ANZ Research August 2023

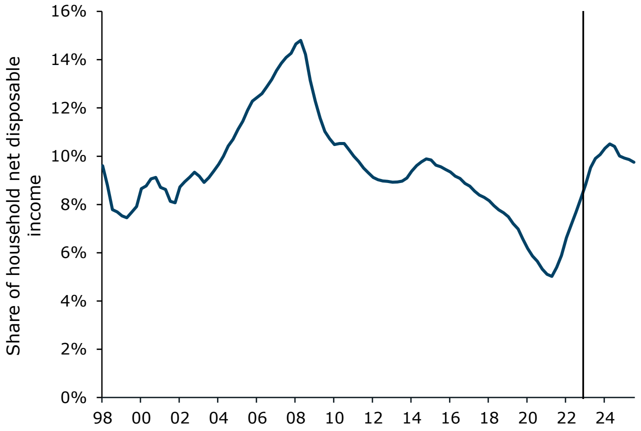
Quarterly Economic Outlook

Waiting on the last domino

Summary of forecasts

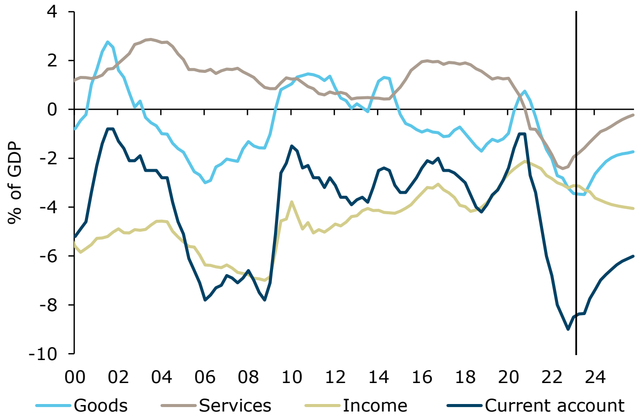
Households are feeling the squeeze, and there's more to come

But the debt-servicing burden is expected to peak well below last cycle.



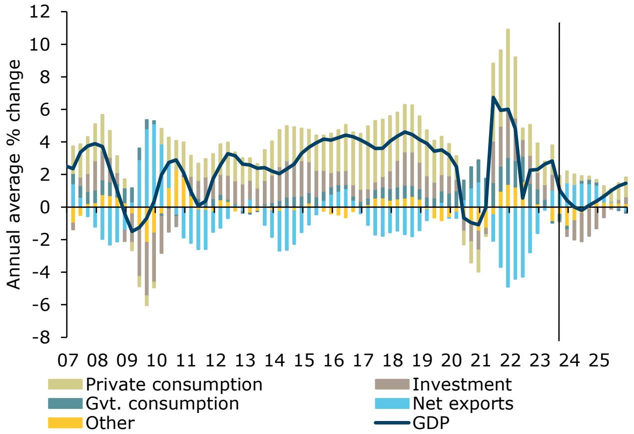
China's economy is slowing, and that will be felt here

We expect a lower terms of trade and a wider current account deficit.



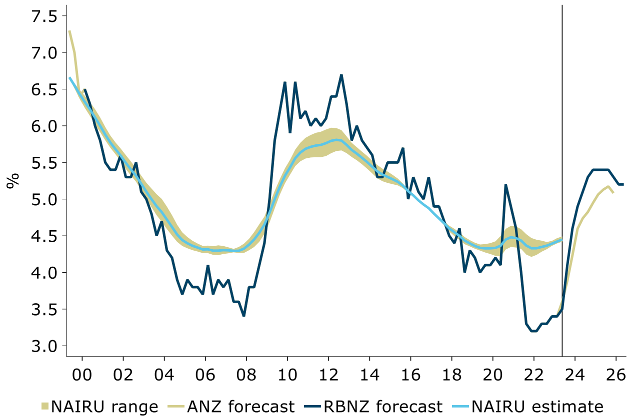
But the services exports recovery will still partially offset weaker domestic demand

Lacklustre economic growth ahead.



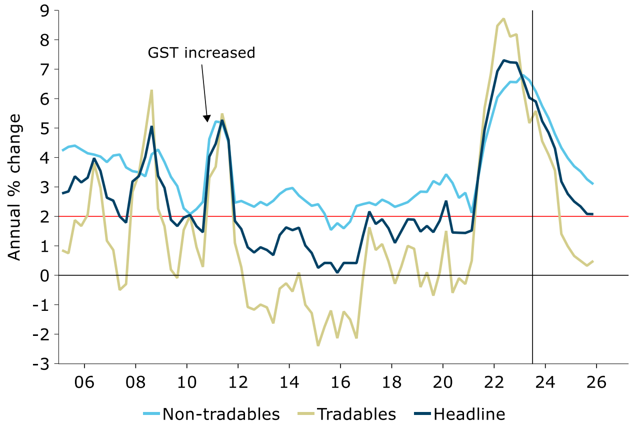
The labour market is expected to loosen

As net migration boosts supply and labour demand remains weak on the soggy activity outlook.



CPI inflation is poised to slow

But we think it'll take a slightly higher OCR than currently to tame sticky domestic inflation.



Inside

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

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A note from the Chief Economist, Sharon Zollner

The economy is in a delicate spot. It’s now clear the economy was accidentally overstimulated during the COVID period. A 46% house price increase in two years when something really quite economically damaging has occurred is not a good sign so far as sustainability goes.

So now here we sit in the symmetric world where ‘good’ news might be bad news in disguise. Signs of resilience in consumer spending, in business activity, in hiring, in house sales; all of these could actually in practice amount to an increased risk that the Reserve Bank is going to have to raise the Official Cash Rate until something breaks properly.

Perhaps not. It could be that in fact all that resilience is about to give way; that things are indeed running out of steam just as the Reserve Bank requires in order to bring inflation down. That the last domino, the labour market, is about to fall.

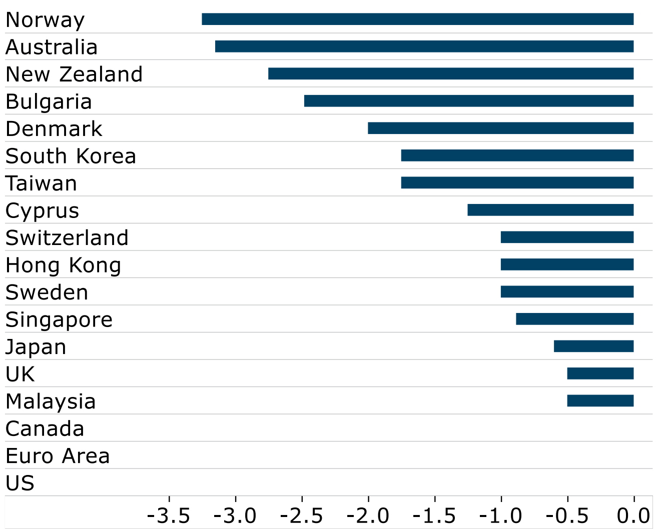
That doesn’t sound like a happy story either, to be fair. The best story of all would be the fairytale that inflation comes all the way down to target despite relative robustness in activity; the best of all worlds. And indeed, there is a flavour of that in the recent data, with activity indicators generally well off their lows – and rising, and inflation indicators generally well off their highs – and trending down.

But our view is that Goldilocks is going to depart before her work is done. The fall in inflation thus far is concentrated in goods and actually has very little to do with the RBNZ’s tightening as yet. That’s not to say monetary policy isn’t working. The pressure on retail sales is clear; house prices fell almost 17% from their peak! And we are forecasting a mild recession and rising unemployment.

But while the RBNZ might be paused, it’s actually in a race: the contractionary impacts of their tightening efforts so far versus a potential creep higher in the neutral OCR the longer inflation stays high. What’s a “good” mortgage rate? What’s a “good” pay increase? If these perceptions are creeping higher, that will chip away at the impact of the tightening that’s already been delivered. If the RBNZ tightens too little initially, there is a cost: having to tighten more later.

We have one more 25bp hike pencilled into our forecast in November, taking the OCR to 5.75%. But that would still be a country mile lower than the 8.25% it took to get on top of inflation in the last business cycle that ended in 2008. Yet inflation peaked 2.3% higher, wage growth is higher, inflation expectations are higher, unemployment is lower, and household debt (adjusted for strong household income growth) is actually a bit lower as well. The RBNZ, along with the central banks of Australia and Norway, stand out in a global comparison, in terms of *not* having raised rates to anywhere near where they peaked in the last cycle. And unlike NZ, those two countries have higher household debt than in the last cycle. Until recently, falling house prices were a pretty solid argument for why the OCR might not need to do so much work tightening financial conditions. But house prices are now on the way up again, though we don’t expect that to come to much.

