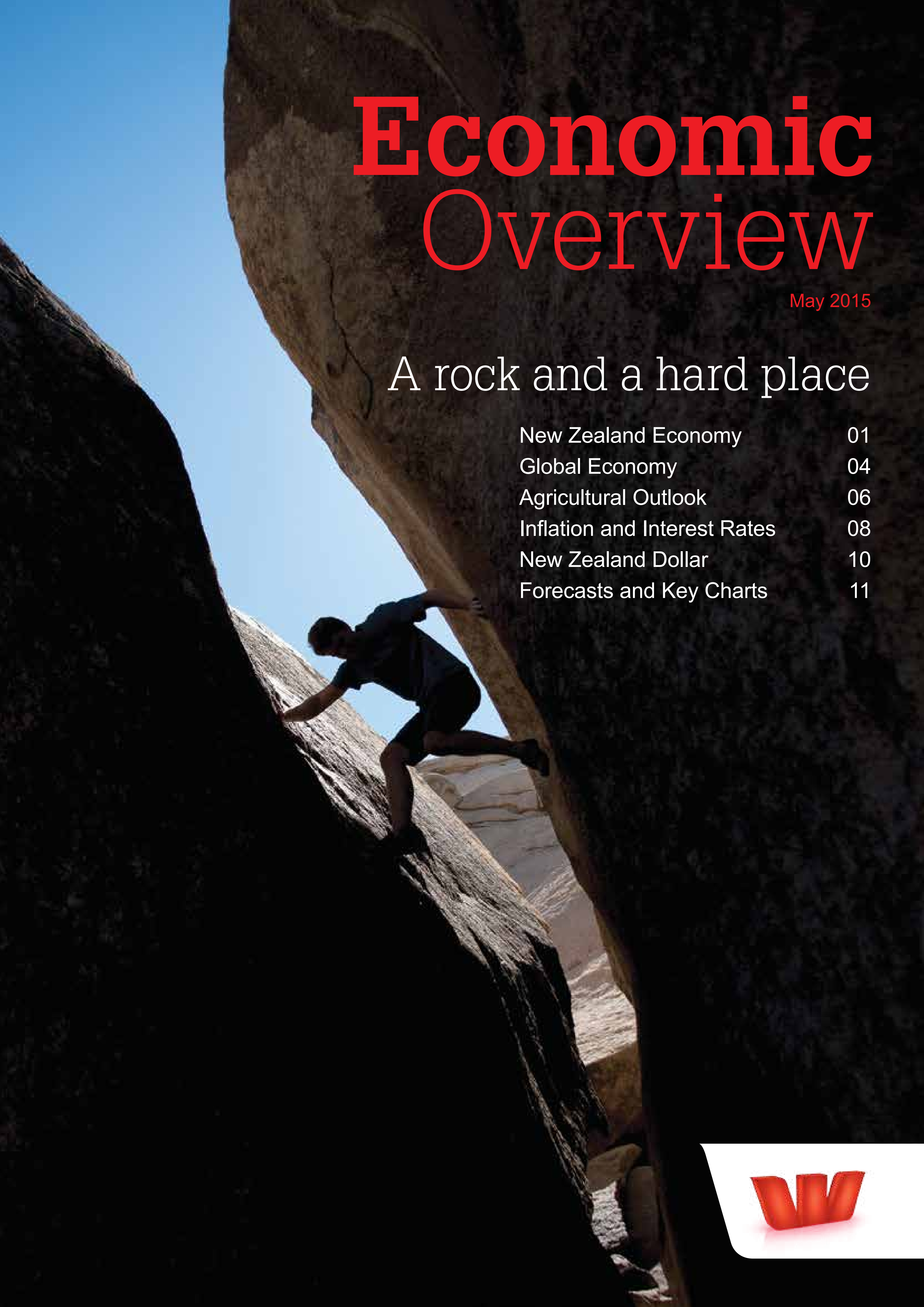
# Economic Overview

May 2015

## A rock and a hard place





**Dominick Stephens**
Chief Economist

# Note from Dominick

This is a landmark edition of the *Economic Overview*.

Ever since I became Westpac's Chief Economist in 2011, our forecast of the next move in the OCR has always been up. There were times, such as late-2012, when financial markets and other economists envisaged impending OCR reductions. We correctly rejected those calls.

The situation has now changed. In this *Economic Overview* we are calling the end of the RBNZ's hiking cycle. We expect that the next move in the OCR will be down.

It is not that the economy is in trouble. In this *Overview* we argue that at least another year of full-bodied economic growth lies ahead, as surging domestic demand outweighs the pain in parts of the agricultural sector. But we have always argued that the economy will run out of steam once the Canterbury rebuild begins to fade. It now looks as though that inevitable slowdown will occur before inflation rises to levels requiring OCR hikes.

Some in financial markets have suggested that the OCR could be cut as early as this year. That is certainly a possibility – we'd give it 40% odds. But the strong economy and low inflation really do leave the Reserve Bank between a rock and a hard place. We find it more likely that the Reserve Bank will wait until the rampant housing market has cooled and the economy has slowed before cutting the OCR. That could be years away.

The housing market really is rampant in Auckland, and markedly slower elsewhere. In the *New Zealand Economy* section we explain why the most commonly-advanced explanations just don't stand up under scrutiny. Instead, we propose an explanation that does match the facts – the recent liberalisation of housing supply rules may have boosted the perceived value of land in Auckland.

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# New Zealand Economy

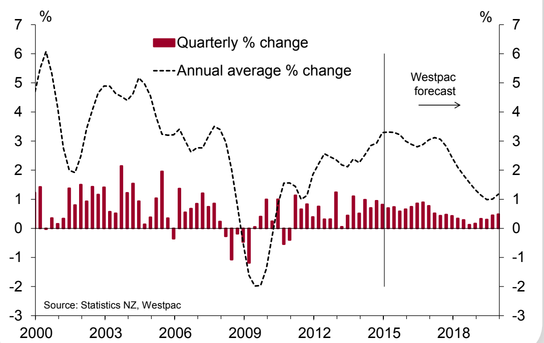
## Build me up

The outlook for domestic demand has continued to strengthen, with booming housing and construction, surging population growth, and increasingly strong household spending. But while these conditions will underpin robust GDP growth over the next couple of years, the New Zealand economy remains 'two-speed', with the external sector continuing to face some strong headwinds.

