BUSINESS NZ

PLANNING FORECAST

SEPTEMBER 2023

BusinessNZ

NZ Economy: Under the pump

Executive Summary

Both domestic and international pressures continue to bear down on the NZ economy with minuscule growth predicted over the forecast period out to September 2025. Although some growth is expected based on recent strong growth in net migration, actual GDP on a per capita basis will show NZ going backwards.

The recently released pre-election Economic and Fiscal Update (PREFU) shows the Government's accounts have continued to deteriorate significantly since the May 2023 Budget. A number of commentators, including BusinessNZ, considered many May Budget assumptions heroic and the latest update has unfortunately proved this assessment right.

A slowing economy is affecting the revenue side of the equation while the Government has struggled to peel back expenditure as a percentage of gross domestic product (GDP) to anywhere near pre-Covid levels. As a result, net debt levels will continue to rise over the short term with the Government's earlier projections of Budget surpluses pushed further out. There are significant risks to achieving forecast outcomes if the economy stutters.

Despite a slowing economy, inflationary pressures remain elevated, not helped by recent moves by a number of oil producing nations to restrict oil supplies. And agricultural commodity prices (important to NZ success) have slumped over recent months only recently showing any tendency to stabilise.

Of recent weeks, Fonterra, and other dairy companies have taken the axe to forecast payouts to dairy farmers and although prices are still around their long-term averages, input costs remain high, adversely affecting returns. A number of agencies consider the forecast payout is well below the level required for a breakeven result while, obviously, interest rate hikes are imposing particular pressure on those with high levels of debt.

Lower commodity prices will particularly impact regional economies already under stress - from lower activity levels, the consequence of disruptive weather events, lower levels of tourism, and the continued difficultly of securing much needed labour.

Net immigration levels have recovered with a record 96,200 for the year to July 2023 but this is very much too little, too late. Many of our competitors have stolen a march on NZ with more inviting regimes in respect to inward flows of both capital and labour.

It is unfortunate that most political parties continue to promote restrictions on foreign investment in one form or another. NZ should have a much more open policy that attracts the foreign capital needed to meet the needs of current and future generations alike.

NZ's regulatory processes need to be much more rigorous as, currently, ad hoc regulations are very much the order of the day. There must be a significant improvement in regulatory processes and the quality of regulation if the country's investment environment is to be capable of providing domestic and international investors with confidence their property rights will be upheld and not further eroded at the stroke of a regulatory pen.

Meanwhile, a number of surveys have confirmed the high cost of doing business as a key business concern. The results of a recent Deloitte and Chapman Tripp Election Survey conducted by BusinessNZ, show 93 percent of respondents believing changes made by the current Government had increased their cost of doing business. The other main concern – of a staggering 85 percent of those responding – was their belief that the current Government does not have a plan for raising New Zealand's economic performance.

HIGHLIGHTS

Growth over the forecast period to September 2025 is expected to remain mediocre with a number of pressures, both domestically and internationally, impacting on activity.

The BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at -6 for the September 2023 quarter, a deterioration of 3 on the previous quarter and a deterioration of 9 on a year ago.

While business confidence has improved significantly of late, it is off a very low base and businesses are still taking a cautious approach to investment. This probably reflects a number of factors, including declining demand but also businesses weighing up the likely shape of the next government and the potential implications for the investment climate.

Both the BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) are operating at sub-par levels, continuing in contraction mode for August.

Other activity indictors, such as retail sales (although temporarily boosted by the FIFA world cup), point to a slowing economy, while continuing low consumer confidence points to declining activity as inflation and rising interest payments curtail spending.

International commodity prices are very much a two-edged sword with oil prices on the up while agricultural prices have taken a hit, reflected in a downgrade in the anticipated milk payout. This will adversely affect the regional economy.

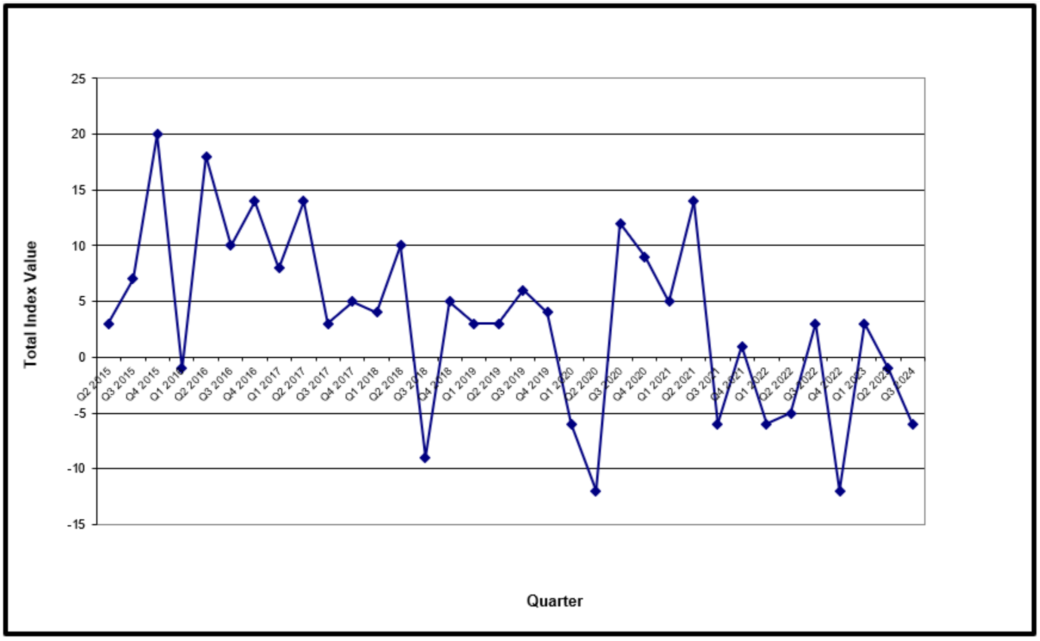
Meanwhile, world growth is expected to be modest over the next few years with nationalism likely to receive greater emphasis than hitherto. At the same time, China's economic woes are problematic for NZ, given China is this country's biggest trading partner.

