

July 2014

Executive Summary

- **July's data releases showed that confidence in the economic outlook had slipped, export growth weakened and housing market activity slowed.**
- **Inflation remained moderate in the June quarter, but with spare capacity exhausted, price pressures are expected to intensify.**
- **The international economy showed signs that growth has strengthened, while inflation is rising in the major advanced economies apart from Europe.**

Data released in July suggested that the pace of expansion in the economy eased in the June quarter. Business confidence retreated from the very high levels reached earlier in the year, but remained well above average. Export values fell sharply in the June quarter as both prices and volumes weakened. Import values rose modestly but the exchange rate appreciated, reducing import prices, pointing to a larger increase in import volumes. As a consequence, net exports are expected to make a negative contribution to real GDP growth in the June quarter.

Migration inflows remained strong in June, adding to the labour supply, but activity in the housing market subsided and house price inflation eased. High levels of migrant inflows may contribute to ongoing moderate wage growth in the June quarter labour market release on 6 August. Inflation also remained moderate in the June quarter, and is not expected to rise above the current 1.6% annual rate before the end of the year.

Spare capacity has fallen and output in the economy is estimated to be close to its potential (or trend) level, pointing to rising inflationary pressures over 2015. Reflecting this, the Reserve Bank increased the Official Cash Rate to 3.5% in July. The Reserve Bank expects to increase the OCR further, but the timing of future increases is dependent on developments in the economy over the coming months.

In the world economy, GDP growth stabilised in China in the June quarter and strengthened on balance in the advanced economies. Inflation is rising in most of the advanced economies owing to rising demand or country-specific factors.

Risks of slower income and price growth increase

Business and consumer confidence have eased from their peaks earlier in year, export growth has weakened, and housing market activity has softened. However, confidence remains at levels indicative of solid growth through the remainder of 2014. Consumer price inflation remained moderate in the June quarter, as the New Zealand dollar appreciated and domestic (non-tradable) inflation eased. Nonetheless, the recent period of strong growth has reduced the extent of spare capacity in the economy, which is expected to add to inflation in coming quarters.

Reflecting this, the Reserve Bank continued on the monetary policy tightening path it laid out earlier this year, increasing the Official Cash Rate (OCR) to 3.5% in July. The Reserve Bank expects to increase the OCR further, but the timing of future increases is dependent on developments in the economy over the coming months.

Overall, data releases in June suggest activity in the economy will continue to expand at a solid pace through the remainder of 2014, but downside risks to the outlook for price and income growth in the economy have increased recently, especially with the recent falls in dairy prices.

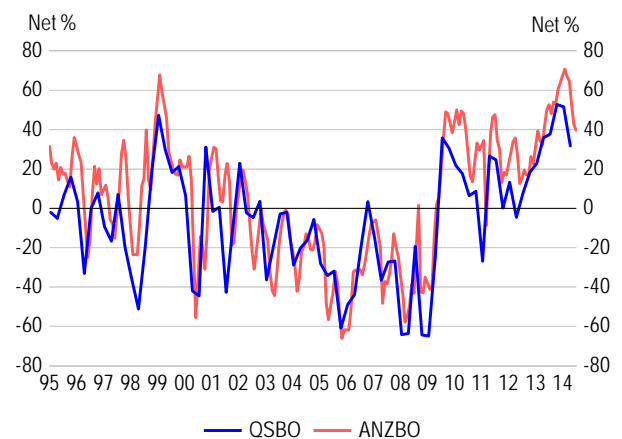
Business confidence eased...

Headline business confidence eased in the June quarter according to both the NZIER's Quarterly Survey of Business Opinion (QSBO) and the ANZ Business Outlook (ANZBO). In the QSBO, a net 32% of respondents considered the general business situation would improve in the next six months, down from 52% in the March quarter, but still well above the long-run average of -6%. The deterioration in the ANZBO survey was of a similar magnitude with a net 54% of respondents considering business conditions would improve in the next 12 months, down from 69% in the March quarter. In July's ANZBO confidence fell further, to a net 40% expecting business conditions to improve, but still well above the long-run average of 10% (Figure 1).

