HUGO*vision*

Assessing the economic and political environment in New Zealand

May 21 2015 | Confidential to HUGO members

Prospects for the medium term continued operation of the Tiwai Point aluminium smelter appeared to brighten, with Rio Tinto seeking again to sell its Pacific Aluminium suite of Australasian smelters as a going concern.

Text finalised May 21

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BUDGET

A conscience-salving budget

The defining characteristic of Bill English's 7th budget is its implicit acknowledgement that income inequality is not only an economic problem, but also a political problem.

By announcing the largest increase to families dependent on benefits since 1972, the government is scratching a political itch from within its own support base, where concern about the growth in income inequality has been causing unease.

This budget seeks to salve that concern, at least to some degree, while setting the government up to increase its annual new spending allowance from the current $1b a year to $2.5b in 2017, paving the way for the announcement of tax cuts worth between $1b and $1.5b annually in an election year budget.

That timing is fortuitous also because the economic growth track falls away in the second half of the forecast period covered by this budget, to just 2.4% in the year to March 2019, from an estimated 3.3% in the year to March this year.

Even that growth may be optimistic. We are unconvinced at face value by the strength of the private consumption figures in the budget, with a forecast of 3.9% growth next year, and 2.8% and 2.7% respectively through to March 2018. The Treasury doesn't produce household savings rate projections, so we can't tell if they expect a reversion to some of the "borrow and spend" habits of the 2000's, but it appears the expectation is that wealth effects from house price inflation, low interest rates and low general inflation will be enough to push consumption.

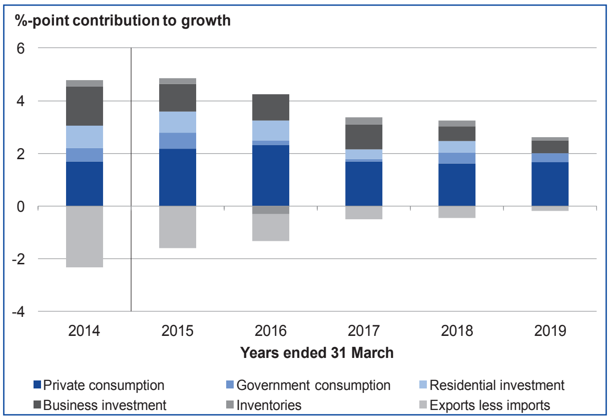
The impulse can't be coming from a continuation of strong net inward migration, which Treasury expects to peak about now and revert to the long term average of around 12,000 per year from close to 57,000 in the year to June.

Nor is the increase in spending power to the lowest income households enough to explain such strong private consumption growth.

Other key assumptions that underpin the budget include:

- The price of West Texas Intermediate Crude returns to US$78 a barrel by March 2019 from US$49 in the March 2015 quarter;
- Wholemilk powder prices rebound to US$3,900 per tonne towars the end of next year, from US$2,390 at this week's GlobalDairyTrade auction;
- US, Euro area and Japanese growth is expected to pick up through 2016, offset by weaker growth in China and Australia;
- There is assumed to be no spare capacity in the economy at present, with ongoing growth likely to add to inflationary pressure;
- 90 day interest rates hold at 3.6% through 2016, rising to 4.9% by June 2019. Ten year bond rates are assumed to rise from 3.3% to 5.2% in June 2019;
- The TWI remains elevated at 77.9 until late 2018, falling to 76.4 in June 2019.

Contributions to GDP growth:



An old-fashioned poverty package

The top-up for benefits paid to non-working families and higher Working for Families tax credits for low income working households acknowledges, in a direct and almost old-fashioned way, that income inequality has become an issue the government can no longer ignore.

On a full year basis, the package of measures is worth $240m a year.

However, it is markedly at odds with Bill English's "investment approach" to social policy, which may explain the apparent disjunction between senior Ministers' comments on whether or not there was to be a "package" to address child poverty in this budget.

We suspect the govt has more social policy initiatives in the works but that difficulties selling its social housing reforms sapped the appetite for anything more experimental, especially if it relied on outsourcing more social service provision to non-govt agencies. As defensible as that approach may be, it has become a political lightning rod for the Opposition, which is succeeding in painting English's approach as a form of privatisation.

