Economic Overview

February 2015

The good oil

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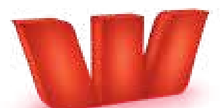

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Note from Dominick

As we developed this *Economic Overview*, two powerful themes pervaded our thinking – plunging global oil prices and the risk of drought in New Zealand.

Cheap oil has left an unmistakable footprint on almost every page of the document. Global economic growth will get a shot in the arm, although there are risks. As cheap oil depresses global inflation, many central banks are easing monetary policy, and that has turned the world of exchange rates on its head.

The New Zealand Economy section details our thinking on the boost consumers are going to get from lower petrol prices. Of course, cheap oil has also demolished any sign of inflation in New Zealand, leading to a sharp drop in fixed interest rates. That will only fuel the housing market fire, marking out another channel through which cheap oil will boost GDP growth over the coming couple of years.

While cheap oil is a clear positive for New Zealand, the risk of drought is a clear negative. The Agricultural Outlook section explains why this year's spell of dry weather will have an even larger impact on milk production than either of the past two droughts, not to mention the damage that will be suffered in other agricultural sectors.

We are bracing for low quarterly GDP growth in March and June 2015. The attendant spell of weak data will no doubt spook markets into pricing more OCR cuts, pushing swap rates even lower.

The RBNZ is most likely to keep the OCR unchanged at 3.5% all year – but we acknowledge that the balance of risks this year is tilted firmly in the direction of OCR cuts, not hikes. With the OCR pinned at 3.5% or lower, and house prices rising sharply, the Reserve Bank will be left with only one viable strategy – we expect macroprudential policy to be tightened at some point this year.

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New Zealand Economy

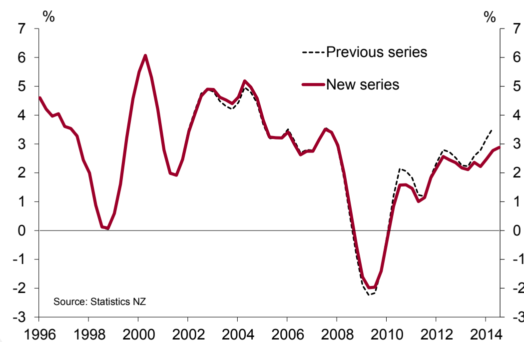
A plus and a minus

Dry weather and low milk prices will weigh on GDP in the near term. However, sharply lower oil prices will provide a potent boost to an economy that was already experiencing a robust upswing. We've revised up our forecast of total growth over the next two years, but with the peak now coming a year later in 2016 and with a continued skew towards domestic demand over exports.

The New Zealand economy maintained a robust pace of growth over the course of 2014, a departure from the somewhat stop-start nature of growth over the previous few years. The construction sector made the single largest contribution to growth, as the Christchurch rebuild continues to ramp up. But it's been joined by a number of positive factors ranging from migration-led population growth, to low interest rates, rising house prices, and low inflation which has supported real growth in household spending.

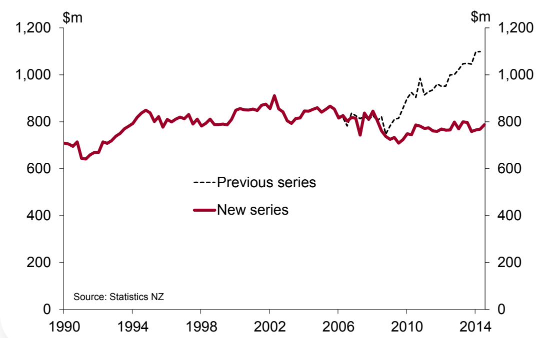
That said, recent revisions to the GDP data paint a slightly less emphatic picture of the pace of growth since the economy emerged from recession a few years ago. Previously, annual average GDP growth was reported to have accelerated to 3.5% by mid-2014, whereas the new figures show that annual growth has yet to achieve a 3% pace in this cycle.

Figure 1: GDP growth, annual average



While these revisions were an unwelcome surprise, they go some way to resolving the mystery of why New Zealand has been experiencing such low inflation despite strong growth in activity – the latter simply wasn't as strong as thought. Moreover, a look at the details shows that the downward revision to growth largely occurred in one sector (petroleum and chemical manufacturing) – which means that the revisions have little bearing on the underlying trends in the economy.

Figure 2: Petroleum and chemical manufacturing GDP



Recent economic data gives the sense of a collective holding of breath ahead of last September's election, especially in but not limited to the housing market. While GDP rose by a greater than expected 1% in the September quarter, this was inflated by a temporary surge in oil exploration and a sharp rise in milk production that will soon go into reverse. The underlying picture was a little more subdued, with the service sectors that make up 70% of the economy recording growth of just 0.3%. House sales were broadly flat, and building consents slowed sharply in September.

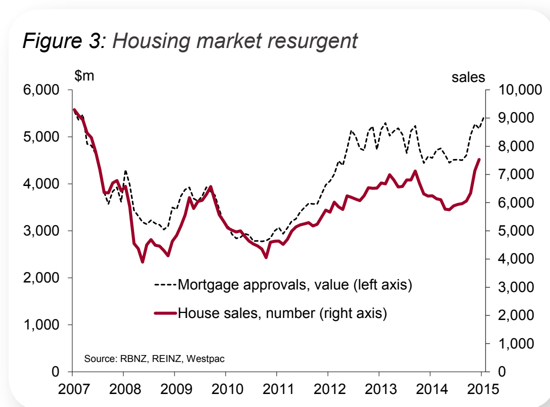
We were surprised to see such a pronounced effect compared to previous elections, but it fits with this election being unusually contentious – a change of government would have meant a less favourable tax treatment for property investment. With that risk out of the way, the growth pulse appears to have improved again in late 2014. Business confidence showed a modest rebound, house sales and building consents have risen strongly, manufacturing and service sector indicators have remained strong, and retail spending growth has remained perky (after accounting for falling prices).