The moderation in confidence was spread across all the major indicators including own activity, exports, investment, profits and construction. The measures of firms' own activity, which closely track real GDP growth, while lower, continue to suggest that the pace of expansion remains brisk,

albeit slower than in recent quarters. In addition, both the BNZ-Business NZ manufacturing and services PMIs were lower in the June quarter, down to 53.4 and 55.8 respectively from 57.0 and 56.4 in March, indicating a slower pace of expansion.

Figure 1: Business confidence eased



Source: NZIER, ANZ

The ANZ-Roy Morgan consumer confidence survey dipped in May, but recovered most of its lost ground in June and July, and remains elevated.

In sum, the easing in business and consumer sentiment indicates the pace of growth has slowed from the rate achieved in recent quarters, consistent with the impact of higher interest rates.

...and other indicators of activity were mixed

Although concrete indicators of June quarter activity remain sparse, those released to date have been mixed. Data on milk production and meat processing point to weaker activity, as do anecdotes from the logging industry.

Retail spending appears to have bounced back, with electronic card transactions (ECT) rising a seasonally adjusted 1.4% in the June quarter, up from a weaker 0.8% in the March quarter. However, private consumption in current prices was up just 0.1% in March quarter's GDP release, compared to a forecast increase of 1.1%. So, despite the bounce back in ECT, the level of consumption may remain lower than previously forecast.

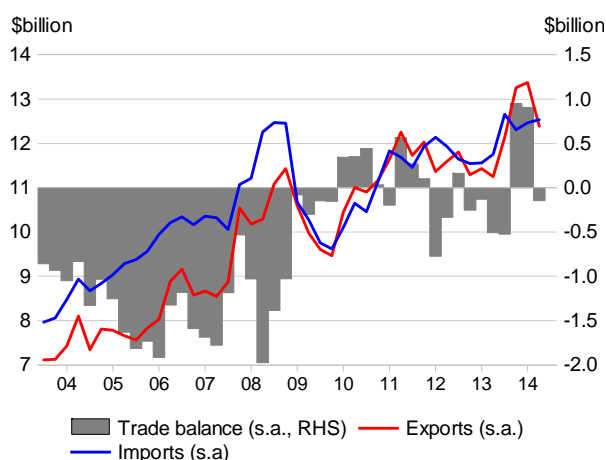
June quarter building consents rose 3.6%, excluding apartments, following a 3.8% rise in March. Including apartments, consents rose 8.4% in the quarter. Non-residential building consents also showed strength, with the quarterly value the

second highest on record. All told, construction activity looks likely to continue to increase over 2014.

External sector weaker...

The external accounts weakened as export values fell sharply, down 7.4% in the June quarter, and import values rose 0.5% (Figure 2). Values for all the major export categories were lower than in the previous quarter, led by dairy (-8.1%), timber (-14.5%) and meat (-7.1%). Dairy volumes fell modestly (-1.4%), implying prices fell sharply. Lower volumes accounted for most of the fall in the other commodities, suggesting that overall export volumes explain a little more than half of the fall in values.

Figure 2: Export values fell sharply



Source: Statistics NZ

On the imports side, capital goods import values were flat in the quarter, indicating the fall in plant and machinery investment in the March quarter national accounts was temporary. However, with the exchange rate rising around 3% in the quarter, import prices are likely to have fallen, pointing to a large negative contribution from net goods trade to June quarter real GDP growth.

Seasonally-adjusted visitor arrivals increased in the June quarter, up 2.7%, but resident departures increased by more, up 3.4%. As a consequence net services exports are unlikely to provide much offset to the weakness in net goods exports.

