag from the terms of trade fades, and low interest rates and a lower AUD boost demand.

Softness in demand for commodities will also have a dampening impact on New Zealand. This is due to reduced demand for our exports from China. In addition, we will be affected by the softer demand picture for Australia (though the strengthening in the Australian housing market will provide some buffer).

*Figure 9: Terms of trade – New Zealand and Australia*




## US conditions continuing to improve

The outperformer on the global stage has been the US economy, where economic conditions have continued to improve. This has been seen most clearly in the labour market, with non-farm employment growth averaging a robust 221,000 jobs in recent months, and the unemployment rate pushing down to 5.3%. This improvement in the labour market has been accompanied by increases in household spending, as well as a strengthening in the housing market. The recovery in the industrial sector has been more gradual, with the appreciation in the US dollar resulting in some headwinds. Nevertheless, the US economy is expected to continue expanding at a steady pace over the coming year.

With the US still the major consumer in the global economy, its continuing recovery bodes favourably for the longer-term global economic outlook. At the same time, the ongoing recovery in the US also means that we are moving closer to the point when the Federal Reserve will start to increase the Federal Funds Rate from its current extremely low level. We expect this to begin in September.

There are concerns that the eventual increase in the Fed Funds Rate will prompt increased volatility in financial markets and asset prices, similar to 2013's 'taper tantrum'. This time around we expect a less vigorous reaction from financial markets. The lift in the Fed Funds Rate has been well signalled, and the pace of tightening is expected to be measured. In addition, the tightening in rates will only occur if the Federal Reserve is convinced that it won't derail the recovery.

## Greek tragedy, but euro area recovery continuing

The recent calamity in Greece made headlines, but financial market reaction has largely been contained within Greece itself. Bond yields in other peripheral euro area economies have remained low. Looking at the euro area more generally, economic activity has continued to recover at a gradual pace, supported by monetary stimulus and less restrictive fiscal policy relative to recent years.

**Economic forecasts (calendar years)**

| Real GDP % yr | 2011 | 2012 | 2013 | 2014 | 2015f | 2016f |
|---|---|---|---|---|---|---|
| New Zealand | 1.8 | 2.4 | 2.3 | 3.3 | 2.2 | 1.8 |
| Australia | 2.7 | 3.6 | 2.1 | 2.7 | 2.4 | 3.0 |
| China | 9.3 | 7.8 | 7.8 | 7.4 | 7.0 | 6.8 |
| United States | 1.6 | 2.3 | 2.2 | 2.4 | 2.2 | 2.8 |
| Japan | -0.5 | 1.8 | 1.6 | -0.1 | 1.0 | 1.7 |
| East Asia ex China | 4.4 | 4.5 | 4.3 | 4.1 | 4.4 | 5.0 |
| India | 6.6 | 5.1 | 6.9 | 7.2 | 7.5 | 8.1 |
| Euro zone | 1.6 | -0.8 | -0.4 | 0.9 | 1.3 | 1.1 |
| United Kingdom | 1.6 | 0.7 | 1.7 | 3.0 | 2.5 | 2.5 |
| **NZ trading partners** | **3.6** | **3.7** | **3.6** | **3.8** | **3.7** | **4.0** |
| **World** | **4.2** | **3.4** | **3.4** | **3.4** | **3.1** | **3.6** |

Forecasts finalised 6 August 2015

# Agricultural Outlook

## Into the red

World dairy prices continue to be driven lower by a shaky international environment and a renewed glut of milk supply. Lower prices will help to rebalance the market over the next year, but in the meantime the New Zealand dairy industry faces substantial financial challenges. The weaker NZ dollar has provided little relief to dairy farmers, but has been a boon to other agricultural exports.

### Dairy in the dumps

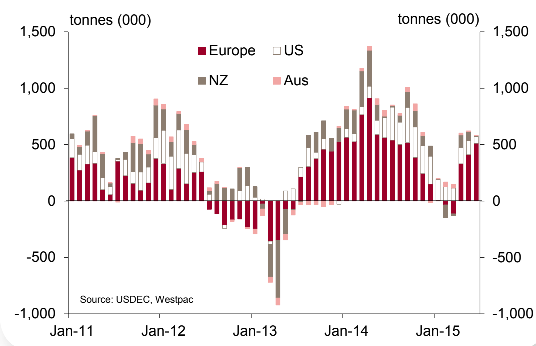
New Zealand's dairy industry faces a severe test over the next year. World prices for dairy products have continued to fall sharply, with prices in the most recent GlobalDairyTrade auction reaching their lowest levels since late 2002. We now expect last season's already-low farmgate milk price of $4.40/kg to be followed by a payment of $3.70/kg this season, which could render even the most efficient operators unprofitable this year.

