ANZ Research

NZ Forecast Update: Getting an extension

17 March 2023

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Contact

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Getting an extension

Bottom line

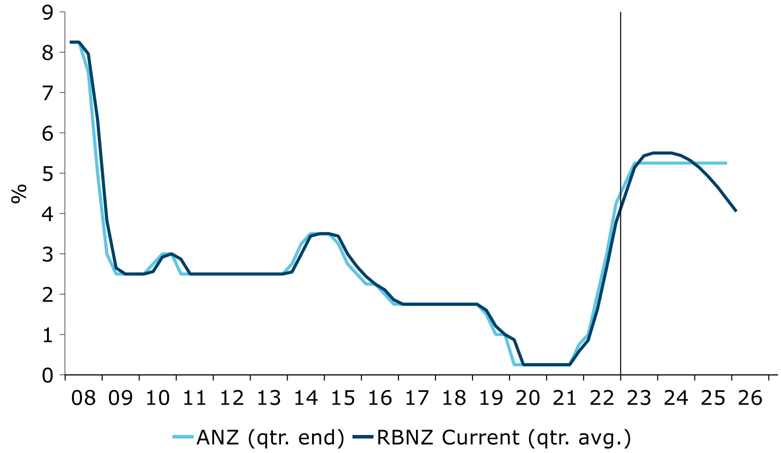
- We have refreshed our macroeconomic forecasts, and extended our forecast horizon to include 2025. Our OCR forecast remains unchanged.
- Q4 GDP came in at -0.6% q/q, well below the RBNZ's forecast for a 0.7% expansion. But weak growth is unlikely to deter the RBNZ given immense volatility in the data, and clear evidence that the economy remains acutely capacity constrained.
- Demand to replace, repair and rebuild damaged property following recent weather events is expected to delay the looming downturn slightly. But on our current estimates, this isn't a game-changer for broader economic momentum (which is slowing on the back of higher interest rates) nor the RBNZ's monetary policy strategy.
- However, cyclone impacts mean the current account deficit (which is currently sitting at a whopping -8.9% of GDP) is expected to improve at a slower pace than previously. That makes New Zealand more vulnerable to global risks that could materialise via the terms of trade.
- Recent developments suggest although economic momentum is clearly slowing, on balance there's more inflation in the system than previously thought. The 'crisis of confidence' implications of November's hawkish MPS have not persisted, inflation expectations have held (too) high, labour market indicators have been resilient, the supply side of the economy has taken a hit from recent weather events (an inflationary shock), and there's likely to be more fiscal stimulus in the pipeline.
- Our updated CPI forecasts expect both domestic (aka non-tradables) and tradables inflation to be higher than previously forecast at year-end. Inflation is looking stickier by the day, and any further upside surprises would need to be reflected in a higher OCR than otherwise.
- The risk profile around our OCR call (two 25bp hikes in April/May to a peak of 5.25%) is nuanced. On the one hand, local economic developments suggest risks to our call for a 5.25% peak OCR are to the upside. Inflation is looking stronger, the labour market is not rolling over, and the recovery from Cyclone Gabrielle will inject more demand into a capacity-constrained economy. The RBNZ's 24 May MPS will also incorporate and respond to the updated fiscal outlook in the Budget (18 May). However, at the other end of the risk spectrum, tail-end financial market risks are currently in focus, with the fallout from Silicon Valley Bank's failure in the US causing immense volatility in global wholesale interest rates in recent days. Our forecasts assume that a wider credit event does not eventuate. But all else equal, now that rates are (almost certainly) in restricted territory, this reminder of global fragility tilts the scales towards 25bp from the RBNZ in April (already our forecast, but we previously saw the hurdle to 50bp as extremely low).

Updated and extended

A lot has happened since we published our February Quarterly Economic Outlook. We've updated our CPI, GDP, and current account forecasts to capture recent starting point surprises, the signal from the timely data, and some initial estimated impacts from recent weather events. We have also extended our forecast by one year to December 2025.

Our OCR call remains unchanged. We continue to pencil in a peak OCR of 5.25%, with 25bp hikes in both April and May. We've held our OCR forecast flat at 5.25% over our full forecast horizon (figure 1), reflecting the fact that it really wouldn't take much to see upside inflation risks materialise, necessitating a higher OCR than our forecast. And cuts remain a distant prospect, given the economic slowdown we are forecasting is deliberate, not accidental. At this uncertain stage, we think a flat OCR is a better signal of how we are seeing the world than getting cute by incorporating OCR cuts at some essentially arbitrary point in the medium-term outlook.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Of course, unless inflation really bolts for some unforecastable reason (such as a large oil shock), OCR cuts will eventually eventuate once it is clear that monetary tightening has been sufficient to tame inflation. But the possibility that sticky inflation risks materialise over the latter part of the year (ie domestic inflation fails to fall as quickly or as far as the RBNZ or we are forecasting) means we see the balance of risks as skewed towards the OCR being higher than 5.25% by year end. In that context, it doesn't make a lot of sense to be incorporating eventual cuts from 5.25% into our forecast when the reality may well be the OCR peaking with a 6-handle!

