BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ economy – on course but some risks

Executive Summary

Economic indicators to date reveal mixed fortunes. Both the BNZ - BusinessNZ Performance of Manufacturing (PMI) survey and its sister survey, the Performance of Services Index (PSI) show manufacturing and services continuing to power on with solid performance and forward looking indicators such as the ANZ Truckometer (which measures freight movements) also showing solid gains. Consumer confidence too remains solid with the new government receiving a relatively healthy tick in terms of support. Terms of trade (a measure of the purchasing power of NZ's exports abroad and a key indicator of the state of the economy overall) reached an all-time high in the September 2017 quarter, driven largely by higher meat and dairy prices.

On the other hand, business confidence has taken a hit although businesses' own confidence has recovered somewhat since the election but is still at relatively low levels. The difficulty at this stage is to determine whether the drop in confidence is the result of fear of the unknown (i.e. a change of government with potentially different policy priorities and the uncertainty which goes with that) or whether it is a more deep-seated fear of future policies and prospects and the incentives or disincentives these might have on investment in the NZ economy. While too early to decide one way or the other, it does appear elements of both are currently driving the business confidence results.

The Government's recently released Half-year Economic and Fiscal Update (HYEFU) shows some deterioration in its fiscal position relative to the pre-election update but given new spending promises have now been factored into future forecasts, this was widely expected. Notwithstanding, key indicators such as net debt levels are forecast to remain at relatively low levels, again, at least by international standards.

The Government's near term agenda of policy proposals, some already implemented, is very full. To be fair, these proposals are a mixed bag, some good, some relatively neutral, and some arguably unhelpful to NZ's future economic prospects. More on this later.

On the international scene, a general recovery is well underway. According to the International Monetary Fund's (IMF) World Economic Outlook (October 2017), the global cyclical upswing that began midway through 2016 has continued to gather pace with accelerating growth in Europe, Japan, China and the United States.

Furthermore, the IMF sees world financial conditions as remaining buoyant. Seemingly, world financial markets are expecting little turbulence as major economies start moving towards greater normalisation of monetary policy conditions.

But despite an overall positive international outlook, the IMF warns that wages growth is relatively weak across the world while overall growth rates per capita have tended to lag behind trend growth rates.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index sits at 3 for the December 2017 quarter, down 1 on the previous quarter and down 11 on a year ago.

The BNZ - BusinessNZ Performance of Manufacturing Index has continued to show solid expansion over the second half of 2017, along with its sister survey, the Performance of Services Index (PSI).

Key sectors, including manufacturing, construction and tourism, are still performing well although construction has dropped from its earlier peak. Others, such as agriculture, are showing somewhat mixed results (relatively high prices on the one hand but concerns over potential for drought and/or government regulatory decision-making on the other).

Net migration, while starting to come off the highs of earlier this year, is still at a relatively high level supporting continued demand for goods and services.

Surveys of business confidence show inflationary pressures starting to become more prominent and this may be driven, at least in part, by government's expansionary fiscal policy along with proposed rises in minimum wage legislation. These could be expected to have some flow-on effects in terms of generalised wage demands.

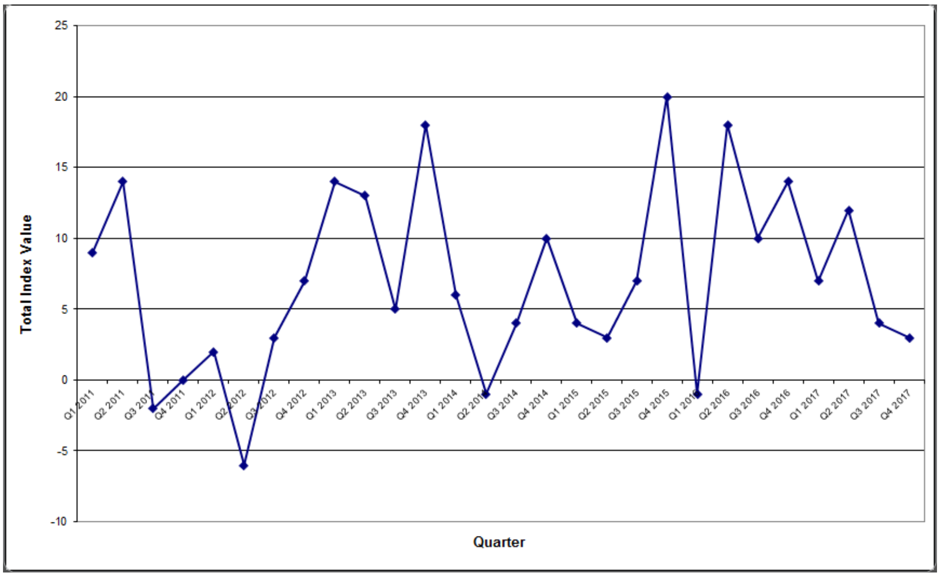
Over the near term the new Government has a very full policy agenda, some proposals already implemented. Moves to ban foreigners purchasing existing houses are unlikely to have much effect on house prices (as restrictions on foreigners purchasing 'sensitive' land). However, both are symbolic of a change in approach, sending mixed signals as to how open NZ is to international investment.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 3 for the December 2017 quarter, down 1 on the previous quarter and down 11 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Of the ECI sub-groups:

