Westpac

Institutional Bank

17 October 2013

Eye on the horizon

Longer-term economic forecasts for New Zealand

- In this bulletin we set out our economic forecasts for the next 10 years.
- We expect New Zealand's economic upswing to continue through 2015. But growth will slow in the second half of the decade as the Canterbury rebuild winds down and the housing market cools.
- New Zealand's trend GDP growth is expected to slow to 2.1% as a result of population aging.
- We expect long-term interest rates to be slightly below historical averages, and the exchange rate to stay historically high.
- We expect inflation to average above 2%.
- See appendix for chart summary.
- Quarterly forecasts to 2023 are available online at **http://www.westpac.co.nz/business/economic-updates/economic-research-and-market-strategy/**

We are often asked for our longer-term economic forecasts. In this bulletin we respond to those requests by extending our forecasts out to 2023.

Why 2023? Looking ahead ten years allows us to trace out New Zealand's current economic cycle to its logical conclusion. The main drivers of that cycle – the Canterbury rebuild and the slow global recovery from the Global Financial Crisis – are unusually long-lived, and will still be shaping economic conditions in the second half of this decade.

Forecasting out ten years is also a way of articulating the economy's 'new normal'. It's short enough to avoid 'blue skies' speculation, but long enough to take into account some important longer-term trends that are already underway, such as population aging, the rising Asian middle class, and changes in the international financial landscape since the financial crisis.

We stress that our forecasts for 2023 aren't meant to be precise predictions. In fact, we can be almost certain that the economy won't be at its 'new normal' in 2023 – some as yet unknowable shock will have bumped the economy in one direction or another before then. Instead, these forecasts are

Key long-term forecasts and historical averages

	1993-2002	2003-2012	2013-2017	2018-2022	2023
GDP	3.6	2.3	2.7	1.8	2.0
Employment	2.3	1.5	1.7	0.7	0.9
Labour productivity	1.2	1.1	0.8	1.1	1.2
CPI	1.9	2.6	2.0	2.2	2.5
Wages	2.5	3.5	3.1	3.0	3.4
Nominal GDP	5.5	4.9	5.0	4.0	4.6
Current account (% GDP)	-4.5%	-5.6%	-4.6%	-3.7%	-3.6%
NZD/USD	0.56	0.70	0.76	0.71	0.71
NZD/AUD	0.84	0.84	0.87	0.86	0.87
90-day interest rate	6.9	5.4	4.3	4.9	5.2
2-year mortgage rate	-	7.3	6.7	6.7	6.9
House prices	5.3	7.6	3.3	2.5	4.6

our best assessment of the future state of the economy, given what we do know today.

We begin this bulletin by briefly describing how we expect the current cycle to play out. We then outline our key longer-term assumptions.

A summary of our longer-term forecasts is provided in the table below. Our full set of quarter-by-quarter economic and financial forecasts for New Zealand has now been extended out to 2023. These forecasts are available on our website, at http://www.westpac.co.nz/business/economic-updates/economic-research-and-market-strategy/, and will be kept updated on a regular basis.

Key long-term forecast and historical averages

How will the current cycle play out?

New Zealand is now enjoying a bona fide upswing in domestic demand, thanks to a combination of very low interest rates, a resurgent construction industry, and favourable export prices.

We expect this upswing to continue for the next couple of years. On our estimates the Canterbury rebuild has only reached about half its peak pace. A building response to the housing shortage in Auckland has only just got going. Construction activity is likely to continue accelerating through to 2015, eventually dominating the economy to an extent not seen since the mid-2000s.

That said, we don't expect the spillovers from this construction boom to be as spectacular as in the 2000s. One reason is that we expect interest rates to gradually rise over the next two years, and the housing market to slow. Current low interest rates are a response to the slow global and local recovery from the 2008/2009 recession, but they are not a 'new normal'. As construction activity continues to build, interest rates will have to rise to keep inflation in check.

A second reason why we expect solid, but not spectacular growth, is fiscal austerity – another legacy of the Global Financial Crisis.The Government is targeting a return to surplus by 2015, and financial markets and rating agencies expect it to stay on track. We expect this government savings drive to partially offset the income growth generated by the Canterbury rebuild.

These features of our forecasts will be familiar to many of our readers. But what will happen once the Canterbury rebuild peaks – as we expect to happen by 2016?

