

Economic Overview

November 2014

The Great Houdini

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Note from Dominick

Like some kind of Houdini, New Zealand appears to have escaped from the traditional economic bind.

Rapid economic growth often leads to inflation or higher interest rates, either of which can put the brakes on growth. But New Zealand's current bout of rapid growth has surprised us by producing no inflation to speak of.

New Zealand's "speed limit" – the rate at which the economy can grow without generating inflationary pressures – appears higher than we gave it credit for. That means the economy has more freedom to grow without the Reserve Bank hiking interest rates so vigorously. And so it now looks as though the OCR hiking cycle will peak at the stunted level of just 4.75%.

And the outlook is indeed for another year of solid economic growth. Sharply lower dairy and forestry prices are certainly going to make life difficult for some regions and some sectors. But we expect broader domestic demand will remain robust, fuelled by the Canterbury rebuild, burgeoning construction activity elsewhere, and booming net immigration.

That said, we remain concerned that New Zealand will experience a significant economic downturn later in the decade, when the Canterbury rebuild has passed its peak, population growth has dropped, and the housing market has finally cracked under the pressure of higher mortgage rates.

A handwritten signature in black ink, appearing to read 'D. Stephens', written over a horizontal line.

Dominick Stephens
Chief Economist

New Zealand Economy

Two speed ahead

Lower dairy payout forecasts and fresh doubts about global growth have darkened New Zealand's export outlook. But with rampant migration adding fuel to a construction boom, and low inflation keeping interest rates low for longer, we expect domestic demand to stay as strong as ever. The result will be respectable overall growth, within a two-speed economy.

New Zealand's latest GDP data highlighted the stark contrast between a weakening export sector and the stronger domestically-focused parts of the economy. Dairy, forestry and mining output fell in the June quarter, and non-food manufacturing was little better than flat. But the services sector, which accounts for 70% of the economy and is more geared towards domestic conditions, registered its strongest quarter of growth since 2006. And of course, the construction boom rolled on.

Overall GDP rose 0.7% in the June quarter, close to the economy's trend growth rate, but a step down from the more than 1% per quarter pace of growth over the preceding nine months. More recent indicators – such as businesses' assessment of their own trading activity in the latest *Quarterly Survey of Business Opinion* – suggest, if anything, a slightly faster pace of economic growth in the September quarter.

In our view, this sets the tone for the likely pace and mix of economic growth over the coming year. The expected drop in income for food exporters from lower commodity prices is a clear negative for the economic outlook. But between the Canterbury rebuild and booming net immigration, there is every reason to expect construction activity to ramp higher over the year ahead. And falling mortgage rates will give the housing market another boost. Along with strong population growth, that should keep the outlook for consumer spending fairly steady. All up, we expect economic growth next year to top 3%.

In future years we may not be so lucky. Later in the decade, the Canterbury rebuild will have entered its long wind-down phase, more New Zealanders will once again be moving across the Tasman as job opportunities in Australia improve, and rising mortgage rates will have prompted a bout of falling house prices. At that point, a more pronounced slowdown in New Zealand economic growth looks likely.

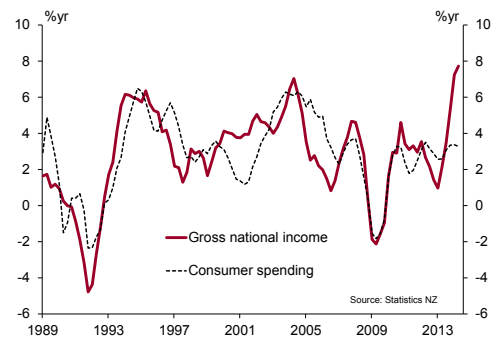
Totting up the losses

The drop in the Fonterra dairy payout to a forecast \$4.80 this season represents a huge reversal of fortune for New Zealand's biggest export industry. But it doesn't automatically translate into lower economic activity – that

depends on how lower export revenues affect spending on goods and services produced in New Zealand.

The good news is that dairy farmers seem to have made hay while the sun shone, using last season's exceptional windfall to shore up their balance sheets rather than go on a spending spree. That leaves them relatively well-placed to absorb the shock of a low payout without slashing their spending.

Figure 1: Consumers didn't spend the dairy windfall



Compared to a 'normal' dairy payout in the low \$6 range, a \$4.80 payout represents about \$2.5bn in lost export revenue. Our forecasts assume that consumers and businesses will adjust their spending by about half of this – a fairly big chunk, but appropriately so given the uncertainty surrounding the export outlook. History suggests business investment is likely to suffer the proportionally bigger impact, with retail spending less dramatically affected.

Add the likely hit to government revenues from lower tax receipts, and the inevitable adjustment of exporters' production levels to weaker market conditions – of which we already saw evidence in the June quarter GDP figures – and we estimate the export downturn will reduce GDP growth by about 0.6 percentage points next year.

To date, consumer and business confidence have held up reasonably well. But we suspect that economic confidence in rural New Zealand will fall further over the coming six months, as the reality of the lowest

payout since 2008/09 sinks in. And of course, it's not just about dairy. Forestry prices are also well down on last year. And while other New Zealand export industries have mostly continued to enjoy strong export prices to date, we wouldn't be surprised if they also saw market conditions deteriorate over the year ahead.

