insightpaper

NEW ZEALAND INSIGHTS

SEPTEMBER 2016

NEW ZEALAND ECONOMY FIRING ON MOST CYLINDERS

The New Zealand economy is firing on many, though not all cylinders. The end result is growth at a level that would be the envy of many in the developed world. GDP growth came in at 3.6% year-on-year (2.8% annual average) in the year to June 2016. That compares with 3.3% in Australia, 1.6% in the Euro area, 1.1% in the United States and 0.6% in Japan.

New Zealand's growth is all the more impressive given the headwinds the economy is facing. This includes the persistent strength in the exchange rate and the weakness in commodity (dairy) prices.

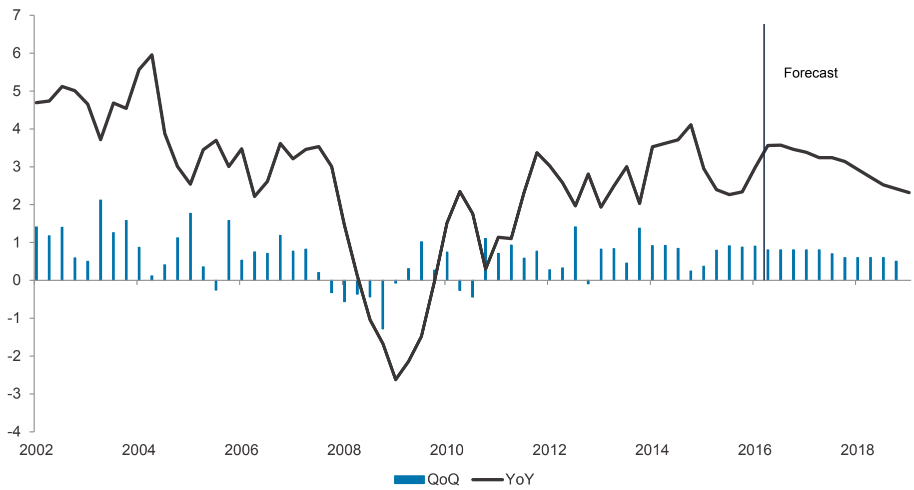
However, there are a number of beneficial tailwinds that are offsetting the negatives, at least at the economy-wide level. These include the continued strength in population growth and the resultant strength in residential construction and retail spending. Also included are strong tourism inflows and highly accommodative monetary conditions, along with the more recent addition of what we believe is rising household consumption on the back of the wealth effect of rising house prices.

BEVAN GRAHAM
NZ Chief Economist

The same set of factors, both positive and negative, are likely to be the driving forces in the economy for the rest of 2016 and into early 2017. This is expected to see growth hold at around the 3.5% level over the next few quarters.

We think this period of growth will be the peak in the cycle. That said, we don't expect growth will be a lot weaker next year. While net migration appears to be peaking, we expect net inflows to remain strong from a historical perspective. Dairy prices are also recovering, with global auction prices up 30% in the last few weeks. But the dairy price outlook remains highly uncertain and it remains to be seen whether the recent improvement can be sustained. In the meantime, we expect annual average growth of 3.1% in 2017, followed by 2.6% in 2018.

NEW ZEALAND GDP
% change



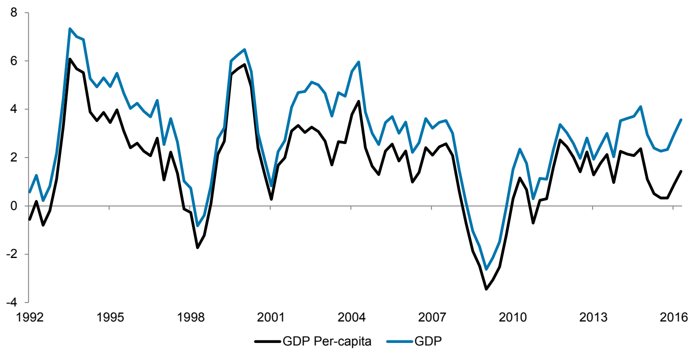
Source: Statistics NZ and AMP Capital

PER CAPITA GDP ON THE MEND

With population growth being a driving force of total growth over the recent past, we've been keeping a close eye on per capita GDP growth. Or in other words, the growth that really matters if you are concerned about whether we are becoming wealthier (still with all the caveats that come from using any form of GDP calculation as a measure of well-being!).

As we mentioned in our last report, per capita GDP growth has been lacklustre – and that's being generous. But there has been a notable pick-up in the last six months. From a low of 0.3% in calendar 2015, annual growth in per capita GDP is now up to 1.4% in the year to June – still a big gap to overall GDP growth, but heading up.

