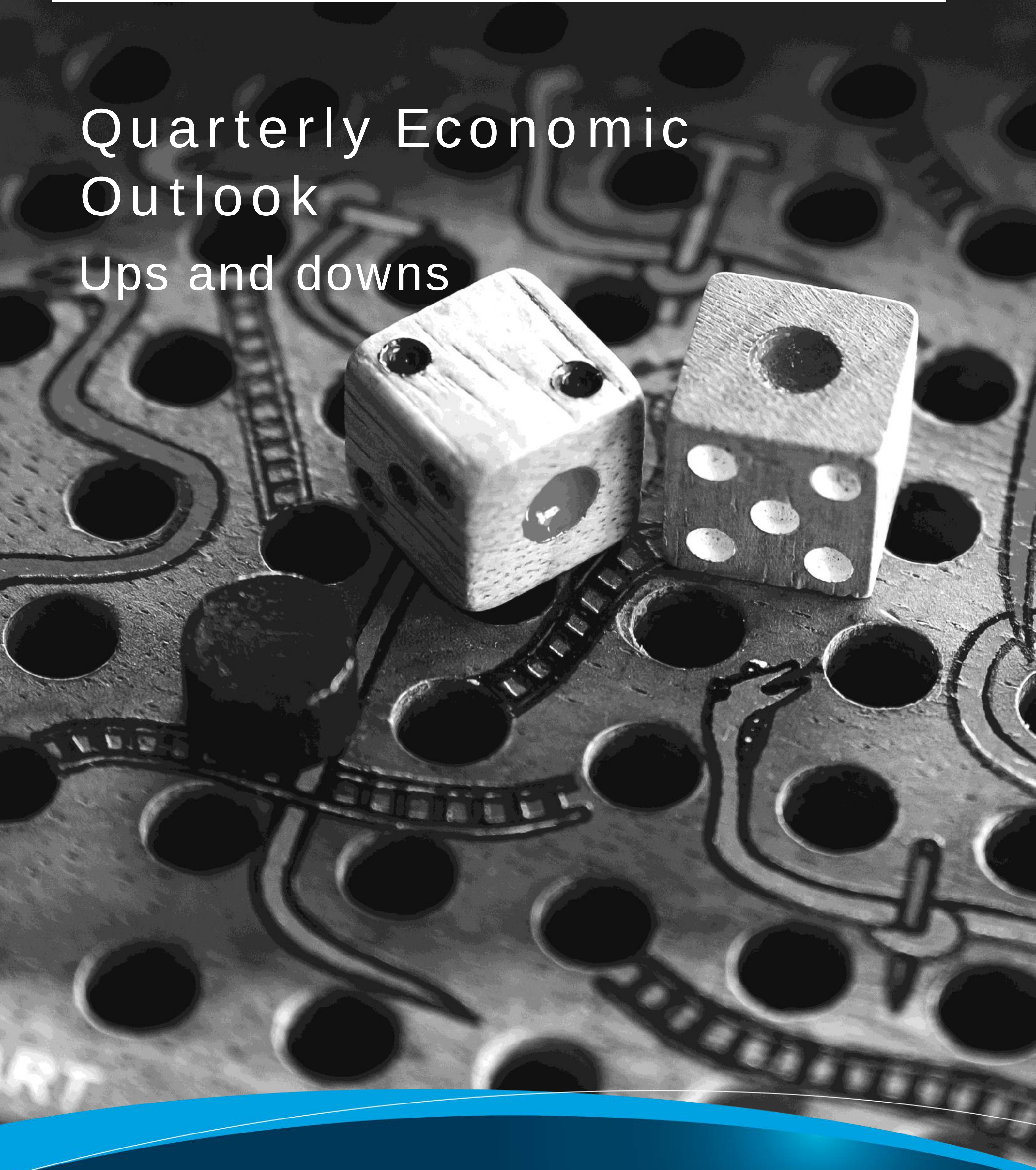
Quarterly Economic Outlook

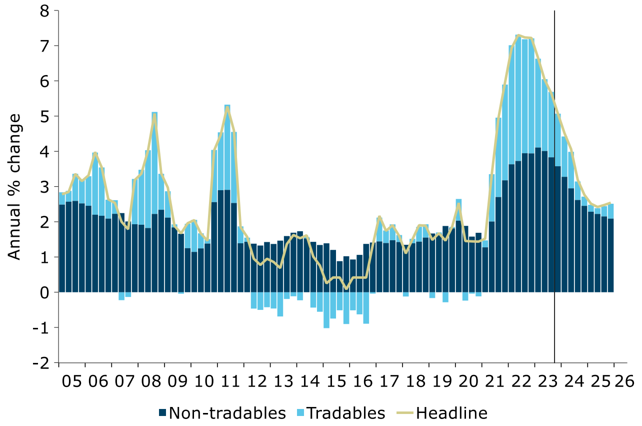
Ups and downs



Summary of forecasts

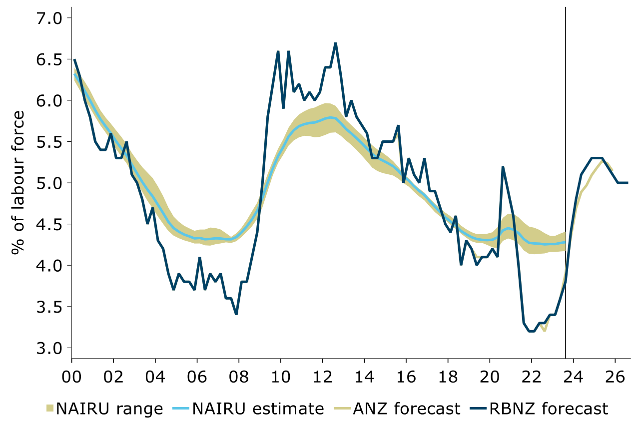
CPI inflation is off its peak…

But this has been mostly driven by tradables. Non-tradables has a long way to go, and is typically sticky.



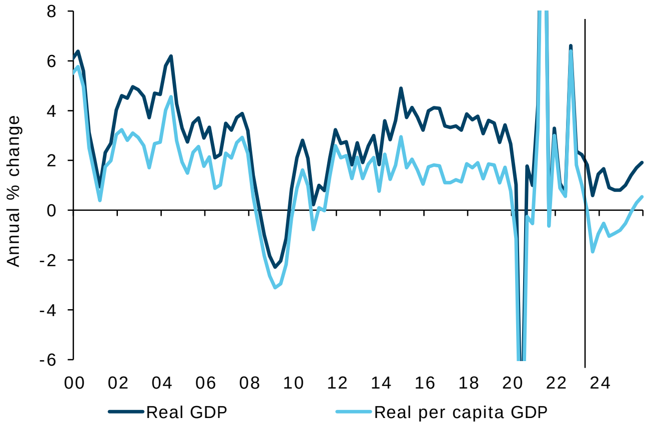
…and the labour market is loosening

But a sustained period in 'loose' territory will be required to drive non-tradable inflation lower.



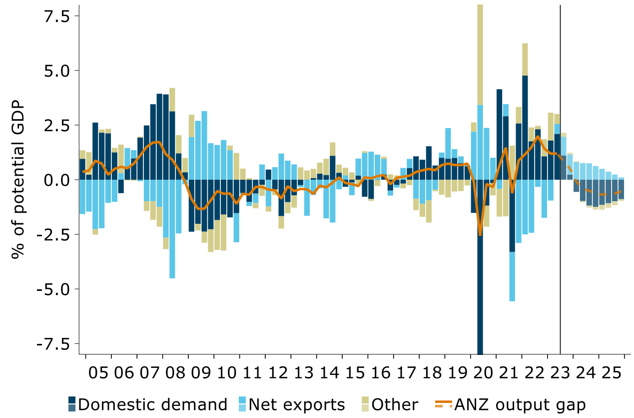
Migration-led population growth is back

And it's masking a very weak GDP outlook in per capita terms.



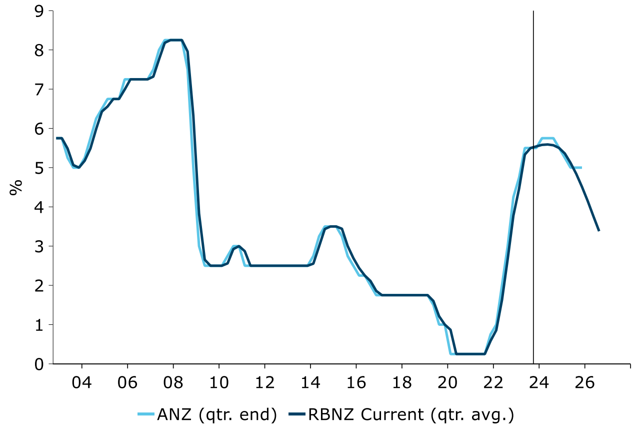
Softer domestic demand is part of the plan

As this is what's going to engineer the necessary degree of spare capacity in the economy (a negative output gap) to drive inflation down.



A higher OCR is still on the cards

We think the RBNZ will need to come back to the hiking table in 2024, but there are risks on both sides.



