ANZ Research

NZ Forecast Update: The much-needed adjustment

16 June 2023

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The much-needed adjustment

Bottom line

- With Q1 2023 GDP data now in the bag, we have revised our macroeconomic outlook, factoring in a weaker starting point but also a stronger net migration impulse, green shoots in housing, the additional fiscal stimulus announced at Budget 2023, the improving vibe across our Business Outlook survey, and slightly easier monetary conditions in the near term than previously expected (given the RBNZ surprised on the dovish side of our expectation in the May MPS).
- These forward-looking developments have a very different vibe to them to the Q1 GDP print, where cyclone impacts (and to a lesser extent, teacher strikes) nudged the economy into a technical recession.
- Broadly, the outlook for economic activity remains sub-par. Monetary conditions are contractionary, and the impact on demand is clear (and building). But despite the weak Q1 GDP print, our updated outlook is a little less dire than previously – in headline terms at least. A decent chunk of it is driven by population growth masking per-capita weakness. Technically, our GDP forecast is for a double-dip recession, with the economy contracting 0.3% over the second half of 2023, but it's very mild. And given the current Q4/Q1 "recession" is based on a 0.1% contraction, it may not even survive revisions!
- Ultimately, New Zealand is not going to have a recession because the Reserve Bank wants one. We're going to have a recession because we've been living beyond our means for some years, and that's unsustainable. With the economy this far out of balance (the labour market is still beyond the bounds of sustainable levels, domestic inflation is running at a record high, and NZ is running a near-record wide current account deficit), a transition to something more sustainable is very much needed – and inevitable.
- By November, we think it'll be clear that the tailwinds of demand associated with strong net migration and the fiscal impulse are seeing resource strains persist a bit longer than the RBNZ is anticipating. With domestic inflation stubbornly high and looking stickier than the RBNZ's expectation, we are forecasting that will push them back into hiking mode by the end of the year. We're pencilling in a peak OCR of 5.75%, and see the risks it picks up a 6-handle as greater than the risk of the next move being a cut.
- That said, there are risks on both sides, as always, and even if our view proves to be bang on, we'd fully expect markets (which appear very eager to price in OCR cuts currently) to take a while to come around to this view. Our CPI inflation outlook has some sizable base effects in the near term (ie large historical price rises dropping out of the annual calculation) that should see annual inflation slow meaningfully. And not just on the tradable side. That'll make everything look right on track for some time, with inflation potentially even surprising on the downside versus the RBNZ's expectations. But once that's all washed through, we expect a core inflation pulse to be revealed that isn't quite playing ball.

- Underpinning the domestic inflation pulse is the state of the labour market, which we see as remaining a little more resilient than the RBNZ expects. We see unemployment at 4.2% by year-end versus the RBNZ's forecast of 4.6%. We don't expect the unemployment rate to become outright disinflationary until the second half of 2024.
- All up, the outlook may be a little brighter than in our previous forecast iteration, but on a per capita basis things are still looking very soggy. But the unfortunately fact is, one way or another, this out-of-balance economy needs to transition to something more sustainable, and that transition in our forecasts involves further monetary tightening, belt tightening, a loosening in the labour market, a focus on export returns, and hopefully, an eventual fiscal consolidation. It's not a particularly cheerful story, but it is a story that sets up the New Zealand economy for success down the track.

Forecast update: More supply, more demand, sticky inflation

With Q1 GDP data now in the bag, we have updated our macro forecasts to incorporate not only the updated starting point, but also the additional fiscal stimulus announced in the Budget, very strong net migration inflows, green shoots in housing, the improving signal in our Business Outlook and the RBNZ's 'dovish' hike in May.

Our OCR call is unchanged. We think sticky inflation risks are currently underappreciated by the RBNZ, and that they will be back at the hiking table come November.

