HSBC Global Research

Macro
Economics – New Zealand
January 2014

New Zealand in 2014

Firing on all cylinders

Growth is picking up pace in New Zealand and we expect the trend to continue through 2014

Post-earthquake reconstruction, a domestic housing boom and high export prices should support broad-based economic growth

We expect NZ dollar strength, underpinned by the healthy domestic economy, to remain a headwind for trade-exposed sectors

By Adam Richardson and Paul Bloxham

Disclosures and Disclaimer This report must be read with the disclosures and analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

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Key points

- After a number of years in the doldrums, we expect **New Zealand's growth to pick up strongly in 2014.** Our forecasts for the coming year suggest that New Zealand is likely to outperform almost all other OECD economies (the exceptions are Chile, Israel and Mexico).
- Growth is expected to be supported by **three key factors**. First, a **substantial post-earthquake reconstruction** effort in the Canterbury region, following the earthquakes in 2010 and 2011. Rebuilding has already begun and is expected to run for a number of years yet. Second, **a local housing boom**, which is already underway and expected to continue. This boom has been fuelled by a combination of low interest rates and weak supply of housing, due to underinvestment in recent years. Third, **dairy export prices have ramped up** substantially in recent years **as a result of strong Asian demand**. This is lifting rural incomes. Overall, annual GDP growth is expected to pick up to 3.4% in 2014 from 2.8% in 2013.
- On the external front, growth is being supported by an expanding middle class in Asia, which is seeing significant shifts in Asian diets. **New Zealand is the single largest exporter of dairy products to China**, accounting for 60% of China's dairy imports, which is up from 40% of China's dairy imports only five years ago. Strong emerging Asian demand for New Zealand's agricultural exports is expected to continue, as the middle classes swell.
- A key challenge is that the economy is **already operating at close to capacity**, which means that further strength in demand could translate quickly into cost pressures. We expect the **RBNZ to be the first developed world central bank to lift rates in this cycle**. We expect the cash rate to be 100bp higher than its current level by end-2014, with the first hike likely to arrive soon.
- While this is a positive story, outperformance will likely present **some challenges**. Strong domestic growth and rate hikes ahead of other developed countries are expected to underpin continued **strength in the NZD**. Managing a strong currency is likely to be a key challenge for local policymakers, as trade-exposed industries like the tourism and manufacturing sectors may struggle. Our FX team expects the NZD to appreciate further this year, reaching US87 cents by end-2014 and that it **may surpass parity against the AUD for the first time in more than four decades**.
- As always, there are risks. **The inflationary impact of the post-earthquake rebuild is a key risk to the outlook**. Any inefficiency in this localised construction project or a faster ramp-up in demand could see the need for higher interest rates from the RBNZ. Strength in Asian demand for New Zealand's exports is a key feature of the growth outlook. Given this, **potential wobbles in the Asian region are a key risk** that could translate into weaker export prices.

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Firing on all cylinders

- Post-earthquake reconstruction activity is continuing to ramp up, providing significant support to the economy
- Dairy prices have increased sharply over the past year, with this income boost set to underpin growth
- The housing market is booming and strong immigration and low interest rates suggest this strength is likely to continue

Boom begins

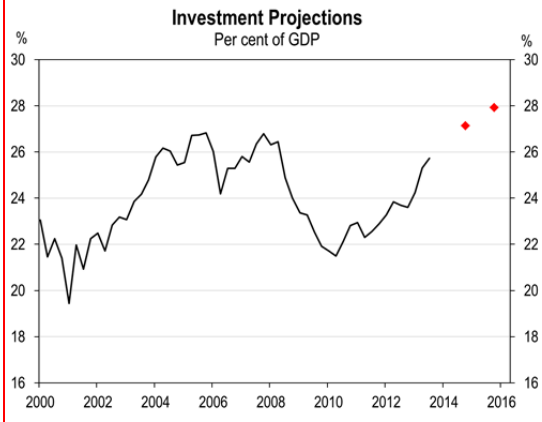
New Zealand is set for a strong 2014, with the economy already firing on all cylinders. Growth is expected to be supported by post-earthquake reconstruction in the Canterbury region, following earthquakes in late 2010 and early 2011, an on-going local housing boom, and rising demand for exports of dairy and meat products, particularly from China. These factors are already driving a broad-based pick-up in growth and are expected to continue to support the economy in 2014 and into 2015.

Rebuild ramping up

Post-earthquake construction activity in the Canterbury region is likely to remain a key source of growth in coming years, driving a ramp-up in investment (Chart 1). The scale of the rebuild is substantial. Estimates from the RBNZ suggest reconstruction activity will total around NZD40bn – equivalent to around 20% of annual GDP. Projections suggest the rebuild is likely to extend through much of the rest of the decade.

To put this in context, this scale of activity is similar (in terms of its share of the economy) to the resource investment boom Australia has experienced through the last decade – a factor that has dominated the economic landscape in Australia recently.

1. Reconstruction activity to provide a sustained boost



Source: Statistics New Zealand, HSBC estimates

Reconstruction activity has already provided a significant boost to the economy, with the value of Canterbury regional construction up +36% y-o-y. Looking ahead, dwelling investment is projected to rise by a further +13% through 2014, building on the +19% y-o-y growth expected in 2013. Strong construction activity (largely pre-financed by offshore insurers) is a key reason why the economy is projected to outperform most

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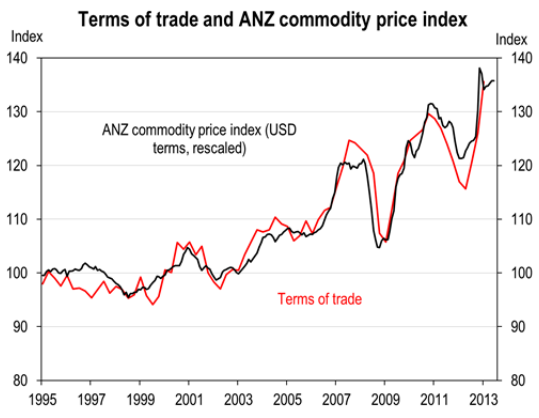
other developed nations in 2014 – a rare achievement in recent decades for New Zealand.