The $65m of new and recycled funding earmarked for social housing over the next four years is indicative of the scale of the challenge of getting multiple agencies working together. The funding is intended to give the initiative "the operational resources required to deliver solutions across the housing continuum," according to Social Housing Minister Paula Bennett, who is increasingly seen to be struggling in the portfolio.

The price of the package has been the ending of the $1,000 kick-start for new Kiwisaver accounts, although the $521 annual tax rebate is still available. By ending the Kiwisaver leg-up, the govt is effectively now investing the bare minimum in future pension savings, with contributions to the NZ Super Fund still not scheduled to begin until 2020/21, when net Crown debt should fall below the target 20% of GDP.

Politics of Housing

The decision to tighten up on property speculators and foreign investors reveals a great deal about the way the Key govt works.

First, it was a reactive decision driven by the political nervousness of the govt's Auckland MPs, particularly its Auckland Ministers.

There were also concerns coming from out of Auckland as feedback from business suggested people were becoming reluctant to take up jobs out of Auckland for fear of being locked out of the Auckland housing market.

The speech by the Reserve Bank Governor on April 15 simply left the govt with no excuse not to act.

Secondly, the decision was made extremely quickly and by only a small group of Ministers.

Between the Spencer speech and the announcement was Anzac weekend and the Prime Minister's trip to the Middle East and Gallipoli.

The final detail was obviously signed off at the Cabinet meeting on May 11.

And third, careful thought was given to how it would impact on National's chances of re-election in 2017.

It was those political concerns which led to the announcement being made last weekend rather than in the Budget.

Apart from the fact that it was a late decision the govt's media advisors did not want anything to overshadow the Budget, which is intended to recast the govt in a "kinder, gentler" light with an emphasis on material deprivation.

And fourth, there was also a view inside the Beehive that the move would offer additional political benefits in that it would put the heat on the Opposition which somehow had to reconcile Labour abandoning its own capital gains tax against the Greens continuing to support one.

In fact, Opposition parties were snookered to the extent that they had nowhere to go other than to agree with the govt's actions, leaving them only with the charge that the changes were too little or too late, or both.

What is clear is that this govt will increasingly be driven by intense political pragmatism as it moves towards its ultimate goal of winning four terms in Government and thus substainably entrenching its "smaller govt" model.

Business-relevant budget decisions:

- Funding for expansion of the UFB rollout to 80% of the NZ population is confirmed, with $210m sourced from the Future Investment Fund and another $150m from the Telecommunications Development Levy;
- $85.8m over four years to increase funding for science teaching (+7.5%), agriculture (+20%), and increases for optometry, pharmacy, and physiotherapy courses;
- $11.4m over four years to increase the number of engineering graduates, including $5.2m for more engineering places;
- new levies for travellers entering and leaving the country. A $16 entry fee and $6 exit fee are proposed to move to cost recovery for border security services that have previously been taxpayer-funded. Total charges for a return journey will total $36 once the new levies are in place, from Jan. 1 2016;
- the Environmental Protection Authority is one of the few govt agencies to successfully argue for an increase in base funding, being granted $4m to fund administration of the EEZ regime, which has been more onerous and costly than anticipated;
- $16.8m is committed over four years to assist local govt and other affected parties get to grips with the evolving, new freshwater management regime;
- $20.4m over four years to be made available to help transition to an RMA regime that relies more on central govt direction through more use National Policy Statements and National Environmental Standards. Note that Environment Minister **Nick Smith implies there will be little legislative change to the RMA,** with reforms to environmental regulation to be achieved by non-legislative measures;
- $12.1m to implement the NZ Business Number scheme, to be in use by key govt agencies by the end of 2017.

$1.4bn for rail

By voting almost $400m of additional capital injections over the next two financial years for KiwiRail, the Crown is bringing its total commitment to the state-owned rail operator to $1.43b since 2010.

Much of this is deemed to have come from the Future Investment Fund, established with the proceeds of partial privatisations. Ministers are warning this level of ongoing support is "unsustainable."

