Monthly Economic Indicators

THE TREASURY
Kaitohutohu Kaupapa Rawa

July 2015

Executive Summary

- **Business sentiment slipped in the June quarter and, along with other indicators, points to growth around trend over the coming year**
- **Inflation was weak in the June quarter, apart from housing costs and petrol prices, and inflation pressures remain subdued**
- **Dairy prices fell further in July, pointing to lower terms of trade**
- **International data were generally positive, but risks around Greece and China were elevated early in the month**

Key economic data releases over the past month point to growth slowing faster than expected in the *Budget Update*. Business confidence and firms' activity expectations eased from earlier levels, although both remain around historical averages. Indicators of private consumption also slipped and it is now expected to make a less positive contribution to growth over the year ahead. That said, GDP growth is expected to be around trend in 2015, supported by high migration, robust construction activity and solid labour income growth.

Weak inflation outturns continued in the June quarter, with annual inflation of only 0.3%, below market expectations. Aside from continued rises in housing costs and a large quarterly increase in petrol prices, other parts of the economy – including both tradable and non-tradable sectors – are showing weak price increases. Similarly, QSBO indicators of pricing pressures remain subdued, pointing to continued low inflation over the rest of 2015.

Dairy prices fell sharply at this month's GDT auctions, with the index down 41% since March 2015. This, along with other weak commodity prices, points to lower terms of trade than expected in the *Budget Update*. However, easier monetary conditions will act to offset some of the reduction in national income from the falling terms of trade.

The Reserve Bank reduced the Official Cash Rate (OCR) from 3.25% to 3.00%, owing to a softer growth outlook (the Canterbury rebuild appears to have peaked and dairy prices have fallen sharply) and low inflation. The Reserve Bank noted that further easing seems likely and market analysts expect at least one more 25 bps reduction in the OCR by the end of 2015.

Overall, recent developments point to a weaker outlook for the New Zealand economy than forecast in the *Budget Update*. However, positive factors will support growth at around trend.

International economic developments were positive on balance, but risks were heightened. The recovery in the US was sustained, while activity and inflation continued to pick up from a low level in the euro area, and domestic activity was stronger than expected in Australia. Risks around Greek debt and the Chinese equity market receded slightly over July, but remain elevated. Monetary policy is expected to tighten in the US and the UK, but was eased in China and Canada. Lower global demand and increased supply drove commodity prices lower, including dairy, iron ore and crude oil.

This month's special topic discusses recent risks in Greece and China and the impact any financial crisis arising from those risks might have on the New Zealand economy.

New Zealand Government

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Analysis

Economic developments over July continued to point to a weaker outlook than in the *Budget Update*. Treasury now considers that growth will be around trend in 2015. Dairy prices continued declining at this month's auctions and they are now expected to take longer to recover than in the *Budget Update*, although the easing in monetary conditions provides some offset. That said, the underlying drivers of growth – high migration, robust construction activity and solid labour income growth – remain intact.

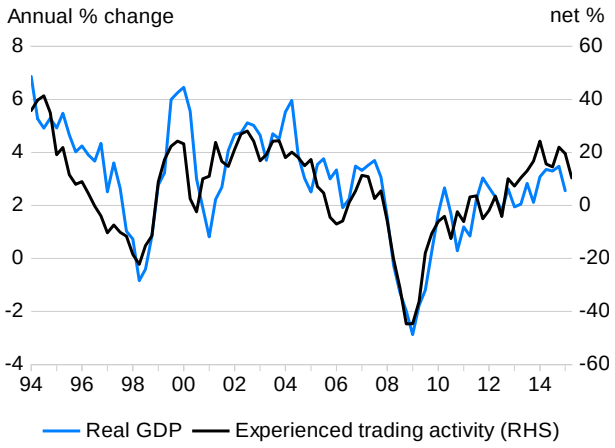
Business confidence eased...

The June Quarterly Survey of Business Opinion (QSBO) showed a net 7% of businesses expect the economy to improve over the next six months, down 13 points from the March quarter. The largest falls occurred in the regions most exposed to the dairy sector, a reflection of successive falls in dairy prices since March. However, despite the large fall, business confidence remains around average.

Fewer firms experienced higher trading activity over the June quarter (10%) than the March quarter, around the long-term average, pointing to annual GDP growth below 3% in the June quarter (Figure 1). Similarly, firms' expectations of their trading activity increasing over the next quarter slipped from a net 26% to a net 13%, although this remains around average. Ongoing expansion was also indicated in the services and manufacturing sectors by the PSI and PMI respectively.

The July ANZ Business Outlook (ANZBO), released July 31, is expected to show a further fall in headline confidence, a result of recent declines in prices at GlobalDairyTrade (GDT) auctions.

Figure 1: GDP growth and own activity experienced



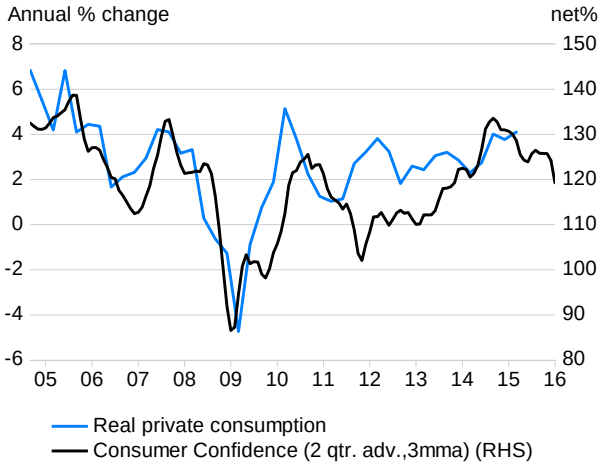
Sources: Statistics NZ, ANZ-Roy Morgan

...along with growth in consumer spending...

As well as the decline in business sentiment, consumer sentiment continues to ease. The July ANZ-Roy Morgan Consumer Confidence survey declined an additional 3 points to 116.4 (s.a.), to be below the long-run average. Similar to the business survey, the regions that experienced the sharpest decline were those most affected by dairy. The fall in sentiment was wide-ranging, but the future conditions index showed the largest drop with consumers negative about one-year ahead expectations for the first time since 2012.