Rural sector's China boost

Adding to the impulse provided by reconstruction activity, the rural sector has hit a sweet spot. Demand from China for dairy and meat products has ramped up and these products are a relatively large share of the New Zealand economy, when compared to other developed nations – agricultural exports account for 45% of total exports, while agricultural-related production accounts for around 10% of GDP.

While drought conditions saw the rural sector struggle through the first half of 2013, the sector has bounced back strongly, with dairy production recovering particularly rapidly. Industry forecasts suggest that milk production (volume) is likely to rise by +6% over the 2013-14 season. At the same time, prices for agricultural products have surged over the past year. Dairy prices increased by +50% in 2013. This strong increase, along with gains in meat and forestry product prices, has seen New Zealand's terms of trade reach their highest level in 40-years (Chart 2).

2. New Zealand's terms of trade has reached 40-year highs

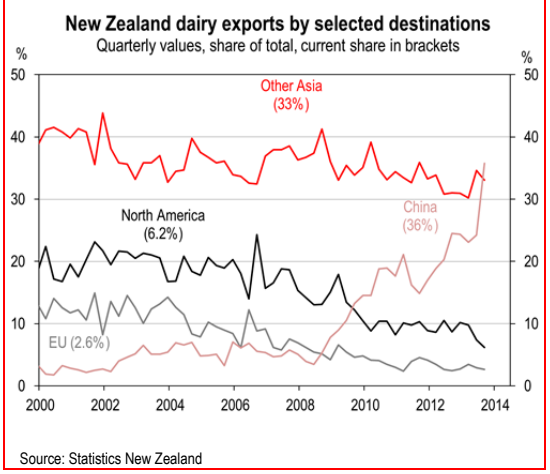


Source: Thomson Reuters Datastream, Statistics New Zealand

The rapid run-up in prices and strong recovery in production represent a significant boost to domestic incomes. Adding the two factors together, revenues for the dairy sector would increase by around NZD4.4bn over 2014 (this is equivalent to around 2% of New Zealand's annual GDP). This strong increase in revenues should support investment and hiring in the sector and help provide downstream support for the wider local economy.

Two factors have led to the rapid increase in dairy prices seen in 2013. First, production amongst a number of key exporters fell through the end of 2012 and beginning of 2013, with weak supply providing a boost to prices (see, Richardson, A. and Bloxham P. (2013), *New Zealand Digest: Global dairy price surge to boost incomes*, 4 October). Second, emerging market demand, particularly from China, has grown strongly. As China is growing richer and more people are entering the middle class, dietary patterns are changing and consumption of animal products (meat and milk) has risen. These trends have seen annual growth in Chinese milk product imports average 32% over the past five years.

3. New Zealand's dairy exports have shifted to China

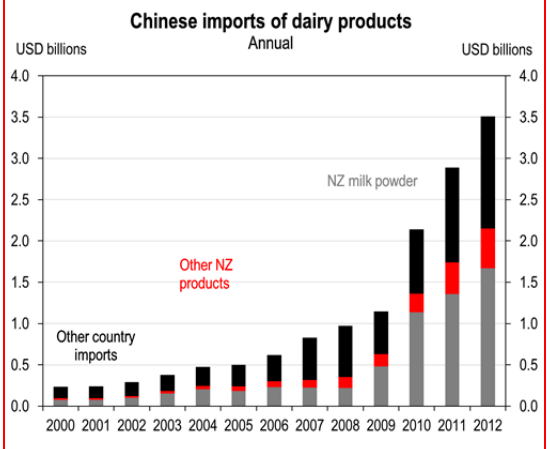


Source: Statistics New Zealand

New Zealand has been a significant beneficiary of this substantial growth in Chinese demand, resulting in a significant shift in trade flows. Since 2008, the share of New Zealand dairy exports going to China has risen from 4% to 36% (Chart 3). The New Zealand market is even more important for China,

with New Zealand products accounting for 60% of China's total imports of dairy products (Chart 4).

4. NZ is the key foreign supplier of dairy products to China

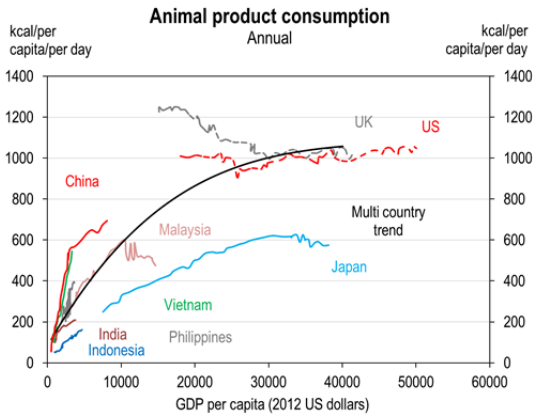


Source: UN

Prices are expected to ease somewhat from the elevated levels seen at the moment, as global dairy production is beginning to recover across a number of key exporting regions. However, dairy prices are expected to remain elevated relative to the levels seen in the preceding decade. Growth in demand from emerging Asia is expected to continue, as further economic development provides a continued boost to meat and dairy consumption in the region.

Medium-term demand for dairy products is expected to continue to rise strongly. Chart 5 outlines how consumption of animal products evolves as an economy develops. Broadly, consumption rises rapidly as an economy approaches per capita GDP of NZD20,000, with growth slowing but continuing beyond this point. If China was to continue to follow this average economy consumption path, Chinese per capita consumption of animal products would increase by 3% per annum between 2009 and 2018, given current per capita GDP forecasts for China. Countries like India, Indonesia and Vietnam are still at much earlier stages in this general development path.

5. China animal protein demand likely to rise further



Source: FAO, Conference Board, HSBC

Overall, strength in emerging market demand is expected to provide support for New Zealand's key export prices in coming years and see the terms of trade remain well above the levels seen in the early 2000s. This income boost should provide on-going support for domestic activity.