Figure 1. Policy rates versus peak since 2002



Source: Macrobond, ANZ Research

In this document we outline how we see things unfolding. The lagged impacts of tighter monetary policy continue to feed through to spending and investment. Exports struggle in a tough global environment. The labour market continues to weaken and unemployment rises. Strong population growth flatters GDP, but per capita growth is very weak.

So why on earth would the RBNZ hike again with all that going on? Because they have an inflation target, not a growth target. And unfortunately, we suspect that inflation is going to prove much harder to push down once lower global goods disinflation has worked it way through. Accordingly, we have another 25bp hike in November built into our forecasts, with the clear risk being that that isn’t the end of it.

Of course, that is not the only scenario. The economy is being buffeted from all sides, as we discuss. And not just on the demand side: the supply side of the economy, from labour supply to weather to health to lockdowns, has been all over the shop in recent years, and that volatility still hasn’t completely subsided. As the saying goes, forecasting is a mug’s game. There are of course many reasons why our forecasts could be off the mark, some good (productivity, supply recovery), some bad (global shocks, upward inflation surprises). One thing is certain: this story ends with a recession – a proper one. Because that’s how business cycles are defined!

But how do we get there? Here’s our story.

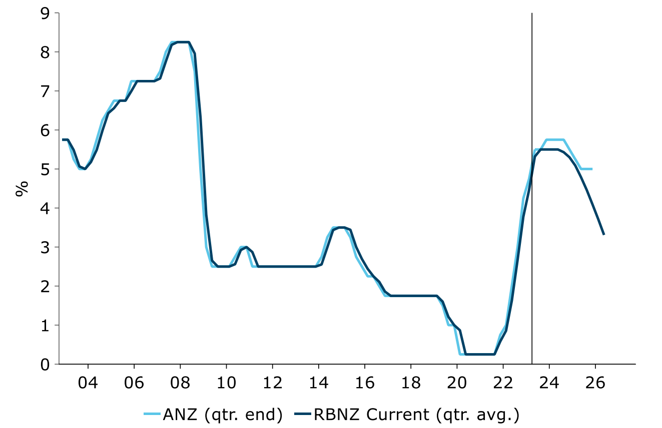
Key economic drivers

Economic drivers going in all directions

Drivers of economic momentum are traveling in all directions at present. Fiscal policy will be expansionary in the near term. Monetary policy will not. Net migration is very strong, but easing quickly. Geopolitical tensions remain heightened. Changes to the RBNZ's macroprudential settings and consumer credit legislation represent a loosening in financial conditions, all else equal. The housing market is now picking up. Falling export prices (particularly dairy) are weighing. High CPI inflation is eroding household incomes, but wage growth is higher, reflecting the tight (but loosening) labour market. Consumer and business surveys have improved, but are still generally low.

All up, it's hardly surprising that there's a range of views out there about where things are going. The economy is clearly softening, but is it softening fast enough to prevent high domestic inflation from becoming entrenched? Our expectation: not quite, which is why we expect the RBNZ to return to the hiking table come November.

Figure 2. OCR forecast



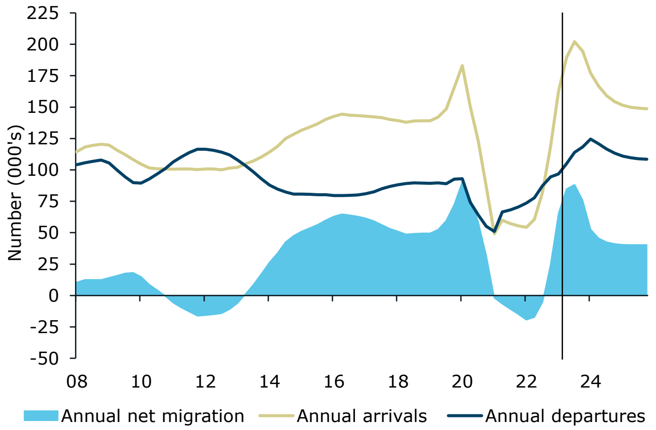
Source: RBNZ, Macrobond, ANZ Research

Let's dig a little more into some of these themes.

Fiscal. Given it's an election year, the outlook for fiscal policy is particularly uncertain. Depending on election promises and results, tax cuts or another lift in government spending (if not fully funded through higher taxes elsewhere or reprioritisation) could add further impetus to the inflation impulse. Our outlook for fiscal settings assumes the status quo for Government policy (as presented in Budget 2023). We will review this after the election. But fair to say, the risk that the RBNZ will need to offset further fiscal stimulus with a higher OCR than otherwise feels very real.

Migration. Net migration cycles are notoriously difficult to accurately predict. Data to May suggest net migration is now normalising from very high levels, as pent-up demand on the arrivals side is worked through and as departures lift, as both the economy and the weather cools. Our forecast assumes annual net migration comes in just above 75k over 2023 (with two thirds over the first half of the year). By end-2024 we assume annual net inflows stabilise at around 40k.

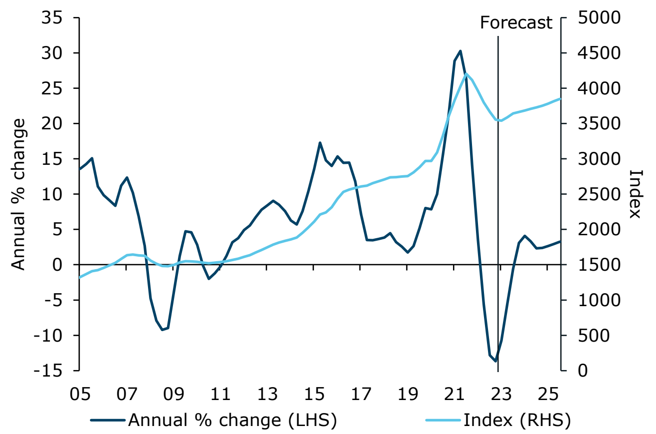
Figure 3. Annual net migration



Source: REINZ, ANZ Research

Housing. While the impacts of net migration on CPI inflation are ambiguous (adding to both supply and demand), the impacts on activity and the housing market are not. June appears to have marked a turning point in the house price cycle, after 18 months of falls. That might seem premature, given mortgage rates are yet to fall, but it in part likely reflects some temporary impetus from the recent loosening in RBNZ restrictions on higher-risk lending and the CCCFA consumer finance legislation, as well as a sense of peak interest rate danger having passed now the RBNZ has called time on hikes (we're not so sure). Our expectation is that house prices will lift around 3% over the second half of the year, before slowing to a snail's pace into 2024 as rising unemployment, still-stretched affordability, and the reality of high-for-longer mortgage rates sets in.

Figure 4. House prices

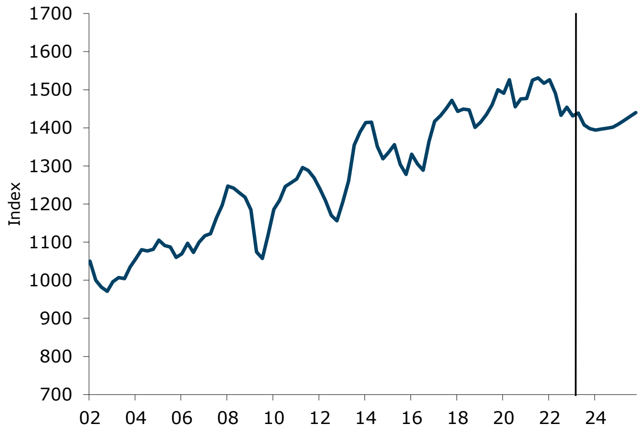


Source: REINZ, ANZ Research

Key economic drivers

The global picture. Global cyclical conditions certainly do not appear favourable for New Zealand's net exports recovery. China is a worry (see page 12), and central banks across many of our other trading partners are trying to get their consumers – our exporters' customers – to tighten their belts to tame CPI inflation. We have downgraded our outlook for export prices, which has softened the terms of trade outlook, implying weaker national incomes than previously, along with wider current account deficits.

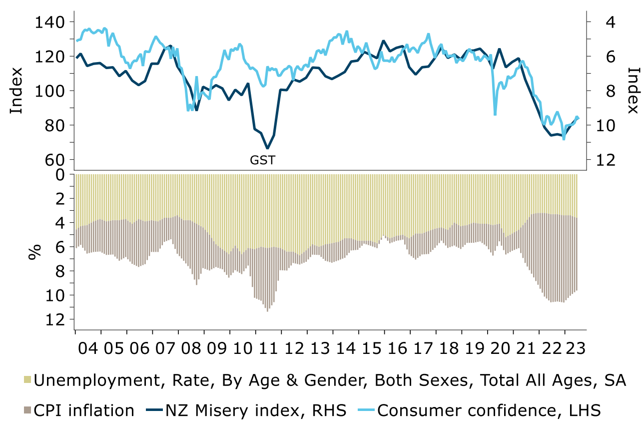
Figure 5. Goods terms of trade (OTI)



Source: Stats NZ, ANZ Research

Meanwhile, **households and businesses are starting to feel a little bit better**. Consumer confidence is still deep in pessimistic territory, but it is improving as slowing CPI inflation offsets a rising unemployment rate (figure 6). Looking forward, it's hard to tell a good news story about households, but there could be a bit more robustness in that sector than meets the eye (see page 6).