It's been a solid start to the year for the New Zealand economy. Over the past few months we've seen continuing strength in the housing market and construction, as well as strong gains in retail spending. These conditions, along with low interest rates, surging immigration, and low inflation have seen demand in the economy growing at a robust pace. This strength is even more impressive given the headwinds in the external sector, including falls in global dairy prices and the elevated NZD.

We're expecting that the economy will remain solid over the next couple of years, and are forecasting GDP to grow by around 3% in both 2015 and 2016. However, underlying this robust aggregate outlook, it's likely that New Zealand will continue to be a 'two-speed' economy. Strength is expected to remain underpinned by domestic demand in the main urban centres. At the same time, conditions in rural regions and among some exporters will be more challenging.

*Figure 1: New Zealand GDP growth*




While the outlook for the next few years is robust, many of the current drivers of growth will fade over time. Notably, the peak in the Canterbury rebuild is rapidly approaching. In addition, the current strength in net immigration will start to dissipate when job markets offshore eventually improve. As this occurs, economic growth will slow from 2017.

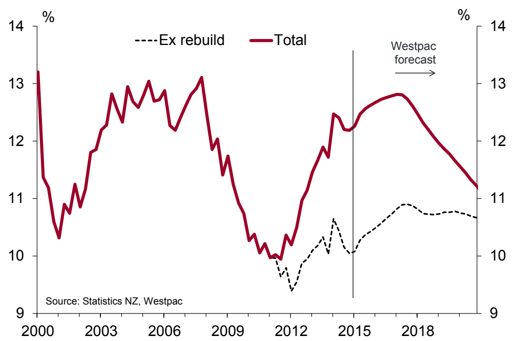
Normally when New Zealand experiences a period of strong demand, increases in inflation and the resultant increases in interest rates spoil the party. But not this time. As discussed in the *Inflation and Interest Rates* section, the outlook for inflation over the next few years looks likely to be so well contained that we now see no need for further OCR hikes in the current economic cycle. Nevertheless, we do expect the RBNZ to implement new mortgage restrictions targeting property investors.

### Hammers and nails

The key driver of New Zealand's current economic upturn has been a strong increase in construction activity. Building levels were up a whopping 23% over the past year, with much of this related to ongoing reconstruction work in Canterbury.

The rebuild is now well advanced, with EQC's home repair program more than 95% complete. And while building levels in Canterbury are expected to remain elevated for some time yet, the peak in the rebuild is clearly in sight. We are already seeing signs that the upward trend in residential building activity has stalled, with new dwelling consent issuance down around 25% over the first three months of the year. As discussed in our recent bulletin, "*Focus on the Canterbury rebuild,*" [1] we expect total reconstruction activity (which also includes commercial and infrastructure projects) will peak in early 2016, and then start easing back from 2017.

*Figure 2: Construction spending (share of GDP)*




[1] Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Focus-on-the-Canterbury-rebuild-April-2015.pdf

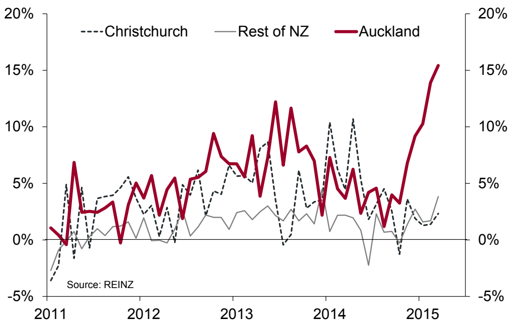
Strength in construction isn't just a Canterbury story, however. Construction activity in Auckland has also been increasing, supported by strong population growth, low building in recent years, and (as discussed below) strong economic incentives. Consents for new dwellings in Auckland have lifted by 20% over the past year. Nevertheless, building levels in Auckland are still below what's needed to keep up with its surging population growth. We expect residential construction in Auckland will remain strong over the next few years, with increases in commercial and infrastructure spending also expected.

As construction levels have increased, capacity pressures in the sector have started to emerge. These pressures mainly relate to the availability of labour, with increasing numbers of firms highlighting difficulties finding suitable staff. This is pushing up construction wages and costs. It's also providing some brake on the pace of construction activity, especially in Auckland.

### "That" housing market

Auckland's housing market is on fire. REINZ data suggest that house prices have risen by 16% over the past six months alone. And while it's not unusual for there to be regional divergencies in prices, Auckland's current degree of out-performance is striking.

*Figure 3: House prices, change over six months*




A number of possible reasons for the strength in Auckland house prices have been suggested. But while these may explain some of the increases we've seen recently, they certainly don't explain the whole picture. For instance, the notion that house prices are rising because of strong population growth and a legacy of underbuilding conveniently ignores the fact that rents in Auckland are rising at the paltry pace of 2.6% per annum – rents would be rising faster if a shortage of accommodation was the key issue. Similarly, construction costs aren't the issue – building costs in Auckland were up 5.9% over the past year, and only make up a proportion of the total cost of a property. Neither are low interest rates the main driver – other parts of New Zealand face the same interest rates but sport very different housing markets. Finally, labelling the Auckland housing market a "bubble" or blaming foreign speculators actually explains nothing – why has the bubble or foreign speculation not emerged in Wellington or Oamaru?

We think that there may be another factor at play: the perceived value of the land in Auckland is rising because housing supply regulations are being liberalised.

At first glance, this idea sounds counterintuitive, but it is actually quite simple. In line with the global trend towards greater centralisation of economic activity, Statistics NZ projections indicate Auckland's population is set to grow by around 740,000 people over the coming thirty years (an increase of close to 50%). This is expected to create unprecedented demand for dwellings located within striking distance of a major Auckland centre of employment, most notably the CBD. At present, much of the relevant area is occupied by single dwellings on relatively large plots of land. In the past, zoning restrictions and building regulations made it difficult or expensive to intensify the use of that land. But recent regulatory changes are opening an easier and cheaper path to intensification. And consequently the value of the land has gone up.

What this means is that the value of today's house-plus-land packages is shooting up. If all goes to plan over time land will be subdivided and the swathe of more affordable housing that Auckland needs will be built. But if a young couple wants to buy into today's market, they first have to outbid a developer or speculator who understands the concepts we have outlined.

The latest data gives no hint of Auckland house prices slowing their upward march, and we have upgraded our forecast of nationwide house price inflation this year to 10%. With low inflation keeping OCR hikes off the table, the RBNZ is instead likely to dip into its macro-prudential tool kit to lean against housing market pressures. We expect that some form of lending restriction will be introduced in the second half of this year targeting residential property investors. However, while such restrictions may take some of the steam out of the housing market, we don't think house price inflation will materially slow until the economy turns.

