Economic Overview

February 2014

Cream of the crop

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Note from Dominick

Over 2013 the New Zealand economy closely followed the narrative we laid out for it at the start of the year. As anticipated, the post-earthquake Canterbury rebuild proved a substantial boost to GDP, but the high exchange rate suppressed inflation and forced the Reserve Bank to keep interest rates low. Low interest rates had the side-effect of provoking double-digit house price inflation, which in turn stimulated consumer spending.

In many respects our forecasts for 2014 represent the next phase of the same narrative. This year is likely to feature a lighter mood and freer spending on the part of businesses and households. But a greater proportion of that spending will be imported, so overall GDP growth will probably continue at about the same quarterly pace as it reached in late-2013. For financial markets, we expect the exchange rate to remain high and short-term interest rates to rise under steady guidance from the Reserve Bank. Under those conditions, house prices can be expected to rise at a slower pace than they did last year.

Our first *Economic Overview* of 2014 also brings to the fore a new twist on an old theme. New Zealand's export prices have reached stratospheric levels. This time the high prices are specific to New Zealand, unlike 2007/08 when we took part in a global commodity price boom. The drivers are starting to look more structural than cyclical. And this is no longer just about the $5 billion increase in income the dairy industry is experiencing this season - a wide range of sectors are benefitting.

We have adopted an even more bullish forecast for New Zealand's terms of trade this decade. The implications are many and varied, and are discussed throughout this document.

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New Zealand Economy

The next step

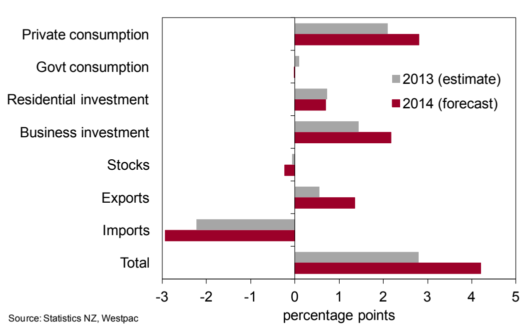
It is now widely accepted that a surge in construction and a buoyant housing market have kicked the economic expansion into a higher gear. Yet we expect that these two factors will be less dominant in 2014 than they were in 2013. Instead, the sustained strength of New Zealand's terms of trade will come to the fore.

Recent data confirms that our positive take on the New Zealand economy's growth prospects is coming to fruition. At the start of 2013 we predicted that GDP growth would reach 3% that year; based on the results for the first three quarters and our assessment of the December quarter, growth for the full year should come in at 2.8%, with the unexpectedly severe drought early last year more or less accounting for the shortfall.

The turn in the economy's fortunes was particularly apparent over the second half of the year. The 1.4% lift in GDP in the September quarter was partly led by a swift rebound in milk production to pre-drought levels, but also implied a lift in underlying momentum. Since then, a broad range of indicators have pointed to December quarter growth in excess of 1%, even in the absence of a further boost from agricultural production.

Indeed, the GDP figures alone don't fully convey the breadth of the improvement. Business surveys over 2013 consistently reported growth across a range of manufacturing and service industries, retail spending growth has accelerated, commodity exporters have enjoyed high prices, and consumer and business confidence have reached new cycle highs (on some measures the latter is at its highest in two decades). In recent months we've also seen a corresponding rise in hiring and investment intentions. This suggests that more businesses are moving beyond just hoping for an improvement in conditions and are now prepared to act.

Figure 1: Contributions to GDP growth in 2013 and 2014

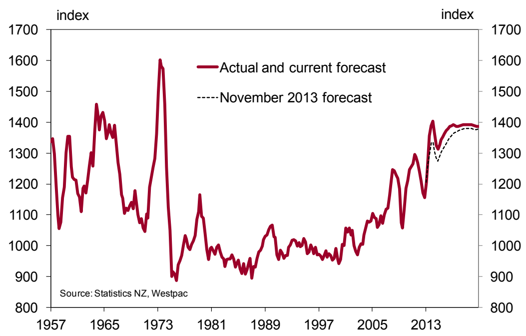


We expect GDP growth to accelerate to 4.2% this year, compared to 3.8% in our November 2013 *Economic Overview.* Over the last two years, we have highlighted a lift in construction activity and a resurgent housing market as key catalysts for the economy's upturn. These two factors will continue to play a major role in the level of economic activity this year, but they have probably passed their peaks in terms of the rate of growth. Instead, we expect them to share the spotlight this year with a third factor, namely, a sharp and sustained lift in national income as a result of New Zealand's record-high terms of trade.

Trading places

Since the November *Overview,* we have upgraded our assessment of the sustainable long-run level of the terms of trade. We recognise that there are substantial risks to this view – particularly in light of the recent wobbles in some global markets – and it's not a judgement that we came to lightly. Indeed, we've been only gradually persuaded by two factors: the sheer level of New Zealand's export commodity prices, at a time when the global economy is fairly lacklustre, and the massive shift in New Zealand's level of engagement with the Chinese market in recent years (see the Agriculture section).

Figure 2: Terms of trade forecasts

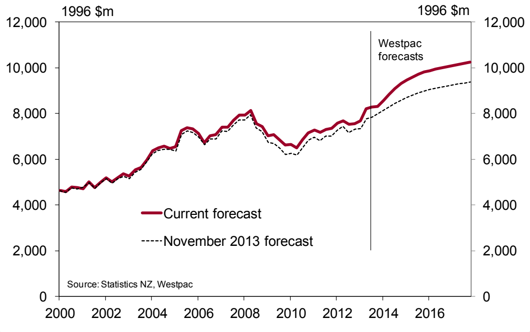


It's difficult to find precedent for such a significant step-change in New Zealand's trade performance. While the terms of trade have been higher in the past, such as in the 1973 boom, that period of prosperity (and eventual overheating) was much shorter-lived than what we're proposing (within two years the OPEC oil shock had sent our terms of trade down to record lows).