Figure 6. Consumer confidence and misery index

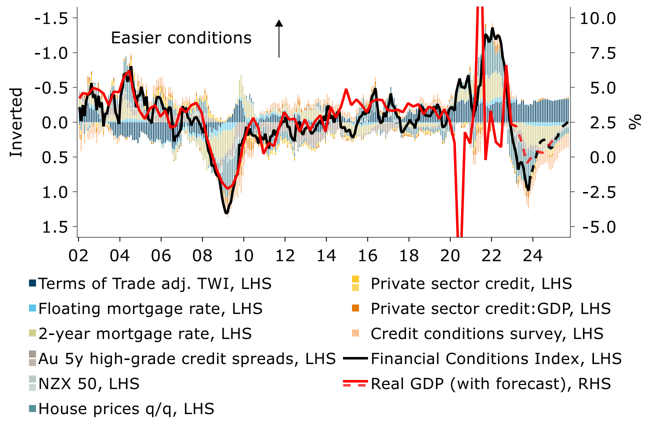


Source: Stats NZ, Roy Morgan, Macrobond, ANZ Research

Businesses are not only feeling a bit better; our Business Outlook survey shows expected profits, employment, residential construction intentions, and broader activity, while still at subdued levels, are recovering, and well off the lows seen late last year. Meanwhile, expected costs, wage growth and pricing intentions are grinding lower, suggesting pipeline CPI inflation is too. So while it's hardly an optimistic state of affairs out there for businesses, at least overall inflation pressures appear to be moving in the right direction for the Reserve Bank.

Putting as much of it together as we can into one indicator, our **financial conditions index** shows conditions are currently quite contractionary, led by higher mortgage rates and the recent contraction in house prices. A trending higher terms of trade in recent years combined with a trending lower NZD-TWI (from very elevated levels in 2014) has provided a partial offset. Looking forward, house prices are expected to lift modestly and any further mortgage rate rises are likely to be small compared to the recent experience, meaning less of a drag on financial conditions overall. Overall, financial conditions are expected to become less contractionary than they are currently over the forecast horizon (figure 7).

Figure 7. Financial conditions index and GDP



Source: Stats NZ, RBNZ, Bloomberg, Macrobond, ANZ Research

All up, after hiking the OCR 525bp in quick succession, the RBNZ is now waiting for a clearer view on whether this will be enough to get inflation back to target in an acceptable timeframe. That's a sensible strategy, given things are broadly moving in the right direction. But it's no slam dunk that the next move will be a cut. Our expectation is that fiscal expansion, population growth, solid household income growth and a turning housing market will prove meaningful offsets to the lagged impacts of tighter monetary policy, weakening export demand, and cost-of-living pressures.

That's a lot of moving parts. But come November, we think the OCR will need to do a little more to ensure inflation is appropriately tamed. And in practice, if the RBNZ is drawn back to hiking, it won't be just 25bp.

Special topic: Household balance sheets

Putting the squeeze on households

The household sector is where the rubber meets the road when it comes to domestic economic momentum. Household consumption accounts for more than 60% of expenditure GDP. If households are spending up large, businesses will hire and invest. If household demand softens, firms will look to reduce costs, including headcount, which will weigh on job security and household incomes, impacting spending, reinforcing the cycle.

The RBNZ's aim is to put just enough of a squeeze on households to set off this chain of events, and therefore create (for a time) a degree of spare capacity in the economy (a negative output gap), putting price pressures on an easing trajectory.

How do higher interest rates impact consumption?

- Higher debt-servicing burdens for net borrowers, reducing disposable income and consumption.
- Net savers are winners, but may choose to save more given higher returns, rather than spend the extra income. It's ambiguous.
- Higher rates tend to negatively impact asset prices (such as equities and houses), which can also impact household saving and consumption.

Higher mortgage rates are certainly being felt across the household sector. Our estimates suggest that the total household debt-servicing burden fell to a low of around 5% of income in 2021 and has lifted to just under 9% now. Based on our forecasts for rates, income growth, and credit growth, we expect debt servicing to lift to a peak of just under 10.5% of income by the second half of 2024. As figure 8 shows, that suggests households are about 70% of the way through the squeeze. It peaks significantly below the pre-GFC peak of almost 15%, representing upside risk to our forecast OCR peak of 5.75%.

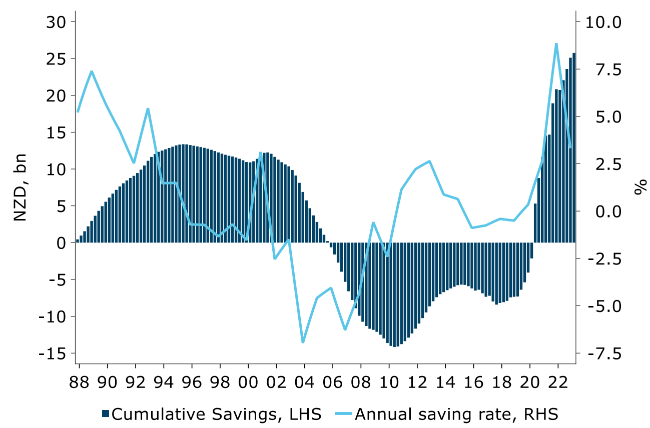
One thing this national-level analysis overlooks is the fact that highly indebted households bear the brunt of the pain. For example, a recent first home buyer will have a far higher debt to income (DTI) ratio than the national average (which is around 1.6 times income). We can run the same modelling to get a feel for how households with higher debt are faring. For a borrower with a DTI ratio of 6, servicing hit a low of around 18% of income in 2021, is around 31% currently, and is posed to peak around 39% based on our forecast. But while that's immensely tougher than the NZ-wide estimate, it's still well below the pre-GFC high of around 53% of income. In other words, the RBNZ is far from putting an unprecedented burden on the household sector. In fact, they're hoping to do the job with an optimistically small stick.

Figure 8. Household debt servicing burden

Source: Stats NZ, RBNZ, ANZ Research

Household savings buffers can also offer some insight into consumption spending. Normally, when the economy is feeling a little uncertain, households increase savings as a hedge against a possible income shock (eg unemployment). When we're in boom times, savings rates typically decline. But this recent boom was different. Lockdowns and extremely large transfers from the Government to the household sector led to a very sharp rise in cumulative household savings over the pandemic. A big concern (particularly for those with a lot of debt) is that the potential unwinding (dis-saving) from these high levels could see consumer spending (and CPI inflation) higher for longer, ultimately meaning more work for the RBNZ to do. And this isn't just a New Zealand phenomenon. Many other economies have seen household savings lift sharply.

Figure 9. Household savings



Source: Stats NZ, Macrobond, ANZ Research

All up, the pieces are certainly in place for household consumption to slow, but there is also a touch more robustness than some may appreciate. The RBNZ is so far going easy, though it may not feel like it.

GDP outlook

Sub-par activity outlook

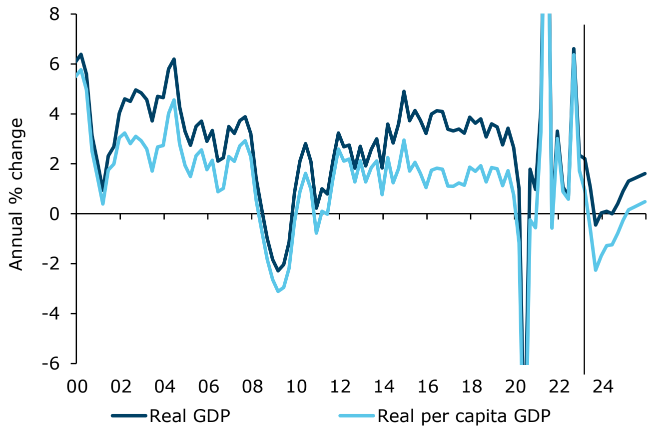
The New Zealand economy kicked off 2023 in technical recession (two consecutive quarters of negative growth). While the economy certainly is slowing, it was disruption from weather events that tipped it into contractionary territory in Q1. Over the medium term, we expect the coming rebuild will more than offset the near-term drag extreme weather has had on activity. That's not to say that having to repair damage is a good thing; if anything, it highlights the limitations of GDP as a measure of wellbeing. But the rebuild will require economic resource, and it will add to demand for goods and services for a time.

