BUSINESS NZ

PLANNING FORECAST

BusinessNZ

DECEMBER 2023

NZ Economy: Turning the page

Executive Summary

While the new Coalition Government has got out of the blocks running with its initial 49 point 100-day plan, there are plenty of issues that will test its mettle over the next three years.

The electorate clearly voted for change and the various coalition agreements, alongside the various National Party policies, are, overall, a reasonably cohesive, and certainly substantial policy platform from which to try and provide the sort of economic framework where businesses once again feel reasonably confident to invest and grow the economy.

Businesses certainly have high expectations for the new Government, and this is likely to have been at least partially reflected in the continuing improvement in business confidence of late. However, it is important to realise that there is more to do than simply stopping activities associated with the previous political regime or repealing existing legislation. This must be backed up by a credible plan for taking the economy forward.

Areas where businesses have been outspoken in the past, such as expressing their concern about the burden and quality of regulation over a wide range of areas from environmental/resource management laws through to labour laws, will hopefully be addressed as a matter of urgency. The appointment of ACT leader David Seymour as Minister of Regulation, alongside the promotion of a Regulatory Standards Act will hopefully set in place the principles for good regulatory decision-making, including upholding property rights and the payment of compensation for regulatory takings.

A greater emphasis on improving the quality of government expenditure is also required and in this respect the Government's focus on achieving better value for money is to be applauded. The Minister of Finance has stated that the government accounts have deteriorated further since the pre-election economic and fiscal update (PREFU), with a number of mandates not future-funded. Significant effort will be required to get expenditure under control while sourcing revenue to provide for much needed tax relief for hard working New Zealanders. Achieving these objectives, while improving the government accounts and reducing debt levels, will take both time and a steely-eyed determination from all coalition partners.

Despite very positive proposals, it needs to be remembered that governments can only do so much to improve the framework that enables businesses to operate and grow. Ultimately, NZ businesses must face the reality of international markets and try and manage the many forces which are outside the control of both businesses and the NZ Government. In this respect, international pressure is still significantly affecting the NZ economy as a number of global challenges continue to restrict overall global growth, including ongoing inflationary pressure and geopolitical tensions, China's slowdown, and the moves key international powers are making towards greater nationalism. All these issues directly or indirectly affect NZ given this country's heavy dependence on international trade for its economic well-being.

Domestically, inflationary pressure continues to haunt the economy with the Reserve Bank's latest review of the official Cash Rate (OCR) suggesting the bank will not hesitate to raise rates further if necessary. Some have suggested the Reserve Bank's positioning was intended to send a message over the bows of the financial markets, not to get ahead of itself in potentially signalling interest rate cuts. In short, the cost of capital is likely to stay higher for longer, not something businesses and households want to hear.

Meanwhile, key economic indicators suggest economic growth is likely to remain relatively low over the forecast period despite a significant boost in net migration figures of late. The latter is very much a two-edged sword. On the one hand, it is having a positive impact on the supply of labour and labour market outcomes but on the other, it will boost demand for many goods and services (and housing).

HIGHLIGHTS

Despite continued improvements in business confidence of late, economic growth over the forecast period to December 2025 is expected to remain subdued, with international and domestic pressures continuing to impact on activity.

The BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) remains in negative territory and sits at -4 for the December 2023 quarter, an improvement of 13 on the previous quarter and an improvement of 8 on a year ago.

Both the BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) are still in contraction mode as of October 2023.

Other activity indicators, such as retail sales, building consent numbers and freight movements, point to a continuing sluggishness while consumer confidence remains downbeat on the back of continued inflation and the likelihood that interest rates will remain at elevated levels for longer.

International commodity prices are bouncing around although there has been some general improvement in agricultural product prices of late. However, producers are still burdened by high input costs which are eating away at profitability.

Meanwhile, world growth is expected to be modest over the next few years with concern about ongoing inflationary pressure, higher cost of capital, geopolitical tensions and greater moves towards nationalism.

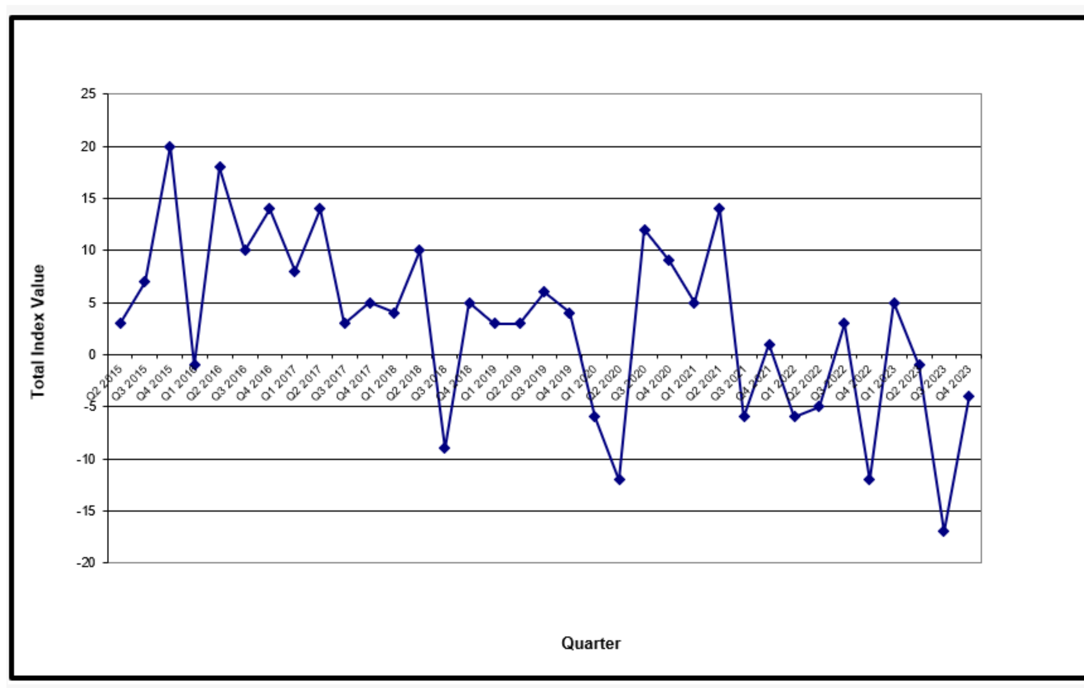
While NZ contributes around 0.5% of world GDP, it is responsible for around 35% of world trade in dairy products with heavy dependence on China as our biggest trading partner. China's much lower growth outlook of late is taking a toll on NZ producers and with China and Australia accounting for around 40% of NZ's trade, the need to expand free trade agreements with other countries is pressing.