Economic growth/performance indicators sit at 3 for the December 2017 quarter, up 4 on the previous quarter, and down 2 on a year ago. With increases in world commodity prices, particularly dairy, New Zealand's terms of trade are now at record levels.

Monetary policy/pricing indicators sit at -3 for the December 2017 quarter, down 2 on the previous quarter and down 5 on a year ago. Inflationary pressures are starting to rise from the ashes, while interest rates are incrementally increasing.

Business/consumer confidence indicators sit at -1 for the December 2017 quarter, down 2 on the previous quarter and the same as a year ago. Business confidence has taken a hit post-election but consumer confidence indicators continue to consolidate at relatively healthy levels.

Labour market indicators sit at 4 for the December 2017 quarter, down 1 on the previous quarter and the same as a year ago. Overall, employment growth remains strong, while unemployment has continued to trend down despite record labour force participation rates.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case; for example, declines in unemployment are seen as positive and increases as negative. Some of the results for the September 2017 and December 20017 quarters are estimates based on available information to date.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – solid

The economic growth outlook has eased slightly from earlier quarters but a still-healthy growth rate of around 3% per annum is forecast out to December 2019.

The Government's recently released Half-year Economic and Fiscal Update (HYEFU) shows some deterioration in the its fiscal position relative to the pre-election update. This was widely expected, given new spending promises have now been factored into future forecasts. Notwithstanding, key indicators such as net debt levels are forecast to remain at relatively low levels, at least by international standards. The key risk is in ensuring the economy continues to grow at respectable rates to deliver the relatively buoyant results forecast in the HYEFU. There is little left in the cupboard if the economy falters.

The HYEFU focused strongly on sharing the gains of a growing economy with an emphasis on social investment. Many key initiatives were pre-announced in the months and weeks leading up to the release of the HYEFU so the update did not contain any real surprises.

The HYEFU includes the cost of the government's 100-day plan. Key expenditure items in the 100-day plan, including the families package (see below) and the tertiary education package (free first-year fees and increased student loan limits) have been offset by the cancelling of the Budget 2017 tax cuts, previously expected from 1 April next year. Expenditure increases from KiwiBuild, as well as the reintroduction of contributions to the NZ Superannuation Fund, will add about $5 billion to net fiscal costs.

The Government's reasonably expansive expenditure programmes, including a regional development fund, will pump more money into the economy. Where this money will go and the quality of the expenditure programmes have yet to be assessed.

Some key economic indicators contained in the HYEFU include:

- **Economic activity,** expected to be modest over the forecast period, averaging 2.9% per year over the next 5 years
- **Inflationary pressures,** expected to remain relatively subdued over the forecast period, averaging around 2.1% annum out to 2022
- **Unemployment,** expected to drift lower to reach 4.0% by 2021
- The budget surplus (before gains and losses), expected to increase gradually to $8.8b by 2021
- **Wage growth (annual percentage change),** expected to increase significantly over the forecast period from 1.6% currently to 3.5% by 2022
- **Core Crown expenses,** currently 28.0% of GDP and expected to decline marginally to 27.6% by 2022
- **Net core Crown debt,** expected to fall from 21.8% (currently) to 19.3% in 2022

While there are sectors where some key drivers of growth are starting to ease off (e.g. net migration inflows have clearly peaked) and construction activity has eased back somewhat, other sectors continue to show solid growth, including the manufacturing and services sectors.

