Monthly Economic Indicators

THE TREASURY
Kaitohutohu Kaupapa Rawa

July 2012

Executive Summary

- **Domestic conditions are showing resilience...**
- **...despite a worsening global outlook as the euro debt crisis intensifies.**
- **Headline inflation is currently subdued, but underlying inflation is stronger and is expected to pick up in coming quarters.**
- **Global weather conditions could see a reversal of recent falls in commodity prices.**

The domestic economy is looking in relatively good shape, especially compared to most other advanced economies. Inflation is currently subdued, although we expect it to pick up from late-2012, and activity indicators suggest that moderate growth will be achieved in coming quarters. This outlook comes despite a further deterioration in international conditions.

Headline domestic inflation is currently subdued and looks likely to be slightly below our *Budget Update* forecasts in the short term. The CPI rose 1.0% in the year to June, the lowest rate since December 1999. The result was constrained by a 1.1% annual fall in tradables prices as the high exchange rate and falling commodity prices reduced the price of imported goods. We expect inflation to pick up in coming quarters as tradables prices stop falling and non tradables inflation accelerates as spare capacity in the economy is absorbed. We believe there is currently some spare capacity and that underlying inflation is around 1.5%.

The global outlook worsened further in July, with downside risks increasing. While there was no development which suggested the euro debt crisis will be tipped over the edge, there were few signs of the crisis abating. There are also other global risks, with the "fiscal cliff" (forced fiscal consolidation on 31 December) looming in the US, and the prospect of a more significant slowdown in emerging Asia. Financial markets have been volatile in reaction to developments and "safe haven" demand continues to be strong with US, German and UK government bond yields at or near record lows.

So far there has been little domestic impact from the recent negative global situation, with relatively small falls in confidence and export commodity prices. New Zealand government bond yields have been pushed down to near-record lows. The falls in confidence were relatively contained and dry weather conditions globally will likely put upward pressure on agricultural commodity prices, benefiting New Zealand. Activity indicators and the main growth drivers have held up well in the face of an uncertain global outlook, pointing to the moderate growth we incorporated into the *Budget Update* eventuating in coming quarters. Moreover, tax revenue in the 11 months to May has come in slightly above forecast.

This month's special topic looks at housing market developments. The housing market has undergone a recent recovery with nationwide house prices and sales recording significant gains in the past few months. The special topic looks at the drivers and dynamics behind the current upturn and its implications for our economic outlook.

New Zealand Government

Analysis

Domestic conditions continue to hold up fairly well in the face of an international outlook where the downside risks continue to grow. Inflation is currently subdued, although expected to pick up, and activity indicators point to moderate growth in coming quarters, as incorporated into the *Budget Update (BEFU)*. The escalating euro debt crisis has seen small falls in confidence and commodity prices, while New Zealand government bond yields are around record lows and the New Zealand dollar (NZD) is at an historically-high level. The lower commodity prices and high NZD have helped contain inflation. While commodity prices are now slightly weaker than incorporated into *BEFU,* there are upside risks from international weather conditions.

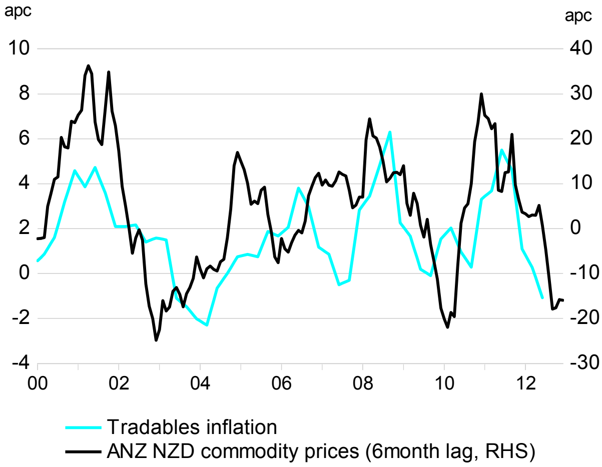
Headline inflation subdued in near term…

Annual inflation at 1.0% came in just below our *BEFU* forecast of 1.2% which, along with recent falls in petrol prices, suggests that headline inflation will be slightly more subdued in the next couple of quarters than we had anticipated. The Consumers Price Index (CPI) rose 0.3% in the June 2012 quarter, following a 0.5% rise in March. This brought annual inflation down from 1.6% to 1.0%, the lowest result since December 1999 when the Reserve Bank's target band was 0-3% rather than the current 1-3%.

The subdued inflation result and the deviation from our forecast was driven by a 1.1% fall in tradables prices (price of goods affected by international prices and the exchange rate) for the year. The weak tradables result came about due to a greater-than-anticipated fall in commodity prices earlier in 2012 and a rise in the NZD over the preceding year. Generally the NZD falls in response to drops in commodity prices, but the euro crisis has kept the NZD elevated. Tough domestic trading conditions have meant that retailers have passed on more-than-proportionate (and greater-than-expected) price decreases from the high exchange rate which had depressed import prices. The effect of the high exchange rate has mainly been seen in falls in household electronics and contents prices, as well as clothing and footwear prices.

The ANZ commodity price index fell 0.5% in July, in world price terms. Commodity prices have fallen significantly over the past year, with the NZD index down 15.3%, contributing to the fall in tradables prices (Figure 1). The commodity price fall has shown up in an annual 0.4% fall in food prices, versus the previous decade average rise of 3.3%, and only a 0.2% rise in petrol prices, versus the previous decade average rise of 6.4%.