We expect GDP to rise by another 1% in the December quarter, even if some of the factors that boosted September quarter growth are likely to reverse next time.

Off the leash

The housing market has exploded out of the blocks in the last few months. Seasonally adjusted house sales jumped 24% in the last three months of 2014. By December, the pace of house sales had risen above the previous peak seen in September 2013, just before the Reserve Bank imposed a cap on the share of home loans with a loan-to-value ratio (LVR) over 80%. House prices have recently shown a similar resurgence, particularly in Auckland where double-digit annual house price growth has resumed. (In contrast, Christchurch house prices are showing some signs of moderation, as repairs and rebuilds gradually restore the housing stock.)

Figure 3: Housing market resurgent



The overseas experience with high-LVR restrictions has been that the impact tends to peak after about six months and subsequently fade, and New Zealand's own experience is looking no different. The fading effect of LVR restrictions, combined with falling fixed-term mortgage rates and a surge in population growth, created a high degree of pent-up demand, ready to be unleashed once election uncertainties were out of the way.

With cheap petrol and an even greater decline in fixed mortgage rates now in the mix, it's not hard to imagine what is going to happen to the housing market – we forecast nationwide house price inflation to accelerate to 7.5% this year, concentrated in Auckland. There has been a surge in Auckland building activity recently, but supply is not going to come to the rescue of house prices any time soon. Our calculations suggest that the population surge has far outweighed the boost to building, meaning Auckland's construction shortfall is more acute than ever.

A hot housing market, but subdued general inflation, is precisely the environment for which the Reserve Bank's suite of macroprudential tools was intended. Our forecasts incorporate a further tightening of macroprudential policy by the second half of this year – though we'll refrain from trying to predict what form it will take, as there's a great deal of scope for variations even within the existing toolkit.

Oil's well that ends well

Our view remains that the New Zealand economy will continue to register above-trend growth over the next two years, gradually applying inflation pressure and requiring higher interest rates. The profile of the Christchurch rebuild – particularly in terms of when the work peaks and starts to run down – is a critical part of this view, and we explore it in more detail in the Construction Spending Outlook section on page 4. The New Zealand economy's relative strength compared to our main trading partners, and a still-high exchange rate, mean that growth is expected to remain two-speed in nature, with domestic growth outstripping exports.

Two major recent developments have altered the profile of our forecasts for the next couple of years. The first is the steep fall in world oil prices (the factors behind this are detailed in the Global Economy section); the second is the rapid emergence of drought conditions in many parts of the country (the Agricultural Outlook section details the specific impacts on that sector).

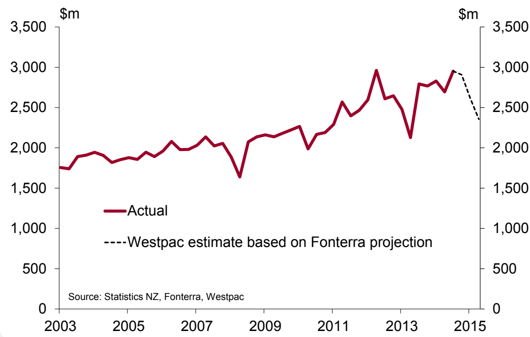
Lower oil prices have a profound, and unambiguously positive, impact on oil-consuming countries such as New Zealand. The direct effect is that lower fuel prices will leave more money in consumers' pockets, which can then be spent elsewhere; our calculations suggest that cheaper fuel will boost private consumption by around 0.8 percentage points over late 2014 and early 2015. It also lowers the cost of doing business, particularly for anything involving transport, resulting in lower prices (or fewer price increases) for a range of goods and services, thus stimulating extra spending. Meanwhile, lower inflation (at least in the near term) allows interest rates to remain low for even longer, which encourages borrowing and investment.

The D word

We estimate that the emerging drought will take about half a percentage point out of GDP growth in the near term, while adding to growth in late 2015 and early 2016 as farm production returns to more normal levels. Consequently, we now see GDP growth reaching 3.6%yr in 2016, a later but stronger peak than in our previous forecasts.

The recent run of hot, dry weather has required a rapid reassessment, with Fonterra now expecting full-season milk collection to be down 3.3% on the previous year. To put that in context, the short but severe drought in 2010 led to a 2% drop in full-season production, while the prolonged drought of 2007-08 saw a 4.3% drop. So this year's drought could potentially be one of the harshest in recent history – at least in terms of dairy production. Of course the ultimate impact is highly dependent on the weather over the next month or two, but we see Fonterra's estimate as a plausible central case.

Figure 4: Milk production, seasonally adjusted



The frequency of droughts in recent years means that the effects on the wider economy are easy to anticipate. Milk production is likely to fall sharply in the first two quarters of this year, before recovering in the second half. The earlier slaughter of sheep and cattle will actually boost GDP in the March quarter, but reduce it in the June quarter, with a net negative impact. We have assumed some second-round impact on household spending and business investment; however, history suggests that the propensity to spend out of farm income is fairly low, so these second-round effects tend to be quite small.

Overall, we expect GDP growth to slow to just 0.4% per quarter over the first half of 2015. That implies a spell of very weak economic data, which could further encourage markets to speculate on the possibility of OCR cuts.

