ASB

Quarterly Economic Forecast

November 2017

Opportunity and uncertainty

- Election-related uncertainty to be short-term only.
- Rapid minimum wage increases to boost NZ wage growth.
- Housing market to remain cool with investors to stay cautious.

Since we published our last Quarterly in August, NZ has joined the list of countries that have had voting outcomes delivering a change in direction. **Inevitably, the change brings about a period of uncertainty about the environment that businesses will operate in over the coming years.** When people are uncertain about how new policies may affect them, there is a risk that decisions get deferred for a period. But for many, changes will be hard to notice. And we emphasise that any uncertainty is going to be short lived. Change also brings opportunity.

It is very early days for the new Government, and it will take time for key policies to be thoroughly formed and put into place. But there are some broad policy implications that will influence the economy.

Inbound migration will slow more rapidly, cooling population growth. That means overall economic growth will not be quite as strong (though there will be some offset from stronger government spending). The policy balancing act will be reducing the inflow without making it impossible to fill some job vacancies for which migrants are the only real option.

The minimum wage increases will be more rapid than in recent years, and are also likely to flow over to other wage rates if businesses want to retain a degree of relativity to the minimum wage. For small businesses, particularly those that employ a large share of low-skilled workers, these wage pressures can be hard to absorb. It will really put the focus on seeking productivity gains to help ‘pay’ for the wage increases.

Housing will see different influences. Future tax changes will make property investors more cautious, with flow-on effects to businesses supporting investors and real estate. But at the same time, the Government will be pushing hard to build more homes in a number of main centres around the country. In particular, the Government is keen on exploring innovative ways of building, which will create new opportunities in the construction sector. And those ideas will be sorely needed. The construction sector is creaking at the seams, and being able to build smarter will become important to minimise the risk of the Government’s KiwiBuild scheme crowding out private-sector building.

An important thing to remember in times of uncertainty, even if short-lived, is to focus on what you can control. A second important thing to remember is that the underlying economic picture is what will have the dominant influence on the business environment. Local and overseas influences point to overall economic growth around 3%, which is still pretty decent. Even with some looming changes to the Reserve Bank’s policy target, interest rates are still likely to be low for some time, certainly over the next year.

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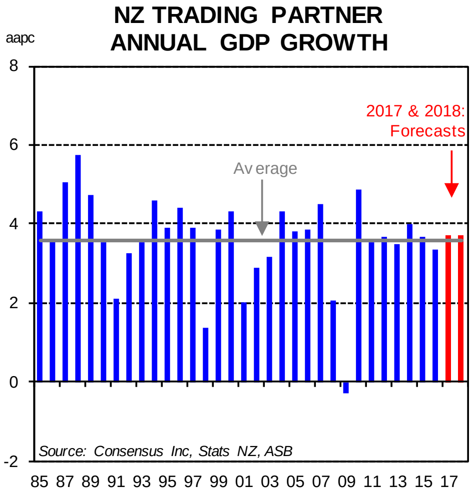
International outlook – Cautious optimism

The global economy is turning the corner, albeit slowly. Obvious political tensions and pressure points remain, but the global economic outlook has undeniably improved for most of our key trading partners over the course of the year. At the centre of the improvement is China, with its improved outlook lifting many boats. As Chinese growth moderates over 2018, we anticipate that the global-growth baton will be shared around. With this in mind, we are cautiously optimistic that the global growth recovery can be sustained.

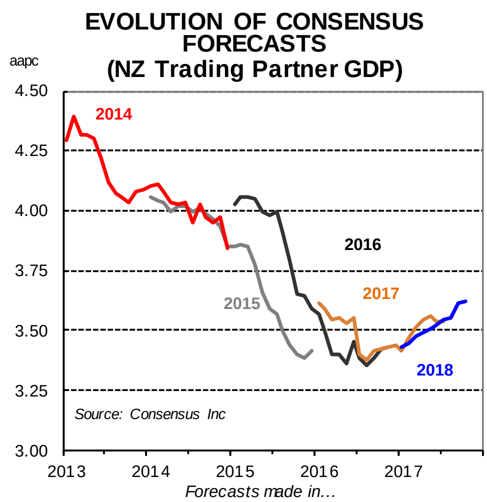


Improved prospects for the Chinese economy have underpinned our improved global outlook. We continue to expect China will grow at a healthy 6.8% pace over 2017. It also seems that now other forecasters share our long-held view; in October the Consensus forecast for 2017 lifted to 6.8% from 6.2%. Indeed, it appears that Chinese leaders ensured robust growth in order to secure their power base at the 19th Communist Party Congress in Q4 2017. With Xi Jinping's leadership now firmly entrenched, leaders may be more comfortable with slower (and more-balanced) growth over 2018 and beyond. **We anticipate a slowing in growth to 6.3% by the end of 2018.**

