

Weekly Commentary

1 May 2017



Policy wrap

In our February *Economic Overview* we noted that many aspects of government policy were likely to be in play this year, ahead of what's shaping up to be a closely-fought election in September. Indeed, many of the issues that we highlighted back in February have cropped up in recent weeks.

While policy decisions do matter for our economic forecasts, they need to be viewed in the broader context. In some instances, the likely direction of a policy change may already be factored into forecasts, even if it's not explicitly quantified. And sometimes the impact of a policy change can be swamped by other developments.

In the February *Overview* we identified immigration policy as the area where the current government appeared to be most vulnerable. Figures released last week showed a net inflow of 6,000 people in March, lifting the annual net inflow to a record of nearly 72,000. Net migration has lifted New Zealand's population growth to over 2% a year, which is unusually high relative to both our own history and to other developed economies.

Last month the government announced changes to residency requirements, including income thresholds for those considered to be in skilled jobs, and a three-year time limit for lower-skilled work visas. Over time, these changes will probably have an impact on net inflows, although the impact is hard to quantify – it's likely that many people will still try their luck on a temporary work visa, hoping to earn more than the income threshold. So the impact could be in the form of more departures in coming years, rather than an immediate drop in arrivals.

The change in immigration policy is itself a response to the fact that, contrary to forecasts, net inflows haven't slowed

of their own accord. One of the key reasons that the net inflow has remained high is that weak job prospects in other parts of the world, especially Australia, have encouraged Kiwis to either remain here or return from overseas. And we don't see that changing any time soon – we're forecasting the Australian unemployment rate to rise to 6.3% this year. Previously we were expecting net migration to slow to less than 60,000 people by the end of this year, but it's now likely that we'll be revising this forecast higher.

The government has also announced that the Budget later this month will include an additional \$2bn allowance for new capital spending. This is the third increase in the capital spending allowance in the last year (there was an even larger increase of \$5.4bn at the Half-Year Update last December), and reflects the fact that a rapidly growing population requires more spending in areas such as infrastructure.

Population pressures are most apparent in Auckland, with roads, public transport and housing all under pressure. Yet it's hard to pin this on immigration policy alone. Compared with Stats NZ's population projections 10 years ago – a relevant time horizon for decisions around infrastructure spending – Auckland's population is tracking about as expected. (It's true that New Zealand's population as a whole is running ahead of forecast, but the surprise has been outside Auckland.) The under-investment in the city's infrastructure in past years has been by choice.

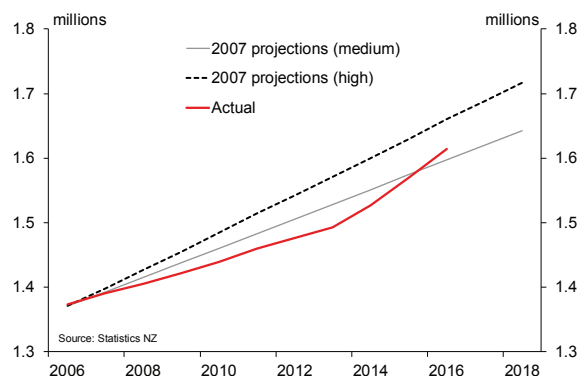
Policy wrap continued

Finally, it looks like some degree of change in the way that the Reserve Bank operates is on the cards. The government has commissioned an investigation into whether the RBNZ should move from a single decision-maker model to a formal voting committee. The main opposition Labour Party has gone further, proposing a committee made up of internal and external members, and the addition of a 'full employment' goal to the RBNZ's legislation, along similar lines to the US and Australia.

Among other central banks, 'full employment' is generally taken to mean a 'natural' rate of unemployment, one that can be sustained over the long term without driving inflation ever higher. This rate is not observable, but estimates for New Zealand generally put it in the range of 4-5%.

If the RBNZ had been given an employment goal along these lines, it's not clear that it would have acted any differently in recent years. The RBNZ's forecasts have typically shown the unemployment rate settling at around 4-5% after three years. In hindsight, those forecasts have proven to be wrong – unemployment (and spare capacity in general) has been persistently higher than forecast. But at the time, the RBNZ was setting monetary policy in a way that it believed would bring unemployment back to its 'natural' level.