Figure 1 – Commodity prices & tradables inflation



Sources: ANZ, Statistics NZ

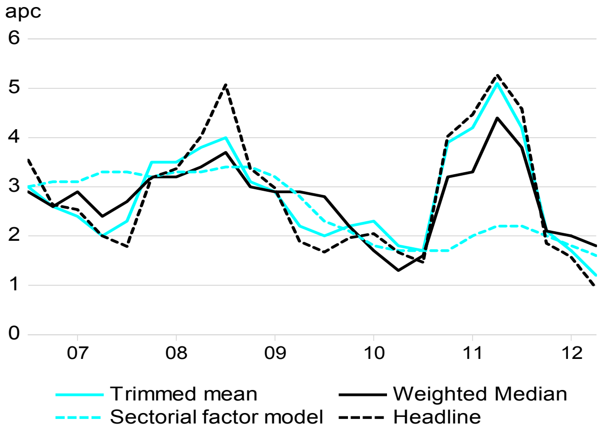
… but domestically-generated inflation is stronger...

Non-tradables prices rose 2.4% for the year, suggesting it is mainly international prices and the exchange rate keeping inflation down, although subdued domestic conditions contribute. The main drivers of non-tradables inflation have been government-related charges, energy and housing-related items. The Canterbury earthquakes, along with a housing supply shortage in Auckland, have put pressure on rents, house building costs and house insurance premiums. Tobacco excise rates went up 14.5% on 1 January 2012 and this was passed onto consumers. Electricity retailers have passed on to households increased wholesale prices resulting from Transpower's network upgrade. Rate rises in the past two years have been 6.8% and 4.6% respectively; we expect an average increase of 4.5% in the second half of 2012.

While New Zealand does not have an official measure of core inflation, a range of underlying inflation measures point to it being stronger than the headline suggests. The Reserve Bank's sectorial factor model shows the components of inflation which are common to all price changes and currently has underlying inflation at 1.6% (Figure 2). The trimmed mean and weighted median measures show underlying inflation by excluding the components which show the largest rises and falls. The weighted median currently shows inflation at 1.8%, while the trimmed

(10-30%) means are between 1.2% and 1.5%. Our estimate of non-tradables inflation excluding government charges is 1.8%. All these measures suggest underlying inflation is 1¼%-1¾%, still below the mid-point of the target band, but not at the bottom of it as the headline is.

Figure 2 – Measures of inflation



Sources: Statistics NZ, Reserve Bank

The Reserve Bank is currently comfortable with the inflation picture. In leaving the OCR on hold in its 26 July review, they commented that underlying inflation is currently below 2% and is expected to be around the middle of the 1-3% target band over the medium term. The July statement said current conditions were consistent with the June Monetary Policy Statement, with a deteriorating international outlook balanced against positive domestic developments.

...and expected to pick up in 2013...

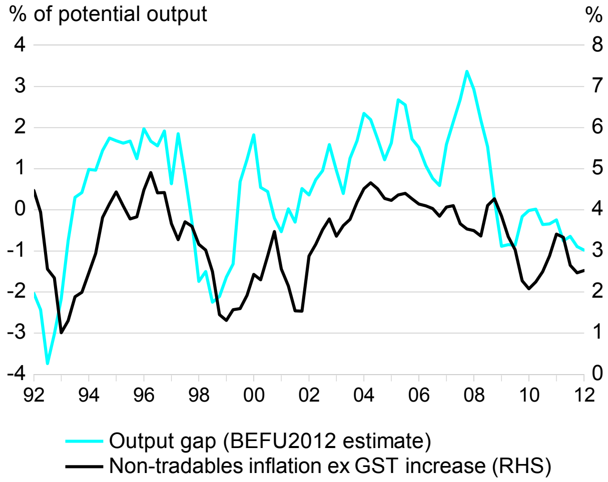
The weaker inflation result in the June quarter has not affected our expectations for the CPI to rise around ½% in the September and December quarters, keeping headline inflation in the bottom half of the target band over 2012. This is consistent with the June Quarterly Survey of Business Opinion (QSBO) which showed expectations for increases in selling prices fell back below historical average levels.

We expect inflation to then rise into the top half of the target band in 2013. This is expected to occur as tradables prices stop falling as the effect of the recent NZD appreciation begins to fade, commodity prices stabilise or in some cases start to rise (see pg 5 for a discussion of the effect of poor weather internationally on food prices) and retailers begin to restore margins which have been squeezed recently. Non-tradables inflation is also expected to rise as spare capacity in the economy is absorbed and the Canterbury rebuild and Auckland housing market shortage place pressure on housing-related prices. Rents, new home purchase and property maintenance prices in Canterbury and Auckland are already increasing by more than the national average.

...in line with limited capacity in the economy...

In general, the rate of non-tradables inflation reflects the balance of supply and demand in the economy. When supply is greater than demand, or there is spare productive capacity in the economy, the rate of increase in prices tends to slow. In *BEFU* we estimated that the economy was only 1% below its level of potential output in the March quarter, i.e. a negative output gap of 1% (Figure 3). However, the output gap is unobservable and any estimate of the output gap is highly uncertain, particularly at the end of the series. The size of the output gap can be gauged by looking at surveyed measures of spare capacity from the Quarterly Survey of Business Opinion (QSBO). These measures suggest there is currently a small amount of capacity remaining in the economy and point to domestically-generated inflation pressures being higher than headline inflation suggests. The rate of capacity utilisation (CUBO) was 89.8% in the June quarter, close to the 20-year average, led by a rise in Canterbury to 92.7% from 89.7% a year earlier. However, capacity as a limiting factor (firms which cite capacity as the largest constraint on increasing turnover) fell from 9.1% to 6.1% in June, to be slightly below its 20-year average.

Figure 3 – Output gap and non-tradables inflation



Sources: NZIER, Statistics NZ, Treasury

Our estimate of underlying inflation being just below the mid-point of the 1-3% target band is also consistent with some (but limited) spare capacity in the economy.

