Graeme Wheeler: The outlook for the New Zealand economy

Speech by Mr Graeme Wheeler, Governor of the Reserve Bank of New Zealand, to the Canterbury Employers' Chamber of Commerce, Christchurch, 4 February 2015.

*   *   *

Good morning and thank you for the invitation to meet with you. It's become an annual tradition to begin the New Year's speaking engagements with the Canterbury Employers' Chamber of Commerce. The Reserve Bank has been speaking regularly at this event for 22 years, and it's my great pleasure to join you again.

We have often discussed how the Reserve Bank is viewing the state of the economy. As we enter 2015 my colleagues have several questions on their mind. What might we expect from the global economy and how could it affect us, what are the prospects for our economy and the main areas of risk, and how might monetary policy unfold in the future?

In essence, the New Zealand economy is performing well in many respects and the prospects are good for continued steady growth, falling unemployment and low inflation. But the risks and uncertainties around the global economy are becoming more complex, and this presents considerable challenges for New Zealand enterprises, including the Reserve Bank. I will discuss the main issues that we are currently focusing on in the Reserve Bank – especially in relation to dairy prices, oil prices, house prices, and the exchange rate, and their implications for monetary policy.

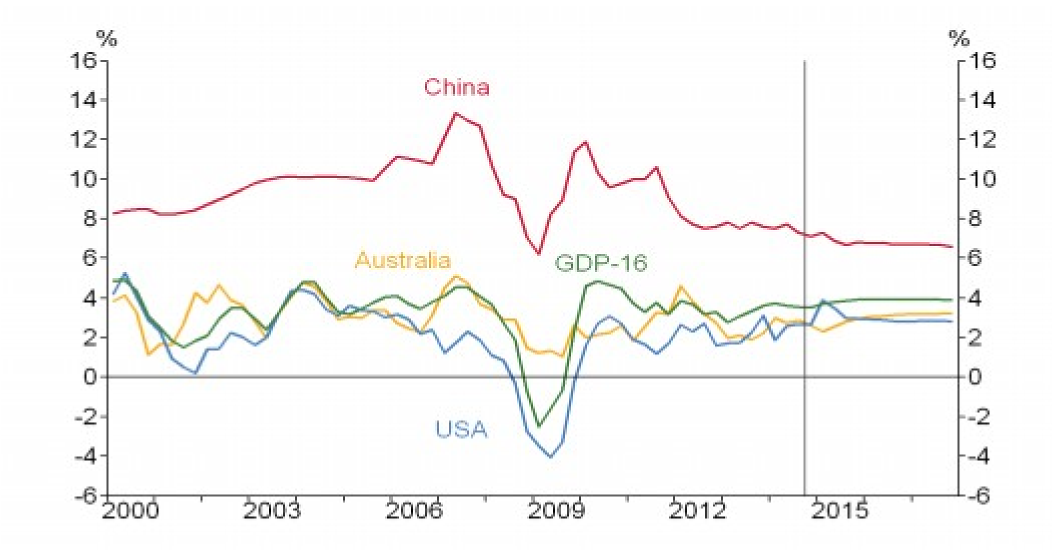
Let me turn first to the global outlook.

A more risky and uncertain global economy

We expect economic growth in New Zealand's trading partners of around 3 ¾ percent this year – a little higher than last year and slightly above the average growth rate over the past 30 years.

Growth in trading partner economies

(Annual percentage change)



Source: Haver Analytics, RBNZ estimates.

While this might sound like business as usual, it's also a more risky and uncertain environment. Why is this?

- First, the divergence in growth between countries has become more marked. This has taken place on two levels: the diminishing contribution of the advanced economies to global growth, and the wide disparities in growth within this group of countries.

  During 1995 – 2007 the advanced contributed around 60 percent of global growth. Since 2008, this has reversed with the emerging economies accounting for about 70 percent of global growth.

