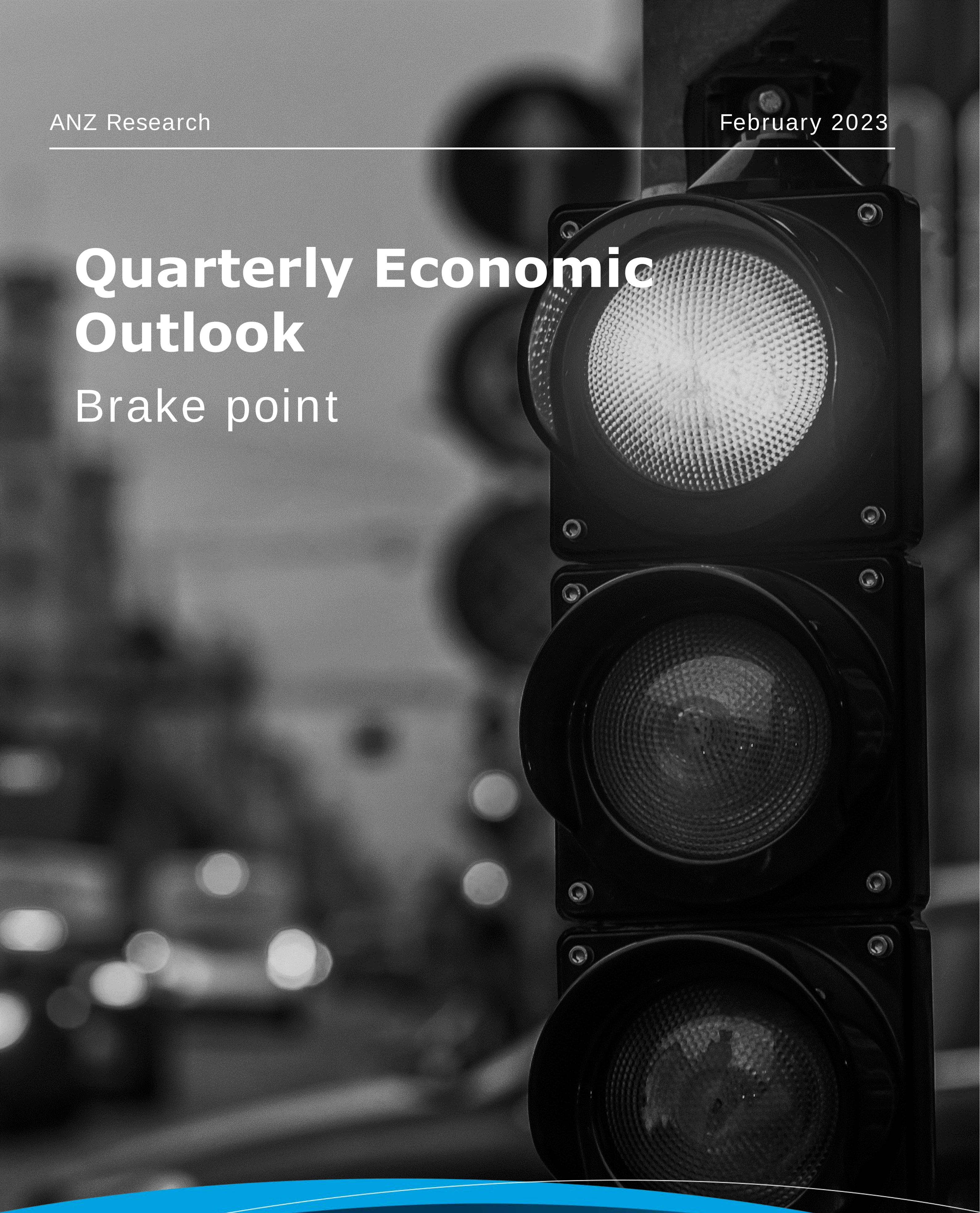
ANZ Research

February 2023

Quarterly Economic Outlook

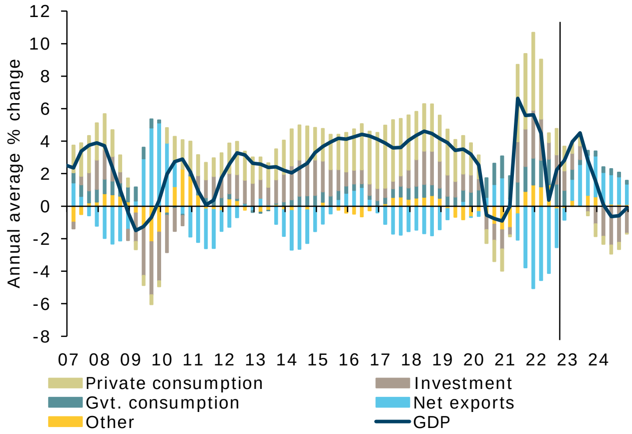
Brake point



Summary of forecasts

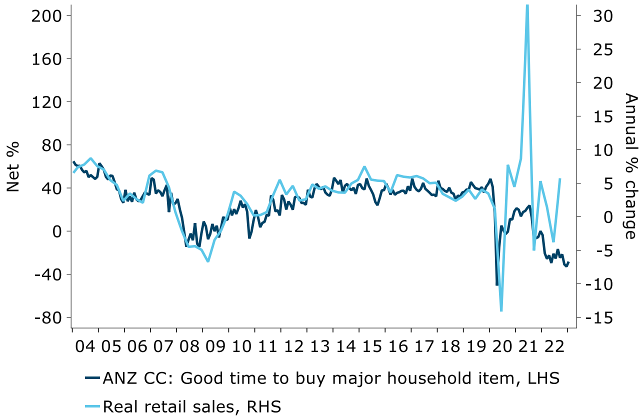
Recession is looming

Slower domestic demand is expected to more than offset the net exports recovery



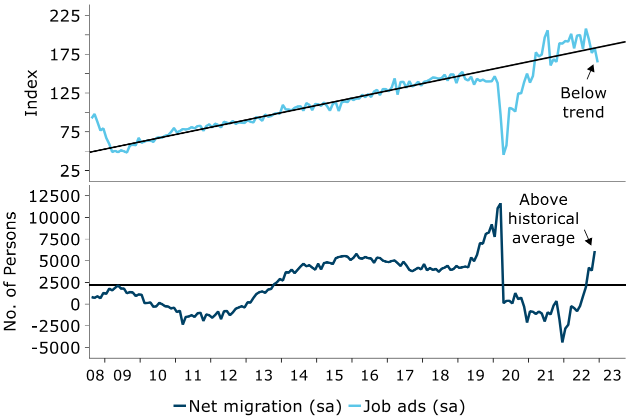
Consumers will have a lot to say about the state of broad economic momentum

Will they finally follow through?



