

August 2016

Economic Overview

Standing out from the crowd

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August 2016 Economic Overview

Note from Michael

Welcome to the August 2016 *Economic Overview*. As we were going through our forecasts for this report, it was notable how the New Zealand economy has largely maintained its trajectory. Growth is looking a little stronger for the year ahead, while inflation is looking weaker. But for the most part, the local economy hasn't thrown up any big surprises in the past three months.

Indeed, New Zealand has seemed like an oasis of calm in light of the issues that the rest of the world has been grappling with. The UK's shock vote to leave the European Union is only the most prominent of those issues; there have also been contentious election campaigns, concerns about fragile banking systems, and general uncertainty about the direction of policy.

Of course, New Zealand's status as a relative safe haven doesn't come without consequences. The foreign exchange market is the great leveller – countries that outperform their peers for any length of time tend to have higher interest rates and attract inflows of capital, resulting in higher exchange rates. The strong New Zealand dollar will undermine prospects for our exporters, and has clearly left the RBNZ unsettled over its ability to meet its inflation target.

In some ways, it's not surprising that the New Zealand economy has stayed the course. As we identified in our previous *Overview*, the greater challenges for the local economy lie a few years ahead. We know that the Canterbury earthquake rebuild is a finite job, and as it enters its wind-down phase in the coming years, it will be as much of a drag on growth as it was a boost on the way up.

The other challenge that we identified is the pace at which households are accumulating debt against property. Our Special Topic highlights how far New Zealand has gone down this path compared to its peers. This dynamic can sustain itself for some time, but we believe that it will eventually reach a natural limit. And as households turn their focus to repaying debt, it will be retailers and other consumer service businesses that find themselves most exposed.

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Text finalised 5th August 2016

ISSN 1176-1598 (Print)
ISSN 2253-2897 (Online)

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New Zealand Economy

Keep on truckin'

The New Zealand economy is set to continue growing at a firm pace for some time, with strength in domestic demand offsetting lingering headwinds in the externally exposed parts of the economy. However, there are growing questions about the underlying resilience of New Zealand households, and a slowdown in growth remains on the cards through the latter part of the decade.

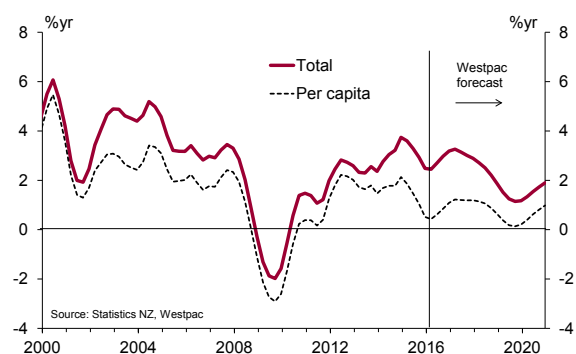
GDP growth is expected to remain firm over the next few years...

The New Zealand economy has grown at a solid pace in recent years and the unemployment rate has trended down to 5.2%. Despite this, there's still a noticeable absence of any upward pressure on wages or consumer prices.

Economic activity is set to remain firm for some time yet, and we've revised up our near-term forecast for growth. We now expect the New Zealand economy to grow by 3.2% over 2016 and 2.9% over 2017. Underpinning this ongoing expansion are some familiar factors, with strong construction activity, population growth, and supportive monetary policy all helping to offset lingering challenges in the externally exposed parts of the economy.

But while the economy is continuing to truck along for now, there are questions about the underlying financial health of New Zealand households. In addition, a slowdown in growth remains on the cards through the latter part of the decade.

Figure 1: GDP growth and per capita GDP growth



...with strong construction activity...

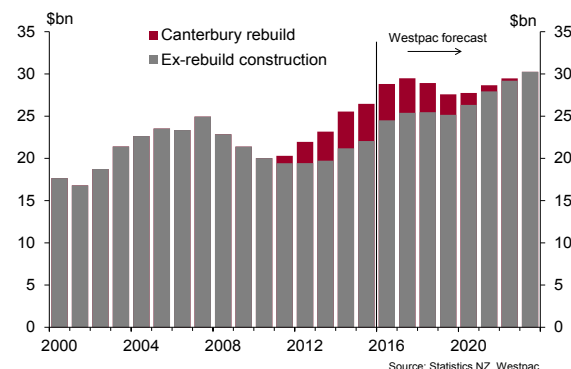
The key factor underpinning GDP growth continues to be strong construction activity. However, the centre of gravity for the building industry has been shifting. After several years of strong activity, Canterbury's rebuild is now well advanced, and the month-to-month spend on reconstruction has levelled off. While there is still a large amount of work to do, rebuild-related spending and employment are expected to be broadly stable for the next couple of years. And eventually, reconstruction activity will start to wind back,

resulting in a drag on GDP growth and employment through the latter part of the decade.

Offsetting the waning impulse from Canterbury's rebuild, however, is strengthening construction activity in other regions, the lion's share of which relates to residential building in Auckland. Low building relative to population growth for a number of years has left Auckland with a shortfall of around 30,000 homes, and population growth in the region is set to remain strong for some time. To address this shortfall and meet the needs of its growing population, Auckland needs to build around 110,000 houses over the next ten years. Building levels in the region have been increasing. And regulatory changes, including policies supporting housing intensification, will encourage further gains. However, at least for now, the rate of home building remains short of the required pace.

Strength in construction isn't just an Auckland story, however. Residential construction has also been increasing in Tauranga, Hamilton and Queenstown. In addition, there is a large pipeline of non-residential work planned nationwide, including a substantial amount of spending on infrastructure.

Figure 2: Annual construction spending (2012 dollars)



...low interest rates...

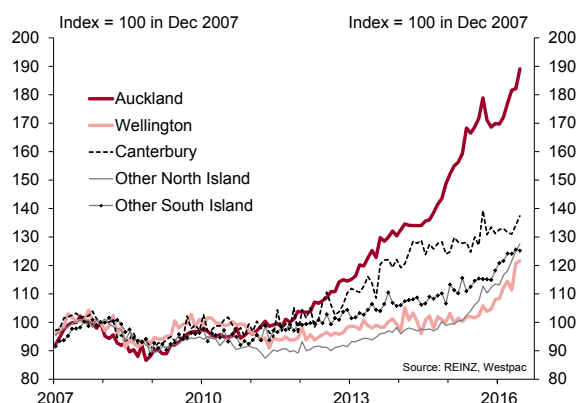
Also boosting demand in the economy are record low interest rates, which are making it less expensive for households and businesses to fund spending and investment.

