Economic Overview

November 2015

Not out of the woods yet

Dominick Stephens
Chief Economist

Note from Dominick

In our last *Economic Overview* we warned of an impending economic slowdown, due in part to the dairy downturn. It now looks as though the economy dodged that particular bullet – the bounce in global dairy prices means farmers are now facing tough, but not disastrous, market conditions.

But we are not out of the woods yet. Brewing El Niño conditions are likely to cause dry weather and knock the economy. And there will be further challenges from a global economic slowdown, the levelling off of the Canterbury rebuild, and the possibility of a housing market slowdown in Auckland.

I thought figure 1 on the facing page shed an interesting light on our forecast for an economic slowdown. From a business point of view, the situation is not too bad. Extremely strong population growth will mean extra bodies in shops, and GDP growth will only slow to 2% or so. But from a household point of view, the situation looks different. Per-capita GDP growth is expected to drop to nil, and unemployment is forecast to rise to 6.6%.

The good news is that from late 2016 we are forecasting a recovery in GDP growth, to almost 3% per annum, as the El Niño passes and the lagged effect of low interest rates and the lower exchange rate kicks in. But beyond that temporary fillip, we still expect the late years of the decade will be slow due to the wind down of the Canterbury rebuild.

Through all of these ups and downs we expect one important dynamic to remain constant – low inflation. That's the key reason we expect the OCR to fall below 2.5% next year – although we freely admit that the RBNZ does not currently share our view.

The intricacies of this outlook will mean different things to different regions. So for this quarter, we have introduced a Regional Outlook section to the *Economic Overview,* which I trust you will find useful.

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New Zealand Economy

Calm before the storm

While there has been some improvement in economic conditions in recent months, the economy is not out of the woods yet. A slowdown in GDP growth is still on the cards for 2016. But with several factors continuing to support domestic demand, we are looking at a slowdown in growth – not a collapse.

Rays of sunshine…

Through the first half of this year, economic growth slowed to a tepid 2.3%. While the overall pace of growth remains modest, recent months have seen a strengthening in economic conditions. This has been centred on the household sector, with retail spending up 6% in the year to September, net immigration rising to a record annual inflow of 61,000 people, and residential building consent numbers climbing by close to 10% over the past year.

On top of this, we have seen continued strength in the housing market. Over the year to December, we expect that nationwide house prices will have risen by around 15%. And this strength hasn't been confined to Auckland. Prices are also rising rapidly in Hamilton and Tauranga. In part, this is a result of an over-flow of demand from Auckland. However, low borrowing rates are providing a more generalised boost to housing markets nationwide.

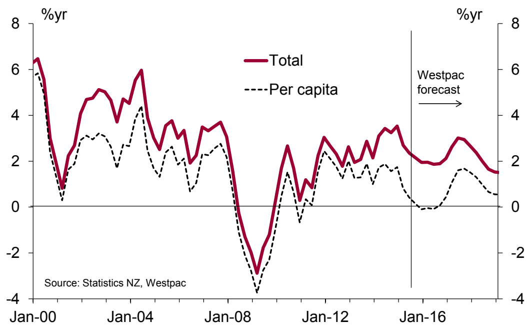
There have also been gains in the businesses sector, with gauges of both manufacturing and service sector activity pushing higher.

…but there are still clouds on the horizon

In our previous *Economic Overview,* we forecast a marked slowdown in GDP growth from the end of this year. This was in large part predicated on a very weak outlook for export earnings in the dairying sector. Conditions in the dairy sector are still far from stellar. However, it now appears that the drag from weakness in dairy export earnings will be less pronounced than we had feared. Dairy prices have rebounded by more than 50% as concerns about drought have emerged and Fonterra has pared back its expectations for milk collection this season. Although many farmers will still find that conditions are tough after last season's low payout, recent price gains will come as a welcome relief and will reduce the need for drastic cost-cutting measures.

But despite this positive development on the dairying front, a slowdown in GDP growth remains on the cards. We're forecasting GDP growth to fall to 2% over 2016, and that the underlying pace of growth will

Figure 1: Total and per-capita GDP growth



remain subdued for some time. However, the drivers of this slowdown are now looking a little different.

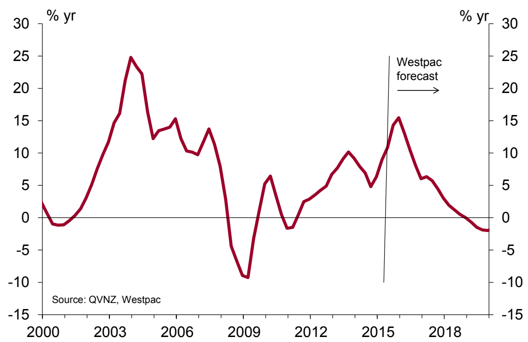
Over the past few months, an air of nervousness has crept into the economy, with economic confidence falling to multi-year lows. And although households and businesses remain cautiously optimistic about their own prospects, a softening in spending and hiring decisions is likely over the coming months.

Looking to 2016, the New Zealand economy will be confronting several significant headwinds. Offshore, growth in many of our key trading partner economies has slowed, and volatility in financial markets has increased. As discussed in the Global Economy section, this is dampening global trade, and is contributing to lower prices for many commodities. New Zealand will not be immune to these developments.

Domestically, meteorologists are warning that the likelihood of drought over the summer as a result of deepening El Niño conditions is high. We have assumed a drought in our forecasts which knocks around 0.6% off GDP over the coming year. Although growing concern about drought has boosted prices for dairy exports, the related reduction in production would put a serious dent in GDP in early 2016. Drought would also unambiguously result in tough conditions for sheep and beef farmers and pipfruit growers. In addition, the resulting reductions in earnings would flow through to decreased activity in other sectors of the economy.

