BUSINESS NZ

PLANNING FORECAST

MARCH 2023

NZ Economy: Challenges Abound

Executive Summary

It is an understatement to say the NZ economy is facing a number of headwinds, the consequence of both domestic and international events. Some are beyond our control, such as the recent North Island weather that caused significant havoc, damage and personal loss, including loss of life.

While the bill associated with Cyclone Gabrielle is yet to be fully assessed, some estimates put it at well over $10 billion. Insurance and reinsurance will cover a significant part of the bill, but households and landowners will still face considerable losses given that land is generally not insurable. Some farming operations have been largely wiped out and some businesses are considering simply walking away.

The impact will obviously be felt through lower economic growth as the destruction of land and buildings will impact on the supply of goods and services (particularly fruit and vegetables) which in turn will drive up food price inflation. Food prices were up a massive 12 percent in February 2023 compared with the same month a year earlier, with fruit and vegetables leading the charge.

Irrespective of insurance payouts, the Government (taxpayers) will be required to stump up $billions to deal with the loss of infrastructure (bridges/roading etc) as it will likely be well beyond the ability of local councils (ratepayers) to repair significant publicly-owned infrastructure. And hard questions will need to be asked as to whether it is even appropriate to repair some infrastructure given the cost for more remote populations.

Inflationary pressures remain elevated with inflationary expectations entrenched and still well outside the Reserve Bank's acceptable band of 1-3 percent. If anything, the recent cyclone will exacerbate these pressures as badly damaged infrastructure competes for limited resources. The situation has not been helped by the slowness in opening up to greater net migration inflows to provide the much-needed labour required to maximize NZ's potential. The rest of the world has moved on with more accommodating policies and it is now much harder for NZ to attract the sort of talent so desperately required across the board.

Meanwhile, households are starting to do it tough with higher interest rates beginning to feed through into mortgage rates, severely eating into disposable incomes. But although there has been a rise in mortgagee housing sales, this is still a low number and off an equally low base.

The international economy is facing significant challenges with geopolitical tension still a major issue on a number of fronts. The Russian invasion of Ukraine proceeds with its continuing destruction of people and capital but with little sign at this stage of any end in sight.

The collapse of the Silicon Valley Bank and the Signature Bank in the US, both mainly associated with the high-tech sector, is concerning and the potential for a flow-on impact on the wider financial sector should not be discounted, despite a quick response from US regulators to try and shore up support for deposit holders. Meanwhile UBS (Union Bank of Switzerland) has agreed to buy out its rival, Credit Suisse, at a fraction of the latter's closing share price a week ago.

On the positive side of the ledger, the reopening of China, after a reassessment of its draconian lockdowns in response to Covid-19, should work to support commodity prices as China both demands greater resources and provides international markets with a significant amount of goods and services. Notwithstanding, China's growth rates are projected to be much lower than the dizzy heights reached some years ago with reports of empty containers being stockpiled at a number of ports as international trade slows significantly in light of continuing international recessionary fears.

HIGHLIGHTS

The NZ economy continues to face both international and domestic pressures, resulting in the increased prospect of a mild recession.

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at -12 for the March 2023 quarter, a deterioration of 2 on the previous quarter and 8 on a year ago.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI), have started 2023 in positive territory, although the PMI is still tracking below its long-term average while the PSI is tracking above its long-term average – perhaps not surprising given that overseas tourists are now back in the mix.

Other activity indictors, such as retail sales, point to a slowing economy, while continued low business and consumer confidence point to declining activity.

Households are increasingly closing their wallets as interest rate hikes start to kick in while the labour market is showing some very early signs of coming off its highs.

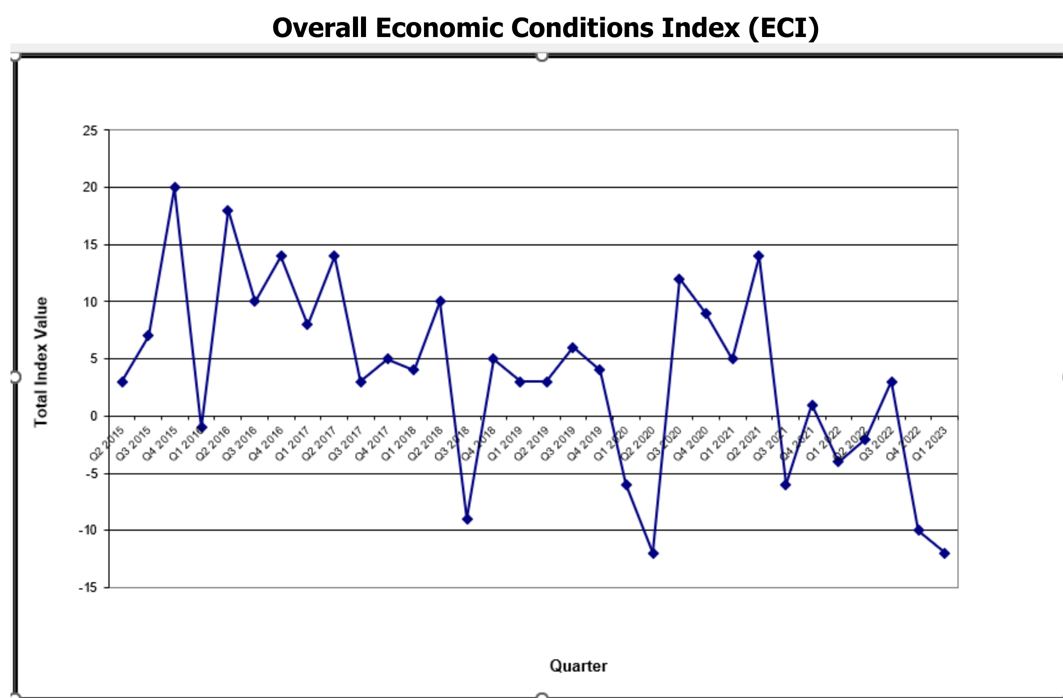
While international commodity prices are holding up reasonably well (although significantly down from their highs), expectations are for softer prices, reflected in a downgrade of the anticipated milk-payout to dairy farmers.

