February 2016

Economic Overview

Course correction

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Note from Dominick

Welcome to the first *Economic Overview* of 2016.

Last year we argued hard that the OCR would have to fall to 2.0% during 2016, while the Reserve Bank itself charted a course for 2.5%. In January this year the Reserve Bank undertook a course correction, and signalled that the OCR may go lower after all. Borrowers who resisted the temptation to fix their interest rates will be pleased. In our view, the low-point in fixed interest rates is drawing nearer, but has not yet arrived.

That said, not everything has panned out as we predicted. The New Zealand economy is humming along quite nicely at present, and we have revised our GDP forecasts higher. That's mainly because New Zealand dodged the feared El Niño drought. But we've also seen very impressive growth in tourism and Auckland construction. Overall confidence has held up better than anticipated, perhaps aided by low interest rates, cheap petrol and strong population growth.

The performance of the economy in recent months has been pleasing, but there are still some things to keep an eye on. The nation faces at least three years of below-cost returns in its biggest export industry, dairy. Surely it is only a matter of time before that has a more telling impact on the wider economy. And then we will face the wind-down phase of the Canterbury rebuild. I can't help wondering whether confidence surveys will soon turn south again.

Dominick Stephens - Chief Economist

Contributing authors

Dominick Stephens
Chief Economist
T +64 9 336 5671

Michael Gordon
Senior Economist
T +64 9 336 5670

Anne Boniface
Senior Economist
T +64 9 336 5669

Satish Ranchhod
Senior Economist
T +64 9 336 5668

David Norman
Industry Economist
T +64 9 336 5656

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For address changes contact:
WNZResearch@westpac.co.nz

New Zealand Economy

Strength in numbers

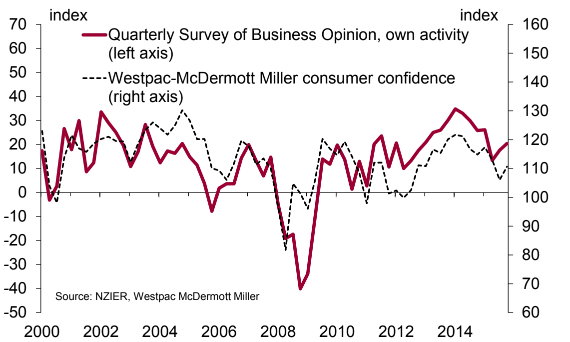
Benign weather, low oil prices, surging tourism and a burgeoning construction pipeline have improved the outlook for the domestic economy over the next year. However, lower dairy earnings and the eventual wind-down of the Canterbury rebuild are likely to cap the pace of growth, which is becoming increasingly dependent on population growth.

After a few years of accelerating growth, the New Zealand economy appeared to hit a softer patch in 2015. In fact it turned out to be a year of two halves, with growth coming almost to a halt in the first half. Dry weather and falling dairy prices reduced farm incomes, and wood harvesting and oil exploration were held back in response to low world prices. But GDP growth rebounded to 0.9% in the September quarter, and the latest available data suggests that the economy retained a strong degree of momentum in late 2015 and into the new year.

Both business and consumer surveys showed a sharp fall in confidence through mid-2015, with corresponding falls in hiring, investment and spending intentions, as world dairy prices plunged and farmgate milk price forecasts fell below $4/kg. As the outlook stabilised, however, confidence improved again over the latter part of 2015.

These swings in confidence were matched by a range of activity indicators such as retail spending, traffic flows, commercial vehicle sales, farm sales, job advertisements and the PMI manufacturing survey. That said, there is a consistent theme across these activity measures: while the growth pulse has picked up in recent months, it remains short of what we saw in 2014, when GDP growth was accelerating towards a 4% annual pace.

Figure 1: Business and consumer confidence



Our outlook for 2016 runs along similar lines: moderately strong growth, albeit a noticeable slowdown from the pace seen in earlier years. But at least this is an improvement on the forecasts we outlined in our November *Economic Overview*.

The not-so-big dry

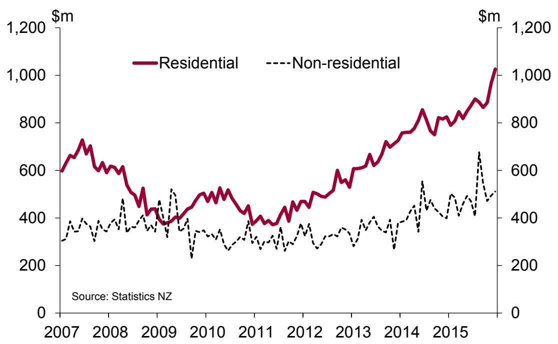
The most significant upgrade to our near-term growth forecasts stems from the absence of drought. Three months ago, the El Niño weather system had strengthened to be on a par with the 1997-98 event that led to a severe drought in New Zealand. In our November *Overview* we took that event as our base case and assumed a 0.6% hit to GDP growth over the first half of 2016, while acknowledging that actual weather conditions could turn out better or worse than this.

As it happens, rainfall has been close to normal so far this summer, so we have removed our drought assumption. This is not to say that the impact on the economy will be zero: the risk of drought, along with low dairy prices, sparked a large pre-emptive cull of cattle and sheep early in the season. Consequently, dairy and meat processing are likely to make sub-par contributions to growth over the first half of 2016.

Can we build it? Yes we can!

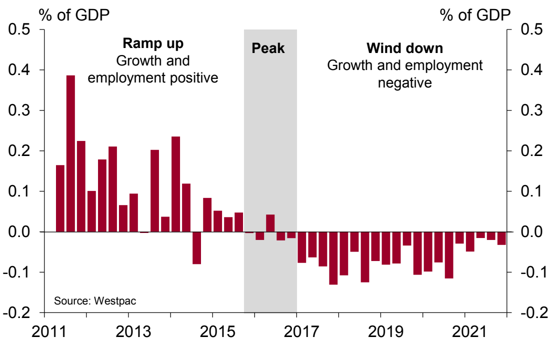
Aside from drought assumptions, there have been some genuinely positive developments behind the upgrade to our growth forecasts. The first is that the momentum in the construction sector is looking very strong – even more so than our already very positive view. Nationwide building consents picked up sharply in the latter part of 2015, for both housing and non-residential buildings, signalling that there is a significant amount of work in the pipeline for 2016.

