HUGOvision

Assessing the economic and political environment in New Zealand

September 16 2014 | Confidential to HUGO members

Forecasts at a glance

	INFLATION ann % change	GROWTH ann avg % change	\$ v \$US spot rate	\$ v \$A spot rate	WORLD GROWTH annual avg % change	TRADING PARTNERS annual avg % change
December 2015	2.7%	3.4%	73.0c	89.0c	3.2%	4.1%
December 2016	3.1%	1.8%	67.0c	88.5c	3.3%	4.2%
December 2017	2.7%	1.2%	63.1c	88.5c	3.1%	4.0%

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National on the last stretch well placed for third term

National rode out the Hager saga and probably will ride out the Dotcom dagger on "mass surveillance". Focus groups were unclear what the real point of the Hager stuff was and whether it was material to good government and thought all politicians do it anyway.

That left National sitting at an average of 48.6% in the polls by midweek last week on the back of improved household finances and his personality. As the table shows, that would be enough to govern with only David Seymour (ACT, Epsom) and Peter Dunne (United Future, Ohariu). If the Maori party wins either two electorate seats (that is, holds Te Ururoa Flavell's and one of the two retiring grandees' seats on which polling is equivocal) or one electorate seat plus a party vote seat, National could drop 3% and still govern with its 2008-14 support team.

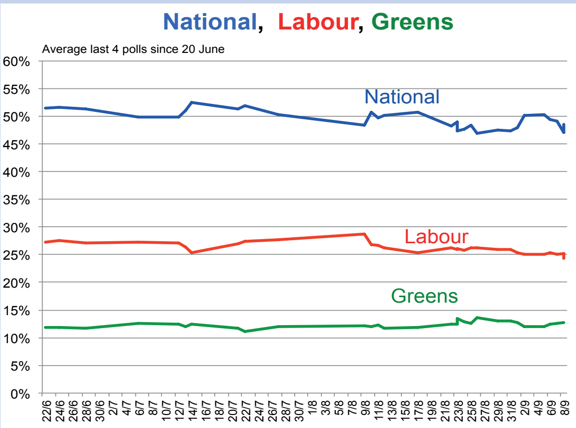
If National's party vote support drops further or one of the above seats does not materialise, John Key will need Winston Peters/New Zealand First or Colin Craig's Conservatives if they climb another percentage point on their latest 3.9% average.

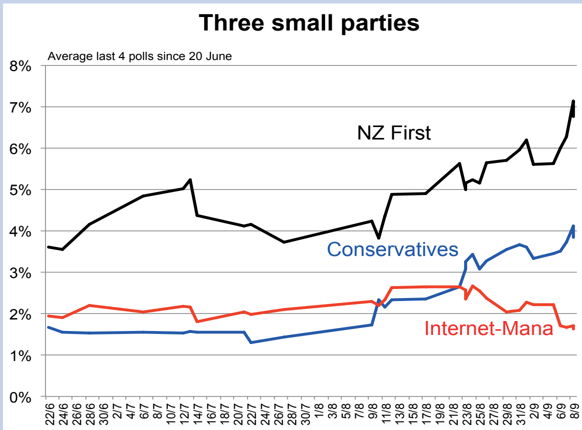
Either is do-able but would come at a cost that is not easily quantifiable in advance. After a period of belligerence towards Key, Peters this week simultaneously anointed Bill English and David Parker as appropriately sobre finance ministers while deriding the Greens' desire for a co-deputy prime ministership. He trailed a coat for a Labour-NZ First coalition and has raised the prospect of sitting on the cross-benches – though if he did that without committing to vote for confidence and supply, that would not fit his declared commitment to "stability". Craig's lot, being new to Parliament and a disparate bunch, might initially be more difficult to manage but it should be do-able, though there could be a risk of instability if they didn't settle in.

But short of a sudden surge for Labour, a left-led coalition still looks very unlikely. Labour is languishing in the mid-20s because voters don't see it as a government lead party. It didn't help Labour that the Greens sniffed around National last week.

The Greens have come through the campaign still polling around 12%-13%, some of that at Labour's cost. But they are still not in government.

Internet Mana has not fired. The latest average was 1.6%. It is still conceivable, but only just, that there will be a late surge on the back of the Dotcom "reveal" on September 15. But there is no evidence yet of any such surge.