Stepping back from that, near-record tightness in the labour market is a little at odds with what one might consider typical 'recessionary' conditions. We think the recent slowdown is in fact a mix of slowing demand for goods and services and biting capacity constraints (ie running out of resource to grow). The upshot is that you can't draw a straight line from weaker GDP to weaker inflation pressures. But as we head into 2024, we expect the lagged impacts of monetary tightening on economic activity to become clearer – particularly with regards to private investment. Both residential and non-residential investment are expected to contract next year (see forecast tables, page 16).

Reflecting a loosening labour market (see next section), private consumption is expected to remain very soft too, which from a broader domestic momentum perspective will more than offset growing consumption and investment demand from the Government in the near term, and an elevated pace of population growth (reflecting high net migration).

On a per capita basis, the economic outlook is quite anaemic (figure 10) as New Zealand goes back to its old tricks of growing the economy via migration-induced population growth.

Figure 10. Headline real GDP vs per capita GDP



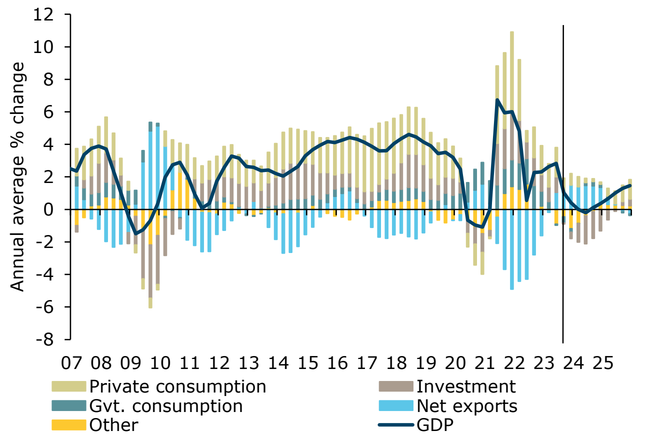
Source: Stats NZ, ANZ Research

Turning to net exports, we expect to see some sizable positive contributions to economic growth as services exports (which will hopefully get a decent bump from the FIFA World Cup this winter) continue their post-COVID recovery. We expect real exports of services to recover to pre-pandemic levels by the end of our forecast horizon (Q4 2025) – a slightly slower pace than our previous forecast, largely reflecting softer demand in China (see page 12). Difficulties across primary industries (see agri outlook) have led to a downgrade to our outlook for goods exports.

Our forecast for total imports, on the other hand, is little changed. Services imports are expected to recover further over the forecast horizon, and softer domestic demand is expected to see imports of goods (particularly capital goods) pull back, but not enough to push the nominal trade balance back into surplus any time soon (see current account section).

All up, our broad outlook is little changed. Domestic demand is expected to drag on economic momentum as a services-led net exports recovery provides an offset (figure 11). We continue to pencil in a double-dip recession over H2, but it's shallow enough that it could actually get lost in quarterly data volatility.

Figure 11. Contributions to expenditure GDP



Source: Stats NZ, ANZ Research

Looking through the noise that's likely to linger in the GDP data for a while yet, monetary policy is unequivocally working insofar as it is encouraging businesses and households to 'cool their jets'. But what is less clear at this stage is whether this is happening fast enough to prevent high CPI inflation from becoming entrenched in wage and price setting behaviour. For the RBNZ to be confident that it has done enough, the last domino still needs to topple: the labour market needs to loosen. That will happen. It's just a question of whether the RBNZ can sit back and wait for it to happen, or whether a bit more tightening is needed. Let's take a closer look at the labour market.

Labour market outlook

Transitioning from unsustainable levels

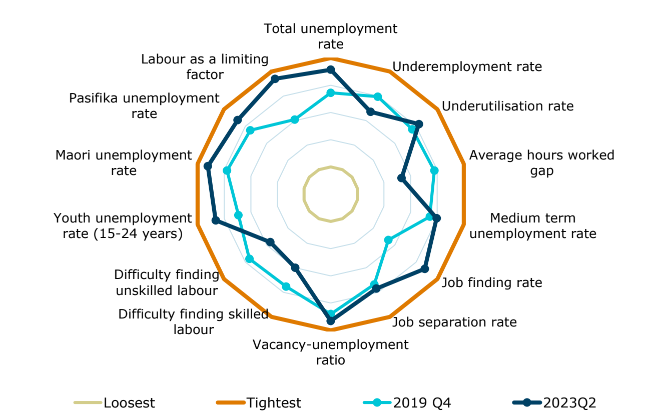
Both we and the RBNZ are forecasting the unemployment rate to rise quite rapidly. In fact the RBNZ profile looks very similar to the wake of the Global Financial Crisis, albeit not going as high. But unlike the RBNZ, we think it's probably going to take an OCR north of 5.5% to make it happen.

A softening labour market certainly isn't a good news story. In fact, it's a very nasty one. But eradicating pipeline CPI inflation pressures (by reducing labour cost inflation) will ultimately mean less economic instability in the longer run. It's a tough pill to swallow, but if the RBNZ were to let the labour market run at unsustainably tight levels, we'd very likely be in for a much larger boom-to-bust transition than otherwise. And that could have lasting impacts on economic confidence and willingness to invest, which can ultimately impact labour productivity (eg less capital per worker), suppressing real wages and making households (and NZ in general) poorer than otherwise in the longer run.

As evidenced by the Q2 release, the labour market is loosening, but remains at very inflationary levels. The unemployment rate ticked up 0.2%pts to 3.6%, despite strong growth in employment of 1.0% q/q. Current strong employment growth is perhaps better interpreted as pent-up labour demand being worked through by strong labour supply growth, rather than a resurgence in demand for labour.

In 2019 (before COVID), the RBNZ were characterising the labour market as consistent with maximum sustainable employment (MSE). As figure 12 shows, even after Q2's slight loosening, 10 out of 14 MSE indicators were in 'tighter' territory than pre-pandemic.

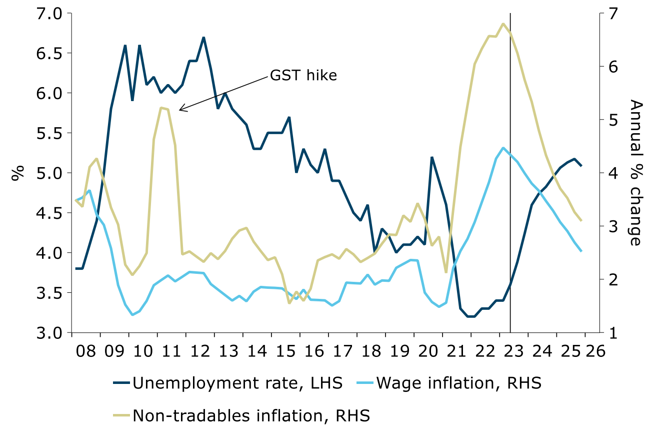
Figure 12. Suite of maximum sustainable employment indicators



Source: Stats NZ, NZIER, ANZ Research

Looking forward, we expect labour demand to weaken as economic activity softens and migration-induced growth in labour supply remains elevated. That combination is expected to see the unemployment rate rise sharply to a peak of 5.2% in 2025. That's expected to take the heat out of wage growth and domestic inflation (figure 13).

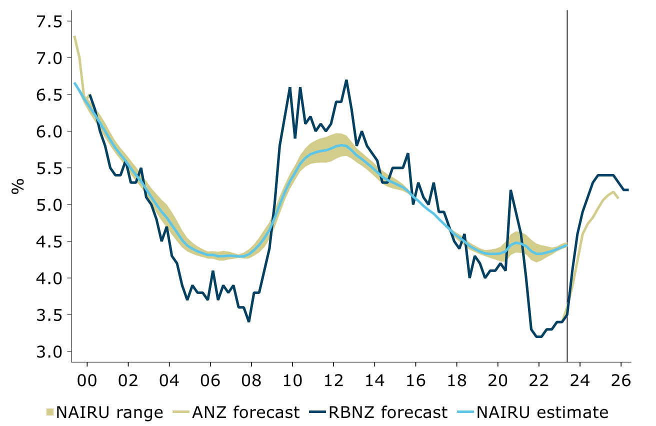
Figure 13. Unemployment, wage and non-tradables inflation



Source: Stats NZ, Macrobond, ANZ Research

For the RBNZ to be confident that upside domestic inflation risks are contained, they will need to be confident that the labour market is transitioning to an outright disinflationary level. In economist speak, that means getting unemployment above the 'non-accelerating inflation rate of unemployment' (NAIRU). NAIRU is another unobservable and time-varying concept that economists use to gauge where we are in the business cycle. And despite a relatively wide uncertainty band around our central estimate, our forecast suggests the labour market will not enter outright disinflationary levels until Q1 2024.

