Quarterly Economic Forecast

November 2018

Summer breeze or summer squeeze?

- NZ's growth outlook remains reasonable, though risks of weak growth have intensified a little further.
- Questions remain over how much cooling will be caused by weak business confidence and trade tensions.
- Inflation pressures are benign enough that interest rates can remain on hold well into 2020.

The time for slapping on sunblock and anticipating that first bite of Christmas mince pie is upon us. It has been a year filled with events, though often with more smoke than heat. So far the economy has held up relatively well in the face of two high-profile uncertainties: stubbornly-weak business confidence and escalating trade tensions. Nevertheless, we expect growth in the last part of 2018 and early 2019 will be a touch softer than what it could have been, slightly below 3% instead of slightly above.

Weak business confidence has been upgraded in status from an elephant in the room to a neon sign with fireworks going off behind it. There are some early signs that business confidence is stabilising, albeit at a level usually consistent with weak economic growth. Trade tensions, capacity constraints, and cost pressures with contracting profit margins will be part of the story. But it is also clear from specific surveying that uncertainty about government policy is an important influence behind the weak level of sentiment.

As the Government firms up key policies over time, the added uncertainty businesses seem to be feeling at present should subside. Nevertheless, we expect that some business capital expenditure will be deferred in the short term, taking the edge off NZ's near-term growth performance. It has been encouraging that, to date, there are few tangible signs that the plunge in business confidence has filtered through to economic growth. Capital goods imports are holding up, as is credit growth to businesses. And the labour market has remained tight with firms continuing to report difficulties in finding both skilled and unskilled labour. The dated publication of Q3 GDP (late December) and Q4 GDP (March) will give a rear-vision mirror reality check.

Trade tensions, unfortunately, continue to simmer between the US and China. So far NZ is not really being impacted but we need to keep a wary eye out for any slowing of Chinese consumer spending growth.

Even taking both these influences into account, NZ still has reasonable momentum, though not as strong as it was two years ago when all the economic ducks were lined up. Some drivers, such as construction, are waning. Consumer spending growth faces some mixed influences. The labour market appears in good health, and added Government support is bolstering household incomes. But fuel prices are considerably higher than what they were at the start of the year. This has squeezed budgets of heavy fuel users, with pressures most acute for rural and Auckland households. Export incomes have been solid, and we expect them to hold up going forward – subject mainly to how the Chinese economy performs. Borrowers are getting some relief from the slight fall in mortgage interest rates in recent months. The RBNZ is set to hold the OCR at records lows till 2020, continuing the tailwind of favourable financial conditions.

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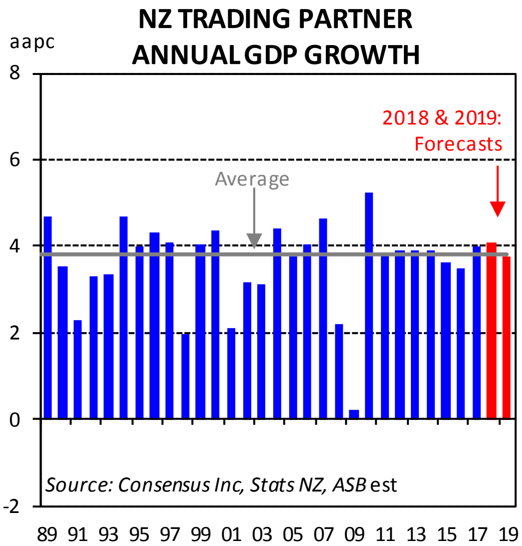
International Outlook – Global economy proving resilient so far

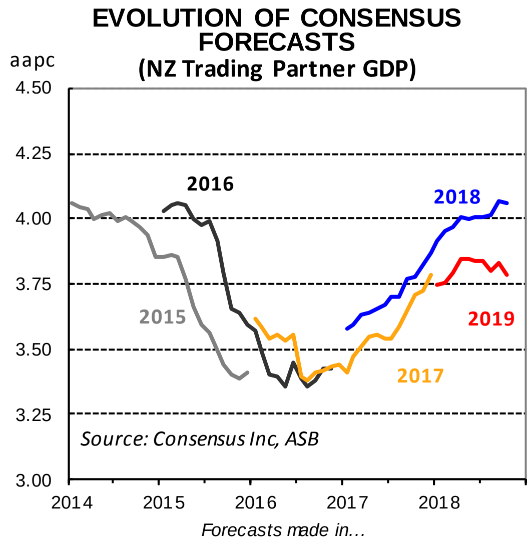
The global growth outlook remains firm. Our estimates for NZ's 2018 and 2019 trading partner growth, based on Consensus forecasts, are much the same as three months ago. Specifically, we anticipate growth of 4.1% and 3.8% over 2018 and 2019, respectively.



