Quarterly Economic Forecast

May 2019

Topsy Turvy

- Global growth has slowed further, and NZ's expected pick-up is taking its time arriving.
- With NZ's economy not performing to its full potential, it can be given a further nudge to spur the pick-up.
- We expect a further interest cut in the second half of this year.

A loss of momentum is creeping in globally. It's more a case of a below-par performance rather than anything dramatic. But here in NZ we have reached the point where more policy stimulus is required to boost growth. We still expect the economy to start picking up, but it is taking slightly longer to happen than anticipated.

The global economy is cooling after a period of above-average growth. Growth for 2019 and 2020 is expected to be below-average. And, unhelpfully, the big distracting sideshows of the past year remain. US-China trade tensions have escalated to DEFCON 1. The US is back to imposing added tariffs on Chinese imports, which China is not taking lying down. It is still possible the world's two biggest economies do end up coming to an agreement. But right at this moment it is hard to read.

And, two years to plan an orderly exit from the EU is clearly not enough time. After a farcical pantomime that even Monty Python wouldn't have the depth of imagination to script, the UK has been granted a Brexit extension until the end of October. That simply extends the period of uncertainty UK businesses have to contend with.

Domestically, there are still some good drivers. Export prices remain high, notwithstanding the softening of global growth, and we remain positive about the export price outlook. Interest rates are historically low. Population growth is still fairly strong – we think anyway, though the new migration measurement means we are guessing to some extent. The 2018 Budget delivered some added stimulus that will increasingly come into effect.

But there are challenges. Business confidence remains woefully low through a combination of challenges in finding suitable staff, cost pressures, and continued uncertainty around government policies. One source of uncertainty, the imposition of a broad-based capital gains tax, has at least been taken off the table and will likely dampen the recent flare-up of business angst. Low interest rates are providing a boon for borrowers, but a headache for savers.

With recent economic growth modest, inflation and wage pressures muted, and with some slack within the labour market, it is clear the economy has scope to grow faster. Short of additional policy stimulus, it is difficult to identify catalysts that will achieve this. Capacity constraints mean that the construction sector can't flex much more, despite the strong pipeline of work. Fiscal policy is unlikely to shoulder any more of the load, given the Government's commitment to its debt target. The RBNZ is expected to continue to do much of the heavy lifting, which should keep NZ interest rates historically low. We expect a further OCR cut in the second half of the year. Over the next few years, this stimulus will be whittled away as the higher bank capital requirements proposed by the RBNZ push up customer borrowing interest rates. In the meantime, though, it should provide a bit of a pick-me-up.

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International Outlook – Soft, but NZ export sector trucking on

The global economic outlook has continued to weaken over recent months. According to Consensus Economics forecasts, NZ's trading partners are likely to grow at the slowest pace over 2019 since the Global Financial Crisis.

Indeed, the risks to global growth continue to crystallise, albeit at a modest pace. For example, 2019 Consensus Economics forecasts put our trading partner growth at 3.5%, down from 3.7% three months ago and 3.9% back in September 2018.

Notably, **the Australian economy has taken a turn for the worse over the past three months.** Concerns there have centred on the weak housing market and the potential for this weakness to flow through to weaker household spending. Indeed, the RBA stands ready to act if labour market data do not meet expectations over coming months.

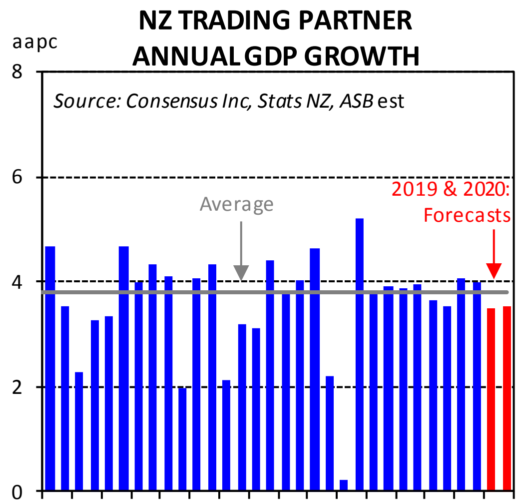
Brexit woes have also weighed on sentiment and economic activity in the UK and across Europe. That said, the Brexit can has been kicked down the road. And while a resolution is no closer, at least financial markets have switched their focus elsewhere for the time being (note the UK has received a six-month Brexit extension to 31 October).

