

## SEPTEMBER 2022

### NZ Economy: Caution signs ahead

#### Executive Summary

Despite some recent improvement in economic activity, the outlook to September 2024 is still for subdued growth due to a range of factors outlined below. Some economic indicators are bouncing around, fluctuating significantly even on a monthly basis. For this reason, a degree of caution is required in making any long-term assumptions about future activity based on current data.

There is also international pressure, ranging from the ongoing war in Ukraine, where Russian retaliatory measures are severely affecting energy supplies from that country to other European nations, to China's economy stumbling on the back of ongoing lockdowns aimed at eliminating Covid. Geopolitical tensions, combined with supply-side issues the consequence of the ongoing Covid pandemic, have encouraged a more insular approach to international trade. Countries are tending to become much more nationalistic in their attitude to the provision of both goods and services.

Around the globe, further interest rate rises can be guaranteed as most central banks try to get the inflation genie back in the bottle following massively expansionary monetary policies over the past two years or so.

On the positive side of the equation, NZ currently has low unemployment, manageable levels of net Crown debt and is continuing to receive a reasonably healthy report card from international credit-rating agencies. Covid infections are falling away and the Government's recent but belated move to abandon Covid-related restrictions such as mask wearing are welcome, although to be fair most New Zealanders outside Wellington had already moved on, reflecting a global trend - the need to get economies moving again.

Despite these positives, both business and consumer confidence remain sub-par for a number of reasons. Borders are finally reopening but supply-side constraints are still weighing heavily on businesses while acute labour shortages are seriously affecting output, including tourism. Many businesses do not have the staff to provide the kind of service most New Zealanders, let alone international tourists, demand. Simply putting up signs saying we are suffering from a labour shortage so bear with us and be kind will not cut it. Discerning tourists are not prepared to pay inflated prices for inferior service. Moreover, a number of regulatory proposals in the pipeline will increase costs for both businesses and households.

International commodity prices have come off their highs, but this is very much a two-edged sword. On the one hand, while weaker growth prospects in Europe and China are taking some of the heat out of oil prices, other energy costs remain extremely problematic given Russia's recent moves to turn off the gas supply in retaliation for NATO and European support for Ukraine.

Reduced international activity is reflected in a reduced demand for NZ's agricultural produce with a significant reduction in the price of dairy products since the start of the year as evidenced by Fonterra's lowering the 2022/2023 forecast dairy payout and a general softening of prices in Global Dairy Trade (GDT) auctions although prices have improved in the latest couple of auctions. On the other hand, input costs to NZ agricultural producers for things such as fertiliser, machinery and labour are continuing to rise, cutting into the outlook for both production and profitability.

As the Reserve Bank reins in its quantitative easing (money printing) programme and progressively raises the Official Cash Rate (OCR), households and businesses will be faced with rising interest rates. As a result, disposable incomes will increasingly be under pressure despite rising wages. Inflationary expectations are still at historic highs. Unfortunately, high inflation most adversely affects those on fixed incomes with few, if any, assets.

#### HIGHLIGHTS

**Global and domestic inflationary and geopolitical pressures continue to affect future economic growth prospects both for the world and for NZ.**

**The ongoing war in Ukraine is severely affecting European energy users, given an over-reliance on Russian energy supplies. So too are the cost pressures arising from the attempt to find alternative energy sources. Consequently, the short-term outlook globally has taken a dive, with the likelihood of a recession in Europe.**

**Inflationary pressures continue to bite both in respect to tradeables inflation and domestically generated inflation (non-tradeables.) The Reserve Bank is likely to hike interest rates further to get inflation back within the target band of 1-3 percent.**

**Domestically, conditions have improved slightly over the last few months with economic growth in positive territory for now. The BusinessNZ Economic Conditions Index, a compilation of NZ's major economic indicators, sits at 3 for the September quarter, up eight on the previous quarter and up 9 on a year ago.**

**Meanwhile the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey - the Performance of Services Index (PSI) have recently shown an uplift in activity, although monthly activity levels are still bouncing around. Ironically, improved activity may result in the Reserve Bank going harder on raising interest rates.**

**Supply chain issues and rising input costs, including labour, remain acute, despite recent but belated moves to open the border to improve labour availability.**

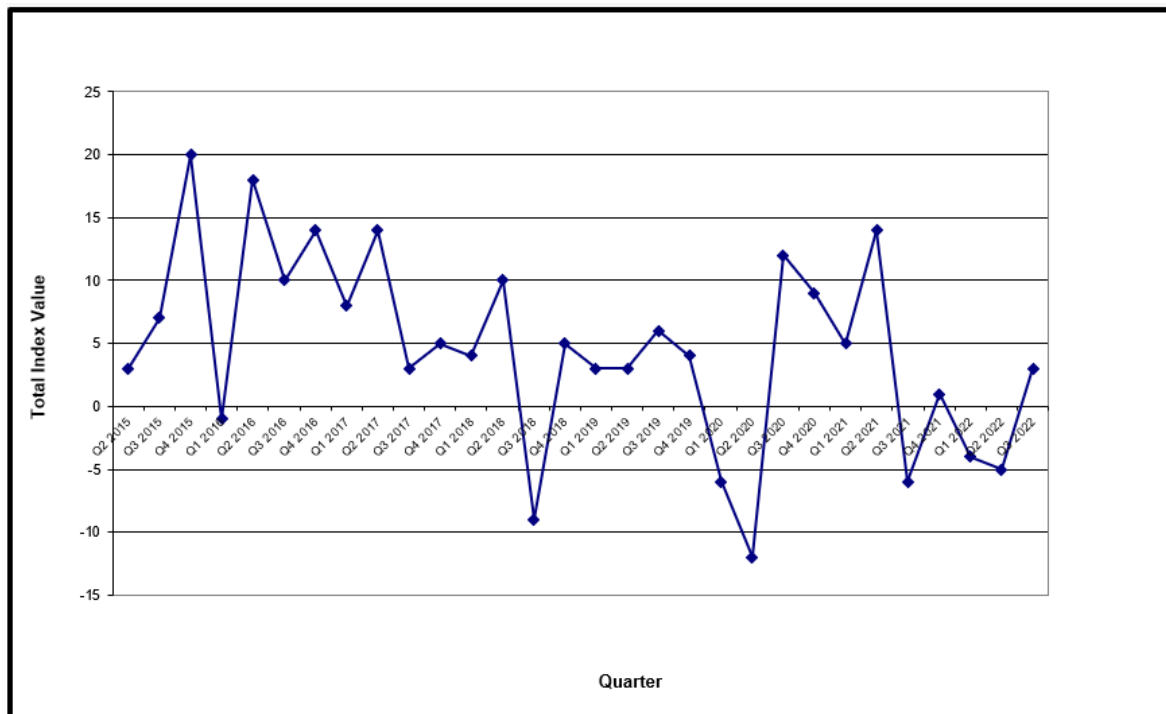
**Increasingly, consumers and households are experiencing inflationary pressure eroding disposable income. Higher interest rates are starting to bite as more fixed rate mortgages come up for renegotiation. Consumption expenditure is coming under pressure with household members tightening their belts in the face of rising costs.**