Figure 2: Building consents by value



The post-quake rebuild in Christchurch has continued to proceed in line with our forecasts. The total level of construction activity appears to have peaked late last year. We expect it to hold around this level through 2016 before gradually winding down over the following several years. Within that rebuild profile, though, the mix is clearly changing: residential and infrastructure work have clearly passed their peaks, while commercial and social buildings are still in the ramp-up phase as the CBD revival progresses.

Figure 3: Quarterly change in rebuild spending



While the Christchurch rebuild is no longer acting as a driver of growth, this is being offset by a strong lift in housing construction in Auckland, as well as in other parts of the North Island. We've been bullish on the outlook for housing construction in Auckland since 2009: strong population growth and a legacy of past under-building has led to increased 'crowding', as indicated by the number of people per dwelling. We have long maintained that a strong lift in the pace of building activity was needed to stabilise and then ease these population pressures.

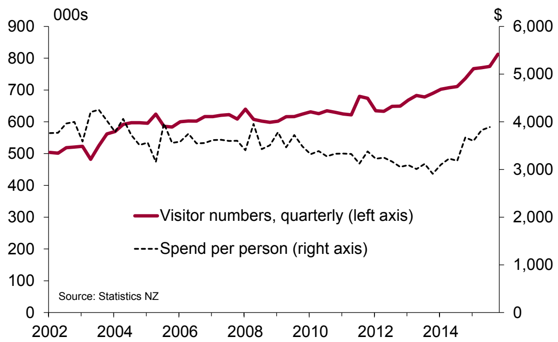
The past two years have seen a consistent trend higher in Auckland dwelling consents, with the mix increasingly turning to higher-density apartments and townhouses. While the number of consented homes has yet to reach the levels needed to stabilise the people-per-dwelling ratio, the recent pace of the increase is also sending a positive signal about the building industry's capacity to meet this demand. As a result, we've upgraded our assumption about how quickly housing construction will reach its necessary peak. We're now expecting a strong lift in residential building through to mid-2017 during the catch-up phase, before we fall towards a more sustainable long-run level.

Haere mae

The growing influx of tourists has been a highlight of the last year or so, and one that we expect to continue in the near term. Visitor numbers rose nearly 10% to a record 3 million last year, and industry contacts report very strong forward bookings for the coming year, and that the industry has grown to the point where capacity constraints are becoming a genuine issue.

We should note here that we have some reservations about the official tourist spending figures. There's no doubt about the surge in visitor numbers, but the data also imply a sudden jump in the average spend per person since the December 2014 quarter, the same time that a 'technical' change was made to the spending survey. This affects the allocation of spending within GDP. We think there is *prima facie* evidence that growth in spending by tourists has been overstated, while growth in spending by New Zealand households has been understated over the past year.

Figure 4: Overseas visitor spending



The good oil

The plunge in world oil prices for a second straight year not only has implications for the inflation outlook, as detailed in the Inflation and Interest Rates section. It also represents a sustained growth-positive shock for a net importer of oil such as New Zealand (though we acknowledge that Taranaki, New Zealand's major oil-producing region, has already suffered a blow as interest in oil exploration has shrivelled).

The most direct effect is that lower fuel prices leave more money in consumers' pockets to be spent elsewhere. Cheaper fuel also lowers the cost of doing business, particularly for transport, resulting in lower prices and higher demand for a wide range of goods and services. Lower fuel prices also tend to lead to lower international airfares (and have done so already), adding further to the positive outlook for tourist numbers.

Not so fast

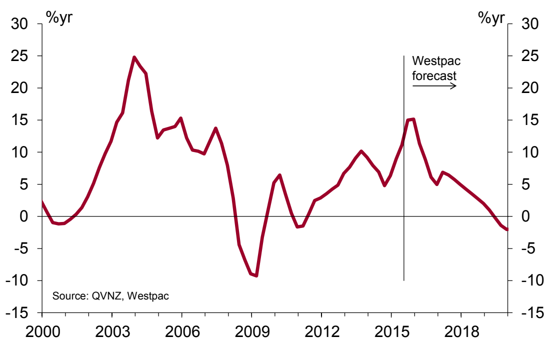
Despite these positive developments, there are still a number of challenges to the economic outlook for New Zealand, for both this year and beyond. The biggest uncertainties to our view stem from overseas. As the Global Economy section notes, we're expecting another year of moderate growth overall among our main trading partners, but there are growing question marks around conditions in China in particular. At the least, we're aware of the confidence-sapping effect that global financial market volatility can have on domestic activity.

We should also be clear that the outlook for agricultural incomes has actually worsened, as the absence of drought has been outweighed by the renewed downward pressure on world dairy prices. We've made further downward adjustments to our household consumption and business investment forecasts, on the assumption that dairy farmers will tighten their belts and reduce on-farm investment, which impacts downstream businesses. We recognise, however, that the timing and magnitude of this impact is highly uncertain. To date, the economy has been surprisingly resilient to this income shock, but we suspect that spending could take a turn for the worse once the likelihood of a third season of low milk prices becomes apparent.

We're also expecting the housing market to be less supportive of growth this year, via the wealth effect on household spending. Nationwide, house prices rose around 15% last year, with the most rapid gains occurring in Auckland, but also spilling over to nearby centres such as Hamilton and Tauranga.

In hindsight, some of the strength in the Auckland housing market was due to purchases being brought forward ahead of the new tax and foreign buyer rules that came into force in October. However, an unprecedented 6% drop in the REINZ stratified house price index for Auckland suggests that the new regulations have had a meaningful impact on housing demand, at least for the near term. We expect nationwide house prices to rise by only 5% this year, a slight downgrade from our last projections despite an upgrade to our assessment of migration-led population pressures.