The financial strain on dairy farmers is already becoming apparent. Agricultural borrowing is up 9.3% in the last year, as dairy farmers borrow to manage themselves through the current period of little or no operating cash flow. Notably, sale prices for dairy farms have held up to date despite the sharp drop in milk prices. History suggests that divergence won't last – and given the thinness of the market, it may only take a small number of distressed farm sales to establish a new, lower benchmark for farm prices across the country. That in turn would constrain farmers' ability to borrow against the equity in their properties.

As a result, cost control will be increasingly important over the next year. This will have knock-on effects for rural regions more generally, as dairy farmers cut back in areas such as repairs and maintenance, farming machinery, fertiliser, supplementary feed and environmental protection. Belt-tightening is being extended to the herds themselves: the dairy cow cull was higher than normal last season, and further culling is likely as the new season progresses, a decision made easier by very high beef prices at the moment. Depending on the conditions for pasture growth, there's a good chance that milk production in New Zealand could be down this season.

So what has led to this situation? It's fair to say that the global economic environment has not been very hospitable to commodity prices in general. But we should also take note of the fact that prices for many of New Zealand's other agricultural commodities – even those where China is a significant market – have held up reasonably well. Dairying's woes have been compounded by excess supply problems that are specific to that market.

*Figure 10: Year on year changes in milk production*

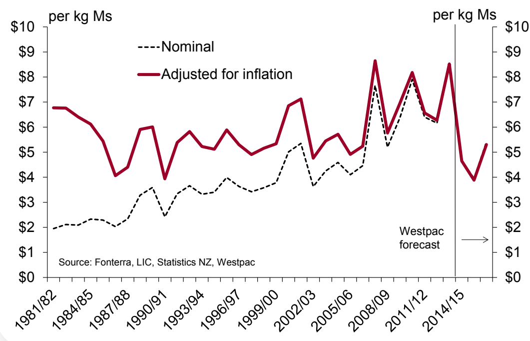



To some extent, the current supply problems are the result of previous years of high dairy prices, which provided an incentive for the global dairy industry to invest in extra capacity. By early 2014, milk production among the major exporters was growing at about 4% per annum, a pace that almost certainly exceeded demand growth. But production slowed as world dairy prices fell from their highs, and by March this year annual growth in milk production had slowed to zero (though this was partly due to the short-lived drought in New Zealand).

However, in April the removal of Europe's long-running milk production quota system led to a resurgence of production in the region – some countries such as Ireland and the Netherlands are running 10% ahead of last year's production levels. The intention to lift production once the quota system was removed is understandable, but the plan has been executed at the worst possible time – right in the midst of an already over-supplied market, signs of fragility in markets such as China and the Middle East, and an extension of Russia's ban on food imports from many Western countries.

This surge in production has occurred despite a recognition that current milk prices are below production costs for most dairy farmers in Europe. Market prices are now falling below Europe's 'intervention' price, which means that a growing share of production will be purchased by governments and taken off the international market. This in itself may help to establish a floor for dairy prices elsewhere.

*Figure 11: Dairy payout history and forecasts*




On the demand side, China remains notably quiet as an importer, and there have been reports of large stockpiles of milk powder. However, we don't believe that this is a recent issue. China's imports of milk powder surged in late 2013 – largely purchased from New Zealand – apparently due to concerns about supply disruptions. Those concerns proved to be unwarranted, leaving Chinese buyers with significant stockpiles that they have been working through since – though there's no clear sense of how far they have progressed.

Our outlook for world dairy prices is effectively down then up again, though remaining below historical averages. Our forecast of a $3.70/kg milk price for this season allows for further price declines in the near term, as the recent surge in milk production adds to the existing glut. However, we expect the market's rebalancing to resume by later this year. Overseas industry bodies such as the USDA are forecasting global milk production to grow by only around 1% this year, which is likely to be slower than the pace of growth in demand.