The government accounts will come under further pressure as the economy slows and costs associated with the recent cyclone kick in, with the upcoming Budget (May 2023) likely to outline a further reprioritisation of expenditure.

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 -12 for the March 2023 quarter, a deterioration of 2 on the previous quarter and a deterioration of 8 on a year ago. The index overall is being dragged down by a continuing tightening in monetary policy conditions (higher interest rates) while there are early signs of a slow-down in the red-hot labour market. Business and consumer confidence indicators remain sub-par despite some slight improvement of late, howbeit off an extremely low base.[1]



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 -1 for the March 2023 quarter, an improvement of 2 on the previous quarter and the same as a year ago. International factors, including recessionary fears, are impacting global demand with commodity prices showing some further signs of easing.

Monetary policy/pricing indicators sit at -8 for the March 2023 quarter, a deterioration of 4 on the previous quarter and a deterioration of 5 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 inflationary expectations still too high. Despite recessionary fears, some further rises in the OCR are quite possible as the Reserve Bank fights to get inflation under control.

Business/consumer confidence indicators sit at 0 for the March 2023 quarter, up 6 on the previous quarter and up 1 on a year ago. Both business and consumer confidence indicators remain sub-par, affecting investment intentions. High levels of household debt, rising interest rates, and sustained inflationary pressures are having a negative effect on household confidence. Households are starting to shut their wallets which will be music to the ears of the Reserve Bank.

Labour market indicators sit at-3 for the March 2023 quarter, down 6 on the previous quarter and down 4 on a year ago. Rising inflationary pressures are eroding disposable incomes, along with significant rises in interest rates. Businesses are still crying out for staff, with shortages a major constraint on growth, although net migration continues to ramp up despite still being well under levels evident pre-Covid. Cost pressures on businesses will likely see some forthcoming softening in labour market activity.

[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 March quarter 2023 are estimates based on available information to date.

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

1.1 Economic growth (GDP) – shrinking

Economic growth is forecast to be marginal out to March 2025 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.

Given NZ's position as an island nation heavily dependent on world trade for our economic wellbeing, it is useful to focus first on what the broader international situation is like before focusing domestically.

The international economy still faces significant challenges with geopolitical tensions a major issue on a number of fronts. The Russian invasion of Ukraine continues unabated with the destruction of people and capital and little sign at this stage of any end in sight.

On several fronts there are simmering trade tensions and significant geopolitical uncertainty. There are also tensions in our own backyard with concerns expressed about China's intentions in the Pacific region.

Inflationary pressures remain strong with a number of central banks continuing to crank up interest rates to try to drive down inflationary expectations. While supply chains are improving, which will assist in helping tame the inflation beast, trade tensions and more nationalistic policies, which will harm free trade and drive up prices, are a concern.

The collapse of the Silicon Valley Bank and Signature Bank in the US, mainly associated with the high-tech sector, is also concerning and the potential for a flow-on impact on the wider financial sector should not be discounted, despite a quick response from US regulators to try and shore up support for deposit holders. Other banks globally have come under pressure with UBS agreeing to buy out its rival Credit Suisse at a fire sale price.

Energy costs have continued to tumble internationally as financial jitters associated with recent bank collapses have added further fears of an international recession. Obviously on the inflationary front, this will help put a lid on inflation as energy costs are so important to the supply of goods around the globe, including to and from NZ.

On the positive side of the ledger, the reopening of China after a reassessment of its draconian lockdowns in response to Covid-19, should work to support commodity prices as China both demands greater resources and provides international markets with a significant amount of goods and services. Notwithstanding, China's growth rates are projected to be much lower than the dizzy heights reached some years ago with reports of empty containers being stockpiled at a number of ports as international trade slows significantly in light of continuing international recessionary fears.

As a result of the above, shipping costs have dropped significantly, lowering one of the key input costs associated with the movement of goods around the world. This is one of the few positives in terms of dampening transport costs.

Given that China is New Zealand's largest trading partner and combined with Australia accounts for around 40 percent of NZ's two-way trade, it almost goes without saying that NZ livelihoods are heavily dependent on the performance of both China and Australia.

The World Bank in its latest World Economic Outlook (2023) shows global growth projected to fall from an estimated 3.4 percent in 2022 to 2.9 percent in 2023, then rise to 3.1 percent in 2024.

Global inflation is expected to fall from 8.8 percent in 2022 to 6.6 percent in 2023 and 4.3 percent in 2024, still above pre-pandemic (2017–19) levels of about 3.5 percent.

Meanwhile, the Organisation for Economic Cooperation and Development (OECD) has said that the global economic outlook is "slightly brighter" this year although inflation challenges remain.