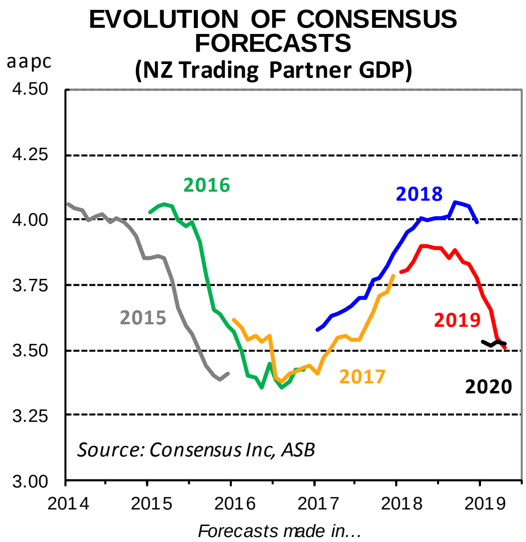
Meanwhile, global sharemarkets have regained much of their lost ground. For example, the S&P 500 and the Nasdaq both hit fresh record highs in April (as did the NZX).

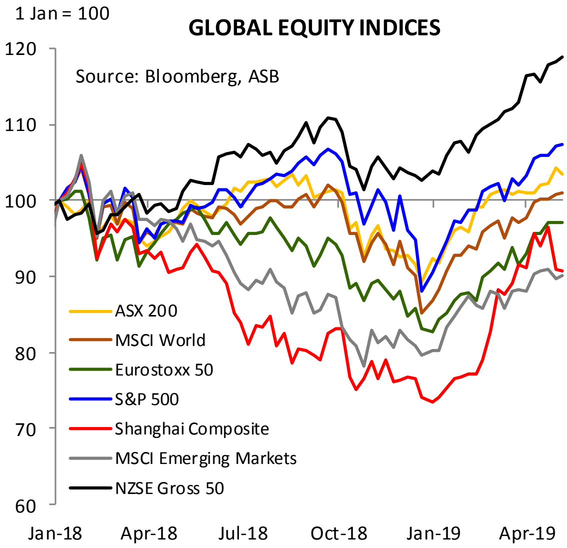
Green shoots have also started to appear in China. In particular, policy stimulus has begun to lift consumption and imports, while manufacturing sector surveys have moved back into expansionary territory.

But it remains very early days in any potential pick-up in global growth and, as such, global central banks remain cautious. The ECB, for one, pushed back the timing of its hiking cycle from the end of the European summer through to at least the end of 2019.

So far, and despite the global slowing, **the NZ export sector continues to truck on**. On this basis, we anticipate that the Terms of Trade may touch record highs over 2019. Indeed for now, NZ's key agricultural markets are in sync with positive Chinese consumer demand growth rather than soft trading partner growth per se.







That said, **we remain wary of the risks to the global growth outlook**. US President Trump's sudden move to increase trade tariffs on Chinese goods is case in point. At this juncture, we anticipate that the US and China will ultimately reach a trade deal. But until that is in the bag, global growth will remain fragile. Anyway, who's not to say that once a US-China deal is done that President Trump doesn't shift trade war focus elsewhere?

The New Zealand Economy – in need of a boost

The NZ economy has lost momentum over the past year, with annual GDP growth forecast to slow to just 2.2% in June 2019, from an annual growth rate of 3.2% a year ago (June 2018). The sharp slowdown in growth comes late in the economic cycle as the NZ economy completes its 8th year of economic expansion. Subsequently, some may assume that the current slowdown might be a result of end-cycle growing pains, i.e. as capacity constraints restrict the pace of growth. And while that may be the case in one or two sectors, notably construction, we believe the broader picture is one of waning economic demand.

