BUSINESS NZ

PLANNING FORECAST

BusinessNZ

DECEMBER 2022

NZ Economy: Storm clouds building

Executive Summary

The NZ economy faces significant headwinds over the forecast period out to December 2024 with a range of economic forecasting agencies, including the Treasury and Reserve Bank, predicting the economy will go into a shallow recession by the second half of next year.

Although on the surface everything might look cosy, with currently historically low levels of unemployment, modest Crown debt by international standards, and commodity prices still holding up reasonably well, a number of areas will continue to provide the Government, businesses and individuals with cause for concern.

Inflation (both tradeable and non-tradeable) remains well outside the Reserve Bank's target range of 1-3 percent, but perhaps more concerning is that inflationary expectations are now entrenched. This will force the Reserve Bank to crank up interest rates further to ensure its credibility does not go completely out the window. It is concerning that several surveys point to concerns about the Bank's ability to put the inflation genie back in the bottle.

To be fair to the Bank, it hasn't been helped in its belated fight against inflation by retaining far too loose monetary policy settings for far too long (now more or less admitted) while some hard to fathom Government policy decisions have not helped. This includes an inability to get to grips with the need for a significant inflow of migrants to produce the goods and services the NZ economy requires (although this changed just as this went to print with the increased number of jobs on the green list but this U-turn is very much too little too late). A number of regulatory measures are also increasing costs and potentially creating greater uncertainty for business.

But domestic factors are not the sole contributors to inflationary pressure; the continuing Russian invasion of Ukraine and associated supply constraints are not only affecting Europe but also in terms of input costs, particularly in respect to New Zealand's agricultural sector. Here, input cost pressures are significant.

Interest rate hikes still have some way to go so many households will not feel their major effects until mortgages are re-priced into next year. Then, rates payable will likely double from those many have become accustomed to over the past couple of years. Combined with elevated levels of household debt, increased mortgage payments will potentially put significant pressure on budgets, particularly if employment falters down the track, given that Treasury in their recent Economic and Fiscal Update considers that unemployment might increases by around 50,000 as the recession hits. Disposable incomes are also increasingly under pressure and combined with an extremely tight labour market, could see the beginning of a wage/price spiral.

On the international scene, most international forecasting agencies have downgraded global economic growth for this year and beyond. On several fronts there are still simmering trade tensions together with significant geopolitical uncertainty including, but not limited to, the current Russian invasion of Ukraine. Tensions are also rising in our own backyard with concerns expressed about China's intentions in the Pacific region.

Meanwhile China's hard line on Covid elimination appears to have floundered with reports of an easing of restrictions leading to widespread infections is concerning. With China the second largest economy in the world behind the US, and the fact that New Zealand relies on China to take a large amount of our agricultural produce - we need it to do well. Nevertheless, covid elimination through draconian restrictions and lockdowns was never a viable economic strategy moving forward and has rightly been shelved.

HIGHLIGHTS

The global economic outlook has deteriorated with both continuing geopolitical risks and supply chain disruption. Central banks are trying to contain inflationary pressures through a continued tightening of monetary policy - although there is some evidence of inflationary pressures abating in some key markets e.g in the US, while international oil prices have dived of late largely on the back of recessionary fears.

The BusinessNZ Economic Conditions Index, a compilation of NZ's major economic indicators, sits at 0 for the December quarter, down 6 on the previous quarter and down 1 on a year ago. Continuing low levels of business and consumer confidence, combined with entrenched inflationary expectations and rising interest rates, are continuing to take a toll on the index.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) show mixed fortunes, with the PMI falling into negative territory for the second successive quarter while the PSI has been firmly in positive territory now for a number of months - not unexpected following the reopening of the border earlier this year.

The agricultural sector, following reasonably healthy returns over the last few years, is facing pressure from the hit international commodity prices are taking as China continues to react to the presence of Covid. Supply chain issues are still affecting input costs, such as the cost of fertilizer, with the sector also facing acute labour shortages which is impacting on output.

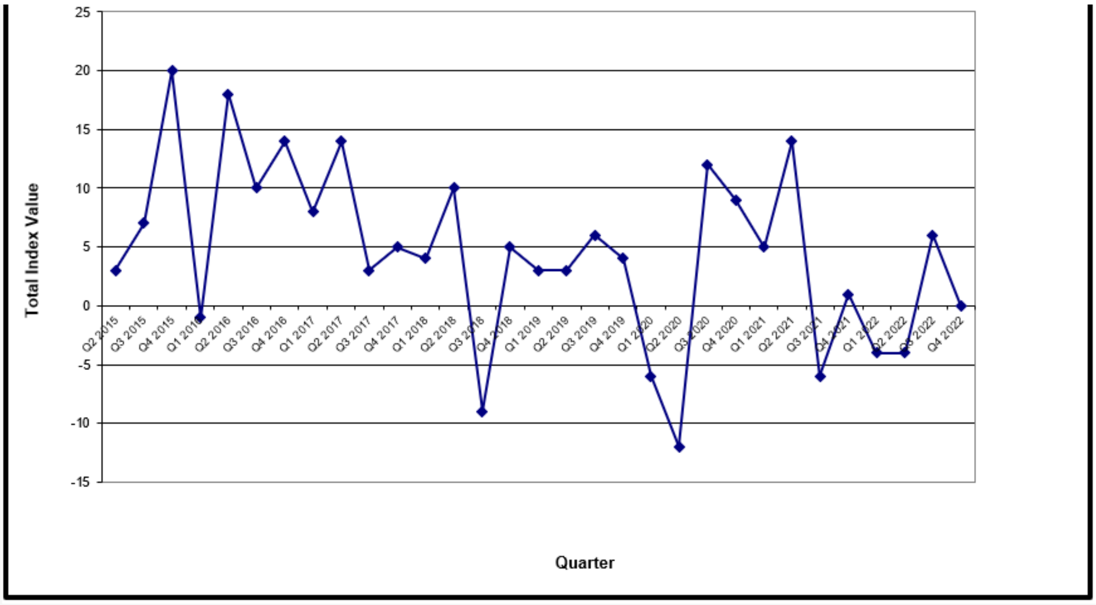
Consumers and households are coming under increasing pressure as inflation and associated higher interest rates start to bite. Meanwhile the Reserve Bank faces the difficult task of trying to suppress inflation while the main problem is on the supply side, reflecting resource availability and continued labour constraints almost across all sectors of the economy.