The benefits to the New Zealand economy over the next year alone will be substantial. The combination of higher world prices and higher export volumes (which were depressed last year by a severe drought) translates to an income boost of nearly $5bn this year. If high export incomes are to become a regular feature rather than a one-off, the impact on the wider economy will be greater still.

The boost to nominal incomes will flow through to real activity in myriad ways, which are not easy to pin down. Our forecasts assume that around half of the income boost will be saved or used to pay down debt; the other half will translate into higher household spending, construction activity and business investment in plant and equipment. Business investment in particular tends to be strongly pro-cyclical, and with a large imported component; there is already tentative evidence for a sizeable upswing, based on surveys of business intentions and a strong lift in imports of capital equipment in recent months. However, the effect on balance will still be higher savings and a smaller current account deficit.

Figure 3: Real business investment forecasts



Another significant transmission channel is the exchange rate; in keeping with our higher terms of trade projections, we now expect the New Zealand dollar to remain elevated for a longer period. This will also support higher consumption and investment growth, as cheaper imports give households and firms more purchasing power.

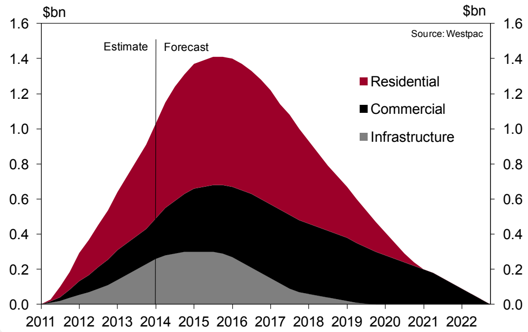
There are some significant distributional effects from a higher exchange rate. Those industries that do not benefit from strong commodity prices, such as manufacturing and tourism, will find conditions tougher. Secondly, firms will find it relatively more attractive to expand their capacity by importing capital equipment than by hiring more workers. This will tend to benefit the economy over the long run, via a deepening of the capital stock that improves productivity. But it highlights one reason why the fall in the unemployment rate could be more gradual this time compared to past cycles.

A higher exchange rate also implies that tradables inflation will remain subdued for longer, providing a substantial offset to the build-up of domestic inflation pressures as the economy uses up its spare capacity. For this reason, our forecast of the OCR in coming years is little changed despite an upgrade to our economic growth forecasts.

House rules

Residential construction has already seen a substantial rebound from its recessionary lows. Post-quake reconstruction in Christchurch played a substantial part in this, and a surge in building consents over the second half of 2013 supports our view that full rebuilds are on track to overtake repairs as the dominant driver of growth this year. Rising house prices have also spurred more building, particularly in Auckland. This has gone some way towards addressing the shortfall of new houses that had developed since the recession (and as we discuss in our Special Topic, new Census data reveals that the shortfall in Auckland is less than previously thought). Nationwide housing construction rose by an estimated 19% over 2013; we expect that to edge down to 16% growth this year – though obviously from a stronger starting point.

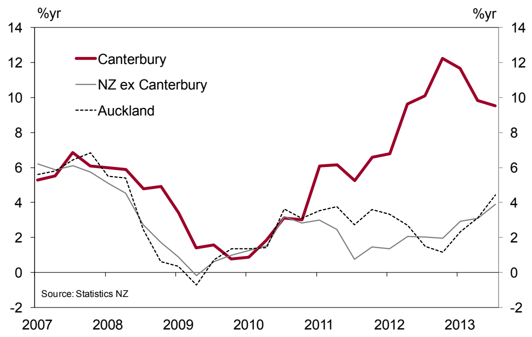
Figure 4: Quake rebuilding profile



While construction as a share of GDP remains below its previous highs, it is moving into territory where capacity constraints have been a major issue in the past. Dwelling construction prices continue to rise rapidly in the Canterbury region, but there is growing evidence that prices are accelerating across the rest of the country (see figure 5 overleaf). We have long expected that this would happen, in contrast to the Reserve Bank's assumption that construction cost pressures generated by the quake rebuild would remain contained (an assumption that appears to have been dropped recently).

There is no doubt now that the housing market has

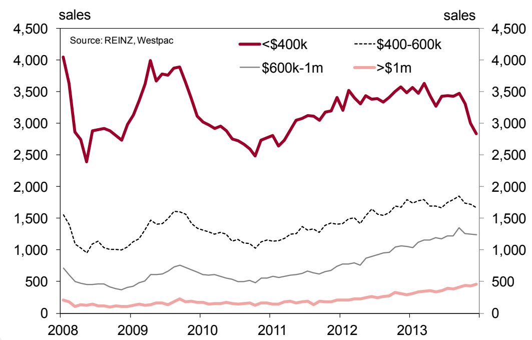
Figure 5: Dwelling construction price inflation



passed its peak. Sales fell by 11% in the three months to December, the average time to sell is lengthening, and there are early signs that house prices are rising at a slower pace. After a 10% rise in prices last year, we expect annual house price growth to slow to 6.5% this year.