Let them come

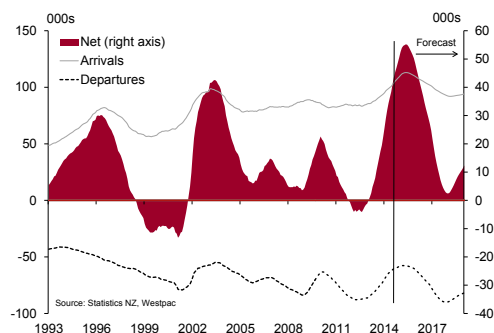
While exporters' prospects have deteriorated over the last three months, the construction sector is going gangbusters.

Construction activity rose 14% over the year to June, and is now 52% above its March 2011 level. The myth of the "slow Canterbury rebuild" remains alive and well in the popular imagination, but nothing could be further from the facts. Consented residential construction activity in Canterbury rose 67% in the year to June, and has risen more than three-fold over the last 3 years, while consented non-residential construction was up 50% over the year to June, and is running at double the peak pace from last decade.

While these numbers are spectacular, they are in keeping with our previous forecasts. Where our view has continued to evolve is on residential construction in Auckland. This now looks set to ramp up more steeply than we previously thought, not least because net immigration has continued to intensify. Monthly net immigration rose to almost record highs in August and September, thanks to a further drop in net departures by New Zealanders to Australia and a further influx of overseas migrants, mostly on work and student visas.

Based on these monthly trends, we now expect annual net immigration to reach an unprecedented 55,000 in the first half of next year. While there are signs that the monthly pace of departures to Australia may now have bottomed out, we don't expect a clear turnaround until the Australian labour market sees significant improvement, which is unlikely before mid-2015. Likewise, the number of work migrants is likely to remain high until the New Zealand job market cools.

Figure 2: Net migration to New Zealand (annual)



This surge in population growth means Auckland's housing squeeze is becoming tighter, despite the increase in building activity that has already occurred in the region. This can be clearly seen from the steep increase in the number of people per house in Auckland over the past year. We are confident we will see more building happening in response. The economic incentives are there, thanks to the past few years' steep house price rises, and there is now more political will to allow building, as seen in the Special Housing Areas set up over the past year to fast-track development. But even on our upgraded forecasts – which will see nationwide residential building growing at double-digit annual rates into 2016 – Auckland's housing shortage will get worse before it gets better.

Figure 3: People per house

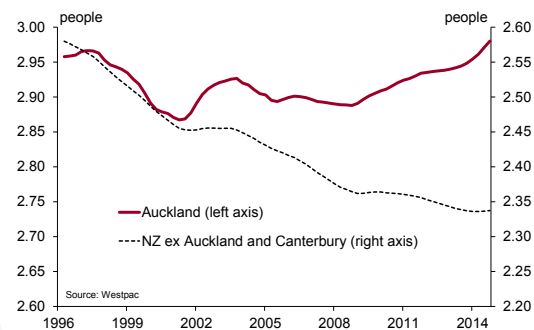
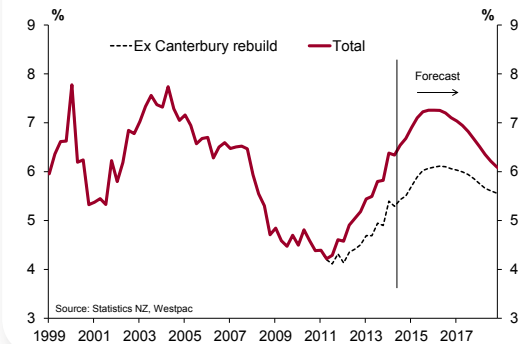


Figure 4: Residential construction (% of GDP)



Room to grow

We have long held doubts that the economy's productive capacity would be up to accommodating the level of domestic demand that the building boom has helped generate. We feared that some economic activity would end up being crowded out, either by rising inflation or by interest rate hikes.

We are pleased to report that the economy's supply side seems to have risen to the challenge to a greater degree than we expected. Put another way, the economy has developed more capacity to meet demand, and has been using its available resources more efficiently.



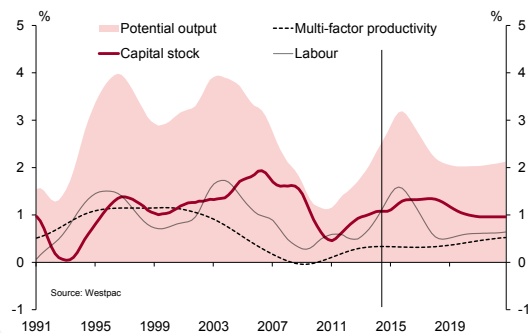
One reason for this is the migration boom itself, which has not just raised demand for housing, goods and services, but also provided the economy with more people of prime working age. As a share of the population, the net inflow of those aged 25-44 has now surpassed its previous peaks in the 1990s and 2000s.

As we explain in the Labour Force Participation section, the supply of available workers has been further boosted by a surprising rise in labour force participation from already high levels – in stark contrast to the experience of other economies in recent years.

Workers are also becoming more productive. A burst of investment spending by businesses has equipped them with more capital. There are also hints that businesses and government are working smarter and leaner, from reports of a greater uptake of energy-saving initiatives to much lower increases in public sector wages and local body rates than was common for much of the 2000s. That impression is supported by the official productivity statistics, which measure how much output the economy is squeezing out of its labour and capital resources. These have picked up in the last few years.

We expect these trends will see the economy's productive capacity continuing to expand for a while. One consequence of our forecasts for strong population growth and rising workforce participation is that we expect unemployment to continue declining only gradually over the next few quarters, and wage growth to stay fairly subdued. The positive flipside is that the economy's ability to grow without generating inflation is higher, at least for now. Based on estimates of available labour, capital and productivity, the 'potential' rate of growth has risen noticeably over the past year – we estimate to about 2.5% - and on our forecasts it will reach 3% next year. That suggests little threat of rising domestic inflation in the near future.