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 -4 for the December 2023 quarter, an improvement of 13 on the previous quarter and an improvement of 8 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 December 2023 quarter, an improvement of 2 on the previous quarter and an improvement of 4 on a year ago. NZ's heavy dependence on China as our major trading partner is affecting export growth as China faces a number of challenges, resulting in reduced demand.

Monetary policy/pricing indicators sit at 1 for the December 2023 quarter, an improvement of 8 on the previous quarter and an improvement of 5 on a year ago. Indications are that while inflationary pressure is starting to ease, including inflationary expectations, there will still be debate whether a further rise in the OCR is likely given stubborn non-tradeables inflation.

Business/consumer confidence indicators sit at 1 for the December 2023 quarter, an improvement of 4 on the previous quarter and an improvement of 6 on a year ago. Business confidence has improved strongly of late but off a very low base. Meanwhile, consumer confidence remains stuck at a low level. High household debt, rising interest rates and inflationary pressure are cutting into disposable household incomes.

Labour market indicators sit at-5 for the December 2023 quarter, a deterioration of 1 on the previous quarter and a deterioration of 7 on a year ago. Net migration continues to ramp up reaching a record of around 119,000 in the year to September taking some of the pressure off the labour market. Reduced demand, as consumers face a cost-of-living crisis, is resulting in fewer job ads and rising unemployment.

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[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the December quarter 2023 are estimates based on available information to date.

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

1.1 Economic growth (GDP) – middling

Economic growth is forecast to remain relatively low over the forecast period out to December 2025 (see forecasts below).

However, although the NZ economy faces a number of challenges, the future is not all doom and gloom. There is some sunlight emerging.

Inflation has slowed in recent months with the expectation that interests rates are close to, if not already at their peak.

Share markets around the world have certainly rallied in the expectation that interest rates have peaked. The NZX made an impressive gain over the month of November 2023 although it is still only hovering around its level at the start of the year.

Strong migration inflows are helping labour markets ease and will support further economic activity.

The election is now behind us and the new Government has a reasonably robust and extensive work programme putting economic growth once again at the centre of decision-making.

Commodity prices have started to lift for key commodities such as dairy, although they are still well down on a year ago.

But the Organisation for Economic Cooperation and Development (OECD), in its latest Economic Outlook, is of the view that the New Zealand economy will post only modest growth for the next couple of years. The OECD has forecast growth to slow to 1.3 percent next year before ticking up to 1.9 percent in 2025, with a number of factors influencing low growth.

"Higher interest rates are weighing on consumption and housing investment, while lower global growth is restraining inbound tourism and reducing the price of commodity exports."

The OECD said the surge in migration this year had been filling labour shortages and supporting broad growth but is also putting pressure on the demand for houses and other services. This will in turn pressure inflation.

The OECD said the state of the economy and inflation mean the Reserve Bank needs to keep policy restrictive.

"The Reserve Bank will need to maintain tight monetary policy throughout 2024, especially as core inflation is still sticky, fiscal consolidation is very gradual, and high population growth due to net inward migration will likely re-ignite pressures in the housing market, slowing the decline in inflation."

Therefore, despite improving business confidence there are still some key risks and challenges facing the NZ economy when it comes to improving growth prospects over the next few years. These are expanded upon below and some the new Government will be trying to tackle over the next 3 years, including improving the quality of regulation and cutting wasteful expenditure. But it is not only domestic pressure that is affecting growth prospects. As a small island nation, NZ is heavily dependent on world trade. The international economy plays an important role in terms of NZ's overall economic well-being. The international trading environment has a huge impact on New Zealanders' standard of living.

While NZ contributes well short of 1% of world GDP it is responsible for around 35% of world trade in dairy products and is heavily dependent on China and Australia, which combined, account for around 40% of NZ trade.

Given NZ's reliance on China as our biggest trading partner, the outlook for China is crucially important for NZ's economic well-being. In this respect, it is concerning that exports to China fell 18.5% in October 2023 compared with the same month a year ago. In the year to the end of October, exports to China were down 7.4%.