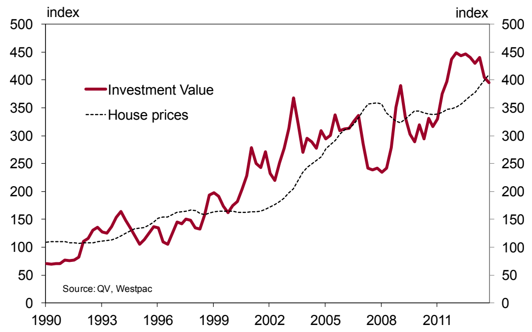
The RBNZ's limits on high loan-to-value ratio (LVR) mortgage lending have been in place since 1 October. Given that overseas evidence suggests that the impact of such restrictions tends to peak after 3-6 months, our conclusions on their effectiveness are only tentative. But it looks to be panning out much in line with our assessment in the August 2013 *Economic Overview.* The drop in sales has been concentrated in the lower-priced end of the market, which is consistent with first-time buyers being hit hardest by the regulations. Meanwhile, two-tier mortgage pricing and lenders' efforts to grow the low-LVR portion of their loan books (if anything, they seem to have been surprised by the potential for growth in this area) have created some very favourable conditions for buyers with large enough deposits. Our judgement remains that the impact on house price inflation will be modest.

Figure 6: House sales by price bracket



We expect that higher interest rates will be the main restraint on house price growth this year. Our investment value approach shows that the valuation gap has already closed as term mortgage rates have risen over the last six months. Rising incomes and stronger net immigration make it difficult to argue for a downward correction in prices in the near future, but we expect prices to start flattening out by next year.

Figure 7: Investment value of housing



The relative underachievers in the economy's current upturn are more or less the same as we have discussed previously. Government spending will remain a drag on the pace of growth compared to past recoveries. Our forecasts are based on a continuation of current policies, with a recognition that the improvement in the fiscal accounts will give both sides room to offer a little more ahead of this year's election. So regardless of the election outcome, we are allowing for a little more spending over 2015-16 than the Treasury's official projections.

The labour market is typically a lagging component of economic upturns, and the pickup to date has been very subdued. However, with the economy moving closer to its non-inflationary capacity, and employment intentions now turning higher, we see scope for a more meaningful reduction in the unemployment rate this year (down to 5.1%). Wage growth should also pick up over the course of this year, though with even more of a lag; the legacy of historically-low inflation last year will continue to have some bearing on wage negotiations.

One final point: while it's perhaps too soon to begin highlighting the 'downhill run' that will be associated with the eventual end of the Canterbury rebuild and slower house price inflation, we nonetheless emphasise that it remains a feature of our long-term forecasts. The current angst in the Australian economy, as its boom in mining investment starts to wind down, is a useful pointer to what New Zealand could be facing a few years from now.

New Zealand Dollar

Points of difference

The US Federal Reserve's decision to 'taper' its asset purchases has put some currencies under fresh pressure, but not the NZ dollar. With soaring export prices now rivalling the Canterbury rebuild as a special feature of the NZ economy, we don't expect a serious correction in the exchange rate until well into 2015.

When US Fed Chairman Bernanke first announced in May that he was contemplating easing off the monetary accelerator, the more volatile currencies around the world embarked on a substantial slide. The sell-off was temporarily interrupted by the Fed's surprise decision to delay 'tapering' in September. But now that tapering is underway, some emerging market exchange rates have experienced fresh routs, while the Australian dollar is at three-year lows.

The NZ dollar has been a remarkable exception. While the Kiwi also took a tumble in mid-2013, since September it has clawed back most of its losses, rising to 7-year highs against the Australian dollar in the process. Clearly, the New Zealand economy has been a special case in investors' minds, defying both the gravity of monetary policy normalisation in the US and signs of a slowdown in China.

Arguably, the Fed's decision to taper has helped focus investors' minds on the New Zealand economy's points of difference, just as it has exposed vulnerabilities in some emerging economies. The big story setting New Zealand apart ever since 2011 has been the immense task of the Canterbury rebuild. That is now tangible reality and has further to go. What has emerged as a new theme since late last year is just how unusual New Zealand's trade patterns have become. Recent growth in China's imports from New Zealand has far outpaced growth in imports from elsewhere. We suspect this reflects structural shifts in the Chinese economy as well as New Zealand specific factors. Either way, it has translated into sky-high prices for New Zealand's main export commodities, pushing New Zealand's terms of trade to a 40-year high.

The recent strength in New Zealand's export prices has been a major surprise to our own forecasts, and we now expect them to stay high over the medium term. This will mean more sustained support for the exchange rate – including vis-à-vis Australia, whose own terms of trade are more than 15% below their 2011 peak. We now see the NZ dollar remaining above US80 cents through this year, and above AU93 cents until the second half of 2015.

Figure 8: NZD/USD and commodity prices, inflation-adjusted

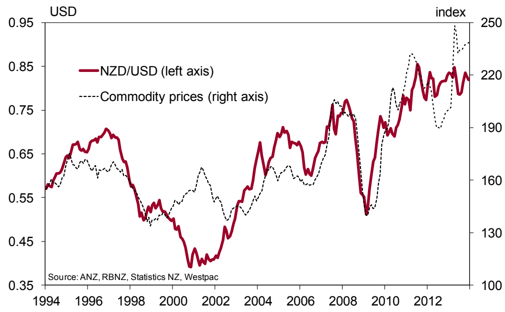
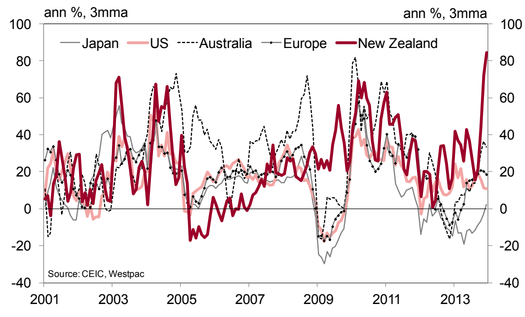