Inside

Source: Stats NZ, RBNZ, Macrobond, ANZ Research

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A note from the Chief Economist, Sharon Zollner

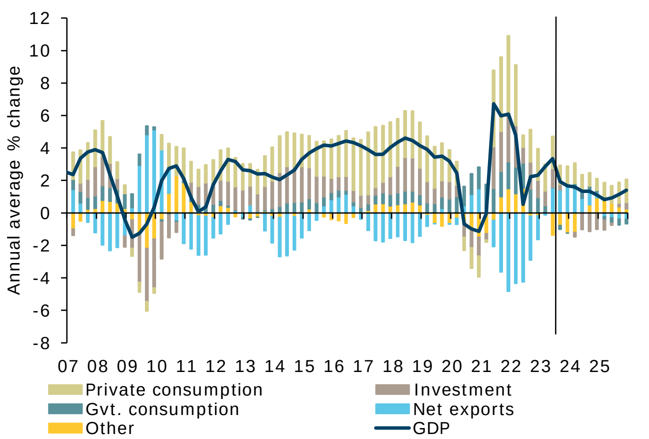
The last few years have been a wild ride for the New Zealand economy. GDP growth went literally off the charts when the lockdowns happened, and even now, the after-effects of the chaos of the COVID period continue to ripple through the economy. No wonder things are volatile, with the economy having faced:

- Unprecedented supply-side disruption – not only short-term lockdowns, but also longer-running disruptions to shipping and to the ability to import labour.
- Unprecedented monetary stimulus, with a record-low Official Cash Rate (OCR) and quantitative easing, followed by the most rapid increase in the OCR ever seen.
- Enormous fiscal stimulus.
- The most extreme house price cycle in decades.
- Extreme weather.
- Very large swings in our commodity prices.

All the noise has not made it any easier for the Reserve Bank (or any other forecaster) to discern trends in a timely manner. But recent data confirms that monetary policy is working, with aggregate supply and demand coming back into balance perhaps a little faster than we previously expected. Yet the inflation-fighting job remains far from done. In this Quarterly Economic Outlook we draw together the strands of the recent data to update the outlook.

The overall forecasts are actually little changed from our August edition. Monetary policy is successfully cooling the economy, but stimulatory fiscal policy and the demand-side impacts of record-high migration are slowing progress in some areas. We expect the economy to continue to cool, as a soft underbelly for domestic demand more than offsets the ongoing net exports recovery (with international tourism and education continuing to recover and import demand softening.

Figure 1. Decomposition of economic growth



Source: Stats NZ, ANZ Research

But although demand is cooling, it's still a long road to the 2% CPI target midpoint from here, and a lot of ducks have to line up: oil prices, inflation expectations, the housing market, and the labour market all have to play ball. We go though some of the risks to our forecasts on page 15, but overall we still see risks tilted towards inflation holding up longer than is acceptable, with the RBNZ hiking again in 2024. The economy is slowing, but domestic inflation is still very high, and the RBNZ's forecast that it's about to suddenly drop away still feels optimistic.

However, it's clear that here and now, there is no smoking gun to prompt a deviation by the RBNZ from its current watch, worry, and wait stance. Things are going in the right direction. By the February Monetary Policy Statement, at which we have pencilled in a resumption of hiking, we'll have another read on every piece of quarterly data, and a bunch more monthly indicators as well. We love all data, but we'll be particularly watching for:

- More evidence on the demand impact of migration, particularly on the housing market (rents and house prices).
- Whether our commodity prices are going to continue to lift, or slump once more.
- Whether the improvement in business sentiment seen over the year continues, or whether the lagged impacts of monetary policy mean the shoe is about to drop.

Of course, we've had an election as well. Any change to fiscal settings is unlikely to result in a material change in broad economic conditions any time soon (fiscal policy is a slow ship to turn). Even if we do see a mini Budget this year, in terms of macroeconomic impacts it's likely to be more 'mini' than 'budget'. However, looser housing-related policy is likely to act as a slightly stronger economic tailwind than otherwise.

Overall, we see the economy muddling through, with some unders and overs, and certainly winners and losers as the big forces (monetary, fiscal, global and demographic) that are buffeting the economy play out. But unfortunately, whether more medicine via another OCR hike is needed to bring it about or not, it'll likely feel like hard yards overall. Strong population growth will mask the weakness that'll be more evident in per capita spending as people watch their pennies. We see the unemployment rate continuing to rise. The agricultural sector is contending with a significant reduction in incomes with export prices low and operating costs (including interest costs) trending higher. But hopefully, the reward for all this restraint will be steadily falling inflation and an improving balance both fiscally and with the rest of the world that will set the economy up for future success.

Key economic drivers

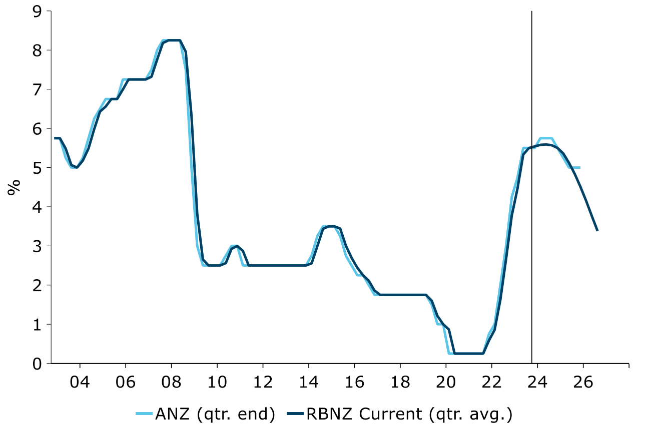
Clash of the titans

The battle between economic tailwinds and headwinds continues to play out. A turning housing market, surging net migration, and expansionary fiscal policy are landing some hefty blows against contractionary monetary conditions, softer global demand, and heightened geopolitical tensions and global market volatility. There are clear winners and losers in the resulting patchy outlook. Overall business sentiment is well off the floor, but remains generally low. Until the RBNZ has CPI inflation back in the bag, it's hard to see economic conditions turning 'rosy' any time soon. However, whether it's a stronger housing market, a lower exchange rate (adding fuel to the net exports recovery), or a stronger household sector, it's still a case of be careful what you wish for. With inflation this high, monetary policy would have to lean against any sources of renewed (or sustained) inflation pressures with a higher OCR than otherwise, whether that's a higher peak than the current level of 5.5% or a deferral of eventual OCR cuts. In that context, muddling along and quietly disinflating isn't a bad adjustment path, if the economy can hold the line.

Let's dig into some key drivers in a little more detail.

Monetary policy. The RBNZ is aiming to set the OCR at the level required to engineer a degree of excess capacity in the economy sufficient to return CPI inflation to target in a timely manner, while avoiding doing more damage to growth and employment than necessary. It's not a case of returning the economy to sustainable 'equilibrium' (ie closing the output gap); they need to engineer a sustained period during which economic supply exceeds demand (a negative output gap) in order to achieve their target. While the output gap does appear to be on verge of closing (we expect it to close by year-end), and is expected to be in negative territory from 2024, we think it'll take a slightly higher OCR to keep this dynamic in play.

Figure 2. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

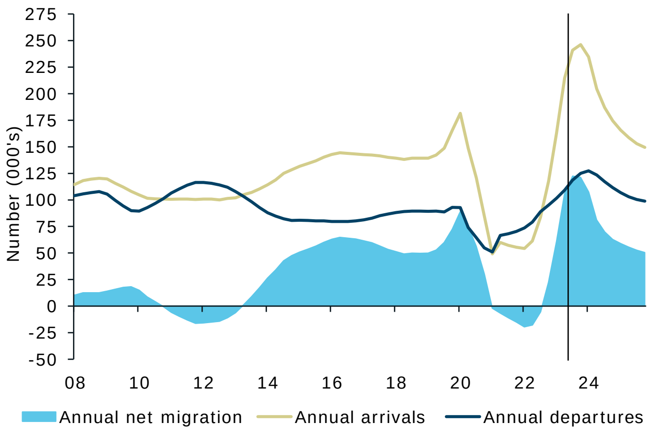
We've pencilled in a 25bp hike for February, but with some of the recent data suggesting the imbalance between aggregate supply and demand may be resolving a little faster than expected, risks are shifting towards a later resumption of hikes, or if the data flow keep surprising on the less-inflationary side, perhaps no further hikes this cycle at all. But let's not get ahead of ourselves: domestic inflation is still sky high, and yet to capitulate. A lot still needs to go right for the OCR to not need to eventually go higher.

Fiscal. Broad fiscal settings are unlikely to change much in the very near term from the rather stimulatory settings announced in Budget 2023. See page 6.

Migration. Living up to its reputation, recent net migration releases have delivered some big surprises, with the combination of consecutive upwards historical revisions and a stronger-than-expected monthly run rate meaning our prior expectation for a net inflow of 75k people over 2023 was too low. We now see this coming in closer to 120k, and that's assuming a moderation in the pace of monthly inflows over the remainder of the year. Seasonally adjusted monthly net inflows appear to have peaked way back in April (28.5k arrivals, 11.5k departures, ~17k).

All up, a cooling economy, and therefore cooling labour demand, is assumed to see annual net migration moderate to just over 60k by the end of 2024, and around 50k by the end of 2025 (around 10k higher than previously assumed). But policy changes may impact the outlook as well.

