Monthly Economic Indicators

THE TREASURY
Kaitohutohu Kaupapa Rawa

August 2016

Executive Summary

- **Solid labour demand drove growth in aggregate labour earnings, boosting household spending in the June quarter.**
- **The upswing in activity continued in the September quarter, driven by high consumer confidence, elevated net migration and tourist arrivals, and strong housing demand.**
- **Despite robust demand in the economy, the inflation outlook remains subdued as cost pressures are generally low.**
- **Weak import values and a pick-up in key commodity prices point to a lower current account deficit than forecast in the June and September quarters.**

Key economic data releases over August continued to point to stronger GDP growth than expected in the *Budget Economic and Fiscal Update*. Solid labour demand drove growth in total labour incomes, contributing to a surge in household spending in the June quarter and pointing to robust private consumption growth. Weakness in retail prices, particularly for fuel and many other exchange rate-sensitive goods, also boosted retail spending. Other factors underpinning strong domestic demand in the June quarter include high population growth, low interest rates, strong growth in tourist arrivals and solid housing demand.

The upswing in activity appears to have continued in the September quarter. Retail spending showed healthy growth in July, annual net migration inflows stayed at an elevated level and short-term visitor arrivals lifted strongly, all pointing to ongoing solid growth in business activity and labour demand. Meanwhile, the high level of house prices, particularly in Auckland, maintained residential building consents at a high level in July.

Despite strong demand facing the economy, the inflation outlook remains weak. Annual growth in business input costs showed a pick-up in the June quarter, but pressures were still mainly concentrated in construction. Broader cost pressures are expected to remain soft, weighed on by the annual price fall in crude oil and hard commodities, slow growth in labour costs, weak global inflation and the appreciation of the New Zealand dollar over the past year, which will continue to weigh on import prices. The Reserve Bank cut the Official Cash Rate to 2.0% in response to a high exchange rate dampening tradables inflation and persistent weakness in inflation expectations, and signalled more policy easing to come.

New Zealand's soft commodity export prices continued to rise in July and August, with dairy prices up 20% over the two GlobalDairyTrade auctions in August, in line with the forecast increase in export prices in the *Budget Update*. At the same time, the annual trade balance remained more positive than expected in July, chiefly as low import prices dampened import values. All told, the current account deficit is expected to be lower than forecast in the *Budget Update* in the June and September quarters. This month's Special Topic examines developments in New Zealand's current account balance over recent years.

Global data releases create a picture of slowing world growth, with June quarter GDP growth in the US and Japan disappointing markets, and meeting already low expectations in the euro area. Indicators of activity have slowed between pre- and post-Brexit in the UK and euro area, although so far by less than expected. Most market attention, however, has been on the US Federal Reserve, whose Chair reiterated the possibility of a 2016 rate hike at the Jackson Hole Symposium. Financial markets have been fairly stable and the New Zealand dollar persistently strong over the month, supported by New Zealand's relatively high interest rates and growth.

New Zealand Government

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Analysis

Domestic data released over August continued to show robust economic activity in the June and September quarters, and stronger growth than expected in the *Budget Economic and Fiscal Update* (BEFU). Ongoing solid hiring by firms in the June quarter boosted growth in total labour earnings, supporting buoyant household spending. Other factors driving domestic demand in the June quarter included high tourist spending, fast population growth, strong housing demand and low interest rates. The upswing in domestic demand appears to have continued in the September quarter, driven by similar factors.

However, the inflation outlook remains weak. While producer prices showed a slight pick-up in the June quarter, cost pressures were concentrated in construction, and a strong New Zealand dollar (NZD) is expected to weigh on import prices. The Reserve Bank cut the Official Cash Rate (OCR) to 2.0% in response to a high NZD dampening tradables inflation and low inflation expectations, and signalled more policy easing to come. Positively, commodity export prices rose further, with dairy prices at the last GlobalDairyTrade (GDT) auction in August up 20.0% up from the last July auction.

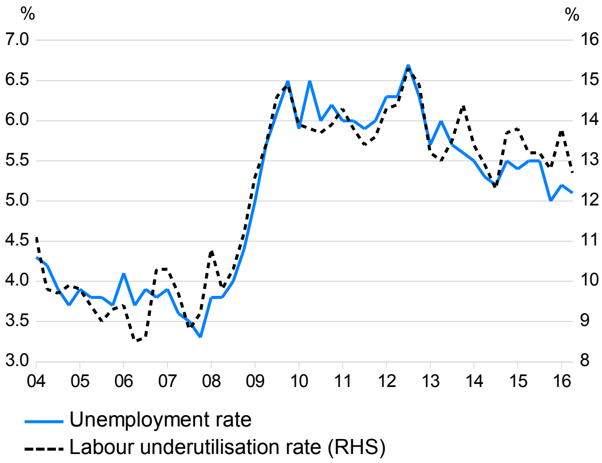
Solid demand for labour in the June quarter…

Total employment grew 2.4% in the June quarter in the Household Labour Force Survey (HLFS), following a solid 1.4% lift in the March quarter. Annual employment growth rose from 2.0% to 4.5%, which partly reflects methodological changes (see below), but also rising labour demand. In the Quarterly Employment Survey (QES), filled jobs rose 3.1% in the June quarter from a year ago and the number of full-time equivalent employees grew 3.2%, indicating that the sustained expansion in activity is boosting labour demand, especially in accommodation and food services and construction.

The HLFS redesign had a significant influence on the employment figures, which makes it difficult to interpret how much of the statistical increase between the June and earlier quarters reflects actual jobs growth. Consequently, the QES figures are likely to be a more accurate measure of employment growth. The new HLFS methodology also altered the allocation of employment across industries and status, with a rise in the number of employers and people in self-employment more than offsetting a fall in the number of wage and salary earners.

The ongoing strength in labour demand was reflected in a fall in the unemployment rate from 5.2% to 5.1% (Figure 1). Information from Statistics NZ shows that the HLFS redesign led to a reduction in the unemployment rate of around 0.5% points in recent years.[1] Allowing for this revision, the unemployment rate in the June quarter is just below the BEFU forecast of 5.7%. The new labour underutilisation measure, which includes people who are unemployed, underemployed and who would like a job but are not actively looking or immediately available for work, fell from 13.2% in June 2015 to 12.7% in June 2016. The decline in the unemployment and the underutilisation rates (Figure 1) points to a gradual tightening in the labour market, but also to the persistence of some spare capacity.