We are also more upbeat on US prospects, with increased optimism that US President Trump can implement tax reforms that will boost US growth. We anticipate that Congress is likely to pass modest tax cuts worth around 0.6% of US GDP in 2018 and 2019. As a result, we have increased our US GDP growth forecast for 2018 from 2.2% to 2.5% and for 2019 from 1.8% to 2.1%. Given the stronger US growth outlook, **we also expect the US Federal Reserve to remove monetary stimulus slightly earlier than we had previously expected.** In addition to a December 2017 Fed hike, we now expect two further hikes over 2018 (March and June), which would take the Funds rate to 2% by the end of 2018 (1.75% previously).

The Australian economy has recovered from a rocky start to 2017, with GDP rising 0.8% in Q2 (+1.8% yoy). We expect this improvement to continue supported by strengthening global growth, the pick-up in non-mining investment, low interest rates, the strengthening labour market, and with higher commodity prices boosting commodity export incomes. As a result, **we expect Australian growth to improve to 2.3% by the end of calendar 2017, and then to 3.0% by 2018.**

In the rest of the world, the growth outlook has generally firmed. The Eurozone economy, in particular, has fared better than expected so far this year, with Consensus growth forecasts for 2017 rising by 0.5% percentage points since the start of the year. Japanese growth prospects have also firmed, but like much of the rest of the world, inflation remains very low.

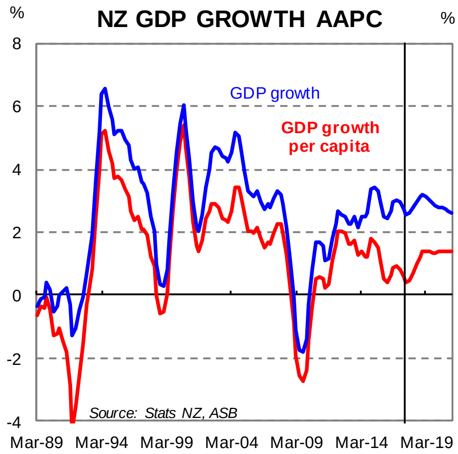


Geopolitical hot spots like North Korea remain. And even normally calm Germany is battling to form a new coalition government following its 24th September election. While Angela Merkel will retain her role as Chancellor, her negotiating position is weaker than in the previous coalition. From here, we expect further political storms of varying intensities and locales to appear occasionally.

All up, **the combined economic prospects of our trading partners continue to improve.** Indeed since the previous quarter, Consensus forecasts for growth of our trading partners for both 2017 and 2018 have lifted to 3.7%, up 0.2 and 0.1 percentage points, respectively. These changes lift forecast growth marginally above its long-term average.

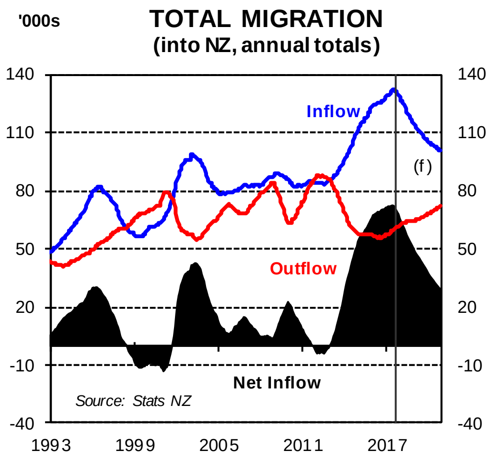
The New Zealand Economy – slower immigration, stronger wage growth

Economic growth slowed slightly over the first half of 2017 and we expect election-related uncertainty to dampen growth in the second half of this year. However, we remain **positive on the outlook beyond 2017 with growth expected to firm to around 3% by mid-2018. Recent economic growth outturns have proven weaker than expected**, which prompted us to review two key assumptions. First, **construction activity unexpectedly contracted** over the first half of the year. Upon closer scrutiny, evidence suggests demand remains robust but **supply constraints look to be holding back construction sector expansion (labour shortages appear particularly acute**). Second, **imports relative to demand have proved to be more robust than expected, weighing on overall GDP.** Domestic demand has picked up broadly as we expected, with low interest rates and a rebound in dairy prices supporting a lift in household spending and plant and machinery investment. However, more of this demand has been met by imports than we had assumed. Going forward, we expect this trend to continue and, as such, we expect **slower NZ *gross domestic production* growth than previously.**



Some of our forecasts have been **tweaked to account for likely new policies of the incoming Government**. However, at the time of writing many policy details remain light, and we have been unable to fully account for their economic impact. **The key changes we have made so far include a sharper fall in net migration, faster wage growth and slightly weaker house prices.** We will update our forecasts as more details emerge.