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 0 for the December 2022 quarter, down 6 on the previous quarter and down 1 on a year ago. While labour market indices remain solid, rising inflationary expectations, higher interest rates and continued low levels of both business and consumer confidence are holding the index down [1]

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

<u>Economic growth/performance indicators</u> sit at 3 for the December 2022 quarter, the same as the previous quarter and up 2 on a year ago. Commodity prices have generally softened lately while reduced demand from China following its strategy until recently of Covid elimination is a continuing concern as China is NZ's largest trading partner.

<u>Monetary policy/pricing indicators</u> sit at -6 for the December 2022 quarter, the same as the previous quarter and down 6 on 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 interest rates are yet to impact fully on businesses and households.

<u>Business/consumer confidence indicators</u> sit at -3 for the December 2022 quarter, down 8 on the previous quarter and down 4 on a year ago. Both business and consumer confidence indicators remain in the cellar with input costs and continued supply chain difficulties affecting investment intentions. High levels of household debt, rising interest rates, and sustained inflationary pressures are having a negative effect on confidence. Crime, ramraids included, is an additional factor affecting both business and consumer confidence as they undertake daily activities.

<u>Labour market indicators</u> sit at 6 for the December 2022 quarter, up 2 on the previous quarter and up 7 on a year ago. While the unemployment rate remains at an historic low, rising inflationary pressures are eroding disposable incomes, as are significant interest rate rises. There are acute staff shortages across the board, a continuing constraint on growth given limited, although improving, migration inflows.

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[1] 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 Dec quarter 2022 are estimates based on available information to date.

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

1.1 Economic growth (GDP) – Slow-down

Both the international and domestic economies are facing significant headwinds with a much softer economic growth outlook evidenced by both international and domestic forecasting agencies.

The international outlook is still dominated by concerns about the continuing Russian invasion of Ukraine (with no end in sight), while a number of other geopolitical tensions remain.

The latest International Monetary Fund (IMF) World Economic Outlook (October 2022) states that the global economy is experiencing several turbulent challenges, including:

- inflation higher than seen in several decades,
- tightening financial conditions in most regions,
- Russia's invasion of Ukraine,
- the lingering COVID-19 pandemic,
- further pandemic-related supply-side disruptions, particularly in China.

According to the IMF: *"Global growth is forecast to slow from 6.0 percent in 2021 to 3.2 percent in 2022 and 2.7 percent in 2023. This is the weakest growth profile since 2001 except for the global financial crisis and the acute phase of the COVID-19 pandemic and reflects significant slowdowns for the largest economies: a US GDP contraction in the first half of 2022, a euro area contraction in the second half of 2022, and prolonged COVID-19 outbreaks and lockdowns in China with a growing property sector crisis. About a third of the world economy faces two consecutive quarters of negative growth."*

Meanwhile global inflation is forecast to rise from 4.7 percent in 2021 to 8.8 percent in 2022 but to decline to 6.5 percent in 2023 and to 4.1 percent by 2024. Energy and food price shocks will continue with the balance of risks on the downside.

The IMF also pointed out the importance of central banks getting on top of inflation to ensure inflationary expectations do not become entrenched (entrenchment would be problematic for future wage and price setting behaviour) and of targeted near-term support to alleviate the burden of the cost-of-living-crisis felt across the globe.

On the domestic front, while on the surface everything might look relatively cosy with historically low levels of unemployment, modest Crown debt (although rising) and commodity prices still holding up reasonably well, certain areas will provide the Government, businesses, and individuals with cause for concern. Perhaps not unexpectedly, the list is reasonably long.

- ***Global outlook – impact on NZ supply chains and input costs***

As a nation highly dependent on global trade for our economic well-being, NZ is not immune from events overseas.

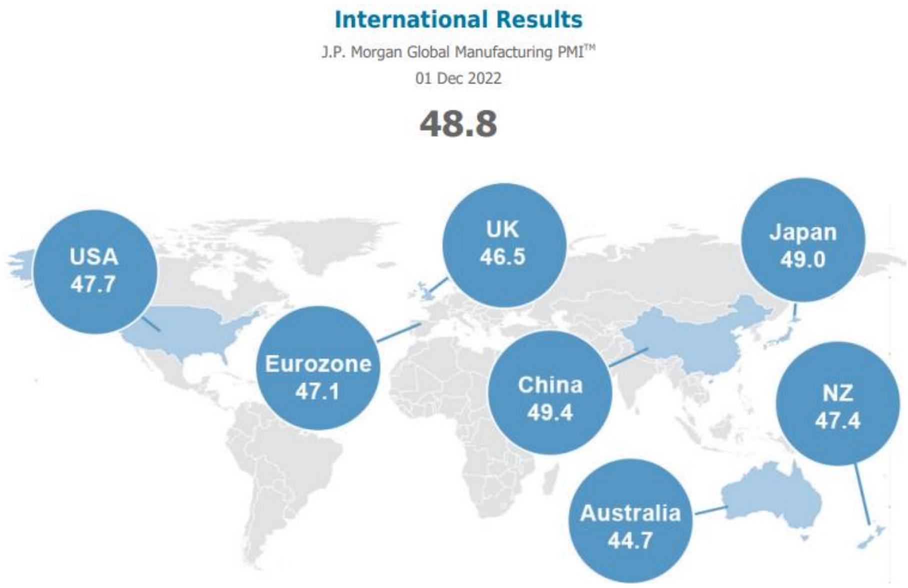
Several factors in the current global environment are not necessarily in NZ's best interests.