Figure 1: Unemployment and underutilisation



Source: Statistics NZ

…drives growth in total labour earnings…

The labour force participation rate surged from 68.8% to 69.7%, the highest since the survey began in 1986, but the HLFS redesign clouded the comparison between the March and June quarters. The participation rate fell for people under 30 years old and increased for most of the older age groups, continuing the trend of rising participation for older people. The working age population rose 0.9% in the quarter to be up 2.7% annually, reflecting elevated net migration inflows.

While annual growth in average weekly earnings remained soft at 1.9% in the June quarter (above the BEFU forecast of 1.7%), low annual CPI inflation (0.4% in June) resulted in solid growth in real wages. A large increase in total paid hours,

[1] See the Special Topic in the July 2016 Monthly Economic Indicators http://www.treasury.govt.nz/economy/mei/jul16.

owing to strong employment growth, led the QES gross weekly earnings to expand 1.2% in the June quarter and 5.1% from a year ago, up from 4.8% in the March quarter.

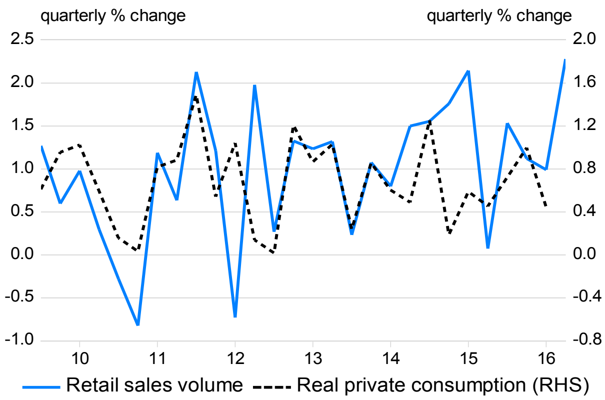
…leading to a surge in household spending…

Growth in total labour incomes was a key driver of buoyant household spending in the June quarter. The seasonally-adjusted volume of retail sales surged 2.3% to be up 6.0% from a year ago, with growth in 12 of the 15 industry groups, following a 1.0% quarterly rise in March. Growth in core retail sales volumes (total sales less vehicles and fuel) was even stronger at 6.4% from a year ago, as it excludes a quarterly fall in fuel volumes, which partly reflects a rise in petrol prices in the quarter.

The product categories driving growth in retail volumes in the June quarter broadly reflect key drivers of demand in the economy. Sales of hardware, building and gardening supplies expanded 11.0% from a year ago, supported by residential construction in Auckland and Canterbury. Food and beverage services grew 8.0% from a year ago, boosted by elevated tourist spending as visitor arrivals grew 9.3% in the June quarter from a year ago.

Growth from a year ago in the sales of electrical and electronic goods (16.6%), department stores (7.5%) and non-store retailing (32.2%) is likely to have been partly supported by low retail prices as the appreciation in the NZD over the past year reduced import prices. In addition, aggregate spending is underpinned by high population growth, low interest rates and solid consumer confidence, pointing to robust private consumption growth in the June quarter (Figure 2).

Figure 2: Retail sales and private consumption



Source: Statistics NZ

Uncertainty remains over how much of the lift in retail spending in the June quarter will be attributed to non-residents, which would show up in services exports instead of household consumption. However, aggregate international visitor spending for the June quarter was broadly steady in seasonally-adjusted terms, suggesting that the rise in retail spending will contribute largely to private consumption growth. June quarter GDP is scheduled for release on 15 September, and growth in the quarter is expected to be stronger than the BEFU forecast of 0.6%, as data point to stronger-than-forecast private consumption and net exports.

…supported by low retail prices

The value of retail sales expanded 2.2% in the June quarter and 5.5% from a year ago, the fastest annual growth since the December quarter 2011. Annual growth in total retail values was less than the increase in volumes, as a result of weaker prices. Core retail values grew 6.6% from a year ago, with a small annual rise in retail prices excluding vehicles and fuel (0.2%) driven by price increases in building hardware and food services that more than offset price falls in many exchange rate-sensitive areas. The overall weakness in retail prices seems to have boosted consumer demand and contributed to strong sales growth. An annual fall in petrol prices of around 8% led fuel retail values to decline 4.5% from a year ago, but fuel sales volumes rose 3.8% from a year ago as lower prices encouraged more fuel purchases.

Retail spending remains solid so far in the September quarter…

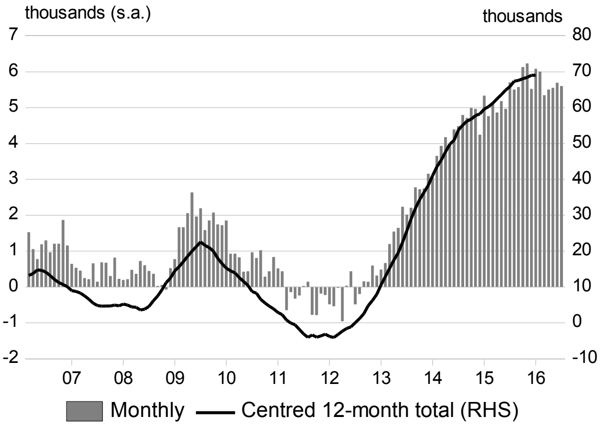
Household spending continued to expand at a fast pace in July. The ANZ-Roy Morgan Consumer Confidence Index dipped slightly to 117.7 in August from 118.2 in July, but remained around its historical average, supported by low interest rates, high house prices and employment growth, and points to continued expansion in household spending in the September quarter.

The seasonally-adjusted value of electronic card transactions rose 0.4% in July, to be up 4.5% from July 2015. Growth in card transactions both in the month and from a year ago was driven by the core retail industries (excludes vehicles and fuel), which expanded 8.3% from July 2015. Growth in total transactions from a year ago (4.5%) was dampened by a fall in fuel values (8.6%), which is chiefly the result of lower petrol prices. Within the core retail industries, robust year-ago growth in hospitality, durables and consumables continues to point to tourist spending, residential construction and population growth as the key drivers underpinning retail demand.

