BUSINESS NZ

PLANNING FORECAST

JUNE 2023

BusinessNZ

NZ Economy: Rocky Road

Executive Summary

The NZ economy is forecast to show mediocre growth over the period to June 2025 with a range of factors currently impacting on performance.

Uncertainty is likely to prevail as we head into a general election in October, the outcome of which is far from certain. This uncertainty will likely mean investors adopt a wait and see approach to new investment.

On the positive side of the ledger, supply chain disruption has largely dissipated, while increased numbers of migrants and tourists represent positive steps forward.

The fall in housing prices seems close to bottoming out for a range of reasons, including interest rates appearing to have peaked (although some still expect further price rises), some easing of late in Loan-to-Value Ratios (LVR) which will help first home buyers, net migration ramping up increasing demand, and a potential change of Government in October which could see some tax changes reversed, encouraging investors to take a greater interest in housing.

On the other hand, inflationary pressures are still elevated despite a massive increase in net migration which should take some pressure off the labour market. But households are starting to come under the pump as fixed term mortgages come up for renewal at significantly increased rates. There are early signs that higher interest rates are dampening demand.

Commodity prices are coming under some pressure which is not helping producers given continued high input costs are resulting in squeezed profit margins.

Regulatory policy remains a key concern with a number of proposals creating uncertainty, for example, climate change policy initiatives and many others that could inflict added costs on businesses and households at a time when some believe NZ is facing a cost-of-living-crisis.

The 2023 Budget's focus on policies aimed at the cost of living increase was welcomed by some, however benefits from the Budget will depend on individuals' current living situation and in that regard there was little in the way of assistance for most.

Some aspects of the announcements BusinessNZ would generally support, including further funding for infrastructure and the creation of scientific research centres. Also, some announcements were necessary due to the external influences on the NZ economy.

It was disappointing, but perhaps not surprising that no tax relief was provided for or even signalled in the Budget. Given that inflation continues to eat away at disposable incomes, at least a signalling of inflation-adjusted personal tax rate thresholds might have been expected. Maybe the Government is saving this as a pre-election sweetener later this year.

The Government's books are still under pressure from the long-term effects of Covid-related expenditure, the impact of North Island weather events earlier this year and continued government expenditure. Revenue is also slowing in line with reduced growth.

Meanwhile, the international economy still faces significant challenges with geopolitical tension on a number of fronts. The ongoing Russian invasion of Ukraine, ongoing concerns over recent financial sector stress and the sustainability of public debt, along with continued inflationary pressure are adding to the cocktail of uncertainty facing international investors.

HIGHLIGHTS

The NZ economy is forecast to show mediocre growth over the period out to June 2025.

The BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at -1 for the June 2023 quarter, a deterioration of 7 on the previous quarter but an improvement of 4 on a year ago. The index remains subdued as businesses and households face higher input costs, while rising interest rates are starting to affect demand.

The global economy faces significant challenges and tensions. World growth is expected to be modest over the next few years with moves towards nationalism hindering further trade liberalisation and global prosperity.

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. At the same time input costs remain elevated, eating into profitability.

The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) remains sub-par but its sister survey, the Performance of Services Index (PSI), is keeping its head above water.

Other activity indictors, such as retail sales, point to a slowing economy, while continuing low business and consumer confidence point to declining activity as inflation and rising interest payments curtail spending.

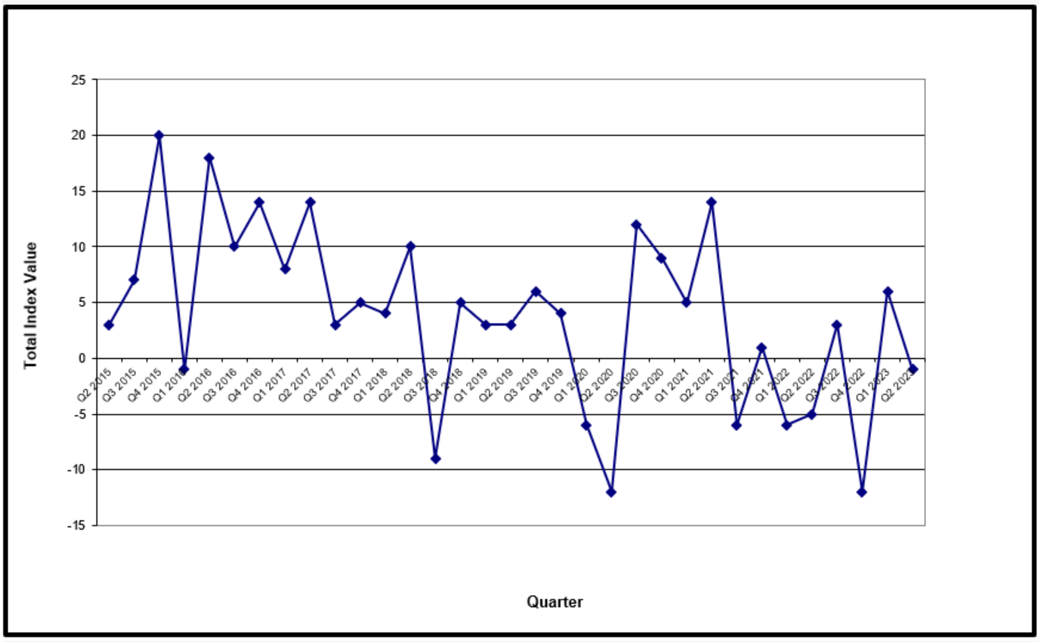
General election uncertainty will likely encourage a cautious approach to investment and spending over coming months as businesses and households weigh up the potential impact of the various political parties' policy approaches.