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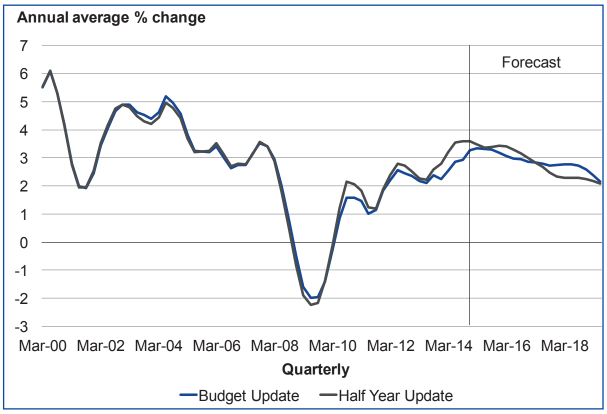
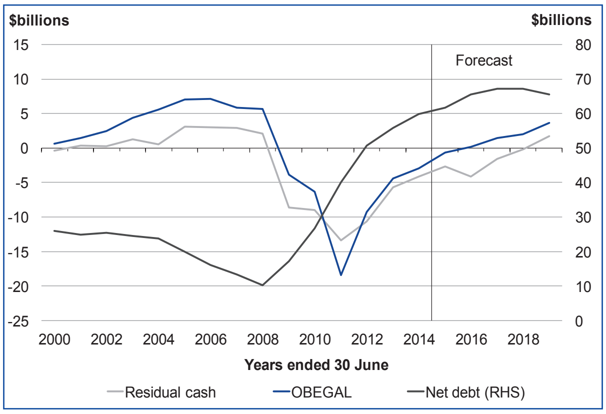
BUDGET

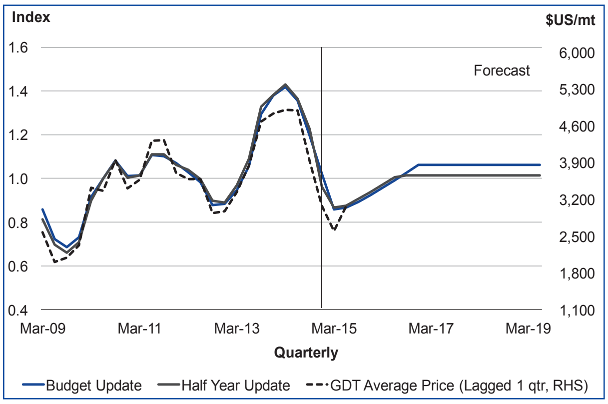
1. Real GDP growth



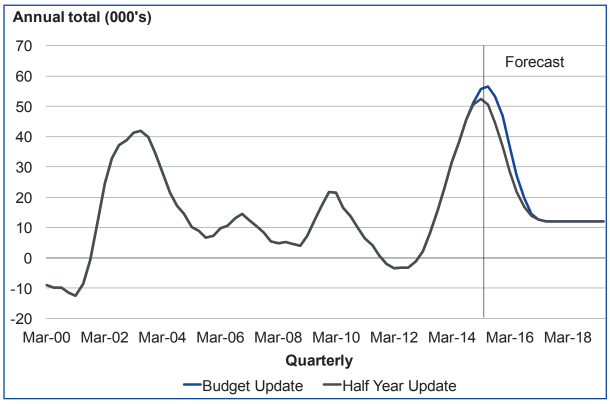
2. Fiscal position



3. Dairy prices



4. Migration flows



Average annual real GDP growth of 2.8% next 4 years

Income growth, increasing house prices, low debt-servicing costs, a more competitive kiwi dollar, and low inflation boosting real incomes all bode well for private consumption.

However, growth moderates in the medium term, as population and income growth ease.

Nominal GDP is seen weakening through mid-2015 to a rate of around 2% p.a., before picking up as the year progresses to average 4.3% over the next four years.

Low inflation/lower revenue story to continue

The govt achieves a small budget surplus a year later than previously forecast, but is determined not to cut spending "simply to chase a surplus".

Net core Crown debt is forecast to fall below 20% of GDP in 2020/21, allowing a return to contributions to the NZ Super Fund in that year.

ACC levy cuts worth $495m p.a. are baked into the forecasts for the next two fiscal years.

A new spending allowance of $1b will operate next year, rising to $2.5b in 2017 to fund possible tax cuts.

Recovery in 2016

Global prices for dairy products are expected to start improving later this year and are forecast to be around US$3,900 per MT for wholemilk powder by the end of next year.

