

PLANNING FORECAST

JUNE 2017



NZ economy – ticking over

Executive Summary

On the domestic front, the economy is ticking over nicely.

While recent Gross Domestic Product (GDP) for the 2016 December quarter and 2017 March quarter came in at the lower end of expectations (0.4 percent and 0.5 percent respectively), there were some specific factors affecting growth rates at the time, namely, the impact of the Kaikoura earthquakes and the lingering effects of lower commodity prices (and production), particularly dairy. These effects have somewhat diminished for the current June quarter and prospects are looking up – not only for NZ but for the rest of the world.

The Government's recent Budget, delivered by Finance Minister the Hon Steven Joyce, similarly confirmed a very positive economic outlook for NZ.

The Government's books are now in a relatively strong position allowing for an increase in expenditure, debt reduction and the offer of some modest tax cuts (in the form of shifting personal income tax thresholds) - all at the same time. This is a relative luxury many other countries (Australia included) do not have.

Not surprisingly, with its key economic indicators generally so positive, international think-tanks and international credit rating agencies have also been reasonably positive in their assessment of NZ. The International Monetary Fund (a global economic agency which normally doesn't easily hand out praise) and the Organization for Economic Cooperation and Development (OECD) have both recently come out in general support of where the NZ economy is at, while at the same time offering suggestions for improvement.

The OECD points out that while overall GDP growth is good by international standards, NZ's productivity growth has continued to lag behind that of many other OECD countries. The OECD acknowledges that overall, NZ's policy settings are among the best in the world but still considers some improvements are needed. The country's overseas investment regime, for example, is seen as unduly restrictive.

In general, the global economy is looking up.

The J.P Morgan Global Manufacturing Performance of Manufacturing Index (PMI) is currently 52.6 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining) and sharemarkets around the world are continuing to rise. Both US and UK shares are at record highs while European shares have rebounded strongly in recent months. Locally, the NZX has recovered much of the ground lost from a sharp sell-off late in 2016 and is now approaching a new high.

While international sentiment might currently be positive compared with the recent past, significant issues continue to confront the global economy. Not least is an increasingly nationalist approach to trade and the moves towards greater protectionism of some key international players.

HIGHLIGHTS

International economic sentiment is generally positive as evidenced by a number of indicators including the JP Morgan Global Manufacturing PMI.

The BusinessNZ Economic Conditions Index (ECI) sits at 10 for the June 2017 quarter, up 1 on the previous quarter and down 8 on a year ago.

After a minor blip in the rate of expansion earlier this year, both the BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) are showing solid expansion as we reach the mid-point of 2017.

Performance across a range of sectors is positive, from manufacturing and services as mentioned above, through to construction and tourism. The agricultural sector, particularly dairy, is increasingly back on track.

Despite relatively high levels of business and consumer confidence, a number of ongoing risks to the economy still need to be addressed. Some of these issues include:

- An overreliance on commodity based exports given pressures are mounting on natural resources (e.g. water)
- The need for greater resilience to expected (and unexpected) events
- Housing cost escalation
- Level of household debt
- Tourism and migration pressures on infrastructure
- Funding of infrastructure in high growth areas (e.g. Auckland) and in areas with population decline where infrastructure upgrades are required
- Regulatory uncertainty.

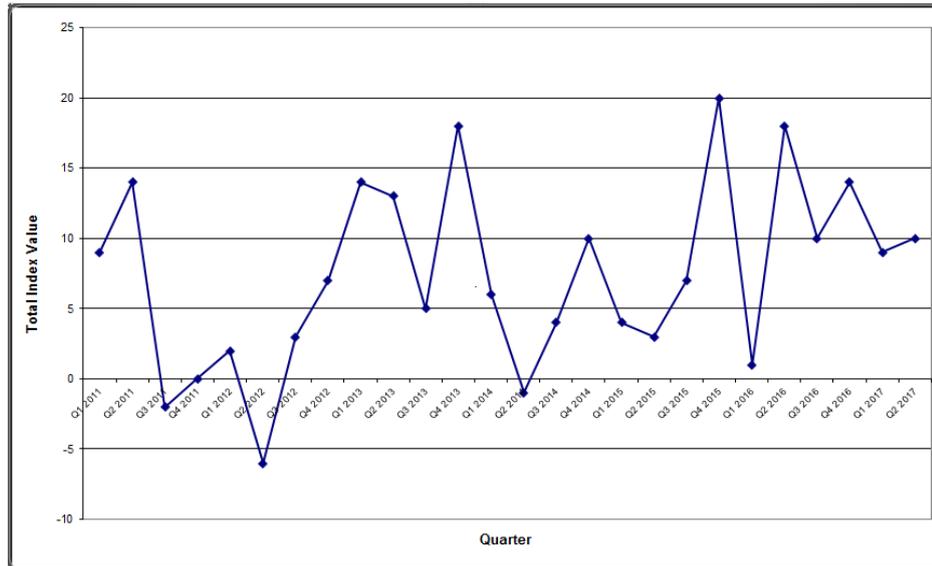
These and other risks are outlined more fully in the body of this report.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 10 for the June 2017 quarter, up 1 on the previous quarter and down 8 on a year ago.¹