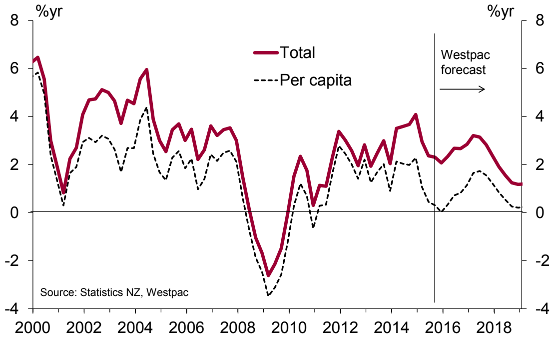
Figure 5: Annual house price inflation



People power

And that brings us to a point that we also highlighted in our previous Overview: GDP growth is becoming increasingly dependent on population growth. Net immigration has continued to surprise to the upside, and we now expect the annual inflow to peak at almost 70,000 people this year. The rise in net immigration is being driven by fewer New Zealanders leaving and more returning from overseas, and also increasingly by foreign students.

Figure 6: Total and per-capita GDP growth



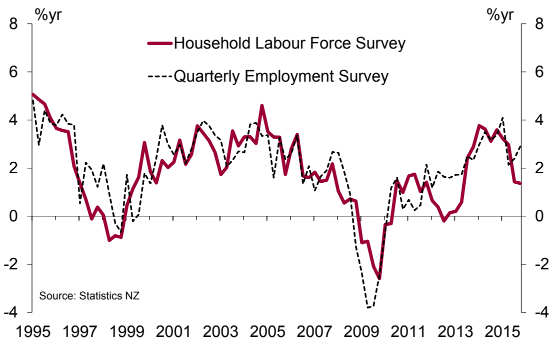
With immigration reaching new record highs, population growth is running at 2% a year, a marked change from the sub-1% growth seen as recently as 2013. What this means, however, is that our forecasts of annual GDP growth of around 2% imply that per-capita growth will be only a whisker above zero.

So whether the outlook for growth is 'good' or 'bad' is very much a matter of perspective. From a firm's point of view, more people means an opportunity for solid growth in sales volumes. But from a household's point of view, per capita growth of just 0.6% doesn't point to meaningful growth in incomes, nor does it suggest that the slack in the labour market will be tightened up particularly quickly. The latest labour market figures for the December 2015 quarter have raised some questions about that degree of slack. Having risen gradually over most of 2015, the unemployment rate fell sharply to a post-crisis low of 5.3%, and the surge in labour force participation that was apparent in the figures a year ago has since been completely unwound.

However, we are cautious in our interpretation of the sharp drop in unemployment. Looking at a broader range of labour market indicators – the Quarterly Employment Survey, the Westpac-McDermott Miller employment confidence index, job advertisements and benefit numbers – suggests a more consistent story. The labour market did indeed appear to soften through mid-2015 then strengthen again towards year-end, just not to the extent that the unemployment rate suggests.

We expect continued moderate growth in employment over the next year, in keeping with our GDP growth forecast. But with strong population growth set to continue as well, we're not expecting a significant further tightening in labour market conditions this year. As we note in the Inflation and Interest Rates section, this has implications for the degree of domestic inflation pressures that are likely to emerge.

Figure 7: Annual employment growth



Beyond this year, our outlook for growth continues to be driven by long-running concerns. We expect the level of quake-related building activity in Canterbury to steadily wind down from 2017 onwards, acting as a drag on the overall pace of GDP growth and pulling the economy below its non-inflationary potential rate of growth.

The Government's recent decision to provide an extra $1bn of capital spending around this time and to bring forward funding of other infrastructure projects is fortuitously timed, but at best will only dampen the degree of economic slowdown. Ultimately, interest rates (and perhaps the exchange rate) will need to fill the 'automatic stabiliser' role over this period.

Global Economy

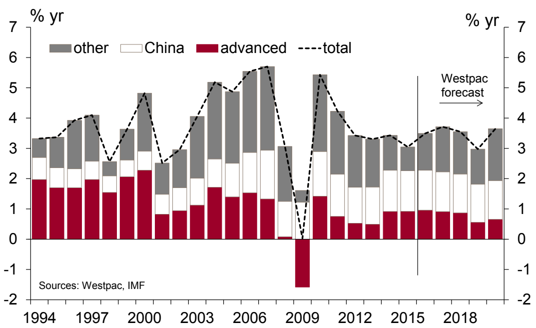
Soaring eagle, sinking dragon

There's been a growing schism in the global economy. Activity has continued to soften in China and emerging markets, and the related falls in commodity prices have resulted in sharp income falls for commodity exporting nations. In contrast, conditions in the US and other higher income economies have firmed. On balance, the result is a very mixed global backdrop from a New Zealand point of view.

It's been a rocky start to the year for the global economy, with heightened volatility in financial markets and sharp declines in major equity indices. This comes against a backdrop of ongoing structural change in the make-up of global demand. Activity in service industries, such as tourism and information technology, has been strengthening as global incomes have risen. But at the same time, demand for goods has been subdued.

These trends are resulting in stark divergences in GDP growth across the globe. While conditions in higher income economies are continuing to firm, growth in emerging market and developing economies has slowed. Combined with heightened nervousness in financial markets, recent developments have prompted us to again mark down our expectations for global growth.

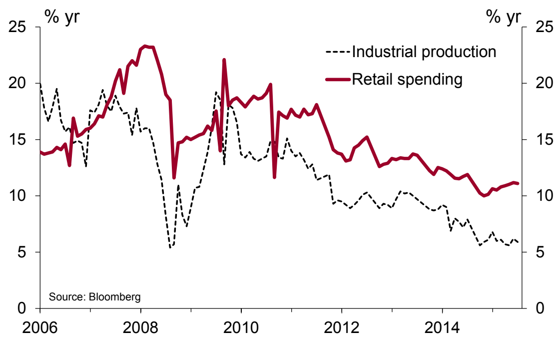
Figure 8: Contributions to world GDP growth



There has been a further slowdown in China and developing economies...

