BUSINESS NZ

PLANNING FORECAST

BusinessNZ

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The economy – confronting risks

Executive summary

The outlook for the New Zealand economy remains positive with a respectable growth rate of around 3 percent expected over the forecast period.

Nearly all key indicators are pointing in the right direction with the latest Budget figures and private sector forecasts painting a generally positive picture.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) continue to track in positive territory while other sectors of the economy, particularly tourism, are going from strength to strength. The construction industry outlook is still very positive and the agricultural sector, including dairy, appears to be weathering the storm of ongoing low prices reasonably well although with significant flow-on effects. These include a very low number of dairy conversions and associated low infrastructure growth, as in the number of dairy sheds.

Recent feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates this optimism is shared reasonably widely across most sectors, although regulatory issues are still holding back some industries from achieving their full potential.

Net migration continues to drive demand and shows no signs of abating in the short term. While significant migration flows have many positives, there are also risks which need to be managed; ensuring there is infrastructure to meet the demands of a growing population and that land and housing are available for purchase, for example.

It is therefore pleasing to see the Government seeking to address key regulatory issues that are acting as a handbrake on growth and development, such as land supply for housing and business development. However, the jury is still out whether a gradual approach to regulatory reform will succeed or whether policy uncertainty will continue to constrain development.

In the absence of legislation to enable better quality regulation (a Regulatory Responsibility Act or similar), a review of New Zealand's regulatory policy settings should be undertaken, preferably by an agency at arm's length from Government (perhaps the Productivity Commission), to determine whether there are fundamental changes that can improve outcomes. Comparing ourselves to world best practice may be selling ourselves short if many of the countries to which we generally compare ourselves have dubious policy development processes.

Household debt levels continue to rise precipitously, while agricultural debt, largely in dairy farms, leaves New Zealanders exposed should asset prices burst and/or interest rates rise.

On the international scene, the International Monetary Fund has lowered the global economic growth outlook to 3.2 percent (after lowering it in January this year and July and October last year). The IMF considers the global economy vulnerable to shocks such as sharp currency devaluation and worsening geopolitical conflict. It cites the risk of political isolationism, notably Britain's possible exit from the European Union and the potential risk of growing economic inequality.

The IMF also cites a worsening spillover from China's economy slowdown as well as the impact of continued relatively low oil prices on some emerging markets. Reliance on China, and to a major extent Australia, does expose New Zealand to some risk, but our export market base is now becoming increasingly diversified.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 7 for the June 2016 quarter, up 8 on the previous quarter and up 4 on a year ago.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) show ongoing consistent expansion. For May 2016 the PMI was 57.1 and the PSI 56.9. (A reading above 50.0 indicates the PMI/PSI generally expanding and below 50.0, declining).

The IMF has lowered the global economic growth outlook to 3.2 percent (the fourth downward revision in the last year), saying the global economy is vulnerable to shocks such as sharp currency devaluation and worsening geopolitical conflict. New Zealand's diversified export markets cushion us from some of the associated flow-on effects.

New Zealand's business and consumer confidence levels remain in positive territory with consumers spending (and borrowing) more in light of reasonably healthy labour market outcomes and perceived net wealth gains through higher house and asset prices.

Household debt levels are a key risk, continuing to rise precipitously, while agricultural debt, largely in dairy farms, leaves New Zealanders exposed should asset prices burst and/or interest rates rise.