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

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 3 for the June 2017 quarter, the same as the previous quarter, and down 2 on a year ago. With increases in world commodity prices, particularly dairy, NZ's terms of trade are now at their highest level since 1973.

Monetary policy/pricing indicators sit at -1 for the June 2017 quarter, the same as the previous quarter and down 6 on a year ago. Inflationary pressures are building slowly as interest rates incrementally increase.

Business/consumer confidence indicators sit at 4 for the June 2017 quarter, up 2 on the previous quarter and up 1 on a year ago. Confidence indicators for both businesses and households continue to consolidate at relatively healthy levels.

Labour market indicators sit at 4 for the June 2017 quarter, down 1 on the previous quarter and down 1 on a year ago. Overall, employment growth remains strong, driving unemployment to below 5%. Labour force participation rates continue to break record highs, with strong migration inflows helping to supplement the domestic workforce.

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. Results for the June 2017 quarter are estimates based on available information to data and forecasts.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?

Global economic sentiment remains positive in the wake of generally robust economic indicators and central banks taking a cautious approach to any monetary policy tightening.

The J.P Morgan Global Manufacturing Performance of Manufacturing Index (PMI) is currently 52.6 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining).



Economic conditions remain solid in most parts of the world. Europe's performance continues to be reasonably good, as outlined in its recent PMI results (see above). Growth in output and new orders have accelerated to be the best in nearly 6 years while Eurozone job creation is currently the best in the 20-year history of this survey.

But the indicators from China have been weaker. Monetary conditions are generally tightening and activity levels are slowing, albeit from a reasonably solid base.

Sharemarkets around the world continue to rise with both US and UK shares at record highs. European shares have rebounded strongly in recent months. Locally, the NZX has recovered much of the ground lost from a sharp sell-off late in 2016 and is now approaching a new high.

While sentiment internationally might be positive compared with the recent past, there are significant issues confronting the global economy. Not least, an increasingly nationalist approach to trade and some key international players' moves towards greater protectionism. Beyond the ability of global economies to control is the ongoing threat of extreme acts of terrorism once again being felt around the world.

1.1 Economic growth (GDP) – solid expansion

Domestically, a solid growth rate of 3 percent plus per annum is forecast out to June 2019 (see below).

Forecasts: Real GDP percent Growth

	Years Ending		
	Jun 17	Jun 18	Jun 19
<i>Highest</i>	2.8	3.3	3.8
<i>Average</i>	2.8	3.0	3.4
<i>Lowest</i>	2.8	2.7	3.1

Source: ASB, BNZ and Westpac

While recent Gross Domestic Product (GDP) for the 2016 December quarter and the 2017 March quarter came in at the lower end of expectations (0.4 percent and 0.5 percent respectively), there were some specific factors affecting growth rates at that time, namely the impact of the Kaikoura earthquakes and the lingering effects of lower commodity prices (and production), particularly dairy. These effects have lifted somewhat for the current June quarter and prospects are looking up – not only in NZ but for the rest of the world.

But despite reasonably solid growth over the last several years, driven in part by high net migration inflows, when GDP growth is considered, the picture is not quite so rosy. For the year to March 2017, New Zealand's annual GDP growth rate was just under 1 percent.

A low annual GDP growth rate notwithstanding, the NZ economy is currently a very positive story with relatively strong growth over a range of sectors - construction, tourism, manufacturing, services and indeed, agriculture.

The Government's recent Budget, delivered by Finance Minister Hon Steven Joyce, also confirmed a very positive economic outlook:

- **Economic growth** is expected to remain in positive territory at around 3% per annum over the next 5 years
- **Inflationary pressures** are expected to remain relatively subdued, averaging around 2% over the next five years
- **Unemployment** is expected to drift lower to reach 4.3% by 2021.

Other key indicators, such as government debt, are also predicted to track lower over time.

