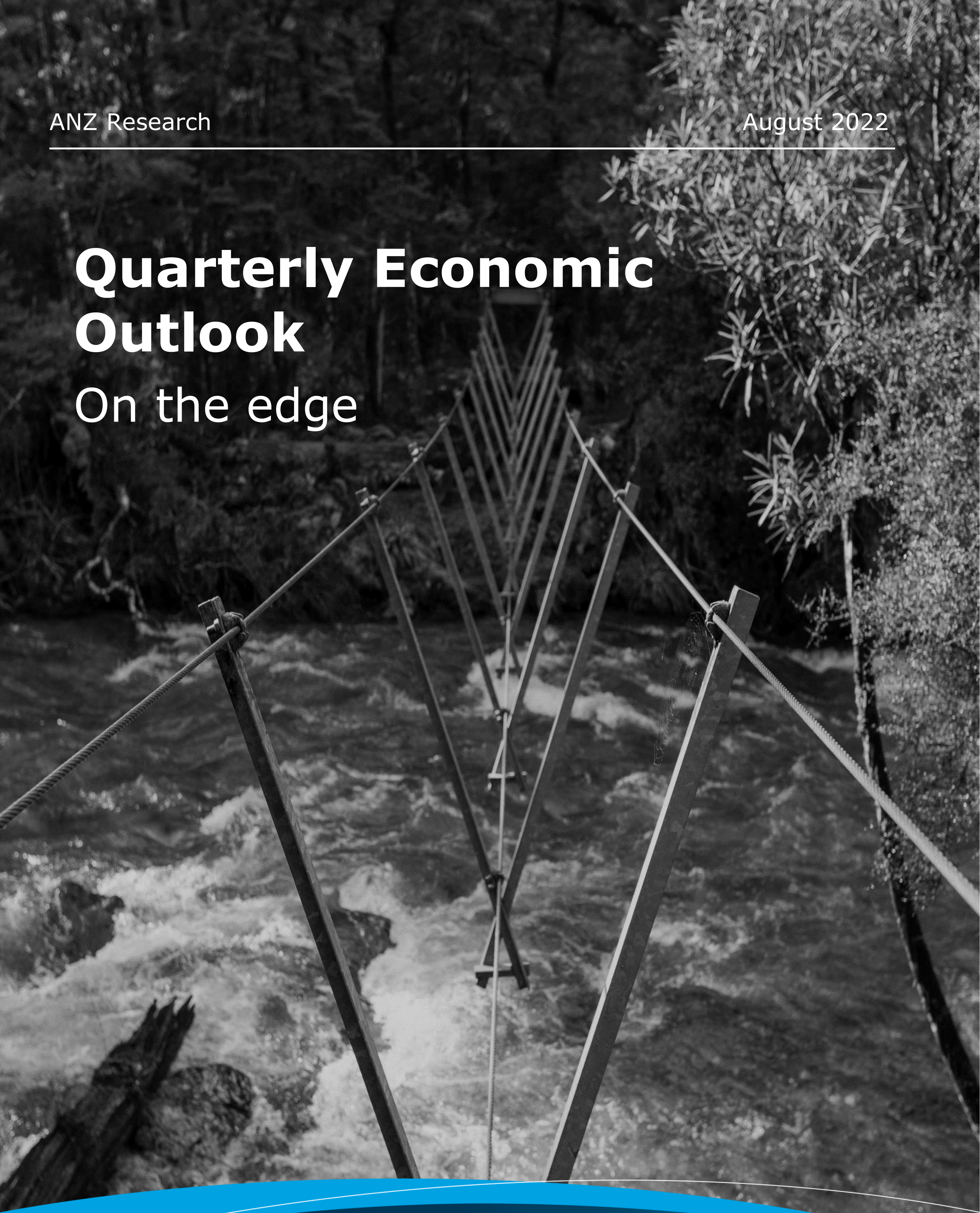
ANZ Research August 2022

Quarterly Economic Outlook

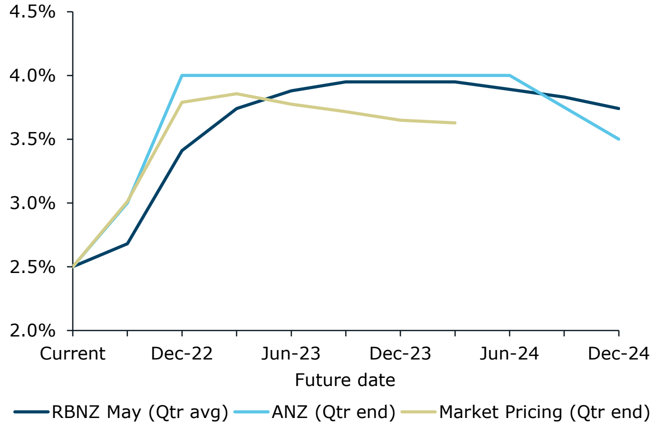
On the edge



Summary of forecasts

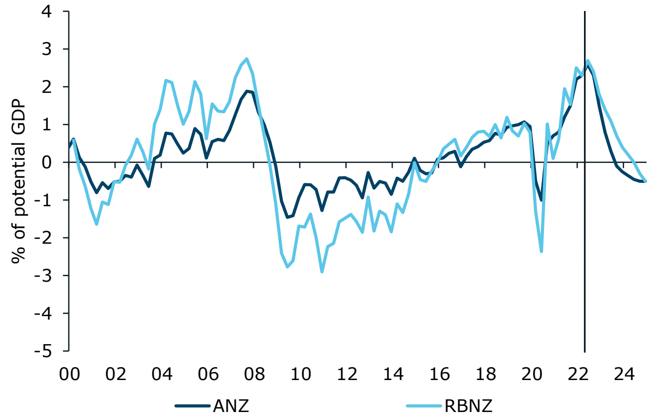
The OCR will go as high as it needs to…

Our OCR forecast peaks at 4%, but 7% y/y wage growth means it may need to go higher.



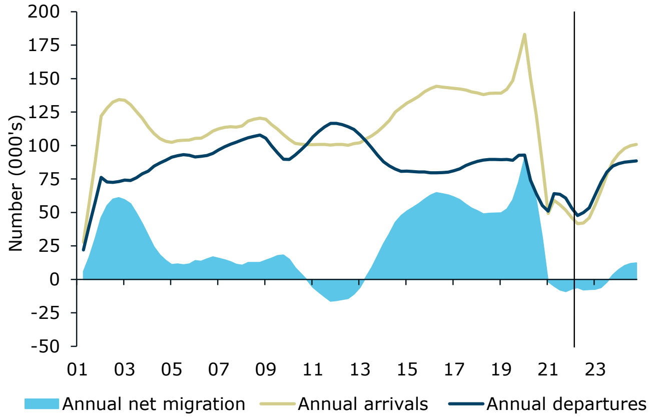
…to align supply with demand

The output gap shows there is no capacity to meet demand without inflation lifting. That needs to change.



