ANZ Research

February 2024

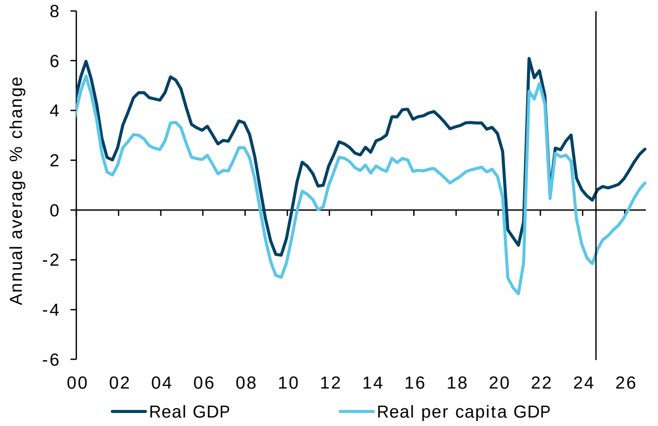
Quarterly Economic Outlook

Calibrating the landing

Summary of forecasts

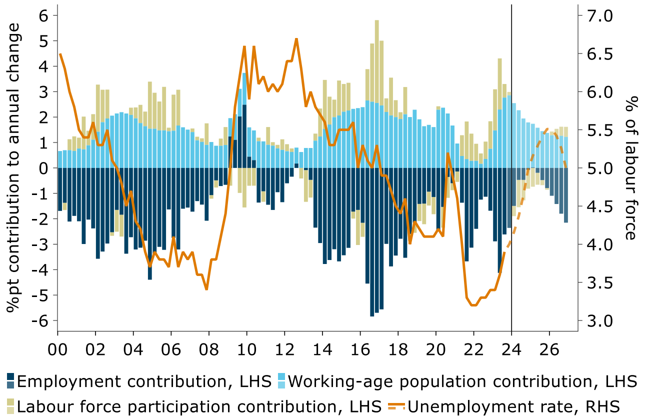
Population growth is bolstering GDP…

As tight monetary policy weighs at the household level, reflected by contracting per-capita GDP.



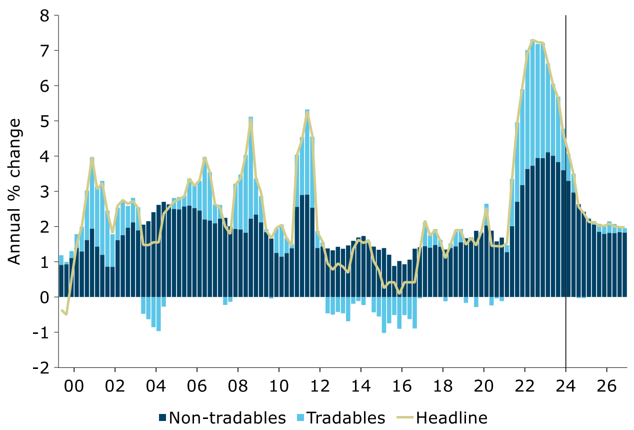
…and labour supply

This is driving the bulk of the expected loosening in the labour market.



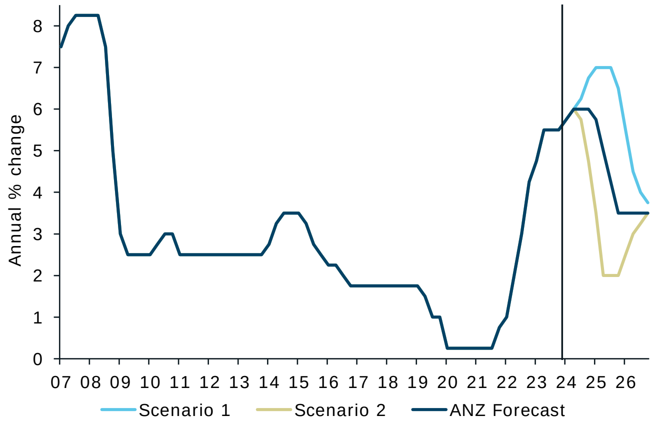
Non-tradables inflation is stubbornly high…

Which is a big threat to maintaining inflation sustainably around 2% over the medium term.



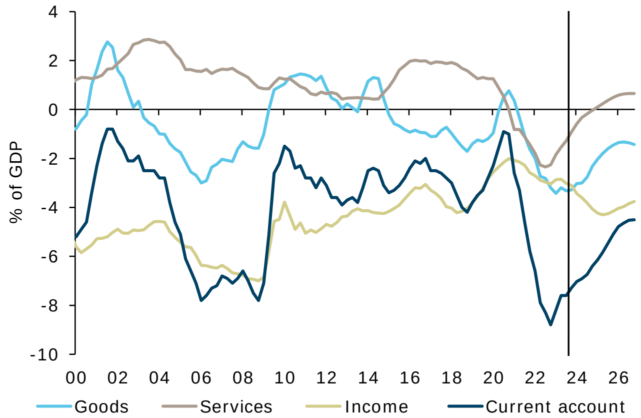
…but a 6% OCR should take care of that

But there's no guarantee the OCR won't have to go even higher. We present two scenarios outlining how the OCR could differ meaningfully from forecast.



External imbalance remains a big worry

But we appear to be on an improving trajectory.



Inside

Source: Stats NZ, RBNZ, Macrobond, ANZ Research

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A note from the Chief Economist, Sharon Zollner

Are we there yet?

The New Zealand economy continues to normalise following the wild ride COVID-19 set it upon. We've had the biggest housing boom in decades, a spectacular amount of prolonged stimulus from fiscal policy, wild swings in labour availability, and an increase in interest rates that's been far sharper than anyone initially envisaged. And now we are picking that rates will go higher yet.

The good news is that we are indeed getting back to a more normal world. No more talk of negative interest rates. No more money printing. And no one telling you how many people you're allowed to meet with for a BBQ and whether they can use your toilet.

The bad news is that we're not quite back to the mythical 'normal' yet. Of course economies never get to equilibrium – stuff keeps happening. But in terms of the ongoing unwind of the factors listed above it could still be a bumpy path ahead.

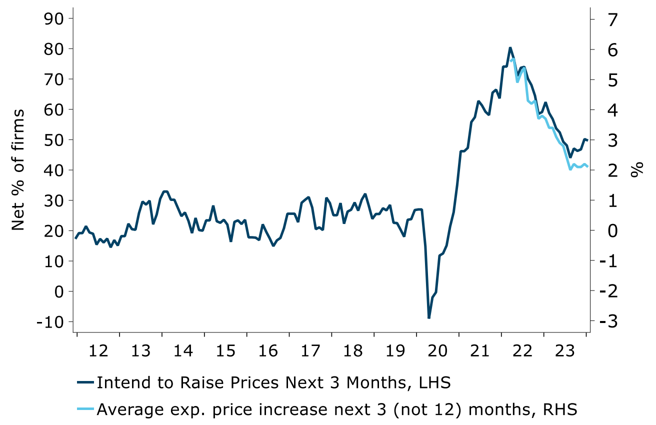
At the risk of a wild generalisation, there are currently two views out there. One is that the economy is not only very weak, but going downhill fast. Those at the more rate-sensitive end of the economy might well think that only rate cuts will revive it, and people of this view would conclude that rate hikes should certainly be out of the question given the steady (albeit not rapid) progress already made getting inflation down.

The other view is that while monetary policy is indeed working, still-stimulatory fiscal policy and strong population growth are meaningful offsets that mean that much of the economy is still ticking along – certainly slower than previously, but not rolling over. And with inflation looking sticky, that could be a problem. We think that's the RBNZ's view, and there are elements of that in the outlook that we lay out in this set of forecasts too: the weakness we see this year is predicated on two more OCR hikes that could have a chilling impact on tentative green shoots in property and investment by reintroducing two-way risk when the general consensus had been that interest rate cuts were just a matter of time.

We won't repeat here our thinking behind our recent prediction that the OCR will be raised again. In short, we are taking the RBNZ at their November word that their patience is running out with the slow progress in getting non-tradable inflation lower, and we see the data since then as tilting towards slower yet.

At the end of the day the RBNZ's Monetary Policy Committee has an inflation target that they can't be confident they are on a path towards. One red flag is an awkward stall in both the proportion of firms intending to raise prices, and the intended size of those increases (figure 1). Pricing intentions have historically been a pretty reliable inflation predictor and there's no obvious reason to discount them currently.

Figure 1. ANZBO pricing intentions



Source: Macrobond, ANZ Research

But the upshot is, whatever OCR it takes to achieve it, the economy is looking at a sustained period of sub-par activity and employment because that's what the RBNZ needs to get inflation down, and they certainly have the means to bring it about. The overarching story of our forecasts is therefore 2024 as a year of subdued activity, 2025 as the year of recovery, and 2026 as the mythical return to equilibrium.

The RBNZ's instruments are imprecise, however, and there is significant uncertainty about both how OCR settings will feed into the real economy, and how that in turn will then feed through into inflation. We look at a couple of scenarios on page 17 where we consider how things could evolve if the transmission of monetary policy were to prove more or less powerful than we are assuming.

We also discuss on page 6 some of the assumptions the RBNZ has to make about invisible but nonetheless important concepts including the neutral OCR, the current speed limit of the economy, and the NAIRU (the non-accelerating inflation rate of unemployment). These invisible lines have as much influence on the RBNZ's assessment of how much spare capacity there is and will be in the economy as the actual data does (though thankfully the RBNZ's estimates of these baselines are a lot less volatile than actual economic outcomes!).

The upshots is that the RBNZ is piloting the plane without knowing quite how hot the engine is running, or whether the plane is entirely level. The aircraft will get down safely in the end, but there could be some hairy moments along the way as a bit of good old trial-and-error is employed, and the weather keeps changing. Buckle up.

