Quarterly Economic Forecast

February 2019

It's getting untidy

- NZ's growth foundations still look reasonable. But caution remains in the wind, locally and globally.
- Global risks continue to loom, amidst signs of economic slowdown outside of the US.
- NZ cash rate increases look more distant, though bank capital changes will do some of the restraining work.

Over 2019 we expect the NZ economy to regain a bit of momentum after it slowed noticeably over the second half of 2018. That pick-up in growth is based on some solid fundamentals still in place for the NZ economy. But it is fair to say that the potential influence of politics on economic activity almost everywhere is making the outlook messy. The risks of even weaker global growth are rising. It really feels like the world could use the political equivalent of Marie Kondo to get everything nicely tidied up and get rid of the baggage.

As we write, US-China trade negotiations to avert tariff escalation have yet to come to a positive conclusion. If they do, that would be helpful in settling a high-profile source of uncertainty. It may also help to alleviate growing concerns about recent slowing in the Chinese economy, a development that has prompted the authorities there to implement added stimulus – a sure sign that growth risks slowing by more than is tolerable. The record US government shutdown caused some short-term disruption, but the US economic picture looks reasonable still. Nevertheless, the US Federal Reserve has become more cautious about the need for further interest rate increases.

For the UK, a different but still-momentous D-Day approaches on March 29. Increasingly, Brexit looks like the deck of the Titanic but without the harmony of a brass band and less capability of arranging deck chairs. Time is running out, with the UK Government in a last-ditch attempt to prise concessions out of the EU that are palatable enough for the UK Parliament to pass an amended agreement with the EU. A failure to do either of these increases the risks of a 'no-deal' Brexit that pushes the UK economy over the edge of the white cliffs of Dover, to overly dramatise it.

Divining the NZ economic outlook has been dogged by low business confidence, even with the benefits of high Terms of Trade and low interest rates. The broader global backdrop and the brief spike in fuel prices have been contributors to soft confidence. Uncertainty over government policy has also been an influence, as both the timing of the initial plunge and more detailed questioning in the Quarterly Survey of Business Opinion show. Some types of business investment have softened. Confidence has showed some tentative signs of lifting since late last year. Government policy proposals for industrial relations and tax will soon give businesses some certainty – for better or worse.

Meanwhile, the RBNZ is proposing to dramatically increase bank capital requirements. Although there may not be much public conversation about these for a number of months, the impact on the economy has potential to be substantial during the transition to higher capital ratios. We have cut our expectation for eventual RBNZ interest rate hikes to a mere 50bp, and not until 2021 – largely on the expected impact on lending rates and the economy.   And, there is a growing risk that interest rates indeed fall if the NZ economy fails to start recovering soon. It's a fluid time at present with lots to sort through. Let's hope that one way or another some joy gets sparked in the global economy!

ASB Economics (649) 301 5659 nick.tuffley@asb.co.nz

International Outlook – Global economy stuttering, but help is on its way

After hanging in there for most of 2018, the global economy has begun to stutter over recent months. According to Consensus Economics forecasts, NZ's trading partners are likely to grow at a below-average pace over both 2019 and 2020.

Indeed, the risks to global growth that we noted repeatedly over 2018 have now crystallised, albeit still modestly at this stage. For example, 2019 Consensus Economics forecasts put our trading partner growth at 3.7%, down from 3.8% three months ago and 3.9% three months prior to that.

In particular, **US-China trade tensions have been a key driver of the weaker growth outlook for our key trading partner, China.** In turn, China's weaker growth outlook has filtered down to many of our other trading partners in the Asia-Pacific, notably Australia.

Global sharemarkets have been quick to incorporate the weaker global economic performance and outlook. Indeed, the S&P 500 plunged by around 10% over December, with the Shanghai Composite Index one of the worst performing global indices over 2018.

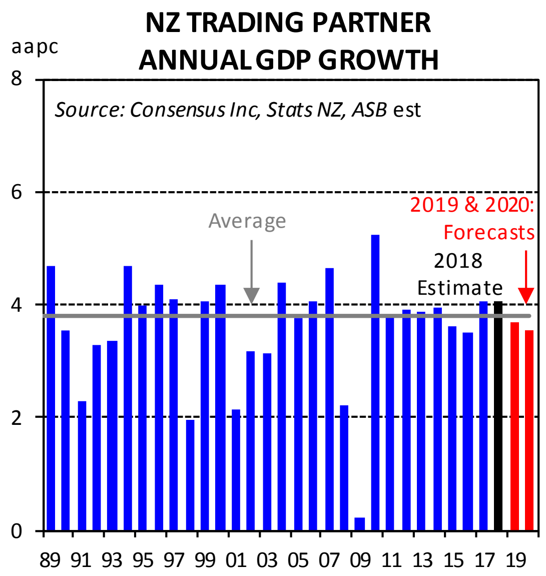
More recently, Brexit woes and the US government shutdown have weighed on sentiment and economic activity. Activity in the Eurozone has noticeably slowed, with Germany narrowly avoiding dipping into recession in Q4. Italy was not so lucky.