The construction sector has grown strongly over this economic cycle and has hit capacity constraints over the past few years, resulting in strong construction cost inflation. In saying this, the **most recent confidence surveys tentatively indicate that building demand may be slowing** and spare capacity may be starting to lift. While building consents are currently strong, architects are noting a fall in pipeline activity. We don't expect construction activity to fall in line with these early indicators, largely due to lower mortgage rates boosting housing demand over the second half of 2019. Nonetheless, further growth in construction will be limited. For broader economic activity to maintain sufficient momentum, the services sector of the economy will need to drive GDP growth over the next few years. However, it appears that **demand is also softening in the services sector, in particular business services, finance services and retail trade.**

The one bright spot in the economy has been the strong export performance, in large part led by the agricultural sector which has translated to robust growth in associated industries. However, many in the agri-sector are likely to focus on debt repayment this year and income growth in this sector may not generate the usual spill overs for the broader economy. Furthermore, dark storm clouds still lurk on the horizon of the global economic outlook, with global growth slowing and geo-political tensions still high.

Business confidence has remained weak in NZ for some time now, and some of this can be attributed to a period of uncertainty as the new Government had yet to finalise major policy details. The Tax Working Group recommendations released in late February had an immediate impact on business confidence, and we will likely see some improvement in business confidence now the Government has taken a capital gains tax off the table entirely. However, there are also other factors contributing to weak business confidence, such as **falling profitability and slowing economic demand.** Demand in the economy appears to have softened across the board, with firms reporting poor trading activity since the second half of 2018. With demand soft and pricing power low, core inflation pressures may soon start to ease.

Weak business confidence has seen business investment growth slow over the past year and recent employment data suggest sluggish economic momentum has started to impact job creation. Meanwhile, wage inflation remains contained at 2% per annum, which is modest by historical standards. While the unemployment rate has continued to edge lower, there still remains some slack in the labour force – particularly the underemployed (people in part-time work but wanting to, and able to, work more) which has not materially reduced in recent years.

Going forward there are many uncertainties on the outlook, but it appears that the headwinds facing the economic outlook are strengthening and that the **risks to growth are skewed to the downside**. We have revised our medium-term growth forecasts lower has it appears that **productivity may not contribute as much to growth as we previously hoped**. Forthcoming research from ASB suggests that lower productivity growth may be due to NZ's low capital stock. The muted productivity performance appears to a global theme.

With economic momentum waning, the RBNZ will need to provide further policy stimulus this year to ensure it will meet its employment and inflation targets. Our economic forecasts assume the RBNZ cuts the OCR to 1.25% over 2019 (with one 25 bp cut to 1.5% already delivered in May). The expectation of a lower OCR has already been largely passed onto some fixed-term mortgage rates, and as a result **we expect lower interest rates to boost house price growth (mostly outside of Auckland) and also provide an extra boost to housing construction this year.**

Interest Rates and Exchange Rates – more record lows for OCR, but solid NZD

In March, we formally shifted to an easing bias, flagging 50bps of OCR cuts over the course of 2019, and **in April we brought forward the timing of OCR cuts to May and August. In May, the RBNZ acted on this bias and cut the OCR by 25bps to 1.50%** and, while the OCR outlook was "more balanced", a slight easing bias remained. Given our view that spare capacity in the labour market will remain and that the medium-term inflation outlook will remain benign, **we have pencilled in a 25bp cut in August** (1.25%). The timing of the next OCR move will depend on the tone of domestic data, the NZD, and global developments, and may come later in 2019.

We expect the OCR to remain at its 1.25% record low until early 2022. Our view is that the weaker short-term growth outlook for growth and solid labour force growth will delay the tightening in the labour market. Furthermore, it will likely be some time before medium-term inflation pressures firm sufficiently to warrant a higher OCR. Also keeping the OCR at historical lows and prompting a low endpoint is our judgment that **proposed increases for bank capital requirements for locally-incorporated NZ banks** will widen the 'wedge' between the OCR and retail lending interest rates by at least 50bps by late 2023. **We expect firming inflationary pressure to trigger RBNZ hikes from early 2022, but for modest OCR tightening to ensue, with the OCR likely to approach 2.25% (our estimates of its neutral level) by late 2023.**

Still-prominent downside risks and a low global inflation backdrop will keep overseas interest rates historically low. 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 late 2020, with risks skewed to the downside. The European Central Bank is unlikely to tighten policy until late 2020 at the earliest, while Brexit risks still 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 eventually drift higher as policy interest rate hikes are contemplated down the track. NZD longer-term yields are expected to lift towards US counterparts by 2022, but should be capped at historically-low levels, particularly if the Fed errs towards rate cuts in a couple of years.