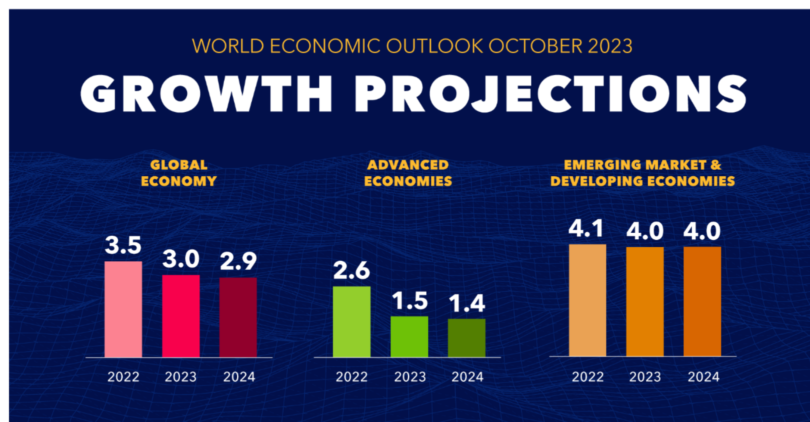
With the reduction in trade with China, it makes sense to pursue free-trade agreements with a wider range of countries ensuring NZ does not have too many eggs in one or two baskets. In this respect, the new Government's emphasis on trying to negotiate free-trade agreements with countries such as the Unted States (US) and India is a positive step.

While the US is NZ's third largest trading partner and there have been previous negotiations, the two countries did not sign an FTA after the US pulled out of earlier versions of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Two-way trade between the US and NZ was worth $28 billion at the end of June 2023 and the US is the fourth largest market for Fonterra in terms of revenue, just shy of $1.5b, its most profitable per metric tonne.

World growth rates and prospects remain sub-par

According to the IMF World Economic Outlook (October 2023), global economic growth is projected to fall from an estimated 3.5% in 2022 to 3.0% this year and further to 2.9% in 2024.



Source: IMF World Economic Outlook (October 2023)

On the positive side of the ledger, the IMF forecasts that global inflation will decline steadily, from 8.7 percent in 2022 to 6.9 percent in 2023 and 5.8 percent in 2024, due to tighter monetary policy aided by lower international commodity prices. Core inflation is projected to decline more gradually.

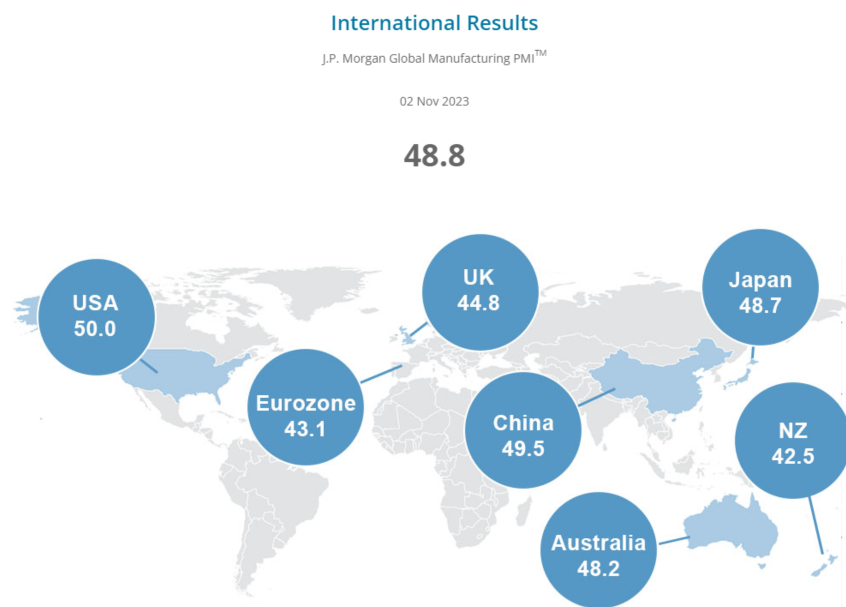
But a number of factors will continue to impact on world growth rates including:

- Central Bank interest rates remaining higher for longer to subdue inflation – the battle has been won but the war is far from over.
- China's low growth (by historical standards) and significant debt issues. Ratings agency *Moody's* on Tuesday cut its outlook on China's government credit ratings from stable to negative as a result of mounting concern over the impact of surging local government debt and a deepening property crisis.
- Commodity prices continue to fluctuate but are still affecting input costs e.g. oil, while export prices for key commodities such as dairy are only starting to recover after being in significant decline up until recent months.
- Continued geopolitical risks - potential escalation in both Ukraine and the Middle East and closer to home, tensions over China's growing influence in the Pacific region - are keeping world powers on their toes.
- Finally, the move of key global players towards greater nationalism e.g. US and China, do not bode well for more free-trade agreements, despite these being of particular relevance for NZ as a nation heavily dependent on international trade.

Meanwhile, globally, manufacturing activity is still below par.

The J.P. Morgan Global Manufacturing PMI shows that global manufacturing started the final quarter of the year on a weak footing. In October, output contracted for the fifth month running, reflecting a further deterioration in new orders. Reduced demand has affected the sector with cutbacks in employment, purchasing and inventories.

The J.P. Morgan Global Manufacturing PMI fell to a three-month low of 48.8 in October, down from 49.2 in September. (A PMI reading above 50.0 indicates that manufacturing is generally expanding: below 50.0 that it is declining.) Apart from the US, all other areas covered showed declines, with NZ at the bottom of the pile, as can be seen from the graph below.



Rolling back unnecessary and damaging legislation

One of the big issues facing the new Government is reining in the burden of regulation that has continued to amass over recent years. This is not to say all regulation is inherently bad, far from it, well-thought through regulation, such as ensuring property rights are upheld and that businesses can be confident to invest knowing the rules and

regulations are clear and well thought through is fundamental.