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

### **BusinessNZ Economic Conditions Index (ECI)**

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 3 for the September 2022 quarter, up 8 on the previous quarter and up 9 on a year ago.<sup>1</sup> The recent improvement coincides with belated moves to loosen up key factors holding the economy back, including border restrictions and most Covid-related restrictions such as mask wearing etc., now scrapped.

### **Overall Economic Conditions Index (ECI)**



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

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

**Economic growth/performance indicators sit at 5 for September 2022 quarter**, up 4 on the previous quarter and up 6 on a year ago. Key commodity prices for agricultural commodities are coming off their highs, largely on the back of reduced demand from China following its recent severe Covid elimination strategy lockdowns.

**Monetary policy/pricing indicators sit at -4 for the September 2022 quarter**, down 2 on the previous quarter and the same as a year ago. Current inflation (both tradeable and non-tradeable) remains well outside the Reserve Bank's target band of 1 – 3 percent with continuing rises in the OCR inevitable as inflationary expectations remain elevated.

**Business/consumer confidence indicators sit at 3 for the September 2022 quarter**, up 5 on the previous quarter and up 8 on a year ago. Both business and consumer confidence indicators remain at historically low levels, affecting investment and consumption intentions. Rising interest rates, and sustained inflationary pressures are having a negative effect on confidence with supply constraints adding fuel to the inflationary fire.

**Labour market indicators sit at -1 for the September 2022 quarter**, up 1 on the previous quarter and down 5 on a year ago. While the unemployment rate remains at an historic low, rising inflationary pressures across the board, along with significant interest rate rises are eroding disposable incomes, despite significant wage and salary rises over recent months. Staff shortages are still a major constraint on economic growth across a range of sectors.

<sup>1</sup> The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the September quarter 2022 are estimates based on available information to date.

## **PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?**

### ***1.1 Economic growth (GDP) – Slowly slowly***

Economic growth is forecast to remain mediocre out to September 2024 at around 1.5 percent per annum as can be seen from the forecasts below.

Events happening both internationally and domestically are weighing heavily on the NZ economy and will do for some time. Notwithstanding, there are still some bright elements such as current full employment, the relaxation of most Covid-19 restrictions and a belated border opening – the latter hopefully helping with labour supply and bringing back high-value tourists. Moreover, NZ's net Crown debt is still relatively low leaving the Government with some headroom, if necessary, to spend even more than it has to date before its credit rating comes under attack.

The international economy is under pressure for a range of reasons. The latest International Monetary Fund (IMF) World Economic Outlook's title, "*Gloomy and More Uncertain*" (July 2022), pretty much sums up where things are at.

According to the IMF, global economic growth is projected to slow from an estimated 6.1 percent in 2021 to 3.6 percent in 2022 and 2023.

Key points to note from the IMF analysis are that:

- A tentative recovery in 2021 has been followed by increasingly gloomy developments in 2022 as risks began to materialise.
- Global output contracted in the second quarter of this year, owing to downturns in China and Russia, while US consumer spending undershot expectations.
- Several shocks have hit a world economy already weakened by the pandemic:
  - (1) higher-than-expected inflation worldwide—especially in the United States and major European economies—triggering tighter financial conditions and interest rate hikes;
  - (2) a worse-than-anticipated slowdown in China, reflecting continued COVID-19 outbreaks and lockdowns; and
  - (3) further negative spillovers from the war in Ukraine, given the role both Ukraine and Russia play in terms of world energy and agricultural production.

Russia is the world's third-biggest petroleum producer and a leading exporter of natural gas, fertiliser and wheat. Farms in Ukraine feed millions globally.

European reliance (notably Germany's) on natural gas from Russia is very concerning. It's not all about price but the fact that Russia is retaliating against western sanctions by continuing to turn off the tap, so things are not looking good.

The potential for a significant European recession should not be ruled out. At a minimum, prices for goods and services will increase, ultimately fuelling inflation around the world - including NZ.

For a number of reasons, the slow-down in China, the world's second largest economy after the United States, is also troubling. China is such a big player in the international economy and also NZ's biggest trading partner, alongside Australia.

