insightpaper

NEW ZEALAND INSIGHTS

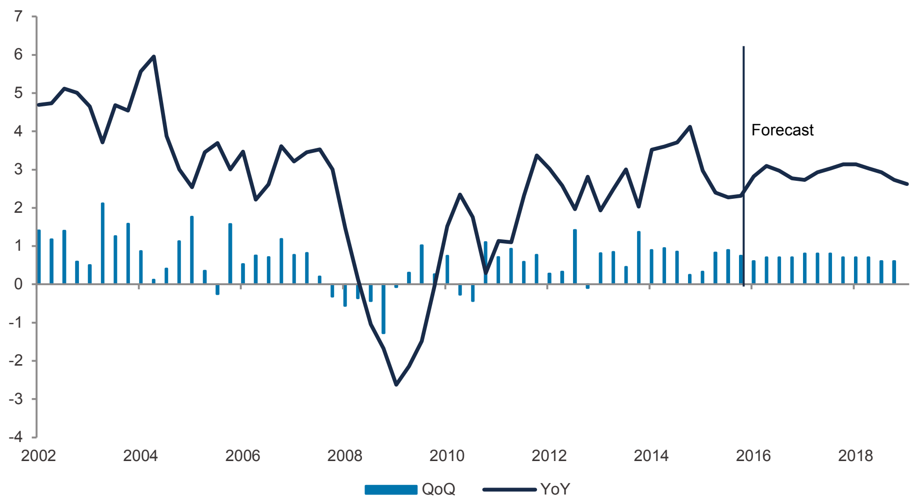
JUNE 2016

The New Zealand economy continues to put in a solid growth performance despite the headwinds from the external sector. The economy grew 2.5% in calendar year 2015 and we expect growth of 2.5-3.0% per annum over the next two years before winding down in 2018, largely on the back of slower population gains.

BEVAN GRAHAM
NZ Chief Economist

SOLID ECONOMIC PERFORMANCE CONTINUES DESPITE HEADWINDS

NEW ZEALAND GDP
% change



Source: Statistics New Zealand and AMP Capital

Factors impacting the external sector remain a drag on growth. The most obvious is lower dairy commodity prices which are yet to be fully reflected in farm-gate incomes and economic activity through rural New Zealand. At the same time, the strength of the exchange rate, while a reflection of New Zealand's strong relative economic performance, remains a challenge for the external sector.

It's not all bad on the external front though. Service exports remain strong on the back of tourism flows and while weaker commodity prices are a negative for the dairy sector, oil prices remain low which has helped moderate the negative impact on the terms of trade.

Domestically, the strong economic growth impetus continues to come from population growth.Sectors that are growing strongly include residential construction, retail spending and the core service areas such as healthcare. More people in the country consume more, need houses to live in, and expend more in core government services.What's more, while inflation remains low and the exchange rate remains elevated, we continue to enjoy highly stimulative monetary conditions. This is also supporting household purchasing power.

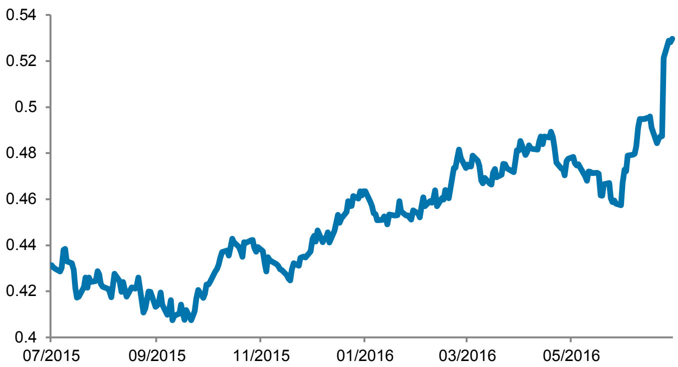
THE NEW ZEALAND ECONOMY AND 'BREXIT'

Britain's decision to exit the European Union (EU) has delivered a significant shock to financial markets. It has also ushered in a period of high economic and political uncertainty for the UK, the members of the EU and the global economy. High uncertainty and financial market ructions are likely to weigh on business and consumer confidence in the UK and EU, and that may have some flow-on to other countries including New Zealand.