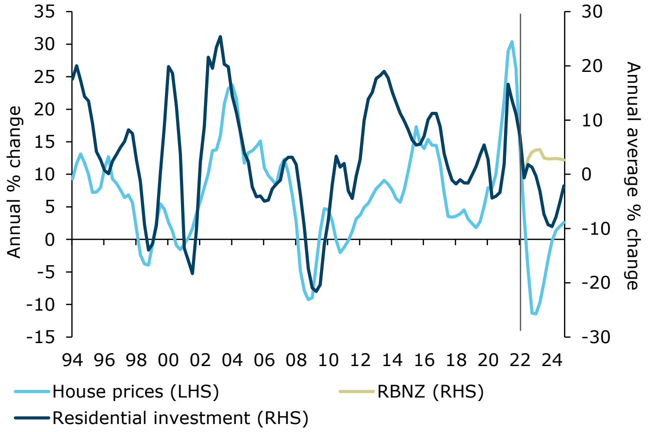
Net migrant outflows mean the labour supply problem won't be resolved quickly

Net migration assumed to stay negative for longer



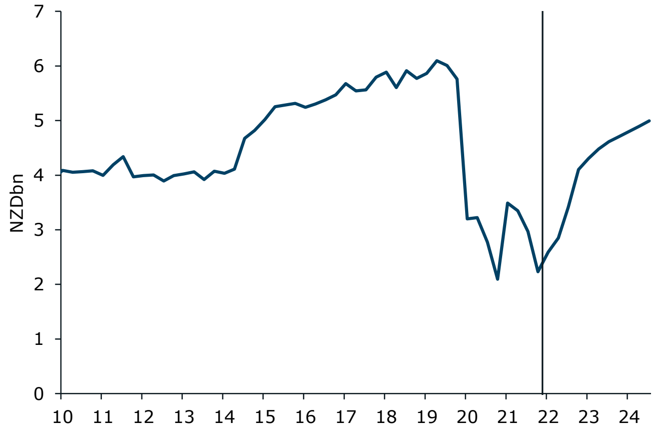
The domestic economy is expected to contract in 2023, led by investment

Residential investment and house prices



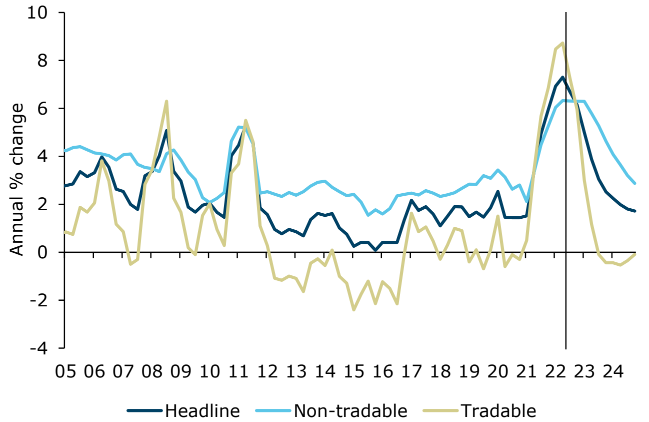
A strong recovery in net exports will hopefully see NZ avoid recession

Real services exports (eg tourism and education)



But unemployment needs to rise for inflation to slow

CPI inflation outlook



Source: Stats NZ, RBNZ, REINZ, Bloomberg, ICAP, ANZ Research

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On the edge

Summary

Our forecasts have the NZ economy avoiding recession, but that's only because we've pencilled in a strong recovery in net exports (as over-stimulated demand for imported goods wanes and exports of services recover). But from a domestic (gross national expenditure) perspective, we do expect a contraction over the first half of 2023. If international tourism and education don't pick up as quickly as we're hoping, the whole economy could easily slip into recession. But for the RBNZ, given the low likelihood of a sharp supply-side recovery (we've downgraded our outlook for net migration), and very strong wage growth, the task of taming inflation hasn't got any easier. We may have downgraded our outlook for activity, but a decent slowdown will be needed to bring inflation under control. Hopefully, it will take an OCR of only 4% to achieve it. But 7% wage growth certainly takes the edge off the tightening delivered so far.

What's changed?

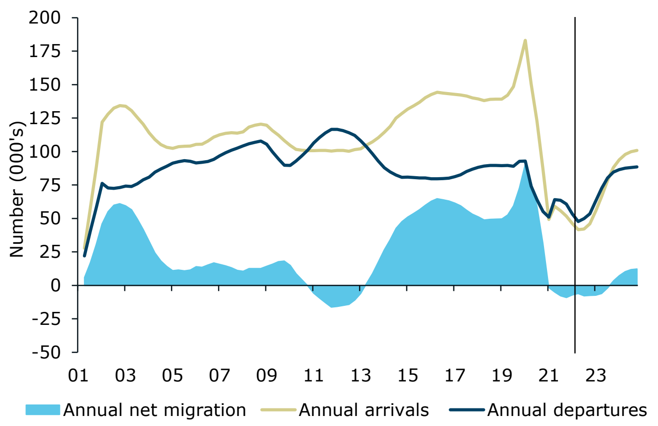
Positive surprises on both domestic inflation and wage inflation are perhaps the most significant developments since our last Quarterly Economic Outlook, as these suggest capacity constraints are biting harder than previously thought. And that means the RBNZ has more work to do. Indeed, in light of the 7.3% y/y Q2 CPI release, we revised up our expectation for how high the OCR needs to go. We now expect 50 basis point hikes all the way to 4% in November, versus our previous pick of 3.5%.

In light of the higher interest rate outlook, we downgraded our house price forecast about a month ago, pencilling in a 15% peak-to-trough decline (previously 12%).

Another key assumption that we've built into this forecast update is a downgrade to the outlook for net migration. Previously, we assumed that the reopening of the border would support a transition to net positive outflows by the end of the year, but we have pushed that out to mid-2023 (figure 1). In a nutshell, non-NZ citizen arrivals are not expected to plug the NZ citizen departures gap for a while yet. The Australian labour market is running too hot – and pays better. As well as pushing out the eventual transition from net negative to net positive migration flows, we've pencilled in a much lower peak (around 12,000 vs our previous expectation of around 25,000).

As it's subject to policy changes and enormous uncertainty, it's best to think of the migration numbers underpinning our forecasts as an assumption. If immigration turns out higher or lower than this, the net impacts for inflation are ambiguous, as migrants add to both housing demand and labour supply. But migrants unambiguously add to GDP by contributing to both demand and supply. But the key point for our forecasts is that this new, lower migration profile suggests New Zealand's labour supply problem won't get much relief from reopening borders. While some vacancies will be filled by new arrivals, other gaps will emerge as departures also lift.