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

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index[1] (a measure of NZ's major economic indicators) sits at -1 for the June 2023 quarter, a deterioration of 7 on the previous quarter but an improvement of 4 on a year ago. The index remains subdued as both businesses and households face higher input costs and rising interest rates start to impact on demand. General election uncertainty will also likely encourage a cautious approach to new investment over coming months as businesses and households weigh up the policy approaches of the various political parties.

Overall Economic Conditions Index (ECI)



Data in the ECI is broken 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 3 for the June 2023 quarter, down 2 on the previous quarter and up 2 on a year ago. Improving tourism numbers are helping NZ's trade balance while on the other hand, international recessionary fears are impacting global demand with commodity prices generally easing.

Monetary policy/pricing indicators sit at -4 for the June 2023 quarter, the same as the previous quarter and a deterioration of 2 on a year ago. Indications are that inflationary pressures are starting to ease but it is questionable whether the Reserve Bank can be confident of no further rises in the OCR given many factors continue to impact on tradeables and non-tradeables inflation.

Business/consumer confidence indicators sit at 1 for the June 2023 quarter, down 2 on the previous quarter but up 2 on a year ago. Some indicators of business and consumer confidence have shown a slight improvement of late, albeit off a low base. High levels of household debt, rising interest rates and uncertainty over the general election outcome will continue to weigh on investment intentions over the coming months.

Labour market indicators sit at-1 for the June 2023 quarter, down 3 on the previous quarter but up 2 on a year ago. Net migration continues to ramp up and should remove some of the extreme constraints facing businesses. On the other hand, rising business cost pressures and reduced consumer demand will likely see some labour-shedding over coming months and a consequent rise in unemployment.

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

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

1.1 Economic growth (GDP) – mediocre

Mediocre economic growth is forecast to June 2025, as can be seen from the forecasts below.

The negative GDP result for the March 2023 quarter (-0.1%) was not unexpected given the disruption caused by Cyclone Gabrielle during February and reduced demand as monetary policy started to really bite consumer spending.

However, given the population has been boosted by strong net inward migration, when GDP is assessed on a per capita basis, the drop in output is significantly higher than headline GDP figures indicate. Headline figures can sometimes distort what is happening more broadly in the economy.

The recession should not be underestimated given the breadth of the downturn, with a 7% annual contraction in the manufacturing sector and agriculture, forestry and fishing shrinking 2.7%.

Meanwhile, a Sense Partners report commissioned by BusinessNZ found average profit margins for non-financial firms shrank to 12.7% in the calendar year 2022 from pre-covid levels of 14.7%. Things are only likely to get tighter from here on in.

Notwithstanding recent results, what will likely happen to GDP in future is of much greater interest.

Treasury forecasts from the recent May Budget show economic growth as a result of the recent floods (rebuild) and stronger tourism numbers, as enough to avoid a further recession despite some forecasting agencies e.g. the Reserve Bank, continuing to predict a short, shallow recession later this year.

On the positive side, supply chain disruption has largely dissipated while the increased number of migrants and tourists is a positive, albeit belated, step forward.

The fall in housing prices seems close to bottoming out for a range of reasons, including interest rates appearing to have peaked (although some still expect further rises), some easing in loan to value ratios which will help first home buyers, net migration ramping up increasing demand, and a potential change of Government in October which could see some tax changes reversed, encouraging investors to take a greater interest in housing.

The International Monetary Fund (IMF), in its recent country report said it expected NZ's economy to continue slowing in the near term as interest rates remain high, but that the labour market is still tight, driving up wage pressures, particularly in the services and construction sectors.

The recovery in tourism and international education – which underpinned a slight drop in the current account deficit to 8.5% of GDP in the March quarter – is seen as helping ease those economic pressures, but IMF officials said the external balance needs to be carefully watched.

The IMF expects annual economic growth to slow to about 1% in 2023 and 2024 and notes the central bank might have to hike the OCR higher than the 5.5% rate if Government spending doesn't abate as planned.

The IMF also went after NZ's politically sacrosanct $19.52b universal pension, saying reform should be considered "to address the intertemporal challenges of funding public pensions from current revenues while the taxpayer base shifts with the ageing population."

The Labour government has ruled out any tweaks to the universal programme, whereas National is pitching a staggered introduction to lift the age of entitlement by two years to 67.

Notwithstanding the above, there are some key ongoing issues facing NZ over the next few years.

These include, in no particular order, the following:

- **Regulatory risk a key issue for investment**

Legislative changes, either proposed, recently enacted, or in the pipeline, have the potential to reduce 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.

There is also widespread concern in the business community over the speed of legislative change. Two issues are uppermost. First, the fundamental question must be asked whether regulatory intervention is required in the first place (i.e does it have net benefits), and second, even if the legislative objective is superficially appealing, unintended consequences may ensue if changes are rushed through without proper scrutiny and debate.

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, input from experts in specific fields, or any apparent consideration of unintended consequences. While many matters fast-tracked might then have been thought essential and logical, a number of changes reduced property rights without providing 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.

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.

The Government has confirmed it will give councils more power to block or control the planting of permanent pine forest plantations as Ministers wrestle with complex and sometimes contradictory policy impacts.

It's the latest move by Ministers to try to balance competing priorities around carbon forests, planted with the primary purpose of earning carbon credits, and not harvested and replanted.

The Ministry for the Environment has just released a discussion document providing four broad options for emissions trading scheme (ETS) reform.

The Government's options for reforming the ETS have not been welcomed by some groups, particularly foresters, with a number saying they will only cause more uncertainty in carbon markets.

Complicating attempts at reform is the fact that political parties have a wide range of policy prescriptions in respect to climate change, the role of the ETS, what is in and what is not, and the role of forestry as a source of carbon storage. This does not provide the level of future certainty required by producers and investors.