The performance of dairy prices this year – both the brief drought-related spike, and the subsequent lurch lower – underscores a point that we have been making for some time: international dairy prices are sensitive even to small changes in supply. A moderation in global milk production could spur a significant rise in prices from current levels. For this reason, we expect next season's farmgate milk price to reach $5.20/kg – still below average, but a substantial improvement on the previous two seasons.

On a related note, the risk of a full-blown *El Niño* weather pattern looks increasingly likely this summer. While it's difficult to predict the severity of such an event, we note that in recent years New Zealand has experienced severe droughts even without a confirmed *El Niño* pattern. Now that a full-blown pattern has been declared, it would be unwise to dismiss its potential impact. Recent droughts in New Zealand have tended to boost milk prices as much as they have hurt production, leaving them broadly revenue-neutral across the industry but with vastly differing fortunes across the regions.

## One man's trash is another's treasure

International prices have been mixed for New Zealand's other major agricultural exports. However, the fall in the New Zealand dollar – in response to the softer domestic economy and weak dairy prices – has generally been a boon for these industries.

Beef remains the star performer. Beef prices in the US remain at high levels, although an ample supply of imports means that a repeat of last summer's price spike is likely to be avoided. However, the weaker New Zealand dollar has lifted domestic schedule prices right back to last year's highs. Lamb prices haven't fared as well by comparison, due to both ample global supply and a lesser decline in the NZD against the British pound and the euro.

Kiwifruit has been a surprisingly strong performer as the industry bounces back from the Psa virus. The new Gold3 variety is now in full swing, and the gold kiwifruit harvest was up sharply on the last few seasons, though with a corresponding drop in export prices. What's more surprising is that the strong lift in green kiwifruit volumes has not had a detectable impact on prices so far this season.

**Commodity price monitor**

| Sector | Trend | Current level[1] | Next 6 months |
|---|---|---|---|
| **Forestry** | Slow overseas demand has weighed on export prices. Demand from the local building industry remains strong. | Average | → |
| **Wool** | Demand from China has been surprisingly strong this year. | High | → |
| **Dairy** | Further weakness likely in the near term as extra European production is absorbed, but we expect some recovery in prices by year-end. | Low | ↗ |
| **Lamb** | Plentiful supply overseas will weigh further on world prices, but this is being offset by a lower NZD. | Below Average | → |
| **Beef** | US beef prices remain high, while the lower NZD has lifted domestic prices back to their recent highs. | High | ↗ |

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

# Economic Imbalances

## Forever dogging us

New Zealand improved considerably on its debt position between 2009 and 2014. But now that the dairy slump has dented incomes, New Zealand's imbalances will be drawn back into sharp relief. Either spending will slow, or the current account deficit will widen to uncomfortable levels.

The financial imbalances the New Zealand economy famously built up during the mid-2000s were observable in two key statistics:

(1) As expenditure on consumption and investment ballooned in excess of national income, the **current account deficit** widened to over 7% of GDP (rising debt servicing costs were also a contributing factor).

(2) New Zealanders financed the shortfall of income relative to expenditure by borrowing. Much of this was mortgage debt funded by banks borrowing from overseas. This caused New Zealand's **net international investment position (NIIP)** to worsen to -85% of GDP.

By the yardstick of these ratios, New Zealand's position in the mid-2000s was similar to that of the PIGS of Europe (Portugal, Ireland, Greece and Spain). But New Zealand navigated the GFC more smoothly than the PIGS thanks to its flexible exchange rate, independent monetary policy, and strong fiscal position.

There was also a healthy dose of luck. The global price of New Zealand's main export products soared, granting the nation the income required to service its huge debts. And while the Canterbury earthquakes were a human tragedy and destroyed capital, from a cyclical point of view the subsequent reconstruction effort functioned like a well-timed, foreign-funded stimulus package.

Shocked by events of 2009, consumers and businesses reined in expenditure and remained cautious until late 2013. Combined with strong income, this allowed a period of balance sheet repair to ensue. The NIIP reverted to around -65% of GDP.

Unfortunately the period of improvement is over. By 2014, we had already observed a ramp up in consumer spending and business investment. More recently, export incomes have plunged. And the pseudo-income of quake-related reinsurance payments will soon start to dry up. Any one of these developments had the potential to worsen New Zealand's economic imbalances – all three at once is sure to do so.

