HUGOvision

Assessing the economic and political environment in New Zealand

July 1 2014 | **Confidential to HUGO members**

Increasingly, the evidence points to a third term for John Key, though the numbers are still not cut and dried. That would presage more of the same but with some complications from support partners. Four focuses for a third term would be: seeking a durable balance in natural resources policy; an extension of the investment principle more widely in social policy; an accent on upgrading the teaching profession; and another assault on getting legislation and regulation aligned with objectives. A change of government would significantly change the business regulatory environment, especially in environment and climate change policy as well as in monetary, tax, industry, education and social policy. If Key gets a third term, expect a change in 2017, though Labour would have to bed in a new leadership and work out its relationship with the Greens better than it has done.

Labour limps into its pre-election congress
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Labour limps into its pre-election congress July 6-7 at a time of dismal poll readings, two and a-half months out from the election. It will make education its centrepiece. This follows its "fiscal plan", which proposes more spending and more tax - notably 36% on incomes over $150,000 - but net government debt down to 3% of GDP by 2020/21 and a tightening of controls on inward migration. There were no surprises in Labour's list, which rejuvenates less than National's.

- National at its conference emphasised regional development and getting out the party vote in safe National and Labour-held seats for which numerical vote targets are being set.

Northern hemisphere analysts scratch their heads about NZ
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Dogged by low growth, high unemployment and excess capacity, analysts marvel at a country which is raising interest rates as an output gap emerges. One major difference is in workforce participation rates, where New Zealand is far above the United States and Australia.

While back home the economy looks to be topping out
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The GDP number for the March quarter was a strong 1.9% and will be matched in the June quarter, adding up to a 4% pace through the first half. But business and consumer confidence have topped out, the performance of manufacturing and services indexes have slowed a bit and house prices dropped marginally in May. That points towards a slowing ahead, though off a high base. Expect another Reserve Bank rate increase on July 24 but then maybe a pause.

IPO-fest continues - "land grabs" vs earners
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Transport fleet software provider ERoad has become the latest in the string of IPO's coming to market, seeking $40 million. Hirepool pulled its float on soft investor interest, while Gentrack sought to distinguish itself as a solid earner rather than a "land grab" tech float.

Forecasts at a glance

	INFLATION	GROWTH	$ v $US	$ v $A	WORLD GROWTH	TRADING PARTNERS
December 2015	-2.5%	3.5%	73.0c	90.1c	3.2%	4.1%
December 2016	4.4%	1.8%	66.0c	86.7c	3.2%	4.2%
December 2017	-0.4%	1.1%	62.1c	87.2c	3.1%	4.0%

Text finalised June 30

POLITICS AND POLICY

In-trouble Labour to emphasise education at its congress

Labour goes into its pre-election congress July 5-6 fearing another clear election loss. Because the election year conference is likely to be thinly attended, being within the three-month campaign spending limit period, it may not be able to create momentum. It is at Wellington High School, except for the leader's keynote, which is at the Michael Fowler Centre.

Labour's problem is at two levels.

David Cunliffe has not jelled and has been losing traction. He was hung on the shonky Liu accusations not for a particular wrong but because (1) he tried to push a cash-for-access line on National's Liu linkages and (2) didn't take the usual political care to hedge his denial of Liu donations. **The Liu episode has deeply soured Labour's relations with the NZ Herald** and has reinforced media bias an issue for the left, coinciding it has with the publication of a new biography of John Key by senior Herald writer John Roughan. Election year political biographies are not uncommon, but they are generally planned and executed by politicians themselves rather than working journalists.

However, blaming the media is a distraction. Audiences find Cunliffe preachy and out of touch. He is said to be discouraging activity by rising stars, like Jacinda Ardern, now something of a celebrity in Auckland, for fear of detracting from his own show.

Some in the party now say it would be doing no worse had David Shearer remained leader. It is hard to disagree.

Labour's second problem is the Greens, who have held firm in the 11%-12% bracket, risking Labour's ability to top 35% support, the minimum for a credible contender for office.

The focal point of Cunliffe's keynote this weekend will be education - traditional Labour territory. Releases leading up to the conference will focus on the sector's long-term strategic needs, including school building infrastructure, and a switch focus on national standards to teacher quality.

Labour backs the government's push for greater professionalism but thinks the proposed ministerial-appointed council will work against that.

This risks Labour being seen as in the pockets of the teacher unions, especially as the primary teachers union has opposed the government's proposals for lead teachers and peripatetic advisory principals, even though significant salary bumps are attached.

Higher spending, higher tax, lower debt

Labour has issued a "fiscal plan" (https://www.labour.org.nz/fiscalplan) with higher spending and revenue tracks but net government debt down to 3% of GDP by 2020-21. Income tax on trusts and personal income over-$150,000 incomes would be 36%, a reduction from 38% proposed in 2011, and Labour would try to tax foreign companies on actual earnings here.

Labour's list favours women, brings Kelvin Davis into what should a winning place and in a good year would also bring in a couple of capable women, in addition to Jenny Salesa who replaces Ross Robertson as MP for Manukau East.

Buoyant National goes for roads

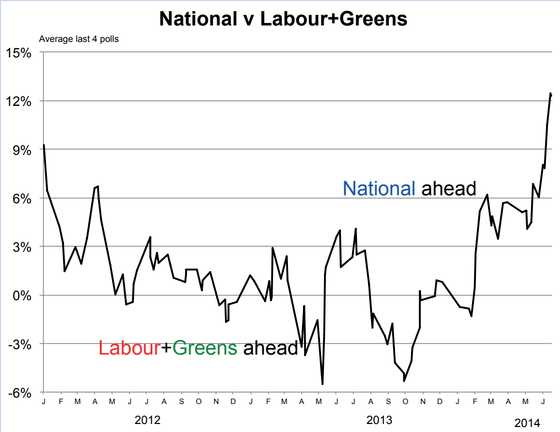
National demonstrated its sensitivity to accusations it has neglected regions outside the main cities by promising a big road and bridge programme paid for from asset sales proceeds. Steven Joyce's big speech heavily focused on how well the "regions" are doing.

The conference was buoyant, prompting predicted warnings on complacency. Campaign chair Joyce pushed a party vote focus in both "red" and safe-National seats. Numerical vote targets have been set.

The polls stay strong for National

National scooted away to wide lead in June. The latest four-poll averages are: National 51.7%, Labour 27.5%, Greens 11.8%, New Zealand First decisively under the5% threshold at 3.6%, Conservatives 1.6%, Internet-Mana 2.0%, Maori party 1.0%, ACT 0.6% and United Future 0.1%.

National's lead over Labour+Greens was 12.3%, maybe now over the post-budget, Donghua Liu 12.5% peak — but what a peak! But, as Steven Joyce told the National conference, National's average is 2% below the same time before the 2011 election.