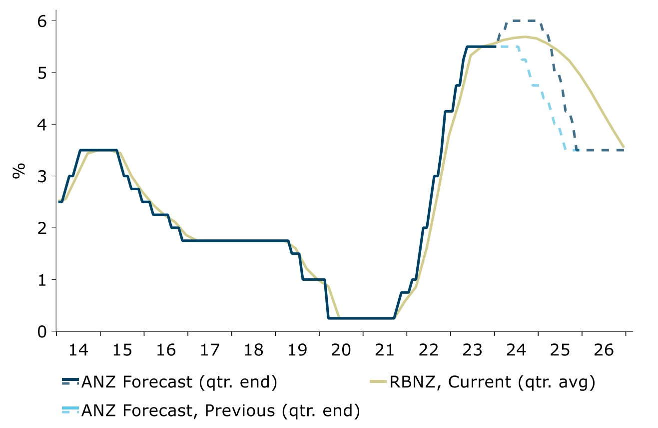
Key economic drivers

Descending through the turbulence

The economy has cooled, but there's still a long descent to 2% inflation to navigate from here. High interest rates are cooling demand and have caused GDP data to look recessionary. However, despite the weakness, capacity pressures need to weaken further in order to get inflation sustainably back to 2%. It's more challenging than usual for the RBNZ to calibrate its policy response, given the large shocks that are still buffeting the economy and old pandemic-era shocks that are still working their way through. Let's dig into some key drivers in a little more detail.

Monetary policy. Inflation and capacity pressures have been too high for too long, eroding real wages and incomes and contributing to dire consumer confidence. The RBNZ has responded to these inflationary pressures with 525bp of OCR hikes, taking the OCR from a record low of 0.25% to its current level of 5.5%. While these hikes are still filtering through the economy and dampening demand, progress to date on getting persistent domestic inflation down has been slow, with non-tradables inflation having overshot the RBNZ's forecasts for most of 2023. We think they're getting impatient; nervous that inflation isn't going to return to their target band sustainably in a sufficiently short time frame. Consequently, we expect them to deliver two more hikes, taking the OCR to 6%.

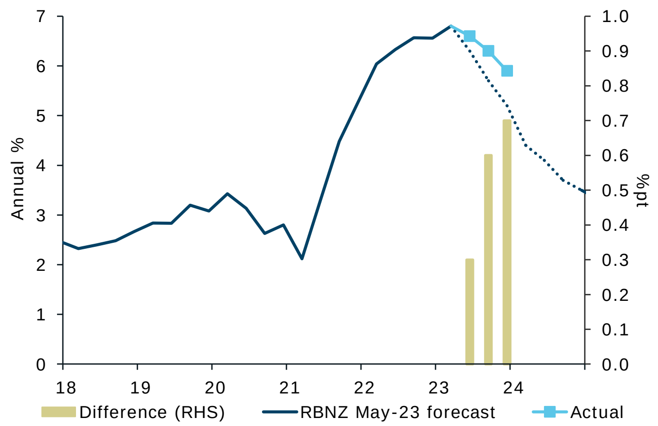
Figure 2. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Over the next couple of years, monetary policy is likely to keep economic growth weak, limiting firms' willingness to hire more workers and give pay rises. Over time, we expect this to reduce inflation, as consumers "cool their jets", given their rising costs through higher interest rates and subdued purchasing power from modest wage rises. We've lightly pencilled in OCR cuts from the start of 2025, but would caution that this far out anyone's forecasts are highly uncertain. The timing of cuts will be determined by the path inflation and capacity pressures tread this year, which will be influenced by external shocks we cannot foresee. The RBNZ will be in no rush to rule out further OCR hikes beyond 6%. They've got an inflation target to hit, and progress on the key non-tradable (domestic) part of inflation since they called a pause on hikes last year has been much slower than they anticipated (figure 3).

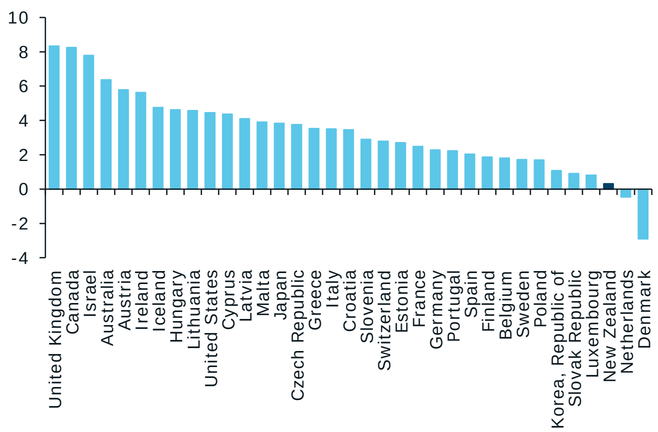
Figure 3. RBNZ's May 2023 non-tradables inflation forecast vs actual outcomes



Source: Stats NZ, RBNZ, ANZ Research

Fiscal policy. One of the reasons the NZ economy is more overheated with a worse inflation problem than elsewhere has been the stance of fiscal policy. Most countries provided significant government spending to insulate their economies through the pandemic with crucial measures such as the wage subsidy. The difference here was that fiscal spending was dialled back much more slowly than in most advanced countries (figure 4).

Figure 4. Change in cyclically-adjusted general govt primary balance (%ppts of GDP) from COVID to projected 2024

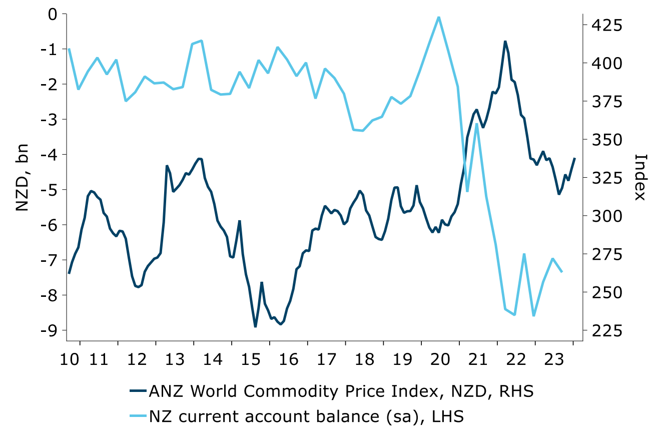


Source: IMF, analysis by Michael Reddell

Expansionary fiscal policy, even if projected to decline over the next few years, presents a challenge to reducing inflation. Government spending uses economic resources that could be used elsewhere. This isn't necessarily a bad thing; some of New Zealand's economic challenges are best fixed through government spending. But expansionary fiscal policy on top of a frothy private economy bids up prices as the government competes with the private sector, driving up inflation as well as meaning less bang-for-buck for taxpayers. What matters for inflation is the total amount of fiscal spend relative to revenue (ie taxation) and the size of the economy. The new Government has signalled fiscally neutral tax cuts will be delivered at the May Budget. We expect this to have a small effect on the macroeconomy overall, but await further details. We will find out more about the new Government's strategy for running the country's finances in the Budget Policy Statement on 27 March – this will give us a feel for the risk profile around fiscal settings.

The world economy. As a small open economy, our outlook is very susceptible to global conditions. The global economy influences NZ in three ways: through trade, financial markets and economic uncertainty. Our terms of trade have been very soft recently. Global inflation has made our imports more expensive, while lacklustre demand from China and cooling western economies has pushed our export prices to low levels, especially for meat products. However, a recent tightening in milk supplies has seen dairy prices lift. This hasn't been enough to save our dire current account balance (see our current account section).

Figure 5. Commodity prices and terms of trade

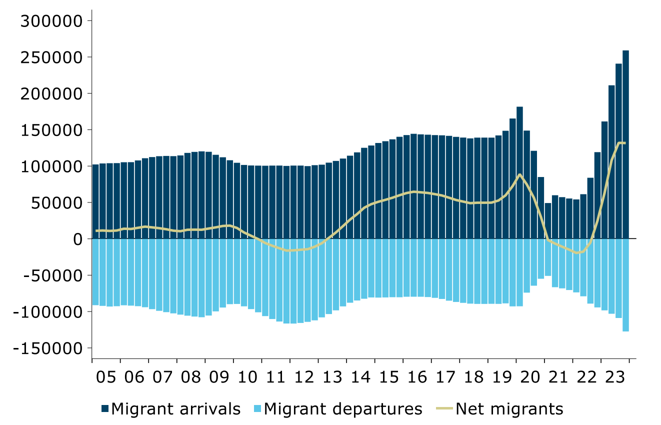


Source: Stats NZ, Macrobond, ANZ Research

Speaking of the exchange rate, the TWI is around 1% higher than it was last quarter, on average. While this difference is small, this change in financial conditions will help cool tradable inflation, but it will worsen returns for unhedged exporters. As for the third channel, at this stage, there are limited effects through economic uncertainty, since the global economy is slowing but orderly. While we can't rule out a crisis coming along (they have every 10-15 years in recent times), it's something that's decidedly in our 'unforeseeable' basket (see risks section for further discussion).

Migration. New Zealand's inbound net migration is near record levels, with 126,000 people joining NZ over the last year. There are two sides to this story: record outbound migration, especially of NZ citizens, is being offset by record inbound migration which, relative to previous immigration waves, is disproportionately from Asian economies.

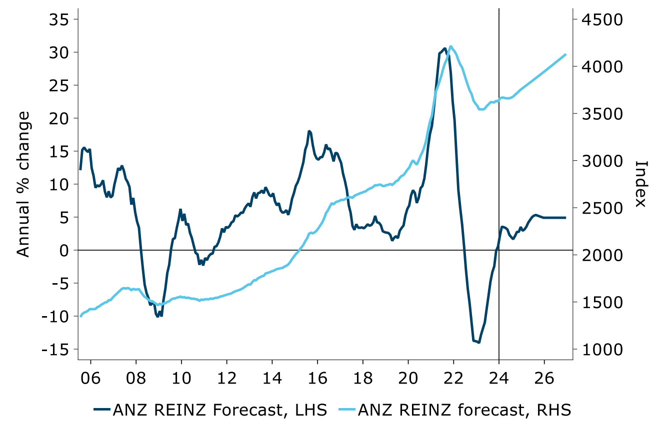
Figure 6. Annual net migration



Source: Stats NZ, Macrobond, ANZ Research

Housing. Despite record population growth, the housing market has had a lacklustre recovery since the RBNZ stopped increasing the OCR in May. We expect this theme to continue this year, with further OCR hikes having the potential to cause further house price falls. In H2 2024 proposed policy changes, such as to the CCCFA and investor interest deductibility, are likely to provide support to the market, along with easing LVR settings. The RBNZ's tolerance for rising house prices will depend on progress in the inflation war.

