ANZ Research

NZ GDP Forecast Update

23 March 2022

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Contact

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Walking the tightrope

Bottom line

- With the Q4 GDP data in tow, we have updated our macroeconomic forecasts and extended our forecast horizon by a year to December 2024.
- With borders closed, economic momentum has been driven by highly stimulated domestic demand. While it's gotten the broader economy through the pandemic with a smaller hit to activity than most, this fiscal and household debt-induced demand surge was never sustainable.
- The next phase in the recovery is the normalisation towards sustainable growth: the return of international tourism and education, but also the RBNZ walking the tightrope of knocking decades-high inflation on the head while hoping to not do too much damage to the near-term growth and employment outlook.
- All up, the cold hard reality is that high inflation will hurt households and businesses, and so too will rising interest rates. Raising rates into a slowing economy is counterintuitive. But if inflation is not contained fast enough with monetary tightening, the RBNZ will likely need to act even more aggressively later on – with an even more difficult job to do. Risks of a hard landing are very high, but too-high inflation could just as easily be the culprit as rising interest rates. In short, recession risks are no longer a good reason for the RBNZ to hike gradually.

The OCR is currently at a stimulatory level. It shouldn't be

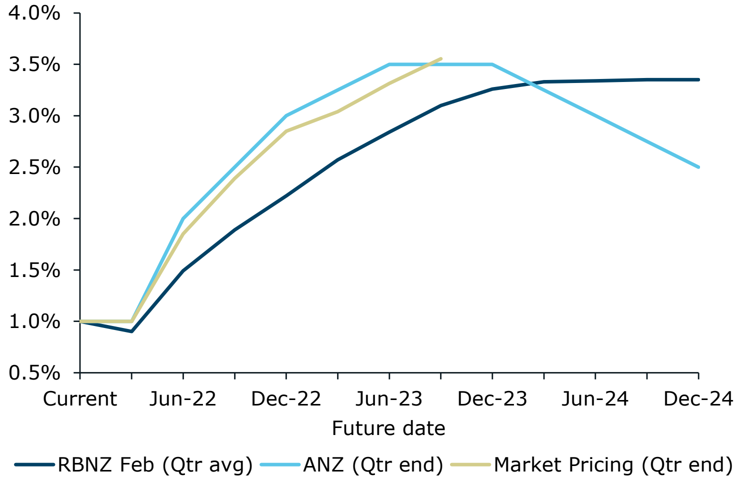
We've recently changed our OCR call to more aggressive hikes and a higher peak. We think the RBNZ needs to hike 50bps in both April and May, with follow-up 25bp hikes at each subsequent opportunity taking the OCR to a peak of 3.5% by April 2023. This relatively aggressive OCR outlook is pinned on the back of an extremely strong inflation outlook, and worryingly-high inflation expectations and firms' pricing intentions. It does assume that downside risks to growth and inflation fail to materialise, and that labour market conditions remain tight. But it also assumes no more upside inflation shocks either, and inflation expectations soon starting to turn.

One might argue that with activity already slowing, aggressive OCR hikes increase the risk of recession. And all else equal, that's true. But all else is never equal! High inflation also increases the risk of recession. Growth in household incomes is not keeping up with the cost of living, necessitating widespread belt tightening among households. For businesses it means margin erosion as costs rise, and because high inflation is volatile inflation, economic uncertainty increases, with price and cost predictability going out the window, and real returns on investment becoming something of a lottery.

In fact, it's increasingly looking like the RBNZ is stuck between a rock and a hard place. If they fail to get ahead of the current inflation shock with aggressive hikes, there's a big risk that inflation persistently overshoots their 1-3% target band. And if inflation were to be permitted to gather momentum for too long, even more aggressive monetary tightening would be required down the track, raising the odds on an even deeper recession. There are no low-risk policy options from this starting point. In short, recession risk is no longer a good reason for the RBNZ to take it slow.

