Quarterly Economic Forecast

November 2019

Are we there yet?

- We are still waiting for resolution of trade tensions and Brexit, and an end to NZ's economic deceleration.
- Monetary policy has done some work to lift growth; the Government also has plenty it could do.
- Australia hasn't had a recession for 28 years, something NZ can actively aspire to.

At the start of this year, US-China trade tensions, Brexit, and the gentle but steady deceleration in NZ's economic growth, all seemed close to turning for the better. But, as the end of the year looms, we are still left wondering where the end is. NZ can't do much to resolve the first two politically-created crises (other than hope that some of the signs of recent progress do firm up). But collectively there is more that can be done to haul NZ's growth back up to a more respectable rate. To frame up the challenge, NZ's per-capita GDP growth peaked at 2.3% for the 12 months ending in June 2015. Roll forward five years to June 2020 and we currently forecast per-capita growth will struggle to exceed zero. In those circumstances, it is hard for NZ to collectively improve people's well-being.

Growth can and should be stronger. The RBNZ has taken some action – and will do more in our view – which will support housing-sensitive activity and consumer spending. But the looming increases in bank capital requirements will progressively boost the price of credit and constrain its supply. And monetary policy is getting closer to the point where unconventional measures would need to be leaned on in any real crisis.

There is an increased role for the Government to both directly boost demand and also to help reduce the amount of uncertainty and caution that is holding businesses back. Fiscal measures that are feasible and sensible have been debated. Infrastructure has timing and resourcing challenges and is best looked at through a long-term lens. Added welfare spending or income tax threshold changes such as those proposed by the Tax Working Group would put money where it is most likely to be spent quickly, though wouldn't do much to boost NZ's long-term performance.

A chunk of the softening economic performance comes from businesses' hesitancy to hire and invest. Yet investment is also an important way to unlock stronger prosperity over the long term. It would be great to see the Government come up with some innovative ways to jolt businesses into acting. A short window of accelerated depreciation on new capital spending might be one carrot to encourage capital spending right now. Tax cuts are another option to lift after-tax returns from businesses, though their impact may be muted than a "use it or lose it" carrot.

Above all, helping reduce the amount of uncertainty and angst businesses are feeling – regardless of the cause – would help. Engaging heavily in two-way dialogue with industries, showing pragmatism, understanding, and a clear commitment to support industries through transitions may give greater comfort that the Government is working with business. Getting key policies finalised as soon as possible, albeit with industry involvement. With NZ's productivity having flat-lined in recent years, a work programme focused on boosting productivity would show a commitment to enabling businesses to grow as well as sowing the seeds for future prosperity. In December the Government will give its formal update on the fiscal and policy outlook, an opportunity to see how next year's Budget will frame up.

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International Outlook – Trade war impact largely passing New Zealand by

The global growth slowdown has become even more entrenched in recent months. Trade war impacts are now more clearly showing up in hard data. Indeed, global manufacturing surveys imply that global manufacturing activity has been contracting since May. However, this has yet to translate into a materially weaker NZ export sector. In fact, and on balance, it appears that NZ's export sector has strengthened over 2019.

According to Consensus Economics forecasts, **growth in NZ's trading partners is expected to print well below trend for the next two years**. 2019 growth is expected at 3.3% and closer to 3.2% is expected for 2020. These forecasts are well down on the long-run average of 3.8%.

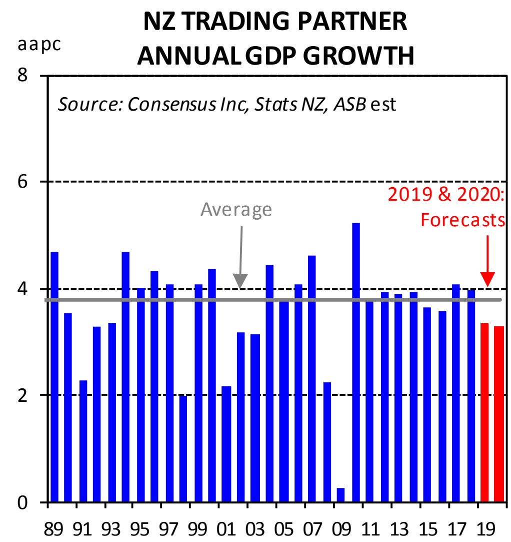
The outlook for the Australian economy has also continued to soften. The RBA has cut its cash rate three times this year, and is ready to cut again next year. Notably, the RBA has grown increasingly pessimistic on the outlook for wage growth, although tax cuts, low interest rates and infrastructure spending are expected to boost growth over 2020. All up, we anticipate the RBA will cut its cash rate to 0.5% in February 2020.