In our view, it's safe to expect an economic slowdown of some magnitude. As reconstruction activity in Christchurch slows, it will turn from an engine of growth to a drag on growth. At the same time interest rates will be approaching their peak: by 2016 we expect mortgage rates to have pushed above 7%. In our view, house price rises will be increasingly hard to sustain at those interest rates – indeed, outright price falls will become likely. With house prices no longer rising, home-owners are likely to retrench and turn their focus back to managing debt. And while we are optimistic that global food demand will keep export prices high by historical standards, we wouldn't go so far as to forecast another surge.

So the only real question is how sharp the downturn will be. That really depends on how exuberant things get in the next couple of years. While we regard a 'boom-bust' scenario as a real risk, it's not our central forecast. It is simply not possible to predict the magnitude and timing of such a scenario. Hence we've gone for a relatively orderly, but long-lived, downswing through the second half of the decade. In particular, we assume that:

- Construction activity will gradually wind down, with some support coming from the protracted rebuild of the Christchurch CBD, residential building in Auckland, and ongoing infrastructure development and quake-strengthening work across New Zealand;
- The housing market will go through an extended 'cooling-off' phase, with prices flattening off in 2015 and modestly falling through 2016-17;
- Inflation will peak in 2015 and slowly start heading back towards 2% over 2016-17. That will allow the Reserve Bank to start cutting the OCR from 2017 onwards, cushioning the downturn.

2023: The economy's 'new normal'

Absent major productivity catch-up, we expect slower economic growth

New Zealand's population has been aging ever since the late 1960s, thanks to increasing life expectancy and smaller families. This process will accelerate over the next two decades as more baby boomers enter retirement age.

More elderly people will mean higher mortality rates, lower birth rates, and slower population growth. We expect the population to grow just 0.8% a year by 2023, compared to an average growth rate of 1.1% over the past ten years, and 1.2% over the 1990s.This is in line with United Nations and Stats NZ projections, both of which anticipate that population growth will slow further in subsequent decades.[1]

By itself, this will mean slower economic growth, via slower growth in the labour force. Indeed, compared to previous decades the slowdown in available labour will be even more pronounced than the slowdown in the overall population. That is because population aging will weigh on labour force participation – a marked change from earlier decades, when rising female employment boosted participation. Granted, the percentage of those aged 65+ who have stayed in the workforce has been steadily rising over the past 10 years and will probably keep rising for some time. The labour force will also will get a modest boost when the 'baby blippers' who were born over 2007-2010 turn 15. But by 2023 a shrinking pool of prime-age workers (among whom participation is

[1] Because of New Zealand's small population, net immigration generates major cycles in population growth. However, we assume that the net immigration rate will settle at its historical average of about 0.3% of the population (about 14,000 people in 2023).

higher in the first place) will outweigh those positives. Older workers may also work fewer hours.

Of course, economic growth also depends on productivity gains - continued investment in (human and physical) capital, as well as that elusive elixir, technical progress.

Prospects for New Zealand's productivity growth are a notorious bone of contention. It is frequently assumed that because New Zealand's productivity levels have so much catching up to do, they will. For example, in its long-term economic projections for New Zealand the OECD explicitly assumes that the productivity gap with the OECD average will gradually close. Equally, the data suggest New Zealand suffers from 'capital shallowness' compared to its economic peers, suggesting capital investment could keep boosting growth for some time.[2]

We are sceptical, at least as far as the next ten years are concerned. After all, why has the productivity catch-up not happened so far? We struggle to see what might happen to trigger it in future. The Canterbury rebuild is an investment boom on massive scale, but it largely replaces what was destroyed. As we detail below, we expect New Zealand interest rates to remain relatively high on average in future, which will continue to weigh on investment. New Zealand's tax structure, which favours the ownership of land over other assets, is well-entrenched. And there are strong arguments to be made that New Zealand's geographic isolation and small population are at least as great a productivity barrier as any regulatory features of the economy.

At the same time, there are reasons why global productivity trends may slow: the effects of the Global Financial Crisis may prove long-lived, population aging may itself weigh on productivity, and finite natural resources may increasingly constrain global growth.