*Figure 12: Annual current account balance*

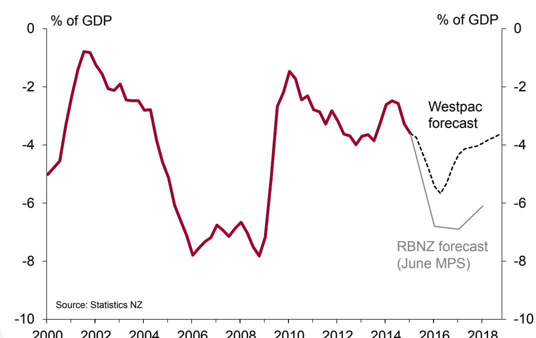
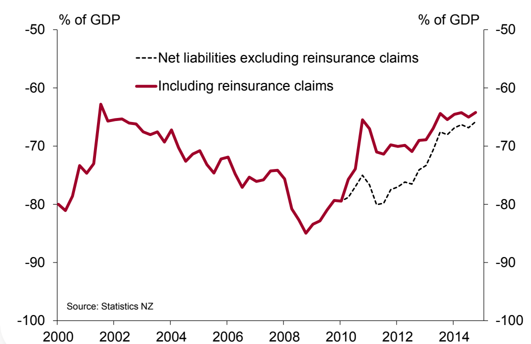



*Figure 13: International investment position*




The economy now faces an uncomfortable set of possible trajectories. At one end of the continuum, consumption and investment spending may hold up as people bet on a return to better times. GDP growth would remain resilient, but the current account deficit would blow out and the net international investment position would worsen. The RBNZ's forecasts are closer to this scenario.

At the other end of the continuum, consumer spending and investment may slow sharply as people adjust to leaner times. In this case, New Zealand would experience a painful short-term slowdown in GDP growth, but would find itself in a more resilient position for the long term. Our forecasts lean a little further in this direction.

# New Zealand Dollar

## Joined at the hip

The New Zealand dollar's performance has historically been linked to commodity export prices. That link supports a further decline in the currency by the end of this year, but we also expect some rebound next year as the global dairy market stabilises. That will make it difficult for the RBNZ to sustain a higher rate of inflation.

The New Zealand dollar (NZD) has continued on the steep downward path that began just over a year ago. At 65 cents at the time of writing, it is now back to its post-float average against the US dollar (USD). Some of this reversal of fortune has been due to the stronger USD; the NZD has not fallen nearly as far against the likes of the euro or the Australian dollar (AUD), reflecting the relative softness in these economies compared to the US.

We have long emphasised that the NZD's fortunes are closely tied to the country's terms of trade, and in particular the prices of our major commodity exports. The exchange rate tends to act as a buffer against external shocks, reducing the volatility of export commodity prices as a whole. This isn't necessarily true for every sector at the same time – for instance, the weaker NZD will enhance the already-high returns for beef farmers. But with dairy being the dominant part of our export basket, the case for a lower exchange rate is clear.

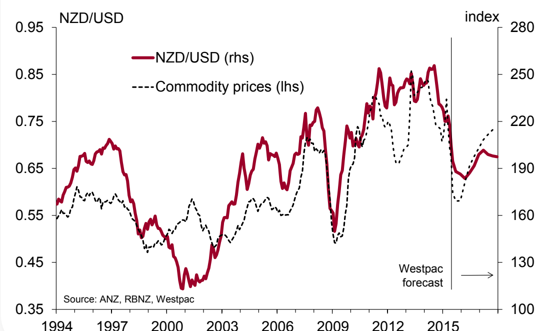
We expect a further drop in the NZD to 62 cents by early next year, based on our view that dairy prices are likely to head lower in the near term before they find some support. Relative interest rates also argue in this direction: we expect further OCR cuts by the Reserve Bank over the coming months, whereas the US Federal Reserve is preparing to start raising rates from near-zero levels.

However, we are also expecting a modest rebound in the NZD over 2016 – again tied to our outlook for commodity prices. As detailed in the *Agricultural Outlook* section, we're expecting some improvement in world dairy prices next year as global milk production slows and excess stocks are worked through. That won't provide immediate relief for dairy farmers in terms of the farmgate milk price for this season, but the forward-looking nature of the foreign exchange market means that the NZD is likely to respond to the prospect of better returns in future seasons.