Housing market booming

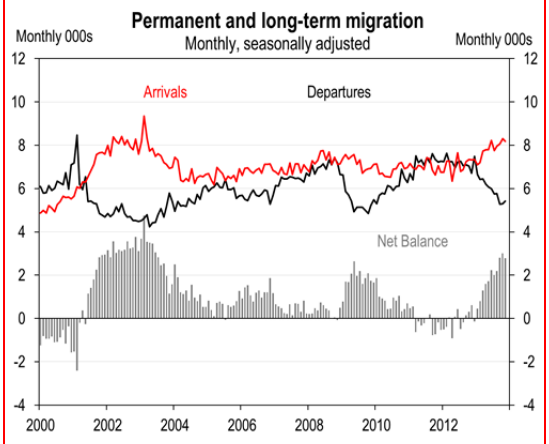
Another factor providing a boost to demand in New Zealand is the booming housing market (Richardson, A. and Bloxham, P. (2013) *New Zealand Digest: House price boom a worry for authorities*, 1 August). New Zealand's housing market has seen a rapid rise over the past year, with annual house price inflation currently tracking around +10%. Low interest rates have provided support. With the RBNZ having held its policy rate at record lows for a number of years, floating mortgage rates have followed suit.

At the same time, supply-side constraints have added to price pressure, particularly in the Auckland market. The housing market has seen a substantial lack of construction activity in recent years, leading to an undersupply of housing. As well as starting with a housing shortage, estimates suggest Auckland will need an additional 13,000 houses per year to keep pace with the demands of population growth. With building consents in the

region tracking at only around 6,000 in the past year, there are only limited signs that these supply-side constraints are easing as yet.

Rising migration has given the housing market a further kick more recently. In addition to broader economic improvement, the Canterbury rebuild has seen an influx of foreign workers to that region. At the same time, fewer New Zealanders are making the trip across the Tasman, due to better job prospects at home. As a result, net inward migration is now running at a pace that is similar to the rates seen in the early 2000s (Chart 6). At that time, strong migration inflows supported a housing boom in the country.

6. Net inward migration has picked up strongly

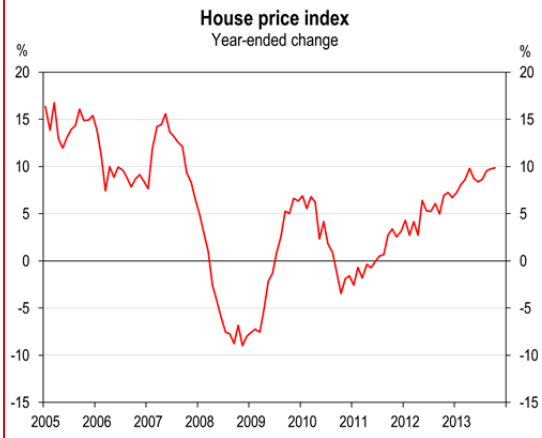


Source: Statistics New Zealand

The strong housing market has presented a policy dilemma for the RBNZ. The central bank has been worried that the rapid run-up in housing prices and rapid growth in new lending could lead to a build-up in risks to financial stability. However, inflation was tracking below the target band, reflecting a strong exchange rate and an economy operating below trend. As a result, any attempt to cool the housing market with higher interest rates risked pushing inflation further below the target. In response, the RBNZ chose to adopt new macro-prudential tools, namely loan-to-value ratio (LVR) restrictions, to cool the housing market.

Our initial view (1 August) was that these policies would have a limited impact on house prices, with the policy equal to around a 25bp hike in rates, at best. Overall, this seems to be playing out, so far. Mortgage approvals have tailed off after the imposition of the policy, but prices have continued to rise strongly (Chart 7).

7. House price inflation is strong, despite LVR restrictions



Source: Bloomberg

Our view remains that despite the imposition of LVR restrictions, fundamentals look set to support further strength in the housing market in the near term. Strong migration inflows underpin further demand for housing in an already undersupplied market. While mortgage interest rates have increased in recent months, they remain at low levels. However, house price inflation is expected to begin to moderate towards the end of 2014, as rate hikes from the RBNZ (we expect 100bp of hikes through 2014) begin to slow the rise in house prices.

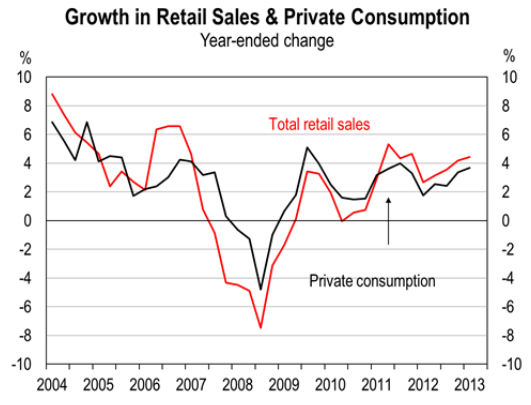
Longer term, this bout of house price inflation has prompted the New Zealand government to reassess the regulatory environment around housing. Policies like the recent Auckland Housing Accord are expected to free up land supply, which is expected to improve the responsiveness of the construction sector to price signals. If regulatory reform continues in this direction, future house price cycles may be more

muted, as we begin to see a construction sector that is more responsive to price signals. However, given the pace at which reforms are progressing and the current shortage of supply in the market, this is likely a factor for future cycles.

Boom is broadening

The pick-up in the housing market has also begun to spill over into wider activity. In particular, consumer spending is beginning to rise in New Zealand, with the increase in household asset prices providing a boost to confidence and available incomes (Chart 8).

8. Housing boom supporting rising household spending



Source: Statistics New Zealand

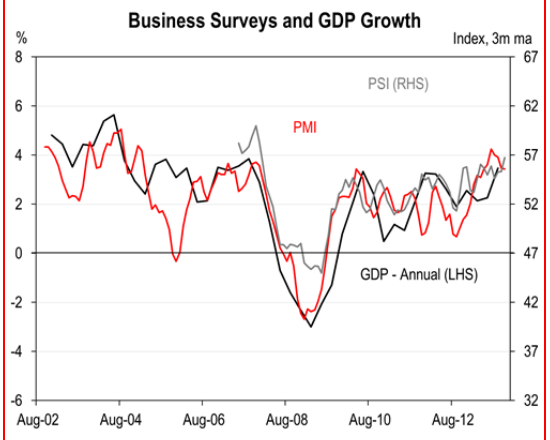
A recovery in the labour market has also played a role in providing support for household consumption. Employment growth has begun to rise as the domestic economy has begun to lift. Wage increases have also remained relatively solid over the past year – with labour incomes having grown relatively strongly more recently.

Overall, these trends are expected to continue in the near term, with a strong housing market and continued improvement in the labour market expected to underpin solid growth in consumer spending through 2014.