First, the ongoing Russian invasion of Ukraine and countries' response in restricting Russian imports of oil, are having an ongoing effect on global energy prices, more particularly in Europe but also a flow-on effect for NZ in terms of higher input costs for key sectors such as agriculture, particularly in respect to fertilizer and transport. Belatedly, oil prices have started to come down significantly as global demand eases as recessionary fears gather pace.

While global shipping costs have pulled back significantly since the chaos a couple of years ago, there are still significant uncertainties over the timely delivery of goods into and out of NZ.

Second, ongoing geopolitical tensions and China's (until recently) hardline approach to eliminating Covid-19 has affected both supply chains and demand for product. In this respect, given China is NZ's biggest trading partner, it is in NZ's interests for the country to be prosperous and growing so there are positive returns for commodities exported from NZ.

Meanwhile, the JP Morgan Global Manufacturing PMI shows that many countries' manufacturing sectors are now in contraction (with a reading above 50.0 implying expansion – below 50.0 a contraction).



- ***Labour shortages***

The number one problem facing businesses in NZ is still a 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.

It is hard to determine how much output is being forfeited simply because of a labour shortage but in some industries and regions the impact is likely significant. Net migration inflows have turned positive only in the last few months although there is still a net outflow on an annual basis. Our slowness in opening our borders to new migrants has seen more than one country – including Australia – steal our lunch from under our nose.

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; ad hoc bureaucratic responses are not the way forward.

- ***Inflation and inflationary expectations***

Inflation, and much more importantly, inflationary expectations, are well and truly entrenched as evidenced by many surveys.

Inflation embedding itself in both business and consumer thinking is problematic and could result in the return of the wage price spiral not seen in NZ since the 1970s and 1980s.

The Reserve Bank continued its very significant monetary easing over 2020 and 2021 and now the consequences are being felt as the Bank tries to put the inflation genie back in the bottle.

To be fair to the Reserve Bank, it has not been helped by some government policy decisions which are proving pretty hard to fathom – three being the continued spend up, adding to the inflationary fire, the inability to get to grips with the need to significant inflows of migrants in order to produce the goods and services the NZ economy requires, and a number of regulatory measures which will increase costs both to businesses and households.

Some countries are already easing off further interest rate rises, or at least (like the US Federal Reserve and the Reserve Bank of Australia), are signaling a much slower path. Meanwhile, the Reserve Bank is effectively signaling further sharp rises in interest rates well into next year. Some might ask why?

The Bank is likely to have a range of reasons for now taking a hardline on inflation.

First, inflation having got away on the Bank (and with inflationary expectations still rising), it is crucial to stomp hard on it since by not moving hard now, future pain might be more pronounced.

Second, there might be a little bit of gamesmanship going on in the form of the Reserve Bank playing big bad cop to try and convince the public of the need to cut back on aggregate spending (which is ultimately the Reserve Bank's goal.)

Third, including the maximum sustainable employment objective in the Reserve Bank Act in 2019 (alongside its long-established price stability objective), might have made the Bank's job a little harder, trying to juggle potentially conflicting aims. BusinessNZ and many other business organisations cautioned against giving the Reserve Bank multiple objectives and in this respect, it is pleasing that at a first glance, with its new remit, the Bank appears to have pulled back from covering issues such as equity, housing, and climate change.

- ***Rising Interest Rates***

High levels of household debt and rising interest rates are problematic for many households and businesses, particularly small businesses whose owners often borrow on their houses to fund business growth.

Ironically, while household debt has continued to climb to currently around 174 percent of household income, until recently debt servicing costs have continued to decline (to around 5% of household income at the end of 2021.) Since then, servicing costs have started to ramp up although they have some way to go before the Reserve Bank decides to pause further interest rate rises.

Given around half of all current mortgages are still on fixed terms with a 2 or 3 in front of them, the impact of the Reserve Bank's reasonably rapid raising of the OCR (admittedly from an historically extremely low base) will start to bite when mortgages come up for renewal in the next 6 months or so.

Aggregate house prices have continued to decline (although wide regional variations remain) but to date the level of mortgagee sales has been low although anecdotally, it is understood some banks have come under pressure to ease the burden on some mortgage holders by using interest only mortgages and the like.

The glue holding the market together at this stage is the extremely high level of employment. If employment falters significantly, then highly geared house owners could come under pressure. To date, few people appear to have negative equity in their houses, but this will be tested only if incomes decline e.g., through a significant bump in unemployment.

Some established households went through the Global Financial Crisis (GFC) and might therefore have a history of being able to adapt to tougher interest rates; the real risk lies with those who bought with little capital over 2021 when the fear of missing out (FOMO) was at its peak. This will be the group under pressure should employment falter.

- ***Impact on disposable incomes***

The recipe that will see disposable incomes coming under significant pressure will be the high the levels of aggregate household debt mentioned above (currently around 174 percent of household income), and higher interest rates combined with inflation (currently over 7 percent.)