But risks aren't one sided, of course. Just this past week we've seen some significant volatility in global financial markets as the failure of Silicon Valley Bank (SVB) sparked concerns about potential contagion risks in the global financial system. Concerns about a G-SIB (global systemically important bank) in Europe did nothing to calm markets. The result has been a dramatic re-pricing lower of expectations for interest rates (here and overseas), as well as significant intra-day volatility in markets. For now, all we can do is watch and wait and see how the global situation evolves. Our forecasts assume no persistent nor significant impacts on the New Zealand economy.

Economic contraction expected, but there's a noisy starting point to transition first

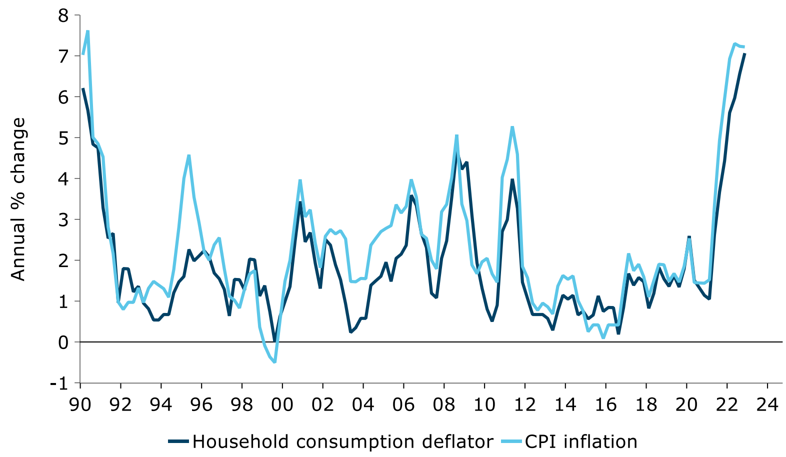
At -0.6% q/q, GDP growth was weaker than expected in Q4 2022, and much weaker than the RBNZ's +0.7% forecast. While it would be relatively easy to (mis)diagnose that as a significant development for the monetary policy outlook, the reality is that the GDP data currently can't tell us much at all about the degree of stretch in the economy, which is what matters from an inflation perspective. These are certainly strange times, as at any 'normal' point in history a 0.6% quarterly contraction in GDP would be a pretty clear signal that the economy is in deep trouble.

It's not the easiest story to tell, but some of the data is just quarterly noise after a huge lift the previous quarter. And of the sectors that do show more convincing evidence of slowing (as opposed to recoiling), it's not clear it's all a demand story. Q4 is typically rush-hour for economic activity as the weather improves. We usually talk about seasonally adjusted activity, so often overlook that. But if you're short of workers, a lot more activity will be foregone in Q4 than in other quarters – in tourism, agriculture and construction particularly. In short, capacity constraints look to be at least as much to blame for weak Q4 activity as softening demand is – and it's an industry-specific story.

Such capacity constraints are bad for activity as measured by GDP, but they are inflationary – that's a very different scenario to a lack of demand, which would tend to lead to discounting and squeezed margins, reducing inflation. We're not saying broad economic momentum isn't slowing and capacity opening up, but rather the pace of contraction in Q4 appears to be significantly overstating the degree to which this has occurred already.

Monetary policy is working, but it does take time, and the Reserve Bank's (valid) concern is that high inflation may be getting increasingly 'normalised' in the meantime. Indeed, there was plenty of inflation to be found in the Q4 GDP data, with the household consumption deflator (another measure of inflation, and the one that's preferred by the US Federal Reserve over the CPI) still rising at an increasing rate. CPI inflation has at least stopped going up (figure 2).