Figure 7. Our house price forecasts



Source: REINZ, Macrobond, ANZ Research

All up, the economy is as complex as ever. Taming inflation remains the core economic challenge, which will drive RBNZ decisions and the broader economic picture. While there has been progress, the fight is not over. The RBNZ's challenge is like landing a jumbo jet on a short runway in poor weather – we'll get there but there could be some bumps and speed fluctuations along the way. Once the economy has stabilised, the focus will return to NZ's longer-run economic trajectory; that's the focus of our 2026 projections.

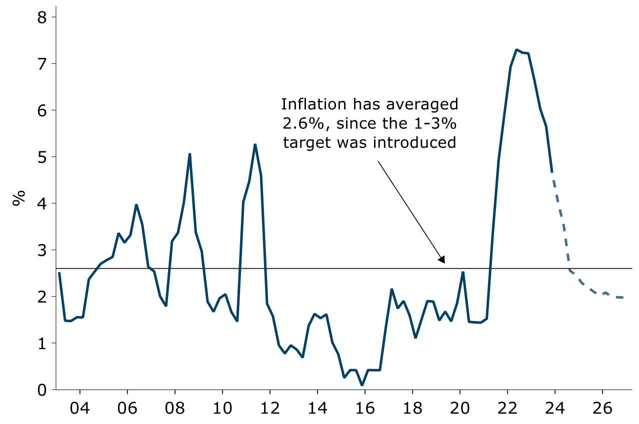
Special topic: Watching the stars from the cockpit

Watching the stars from the cockpit

In this QEO we have extended our forecasts another year, out to 2026. Forecasting that far out is always a challenge (if not a mug's game). New events will come along that we can't foresee right now; no one in 2018 predicted 2020 would be the year of the pandemic.

Inflation. While we can't predict what sideswipes will come along, we can form a view on how the economy might look once the plane is through the pandemic turbulence. The anchor for our expectations for 2026 is the RBNZ's 2% inflation target midpoint. We trust that the RBNZ will set the OCR at a level that achieves that target. To be fair, over history this has had mixed success. Over the 20 years since the RBNZ introduced the current 1-3% target band, inflation has averaged 2.6%, mainly because sideswipes such as the pandemic or the GST increase have come along and thrown them off course.

Figure 8. Inflation has averaged 2.6% since 2002

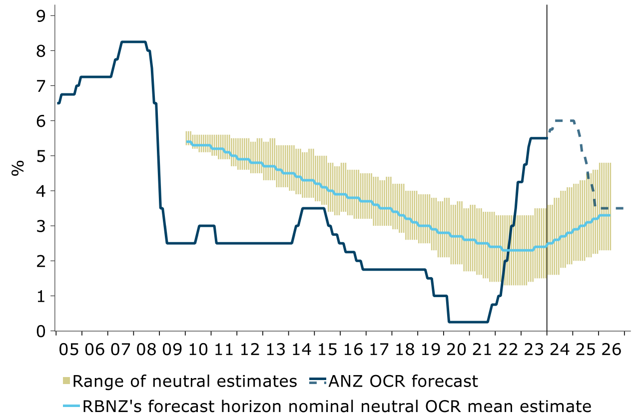


Source: RBNZ, Macrobond, ANZ Research

Interest rates. One key anchoring question for our forecasts is what OCR is required to maintain 2% inflation, once the economic dust has settled. The RBNZ opines on this directly. By the end of their forecast horizon in 2026, they expect the neutral OCR to be around 3.4%. We've assumed they are right, and have pencilled in cuts to 3.5%. But as the RBNZ acknowledges with their 250bp band around their estimates, where neutral currently sits and is going is highly uncertain and will ultimately only be found out through trial and error as the RBNZ observes the inflation consequences of their policy stance.

The neutral OCR isn't directly observable, but it moves around with long-term demand for savings and investments and can be affected by global movements in neutral rates, given our status as a small open economy.

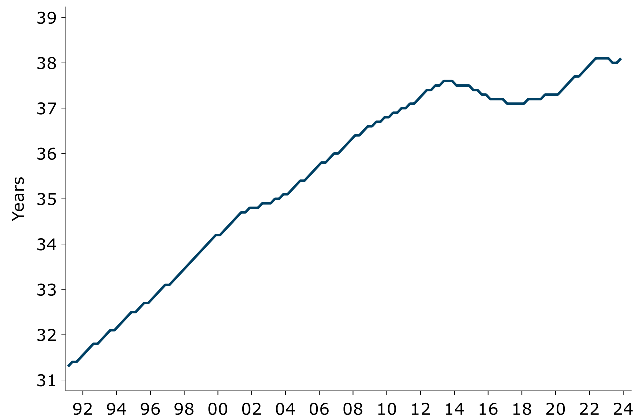
Figure 9. Forecast horizon neutral and our OCR forecast



Source: RBNZ, Macrobond, ANZ Research

As New Zealand's population ages, collectively we are likely to save more and invest less, a dynamic that has driven neutral interest rates to near zero in Japan and is playing out amongst almost all global economies. Interest rates in New Zealand have trended lower as our population has aged.

Figure 10. Median age in New Zealand



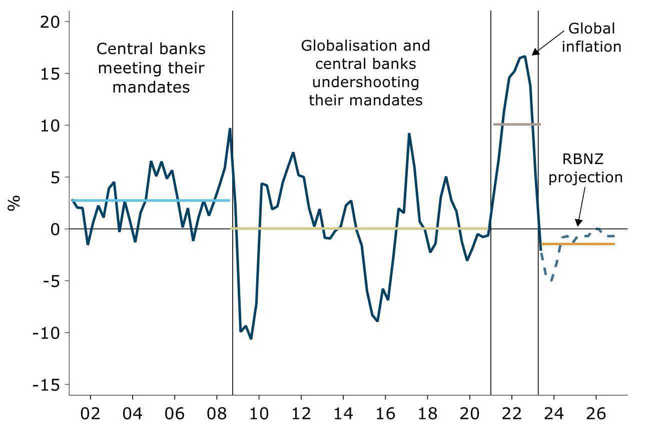
Source: Stats NZ, Macrobond, ANZ Research

An aging population places downwards pressure on neutral interest rates in two ways. First, a larger proportion of people are in a stage in life where they don't have dependants (ie the kids have left home), but still are earning solid incomes, out of which they are likely frantically saving to fund their retirement. Second, a lower birth rate means over the long term, natural population growth is slowing down, meaning we have to invest less to build infrastructure.

It's not one-way traffic. For one thing, New Zealand has tended to make up for slowing natural population growth with strong immigration. And second, demand for investment globally is likely to be supported by decarbonisation and deglobalisation. As New Zealand decarbonises we are likely to increase our construction of renewable electricity sources, replace fossil fuel industrial heat and rejuvenate our vehicle fleet in order to meet our commitments under the Zero Carbon Act. As this extra investment ramps up, this will increase demand for capital, meaning on average investors are likely to require higher returns through higher interest rates.

Likewise, a slowing pace of globalisation is likely to increase demand for investment, as some supply chains shift from a "just-in-time" model to a "just-in-case" model. For little old New Zealand, this shift may reduce our long-running decline in import prices as firms seek to recoup the costs of their global investments. Higher tradables inflation, if it eventuates, would require an offset in the form of lower non-tradables inflation in order to maintain the RBNZ's 2% inflation target; a risk to which the RBNZ is highly attentive. This would return us to a world more akin to the early 2000s, potentially lifting the neutral interest rate from its near-2% lows in the late 2010s.

Figure 11. Import prices during inflation targeting



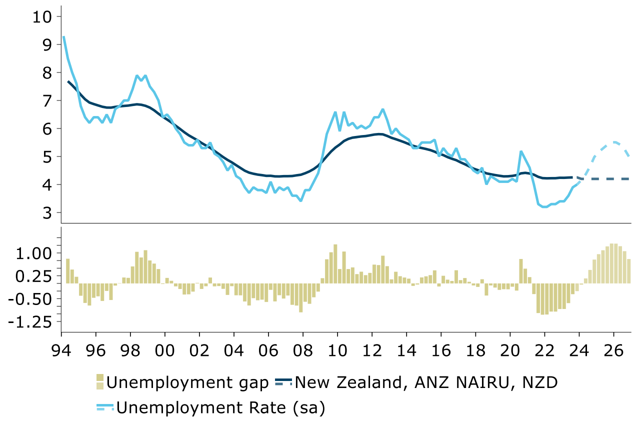
Source: RBNZ, Macrobond, ANZ Research

The amount of growth and unemployment that is consistent with 2% inflation is also unobservable and moves around through time.

Unemployment. As New Zealand's labour market has become more flexible, the Non-Accelerating Inflation Rate of Unemployment (NAIRU) has fallen from around 7% in the 1990s to the low 4%s today. This is the level of unemployment where inflation neither increases or decreases as a result of the labour market, although the composition of a broader suite of labour market indicators matters here too. Like with the neutral OCR, estimates of the NAIRU in real time are highly uncertain (let alone where it is going).

That said, we are assuming that the NAIRU will continue its downwards trajectory, as the big theme of labour market flexibility hasn't changed. It's true that COVID lockdowns and the border closure caused some one-off reallocation of labour between sectors (eg out of tourism) and a shortage of migrant labour (eg in horticulture), both of which reduced labour market efficiency during recent years, increasing the NAIRU. But with the border now open, we think these frictions have largely run their course, allowing the NAIRU to have returned to its long-run trend. However, the true level of the NAIRU through this period is only likely to reveal itself as the labour market loosens and domestic inflationary pressures decline further. It's important to note that monetary policy cannot sustainably push unemployment below the NAIRU.

Figure 12. Our NAIRU estimate



Source: RBNZ, Macrobond, ANZ Research

GDP. Economic output is also influenced by these long-run factors. Our productive potential as a nation over the long term is determined by our natural resources, population growth and our ability to apply technological progress to our economy. A few of the emerging trends for productivity growth include artificial intelligence such as large language models that are likely to support our productivity growth, but on the other hand more frequent one-off climate events that are likely to deplete our capital stock faster, reducing productivity growth. Productivity and long-run growth aren't influenced by monetary policy, but can be affected by fiscal and regulatory policy settings. Weighing it all up, we think 2.8% y/y is an appropriate speed limit for the late 2020s economy.