The cost-the-living-crisis, as some like to put it, is not only an issue for many New Zealanders, but as the International Monetary Fund (IMF) stated in its latest Economic Outlook, it is an issue across the world.

The Government has tried to ease some of the pressures on individual households and businesses through reducing fuel taxes and subsidising public transport, but these are simply stop-gap measures, poorly targeted given their universal coverage. Arguably, they work against some of the Government's thinking in other areas, such as encouraging people to pay the full cost associated with transport and transport-related externalities.

It is noted that the Government has recently stated that these subsidies will be phased out by the end of March 2022.

- ***Low levels of Business and Consumer Confidence***

One of the key factors driving investment and growth is business and consumers having the confidence to invest. Currently both business and consumer confidence are in the cellar.

There are some obvious and perhaps not so obvious reasons for this.

From a business perspective, labour shortages ae imposing significant pressure. Many businesses must be extremely innovative to ensure maximum output given the constrained resource base they are working with.

Second, input costs show no signs of abating and the ability to continue to pass such costs on is constrained as households and businesses face lower disposable incomes.

Third, the regulatory environment is not particularly conducive to investment activities with the Government, rightly or wrongly, introducing a significant number of legislative changes that will impact on business cost structures and flexibility to operate.

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 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. The 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. Penalising domestic suppliers of goods and services makes no sense if businesses and households have to purchase essential inputs from offshore which may well not be subject to carbon emission charges.

There is also widespread concern in the business community about the speed of legislative change. Two specific issues are of concern here. First, the fundamental question must be asked as whether regulatory intervention is required in the first place (i.e does it have net benefits), and second, even if the legislative objective might seem superficially appealing, the devil can be in the detail if legislation is rushed through without proper scrutiny and debate.

Without going into too much detail, the recent debacle over the Three Waters reforms and the possibility of entrenchment to prevent future water privatisation (which the Government thankfully pulled back from) is an example of why the Government needs to take a deep breath and slow-down its reform agenda. Irrespective of whether business supports a particular policy proposal, the Government needs to ensure what is proposed is at least workable in practice and won't require further tinkering down the track. Meanwhile, the Government and various related departments continue to put out public discussion/consultation documents on major issues with short turn around periods for public submissions making it very hard for the business community and others to provide comprehensive responses given the sheer weight of input required.

- ***Regulatory Responsibility***

Given the above concerns, it is evident 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 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, some 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.

There is no obvious silver bullet but potentially, a range of mechanisms which could be explored to improve the quality of regulatory processes.

An option which BusinessNZ and several other business organisations have promoted (and is also being promoted by the ACT Party) is the possibility of a Regulatory Responsibility/Standards Act.

Such an Act would identify a set of drafting principles for responsible regulation that all legislation should be consistent with. Regulation would be defined to include:

- Acts of Parliament,
- Legislative instruments (regulations),
- Tertiary legislation (made by a lawmaker other than parliament.)

The principles of such an Act could include:

- the rule of law,
- the protection of individual liberties,
- the protection of property rights,
- the creation of taxes and charges,
- the role of the courts,
- the review of administrative decisions, and
- good law-making.

- ***Crime and security***

Finally, an issue increasingly causing distress to both businesses and households is the growing crime rate, particularly brazen activities associated with ramraids and indeed, assault and theft in the middle of the day.

In a recent Stuff NowNext Local Survey, the level of general happiness was at a low point.

A key concern for around 67 percent of respondents from across the country was the cost of living, higher than for any other issue, and up from the August survey.

The second biggest worry nationwide was housing affordability, although that was down from three months ago to 48 percent.

Quite astoundingly though was worry about crime and safety, which rose sharply to 43 percent from 26 percent, making it respondents' third biggest concern. Crime was a top concern for 54 percent of Aucklanders taking part in the survey.

Several businesses have stated they have or are contemplating either selling or closing down, while others are now having difficultly securing insurance at reasonable rates given how often their business has been robbed, with massive associated infrastructure repair costs in some cases.

Crimes and ramraids are not isolated events but are starting to impact on the viability of some businesses as households think twice about going out, particularly to our major cities' CBDs. Trade and business activity will suffer if consumers do not feel safe going about their daily activities, largely taken for granted until recently.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 22	Dec 23	Dec 24
Highest	2.6	1.7	1.6
Average	2.5	1.3	0.7
Lowest	2.4	1.0	0.1

Source: BNZ, Kiwibank and Westpac

1.2 Monetary Policy – tightening the screws

The Reserve Bank has come in for strong criticism recently from respected commentators and from some previous Reserve Bank governors.

The criticism has been targeted both in terms of the Bank's expansionist monetary policies during Covid, but more importantly, its slowness in tightening monetary policy when inflationary pressures were building into 2021, particularly in respect to housing.

Other criticisms have been of the Reserve Bank's dual mandate (price stability and maximum sustainable employment – yet to be defined, a government not Reserve Bank policy), while there has been concern about the Bank's greater interest in issues outside its core role, such as climate and housing policy, and how these should influence interest rate settings through the Bank's remit.

In an internal review of its actions over the period 2017 – 2022, the Reserve Bank said its *"formulation and implementation of monetary policy over the last five years is consistent with the objectives set out in the remit."*

This is an interesting assessment to say the least given that inflation is currently over 7 percent, and the unemployment rate is at an historic low of just over 3 percent.

The RB did however say that *"while monetary policy decisions have been consistent with the economic data available at the time with the benefit of hindsight, it appears that monetary policy should have been tightened earlier in 2021".* This is hardly an admission that any serious errors of judgment were made despite indicators showing the impact of Covid in late 2020 was not as bad as first thought or in early 2021, when house prices were starting to get out of control.