In this respect, it is refreshing and long overdue that the new Government is putting the heat on Ministers and the public sector to improve the quality of regulation, while stopping activity in areas which will hinder, rather than make the economic boat go faster.

Areas where businesses have been outspoken in the past, such as concern with both the burden and quality of regulation over a wide range of areas from environmental/resource management laws through to labour laws, will be addressed as a matter of urgency, as outlined in the Government's 49 point 100-day plan. Having ACT leader David Seymour as Minister of Regulation, alongside the promotion of a Regulatory Standards Act, will hopefully set in place principles for good regulatory decision-making, including upholding property rights and paying compensation for regulatory takings.

Businesses certainly have high expectations of the new Government in terms of overall regulatory improvement, and this is likely to have been at least partially reflected in the continuing improvement in business confidence of late. However, it is important to realise there is more to do than simply stopping activities associated with the previous political regime or repealing existing legislation. This must be backed up by a credible plan of initiatives to take the economy forward, although it is fair to say that many laws could be chopped forthwith given they are unnecessary and are simply a drag on business growth.

Government Expenditure Control

A greater emphasis on improving the quality of government expenditure is also required and in this respect the Government's focus on achieving better value for money is to be applauded. The Minister of Finance has stated that the Government Accounts have deteriorated further since the pre-election Economic and Fiscal Update (PREFU) with a number of mandates not future-funded. She believes the Half-yearly Economic and Fiscal Update (HYEFU) due to be made public on December 20th will show "fiscal cliffs", suggesting the previous administration might have upheld the letter of the law but not necessarily its spirit.

Significant effort will be required to get expenditure under control while sourcing revenue to provide for much needed tax relief for hard working New Zealanders. Achieving these objectives, while improving the government accounts and reducing debt levels, will take both time and a steely eyed determination from all coalition partners.

A slowing economy is affecting the revenue side of the equation while the previous Government 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 previous Government's unfunded mandates beyond the short term (e.g. school lunch programme) will put added pressure on the government accounts. There are significant risks for the new Government in achieving the forecast outcomes should the economy stutter.

All government (taxpayer) funded projects need 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 decision-making.

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 is being spent. In his letter he noted the fund is so big it will have an impact on government finances and debt for years to come.

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 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. The Coalition agreements appear to provide the framework for this to occur.

Managing expectation surrounding managed retreat

The impact of climate change and issues relating to managed retreat were given some prominence pre-election with the previous climate change Minister, James Shaw, setting up an Environment Committee Inquiry into Climate Adaptation *("the Inquiry")* of which the Terms of Reference were released on 24th August 2023.

Whether the inquiry continues under the new Government is not yet clear, but one thing is certain, climate change and managed retreat issues are not going to go away.

BusinessNZ made an extensive submission to the Environment Committee covering off some key points which need to be addressed in order to better inform decision-making.

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 infrastructure - and responses - are future-proofed to deal with climate change's additional stresses.

Managed retreat is an important issue with significant implications for property rights; it has to be carefully thought through. We support the Government's view that care will be needed to manage any ~~perverse or~~ unintended outcomes - moral hazard for example (that is, inappropriate incentives to continue development in at-risk areas).

The economic perspective of risk stresses two ideas:

1. More resources, including time and money, are needed to reduce risk; and
2. People (through their actions) have an acceptable level of risk well short of zero, because of otherwise increased costs or other less desirable considerations.

It is important to understand upfront that there is an optimal amount of resource which should be utilised in reducing risk arising from natural hazards, just as there is an optimal amount of resource that should be spent on crime prevention, health interventions etc. The crucial and undeniable fact is that resources are limited while risk can often not be completely eliminated or not, at least, without great cost. It might be possible to reduce risk but beyond a certain point the marginal cost of acting becomes progressively higher, while the potential returns reduce. Therefore, it pays for companies and individuals to invest in risk minimisation strategies only up to the point at which the marginal cost of dealing with the risk equals the marginal benefit.

It is not a case of eliminating risk, to do so would effectively be to close down all productive activity.

BusinessNZ considers there should be a very high threshold for central or local government requiring people to move, generally restricted to cases where there is significant public risk to the wider community, or where the cost of continuing to provide infrastructure services (roading/water/sewage etc.) is prohibitive and cannot reasonably be funded principally by the beneficiaries of those services.

In any case, there can be no "one-size fits-all approach". Such an approach would not reflect the unique circumstances facing different communities; government should encourage local solutions for local problems where possible.

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

It will also be important that providers of critical infrastructure are involved early on in the decision-making process around adaptation and managed retreat (such as the development of regional risk assessments, local adaptation planning, and relocation planning). For example, if the processes recommended by the Report of the Expert Working Group on Managed Retreat are adopted, this should include critical infrastructure entity representation on the new adaptation committees engaging in local adaptation planning. Without careful planning, constraints or relocation requirements imposed on critical infrastructure by adaptation and managed retreat processes will have significant implications for the ongoing operation of essential services.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 23	Dec 24	Dec 25
Highest	1.7	1.5	2.8
Average	1.4	0.8	1.8
Lowest	1.2	0.3	0.8

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – changes afoot to Reserve Bank Act

The new Government has signalled the introduction of legislation to narrow the Reserve Bank's mandate to price stability and have it passed through all Palriamentary stages by Christmas.