The result on the latest averages

• National	48.6%	61 seats
• ACT/United	0.7%	2 seats
• Conservatives	3.9%	0 seats
• TOTAL NATIONAL SIDE		63 seats
• Maori party	1.0%	2 seats*
• NZ First	6.9%	8 seats
• Labour	24.3%	30 seats
• Greens	12.8%	16 seats
• LABOUR+GREENS		46 seats
• [Mana-Internet	1.6%	2 seats]

[* The Maori party is assigned two seats, with one an "overhang"]

National in a third term: some strategic ambitions

The "triangle" of John Key as presenter, Bill English as strategic thinker and policy developer and Steven Joyce as project manager will still be in place in a third term if re-elected – and will in effect apply even if Winston Peters is a senior minister. Key has said he will serve out the whole of a third term if re-elected and that is believable (but not 100% certain). English has gone on the list, which is usually a signal of impending retirement. If he is intending this to be his last term, there is a question over who would deliver the 2017 budget. Steven Joyce is unchallengeable as leader if Key goes and he wants the job. Note that Key told his biographer, John Roughan, that he would contemplate a fourth term as Prime Minister, although that was before the tarnishing effect of the *Dirty Politics* saga.

Promotions for Paula Bennett (health?), Simon Bridges (out from Joyce's shadow) and Nikki Kaye are likely. Watch newcomer MP Todd Muller's potential for a cabinet post by 2017. And note Key's relentless refreshing of cabinet and caucus.

The policy track in a third term would to some extent be determined by a combination of:

- continuation of the 2008-14 line, with more complex cross -portfolio "results";
- potholing politically difficult issues and responding to issues as they arise; *and*
- some strategic extensions, *complicated by*
- adjusting for constraints of support parties.

Continuation would include:

- ***fiscal consolidation***, reducing net debt to 20% of GDP, developing the government balance sheet, allowing New Zealand Superannuation contributions to restart in 2018-19 and, depending on fiscal conditions, a ***small tax cut*** aimed at low-middle incomes amounting to a fiscal drag offset;
- ***maintaining monetary policy*** broadly as adjusted in the 2011-14 term with the addition of macroprudential measures;
- legislative change, mainly in a ***deregulatory direction***, particularly in the labour market, resource management and local government, coupled with removal of obstacles to doing business, offset by more regulation to deal with embarrassments, as in workplace safety but adjusted for support party constraints – the ***2011-14 term is likely to have been the big one*** in this area;
- ***infrastructure*** development, particularly roads and fast broadband, recently boosted;
- a proactive approach to ***oil and minerals*** development and to ***irrigation*** to boost agriculture and horticulture, both subject to support party constraints and to the strategic reworking of natural resources policy (*see below*);
- ***education reform***, now focused on professionalisation of teachers (*see below*);
- ***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 mere "spending" (*see also below*);
- restructuring of government ***science and research*** programmes and an aim to boost government investment to 0.8% of GDP; *and*
- a ***trade*** policy aimed at free trade negotiations, within an "independent" foreign policy.

Potholing difficult issues includes:

- trying to get on top of "affordable ***housing***" issues or at least dampen public upset;
- maybe trying to take some edge off "inequality";
- taking the edge off some ***conservation*** concerns (as in a raft of election announcements)
- easing financial pressures in the ***health system***;
- managing public concern over ***foreign*** (read Chinese) ***land purchases***;
- adjusting ***transport*** policy, for example, cycleways and Auckland's rail loop; *and*
- ***crime*** and violence measures.

Strategic extensions focus on:

- improving management of ***water and natural resources*** generally and finding a durable balance between production and mining and environmental objectives and possibly some climate change/energy efficiency initiatives;
- ***teacher professionalisation*** and other moves to modernise, and lift quality in, the education system and focus it more on usable skills;
- another attempt to address ***regulatory complexity*** to ensure consistency and that stated objectives are met and transaction costs reduced; *and*
- an ***expansion of the investment approach*** to other social policy programmes, for instance in very early childhood programmes – budget 2014 made a tentative start.

Support party constraints would include:

- ***ACT*** would obviously support more deregulation, mining and GDP growth policies but have concerns about infringements of individual liberty.