In emerging market and developing economies, where activity is more heavily weighted towards trade in goods, 2015 saw GDP growth fall to its slowest pace since the financial crisis. At the heart of this slowdown is China, where GDP growth has been decelerating since 2013. Chinese demand is continuing to shift away from state-led investment in infrastructure and property, and towards private consumption and services. However, the pick-up in domestic spending to date hasn't been strong enough to offset the slowdown in manufacturing and construction. Consequently, Chinese growth is set to continue slowing over 2016.

Figure 9: Chinese activity indicators



The drop-off in Chinese GDP growth is creating large ripples through the global economy. As construction and manufacturing activity in China has waned, demand for all manner of related goods has dried up, prompting a slowdown in global trade and manufacturing. Such impacts have been most pronounced in East Asian economies that are closely tied to the demand cycle in China. However, other regions have also been affected. For instance, around 10% of EU exports go to China.

Concern about the downside risks for global growth has also resulted in increased nervousness in financial markets. Investors have withdrawn funds from emerging markets where growth outlooks have deteriorated. In addition, to compensate for the increase in risk, investors are requiring a higher return on funds, which has pushed up borrowing costs in many economies, including New Zealand.

Heightened concern about the economic outlook has also resulted in downward pressure on many currencies. Notably, Chinese policy makers have devalued the yuan and, as the New Zealand Dollar section notes, there is the risk of further devaluation over the coming months. Other Asian currencies have also fallen.

But while lower exchange rates may assist exporters, they are adding to concerns about corporate indebtedness in China and emerging markets. In recent years many businesses borrowed in USD to support expansion. But as currencies have fallen, many of these businesses are seeing debt servicing costs rise at the same time as demand has softened.

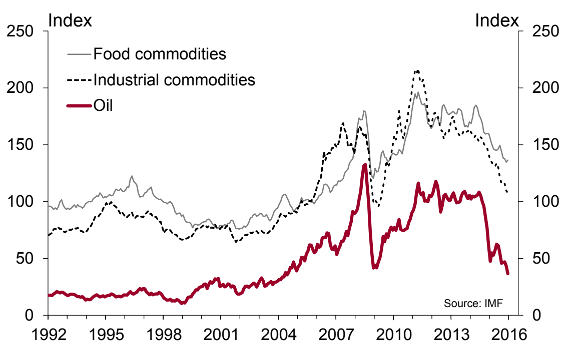
...which has dragged down commodity prices...

The slowdown in global manufacturing and related softening in investment spending has seen prices for internationally traded commodities plummet. In many cases, price declines have been reinforced by increases in global supply. There has been a particularly sharp fall in the price of oil, which has dropped by around 50% since the start of last year. Westpac forecasts only a limited recovery in oil prices over the coming year.

Commodity price declines are having a significant impact on earnings in commodity exporting nations. This is affecting both corporate and fiscal revenues, and is making these economies less attractive to investors. Reduced earnings from commodity exports have reinforced growth slowdowns in Brazil and Russia, and have seen growth in many oil exporting Middle Eastern economies slow or turn negative over 2015.

Weakness in commodity prices is also having a significant impact on the Australian economy. The Australian terms of trade fell by around 10% in both 2014 and 2015. And with the supply of hard commodities continuing to expand in the face of slowing demand, another similarly sized fall in the terms of trade is on the cards for 2016. However, a pick-up in labour intensive service exports (such as tourism) and the fall in the AUD will provide an offset, meaning that some recovery in Australian GDP growth can be expected this year.

Figure 10: Global commodity prices



...though conditions in high income economies have firmed

In contrast to lower income economies, GDP growth in the higher income economies of the US, UK and EU has been strengthening. Activity in these economies is more heavily oriented towards services, the growing demand for which is helping to offset softness in manufacturing.

The standout performer in this group continues to be the US, where GDP growth is forecast to accelerate to 2.7% in 2016. US domestic demand has strengthened, supported by gains in private consumption spending and investment outside of the oil sector. This has driven continued improvements in the US labour market, with solid gains in non-farm payrolls in recent months.

This combination of conditions, as well as some lift in core inflation, saw the Federal Reserve increase the federal funds rate in December, with some further increase expected over the coming year. However, with recent global developments prompting a heightened sense of caution among policy makers, hikes are likely to occur only gradually.

New Zealand continues to have a foot in both hemispheres

For New Zealand, recent global developments have been a very mixed bag. On the downside, softer global demand for commodities is directly weighing on the prices for our exports, and is also affecting us through the drag on activity in Australia (our second largest trading partner). On top of this, recent volatility in global financial markets means that New Zealand banks are facing higher offshore funding costs.

However, on the upside, New Zealand is also an importer of commodities. Falls in global oil prices are providing a significant boost to households' real incomes. The resulting low inflation is also adding to the case for interest rate reductions domestically. Finally, New Zealand is benefiting from the income growth in many economies, which is boosting demand for services such as tourism and accommodation.

Economic forecasts (calendar years)

Real GDP % yr	**2012**	**2013**	**2014**	**2015**	**2016f**	**2017f**
New Zealand	2.6	2.4	3.7	2.4	2.6	2.9
Australia	3.6	2.1	2.6	2.3	2.8	2.8
China	7.8	7.8	7.3	6.9	6.6	6.4
United States	2.3	2.2	2.4	2.4	2.7	2.0
Japan	1.8	1.6	-0.1	0.6	1.4	1.8
East Asia ex China	4.6	4.2	4.1	3.6	3.8	4.6
India	5.1	6.9	7.3	6.9	7.9	7.4
Euro zone	-0.8	-0.4	0.9	1.4	1.1	1.3
United Kingdom	0.7	1.7	3.0	2.5	2.5	2.0
NZ trading partners	**3.8**	**3.6**	**3.8**	**3.5**	**3.6**	**3.6**
World	**3.4**	**3.3**	**3.4**	**3.0**	**3.5**	**3.7**

Forecasts finalised 20 January 2016

Agricultural Outlook

Out of the fire but back into the frying pan

International developments and falling commodity prices have replaced El Niño at the top of the list of things keeping farmers awake at night. But it's not all bad news for the agriculture sector. While many developing economies are expected to struggle this year, growth in key developed countries is forecast to improve. This divergent outlook will provide opportunities for some, and challenges for others.