Figure 9: Chinese imports from developed markets



Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-14	0.84	0.93	0.63	0.53	85.7	79.5
Jun-14	0.83	0.94	0.64	0.52	83.8	79.4
Sep-14	0.82	0.94	0.63	0.52	82.0	78.6
Dec-14	0.81	0.94	0.64	0.51	80.2	78.1
Mar-15	0.80	0.94	0.63	0.50	80.0	77.6
Jun-15	0.80	0.93	0.63	0.48	81.1	77.5
Sep-15	0.81	0.92	0.63	0.47	82.3	77.3
Dec-15	0.81	0.91	0.63	0.45	83.4	77.2
Mar-16	0.80	0.91	0.63	0.45	80.0	76.3
Jun-16	0.79	0.90	0.63	0.45	76.6	75.5

Inflation and Interest Rates

Listen to the boss

Most people now agree with the notion that a substantial OCR hiking cycle lies ahead for New Zealand. But important questions remain about the details. When will the RBNZ choose to hike, and when will it pause? Will the RBNZ hike by 25 basis points at a time, or will it make bigger moves? Our view is that the upcoming hiking cycle will be slow, steady and well-signalled – even boring.

We expect the OCR hiking cycle will proceed in increments of 25 basis points (bps) – OCR hikes of 50bps or more are highly unlikely. The hikes will be well signalled in advance, as will any decision to pause. The RBNZ will eschew on-the-day surprises, such as lifting the OCR without having given prior warning.

The January OCR Review was a useful blueprint. The economic case for hiking was clear, but the RBNZ opted to keep the OCR at 2.5% while clearly signalling a hike at the March *Monetary Policy Statement*. The following day the Governor gave a speech reiterating and justifying the case for higher interest rates.

We firmly expect that the RBNZ will follow up with an OCR hike of 25 basis points on March 12. When it does so, there will be hardly any market reaction.

There are a range of reasons the RBNZ will want to keep the OCR hiking cycle well-signalled, smooth and unsurprising. Credible signals can push longer-term interest rates up in advance of actual OCR hikes, doing much of the RBNZ's work for it. At the same time, clear and credible signals help to minimise financial market volatility by reducing the scope for markets to go on wild-goose chases.

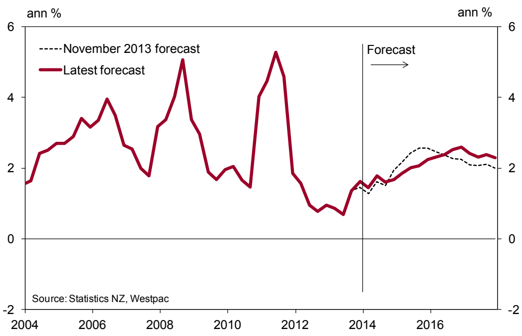
Another of the RBNZ's motivations is more subtle and political in nature. In New Zealand there is a strong body of opposition to inflation targeting, stemming from a mistaken belief that the RBNZ is responsible for the high exchange rate. The RBNZ won't want to antagonise the general public any more than it has to, for fear of gifting its perennial critics political ammunition – especially after the public-relations challenges of the high-LVR mortgage restrictions. A good way to avoid antagonising people is to make sure that they are well warned in advance. Another is to ensure that, on the day of OCR hikes, any increase in market interest rates and the exchange rate is kept to a minimum.

Finally, the inflation outlook is such that the RBNZ can afford a slow and steady approach. Our inflation forecast, charted below, now features fairly benign inflation in the near term due to the likelihood of a sustained high exchange rate and a few expected one-offs such as falling ACC levies. True, we are still forecasting an extended period of inflation above the RBNZ's 2% target, but this outlook is more uncomfortable than panic-inducing for the RBNZ.

We are forecasting OCR hikes of 25bps in March, April, June, July and December this year. But in keeping with the theme of this section, we may adapt our near-term OCR forecast in light of RBNZ communications.

Regarding the eventual extent of the OCR hiking cycle, we have not changed our view. We forecast the OCR to peak at 5.5% in 2016, and to subsequently fall as the Canterbury rebuild winds down.

Figure 10: New Zealand inflation



Annual Inflation and Interest Rate Forecasts
(end of quarter)

	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Mar-14	1.4	2.75	3.10	3.90	4.60
Jun-14	1.8	3.25	3.50	4.10	4.70
Sep-14	1.6	3.50	3.75	4.30	4.80
Dec-14	1.7	3.75	4.00	4.50	4.90
Mar-15	1.8	4.00	4.20	4.65	5.05
Jun-15	2.0	4.00	4.30	4.80	5.20
Sep-15	2.1	4.25	4.50	5.00	5.35
Dec-15	2.2	4.50	4.75	5.20	5.50
Mar-16	2.3	4.75	5.00	5.30	5.60
Jun-16	2.4	5.00	5.25	5.30	5.60

Global Economy
A winding path

Global growth in 2014 is likely to be a passable but unspectacular. A gradual rebalancing is underway, with prospects for the US and Europe slowly improving at the expense of emerging markets. But with the outlook for the US economy still fragile, further 'tapering' by the Federal Reserve is unlikely to proceed quite as smoothly as some anticipate.