In the Balance of Payments, June's quarterly goods surplus is expected to narrow from March, but to be wider than in June last year when exports were constrained by drought, leading to a larger annual surplus. With little change in the services surplus, June's current account deficit is expected to narrow a little from 2.8% of GDP in the March year. Thereafter, falling export values and import values that rise to meet the demands

of an expanding economy are likely to lead to a deterioration in the current account.

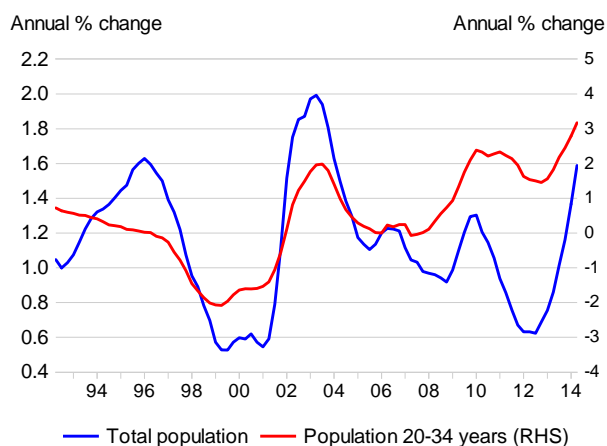
...as dairy prices fall further

Dairy prices fell further in July's GlobalDairyTrade auctions and, in combination with the strong dollar, this has led the major dairy cooperatives to reduce their forecasts of the prices members will receive. The largest cooperative, Fonterra, is forecasting a milk price of \$6.00 per kilogram of milksolids in 2014/15, down from \$8.40 in the 2013/14 season. Analysts estimate this will reduce farm incomes by around \$3.5 billion over the next year, or around 1.5% of GDP.

Expanding labour supply...

Seasonally-adjusted net permanent and long-term migration exceeded the 4,000 mark for the third consecutive month in June, taking the annual total net inflow to 38,300. The total population increased at its fastest pace in a decade, up 1.6% in the year ended June (Figure 3). Migration inflows have been particularly strong in the 20 to 34 year age group. The population in this age group grew 3% (27,000) in the year ended June, the largest increase on record. Also adding to the labour market are temporary migrants on work visas, which increased to 68,000 in the year ended June 2014 from 59,000 in the previous year.

Figure 3: Population growth strengthened



Source: Statistics NZ

...may restrain wage growth...

Labour market data for the June quarter will be released on 6 August. Labour market indicators in the QSBO and recent ANZBO releases were well above their long-run averages, suggesting that employment will continue to grow in the June quarter and for the remainder of the year. Employment growth accelerated in the second half of 2013, rising to 3.7% in the March 2014 quarter from the same quarter a year ago.

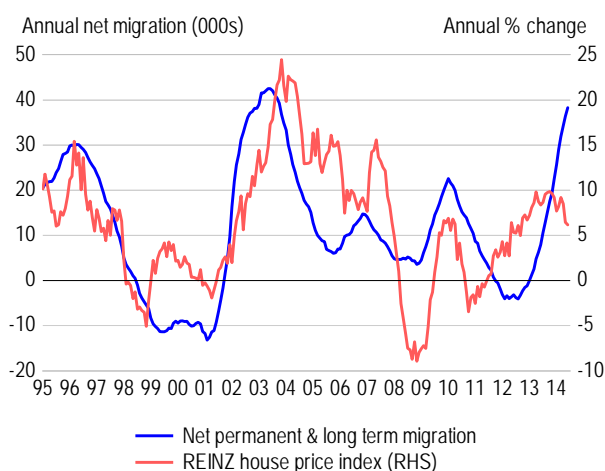
Quarterly employment growth is expected to ease in June, but annual growth is expected to increase to around 4.0%. Unemployment is expected to fall modestly from 6.0% in the March quarter, even as participation remains high, supported by the high level of migrant inflows.

With CPI inflation remaining subdued and the labour supply expanding strongly, growth in average hourly earnings is likely to be moderate.