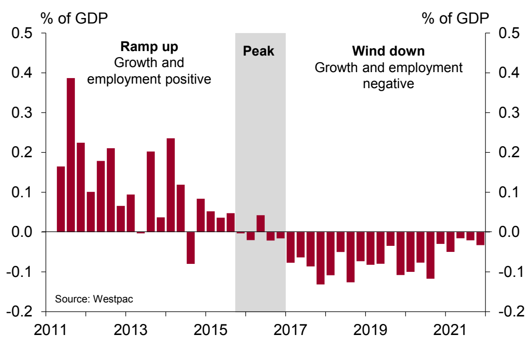
A slowdown in house price inflation in Auckland is also expected to weigh on GDP growth. Much of the strong house price growth that we've seen in Auckland has been related to demand from investors. However, the government has now strengthened the rules relating to the taxation of capital gains on investment property, and the RBNZ has tightened the restrictions on investment lending in Auckland. Combined with rising unemployment, these developments will challenge investor confidence. In fact, recent anecdotes suggest that demand in the Auckland housing market has already eased significantly as these new policies have come into effect. At the same time, housing markets in other parts of New Zealand will experience a boost from falling interest rates and looser lending restrictions. But on balance, we are forecasting national house price inflation to fall from rates of around 15% currently, to around 6% in 2016.

Figure 2: House price inflation



As the impact of drought passes, we'll see a recovery in GDP growth. But aside from this temporary rebound, a period of below trend economic growth is likely as the economy comes up against the wind down phase of the Canterbury rebuild. Reconstruction spending was a significant driver of New Zealand's upturn between 2012 and 2014. From late 2016, however, the gradual easing

Figure 3: Quarterly changes in reconstruction spending



back of reconstruction spending will become a drag on GDP growth and employment nationwide.

Silver linings

While the above headwinds will result in an extended period of below trend growth, we are still only looking at a slowdown in economic activity – not a collapse. Several key factors are continuing to support domestic demand.

The first is strong net immigration, which means that New Zealand's population growth over 2015 will be the fastest since 1974. Some of this is a result of a temporary surge in arrivals of overseas citizens. But as discussed in our recent report,[1] around half of the pick-up in net immigration has been due to increasing numbers of New Zealanders choosing to either stay on shore or come back home.

For businesses, strong population growth will provide a buffer from the headwinds hitting the economy. The larger customer base will boost demand and limit the extent of the slowdown in GDP growth. However, for individual households, the slowdown is likely to feel much more acute. Per-capita GDP growth is expected to be essentially flat over the coming year. In addition, labour market conditions are likely to be tougher. Stronger population growth, combined with softening GDP growth, will result in the unemployment rate rising to 6.5% next year. These conditions also mean that wage growth is likely to remain subdued over the coming years.

It's important to remember that while net migration is currently strong, it won't remain this way indefinitely. Over time, softer GDP growth and the related reduction in labour market opportunities will make other destinations start to look more attractive. The resulting reduction in migration flows will be a drag on growth in the latter part of the decade.

The second factor helping to support demand over the coming years is construction spending outside of Canterbury, particularly in Auckland. Our research indicates that population needs will require around 11,000 new homes to be built in Auckland per year for a number of years.[2] This would require a sustained increase in construction of around 25% from current levels.

Finally, New Zealand has effective mechanisms for dealing with a slowdown. The RBNZ has already swung into action, reducing the OCR. In addition, the exchange rate is much lower than it was last year. These "automatic stabilisers" will support the economy, limiting the extent of the slowdown in GDP growth.

[1] Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/When-will-the-tide-go-out-October-2015.pdf

[2] Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Outlook-for-Auckland-residential-construction-August-2015.pdf

Inflation and Interest Rates

Not on track

Boosting inflation from today's low rate to two percent on a sustained basis will be a daunting task for the RBNZ. The RBNZ is firmly of the view that the OCR will have to fall to 2.5%, but no further. We are doubtful that will be sufficient – in our view, the OCR will eventually have to fall to 2.0%.

Inflation is set to pick up in early 2016, as last year's plunge in global oil prices drops out of annual calculations. But a range of factors will conspire to limit the increase and keep inflation well below two percent. First, the impending slowdown in economic growth will reduce pressure on wages and prices. Second, the low-inflation global backdrop will pass through to New Zealand. Third, certain government charges will remain subdued. For example, ACC levies will fall and tobacco excise tax increases will be minimal. And finally, low inflation expectations will become something of a self-fulfilling prophecy – for instance, surveys indicate there is little pressure for wage hikes at present.

It is abundantly clear that the RBNZ has needed to reduce the OCR. Less clear is how far the OCR will have to fall to secure a return to two percent inflation on a sustained basis. The RBNZ is firmly of the view that one more cut, taking the OCR down to 2.5%, will be sufficient. Said cut is most likely to be delivered in December, although the timing does depend on emerging data.

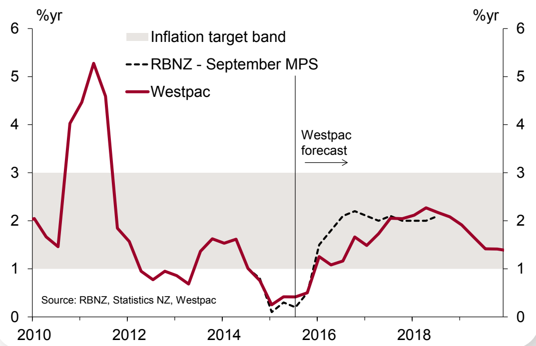
By contrast, we doubt that 2.5% will be low enough. Over the first half of 2016, we expect to see data suggesting that inflation is not on track to meet the RBNZ's target – at which point the RBNZ will have to cut the OCR further. We are forecasting OCR cuts in December, March and June.