Figure 14. Unemployment rate vs NAIRU



Source: Stats NZ, Macrobond, ANZ Research

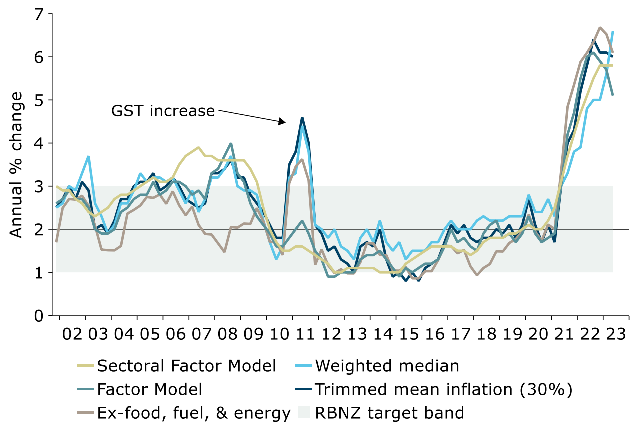
All up, the labour market holds the key to ensuring medium term inflation sustainably returns to target. Recent data suggest this last domino is starting to wobble, but it hasn't yet toppled over. But the RBNZ will do what it must to ensure it does.

Consumers price inflation outlook

A sticky situation

Core inflation remains worryingly high. Some measures are off their peaks and others have plateaued, but some are still accelerating. While the worst appears to be behind us, the RBNZ should still be very worried about the possibility that core inflation proves sticky at high levels. But at the same time, given the typical lags between inflation and monetary policy settings, the RBNZ will be cognisant that if they keep hiking until all core measures are decisively lower, they will have likely over tightened.

Figure 15. Core CPI inflation vs 1-3% target band



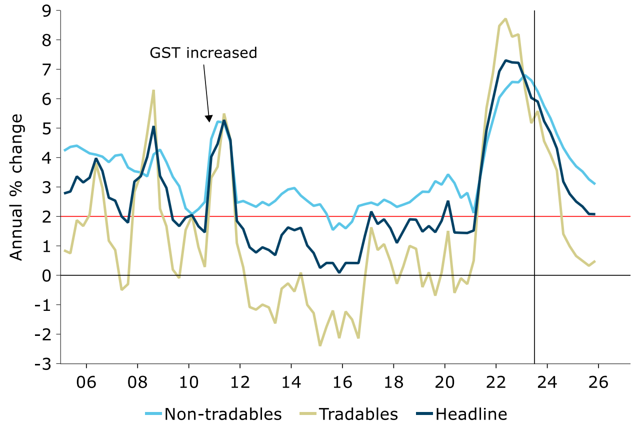
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

While Q2 headline inflation was in line with the RBNZ's May MPS forecast, the details were on the worrying side. Non-tradables inflation (the domestic and potentially sticky kind) came in stronger than their forecast (1.3% q/q vs 1.0% expected), and the RBNZ's own Sectoral Factor Model of core inflation moved sideways at a whopping 5.8%. This measure suggests there's been no progress on the core inflation front since Q4 2022. Further, there was some evidence in the details to suggest inflation could be 'normalising' above the RBNZ's 2% target midpoint – which is ultimately the RBNZ's biggest fear – with the proportion of the CPI basket running greater than 2% y/y lifting further to 84% in Q2.

Looking forward, we expect annual inflation to remain flat at 6.0% y/y in Q3. That, in part, reflects temporary price increases from unwinding transport and fuel excise subsidies, which together add roughly 0.6%pts to annual inflation. Big increases in local council rates are also on the cards for Q3, symptomatic of a still intensely inflationary environment. We're expecting annual non-tradables inflation will slow only slightly from 6.6% in Q2 to 6.2% in Q3.

Beyond Q3, we expect both annual tradables and non-tradables inflation to slow meaningfully.

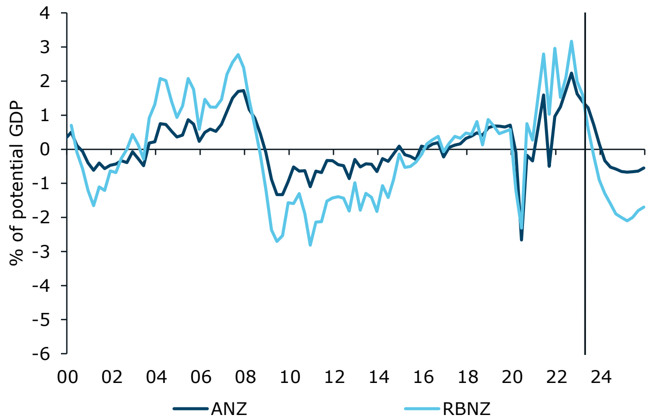
Figure 16. ANZ inflation forecast



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. Construction cost inflation is finally easing as the heat comes out of the residential building sector; the labour market is loosening (albeit from extremely tight levels); and economic activity is running below trend. Putting it all together, the output gap is expected to turn negative (disinflationary) late 2023/early 2024 – a necessary condition for domestic inflation to slow.

Figure 17. Output gap



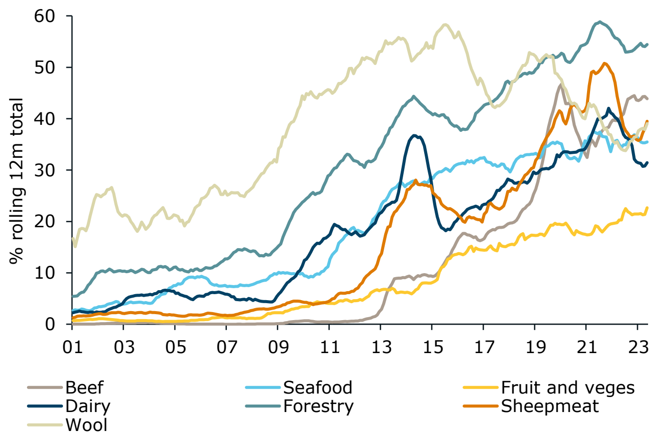
Source: Stats NZ, Macrobond, ANZ Research

The outlook for tradables inflation (ie for goods that are largely imported, or could be) remains relatively uncertain. We should see imported inflation pressures continue to reduce in coming months. China's reopening hasn't resulted in a second round of heightened global inflation (as once feared), and now looks more likely to be a disinflationary force for NZ (and the rest of the world). However, Russia's war in Ukraine, increasing weather volatility and simmering geopolitical tensions highlight that risks to the global supply recovery have not gone away. Global oil prices are rising, up around 23% from their June lows.

Down on the farm: income down, costs up

Slower global economic growth, particularly the slowdown in China's economy (see page 12), has negatively impacted prices for most of our major export commodities. New Zealand has increased its exposure to China over the past couple of decades; it's now the largest market for most of our commodity exports.

Figure 18. Portion of goods exported to China



Source: Stats NZ

China generally imports about 30% of our dairy products, but our meat exports are even more exposed to this market. In the past few years, China has been buying virtually all the mutton and raw logs that NZ can produce, meaning we now have limited alternative markets for these products.

The recent heatwaves in the Northern Hemisphere and challenges getting product out of Ukraine are putting upward pressure on grain prices, but protein prices generally remain subdued. Eventually, the higher costs of production will curb supplies of meat and dairy products, which will help prices recover, but for now weaker demand is dominating market pricing.

Softer demand for our export products is now flowing through to farmgate prices. These have trended down rapidly, as seen in the 40% reduction in the Global Dairy Trade Price Index since March 2022. Meat prices held a little longer, with prices remaining strong through the autumn, but they have now retreated by 15-20%, and further weakness in our international markets is expected.

Weaker international prices are now flowing through to the price that farmers are being paid for stock heading to slaughter, and for livestock traded between farms. Extremely wet soil conditions are another factor impacting farmer confidence, and also reducing demand for livestock, as the majority of farms look to reduce stocking rates.

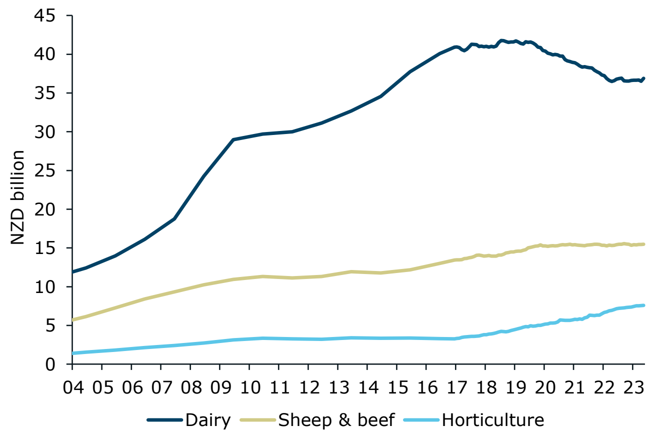
International prices for our horticultural products are holding up a little better than our other food exports. This is largely due to New Zealand having less produce to sell this season due to the reduced harvest. Inclement weather earlier in the season, including major devastation from cyclones Hale and Gabrielle, means there were significantly less kiwifruit and apples to harvest this year. Fruit exporters have been in a stronger negotiating position, which has tended to result in pricing being higher, or at least matching last season. Grower incomes are generally still well below last season due to reduced volumes, however, so it's hardly a good news story.