More work is needed to promote informed decision-making. Uncertainty creates risk which is in no one's interest when trying to make progress on what is a significant issue facing NZ and its sector producers.

- **Cyclone Gabrielle and Managed Retreat**

While the Bill associated with Cyclone Gabrielle is yet to be fully assessed, some estimates put the cost 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 business owners are considering simply walking away.

The Government recently made a number of decisions in respect to "at risk" houses, without around 700 houses earmarked for demolition, owners to be paid out and costs likely to be split between central and local government. Some insurance money will also potentially be involved. It is likely at this stage the cost will be around $ 1billion, although the exact sharing of the cost has yet to be made public.

BusinessNZ acknowledges the current and future effects of more frequent extreme weather on NZ and its infrastructure, including on transport, energy, and water. But more long-term thinking is needed to make sure responses and infrastructure are future-proofed to deal with climate change's additional stresses.

While one can have significant sympathy for the stress on individuals, households and communities caused by a loss of assets from numerous weather events, the Government is walking a difficult tight rope between ensuring that people are protected to the extent necessary and that individuals and, potentially, communities, do not try to offload their risks onto third parties, principally taxpayers.

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 generally be a very high threshold for central and local government intervention which should be restricted to cases where there is a significant risk to the wider community.

Cyclone Gabrielle, and the Government's stated response so far, raise significant issues in terms of the wider approach associated with managed retreat, the subject of a separate Climate Change Adaption Bill yet to see the light of day. Government has signalled its intention to introduce the Bill before Parliament rises pre-election.

Given the potential risks involved, including the financial impact on taxpayers and a potential effect on current landowners' property rights, the Government will need to tread carefully in guiding the Bill through Parliament. With the risks involved, it would be prudent to have an exposure draft of any legislation to allow public input so that any adverse outcomes (intended or unintended) can be ironed out before the Bill is introduced and becomes law. Obviously, cross-party support for such legislation is desirable to ensure that once a rigorous and economically viable framework has been developed, it is not subject to political manipulation.

- **Government Accounts under further pressure with some expenditure questionable**

While currently, the recent (May 2023) Budget's key economic and fiscal indicators look reasonable, there are still significant risks to these forecasts being realised.

The Government's books are "not immune from a cooling economy," was the line from the Minister of Finance in response to the April 2023 Crown financial results showing most key fiscal indicators as weaker than expected.

While finances can move about from month to month, the general trend is of concern.

NZ's net Crown debt is still relatively low, leaving the Government with some headroom to spend even more than it has to date before NZ's credit rating comes under attack. But with the country's reliance on international trade and its vulnerably to natural hazards, reining in expenditure would be wise.

The Government has been quick to push the line that extraordinary times require extraordinary measures (e.g., increased fiscal support) but also need to address the other side of the coin. Many of the things NZers take for granted might have to be rigorously pruned back if the Government is to get its books in order over a reasonable time period before another "one-off" event hits. In economic terms, there is no such thing as a free lunch.

It is unrealistic to assume the Government will be able to turn the tap off on future expenditure in the out years even although the last couple of years' extraordinary expenditure increases were a direct result of fiscal initiatives taken to soften the blow from Covid.

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

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

More recently, the Auditor-General has been critical of the Provincial Growth Fund (PGF), questioning whether taxpayers are getting good value for money on some of these projects.

According to the Auditor General's report, the PGF showed next to no oversight or measurable achievements for what was a huge amount of taxpayer money. The report states: *"We saw no evidence of clear reporting or regular monitoring of how well the PGF reset was achieving its objectives or how its overall success or value for money could be determined. We also did not see evidence of planning for, or commitment to, an evaluation of the outcomes of the PGF reset."*

Meanwhile NZ's high and persistent current account deficit is problematic for two main reasons. First, increased risk is likely to put NZ under scrutiny by international credit rating agencies which could in turn 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 against our major competitors, certainly not helpful in trying to contain tradeables inflation.

While the Treasury in its May Budget forecast the current account deficit would slowly narrow to 4.6% of GDP by 2025, this would still be significantly wider than the average deficit since 1988, where it has been around 3.3%.

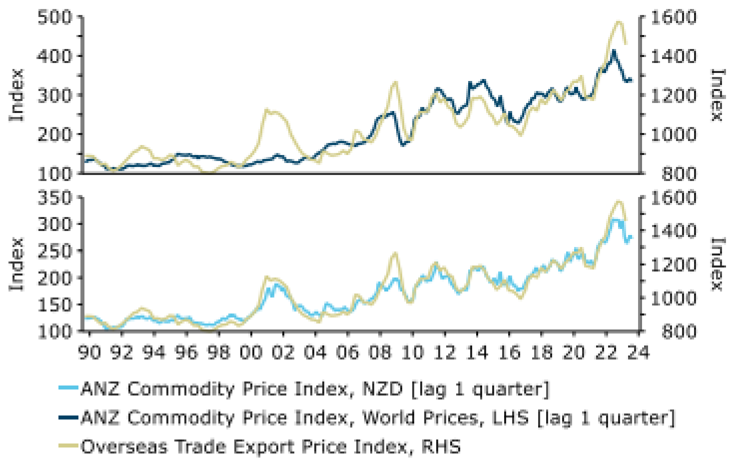
It was disappointing, but perhaps not surprising given the state of the Government's books, that no real form of tax relief was proposed or even signalled in the recent Budget. Given that inflation continues to eat away at disposable incomes, at least a signalling of inflation-adjusting personal tax rate thresholds could have been expected. Maybe this is being saved as a pre-election sweetener later this year.