The Government's books are now in a relatively strong position with the ability to increase expenditure, reduce debt and offer some modest tax cuts in the form of shifting personal income tax thresholds - all at the same time. This is a relative luxury many other countries (Australia included) do not have.

Not surprisingly, with its key economic indicators generally so positive, international think-tanks and international credit rating agencies have also been reasonably positive in their assessment of NZ. The International Monetary Fund (a global economic agency which normally doesn't easily hand out praise) and the Organization for Economic Cooperation and Development (OECD) have both recently come out in general support of where the NZ economy is at, while at the same time offering suggestions for improvement.

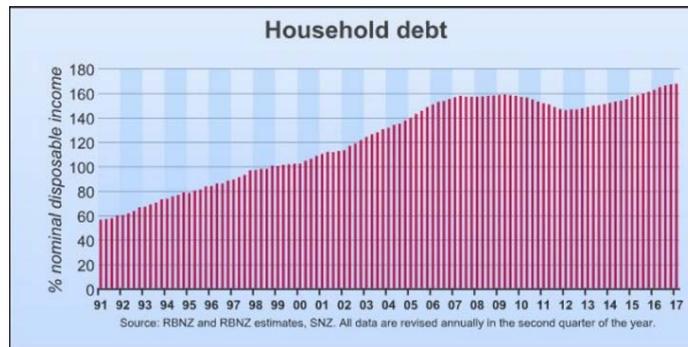
The OECD points out that while overall GDP growth is good by international standards, NZ's productivity growth has continued to lag behind that of many other OECD countries. While, the OECD acknowledges that overall, NZ's policy settings are among the best in the world, some improvements are still thought to be needed. The country's overseas investment regime, for example, is seen as unduly restrictive.

In some respects the NZ economy is experiencing "growing pains", which is not a bad problem to have but nonetheless, highlights risk factors which need to be managed. These risk factors – expanded on below – relate to the efficient use of resources (particularly natural resources such as water) and the funding of infrastructure and community services. Note that the issues raised are not necessarily set out in any order of importance. All these issues are important in their own right.

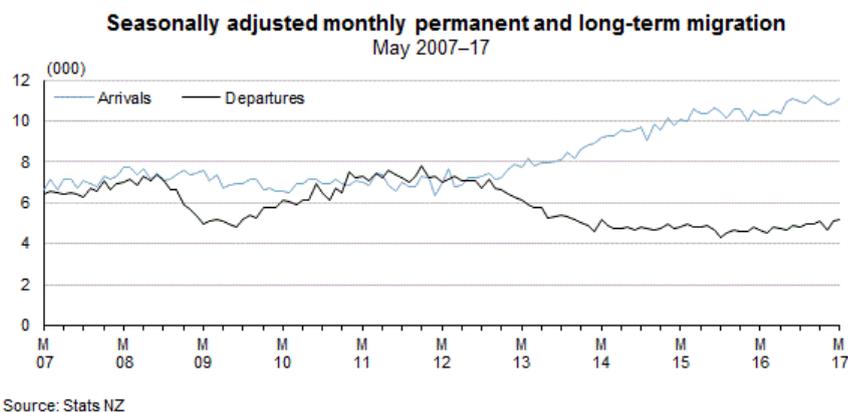
- **New Zealand is a relatively small producer in terms of overall world production** but is a very important international trader. For example, NZ contributes less than 1% of world dairy production but generates around 30% of the world trade in dairy products. Given the vagaries of international trade flows and a general increase in protectionism around the world, means NZ producers carry a considerable risk.
- **NZ is very dependent on export markets** for our trade in goods and services and protectionist moves internationally (particularly by Trump in the US and in the UK with the vote on Brexit) will leave the country vulnerable if this wider protectionist stance gains further traction.
- **China and Australia, New Zealand's two largest trading partners, are at present experiencing difficulties**, a cause of some concern for NZ. In simple terms, it is in NZ's interests that our trading partners are successful, enabling us to sell more product at a healthy price.
- **In the background is always the potential risk of terrorist attacks** – yes it could happen in NZ. Probably even worse is the threat of eco-terrorism which could potentially damage our clean/green reputation overnight – not to mention public health.
- **Housing costs are currently at the forefront of many people's minds** with house price escalation, particularly in the main centres, a concern as affecting the ability to attract skilled labour and imposing significant stress on family budgets. The potential for social unrest is very real unless action is taken to ensure home ownership is within New Zealanders' reasonable reach.