Getting inflation back to target with aggressive monetary tightening should, all going to plan, enable the RBNZ eventually normalise the OCR towards more neutral settings. The extension of our forecast horizon to December 2024 allows us to bake some of this in (figure 1). Of course, gauging exactly where the neutral OCR might rest in the future is riddled with uncertainty (and beyond the scope of this note). Demographic trends continue, but supply shocks (the pandemic, geopolitics and climate change) and even rising income inequality are all potential reasons to think the days of the neutral OCR trending lower may have come to an end. The RBNZ's last-published estimate for neutral is around 2%. For some international context, the US Fed forecasts last week included a "long-run central tendency" for the fed funds rate (generally interpreted as the Committee members' median estimate of neutral) of 2.4%, with Fed speakers in the last week quoting estimates ranging from 1.75% to 2.5%.

Figure 1. ANZ OCR forecast



Source: RBNZ, Bloomberg, ANZ Research

There's a lot of inflationary water to flow under the bridge, but assuming a 3.5% OCR come April 2023 is enough to get the job done, then it's likely it won't need to be at this level forever. For the sake of argument, we've pencilled in a gradual normalisation towards 2.5% by December 2024. Part of this assumes that a recovery in the supply side of the global and domestic economy does some of the disinflation work for the RBNZ, by lifting potential GDP. If that fails to come to pass, or if inflation expectations prove stubborn despite headline inflation returning to target, rates may well need to stay higher for longer.

Tighter monetary conditions and high inflation will weigh on demand

Now that the Q4 GDP data have been released, we can incorporate this and other developments into our medium-term forecast for economic activity.

Broadly, the overarching narrative in our latest Quarterly Economic Outlook is little changed: the outlook contains an unusually lengthy list of key turning points across the many drivers of economic activity. That adds to forecast uncertainty and suggests the path ahead is unlikely to be a straight one. We're not going to cover all of these turning points again in detail here, but rather focus on the most significant developments since we published our full suite of forecasts: an expected faster withdrawal of monetary stimulus, and a much stronger inflation outlook. Both are expected to weigh on demand.

It's worth noting at this stage that GDP data is still navigating a very noisy patch. Q3 saw the economy contract 3.6% q/q as the Delta-induced lockdown weighed. That was followed by a partial (3%) rebound in Q4. However, Omicron cases went exponential in February, with isolation rates and general people-avoidance creating quasi-lockdown conditions for some firms and households – but with less fiscal support. This balance between the continued Delta recovery and Omicron disruption in Q1 has made it very difficult to pin down Q1 and Q2 GDP picks. But that shouldn't matter too much provided Omicron impacts are similar to that seen overseas: a short, sharp drop in activity followed by a sharp rebound once case numbers abate. In other words, growth in the first half of this year is going to be difficult to forecast and interpret. Just for a change.

But there's more going on out there than near-term COVID-induced wobbles. CPI-adjusted household incomes are falling, and debt-servicing costs are rising. Balancing it all up, we've pencilled in a 0.5% q/q lift in GDP in Q1 followed by a 0.2% rise in Q2 (when activity finally recovers to Q2 2021 levels).

More generally, with capacity and inflation biting, the economy is expected to maintain a softer vibe until the summer of 2022/23 arrives and national incomes are once again bolstered by the seasonal uptick in international visitor arrivals (but even then, domestic activity will continue to face headwinds). Open borders should hopefully see the economy's productive capacity increase (as hibernated labour and capital are brought back on stream). However, as Figure 3 shows, typical seasonality in net visitor arrivals suggests open borders may well be a headwind (in aggregate) over the coming winter before the summer brings a much-anticipated (and stronger) tailwind. Ski havens such as Queenstown will of course benefit from open borders during the winter, but overall NZ makes the bulk of its tourism receipts during the summer – kiwis heading offshore dominate during the middle of the year, and there are certainly a lot of people desperately keen to reconnect with family and friends overseas.