Two elections in the next 5 years: expect change after one of them

National looks headed for a third term, although an upset is still possible. But the historical odds are against a fourth term after 2017. The regulatory environment should therefore be expected to change towards the end of the decade to reflect a centre-left government. It could be significant, though maybe less so than if there were a change now.

The leadup to the 2014 election

Opinion polls are strong for National – an average of 48.1% January-June (June average 51.7%). In a proportional system those are very high numbers. Other poll readings were also strong: for John Key as Prime Minister (eg, preferred Prime Minister, TV3 47% late June, Colmar Brunton 47% late June), consumer confidence (eg, Morgan 131.9 in early June) and high (though topping out) positive measures of whether the country is on the right track (Morgan 139.5 in early June, UMR confidential but similarly strongly positive). In Morgan 100 is neutral.

But Labour+Greens still averaged 42.3% in polls January-June (June average 39.3%).

Polls generally close up as election day approaches, so as usual, minor parties will decide who rules. National dropped 7 points from a pre-campaign opinion poll average across 2011 of 53.6% to 47.3% in the election. So an election score of 44%-46% would be a reasonable guess, if not prediction.

Labour, under 30% in recent polls, needs the 35% it got in the electorate vote in 2011, but failed to convert into party votes, where it scored only 27.5%. Otherwise, voters are unlikely to see a Labour+Greens combination as a realistic alternative government. That seemed to be on track in 2013 but the risk now is a repeat of 2011 when voters concluded it would not form a government. That led to some searching for a party to restrain National, which helped push NZ First to 6.6% and others feeling free vote Green, lifting their party vote to 11.1%.

National's options: National has three existing support parties and two possibles.

John Key has made it clear he wants National voters in Epsom and Ohariu to vote for ACT's David Seymour and United Future's Peter Dunne. Both are likely to get there. But that would add only a net one seat to National's side because National would almost certainly lose one party vote quota. It is highly unlikely United Future will get a big enough party vote to bring in additional MPs. It cannot be ruled out for ACT but most additional ACT party votes would come from National and so not add seats.

The Maori party (average party vote of 1.1% January-June) looks headed for two seats, down from its current three (one electorate seat plus a party vote of 1.2% would deliver a list seat). New co-leader Te Ururoa Flavell at Ratana late January distanced the party from National to recognise that the bulk of its voters are more socioeconomically Labour than National. A deal with National would need to be at a greater distance than in 2008-11 and 2011-14.

Key has not closed the door to Colin Craig's Conservatives but many in National don't want a bar of them. They averaged 1.7% January-June, which suggests an election score of 2.5% is credible (2.7% in 2011). But 5% is highly unlikely, so National would need to engineer a winnable seat for Craig.

If NZ First does not clear 5%, that would boost the "wasted vote" and lower the vote needed for a seat majority to 47%-47.5%. It averaged 4.6% in polls January-June, which should be a springboard for 5% in the election. The party has a reconstituted board, more members and more money. But it averaged only 3.8% in June.

Winston Peters still deeply resents Key's attacks on him in 2008 over election donations. But there are back-channels that need not put Key and Peters face-to-face, would not involve loss of face for Peters and could give him mana. Peters was a National MP and coalesced with National in 1996 (though was fired in 1998); National will have the most seats.

If National gets at least 43% and New Zealand First backs it post-election, National gets a third term.

One other option some in National have talked of is for two or three National MPs in safe seats to stand as independents, thereby replicating the ACT/United Future/Conservative options. This is highly unlikely.

Labour-side options: Labour and the Greens are likely to form a coalition government if they get the numbers, with Greens in the cabinet, not as a support party outside the cabinet, though there is a long way to go before they have worked out who gets what and how the cabinet would operate. In 2011 the Greens leaned Labour but were not committed.

As with National, NZ First is a crucial support option for Labour. There is a shared emphasis on a more active and nationalist government in economic affairs and social services, opposition to sale of sensitive assets to foreign investors and a good working relationship with Labour in 2005-08. But there is real discomfort with Labour-Green social liberalism and Peters may reject formal coalition if the Greens are in Cabinet. Peters is also sceptical of Maori-specific policies and iwi/whanau delivery agencies.

The Maori party could switch sides, with two seats.

Mana is likely to hold Hone Harawira's seat. So Internet-Mana is likely to win at least two seats. More will depend on motivating young non-voters who don't fit traditional politics (even the Greens). Harawira and Laila Harre, Internet leader, are hardly young and snazzy; both are old-hard-left. But the Internet candidates look young, savvy and attractive. Internet-Mana has declared it is anti-National.

Winston Peters on the cross-benches? That is a real and possibly the main option for Peters, voting on a case-by-case basis, giving possibly qualified support on the budget. This would be a **recipe for instability**.

Who will govern after 2014?

Factor in: very high business and strong consumer confidence, even if now slipping a bit; rising jobs and wages and strongly positive opinion poll readings that the country is on the right track, against which rising interest rates will directly affect only some people to some extent before election day (though others may anticipate an effect). That **points to a third term**, though getting to 61 seats is not straightforward.

Also: John Key has a stable government with little tension; Labour's David Cunliffe has yet to connect, has a track record of impulsive comments and contradictions and an unsettled caucus. Voters might again perceive a lack of a real alternative. Labour is in transition to a younger generation, not yet completed. Labour and the Greens have yet to clarify how they would work together and NZ First is an enigma – so, is there a real alternative government?

Note Key's development of a succession planning culture, in which 15 underperforming and ageing ministers and MPs are departing. That and Key's frequent reshuffles are unusual in NZ politics. This is National's potential for a generational transition.

But watch out for: a global economic shock (though that may actually frighten voters to stay onside); a John Key brain fade (eg, over the spy bill in 2013) or a government misstep (eg, over backing Chorus in 2013 on keeping copper broadband charges up); National miscalculating on support parties; an election campaign blunder, such as Key's over-reaction to the so-called "tea-pot tapes" in 2011; David Cunliffe's high plausibility at first encounter suddenly connecting him with voters; Labour and/or Cunliffe succeeding in connecting with a chunk of middle NZ wanting more government intervention, especially as focus grows on income inequality; middling voters being so economically confident they feel free to punt on Labour; or Labour succeeding significantly in its ambition of Obama-style use of statistical analysis and targeted contact to motivate Labour-leaning people who did not vote in one or both of the last two elections, and who are thought be worth one or two percentage points.

The way the ball bounces. The January-June poll averages (adjusted to give New Zealand First 5.0% and not assigning Colin Craig a seat) would give:

National	48.1%	59 seats
ACT/United	0.6%	2 seats
Conservatives	1.7%	0 seats
TOTAL NATIONAL SIDE		**61 seats**
Maori party	1.1%	1 seat
NZ First	5.0%	6 seats
Labour	30.5%	37 seats
Greens	11.8%	14 seats
LABOUR+GREENS		**51 seats**
Internet-Mana	1.2%	1 seat

On this scenario National just gets there. If slightly less, it would need Colin Craig or Winston Peters. On the June averages, National gets home easily.