Figure 1. Annual net migration



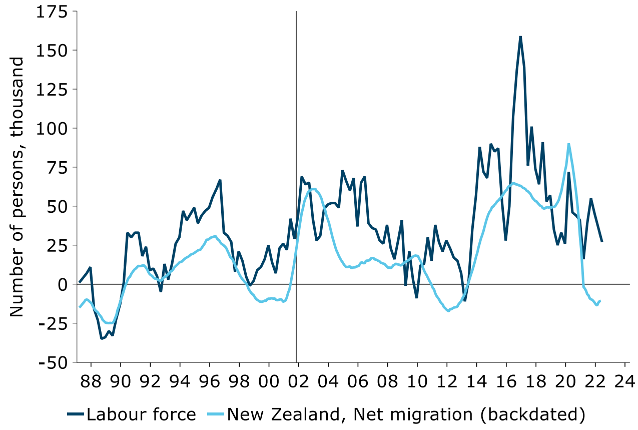
Source: Stats NZ, ANZ Research

While a small net negative outflow in migration may not look like a significant labour supply shock relative to the size of the labour force (the workforce is still growing on the back of natural population change and as participation remains high), the closed border has definitely introduced a supply shock in growth terms.

Assuming net migration would have continued to run at an annual pace of around 55k had COVID-19 never happened, the recent drastic fall in net migration represents foregone population growth of over 100k people to date. Based on the historical correlation, that suggests we're down around 50k workers (or more) relative to the counterfactual. That's a small share of the total labour force of around 2.9 million people, but it's significant in growth terms – shaving about 1%points off annual growth in the labour force over the past couple of years.

So in other words, economic demand has grown on the back of significant fiscal and monetary stimulus, but labour supply has not. The result is an extremely tight labour market, and sharply higher wage and CPI inflation. But this isn't the good type of wage growth – it's not productivity-driven, and therefore must either go into prices (higher CPI inflation), be met with capital substitution (if possible/cheaper), or eat into firms' margins. The latter can't go on indefinitely without firms becoming insolvent.

Figure 2. Annual net migration and change in the labour force



Source: Stats NZ, Macrobond, ANZ Research

We also need to factor in that COVID-19 represents a severe labour productivity shock, with worker absenteeism meaning less output for a given headcount. Then there's the additional resource required to set up work-from-home capabilities, undergo regular deep cleaning, and establish new health measures (such as distancing) in the workplace. The additional labour input required just to keep output stable starts to add up. Case in point; it was the supply side of the economy that saw the economy contract 0.2% Q1 – there was certainly no shortage of demand. Q3 labour supply has also been impacted by the winter waves of both COVID and flu.

So will the domestic supply shackles loosen?

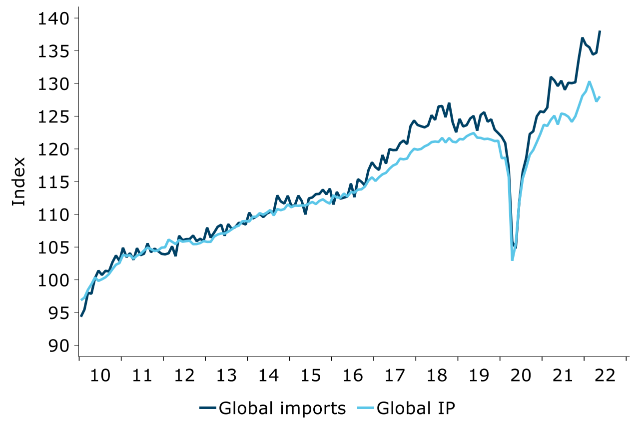
- Work from home capabilities are now largely established, so that one-off is now in the rear view mirror.
- Other workplace health precautions are expected to be ongoing for a long time yet.
- The economy will remain vulnerable to further COVID waves and associated worker absenteeism for the foreseeable future.
- And as discussed, our forecasts assume net migration remains negative until mid-2023 (and there's a risk the migration deficit widens more than we expect and/or for longer).

All up, it looks like the domestic supply recovery is going to take longer than we previously thought, and that means the RBNZ will need to hit the demand side even harder to get the economy back in balance. That means an even weaker activity outlook for a given level of (high) inflation.

What about the global supply side situation?

As in New Zealand, global demand for goods picked up very strongly after the initial lockdowns (figure 3). Many services, such as travel and hospitality, were no longer an option, so people bought stuff instead. Lots of it. Cars and boats and spas – and dogs. All this demand for goods caught global supply chains by surprise, leading to the shipping bottlenecks we're all now very familiar with.

Figure 3. Global imports and industrial production



Source: CPB, Bloomberg, Macrobond, ANZ Research

The good news is that international travel is gradually becoming an option again, which all else equal, reduces demand for goods. That, alongside global monetary tightening and supply chain bottlenecks being worked through will help take the heat out of tradable inflation in time – hopefully as inflationary pressures owing to the Ukraine crisis ease. COVID in China remains a wild card for supply chains, but shipping costs are starting to fall. So while the domestic labour supply shackles may take a long time to loosen, at least the global supply situation should improve from here.

Policy mistakes?

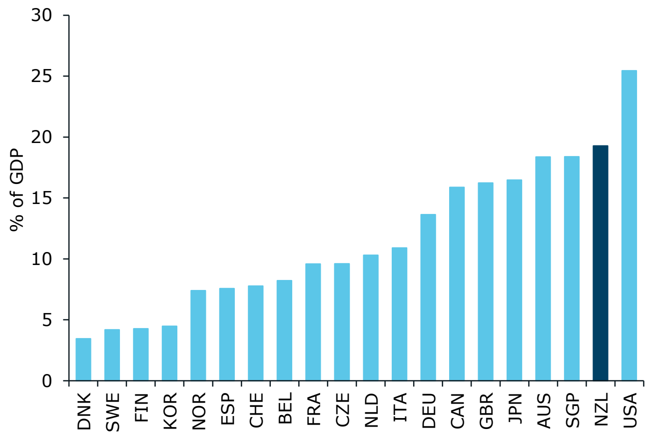
In sum, the supply side of the economy remains impaired to some extent, though probably not as badly as at the peak. What about the demand side of things?

The post-COVID mini-cycle has certainly been nutty. When the pandemic first hit, it seemed very reasonable to assume that it would result in a very long-lasting, deep hit to private sector confidence, and the desire to spend, invest and employ. Accordingly, economic policy makers threw the kitchen sink at it, hoping to limit the fallout.

As it turns out, this stimulus was too much for the conditions: health outcomes were less bad than feared; no overseas holidays meant demand for goods surged; and the housing market took off like a rocket, boosting both durables demand and construction. Economic capacity became exhausted and inflation surged. But as the data rolled in confirming that state of affairs, the RBNZ changed its stance and tightened monetary conditions – going it pretty much alone on the global stage to do so. Hindsight is a wonderful thing; earlier would undoubtedly have been better. But it's easy to forget just how volatile the data was, and how difficult it was to get an accurate read on the real-time state of play, let alone the outlook!

Fiscal policy also leapt into the fray, and the wage subsidy was very important in keeping workers attached to their jobs. As figure 4 shows, NZ's discretionary fiscal response to COVID-19 as a share of GDP was high among advanced economy peers.