Figure 5: Potential output growth

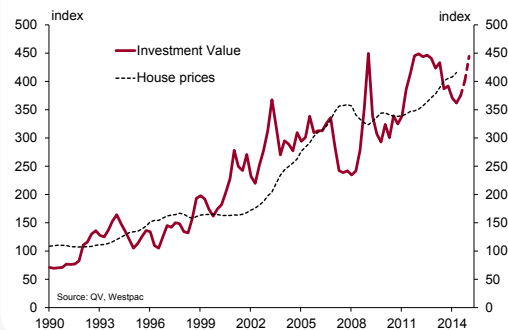


A brief reprieve

In this low-inflation environment, the Reserve Bank will be able to keep the OCR on hold for longer – we think until the second half of next year. One of the key ways in which this will give the economy more room to grow is by pushing out the day of reckoning for the housing market, which in turn will support consumer confidence and retail activity.

As regular readers will know, we tend to place significant weight on financial conditions as a driver of house price trends. After all, houses are assets and as such have a 'fair' or break-even investment value. This depends on rental yields, but also on the cost of borrowing, expected inflation, and taxation.

Figure 6: Investment value of housing



According to our Investment Value of Housing model, the sharp lift in mortgage rates last year was enough to put house prices under downward pressure. The Reserve Bank's restrictions on mortgage lending made the financial environment still less favourable for the housing market. Sure enough, house price inflation slowed almost to a standstill in early 2014, despite accelerating population growth.

Since that time financial conditions have been easing as fixed mortgage rates have fallen, and house prices have regained some momentum. Mortgage rates have fallen particularly sharply over the past month, and could fall further in the near term. Our Investment Value model is now giving a broadly neutral signal for house prices.

Lower mortgage rates, ongoing strong population growth, and an election result that removed the risk around capital gains tax could well conspire to cause something of a second wind in the housing market over the coming year. However, we remain of the view that a more lasting increase in mortgage rates will cause a bout of house price decline later in the decade.

Labour force participation

Defying demographic gravity

A surprisingly high proportion of New Zealanders are participating in the workforce – both compared to history and compared to many other countries. In this special topic we explore why this has been the case, and suggest participation could continue rising for a while yet.¹

Since the Global Financial Crisis, many developed economies – most notably the US – have seen a growing number of people drop out of the workforce, creating concern about the economy’s growth potential. New Zealand has been a striking exception. Though the share of the population in the workforce did dip in the wake of the 2008/2009 recession, it has since recovered and is now once again among the highest in the OECD.

In New Zealand, as in other countries, an aging population means that older workers are a growing proportion of the workforce. On its own this should cause participation to fall, as older people are on average less likely to work than younger people.

But in New Zealand, to a greater extent than elsewhere, this has been counteracted by a rising tendency of both younger and older people to work.

The economic cycle is part of the reason. People tend to drop out of the workforce when times are tough, and to re-enter it when jobs are plentiful. And New Zealand’s job market is now on the mend, particularly in Canterbury, where the unemployment rate is approaching historic lows.

Recent benefit reforms may also have played a role. Changes to welfare eligibility in 2012 and 2013 imposed new work obligations on some groups, particularly single parents.

But the most important reason for New Zealand’s high and rising participation rate is probably retirement policy. New Zealand men and women retire unusually late. This wasn’t always the case, and we can trace the change to specific reforms to New Zealand’s public pension system. Most importantly, since 1998, New Zealand’s basic pension hasn’t been means tested – you can keep working beyond age 65 and still get the full pension. Combined with a low level of private savings, this means New Zealanders face fewer incentives to retire than in other countries.

Participation among older New Zealanders has continued to rise in recent years, perhaps in response to the phasing out of defined-benefit pension schemes,

volatile investment returns since the Global Financial Crisis, and rising life expectancy, meaning savings have to go further.

The trend towards later retirement could well continue. In addition, history suggests that strong growth in demand for labour will continue to draw younger people into the workforce over the next year or two.

If so, New Zealand’s labour market will defy demographic gravity for a while longer. Later this decade, the influence of a changing age mix will become increasingly powerful, and New Zealand’s participation rate will start to slide. But for now, we expect it to keep rising, helping alleviate labour shortages and keeping wage pressures to a minimum.

Figure 7: New Zealand labour force participation rate

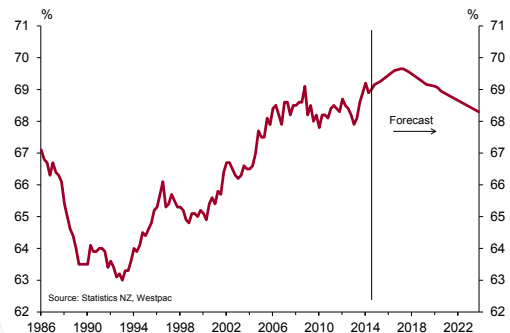
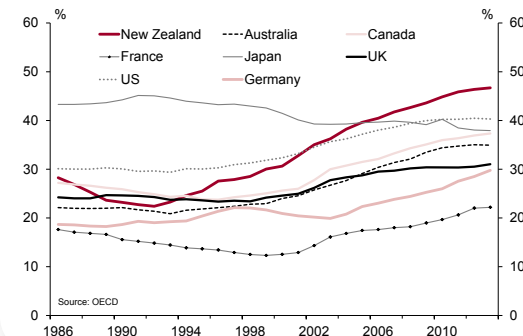


Figure 8: Labour force participation rates, age 55+



¹ Findings are taken from our research bulletin, 'In or out: Labour force participation in New Zealand'.