The impact of these low borrowing rates has been seen most clearly in the housing market. Demand from

owner-occupiers has increased. In addition, low interest rates and the expectation of capital gains have seen demand from investors surge. In Auckland, these factors have seen house prices rising at a rapid pace for some time. However, the strength in house prices has become increasingly broad-based, with prices outside of Auckland and Canterbury rising by 15% over the past year.

The eye-watering pace of house price growth has given rise to renewed concerns around financial stability. The Reserve Bank has already stepped in to cool the market through tighter lending restrictions, and further interventions are likely. Nevertheless, tight supply, strong price increases to date and the likelihood of continued low interest rates have prompted us to once again revise up our forecasts for house price growth. We now expect nationwide house prices will rise by 16% over 2016 (up from an already strong forecast of 11% at the time of our last *Overview*, which included an allowance for a tightening in macro-prudential policy). A further 8% gain is expected over 2017.

Figure 3: House prices



...and strong population growth...

Providing a further boost to demand and flattering overall GDP growth has been strong population growth on the back of record levels of net migration. On an annual basis, net migration rose to a record high of 69,000 in June this year. In part, this has been due to elevated levels of new arrivals to the country, including large numbers of international students. We've also seen increases in the number of New Zealanders choosing to stay onshore or come back from overseas, particularly from Australia. This has resulted in the net outflow of New Zealanders dropping to its lowest level in 25 years, accounting for half of the increase in net migration.

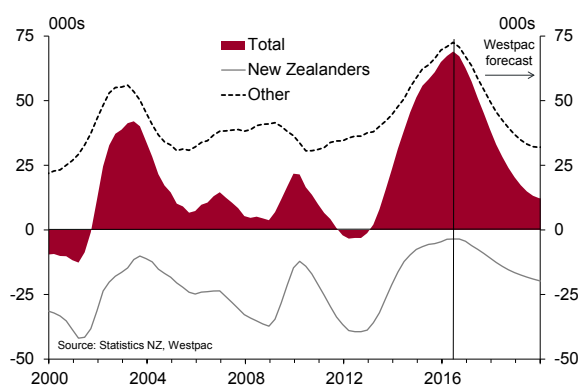
The resulting boost to the population has masked a sharp drop-off in per capita growth over the past year. This has meant that the economic environment currently feels very different depending on your perspective. In the business sector, confidence levels remain firm. Population growth has meant more bodies in stores, and has provided an offset to the headwinds buffeting the economy, such as weakness in dairy prices. But at the same time, for many individual households the economic environment is likely to feel a lot tougher. This is especially true for those in regions

that are closely linked to the dairy sector, where income growth has been under downward pressure.

While annual net migration is currently strong, we think it peaked in June. And over the coming years, population growth is expected to ease back to more normal levels. Arrivals of international students have already eased off in response to a tightening in entry requirements, and students that arrived in recent years will soon start to depart as their courses are completed. On top of this, increasing numbers of New Zealanders are likely to contemplate moving abroad over the coming years with Australia's labour market expected to strengthen.

Just as the pick-up in net migration boosted demand in recent years, the coming wind down will be a drag.

Figure 4: Annual net migration



...offsetting lingering headwinds in the external sector

Balanced against the aforementioned tailwinds for the economy are continuing headwinds in the external sector. As discussed in the *Global Economy* section, growth and inflation in our trading partner economies has remained modest, and there continues to be bouts of heightened volatility in financial conditions (such as we saw following the Brexit vote). The resulting downward pressure on interest rates in many economies is adding to upward pressure on the NZ dollar. Combined, these conditions are resulting in a challenging environment for many New Zealand exporters, as well domestic producers that compete against imports.

Softness in global demand is a particular challenge for parts of the primary sector, especially in regions closely connected to dairying. Subdued global demand and increases in global production have seen international dairy prices lingering at low levels, and only a modest recovery in prices is expected over the coming year. This is weighing on incomes and confidence in many rural regions, and the subsequent softness in spending is being felt more widely.

Despite these headwinds, it's certainly not all bad news on the external front. New Zealand is benefiting from growth in global demand for services, which has been a boon for industries such as tourism and software development. Lower prices for imported goods have also provided a significant boost to households' purchasing power.

However, there are questions around the resilience of New Zealand households...

Putting it all together, the conditions described above leave us with a solid outlook for GDP growth through 2016 and 2017. However, underlying this are growing questions about the financial health of households.

First of all, as discussed in the *Special Topic*, household debt levels have been climbing rapidly in recent years. The resulting reduction in financial buffers mean that households are now more vulnerable to unfavourable changes in economic conditions. In addition, increases in debt levels will weigh on household spending growth over time.

On top of these concerns, much of the increase in household borrowing has been used to fund the purchase of investment housing. Relative to metrics such as household incomes, house prices in parts of the country have risen to extremely high levels, especially in Auckland. Consequently, there is increased risk of a sharp correction in house prices at some point. This could have significant impacts on the banking system and economic activity more generally.

Concerns about financial stability and household debt levels have prompted the RBNZ to tighten the restrictions on banks' residential lending. This has taken the form of a broadening of the existing loan-to-value ratio restrictions on investor lending in Auckland to the rest of the country, as well as a tightening of the nationwide speed limit for owner-occupied lending. The RBNZ is also looking at additional policy tools, including restrictions on debt-to-income ratios. However, any further changes are unlikely to be put in place this year.

The tightening in lending restrictions will take some of the wind out of the housing market, with house price growth in both 2016 and 2017 expected to be around 3 percentage points lower than it would be otherwise. But while these measures will help to improve the resilience of the financial system, strong demand for housing, especially in Auckland, is likely to be sustained for an extended period.