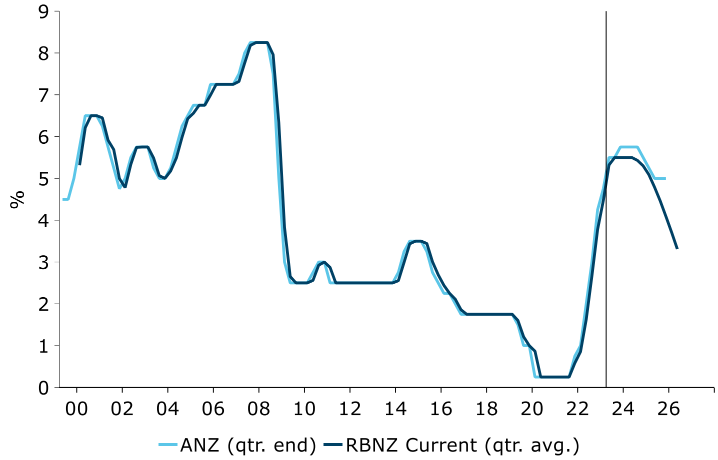
At the end of the day, 5.5% is just the RBNZ's first pass at how much hiking is needed to get on top of inflation. Given how hard economic forecasting is at the best of times, and that the current situation is far from the best of times given all the moving parts on both the demand and supply sides of the economy, it would be quite something to get it exactly right first time, really. Far likelier that 5.5% is either too much or too little, and both views are out there in the marketplace. For our part, we've pencilled in one more 25bp hike as a placeholder for how we see the balance of risks – and in practice, if the RBNZ does clear the hurdle for restarting tightening, it's unlikely to be for the sake of just 25bps. That is, officially our OCR forecast peaks at 5.75%, but we think the risk that the OCR picks up a 6-handle is greater than the next move being a cut.

In our view, unless something very nasty comes along out of left field, OCR cuts remain a very distant prospect indeed. The current economic slowdown we are forecasting isn't your run-of-the-mill downturn that policymakers will hasten to bring to an end; it's being deliberately engineered by the RBNZ, making it very different to an unexpected shock (such as a financial crisis). Households and business are able to plan for what's coming, and that appears to be adding to broader economic resilience.

While some households and businesses in rate-sensitive sectors are really struggling, a sense of relief does appear to be building now that the RBNZ has signalled it thinks it's done with rate hikes. But at the end of the day, the more robust underlying economic momentum proves to be, the more work the RBNZ will need to do to get on top of sticky inflation risks and guide the labour market to looser, but more sustainable, levels.

We're reminded of the pre-GFC hiking cycle, where the RBNZ paused for a few months in 2005, hiked 50 basis points, paused for around a year, and hiked another 100bps in 2007. Then the Global Financial Crisis came along, necessitating large, rapid cuts.

Figure 1. OCR forecast



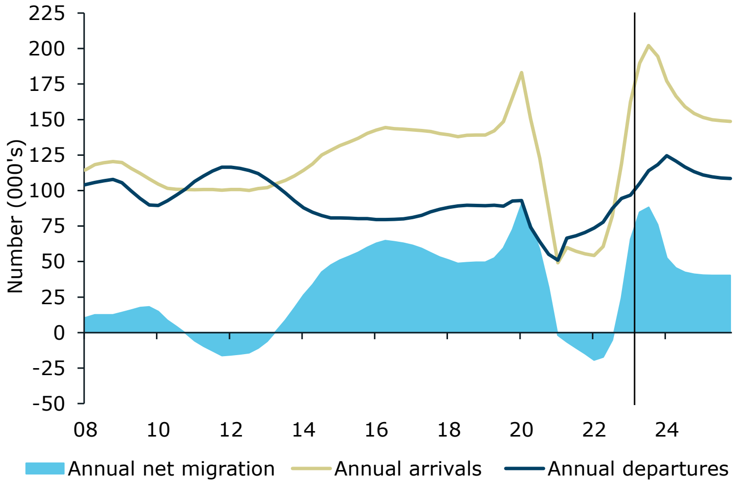
Source: RBNZ, Macrobond, ANZ Research

A shallower contraction expected

At -0.1% q/q, GDP growth was weaker than we or the RBNZ expected in Q1. There was noise in the data, certainly (including cyclone impacts and teacher strikes), but on a per capita basis the economy contracted 0.7% q/q, showing the economic situation at an individual household level is quite soft.

We have incorporated the recent surge in net migration into our activity forecast, almost doubling our previous net migration assumption for 2023 to just over 75k. Things are starting to settle down: the April data showed not only a dip in arrivals following a record high in March, but also that departures are picking up strongly into the NZ winter, which is something we have been expecting to see. Our forecasts assume that the tentative easing in arrivals is maintained, seeing net inflows decline on a quarterly basis over the second half of the year. Annual net migration settles around 40k by the end of our forecast.