China's obsession with eliminating Covid strains via successive draconian lockdowns, while the rest of the world learns to live with the virus, is problematic for international commodity prices. On the positive side, the lockdowns might take some of the pressure off energy costs but also constrain the growth in agricultural prices as reflected in the lower prices generally coming through the Global Dairy Trade (GDT) auctions, although the latest couple of auctions have shown some improvement from earlier declines.

Given NZ is responsible for only about 2 percent of world dairy production but about 30 percent of the world dairy trade, it is fundamental to our economy that China does well.

There are still simmering trade tensions and significant geopolitical uncertainty on several fronts including, but not limited to, the tension and uncertainty arising from the current Russian invasion of Ukraine. Tensions are also growing in our own backyard with concerns expressed about China's intentions in the Pacific region.

One of the unfortunate outcomes of the onset of Covid is that many countries used Covid as an excuse to close their borders, not only to movement of people but also goods and services. There is now a much more nationalistic, and insular approach to world trading arrangements than there was pre-Covid. A number of countries are, or have been, facing general elections where the far right is gaining a foothold leading to the pursuit of increasingly nationalistic policies and protectionism at the expense of more liberal world trading arrangements. This is not good news for countries such as NZ which rely on trade for their economic well-being.

More positively, there is some evidence that inflationary pressures may have peaked or are close to peaking internationally. Commodity prices have come off their highs while the international price of oil is close to the level it was before the Russian invasion of Ukraine. However further interest rate hikes are likely around the world given that many central banks have been rather slow out of the blocks in addressing inflationary pressures.

On the domestic scene, for a range of reasons, businesses and households are increasingly nervous, affecting confidence across the board. The following are some key risks, in no particular order.

### **1. High levels of household debt**

Households have continued to rack up debt both pre- during and post-Covid. Ironically, as debt levels moved up (currently around 170 percent of household income on average), debt servicing costs declined because of historically low interest rates. That is changing and would raise significant concerns should employment levels falter.

### **2. Interest rates on the rise with more to come**

It will take a while for rates to impact on households given that many households have fixed mortgages for 1-2 years. But when a mortgage comes up for review things will become problematic. Many are expecting a doubling in their interest rates when they come to re-finance. Nevertheless, banks, largely, have already factored probable future OCR hikes into their long-term mortgage rates.

### **3. Inflationary expectations remain elevated**

Inflationary expectations are now being built into people's thinking. Not only is the CPI elevated but producer input and business output prices are elevated as well. Inflation is here to stay for a while.

Inflationary pressures are largely the result of supply-side constraints not rampant demand. The Reserve Bank has had limited (if any) ability to influence supply-side constraints (effectively closed borders until recently, and there are also supply chain issues (including shipping), and a labour market arguably exhibiting over full employment.

### **4. Expanding role for the Reserve Bank**

There has recently been quite open criticism of current banking decisions from previous bank Governors and staff and from respected commentators such as Dr Bryce Wilkinson the NZ Initiative – a think tank based in Wellington.

The Reserve Bank's role is expanding almost daily, from the inclusion of employment objectives to potentially addressing climate change and housing within its remit.

The danger from the Reserve Bank having so many balls in the air is that it will no longer concentrate on monetary policy's prime purpose which is to ensure a relatively stable price level over time. This would be unfortunate and could reduce New Zealanders' confidence in the independence and predictability of the Bank's monetary policy settings. To do its principal job (maintaining price stability) is probably asking enough of the Reserve Bank. Even then, the Bank needs mates to help it perform its functions well, at least in regard to the overall cost to the economy. This means developing sound fiscal and regulatory policies.

### **5. Housing prices continue to slide despite high input costs**

House prices have taken a tumble over the last quarter, but the real effect is likely yet to come since many would-be sellers have withdrawn their houses from the market due to a reduction in prices offered. Housing markets are therefore likely to be much stickier compared with other markets, such as equities where prices chop and

change almost on a daily basis.

Downward pressure on house prices is likely to continue for a range of reasons including:

- Net migration is still significantly negative despite a gradual re-opening of the borders. Expectations are for a number of young people to exit the country given the high cost of living (particularly housing) and relatively lower income growth compared with other countries
- Recent tightening of Loan to Value Ratios (LVRs) impacting on credit availability
- Uncertainty about the impact of the Credit Contracts and Consumer Finance Acts and banks' willingness to lend despite some tweaking of the original rules. Many, including the NZ Bankers' Association, consider most people seeking credit won't see much difference as existing requirements mostly remain in place. Customers will still have to provide detailed information about their spending - a more painstaking process with more loan applications declined
- Rapidly rising interest rates pricing many out of the market (with more rises to come)
- Individuals taking a more "wait and see" approach to whether they enter the market with the market slowing suddenly. Fear of missing out (FOMA) has been replaced by Fear of overpaying (FOOP). Over recent months, real estate agents have reported a significant reduction in interest from buyers across the board while buyers now have significantly more options
- Finally, the risk of a recession, at least a technical recession (which is considered two consecutive quarters of negative economic growth) cannot be totally ruled out.

## **6. Significant labour shortages**

This is not helped at all by the Government's ad hoc approach to migration settings. Currently, in net terms we have around 11,000 more people exiting NZ than coming in, that is a net loss of around 11,000 people per annum. This compares with net in-flows approaching 70,000 five years ago.

A number of credible commentators have said that in particular, more young people will be exiting the country due, among other factors, to the high cost of living.

The Government has failed to understand that NZ is part of an international market for labour. Migrant labour is essential to our ability to produce and process products, both in high-skilled and lesser-skilled areas.

Shortage of labour is not only a NZ but an international phenomenon. Rather than front-footing our border opening, the NZ Government has been very cautious, hence references by a number of commentators to NZ still, post-Covid, remaining largely a hermit kingdom.

## **7. The challenges associated with infrastructure investment**

Infrastructure needs have been firmly outlined in the recent NZ Infrastructure Publication – NZ Infrastructure Strategy 2022-25.