The RB did however knowledge areas for improvement, including the need to develop broader insights into the impact of supply shocks on inflation, and to develop new sources of data for economic monitoring, along with the need for a better measure of what "neutral" interest rates look like. These are all good points.

Inflation – expectations remain elevated

Current inflation (both tradeable and non-tradeable) remains at elevated levels and well outside the Reserve Bank's target band of 1-3 percent. Perhaps more importantly, is that inflationary pressures remain widespread and are not necessarily restricted to one or two sectors. Meanwhile inflationary expectations also remain elevated, concerning given they will flow on into business and household investment decisions alongside pricing behaviour.

Unfortunately, many business opinion surveys now consistently show inflationary expectations as still high with some debate as to whether inflation has peaked. Most respondents are reporting their intention to raise prices over the next year and even more respondents are expecting input costs will also rise.

Businesses are facing significant input cost rises for goods and services but as well, the shortage of labour is constraining activity and their ability to provide in a timely manner the goods and services other businesses demand. Not unexpectedly, labour costs are rising because it is not only very difficult to access migrant labour but people are job hopping, in some cases, to substantially increase their salaries.

Unfortunately, shortages of labour and supply constraints mean the cost of production is likely to increase while the need for businesses to find innovative ways to try and keep up production could impact on overall workforce productivity hence further adding to costs.

However, there is some light on the horizon. Global shipping prices have eased of late as the export of goods from China has slowed because of that country's continuing covid challenges. 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.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Dec 22	Dec 23	Dec 24
Highest	7.4	4.3	2.4
Average	7.0	3.6	2.2
Lowest	6.6	3.1	1.9

Source: BNZ, Kiwibank and Westpac

Interest Rates – still more rises to come

Further rises in the Official Cash Rate (OCR) are expected next year as the Reserve Bank has indicated the OCR will likely peak at around 5.5 percent by the middle of the year (currently it is 4.25 percent.)

This means businesses and homeowners are likely to be faced with more substantial interest rate rises. Major banks by and large have already increased floating rates in response to the most recent OCR rise and there is a further expectation rises in bank borrowing costs are on their way.

Some commentators have suggested there is a risk of the RB overdoing it in respect to further interest rate rises, and the associated risks of a hard landing. They indicate a number of countries, including the US Federal Reserve and the RBA in Australia, have hinted they might take a slowly, slowly approach to further interest rate hikes with their peak rates expected to be less than NZ's – despite both NZ and Australia having similar inflation rates.

The RB's belated willingness to do what it takes to get the inflation genie back in the bottle – suggesting a terminal rate for the OCR of around 5.5 percent is on the cards next year - is at least from the Bank's point of view, having a positive effect on the NZ exchange rate. This essentially means tradable's' inflation is likely to be more subdued than has been the case recently, although on the other side of the coin, there will be an impact on export returns when converted back into NZ dollars.

The difficulty for the RB though, is that because inflation has arguably escaped its clutches (i.e., well outside the target band of 1-3 percent), it will need to keep its foot firmly on the brake or risk undermining its credibility as an institution.

The RB arguably has not helped itself by dabbling in areas outside its core mandate of price stability (such as climate change, housing, and equity) which might confuse the public about its core role.

Just as when sports coaches and captains of sports teams talk about team success, there is often an emphasis placed on doing core roles well. Generally, the results will come after that.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Dec 22	Dec 23	Dec 24
Highest	4.7	5.6	4.1
Average	4.6	5.4	3.9
Lowest	4.5	5.3	3.8

Source: BNZ, Kiwibank and Westpac

The NZ dollar – roller coaster ride

The NZ dollar bounced around substantially over recent months, having dropped significantly against most major trading partners. It then made a swift recovery, on the back of further interest rate rises – with more to come.

At the time of writing, the NZ dollar has continued to rebound against both the US and Australian dollars.

Currently, the $NZ is around US$0.64. While it remains around 6 percent below where it started the year and marginally below its long-term average of US$0.66, the NZ dollar has rallied 16.5 percent against the $US since falling to a 13-year low of US$0.55 a couple of months ago. This is partly due to an improvement in risk sentiment generally and more resolute comments from the RB of its determination to crank up the OCR and do whatever it takes to get inflation back under control.

Against the $Australian, the $NZ has also rallied. As noted above, this may be due to the RBA taking a much more considered and calm approach to raising interest rates, despite both countries having relatively similar inflation paths overall. With higher interest rates expected in NZ, the more attractive the $NZ will become, all other things being equal.

Further out, the forecasts below show the $NZ is likely to appreciate further in respect to the US dollar while the Trade-weighted Index (TWI) is expected to remain relatively constant.