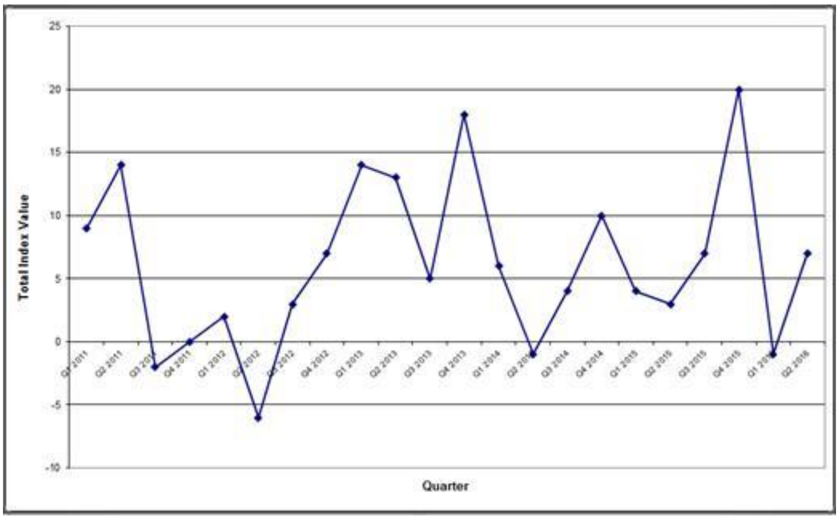
Inflation remains subdued, despite some recent rises in international oil prices, although off a low base. The jury is still out whether the Reserve Bank will make one further cut to the Official Cash Rate with the pros and cons finely balanced.

PART 1: THE NEW ZEALAND ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of New Zealand's major economic indicators) sits at 7 for the June 2016 quarter, an increase of 8 on the previous quarter and up 4 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Of the ECI sub-groups:

Economic growth/performance indicators sit at 1 for the June 2016 quarter, up 2 on the previous quarter, and down 4 on a year ago. International commodity prices remain subdued with little likelihood of recovery in the short term.

Monetary policy/pricing indicators sit at 3 for the June 2016 quarter, up 3 on the previous quarter and up 1 on a year ago. Benign inflationary pressures have seen the Reserve Bank reduce the Official Cash Rate to historic low levels. However, the jury is out whether there will be any further cuts.

Business/consumer confidence indicators sit at 1 for the June 2016 quarter, up 4 on the previous quarter and up 4 on a year ago. Business and consumer confidence, driven by both international and domestic factors, remain positive despite continued global risks.

Labour market indicators sit at 2 for the June 2016 quarter, down 1 on the previous quarter and up 3 on a year ago. While employment growth remains relatively strong, this is somewhat offset by relatively high numbers entering the labour market, dampening the ability to make a sizable dent in the unemployment rate.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case; for example, declines in unemployment are seen as positive and increases as negative.

PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE HEADING?

1.1 Economic growth (GDP) – 3 percent

Economic growth approaching 3 percent is forecast out for the year to June 2018 (see below).

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 16	Jun 17	Jun 18
Highest	2.7	3.5	3.9
Average	2.6	2.8	2.9
Lowest	2.5	2.4	2.5

Source: ANZ, ASB, BNZ and Westpac

Recent feedback from BusinessNZ's Affiliated Industries Group indicates this forecast optimism is shared reasonably widely across most sectors, although regulatory issues are still holding back some industries from meeting their full potential.

Several factors are acting as positive drivers of the New Zealand economy's future growth prospects, including:

- World commodity prices, particularly oil, have partially recovered from a very low base, while other global commodity prices, including dairy, appear to be bouncing along the bottom with some slight improvement likely over the next year
- World equity markets have recovered most of the losses experienced early in 2016 with the New Zealand sharemarket approaching new highs
- Strong net migration inflows are at record highs, adding to the demand for goods and services
- Construction activity is generally still positive across the country, including housing construction, large scale infrastructure (notably roading) and the continuing earthquake strengthening of commercial buildings
- Tourism growth is strong with a flow-on impact on accommodation and hospitality. Given international terrorism concerns about many holiday destinations, the attraction of New Zealand as a safe place to visit might be driving some of this growth.
- A low inflationary environment with historically low interest rates is likely to persist for the foreseeable future
- An exchange rate, although appreciating more rapidly of late, is at competitive levels for exporters.