Strengthening demand is also beginning to provide a boost to business investment. Business investment has generally been fairly subdued in recent years. Weak demand and low confidence, both locally and internationally, have seen local businesses focus on cost cutting and efficiency improvements rather than large-scale investment. However, as demand begins to increase and profitability improves, firms are likely to look to boost investment.

Overall, the New Zealand economy is already registering a strong pace of growth, having expanded +3.5% y-o-y in September 2013. Recent surveys of business sentiment suggest this rapid pace of expansion is set to continue (Chart 9).

9. Surveys point to strong GDP growth in Q4 2013



Source: Statistics New Zealand, Thomson Reuters Datastream, CEIC

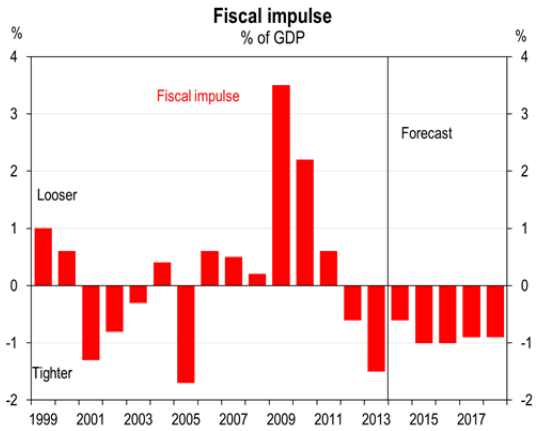
Fiscal policy key headwind

A headwind for the economy over the next few years is likely the scale of fiscal consolidation being undertaken by the government.

The government is still aiming to return to surplus by the 2014-15 financial year. With the budget deficit sitting at -2.1% of GDP in 2012-13, this consolidation represents a 2 percentage point improvement in the operating balance (as a percentage of GDP) over the next two years. The New Zealand Treasury estimates the negative demand impulse from this consolidation totals around -2.6% of GDP over the next three years – representing a substantial headwind for growth (Chart 10). However, a somewhat stronger

economy and healthier tax receipts have led to an improvement in the government's financial position, which should make the task of fiscal consolidation less burdensome.

10. Fiscal consolidation likely to be a drag on growth



Source: New Zealand Treasury

Election due in late 2014

A potential change of government will be a further political issue that comes into focus in 2014. A general election in New Zealand needs to be announced before mid-December 2014, when parliament would otherwise be dissolved. The election is likely to occur in late 2014.

The *Herald-Digi* and *Roy-Morgan* polls, taken in November and December, suggest a change of government is a possibility, from the current centre-right National party to a centre-left coalition between the Labour party and the Greens. Recent rhetoric from the Labour and the Greens suggests a change to the monetary policy framework could be a possible election issue – with Labour flagging a desire to broaden the RBNZ's focus beyond inflation targeting to take account of the exchange rate and external balances.

Set to outperform this year

New Zealand's economy looks on track to post strong growth over the end of 2013 and through 2014. A combination of low policy rates, a rising housing market, the Canterbury rebuild and elevated terms of trade represent a significant demand boost. Recent business surveys point to solid momentum in the economy and are consistent with growth running at around a 4% annualised pace around the end of 2013. Putting these factors together, we see growth of +3.4% in 2014, up from +2.8% in 2013. From there, tighter monetary policy and capacity constraints are expected to see growth fall back towards trend, with annual growth of +2.6% projected for 2015.

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Running up against limited capacity

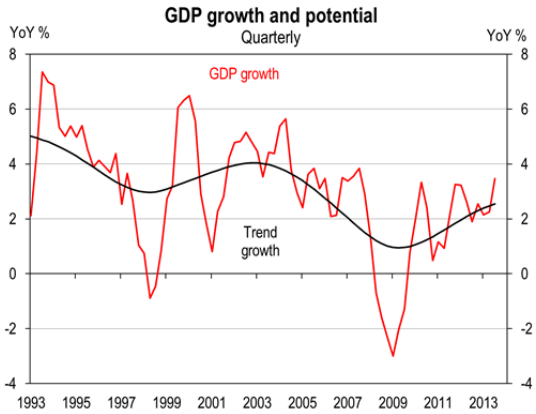
- New Zealand's potential growth rate looks to have fallen since the global financial crisis
- With demand having picked up recently, the economy is already operating at close to full capacity
- Cost pressures are expected to build further through 2014, as demand runs ahead of local supply in coming quarters

Supply potential has fallen

With demand set to boom in New Zealand, as set out above, the key question is: how much of this impulse can the New Zealand economy accommodate before running up against capacity and pushing up costs?

In our view, the answer is: less than it could have prior to the financial crisis. Overall, New Zealand's supply and growth potential look to have taken a step down in recent years. Taking a simple approach, using a Hodrick-Prescott filter to extract the trend level of GDP, would suggest New Zealand's growth potential currently sits around 2.5% (Chart 11). This is down from rates that were 3.5-4.0% back in the 1990s and early 2000s.

11. New Zealand's supply potential has taken a hit recently



Source: Statistics New Zealand, HSBC

While this is a relatively simple approach to modelling New Zealand's growth potential, there are a number of cross checks that make us comfortable with this assessment. One factor is that the output gap implied by this assumption is consistent with the feedback New Zealand businesses are giving on capacity pressures (Chart 12).