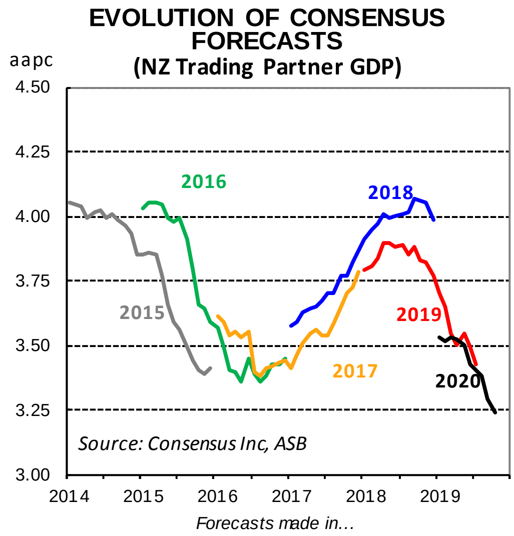
Meanwhile, Chinese economic growth continues to slow. Authorities' stimulatory efforts haven't had a material effect on credit growth to date, with the trade war dampening the impact of stimulus measures. On balance, we expect GDP growth to slow to 5.8% next year, from 6.0% over 2019. That said, the service sector, including retail, continues to post firm growth numbers, which bodes well for demand for NZ exports such as food.

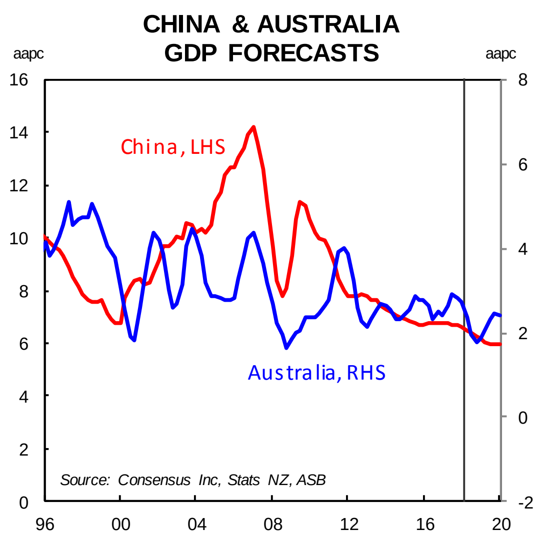
On a brighter note, the UK appears headed towards an orderly Brexit. On 28 October, the EU and UK agreed to a Brexit "flextension" until 31 January 2020. The "flextension" means Brexit can take place earlier on 1 December 2019 or 1 January 2020, if the withdrawal agreement (WA) is ratified by both main UK parties. Meanwhile, a UK general election is set for 12 December and, encouragingly, no major UK political party has a hard-Brexit platform.

Central banks in Europe and the US continue to act to support their economies. The ECB noted in October the need for monetary accommodation for a prolonged period of time. Meanwhile, the US economy, by contrast, is holding up relatively well, with the Fed lowering rates more as an insurance policy than for disaster recovery.

Despite the ongoing slowdown in global growth, on balance, **the NZ export sector continues to perform well**. Indeed, we expect NZ's Terms of Trade to hit fresh highs this year. Beef and lamb prices are leading the charge, with both hitting new record highs this November. Meanwhile, with NZ spring production growth hitting a snag, we see upside risks to our already-bullish 2019/20 milk price forecast of $7.00 per kg of milk solids.







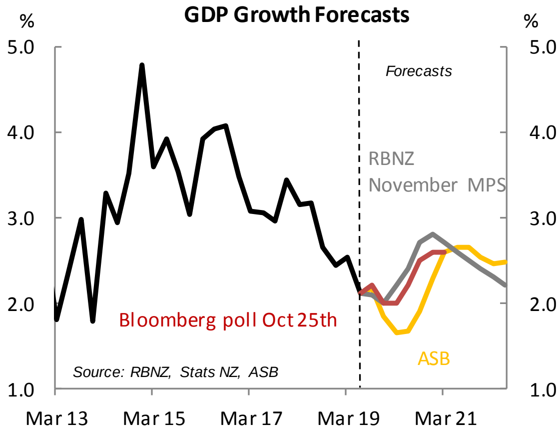
The sector perhaps most at risk from the global slowdown is tourism. The tourism boom is already showing signs of peaking, and the longer global growth remains below par the bigger the risk that overseas arrivals tail off faster than we currently expect. But all up, **NZ's export sector appears to be largely riding out this global growth storm.**

The New Zealand Economy – Growth forecasts slashed

We have revised our GDP growth forecasts significantly lower since our latest Quarterly Economic forecasts. Although general business sentiment has been pessimistic over the past two years, it has only been more recently that we have seen tangible signs that businesses are facing material headwinds – raising concern about the economy's resilience. Since the start of 2019, firms have reported a fall in demand and a decline in profitability, and this weakness has been fairly broad-based across segments of the economy. Businesses have reacted by pushing pause on major investment projects and as a result business investment growth has stalled over the past year. To date, job creation has not yet been materially impacted and consumer demand has held up due to labour income growth.

