A QUESTION OF BALANCE

KEY POINTS

- **The commentary on the New Zealand economy has swung remarkably negative of late.** Certainly, the likes of our own Business Outlook survey, and the softening in a number of other timely indicators, justify a weaker tone. But when talk shifts to recession-style prospects and material probabilities are thrown around on such an outcome, we feel this tone has swung too far.

- **There is no denying that some clear economic challenges exist.** Growth is set to slip below 2%; it is mathematically very difficult for sequential growth not to fall below 2% y/y this calendar year given indicators to date. That’s soft and can’t be denied. The economy is grappling with a massive terms of trade hit, a plateauing in the earthquake rebuild and the risks associated with the considerable ramp up in Auckland house price growth. The global backdrop is also looking far more tenuous.

- **Despite this, numerous positives still exist.** Financial conditions have loosened – a lot, the NZD is providing tangible benefits to the wider export sector, the pipeline of construction work is still massive, the terms of trade hit is not shaping as large as earlier feared (given lower oil prices and the latest dairy price bounce), migration inflows remain strong, and NZ’s sound microeconomic backdrop (the small things) is underappreciated. The latter is economic “glue” amidst macroeconomic turbulence.

- **Some of the borrow-and-spend type behaviour seen recently (stronger credit growth) is actually to be expected.** Yes it brings vulnerabilities. Debt levels across the economy (particularly for households) are still high. But it also highlights monetary policy at work and the smoothing of the business cycle. Growth in the future is being brought forward to offset the downside risk now. There will be payback (a tempered eventual recovery), but that’s policy at work.

- **Our probit model puts low odds on the economy actually moving backwards at present.**

- **We are not downplaying the challenges.** Economies are far more vulnerable when they slip to “stall speed” (around 1-2% growth), which is where we see domestic growth at present. There will be pockets and regions of the economy that will struggle over the next 18 months or so. The global backdrop (with China at the top of the list) and likely El Nino also reinforces the risk profile (and with it the risk profile for the OCR and NZD). It is unlikely to be a smooth ride.

- **The recent swing in the commentary to the extreme negative side of the ledger simply looks overdone.** Some balance needs to be restored, but also with a dose of reality; there are still significant challenges too.

- **We still expect the RBNZ to cut the OCR another 25bps next week, taking the OCR to 2.75%. However, the path of easing beyond that is a much more open question** (we see another 25bp cut, but not until March). After the cut next week, we see the RBNZ pausing for thought.
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The pendulum across economic commentary has swung sharply negative of late. A “weakening” economy has now become a “weak” one. Surveys such as our own Business Outlook report certainly support this weaker tone, with confidence falling to lows not seen in six years. Firms’ own activity expectations are still positive but well down from highs. Other indicators we produce are either very soft or have receded (Truckometer, Job Ads, Consumer Confidence). But the leap to discuss recession-style prospects, and the putting of some reasonably high probabilities on such an outcome, has swung the tone too far.

Admittedly, it is not hard to point to some clear economic challenges. Domestically, we have three ugly ducklings driving this reassessment of views in the form of:

- The massive terms of trade (dairy) hit.
- Signs the Auckland property market is flattening and the associated vulnerabilities from such a rapid rise in prices (i.e. borrowing the spending our way to growth).
- The Christchurch city rebuild, which is now plateauing / starting to recede.

Not only this, but the global backdrop is looking far more tenuous as well. Throw together the extreme volatility out of China (and emerging markets more broadly), the prospects for the Fed lifting rates to get some runs on the board and the possibility of another El Nino event affecting domestic weather patterns, and this only adds to the negative skew in New Zealand’s economic risk profile.

