

Economic Overview

May 2014

Doing more with less

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Note from Dominick

In this edition of the *Economic Overview* we are easing up on the pessimism a little.

It might sound odd to label ourselves pessimists – we spent a great deal of the past two years arguing that New Zealand would go through a period of very strong GDP growth. But pessimistic we were, because we viewed the economic upturn as mainly a temporary post-earthquake rebuild and an interest-rate induced house price blip, not a permanent improvement in New Zealanders' standard of living. Without any improvement in the economy's capacity to produce goods and services, we felt that rapid economic growth would soon degenerate into inflation and OCR hikes.

That basic idea is still valid. Everybody agrees that the OCR is heading higher in the near future. But this quarter we are giving the economy just a little more credit where credit is due. We have moderated our OCR forecast, to a peak of 5.25%, without significantly changing our GDP forecast.

One reason we have become more constructive on New Zealand's capacity to grow is labour supply. Because so many people are pouring into the labour force, wage growth has remained subdued despite firms going on the biggest hiring binge in a decade.

It is also apparent that firms are moving up the productivity ladder by investing avidly in plant and machinery. Greater productivity means firms can produce more at lower cost, helping to contain inflation.

Of course, there are more immediate reasons inflation has been low recently. First and foremost, the high exchange rate. We see no significant change on that front this year. Second, low inflation is actually a global theme, which is why we expect the big central banks to keep interest rates low for a long while yet, even as their economies experience modest recoveries.

One obvious risk to our forecasts is this September's election. Our special topic this quarter discusses what the election might mean for financial markets.

A handwritten signature in black ink, appearing to read 'D. Stephens', written over a horizontal line.

Dominick Stephens
Chief Economist

New Zealand Economy

Room to grow

The economic upswing has continued, supported by resurgent construction and high export returns. Businesses have now joined the party, investing and hiring more. Of course, the Canterbury rebuild won't go on forever, and the RBNZ has succeeded in slowing the housing market. But there are encouraging signs that the economy has more room to grow than we previously thought.

The New Zealand economy finished 2013 on an upbeat note, expanding 0.9% over the December quarter and 2.7% over the year. The details confirmed that the economy is firing on multiple cylinders. The Canterbury rebuild is still the principal actor, but strong supporting roles are being played by construction activity in Auckland, buoyant consumer spending on the back of last year's house price inflation, a four-decade high in the terms of trade, and business investment.

The economy seems to have sustained a 1% quarterly pace of growth over the first half of 2014, but we doubt it can do so for much longer: rising interest rates, a slowing housing market, the high exchange rate, lower dairy export prices and ongoing government restraint are all acting to moderate exuberance in the economy.

That said, there are encouraging signs that the economic expansion is causing less inflation pressure than we might have expected. Strong population growth and labour force participation are holding wages down despite rapid employment growth. Business investment seems to be boosting productivity, which in principle allows more output at lower cost. And inflation expectations remain contained. All this has led us to moderate our forecast of the OCR hiking cycle, as explained in the Inflation and Interest Rates section.

A tale of two booms

The Canterbury rebuild and the high terms of trade remain the main drivers of New Zealand's economic expansion – and that is a sobering thought, when one considers that the first of these is temporary and the second has often been a fickle friend in the past.

That said, our view on the longer-term prospects for New Zealand's major commodity exporters continues to be very positive. As we explain in the Agricultural Outlook section, we see the recent drop in dairy prices as an overdue response to improved global supply conditions, not as a sign that this major good news story is in jeopardy. We continue to expect high prices and better growing conditions to give the dairy industry an income boost close to \$6bn this year.

Our outlook for the Canterbury rebuild has changed little. After reviewing progress to date, it seems that

Figure 1: Quake-related construction (in 2012 dollars)

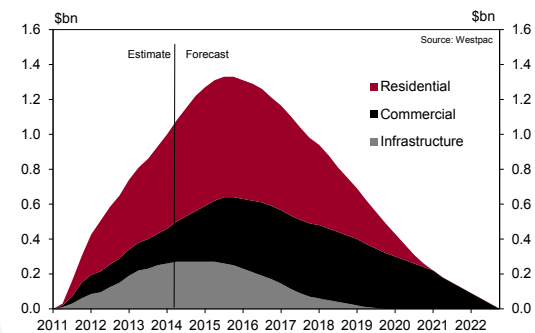
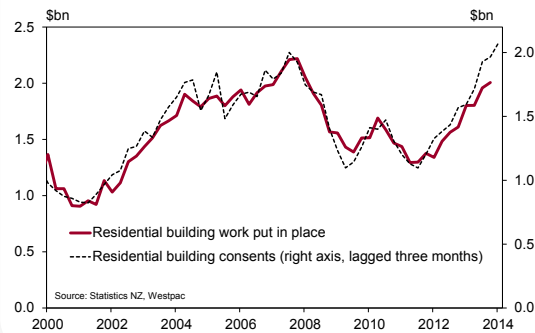


Figure 2: Residential building activity and consents issued



residential building has been more front-loaded than we anticipated, while the initial surge in commercial construction plateaued over 2013. However, we expect both residential and commercial reconstruction activity to take another significant leg higher this year. In the residential space full-scale rebuilds are increasingly replacing smaller repair work, and work on commercial structures in the Christchurch CBD is at last ramping up. Infrastructure work is probably already close to its peak pace, and may not ramp up much further from here.