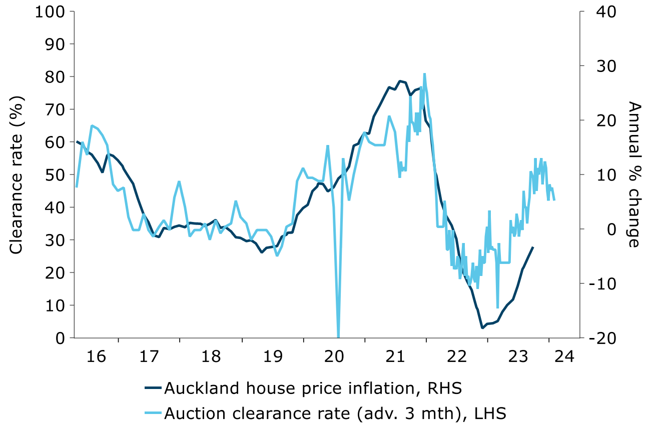
Figure 3. Annual net migration



Source: Stats NZ, ANZ Research

Housing. While the impacts of net migration on CPI inflation are ambiguous (as it adds to both supply and demand), the impacts on activity and the housing market are not. Strong population growth is underpinning both rents and housing market activity. Traditionally, Auckland tends to get more than its fair share of migrant inflows, making its housing market more sensitive to migration. But the auction clearance rate has dipped a little and the September REINZ data was nothing flash (figure 4). That possibly reflects election-related uncertainty, but it's also true that housing headwinds (chiefly higher mortgage rates and stretched affordability) are still blowing very strongly.

Figure 4. Auckland auction clearance rates



Source: REINZ, Barfoot & Thompson, interest.co.nz, Macrobond, ANZ Research

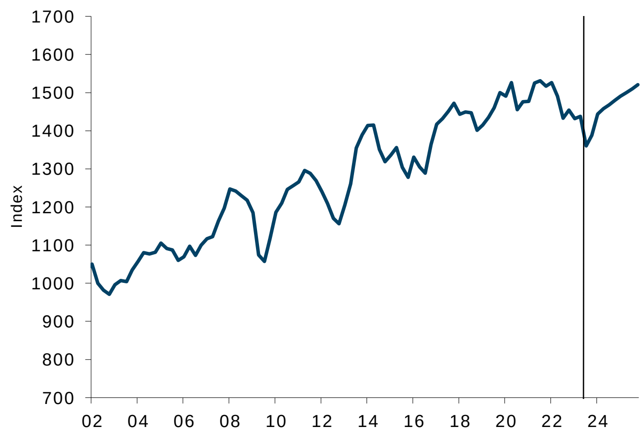
A number of housing-related policy tweaks have coincided with the turn in the housing market (such as loosening LVR restrictions and CCCFA legislation), and it's possible this has added a larger temporary bump to price pressures than we assume. A change in Government means additional investor-friendly tax and other policy changes are now in the pipeline, and that will provide a boost to the to the market, all else equal. However, it's unclear how much of this may have already occurred, given polls have been suggesting a change of Government for some time. Conversely, the RBNZ has signalled that debt-to-income (DTI) restrictions could be in place come mid-2024. The initial settings may or may not be restrictive. But certainly, the more investor demand picks up in response to other policy changes between now and mid-2024, the more likely DTI limits will be set at binding levels (and/or LVR limits) for investors at least (note: the RBNZ's prior analysis suggests DTI limits are likely to weigh more on investors than first home buyers).

All in all, despite looser housing policy and surging migration, we think higher mortgage rates and a softening labour market will continue to cap borrowing capacity and demand more broadly, limiting the upside for house prices. But the RBNZ will be nervous about a possible resurgence in the housing market over the coming summer, as that would suggest monetary tightening may not quite be getting the *sustained* traction that's needed to get CPI inflation lower in a reasonable timeframe. Our house price forecast is for relatively modest growth from here, but we are braced for a stint of potential data surprises in the near term as election-related noise infiltrates the upcoming data.

The global picture. Global cyclical conditions certainly do not appear favourable for New Zealand's net exports recovery. The Chinese economy appears to have found a floor, but there are lingering structural issues (such as an aging population and debt concentration risks) that are likely to limit the upside. Central banks across many of our other trading partners are trying to get their consumers – our exporters' customers and our tourists – to tighten their belts to tame CPI inflation.

We have downgraded our near-term outlook for the terms of trade, largely reflecting weakness in dairy prices over Q3 alongside sharply higher oil prices. However, dairy prices have since recovered meaningfully and oil prices are off their recent peaks, meaning a rebound is expected over the next half-year. Beyond the near term, while the terms of trade are expected to trend higher over time, a challenging global backdrop is expected to limit the upside.

Figure 5. Goods terms of trade (OTI)



Source: Stats NZ, ANZ Research

Economic sentiment remains sup-par, but has improved. Consumer confidence is creeping higher from very pessimistic levels as slowing inflation (a positive for confidence) meets a softening labour market (a big negative). Meanwhile, business sentiment has lifted sharply, with most activity indicators now back in the black. While there's still a long slog ahead for both businesses and households, there appears to be a sense that the worst may now be behind them.

All up, it remains a mixed bag for key economic drivers, but one thing we can be sure of is that the RBNZ will respond as economic conditions evolve. Braking hard enough to bring inflation down while avoiding a spin-out will take some skill. But unless the wheels fall off, OCR cuts remain a distant prospect.

Special topic: Fiscal outlook

New government, similar fiscal outlook (for now at least)

The final vote count is in, suggesting New Zealand will have a three-party Government led by National.

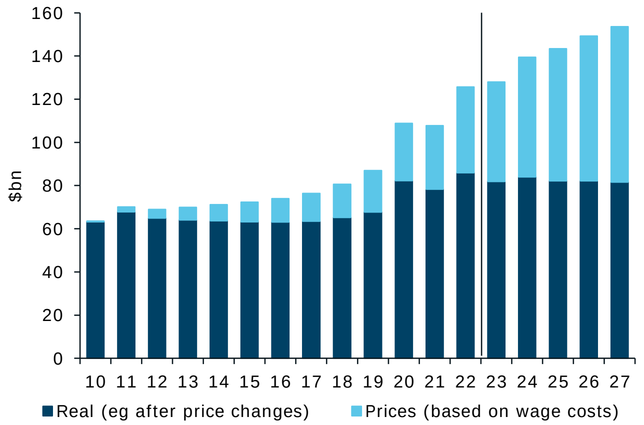
While it's possible we'll see a "mini Budget" released alongside December's Half-Year Economic and Fiscal Update (HYEFU), we're not convinced there will be sufficient time to conclude coalition negotiations and make meaningful adjustments to near-term fiscal settings (ie the current fiscal year to June 2024). The HYEFU must be released no later than 31 December, meaning the Treasury will be looking to lock down the fiscal forecasts anytime from late November (eg for a mid-December release). That said, the Treasury will be able to incorporate the Government's broad policy agenda into the medium-term forecast at HYEFU, but this is likely to be refined further in May's Budget Update, once the new Government has a chance to really get stuck into the details of fiscal policy settings.

As we noted after the election, from an aggregate demand perspective, the 'on paper' comparisons between a Labour-led Government and a National-led government appear relatively small, with National spending less (less demand from Government) but taxing less (more demand from the private sector): same-sized milkshake, different flavour. However, looser housing-related policy is likely to act as a slightly stronger economic tailwind than otherwise.

One key uncertainty is whether coalition negotiations will result in deeper spending cuts than signalled in National's fiscal plan. Even after adjusting for the higher cost of delivering Government services, the new Government is inheriting a material increase in real government expenses compared to pre-pandemic levels. Depending on the cost deflator estimate used in the calculation, real core Crown expenses as outlined in the Pre-election Update are $15-20bn higher per year over the forecast period compared to pre-pandemic (2019) (figure 6).

For context, the National party's pre-election fiscal plan was to cut spending by $8.5bn on a cumulative basis to 2028, suggesting there's scope for much deeper spending cuts while still maintaining a larger public service compared to pre-pandemic. The question is whether there's political appetite to reduce the size of Government by more than signalled, and if so, whether that happens quickly (with material cuts to spending) or slowly (eg by making larger reprioritisations and containing growth in new spending cover the coming years). While the sharper path would help take pressure off CPI inflation here and now, meaning the OCR wouldn't need to remain as high for as long, delivering significant spending cuts in short succession won't be easy, or popular.

Figure 6. Contributions to core Crown expenses



Source: The Treasury, ANZ Research

When it comes to assessing risks to the fiscal outlook, the new Government's fiscal strategy will be key. The previous Government loosened their strategy after COVID, abandoning a debt 'target' and being relatively vague about when it will return the operating balance to surplus. That, in our view, skewed the balance of risks towards further increases in Government spending over time, particularly if the economy performed better than expected, bolstering revenue, and taking pressure off expenses (a pro-cyclical, and therefore unhelpful, dynamic from a monetary policy perspective). We suspect a National-led Government will adopt a tighter fiscal strategy, meaning less scope for looser fiscal policy surprises, less scope for further slippage in balancing the books, and a lower likelihood that the RBNZ will have to offset further fiscal expansion with a higher-than-otherwise OCR.

The Budget Policy Statement, which is normally released alongside the HYEFU (but can be as late as 31 March) will outline the new Government's fiscal strategy.

All up, while the change in Government doesn't appear to be a game changer in terms of the 'on paper' fiscal policy impacts on aggregate demand, the housing market is likely to be a little stronger than otherwise. That's a small upside risk to CPI inflation that we think is broadly offset by the risk that Government spending is cut by a little more than signalled. But to get a handle on that, we'll probably have to wait until May's Budget.