The mood in the agriculture sector has darkened over the last three months, but not for the reasons that we feared in our last *Economic Overview*. That's because, in many places, the grass is actually looking greener. Well, greener than we had feared it might be at the height of summer in the aftermath of a big El Niño event. And while parts of the country remain pretty dry, and drought concerns haven't completely dissipated, it does appear most farmers have dodged this particular bullet – at least for now.

The consequence of improved pasture conditions, particularly for the dairy sector, is that supply hasn't dropped to the extent we had expected. While domestic milk production will still contract this season, global milk supply is continuing to grow strongly. In Europe, production is 2.2% higher in the year to November, while US production is up 1.2% over the year to December. This strong growth in supply combined with lacklustre demand from China is continuing to put downward pressure on prices. We now expect the 2015/16 farm gate milk price to be $4/kg milk solids, and next season isn't looking much better. We're forecasting a $4.60 milk price.

Yet while China is an important market for many agricultural exporters, some have a more diverse customer base than others, exporting not only to developing economies, but also to the rich countries that are currently faring better.

Almost half of New Zealand's beef exports head to the US while more than a third of New Zealand's lamb exports (both by value) are destined for the UK and Europe. In contrast, the vast majority of New Zealand's dairy exports are sent to China and oil producing economies. So while meat prices won't be immune from the effects of insipid demand in China, better growth prospects in the US and Europe should provide at least some offset. Add to this tightening global beef and lamb supplies (with Australian farmers expected to undertake herd and flock rebuilding this year) and prices in the near term are likely to be soggy rather than dreadful.

Another example is wine exporters, who have been insulated from the downdraft in commodity markets by sending the bulk of their exports to countries such as the US, UK and Australia. Horticulture exporters also have important markets in the wealthy economies of Japan and Europe.

The weaker New Zealand dollar is also providing an important boost to incomes of New Zealand exporters. And as we outline in this document, we think the NZ dollar has further to fall yet. While this clearly won't fully offset the dark clouds hanging over the sector as a whole, as dairy farmers struggle through a third consecutive season of very low returns, it should provide a silver lining.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Surprising improvement in prices on the back of tight international supplies but we are sceptical this will be maintained.	High	↘
Wool	Subdued Chinese growth to weigh on demand.	High	↘
Dairy	Soft demand and ample global supply likely to mean ongoing pressure on prices.	Low	↘
Lamb	Diverging fortunes in key markets, but tighter global supplies expected this year.	Average	↘
Beef	Prices have fallen sharply but over the medium term should be underpinned by relatively tight global supplies and ongoing consumption growth in the US.	High	→

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

The Paris Agreement

What it means for the New Zealand economy

New Zealand has agreed to reduce its greenhouse gas emissions. The emissions target is likely to be met mostly by emitting businesses buying surplus carbon units from forest owners or from other businesses that have gained units by reducing global emissions. Agriculture, the country's biggest emitter, is excluded from financial obligations, which will pass the burden onto other businesses and households.

The Paris Agreement aimed to reduce greenhouse gas emissions, which are blamed for climate change. New Zealand's proposed headline target is to reduce post-2020 greenhouse gas emissions to 30% below 2005 levels by 2030.

Some believe that the opportunities for New Zealand's emitters to reduce their emissions are limited. This means New Zealand's emissions targets will likely be met through forestry, which generates carbon units by sequestering carbon, and by buying units from other businesses, whether local or international, that have generated surplus units through reducing emissions.

A key nuance of international climate change frameworks is that they do not require each individual country to physically cut emissions. The most economically efficient way for New Zealand to meet its targets may be to buy offset units from countries that reduce their emissions more than their targets require, while New Zealand businesses continue to emit. As long as the units produced overseas lead to a genuine reduction in global emissions, and New Zealand businesses are paying the market price, the climate change goal is achieved.

A move to reduce global emissions is a step in the right direction, but economically efficient use of resources to limit climate change requires two things. First, a framework will need to be in place to ensure that carbon units traded internationally represent a genuine reduction in global emissions.

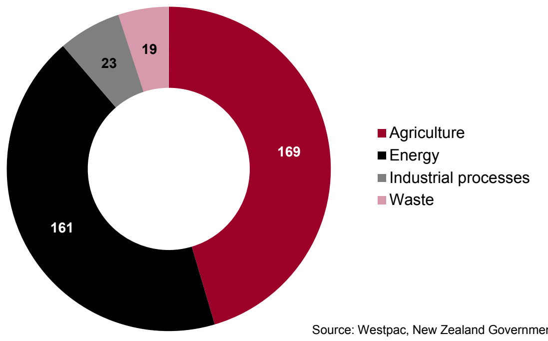
A mechanism whereby carbon units may be traded internationally after 2020, when the Paris Agreement would come into effect, is not yet in place. Our assumption is that an international market will develop, which would allow New Zealand emitters to play their part in reducing global emissions by buying overseas units.

New Zealand has a surplus of carbon units, thanks to carbon sequestration by forests. These reserves are expected to fall as forests are harvested and some are not replanted. This may, in the absence of access to international units, push up the price of units for New Zealand businesses.

The second requirement of an economically efficient system is that it distributes the cost of meeting emissions targets across polluters. The Government has stated that agriculture, which produces nearly half of this country's emissions, will continue to be excluded from financial obligations for the foreseeable future because it does not believe there are currently cost-effective ways for the sector to reduce its emissions.

Figure 11: Agriculture, the largest polluter

Where net emissions came from, 2008-2012 (m tonnes)



Source: Westpac, New Zealand Government

This exclusion passes the cost of agricultural emissions onto taxpayers and other businesses. It means either tighter targets for industries with emissions obligations (energy, landfills, industrial processes and forestry), so that agriculture can continue to emit, or that the Government has to purchase, at taxpayer expense, carbon units to pay for agriculture's emissions. This amounts to an implicit subsidy that will skew the New Zealand economy and land use toward agriculture.