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 -6 for the September 2023 quarter, a deterioration of 3 on the previous quarter and a deterioration of 9 on a year ago.

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 1 for the September 2023 quarter, down 2 on the previous quarter and down 2 on a year ago. NZ's dependence on China is affecting performance as the Chinese economy faces a number of economic problems.

Monetary policy/pricing indicators sit at -3 for the September 2023 quarter, a deterioration of 1 on the previous quarter but an improvement of 5 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 OCR rises given many factors continue to impact on tradeables' and non-tradeables' inflation, including international efforts to restrict oil supplies.

Business/consumer confidence indicators sit at -1 for the September2023 quarter, the same as the previous quarter but down 4 on a year ago. While business confidence has improved of late, this has been off a very low base. Meanwhile, consumer confidence remains stuck at low levels. High levels of household debt, rising interest rates and inflationary pressures are cutting into disposable household incomes.

Labour market indicators sit at-3 for the September 2023 quarter, down 4 on the previous quarter and down 8 on a year ago. Net migration continues to ramp up reaching record levels in the year to July 2023, easing some of the pressure on the labour market. On the other hand, rising business cost pressures and reduced demand as consumers close their wallets will result in a rise in unemployment over the forecast period.

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

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

1.1 Economic growth (GDP) – sub-par

Economic growth is forecast to remain mediocre over the forecast period out to September 2025 (see below).

Both domestic and international pressures continue to bear down on the NZ economy but with minuscule growth predicted over the forecast period out to September 2025.

The latest opening of the government books (the Pre-election Economic and Fiscal Update – PREFU) suggests NZ will avoid a further recession with minuscule growth projected over the next few years, much of it based on significantly increased migration levels. When converted to per capita growth, NZ will be going backwards.

A recent Deloitte and Chapman Tripp Election Survey conducted by BusinessNZ, shows 93 percent of respondents saying changes made by the current Government have increased their cost of doing business. Perhaps even more concerning, 85 percent of those responding believe there was a lack of any plan for raising New Zealand's economic performance.

In its latest annual assessment of the NZ economy, the International Monetary Fund (IMF) has forecast growth to slow to around 1% in 2023 and 2024, as tighter monetary policy takes a firmer grip on household spending.

The IMF shows inflation returning to the Reserve Bank's target range in 2025 but with interest rates remaining around current levels until 2025. Unemployment is also expected to edge up to reach 5% in 2025.

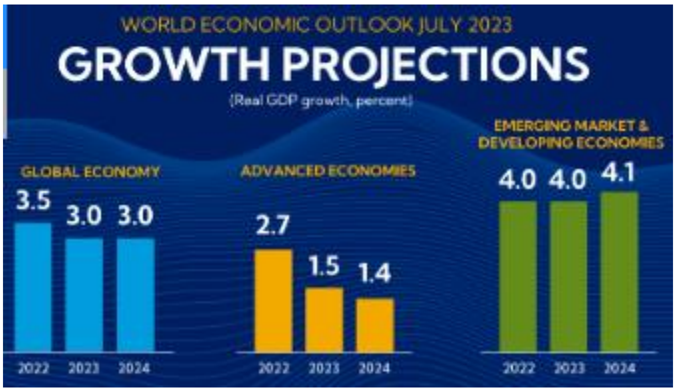
There are some key risks facing the NZ economy when it comes to improving growth prospects over the next few years.

These include, in no particular order, the following:

World growth rates remain subdued

It goes without saying that NZ, as a trading nation, is heavily dependent on the ability of our major trading partners to buy our products, as we are still significantly focused on agricultural production.

According to the IMF World Economic Outlook (July 2023) global economic growth is projected to fall from an estimated 3.5% in 2022 to 3.0% in both 2023 and 2024.



Source: IMF World Economic Outlook (July 2023)

While the forecast for 2023 is marginally up on earlier forecasts, it remains weak by historical standards.
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A key issue identified by the IMF as weighing on growth is the continued rise in central bank interest rates to fight inflation, with underlying core inflation projected to decline more gradually than headline rates.

The IMF also points to continued risks associated with an intensification of the war in Ukraine and extreme weather-related events that might increase prices and hence require even further tightening by central backs.

China is also called out for mention given its slow recovery and issues associated with unresolved real estate problems, with negative cross-border spillovers. Debt levels are also coming under scrutiny.

Given China is NZ's largest trading partner, it is concerning that as China's economic prospects have taken a hit that is being reflected in reduced demand for NZ products with consequential flow-on effects for NZ's regional economies, heavily dependent on the fortunes of the agricultural sector.

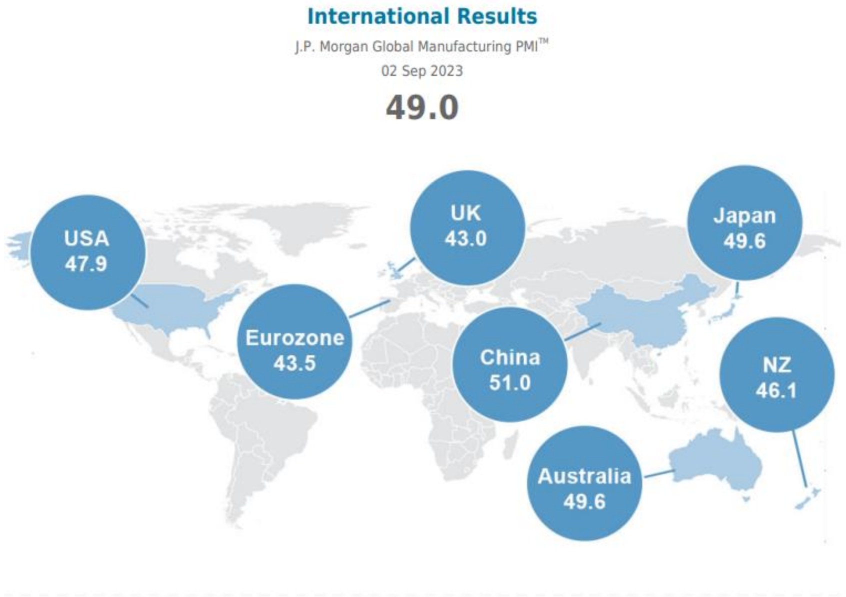
Notwithstanding the above, latest Chinese activity indicators for the month of August were better than expected. Industrial production and retail sales improved, rising at the fastest rate since April and May.