In the rest of the country, residential building has lagged behind what we might have expected, given the significant lift in building consents over the past year. Unsurprisingly, house-building in Auckland has seen the most consistent gains, albeit still not enough to keep pace with the region's population growth. We are

sticking to the view that construction outside of Canterbury will ramp higher as the year goes on, given the growing backlog of consented work, evidence from business surveys, and the stream of positive anecdotes we are getting from the industry.

Consumers are holding back

The buoyant economy has certainly improved consumers' moods, but this has not led to a re-run of the largesse we saw in the mid-1990s or the mid-2000s. Compared to those periods, surveyed attitudes towards household spending are more subdued. 'Hard' data on retail activity are telling a similar story. In fact, electronic card spending data suggest that retail activity may have lost some momentum in early 2014.

This may in part reflect the cooling effect that rising mortgage rates and restrictions on low-equity lending have had on the housing market. House sales have fallen 13% since the restrictions were introduced last October, properties are selling more slowly, the number of houses available for sale has risen, and household loan growth has slowed. It is hard to tell what is going on with house prices, as the data have been skewed by a shift in the composition of sales towards higher-end properties. But as far as we can tell, house price inflation has slowed considerably.

The housing market might pick up a bit through the middle of the year, as the banks adjust fully to the RBNZ's restrictions. The RBNZ required banks to limit lending to home-buyers with less than 20% equity to 10% of new mortgage lending. In fact, the share has fallen to 3.6%. Banks are currently in the process of loosening up, and lending to first home buyers could soon lift a little.

The current migration boom is a second reason to expect a brief recovery in the housing market. Annual net immigration topped 30,000 in March, and we now expect it to peak just above 40,000 by the end of the year, adding nearly one percentage point to population growth. This is the biggest net immigration boom in a decade, although it has more to do with fewer New Zealanders leaving than foreign arrivals.

In our view, any housing market revival will be short-lived. The migration boom is only a temporary response to the New Zealand economy's temporary outperformance of Australia. What is more, our fair value models – which successfully picked the double-digit house price inflation of 2013 – are now suggesting that house prices are overvalued based on current rents, interest rates, inflation and taxation. As interest rates rise further, the degree of overvaluation will deepen. We firmly expect house prices to plateau in 2015, and wouldn't be surprised to see a drawn-out period of price decline in the second half of the decade.

Figure 3: Net immigration to New Zealand

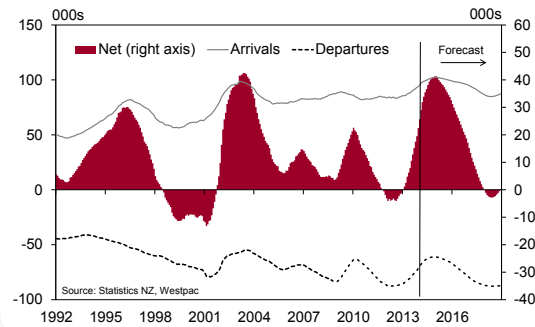
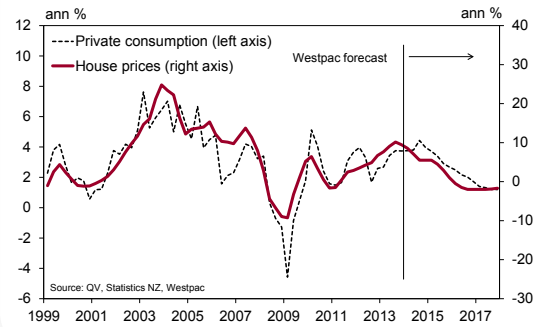


Figure 4: House price forecast and consumer spending



If so, the housing market will become a progressively dampening influence on consumer spending.

Firms doing more with less

As confidence has improved, businesses have also firmly moved into growth mode. The number of people in jobs rose 3.7% over the past year, the fastest rate of increase in over a decade. That may overstate the underlying pace of improvement – a year ago or so we were puzzling over why the official employment statistics were looking so dismal in an otherwise strengthening economy. But there's no question that the labour market is on the mend, with the share of the population in employment at its highest in five years.

What's surprised us is the extent to which employers have been able to meet this growing demand for workers without having to offer significantly higher wages (outside Canterbury, where unemployment is rapidly approaching pre-2008 lows). One reason, of course, is strong population growth; but the economic upswing has also encouraged a surprisingly large number of people to remain in the workforce. The labour force participation rate is now sitting at a record high of just under 70%, with a particularly noticeable uptrend among those aged 50 and over. This recent experience sets New Zealand apart from some other Western economies: in the US, for example, the proportion of older people in work has flattened off in

recent years, and overall workforce participation rates have fallen to multi-decade lows. The drawback of improving job prospects in New Zealand is one likely reason for the divergence; another may be New Zealand's universal pension, which doesn't penalise working at retirement age. At some point in the future the ageing population will have to dominate in New Zealand as well. But that may happen later, and from a stronger starting point, than we previously thought.

What may also be keeping labour costs down for businesses is the fact that they have been increasingly engaged in productivity-enhancing capital investment. The latest *Quarterly Survey of Business Opinion* shows that intentions to invest in plant and machinery or buildings are at the highest level in twenty years, while hiring intentions are merely in a moderate cyclical upswing.

To some extent, this is simply another consequence of the high exchange rate, which has helped push down the cost of imported machinery. But it may also reflect a deeper, technology-facilitated efficiency drive. After all, globally the price of a wide range of electronic goods has continued to tumble. And we've seen other signs of the economy becoming more cost-efficient in recent years. A particularly notable example has been the startling drop in New Zealand electricity consumption since 2011. Part of that decline reflects the beleaguered state of some major industrial electricity users, but that

is not the whole story – commercial, agricultural and residential power use has also fallen in the last few years. What we've seen here is a combination of people responding to high power prices, energy-saving technology, and more energy-efficient building (encouraged by government subsidies).