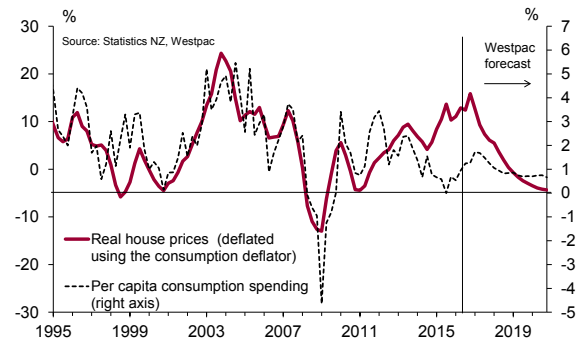
On a per-capita basis, household spending has been weak, rising only 0.6% over the past year. That's the slowest pace since 2010, when the economy was emerging from recession.

This weakness in per capita spending is particularly surprising given the low level of interest rates and related strength of house prices. With New Zealanders holding a large proportion of their assets in housing, gains in house prices have typically been associated with increases in spending. Relatively weak spending may reflect that much of the strength in house prices has been due to the increased demand from investors, who tend to be less prone to spending the gains associated with household wealth. Headwinds in the external sector, particularly the hit to incomes in the dairying sector from low global prices, may also be dampening spending appetites.

In any case, the softness in household spending raises important concerns for monetary policy. If low interest

rates and gains in house prices are not boosting domestic demand in the manner they usually do, this suggests that one of the key channels that monetary policy usually operates through could be impaired. And that would be extremely important. It means that the Reserve Bank faces a tougher task in terms of achieving its inflation goals.

Figure 5: Per capita household spending and house prices (annual)



...and growth is set to slow late in the decade

Looking to the latter part of the decade, the current period of firm activity is set to give way to a period of below average growth from around 2018. The factors that are expected to contribute to this slowdown are already in place. Spending associated with the Canterbury rebuild has levelled off, and over time will start to wind down. In addition, net migration inflows have peaked, and are likely to moderate further. Both of these factors provided powerful boosts to demand in recent years. And their eventual downturns will dampen GDP growth as we approach the end of the decade.

The run up in household debt levels adds to the downside risks for activity over the coming years. And as higher debt levels have eroded households' financial buffers, there is a risk that we see a sharp reduction in household spending in response to the other factors that will dampen growth. This could have a particularly marked impact on retailers and suppliers of consumer services.

This late decade slowdown signals a challenging environment for policy makers, and highlights the need for coordination between monetary and fiscal policy. Slowing GDP growth will result in continued downward pressure on inflation. And, as discussed in the *Inflation and Interest Rates* section, it's likely the RBNZ will consequently hold the Official Cash Rate at very low levels for an extended period. However, this could push asset prices and debt levels higher still, exacerbating the risks for financial stability. To limit such risk, and provide an offset from slowing activity in some parts of the economy, targeted increases in fiscal spending could be appropriate. However, any such increases in spending would need to be balanced against the Government's longer-term aim of continued improvement in the country's public debt position.

Global Economy

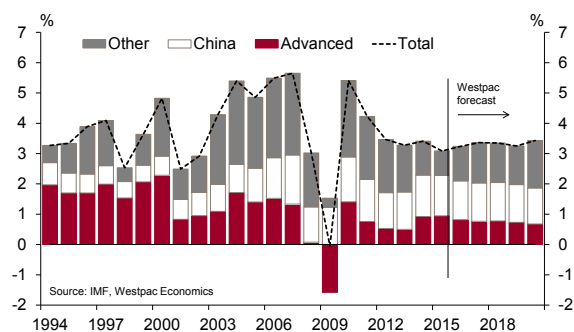
Uncertainty reigns supreme

The external environment remains challenging, with global growth subdued. The path forward is fraught with uncertainty, and the UK's decision to exit the European Union has skewed the risks to the downside. Despite this, market measures of risk are at the lowest levels in a year – spurred by expectations of looser monetary policy around the world. However, markets may be overestimating the clarity of the central bank to revive demand.

Financial markets hit another rocky patch in June, as the UK voted to leave the European Union. Risky assets such as equities declined sharply, before swiftly recovering as fears of imminent spill-overs to the global economy receded. Following the event, market expectations for looser monetary policy around the world rose, and this spurred risk sentiment higher still. Credit spreads are now around the lowest level in a year, and US equities have reached record highs.

This sanguine market backdrop is not based on an improvement in economic fundamentals. Indeed, even assuming Brexit has a limited impact on the global economy, our forecast for global growth has edged lower. Brexit has also added an additional layer of uncertainty to the global outlook, skewing risks to the downside. And while markets are settled for now, there could be further bouts of market volatility as the exit process progresses, which could tighten financial conditions and dent confidence across countries. The US presidential election in November is another event on the horizon that could shake investor sentiment.

Figure 6: Contributions to world growth



Even before Brexit, the global economy was fragile. Structural changes including a shift to services consumption away from goods, in part reflecting slower growth in China's industrial sector, have contributed to slow growth in global goods trade and industrial production. This has weighed heavily on commodity prices, especially for industrial goods, creating significant challenges for commodity exporters, including a number of large emerging market economies.

While advanced economies have fared slightly better, most central banks are grappling with low inflation. The large declines in commodity prices, especially oil which has fallen

over 60% since mid-2014, have been an important element of the global disinflationary backdrop. Excess capacity in global manufacturing has also transmitted weak price pressures across borders. Over and above this, underlying inflation pressures remain subdued across many advanced economies – a legacy of persistent spare capacity.

In response, many central banks have reduced interest rates to record lows, and further monetary easing is priced in by interest rate markets. However, the limits of monetary policy are being tested in some cases, especially in the Euro area and Japan where interest rates are already negative. Markets might be disappointed in the ability of central banks to revive demand, especially if this highlights deep-seated problems across economies.

Consumer takes all

The United States remains an outlier among advanced economies, with the debate about when the next rate rise will be. However, surprisingly weak growth in the first half of this year and heightened global risks reinforce our view that the pace of tightening will remain gradual.

