Quarterly Economic Forecast

February 2018

Keep on keeping on

- New figures show NZ's economy has performed stronger than previously thought; likely to continue doing so.
- NZ's main theme for 2018 will be the settling in of the new Government and clarity of its key policies.
- Weather, confidence and housing are key local risks; geopolitics a continued threat to positive global backdrop.

All of a sudden the growth outlook appears a little rosier, thanks to extensive revisions after Statistics NZ improved its measurement of GDP. The economy has grown faster over the past 3 years than previously reported, and more in keeping with what was expected from the many underlying boosters that have been there all along. Some of that momentum will continue (and continue to be measured). We are now expecting growth to exceed 3.5% over the next couple of years. Per-capita growth also looks healthier, and set to gradually return to the 2% pace it has hit for much of the post-GFC period.

For NZ the main theme will be the settling in of the new Government and development and implementation of its key economic policies. Given the sharp drop in business confidence that followed the change in government, it would be fair to say the business community had some trepidation as 2017 closed out. Some businesses will have genuine concerns about the impact the new Government will have. Sharp minimum wage increases and the flow-on impact to other wage rates will be one, as will uncertainty over exactly what the looming industrial relations changes will mean for businesses' operations. Businesses closely linked to the property market will be variously impacted by the crackdown on property investors and by the impact of the Government's KiwiBuild scheme on private sector housing development. For many businesses, though, it is the underlying backdrop that matters – and that backdrop remains decent.

Ever since the GFC, economic forecasters (and many others) have kept a vigilant lookout for threats to the ongoing economic recovery, very aware that many fragilities are not far below the surface. Looking ahead for 2018 there are still a number of risks to be wary of.

Weather is one. Over spring and early summer we swung from too much rain to too little. Dairy production is now likely to barely grow from last season instead of being up several percent. At this point drought impacts appear contained, and early New Year storms have normalised soil conditions in many parts of the country. Another local risk is the potential for businesses to talk themselves into a downturn. But even before 2017 ended there were tentative signs confidence was starting to recover. We are also relaxed about housing market risks, despite the noticeable cooling off over the past 18 months. Auckland, the most stretched market, is still struggling to build sufficient homes.

Most of the 'what ifs' seem to still be from overseas. Italy is holding its general election on March 4, and its most popular political party is anti-establishment and euro-sceptic. Donald Trump's ever-surprising US Presidency continues, and geopolitical tensions, such as North Korea, remain. Barring meltdown in financial markets, the global economic outlook for 2018 looks set for one of its better years since the bounce out of the Global Financial Crisis.

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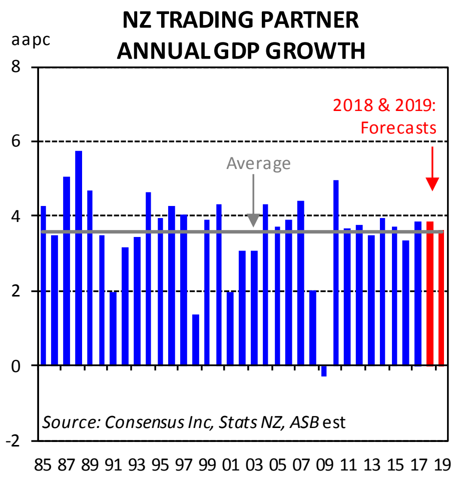
International outlook – on the same page

A synchronised global expansion is underway, with trading partner growth strengthening for most of our trading partners. The current upswing has considerable momentum, which should see trading partner growth maintain its above-trend pace over 2018. Growth is expected to moderate to on-trend rates over 2019 as growth supports fade.



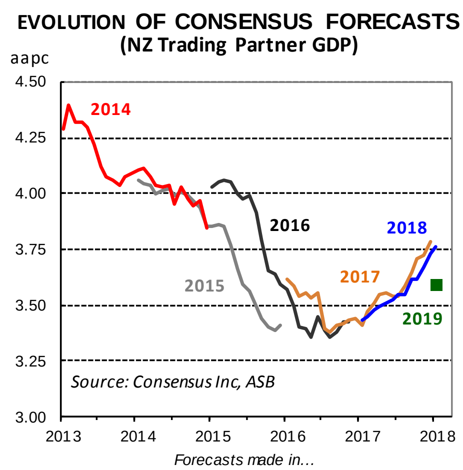
We are constructive on US prospects, with a short-term boost to growth provided by the USD 1.5 trillion tax cut package. We have increased our US GDP growth forecasts for 2018 from 2.5% to 2.7%, with 2.4% growth forecast for 2019 as the growth impact of the package wanes. A diminishing margin of spare capacity is expected to continue to push up core inflation, with at least two Fed hikes expected for 2018 (March and June) and the possibility of a third 2018 hike.