PER-CAPITA GDP
Production based, annual % change

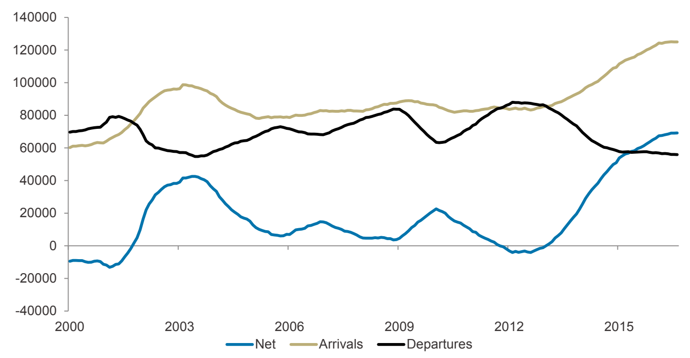


Source: Statistics New Zealand

That said, we think net migration and population growth will continue to be a significant part of the growth story, and that there will continue to be a significant gap between GDP growth and per capita GDP growth. While net migration appears to be peaking at around 69,000 (1.6% population growth), we are not anticipating a rapid wind back.

While Australia is starting to look stronger, we are not anticipating a significant degree of outperformance relative to New Zealand that would see armies of Kiwis heading back over the ditch to Australia any time soon. At the same time, we think the global environment of economic frailty and political disruption will see New Zealand remain a destination of choice for many people.

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

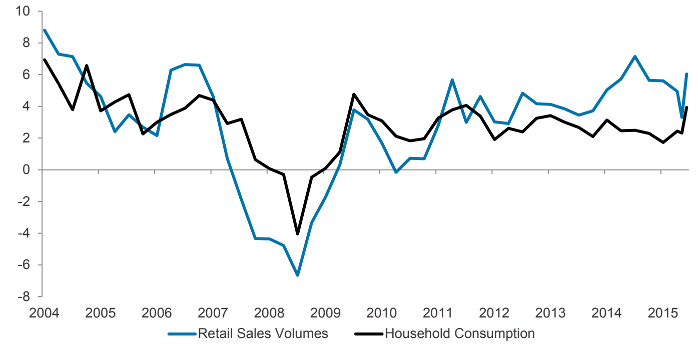


Source: Statistics New Zealand

HOUSEHOLDS IN FINE FETTLE

The pick-up in per capita GDP growth is a sign of a broadening in the strength in the domestic economy, particularly private consumption. Retail spending growth has been largely reliant on population growth and strong levels of house building is supporting growth in consumer durables as new houses need to be furnished. In addition, lower import prices are supporting volume growth which is still running hotter than the growth in the value of sales. Rising labour income is also helping.

NEW ZEALAND RETAIL SPENDING
Annual % change



Source: Statistics New Zealand and AMP Capital

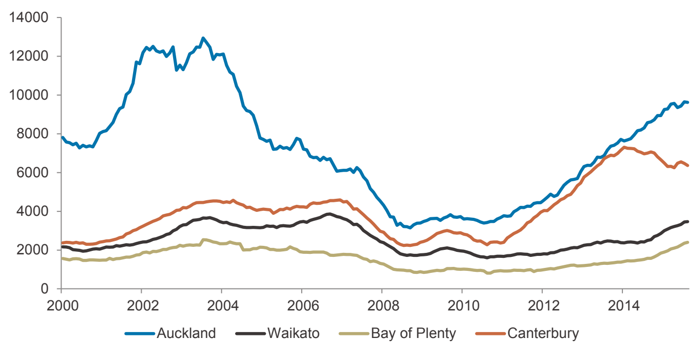
Despite all the positives, there has until recently been little to demonstrate a stronger appetite by established households to increase their spending. That has changed over the last quarter or two as households appear to be feeling the warm glow that comes with rising property prices and are loosening the tight grip on the wallets and purses around the country. We think this is behind some of the recent pick-up in housing lending which is now at 9.0% year-on-year, its highest level since May 2008.

If that is the case, there will be some cause for concern at the Reserve Bank of New Zealand (RBNZ). While they are already concerned about the financial stability risks associated with rapidly rising house prices, they will be more concerned about the prospect of a strengthening in domestic demand.

HOUSING IMBALANCE PERSISTS

Housing construction remains a key part of the New Zealand growth story, and has been for some time. However, as we have noted before, the centre of growth in activity has shifted from Canterbury reconstruction to the acute supply shortage in Auckland. There is also strong growth spilling over into other top of the North Island regions, most notably Waikato and Bay of Plenty.