New Zealand's Emissions Trading Scheme (ETS) is currently being reviewed. One aspect of the review is whether the policy whereby emitters included in the scheme are required to surrender one unit for every two tonnes of emissions should continue. This policy shifts half the costs of meeting obligations onto other businesses and households, which similarly skews the use of resources toward carbon-intensive industries as the true costs of operating are not fully borne by the emitter.

An ETS that comprehensively aligns the private cost of emissions with the social cost would be the most economically efficient way of contributing to global emissions reduction efforts.

Inflation and Interest Rates

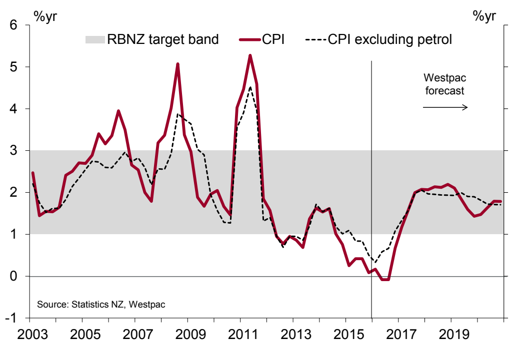
Down and out

We have long expected that low inflation would require the Reserve Bank to cut the OCR to a record low of 2.0%. Recent developments have reinforced this view. Inflation is already below the RBNZ's target band, and over the coming year it will approach historically low levels. While much of this weakness is due to falls in oil prices, there is also a more broad based softness in the prices of other goods and services.

Inflation is set to fall to historically low levels...

Inflation has been below the bottom of the RBNZ's target band for over a year now, and it's set to push even lower. In fact, it's likely the latter half of 2016 will see annual inflation dropping to around zero, with a very real risk it goes negative. The only other time that's occurred in the past 70 years was in 1999, and that was only because of a change in how the CPI was calculated. This softness in inflation isn't just a near-term issue either. We don't expect inflation will be back inside the RBNZ's target band, let alone close to 2%, until 2017.

Figure 12: Inflation forecasts



...partly as a result of falls in oil prices...

A key reason for this weak inflation outlook is the 50% drop in global oil prices since the start of last year, which has resulted in sharp falls in petrol prices. The RBNZ's medium term focus means that they look through temporary changes in inflation associated with volatile items like oil. Prices for such items can swing around quickly, and consequently can be an unreliable guide for setting policy. However, oil prices have already been low for some time. And this isn't just resulting in lower petrol prices. Lower fuel costs have reduced prices for services such as air travel, and have dampened prices on shop floors as the distribution costs for retail items have declined. In addition, as discussed below, the low level of overall inflation resulting from falls in oil prices is weighing on inflation expectations. These developments, especially the latter, will be very hard for the RBNZ to ignore.

...and a more generalised softness in prices...

Just to be clear, our forecasts for low inflation and the need for OCR cuts don't just reflect movements in the price of one volatile commodity. Even excluding petrol prices, inflation has been below 1% for most of the past year, and it's set to remain low through 2016.

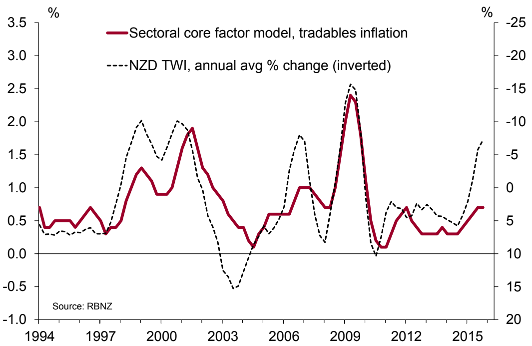
Much of this weakness has been due to conditions offshore. Low global inflation is holding down the prices of many imported goods. This trend looks set to continue for some time given the recent deterioration in global trade and widespread falls in commodity prices.

Domestic conditions are also dampening inflation. Structural changes in the retail sector, such as increased price competition and the growing prevalence of online trading, mean that pass-through from the lower exchange rate into consumer prices has been limited. On top of this, lingering unemployment over the past year has limited pressure on wages.

All of this has resulted in a very soft underlying inflation environment. Measures of core inflation remain low, and even those that have picked up are only at modest levels. The RBNZ has highlighted that its preferred sectoral factor model measure of core inflation (which looks at the underlying trend in prices) sits within their target band at 1.6%. However, even this measure actually demonstrates just how limited inflationary pressures are. Core tradables inflation has actually been remarkably muted given the 10% fall in the exchange rate over the past year, illustrating our point that a lower exchange will not generate enough of a lift in inflation to satisfy the RBNZ's target. At the same time, core non-tradables inflation is only 2.6% despite strong GDP growth in recent years.

In light of these conditions, the RBNZ will have a tough job ahead of it to generate a sustained increase in inflation. The structural influences described above are likely to continue dampening inflation for some time. In addition, given our forecasts for more subdued GDP growth through much of the remainder of this decade, an increase in the underlying rate of non-tradables inflation could be hard to achieve.

Figure 13: RBNZ core tradables inflation and the NZD

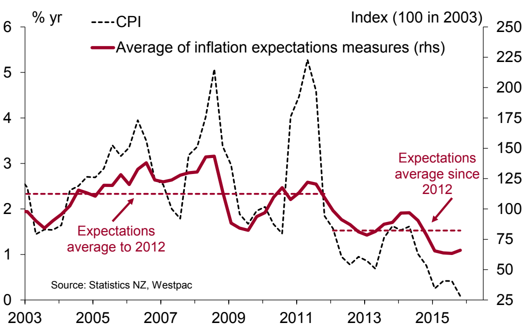


...which is weighing on inflation expectations

Importantly, the extended period of broad based low inflation in recent years has put downward pressure on inflation expectations. That's been reflected in a range of surveys that measure households' and businesses' expectations for prices, costs and wage inflation, all of which have trended down. And with inflation set to take another step down this year, that downward pressure is set to become even more pronounced. In fact, measures of inflation expectations based on market pricing have already fallen by 0.2ppts in the early part of 2016.