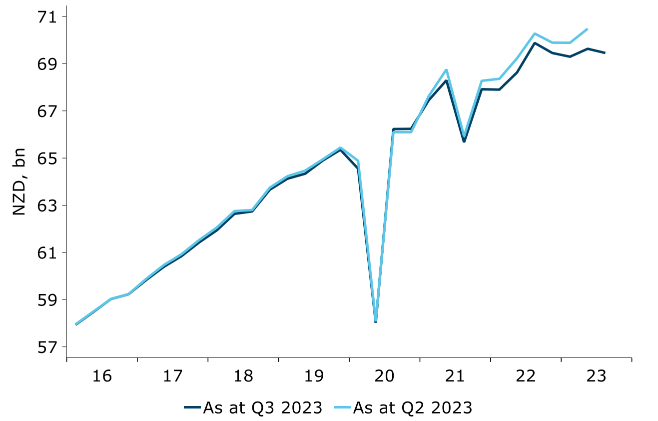
It's challenging to know where the economy will settle once the extraordinary economic surprises of the early 2020s have fully washed through. Our newly extended forecasts for 2026 for the most part assume that New Zealand will be back on an even keel, with inflation at 2%, the OCR at its neutral rate and the lagging unemployment data trending towards NAIRU. An enormous health warning is needed here: there will be economic shocks we cannot foresee that will buffet the economy. It is highly unlikely that we will return to the mythical 'equilibrium' state laid out in this special topic, but it's our base case from which to adapt our 2026 forecasts as that year approaches.

GDP outlook

Sluggish year ahead

The Q3 GDP release altered our understanding of underlying economic momentum, given both the quarterly growth rate in Q3 coming in weaker than expected (-0.3% vs our forecast at the time for a small rise) and meaningful downward revisions to prior quarters. Those left the trajectory trending broadly sideways over the past year, in contrast to the original data that was trending higher.

Figure 13. Production GDP



Source: Stats NZ, Macrobond, ANZ Research

In the expenditure cut, government consumption and investment were the main drivers of the revisions (partly owing to better measurement of school truancy). Conversely, private sector activity (more sensitive to interest rates) was revised slightly higher, suggesting that while momentum does look a little weaker than our prior understanding, it's perhaps not as much of a 'monetary policy getting traction' story as it might appear at first glance.

Nonetheless, even after accounting for these factors, the latest GDP data suggest NZ's economic engines have been sputtering. That's particularly clear in the production cut of the GDP data, where goods-producing industries are down almost 3% on an annual average basis, led by a 10.5% decline in manufacturing ex-food. Monetary tightening is certainly getting traction.

While economic activity has struggled, NZ's productive capacity has continued to expand. Surging net migration is adding to the labour force, and productivity is expected to be recovering as the labour market loosens (as matching efficiency improves and skills shortages resolve). In other words, supply constraints are easing. And with economic momentum weak and further OCR hikes expected, 2024 is expected to be the first year in quite a few where economic supply exceeds demand – a necessary condition to sustainably tackle too-high inflation.

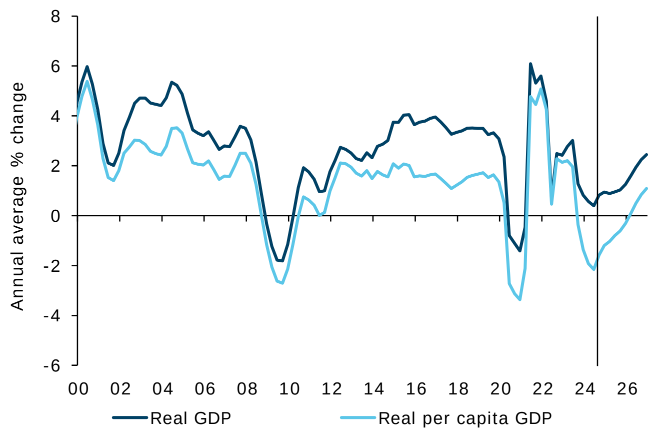
If we were to put a theme on each year of our forecast, 2024 would be the year of sluggish growth and excess capacity; 2025 the year of gradual recovery; and 2026 the year in which the economy is able to return to its equilibrium state: the goldilocks zone where activity, employment, and the OCR are around their potential/neutral/star levels (see our special topic for further discussion). Forecasting is an imprecise art, however, and page 17 provides a couple of scenarios outlining how things might differ if we're proven wrong on a couple of key assumptions.

Turning to our GDP forecast in more detail, recent data suggest growth picked up a little over Q4, with our Heavy Traffic index, the NZIER QSBO's domestic trading activity, our Business Outlook, and the BusinessNZ-BNZ PMI/PSI all pointing to stronger growth in Q4 than the flat (0.0% q/q) read we had previously pencilled in. We've upgraded our Q4 forecast to 0.4% q/q.

Looking to 2024 and beyond, tighter monetary conditions are expected to keep a dampener on growth, with interest rate-sensitive pockets of the economy such as residential investment, business investment and household spending on durable goods expected to underperform the broader economy. Weak domestic demand is expected to weigh on imports, which, alongside the ongoing recovery in services exports (eg international tourism and education) should see net exports provide some offset to weak domestic demand over 2024.

All up, we see the economy expanding 0.9% on an annual average basis over 2024 (from 0.8% over 2023). 2025 is expected to see annual growth pick up to 1.3%, and by the time 2026 has concluded monetary easing is expected to see the economy growing close to trend (2.4%). On a per capita basis, our GDP forecasts are particularly dire: annual average growth of -1.2% is expected over 2024 and -0.3% over 2025. At 1.1% over 2026, per capita growth finally recovers towards its historical pace.

Figure 14. Headline vs per capita GDP



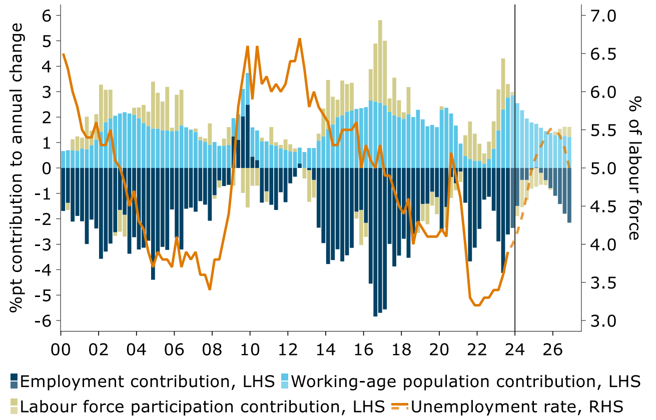
Source: Stats NZ, ANZ Research

Labour market outlook

Supply in the driver's seat

The Q4 labour market data was stronger than we anticipated and suggested that labour market resilience has further the run. While labour market capacity pressures eased dramatically over 2023, it was all at the hands of the ongoing recovery in labour supply, reflecting record-high net migration inflows. In NZIER's QSBO, businesses reported that it is now as easy to find labour as it was during the GFC, when the economy was in recession. And while there are certainly recessionary dynamics evident in the economic activity data, that has yet to become evident in labour demand. We do expect weak economic activity to flow through to the labour market, and the fact that we haven't seen it yet is likely a matter of timing. Monetary policy acts with long and variable lags, and forward-looking indicators broadly suggest cooling labour demand across the year ahead.

Figure 15. Contributions to changes in unemployment rate

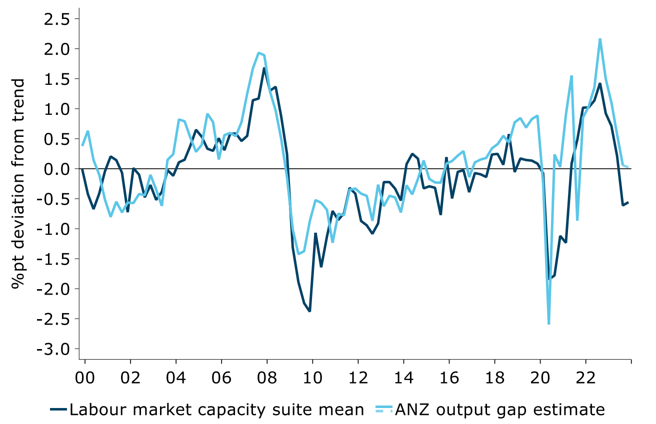


Source: Stats NZ, Macrobond, ANZ Research

Resilient labour demand is a common theme across advanced economies globally, raising questions about the potency of monetary policy. However, some structural shifts in economies in the post-COVID era have likely disrupted previous dynamics. The services sector of New Zealand's economy has expanded sharply through the COVID period, and the employment-rich and less interest-rate sensitive nature of the sector may thus partly explain the relative resilience of labour demand.

But the RBNZ does not necessarily need to see a sharp slowdown in the labour demand, as has occurred in past slowdowns. It's the balance between labour supply and demand that determine the inflationary consequences of labour market conditions. And we have seen inflationary pressures stemming from the labour market fade over the past year, despite the absence of a significant hit to labour demand, and the unemployment rate remaining relatively low. Our broader suite of labour market capacity indicators, which captures more leading indicators, has shifted into disinflationary territory – though only just. While the RBNZ has seen significant progress in the labour market to date, ultimately a sustained period of labour market slack is required to see take the heat out of wage growth and domestic inflation.

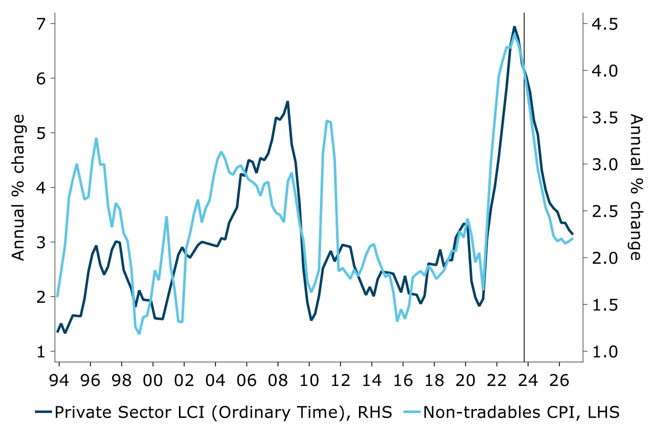
Figure 16. Labour market capacity indicators



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

And on our forecasts, they will get there. We expect the labour market to shift further into disinflationary territory over the year ahead. While wage growth was stronger than we anticipated in Q4, the easing in capacity pressures last year suggests a pipeline of disinflation is yet to flow through. And with spare capacity expected to grow over the year ahead, wage growth should continue to ease.