- ***Peter Dunne*** has already broken ranks a number of times, as in 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 it is supporting National.
- ***New Zealand First*** has many points of difference with National, notably on immigration, foreign investment, free trade, asset sales, social services and Treaty policy. Winston Peters has said buying back the electricity companies is a bottom line. But he was restrained in his demands of Helen Clark in 2005-08 and may well be so now.
- The ***Conservatives*** are economic nationalists, oppose state-owned enterprises selldowns and land sales and liberal social policy but back welfare reform and private enterprise. Binding citizens-initiated referendums, unacceptable to National, are their bottom line.

Labour plus Greens plus … equals big regulatory change

A Labour+Greens government after 2014 would spell significant regulatory risk. This is partly because of a shift in Labour's approach and the partly because of the influence of a now-strong Green party and, assuming it is in the mix, New Zealand First.

Labour and the Greens will not be able to form a government on their own, unless there is an astonishing shift in public opinion this week.

That brings New Zealand First into play. Labour has ruled out having the Maori party and Internet-Mana in the ministry, though their votes might well be needed for a majority, which would require some concessions.

Labour, Greens and New Zealand First broadly agree on:

- maintaining the ***fiscal track*** in terms of the operating surplus through to 2020, though with higher revenue and higher spending and differences on exactly how to raise the extra revenue;
- tighter controls on ***foreign purchases of land***;
- big changes in ***monetary policy***, with big differences on detail;
- significantly tighter ***environmental*** controls; *and*
- more ***active social policies***, though with many differences of emphasis.

In addition, Labour and the Greens agree on a more active ***climate change*** policy. New Zealand First is less enthusiastic but does want change.

Labour would command the top ministerial posts:

- Labour cannot concede the ***prime ministership*** to Winston Peters even if it means not taking office. That would seriously damage Labour's credibility.
- The ***Greens*** are insisting on – and Labour would be prepared to agree – the ***deputy prime ministership***, perhaps jointly held by Russel Norman and Metiria Turei. Winston Peters might refuse to join a government with Greens in the cabinet, especially if the Greens were deputy prime ministers. Peters might also want the deputy prime ministership but will have fewer MPs and so a lesser claim.
- Labour cannot concede the ***finance*** portfolio. But the Greens would have something in economic development.
- Labour may also insist on the ***environment*** portfolio but the Greens would have significant related portfolios. Kevin Hague would likely be ***health*** minister.
- ***Winston Peters***, if in the mix, might have something in the ***foreign affairs*** area.

Labour has shifted from the Clark years. It now intends to be an ***"active" government*** in economic management and development. This is evident in many areas, including:

- in ***monetary policy***, a multiple target (including inflation), more use of macroprudential tools, including raising and lowering KiwiSaver contribution rates countercyclically, a board making the decisions and advising the government;
- in ***fiscal policy***, balancing the budget and reducing net debt to 3% of GDP by 2020-21;
- ***compulsory KiwiSaver*** (except on undefined very low incomes), rising over six years to 4.5% employer/employee contributions;
- a ***capital gains tax*** and 36% income tax on incomes above $150,000, limits on multinational companies' 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 Christchurch Earthquake Court;
- an investment fund built up from half the dividends of remaining state-owned enterprises to invest in "high-growth New Zealand assets" plus a

"Kiwi share" arrangement to stop sales;