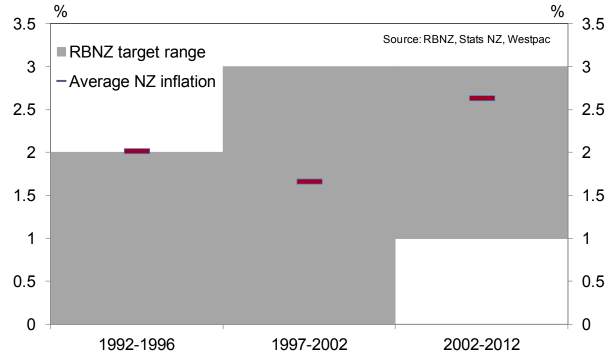
Without wanting to be too pessimistic, we've conservatively decided to assume that the 'new normal' for New Zealand's labour productivity growth will be similar to its average over the past two decades, which is about 1.2% per year. Along with a more slowly growing labour force than in the past, that implies slower trend economic growth than we've become used to – we expect just 2.1% by 2023, compared to an average of 3% over the past twenty years.

Inflation will continue to average above 2%

The third key input into our long-run forecasts is inflation. Beyond five years or so that largely boils down to a view about how the Reserve Bank will evolve.

Under RBNZ Governors Brash and Bollard, New Zealand's inflation-targeting experience had two consistent features. Inflation averaged in the upper half of the Reserve Bank's inflation target range, and the target range was itself steadily relaxed and ratcheted up over time.

Where has inflation been compared to RBNZ targets?



Of course, the Policy Targets Agreement (PTA) signed by Governor Wheeler in September last year broke with this trend, explicitly directing the Reserve Bank to focus on the 2% mid-point of the target range. That may well result in lower average inflation during Governor Wheeler's tenure. However, in 10 years' time we will very probably be dealing with a different Reserve Bank Governor, a different Government, and a different PTA. And history shows that the temptation to 'buy' just a bit more short-term growth with just a bit more inflation is very powerful. So we wouldn't be surprised to see average inflation drift back up.

In our view, this wouldn't have any long-term benefits for New Zealand, and could have serious costs. It wouldn't mean lower interest rates, as investors would eventually demand higher yields to compensate them for higher inflation. It wouldn't improve New Zealand's long-term competitiveness, because any fall in the exchange rate would eventually be undone by higher NZ dollar prices. What it would do is worsen New Zealand's tax bias in favour of land ownership and against other forms of investment via the lack of a capital gains tax (real estate becomes more valuable as a tax hedge when inflation is higher). The New Zealand economy could become even more focussed on agriculture and housing.

That said, we wouldn't want to take this logic too far. In particular, there is still a strong international consensus that targeting inflation below 3% is a good thing, which has so far survived the Global Financial Crisis intact. We think the hurdle for New Zealand to step outside the mainstream would have to be quite high. So for 2023 our inflation forecast is 2.5%.[3]

Rising global demand for food will keep the NZ dollar at historically high levels

Over the long haul, exchange rate trends depend on two main sets of economic fundamentals:[4]

- Relative inflation: A currency experiencing persistently high inflation gradually loses its value, which ends up being reflected in a lower exchange rate.

[2] See OECD (2012), 'Looking to 2060: Long-term global growth prospects', and NZIER (2011), 'Industry productivity and the Australia-New Zealand income gap'.

[3] Among OECD economies, only Chile, Hungary, Korea, Mexico and Turkey have inflation target mid-points at 3% or above.

[4] See our occasional paper, 'A forecasting model for the NZD/AUD exchange rate' for more detail, at http://www.westpac.co.nz/assets/Business/Economic-Updates/2011/Explaining-the-NZ-Australian-exchange-rate.pdf.

- Relative productivity and export earnings: A country that earns relatively high global returns from its export industries can sustain relatively high prices and wages across the economy – which usually happens via a high exchange rate.

The overriding factor that has allowed the NZ dollar to appreciate against most currencies over the past two decades is the rise in global food prices, which has boosted New Zealand's terms of trade. Over the next 10 years, we expect global food prices (notably dairy) to be supported both by the ongoing development of Asian retail markets, and by New Zealand's competitive strength in these markets. This is likely to keep the NZ dollar at historically high levels against the US dollar, euro, or pound, though probably not quite at recent peaks.[5]

The situation isn't quite so clear-cut for the NZD/AUD. We suspect that over the long haul, 'soft' commodity exporters like New Zealand will do better out of the rise of Asia than 'hard' commodity exporters like Australia. After all, investment booms, even ones as massive as China's, eventually mature, while changes in diets and consumption patterns can last a lot longer. (Arguably, the recent strength of dairy and other food commodity prices is already a symptom of China's rotation from an investment-led to a more consumption-focussed economy.)