- **The level of household debt** is also concerning with the average household debt level now close to 170% of household income and again climbing consistently after taking a breather post the 2008 global financial crisis. High debt levels will have a damaging effect on households should interest rates rise significantly, which is not out of the question. However, it has to be understood that debt in itself is not necessarily bad but needs to be put in context. Debt for investment purposes may often be highly desirable as opposed to debt simply to fund short-term consumption.



- **Tourism numbers**, while remaining strong, are putting added pressure on some regions' ability to cope with associated infrastructure demands, including water and sewerage. Infrastructure funding has been a source of tension where locals want to see tourism growth but don't want to be the principal funders of tourism growth's requirements. Alternatives to general rates, such as the "bed taxes" proposed in Auckland, have not had a favourable reception. One wonders why, with the advent of time use monitoring etc., more "user-pays" principles cannot be brought to bear on some of these so-called controversial issues.
- **Funding** of high growth areas (e.g. Auckland), as well as of regional areas with declining population bases but requiring infrastructure in one form or another, will place added pressure on councils to come up with alternative funding mechanisms, other than the traditional rates base.
- **High levels of migration** – even though migration effects are generally positive – are imposing pressure points on NZ's infrastructure which have to be managed. Of late, migration levels have caused some controversy among political parties and indeed among the wider NZ public. However, it is important to understand that the matter is not as simple as many would have us believe; the vast bulk of high net migration inflows is driven by more New Zealanders returning home and fewer New Zealanders leaving. This situation shows the economy is performing well and that people see advantages both in staying in NZ and returning home from overseas.



- **Inappropriate regulation** is still restricting the ability to move ahead with infrastructure developments as and when required. The Resource Management Act (RMA) readily comes to mind in this respect.
- **The mounting pressure on natural resources** with concerns about water use – both quality and quantity, including how to deal with over-allocation – needs to be addressed. This is an issue affecting both urban and rural communities.
- **Greater resilience is needed from expected (and unexpected) events**, including natural disasters. This issue is now being given more prominence by businesses, local government and indeed by central government.
- **Some local authorities are looking more actively at how to deal with the risk** associated with potential natural disasters. For example, in the Wellington Region, there is exploration currently directed to finding alternative sources of drinking water. Roading and electricity are two other issues requiring attention, major infrastructure above and below the ground included.
- **At a regional level, disparities remain** in terms of both population growth (decline) and income growth (decline). To ensure economic and social cohesion it is important for individuals and communities to feel part of the solution and not simply left to wither on the vine, as it were. International lessons teach us that reforms must focus on everyone sharing the vision or risk disaffected members of the public becoming anti-change, leading to the isolationist and protectionist mind-sets currently in vogue in parts of the US and Europe.
- **Collaboration between central and local government is not necessarily at the level it should be**, although the reasons for this are not necessarily obvious or always the same. Within the regions, agencies assisting in regional development are often fragmented, lacking in scale and with ill-defined or even non-existent objectives. Either that, or with objectives that cannot be measured to determine if ratepayers and taxpayers are getting value for money. While local government amalgamation is off the political radar for the foreseeable future, there is still significant potential for the sharing of services, particularly between smaller councils, ensuring ratepayers are getting value for money.
- **Finally, in relation to risk, is the upcoming general election in September.** While the smart money will likely be on National attracting the most party votes come September, the question is what its potential coalition partners will look like. Current coalition support partners - the Maori Party, United Future and ACT are all polling rather low, while Winston Peters and the NZ First Party are currently polling around 10%. If, post the election, NZ First holds the balance of power, which of the two traditional main parties (Labour or National) will the party go with and, the \$64 million dollar question, at what cost? The key issues which drive NZ First supporters at election time tend to be immigration, foreign investment and that old hobbyhorse, the Reserve Bank Act. Irrespective of such uncertainty and the new Government's final make-up, it is most unlikely there will be radical changes to the twin pillars of monetary and fiscal policy which have stood NZ in good stead for 2-3 decades. Major regulatory changes are also unlikely. As has been the case internationally, what political parties promise (or suggest) they might do before an election tends to get pushed back somewhat when they realise the ramifications of making radical (and sometimes ill-considered) changes without adequately thinking through the consequences, including the unintended consequences.

1.2 Monetary conditions – tightening still someway off?

The last sentence of the Reserve Bank's review of the Official Cash Rate (OCR) - which retained the OCR at 1.75 percent (22 June 2017) - clearly outlines the Reserve Bank's position. *"Monetary Policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."* Taking this statement at its face value would suggest there is unlikely to be any upward movement in the OCR until well into next year. However, as will be expanded on below, this does not mean interest rates won't ratchet upwards, even if the Bank retains the OCR at current levels for an extended period.