Electronic card transaction values increased 0.6% in June, taking the June quarter increase to 1.2%. This rise was almost entirely driven by petrol, a result of prices rising around 9%, with core sales values up only 0.1% in the quarter. This, along with the weaker consumer confidence, points to private consumption growth easing sooner than forecast in the *Budget Update,* where annual growth of 4.1% in December 2015 was expected.

Figure 2: Private consumption and consumer confidence



Sources: Statistics NZ, ANZ-Roy Morgan

...and other key indicators...

The weaker outlook was reflected in the labour market. Hiring intentions declined slightly from a net 16% of firms expecting to hire in the next quarter to a net 10%, but remain high compared with the historical average. Firms also found it slightly easier to find skilled labour in the June quarter (from a net -36% to net -30%) but, similarly, firms considered finding skilled labour more difficult than the long-run average. These results point to ongoing positive employment growth in the June and September quarters (June data will be released in early August).

Business investment intentions also slipped slightly, a reflection of a net 2% of businesses expecting lower profits in the September quarter. However, both building (net 5%), and plant and machinery (net 18%) investment intentions remain above long-term averages of -13% and -1% respectively.

...and growth around trend is now expected

Overall, while firms are less optimistic than in the March quarter, and private consumption growth is expected to be below forecast, most indicators remain around their long-run averages. This is consistent with the economy moderating to trend growth (2.5-3.0%), compared to the above 3% growth expected in the *Budget Update.*

Inflation remains low...

Reflecting the weaker demand in the economy, inflation remained subdued in the June quarter. The Consumers Price Index (CPI) rose 0.4% in the June quarter, to be up 0.3% in the year, in line with the Reserve Bank (RB) June *Monetary Policy Statement* (MPS) forecast and our *Budget Update* forecast, although fuel price fluctuations led to differences on a quarterly basis. However, it was slightly lower than many commentators were expecting (0.4% for the year).

The quarterly outturn was driven by contributions from petrol price increases (+0.4% points), a seasonal rise in vegetable prices (+0.1% points) and housing costs (+0.1% points). These were partially offset by price falls for telecommunication services (-0.1% points) and domestic airfares (-0.1% points).

...with tradables inflation tracking nearer to zero...

Tradables prices increased 1.0% in the June quarter, driven by the 8.8% rise in fuel prices, a result of a rise in international oil prices and the depreciation of the NZ dollar against the US dollar. Excluding fuel, tradables prices declined 0.1% in the quarter, owing to the continued effect on prices of the strong NZ dollar over 2014 and early 2015. Business competition continues to play a part, with the average discount increasing for clothing, household contents and vehicles.

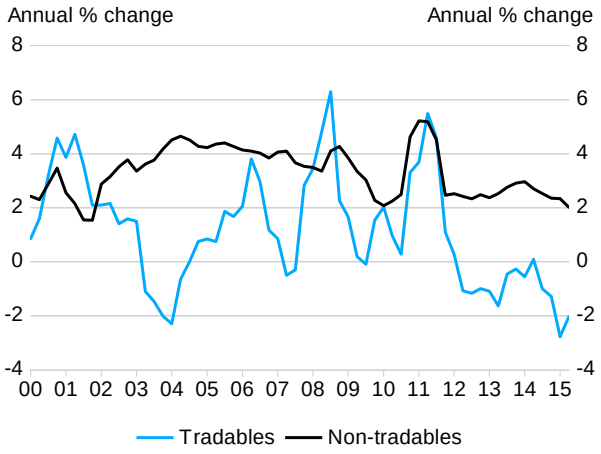
The increase in tradables prices in the quarter led their annual decline to slow from 2.4% in March to 2.0%. The annual decline was chiefly a result of petrol prices falling in the December and March quarters, owing to the plunge in international oil prices, along with ongoing falls in durable goods prices. Annual tradables inflation excluding fuel was still negative at -1.2% in June.

...and non-tradables inflation slowing

Non-tradables prices rose 0.1% in the quarter (0.3% s.a.), following a 1.1% rise in the March quarter (0.6% s.a.). The rise in domestic prices continues to be heavily influenced by an increase in housing costs (rent and purchase of new housing), with restaurant and ready-to-eat meals and beer also making significant contributions in the quarter. On the other hand, domestic airfares fell 13.3%, their largest recorded quarterly change, partially owing to an unwind in prices following the Cricket World Cup. Other significant negative contributions were recorded for telecommunication services (-1.9%), and a holiday-related reversal in rental car prices (-7.4%). Electricity prices rose much less than usual, up only 0.6% in the quarter, partly a result of lower lines charges, compared with the usual circa 3.0% rise in the June quarter.

Overall, these changes resulted in non-tradables inflation slowing from 2.3% in the year to March to 2.0% in June, its slowest pace since December 2001 (Figure 3).

Figure 3: Tradables and non-tradables inflation



Source: Statistics NZ

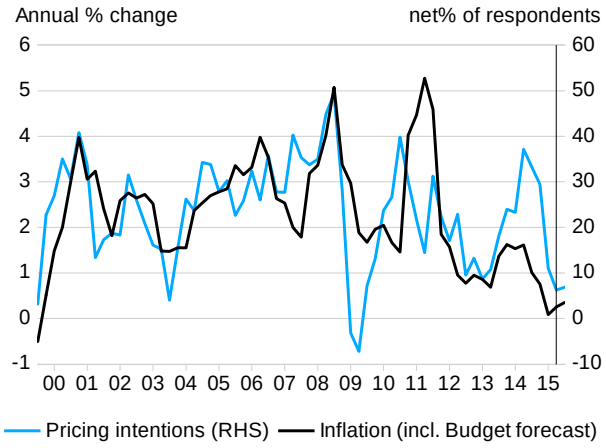
Pricing pressures remain weak...

While inflation remained low in the June quarter, it is unlikely to increase significantly in the near term with indicators of pricing pressures in the economy remaining weak. Similar to the previous two quarters, only a net 7% of firms expect to increase their selling prices in the next quarter (Figure 4). This compares with the long-run average of 32% and is down from 33% in June 2014, despite a net 22% of firms expecting their input costs to increase. Slowing growth, along with the reluctance of businesses to pass on

higher costs to consumers and the reduction in ACC vehicle levy rates, indicates that non-tradables inflation is likely to remain weak in coming quarters.