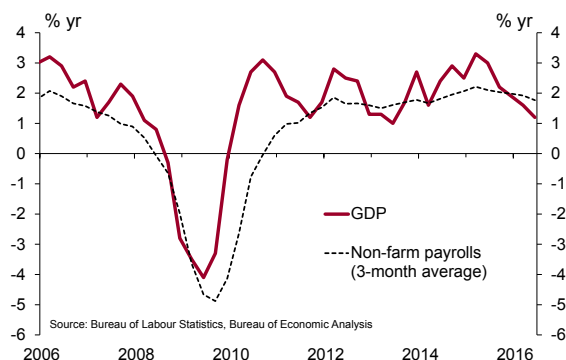
Concerns about global headwinds are not new. Weak global demand and strengthening of the US dollar have contributed to net exports being a drag on growth since 2014. This weakness has flowed into other parts of the economy, with business investment declining over recent quarters. A significant run-down in inventories over the past year also weighed on GDP growth. However, the prospects for future growth are more encouraging, with recent improvements in manufacturing surveys suggesting that the drags from global headwinds and inventory destocking are fading.

Meanwhile, the household sector has continued to provide a strong offsetting force. This is inextricably linked with ongoing improvement in the labour market, as solid employment growth boosts earnings and consumer confidence. And while employment growth has slowed in 2016, it has still been fast enough to see the unemployment rate move below 5%.

With the labour market near full employment, the outlook for inflation is vital. The Fed's preferred measure of core inflation has stalled around 1.6% this year, but wage inflation has been rising. Expectations for further labour market improvement should provide the Fed some comfort that inflation will rise. We're picking a rate hike in December,

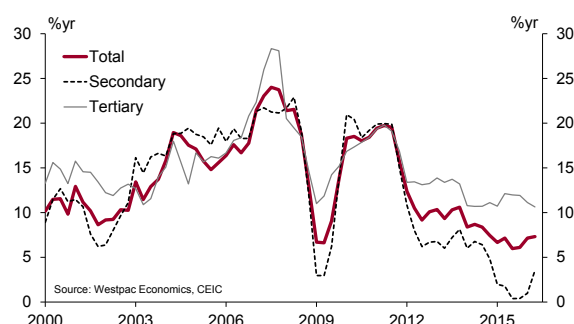
but this could be delayed if recent GDP weakness translates into softer employment growth, or if global risks intensify. A softer trajectory for US interest rates would take pressure off the US dollar, propping the NZD/USD up for longer.

Figure 7: US GDP and labour market growth



sector. Consumer sentiment has improved this year, but remains below average. Overall, the desired rebalancing of the economy appears to have stalled, which doesn't bode well for strong demand growth for New Zealand's consumer-orientated exports.

Figure 8: China nominal GDP growth



What rebalancing?

Momentum in the Chinese economy picked up in recent months, with annual growth stabilising at 6.7% in Q2. The improvement in nominal terms was even more notable as growth in the secondary sector (manufacturing and construction) rebounded strongly, after slowing to a crawl in previous quarters. This resurgence in growth has been fuelled by easier credit conditions and a surge in government spending. Notably, public investment has surged 23.5% this year, while growth in private investment slowed to 2.8%.

However, the recent impulse to growth doesn't look sustainable and the economy looks set to slow over the second half of the year. A raft of concerns about the Chinese economy remain, with the unsustainable rise in debt at the fore. Moreover, the returns from credit growth are diminishing as credit is channelled through public investment into sectors already struggling with excess capacity.

While conditions in the tertiary (services) sector have been more stable, it is not clear that this will be enough to offset the inevitable deceleration in growth in the secondary

Growth but no inflation

The Australian economy has remained resilient in a challenging environment. Real GDP has been growing at a pace just above trend, despite further declines in the terms of trade. Low interest rates are supporting domestic demand, and the lower Australian dollar is boosting services exports. However, mining investment continues to decline, and non-mining investment is weak.

GDP growth is expected to remain above trend over the next couple of years, as the terms of trade stabilise and the drag from mining investment wanes. We expect relative labour market conditions to move in Australia's favour by 2018, contributing to a downturn in New Zealand's net migration flows.

Despite solid growth, the RBA is grappling with low inflation, and has cut interest rates 50 basis points this year to a record low of 1.50%. Inflation has been pulled down by global disinflationary forces, subdued price pressures in the housing market, and low wage inflation.

Economic forecasts (calendar years)

Real GDP % yr	2012	2013	2014	2015	2016f	2017f
New Zealand	2.6	2.4	3.7	2.5	3.2	2.9
Australia	3.5	2.0	2.7	2.5	3.0	3.0
China	7.7	7.7	7.3	6.9	6.4	6.2
United States	2.2	1.5	2.4	2.4	1.6	2.1
Japan	1.7	1.4	0.0	0.5	0.6	0.5
East Asia ex China	4.6	4.2	4.1	3.7	3.7	3.9
India	5.6	6.6	7.2	7.3	7.7	7.6
Euro zone	-0.9	-0.3	0.9	1.6	1.5	1.2
United Kingdom	1.2	2.2	2.9	2.2	1.1	0.5
NZ trading partners	3.7	3.5	3.8	3.5	3.3	3.3
World	3.5	3.3	3.4	3.1	3.2	3.4

Forecasts finalised 3 August 2016

Agricultural Outlook

One foot in front of the other

Across the country, dairy farmers are struggling to keep their heads above water as global dairy prices remain firmly in the doldrums. But while the dairy sector's challenges continue to be a major headwind for the New Zealand economy, not all exporters are in as dire straits. There are parts of the agricultural sector that are performing much more strongly. That said, the strong NZ dollar combined with the insipid global growth backdrop will continue to create challenges for the agricultural sector for some time yet.

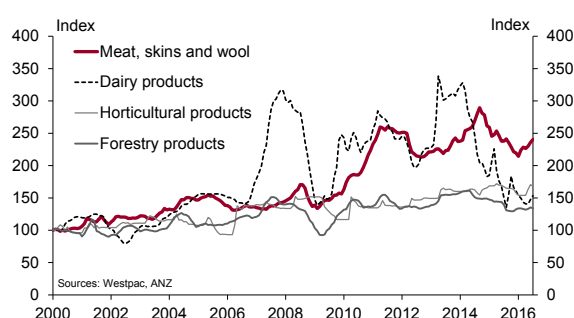
Dairy remains the weakest link in the agriculture sector. Despite significant cost cutting and efficiency gains in the sector, the modest lift in incomes forecast for this season still won't be enough to drag most farmers out of the red. That said, our forecast of a \$4.60 farm gate milk price is still more optimistic than Fonterra's view, which currently sits at \$4.25.