Auckland's population



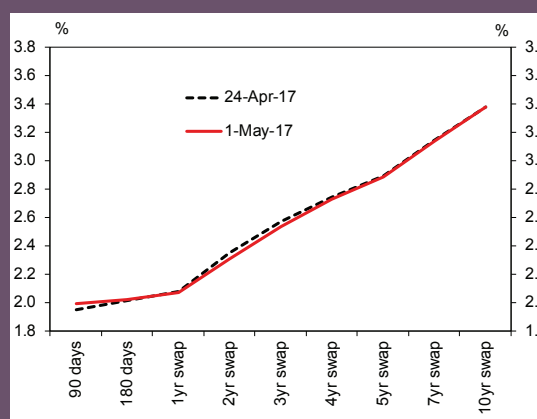
So the value of moving to a voting committee depends on whether those additional decision-makers could challenge the RBNZ's forecasts in a way that leads to better outcomes. This is an area where external committee members might be able to add some value, although that's by no means certain – lacking the resources of the RBNZ's own forecasters, they may struggle to present a credible alternative view.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term still have a chance to lock in at historically quite low levels.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

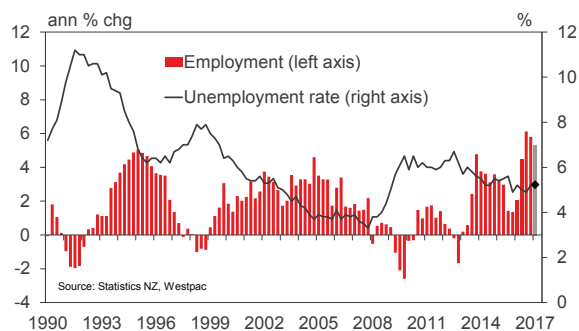
NZ Q1 household labour force survey

May 3, Employment, last: 1.3%, WBC f/c: 0.8%, Mkt f/c: +0.8%

May 3, Unemployment, last: 5.2%, WBC: 5.2%, Mkt f/c: 5.1%

- We expect the Household Labour Force Survey to show that employment levels increased by a solid 0.8% in the March quarter, with gains supported by firm economic conditions as well as strong population growth. Increases in employment are expected to be widespread, with the largest gains expected in service sectors (such as professional services) and construction.
- Labour force participation is expected to nudge higher again in March, taking it a record high of 70.6%. Job growth has encouraged more people to enter the labour market. This has been reinforced by strong net migration. These factors are providing a floor under the unemployment rate, which we expect to remain unchanged at 5.2%

Household Labour Force Survey

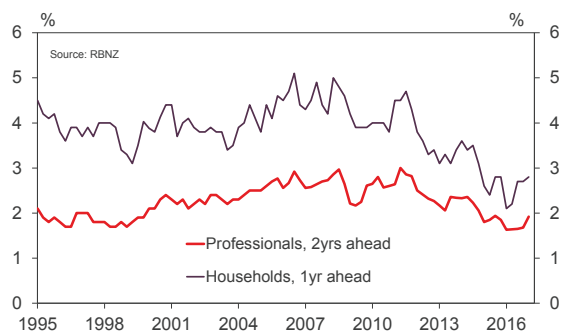


NZ Q2 survey of inflation expectations

May 5, Two years ahead, last: 1.92%

- The closely watched 2-year ahead inflation expectations measure rebounded last quarter, rising from 1.68% to 1.92% - very close to the 2% mid-point of the RBNZ's inflation target range and the highest level since 2014.
- The latest expectations survey was held immediately after the Q1 CPI report, which saw annual inflation rising sharply to 2.2% - the first time it has been above 2% since 2011. While this was influenced by temporary factors, such as food and fuel price increases, it will no doubt have been a welcome surprise to the RBNZ.
- With inflation set to remain around 2% over the coming year, and a firm outlook for domestic activity, we expect that inflation expectations will likely rise again this quarter to levels around the RBNZ's 2% target midpoint.