As stated above, the $NZ has fluctuated quite significantly over this year and it should be noted that predicting the future in respect to currency movements is fraught, particularly when there is so much global uncertainty and geopolitical tension around the world which are likely to persist for some time.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 22	Dec 23	Dec 24
Highest	0.94	0.93	0.94
Average	0.93	0.92	0.91
Lowest	0.93	0.91	0.88

USD (cents)			
	Dec 22	Dec 23	Dec 24
Highest	0.65	0.68	0.69
Average	0.64	0.63	0.67
Lowest	0.63	0.55	0.63

TWI			
	Dec 22	Dec 23	Dec 24
Highest	73.5	73.5	74.5
Average	73.2	72.5	72.9
Lowest	73.0	71.0	71.4

Source: BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – cellar dwellers

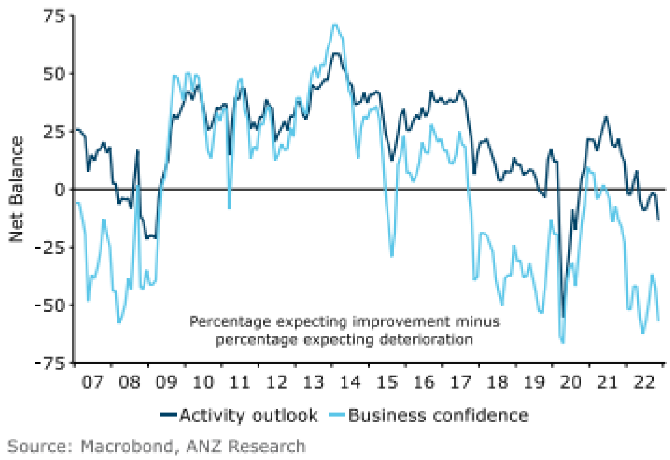
Several surveys show that both business and consumer confidence remain at historically very low levels with little upside in sight.

Low levels of confidence are evident from the latest ANZ Business Outlook (see below) with key points being:

- Business confidence fell 14 points in November to -57,
- Expected own activity fell 11 points to -14 (only 8 points shy of 2009 lows),
- Activity indicators fell,
- Residential construction intentions tanked,
- Employment intentions were negative for the first time since Oct 2020,
- Inflation pressures remain intense, though pricing intentions eased.

Overall, not a pretty picture. But perhaps most concerning is firms own activity outlook which tends to closely mirror future economic growth. Here the news is not good. Firms own activity outlook are at their lowest level since the Global Financial Crisis (GFC) – if we exclude the extremely sharp (but short-lived) drop in confidence as a result of Covid first hitting our shores in early 2020.

ANZ Business Confidence Index and ANZ Own Activity Index



Both households and individuals are equally pessimistic about the next 12 months or so.

Kiwis are feeling more pessimistic about the economy's immediate future than at any other point in the last decade, according to a recent 1News Kantar Public Poll.

Respondents were asked: "Do you think during the next 12 months the economy will be in a better state than at present, or in a worse state?" Of those polled, 18 percent responded "better", 21 percent responded "same" and a massive 61 percent responded "worse".

This is a significant shift since the last poll in September, when 36 percent responded "better" and 38 percent responded "worse".

Meanwhile the ANZ-Roy Morgan Consumer Confidence Index shows consumer confidence falling 5 points in November to 80.7.

The proportion of people who believe it is a good time to buy a major household item fell 9 points to -31 percent.

Inflation expectations lifted to 5.3 percent up from 5.0 percent last month.

ANZ-Roy Morgan Consumer Confidence

These results are perhaps not unexpected given that despite an extremely tight labour market with very low levels of unemployment by historic standards, consumers are under the pump with the cost-of-living crisis.

Real disposable incomes are under pressure, increasing wages and salaries notwithstanding, as inflationary pressures eat away into net incomes.

Interest rate rises are going to be particularly problematic for those households who bought at the peak of the housing market in 2021, and now face the prospect of having negative equity in their property as house prices fall substantially in nominal terms – but much more so in real terms.

The Real Estate Institute of NZ (REINZ) in its latest survey and Tony Alexander Real Estate Survey (Dec 6, 2022) show the following key results:

- The Reserve Bank's cash rate increase and words of warning about recession have had an immediate impact on the real estate market,
- Agents report new downward pressure on average sales prices,
- First home buyers have pulled back but remain much more interested in making a purchase than investors,
- Buyers remain concerned about high interest rates, access to finance, and prices falling after buying.

It is unfortunate that there is certainly likely to be much more pain to come as the lagged effect of interest rate hikes starts to have an effect next year once fixed rate mortgages come up for renewal. There is also the likelihood of an unemployment rise – an inevitable outcome according to the RB, if inflation is to be got back under control. Overall, not a particularly nice outlook.

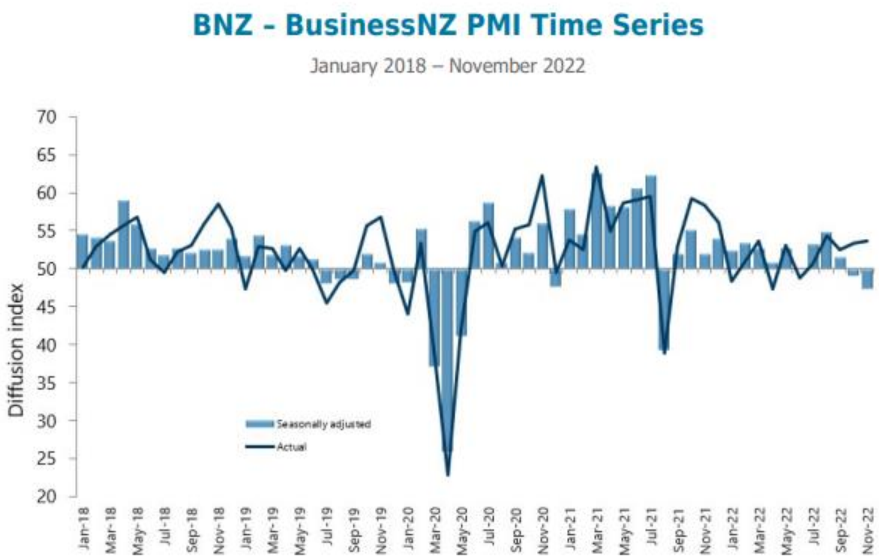
The other factor which might be impacting on consumer confidence is the fact that KiwiSaver and broader equities have taken a hammering over the last year and, along with the reduction in house prices, have resulted in many households' net worth taking a rapid fall – at least in terms of a paper loss, if not a real loss for those forced to sell prematurely.

