Economy Watch

28 July 2017

NZ Keeps On Keeping On

- Expansion now over six years long
- The curse of the eight about to be broken
- Economy to grow near potential for some time
- Both fiscal and monetary policies are growth supportive
- And we revise higher our population expectations again

It has now been over six years since New Zealand last experienced a technical recession, and that was largely due to the fall-out from the Darfield earthquake. Before that, you have to go back to the GFC period of 2008/09. This represents a remarkably long period of expansion by historical standards and, importantly, one which looks set to be sustained for some time to come.

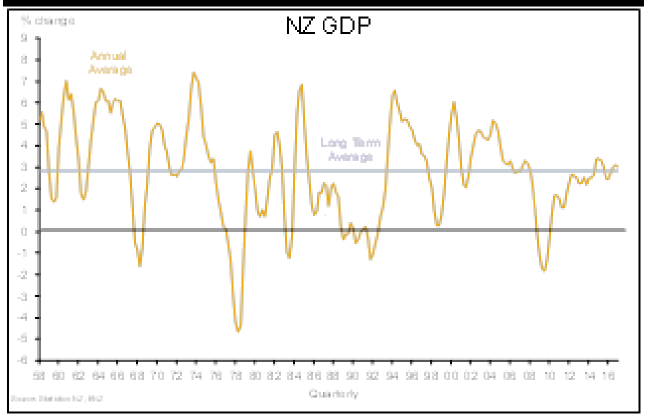
Typically, one of three things brings the New Zealand economy to its knees:

- an international shock;
- a drought;
- a sharp tightening in monetary policy.

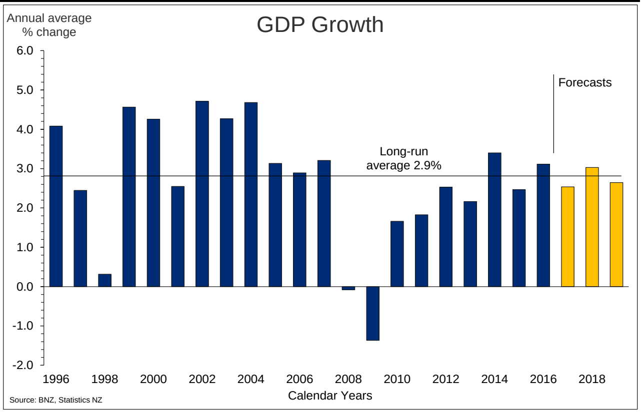
An international shock is, by definition, not forecast-able but we would say that the balance of risk, internationally, seems to be moving more towards the positive than the negative.

Believe it or not, there are some areas of the country that are facing water shortages - namely where some of the hydro storage lakes are – but for the agriculture sector it's almost a case of too much water rather than not enough.

Beware Years Ended in '8'!



Solid Growth Continues



And a sharp tightening of monetary policy any time soon seems out of the question. The Reserve Bank is adamant that nothing at all happens until late 2019/early 2020 and recent inflation data, housing developments and currency strength are supportive of that.

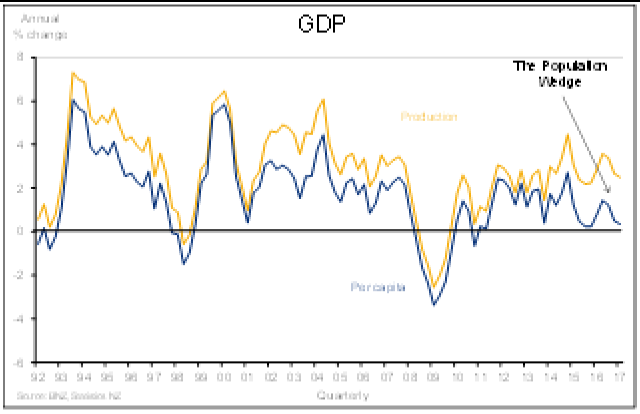
Could it then be that the jinx of being in Government in a year ending in 8 is about to end? Recessions (and quite deep ones) were recorded in 1968, 1978, 1988, 1998 and 2008. The odds on a 2018 repeat look slim though those with a superstitious bent may still want to take the bet on a recession outcome.

We are toward the more pessimistic end of the spectrum in terms of our economic forecasts but we too are still anticipating a relatively solid ongoing expansion. For the record, we are forecasting the economy to expand 2.5% across calendar 2017, rising to 3.0% in 2018 before moderating to 2.6% the year after.