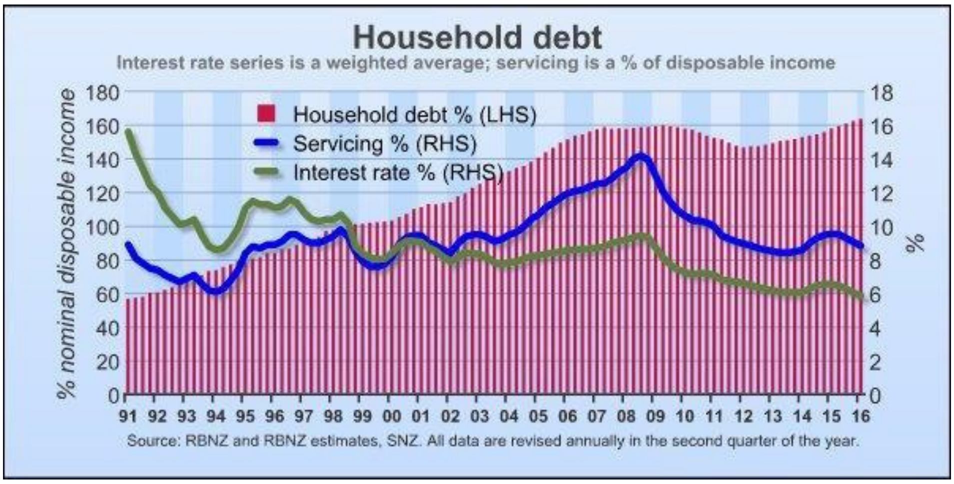
But economic risks remain.

First, on the international scene, the IMF has lowered the global economic growth outlook to 3.2 percent (after lowering it in January this year and July and October last year).

The IMF considers the global economy is vulnerable to shocks such as sharp currency devaluation and worsening geopolitical conflict. It cites the risk of political isolationism, notably Britain's possible exit from the European Union and the potential risk of growing economic inequality.

The IMF also cites a worsening spillover from China's economy slowdown as well as the impact of continued relatively low oil prices on some emerging markets. Reliance on China, and to a major extent Australia, does expose New Zealand to some risk but this is tempered by ongoing export market diversification.

Second, on the domestic scene, rising household debt is concerning. While it is important to accept that there is good debt and bad debt, depending on its purpose and use, the precipitous increase in household and agricultural (largely dairy) debt leaves New Zealanders significantly exposed should asset prices burst and/or interest rates rise.



The real concern is that debt is increasing at a time when servicing costs are relatively low, with historically low interest rates. The danger is that when interest rates rise, as they inevitably will (although the exact timing of the rise can always be debated), households will get into strife. Although significant household debt reduction was achieved post-2009, households appear to have partially forgotten the lessons of the past. Rising house prices might provide a feel-good factor but it would be dangerous to consider this represents a real increase in wealth. At the end of the day people have to live somewhere and the cost of housing will ultimately be passed on to households through higher rental costs.

Third, in spite of the many positives associated with significant migration inflows, there are risks which need to be managed, including ensuring infrastructure is available to meet the demands of a growing population and that land and housing are available for purchase.

It is ironic that in New Zealand, with only 4.5 million people, many are struggling against a regulatory web of rules and vested interests to pursue their dream of obtaining land for business and housing purposes as and when they require it, rather than when planners make it available.

BusinessNZ supports moves to free up more land for development as most politicians now accept, but has concerns that the Government's proposed National Policy Statement (NPS) on Urban Development Capacity cannot reflect changing market demands and will not adequately achieve the objective of ensuring land supply for housing and business development.

A gradual approach to dismantling metropolitan urban limits is not decisive enough to stem dramatic imbalances in land and house prices.

The NPS calls into question the role of planning itself. Problems with an undersupply of housing in some areas, notably Auckland, stem from overly restrictive planning. Rather than a 'more planning' approach as in the NPS, less planning is required. Land value should not be dictated by planners, but should be set by its highest value use, and markets should be allowed to find that value.

As long as planners constrain land supply, as would be likely under the proposed NPS, the price of land zoned urban will remain well above that of the same or equivalent rural-zoned land. Consequently, the many "planning" dislocations and unintended absurdities will continue.

Much new home building is presently delayed in Auckland by regime uncertainty, with the blame often laid with so-called land-bankers waiting to see what finally appears from the Unitary Plan. But even with the Unitary Plan finally enshrined and the NPS in place, private property will still be constrained by planners and regulators.