- 12.5% tax credits for company ***research and development*** to push high-end manufacturing, backed also by "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 reduced compliance costs for SMEs raising capital (and other assistance) and a rationalisation of the meat sector with the aim of getting higher-value products;
- better access to venture capital; reviews of the ultra-fast broadband scheme, Crown Fibre Holdings, the rural broadband initiative and the telecommunications regulatory framework; an active part in improving international digital connections; a ***"chief technology officer"*** advising the Prime Minister, a "digital technology roadmap", a "national digital architecture" and a "digital bill of rights";
- a ***$15 minimum wage*** within 100 days and a ***"living wage"*** for public service employees, then for state employees, then for employees of contractors to the government, and ***repeal*** of the 90-day trial law for new employees, plus ***repeal or reversal of most labour law changes*** since 2008 and a commission of inquiry into wages and collective bargaining;
- smoothing of cyclical fluctuations of foreign ***immigrants***, directing them into provinces, with a focus on skills and a requirement that sponsored immigrants be paid the living wage, which is targeted mainly at agricultural/horticultural employers;
- much more emphasis on ***public transport***;
- a "voice" in free ***trade negotiations***;
- stricter rules on ***foreign purchases of land***, especially rural land where buyers would have to demonstrate real value-adding investment;
- overhaul of ***climate change*** policy to make the emissions trading scheme effective, with agriculture phased in and with complementary measures such as energy efficiency and investment of revenues from oil royalties in renewable energy and clean technology; in general, stronger environmental protections, particularly on dairy farming and mining but mining would be backed. Much greater use of National Policy Statements to direct outcomes, particularly in housing;
- a big government ***house-building*** programme, targeting 10,000 dwellings a year for 10 years, priced for lower-income buyers;
- in compulsory education 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*** plus more teachers to enable class sizes to be reduced; more emphasis on ***cooperation between tertiary institutions***, focusing polytechnics on economic growth and not degrees, "centres of research excellence", more focus on the transition from school to tertiary institutions, removal of "perverse" incentives in pass-rate-based funding, a major review of student support including adult study, reversal of the current governance change proposals and watch-and-see on online developments;
- in ***health*** a boost to primary care and to deal with chronic non-infectious diseases and free access to GPs for over-65s, under-13s, pregnant women, and disabled and chronically ill people, with an all up estimated cost of $200 million annually;
- 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; *and*
- a review of the public/state services legislative framework to enhance collaboration and outcomes and ensure agencies work together, rebuild core numbers, develop a career path and invest in training, require contractors and suppliers to be good, fair-wage, safe, healthy employers and ensure New Zealand suppliers are not disadvantaged.

The Greens would push Labour to go further in social, including Maori, and environmental policy, with the top priority making all rivers, lakes and oceans at beaches swimmable. 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 an alternative 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 would ***oppose free trade agreements,*** as would New Zealand First, but Labour would turn to National for support. The Greens want a higher tax on above-$150,000 incomes.

New Zealand First would block a change in superannuation, oppose free trade agreements and push for constraints on immigration, GST off rates and some food, a KiwiSaver scheme for children and the buyback of electricity companies. Peters can be expected to consider retirement and succession. He turns 70 next April. Persistent speculation suggests Labour renegade Shane Jones would jump at the chance to lead such a populist vehicle with its established "blokey" brand.

How stable would a Labour-led government be?

A straight Labour+Greens government would work reasonably well, though its arrangements would take some time to work out. The Greens are determined to develop into a party capable of being in government, requiring compromise), and yet holding on to its support. Tensions should be manageable.

New Zealand First in the mix might limit it to one three-year term. If Internet-Mana were required to provide a majority), it would be very difficult to manage: Laila Harre led the Alliance out of the 1999-2002 coalition and Hone Harawira left the Maori party because he couldn't bear the constraints of party unity.

Moreover, ***Labour is itself in transition*** from the late baby-boomers – David Cunliffe and David Parker are of that cohort – 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 may need a change of leader.

If Labour is in opposition expect a ***leadership change***, though David Cunliffe would fight to hold on, especially if National needs more partners than ACT, United Future and the Maori party. That change would likely be to Grant Robertson, who is 43 in October, and Jacinda Ardern (33), who might succeed in projecting a new-generation image and thus lift Labour's support.

Labour will need to ***adjust to the Greens being a significant party***, not just an add-on, which will probably lock Labour out of getting a vote above 40%. Labour will need to work out a "coalition-government-in-waiting" arrangement, which will also ***require the Greens to adjust***.

Labour will also need to rethink policy from first principles. There is some new thinking in Europe and the United States which responds to the reality of a highly interconnected and highly interdependent world. Grant Robertson has plugged into this. Likewise, the Greens still need to adjust economic policy to global realities, which management consultant James Shaw, now sure to be elected, will help push along.

Labour will also still need to rethink its approach to the ***Maori seats*** to better reflect Maori political aspirations.

If National is in opposition, expect a swift change of leader to Steven Joyce, but watch Simon Bridges down the track. We are less convinced by recent talk that Paula Bennett is a contender. She is an able "retail politician" and we expect her to test the waters, now that she's been touted as a leader, but there are more obvious choices, at least in the short term.