... and strengthening housing market

The housing market is a potential source of inflationary pressures. The housing market has begun to show signs of strengthening, with house prices beginning to pick up (see the Special Topic on the housing market for more details). The purchase of new housing, rents, as well as property maintenance materials and services make up 16.4% of the CPI and have been some of the biggest inflationary drivers in the last year (and previous decade), contributing around 0.4% points to the 1.0% annual inflation figure. With the earthquake rebuild accelerating and a general housing market pickup led by supply shortages in Auckland, the housing-related components of the CPI are expected to drive non-tradables inflation higher over the next couple of years.

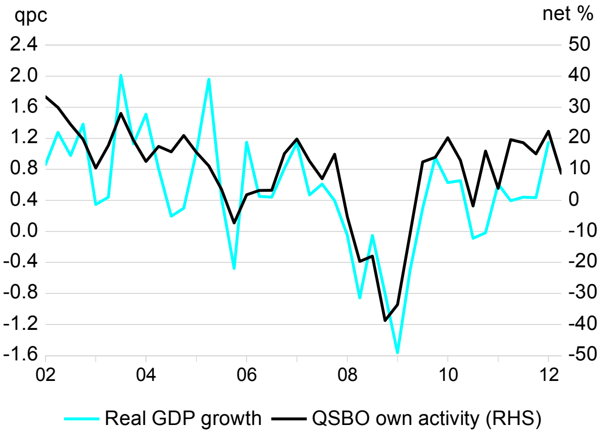
Business confidence takes a hit...

The deteriorating global outlook has finally caught up with business confidence. The June quarter QSBO fell 24% points to where the number of optimists equal pessimists. There was a small recovery in National Bank Business Outlook (NBBO) confidence in July, up 2% points from June, suggesting the QSBO survey was taken at a time of heightened pessimism. Consumer confidence has also held up, with a 5 index point rise in July from June taking the three-month moving average down by only 1 index point.

...but activity holds up...

While confidence has taken a hit from international developments, activity measures (which are a better indicator for GDP), remain consistent with the moderate growth we forecast in *BEFU*. The QSBO own activity expectations series fell back from a net 22% of firms expecting to increase activity in March to a net 9% in June (Figure 4). This is still consistent with modest GDP growth in coming quarters, with a pull back from the March quarter's strong 1.1% growth. The NBBO measure of activity expectations increased three points in July. Both the Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) fell in June, dragging the Performance of Composite Index (PCI - GDP weighted average of the PMI and PSI) down from 56.5 to 53.6 in June. However, both the PMI and PSI remain in expansionary territory (over 50) and are stronger than most international counterparts; the JP Morgan global PCI sat at 50.3 in June. This demonstrates that New Zealand is in a relatively good position and has not yet seen a significant impact from the deterioration in the global outlook.

Figure 4 – QSBO and GDP



Sources: Statistics NZ, NZIER

...driven by Canterbury

Canterbury was the strongest region in both the QSBO and the PSI, as activity continues to recover from the earthquakes and as rebuild expectations continue to dominate the economic outlook. In the QSBO, Canterbury continues to outperform the rest of the country in terms of investment and employment intentions, as well as activity expectations. The outlook for the construction industry remains positive owing to the large amount of work to be done in Canterbury. Capacity pressures are also starting to build in Canterbury and annual CPI inflation in the region was 1.5% versus 1.0% for the whole country.

Domestic growth drivers on track...

The key drivers of growth in New Zealand appear to be fairly well in balance, with a weak external environment offsetting stronger domestic conditions. The economy appears on track to produce moderate growth, averaging around ½% per quarter over the rest of 2012. Interest rates are currently stimulatory, with an all-time low OCR of 2.50% contributing to historically-low mortgage rates. Partly offsetting this, the exchange rate is currently at a historically-high level. However, the NZD is currently close to our *BEFU* forecast suggesting no extra drag on the economy. In contrast to monetary conditions, New Zealand is about to undergo a period of fiscal consolidation with a negative impulse of around 0.5% of GDP in 2012/13 and 2% in 2013/14.[1] However, this well-signalled fiscal consolidation is not expected to result in weaker aggregate GDP, as it should slow the pace of monetary policy tightening, which will

1 These figures take into account that earthquake spending has already been accrued in the official accounts but has not yet been spent. This spending will provide a positive fiscal impulse, despite not showing up in the official accrual figures.

have some offsetting stimulatory effects. In other words, it is thought that New Zealand's fiscal multiplier is probably small or close to zero (see May's Special Topic 2 for more details).

Household spending appears to be holding up fairly well. Electronic Card Transactions (ECT) rose 0.3% in June, following rises of 0.8% in April and 1.3% in May. The ECT growth, along with other indicators, suggest there is upside risk to the 0.5% private consumption forecast for the June quarter in *BEFU*. In terms of medium-term drivers, consumer confidence is still consistent with households being cautious with their spending decisions but spending will gain some support from increasing house prices. These factors match our *BEFU* expectations of 2-3% annual private consumption growth in coming quarters.

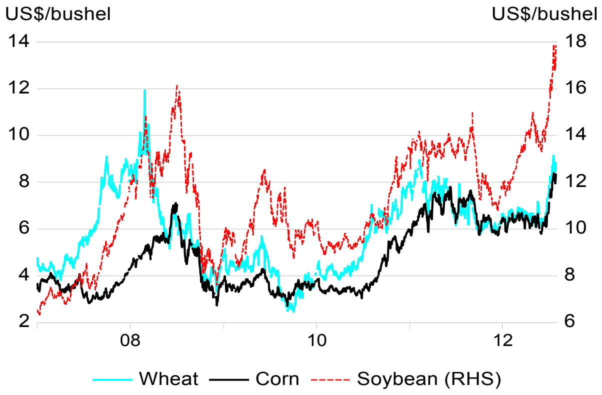
...but external factors more negative...