Either way, this all goes some way towards alleviating our long-standing concerns around New Zealand's long-term standard of living. As we've noted in previous *Economic Overviews*, we haven't been optimistic about New Zealand's long-term growth prospects, given our small size and distance from major markets, population ageing, and our poor track record in terms of both the quantity and quality of investment.

But more investment (of the smart kind) will help make the workforce more productive – able to produce more and better goods and services with the same resources. New Zealand's latest official productivity estimates do suggest that the investment and rationalisation of recent years have started to pay dividends in terms of higher multi-factor productivity – another way of saying that the economy has been growing faster than the sum of its parts.

Of course, this won't benefit everyone equally. To date, it's meant that the number of unemployed has stayed higher than it would have done otherwise. And it will mean less scope for wage increases as the economy grows (except for those who find the value of their skill-set enhanced by new technologies).

The positive flipside of this is that the economy will be able to grow for longer without generating inflation. Typically, as economic activity increases, demand can eventually only be met by offering higher wages to encourage staff to work longer hours, and by raising prices to maintain businesses' margins. It now looks likely that these processes will take longer than we previously thought.

Figure 5: Businesses' investment and employment intentions

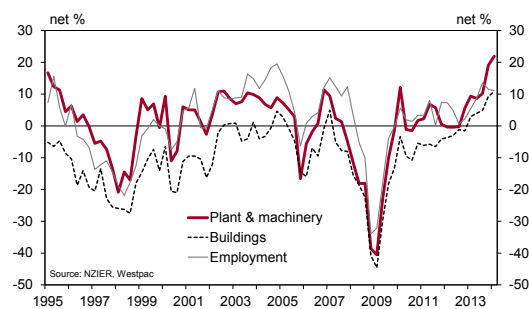


Figure 6: Electricity consumption and GDP

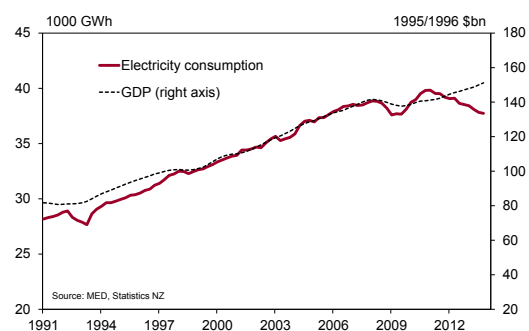
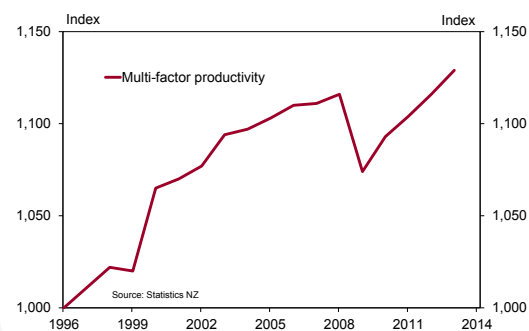


Figure 7: New Zealand's productivity performance



New Zealand Dollar

Divergent

New Zealand's relatively strong economic prospects and the outlook for monetary policy are well recognised by now, and seem to be fully factored into the New Zealand dollar. Weaker dairy export prices are a more recent development that could take some of the edge off the exchange rate this year.

The New Zealand dollar has so far lived up to our view that it would stay elevated over the course of this year. In fact, it's been a touch stronger than even we expected, setting a new post-float high in May on a trade-weighted basis (though not against the US dollar).

Since our last *Economic Overview* we've seen two interest rate increases by the RBNZ. Neither action caused much of a stir in the exchange rate at the time, a sign that the need for monetary tightening has been well anticipated and thoroughly factored in. That will give some comfort to the RBNZ; it should be able to carry through with its planned interest rate hikes without the risk of driving the exchange rate up to uncomfortably high levels.

The influence of monetary policy overseas has been more peculiar. While the US Federal Reserve has further reduced the pace of its asset purchases – an action that was also widely anticipated – there has been a distinctively negative vibe towards the US dollar in recent months. Indeed, with the US dollar sliding, long-term interest rates falling around the world, and global equities heading to new highs, markets are behaving as if they expect looser, not tighter, US monetary policy in the future. We expect the US dollar to regain a little ground this year as the Fed's asset purchases come to an end and the economy recovers from its winter slump (see the Global Economy section, p8).

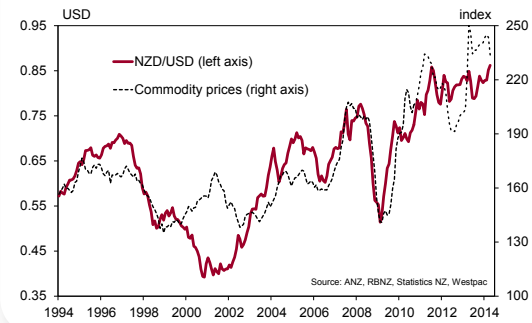
We have long been making the point that the multi-decade high in New Zealand's terms of trade has been a significant factor behind the NZ dollar's strength. However, there has been a marked divergence recently: dairy export prices have fallen sharply in the last few months, while the currency has tended to head higher.