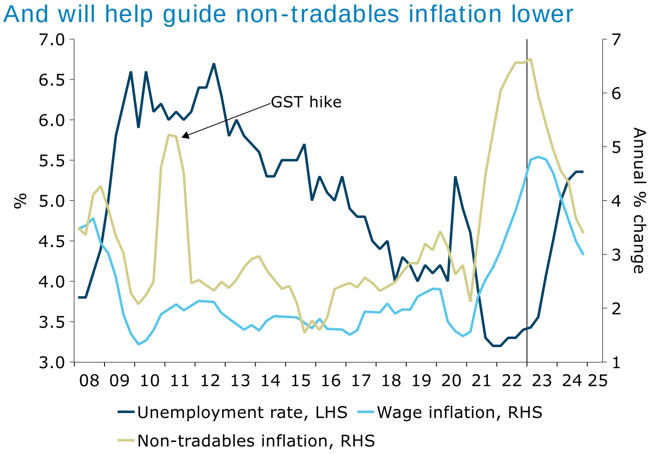
Labour demand is moderating

Just as imported labour supply appears to be picking up at pace



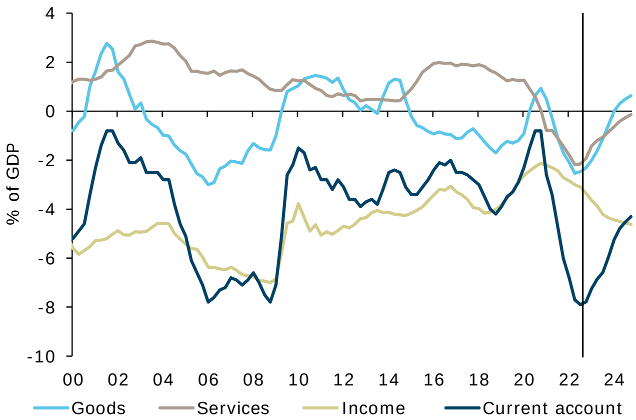
A higher unemployment rate and slower growth in labour costs are expected

And will help guide non-tradables inflation lower



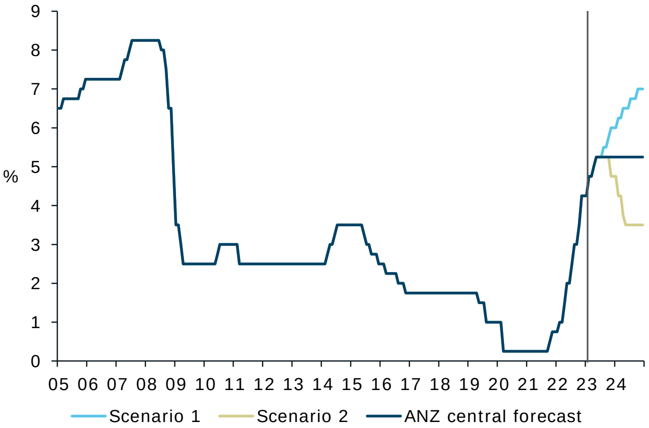
External imbalance will improve

But a weaker domestic economy is part of the cure



Risks around our OCR call feel balanced

But in this unusual environment it's not hard to come up with scenarios where we're (very) wrong



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

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Brake point

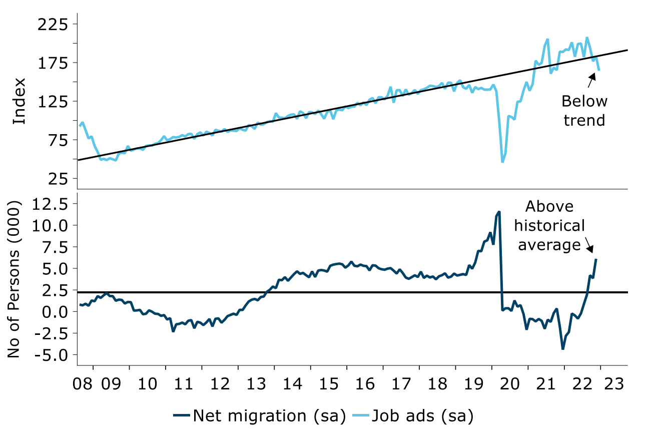
Summary

A policy-induced recession is looming. While it's going to hurt some households more than others, we're hopeful this slowdown will turn the tide on domestic inflation, and set the broader economy on a more sustainable path over the longer run. Risks remain bi-directional, but we think they are broadly balanced around our recently updated OCR call for a peak of 5.25%. But no doubt 2023 has a few surprises waiting for us. This time last year we were forecasting a peak OCR of 3% – and as we go to print the OCR is at 4.25%! We present two 'plausible' scenarios that could see the OCR a year from now higher or lower than our forecast by a similar magnitude. Special topics on how the Auckland floods and what tentatively look like strong net migration inflows have been factored into our outlook are on page 9 and 10 respectively.

Macroeconomic policy will find balance in 2023

Monetary tightening is clearly getting traction: the housing market is firmly in retreat, both consumer and business confidence are in disarray, households are tightening their belts, and labour demand is falling (just as imported labour supply appears to be lifting sharply, figure 1).

Figure 1. Monthly job ads and net migration



Source: MBIE, Stats NZ, Macrobond, ANZ Research

At some point over the coming months, the RBNZ will become convinced that the OCR is sufficiently high to guide inflation back to the 2% target midpoint in an acceptable timeframe, and that 'sticky' inflation risks are balanced against downside activity risks. In other words, the RBNZ's strategy will change from a full-on counter-attack against inflation to 'watch, worry, and wait' mode.

Markets, however, wait for no one, and will be eager to price in something. In fact, they already are, with OCR cuts currently priced in by year-end (see the markets section for more). But unless downside (deflationary) economic risks materialise, we think that the job of getting domestic (non-tradables) inflation down could prove harder than some realise – this kind of inflation tends to be sticky! That's why our forecast is for the OCR to remain on hold at 5.25% from May through to the end of our forecast horizon. Of course, that peak could easily be 5% or 5.5%, depending on how the data evolve over coming months. But wherever the RBNZ decides to park the OCR while they wait for core inflation to slow and the labour market to transition to sustainable levels, unless something left-field occurs, it could be there for quite some time.

In fact, we'd considered as broadly balanced the risks that a) the RBNZ needs to do a series of 'top-up' 25bp hikes (as domestic inflation proves stubborn) against b) downside economic risks that would necessitate cuts (see page 8 for a discussion of these two scenarios). But gauging appropriate settings in real time will be tricky – especially when a seasonal tourism recovery, Auckland lockdown base effects, floods and generally heightened data volatility are muddying the waters.

Other than making sure they are doing enough to get on top of sticky domestic inflation, perhaps the biggest challenge the RBNZ will face this year will be the optics around maintaining contractionary monetary conditions while the economy is in recession. It's going to be difficult times ahead for those feeling the brunt of rate hikes, and the bad news stories are only set to become more frequent as highly indebted households continue to roll onto higher mortgage rates. But this is the unfortunate reality of how monetary tightening works, pulling demand out of the economy by squeezing those with debt, and encouraging others to save. Of course, we, and the RBNZ, will be on the lookout for any material rise in non-performing loans and forced house sales, which would likely be a precursor to a much harder economic landing than expected, but as we note in our latest Property Focus, that doesn't appear to be happening *en masse*.

This certainly isn't your typical business cycle. Normally, the central bank tightens conditions to shave the peak off the upswing, and then cuts to support demand during some unforeseen economic shock. This time, after the Government and RBNZ delivered too much stimulus for the conditions (with the benefit of hindsight), the RBNZ is now tasked with dealing with the resulting inflation problem. Instead of coming from left field, the looming downturn is being deliberately engineered. That's what's required to get the economy operating sustainably once more, but while the RBNZ certainly has the tools to do the job, calibrating the amount of braking just right is a fiendishly difficult task. Monetary policy operates with a lag, and economic data is only available with a lag as well. Add those two things together, plus the fact that unexpected stuff keeps happening, and the one thing we can be certain of is that anyone's current forecast is likely to be wrong to a greater or less extent. And the RBNZ will inevitably continue to conclude they would have done things a little differently if they'd known then what they know now.