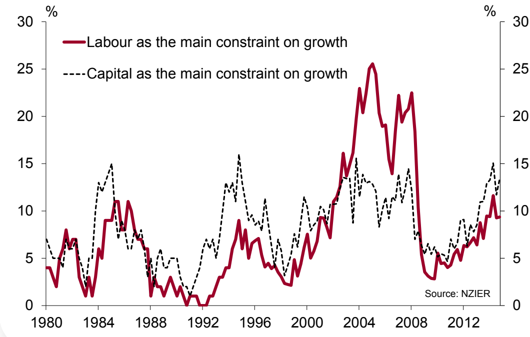
Keeping the purse strings tight

The fiscal position is expected to remain a drag on the pace of growth. Last December, a continued shortfall in the tax take prompted the Government to forecast a later return to surplus, and to delay $1bn worth of the planned increases in the operational spending until 2017. We suspect that the delayed portion of ‘spending’ had been earmarked for tax cuts, which would have been phased in gradually. Hence, we’ve captured the change in spending plans by shaving back our household consumption forecasts a little for the next two years.

Workers in abundance

The labour market was one of the most notable laggards in the economy’s recovery, but has now been recording consistent gains for over a year. While there are some indications that the labour market is starting to tip over into ‘tight’ territory, it remains substantially less of a constraint than what we saw in the mid-2000s boom – in contrast to other measures of capacity constraints, which are reaching significant levels.

Figure 5: Surveyed constraints on business growth



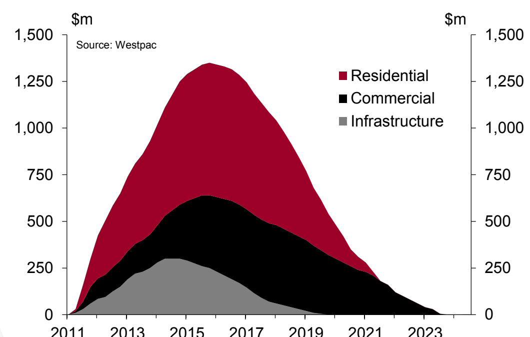
One major reason for this is that demand for workers has been met by stronger growth in the workforce. As we’ve detailed in previous issues, labour force participation has risen to record highs in New Zealand, particularly for older workers. In addition, net inward migration flows have continued to power ahead – we expect the annual net inflow to peak at a record 60,000 people later this year. We suspect this flow won’t be stemmed significantly until the Australian jobs market shows some new signs of life.

The relatively slow reduction in unemployment in turn means that wage growth is expected to increase only gradually. Slow wage growth, at least in nominal terms, will be further underscored by very low headline inflation over the next year.

Over the hill

We expect that 2016 will mark the high point for New Zealand’s economic growth for some time. The following years will see the level of quake-related building activity peak and then run down; net migration inflows will slow as the Australian jobs market starts to look relatively more appealing; and an eventual rise in interest rates will weigh on house prices. We’re bracing for a marked economic slowdown by 2018 – Australia’s recent experience, as the wave of investment in new mining projects has reached conclusion, is instructive in this regard.

Figure 6: Quake-related construction forecasts

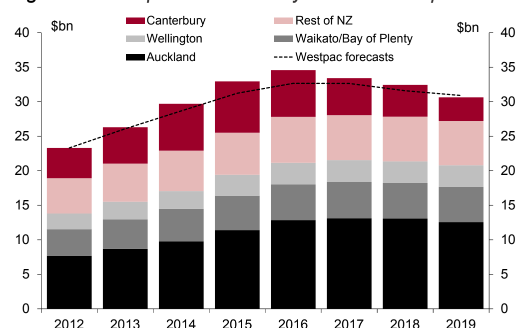


Special Topic
Construction Spending Outlook

Construction spending will be a key determinant of the strength in the domestic economy over the coming year. Strong growth in construction spending is expected over 2015 and 2016. Further ahead, although spending is expected to remain elevated, it will start to ease back.

A strong outlook for nationwide construction spending underpins our expectation of robust domestic growth over 2015 and 2016. Further ahead, there will be moderation in spending as the Canterbury rebuild begins to gradually wind down and population growth returns to more normal levels. This will contribute to slowing GDP growth. Nevertheless, the level of nationwide construction spending is expected remain elevated for several years, supported by activity in Auckland.

Figure 7: Westpac and industry forecast comparison



Source: NZ Building and Construction Productivity Partnership, Westpac

Canterbury rebuild

The anticipated strength in construction activity is a result of several significant work streams. First is the continuing reconstruction work that is occurring in Canterbury. We estimate that the value of reconstruction work will be around $35bn (in 2012 dollars). This is lower than the government's $40bn estimate, reflecting the fact that there have been significant construction cost increases since plans for the rebuild were initially developed, with more expected over the coming years. As a result of these cost increases, it is likely that some of the planned projects will not be economically viable, particularly in the non-residential sphere. Nevertheless, reconstruction still represents a significant impulse for the building sector, equivalent to around 15% of annual GDP.

At the start of 2015, around $10bn of reconstruction work had been completed. Further increases in spending are expected over the coming year, consistent with reports from insurers and government agencies that increasing numbers of projects are moving into design and construction, and strong increases in building consent numbers.

Reconstruction activity is projected to peak over 2015/16, and then start gradually easing back from 2017. This profile is consistent with announced plans for public sector spending. It also reflects the increases in costs of building noted above, as well as very low unemployment in Canterbury, which combined will limit the potential for continued increases in reconstruction activity. Average residential construction costs in Canterbury have risen by around 30% since 2011, pushing them to higher levels than in Auckland. That was in the context of subdued nationwide activity. Now, with construction spending increasing in other regions, cost pressures are expected to become more pronounced.

Auckland housing market

The second work stream that is expected to underpin strength in construction spending is residential construction in Auckland. Auckland currently has a shortage of housing following low levels of home construction in recent years, as well as strong population growth. Our research indicates that population needs will require around 9,000 new homes to be built in Auckland per year for a number of years. This would require a sustained increase in construction of around 20% from current levels.