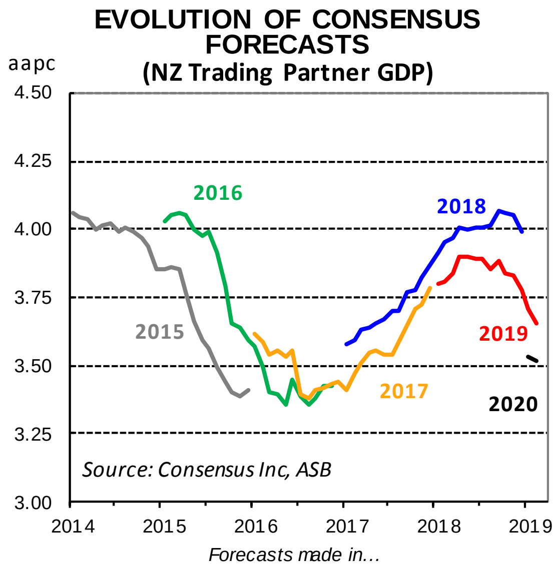
With the weaker outlook in mind, global central banks have been called into action. Notably the US Federal Reserve (Fed) has moved to a neutral bias. Accordingly, we now expect the Fed to keep its interest rate unchanged over 2019 and 2020. Similarly, we have pushed back our forecast for policy tightening by the ECB from Q4 2019 to Q4 2020.

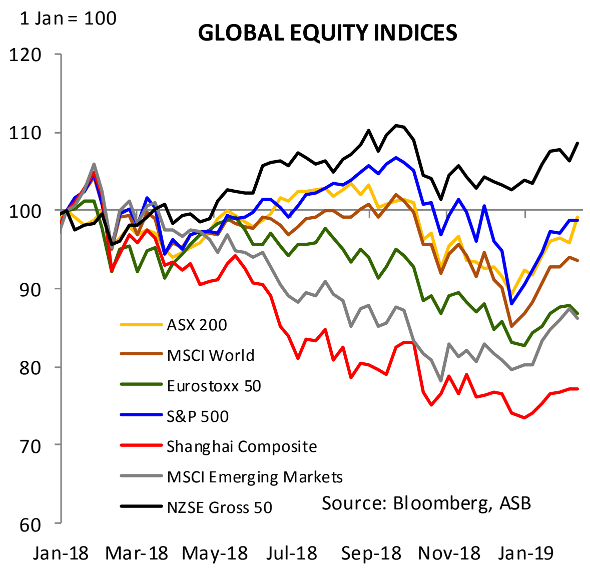
Help is also on its way in China. **Over recent months, Chinese officials have moved to shore up the Chinese economy**. The measures introduced include tax cuts, infrastructure spending and looser monetary policy.

So far and despite the global slowing, **the NZ export sector continues to perform well**. On this basis we anticipate that the Terms of Trade will remain relatively high over 2019. Also for now, agricultural markets are moving positively and out of sync with other commodity markets like oil.

That said, **the Chinese economy – or more specifically Chinese consumer demand – remains key to our export performance**. With this in mind, the NZ Government's relations with China take on increasing importance, particularly given rumours of Chinese officials' displeasure at our recent foreign policy stands.





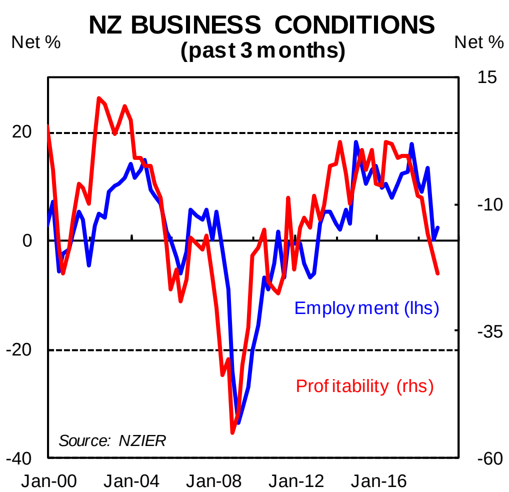


The New Zealand Economy – Navigating the slowdown

The **NZ economy has completed its 8th year of continuous economic expansion.** As a result of updated estimates of the economy, we now know that economic growth has been running at a strong pace since 2014. In part, growth over the past cycle has **been led by strong population growth** lifting demand for new housing construction and consumer goods. In addition, underlying demand has also been robust with annual per capita growth in a healthy 1.5%-2.0% range from 2011 through to the end of 2016.