Following intense speculation, the US Federal Reserve announced in December that it would begin tapering the pace of its asset purchases by $10bn per month. We were surprised, as we felt that disappointing growth, a weak labour market and ongoing political brinkmanship would justify a delay. The most interesting part of the December announcement was the muted market reaction. While unambiguously taking a step along the path to policy normalisation, the Fed simultaneously convinced markets that it wouldn't be rushed into raising interest rates any time soon.

Such an orderly outcome was in stark contrast to the market turbulence we saw toward the middle of last year when the prospect of tapering was first floated by Chairman Bernanke. Then, markets reacted abruptly. Long term US interest rates rose sharply, there was a big outflow of capital from emerging market economies toward the US, and a sharp depreciation of high yielding currencies against the US dollar.

Such turbulence serves as reminder of some of the important risks posed by global growth rebalancing. As the US economy gradually strengthens and the Fed continues to remove stimulus, we would expect to see the US dollar appreciate, and emerging market currencies fall. This in turn means more imported inflation in emerging market economies and may mean tighter monetary policy is required. Alternatively, those emerging market economies with exchange rates pegged to the US dollar in some way will import higher US interest rates directly. Either way, tighter US monetary policy becomes a drag on growth in emerging markets. This is likely to be only partially offset by the benefits of stronger trade flows on the back of strengthening growth in developed economies.

An orderly rebalancing of global growth is unlikely to deter the Federal Reserve from walking further along the path of policy normalisation. Officials clearly believe the US economy is now on a firmer footing and will need some convincing otherwise. However, we're forecasting the US economy to fall well short of the Fed's expectations. Should the evidence land in our favour over the coming months, then quantitative easing is likely to remain in place longer than many expect.

Australia

There have been pockets of improvement in the Australian economy. Most notably, low interest rates have stoked demand in the housing market and the construction sector.

Yet despite this, GDP growth this year is likely to remain below trend. This is partly due to the lacklustre outlook for the global economy we've described earlier, but is also a consequence of strong domestic headwinds, and in particular slowing mining investment. Over the last few years, mining investment has been a key driver of growth in the Australian economy. But as the pace of investment slows this is set to reverse with mining investment poised to swing from making a 1 percentage point positive contribution to GDP growth in 2012, to taking an (expected) 0.25 percentage points off growth this year.

Of course all this investment will eventually bear fruit, lifting exports and helping cushion the slowdown in growth. Yet this will do little to bolster the outlook for the labour market. Instead, improved employment prospects will need to come via a broader rebalancing in the Australian economy which includes a pickup in non-mining investment, consumer spending and residential construction. But achieving this in an environment of fiscal consolidation, fear of interest rate increases and weak employment trend to date will be no easy feat.

Recent stronger than expected inflation data has prompted financial markets to flirt with the idea of rate hikes by the RBA. In stark contrast, we continue think that the RBA's next move will be in the opposite direction, albeit later than we envisioned 3 months ago. We are now forecasting two 25 basis point rate cuts by the RBA in September and November.

China

It's difficult to overstate the importance of the Chinese economy to New Zealand's outlook. As highlighted throughout this document, China is now our single most important merchandise trade partner with strong Chinese demand fundamental in pushing our terms of trade to a 40 year high. Importantly, this has occurred at a time when Chinese growth has been rather modest by recent standards. Our forecast of GDP growth of 7.4% this year is noticeably slower than in the recent past as the Chinese leadership prioritise the quality of growth over its quantity.

Within this context, the determination of the Chinese leadership to implement market reforms was underscored by the outcomes of the Third Plenum – the Chinese leadership's blueprint for social and economic reforms. While necessarily light the on nitty gritty details, the market's role in the allocation of resources has been upgraded from playing a 'basic' role to a 'decisive' one, signalling price signals are set to play a more important role in the allocation of resources in the Chinese economy.

Of course even in the Chinese economy price signals already have a role to play, as evidenced by the growth of the shadow banking sector. There, intermediaries have taken advantage of an opportunity by matching Chinese investors looking for higher rates of return with borrowers unable to access funding through official channels. But the lack of transparency and pace of growth in the sector has some fearing for the stability of the financial system, should borrowers struggle to meet their obligations. Perhaps an even bigger threat is posed by local government debt (estimated to be worth up to 40% of GDP). Official attempts to restructure this sector in order to improve accountability of borrowers have the potential to prove very messy.

Europe and the UK

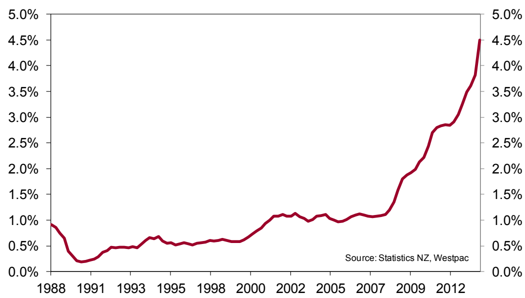
The fortunes of the euro zone and the UK have diverged over the last few months. While the outlook for European recovery remains fragile, there has been a more positive tone to news out of the UK.

The European Central Bank (ECB) cut its refinancing rate to 0.25% in November. The labour market situation remains dire and inflation is running at just 0.8%, well below the ECB's 2% target. So with interest rates approaching zero, speculation has again turned to what new tools the ECB might be able to introduce to provide additional stimulus. A Fed style quantitative easing programme is barred under European Union rules but using the ECB's balance sheet in other ways remains a possibility according to ECB President Draghi.