For business activity, signals are mixed. Some sectors are still performing well while others are under the pump.

A common theme across all industries and sectors is that labour is in short supply while input costs continue to ratchet up.

New Zealand's manufacturing sector saw deeper levels of contraction in November, according to the latest BNZ - BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for November was 47.4 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 1.7 points lower than October, and the first time the PMI has shown consecutive months of contraction since the first nationwide lockdown in 2020.



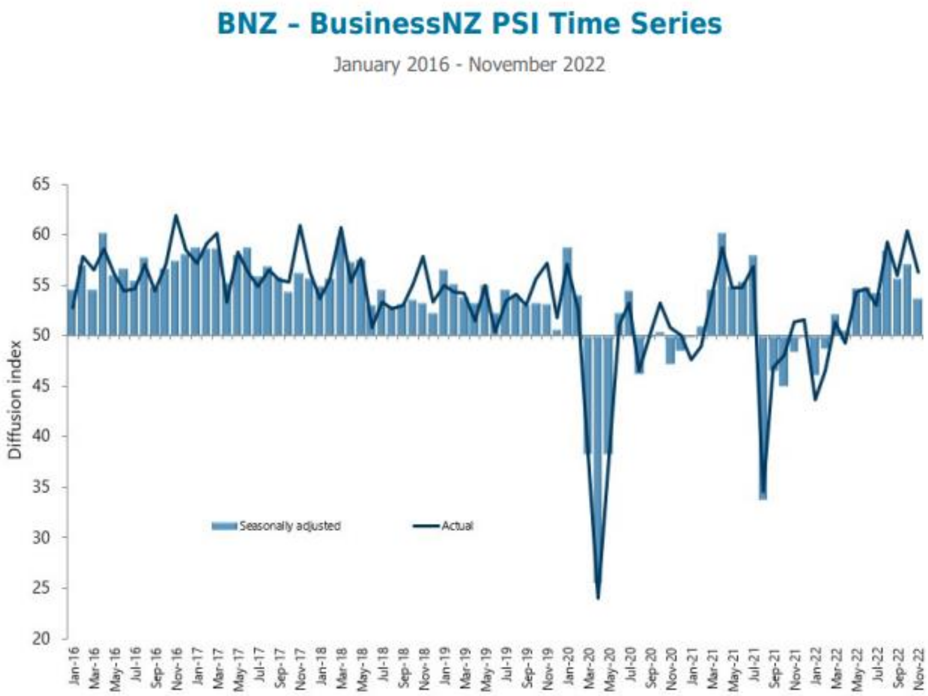
Overall activity levels in New Zealand are now starting to mirror the global trend of contraction, which may indicate a tough start to 2023 for manufacturers.

For the main sub-index results, New Orders (41.8) have now experienced three consecutive months of contraction, while Production (49.6) dipped slightly lower than the October result. Finished Stocks (56.1) continued to push upwards, while Deliveries (50.7) decreased 4.7 points from the previous month.

Manufacturers have continued with a more negative mindset, with the proportion of negative comments at 58.4% for November. However, this was down from 61.6% for October and 61.5% for September. Manufacturers noted a general slowdown of conditions both domestically and overseas, as well as persistent labour shortages, particularly for skilled staff.

Meanwhile, expansion levels for New Zealand's services sector eased back in November, according to the BNZ - BusinessNZ Performance of Services Index (PSI).

The PSI for November was 53.7 (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). This was down 3.4 points from October, and the lowest level of overall activity since April 2022. However, it was still just above the long-term average of 53.6 for the survey.



After showing healthy expansion for six months, the November result was dragged back by the key sub-index values for Activity/Sales (58.1) and New Orders/Business (57.3) coming off previously strong results, although both remain in a very healthy position. In addition, Supplier Deliveries (47.3) fell back into contraction during November.

With its sister survey the PMI again showing contraction in November and economic headwinds approaching, the easing of expansion in activity is not unexpected. Also, with the Global PSI result of 48.1 at a 29-month low, it will be a tall order for the New Zealand services sector to continue the overall trends experienced during the second half of 2022.

The construction sector, like many other sectors, still faces significant cost pressures due to ongoing supply chain issues and labour shortages.

The above said, it was quite surprising that the volume of building activity in New Zealand rose 3.8 percent in the September 2022 quarter, compared with the June 2022 quarter, according to StatsNZ data.

Residential building activity rose 3.1 percent in the September 2022 quarter, while non-residential building activity rose 4.9 percent. Building activity increased across most building types and regions for the September quarter.

Although the number of consents issued over the past year is still at relatively high levels by historical standards, there are signs of an easing in construction demand.

Banks have already started tightening access to lending for residential and commercial property, and the effects on activity should be more pronounced as we head into 2023.

At the same time, house prices continue to fall in many, but not all, parts of the of the country with prospective buyers increasingly nervous. This is flowing through in terms of new development with developers cautious about bringing new projects to market. There is at least anecdotal evidence that new orders are dropping off as a result.

Notwithstanding the above, there is still a long pipeline of construction work on the horizon so it might be a case of redeploying resources in this sector rather than a significant downturn across the board.

Agriculture continues to be a bright light but is also under substantial input cost pressure. It faces new regulatory constraints – including potentially being charged for greenhouse gas emissions. – leading to a loud response from the wider agricultural sector. Processing companies and other down-stream industries will increasingly need greater understanding of on-farm emissions if they are to continue to sell product into discerning overseas markets where a premium is offered for what are considered sustainable management practices on-farm.