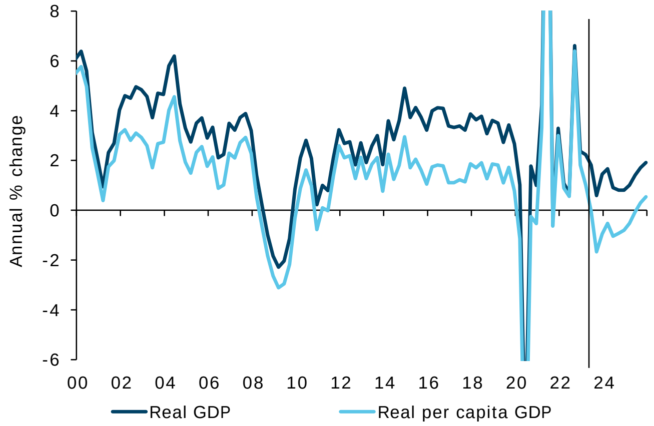
GDP outlook

Population growth driving GDP growth

The New Zealand economy bounced sharply in Q2, recording a strong 0.9% q/q expansion. Some of that strength reflects a rebound from weather disruption in Q1 and can therefore be teed up to noise. But combined with positive historical revisions, we think there's also a touch more economic momentum under the hood than previously thought. While tight monetary conditions are a considerable headwind to growth, the tailwinds from net migration and fiscal expansion have so far proven quite meaningful.

Compared to our last edition, we've made only small tweaks to our outlook for economic activity. A stronger net migration impulse is expected to add a smidgen more strength to headline GDP, with per capita growth remaining very weak (figure 7).

Figure 7. Headline vs per capita GDP



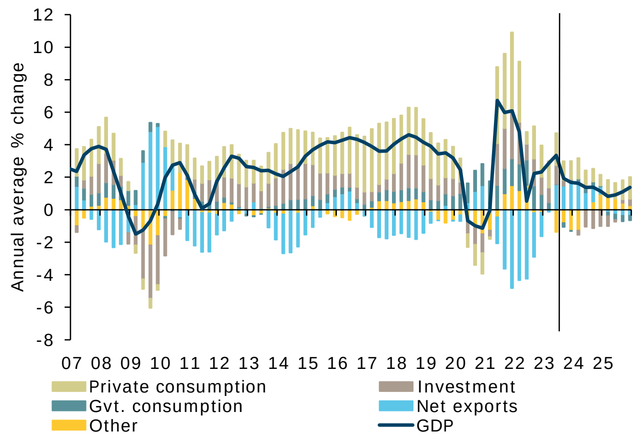
Source: Stats NZ, ANZ Research

Following the change in Government we've changed the mix of domestic demand in our outlook slightly, with weaker government consumption offset by higher private consumption (reflecting tax cuts). Primary export volumes are also expected to be a touch weaker, with milk production down on the back of challenging weather conditions, and forestry exports lower, reflecting subdued demand in China.

Beyond these minor tweaks, the broad composition of our medium-term GDP outlook is little changed from that presented in our August edition. The economy is expected to continue its post-pandemic normalisation, with services exports (chiefly international tourism and education) continuing to recover. Meanwhile, domestic demand is expected to remain subdued as restrictive monetary conditions weigh.

Interest rate sensitive pockets of the economy such as residential investment, business investment, and household spending on durable goods are expected to underperform the broader economy. And that's expected to weigh on demand for imports, which, alongside recovering services exports, will see net exports provide a meaningful offset to slowing domestic growth over 2024 (figure 8). Importantly, the positive net exports contribution masks what can only be described as tough times ahead for primary goods exports (see Agri outlook).

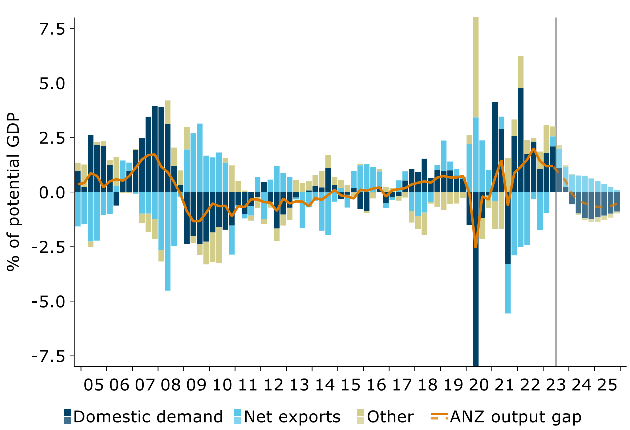
Figure 8. Contributions to expenditure GDP



Source: Stats NZ, ANZ Research

Cyclone impacts, wonky seasonality in some GDP components (reflecting the ongoing post-COVID normalisation), lockdowns, and ongoing methodological adjustments to data (largely due to COVID impacts) have resulted in some significant volatility in the GDP data in recent years. That's made diagnosing the underlying signal all the more challenging. Looking through the noise isn't always easy, but we are confident that growth is trending well below its historical average of 0.7% q/q and estimates of potential GDP growth. As figure 9 shows, domestic demand remains on track to see the output gap turn negative by 2024, which is exactly what's needed to tame CPI inflation. See the inflation section for more.

Figure 9. Activity contributions to output gap



Source: Stats NZ, Macrobond, ANZ Research

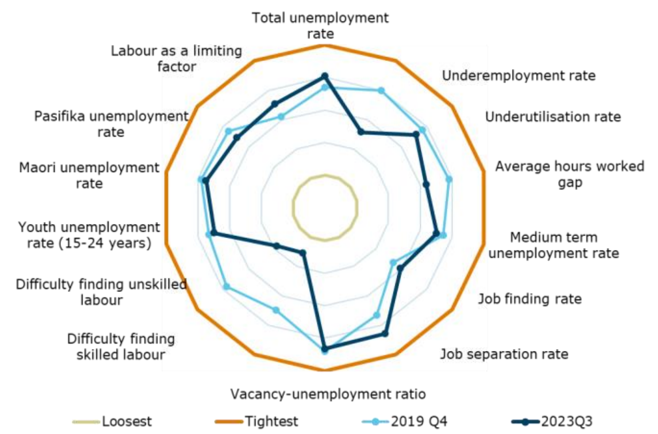
Labour market outlook

From scorching to tepid, and eventually cool

The Q3 labour market data signalled a clear turning point in labour market conditions. While labour market pressures have been easing this year, that has largely been a story of recovering labour supply. But the Q3 data showed that labour demand is now also cooling, with employment unexpectedly contracting and labour force participation falling from its peak. Continued supply expansion in conjunction with slowing labour demand is a potent mix that should see the unemployment rate rise relatively quickly in the near term.

We'd now categorise the labour market as being at or near 'maximum sustainable employment' (MSE). Of the 14 indicators of MSE, 10 are now in 'looser' territory than in Q4 2019, when the RBNZ assessed the labour market as being "at or slightly above" MSE. That will give the RBNZ confidence that inflationary pressures stemming from the labour market have largely run their course. But that's only the first milestone. Ultimately, the RBNZ needs to see a fair amount of slack emerge in the labour market to generate the necessary downward pressure on inflation.

Figure 10. Suite of maximum sustainable employment indicators

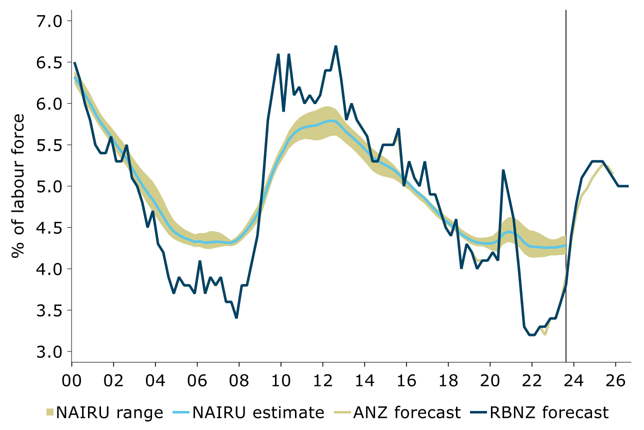


Source: Stats NZ, NZIER, ANZ Research

We are expecting to see the labour market cool fairly quickly from here. Weaker labour demand as economic activity softens, combined with solid growth in labour supply from net migration are together expected to see the unemployment rate rise to a peak of 5.3% in 2025.

It remains highly uncertain how much the labour market will need to cool to get inflation back to target. Our estimate of the non-accelerating inflation rate of unemployment (NAIRU) has fallen from 4.4% to 4.3%. In our forecasts the unemployment rate crosses that threshold early next year, but other indicators of labour market capacity pressure suggest we're already very close to that threshold, and it's also important to remember that the unemployment rate tends to lag broader labour market developments. We see the labour market transitioning to an outright disinflationary state later this year or early next year, but labour market conditions will need to remain soft for a sustained period of time.

