

New Zealand Business Forecast Report Q2 2014

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Abstracts

Core Views

Indicators suggest that the performance of the New Zealand economy remains on a stable trend. However, the combination of uncertainties stemming from a slowdown in the Australian economy as well as a potential for policy vacuum to occur as parliamentary elections draw nearer in November lead us to maintain that growth is likely to moderate in 2014 to 2.7% versus an estimated 3.5% for 2013. We believe that the Reserve Bank of New Zealand (RBNZ) will hike its policy rate once by 25 basis points at the end of Q114, and subsequently hold its rates at 2.75% for the rest of the year. We believe the rate hike will be largely pre-emptive in nature, in response to cool domestic price pressures that have been on the rise. That said, the subdued, though growing, growth contribution from business credit suggests to us that the central bank will avoid hiking interest rates further, and instead re-focus on cooling the housing market through its macro-prudential rules. Indeed, we note growing signs that the macro-prudential rules are beginning to have their intended effect on housing market.

Volatile weather and a trend of increasing compliance/regulations will continue to pose risks to New Zealand exports, given the changing composition of its trade with the external world. While dairy exports have surged of late, we believe this is unsustainable, driven mainly by Chinese importers fearing a possible lack of supply as new regulations are set to be implemented in March. Taking a longer term view of things, we believe that the trade balance will record a surplus and continue to head in the right direction as the interest rate hike by the RBNZ to help rein in import consumption, and reduce external liabilities in the banking sector as housing-related lending cools the banking sectors. This will help narrow the current account deficit over the coming years will allow the country to gradually pay back its huge external liabilities and reduce its vulnerability to external shocks.

The National Party remains determined on achieving its goal of returning the fiscal budget to surplus in fiscal year 2014/15. While the issues of housing affordability, drought assistance for farmers and controversial decisions on the country's pull-out from the second commitment period of the Kyoto Protocol remain contentious topics that could affect the ruling party's popularity as it approaches parliamentary elections in 2014. Moreover, rising popularity of the opposition Labour Party suggests that the government will be increasingly pressured to lean towards a more populist platform. That said, we do not see any immediate threat to its ability to formulate policy. We maintain our short-term political risk rating at 84.0 (out of 100), and expect the issue of affordable housing to be one of the key issues in the 2014 elections.

Major Forecast Changes

The strong production and new orders indices for the manufacturing and services sectors suggest that the New Zealand economy is likely to enjoy relatively strong growth over the next few months. As such, we have raised our 2014 real GDP forecast to 2.7% from 2.3%, but maintained a conservative stance given the growing probability of adverse impact on the domestic economy in the event of a decline in external demand for New Zealand assets.

Key Risks To Outlook

A global recession, brought about by a recession in the US and, increasingly, China. This would hit the price of New Zealand's export commodities and corporate profits.

A banking crisis in Australia, which would likely spread to New Zealand given the external borrowing of local banks, could cause extreme stress to the financial system as liquidity and credit dry up. While not our core view, this could accelerate the debt deflation spiral in the country.

A strong New Zealand dollar, supported by demand for 'safe' assets as uncertainty surrounding the eurozone continues, could cause the country to accumulate even greater external imbalances. The rising demand for New Zealand assets is likely to affect have an upside impact on house prices. But ultimately, we maintain that the economy has to eventually head back on the path of deleveraging and redistributing resources to productive sectors in the economy.

Volatile weather conditions, such as the extreme dry conditions in key farming regions in the north, could adversely impact export volumes and farmers' profitability. This

could affect export performance, and poses downside risks to our overall growth forecast.

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We believe that the residential solar loan programme proposed by New Zealand's Green Party could potentially be feasible, depending on the precise terms of the scheme. We highlight that such a scheme would have to be cost-neutral and not require any subsidies, as the government is unlikely to provide subsidies for the scheme based on its fiscal account.

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Stability To Prevail, But Not Without Challenges

New Zealand is likely to remain one of the most stable states in the world over the coming decade. The government's main challenges are to rein in the budget deficit, improve the business environment to attract greater foreign investment and raise opportunities for the indigenous Maori population. In the realm of foreign policy, New Zealand is likely to continue relying on Australia as its guardian. A key wild card is whether New Zealand deepens political ties with its neighbour, possibly in the form of a confederation.

CHAPTER 2: ECONOMIC OUTLOOK

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The Reserve Bank of New Zealand (RBNZ) held its policy rate at 2.50% in its monetary policy meeting on January 30. However, the recent acceleration in the prices of non-tradable goods and services, which grew by 2.9% y-o-y, has led us to believe that the central bank will hike its policy rate by 25 basis points (bps) at its next meeting in March.

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Although there has been significant increase in New Zealand milk powder exports over the past four months since October, we do not expect this performance to be sustained beyond Q114 given that we believe the surge in demand has been driven by importers frontloading imports, before new regulations are implemented. We expect exports to normalise in H214, and maintain that the widening milk deficit in China should support New Zealand's export growth. Together with our expectations for an interest rate hike in H114 to help temper import growth, we believe the country remains on track to record a trade surplus in 2014.

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The main factors that contributed to New Zealand's solid real GDP growth outturn over the past decade will not be in play to the same degree over the next 10 years.

Population growth will slow, terms of trade support will be hard to come by, and we expect New Zealand households will eventually experience protracted deleveraging cycle. These factors should see real GDP growth average 2.4% over the 2015-2023 period, below the 3.6% growth rate seen over the 1999-2007 boom years.

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