However, inflation *will* slow; the RBNZ 'just' needs to tighten monetary conditions sufficiently. If they overcook it, cuts will come sooner than otherwise; if they undercook it; the OCR will end up going higher than otherwise. But OCR hikes can get the job done, there's no doubt about that. Where the question does lie is in how much short-term damage to the housing market and labour market might be incurred, by necessity or not, along the way.

As the 2023 election approaches, the 'cost of living crisis' (aka too-high inflation) will be centre stage. So is there anything the Government do to address it?

Quick fixes are certainly in short supply. The Government can help slow inflation, but the only sustainable way to do this is by reducing public sector demand for goods and services (ie significant near-term spending cuts), and ensuring tax policy isn't adding to private sector demand. That's a big ask when the cost of delivering key services is on the rise, and the need in our communities is lifting – and it's election year.

Fuel tax cuts and subsidised public transport, and other potential measures such as eliminating GST on fresh food may temporarily alleviate the symptoms of high inflation, but these policies do nothing to address the underlying cause. In fact, the opposite is true. Any form of tax cut is more fiscal stimulus (all else equal), and a fuel tax cut is far from targeted. Better to direct more support to those really doing it tough than give everyone a small net income bump. While the recent extension of the cost-of-living package policy may be funded from an underspend elsewhere, it nonetheless represents a lost opportunity to consolidate the fiscal position faster than otherwise, thereby reducing the inflation pulse.

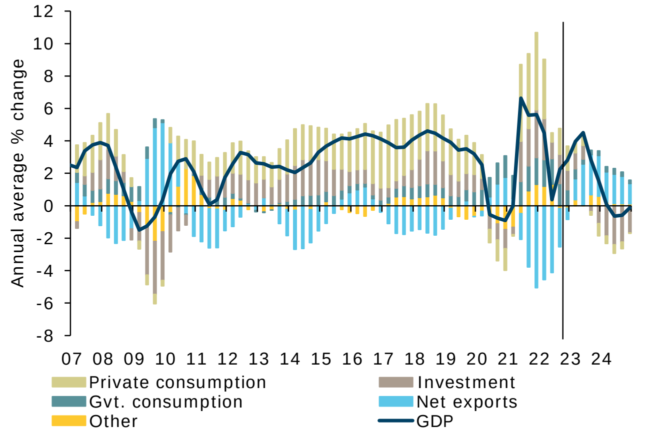
Indeed, the Half-Year Update added more spending to the mix for the RBNZ to offset. This wasn't large by any means, but it also wasn't helpful from an inflation-fighting perspective.

Overall, it's quite clear how the RBNZ will seek to find policy balance in 2023 and beyond, but how the Government will do it is a lot less certain. It's going to be an eventful year on the fiscal front: the Budget in May, the Pre-election Update in September, and the Half-Year Update in December (incorporating any change in Government). Like those of the NZ Treasury and RBNZ, our forecasts don't speculate on future policy – we assume the status quo until it changes.

Our outlook in detail

The broad story around our outlook hasn't changed a lot over the past few quarters, but we have had to think hard about data volatility, timing and magnitude. Overall, domestic demand is poised to contract, but the ongoing recovery in services exports (chiefly international tourism and education) and softer demand for imports will provide a sizable offset (figure 2). But the RBNZ has signalled that in order to get inflation down they need the domestic downturn to dominate (resulting in recession), and they have the tools to make it happen.

Figure 2. Contributions to GDP growth

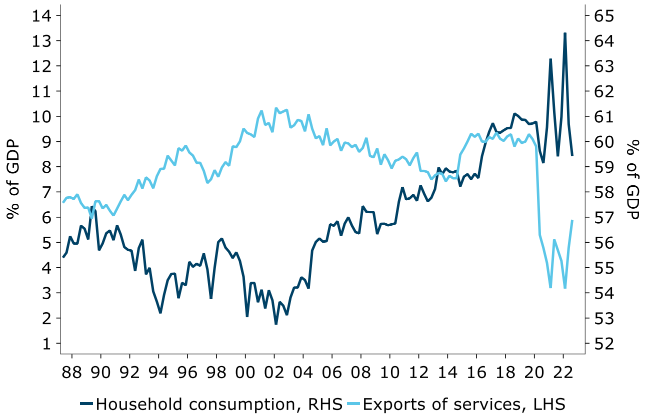


Source: Stats NZ, ANZ Research

Our forecast has the economy entering recession in Q2 2023, but the GDP data are currently very volatile. If this volatility persists, recession could easily end up occurring sooner than expected or not at all, if one focuses on the technical definition of two quarters of negative GDP growth in a row.

Indeed, with lockdowns and closed borders interrupting typical seasonal patterns for both household and tourist spending, some of the GDP components have been all over the shop in the past couple of years (figure 3).

Figure 3. Household consumption and services exports



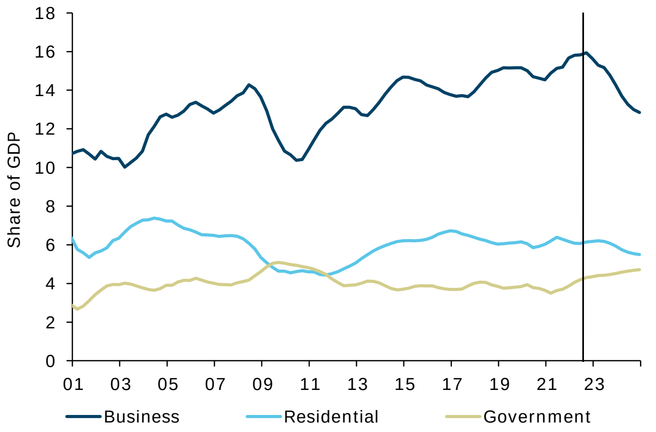
Source: Stats NZ, Macrobond, ANZ Research

Brake point

With borders now open and lockdowns assumed to be a thing of the past, our forecast assumes these GDP shares stabilise from here. Let's just say we wouldn't be surprised if the evolution of quarterly GDP growth is a lot more volatile than our forecasts can confidently incorporate. But regardless of volatility, it's the broad momentum story that matters, and that, unfortunately, is travelling south.

As the most interest rate-sensitive segment of the economy, investment is expected to contract the most over the year ahead. Our forecast has residential investment activity contracting around 10% over 2023, with a peak-to-trough contraction of 12.5% come early 2024. Other investment is expected to contract by a similar amount, as weak business investment offsets elevated government investment (figure 4).

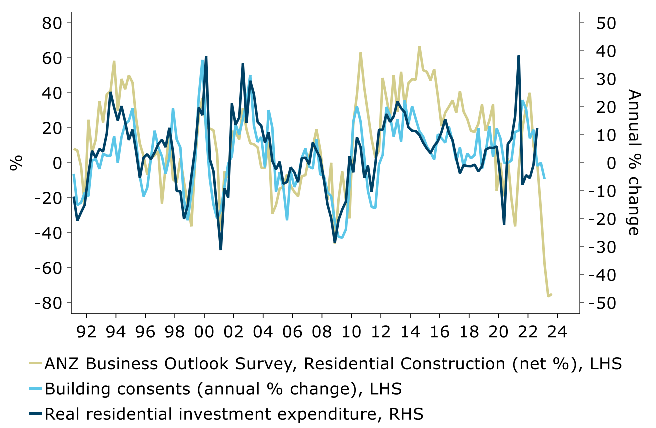
Figure 4. Investment share of GDP



Source: Stats NZ, RBNZ, ANZ Research

Our Business Outlook survey suggests risks to business and residential investment are very much to the downside. But while building consents clearly show the pipeline of work is shrinking, they (like our residential investment forecast) are slowing relatively gradually (figure 5).