RESIDENTIAL BUILDING CONSENTS
Number, year-to-date



Source: Statistics New Zealand

Construction activity remains short of what is required. While monthly dwelling permit issuance in Auckland has more than doubled over the last few years, from around 3500 per month in 2010/11 to 9500 per month recently, that is short of the estimated 13,000 per month required to close the gap over time. Recent planning changes allowing for greater densification within the city boundaries will be a big help. Even so, closing the supply demand imbalance will be a long-term game.

IN THE MEANTIME, HOUSE PRICES ARE EXPECTED TO CONTINUE TO RISE.

So long as demand continues to out-strip supply, the most basic law of economics tells us that prices will continue to rise. The cautionary note for house buyers is that at some point the supply demand dynamic will flip back the other way, and we would expect to see some softening in house prices at that time. If you are an aspiring first home buyer, patience may prove a valuable commodity.

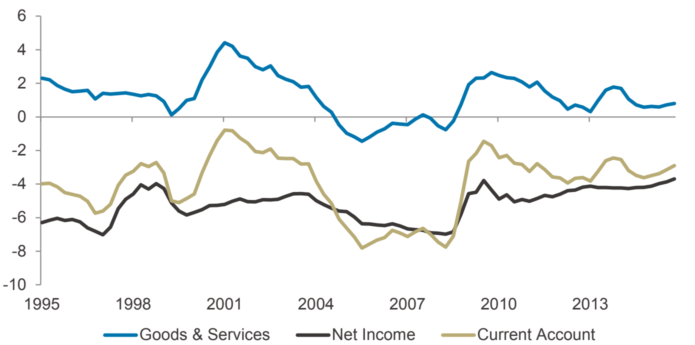
Macro-prudential policies have taken the wind out of the sails of the market at various times, albeit temporarily. A new round of restrictions is about to kick-off and further restraints are probably likely. However, there is only one thing that will fix this: supply.

EXTERNAL ACCOUNT IN GOOD SHAPE DESPITE CHALLENGES

The current account balance doesn't get watched much these days, especially when it's at a broadly sustainable level. The surprise has been we haven't seen the degree of deterioration we would expect in a period of strong growth, especially when combined with the degree of dairy price weakness seen recently.

The current account deficit is currently -2.9% of GDP, lower than long-term average of -4.0% of GDP. Two years ago we thought the deficit would be around -5.5% of GDP by now. A number of factors have been helping, mostly on the income side of the account. In particular, interest payments on external debt have been lower reflecting low global interest rates, while outflows of income earned from foreign investment have also been lower than expected. In fact, the investment income deficit has nearly halved from -7% of GDP in calendar 2008 to -3.7% of GDP in June this year.

CURRENT ACCOUNT BALANCE
Year to date: Percent of GDP



Source: Statistics NZ

Other factors helping recently have been strong tourism inflows (services exports), stronger-than-expected export volumes despite price weakness, and lower oil prices.

With respect to prices, the terms of trade has not deteriorated to the extent expected. Weakness in dairy export prices has been offset to some extent by strength in other export prices, but mostly due to lower petroleum import prices. From peak to trough, the terms of trade has only fallen 6%. The flipside is that as dairy prices recover, we expect some of that will be offset by rising oil prices. The upshot is a period of surprisingly stability for the terms of trade, and at a high level relative to history.

We expect some deterioration in the current account deficit in the period ahead, but expect it to remain well-contained relative to history at around -4.0-4.5% of GDP.

SPARE CAPACITY BEING ABSORBED...SLOWLY

Labour market data is difficult to interpret right now. A change to survey methodology has resulted in a 'structural break' in the survey that makes the level of employment growth difficult to ascertain. However, we have sufficient confidence in developments to suggest that employment growth continues to be solid, though so too does the growth in the supply of labour.

We think the modest decline in the unemployment rate, which ticked lower from 5.2% in March to 5.1% in June, is more reliable. This tells us that spare capacity in the labour market continues to be absorbed, though only slowly. The new measure of labour market underutilisation is also declining slowly, supporting the capacity absorption assertion. Business surveys indicate that capacity utilisation more generally is running at relatively high levels.

In the meantime, growth in labour supply means wage inflation remains subdued. This has been a key factor behind persistently low domestic inflationary pressures. Average weekly (ordinary time) earnings rose only 2.0% in the year to June, though with the inflation rate running at only 0.4% that indicates a solid increase in real wages.

The Labour Cost Index, a measure akin to unit labour costs and a good signal of inflationary pressures emanating from the labour market, remains under 2%. It will be a key indicator to see if wage growth starts to become more of a concern from an inflation perspective.

