Quarterly Economic Forecast

August 2018

Don’t worry, be happy (please)

- NZ growth should still benefit from a variety of drivers to keep growth around 3%.
- Healthy export earnings and resurgent house-building will offset softer business investment.
- But trade tensions and the risk of talking ourselves into a downturn are threats to that performance.

The first thing to say about NZ’s growth outlook is that we are positive about it. We expect growth to pick up from the moderate pace that set in from the middle of last year, and head back to a 3+% pace heading into 2019. Over 2020 per-capita growth should settle around the pace averaged over 2012-2016, the purple patch of our post-crisis economic expansion.

We see an economy that is being supported by solid fundamentals, with the drivers of growth being slightly more tilted to net exports. Global growth prospects remain very respectable – provided full-blown trade wars don’t occur. Our Terms of Trade will hold not too far off their recent record high, courtesy of strong export prices. This export performance is boosting incomes across many regions of NZ, evident in our Regional Scoreboard. For the past 3 years, provincial NZ has continuously taken the Number 1 ranking in the Scoreboard.

Domestically, a number of supports remain in place. Interest rates will remain low into 2020 on our updated OCR outlook. Population growth will continue at an above-average pace, even as the net migration inflow gradually slows. And a stronger focus on the quality of inbound migrants, such as refining lists of needed skills, should mean a greater economic contribution from the slight mix shift. Housing construction is set to surge again this year. The new Government is delivering more stimulus through more welfare support and added infrastructure development. But there is likely to be some drag from commercial construction, particularly in the wake of the construction sector’s internal challenges. Weak business confidence risks holding back investment by businesses.

There is a lot of debate at present about the direction of the economy, particularly given the depths to which business confidence has plummeted over the past 9 months. Our forecasts put us at the ‘cheerleading’ end of the spectrum rather than the ‘Chicken Little’ end. Where will reality end up?

What does seem relatively certain is that NZ’s expansion has been going for a considerable period, and it does need some fresh drivers as recent ones mature. Businesses are starting to face – or at least anticipate – added cost pressures, but seem less certain of their ability to pass these on or sufficiently adapt. And businesses have genuine anxiety about potential shifts in government policy, such as industrial relations, which may not recede until clarity is provided.

Aside from the risks from current trade tensions, business uncertainty is the biggest risk to a decent growth outlook. Downbeat perception is bumping up against what appears to be a decent reality. What will win out? At this point we anticipate reality will eventually bolster perceptions, rather than the other way around. But the risks are clear.

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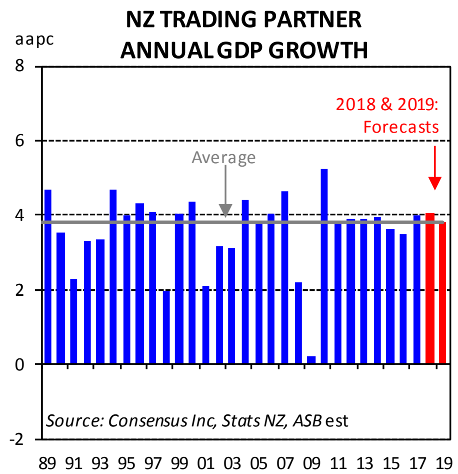
International Outlook – mix, match and more trade concerns

At a high level, **the global growth outlook remains firm and supportive of the NZ export sector.** In numbers terms, various forecasts for global and trading partner growth have effectively been unchanged over the quarter. **But the "unchanged" forecasts mask both a change in the mix of global growth and increasing downside risks,** on the back of the escalation in US-China trade tensions over the quarter.

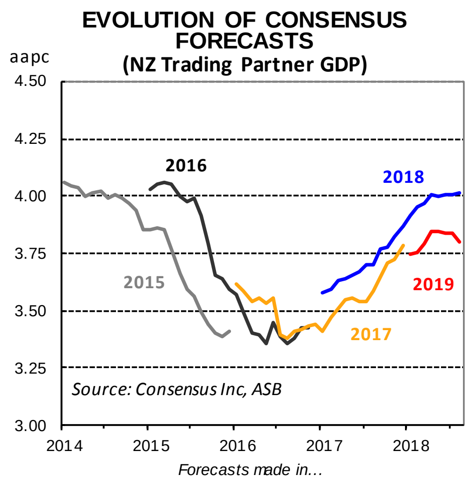


Importantly, **the US-China trade skirmish shifted from threats to actual tariff measures.** Moreover, the trade war has moved further away from a resolution in recent months. In July, the US implemented tariffs on US$34 billion of imports from China – China swiftly followed suit with equivalent tariffs on US imports. Since then, the latest tit-for-tat threat has seen the Washington more than double the value of its tariff threats against Beijing, announcing plans to increase the size of proposed duties on $US200 billion worth of Chinese goods to 25%, from 10%.