- **Commodity prices easing but input costs still rising**

The ANZ World Commodity Price Index gained 0.3% m/m in May. Dairy prices lifted but prices for meat, export logs and aluminium fell. In local currency terms the index gained 0.7% m/m, supported by a 0.4% m/m easing of the NZD against the US dollar.

Compared with a year ago, the World Price Index has declined by over 13% while in NZ dollar terms it has dropped by 10% over the same period.

ANZ Commodity Price Index



Source: Stats NZ, Macrobond, ANZ Research

It could be argued that commodity prices are still holding up reasonably well on an historical basis but it must be remembered that input costs have risen rapidly for some of our key export commodities such as dairy and meat.

The Beef + Lamb NZ Economic Service (Sheep and Beef On-farm Inflation 2022-23 (May 2023)) found that at 16.3% in the year to March 2023, on-farm inflation was even higher than the past year's 40 year high (10.2%), and higher than anticipated earlier in the year. In fact, it was the highest on-farm inflation since 1981.

A key driver of on-farm inflation was interest expenditure because, on average, 80% of farm term debt is on floating interest rates and these rates doubled over the period.

In March B+LNZ forecast a 30% decrease in average farm profit based on estimated on-farm inflation of 12-13%. This latest result means farm profits are likely to fall even further.

The significant erosion in profitability and ongoing high input costs means farmers are more sensitive than ever to changes that could increase their costs, such as new rules and regulations.

- **International economic risks**

Meanwhile, the international economy continues to face significant challenges with geopolitical tensions a major issue on a number of fronts. Significant geopolitical uncertainty is particularly evident as the major international powers flex their muscles on the global stage.

Trade tensions are significant and greater moves towards nationalistic policies will harm free trade initiatives while potentially driving up prices as competitive pressures take a back seat.

Ongoing concerns with recent financial sector stress and the sustainability of public debt, along with continued inflationary pressure, are adding to the cocktail of uncertainty facing international investors. World growth is expected to be modest over the next few years, despite the reopening of China after its draconian lockdowns in response to Covid-19.

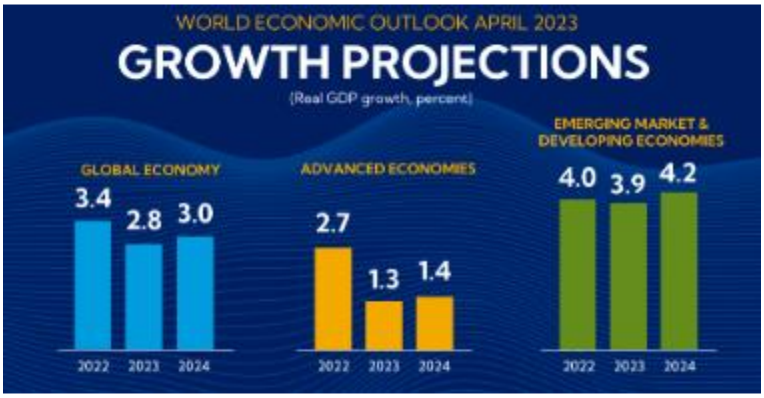
Given that China is NZ's largest trading partner and, combined with Australia, accounts for around 40% of NZ's two-way trade, it almost goes without saying that NZ livelihoods are heavily dependent on the performance of both China and Australia. This does raise the concern that NZ currently has too many eggs in one or two baskets, potentially exposing the country to the vagaries of geopolitical tensions.

The International Monetary Fund (IMF), in its latest World Economic Outlook (April 2023), considers tentative signs that the global economy could achieve a soft landing have receded amid stubbornly high inflation and recent financial sector turmoil. Underlying price pressures are proving sticky with labour markets still particularly tight in a number of developed economies, despite significant rises in net migration of late.

The IMF considers many of the issues facing the world economy last year are set to continue but with a changed intensity. Debt levels remain high, limiting the ability of fiscal policy-makers to respond to new challenges and while inflationary pressures are abating, geopolitical tensions are also still high.

The IMF reiterated that despite supply chain pressures easing, together with energy and food prices, risks are firmly on the downside given increased uncertainty from the recent financial turmoil.

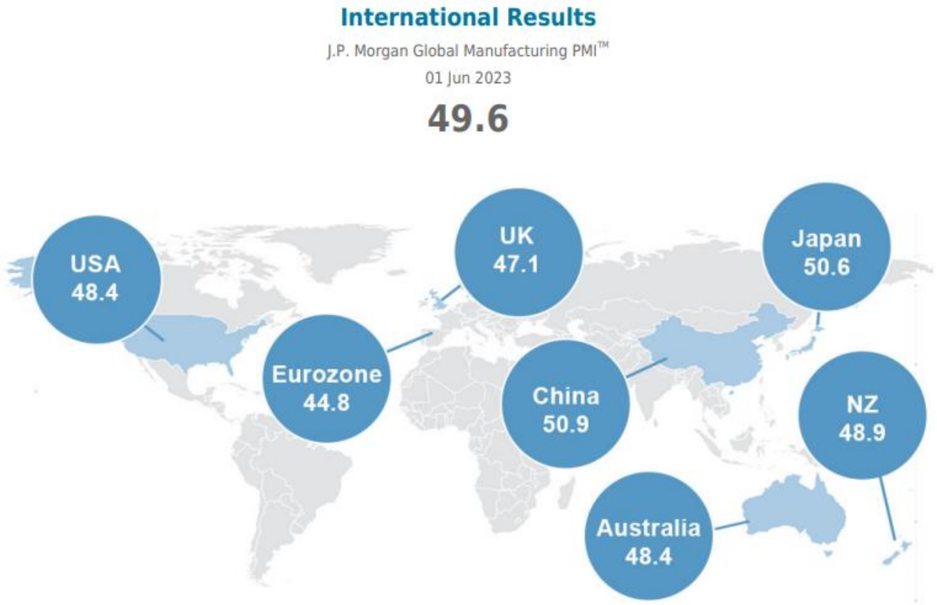
World economic growth is forecast to fall from 3.4% in 2022 to 2.8% in 2023, before rising slowly and settling at 3.0% five years out – the lowest medium-term forecast in decades.