After three consecutive seasons where incomes have failed to cover costs, this is a position which is becoming increasingly uncomfortable for large swathes of the sector. Gradually, this is being reflected in land values, even on light turnover. The REINZ dairy farm price index is 18% below a year ago, noticeably weaker than the overall farm price index, which is down 4%. We suspect there could be further downward pressure to come as the industry adjusts its medium-term expectations to a world where commodity prices are lower for longer.

If there is a silver lining for dairy farmers, it's that the tidal wave of milk that has sloshed around the global market over the last year has started to ease – albeit from a very high level. A decline in milk production, particularly out of Europe, but also to some extent from other major exporters, is a key reason we expect to see dairy prices grind higher from late 2016 and into next year. But a sustained recovery will require support from the demand side too. In this regard we are much more cautious. The sustained period of low prices has given buyers ample opportunity to stock up, while the global growth backdrop remains uninspiring.

But not all parts of the agriculture sector are as downbeat as dairy. The glow surrounding the horticulture sector in particular continues to brighten. Kiwifruit exports are hitting record levels and apple exporters are also smiling. In both cases, growers have benefited from product innovation and the ability to differentiate their offering on the international stage. They also have the benefit of more diversified markets, meaning they are not as exposed to the downturn in China as some sectors. No doubt other parts of New Zealand's agriculture sector will look to take these lessons and apply them to their own operations.

Figure 9: NZ export commodity prices (world prices)



Commodity price monitor

Sector	Trend	Current level ¹	Next 6 months
Forestry	Log prices remain elevated, supported by tight supply and strong domestic demand. We continue to expect downward pressure on export prices in the coming months.	High	↘
Wool	Further moderation in prices is likely given weak demand outlook in China. Low oil prices continue to make synthetics an attractive option.	Average	↘
Dairy	Despite a recent sharp lift in dairy prices, we continue to expect the road to recovery to be a long one. Further reductions in global and a lift in Chinese demand remain key.	Low	↗
Lamb	Brexit creates downside risk for NZ lamb exports to the UK, but tight global supplies should help underpin prices.	Average	→
Beef	While global supplies remain relatively tight, the potential re-entry of Brazil to key markets remains a wild card.	High	→

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

Exchange Rates

Freeze frame

The New Zealand dollar is lingering above 70c against the US dollar as New Zealand interest rates continue to stand out from the crowd. That's despite signs that the RBNZ will need to cut the cash rate to a new low of 1.75%. But as the Fed continues on its path toward tighter monetary policy, and dairy prices struggle to improve against a weak global growth backdrop, we expect the NZ dollar to lose its allure. We maintain our view that the NZ dollar is headed lower from here.

A feature of the New Zealand economic landscape since the *May Overview* has been the strength of the NZ dollar. Indeed, the outperformance of the Kiwi has come despite falling local interest rates on the back of firming expectations that the RBNZ will have to cut the OCR below 2%.

That's because, even if the OCR falls to 1.75% this year as we expect, New Zealand interest rates still stick out like a sore thumb compared to our usual contemporaries. Across the ditch, the RBA has cut its policy rate to 1.5%. The Brexit vote has seen expectations of Bank of England policy do a 180, with a cut to 0.25% and further quantitative easing, while further quantitative easing is also not far from European Central Bank or Bank of Japan policy makers' minds as they also contemplate pushing rates further into uncharted negative territory.

Take this international interest rate backdrop and a global growth environment fraught with risk and uncertainty, and mix in solid near-term local growth prospects and stable (albeit historically low) export commodity prices, and it's not too hard to see why buying NZ dollars has looked like an attractive proposition until now.

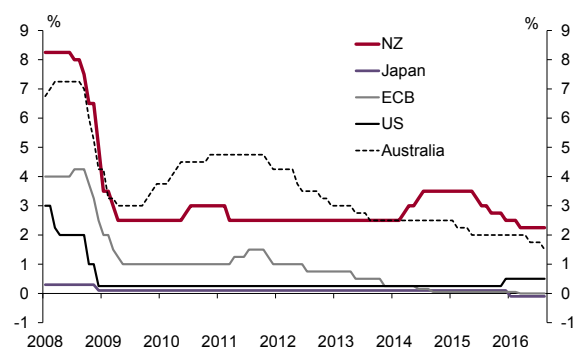
In contrast, the US dollar has largely failed to break higher in recent months. That's because, against the backdrop of heightened global uncertainty, markets have put Fed rate hikes on ice almost indefinitely. A 25 basis point rate hike is now not fully priced until the end of 2017. In stark contrast, we think the outlook for the US consumer will leave the Fed comfortable in hiking rates in December, much sooner than the market anticipates. This in turn should push the NZD/USD down below 70c by the end of the year.

Clearly though, much hinges on the path of Fed policy from here, with the risk that if the Fed delays further tightening beyond December, that the NZ dollar will remain elevated. Yet while the near term tactics of the Fed are somewhat uncertain, we probably have more conviction on our domestic growth forecasts. And by 2018, as New Zealand's growth prospects fade under the weight of slower population growth, the wind down of the Canterbury rebuild and high household debt levels, we expect the NZ dollar to fall further.

Closer to home, the NZ dollar has continued to broadly track sideways against its Aussie counterpart, continuing the theme of the last year. With interest rate expectations falling in both countries, much boils down to relative commodity price and growth prospects. And while

New Zealand is holding its own on these fronts for now, by 2018 it's likely that the New Zealand economy will be battling growing headwinds while the Australian economy is starting to perform more strongly. Certainly, net migration flows are expected to be moving firmly in Australia's favour at this horizon. This is expected to push the NZD/AUD from its current 93c range, down to the low 80s by the end of 2019.