We don't claim that the link is a mechanical one; it could equally be argued that the market looked through the sharp lift in dairy prices last year. Nevertheless, the combined effect of lower export prices and a higher exchange rate will have been a negative surprise for the RBNZ relative to its last set of forecasts, and the longer this situation persists, the less the need for interest rate hikes. It also brings the

NZ dollar closer to meeting the criteria for exchange rate intervention, as the RBNZ Governor noted in a recent speech. We don't see intervention as effective in its own right, but it does create an additional layer of uncertainty in the market.

The exception to the NZ dollar's recent gains has been against the Australian dollar, reflecting a resurgence in the AUD as the market has started to anticipate interest rate hikes from the RBA by the end of the year. But with the Australian economy still running at a below-trend pace of growth, we think those expectations will be dashed and that the NZD/AUD exchange rate will regain some ground over the course of this year.

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



Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Jun-14	0.86	0.93	0.62	0.50	89.4	80.3
Sep-14	0.86	0.94	0.63	0.50	88.1	80.2
Dec-14	0.85	0.94	0.63	0.50	86.7	80.1
Mar-15	0.84	0.93	0.63	0.48	86.5	79.1
Jun-15	0.84	0.91	0.62	0.46	87.4	78.6
Sep-15	0.84	0.90	0.62	0.45	88.2	78.3
Dec-15	0.84	0.89	0.62	0.44	89.0	78.0
Mar-16	0.83	0.88	0.61	0.42	89.1	77.0
Jun-16	0.83	0.86	0.60	0.42	89.1	76.1
Sep-16	0.82	0.86	0.58	0.41	89.1	75.3

Inflation and Interest Rates

Gear shift

The Reserve Bank seems intent upon delivering a third consecutive OCR hike in June, but will probably slow the pace of hikes beyond that. We think the final two hikes of 2014 will come in September and December.

The Reserve Bank was crystal clear when it issued the March *Monetary Policy Statement* - the 25 basis point hike delivered that day was intended as the first of a long series of hikes. Over two years, the RBNZ expected to lift the OCR by a total of 200 basis points. But the Reserve Bank was equally clear that the pace and extent of hikes would depend on evolving data.

As it happens, the data since March have clearly leaned in the direction of less inflation, and therefore a reduction in the need for OCR hikes.

First, the exchange rate has risen at the same time as New Zealand's terms of trade have deteriorated. That has probably left the RBNZ thinking that it will only need to deliver a total of 175 basis points of hikes by the end of 2015, instead of 200.

Second, March quarter inflation was significantly weaker than expected, and slow wage growth points to inflation staying low for longer. It now looks as if inflation will not exceed 2% until the middle of 2015. That reduces the urgency to deliver OCR hikes.

We still expect the RBNZ to hike the OCR in June – that move has been solidly foreshadowed. But with time on its side, we expect the RBNZ will use the June *MPS* to signal a slower pace of subsequent hikes. Perhaps it will hint at one hike per quarter. That would set the RBNZ up to keep the OCR on hold in July without financial markets overreacting.

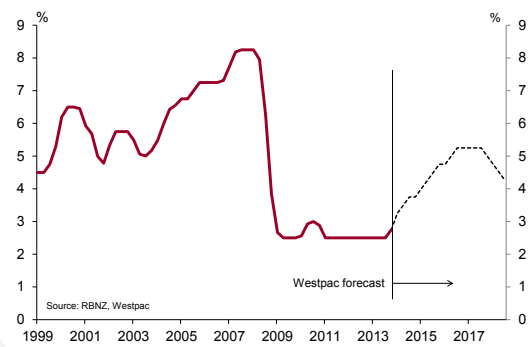
That would make September and December the most likely dates for OCR hikes over the remainder of this year, not least because on those dates the RBNZ will issue full *Monetary Policy Statements* rather than the one-page press releases that accompany OCR Reviews.

Some might argue against a September OCR hike on the basis that the RBNZ will be loath to change the OCR nine days before a general election. The facts say otherwise. In 1999 the RBNZ hiked 50 basis points just ten days before an election. It hiked 25 basis points in the lead up to the 2002 election. And it cut 100 basis points shortly before the 2008 election. There have actually been only two election campaigns during which the OCR remained on hold! The RBNZ will be a political football whatever it does at election time. The best strategy is to signal its

intentions clearly ahead of time, and ensure that the decision on the day is well reasoned and solidly justified – the same as any OCR decision, really.

Our longer-term interest rate views have been broadly unchanged since May 2013, and so they remain. To control the inflationary pressures emanating from the Canterbury rebuild and recent house price inflation, we believe the RBNZ will have to hike the OCR substantially over the coming three years. However, we have tweaked our forecast of the peak OCR down to 5.25%, instead of 5.5%, in response to signs that the New Zealand economy is able to handle more growth without inflation pressure than we had previously given it credit for.

Figure 9: Westpac OCR forecast



Annual Inflation and Interest Rate Forecasts

(end of quarter)

	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Jun-14	1.7	3.25	3.40	4.10	4.60
Sep-14	1.3	3.50	3.70	4.30	4.80
Dec-14	1.6	3.75	3.90	4.50	5.00
Mar-15	1.8	3.75	4.00	4.70	5.10
Jun-15	2.2	4.00	4.20	4.90	5.20
Sep-15	2.3	4.25	4.45	5.00	5.25
Dec-15	2.5	4.50	4.70	5.10	5.30
Mar-16	2.6	4.75	4.90	5.20	5.30
Jun-16	2.5	4.75	5.00	5.20	5.30
Sep-16	2.7	5.00	5.20	5.20	5.30

Global Economy

End of an era

Global growth has continued its gradual rebalancing, with prospects for the US and Europe improving at the expense of emerging markets. In the US, the long era of unconventional monetary easing appears to be coming to an end. But with growth and inflation both still falling short of expectations, global interest rate settings are likely to remain supportive for some time yet.