Source: IMF World Economic Outlook (April 2023)

Meanwhile, global headline inflation is forecast to fall from 8.7% in 2022 to 7% in 2023 on the back of lower commodity prices while underlying (core) inflation is likely to decline more slowly.

Globally, manufacturing activity is still below par, although it is improving as supply chains improve and input costs decrease for the first time since May 2020. Worryingly though, global business optimism has dipped to a five-month low, while new order intakes continue to fall.



The latest Organisation for Economic Cooperation and Development (OECD) Economic Outlook shows growth is fragile, inflation remains sticky, and pro-economic growth structural reforms are required.

The OCED Policy recommendations included:

- **Monetary policy:** To durably reduce underlying inflationary pressures, **monetary policy needs to remain restrictive**. This may require additional interest rate increases in economies in which high core inflation is proving persistent.
- **Target fiscal support:** With global food and energy prices having declined, **fiscal support to mitigate the cost-of-living crisis** should increasingly become **targeted toward vulnerable households** inadequately covered by the general social protection system.
- **Pro-growth structural reforms:** Enhancing **business dynamism**, lowering barriers to cross-border trade and economic migration, and fostering flexible and inclusive labour markets, are all key policy areas where well-designed reforms would help to **boost competition, revive investment, and alleviate supply constraints**.
- **Promoting gender equality:** Wage gaps have generally narrowed at a relatively **modest pace over the past decade**, calling for **further action** across a broad range of policy areas to strengthen participation, **skills, and opportunities for women**. Such action would improve growth prospects and make labour markets more inclusive.

Forecasts: Real GDP percent Growth

	Years Ending		
	Jun 23	Jun 24	Jun 25
Highest	3.2	1.4	3.0
Average	3.1	0.5	2.0
Lowest	3.0	-0.3	0.9

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – pause and reflect?

Despite calls from a few commentators for the Reserve Bank to continue hiking interest rates beyond the current 5.5% rate, the Bank has been reasonably upfront in indicating there is no intention to advance the rate further.

At the back of the Reserve Bank's thinking will be the fact the OCR has risen dramatically over the last 18 months from a low of 0.25% to the 5.5% it is now, and that monetary policy takes some time to impact fully on the economy. For example, many households are facing significant mortgage interest rate rises given the number of mortgages still to come up for renewal.

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

Politicians from almost across the political spectrum have targeted banks for making allegedly excess profits, with 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, a Commerce Commission inquiry into the banking sector has just been announced.

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% while the average ROE of the S&P/NZX 50 Index companies was 15%.

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 effectively, no new players can enter the market.

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

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

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 higher cost of credit and/or restrictions on credit availability.

In the meantime, the Reserve Bank has moved to ease loan to value ratios (LVRs) put in place some years ago to contain upward pressure on house prices. Easing LVRs should encourage more interest in housing, particularly from first home buyers, many of whom to date have effectively been shut out of the market.

It should be noted that the Government is in the final throes of enacting legislation (the Deposit Takers Bill) to protect depositors against bank collapse.

The scheme aims to stabilise NZ's financial system by providing each eligible depositor with $100,000 of compensation protection for their protected deposit at each deposit taker (principally banks). It is likely that this will provide cover for more than 90% of depositors.

While this might sound an attractive idea, it does have some downsides.

First, it has to be paid for, so there is a logical assumption that end consumers (depositors) will ultimately bear the cost through reduced deposit rates.

Second, on the margins at least, it could encourage banks to be riskier in their lending procedures, knowing that if depositors lose their money, they will be compensated.

Third, and quite importantly, it could encourage unintended consequences, if individuals think all their investments (e.g., KiwiSaver) are protected against loss and hence fail to monitor deposit takers in a rigorous manner.

As with many regulatory interventions, there is no such thing as a free lunch here.

Inflation – still front of mind

The annual growth in the Consumers Price Index (CPI) is expected to remain elevated above the Reserve Bank's 1–3% inflation target band in the year ending June 2024 and fall to 2.5% by June 2025. Although the Reserve Bank has been increasing the Official Cash Rate (OCR) since November 2021, it is only in recent months that the NZ economy has started to show signs of inflation turning a corner. The March 2023 CPI indicated annual inflation of 6.7% with higher food prices the largest contributor.

There are still potential upside risks to inflation pressure from the post-storm rebuild and the strong recovery in net migration as these will likely contribute to construction activity and the demand for a wide range of goods and services.

NZ's move to reduce carbon emissions to meet its international obligation of net zero by 2050 will also necessarily involve increasing cost 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.

Meanwhile, insurance costs are due to continue rising as a result of increased risk with a number of insurers likely to increase premiums on housing and cars by between 20 and 30%.

There are also upside inflationary risks from the current international geopolitical situation which will likely cause countries to become much more insular and concerned about sourcing materials internally. This will add further to the cost 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 past 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, reflected in downward revisions to the milk payout for NZ producers. Notwithstanding, payouts remain well above their long-term average although are being rapidly eroded through higher input costs.

The addition to labour supply that comes with a gain in migration will likely outweigh the addition to demand, on balance, generating less inflationary pressure than has been seen in previous immigration booms.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Jun 23	Jun 24	Jun 25
Highest	6.1	3.8	2.7
Average	6.0	3.3	2.5
Lowest	5.9	2.6	2.1

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – elevated for longer

The Reserve Bank recently increased the OCR by 25 basis points to 5.5%, but surprised some commentators and financial markets by saying there would be no further rises at this stage.

