BUSINESS NZ

PLANNING FORECAST

DECEMBER 2018

NZ Economy – Onshore trumps off offshore

Executive Summary

While in general, key domestic economic indicators still point to a relatively robust NZ economy as a whole, the same cannot be said of the wider global economic outlook.

The latest New Zealand Institute of Economic Research's (NZIER) Consensus forecasts show a growth outlook broadly unchanged from the previous quarter, with 3 percent economic growth per annum generally agreed, although with some obvious concerns.

Continuing low levels of business confidence is a cause for concern despite some mild improvement of late. A number of other domestic difficulties and risks are identified in the body of this report.

International commodity prices have tended to drift lower over recent months and a stronger global supply relative to demand has caused Fonterra to revise its Farmgate Milk Price down to $6.00-$6.30 - still a solid payout by historical standards. Forecast earnings per share range from 25-35 cents per annum.

On the positive side of the ledger, the labour market continues to go from strength to strength with record employment rates and an unemployment rate currently under 4 percent. It's not all positive though. For many businesses their ability to source skilled (and in some cases unskilled) labour is a serious constraint on productivity growth. Capacity constraints are a real cause for concern limiting NZ's ability to up its game by improving productivity and hence, over time, its collective standard of living.

Inflation remains under firm control, although a number of factors, including yo-yoing in international oil prices have affected the headline CPI. But a still highly-competitive retail sector is keeping a firm lid on prices.

Housing prices have largely stabilised, although in some cases at very high levels. House prices are unlikely to drop significantly overall without a radical change in policy, such as a move by government to abolish town boundaries to free up land for housing. Politics would suggest this is not likely to happen.

On the Government front, the Half Yearly Economic and Fiscal Update (HYEFU) shows the Government's accounts as still in reasonably good shape. A solid tax take is allowing for much of the added expenditure to date and more is forecast to come.

Global risks have heightened of late, largely as a result of trade policy shocks which have caused some, at this stage minor, ripples through financial markets. Certainly global share markets have had a roller coaster ride for most of this year as investors try to decipher, almost on an hourly basis, where trade policy is heading.

Added to the global mix, the risk of a financial market correction, geopolitical hazards and moves internationally to raise interest rates in light of rising inflationary pressures have the potential to weigh significantly on future international growth prospects. As an intentional trader still very dependent on commodity exports, NZ will not be immune from any fall-out from lower international growth prospects and the flow-on effects of increasingly nationalistic and protectionist trade policies.

HIGHLIGHTS

The NZ economy is forecast to grow at around 3 percent out to December 2020.

The BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 6 for the December 2018 quarter, up 10 on the previous quarter and up 1 on a year ago.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), continued to display solid levels of expansion going into the December quarter 2018.

Despite reasonably robust economic data over a range of sectors, business confidence has remained low for a number of months now, while consumer confidence has also drifted lower. With lower business confidence, there is a concern this is increasingly being reflected in lower business investment intentions – not a good sign for future growth prospects.

At the international level, growth rates remain solid, although there are risks over the medium term. These include greater moves towards trade protectionism and tit for tat tariff policy retaliation from affected countries.