It has also led to a widening of credit spreads and likely higher bank funding costs. If that is sustained, it will likely get the Reserve Bank of New Zealand (RBNZ) across the line with a rate cut in August.

As we go to print the NZD/GBP exchange rate is at its highest level since mid-2013 at 0.53. While that's good news if you are an importer of goods from or planning a holiday to the UK, it makes conditions more problematic for exporters.

NZD/GBP



Source: Bloomberg

The UK takes around 3% of our merchandise exports (lamb, wine) but accounts for a greater 9% share of service exports (tourism).

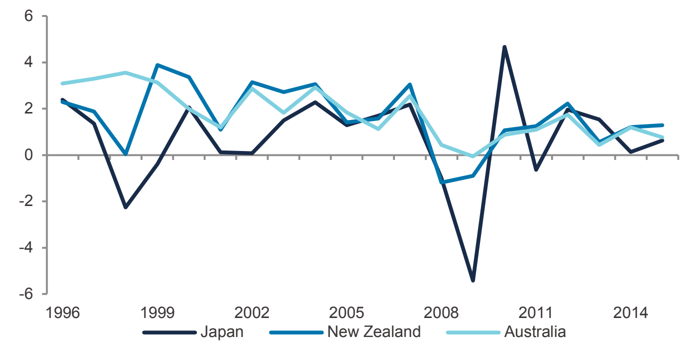
ANY NEGATIVE IMPACT FROM THE HIGHER EXCHANGE RATE OR FALL-OUT FROM LOWER CONSUMER CONFIDENCE AND SPENDING IN THE UK IS LIKELY TO BE MANAGEABLE.

In terms of trade access, nothing changes in the meantime but there is now uncertainty about what access arrangements will look like in the future. It will be some time before we know the answer to that question.

CURBING THE GROWTH ENTHUSIASM

It's useful to remind ourselves occasionally about what GDP growth doesn't show us – how much wealthier we are becoming. While by no means a perfect measure, growth in GDP per person or per capita GDP is a better indicator of changes in our standard of living.

PER-CAPITA GDP GROWTH
Year-on-year, constant prices



Source: IMF

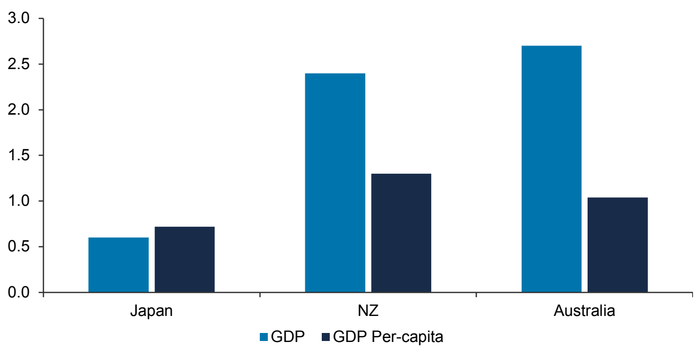
So while we have enjoyed and celebrated strong GDP growth, which has averaged 2.4% over the last five years in real (inflation adjusted) terms, per-capita GDP growth has been a more subdued 1.3% per annum over the same period. That's the real indicator of whether we can afford new things like extended paid parental leave – an issue that's been in the New Zealand media recently. (Note I am conveniently ignoring the other more vexed issue of what the Government of the day CHOOSES to spend taxpayer dollars on. For example, whether it's better to extend paid parental leave or continue to commit to current arrangements for New Zealand Superannuation.)

AUSTRALIA IS IN A SIMILAR POSITION WITH SOLID GROWTH OVER THE LAST FIVE YEARS BUT A LOT OF THAT DRIVEN BY POPULATION GROWTH.

Over the last five years Australia has averaged real GDP growth of 2.7%, but that comes down to 1.0% on a per capita basis.

We tend to beat-up on Japan and its low rate of growth, but remember Japan's population is in decline. Over the last five years its per capita rate of growth (0.7%) is higher than GDP growth (0.6%). So New Zealand and Australia are still doing better, but the differential is narrower once you adjust for population growth.