Agricultural Outlook

Brace for impact

World prices for many agricultural commodities have taken a sharp leg lower since mid-year. Some of the factors behind this price weakness are likely to prove temporary, but in the meantime a tough year lies ahead for New Zealand dairy farmers in particular.

International dairy prices have now almost halved from the record highs set in February this year. Growth in the developing economies has slowed by more than expected, while global milk production has continued to grow strongly. Russia's temporary ban on food imports from many Western countries has been an additional complication: while New Zealand wasn't a direct target of the ban, it means we're competing with product from elsewhere that has been forced back onto the market.

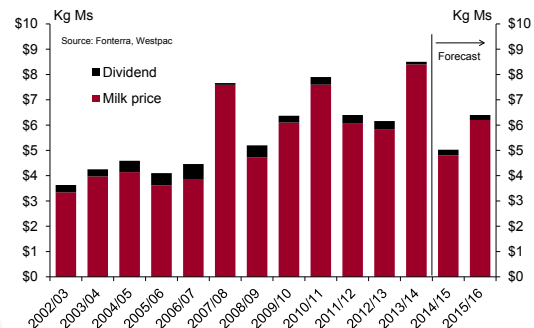
Our view is that within the context of a positive long-term outlook for New Zealand's dairy exports, prices this year have been hit by several factors that will prove to be cyclical or temporary – most obviously the Russian import ban, which is slated to expire next August. Nevertheless, it now appears that the recovery in dairy prices will be later and slower than we expected a few months ago. Lower prices have yet to discourage growth in milk production in the Northern Hemisphere, as feed costs have also been plunging. And Chinese consumers remain circumspect, in the absence of any major policy stimulus until very recently.

As a result, we've revised down our forecasts of Fonterra's payouts for both this season and next season. For this season we expect the milk price to fall to \$4.80/kg, which if realised would be the lowest since the 2008/09 recession. A payout this low would likely lead to some financial stress among higher-cost dairy farms, though this may not become apparent until next

year given that farmers have just received the final payments for last season's record price of \$8.40/kg. The impact may be softened by the fact that farmers appear to have taken a cautious approach to last year's windfall, using it to shore up their balance sheets and reduce debt. For the 2014/15 season we expect a milk price of \$6.20 (previously \$6.60), which is around the average of the last decade.

The slowdown in the global economy this year has largely been an emerging market story. In contrast, growth in the developed world has picked up a little on balance, and prices for agricultural products sold into those markets have held up relatively well. A stronger US economy is a key reason behind our view that Chinese demand will pick up some momentum again next year.

Figure 9: Fonterra payout history and forecasts



Commodity price monitor

Sector	Trend	Current level ²	Next 6 months
Forestry	Reduced harvesting has helped to align supply with softer world demand. Demand from the local building industry remains strong.	Average	↗
Wool	Coarse wool prices have picked up recently, underpinned by tight global supplies.	Above Average	→
Dairy	Global milk production continues to grow strongly, while Chinese demand has been slow to return.	Low	↕
Lamb	Global lamb production is adequate to meet demand at the moment.	Average	→
Beef	US prices are now receding from their shortage-induced summer spike, though low cattle inventories should limit the extent to which prices fall.	High	↘

² NZD prices adjusted for inflation, deviation from 10yr average.

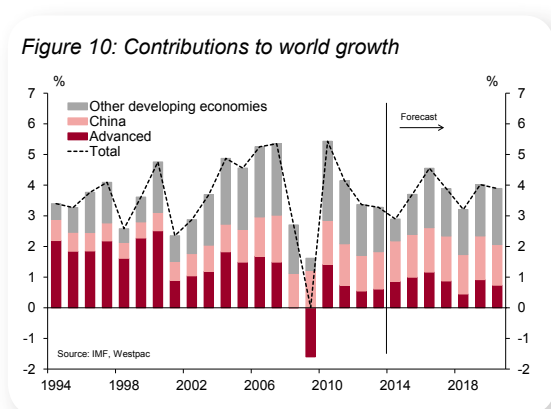
Global Economy

Growth to pick up, but where's the inflation?

We expect that the current slowdown in global growth will be temporary. However, lingering softness in inflation combined with an extended period of very easy monetary policy around the globe raises some concerns about how financial markets will react when interest rates eventually rise.

Global growth has taken a step down in recent months

We now expect the global economy to expand by just 2.9% over 2014. This would be down from 3.3% in 2013, which itself was not a good year. However, underlying the slowdown in global growth has been a divergence across regions.



On the upside, conditions in the US have continued to improve. Non-farm employment has strengthened, with the unemployment rate falling back to 5.9% in September - its lowest level in six years. Private consumption spending has also increased, and surveys of business sector conditions point to increases in output and capital expenditure over the coming quarters.

In contrast, growth in other major regions has taken a step down since the time of our previous *Economic Overview*. In China, our largest trading partner, there was a marked loss of momentum in domestic demand in the September quarter with annual GDP growth slowing to 7.3 percent. This followed earlier efforts by the Chinese government to dampen excessive investment in parts of the economy, including the housing market. Recent months have also seen gauges of business sector activity and consumer confidence remaining subdued.

The euro area remains weak, with declines in output and orders signalling the continuation of low growth though the second half of 2014. Furthermore, demand

and production in Japan have been soft following the hike in their consumption tax earlier in the year, though at least some of this softness is likely to be temporary.

Geopolitical events have added a further layer of uncertainty to the economic outlook, with ongoing conflicts in the Ukraine and Middle East, and concern about potential disruptions that could result from a further spreading of Ebola.