Policy direction in a National-led third term

Support-party constraints would affect National's ability to progress its programme in a third term.

The 2011-14 term has focused on "results", geared to GDP growth. The main ingredients are:

- fiscal consolidation, which will allow NZ Superannuation payments to restart 2018-19 and possibly a small tax cut,
- labour market, resource management and local government reforms, coupled with removal of obstacles to doing business while stepping up action on problem areas such as workplace safety,
- infrastructure, mainly roads and fast broadband;
- backing oil and minerals development and irrigation to boost agriculture and horticulture,
- education reform, now aimed at better teaching and a core focus in a third term,
- public service reform with much more emphasis on cross-portfolio cooperation, based on "sectors", each with a lead agency and lead minister,
- welfare reform based on an "investment" approach, arguably the government's most important innovation, moving past "spending", which is in essence palliative, and
- a trade policy aimed at free trade negotiations.

In addition, in a third term expect a focus on:

- management of water and natural resources, with a durable balance between production and mining and environmental objectives,
- more investment in research and development, aimed to match the OECD average in government

investment and rationalising funding streams, and

- another attempt to address regulatory complexity to ensure consistency and that stated objectives are met and economic transaction costs reduced.

The Cabinet's core driving team has been: John Key as presenter; superminister Bill English as fiscal consolidator, policy wonk and party traditionalist; and superminister Steven Joyce as project manager and unashamed interventionist. This latter factor may see tensions develop in a third term.

To these are added Gerry Brownlee and Murray McCully as the inner Cabinet framing political strategy. Occasionally, other ministers (viz Paula Bennett) join the group in its late-night meetings. One to watch in that respect is Simon Bridges. Amy Adams has lost some traction with errors.

John Key has committed to serve out a third term. If not, Steven Joyce is the most likely replacement. English has signalled retirement in 2017 by opting for the list only. Judith Collins's pretensions were damaged by mishandling a dinner in China. Simon Bridges would stand if in Opposition.

Top of the list of likely new ministers post-election is Paul Goldsmith, now chair of Parliament's finance and expenditure committee. Watch Jami-Lee Ross, Melissa Lee and whip Louise Upston. New Bay of Plenty candidate Todd Muller, jumping straight out of the Fonterra senior management team, would hope to climb rapidly off the backbenches.

Support parties would complicate continuation of the policy direction in a third term. ACT would obviously support more deregulation, mining and GDP growth policies but would have concerns about infringements of individual liberty. Peter Dunne has broken ranks a number of times, eg, the change in purpose for the Resource Management Act, paid parental leave and climate change policy. The Maori party has frequently voted against the government and may further qualify its support post-2014 if in fact it is supporting National. The Conservatives are economic nationalists, opposed to asset sales and liberal social policy but for welfare reform and private enterprise. NZ First remains an economic nationalist party, with many points of difference with National, notably on immigration, foreign investment, free trade, social services and Treaty policy. While the party's future post-Peters is fragile, his influence for at least one more parliamentary term is unlikely to look different from the past.

Thus the second term has been the big one. Support parties are unlikely to undo much, if any, of the reforms but those not completed by the election may stall. Reforms to RMA purpose clauses and labour reforms have already stalled.

Policy direction under a Labour-led government – regulatory risk

A Labour+Greens government after 2014 would spell significant regulatory risk.

Labour now intends to be an "active" government:

- in monetary policy, a complex target, more use of macroprudential tools, including raising and lowering KiwiSaver contribution rates countercyclically, a board making the decisions and an advisory role to the government,
- compulsory KiwiSaver, except on undefined very low incomes, rising over six years to 4.5% employer/employee contributions,
- a capital gains tax and 36% tax on incomes above $150,000 and trusts, limits on multinationals' transfer of income to other jurisdictions and accelerated depreciation for industrial plant and equipment,
- a government agency to buy all electricity from generators to control the price,
- a government-backed insurance company and a special Christchurch Earthquake Court,
- 12.5% tax credits for company research and development to push high-end manufacturing, "a national procurement policy favouring Kiwi-made" and generally, more direct assistance to companies to do further processing (eg, in forest products), particularly in the "regions" plus reducing compliance costs for SMEs raising capital,
- better access to venture capital, more apprentices,
- a $15 minimum wage within 100 days and a "living wage" for public service employees, then for state employees, then employees of contractors and repeal of the 90-day trial law for new employees,
- smooth cyclical fluctuations of foreign immigrants, get them into the provinces and focus on skills,
- a "voice" in free trade negotiations,
- stricter rules on foreign purchases of land, especially rural land where buyers would have to demonstrate value-adding investment,
- a big government house-building programme – 10,000 a year for 10 years,
- a higher bar to entry into teaching to lift quality, plus the same for promotion to principal and an emphasis on collaboration between teachers and long-term infrastructure planning; more emphasis on cooperation between tertiary institutions, focusing polytechnics on economic growth and not degrees, more focus on the transition from school to tertiary institutions, removing "perverse"

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incentives in pass-rate-based funding, a major review of student support including adult study and reversal of governance changes, and

- much more active intervention in pre-birth and early-post-birth years to identify at-risk children and invest in their health and cognitive development, plus a child benefit for nearly all up to a year and for the needy for three years.

Labour and the Greens would **reverse or repeal a number of changes** made by the Key government, notably in resource management, local government and workplace relations. It would be much more active in environment (a price on water for industrial and agricultural users) and climate change policy. **Transport policy would swing in favour of rail and public transport over roading.**

Balancing the budget and reducing net debt to 3% of GDP by 2020-21, a Labour commitment, to be achieved in part with higher revenue, would likely be backed by Greens and NZ First.

Labour would review the public services legislative framework to enhance collaboration and outcomes, rebuild core numbers, develop a career path and invest in training, require contractors/suppliers to be good, fair-wage, safe, healthy employers. Labour and the Greens favour a commission of inquiry.

The **Greens would push** Labour to go further in social and environmental policy. They want to replace the emissions trading scheme with a $25/tonne carbon tax ($12.50 on dairy, zero on other agriculture) and $12.50/tonne credits for forestry, with the proceeds going to a 1% cut in company tax and a tax-free zone for incomes under $2000. Labour would refuse that but the Greens might use that refusal as leverage for another policy concession. Greens would oppose offshore and much onshore mining, but Labour would mostly prevail and rejected a move to phase out fossil fuel mining at its 2013 conference. The Greens and NZ First would oppose free trade agreements, but Labour would turn to National for support. Green activism on Tibet could strain relations with China, with risk of consequences for the trade relationship.

NZ First would want migration constraints and would block superannuation reform. Internet-Mana's influence is unclear at this stage

A straight Labour+Greens government would work reasonably well. The Greens are determined to develop into a party capable of being in government, meaning capable of compromise, and yet holding its support. Tensions should be manageable. But the addition of other parties would make it less stable.