On the other hand, tradables inflation is expected to increase towards zero, largely as a result of the lower NZ dollar and higher petrol prices. Since July 2014, the NZ dollar has declined 15% on the TWI and 25% against the US dollar. The depreciation of the NZ dollar is expected to start flowing through in coming quarters, although how much and how quickly is uncertain, with weaker growth in the economy now expected.

Figure 4: Pricing intentions and Inflation



Sources: Statistics NZ, NZIER, The Treasury

Overall, we expect the September quarter CPI outturn to be broadly in-line with our *Budget Update* forecast of 0.4% (0.3% annual), with higher local authority rates and petrol prices offset by other weaker non-tradable components owing to more subdued demand and increased capacity.

...as labour supply continues to increase...

Labour supply continues to increase rapidly owing to the high net inflow of migrants. The number of net permanent and long-term migrants was 4,800 in June, a similar level to the previous nine months. This took the annual total to a record net gain of 58,300, slightly above the *Budget Update* forecast of 56,850 but below the Scenario Two peak of 60,000. The annual net gain was owing to higher arrivals and fewer departures, but departures rose slightly on a quarterly basis and arrivals were relatively flat. Arrivals in the year to June were dominated by increased student numbers, up 7,700 on 2014, although this appears to have levelled off. That said, July tends to have a large influx of students owing to the start of the semester, so these may increase further.

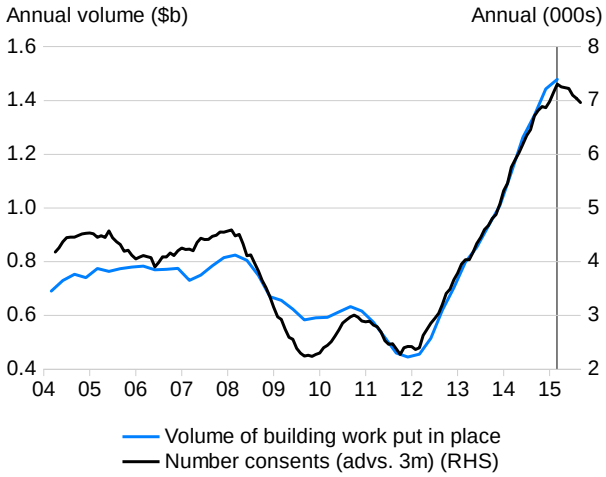
With net migrants declining only slightly on a quarterly basis, the annual inflow is not likely to tail off as sharply as expected in the central *Budget Update* forecast. Elevated net inflows for longer could result in net annual immigration remaining above 50,000 until March 2016, as illustrated in Scenario Two.

...adding to housing demand

The increase in net migrants continues to add to housing demand. The REINZ house price index rose a seasonally adjusted 2.3% in the June month, resulting in annual house price inflation increasing from 11.8% in May to 14.8%, the fastest rate of growth since May 2007. The housing market continues to reflect diverging regional trends, with the increase dominated by Auckland where the median price rose by 25.8% from a year ago. In contrast, the rest of NZ's median house price was steady from a year ago.

The diverging regional trend has also been seen in residential building consents. Auckland consents were up 16.3% in the June quarter (s.a.), while consents were up only 3.1% nationally. Residential consents in Canterbury fell 4.8% in the quarter, back to late 2013 levels, indicating that residential building in Christchurch may have peaked (Figure 5). That said, the QSBO building capacity utilisation reached a new record high of 94.6%, possibly contributing to consent numbers levelling off, albeit at a high level.

Figure 5: Canterbury consents and building activity



Sources: Statistics NZ, The Treasury

Goods deficit continues to widen...

Merchandise trade data showed a seasonally adjusted deficit of $370 million in the June month, leading to a $460 million deficit for the quarter. Export values rose a modest 0.4% in the quarter, with higher forestry and fruit export values partially offset by lower dairy and meat values. The fall in dairy export values was entirely driven by

volumes, with price rising 3.4% in the quarter, a reflection of the brief rally in GDT prices early in 2015. Import values increased 0.4% in the quarter, with an increase in capital goods and mineral fuels partially offset by a decline in consumer goods imports. On an annual basis, the trade deficit widened further to $2.8 billion in June, consistent with our view of the current account deficit widening to 5.6% of GDP by March 2016.

...and commodity prices decline further in June

The ANZ commodity price index continued to decline in June, down 3.1% to its lowest level in three years. The decline was led by aluminium prices (-6.4%), closely followed by dairy (-4.4%) and meat (-3.4%). All commodities declined in the month except forestry, which rose only 0.1%. Owing to the continued weakness in commodities and the significant decline in dairy prices, a weaker terms of trade is now expected than in the *Budget Update*.

Dairy prices plunge in July...

Following dairy price falls in June, the GlobalDairyTrade index fell sharply at both auctions in July, by 5.9% and 10.7% respectively, with falls recorded across all products. The index has fallen 41% since March 2015 and is now at its lowest level since December 2002, a continuation of the dynamics of high supply and weak demand. Whole milk powder (WMP) recorded declines of 11.9% and 13.1% in the month, with the average price at the second auction down to US$1,848/mt. WMP is particularly influenced by Chinese demand, with price weakness attributed to high WMP inventories, the weakening Chinese economic outlook and concerns around the stock market affecting buyer sentiment (see further discussions of China's share market in this month's Special Topic).

Analysts' forecasts for the farm gate milk price for the 2015/16 season now range from $3.75 to $5.00/kg MS compared to Fonterra's forecast of $5.25/kg MS. With the spot price estimated by Agri NZ to be equivalent to $3.17/kg MS, all forecasters are expecting some recovery in dairy prices over the season. Fonterra will review its farm gate price by the end of August, with this likely to be following the board meeting on August 7.

...leading the RB to reduce the OCR...