Measures introduced to support a property sector under pressure appear to have bought some much-needed stability. Nevertheless, the number of issues facing the Chinese economy should not be downplayed despite some recent improvement in data.

Globally, manufacturing activity is still below par, although showing a marginal improvement of late.

Rates of decline for production, total new orders and new export business all slowed and employment edged higher.

The J.P Morgan Global Manufacturing PMI rose to a three-month high of 49.0 in August, up from 48.6 in July, but still in contraction. (A PMI reading above 50.0 indicates that manufacturing is generally expanding: below 50.0 that it is declining.)

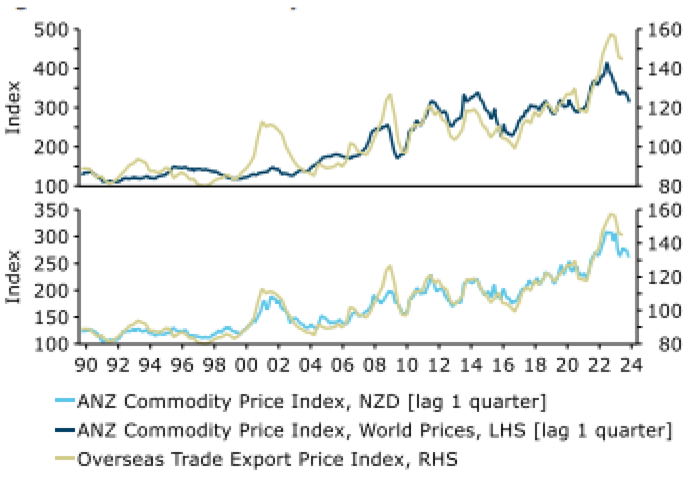


Commodity prices easing but input costs still rising

Despite a slowing economy, inflationary pressures remain elevated, not helped by recent moves by a number of oil producing nations to restrict oil supplies. Agricultural commodity prices (important to N'Zs success) have slumped over recent months and have only recently shown any tendency to stabilise.

The ANZ World Commodity Price Index fell for the third consecutive month, dropping 2.9% m/m in August. Dairy and lamb prices fell while slightly stronger prices were recorded for other food commodities. In local currency terms, the index rose 0.6% m/m as the NZD depreciated 2.2% against the Trade Weighted Index (TWI).

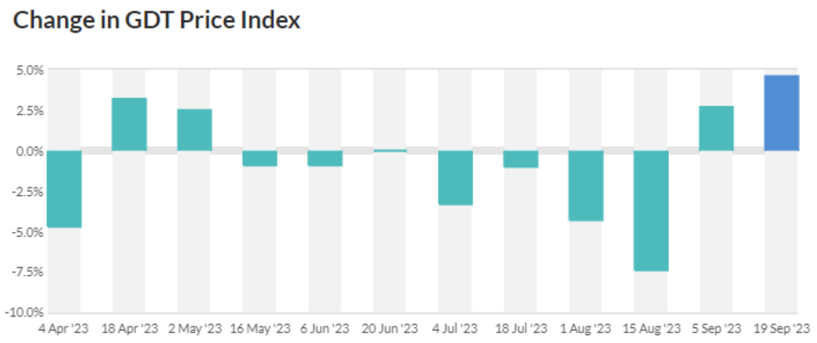
ANZ Commodity Price Index



Source: Stats NZ, Macrobond, ANZ Research

Demand for key NZ commodities such as dairy has slumped over recent months, with the projected dairy payout to farmers successively cut over recent weeks.

While the latest two global dairy trade (GDT) auctions saw prices rise, the headline GDT index is still down around 25% on a year ago. Reduced demand from China, the world's biggest market for dairy and Fonterra's biggest market for whole milk powder, has been the principal reason for the price reduction.


Change in GDT Price Index

Forsyth Barr analysts estimate there is a gap of nearly 90 cents per kilogram between the current milk price and dairy farmers' break-even point.

Fonterra slashed its forecast payout twice in August and is currently forecasting a farmgate payout of between $6 and $7.50 per kilogram of milk solids (kgMS), with a midpoint of $6.75.

In their latest Dairy Digest report, Forsyth Barr analysts have estimated a break-even milk price for the current season of $7.55kgMS. This leaves a shortfall of around 86ckgMS.

Individual farmer circumstances will differ as to what a potential shortfall will be (including levels of debt and associated debt servicing costs), however likely outcomes will reflect negatively on the rural economy and many regions dependent on the fortunes of farmers for their overall livelihood.

Meanwhile, two of NZ's largest meat processors (Silver Fern Farms and the Alliance Group) have put out forecasts until the end of the year, both of which make sober reading.

The Chinese economy slowdown has put significant pressure on NZ's exports to that country, particularly red meat and dairy products and prices are under pressure.

In a newsletter to suppliers, Silver Ferm Farms said it was facing low demand, high inventories, and increased production from other markets, including Australia and Brazil.

It was cautiously optimistic that prices had bottomed out for beef but stated that for lamb, things are still very challenging.

While Silver Ferm Farms was confident the underlying demand for red meat protein would continue to grow over time, the real question in respect to that timing is China's potential recovery.

The Alliance Group commentary made similar points.

Lower commodity prices facing NZ producers, combined with continued high input costs (some domestically generated and some overseas generated – e.g., restricted oil supplies) have put significant pressure on farming budgets. Ultimately, this will flow through into reduced investment, a lower tax take for the sector and will also affect the economic viability of some rural communities, some already struggling with the consequences of adverse weather events earlier this year.