…boosted by elevated net migration inflows…

Population growth continued to be driven by net migration inflows. A seasonally-adjusted 5,600 net permanent and long-term migrants arrived in July, easing from 5,700 in June. Annual net migration remained elevated at 69,000, although it eased from 69,100 in June and ending the 23-month run of gains. Annual net migration is expected to decline further in coming months as large monthly increases in late 2015 continue to drop out of the annual figures (Figure 3). The recent levelling-off in annual net migration was in line with the BEFU forecast of a peak in the June quarter, although the level was slightly lower than expected.

Figure 3: Net migration inflows



Source: Statistics NZ

Migrant arrivals lifted to 125,000 in the year to July from 117,100 in the previous July year, driven by workers and new residents. China, South Africa and Australia showed the largest increases in arrivals. On the other hand, reflecting a fall in student arrivals, Indian migrants declined both on a monthly and annual basis. Annual departures remained stable at 56,000. Net migration is estimated to have contributed to around three-quarters of population growth in the year to June, supporting growth in labour demand and supply.

Seasonally-adjusted short-term visitor arrivals rose 2.9% in July to be up 11.2% in the year to July, which will support tourist spending and travel services exports in the September quarter.

…and supporting business activity and hiring

Business activity expanded further in response to high demand in July. The seasonally-adjusted BNZ-BusinessNZ Performance of Manufacturing Index (55.8) showed a solid pace of expansion in manufacturing activity. A decline in inventories and a lift in new orders point to continued growth in activity over coming months. The Performance of Services Index in July (54.2) also showed steady growth in the services sector despite falling from June (56.4), with high sales and new orders.

The ANZ Business Outlook showed business confidence hitting a 20-month high in August in seasonally-adjusted terms, driven by broad-based improvements across most sectors, particularly in retail trade and manufacturing; in addition, confidence for agricultural businesses continued to pick up on the back of higher dairy prices. Firms' expectations of their own activity rose to a 21-month high in August after adjusting for seasonal effects, and profit expectations, employment intentions and investment intentions all lifted strongly in August following solid increases in July. In line with rising labour demand, the seasonally-adjusted number of ANZ job advertisements lifted 1.4% in July, the sixth consecutive lift, to be 9.8% higher than July 2015.

Growth in house prices over the past year…

Housing demand continued to outpace supply across many areas of the country. The Real Estate Institute of New Zealand's stratified house price index rose 2.2% in July, to be up 16.3% annually. Annual price growth continued to exceed the national average in the North Island outside of Auckland, particularly in Wellington and the Waikato. However, Auckland annual house price growth remains fast at 13.6%. Strong housing demand reflects elevated net migration, low interest rates and higher investor demand. Total household credit grew 8.3% in the year to July, the highest rate of annual growth since May 2008, driven by growth in housing credit (8.8%).

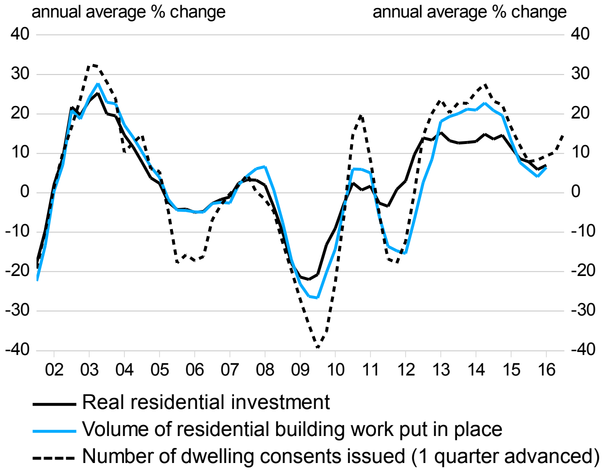
The number of house sales fell around 10% in July from July 2015 as the number of houses listed for sale declined by around a third. The fall in sales in the July month may also reflect the announcement of the proposed tightening in loan-to-value ratios (LVR) by the Reserve Bank and uncertainty around the Auckland Unitary Plan. The Reserve Bank has deferred the start of its proposed LVR tightening from 1 September to 1 October to give retail banks more time to meet the new lending criteria, although many banks are already applying the 40% deposit requirement to new investor mortgages.

…continues to boost construction activity

The high level of Auckland house prices continues to support construction activity in the city, which more than offset a declining trend for Canterbury. The nationwide number of housing consents rose 4.4% in June, while a surge in the volatile apartment consents led total dwelling consents to rise 21.9% in the month. Dwelling consents in the

June quarter were 10.9% higher than in the March quarter, pointing to an upswing in residential investment growth in the September quarter (Figure 4), which is expected to be stronger than the BEFU forecast of 1.4%. The number of dwelling consents reversed 10.5% in July from June, but was still up 1.6% from its June quarter average, supporting the outlook for residential investment growth in the December quarter.

Figure 4: Dwelling consents and construction



Source: Statistics NZ

The inflation outlook remains subdued…

Broad price pressures in the economy remained low, despite a pick-up in producer prices. Producer input prices rose 0.3% in the June quarter from a year ago, the first annual increase since June 2014, while output prices rose 0.5% (up from -0.9% and 0.1% in the March quarter, respectively). The pick-up was driven by continued solid growth in construction costs over the past year and by higher soft commodity prices in the June quarter. However, the large annual fall in crude oil prices, weak retail prices and the appreciation in the NZD over 2016 will continue to weigh on producer input and output prices.

The Labour Cost Index (LCI) rose solidly in some industries experiencing strong labour demand, including construction, accommodation and food services, and retail trade. However, headline annual growth in the LCI remained historically low at 1.5% in the June quarter, showing overall muted growth in unit labour costs.