However, there is considerable uncertainty about the impact of the removal of EU dairy production quotas.

Russia may re-enter global markets, while Chinese inventories are expected to normalise, with a flow-on to increased demand.

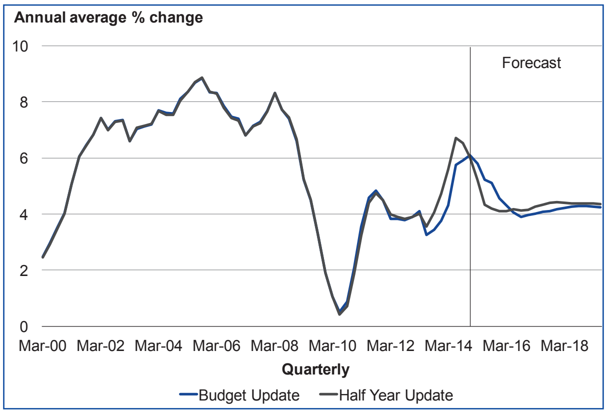
Top of the cycle

The Treasury believes the current very strong net migration cycle will come to an end in the year to June, topping out at a net 56,600 net new arrivals.

A return to the long term average of a net 12,000 new arrivals p.a. is assumed.

A slower rate of net migration should take some of the pressure off housing prices and could lead to labour shortages.

5. Wages and salaries



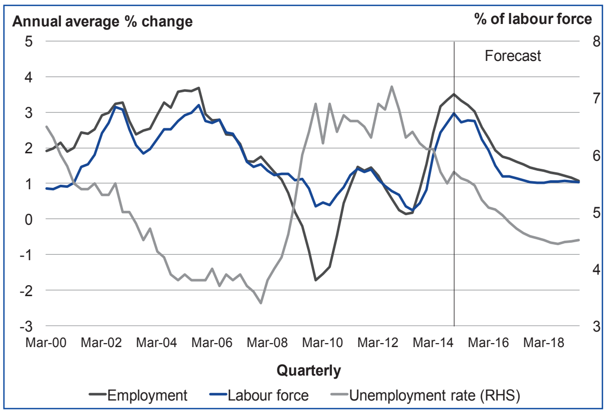
Subdued wage growth

High net migrant inflows and low inflation are expected to keep wage growth subdued this year at around 2.1%.

Low inflation has boosted real household income growth, underpinning expected strong private consumption, at least this year.

Average hourly wage growth is expected to rise by 3.3% by early 2019.

6. Employment, labour force and unemployment



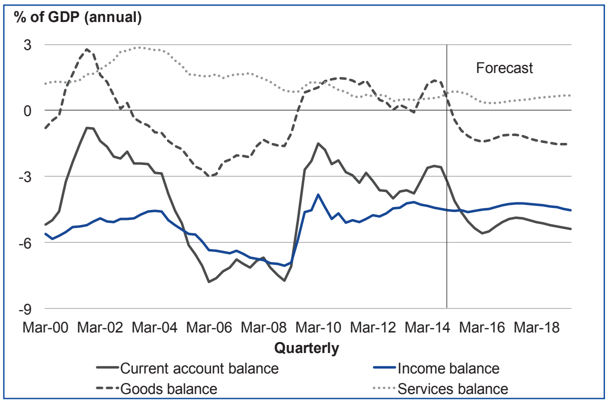
Strong participation rates continue

Historically high participation rates are expected to continue at close to 69% of the available workforce.

While employment growth has been running at around 3.5% p.a., that is expected to moderate towards the end of this year.

Unemployment falls gradually to 4.5% by 2017.

7. Current account outlook



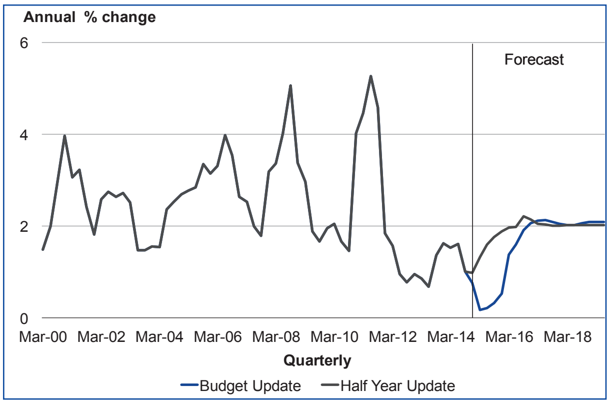
External accounts stabilise

The current account deficit is seen widening from under 3% of GDP at present to close to 6% over the forecast period, although it is expected to stabilise at between 5.5% and 6% of GDP.