Figure 17. Wage growth



Source: Stats NZ, Macrobond, ANZ Research

Ultimately, the RBNZ will do what is necessary to generate slack in the labour market. We expect labour supply expansion to do the heavy lifting, but the RBNZ simply won't tolerate ongoing resilience in labour demand if it prevents spare capacity from opening up. The unemployment rate will rise one way or the other, and we expect it to hit 5% by year end. That's certainly a challenging proposition for households, but it is the unfortunate cost of getting inflation down.

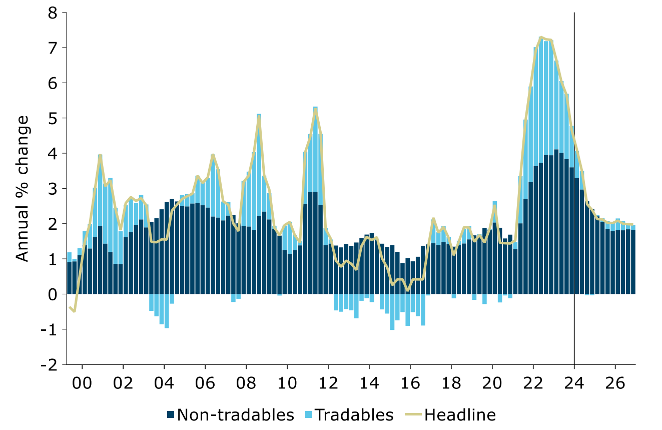
Consumers price inflation outlook

Divergence across the basket

There has been meaningful slowing in inflation in recent months. However, a growing divergence in disinflation trends across the CPI basket has also emerged.

The RBNZ has received a very healthy dividend from the global disinflation story, and tradables inflation has fallen sharply amidst the ongoing global supply recovery. Of the two key drivers of the initial surge in inflation, energy markets have come back into better balance and global supply-chain disruption has reduced, though geopolitical risks remain heightened. Tradable inflation, which the RBNZ has limited influence over, is incredibly volatile, and while it is providing a helping hand to the RBNZ currently, it can't be relied upon as an enduring form of disinflation.

Figure 18. CPI inflation forecast

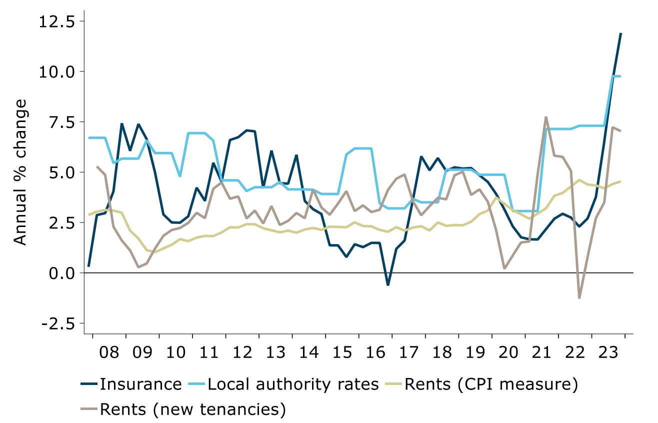


Source: Stats NZ, Macrobond, ANZ Research

For the RBNZ to be confident that inflation is returning to target sustainably, it needs to see further progress on the domestic component of inflation. And while progress has been made on non-tradable inflation, it is the pace of that progress that we think will concern the RBNZ. In fact, we're expecting non-tradable inflation to surprise the RBNZ to the upside across the first half of this year. That's not to say that we are not expecting it to continue to moderate over the year ahead; spare capacity is now emerging across the economy, the necessary condition for sustained core domestic disinflation, albeit at a slower pace than previously thought.

Domestic inflation has proved stickier than the RBNZ anticipated. Rents are increasingly likely to become a driver of non-tradable inflation, as the impacts of strong net migration inflows continue to be felt in the market. Local authority rates bills are seeing significant increases, in part reflecting higher debt-servicing costs and increasing infrastructure investment challenges. Insurance costs have also surged, in part reflecting the repricing of risk, but, as with council rate bills, it also reflects the broad-based nature of inflation over the past few years, increasing insurance replacement costs and the cost of delivering local government services. Monetary policy has in some respects limited influence over relative price changes, but re-anchoring inflation expectations, which can be influenced by relative price changes, certainly is the role of monetary policy.

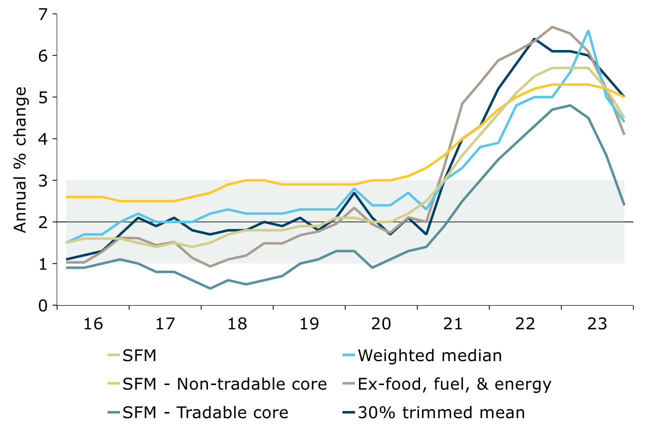
Figure 19. Rents, rates, insurance



Source: Stats NZ, Macrobond, ANZ Research

Inflation targeting isn't likely to be 'easy' any time soon, and relative price changes ultimately require further downward pressure on prices in other sectors of the economy for the RBNZ to meet its target – in other words, tighter policy settings. We continue to view the RBNZ's non-tradable inflation forecasts as optimistic.

Figure 20. Core inflation measures



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

We are forecasting headline inflation to be back within the RBNZ's 1-3% target band in Q3 this year, and approach the 2% midpoint in 2025. However, our inflation forecast is highly conditional on the absence of shocks, ie any sudden unpredictable developments that change the outlook. Monetary policy is about risk management, and we think the RBNZ will see the risks that inflation stabilises above target as outweighing the risk that inflation persistently undershoots the 2% target in the medium term, keeping upward pressure on the OCR.

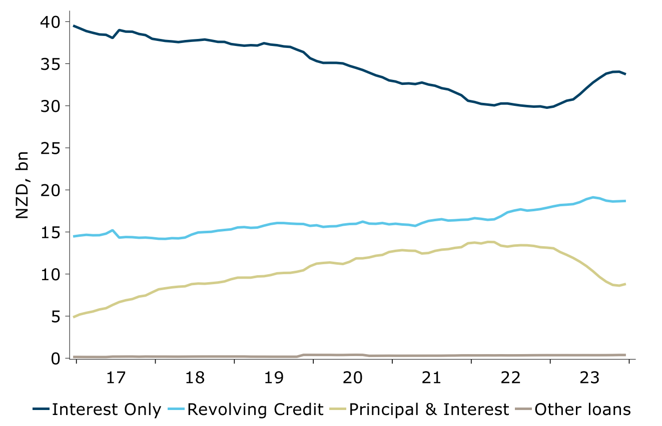
Agri outlook

Clouds linger across primary sector outlook

The agricultural sector is battling the combined impact of costs running at elevated levels whilst returns are low. Farm expenses have lifted at a much higher rate than the CPI in the past few years, and although the upward pressure on farm costs has now largely dissipated, cost levels remain high.

Businesses with high debt are particularly vulnerable due to the rapid rise in interest rates. To survive, many businesses have switched to interest-only loans as principal repayments are not possible with returns so low. This has undone a lot of the recent work to reduce debt in the agricultural sector to more sustainable levels.

Figure 21. Agricultural loans by type



Source: RBNZ, Macrobond, ANZ Research

Returns for most agricultural sectors are hovering at low levels, but we are starting to see some uplift in prices for dairy products. A slowdown in global milk production is tightening supply, prompting buyers to secure more product with a little more urgency. Dairy returns now look like they will exceed the average breakeven price for this season.

Meat pricing remains weak as global supplies increase whilst demand is low. China's appetite for expensive meat has waned in line with its consumer confidence. Slower economic growth in China has encouraged consumers to move back to cheaper forms of protein such as pork and chicken.

Extra supplies of both lamb and beef from Australia have provided more options for many buyers. Importers from the United States have bought much of the beef that would normally have been sent to China. The lack of competition from other markets means prices are relatively soft and expected to fall further as New Zealand's supply of beef lifts in the autumn.

Last year both the kiwifruit and apple harvests were smaller than normal. This helped keep prices elevated but this season the harvests are expected to be larger. The record kiwifruit harvest forecast will test both processing capacity and market appetite.

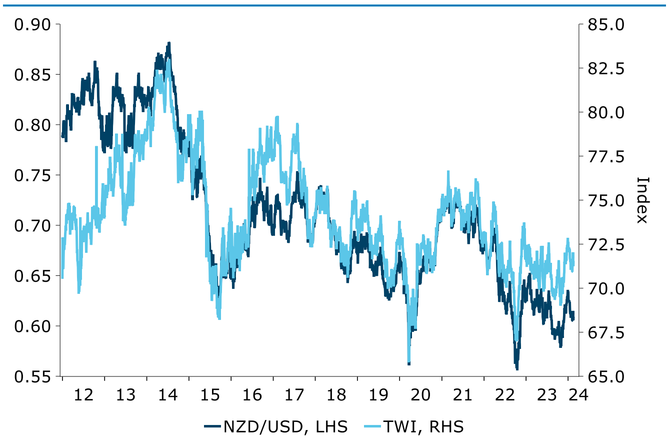
Getting fruit to market may also be more challenging this season as shipping through both the Suez Canal and the Panama Canal has diminished. Alternative shipping routes extend the time it takes to get goods to market. This will be a challenge for perishable goods such as kiwifruit and apples heading to Europe.

The majority of New Zealand's exports are bound for Asia, and while these shipping routes won't be directly impacted, shipping costs in general are expected to rise as the longer shipping routes effectively reduce the availability of ships. Containers may also be in short supply. As we found during the pandemic, relatively small delays in shipping times or unloading times can cause major problems for relocating containers.