RBNZ survey of inflation expectations



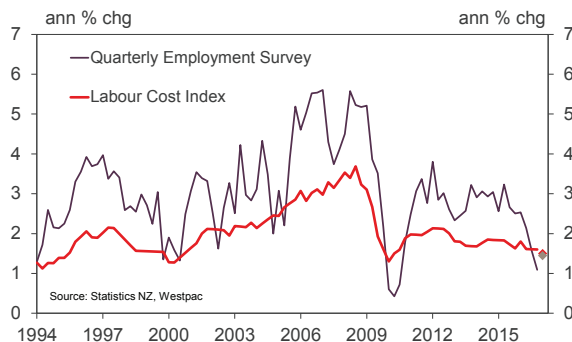
NZ Q1 labour cost index

May 3, Private sector (incl. overtime), last: 0.4%,

WBC f/c: 0.4%, Mkt f/c: 0.5%

- Although the labour market has been strengthening, wage inflation remains low. We're expecting the March quarter Labour Cost Index will show that base wage rates rose by only 1.6% over the past year. Similarly, the broader QES measures of average hourly earnings is expected to have risen by only 1.4% - both largely unchanged from last quarter and still low.
- But while wage growth is currently low, this won't be the case forever. We expect that strong demand for workers, as well as increasing cost of living adjustments will contribute to rising wage inflation over the coming year.

LCI and QES wages



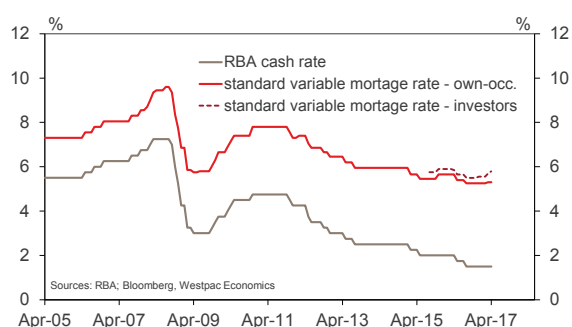
Aus RBA policy decision

May 2, Last: 1.50%, WBC f/c: 1.50%

Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA has left rates unchanged since August last year and is expected to keep the cash rate at 1.5% at its May meeting. The minutes to the April meeting singled out labour and housing markets as key areas being monitored closely. With a stronger than expected jobs gain in March, and new macro-prudential measures recently deployed to deal with housing concerns, developments in both areas will have further cemented the Bank's 'on hold' position.
- The May Statement on Monetary Policy, due Friday, will give a more detailed account of the Bank's views. The growth and inflation outlook is expected to be largely unchanged from Feb but we will be very interested in how the Bank is reading recent labour market and housing policy developments and how risks are shaping.

RBA cash rate & market pricing



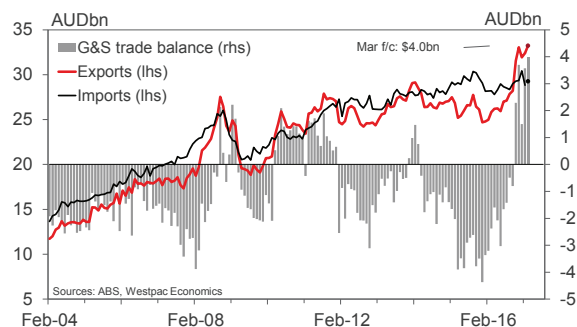
The week ahead

Aus Mar trade balance, AUDbn

May 4, Last: 3.6, WBC f/c: 4.0, Mkt f/c: 3.33, Range: 1.8 to 4.0

- Australia's trade account has moved well into surplus as a spike in commodity prices boosts export earnings. For March, we expect a surplus of \$4.0bn, a \$0.4bn improvement on February.
- Export earnings rise a forecast \$0.8bn, +2.5%. While partial indicators for the month are mixed we see the potential for a boost from upward revisions to history. Notably, goods export prices rose 9.4% in the quarter, suggesting that the monthly export results to date look a little understated. For imports, we've factored in a rise of 1.5%, \$0.4bn. Recall imports were brought forward into January (+3.7%) ahead of a Lunar new year disrupted February (-5.3%).
- *NOTE: Since January 2016, there is additional uncertainty around the import and trade forecast. The ABS no longer publishes customs goods imports ahead of the trade release.*