Tourist arrivals growth, lower oil prices, and low global interest rates all offset consumption and outflows of profits from NZ firms with offshore owners.

Net international liabilities are expected to sit at 74.8% of GDP by March 2019, better than than 79.8% forecast at the half-year fiscal and economic update.

8. CPI



Inflation slowly picks up

Inflation is expected to rise to 2.1% p.a. by the end of 2016, the mid-point of the RBNZ's target 1% to 3% range.

Also contributing to rising inflation is the expected pressure on output capacity, which is already judged to be fully used.

Non-tradables inflation should rise to more than 3% as capacity pressures develop.

Inflation expectations rise

The RBNZ's latest survey of inflation expectations will take some of the volume out of current calls for a cut this year to the Official Cash Rate. The CPI is seen rising an annual 1.32% on a mean basis in the year ahead, up from the 1.11% pace seen in the March quarter. Expectations two years out increased to 1.86% from 1.8% three months earlier, and are closing on the mid-point of the central bank's 1-3% target range.

Economic impact of ICT

The govt has released an updated snapshot of the small, but fast-growing impact of the ICT sector on the NZ economy, with skills shortages the standout area of difficulty and a big swing in recent years away from health and bio-sciences to computer design as the primary source of activity.

The MBIE report shows the sector contributes just 1.7% of GDP but has been growing at a compound annual growth rate of 9.3% between 2008 and 2013, while ICT occupations across the whole economy total 74,900, or 3.8% of the total workforce and have been growing at a CAGR of 3% since 2004.

The relatively high productivity of the sector, at $181,716 value added per employee, is reflected in the fact that this figure is 133% of the NZ average. The report also suggests almost all recent business r&d expenditure has been in computer services, growing at a CAGR of 13.2% since 2004.

The sector is judged strong in its job growth, salaries, availability of incubators and specialised media, and ranks strongly across all factors of knowledge intensity including product complexity, innovation and skills levels.

Wellington punches above its weight for growth and contributions to the sector, with 8% employment growth between 2009 and 2014, compared with 7% in Auckland, although Auckland's total ICT workforce, at 13,910 in 2014 dwarfs Wellington's at 7,480. ICT jobs in the rest of the country totalled just 5,901.

Record Chinese visitor numbers

Visitor numbers from China rose 26% to a record 302,128 in the year to April. Total annual visitor arrivals increased 6.7 percent to 2.96 million.

China is expected to overtake Australia as the biggest tourism market in expenditure terms within seven years, although Australia will likely to continue to be the largest source of tourists, according to forecasts published this week by MBIE.

ECB to step up QE

The European Central Bank has signalled its intention to "front-load" some of its 1 trillion euro bond-buying quantitative easing programme in May and June to ease predicted liquidity shortages in July and August. The euro fell sharply on the announcement, earlier this week. The QE programme is scheduled to run through to September next year. Meanwhile, the Greek govt says it expects to sign a bail-out deal with its international creditors within the next week to stave off national bankruptcy and a potentially disorderly exit from the Eurozone.

Aussie budget bounce for Abbott

Early signs are that Australian federal Treasurer Joe Hockey's second budget is achieving its political objective of bolstering the shaky ratings for the Abbott govt. Polls for News Ltd and Fairfax both showed improved fortunes for the Liberal coalition, with the Newspoll for The Australian, published May 17, showing the coalition on 40% support against 37% for the ALP, although on two party preferred basis, reflecting Australia's preferential voting system, the ALP's lead over the coalition grew slightly to 53% vs 47% for the coaltion.

Abbott's preferred Prime Minister ranking improved to 41%, putting him one point ahead of ALP leader Bill Shorten, compared to an 18% point gap at the time of a failed attempt to oust Abbott as leader earlier this year.