And there is other refreshment: National's list and electorate selections look likely to add three generation Y and two generation X people to the existing two generation Y and two generation X MPs. That could start to challenge Labour's generational change lead by 2017.

ACT and Peter Dunne might find less National willingness to renew their tenures in 2017.

Looking ahead to 2017

The slowing economic track in Hugo's forecasts, some fiscal pressures, and higher mortgage interest rates would put political pressure on whichever government is in office, but particularly a third term National-led government. John Key's personal authority has been damaged by the Hager and related episodes.

That points to a ***likely Labour+Green government in 2017*** if National gets a third term. Not least, a Robertson-Ardern team would be better able to project a "we are the future, they are the past" line than Cunliffe has managed.

Such a government might not reverse so much of the National-led governments' changes because they will have become more status quo by then, and because there would have been some updating of Labour's and the Greens' policy approaches.

But Labour and the Greens may still have trouble working out their relationship. The Robertson-Ardern team might not work, or it might not be the team. And National's refreshment of its caucus with younger MPs could challenge the "we are the future" line.

So don't rule out a fourth term for John Key. And, if Labour+Greens+Peters is the government 2014-17, there would be a fair prospect of a return to office for National in 2017.

Bear mind the possibility the Conservatives may gain strength if New Zealand First fades. An electorate seat deal may be possible for Colin Craig if Murray McCully retires in East Coast Bays in 2017. Watch to see whether the Internet party evaporates or grows. Evaporation seems more likely. Also, there may be new parties, especially in the Maori seats.

A change of gear

For an economy that's supposed to be coming off the boil, the Sept monetary policy statement from the RBNZ painted a remarkably solid picture. Particularly notable in the soup of reasons for weaker than anticipated inflationary pressure is evidence of capacity expansion caused by business investment, ongoing inward migration that is expected to add a net 50,000 to the workforce along with low unemployment and high participation rates, and stronger productivity improvements than are widely appreciated.

House price inflation appears to be under control, thanks to LVR lending restrictions and, in the medium term, because of new stock coming to market. In the short term, net inwards migration has had relatively less impact on housing demand than usual as much of that impulse comes from NZers staying put, reducing pressure on housing demand.

The subdued inflation outlook also assumes a lower kiwi dollar and interest rates than it was forecasting at the June MPS.

In part, this is because the US, UK and Australia are emerging only slowly from recession, while Japan and the Eurozone are still engaging in quantitative easing for the foreseeable future.

Non-inflationary growth potential of the NZ economy rose to 2.8% p.a., from 2.4% previously, wage pressure is subdued and households look unlikely to return to dissaving, with credit growth slower than the rate of nominal GDP growth.

Meanwhile, the kiwi dollar is going through what appears to be an accelerating downward rerating.

So, while this Thursday's June quarter GDP stats are expected to give a less positive reading than the govt might have hoped for just before election day, at an expected 0.5%, leading indicators of manufacturing and service industry activity suggest a rebound in Q3.

Balance of payments figures due on Wednesday are likely to show the external accounts reaching their low point in the current cycle, with a deficit around 3% of GDP, but heading back to 5% from here.

Migration statistics and Roy Morgan consumer confidence readings for August are due Friday, the last indicators before NZers go to the polls.

However, there's also a prospect of substantial revisions to both the GDP and balance of payments statistics, which may change the view about economic performance over the last year. The BOP figures will be distorted by the import of a 787 by Air NZ.

Russian sanctions to hurt dairy

While the RBNZ expects dairy prices to rebound this year and the terms of trade to remain at historic highs through 2015, Rabobank is warning Russian sanctions on EU dairy products will hurt global dairy prices.

Russia banned imports of EU-produced dairy products last month in retaliation for sanctions imposed by Europe on Russia over its involvement in tensions in eastern Ukraine.

European milk that was destined to become cheese for the Russian market will need to find another home, creating an overhang on the international market that is expected to last through the peak production and export season in both NZ and Aust.

Further downward revisions in the Fonterra milk price payout are expected, with the potential for an update when the cooperative announces its 2013/14 earnings on Sept 24.

Revisions might be lower if the kiwi dollar falls further than it has already. Sept 29 is the first occasion we'll get to see whether or not the RBNZ has been "passively" intervening to assist the recent steady slide in our dollar.