INFLATION STILL BELOW TARGET, SLOW TO RETURN

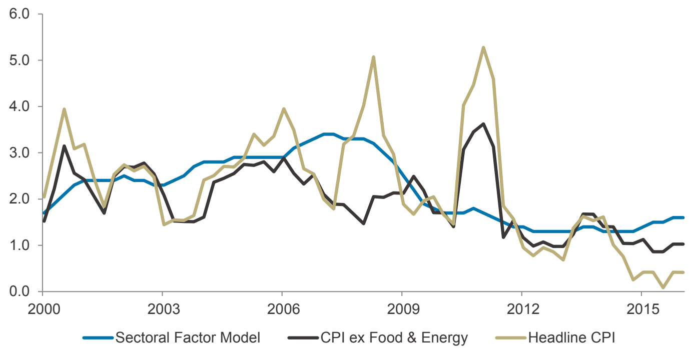
Low inflation remains a function of both external and domestic factors. Tradeable inflation is low due to low global inflation which, in turn, is the result of persistently large output gaps in some of the world's major economies, low commodity prices and the high New Zealand dollar.

On the domestic front, despite solid employment growth, wages have remained suppressed on the back of the growth in labour supply through strong net migration and high labour market participation. The reduction in ACC levies has also had a dampening effect on domestic inflationary pressures.

THE ONLY REAL SOURCE OF DOMESTIC INFLATIONARY PRESSURES IS IN THE HOUSING RELATED COMPONENTS OF THE CPI WHERE THE STRENGTH OF DEMAND HAS LED TO CAPACITY CONSTRAINTS AND RISING CONSTRUCTION COSTS. RENTS ARE ALSO RISING FASTER THAN THE CPI AS A WHOLE.

That combination of factors has led to headline inflation continuing to undershoot the inflation target band. Annual headline inflation came in at 0.4% for the year to June 2016. Core measures of inflation are higher, but are still below the mid-point of the target band.

NZ INFLATION
Annual % change



Source: Statistics New Zealand, RBNZ

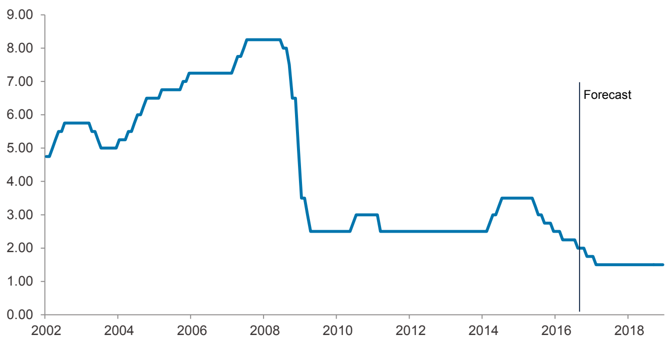
We expect inflation to rise gradually from here, as previous low quarterly numbers roll out of the annual calculation and as spare capacity is absorbed, albeit slowly. We expect headline inflation to be back to the bottom of the 1-3% target band at the end of 2016, but not back to the 2% mid-point until 2018.

FURTHER RBNZ EASING TO COME

In the meantime, the RBNZ is concerned that low inflation becomes entrenched through the impact of persistently low inflation outcomes on inflation expectations. So despite the solid growth outlook, the obvious strength of the housing market and the risks to financial stability, the persistently low inflation saw the RBNZ cut the Official Cash Rate to a new historical low of 2.0% in August.

The RBNZ has flagged further cuts are likely and interest rate markets are currently pricing in one-and-a-bit further 0.25% cuts – one in November this year and part of a further cut early in 2017.

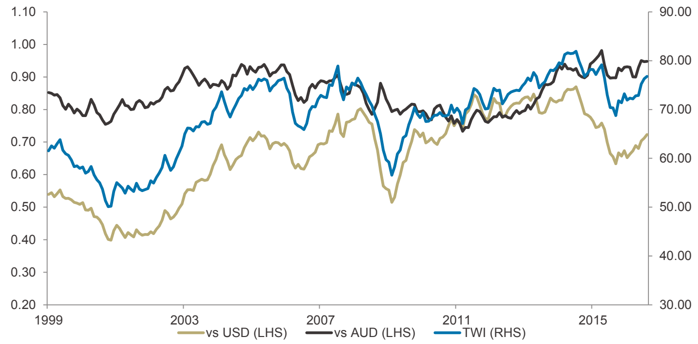
NZ Official Cash Rate



Source: RBNZ and AMP Capital

These cuts are targeted at exchange rate strength where the Trade Weighted Exchange Rate Index continues to exceed RBNZ expectations. That is a function of what we have previously called global competitive easing where continued easy monetary conditions in the Euro area and Japan are preventing the US from hiking rates, with the end result being elevated exchange rates for the likes of New Zealand and Australia. It remains the case that the best thing for the RBNZ would be an end to emergency policy settings in Europe and Japan and for the US Federal Reserve to push on with interest rate normalisation.