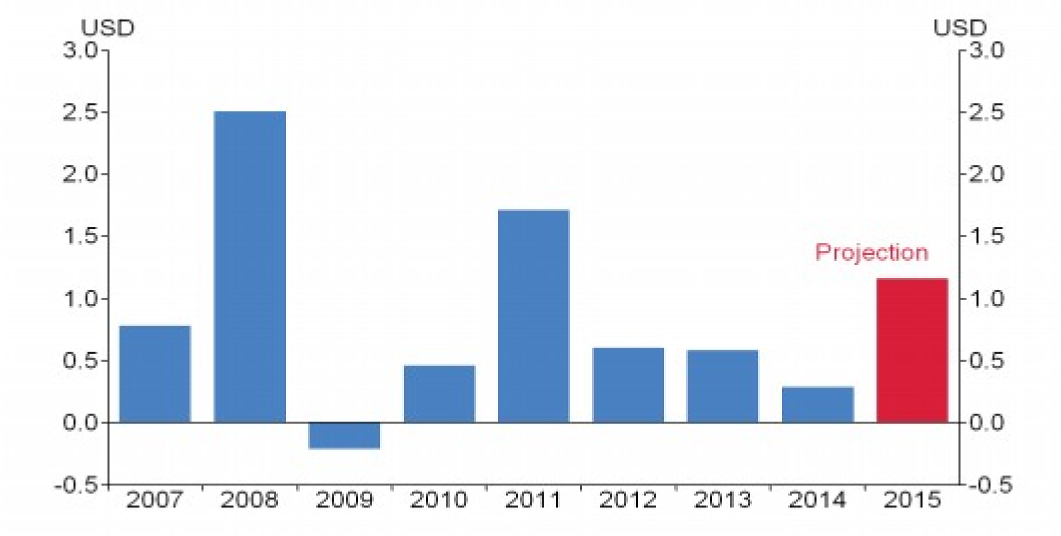
  Advanced economies are experiencing their weakest recovery in 70 years. The good news is that the US economy finally has momentum and has been expanding at an annualised rate of 4 percent since April 2014, despite the weaker fourth quarter. By contrast, Japan and the 19 economies that form the Euro-area (which, when combined, are similar in size to the US economy), have grown about a third as fast as the US economy over the past 5 years.

  The disparities in economic performance are particularly great within the euro-area. For example, the unemployment rate in Spain and Greece, at around 25 percent, is at a post war high. On the other hand, Germany's unemployment rate, at 4.9 percent, is at a post-reunification low. Real per capita GDP remains below 2007 levels in several European economies and in Italy it is back to 1997 levels.

- Second, even though the Federal Reserve completed its quantitative easing in October, the expected scale of quantitative easing by the Bank of Japan and the European Central Bank means that total central bank asset purchases in 2015 are likely to be the highest since 2011.

Estimated annual change in major central bank balance sheets

USD trillion



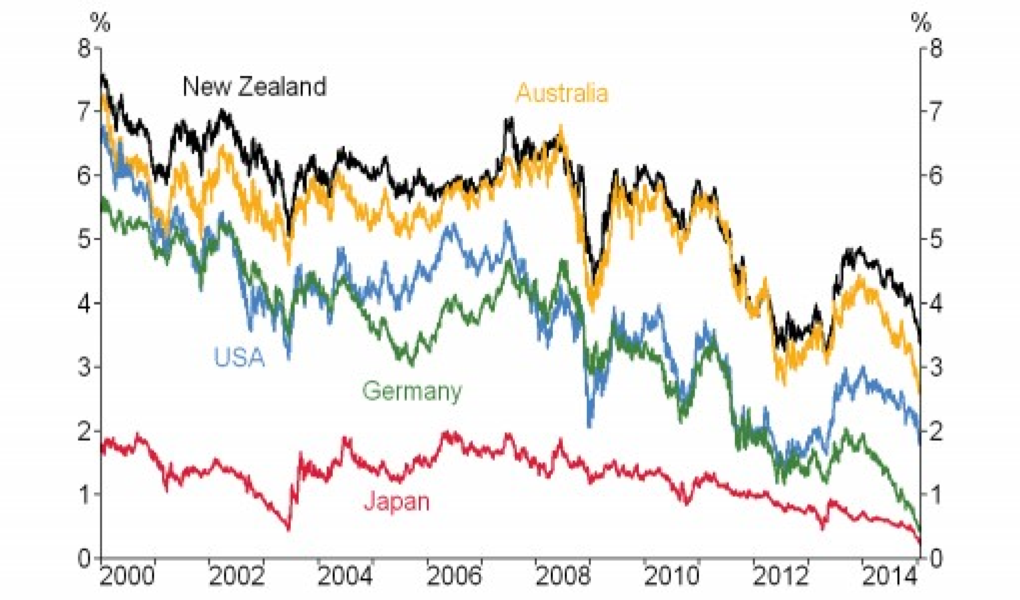
Source: Bloomberg, RBNZ estimates.

(Note: estimated increase in balance sheets of the Bank of England, Bank of Japan, ECB and Federal Reserve.)

Extensive monetary easing by central banks has stimulated asset prices globally, reduced risk spreads, and until recently, generated extremely low levels of market volatility. For example, the S&P 500 Index ended the year at historic highs and the

Nikkei 225 Index increased by 68 percent during the past 2 years. Yields on Japanese and German 10 year government bonds fell to historic lows of 0.20 percent and 0.35 percent respectively (German yields are negative for maturities up to six years). Yields on 10 year sovereign bonds are also at historic lows in France and Spain, most European two-year rates are now negative, and the policy rate at the Bank of England is at its lowest level since the Bank was established in 1694.