Net exports are likely to subtract from growth in coming quarters. There was an improvement in the annual trade deficit in June to $747 million from $876 million in May, as a monthly surplus of $331 million was recorded. The result arrested a slide that had occurred in the previous three months, after surpluses were recorded up until the year to March. However, the merchandise trade deficit is likely to resume widening over the rest of the year, as the terms of trade continue to fall as the result of weakening export prices. Export demand is constrained by a weak global outlook and a high NZD, as well as imports related to the earthquake rebuild picking up. This will contribute to a further widening of the current account deficit from the 4.8% of GDP in the year to March. Export values are on track with our *BEFU* forecasts, although import values have been stronger to date, suggesting a larger current account deficit than we previously expected.

Possibly offsetting some of the expected deterioration in the external accounts are weather conditions worldwide. While we continue to expect agricultural production to normalise following the strong pastoral growing conditions in 2011 and there is a risk of El Nino weather conditions limiting domestic production in late 2012, dry conditions globally provide upside to NZ export commodity prices. The current drought in the US is the most widespread in over 50 years, with 73% of cattle in affected areas. There have also been adverse weather conditions in the Black Sea region and India. These dry conditions have lowered production estimates, with the US Department of Agriculture revising down their 2012/13 world wheat, corn and soybean supply estimates by 0.6%, 4.7% and 1.4% respectively between June and July. Recently, corn and soybean prices have reached record highs and wheat prices are their highest since 2008 (Figure 5). This will push agricultural feed costs higher and likely result in a spike in slaughter numbers, pushing global meat prices lower in the short run (but supporting them medium term) and constraining further falls in dairy prices. Demonstrating this effect, Global Dairy Trade auction prices rose 3.5% from a fortnight earlier.

The other direct effect on NZ, which would be a negative, will be through food prices. The US Department of Agriculture expects US food prices to rise 3-4% in 2013, mainly due to the recent droughts.

Figure 5 – Commodity prices



Source: Haver

...consistent with tax being close to forecast

In the 11 months to May, Core Crown tax revenue was 1.3% above the *BEFU* forecast. The main reasons for the higher-than-expected tax take were greater PIE tax as the result of volume growth and higher terminal tax related to 2011 fiscal year corporate profitability. GST and PAYE are tracking fairly close to forecast, indicative of private consumption and the labour market evolving much as we had expected. Provisional corporate and other persons tax are also close to forecast, suggesting that current year profitability is about where we thought it would be.

Risks to global economy remain elevated

The downside risks for the economies of our major trading partners increased in July, with the euro debt crisis intensifying. However, this is not the only risk, with the "fiscal cliff" looming in the US, and the prospect of a more significant slowdown in emerging Asia.

Long-term solutions fail to solve short-term problems in the euro area…

The meeting of EU leaders at the end of June saw some progress in the long-run resolution of the crisis, but did little to solve short-term funding issues. The main measures agreed to were: to make funds provided to Spain for bank recapitalisation not have senior status over existing debt; plans for the ECB to become a region-wide banking supervisor, having the ability to directly inject capital to banks, rather than through government balance sheets; and allowing Spain and Italy to request emergency assistance from the ESM to reduce yields in their bond markets without additional austerity measures being required.

Markets were initially buoyed by the announcement, but soon realised that significant issues remained unaddressed, such as further fiscal integration. By late July, Spanish 10-year bond yields had risen over 7.5%, a level that is unsustainable if held for a period of time. Yields retreated somewhat after ECB President Draghi said that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." While this supported markets in the near term, it was not clear exactly what was envisaged and there is still some disagreement amongst euro members over the appropriate ECB action. The ECB took no action at its 2 August meeting, disappointing markets, but left the way open for "further non-standard monetary policy measures". Regardless, many in the market expect Spain to require a full bailout in the near future, despite official denials.

Greece also re-entered the spotlight, with increasing expectations that the country will leave the euro area in the next 18 months. The austerity programme is significantly behind target, with speculation that the next tranche of the bailout will be denied. While the government is trying to find the required savings, it remains to be seen how much more patience creditors will have.

...pushing the region into recession…

The turmoil in financial markets caused by the euro crisis is translating to the real economy, with euro area unemployment at 11.2% in June, the highest in two decades. Forward indicators point to a recession for the euro area in mid-2012. The euro area manufacturing PMI has been well below 50 for some time, with even Germany's taking a significant dive recently. Consumer and business confidence is low, and credit growth is also subdued, meaning that investment and consumer spending will likely also remain weak. Consensus forecasts have euro area growth as negative in 2012, and only very slightly recovering in 2013. Being closely connected with Europe, the UK is also suffering, with GDP falling 0.7% in the June quarter.

BEFU forecasts assumed that policy makers would "manage through" the euro crisis, but no breakup would occur. While we consider this assumption still holds, stakes are rising each month in which the crisis is not resolved. Policy makers may find a solution that satisfies markets, but in the meantime, growth is set to remain low (or negative), as the probability of at least a partial breakup remains, which would have significant implications for the world and New Zealand economies.

...with markets volatile

Global equity markets were volatile during the month, responding to news on the euro crisis, as well as the generally weaker economic data, and reasonable US earnings reports. Overall, most of the major indices finished July slightly higher, recovering following comments by ECB President Draghi. Global commodity prices rose over the month, led by grain prices, but also supported by precious metals and oil. The NZD was also reasonably volatile, but finished only slightly higher at almost US $0.81.

Bond rates for safe haven countries have remained at or near record lows, as investors remain cautious amid the volatility. US 10-year rates are around 1.5%, while German are at about 1.3% after being as low as 1.06% earlier in the month. NZ 10-year rates remain low at 3.5%, after rising slightly in late July as Draghi's comments supported a more risk-on move.