### Sizzling

It's not just housing and construction activity that has been strong. Domestic demand more generally has been picking up. Notably, household spending has been charging ahead in recent months, and we now expect that spending growth over 2015 and 2016 will be the strongest we've seen in close to a decade.

*Figure 4: Household consumption growth, annual average*

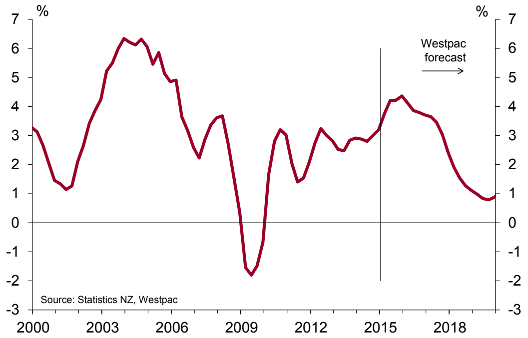
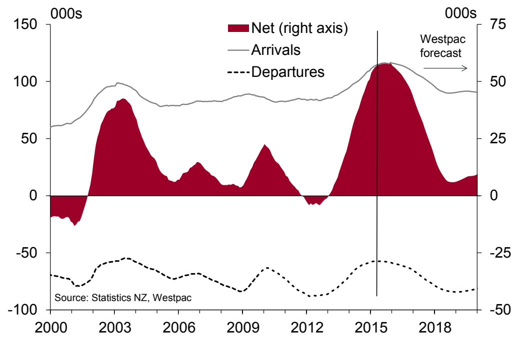



*Figure 5: Annual net immigration*




Contributing to the robust outlook for consumption spending have been solid gains in real labour earnings. The proportion of New Zealanders in employment has been trending higher in recent years. In addition, although nominal wage growth has been moderate, adjusting for changes in purchasing power, households' earnings have actually been growing at a firm pace. In fact, real wage growth in the year to March was the highest it's been over a decade. Households' purchasing power has received a particularly large boost from lingering strength in the NZD, which has dampened prices for a range of goods.

Adding to the strength in household spending have been the gains in household wealth associated with rising house prices. In addition, many households are benefiting from current low borrowing rates.

Surging population growth has been another driver of consumer spending. New Zealand's strong relative economic performance and labour market conditions have seen net immigration climb to 56,000 people in the year to March – 30% higher than the peak of early-2000s migration boom.

We've been upbeat on the outlook for net immigration for some time, and it's now looking likely that immigration levels will stay high for longer than we had previously assumed. While conditions in New Zealand have strengthened, the global economy is still experiencing a gradual recovery. Importantly, the outlook for Australia (the main destination for New Zealanders travelling abroad) is looking softer than previously assumed. As a result, we now expect that net immigration will remain firm through to 2016, before turning down as growth in New Zealand slows and labour market conditions offshore gradually improve.

There are two important headwinds for the household sector - continuing restraint in government spending, and (as discussed below) flagging export earnings. We expect that the latter will shave around 0.7 percentage points off consumer spending over the coming year. However, the drag from these two factors is materially smaller than the positive impact of the factors mentioned above. Consequently, we still expect consumption spending to grow at a rapid pace over the coming years.

## From dry to damp

As discussed in the *Agricultural Outlook* section, the drought conditions that were weighing on the outlook at the time of our previous quarterly update have proven less severe than feared. Nevertheless, the external sector is continuing to face a number of significant headwinds.

Falling prices for some of our key commodity exports, particularly dairy, will drain a significant chunk of income out of the economy. Our forecasts assume that around half of this loss in export earnings will pass through to lower spending, resulting in a significant drag on growth. Our research indicates that the reduction in export earnings will have a particularly large impact on plant and machinery investment spending. Retail spending in rural communities may also be affected. However, history suggests that the overall sensitivity of consumer spending to export incomes is actually quite low. In addition, the spending power of all households is receiving a significant boost from the high NZD.

Exporters outside of the dairy sector have also been facing a number of headwinds, including lingering softness in global demand. But despite such headwinds, export levels have actually held up. We have been surprised by the resilience of manufactured exports in the face of the high NZD/AUD and weakness in the Australian economy. As discussed in the *Global Economy* section, this may be because a significant proportion of New Zealand exports to Australia relate to the construction sector, which has actually been faring better than other parts of the Australian economy. In addition, increasing Chinese visitor numbers and reviving Northern Hemisphere visitors have helped to boost tourism earnings. Meanwhile, a lift in foreign students numbers has boosted education exports.

# Global Economy

## Winter woes

The last few months have not been kind to the global economy. The Chinese economy remains in a funk, Australia's export prices have tumbled, and US consumers have gone back into their shells. The offshore environment isn't without its bright spots, but is likely to stay challenging for some time yet.

In our February *Economic Overview* we expressed cautious optimism that the combination of cheaper oil, a strengthening US labour market and more aggressive policy stimulus by the world's central banks would kick-start the global economy into faster growth by the second half of this year.

Developments since then haven't been encouraging to this view. Beneath the surface of the official growth figures, the Chinese slowdown has deepened. The US economic upswing stalled in the cold winter months and signs of a rebound have yet to emerge. Perhaps of most concern for New Zealand, the iron ore price has tumbled, severely denting Australia's near-term economic prospects.

The news has not been uniformly gloomy, with the Australian residential construction sector a notable bright spot. There has also been further policy support from the Reserve Bank of Australia and the Chinese authorities. In time, measures like these will support a recovery in global demand. However, on recent evidence they will take longer to bear fruit than we expected three months ago. We expect global growth to remain poor this year and to improve only gradually in 2016.

### The Chinese economy remains in a funk

The Chinese economy grew 7% in the year to March, in line with the Chinese government's newly downgraded growth targets. But scratching beneath the surface reveals a gloomier picture. The nominal economy is running well behind plan, with consumer prices rising just 1.4% over the past year and producer prices in deep deflation. China's shift to a more consumer-centric business model has left heavy industry with cavernous excess capacity. The housing market remains weak, though prices have bottomed out in a minority of cities. And the best we can say about consumer confidence is that it has stabilised at a very low level.

To be sure, the government has responded in kind. Since the February *Economic Overview* a raft of new stimulus measures have been announced, from cuts to policy interest rates and banks' reserve requirements, to a lifting of lending caps for both first and second home buyers. These measures, and the green shoots we have seen in the housing market, give us reason to believe that the Chinese authorities will continue to achieve their roughly 7% growth target. But that is likely to be as good as it gets for some time.