Monetary policy has often been the subject of political point scoring in the build up to general elections. To be fair, most political parties have taken a rather nuanced approach to making any significant changes to monetary policy settings apart from the usual murmurings from some quarters for the Reserve Bank to have multiple objectives rather than a single inflationary focus. Also questioned is whether the OCR should be the sole responsibility of the Governor or whether the Reserve Bank Board, or some other "expert committee" should set the rate. These issues have been well canvassed in the past and are not repeated here. Suffice it to say that Monetary Policy, along with Fiscal Policy, is generally well-cemented into place in the NZ context and has been broadly supported by successive NZ Governments for at least three decades.

The Reserve Bank has been seeking to add debt-to-income (DTI) ratio limits to the list of macro prudential tools covered in its Memorandum of Understanding with the Government but it would be fair to say that the Government has been lukewarm to any such proposal. The Minister of Finance has requested a thorough cost-benefit analysis be carried out before the addition of DTI limits to the Bank's list of tools is considered.

The present Governor of the Reserve Bank, Graeme Wheeler, is standing down soon – as widely publicised for some time - with his spot to be temporarily taken by Deputy Governor, Grant Spencer, allowing an incoming Government time to consider what the ideal requirements for a new Governor should be. This should result in only minimal changes to the Bank's monetary policy setting or associated financial prudential requirements until the outcome of the general election is known with any changes that might be proposed clearly articulated and understood.

Interest rates – incremental rises

The 90-day bill rate is forecast to lift incrementally to reach 2.8 by June 2019 (see forecasts below).

At the last OCR review on 22 June, the Reserve Bank, as widely expected, kept the OCR at 1.75%. However, there is some debate as to when interest rates will be raised to more neutral levels, despite indications from the Bank that interest rate rises might not take effect until further down the track.

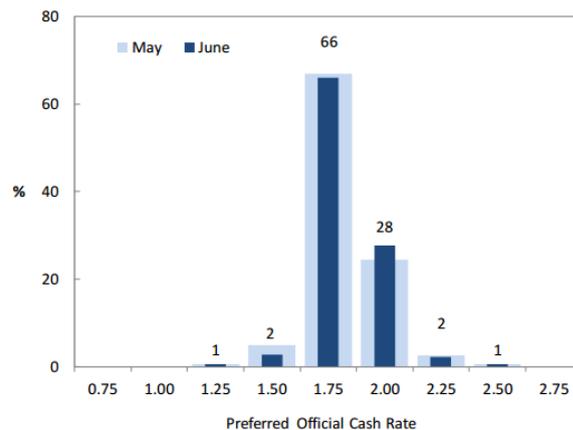
Forecasts: Interest Rates (90 day bills)

	Years ending		
	Jun 17	Jun 18	Jun 19
Highest	2.0	2.5	3.5
Average	2.0	2.2	2.8
Lowest	2.0	2.0	2.5

Source: ASB, BNZ and Westpac

The NZIER Monetary Policy Shadow Board, in its most recent statement (20 June), also saw little urgency for the OCR to increase. Its recommendation to the Reserve Bank was broadly unchanged from the previous meeting in May: *“The New Zealand economic outlook remains positive, and annual inflation lifted to 2.2 percent for the year to March. While higher food and fuel prices have largely driven the recent pick-up in inflation, and may be transitory only, there are also signs that underlying inflation is continuing to lift.”*

Figure 1 NZIER's Shadow Board retains a tightening bias in its recommendation that the Reserve Bank remains on hold



Source: NZIER Monetary Policy Shadow Board

But despite the considered statements of both the Reserve Bank and the NZIER Monetary Policy Shadow Board, there are at least two reasons why, this year, borrowers are likely to face increased interest rates and in fact, already are facing them, irrespective of whether or not the OCR is left at 1.75 percent.

First, given New Zealanders' propensity to spend, most NZ banks have to source at least part of their borrowings off-shore and as the international economy has improved, so too has the cost of borrowing.

Second, some banking experts expect the cost of borrowing to increase by around 10 basis points due to the increased cost banks will face after the international credit rating agency, Moody's, downgraded the credit rating of some NZ banks and their Australian parents.

However, as outlined above, the increased cost of borrowing will affect only those banks that raise a proportion of their funding from international wholesale markets rather than from deposits from within NZ.

The NZ dollar – in the zone

The difficulty of forecasting movements in exchange rates is illustrated below with a significant difference in views as to how the NZ dollar will move relative to the country's major trading partners. Nevertheless, taking the average of forecast results suggests there will be very little movement. The TWI is likely to drift slightly lower out to June 2019, as can also be seen below.