The budget, which unwound some unpopular measures, including pension indexation, and raised spending on childcare and small business grants, saw 46% of those polled in the Newspoll endorsing the budget as good for the Australian economy, compared with 48% who believed last year's budget would be harmful.

Soggy Q2 for Asian markets?

The slowdown in Chinese activity this year is more pronounced than in previous years, HSBC analysis suggests. Industrial production fell to a post-crisis low of 5.6% y-o-y in March, marginally better than the all-time low of 5.4%. Meanwhile, the HSBC China Manufacturing PMI dropped to 48.9 in April.

Signs of life from the US and Eurozone are also unlikely to hold much upside for Asian markets. Export and PMI data in Asia reflect external weakness, with Q3 the earliest for any pick-up.

Rate cuts are likely in China, India, Korea, Taiwan, Indonesia, Malaysia and Sri Lanka, not to mention Japan.

Tiwai Point

International media reports suggest that Rio Tinto will attempt again to sell its suite of Australasian aluminium smelters and associated assets, Pacific Aluminium, having failed to do so in 2013. That bodes well for the continued operation of the Tiwai Point smelter, at least in the short term, with PacAl required to make a call mid-year on whether to extend its contract for electricity supply. NZ Aluminium Smelters is known to have been negotiating with providers other than its incumbent supplier, Meridian Energy, for at least part of its annual load. The NZ unit of PacAl reported after tax earnings of $73.8m in the year to Dec 31 2014, compared with $66.8m the previous year, on sales of $710.8m ($655.2m).

Infratil and Trustpower

Infratil expects Trustpower to sell out of its completed A$430m Snowtown wind farm project in South Australia in order to fund other renewable opportunities in Australia, saying most of the margin gains from the development have been realised. On completion, Snowtown was revalued to A$730m. While the federal government's Renewable Energy Target is to be reduced to 33,000GWh of new production, Infratil expects there to be "more than enough" opportunity for Trustpower to take a share of that action, with 1,280MW of projects in the consenting phase and another 750MW of identified development sites. Infratil is taking a more cautious approach to new capex in the year ahead, as low interest rates pump values for real assets and with a weather eye on global market disruptions if and when the US starts to tighten monetary policy.

Media

APN News & Media has confirmed its NZ news operations, NZME., will introduce a paywall subscription model for news websites, although gave no hint on timing. A key NZME. executive involved in planning the paywall for the NZ Herald site has recently moved to Fairfax Media, which is committed in NZ to a paywall-free model, driving traffic and advertising revenues using models drawn from the success of social media giants such as facebook.

MediaWorks is to launch a new current affairs show four nights a week to replace Campbell Live. The company offered a co-hosting role to Campbell, who declined. Speculation suggests he will join Radio NZ, which has a slightly expanded mandate under new legislation before the House at present. RNZ also recently employed Campbell's former producer, Carol Hirschfeld. Campbell had become TV3's most-watched show since its future became uncertain.

The much-vaunted multi-platform morning show starring Paul Henry is struggling to rate with both TV and radio audiences.

Lobbying

After a decade at the helm of Business NZ, its executive director Phil O'Reilly is to step down at the end of the year. O'Reilly has overseen amalgamations among regional affiliate organisations to create a strong voice for the business community. However, there had been some feeling O'Reilly had become too close to the current administration to offer robust alternative views. O'Reilly may look for roles offshore, noting he sits on OECD and ILO committees.

Financial stability

The Reserve Bank deems NZ's financial system sound in its latest financial stability report, with lenders' capital and liquidity buffers increasing in recent years and bank profitability improving with fewer impaired assets and growth in net interest income. Lenders have told the central bank they plan to use new capital instruments allowed under Basel III, and the RBNZ plans to undertake a review of current capital requirements to see how the global and domestic context has changed in recent years. Apart from Auckland's housing market, where the bank has tightened lending rules, dairy farming was a key risk to financial stability, it said. About 25% of farmers, accounting for 32% of the sector's $29b in debt, are estimated to have negative cash flow this season as dairy product prices hold near five-year lows and the outlook remains subdued. The bank estimates about 11% of debt is held by farms with high loan-to-value ratios of above 65%.