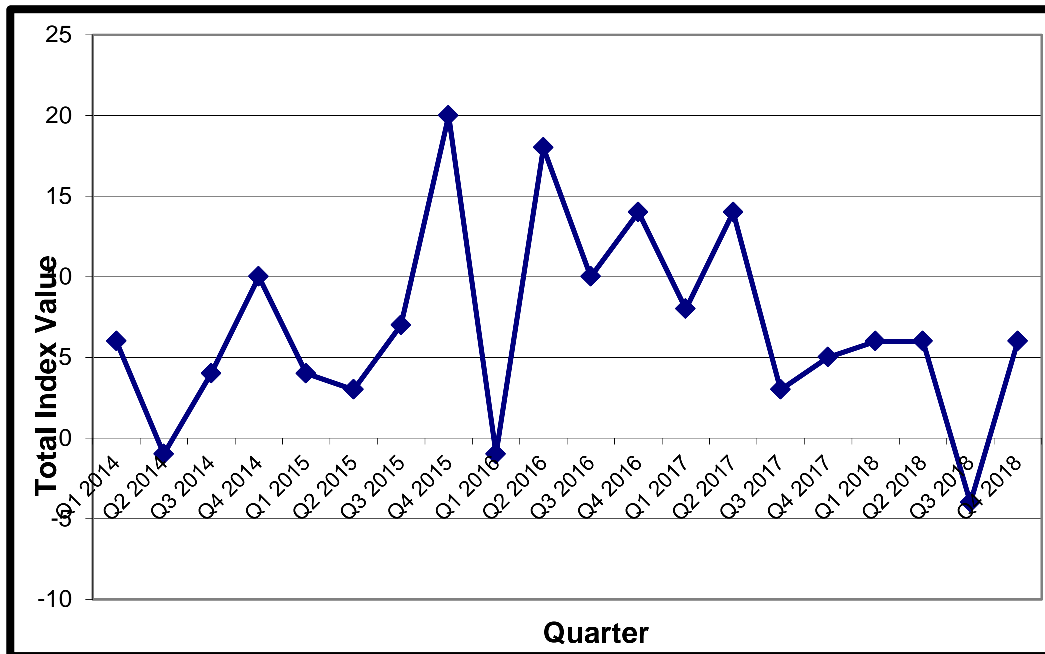
Inconsistent and ad hoc policy decisions at the international level have caused some jitters in financial markets with higher interest rates reflecting this risk. Global sharemarkets, particularly in the US, have shown greater volatility over the last few months and the Dow Jones is now basically back to where it was at the start of the year.

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 6 for the December 2018 quarter, up 10 on the previous quarter and up 1 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 1 for the December 2018 quarter, down 2 on the previous quarter and down 4 on a year ago. Despite these results, New Zealand's terms of trade (a measure of the purchasing power of its exports and a key indicator of the economy overall) still remain close to record levels.

Monetary policy/pricing indicators sit at -2 for the December 2018 quarter, up 2 on the previous quarter and down 4 on a year ago. Domestic inflation remains under firm control although internationally, inflationary pressures are slowly rising, with some upward lift in interest rates.

Business/consumer confidence indicators sit at 7 for the December 2018 quarter, up 10 on the previous quarter and up 11 on a year ago. Business confidence indicators have shown a slight recovery from their previous very downbeat state while consumer confidence continues to slip from previously relatively healthy levels.

Labour market indicators sit at 0 for the December 2018 quarter, down 3 on the previous quarter and down 2 on a year ago. Reasonable employment growth, lower net migration inflows, and unemployment below 4 percent are causing significant stress on businesses trying to source both skilled, and some extent unskilled, labour.

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[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. The results for the December quarter 2018 are estimates based on available information to date.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – steady does it

Forecasts out to December 2020 show the NZ economy continuing to grow at a similar rate to that currently – i.e. around 3 percent per annum.

While there are many positive economic indicators out there, including a labour market going from strength to strength, relatively solid international commodity prices (although with some softening of late), low inflationary pressures (domestically), and a housing market finally showing some sanity, there are still considerable risks.

With business confidence still at relatively low levels, a soft outlook for business investment intentions, along with a potentially lower profitability outlook, is still of concern. This state of affairs does not augur well for the future productivity improvements on which the economy depends if our collective standard of living is to rise over time.

While the Government's policy agenda is full steam ahead, there are still a number of working groups yet to report back – in some instances with consequences that could cause considerable stress to the business community.

The tax working group is due to present its final report to the Government in late January (a month earlier than originally anticipated) and although not privy to its findings and recommendations, it would be fair to say media comment suggests there may be some tensions within the group - perhaps not unexpected given the members' varying backgrounds. Controversial issues such as the scope of capital gains taxes and what is potentially in or out, could result in a far more complex taxation regime than currently, with major compliance cost implications for business.

One lessons to be had from the working group is that unduly restricting the ability to look comprehensively at an issue by imposing pre-determined exclusions (such as the family home from any capital gains tax investigation) makes it extremely difficult to come up with a reasonably cohesive set of recommendations without causing more mischief than offering solutions.