GDP GROWTH
Average 2011-2015, Real

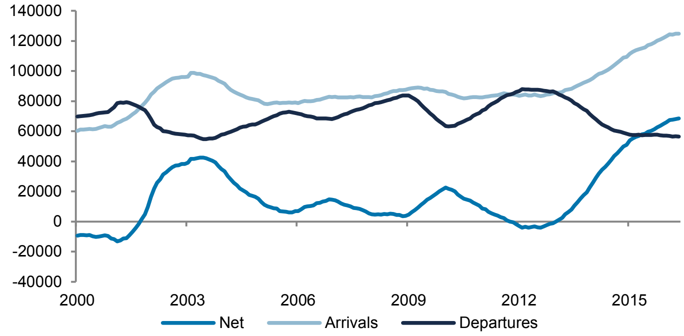


Source: IMF

NET MIGRATION PEAKING, BUT WHAT NEXT?

Monthly net migration gains appear to be levelling off, with the running annual total looking like peaking at just short of 70,000, or a 1.6% contribution to population growth. Add in natural growth and the population is currently growing at a 2% annual clip.

NZ PERMANENT AND LONG-TERM MIGRATION
Number, year to date



Source: Statistics New Zealand

The key question now, assuming we are close to peak in net migration, is where does it head from here? There is a tendency for economists to assume mean reversion. That would suggest the annual gain will head back to the long-term average of around 12,000 per annum. Indeed, in the latest Budget projections the New Zealand Treasury assumed we would be back to that level by 2019.

We're not convinced. While we don't expect the net gain to stay at 70,000 per annum, nor do we expect it to fall away sharply either.

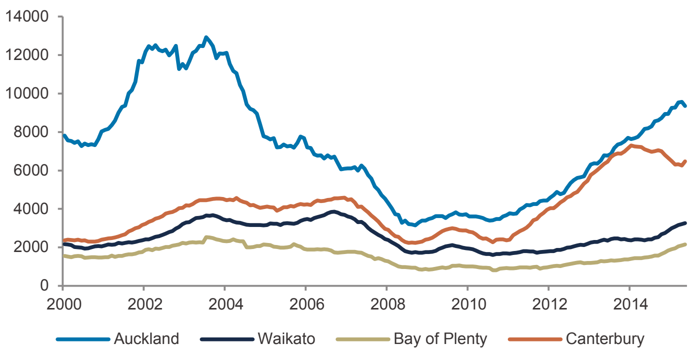
RELATIVE ECONOMIC PERFORMANCE AND PARTICULARLY RELATIVE LABOUR MARKET PERFORMANCE BETWEEN US AND AUSTRALIA IS A KEY DETERMINANT OF NET MIGRATION FLOWS.

For a long while Australia was performing more strongly than New Zealand, largely on the back of the commodity boom. Of course with the end of the mining boom a lot of those kiwis headed back, and a lot who were thinking about going chose to stay put. While we think Australia is picking up, we don't believe it will be to the extent, nor in the sectors, that's going to lead to a whole lot of kiwis deciding to leave for Australia. So we expect net migration to stay relatively high for a while yet.

HOUSING AND CONSTRUCTION

Residential construction has been a significant contributor to strong domestic demand over recent years. This began with the Canterbury rebuild, but more recently Auckland has picked up the baton as a sharply rising population has collided with the reality of years of under-building following the Global Financial Crisis (GFC).

RESIDENTIAL BUILDING CONSENTS
Year-to-date



Source: Statistics New Zealand

NON-RESIDENTIAL CONSTRUCTION IS ALSO MAKING A STRONG CONTRIBUTION TO GROWTH AT PRESENT, WITH A NUMBER OF LARGE, PARTICULARLY ROADING, INFRASTRUCTURE PROJECTS CURRENTLY UNDERWAY.

The combination of a significant demand/supply imbalance along with record low interest rates has seen a significant increase in residential house prices. This has been most significant in Auckland, but has spilled over into much of the rest of the country, at least to some extent, and most notably in neighbouring Waikato and Bay of Plenty.