Non-residential construction

The final stream of construction spending expected over the coming years relates to non-residential projects. Much of this relates to planned infrastructure spending by both central and local government, with figures from the Treasury's National Infrastructure Unit signalling significant spending in the areas of roading, water services, and social assets. Spending is expected to be concentrated in Auckland and Canterbury, but it will be spread across the country.

Business surveys such as the *QSBO* also point to increases in private non-residential construction over the coming years. This is being encouraged by strength in domestic demand, firm levels of business confidence, and low interest rates. Increases in the construction of both offices and industrial buildings is expected.

Agricultural Outlook

It never rains but it pours

The dairying sector now faces a double whammy from both low milk prices and dry weather – indeed, the interaction between the two could have a potent impact on milk production. Droughts tend to depress meat prices but boost dairy prices, although global market conditions mean that the latter effect may be less dramatic than on previous occasions.

Toward the end of last year we noted that there was a heightened risk of an El Niño weather pattern developing this summer, which is typically associated with severe droughts in New Zealand. The subsequent weeks of hot, dry weather have brought this risk into stark focus. While there has been no official drought declaration at the time of writing, it's clear that farmers are already having to make decisions that will have a negative impact on farm output for this year.

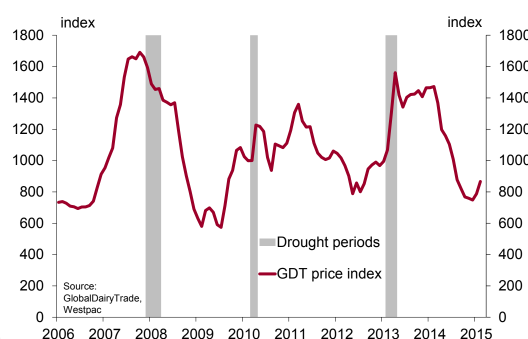
Dry weather is having a particularly potent impact on the dairying industry. The farmgate milk price for the current season is expected to be the lowest since the 2008/09 season, and below the breakeven level for a number of dairy farmers. With prices low, farmers have limited scope to bring in additional feed in order to maintain milk production, instead relying on their own stores of feed and rainfall to spur on grass growth. As a result, milk production is even more vulnerable than usual to drought. Fonterra expects full-season milk production to be down 3.3% on the previous year.

New Zealand is the world's biggest exporter of dairy products, so any disruption to supply from here can have a significant impact on the global market. Indeed, the last few droughts saw world dairy prices soar to new highs, as milk supply from the rest of the world was unable to adjust quickly enough. Supply conditions are not as stretched this time around – milk production in the Northern Hemisphere has grown strongly over the last year, and Russia's import ban has put a substantial amount of product back on the world market. But that only argues against prices returning to their previous highs; it doesn't negate the point that prices rise when supply falls short.

We have revised up our forecast of Fonterra's farmgate milk price this season to $5.00/kg – still low relative to recent history, but taking some of the financial strain off those dairy farmers that are able to maintain production. We expect the milk price to rise to a slightly above-average $6.40/kg for next season.

In contrast, drought is an unambiguous negative for meat producers, as livestock are sent to slaughter earlier than usual and in less than desirable condition. Lamb and beef prices are likely to remain under downward pressure in coming months.

Figure 8: World dairy prices and New Zealand droughts



Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	Reduced harvesting has helped to align supply with softer world demand. Demand from the local building industry remains strong.	Above Average	↗
Wool	Competition from oil-derived synthetics likely to prove the biggest challenge this year.	Above Average	↘
Dairy	Signs that supply and demand are coming into better balance as Chinese buyers run down excess stocks. Drought in NZ will further boost prices from current low levels.	Low	↑
Lamb	Early slaughter due to drought is likely to depress prices in early 2015.	Average	↘
Beef	Early slaughter due to drought will depress local prices. US beef supply remains tight, supporting the longer-term uptrend in prices.	Above Average	↘

[1] NZD prices adjusted for inflation, deviation from 10yr average.

Global Economy

Oiling the machine

The global slowdown has deepened and fresh risks have emerged. However, cheap oil, bolder central banks, and the ongoing US recovery leave us cautiously optimistic that things will improve later this year.

The global bears have had plenty to feed on in the last three months. Japan has fallen back into recession, Europe is navigating the shoals of deflation, Greece and the Russian crisis, and China has yet to emerge from its slowdown. Commodity exporters, including Australia, have struggled.

However, there has also been a fair share of good news. Plunging oil prices are spreading the spoils of North American oil production to global consumers. The Chinese government and European Central Bank have recognised the need for more aggressive policy stimulus. And the US economy has continued to heal.

Taken together, these three developments give us confidence that the global economy has a good chance of weathering the current storms. We continue to expect a modest pickup in global growth by the second half of the year, firming up in 2016.

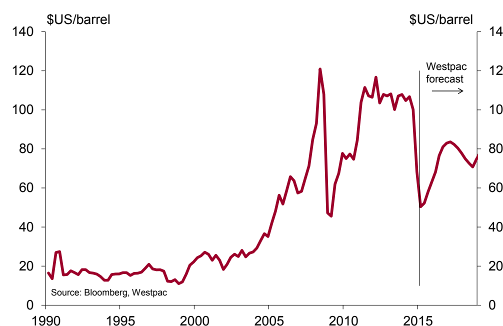
More gas in the tank

The single biggest global development of the last three months has been the halving of crude oil prices. As we detail in the rest of this *Economic Overview*, for New Zealand this will have an unambiguously positive effect on consumers' purchasing power and economic growth. At the global level the net impact should also be positive, though there will be losers (net oil producers like Russia and Canada) as well as winners (net oil consumers like New Zealand and Japan).