At present, the only real certainty is the uncertainty prevailing both internationally and domestically. Businesses, and indeed households, must increasingly manage a number of risk factors which in the past would have been considered one-offs or would not have fallen within the realm of rational possibility.

Domestically, risks include:

- High levels of both household and agricultural debt.
- The longer-term impact of Mycoplasma Bovis on agricultural production and capital stock numbers.
- Capacity constraints, not only in respect to natural resources (e.g. water) but wider constraints on labour supply.
- Transition costs associated with moving towards a zero-net carbon emission economy by 2050.
- The potential impact of uneven growth throughout NZ given varying regional growth rates.
- Potential political threats to the Government's ability to proceed with key regulatory reforms such as of the Resource Management Act (RMA), and more generally to the overall improvement of regulatory quality.
- The impact of significant changes to labour market legislation (including significant rises in the minimum wage) which could adversely affect both business costs and the ability of low-skilled persons to enter the labour market and improve their earnings potential over time.

The above factors together are likely to make forecasting future growth prospects extremely difficult.

On the international front, trade is a key issue causing international markets significant uncertainty and jitters. The on again off again tensions between Washington and Beijing have the potential to cause considerable damage, seriously undermining several decades' worth of good work in opening up international markets, with credible institutions such as the World Trade Organisation (WTO) leading the way. President Trump tweeting he is a "Tariff Man" doesn't really help to settle markets! As has been said many times, markets hate uncertainty and will build in buffers to take account of increased risk. This generally results in higher interest rates, a reduced supply of capital and lower growth.

The International Monetary Fund (IMF) has already cut its global growth forecasts as trade tensions between the US and its trading partners have started to hit economic activity worldwide.

The IMF has said the global economy is now expected to grow 3.7 percent this year and next year – down 0.2 percentage points from earlier forecasts.

The two countries at the centre of the ongoing tariff fight – the US and China – are expected to grow by 2.9 percent and 6.6 percent respectively in 2018 but, according to the IMF forecasts, will grow more slowly than expected - 2.5 percent and 6.2 percent - in 2019.

Share markets around the world, and particularly in the US, have fluctuated significantly of late with both the Dow Jones and S&P 500 taking significant hits and both indexes sitting at levels similar to those at the start of the year.

Added to the global mix, the risk of a financial market correction, geopolitical hazards and the impact of moves internationally to raise interest rates in light of rising inflationary pressures have the potential to weigh significantly on future international growth prospects.

As an intentional trader still very dependent on commodity exports, NZ will not be immune from fall-out from lower international growth prospects and the flow-on effects of increasingly nationalistic and protectionist trade policies. Watch this space.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 18	Dec 19	Dec 20
Highest	2.9	3.2	3.2
Average	2.8	2.9	3.0
Lowest	2.7	2.8	2.6

Source: ASB, BNZ and Westpac

1.2 Monetary conditions – Shake up of Reserve Bank Act – stage 2?

The Treasury and the Reserve Bank of NZ have released a Consultation Document entitled *"Safeguarding the future of our financial system".*

This round of consultation focuses on five key issues:

- Objectives: What high-level financial objectives should the Reserve Bank have?
- Regulatory Perimeter: What financial firms should the Reserve Bank regulate and how should the regulatory perimeter be set?
- Depositor Protection: Should there be depositor protection in New Zealand?
- Separation: Should the regulation of financial firms remain with the Reserve Bank?
- Governance: How should the Reserve Bank be governed, including who should make the Reserve Bank's decisions?

It is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems to see if anything more can be done to manage risk successfully. But in doing so it should keep in mind that there is an optimal amount of resource to be used in reducing risk, given risk cannot be completely eliminated or if at all, not without great cost. For example, requiring greater financial stability could come at the significant cost of increasing the aggregate cost of capital.

The Consultation Paper outlines potential reasons for protecting depositors and also some of the risks associated with same. The pros and cons are clearly outlined in the paper and so are not repeated here; suffice it to say BusinessNZ considers the risks to be potentially significant, particularly if protection for bank depositors opens the flood-gates to requests for protection from all other kinds of investments that happen to go wrong. In short, where do the boundaries start and end?