Figure 2. Production GDP forecast

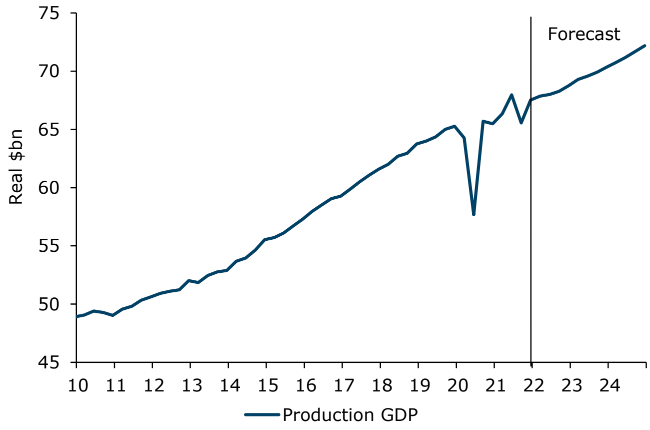
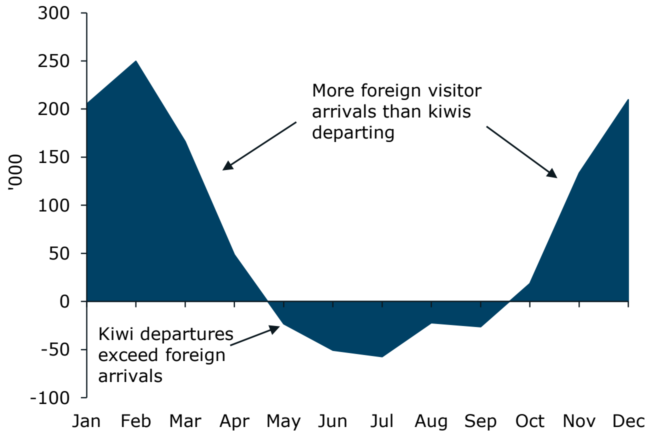


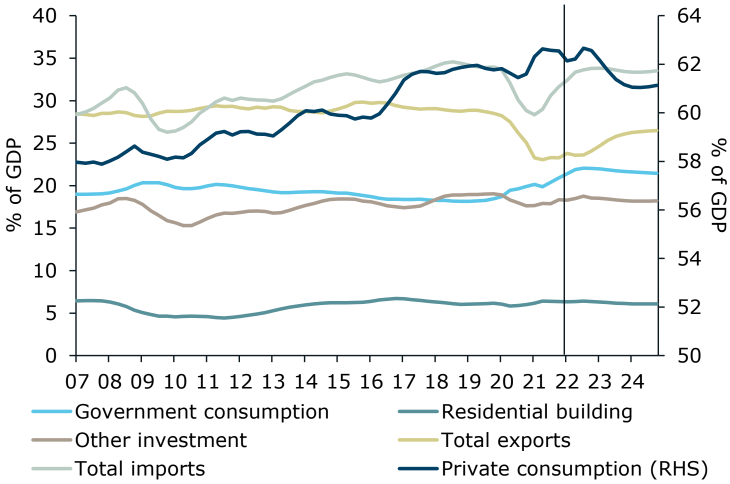
Figure 3. Net visitor arrival seasonality



Source: Stats NZ, ANZ Research

Looking at the expenditure GDP components as a share of total GDP probably provides better colour on the medium-term outlook than focusing on the production measure. Higher inflation and interest rates are expected to see real private consumption slip as a share of GDP, and that will also drag on demand for imported goods. However, imports should maintain an elevated share of GDP as services imports pick up as kiwis begin to holiday abroad once again. Total exports as a share of GDP will also rise once international tourism is back on its feet.