Figure 2. New Zealand inflation measures

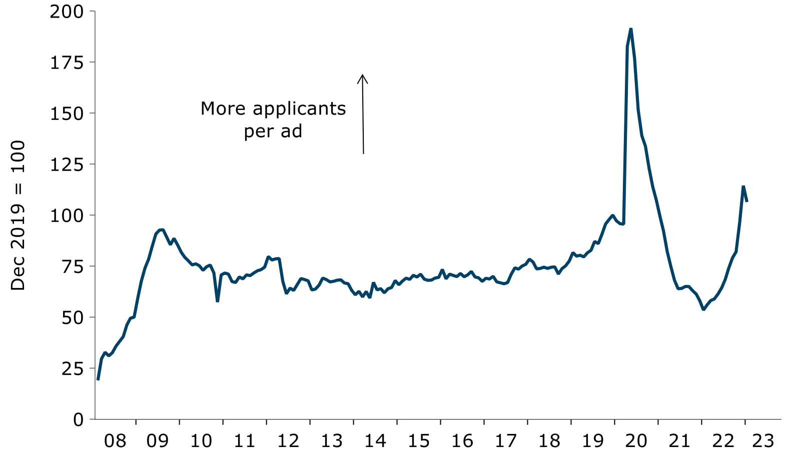


Source: Stats NZ, Macrobond, ANZ Research

When the GDP data are this noisy and uncertain, it pays to give it a bit of a sniff test against a broader suite of data. On balance these suggest that economic momentum isn't quite as dire as the Q4 GDP data would suggest:

- Employment and hours worked both expanded in Q4 (0.1% q/q and 1.4% q/q respectively) – hardly an indication that the economy is going backwards. Monthly filled jobs reaccelerated in January (up 0.8% m/m). And job vacancies have posted modest monthly gains over January and February, after slowing sharply at the end of 2022. This may have as much to do with the improved availability of workers now the border has opened (ie it's now worth paying for a job ad!) as it does to do with any rebound in labour demand. Some indicators do support this interpretation, such as applicants per job ad (figure 3, over). But rebounding hiring is certainly a sign that labour demand has not yet dropped sharply. Anecdotes suggest the labour market is turning. But not particularly fast, and from particularly extreme levels of tightness.

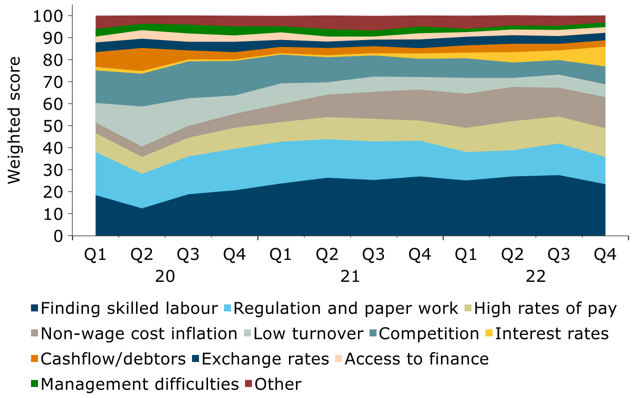
Figure 3. Applications per ad



Source: SEEK, Macrobond, ANZ Research

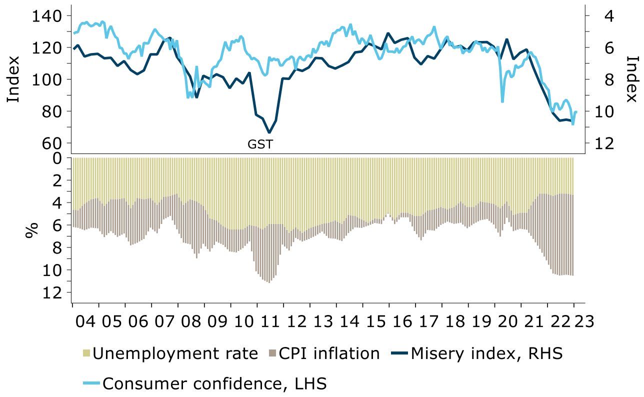
- While the PMI and PSI both softened over Q4 (possibly reflecting an initial slightly stunned take on the RBNZ's hawkish November Monetary Policy Statement), they have since rebounded well into expansionary territory.
- Net migration (if you take the data at face value) has recently shot up, with the monthly run-rate close to the record high pre-pandemic levels.
- Conversely, the housing market's orderly decline has continued. The Auckland auction clearance rate is off its lows and anecdote from brokers suggests first home buyers are still keen to get in – but sharply higher interest rates mean their ability to borrow has fallen more than house prices have. We continue to expect house prices to fall a total of 22%.
- Businesses continue to report weak activity and employment expectations/intentions. However, these have bounced off their recent lows and difficulty finding labour remains the biggest problem for firms (Figure 4.).
- Consumer confidence has softened meaningfully, but this too has bounced back a bit recently. Further, as demonstrated by the 'misery index' (unemployment plus inflation – figure 5), consumer pessimism so far appears to be driven more by high inflation than typical recessionary problems such as deteriorating job security. That could be an important distinction when it comes to household decision making about spending and saving.