Figure 10: Selected central bank policy rates



Exchange Rate Forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Sep-16	0.70	0.93	0.64	0.54	73.5	75.4
Dec-16	0.68	0.93	0.63	0.53	70.0	73.9
Mar-17	0.67	0.92	0.63	0.53	68.3	73.3
Jun-17	0.65	0.92	0.62	0.51	65.7	71.7
Sep-17	0.63	0.91	0.59	0.49	64.3	69.9
Dec-17	0.62	0.91	0.58	0.48	64.5	68.6
Mar-18	0.61	0.90	0.57	0.47	63.4	67.9
Jun-18	0.60	0.88	0.56	0.46	63.6	67.3
Sep-18	0.59	0.86	0.55	0.44	63.7	66.4
Dec-18	0.58	0.83	0.53	0.42	64.4	65.5

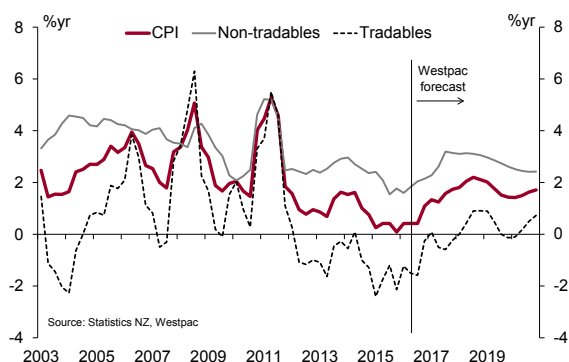
Inflation and Interest Rates

Up against it

Inflation has remained subdued, and the stronger New Zealand dollar will continue to undermine it in the near term. Domestic growth and the end of some temporary depressing factors will help to lift the annual inflation rate in the next couple of years. So the risk facing the Reserve Bank appears to be more one of an uncomfortably slow return to the inflation target, rather than a persistent undershoot. We expect further OCR cuts in August and November.

Annual inflation fell short of forecasts once again in the June quarter, holding steady at just 0.4%. Prices of internationally-traded goods and services continued their decline, and home-grown price pressures were limited outside of the housing market. Inflation has been below the Reserve Bank's 1-3% target band for two years straight now, and it's a close call as to whether it will return to within the band by the end of this year.

Figure 11: Inflation forecasts



Part of the shortfall in recent years has been due to unavoidable temporary factors, the most prominent being the steep fall in world oil prices. The resulting fall in local fuel prices has alone shaved about a percentage point off the CPI over the last two years. It has also dampened prices for many goods and services where fuel is a significant part of the cost, particularly airfares. Barring another sharp drop in oil prices, we expect that by the second half of 2017 this factor will no longer be a drag on the annual inflation rate.

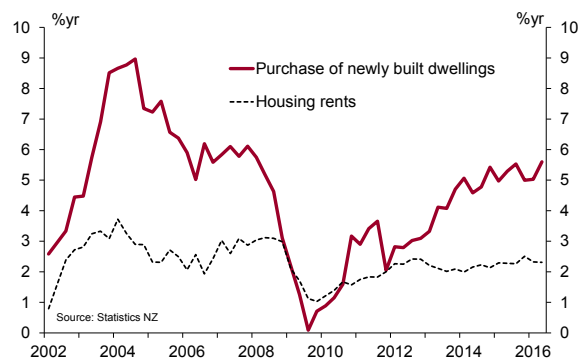
The other notable factor was the sharp reduction in ACC levies for motor vehicles, which reduced inflation by around 0.3ppts over the past year and will do the same again over the coming year. But again, once this effect passes, annual inflation will pop higher.

Notwithstanding those temporary factors, the underlying inflation picture has remained subdued. We estimate that the economy is running only slightly above its non-inflationary potential, which means that there has been only limited upward pressure on wages and prices. That's also been borne out in recent business surveys. While firms are increasingly saying that supply-side factors are the main

constraint on their growth, a relatively low proportion of them are reporting a rise in costs or selling prices.

The notable exceptions are in the housing-related components of the CPI. Construction costs have been rising rapidly, reflecting the strength of demand and capacity constraints in the building industry. In addition, rents have been rising faster than the general rate of inflation. Even for these categories, though, the story is not universal. Rents and construction costs have been accelerating in Auckland, where there is a clear shortage of dwellings. But in Canterbury, the rise in construction costs has slowed and rents are now falling, as the housing stock is being gradually restored to pre-quake levels.

Figure 12: CPI housing components

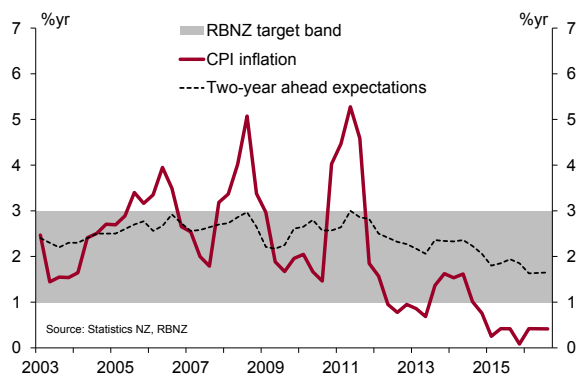


Meanwhile, the weakness in global inflation has continued to depress the prices of imported goods. The sharp fall in the New Zealand dollar in 2015 has resulted in price increases for some imports over the last year, but this effect was relatively muted and appears to have largely run its course. More recently, the NZ dollar has risen again, and if that strength is sustained, we could see tradables inflation head lower again before it heads higher.

Taking these trends into account, the RBNZ faces a significant challenge in bringing inflation back towards the 2% midpoint of its target range on a sustained basis. That challenge has been compounded by a decline in inflation expectations, with some key measures having fallen well below 2% this year. The RBNZ could take some comfort from the fact that expectations have stabilised recently. But that just reinforces the sense that there's a backward-

looking element to price- and wage-setting decisions. Put another way, it seems that people won't believe in higher inflation until they see it – which puts the onus on the RBNZ to generate that initial pickup.

Figure 13: CPI and inflation expectations



Despite the range of forces continuing to dampen inflation, a return above 1% still looks likely next year, as the temporary factors that have depressed headline inflation drop out. The risk that the RBNZ faces seems to be more that, under current policy settings, the return to the 2% target midpoint will be uncomfortably slow. That implies some further easing would be appropriate.

We expect a 25 basis point cut in the OCR in August, followed by another cut in November to a new low of 1.75%. Beyond that date, though, the case for further cuts becomes less compelling. With annual inflation returning within the target band next year, and domestic growth remaining firm, the risk of inflation expectations becoming unanchored will diminish. That said, our forecasts rely on the NZ dollar softening over the next year on the back of Fed rate hikes and US dollar strength. If the currency's adjustment is delayed, further rate cuts could be on the cards.