Global inflation has also remained low

A significant feature of the current global economic environment is the lingering softness in inflation. This reflects the slowdown in global growth and lingering slack in some advanced economies, but has also been a product of declines in commodity prices. For New Zealand, the most significant declines have been in the prices for dairy and log exports (as discussed in the Agricultural Outlook section). However, declines in international commodity prices have been widespread, with prices for foodstuffs down 6% over the past year, oil prices down 11% and industrial commodities down 5% according to the IMF. Given these conditions, any material pick up in global inflation seems unlikely in the near term.

Monetary policy to contribute to accelerating growth from 2015

In light of this soft inflation outlook, monetary policy in most economies is expected to remain accommodative for some time, and in both the euro area and China there has been a loosening in policy in recent months.

Speculation has grown as to when US interest rates may increase. However, our expectation is that any such increases are still some way off. It is likely the Federal Reserve will wish to see clear signs that the recovery is self-sustaining, even as inflation and labour market conditions approach target levels.

We expect that global growth will lift over the coming years as the continuation of accommodative monetary policy in advanced economies underpins increases in global demand. In the US, which is expected to be a central pillar of support for the global economy, growth is also expected to be boosted by increases in

Figure 11: Global inflation

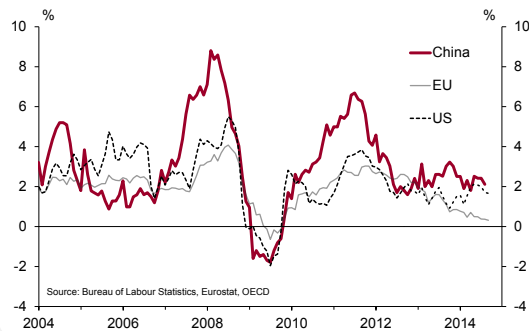
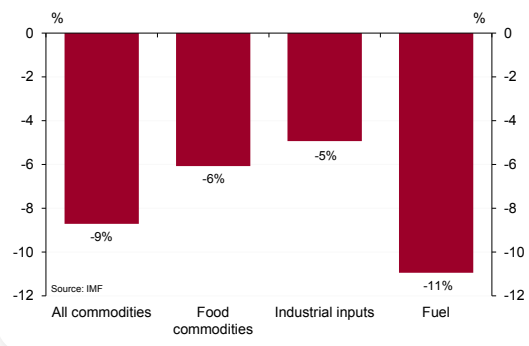


Figure 12: Changes in commodity prices (year to Sep 2014)



household and business confidence, as well as a smaller drag from fiscal policy.

Strengthening demand in advanced economies will support increases in global trade and production. As the world's largest exporter, China can't help but benefit from such an improvement. At the same time, we expect that growth in China will get a boost from a loosening in policy by the Chinese government and the People's Bank of China.

Risks on the horizon

For central banks, this subdued inflation outlook is providing scope to keep interest rates low to support growth. However, persistent low inflation combined with an extended period of easy policy can become a problem for central banks. The perceived willingness of central banks to underwrite economic growth has resulted in low volatility in financial markets, with a corresponding increase in willingness to invest in risky assets. When interest rates eventually lift this could produce disruptive volatility in markets and asset prices.

A further risk is that, when rates do need to eventually increase, policy makers in many economies may be a little gun shy as they try to 'give growth a chance'. As a result, when interest rates do eventually adjust, increases may need to be larger than would have otherwise been the case.

Australia

The Australian economy is facing a number of headwinds, with the ongoing reduction in mining investment spending and sharp declines in commodity export prices in recent years. At the same time, public sector demand has been sluggish as the various branches of the government focus on balance sheet repair. Nevertheless, growth is expected to remain resilient in the final months of 2014 and through 2015. The investment phase of the mining boom is giving way to the output phase, and exports of services are growing strongly. At the same time, consumer spending and home building activity have been increasing.

Against this backdrop, and with core inflation lingering in the upper half of the RBA's target band, cuts in the cash rate seem unlikely. However, we don't expect hikes either until late 2015 as the RBA tries to ensure the durability of the current expansion.

Economic forecasts (calendar years)

Real GDP, annual average % change	2010	2011	2012	2013	2014f	2015f
New Zealand	2.1	1.9	2.5	2.8	3.6	3.2
Australia	2.2	2.6	3.6	2.3	3.2	3.2
China	10.4	9.3	7.7	7.7	7.4	7.5
United States	2.5	1.6	2.3	2.2	2.2	2.5
Japan	4.9	-0.3	1.5	1.6	1.0	1.4
East Asia ex China	7.7	4.5	4.5	4.3	4.1	5.1
India	9.3	7.7	4.8	4.7	5.5	6.6
Euro zone	2.0	1.6	-0.6	-0.4	0.7	0.9
United Kingdom	1.7	1.1	0.3	1.7	2.6	2.1
NZ trading partners	4.8	3.6	3.7	3.6	4.0	4.2
World	5.4	4.1	3.4	3.3	2.9	3.7

Forecasts finalised 31 October 2014.



New Zealand Dollar

Don't hold your breath

The New Zealand dollar has lost altitude as export prices have fallen and the US dollar has found some favour. We expect some further weakness in the near term, but the conditions for a sustained slide in the currency don't appear to be in place just yet.

At the time of our August *Economic Overview*, the New Zealand dollar was starting to pull back from the post-float high that it had reached in July. The tone of the local economic data had begun to soften, the Reserve Bank had shifted to an on-hold stance on interest rates, and the fall in dairy export prices had clearly gone beyond a mere correction of the drought-induced surge in prices last year.