Figure 4. Discretionary fiscal response to COVID-19 to mid-21 (additional spending and foregone revenue)



Source: IMF, ANZ Research[1]

But fiscal policy has been less successful than monetary policy in winding back stimulus in a timely manner. Budget 2022 shows more government spending will be injected into the economy this fiscal year (which started in July). But the economy currently has very little capacity to accommodate it, meaning it'll add to the inflation pulse as well as activity.

While there has been a cost of living response from the Government aimed at alleviating some of the symptoms of inflation, the tax cuts on fuel and temporary payments to households are both forms of stimulus at the end of the day, meaning they are working against monetary policy. For the Government to fundamentally subtract from the inflation pulse it needs to spend less today than it was spending yesterday and/or lift taxes. There are supply-side levers that can be pulled too, such as paving the way for more migrant workers to fill key labour shortages and cutting red tape around construction etc. But boosting the supply side of the economy is generally a lot harder than juicing demand.

All up, with the benefit of hindsight, it's clear that there was too much stimulus added to the economy in the wake of the pandemic. That's been a global phenomenon. The hit to demand was less than expected, while the inflationary supply disruptions (eg to shipping) rolled on and on – and still aren't resolved. But it was a crazy time to try to set policy, and what's done is done. Here and now, monetary and fiscal policy are pulling in different directions to some extent, but we do expect overall demand to slow as the RBNZ's tightening bites.

The activity outlook

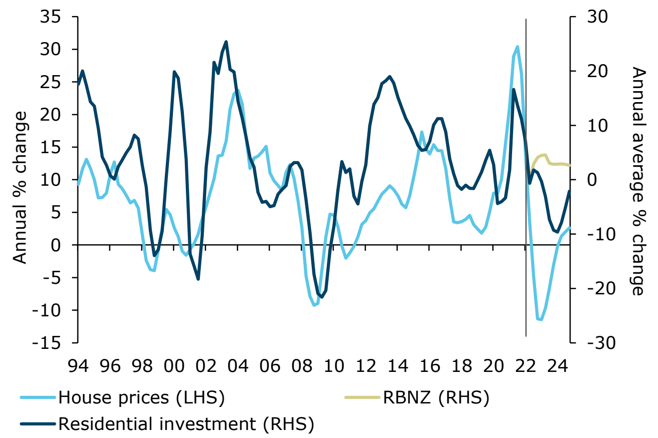
Turning to the outlook for activity, things are looking less rosy as the inflationary data roll in. Recent data has brought upside surprises on inflation – for the prices of both goods and labour. This suggests economic capacity limits are biting harder than previously thought, which raises the risk that the OCR will need to go still higher (hurting demand). With wage inflation running at 7% and unemployment so low, getting households to spend less becomes a harder task. Indeed, the upside surprise to wage growth goes a long way to explaining why household spending has been holding up so well despite higher interest rates and low confidence. But the fact is, in the absence of a significant supply recovery, the RBNZ needs demand to soften, and will keep hiking until it does!

The domestic side of the economy is where the slowdown will be felt most acutely.

Falling house prices mean residential investment is expected to undergo a typical outsized downswing over the coming year or so. We've pencilled in around a 10% contraction over 2023 (previous: -6%), and see downside risks to this outlook. Falling dwelling consents should see the RBNZ downgrade their forecast here too. Initially, the slowdown in residential investment activity will be primarily capacity driven (ie due to labour and materials shortages), but by 2023, falling demand is expected to be the dominant driver.

[1] Note: Estimates as of 5 June 2021. Numbers are in USD and percent of GDP are based on July 2021 World Economic Outlook Update unless otherwise stated. Country group averages are weighted by GDP in USD adjusted by purchasing power parity.

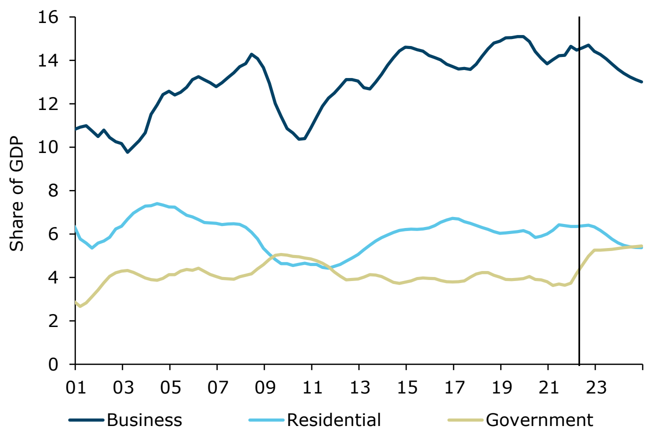
Figure 5. House prices and residential investment



Source: REINZ, RBNZ, Stats NZ, ANZ Research

At the same time, we expect general economic uncertainty and higher interest rates will lead to a pullback in business investment, while government investment remains elevated. Like residential investment, business investment (the lion's share of investment) tends to undergo outsized cycles. That means the looming downswing could be much sharper than we've pencilled in – around a 3% contraction in total investment in the year to December 2023.

Figure 6. Investment share of GDP



Source: Stats NZ, RBNZ, ANZ Research

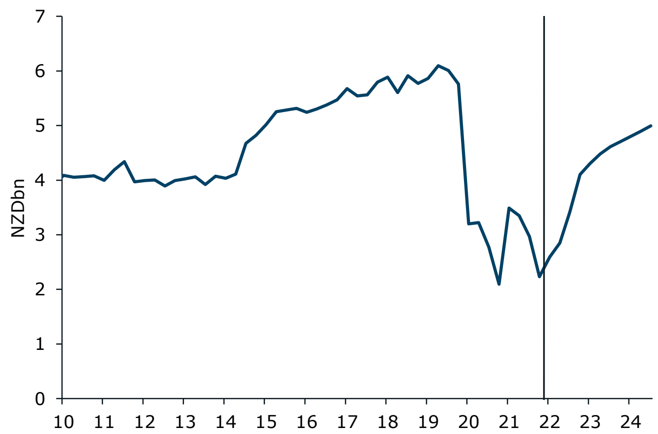
For private consumption, weaker housing and a little less appetite to splurge (as economic uncertainty bites) means in all likelihood weaker demand for both durable and luxury goods. While very strong wage growth will provide a partial offset, we still expect a period of belt tightening ahead. All up, we expect very modest growth in real consumption in the near term (as the still-tight labour market meets the drag from negative net migration). But come early 2023, we think the belt-tightening story will dominate. All up, we've pencilled in a 0.6% contraction in private consumption over 2023, but that's coming off an extremely high (overstimulated) base.

Reflecting further fiscal expansion in Budget 2022, we expect Government consumption to remain at very high levels. However, given capacity constraints (particularly in the near term) we don't expect government spending to add significantly to total GDP. There isn't enough capacity for that to happen. Rather, the stimulatory fiscal stance is expected to lead to a degree of "crowding out" – displacing private sector activity that would otherwise have happened (but with the excess demand leaving CPI inflation pressure higher than otherwise).

When we put all the domestic GDP components together, we're left with a contraction in gross national expenditure (ie GDP excluding net exports) of around 0.5% over 2023, driven by a contraction over the first half of next year.