Virtually all of our primary sectors are facing lower returns this season, but operating costs are continuing to rise.

International energy prices have receded versus last year, but unfortunately prices for fertiliser in New Zealand remain relatively high, as much of the product currently held was purchased when prices were still elevated. The removal of government subsidies on petrol and road user charges has also offset some recent moderation in fuel costs.

The prices of other farm inputs have generally stabilised or eased following large price hikes in recent years. However, the rapid rise in interest rates is now taking a toll on indebted businesses. Debt levels in the dairy sector have reduced in recent years but many businesses are now finding it harder to make inroads.

Figure 19. Agriculture debt by sector



Source: RBNZ

The overall impact of the decrease in income and increased costs is that many businesses operating in the primary sector will struggle to break even in the coming season.

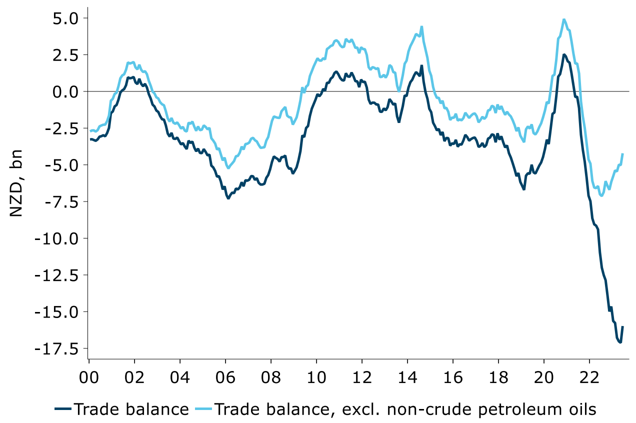
Current account outlook

Structurally wider?

As noted in the previous section, the primary sector is facing significant headwinds. Softer demand in China is weighing on export prices, while regulatory uncertainty, bad weather, tighter credit conditions, and difficulty finding labour are all weighing on production volumes. The outlook for nominal goods exports isn't flash, and some of the reasons (regulatory impacts on costs and output and more frequent extreme weather events) look permanent.

Meanwhile, with the closure of Marsden Point, New Zealand is now permanently more dependent on imports, and that's adding significant widening pressure to the merchandise trade balance (figure 20).

Figure 20. Merchandise trade balance



Source: Stats NZ, Macrobond, ANZ Research

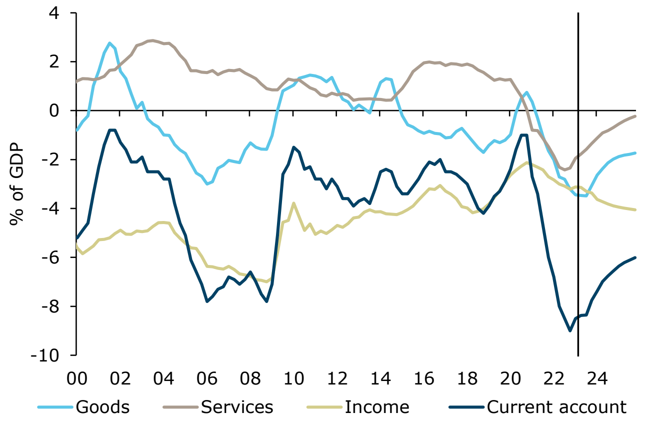
Weaker goods exports, combined with a structurally higher imports share of GDP, mean we do not expect the annual goods balance to post a surplus over the forecast horizon. But we do expect the goods deficit to narrow as weak domestic demand weighs on discretionary imports.

The annual services deficit (which is typically in surplus) is expected to narrow over the forecast horizon as both exports (chiefly tourism and education) and imports continue to recover. But with exports now expected to recover a little more slowly than previously, this balance is also expected to remain in deficit over the forecast horizon.

Reflecting the sizable stock of net external debt following persistent trade deficits, and the higher global interest rate environment, the income deficit is expected to widen over the forecast horizon, partially offsetting narrowing goods and services deficits.

Putting it all together, we expect the annual current account deficit to narrow from a stonking 9% of GDP in Q4 2022 (8.5% in Q1 2023) to 6% by the end of our forecast horizon (Q4 2025). That's still about 2%pts wider than the historical average of 3.5-4%.

Figure 21. Current account forecast



Source: Stats NZ, ANZ Research

Sovereign credit agencies do focus on New Zealand's ability to pay its way in the world, and we doubt any of them would be feeling comfortable with recent outturns. The good news is that ratings agencies tend to be forward-looking, and the outlook is for New Zealand's imbalance to improve, albeit less than previously. That said, it's hard to know if an improvement as gradual as the one we now expect would alleviate their concerns.

Certainly, a deficit of 6% of GDP, if it were to persist for too long, wouldn't pass the 'sustainable' sniff test. Assuming historically average nominal GDP growth of just over 5% y/y, and net valuation changes across New Zealand's net international investment position close to zero, a 6% current account deficit would imply a growing net external liability position as a share of GDP in perpetuity. In other words, 6% is simply too wide a deficit to stabilise New Zealand's sizable debt with the rest of the world as a share of the economy.

Another worry is the fact that credit ratings tend to be a *relative* concept over the longer run, meaning it's not just New Zealand's performance relative to history that matters, but also relative to the rest of the world. And on that score, we aren't doing well, with the widest deficit across OECD economies as at Q1 2023.

Hopefully New Zealand manages to grind away at the too-wide current account deficit over coming years, but the longer this takes, the longer the economy will be vulnerable to a significant terms of trade shock that could trigger a sovereign ratings downgrade, or worse, necessitate a very sharp correction in domestic investment activity (as the country is forced to abruptly live within its means). All else equal, and in this context, it's a bit of head scratcher why the NZD isn't falling out of bed. The current account certainly represents downside to NZD and upside to domestic interest rates. See markets outlook for more.

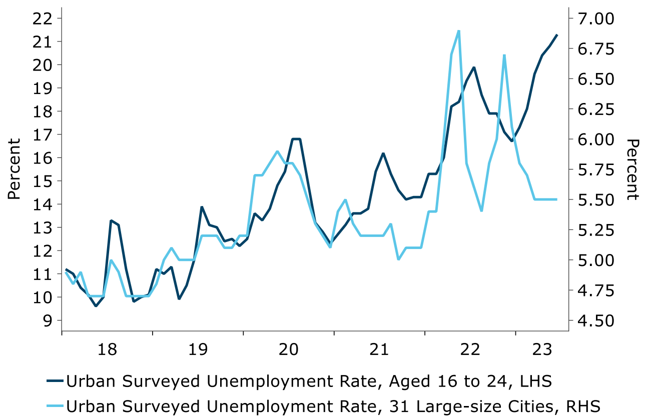
Special topic: China in focus

Slowdown in China will be felt in NZ

China's economy is slowing. The property sector has entered its longest downtrend in the past two decades and the worst may not be over. Although policy makers have introduced measures to support the market, there is no panacea to the potentially lengthy adjustment that lies ahead. All else equal, a prolonged period of sluggish property prices has the potential to further dampen domestic demand, with inflation lower than considered desirable. This is in stark contrast to many other economies (including New Zealand) where overstretched labour markets present a risk that high inflation will persist for longer than we all expect.

China's urban unemployment rate across its 31 largest cities has trended a little higher over the past few years, but at 5.5% it is still well off its 2022 COVID-affected peak (figure 22). However, the youth unemployment rate (16-24 year olds) is sending some worrying signals. This measure lifted to 21.3% in June, suggesting the jobs market is quite sluggish for new entrants.