Calling time on further increases was perhaps a surprise given a still high level of inflationary expectations, although in the view of some banks, the Reserve Bank will have to reconsider as further rises out to 6% later this year will be required if it is serious about getting inflation within the 1-3% target over the medium term.

Unfortunately, but not unexpectedly, wholesale interest rates have tended to decrease as a result, not something the Reserve Bank will necessarily be pleased about. While reductions in wholesale rates have yet to feed through to lower retail rates, this will not help the Bank achieve its mandate in a timely manner. Now is not the time for the Reserve Bank to blink.

Having said that, the rate of rise in the OCR over the past year has been very significant and the Reserve Bank probably has at the back of its mind that the economic impact of such rises will take some time to filter through.

On the one hand, the global economy is under pressure and there have been generalised reductions in inflationary pressure (including commodity prices), positive for their inflationary impact on NZ. On the other hand, NZ's current account deficit is seen as putting the NZ dollar under some pressure, which means tradables' inflation might feed through further to NZ households than would otherwise be the case.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Jun 23	Jun 24	Jun 25
Highest	5.7	5.6	4.0
Average	5.7	5.2	3.8
Lowest	5.6	5.0	3.5

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – lower for longer

The NZ dollar is likely to come under further pressure over the next year, the consequence of a number of factors.

First, the Reserve Bank's signalling that further rate hikes in the OCR are effectively off the table will likely impact on the demand for NZ dollars as, potentially, interest rates will start to fall (given other countries are still hiking rates to a greater or lesser degree.)

Second, the Reserve Bank's relatively dovish tone in referring to the economic growth outlook will take some interest away from NZ as an investment destination.

Third, commodity prices are coming under pressure and given NZ dollar fortunes are traditionally heavily tied to commodity prices, this could see some further weakening.

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

Fifth, a blow-out in the Government's current account deficit is a cause for concern given the balance of payments, or current account, which measure inflows and outflows of payments associated with imports, exports, investment and debt servicing, essentially track whether NZ is paying its way in the world. While the current account deficit is forecast to reduce significantly over time largely as a result of improving visitor numbers, it is still problematic.

Finally, uncertainty is likely to prevail as we head into the general election in October. The election's outcome is highly uncertain at this stage which will likely to add to investors taking a wait and see approach to new investment.

Forecasts: Exchange Rates

AUD (cents)			
	Jun 23	Jun 24	Jun 25
Highest	0.95	0.93	0.94
Average	0.94	0.91	0.90
Lowest	0.91	0.89	0.87

USD (cents)			
	Jun 23	Jun 24	Jun 25
Highest	0.64	0.68	0.69
Average	0.62	0.63	0.67
Lowest	0.60	0.56	0.65

TWI			
	Jun 23	Jun 24	Jun 25
Highest	72.0	73.0	74.0
Average	71.2	71.5	72.4
Lowest	70.5	70.5	70.9

Source: ASB, BNZ, Kiwibank and Westpac

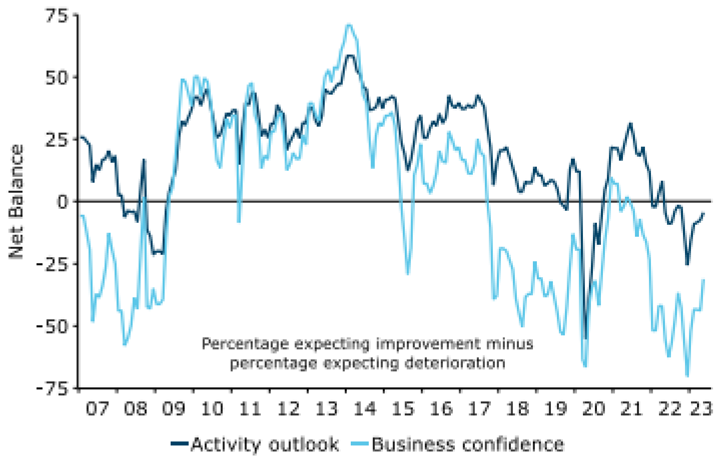
1.3 Business activity and confidence – improvement but off low base

Both business and consumer confidence remain downbeat although there has been a general improvement compared with the lows experienced last year and earlier this year.

The ANZ NZ Business Outlook shows business confidence and expected own activity both lifting in May, albeit, off a low base.

Business confidence lifted 13 points from -43.8 to -31.1, while expected own activity rose from -7.6 to -4.5.

On the positive side of the coin, inflation indicators have generally eased, although cost expectations remain stuck at high levels.



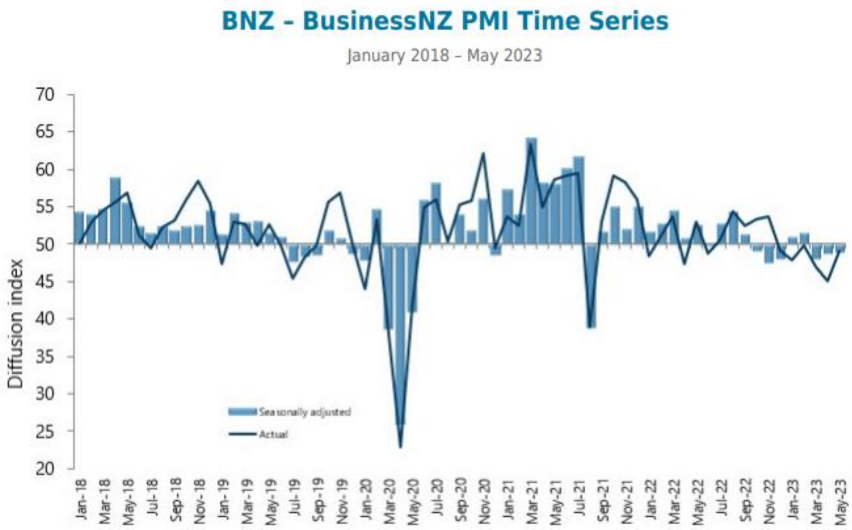
Source: Macrobond, ANZ Research

Meanwhile investment intentions remain steady at low levels (-6.8), unchanged from April, as uncertainty bites.