If New Zealand were a closed economy, this forecast would be a recession. But fortunately, we're an open economy that (touch wood) is about to undergo a sharp (albeit not full) recovery in services exports (chiefly, international tourism and education). Services imports are also lifting as the border reopens (ie kiwis traveling overseas), but New Zealand's services imports are less travel-intensive than our services exports, so don't have as far to recover. All up, we're assuming services exports will be running at around 70% of their pre-pandemic level by the end of the 2022/23 summer (summer is the tourism peak for NZ).

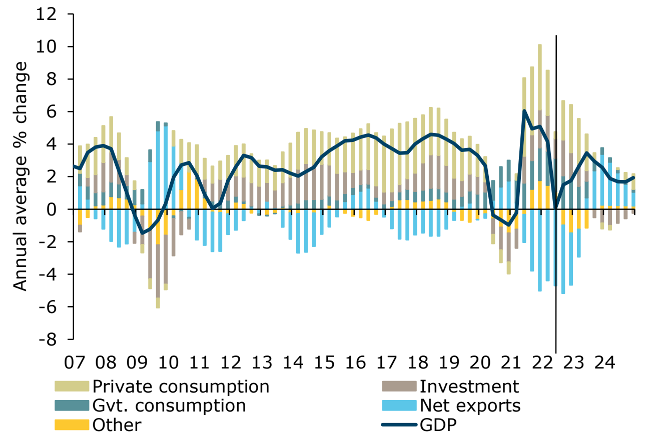
Figure 7. Real services exports



Source: Stats NZ, ANZ Research

Another significant driver of the net exports recovery in our forecast is an expectation that demand for imported goods will fall alongside the weakening domestic economy. Imports detract from GDP, so with goods exports holding up (subject to weather conditions), this will hopefully keep headline GDP growth from turning negative. But a weaker recovery for international education and tourism alongside a persistently high import dependence could easily see the economy in recession.

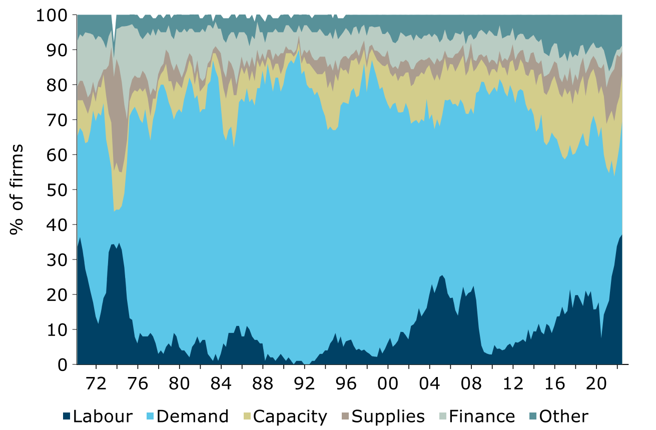
Figure 8. Contributions to annual average GDP growth



Source: Stats NZ, ANZ Research

For the labour market, the starting point is even more inflationary than we or the RBNZ feared. True, the actual unemployment rate increased 0.1ppts to 3.3% in Q2 on the back of zero employment growth over the first half of 2022. But given the margin of error on estimated unemployment is 0.3% points, that's neither here nor there. There's no denying this is still an incredibly tight labour market. Labour demand remains insatiable, with the share of firms reporting labour as a constraint on increasing output at its highest level in data going back to the 1970s.

Figure 9. Firms' limiting factors of production



Source: NZIER, Macrobond, ANZ Research

Meanwhile, labour supply remains hampered by slightly negative net migration, as well as ongoing absenteeism and disruption from COVID and the winter flu. But there are still just under 100k people counted as unemployed by Stats NZ – so why are we not seeing any employment growth? Our take on the situation is that the domestic labour market has simply reached the end of its ability to match jobseekers with vacant positions (eg due to skills and/or geographic mismatches). That means it's unlikely to get any easier to find staff – but we may not see that difficulty finding labour reflected in a lower unemployment rate.

The difficulty finding labour is, however, being reflected in wages. Annual private sector wage growth accelerated to 7.0% in Q2 (5.3% previously), and has pretty much caught up to inflation (indeed, wage growth will likely exceed inflation in Q3). Wages have risen faster and further than we or the RBNZ expected. This suggests high inflation is becoming embedded in wage- and price-setting behaviour. That's a recipe for a wage-price spiral.

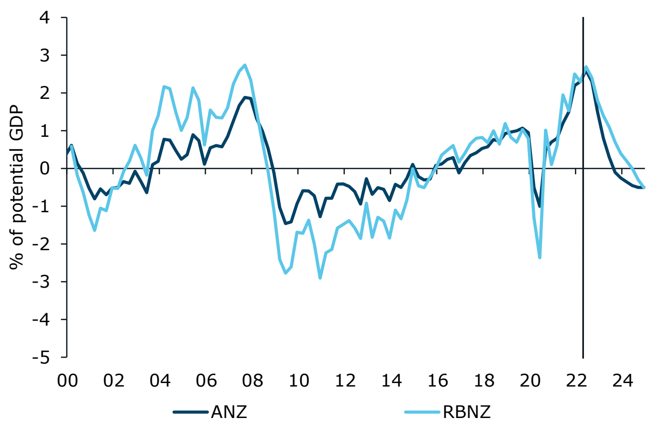
Turning to the labour market outlook, we're anticipating very low employment growth over the rest of the year, with annual employment growth slowing to just 0.1% in 2022, versus 3.4% in 2021. But that's very much a supply story, rather than a lack of demand (ie this is still inflationary). Where demand starts to come into the picture is over 2023, as a weaker domestic economy starts to weigh on the labour market. We're anticipating employment will decline by 0.5% over 2023 as demand for workers falls away. This sees unemployment rise from the current low of 3.3%, to 4.9% at the end of our forecast horizon in Q4 2024.

For wage growth, the only way is up in the near term. High inflation and the tight labour market are likely to keep the pressure on wages over the next year, and a rapidly tightening Australian labour market is yet another source of competition for Kiwi workers. Given the already-high starting point for hourly earnings growth, we're anticipating we could see wage growth peak as high as 8.5% over the next six months – comfortably outstripping the cost of living (which makes the RBNZ's job of denting demand to bring down inflation that much harder). However, dent it they will – the question is just how high the OCR will need to go to do it.

With unemployment set to rise pretty quickly over 2023/24, we should start to see wage inflation ease back to levels more consistent with low and stable inflation. But until that happens, the pressure-cooker labour market will be a key driver of already-too-strong domestic inflation pressures.

All up, bringing our updated supply and demand outlooks together leaves us with a more inflationary economy in the near term. However, more hikes and more demand destruction over the medium term should be enough to see capacity pressures ease and inflation eventually dissipate. This is reflected in our output gap estimate that shows current immense capacity stretch dissipating as the economy slows.