In terms of what will drive the expansion it's a case of same old, same old:

- tourism will remain a significant driver;
- construction will continue to expand;
- stimulatory interest rates will remain supportive; and
- migration-driven population growth will be central to the thesis.

Per Capita Not So Strong



It is true that per capita growth will look a lot less spectacular. It is also right to be concerned by this and by the growing negative externalities associated with a rapidly growing population. Nonetheless, for businesses looking for someone to sell to, for people looking for employment, and for asset holders looking for asset price appreciation, the growth outlook is predominantly good news.

In addition to the regular culprits, the next year or so will also be buoyed by the resumption of tailwinds from the dairy sector and a boost to household spending from tax cuts and increased benefit entitlements. There's even an outside chance that, at long last, wages start to push higher too.

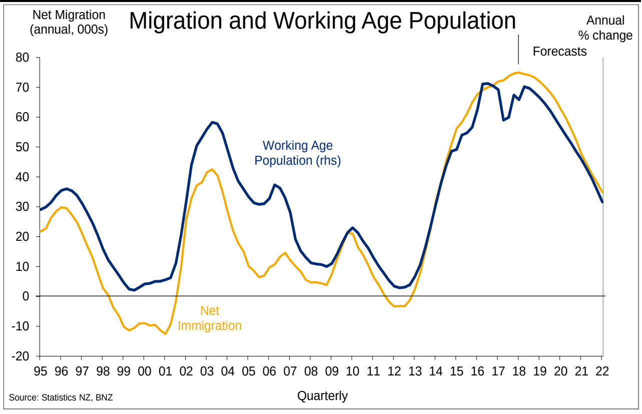
While our view of the trend in the expansion is fairly stable, there is the potential for significant quarterly variation based on a number of one-off hits to the data. These include:

- the impact of the Masters games on Q1, 2017;
- the Lions tour (both the spike upwards and the correction thereafter);
- the impact of the tax cuts and benefit changes on consumer spending in Q2 and Q3, 2018; and
- adverse weather issues

Additionally, there is the possibility that the General Election impacts spending and investment (though there is no sign of this yet). Furthermore, the shock that Auckland house prices are no longer appreciating at double digit rates may have an adverse impact on some though, of course, may boost the spirits of others.

Another point we should note up front is that our overall projections are heavily predicated on net immigration flows holding up at current levels for a year or so before gently abating. We have just raised our track based on the ongoing strength in inflows but still believe a peak is nigh.

Migration Forecasts Revised Higher

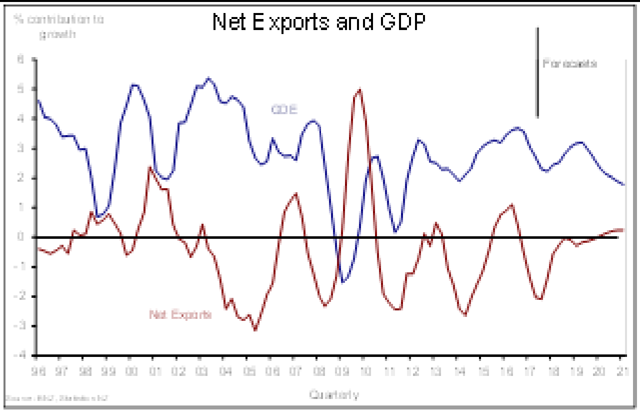


Net migration can be a relatively fickle beast, however, and could well surprise significantly in either direction

The other key aspect to our expectations is the view that the topside to New Zealand's economic expansion is contained by the economy's capacity to grow. Anything much above 3.0% growth and the country would quickly meet physical capacity constraints.

Given the combined strength in household spending and residential investment, domestic demand will drive the expansion while net exports contribution will be near zero. Export volume growth looks set to be about normal, barring any unusual weather event, but domestic demand itself continues to put upward pressure on imports.

Domestic Demons The Driver



That said, the income effect, via the terms of trade, of export prices appreciating faster than import prices will have a significant positive impact on New Zealanders incomes which will serve to further bolster domestic spending.

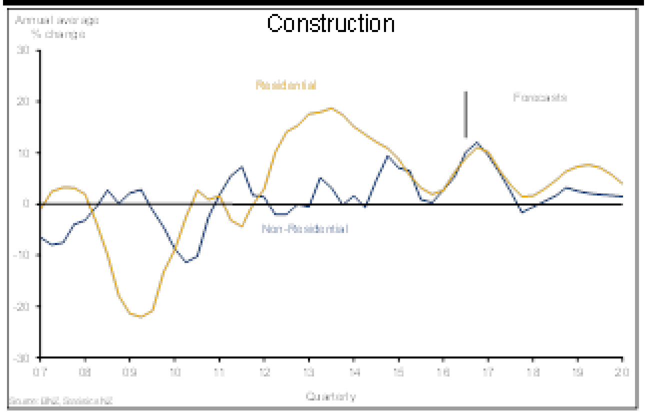
Capacity constraints will be significant in holding back residential construction not only in a physical sense but also, indirectly, as the cost of construction continues to rise (reflecting supply shortages and bottlenecks) and putting the cost of building further beyond the means of many.