Since then, economic conditions have further conspired against the currency, sending it below 80c against the US dollar by late September. World dairy prices have continued to fall sharply, though prices for New Zealand's other major export commodities have held up relatively well. Another factor is that the US dollar has been more in favour recently, as the US economy has gained momentum and markets have anticipated interest rate hikes from next year. At a time when concerns about global growth have occasionally come to the fore, and some major economies (such as the euro zone and Japan) are still looking to ease monetary policy to tackle uncomfortably low rates of inflation, the US dollar starts to look like the best of a bad bunch.

The Reserve Bank has done its best to spur on the NZ dollar's decline, warning that it sees the exchange rate as "unjustified and unsustainable", and that it expects "a further significant depreciation, which should be reinforced as monetary policy in the US begins to normalise." The RBNZ backed up these words by intervening in the foreign exchange market to sell the NZD in August.

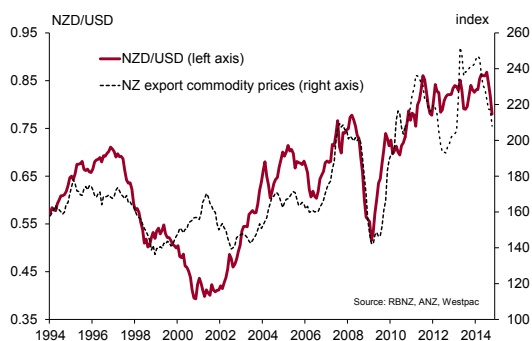
We find that commodity prices are the single best indicator for the NZD. The correlation between the two has been fairly close over the past two decades, and on the strength of this relationship alone we could justifiably expect some further weakness in the coming months. A delay to the resumption of interest rate hikes will also take some of the pressure off the exchange rate in the near term. We expect NZD/USD to fall to around 77 cents on average over the March quarter of next year.

Great expectations

However, we don't share the RBNZ's expressed opinion that the New Zealand dollar is primed for a large, sustained decline. In fact, we expect that cyclical forces will help the NZD to regain some ground against the USD over the course of 2015. While the New Zealand economy's status as a global outperformer has probably passed its zenith, there are still a number of significant factors in our favour that would argue for the NZD remaining at relatively high levels for a while longer.

Our first objection concerns the difficulty of estimating the exchange rate's long-run sustainable level. The sustainable level is really a theoretical construct, one that's consistent with balance in the broader economy once the effects of business cycles wash out. There have been a number of attempts to determine the sustainable level of the exchange rate, though none of them very satisfactory. The IMF favours an

Figure 13: NZD and commodity prices, adjusted for inflation



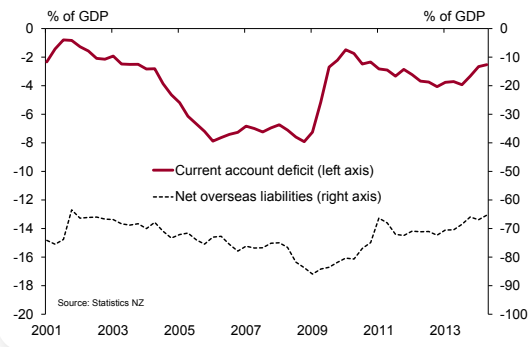
Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Dec-14	0.79	0.88	0.63	0.49	86.9	76.8
Mar-15	0.77	0.86	0.61	0.48	85.5	74.9
Jun-15	0.78	0.85	0.61	0.47	87.4	75.3
Sep-15	0.79	0.85	0.62	0.46	89.3	75.9
Dec-15	0.80	0.85	0.62	0.45	91.2	76.5
Mar-16	0.81	0.85	0.62	0.45	93.2	77.2
Jun-16	0.82	0.85	0.63	0.45	95.1	77.9
Sep-16	0.82	0.84	0.62	0.44	95.9	77.3
Dec-16	0.82	0.82	0.61	0.43	96.8	76.7
Mar-17	0.80	0.81	0.61	0.43	93.8	75.4

'external balances' approach, assessing the level of the exchange rate that would stabilise net overseas debt and/or the current account deficit. On this basis the IMF has consistently deemed the NZ dollar to be overvalued by 5-15%.

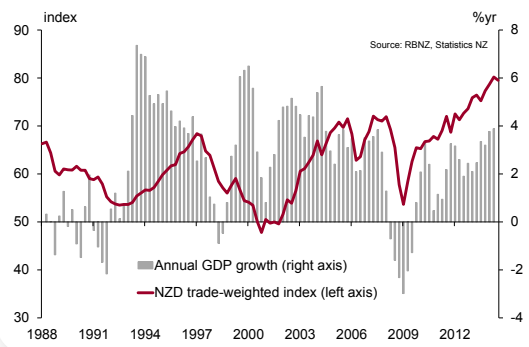
However, this judgement is only as good as the forecast of what would happen in the absence of a 'correction' in the exchange rate – and the track record of these forecasts has not been good. Given that New Zealand's current account deficit has actually narrowed to 2.5% of GDP and its net overseas debt to GDP ratio has fallen to a ten-year low, it's hard to argue that the exchange rate has been on an unsustainable path in recent years. Admittedly, the current account deficit is set to widen over the next year as the impact of lower dairy prices flows through. But that underscores the case for a weaker NZD in the near term, not a long-term overvaluation.