Figure 10. Output gap



Source: RBNZ, ANZ Research

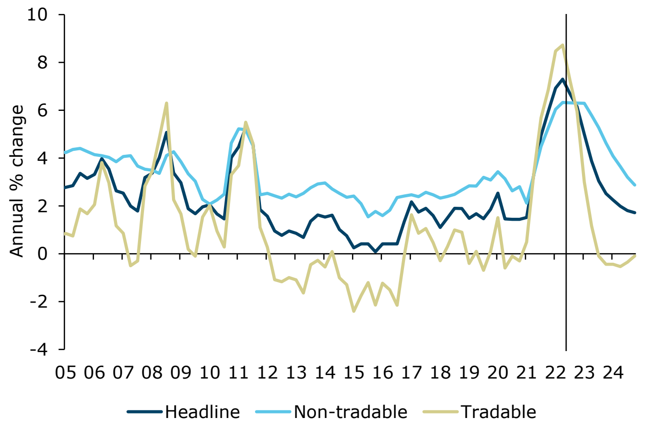
In line with above, domestic (aka non-tradable) CPI inflation is expected to slow. A large part of that will come from the housing and household utilities group as residential investment cools (taking building cost inflation with it). But for domestic inflation to really stabilise close to the RBNZ's target, the labour market needs to loosen (taking the pressure off wage growth), and that's expected to happen a little more slowly than the housing story. Accordingly, we're expecting only a gradual decline in non-tradable inflation.

On the tradables side, we expect high inflation to fall much faster:

- oil prices are well off their highs (that's true for many hard and soft commodities as global monetary tightening bites and recession fears rise);
- the NZD will hopefully hold on an upwards trajectory; and
- global shipping costs will hopefully slip.

Put all that together and we expect to see headline inflation settle just below 2% by the end of the forecast.

Figure 11. CPI forecast



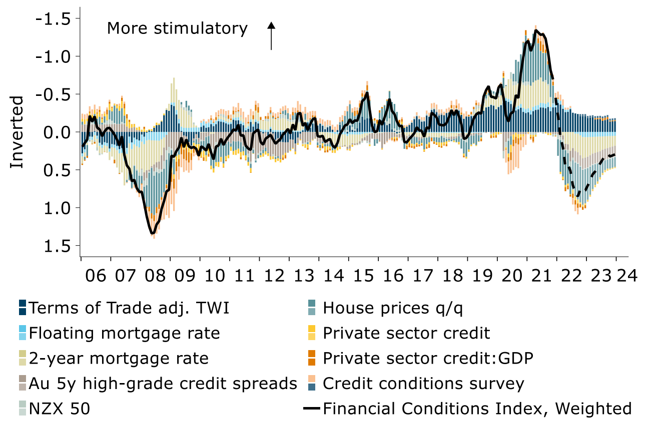
Source: Stats NZ, ANZ Research

A broken record called risk

At the risk of sounding like a broken record, these are volatile times, and risks to the outlook are heightened. The list of things that may not go to plan is lengthy, and the below is by no means an exhaustive list. But here are a couple of the things exercising our minds.

- The neutral OCR might be considerably higher. That's the level of the OCR that's consistent with stable inflation around target. Many factors influence this, including inflation expectations, and wage growth – and we've seen a solid rise in those. Another way to think about this is that as inflation becomes more embedded in wage- and price-setting behaviour, a given level of interest rates is less contractionary. All else equal, that means the RBNZ will need to hike the OCR even more in order to squeeze household demand and tame inflation. Given recent wage data, we think there's a very real risk that the RBNZ concludes that the neutral OCR must be currently considerably higher than the ~2% they showed as a mid-point estimate in the May MPS, and therefore conclude that the OCR needs to go higher still.
- On the other hand, financial conditions have changed dramatically over the past year or so. Our financial conditions index shows that it really wouldn't take much (a sharper global downturn taking the terms of trade along for the ride, a sharper fall in house prices, much tighter credit conditions, or a sharper correction in equities), for financial conditions to weaken to Global Financial Crisis levels.

Figure 12. Financial conditions



Source: Stats NZ, Bloomberg, Macrobond, ANZ Research

All up, it's fair to say that the general risk profile around our outlook is skewed towards weaker activity, a higher OCR, and higher (or more persistent) inflation. One implication of this is that the RBNZ's ability to come to the rescue if the economy is weaker than expected could be pretty limited: inflation may remain high, because the slowdown is partly supply driven, and/or because core inflation pressures remain much too high. In that scenario, the RBNZ may not be able to cut rates without compromising its inflation target.

Time to stop living (so far) beyond our means

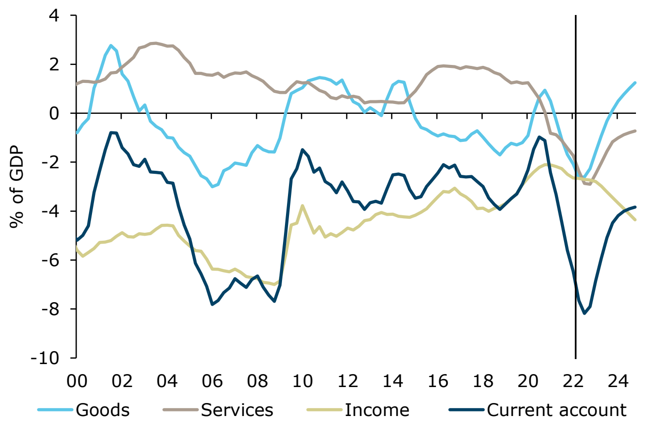
External balance is a useful lens on the economy through which we, the RBNZ, and the Government should be looking through from time to time.

New Zealand is a net borrower from the rest of the world, meaning we rely on foreign capital to fund domestic activity. That's not necessarily a bad thing, provided this foreign capital is put to good (productive) use. But the higher this dependency, the greater the chance of a misallocation of capital, and the greater the chance of a sharp correction. Worst case scenario, global appetite to lend to New Zealand could dry up, meaning Government consumption and investment has to pull back sharply (as the cost of government borrowing explodes), and private consumption and investment also need to realign. That would be a very painful transition.

Over the past year or so, extreme levels of fiscal and monetary stimulus, combined with the loss of our largest export (tourism), have seen our current account deficit widen significantly. Imports of goods have lifted more than exports (despite growth in export prices outperforming import prices), causing the goods deficit to widen. The services balance flipped from surplus to deficit (ie from generating foreign revenue that can go towards paying our way in the world, to adding to the international funding burden). Meanwhile, the income deficit (ie returns on net investment) was contained. But all together, this saw the annual current account deficit widen from its pre-pandemic norm of around 3.5-4% of GDP to 6.5% of GDP as at Q1 2022. And we expect it to widen further, to around 8% of GDP – that's pushing the envelope of respectability.

The good news is that provided slowing domestic demand takes the nuttiness out of imports, as international tourism and education gets back on its feet, the current account deficit is set to improve. But a net borrower like New Zealand is always susceptible to interest rate risk, and our income deficit is therefore likely to widen even as the trade balance (goods and services) improves.

