

MARCH 2016

## The economy – mostly sunny despite cloudy periods

### Executive summary

Summing up the NZ economy in one phrase is difficult but the weather analogy, “mostly sunny despite cloudy periods”, aptly describes the current environment. Risks remain both domestically and internationally but over the last decade NZ’s economy has shown a strong degree of resilience while many other economies have floundered. This can be put down to a number of factors including kiwi ingenuity backed up by a relatively strong and transparent fiscal, monetary, and regulatory policy framework, providing a degree of confidence for investment in NZ business. Despite NZ’s relatively strong fundamentals, it is important that current policies are consistently reviewed to ensure they are still fit for purpose.

The future of dairy continues to be widely debated in the light of declining milk prices, and investors need to be aware of the risks involved in investing in commodity-based businesses and factor them in when investing in land. As with house price increases, upward price movements can reflect a range of factors that must be understood. Achieving \$8 plus returns per kg of milk solids a few short years ago did not mean milk prices were going to stay permanently at such historically high levels. Even at \$8, it was arguable whether some production was profitable.

Overall debt levels which have continued to expand rapidly over the last 10 years – somewhat in tandem with dairy conversions - are another big issue facing agriculture, particularly dairy.

Agriculture also faces the ongoing saga of freshwater quantity and quality. Until clear property rights to water are determined, with tradability between parties openly provided for, water is unlikely to move to its highest-valued use. Nor is investment in water infrastructure likely to be encouraged, given the existing degree of uncertainty over future rights and interests in water.

However, agriculture is much more than dairy and other parts of the sector, beef and lamb included, are doing reasonably well. So too are related industries such as horticulture which is quietly increasing its exports.

Both quantitative data and feedback from BusinessNZ’s Affiliated Industries Group (AIG) show many other sectors of the economy still with relatively strong growth, although in some cases there are ongoing issues yet to be resolved.

The construction sector continues apace while tourism is expanding on the back of strong flow of inward-bound tourists. Both the manufacturing and services sectors are continuing to perform at relatively high levels.

The BNZ–BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show economic growth holding up well, while other forward looking indicators, such as the ANZ Truckometer (a measure of freight movements), are also showing steady growth.

Business and consumer confidence continue to hold up based on a number of factors including a lower dollar, benign inflationary expectations, historically low interest rates, a still-buoyant housing market, record migration inflows and continued employment growth – although quarterly unemployment rates can move around a bit and need to be taken with a grain of salt.

### HIGHLIGHTS

**Globally, there are risks from which NZ is not totally immune, although NZ’s future forecast economic growth rates are still acceptable compared with those of many of our trading partners.**

**The BusinessNZ Economic Conditions Index (ECI) sits at 11 for the March 2016 quarter, down 8 on the previous quarter and up 7 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 February 2016 the PMI was 56.0 and the PSI 56.9. (A reading above 50.0 indicates the PMI/PSI generally expanding and below 50.0, declining).**

**The agricultural sector faces mixed fortunes with the widely analysed drop in global dairy prices still dominating the headlines. Excluding dairy, other parts of the agricultural sector are performing reasonably well.**

**Dairy sector issues notwithstanding, other sectors of the economy continue to go from strength to strength. The construction and tourism sectors are particularly buoyant with strong migration inflows and pent-up demand for housing likely to drive construction for a number of years to come.**