While the OECD stated that inflation is starting to tick down, the organisation also noted that we are not on top of the inflation challenge yet and encouraged central banks to continue to monitor data and adjust their decisions accordingly.

Turning to the NZ economy, it is an understatement to say it is facing a number of head winds, the consequence of both domestic and international events. Some are beyond our control, such as the recent North Island weather that caused significant havoc, damage, and personal loss, including loss of life.

While the Bill associated with Cyclone Gabrielle is yet to be fully assessed, some estimates put it at well over $10 billion. Insurance and reinsurance will cover a major part of the Bill, but households and landowners will face significant losses given that land is generally not insurable. Some farming operations have been largely wiped out and some businesses are considering simply walking away.

Irrespective of insurance, the Government (taxpayers) will be required to stump up $billions to deal with the loss of infrastructure (bridges/roading etc) as it will likely be well beyond the ability of local councils (ratepayers) to repair significant publicly owned infrastructure. And hard questions will need to be asked as to whether it is even appropriate to repair some infrastructure given the cost for more remote populations.

Issues relating to managed retreat as a result of climate change have been given more airtime since the recent cyclones, but this is not an easy topic to navigate given the cost, among other complexities involved. Perhaps the biggest question on everyone's lips is – who pays?

Some, such as the drafters of the report into the Future of Local Government Review (October 2023), consider that an intergenerational fund for climate change could be a possibility.

BusinessNZ would suggest any moves towards adopting an intergenerational fund for climate change, as outlined in the draft report, should be approached with a considerable degree of caution for a range of reasons, including the potential for unintended consequences and gaming. Principally, such a move could provide added incentives for individuals and councils to try and offload risk to third parties, in this case, general taxpayers.

This is not to say there won't be issues which will need to be dealt with on a national basis, but by and large, management of risk is best left to those closest to the actual situation, so they are aware of the costs and benefits of taking or not taking a specific action.

Notwithstanding the above, BusinessNZ acknowledges the current and future effects of more frequent extreme weather on New Zealand and its infrastructure, including transport, energy, water, and so on. More long-term thinking is needed to make sure our responses and infrastructure are future-proofed to deal with any additional stress caused by climate change.

BusinessNZ considers that as a general guiding principle, costs and benefits should be internalised and passed on to individuals to the extent possible. In other words, individuals should manage their own risk whether through insurance or through normal market mechanisms (i.e. high risk generally means lower cost property).

There should be a very high threshold for central and local government intervention. Intervention should be restricted to cases where there is significant risk to the wider community, e.g. an oil tank next to a waterway or where a building is close to the sea and if not moved away there might be significant environmental and economic damage or public health issues affecting third parties that cannot be mitigated through bonds etc. from property owners.

There are many possibilities in terms of solutions for local problems and the following might be particularly worth investigating further. Where the costs of continually providing infrastructure are increasing prohibitively due to climate change, it might be possible for local and/or central government to gift assets to local communities to manage as they see fit (provided standards of hygiene for sewage disposal etc. are met). Alternatively, assets could be sold to communities for heavily discounted values accompanied (or not) by compensation. Contract details would need to be carefully worked through to ensure each party was clear as to what liabilities would arise from such agreements.

There are other examples of funding arrangements, such as the Lake Taupo "clean-up", where contributions to reducing nutrient emissions going into the lake have been shared between several parties. This has been necessary because of the difficulty in clearly determining who precisely has caused nutrient leaching where leaching has taken place over many years and cannot entirely be pinned on current landowners.

There is a strong argument for grandparenting current rights (i.e. individuals, businesses/households are compensated if they must move under a high threshold test). Unless businesses and individuals have reasonable

security over their property rights so these are not subject to confiscation or regulatory takings by the state, they will have little incentive to invest. However, given new investors should be aware of the risks to which climate change (and other factors) may give rise, there is a strong argument that in these circumstances, new investors should bear the costs involved (of land erosion etc).

A complicating factor for businesses and industries making decisions on climate change mitigation policies is that several industries (in, for example, the energy sector) are regulated by the Commerce Commission and/or other agencies of government in terms of their Rate of Return (ROR) and supply/service agreements. This limits their ability to take account of potential climate risks/hazards without the danger of falling foul of government agency requirements. Therefore, some cost-sharing arrangements between government and industry might be needed in dealing with current and/or future risks associated with investment in climate change mitigation measures.

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.

- **Government Accounts under further pressure**

While net government debt is still relatively low compared with many countries we traditionally compare ourselves to, the government accounts will continue to come under pressure post-Covid and more lately as a result of Cyclone Gabrielle. Some hard calls will need to be made in the upcoming Budget (May 2023) on reprioritising expenditure with some pet projects likely to be ditched completely.

While the Prime Minister has announced a raft of initiatives that will no longer proceed (or will be delayed until fiscal conditions permit), there is a question mark over whether many of the projects being shelved for now should have been seriously considered in the first place.

Meanwhile a continuing blow-out in the current account deficit is a cause for concern.

The annual current account deficit was $33.8 billion (8.9 percent of gross domestic product (GDP)) in the year ended December 31 2022. This was $12.7 billion wider than in the year ended December 31 2021 (6.0 per cent of GDP), the largest annual current account deficit to GDP ratio since the series began in March 1988. The largest prior to the COVID pandemic was 7.8 percent of GDP in December 2008, during the global financial crisis.