...but could add to house price inflation

Despite the acceleration in population growth, activity in the housing market has eased. REINZ data show house sales in the three months ending June were 14% lower than the same period a year ago. This weaker activity is being reflected in prices. The most recent data from Quotable Value showed house prices were flat in the March quarter, and the annual rate of increase eased to 7.3% from 9.1% previously. The timelier, but less precise, REINZ measure of house price inflation eased to 7.0% in the three months to June from the same period a year ago (Figure 4).

Figure 4: House price inflation eased even as migration increased



Source: Statistics NZ, REINZ

Rents for housing have increased steadily in the Consumers Price Index, up 2.2% in the year ended June 2014, compared to a 2.1% increase in the prior year. With population rising strongly, other factors must be offsetting the demand effect. The two most obvious candidates are restrictions on loan to value ratios and higher interest rates. However, the longer migration inflows remain high, the greater the risk that house prices begin to rise more rapidly.

Inflation remained moderate...

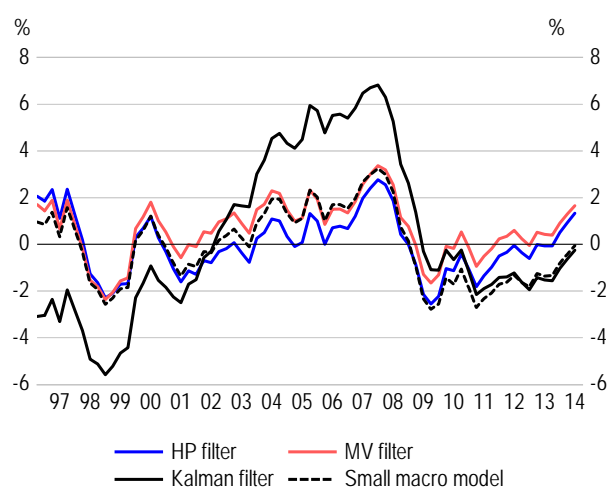
The Consumers Price Index rose 0.3% in the June quarter, which took annual inflation to 1.6%, from 1.5% in March. This was below the *Budget*

forecast of an increase to 1.8%. Non-tradables inflation was weaker than expected, rising 2.7% from the same quarter a year ago. At present there are few reasons to expect inflation will pickup sharply in the next few quarters, which implies the price level will likely remain lower than previously expected.

...but price pressures are expected to increase

Strong growth in recent quarters has led to a reduction in spare capacity, which is expected to add to non-tradable inflation. The Treasury's estimates of spare capacity in the economy, or the output gap, show that actual output is now equal to or slightly above potential output (Figure 5).

Figure 5: Estimates of the output gap



Source: Treasury

Reflecting this, the Reserve Bank increased the Official Cash Rate to 3.5% from 3.25% in June and 2.5% in March 2014. The Reserve Bank added that the increase in interest rates since March was likely to be restraining demand in the economy and that there would be a period of assessment before interest rates increased further. The Bank's statement also contained stronger language on the extent of exchange rate over-valuation, which some analysts interpreted as hinting at intervention in the foreign exchange market. Subsequently, the Trade Weighted Index, which had been around 81 prior to the statement, has been below 80. Most analysts anticipate the next OCR increase will occur late this year or early in 2015.

Stronger Q2 growth in the major economies

Growth stabilised in China in the June quarter and strengthened on balance in the advanced economies. Inflation is rising in most of the advanced economies owing to rising demand or country-specific factors.

The IMF, in its July Update to its World Economic Outlook, continues to expect global growth to rebound in the June quarter, but revised down its 2014 growth forecast owing to weak March quarter outturns. Global growth was revised down by 0.3% points to 3.6% in 2014, and advanced economies' growth by 0.4% points to 1.8%, owing to a cut to US growth.