The approaching end to the US Federal Reserve's quantitative easing (QE) programme could be one of the more significant challenges that the global economic recovery faces this year. As we saw in 2013, even the anticipation of such a policy shift can be a source of upheaval and uncertainty for international markets.

Our view is that the global economy has sufficient momentum to withstand the removal of QE. However, with low inflation and already-lacklustre growth in the global money supply, the world's major central banks will be warranted in keeping interest rates low for a long while.

Figure 10: Money supply growth in the OECD



US

The unusually harsh weather over the US winter clearly had an impact on the economy, with GDP growth slowing to zero over the March quarter. While indicators have picked up since, they are generally not yet back at pre-winter levels, raising the possibility that the US recovery may have also lost some underlying momentum in addition to the winter volatility.

The Federal Reserve is clearly willing to look through this near-term weakness and, with an eye towards stronger growth over this year, has continued to reduce the pace of its asset purchases from an initial \$85bn to \$45bn per month. Indeed, the Fed's willingness to continue reducing its asset purchases, despite both growth and inflation falling short of its expectations, suggests that it is more determined to

end its asset purchase programme than we had given it credit for. We now expect the Fed to continue tapering without pause, with asset purchases reaching zero by October this year.

The Fed's apparent determination to get out of the 'unconventional easing' game does not, however, mean that interest rate hikes will soon follow. Our assessment is that in the short term there is enough underlying momentum to withstand an end to tapering, but not materially higher longer-term interest rates. This is especially apparent in the housing market, which has slowed significantly since long-term interest rates began to rise in the middle of last year. We expect that increases in the Fed Funds rate will be delayed until late 2015, by which time domestic demand growth should be running closer to 3%.

China

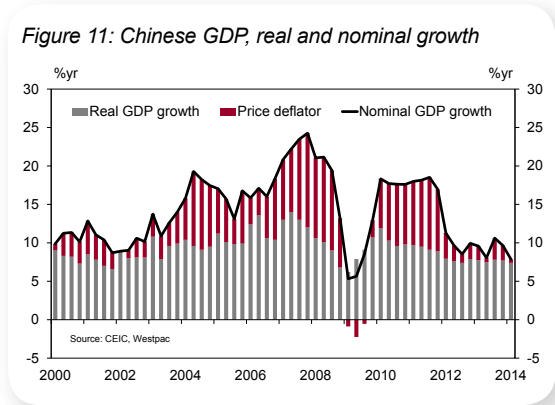
The pace of China's economic expansion has continued to slow, as its leadership has focused on the difficult transition to more sustainable sources of growth. GDP growth slowed to 7.4%/yr in the March quarter, compared to a 7.7%/yr pace over 2013. The impact of this transition is even more apparent when we look at growth in nominal terms (including price changes), which has slowed dramatically over the last two years and by early this year had reached its slowest pace since the Global Financial Crisis. Overinvestment in capacity for heavy industry in past years has been a factor in both the subsequent slowdown in growth and the waning of inflation pressures.

We expect policy makers to loosen the reins to some degree over the course of this year, in order to replenish the pipeline of new investments in those sectors where overcapacity is less of an issue. Without this, the pace of domestic demand growth would fall below 7%, which would be viewed as unpalatable from the point of view of job creation.

Concerns about the stability of China's financial system are likely to remain in the headlines for some time. We consider the risk of disaster to be low: bad loans are on the rise but the banking system has significant scope to absorb them, and China is not

dependent upon attracting foreign capital. Nevertheless, the tightening in financial conditions over the second half of last year will continue to hinder growth in the first half of this year.

We expect that efforts by policy makers to stabilise growth, combined with a firmer track for the global economy, will assist China next year as it attempts to grow in a less credit-intensive fashion.



Australia

There are signs that the Australian economy is gathering strength, albeit from a soft starting position, particularly in the interest rate-sensitive areas of housing and consumer spending. Economic growth is expected to remain below trend this year, with the economy navigating a period of transition as the mining boom moves from the jobs-intensive investment phase to the production phase.

As the rate of spending on new projects passed its peak, mining investment shifted from being a source of growth in 2012 to a drag on the rate of growth in 2013, and is expected to remain a drag in coming years. However, this drag is now starting to be offset by

increased exports from already-completed projects, with the peak boost to GDP expected to come next year.

Our view is that the labour market has reached a turning point, with lead indicators pointing to an end of the hiring freeze. But we see a number of headwinds to job creation: sub-trend public demand growth as state and Federal governments focus on budget repair, a slowdown in Chinese growth and lower commodity prices, and a still-high Australian dollar, which is driving significant structural change in trade-exposed sectors.

We expect no further rate cuts from the Reserve Bank of Australia this year. However, its discomfort with the ongoing strength of the Australian dollar suggests that interest rate hikes are unlikely this year, in contrast to market expectations.

Europe and the UK

While the euro zone's two-year long recession has ended, growth remains sluggish and with annual inflation slowing further to 0.5%, the region is at risk of slipping into deflation. With interest rates already near zero, the European Central Bank (ECB) has said that it is investigating unconventional methods of easing monetary policy. However, there are limits on what assets the ECB would be able to purchase, and this may not be feasible until a review of the quality of banks' assets has been completed (unlikely before year end).

The UK's fortunes have continued to diverge from those of the euro zone. Growth is now running above 3%yr, unemployment has fallen significantly, and the housing market has remained lively even after the Bank of England ended its 'funding for lending' scheme in January. Indeed, markets are now coming to the view that the UK economy has been overstimulated. However, with inflation now falling below the BoE's target of 2%, we view rate hikes as unlikely this year.