Notably though, **the 2019 growth outlook has started to trend marginally lower**. The IMF has also revised down its forecast world growth by 0.2 percentage points to 3.7% for both 2018 and 2019.

The general, but small, downward revisions reflect heightened risks to the growth outlook. In particular, the US-China trade spat remains a key risk to the global economy. For example, the IMF estimates that the existing and proposed tariff changes from both sides could trim up to 0.5 percentage points off global growth over the long term.

The recent US mid-term election results may even exacerbate these trade concerns. With the US Government now split along party lines, President Trump will face high hurdles to advancing his domestic policy agenda. On the other hand, he retains a full foreign policy remit. As such, Trump may choose to focus on advancing his protectionist *America First* policy as he looks to position himself favourably with voters ahead of the next Presidential election.



We assume that the US ratchets up tariffs on Chinese exports, eventually applying a 25% tariff on all of its $US500 billion plus of imports from China. We estimate that the impact of these further tariff increases is to trim 0.4 percentage points off Chinese GDP growth over 2019.

However, help is on its way. **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. In addition, the weaker Chinese yuan will help offset some of the loss of competitiveness in the US market. All up, Chinese growth should be little changed.

Complicating matters is the global sharemarket slump over October. The slump was widespread, with the MSCI World Index, sliding around 10% over the month. Notably, the key triggers for the slide were ongoing concerns from the US-China trade spat and rising US interest rates. That all said, global sharemarkets have pared around half their losses so far over November.

Looking at global interest rates, **the US Federal Reserve continues to signal gradual lifts to its benchmark rate**. In September the Fed lifted its Funds rate by 0.25%pts to 2.0%-2.25% as widely expected. With the US economy running hot, we expect the Fed to increase the Funds rate by 0.25% at its December meeting and to increase the Funds rate twice further in the first half of 2019.

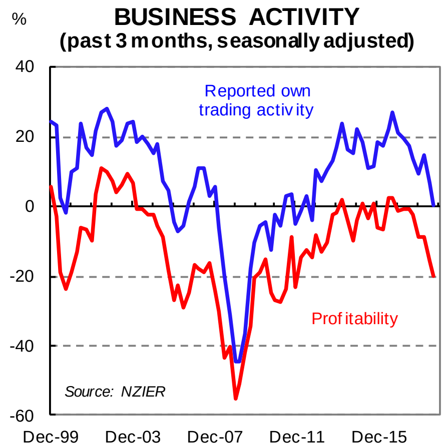
Meanwhile, **the pace of monetary policy tightening is much more gradual in Europe and the UK**. The ECB is on track to begin hiking its benchmark rate from around mid-2019 and to cease asset purchases by the end of 2018. Across the English Channel, the Bank of England is on hold while Brexit negotiations are ongoing.

Although the risks have increased, **the global economy outlook remains supportive for the NZ export sector**. This outlook will underpin the Terms of Trade at near-record levels and help boost export volumes over 2019. That said, **we keep a wary on the global economy**, particularly for any signs that China is cooling. After all, one cannot relax, particularly while President Trump remains in office.

The New Zealand Economy – under the pump

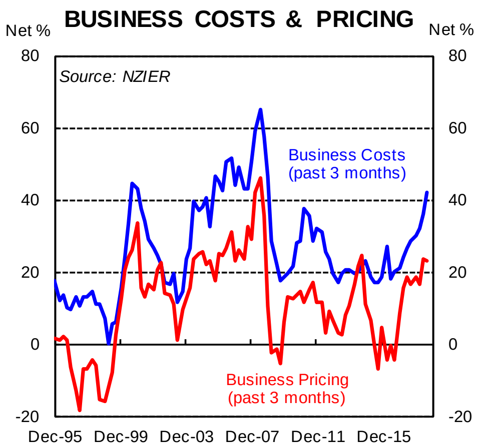
NZ economic growth eased over 2017, with momentum then remaining steady over the first half of 2018. NZ's economy has been supported by the tailwinds produced from record-high Terms of Trade, low interest rates and strong population growth. Nonetheless, **business confidence remains weak and points to a slowdown in growth over the second half of 2018, led by a fall in business investment over the coming year.**