### US consumers have gone back into their shells

After gathering speed through 2014, the US economy suffered a renewed loss of momentum this year. An unusually cold winter and labour disputes at key US ports were partly responsible, so we should see some rebound in coming months. However, signs to date of a post-winter revival in either business investment or consumer spending have been few and far between. In particular, the lower oil price doesn't seem to have translated into a significant pick-up in consumer spending – on which a sustained US upswing ultimately depends.

With China on the side-lines a slower US recovery means slower global growth. The recent US data also raise doubts around the timing of interest rate rises by the US Fed. Financial markets have pushed out their expectations of a rate hike into 2016. We are sticking to our call for a move late this year, but the risks have clearly shifted towards a delay.

### The Australian economy will take longer to recover

In a range of commodity markets, from dairy to oil to iron ore, the global slowdown coincided with rising supplies, doubling the downward pressure on prices. In the case of iron ore, there has been a massive lift in Australian mining capacity in recent years, thanks to the mining investment boom. Similar to the oil price collapse late last year, when it became clear that OPEC wouldn't cut production to support prices, the iron ore price plunged in March as the major mining companies continued to aggressively chase market share.

The past few weeks have brought some stability, as some of the majors have finally 'blinked' and announced they are taking their foot off the pedal. However it is still early days, and the outlook for the iron ore price depends as much on production cutbacks by the largely state-owned Chinese mining companies, of which there is still little evidence. While iron ore markets may have bottomed out, they are likely to remain depressed for some time yet.

Lower iron ore prices will compound the challenges facing the Australian economy as it reorients itself away from mining investment. While the lift in mining production has provided some offset, the net impact is a clear negative – meaning softer spending not just by the mining companies, but by governments facing unexpectedly low tax revenues and by households who are likely to see lower wage growth as businesses cut costs.

As a result we now expect Australian economic growth to slow further this year from an already poor 2014 and to remain below trend into next year. The implications for New Zealand are far-reaching and are spread through this *Economic Overview*.

That said, some parts of the Australian economy are faring better than others. In particular, Australia's residential construction industry has been enjoying a significant revival in recent years. Much attention has focused on Sydney, where a legacy of underbuilding and strong foreign investor interest have supported the housing market, but the upswing in building has been more widespread. And with a growing number of large-scale apartment projects in the pipeline, the sector is likely to enjoy further growth over the year ahead.

The composition of Australia's slowdown may help explain why there has not been more fallout for New Zealand exporters. Excluding gold and oil, New Zealand's merchandise exports to Australia are mostly manufactured goods, and New Zealand's manufacturing industry is closely tied in with construction. These exports have clearly been under pressure as the Australian dollar has weakened relative to the NZD, but the trend has at least stabilised over the last 18 months. So Australia's residential construction upturn may have provided some relief for New Zealand's manufacturing exporters on balance.

*Figure 6: NZ exports to Australia and Australian residential construction*

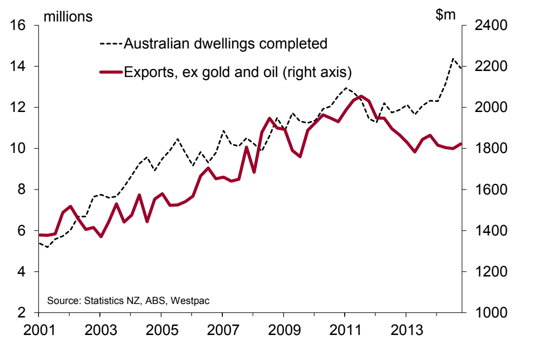
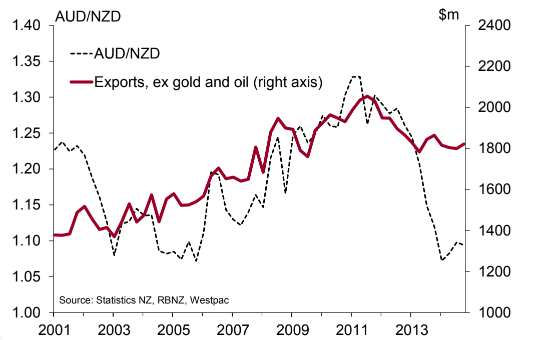



*Figure 7: Exports to Australia and the exchange rate*




**Economic forecasts (calendar years)**

| Real GDP % yr | 2011 | 2012 | 2013 | 2014 | 2015f | 2016f |
|---|---|---|---|---|---|---|
| New Zealand | 1.8 | 2.4 | 2.3 | 3.3 | 3.0 | 3.0 |
| Australia | 2.7 | 3.6 | 2.1 | 2.7 | 2.2 | 3.0 |
| China | 9.3 | 7.8 | 7.8 | 7.4 | 7.0 | 7.0 |
| United States | 1.6 | 2.3 | 2.2 | 2.4 | 2.2 | 3.2 |
| 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 | 0.8 | 1.1 | 1.1 |
| United Kingdom | 1.6 | 0.7 | 1.7 | 2.6 | 2.5 | 2.7 |
| **NZ trading partners** | **3.6** | **3.7** | **3.6** | **3.8** | **3.6** | **4.1** |
| **World** | **4.2** | **3.4** | **3.4** | **3.4** | **3.2** | **4.0** |

Forecasts finalised 8 May 2015

# Agricultural Outlook

## Is the best behind us?

This season the dairying sector was caught in a perfect storm of forces that pushed prices lower. We don't see those factors repeating to the same degree over the next season. Nevertheless, there is reason to think that the shape of the global dairy market has evolved in recent years; the opportunities for outsized returns to dairying in New Zealand may be a thing of the past.

The threat of drought that loomed over our previous *Economic Overview* has largely abated. Rainfall since March has revitalised milk production in the North Island, and demand for supplementary feed has remained strong despite low milk prices. We expect industry-wide milk production for the current season to be up 2% on the previous season – a substantial improvement compared to three months ago when a fall looked more likely.

