Macroeconomic outlook

Strong migration-led population growth and tourist inflows remain the key driving forces behind the New Zealand economy. Although GDP growth and inflation outcomes released in the first half of 2017 turned out softer than expected, the New Zealand economic outlook remains positive.

The continued surge in tourist inflows is supporting demand for the construction of new hotels, and lifting activity in the regions not impacted by immigration. The tourism sector received a further boost from the hosting of the World Masters Games and the Lions tour in the June quarter. We expect tourism will continue to underpin robust spending in hospitality and accommodation across the regions through to 2019.

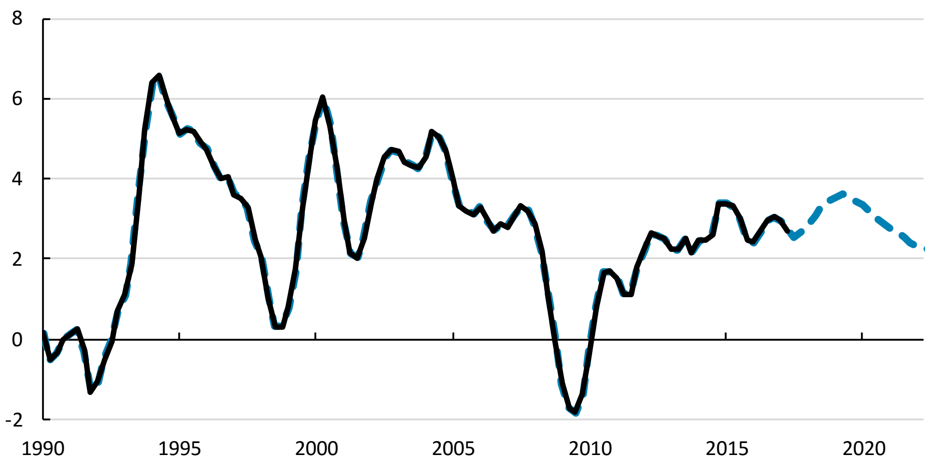
The outlook is also positive for our other largest export: dairy. Global prices for our key dairy export Whole Milk Powder have recovered over the past year, with Fonterra in late July revising up its milk price payout forecast for the 2017/18 season to $6.75 per kg of milk solids. We expect this will support a recovery in on-farm investment over 2018.

The global landscape remains highly uncertain, especially around Brexit, the renegotiation of the North American Free Trade Agreement and the United States' approach to trade with China, as well as its escalating tensions with North Korea. On a more positive note, negotiations on TPP11 have commenced in the wake of the United States' withdrawal from the Trans-Pacific Partnership, with NZ aiming for improved access to key markets including Japan, Canada and Mexico.

The easing in CPI inflation in the June quarter indicated there was little urgency for the Reserve Bank to lift the Official Cash Rate (OCR). While there are pockets of capacity pressures in sectors such as construction, overall inflation pressures remain modest. The easing in housing market activity in recent months also allows the central bank time to assess when it commences monetary policy tightening. We now expect the Reserve Bank will keep the OCR on hold until November 2018, before embarking on a measured tightening cycle.