Similarly, annual growth in the capital goods price index in the June quarter (3.4%) continued to be driven by residential buildings (5.1%). The outlook for capital goods prices outside of dwellings is subdued, as the lift to imported capital prices from the earlier depreciation in the NZD drops out of the annual calculations and the recent appreciation is expected to flow through to lower import prices. Also reflecting low price pressures, the ANZ Business Outlook showed further falls in pricing intentions, and continued weak inflation expectations for the year ahead. Overall low cost pressures outside of construction and price expectations suggest that September quarter annual CPI inflation is likely to remain low.

…leading the Reserve Bank to cut the OCR…

In order to bring inflation up to its target range, the Reserve Bank reduced the OCR by 25bps to a record low of 2.0% in August. The Reserve Bank stated that a high exchange rate and low global inflation are weighing on prices in the tradables sector. The Reserve Bank in its August *Monetary Policy Statement* also revised down its (March year) inflation forecast to 1.1% in 2017 and 1.7% in 2018, from 1.5% and 2.1% respectively, despite a stronger outlook for GDP growth. Markets have priced in around a 90% probability of a 25-basis point cut in November and a 50% probability of a second cut by March.

…but export prices show signs of recovery…

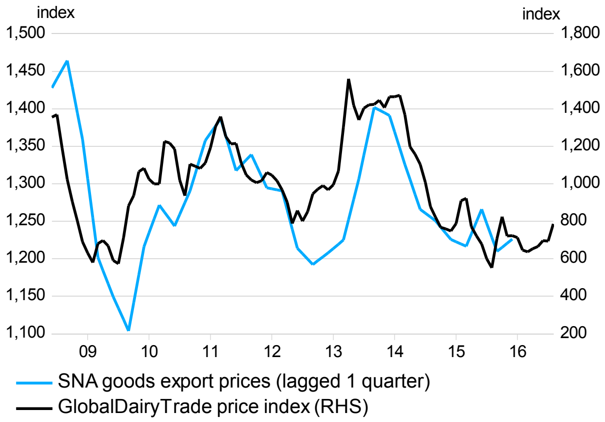
While domestic inflationary pressures remain low, key export prices showed a pick-up. The ANZ commodity world price index rose 2.0% in July, bringing its annual growth (2.0%) into positive territory for the first time since June 2014. The monthly increase was led by dairy prices (up 4.1%), while forestry and horticulture prices dipped. However, while the world price index lifted 6.9% in July from three months ago, the NZD price index rose only 2.5% owing to an appreciation in the exchange rate.

Dairy prices increased further over the two GlobalDairyTrade (GDT) auctions in August. The GDT price index rose 20.0% from the end of July to the end of August, with whole milk powder (half of the auction value) leading the rise to be up 29.6%, although skim milk power prices rose just 5.2%. Other product categories also showed price increases, with anhydrous milk fat up 14.3% and butter up 24.8%. The rebound in prices at the GDT auctions reflected a seasonal pick-up in demand, an expected fall in New Zealand milk production in the 2016/17 season, and slowing growth in global production.

The pick-up in soft commodity prices over recent months, particularly for dairy, is broadly in line with a rise in goods export prices forecast in the BEFU (Figure 5). Dairy prices in USD terms are shaping up to be a little stronger than expected, but a high NZD will weigh on NZD-adjusted prices to an extent. Fonterra has revised up its farm-gate milk price forecast for the 2016/17 season by

50 cents to $4.75 per kg of milk solids, and Westland also upgraded its forecast by 20 cents to between $4.55 and $4.95, in line with the expected increase in export prices.

Figure 5: Dairy and goods export prices



Source: Statistics NZ, GlobalDairyTrade

…pointing to a lower current account deficit

The seasonally adjusted merchandise trade deficit widened in July (to $218 million) as a 5.6% rise in goods import values outpaced a 2.2% increase in exports. However, goods imports were broadly unchanged in July excluding the import of a large aircraft and were down 10.3% from July 2015. On the export side, dairy export values rose 0.6% in July, driven by higher volumes, following a June increase in dairy values of 10.4%. Recent gains in GDT prices are expected to show up in the trade data after the September quarter. Despite a wider monthly trade deficit, the annual deficit narrowed to $3.0 billion in July, from $3.3 billion in June.

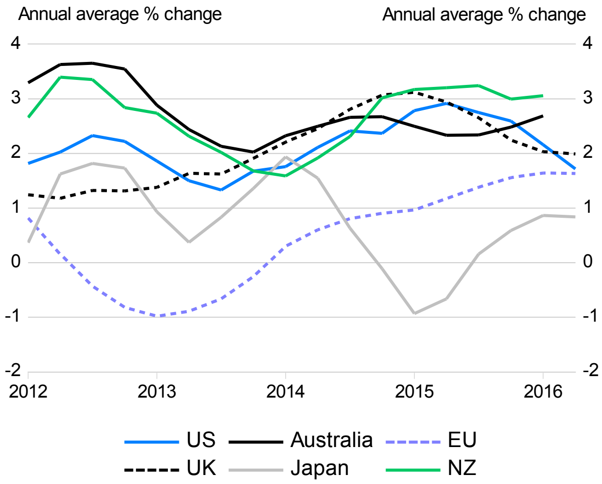
The annual trade balance is staying more positive than expected in the BEFU forecast. On the import side, weak global prices and the strong NZD are likely to keep import values subdued, while the recent pick-up in commodity prices is likely to support exports. The June quarter Balance of Payments is scheduled for release on 14 September, and the current account deficit is expected to be lower than the BEFU forecast of 3.5% and 3.9% of GDP in the June and September quarters. This month's Special Topic examines developments in New Zealand's current account balance over recent years.

Evidence of slowing global growth

Global data releases in August point to slowing world growth, with June quarter GDP growth in the US and Japan disappointing markets, and meeting already low expectations in the euro area (Figure 6). Indicators of activity have slowed between pre- and post-Brexit in the UK and euro area, although so far by less than expected.

Most market attention, however, has been on the US Federal Reserve, whose Chair reiterated the possibility of a 2016 rate hike at the Jackson Hole Symposium. This signal highlights the divergence in monetary policy direction between the US and other developed economies.