Some might argue that falling oil prices are just another symptom of the global malaise. However, we would counter that oil prices have fallen much more steeply than other commodity prices, reflecting oil-specific factors – the significant lift in unconventional supplies in the US and Canada, a recent recovery in oil output in the likes of Libya and Iraq, and a move to improve energy efficiency among consumers. To that extent, the global economy has experienced a genuine positive oil 'shock', which has reduced global production and living costs, and will give global growth a shot in the arm.

That said, oil may not stay this cheap for long. The unconventional supplies which have largely driven the lift in global oil production are also likely to be more reactive to any price declines than traditional sources. Fracking requires regular drilling just to maintain production at existing levels, and the number of operational drilling rigs in the US is already shrinking. As US producers continue to retrench and energy demand starts to rise, we expect oil prices to stage a fairly rapid recovery.

Figure 9: Dubai oil price



Better late than never

Of course, lower oil prices also come with risks. One concern is that plunging energy prices will entrench expectations of deflation in Europe and Japan. That would be a nightmare scenario for the European Central Bank and Bank of Japan, pushing up real interest rates when the economy is already weak.

Then there is Russia. According to the Russian central bank, more than $100bn of Russian foreign-currency debt is due for renewal this year. With a rouble that could go anywhere, Russian corporates shut out from international capital markets by sanctions, and uncertainty around how liquid Russia's $400bn-odd of foreign reserves really are, Russia's situation remains combustible to say the least.

Fortunately, the mix of growth concerns and falling inflation has emboldened central banks' and governments' stimulus efforts. The Chinese policy stance has become much more unambiguously pro-growth, the Bank of Japan has embarked on a fresh round of quantitative easing, the European

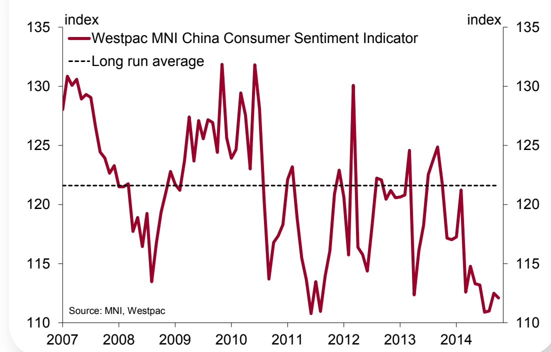


Figure 10: Chinese consumer confidence

Central Bank has belatedly come to the party, and central banks from the Bank of Canada to the Reserve Bank of India have surprised markets with rate cuts.

It will take time for these measures to affect economic activity. Their impact will be muted by earlier fiscal austerity, risk averse households and banks, and (in China) a stock overhang in the housing market and the continuing reverberations of the anti-corruption drive.

However, the impact will show through. Indeed, in China, the housing market and consumer sentiment have already sprouted the greenest of green shoots. And in the interim, the Bank of Japan's and ECB's easing measures have given Japanese and European exporters a much-needed profit buffer to absorb any challenges ahead, via plunging exchange rates.

The US is still an engine of growth

While US GDP growth remains volatile, the underlying trend has clearly been positive. Crucially, consumer demand has firmed, helped by cheap credit and Obamacare, as well as a genuine firming in the labour market. US unemployment is now falling not because people are leaving the workforce, but because of faster jobs growth.

The US story is still far from uniformly rosy. The housing market recovery remains slow, and businesses are reluctant to invest – a trend which the stronger US dollar and retrenchment in the energy sector could well exacerbate. But it's significant that the Fed has kept its eye firmly on eventual rate hikes. Our central case continues to be that the Fed will actually start to move in September, but if jobs continue to grow at their recent rapid pace the odds could well start to favour June.

While the US recovery is now conventional wisdom, its importance for the global economy is not. In our view, stronger US growth will make a major difference not just to Chinese exporters, but to the Chinese economy in general. China remains the world's biggest exporter of manufactured goods, and 17% of China's gross value added comes from the export sector.

Australia – two steps back

The headwinds faced by the Australian economy have gathered force in recent months. The economy grew much more slowly than expected in the September quarter, particularly outside New South Wales. Since then, the loss of economic momentum – in large part the result of a continued pull-back in mining investment and public spending – has been compounded by further sharp falls in iron ore prices and a continued slide in consumer confidence.

In response the RBA cut its cash rate at its February meeting. We expect a follow-up cut in March, and a return to higher interest rates looks unlikely until 2016, when stronger global growth is well-entrenched and the US Fed's tightening cycle is in full flow. A moderation in house price inflation in recent months, as well as APRA's recent moves to beef up regulatory scrutiny of investor lending, should lessen any concerns within the RBA that lower interest rates might stimulate the housing market.

Economic forecasts (calendar years)

Real GDP % yr	2011	2012	2013	2014f	2015f	2016f
New Zealand	1.8	2.4	2.2	3.3	2.9	3.6
Australia	2.7	3.6	2.1	2.7	2.7	3.5
China	9.3	7.7	7.7	7.4	7.3	7.5
United States	1.6	2.3	2.2	2.4	2.7	3.2
Japan	-0.3	1.8	1.6	0.4	1.2	1.6
East Asia ex China	4.5	4.5	4.3	4.1	4.8	5.8
India	7.7	4.8	4.7	5.4	6.6	8.0
Euro zone	1.6	-0.6	-0.4	0.7	0.9	1.0
United Kingdom	1.1	0.3	1.7	2.7	2.5	2.7
NZ trading partners	**3.6**	**3.7**	**3.6**	**3.8**	**3.9**	**4.4**
World	**4.1**	**3.4**	**3.3**	**3.2**	**3.5**	**4.4**