Government Accounts remain under pressure

The recently released pre-election PREFU shows the Government's accounts have continued to deteriorate significantly from those outlined in the May 2023 Budget. Many commentators, including BusinessNZ, considered many of the assumptions in the May Budget were heroic and the latest update has unfortunately proved this assessment to be correct.

A slowing economy is affecting the revenue side of the equation while the Government has struggled to peel back expenditure as a percentage of GDP to anywhere near pre-Covid levels. As a result, net debt levels will continue to rise over the short term while the Government's earlier projections of Budget surpluses have been pushed further out. There are significant risks to achieving the forecast outcomes if the economy stutters.

A number of credible economic commentators (including Dr Bryce Wilkinson) also question whether the PREFU forecasts are realistic given the Government's previous record of trying to contain expenditure.

Dr Wilkinson's reasons for scepticism seem very plausible, as outlined in a recent article in the NZ Herald.

"The forecasts accept, as Treasury must, the Minister of Finance's advice that the Government is going to be very tight with new spending initiatives through to 2027. Allowances have been cut by around 1 per cent of GDP.

Why does this advice feel unreal?

It feels unreal because Labour's Fiscal Plan in 2017 proposed to increase core Crown operating spending by just $11.7 billion, spread over the five years to June 2022.

Two years later (pre-Covid-19), Treasury put the increase at $27.7 b. That made a mockery of Labour's fiscal plan.

The subsequent spending response to Covid-19 took the increase to $77.4 b. That additional blow-out would have been understandable were it temporary.

It is neither temporary nor the full story. Treasury's pre-election forecasts in 2020 were informed by Covid spending responses. Spending to the year ended June 2024 was forecast to be $116b. This week, the forecast spending is $139b.

Even on the latest optimistic forecasts, core Crown operating spending will average 32.5 percent of GDP during the four years to 2026-27. That compares with a pre-Covid ratio of 28.0 percent in 2018/19."

There is a real danger in Treasury's forecast that only in 2027 is there a projection of a small surplus. In general, history would show that forecasting deficits out for this length of time is usually problematic and without significant expenditure costs, the risk is that more 'one-of' events will occur and blow the forecasts clean out of the water.

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 last year (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."*

There is clearly a need to take an axe to Government expenditure if NZ is to get its house in order without further burdening future generations with increased debt. Financing debt is already costing the Government (read taxpayer) around $9 billion per annum with little to show for it. If the Government could point to major infrastructure investments, then maybe there would be some public acceptance of increasing debt. Funding current consumption is simply not a recipe for future growth.

Reining in Regulatory Overkill

While net immigration levels have recovered with a record 96,200 for the year to July 2023, this is very much too little too late as many of our competitors have stolen a march on us with more inviting regimes in respect to inward flows of both capital and labour.

It is unfortunate most political parties still promote restrictions on foreign investment in one form or another when NZ needs a much more open policy to attract the foreign capital required to meet the requirements of current and future generations.

One useful recommendation coming out of the recent Review into the Future for Local Government Final Report (June 2023) was *"Cabinet is required to consider the funding impact on local government of proposed policy decisions."* The idea is that for too long central government has burdened local government with largely unfunded mandates, resulting in ratepayers ultimately picking up the tab for often ill-considered regulatory interventions.

The Review's recommendation is well-intentioned but to be successful would require a significant improvement in central government's Regulatory Impact Analysis (RIA).

Also required would be a fundamental change in the culture of New Zealand regulators.

We need to get serious about the regulatory overkill in this country, taking a good hard look at both the quantity and quality of the regulations currently afflicting business.

Improving the quantity and quality of regulation should be a focus for both local and central government.

Legislative changes, either proposed, recently enacted or in the pipeline have the potential to reduce business flexibility and competitiveness, add to the costs and risks of doing business, and flow ultimately on to consumers.

Moreover, there is concern with the ad hoc approach and ongoing meddling in some areas (e.g., climate change policy) which create huge uncertainty for many businesses, including iwi-owned forestry assets. Many are bothered by the potential for government to ride rough-shod over existing private property rights.

It is a fundamental pillar of a market economy that property rights should be clear, 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.

The question becomes what, if anything, can be done about the greater encroachment of government legislators into the legitimate affairs of business.

While there is no obvious silver bullet, there is potentially a range of mechanisms which could be explored to improve the quality of regulatory processes and minimise the risk of excessive regulatory takings.

The recommendation by the Review of the Future for Local Government dovetails nicely into a policy released by the ACT Party to improve the quality of Regulation by appointing a new Minister and Ministry of Regulation to control the impact of regulation. Perhaps even more importantly, ACT is proposing to introduce a Regulatory Standards Act to set a higher bar for new regulation by adopting a set of regulatory principles, including the rule of law, protection of individual liberties, protection of property rights, and good lawmaking.

Given that improving the quality of regulation should be a concern crossing political boundaries, there is a convincing case for business to lead the push to improve regulatory processes, as this would ultimately benefit all New Zealanders.

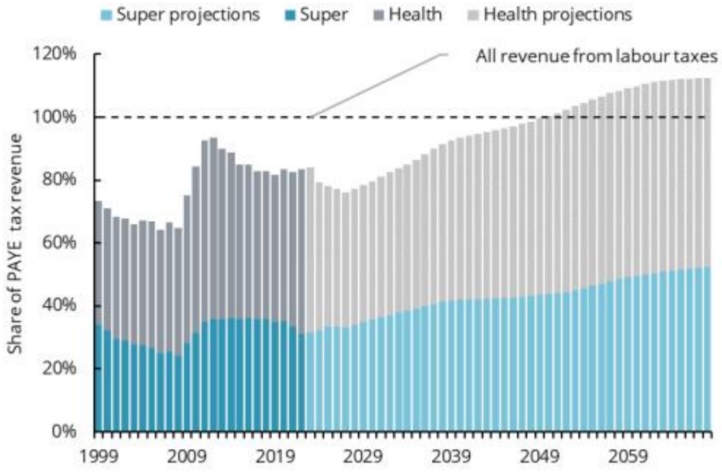
Fiscal risks associated with an ageing population

Sense Partners, in a report for BusinessNZ[1], found the business environment likely to become increasingly uncertain over the next 25 years.