Figure 4. Firms Biggest problems



Source: Macrobond, ANZ Research

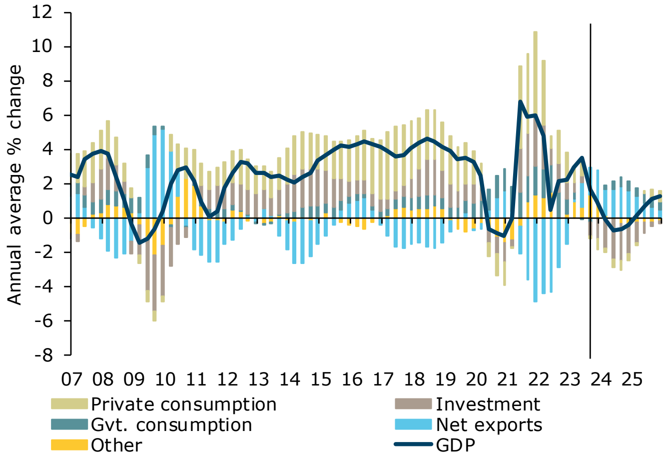
Figure 5. Consumer confidence and misery index



Source: Stats NZ, Roy Morgan, Macrobond, ANZ Research

Looking beyond the recent noise, our broad outlook for economic activity is little changed: domestic demand is poised to contract, but the ongoing recovery in services exports (chiefly international tourism and education) and softer demand for imports will provide a partial offset to headline growth (figure 6). However, the timing, magnitude, and underlying composition has changed a bit to the picture presented in our February Outlook.

Figure 6. Contributions to GDP growth



Source: Stats NZ, ANZ Research

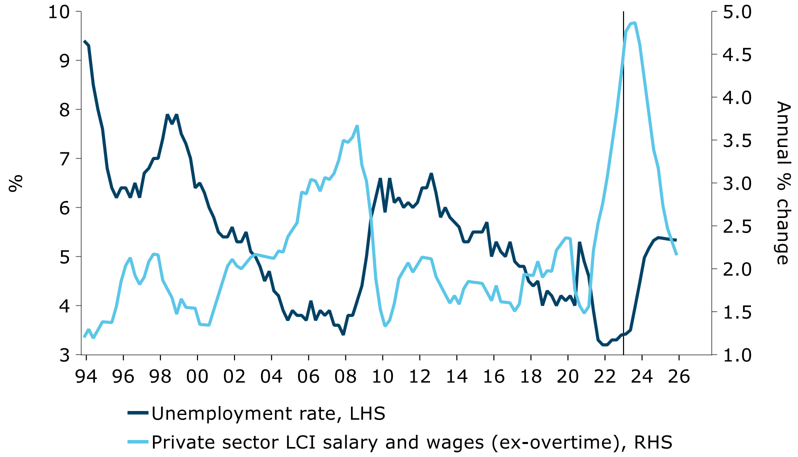
Some of this reflects how the Q4 data landed, with Q4 GDP weaker than our February forecast of +0.3% q/q. Some of it reflects historical revisions to the data. And some of the change reflects forecast tweaks based on the news flow since then. This includes factoring in a little more signal from recent anecdote and business survey data (which point to a weaker residential investment outlook in particular), but also incorporating some initial flooding and cyclone impacts (which are expected to drag on Q1 activity but provide a small boost thereafter).

Starting with Q1 2023, we've pencilled in a modest 0.2% q/q lift in GDP. This reflects a mix of ongoing capacity constraints (which we suspect are preventing the economy from achieving its normal seasonal strength over the summer period), lost activity related to the Auckland flooding and Cyclone Gabrielle, and some 'technical payback' from Q4's softer read. Q2 GDP is expected to see any negative impacts from recent weather events drop out, and even provide a small boost to growth. We've pencilled in a 0.3% q/q expansion for this quarter.

From the second half of 2023, the economy is expected to enter recession, with negative growth continuing into early 2024 as monetary tightening weighs. Quarterly growth is expected to turn mildly positive from Q2 2024 (but remaining well below trend), as contractionary monetary conditions continue to weigh, but population growth (at around 0.3% q/q) due to positive net migration and recovering productivity growth provide support. We haven't found a productivity magic bullet, sadly; it's rather an unwinding of the recent hit to productivity associated with COVID, lockdowns, and closed borders – eg skills mis-matches in the labour market, heightened health restrictions and worker absenteeism.

As the economy softens, we continue to forecast a relatively sharp increase in the unemployment rate from the second half of this year. We anticipate the unemployment rate will rise to a peak of 5.4%, from the current low level of 3.4% (figure 7). Wage growth is also set to soften as the heat comes out of the labour market, easing to a level consistent with 2% CPI inflation.