That, plus the fact that Australia has tended to see slightly higher average inflation than New Zealand (in line with the RBA's higher inflation target), would argue for the NZD/AUD to drift higher. But we have to balance that against Australia's better record on productivity, which we don't expect to change any time soon. Weighing up the risks, our long-run forecast for the NZD/AUD is $0.87 – close to its average over the past 25 years when adjusted for inflation.

What about New Zealand's high foreign debt and persistent current account deficit – won't that eventually require a downward adjustment in the NZD? We certainly agree that the exchange rate is vulnerable to a global funding shock. But such a shock would most likely coincide with a sharp fall in New Zealand's export earnings, such as a steep fall in global commodity prices. While that's always a possibility, it's not our central outlook. On our relatively upbeat commodity price forecasts, the trade balance will return to a modest surplus later this decade, and our net foreign liabilities will settle close to 80% of GDP, roughly where they were back in 2008.

Interest rates are currently below their long-run level

The 'new normal' for interest rates is possibly even more controversial than New Zealand's productivity prospects. In our view, the future trend level for interest rates is probably lower than it was before the Global Financial Crisis, but substantially above where interest rates currently are.

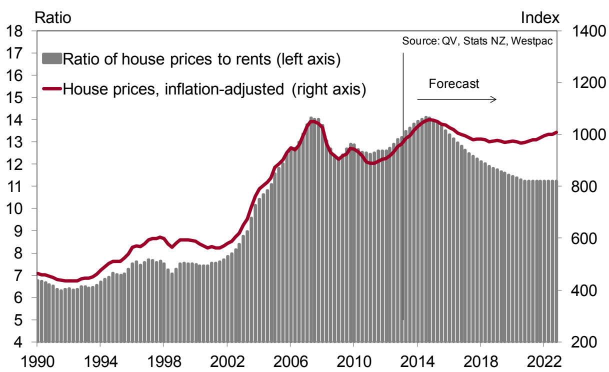
We've long maintained that while the RBNZ can push the OCR temporarily above or below average, it can't affect that average level as such.[6] That depends on the returns demanded by local and global investors. And those in turn depend on factors like expected inflation; expected economic growth in New Zealand and offshore; and global and local savings appetites.

On balance, we think these factors do point to a lower average OCR in future – perhaps 5%, compared to the pre-2009 average of over 6%. (This is our estimate of where the 'neutral' OCR will be in 2023.) Our long-run inflation forecast is close to historical averages, but we anticipate that population aging will lead to slower economic growth, both in New Zealand and offshore. And depending on how long the after-effects of the Global Financial Crisis boost saving rates in New Zealand and globally, we could see additional persistent downward pressure on interest rates.[7]

However, the post-GFC reality also means that the 'new normal' for lending and deposit rates has probably fallen by less. Since the Global Financial Crisis banks have shifted into safer, but more expensive forms of funding such as retail deposits and longer-term wholesale funding. So while bank funding costs have fallen from their post-GFC highs and are likely to fall further, we don't expect them to come all the way back to levels seen before 2008.

The upshot is that we expect mortgage rates to average 7% in future, compared to an average level of about 7.5% over the past ten years. That has important implications for the housing market. We expect that mortgage rates will have to rise above this new average to keep inflation in check. As mortgage rates rise, they will crimp housing affordability, worsen net returns for landlords, and skew the rent-or-buy decision away from buying. Of course there are still many unknowns for house prices, such as what will happen to the tax structure over the next ten years, or to what extent new building will relieve pressure on rents. But even if (as we assume) rents grow at an average rate of about 4% a year, and there are no major tax changes, we wouldn't be surprised to see house prices actually fall by 2016, and to fail to keep pace with inflation through the second half of this decade.

Long-term house price trends – Westpac forecasts



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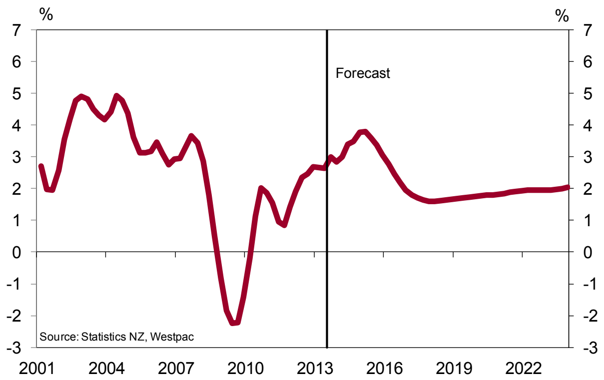
[5] Another exception is the NZD/JPY, where years of Japanese deflation have caused the exchange rate to trend down over the past two decades.