Dairy remains weak

Dairy product prices fell for the fifth consecutive GlobalDairyTrade auction, pushing the GDT Price Index to its lowest level since Aug 2009. The GDT average winning price fell 2.2% to US$2,472 from US$ 2,515 at the previous auction two weeks ago. Some 26,535 tonnes of product was sold, down from 27,369 tonnes in the previous auction. Whole milk powder, the biggest product by volume offered on the GDT platform, fell 0.5% to US$2,390/tonne, slowing from the 1.8% decline in the previous auction while taking its decline since late Feb to 27%.

El Nino

In a report this month, the IMF singled out NZ for its exposure to a major El Nino weather event, which it said lowers GDP growth by 0.29% in the quarter immediately after an event as drought in parts of the country and flooding in other places saps agricultural production. An initial slowdown can also be detected in Australia, Chile, Indonesia, India, Japan and South Africa. But unique to NZ was disinflation, amounting to 0.61% after four quarters following an event. The IMF research covered the macroeconomic impact of El Nino shocks from 1979 to 2013 across 21 countries and regions.

Chinese tourism trend

China is expected to overtake Australia as the biggest tourism market for NZ in terms of expenditure within seven years, according to an MBIE projection. Chinese tourism is growing at a 14% compound average growth rate and its share of total tourist spending in NZ is forecast to grow from 14% last year to 24% in 2021, totaling $2.6b, MBIE said in figures released at the annual Trenz tourism conference in Rotorua. The anticipated increase in spending by Chinese tourists is partly driven by a shift to more free independent travelers, who tend to travel more extensively and stay longer. Chinese tourists are expected to prolong the average length of their stay from 18 days last year to 28 days in 2021 while the Australians will continue to keep their stay as long as 12 days, as they come mainly to visit family and friends.

ACC levies

The government is targeting $500m of cuts to Accident Compensation Corp levies by 2018, ACC Minister Nikki Kaye says. The cuts will include $375m in 2016-17 and $120m in 2017-18 and will be spread across motor vehicle, work and earners accounts. The final details of the cuts won't be known until ACC completes a public consultation round. Kaye also announced legislation to put in place a new ACC levy-setting framework, which will take effect in 2016/17, called the ACC Financial Responsibility and Transparency Amendment Bill.

Super Fund independence

Finance Minister Bill English plans to amend legislation that would allow the NZ Superannuation Fund streamline its investment structure to prevent politicians from interfering with management, dropping recommendations drafted in select committee. English plans to introduce a supplementary order paper to the New Zealand Superannuation and Retirement Income Amendment Bill that would drop the need for ministerial approval over investment decisions. The main feature of the bill lets the Guardians of NZ Superannuation control Fund Investment Vehicles (FIVs) – holding companies the fund would use to invest in other entities, funds and assets. English's change would drop a clause requiring ministerial sign-off on the use of FIVs. He said politicians interfering to the fund's management was the "biggest risk to the taxpayer".

Services, manufacturing

NZ's services sector is tracking at a faster clip than manufacturing, although both slowed last month. The BNZ-BusinessNZ performance of services index fell 1.1 points to 56.5, with stock/inventories and supplier deliveries both lower. The PMI for April fell to a seasonally adjusted 51.8 from 54.6 in March, remaining in expansion for the 30th month in a row. The BNZ-BusinessNZ performance of composite index, which combines the PSI and PMI, fell 1.2 points to a GDP-weighted index reading 55.9, while the free-weighted index declined 1 point to 55.4.

Retail sales

NZ retail sales rose at a record 2.7% pace, seasonally adjusted, in the first quarter as the start of the school year underpinned demand for consumer electronics such as laptops and tablets. Stripping out vehicle-related spending, retail sales rose 2.9%, led by an 8.9% gain in sales of electrical and electronic goods. Sales may have slowed in the second quarter. Spending on credit and debit cards fell 0.8% in April, snapping nine consecutive monthly gains.

Auckland house prices

Auckland's median house price was unchanged at $720,000 in March and April, to be up almost 18% from April 2014, Real Estate Institute figures show. The figures are the first to be released since REINZ reissued its historical series yesterday, significantly reducing its previously published path for house prices in the country's largest city. Where REINZ was previously saying the median Auckland house price rose 20.2% in the year to March, it now says that increase was 16.7%.

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