The agricultural sector is facing both positive and negative pressure and this is impacting on confidence. On the positive side of the equation, dairy prices have generally recovered (despite some easing of the Global Dairy Trade over the last six months and Fonterra's recent downward revision of its forecast Farmgate Milk Price for the 2017/18 season from $6.75 to $6.40 per kgMS). Meat prices have improved, with relatively strong demand both for beef and lamb and the lambing percentage one of the best for many years. Productivity per animal continues to improve, good news when looking at the wider picture of agricultural production in NZ and the current pressure on land use and nutrient discharge. The global economy is also showing continuing improvement, helping to increase the demand for quality protein and favouring NZ producers.

On the downside, there are some risks.

First, various trade agreements are making mixed progress, and the threat is always present of moving backwards to protectionism and a rise in nationalist tendencies which would not be in NZ's best interests.

Second, the potential for drought to impact on capital stock numbers should not be underestimated. A couple of months ago it would have seemed almost laughable to be talking about potential drought conditions given a relatively wet winter/spring across much of the country. Now, very dry conditions over November and early December mean some stock numbers will have to be reviewed, particularly if in many areas there is no significant rainfall to improve soil moisture deficits.

Third, farmer confidence is likely to have taken a hit over concerns about the potential impact of the new Government's policy proposals on agricultural emissions. In light of the current debate about water charges, it is understandable many in the agricultural community are looking ahead with some degree of uncertainty. That is not to say nutrient discharge and water quality issues are not crucial and need to be addressed but this should be done in tandem with a more market-based approach to water allocation. Water should be able to move to its highest value use without government effectively trying to pick winners. A rational, cohesive strategy is required to address issues of this kind.

The new Government has a very full agenda of policy proposals over the near term; some already implemented (e.g. fees-free tertiary education for the first year of study). The range of policies proposed is a mixed bag from an economic perspective, some good, some relatively neutral, and some arguably detrimental to NZ's long-term economic prospects.

Both NZ First and Labour have stated the change in Government represents a change to the economic and social environment in which New Zealanders operate. There is to be a more hands-on approach to governing NZ, with a larger role for Government over a range of areas including regional development, and involvement with broader macro-economic levers such as monetary policy (changes to the Reserve Bank Act and taxation policy), together with greater controls on foreign investment, particularly in respect to home ownership.

In the good category, the move to free up land supply for housing by abolishing urban boundaries, as advocated by Labour pre-election, is very positive. Such a move should arguably have happened years ago rather than simply designating some areas special housing zones in an attempt to get more houses built.

Another coalition policy which is also very positive but has not received much airplay is the agreement to hold a public inquiry to investigate the drivers of local government costs and their revenue base. This is potentially a very useful initiative given local government funding mechanisms (principally rates-based) are coming under pressure, as are concerns about the funding of replacement infrastructure in low population growth areas and how to provide for growth in high population growth areas.

The Government's commitment to a Tax Working Group (Terms of Reference have been released) is positive, as tax policy needs to keep pace with the changing nature of the economy and international best practice, since capital and labour are internationally mobile. Consequently, it is important for NZ to look further afield when developing long-term tax changes; these must not only meet our domestic requirements but be robust and internationally competitive as well.

On the other hand, it is disappointing that the Terms of Reference include a number of 'no-go' zones. This is unfortunate given the purpose of a tax review should be to look at the whole system, warts and all, and determine what is ideal; and only then should a decision be made about what can and cannot be realistically implemented. Restricting that conversation could lead to a future tax system that is less than optimal.

Some other polices, such as moves to ban foreigners from purchasing existing housing in NZ, are unlikely to have much effect on house prices (nor are restrictions on foreigners purchasing sensitive land). However, on the downside, while such policies may have limited short-term impact, they are likely to be seen by international investors as a move towards greater government involvement in decision-making raising the issue of NZ's openness to overseas investment. This is important given that internationally, labour and capital can generally freely flow around the world to their most desirable destinations. NZ's fiscal, monetary and general regulatory structures have usually been taken as being at the top end of international best practice, although there is always room for improvement. It would be unfortunate if NZ were to chip away at these economic pillars for the sake of a short-term political win and to the detriment of future success.

NZ has in the past been singled out by the OECD as having a rather closed approached to foreign investment, particularly owing to requirements regarding the sale of sensitive land. While this is, in our view, a little unfair to NZ, as by and large the country is open to foreign direct investment, the potential implications should not be underestimated.

