NZ Insight: Early thoughts on the Upper North Island floods

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Contact

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Confused by acronyms or jargon? See a glossary here.

Our thoughts are with those impacted by these events

Broken-window economics

- It's too soon to quantify the impact of the ongoing Upper North Island flooding.
- The floods are unlikely to be a game-changer for the broader economic outlook, but they are likely to be an inflationary event overall.
- Supply-side impacts could be seen in fruit & vegetables, rents, transport costs, among others. On the demand side, there are both confidence and potential wealth impacts via under-insurance.

It's extremely early days in terms of assessing the potential macroeconomic impact of the ongoing Auckland floods – the event is still going on! But at this stage, it's looking unlikely to be a game-changer for the broad economic outlook. It is, however, looking inflationary, though in practice it will be impossible to ever be able to quantify the impact precisely.

Supply-side impacts

This weather event is primarily a supply shock for the economy. Significant disruption is occurring to transport, with roads closed or damaged, supply chains more generally, including via lost inventory, and – yet again – fruit and vegetable supplies, at a time when food price inflation is already running at 11% y/y.

The floods have significantly impacted vegetable production, particularly in the Pukekohe region. This will mainly impact domestic supplies, and therefore the price of green vegetables and some root vegetables. There will also be a lot fewer onions available for export as many onions currently drying in paddocks have been washed away, and fewer onions that are harvested are expected to make export grade. Typically, 85% of the onion crop is exported.

The Northland/Pukekohe/Waikato/Bay of Plenty regions account for approximately 55% of NZ's onion production and 30% of NZ's potato production. Quality issues are also expected with potatoes, although the extent of the damage won't be known until these are harvested later in the season. There has been some slipping and significant flood damage on some grazing farms, but as there is plenty of feed available, this will not have a significant impact on New Zealand's total milk and meat production.

There will also be some short-term pressure on housing supply and rents due to displaced people and lost housing supply. At the time of writing, 77 houses have been red-stickered and 318 yellow-stickered, with this number set to rise. In the context of 57,000 dwellings consented in the Auckland region alone since 2020, these numbers are of course very small. But if brave long-term decisions are made about not just banning building in the most flood-prone areas of the city but actually abandoning housing, a chunk of the progress made in recent years towards reducing Auckland's housing shortages will be effectively undone. These decisions will need to be carefully thought through, and are unlikely to be made any time soon.

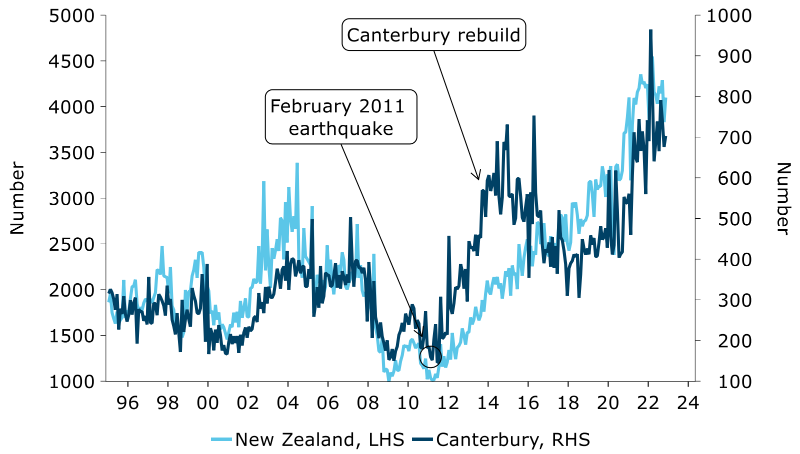
Another area we could see short-term price pressure is used cars. A large number of cars have been written off, and car retailers (eg in Wairau Valley) have seen their stock destroyed.

Demand-side impacts

There will also be impacts on the demand side of the economy, both positive and negative. Auckland (re)construction activity will boost GDP – and likely construction costs – through building activity holding up longer than otherwise, but it's impossible to quantify at this point. Of course, breaking something and rebuilding it might boost GDP, but it's not a path to wellbeing. Just ask Christchurch.

It's hard to get a handle on the required rebuild effort at this point, but for context, following the Christchurch earthquakes, Canterbury consents quadrupled, rising much faster than the nationwide pick-up in consenting activity as the building industry recovered from the 2008 recession (figure 1). We're not looking at anything remotely on that scale. But further pressure on an already stretched local construction industry will likely be inflationary. In Christchurch, the elevated level of (re)building activity put significant pressure on the construction sector, with Canterbury construction cost inflation, as measured in the CPI, peaking at 12.3% y/y in Q1 2013, versus 3.4% y/y nationally.