Megatrends such as climate change, complex geopolitics, rapid technology change, an ageing population and expensive housing inequities will all have disruptive and divisive effects on New Zealand's economy and society.

The stark reality of the cost potentially associated with an ageing population is clearly illustrated in the graph below, particularly in respect to both superannuation and health cost projections.

Projections of Superannuation and healthcare costs combining population forecasts and costs by age



SOURCE: SENSE PARTNERS

Without material change to policy settings, Sense Partners estimates meeting the future cost of NZ's Superannuation and healthcare will soak up all labour taxes by 2049.

Political parties, with one or two exceptions, have largely kicked the can down the road in terms of how superannuation payments will be funded and what criteria should be in place. The politics of addressing an ageing population might be difficult but that does not make the problem go away.

Given this analysis by Sense Partners and others, entitlement to NZ Superannuation will be something a future government will have to address, perhaps sooner rather than later.

[1] Sense Partners, We're all in this together – How can business and government collaborate to address shared challenges out to 2050? (August 2023)

Superannuation makes up over 50% of New Zealand's total social security and welfare spending and this number is projected to increase over time. Spending is almost as great as the total cost of spending on health and education combined.

Total spending on superannuation is driven largely by the number of people entitled to receive it, i.e. essentially any NZ citizen or permanent resident aged 65 and over.

A fundamental issue is how to ensure people of retirement age have the resources and income adequate to ensure a reasonable standard of living in their later years.

There are a number of possible options for reducing the cost of superannuation over the medium term, some perhaps more palpable than others.

Arguably the general focus should be on tightening the criteria for age-related benefits. These could be provided in one, or possibly in a combination, of the following ways:

- extending out the age of eligibility (either in line with increases in life expectancy or on an ad hoc basis to keep costs manageable).
- having (possibly) a tiered approach to superannuation depending on when a person opts to take it e.g., the later someone 'opts in' the higher the level of payment for the rest of their life.
- stepping up the level of benefit depending on age e.g., 50 percent of average income at 65 years of age, 70 percent of average income at 75 years of age.
- reducing the amount paid (currently two-thirds of the average wage) over time either through freezing benefits or indexing them to the Consumers' Price Index (CPI) rather than wages.
- means testing benefits either through asset(s) and/or income testing.
- discontinuing NZ Superannuation payments by simply phasing them out over time e.g., those currently below the age of say 30 will not be entitled to any state provision.

With individuals generally living longer, on average, and with medical advances, living with improved quality of life, it is reasonable to expect the age of entitlement will increase, as many other countries are increasing their age of pension coverage e.g., Australia, Britain and the US.

However, many of the approaches mentioned above have significant drawbacks e.g., in the case of freezing benefits, the impact this would have on those dependent on NZ Superannuation as a sole source of retirement income. Different levels of benefit depending on age can raise issues of ethnicity (given differing life expectancies), while the pitfalls of income and asset testing are generally well known.

Irrespective of these concerns, eligibility for superannuation is something that will need to be addressed one way or another.

Forecasts: Real GDP percent Growth

	Years Ending		
	Sep 23	Sep 24	Sep 25
Highest	1.5	0.5	2.6
Average	1.4	0.2	1.8
Lowest	1.2	-0.1	0.9

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – change in the air?

Despite the views of a few commentators that the Reserve Bank may need to continue hiking interest rates beyond the current 5.5%, the Bank has been reasonably upfront in indicating there is no intention to advance the rate further.

Notwithstanding, both the Treasury in their recent PREFU (September 2023) and the Reserve Bank in its latest Monetary Policy Statement (August 2023) have stated that interest rates will likely stay at the higher rate for longer as a consequence of inflationary pressures remaining relatively strong – although declining.

Depending on the outcome of next month's general election, the Reserve Bank Act may be in for a shake-up, particularly if National and ACT secure the treasury benches.

Both parties have clearly stated that the Reserve Bank needs to focus principally on maintaining price stability (i.e., a single objective) rather than, as currently, having potentially conflicting objectives in respect to price stability and maximum sustainable employment.

Moreover, the Bank's tendency to dabble in other activities, such as climate change and housing, is also likely to be peeled back giving it a steely focus on inflation. Time will tell whether these, and other possible changes will be made to the Reserve Bank's operational policy.

Inflation – taming the beast no easy task

The annual growth in the Consumers Price Index (CPI) is expected to remain elevated above the Reserve Bank's 1–3% inflation target band during the year ending September 2023, falling to just under that target band by September 2024, although remaining close to the upper limit well into 2025 (see forecasts below).

While inflation has peaked, there is still a significant risk of its remaining elevated as the inflationary expectations of both businesses and consumers, while falling, are still at worrying levels.

There are still potential upside risks to inflationary pressure from the post-storm rebuild and the strong recovery in net migration, both likely to contribute to construction activity and a demand for a wide range of goods and services. The addition to labour supply that comes with a gain in migration will, however, likely outweigh the addition to demand, on balance, generating less inflationary pressure than seen in previous immigration booms.

Tradeables' inflation is still very much a two-edged sword with food commodity prices coming down substantially. This should ultimately be reflected in consumer food prices but has certainly not been the case to date. While returns to producers (farmers) for meat and dairy have taken a substantial hit, food prices were still up 8.9% in the year to August 2023, putting further pressure on household budgets. Food price rises have certainly slowed of late (with declines month on month between June and July) but are still at elevated levels.

There are a number of factors at play here. While producers are getting less of their product into international markets, the costs of production continue to rise, notably through higher fuel costs as a number of overseas producers restrict oil supplies to force up prices. Also, general costs, rent, labour and mortgage rates have also forced up production costs.

NZ's move to reduce carbon emissions to meet its international obligation of net zero by 2050 will, as well, necessarily involve increasing the 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%.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Sep 23	Sep 24	Sep 25
Highest	6.1	2.9	2.8
Average	5.9	2.8	2.4
Lowest	5.4	2.5	2.1

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – elevated for longer

The Reserve Bank was reasonably clear in its recent Monetary Policy statement that while not expecting to raise the OCR any further, forecasts show the OCR staying at current levels for longer than previously forecast.