Figure 2. Net migration assumption



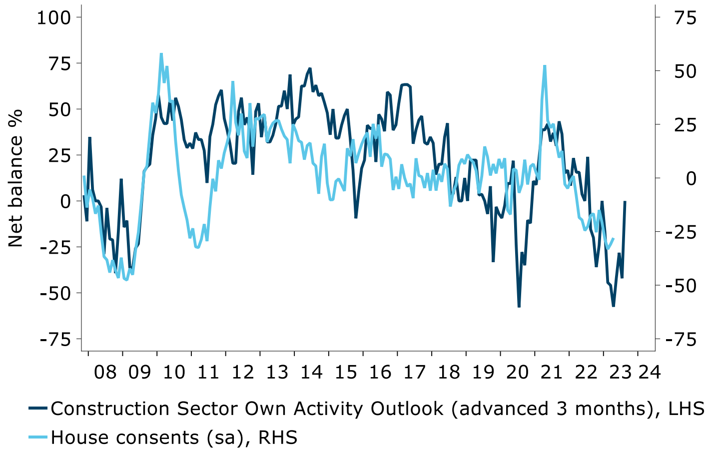
Source: Stats NZ, ANZ Research

Migration-led population growth is bolstering demand for goods and services (including housing) and adding to labour supply (see next section). We've recently revised our house price outlook to reflect emerging green shoots, which appears to be a function of a widening under-supply of houses and the fact that some mortgage rates are falling. Looser LVR restrictions are also expected to add to demand for a short period.

Weighing it all up, we think housing tailwinds are currently blowing stronger than headwinds and that house prices will start mildly lifting again over the second half of the year. But not for long, given our expectation that the RBNZ will need to take a hawkish pivot later in the year, and also the fact that we are forecasting unemployment to rise over the remainder of the year.

Green shoots in housing may be one of the factors influencing business sentiment, with our Business Outlook showing a sharp recovery in construction intentions in May (albeit to still-weak levels). Headline confidence and a number of other activity indicators picked up strongly too, a trajectory that suggests the economy may in fact be picking up momentum before the RBNZ has even seen annual domestic inflation turn a corner. Of course, with the OCR 525bp higher over 18 months and more and more people steadily rolling over onto higher mortgage rates, upside is limited. But the RBNZ doesn’t only need the economy to lose steam; they need it to roll over quite quickly – particularly the labour market.

Figure 3. Residential construction intentions and house consents



Source: Stats NZ, Macrobond, ANZ Research

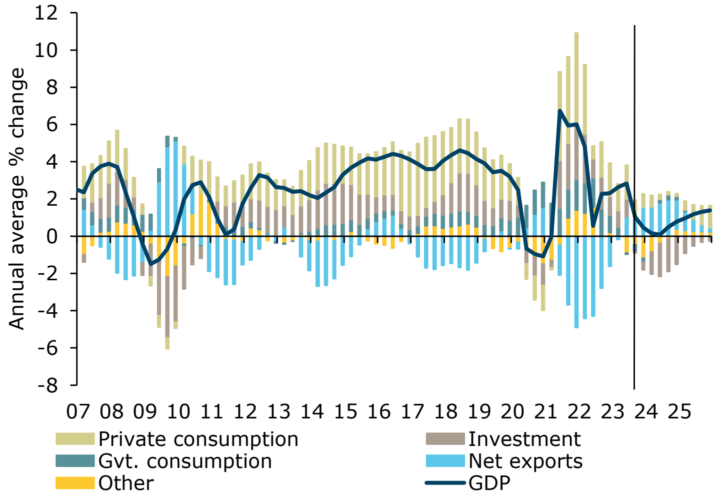
Meanwhile, Budget 2023 earmarked an additional $5bn or so (around 1.4% of GDP) in Government spending for the year to June 2024 that we did not previously expect. While fiscal consolidation is factored into the Treasury’s medium-term forecast, this additional stimulus is expected to arrive at a time when there is little economic capacity to accommodate it. All else equal, that speaks to higher inflation and therefore higher interest rates than otherwise. The RBNZ’s May MPS certainly played this risk down, but pro-cyclical fiscal expansion remains a near-term reality whatever the RBNZ does or doesn’t say about it. We’re certainly not saying the Government shouldn’t respond to Cyclone Gabrielle, but larger spending reprioritisations and/or new revenue initiatives would have gone a long way towards containing the inflationary implications.