The balance of payments, or current account, essentially tracks whether NZ is paying its way in the world. It measures inflows and outflows of payments associated with imports, exports, investments and debt servicing. A deficit indicates that NZ is a net importer of goods and services.

The current deficit is due to several factors, some Covid-related, for example, the collapse of international tourism, an increase in the cost of imported goods (including shipping costs) and higher global interest rates leading to increasing interest payments on money borrowed from overseas.

In essence the above means we have an overheated economy and are spending beyond our means.

High and persistent current account deficits are problematic for two main reasons. First, increased risk is likely to put NZ under scrutiny by credit rating agencies which in turn could result in a general increase in the cost of credit to government, businesses and households. Second, the deficit will likely put further downward pressure on the NZ dollar, not helpful in trying to contain tradeables inflation.

- **High levels of household debt**

Households have continued to rack up debt. 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 situation is changing as fixed rate mortgages come up for renewal this year and beyond, raising real concerns should employment levels falter.

To date, moderate employment growth and extremely low unemployment rates by historical standards have meant few households have had to sell assets at a significant loss.

The recipe that will see disposable incomes coming under significant pressure will be the high 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 Government has tried to ease some of the pressure on individual households and businesses by 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 costs associated with transport and transport-related externalities.

- **Inflationary pressures and inflationary expectations remain elevated**

Inflationary pressures are largely the result of supply-side constraints, particularly in relation to labour shortages across the board, which have elevated inflationary expectations and to recent events, such as Cyclone Gabrielle. They will result in more resources being sucked in to undertaking urgent significant infrastructural work in affected areas.

While arguably the Reserve Bank can do little to enhance supply-side constraints on the economy, it will need to keep its foot on the throat of inflation until it is subdued – well into next year by the look of things.

Recent consensus forecasts by the New Zealand Institute of Economic Research (NZIER) show inflationary expectations still outside the Reserve Bank's target band of 1-3 percent, well into 2024.

- **Housing prices continue to fall despite high input costs**

House prices continue to fall, with many fewer sales than in their heyday of a year or so ago. There is plenty of choice, with would-be buyers having time to do their due diligence on properties without fear of someone coming in and offering a higher price.

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

- Net long-term inward migration, while now firmly in positive territory, is still not at levels likely to cause significant pressure on the housing market. There is also the expectation of a number of young people exiting the country given the high cost of living (particularly housing) and relatively lower income growth compared with other countries
- Rapidly rising interest rates pricing many out of the market (with more rises to come)
- The cost of credit not only increasing but banks, for range of reasons, being much more discerning about who is getting credit
- 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
- The strong likelihood of a recession or at least a technical recession (viewed as two consecutive quarters of negative economic growth) cannot be ruled out
- Finally, some of the gloss is coming off the strong labour market, with some surveys suggesting that the days of people being able to pick and choose jobs for higher salaries may be over.

- **Significant labour shortages remain**

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, with ad hoc "picking winners "as to who can and can't come and work in NZ.

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.

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 considerable. Net migration inflows have turned positive only in the last few months. 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.

- **Regulatory interventions need improvement**

Legislative changes, either proposed, recently enacted, or in the pipeline, have 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 in determining wages and conditions.

To add to the above, 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 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 has said it is unwilling to look again at aspects of this reform.

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 to 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.

The Government's separate pieces of legislation to replace the current Resource Management Act (RMA) are extremely complex and although the business community might be supportive of many of the changes proposed, it is not clear how these will be implemented in practice, given that many of the key issues have yet to be decided on.

For example, the Natural and Built Environment Bill includes a list of objectives (system outcomes, including protecting the environment, providing for infrastructure etc) but there is no hierarchy, and little or no ability to make cost/benefit decisions in terms of trade-offs between potentially competing, or in some cases even conflicting, system outcomes.

There is also widespread concern that, with very wide powers allowing Ministers to make changes via regulations, there is the potential for significant changes in position depending on the pressures facing the Minister at the time and/or when a Government changes. This will provide businesses with little certainty given the long-term investment horizon of many projects.

There is scarcely a mention of upholding property rights in the Natural and Built Environment Bill, and there is the potential for existing property rights to be eroded (e.g. in terms of water consents), which will have a chilling effect on business investment.

It is a fundamental pillar of a market economy that property rights should be relatively clear and unambiguous and able to be upheld in a court of law. Where property rights are removed or reduced by way of regulatory takings, compensation should generally be paid.

Without reasonable security from confiscation by the state or others, the incentive for individuals and businesses to invest and build up productive assets is severely weakened.

NZ's regulatory system needs more checks and balances to ensure a serious analysis of the wider implications of legislative decision-making. Checks and balances were particularly needed during Covid-19, when a number of laws and regulations were fast-tracked through Parliament without adequate public consultation or input from experts in specific fields or any apparent consideration of unintended consequences. While many matters fast-tracked might have been thought essential and logical at the time, a number of changes reduced property rights without providing for any form of compensation. There is a risk that if fast-tracking becomes widespread, business and household incentives to invest and build up assets will be undermined. There must be adequate safeguards against government (local or central) reducing the rights owners should legitimately expect to have over the use of their property.