Economic forecasts (calendar years)

Real GDP % yr	2010	2011	2012	2013	2014f	2015f
New Zealand	2.0	1.9	2.6	2.7	3.9	3.3
Australia	2.2	2.6	3.6	2.4	2.7	3.0
China	10.4	9.3	7.7	7.7	7.2	7.6
United States	2.5	1.8	2.8	1.9	1.8	2.5
Japan	4.9	-0.3	1.5	1.6	1.4	1.3
East Asia ex China	7.8	4.3	3.8	4.0	4.3	5.0
India	9.7	7.5	4.6	4.7	5.3	6.3
Euro zone	2.0	1.6	-0.7	-0.4	0.8	0.8
United Kingdom	1.7	1.1	0.3	1.8	2.6	2.1
NZ trading partners	4.9	3.5	3.6	3.5	3.7	4.1
World	5.2	3.9	3.2	3.0	3.1	3.7

Forecasts finalised 7 May 2014.

A guide to the 2014 election for financial markets

We are often asked how the election, scheduled for September 20th, might affect our forecasts of interest rates and the exchange rate. Should the ruling National Party gain re-election, we would not alter our forecasts. If a centre/left coalition were elected, we would alter our forecasts in the direction of fewer OCR hikes and a slightly lower exchange rate over the next couple of years. This is based on our assessment that a change of government would produce a temporary period of slower domestic spending and slower GDP growth, relative to our current forecast. The election outcome has no clear implication for interest rates or the exchange rate over the long run.

Background on New Zealand's political landscape

The governing National Party has been in power since November 2008. A centre/right party, National's policies tend to favour reduced regulation and taxation, fiscal consolidation, and small government.

The largest opposition party is the centre/left Labour Party, which has social democratic roots and strong ties to unions. Under the current leadership, Labour's policies favour a greater role for government in the economy (in contrast to the 1999 to 2008 Labour Government, which was more laissez-faire).

The third largest party in Parliament is the Green Party, which is focussed on environmental issues and is further left on the economic spectrum than Labour.

Opinion polls put support for the National Party around 47%, Labour 31%, and the Greens 11%.¹ The prediction market iPredict is currently placing a 69% chance on the next government being led by a National Prime Minister.

However New Zealand's system of proportional representation creates a complicated maze of potential election outcomes. Since the system was introduced in 1996, no single party has won more than 50% of the seats in parliament and governed alone. Instead, the major parties usually require support from some of the many and varied smaller parties in parliament.

We see three main scenarios following the election. The first is a continuation of the National-led government, supported by an array of parties with between one and three seats each – the Māori Party, ACT, United Future and possibly the Conservative Party. All of these minor parties are polling well below the 5% party vote threshold for entering parliament – each of them would have to win an electorate in order to gain representation. It is by no means certain that all will succeed in this endeavour.

In the other scenarios, the New Zealand First Party would hold the balance of power. NZ First is the fourth largest party in the current parliament, and most polls rate it above the 5% party vote threshold. iPredict puts a 34% chance on NZ First holding the balance of power following the election.

NZ First policies advocate, amongst other things, tighter controls on immigration and foreign investment, no state asset sales, retaining the retirement age at 65, compulsory savings, and smaller government. In the past NZ First has joined forces with both National and Labour (in 1996 and 2005 respectively), and could conceivably leap either way after this election.

In scenario two, NZ First supports a National-led government. It is difficult to tell what concessions NZ First might extract in exchange for its support, which could come in the form of a formal coalition or a confidence and supply agreement. Most likely, Government policy would have to shift in the direction of restricting foreign investment and/or immigration.

In the third scenario, NZ First supports a broad coalition of the centre/left. Led by a Labour Prime Minister, this would include the Greens, the Mana Party and NZ First as either coalition partners or support partners.

Either of scenario one or two, which both result in a National-led Government, would be business-as-usual for our forecasts. We would continue to expect a gradual rise in the OCR over the next couple of years. We suspect that markets would feel the same way – market reaction to National's re-election would be slight.

In the event that a broad coalition of the centre/left takes power, the market implications would be substantial. Based on our assessment of two key policy areas explained below, we would change our forecasts in the following ways:

- Fewer OCR hikes over 2015 and 2016 on the back of a downturn in domestic demand.

¹ One News Colmar Brunton Poll, March 2014.

- A lower exchange rate over 2015 and 2016, to match the attenuated OCR profile.
- Unchanged long-run forecasts for interest rates or the exchange rate.

It is reasonable to expect a change of government to result in a short period of slower economic activity via business uncertainty. Businesses might hold off on investment and hiring decisions until the new policy environment became clear – especially considering that a centre/left coalition would comprise three major parties among which new policies must be negotiated. But more substantively, there are two key centre/left policies that can be expected to produce temporarily slower domestic spending, as we explain below.

Centre/left tax reform would temporarily slow the housing market and spending

Both Labour and the Greens propose dramatically broadening New Zealand's capital gains tax (CGT), which is currently so narrow that it is almost irrelevant. The new CGT would be levied at 15%, payable on realisation, and the family home would be exempt. Labour further proposes to “ring-fence” losses for residential landlords, meaning losses can't be offset against other income for tax purposes.

We support the introduction of a CGT, because it will help right the current misallocation of resources to land-based economic activities, and would lift the rate of home ownership (other useful measures would include lowering the rate of income tax and reducing the rate of inflation). By broadening the tax base, a CGT may allow other distorting taxes to be reduced in the future.