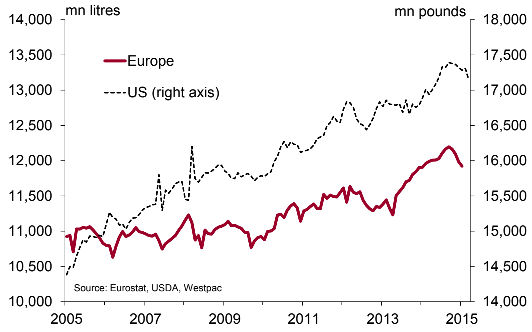
The flipside of better than expected milk production in New Zealand, however, has been a renewed downdraft for world dairy prices. The 'drought premium' that was incorporated into prices in February has since been completely unwound, and futures markets indicate that world prices are not expected to pick up in the near future. Fonterra has revised down its expected farmgate milk price for this season to $4.50 per kilo of milksolids, which would be the lowest in over a decade in inflation-adjusted terms.

The current gloom around dairy prices has raised questions about the longer-term prospects of New Zealand's largest export industry (especially in light of the similar concerns in Australia around iron ore prices). Our view is that the dairying industry faced a perfect storm of forces that came together to drive prices lower this season; we don't expect all of these forces to be repeated next season, or at least not to the same degree. We identify four factors in particular.

**Stronger global production:** In a sense, the dairy price boom in 2013 sowed the seeds of its own demise. The near-record prices on offer provided the incentive for a strong lift in milk production the following season, particularly in the US and Europe. That dynamic has since reversed. With prices now at very low levels, milk production in those two regions has started to fall again in recent months. The fall to date is encouraging, but we would need to see it go further before we could comfortably predict a recovery in milk prices.

**China's slowdown:** The pace of GDP growth in China slowed further to 7% last year, a pace that we expect to be maintained over the next two years. On the positive side, recent policy measures to stimulate the economy have been directed more towards the household sector,

*Figure 8: Northern hemisphere milk production*



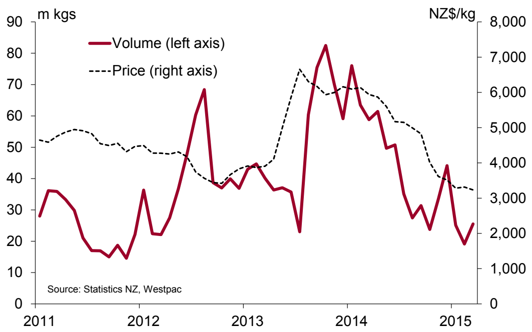

which is of most relevance to New Zealand's major exports to China.

**Overstocking:** Chinese demand for milk powder went ballistic in late 2013, first in response to the drought in New Zealand, then on fears that an outbreak of foot-and-mouth disease would decimate China's own dairy herd. In hindsight, the risk of a disruption to the supply of milk powder appears to have been overstated. Chinese buyers found themselves holding greater stocks of powder than needed, and as a result they have been less of a presence in the market in the past year. These buyers will eventually return as their excess stocks are run down.

**Russia's trade ban:** In the midst of the Ukraine conflict, Russia placed a ban on food imports from many Western nations in August last year. While New Zealand itself wasn't subject to the ban, it meant that dairy products from competing exporters such as Europe, the US and Australia had to find a home elsewhere. Russia is – or was – the second-largest importer of dairy products, so its absence from the market is likely to have been a significant weight on world prices. The trade ban is due to expire this August, although there is a risk that it is extended.

While we expect more favourable conditions in the global dairy market over the next year, our outlook for dairy prices is far from ebullient: our forecast of a $5.70/kg farmgate milk price for next season is still below average in inflation-adjusted terms. A second season of below-average returns would still mean that caution is required among dairy farmers.

*Figure 9: Whole milk powder exports to China*




The lower payout for this season may lead some to question the dairy industry's longer-term prospects. Our conclusion is that milk prices over coming years are likely to be lower, on average, than they were over the period between 2008 and 2013 when New Zealand enjoyed a first-mover advantage. As China emerged as a major source of demand for dairy products, New Zealand was effectively the only producer that was in a position to meet this demand. But several years of higher dairy prices (on average) have incentivised other countries, including China itself, to expand capacity in their own dairying sectors, leaving them better positioned to respond to changes in demand.

The end of the European Union's milk production quota system represents one facet of the global industry's greater responsiveness. The term 'quota' is something of a misnomer. In practice it worked as a levy on excess production, equating to around US$250 per tonne of milksolids, which was easily affordable and did little to discourage production growth when world dairy prices were high.

Hence, some of the predictions of an explosion in milk production after the removal of the quotas are probably overstated. Indeed, the more likely outcome in the next year or so is that low milk prices will restrain growth. But over the longer term, the removal of the quota system should lead to greater flexibility in the global milk supply. At the least, this suggests that the days of farmgate milk prices in New Zealand shooting up towards $8/kg in any given season are probably a thing of the past.

## Other sectors

The overall experience of New Zealand's agricultural exports has been more varied than the popular, often dairy-dominated commentary might suggest. While sub-par global growth and the high New Zealand dollar have continued to provide headwinds, export earnings outside of dairy are generally holding up.

Admittedly some sectors have struggled at least as much as dairy. The forestry sector has been hit by renewed softness in world prices and increased competition from cheaper Russian exports. There are also signs that supplies of logs are building up at Chinese ports again. Like milk powder, logs are a storable commodity, so it can take some time for global supply to move back into alignment with demand.

However, there have also been some major success stories such as beef. Beef is unusual among New Zealand's commodity exports in that the US, rather than Asia, is the dominant market. The gradual improvement in the US economy has supported an upward trend in beef prices in recent years, and in 2014 this was compounded by a shortage of supply of beef over the US summer. Exports from New Zealand and Australia have helped to fill the gap, but beef prices have remained high after a sharp upward spike last year. The supply of beef in the US is expected to remain tight, as it will take some time to build up its herds.

There have also been pockets of strength in areas such as wool, where prices have risen to around their highest in three years; and kiwifruit, which is set for a surge in exports this year thanks to the new varieties that are more resistant to the Psa virus. Wine exports have also made a notably strong start to the year.

**Commodity price monitor**

| Sector | Trend | Current level[1] | Next 6 months |
|---|---|---|---|
| **Forestry** | Slow overseas demand and competition from Russian log exports likely to weigh on prices. Demand from the local building industry remains strong. | Above Average | ↘ |
| **Wool** | Competition from oil-derived synthetics could prove to be a challenge this year. | Above Average | ↘ |
| **Dairy** | Low prices will help to restrain global milk supply, though the process could be a slow one. | Low | ↗ |
| **Lamb** | Plentiful supply overseas will weigh further on prices. | Average | ↘ |
| **Beef** | US beef supply remains tight, though prices may moderate as a growing number of countries look to fill the gap. | Above Average | ↘ |

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

# Inflation and Interest Rates

## End of an era

We no longer see any need for the Reserve Bank to hike the OCR in the current economic cycle. The economy will start to cool before inflation becomes a noxious problem, and the RBNZ will opt for macroprudential tools to deal with the overheating housing market. The timing of the first OCR cut is uncertain, but on balance we expect the RBNZ to wait until late in the decade.