The key point of difference concerns the exchange rate. Back in September, the RBNZ argued that the lower exchange rate would give inflation a substantial and sustained boost. We are sceptical. Historically, exchange rate induced inflation has been fleeting, not sustained. And in the current environment of stiff online competition and low consumer confidence, retailers have little ability to hike prices. Not to mention the fact that the exchange rate itself has risen sharply in recent weeks.

To produce sustained inflation around two percent, the RBNZ is going to have to boost domestically-determined prices (non-tradables inflation). Reducing the OCR will benefit house prices, in turn boosting consumer spending and construction activity. That could generate a bit of inflation, especially in construction-related areas. But given the impending near-term economic slowdown, not to mention the plateau and inevitable wind-down of the Canterbury rebuild, it is going to take a great deal of stimulus to produce much in the way of a domestic inflation dynamic.

Our OCR forecast is predicated on the Auckland housing market slowing by early 2016. If house prices instead continued to rise rapidly, the RBNZ would eschew OCR cuts. But that strategy would be valid only for so long. Over a longer timeframe, monetary policy must achieve the inflation target – a target that our longer-run forecasts suggest the RBNZ is in danger of persistently undershooting.

Figure 4: Westpac and RBNZ inflation forecasts



Financial market forecasts
(end of quarter)

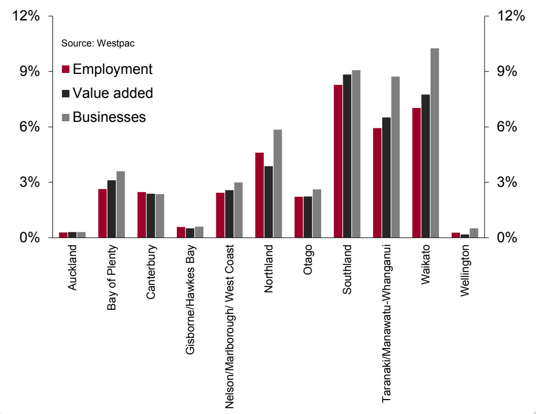
	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Dec-15	0.5	2.50	2.60	2.60	3.10
Mar-16	1.3	2.25	2.30	2.40	3.10
Jun-16	1.1	2.00	2.10	2.20	3.10
Sep-16	1.2	2.00	2.10	2.20	3.20
Dec-16	1.7	2.00	2.10	2.20	3.20
Mar-17	1.5	2.00	2.10	2.20	3.20
Jun-17	1.7	2.00	2.10	2.20	3.20
Sep-17	2.1	2.00	2.10	2.20	3.10
Dec-17	2.0	2.00	2.10	2.20	3.00
Mar-18	2.1	2.00	2.10	2.30	2.90

Regional Outlook

Dairy, dwellings and the deep blue sea

The outlook across New Zealand's regions largely depends on three strands of the economic web – exposure to dairy and other agricultural products, the housing market, and the Canterbury rebuild. These factors are leading to a widely divergent picture across the regions. Dairy regions face a particularly challenging year, while the upper North Island has a more rosy outlook.

Figure 5: Dairy's share of regional economies



Auckland

By the end of 2015, we expect signs that the 77% increase in Auckland house prices since 2009 is beginning to slow. Anecdotal evidence suggests that the new LVR restrictions and rules for foreign buyers are having an impact on investment property sales in particular, which explains part of the slowdown.

Other indicators are largely positive – retail and commercial vehicle sales and residential consents continue to grow while the unemployment rate is flat. Population growth remains strong, meaning a positive outlook for the region, including continued strength in residential construction. However, unemployment may rise a little.

Bay of Plenty

The Bay of Plenty is not overly exposed to dairy, and kiwifruit exports have rebounded since the Psa outbreak. Some risks to the large agricultural sector from the impending El Niño related drought exist.

There is strong evidence that the house price boom in Auckland is flowing on to Tauranga. This will generate a wealth effect, and will underpin strength in retail spending and purchases of passenger vehicles there.

These positives must be balanced against the outlook for the rural districts. The region's unemployment rate is rising (7.8% in June), and employment confidence was down significantly in September. A lukewarm outlook for forestry and the impact of drought suggest a less rosy outlook over the next year.

Canterbury

The Canterbury rebuild has peaked but will continue to provide some impetus to the regional economy for years to come. House prices are flattening as supply catches up with demand, but sales are still strong.

We expect regional economic confidence to remain strong for several more quarters, but this may be skewed toward Christchurch. Rural districts are expected to struggle through the summer's drought, with both dairy, and sheep and beef affected. However, the rebuild will play a decreasing role in the economy from late 2016. As a result, we expect significant downward pressure on employment at that stage.

Gisborne/Hawkes Bay

There are signs of life in the local housing market. Sales are up and prices have recovered modestly after years of stagnation. The region is seeing a boost from lower interest rates and higher beef prices.

Outside of the urban centres, the outlook is relatively tepid. Forestry remains depressed with demand from China well down and unlikely to recover soon. El Niño droughts typically take their toll on the region's meat and wool sector, which provides 13% of regional employment, and on pipfruit production.

Nelson/Marlborough/West Coast

The West Coast will feel the effects of lower dairy (1 in 12 local jobs) and mining commodity prices for longer. Overall regional confidence remains positive, but we suspect this is skewed toward Nelson-Tasman and Marlborough, which are not as exposed.

Marlborough's viticulture industry (1 in 5 jobs there) may experience mixed outcomes as drought hits. Drier weather means lower volumes, but can improve quality. Tasman's pipfruit industry will likely see fruit development and marketability affected.