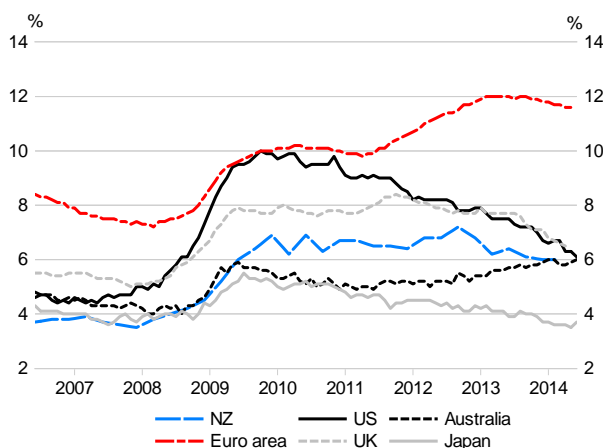
China's growth stabilised on policy support...

The Chinese economy grew 7.5% on a year ago in the June quarter, consistent with the government's 2014 target. Activity stabilised on the back of limited fiscal stimulus, monetary easing by the People's Bank of China (PBoC), and stronger external demand. Meanwhile, inflation eased 0.2% points to 2.3% in June, below its target of 3.5%, showing that the PBoC has room to ease policy further to support demand.

...and some advanced economies continued to recover...

The US economy expanded 1.0% in the June quarter, above expectations, as demand rebounded following the harsh winter. Growth was driven by investment, private consumption and inventories, while net exports provided a partial offset. Rising activity led to higher demand for labour: non-farm payrolls grew 272,000 a month in the June quarter, higher than the average of 194,000 in the previous two quarters, and the unemployment rate fell to 6.1% (Figure 6). However, uncertainty persisted around the recovery in the housing market.

Figure 6: Unemployment rates



Source: Haver

The UK economy expanded 0.8% in the June quarter, driven by a cyclical upswing in the domestic sectors. The labour market strengthened, with the average unemployment rate in the three months to May falling to 6.5% (Figure 6). However, export growth remained low,

mainly owing to weak demand from the euro area and the strong sterling.

Australian developments were mixed. The housing market is strong, with construction and mortgage lending growing solidly. However, the investment outlook is weak, and private consumption growth appeared subdued in the June quarter. Soft labour demand led the unemployment rate to return to a decade high of 6.0% in June, while export values fell owing to lower commodity prices and AUD appreciation.

...although other economies remained soft

Activity was subdued in some advanced economies in the June quarter. In the euro area, industrial production and retail sales growth was soft in May, and imports and exports contracted. However, the PMIs continued to indicate moderate growth in manufacturing and services activity. In Japan, domestic demand weakened following the sales tax rise in April, and the current account returned to surplus as lower demand led to a fall in imports. Forecasters expect June quarter GDP to contract 0.7% as weakness in the domestic sectors outweighs a pick-up in net exports.

Higher inflation in the advanced economies...

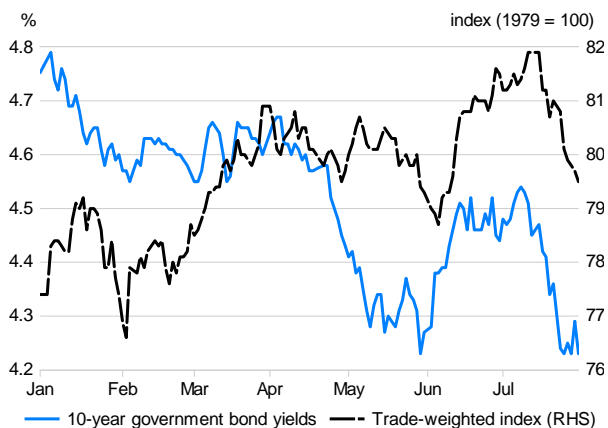
Annual inflation is rising in many advanced economies. US headline inflation was 2.1% in the June quarter, up from 1.4% in the March quarter, and core inflation (excluding food and energy) was also higher at 1.9% in the quarter. Meanwhile, UK inflation rose 0.4% points to 1.9% in June. The inflation pick-up in the US and UK reflected stronger demand as their recoveries become more entrenched. Japanese headline inflation was elevated at 3.6% in June owing to the sales tax rise, but remained at round 1.5% excluding the effect of higher taxes. Australian inflation rose 0.1% point to 3.0% in the quarter, driven by the earlier AUD depreciation. Inflation in the euro area remained low at 0.5% in June, mainly due to the strong euro and weak domestic demand.