On balance, **the changing mix of global growth and the increased risk from US-China trade tensions are a slight negative for NZ export demand and export income.** In particular, less Chinese growth offset by more US growth is an unfavourable growth mix for NZ export demand. This dynamic occurs as China is often our largest market and thus the marginal buyer of our key exports such as dairy, logs and lamb. Subsequently, we have shaded down our export prices and Terms of Trade forecasts compared to last quarter, although these remain near record highs.

Looking at China, momentum in the Chinese economy has slowed over recent months as the economy has faced headwinds from the US tariffs, slumping equities and slowing credit growth. Recent PMIs suggest that the June activity slowdown extended into July, with the export orders components notably weak. Moreover, Chinese equities continue to be weak, with the Shanghai Composite Index 26% below January peaks.

In a sure sign of waning growth, **Chinese officials have begun to provide stimulus to the economy**. Already, the People's Bank of China (PBoC) cut the reserve ratio requirement (RRR) for major banks by 50 basis points to 15.5% in July. And from here, we expect further RRR cuts. In addition, Chinese officials announced tax cuts and fee reductions to further boost growth.



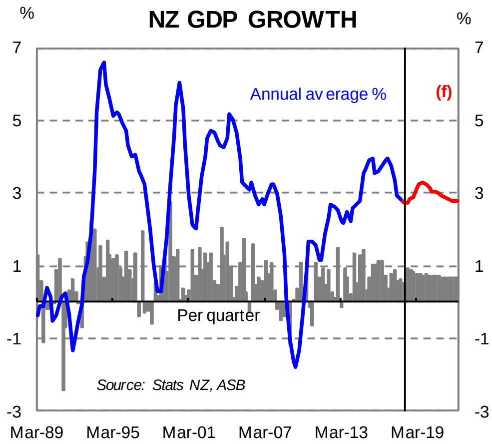
In contrast, **the US economy is cranking along as tax cuts begin to boost economic growth**. Growth surged over Q2, with the US economy posting 4.1% annualised growth. The labour market is similarly strong, with the US unemployment rate sitting at 3.9% in its July reading. Importantly for the Fed, inflation is also strengthening; the Fed's favoured inflation measure (PCE core consumer prices) printed at 1.9% over Q2, leaving it very close to the Fed's target.

As a result, **the Fed has reiterated its plans to continue gradually tightening monetary policy.** Specifically, the Fed continues to pencil in one hike per quarter. For our part, we see two more Fed moves in 2018, followed by two more over 2019. This would take the Fed funds rate band to 2.75% to 3.00% from 1.75% to 2.00% as it stands.

Elsewhere, **the growth outlook has waxed and waned over the quarter, but generally remains positive.** Across the Tasman, we expect growth of 3% or above for 2018 and 2019. Similarly, Eurozone growth has been relatively healthy by recent standards, with signs that inflation is picking up. For the Reserve Bank of Australia (RBA) and the European Central Bank (ECB), respectively, we expect hiking cycles to begin in November and September 2019, respectively. Meanwhile, after its hike this month, we expect the Bank of England to hold off until the June 2019 quarter.

The New Zealand Economy – healthy but with risks

We continue to expect economic growth will be supported by low interest rates, high Terms of Trade, strong population growth and improving labour incomes. Nonetheless, our relatively upbeat outlook is overshadowed by a number of growing risks which, if they eventuate, may see growth underperform our forecasts.

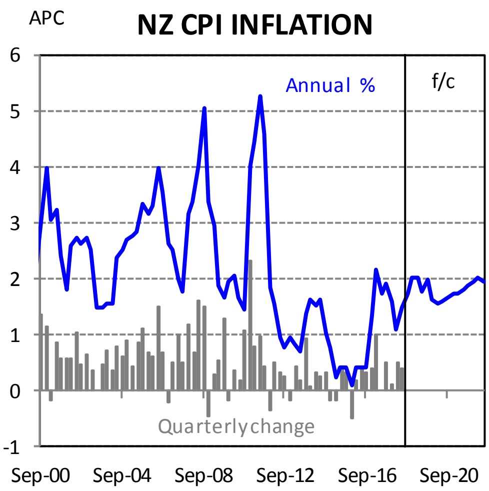


A key risk to our outlook stems from the recent trade spat between NZ's major trading partners. We anticipate that the tariffs announced so far are likely to only have a small impact on global economic growth (in particular, we expect Chinese economic growth would only fall by 0.2 percentage points). However, there is a **growing possibility that trade tensions escalate further,** in which case increasing trade restrictions will reduce global growth and weaken one of NZ's key economic supports.