Figure 14: External balances



Setting aside the tricky questions around the long-run sustainable level, simply identifying an 'overvaluation' is not in itself a useful basis for forecasting the exchange rate. Over the post-float history of the New Zealand dollar, large, sustained declines have typically occurred during recessions, often coupled with stresses in the financial system (whether caused by local or overseas forces). In these sorts of conditions, a big fall in the exchange rate is not only a reasonable expectation, it's a necessary part of the economy's adjustment process.

Figure 15: NZ dollar and GDP growth



Moreover, falling demand is likely to overwhelm any relief that exporters receive from a lower exchange rate.

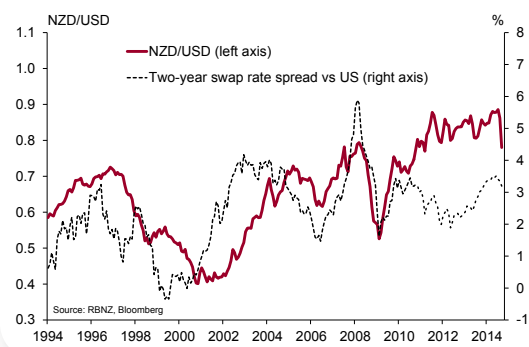
Obviously we don't see those conditions being in place any time soon. While the New Zealand economy has probably passed its peak rate of growth, it's likely to remain an outperformer among the developed economies for a while longer as the construction boom gets into full swing. The case for a sustained decline becomes more credible for 2016 and beyond, the as the Christchurch rebuild passes its peak and becomes a drag on the rate of GDP growth.

As noted earlier, commodity prices are a powerful indicator of the exchange rate's fair value over the short term, and at the moment they argue that there's scope for the NZD to fall further. However, we expect that a recovery in world dairy prices from their very low current levels will help to support the NZD again next year.

Relative interest rates are often cited as a driver of exchange rates (the basis for the 'carry trade'). And indeed, our forecasts suggest that New Zealand's positive interest rate gap will narrow from here. While we don't expect the US Federal Reserve to start raising rates until September next year – around the same time as the RBNZ – it is likely to move faster given that the US has further to go to get back to normal.

However, the link between interest rates and exchange rates is rather sketchy in practice. Investors appear to be motivated by perceptions of risk at least as much as by rates of return. We're expecting the US economy to pick up momentum over the next couple of years, and typically what's good for the US is perceived as being even better for the developing world, leading investors to move out of the US dollar in search of higher-yielding opportunities. Consequently, we expect the USD to lose some ground next year even as US interest rates rise.

Figure 16: NZD and relative interest rates



Inflation and Interest Rates

Missing in action

After hiking the OCR 100 basis points, the Reserve Bank must have been dismayed to see inflation drop to one percent. With inflation missing in action, the RBNZ will not have to hike the OCR again for quite some time, and the OCR may end up peaking at a rather stunted 4.75%.

The latest bout of low inflation was partly due to cheap vegetables following a mild winter. That's clearly a transitory influence of little real consequence. But beneath the headlines there has also been a powerful trend of surprisingly subdued inflation over the past three years. Construction costs have ramped up as we anticipated. But the other elements of inflation have been amazingly quiescent, despite the strong economy.

Clues as to the cause of the low inflation trend are sprinkled throughout the earlier sections of this document. The New Zealand Economy section remarked on the improvement in New Zealand's rate of potential output growth – the economy's capacity to supply goods and services without generating inflation has proven more robust than expected. The next section explained that rising labour force participation is minimising wage growth. The Global Economy section pointed out that surprisingly low inflation is a global theme, and could be reinforced by falling oil prices. And the New Zealand dollar section argued that the exchange rate will remain relatively strong over the year ahead. This will help suppress inflation, not least because nowadays consumers can leverage their strong New Zealand dollars by buying online direct from overseas.

A couple of special factors have also been contributing to low inflation over the past year, and next year a reduction in ACC levies will reduce the Consumers Price Index by 0.4 percentage points.

Finally, years of low inflation combined with the strict-on-inflation strategy of the current Reserve Bank Governor appears to have reduced inflation expectations.

When people expect low inflation they are more willing to accept modest wage and price increases, thus reinforcing low inflation in a virtuous circle.

The Reserve Bank has been surprised by the non-appearance of inflation following the economic upturn, and has responded by announcing a period of "monitoring and assessment." This basically means that the RBNZ will not hike the OCR until it sees the whites of the eyes of actual inflation.

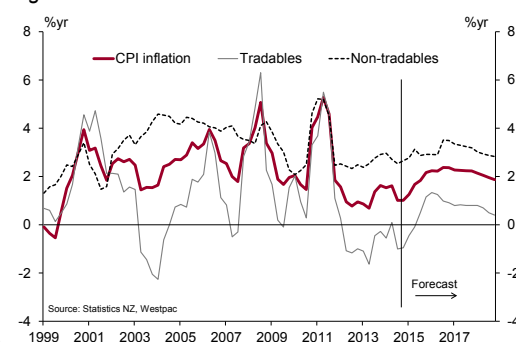
That is not likely to happen before late-2015. We expect inflation will be just 1.3% in March 2015, and will not rise

to anything resembling a threat until June 2015. Accordingly, we expect the Reserve Bank will keep the OCR on hold at 3.5% until September 2015.

Inflation will eventually rise as some of the temporary factors fade and economic growth continues. But by our reckoning, only a few years remain before the Canterbury rebuild passes its peak and the economy enters a serious downturn. There is not enough time for the strong economy to generate a noxious inflation problem. Consequently, we now expect the OCR will peak at just 4.75%.

Swap rates have fallen recently, but we suspect they will fall even further over the months ahead as the theme of low inflation continues to play out.