Figure 4. Real expenditure GDP shares



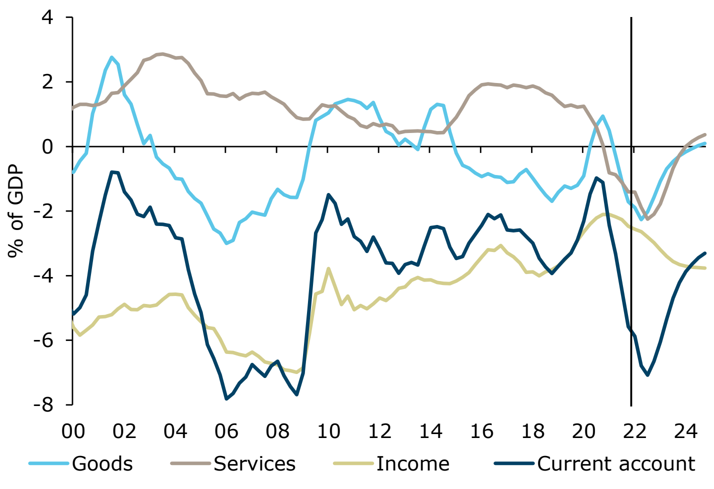
Source: Stats NZ, ANZ Research

Despite strong growth in nominal government spending, we expect real government consumption to gradually soften as a share of GDP. This reflects the fact that pro-cyclical fiscal settings, such as those earmarked for Budget 2022 will (like private sector firms) likely struggle to achieve much growth in real activity terms when capacity constraints are biting. On the investment side, we expect residential investment to travel broadly sideways from here as capacity constraints continue to limit upside and as the slowing housing market drags on demand. Other investment should hold its own as labour shortages continue to bolster demand for labour-saving technology and machinery. But rising interest rates and heightened uncertainty should keep a cap on things in that department too.

In short, our expectation is that the over-stimulated domestic economy will need to hand the growth baton to the revival of our international tourism and education sectors. But even if that goes 100% according to plan, we'll likely have to wait until late in the year before seeing the dividends.

There's probably no better place than the current account to see the impacts of both a closed border and an overstimulated domestic economy (figure 5).

Figure 5. Balance of payments



Source: Stats NZ, ANZ Research

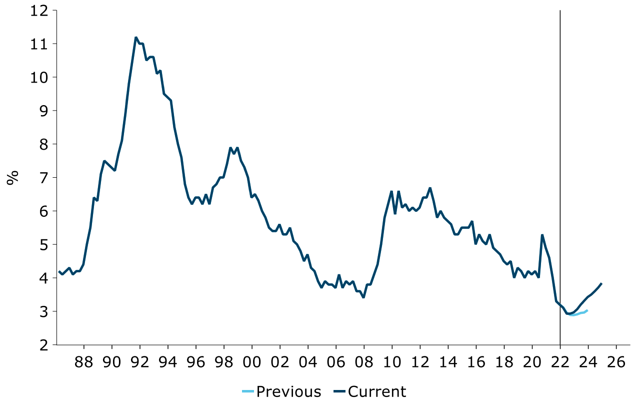
As at Q4 2021, the annual current account deficit had widened from 2.9% of GDP in Q4 2019 (pre pandemic) to 5.6%. The loss of travel-related exports drove net services exports into deficit, while very strong domestic demand saw goods imports outpace exports, despite global shipping disruptions and the strengthening terms of trade.

Looking forward, we expect the annual current account deficit to widen to around 7% of GDP this year, before narrowing to around 3.5% of GDP in 2024. The services deficit is expected to narrow and eventually return to surplus as travel-services exports return. The goods deficit should also narrow as domestic demand moderates. Conversely, the income deficit is poised to widen (with downside risks) as global interest rates rise to combat inflation.

Underpinning all of the above is an expectation that tight labour market conditions will persist. Indeed, with the risk that open borders create a net migration outflow in the near term, it would appear that labour is likely to remain hard to get over the remainder of the year. However, back-to-back 50bp rate OCR hikes, combined with household belt tightening as inflation outpaces income growth, are likely to have some impact beyond that. And while the alternative (ie even higher inflation) is worse, the medicine certainly isn't pleasant.