In contrast to the USD outlook, we expect the NZD to hold around current levels against the AUD. Three months ago we noted that our estimate of 'fair value' for NZD/AUD was around 0.91, and on that basis we regarded a move beyond parity as too great a stretch – which proved to be the case. However, we expected the cross rate to remain at high levels by historical standards.

That reasoning still broadly stands, although there has been some deterioration in New Zealand's relative economic position since then. We have downgraded our GDP growth forecasts for New Zealand relative to Australia, and interest rate spreads are likely to narrow as the RBNZ cuts rates further in coming months. However, in terms of each nation's major export commodity, we expect New Zealand dairy prices to fare better over the next year than Australian iron ore prices, where the issue of global oversupply is more intractable. Also, persistently lower inflation in New Zealand than in Australia is boosting our relative competitiveness, which supports a gradual trend higher in NZD/AUD over time.

*Figure 14: NZD and commodity prices, inflation-adjusted*




**Exchange Rate Forecasts** (end of quarter)

| | NZD/ USD | NZD/ AUD | NZD/ EUR | NZD/ GBP | NZD/ JPY | TWI |
|---|---|---|---|---|---|---|
| Sep-15 | 0.64 | 0.90 | 0.60 | 0.43 | 79.4 | 70.0 |
| Dec-15 | 0.63 | 0.90 | 0.60 | 0.43 | 79.4 | 69.4 |
| Mar-16 | 0.62 | 0.89 | 0.59 | 0.42 | 78.1 | 68.3 |
| Jun-16 | 0.63 | 0.91 | 0.60 | 0.43 | 80.6 | 69.9 |
| Sep-16 | 0.65 | 0.92 | 0.61 | 0.43 | 83.2 | 71.2 |
| Dec-16 | 0.67 | 0.92 | 0.62 | 0.43 | 86.4 | 72.6 |
| Mar-17 | 0.68 | 0.92 | 0.62 | 0.42 | 84.3 | 72.6 |
| Jun-17 | 0.67 | 0.90 | 0.61 | 0.41 | 83.6 | 71.4 |
| Sep-17 | 0.67 | 0.88 | 0.59 | 0.39 | 83.0 | 70.2 |
| Dec-17 | 0.66 | 0.87 | 0.59 | 0.38 | 83.0 | 69.7 |

# Inflation and Interest Rates

## A temporary reprieve

Inflation is set to rebound over the coming quarters as earlier declines in import prices reverse. However, this pick-up will be only a temporary reprieve. With growth expected to slow over the coming year, the economy is going to need a significant shot in the arm in the form of lower interest rates to keep inflation near the RBNZ's target over the medium term.

Inflation fell to its lowest level in over a decade in early 2015, but we expect it will pop higher to 1.8% in early 2016. This is because two of the key factors that had dampened inflation over the past year – falls in petrol prices and strength in the NZD – have now reversed.

But this amounts to no more than a temporary fillip for inflation. The underlying issue is stubbornly low domestic inflation. Non-tradables inflation fell to 2% in June, its lowest level since 2001. And this wasn't just because of a few rogue prices. The Reserve Bank's sectoral inflation model estimates that the underlying trend in inflation has steadily dropped away in recent years, and now stands at just 1.3%. With the economy entering a marked downturn at present and the waning Canterbury rebuild set to create a further headwind from late 2016 onwards, the Reserve Bank will have to work hard to prevent inflation from remaining too low.

The Reserve Bank recognises this, and has already reduced the OCR from 3.5% to 3.0%. Its most recent communications indicate that the RBNZ expects to reduce the OCR only once or twice more. By contrast, we expect the OCR will have to fall to a record low of 2.0% over the coming year.