The recent weakness in NZ economic growth has coincided with a slowdown in global economic growth, with key major trading partners (such as Australia, US and China) also experiencing slower economic growth over 2019. We have seen weaker global demand directly weigh on growth in the tourism sector via a slowdown in growth in overseas visitor arrivals over the past year. However, a large share of our export sector has not been directly impacted (i.e. dairy, meat and fruit), suggesting the slowdown in NZ economic growth cannot be solely explained by weaker trading partner demand for exports.

At the time of writing, our economic growth forecasts place ASB towards the bottom of the consensus range (Bloomberg Survey October 25th) and, also below the RBNZ's November Monetary Policy Statement economic forecasts. **Our suite of GDP growth indicators suggests the underlying pace of quarterly economic growth has remained weak over the second half of 2019.** Our Recession Probability Model continues to estimate a 30% chance of the NZ economy entering recession over H2 2019, which further reinforces our view of sub-trend growth. Please note we are NOT forecasting a recession at this stage, just highlighting there is currently an elevated risk of a recession forming. We encourage policy makers to take more concerted action to ensure a recession doesn't occur.



We continue to believe that low interest rates will stimulate economic demand and support a recovery in economic growth, with some green shoots already evident in interest-rate sensitive sectors of the economy, such as the housing market. But structural changes taking place in the finance sector (in particular the RBNZ's proposed changes to minimum bank capital requirements) are likely to impact credit availability, blunting the effectiveness of lower interest rates to stimulate the economy. **We believe (like many) some additional targeted fiscal support will be required, but given the lags in implementing any fiscal boost we have pushed out the timing of our anticipated economic recovery.**

To date, the labour market remains relatively healthy, although we believe the labour market's strength has peaked and that labour market conditions will continue to soften. The unemployment rate and underemployment rate have fallen over the past year and wage growth has started to pick up (although some of this can be attributed to minimum wage increases and pay equity deals rather than a cyclically tight labour market). **A relatively robust labour market has provided a floor under consumer confidence** (consumer confidence questions related to consumers' own financial position have not declined as dramatically as businesses' expectations of their own trading activity). Labour income growth and job security are both required to maintain a reasonable pace of household spending growth. Going forward, we expect the labour market to soften, with the unemployment rate likely to edge higher.

Domestic inflation pressures have picked up – but with growth slowing over the past year, we **doubt the pick-up in inflation pressure is sustainable** without further policy support provided by the RBNZ over the year. The RBNZ is only just meeting its inflation and labour market obligations, and going forward the risks are skewed one way.

Interest Rates and Exchange Rates – Back to square one

In the November Monetary Policy Statement, the RBNZ surprised the market and left the OCR on hold at 1.00%, deeming economic developments had not warranted a change in stance since the 50bp August OCR cut. Market reaction was sizeable, with NZ swap rates up 10-15bps on the day and back to levels they were prior to the RBNZ's surprise 50bp cut back in August. Yields are now roughly 30-40bps above their October lows.

We still expect 0.50% will be the lull in the OCR this cycle, but have pushed back the timing of OCR cuts to February (-25bps) and May (-25bps) next year. Risks are tilted to a later start to OCR cuts given improving global sentiment and signs that the NZ data pulse has shown signs of improvement. However, the NZ economy is hardly booming and the risk profile remains downwardly skewed. If the RBNZ reveals capital requirements on December 5 for locally-incorporated NZ banks in a similar form to those currently proposed, it will push up lending interest rates, lower deposit interest rates and restrict credit availability. The OCR would stay lower for longer than it would otherwise be, weighing on NZ swap rates. **We expect gradual RBNZ hikes from early 2022, with the OCR ending 2024 at just 2%.**

New Zealand longer-term interest rates are off recent lows, matching recent climbs in global counterparts. However, there does not seem to be much substance behind the recent lift in yields. **We still expect more central bank policy stimulus will be employed overseas to combat slowing global growth and offset low** inflation and inflation expectations. As such, we still expect, the US Federal Open Market Committee to cut the 1.50%-1.75% Federal Funds rate by 75bps, but have delayed the timing of the next cut from December 2019 to March 2020. We expect a further 25bp cut to the RBA's 0.75% cash rate in February and a 0.50% cash rate floor. More monetary policy easing is expected elsewhere, including China and Canada.