While National promised pre-election to ensure the Reserve Bank focused solely on price stability, the ACT/National collation agreement requires the following additional issues to a looked at:

- Narrow the Reserve Bank's remit, to focus on price stability, and take advice on replacing "medium term" with specific time targets.
- Amend the Reserve Bank of New Zealand Act 2021 to remove the dual mandate and take advice on removing the Treasury observer and returning to a single decision maker model.

The focus on price stability is sound, given the potential for a dual mandate (price stability and maximum sustainable employment) to be potentially in conflict at various points in time, despite the Governor's assurance in the latest Monetary Policy Statement that having the dual mandate has not affected his decisions to date.

BusinessNZ strongly opposed the introduction of the dual mandate in 2019, outlining a number of objections and stressing that the sole focus on price stability (along with the single decision-maker being the Governor of the Reserve Bank) clearly emphasises that the best contribution that the Reserve Bank can make to monetary policy and the broader economic environment is to ensure a steely focus on price stability.

It could be argued that the Reserve Bank has tended to drift into areas outside its brief over more recent years, including focusing on climate change, income distribution and housing, although it pulled back from most of these issues when reviewing its remit earlier this year. Certainly, inflation is well outside the target band of 1-3 percent with businesses and households now feeling the heat of higher interest rates as the Reserve Bank, belatedly tries to get the inflation genie back in the bottle.

Hopefully, going back to a single mandate will remove any element of doubt that the Reverse Bank should be totally focused on inflation over time.

Inflation – battle won but war far from over

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 with the headline CPI remaining close to the upper limit well into 2024 (see forecasts below).

There are still many upside risks to inflationary pressure from both domestic and international factors.

Starting with international factors, geopolitical tensions have the potential to adversely impact on supply chains and the cost of key inputs, such as oil, although oil prcies have fallen of late.

Non-tradeables inflationary pressures are more problematic. A number of factors are continuing to affect inflation and are briefly outlined below.

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

Second, more immediately, a significant surge in net inward migration levels (around 120,000) over the last year, while positive in terms of taking some of the pressure off the labour market, is a big number of people and will both affect housing demand and add to the demand for goods and services more generally.

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

Fourth, households face significant local government rate rises (some up at around 25%) as Councils try and balance their books in the face of increased infrastructure investment costs e.g., water infrastructure.

On the other side of the coin, the new Government's proposals to slash regulatory barriers and reduce government expenditure may take some of the heat out of inflation, although this will likely take some time to filter through.

Notwithstanding the above, overall, the factors referred to tend to point to inflationary expectations pressures being very much being on the upside rather than downside.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Dec 23	Dec 24	Dec 25
Highest	4.8	3.3	2.5
Average	4.8	2.9	2.3
Lowest	4.7	2.4	2.1

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – peaked?

Domestically, inflation pressure continues to haunt the economy with the Reserve Bank in its latest review of the official Cash Rate (OCR) suggesting it won't hesitate to raise rates further if necessary. Some have suggested this positioning by the Reserve Bank was to send a message over the bows of the financial markets not to get ahead of themselves in potentially signalling interest rate cuts. In short, the cost of capital is likely to stay higher for longer, not what businesses and households want to hear.

Most economic commentators consider the Reserve Bank is done with interest rate rises, but its track for the OCR over the next year (up from 5.59 to 5.69) was a surprise and would suggest that a further rise to 5.75% cannot be completely ruled out.

Thie possibility of a further interest rate rise slightly took markets by surprise with many in the finance sector contemplating actual rate cuts beginning near the start of 2024. This latest serve from the Reserve Bank might be enough to ensure current interest rates remain elevated for longer than predicted up to a month or so ago.

The Reserve Bank's concern is largely focused around the pressure associated with the surge in migration that triggered its sterner tone. The RB is not too concerned about tradeables inflation (and can do little about it anyway) but concern revolves around domestic inflation. Clearly the Reserve Bank sees a greater risk that the boost to aggregate demand and housing (specifically rents) will outweigh the disinflationary force of the greater productive capacity resulting from the surge in net migration.

The Reserve Bank will also be extremely wary of signalling any moves to lower the OCR prematurely as inflation is still well outside its target band of 1-3 percent.

It is possible the proposed move for the Reserve Bank to refocus on the single objective of price stability could also, on the margin at least, require it to take a harder line on inflation than was the case when it had a dual mandate with perhaps an element of flexibility as to how hard it drove its price stability objective.

Also, as many households have yet to feel the full effects of rising interest rates, given a general propensity to have 2-3 year fixed mortgages, the real impact of the Reserve Bank's hikes in the OCR has yet to flow through.

It is a waiting game on interest rates, but on balance we do not expect to see another hike in the OCR despite the Reserve Bank's rather bullish outlook on inflation – time will tell whether the bank has done enough to subdue inflation without further pain to the economy. Given consumer confidence remains downbeat and consumption is taking a hit, as reflected in lower retail sales and broader hospitality figures, in our view the Reserve Bank should sit on its hands.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Dec 23	Dec 24	Dec 25
Highest	5.9	5.8	4.8
Average	5.7	5.3	3.9
Lowest	5.6	4.8	2.9

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – holding its own

Short term interest rate expectations will likely drive currency volatility over the next few months as markets take account of the timing and size of rate cuts in the months ahead.

First, the Reserve Bank's signalling that further hikes in the OCR are effectively on hold (although increases are still possible) will likely affect demand for the NZ dollar.

Second, commodity prices for NZ's traditional exports are still under some pressure as traditionally, NZ dollar fortunes are heavily tied to commodity prices.

Third, 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 measures inflows and outflows of payments associated with imports, exports, investment and debt servicing) essentially tracks whether NZ is paying its way in the world.