...and the policy outlook of some central banks tilted more towards normalisation

Monetary policy in the US and the UK may be tightened sooner than previously expected if data continue to be strong. Early in July, the Federal Reserve's (Fed) judgements on the economy were cautious despite the pick-up in data and inflation, leading to lower long term yields and a depreciation in the USD. A global search for yield and a Fitch upgrade to New Zealand's credit

rating led NZ interest rates to fall, and the NZD TWI rose to a post-float high of 81.9 (Figure 7).

Figure 7: New Zealand monetary conditions



Sources: Reuters, RBNZ

Later in July, the Fed's policy tone was tilted more towards normalisation, as Chair Yellen acknowledged the possibility of an early rise in the policy rate if the economy continued to improve

more than expected. The Fed reduced its monthly asset purchases by US\$10bn to \$25bn starting in August, and has previously indicated that the asset purchase programme is likely to end in October. The Fed is also considering options to reduce its total stock of assets.

Meanwhile, markets expect a rise in the Bank of England's policy rate in November 2014, after Governor Carney suggested that the UK's cyclical upturn may warrant early monetary tightening. However, the policy outlook of other major central banks remains highly accommodative.

Geopolitical risks elevated

Geopolitical risks in the Middle East and Eastern Europe continued to affect global financial markets, leading to volatility in equity prices. While energy prices have receded from their high levels in June, they rose again in late July as further sanctions were imposed against Russia, a major energy supplier to Western Europe. Risks remained elevated at the end of the month.

Monthly Economic Indicators is a regular report prepared by the Modelling and Forecasting team of the Treasury.

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New Zealand Key Economic Data