Figure 13. Current account



Source: Stats NZ, ANZ Research

For now, this profile shouldn't get the sovereign credit rating agencies too worried, but the external balance situation will certainly be on their radar. In this light, a return to something a little more sustainable (ie an eventual fiscal consolidation and reduced household demand), is not only a good thing from an inflation-fighting perspective; it's a good thing from a sustainable external position perspective. The debt-fuelled stimulus policy makers engineered to get the economy through the pandemic was never a sustainable economic driver. And with economic resource now all but spent, it's time to wean the economy off it.

Markets outlook

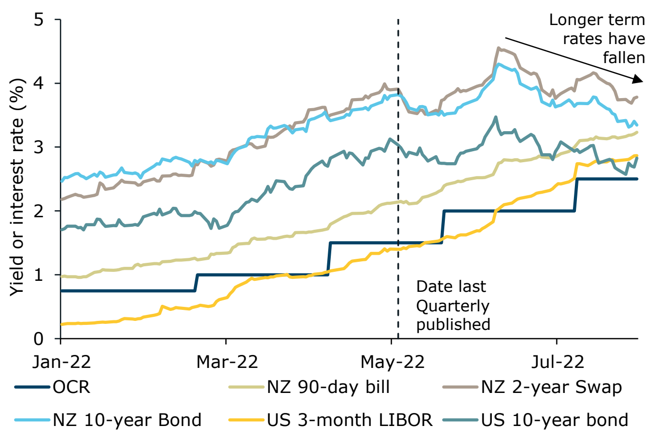
Summary

Global bond yields and expectations for policy rates have moderated since our last quarterly, fuelled by fears of recession both in the US, and New Zealand. While this is a natural response, and both countries could well be in recession later this year or in 2023, we have yet to see evidence of a meaningful moderation in inflation pressures, and any recession here or in the US is unlikely to be associated with falling nominal incomes. Thus, we think markets have been premature to call for a turn in policy rate cycles. While the downward correction in local and global interest rates early in Q3 was swift, it has been challenged by recent data and consistently hawkish commentary from US Federal Reserve officials. Local markets seem equally unprepared for a higher RBNZ OCR track in August; if that does occur, we are likely to see the whole term structure of interest rates rise over the rest of Q3. Our FX forecasts call for gradual NZD/USD strength into year end, closing the gap to our measure of fair value.

Super-sized hikes have been delivered…

Policy rates have risen sharply in New Zealand and in many other countries since our last quarterly – in some cases very sharply, thanks to super-sized hikes of a magnitude not seen in over two decades. In New Zealand, 50bp hikes have been the norm, but central banks in the US and Canada have delivered 75bp and 100bp hikes respectively. All of this has put significant upward pressure on short-end interest rates, with key very short-term bellwethers like the New Zealand 90-day bill rate and the USD 3-month LIBOR rate both sharply higher (with the former up around 1.1%pts to 3.3% and the latter up around 1.5%pts to 2.9%). The lesser rise locally simply reflects that the RBNZ started hiking earlier, and has "only" hiked in 50bp steps.

Figure 1. Selected NZ and US interest rates



Source: Bloomberg, ANZ Research

… but most interest rates are lower, fuelled by recession fears …

However, as figure 1 shows, many other interest rates are actually lower, with the largest falls seen in longer-term interest rates, such as the 10-year government bond yield. New Zealand long-term interest rates are more sensitive to moves in global interest rates than they are to moves in the OCR, and while we did see US bond yields rise over May and June (taking the bellwether 10-year Treasury bond yield to a high of 3.49%), they have since retreated to below 3%. This, in turn, has seen 10-year New Zealand government bond (NZGB) yields fall from a peak of around 4.3% in mid-June to around 3.4% by early August.

This sharp turnaround, which has inverted the US Treasury bond yield curve and the New Zealand swap curve, has been fuelled by recession fears in the US and here. This is a logical response, and one that bond markets have demonstrated many times in the past. The logic goes that short-end rates like 3-month and 2-year rates have no "choice" but to move higher as policy rates move higher, but interest rates on longer-term bonds and swaps (which will span several policy cycles) are now starting to contemplate a peak in policy rates, and eventual policy rate cuts. But while that logic is easy to follow, it is of course highly dependent on the timing of when those cuts might eventually occur. And this is where things start to get interesting.

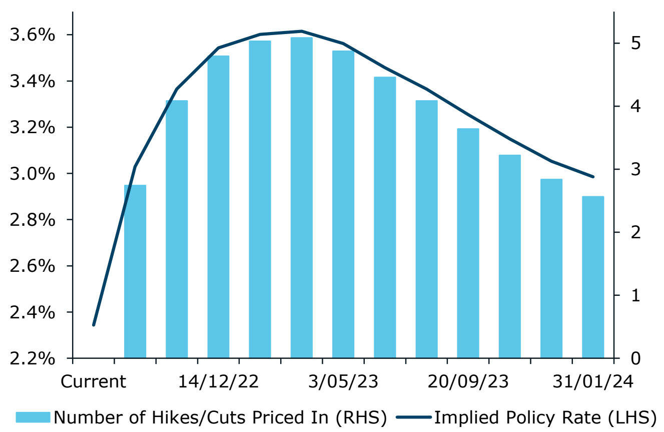
…but inflation risks haven't really eased

We say "interesting" because while stiff hikes here and abroad have stoked recession fears, there hasn't been any material easing in inflation pressures, other than what has been observed in some commodity prices. This is key, as the idea that central banks can ease before inflation moderates is challenging. Supply chains remain clogged and in many markets there is still a notable supply-demand imbalance. Policy rates have been lifted in a bid to try to align demand with the available supply, but not only are there transmission lags; consumers here and in the US have shown remarkable resilience to higher policy rates. That's partly due to savings over the COVID period, but also the super-tight labour market. Job security is high with unemployment rates so low, and wage growth is strong. Indeed, the risks of a wage-price spiral have increased, not decreased, and that leaves us coy about declaring "job done" on the fight against inflation. Accordingly, we're wary about the idea that policy rates have scope to come down any time soon.

The traditional way that bond markets respond to the threat of a recession is to invert yield curves (especially when there's a sense that a prospective recession will be exacerbated by hawkish policy). But is that still a valid response to a recession that is likely to be associated with still-rising nominal incomes? Real GDP (ie volumes) may fall over successive quarters, but if nominal income doesn't fall (and there is no sign in wages data here in the US to suggest that it will), it is worth asking; have yield curves inverted prematurely?