This continuing downward pressure on inflation expectations is a major worry for the RBNZ. Inflation expectations are a significant influence on wage and price setting decisions, and as a result play an important role in determining actual inflation. If inflation expectations remain low or continue to fall, it will make the uphill battle the RBNZ has been fighting to generate a sustained lift in inflation that much harder.

Figure 14: Consumer price inflation and inflation expectations



Note: The "Average of inflation expectations measures" is an index that combines 10 survey measures of expected inflation, wages, prices and costs.

The case for cuts – waiting is the hardest part

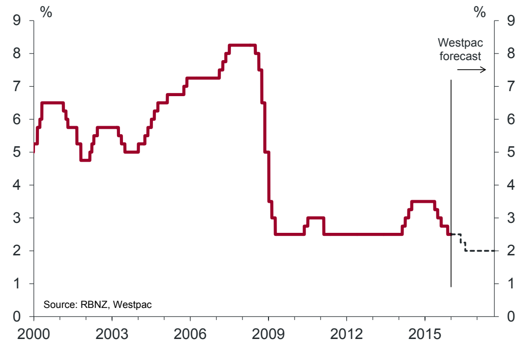
Back in July 2015, we forecast that the OCR would need to drop to a record low of 2%. This reflected our assessment that inflation was not on track to meet the RBNZ's medium term target. Since that time, the deterioration in the inflation outlook and the related downside risk for inflation expectations described above have reinforced this case.

The RBNZ has recognised these developments, and changed course at its January OCR Review, noting that "some further policy easing may be required over the coming year."

RBNZ Governor Wheeler's February speech reiterated the explicit easing bias, focussing almost exclusively on downside risks to the economy. However, the RBNZ did not sound as though it was in a hurry to reduce the OCR. Given the RBNZ's hesitance, we think that it is most likely that we'll see OCR cuts in June and August. However, this will be dependent on the flow of data, and March and April are certainly live decisions. Continued downside surprises in terms of inflation, inflation expectations, or a weakening in the global economy could force the RBNZ's hand earlier than June.

The Governor's speech also stressed the RBNZ's flexible, medium-term approach to inflation targeting. The Governor counselled against focussing on the headline inflation rate of the moment when assessing what might happen to the OCR. That fits very well with the arguments we have outlined above. Our long-held view that the OCR will fall to 2.0% is based on our assessment of medium-term inflation, not today's low rate of actual inflation.

Figure 15: Official Cash Rate



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-16	0.2	2.50	2.60	2.60	2.90
Jun-16	-0.1	2.25	2.30	2.40	2.90
Sep-16	-0.1	2.00	2.10	2.20	3.00
Dec-16	0.7	2.00	2.10	2.20	3.00
Mar-17	1.2	2.00	2.10	2.20	3.10
Jun-17	1.6	2.00	2.10	2.20	3.10
Sep-17	2.0	2.00	2.10	2.20	3.10
Dec-17	2.1	2.00	2.10	2.20	3.00
Mar-18	2.1	2.00	2.10	2.20	2.90
Jun-18	2.1	2.00	2.10	2.20	2.90

Exchange Rates

Lower and lower still

The New Zealand dollar has lost some altitude, and we expect it will fall further in the months ahead due to poor export conditions and falling local interest rates. And there is a looming risk that is not factored into our forecast – the possibility of significant yuan devaluation. In this event the NZ dollar would probably fall against the US dollar, but would rise on a trade-weighted basis.

The New Zealand dollar was surprisingly resilient in the final two months of 2015, trading as high as 69 cents against the US dollar. But as risk-aversion gripped markets in January, the NZD/USD retreated back to around 65 cents. While that is more in keeping with our downbeat view on the exchange rate, we don't think the Kiwi's recent slide has gone far enough. We are forecasting quarter-averages for the NZD/USD of 61 cents later this year. Given normal intra-quarter trading ranges, that implies the New Zealand dollar could trade in the 50s at some point.

There are two compelling reasons to expect a lower exchange rate. First, the New Zealand dollar is a classic commodity currency, meaning it tends to wax and wane with global commodity prices (see Figure 16). As the world sinks further into a low commodity price environment this year, so further downward pressure will be applied to the New Zealand dollar. Second, we expect that the RBNZ will reduce interest rates further than markets anticipate this year, which will dampen investor enthusiasm for New Zealand.

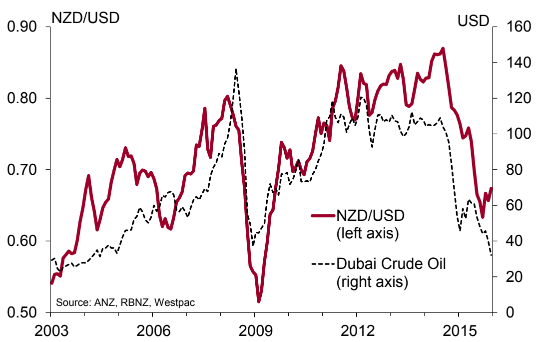
We have less conviction in our forecasts of the New Zealand dollar against the Australian dollar. We are essentially forecasting the cross to move sideways from here. The relative interest rate outlook between the two countries argues for a lower NZD/AUD – we expect interest rate reductions in New Zealand but not in Australia. However, the relative fortunes of the two countries' export sectors argue for a stronger NZD/AUD. Australia's key export sectors are enduring even more severe price declines than New Zealand's, as Australia is more bound up with China's economy than New Zealand.

There is one looming risk that is not factored into our forecasts – Chinese yuan devaluation. There is currently a rush of Chinese investors seeking to buy overseas assets, selling yuan in the process. In order to maintain the (more-or-less) fixed exchange rate, the Chinese authorities have been forced to buy up these excess yuan. China finances these yuan purchases by selling its foreign exchange reserves. Obviously, China can only continue on this path for as long as its reserves last.