Finally, the outcome of the recent general election, with a new Government in place with a solid policy agenda targeted at promoting the conditions for economic growth, may give the dollar some upward support.

Forecasts: Exchange Rates

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

	USD (cents)		
	Dec 23	Dec 24	Dec 25
Highest	0.61	0.67	0.71
Average	0.60	0.64	0.66
Lowest	0.60	0.60	0.62

	TWI		
	Dec 23	Dec 24	Dec 25
Highest	71.3	73.2	75.2
Average	70.2	71.2	72.0
Lowest	69.4	69.2	67.8

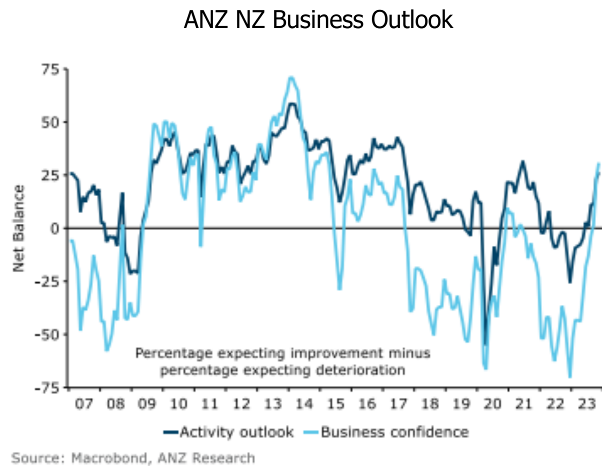
Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – Business confidence up strongly

Business confidence has risen to its highest level in nearly nine years according to the ANZ Business Outlook, but consumer confidence remains downbeat.

ANZ's October monthly survey of businesses showed a net 31 percent of respondents expecting the overall economy to improve over the next 12 months, the highest number since March 2015. This is up 8 points on the previous month. Meanwhile, a net 26 percent of business expect their own activity to rise, up 3 points on the previous month.

Despite the welcome rise in business confidence, there are still mixed messages in terms of the key data and sectors, with cost expectations, pricing expectations, and wage expectations, continuing to creep lower. Some sectors are still under the pump, including manufacturing, with a fall across most activity indicators.



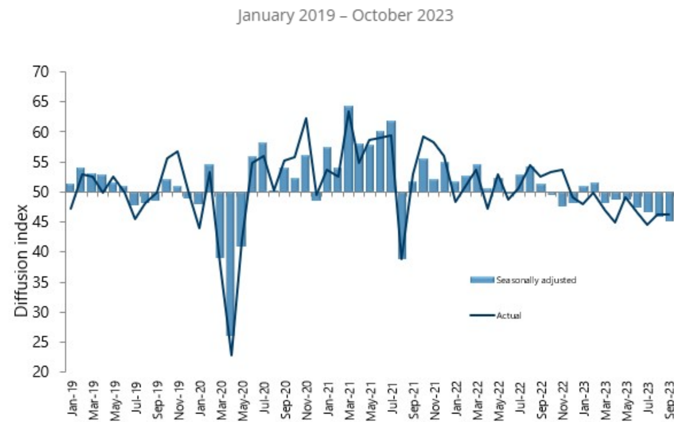
Despite a significant improvement in business confidence from the doldrums experienced over 2022 and the first half of this year, many sectors are still doing it tough, as evidenced by both qualitative and quantitative data.

Consistent with the ANZ Business Outlook mentioned above, New Zealand's manufacturing sector continued to lose momentum in October according to the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for October was 42.5 (A PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining.) This was down from 45.1 in September, and the lowest level of activity for a non-COVID affected month since May 2009. The October result represented the fifth consecutive drop in activity levels, significantly below the long-term average activity rate of 52.8.

The October result represented a further downward spiral of activity for the sector and was seen across all the sub index measures.

BNZ – BusinessNZ PMI Time Series



The key sub index measures of Production (41.5) and New Orders (44.1) fell back from September, with the former at its lowest level for a non-COVID month since May 2009. Employment (43.3) decreased a further 1.8 points from September, with Deliveries (42.9) dropping 1.4 points.

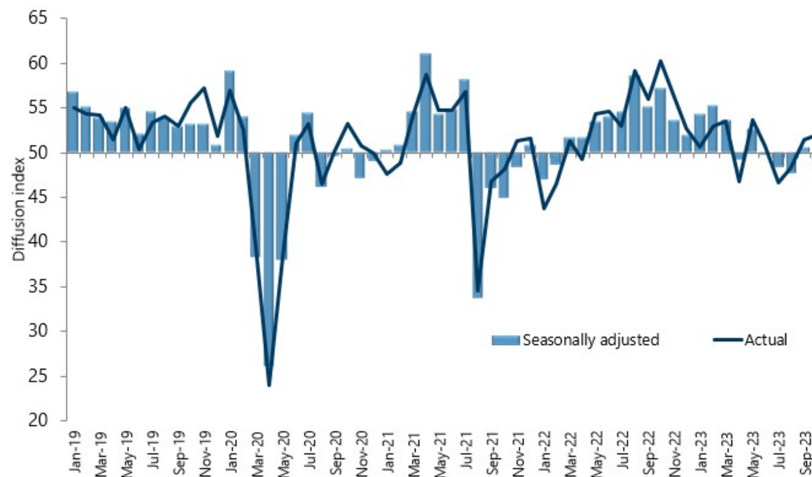
The proportion of negative comments stood at 65.1%, down from 68.8% in September and 66.7% in August. Numerous manufacturers noted both softening orders, as well as patchy/slowing sales for October.