Figure 7. Unemployment and wage growth forecasts



Source: Stats NZ, Macrobond, ANZ Research

Recent weather events will impact the composition of GDP

Recent weather events are expected to have ongoing implications for the composition of GDP. Despite the devastating impacts of the flooding and cyclone on some parts of the North Island, these events are not expected to be game-changing from a broader economic momentum perspective (higher interest rates are driving key macroeconomic outcomes). But it’s still a useful exercise to work through the likely (and still extremely uncertain) impacts:

- Export volumes will be weaker in 2023, with hundreds of millions of dollars of primary production estimated to have been wiped out by the cyclone and flooding, and transport and shipping significantly disrupted in some areas. To a smaller extent, lost agricultural production will extend beyond 2023, given damage to rootstock and soils that will impact production for seasons to come.
- It’ll be a double whammy for the trade deficit, as goods imports are expected to be higher over the next year or so as damaged household possessions from washing machines to laptops to motorcars are replaced. Replacement capital goods, such as plant and machinery, will also bolster imports.
- Private consumption and investment are expected to be higher than otherwise as the repair-rebuild-replace process works through. Some of this could take a while as insurance claims are assessed and eventually paid out. The overall size is still unknown, but the number of red and yellow stickered homes (around 3,000 reported in Auckland, and about half that in other districts) suggests the potential impact on residential investment is relatively small compared to the 20,000+ new house consents issued in a given year. The big challenge for the rebuild is the concentration of demand, where damage in smaller regions represents years of business-as-usual residential construction activity. Labour mobility (or the lack of it) will be a key determinant of the speed of the rebuild.
- Government consumption and investment will also be higher than if the weather events had not occurred (all else equal). Given the inflationary implications of further fiscal expansion, the Government is reviewing its other spending plans with a view to making reprioritisations, lessening the Government’s demand for economic resources (such as labour), and therefore containing the additional capacity pressures and inflation pressures that the RBNZ is currently addressing by raising the OCR.

- Our expectation is that reprioritisations can only partially offset the additional fiscal cost (which is likely to run well into the billions over coming years), meaning the rest will need to be funded through some mix of:
  - new revenue initiatives (ie more/higher taxes, which would be a targeted way for the Government to choose who should pick up the tab while also offsetting the aggregate demand, aka inflationary, impacts), and/or
  - higher-than-otherwise government debt (and to the extent that it bolsters inflation, a higher-than-otherwise OCR).

The details will be provided in the Budget (18 May) – giving just enough time for the RBNZ to respond in the May MPS (24 May).

Putting it all together, there will be some significant offsets in terms of the impacts of the weather events for overall GDP: lower exports and higher imports will weigh on headline GDP, but higher-than-otherwise private and public sector demand should more than offset that. The flooding and cyclone events have obviously been devastating for many people, but relative to the aggregate economic story, we don't think these events are a cycle-changer. If anything, they will be a cycle extender, with an unwelcome impact on New Zealand's external balance thrown in.

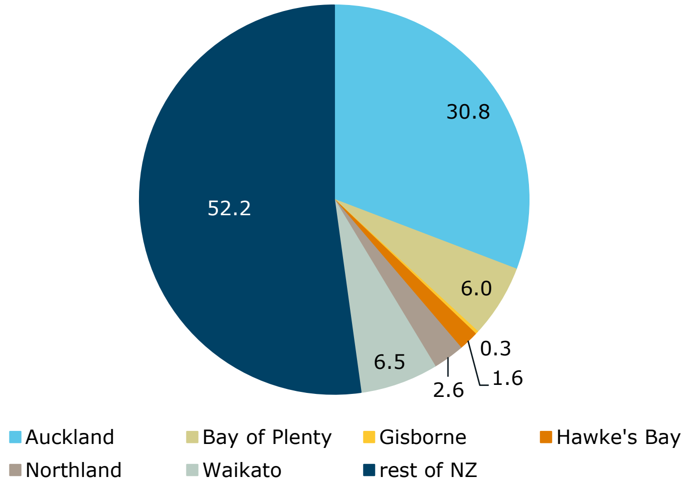
External (im)balance

New Zealand's current account deficit widened to 8.9% of GDP in Q4 2022 – that's a record breaker in data going back to the 1980s. There's a lot to unpack in terms of how we got here:

- the fiscal and monetary stimulus delivered on the back of the pandemic bolstered domestic demand and naturally a share of that was imported.
- Export volumes have struggled in the face of bad weather, regulatory uncertainty, labour shortages, and supply disruptions.
- The terms of trade have fallen as high global inflation has seen import prices lift more than our export prices.
- The closed border annihilated international tourism and education receipts, decimating services exports while services imports (which are less travel intensive) were less impacted by closed borders.
- The income deficit has begun to widen as higher global interest costs start to bite – something that's set to persist.

Recent weather events mean the current account deficit will be wider than otherwise. Net exports will be lower (as outlined previously), and international tourist arrivals may be slightly lower than otherwise too (but severely impacted regions only account for a small share of international tourist spending – figure 8, over). The income deficit may be narrower than otherwise over the coming year or so, as outflows associated with insurance companies reduce, as these companies divert resource to the problem at hand.