Forecasts: Exchange Rates

AUD (cents)				USD (cents)			
	Jun 17	Jun 18	Jun 19		Jun 17	Jun 18	Jun 19
Highest	0.96	0.97	1.00	Highest	0.72	0.74	0.76
Average	0.95	0.96	0.96	Average	0.71	0.70	0.70
Lowest	0.93	0.95	0.93	Lowest	0.70	0.67	0.64

TWI			
	Jun 17	Jun 18	Jun 19
Highest	78.1	78.0	78.4
Average	77.8	76.7	76.6
Lowest	77.3	75.9	73.6

Source: ASB, BNZ and Westpac

Inflation – underlying rate increasing

Forecasts below show inflation will likely remain well within the Reserve Bank's target band of 1-3 percent to June 2019, although gradual rises cannot be ruled out.

Some of the factors driving non-tradables' inflation to date have eased slightly over recent months, particularly house price inflation. This change has no doubt been influenced to some extent by loan-to-value ratio restrictions and generally tighter (voluntary) bank restrictions on lending.

In the March quarter tradables' inflation rose significantly in relative terms on the back of higher petrol and food prices. However, while the TWI increased around 3 percent, since that time oil prices internationally have come back somewhat and food prices (including dairy) have moderated internationally. Taking into account these one-off effects, tradables' inflation, combined with a slightly rising TWI suggests that inflationary pressures are likely to remain well within the Reserve Bank's target band of 1-3 percent for the foreseeable future.

The Reserve Bank is slightly between a rock and a hard place when it comes to moving on the OCR. On the one hand it will be cautious in not moving interest rates higher before underlying inflationary pressures become apparent. On the other hand, it will not want to wait until the horse has bolted, as was the case some years earlier when using interest rates to rein in inflationary pressures was much more difficult. However, when they do kick in, higher interest rates will likely have a greater impact this time around than in the past, given the high levels of household debt mentioned earlier.

Forecasts: percent Change in Inflation (CPI)

	Years Ending		
	Jun 17	Jun 18	Jun 19
Highest	1.9	2.2	2.2
Average	1.9	1.8	1.9
Lowest	1.9	1.5	1.8

Source: ASB, BNZ and Westpac

1.3 Business activity and consumer confidence on a solid footing

Business activity solid

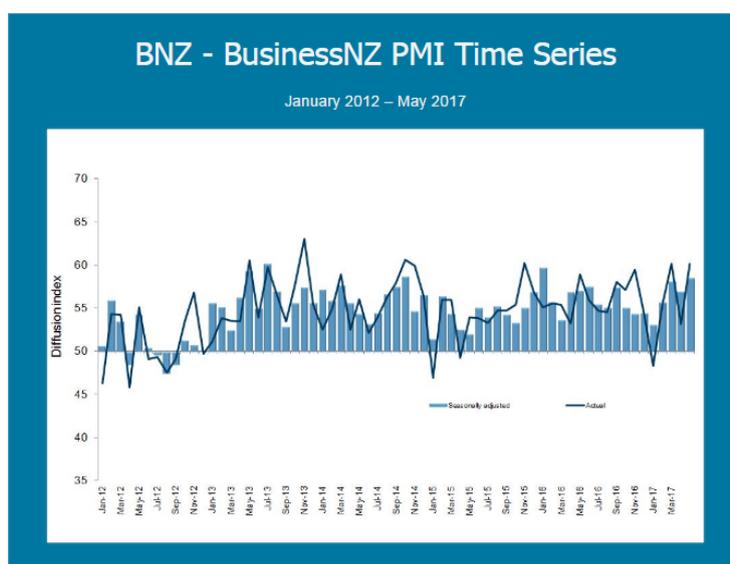
Business and consumer confidence has remained firmly in positive territory for some time. More importantly, businesses are generally upbeat about their own business prospects, a good indicator of future growth prospects.

The latest NZIER *Consensus Forecasts* points to continued momentum in the economy with a moderately softer growth outlook in the short-term but an upward revision from 2019.

Household spending is forecast to be slightly lower over the forecast period compared with earlier forecasts but the outlook is still robust and the expectation is that annual growth will hold up above 3 percent in 2019.

Employment growth is expected to remain relatively strong over the forecast period with an expectation of slightly reduced unemployment, broadly in line with other projections. Overall, then, a solid outlook for both business and consumer confidence.