Calling time on further increases was perhaps a surprise given a still high level of inflationary expectations and if the Reserve Bank is serious about getting inflation within the 1-3% target over the medium term, some commentators believe further rises will be required later this year.

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 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 in their inflationary impact on NZ. Conversely, NZ's still high 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		
	Sep 23	Sep 24	Sep 25
Highest	5.7	5.6	4.6
Average	5.6	5.1	3.8
Lowest	5.6	4.5	3.2

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – short term pressures will ease

The NZ dollar has come under pressure in recent times but further out is likely to appreciate against the TWI.

There are a number of reasons for the recent downwards pressures.

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 the NZ dollar as, potentially, interest rates will start to fall (given other countries are still hiking rates to a greater or lesser degree).

Second, commodity prices for NZ's traditional exports are coming under pressure and with NZ dollar fortunes traditionally heavily tied to commodity prices, this could see some further weakening.

Third, 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.

Fourth, the Government's current account deficit, while projected to continue to improve, is still 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.

Finally, the outcome of next month's general election is still very uncertain at this stage and will likely add to investors taking a wait and see approach to new investments.

Forecasts: Exchange Rates

AUD (cents)			
	Sep 23	Sep 24	Sep 25
Highest	0.92	0.93	0.94
Average	0.92	0.91	0.90
Lowest	0.92	0.89	0.87

USD (cents)			
	Sep 23	Sep 24	Sep 25
Highest	0.61	0.66	0.71
Average	0.59	0.63	0.67
Lowest	0.58	0.59	0.63

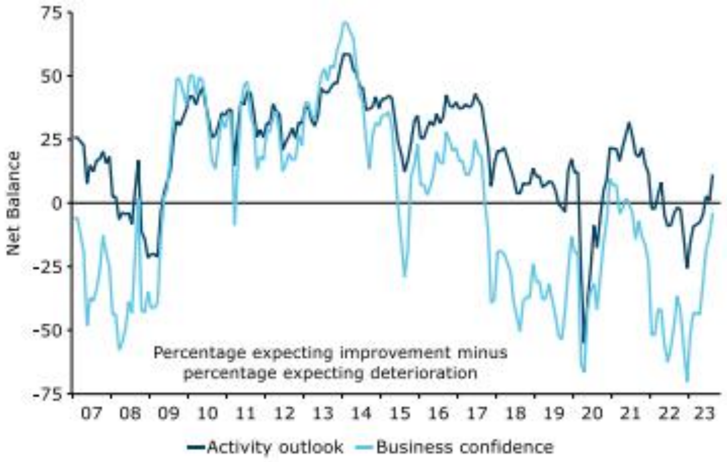
TWI			
	Sep 23	Sep 24	Sep 25
Highest	70.5	72.9	75.2
Average	69.8	71.1	72.6
Lowest	69.1	68.9	67.6

Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – some improvement but off a low base

The ANZ NZ Business Outlook shows business confidence lifted another 9 points in August to -4, the highest since mid-2021. Expected own activity also jumped 10 points, to +11. Also of significance, inflationary expectations continued to ease slightly.

ANZ NZ Business Outlook

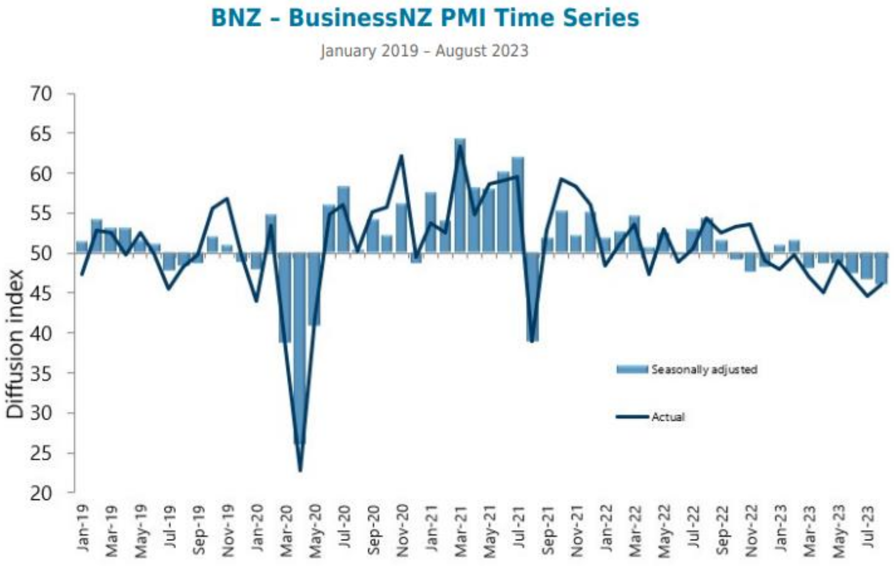


Source: Macrobond, ANZ Research

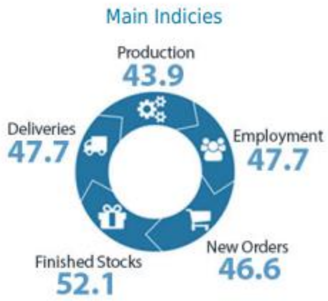
Despite a significant improvement in business confidence from the doldrums experienced over 2022 and the first half of this year, many sectors are still doing it tough, as evidenced by both qualitative and quantitative data.

New Zealand's manufacturing sector continued to lose momentum in August according to the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for Augst was 46.1 (A PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining.)   This was down from 46.6 in July, and the lowest level of activity for a non-Covid affected month since June 2009. The August result is also well below the long-term average of 52.9.