And the NZ economy is undeniably sluggish. Policymakers are still talking about 2.5% growth this year, although it appears there is some ambiguity over whether this is for the fiscal year or calendar year, and whether it is annual or annual average growth. Whatever the case, we believe it is mathematically difficult to achieve 2% y/y growth this calendar year. Q1 saw 0.2% q/q growth (weighed down heavily by agriculture). Q2 looks a bit better than that (some recoil, although a soft undertone) but the economy hardly feels like it is going gangbusters in the second half of the year. Something south of 2% beckons and forecasters have been revising down estimates as the year has progressed. Treasury and the RBNZ will no doubt follow. We see annual growth ending the year at 1.6% y/y.

Economies become much more vulnerable when growth slips into the 1-2% zone. We don’t want to downplay the challenges currently being faced with the economy sluggish. However, many of the positives are being overlooked, and this – by definition – leaves you with a plate full of negatives.

So let’s have a look at the other side of the ledger.

- It is important to remember that part of the current slowdown – at least in the initial stages – is natural. Economies record strong growth when rebounding off lows. They then transition into a period of moderate growth but off a higher base as speed limit constraints kick in. Importantly, this dynamic can skew business surveys given that they ask if things are going to “get worse, stay the same, or get better”. If things have been pretty good previously then responses can potentially get a biased to the downside; it’s simply harder to be positive when things are already good. The converse also applies. This doesn’t mean we ignore such surveys – they are still tremendously helpful – but we simply need to be mindful of what they ask (and the starting point) when we interpret the results. We also never get caught up focusing on headline confidence; it is firms’ own activity expectations that matter. They have weakened but don’t portray an economy on its knees.

- Encouragingly, the terms of trade hit is not shaping up as large as initially feared. Recent lifts in dairy prices have helped, but it is relative price movements (as opposed to just export prices) that are critical in determining wider national incomes. Oil, which New Zealand is still a net importer of, has been the big mover of late. Undeniably, the depressed level of dairy prices (and as such the low dairy payout) still represents a massive income loss across the economy, and the income strains will persist for an extended period. But given the recent bounce in dairy and the falls in oil, the terms of trade hit is no longer looking like the potential knockout punch it was just a few months ago. We are now talking about a circa 15% peak-to-trough goods terms of trade fall as opposed to what was shaping as a 20-25% one. Interestingly, this is pretty close to what the RBNZ projected back at its June MPS, which also had: a) only two rate cuts and; b) the NZD higher too (the TWI at 74.7 in Q3 relative to 69.6 now).
Firms are still reporting that finding skilled employees is a top three constraint (from our small business monitor). That’s a supply-side issue not a demand one.

New Zealand’s export performance goes well beyond just dairy. In the year to June 2015, dairy represented $12 billion of a $65 billion export pool (or 18%). It was $16.9 billion in June 2014, so it is well down. But $12 billion out of $65 billion (or even $17 billion out of $65 billion) is not an overly large concentration in our view, and it is certainly not like dairy exports are likely to cease altogether! Tourism exports (including education travel) were worth $11.7 billion in the June 2015 year, and were performing strongly even before the NZD’s recent fall. The sector is about to overtake dairying and the outlook certainly looks strong.

There is no shortage of construction work across the country. So while the plateauing in activity associated with the Christchurch rebuild might make for some regional headaches, there is certainly demand elsewhere. Resources (manpower) will shift. There is a large pipeline of infrastructure work ahead, with the New Zealand Council for Infrastructure Development identifying $35bn of work for the next two decades. Other major projects (Sky City convention centre) have yet to be tendered upon or consented, and then there is a massive amount of future work to address Auckland’s housing needs. Drive around the country and eye all those orange cones! The July rebound in residential consents after a flat-lining period was welcome. On a floor-area basis, the story looks strong, with residential investment set to lift over the second half of the year after somewhat of a siesta. Construction is the most pro-cyclical part of the economy and is still doing well. Service firms, and construction-aligned manufacturing firms will benefit.

Financial conditions have loosened – a lot. The NZD has fallen a long way, and for exporters outside of dairying who have their cost structures in order, a NZD at 64 US cents must feel like Christmas. Even recent equity price declines haven’t dented overall conditions much. While Auckland property prices may be starting to flat-line in the month-on-month growth stakes, prices in the regions are clearly now moving up. The “gap” between the regions and Auckland has become so stark that the former looks for a period of catch-up such as what happened between 2003 and 2007.