In contrast, forecasters have been upgrading their outlook for the UK economy. Growth has benefitted from easier credit conditions, improved confidence and a strengthening labour market.

Indeed, the UK unemployment rate has dropped to almost 7% much more quickly than most forecasters (including both the BoE and ourselves) envisioned. This has left the market speculating about possible rate hikes in 2014, but we regard that as unlikely.

Figure 11: New Zealand exports to China as % of GDP



Economic forecasts (calendar years)

Real GDP % yr	2010	2011	2012	2013e	2014f	2015f
New Zealand	2.0	1.9	2.6	2.8	4.2	3.2
Australia	2.3	2.6	3.6	2.4	2.6	3.0
China	10.4	9.3	7.7	7.7	7.4	7.5
United States	2.5	1.8	2.8	1.9	2.2	2.5
Japan	4.9	-0.5	1.9	1.8	1.8	1.4
East Asia ex China	7.8	4.3	3.9	3.9	3.1	4.8
India	9.7	7.5	5.1	4.6	5.2	6.1
Euro zone	2.0	1.5	-0.6	-0.5	0.4	0.6
United Kingdom	1.7	1.1	0.3	1.9	2.6	1.9
NZ trading partners	**4.9**	**3.5**	**3.7**	**3.5**	**3.5**	**4.1**
World	**5.2**	**3.9**	**3.2**	**2.9**	**3.2**	**3.8**

Forecasts finalised 5 February 2013.

Where should we build?

Regional housing supply

We remain very bullish on residential construction activity outside of quake-affected Canterbury. However, our view is now more moderate than it was a year ago, because the 2013 Census revealed that Auckland's construction shortfall is not as severe as previously thought. In this Special Topic we review the state of construction activity relative to population growth in regions of New Zealand.

A year ago our bulletin "Where should we build?" assessed the state of housing supply relative to population in each region of New Zealand except Canterbury. The main finding was that Auckland was building far too few houses, Wellington was building slightly too few, and in all other regions construction was commensurate with population growth. We concluded that construction activity would ramp up substantially in Auckland, but would change little elsewhere.

Our Special Topic this quarter updates our dwelling supply estimates to account for construction activity over the past year, stronger net immigration, and the wealth of new information in the 2013 Census.

The analysis is based on the idea that the number of people per house (PPH) in a region should normally decline slowly as families shrink, the population ages, and average incomes rise. Abnormal changes in PPH may indicate that the prevailing rate of construction activity is unsustainable. For example, if PPH is rising then the rate of building activity is failing to keep pace with population growth, suggesting that at some point building activity will increase.

The pace of residential construction in Auckland has ramped up by 20% over the past year. Nevertheless, the pace remains far too slow. We estimate that a further 53% increase in construction activity is required before Auckland's PPH begins to fall gently.

That said, Auckland's shortage of housing is not as severe as we thought last year. We now estimate that over the past five years Auckland has built 13,640 too few dwellings. A year ago the comparable figure was 21,840. The Census revealed that Auckland's population is lower than previously estimated (this has been widely reported elsewhere). Our calculations also reveal that the rate of increase in Auckland's housing stock has been faster than previously estimated. (Our estimate of new dwelling construction relies on a 'conversion rate' from dwelling consents to actual increases in the housing stock. The 2013 Census revealed a higher conversion rate than the 2006 Census.)

We have altered our forecast of residential construction activity outside Canterbury accordingly. We still expect an aggressive increase over 2014. And we still estimate that the 'normal' rate of residential construction is higher

Residential construction relative to population growth by region

	Building surplus/ deficit past five years	Current annual rate of increase in dwellings	Required annual rate of increase in dwellings	Required change
Northland	330 surplus	678	None	
Auckland	13,640 deficit	5,986	9,169	53%
Waikato	None	2,023	None	
Bay of Plenty	None	1,098	None	
Gisbourne	None	58	None	
Hawkes Bay	None	309	None	
Taranaki	390 deficit	422	None	
Manawatu-Wanganui	None	455	None	
Wellington	1,220 deficit	1,367	1,731	27%
Nelson/Tasman	260 deficit	388	461	19%
Marlborough	None	167	None	
Otago	None	963	None	
Southland	None	150	None	

than today's rate. But with Auckland's shortfall of construction activity now looking less severe than previously thought, we have moderated our construction forecasts from 2015 onwards.

Our update also confirmed that Wellington is building too few houses, and needs a 27% increase in construction activity to allow PPH to fall gently. This is very similar to our estimate from a year ago. We continue to anticipate a modest pickup in new dwelling construction in Wellington.

Unlike last year, we now estimate that Nelson/Tasman is building too few new dwellings, and requires a 19% increase. The 2013 Census revealed that Nelson/Tasman's population has been growing more rapidly than previously estimated. However, new dwelling construction has slowed recently in Nelson/Tasman. A return to the pace that prevailed in early-2013 would be sufficient to keep pace with population growth.

Building activity in all other regions of New Zealand appears to be broadly commensurate with population growth. There is no strong reason to expect large changes in rate of construction of new dwellings in these regions.