At the same time, house prices and sales are on the up in Nelson-Tasman, meaning capital gains and likely support for retail and other purchases.

Northland

Northland is experiencing a period of growth after several challenging years, when key indicators are compared to the same time last year, five years ago, or the last quarter. Regional economic confidence is weak, but commercial and passenger vehicle sales are strong, and house sales and prices are rising.

The region has some exposure to dairy, which will weigh on its outlook, but the resurgent kiwifruit industry is unlikely to be as badly affected by drought. Forestry's lacklustre performance will do little to reduce the unemployment rate, which remains the highest in the country despite recent improvements.

Otago

Recent performance of the regional economy has been mixed. The housing market is taking off, led by Queenstown-Lakes and to a lesser extent Dunedin. Yet new dwelling consents and passenger vehicle sales are down. Overall regional economic confidence is weak, and employment confidence has fallen.

The region may experience some impacts from El Niño, affecting dairy, sheep and beef, and stonefruit production although probably not to the same extent as Canterbury. Meanwhile a weaker NZD will help continue growth in tourism to Queenstown-Lakes.

Southland

Southland has the weakest regional economic confidence in the country. It is very exposed to dairy, meaning the lower-than-average payout expected this season will hurt.

The weakness in dairy (1 in 12 jobs) has contributed to a sharply higher unemployment rate, and there is little reason to expect that to fall significantly in the next few quarters. Sheep and beef, short-term drought implications aside, faces a more positive medium term outlook with exports on the rise.

Taranaki/Manawatu-Whanagnui

Taranaki has suffered the double hit of a sharp fall in oil and gas prices and dairy prices. As a result, exploration activity is down, unemployment is up, and regional economic confidence has taken a beating.

Oil prices are expected to stay low for some time, which will depress exploration activity and potential new production for some years. While dairy prices have rebounded somewhat, both Taranaki and Manawatu-Whanganui will need to see payout forecasts rise further for confidence, residential building, private and farm vehicle sales to recover. We don't expect this to happen in the next two seasons.

Waikato

While regional economic and employment confidence remain weak in the Waikato, many positive signs (outside of dairy) are appearing. House prices and sales are surging in Hamilton as the Auckland effect flows over with tighter restrictions and high prices there encouraging purchasers to look further afield.

Unemployment is down markedly from a year ago while other measures of economic activity including electronic card spending and overall consent values are up. Despite a strong dairy presence, the region is not expected to be as affected by El Niño conditions. Although a higher payout forecast is welcome, it is still well down on historical averages. Farmers will continue to feel the pinch even if production volumes are less drought-affected than in other parts of the country.

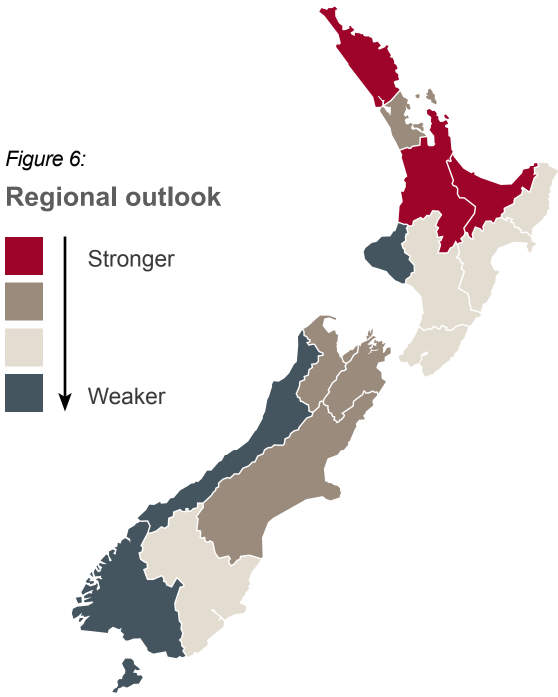
Wellington

The outlook for Wellington is mixed. It is largely unaffected by falls in commodity prices and the looming drought, but recent economic results for the region have shown few signs of emerging strength.

Building activity, regional economic confidence and regional employment confidence are all broadly flat or down on the previous quarter and the same quarter last year. House sales are up but prices are steady. Electronic card sales are flat. As a result, the outlook is steady-as-she-goes, not unlike what Wellington has experienced for the last two years.

Figure 6:

Regional outlook



Global Economy

Stuck in a hole

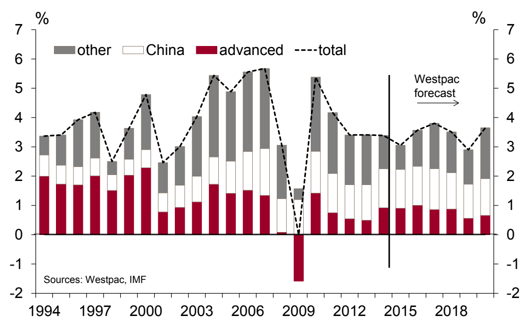
The global economy remains in a funk as the sharp slowdown in Chinese growth reverberates throughout South East Asia, depressing trade prospects and weighing on commodity prices. While the outlook for the US and European economies is a little more promising, conditions for New Zealand exporters will remain challenging for a while yet.

The global economy has slowed in 2015. And while our global growth forecasts for this year and next are only a touch softer than at the time of the last *Economic Overview,* they have been doused with a fresh sense of pessimism. In short, the global economic outlook remains decidedly patchy.

The primary reason growth amongst New Zealand's biggest trading partners is now expected to be even softer than we thought three months ago is a more downbeat view of Asian growth prospects (beyond China). It has become increasing clear that countries including Singapore and South Korea will be unable to emerge unscathed from the sharp slowdown in China. Asian commodity exporters such as Malaysia and Indonesia are feeling the pinch from lower export prices, while weak trade volumes and soft external demand are reverberating throughout the region.