There are many issues covered in the document; some key issues include:

- \$90 billion needed to fix water networks
- 115,000 more homes required to fix the current housing crisis
- \$5 billion council infrastructure exposure to sea level rises
- 170% increase needed in electricity generation capacity
- 60% faster increase in infrastructure construction costs than in price rises elsewhere in the economy
- 18,500 shortfall in construction workers by 2024
- 75% chance of an Alpine Fault earthquake by 2070.

While some of these issues are not necessarily of immediate concern, they nevertheless indicate the many and varied risks arising from NZ's current infrastructure deficit.

## **8. Ad hoc legislation with greater government control over use of private assets**

There are legislative proposals coming down the track with the potential to reduce NZ businesses' flexibility and competitiveness and add to the costs and risks facing business activity. For example, recent employment relations initiatives (Fair Pay Agreements in particular) will, if implemented, lead to greater centralisation when it comes to determining wages and conditions. The Government's proposed social insurance scheme will also add further to business costs, particularly if elements of sickness are included in the mix.

To add to this, climate change proposals, while well-intended, have the potential to impose increased costs on businesses and households during the transition phase. Government must remain committed to ensuring NZ businesses and households can meet its international commitment to net carbon emissions' reduction at least

overall cost to the economy.

Moreover, the Government has increasingly moved to control the use of private sector assets for example, the three-waters' proposals and greater control over private contract arrangements e.g., in the electricity sector. This interference will have a negative impact on investment intentions.

NZ's regulatory system needs more checks and balances to ensure serious analysis of the wider implications of legislative decision-making. Checks and balances were particularly needed during Covid when a number of laws and regulations were effectively fast-tracked through Parliament without adequate public consultation or input from experts in specific fields. While many matters fast-tracked might at the time have been considered essential and logical, a number of changes reduced property rights without any form of compensation being considered. There is a risk that if fast-tracking becomes widespread, business and household incentives to invest and build-up assets will be constrained. There must be adequate safeguards against government (local or central) reducing the rights that owners should legitimately expect to have over the use of their property.

In this respect, it is noted that a number of political parties have been calling for an independent review of the Government's response to the Covid-19 pandemic. ACT has certainly been promoting an independent review with a Terms of Reference, which on an initial look, seems to cover the crucial issues pretty well.

*Its terms of reference would include:*

- *The effects of the Government's response on mental health, children and crime*
- *The effects of the Government's response on social cohesion and trust in institutions*
- *The fiscal and economic costs of the Government's response, including the use of unconventional monetary policy*
- *The cost of Quality Adjusted Life Years saved from Covid in comparison with other challenges*
- *Compliance with the Bill of Rights, and whether restrictions were always justifiable in a free and democratic society*
- *Absorption of technologies such as for testing and tracing, into the Government's response*
- *Relationships with private sector partners including technology suppliers, GPs, and community vaccination centres*
- *The quality of advice and the Government's attention to advice from a range of departments other than Health, such as the Ministry of Education and Treasury*
- *The timing of vaccine ordering and distribution.*

With the social and economic upheaval and massive cost of various support measures put in place during Covid, it is only fitting that an independent review (with international experts on board) be undertaken to ensure lessons can be learnt for any similar future event.

All Government (taxpayer) funded projects should require sound cost/benefit analysis given the potential cost of poor decision-making. The Auditor-General, John Ryan, has had some strong words to say regarding the quality and transparency of recent expenditure decisions.

Ryan wrote to the Treasury (4 May 2022) stating he wanted more accountability for how the \$74.1 billion Covid Response and Recovery Fund (CRRF) is being spent. In his letter he noted the fund is so big it will have an impact on Government Finances and debt for years to come.

**Forecasts: Real GDP percent Growth**

	Years Ending		
	Sep 22	Sep 23	Sep 24
<i>Highest</i>	2.5	2.1	1.5
<i>Average</i>	2.3	1.6	1.2
<i>Lowest</i>	2.1	1.1	0.7

*Source: ASB, BNZ, Kiwibank and Westpac*

## **1.2 Monetary Policy – keeping it tight**

The actions of the Reserve Bank over the last two years or so have come in for some strong criticism from respected commentators and also from some previous Reserve Bank governors.

To be fair, the criticism is not necessarily restricted to the Reserve Bank of NZ but is more broadly directed to central banks around the world, both in terms of their expansionist monetary policies during Covid, but more importantly, their slowness in tightening monetary policy when inflationary pressures were building in late 2020 and into 2021 – in NZ, particularly in respect to housing.

A paper by Graeme Wheeler (ex-Reserve Bank Governor of NZ) and Dr Bryce Wilkinson (Senior Research Fellow with the NZ Initiative) stated that with the significant loosening of monetary policy inflation was inevitable:

*"Central banks overdid interest rate cuts and the scale of their quantitative easing, and many continued large asset purchase programs when it was clear from the tightness of the labour market and rise in bond yields from late 2020 that their economies were stronger than forecast and that inflation pressures were starting to build.*

*It was inevitable that the combination of extremely low and often unprecedented interest rates, readily available liquidity, and central bank pressuring of commercial banks to rapidly expand their lending would fuel house price inflation, especially as the size of the housing stock changes very slowly. Between the December quarter 2019 and December quarter 2021 real house prices in the OECD median country increased by 13% - in New Zealand they rose 33%, second only to Turkey"<sup>1</sup>*

Other criticism of the Reserve Bank, but recognising this was government policy, has been the decision to include maximum sustainable employment (however defined), alongside price stability as a key objective of the Reserve Bank Act. More recently, there has been criticism of the Bank's greater interest in climate change issues and housing policy and how these should influence interest rate settings through the Reserve Bank Remit. Although housing affordability and climate change issues are critically important, they are not necessarily within the monetary policy framework under which the Reserve Bank is meant to operate.