Looking forward, it’s difficult to have a firm view of fiscal settings given policy could change significantly following October’s General Election. Our outlook assumes the status quo for fiscal policy (as announced in Budget 2023) and will incorporate any changes to fiscal settings resulting from the election once we know the outcome.

Putting it all together, the outlook for headline activity is looking a little stronger than previously. Officially, our forecast is for the economy to enter a very shallow double-dip recession over the second half of the year, but with the overall level of GDP ending a little higher than in our previous forecast. After Q2 brings some payback from Q1’s weakness (we’ve pencilled in +0.4% q/q for Q2), our forecast has the economy contracting 0.3% over the second half of 2023 as households continue to tighten their belts and businesses pull back on their investment plans.

Broadly, the details of our updated activity outlook are similar to those previously published, just a little less pessimistic. Domestic demand is expected to remain sluggish as monetary tightening continues to weigh. Net exports are expected to contribute positively to growth, reflecting the ongoing recovery in services exports (chiefly international tourism and education – the former will be aided by the FIFA Woman's World Cup this winter) and as the weaker domestic demand pulse sees imports soften (figure 4).

Figure 4. Contributions to GDP growth



Source: Stats NZ, ANZ Research

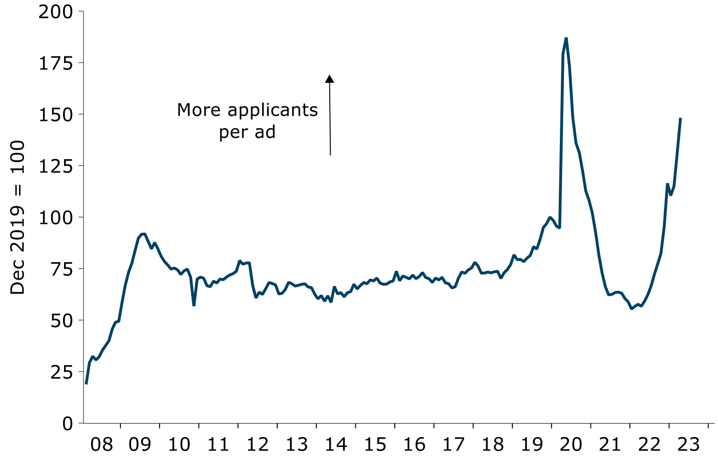
Labour market expected to loosen more gradually

The labour remained exceptionally tight in Q1, with the unemployment rate remaining near a record low at 3.4%, the underutilisation rate falling further, and the labour force participation rate hitting a new record high of 72.0%. The recent surge in net migration has helped to boost labour supply, although strong employment growth of 0.8% q/q outpaced working-age population growth to see the employment rate hit a new record of 69.5%.

We're still expecting the labour market to soften across the rest of the year; however, we now think that supply-side lifts (more workers) will be a bigger driver than weaker demand. Employment growth is still running strong, with filled jobs rising 0.6% m/m in April, indicating labour demand is holding up for now. But we think that strength reflects previously unmet labour demand finally being worked through, rather than new or rising demand.

Indeed, forward-looking indicators of demand point to a softening, though not drastically. Employment intentions in our Business Outlook survey have been negative for more than six months, while job advertisements are declining, and applications per job have recently shot higher. That said, employment intentions remain well above levels in the last recession, and while job advertisements have declined, that's largely a case of falling back to a trend level after a massive surge last year. The recent pick-up in applicants per job advertisement, while sharp, is also likely reflective of improvements in labour supply. All up, whether driven by demand or supply-side factors, those indicators do read positively for increasing slack in the labour market, which the RBNZ will welcome.