Australia's trade balance

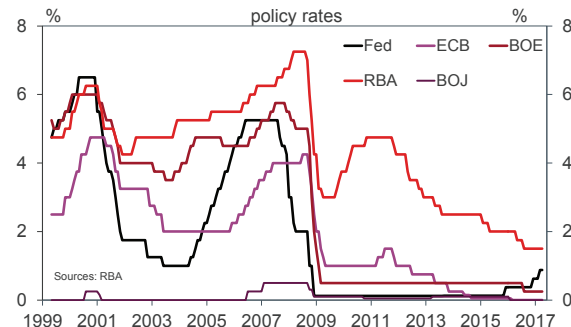


US May FOMC meeting

May 3, Last: 0.875%, WBC 0.875%

- At its March meeting, the FOMC went ahead with a well-telegraphed rate hike, the third in this cycle.
- With full employment having been attained; job and income growth continuing; and inflation near enough to target, there was no cause to delay – particularly given political developments may force them to stay their hand in the future.
- The May meeting will not see a follow-up hike. To our mind, that will need to wait until June. However, market participants will be on the look out for any further guidance in the timing of changes to their other policy lever, the size of the balance sheet. Currently, expectations are centred on a December announcement and January 2018 commencement of balance sheet normalisation.

Developed world policy interest rates

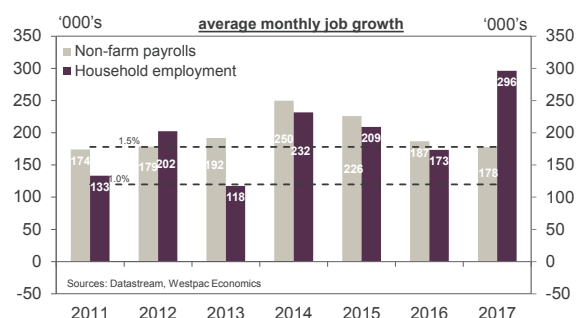


US April employment report

May 5, Last: 98k, WBC 180k

- Through early 2017, as payrolls printed well above expectations, we continued to emphasise that job growth was set to slow, not because the economy had deteriorated but rather simply because full employment had already been attained.
- March's 98k result and the 38k in downward revisions to the prior two months went a long way towards bringing about the pace of jobs growth we had previously anticipated.
- At 178k the Q1 average pace of job creation is still best considered strong. We expect a similar outcome in April, circa 180k. Household survey estimates have been volatile of late, but the level of the unemployment rate should remain broadly consistent with full employment, near 4.6%.