Forecasts: Real GDP percent Growth

	Years Ending		
	Mar 23	Mar 24	Mar 25
Highest	3.4	0.4	1.2
Average	3.2	-0.1	0.7
Lowest	2.7	-0.7	-0.3

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – don't blink

Despite calls from a few commentators for the Reserve Bank to pause its recent 50 basis point hike in the Official Cash Rate (OCR) to 4.75 percent, the Reserve Bank has correctly stayed the course and resisted the temptation to get side-tracked, and has focused on the important goal of getting inflation back under control, howbeit now over a much longer time period than was originally contemplated.

There is a range of reasons for the Reserve Bank taking an increasingly steely-eyed approach to inflation which are briefly outlined below, but essentially the Reserve Bank's credibility is under fire if it isn't successful in its prime objective of maintaining price stability.

Given that interest rates have risen and given high levels of household debt, it is perhaps not surprising that both the Reserve Bank and the wider banking sector have come in for some stick (mostly unjustified in our view) as higher interest rates start to seriously impact on household budgets.

Banks have been targeted by politicians from almost across the political spectrum, for making allegedly excess profits, with various calls from the National Party for a Select Committee inquiry into the banks (supported by the Greens) and the Government making strong noises about getting the Commerce Commission to undertake a market studies review of the banking sector. At the time of writing, the Select Committee option has been discounted but there is every likelihood of a Commerce Commission inquiry into the banking sector.

There is little or no evidence that the wider banking sector is making excessive profits as evidenced by their recent returns which, by and large, are similar, or even below the average of companies listed on the NZX.

A recent KPMG report found that using one of the most accepted measures of profitability, return on equity (ROE), the NZ banking sector's result was 13.4 percent while the average ROE of the S&P/NZX 50 Index companies was 15 percent.

Second, if there were opportunities for banks to make excessive profits then this should have resulted in a number of new banks trying to access the NZ market – which doesn't appear to have happened, although to be fair, it is important that regulatory barriers to entry are not so stringent that no new players can effectively enter the market.

Third, it appears that competition is alive and well within the wider banking sector with a number of banks, to retain market share, offering relatively low-rate mortgages for fixed terms to entice customers to shift banks.

Finally, there has been talk of banks being slow to increase deposit rates, while increasing rates rapidly in light of changes in the OCR or other factors. It is important that banks get their funds from multiple sources, with domestic deposits being only one source. Like most companies, in a competitive environment, banks should be seeking to maximize profitability for their shareholders, by providing the goods and services demanded by the market. In this respect, banks should seek to secure funds from least-cost sources as much as possible.

The obvious danger with going on a witch hunt is that ultimately the greater the number of controls imposed on banks, the more these will ultimately be passed on to customers in the form of (a) a higher cost of credit and/or (b) restrictions on the availability of credit. At the end of the day there is no free lunch here.

Inflation – long hard slog

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

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 Government policy decisions which are proving pretty hard to fathom – three of them being the continued spend-up that has added to the inflationary fire, the inability to get to grips with the need for 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.

Also, the recent Cyclone Gabrielle, resulting in massive infrastructure and property damage in parts of the North Island, will add to inflationary pressures, as resources which otherwise would have been deployed elsewhere will be sucked in to provide much needed repairs within tight timeframes. This, alongside the implication for food costs, as many crops were wiped out or significantly affected, will also flow through into cost pressures.

NZ's move to reduce carbon emissions to meet its international obligations of being net zero by 2050 will also necessarily involve increasing costs to some sectors, at least initially, as more costly alternatives to fossil fuels are developed over time, likely adding to inflationary pressure during the decarbonisation process.

There are also upside inflationary risks as the current international geopolitical situation will cause countries to become much more insular and concerned about sourcing materials internally. This is likely to add further to the costs of production and inhibit innovation, with costs ultimately passed on to consumers. Management of risk is an issue, particularly for those countries exposed principally to a single market, but the risk must be weighed against the downside of restricting free trade in goods and services.

On the other hand, international shipping costs have receded substantially over the last year with the stock-piling of containers in a number of international ports as trading volumes decline. This will reduce the cost of transporting goods overseas so is positive for NZ exporters overall. At the same time, commodity prices are generally continuing to soften, although from a relatively high level. This is reflected in downward revisions to the milk payout for NZ producers by both Fonterra and Synlait. Notwithstanding, payouts still remain well above their long-term average although are being rapidly eroded through higher input costs with Stats NZ's farm expenses price index showing that all input costs (excluding livestock) were up a massive 15.3 percent in the December 2022 quarter compared with the same quarter a year ago.

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 signalling a much slower path. Meanwhile, the Reserve Bank is effectively signalling further interest rate rises despite the economy shrinking for the fourth quarter of 2022. 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 elevated, 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 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 and appears to be working as households are starting to put their wallets away).

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 with its new remit, the Bank appears to have pulled back from covering issues such as equity, housing and climate change.

The Reserve Bank needs to remain focused on price stability and not get involved in side-shows.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Mar 23	Mar 24	Mar 25
Highest	7.4	5.7	3.1
Average	7.2	4.2	2.6
Lowest	6.7	2.7	2.1

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – close to peaking?

While the Official Cash Rate (OCR) currently sits at 4.75 percent, expectations are for at least one if not two further moves to increase it to peak at around 5.25 percent later this year, although it is not inconceivable that the Reserve Bank will take a breather at its next review later this month.

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 extremely low historical base) will start to really 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.

While mortgagee sales have increased over the last few months, they are still low and, also significantly, are off a very low base.