New Zealand and global longer-term yields are biased to fall towards historical lows, before eventually drifting higher as policy interest rate hikes are contemplated down the track. There is the **risk that long-term yields could retrace recent gains if downside global risks crystallise.** We expect NZ longer-term yields to settle towards 2.50% by the end of the projection period, in a similar ballpark to our estimates of the neutral OCR.

The NZD Trade Weighted Index is little changed on a trade-weighted basis since our August forecasts. **We have retained a modest short-term downside bias for NZD direction**, with the sub-par NZ growth outlook, and anticipated OCR cuts to weigh on the NZD, which is expected to trough at around 62 US cents and 64 yen by early next year.

A modest strengthening of the NZD from its early 2020 lull is then envisaged. Supporting this are both domestic and global factors. NZ's economic growth is expected to gradually firm from its early 2020 trough. Other dollar-supportive influences are a solid commodity export price outlook, persistently-high Terms of Trade, strong NZ fiscal position and continued investor interest in NZ assets.

Central bank cuts by our trading partners will also support the NZD. With the Fed set to trim policy interest rates further and with policy stimulus to boost growth prospects in China, the **USD is expected to weaken over the projection period**, with the NZD gradually strengthening to 0.72USD by the end of 2022. We expect the **NZD/AUD to remain supported** by the stronger outlook for our Terms of Trade. We see the NZD ending 2022 at around 94 Australian cents. Gradual NZD strengthening is expected against the Chinese yuan and Japanese yen, with the kiwi at around a 5.0 yuan and 72 yen by late 2022. We expect the NZD to strengthen against the euro, with the NZD moving above 60 euro cents over the projection period. Although risks of a hard Brexit are lower, Sterling is expected to remain volatile until its future position (in or out) with the European Union is confirmed. We expect the NZD to modestly strengthen towards 54 pence by late 2022.

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Economic and Financial Forecasts

ASB economic forecasts		Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
			<<actual	forecast >>					
NZ GDP real	**AA%**	**2.7**	**2.4**	**2.3**	**2.2**	**1.9**	**2.1**	**2.6**	**2.5**
private consumption	AA%	3.3	3.3	3.0	2.7	2.3	3.0	3.1	2.8
dwelling construction	AA%	3.7	4.0	4.8	5.0	3.3	-1.7	-4.7	-4.8
other investment	AA%	2.1	0.7	0.8	0.8	0.0	1.0	4.6	5.1
exports	AA%	2.7	2.5	3.0	3.3	2.3	2.8	2.3	2.1
imports	AA%	3.9	1.7	0.5	0.3	0.3	3.3	4.2	3.5
NZ GDP real	A%	2.5	2.1	2.2	1.8	1.6	2.6	2.5	2.5
NZ GDP real	Q%	0.6	0.5	0.4	0.3				
NZ CPI	**A%**	**1.5**	**1.7**	**1.5**	**1.7**	**2.1**	**1.7**	**1.7**	**1.8**
NZ house prices (QV index)	A%	1.8	1.2	1.7	2.7	3.7	2.3	1.1	2.6
NZ unemployment (sa%)	Qtr	4.2	3.9	4.2	4.1	4.3	4.3	4.2	4.4
NZ private sector wages (LCI)	A%	2.0	2.2	2.3	2.3	2.4	2.4	2.5	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	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)			<<actual	forecast >>				
NZ cash rate target	1.75	1.50	1.00	1.00	0.75	0.50	0.75	1.25
NZ 90-day bank bill	1.85	1.65	1.15	1.20	0.95	0.75	1.00	1.50
NZ 2-year swap rate	1.63	1.35	0.94	1.05	0.95	0.85	1.20	1.60
NZ 10-year gov't stock	1.81	1.57	1.10	1.30	1.20	1.10	1.30	1.70

ASB foreign exchange forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)			<<actual	forecast >>				
USD per NZD	0.68	0.67	0.63	0.63	0.62	0.67	0.71	0.72
GBP per NZD	0.52	0.53	0.51	0.49	0.46	0.51	0.53	0.54
AUD per NZD	0.96	0.96	0.93	0.94	0.94	0.94	0.94	0.94
JPY per NZD	75.2	72.1	67.7	66.2	63.9	70.4	71.7	72.0
EUR per NZD	0.60	0.59	0.57	0.57	0.57	0.59	0.61	0.62
CNY per NZD	4.57	4.60	4.47	4.47	4.43	4.72	4.98	5.05
TWI - 17 country	73.86	73.2	70.2	69.1	67.9	71.5	74.3	75.0

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