Higher shipping costs erode returns to New Zealand producers in a similar way that a stronger NZ dollar does.

The NZ dollar has appreciated a little recently but remains relatively low. Any increase in the value of the NZ dollar will alleviate the cost of imported inputs such as fertiliser, diesel and machinery but will reduce farmgate returns.

Figure 22. NZD/USD and NZD TWI



Source: RBNZ, Macrobond, ANZ Research

Overall, this season is one our primary producers will be looking forward to putting behind them, but for many sectors the view from the cockpit remains cloudy. The dairy sector is starting to see blue skies ahead but most of our other primary sectors are yet to see profits re-emerge.

See out latest Agri Focus for more.

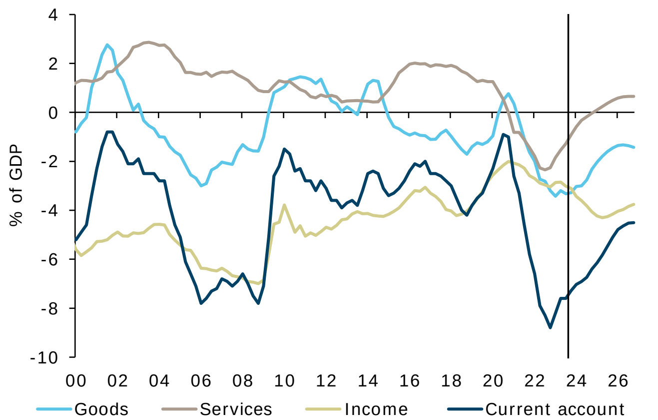
Current account outlook

A long way from sustainable

The annual current account deficit widened from $30.2bn in Q2 to $30.6bn in Q3. As a share of GDP, it was unchanged at 7.6%, which is far better than 8.8% in Q4 2022, but still too wide to call sustainable. Indeed, at these levels the current account remains a key vulnerability for the economy, and could well trigger a sovereign credit ratings downgrade if New Zealand's net exports recovery falters (see risks section for further discussion).

Looking forward, our expectation is that tight monetary conditions, fiscal restraint, and the ongoing services exports recovery (chiefly international tourism) will eventually get New Zealand onto a more sustainable footing. Our forecast is for the current account deficit to narrow from 7.3% of GDP in Q4 2023 to just under 6.5% in Q4 2024, around 5% by Q4 2025, and 4.5% by Q4 2026.

Figure 23. Current account outlook

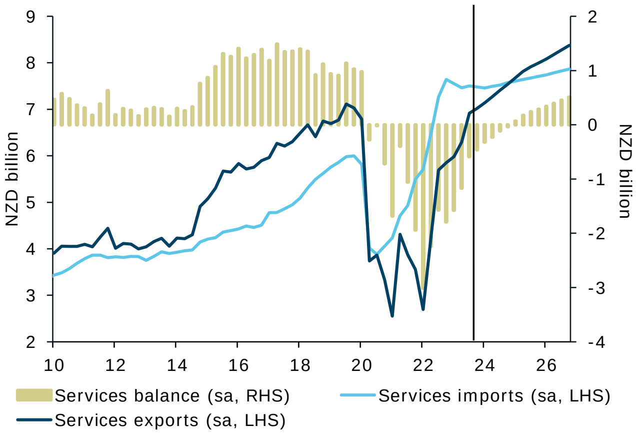


Source: Stats NZ, ANZ Research

Turning to the details, the goods balance is expected to remain in deficit over the entire forecast horizon. Growth in primary export volumes is expected to be muted over the next few years as a shrinking dairy herd largely offsets productivity gains. Non-primary exports are expected to outperform primary exports, but soft global demand limits the upside. Conversely, growth in imported goods is expected to remain sub-par, reflecting global disinflation and weak domestic demand, as tight monetary conditions and the eventual fiscal consolidation weigh.

On the services side, we expect the annual services balance to flip back into surplus around the middle of 2025, marking a little more than four years in deficit since the borders were closed. The transition back to surplus is so lengthy because the recovery isn't just about getting exports (tourist numbers) back to their pre-pandemic level. Rather, because imports are now significantly higher than pre-pandemic levels (owing to surging global inflation and the fact that New Zealand's imports are less travel intensive than exports, and therefore took a smaller hit from closed borders), exports need to recover beyond their pre-pandemic level before reaching an eventual surplus.

Figure 24. Quarterly services trade



Source: Stats NZ, ANZ Research

Indeed, the latest snapshot suggests there is still a way to go, with monthly visitor arrivals in December 2023 sitting just below 80% of their pre-pandemic level. Arrivals from China are the under-performer (closer to 50% of pre-pandemic levels), while at 92%, arrivals from the US have outperformed all other major country groupings. That aligns with the relative economic performance of these economies.

Turning to the income deficit, the higher global interest rate environment combined with New Zealand's very large external debt position means a narrowing goods deficit and eventual services surplus will likely face some offset from a widening primary income deficit. We expect the annual income deficit to widen through to mid-2025 before narrowing slowly from the second half of 2025 onwards (reflecting lower global interest rates).

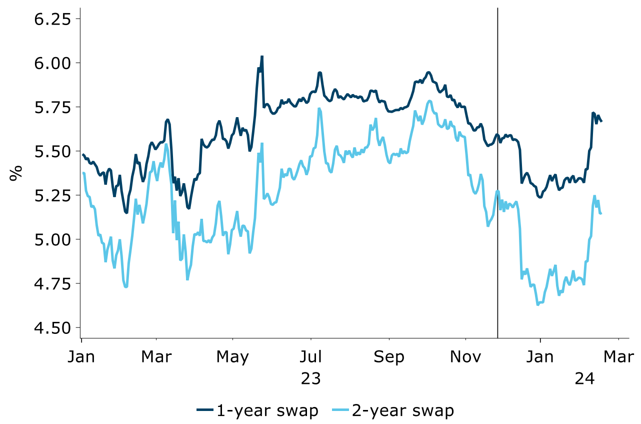
All in all, at current levels the current account remains a key vulnerability for the economy, and it could be a while before that vulnerability is behind us. Tight monetary conditions alongside fiscal consolidation will play a key role in getting New Zealand's external position back towards sustainable territory. But there are risks, such as a terms of trade shock, that policy makers can't fully mitigate. From a point of such significant imbalance, getting back to sustainable deficit territory will require more than the right policy settings: a bit of luck will be required too. And if lady luck doesn't show up, a wider risk premium (which will put upwards pressure on domestic interest rates) and/or a weaker NZD may end up being part of the transition. Worst case: access to foreign capital dries up and NZ is forced to live within its means very abruptly.

Markets outlook

Resumption of OCR hikes to keep mild upward pressure on short-end rates …

Our revised forecasts for two more OCR hikes (to be delivered in February and April) pose clear upside risks to short-end interest rates, but how this flows through to the term structure is likely to be very nuanced. That's largely because markets are now pricing in the real risk of further hikes, with market expectations of the OCR by May ebbing and flowing between around +10bp and +30bp. While those expectations are clearly not as hawkish as our own forecast of another 50bp of hikes, 2yr swap rates have come a long way (around 50bp – see figure 25) since the second half of January, when markets were pricing OCR cuts as if they were a sure bet. Our sense is that much of the upward movement in short-end swap rates has now occurred, overshoots notwithstanding. So, although our new forecasts have the OCR topping out at 6%, once it gets there, that's likely to reinforce rather than challenge market expectations of OCR cuts going forward, as we saw late last year. That's the main reason why we don't envisage 2yr rates moving materially above where they are now, or beyond last year's highs.

Figure 25. NZ 2yr swap rate over the last 6 months



Source: Bloomberg, Macrobond, ANZ Research

By contrast, much shorter tenors like the 90-day bank bills, which move in lock-step with the OCR, have scope to keep rising, and they are the only interest rates in the term structure expected to move beyond 6%.

OCR hikes to keep long-end NZ/US spreads elevated but outright yields to fall over H2

Our expectation for a resumption of OCR hikes isn't expected to materially alter the outlook for long-end interest rates and bond yields, which are more sensitive to moves in global interest rates. The way we see it playing out is via a wider NZ/US spread, but as with the 2yr swap, that move has already largely occurred, so we don't envisage significant further upside, and we expect 10yr bond yields to fall over the second half of the year. In essence, our call for a higher OCR is expected to delay, rather than derail, already-expected falls in long-end rates as NZ yields lag moves in US yields.

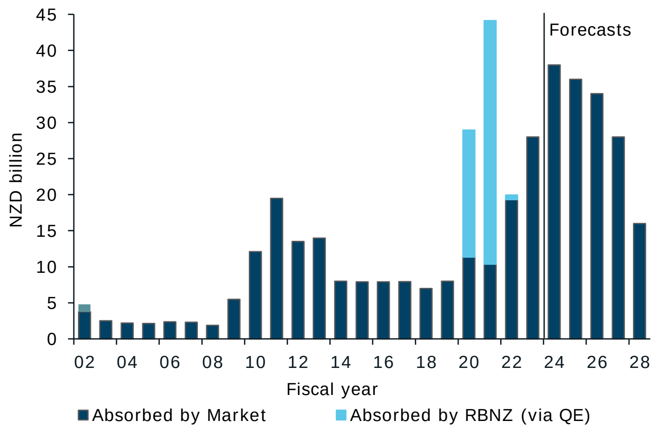
Eventual easing will allow yield curves to dis-invert over H2 2024

The recent rise in short-end interest rates re-inverted New Zealand yield curves, which were almost flat at the end of October. This re-inversion is not expected to persist for much longer, with yield curves expected to dis-invert and eventually become positively sloped over H2 as short-end rates fall more quickly than their long-end counterparts. Lower long-end rates also played a role in the recent inversion of yield curves, but as key offshore markets like the US contemplate sticky inflation and fiscal slippage (manifested via increased government bond issuance), that is expected to limit the ability of long-end global bond yields to fall in the future. To illustrate, while we expect the RBNZ to cut the OCR by 250bp from early 2025, we expect US 10yr bond yields to level off at around 3.75%, which is only around 50bp below their current level.