It has to be asked why the focus is on mandatory insurance when individuals are not required to obtain compulsory insurance for other activities which could impose significant costs on them personally, on their families, and ultimately on the general public (taxpayers) via social welfare benefit payments and public health expenditure. While individuals can, and often do, insure for risks of this kind, taking out insurance is still entirely voluntary.

Many people fail to obtain appropriate cover for a whole host of possible risks (e.g. loss of employment income, health difficulties, property damage as a result of storms etc.) all of which could impose significant costs. Taken to the extreme, one could argue that those who undertake risky activities e.g. are obese or adopt a sedentary lifestyle should have to take out mandatory health insurance to minimise the cost to taxpayers should expensive health treatment be needed later in life. While voluntary insurance is available both for health-related and many other risks, generally it is not compulsory (apart from ACC levies covering workplace accidents, accidents to earners outside the workplace and motor vehicle accidents, with the taxpayer picking up the bill for personal injuries to non-earners).[1]

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[1] There may be cases where insurance is also required in respect to membership of some professional associations and in respect to some occupational regulation.

There has been some push over the years to require greater use of compulsory insurance in a range of situations (including proposals for compulsory third party insurance against motor vehicle accidents) but for many reasons, including the potential for unintended consequences, the government of the day has not followed through with such proposals.

The Government needs to be aware that requiring compulsory depositor insurance (protection) will require it to explain why a great many other compulsory insurance obligations are not also imposed on individuals and households. Picking mandatory depositor insurance out from a host of other so-called issues perceived as deserving is unlikely to sit well with the NZ public, quite apart from sending a signal that implicitly (if not explicitly) government is there to bail out anyone whose finances are affected by an adverse event.

Interest Rates – status quo

The 90-day bill rate is forecast to edge up slightly by December 2020 (see forecasts below).

At its last review, the Reserve Bank, as widely predicted given some current uncertainty both nationally and internationally, kept the OCR at 1.75 percent. There is little pressure at this stage to lift the rate, certainly the majority – but not unanimous – view of the Institute of Economic Research's (NZIER's) Shadow Policy Board at its most recent review.

At the international level, an improvement in the global economy over the past year has seen a number of countries raise interest rates, albeit from a very low base. However, given trade tensions have the potential to derail relatively solid growth prospects internationally, any future rise in international interest rates is likely to be tempered.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Dec 18	Dec 19	Dec 20
Highest	2.0	2.3	2.5
Average	2.0	2.1	2.4
Lowest	1.9	1.9	2.2

Source: ASB, BNZ and Westpac

The NZ dollar – in the zone

On balance, the $NZ is expected to remain relatively stable against both the $Australian and the $US. As a consequence, the Trade-weighted- Index (TWI) is also expected to remain constant out to December 2020.

But despite current forecasts, the risks of wild swings in exchange rates cannot be ruled out with particular attention focused on international economic developments, both interest rate movements and potential trade wars.

Uncertainty over trade deals and uncertainty in general will affect the currencies of countries such as NZ that depend largely on commodity-based exports.

Some softening of late notwithstanding, commodity prices in general have remained relatively stable, particularly the price of agricultural commodities. The currencies of countries heavily dependent on commodity-based exports, such as NZ, tend to follow world commodity prices relatively closely. Currently, there appear overall to be no major factors to disturb this relative stability.

However, trying to predict the future value of the NZ dollar or any other currency is a fraught exercise. Some volatility continues to be the name of the game, mainly the result of external factors rather than domestic policies per se.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 18	Dec 19	Dec 20
Highest	0.95	0.93	0.92
Average	0.92	0.91	0.91
Lowest	0.90	0.89	0.89

USD (cents)			
	Dec 18	Dec 19	Dec 20
Highest	0.69	0.70	0.73
Average	0.67	0.67	0.69
Lowest	0.65	0.62	0.66

TWI			
	Dec 18	Dec 19	Dec 20
Highest	75.2	75.6	75.5
Average	73.1	72.3	72.5
Lowest	71.4	68.6	69.4

Source: ASB, BNZ and Westpac

Inflation – stability rules to date

Forecasts below show inflation as measured by the Consumers' Price Index (CPI) is likely to remain well within the Reserve Bank's target band of 1-3 percent to December 2020.