US job creation still strong



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 1					
Aus	Apr AiG PMI	57.5	-	-	Manufacturing expands, on building upswing + lower AUD.
	Apr CoreLogic home value index	1.4%	-	0.2%	Faint hints of a slowdown? Clouded by monthly volatility, seasonality.
	Apr MI inflation gauge %yr	2.2%	-	-	Did better in Q1 but was an unreliable predictor in 2016.
US	Mar personal income	0.4%	0.3%	0.4%	Household incomes continue grow at a solid pace...
	Mar personal spending	0.1%	0.2%	0.2%	... but personal spending has been mixed.
	Mar PCE deflator	0.1%	-0.2%	-0.1%	Inflation to be impacted by energy prices, though core also soft.
	Apr Markit manufacturing PMI (final)	52.8	-	-	Materially weaker than ISM surveys...
	Apr ISM manufacturing	57.2	56.5	-	... which look to be more heavily influenced by sentiment.
	Mar construction spending	0.8%	0.4%	-	Lacks momentum.
Tue 2					
Aus	RBA policy decision	1.50%	1.50%	1.50%	No chance of a move - if anything RBA more firmly on hold.
Chn	Apr Caixin China PMI	51.2	51.4	-	Tracking just above average consistent with growth figures.
Eur	Apr Markit manufacturing PMI (final)	56.8	56.8	-	Very strong of late.
	Mar unemployment rate	9.5%	9.4%	-	Continuing to slowly improve.
Ger	Apr Markit manufacturing PMI (final)	58.2	58.2	-	External and domestic demand aiding activity.
UK	Apr Markit manufacturing PMI (final)	54.2	54.0	-	The lower pound is boosting exporting and manufacturing.
Wed 3					
NZ	GlobalDairyTrade auction	3.1%	-	-	Futures suggest dairy prices will dampen and be slightly lower.
	Apr QV house prices, %yr	12.9%	-	-	Prices have flattened out in Auckland and are slowing elsewhere.
	Q1 unemployment rate	5.2%	5.1%	5.2%	Higher participation is providing a floor under unemployment...
	Q1 employment change	0.8%	0.8%	0.8%	...despite firm economic activity supporting jobs growth.
	Q1 Labour Cost Index incl. overtime	0.4%	0.5%	0.4%	Wage inflation remains subdued for now.
Aus	Apr AiG PSI	51.7	-	-	Services index +2.7pts in March, supported by lower rates.
Eur	Q1 GDP (advance)	0.4%	0.5%	-	Partials indicate improved growth solidifying.
US	Apr ADP employment change	263k	175k	-	Strong in recent months; mixed lead for payrolls.
	Apr Markit service PMI	52.5	-	-	As for manufacturing survey, Markit much weaker than...
	Apr ISM non-manufacturing	55.2	56.0	-	... ISM measure.
	FOMC policy decision, mid point	0.875%	0.875%	0.875%	Guidance on June to come later. Statement to carry robust tone.
Thu 4					
Aus	Mar trade balance, AUDbn	3.6	3.3	4.0	Exports +2.5%, higher prices & possible revisions, see textbox.
	RBA Governor Lowe speaks	-	-	-	Economic Society Business Lunch, Brisbane 1.10pm AEST.
Chn	Apr Caixin China PMI services	-	-	-	Dated versus official measures.
Eur	ECB Draghi speaks	-	-	-	Speaking in Lausanne at an award ceremony.
	Apr Markit services PMI	56.2	-	-	Stronger domestic growth across continent...
Ger	Apr Markit services PMI	54.7	54.7	-	... is aiding services activity.
UK	Apr Markit/CIPS services PMI	55.0	54.6	-	Activity remains moderate, rising inflation weighing on demand.
	Mar net lending sec. on dwellings, £b	3.5	3.3	-	Lending growth has slowed as rising inflation dampens spend.
	Mar mortgage approvals	68.3k	67.5k	-	Housing lending has levelled off since the referendum.
US	Mar trade balance US\$bn	-43.6	-45.2	-	Stronger US dollar an impediment to US productivity.
	Initial jobless claims	257k	-	-	At historically low levels.
	Mar factory orders	1.0%	0.6%	-	Durables rose with core orders up.
Fri 5					
NZ	Apr ANZ commodity price index	0.4%	-	0.8%	Dairy prices picked up again in April.
	Q2 RBNZ inflation expectations 2yrs	1.92%	-	-	Likely to return to 2%+ along with headline inflation.
Aus	RBA Statement on Monetary Policy	-	-	-	Growth and inflation forecasts likely to be largely unchanged.
UK	Apr Halifax house prices	0.0%	-	-	Uncertainty dampening house price inflation.
US	Apr non-farm payrolls	98k	193k	180k	Employment growth should slow through year...
	Apr unemployment rate	4.5%	4.6%	4.6%	... participation and job fluctuations seeing U/E volatility.
	Mar consumer credit	15.206	14.000	-	Auto and student loans continue to drive gains.
	Fed Chair Yellen speaks	-	-	-	Speech on '125 Years of Women's Participation in the Economy'.
	Fedspeak	-	-	-	Fischer, Williams, Evans, Bullard and Rosengren at various events.
Can	Apr Ivey PMI	61.1	-	-	Oil price recovery likely to maintain upward trend.
Sat 6					
US	Fedspeak	-	-	-	Williams in a debate on whether the 'neutral' rate has declined.