Growth prospects in the Eurozone have also improved (2.2% for 2018 and 1.8% for 2019). The outlook is brighter for many euro area economies, especially Germany, Italy, and the Netherlands. Strengthening momentum in domestic demand and higher external demand has been evident. However, **Brexit-related headwinds are expected to weigh on UK growth in 2018 and 2019 (1.4% and 1.5%, respectively).**

Strengthening global trade growth provides a powerful tailwind. However, authorities in China are seeking to rebalance the Chinese economy, by cutting back on fiscal stimulus and reining in credit growth to strengthen its overextended financial system. Consequently, **we expect growth in China to slow from 6.9% in 2017 to 6.5% (2018) and 6.3% (2018).** Other economies in the region are expected to grow at broadly similar rates to what they achieved in 2017. Growth in India is expected to continue to outpace that of other trading partners with yearly growth expected to remain above 7%. Marginally weaker growth is expected for Japan (1.4% for 2018 and 1.1% for 2019).

In Australia, growth of 2.7% is expected for this year and next. Strengthening global growth is underpinning increases in export commodity prices and the Terms of Trade, with domestic demand bolstered by rising business investment, despite the tailing off in mining and residential investment. Consumer spending is being supported by the tightening labour market, with jobs growth particularly strong for this stage of the cycle.

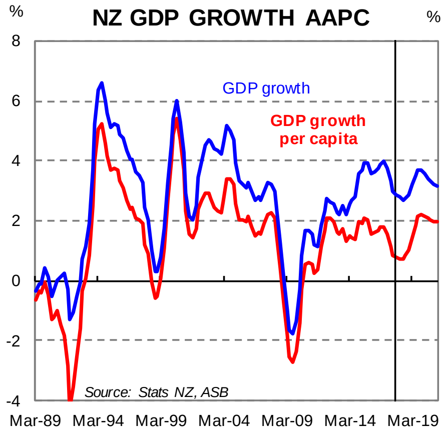
Risks appear broadly balanced in the near term. Upward revisions to growth expectations have been evident for at least the last 12 months. **Medium-term risks remain downwardly skewed, however.** Asset prices are stratospheric and debt levels are high. As recent ructions in financial markets suggest, it is unclear how well the global economy will manage the transition to the eventual normalisation in global interest rate settings. Geopolitical tensions (e.g. North Korea) remain as do risks from trade protectionism, with challenges posed by marked income inequality and climate change.



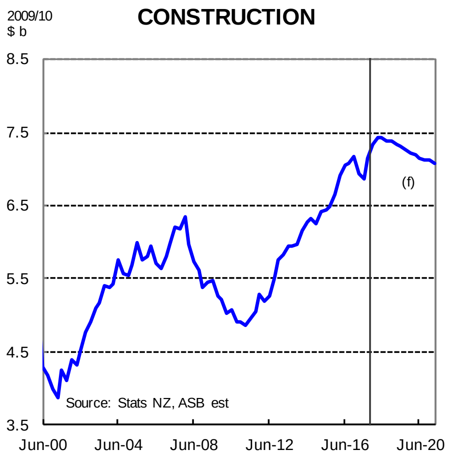
For now at least, however, **the combined economic prospects of our trading partners remain solid. Consensus growth forecasts suggest that trading partner growth will remain at 3.8% for 2018, a similar rate to what was achieved in 2017. Largely reflecting the geographically widespread deceleration, growth of 3.6% is expected for 2019**, broadly in line with historical averages.

The New Zealand Economy – rewriting history

At the end of 2017, Statistics NZ reviewed its estimates of NZ GDP, incorporating two years of annual benchmark data and other methodology improvements. As a result, **StatsNZ concluded the NZ economy grew approximately 1% faster per annum over the past three years,** compared to previous estimates**.** The implications for assessing NZ's economic performance are significant. As a result, **inflation-adjusted per-capita GDP grew at a relatively respectable rate over recent years, recording annual growth in the vicinity of 1.5-2% since 2012.**



Nonetheless, the **NZ economy did lose momentum over 2017**, with per-capita GDP growth slowing below 1% per annum by Q3 2017. **For growth to slow ahead of an election is not unusual**, as uncertainty about future polices are likely to weigh on major investment decisions. Indeed the **NZ housing market was particularly quiet in the 6 months ahead of the election,** but then appears to have recovered somewhat in the months following. Some of the temporary slowdown in other areas of the economy may also reflect uncertainty due to the change of Government. **Clarity around the incoming Government's policies will see business confidence recover and activity resume.**