Planners and regulators cannot be expected to keep up with market changes as quickly as market participants can. A market-based approach to housing provision can be more responsive and flexible than a planning approach. The NPS focuses too much on planning and not enough on allowing markets to work. Home-owners and businesses are best placed to make individual choices reflecting their needs and wants rather than having planners make decisions for them.

As long as developers pay the economic and environmental costs of associated infrastructure, development should be allowed wherever businesses and homeowners choose to build.

Fourth, New Zealand sharemarket continues to drive upwards and is now one of the world's top performers. However, increasingly there is a question whether New Zealand shares are becoming too expensive compared with underlying returns and whether it is time to ease back. Given very low interest rates and the amount siphoned off into KiwiSaver schemes, the share market has until now had a ready source of capital looking for a home with respectable returns. Investment fundamentals suggest a correction is inevitable, sooner rather than later.

Fifth, despite efforts to improve the quality of New Zealand's regulation, there is still a long way to go with continuing examples of sub-standard economic analysis of regulatory interventions. A number of legislative initiatives fail basic cost/benefit analysis, for example, the recently enacted Building (Earthquake-prone Buildings) Amendment Act. To be fair, the Act is an improvement on the one-size-fits-all approach to earthquake risk which typified the original Bill, but the rationale for the Bill in the first place was misguided.

The question of how to improve the quality of New Zealand's regulation remains. If the answer is not a Regulatory Responsibility Act (with a set of principles) to guide Government and officials in regulatory decision-making, what is it? Ad hoc reviews are hardly likely to move the needle.

In the absence of an RRA or similar to ensure better quality regulation, a review of New Zealand's regulatory policy settings should be undertaken, preferably by an agency at arm's length from Government, (perhaps the Productivity Commission) to understand whether fundamental changes can be made to improve outcomes. Comparing ourselves to world best practice may be selling ourselves short, if many of the countries to which we generally compare ourselves have dubious policy development processes.

1.2 Monetary conditions – holding tight for now

Interest rates – lower for longer

The 90-day bill rate is forecast to decline slightly for the year to June 2017 and then regain some ground out to June 2018 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

	Years ending		
	Jun 16	Jun 17	Jun 18
Highest	2.4	2.2	2.9
Average	2.4	2.0	2.5
Lowest	2.4	1.9	2.2

Source: ANZ, ASB, BNZ and Westpac

As most expected, the Reserve Bank kept the Official Cash Rate at an historic low of 2.25 percent in its most recent review. Certainly, the New Zealand Institute of Economic Research's Shadow Board recommended the Bank continue to hold the OCR at 2.25.

In releasing the results of the Shadow Board's decision, Christina Leung, Senior Economist at NZIER said:

> *"The New Zealand economy is showing decent momentum, and there has been renewed interest in housing in the wake of the OCR cut in March. The acceleration in house prices is in stark contrast to the continued subdued inflation outlook. This tension is causing more headaches for the Reserve Bank.*
>
> *"Although the Shadow Board recommends the Reserve Bank holds the OCR at 2.25 [for the moment], it sees increased downside risk to the interest rate outlook. The pick-up in house price inflation is concerning, particularly from a financial stability perspective, but as long as the Reserve Bank's primary goal is on lifting inflation back to its 2 percent mid-point target it will see further scope to cut interest rates."*

The tension referred to above between rising house prices and a continued subdued inflation outlook is difficult for the Reserve Bank to navigate but there are reasons why it might hold off any further cuts to the OCR, despite several respected economists considering the Bank will lower the OCR to 2 percent later this year (before possibly raising rates to more neutral levels well down the track).

First, while headline inflation (which measures consumer prices) is still outside the Reserve Bank's target band of 1-3 percent, core inflation, discounting one-offs, is much more in the line of 1.5 percent. There is an argument that the public is more in tune with headline inflation but the Bank's role is to look broadly through one-off results and focus on the longer term. Therefore it can be argued that core inflation is a much more credible number for the Reserve Bank to target over the medium term.