Never the twain

The prospect of even lower interest rates will add more fuel to the already-hot housing market. That raises questions about whether the RBNZ can pursue its monetary policy goals without generating risks to financial stability. Indeed, some overlap between the two roles is unavoidable, since the housing market is one of the channels through which monetary policy is meant to work; rising house prices increase household wealth, spurring more spending and putting upward pressure on the general level of prices.

Nevertheless, the RBNZ's macroprudential toolkit gives it the flexibility to address these two roles separately. The RBNZ's responsibility is toward the degree of risk in the financial system as a whole, rather than in the housing market per se. Tools such as loan-to-value ratios help to limit lenders' exposure to a downturn in the housing market. But any dampening effect that these tools have on house prices is a secondary concern, and experience suggests that the impact beyond the short term is limited.

That leaves monetary policy to focus on the outlook for inflation. In that sense, rising house prices matter for interest rates to the extent that they tell us something

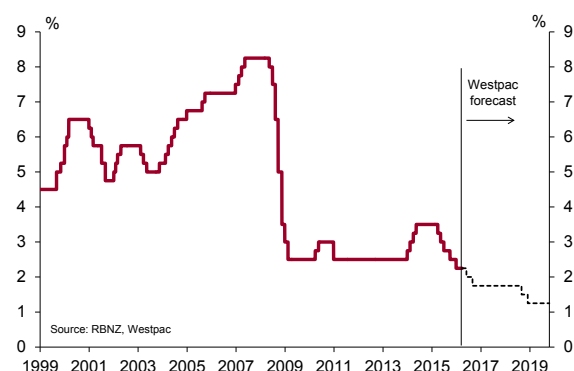
about inflation pressures. But as the *New Zealand Economy* section notes, the link from house prices to domestic demand has been unusually muted in recent times. That implies that monetary policy may need to keep the housing market 'hot' for some time, which means that tight macroprudential policy could be here to stay for some time as well.

Over the horizon

Regardless of how far the RBNZ cuts in the near term, interest rates are likely to remain low for an extended period. In fact, we expect the next phase for the OCR to be another move lower from late 2018. By that time, the Canterbury earthquake rebuild will be firmly in its wind-down phase, economic growth will fall below trend, and inflation pressures will start to wane even before they've had a significant chance to build.

Our view stands in marked contrast with financial market pricing, which implies a gradual rise in interest rates from late 2017 onwards. We recognise that forecasting over these kinds of horizons is fraught with difficulty; at some point, assumptions about a reversion to average levels tend to kick in. But the Canterbury rebuild is an unusually predictable phenomenon. It's a finite job, so at some point it must wind down, and the impact on the wider economy won't be negligible.

Figure 14: Official Cash Rate forecast



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Sep-16	0.4	2.00	2.00	2.00	2.10
Dec-16	1.1	1.75	1.90	1.90	2.10
Mar-17	1.3	1.75	1.90	2.00	2.20
Jun-17	1.2	1.75	1.90	2.00	2.30
Sep-17	1.6	1.75	1.90	2.00	2.40
Dec-17	1.7	1.75	1.90	2.00	2.50
Mar-18	1.8	1.75	1.90	2.00	2.50
Jun-18	2.0	1.75	1.90	1.90	2.50
Sep-18	2.2	1.75	1.75	1.80	2.40
Dec-18	2.1	1.50	1.50	1.70	2.30

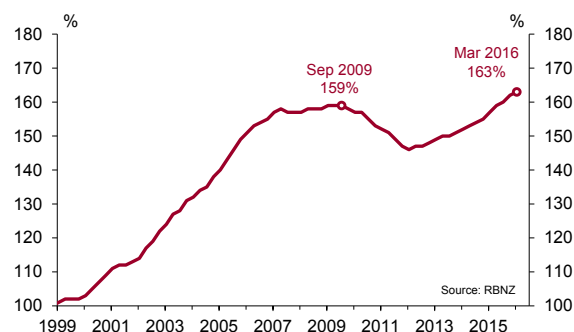
Special Topic

Household debt

Compared to other developed economies, household debt levels in New Zealand are high and have been climbing at a relatively fast pace. Increases in debt levels are not necessarily a problem for the economy. However, this does add to the economy's vulnerabilities.

Household debt in New Zealand has risen to record levels, equivalent to 163% of annual household disposable income. Very low interest rates have been a key contributor to this trend. Low borrowing rates have made it very attractive for investors to purchase residential property using debt, especially given the low level of building relative to population growth in some areas. The resulting strong growth in house prices has also meant that owner-occupiers are borrowing more to purchase housing, while existing owners have spent some of their perceived windfall as house values have risen. Combined, these conditions have resulted in household credit growth rising at its fastest pace since 2008.

Figure 15: Household debt as a share of disposable income (including investment housing)



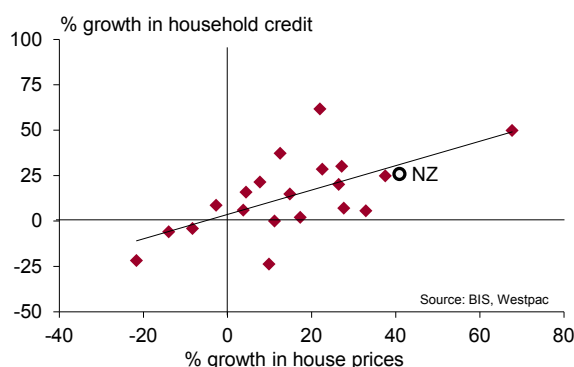
New Zealand is not the only country where household debt-to-income levels have been climbing. However, compared to most other developed economies, household debt-to-GDP in New Zealand is relatively high and has been rising at a fast pace, as have our house prices.

Some pick-up in debt levels is not inherently a problem for an economy. Debt and credit play important roles in ensuring that economies run smoothly. And the increase in household debt on the back of low interest rates is an important channel that monetary policy works through.

While household debt levels in New Zealand are high, this doesn't mean that the economy is about to topple over. Since the financial crisis, lending policies have tightened globally as regulators have attempted to improve the stability of the financial system. Many lenders have also

independently tightened access to credit to limit the risks associated with highly leveraged lending. Furthermore, very low interest rates mean that households' debt servicing costs remain modest despite the increase in debt levels. On top of this, the current account deficit is only around 3% of GDP, and we don't expect that to change much over the year ahead.