The microeconomic story across the economy is not sufficiently appreciated. Microeconomics is the small stuff that keeps business wheels turning. Auckland’s housing woes are not being fixed but they are being improved on from the supply angle; consents have lifted and should continue doing so. Developments such as Christchurch Airport signing up with China...
Southern Airlines for more routes are not game-changers by themselves, but add substance to the economic story when part of an ongoing theme. Air NZ with its Houston route is another example. Queenstown will be getting night flights next year. Other export industries are doing well; honey, pipfruit, kiwifruit etc. Businesses appear to have more of that self-belief dynamic that the current New Zealand cricket team has. There is a reason New Zealand’s labour force participation rate is four percentage points above Australia’s; better microeconomics within the labour market. That’s just a sample of small things.

- **The relevant sectoral multipliers are important to consider.** Input/output tables for 2006/07 suggest the multiplier from the agricultural sector to the wider economy of approximately 2.7. For example, a $100 rise (or fall) in incomes would result in a $170 rise (or fall) in incomes in other sectors, leading to a $270 impact all-up. The construction sector has a slightly higher multiplier of around 3, with the manufacturing and services sector major beneficiaries from a stepping up of construction sector work. Multipliers for the tourism sector are more difficult to quantify, but a New Zealand study by Singh and Tantirigama (2009) placed them at around 4.5, suggesting a broader impact on other sectors within the economy.

- **We can’t see the migration boom stopping.** New Zealand might be slowing in the growth stakes but so are others. Witness Australia’s GDP figures yesterday. Education related inflows are still strong and of course the Government has made it easier for migrants to get into New Zealand if they are headed into the regions.

- **An element of the borrow-and-spend style growth seen of late (stronger credit growth) is actually to be expected at this juncture. It does bring with it vulnerabilities (so we need to be mindful), but it is also a sign of monetary policy at work.** Increased borrowing (if managed well) importantly brings forward activity from the future. Of course, at some stage there will be payback; when times are good the kitty jar will need restocked. But a key implication here is that it helps smooth the cycle. The downside in the near-term is looking less stark, but any pending recovery will be less cyclical on the upside too.

If probabilities are going to be thrown around about the dreaded ‘R’, then some science needs to be behind it. For the econometric boffins this is where we can use a probit model. Such models have hits and misses in terms of actually predicting recessions in New Zealand (ours was late to the party in 1997 and there have been false signals such as in 2011/12). They also rely on where indicators sit today and so lack a strong forward looking element. But at least they provide an element of science.

**No matter what specification we try, the model points to the odds of recession being low at present.** This is partly because of the rate at which house prices are growing. Also, a lower NZD has a big impact, offsetting terms of trade, equity and yield curve dynamics. If we instead look at the probability that annual growth slows to less than 1½%, the odds are closer to 40%. That fits with our core view (we have growth slowing to 1.6% y/y, and there are both upside and downside risks around that).

**FIGURE 4. NZ RECESSION PROBABILITY**

This does not mean we are downplaying the challenges. There are plenty. And it will certainly not be plain sailing. We have an economy full of tensions and frictions; akin to our “grumpy growth” depiction a few years ago.

And of course we also mindful of the numerous risks that still exist. China is front and centre here and it alone skews the risk profile for the OCR and NZD lower. However, it doesn’t cement the movement occurring, for we need to appreciate that they are the risks and unknowns as opposed to the knowns.

There are pockets across the economy that are going to struggle and pain will be apparent; the reality of low dairy prices / incomes and a long road back will be felt for another 18 months. Some parts of regional New Zealand will clearly struggle. However, we view the extent to which the mood has shifted to the negative side of the ledger as being overdone. Some balance needs to be restored but also with a dose of reality; there are still significant challenges too.
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