Add to this ongoing jitters in financial markets about how the region, and emerging markets more broadly, will cope with the consequences of the Federal Reserve's rate hikes (such as a stronger US dollar and increased foreign financing costs), and it's unlikely to be smooth sailing for these countries for a while yet.

Figure 7: Contributions to global growth



All eyes to the East

Developments in China will be critically important for the region. And for now, the Chinese economy appears to be firmly ensconced in the doldrums.

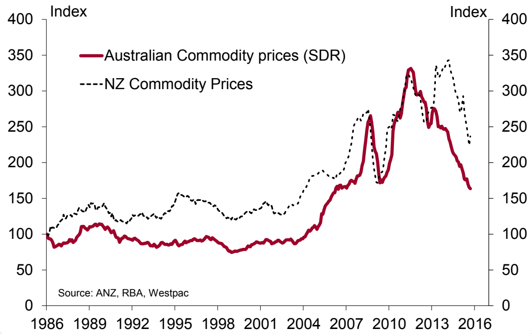
Chinese equity markets may have partially recovered from their midyear plunge, but remain 34% below their earlier peaks. Business and consumer confidence languishes near cyclical lows, demand for credit is falling, exports are weak and indicators of industrial production remain decidedly sluggish. Indeed, these indicators probably point to an even softer story for some sectors of the economy than headline GDP numbers suggest.

GDP growth drifted below 7% in the September quarter and is set to slow even further next year. This slowdown, combined with ample supply in many markets, has weighed heavily on commodity prices.

Policymakers in China have responded to the deterioration in economic conditions by cutting interest rates and loosening lending restrictions, leaving the domestic policy backdrop much less restrictive than it was in 2014. We expect they will be compelled to introduce further support measures over the coming months.

However, there will be no backing away from longer-run policy aims of promoting a rebalancing of the Chinese economy. This reorientation away from investment led growth toward a bigger role for Chinese consumers is well in train. For New Zealand exporters this provides a silver lining amongst the dark cloud of slower growth. After all, it is Chinese households who will ultimately consume many of the goods and services New Zealand exporters can provide.

Figure 8: New Zealand vs Australian commodity prices



Caught in the downdraft

But for New Zealand's second biggest trading partner, Australia, there is no such glimmer of hope. The fortunes of Australia's minerals and mining sector are inextricably tied to the Chinese investment cycle, and the Australian economy has struggled to escape the downdraft of plunging hard commodity prices.

GDP grew just 0.2% in the June quarter, pushing the annual growth rate down to just 2% - the slowest pace in two years. The declining terms of trade and subdued wage growth mean incomes are being squeezed right across the business, government and household sectors of the economy. This in turn is impacting spending decisions and will translate to softer demand for New Zealand exports.

One sector of the Australian economy which is particularly important for New Zealand exporters is the housing market. Against a backdrop of low interest rates, recent housing market strength has been concentrated in Sydney and, to a lesser extent, Melbourne. Outside these main centres, developments in the housing market have been much duller. Importantly, investor activity has been the major driver of gains over the last year or so. However, the Sydney market is increasingly coming under renewed pressure from rising borrowing costs, the ongoing pressure on incomes and the introduction by the RBA of macro prudential measures targeting the investor segment.

More generally, we expect to see a modest improvement in the Australian economy next year (and are forecasting GDP growth to increase from 2.2% in 2015 to 2.7% in 2016) but growth is still likely to remain below potential for a while.

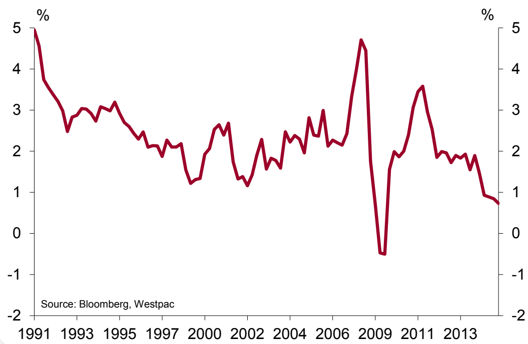
Bright(er) spots

In contrast to developments in Australia and much of Asia, conditions in the US and UK (and to a lesser extent Europe and Japan) have continued to gradually improve over the last three months. The improvement hasn't been enough to cement a Federal Reserve rate hike just yet. Nevertheless, come December, improving labour market conditions and further strengthening in household spending and the manufacturing sector should be sufficient to compel the Fed to raise rates for the first time since 2006.

One reason the Fed has been reluctant to rush into raising interest rates has been the benign inflation outlook. And they are by no means the only central bank facing such a predicament. Around the world policymakers are getting to grips with very low headline (and to a lesser extent core) inflation. As we outline in this document, we expect low inflation in New Zealand to force the RBNZ to lower the OCR to just 2% next year.

Low global inflation brings with it a number of risks including destabilising inflation expectations, over-easy monetary policy stoking asset price bubbles, and the potential for a sharp increase in financial market volatility when policy settings do eventually have to tighten. All are threats to the international outlook that will be worth keeping a close eye on over the next couple of years.