Figure 12: People per house, Auckland

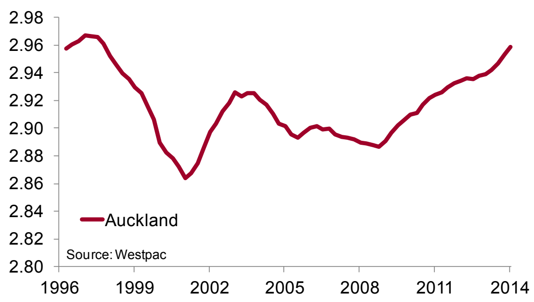


Figure 13: People per house, Wellington

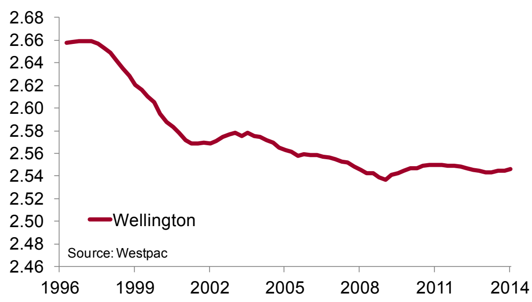


Figure 14: People per house, Nelson/Tasman

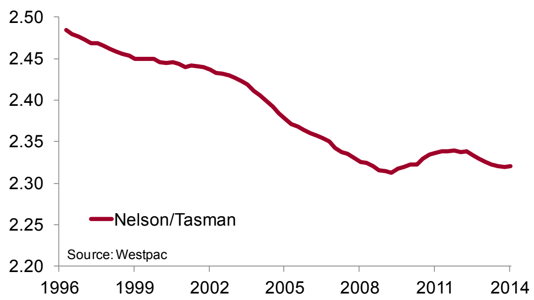


Figure 15: People per house, rest of New Zealand ex Canterbury

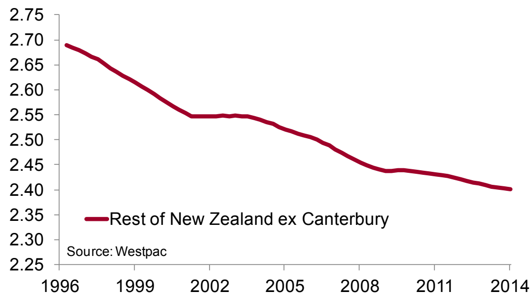


Figure 16: Annual addition to housing stock

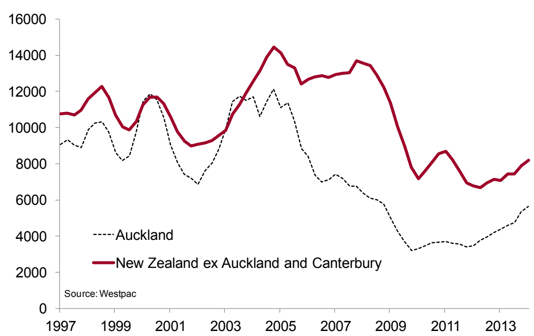
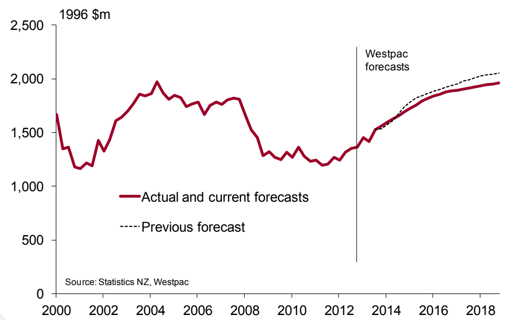


Figure 17: Real residential construction activity, New Zealand ex Canterbury



Agricultural Outlook

Eyes to the East

The agricultural sector has started 2014 on a high. Confidence in the sector is up, buoyed by impressive farm gate prices and favourable growing conditions for many farmers. While we suspect such a sweet spot won't last forever, strong demand from China looks set to benefit NZ's agricultural sector for some time yet.

It has been a great start to the year for many farmers. In most parts of the country summer has featured timely rainfalls and good pasture growth with milk flows running well ahead of last season.

But the biggest boon has been the high prices we are receiving for our export products. Dairy prices have been the standout over the last year but log, meat and wool prices have also strengthened noticeably. Looking ahead, we expect dairy prices to soften moderately as global supply increases in response to high prices on offer. However in other sectors such as beef, tight international supplies may persist for longer, leaving us more optimistic on these prices in the near term.

At the heart of the matter is China. Urbanisation, increasing incomes and changing diets mean Chinese households are consuming more dairy products. Add to that cultural factors such as relatively low rates of breastfeeding and young children living apart from parents, and it is easy to understand how demand for dairy products has outstripped local supply, and just why New Zealand exports are filling this gap. New Zealand's dairy exports to China jumped 79% in 2013 compared to a year earlier, led by whole milk powder exports which are up a whopping 97%. Over a third of our dairy exports are now destined for China.

But it's not just milk. China has ramped up its imports of a wide range of New Zealand's primary products. For example, over the last year the value of our meat, wood and seafood exports to China have surged 114%, 53% and 18% respectively. It's also been notable that growth in China's imports from New Zealand has far outpaced growth in imports from other developed countries.

Given this evidence, it's not a long bow to draw to conclude that the Free Trade Agreement between China and New Zealand, signed in 2008, is working strongly in New Zealand's favour. But even this is unlikely to be the only factor at play. New Zealand's enviable reputation, stringent food safety rules (even given recent high profile scares) and high biosecurity standards all contribute to New Zealand exporters being well placed to meet China's growing demands.

Given the drivers of Chinese demand appear to be structural as well as cyclical, we expect high prices for New Zealand's export commodities to persist for some time to come.