The coalition agreement places a particular focus on regional development, an issue where most political parties saw as an opportunity pre-election. Under the Labour/NZ First Coalition there has been an agreement to set up a $1 billion per annum Regional Development (Provincial Growth) Fund, including significant investment in regional rail, planting 100 million trees per annum (the Billion Trees Planting Programme), commissioning a feasibility study on options for moving the Ports of Auckland - including giving Northport serious consideration - and re-establishing the NZ Forestry Service. Other large-scale capital projects will also be considered along with a commitment to relocate government functions to various regions. Risks associated with such a large regional development budget are whether this is a good use of taxpayer funds and whether there are adequate controls ensuring expenditure quality. There is a danger of focusing on pet projects and not on sound investment, with taxpayers ultimately bearing the risk. Regions are already queuing up with ideas on how to spend other people's money.

Other polices, such as agreeing to ditch the previous National Government's long-term plan to lift the superannuation age from 65 are unlikely to have a major impact on the NZ economy – at least over the short to medium term. The lifting of the NZ superannuation age to 67 was so far out (2040) that it was in any case largely meaningless. However, there is still a strong case for lifting the age of entitlement since many people post-65 are remaining in the workforce and lifespans and quality of life are expanding.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 17	Dec 18	Dec 19
Highest	2.6	3.2	3.2
Average	2.5	2.8	3.0
Lowest	2.4	2.4	2.8

Source: ASB, BNZ and Westpac

1.2 Monetary conditions – review of Reserve Bank Act

The Labour/NZ First Coalition agreement contains a proposal to review the Reserve Bank Act and the factors the Reserve Bank must take into account in conducting monetary policy.

The review is to be undertaken in two phases of work.

Phase 1 (which will be led by the Treasury, on behalf of the Minister of Finance) will recommend changes to the Reserve Bank Act to:

- require monetary policy decision makers to give due consideration to maximizing employment alongside the price stability framework
- provide a decision making model for monetary policy decisions, in particular the introduction of a committee approach including the participation of external experts
- Also considered will be whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision-making model

An independent Reserve Bank with a sole focus on price stability objectives (low inflation) has been a core policy platform for successive Labour- and National-led governments since the mid-late 1980s.

Overseas, it is not uncommon for central banks to be required to target low unemployment, sometimes along with growth or external balance objectives. However, it is difficult if not impossible to achieve all such goals with the single instrument of interest rates. Notwithstanding the review's recommendations, it is likely inflation prospects will still take precedent when monetary policy is determined, however the immediate risk is greater policy uncertainty, which is not beneficial for investment.

Moving towards a committee approach for determining monetary policy is unlikely to have any material effect as the Reserve Bank already consults widely with a range of sectors when evaluating economic prospects. Difficulty may occur if the committee approach involves vested sector interests rather than a truly independent expert group. Issues such as whether or not members of the committee will be permitted to publicly air differences about the committee's decisions could undermine the high regard in which the Reserve Bank is generally held. While these might seem rather trivial matters in the context of monetary policy setting, they are nonetheless important for NZ's overall credibility and for providing certainty to those prepared to put their investments at risk. Markets hate uncertainty and generally attach a premium to ensure returns more than compensate for this.

Phase 2 of the review will further investigate the Reserve Bank's activities with a list of issues for consideration to be developed in consultation with an Independent Expert Advisory Panel.

Interest rates – edging up

The 90-day bill rate is forecast to edge up to 2.7% by December 2019 (see forecasts below).

The Reserve Bank, as widely predicted given some post-election uncertainty, kept the OCR at 1.75% at the last review. There is little pressure at this stage to lift the OCR, although there are some hints of underlying inflationary pressures (both tradeable and non-tradable) that will likely keep the Reserve Bank focused on inflation.

Forecasts: Interest Rates (90 day bills)

	Years ending		
	Dec 17	Dec 18	Dec 19
Highest	2.0	2.6	3.2
Average	2.0	2.2	2.7
Lowest	2.0	2.0	2.2

Source: ASB, BNZ and Westpac

The NZ dollar – in the zone

There were no wild fluctuations in the value of the NZ dollar during the post-election negotiation phase; markets continued on largely as though nothing had happened.

This may reflect a number of factors.

First, and perhaps foremost, despite what die-hard supporters of particular parties might believe, the differences between our major political parties, from an international perspective at least, are not as significant as some might think. By international standards, National, Labour, NZ First and the Greens appear relatively centrist in nature, particularly compared with the rest of the world.

NZ is still considered a relatively low political risk and many of our institutions are broadly supported across the political spectrum.