For some time our *Economic Overviews* have emphasised how surprisingly low inflation has been over the current economic cycle. For the most part this has been due to low global inflation, a rising exchange rate and the growth of internet-based retailing, which have conspired to supress prices for tradable goods and services. The most recent inflation figures were driven even lower by nose-diving global oil prices – annual tradables inflation has dropped to -2.8%, and overall inflation to just 0.1%.

Perusing the latest inflation data also left us unimpressed with the state of non-tradables inflation. True, sustained economic growth has led to a situation in which productive capacity is struggling to keep up with demand in some parts of the economy. This is putting upward pressure on some prices, mainly related to housing or construction.

But outside of construction, there has been a pervasive and widespread softness to domestic price setting behaviour. Annual non-tradables inflation has trended down to 2.3%, and the Reserve Bank's "factor model" of inflation, which strips away the noise and measures the underlying trend in inflation, has dropped away to just 1.3%. Part of this softness can be traced back to cross-over from low tradables inflation – for example, prices are probably falling for the hairdressers' hair dye and the taxi-drivers' vehicles, allowing prices for the relevant "non-tradable" services to remain lower.

The other, more insidious issue is soft inflation expectations. Inflation has been below two percent for three years now. Signs are emerging that this has impacted people's expectations for future inflation (see figure 14 overleaf). And there is plenty of scope for inflation expectations to fall even further, given that the legacy of low oil prices and reductions to Accident Compensation Corporation (ACC) levies will keep actual inflation low for the remainder of this year.

*Figure 10: Inflation and its components*

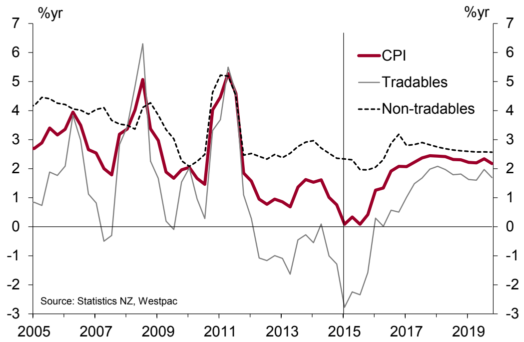



*Figure 11: Surveyed capacity constraints*

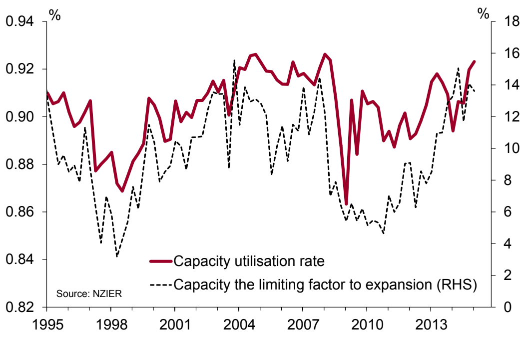



*Figure 12: RBNZ sectoral factor model of core inflation*

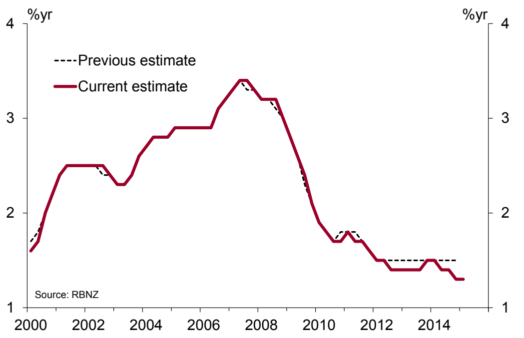


*Figure 13: Inflation expectations, RBNZ survey*

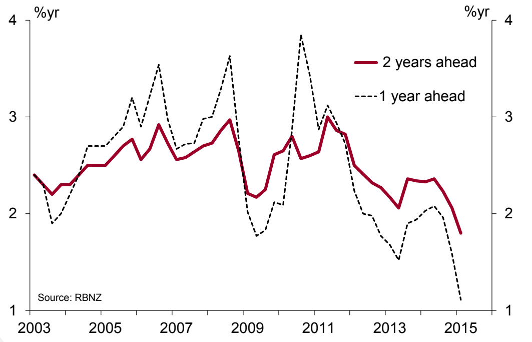
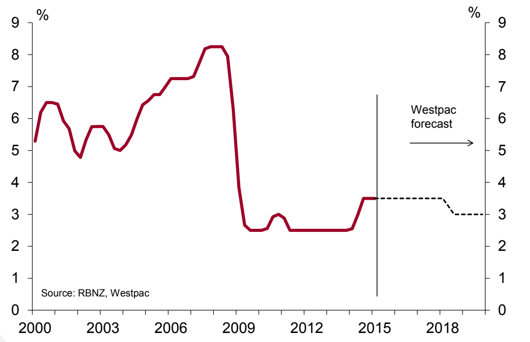



*Figure 14: Westpac OCR forecast*




In a classic vicious circle, low inflation expectations are influencing inflation itself. Wage inflation is low despite years of strong employment growth, partly because wage negotiations often reference recent rates of inflation. Surveys indicate that few firms are experiencing cost increases or intend to raise their prices.

The situation should start to rectify itself during 2016. Inflation will certainly pop higher when this year's fall in petrol prices and ACC levy cuts drop out of annual calculations. Beyond that, three key factors are influencing inflation. While we do expect inflation expectations to remain soft, the strong economy will increasingly boost non-tradables inflation. In addition, as the NZD section explains, the outlook is for a flat to falling trade-weighted exchange rate, which will boost tradables inflation. This combination of conditions will push overall inflation to 2.4% by 2017.

Beyond that point, however, we expect economic growth to slow as the Canterbury rebuild winds down – and slower economic growth would imply renewed downward pressure on inflation.

If our inflation forecasts are correct, there will be no reason for the Reserve Bank to hike the OCR again in the current economic cycle. The strong economy will run out of steam before inflation becomes a noxious problem. True, inflation is expected to rise into the upper half of the Reserve Bank's target band, but only briefly, and only at a time when economic growth is cooling. No forward-looking central bank would hike in such an environment. Instead, we envisage OCR cuts once the economy has cooled – most likely late in the decade.