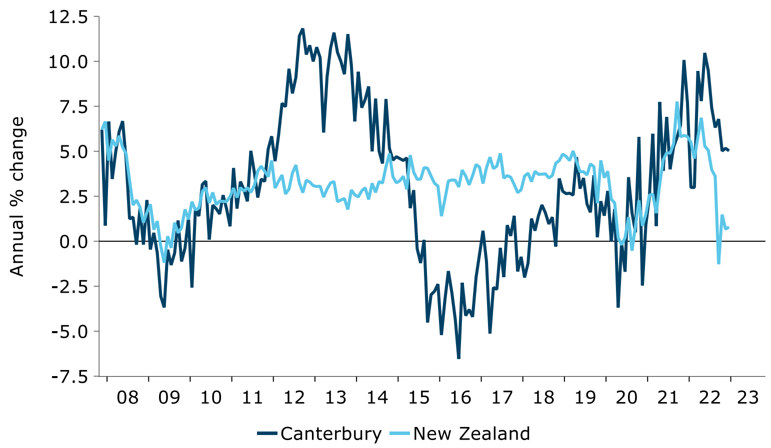
Figure 1. Canterbury consent activity



Source: Stats NZ, Macrobond, ANZ Research

Another unfortunate side-effect of the earthquakes was to drive a big spike in rental inflation, which peaked at 11.8% y/y in September 2012 in Canterbury, versus 2.7% y/y nationally (figure 2). Again, a far smaller proportion of the housing stock is affected by this event. But at the margin, the event could support local rent and construction cost inflation.

Figure 2. Canterbury rental inflation



Source: Stats NZ, Macrobond, ANZ Research

Confidence impacts could see a hit to consumer spending and business investment and employment. We'll keep an eye on the Auckland/Rest-of-NZ split in the next Business Outlook survey (which kicked off this morning) in order to gauge the business confidence impact. The February ANZ consumer confidence survey also has a regional split available.

We could also see a negative wealth effect, though again, this is impossible to quantify at this stage. Anecdotally, a number of small businesses have reduced or removed their insurance cover in recent years as a means of cutting costs in the face of margin pressure. Losses from this event could be the final straw for some. As for consumers, there's long been concern that the shift in the house insurance market towards fixed sum-insured could result in an increasing degree of under-insurance over time – though this is only likely to kick in with something close to a total rebuild, rather than minor repairs. Another factor is that many households could have reduced or stopped their contents and car insurance as they have attempted to cut living costs.

And finally, in another potential demand hit we could see some international tourists cancel their holidays, though the numbers would likely be small. Certainly Auckland Anniversary Weekend was a write-off for upper North Island domestic tourism providers, though accommodation providers around Auckland airport probably did rather well. The Coromandel region will be badly affected by the collapse of Highway 25A.

Impacts for the RBNZ and the February MPS

Yet another unhelpful inflationary shock.

Just like all the other temporary shocks that have boosted inflation in recent years, the Reserve Bank's ability to 'look through' the impact (to the extent it can even be gauged) will depend heavily on what's happening with inflation expectations. With inflation already having spent nine months stuck above 7%, the RBNZ is quite right to be nervous that consumers and businesses could increasingly start to view high inflation as part of the landscape.

But our CPI forecasts do have inflation dropping away steadily from here, and the starting point for non-tradables inflation in Q4 wasn't as bad as the RBNZ feared back in November. As long as evidence continues to accumulate that the red-hot labour market (heat likely to be confirmed in data tomorrow) is starting to cool, we think the RBNZ can correspondingly take a slightly cooler approach to OCR hikes, delivering 'only' a 50bp hike next month on the way to a 5.25% peak, with risks balanced around that endpoint. It's still a pretty big deal to be delivering double-sized hikes at a time when house prices are down 15% and still going, and confidence is on the floor. The RBNZ is not going soft.

As regards the February OCR decision, the impact of the floods could go either way. On the one hand, it's likely to be a net inflationary event, albeit temporarily. On the other hand, it's another potential blow to confidence, and smacking the economy with another 75bp rise at such a time might look a little tone deaf. But the RBNZ Monetary Policy Committee won't have forgotten August 2021, when they didn't hike because of the bad PR with Auckland going into lockdown the day before, and in the fullness of time wished they had gone ahead. On balance we don't think it's likely to play a big part in the decision; we remain comfortable with our updated call for a 50bp hike to 4.75% next month.

Consequences for financial markets

The immediate implications for financial markets are limited, and markets have thus far largely looked through it. As noted above we are likely to see more inflation at the margin, but on the other hand, the shock of it all may weigh on confidence, and if Auckland is at a standstill for a week or so, that'll weigh on GDP. Clean-up and reconstruction work will add to activity, but by how much and for how long remains to be seen.

For interest rate markets, the arguments for more or less tightening are at the margin and fairly balanced. As noted earlier, we remain comfortable with our call for a 50bp hike in February. What really matters is what this all means for the long-term inflation outlook, and thus terminal OCR expectations. And at the margin, the floods pose upside risks (mainly via food, rent, and construction costs, as well as inflation expectations). That risks higher short-end interest rates, but we wouldn't push that point too hard given the near-term shock value and the downside risks to confidence.

FX markets are already talking about reinsurance inflows from offshore. As we saw in the aftermath of the Canterbury earthquakes, we will likely see inflows later on down the track. Some insurers have already released statements saying that they are covered by reinsurance. But the scale of the damage in relation to Canterbury is far less, reinsurers already manage FX risks around their exposures, and any inflows need to be weighed up against other recent developments like the RBNZ's decision to increase its foreign reserves (which means they will be gradually be selling NZD).

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