Labour is itself in transition from the late baby-boomers, including David Cunliffe and David Parker, to the under-45-ers: notably Grant Robertson, Jacinda Ardern, Chris Hipkins, David Clark and Megan Woods, who have a different, 2020s-focused, perspective. This transition needs more time and needs a change of leader. **A Robertson-Ardern duo is likely if Labour loses now**.

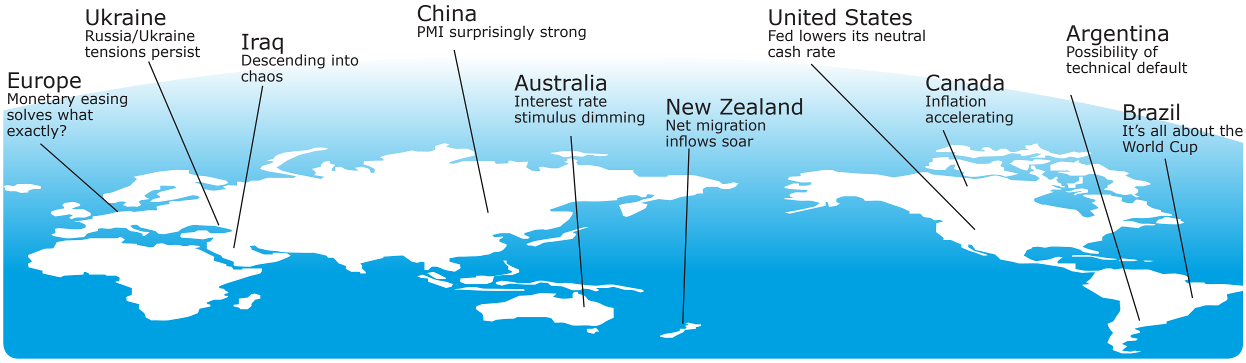
Beyond 2017

If National wins in 2014, rate 75:25 a Labour+Greens-led government after the next election on the back of slower GDP growth, higher interest rates, fiscal pressures, wear and tear on National and fresh Labour leadership. But don't rule out a fourth term: National's big 2014 intake might refresh its look. **Bear in mind the real possibility of new parties.**

A post-2017 Labour+Greens government may not reverse and repeal as much of the 2008-14 deregulation as a post-2014 Labour+Greens one would because it would have become the status quo.

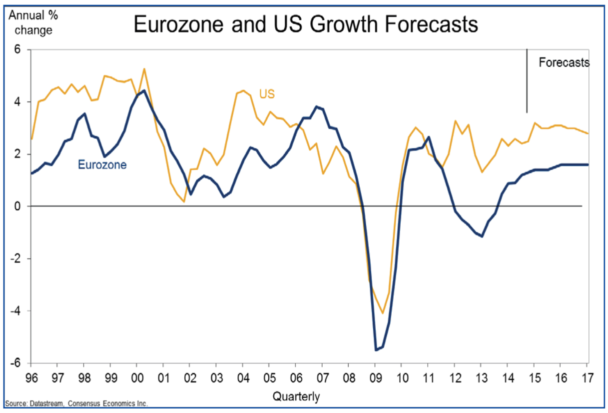
If National were to regain power in 2017 from a 2014-17 Labour+Greens government, it may reverse some Labour+Greens 2014-17 regulatory reversals but also may not be as GDP-growth-oriented as now and leave some of the reversals in place.

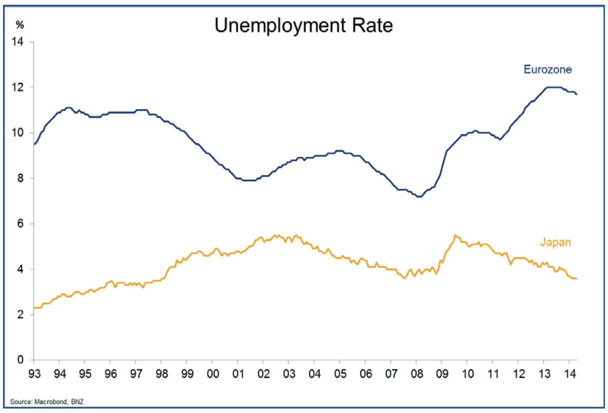
The world at a glance

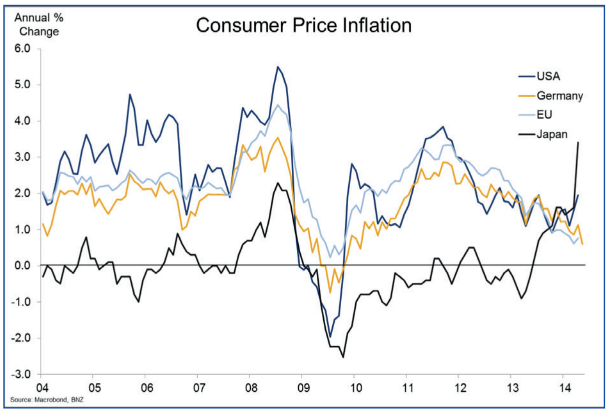


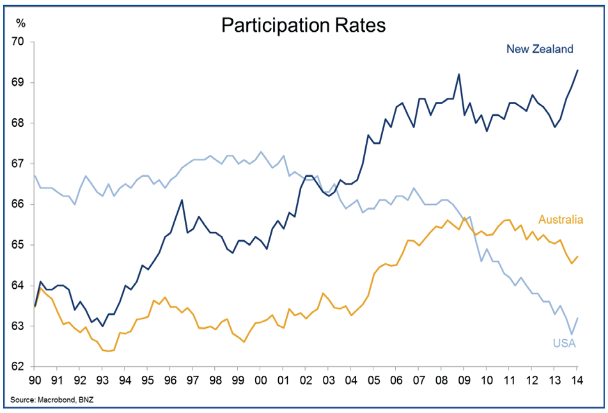
In the rich-world league New Zealand is an outlier

In northern hemisphere finance capitals, New Zealand is a puzzle: strong GDP growth, rising inflation and a central bank intent on raising interest rates from levels that already look high by rich-world standards. The Eurozone in late June reported stalling growth, with unemployment still at 11%-12% levels that would be considered a disaster here and the European Central Bank took one of its rates negative in June. The United States Federal Reserve









Trading partner growth

(2013 actual; 2014-15 Consensus Forecasts; 2016-17 figures Hugo estimates)