Second, the broad New Zealand economy is now performing relatively strongly (after an earlier dip mid-2015). With strong and prolonged high net inward migration levels and continued housing price pressures, lowering the rate might fuel even greater domestic demand and put the economy at risk.

Third, with interest rates at historically low levels, it is debatable whether lowering them even further would have much impact on investment activity. Investment opportunities and risk might be more dependent on the regulatory framework than on interest rates per se.

Fourth, given that international commodity prices have bottomed out and are arguably showing some slight rises of late, it would be unfortunate to have to speedily reverse any further interest rate cuts. For now, the sensible position might be to sit tight.

The New Zealand dollar – in the zone

Forecasts below show the New Zealand dollar is generally expected to change little against either the Australian or the US dollar, although most commentators concede that predicting its future direction is difficult.

Inflaming the uncertainty is that moves towards more normalised international monetary policy regimes are looking more remote by the day, despite the United States appearing to return to the fold. There are countries with negative interest rates clearly struggling for solutions and a handful of developed countries with rates close to zero. New Zealand's OCR of 2.25 looks positively high by international standards.

Also noteworthy is the IMF's warning that the global economy is vulnerable to shocks such as sharp currency devaluation and worsening geopolitical conflict. The IMF cites the risk of political isolationism, notably Britain's possible exit from the European Union, and the potential risk of growing economic inequality.

Forecasts: Exchange Rates

AUD (cents)			
	Jun 16	Jun 17	Jun 18
Highest	0.96	0.93	0.94
Average	0.95	0.89	0.90
Lowest	0.92	0.81	0.86

USD (cents)			
	Jun 16	Jun 17	Jun 18
Highest	0.70	0.70	0.75
Average	0.69	0.64	0.65
Lowest	0.67	0.61	0.60

TWI			
	Jun 16	Jun 17	Jun 18
Highest	75.3	71.0	73.1
Average	74.0	68.4	69.3
Lowest	71.5	64.0	66.2

Source: ANZ, ASB, BNZ and Westpac

Inflation – conflicting pressures

Forecasts below show inflation firmly under control over the period to June 2018, remaining well within the Reserve Bank's target range of 1-3 percent and only reaching 2.0 percent by June 2018.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 16	Jun 17	Jun 18
Highest	0.7	2.0	2.4
Average	0.6	1.5	2.0
Lowest	0.5	1.2	1.7

Source: ANZ, ASB, BNZ and Westpac

Tradeables inflation has not been an issue to date with international commodity prices currently bouncing along the bottom. On the other hand, non-tradeables inflation - particularly housing - is a problem, with significant and ongoing pressures now spreading well beyond Auckland. For financial stability, this is likely to concern the Reserve Bank much more than inflationary pressures. Given New Zealand's levels of household debt, the risk of a housing slump does not bear thinking about.

1.3 Business activity and consumer confidence firmer

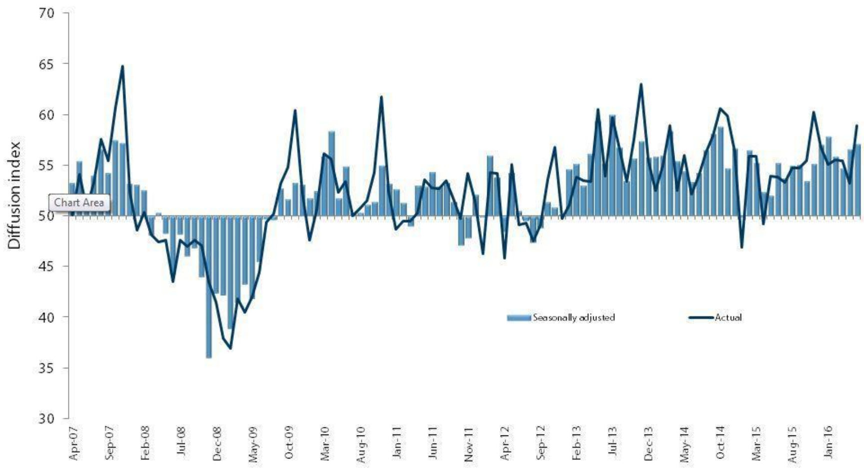
Business activity solid

Business activity and consumer confidence are generally improving after earlier falls as evidenced by a number of key indicators.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) both show continued solid growth.