Housing affordability has very much to do with overburdensome land supply planning, interest rates, lack of financial options for funding new infrastructure, and a broad range of regulatory requirements restricting what, and how, something should be built rather than requiring reasonable building standards to be met while not adversely affecting others in the community. Recent work from the Housing Technical Working Group (a forum of experts from the Treasury, the Reserve Bank and the Ministry of Housing and Urban Development) essentially confirmed the importance of urban land supply, interest rates and tax as key determinants of housing affordability.

### ***Inflation – expectations remain elevated***

Current inflation (both tradeable and non-tradeable) remains at elevated levels and is now reflected in continued interest rate rises as the Reserve Bank starts on its track of getting inflation under control. Perhaps of concern is that inflationary pressures remain widespread and are not necessarily restricted to one or two sectors. While there are several reasons for the recent hike in inflationary pressure, including, but not limited to, input costs from the tradeables sector, there is a danger of inflationary expectations remaining at elevated levels in the outyears despite the forecasts below showing that as measured by the CPI, inflation should be close to meeting the Reserve Bank's target band by this time next year, and well within the band a year later.

Unfortunately, many business opinion surveys now consistently show inflationary expectations as still high, despite inflation in NZ likely having peaked in the June 2022 quarter. Most respondents are reporting their intention to raise prices over the next year. At the same time, even more respondents are expecting input costs will also rise.

As outlined earlier, inflationary pressure is not only a NZ phenomenon but is being felt more and more around the world as expansionary monetary and fiscal policies bring a growing demand for goods and services, fuelled by historically low interest rates. The boost to oil prices from restrictions on supplies coming out of Russia adds to the inflationary mix along with constraints on the supply of cereal from both Russia and Ukraine.

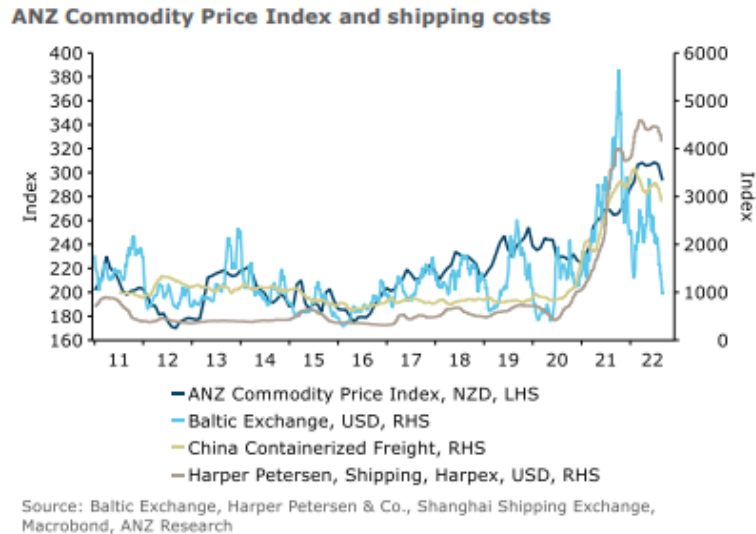
Global shipping prices have eased of late as the export of goods from China has slowed as a consequence of that country's recent major lockdowns. Notwithstanding, the price paid by local NZ exporters continues to be high with refrigerated shipping containers in tight supply and obtaining shipping space in general an ongoing challenge.

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<sup>1</sup> How Central Bank Mistakes After 2019 Led to Inflation – Graeme Wheeler & Bryce Wilkinson (NZ Initiative – July 2022).

Some analysts expect supply chain disruption and shipping issues to remain problematic for at least another year.

Commodity prices and shipping costs continue to trend downwards having been particularly strong in the first half of this year. More recently, commodity prices have tended to trend down, as can be seen from the latest ANZ Commodity Price Index and shipping costs (see below).



The ANZ World Commodity Price Index fell 3.3% in August, with the pace of decline accelerating in the past three months. Once converted into \$NZs, the decline is even more stark with the index falling 4.4 percent and the NZ dollar appreciating 1.1 percent according to the Trade Weighted Index (TWI).

It is also clear that while shipping prices are easing, they still remain well above the pre-pandemic levels. Global shipping demand also appears to be easing but this might imply the global demand for goods and services is falling rather than supply chains having been freed up. Inflationary pressures are certainly impacting on demand, both internationally and domestically.

### **Forecasts: Percent Change in Inflation (CPI)**

	Years Ending		
	Sep 22	Sep 23	Sep 24
Highest	6.6	4.2	2.8
Average	6.5	3.3	2.4
Lowest	6.4	2.7	1.8

*Source: ASB, BNZ, Kiwibank and Westpac*

### **Interest Rates – more hikes to come**

The importance of the Reserve Bank getting on top of inflation should not be underestimated as rather than being transitory, inflation is here to stay for some time. Importantly, it is a world-wide phenomenon, not confined to just a few economies.

Perhaps ironically, while the NZ economy showed solid growth in the June quarter and other indicators such as the manufacturing and the services sectors are showing an uplift according to the BNZ – BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), this might require the Reserve Bank to go harder and faster than previously thought in raising interest rates to suppress inflationary expectations. Most commentators expect the OCR to top out at slightly over 4 percent at the beginning of next year before moderating the year after. However, some banks have recently revised their forecasts in light of recent activity growth and suggest that the OCR will peak at closer to 5 percent. Time will tell.



Inflation is well outside the Reserve Bank's target range and combined with criticism from some quarters that the Bank has not been doing its core job of maintaining price stability that well, there will be pressure on the Bank to deliver, ensuring the inflation beast is well and truly under control before any thought is given to lowering interest rates down the track.