Figure 6: Expenditure GDP



Source: Haver

Strong US labour market but weak inflation

GDP growth in the US disappointed in the June quarter, with below-expected growth of 0.3%. Growth was supported by private consumption (1.1%) and rebounding exports (up 0.3%), but dampened by weaker-than-anticipated private investment (-0.6%) and a sharp fall in inventories. Subsequent outturns have been largely positive. Non-farm payrolls point to a strong labour market, with 255,000 jobs created in July, well above expectations of 170,000. The unemployment rate was stable (at 4.9%) and personal income growth accelerated in July (up 0.4%). July industrial production and consumer spending growth were reasonable (up 0.7% and 0.3% respectively), while retail sales were flat in July. Surveys of business activity in August disappointed, but consumer confidence surged above expectations.

However, price pressures remain weak. Personal consumption expenditure (PCE) (the Fed's preferred measure) and CPI inflation were both 0.8% in the year to July (PCE core 1.6%, CPI core 2.2%). Chair Yellen noted that the case for a rate hike had "strengthened in recent months", to which markets responded by pricing in a 20% probability of a hike in September. August non-farm payrolls (released Friday 2 September) will be an important factor in the Fed's decision.

Australia: soft investment and price pressures

Investment in Australia continues to weigh down growth, with releases this month showing weak private sector credit growth and construction work in June. The labour market remains steady, with stable unemployment (5.7%) and participation rates (64.9%) and robust employment growth in July (1.9% apc). But annual wage inflation remains at a record low (2.1%), indicating spare capacity in the labour market (also seen in the relatively stronger growth in part-time jobs than full-time jobs), which may suppress future price pressures. The Reserve Bank of Australia cut the cash rate from 1.75% to 1.50% at its August meeting, after June quarter CPI came in at 1.0% (apc), the lowest annual rate since 1999.

Euro area growth continues, albeit slowly

Euro area releases show continued, if slow, growth, with less impact from Brexit uncertainty than feared. Euro area June quarter GDP growth slowed from 0.6% to 0.3%, largely in line with expectations. The unemployment rate was steady at 10.1% in August and annual consumer price inflation was stable higher at 0.2% (core 0.8%). Retail sales growth dipped slightly (to 1.6% apc), but industrial production growth remained stable (0.4% apc) in June. Most indicators of subsequent (post-Brexit) activity remained subdued in August. In other news, euro area banking stress tests showed European banks are in a healthier position than in 2014, although Brexit was not included as a scenario.

UK pre-Brexit data positive

Pre-Brexit data releases for the UK were largely positive. June quarter GDP growth was 0.6% (2.2% apc), driven by private consumption. June labour market data showed the unemployment rate was stable at 4.9% (a decade low), with robust earnings and employment growth. Post-Brexit activity, however, indicates a softer growth path for the UK. Retail sales grew 1.4% in July, but were driven by temporary factors such as better than expected weather and foreign demand (owing to the low GBP). Industrial production grew only 0.1% in July, and annual consumer price inflation rose slightly to 0.6% in July (core 1.3%). In response to the weaker outlook, the Bank of England warned the outlook had "weakened markedly", cut its policy rate from 0.5% to 0.25% in August, and expanded its quantitative easing.

No GDP growth in Japan over June quarter

Japan's GDP growth was flat in the June quarter, below expectations and March quarter's growth of 0.5%. Private consumption growth slowed significantly, but was partially offset by a rebound in capital formation. The higher yen (up around 15% against the USD this year) and rising fuel prices likely contributed to net exports subtracting 0.3ppts from GDP. Subsequent indicators of activity have reinforced that Japan's weak growth is broad-based, except for a surprise increase in the participation rate and retail sales in July. Bank of Japan Governor Kuroda has pledged to increase stimulus if necessary, with consumer prices falling for the fourth consecutive month in July (-0.4% apc, core -0.5% apc).

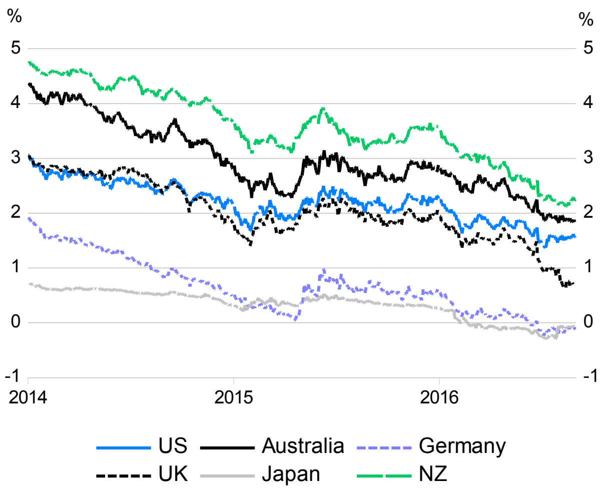
China's activity in July below expectations

China's recent outturns have all been below expectations, painting a picture of slowing activity. Annual growth in industrial production, retail sales and lending declined slightly in July, while year-to-date fixed asset investment growth fell from 9.0% to 8.1% and imports fell 5.7% in the year to July (in CNY terms). Inflation pressures were subdued, with both core and headline annual consumer price inflation of 1.8% in July, below target, while producer price deflation continued. More stimulus is expected in order to sustain growth.

Markets broadly stable

Market volatility in August has been comparatively low, with an average VIX (an index of market volatility) of 12.3, compared to the July and June averages of 13.2 and 17.8. Ten-year government bond yields have also been relatively stable over the month (Figure 7), but oil prices have rallied on speculation of co-ordinated action to stabilise prices. The NZD has remained persistently strong in August, in keeping with New Zealand's relatively high interest rates, bond yields and growth (Figures 6 and 7).

Figure 7: Ten-year government bond yields



Source: Haver

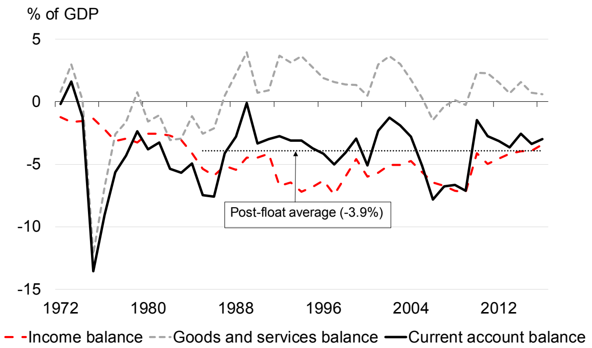
Special Topic: Why has the current account deficit remained moderate?