Figure 17: Inflation forecasts



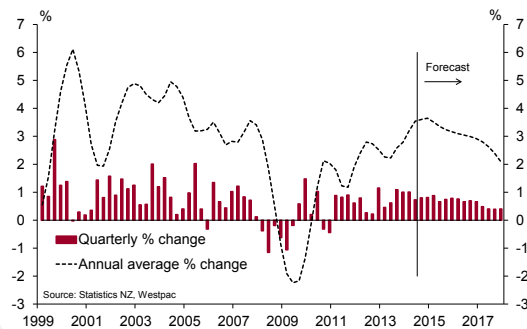
Annual Inflation and Interest Rate Forecasts

(end of quarter)

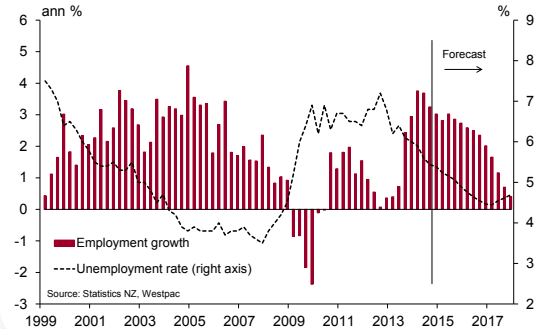
	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Dec-14	1.0	3.50	3.70	3.80	4.10
Mar-15	1.3	3.50	3.70	3.90	4.20
Jun-15	1.7	3.50	3.75	4.10	4.40
Sep-15	1.8	3.75	4.00	4.50	4.70
Dec-15	2.2	4.00	4.25	4.70	4.90
Mar-16	2.2	4.25	4.50	4.80	5.00
Jun-16	2.2	4.50	4.70	4.80	5.00
Sep-16	2.4	4.75	4.90	4.80	5.00
Dec-16	2.4	4.75	4.90	4.70	4.90
Mar-17	2.3	4.75	4.90	4.60	4.80

Annual average % change	March years				Calendar years			
	2014	2015f	2016f	2017f	2013	2014f	2015f	2016f
GDP (production)	3.2	3.5	3.1	2.8	2.8	3.6	3.2	2.9
Private consumption	3.4	3.4	2.9	2.8	3.3	3.2	3.2	2.8
Government consumption	1.7	2.1	0.6	0.6	0.9	2.6	0.7	0.5
Residential investment	17.0	16.3	12.4	1.9	17.3	18.7	13.3	4.0
Business Investment	8.4	7.9	5.3	4.8	7.2	6.8	6.7	5.1
Stocks (% contribution)	0.3	0.1	-0.2	-0.1	-0.1	0.3	-0.3	-0.1
Exports	0.4	2.0	2.3	2.5	1.3	3.2	1.2	2.6
Imports	8.0	7.5	2.8	2.3	6.3	8.0	3.5	2.6
Inflation (% annual)	1.5	1.3	2.2	2.3	1.6	1.0	2.2	2.4
Employment (% annual)	3.8	2.8	2.6	1.7	2.9	3.0	2.7	2.0
Unemployment rate (% s.a. end of period)	5.9	5.2	4.8	4.4	6.0	5.4	4.9	4.5
Labour cost index (all sectors, % annual)	1.6	2.1	2.1	2.2	1.6	2.0	2.1	2.2
Current account balance (% of GDP)	-2.7	-4.6	-5.8	-4.8	-3.3	-3.4	-5.9	-5.0
Terms of trade (% annual)	17.3	-7.6	3.0	3.1	20.2	-3.6	-1.5	5.4
House prices (% annual)	7.9	6.3	2.5	0.4	9.2	5.5	3.5	1.0
90 day bank bill (end of period)	2.95	3.70	4.50	4.90	2.69	3.70	4.25	4.90
5 year swap (end of period)	4.57	4.20	5.00	4.80	4.49	4.10	4.90	4.90
TWI (end of period)	78.7	74.9	77.2	75.4	77.3	76.8	76.5	76.7
NZD/USD (end of period)	0.84	0.77	0.81	0.80	0.83	0.79	0.80	0.82
NZD/AUD (end of period)	0.93	0.86	0.85	0.81	0.89	0.88	0.85	0.82
NZD/EUR (end of period)	0.61	0.61	0.62	0.61	0.61	0.63	0.62	0.61
NZD/GBP (end of period)	0.51	0.48	0.45	0.43	0.51	0.49	0.45	0.43

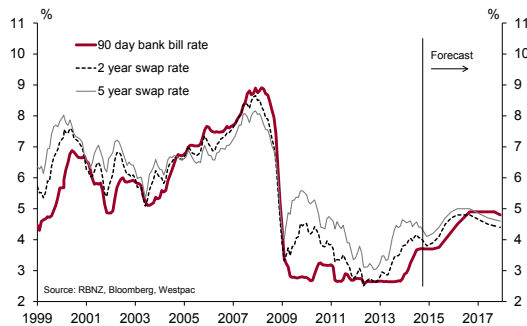
New Zealand GDP growth



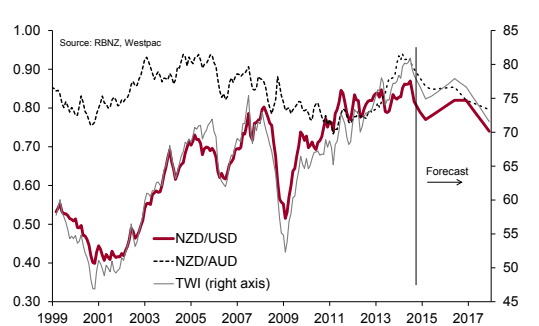
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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