The above suggests markets, particularly financial markets, place more weight on NZ's robust economic position – solid growth, low unemployment, dairy sector improving substantially and many regional areas doing well on the back of strong migration and tourism growth – than on which Government is in office. When the economy is doing well, Governments per se are considered less relevant.

Second and perhaps not widely understood by the general public, is the fact that even up to two years ago, political polls, with the odd exception, showed NZ First as almost inevitably holding the balance of power. So in reality on election day there were no real surprises.

Third, since MMP was first introduced, the need to develop formal coalitions is now much more understood by the political parties and by the general public. And NZ First (and more particularly its leader Winston Peters) has previously been involved in coalition agreements with both National and Labour.

Notwithstanding the above, determining the future direction of the exchange rate is fraught with difficulty and short-term fluctuations will continue to be the order of the day – whether driven by internal decision-making or perhaps more importantly, by what is happening on international markets and the stability of the international economy.

Future business and consumer confidence indicators will also play a part in deciding the continued relative strength of the NZ dollar, and the effect of inflationary pressures.

Averaging forecast results suggest there will be very little movement in exchange rates, although the differences between the highest and lowest forecasts are quite significant, as can be seen below.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 17	Dec 18	Dec 19
Highest	0.93	0.96	0.95
Average	0.91	0.92	0.92
Lowest	0.89	0.90	0.90

USD (cents)			
	Dec 17	Dec 18	Dec 19
Highest	0.71	0.75	0.79
Average	0.70	0.69	0.72
Lowest	0.68	0.63	0.64

TWI			
	Dec 17	Dec 18	Dec 19
Highest	75.3	75.7	77.4
Average	74.3	73.4	74.8
Lowest	72.6	69.2	70.3

Source: ASB, BNZ and Westpac

Inflation – little pressure - yet

Forecasts below show inflation will likely remain well within the Reserve Bank's target band of 1-3% to September 2019, although gradual rises cannot be ruled out. There are potential pressures from both tradable and non-tradable inflation.

On the tradable side, a continued improvement in the world economy is putting some, at this stage minor, upward pressure on commodity prices, while monetary policies across a range of countries are finally moving back toward more long-term normalised positions. In short, inflationary pressures, while still low internationally, have the potential to escalate over time.

Notwithstanding the above, over recent years global competition and innovation have cranked up the development of better products and services at lower cost. Consequently, the old argument that as demand ratchets up prices will rise does not necessarily hold now as it did in the past. Prices over a wide range of products and services are dropping, both in real and nominal terms, a significant shift away from the traditional assumption that generalised inflation is here to stay.

On the domestic front, inflationary pressures are almost in conflict. Reducing net migration from the recent highs achieved, stabilisation (generally) of house prices and a highly competitive retail sector are keeping a lid on general price increases. On the other hand, the new Government's generally expansionary fiscal policy, together with its large building programme, could put upward pressure on prices. Other new policy proposals, such as raising the minimum wage to $20 per hour by 2021, might also put some upward pressure on wage costs.

The Reserve Bank has signalled its intention to ease its Loan-to-Value ratio (LVR), starting early next year, as it no longer sees a major generalised threat in house price inflation. The move will be welcomed by first home buyers, many of whom were effectively locked out of the housing market as, in respect to investment properties, tighter LVR rules really kicked in some 12 months ago.

Forecasts: percent Change in Inflation (CPI)

	Years Ending		
	Dec 17	Dec 18	Dec 19
Highest	2.1	2.0	2.1
Average	2.1	1.5	1.8
Lowest	2.1	1.0	1.6

Source: ASB, BNZ and Westpac

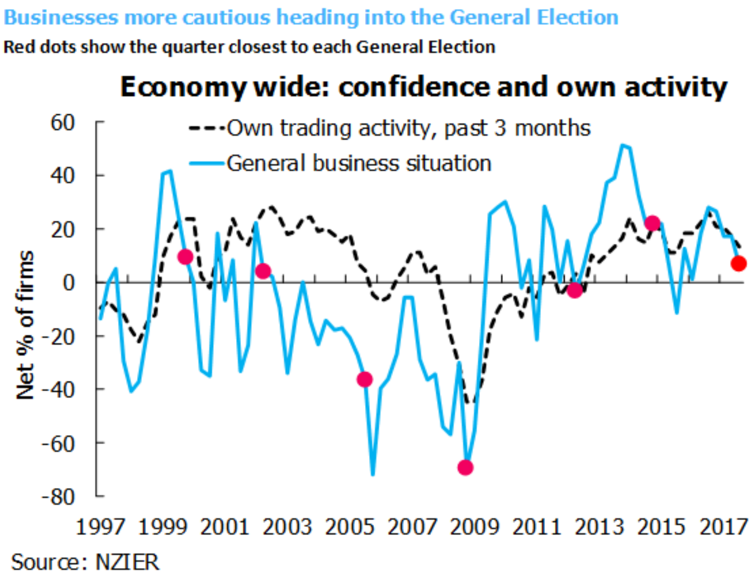
1.3 Business activity and consumer confidence