Figure 9: Inflation averaged across NZ's trade partners



Economic forecasts (calendar years)

Real GDP % yr	2011	2012	2013	2014	2015f	2016f
New Zealand	1.8	2.4	2.3	3.3	2.3	2.0
Australia	2.7	3.6	2.1	2.7	2.2	2.7
China	9.5	7.8	7.8	7.3	7.0	6.8
United States	1.6	2.3	2.2	2.4	2.4	2.8
Japan	-0.5	1.8	1.6	-0.1	0.6	1.3
East Asia ex China	4.5	4.6	4.2	4.1	3.5	4.0
India	6.6	5.1	6.9	7.3	6.9	8.1
Euro zone	1.6	-0.8	-0.4	0.9	1.5	1.1
United Kingdom	1.6	0.7	1.7	3.0	2.5	2.5
NZ trading partners	**3.6**	**3.7**	**3.6**	**3.8**	**3.5**	**3.7**
World	**4.2**	**3.4**	**3.3**	**3.4**	**3.0**	**3.6**

Forecasts finalised 30 October 2015

Agricultural Outlook

Running dry

Agriculture remains a significant weak spot in our outlook for the economy over the next year, as the diminishing risks from low milk prices are replaced by the likelihood of drought. Our forecasts are based on a climatic event in line with past El Niños, though changes in the makeup of the agricultural sector since then should help to soften the economic impact.

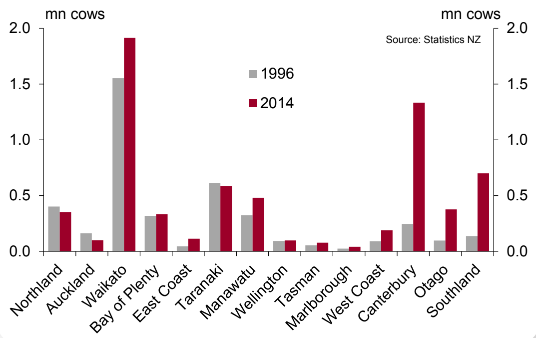
Meteorologists are warning that this summer will be characterised by the strongest El Niño weather pattern since 1997/98. El Niño typically brings drought to some of New Zealand's key farming regions, and previous events have sometimes been associated with recession in the wider economy (although weather wasn't the only factor).

During El Niño, New Zealand tends to experience stronger or more frequent winds from the west in summer, leading to dryness in east coast areas and more rain in the west. However, the regions where droughts occur can vary from one event to another. Given the difficulty in predicting these regional effects, we've based our forecasts around a 'typical' El Niño pattern, with the acknowledgement that the impact could be less or more severe than this.

While previous El Niño events may be a useful guide as to what to expect weather-wise this summer, we'd caution against using those events to gauge the economic impact this time around. Compared to even the most recent event in 1997/98, the shape of the agriculture sector has seen some dramatic changes that may help to mitigate the impact of an El Niño-based drought.

The first significant change is that dairying has made major inroads into the regions that are most vulnerable to El Niño, largely at the expense of sheep and beef farming. This is particularly true of the South Island, which accounts for around 80% of the increase in the national dairy herd in the last two decades.

Figure 10: Regional dairy herds



This matters for a drought's impact on farm incomes. New Zealand supplies up to a third of internationally-traded dairy products, so a drop in milk production during a drought is offset by a rise in world dairy prices. Indeed, recent droughts have arguably been revenue-positive for the dairy sector as a whole (though not for the most afflicted areas). In contrast, a drought forces farmers to send sheep and beef cattle to slaughter earlier, at lower weights, which depresses both prices and volumes.

The second major change is the growing use of irrigation, which has enabled the spread of dairying to drier regions. The total area of land under irrigation has grown by more than 50% in the last decade; a report by NZIER estimated that this increase added more than $1bn to the value of farm output in a normal year. Although water will still have to be carefully managed during a drought, access to irrigation is likely to substantially mitigate the impact of an El Niño weather pattern.

Overall, we have assumed that the hit to farm output and the resulting knock-on effects on spending will reduce GDP growth by 0.6 percentage points over the first half of next year. By comparison, the 1997/98 El Niño event is estimated to have reduced GDP by 1% or more, though other factors also contributed to the recession at that time, such as the Asian Financial Crisis and overly tight monetary policy.

Boost to dairy prices temporary

The prospect of a shortfall in New Zealand's milk production this season is already having a mitigating effect on dairying incomes. It was Fonterra's initial forecast in August of a fall in milk volumes that halted the slide in world dairy prices, which have rebounded by more than 50% from their lows. Since the last *Economic Overview,* we have revised up our forecast of the farmgate milk price for this season from $3.70/kg to $5.30/kg, which would be close to the break-even price for the average dairy farm.

Recent figures confirm that milk production in New Zealand is already running behind last season's levels. The prospect of a very low payout for this season prompted farmers to reduce spending on feed and cull significantly more cows than usual. The slow start to spring also affected pasture growth in some regions. We expect dairy prices to remain supported over summer as the effects of the dry weather become apparent.

However, we would caution against extrapolating too far from the recent price gains, and indeed our forecasts assume that world dairy prices fall below their current levels again by the end of this season, once the drought risk has passed. The poor outlook for the dairying sector three months ago was motivated by a global supply glut, and that remains the case even with the anticipated drop in New Zealand's milk production. Output in Europe has been particularly strong since production quotas were removed in April; in some lower-cost regions such as Ireland and the Netherlands, production is growing at double-digit annual rates as farmers try to claim the market share that was denied to them under the quota system.

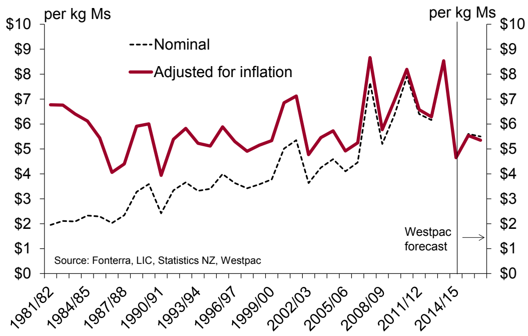
Consequences beyond dairy

Drought will have more severe effects on other forms of agriculture, where New Zealand lacks the influence over global prices that it has in dairy. In particular, it is likely to accelerate the long-running decline in sheep numbers, which are still concentrated in the regions that are most vulnerable to El Niño, albeit much less so than they were two decades ago.