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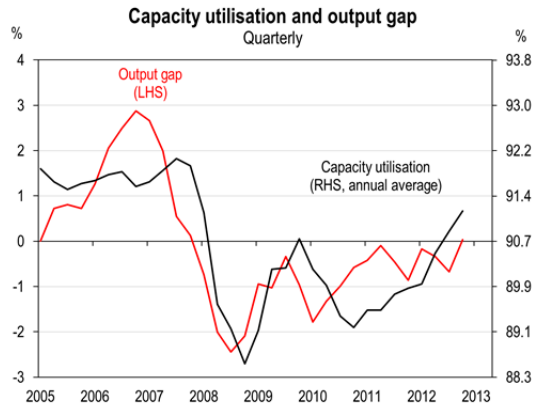
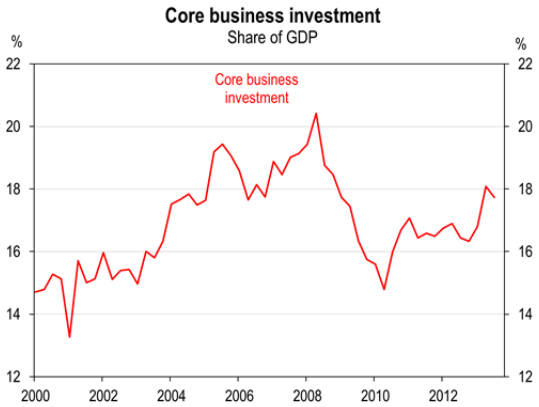
12. Firms are already signalling they have reached capacity



Source: Bloomberg, Thomson Reuters Datastream, Statistics New Zealand, HSBC

There are also a number of factors that likely explain New Zealand's drop in potential growth. One factor is that business investment has been particularly subdued since the onset of the global financial crisis in 2008, with core business investment (total investment, excluding dwelling and intangible asset investment) still 4% below the peak reached in 2008 (Chart 13). This has meant a slowdown in the rate of capital accumulation, which has dented the future growth potential of the New Zealand economy.

13. The recovery in business investment has been slow

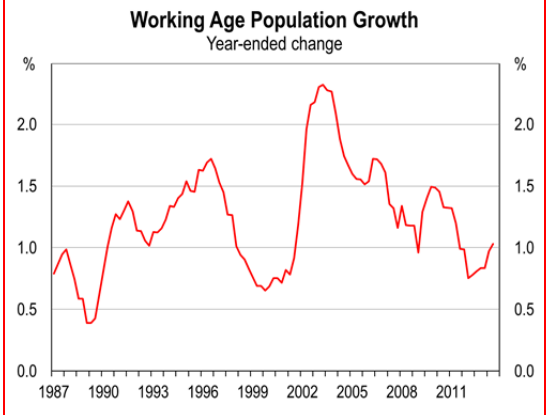


Source: Statistics New Zealand

The destruction of a large swathe of the capital stock due to the Canterbury earthquakes is also likely to have curtailed New Zealand's potential growth rate.

New Zealand's potential growth is also determined by the amount of people available to work. With slowing population growth and falling inward migration during the recession, growth in labour supply has slowed in recently years (Chart 14). In addition, there have been less people choosing to enter the workforce as the prospect of finding a job deteriorated. The average work week has also been dropping in recent years. With less labour available, the economy's productive potential has taken a hit.

14. Population growth has slowed in recent years



Source: Statistics New Zealand

Productivity growth also looks to have slowed in recent years. The drivers of this are harder to pin down. The shock of the global financial crisis and uncertainty around the outlook for Europe since the global recession may have held back confidence and stifled innovation. Long-term issues also have constrained New Zealand's productivity growth, including low domestic savings, geographical isolation and a slowdown in the pace of micro-economic reform.

Looking ahead, potential growth should rise modestly over the next few years, as some of these factors reverse. There are likely to be more people available and willing to work, with inward migration having recently picked up, while an improving economy should encourage more people back into the labour force. At the same time, as final

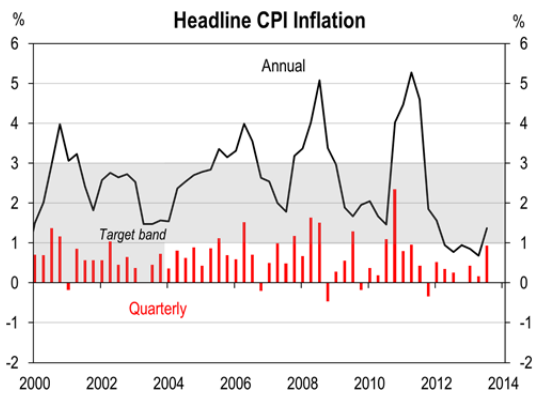
demand begins to improve, New Zealand's businesses should start investing again, which will boost the productive capacity of the economy.

Cost pressures are rising

Overall, we estimate the New Zealand economy's growth potential is around 2.5%. This means, with the economy already running at capacity, the coming demand boost could quickly translate into resource and cost pressures. To use the economist's jargon, we see the output gap as already closed.

These factors are likely to put some further upward pressure on inflation. Inflation has remained low over the past year, sitting at 1.4% y-o-y in the Q3 2013 quarter, after having been below the RBNZ's 1-3% target band for four consecutive quarters (Chart 15).

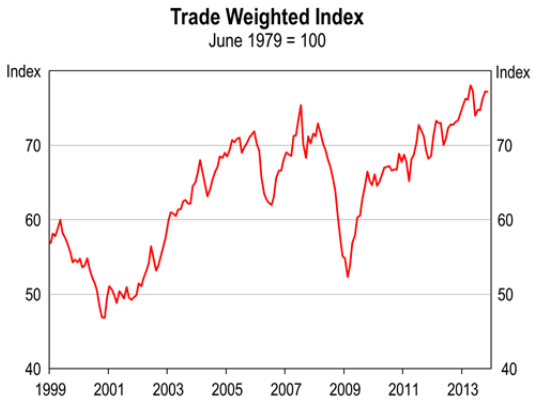
15. Inflation subdued, but picking up



Source: Statistics New Zealand, HSBC

An elevated and rising NZD has been a key factor holding back inflation in the country. The NZD TWI appreciated by around 15% between the beginning of 2012 and mid-2013 (Chart 16). This held back the price of imported goods in New Zealand and saw annual tradable inflation fall to low of -1.6% in Q2 2013.

16. A rising exchange rate has held back import prices



Source: RBNZ

At the same time, New Zealand's recovery from the global recession was relatively slow compared to previous recoveries. This led to persistent spare capacity, dampened wage inflation and limited the ability of companies to pass on any cost increases.

The other key factor holding back inflation pressure was a subdued global environment. Any imported cost pressures were modest, given ample spare capacity around the world. At the same time, ultra loose monetary policy associated with subdued demand in major Western nations provided a further boost for New Zealand's exchange rate – further holding back imported costs.

But the factors that had been holding back costs in the New Zealand economy look to have turned. The NZD has stabilised somewhat in recent months. With the currency no longer appreciating rapidly, its dampening impact on tradable inflation should wane (Chart 17). Our currency strategists see the NZD appreciating only modestly through 2014 (see Bloom, D. et al (2013) *Currency Outlook: 2013 in review*, 12 December).