In part, this explains why total residential fixed capital formation will probably have risen by a mere 1.5% across calendar 2017 despite the obvious demand for more. We are forecasting increases averaging over 6.0% per annum over the following two years.

We are forecasting business investment growth to be relatively modest as economic growth is not currently centred on capital intensive activities. However, we still see plant and machinery investment continuing at a relatively high level and anticipate it holding up as a percentage of GDP. We also concede that there is potential for positive surprise from this sector.

Strong employment growth, increased farm incomes, fiscal easing and some real wage growth are all expected to contribute to a solid increase in private consumption over the next two years. However, spending growth is not expected to keep pace with this year's efforts as support from house price appreciation diminishes and population growth moderates. From a real retail sales perspective, we see growth easing to 4.2% across calendar 2017 (from 4.9% in 2016 and 5.8% in 2015) and then falling further to 4.0% and 3.1% in each of the following two years. Bear in mind that tourism inflows support retailers in addition to domestic sourced spending.

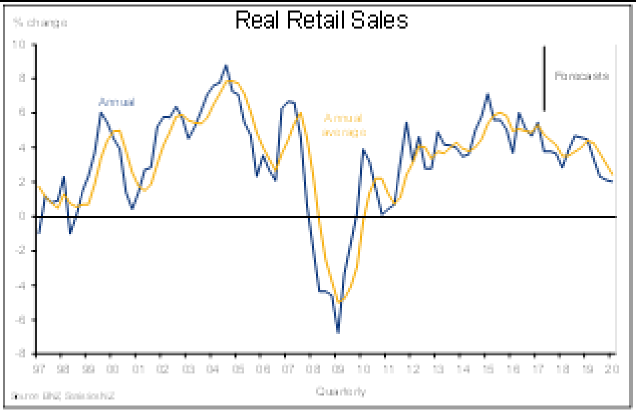
Still Building



As noted above, the export story is probably more about prices than volumes and the record terms of trade says it all. That said primary production export volumes have recently been weak due to previous poor growing conditions. With an expected reversion to "normal", primary production growth should contribute strongly to goods exports through calendar 2018 and into 2019.

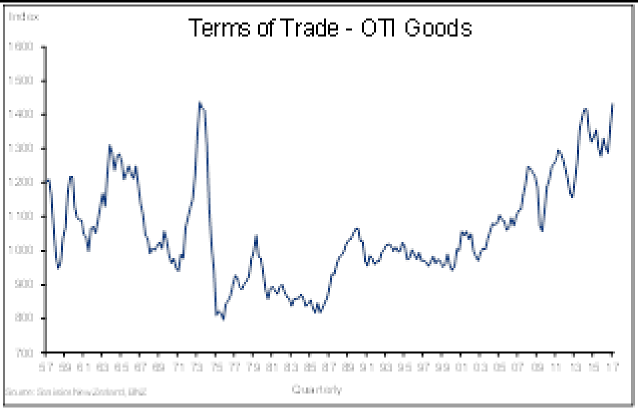
Short term, services exports will come under some pressure from the stronger NZD, tighter controls on the sales of education services to foreigners in New Zealand, and capacity constraints.

Retail Growth Moderates



Nonetheless, further growth from services is anticipated. For the record, we predict annual average total export growth of just 1.4% in calendar 2017 rising to a 4.0% average over the following two years.

Terms Of Trade Soars



Overall then, the New Zealand economy continues to tick along quite nicely. This is not to deny that there are numerous issues that still need to be confronted and, eventually, resolved. But facing into such issues from a position of relative strength is far better than being on the back foot. In this regard, it is important to note that the strength in the broader economy continues to deliver dividends for government which are, in turn, allowing it, and any future government, to fund measures advantageous to New Zealand's future.

Inevitably, the economic cycle will one day turn nastily downward. But, for now, at least, that eventuality does not look to be any time soon. Fingers crossed, the next few years will continue to deliver near trend growth, rising employment, falling unemployment and the opportunity for improved flexibility in fiscal policy.

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