Figure 16: Growth in house prices and household credit 2011 to 2015, selected economies



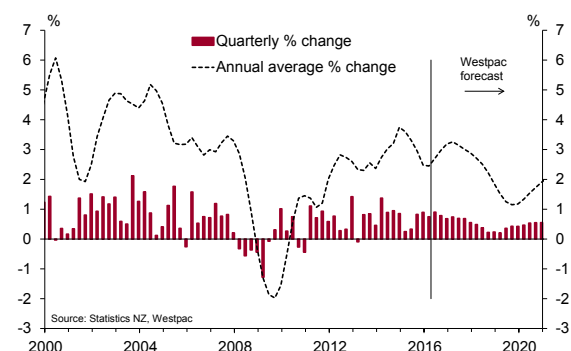
A notable feature of the increase in debt levels in recent years is that much of it has been secured against investment housing. Looking at households' debt levels compared to their assets, there has been a stark improvement in recent years. In fact, debt-to-asset ratios have dropped back to levels last seen in 2007. But much of this apparent improvement is because low interest rates have boosted house prices, flattering households' financial positions. If house prices were to fall, most households would still have a substantial financial buffer. However, those who purchased houses very recently would feel the pinch.

Nevertheless, elevated levels of household debt still raise important concerns for the longer-term economic outlook for two main reasons. First, increases in debt can't boost growth indefinitely. Households eventually need to repay debt, and larger increases now will require them to commit a greater proportion of their income to debt servicing in the future. Second, higher debt levels mean that the economy is more vulnerable to unfavourable changes in economic conditions as households have smaller financial buffers.

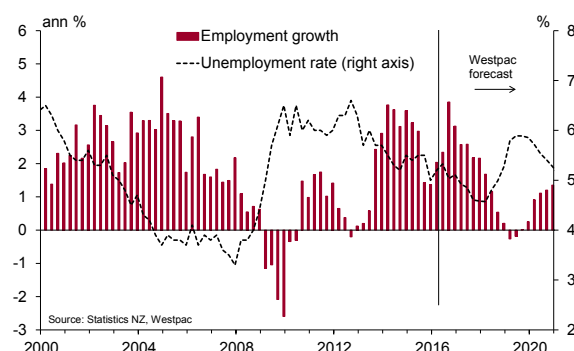
Forecasts and key charts

Annual average % change	March years				Calendar years			
	2016	2017f	2018f	2019f	2015	2016f	2017f	2018f
GDP (production)	2.4	3.3	2.7	1.5	2.5	3.2	2.9	1.9
Private consumption	2.5	3.4	2.9	2.0	2.5	3.2	3.2	2.1
Government consumption	1.8	1.0	1.5	1.9	2.0	1.0	1.4	1.8
Residential investment	7.0	9.8	2.7	-5.3	5.9	10.5	4.5	-3.6
Business investment	1.4	2.4	3.2	-0.5	1.9	2.4	3.2	0.9
Stocks (% contribution)	-0.2	0.0	0.2	0.0	-0.3	0.0	0.2	0.0
Exports	5.0	1.8	2.4	2.0	6.5	1.1	2.6	2.4
Imports	1.9	1.5	2.9	0.6	3.5	0.7	3.1	1.2
Inflation (% annual)	0.4	1.3	1.8	2.0	0.1	1.1	1.7	2.1
Employment (% annual)	2.0	2.6	1.7	-0.3	1.4	3.1	2.2	0.2
Unemployment rate (% s.a. end of period)	5.2	4.9	4.6	5.8	5.0	5.1	4.6	5.3
Labour cost index (all sectors, % annual)	1.6	1.7	1.8	1.9	1.5	1.7	1.7	1.9
Current account balance (% of GDP)	-3.0	-3.3	-3.6	-3.5	-3.2	-3.0	-3.7	-3.5
Terms of trade (% annual)	-0.1	-3.1	1.4	-0.4	-3.2	1.2	1.1	0.9
House prices (% annual)	11.4	14.0	7.5	1.4	11.1	16.0	8.0	2.5
90 day bank bill (end of period)	2.50	1.90	1.90	1.40	2.80	1.90	1.90	1.50
5 year swap (end of period)	2.82	2.20	2.50	2.20	3.10	2.10	2.50	2.30
TWI (end of period)	72.2	73.3	67.9	65.0	72.1	73.9	68.6	65.5
NZD/USD (end of period)	0.66	0.67	0.61	0.58	0.67	0.68	0.62	0.58
NZD/AUD (end of period)	0.92	0.92	0.90	0.82	0.93	0.93	0.91	0.83
NZD/EUR (end of period)	0.60	0.63	0.57	0.53	0.61	0.63	0.58	0.53
NZD/GBP (end of period)	0.46	0.53	0.47	0.41	0.44	0.53	0.48	0.42

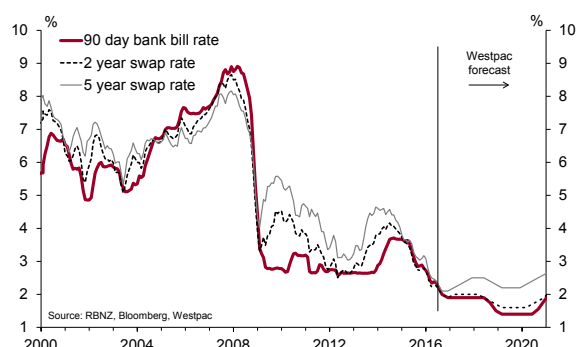
New Zealand GDP growth



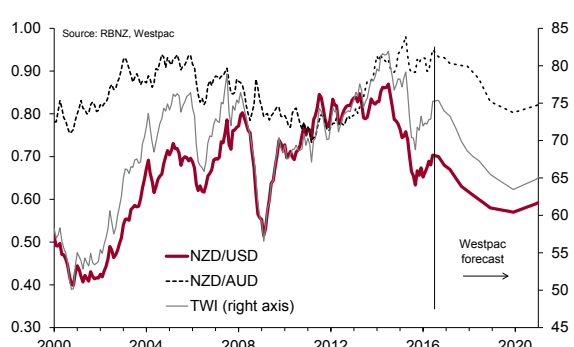
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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