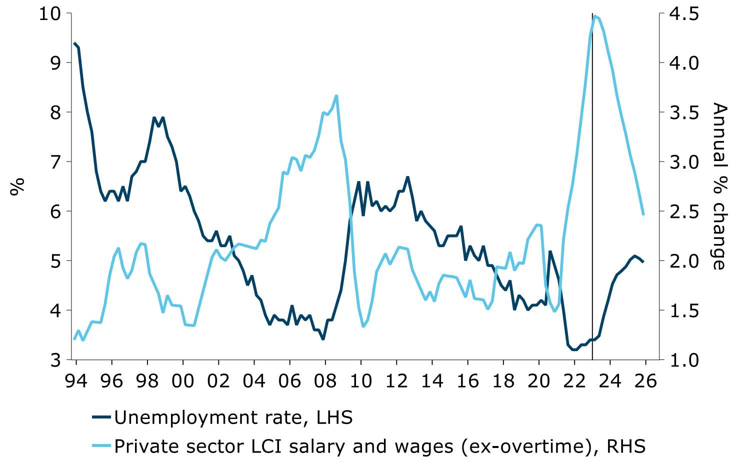
Figure 5. Applications per ad



Source: SEEK, Macrobond, ANZ Research

We now expect the unemployment rate to rise more slowly across the second half of the year, to 4.2% by Q4 2023 (previous: 4.4%, RBNZ: 4.6%), and rising to a peak of 5.1% in 2025 (previous: 5.4%). Employment growth is expected to hold up, with a modest contraction occurring later this year. We expect both strong working-age population growth and the labour force participation rate to remain higher for longer. Together, these should allow the labour market to loosen despite stronger employment growth.

Figure 6. Unemployment and wage growth forecasts



Source: Stats NZ, Macrobond, ANZ Research

Softer inflation in the near term masks underlying persistence

Positively, we've revised down our near-term inflation forecasts to reflect:

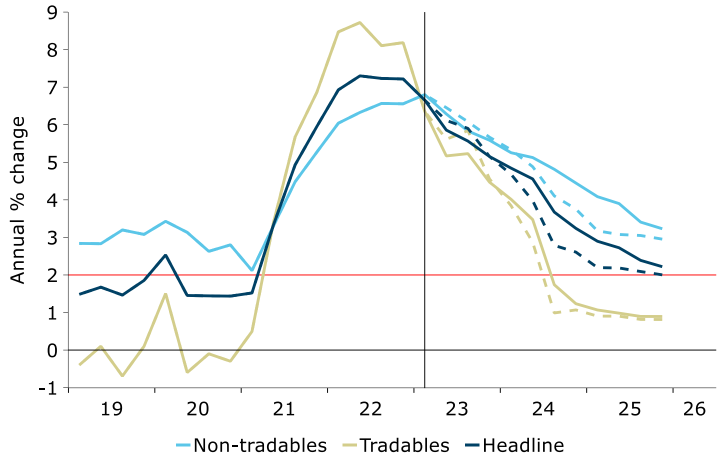
- easing construction costs,
- weaker-than-expected food price increases, and
- softer petrol and diesel prices (albeit temporarily).

Adjustments to these component forecasts result in annual CPI inflation decreasing to 5.9% y/y in Q2 (6.1% previously expected), and reaching 5.2% y/y in Q4, in line with our previous forecast.

Global inflation is declining, with shipping costs back to pre-COVID levels and supply-chain pressures falling to a record low in May, and subdued growth in China keeping downward pressure on global goods prices. This will all help see headline inflation ease across the second half of this year. Of course, this process was always going to occur, given the sharp and unsustainable surges in prices last year. While these have unwound a little faster than we had expected, it’s a question of timing. And it masks an underlying domestically driven inflation impulse that is proving persistent.

The key driver of this is the tight labour market, exacerbated by the ongoing rebalancing of consumption from goods to services. The overheated labour market is culminating in strong wage pressures that are now in excess of both inflation and reasonable estimates for labour productivity gains. Cost pressures remain intense according to Business Outlook survey, and while pricing intentions have fallen much faster, indicating margins are compressing, prices tend to be much stickier coming down than going up as firms attempt to rebuild margins. The dynamics will depend ultimately on not only competition, but also how price-sensitive customers are, as that will determine optimal price strategy. The RBNZ is setting out to make consumers very price-sensitive indeed, in order to throw sand in the gears of the inflation machine.