Figure 8. Share of international tourist spending by region (2019)

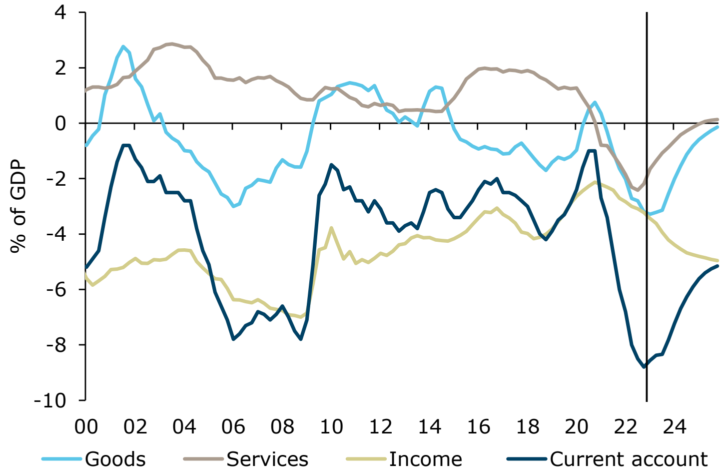


Source: MBIE, ANZ Research

All up, weaker exports and stronger imports are expected to more than offset smaller income outflows. Our initial estimates suggest the current account deficit will be around 0.6-0.8ppt of GDP wider than otherwise by year end as a result of the recent weather effects.

That doesn't change the broad outlook that the current account deficit will narrow as weaker domestic demand dampens imports, while at the same time services exports (chiefly tourism and education) continue to recover. But it does make external sector sustainability more vulnerable to any negative global shock that would cause the terms of trade to deteriorate. In our updated forecast the current account narrows from 8.9% of GDP in Q4 2022 to 5.0% by the end of 2025 (figure 9).

Figure 9. Current account balance forecasts



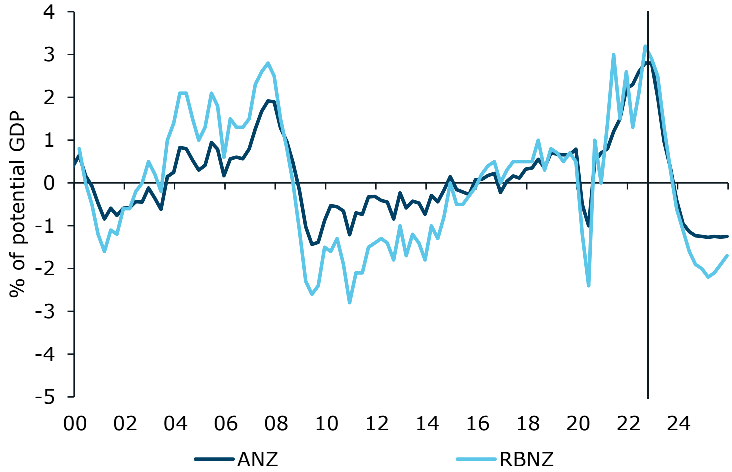
Source: Stats NZ, ANZ Research

Capacity pressures should ease

The looming economic contraction and subsequent period of below-trend growth is expected to see spare economic capacity open up – ie successfully engineer the negative output gap (figure 10) that is necessary to take the heat out of underlying inflation pressures. But this assumes the supply side of the economy recovers from here after what's felt like a constant bombardment: COVID-19, Russia's invasion of Ukraine, and local flooding and cyclone events. Because of these events, economic resource hasn't been allocated as efficiently as otherwise and productive capacity (eg capital stock) has been erased. That means for a given level of demand, we've seen more inflation than otherwise.

At this delicate juncture, there is little scope for the RBNZ to tolerate further inflationary shocks. We've added more persistence to our near-term inflation forecasts, and that unfortunately tilts the balance of risks further towards inflation becoming embedded in wage and price setting behaviour.

Figure 10. Output gap forecast



Source: RBNZ, ANZ Research

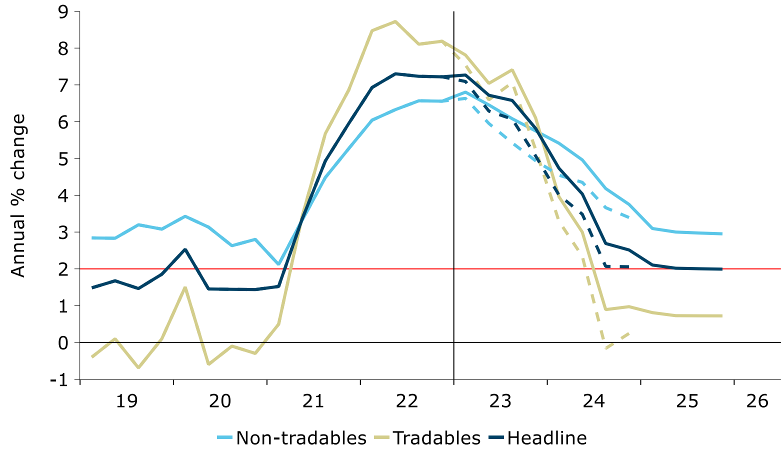
The inflation outlook is higher

Developments since our last inflation forecast update point to inflation pressures remaining stronger than expected over 2023. The near- and medium-term impacts of Cyclone Gabrielle are still very uncertain, but we have now made an attempt to incorporate cyclone impacts into our outlook. We anticipate stronger-than-otherwise price pressures over 2023 for a broad range of CPI components, including:

- food prices
- rents
- construction costs
- property maintenance
- household contents and services
- second-hand cars
- insurance, and
- domestic accommodation.

Adjustments to these component forecasts result in annual CPI inflation increasing to 7.3% in Q1 (7.1% previously expected), and only easing to 5.8% by the end of 2023, versus our previous expectation that inflation would ease to 5.1% by year-end (figure 11). The overall magnitude of Cyclone Gabrielle's inflationary impact remains extremely uncertain, but the sheer strength in February food prices (up 2.1% m/m on a seasonally adjusted basis) underscores our expectation that Cyclone Gabrielle will mean inflation is higher for longer, at least over the next year. Longer term, the potential impacts of the cyclone are even fuzzier, and will depend on the scale of the rebuild/repair/resilience work we undertake as a nation, as well as how it's funded (eg taxes would be less inflationary than borrowing the money).

Figure 11. Revisions to ANZ CPI inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

Even without the cyclone, inflation pressures in New Zealand are far too strong. A key driver of the underlying inflation pulse is our overheated labour market. As mentioned above, timely indicators are pointing to something of a second wind in early 2023, though how long this will persist is questionable. We're not expecting labour demand to reaccelerate. But nor are we sure that it is going to drop away as rapidly as the RBNZ is forecasting.

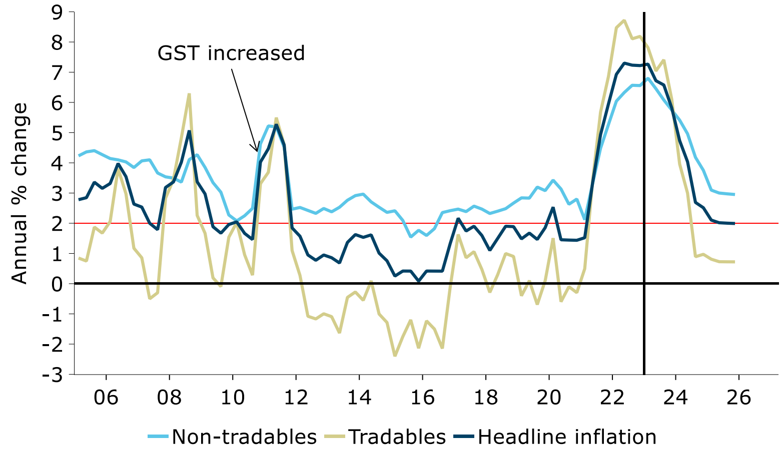
As we explored in an Insight Note last week, the inflation pulse is rotating away from goods prices and into sticky services. Services inflation is tightly linked to wage pressures and the labour market. As long as the labour market remains hot, domestic inflation pressures will likely remain stubbornly strong. Wage gains for private sector workers now comfortably exceed inflation, and are running far ahead of any reasonable estimate of productivity growth. That's inflationary.

This ongoing labour market strength is a key reason why we've been forecasting for some time that non-tradables inflation will be very slow to decline to levels consistent with 2% CPI inflation. There's some hope that rising net migration will help to ease the logjam in the labour market, but it will also have inflationary implications for rental and housing markets. So we're not counting on the return of migration as the silver bullet for bringing inflation down. And neither is the RBNZ.

There are also technical forecast assumptions to be made around the end of the Government's cost-of-living supports (including the 25 cents/litre reduction in fuel excise duty). These are all due to end at the end of Q2. Restoring petrol, road user charges, and public transport to their full cost will cause a one-off jump in the Q3 CPI. We estimate this will add around 0.5ppt to annual CPI inflation in Q3. We have incorporated the end of the cost-of-living supports as announced into our forecast, cognisant of the fact that this has already been pushed out several times.

Looking ahead, we anticipate that the extra inflation pressure/persistence resulting from Cyclone Gabrielle and a resilient labour market will see inflation return to target in Q3 2024. That forecast implies CPI inflation will be outside of the RBNZ's 1-3% for 3¼ years (figure 12, over).