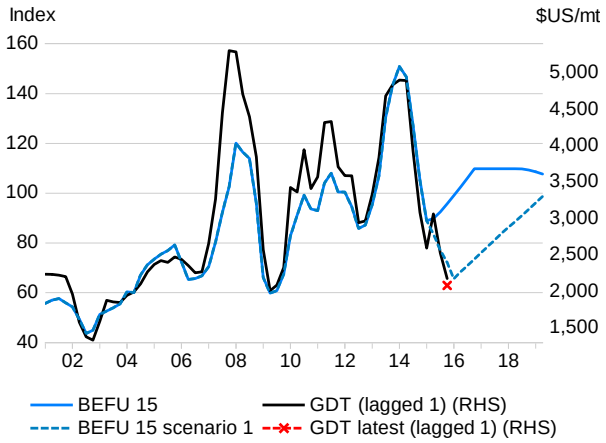
As widely expected, the RB reduced the OCR by an additional 25 bps to 3.00% at the July interim review, although the tone of the statement was slightly less dovish than the market was expecting. The RB cited low inflation and the softer growth outlook, owing to the rebuild activity in Canterbury appearing to have peaked and the sharp fall in dairy prices, as the main reasons for the reduction. The RB softened its description of the level of the NZ dollar from "unjustified and unsustainable" to say that "further depreciation is necessary".

The Reserve Bank noted that some further easing seems likely, more explicit language than at the June MPS. Market analysts' central view is for an additional 25 bps reduction at the September MPS and some are forecasting a fourth reduction by the end of the year. The market has a 25 bps reduction in September fully priced in and an additional 38 bps of reductions by April 2016.

...providing some offset for dairy exporters

Since the *Budget Update* was finalised, the reduction in the OCR, along with the depreciation in the NZ dollar earlier and at a faster rate, will provide some offset to weaker dairy prices. Overall, international dairy prices are now closer to Scenario One in the *Budget Update* than to our central forecast (Figure 6) and are expected to take longer to recover, although the offsetting factors of easier monetary conditions were not present in Scenario One. Together these will reduce some of the declines in national income from lower export revenues relative to Scenario One, with the NZ dollar expected to provide approximately $0.40-$0.50/kg MS to the farm gate price (depending on how much dairy processors have hedged their currency exposure).

Figure 6: Budget Update dairy export deflator forecasts and GDT prices



Source: The Treasury, GlobalDairyTrade

The exchange rate has been volatile

Weaker than expected dairy prices, along with the additional easing in the OCR now expected by the

market, contributed to exchange rate depreciation early in the month. At the start of July, the NZD was trading at 68 cents against the USD and 70.9 on the TWI; by the middle of July it had fallen to 65 cents and 69.3 respectively. However, following the OCR review and the speech by the RB Governor - which analysts saw as indicating more than one additional reduction in the OCR was less likely - the NZ dollar rose to 67 cents and 71.1 respectively. That said, the NZD dollar has fallen more than 10% against the USD and 8% on the TWI in the last three months, which will help boost export receipts and will also eventually put upwards pressure on tradables inflation by making imported goods more expensive in domestic terms.

Global activity picks up but risks high...

Reported data on most of our trading partners were generally positive in July, but risks arising from Greece and China came to the fore in the first part of the month, before declining later. US and UK monetary policy is expected to tighten, but some other central banks eased policy further. Global commodity prices continued to fall, reflecting concerns over the strength of future demand, as well as increased supply.

...as major advanced economies recover...

The US economy continued to strengthen. Non-farm payrolls expanded 223,000 in June, bringing growth in the June quarter (Q2) to 664,000 from 586,000 in the March quarter. The unemployment rate fell 0.2% points to 5.3% in June. Growth in activity was solid in both manufacturing and services, and construction rebounded following higher house price growth. However, retail sales dipped 0.3% in June, and a sharp fall in consumer confidence in July points to soft spending growth.

Euro area developments were positive overall. The unemployment rate remained at 11.1% in May, but down from 11.6% a year ago. Growth in consumer spending was solid, boosted by faster jobs growth and low interest rates. However, growth in industrial activity was soft in Q2 so far. Annual inflation was 0.2% in June, showing a slow pick-up since the start of 2015. The UK recovery continued, with GDP expanding 0.7% in Q2, driven by services. The unemployment rate rose 0.1% point to 5.6% over the three months to May, but annual wage growth picked up to 3.2%. Meanwhile, the Japanese economy showed a gradual recovery, with conditions facing households and businesses improving slowly.

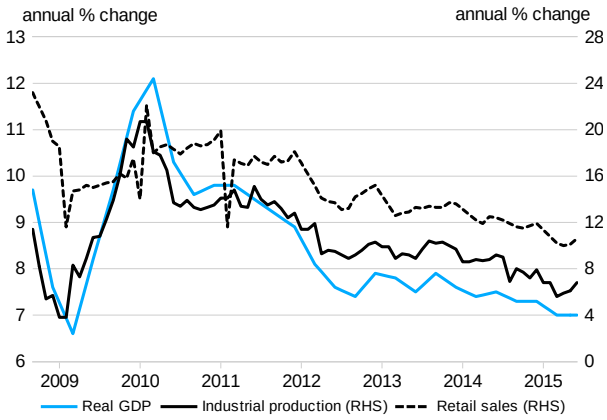
Australian employment grew 2.0% from a year ago in June, although the unemployment rate rose 0.1% point to 6.0% as the participation rate rose. Retail sales values rose 3.8% from a year ago, supported by faster jobs growth. However, the terms of trade are expected to fall further in Q2 and drag on nominal GDP growth. Annual inflation rose from 1.3% to 1.5% in Q2, driven by higher petrol prices, with core inflation (excluding large price movements) steady at 2.2%.

...and growth in China in line with target

The Chinese economy expanded at an historically slow pace of 7.0% in Q2 from a year ago (Figure 7), but at the government's target and exceeding market expectations (6.8%). Annual inflation rose to 1.4% in June from 1.2% in May, but remained significantly below the government's 3% target. House prices continued to recover gradually from large falls over 2014, rising 0.4% in June. However, the Caixin manufacturing PMI (formerly the HSBC PMI) fell 1.2 points to 48.2 in July, showing below-trend growth in industrial activity.

Growth in South Korea was slower than expected at 0.3% in Q2, as the MERS outbreak affected consumption and tourist arrivals. A high exchange rate and subdued Chinese demand also weighed on export growth.

Figure 7: Chinese real GDP growth



Source: Haver

Risks elevated in early July before falling

Key risks weighed on investor sentiment early in July. Chinese equity prices declined 32% from mid June to early July, although markets have since stabilised to an extent and equity prices remain 64% higher than a year ago. Supportive government measures lifted market sentiment, but volatility resurfaced towards the end of July.