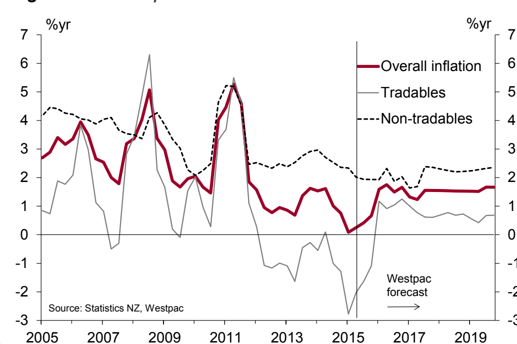
Some of this difference of opinion stems from differing reads on the economy – the RBNZ does not envisage as much of a near-term slowdown as we do. But we also have differing views on the role of the exchange rate. The RBNZ argues that the falling exchange rate will boost inflation, but we doubt it can do so on a sustained basis.

If export commodity prices recover next year as we are forecasting, the exchange rate will recover somewhat. This would cause import prices to stabilise, and inflation would threaten to drop back to its underlying trend. Alternatively, if export commodity prices fail to recover, the exchange rate would keep falling, but the weak economy would hammer domestic inflation. Either way, further reductions in the OCR will be required.

Our forecast for a 2.0% OCR does imply interest rates that are below the levels reached in the aftermath of the Global Financial Crisis (GFC). We would appeal here to the precedent set by Australia in recent years. When Australia's terms of trade and construction booms faded, the cash rate was reduced to 2.0% – much lower than the 3.0% cash rate low reached during the GFC. We struggle to see why New Zealand will differ materially as its own terms of trade and construction booms fade.

The second point to consider here is that inflation and inflation expectations are much lower now than they were in 2009. An OCR of 2.0% today actually equates to *higher* real (inflation adjusted) interest rates than we experienced in 2009.

*Figure 15: Westpac inflation forecasts*

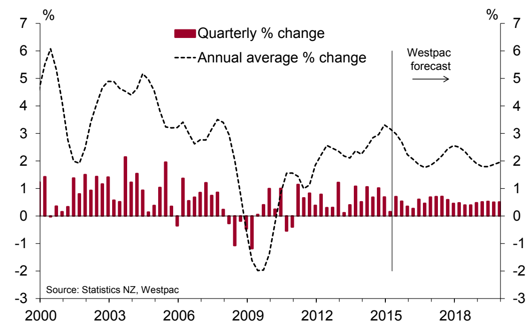



**Financial market forecasts**
(end of quarter)

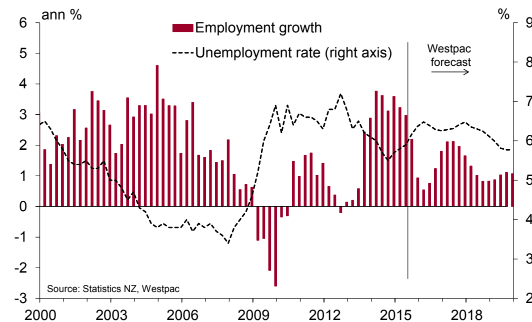
| | CPI inflation | OCR | 90-day bill | 2 year swap | 5 year swap |
|---|---|---|---|---|---|
| Sep-15 | 0.4 | 2.75 | 2.70 | 2.60 | 2.90 |
| Dec-15 | 0.7 | 2.25 | 2.20 | 2.30 | 2.70 |
| Mar-16 | 1.6 | 2.00 | 2.10 | 2.20 | 2.70 |
| Jun-16 | 1.8 | 2.00 | 2.10 | 2.10 | 2.60 |
| Sep-16 | 1.5 | 2.00 | 2.10 | 2.10 | 2.60 |
| Dec-16 | 1.7 | 2.00 | 2.10 | 2.10 | 2.70 |
| Mar-17 | 1.3 | 2.00 | 2.10 | 2.10 | 2.80 |
| Jun-17 | 1.2 | 2.00 | 2.10 | 2.10 | 2.90 |
| Sep-17 | 1.6 | 2.00 | 2.10 | 2.10 | 2.90 |
| Dec-17 | 1.6 | 2.00 | 2.10 | 2.20 | 2.90 |