While the September quarter 2018 result came in slightly ahead of market expectations, this was somewhat influenced by "one-offs" e.g. increased petrol prices (which subsequently dropped back considerably going into the December 2018 quarter).

However, despite the relatively stable inflation outcomes expected over the next couple of years, there are both upward and downward risks to maintaining inflation within the Reserve Bank target band.

On the tradeable side, a slight lower outlook for commodity prices should see any tradeables' inflation relatively subdued, supported by a relatively stable $NZ.

On the domestic front, increases to the minimum wage for lower income earners may put some upward pressure on prices although in most industries, both domestic and international, the pressure will either see costs largely absorbed through greater productivity gains or households sourcing materials off-shore.

Insurance costs have increased significantly as reinsurers re-price not only earthquake risk but risks associated with possible events such as the impact of climate change, which could cause increased flooding in some areas. But also, given NZ's relatively small population but with the potential for significant claims costs as a result of natural disasters, there is a risk that some insurers will leave the market completely.

And there are downside pressures on inflation.

Over recent years, global competition and innovation have allowed the development of better products and services at lower cost. Consequently, the old argument that as demand ratchets up, prices will rise does not necessarily hold good now as it did in the past. Prices over a wide range of products and services are dropping, both in real and nominal terms, a significant shift away from the traditional assumption that generalised inflation is here to stay. Moreover, consumers have much more choice about where they can source their products, including the fact that on-line shopping is now a very fast and efficient method of obtaining goods and services.

House prices have largely stabilised, although there are pockets across the country where there are still significant price rises.

In general, the housing market is cooling faster than many predicted as migration continues to ease, while the Government is considering a number of policy changes also likely to have a sobering effect on house price inflation. The latter include loss ring fencing, extension of the bright line test, and changes to the tax treatment of housing that might come out of the Tax Review, particularly some form of capital gains tax.

The trending down of net long-term migration numbers, after the record number of people coming into the country over the last few years, is continuing to take pressure off both the housing market and general demand. But the Government's decision to stop foreigners buying property in NZ is likely to have little effect on house prices other than in unique key areas such as Queenstown and to a lesser extent, Auckland.

Given all the above, the factors potentially driving up inflationary pressures closely align with those driving inflationary pressures down. Therefore, it is unlikely the Reserve Bank will, for some time, be moving interest rates either up or down.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Dec 18	Dec 19	Dec 20
Highest	2.1	1.9	2.1
Average	2.0	1.8	1.9
Lowest	1.9	1.7	1.8

Source: ASB, BNZ and Westpac

1.3 Business activity and confidence

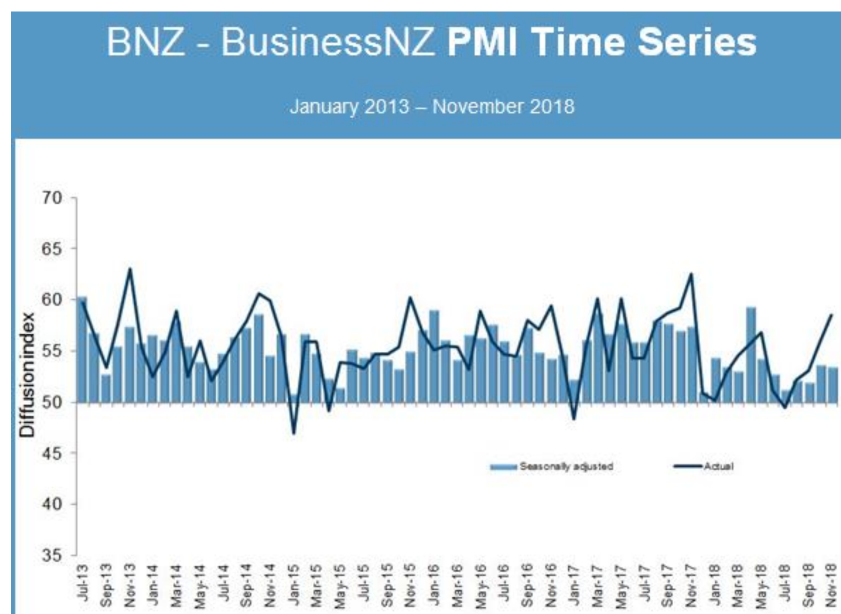
Business activity and business confidence – all mixed up