Figure 1: New Zealand growth outlook remains solid

Annual average % change in GDP



Source: Statistics NZ, NZIER

Table 1: Forecasts for the NZ economy

March year	2015	2016	2017	2018 f	2019 f	2020 f	2021 f	2022 f
Economic activity								
Expenditure on GDP, real, aapc	3.1	3.5	3.1	3.1	3.6	3.4	3.1	2.5
Real GDP per person, aapc	1.7	0.4	0.8	0.7	1.5	1.5	1.2	1.0
Retail sales, real aapc	5.3	4.9	5.1	5.3	4.1	3.9	3.8	3.6
Housing investment, real, aapc	8.8	2.8	10.3	-0.4	6.4	5.0	2.1	-3.1
Other investment, real, aapc	6.1	2.5	4.0	4.2	6.4	6.0	4.3	3.6
Exports, real aapc	4.2	5.8	0.8	2.4	2.1	2.8	2.8	2.9
Imports, real, aapc	7.4	2.1	5.0	3.9	2.4	2.4	2.6	2.6
Current account balance, $ billions	-8.5	-7.8	-8.1	-4.6	-6.7	-8.7	-10.5	-11.7
Current account balance, % of GDP	-3.5	-3.1	-3.1	-1.7	-2.3	-3.0	-3.5	-3.7
Population, millions	4.6	4.7	4.8	4.9	5.0	5.0	5.1	5.2
Population growth, apc	1.8	2.1	2.2	2.0	1.9	1.7	1.5	1.2
Nominal GDP, NZ$ billions	241	251	265	275	286	298	309	320
Nominal GDP per person, NZ$	53,194	54,300	56,168	57,233	58,251	59,603	60,987	62,337
GDP, US$ billions	195	170	188	196	195	201	207	215
GDP per person, US$	43,074	36,817	39,835	40,771	39,829	40,157	40,861	41,766
Prices								
Consumers price index, apc	0.3	0.4	2.2	1.3	1.8	1.9	2.0	2.1
Producers output price index, apc	-2.5	0.1	4.1	3.9	2.9	2.5	2.3	2.3
Labour market								
Average hourly earnings, $, Mar quarter	26.8	27.5	27.8	28.5	29.2	30.0	30.9	31.7
Average hourly earnings, aapc	2.9	2.7	1.5	1.8	2.4	2.7	2.9	2.7
Persons employed, 000s	2,354	2,401	2,538	2,582	2,645	2,688	2,749	2,808
Persons employed, apc	3.2	2.0	5.7	1.7	2.4	1.6	2.3	2.1
Persons unemployed, 000s	135.0	132.0	131.0	127.5	133.5	135.0	134.7	132.4
Unemployment rate, % of labour force, sa	5.4	5.2	4.9	4.7	4.8	4.8	4.7	4.5
Government								
Operating balance, $ billions	0.4	1.8	4.0	3.4	4.3	6.7	7.7	9.7
Operating balance (core), % of GDP	0.2	0.7	1.5	1.2	1.5	2.3	2.5	3.0
Gross core Crown debt, $ billions	95.5	95.0	94.5	91.1	91.8	91.4	86.2	84.7
Gross core Crown debt, % of GDP	39.7	37.9	35.7	33.1	32.1	30.7	27.9	26.4
Financial indicators								
Exchange rate (trade weighted) index (3)	79.2	72.6	76.5	76.0	73.5	72.1	71.0	70.6
USD/NZD (4)	0.75	0.66	0.71	0.69	0.68	0.67	0.67	0.67
AUD/NZD (4)	0.96	0.92	0.94	0.92	0.88	0.86	0.82	0.85
90 day bank bill yield (4)	3.6	2.6	2.0	0.4	0.5	1.2	1.6	2.0
10 year gov't stock yield (4)	3.3	3.1	3.3	3.2	3.4	3.7	3.8	4.0

Notes:
(1) The forecasts and estimates presented above should be regarded as indicative. Data may have been rounded and therefore may not sum precisely.
All annual totals are based on seasonally adjusted data.
(2) For government balances, using generally accepted accounting practice (GAAP) based measure of the difference between current revenue and expenditure.
(3) Exchange rate index is the average level for the year to March.
(4) New Zealand dollar exchange rates and interest rates are the average level for the March quarter.
(5) apc = annual percent change, aapc = annual average percent change, sa = seasonally adjusted

Source: Reserve Bank of New Zealand, Statistics New Zealand, New Zealand Treasury, NZIER estimates and forecasts

NZ credit markets

Long-term interest rates

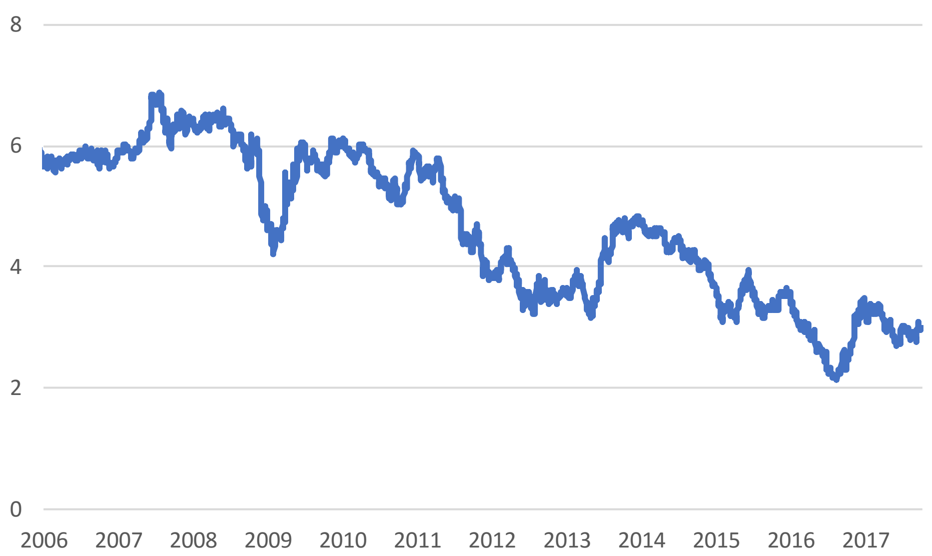
New Zealand bond yields largely eased over 2017 in line with offshore movements, partly retracing the sharp rebound in bond yields that occurred over late 2016. Heightened geo-political tensions raised risk aversion in markets and drove investors towards the safe haven of Government bonds.