New Zealand forecasts

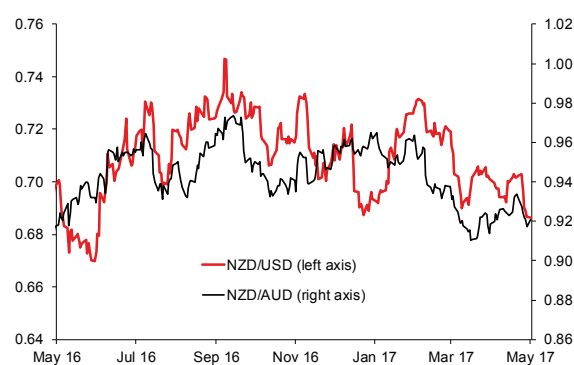
Economic Forecasts	March years				Calendar years				
	% change	2015	2016	2017f	2018f	2015	2016	2017f	2018f
GDP (Production) ann avg		3.4	2.4	3.1	3.3	2.5	3.1	3.2	3.4
Employment		3.2	2.0	5.3	2.1	1.4	5.8	2.3	1.5
Unemployment Rate % s.a.		5.4	5.2	4.9	4.7	4.9	5.2	4.7	4.7
CPI		0.3	0.4	2.0	1.5	0.1	1.3	1.8	2.1
Current Account Balance % of GDP		-3.5	-3.1	-2.5	-2.1	-3.4	-2.7	-2.0	-2.7

Financial Forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.00
2 Year Swap	2.40	2.40	2.40	2.50	2.60	2.70
5 Year Swap	3.00	3.10	3.15	3.25	3.35	3.50
10 Year Bond	3.30	3.50	3.60	3.65	3.75	4.00
NZD/USD	0.69	0.68	0.67	0.66	0.64	0.63
NZD/AUD	0.91	0.91	0.91	0.91	0.92	0.93
NZD/JPY	81.4	80.2	80.4	80.3	79.7	79.4
NZD/EUR	0.66	0.66	0.66	0.66	0.65	0.64
NZD/GBP	0.57	0.57	0.56	0.56	0.54	0.53
TWI	76.2	75.8	75.4	74.9	74.2	73.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 1 May 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.84%	1.90%
60 Days	1.91%	1.90%	1.94%
90 Days	1.99%	1.96%	1.99%
2 Year Swap	2.31%	2.27%	2.32%
5 Year Swap	2.89%	2.80%	2.92%

NZ foreign currency mid-rates as at Monday 1 May 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6865	0.7008	0.7000
NZD/EUR	0.6300	0.6584	0.6565
NZD/GBP	0.5311	0.5577	0.5578
NZD/JPY	76.48	76.35	77.99
NZD/AUD	0.9207	0.9233	0.9170
TWI	74.80	76.24	76.22

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.6	2.8
CPI inflation % annual	2.7	1.7	1.7	1.5	2.2	2.1
Unemployment %	5.8	6.2	5.8	5.7	6.3	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-0.6	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.2	2.4
Consumer Prices %yr	1.5	1.6	0.1	1.3	2.1	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.5	4.4
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.7	-2.8
Japan						
Real GDP %yr	1.4	0.0	0.5	0.6	0.8	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.6	1.2
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.9	1.5
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.6	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.8	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.5

Forecasts finalised 13 April 2017

Interest Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.75	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.57	2.85	3.00	3.05	3.15	3.25	3.40	3.40
International								
Fed Funds	0.875	1.125	1.125	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.29	2.55	2.75	2.85	3.00	3.10	3.30	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
AUD/USD	0.7470	0.76	0.75	0.74	0.72	0.70	0.68	0.66
USD/JPY	111.10	111	112	114	116	117	118	118
EUR/USD	1.0866	1.05	1.04	1.03	1.02	1.01	1.00	0.99
AUD/NZD	1.0865	1.10	1.10	1.10	1.09	1.09	1.08	1.06

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