Some commentators have suggested the Reserve Bank should ease off further increases in the OCR as household consumption has taken a hit and many households have not yet faced the full force of interest rate hikes. The pressure on the Bank is likely to remain and the recent uplift in activity is arguably making its job even more difficult than had it moved earlier and decisively to ease interest rates before generalised inflation became an issue. Nevertheless, hindsight is a wonderful thing.

On the other hand, that interest rate increases take around a year to really bite (particularly as many households have short-term mortgages at low interest rates which will only be re-priced near the end of the year) could mean rates might not rise as fast as some predict.

House prices have already fallen substantially in nominal terms, and much more so in real (inflation-adjusted) terms. Some surveys suggest consumers are prepared to cut their spending over the next year and indeed household consumption has already taken a hit. Combined with the high level of household debt, of which around 90 percent is tied directly to housing, any interest rate increase will hit some highly leveraged households hard.

Finally, it should be noted that interest rate rises will not unblock supply chains or increase production where both are desperately needed. Inflationary pressures are largely the result of supply-side constraints (both domestically and internationally), and there is little the Reserve Bank can do through the interest rate mechanism to free up supply chains or increase the labour supply. Sound monetary policy needs to be supported by equally sound fiscal and regulatory policies to avoid forcing monetary policy (interest rates) to do all the hard lifting to suppress inflation.

#### ***Forecasts: Interest Rates (90-day bills)***

	Years ending		
	Sep 22	Sep 23	Sep 24
Highest	3.7	4.2	4.1
Average	3.6	4.1	3.4
Lowest	3.5	4.1	3.1

*Source: ASB, BNZ, Kiwibank and Westpac*

#### ***The NZ dollar – appreciating forecast***

The NZ dollar is likely to be supported over coming months due to factors such as continuing and significant interest rate rises, as outlined in the forecasts below. Notwithstanding, many currencies are fluctuating wildly in light of major changes to international interest rate and current ongoing geopolitical risks.

NZ was one of the first countries to start increasing interest rates, likely tempting investors to seek higher returns here. Nonetheless, other countries are rapidly following suit as central banks around the world try and tame the inflation beast.

Current geopolitical risks also mean there will probably be a move towards safe haven currencies such as the US dollar and Japanese yen combined with more hawkish tones from the US Federal Reserve.

The speed at which world-wide interest rates rise will also have an impact on future currency movements. Central banks are at present reviewing their monetary policy settings and it is likely that in a number of countries, if inflationary pressures increase and persist, interest rate rises will occur sooner than originally intended. Already there is evidence that larger than expected rises have or will be delivered in the US given persistent and embedded inflationary pressures.

**Forecasts: Exchange Rates**

AUD (cents)			
	Sep 22	Sep 23	Sep 24
Highest	0.91	0.93	0.94
Average	0.90	0.91	0.92
Lowest	0.90	0.90	0.90

USD (cents)			
	Sep 22	Sep 23	Sep 24
Highest	0.64	0.70	0.71
Average	0.62	0.66	0.69
Lowest	0.61	0.58	0.66

TWI			
	Sep 22	Sep 23	Sep 24
Highest	71.6	74.5	74.8
Average	70.6	71.5	73.1
Lowest	69.5	66.3	72.4

Source: ASB, BNZ, Kiwibank and Westpac

**1.3 Business activity and confidence – still sickly**

Both business and consumer confidence remain in the sick bay.

The ANZ Business Outlook for August 2022 shows that business confidence lifted slightly (9 points) to -48, while expected own activity improved slightly from -9 to -5. While this is a slight improvement, the levels are similar to those when Covid first struck, resulting in lockdowns in March 2020, and during the Global Financial Crisis (GFC) in 2008.

As widely known, inflationary pressures remain intense with most expecting higher input costs and many continuing to ramp up prices to compensate for the cost increases.

ANZ Business Confidence Index



Source: Macrobond, ANZ Research

Consumer confidence remains very low and there are broad household concerns about the cost of living and the impact of rapidly rising interest rates on disposable incomes. Furthermore, consumer confidence for whatever reason tends to falter when homeowners' most valuable asset (housing) is going backwards. On the other hand, with a very tight labour market and essentially full employment, the ability to service higher mortgage rates has to date generally not been problematic. However, it has been suggested that some investors in housing have been told by their financiers to lower their level of debt. This, in some cases, has resulted in a sell-off. By and large, though, most homeowners have decided to keep their houses and withdraw from the market rather than release

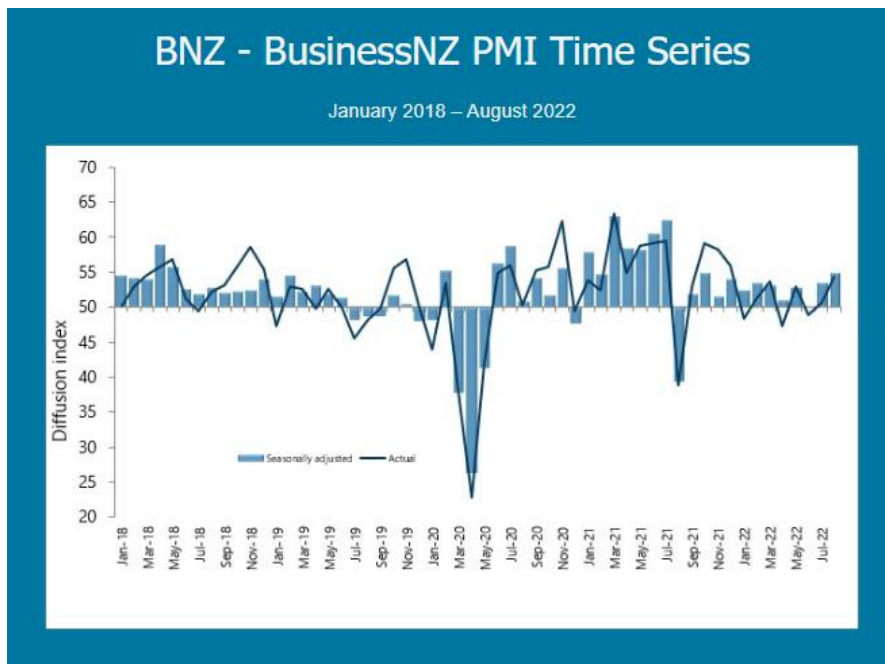
them under fire-sale conditions. To date they have had this option due to the maintenance of full employment. Should employment levels falter then it is a different scenario.