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.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Mar 23	Mar 24	Mar 25
Highest	5.4	5.3	4.3
Average	5.1	5.2	3.7
Lowest	4.9	5.1	3.3

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – some downward pressure?

The NZ dollar is likely to come under further pressure over the next year as a result of two main factors.

First, the recent financial jitters in world financial markets as a result of a number of banks getting into financial difficulty will encourage flight to safe currencies such as the $US and Japanese yen.

Second, the recent current account deficit in NZ's balance of payments expanded to 8.9 percent of GDP ($33 billion) in the final quarter of 2022 with Stats NZ stating it was the largest deficit since the series began in 1988.

High and persistent current account deficits are problematic for two main reasons. First, given increased risks they are likely to put NZ under scrutiny by credit rating agencies which in turn may result in a general increase in the cost of credit. Second, they will likely put further pressure on the NZ dollar, not helpful in trying to contain tradeables inflation.

Forecasts: Exchange Rates

AUD (cents)			
	Mar 23	Mar 24	Mar 25
Highest	0.92	0.94	0.94
Average	0.91	0.91	0.90
Lowest	0.90	0.89	0.87

USD (cents)			
	Mar 23	Mar 24	Mar 25
Highest	0.68	0.70	0.72
Average	0.64	0.63	0.67
Lowest	0.62	0.56	0.63

TWI			
	Mar 23	Mar 24	Mar 25
Highest	75.3	74.2	75.0
Average	72.6	71.5	73.1
Lowest	71.2	67.2	71.0

Source: ASB, BNZ, Kiwibank and Westpac

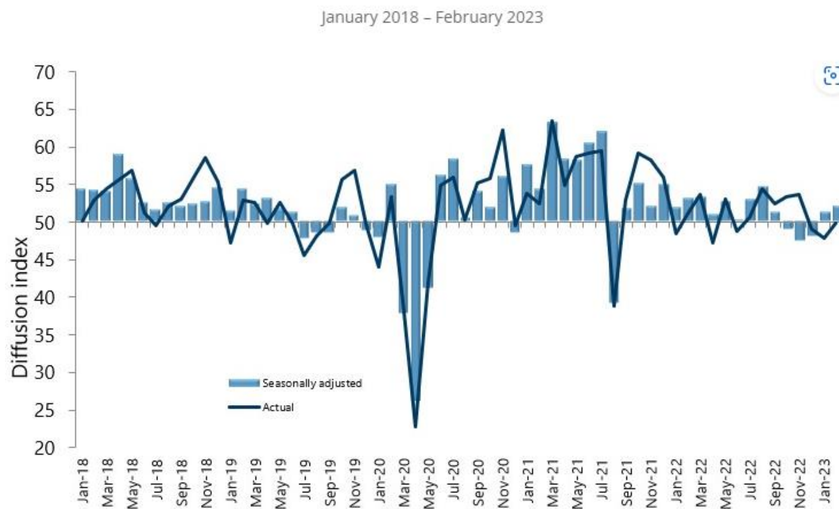
1.3 Business activity and confidence – downbeat

Both business and consumer confidence remain downbeat for a range of reasons, and this is reflected in business activity levels.

Notwithstanding, some sectors are continuing to perform adequately while others are increasingly coming under the pump.

New Zealand's manufacturing sector experienced a further increase in expansion, according to the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for February was 52.0 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 0.8 points up from January, although still below the long-term average activity rate of 53.0.



The February result managed to show an incremental step towards higher levels of activity, at the very least starting the year off with two months of consecutive expansion.

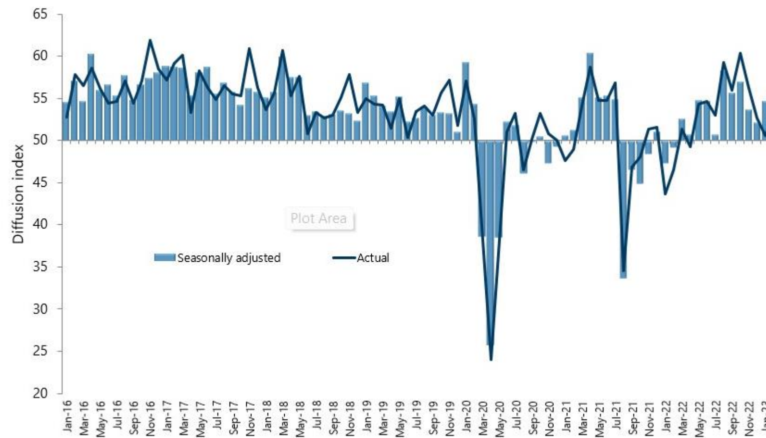
The key sub-index of New Orders (52.0) returned to expansion after five consecutive months of contraction, while Finished Stocks (55.8) and Employment (54.0) both experienced ongoing growth. However, Production (49.4) fell back into contraction to its lowest level since June 2022, while Deliveries (51.8) showed the same level of expansion as the previous month.

With a further lift in activity for February, the proportion of negative comments from manufacturers dipped to 60.2 percent compared with 69.9 percent for January, 63.5 percent for December and 58.4 percent for November. Manufacturers were somewhat split with some noticing a slowdown in sales and enquiries while others noted a bump in activity, including new customers both domestically and offshore.

Meanwhile, expansion levels for NZ's services sector lifted again during February, according to the BNZ – BusinessNZ Performance of Services Index (PSI).