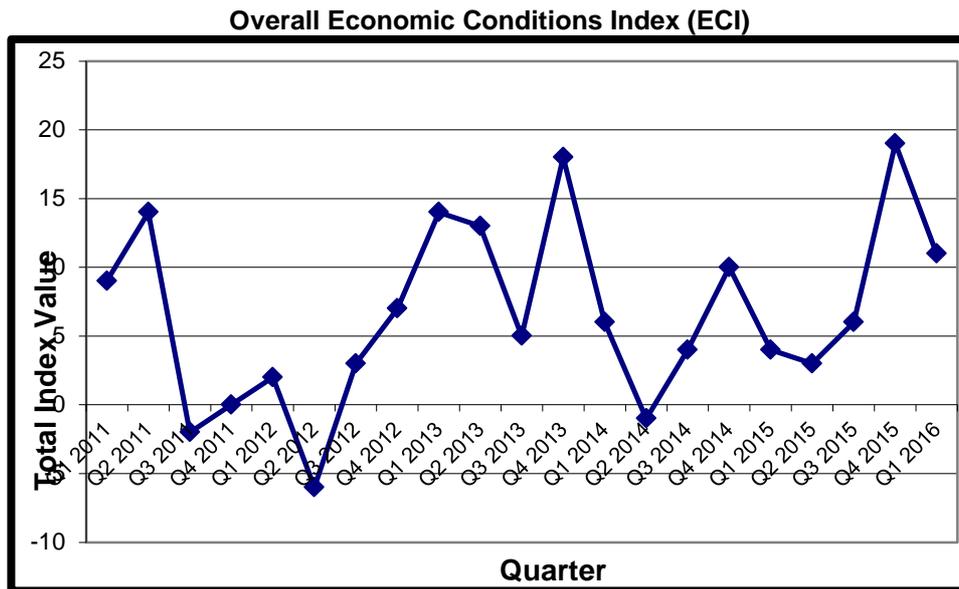
**Inflation remains subdued, despite some recent rises in international oil prices, although off a low base. The jury is still out as to whether the Reserve Bank will lower the Official Cash Rate (OCR) further, despite interest rates currently at an historic low.**

**The labour market is still a mixed bag, recent official statistics tending to over-inflate future employment prospects while, on a headline unemployment basis, underestimating the actual unemployment rate.**

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

### **BusinessNZ Economic Conditions Index (ECI)**

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at 11 for the March 2016 quarter, a drop of 8 on the previous quarter and up 7 on a year ago.<sup>1</sup>



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 March 2016 quarter**, down 2 on the previous quarter and the same as a year ago. The generally lower NZ dollar has helped offset some of the downside associated with reduced international commodity prices.

**Monetary policy/pricing indicators sit at 5 for the March 2016 quarter**, down 2 on the previous quarter and up 3 on a year ago. Benign inflationary pressures have seen the Reserve Bank act to lower the OCR further with interest rates now at historically low levels.

**Business/consumer confidence indicators sit at 3 for the March 2016 quarter**, down 4 on the previous quarter and up 4 on a year ago. Business and consumer confidence are holding up well despite continued global risks.

**Labour market indicators sit at 4 for the March 2016 quarter**, the same as both the previous quarter and a year ago. Current official labour force data needs to be taken with a grain of salt given potentially upward pressures on unemployment through significant population growth.

<sup>1</sup> 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 NZ ECONOMY – WHERE ARE WE HEADING?**

### **1.1 Economic growth (GDP) – 3 percent at a stretch**

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

<b>Forecasts: Real GDP % Growth</b>			
	<b>Years Ending</b>		
	<b>Mar 16</b>	<b>Mar 17</b>	<b>Mar 18</b>
<b>Highest</b>	2.4	3.0	3.6
<b>Average</b>	2.4	2.8	2.9
<b>Lowest</b>	2.4	2.4	2.6

*Source: ANZ, ASB, BNZ, and Westpac*

Most sectors are putting in a solid performance and growth is generally widespread across the economy, with some exceptions e.g. dairy which continues to face some headwinds.

In short, a number of factors are acting as positive drivers of future growth prospects for the NZ economy:

- World commodity prices, particularly oil, have partially recovered from a very low base, while other global commodity prices, including dairy, appear to be close to bottoming out
- World equity markets have recovered most of the losses experienced early in 2016 with the NZ sharemarket approaching new highs
- Chinese economic growth is well above current fear-driven estimates while the United States economic expansion remains largely on track despite some nervousness about the final outcome of the Federal elections
- Strong net migration inflows are at record highs, adding to the demand for goods and services
- Pent-up demand for housing bodes well for construction activity generally
- Earthquake strengthening of commercial buildings is continuing
- Freight movement – a key forward indicator of economic growth - is experiencing continued strong growth
- Tourism growth is strong on the back of a lower NZ dollar and the attraction of NZ as a safe destination
- A low inflationary environment with historically low interest rates likely to persist for the foreseeable future
- An exchange rate at much more competitive levels for exporters - a theme which has come through in recent BNZ-BusinessNZ Performance of Manufacturing Index (PMI) comments
- Very transparent fiscal and monetary policy regimes by international standards, with a stable and predictable government.