Business activity and confidence sends mixed messages

Business activity and confidence indicators have sent very mixed messages of late. On the one hand, key quantitative indicators show the economy steaming along reasonably nicely, evidenced by the latest BNZ-Business NZ Performance of Manufacturing (PMI), and its sister survey, the Performance of Services (PSI).

On the other hand, business confidence has fallen off, including individual businesses' assessment of their own prospects.

Part of the confidence slump is to be expected pre-and-post election as the NZ Institute of Economic Research (NZIER) graph below shows. As the graph indicates, confidence (both in respect to the general business situation and businesses' own trading activity) generally drops around the time of a general election and the effect was no different this time round.



However, what is different this time is the election impact two months down the track where confidence, according to some surveys, has remained relatively low. For example, the most recent ANZ Business Outlook (December 2017) shows some recovery in businesses' own prospects from the previous month, but is still at relatively low levels.

Headline business confidence improved slightly from a net -39.0 in November to a net -38.0 in December, while businesses' own activity outlook lifted from to +7 to +16. The historical average is +28.

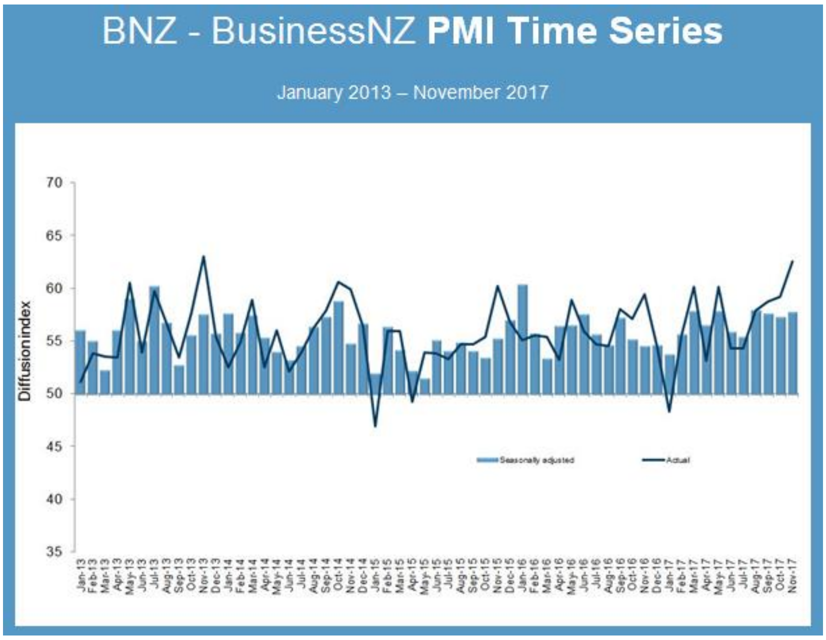
As previously stated, and reinforced in the NZIER survey, it is not uncommon for confidence to drop around the time of a general election, but the magnitude of the drop this time was certainly not anticipated by most commentators. But as mentioned earlier, NZ's key institutions are still largely on track and it is hard to compare NZ's current position with that during the global financial crisis. Internationally, economic growth is on the rise, and by international standards NZ's books are still in relatively sound shape despite some deterioration in light of the increased spending promises factored in to the December Economic and Fiscal Update.

The Wellington Chamber of Commerce's quarterly business confidence survey also found confidence suddenly dipping with a net 13% of businesses surveyed pessimistic about the economy, the first time the reading has been negative since 2009. The survey was conducted over a two-week period in November following the formation of the incoming coalition government. It is worth noting that it took place during a week which saw a one-day train strike.