Though a number of business activity indicators are still relatively solid, business confidence remains in the doldrums with little real uplift since the post-election drop-off last year.

However, key quantitative indicators, such as the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), remain in solid expansion mode.

Activity in NZ's manufacturing sector for November produced a result similar to that of the previous month.

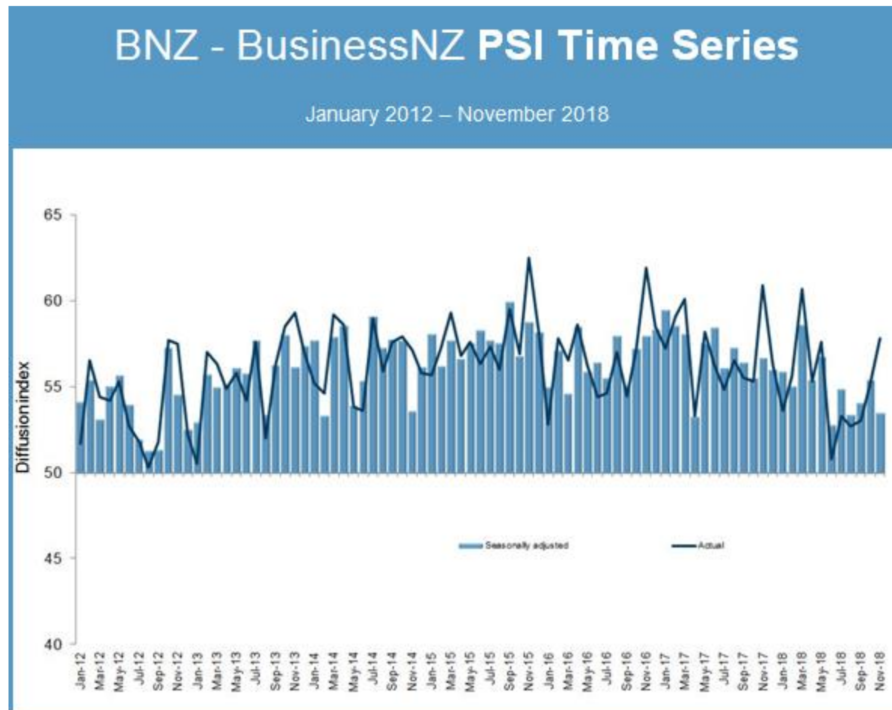
The seasonally-adjusted BNZ-BusinessNZ Performance of Manufacturing Index (PMI) for November 2018 was 53.5 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). Although this was 0.2 points lower than October, it remained just above the long-term average of 53.4 for the survey.



In addition, the proportion of positive comments for November (60.1%) improved from October (58.3%). Seasonal factors were obviously a major discussion point, although a number of responses pointed to increased general customer demand and sales.

The NZ services sector experienced a decrease in expansion levels during November, according to the BNZ-BusinessNZ Performance of Services Index (PSI).

The PSI for November was 53.5, 1.9 points lower than October (A PSI reading above 50 indicates the services sector is generally expanding: below 50.0 that it is declining), and a return to levels of expansion last seen in August. It was also below the long-term average of 54.5 for the survey.



Although the sub-index of employment (54.7) was at its highest level since December 2017, activity/sales (53.6) returned to levels last experienced in February, while stock/inventories (50.7) dropped back to levels last seen in April 2017. New orders/business (57.3) remained in healthy territory, although supplier deliveries (48.5) went into contraction, the first time one of the sub-indexes has produced a negative result for 5 months.