10-year sovereign bond yields



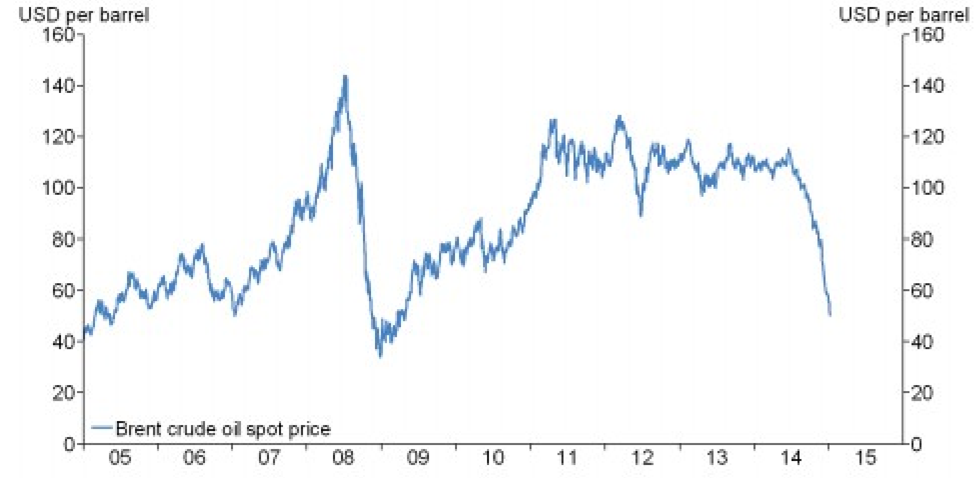
Source: Reuters.

- Third, consumer price inflation is very low and below the monetary policy target bands in several advanced economies. Consumer price inflation has been falling steadily in many advanced economies over the past four years due to the high levels of excess capacity, the global oversupply of capital goods and manufactured products, and falling prices of information technology. But the 58 percent decline in oil prices in US dollars and the 26 percent decline in a wide range of commodity prices since the end of June mean several countries will experience negative headline inflation over the coming year[1].

[1] The Bloomberg Commodity Index recently hit its lowest level since August 2002.

World oil price

(Brent crude)



Source: Haver Analytics.

- And fourth, financial markets have been surprised by several developments in recent weeks. Although quantitative easing by the ECB had long been anticipated, the planned scale of asset purchases is at the upper end of market expectations. In the last three weeks we have seen the Swiss National Bank abandon its exchange rate cap, interest rate cuts by the Danish Central Bank, the Bank of Canada, and the Reserve Bank of Australia, (and twelve other central banks), a victory by the Syriza Party in Greece, and marked differences in view among commentators around the timing of interest rate increases by the FOMC.

What might this mean for financial markets?

Almost seven years after the onset of the Global Financial Crisis, central banks are increasingly operating in uncharted waters. Many continue to search intensively for mechanisms to help inflate their economies and return inflation expectations to their desired ranges. And they are doing so at a time when they, like financial markets, are unsure to what extent the weakness in commodity prices and particularly oil prices, reflects the possibility of weaker global growth.

Market volatility, as reflected in exchange rate movements, interest rate spreads, and equity returns has increased in recent weeks, and we expect the rise in volatility to be sustained through 2015. There are two main reasons for this.

- Yields on long term bonds in many countries are now so low that the primary transmission mechanism for expanded quantitative easing is likely to be through exchange rate adjustment. Exchange rate tensions among countries will increase if market shares are materially affected by countries seeking lower exchange rates.
- US dollar liquidity has tightened since the Federal Reserve completed its asset purchases and will continue to do so as US interest rates start to increase. A re-rating of credit and liquidity risk is underway and lending spreads are likely to widen for countries and businesses with large international funding needs. In addition, regulatory changes in recent years have reduced the ability of banks to underwrite or intermediate risk.

Let me now offer some thoughts on the prospects for our economy.