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



The PMI saw activity increase in May after a slight dip in expansion early this year. The seasonally-adjusted PMI for May was 58.5 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 1.6 points higher than in April and the highest level of expansion since January 2016. Overall, the manufacturing sector has remained in expansion in nearly every month since October 2012.

The May value for new orders (61.2) remained above the 60-point range, the highest three-monthly level of expansion for that sub-index since 2004. Production (59.7) lifted 2.7 points, while employment (55.3) rose to its highest value since October 2014.

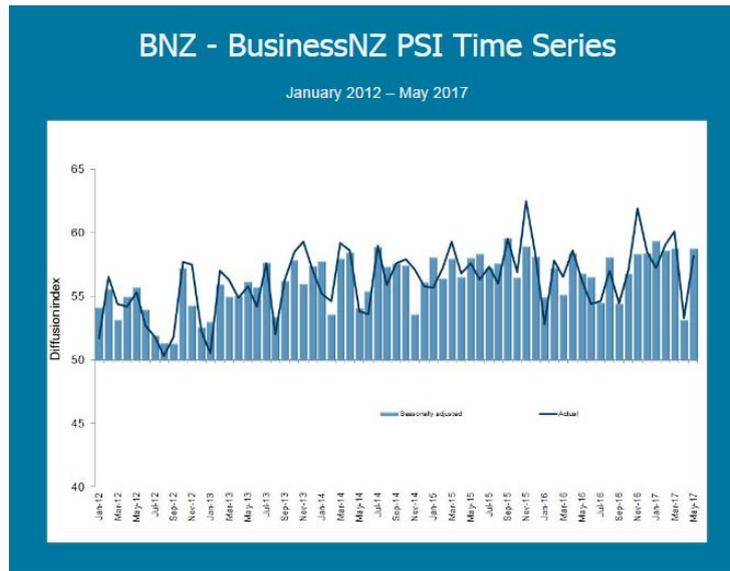
Mirroring the overall result, the proportion of positive comments rose to 69.4 percent, compared with 64.7% in April and 67.2 percent in March.

The PMI has now pushed up to its highest level in 16 months, making the mild slowdown we saw at the beginning of the year a distant memory.

The PSI similarly shows very positive results for February, a continuation of an expansionary phase in the services sector apparent now for a number of years.

The PSI for May was 58.8. This was 5.6 points higher than in April and a return to expansion levels seen during five of the last six months. April's drop was due to a number of external factors, which corrected themselves for May.

Four of the five sub-indices increased their expansion levels during May and the key indicators, activity/sales (63.1) and new orders/business (63.2) were both back over the 60-point mark.



With the proportion of positive comments (68.2 percent) from respondents also at a very healthy level, we can expect continued expansion ahead.

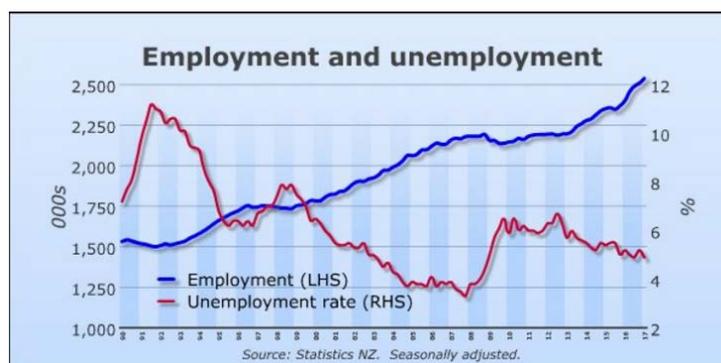
1.4 Labour market – going from strength to strength

Employment – onwards and upwards

The labour market continues to go from strength to strength with continuing strong employment growth and an associated decline in unemployment.

As number of official statistics and surveys indicate that the labour market is relatively strong. StatisticsNZ's Household Labour Force Survey (HLFS), the PMI and its sister Survey, the PSI show continued strength largely across the board.

Notwithstanding, there are still significant differences in employment growth and perhaps more importantly in various regional areas' unemployment rates. Throw into the mix still very high levels of youth unemployment and young people not in education, employment or training (NEETS) and the headline employment and unemployment figures are not quite so rosy.



While the Government has rightly focused on a social investment approach to improving outcomes for “at risk” youth, there is a need to strengthen mechanisms both to encourage and retain a connection with the labour market. This may involve greater individualised case management to understand the barriers to greater workforce participation, whether these involve child-care issues or simply transport issues.