Several key issues on the risk side of the equation are:

- Globally, moves towards more transparent and stable monetary policy regimes are a long way off with some economies moving into a negative interest rate regimes as a mechanism to boost demand.
- The ongoing threat of international terrorism and its effect on investment confidence
- Australia's mediocre growth given Australia, along with China, remains a key market for NZ products and services
- High levels of household and agricultural debt posing a threat should asset prices burst (and/or interest rates rise significantly)
- The potential for (farm) land prices to fall which could deter ongoing investment if individuals hold-out for even lower prices
- The potential flow-on effect to regional and rural communities if dairy prices remain depressed for longer.
- The possibility of government third term-itis with crucial reforms either on hold or on a slow path, for example, Resource Management Act (RMA) reform and only incremental freshwater management reform. More urgency is required if NZ is to unlock the true value of our natural resources – particularly water.

## 1.2 Monetary conditions – further loosening on the cards

### **Interest rates – lower for longer**

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

**Forecasts: Interest Rates (90 day bills)**

	Years ending		
	Mar 16	Mar 17	Mar 18
Highest	2.4	2.2	3.1
Average	2.3	2.0	2.4
Lowest	2.3	1.9	1.9

*Source: ANZ, ASB, BNZ, and Westpac*

The Reserve Bank recently reduced the Official Cash Rate to an historic low of 2.25 percent which caught some market participants by surprise – not so much the cut itself but its timing. A number of economists and other commentators suggested the Reserve Bank should hold fire until the pros and cons of current economic activity were more clearly understood and perhaps more importantly, it had established whether a reduction in the OCR would have any credible impact on demand generally without unnecessarily fueling housing demand. Certainly a wait and see approach was the majority - but far from unanimous - view of the Institute of Economic Research's (NZIER's) Shadow Monetary Policy Board members in their assessment of interest rate movements that preceded the decision to drop the OCR.

Recently, media attention has focused on some political commentators' complaint that not all banks have passed on the recent Reserve Bank's 0.25 percent cut in the Official Cash Rate (OCR). Commentators have been suggesting that banks are somehow milking it. There are at least three reasons why this view is somewhat misleading.

First, most banks source around 25 percent of their capital from foreign savers. Given greater global risk, international interest rates have moved up, a movement from which NZ banks are not immune.

Second, at least one or two banks are understood to source most, if not all, their capital from NZ investors and so might be reluctant to reduce interest rates to borrowers when the bank's actual borrowing costs have not come down significantly.

Third, competition is important in determining when and how banks decide to lower (or increase) interest rates. A range of factors is in play beyond simply a 1 for 1 move in the OCR.

An interesting issue arising from lower interest rates is how individuals and households will adapt to interest rate and risk changes in light of currently perceived lower returns. In a high inflationary environment (say in the 1980s) individuals often received nominal returns of 20 percent per annum or more but by the time tax and inflation were taken out of the equation, their real returns were negative. And while nominal returns of 3 percent currently don't look terribly good, individuals need to be aware that nominal returns of 10 percent or even 20 percent plus as relatively safe investments are probably a thing of the past, at least for the foreseeable future.

The present situation means individuals who thought they could retire and live off the returns from assets invested or from bank deposits need to be more sophisticated in their thinking and to look for other options. Reverse mortgages are appropriate for some who are asset rich but cash poor.

### **The NZ dollar – small change**

Forecasts below show the NZ dollar is generally expected to change little against both the Australian and US dollar, although most commentators concede that predicting its future direction is difficult, with about as much certainty as when amateurs throw darts at a dart board.