31 July 2014

Quarterly Indicators

		2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg ¹	1.2	0.5	0.6	1.1	1.0	1.0	...
	ann ave % chg	2.5	2.3	2.2	2.6	2.9	3.3	...
Real private consumption	qtr % chg ¹	1.3	0.9	1.1	0.4	1.2	0.0	...
	ann ave % chg	2.9	2.6	2.6	3.1	3.4	3.4	...
Real public consumption	qtr % chg ¹	0.1	-0.2	0.1	2.5	-0.5	1.1	...
	ann ave % chg	-1.5	-1.0	-0.4	0.4	1.1	1.9	...
Real residential investment	qtr % chg ¹	3.6	6.3	0.1	7.0	0.6	11.6	...
	ann ave % chg	15.7	19.3	17.9	17.5	17.3	16.9	...
Real non-residential investment	qtr % chg ¹	0.9	1.6	7.0	0.4	0.6	-1.5	...
	ann ave % chg	4.6	3.7	3.8	5.5	7.2	8.4	...
Export volumes	qtr % chg ¹	-0.2	0.8	-3.3	-0.4	3.5	3.1	...
	ann ave % chg	2.2	2.5	2.6	0.9	0.7	0.4	...
Import volumes	qtr % chg ¹	0.6	1.8	2.3	4.0	0.1	1.7	...
	ann ave % chg	2.6	1.2	2.4	4.5	6.2	7.9	...
Nominal GDP - expenditure basis	ann ave % chg	2.2	2.0	1.6	2.8	5.3	7.0	...
Real GDP per capita	ann ave % chg	1.9	1.6	1.5	1.8	1.9	2.2	...
Real Gross National Disposable Income	ann ave % chg	1.0	0.6	1.8	3.2	5.4	7.3	...
External Trade								
Current account balance (annual)	NZ\$ millions	-8,590	-8,349	-8,243	-8,868	-7,622	-6,322	...
	% of GDP	-4.1	-3.9	-3.9	-4.1	-3.4	-2.8	...
Investment income balance (annual)	NZ\$ millions	-9,300	-9,327	-8,896	-8,972	-9,390	-9,771	...
Merchandise terms of trade	qtr % chg	-1.2	4.2	4.6	7.5	2.5	1.8	...
	ann % chg	-8.9	-2.8	4.3	15.8	20.2	17.3	...
Prices								
CPI inflation	qtr % chg	-0.2	0.4	0.2	0.9	0.1	0.3	0.3
	ann % chg	0.9	0.9	0.7	1.4	1.6	1.5	1.6
Tradable inflation	ann % chg	-1.0	-1.1	-1.6	-0.5	-0.3	-0.6	0.1
Non-tradable inflation	ann % chg	2.5	2.4	2.5	2.8	2.9	3.0	2.7
GDP deflator	ann % chg	-2.3	0.4	0.4	3.4	7.3	6.3	...
Consumption deflator	ann % chg	0.5	0.5	0.1	0.6	1.0	0.9	...
Labour Market								
Employment (HLFS)	qtr % chg ¹	0.5	0.2	0.4	1.2	1.1	0.9	...
	ann % chg ¹	0.4	0.4	0.7	2.4	3.0	3.7	...
Unemployment rate	% ¹	6.8	6.2	6.4	6.1	6.0	6.0	...
Participation rate	% ¹	68.2	67.9	68.1	68.6	68.9	69.3	...
LCI salary & wage rates - total (adjusted) ⁵	qtr % chg	0.5	0.4	0.4	0.4	0.5	0.3	...
	ann % chg	1.8	1.8	1.7	1.6	1.6	1.5	...
QES average hourly earnings - total ⁵	qtr % chg	-0.1	0.8	0.2	1.6	0.2	0.5	...
	ann % chg	2.6	2.1	2.1	2.6	2.9	2.5	...
Labour productivity ⁶	ann ave % chg	3.3	2.3	1.6	0.7	-0.3	-0.3	...
Retail Sales								
Core retail sales volume	qtr % chg ¹	1.1	0.9	2.0	-0.2	1.0	0.8	...
	ann % chg	1.8	2.5	4.4	4.3	3.7	3.6	...
Total retail sales volume	qtr % chg ¹	1.9	0.8	1.5	0.2	1.4	0.7	...
	ann % chg	3.2	3.5	4.2	4.7	3.9	3.8	...
Confidence Indicators/Surveys								
WMM - consumer confidence ³	Index	111	111	117	115	120	122	121
OSBO - general business situation ⁴	net %	18.5	22.8	35.9	37.8	52.8	51.7	31.7
OSBO - own activity outlook ⁴	net %	10.9	7.5	9.9	12.7	17.8	24.3	14.9