The second key risk to our outlook stems from New Zealand's low level of business confidence, which has persisted for nine months. Weak business confidence is now broad based across various industries, which is surprising given that some of these industries are still seeing ongoing demand growth (albeit at a slower growth rate than a year ago). This highlights to Government officials the importance of managing perceptions. **We have made some allowance for a small contraction in business investment (excluding construction) over 2018**. However, we assume New Zealand's strong economic fundamentals assert themselves and that business confidence will strengthen by the end of the year.

Building consents issued over recent months proved considerably stronger than expected, which has led to some sizable upward revisions to our near-term construction outlook**. Nonetheless, we still believe we are close to the peak in construction**, with confidence in the construction sector falling and evidence of limited spare capacity in the industry to enable further growth. Near-term growth in construction will offset declines in other forms of business investment such as plant and machinery, and we still expect strong GDP growth over the rest of 2018.

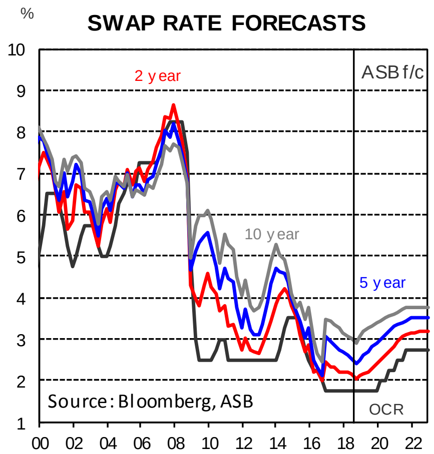
We expect a strong labour market, rising wages, population growth and low interest rates to support consumer spending growth. However, there is **some risk that a weak housing market in Auckland and a slowdown in visitor arrivals may weigh on retail activity in the near term.** A key driver of our GDP growth forecasts is our expectation that stronger wages will boost consumer spending. **A tight labour market, higher inflation benchmarks and minimum wage increases are all factors which should see wage inflation accelerate over the next few years**. We also expect that households will increase spending in line with income growth, underpinned by strong consumer confidence due to a strong labour market and perceptions of high job security. Furthermore, income growth is likely to be greatest for those on lower incomes (i.e. at or close to the minimum wage) and who have a higher propensity to spend, which is another factor that will boost consumer spending.



However, **we also expect house price growth to be weak over the next few years**, reflecting reduced affordability, a catch-up in housing supply, and reduced investor demand. There is some risk that a muted housing market will affect households' perceptions of financial security, resulting in an increase in precautionary savings.

Inflation is expected to lift back toward 2% in the near term through continued increases in housing and fuel costs. Core inflation measures are also lifting. However, with prices growing fastest in areas of non-discretionary spending such as fuel and housing, discretionary consumer spending may be eroded as a result. **The risk remains that inflation pressures are relatively moderate in 2020, even after allowing for a boost from higher wage inflation.**

Interest Rates and Exchange Rates – No OCR hikes until 2020 and lower end-point



The cautious RBNZ assessment and our expectation that CPI inflation will remain low have seen us push out the start of the next expected RBNZ tightening cycle to February 2020 (previously November 2019). The Official Cash Rate (OCR) has been at record lows (1.75%) since late 2016, but the RBNZ has recently become more cautious in its interest rate outlook. The August 2018 Monetary Policy Statement pledged to keep the OCR at current levels into 2020, with a neutral bias for subsequent OCR moves. We remain constructive on the economic outlook and do not expect RBNZ cuts. **However, the risk is that if inflationary pressure fails to materialise,** eventual OCR increases may occur later than early 2020.

We have also revised down our assumed end-point for the extent to RBNZ tightening, with the OCR expected to peak at just 2.75% this cycle (from August 2021 onwards). This is based on our updated judgement that the 'neutral' OCR is now closer to 3% than the circa 3.5% assumed by the RBNZ. We also expect that the RBNZ will tread more carefully given the moderate policy tightening expected from other central banks and downward global risk profile: the RBNZ is unlikely to continue to raise rates when overseas central banks are on hold or contemplating rate cuts. **Longer-term NZD rates should move higher with global counterparts.** We expect a further 100bps of Fed hikes through to mid-2019, which should see US 10-year Treasury yields move above 3% before year end. US yields should remain capped at relatively-low levels as the Fed tightening cycle matures. NZD swap yields are expected to gradually drift above US counterparts, although modest RBNZ tightening, a contained backdrop for NZ inflation, and strong demand should cap NZ yields at low levels.