Keeping the OCR so low for so long does risk inflaming the already-hot housing market. The Reserve Bank will use macroprudential tools in an attempt to address this issue. Since last November we have been forecasting fresh restrictions on mortgage lending, over and above those already in place. In a recent speech the RBNZ signalled that new restrictions aimed at landlords are indeed in the pipeline. However, we suspect that these mortgage restrictions will dent rather than derail the house price steam train – we are still forecasting strongly rising house prices over 2015 and 2016.

Some might argue that the Reserve Bank should cut the OCR this year in response to low inflation and the high exchange rate, rather than waiting for the economy to cool. We seriously considered that possibility, but ultimately rejected it. Our analysis suggested that OCR cuts this year would provoke an unacceptable acceleration in house price inflation, and would turbo-charge domestic demand. Combined with a possible drop in the exchange rate, that would imply inflation forecasts too far above two percent for the Reserve Bank's comfort.

We must admit, however, that deciding whether the OCR was most likely to remain on hold or to fall this year was finely balanced. Any sign of economic growth faltering could tip the balance and push the Reserve Bank into cutting. We would assign roughly 40% odds to two or more OCR cuts occurring over the coming year (and 60% odds to no change).

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

| | CPI inflation | OCR | 90-day bill | 2 year swap | 5 year swap |
|---|---|---|---|---|---|
| Jun-15 | 0.3 | 3.50 | 3.60 | 3.40 | 3.50 |
| Sep-15 | 0.1 | 3.50 | 3.65 | 3.50 | 3.60 |
| Dec-15 | 0.4 | 3.50 | 3.70 | 3.60 | 3.70 |
| Mar-16 | 1.3 | 3.50 | 3.70 | 3.70 | 3.80 |
| Jun-16 | 1.3 | 3.50 | 3.70 | 3.80 | 3.90 |
| Sep-16 | 1.9 | 3.50 | 3.70 | 3.80 | 4.00 |
| Dec-16 | 2.1 | 3.50 | 3.70 | 3.80 | 4.00 |
| Mar-17 | 2.1 | 3.50 | 3.70 | 3.80 | 4.00 |
| Jun-17 | 2.2 | 3.50 | 3.70 | 3.80 | 4.00 |
| Sep-17 | 2.4 | 3.50 | 3.70 | 3.70 | 3.90 |

# New Zealand Dollar

## Mixed fortunes

For those with foreign currency exposures, the past year has been a case of the market giving with one hand and taking away with the other. The New Zealand dollar's long-awaited fall against the US dollar has been stymied by gains against the other major currencies, as low or negative inflation sparked a fresh wave of monetary easing in many parts of the world.

Market sentiment towards the US dollar had clearly improved by the start of this year. The Federal Reserve ended its bond purchasing programme late last year, and attention had turned towards the timing of interest rate hikes, with some Fed officials indicating that the first move could come as early as June. We've long believed that rate hikes would come later than the market expects, and indeed some of the recent US data on inflation and growth has blunted the case for early hikes, sending the USD lower again. However, we expect the USD's gains to resume over the second half of this year.

In contrast, many central banks have favoured further monetary easing this year – most prominently the European Central Bank (ECB), which has begun its own bond purchase programme after several years of internal wrangling. The renewed sense of crisis in Greece has likely added to the downward pressure on the euro, which recently fell to a 12-year low against the USD, and consequently a record low against the NZD.

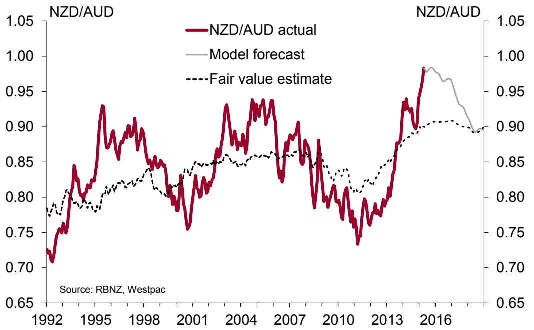
We suspect that the recent wave of monetary easing overseas, like the deflation 'scare' which prompted it, will prove to be short-lived. Oil prices have bottomed out and have actually regained some ground; by early next year, the plunge in oil prices will be dropping out of the calculation of annual inflation rates. As a result, we don't expect the other non-USD currencies to lose much more ground relative to the NZ dollar.

The NZD/AUD exchange rate has been a point of focus recently, particularly as it came within a whisker of parity for the first time since the two currencies were floated. Our long-running model of the NZD/AUD exchange rate places 'fair value' at around 0.91. That's the highest it's been in the post-float era, and reflects the fact that persistently lower inflation in New Zealand has improved our relative competitiveness. So we support the idea of the NZD/AUD remaining at a high level over the next year, due to the relative strength of the two economies, but we regard a move beyond parity as too great a stretch.

Altogether, our exchange rate forecasts imply that the trade-weighted index will hold at around current levels over the next year. Nevertheless, even a flat path for the trade-weighted index has different implications for the economy than a constantly rising one. A rising exchange rate tends to push the prices of internationally-traded goods lower and lower, depressing the overall rate of inflation. Even a flat exchange rate would bring an end to that dynamic, leading to a rise in the inflation rate from its current below-target pace.

The prospects for a sustained fall in the trade-weighted index probably lie in 2017 and beyond. By then, New Zealand's yield spreads with the rest of the world should be narrowing as other central banks raise interest rates, and the fading Canterbury rebuild will have rendered New Zealand an economic underperformer.