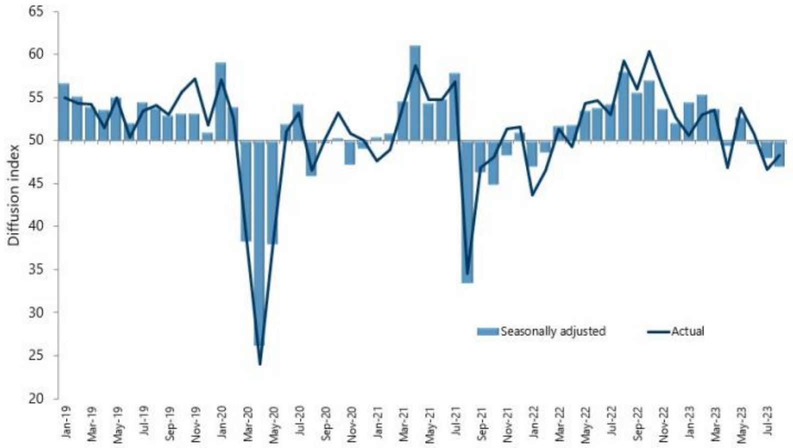
While the key sub-index components of New Orders (46.6 and production (43.9) improved slightly from July, the trend since March has seen them all but entrenched in contraction. For there to be any movement towards overall expansion in the sector, there needs to be a sustained lift above 50.0 for both these key PMI components. Again, only Finished Stocks (52.1) remained in positive territory for August.



The proportion of negaitve comments stood at 66.7%, down slightly from 72% in July, but identical to May (66.7%). Manufacturers continued to note general market uncertainty (both domestic and offshore), rising costs, and weather affecting demand as the key negative influences on activity for August.

Meanwhile, according to the BNZ – BusinessNZ Performance of Services Index (PSI), the PSI for August was 47.1. (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining.)

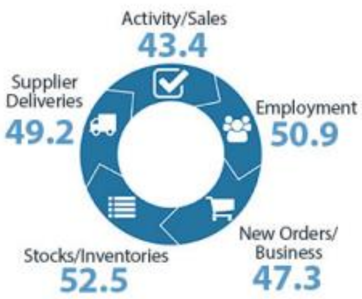
This was down 0.9 points from July, and almost at the level seen back in January 2022. It was also well below the long-term average of 53.5 for the survey.



BNZ - BusinessNZ PSI Time Series

January 2019 – August 2023

The August result showed little in the way of a road to recovery. While Employment (50.9) went back into slight expansion, Activity/Sales (43.4) remained in strong contraction and New Orders/Business (47.3) was in contraction for a second consecutive month. In addition, Supplier Deliveries (49.2) went into contraction for the first time since November 2022.



Main Indicies

The proportion of negative comments stood at 63.9% in August, compared with 67% in July and 55.6% in June. Overall, negative comments received were strongly dominated by uncertainty regarding the upcoming general election, as well as continued adverse economic conditions.

Meanwhile, the agricultural sector continues to remain under the pump as world commodity prices have taken a hit of late. Conversely input costs, including fuel, have continued to remain high, adversely affecting profitability.

Federated Farmers of NZ's New Season Farm Confidence Survey (July 2023) makes sober reading.

Some of the key highlights from the survey (which is undertaken bi-annually in January and July) include:

General economic conditions (current): A net 80% of respondents consider current economic conditions to be bad, 15 points worse than January 2023 when a net 65% considered conditions to be bad.

General economic conditions (expectations): A net 70% of respondents expect economic conditions to deteriorate over the next 12 months but 12 points better than the January 2023 survey when a net 82% expected conditions to deteriorate. Importantly, the improvement in net score was not because more people expect things to improve, rather it was because more people expect conditions to stay the same rather than worsen.

Farm profitability (current): A net 1.8% of respondents reported making a profit currently, down 26 points on the January 2023 survey when a net 28% reported making a profit.

Farm profitability (expectations): A net 70% of respondents expect their profitability to decline over the next 12 months, 3 points worse than the January 2023 survey when a net 67% expected it to decline.

Greatest concerns (current): The four greatest concerns for farmers were Debt, Interest and Banks, Regulation and Compliance Costs, Climate Change Policy and ETS, and Input Costs.

Meanwhile, the construction sector is facing mixed fortunes with the number of consents continuing to drift lower.

The seasonally adjusted volume of building activity was $8.9 billion in the June 2023 quarter, down 0.1% compared with the March 2023 quarter, according to StatsNZ.

The volume of residential building work was down 2.0% to $5.8 billion, while non-residential building work was up 3.7% to $3.1 billion over the same period.

The June 2023 quarter marked the third quarter in a row where the volume of building work has fallen for residential buildings but risen for non-residential buildings.

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 easing supply-side constraints on building materials.

The decline in house prices over the past couple of years appears to have bottomed out of late and there is the potential for some rises as we head into next year.

On the upside, the almost 100,000 increase in net migration will put significant upward pressure on prices, particularly as new housing growth has been insufficient to meet the housing shortage built up over the last few years. Moreover, a change of government, with some parties looking at changes to the tax rules to make housing more attractive, could see the re-entry of investors as housing can potentially provide better returns than are currently available.

Interest rates are now likely 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 since a number of forecasting agencies are expecting rates generally to fall next year. However, this is far from certain given the prolonged inflationary expectations embedded into business and household thinking.

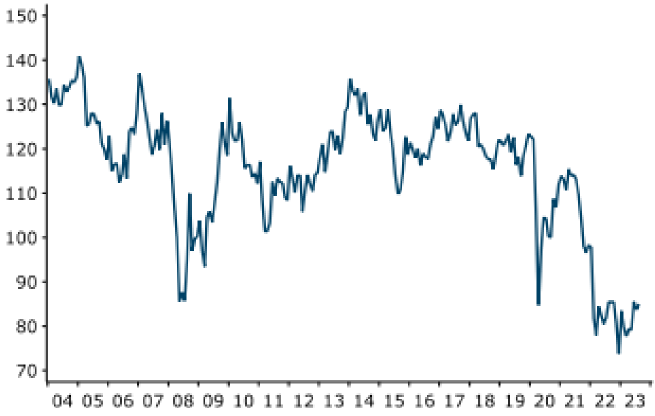
The Reserve Bank has also moved to ease loan to value ratios (LVRs) put in place some years ago to contain upward pressure on house prices. Easing LVRs should encourage more interest in housing, particularly from first home buyers, many of whom have to date been effectively shut out of the housing market.