Figure 7. Revisions to ANZ CPI inflation forecast



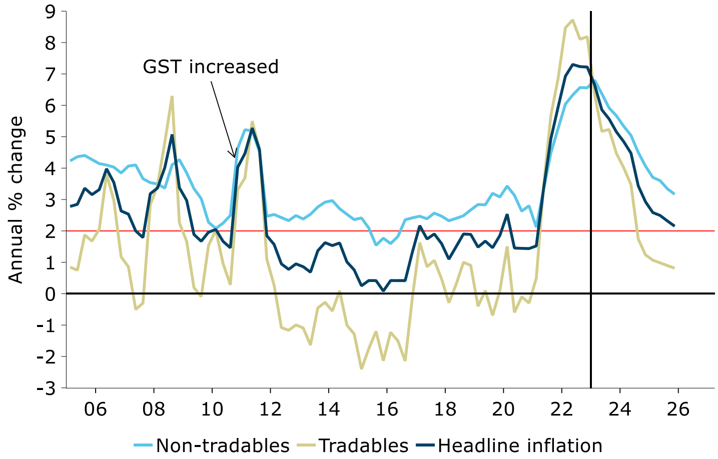
Source: Stats NZ, Macrobond, ANZ Research

The surge in migration complicates the inflation picture.

On the one hand, labour supply improvements are easing capacity constraints, creating the degree of slack needed to reduce wage pressures. Given the unprecedented state of tightness in the labour market currently, those disinflationary impacts may be larger than usual. However, the rapid increase in net migration inflows adds to demand in other areas of the economy, particularly the housing market. Consents are easing just as housing demand has surged, which has seen New Zealand’s housing deficit widen again. In conjunction with disruption from Cyclone Gabrielle and the return of international students, that is likely to put upward pressure on rents.

Looking ahead to next year, we see the disinflation process becoming more challenging once the low-hanging fruit has been picked. With stronger economic activity and a tighter labour market than previously forecast, once base effects roll out, we see a risk that inflation gets a bit stuck. Although near-term disinflation will support the continued gradual decline in inflation expectations we’ve seen in recent months, expectations for now are still well above target and proving sticky. Headline inflation no longer returns to the 2% midpoint of the RBNZ’s target band within our forecast horizon, although it gets very close, falling to 2.2% by the end of 2025.

Figure 8. ANZ CPI inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

External sector imbalance remains a big concern

New Zealand's current account deficit narrowed 0.5%pts of GDP to 8.5% in Q1 2023 – Q4's 9% was a record-breaker in data going back to the 1980s. There's a lot to unpack in terms of how we got here.

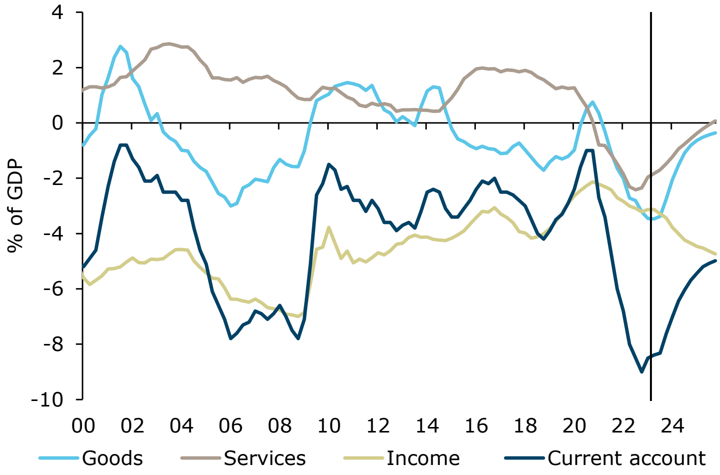
- The fiscal and monetary stimulus delivered on the back of the pandemic bolstered domestic demand, and an even larger share of that than normal was imported because of COVID restrictions on services spending.
- Export volumes have struggled in the face of bad weather, regulatory uncertainty and change, 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 is widening as higher global interest costs start to bite – something that's set to persist.

Our forecast is for the current account deficit to narrow as services exports continue to recover and imports of goods soften alongside domestic demand. But partially offsetting this is an expectation that the higher global interest rate environment will keep the income deficit under widening pressure (figure 9).