Elevated issuance projections still weighing on NZ government bond market sentiment

Elevated bond issuance isn't just something markets are nervous about in the US – it's also weighing on bond market sentiment locally in the wake of higher issuance projections published by the Treasury in its Half-Year Economic and Fiscal Update (HYEFU). Those new projections call for \$38bn of NZ government bonds (NZGBs) to be issued this fiscal year. While we saw more issuance in the 2020/21 fiscal year as part of the Crown's fiscal response to COVID, back then, the RBNZ's large-scale asset-purchase programme (dubbed the LSAP, or quantitative easing) of bond purchases took pressure off markets. That programme ended in 2021, and now that the RBNZ no longer has the market's proverbial back, markets are essentially being asked to absorb a record volume of NZGBs (figure 26, overleaf).

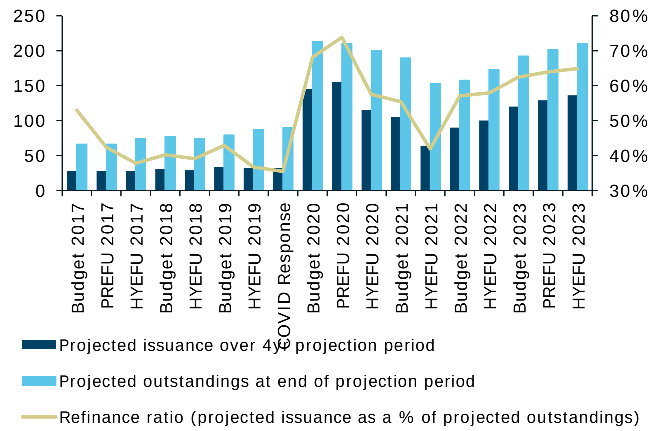
Figure 26. NZGB issuance and net market absorption



Source: NZDM, RBNZ, Bloomberg, ANZ Research

Bumper issuance has weighed on sentiment for some time, so it's not new (we discussed this in our last quarterly), but markets have become warier after five successive upgrades to projected issuance, and the blowout in refinance ratios (figure 27).

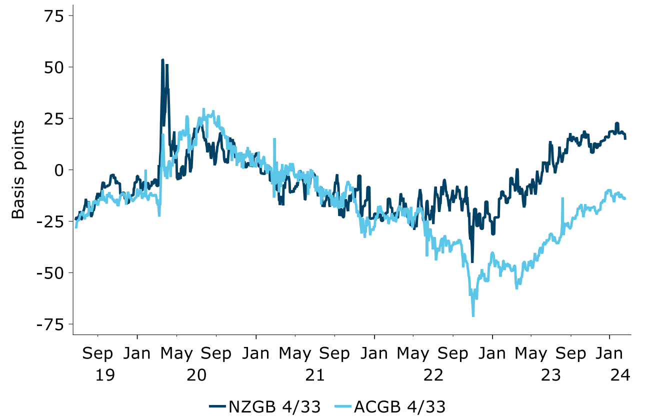
Figure 27. Projected NZGB issuance, outstandings and refinancing ratio



Source: NZDM, ANZ Research

Markets are hopeful of fiscal consolidation ahead, and the working assumption held by many bond buyers is that the worst is behind us, but we are unlikely to see long-end bond yields trade back below comparable tenor swap rates. In that regard, New Zealand has been an underperformer. We note, for example, that while 10yr NZGBs trade at around +18bp over 10yr swap rates, 10yr Australian Government bonds (ACGBs) trade at around -14bp below 10yr swap rates, with the circa 30bp gap (figure 28) explained by market frustration with the string of recent fiscal downgrades/issuance upgrades.

Figure 28. NZ and Australian 10yr bond spreads to swap



Source: Bloomberg, Macrobond, ANZ Research

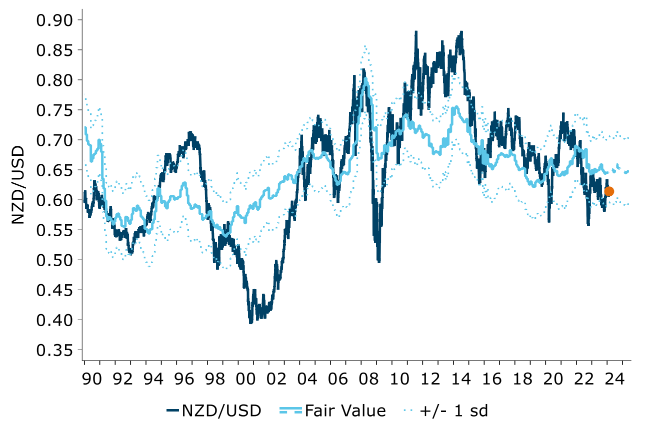
NZD/USD: steady into year-end and then a gradual climb over 2024 still expected

Our currency forecasts haven't changed materially since our last quarterly, with the Kiwi still expected to appreciate gradually, taking it to 0.63 by the end of 2024 and 0.64 by the end of 2025.

Currency markets have shown themselves to be particularly sensitive to the ebb and flow of policy rate expectations this year, and that has been a source of volatility. While that pattern is likely to persist, a higher OCR is expected to support the Kiwi over the near term, as was the case when short-end swap rates spiked higher in early February.

That said, we remain guarded about the global risk environment, with geopolitical tensions at the fore and the US still sporting the equal-highest cash rate (alongside NZ) across the so-called G10 markets. All that means is that the USD is unlikely to depreciate materially from here; hence our forecast for a milder NZD appreciation, which is supported by our assessment of where fair value lies (figure x).

Figure 29. USD DXY Index and our fair value estimate



Source: Bloomberg, Macrobond, ANZ Research

Markets outlook

Table 1: Forecasts (end of quarter)

FX Rates	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
NZD/USD	0.62	0.62	0.63	0.63	0.64	0.64	0.64
NZD/AUD	0.91	0.90	0.90	0.90	0.90	0.90	0.89
NZD/EUR	0.56	0.55	0.55	0.55	0.55	0.55	0.54
NZD/JPY	86.8	85.6	86.3	85.7	85.8	84.5	83.2
NZD/GBP	0.48	0.47	0.47	0.47	0.47	0.47	0.47
NZD/CNY	4.43	4.40	4.44	4.41	4.47	4.45	4.44
NZ$ TWI	70.9	70.2	70.8	70.4	71.1	70.8	70.3
Interest Rates	**Mar-24**	**Jun-24**	**Sep-24**	**Dec-24**	**Mar-25**	**Jun-25**	**Sep-25**
NZ OCR	5.75	6.00	6.00	6.00	5.75	5.00	4.25
NZ 90-day bill	6.09	6.05	5.74	5.50	4.92	4.30	3.72
NZ 2-yr swap	5.20	4.89	4.55	4.21	3.92	3.72	3.67
NZ 10-yr bond	5.00	4.75	4.50	4.25	4.25	4.25	4.25

Source: Bloomberg, ANZ Research

Key risks

Known unknowns, unknown unknowns, and plenty of scope for miscalibration

The risk profile around our outlook can be split several ways. One lens is to think about all of the things that could happen but are not in our forecast – either because the probability of them occurring is not deemed to be high enough to incorporate into the outlook (eg the risk of a broader war in Europe), or because they are not on our radar as there is currently no evidence of their existence (eg forecasting the COVID-19 pandemic before the virus was ever detected).

Another lens is to consider some of the underlying assumptions that we have calibrated our outlook against. We may be right about some parts of our outlook, but wrong about what this means for CPI inflation and therefore monetary policy (eg the neutral OCR could be higher than assumed, meaning monetary tightening hasn't been getting the CPI-fighting traction we and the RBNZ have thought).

In this section, we run through some of the risks that are top of mind but are not 'centralised' in our forecast. We then provide a couple of scenarios that don't require any single significant risk to materialise. Rather, these scenarios investigate the implications of our forecast being wrong about the potency of monetary tightening on demand and inflation.

In big-picture terms, the list of risks that are not captured in our central forecast is little changed compared to our last edition:

- Geopolitical tensions remain a big worry. And insofar as inflation is concerned, anything that negatively impacts global shipping and supply chains, and positively impacts energy prices, will be felt in NZ to some extent. Second-round impacts via higher-than-otherwise inflation expectations would be a big worry for the RBNZ.
- Elections in the US, UK, Europe, and Asia over the coming year present an additional layer of geopolitical risk.
- Speaking of a change in government, the new National-led Government will be releasing its first Budget on 30 May. Fiscal policy has been pro-cyclical through the bulk of the pandemic era (adding to inflation pressure), more so than most of the other countries to which we tend to compare ourselves. Fiscal consolidation is both overdue and expected. However, the pace of consolidation is uncertain. After adjusting for the increasing cost of delivering public services, there is plenty of scope to make deeper spending cuts than signalled while still maintaining a larger Government than before COVID-19. However, we don't know if there is political appetite for this or how easy it'll be to identify some of the lower-value spending. From an inflation and OCR perspective, we see fiscal policy as a potential source of downside risk. But we'll get a better feel for the risk profile when the Government releases its Budget Policy Statement 27 March.
- Recent wobbles in a handful of regional banks in the US could spiral into something a little more systemic, affecting credit availability, confidence and incomes in NZ (a deflationary risk).
- China's economic recovery remains fragile, and associated deflationary risks have not gone away. We've already seen softer prices for some of New Zealand's key exports, and while commodity prices have recovered somewhat, upside appears limited. Total international visitor arrivals are still running below pre-COVID levels, with the recovery in arrivals from China particularly soft.
- Combine the above with the fact that New Zealand's external position is severely out of balance (see the current account section above), and it's not difficult to foresee New Zealand experiencing a sovereign ratings downgrade if the net exports recovery falters.
- The housing market always carries plenty of scope to surprise. Recent data prints have been softer than expected, and given market participants have been expecting mortgage rates to fall from here, further OCR hikes (as we are forecasting) could be very potent.
- Net migration is another wild card – not only the outlook, but also the ultimate impacts on supply and demand, and therefore inflation. 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 only a mildly inflationary net impact, as does the RBNZ's, but we see inflation risks as skewed to the upside.