Slower population growth will result in slower demand growth for housing and services. However, weaker labour force growth will likely tighten the labour market and push up wages. The minimum wage is set to increase from $15.75 per hour at present to $20 by 2021, which, along with recent pay equity settlements, will further boost wage growth and lift household incomes. **We expect rising household incomes to support per-capita consumer spending,** along with stronger rural incomes and low interest rates. However, we see headwinds to household spending growth from a softer housing sector, with slower house price growth weighing on consumer confidence and slowing demand for durable consumer goods as housing construction peaks.



The housing outlook is a key area of uncertainty. We expect housing construction to continue to strengthen in Wellington and remain steady in Auckland, as continued housing supply shortages underpin construction demand in these cities. Meanwhile, house building demand is likely to ease from cyclically-high levels throughout the rest of the country as population growth slows. The Labour/NZ First Government housing policies are likely to result in slightly less pressure on house prices than we previously expected. Nonetheless, **we continue to expect the physical shortage of housing in Auckland and Wellington to support house prices.**

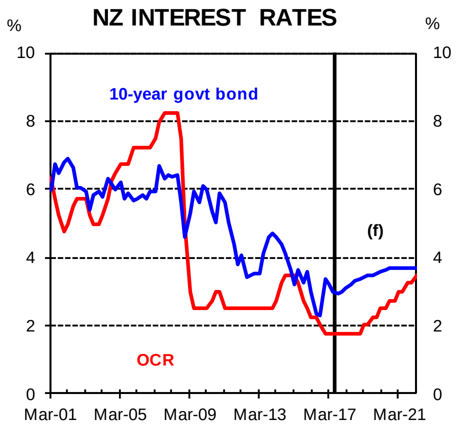
Improving global incomes will continue to support NZ export demand. We expect NZ merchandise Terms of Trade (export prices relative to import prices) to remain near historically-high levels. Strong global demand recently drove butter prices to record highs. Furthermore, poor grass growing conditions in spring will likely squeeze NZ production and provide ongoing support to dairy prices. We continue to stick with our 2017/18 milk price forecast of $6.75/kg. Growth in exports of services may slow as the **tourism sector hits capacity constraints** (in particular, accommodation).

Headline CPI inflation recently lifted back above 2% at the start of 2017, due to volatility in food and fuel prices. We expect this lift will be temporary, and for headline inflation to fall briefly again over 2018. We expect inflation to remain in the bottom half of the RBNZ's 1-3% target band until late 2020.

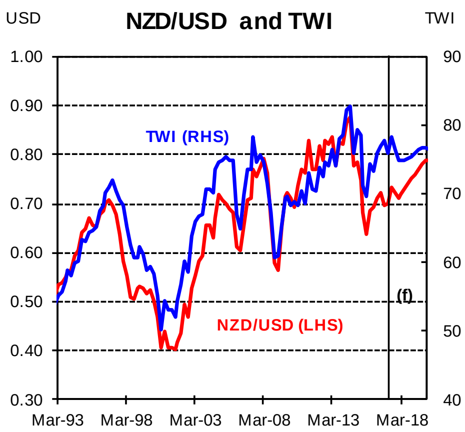
Interest Rates and Exchange Rates – new government muddies outlook

The Official Cash Rate (OCR) has now been at a record-low 1.75% for a year. Given this extended period of stability in the OCR, short-term interest rate movements have also been subdued. With the OCR unlikely to change until 2019, short-term interest rate movements are likely to remain muted for some time.

However, the **arrival of a new Labour-led Government has somewhat muddied the future path of interest rates.** The Government intends to review and reform the Reserve Bank Act, including adding an employment target to the agreement. These changes are unlikely to change the average level of NZ interest rates over the longer term. However, by targeting two economic variables, rather than one, there is a chance that monetary policy could develop slightly differently over the economic cycle than if the RBNZ continued to solely target inflation.



Longer-term rates, on the other hand, are more influenced by offshore interest rate movements. US rates had been easing following the post-US election highs. However, with tax reforms back in the spotlight and a Fed rate hike expected in December, US rates have resumed their slow creep higher. NZ long-term rates remain historically low, but are expected to drift gradually higher as global rates rise and domestic inflationary pressures stir.