The Greek referendum on 5 July resulted in a 'no' vote to the EU's previous bailout proposal, but

risks declined as Greece and the EU agreed to negotiate a third bailout. The Greek 5-year bond yields fell from 36% in early July to 16% towards the end of the month. This month's special topic discusses the impact on New Zealand if developments in Greece and China lead to a major financial crisis.

Fed and BoE on track to tighten policy...

The US Federal Reserve (Fed) affirmed that a rise in the Funds Rate in 2015 is appropriate given the solid recovery in the US economy. The Fed's July statement noted sustained improvement in the jobs market, and, while board members raised concerns around Greece and China, these risks have receded. The Bank of England Governor Carney indicated that gradual rate increases may occur as soon as the beginning of 2016.

The European Central Bank appears less likely to extend its quantitative easing (QE) beyond 2016, given the tentative pick-up in inflation. However, an extension remains possible if inflation stays significantly below 2% by mid 2016.

...but some central banks continued to ease

Some central banks continued to ease policy. The People's Bank of China (PBoC) reduced its key policy rates in late June, and analysts expect further easing to support growth and stabilise the stock market. The Bank of Canada lowered its policy rate by 25 basis points to 0.5% and cut its 2015 growth forecast heavily in response to falling commodity export prices.

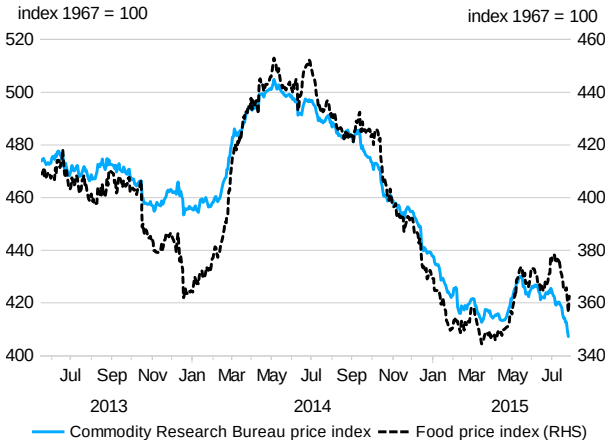
Markets expect further monetary easing by some other central banks. The Reserve Bank of Australia left its policy rate unchanged at 2.0%, but markets continue to price in an 80% probability of a rate reduction by December 2015. The Bank of Japan (BoJ) remains upbeat on achieving 2% inflation (by mid 2016), citing a strengthening jobs market and the effect of oil price falls receding. However, the BoJ lowered its growth and inflation forecasts, and analysts expect an expansion of its QE programme.

US bond yields higher but NZ yields declined

Global market movements reflected risks and the divergence in policy outlook. The US 10-year bond yield was volatile, falling 7 bps over the month to 2.28%. The NZ 10-year bond yield dropped 26 bps to 3.36%, owing to a sharp fall in dairy prices and the RBNZ's OCR cut (see p.5). Euro area yields declined from high levels as Greek risks eased.

Commodity prices declined further (Figure 8), reflecting higher global supply but also lower demand from emerging economies. Brent crude oil prices fell 11% to US$53.5/bbl, owing to continued high oil production from Saudi Arabia and North America, and a nuclear agreement between the US and Iran which is expected to increase global supply. Iron ore prices declined 8.8% to US$55.9/tonne owing to increased supply and weaker demand from China.

Figure 8: CRB commodity index



Source: Haver

Special Topic: Greece and China – risk and resilience in the NZ economy

The *Budget Economic and Fiscal Update* discussed a number of risks which might impinge on the outlook for the New Zealand economy. Amongst them were a marked slowdown in China's economy, possibly sparked by a fall in house prices, and a weaker recovery in the euro area as a result of high levels of sovereign debt and banking sector weakness in peripheral economies. The risk of Greece defaulting on its debt or being unable to reach a further funding agreement with its European partners was seen as a particular risk.[1]

Both of these risks became elevated in the past month, but the Chinese equity market was the cause for concern rather than the housing market. By the end of the month, the immediate risks appeared to have lessened, but concerns remain about future developments in both economies.

This topic briefly recaps recent developments and then looks at the transmission channels to the New Zealand economy if those risks were to eventuate. It concludes that while they could have a material impact on the NZ economy, it is relatively well placed to adjust to such shocks.

Greek debt crisis to the fore in late June...

The Greek debt crisis came to a head in late June when negotiations between Greece and its European partners broke down, the Greek Prime Minister called a referendum on the latest proposal from its creditors, the existing bailout expired without any extension, and Greece went into arrears in its repayments to the International Monetary Fund (IMF). As a result of these developments, the European Central Bank (ECB) capped its Emergency Liquidity Assistance (ELA) to the Greek banking system; this in turn led to the imposition of capital controls in Greece, with banks closed for three weeks and limited cash withdrawals available from ATMs.

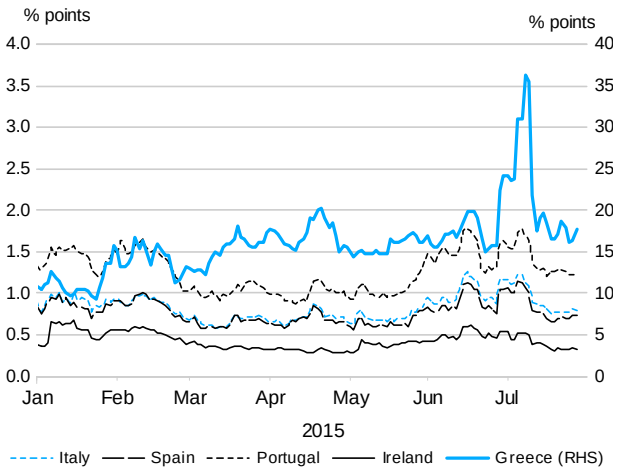
Although Greek voters rejected the latest proposal from their European creditors, negotiations recommenced with Greece submitting fresh proposals for spending reductions, tax reforms and other policy changes. After protracted negotiations over the weekend of 11-12 July, agreement for a third funding arrangement was reached subject to passing of "prior actions" by the Greek parliament and approval of the proposal by other European parliaments (where required). These conditions were met, preparing the way for formal negotiations on a fresh funding arrangement. As a result, Greece's European creditors arranged a bridging loan from the European Financial Stability Mechanism (EFSM) which allowed Greece to clear its arrears with the IMF and repay the ECB on 20 July.