Wider data on sector performance continues to show variable performance, although the risks appear to be on a downside at this stage.

New Zealand's manufacturing sector continued its contraction in May, according to the latest BNZ – BusinessNZ

Performance of Manufacturing Index (PMI). The seasonally adjusted PMI for May was 48.9. (A PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining.)

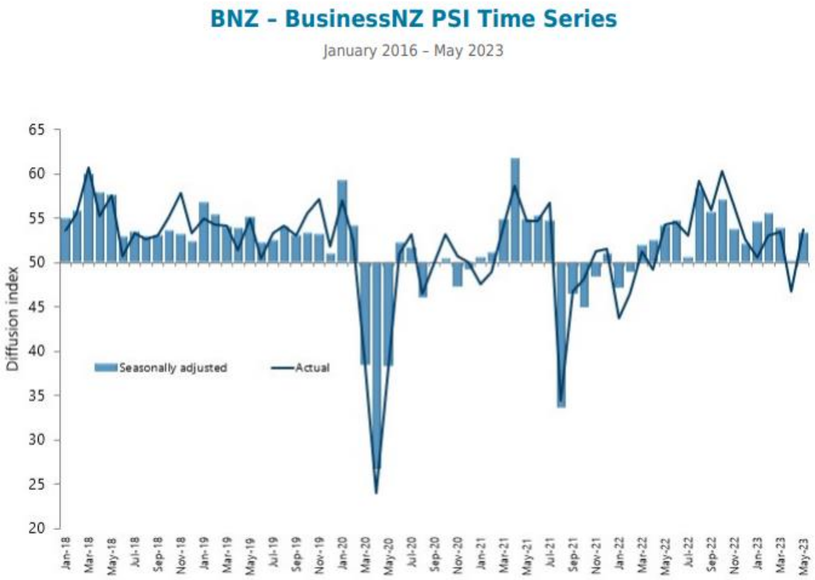


The latest result was all but unchanged from April, and still well below the long-term average activity rate of 53.0. Despite a few positive movements in the make-up of the Index, the sector is still continuing its trend of contraction.

While the overall activity result has crept upwards over time, Production (45.7) remains stumblingly entrenched below the 50-point mark. Employment (49.5) lifted compared with the previous two months, while New Orders (50.8) provided a positive result after two months of contraction.

The proportion of negative comments stood at 66.7%, slightly down from 70.3% in April, but up on 63.2% in March and 60.2% in February. Beyond seasonal factors such as weather, comments tended to concentrate on slowing orders/deteriorating demand and lower sales levels.

Meanwhile, NZ's services sector increased its expansion during May, according to the BNZ – BusinessNZ Performance of Services Index (PSI). The PSI for May was 53.3. (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining.)



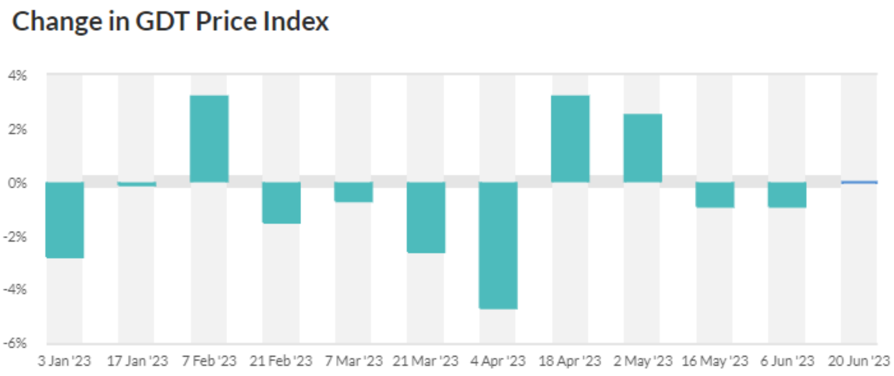
This was up 3.2 points from April, but still below the survey's long-term average of 53.6.

In terms of the sub-index results, all five measures showed expansion with Stocks/Inventories (56.8) leading the way, followed by New Orders/Business (55.4).

The lift in expansion for May also saw a pickup in the proportion of positive comments, which rose from 39.8% in April to 50.6% for the current month. Overall, positive comments received did not show any defining themes. Instead, they were either industry-specific or very general around increased activity.

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 continue to drift lower. While the latest global dairy trade (GDT) auction saw prices remain static, the headline GDT index is now down around 26% on this time last year. Fonterra recently reduced its forecast payout for the 2022/23 season to $8.10-$8.30 (with a midpoint of $8.20), a decline of 8.9% compared with what it was estimating at the beginning of the year. The co-operative has noted that reduced short-term demand, particularly from China, has meant GDT prices have not recovered as much as hoped. Looking ahead to the 2023/24 season, Fonterra has an opening forecast of $7.25-$8.75, with a midpoint of $8.00.



The latest farm expenses price index from StatsNZ showed input costs continuing to lift but at a slower pace. All inputs, excluding livestock, rose 0.5% in the March quarter compared with the December quarter, when they rose 3.0%.

Pressure eased because of a 10% slide in fuel costs and a 4.2% decline in fertiliser costs. Interest rate costs were up 7.9%.