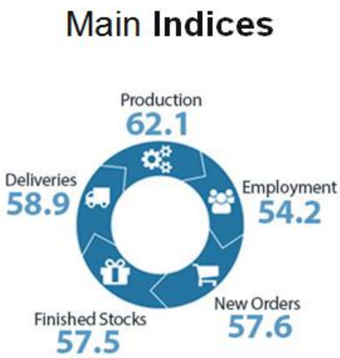
Perhaps more importantly, confidence among respondents on their businesses' own situation, earnings forecasts, forecast investment in new plant and equipment and hiring intentions declined from earlier very high levels. It was not the drop in confidence that came as a surprise, but the degree of fall.

Given the positive story coming out of the Manufacturing and Services sectors (see below), it is hard not to read a bit of chest beating into the recent results which should settle down over time. Results in the New Year will provide a better feel as to whether this was actually the case or whether businesses are genuinely concerned about the potential impact of new Government policies on their businesses and hence on any forthcoming decisions to invest in labour and capital.

On a more positive note, the seasonally-adjusted PMI for November was 57.7, 0.4 points higher than in October (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). Overall the sector has remained in expansion in all months since October 2012.

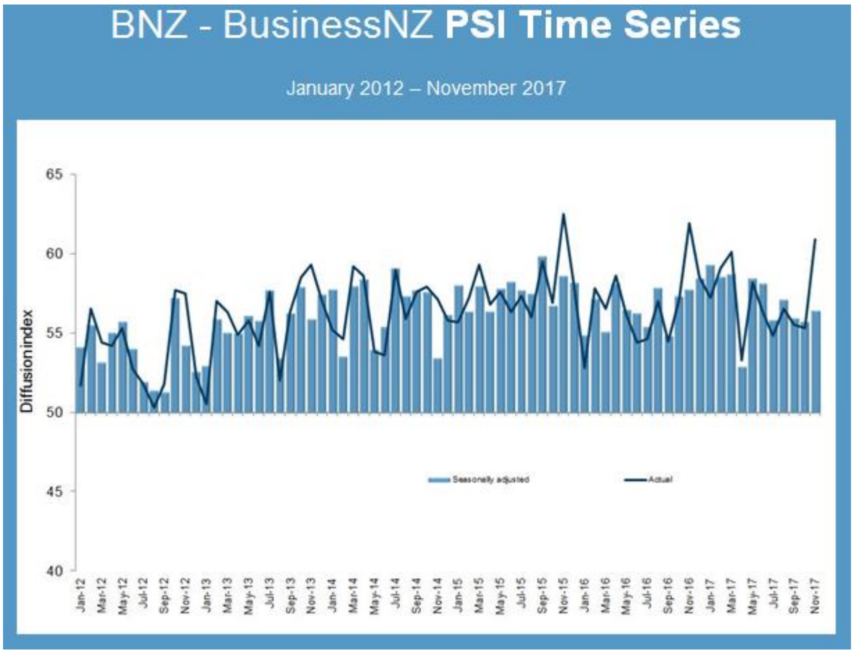


The sub index value for production (62.1) was at its highest level of expansion since July 2013, while finished stocks (57.5) was the highest recorded since the survey began, just pipping the 57.4 recorded in September 2014. It was also good to see the proportion of positive comments for November (65.1%) building on the October result (64.2%).



The services sector also remains in positive territory, with a sunny November likely to have contributed to a slight boost in services activity.

The PSI for November was 56.4 (a PSI reading above 50.0 indicates that the services sector is generally expanding; below 50.0 that it is declining). This was 0.7 points up from the previous month, and stopped two consecutive months of lower expansion in the sector.



The sector remains in solid territory, with the slight lift in expansion levels boosted by a pick-up in the key sub-indices of both activity/sales (60.5) and new orders/business (60.7).

It was also good to see the proportion of positive comments for November (68.7%) build on the substantive lift in October (67.6%), with many stating that seasonal factors played a part in the uplift.

Consumer confidence, unlike business confidence, is still relatively buoyant and above its historical average. Here a number of factors are likely to be at play including labour market activity remaining strong (see below) with opportunities to enter the labour market driving up labour force participation rates to all-time highs.

Consumers appear to have little enthusiasm for paying down debt; household debt levels are continuing to edge up despite the threat of higher interest rates down the track. Consumers now appear comfortable with the fact that mortgage interest rates have been at historic lows for some time now. They appear not to have factored in an understanding that, one day, rates will rise, putting many households and indeed some businesses under financial strain.

Buoyant consumer confidence is also fuelling solid retail spending as we head towards Christmas. No doubt generally fine weather is also playing a part in driving an upbeat household sector.