The PMI results are not a good look for GDP and employment growth. While many forecasters have downgraded the outlook for manufacturing, there is a chance that the decline is bigger than many have predicted.

The PMI's sister survey, the BNZ – BusinessNZ Performance of Services Index (PSI), is also in contraction with the PSI reading for October 48.9. (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining.) This was down 1.7 points from September and well below the long-term average for the survey of 53.5.

BNZ – BusinessNZ PSI Time Series

January 2019 – October 2023



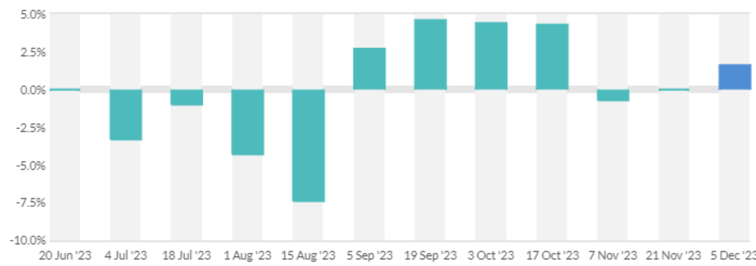
The return to expansion in September was short lived, with the key sub-index results for Activity/Sales (47.4) and New Orders/Business (51.9) showing a lower level of activity in October. Employment (49.3) returned to slight contraction, while Supplier Deliveries (49.8) remained in the tight band of activity that has been evident over the last three months.

Despite the October result falling back into contraction, the proportion of negative comments stood at 58.2% for October, down from 61.8% in September and 63.9% in August. Overall, negative comments continued to be strongly dominated by the General Election, as well as by the general slowdown in the economy.

Other sectors continue to have mixed fortunes.

The agricultural sector still remains under some pressure. High input costs, including fuel, have stayed at elevated levels, adversely affecting profitability. On the other hand, the sector will be pleased that the new Government has promised to review a number of regulations that are adversely affecting efficient land use. However, the review of existing regulatory constraints will take time.

On the brighter side of the equation, commodity prices have tended, on average, to partially recover from the significant drops experienced in the first half of this year with an improvement in the Global Dairy Trade (GDT) auctions of late.



Notwithstanding a recent general increase in prices, these are still well below the levels reached earlier this year. This reflects a number of factors, including, but not limited to, slower world demand, particularly from China.

On the other hand, there appears to have been a lift in demand from Middle Eastern buyers, alongside an increased risk of supply disruption as a consequence of summer droughts. If inventories run down in key export markets such as China, this may lead to further price improvements.

After the latest GDT announcement, Fonterra have revised up their forecast milk payout to famers for the current 2023/24 season. The Forecast Farmgate Milk Price midpoint has been lifted by 25 cents to $7.50, with the forecast range moving from $6.50 - $8.00 per kgMS to $7.00-$8.00 per kgMS.

Fonterra stated in support of the move that:

> *"The revised forecast Farmgate Milk Price for the season reflects recent strengthening in demand for reference commodity products, including improvement in demand from China during the first quarter.*
>
> *Global Dairy Trade prices have lifted, and our sales book is also well contracted for this time of year, giving us confidence to increase our forecast Farmgate Milk Price.*
>
> *It's still early in the year, with potential for further volatility in commodity prices, so we will continue to watch market dynamics closely and provide updates as needed."*

Other agricultural commodities are still facing reduced demand and the potential impact of higher production from other countries including Australia.

The farmgate price for lamb is expected to remain under pressure for quite some time as product from Australia continues to flood overseas markets. Over the last few years, Australian farmers have been able to build up their flock numbers, as a consequence of generally favourable weather conditions. More latterly, the return of drought conditions has massively increased Australian slaughter numbers and this has seen an additional amount of product enter international markets.

All red meat products have faced downward pressure this year as the general global economy has slowed and consumers in NZ's key export markets have reduced their expenditure.

The construction sector continues to face mixed fortunes.

The seasonally adjusted volume of building work activity in NZ was $8.6 billion in the September 2023 quarter, down 2.4 percent compared with the June 2023 quarter, according to figures released by StatsNZ.

The volume of non-residential building work was down 5.9 percent to $2.9 billion and residential building work was also down 0.6 percent to $5.7 billion over the same period.

Building consents also continue to trend down but there is likely to be an improvement in house prices over coming months, for a number of reasons.

The almost 120,000 increase in net migration over the last year 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, the change of government, with changes to 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 also likely close to their peak, although the Reserve Bank has been relatively bullish in its latest Monetary Policy Statement by increasing the OCR's potential path over the coming year. Nevertheless, a potential peak in interest rates will give some confidence to future buyers that it is unlikely rates will go higher, although this is far from certain given the prolonged inflationary expectations embedded into business and household thinking.

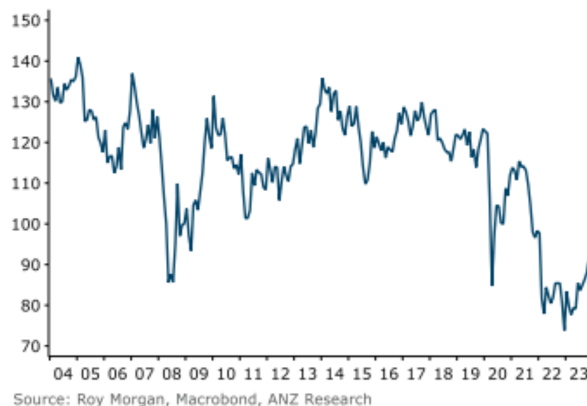
The tourism sector is showing strong signs of life, having largely recovered to pre-Covid levels. Borders are open and visitors are now coming from a wide range of countries, including China.