Inflaming the uncertainty is that any future moves towards more normalised monetary policy regimes internationally, are looking more remote by the day, despite the United States appearing to have returned to the fold. Some countries are clearly struggling for solutions with negative interest rates now prevalent in Switzerland, Japan, Denmark and Sweden and close to zero in a handful of other developed countries. NZ's OCR of 2.25 looks positively high by international standards.

**Forecasts: Exchange Rates**

AUD (cents)			
	Mar 16	Mar 17	Mar 18
Highest	0.89	0.89	0.90
Average	0.89	0.88	0.88
Lowest	0.88	0.88	0.85

USD (cents)			
	Mar 16	Mar 17	Mar 18
Highest	0.68	0.71	0.75
Average	0.67	0.63	0.67
Lowest	0.66	0.58	0.62

TWI			
	Mar 16	Mar 17	Mar 18
Highest	71.9	72.0	72.8
Average	71.4	69.0	70.4
Lowest	70.4	68.0	67.0

Source: ANZ, ASB, BNZ, and Westpac

***Inflation – slowly, slowly***

Forecasts below show inflation firmly under control over the period to March 2018, remaining well within the Reserve Bank's target range of 1-3 percent and only reaching 1.9 percent by March 2018.

**Forecasts: % Change in Inflation (CPI)**

	Years Ending		
	Mar 16	Mar 17	Mar 18
Highest	0.5	1.7	2.2
Average	0.4	1.5	1.9
Lowest	0.3	1.1	1.7

Source: ANZ, ASB, BNZ, and Westpac

Despite a significant decline in the NZ dollar over the past six months and a levelling out of late, tradeables' inflation has not been an issue to date with declines in international commodity prices (e.g. oil) well and truly offsetting any cost flow-ons from a lower currency.

Notwithstanding current headline inflation, it is important when setting monetary policy, to take the horizon as the next 2-3 years and not respond with a kneejerk reaction to current headline rates.

Oil prices have bottomed out and global commodity prices, in general, are starting to recover, so we should not be too smug about assuming low inflation is here to stay.

An interesting fact about inflation is that of recent years both global competition and innovation have cranked up the development of better products and services at lower cost. Consequently, the old argument that as demand ratchets up prices will rise does not now necessarily hold as good as it did in the past. Prices over a wide range of products and services are in real terms, and indeed even in nominal terms, dropping.

On balance, therefore, inflationary pressures still appear to be on the downside although there are some indications that housing prices have ramped up in areas outside Auckland. Anecdotal evidence suggests that even Wellington prices are taking a step up, while increased oil prices are starting to be reflected in prices faced at the pump.

Downside drivers include:

- Relatively flat international commodity prices overall
- Record low interest rates reducing debt servicing costs to both businesses and households
- Strong and continuing competition in many sectors (particularly retail) keeping a lid on prices generally
- High population growth on the back of continued strong net migration inflows keeping wage pressures under firm control while making it difficult to gain headway on the unemployment front
- An international economy still awash with money looking for a home, although international risk (and hence interest rates) is rising.

### 1.3 Business activity and consumer confidence – firm footing

#### **Business activity – solid results**

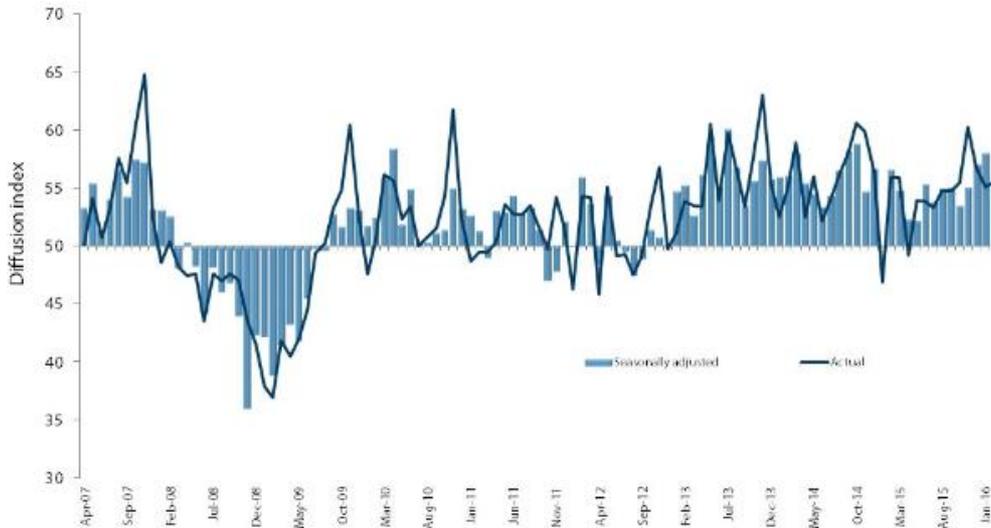
Business activity and confidence remain robust as evidenced by a number of key indicators.