The average size of deficits recorded in the current account of the balance of payments has been relatively low in recent years. During the same period New Zealand's net external liability position has decreased from 80% of GDP to 60%. These developments suggest that the New Zealand economy is less likely to experience a disruptive outflow of foreign capital than in the past. This special topic looks at the factors underpinning the lower deficits and considers the implications for Treasury's forecast of wider deficits in coming years.

Current account deficits reflect the imbalance between national saving and investment…

The current account of the balance of payments records transactions of goods and services, including financial transactions (interest payments, dividends and reinvested earnings), between New Zealand residents and non-residents. The current account is the sum of these balances and, to the extent the current account is in deficit, it must be financed. The financing of the deficit is shown in the financial account of the balance of payments[2]. This account records financial transactions with non-residents (eg sale of assets or increased borrowing), which result in financial liability and asset positions that are captured in the International Investment Position.

Figure 1: Current account and its components



Source: Statistics New Zealand

Figure 1 shows that New Zealand has persistently run current account deficits and that this is primarily driven by the income balance (which includes interest payments, dividends and reinvested earnings). These outflows are in turn a reflection of the sizeable stock of international liabilities New Zealanders have accumulated over time. These income outflows reduce gross national income (or GDP) to give gross national disposable income. When national disposable income is less than the value of current consumption (both private and public), the difference must be met from lower domestic saving or, where domestic saving is not sufficient, by borrowing offshore. Alternatively, given that saving is the difference between gross national income and consumption, then if saving is not sufficient to fund all investment, the balance must come from foreign saving.

At times the imbalances between saving and investment have been very large giving rise to concerns about how the necessary adjustment would take place. In particular, the risk was that large capital outflows would precipitate sharp adjustments in asset prices and consumer behaviour. In the end, the global financial crisis (GFC) and ensuing global recession provided the trigger for adjustment.

…the size of the imbalance has reduced…

Figure 1 shows that much of the current account adjustment has occurred through the income balance. From around 7% of GDP in 2008, income deficits have retreated to around 4% of GDP. The main drivers have been reduced outflows of investment income from foreign investment in New Zealand and reduced interest payments offshore as global interest rates have fallen and the level of external debt has stabilised.

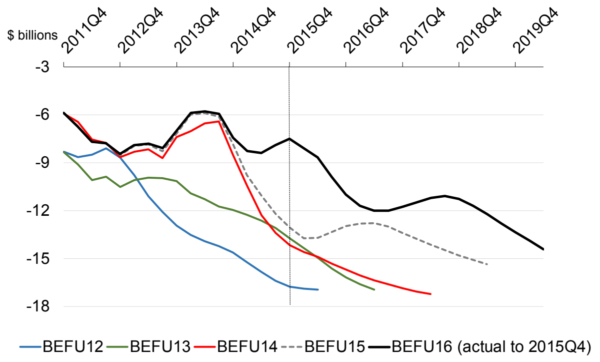
The latest statistics, for the year ending March 2016, show a current account deficit of 3.0% of GDP. Since then the goods trade deficit has narrowed and services surplus has remained high. This means that when the June year figures are released on 14 September the current account deficit may be below 3.0% of GDP.

…challenging the Treasury's forecasts

In contrast, the Treasury's Budget forecasts show the annual deficit widening to 3.5% of GDP in June and to 4.6% of GDP by June 2017. However, the Treasury has tended to overestimate the extent of deterioration in the current account. Figure 2 shows that in each Budget from 2012 to 2015 the Treasury forecast the current account deficit to be between \$13 billion and \$17 billion (or 5.6% to 6.7% of GDP) by the end of 2015. The Treasury's most recent forecast projects a deficit of \$15 billion (4.8% of GDP) in March 2020.

[2] The capital account, which captures capital transfers such as the Canterbury earthquake insurance claim settlements is a further source of financing.

Figure 2: The current account deficit has been narrower than expected



Sources: Statistics New Zealand, the Treasury

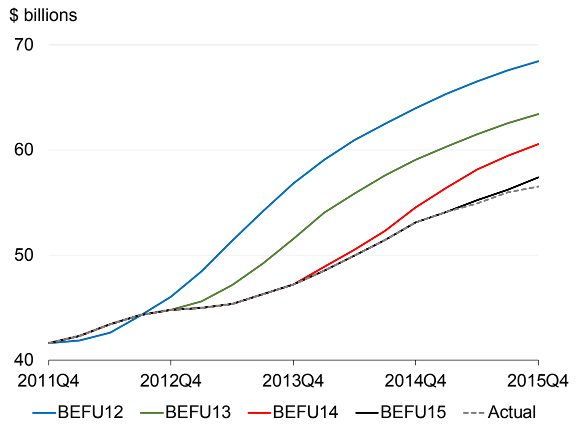
A variety of factors at play…

When we look into the source of these forecast errors we find a number of factors at play, which is not surprising given the variety of factors underpinning the current account (including commodity prices, import and export volumes, exchange rates, interest rates, profits and their interactions etc). Nevertheless, the main drivers of these errors appear to be:

- export volumes proved more resilient to drought than anticipated in Budget 2013 and 2015
- the sharp rise in export prices in 2014
- persistent strength in services exports from late 2014
- ongoing weakness on global interest rates.

These factors have all tended to support a lower current account deficit and the associated financing requirement.

Figure 3: Treasury investment forecasts

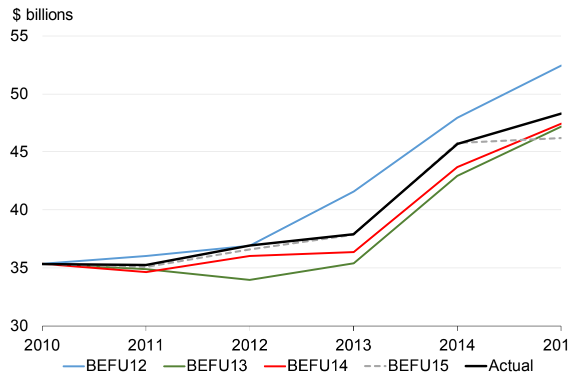


Sources: Statistics New Zealand, the Treasury

At the same time, we also find that domestic investment has consistently disappointed our expectations (Figure 3). Both business and residential investment have been more sluggish than anticipated, which reduces the demand for finance, and takes pressure off the current account balance.