However, a new funding arrangement still has to be agreed and more reforms be passed by the Greek parliament. In addition, the IMF and European Union Commission consider that Greek debt is unsustainable, and Greece's economic competitiveness needs to be restored. As a result, risks remain and some commentators still consider that Greece is likely to leave the European Monetary Union in the next few years.

...but limited financial contagion in Europe

Although Greek bond rates spiked at the height of the debt crisis, spreads to German bunds in other peripheral European bond markets did not spike to the same extent (Figure 1). This could be taken either as an indication that markets considered that an escalation of the Greek debt crisis was unlikely, or that if it did escalate contagion to other financial markets in Europe would be limited. The latter view is supported by the steps that European authorities have taken since the previous Greek bailout in 2012 to strengthen the financial system and support peripheral economies' bond markets; for example the ECB's quantitative easing policy whereby it is purchasing government bonds in secondary markets. In addition, most Greek debt is now held publicly and so European banks are less exposed.

Figure 1: 5-year bond spreads to German bunds



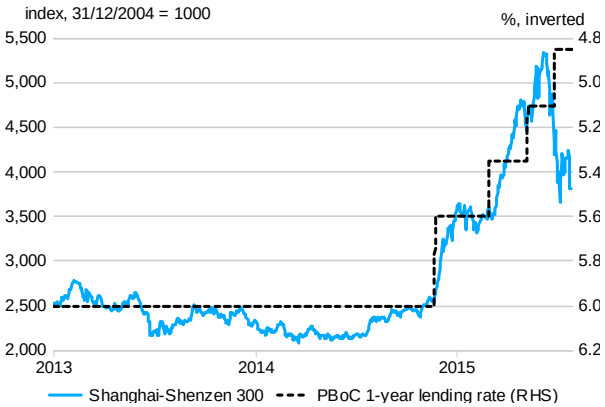
Source: Haver

[1] Risks and Scenarios chapter, pp.54-55, http://www.treasury.govt.nz/budget/forecasts/befu2015/befu15-5of11.pdf

Sharp fall in Chinese equity market...

The China Securities Index 300 (CSI300, an index of 300 stocks traded on the Shanghai and Shenzen stock markets) peaked at 5,354 on 8 June 2015, up 145% from a year before (Figure 2). Its ascent had been particularly rapid since late 2014, doubling in value since November.

Figure 2: CSI300 and PBoC 1-year landing rate



Source: Haver

The rise in the Index was supported by a number of factors: the People's Bank of China (PBoC) was reducing interest rates (Figure 2) and banks' reserve requirement ratios at the time in order to offset slowing economic growth and further monetary easing was expected; falling house prices may have encouraged some investors to switch from property to equities; the government was taking steps to liberalise financial markets, for example by connecting the Shanghai and Hong Kong share markets; in addition the government provided funding for margin trading (leveraged borrowing to buy shares); and there was general encouragement for investing in the share market to give firms another source of capital in addition to bank lending.

Prices fell sharply in the second half of June and reached a low of 3,663 on 8 July, down 32% in one month. The immediate trigger for the fall was a clampdown on the use of margin finance in response to concerns about an equity bubble. Concerns that the economy was slowing may also have been a factor (although the market had been rising even as the economy was slowing), as well as prospective monetary tightening in the US and concerns about euro area financial stability.

When equity prices began to fall precipitously, the authorities stepped in to halt the fall. Interest rates were reduced further (Figure 2), trading was halted for selected firms, there was a temporary ban on the sale of selected stocks by major shareholders, initial public offerings were suspended, additional liquidity was provided and a market stabilisation fund established. The market stabilised temporarily in mid July, but then fell by 10% again in late July before steadying.

...but limited impact on other markets...

The fall in Chinese share prices had some effect on other equity markets, especially in Asia, but it is difficult to distinguish that from the impact of the Greek crisis. Exchange rates were also volatile. There was some increased risk aversion in global financial markets, with increased demand for US Treasury bonds, and both the Federal Reserve and Bank of England mentioned global risks as factors which might delay monetary tightening.

There was also some additional weakness in commodity prices; iron ore prices also recorded a 32% fall over the same period as Chinese equity prices, but from an already low base. They have since recovered slightly. How much of the recent decline in dairy prices is attributable to the share market fall is uncertain, as dairy prices continued to fall after the temporary stabilisation of the share market in mid July. Buyer sentiment may have been affected, given China's importance to NZ's dairy exports. Weaker economic growth in China and high dairy stocks, along with the imbalance in global dairy supply and demand, are the more important factors in the current weakness. (See discussion of recent dairy prices on p.5 above.)

...and on the Chinese economy...

However, the impact of the share market fall on China's wider economy, including demand for dairy products, is not expected to be large:

- share values spiked briefly and households had not yet responded to the increase, so any response to the decrease is likely to be limited;
- the total market capitalisation of China's share market is small relative to the size of the economy (equivalent to around 40% of GDP) compared with most developed economies (around 100% of GDP);
- although retail investors account for around 80% of market turnover, only 8% of households invest in the share market;
- shares account for only 10-15% of household financial assets (compared with around 50% in the US), reducing any wealth effects from the losses, whether realised or potential;
- business investment is unlikely to be adversely affected by the fall because even at the peak equity issuance accounted for only 5% of fundraising, compared with bank loans and corporate bonds at 75% and 10% respectively.

...but it may have other effects...

However, the share market fall may have other less tangible effects on China's economy. It may have an adverse effect on consumer confidence, but retail sales had been easing despite previous increases in consumer confidence. Another possible impact is that GDP growth in the year to June was boosted by increased activity in the financial sector; to the extent that reflected higher share trading, the fall in the market may contribute to slightly lower growth in the second half of 2015.

The fall in the share market does not appear to pose a threat to financial stability, and may be positive in the long run given that it reverses a rapid increase before it became entrenched. The debt on leveraged share purchases is estimated at only 1.5% of total assets in the banking system.