Figure 12. ANZ CPI inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

OCR risks still tilted to the upside

Any further inflationary surprises from here will need to go into OCR settings. Higher inflation expectations (or even sticky at high levels), further supply disruption, a significant fiscal expansion, green shoots in the housing market, a persistently robust household sector, ongoing labour scarcity or a sharp lift in oil prices are all possible catalysts that could see our OCR call pushed higher.

Accordingly, assuming a meaningful tightening in financial conditions doesn't eventuate from current global financial market turmoil (which would mean less work for the OCR to do), we see upside risks to our OCR call for a peak of 5.25%. We have published an array of Insight Notes in recent weeks, outlining how Cyclone Gabrielle, a resilient labour market, and the interplay between services inflation and soaring wage growth could all see inflation hold up even longer. That's problematic when survey measures of consumer and business inflation expectations are showing no signs of returning to the low levels seen before COVID-19.

That's not to say that the risks are one-sided. The high-profile failure of Silicon Valley Bank (SVB) in the US and subsequent market stresses highlights that the exit from the post-GFC era of super-low interest rates is unlikely to be a smooth path. There's plenty of room for things to go wrong as over a decade of cheap credit comes to an end. But as the saying goes, you can't make an omelette without breaking a few eggs, and the cold hard fact is that business failure is part of the transition mechanism of monetary tightening, and actually part of how capitalism is supposed to discipline the allocation of resources (though there's always collateral damage – particularly when financial sector firms are involved).

The hard part for policy makers is gauging when they've done enough, and now a new challenge: working out if financial market risks have the potential to become systemic. It's even more difficult to get things right when risks are growing on both sides. But now that the RBNZ is (pretty) confident that the OCR is in contractionary territory, there is scope to tread more cautiously in the face of an evolving risk, despite inflation risks. We were already forecasting a 25bp hike in April but saw the hurdle to a 50bp hike as very low; recent financial turmoil has definitely raised that bar. But not to an impossible height by any means. The RBNZ (and we) will be closely watching every piece of data and news flow right up to decision day.

Key forecasts

Calendar Years	2019	2020	2021	2022	2023(f)	2024(f)	2025(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.1	-1.5	6.1	2.4	0.9	-0.4	1.2
Private Consumption	3.2	-2.2	7.9	2.8	-0.9	-0.7	1.1
Public Consumption	4.7	7.2	8.2	4.5	-0.1	2.6	2.4
Residential investment	5.3	-3.1	8.4	0.3	-5.0	-10.1	0.8
Other investment	4.0	-5.1	13.9	4.6	-4.6	-6.1	-1.1
Stockbuilding[1]	-0.5	-0.8	1.3	-0.1	0.1	-0.2	-0.2
Gross National Expenditure	3.1	-1.8	10.3	3.4	-0.9	-1.8	0.7
Total Exports	2.6	-13.5	-2.3	-0.7	12.2	5.6	3.5
Total Imports	2.2	-15.8	14.8	4.5	2.7	-0.5	1.5
Employment (annual %)	1.2	0.6	3.3	1.3	-0.3	-0.2	1.5
Unemployment Rate (sa; Dec qtr)	4.1	4.9	3.2	3.4	4.5	5.4	5.3
Labour Cost Index (annual %)	2.4	1.5	2.8	4.3	4.6	3.2	2.2
Terms of trade (OTI basis; annual %)	7.1	-1.6	2.8	-3.9	2.0	1.5	1.6
Prices (annual % change)							
CPI Inflation	1.9	1.4	5.9	7.2	5.8	2.5	2.0
Non-tradable Inflation	3.1	2.8	5.3	6.6	5.7	3.8	3.0
Tradable Inflation	0.1	-0.3	6.9	8.2	6.1	1.0	0.7
REINZ House Price Index	5.1	15.5	26.2	-12.9	-9.7	2.2	2.4
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.72	0.68	0.64	0.66	0.68	--
NZD/AUD	0.96	0.94	0.94	0.93	0.88	0.85	--
NZD/EUR	0.60	0.59	0.60	0.59	0.58	0.57	--
NZD/JPY	73.1	74.6	78.6	83.3	81.8	78.9	--
NZD/GBP	0.51	0.53	0.51	0.52	0.52	0.52	--
NZD/CNY	4.69	4.74	4.35	4.38	4.32	4.35	--
NZ$ TWI	73.7	75.2	73.2	72.1	71.1	71.0	--
Official Cash Rate	1.00	0.25	0.75	4.25	5.25	5.25	5.25
90-day bank bill rate	1.29	0.27	0.97	4.65	5.35	5.35	5.35
2-year swap rate	1.26	0.28	2.17	5.38	5.75	5.45	5.15
10-year government bond rate	1.65	0.99	2.39	4.47	4.55	4.25	4.00

[1] Percentage point contribution to growth
Forecasts finalised 17 March 2023
Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

Contact us

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