1.4 Labour market – all hands to the pump

Employment – solid growth

The labour market continues to perform reasonably well with a number of forward-looking indicators showing unemployment likely to remain relatively static at around 4.6% over the forecast period, as can be seen below.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 17	Dec 18	Dec 19
Highest	4.8	5.0	4.7
Average	4.6	4.7	4.6
Lowest	4.5	4.4	4.5

Source: ASB, BNZ and Westpac

Official statistics and several business surveys reveal a relatively strong labour market. StatisticsNZ's Household Labour Force Survey (HLFS) shows participation rates continuing to break new records, while the PMI and PSI show continued strength, largely across the board.

Notwithstanding a positive picture overall for aggregate employment growth, associated declines in unemployment, and continued strong growth in job vacancies, significant regional differences, and perhaps more importantly differences in various regional areas' unemployment rates, remain. Considering levels of youth unemployment and of young people not in education, employment or training (NEETS) are still relatively high, a great deal of effort will be required to ensure the most vulnerable in society are able to actively participate in the labour market rather than simply fall into a life of benefit dependency.

Labour costs – incremental rises

Expectations are that a tighter labour market will not flow through to significantly increased wage pressures, as can be seen below.

Forecasts below indicate labour costs in general increasing relatively slowly with a growth rate of around 2% per annum over the forecast period to December 2019.

Forecasts: Labour cost index percentage change (wages & salaries)

	Years ending		
	Dec 17	Dec 18	Dec 19
Highest	2.0	2.3	2.7
Average	1.9	2.3	2.4
Lowest	1.9	2.2	2.1

Source: ASB, BNZ and Westpac

In some respects it is slightly puzzling that with greatly improved employment growth and firms' reported difficulties in finding skilled staff, wage costs have not risen significantly yet.

The Labour/NZ First coalition agreement outlines proposals to progressively increase the minimum wage (currently $15.75) to $20 per hour by 2021, with Labour agreeing to increase the minimum wage to $16.50 (a 4.75% increase) from next April. There are risks in increasing wages without increased productivity or where there is a lack of understanding that wages are increasingly set internationally based on productivity and competitive pressures.

The typical annual increase in the minimum wage over the last few years has been around 50 cents per hour (or around 3% per annum - roughly inflation plus 1%). The proposed increases in the out-years are likely to be in the order of 7% if the target goal of $20 per hour by 2021 is to be reached. These are significant increases by historical standards, not only in terms of percentage rises, but perhaps as importantly, in relation to general wage rises. The impact of such increases needs to be understood.

First, a significant wage increase could see employers substituting capital for labour (or closing down completely in the worst case scenario) resulting in the most vulnerable (particularly the young and unskilled) exiting the labour market or having no opportunity to enter it and thereby build up the skills and experience which would allow them to increase their earnings potential over time.

Second, substantial minimum wage rises may trigger relativity arguments from the majority of employees currently receiving a margin on top of the minimum.

Third, the likely outcome will be greater employment costs ultimately producing higher overall cost pressures – inflation – and thereby affecting interest rates when the Reserve Bank moves to ensure inflation is controlled within its target band of 1-3 percent.

Fourth, wage inflation and higher interest rates could result in employers providing less training and fewer other fringe benefits as they try to control business costs and focus largely on the total (wage and non-wage) cost of employing labour. It should be noted that the new Government has indicated it will be looking at ways to try to offset, for some businesses, some of the costs associated with increasing the minimum wage. Whether this will be by way of some form of tax break is not clear at this stage.

Most forecasters are picking net migration will likely continue trending down, although not necessarily as a consequence of the Government's proposal for a tighter net migration regime. The impact could be downward pressure on house prices plus a boost for wages growth.

Net migration is likely to fall for a number of reasons including, but not limited to, the fact that the international economy is improving and therefore the desire to come and live in NZ is perhaps slightly tapering off. Government proposals to tighten migration settings (while still trying to ensure regions' skills demands are catered for) will have some impact on net migration numbers, although net migration was already reducing and dropped from its peak some months ago. Therefore, tightening up immigration settings may have a much lesser impact than natural changes in migration flows (supply and demand).

The HYEFU suggests annual net migration is likely to fall steadily from its current level of 71,000 to around 15,000 by 2022. Moreover, the HYEFU states that the composition of immigration may change with fewer students and more work visas, including the proposed KiwiBuild visa.