Meanwhile Federated Farmers has released its pre-election roadmap for restoring confidence in the agriculture sector.

Federated Farmers' 12 policy priorities for the next Government include:

1. Support better use of technologies
2. Unlock potential through water storage
3. Allow young farmers to access their KiwiSaver
4. Urgently review our methane targets
5. Rethink our ETS Forestry Rules and net-zero target
6. Scrap the Ute tax and fix our infrastructure
7. Give back control to local communities
8. Fix our unworkable freshwater rules
9. Get RMA reform right
10. Simplify Significant Natural Areas
11. Build the farmer workforce

The construction sector is facing mixed fortunes with the number of consents starting to drift lower. Weaker housing market activity and high interest rates will continue to weigh on construction demand for the coming year.

The seasonally adjusted volume of total building activity was $9.1 billion in the March 2023 quarter, up 0.6% compared with the December 2022 quarter, according to figures released by StatsNZ.

The volume of residential building work was down 0.8% to $6.1 billion in the March 2023 quarter, while non-residential building work was up 3.6% to $3 billion over the same period.

The March 2023 quarter marked the second quarter in a row where NZ has seen a fall in the volume of residential building work. The volume of non-residential building work, on the other hand, has seen four consecutive quarters of growth.

Prospective buyers are still 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 on building materials.

The drop in housing prices over the past couple of years appears to be slowing of late with the potential for some rises as we head into the second half of this year.

On the downside, household budgets are under pressure with the flow-on effect of higher interest rates yet to fully impact on many households given a number of mortgages are yet to come up for renewal. The potential for lower economic growth and forecast higher levels of unemployment could put a handbrake on further rises.

On the other hand, there are several factors likely to impact positively on the housing market over the coming months.

First, interest rates are now likely to be close to their peak (although some banks have continued to raise rates as we speak). Nevertheless, the potential peak in interest rates will give some confidence to future buyers with a number of forecasting agencies expecting rates generally to fall next year. However, this is far from certain given the prolonged inflationary expectations embedded into business and household thinking.

Second, with lower overall housing prices, rental yields look better.

Third, the recent Reserve Bank easing of loan to value ratios provides first home buyers with more opportunity to enter the market.

Fourth, building consent numbers continue to ease which, combined with a significant rise in net migration numbers, will mean there is the potential for pent-up demand for accommodation.

Fifth, a potential change in the Government in October this year would likely mean a change in tax policy in respect to housing with the reinstatement of property investment interest costs as tax-deductible and a reduced bright line test. These, and some other factors, could see some upturn in housing interest, at least post-election.

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

Total retail card spending fell $113 million (1.7%) in May 2023 compared with April 2023, when adjusted for seasonal effects, according to data released by StatsNZ.

Seasonally adjusted card spending fell across all retail industries (including consumables, durables, apparel, fuel, and motor vehicles), as well as non-retail, excluding the services category. Services was the only industry that saw an increase, rising $1.4 million (0.4%) compared with April 2023.

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. Shortage of staff is still a major issue for these sectors, despite increases in net migration of late.

1.4 Labour market – signs of easing

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

While the Household Labour Force Survey shows the unemployment rate for the March 2023 quarter stayed at 3.4%, the labour force participation and employment rates reached record highs – 72% and 69.5% respectively.

Meanwhile, migration has surged spectacularly. In the space of a year NZ has gone from an annual net outflow of over 19,000 to an annual net inflow of 72,300.

While the healthy net migration gain continues, it should also be noted that there has been an exodus of NZers heading overseas, not unexpected given the closed borders prevalent until last year.

There was a net loss of 26,100 NZ citizens over the last year, larger than the 5,000 average net loss from 2015-19, but smaller than the 29,000 average net loss between 2005 and 2014.

Despite the hype over the recent increase in net migration, the increase is likely to be explained more as a result of closed borders than as any sort of flow of individuals to NZ as an attractive economic destination.

Most forecasting agencies are predicting that net migration will not rapidly fall back to the long-term average of around 30-40,000 per annum.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 23	Jun 24	Jun 25
Highest	3.5	5.0	5.4
Average	3.5	4.8	5.2
Lowest	3.4	4.5	5.0

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – trending lower

Wage growth is forecast to trend lower both as a result of a slowing economy and unemployment forecast to trend higher. Annual increases in both Stats NZ's measures for wages and salaries were historically high in the March 2023 quarter – a 7.6% increase in the Quarterly Employment Survey's (QES) average hourly earnings and a 4.5% increase in the Labour Cost Index (LCI).

The LCI's primary measure of wage inflation adjusts for changes in employment quality. Therefore, employees receiving promotions or moving to different roles do not affect this measure of wage inflation. However, these movements are captured in the QES's hourly earnings statistics.

Meanwhile, advertised salaries increased by 4.7% in the year to May 2023, the fastest annual growth recorded by Seek NZ since its data collection began in 2016.

With more people coming from overseas to work in NZ, we can expect an easing in labour shortages over the coming year, and this should help moderate wage growth, as can be seen from the forecasts below.

According to data from Seek NZ, jobs ads declined 5% month-on-month and were 22% lower than in May 2022, when they were at their highest on record.

Manufacturing, transport and logistics drove the overall decline in job ads down 7% month-on-month, followed by hospitality and tourism (-10%) and trade and services (-6%).

Healthcare and medical had the largest increase in ads, up 1% month-on-mouth, driven by a demand for aged care nurses, psychologists and physiotherapists. Construction (3%) and engineering roles (4%) also showed an upturn.

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

	Years Ending		
	Jun 23	Jun 24	Jun 25
Highest	4.6	4.8	3.9
Average	4.6	4.2	3.3
Lowest	4.5	3.2	2.4

Source: ASB, BNZ, Kiwibank and Westpac