US growth slows as fiscal cliff looms…

As expected, June quarter GDP revealed slowing momentum in the US economy, with output up 0.4% in the quarter following 1.0% and 0.5% in the previous two quarters. Non-farm payrolls disappointed again, rising only 80,000 in June, their third sub-100,000 reading in a row. The manufacturing sector was also weaker, with the ISM for June falling 3.8 points to 49.7. On top of the softer data, the major risk for the US is the so called "fiscal cliff" at the end of 2012, when US $600bn of tax increases and spending cuts are due to take place (4% of GDP). This would almost certainly put the US economy back into recession at the start of 2013, and in the meantime is creating additional uncertainty for businesses which may delay hiring staff and undertaking investment until the outcome is known. Most analysts believe that the political gridlock will be broken in time, and policy will be changed in order to prevent such a large contraction.

…and risks remain for significant slowdown in emerging Asia

Although less significant than the other risks discussed, downside risks remain for a more significant slowdown in emerging Asia. Part of this stems from the ongoing weakness in developed economies, but also from more internally-generated risks (such as housing bubbles). Also of concern, as discussed above, is the recent rise in corn and soybean commodity prices. This could lead to increased inflation, reducing the scope available to loosen policy by the region's central banks.

China, the major economy in the region, faces several headwinds, but the consensus still sees the economy in a soft landing at this stage. Growth fell to an annual 7.6% in the June quarter, down from 8.1% in the March quarter. This slowing was expected, and seen as favourable by many, as the country rebalances and heads to more sustainable growth. Having said this, with recent loosening of monetary conditions and with more expected, June quarter growth is likely to be the trough, with a rebound over the second half of 2012. Inflation remains modest at this stage, giving authorities space to ease policy to support growth, although they want to avoid further inflating house prices.

Overall, New Zealand is benefitting from increasing exposure to faster growing parts of the world, including emerging Asia. So far we have been relatively well insulated from negative global developments and the domestic outlook is more positive than the international outlook. One of the risks facing the global economy – rising food prices as the result of supply disruptions – could actually be a net positive for New Zealand as a large net agricultural exporter.

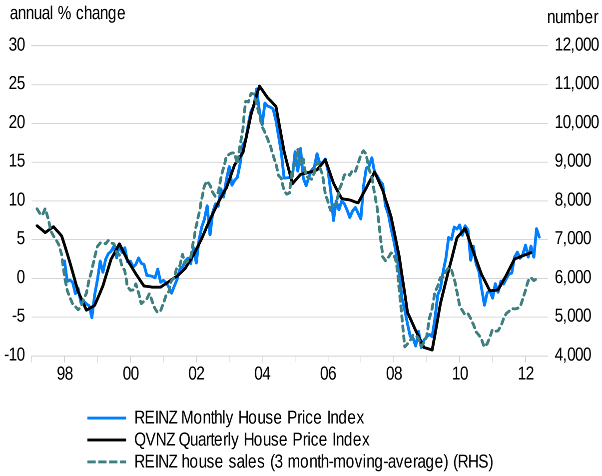
Special Topic: Housing Market Developments

Nationwide house prices and house sales have recorded significant gains in the past few months. This special topic looks at the drivers and dynamics behind the upturn and its implications for the economic outlook.

Housing activity picks up...

There has been a gradual lift in nationwide house prices since the beginning of 2011 according to both the Real Estate Institute of New Zealand (REINZ) monthly Housing Price Index (HPI) and the Quotable Value New Zealand (QVNZ) quarterly House Price Index. There is little difference between the two measures apart from timeliness, although the QVNZ index does have a wider coverage. The timelier REINZ HPI shows that average house prices were 5.3% higher in June than at the same time last year (Figure 6).

Figure 6 – House prices and sales volumes



Sources: Quotable Value New Zealand (QVNZ), REINZ

Indicators of housing market activity displayed in Table 1 show that buyer demand has been steadily increasing but a supply response has been lacking, placing upward pressure on prices. House sales have recovered to levels last seen in 2009 but are still below their average since 2001. The average number of days it takes to sell a house has also been falling and indicates that the rise in demand has not been fully met by an increase in new listings. There has also been a surge in mortgage approvals this year with annual growth averaging around 20% in the last seven months, helped by record-low mortgage rates. Mortgage approvals do not necessarily translate into new housing loans as they include homeowners who switch banks and/or refinance. The higher frequency of auction sales, particularly in Auckland, means that there can be several pre-approvals per house sale.

On the other hand, new listings and consents for new dwelling approvals remain low and below average since 2001. According to the NZ Property Report from Realestate.co.nz for June, the inventory of unsold houses nationally is currently at a four year low. The slow growth in the housing stock in recent years has placed upward pressure on rents and since 2010, house prices and rents have been rising at a similar pace, keeping rental yields subdued.

Table 1 – Housing market indicators

	2012				Averages
	Mar	Apr	May	Jun	since 2001
Activity					
Mortgage approvals (000's) (1)	23.1	22.7	25.8	27.4	27.5
REINZ sales (2)	6016	5564	6355	6104	6897
REINZ days to sell (2)	38	37	36	35	40
B&T new listings (2)	1290	1362	1416	1350	1523
Dwelling consents (3)	1344	1352	1354	1349	1775
Prices (4)					
REINZ Housing Price Index	4.2	2.7	6.4	5.3	5.7
Auckland median price index	6.0	4.5	8.4	7.1	5.2
Christchurch median price index	4.2	7.6	5.4	8.7	6.1

(1) Four week rolling sum (average since Jan 2004)
(2) Seasonally-adjusted
(3) Trend measure - including apartments
(4) Annual percentage change

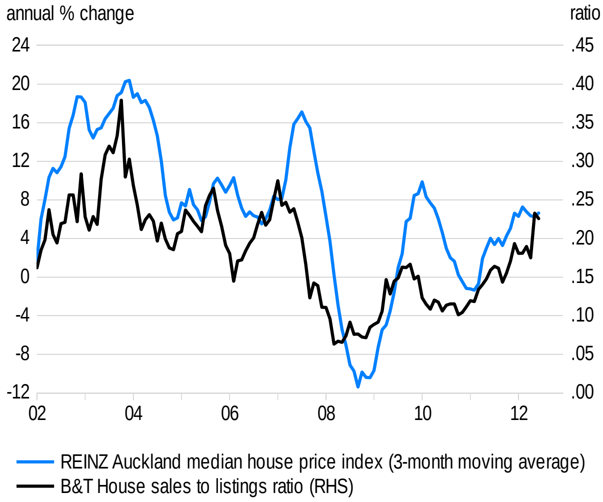
Sources: QVNZ, REINZ, Reserve Bank, Barfoot & Thompson (B&T), Statistics NZ

...buoyed by Canterbury and Auckland...