Other sectors are showing mixed results with retail and hospitality still impacted by low levels of consumer confidence, with households are under serious financial pressure as a result of the cost-of-living crisis. The general level of prices across the board is continuing to constrain net disposable incomes, while significant interest rate rises over the last 18 months are now starting to affect the incomes of households with high levels of debt. Debt servicing as a percentage of household incomes is really ratcheting upwards after a long period of relatively low servicing costs.

The ANZ-Roy Morgan NZ Consumer Confidence survey shows, as do most other consumer confidence surveys, consumer confidence remaining subdued, despite some slight upward movement this year.

Consumer confidence rose 4 points in November to 91.9, but this is still a very subdued result compared with the long-term average.

The ANZ-Roy Morgan NZ Consumer Confidence Survey



Inflationary expectations were little changed at 4.6% but continued financial pressure remains a key issue.

Perceptions of the economic outlook in 12 months' time were little changed (-21%) the 5 year-ahead measure lifted 4 points to +9.

1.4 Labour market – constraints progressively being removed

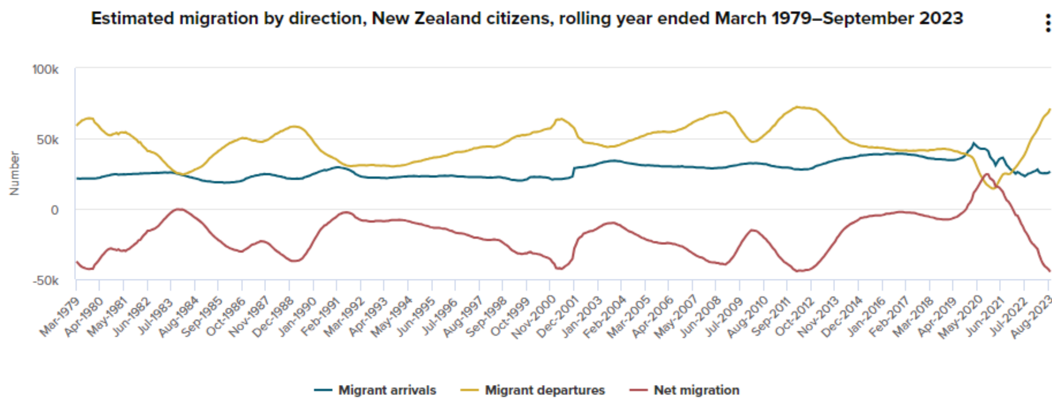
There are clear signs of labour market constraints easing, boosted in part by strong net migration, while the Government has stated it will improve the regulatory environment through the removal of a number of constraints and the introduction of policies that will provide for greater potential participation in the labour market - getting rid of so-called Fair Pay Agreement (FPS) and reinstating the 90-day trial period for all businesses. Both measures have been strongly supported by businesses, ensuring a more flexible and responsive labour market that more closely meets the needs of both employers and employees at the individual enterprise level.

The latest Household Labour Force Survey (HLFS) for the September Quarter 2023 shows unemployment as 3.9 percent in the September quarter – up from 3.6 percent in June. Meanwhile, the labour force participation rate fell slightly to 72.0 percent.

The number of businesses that report labour shortages as a major constraint has reduced substantially over the last few months, with high levels of net migration (close to 119,000 over the last year) helping to fill the gap.

As stated earlier, the impact of migration on the economy is generally positive from a labour market perspective in that it eases labour shortages and provides the ability for constrained businesses to increase output. It also increases a generalised demand of goods and services as migrants, like all other people, require housing and other goods and services as part of day to day living. This should help boost future economic activity, although it might put added pressure on the Reserve Bank to keep interest rates higher for longer in view of a possible threat of prolonged inflationary pressure.

One concerning factor is that while strong net migration is an overall positive for the NZ economy, there was a record net migration loss of close to 45,000 NZ citizens in the September 2023 year as can be seen from the graph below. This net migration loss was made up of 26,400 migrant arrivals and 71,200 migrant departures. According to StatsNZ, just under half of the departures went to Australia.



Source: StatsNZ

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.

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 also continued to decline as businesses face reduced demand. There will likely be increased restructuring in various sectors (both the public and private sectors) over the coming year or so which will probably lead to some business shutdowns and redundancies as businesses adapt to the realities of NZ's economic trading environment.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 23	Dec 24	Dec 25
Highest	4.3	5.7	5.8
Average	4.3	5.2	5.2
Lowest	4.3	4.9	4.9

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – moderating over time

To date, wage growth remains at relatively high levels. For the third quarter in a row, the annual increase in the Labour Cost Index (LCI) continued at 4.3 percent. Meanwhile, according to the Quarterly Employment Survey,

(QES) annual average hourly earnings increased by 6.7 percent in the year to September 2023 although increases are expected to weaken over the next few quarters.

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.

As a result of easing labour market pressures, wage growth is forecast to trend lower (as shown below) both as a result of a slowing economy (reduced demand), increasing numbers of people entering the workforce, and higher levels of unemployment.

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 further wage pressure on businesses, 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		
	Dec 23	Dec 24	Dec 25
Highest	4.2	3.6	3.2
Average	4.0	3.3	2.9
Lowest	3.8	2.8	2.5

Source: ASB, BNZ, Kiwibank and Westpac