Outlook for the New Zealand economy

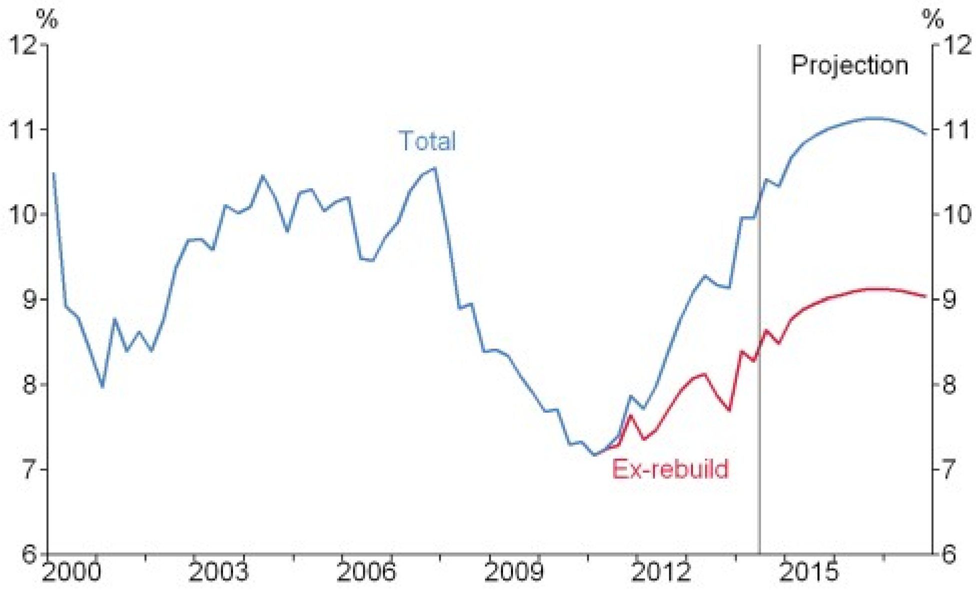
In many respects, our economy is performing very well. The Bank's current forecast is for real GDP growth of around 3 percent in 2015, falling unemployment, and continued low inflation. One concern is the balance between the traded and non- traded sectors of the economy, a subject I will return to in commenting on the exchange rate.

Over the past three years the economy's productive capacity has been increasing, primarily through increases in labour force growth and business investment[2].

- The labour force has increased by 4.6 percent, labour force participation is around historic highs, and the annual increase in net permanent and long-term migration, currently running at 50,000, is also at an historic high.
- The investment share of real GDP has been rising, having increased from 21 percent in 2011 to 24 percent in 2014. Investment has been increasing steadily, particularly commercial and residential construction in Auckland and Christchurch, but also as businesses take advantage of declining capital goods prices and expanding demand.

SNA total construction expenditure

(Seasonally adjusted, percent of potential output)



Source: Statistics New Zealand, RBNZ estimates.

Domestic demand growth has maintained its momentum despite the [52] percent decline in whole milk powder prices since February. Prices for meat and wool have provided some offset and farmers continue to show an extraordinary capacity to absorb shocks. Private consumption and construction spending have remained strong, and interest rates remain low by historic standards.

Two other factors will affect demand growth. The fall in oil prices should provide an income boost to the economy in the order of 1 percent of GDP, and fiscal consolidation, equivalent to around 0.2 percent of GDP, is expected to take place during the 2015/16 financial year[3].

2 Total factor productivity and labour productivity have been fairly flat over 2012–2014.

Risks and uncertainties

As with any economic forecasts, there are several risks and uncertainties, but I will comment only on the main ones we think about. These relate to the Chinese economy, and four key prices – dairy prices, oil prices, house prices and the exchange rate.

- **A significant slowdown in growth in China**.

  China is pivotal in the global trading system as it's the world's largest trading nation and the number one or two trading partner for over 100 countries. Australia and China are our main trading partners and account for around 38 percent of our merchandise exports. We are particularly vulnerable to any major downturn in China as China is also Australia's main trading partner (absorbing 37 percent of Australia's merchandise exports).

  There are question marks around developments in China such as: the effects of the current slowdown in demand growth and declining property prices across major cities; the exposure of the shadow banking system to the construction sector; the decline in the working age population; the implications of population aging and stricter environmental standards for future public spending; the impact of the anti-corruption campaign; the declining return on capital; and the commitment to the extensive economy-wide reforms that emerged from the Third Plenum.

  But China is, unquestionably, the greatest global economic success story over the past 35 years – with real GDP growth averaging 10 percent in the 30 years to 2010 and then transitioning to a trend rate of growth of around 7 to 7.5 percent.

  China's growth will almost certainly slow to a more moderate trend rate: the issue is when and how successfully it can make this transition. As an increasingly higher wage economy it needs to produce higher value added products in its export mix, become more dependent on internal sources of demand for its economic growth, and balance the expectations of its vast populous for prosperity and other goals.

  Although this transition will inevitably be accompanied by a range of economic shocks, there are grounds for confidence. China's 54 percent urbanisation rate is still a long way below the 75–90 percent urbanisation rate seen in most advanced economies. China also has enormous scope for exploiting catch-up technology given its very low ranking in international surveys, it has foreign exchange reserves of almost USD 4 trillion, and it has had 35 years of successful and pragmatic policy making.