The recent uplift in the housing market can be attributed to the shortages in Canterbury and a more general shortage in Auckland with housing markets elsewhere in the country relatively subdued. Median house prices in Auckland and Christchurch both posted record highs, up 7.1% and 8.7% respectively over June last year. It also takes three to four fewer days to sell a property on average in these regions compared to the national average. Although there are pockets of weakness in other regions, median house prices have generally risen between 1% and 4%.

The Auckland market is facing considerable demand pressure as the growth in new listings fails to keep pace with rising house sale volumes (Figure 7). This dynamic has been reflected in rising house prices. The shortage in Christchurch, as a result of the earthquakes, is seeing heightened competition for undamaged dwellings. Not only are Red Zone buyers entering the market, but first home buyers and investors are also actively seeking properties. Since the earthquake last year, rents in Canterbury have been growing at an annual rate of 6% on average, double the national rate of 3%.

Figure 7 – Auckland housing market

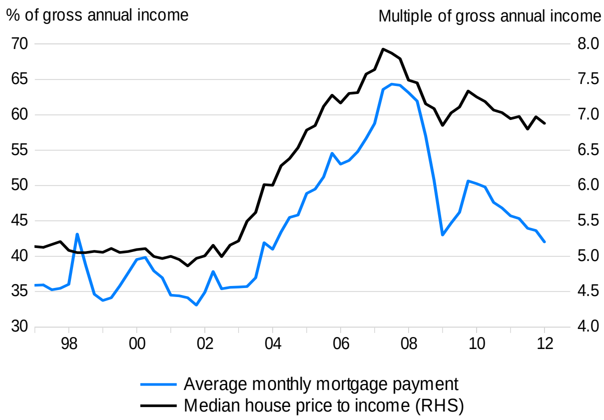


Sources: REINZ, B&T

...as market participation increases...

House prices and rents have been rising at a similar pace but low mortgage rates are encouraging more buyers to enter the market. Although median house prices (expressed as a percentage of gross annual income) are still a barrier to some, debt-servicing costs have fallen significantly (Figure 8). The BNZ-REINZ Residential Market Survey showed a net 44% of agents reporting more first home buyers in the market in July, 14% higher than the same time last year. Property investors have also been seeking higher-yielding properties given subdued rental yields, but according to QVNZ they are being increasingly outbid by first home buyers.

Figure 8 – House prices and debt servicing relative to gross annual income.

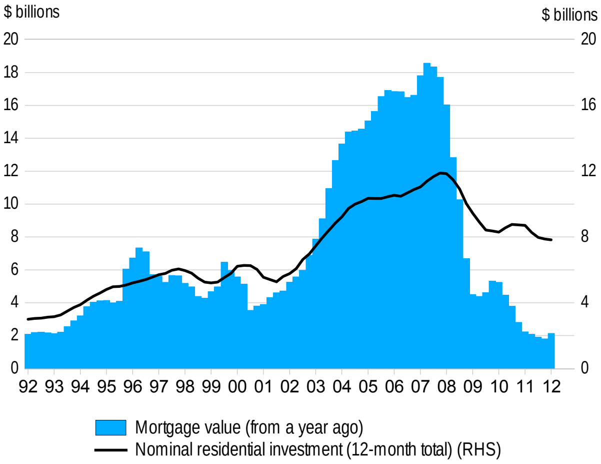


Sources: REINZ, Statistics NZ

...but households remain cautious...

The growth in new housing loans remains weak even though mortgage approval rates have been strong. Data from the RBNZ show that total household credit claims in July grew at an annual rate of 1.8%, well below the growth rate of house prices, and is indicative of the subdued level of residential investment (Figure 9). Since 2007, residential investment has grown more rapidly than the value of housing loans which means household equity has been rising. Equity injection or the share of residential investment not funded by mortgages, has risen by $13 billion between 2007 and 2012. This is helped by falling mortgage interest rates which boost the pay down of loans.

Figure 9 – Housing loan growth and residential investment



Sources: Statistics NZ, RBNZ

...and supply has been slow to respond

Forward indicators of activity such as the National Bank Business Outlook and the NZIER Quarterly Survey of Business Opinion show that the building industry continues to be the most optimistic. However, the pace of residential dwelling construction and consents has fallen short of expectations. Listings of existing homes have also been slow to rise.

Several reasons have been advanced to explain the low market turnover and building activity. New listings have been constrained, with existing homeowners unable to trade up owing to the poor quality of listings, some may be holding out for higher capital gains or unwilling to take on more debt. New housing construction continues to be skewed towards the upper end of the market as inexpensive houses are under-capitalised in the face of elevated section prices. A shortage of new low cost housing in the last decade has seen lower quartile house prices increasing by more than upper quartile houses in all major regions.[2]

New construction could be held back due to the high cost of construction relative to existing house prices. Structural factors such as land availability and low productivity currently underlie elevated section prices and building costs. A preference for high-specification housing and the relatively higher cost of building materials in New Zealand also lead to high construction costs. These issues were raised in the Productivity Commission Inquiry into housing affordability and the government is currently considering its response.