Despite downward tweaks to our NZD interest rate view, there are only modest changes to our currency outlook. 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.

With the US Federal Reserve on the sidelines, and with additional policy stimulus supporting growth prospects in China, **the USD is expected to weaken over the projection period, with the NZD rising to 0.75 USD by the end of 2022.** NZ short-term yields are likely to fall below Australian counterparts before the end of the year, but we expect the NZD/AUD to be broadly supported by the stronger outlook for our Terms of Trade, our sounder nationwide housing market and consumer spending outlook. **We see the NZD ending 2022 at around 97 Australian cents.**

The Chinese yuan is expected to weaken, to around 5.1 NZD by late 2022, with risks towards a stronger CNY profile if policy stimulus ignites the Chinese economy. **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 to hover around 60 euro cents over the projection period. UK Sterling is expected to remain volatile, **but risks and structural challenges posed by Brexit are likely to weigh on the GBP, with the NZD at around 58 pence by late 2022.**

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Economic and Financial Forecasts

ASB economic forecasts		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**	**2.8**	**2.6**	**2.3**	**2.4**	**2.5**	**2.7**	**2.6**	**2.4**
private consumption	AA%	3.4	3.3	3.6	3.8	3.9	3.9	3.6	3.2	2.9
dwelling construction	AA%	2.5	2.7	3.4	4.5	6.7	8.4	9.4	1.0	-6.4
other investment	AA%	6.5	4.5	1.6	-0.3	-0.6	-0.6	0.4	3.9	5.0
exports	AA%	3.6	3.0	3.5	3.7	4.6	5.2	4.5	2.8	2.6
imports	AA%	7.6	5.6	3.6	1.4	0.5	1.1	2.0	4.4	3.2
NZ GDP real	A%	2.6	2.3	2.2	2.2	2.7	2.9	3.1	2.4	2.4
NZ GDP real	Q%	0.3	0.6	0.4	0.9					
NZ CPI	A%	**1.9**	**1.9**	**1.5**	**1.8**	**1.6**	**1.6**	**1.8**	**1.8**	**1.8**
NZ house prices (QV index)	A%	3.9	3.1	2.2	3.9	4.9	6.1	6.8	1.7	0.2
NZ unemployment (sa%)	Qtr	4.0	4.3	4.2	4.3	4.4	4.3	4.4	4.3	4.2
NZ private sector wages (LCI)	A%	1.9	2.0	2.0	2.0	2.1	2.1	2.2	2.4	2.5
NZ current account ($b)	Yr	-10.6	-11.0	-9.7	-8.6	-7.6	-6.7	-6.4	-6.5	-5.9
as a % of GDP	Yr	-3.6	-3.7	-3.3	-2.9	-2.5	-2.2	-2.0	-2.0	-1.7

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-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	1.50	1.25	1.25	1.25	1.25	1.50
NZ 90-day bank bill	1.91	1.97	1.85	1.70	1.50	1.45	1.45	1.45	1.75
NZ 2-year swap rate	2.04	1.97	1.63	1.55	1.50	1.50	1.50	1.55	1.90
NZ 10-year gov't stock	2.65	2.38	1.81	1.80	1.75	1.75	1.75	2.05	2.35

ASB foreign exchange forecasts	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	0.662	0.671	0.68	0.68	0.69	0.69	0.70	0.72	0.74
GBP per NZD	0.506	0.529	0.52	0.54	0.54	0.54	0.54	0.55	0.57
AUD per NZD	0.917	0.952	0.96	0.96	0.96	0.96	0.96	0.96	0.97
JPY per NZD	75.1	74.1	75.2	76.2	77.3	76.6	77.0	77.8	79.9
EUR per NZD	0.568	0.587	0.60	0.60	0.60	0.59	0.59	0.59	0.60
CNY per NZD	4.55	4.61	4.57	4.62	4.73	4.76	4.90	4.97	5.03
TWI - 17 country	72.1	73.5	73.9	73.8	74.4	73.9	74.6	75.3	76.6

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