Trading partners		GDP Growth (ann avg %)					CPI Inflation (ann avg %)				
	Weights %	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
China	25.2	7.7	7.3	7.1	7.1	7.3	2.6	2.5	2.9	3.1	2.8
Australia	23.1	2.4	3.1	3.0	3.2	2.9	2.4	2.7	2.6	2.8	2.6
United States	10.3	1.9	2.2	3.1	3.0	2.6	1.5	1.8	1.9	2.2	1.9
Japan	7.2	1.5	1.5	1.2	1.1	1.3	0.4	2.6	1.8	1.8	1.7
Eurozone	7.2	-0.4	1.1	1.5	1.6	1.0	1.3	0.7	1.2	1.1	1.1
United Kingdom	3.5	1.7	3.0	2.6	2.2	2.4	2.6	1.8	2.1	2.4	2.2
South Korea	4.1	3.0	3.6	3.7	3.7	3.5	1.3	1.8	2.5	2.6	2.1
Indonesia	2.2	5.8	5.3	5.7	5.8	5.7	6.4	6.2	5.7	5.1	5.9
Hong Kong	2.0	2.9	3.3	3.5	3.6	3.3	4.3	3.9	3.6	3.3	3.8
Taiwan	2.2	2.1	3.2	3.6	3.6	3.1	0.8	1.2	1.8	1.7	1.4
Singapore	2.6	3.9	3.8	4.0	4.1	4.0	2.4	2.2	2.7	2.3	2.4
Malaysia	2.3	4.7	5.3	5.1	5.3	5.1	2.1	3.3	3.6	3.1	3.0
Philippines	1.9	7.2	6.4	6.3	6.0	6.5	2.9	4.2	3.9	4.1	3.8
Thailand	1.8	2.9	1.3	4.1	4.5	3.2	2.2	2.4	2.8	3.0	2.6
India	1.7	4.7	5.4	6.2	6.4	5.7	9.5	7.8	7.0	6.8	7.8
Vietnam	1.2	5.4	5.6	5.9	6.0	5.7	6.6	5.6	6.8	7.0	6.5
Canada	1.3	2.0	2.2	2.5	2.5	2.3	1.0	1.8	2.0	2.0	1.7
NZ Trading Partners	100.0	3.8	4.0	4.1	4.2	4.0	2.3	2.5	2.7	2.8	2.6
Forecasts for New Zealand											
Consensus		2.7	3.6	3.0	2.6	3.0	1.1	1.8	2.2	2.4	1.9
BNZ Forecasts		2.7	4.1	3.4	1.8	1.1	1.1	1.7	2.4	3.0	3.0
The World		2.5	2.8	3.2	3.2	3.1	2.7	3.1	3.1	3.2	3.0

has been winding down its "quantitative easing" and beginning to intimate rate rises in late 2015.

US GDP growth has been reasonable – around 2% a year over the past three years - although the economy contracted by 0.75% in the March quarter, partly explained by very bad weather. But household demand continues to be affected by modest job growth. Unemployment is falling but only because the participation rate is falling.

This is another contrast. NZ's participation rate has climbed close to 70%, which is very high historically and far above Australia's 65% and 63% in the US.

In Japan, Abenomics was supposed to prove a tonic, and while fiscal and monetary loosening did inject an initial bounce, households have not responded commensurately. And Abe has yet to deliver much of the crucial third "arrow" - structural change - and looks unlikely to, despite promising in late June to lower the company tax rate from 35.64% to below 30% sometime in the next few years and allow more women and immigrants in the workforce.

So, puzzle and envy in the big rich countries at New Zealand's buoyancy is understandable. But will there still be puzzle and envy 12 months from now?

The NZ economy is topping out – but at a level way above trend

GDP growth was 3.3% to March on an annual average basis and 1.0% in the March quarter alone. The June quarter looks likely to be healthy, too. Hugo is projecting 1.1%. That's a 4% annual pace.

Still, over the past two months consumer and business confidence have come off their highs. The performance of manufacturing and services indexes (PMI and PSI), while still in expansion, have slowed a bit. Dairy prices are down by a quarter since February (though still historically high).

The big driver in the strong March quarter was construction.

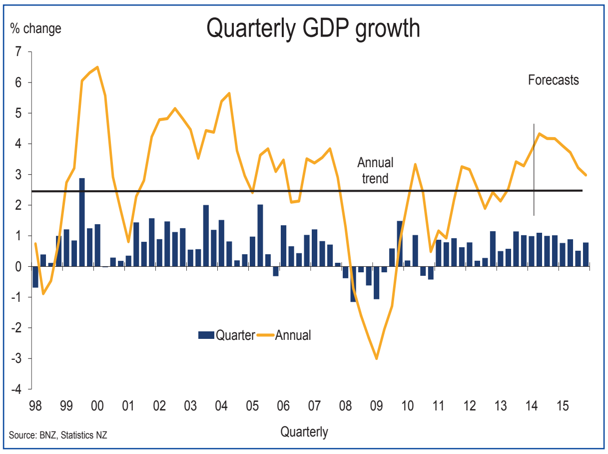
Manufacturing and consumer spending were slack in the quarter. But that looked mainly an issue of timing, not the start of a trend. The real gross national income figure, which captures the very high terms of trade, grew 7.3% in the year to March.

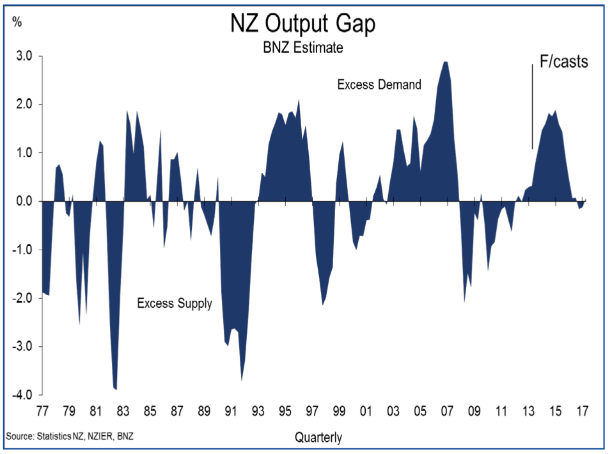
Growth has eaten into spare capacity. There is now excess aggregate demand, to the tune of 1.3% of GDP. That output gap is set to rise further, which is another contrast with the big rich northern economies where there is still excess capacity.

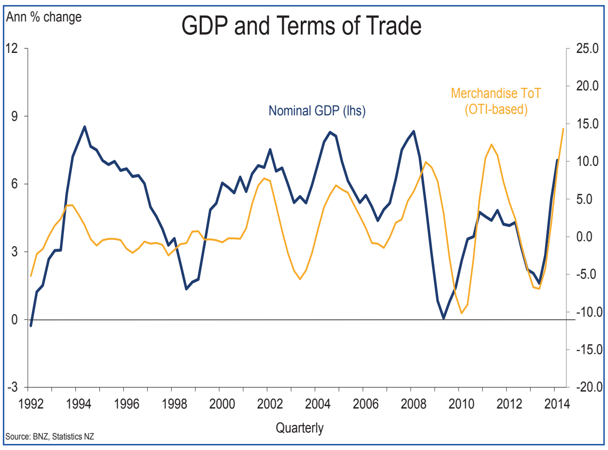
That will drive inflation and the Reserve Bank is still likely to raise the official cash rate on July 24, though it may then pause for a bit, having whacked 1% on the OCR. The output gap will also cap the level to which GDP can rise this year.