We also have a stronger USD outlook given the solid US growth outlook, high Terms of Trade, and continued repatriation of US profits. Escalating trade tensions, emerging market risks and slowing growth in China will likely further support the USD. **We expect the NZD to oscillate in a 65 to 71 US cent range over the forecast period.** The more moderate profile for NZ interest rate increases and the weaker outlook for the Chinese yuan have also seen us marginally scale back our NZD forecasts against other NZD bilaterals. Nevertheless, the **NZD TWI should remain broadly supported by a solid growth outlook, our historically-high terms of trade and upwardly-drifting NZ interest rates.**

The NZD is expected to remain in a 90-91 Australian cent zone through to the end of next year. Our CBA colleagues have delayed the timing of the commencement of the RBA's tightening cycle to November 2019, and the Chinese and Australian terms of trade outlook is weaker. **We expect the NZD to ease slightly over the projection period relative to EUR.** The European Central Bank is expected to hike rates in September 2019 although slow growth in the Eurozone will limit the extent of ECB tightening. Political uncertainty in Italy, the weak fiscal outlook in some countries, and risks of an escalation in trade tensions should cap euro upside. We also expect that Brexit risks will keep the **GBP low against the NZD**. Low inflation is expected to keep the Bank of Japan on hold, **with the NZD/JPY modestly strengthening over the forecast period**.

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Economic and Financial Forecasts

ASB economic forecasts		Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
		<<actual	forecast >>									
NZ GDP real	**AA%**	**2.7**	**2.7**	**2.8**	**2.9**	**3.1**	**3.3**	**3.3**	**3.3**	**3.1**	**3.0**	**2.8**
private consumption	AA%	3.8	3.4	3.2	2.7	2.8	3.0	3.2	3.4	3.4	3.2	3.2
dwelling construction	AA%	0.7	2.8	4.8	6.5	8.1	7.7	5.3	2.9	0.3	-2.6	-3.5
other investment	AA%	5.5	5.9	5.9	4.0	2.0	0.3	-0.5	0.0	1.1	4.2	4.7
exports	AA%	3.8	3.9	4.0	3.9	4.3	4.9	4.8	4.1	3.2	2.0	1.4
imports	AA%	7.0	7.4	6.9	4.8	2.7	1.4	1.0	1.5	2.1	2.8	3.1
NZ GDP real	A%	2.7	2.7	3.0	3.2	3.5	3.3	3.1	3.1	3.1	2.9	2.8
NZ GDP real	Q%	0.5	0.9	0.9								
NZ CPI	**A%**	**1.1**	**1.5**	**1.8**	**1.9**	**1.7**	**2.1**	**1.8**	**1.6**	**1.6**	**1.7**	**2.0**
NZ house prices (QV index)	A%	6.6	5.7	4.9	2.7	2.5	1.9	1.9	1.5	1.1	0.7	0.7
NZ unemployment (sa%)	Qtr	4.4	4.5	4.4	4.3	4.2	4.2	4.1	4.2	4.1	4.1	4.0
NZ private sector wages (LCI)	A%	1.9	2.1	2.0	2.0	2.1	2.3	2.4	2.5	2.7	2.7	2.5
NZ current account ($b)	Yr	-7.9	-8.8	-9.4	-9.3	-7.9	-7.6	-7.7	-8.0	-8.1	-9.5	-10.5
as a % of GDP	Yr	-2.8	-3.0	-3.2	-3.1	-2.6	-2.5	-2.5	-2.6	-2.6	-2.9	-3.1

A% = percentage change since same quarter the previous year

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

ASB interest rate forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<<actual	forecast >>								
NZ cash rate target	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.75
NZ 90-day bank bill	1.96	2.00	1.90	1.92	1.95	2.00	2.10	2.20	2.30	2.70	3.00
NZ 2-year swap rate	2.22	2.15	2.05	2.10	2.15	2.20	2.30	2.40	2.50	2.95	3.15
NZ 10-year gov't stock	2.74	2.85	2.80	2.95	3.10	3.15	3.20	3.25	3.30	3.50	3.60

ASB foreign exchange forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<<actual	forecast >>								
USD per NZD	0.720	0.674	0.66	0.65	0.66	0.67	0.67	0.68	0.68	0.70	0.66
GBP per NZD	0.512	0.516	0.52	0.52	0.53	0.53	0.53	0.53	0.53	0.54	0.51
AUD per NZD	0.941	0.918	0.90	0.90	0.90	0.91	0.91	0.91	0.91	0.90	0.90
JPY per NZD	77.0	74.5	72.6	73.5	73.9	74.4	73.7	74.8	73.4	74.9	73.9
EUR per NZD	0.585	0.583	0.58	0.58	0.58	0.57	0.56	0.56	0.55	0.55	0.54
CNY per NZD	4.53	4.48	4.55	4.52	4.62	4.76	4.82	4.96	5.03	5.11	4.82
TWI - 17 country	74.3	72.5	71.8	71.4	71.9	72.4	72.1	72.6	72.3	72.8	70.2

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