BNZ – BusinessNZ PSI Time Series

January 2016 – February 2023



The PSI for January was 55.8 (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). This was up 1.1 points from December, and again above the long-term average of 53.6 for the survey.

The February result built on momentum from January. In terms of the sub-index results, the two key sub-index values of Activity/Sales (53.6) and New Orders/Business (57.1) both lifted from the previous month, as did Stocks/Inventories (58.3) and Supplier Deliveries (55.9). By contrast, Employment (51.2) dropped slightly from January.

The further lift in expansion levels in the services sector also saw a sizeable drop in the proportion of negative comments, which stood at 51.9 percent in February compared with 61.7 percent in January, 58.2 percent in December and 47.3 percent in November. Reasons were varied across those who provided positive comments. The return of customers after the holiday season was one, along with a general pick-up in tourism, including in overseas visitor numbers.

The agricultural sector continues to operate at a satisfactory level, and global commodity prices which, although for a number of reasons are now well off their peak, are still reasonably high by historical standards.

Dairy prices slipped slightly at the most recent Global Dairy Trade (GDT) auction, with the headline global dairy trade (GDT) index down 0.7 percent. Prices are now 34.8 percent below the 15-year high in March last year, although they aren't too far off the average for the past five years. Fonterra recently reduced its forecast payout range for the 2022/23 season from $8.50-9.50 (with a midpoint of $9.00) to $8.20-8.80 (with a midpoint of $8.50). The decline of 5.6 percent was attributed to softer demand from China, at a time when the global milk supply from key exporting regions was balanced. Last season's milk price was a record $9.30, while the next-highest was the $8.40 payout from 2013/14, so a payout of $8.50 would still be the second-highest of all time.

Synlait Milk has also reduced its forecast base milk price for the 2022-23 season to $8.50 per kilogram of milk solids (kgMS) from $9.00/kgMS.

In a notice to the NZ stock exchange (NZX), Synlait said the key drivers of the revised forecast were subdued global economic activity as well as a slower than expected recovery in Chinese demand following the pandemic.

Despite the relatively positive outlook for agriculture, the sector is still facing risks, as indicated below.

First, food and fibre exports make up over 80 percent of NZ's merchandise exports and these agricultural exports overwhelmingly go to China. With its reliance on China (and Australia) it is imperative for NZ's future standard of living that both China and Australia continue to perform well.

Second, there is significant concern in the agricultural community over the uncertainty arising from a number of recent and proposed environment-related regulations including, but not limited to, how greenhouse emission charges will affect the agricultural sector.

Third (and not necessarily restricted to the agricultural sector), constraints on human resource capability and capacity are evident in the meat processing sector which lacks the migrant labour that traditionally assists with the processing of stock.

Fourth, inflationary pressures (input costs) are weighing heavily on the agricultural sector. For farmers, higher interest rates are coming on top of significant hikes in the cost of other farm inputs, including freight, fertiliser and labour. According to Stats NZ's farm expenses price index, all input costs (excluding livestock) were up 15.3 percent in the December 2022 quarter compared with the same quarter a year ago.

DairyNZ DairyBase data is forecasting total farm work costs for the current season to increase to around $9 per kilogram of milk solids (KgMS) - an 11 percent increase on last season's $8.13/KgMS.

The above is about 50c higher than Fonterra's current midpoint of $8.50/kgMS. NZ stock exchange-listed Synlait is paying the same price.

DairyNZ has said the increase was mainly driven by increases in feed, up 21 percent, fertiliser, up 28 percent, and interest costs, which saw the biggest increase, up 39 percent. Its forecast figure includes farm working expenses, depreciation, interest and rent, tax and the cost of borrowing.

Federated Farmers of NZ's mid-season Farm Confidence survey (January 2023) shows that confidence remains low for the agricultural sector.

Some points from the survey are as follows:

General economic conditions (expectations): A net 81.8 percent of respondents expect general economic conditions to deteriorate over the next 12 months, 0.9 points worse than the July 2022 survey when a net 80.9 percent expected conditions to deteriorate.

Farm profitability (expectations): A net 67.1 percent of respondents expect their profitability to decline over the next 12 months, 14.0 points worse than the July 2022 survey when a net 53.1 percent expected profitability to decline.

Farm production (expectations): A net 5.4 percent of respondents expect their production to decline over the next 12 months, 4.9 points worse than the July 2022 survey when a net 0.5 percent expected a decline.

Farm spending (expectations): A net 24.1 percent of respondents expect their spending to increase over the next 12 months, down 30.5 points on the July 2022 survey when a net 54.6 percent expected their spending to increase.

Farm debt (expectations): A net 3.7 percent of respondents expect their debt to increase over the next 12 months, up 19.0 points on the July 2022 survey when a net 15.3 percent expected their debt to reduce.

Ability to recruit (experienced): A net 45.7 percent of respondents reported it has been harder to recruit skilled and motivated staff over the past six months, up 1.4 points on the July 2022 survey when a net 44.3 percent reported it had been harder.

Greatest concerns (current): The four greatest concerns for farmers were Climate Change Policy & ETS, debt, interest, banks, regulation & compliance costs and input costs.

Highest government priorities: The four highest priorities farmers wanted the Government to address were

fiscal policy, economy & business environment, regulation & compliance costs, and supporting agriculture & exporters.

Meanwhile, Federated Farmers says the total cost to farmers of Cyclone Gabrielle may top $1 billion.