On the activity side of things, 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 February 2016 was 56.0 that is, 2 points lower than in January, although still the third highest level of activity over the last 12 months (a reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). The sector has now been in continued expansion since October 2012.

While January’s sizzling result could not be built on, for February the level of expansion in the sector was still healthy, a conclusion supported by the fact that over two-thirds of comments from respondents remained positive.

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



The other area of interest in the February result was a slight contraction in employment, which last occurred in December 2014. Given the other sub-indexes of new orders and production remain very healthy, it will be interesting to see how employment growth plays out in the months to come.

#### Main Indices

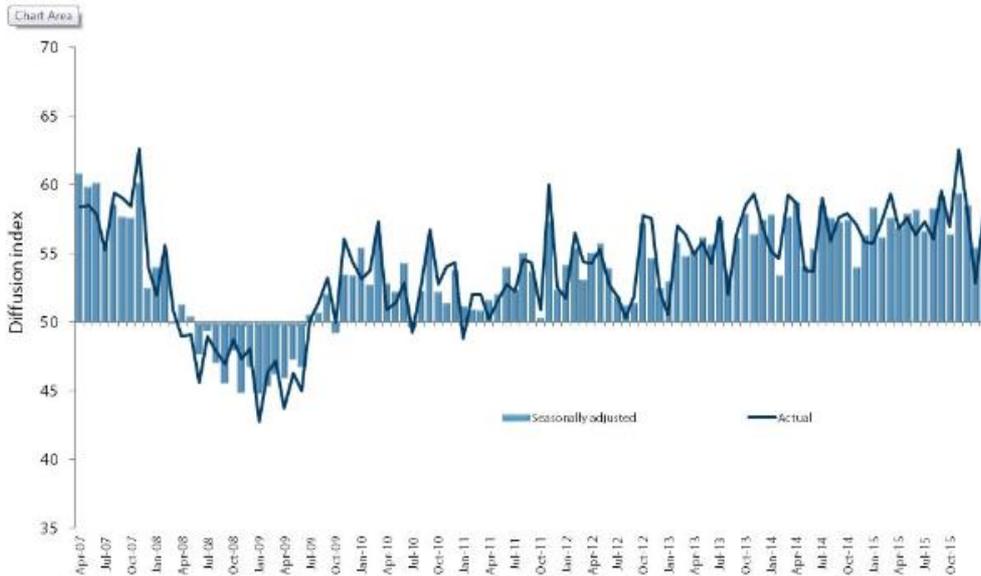


#### Regional Results



The PMI's sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI), continued strongly, with further expansion in February 2016. The PSI for February was 56.9 - 1.5 points higher than for January - continued the sector's trend of recording a post-55 point value since December 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)**



February's result was boosted by a strong showing in sales (60.0) and new orders/business (61.4). An overall increase in expansion also saw a lift in the proportion of positive comments from respondents, rising from 59.7% in January to 67.6% in February. While some comments revolved around seasonal factors, a number noted increased tourist numbers, as well as proactive steps to increase market share.

Perhaps the most reassuring aspect of February's PSI was, however, the bounce back in its employment index. This proved important, in that it offset the softness in February's PMI on staffing, which moved into contraction territory.