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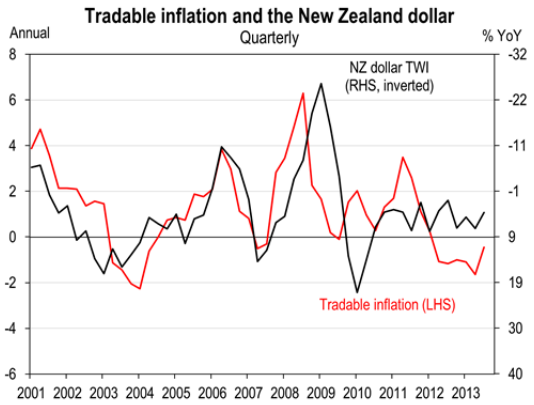
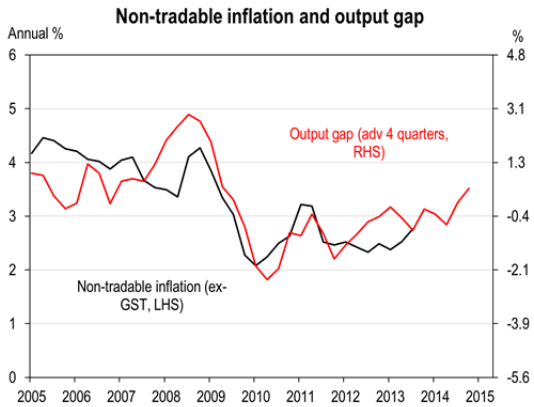
17. A stable currency should see tradable inflation rise



Source: Statistics New Zealand, RBNZ

The boost to domestic demand is likely to see domestic cost pressures pick up (Chart 18). The strong demand environment is expected to see firms increasingly competing for scarce labour, boosting wage inflation. Such an environment should also help firms pass on any cost increases and recover margins that may have been held back in the slow recovery following the financial crisis. As a result, non-tradable inflation is forecast to rise through 2014.

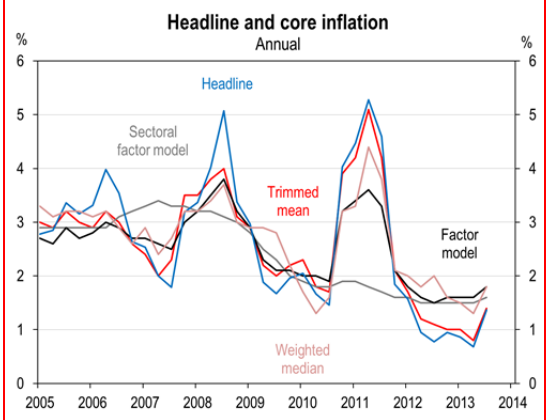
18. Rising demand could drive up domestic costs



Source: Statistics New Zealand, HSBC

There are already signs that inflation pressure is beginning to rise in New Zealand. CPI inflation jumped higher in Q3 2013 to +1.4% y-o-y from +0.7% y-o-y in Q2 2013. Core inflation measures have also been lifting recently, suggesting that underlying inflation pressures are beginning to build (Chart 19). In addition, there are signs that low interest rates and surging demand are starting to put some pressure on inflation expectations. Signs that inflation expectations are becoming unanchored would be a concern for the RBNZ.

19. Inflation is lifting across the underlying measures



Source: Statistics New Zealand, RBNZ

Overall, with demand surging and the economy's potential growth rate likely to be lower than it was previously, we expect cost pressures to begin to rise in 2014. From an annual rate of +1.2% in 2013, we are forecasting inflation to pick up to +2.5% in 2014, before moderating at +2.3% in 2015, as the RBNZ begins to contain inflation through tighter monetary policy.

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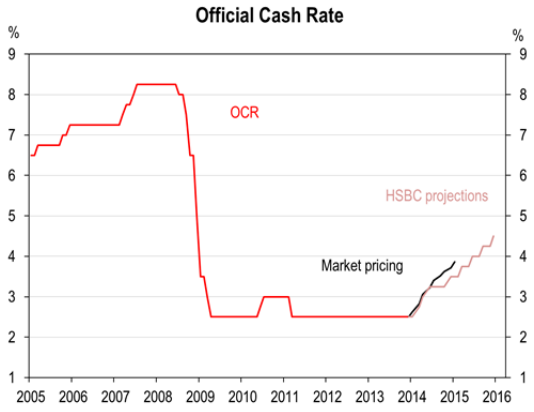
Managing a boom: policy and market implications

- The RBNZ will likely soon need to raise interest rates to keep medium-term inflation in check – we expect 100bp of hikes in 2014
- Given New Zealand's increasing ties to Asia, developments in the region present the biggest downside risk to the outlook
- Authorities are expected to face the on-going challenge of structural change as we expect the NZD to remain high

Rate hikes needed soon

Concerns about an elevated exchange rate and some confidence that recently implemented housing loan restrictions would cool the housing market, kept the RBNZ from lifting interest rates in 2013.

20. Rate hikes will soon be required from the RBNZ



Source: RBNZ, HSBC

However, with demand beginning to boom and the economy's supply potential constrained, interest rates may soon need to rise to keep inflation in check. We expect an accelerating economy to prompt the RBNZ to begin to hike interest rates soon (Chart 20).

With the RBNZ stating that rate hikes will likely be required in 2014, the key question is: to what extent will rates need to rise?

Neutral rate may be lower

Overall, with an economy already operating at capacity and demand set to accelerate, the RBNZ will likely need to return policy rates to neutral over the next couple of years to keep inflation under control. In previous cycles, the neutral cash rate was considered around 6.0%. However, the level of the neutral official cash rate (OCR) has likely shifted downwards since the global financial crisis.

A key driver of this has been a rise in funding costs for domestic banks – which has led to a greater wedge between the OCR and the interest rates faced by businesses and households.