A better balance with the world

There is also good news in the external accounts. The annual current account deficit fell from 3.4% of GDP in calendar 2013 to 2.8% in the year to March. That helped bring the international investment deficit down to 65.3% of GDP from 71.4% in March 2013. Gross debt was down (to 109.8% of GDP from a peak of 140.4% in 2009), even though public sector gross debt has risen.



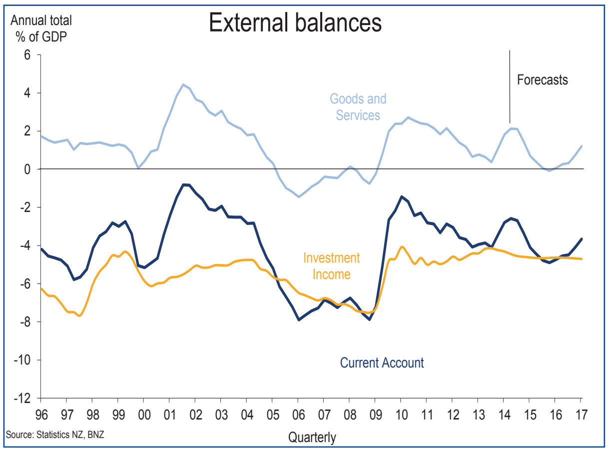


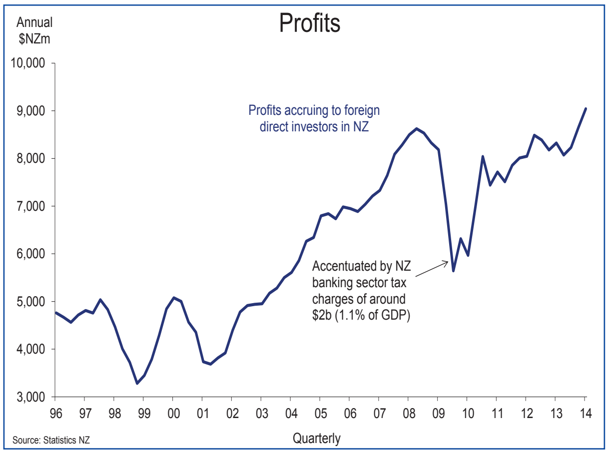


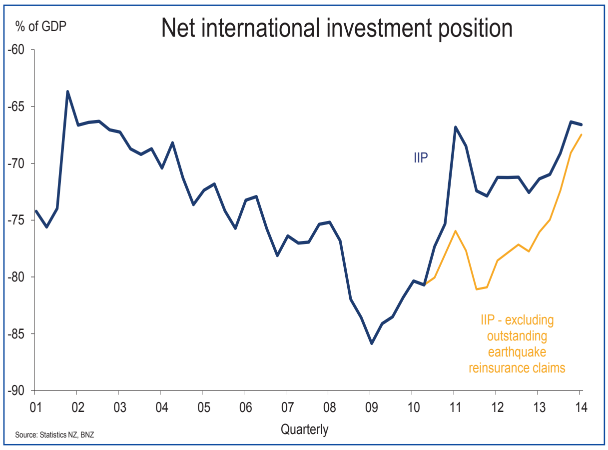
The high terms of trade was a big factor. So, as lower export prices bring the terms of trade back a bit and as domestic activity lifts, the current account deficit is set to rise to around 5% of GDP in 2015, in part driven by strong investment, then to moderate some.

The international investment deficit, however, will not worsen as long as the current account deficit stays below nominal GDP growth, which is likely for some time. And, note that the earthquake effect – the influx of reinsurance funds – has now largely worked through.

That in turn reduces debt servicing costs – to 9.1% of export revenue, the lowest in the history of this data series. Costs topped 20% through 2007-08.







Off the highs, just

As noted above, evidence is accumulating that the domestic economy is coming off its highs, albeit at a new level of sustained activity.

- May's ANZ Bank business survey recorded own-activity expectations at 51.0, down from 52.5 in April and 58.2 in March.
- The Westpac McDermott Miller consumer confidence index for June slipped to 121.2 from 121.7 in March – seasonally adjusted, the dip is to 120.6 from 123.8.
- The May performance of manufacturing index (PMI) fell to a seasonally adjusted level of 52.7, the slowest in 18 months, from 54.4 in April.
- The performance of services index dropped to 54.2, from 58.5.
- The Real Estate Institute of New Zealand (REINZ) stratified house price index was down 1.2% in May, though that is partly the impact of the loan-to-value restrictions.

Against this, note strong investment, tourism and net migration and strong job growth (3.7% annual growth in the March quarter. Add it all up: GDP in the second half of 2014 should just match the first-half 4% pace to give 4.1% for the year. But next year will be slower – but only to an above-trend 3.5%.

Australia-China trade deal by November?

Australia's Trade and Investment Minister Andrew Robb said June 24 Australia and China are on track to sign a trade agreement by November. Robb met Xu Shaoshi, chair of China's National Development and Reform Commission, in the first annual Australia-China strategic economic dialogue. But there has been little outward sign of progress. Talks have been stymied by Beijing's concerns over opening markets to Australian food and Canberra fears the threat to domestic producers from cheap Chinese goods.

Shipping

The Kotahi logistics venture created by Fonterra and Silver Fern Farms in 2011 has signed a 10-year deal with Maersk to ship 2.5 million export containers, giving the shipping line confidence to introduce 6,500 TEU vessels by the end of 2016, compared with 4,500 TEU vessels now. Ships will initially only call in at Port of Tauranga (POT) and Kotahi has separately signed a 10-year accord to send 1.8 million containers across its wharves and South

Continued p12

ECONOMY AT A GLANCE

New Zealand economy

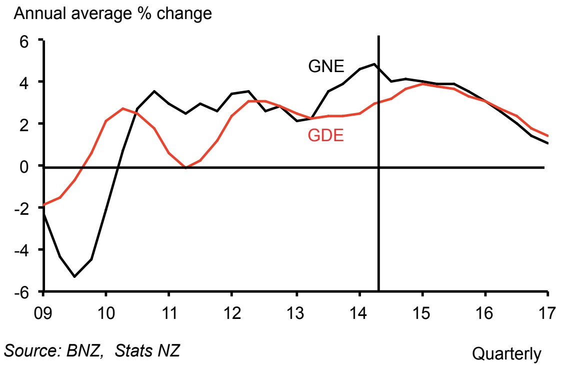
(% change on previous year
Calendar year except where indicated)