- **Continuation of low dairy prices**

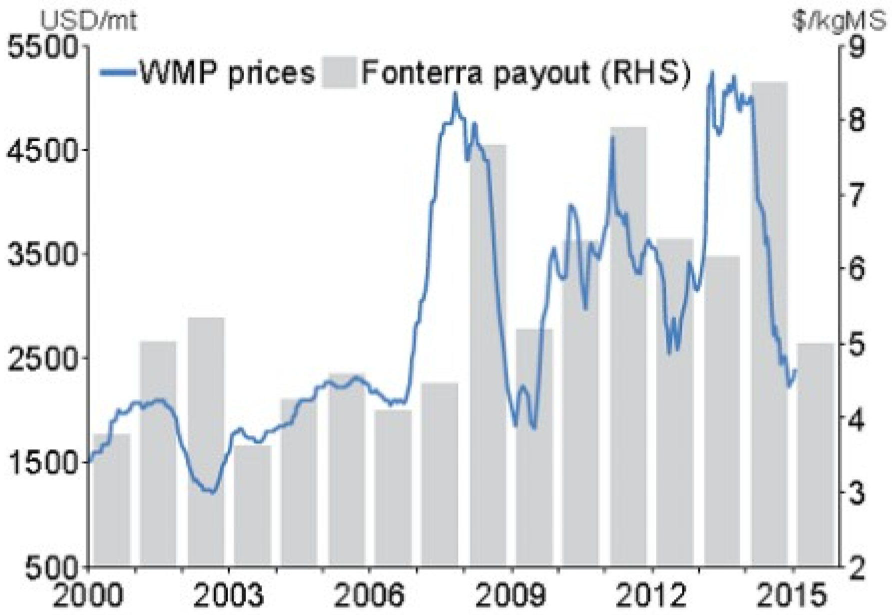
  Dairy exports account for about a third of our merchandise exports. We are the world's largest exporter of whole milk powder (WMP), China is the largest importer of dairy products, and about 90 percent of China's WMP imports are from New Zealand.

  The international auction price for WMP has fallen sharply from a peak of USD 5,200 per metric tonne in October 2013 to USD 2,400 per metric tonne now.

[3] Based on Treasury's December 2014 Economic and Fiscal Update.

Dairy sector payout and international auction prices

(USD/metric tonne)



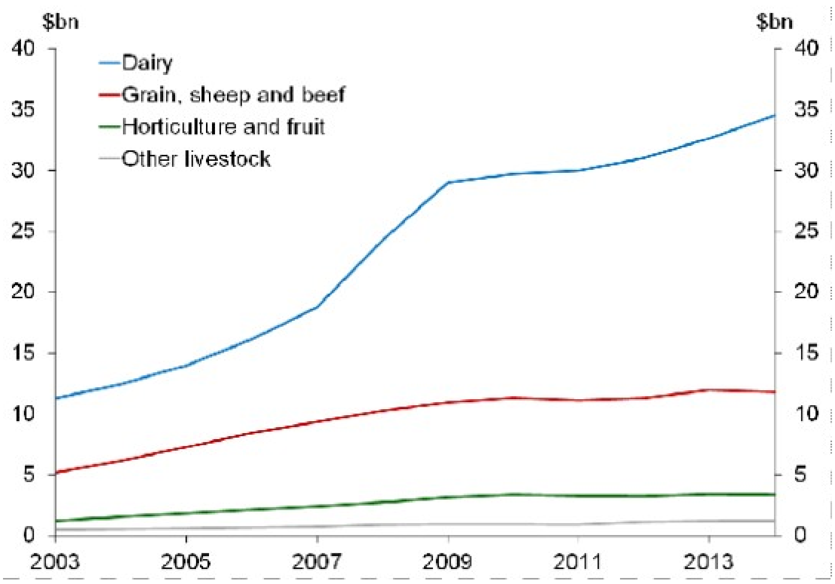
Source: Global Dairy Trade, Fonterra, USDA, RBNZ estimates

(Note: Payout figures in chart include dividends)

The drop in global prices is expected to lower dairy farmers' incomes by NZD 6 billion compared with the 2013/14 season. However, the effect on farmers' spending in 2015 is likely to be much smaller than that: farmers normally smooth spending through swings in income, and there are signs that last season's record pay-out was used by many to bolster farm balance sheets.

If prices do not recover as expected, there is a risk that spending will slow more sharply in 2016 as additional pressure comes on balance sheets and land prices. Dairy farm debt has trebled since 2003, and around half of the debt is held by 10 percent of the farmers.

Agricultural lending by sector



Estimates of the medium-term market clearing price for WMP tend to range around USD$3200 – 3800 a metric tonne. How long prices take to recover will depend on how quickly current demand/supply imbalances work through global markets.