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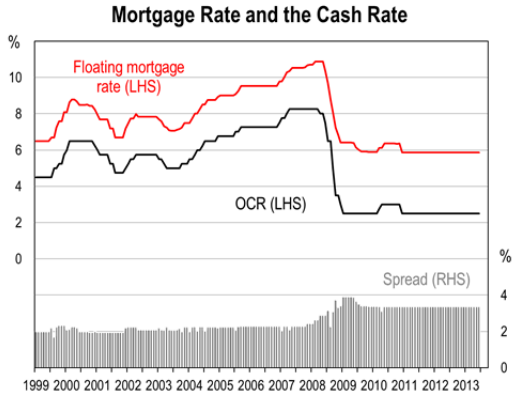
Focusing on mortgage rates, the spread between the OCR and mortgage rates has risen by around 130bp since the global financial crisis began (Chart 21). So, one way to think about this is that the equivalent level of the OCR now delivers around 130bp of additional tightening beyond that delivered prior to 2008. The subdued demand environment has also led to a drop in inflation expectations, which had persisted in the upper part of the central bank's target band for much of the past decade. This has also likely led to a drop in neutral *nominal* interest rates. Taking into account these factors, we see the neutral OCR as around 4.25%. This is broadly consistent with recent estimates presented by the RBNZ.

21. Increased funding costs have lowered the neutral OCR



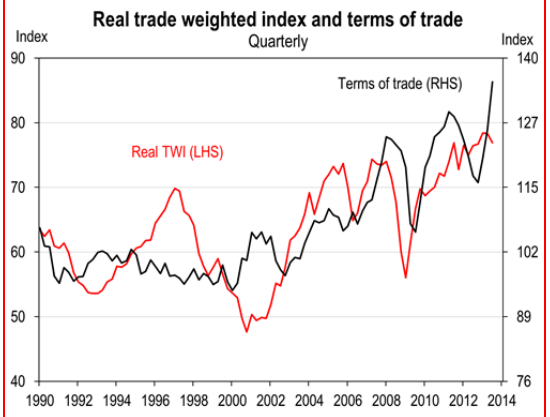
Source: RBNZ

As a result, with a significant boost to demand likely in 2014, we expect the RBNZ will need to lift rates by 100bp to 3.50% by December 2014 – with an additional 100bp of tightening expected through 2015 – to get the cash rate back just above neutral.

High NZD a challenge

Our currency strategists expect the NZD to appreciate through 2014, supported by elevated commodity prices and strong growth. And with strong demand likely to underpin export prices over the medium term, the New Zealand economy may need to deal with an exchange rate that holds up much higher than the average seen post float (Chart 22). At the same time, the New Zealand economy is likely to outperform Australia's economy, and this could see the NZD/AUD cross rate reach parity sometime in 2014.

22. A strong terms of trade may see the NZD hold up



Source: RBNZ, Statistics New Zealand

A strong exchange rate will likely help manage the boom. An elevated NZD helps spread the benefits of strong commodity prices more broadly, by providing a boost to the offshore purchasing power of New Zealand's consumers. A high exchange rate also shifts some demand offshore, helping to make room for the rebuild and keeping a lid on cost pressures. At the same time, however, there will likely be sectors of the economy that will face the challenges of a high exchange rate – in particular trade-exposed industries outside of agriculture.

We expect that the high NZD will remain a headwind for the tourism sector. While a continued trend of a rise in Chinese tourist numbers will provide support, a high currency will continue to constrain tourist spending more generally (Chart 23). In addition, given the more favourable outlook for the NZD against the AUD, more and more holidaying Australians are likely to be tempted to other destinations.

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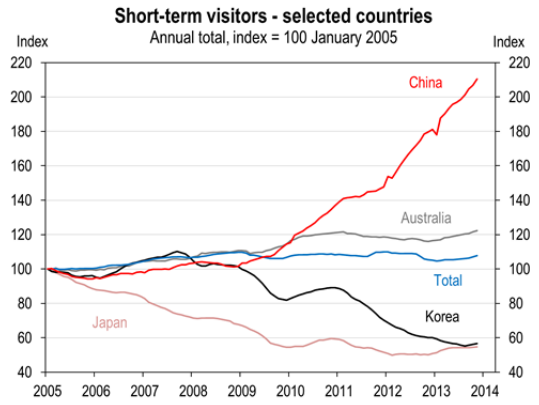
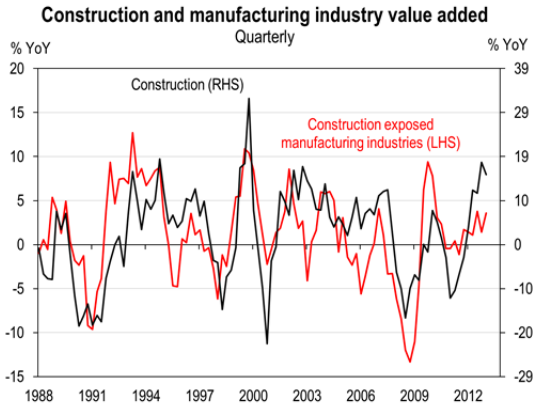
23. Chinese tourist arrivals have risen despite the high NZD



Source: Statistics New Zealand

The manufacturing sector has also been struggling in the face of an elevated NZD, as it has weakened New Zealand's global competitiveness. However, strong construction activity will provide some offset to this in coming years. Manufacturing in New Zealand is highly exposed to domestic construction, with estimates suggesting that a +1% expansion in construction activity requires a +0.4% expansion in manufacturing activity. The continued rise in construction will provide an on-going boost to a number of manufacturing sectors (Chart 24).

24. Manufacturing should get a boost from construction



Source: Statistics New Zealand

NZD key to rate hike profile

The NZD also plays a key role in the degree to which the RBNZ will likely tighten rates in 2014. Of course, the response of the RBNZ does depend on what the central bank perceives as the key drivers of the currency's movements. If the New Zealand economy was to strengthen even more than assumed and the NZD rose in response to this, the impact on the outlook for interest rates would likely be limited. Weaker imported costs would be offset by stronger domestic cost pressures.

However, if the New Zealand dollar was to hold up less for fundamental reasons (for example, due to portfolio rebalancing-type effects) this could limit the extent of rate hikes from the RBNZ. A slower withdrawal of stimulus from the US Federal Reserve and the potential boost this would provide to the NZD could be one such risk.