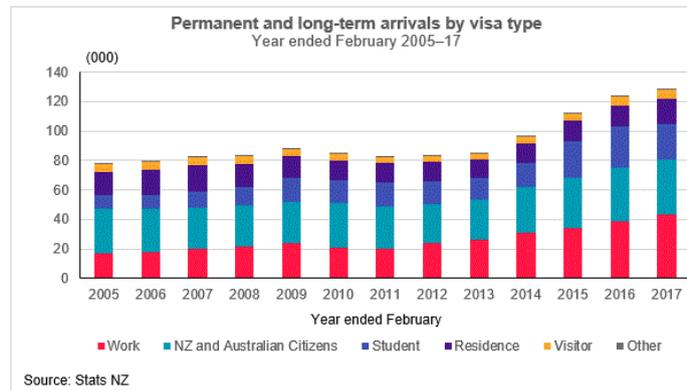
Strong growth in employment has been assisted by high net migration numbers and record participation rates. Forecasts below show the unemployment rate expected to continue to drift lower from the current 4.9 percent to 4.6 percent by June 2019.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 17	Jun 18	Jun 19
Highest	4.9	4.8	5.0
Average	4.9	4.6	4.6
Lowest	4.8	4.5	4.3

Source: ASB, BNZ and Westpac

Net migration continues to reach record highs with annual net migration touching 72,000. Many arrivals have work visas, boosting the potential labour force, as the graph below shows.



In this respect, it is slightly disconcerting that the politicians are already focusing on immigration, although probably not unexpectedly given that it is election year.

Both major political parties have now shown the direction of their policies: National is trying to constrain overall immigration slightly, while Labour is focused on restricting the number of overseas students.

National's approach is to tweak the system (restricting low-skilled migrants to 3-year visas, limiting skilled worker visas to those earning over \$49,000 a year and increasing the points needed for skilled migrants to get residency), reducing immigration by about 8,500.

Labour's approach is to clamp down on the numbers of overseas students (tighter entrance criteria for lower-level courses, fewer overseas students allowed to work while studying here, no work visas for those who've completed study here if they don't already have a job), reducing immigration by about 30,000.

Tweak the system or restrict foreign students - which is the better approach?

Actually, business is not enthusiastic about either. Many employers are experiencing unprecedented demand for their goods and services and want to continue to meet that demand.

It would be good if the system allowed more high-skilled workers in but lower-skilled workers are needed in many industries too. For example, around 20 percent of hospitality workforce members (made up of different skill levels) are migrants because there are not enough New Zealanders to fill the jobs, as labour market tests confirm.

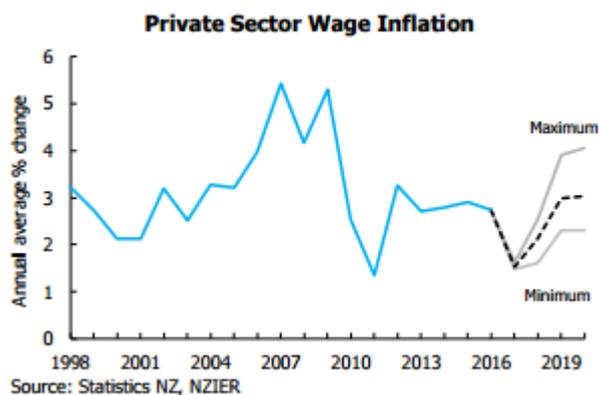
Simplicity is needed for an effective immigration policy. Concerns about immigration levels over recent years have resulted in a system laden with rules that are complex and hard to navigate. This in itself is a constraint on business.

The danger in election year is that the parties will seek votes by proposing more restrictions on immigration, to the detriment of business and the economy.

Labour costs – drifting up

Forecasts below indicate labour costs in general to increase relatively slowly to 2.4 percent for the year ending June 2018 before moderating to 2.2 percent in the year to June 2019.

The latest NZIER *Consensus Forecasts* suggests that expectations of an even tighter labour market will not flow through to significantly increased wage pressures, as can be seen below.



In many respects it is slightly puzzling that with greatly improved employment growth and firms' reported difficulties in finding skilled staff, wage costs have not risen significantly – yet.

A number of businesses have commented that in some cases, irrespective of what wage rates or salaries are offered, there are often skill shortages which means that irrespective of the wage rate, jobs cannot necessarily be filled. This raises a concern whether the moves to tighten up immigration, as evidenced by the major political parties', National and Labour, latest positions, is actually wise.

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

	Years ending		
	Jun 17	Jun 18	Jun 19
Highest	1.6	2.5	2.6
Average	1.6	2.4	2.2
Lowest	1.6	2.2	2.0

Source: ASB, BNZ and Westpac