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

Other sectors including retail, tourism and hospitality, continue to do it tough although the FIFA world cup and an increased number of overseas tourists at least temporarily boosted sales. Consumers have largely shut their wallets in response to rising interest rates and increased costs, together with a general drop in real (inflation-adjusted) household income. This is reflected in the continuing low level consumer confidence demonstrated in a number of recent confidence surveys.

The ANZ-Roy Morgan NZ Consumer Confidence Survey shows consumer confidence rising 1 point in August to 85.0, the lift driven by the response to the question whether it’s a good time to buy a major household item, which rose from -39% to -31%. Notwithstanding, consumer confidence currently remains at historically low levels.

ANZ-Roy Morgan Consumer Confidence

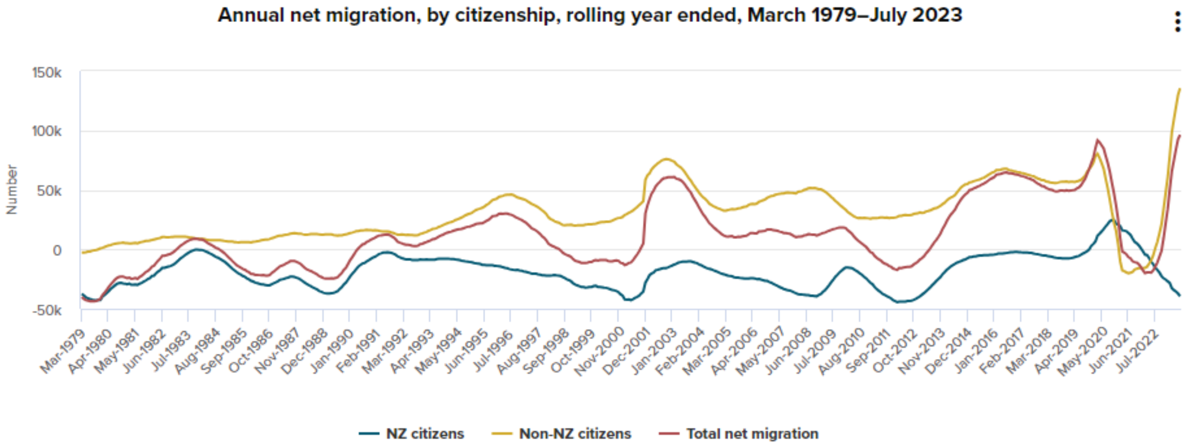


Source: Roy Morgan, Macrobond, ANZ Research

Consumers are coming under pressure as rising costs, particularly debt servicing costs, continue to ramp up despite the Resreve Bank saying it does not intend lifting the OCR further. Nevertheless, a number of banks have continued to increase mortage interest rates, reflecting to some exent the cost of borrowing, related both to the domestic and international cost of sourcing capital. Costs associated with overeas capital are generally continuing to rise and it is possible NZ will face a risk premium given a still relalatively high current account deficit and the need for government to continue funding increased debt and the associated debt servicign costs associted with same.

1.4 Labour market – migration to the rescue

Recent indicators still point to a relatively tight labour market, but there are clear signs of easing, boosted in part by strong net migration. Projections are for net migration to peak at around 100,000 in the year to September, after a record gain of 96,200 in the year to July.



Source: StatsNZ

Net gains were driven largely by an inflow of non-NZ citizens but changes to modelling in light of the post-Covid period mean recent gains need to be taken with a grain of salt.

Dipping a little deeper into the figures, there are concerning signs that the significant gain in net migration has to some extent been offset by a large outflow of NZ citizens, presumably seeking greener pastures overseas.

In the year ended July 2023 there was close to a net migration loss of 40,000 NZ citizens (migration arrivals of 25,900 and departures of 65,300). The net loss is approaching the record loss of 44,400 in the February 2012 year.

While not necessarily in alarm bell territory - the loss might well be the result of pent-up movements post-Covid - importantly, if it represents the youngest, best educated and brightest of the population, that is a significant loss of future human capital.

Most forecasting agencies are predicting that net migration will fall back to the long-term average of around 30-40,000 per annum.

Meanwhile, forecasts are for the unemployment rate to increase as the economy goes through a slow growth phase, along with the impact of the tight monetary policy settings necessary to get the inflation genie back in the bottle, cuts to real household disposable incomes on the back of significant interest rate hikes, and projections that interest rates will remain elevated for longer than originally envisaged. Job ads have declined of late, a good indicator that the demand for employees is starting to fall away.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Sep 23	Sep 24	Sep 25
Highest	3.8	5.3	5.3
Average	3.8	5.2	5.1
Lowest	3.7	5.0	4.9

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – moderating

Wage growth is forecast to trend lower (as shown below) both as a result of a slowing economy and increasing numbers of people entering the workforce.

The forecasts show the Labour Cost Index (LCI) trending down to reach 3.0% in the year ending September 2025.

It was slightly surprising that in the latest PREFU, Treasury forecast hourly wages (annual percentage change), based on the Quarterly Employment Survey (QES), as expected to remain relatively robust out to 2027 with rates trending down from 6.9% currently to 5.2% by 2025 and 3.7% by 2027.

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

While it needs to be understood that there are fundamental differences in measuring labour costs through the LCI and QES (as outlined above), it still appears that Treasury is predicting quite robust rises in wage levels over the forecast period while forecasting mediocre growth and rising unemployment, at least until 2025.

Moreover, recent surveys have generally shown a marked easing in labour shortages, particularly in respect to unskilled labour. This easing in labour shortages should continue, both as a result of increased net migration and also because of a slowing economy in general acting to reduce some further wage pressures on businesses and in turn, hopefully flowing through into reduced generalised inflationary pressure on the wider economy.

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

	Years Ending		
	Sep 23	Sep 24	Sep 25
Highest	4.4	4.1	3.7
Average	4.3	3.8	3.0
Lowest	4.2	3.2	2.2

Source: ASB, BNZ, Kiwibank and Westpac