...and raise deeper concerns

Another concern with China's share market fall is that, rather than leading to weaker demand, it is itself a sign of slower economic growth. Indicators of economic activity have remained relatively robust so far (albeit against a background of slowing growth). However, the Caixin flash manufacturing PMI fell from 49.4 in June to 48.2 in July, indicating below-trend industrial growth. On the other hand, recent movements in the share market were influenced by a range of factors, most of which were not economic (including promotion of the stock market via official state media outlets), so it may not be a good indicator of economic activity. That said, the volatility in the market may discourage some local and foreign investors in the future and set back China's financial liberalisation and reform agenda.

Impact on New Zealand minimal so far...

So far, the Greek debt crisis and the fall in China's share market have had limited impact on global financial markets and the world economy, largely because the crises appear to have been temporarily resolved and the risks have declined. However, a more sustainable solution to Greece's debt still needs to be found and China's share market may have further to fall. The effect on New Zealand has also been limited so far, but it is worth considering how such risks would impact on the New Zealand economy if they developed further. The risks differ in each case and the effects would also be different.

Direct trade impacts from a financial crisis in Greece would be minimal as Greece accounted for only 0.1% of goods exports in 2014. However, the European Union accounts for around 12% of goods and services exports and a wider European financial crisis would have a larger impact on demand for New Zealand products and services.

In the case of a financial crisis in China which led to a more pronounced slowdown than currently expected, the impact on New Zealand would be more direct. China accounted for 17% of goods exports in the year to June 2015, with 76% of that concentrated in dairy, meat, forestry, wool and seafood exports. The recent fall in the share market is not expected to impact directly on consumer demand in China (for the reasons discussed above), but if it did it would lead to large falls in prices for these commodities. New Zealand could also be impacted by falling demand for services exports from Chinese consumers. China accounts for 10% of New Zealand's services exports, with 20% growth in the past year, mainly in tourism and education.

There could also be an indirect effect via Australia from weaker demand in China, particularly for mineral resources, as lower growth in Australia (our largest export market) would also impact on New Zealand. There would also be an indirect effect via the rest of east Asia which accounts for 16% of NZ goods exports (excluding Japan).

In addition, a financial crisis, arising from either Greece or China, would lead to higher commercial interest rates and risk premiums, making offshore borrowing more expensive for New Zealand banks. Wealth effects, as asset prices fell, would also be important in such a case, as well as the impact on business and consumer confidence leading to lower investment and consumption.

...but NZ's policies and frameworks are sound

However, New Zealand is relatively well placed to withstand a global economic or financial shock. The key points of resilience are:

- a floating exchange rate which has already started to adjust to the weakness in commodity prices that has occurred for other reasons;
- flexible monetary policy and room to reduce the policy rate further to offset any increase in offshore funding costs;
- regulatory changes since the global financial crisis have increased the strength and resilience of the banking system, e.g. the core funding ratio and "mis-match ratios" ensure that banks have stable funding and can meet immediate cash needs in the event of a crisis;
- bank capital requirements have been tightened to increase resilience and Basel III capital

requirements were introduced in January 2013;

- the Reserve Bank could provide additional liquidity to the banking system, as it did during the global financial crisis;
- the Crown's fiscal position is relatively strong and net debt is low, providing room for the government to cushion any adverse shock to the economy.

There are currently no signs that a financial crisis is developing from either of these risks, but if one were to develop it would have an effect on a small open economy such as New Zealand's. However, the policies, frameworks and strength of public finances would buffer its impact on the economy

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

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New Zealand Key Economic Data

Quarterly Indicators

		2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg[1]	0.5	1.1	0.7	1.0	0.7	0.2	...
	ann ave % chg	2.2	2.5	2.8	3.0	3.3	3.2	...
Real private consumption	qtr % chg[1]	0.9	0.4	1.2	1.4	0.7	0.7	...
	ann ave % chg	2.9	2.9	2.8	3.0	3.2	3.7	...
Real public consumption	qtr % chg[1]	0.5	1.2	0.5	0.8	0.6	0.2	...
	ann ave % chg	1.9	2.7	3.3	3.3	3.4	3.0	...
Real residential investment	qtr % chg[1]	0.2	10.3	0.0	-0.2	4.9	0.6	...
	ann ave % chg	16.6	16.6	18.0	16.0	16.2	12.3	...
Real non-residential investment	qtr % chg[1]	-0.3	0.4	1.9	3.8	-1.3	-2.8	...
	ann ave % chg	6.2	8.4	8.7	7.4	6.2	4.6	...
Export volumes	qtr % chg[1]	2.5	2.6	-2.8	0.4	5.9	1.5	...
	ann ave % chg	1.0	0.3	0.6	2.0	3.3	3.9	...
Import volumes	qtr % chg[1]	0.2	2.0	2.9	0.3	2.8	1.0	...
	ann ave % chg	6.3	8.0	8.9	7.9	7.8	7.5	...
Nominal GDP - expenditure basis	ann ave % chg	5.4	6.8	8.1	7.6	5.5	3.9	...
Real GDP per capita	ann ave % chg	1.4	1.5	1.7	1.6	1.8	1.5	...
Real Gross National Disposable Income	ann ave % chg	4.4	5.8	6.3	5.9	4.5	2.9	...
External Trade								
Current account balance (annual)	NZ$ millions	-7,350	-6,005	-5,814	-6,093	-7,798	-8,604	...
	% of GDP	-3.3	-2.6	-2.5	-2.6	-3.3	-3.6	...
Investment income balance (annual)	NZ$ millions	-9,027	-9,338	-9,770	-9,956	-9,996	-9,706	...
Merchandise terms of trade	qtr % chg	2.5	1.8	0.1	-4.5	-2.4	1.4	...
	ann % chg	20.2	17.3	12.2	-0.3	-5.0	-5.4	...
Prices								
CPI inflation	qtr % chg	0.1	0.3	0.3	0.3	-0.2	-0.3	0.4
	ann % chg	1.6	1.5	1.6	1.0	0.8	0.1	0.3
Tradable inflation	ann % chg	-0.3	-0.6	0.1	-1.0	-1.3	-2.8	-2.0
Non-tradable inflation	ann % chg	2.9	3.0	2.7	2.5	2.4	2.3	2.0
GDP deflator	ann % chg	7.7	5.6	4.5	1.2	-2.1	-0.8	...
Consumption deflator	ann % chg	0.9	0.9	1.0	0.6	0.7	0.7	...
Labour Market								
Employment (HLFS)	qtr % chg[1]	0.8	1.0	0.4	1.0	1.2	0.7	...
	ann % chg[1]	2.9	3.7	3.6	3.2	3.5	3.2	...
Unemployment rate	%[1]	6.1	6.0	5.7	5.5	5.8	5.8	...
Participation rate	%[1]	68.7	69.0	68.6	68.8	69.4	69.6	...
LCI salary & wage rates - total (adjusted)[5]	qtr % chg	0.5	0.3	0.5	0.5	0.5	0.3	...
	ann % chg	1.6	1.5	1.6	1.7	1.7	1.7	...
QES average hourly earnings - total[5]	qtr % chg	0.2	0.5	0.2	1.4	0.5	0.0	...
	ann % chg	2.9	2.5	2.5	2.3	2.6	2.1	...
Labour productivity[6]	ann ave % chg	-0.7	-0.9	-0.9	-0.7	-0.3	0.0	...
Retail Sales								
Core retail sales volume	qtr % chg[1]	1.0	0.9	1.3	1.5	1.9	2.9	...
	ann % chg	3.7	3.5	3.0	4.5	6.0	7.5	...
Total retail sales volume	qtr % chg[1]	1.1	0.9	1.3	1.6	1.9	2.7	...
	ann % chg	3.9	3.6	3.6	4.7	5.9	7.4	...
Confidence Indicators/Surveys								
WMM - consumer confidence[3]	Index	120	122	121	117	115	117	113
QSBO - general business situation[4]	net %	52.8	51.7	31.7	19.0	23.6	23.3	5.1
QSBO - own activity outlook[4]	net %	30.8	33.2	29.7	33.9	26.7	25.0	9.3