Increased national savings have also reduced the need to access foreign saving (Figure 4). However, the Treasury's forecasts of national savings have tended to be reasonably close to the most recent figures, which suggests that lower investment demand is the main contributor to the narrower-than-expected current account deficits.

Figure 4: National saving has increased



Sources: Statistics New Zealand, the Treasury

Reasons for weaker investment include the Canterbury rebuild not progressing as expected, but that does not explain all the difference from forecast. The relatively subdued pace of investment growth is likely to reflect, at least in part, some of the same factors that are contributing to the global slowdown in investment growth. These factors are not well understood, but may include uncertainty around the strength of consumer demand, rising regulatory burdens and expectations of higher future taxes.

Overall, these developments suggest the recent run of relatively low current account deficits is a mix of both structural (low global interest rates, greater drought tolerance, higher saving, improved access to China's tourism market) and cyclical factors (including weak credit demand, high dairy and subsequently low oil prices).

…raising questions for the future

This raises the question of whether current accounts deficits of around 4%, which is the average since 1984, or less can be sustained over the longer term and whether it is in some sense optimal or desirable to do so.

There are a range of views. One view is that accessing foreign saving to fund domestic investment is rational provided the returns from doing so are sufficiently high. On the other hand, the need to borrow offshore may be seen as a sign that domestic policies are somehow promoting an imbalance that needs to be addressed.

A position somewhere between these views would suggest there is little concern with ongoing modest current account deficits. However, whether that deficit is 3%, 4% or 5% of GDP is largely a matter of judgement about what can be comfortably sustained over the longer term. That is, are the current account deficits causing New Zealand's net liabilities to increase to a point where they are likely to cause funding issues? For example, in the mid-2000s New Zealand's current account deficits exceeded 7% of GDP and the net liability position rose to over 80% of GDP (subsequent data revisions show the net liability position was around 75% over this time), giving rise to concerns about the consequences of a sudden drop in international demand for the country's securities (including debt and equity).

Although the deficits continued to be funded without apparent difficulty, the composition and tenure of funding increased our vulnerability to adverse developments in foreign financial markets and imposed additional costs, through risk premia on lending and other investment, on the economy.

Ongoing deficits of over 4% of GDP would likely increase our net liability position from the current 63% of GDP, which is already among the highest in the world. Conversely, to significantly improve the net liability position, sustained current account deficits of below 3% of GDP would likely be required.

Looking forward, provided the improvement in national saving remains in place, the current account deficit may remain within its recent range of between 3% and 4% of GDP. However, if a faster pace of investment were to eventuate (which seems desirable) further adjustment in saving is likely to be needed to fund it.

On the trade side, higher investment would likely be reflected in higher imports, which suggests improving our productivity through better skills, infrastructure and regulation and ongoing success in accessing new export markets would be needed.

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

		2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg[1]	0.9	0.2	0.3	0.8	0.9	0.7	...
	ann ave % chg	3.7	3.6	3.3	3.0	2.5	2.4	...
Real private consumption	qtr % chg[1]	0.2	0.6	0.5	0.7	1.0	0.4	...
	ann ave % chg	2.7	2.6	2.7	2.4	2.5	2.5	...
Real public consumption	qtr % chg[1]	0.3	0.8	0.9	0.1	-0.3	0.5	...
	ann ave % chg	2.7	2.3	2.1	2.0	2.0	1.8	...
Real residential investment	qtr % chg[1]	4.3	-0.1	0.6	1.4	1.3	4.2	...
	ann ave % chg	14.6	11.5	8.6	7.8	5.9	7.0	...
Real non-residential investment	qtr % chg[1]	-0.1	-2.4	1.1	2.8	-3.0	2.0	...
	ann ave % chg	9.6	9.0	7.5	4.9	1.9	1.4	...
Export volumes	qtr % chg[1]	5.8	1.3	0.2	1.9	0.0	-1.0	...
	ann ave % chg	3.0	4.2	5.7	7.3	6.5	5.0	...
Import volumes	qtr % chg[1]	2.4	0.7	1.5	-2.6	0.8	0.2	...
	ann ave % chg	7.9	7.4	6.6	5.5	3.5	1.9	...
Nominal GDP - expenditure basis	ann ave % chg	5.1	3.6	2.8	2.8	3.2	3.8	...
Real GDP per capita	ann ave % chg	2.2	1.9	1.5	1.1	0.6	0.5	...
Real Gross National Disposable Income	ann ave % chg	5.1	3.5	2.3	1.5	1.5	2.0	...
External Trade								
Current account balance (annual)	NZ$ millions	-7,464	-8,064	-8,259	-8,096	-7,989	-7,504	...
	% of GDP	-3.1	-3.4	-3.4	-3.3	-3.2	-3.0	...
Investment income balance (annual)	NZ$ millions	-9,449	-9,217	-9,049	-9,094	-8,721	-8,207	...
Merchandise terms of trade	qtr % chg	-2.4	1.2	1.5	-3.8	-2.0	4.4	...
	ann % chg	-5.0	-5.6	-4.2	-3.6	-3.2	-0.1	...
Prices								
CPI inflation	qtr % chg	-0.2	-0.2	0.4	0.3	-0.5	0.2	0.4
	ann % chg	0.8	0.3	0.4	0.4	0.1	0.4	0.4
Tradable inflation	ann % chg	-1.3	-2.4	-1.8	-1.2	-2.1	-1.2	-1.5
Non-tradable inflation	ann % chg	2.4	2.4	2.1	1.5	1.8	1.6	1.8
GDP deflator	ann % chg	-2.2	-0.9	0.5	0.8	0.4	1.3	...
Consumption deflator	ann % chg	0.7	0.6	0.6	1.1	0.7	0.8	...
Labour Market								
Employment (HLFS)	qtr % chg[1]	1.1	0.6	0.0	-0.3	0.9	1.4	2.4
	ann % chg[1]	3.6	3.2	2.9	1.5	1.3	2.0	4.5
Unemployment rate	%[1]	5.5	5.4	5.5	5.5	5.0	5.2	5.1
Participation rate	%[1]	69.3	69.3	68.9	68.3	68.2	68.8	69.7
LCI salary & wage rates - total (adjusted)[5]	qtr % chg	0.5	0.3	0.5	0.4	0.4	0.4	0.4
	ann % chg	1.7	1.7	1.6	1.6	1.5	1.6	1.5
QES average hourly earnings - total[5]	qtr % chg	0.5	0.0	0.8	1.0	0.3	0.3	0.5
	ann % chg	2.6	2.1	2.8	2.3	2.1	2.4	2.1
Labour productivity[6]	ann ave % chg	0.2	0.5	0.6	0.7	0.5	0.8	...
Retail Sales								
Core retail sales volume	qtr % chg[1]	1.7	2.2	0.0	1.2	1.4	1.1	2.6
	ann % chg	6.0	7.2	5.8	5.2	5.2	4.8	6.4
Total retail sales volume	qtr % chg[1]	1.8	2.1	0.1	1.5	1.1	1.0	2.3
	ann % chg	5.9	7.1	5.5	5.7	5.3	4.9	6.0
Confidence Indicators/Surveys								
WMM - consumer confidence[3]	Index	115	117	113	106	111	110	106
QSBO - general business situation[4]	net %	23.6	23.3	5.1	-14.5	14.7	1.7	18.6
QSBO - own activity outlook[4]	net %	26.7	25.0	9.3	21.7	21.6	3.8	16.8