Figure 5. Residential investment and forward indicators

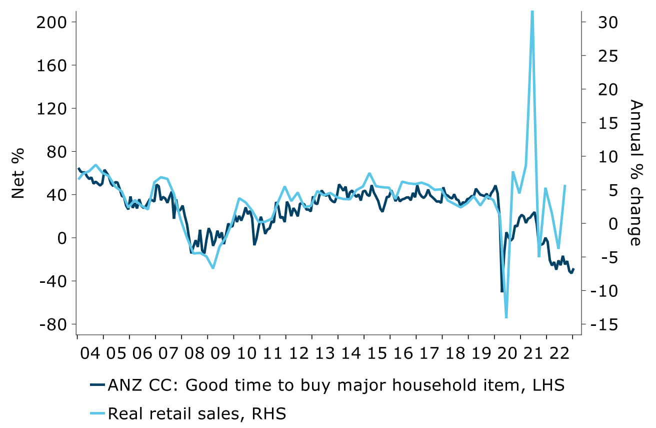


Source: Stats NZ, Macrobond, ANZ Research

Multi-unit dwellings have driven a lot of the recent strength in building consents, and given these projects can be larger and more investor-driven than building a family home, they could face a lower hurdle to being scrapped (owing, say, to a cost blow-out). But also, being larger projects, they can extend the lag between consent and activity completed, and potentially make residential investment 'lumpier' than otherwise.

A weakening demand pulse from households is expected to be a key driver of weaker investment too. Given its sheer size, private consumption expenditure always has a lot to say when it comes to broad economic momentum. And the mix of rising interest rates, falling house prices (we maintain our forecast for peak-to-trough decline of 22%), and a softening labour market is expected to see households tighten their belts further. While continued data volatility seems like a very real possibility over the next few quarters, the signal from our consumer confidence survey suggests some softer retail spending ahead.

Figure 6. Good time to buy a major household item vs retail sales

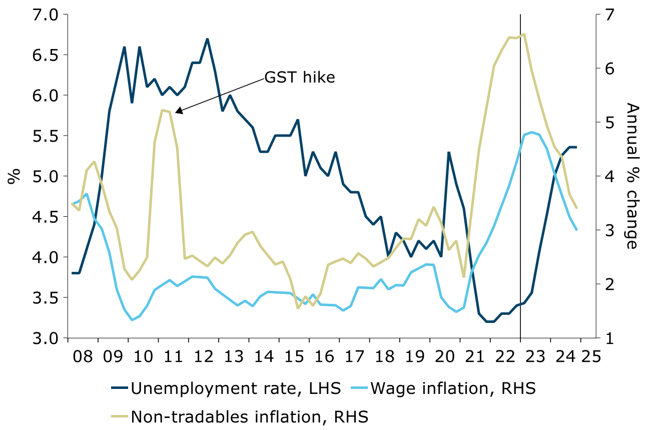


Source: Stats NZ, Roy Morgan, ANZ Research

That said, the recent experience has been consumers reporting that it's a terrible time to buy a major household item, but then going out and spending anyway. However, we think this dynamic has turned. Indeed, consumer wariness in an environment of high income growth and strong job security is one thing, but wariness against a backdrop of a slowing economy and deteriorating job security is quite another.

A loosening labour market is expected to weigh on households. While still very tight (and inflationary) in an absolute sense, the Q4 labour market statistics did show cracks beginning to appear. Our forecast has the unemployment rate lifting sharply from the second half of 2023, peaking at 5.4% in 2024. It's not a good news story, but that's what's needed to get the economy back to a sustainable trajectory, with less pressure on wage costs taking the heat out of non-tradable inflation (figure 7).

Figure 7. Unemployment rate, wage and non-tradables inflation

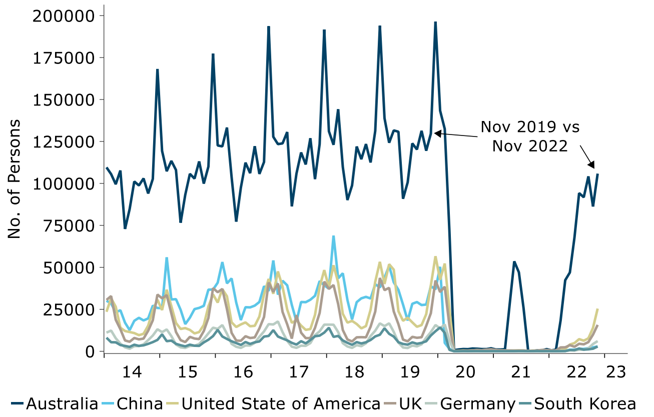


Source: Stats NZ, Macrobond, ANZ Research

The outlook for net exports (exports less imports) remains strong. Softening domestic demand is expected to see imports fall back from recent high levels – a process that's already evident in the monthly merchandise trade data. Primary goods exports will struggle due to labour shortages, weather events, and regulatory costs, but China's reopening should help prop up export prices, and the terms of trade.

After closed borders saw services exports spend a couple of years in the doldrums, things are finally tuning around. As at November, the recovery in short-term visitors to New Zealand had been significant, but partial compared to pre-crisis levels (figure 8).

Figure 8. Short-term visitor arrivals (key tourism markets)

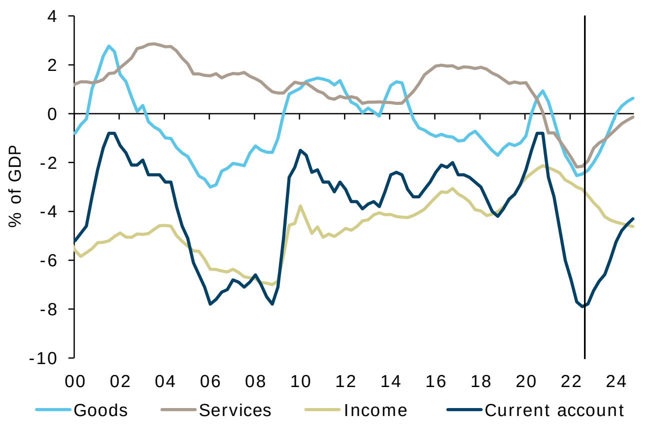


Source: Stats NZ, Macrobond, ANZ Research

We've already seen some monstrous growth in real services exports in recent quarters reflecting this (up 54.5% q/q in Q2 2022 and 25.7% q/q in Q3). And that's accounted for a significant share of the positive surprise to headline GDP growth recently (coming in at 1.9% and 2.0% q/q in Q2 and Q3 respectively). However, a mix of capacity constraints and bad weather suggests the Q4 and Q1 data (when international visitor spending typically peaks), will see less impressive growth in this sector (particularly in seasonally adjusted terms).

The FIFA Women's World Cup in July and August this year will certainly help keep the tourism recovery going, but capacity could still be a real problem come winter. For comparison, the 2017 British Lion's tour was associated with around 26k international visitors, and an overall bump in GDP (domestic plus international spend) of just under $200 million. The FIFA World Cup is estimated to bring in anywhere between 20-40k visitors. However, given capacity constraints, this could very likely crowd out visitors from elsewhere. All up we've assumed around a $250 million bump to nominal GDP, but with most of this coming via the deflator (prices). Not much bump to real GDP perhaps, but from an external balance perspective, the current account doesn't discriminate between prices or activity. It's all foreign earnings.