Domestic risks

We see the domestic risks as tilted to the upside, particularly for the inflation outlook. On this, the RBNZ is assuming a relatively modest scenario when it comes to the inflationary impact of the Canterbury rebuild. First of all, the RBNZ is assuming a degree of self-rationing in the construction sector, with the demand impulse spread over the rest of the decade. There is a risk that the demand impulse from the rebuild is much more concentrated. If there is a push by those involved to get much of the construction project finished in a shorter space of time, the policy response from the RBNZ will need to be sharper and shorter. In such a scenario, interest rates could need to rise to a greater extent than the central bank is expecting, in order to crowd out other sectors to make way for reconstruction activity.

As well as this assumption, the RBNZ is also assuming that the construction boom is similar to the ones we have seen before. If workers and equipment can be diverted towards Canterbury in

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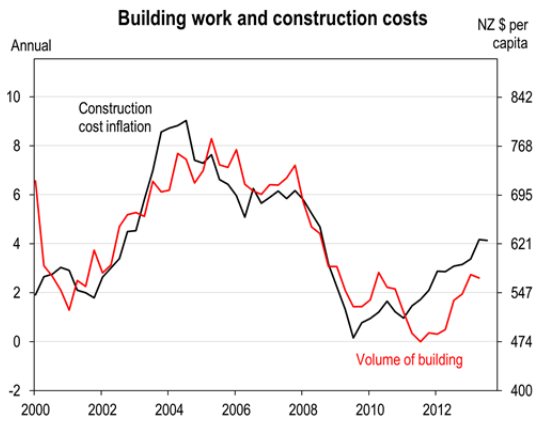
an efficient way, then this assumption will likely hold. However, the localised nature of the rebuild is a factor that could add to the cost of construction through this cycle. Mobilising resources from Auckland and elsewhere adds costs to a Canterbury-based project. As such, the inflationary consequences of this construction boom could be larger than in previous cycles.

There are already early signs that this is occurring. Construction costs are running slightly ahead of where current building activity would suggest – which implies that there may be some inefficiency in moving resources and it is only early days (Chart 25). As the rebuild ramps up, such a divergence could widen – further boosting cost pressures.

25. Construction costs are running ahead of activity



Source: Statistics New Zealand

Strong ties to Asia bring risks

Downside risks stem from the outlook for the Asian region. New Zealand's increased ties to Asia (particularly China) and the heavy reliance on this market for demand are key reasons for the strength of our outlook for 2014. At the same time, they are also a key source of risk. Any wobbles in the region could dampen demand for exports and put downward pressure on export prices and the terms of trade.

The Fed 'non-taper' in September 2013 highlighted the impact the removal of ultra-loose monetary policy can have on emerging markets – particularly given the build-up of debt in the region. At the same time, the region faces the prospects of slowing population growth and weak productivity growth. Without progress on structural reforms, emerging Asia faces some downside risks to its future growth prospects (see Neumann, F. and Man, R. (2013) *Asia's next challenge, Part 1: The demons of 1997*, 17 September).

In China, the economy has stabilised after a slowdown earlier in 2013. The focus on the quality rather than quantity of growth is a positive shift, where recent reform announcements have the potential to ensure sustained strong growth over the longer term. However, the risk of a hard landing remains, particularly given risks stemming from the shadow banking sector (see King, S. et al (2013) *Top 10 risks for 2014: Multi-asset special*, 10 December).

Some final words

We remain optimistic about New Zealand's growth prospects.

Local demand is rising, led by a housing boom and the post-earthquake reconstruction of the Canterbury region. New Zealand is also well-placed to take advantage of the demand that is coming from the rapidly expanding middle classes in Asia. This has, so far, manifested itself in demand for dairy and meat products, but services exports are also likely to get significant support in coming years.

While the high NZD presents some challenges for New Zealand's businesses and policymakers, the currency's strength is also a testament to the strong growth prospects that New Zealand is seen as having.

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HSBC's forecasts for New Zealand

	Year-average			Year-ended									
	2013	2014	2015	Q313	Q413	Q114	Q214	Q314	Q414	Q115	Q215	Q315	Q415
%													
GDP	2.8	3.4	2.6	3.5	3.3	3.6	4.0	3.3	2.7	2.7	2.6	2.6	2.6
Consumer Spending	3.2	3.1	2.1	3.7	3.4	3.2	2.9	3.2	2.8	2.5	2.1	1.9	1.8
Govt Consumption	0.8	1.1	0.8	2.0	0.7	1.6	1.8	-0.2	1.0	0.9	0.8	0.8	0.8
Investment	9.6	9.0	7.0	12.3	10.9	10.5	8.2	7.3	9.9	8.6	7.4	6.5	5.7
Domestic Demand	4.7	4.5	3.1	6.8	5.8	5.7	5.0	3.2	4.2	3.7	3.2	2.9	2.6
Exports	0.5	3.8	3.3	-2.9	-0.4	0.0	5.0	6.6	4.0	3.4	3.2	3.2	3.1
Imports	6.2	7.8	4.3	9.1	8.8	8.8	8.8	5.8	7.8	6.1	4.6	3.7	2.9
GDP (%quarter)	n/a	n/a	n/a	1.4	1.1	0.8	0.7	0.7	0.6	0.7	0.6	0.7	0.6
CPI	1.2	2.5	2.3	1.4	1.7	2.1	2.6	2.5	2.8	2.5	2.5	2.1	2.1
Unemployment	6.2	5.4	5.0	6.2	5.9	5.6	5.5	5.3	5.2	5.1	5.0	4.9	5.0
Labour cost index	1.7	2.3	2.0	1.7	1.8	2.1	2.3	2.4	2.3	2.2	2.0	1.9	1.8
Current Account (%GDP)	-3.9	-4.5	-5.4	-4.6	-3.5	-3.7	-4.3	-4.7	-5.2	-5.2	-5.3	-5.4	-5.6
Cash rate (period end)	2.50	3.50	4.50	2.50	2.50	2.75	3.25	3.25	3.50	3.75	4.00	4.25	4.50
USD/NZD (period end)	0.83	0.87	0.88	0.83	0.83	0.84	0.85	0.86	0.87	0.88	0.88	0.88	0.88
10yr yield (period end)	4.80	4.80	5.50	4.70	4.80	4.50	4.60	4.70	4.80	5.00	5.20	5.40	5.50

Source: RBNZ; Statistics New Zealand; HSBC forecasts

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Notes

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Disclosure appendix

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