Monthly Indicators

		2016M02	2016M03	2016M04	2016M05	2016M06	2016M07	2016M08
External Sector								
Merchandise trade - exports	mth % chg[1]	-6.3	-7.5	11.7	-1.4	-1.0	5.6	...
	ann % chg[1]	9.0	-14.4	4.7	4.7	2.4	-4.9	...
Merchandise trade - imports	mth % chg[1]	-7.9	-17.2	24.3	-1.2	-0.9	2.2	...
	ann % chg[1]	1.8	-5.5	0.7	5.7	-4.5	-10.3	...
Merchandise trade balance (12 month total)	NZ$ million	-3293	-3765	-3600	-3623	-3331	-3034	...
Visitor arrivals	number[1]	277,170	288,370	285,030	285,530	283,420	291,670	...
Visitor departures	number[1]	293,550	284,360	294,720	295,360	287,070	298,810	...
Housing								
Dwelling consents - residential	mth % chg[1]	10.6	-9.2	7.8	0.1	16.3	...	...
	ann % chg[1]	35.3	1.9	11.8	16.1	34.8	...	...
House sales - dwellings	mth % chg[1]	4.6	5.2	8.5	-3.3	-1.7	-11.0	...
	ann % chg[1]	5.7	8.2	18.4	13.6	5.9	-10.1	...
REINZ - house price index	mth % chg	1.7	2.2	2.2	2.1	1.9	2.4	...
	ann % chg	11.9	13.3	14.5	14.7	14.2	16.3	...
Private Consumption								
Electronic card transactions - total retail	mth % chg[1]	0.7	0.1	0.8	-0.3	1.2	0.3	...
	ann % chg	9.2	6.2	7.8	3.3	6.8	5.8	...
New car registrations	mth % chg[1]	5.8	-3.8	6.2	-3.6	-1.0	-0.5	...
	ann % chg	7.4	-0.2	8.7	4.2	-1.2	-1.9	...
Migration								
Permanent & long-term arrivals	number[1]	10,590	9,900	10,430	10,210	10,240	10,420	...
Permanent & long-term departures	number[1]	4,590	4,560	4,940	4,660	4,540	4,820	...
Net PLT migration (12 month total)	number	67,391	67,619	68,110	68,432	69,090	69,015	...
Commodity Prices								
Brent oil price	US$/Barrel	32.18	38.20	41.58	46.74	48.25	44.95	...
WTI oil price	US$/Barrel	30.50	37.80	40.76	46.76	48.80	44.69	...
ANZ NZ commodity price index	mth % chg	0.0	-3.0	-2.8	2.5	0.3	-0.4	...
	ann % chg	-10.3	-14.3	-8.5	-3.4	-5.9	-5.7	...
ANZ world commodity price index	mth % chg	0.5	-1.3	-0.8	1.1	3.7	2.0	...
	ann % chg	-17.8	-22.4	-16.8	-11.6	-5.4	2.0	...
Financial Markets								
NZD/USD	$[2]	0.6634	0.6733	0.6892	0.6804	0.7034	0.7123	*0.7229*
NZD/AUD	$[2]	0.9300	0.9001	0.8998	0.9290	0.9502	0.9472	*0.9481*
Trade weighted index (TWI)	June 1979 = 100[2]	72.35	72.19	72.80	72.86	75.23	76.30	*76.77*
Official cash rate (OCR)	%	2.50	2.25	2.25	2.25	2.25	2.25	2.00
90 day bank bill rate	%[2]	2.62	2.43	2.34	2.38	2.37	2.37	*2.24*
10 year govt bond rate	%[2]	3.06	3.02	2.86	2.67	2.51	2.27	*2.19*
Confidence Indicators/Surveys								
ANZ - business confidence	net %	7.1	3.2	6.2	11.3	20.2	16.0	15.5
ANZ - activity outlook	net %	25.5	29.4	32.1	30.4	35.1	31.4	33.7
ANZ-Roy Morgan - consumer confidence	net %	119.7	118.0	120.0	116.2	118.9	118.2	117.7
Performance of Manufacturing Index	Index	55.7	54.8	56.6	57.1	57.6	55.8	...
Performance of Services Index	Index	57.1	55.1	57.7	56.7	56.4	54.2	...

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 Analytics, Thompson Reuters, Westpac McDermott Miller, ANZ-Roy Morgan, REINZ, BNZ-Business NZ