The imbalances reflect a number of factors. In 2013, global –especially Chinese – dairy inventories rose sharply following the perfect storm of a drought in New Zealand, global production shortages, and in China the rationalisation of small dairy producers and an episode of foot and mouth disease. In 2014, with inventories already high, global supply rebounded strongly in response to good weather and the high prices of the previous year. Adding to downward pressure on prices has been the diversion of trade from the Russian market after the imposition of trade sanctions.

With household demand in China remaining solid, global dairy analysts expect Chinese import demand to recover from mid-2015 as inventories are run down, supporting a recovery in prices.

A further risk to farm incomes stems from dry weather in several of New Zealand's dairy regions recently. The recent dry weather has caused Fonterra to reduce its milk volume forecast for the 2014/15 season to 3.3 percent below that collected last season.

- **Oil Prices**

  A key uncertainty is whether we have moved into a new era in the global oil market.

  Oil prices have fallen by 58 percent since the end of June 2014 and 35 percent since the end of November 2014. While both demand and supply factors help explain the fall in oil prices since mid-2014, commentators disagree about the exact balance and several influences are commonly cited. We put most weight on supply side explanations. A ramp up in global supply due to increased US oil production, lower than expected supply disruptions in the Middle-East, and, importantly, the OPEC decision to not change supply quotas have all played a role in pushing prices lower. Lower energy demand has also contributed, reflecting in part a weaker growth outlook in emerging Asia and Europe, and also changing demand patterns due to aging populations and ongoing increases in energy efficiency.

  Lower oil prices should bring several benefits to our economy. If supply-side factors are the major cause and oil prices remain around USD 50 per barrel, the cost of New Zealand's annual petroleum imports would fall by about NZD 2.3 billion or 1 percent of nominal GDP compared with the price in mid-2014. It would represent a significant boost to household disposable income of around $600 per annum per household. If the main driver is weakening global demand, this would point to ongoing weakness in New Zealand's export incomes.

  Lower oil prices pass directly and quickly into New Zealand prices for petrol. For example, in the December quarter petrol prices detracted 0.3 percentage points from headline CPI inflation, and we expect a larger effect in the March quarter. Over following quarters, lower petrol prices pass into lower input costs and lower prices for other firms – e.g. through lower freight costs. An important issue is how significant these indirect impacts of lower fuel prices might be, and to what extent they reduce households' expectations of future inflation. We will analyse this in the March Monetary Policy Statement.

  Oil inventory levels are increasing, and supply remains high, so oil prices are unlikely to recover in the near term.

- **Housing**

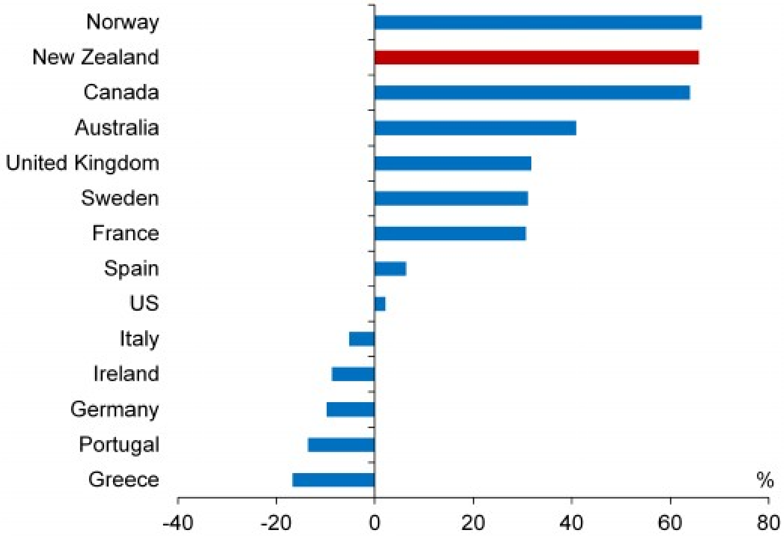
  We will be talking more about the housing market over the next few months.

  Our concern about house price inflation is based on the risk it poses to financial stability and the broader economy. Although it has not been a major factor in recent years, high rates of house price inflation can spill over into stronger spending and pressure on consumer price inflation. And the more that house prices get out of line with historic relativities, the greater the risk of a sharp correction, leading to financial instability.

  Analysis by the IMF in 2013 indicated that New Zealand, along with Norway, had the greatest deviation in house price to income ratios from its historic trends among several advanced economies.