Beef farming continues to benefit from strong demand from the US, which takes around half of New Zealand's exports. However, both New Zealand and Australia are now running up against their tariff-free quotas for exports to the US in this calendar year (and are likely to face the same problem next year as well). Consequently, the prices offered by US buyers are likely to be depressed over the near term, before picking up again early next year.

Depending on its regional effects, El Niño is also likely to weigh on sectors such as pipfruit and kiwifruit. The impact on viticulture is uncertain, as dry weather reduces volume but can improve the quality within limits.

Figure 11: Dairy payout history



The Trans-Pacific Partnership

After several years of negotiations, the TPP has been agreed in principle by the 12 negotiating nations. The agreement provides for the complete elimination of tariffs on New Zealand's exports, with two exceptions: only partial liberalisation of dairy exports, and a sharp reduction but not removal of tariffs on beef exports to Japan.

Once the TPP is fully implemented, it is estimated that it will provide for tariff savings of $259m a year, based on today's export volumes. This compares to estimated savings of $115m a year from the New Zealand-China Free Trade Agreement signed in 2008. But the experience of the China FTA showed that the gains overwhelmingly come from increased trade volumes and new business opportunities, and will be much larger than the tariff savings alone.

The TPP extends well beyond liberalising trade in goods; it also creates standards in areas such as worker protection and intellectual property. Some instances, such as the extension of copyright, will mean higher costs for New Zealand, but in these cases the impact is more difficult to quantify.

Commodity price monitor

Sector	Trend	Current level[3]	Next 6 months
Forestry	Soft overseas demand has weighed on export prices. Demand from the local building industry remains strong.	Average	→
Wool	Strong demand from China for clothing this year, but looks to be ebbing now.	High	↘
Dairy	Weak NZ milk production this season will support prices in the near term, but the global supply glut has yet to be addressed.	Below Average	↗
Lamb	No obvious trend in prices; demand is solid but supply from overseas remains ample.	Average	→
Beef	Prices paid in US have fallen as NZ approaches import quota, should recover into early next year.	High	↘

[3] NZD prices adjusted for inflation, deviation from 10 year average.

New Zealand Dollar

Mind the gap

The New Zealand dollar's decline has been checked by a rebound in export commodity prices and a delayed start to US interest rate hikes. Nevertheless, we expect the NZD to edge lower against the USD over the next year as the interest rate gap narrows. Strength against the AUD may persist for longer as the latter is weighed down by weak commodity prices.

The latest gyrations in the New Zealand dollar have been consistent with our long-held view that the currency's fortunes are closely linked to the prices of our major commodity exports. After falling to a six-year low against the US dollar in September, the exchange rate has seen a modest rebound on the back of the resurgence in dairy prices. An improvement in the local economic data and some less dovish comments on interest rates by the RBNZ have also provided a boost.

As noted in the Agricultural Outlook, we expect the likelihood of lower milk production due to an El Niño-led drought this summer to keep world dairy prices elevated over the next few months, with corresponding support for the NZD. However, there are a number of other factors that we see weighing against the NZD by the end of this year and into next year. First, the anticipated drought will lead to a sharp slowdown in economic growth over the first half of 2016. This will counter some of the benefits of higher export prices.

Second, we believe that financial markets will be surprised by monetary policy on both sides of the ledger. We expect that the RBNZ will need to cut the OCR further to 2% next year, in contrast to current market pricing which is more in line with the RBNZ's expressed view that only one further cut to 2.5% will be needed.

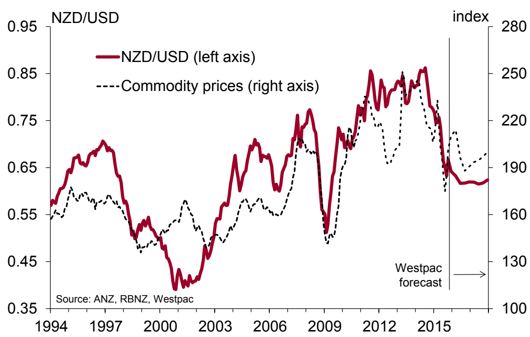
And we believe that the US Federal Reserve is more motivated to raise interest rates than the market thinks. Once that process starts (which we think will be in December), rising interest rates should provide support for a stronger US dollar against other currencies.

Within this environment, we would expect the NZD to fare better than the Australian dollar, at least over the first half of 2016. The AUD continues to be weighed down by weak export commodity prices, reflecting the degree of overcapacity in the global steel market and the softening in demand from China. However, as detailed in the Global Economy section, the Chinese consumer is in relatively better shape, to the benefit of New Zealand's exports which are more oriented towards consumer goods.

Altogether we expect the NZD trade-weighted index to fall by around 7% from its current level over the next year, on top of the 11% depreciation to date from last year's peaks. The consequent pressure on import prices will help to lift the annual inflation rate back above 1% in 2016. But we remain sceptical that a lower exchange rate on its own will be enough to return inflation to the 2% target midpoint on a sustained basis.

Indeed, we have to emphasise that our forecast profile for the NZ dollar is contingent on the RBNZ delivering the further OCR cuts that we are expecting. In contrast, if the RBNZ maintains that 2.5% will be the low point for the OCR in this cycle, a further decline in the NZD would be less likely.