Forecasts finalised 4 February 2015

Inflation and Interest Rates

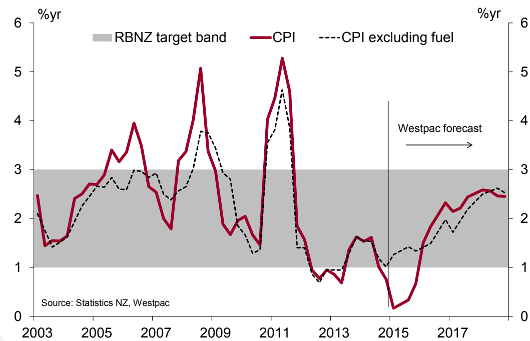
Hold, hold, hold…

Sharp falls in oil prices combined with more generalised softness in prices is likely to result in inflation lingering below the RBNZ's target band through 2015. Despite the firm outlook for domestic demand, this softness in headline inflation will keep OCR hikes off the table for some time, and there is a risk that rates could go lower in the near term.

Inflation to remain low over 2015…

At the start of last year annual headline inflation was 1.5%. By the end of the year, it had dropped to just 0.8%, and over the coming months it will drop sharply lower. We expect that the annual rate of inflation will fall to 0.2% in the March quarter - its lowest level in well over a decade – and that headline inflation will remain below the RBNZ's 1% to 3% target band through all of 2015.

Figure 11: CPI inflation forecasts

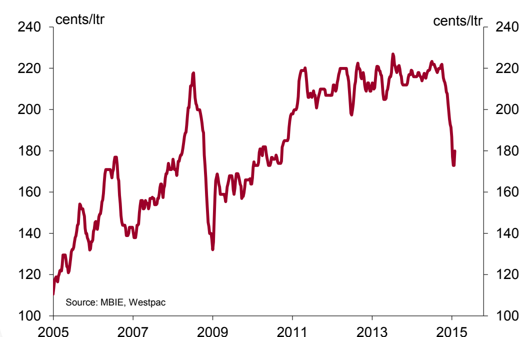


…as a result of low costs…

This rapid decline in inflation is, for the most part, a result of sharp falls in the international price of oil. Global crude oil prices have fallen by more than 50% since mid-2014, pushing nationwide pump prices down to their lowest level since 2010. This is already flowing through to lower costs for households. It will also dampen inflation more generally due to the effect on businesses' costs of production and transport, both domestically and offshore.

But low inflation is not due to oil price falls alone. Inflation in New Zealand has been surprisingly subdued for several years now. Looking through the range of 'special' and one-off factors that frequently push quarterly inflation up and down, low inflation in New Zealand has mainly been a result of softness in cost pressures. In particular, the gradual recovery in the global economy and lingering strength in the NZD has meant that the cost of imported goods, even excluding oil, has remained low. For many imported goods, softness in prices has been reinforced by increased competition stemming from the rise of online sales.

Figure 12: Petrol prices



There has also been softness in domestic cost pressures. Increases in labour costs have been limited as low consumer price inflation has moderated cost of living adjustments to wages. At the same time, strong population growth and increases in capital expenditure have added to the economy's productive capacity, allowing the economy to grow without a significant increase in inflation.

The notable exception to this pattern is the construction sector, where wages and costs have been rising more rapidly. Unsurprisingly, increases in construction costs have been strongest in Auckland and Canterbury. And with a strengthening outlook for construction demand in both of these regions, as well as more generally, construction cost inflation is expected to accelerate over the coming years.

…rather than weak demand

New Zealand is not the only economy currently confronting low inflation. However, New Zealand is in a very different position from economies such as the euro area that are facing the spectre of deflation. In those economies, much of the weakness in inflation is a result of weakness in demand. In contrast, the New Zealand economy has been expanding at a solid pace, and low inflation will only reinforce that.

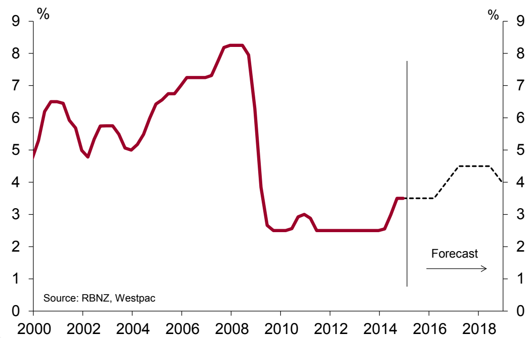
OCR to remain on hold through 2015…

Although inflation is below the RBNZ's target band, we expect the OCR to remain on hold for some time. The RBNZ looks through near-term weakness in inflation associated with volatile items such as oil. Instead, it focuses on longer-term drivers of future inflation. This is because interest rate reductions can do little to offset the effects of declines in oil prices that have already occurred, and hence would have only a limited impact on near-term inflation. However, lower interest rates could super-charge the already strong housing market.

With the domestic economy expected to grow at a robust pace, underlying inflation (i.e. excluding petrol prices) will pick up over time. As a result, the OCR will need to eventually increase. But it's unlikely that the RBNZ will begin hiking until inflation is much closer to 2%, which we estimate will be June 2016.

However, pinpointing the exact timing of hikes right now is a bit of a red herring – the main point is that hikes are likely to be some way off. Furthermore, the eventual hiking cycle is expected to be relatively muted, with rates projected to peak at 4.5% – well below the levels seen during the mid-2000s construction boom. This is because, although inflation is expected to pick up from 2016, growth in the economy is expected to slow from 2017 as spending on the Canterbury rebuild begins to gradually ease back and population growth returns to more normal levels.