The result has been a resurgence in household debt levels which had been trending lower in the immediate aftermath of the GFC. Household debt as a proportion of total annual disposable income now stands at 162%, which is higher than the pre-GFC peak of 159%.

Despite the obvious constraint high household debt levels places on households' ability to spend in the future, it also leaves households, the finance sector and the economy vulnerable to a correction in the housing market. While we don't hold immediate fears of such a correction, a sharp rise in debt servicing costs or a recession causing job losses and forced house sales would be difficult to manage.

Increased supply is the most obvious and effective answer to the imbalance in the housing market, but this will continue to take time to resolve. In the meantime, the RBNZ has deployed loan-to-value ratio (LVR) restrictions to try and manage demand and maintain stability in the finance sector.

We expect to see further macroprudential measures deployed, especially if the RBNZ believe it necessary to reduce interest rates further in order to achieve their inflation mandate. This could be in the form of further use of LVR restrictions, the use of other tools already at their disposal (bank capital requirements), or the development of new tools (debt-to-income restrictions).

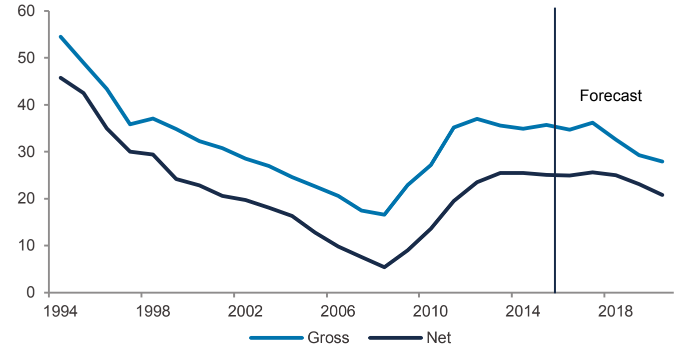
GOVERNMENT HAS CHOICES

The overarching message from Budget 2016 was that New Zealand is in good economic and fiscal shape. The Government's long-term investment-focused approach, particularly in challenging areas such as social policy, is a lesson for many countries whose governments continue to struggle with developing and articulating credible and sustainable long-term fiscal strategies.

The improved fiscal outlook has finally given the Government what any government wants: choices. In this Budget the Government has chosen to prioritise spending in health, social investment, innovation and public infrastructure. The political hot potato of housing gets a boost via increased spending on social housing and a new allocation of capital funding to support housing development on surplus Crown land.

As was flagged before the Budget, the Government has also chosen to prioritise debt repayment to get net debt down to its self-imposed 'prudent' level of 20% of GDP. The Budget projections show net debt reaching 20.8% of GDP by 2020, so it's getting close. This is lower than the 24.0% forecast for 2020 in the December Economic and Fiscal Update (DEFU) by virtue of expected stronger economic and revenue growth, along with a reduction in planned capital expenditure.

CROWN DEBT
% of GDP



Source: NZ Treasury

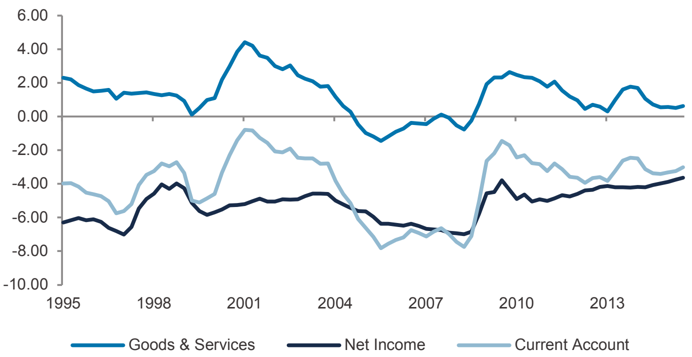
We agree with this approach. With so many of the country's debt metrics in worrisome territory (household, dairy), it's good to have at least one measure moving lower. We don't agree that now is the time to borrow and invest just because interest rates are low. There will be a more appropriate point in the economic cycle to take that approach, so now is the time to build the headroom for that to happen.