Monthly Indicators

		2014M01	2014M02	2014M03	2014M04	2014M05	2014M06	2014M07
External Sector								
Merchandise trade - exports	mth % chg ¹	-5.1	2.7	4.4	-5.3	2.7	0.1	...
	ann % chg ¹	21.5	16.4	14.2	11.8	12.4	4.8	...
Merchandise trade - imports	mth % chg ¹	0.2	3.4	0.2	-7.5	0.4	-0.7	...
	ann % chg ¹	3.9	7.9	12.3	4.4	6.8	8.7	...
Merchandise trade balance (12 month total)	NZ\$ million	262	627	798	1095	1325	1201	...
Visitor arrivals	number ¹	237,480	241,240	233,770	237,580	238,260	237,650	...
Visitor departures	number ¹	233,410	246,450	240,870	236,620	247,470	247,210	...
Housing								
Dwelling consents - residential	mth % chg ¹	-10.5	-1.3	9.0	2.3	-4.4	3.5	...
	ann % chg ¹	25.0	14.7	35.5	18.6	7.8	26.7	...
House sales - dwellings	mth % chg ¹	3.6	-6.0	-1.8	-7.1	2.1	-0.3	...
	ann % chg ¹	-4.3	-7.6	-10.0	-20.2	-14.8	-6.1	...
REINZ - house price index	mth % chg	-2.4	2.1	3.4	0.2	-1.2	-0.3	...
	ann % chg	7.7	8.2	9.2	8.5	6.5	6.2	...
Private Consumption								
Electronic card transactions - total retail	mth % chg ¹	-0.4	0.8	0.1	0.4	1.2	0.0	...
	ann % chg	6.1	5.7	5.1	5.7	7.6	4.0	...
New car registrations	mth % chg ¹	2.5	4.1	3.3	-0.4	3.5	3.1	...
	ann % chg	20.2	23.6	26.8	17.5	21.7	25.2	...
Migration								
Permanent & long-term arrivals	number ¹	8,240	8,530	8,780	8,780	9,130	9,210	...
Permanent & long-term departures	number ¹	5,060	4,930	4,890	4,680	5,100	4,940	...
Net PLT migration (12 month total)	number	25,666	29,022	31,914	34,366	36,397	38,338	...
Commodity Prices								
Brent oil price	US\$/Barrel	108.11	109.05	107.49	107.78	109.48	111.84	106.91
WTI oil price	US\$/Barrel	94.64	100.82	100.80	102.07	102.11	105.79	103.20
ANZ NZ commodity price index	mth % chg	0.6	0.8	-2.6	-4.7	-2.1	-1.1	...
	ann % chg	23.8	24.4	11.8	-3.4	-6.0	-7.8	...
ANZ world commodity price index	mth % chg	1.2	0.9	-0.1	-3.7	-2.2	-0.9	...
	ann % chg	22.6	22.4	14.0	-2.5	-3.1	-0.3	...
Financial Markets								
NZD/USD	\$ ²	0.8283	0.8288	0.8517	0.862	0.861	0.8621	0.8706
NZD/AUD	\$ ²	0.9347	0.9239	0.9395	0.9254	0.9255	0.9204	0.9266
Trade weighted index (TWI)	June 1979 = 100 ²	78.41	77.96	79.70	80.21	80.10	80.33	81.00
Official cash rate (OCR)	%	2.50	2.50	2.75	3.00	3.00	3.25	3.31
90 day bank bill rate	% ²	2.88	2.93	3.05	3.24	3.38	3.52	3.67
10 year govt bond rate	% ²	4.64	4.57	4.58	4.55	4.30	4.42	4.37
Confidence Indicators/Surveys								
ANZ - business confidence	net %	...	70.8	67.3	64.8	53.5	42.8	39.7
ANZ - activity outlook	net %	...	58.5	58.2	52.5	51.0	45.8	45.1
ANZ-Roy Morgan - consumer confidence	net %	135.8	133.0	132.0	133.5	127.6	131.9	132.7
Performance of Manufacturing Index	Index	56.4	56.2	58.3	54.3	52.6	53.3	...
Performance of Services Index	Index	58.1	52.9	58.2	58.6	54.1	54.7	...
qtr % chg	quarterly percent change			¹	Seasonally adjusted			
mth % chg	monthly percent change			²	Average (11am)			
ann % chg	annual percent change			³	Westpac McDermott Miller			
ann ave % chg	annual average percent change			⁴	Quarterly Survey of Business Opinion			
				⁵	Ordinary time			
				⁶	Production GDP divided by HLFS hours worked			

Sources: Statistics New Zealand, Reserve Bank of New Zealand, NZIER, ANZ, Haver, Westpac McDermott Miller, ANZ-Roy Morgan, REINZ, BNZ-Business NZ