In the October issue of **NZIER's Quarterly Survey of Business Opinion, businesses reported a sharp drop in trading activity and profitability over the September quarter**. This suggests that demand may not be as strong as we would typically expect given the number of supports in the economy (as mentioned above). **Weaker demand, growing costs and falls in profitability may be linked to the mid-2018 spike in fuel prices** that had been driven by higher global oil prices, a lower NZD and the introduction of the Auckland regional fuel tax and nationwide fuel excise tax increases. Higher fuel prices have presented challenges to both households and firms (particularly those with high transport costs). The household sector has, to date, been relatively well supported by a strong labour market and low borrowing costs. **But rising costs for necessities** (rent, food and fuel) **are likely placing pressure on households**, particularly those with less disposable income and tighter budgets. **Sharp falls in international oil prices since their mid-October peak raise the possibility of further cuts to retail fuel prices and may offer some respite.**

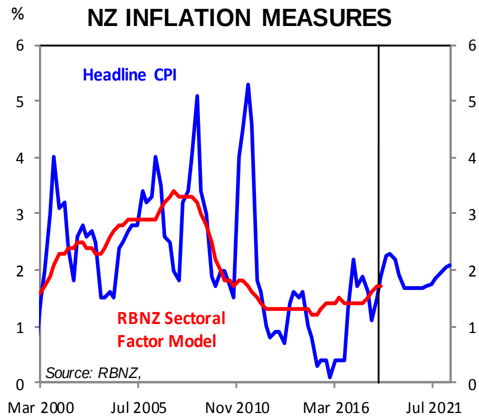


With an increasing number of firms reporting an increase in costs, **the key test for the economy over the next six months will be the ability of firms to pass on increased costs to consumers** (thus reinforcing the recent lift in core inflation). But if firms find that final demand is not strong enough to absorb higher prices, economic growth and core inflation are likely to slow.

The export sector has been a source of strength for the NZ economy over the past year, largely owing to the strong performance of the global economy. **But there is an increasing risk global growth slows, with growing trade tensions between the US and China a key risk.** Our core view remains that economic growth of NZ's key trading partners continues around the recent pace of the past few years. Tariffs placed on Chinese exports to the US are likely to impact Chinese economic growth, but we currently expect economic stimulus by the Chinese authorities and the softer yuan will be sufficient to offset this. Continued economic development in China and growth in Chinese household disposable incomes had been key factors in supporting strong demand for NZ exports to China, particularly food exports.



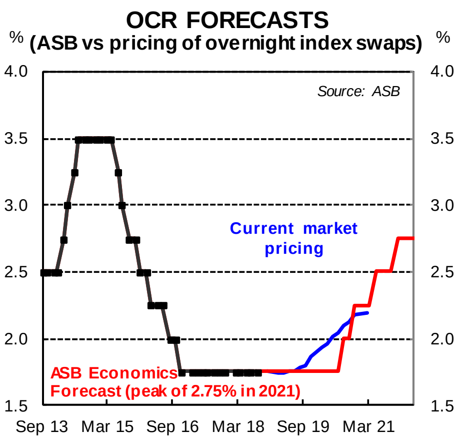
NZ CPI inflation surged over Q3, in most part reflecting higher fuel prices (a volatile component of inflation the RBNZ often looks through). Nonetheless, domestic inflation pressures have been gradually lifting and core inflation remained steady over Q3 at 1.7%, holding onto its recent increase over the past year. Global oil prices appear to be easing from recent highs and headline inflation will fall over the coming year as the recent lift in fuel prices falls out of the annual figures. **Looking through this volatility we expect core domestic inflation to continue to gradually lift, largely as a result of higher wage inflation spurred by increases in the minimum wage and a tight labour market.**



Interest Rates and Exchange Rates – No OCR hikes until 2020, NZD resilience

We now expect the OCR to remain on hold at its record low of 1.75% until August 2020 (February 2020 in our August forecasts). The pushing out of the OCR profile comes despite a modestly firmer starting point for NZ wholesale interest rates and an unchanged OCR profile in the November Monetary Policy Statement. **It reflects our judgment that the growth and medium-term inflation outlook will not be strong enough to clear the high hurdle necessary to trigger an OCR hike.** However, we also view the hurdle to OCR cuts as having risen given the solidity of recent data, high labour utilisation and various economic supports that should keep the economy moving.

We also expect very mild RBNZ policy tightening by historical standards, culminating in the OCR peaking at just 2.75% this cycle (from late 2021). Our recent research suggests the 'neutral' OCR has been trending lower since the Global Financial Crisis (GFC), and could continue to ease from current levels (around 2.75%). The RBNZ will also be mindful of not getting policy settings too far out of synch with other central banks. The US Federal Reserve is expected to hike rates by a further 75bps by mid-2019 (to 2.75-3%) but to then start trimming settings from 2021 as US growth slows. The RBA is expected to raise the cash rate from November 2019, with rates peaking at 2½% in mid-2021.