Despite the dip in expansion, the proportion of positive comments in November (60.1%) rose from October (56.5%) and September (50.7%). Christmas is playing a large part in the increased activity, although a number of comments also referred to the end of year rush to complete projects.

But continuing positive results for both the PMI and PSI aside, a number of business confidence surveys show business confidence remaining at historically low levels.

There will likely be a range of reasons for such business community pessimism, not least the uncertainty over policy direction.

Perhaps more importantly, a number of surveys show that businesses' view of their own activity levels, while relatively stable, is still low by historical standards. Some commentators have rightly said that confidence has often fallen post-election in the past but that businesses continue to be concerned about their own business prospects is worrying given the relatively close connection between how firms see their prospects and economic growth over time. Equally worrying is that the concern is evident over a wide range of surveys on business sector confidence, tending to negate bias factors that might be associated with any particular survey.

The other critical concern is that measures on employment intentions and investment remain lacklustre. Lower investment intentions are not good news since the need to improve productivity is key to improving NZ's standard of living over time. Greater investment is critical to productivity growth and businesses resisting the implementation of investment plans are not what NZ needs at this stage.

1.4 Labour market – reform continuing apace

The Government continues apace with labour relations reform through both legislative changes and the establishment of a number of working parties focused on advancing its agenda. Many working groups have yet to report back on issues such as the Holidays Act and Fair Pay Agreements.

Employment – at capacity

According to StatisticsNZ's Household Labour Force Survey (HLFS) for the September 2018 quarter, while employment continued to show solid growth, underpinned by record labour force participation, the unemployment rate dropped to 3.9 percent.

While care needs to be taken not to read too much into the results for one quarter, it is fair to say the labour market is approaching what could be described as full employment.

It is interesting, but not unexpected, that a number of business and research organisations' surveys show the inability to recruit skilled (and in some cases unskilled) labour as now one of the biggest issues affecting business productivity.

Notwithstanding a positive overall picture for aggregate employment growth, associated declines in unemployment and a continued, but moderating, growth in job vacancies, significant regional differences remain and perhaps more importantly, differences in various regional areas' unemployment rates. With levels of youth unemployment and young people not in education, employment or training (NEETS) still relatively high, a great deal of effort will be required to ensure the most vulnerable in society are able to participate actively in the labour market.

Although the unemployment rate is forecast to remain broadly stable at around 4 percent out to December 2020 (see below) there are potential risks to labour market outcomes.

These include a slump in business confidence, where both investment and employment intentions have eased, together with the potential impact of labour market changes with the potential to reduce flexibility and increase business costs, thereby making businesses less competitive.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 18	Dec 19	Dec 20
Highest	4.3	4.2	4.1
Average	4.2	4.1	4.0
Lowest	4.2	4.0	4.0

Source: ASB, BNZ and Westpac

Labour costs – edging up

The expectation is that a tight labour market will slowly filter through into increased wage rates, as can be seen in the forecasts below.

Forecasts indicate labour costs in general are increasing with a growth rate of just over 2.5 percent per annum over the forecast period to December 2020.

Notwithstanding very modest increases in wage rates to date, significant increases in minimum wages over the next couple of years, not to mention the effect of potential pay equity settlements, could have flow-on effects to other areas as employees raise relativity arguments. The Government's proposed regulatory regime for labour markets is also likely to ratchet up labour costs, more so than in the past, given a generalised move towards more centralised bargaining arrangements.

The continued slow-down in net migration numbers will also further constrain the size of the labour market, particularly as labour force participation rates are now at record levels.

Marked increases in public sector pay settlements for nurses with more to come for the education sector, the police and other areas as well will not only put added pressure on the Government's accounts but will add significantly to wage pressures. It is unclear how much of the Government budget has been set aside to fund specific contingencies, such as wage claims, but the Government has repeated several times that there is a strictly limited pool of funds available for such funds.

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

	Years ending		
	Dec 18	Dec 19	Dec 20
Highest	2.0	2.6	2.8
Average	2.0	2.5	2.7
Lowest	2.0	2.4	2.6

Source: ASB, BNZ and Westpac