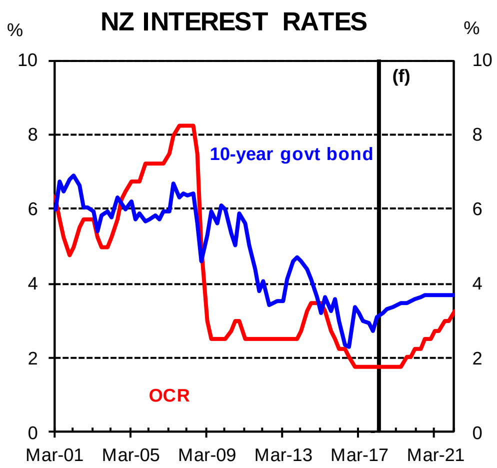
Another contributing factor to slower growth includes capacity constraints in construction and tourism, which is slowing the growth contribution of two of NZ's strongest performing sectors over the past few years. We expect residential construction may be close to a peak, despite large supply short-falls continuing to exist in Auckland, Wellington and other hot spots around the country. **There is widespread evidence of capacity constraints biting in the construction sector and construction costs are soaring.** Housing construction resources around the country will need to be redirected to these hotspots, and construction activity will remain elevated for some time as supply works to catch up to demand growth over recent years. Meanwhile, the **tourism sector is likely to enter a period of muted growth as international visitor arrivals growth appears to have slowed over the past year**, and visitor accommodation capacity is also very tight. Over time, increased investment in infrastructure and visitor accommodation could pave the way for a renewed growth spurt.

Over the coming years, we expect the NZ economy to regain momentum and for growth to be driven by areas outside of construction and tourism. Strong demand and tight capacity are likely to sustain investment and employment demand. Rural incomes will also remain a key support, reflecting improved dairy incomes and as prospects for many exporters (in particular fruit) remain buoyant on robust global demand.

Household incomes are also set to improve. The labour market will continue to tighten and we expect wage inflation to accelerate. Stronger household income growth will be a key area supporting household spending. **Per-capita demand will remain robust, supported by strong employment confidence and low interest rates.** However, offsetting this, slowing population growth (as net migration appears to have peaked in 2017) also means slower growth in demand for goods and services.

Despite **NZ's relatively strong economic performance, the inflation outlook remains benign.** We expect NZ inflation to remain around the bottom half of the RBNZ's target band (1-3%), with core inflation pressures slow to lift. Outside of the housing sector, there is very little evidence of stronger domestic inflation. Meanwhile, global inflation pressures are likely to remain subdued and a drag on NZ's CPI inflation rate. **The subdued inflation outlook will ensure NZ interest rates will remain low over the next few years.**

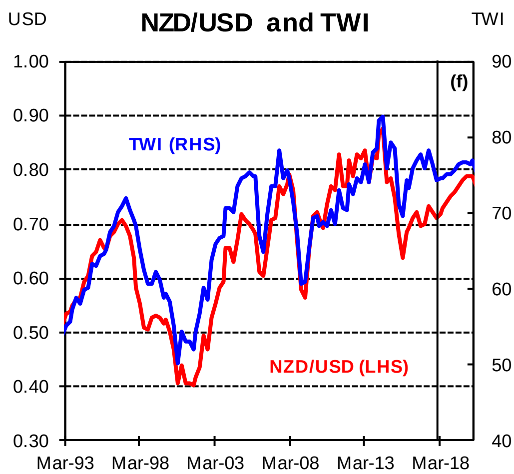
Interest Rates and Exchange Rates – RBNZ still firmly on hold



NZ short-term interest rates remain low and relatively stable. The RBNZ has left the Official Cash Rate (OCR) on hold at 1.75% since November 2016, reflecting the ongoing benign inflation environment. And, with inflation yet to pick up materially and **the RBNZ now set to leave to OCR on hold until the second half of 2019**, we expect shorter-term interest rates to remain subdued. Further, once the RBNZ does resume lifting the OCR, it is likely to be a gradual process.

However, short-term interest rates have crept down following the much softer than expected Q4 CPI read. Before the release, markets were pricing in one OCR hike by the end of 2018. However, the soft release has seen the chances of an OCR hike in 2018 roughly halved, with a full hike not priced until May 2019.