Figure 13: Westpac OCR forecast

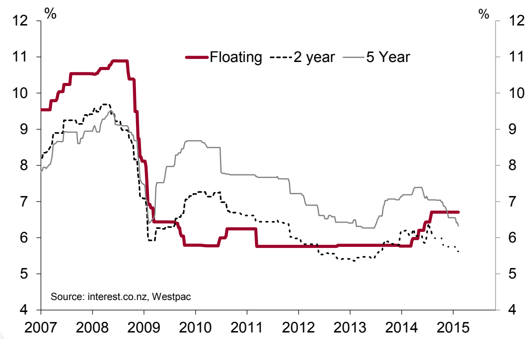


…though it could go lower in the near term…

While it is most likely the OCR will remain on hold through 2015, cuts are a possibility. Given the strong outlook for domestic activity, low headline inflation on its own won't be enough to prompt such a change in stance from the RBNZ. But if there is a significant disruption to economic or financial conditions, or a shock to confidence in the economy, cuts will definitely be on the RBNZ's radar. And in this respect, there are a few red flags on the horizon, including the risk of drought, further changes in offshore monetary policy that affect the NZD, and continued volatility in the global economy.

Financial markets have been moving to price in some risk of an OCR cut. Interest rate markets are currently pricing in around 20 basis points of cuts over 2015, which implies a 40% chance of two cuts. This has resulted in some further reductions in fixed-term mortgage rates.

Figure 14: Average advertised mortgage rates



…and the mix of policy settings could also change

Even lower mortgage rates at this juncture will be of particular concern for the RBNZ. The property market is already smoking, and lower mortgage rates will really be pouring fuel on the fire, raising concerns about longer term inflation and financial stability.

With low inflation keeping OCR hikes off the table for the next while, the RBNZ will be looking at whether it can make use of its other tools to limit the risk for the economy that a build-up of pressures in the housing market could pose. While the exact nature of any tools or regulations the RBNZ could introduce is not clear at this stage, we do expect to see some tightening in macro-prudential regulations this year.

Financial market forecasts
(end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-15	0.2	3.50	3.70	3.50	3.60
Jun-15	0.3	3.50	3.70	3.60	3.70
Sep-15	0.3	3.50	3.70	3.70	3.80
Dec-15	0.7	3.50	3.70	3.80	3.90
Mar-16	1.5	3.50	3.75	4.00	4.10
Jun-16	1.8	3.75	4.00	4.20	4.40
Sep-16	2.1	4.00	4.25	4.50	4.60
Dec-16	2.3	4.25	4.50	4.60	4.70
Mar-17	2.1	4.50	4.70	4.60	4.70
Jun-17	2.2	4.50	4.70	4.60	4.70

New Zealand Dollar

A mere pawn

The New Zealand dollar has been a mere pawn in a bigger game played out between the heavyweight currencies of the world. Although the NZD has fallen against the USD, it remains strong on a trade weighted basis. We anticipate more of the same for the time being, before a recovery in global risk sentiment sparks a rise in NZD/USD later this year.

The past six months have marked one of the sharpest declines in the New Zealand dollar's post-float history. After reaching an all-time high above 88 cents in July, by the time of writing the NZD/USD exchange rate had almost fallen to 72 cents. It is now barely accurate to describe the NZD/USD as "high" – the inflation-adjusted average, measured from 1986 to today, is 65 cents.

The key driver of this dramatic move has been US dollar strength following the end of the US quantitative easing (QE) programme, a run of robust US economic data, increasing speculation on the possibility of the Federal Funds Rate rising this year, and a bout of safe haven buying around the time that concerns about global growth emerged.

By contrast New Zealand has experienced a collapse in the global price of its main export product and a revision of monetary policy expectations that saw two-year swap rates fall by 70 basis points. Not to mention that the Reserve Bank has actively encouraged the fall in the New Zealand dollar through rhetoric and market intervention.

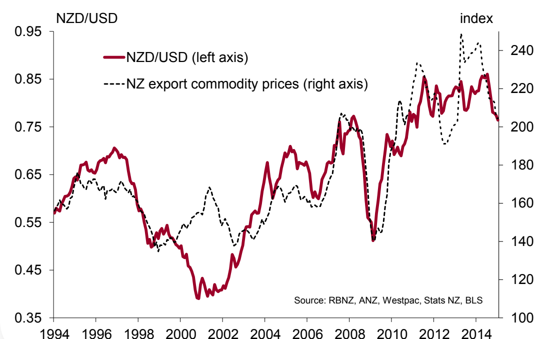
But in comparison to many other currencies, the New Zealand dollar has been resilient. The euro was routed following the ECB's decision to initiate its own QE programme. The Australian dollar has been under great pressure due to falling hard commodity prices and expectations of cash rate cuts. And the yen fell 16% late last year as Japanese monetary policy was eased further.

The New Zealand dollar appreciated against all of these currencies, such that the Trade Weighted Index (TWI) rose steadily from October until mid-January. And although the TWI lost those gains around the time when the possibility of New Zealand OCR cuts came to the fore of market thinking, the TWI is still high by historical standards. It is the high level of the TWI that will pervade the RBNZ's thinking about inflation, not the mundane level of the NZD against the USD.

Over the next few months we anticipate a continuation of these trends. There is no end in sight to the strong US dollar theme, and markets are not done with marking New Zealand monetary policy expectations lower, so the NZD/USD has room to fall further. But with the RBA embarking on cash rate reductions and the Greek sovereign debt saga kicking off again in Europe, one must surely expect the Kiwi to remain strong against the Australian dollar and the euro.

Further ahead, we anticipate a recovery in the NZD/USD. As explained in the Global Economy section, we expect cheap oil, stimulatory monetary policy, and strong US consumer demand to herald a renewed era of advancing global growth and strong risk sentiment from mid-2015 until late-2016. In such an environment the New Zealand dollar can be expected to benefit from improved risk sentiment, and from rising global dairy prices.