| Annual average % change | March years | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| | 2015 | 2016f | 2017f | 2018f | 2014 | 2015f | 2016f | 2017f |
| GDP (production) | 3.2 | 2.1 | 2.0 | 2.5 | 3.3 | 2.2 | 1.8 | 2.6 |
| Private consumption | 3.7 | 2.6 | 1.9 | 2.4 | 3.2 | 3.1 | 1.9 | 2.5 |
| Government consumption | 3.0 | 1.2 | 1.1 | 1.5 | 3.4 | 1.5 | 1.0 | 1.4 |
| Residential investment | 12.3 | 2.5 | -0.1 | -1.1 | 16.2 | 4.0 | -0.2 | -0.4 |
| Business investment | 4.6 | 0.1 | -1.9 | 6.2 | 6.2 | 0.7 | -3.1 | 6.0 |
| Stocks (% contribution) | 0.2 | -0.2 | 0.0 | 0.0 | 0.1 | -0.2 | 0.0 | 0.0 |
| Exports | 3.9 | 4.2 | 2.3 | 1.4 | 3.3 | 5.1 | 2.3 | 1.4 |
| Imports | 7.5 | 3.0 | -1.0 | 2.0 | 7.8 | 4.7 | -1.2 | 1.9 |
| Inflation (% annual) | 0.1 | 1.6 | 1.3 | 1.5 | 0.8 | 0.7 | 1.7 | 1.6 |
| Employment (% annual) | 3.2 | 0.5 | 2.1 | 1.3 | 3.6 | 0.9 | 1.8 | 1.7 |
| Unemployment rate (% s.a. end of period) | 5.8 | 6.5 | 6.3 | 6.4 | 5.7 | 6.4 | 6.3 | 6.5 |
| Labour cost index (all sectors, % annual) | 1.7 | 1.6 | 1.4 | 1.3 | 1.8 | 1.6 | 1.4 | 1.3 |
| Current account balance (% of GDP) | -3.6 | -5.4 | -4.4 | -4.0 | -3.3 | -4.8 | -4.8 | -4.1 |
| Terms of trade (% annual) | -5.4 | -10.3 | 6.2 | 2.2 | -5.0 | -9.8 | 6.1 | 2.7 |
| House prices (% annual) | 8.3 | 8.3 | 4.6 | 0.5 | 6.4 | 10.0 | 4.5 | 1.5 |
| 90 day bank bill (end of period) | 3.63 | 2.10 | 2.10 | 2.10 | 3.64 | 2.20 | 2.10 | 2.10 |
| 5 year swap (end of period) | 3.71 | 2.70 | 2.80 | 2.90 | 4.16 | 2.70 | 2.70 | 2.90 |
| TWI (end of period) | 77.9 | 68.3 | 72.6 | 69.1 | 77.5 | 69.4 | 72.6 | 69.7 |
| NZD/USD (end of period) | 0.75 | 0.62 | 0.68 | 0.66 | 0.78 | 0.63 | 0.67 | 0.66 |
| NZD/AUD (end of period) | 0.96 | 0.89 | 0.92 | 0.87 | 0.91 | 0.90 | 0.92 | 0.87 |
| NZD/EUR (end of period) | 0.67 | 0.59 | 0.62 | 0.58 | 0.63 | 0.60 | 0.62 | 0.59 |
| NZD/GBP (end of period) | 0.50 | 0.42 | 0.42 | 0.37 | 0.49 | 0.43 | 0.43 | 0.38 |

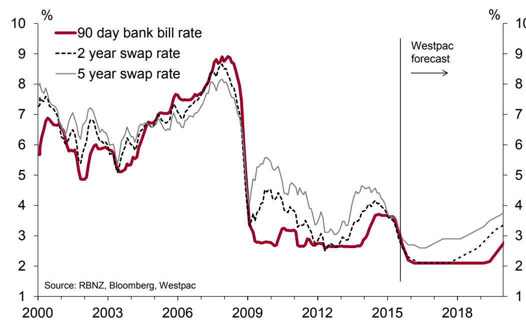
*New Zealand GDP growth*



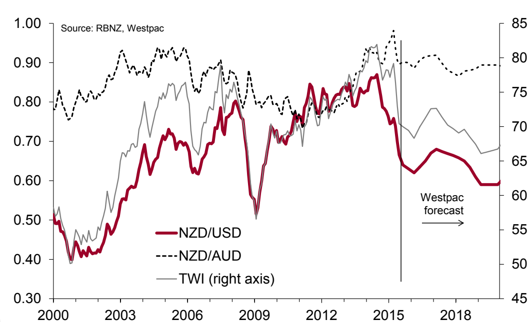

*New Zealand employment and unemployment*




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




*NZD/USD, NZD/AUD and TWI*



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