[6] See our 2010 bulletin, 'A matter of interest', at http://www.westpac.co.nz/assets/Business/Economic-Updates/2012/Bulletins-2012/Amatterofinterest.pdf.

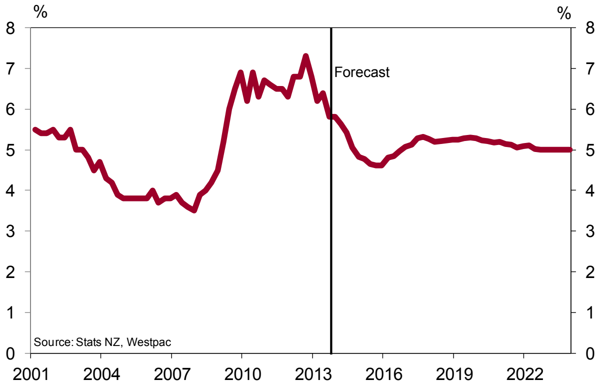
[7] Financial and economic reform in China and other emerging economies could potentially work in the other direction, lowering saving rates in those economies and generating new opportunities for global investors. But we assume this process of global financial 'rebalancing' will continue to be gradual.

Chart summary of key forecasts

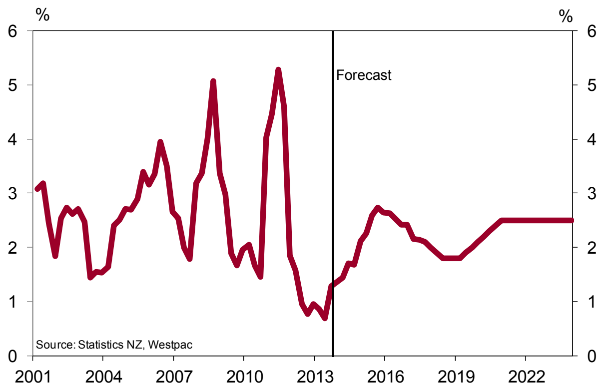
GDP growth (annual average % change)



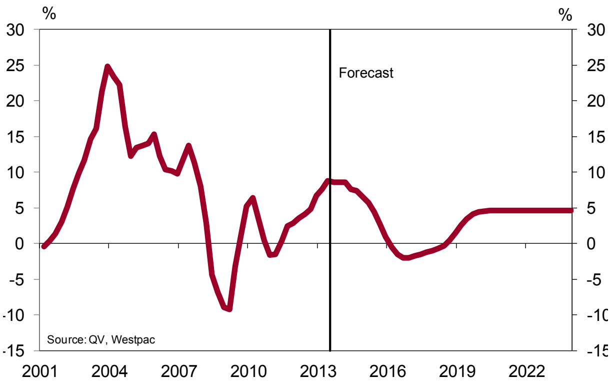
Unemployment rate



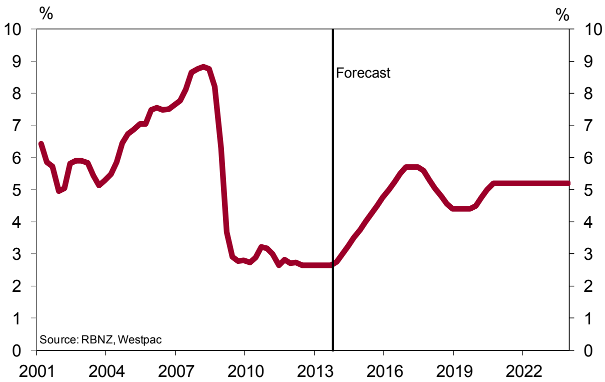
Annual inflation



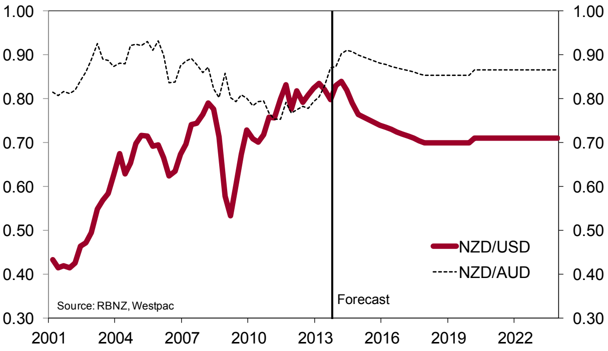
House price inflation (annual % change)



90-day interest rate



NZD/USD and NZD/AUD exchange rates



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