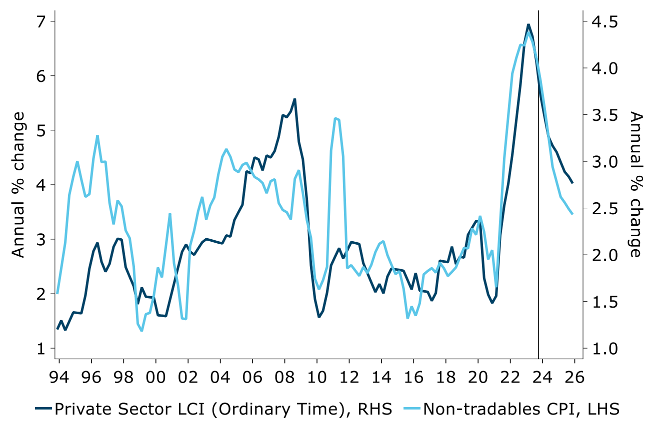
Figure 11. Unemployment rate vs NAIRU



Source: Stats NZ, Macrobond, ANZ Research

Generating slack in the labour market is a necessary condition for taking the heat out of wage growth, itself a key part of the RBNZ's recipe for bringing down domestic inflation. In Q3, wage data was, on balance, weaker than we and the RBNZ had expected, suggesting that the disinflationary impact of net migration on wages has occurred a little faster than anticipated. We now see a faster moderation in wage growth in the near term, but the transition to levels consistent with inflation at target will take some time. Still-elevated inflation expectations continue to present upside risks, and could put a floor under the initial moderation due to fading capacity pressures.

Figure 12. Wage growth



Source: Stats NZ, Macrobond, ANZ Research

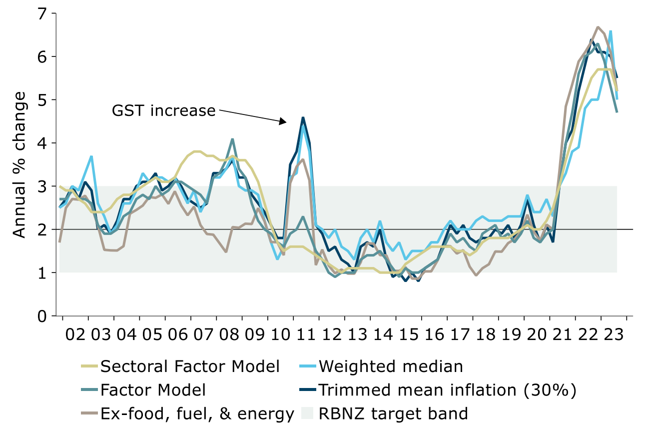
Softer labour market conditions are a grim outlook for households. But ultimately, it's what's necessary to get inflation down. Leaving the labour market at unsustainable levels would exacerbate the boom-bust in the long run, incurring more pain than it would save.

Consumers price inflation outlook

Turning point

The clear moderation across the suite of core inflation measures in Q3 was an important milestone for the RBNZ. While progress was evident, and buys time for the RBNZ to assess the sustainability of the downward trend, most core measures of inflation remain above 5%, a long way from the 1-3% target band. Inflation will return to the target band, though it may take a higher OCR to get it there in an appropriate timeframe.

Figure 13. Core CPI inflation vs 1-3% target band



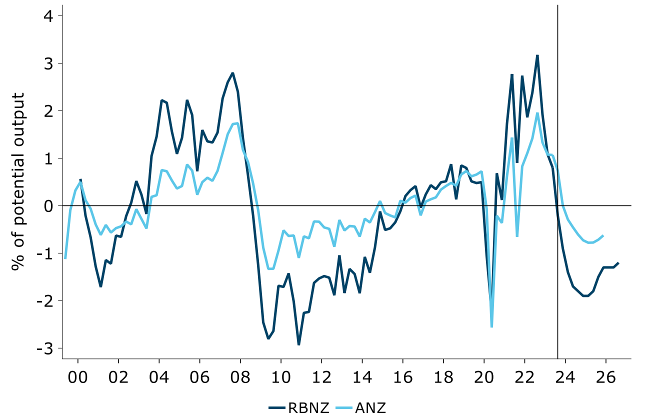
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Evident in the details of the Q3 CPI data, global goods disinflation is finally washing onto New Zealand's shores. While geopolitical instability is generating substantial volatility in oil markets, and poses upside risk to inflation, we expect a faster normalisation in tradables inflation than previously. Shipping costs are back to pre-COVID levels, global supply-chain disruption has faded, international airfares continue to fall as capacity increases, and food prices look to be returning to a 'new normal.' Those factors will drive a faster fall in inflation than previously expected, but the fall in tradables masks what's been very slow progress in reducing the domestic inflation pulse.

The fact is, we have yet to see a meaningful fall in non-tradables inflation. At 6.3% y/y, it is more than twice the level consistent with inflation at the 2% midpoint. It will slow; indeed, there are increasing signs that is occurring. Construction cost inflation is clearly cooling as activity slows, and the labour market is close to transitioning into disinflationary territory, aided by surging immigration. But there are also many drivers that point to persistence, such as migration-induced rises in rents, surging insurance premiums, and the annual adjustment of government-related charges to past inflation.

While these drivers are outside the direct influence of monetary policy, more broadly the necessary slack required across the economy to generate disinflation has yet to be achieved. That requires a negative output gap. We estimate it is on the verge of turning negative, but given the level of inflation in the system, a period of sustained below-trend growth is required to unroot sticky inflation expectations.

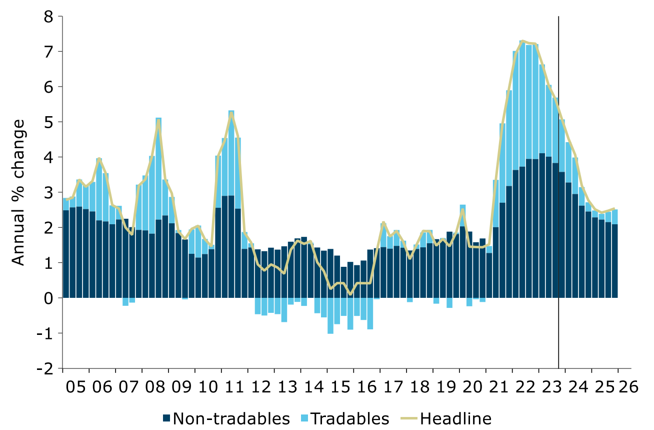
Figure 14. Output Gap Estimates



Source: RBNZ, Macrobond, ANZ Research

We expect headline inflation to return to the RBNZ's 1-3% target band by the end of 2024, helped by the tailwind of falling tradables inflation. But once the normalisation in tradables inflation has occurred, we see tradables inflation rising again, which could leave inflation stranded above the 2% target midpoint. Obviously anything that far out is massively uncertain, but there are plenty of arguments why global inflation could settle higher than experienced last decade: climate change, geopolitical fragmentation, increasing trade protectionism and re-shoring. Relying on tradables inflation to solve our inflation problem leaves us vulnerable. It could only take another negative supply shock to see the tradables tailwind switch to a headwind.

Figure 15. ANZ inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

Inflation targeting isn't likely to be 'easy' any time soon. We're yet to be convinced that the moderation in domestic inflation is occurring fast enough to secure progress. We think the balance of risks continues to be that that will ultimately require a higher OCR.

Buckling up and hunkering down on the farm as costs rise

The agricultural sector is contending with a significant reduction in incomes and profitability as export prices are currently low, whilst operating costs and interest rates continue to trend higher. Farmers are adapting to the low returns by cutting expenses where possible, which in turn is curbing economic activity in rural towns that service our agricultural communities.

Global demand for the goods New Zealand exports is weaker than normal, due to reduced economic growth across the majority of our trading partners, and a wary mood amongst consumers in China. In China, the prolonged lockdowns, a prolonged property downturn, and higher unemployment (particularly amongst youth) has resulted in consumers choosing to save more and spend less, which in turn has reduced demand for most of the goods we export to this market. While food is a necessity, New Zealand exports tend to sit at the more premium end. That's where you get the high returns, but also the high elasticity of demand as it's discretionary spending, ie a relatively easy thing to cut back on when you're watching your yuan. And our forestry exports are very exposed to the struggling Chinese property sector.

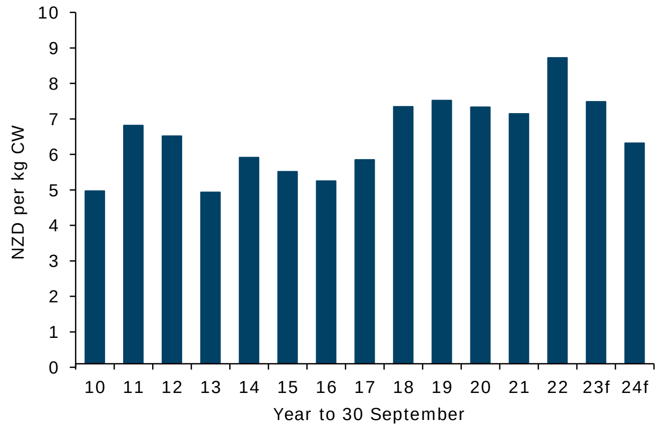
The export sectors that have been hit the hardest are raw logs and mutton, both of which have become highly dependent on demand from China. Exporters are trying to redirect some mutton and lamb into the Middle East to reduce their reliance on China, but this also has challenges given the political instability in this region.

More beef is being directed to the US market. Demand for manufacturing-grade beef remains robust as consumers trade down to lower-priced meals such as burgers rather than steak.

Sheep and beef farmers are bracing themselves for a particularly tough season and it will be challenging for many farms to break even. Lamb prices are forecast to be the lowest since 2017, and on-farm costs are massively higher than they were then. High lamb survival rates this season do mean there will be more lambs available to process, but this extra volume is expected to put further pressure on pricing. The volume of meat being produced in Australia is very high at present as farmers destock in drought-prone regions. This additional supply is also putting downward pressure on global returns, though the impact will reverse to some extent next season.