	2013A	2014F	2015F	2016F	2017F
GDP components					
Consumption	2.9	2.8	2.9	1.4	0.9
Investment	9.7	8.8	6.5	2.1	1.1
Stocks (contribution to growth)	-0.1	0.4	-0.2	-0.1	0.0
GNE	3.9	4.1	3.5	1.5	0.9
Exports	0.7	5.3	3.8	4.1	3.8
Imports	6.2	5.7	4.3	2.9	2.7
Activity					
Real GDP (production)	2.9	4.1	3.5	1.8	1.1
Output gap	0.3	1.5	1.9	0.5	-0.1
Labour productivity growth	0.7	0.4	0.3	0.2	0.1
Employment growth (annual % change)	3.0	3.4	2.7	1.3	1.0
Unemployment rate (S.A. % as at Dec Q)	6.0	5.6	5.2	5.3	5.6
Inflation (% increase from Dec Q previous year)					
Consumer prices	1.6	1.9	2.8	3.0	2.8
Average hourly earnings	3.2	3.3	3.8	3.2	2.7
Terms of trade	20.2	-6.8	-2.5	4.4	-0.4
Financial sector					
Operating balance (OBEGAL)					
(as % of GDP – June Year)	-2.1	-1.1	0.2	0.5	0.9
Net debt (as % of GDP – June)	26.2	25.8	26.4	25.9	24.0
90 day bank bill (%) (1)	2.7	4.1	5.0	5.3	4.4
5 yr NZGS yield (%) (1)	4.2	4.4	5.3	5.1	4.4
10 yr NZGS yield (%) (1)	4.8	4.8	5.7	5.6	4.6
External sector					
$NZ/$US(1)	0.823	0.797	0.730	0.660	0.621
$NZ/$A(1)	0.915	0.934	0.901	0.867	0.872
$NZ/Y(1)	85.1	86.1	85.4	83.2	78.3
TWI(1)	77.5	77.5	74.1	70.2	67.0
Trade balance $(m)	1307	2439	-1033	596	2758
Current account $(m)	-7622	-7990	-12229	-10735	-8780
(as % of GDP)	-3.4	-3.4	-4.9	-4.1	-3.3