Figure 12: NZD and commodity prices, inflation-adjusted

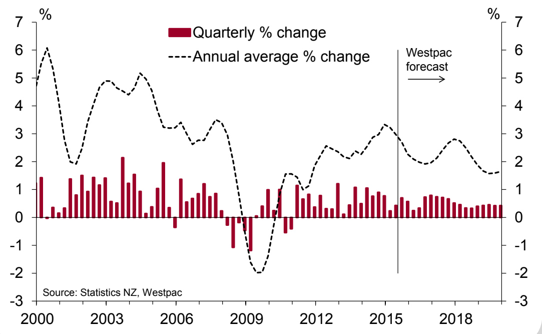


Exchange Rate Forecasts (end of quarter)

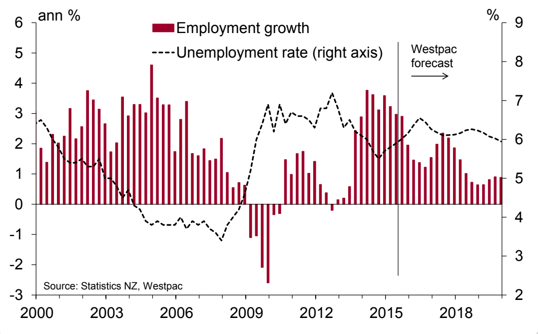
	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Dec-15	0.64	0.94	0.59	0.43	77.4	69.9
Mar-16	0.63	0.95	0.59	0.43	76.2	69.7
Jun-16	0.62	0.94	0.58	0.42	75.6	68.7
Sep-16	0.62	0.93	0.57	0.42	76.3	68.3
Dec-16	0.62	0.90	0.56	0.40	76.9	67.4
Mar-17	0.62	0.89	0.56	0.40	75.0	66.7
Jun-17	0.62	0.87	0.55	0.38	75.0	66.1
Sep-17	0.62	0.86	0.54	0.38	75.0	65.6
Dec-17	0.62	0.87	0.54	0.38	76.1	66.1
Mar-18	0.62	0.86	0.54	0.38	76.3	65.7

Annual average % change	March years				Calendar years			
	2014	2015	2016f	2017f	2014	2015f	2016f	2017f
GDP (production)	2.5	3.2	2.1	2.1	3.3	2.3	2.0	2.8
Private consumption	3.1	3.2	3.0	2.9	3.2	2.9	3.0	2.9
Government consumption	2.7	2.8	2.5	1.1	3.0	2.8	1.1	1.4
Residential investment	16.6	12.3	2.7	-0.1	16.2	4.2	-0.1	-0.4
Business investment	8.4	4.5	0.2	0.3	6.2	0.3	-0.7	6.1
Stocks (% contribution)	0.2	0.1	-0.1	0.0	0.1	-0.2	0.1	0.0
Exports	0.0	4.2	4.6	1.1	3.0	5.9	1.2	2.0
Imports	8.1	7.4	4.5	0.5	7.9	5.5	0.6	2.5
Inflation (% annual)	1.5	0.3	1.3	1.5	0.8	0.5	1.7	2.0
Employment (% annual)	3.8	3.2	1.4	2.0	3.6	1.9	1.5	1.9
Unemployment rate (% s.a. end of period)	6.0	5.8	6.5	6.3	5.7	6.2	6.4	6.2
Labour cost index (all sectors, % annual)	1.6	1.7	1.9	1.6	1.8	1.7	1.7	1.6
Current account balance (% of GDP)	-2.6	-3.4	-4.4	-4.3	-3.1	-3.9	-4.5	-4.2
Terms of trade (% annual)	17.3	-5.6	-5.7	4.0	-5.0	-4.6	3.0	1.0
House prices (% annual)	7.9	9.0	13.1	6.3	6.4	15.5	6.0	3.0
90 day bank bill (end of period)	2.78	3.63	2.30	2.10	3.64	2.60	2.10	2.10
5 year swap (end of period)	4.57	3.71	3.10	3.20	4.16	3.10	3.20	3.00
TWI (end of period)	80.0	77.9	69.7	66.7	77.5	69.9	67.4	66.1
NZD/USD (end of period)	0.84	0.75	0.63	0.62	0.78	0.64	0.62	0.62
NZD/AUD (end of period)	0.93	0.96	0.95	0.89	0.91	0.94	0.90	0.87
NZD/EUR (end of period)	0.61	0.67	0.59	0.56	0.63	0.59	0.56	0.54
NZD/GBP (end of period)	0.51	0.50	0.43	0.40	0.49	0.43	0.40	0.38

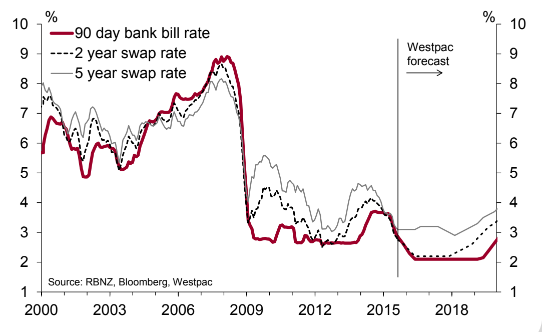
New Zealand GDP growth



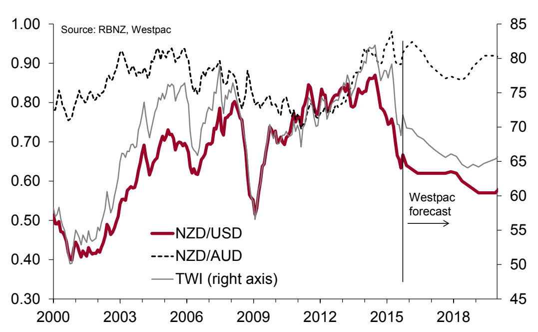
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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