But introducing a CGT in combination with ring-fencing would affect house prices by discouraging investors. We calculate that a 15% CGT would reduce the value to an investor of a given property by 23%, if rents remained unchanged. Even if we assume a 10% lift in rents, the loss in net present value of the house to a landlord is still 15%. Similarly, removing the tax-free status of most capital gains would reduce the capital value of farm land. How such a change in fundamentals would affect actual market prices is, of course, unknown. But our suspicion is that the mere announcement of a CGT would have a marked impact on farm and property prices.

Consumer spending is closely tied to house and farm prices. A reduction in house and farm prices, or even a slower rate of increase, would translate directly into slower consumer spending. What's more, the introduction of CGT might directly affect economic activity in the short run by reducing housing turnover. This combination would temporarily slow GDP growth, requiring the RBNZ to moderate its tightening cycle.

Changes to savings and monetary policy might further restrict domestic demand in the short run

The Labour Party recently introduced three key changes to savings policy and monetary policy – all of which are highly likely to be supported by potential coalition partners:

- A dual mandate for the RBNZ to target both inflation and “positive external balances” (a higher savings rate).
- A compulsory savings scheme set at 9% of labour income.
- Giving the Reserve Bank some ability to vary the rate of compulsory savings contributions, through a new tool called the Variable Savings Rate (VSR).

We don't think these changes are necessary. But their effects will be fairly modest. The proposed compulsory savings scheme would lift national savings by only about 0.6 percent of GDP, drawn out over an extended phase-in period. The VSR would be a much less potent demand-management tool than the OCR – our back-of-the-envelope calculations suggest that a one percentage-point hike in the VSR would be equivalent to an OCR hike of about 10 to 15 basis points. And because it would be impossible for the RBNZ to have more than a passing effect on external balances, the second part of the new dual mandate would have little bite.

However, the initial transition to compulsory savings would require the household sector to reduce spending to some extent. At the margin this might contribute to the reduction in domestic demand and GDP growth.

Ambiguous implications for the long run

The discussion above relates only to the short run. In our view, a change of government would not necessarily alter New Zealand's long-run average exchange rate. It is possible that the centre/left's policies will alter interest rates in the long run, but the direction of change depends on which of the following dominates:

- The introduction of capital gains tax and compulsory savings might reduce New Zealand's reliance on overseas capital, thereby permanently reducing interest rates.
- Giving the RBNZ a dual mandate might cause the central bank to lose focus on inflation, which would lead to higher interest rates in the long run.
- While all parties seem equally intent on budget surpluses, in practise it may be more difficult for a broad coalition to keep government spending in check, which may put upward pressure on interest rates over time.

Agricultural Outlook

Tip toe

Global prices for NZ's key commodity exports remain high – though not quite as high as they were three months ago. Dairy prices have fallen, but this should not have come as a surprise. Fortunately farmers have responded cautiously to the recent income boost, strengthening balance sheets rather than taking on new debt.

In our last *Economic Overview* we warned that increasing global supply could see dairy “prices come under downward pressure in Q2”. And indeed that’s what happened. On a trade weighted basis prices on the GlobalDairyTrade platform have fallen 21% since February. Yet the 2013/14 season is still shaping up as a bumper season for most dairy farmers. We’re forecasting a Fonterra milk price payout of \$8.50/Kg of milk solids. And the record setting doesn’t end there. Production is expected to leap around 11% on last season’s drought affected levels to also set a fresh record. That’s despite the dry weather which restricted pasture growth in many parts of the country up until widespread rain in mid-April. The high prices on offer have seen dairy farmers willing (and able) to buy in supplementary feed, allowing them to keep milking for longer than would usually have been the case.

All up this translates to an income boost for NZ dairy farmers to the tune of \$6bn compared to last season. Add to this mix the improvement in prices for other commodities such as lamb, beef and logs (as detailed in the table below) and the boost to rural economies looks substantial. We remain optimistic that New Zealand’s agricultural exporters will continue to benefit from growing trade with China and other emerging

economies over the medium term (though of course there will always be volatility from season to season).

Encouragingly, farmers are not falling into the trap of thinking the sweet spot will persist indefinitely. Next year’s payout is likely to be lower than the current season (we’re forecasting a milk price of \$7.10). There are also concerns around the rising risk of an El Niño weather pattern developing over winter (which in the past has sometimes caused major droughts – most notably in 1997/98). Like New Zealand businesses more generally, farmers appear to be taking a cautious approach to debt. Farm sales are picking up, and conversions and investment on farm is increasing, but agricultural credit growth remains subdued. Indeed many farmers are opting to use additional cash flow to reduce debt.

This will be a pleasing development from the Reserve Bank’s perspective. The RBNZ has long been warning of the risks to the economy from the highly indebted dairy sector. While these risks haven’t evaporated completely the cautious approach being taken by farmers does help. If this continues, the Reserve Bank may not feel the need to slap restrictions on farm lending as some have speculated it might.