Economic momentum appears to have slowed slightly from 2017 onwards with some of this slowdown reflecting **growing capacity constraints in specific sectors.** In particular, the construction sector – which has been a key driver of economic growth – appears to be capacity constrained with demand at cyclically-high levels across all types of construction including housing, commercial and infrastructure requirements. The construction industry reports continued difficulty in finding both skilled and unskilled labour. Construction cost inflation has also remained high. International tourism is another sector which appears to be slowing, with growth in tourist arrivals easing over the past year. Short-term accommodation providers are reporting reduced vacancy rates and accommodation inflation increased strongly over 2018. However, capacity constraints appear to have been largely isolated to these key sectors. Capacity may not be such an issue in other sectors of the economy and, as a result, generalised inflation pressures have remained subdued.

Over the second half of 2018, growth appears to have slowed sharply. Weak official GDP estimates are corroborated by business activity surveys (in particular, the NZIER Quarterly Survey of Business Opinion) which reveal softer demand and a fall in profitability. **We currently believe much of this slowdown over H2 2018 was due to temporary factors.** In particular, the sharp and substantial increase in petrol prices over the NZ winter appears to have materially dented consumer and business sentiment. Furthermore, an increased proportion of firms reported an increase in costs but also seemed unable to pass on the higher costs through to selling prices, resulting in a sharp fall in profitability over H2 2018. The spike in petrol prices unwound over the latter months of 2018 and we have subsequently seen consumer and business confidence improve. **We continue to see strong underlying fundamentals supporting NZ economic growth, including high Terms of Trade, low interest rates and our expectation of improving labour incomes.** The export sector has performed well in recent years, with strong export prices for most non-dairy commodity exports. The labour market has gradually tightened and we expect this will translate into higher wage growth over the coming year, with an additional boost stemming from minimum wage increases.



Even so, the downside risks to our forecasts have grown and we are now less confident growth will pick up in 2019. **Weak profitability** and relatively low levels of business confidence could potentially weigh on employment and investment demand. In that case, economic momentum could remain soft over 2019. In addition, **weakening global prospects** present a risk to our upbeat outlook for exporters. Finally, we expect a relatively mild house price outlook, with Auckland and Christchurch house prices remaining flat and house price growth gradually slowing in Wellington and the regions. But there are also **growing downside risks to the housing outlook**, with potential for a tightening in credit conditions.

Interest Rates and Exchange Rates – No OCR hikes until 2021, NZD resilience

We now expect the OCR to remain at its 1.75% record low until February 2021 (August 2020 in our November forecasts). Our view is that while employment is expected to remain around maximum sustainable levels, it may be some time before pressures on medium-term inflation firm sufficiently to warrant a higher OCR. The inflation genie remains ensconced in its bottle and we do not envisage the OCR moving significantly higher over the foreseeable future. This quarter we have also **incorporated the impacts of proposed increases for bank capital requirements for locally-incorporated NZ banks,** which we estimate to increase bank funding costs by approximately 50bps by late 2023, lowering our estimates of the neutral OCR by a similar margin (to 2.25%). **We expect just 50bps of hikes, with the OCR likely to approach 2.25% by late 2021.** The increase in funding costs will widen the 'wedge' between the OCR and retail lending and deposit interest rates. It would, however, dampen upward pressure on NZD swap rates across the curve.

Slowing global growth and increasingly prominent downside risks also have us pushing out the timing of policy hikes by overseas central banks. The Fed is expected to remain "patient", holding the Federal Funds rate at 2.25%-2.50% for the foreseeable future. The Reserve Bank of Australia (RBA) is expected to hold the cash rate at 1.5% until at least the end of 2020, with more downside than upside risk over the next six months. Moreover, the European Central Bank is unlikely to tighten policy until late 2020 at the earliest, and Brexit risks cloud the UK interest rate outlook. More policy stimulus is expected from the People's Bank of China.

NZ and Australian longer-term yields are expected to drift higher as policy interest rate hikes near. However, US 10-year Treasury yields are forecast to ease as the Fed errs towards considering rate cuts. NZD longer-term yields are expected to move above US counterparts by 2021, but mild RBNZ tightening, contained NZ inflation, and demand for NZ assets should cap longer-term NZ yields at historically-low levels.