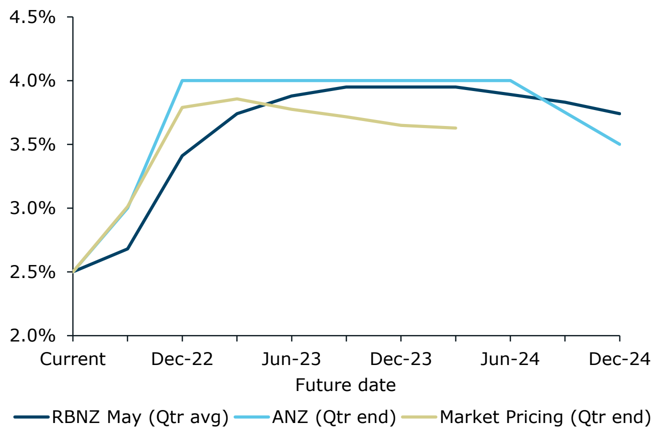
It is always hard to go against market pricing, which essentially means refuting the collective wisdom of millions of market participants, but we think the risks remain tilted to the upside in relation to inflation and policy rates, and struggle to envisage policy rate cuts any time soon. By contrast, markets are pricing rate cuts beyond Q1 2023 both here and in the US (figure 2). And it is this skew of risks that stands behind our forecasts calling for higher interest rates over coming months.

Figure 2. Market expectations for the US Fed Funds Rate



Source: Bloomberg, ANZ Research

Figure 3. ANZ OCR forecasts vs the market and RBNZ



Source: Bloomberg, ANZ Research

Our more cautious stance aligns with comments by US Federal Reserve officials in the wake of the second 75bp hike in July, the broad thrust of which was: inflation is still too high, it may not have turned, and the Fed's job is far from done. We also wonder how resilient local markets will be to a higher OCR track in the RBNZ's August MPS. In May, the RBNZ pencilled in a 3.9% peak in the OCR (in 2023) followed by mild easing in 2024. Since then, inflation and wage data has surprised to the upside, and among other things, that has seen us revise up our OCR forecasts.

At the moment, market expectations for the peak in the OCR sit below our forecasts (figure 3), and that's before we add in our judgement that the risks to our forecasts are skewed to the topside. This is the main reason why our forecasts have key short-end interest rates like the 90-day bill and 2-year swap rate rising between now and the end of the year. While we do see a peak and eventual reduction, that is predicated on our assumption that we will see OCR cuts in late-2024. But that is not a given, and the risk is we see policy rates on hold at higher levels for longer.

Our longer-term interest rates assume that US interest rates correct higher, dragging New Zealand interest rates up with them. One key judgement here isn't just the likelihood of recession in the US (and locally), but whether inflation moderates, and whether a wage-price spiral can actually be avoided.

Mild further NZD strength expected to close gap to fair value

In the FX space, we have made further downgrades to our NZD/USD forecasts, acknowledging that the RBNZ is leading the policy rate cycle, and that slowing global growth poses downside risks to commodity prices (the impact of which has been evident in recent GDT auction results).

The mild appreciation we do have pencilled in (to 0.63 by year-end and 0.65 by the end of 2023) is courtesy of the fact that we see fair value at around 0.66 right now, and it makes sense for this gap to gradually close over time. However, if inflation proves to be more persistent and the US Federal Reserve (whose policy rate is already on a par with the RBNZ's OCR) is forced to hike more aggressively, and that drives a fresh bout of risk aversion, USD strength may return.

Markets have been extremely US-centric of late, and US themes have driven price action. We don't see that changing any time soon, and within that, we are cognisant not to over-emphasise domestic considerations, including positive ones like New Zealand's much higher bond yields and comparatively low levels of Government debt.

Markets outlook

Table 1: Forecasts (end of quarter)

FX Rates	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
NZD/USD	0.63	0.63	0.64	0.65	0.65	0.65	0.65
NZD/AUD	0.89	0.88	0.86	0.87	0.87	0.87	0.87
NZD/EUR	0.62	0.60	0.60	0.59	0.58	0.58	0.57
NZD/JPY	84.4	83.2	83.2	83.2	82.6	81.9	81.3
NZD/GBP	0.52	0.51	0.52	0.52	0.51	0.51	0.50
NZD/CNY	4.22	4.19	4.22	4.26	4.23	4.19	4.18
NZ$ TWI	71.0	70.2	70.4	70.7	70.3	69.9	69.6
Interest Rates	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
NZ OCR	3.00	4.00	4.00	4.00	4.00	4.00	4.00
NZ 90 day bill	3.93	4.10	4.10	4.10	4.10	4.10	4.10
NZ 2-yr swap	4.37	4.21	3.99	3.93	3.82	3.76	3.69
NZ 10-yr bond	4.25	4.00	4.00	4.00	3.75	3.75	3.75

Source: Bloomberg, ANZ Research

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	5.7	1.9	1.8	1.7
Private Consumption	4.6	3.2	-1.2	6.5	4.7	-0.6	1.5
Public Consumption	3.3	5.1	6.8	10.1	8.4	1.8	0.8
Residential investment	-1.6	5.4	-3.3	11.1	1.3	-9.3	-2.1
Other investment	9.7	4.1	-8.2	9.5	8.9	-1.3	-0.7
Stockbuilding[1]	0.3	-0.5	-0.8	1.6	-0.7	0.0	0.0
Gross National Expenditure	5.2	3.2	-1.9	9.6	4.9	-0.4	1.0
Total Exports	3.2	2.4	-12.8	-3.2	-7.1	15.9	5.1
Total Imports	6.4	2.0	-15.9	14.7	5.0	0.7	1.2
Employment (annual %)	2.2	1.2	0.6	3.4	0.1	-0.5	0.2
Unemployment Rate (sa; Dec qtr)	4.4	4.1	4.9	3.2	3.4	4.5	4.9
Labour Cost Index (annual %)	2.0	2.4	1.5	2.8	4.3	3.8	2.3
Terms of trade (OTI basis; annual %)	-4.8	7.1	-1.6	2.8	1.6	1.9	1.6
Prices (annual % change)							
CPI Inflation	1.9	1.9	1.4	5.9	6.1	2.5	1.7
Non-tradable Inflation	2.7	3.1	2.8	5.3	6.3	4.6	2.9
Tradable Inflation	0.9	0.1	-0.3	6.9	6.0	-0.4	-0.1
REINZ House Price Index	3.1	5.1	15.5	26.2	-11.3	-3.1	2.6
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.67	0.72	0.68	0.63	0.65	0.65
NZD/AUD	0.95	0.96	0.94	0.94	0.88	0.87	0.87
NZD/EUR	0.59	0.60	0.59	0.60	0.60	0.58	0.55
NZD/JPY	73.8	73.1	74.6	78.6	83.2	81.9	76.7
NZD/GBP	0.53	0.51	0.53	0.51	0.51	0.51	0.49
NZD/CNY	4.62	4.69	4.74	4.35	4.19	4.19	4.13
NZ$ TWI	73.4	73.7	75.2	73.2	70.2	69.9	68.8
Official Cash Rate	1.75	1.00	0.25	0.75	4.00	4.00	3.50
90-day bank bill rate	1.97	1.29	0.27	0.97	4.10	4.10	3.60
2-year swap rate	1.97	1.26	0.28	2.17	4.21	3.76	3.60
10-year government bond rate	2.37	1.65	0.99	2.39	4.00	3.75	3.50

[1] Percentage point contribution to growth

Forecasts finalised 9 August 2022

Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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