Figure 9. Current account deficit

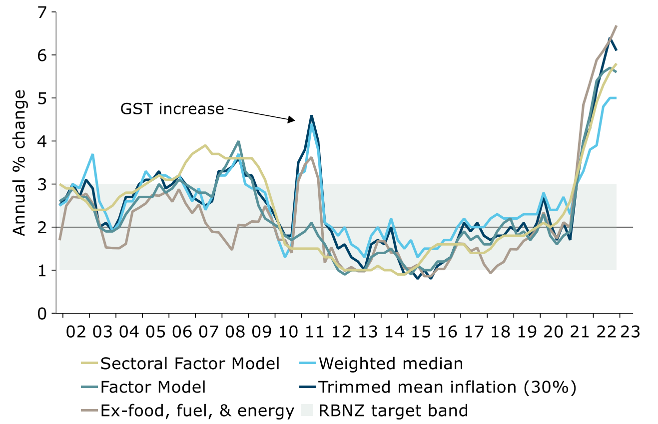


Source: Stats NZ, ANZ Research

Softening goods imports, an upward-trending goods terms of trade, and a sharp recovery in services exports mean the annual trade deficit (goods and services) is expected to narrow significantly over the next couple of years. In fact, with services exports recovering faster than previously thought, and goods imports slowing sharply, the annual deficit should start narrowing very soon, and as a share of GDP should just avoid picking up an 8-handle. However, the rising global interest rate environment, combined with the fact that New Zealand is a net borrower from the rest of the world, means the income deficit will provide a partial offset, causing the current account deficit to narrow more slowly than otherwise (figure 9).

Turning to CPI inflation, core inflation is currently running at a pace around three times where it should be. But as figure 10 shows, some measures are now tentatively off their peaks and others have plateaued, but some are still accelerating. While there is some comfort to be had in these data (at least not all measures are still rising), the RBNZ will still be very worried about the current rate of core inflation, and the possibility that it proves sticky. However, at the same time, given core inflation measures tend to have a bit of persistence to them – particularly the sectoral factor model – the RBNZ will be cognisant that if they keep hiking until all measures have decisively turned a corner, chances are they will overshoot.

Figure 10. Core CPI inflation vs 1-3% target band

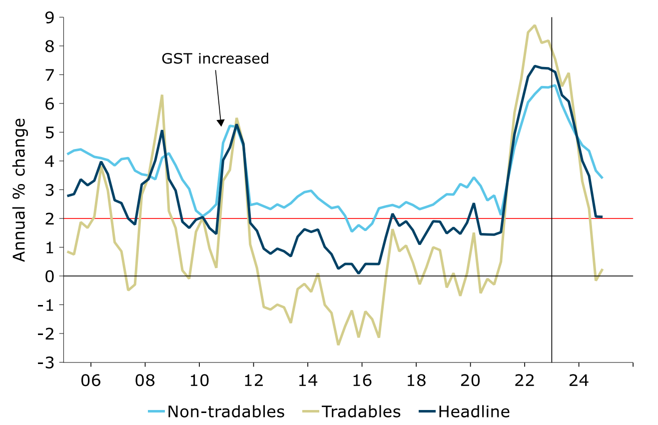


Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Inflation may still be far too high in New Zealand, but the outlook, in our view, is not as bad as the RBNZ feared back in November. Instead of annual CPI inflation re-accelerating to 7.5% in Q4 as the RBNZ expected, it remained flat at 7.2%. And most encouragingly, non-tradables inflation was flat at 6.6%, versus the November MPS forecast for a further acceleration to 7.0%.

We expect inflation will decline from here, approaching the 2% midpoint of the RBNZ's 1-3% target range in the second half of 2024 (figure 11).

Figure 11. ANZ inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

There are increasingly concrete factors we can point to that should see non-tradables inflation (ie domestic inflation) moderate this year. Construction cost inflation is finally easing as the heat comes out of the residential building sector, rental inflation for new tenancies has slowed to a crawl, and labour demand has softened significantly in recent months (albeit from unprecedented levels). 2023 is also the year when many households will be rolling onto markedly higher mortgage rates, which will dent consumer demand, further helping to bring down domestic inflation.

The outlook for tradables inflation (ie for goods that are largely imported, or could be) is uncertain. The global inflation pulse looks to have turned, and we forecast that that will see imported inflation pressures continue to reduce in coming months. But risks abound. China's reopening may see the downtrend in global inflation become less pronounced (or even stall) if we see higher Chinese demand flow through into stronger commodity prices. The geopolitical environment remains volatile, with Russia's war on Ukraine approaching the one-year mark. And increasingly volatile weather globally is an ongoing threat to food security (and therefore food prices).

There's also Government policy (eg the extension of the cost of living supports) and the impacts of the North Island flooding to be taken into account. We have incorporated government policy as announced, and discuss the uncertain flooding impacts here and on page 9. Our take is that these are unlikely to play significantly into RBNZ OCR decisions.

Looking beyond construction and global developments, strength in inflation is becoming concentrated in services prices, which are tightly linked to domestic labour market developments. This is a key reason why the RBNZ needs to see a realignment of labour demand and supply. As long as firms are engaged in a relentless bidding war for workers, we're unlikely to see underlying domestic inflation pressures fall back to acceptable levels. The Q4 labour market report did show cracks starting to appear in the labour market, but the RBNZ would no doubt still describe the labour market as beyond 'maximum sustainable employment'. How quickly labour market pressures ease will likely be the key determinant of how quickly core inflation pressures subside. But long and variable lags mean this isn't going to be easy to diagnose in real time.

Brake point

When you're balancing, there's always a risk of falling

Our economic outlook and our OCR call represent what we see as a reasonable balance between two quite plausible scenarios (outlined in figure 12, over).

Scenario 1: The household sector proves more resilient than expected, keeping demand for goods and services higher than otherwise, labour demand and wage pressures higher, and domestic CPI inflation pressures too high. In this scenario, while there will still be many households out there hurting from the higher rates environment, this doesn't influence broader economic momentum as much as forecast, meaning the RBNZ needs to go further.

The way we would expect this to play out is that the RBNZ first gets the OCR to their desired 'watch, worry and wait' level (we see this as 5.25%), then as the data roll in over the second half of 2023 it reveals that labour scarcity remains the biggest problem for firms and that households aren't 'cooling their jets' sufficiently. Wage growth and non-tradables inflation fails to slow significantly, and the RBNZ is forced (once again) to reassess how much tightening is appropriate. 25bp hikes in August, October and November take the OCR to 6% by the end of the year, and persistent sticky inflation sees four more 25bp 'top-up' hikes delivered in 2024, taking the OCR to 7%.

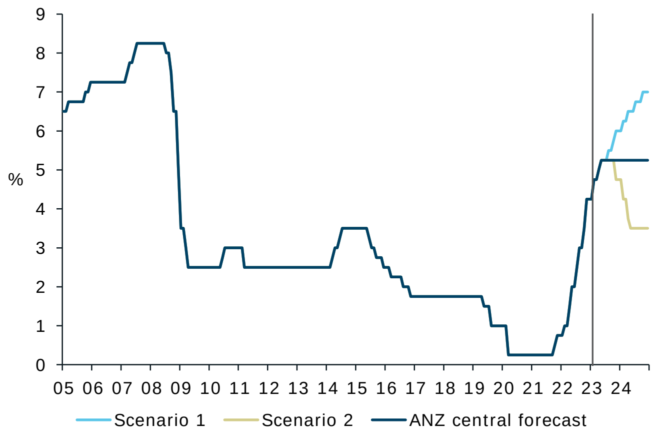
Essentially, in this scenario the RBNZ underestimates the degree to which the neutral OCR has risen, and is therefore surprised by the economy's resilience to hikes. In this scenario, activity and the labour market actually evolve close to our expectation; it just takes a higher OCR than expected to induce the softer domestic demand pulse and engineer a loosening in the labour market. House prices would very likely decline more than the 22% peak to trough decline we've pencilled in, but that's just part of the transmission of monetary policy.