The shake-out of the non-bank finance sector has reduced the availability of finance, and could be limiting the supply response. Banks are reluctant to fund projects with a high degree of uncertainty, particularly those that require new infrastructure. Alternative investment vehicles such as equity-based partnerships, for example, may be required.

The annual running total for new dwelling consents in Canterbury has now returned to pre-quake levels but the consents data has yet to signal a clear ramp-up. Activity so far has been centred on small repairs but larger value repairs are now getting underway. The difficulty around settling insurance claims also remains a bottleneck to progress. Some areas have been earmarked for new subdivisions but uptake from investors and residents is slow. Certainty and clarification around technical building requirements will also be required for investment decisions. However, the new CBD recovery plan will provide some confidence to investors.

Implications for the economic outlook

Given the tight market, we now expect house prices to exceed our Budget forecast of 1.6% annual growth in the year to December. However, house price growth is expected to moderate over the medium term as residential construction expands and new listings rise. Weak population growth outside of Auckland, rising interest rates and a cautious household sector over the forecast horizon will provide additional offsets to house price growth. In the short-term, rising house prices will provide some support for consumption growth but are unlikely to add much.

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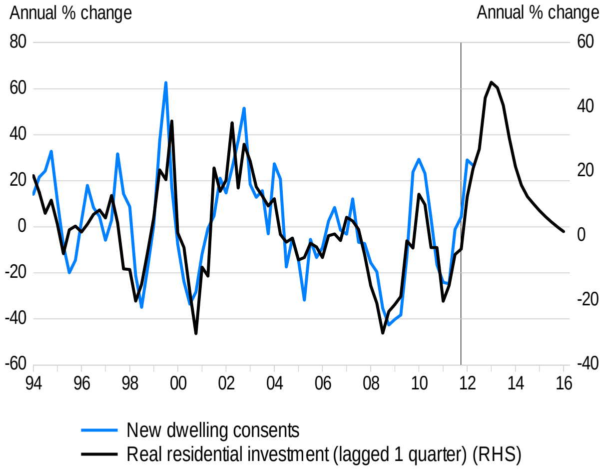
2 See forthcoming Treasury Working Paper, '*Housing Affordability in New Zealand: Evidence from Household Surveys*' by Law and Meehan (2012).

While consents fell in the June quarter, we expect residential investment to pick up in the near term as a backlog of consents from 2011 remains. The level of residential investment over the medium term is expected to surpass previous housing booms given the demand stimulus from the Canterbury rebuild and under-building in recent years (Figure 10).

These recent developments will be factored into our forecasts in the *Half Year Update*.

Figure 10 – Residential investment forecast and consents



Sources: Statistics NZ, Treasury

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

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New Zealand Key Economic Data

2 August 2012

Quarterly Indicators

		2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2
Gross Domestic Product (GDP)								
Real production GDP	qtr % chg[1]	0.0	0.6	0.4	0.4	0.4	1.1	...
	ann ave % chg	1.8	1.7	1.3	1.2	1.4	1.7	...
Real private consumption	qtr % chg[1]	-0.4	0.2	0.9	1.5	0.1	0.1	...
	ann ave % chg	2.3	1.6	0.8	1.0	1.5	2.0	...
Real public consumption	qtr % chg[1]	0.6	0.1	0.1	0.5	-0.7	0.5	...
	ann ave % chg	0.6	0.3	0.0	0.3	0.2	0.3	...
Real residential investment	qtr % chg[1]	-6.5	-2.2	-8.4	1.0	4.2	-0.5	...
	ann ave % chg	3.8	3.8	-4.9	-11.1	-11.7	-11.9	...
Real non-residential investment	qtr % chg[1]	4.8	1.4	-2.7	-0.7	0.7	2.1	...
	ann ave % chg	1.7	6.9	10.6	10.0	5.8	2.4	...
Export volumes	qtr % chg[1]	-0.5	1.5	-0.5	0.7	2.9	-1.7	...
	ann ave % chg	3.2	2.1	1.3	1.2	2.0	1.9	...
Import volumes	qtr % chg[1]	7.2	-2.8	2.0	2.8	-2.2	4.1	...
	ann ave % chg	10.6	11.1	11.0	10.3	6.4	6.0	...
Nominal GDP - expenditure basis	ann ave % chg	5.0	4.8	4.9	4.6	3.4	3.1	...
Real GDP per capita	ann ave % chg	0.6	0.5	0.2	0.1	0.4	0.8	...
Real Gross National Disposable Income	ann ave % chg	2.9	2.5	2.9	3.0	2.1	1.7	...
External Trade								
Current account balance (annual)	NZ$ millions	-6,787	-7,196	-7,396	-8,827	-8,338	-9,738	...
	% of GDP	-3.5	-3.7	-3.7	-4.4	-4.2	-4.8	...
Investment income balance (annual)	NZ$ millions	-9,538	-9,649	-9,501	-10,363	-10,405	-10,633	...
Merchandise terms of trade	qtr % chg	0.8	0.8	2.4	-0.6	-1.5	-2.3	...
	ann % chg	12.3	6.7	7.1	3.4	1.0	-2.1	...
Prices								
CPI inflation	qtr % chg	2.3	0.8	1.0	0.4	-0.3	0.5	0.3
	ann % chg	4.0	4.5	5.3	4.6	1.8	1.6	1.0
Tradable inflation	ann % chg	3.3	3.7	5.5	4.6	1.1	0.3	-1.1
Non-tradable inflation	ann % chg	4.6	5.2	5.2	4.5	2.5	2.5	2.4
GDP deflator	ann % chg	7.0	4.3	4.5	3.1	0.6	0.5	...
Consumption deflator	ann % chg	3.3	3.6	4.6	3.7	1.7	1.4	...
Labour Market								
Employment (HLFS)	qtr % chg[1]	-0.3	1.1	0.1	0.2	0.2	0.4	...
	ann % chg[1]	1.3	1.7	2.0	1.1	1.6	0.9	...
Unemployment rate	%[1]	6.7	6.6	6.5	6.6	6.4	6.7	...
Participation rate	%[1]	68.0	68.6	68.4	68.4	68.2	68.8	...
LCI salary & wage rates - total (adjusted)[5]	qtr % chg	0.5	0.4	0.5	0.6	0.6	0.4	...
	ann % chg	1.7	1.8	1.9	2.0	2.0	2.0	...
QES average hourly earnings - total[5]	qtr % chg	0.5	0.4	1.1	1.2	0.1	1.4	...
	ann % chg	1.8	2.6	3.0	3.2	2.8	3.8	...
Labour productivity[6]	ann ave % chg	0.3	-0.3	-0.7	-0.8	-0.1	0.2	...
Retail Sales								
Core retail sales volume	qtr % chg[1]	-0.3	1.4	1	2.6	2.2	-1.4	...
	ann % chg	0.3	1.4	1.9	4.5	7.3	4.3	...
Total retail sales volume	qtr % chg[1]	-0.6	1.4	0.9	2.3	1.6	-0.6	...
	ann % chg	-0.1	0.7	1.1	3.9	6.4	4.2	...
Confidence Indicators/Surveys								
WMM - consumer confidence[3]	Index	108	98	112	112	101	102	100
QSBO - general business situation[4]	net %	8.1	-26.8	26.6	24.6	0.1	13.0	-4.1
QSBO - own activity outlook[4]	net %	11.4	-1.6	18.4	30.0	9.9	16.9	8.1