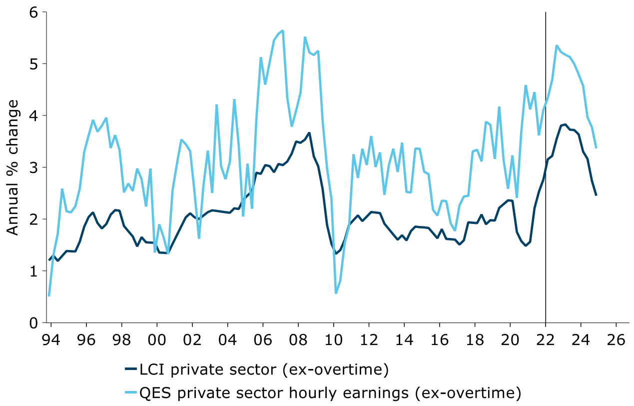
We expect unemployment will drop a little further to 2.9% over mid-2022, before gradually rising to just under 4%, as interest rate hikes do their thing (figure 6). A 4% unemployment rate is still very low – consistent with both aspects of the RBNZ's dual mandate, and on par with the labour market at the end of 2019, which the RBNZ judged to be "at or slightly above its maximum sustainable level".

Figure 6. Unemployment rate forecast



Source: Stats NZ, Macrobond, ANZ Research

Figure 7. Wage inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

The labour market is not yet done adding to inflation pressures. Wages tend to adjust more slowly than headline inflation – so we're expecting that we will see wage growth accelerate this year (figure 7). That will add to momentum in domestic inflation pressures over 2022 – even as we assume global price pressures ease. But as the boiling labour market comes down to more of a simmer, we should also see wage growth ease back to levels more consistent with low and stable inflation.

All up, New Zealand's economic performance through the pandemic has been robust – our very tight labour market speaks to that. However, it's been far from even, with many businesses and households doing it tough while others have never been so busy. This wonkiness should even out in time as housing continues to slow and our borders reopen, but it won't happen overnight.

On top of all this, the RBNZ clearly has its work cut out to ensure high inflation doesn't become a persistent feature of the economy. In fact, it may already be too late to prevent a widespread inflation-induced belt tightening from driving a more marked slowdown than we expect. But either way, at this point, recession risks are no longer a good reason not to get ahead of the inflation surge.

Key forecasts

Calendar Years	2018	2019	2020	2021	2022(f)	2023(f)	2024(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.4	2.9	-2.1	5.6	2.1	2.3	2.4
Private Consumption	4.6	3.2	-1.2	6.6	2.0	1.6	3.0
Public Consumption	3.3	5.1	6.8	10.4	7.4	2.1	2.0
Residential investment	-1.6	5.4	-3.3	11.0	2.3	-0.2	2.4
Other investment	9.7	4.1	-8.2	9.2	3.1	2.2	2.8
Stockbuilding[1]	0.3	-0.5	-0.8	1.6	-0.9	0.0	0.0
Gross National Expenditure	5.2	3.2	-1.9	9.6	2.6	2.0	2.8
Total Exports	3.2	2.4	-12.9	-2.5	5.5	12.5	4.6
Total Imports	6.4	2.1	-15.9	15.4	8.8	2.8	3.2
Employment (annual %)	2.3	1.2	0.6	3.7	0.8	1.3	0.9
Unemployment Rate (sa; Dec qtr)	4.3	4.1	4.9	3.2	3.0	3.4	3.8
Labour Cost Index (annual %)	2.0	2.4	1.5	2.8	3.8	3.6	2.5
Terms of trade (OTI basis; annual %)	-4.8	7.1	-1.6	2.6	3.7	1.5	2.0
Prices (annual % change)							
CPI Inflation	1.9	1.9	1.4	5.9	5.7	2.7	2.0
Non-tradable Inflation	2.7	3.1	2.8	5.3	5.4	4.7	3.4
Tradable Inflation	0.9	0.1	-0.3	6.9	6.0	-0.3	-0.1
REINZ House Price Index	3.1	5.1	15.5	26.2	-10.0	1.8	3.7

[1] Percentage point contribution to growth
Forecasts finalised 23 March 2022
Source: Statistics NZ, REINZ, ANZ Research

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