Although bond yields started 2017 continuing its ascent on expectations expansionary US fiscal policy would boost inflation, heightened geo-political tensions started to weigh on yields in April. Lower inflation outturns both in New Zealand and the major economies added to the downward pressure on bond yields later in the year.

Over the longer term, the trend remains one of a lift in long-term bond yields as interest rates gradually normalise. An improvement in global growth and pick-up in inflation should underpin a further rise in long-term interest rates from historically low levels, both here in New Zealand and globally. The Federal Open Market Committee is continuing to tighten monetary policy in the US by raising its policy rate and reducing the Federal Reserve's bond holdings, with the tightening in monetary conditions supporting higher interest rates globally.

Figure 2: Long term bond yields eased over 2017 in line with offshore movements

Ten-year government bond yields (% p.a.)



Source: RBNZ

Kauri issuance

Kauri bond issuance in New Zealand has been subdued over 2017, with issuance for the year to date well below record levels reached in 2014 and 2015, when annual issuance totalled NZ$6.3 billion in each of the years. The appreciation in the US and Australian currencies reduced the appeal of foreign issuer to issue in New Zealand. Meanwhile, offshore demand has fallen in light of the declining absolute yield pick-up for high-grade New Zealand bonds, as interest rate differentials between New Zealand and the US narrowed. The proportion of non-resident holdings of outstanding

Kauri bonds fell from 47.5 percent for the year to March 2016 to 42.4 percent for the year to March 2017.

Government and local authority

The reduced supply of Kauri bonds has increased domestic demand for Government and local authority bonds. However, the supply of Government bonds is also tightening, with redemptions of government bonds set to exceed issuance over the coming years.

Meanwhile, many councils including the Auckland Council are reaching their debt ceilings as they borrow to fund spending to cope with the demands of a growing population. This is limiting further issuance of local authority bonds.

Corporate bonds

Demand for corporate bonds is strong against a backdrop of tight supply. Issuance was slow over early 2017, but attractive credit spreads (lower margins over swap rates) and a desire to diversify debt sources away from bank debt is driving increased interest in corporate bond issuance more recently.

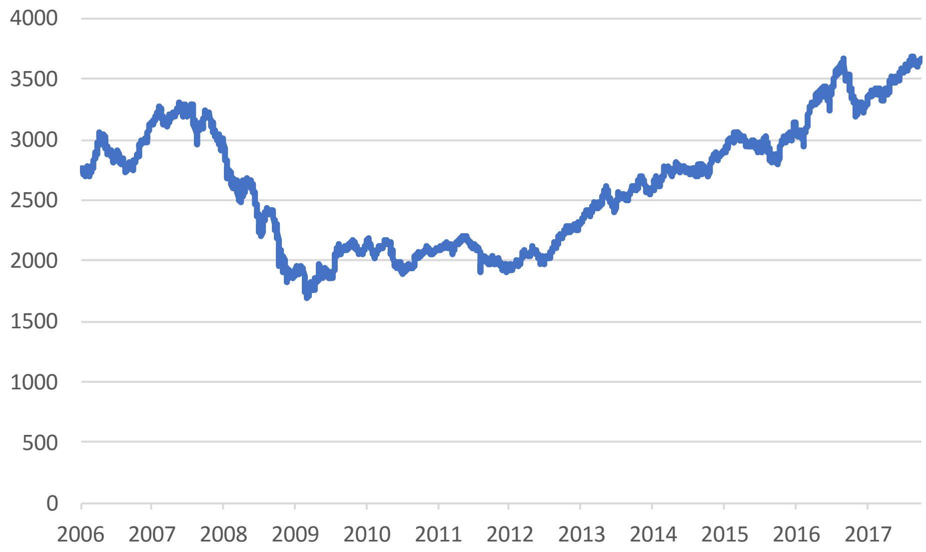
NZ equity markets

The NZX50 index has lifted since the beginning of the year, recording double-digit growth for the year to date. The increase was despite some high-profile profit warnings from some major companies including Fletcher Building and Steel & Tube. The overall favourable New Zealand economic outlook and low interest rate environment has continued to buoy equity markets, despite uncertainty over the New Zealand General Election as well as heightened geo-political tensions offshore. Although business confidence dipped ahead of the New Zealand General Election, businesses continue to plan for expansion through hiring and investment. This indicates confidence about the economic outlook over the coming years.