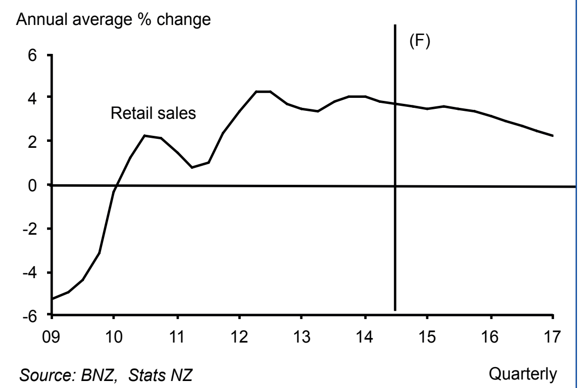
(1) Average for month of December

(2) Using current prices

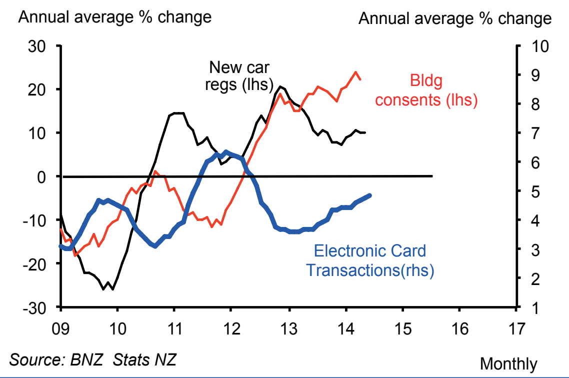
Economic growth



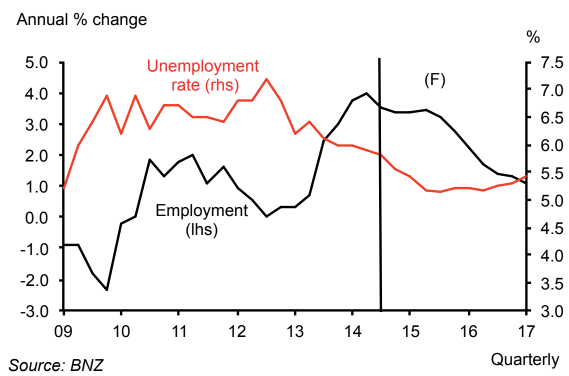
Retail sales



Partial indicators

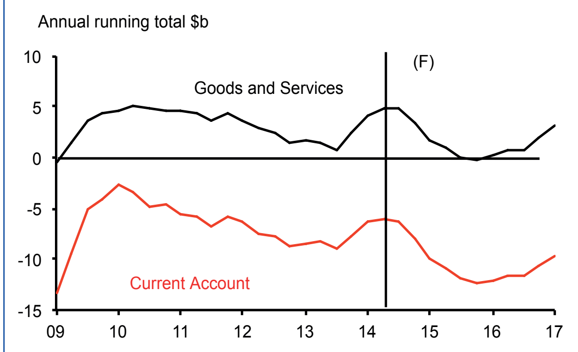


The labour market



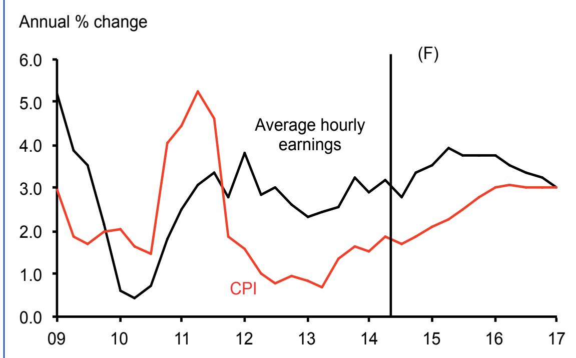
ECONOMY AT A GLANCE

Balance of payments



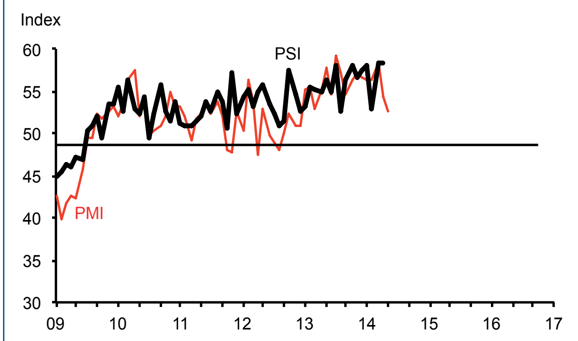
Source: BNZ, Stats NZ Quarterly

Inflation



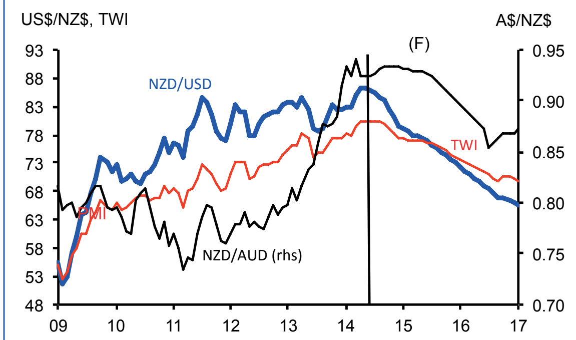
Source: BNZ, Stats NZ Quarterly

PSI and PMI



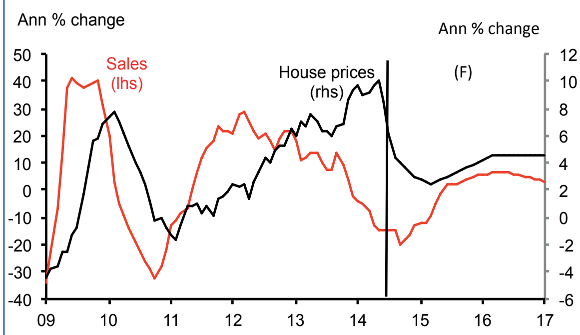
Source: BNZ Monthly

Exchange rates



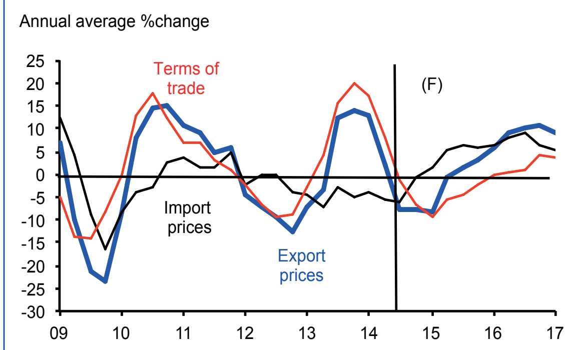
Source: BNZ Monthly

Housing market (three month average)



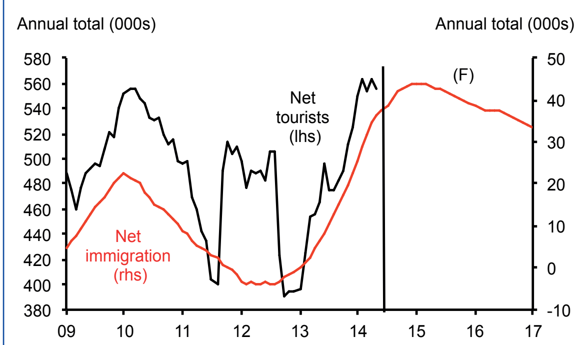
Source: BNZ REINZ Monthly

Terms of trade



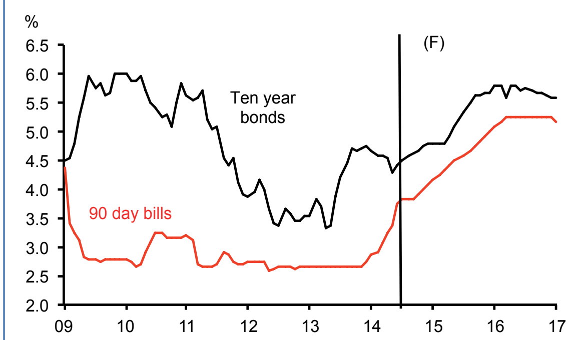
Source: BNZ Stats NZ Quarterly

Net migration flows



Source: BNZ Stats NZ Monthly

Interest rates



Source: BNZ Monthly

Continued from p9

Island containers through POT's Timaru Container Terminal. Kotahi gets 1.5% of POT's shares and 49.9% of the Timaru terminal, to compensate for the loss of existing rebates. POT needs to complete dredging to accommodate the larger vessels and the arrangements will add 52 vessel calls a year to Timaru. Port of Lyttelton, eyeing a resurgent Timaru rival, has announced a $1 billion development plan spanning up to 30 years.

New listings

Gentrack Group, a profitable developer of utilities and airports management software, has distanced itself from what it terms "land grab" technology companies that burn cash to chase sales in the expectation scale will eventually deliver profits. Its NZX debut, after an IPO that raised $36 million of new capital, gives Gentrack a market capitalisation of about $180 million, ranking it alongside the likes of Hallenstein Glasson and pharmacy operator Green Cross Health. Serko, the online business travel booking company forecasting two years of losses, fell below its IPO price after listing. Investors may have been rattled by Australian private equity firm Next Capital's decision the same day to pull its $262 million IPO for Hirepool, the unprofitable equipment rental company that some institutions valued at well below the offer range. It was an unusual miss for lead managers Deutsche Craigs, Macquarie Securities and UBS New Zealand. Hirepool will have given fruit and vegetable distributor Scales Corp pause for thought over its $186.5 million IPO scheduled for July, a share sale that involves a major selldown by owner Direct Capital. IkeGPS, the unprofitable mobile measuring device company backed by Jenny Morel's No 8 Ventures and General Electric, has a more modest $25 million target, which it plans to spend to ramp up its sales force. Latest to announce listing plans is ERoad, seeking $40 million to develop its transport logistics software platform.

Retailing

Warehouse Group and Kathmandu have both cited unusually warm weather for slack sales of seasonal winter stock. Warehouse, whose shares have been punished for the downgrade, said annual profit will be $59 million to $62 million, down from $73.7 million last year. The performance has disappointed investors given it has been rejuvenating the Red Shed stores that generate 70% of sales. And there are questions about the integration of Noel Leeming, outdoor sports chain R&R Sports and online retailer Torpedo7, which are key to Warehouse's strategy to diversify earnings.

Seabed mining

TransTasman Resources must decide by next Wednesday whether to appeal the rejection of its application to mine ironsands off the Taranaki coast or re-apply. The company spent seven years and more than $60 million before lodging its application through the six month fast-track process administered by the Environmental Protection Authority. Part of the shock for the mining industry is that under the EPA rules, the decision on an application "is binary", leaving no clear path forward, says lobby group Straterra's Chris Baker. Its decision-making committee found the application "premature", leaving uncertainty about environmental effects including the impact of the sediment plume stirred up by the mining and a lack of clarity about the economic benefits. Shelved for now will be TTR's plan to raise as much as US$550 million in debt and equity to fund the project. More broadly, it is a set-back for government's strategy of lifting mineral extraction and the fast-track process for consents within New Zealand's vast Exclusive Economic Zone. It is also a setback for Chatham Rock Phosphate, the second applicant under the regime, which aims to mine phosphate from the seafloor of the Chatham Rise

Construction growth

Construction grew 12.5% in the first quarter, according to gross domestic product data, the biggest increase since the first quarter of 2000, making the biggest contribution to economic growth in the first three months of the year. Construction probably won't provide the same stimulus in the second quarter, although the Reserve Bank was driven to raise its forecast for GDP in the first half of this year to 4% from the 3.5% estimate it gave in its April estimate. The country gained a net 36,400 migrants in the year through May, there's evidence in Real Estate Institute figures that the bank's LVR mortgage restrictions are cooling demand, and dairy prices are abating, leaving only the New Zealand dollar as an aberration near record high levels on a trade-weighted basis.

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