NZ competitiveness ranked 17th

One of the longest-running competitiveness surveys, from the World Economic Forum in Davos, puts NZ at 17th most competitive in the world, although it's trustworthiness rather than economic dynamism that drives the placing.

Also pushing the rankings in the Global Competitiveness Index are the public health and education systems.

The ranking is the country's highest since the index began in 2000, but the picture has changed little in terms of the country's strengths and weaknesses, with property rights, institutional arrangements, high integrity and sound legal and political systems pushing New Zealand's ranking five ahead of Australia, which fell to 22nd place in the overall index.

Infrastructure and innovation measures are comparatively weak.

The three "most problematic factors" for doing business in New Zealand are identified as inadequate supply of infrastructure, inefficient government bureaucracy, and insufficient capacity to innovate, based on interviews with 42 senior business leaders, coordinated by Business NZ and the New Zealand Initiative.

China: sluggish August

A surprisingly weak set of domestic economic indicators for August is raising questions as to how Beijing will ensure it achieves its target 7.5% p.a. growth rate.

A continued slump in the local retail estate market combined with a 40% drop in monthly import volumes and the lowest level of industrial output on a monthly basis since the height of the global financial crisis.

Output rose 6.9% for August yoy, compared with 9% in July. Retail sales growth was also slow.

Chinese authorities have become more reluctant to use monetary stimulus after the debt-fuelled approach of the last four years, which helped stabilise global growth while developed economies were in recession.

Micro-economic reforms also make fiscal stimulus less appealing, although some economists are speculating that targeted stimulus may still be possible in public housing and transport and that a relatively benign inflationary environment may allow an interest rate cut.

Legislation

We will have the next legislative update in the October 16 issue

Scotland the brave, indeed

It's a week for elections. Fijians are going to the polls for a vote that concludes on Wednesday, the first democratic election in the republic since 1976 and potentially a game-changer for the strained NZ relationship. A legitimately elected Fijian govt could hope to exploit the one of Melanesia's few potentially viable island states' economic opportunities more effectively.

However, global attention is on Thursday's Scottish referendum on remaining in the United Kingdom.

The polls were swinging towards a "no" vote early this week. If that's the outcome, the Scots have created a canny negotiating position with London.

FOMC meeting this week

The US Federal Reserve's Open Market Committee meets Tues/Wed this week, amid signs financial markets are anticipating an interest rate track lower than the Fed has formally signalled.

That raises the prospect of disproportionate correction when the time comes, says UBS in pre-FOMC analysis, although the investment house also gives a 60% chance to the Fed just leaving things as they are on this occasion.

Not dissimilarly to NZ, the market and the Fed may be apart on the rate of interest rate rises, but there's consensus on when the first rate rise will be: mid-2015.

That should help as a guide for how quickly or otherwise the RBNZ might move. It noted, without comment, at last week's MPS that financial markets here are anticipating an OCR rate rise in April.

BNZ has been forecasting the same end-point for the OCR as the RBNZ, but with a slower take-off and sharper late surge.

However, if there is any hint of the Fed removing previous references to the "considerable time" it sees elapsing before a rate hike, there could be a market reaction. UBS rates that a 15% chance. The other alternative is a nudge upwards to the track the Fed sees, which is more gradual.

"Prior to the Fed hiking rates (Q4 14 or Q1 15), they will need to confess to the market how important the balance sheet size is to policy accommodation and consider new tools to reduce that stimulus," UBS says. US data activity bounced strongly in July, house starts and new permits recovered, and house sales stabilised. Rising activity supported jobs growth: non-farm payrolls rose 209,000 in July and labour force participation increased.

Elsewhere, the recovery has stalled. Euro area GDP was flat in the June quarter, as the German and Italian economies contracted 0.2% and French GDP was unchanged. Euro area PMIs showed only a modest expansion in business activity in August, while country PMIs continue to indicate stronger activity in Germany and softness in the peripheral economies. The Japanese economy contracted 1.7% in the June quarter, as domestic demand fell owing to the sales tax increase on 1 April and the frontloading of demand into the March quarter. Growth appears weak in Australia, as the decline in household confidence and low wage growth weigh on consumption, and weak Chinese demand affects hard commodity exports. Reflecting soft activity, employment eased in July and contributed to a rise in the unemployment rate to 6.4%.

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