However, with the end of domestic petroleum refining adding further dependence on fuel imports, we think it'll take a lot for the goods trade balance to return to surplus any time soon – particularly with the risk of further severe weather events, ongoing labour shortages, cost escalation, a protectionist global trade environment, and ongoing regulatory change for agriculture making times tough for key exporters. Even with our expectation that the terms of trade will trend higher, we still don't expect the goods balance to return to surplus over our forecast horizon. We expect the current account to narrow to 5% of GDP by the end of 2025, wider than its historical average of -3.5 to -4%.

With a little luck, an outlook for a narrowing current account deficit should be enough to prevent New Zealand experiencing a sovereign credit ratings downgrade, but at these very wide levels it may not take much – a terms of trade shock for example, on the back of a weaker-than-expected global economy.

Figure 9. Current account balance forecasts



Source: Stats NZ, ANZ Research

Stepping back, the New Zealand economy has become quite out of balance in the wake of COVID-19. Closing the border significantly eroded the country's ability to earn foreign revenue to pay for its imports. Meanwhile, too much fiscal and monetary stimulus created a significant domestic inflation problem, an unsustainably tight (ie inflationary) labour market, and a big impetus to imports.

This wonkiness will correct in time, but the adjustment won't be fun. It will require a pullback in aggregate demand, brought about by contractionary monetary policy and fiscal discipline (which appears structurally looser in the wake of the pandemic). The stakes are high, as the alternative to running unsustainable macroeconomic conditions is an even harder landing and sharper adjustment. Better to correct early than rely on the brakes at the last second.

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	2.7	0.7	0.7	1.5
Private Consumption	3.2	-2.2	7.9	2.9	1.2	0.2	1.9
Public Consumption	4.7	7.2	8.2	4.5	-1.0	0.9	-0.5
Residential investment	5.3	-3.1	8.4	1.0	-4.4	-7.0	1.3
Other investment	4.0	-5.1	13.9	4.9	-0.7	-5.6	-1.2
Stockbuilding[1]	-0.5	-0.8	1.3	0.0	-1.3	0.2	0.1
Gross National Expenditure	3.1	-1.8	10.3	3.5	-0.9	-0.8	1.1
Total Exports	2.6	-13.5	-2.4	0.3	7.3	6.7	5.4
Total Imports	2.2	-15.8	14.8	5.4	0.3	0.1	3.5
Employment (annual %)	1.2	0.6	3.3	1.6	1.1	0.3	1.3
Unemployment Rate (sa; Dec qtr)	4.1	4.9	3.2	3.4	4.2	4.9	5.1
Labour Cost Index (annual %)	2.4	1.5	2.8	4.3	4.1	3.3	2.5
Terms of trade (OTI basis; annual %)	7.1	-1.6	2.8	-4.2	0.6	1.6	1.7
Prices (annual % change)							
CPI Inflation	1.9	1.4	5.9	7.2	5.2	2.9	2.2
Non-tradable Inflation	3.1	2.8	5.3	6.6	5.7	4.1	3.2
Tradable Inflation	0.1	-0.3	6.9	8.2	4.5	1.2	0.8
REINZ House Price Index	5.1	15.5	26.2	-12.8	-0.2	2.3	3.2
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.72	0.68	0.64	0.63	0.65	--
NZD/AUD	0.96	0.94	0.94	0.93	0.90	0.89	--
NZD/EUR	0.60	0.59	0.60	0.59	0.55	0.54	--
NZD/JPY	73.1	74.6	78.6	83.3	78.1	75.4	--
NZD/GBP	0.51	0.53	0.51	0.52	0.48	0.48	--
NZD/CNY	4.69	4.74	4.35	4.38	4.13	4.16	--
NZ$ TWI	73.7	75.2	73.2	72.1	68.7	68.9	--
Official Cash Rate	1.00	0.25	0.75	4.25	5.75	5.50	5.00
90-day bank bill rate	1.29	0.27	0.97	4.65	5.85	5.43	5.10
2-year swap rate	1.26	0.28	2.17	5.38	5.21	4.37	4.35
10-year government bond rate	1.65	0.99	2.39	4.47	4.30	4.00	4.00

[1] Percentage point contribution to growth

Forecasts finalised 16 June 2023

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

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