Figure 22. China's unemployment rate



Source: NBS, Macrobond, ANZ Research

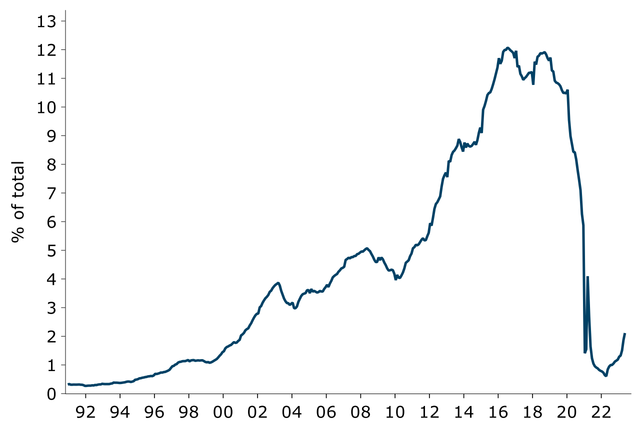
In recent months, China's political leadership has stressed the need for high-quality economic development, as opposed to focusing on short-term GDP growth, but it has also hinted about a need for counter-cyclical policy. That suggests policy makers are looking to strike a balance between supporting growth in the near term, and seeking more sustainable drivers of growth. Looking forward, we expect fiscal policy to pick up the baton in the second half of the year to support growth, but we also see downside risks around household spending. A key gauge of the policy impact will be whether confidence in the private sector and household sector responds favourably.

From a New Zealand perspective, we've already witnessed some of the impacts of China's slowdown. Dairy prices have fallen around 40% on the Global Dairy Trade platform since March 2022. And with China our largest market for the likes of dairy, sheep meat, logs and wool, concern is warranted.

All else equal, softer commodity prices do not bode well for New Zealand's terms of trade, but with price pressures in China subdued, there should be some offsets via weaker import prices, given New Zealand sources around 20% of its goods imports from China. In net terms, though, we view recent developments as negative for the goods terms of trade, and have downgraded our outlook slightly (see page 4).

Turning to services, China's reopening brought optimism that international tourism will recover to pre-pandemic levels within a relatively short timeframe. But with the current cyclical downturn in China making households more cautious, a return to pre-pandemic visitor arrivals now seems a distant prospect. We have downgraded our outlook for services exports because of this. When it comes to services exports, China isn't our largest trading partner (Australia is), but at around 12% of total visitor arrivals prior to the pandemic (figure 23), the absence of Chinese tourists has been noticed.

Figure 23. Short term visitor arrivals from China



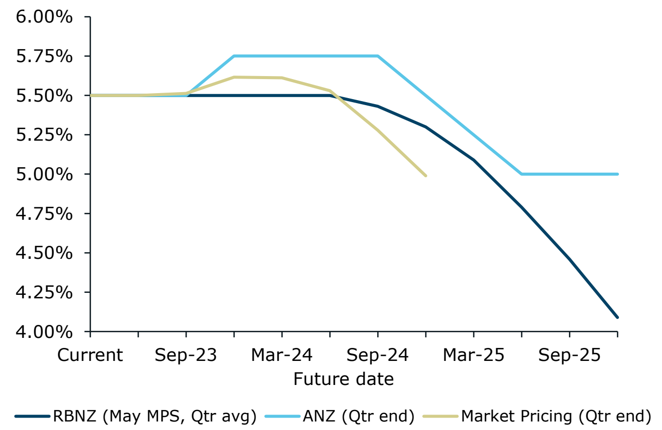
Source: Stats NZ, Macrobond, ANZ Research

All up, the weaker demand impulse in China has been factored into our updated forecasts. China will remain a key market for New Zealand, and will continue to grow, but the pace of expansion is now expected to be less supportive of activity in New Zealand than previously. For the current account deficit (see page 11), this is bad news on top of an already worrying situation. Perhaps even more worrying, is that even after these forecast tweaks, downside risks to China's outlook remain. Now it's all eyes on how China's policy makers respond.

Short-term interest rates have further to rise, and are expected to hold up for longer

The RBNZ has delivered 525bps of hikes this cycle. However, we expect at least one more hike to be delivered, in November. Technically, another OCR hike shouldn't, on its own, have a significant impact on term interest rates, especially with the market already pricing in greater odds of a hike by November than not (figure 24). But at that juncture, markets will also have to contend with the possibility that we may not just see one hike. At this stage we don't have the confidence to put a second hike into our forecasts, but that's certainly the skew of risks.

Figure 24. Market expectations for the OCR vs ANZ forecasts and RBNZ projections



Source: RBNZ, Bloomberg, ANZ Research

Figure 25. Historic and forward implied 2yr swap rates

Source: RBNZ, Bloomberg, ANZ Research

Another hike would also likely see the market temper its enthusiasm for cuts, currently priced in over the course of 2024. The "pricing out" of these cuts would have an upward impact on key market rates like the 2-year swap rate. Because we don't expect the next hike to be delivered till November, we have pushed out the timing of when we see 2-year swap rates peaking (at around 5.7%, which is close to where they got to in May before the RBNZ surprised markets with their "we're done" rhetoric). Of note, our forecast profile has 2yr swap rates holding up for longer, and at a higher level than market-implied forward interest rates (figure 25).

By the end of Q1 2024 we expect markets to revert to anticipating cuts, and that's likely to be associated with a gradual fall in 2-year interest rates. As with past cycles, this period is likely to be associated with a rise in volatility as markets repeatedly price in cuts and get disappointed. This ebb and flow is typical at the top of the interest rate cycle. Eventually, markets will get "rewarded" with a cut, but we don't expect that to occur till November 2024.

Upward pressure on NZ long-end rates

Longer-term interest rates are also forecast to rise a little further yet, fuelled by a combination of higher global interest rates, deteriorating fiscal metrics, and the ongoing impact of quantitative tightening (QT). These drivers have been in play for some time, and they have driven New Zealand bond yields gradually higher (amid bouts of volatility) over 2023. However, we expect each driver to intensify over coming months, with our forecasts taking New Zealand 10-year bond yields up to around 5% by year end.

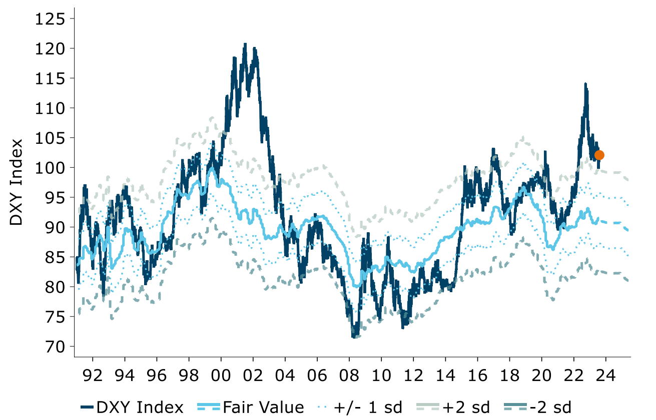
On the fiscal side, as we note on page 15, the risks look worryingly skewed in the wrong direction, with tax revenue already well behind plan and forward-looking indicators of growth suggesting that Budget forecasts were overly optimistic. With deficits forecast for the next two fiscal years (or longer if the economy continues to deteriorate), the Treasury has no choice but to borrow to plug the gap, and that's likely to put further upward pressure on bond yields even as long-term swap rates remain more contained.

On the quantitative tightening side, the late July move by the Bank of Japan to walk back yield curve control (their version of QE) has added to upward pressure on Japanese bond yields and raised the spectre of capital repatriation to Japan, away from other markets. Although this is likely to occur only gradually (even after the announcement, Japanese bond yields remain low), if there is more caution on the part of Japanese buyers with respect to US, Australian and New Zealand bonds, that could take a set of buyers out of the market at a time when bond issuance is elevated (and potentially set to grow further). Markets are also reeling from the recent downgrade of the United States' credit rating by Fitch, who dropped them from AAA to AA+. In and of itself, this action may not change investor behaviour, especially given the size of the US government bond market and its global benchmark status. But it has honed the focus on creditworthiness at a time when NZ's fiscal outlook is looking softer and current account deficits wider.

NZD forecast to appreciate but risks skewed towards that not happening

Our currency forecasts assume a further gradual appreciation of the Kiwi over coming quarters, taking it to 0.63 by year end, and 0.65 by the end of 2024. As was the case when we made the forecast, it is based on our expectation of USD weakness as the US tightening cycle comes to an end and the USD reverts to our analytical estimate of fair value. We see fair value at around in 91.5 DXY terms (figure 26).