*Figure 15:* *NZD/AUD fair value model*

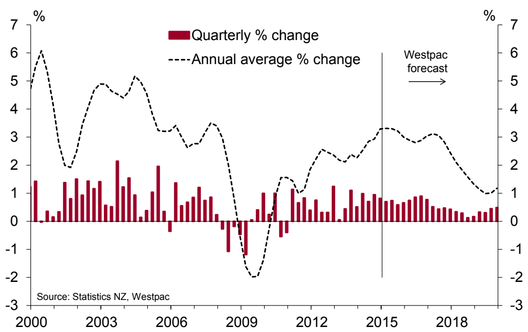



**Exchange Rate Forecasts** (end of quarter)

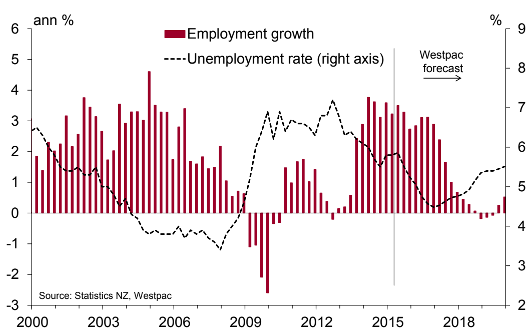
| | NZD/ USD | NZD/ AUD | NZD/ EUR | NZD/ GBP | NZD/ JPY | TWI |
|---|---|---|---|---|---|---|
| Jun-15 | 0.75 | 0.96 | 0.69 | 0.50 | 90.0 | 79.4 |
| Sep-15 | 0.74 | 0.98 | 0.71 | 0.51 | 90.0 | 80.0 |
| Dec-15 | 0.72 | 0.98 | 0.70 | 0.50 | 88.8 | 78.9 |
| Mar-16 | 0.71 | 0.98 | 0.70 | 0.49 | 88.6 | 78.7 |
| Jun-16 | 0.71 | 0.98 | 0.70 | 0.48 | 89.3 | 78.6 |
| Sep-16 | 0.71 | 0.97 | 0.70 | 0.47 | 89.5 | 78.2 |
| Dec-16 | 0.71 | 0.95 | 0.69 | 0.46 | 90.2 | 77.3 |
| Mar-17 | 0.71 | 0.92 | 0.67 | 0.44 | 86.6 | 75.7 |
| Jun-17 | 0.71 | 0.92 | 0.66 | 0.43 | 87.2 | 75.5 |
| Sep-17 | 0.71 | 0.90 | 0.65 | 0.41 | 86.5 | 74.3 |

| Annual average % change | March years | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015f | 2016f | 2017f | 2014 | 2015f | 2016f | 2017f |
| GDP (production) | 2.5 | 3.3 | 2.9 | 3.1 | 3.3 | 3.0 | 3.0 | 2.4 |
| Private consumption | 2.9 | 3.8 | 4.1 | 3.6 | 3.2 | 4.4 | 3.7 | 2.4 |
| Government consumption | 2.7 | 3.2 | 0.9 | 0.6 | 3.6 | 1.3 | 0.5 | 1.2 |
| Residential investment | 16.6 | 12.0 | 6.4 | 6.6 | 16.6 | 5.2 | 7.2 | 2.6 |
| Business Investment | 8.4 | 5.8 | 4.1 | 5.9 | 6.0 | 5.0 | 5.2 | 3.8 |
| Stocks (% contribution) | 0.2 | 0.2 | -0.2 | 0.0 | 0.2 | -0.3 | 0.1 | -0.1 |
| Exports | 0.3 | 2.7 | 4.0 | 2.5 | 2.7 | 4.2 | 2.5 | 2.1 |
| Imports | 8.0 | 7.3 | 4.8 | 4.3 | 7.9 | 4.9 | 4.7 | 2.0 |
| Inflation (% annual) | 1.5 | 0.1 | 1.3 | 2.1 | 0.8 | 0.4 | 2.1 | 2.4 |
| Employment (% annual) | 3.8 | 3.2 | 2.8 | 2.4 | 3.6 | 2.7 | 2.9 | 0.7 |
| Unemployment rate (% s.a. end of period) | 6.0 | 5.8 | 5.1 | 4.5 | 5.8 | 5.2 | 4.5 | 4.8 |
| Labour cost index (all sectors, % annual) | 1.6 | 1.7 | 1.7 | 1.9 | 1.8 | 1.6 | 1.9 | 1.9 |
| Current account balance (% of GDP) | -2.6 | -4.0 | -4.9 | -4.5 | -3.3 | -4.8 | -4.6 | -4.6 |
| Terms of trade (% annual) | 17.3 | -6.0 | 1.9 | 2.1 | -4.6 | -0.3 | 4.4 | 0.9 |
| House prices (% annual) | 7.9 | 8.5 | 8.5 | 3.3 | 6.2 | 10.0 | 4.5 | 0.0 |
| 90 day bank bill (end of period) | 2.78 | 3.63 | 3.70 | 3.70 | 3.64 | 3.70 | 3.70 | 3.70 |
| 5 year swap (end of period) | 4.57 | 3.71 | 3.80 | 4.00 | 4.16 | 3.70 | 4.00 | 3.80 |
| TWI (end of period) | 78.7 | 77.9 | 78.7 | 75.7 | 77.5 | 78.9 | 77.3 | 73.4 |
| NZD/USD (end of period) | 0.84 | 0.75 | 0.71 | 0.71 | 0.78 | 0.72 | 0.71 | 0.70 |
| NZD/AUD (end of period) | 0.93 | 0.96 | 0.98 | 0.92 | 0.91 | 0.98 | 0.95 | 0.89 |
| NZD/EUR (end of period) | 0.61 | 0.67 | 0.70 | 0.67 | 0.63 | 0.70 | 0.69 | 0.64 |
| NZD/GBP (end of period) | 0.51 | 0.50 | 0.49 | 0.44 | 0.49 | 0.50 | 0.46 | 0.40 |

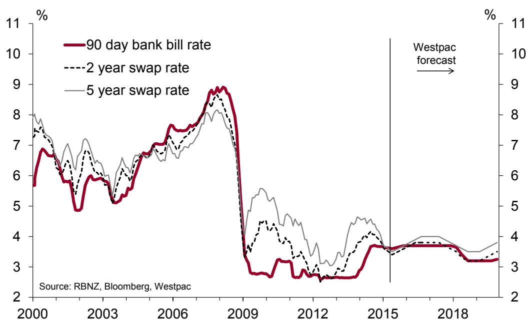
*New Zealand GDP growth*



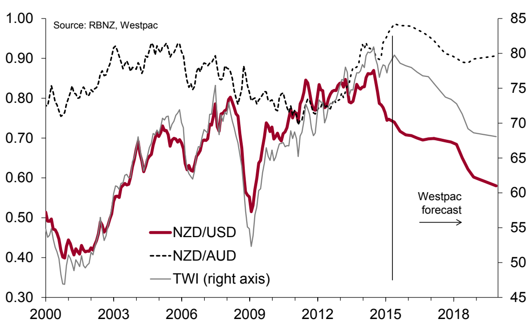

*New Zealand employment and unemployment*




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




*NZD/USD, NZD/AUD and TWI*



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