Federated Farmers chief executive, Terry Copeland, said an educated guess was its estimate of the total on-farm costs of the cyclone, including income disruption, infrastructure repair and the cost of restoring crops and orchards for all affected farmers and growers. It also includes costs from the earlier Cyclone Hale.

He believed the estimate meant the cyclone was shaping up to be the country's most expensive weather event, but it came in the context of initial fears that the total cost to the economy could run into the tens of billions of dollars and rival that of the Canterbury earthquakes.

The NZ pip fruit crop has been re-estimated after Cyclone Gabrielle affected parts of the East Coast of the North Island, according to New Zealand Apples and Pears Incorporated.

Tairāwhiti Gisborne crop re-estimates are yet to be completed but at this stage, the overall NZ crop is estimated to be down 21 percent on the original January crop estimate.

On the East Coast, there is a clear distinction between blocks that have been significantly and severely affected by the storm and blocks that are untouched. For unaffected blocks, the remaining crop harvest is well underway, and conditions for the remaining harvest period look good. However, as a result of the storm, the Hawke's Bay pipfruit crop is down by 33 percent.

Meanwhile the construction sector is facing mixed fortunes with the number of consents starting to drift lower with nonresidential consent issuance having declined by 13 percent compared with a year ago. Weaker housing market activity and high interest rates will continue to weigh on construction demand for the coming year.

The volume of residential construction also slowed in the December quarter, following four quarters of growth.

Stats NZ figures show the volume of all work shrank 1.6 percent in the three months ended Dec 31 due to a 2.6 percent contraction in residential work. Non-residential work grew 0.4 percent in the quarter.

Prospective buyers are increasingly nervous about the future direction of house prices, while developers are cautious about bringing new projects to market.

On the other hand, rebuild and repair activity associated with the recent cyclone will boost construction demand. With existing capacity constraints in the construction sector still clearly evident, construction costs will likely remain elevated for some time, despite some easing in supply-side constraints in respect to building materials.

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 the general drop in real (inflation-adjusted) household income, reflected in the significant drop in consumer confidence demonstrated in a number of recent confidence surveys.

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.

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.

1.4 Labour market – marginal signs of weakening

Recent labour market indicators still point to a tight labour market, but there are early signs of easing.

Stats NZ's Household Labour Force Survey (HLFS) saw a marginal increase in the unemployment rate to 3.4 percent in the December 2022 quarter, while the labour force participation rate and employment rate remained unchanged.

Despite increased net migration (still well below pre-Covid levels) labour shortages remain the number one issue affecting businesses, according to several surveys.

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 last few months. Our slowness in opening our borders to new migrants has seen several countries, 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 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.

New research shows NZ's need for workers will outstrip supply by a quarter of a million people by 2048.

Sense Partners' *The future of workforce supply,* a new report commissioned by BusinessNZ, shows that without policy changes our tightest-ever labour market will get tighter.

BusinessNZ Chief Executive Kirk Hope says the report proves there is no slack in the labour market: "NZ is in a global war for talent and NZ's labour shortage is the most intense in the OECD. Inaction is not an option and the labour market will not correct itself. As our ageing population retires from the workforce, sufficient immigration is needed to boost the economy. It's not just a numbers game. The diversity of skills, experiences and networks migrants provide can combine with local skills to help NZ businesses thrive."

Besides immigration, the report demonstrates additional measures required to chart a course out of the current labour crisis, such as increasing the participation and employment of Māori, Pasifika, women, and older people, to help close the workforce gap, or by making capital investment in labour-saving technology simpler.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Mar 23	Mar 24	Mar 25
Highest	3.5	4.9	5.6
Average	3.5	4.7	5.1
Lowest	3.4	4.3	4.8

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – moderating?

Wage growth has further accelerated as the tight labour market persists. Annual increases in both Stats NZ's measures for wages and salaries were historically high in the December 2022 quarter – a 7.6 percent increase in the Quarterly Employment Survey's average hourly earnings and a 4.1 percent increase in the Labour Cost Index.

However, with more people coming from overseas to NZ to work, we expect an easing in labour shortages over the coming year, and this should help moderate wage growth.

It is noted that the Government is exploring permanently pegging annual benefit increases to whichever is higher: consumer price inflation (CPI) or average wage growth.

In 2020, the Labour-NZ First Government indexed main benefits to wage growth rather than inflation because in preceding periods wages had risen more quickly than inflation, impacting on benefit levels relative to wages (although maintaining purchasing power given they were indexed to the CPI).

This raises an important question in respect to benefit levels: should they be tied to the CPI (to maintain purchasing power) or should they be linked to wages? There are reasonably strong arguments for focusing on the CPI given that it is important to incentivise individuals to seek employment where possible. Increasing the gap between benefits and wages will, on the margin at least, improve the case for actively seeking full-time employment.

As an aside, the minimum wage was increased recently in line with inflation, but the distinct problem with this is that it is possible wage and salary earners will, over time, be disadvantaged compared with those on benefits as the higher of the two measures (CPI and wage movements) will be considered in benefit setting. This hardly

incentivises moving from a benefit to employment, particularly for those capable of being actively engaged in the labour force.

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

	Years Ending		
	Mar 23	Mar 24	Mar 25
Highest	4.7	5.0	4.1
Average	4.5	4.6	3.5
Lowest	4.2	4.0	2.6

Source: ASB, BNZ, Kiwibank and Westpac