The NZD has fallen sharply in the aftermath of the General Election. In the days following the coalition announcement the NZD/USD fell around 5%, with the NZ trade-weighted index also falling nearly 4%. Although there is a risk of further NZD softness in the near term, the fundamental drivers of the NZD remain intact. For example, New Zealand's near record-high Terms of Trade, strong export commodity prices and narrow current account deficit will continue to support the NZD outside of these near-term headwinds.

As a result, **we expect the NZD/USD to resume its pre-election upward trend early next year.** However, the pace of this lift is likely to be somewhat tempered by a stronger USD as we expect the US Government to pass the tax reform bill this side of Christmas. Elsewhere, we expect major currency pairs to remain largely steady. For example, the NZD/GBP appears to have peaked following the GBP's post-Brexit lows. Although the BoE's first rate hike in 10 years didn't boost the GBP, the risk is the market starts to price in further UK rate hikes, which will support the Pound.

The NZD/AUD has also fallen substantially following the election. Although we expect some recovery in the NZD/AUD, Australia's improving fundamentals limit the upside risk. Finally, we expect the EUR/USD to lift further as a result of the ECB tapering asset purchases. Outside of near-term NZD/EUR volatility, we expect the NZD/EUR to remain largely steady.

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Economic and Financial Forecasts

ASB economic forecasts		Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<<actual	forecast >>								
NZ GDP real	**AA%**	**2.7**	**2.5**	**2.6**	**2.8**	**2.9**	**3.1**	**3.2**	**3.1**	**2.8**	**2.6**
private consumption	AA%	4.7	4.1	3.9	3.2	2.9	2.9	2.8	2.9	2.7	2.3
dwelling construction	AA%	6.3	3.2	0.8	0.4	1.8	2.6	2.7	1.9	-1.9	-2.7
other investment	AA%	3.8	4.8	4.4	3.8	4.1	4.1	4.3	4.4	3.7	3.8
exports	AA%	0.0	-0.3	0.9	2.1	1.7	2.4	2.4	2.3	2.6	2.6
imports	AA%	6.0	6.0	5.4	4.7	4.6	4.3	4.2	4.1	3.3	2.6
NZ GDP real	A%	2.5	2.5	2.8	3.2	3.2	3.2	3.1	2.9	2.8	2.6
NZ GDP real	Q%	0.8	0.7	0.7							
NZ CPI	**A%**	**1.7**	**1.9**	**2.1**	**1.5**	**1.5**	**1.5**	**1.0**	**1.3**	**1.8**	**2.1**
NZ house prices (QV index)	A%	5.3	1.6	-0.1	-0.7	-1.8	-1.4	0.6	1.0	0.7	0.7
NZ unemployment (sa%)	Qtr	4.8	4.6	4.8	4.9	5.0	5.0	5.0	4.9	4.3	3.9
NZ private sector wages (LCI)	A%	1.6	1.9	1.9	2.0	2.3	2.2	2.3	2.4	2.8	2.8
NZ current account ($b)	Yr	-7.5	-7.5	-8.3	-7.5	-8.5	-9.0	-9.3	-9.2	-9.3	-9.3
as a % of GDP	Yr	-2.8	-2.8	-3.0	-2.7	-3.0	-3.2	-3.2	-3.2	-3.1	-3.0

A%=percentage change since same quarter the previous year

AA%=percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
(end of quarter)		<<actual	forecast >>							
NZ cash rate target	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	3.00
NZ 90-day bank bill	1.96	1.96	2.00	2.00	2.00	2.00	2.15	2.25	2.75	3.25
NZ 3-year swap rate	2.54	2.41	2.45	2.50	2.60	2.70	2.80	2.90	3.35	3.70
NZ 10-year gov't stock	2.97	2.96	3.00	3.10	3.20	3.30	3.35	3.40	3.60	3.70

ASB foreign exchange forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-20
(end of quarter)		<<actual	forecast >>							
USD per NZD	0.733	0.722	0.71	0.72	0.73	0.74	0.75	0.76	0.79	0.75
GBP per NZD	0.563	0.538	0.53	0.53	0.53	0.54	0.54	0.53	0.54	0.54
AUD per NZD	0.951	0.920	0.91	0.90	0.90	0.90	0.90	0.90	0.90	0.89
JPY per NZD	82.0	81.3	79.5	79.2	78.1	78.4	78.8	79.0	79.0	81.0
EUR per NZD	0.640	0.613	0.61	0.61	0.61	0.61	0.61	0.61	0.60	0.59
CNY per NZD	4.96	4.82	4.72	4.72	4.71	4.74	4.76	4.79	4.82	4.58
TWI - 17 country	78.4	76.4	74.9	74.9	74.9	75.3	75.4	75.8	76.5	74.0

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