International house price-to-income ratios

(deviation from historical average, 2013)



Source: IMF

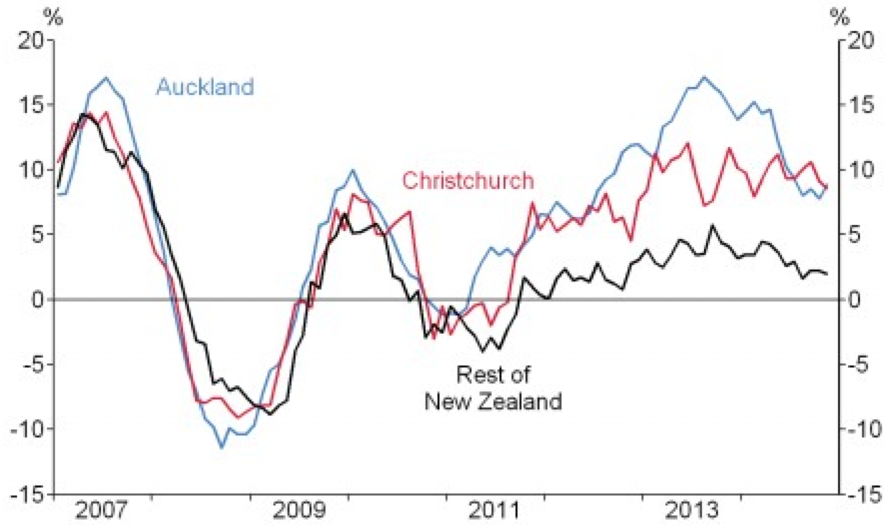
Our focus is mainly on the Auckland and Christchurch markets as they represent around half of the national real estate market: they are where the housing shortages are greatest and where market pressures are the most intense. Auckland and Christchurch house prices are 39 and 27 percent respectively above their 2007 levels.

House price inflation slowed as the Loan-to-Value ratio restrictions and the rise in mortgage interest rates helped to constrain demand, but appears to be increasing again in Auckland due to rising household incomes, falling interest rates on fixed-rate mortgages, strong migration inflows and continued market tightness[4]. Annual house price inflation measured on a three-month moving average basis is currently 10.9 and 7.4 percent in Auckland and Christchurch respectively, and 1.1 percent in the rest of New Zealand. We will have a clearer assessment when the February/March REINZ data is available.

[4] Data on inventories, days-to-sell and sales all point to continued price pressures.

House price inflation

(annual, 3-month moving average)



Source: REINZ, RBNZ estimates.

Resolving the housing shortages is key. In Christchurch this issue is expected to be resolved, albeit with longer delays than originally anticipated. In Auckland, much more needs to be done, especially in creating opportunities for residential construction in Auckland central. Auckland's housing shortage is estimated to have increased over the past year to between 15,000 and 20,000 dwellings, and the Auckland Council estimates that 10,000 houses a year will be required for the next 3 decades. Residential building permits are currently running at an annual rate of 7,700 – a 70 percent increase over 2012 and twice the 2011 level, but well short of the increase that needs to be sustained over a long period.

We will continue to monitor housing developments carefully, and the role that the banking system may be playing in contributing to pricing pressures in the housing market.

- **Exchange rate**

  The New Zealand dollar exchange rate is at exceptional levels compared with its history. The Trade Weighted Index (TWI) is above its 90th percentile calculated from historical data. Relative to the yen and Euro the exchange rate is above the 90th percentile. It is close to the 90th percentile against the Australian dollar.

  The upward pressure on the TWI reflects several influences but primarily investors have been attracted by the broad strength of the economy and our higher interest rates. The strong exchange rate has boosted the real disposable income of consumers but been a significant headwind for export firms that are not experiencing high international prices for their products, and for manufacturers and other businesses that compete with foreign imports.

  Within the overall TWI some important adjustments have occurred. We welcome the 11 percent depreciation of the New Zealand dollar against the US dollar over the past year[5]. However, the New Zealand dollar has appreciated by 7 percent and 4 percent respectively against the euro and the yen during this time. This reflects the impact of considerable policy easing by the ECB and Bank of Japan, which has further widened long term interest rate differentials with New Zealand.

While the New Zealand dollar has eased recently on a TWI basis, the exchange rate remains unjustified in terms of current economic conditions, particularly export prices, and unsustainable in terms of New Zealand's long-term economic fundamentals. We believe that, over time, New Zealand's growth differentials will narrow vis a vis the advanced economies, making the New Zealand dollar more likely to undergo a significant downward adjustment.