Meanwhile, given the slowdown in global activity it is not surprising commodity prices have generally declined substantially of late – although off a very high base.

The ANZ Commodity Price Index fell 3.9 percent in November as prices for food commodities eased. Converted into $NZ, the index dropped a substantial 9.1 percent as the NZD appreciated 4.6 percent against the Trade Weighted Index (TWI).

Dairy prices continue to fall and are now 10.2 percent lower than a year ago – reflecting the fact that global demand is weakening.

Lamb prices are also down, indicating consumers are under the pump in terms of what cuts of meat they can afford during hard economic times.

Despite falling commodity prices, the outlook for the agriculture sector is still relatively healthy.

The Situation and Outlook for Primary Industries (SOPI), recently released by the Ministry for Primary Industries, shows food and fibre export revenue forecast to grow to a record level of $55 billion this year.

Dairy remains our largest export, with revenue forecast to grow 6 percent to a new high of $23.3 billion. The sheep and beef sector remains relatively strong and red meat and wool revenues are tipped to increase to a record $12.4 billion.

Meanwhile, horticulture export revenue is expected to grow 5 percent to $7.1 billion, and strong demand for our processed food and other products is expected to drive 3 percent growth to $3.3 billion.

Tourism, hospitality, and retail are still subdued despite the slow return of overseas visitors.

While the hospitality and tourism sectors have reported an uplift in sales activity (perhaps not surprising given the recent opening of the borders to foreign tourists), there is some way to go before pre-pandemic levels are reached. Moreover, the increased spend-up over the past couple of quarters may be about to come to an end as there are widespread concerns about household disposable income coming under threat with the "R" word (recession) looming large on the horizon.

The shortage of labour is hamstringing these sectors and businesses are not able to take up business opportunities simply because of an inability to source labour. Any removal of restrictions on migrant labour has been very much too little too late.

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.

Delays in processing visas for tourists from countries for which visitor visas are required are affecting inbound tourist operators and hotels. Some tourists and tourism operators are cancelling simply because of the increased uncertainty of timely visa processing. This is extremely frustrating for an industry trying desperately to rebuild itself after the devastation caused by the closed borders instituted under Covid.

1.4 Labour market – tight as a drum

The New Zealand labour market saw even further tightening over the past quarter. StatisticsNZ's Household Labour Force Survey's (HLFS) measure of the unemployment rate stayed at 3.3 percent in the September quarter.

Shortages of labour are currently the biggest constraint on NZ's 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 due to a labour shortage, in some industries and regions the impact is likely significant. Surveys showing net migration inflows have turned positive only over the few months. Our slowness in opening our borders to new migrants has seen several countries – including Australia – steal our lunch from under our nose.

In this respect, New Zealand's population growth has been at its lowest since 1986 and though net migration loss has been a contributor, the size of this loss has reduced as NZ saw a net migration gain of non-NZ citizens in the year to September 2022. Some might argue that bringing in substantial numbers of migrants might in fact add to inflationary pressure (demand for goods and services, including housing etc.,) but this very much depends on who comes into NZ and whether they can be quickly absorbed into the labour force, thereby reducing some of the still chronic supply-side shortages in most industries.

At the end of the day, labour, like capital, is now highly mobile, and individuals will inevitably 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		
	Dec 22	Dec 23	Dec 24
Highest	3.3	4.5	5.0
Average	3.2	4.1	4.8
Lowest	3.2	3.9	4.5

Source: BNZ, Kiwibank and Westpac

Labour Costs – upward momentum

Acute labour shortages continue to drive high wage expectations. StatisticsNZ's measure for wages and salaries (the Labour Cost Index – LCI) saw a strong increase in the year to September 2022 – a 3.7 percent increase. The other major measure of wages (the Quarterly Employment Survey – the QES) showed average earnings increasing by a significant 7.4 percent.

The difference in outcomes for the two measures can be explained by the fact that the LCI measures wages/salaries for a particular job whereas the QES measures what is happening to the wages and salaries of individuals, so includes wage/salary increases as a result of job hopping to higher paid positions.

Some moderation in wage growth over the coming year is possible as more firms can now bring in workers from overseas, which should help ease labour shortages. While increases in wages and salaries have contributed to steady income growth over the last year, this has been more than offset by inflationary pressures.

The high levels of aggregate household debt mentioned above (currently around 174 percent of household income) and higher interest rate rates combined with inflation (currently over 7 percent) are a recipe for the continuing erosion of disposable income.

While the Government has tried to ease some of the pressures on individual households and business through reducing fuel taxes and subsidising public transport, these are simply stop-gap measures, poorly targeted given their universal coverage. Arguably, they work against some government thinking in other areas such as encouraging people to pay for the full cost associated with transport and transport-related externalities.

Other regulatory measures implemented and proposed (including the recently passed Fair Pay Agreements Act) will result in much greater centralisation of salaries and wage rates and could lead to a further ratcheting up of wages and salaries in some sectors. The potential introduction of the Income Insurance Scheme will also act to suck out contributions from employers and employees to fund the scheme.

At the end of the day, wage and salary rate changes need to reflect productivity increases or NZ will face becoming internationally uncompetitive. This, down the track, will lead to higher unemployment than might otherwise have been expected.

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

	Years Ending		
	Dec 22	Dec 23	Dec 24
Highest	4.2	4.6	4.4
Average	4.1	4.4	3.5
Lowest	4.0	4.1	2.8

Source: BNZ, Kiwibank and Westpac