The seasonally adjusted PMI for May 2016 was 57.1, that is, 0.5 points higher than in April, and the highest level of expansion since January (a reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). The sector has now been in expansion in all months since October 2012.

BNZ-BusinessNZ Performance of Manufacturing Index (PMI)
(2007 onwards)



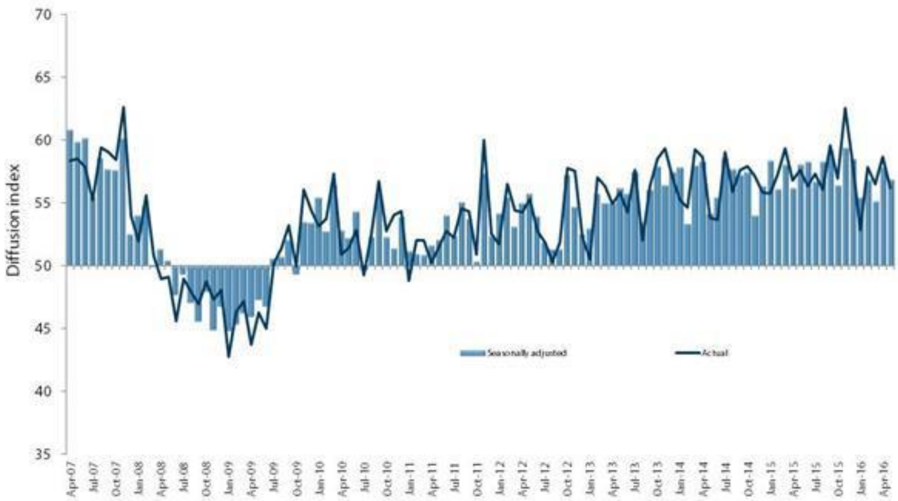
Production (61.1) lifted its head above the 60-point mark for the first time since December 2014, while new orders (59.9) has remained within a tight band range of 2.5 points since November 2015. In addition, the proportion of positive comments rose to 66.4 percent, with a number pointing to business as usual and a steady flow of activity/orders.

Main **Indices**

Regional **Results**

The PMI's sister survey, the BNZ–BusinessNZ Performance of Services Index (PSI), continued strongly, with expansion continuing in May 2016. The PSI for May was 56.9. While this was 0.9 points lower than April, it was the same level of activity as February, and continues a post-55 level of expansion since November 2014 (A PSI reading above 50 indicates that the service sector is generally expanding; below 50.0 that it is declining).

BNZ-BusinessNZ Performance of Services Index (PSI)
(2007 onwards)



Both activity/sales (60.6) and new orders/business (60.1) continued to keep their head above the 60-point mark, while employment (54.5) was at its highest level since November 2015. In addition, the proportion of positive comments for a sizeable number of businesses (67.6 percent) tended to indicate a combination of a continued market demand and new market opportunities.

Main **Indices**

Regional **Results**

Other sectors, with the exception of dairy, are all holding up well as evidenced by both quantitative and qualitative data. Tourism is booming while construction activity continues to go from strength to strength. The retail sector is lifting slightly on the back of greater consumer confidence and household spending.

Consumer confidence shows optimism. Household debt levels have been increasing, an obvious threat but offset to some degree by historically low debt servicing costs, along with relatively strong employment growth, although the unemployment rate continues to bob around.

Households, like businesses, are still somewhat nervous about the general economic situation but remain much more optimistic about their personal economic circumstances. As a result, they are still in spending mode.