The fiscal forecasts are based on a relatively upbeat view of the economic outlook. Assuming the economic forecasts are met and the fiscal outlook improves, the Government will continue to have choices between spending, investing, repaying debt, and tax reductions. If our growth forecasts prove more correct the choices will be there, but somewhat more constrained. We expect to hear more about them in Budget 2017, just a few months before next year's general election.

EXTERNAL SECTOR IN BETTER-THAN-EXPECTED SHAPE

New Zealand's current account position is also in relatively good shape, both in comparison with history and in terms of the deterioration we expected to see this time last year which hasn't manifested itself. The current account deficit stood at 3.0% of GDP in the year to March 2016. That compares with a historical average of just over 4% of GDP.

CURRENT ACCOUNT BALANCE
Year to Date: Percent of GDP



Source: Statistics NZ

While we have seen some deterioration in the trade balance over the past twelve months, this has not been as large as expected. Weaker dairy prices account for a significant proportion of the detonation but this has been offset by weaker oil prices. At the same time, we have seen a significant improvement in the services balance on the back of the recent strength in tourism flows. Not only are we seeing more tourists, but the average spend per tourist is also rising.

The income investment balance has also improved recently, though this is not a totally good news story. While lower global net rest rates are reducing debt servicing costs, it also reflects lower investment income debits, or in other words lower earnings from foreign investment in New Zealand.

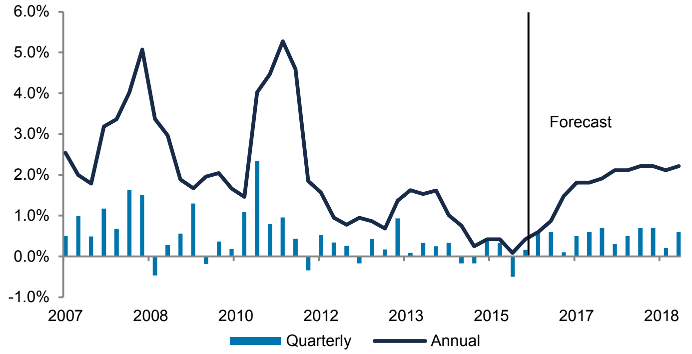
We continue to expect some deterioration in the current account deficit, but now see this being contained at around 4% of GDP, far better than the deterioration to over 5% of GDP we envisaged a year ago. New Zealand's international net liability position remains high at 63.1% of GDP, but is heading lower. This ratio was over 80% during the GFC. So while this remains a source of vulnerability, we are in better shape to handle any shocks.

INFLATION AND MONETARY POLICY

After its surprise cut in the Official Cash Rate to 2.25% in March, the RBNZ left interest rates unchanged at its two subsequent opportunities to move in April and June. Those won't have been easy calls for the Bank. While the economy is doing well and the housing market is strong, inflation is low and the exchange rate is higher than the fundamentals (particularly commodity prices) would warrant.

The Bank still has a bias to ease with another quarter-point cut built into its interest rate projections. It's by no means certain we will get that cut given the solid growth outlook. There's also the fact that spare capacity in the economy will likely continue to be absorbed, most noticeably in the labour market given our expectations of further falls in the unemployment rate. We expect inflation to gradually move higher over time, helped by low quarterly numbers from last year dropping out of the annual calculation.

NEW ZEALAND INFLATION
% change



Source: Statistics New Zealand and AMP Capital

> KEY RISKS TO THE INFLATION OUTLOOK REMAIN EXTERNAL AND MOSTLY RELATE TO THE EXCHANGE RATE.

We always thought strength in the exchange rate would be the catalyst to get the Bank to cut again. In that respect 'Brexit' has increased the odds of a further interest rate reduction with the trade-weighted exchange rate index sitting at 76.2, 6.5% higher than the 71.6 assumed for the September quarter in the June Monetary Policy Statement. The RBNZ has also been relying on help from offshore in the form of higher US interest rates, expectations of which have already been scaled back post-Brexit. Higher bank funding costs could also prompt a further OCR cut, even if simply to maintain mortgage interest rates where they already are.

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