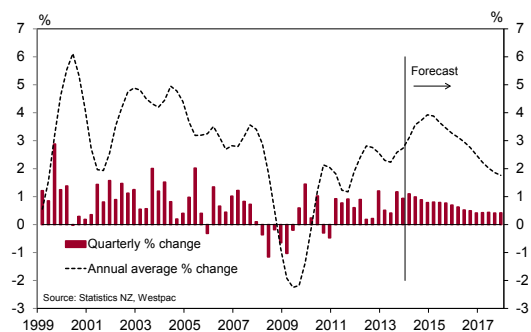
Commodity price monitor

Sector	Trend	Current level ¹	Next 6 months
Forestry	Log prices continue to hover near record highs. Demand from China remains strong but a build-up in inventories on the back of record Chinese log imports could see prices moderate from these levels.	High	↘
Wool	After falling sharply in 2013, coarse wool prices have remained relatively stable over the last few months. Globally, wool supplies remain tight. This should help support prices near current levels.	Above Average	→
Dairy	Prices have fallen significantly over the last quarter under the weight of a strong finish to the New Zealand production season, a pickup in Northern hemisphere production and seasonal variation in Chinese demand. We think the bulk of the downward adjustment in prices has now occurred and would expect prices to remain broadly stable around current levels over the coming months.	Average	→
Lamb	Lamb prices have continued to improve, supported by tight supplies and improving demand conditions in traditional markets. This, combined with robust demand in the increasingly important Chinese market, should continue to support prices.	Average	↗
Beef	International beef prices have eased a touch but remain at very high levels. Tight global supplies should continue to underpin prices, supported by further improvements in demand.	Average	↗

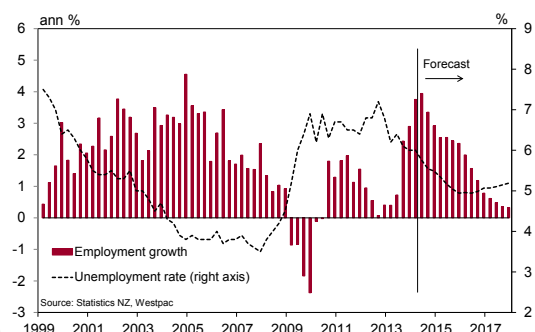
¹ NZD prices adjusted for inflation, deviation from 10yr average.

Annual Average % change	March years				Calendar years			
	2013	2014f	2015f	2016f	2013	2014e	2015f	2016f
GDP (production)	2.3	3.1	3.9	3.1	2.7	3.9	3.3	2.5
Private consumption	2.6	3.7	4.0	2.9	3.4	4.0	3.2	2.1
Government consumption	-0.6	1.2	0.0	0.9	0.8	0.2	0.8	1.0
Residential investment	19.3	15.4	15.6	9.0	17.4	16.1	10.3	4.1
Business Investment	3.7	9.1	10.1	7.2	6.9	9.8	8.8	3.4
Stocks (% contribution)	-0.4	0.0	-0.1	0.2	0.0	-0.5	0.4	0.0
Exports	2.5	0.4	5.3	1.7	1.0	5.7	1.2	2.5
Imports	1.2	8.3	8.3	4.2	6.3	8.7	5.4	2.1
Inflation (% annual)	0.9	1.5	1.8	2.6	1.6	1.6	2.5	2.7
Employment (% annual)	0.4	3.8	2.5	2.0	2.9	2.9	2.4	0.8
Unemployment rate (% s.a. end of period)	6.2	6.0	5.3	5.0	6.0	5.5	4.9	5.1
Labour cost index (all sectors, % annual)	1.7	1.6	2.0	2.1	1.6	1.8	2.1	2.2
Current account balance (% of GDP)	-3.9	-2.8	-4.0	-4.5	-3.4	-3.2	-4.7	-4.1
Terms of trade (% annual)	-2.8	16.8	-5.9	3.3	20.0	-5.6	3.9	1.4
House prices (% annual)	7.7	8.6	5.5	-0.5	9.5	5.5	1.0	-2.0
90 day bank bill (end of period)	2.65	2.95	4.00	4.90	2.69	3.90	4.70	5.40
5 year swap (end of period)	3.40	4.57	5.10	5.30	4.49	5.00	5.30	5.20
TWI (end of period)	75.9	78.7	79.1	77.0	77.3	80.1	78.0	74.8
NZD/USD (end of period)	0.83	0.84	0.84	0.83	0.83	0.85	0.84	0.81
NZD/AUD (end of period)	0.80	0.93	0.93	0.88	0.89	0.94	0.89	0.85
NZD/EUR (end of period)	0.63	0.61	0.63	0.61	0.61	0.63	0.62	0.59
NZD/GBP (end of period)	0.54	0.51	0.48	0.42	0.51	0.50	0.44	0.41

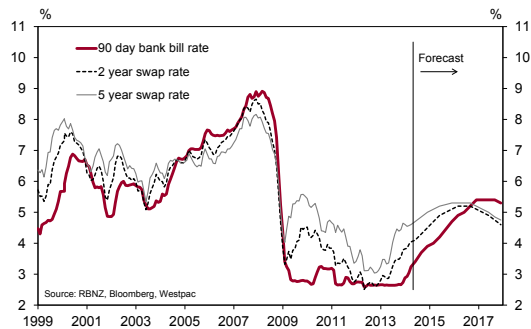
New Zealand GDP growth



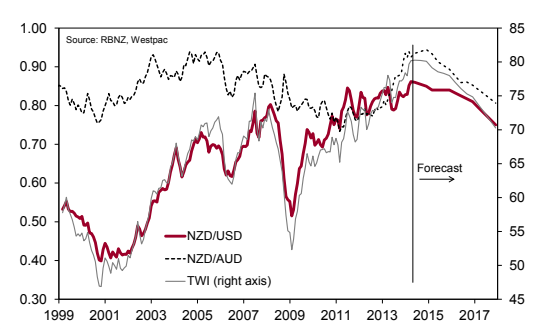
New Zealand employment and unemployment



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



NZD/USD, NZD/AUD and TWI



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