Scenario 2: Basically the opposite to scenario one: the RBNZ overshoots. Households tighten their belts more than forecast; businesses shed headcount at a greater pace; the associated shock to household incomes sees forced house sales pick up, causing house prices to plummet; economic confidence tanks; a rapid and wide opening up of spare capacity sees underlying inflation pressures dissipate much faster than expected. It's a train derailment in slow motion.

However, because core inflation and the labour market tend to move with a considerable lag, this scenario likely wouldn't be accurately diagnosed in real time. That is, the RBNZ would see early signals that labour demand and household spending are indeed slowing sharply, but the inflation pulse doesn't reflect this straight away. It's November before the RBNZ has enough evidence to suggest that looser monetary conditions are needed. After resting at 5.25% for a few months, November, February, and April see the OCR cut 50bp, with May 2024 bringing a final 25bp cut that takes the OCR to 3.5%.

With monetary conditions too tight for too long in this scenario, economic activity comes in significantly weaker than our forecast. The recession is deeper and more prolonged, and the unemployment lifts beyond our forecast by a decent clip. But at the same time, the RBNZ's assumed delay in cutting is an entirely defensible approach – domestic inflation pressures and supply constraints look like they will be a lot more persistent than they turn out to be. And it's that fact that in this scenario prevents the RBNZ from taking the OCR lower than 3.5%: upside (supply-driven) inflation remains too threatening to enter 'ultra-accommodate' territory.

Figure 12. OCR forecast vs scenarios



Source: RBNZ, ANZ Research

It's worth noting that the scenarios presented here aren't unique to New Zealand. Many central banks are at risk of either overshooting, or not doing enough. As a small open economy, a harder landing across our key trading partners could have material confidence and national income implications here. And given the similarities between the RBNZ and the broad spectrum of global central banks currently deploying a similar strategy, there is a possibility that we all go down together, amplifying the hard landing.

Lastly, it's worth noting that neither of the scenarios presented above address the more extreme risks to the outlook: another pandemic, war, global financial crisis, a natural disaster, or an alien invasion. Regardless of how small the probability, black swan events do happen from time to time, and they tend to be both unforecastable and a complete game changer for the outlook.

Special topic 1: Broader economic impacts of the North Island flooding

Auckland hosts around a third of the population, and its higher-than-average GDP per capita means it accounts for around 38% of GDP. Any significant shock that occurs in the region is thus likely to have economy-wide implications.

The recent flooding event will have many direct and indirect economic impacts, some of which, such as higher-than-otherwise food prices, will be felt across the entire country. But information remains scarce at this stage. The micro-economic analysis must first be completed before we macroeconomists can start to accurately gauge what this might mean for the broader outlook. The following should be considered a first cut of incorporating these into our forecast, as opposed to the final word on the matter.

Q1 GDP data will capture the fact that parts of the North Island have been temporarily closed for business, but by end-March, demand for goods and services will also be higher-than-otherwise as the process to repair or replace damaged property gets underway. While the timing and magnitude remain uncertain, we can be confident that the repair/replace process is going to be a long one, boosting GDP after the initial disruption.

So how large are we talking? This is where things get very uncertain. But for what it's worth, we've shaved 0.2ppt off our forecast for quarterly growth in Q1, and added a little more than that back over the following few quarters. The net difference: our forecast now has the economy contracting 1.1% overall vs 1.3% previously. But we must stress that we've had very little information to go on in terms of estimating these GDP impacts as yet.

Regional GDP data is released only in annual terms, and with a decent lag: data covering the year to March 2022 will be released in March 2023. But we will get regional cuts of some of the partial indicators that feed into GDP, such as retail trade and building work put in place. So when these indicators are released ahead of the Q1 GDP data, we should be able to get some feel of the flooding impacts.

While the net impact of the flooding might end up a positive for overall GDP, this kind of 'broken window' economics doesn't affect overall economic momentum, and it certainly doesn't represent a good-news story. Replacing/repairing the damage uses resources that could otherwise have gone towards other things. In other words, GDP growth may get a bump, but overall assets and the capital stock in the economy (eg. houses, plant and machinery etc) could remain lower than otherwise for a long time to come.

All in all, we're looking at a shock that's negative on the supply side (productive capital, inventories, intermediate goods, and household possessions have been destroyed, and transport routes damaged) and positive on the demand side (all that stuff needs to be repaired or replaced). This mix, unfortunately, is expected to put upwards pressure on inflation, all else equal. But once again, it's hard to quantify just how much we're talking here. We incorporated around a 0.1ppt bump to quarterly inflation over the next couple of quarters to reflect the impacts on the likes of food, used cars, rents and construction costs.

So putting it all together, our current estimated impacts from the floods don't significantly move the dial in terms of macroeconomic outcomes, but we're keeping a close eye on things.

Similarly, we expect the February MPS to include relatively small estimated impacts on the activity and inflation outlook, with an acknowledgement that these are very uncertain, and that this shock is a potential upside risk for inflation. We think this is consistent with a 50bp hike this month.

Beyond the business cycle, it is clear that climate change is here, and it's bringing economic change:

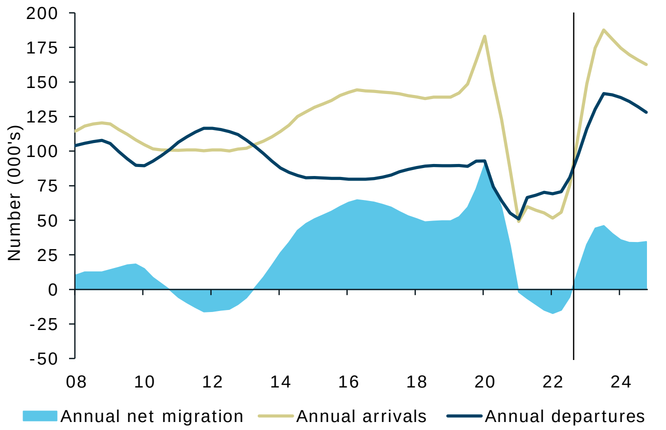
- More extreme weather events will mean more volatility in production and prices, particularly food.
- The changing risk profile will likely mean ongoing changes in how insurance, finance, and consenting are approached (affecting where and how we build, and asset valuations).
- reducing emissions and mitigating the impacts of climate change will require economic resource that then can't be used for other things.

In a nutshell, climate change is an ongoing negative productivity shock: we're going to get less out for a given amount of resource put in. The ongoing additional resource required to meet this challenge, combined with the weather-induced volatility in output and the capital stock, is likely to keep inflation higher on average, but also more volatile. Factoring this into a near-term forecast isn't easy, but the potential for economic disruption over the longer run is huge.