Monthly Indicators

		2012M01	2012M02	2012M03	2012M04	2012M05	2012M06	2012M07
External Sector								
Merchandise trade - exports	mth % chg[1]	9.0	-11.9	8.2	-3.4	2.0	1.7	...
	ann % chg[1]	12.7	-6.3	-8.9	-17.5	-4.5	6.2	...
Merchandise trade - imports	mth % chg[1]	-1.9	-10.1	2.1	-0.4	-1.5	13.6	...
	ann % chg[1]	17.9	-7.3	-0.4	0.2	2.7	3.0	...
Merchandise trade balance (12 month total)	NZ$ million	637	663	267	-558	-876	-747	...
Visitor arrivals	number[1]	213,370	203,700	210,940	213,350	211,680	217,670	...
Visitor departures	number[1]	218,690	215,030	209,220	219,060	207,370	219,770	...
Housing								
Dwelling consents - residential	mth % chg[1]	9.0	-6.5	18.8	-7.8	-7.2	5.7	...
	ann % chg[1]	26.6	23.7	43.4	32.7	20.5	28.3	...
House sales - dwellings	mth % chg[1]	1.0	7.5	-3.7	-7.5	14.2	-3.9	...
	ann % chg[1]	25.2	37.0	25.3	13.8	24.4	17.3	...
REINZ - house price index	mth % chg	-1.4	0.8	1.9	-0.3	1.7	0.3	...
	ann % chg	4.3	2.7	4.2	2.7	6.4	5.3	...
Private Consumption								
Electronic card transactions - total retail	mth % chg[1]	1.1	-0.6	0.4	0.9	1.0	0.4	...
	ann % chg	4.7	8.2	5.6	1.2	6.1	5.5	...
New car registrations	mth % chg[1]	2.0	-1.8	-3.2	3.5	3.5	-0.9	...
	ann % chg	4.5	2.3	-1.0	8.6	10.3	11.7	...
Migration								
Permanent & long-term arrivals	number[1]	6,620	7,210	7,430	6,430	7,120	7,720	...
Permanent & long-term departures	number[1]	7,250	7,520	7,290	7,240	6,910	7,240	...
Net PLT migration (12 month total)	number	-3,134	-4,068	-3,383	-4,006	-3,653	-3,191	...
Commodity Prices								
Brent oil price	US$/Barrel	110.45	119.43	125.38	120.08	110.24	95.29	102.79
WTI oil price	US$/Barrel	100.24	102.25	106.19	103.33	94.7	82.41	87.93
ANZ NZ commodity price index	mth % chg	-2.8	-4.1	-0.2	-4.0	0.7	-3.4	-3.1
	ann % chg	-4.7	-11.1	-17.9	-17.6	-15.9	-16.1	-15.2
ANZ world commodity price index	mth % chg	1.2	-0.1	-1.7	-4.5	-4.4	-2.4	-0.5
	ann % chg	-0.2	-2.9	-8.9	-13.9	-17.5	-18.7	-18.6
Financial Markets								
NZD/USD	$[2]	0.8007	0.8343	0.8208	0.819	0.7762	0.7801	0.7982
NZD/AUD	$[2]	0.7691	0.778	0.7779	0.7908	0.7766	0.7813	0.7757
Trade weighted index (TWI)	June 1979 = 100[2]	71.23	73.36	73.00	73.00	70.04	70.86	72.31
Official cash rate (OCR)	%	2.50	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill rate	%[2]	2.74	2.75	2.74	2.74	2.59	2.61	2.67
10 year govt bond rate	%[2]	3.87	3.99	4.17	3.98	3.66	3.41	3.40
Confidence Indicators/Surveys								
National Bank - business confidence	net %	...	28.0	33.8	35.8	27.1	12.6	15.1
National Bank - activity outlook	net %	...	31.2	38.8	36.1	34.9	20.8	24.0
ANZ-Roy Morgan - consumer confidence	net %	116.1	113.3	110.2	114.0	113.9	105.8	110.5

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, National Bank of New Zealand, NZIER, ANZ, Datastream, Westpac McDermott Miller, One News Colmar Brunton