Dairy commodity prices have lifted, and if the trend is able to be maintained through the season the majority of farmers should be able to break even as long as they keep spending in check. Debt levels in this sector remain relatively high – despite some progress on debt repayment being made in recent years – meaning interest costs are burdensome for many farmers.

Figure 16. Average farmgate lamb prices (year to September)

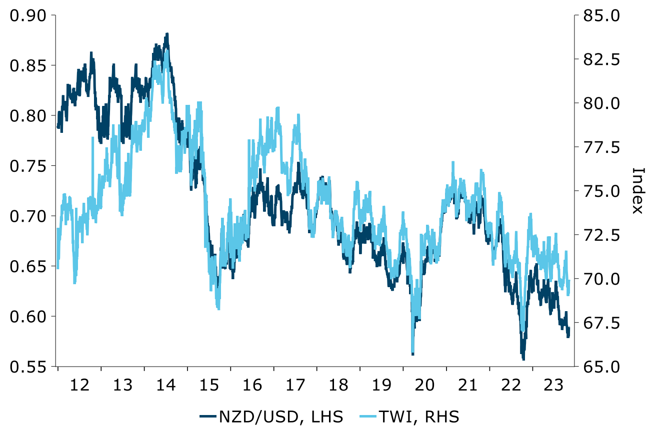


Source: AgriHQ, ANZ Research

Low yields have been the consistent theme for our horticulture sector this season. That has had a small silver lining insofar as it has been somewhat supportive of prices. The kiwifruit export season finished up 10 weeks earlier than normal but the challenge for this sector will be to maintain quality and returns with a much larger crop forecast for 2024.

The low NZ dollar is providing some buffer to the low commodity prices in terms of export returns, but it has also contributed to higher operating costs as fertiliser, diesel and machinery is typically imported.

Figure 17. NZD/USD and NZD TWI



Source: RBNZ, Macrobond, ANZ Research

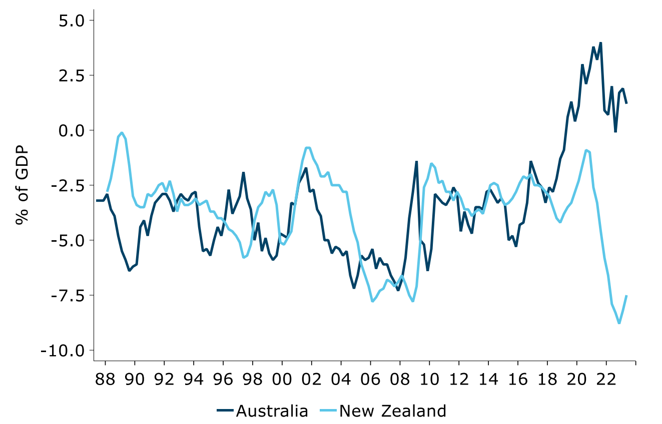
Overall, this season will be one where our primary sector buckles up, but doesn't buckle. Operators will need to concentrate on using resources as efficiently as possible to minimise costs whilst also continuously improving environmental outcomes. See out latest Agri Focus for more.

Current account outlook

Better starting point, but a long way from sustainable levels

Largely due to favourable historical revisions, the annual current account deficit was narrower than our prior expectation in Q2. But at a still-whopping 7.5% of GDP, New Zealand's deficit remains deep in 'out of balance' territory, particularly when compared to other advanced economies, including Australia (figure 18).

Figure 18. Annual current account deficit



Source: Stats NZ, ABS, Macrobond, ANZ Research

Part of the recent widening reflects too much historical fiscal and monetary stimulus for the conditions (overheating the economy and sucking in imports in the process), and some of it reflects the impact of closed borders (turning off a key foreign income earner).

Reopened borders and monetary tightening (which will weigh on domestic demand and therefore imports) mean there is certainly more narrowing in the current account deficit to come. However, near-term fiscal stimulus will work against this to some extent. And while the low-hanging fruit is being picked (tourism recovery and cyclical forces), we think it'll be a long time before the annual deficit is back at "sustainable" levels.

As we outlined in a recent Insight note, returning New Zealand's trade balance to surplus could prove difficult as the likes of 'peak cow', China's aging population, deglobalisation, an upwards trend in import dependency, and climate change present challenges. And while it's not one-way traffic, the net impact is likely to mean wider-for-longer current account deficits. While these factors have been incorporated in our forecasts (as best we can) for a long time, each carries their own distribution of risks.

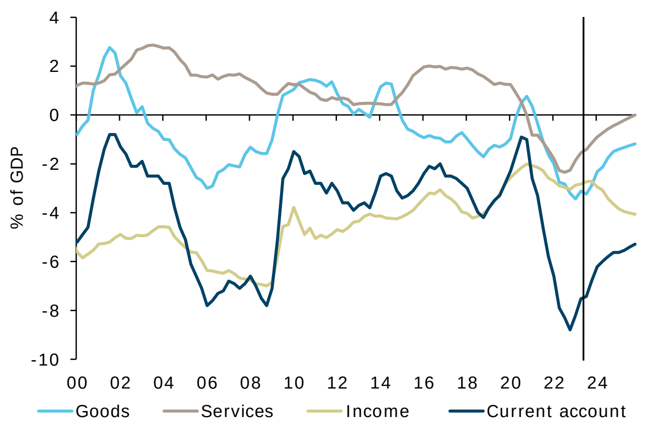
Turning to the outlook, given subdued global demand (weighing on demand for our exports) our expectation that the annual goods deficit will narrow from here will require sustained moderation in imports, as tight monetary conditions continue to weigh. Meanwhile, growing risks of drought conditions stemming from El Niño conditions add downside risk to export receipts, albeit one that we'd expect to see a partial offset via prices if primary production is significantly impaired.

The ongoing recovery in international tourism is expected to see the annual services deficit flip back into surplus at the end of the forecast period (late 2025), but only just. International visitor arrivals have recovered to over 80% of pre-pandemic levels, though weakness in China's economy risks the recovery stalling somewhat. Ultimately, given ongoing growth on the imports side, services exports will need to lift beyond pre-pandemic levels for the services balance to flip back into surplus, which may be a hard slog in the context of a slowing global economy. A weaker NZD would certainly help here (see markets section).

All the while, the higher global interest rate environment combined with New Zealand's very large external debt position means a narrowing goods and services deficit will face a meaningful offset from a widening primary income deficit. We expect the annual income deficit to continue widening over the forecast horizon.

Putting it all together, our forecast has the current account narrowing to 5.3% of GDP by the end of 2025 – still too wide to call "sustainable".

Figure 19. Current account forecast



Source: Stats NZ, ANZ Research

At these levels, the current account remains a key vulnerability for the economy. Tighter monetary and fiscal policy settings have a key role to play in constraining import demand, but with risks to our export performance skewed south, New Zealand has a potentially lengthy, and not very fun, path towards macroeconomic sustainability to walk. Higher interest rates (via a widening risk premium) and a weaker currency may well prove to be necessary parts of that transition.

Markets outlook

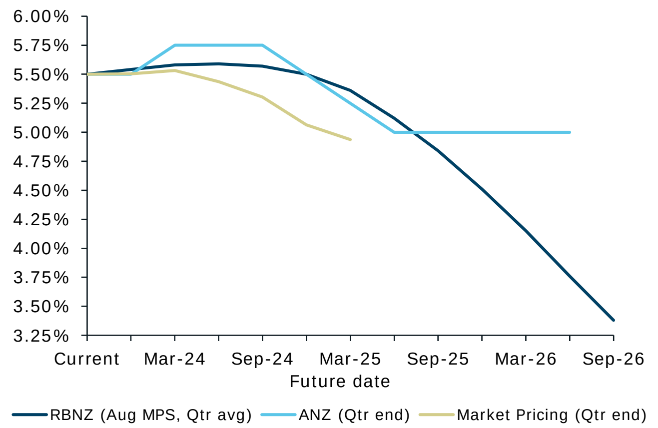
Short-term rates have scope to drift higher, but 2yr rates have likely already peaked

The triple combination of lower-than-expected (but still high) Q3 CPI data, evidence of a cooling labour market and growing expectations that the US Federal Reserve ("Fed") is done with hikes has put downward pressure on local short-end rates since they peaked in early October. In terms of the direction of travel, those moves are entirely understandable, but the moves have been large. As we go to print, key bellwethers like the NZ 2yr swap rate are back at lows not seen since June, shortly after the RBNZ put the OCR on ice at 5.5%.

We won't rehash the inflation outlook in detail here (see page 9), but in terms of the recent data evolution, Q3 inflation and labour market data were certainly very encouraging from the RBNZ's perspective. In fact the CPI data showed sufficient progress (even if it was all on the tradable inflation side, rather than domestic inflation) for us to shift out the timing of the next OCR hike in our forecast from November to February. That was then followed by even more encouraging labour market data that further raises the hurdle to another hike. But at this point we are not satisfied that it's enough to take the chance of further hikes off the table. It's not because we don't think the RBNZ is making progress, but because that progress has been slow, there's still a long way to go, and progress could yet stall. We are also mindful of upside risks to housing and the weaker exchange rate, and as such, on balance, we are not yet confident that the RBNZ is done.

In contrast, markets *are* currently feeling confident the RBNZ has done enough (figure 20) and it's that gap that's behind our expectation that short-end rates will rise again before they eventually fall.