Growth expectations between sectors still differ widely.

New Zealand’s manufacturing sector has made a further step up according to the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for August was 54.9 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining.) This was 1.4 points higher than July, and the highest level of activity since July 2021.

The August result represented the second consecutive month being above the long-term average of 53.1 for the survey.



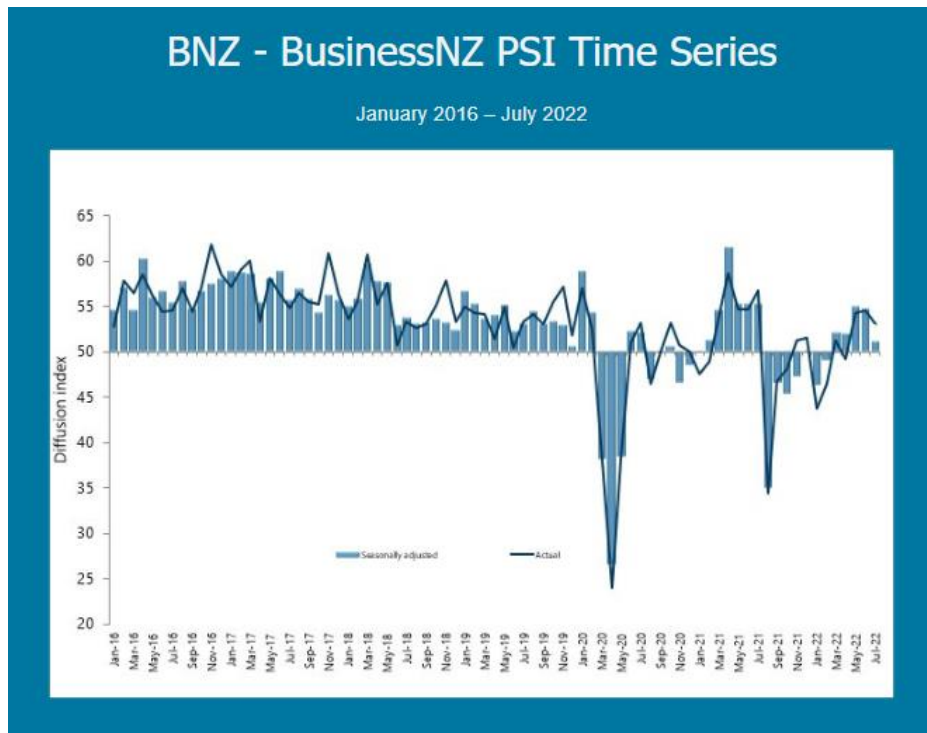
Looking at the sub-index results, the pick-up was influenced by New Orders (59.2) at its highest level since July 2021, along with Production (54.6) at its highest point for 2022. Overall, it was the first time all five sub-index values were in expansion since May 2022.



Despite the lift in overall expansion levels, manufacturers have continued to have a more negative mindset, although the proportion of negative comments was down from 62.1 percent in July to 53.6 percent in August. Staff retention/shortages continue to dominate manufacturers' comments.

Meanwhile activity levels in New Zealand's services sector displayed a sizable uplift in August 2022 according to the BNZ BusinessNZ Performance of Services Index (PSI). This is perhaps not surprising and coincides with moves to open the borders and allow a greater flow of international tourists. Moves to reduce Covid restrictions will help to produce positive results in the months ahead.

The PSI for August was 58.6 (a PSI reading above 50.0 indicates the service sector is generally expanding; below 50.0 that it is declining). This was up 4.2 points from July, and the highest level of activity since April 2021. It was also above the long-term average of 53.6 for the survey.



The August result was the consequence of several factors that led to a substantial increase in the level of overall activity. The two key sub-indexes of New Sales/Activity (67.1) and Orders/Business (66.5) both displayed significant gains, while stocks/inventories (59.6) were at their highest level since November 2019. Although Employment (50.8) remained somewhat lacklustre and Supplier Deliveries (49.6) remained in contraction, the positive position of the other sub-index values was more than enough to push the national result higher.

### Main Indices



In line with the improved main figure, the proportion of positive comments for August (56.3 percent) came out on top, compared with negative comments dominating in July (58.2 percent) and June (59 percent.)

Activity in other sectors remains mixed.

In respect to consumption, consumers and households are coming under increasing strain as inflationary pressures erode disposable income. Higher interest rates are starting to bite given high levels of household debt.

Real disposable incomes are being eroded despite significant wage rises of late. Incomes have risen over 8 percent (mainly due to the higher number of people working full-time rather than part-time) and around 6.5 percent on an hourly basis - still not enough to keep pace with current inflation.

Very high levels of employment and associated low unemployment are the glue holding the household sector together, although households are closing their wallets, as reflected in stagnation in both retail and electronic sales of late.

In respect to construction and housing, an inability to source key inputs - labour and materials - is constraining output, forcing prices upwards and new builds to slow.