One way out of this situation would be for China to devalue the yuan earlier rather than later. This would discourage imports, encourage exports, and could reduce the outflow of capital, all of which would balance supply and demand for yuan. A pre-emptive devaluation is looking like a more realistic possibility every day.

The New Zealand dollar would be caught up in any yuan devaluation, and would fall against safe haven currencies like the US dollar, euro, yen and sterling. However, the New Zealand dollar would probably rise against most East Asian currencies and the Australian dollar, as the latter regions are more exposed to China than New Zealand. This implies that yuan devaluation would actually push New Zealand's trade-weighted index (TWI) higher. Australia, China and East Asia make up 60% of the TWI, versus 37% for the safe haven currencies (Canada and India comprise the remaining 3%). Thus a yuan devaluation could actually become one more factor that depresses inflation in New Zealand.

Figure 16: NZD/USD and the price of oil



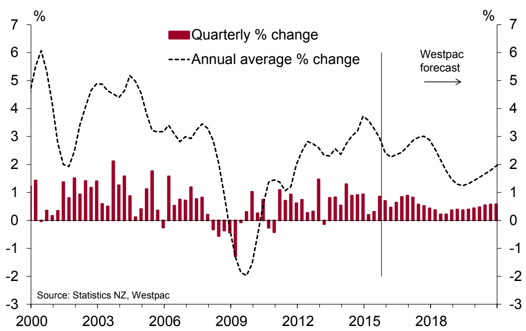
Exchange Rate Forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Mar-16	0.65	0.93	0.61	0.44	79.5	71.1
Jun-16	0.63	0.93	0.61	0.44	77.7	70.1
Sep-16	0.61	0.92	0.59	0.43	75.9	68.4
Dec-16	0.61	0.91	0.58	0.42	76.5	68.0
Mar-17	0.62	0.90	0.57	0.41	75.9	67.7
Jun-17	0.62	0.89	0.57	0.40	75.9	67.1
Sep-17	0.62	0.87	0.56	0.39	75.9	66.5
Dec-17	0.62	0.88	0.56	0.39	77.0	66.9
Mar-18	0.62	0.87	0.56	0.38	77.1	66.5
Jun-18	0.60	0.87	0.56	0.39	73.4	65.5

Forecasts and key charts

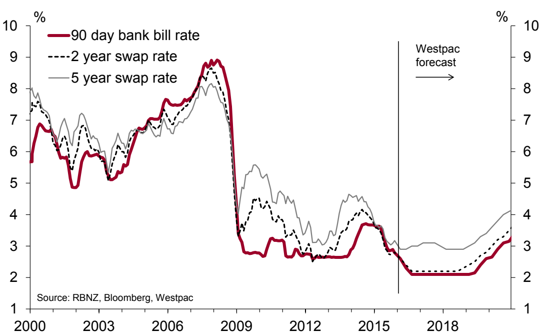
Annual average % change	March years				Calendar years			
	2015	2016f	2017f	2018f	2015	2016f	2017f	2018f
GDP (production)	3.6	2.3	2.9	2.5	2.4	2.6	2.9	1.5
Private consumption	2.6	2.3	2.9	3.1	2.4	2.6	3.3	2.3
Government consumption	2.3	1.8	0.9	1.5	2.0	0.8	1.4	1.8
Residential investment	11.6	4.7	8.7	1.1	5.0	7.9	4.1	-7.3
Business investment	9.0	1.6	2.9	5.0	2.3	1.3	6.9	-0.2
Stocks (% contribution)	0.1	-0.4	0.1	0.0	-0.4	0.1	0.0	0.0
Exports	4.2	5.9	3.0	2.1	6.6	3.5	2.2	2.0
Imports	7.4	2.5	3.6	3.6	3.8	2.5	4.5	1.0
Inflation (% annual)	0.3	0.2	1.2	2.1	0.1	0.7	2.1	2.2
Employment (% annual)	3.2	1.2	2.8	1.2	1.4	2.8	1.7	0.6
Unemployment rate (% s.a. end of period)	5.8	5.8	5.2	5.4	5.3	5.3	5.3	5.6
Labour cost index (all sectors, % annual)	1.7	1.7	1.5	1.6	1.5	1.5	1.5	1.6
Current account balance (% of GDP)	-3.4	-3.4	-3.6	-3.8	-3.3	-3.7	-3.9	-3.8
Terms of trade (% annual)	-5.6	-2.2	4.6	0.0	0.0	2.5	1.0	0.0
House prices (% annual)	9.0	11.3	6.9	4.2	15.1	5.0	5.0	2.0
90 day bank bill (end of period)	3.63	2.60	2.10	2.10	2.80	2.10	2.10	2.10
5 year swap (end of period)	3.71	2.90	3.10	2.90	3.10	3.00	3.00	2.90
TWI (end of period)	77.9	71.1	67.7	66.5	72.1	68.0	66.9	65.5
NZD/USD (end of period)	0.75	0.65	0.62	0.62	0.67	0.61	0.62	0.58
NZD/AUD (end of period)	0.96	0.93	0.90	0.87	0.93	0.91	0.88	0.91
NZD/EUR (end of period)	0.67	0.61	0.57	0.56	0.61	0.58	0.56	0.58
NZD/GBP (end of period)	0.50	0.44	0.41	0.38	0.44	0.42	0.39	0.40

New Zealand GDP growth

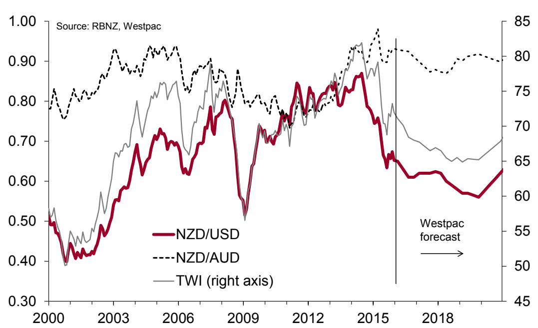


New Zealand employment and unemployment

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



NZD/USD, NZD/AUD and TWI



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