From a historical perspective, the New Zealand equity market is very buoyant, with the NZX50 index remaining close to record highs above 3,500. This is in line with the performance of equity markets globally, and largely reflects the effects of very low interest rates as investors seek yield in riskier assets. Although there has been heightened geo-political uncertainty stemming from the rise of anti-Establishment sentiment in the US and Europe over 2016, low interest rates has been the dominant influence in supporting equities higher globally in recent years. With the Federal Reserve on track to tighten US monetary policy, higher interest rates should start to weigh on equity markets in the next few years.

Figure 3: NZ equity markets rebounded in 2017, shaking off the geo-political uncertainty of 2016

NZX 50 Index



Source: Thomson Reuters

Corporate earnings

Notwithstanding high-profile profit warnings from Fletcher Building and Steel & Tube, corporate earnings have generally been favourable, reflecting solid demand in the New Zealand economy. Improved farm income is supporting stronger earnings for rural sector companies, while a large inflow of international visitors is boosting the profitability of tourism companies. Positive earnings results are supporting equity valuations.

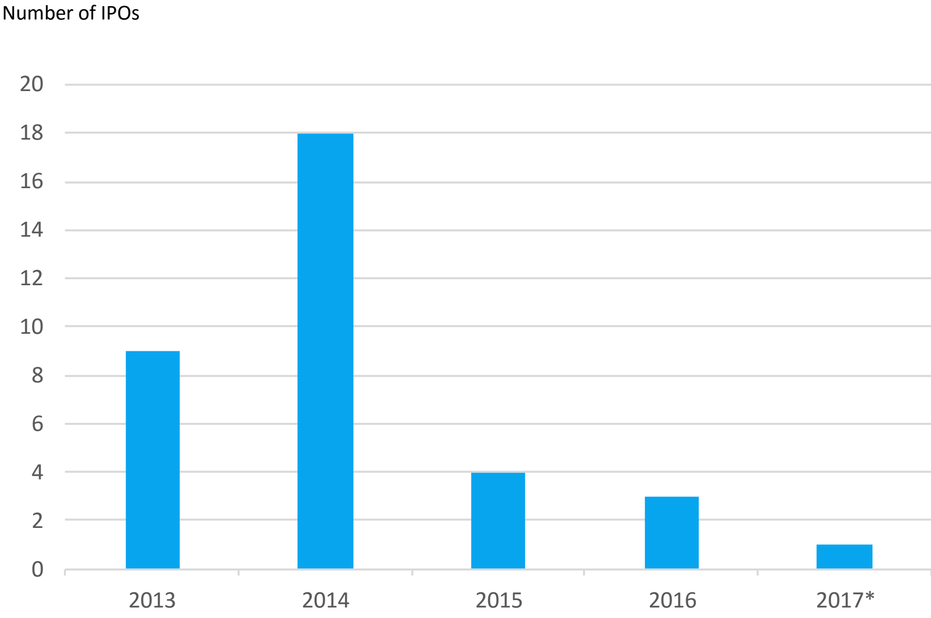
Despite strong construction activity, the competitive environment has impacted negatively on the earnings of construction sector companies. Cost pressures remain high, but firms have found it difficult to pass increased costs onto customers in the form of higher prices.

Capital raising

The pipeline of Initial Public Offerings (IPO) was thin in 2017, despite the strong performance of the sharemarket. The offering of Oceania Healthcare in May was a highlight, and there is the potential for Vodafone Group to list on the NZ Stock Exchange over the coming year.

The number of IPOs in New Zealand has been trending lower in recent years. The high cost of capital raising discourages companies from listing on the NZ Stock Exchange, and there has also been a decline in the number of broker intermediaries to help companies prepare for listing and organise capital raisings. Some NZ companies have favoured listing on the Australian Stock Exchange given the more favourable market conditions and greater liquidity of the Australian sharemarket. The reduced appeal of the NZ Stock Exchange, as well as heightened geo-political risks offshore and uncertainty over the formation of the new Government here in New Zealand, will likely continue to dampen investor appetite for new offerings over the next year.

Figure 4: NZ IPOs have been trending lower



*2017 is for year to August

Source: World Federation of Exchanges

Payment Systems Replacement Programme

The Reserve Bank of New Zealand commenced its Payment Systems Replacement Programme in April 2016, following a strategic review of its clearing, settlement and exchange system. While it would retain its Exchange Settlement Account System (ESAS) and NZ Clear business, it has opted to replace the software underpinning the ESAS with a Real Time Gross Settlement System (RTGS). A Central Securities Depository (CSD) will also be developed to replace the system underpinning NZ Clear.

The Payment System Replacement Project is also on track to replace the infrastructure behind the current ESAS and NZ Clear systems, with the build, physical setup and test programme scheduled to run through to the end of 2017.[1]

[1] See https://www.rbnz.govt.nz/markets-and-payments/payments-system-replacement for further information.