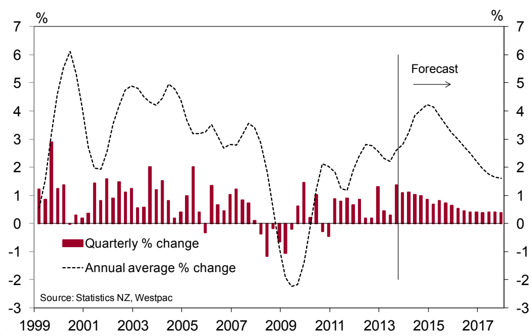
Commodity price monitor

Sector	Trend	Current NZD level[1]	Next 6 months
Forestry	Log prices remain high, supported by strong demand from China and increased building activity domestically.	High	↘
Wool	Coarse wool prices fell sharply in late 2013, but have since stabilised with supplies remaining tight. European demand for high-end products likely to remain subdued.	Above Average	→
Dairy	Strong demand from China continues to support prices even at current high levels. There are few signs of weakness in the near term. However, with Northern Hemisphere supply peaking close to the middle of 2014, prices may come under downward pressure in Q2.	High	↘
Lamb	Some improvement in the outlook for consumers in the UK, combined with tight domestic supplies both locally and globally, should support prices.	Average	↗
Beef	Tight global supplies should underpin beef prices in early 2014, supported by solid demand from Asia.	High	↗

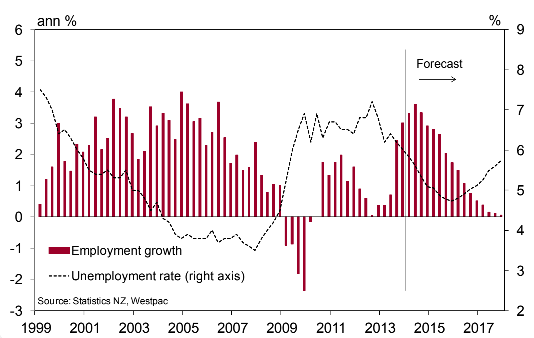
[1] NZD prices adjusted for inflation, deviation from 10yr average.

Annual Average % change	March years				Calendar years			
	2013	2014f	2015f	2016f	2012	2013e	2014f	2015f
GDP (production)	2.3	3.2	4.1	3.0	2.6	2.8	4.2	3.2
Private consumption	2.5	3.7	4.4	2.7	2.9	3.4	4.5	3.1
Government consumption	-0.6	0.5	0.0	0.9	-1.0	0.5	-0.1	0.8
Residential investment	19.1	17.1	14.9	9.1	15.4	18.9	15.8	10.1
Business Investment	3.6	9.5	10.1	6.3	4.3	7.1	10.3	7.7
Stocks (% contribution)	-0.4	0.3	-0.2	0.2	0.3	0.1	-0.4	0.3
Exports	2.5	0.3	4.6	1.7	2.2	1.1	4.8	1.3
Imports	1.2	7.6	7.4	3.6	2.6	6.0	7.7	4.6
Inflation (% annual)	0.9	1.4	1.8	2.3	0.9	1.6	1.7	2.2
Employment (% annual)	0.4	3.3	2.8	1.5	0.4	2.9	3.0	1.7
Unemployment rate (% s.a. end of period)	6.2	5.8	5.1	4.8	6.8	6.0	5.1	4.7
Labour cost index (all sectors, % annual)	1.7	1.7	2.3	2.4	1.8	1.6	2.2	2.4
Current account balance (% of GDP)	-3.9	-3.7	-5.7	-6.0	-4.1	-3.8	-5.0	-6.2
Terms of trade (% annual)	-2.8	12.5	-5.3	3.3	-8.9	16.1	-5.6	3.9
House prices (% annual)	7.7	10.7	5.4	-0.5	6.8	10.5	6.5	1.0
90 day bank bill (end of period)	2.65	3.10	4.20	5.00	2.65	2.69	4.00	4.75
5 year swap (end of period)	3.40	4.60	5.05	5.60	3.07	4.49	4.90	5.50
TWI (end of period)	75.9	79.5	77.6	76.3	73.6	77.3	78.1	77.2
NZD/USD (end of period)	0.83	0.84	0.80	0.80	0.82	0.83	0.81	0.81
NZD/AUD (end of period)	0.80	0.93	0.94	0.91	0.79	0.89	0.94	0.91
NZD/EUR (end of period)	0.63	0.63	0.63	0.63	0.64	0.61	0.64	0.63
NZD/GBP (end of period)	0.54	0.53	0.50	0.45	0.51	0.51	0.51	0.45

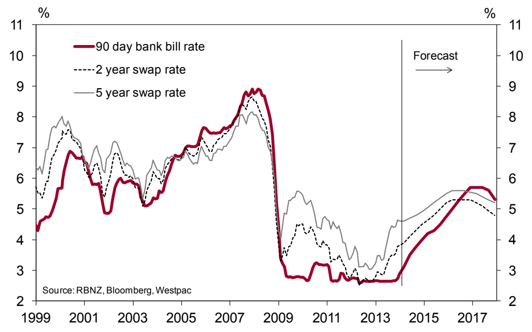
New Zealand GDP growth



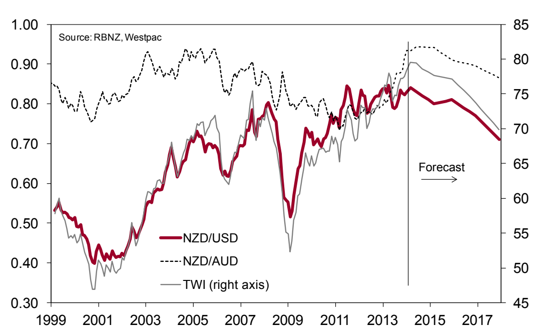
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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