Reflections on monetary policy

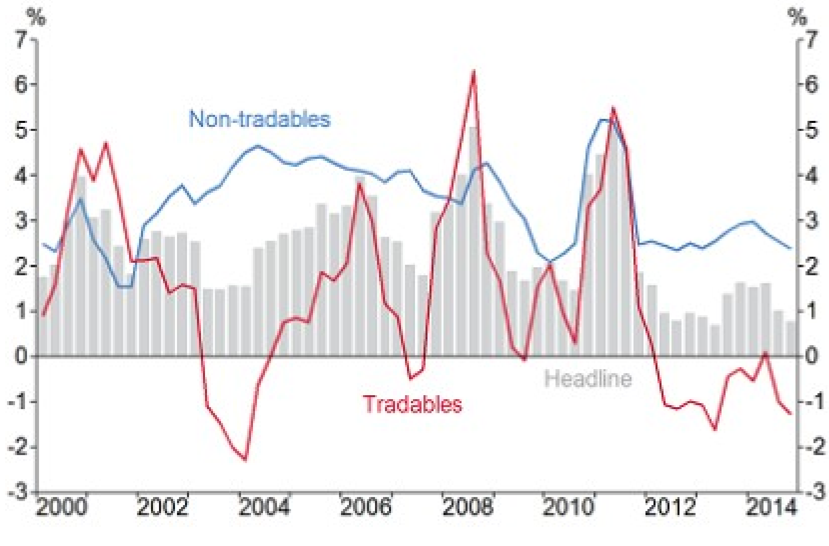
So what might this mean for monetary policy going forward?

Annual consumer price inflation is currently running at 0.8 percent. The low rate of headline inflation is driven by the high exchange rate, low global inflation, and falling oil prices. Inflation in the tradables sector has been negative for much of the past 2½ years and remains very weak. Our pricing models point to further declines in headline inflation over the coming year as a direct result of this weakness in traded goods prices.

Non tradables inflation – the more persistent component of inflation that is driven by domestic demand pressure and government charges – has been running at around 2½ percent. This inflation has come from varied sources including construction, household utilities and property maintenance, and taxes on tobacco and alcohol.

CPI inflation and components

(annual)



Source: Statistics New Zealand, RBNZ estimates.

We are currently undertaking analysis for the March MPS, but annual CPI inflation is expected to be below the band and could become negative for a period during 2015 as the

5 The US dollar has appreciated by 15 percent on a TWI basis since June 2014. The New Zealand dollar has depreciated by 16 percent against the US dollar since June 2014.

direct and indirect impacts of falling oil prices feed through the economy. We regard the fall in the oil price as a positive supply shock that will temporarily lower headline inflation. We then expect inflation to increase and move back towards the middle of the 1 percent to 3 percent target band, albeit more gradually than previously anticipated.

We increased the OCR by 100 basis points in the period March 2014 to July 2014 because consumer price inflation was increasing as the output gap became positive and was expected to increase further. Since July, the OCR has been on hold while we assessed the impact of the policy tightening and the reasons for the lower-than-expected domestic inflation outcomes.

The inflation outlook suggests that the OCR could remain at its current level for some time. How long will largely depend on the development of inflation pressures in both the traded and non-traded sector. The former is affected by inflation in our trading partners and movements in our exchange rate; the latter by capacity pressures in the economy and how expectations of future inflation develop in the private sector and affect price and wage setting.

In our OCR statement last Thursday we indicated that in the current circumstances we expect to keep the OCR on hold for some time, and that future interest rate adjustments, either up or down, will depend on the emerging flow of economic data.

Some commentators have suggested that a cut in interest rates would be appropriate at this stage. With a sizeable positive supply side shock, such as a major fall in the price of oil, a cut in interest rates can be appropriate if there is sufficient capacity to accommodate additional demand. Monetary policy settings could also warrant easing if domestic demand deteriorated and domestic price pressures abated further, perhaps in response to drought or a worsening in external economic circumstances.

However, in our current situation there are important considerations why a period of OCR stability is the most prudent option.

Commodity price declines reduce headline inflation for a period but do not deliver a sustained decline in inflation. Weak or even negative headline inflation that could be observed in 2015 is not reflective of underlying cost pressure in the non-tradables sector of the economy, and our medium term forecasts and measures of core inflation are well within the target band.

New Zealand is the only country among the advanced economies that has had a positive output gap in the past two years, our unemployment rate is low and falling, net inward migration and labour force participation is at record levels, and business and consumer confidence surveys remain strong. In addition, we have already seen some effective easing of credit conditions with declines in fixed-rate mortgages, at a time when we have financial stability concerns about accelerating house prices in Auckland.

Similarly, before any decision to raise interest rates, we would need to be confident that capacity utilisation and labour market pressures were generating, or about to generate, a substantial increase in inflation.

Concluding comment

New Zealand's economy is in a strong position with continued steady growth, falling unemployment, and inflation at low levels. The drivers of growth look sustainable, particularly in light of the increase in productive capacity that has occurred in recent years. Monetary policy remains in a strong position to continue supporting ongoing low inflationary growth in the New Zealand economy.