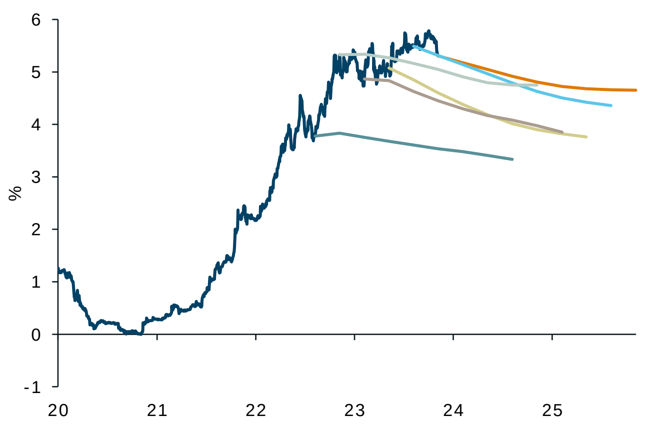
Figure 20. Market expectations for the OCR vs ANZ forecasts and RBNZ projections



Source: RBNZ, Bloomberg, ANZ Research

We questioned the markets' collective enthusiasm for pricing in cuts in our last quarterly. At that time, markets were pricing in a sharp fall in the bellwether 2yr swap rate, from its then-rate of 5.52% to 4.78% one year forward and 4.35% two years' forward. While the 2yr swap rate is now lower, at around 5.30%, during the past quarter it rose to a high of 5.85%, briefly defying those expectations. The whole time, markets have been pricing in lower future rates, and they still are today (figure 21).

Figure 21. Historic and forward implied 2yr swap rates



Source: RBNZ, Bloomberg, ANZ Research

This tendency for markets to price in lower rates regardless of the level of interest rates is typical late-cycle behaviour. We expect that tendency to persist, which is why we expect that the 2yr swap rate has peaked. In the short term, our forecasts assume that the 2yr swap rate will edge higher into year-end (thanks to our expectation – albeit a less firm one than previously – that we'll see another OCR hike). However, the tendency for markets to price in lower rates going forward and our own expectation that the RBNZ will eventually be cut (while we've pencilled in a hike for February, we have cuts in our forecasts from November next year) will cap the upside.

By contrast, very short-term interest rates like the 90-day bill will move in step with the OCR. They'll go higher as the OCR increases, and the move above 6% in our forecasts assumes that markets will price in the risk of follow-up hikes should another one be delivered (while still pricing cuts a little further out).

'Higher for longer' theme and bond supply the main risks for long-term rates

Global long-term interest rates rose to highs not seen since before the GFC in October, with the bellwether US 10yr Treasury bond yield exceeding 5% at one point. As a rule, NZ long-term rates tend to follow global rates, and this time was no different, with NZ 10yr bond yields briefly rising to just above 5.5%.

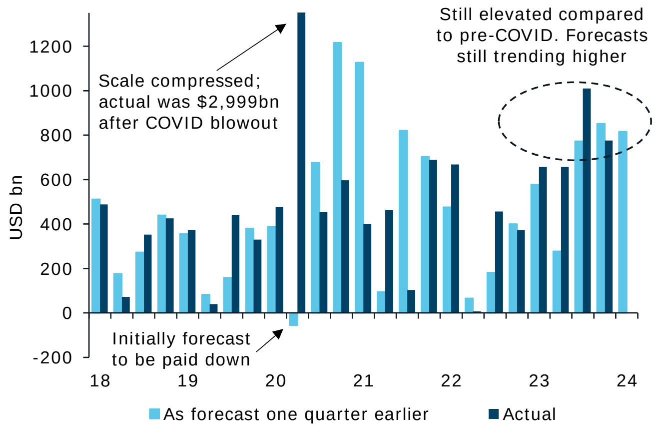
Markets outlook

We expect this closeness between US and NZ bond yields to continue, driven not just by historic tendencies, but by similarities between the issues facing the two economies and markets. Both central banks' policy rates are at 5.5%, both are on hold (for the time being at least), and both have made progress on inflation but are not yet ready to declare 'mission accomplished'. Both central banks have framed the policy outlook as one of rates remaining 'high for longer' and cautioned markets against assuming that cuts are just around the corner, given the theme of economic data over the past 12 months has broadly been one of more resilience than anticipated and labour markets that have been slow to turn (but now have). Given what's priced in, if cuts are slower to arrive than markets expect, that has upside implications for term interest rates. The apparent willingness of central banks to tolerate higher inflation over the near term in a bid to avoid a hard landing has put upward pressure on bond yields as investors seek compensation for potentially higher average inflation going forward.

But perhaps the biggest challenge facing global long-term interest rates is forecast bond issuance. This is another area of commonality between the US and NZ, with government bond issuance running at around 11% and ~9% of GDP respectively.

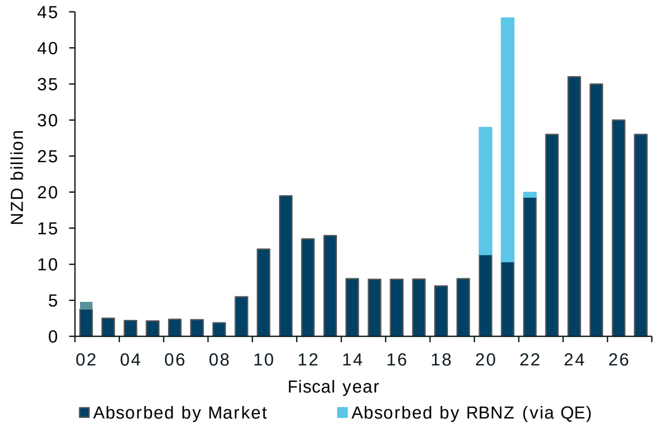
As figures 22 and 23 show, both bond markets are being asked to absorb nominal issuance volumes that have only once been exceeded (the initial fiscal response to COVID). The big difference is that back in 2020-21, central banks were absorbing much of the issuance via QE (we plot the NZ experience in figure 23). That's not the case right now, and instead markets are bearing the burden alone. That is keeping investors wary and is one of the main drivers behind our expectation for higher long-end yields, and eventually a positively sloped yield curve. But we expect plenty of volatility along the way.

Figure 22. US Treasury quarterly refunding estimates



Source: US Department of the Treasury, ANZ Research

Figure 23. NZGB issuance and net market absorption



Source: NZDM, RBNZ, Bloomberg, ANZ Research

NZD/USD: steady into year-end and then a gradual climb in 2024

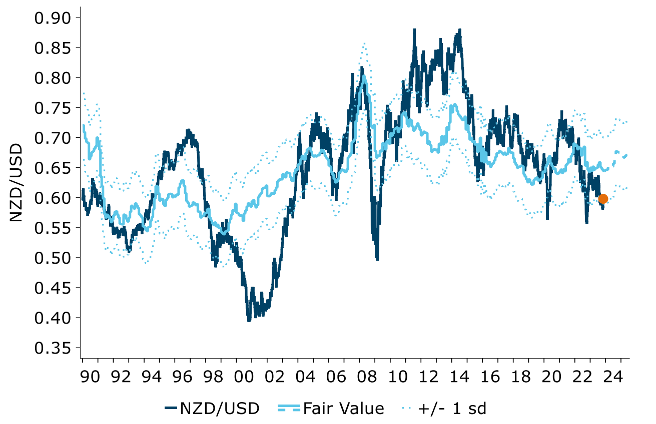
Our currency forecasts have the NZD/USD holding steady until the end of the year, and then gradually appreciating to 0.63 by the end of next year. The downside risks we discussed last quarter ended up materialising in the end, ultimately taking the Kiwi to a low just below 0.58, but as US bond yields have fallen from their highs, the USD has come back, giving the Kiwi some oxygen.

Our expectation for mild strength over 2024 remains guided by our fair value analysis, which puts long-term fair value at 0.63, and is further supported by our expectation of another OCR hike. Although as we have noted, that's a closer call than previously, we think markets' expectations for OCR cuts are likely to be disappointed for another year or so, and we expect that'll provide a leg of support for the Kiwi.

Returning to fair-value considerations, as we have seen in the past, FX markets can stray from fair value for months at a time, but it's unusual for them to move significantly beyond 1 standard deviation of fair value, and in the most recent move lower, that's roughly where the selling petered out (figure 24). We're not going to write off the USD just yet, even after the sharp fall in bond yields. One of the reasons Fed chair Powell cited at the November meeting for perhaps not having to hike again was high bond yields, but he also warned that high yields would need to be sustained (ie that markets couldn't have their proverbial cake (no more Fed hikes) and eat it too (lower bond yields). More time is needed to see how things play out, especially with the Israel-Hamas war and tensions elsewhere fuelling demand for safe-haven assets and currencies like the USD.