Monthly Indicators

		2015M01	2015M02	2015M03	2015M04	2015M05	2015M06	2015M07
External Sector								
Merchandise trade - exports	mth % chg[1]	-8.9	4.9	1.3	-3.2	0.2	5.0	...
	ann % chg[1]	-9.5	-14.2	-2.5	-6.2	-4.7	1.3	...
Merchandise trade - imports	mth % chg[1]	2.4	-3.8	5.9	-2.4	3.7	-4.4	...
	ann % chg[1]	-4.1	1.8	2.8	0.3	-7.5	9.0	...
Merchandise trade balance (12 month total)	NZ$ million	-1416	-2129	-2372	-2655	-2549	-2848	...
Visitor arrivals	number[1]	248,690	266,890	255,770	259,380	259,550	259,030	...
Visitor departures	number[1]	251,980	259,880	269,380	259,660	268,180	266,600	...
Housing								
Dwelling consents - residential	mth % chg[1]	-2.4	-5.5	10.0	-1.1	0.0	-4.1	...
	ann % chg[1]	3.6	-0.6	13.6	1.4	2.2	2.0	...
House sales - dwellings	mth % chg[1]	-15.7	4.0	4.7	0.1	-1.4	5.1	...
	ann % chg[1]	2.6	12.6	20.3	27.6	21.6	29.1	...
REINZ - house price index	mth % chg	1.8	1.1	1.1	1.3	2.0	2.3	...
	ann % chg	8.5	7.1	8.5	9.3	11.8	14.8	...
Private Consumption								
Electronic card transactions - total retail	mth % chg[1]	0.0	1.0	0.7	-0.6	1.3	0.5	...
	ann % chg	4.5	4.0	3.7	3.9	3.2	5.0	...
New car registrations	mth % chg[1]	-0.7	-0.3	2.5	-1.5	-0.2	5.3	...
	ann % chg	17.1	12.1	11.8	11.2	6.8	11.2	...
Migration								
Permanent & long-term arrivals	number[1]	10,070	9,560	9,890	9,620	9,910	9,800	...
Permanent & long-term departures	number[1]	4,600	4,720	4,880	4,850	4,830	5,000	...
Net PLT migration (12 month total)	number	53,797	55,121	56,275	56,813	57,822	58,259	...
Commodity Prices								
Brent oil price	US$/Barrel	47.76	58.10	55.89	59.52	64.08	61.48	*56.93*
WTI oil price	US$/Barrel	47.22	50.58	47.82	54.45	59.27	59.82	*51.22*
ANZ NZ commodity price index	mth % chg	0.1	9.7	1.5	-9.0	-2.9	2.9	...
	ann % chg	-14.1	-6.5	-2.5	-6.9	-8.1	-4.3	...
ANZ world commodity price index	mth % chg	-0.3	4.2	4.6	-7.4	-4.9	-3.1	...
	ann % chg	-18.4	-15.8	-11.9	-15.3	-18.0	-19.7	...
Financial Markets								
NZD/USD	$[2]	0.764	0.7444	0.7473	0.7583	0.7394	0.6990	*0.6656*
NZD/AUD	$[2]	0.9465	0.9555	0.9658	0.9814	0.9368	0.9055	*0.8955*
Trade weighted index (TWI)	June 1979 = 100[2]	78.18	77.16	78.27	79.17	76.49	72.97	*70.41*
Official cash rate (OCR)	%	3.50	3.50	3.50	3.50	3.50	3.25	3.00
90 day bank bill rate	%[2]	3.67	3.63	3.63	3.63	3.53	3.33	*3.13*
10 year govt bond rate	%[2]	3.42	3.27	3.30	3.25	3.66	3.77	*3.48*
Confidence Indicators/Surveys								
ANZ - business confidence	net %	...	34.4	35.8	30.2	15.7	-2.3	...
ANZ - activity outlook	net %	...	40.9	42.2	41.3	32.6	23.6	...
ANZ-Roy Morgan - consumer confidence	net %	128.9	124.0	124.6	128.8	123.9	119.9	113.9
Performance of Manufacturing Index	Index	51.4	56.3	54.6	52.1	52.0	55.2	...
Performance of Services Index	Index	57.8	56.0	57.6	56.7	58.1	58.2	...

qtr % chg — quarterly percent change
mth % chg — monthly percent change
ann % chg — annual percent change
ann ave % chg — annual average percent change

[1] Seasonally adjusted
[2] Average (11am)
[3] Westpac McDermott Miller
[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