**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 and building activity are continuing apace with the number of building consents and the value of building work continuing to rise. The retail sector is lifting slightly on the back of greater consumer confidence and household spending.

Household debt levels have been increasing, an obvious threat but offset to some degree by historically low debt servicing costs (interest rates) along with relatively strong employment growth (although the unemployment rate continues to bobble around).

## 1.4 Labour market – statistical yo-yo

### **Employment – growth continues but offset by a growing population**

Forecasts below show the unemployment rate projected to drift slightly lower (after increasing in the March 2016 quarter) to reach 5.4 percent in the year to March 2018.

#### **Forecasts: Unemployment percentage (HLFS)**

	Quarter		
	Mar 16	Mar 17	Mar 18
Highest	5.8	6.0	5.6
Average	5.7	5.6	5.4
Lowest	5.3	5.2	5.2

*Source: ANZ, ASB, BNZ, and Westpac*

The Household Labour Force Survey (HLFS) for the December quarter 2015 threw up some surprising results which need to be interpreted with a healthy grain of salt.

The unemployment rate dropped substantially to 5.3 percent (down from 6 percent the previous quarter) which on the surface looks to be a good result. However, this apparent good result needs to be seen in light of the participation rate continuing to drop with discouraged workers exiting the labour market altogether.

Other measures of employment growth show activity as more subdued.

The ANZ Jobs Ads series for February 2016 shows that while job ads rose slightly for the month (up 0.9 percent), this did not compensate for the 2.9 percent drop in January (seasonally-adjusted). In fact, compared with a year ago, total job advertising is up only marginally (0.4 percent based on 3-month average).

Other credible statistics, including the BNZ-BusinessNZ Performance of Manufacturing Index (PMI), which experienced a drop into negative territory for February 2016, point to similar fluctuations in employment. 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**

Month	PMI	PSI
Jun 15	53.8	54.0
July 15	50.7	53.7
Aug 15	53.1	53.7
Sept 15	51.1	53.5
Oct 15	52.3	53.1
Nov 15	53.8	54.9
Dec 15	53.1	53.4
Jan 16	54.7	50.9
Feb 16	48.5	53.5

*Source: BusinessNZ*

Adding to the mix of factors which might impact on labour market outcomes is continued strong population growth, mainly driven on the back of strong net migration inflows which continue to set new records. Given the migration effect, there is unlikely to be any substantial tightening in labour market conditions this year.

New Zealand's annual net migrant gain has continued to rise, with an unadjusted figure of 67,400 in the February 2016 year, the 19<sup>th</sup> consecutive month to show a record annual gain. Migrant arrivals reached a new high of 124,200 with departures falling very slightly to 56,900.

Net migration from Australia continued to rise with a net gain of 1,600. This is the highest annual net gain from Australia since the September 1991 year and the fifth consecutive month to show an annual net gain.

Of migrant arrivals in the February 2016 year 30,700 were NZ citizens, making up one-quarter of all such arrivals. 13,800 migrants were from India, almost three-quarters with student visas and 13,500 from the United Kingdom, almost half with work visas.

Unpicking which individuals are utilizing their “right to work” in NZ (by visa type) would be a useful exercise and would provide a better picture of the impact of migrant labour on labour market outcomes generally, and in particular, as it affects the regions.

### **Labour costs – little pressure**

Forecasts below indicate labour costs expected to increase only slowly to 1.7 percent for the year ending March 2018.

While the latest NZIER *Consensus Forecasts* shows forecasters revising up expectations of growth and employment through to 2019, expectations for inflation and wage growth have been lowered.

Despite reasonably solid employment growth, wage pressures will likely be constrained overall, given the high numbers of people entering the labour market, including the ongoing impact of strong net inward migration.

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

	Years ending		
	Mar 16	Mar 17	Mar 18
Highest	1.7	1.9	2.1
Average	1.6	1.7	1.7
Lowest	1.3	1.2	1.2

*Source: ANZ, ASB, BNZ, and Westpac*