While building consents continue to remain at healthy levels, this is not necessarily being reflected in new builds.

A number of building developers have stated that because of the shortage of materials and the costs associated with new builds, alongside a reduction in demand for existing houses, there is likely to be a significant slow-down, at least in the residential sector.

As the market cools, a number of developers are using innovative techniques to try and maintain interest in town houses. Some have even offered to pay mortgages for a year for new buyers – with obvious conditions attached.

As stated earlier, house prices have taken a tumble over the last quarter for a range of reasons with the downward pressure on prices likely to continue for some time yet.

While many commentators expect a reduction of around 20 percent from the highs reached late last year, when converted into real terms (inflation-adjusted) the drop will more likely be 30 percent. Despite this likelihood, house prices are still significantly higher than they were pre-Covid, but this will be of little comfort for those who bought at the height of the market and have to sell for whatever reason.

The agricultural sector, after reasonably healthy returns over the last few years, is facing pressure from the hit international commodity prices are taking as China comes out of hard Covid lockdowns. Continuing supply chain issues are badly affecting input costs, such as the cost of fertiliser, with the sector also facing labour shortages.

A recent Federated Farmers Farm Confidence Survey (July 2022) shows that for the first time in the survey's history, a net 0.5 percent of respondents expect production to decline over the next 12 months.

There are several reasons for this – higher input costs, lack of labour and greater government legislative initiatives (such as environmental legislation) which are impacting on profitability and driving up costs.

Other sectors including retail, tourism and hospitality, continue to do it tough. Consumers are starting to shut their wallets in response to rising interest rates and increased costs along with a general drop in real (inflation-adjusted) household income, reflected in the significant drop in consumer confidence demonstrated in a number of recent confidence surveys.

Borders are finally reopening but supply-side constraints are still weighing heavily on businesses while acute labour shortages are seriously affecting output, including tourism, as many businesses simply do not have the staff to provide the kind of service most New Zealanders, let alone foreign tourists, demand. Drawing attention to labour shortages by putting up signs saying bear with us and be kind will not cut the mustard with discerning tourists not prepared to pay inflated prices for inferior service.

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#### **1.4 Labour market – extremely tight**

The number one problem facing businesses in NZ is the lack of workers. Shortage of labour is currently NZ's biggest constraint on economic growth as businesses try and shuffle available labour around to maximise production.

While it is hard to determine how much output is being forfeited simply because of a labour shortage, in some industries and regions the impact is likely significant. For example, in tourist towns such as Queenstown, numerous restaurants are shut or only open at limited times due principally to a lack of available staff. And this despite the ski season being in full swing with a number of overseas tourists, principally Australians, walking the streets.

A recent survey of Employers and Manufacturers (EMA) members showed 100 percent of respondents struggling to fill vacancies. With unemployment as measured by the Household Labour Force Survey (HLFS) at just over 3 percent, this indicates a pool of domestic labour as basically non-existent.

Also, a number of surveys are showing there is an expectation of net migration deficits for some time to come, as younger people seek opportunities offshore. Our slowness in opening our borders to new migrants has seen a number of countries steal our lunch – including Australia – from under our nose.

- Up to 125 thousand working-age NZers will emigrate this year (says MBIE).
- We are in negative net migration now, and there will be a net outflow of 20,000 people this year (says Kiwibank).

Although education and upskilling are the way to get more staff in the longer term, they are not an answer right now. Right now, we need to bring in more people from overseas.

The Government is currently implementing an 'immigration rebalance' to reduce the number of low-skilled migrants while at the same time attracting more high-skilled migrants. By contrast, around 11,000 employers have applied for accreditation to bring in over 50,000 migrant workers. But many countries have already stolen a march on us given the bureaucratic and ad hoc nature of current immigration settings.

At the end of the day, labour, like capital, is now highly mobile, and individuals will be likely to gravitate to destinations where they are made most welcome (i.e. where investment returns are most attractive). NZ must compete with the rest of the world for labour and ad hoc bureaucratic responses are not the way forward.

#### **Forecasts: Unemployment percentage (HLFS)**

	Quarter		
	Sep 22	Sep 23	Sep 24
Highest	3.3	4.2	5.1
Average	3.3	3.9	4.5
Lowest	3.2	3.7	4.1

*Source: ASB, BNZ, Kiwibank and Westpac*

#### **Labour Costs – rising in the near term**

It is not surprising that with NZ's extremely tight labour market, forecasts below show some upward movement in labour costs.

Forecasts of aggregate changes over the next couple of years tend to mask significant gains for specific sectors and for individuals within sectors. The inability to source skilled immigrants is seeing some job-hopping as businesses compete to obtain required expertise from a diminished pool.

For some, particularly temporary workers on short-term contracts, salary and pay rates have in many cases shot up significantly as businesses compete for resources to ensure they are able to remain open. This is obviously affecting input costs, adding further inflationary pressure which will ultimately be passed on to consumers and households.

The impact of impending regulatory cost increases also needs to be thrown into the mix of factors driving labour cost changes. Overall, a number of labour market reforms (some proposed and some enacted) might result in increased wage rates for some but will also mean reduced job opportunities, if not actual job loss, for others. The Government must recognise the need for flexible labour market practices allowing individuals and companies to agree arrangements best suited to their individual circumstances. Moves back to more centralised wage bargaining (FPAs) do not take account of the unique pressures facing individual companies in particular markets. The risk remains of people exiting the labour market and becoming dependent on the state.

***Forecasts: Labour cost index percentage change (wages and salaries)***

	Years Ending		
	Sep 22	Sep 23	Sep 24
Highest	3.9	4.8	4.5
Average	3.7	4.4	3.6
Lowest	3.5	3.8	2.1

*Source: ASB, BNZ, Kiwibank and Westpac*