Longer-term NZD interest rates should drift higher as global yields initially rise. We expect Treasury yields to edge higher as US Fed hikes continue into 2019. US yields are then expected to soften as the Fed tightening cycle matures and rate cuts are contemplated and then enacted. **NZD long-term yields are expected to gradually firm and move above US counterparts, but the eventual easing of US Treasury yields, mild RBNZ tightening, contained NZ inflation, and the strong allure for NZ assets should cap longer-term NZ yields at historically low levels.**

Current support for the NZD is being provided by our solid growth outlook, historically-high Terms of Trade, and the resilience of local economic data in the face of weak confidence and adverse positioning. NZD supports are generally expected to remain in place, but our expectation of further depreciation of the Chinese yuan and the negative risk profile for global growth should temper optimism, with the NZD losing some of its lustre.

Importantly, we have retained our strong USD outlook. Supports to the Greenback remain, including the solid US growth outlook, higher US interest rates relative to most global peers, and the elevated US Terms of Trade. Moreover, the fickle global scene, elevated trade tensions, and slowing growth in China should support the USD. **We expect the NZD to oscillate in a 65 to 71 US cent range over the forecast period.**

Narrowing interest rate differentials should see the NZD settle back into a 90-91 Australian cent zone by the end of next year. **Initial NZD strength against the euro is expected to abate, with the NZD at 0.55 EUR by end 2019.** The European Central Bank is expected to hike rates in September 2019, although euro upside is limited by sluggish Eurozone GDP growth and fiscal solvency concerns. Brexit risks and the large UK current account deficit should keep the **GBP low, with the NZD ending 2019 at around 0.53 GBP**. The downward risk profile for global growth and the strong Japanese external position should support the yen, with the **NZD/JPY modestly lower over the forecast period**.

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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%**	**2.7**	**2.8**	**2.7**	**2.7**	**2.7**	**2.7**	**2.8**	**2.8**	**3.2**	**2.9**
private consumption	AA%	3.5	3.2	2.9	3.0	3.1	3.2	3.4	3.3	3.2	3.2
dwelling construction	AA%	1.8	2.6	3.3	4.0	4.2	2.8	1.4	-0.4	-3.1	-4.3
other investment	AA%	5.7	5.6	3.4	1.0	-1.0	-2.2	-1.7	0.1	7.2	5.1
exports	AA%	3.6	4.0	4.4	5.2	5.7	5.7	5.0	3.9	2.6	2.0
imports	AA%	8.0	7.9	6.2	4.4	2.2	1.2	1.3	1.8	4.2	3.2
NZ GDP real	A%	2.8	2.7	2.6	2.8	2.5	2.7	3.0	3.1	3.1	2.9
NZ GDP real	Q%	1.0	0.6	0.5							
NZ CPI	**A%**	**1.5**	**1.9**	**2.1**	**2.2**	**2.2**	**1.9**	**1.8**	**1.8**	**1.7**	**2.1**
NZ house prices (QV index)	A%	5.0	5.5	2.4	1.9	2.0	0.7	1.2	0.9	0.6	0.4
NZ unemployment (sa%)	Qtr	4.4	3.9	4.2	4.1	4.1	4.1	4.1	4.0	4.0	4.2
NZ private sector wages (LCI)	A%	2.1	1.9	2.0	2.1	2.3	2.5	2.6	2.8	2.8	2.7
NZ current account ($b)	Yr	-9.5	-10.0	-10.0	-8.5	-7.9	-8.1	-7.9	-7.6	-7.8	-8.9
as a % of GDP	Yr	-3.3	-3.4	-3.4	-2.9	-2.6	-2.6	-2.5	-2.4	-2.4	-2.6

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	2.25	2.75
NZ 90-day bank bill	2.00	1.91	2.00	2.05	2.05	2.10	2.10	2.10	2.50	3.00
NZ 2-year swap rate	2.15	2.04	2.20	2.25	2.35	2.45	2.55	2.65	2.95	3.15
NZ 10-year gov't stock	2.85	2.65	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.35

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	0.66	0.65	0.66	0.67	0.67	0.68	0.68	0.70	0.66
GBP per NZD	0.516	0.51	0.52	0.53	0.53	0.53	0.53	0.53	0.54	0.51
AUD per NZD	0.918	0.92	0.90	0.90	0.91	0.91	0.91	0.91	0.90	0.90
JPY per NZD	74.5	75.1	73.5	73.9	74.4	73.7	74.8	73.4	74.9	73.9
EUR per NZD	0.583	0.57	0.58	0.58	0.57	0.56	0.56	0.55	0.55	0.54
CNY per NZD	4.48	4.55	4.52	4.62	4.76	4.82	4.96	5.03	5.11	4.82
TWI - 17 country	72.5	72.1	71.4	71.9	72.4	72.1	72.6	72.3	72.8	70.2

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