On the other hand, longer-term rates tend to be more aligned to movements in US interest rates. US 10-year Government bond yields have risen by roughly 45bp so far over 2018, reflecting growing optimism that the US economy will continue to outperform and drive inflation higher. With close to three Fed rate hikes priced in over 2018, we expect to see upward pressure on US rates. As a result, we also expect NZ longer-term rates to lift higher. However, with the RBNZ firmly on hold, spreads between NZ 10-year and US 10-year yields are expected to remain historically low.



The NZD has recovered from its post-election lows and is currently running ahead of our forecasts vs. the USD for Q1 2018. Much of the NZD/USD's directional change reflects a period of sustained USD weakness. More recently, the USD has recovered slightly, in line with higher US interest rate expectations. A key consequence of higher US rate expectations is the declining NZ interest rate premium vs. US yields. Although this represents a weakening of a recent NZD support, we expect the NZD/USD to remain elevated over 2018 as the historically-high Terms of Trade and the solid NZ domestic outlook continue to support the NZD.

Elsewhere, **we recently revised our NZD/EUR forecasts lower** on the expectation that the ECB would begin to normalise monetary policy this year after a period of quantitative easing. We expect the remaining major currency pairs to remain largely steady. **The NZD/AUD is expected to soften from current levels** as the RBA looks likely to raise interest rates in late 2018, ahead of the RBNZ. Finally, we expect the **NZD/GBP to hover around 0.53 over the remainder of the year** as the Pound has passed its post-Brexit lows.

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Economic and Financial Forecasts

ASB economic forecasts		Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<<actual	forecast >>							
NZ GDP real	AA%	**3.0**	**2.9**	**2.8**	**2.7**	**2.8**	**2.9**	**3.2**	**3.6**	**3.2**
private consumption	AA%	4.4	4.2	3.8	3.7	3.8	3.8	3.8	3.5	2.9
dwelling construction	AA%	2.5	1.4	2.3	4.7	5.3	4.5	2.8	-1.9	-2.7
other investment	AA%	4.2	3.7	3.6	3.6	3.8	4.0	4.0	3.7	3.9
exports	AA%	0.7	3.2	5.0	4.8	4.2	2.2	1.3	2.6	2.4
imports	AA%	6.2	5.9	5.3	5.2	4.6	4.1	3.8	3.5	3.1
NZ GDP real	A%	2.7	2.9	2.6	2.6	3.0	3.4	3.9	3.3	3.1
NZ GDP real	Q%	0.6	0.6							
NZ CPI	A%	**1.9**	**1.6**	**1.0**	**1.5**	**1.5**	**1.2**	**1.5**	**1.7**	**2.0**
NZ house prices (QV index)	A%	3.3	7.0	7.7	5.9	5.5	2.5	1.8	0.8	0.7
NZ unemployment (sa%)	Qtr	4.6	4.5	4.3	4.2	3.9	3.7	3.6	3.3	3.1
NZ private sector wages (LCI)	A%	1.9	1.9	2.0	2.3	2.2	2.3	2.4	2.8	2.8
NZ current account ($b)	Yr	-7.1	-7.6	-6.7	-7.2	-7.6	-7.9	-7.8	-7.6	-7.9
as a % of GDP	Yr	-2.6	-2.7	-2.4	-2.5	-2.6	-2.7	-2.6	-2.4	-2.4

A%=percentage change since same quarter the previous year

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

ASB interest rate forecasts	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	2.25	2.75
NZ 90-day bank bill	1.96	1.88	1.90	1.90	1.90	1.95	2.00	2.50	3.00
NZ 3-year swap rate	2.41	2.39	2.35	2.40	2.50	2.60	2.70	3.15	3.55
NZ 10-year gov't stock	2.96	2.75	3.00	3.15	3.25	3.30	3.35	3.50	3.50

ASB foreign exchange forecasts	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	0.722	0.710	0.72	0.73	0.74	0.75	0.76	0.79	0.75
GBP per NZD	0.538	0.528	0.53	0.53	0.53	0.53	0.53	0.54	0.54
AUD per NZD	0.920	0.910	0.90	0.90	0.90	0.90	0.90	0.90	0.89
JPY per NZD	81.3	80.1	79.2	78.1	78.4	78.8	79.0	79.0	81.0
EUR per NZD	0.613	0.594	0.60	0.59	0.59	0.59	0.60	0.60	0.59
CNY per NZD	4.82	4.64	4.72	4.71	4.74	4.76	4.79	4.82	4.58
TWI - 17 country	76.4	74.3	74.6	74.7	75.0	75.1	75.7	76.6	74.0

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