Special Topic 2: Migration data getting interesting, but not a game changer (yet)

Recent strength in the monthly net migration figures has presented some big questions. Is it data noise, or will it persist? On the back of the recent data, and the signal from the Government that migration policy settings are likely to be loosened, we've upgraded our migration assumption. We've pencilled in an annual net inflow of around 40k over 2023 and an annual net inflow of around 35k in 2024 (figure 1). That's around 10-15k higher per year than our previous assumption.

Figure 1. Annual net migration assumption

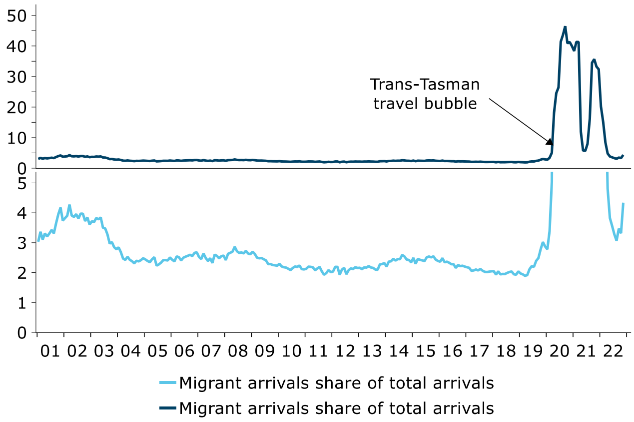


Source: Stats NZ, Macrobond, ANZ Research

We see this updated assumption as a middle ground between uncertain pent-up demand dynamics (arrivals may just prove super-strong for a short while, whereas departures could still have more in the tank as kiwis choose to depart once the NZ summer is over) and general migration data untrustworthiness for a while following release. Since the removal of departure cards, these data undergo significant revision, meaning we won't know if the recent strength in these figures is real for a few months yet.

The arrivals data certainly pose a few questions. Figure 2 shows that the migrant share of total arrivals has lifted from a little under 3% in late 2019 to about 4.3% as at November. A bump in the migrant share isn't implausible, but if it turns out that in fact only 3% of arrivals are indeed migrants (and departures remain the same), then arrivals in that month alone could be revised down by 5.5k people, significantly changing the story. Given this, we have opted to take only some of the signal in these data, and at this stage limit any flow-on assumptions re what a higher net migration assumption might mean for economic activity, house prices, wages and inflation etc.

Figure 2. Migrant arrivals share of total arrivals to New Zealand (bottom panel zooms in)



Source: Stats NZ, Macrobond, ANZ Research

If the passage of time shows migration is indeed stronger than we think, then, all else equal, this would pose some upward risk to our house price forecast and activity outlook, and some downward risk to the outlook for wages. But it is unlikely that the RBNZ will assume that this will be a net negative for CPI inflation. That's because faster population growth via migration would add to demand for goods and services as well as to labour supply.

All up, it's possible that net migration surprises our assumptions over the next few years – that wouldn't be a surprise, given how hard it is to forecast. However, given the challenges interpreting the data as it is initially printed, and the ambiguous economic impacts, we don't see the net migration data itself as ever being a primary driver of monetary policy decisions.

But the flow-on impacts from migration to the other data will have an influence. For example, a surge in migrant workers may reduce labour scarcity much faster than expected – if so, we expect that would be evident in the degree of difficulty finding labour in the business survey data. We're not saying net migration doesn't matter for broader economic settings, but it is a big ask to expect policy makers to use this data a keystone of policy decisions.

Markets outlook

Summary

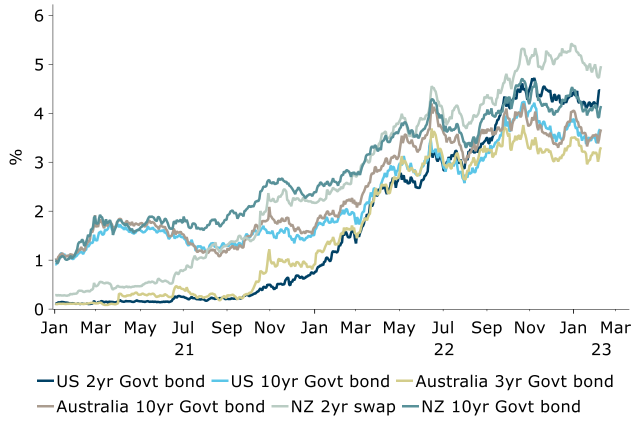
Interest rate and foreign exchange markets have had a volatile start to 2023, and that's a feature we expect to remain a constant as the year progresses. Having ramped up the pace of hikes last year, many central banks (including, we think, the RBNZ) are set to pare back the pace of hikes and eventually pause this year. We expect another 100bp of OCR hikes, but there are risks in both directions, as discussed on page 8. Central bank policy will be data-dependent from here on now that most have their policy rates at or above neutral. We're likely to enter a period of increased volatility as markets ask whether a policy turn is next, or whether a further extension to the hiking cycle is more appropriate. We think it's too soon for central banks to contemplate easing here or in the US, but bond markets are always looking for the next move. We suspect that for much of the year they will be pricing in cuts that don't actually arrive, and that will, in turn, keep a lid on yields. In FX markets, we are expecting the NZD to gradually firm over the year as last year's USD strength unwinds. But that's unlikely to be a smooth journey either, especially if we do see increased interest rate volatility.

Last year was about directionality, but this year is likely to be more about volatility

Interest rates climbed swiftly over the course of 2022, driven by rising inflation and the series of rapid-fire rate hikes delivered by central banks. Although these moves weren't completely synchronised across all of the main markets, and short-term rates moved up more than long-term rates did, for most markets it was the swiftness of the move that caught many by surprise. Inflation and labour market data did, for the most part, come in progressively stronger for the first three quarters of the year, and that in turn, led to pretty directional and correlated moves in most interest rates across key markets such as the US, Australia and New Zealand (figure 1).

By contrast, we don't expect 2023 to be such one-way traffic. As discussed in the main macroeconomics section of this report, we don't think central banks are yet done with rate hikes. In New Zealand's case, we expect the OCR to rise to 5.25%, with that being delivered via a 50bp hike in February and a pair of back-to-back 25bp hikes in April and May. So more hikes are coming, but not at the same ramped-up (75bp) pace as November (and as they signalled at the time was on the cards for February). However, because financial markets are already expecting this profile (ie it's 'priced in', to use market parlance), we don't expect to see a repeat of the sharp rises in market interest rates that characterised 2022.

Figure 1. US, Australian and New Zealand interest rates



Source: Bloomberg, Macrobond, ANZ Research

In broad terms, based on our central scenario policy forecasts, we believe market interest rates have either peaked, or are close to it. This is reflected in our expectation that the 2-year swap rate drifts sideways for a few months before declining slowly, and our expectation that 10yr bond yields peak a touch higher than where they are now (see table on page 12).

However, we do expect significant volatility around our forecasts as markets navigate their way through the slowing pace of hikes. As we approach the time when we think it's appropriate for the RBNZ to pause and reflect on the impact of hikes to date, markets are likely to flitter between the two scenarios presented on page 8. Generally speaking, we expect markets to err on the side of expecting cuts given recession fears, and term interest rates to remain below where they really 'ought' to be if market expectations for the OCR were aligned with our forecasts. That's a natural and oft-observed tendency of markets as we near the end of tightening cycles. In other words, our forecasts assume that markets will continue to price in hard-landing risks, and in turn, will continue to price in cuts over coming quarters, and that's despite us not expecting these cuts to eventuate.