Figure 15: NZD and commodity prices, inflation-adjusted

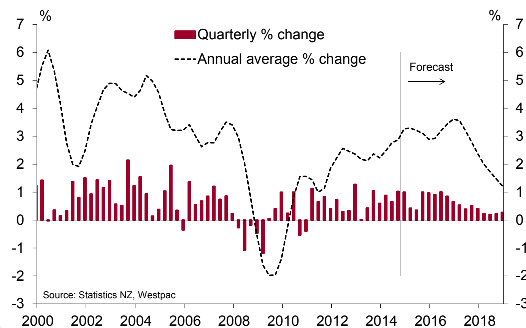


Exchange Rate Forecasts (end of quarter)

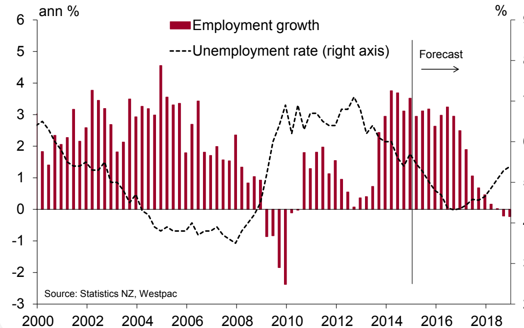
	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-15	0.71	0.95	0.63	0.48	83.9	75.3
Jun-15	0.73	0.95	0.64	0.48	87.6	76.3
Sep-15	0.74	0.95	0.64	0.47	90.3	77.1
Dec-15	0.75	0.95	0.65	0.47	93.0	77.9
Mar-16	0.77	0.95	0.66	0.47	95.5	79.2
Jun-16	0.79	0.94	0.66	0.47	98.8	80.1
Sep-16	0.80	0.94	0.66	0.46	100.8	80.7
Dec-16	0.79	0.92	0.65	0.45	100.3	79.3
Mar-17	0.78	0.90	0.63	0.43	95.2	77.3
Jun-17	0.74	0.88	0.63	0.42	90.3	74.8

Annual average % change	March years				Calendar years			
	2014	2015f	2016f	2017f	2013	2014f	2015f	2016f
GDP (production)	2.5	3.3	2.9	3.6	2.2	3.3	2.9	3.6
Private consumption	2.9	3.9	3.9	3.0	2.9	3.3	4.2	3.2
Government consumption	2.7	3.0	0.7	0.6	1.9	3.5	1.0	0.5
Residential investment	16.6	12.6	11.9	4.7	16.6	16.1	11.3	6.5
Business Investment	8.4	7.0	4.6	6.8	6.2	6.9	5.3	7.1
Stocks (% contribution)	0.2	0.1	-0.1	-0.1	0.1	0.1	-0.1	0.0
Exports	0.3	0.2	1.3	4.8	1.1	1.7	-0.3	4.6
Imports	8.0	7.4	4.7	3.7	6.3	7.8	5.0	4.5
Inflation (% annual)	1.5	0.2	1.5	2.1	1.6	0.8	0.7	2.3
Employment (% annual)	3.8	2.9	3.0	1.9	2.9	3.5	2.6	2.5
Unemployment rate (% s.a. end of period)	6.0	5.5	4.7	4.4	6.0	5.7	4.8	4.3
Labour cost index (all sectors, % annual)	1.6	1.8	1.8	2.0	1.6	1.8	1.8	1.9
Current account balance (% of GDP)	-2.6	-3.9	-5.0	-4.3	-3.3	-3.1	-5.0	-4.6
Terms of trade (% annual)	17.3	-4.4	1.6	1.1	20.2	-2.7	0.9	1.6
House prices (% annual)	7.9	6.6	5.7	0.5	9.2	4.7	7.5	1.5
90 day bank bill (end of period)	2.78	3.70	3.75	4.70	2.65	3.64	3.70	4.50
5 year swap (end of period)	4.57	3.60	4.10	4.70	4.49	4.16	3.90	4.70
TWI (end of period)	78.7	75.3	79.2	77.3	77.3	77.5	77.9	79.3
NZD/USD (end of period)	0.84	0.71	0.77	0.78	0.83	0.78	0.75	0.79
NZD/AUD (end of period)	0.93	0.95	0.95	0.90	0.89	0.91	0.95	0.92
NZD/EUR (end of period)	0.61	0.63	0.66	0.63	0.61	0.63	0.65	0.65
NZD/GBP (end of period)	0.51	0.48	0.47	0.43	0.51	0.49	0.47	0.45

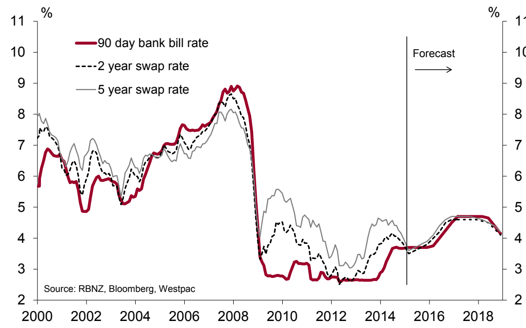
New Zealand GDP growth



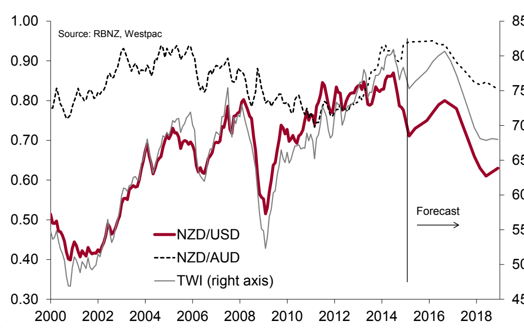
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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