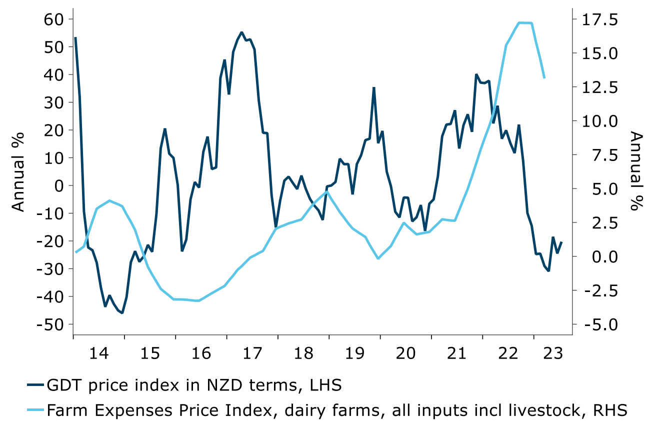
Figure 26. USD DXY Index and our fair value estimate



Source: Bloomberg, Macrobond, ANZ Research

That is around 10% below where the DXY (a measure of the USD against a basket of currencies) was at the end of July (around 102). Although we like to anchor our forecasts to measures of fair value, we are mindful that the market has been unwilling to embrace the idea of a substantially weaker US dollar yet. That likely reflects broad economic resilience there (which is somewhat surprising, given how aggressively the Fed has tightened policy) and a sense that fragilities elsewhere (especially in China) add to the appeal of the US dollar. On that score, we note that the DXY has not weakened in the wake of Fitch's downgrade of the US' credit rating. It has appreciated slightly, with the market taking the view that any "risk off" vibe associated with the announcement adds to, rather than detracts from, the safe-haven appeal of the USD.

Figure 27. GDT price index and farm expenses index



Source: Global Dairy Trade, Stats NZ, Macrobond, ANZ Research

NZ's current account is clearly a concern, and lower milk prices are part of the story. Milk prices are down sharply and that has, in turn, led to concerns about the dairy payout for the 2023/24 season. Our relatively recent dairy payout forecast of $7.75 will come under downward pressure if milk price weakness persists. Meanwhile, dairy farm cost inflation remains high (figure 27), squeezing on-farm profitability and export earnings.

Table 1: Forecasts (end of quarter)

FX Rates	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
NZD/USD	0.62	0.63	0.65	0.65	0.65	0.65	0.66
NZD/AUD	0.91	0.90	0.90	0.89	0.89	0.89	0.90
NZD/EUR	0.55	0.55	0.56	0.55	0.54	0.54	0.55
NZD/JPY	85.6	85.1	85.8	83.2	81.9	80.6	81.8
NZD/GBP	0.48	0.48	0.49	0.49	0.48	0.48	0.49
NZD/CNY	4.31	4.28	4.39	4.36	4.32	4.29	4.32
NZ$ TWI	70.1	69.9	71.2	70.5	70.0	69.8	70.7
Interest Rates	**Sep-23**	**Dec-23**	**Mar-24**	**Jun-24**	**Sep-24**	**Dec-24**	**Mar-25**
NZ OCR	5.50	5.75	5.75	5.75	5.75	5.50	5.25
NZ 90-day bill	5.79	5.90	5.87	5.85	5.68	5.43	5.10
NZ 2-yr swap	5.57	5.67	5.52	5.38	5.18	5.02	4.95
NZ 10-yr bond	4.85	5.00	4.85	4.75	4.75	4.75	4.75

Source: Bloomberg, ANZ Research

Key risks

Harder landing and/or sticky inflation?

The broad risk profile is little changed since our last edition, but the mix is looking a little different. For now, at least, global financial market turmoil following the failure of a couple of domestic US banks and one in Europe earlier in the year has settled significantly. That's not to say there won't be further bumps along the road as tighter global monetary conditions bite, but insofar as these particular events go, so far this one isn't looking systemic.

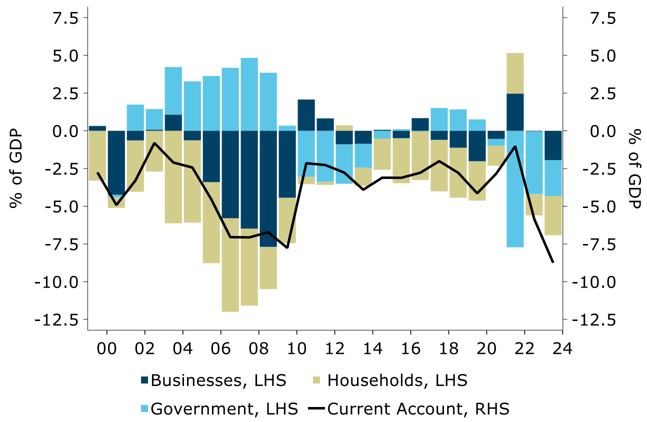
As noted on page 12, economic conditions in China have softened somewhat recently, and risks, particularly around the property sector, are heightened. Meanwhile, geopolitical tensions remain elevated, as Russia's war with Ukraine continues, and US-China relations remain icy.

All the while, many central banks around the world are attempting the same balancing act as the RBNZ, hoping to tighten monetary conditions just enough to tame inflation, but not so much that they induce a harder landing than necessary.

As a small, open economy, New Zealand certainly doesn't face a shortage of global risks that could materially change the outlook. And with the current account deficit looking wider for longer, it's worth questioning whether New Zealand is one material terms of trade shock away from a sovereign credit ratings downgrade. All else equal, the mix of risks (and external balance fundamentals) suggests a weaker NZD and/or higher interest rates would appropriately reflect the risk profile. There is simply no easy way to say it: New Zealand's capacity to pay its way in the world is being eroded by both climate regulation and climate events. And as necessary as the former may be to mitigate the longer-term impacts of the latter, this mix still represents a productivity shock that's here to stay, and one that may necessitate a faster adjustment in domestic activity than policy makers would deem desirable.

In this context, risks around additional fiscal expansion are quite worrying, as government dis-saving in recent years has been a meaningful driver of the widening current account deficit (figure 28).

Figure 28. Sector contributions to current account deficit



Source: Stats NZ, Macrobond, ANZ Research

Domestically, while we believe the RBNZ has more work to do, we are also continuously trying to assess if the RBNZ has over-tightened and we're in for a more deflationary and harder economic landing than we expect. But worse than either of these scenarios: what if the harder-than-expected economic landing is coming, but it doesn't solve the inflation problem? That could be because of more persistent supply constraints, a more developed wage-price spiral, or a larger and more persistent productivity shock.

At the other end of the spectrum, there is also a goldilocks scenario: supply capacity recovers significantly, inflation expectations quickly return to around 2%, wage-price spiral dynamics fade, productivity growth comes back with a vengeance (perhaps broad-based technological innovation and adoption). In other words, the RBNZ is able to loosen monetary conditions despite robust growth in economic activity. Honestly, the latter is a harder story to tell right now, but maybe it'll become easier this time next quarter, when our next update is due. One can only hope.

But regardless of domestic settings, it's worth bearing in mind that New Zealand business cycles in practice tend to be brought to an end by global factors. And even though optimism appears to be lifting that the RBNZ can pull of a soft(ish) landing, there's no shortage of global candidates that could change the picture abruptly. We are sceptical that a 5.5% OCR is enough to bring inflation back down to target in an acceptable time frame as things stand. But things never stand still. One risk we're thinking about: there is a lot more to financial conditions than just the OCR, and global factors are not under the RBNZ's control. Higher long rates, higher funding costs, a higher exchange rate, falling equity markets, tightening lending conditions … any of these could in practice do the OCR's work for it. But that would definitely be a case of "be careful what you wish for".

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	0.3	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	-4.3	-5.8	1.9
Other investment	4.0	-5.1	13.9	4.9	-0.7	-4.9	1.6
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	-0.6	1.6
Total Exports	2.6	-13.5	-2.4	0.3	7.5	4.7	3.5
Total Imports	2.2	-15.8	14.8	5.4	0.6	0.5	3.5
Employment (annual %)	1.2	0.6	3.3	1.7	2.3	0.3	1.6
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	4.0	3.3	2.5
Terms of trade (OTI basis; annual %)	7.1	-1.6	2.8	-4.2	-3.9	0.3	2.7
Prices (annual % change)							
CPI Inflation	1.9	1.4	5.9	7.2	5.3	2.7	2.0
Non-tradable Inflation	3.1	2.8	5.3	6.6	5.8	4.0	3.0
Tradable Inflation	0.1	-0.3	6.9	8.2	4.7	0.9	0.5
REINZ House Price Index	5.2	15.6	26.3	-12.8	-0.6	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	0.66
NZD/AUD	0.96	0.94	0.94	0.93	0.90	0.89	0.90
NZD/EUR	0.60	0.59	0.60	0.59	0.55	0.54	0.55
NZD/JPY	73.1	74.6	78.6	83.3	85.1	80.6	81.8
NZD/GBP	0.51	0.53	0.51	0.52	0.48	0.48	0.49
NZD/CNY	4.69	4.74	4.35	4.38	4.28	4.29	4.29
NZ$ TWI	73.7	75.2	73.2	72.1	69.9	69.8	70.5
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	5.90	5.43	5.10
2-year swap rate	1.26	0.28	2.17	5.38	5.67	5.02	4.80
10-year government bond rate	1.65	0.99	2.39	4.47	5.00	4.75	4.75

[1] Percentage point contribution to growth

Forecasts finalised 8 August 2023

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

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Important notice

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