Asymmetric risks for short-end rates

For short-term market interest rates like the 2-year swap rate, we believe that the skew of risks is slanted towards the upside rather than the downside. To be sure, it is possible that these fall again (as they did in late January/early February). However, because markets are already pricing in a turn in the cycle (with the OCR expected to peak at 5.21% in July and then end the year at 4.79%), our sense is that we'd need to see a significant series of downside economic surprises (and for everything to go the RBNZ's way on inflation) for meaningfully deeper cuts to be priced in.

Going the other way, we think it is worth considering the possibility that the economy continues to simmer away, the labour market remains tight, people adjust to higher mortgage rates, and/or inflation proves to be sticky. We see that broad scenario as the biggest source of upside risk to our forecasts. And since the market is already pricing in cuts over the second half of the year, even if expectations simply moved to price in a period of stability, that in itself would drive short-term rates like the 2-year back above 5% again. Things could get much messier if markets were to conclude that instead of cutting after a pause later this year, the RBNZ might have to embark on a second wave of hikes (as was the case in 2006/7 and as we present as a scenario on page 8). That would have a dramatic impact on market rates.

US bond yields expected to rise, taking NZ rates with them, albeit to a lesser extent

Longer-term interest rates are expected to continue to take their lead from US interest rates, as they generally have a tendency to do, with some part of the expected rise in US bond yields to be absorbed via a continued narrowing in the NZ/US 10-year spread.

We expect US interest rates to rise and for there to be further volatility for many of the same reasons why we think the risks are skewed to the upside locally – namely because US markets are prising in deep fed funds rate cuts over 2023 H2. What is expected is much more extreme than in New Zealand, and it is the unwinding of this expectation that stands behind our expectation for a larger rise in US bond yields. Inflation and wage growth have slowed in the US, but as in New Zealand, the level of inflation remains way too high in relation to target, and the jobs market remains very tight, all of which suggests policy needs to remain restrictive for longer. As Fed Chair Powell reiterated recently, "the historical record cautions strongly against prematurely loosening policy".

NZD/USD forecasts upgraded, NZD/AUD forecasts downgraded

The NZD had a solid start to the year, but dipped back in the wake of stronger US January jobs data, which triggered a broad USD rebound. We are not forecasting an extension of that rebound, and instead expect the USD DXY index to gravitate back towards fair value (which we see at around 10% below current levels) as the Fed slows the pace of hikes. This has been a factor in our upgraded NZD/USD forecast.

The primary driver of recent NZD strength has been an improvement in global risk sentiment, which in turn delivered the largest 12-week fall in the DXY since the global financial crisis – basically 'a tide that lifted all boats'. Given the pace of the USD decline, we are cautious about extrapolating NZD strength too much further, but we still believe its path is modestly higher. Correlation analysis shows the NZD has traded most closely with risk appetite and US equities over the first month of 2023. This confirms that global dynamics are still the dominant drivers of NZD direction.

We also expect positive economic ripples from the rebound in Chinese activity to be another source of NZD strength, particularly against currencies that are less sensitive to Chinese demand (GBP, CAD). A recent Chinese State Council Meeting issued a statement promoting the accelerated recovery of consumption and a goal to make it the driving force of China's economy. This consumption-led rather than investment-led approach to economic stimulus could bode well for food producers like New Zealand.

Our new forecasts also have NZD/AUD continuing to decline. This is predicated on the strength of Australian economic momentum, relative to New Zealand, which is much further ahead in the inflation, growth and interest rate cycle.

Table 1: Forecasts (end of quarter)

FX Rates	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24
NZD/USD	0.64	0.65	0.66	0.66	0.67	0.67	0.68
NZD/AUD	0.90	0.89	0.89	0.88	0.87	0.86	0.86
NZD/EUR	0.59	0.59	0.58	0.58	0.58	0.57	0.57
NZD/JPY	83.2	83.2	83.2	81.8	81.7	80.4	80.2
NZD/GBP	0.52	0.52	0.53	0.52	0.52	0.52	0.52
NZD/CNY	4.32	4.32	4.36	4.32	4.36	4.32	4.35
NZ$ TWI	71.2	71.2	71.7	71.1	71.4	70.8	71.3
Interest Rates	**Mar-23**	**Jun-23**	**Sep-23**	**Dec-23**	**Mar-24**	**Jun-24**	**Sep-24**
NZ OCR	4.75	5.25	5.25	5.25	5.25	5.25	5.25
NZ 90 day bill	5.27	5.35	5.35	5.35	5.35	5.35	5.35
NZ 2-yr swap	4.85	4.85	4.65	4.60	4.55	4.45	4.35
NZ 10-yr bond	4.25	4.20	4.15	4.05	4.05	4.00	3.85

Source: Bloomberg, ANZ Research

Key forecasts

Calendar Years	2018	2019	2020	2021	2022(e)	2023(f)	2024(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.6	3.1	-1.5	6.1	2.8	1.4	-0.1
Private Consumption	4.6	3.2	-2.2	7.8	2.4	-1.2	-0.1
Public Consumption	3.4	4.7	7.2	8.2	4.8	1.4	1.1
Residential investment	-1.6	5.3	-3.1	8.3	2.8	-2.5	-7.4
Other investment	9.7	4.0	-5.2	13.4	5.2	-4.7	-6.5
Stockbuilding[1]	0.3	-0.5	-0.8	1.3	-0.2	0.2	0.0
Gross National Expenditure	5.2	3.1	-1.8	10.1	3.2	-1.0	-1.3
Total Exports	3.1	2.6	-12.9	-3.2	0.2	13.0	5.0
Total Imports	6.9	2.2	-15.8	14.6	2.4	1.3	-0.1
Employment (annual %)	2.2	1.2	0.6	3.3	1.3	-0.7	-0.2
Unemployment Rate (sa; Dec qtr)	4.3	4.1	4.9	3.2	3.4	4.5	5.4
Labour Cost Index (annual %)	2.0	2.4	1.5	2.8	4.3	4.5	3.0
Terms of trade (OTI basis; annual %)	-4.8	7.1	-1.6	2.8	-3.7	5.2	1.6
Prices (annual % change)							
CPI Inflation	1.9	1.9	1.4	5.9	7.2	5.1	2.1
Non-tradable Inflation	2.7	3.1	2.8	5.3	6.6	4.9	3.4
Tradable Inflation	0.9	0.1	-0.3	6.9	8.2	5.2	0.2
REINZ House Price Index	3.1	5.1	15.5	26.2	-12.8	-9.7	2.6
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.67	0.72	0.68	0.64	0.66	0.68
NZD/AUD	0.95	0.96	0.94	0.94	0.93	0.88	0.85
NZD/EUR	0.59	0.60	0.59	0.60	0.59	0.58	0.57
NZD/JPY	73.8	73.1	74.6	78.6	83.3	81.8	78.9
NZD/GBP	0.53	0.51	0.53	0.51	0.52	0.52	0.52
NZD/CNY	4.62	4.69	4.74	4.35	4.38	4.32	4.35
NZ$ TWI	73.4	73.7	75.2	73.2	72.1	71.1	71.0
Official Cash Rate	1.75	1.00	0.25	0.75	4.25	5.25	5.25
90-day bank bill rate	1.97	1.29	0.27	0.97	4.65	5.35	5.35
2-year swap rate	1.97	1.26	0.28	2.17	5.38	4.60	4.35
10-year government bond rate	2.37	1.65	0.99	2.39	4.47	4.05	3.85

[1] Percentage point contribution to growth

Forecasts finalised 8 February 2023

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

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