Markets outlook

Figure 24. USD DXY Index and our fair value estimate

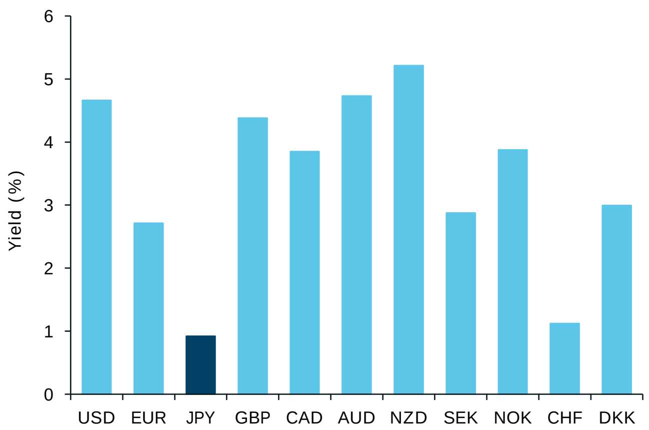


Source: Bloomberg, Macrobond, ANZ Research

But whereas we expect NZD/USD to appreciate gradually, our forecasts for key cross rates like NZD/AUD and NZD/JPY are lower, and that's expected to deliver a slightly lower TWI (our forecasts have it falling below 69 by year-end). NZD/AUD weakness is expected to be the result of narrowing NZ/AU interest rate spreads as markets firm up expectations for RBA hikes, with Australian core inflation surprising to the upside (while NZ Q3 inflation surprised to the downside).

NZD/JPY weakness is largely expected to be driven by yen strength (ie a lower USD/JPY exchange rate) as the Bank of Japan slowly exits its super-easy policy settings and allows Japanese bond yields to rise further. Whether we will see significant yen repatriation flows is uncertain. Even if Japanese 10yr bond yields (which the BOJ caps with yield curve control) were to rise significantly, they'd have to go a long way before they got remotely close to yields in the major "dollar bloc" bond markets (the US, Canada, Australia and NZ), as figure 25 shows. But even if Japanese bond yields were to rise only a little, if Japanese investors respond by paring back foreign bond purchases, that would still blunt an erstwhile negative factor for the yen.

Figure 25. G10 10 year government bond yields



Source: Bloomberg, ANZ Research

Table 1: Forecasts (end of quarter)

FX Rates	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25
NZD/USD	0.59	0.61	0.61	0.62	0.63	0.63	0.63
NZD/AUD	0.91	0.90	0.90	0.89	0.88	0.88	0.88
NZD/EUR	0.54	0.55	0.54	0.54	0.54	0.54	0.54
NZD/JPY	85.6	85.4	83.0	81.8	80.6	80.6	80.6
NZD/GBP	0.46	0.47	0.46	0.46	0.46	0.46	0.46
NZD/CNY	4.28	4.38	4.33	4.37	4.41	4.40	4.38
NZ$ TWI	68.7	69.8	69.1	69.4	69.5	69.4	69.3
Interest Rates	**Dec-23**	**Mar-24**	**Jun-24**	**Sep-24**	**Dec-24**	**Mar-25**	**Jun-25**
NZ OCR	5.50	5.75	5.75	5.75	5.50	5.25	5.00
NZ 90-day bill	5.83	6.07	6.10	5.93	5.82	5.57	5.33
NZ 2-yr swap	5.68	5.64	5.48	5.35	5.25	5.17	5.12
NZ 10-yr bond	5.70	5.75	5.65	5.50	5.35	5.25	5.00

Source: Bloomberg, ANZ Research

Key risks

Risky business

Compared to our last edition, the broad risk profile around the outlook is little changed. Geopolitical tensions are more heightened than previously, while on the other hand domestic data flow has suggested the RBNZ is so far getting the desired traction with its monetary tightening. In what follows we list a few key risks that if they materialised in a meaningful way, could alter the path of the OCR either slightly or significantly from our expectation. This list is by no means exhaustive!

Upside risks to the OCR outlook:

- Sticky inflation: While global disinflation has given a helping hand to the RBNZ, there's still plenty of upside risks to keep them worried. The Israel-Hamas war has caused renewed volatility in global oil markets and risks of contagion to the wider region, while low, could cause an unwelcome surge in inflation. That's not helped by a weak NZD. The RBNZ can generally look through such volatility, so long as it doesn't seep into broader inflation. But in the current high-inflation environment where firm margins are under pressure, and inflation expectations already far too high, we don't think the RBNZ would necessarily have the same luxury. Inflation is still really high, and the risk that expectations level out above target remains heightened.

- Housing market rebound: There are some fierce headwinds and tailwinds blowing in the housing market currently. The surge in demand from migration at a time of easing supply, combined with the proposed loosening of tax policy, alongside sometimes-unpredictable animal spirits could be a potent cocktail that drives a faster rebound in the housing market. If that catalyses into demand more broadly across the economy, keeping inflation high, that could create a challenge for the RBNZ. Our baseline assumption is that the housing rebound won't come to much, but if the current slump in long-term wholesale rates persists and starts feeding through into meaningfully lower fixed mortgage rates, the significance of this risk will grow.

- Migration momentum: Net migration flows, while easing from earlier highs, have been far higher than anticipated. While we've seen evidence of the disinflationary influence via labour supply, we're yet to see the full extent of the demand impulse. With capacity pressures in the labour market having now largely faded, demand-side impacts could start to outweigh the remaining supply-side effects, leading to a more inflationary impulse from migration from here.

Our central forecast assumes an only mildly inflationary net impact, as does the RBNZ's, but we see inflation risks as skewed to the upside.

Downside risks to the OCR outlook:

- Weaker fiscal impulse: We're yet to know the composition and policy mix of the incoming Government. In the near term, we don't expect material changes to the fiscal policy stance, but we certainly haven't ruled out the possibility that spending could be cut by more than signalled in National's fiscal plan (particularly if weaker taxes threaten to delay the return to OBEGAL surplus (which is something for which sovereign credit ratings agencies may have little tolerance). Weaker demand from Government would see the economy cool faster than otherwise, allowing for a faster return of CPI inflation to target.

- Slowing momentum in China: The path of China's economic recovery remains fragile, and deflation risks have not gone away. We've already seen the impacts wash onto New Zealand's shores via weaker export returns, and that's unlikely to change any time soon. As the global economy continues to slow due to tight monetary conditions, an absence of tourists from China may become more pronounced, hampering the ongoing recovery in the tourism sector, which has been one of the economy's bright spots.

- The emergence of global stresses: Global financial sector stresses appear to have faded from earlier in the year, but financial markets remain volatile. We're going through the largest re-pricing of risk since the GFC, and we are yet to see the full consequences of investment decisions made during the ultra-low interest rate period earlier in the pandemic. So far so good, but relative resilience in economic conditions may be masking these stresses; they are more likely to emerge as the global economy slows.

- El Niño and drought risks: The current El Niño cycle is expected to be one of the strongest New Zealand has experienced, raising the risk of drought conditions occurring this summer. If that were to happen, that could lead to a larger-than-usual economic impact given farmers are already under pressure from soft returns at a time of intense cost pressures. The combination of weaker production and prices could be a very nasty mix for the rural sector and the economy more broadly. It's not just the growth outlook. New Zealand's current account deficit remains far too wide, and near-term disruption would simply push us further off the course necessary to achieve a sustainable external position.

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	6.0	2.7	1.5	1.0	1.5
Private Consumption	3.2	-2.1	7.8	3.1	1.8	1.2	2.3
Public Consumption	4.7	7.1	8.2	4.6	0.0	0.6	-1.4
Residential investment	5.3	-3.1	8.4	1.0	-4.2	-4.0	1.8
Other investment	4.0	-5.1	13.7	5.1	2.1	-3.9	1.5
Stockbuilding[1]	-0.5	-0.8	1.4	-0.3	-1.5	0.9	0.2
Gross National Expenditure	3.1	-1.8	10.3	3.4	-0.1	0.7	1.7
Total Exports	2.6	-13.5	-2.4	0.2	8.6	2.0	3.1
Total Imports	2.3	-15.6	14.4	4.8	1.0	0.5	3.6
Employment (annual %)	1.2	0.6	3.3	1.7	1.6	-0.2	1.2
Unemployment Rate (sa; Dec qtr)	4.1	4.9	3.2	3.4	4.3	5.1	5.1
Labour Cost Index (annual %)	2.4	1.5	2.8	4.3	3.7	3.1	2.8
Terms of trade (OTI basis; annual %)	7.1	-1.6	2.8	-4.2	-4.5	6.6	2.8
Prices (annual % change)							
CPI Inflation	1.9	1.4	5.9	7.2	5.1	2.8	2.5
Non-tradable Inflation	3.1	2.8	5.3	6.6	5.9	4.1	3.5
Tradable Inflation	0.1	-0.3	6.9	8.2	3.8	0.7	1.1
REINZ House Price Index	5.2	15.5	26.3	-12.8	0.2	5.8	3.0
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.72	0.68	0.64	0.59	0.63	0.63
NZD/AUD	0.96	0.94	0.94	0.93	0.91	0.88	0.88
NZD/EUR	0.60	0.59	0.60	0.59	0.54	0.54	0.54
NZD/JPY	73.1	74.6	78.6	83.3	85.6	80.6	80.6
NZD/GBP	0.51	0.53	0.51	0.52	0.46	0.46	0.46
NZD/CNY	4.69	4.74	4.35	4.38	4.28	4.41	4.35
NZ$ TWI	73.7	75.2	73.2	72.1	68.7	69.5	69.1
Official Cash Rate	1.00	0.25	0.75	4.25	5.50	5.50	5.00
90-day bank bill rate	1.29	0.27	0.97	4.65	5.83	5.82	5.10
2-year swap rate	1.26	0.28	2.17	5.38	5.68	5.25	5.10
10-year government bond rate	1.65	0.99	2.39	4.47	5.70	5.35	4.80

[1] Percentage point contribution to growth

Forecasts finalised 7 November 2023

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

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We welcome your questions and feedback. Click here for more information about our team.

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Important notice

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