We have also changed our currency forecasts. The NZD is expected to remain resilient over the forecast horizon, given the generally-solid NZ outlook, strong NZ public finances, our persistently-high Terms of Trade and continued investor interest in NZ assets. **We now expect the USD to weaken over the projection period, given the change in the US Federal Reserve view,** and with brighter signs expected to emerge in the Chinese and Eurozone economies. **The NZD is expected to progressively strengthen against the USD, reaching 0.75 by the end of 2022.**

We also expect the NZD to hold onto its current strength against the AUD given the stronger outlook for our Terms of Trade and our sounder nationwide housing market outlook. **We see the NZD ending 2022 at around 97 Australian cents,** but still believe that the parity-party champagne should remain on ice. **The Chinese yuan is expected to weaken, to around 5.1 NZD by late 2022,** although the risks are tilted towards a stronger profile if policy stimulus ignites the Chinese economy and Chinese financial market liberalisation supports demand for CNY. **Gradual NZD strengthening is expected against the yen, with the kiwi at around 83 yen by late 2022.**

We expect the NZD to broadly keep pace with the euro, with the NZD around 60 euro cents over the projection period. Sterling is expected to remain volatile, **but cyclical weakness and structural challenges posed by Brexit are expected to further weigh on the pound, with the NZD at around 58 pence by late 2022.**

For more discussion on the current state of the **housing market** – please read our latest Housing Confidence report.

For more discussion on **regional economic developments** – please read our latest Regional Economic Scoreboard.

For more discussion on **rural developments** – please read Farmshed Economics and the Weekly Commodities Report.

For up-to-date discussion on **global financial market themes** – please read our Markets Monthly Report.

The Economic backdrop can change quickly – for the most up to date views on **Interest Rates and FX** – please read our Economic Weekly and for our latest views on the changing economic landscape – subscribe to our Economic Notes and Rural Economic Notes.

Subscribe to all of these reports here.

Economic and Financial Forecasts

ASB economic forecasts		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%**	**3.1**	**3.0**	**2.8**	**2.7**	**2.5**	**2.6**	**2.8**	**3.0**	**3.1**	**2.9**
private consumption	AA%	3.6	3.4	3.1	3.2	3.3	3.3	3.4	3.3	3.2	3.2
dwelling construction	AA%	2.6	2.9	2.3	1.9	0.9	-0.3	-0.7	-1.5	-2.9	-4.3
other investment	AA%	7.1	6.5	3.8	0.3	-2.1	-2.8	-1.8	0.4	7.2	5.1
exports	AA%	3.6	3.8	3.5	3.6	3.6	3.7	3.7	3.3	2.8	2.6
imports	AA%	7.9	7.8	6.1	4.4	2.3	1.3	1.4	1.9	4.2	3.2
NZ GDP real	A%	3.2	2.6	2.4	2.6	2.5	2.9	3.3	3.3	3.0	2.9
NZ GDP real	Q%	1.0	0.3	0.5	0.8						
NZ CPI	**A%**	**1.5**	**1.9**	**1.9**	**1.5**	**1.6**	**1.3**	**1.4**	**2.0**	**1.8**	**1.9**
NZ house prices (QV index)	A%	3.6	3.7	2.8	2.7	3.1	2.6	2.7	1.7	0.5	0.4
NZ unemployment (sa%)	Qtr	4.4	4.0	4.3	4.1	4.1	4.0	4.0	3.9	3.9	3.9
NZ private sector wages (LCI)	A%	2.1	1.9	2.0	2.1	2.2	2.4	2.5	2.6	2.7	2.7
NZ current account ($b)	Yr	-9.5	-10.5	-11.3	-10.9	-11.1	-11.3	-11.3	-11.1	-11.3	-12.1
as a % of GDP	Yr	-3.3	-3.6	-3.9	-3.7	-3.7	-3.8	-3.7	-3.6	-3.5	-3.6

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-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	2.25
NZ 90-day bank bill	2.00	1.91	1.97	1.90	1.95	1.95	1.95	1.95	2.30	2.50
NZ 2-year swap rate	2.15	2.04	1.97	1.90	1.95	2.00	2.05	2.15	2.55	2.70
NZ 10-year gov't stock	2.85	2.65	2.38	2.15	2.25	2.35	2.45	2.50	2.70	2.80

ASB foreign exchange forecasts	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	0.674	0.662	0.671	0.68	0.68	0.69	0.69	0.70	0.72	0.74
GBP per NZD	0.516	0.506	0.529	0.55	0.54	0.54	0.54	0.54	0.55	0.57
AUD per NZD	0.918	0.917	0.952	0.96	0.96	0.96	0.96	0.96	0.96	0.97
JPY per NZD	74.5	75.1	74.1	75.5	76.2	77.3	76.6	77.0	77.8	79.9
EUR per NZD	0.583	0.568	0.587	0.60	0.60	0.60	0.59	0.59	0.59	0.60
CNY per NZD	4.48	4.55	4.61	4.62	4.66	4.76	4.83	4.97	4.90	5.03
TWI - 17 country	72.5	72.1	73.5	74.1	73.9	74.5	74.1	74.8	75.0	76.6

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics

@ASBMarkets