THE NEW ZEALAND DOLLAR



Source: RBNZ

The longer-term outlook for domestic interest rates is highly uncertain. Many factors will come into play, including how the economy continues to grow relative to its potential and the outlook for monetary conditions globally which will determine the path of the exchange rate. Beyond the next cut or two, we think the safest bet is to assume a long period of low and stable interest rates.

INFLATION TARGETING STILL RIGHT FOR NEW ZEALAND, FISCAL STIMULUS NOT REQUIRED (YET)

As many central banks have struggled to achieve their inflation mandates in the post-Global Financial Crisis world, questions are increasingly being asked about the efficacy of monetary policy and the appropriateness of inflation targeting as the anchor for monetary policy actions. That is leading to speculation about possible changes to the inflation targeting framework we have come to know and love, even including the possibility of adopting a different or supplementary target such as nominal GDP.

WE DON'T THINK THE INFLATION TARGETING FRAMEWORK IS BROKEN. THE BIGGER QUESTION GLOBALLY IS ONE OF POLICY CO-ORDINATION: HOW CAN GOVERNMENTS BETTER CO-ORDINATE MONETARY AND FISCAL POLICIES ALONGSIDE NECESSARY STRUCTURAL REFORMS TO ACHIEVE HIGHER SUSTAINABLE GROWTH AND PRICE STABILITY?

The reality is that in Europe and Japan, where these questions are being asked most, tight fiscal policy (in Europe in the wake of the sovereign debt crisis and Japan's 2014 consumption tax increase) simply created too big a demand deficit for monetary policy alone to fix.

There have been some calls for a loosening of the fiscal purse strings in New Zealand to help the RBNZ out in achieving higher inflation. While looser fiscal policy is appropriate for some countries, it's not needed here, at least not yet. Our problem is the exchange rate strength that comes from continued aggressive monetary easing elsewhere. There will be a more appropriate time for fiscal expansion in New Zealand when the cycle turns down.

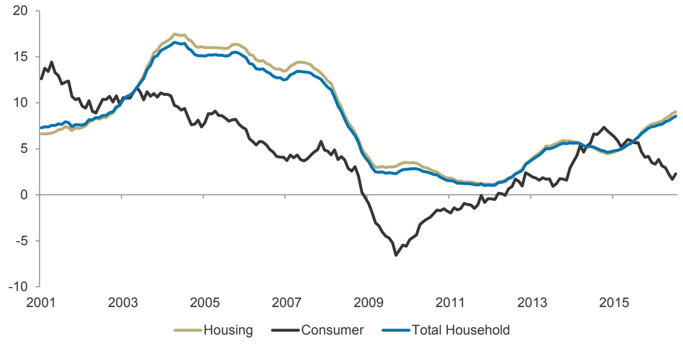
In our view, inflation targeting remains the right policy anchor for New Zealand. But that needs to come with an appropriate degree of patience. When lower than mandated inflation is not entirely of our own making, it's important we don't sacrifice our own macroeconomic stability to hit the target.

NEW ZEALAND IN GOOD SHAPE OVERALL BUT THERE ARE VULNERABILITIES

The New Zealand economy is in pretty good shape. Despite significant headwinds, the economy is performing well, albeit as a result of 'easy' growth through population gain. Furthermore, the economy is structurally sound with two of the key imbalances we monitor, the current account balance and the Crown's fiscal balance, both in good shape. Public debt is low and set to decline, creating a buffer for when some degree of fiscal expansion will inevitably be needed.

But there are vulnerabilities, and these mostly relate to the household sector where credit growth is accelerating and household debt as a percentage of national disposable income is at 163% and rising. At the same time, house prices are rising and in some centres, most notably Auckland, prices are at an unsustainable multiple of average income.

HOUSEHOLD CREDIT GROWTH
Annual % change



Source: RBNZ

This is clearly less of a problem when interest rates are low. While we think the outlook for interest rates is highly uncertain, if we are right and we are seeing households stepping up consumption on the back of house price gains, that's one factor that could tip the balance in favour of higher interest rates in the future. Low interest rates are not guaranteed forever.

CONTACT US

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