1.4 Labour market – positive outcomes

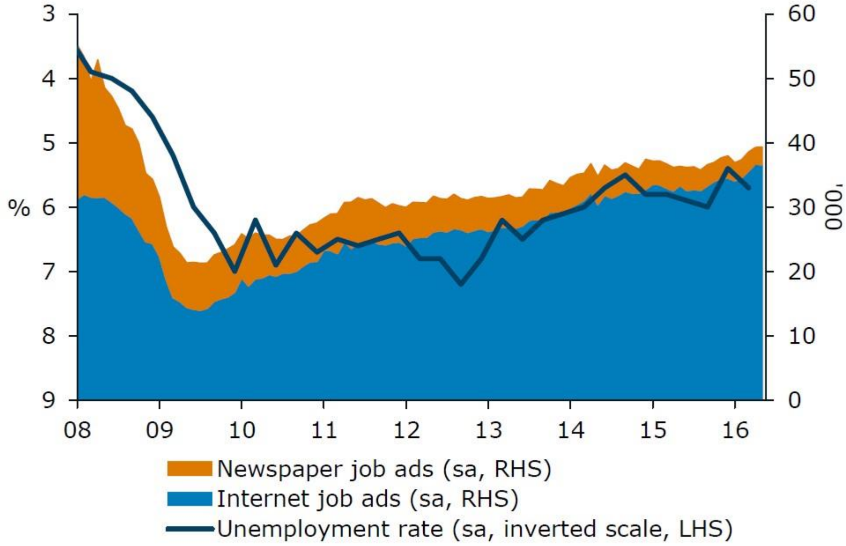
Employment – growth continues

The ANZ Jobs Ads series for May 2016 shows job ads rising slightly for the month (up 0.2 percent) on a seasonally-adjusted basis. Compared with a year ago, total job advertising is on an upward trend (7.2 percent higher than a year ago (based on 3-month average)).

Auckland led the charge with job ads 11.8 percent higher than a year ago, Wellington job ads were up while Canterbury job ads were 11.3 percent lower than a year ago (3-month average). The Canterbury results need to be put in context given the huge growth in employment over the last few years as a result of the ongoing rebuild and redevelopment post the 2011 earthquake.

A number of the regions are showing relatively strong growth, despite continuing dairy sector concerns, suggesting the construction and tourism sectors are booming and compensating for tighter labour market conditions currently experienced by the dairy sector.

FIGURE 1. JOB ADS AND THE UNEMPLOYMENT RATE



Source: ANZ, Statistics NZ, Seek, Trade Me, Dominion Post, Hawke's Bay Today, Manawatu Standard, NZ Herald, ODT, The Press, Waikato Times

Other credible statistics - including the BNZ-BusinessNZ Performance of Manufacturing Index (PMI), which has recovered from a recent drop into negative territory - point to expanding employment growth. Its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) showed a bounce back in employment after a blip in January. See table below.

Employment

Seasonally-adjusted time series for PMI and PSI

Jan 16	54.3	51.1
Feb 16	48.9	53.7
Mar 16	49.0	53.0
Apr 16	50.0	53.8
May 16	52.8	54.5

Source: BusinessNZ

The mix of factors impacting on labour market outcomes includes continued strong population growth, driven by strong net migration inflows. This level of migration means there is unlikely to be any substantial tightening of labour market conditions this year.

Despite relatively strong employment growth, forecasts below show the unemployment rate projected to drift only slightly lower to reach 5.2 percent in the year to June 2018.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 16	Jun 17	Jun 18
Highest	5.7	5.9	5.8
Average	5.6	5.5	5.2
Lowest	5.5	5.2	4.8

Source: ANZ, ASB, BNZ and Westpac

Labour costs – generally subdued

Forecasts below indicate labour costs are expected to increase only slowly to 1.9 percent for the year ending June 2018.

Reasonably solid employment growth notwithstanding, the high numbers of people entering the labour market, including the ongoing impact of strong net inward migration, will likely see wage pressures generally constrained.

Forecasts: Labour cost index percentage change (wages & salaries)

	Years ending		
	Jun 16	Jun 17	Jun 18
Highest	1.8	2.0	2.1
Average	1.7	1.8	1.9
Lowest	1.6	1.6	1.6

Source: ANZ, ASB, BNZ and Westpac