Key risks

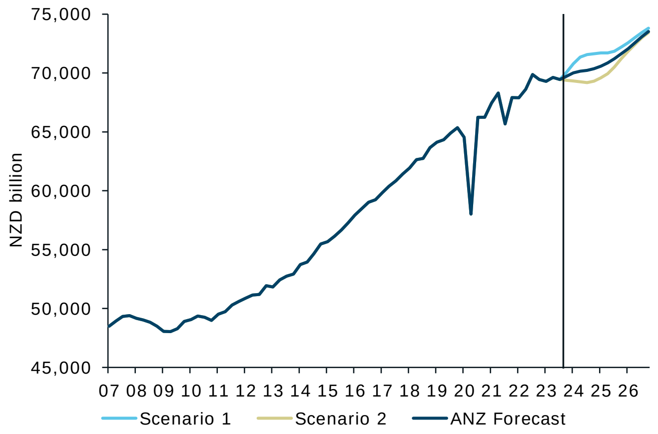
A couple of scenarios

We present two scenarios that don't require the risks mentioned above to materialise. Rather, the following scenarios reflect forecast calibration uncertainty, and in particular, states of the world where our assumptions around the potency of monetary tightening are wrong.

Scenario 1 reflects an outlook where the neutral OCR is higher than we assume (see page 6 for a discussion of neutral), meaning for a given level of monetary tightening, the impact on demand and inflation isn't quite as severe as expected. The RBNZ has revised its long-run nominal neutral OCR assumption higher recently, and there's no guarantee the increase in November will be the last.

In this scenario, high household income growth (fuelled by rapid wage growth and solid employment growth) takes a lot of the sting out of higher interest rates. And a relatively robust household sector leads to stronger private consumption, labour demand, and ultimately more pressure on economic resources than otherwise.

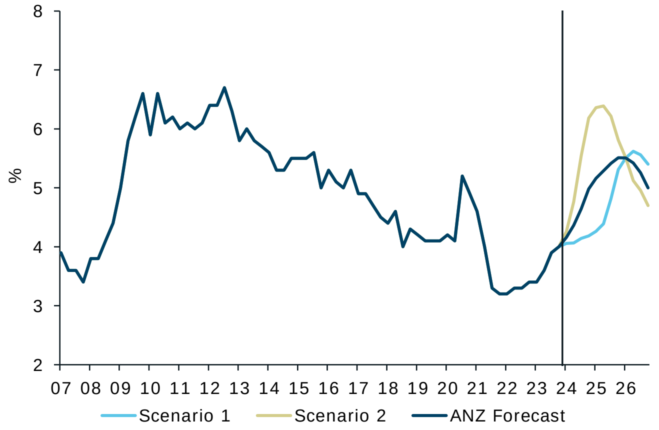
Figure 30. GDP



Source: Stats NZ, ANZ Research

The unemployment rate drifts up only very slowly over the next 18 months or so, remaining in a state that's neither adding to nor subtracting from inflation pressures (as strong migration-induced growth in labour supply is absorbed by robust demand). Non-tradable inflation (ie largely domestically driven inflation) gets stuck at around 5% y/y over 2024, and forward indicators for activity, employment, capacity, and prices fail to suggest the additional 50bp of hikes we've pencilled in will be enough to guide inflation sustainably lower.

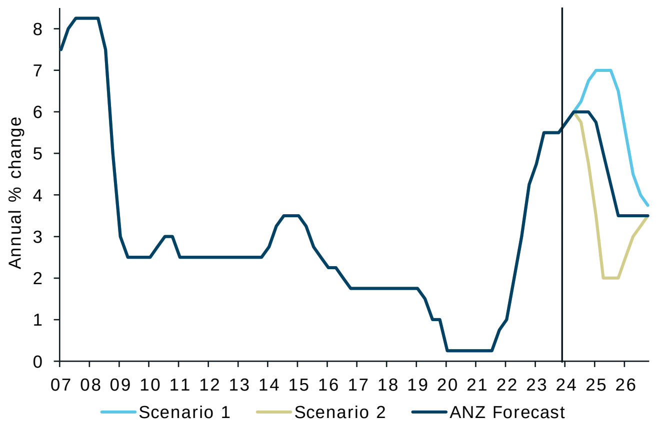
Figure 31. Unemployment rate



Source: Stats NZ, ANZ Research

By the August MPS, the RBNZ sees the writing on the wall and resumes hiking, delivering back-to-back 25bp hikes to a peak of 7% in early 2025. Monetary conditions tighten meaningfully, with higher mortgage rates triggering another round of house price declines, and economic confidence wobbling like a wobbly thing.

Figure 32. OCR



Source: RBNZ, ANZ Research

Tradable inflation (largely imported) is slightly lower than our forecast owing to a higher NZD, which finds support from the higher rates environment. But that's not enough to stop headline inflation getting stuck just outside the top of the target band through to mid-2025; the RBNZ facepalming in frustration along the way, worried about how embedded high inflation is becoming, and how high the neutral OCR might be.

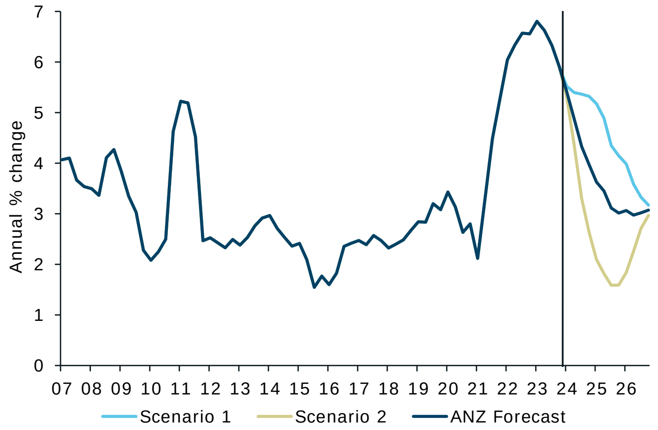
However, from the second half of 2025, the impact of additional monetary tightening begins to show in domestic inflation and the labour market. Non-tradable inflation slows towards 3% y/y and the unemployment rate lifts to just over 5.5% in 2026. Headline inflation finally settles around the middle of the target band in the second half of 2026. The RBNZ has finally beaten inflation into submission, but compared to our central forecast, inflation remains above the 1-3% target band around one year longer than expected, marking four years outside of the target band. In this state of the world, the RBNZ would be wishing they took the OCR higher earlier. But the moral of this story is that monetary policy is a repeat game: the RBNZ gets to keep playing until it has won the war on inflation; it's just a question of how high the OCR needs to go.

Scenario 2 presents the opposite state of the world. Monetary tightening is more potent than previously thought, and that's about to make itself clear in the data.

In this world it turns out the -0.3% q/q GDP print in Q3 is the beginning of a technical recession that lasts through to the second half of 2024. Demand for labour plummets and employment growth contracts, causing the unemployment rate to shoot up to around 6.5% by the end of the year.

Slack in the labour market takes the heat out of wage pressures, with non-tradable inflation slowing to 1.6% y/y by mid-2025. Headline inflation falls through the 2% mid-point by the end of 2024, troughing at just over 1% by early 2025.

Figure 33. Non-tradable inflation



Source: Stats NZ, ANZ Research

Once again, the RBNZ's is responding to this alternate state of the world by August, starting with a 25bp cut that quickly morphs into outsized cuts in subsequent meetings, as the data continue to deteriorate and the RBNZ becomes increasingly concerned about inflation potentially undershooting their target band.

With the OCR at 2% by the middle of 2025, the RBNZ is comfortable that monetary settings are now shoring up demand, confidence and inflation pressures. Monetary stimulus supports a broad recovery, allowing the RBNZ to "normalise" the OCR towards neutral over 2026. The unemployment rate falls towards 4.5% by the end of the forecast horizon and activity expands around its trend pace (not too hot, not too cold).

Key take-outs

While scenario analysis is chiefly a story-telling exercise, we do get a feel for which scenarios seems likelier to occur as we're putting them together. And that's useful information in and of itself. After changing our OCR call to include further hikes in February and April, we'd characterise the risk of each scenario as broadly similar. But that's only because we have an out-of-consensus call for further hikes. Should the RBNZ not deliver on these, then Scenario 1 would certainly seem like the more likely, with non-tradables inflation getting stuck at high levels and the return to the 2% midpoint delayed further.

At the same time, further OCR hikes at a point in time where most Kiwis were begging to see light at the end of the mortgage-rate tunnel is not without risks. The impact on confidence, housing, and broader demand for goods and services could be much more potent than we assume, which with the benefit of hindsight could make additional hikes look like a policy mistake. We would add, however, this is the risk mitigation game the RBNZ needs to play. If the RBNZ is not confident monetary tightening is working fast enough to bring inflation sustainably down to target in an acceptable time frame, and market expectations are causing financial conditions to ease prematurely, then we shouldn't underestimate their readiness to hike.

Key forecasts

Calendar Years	2020	2021	2022	2023	2024f	2025f	2026f
NZ Economy (annual average % change)							
Real GDP (production)	-1.4	5.6	2.4	0.8(f)	0.9	1.3	2.4
Private Consumption	-1.7	7.7	3.3	0.8(f)	0.6	2.1	3.0
Public Consumption	6.6	7.8	4.9	-1.0(f)	0.3	-3.1	1.1
Residential investment	-3.2	9.0	-0.9	-4.0(f)	-4.7	0.7	3.0
Other investment	-5.2	13.1	4.8	-0.6(f)	-4.5	1.4	3.1
Stockbuilding[1]	-0.8	1.4	-0.4	-0.5(f)	0.3	-0.1	0.0
Gross National Expenditure	-1.7	10.1	3.4	-0.8(f)	-0.1	1.2	2.8
Total Exports	-13.5	-2.4	0.2	7.5(f)	2.7	3.3	3.0
Total Imports	-15.6	14.4	4.7	1.8(f)	-0.3	1.8	4.2
Employment (annual %)	0.6	3.3	1.7	2.4	0.1	0.8	2.3
Unemployment Rate (sa; Dec qtr)	4.9	3.2	3.4	4.0	5.0	5.5	5.0
Labour Cost Index (annual %)	1.5	2.8	4.3	3.9	2.9	2.5	2.2
Terms of trade (OTI basis; annual %)	-1.6	2.8	-4.2	-6.1(f)	5.9	2.8	2.8
Prices (annual % change)							
CPI Inflation	1.4	5.9	7.2	4.7	2.5	2.0	2.0
Non-tradable Inflation	2.8	5.3	6.6	5.9	4.0	3.0	3.1
Tradable Inflation	-0.3	6.9	8.2	3.0	-0.1	0.7	0.3
REINZ House Price Index	15.5	26.2	-12.8	-0.7	3.0	5.0	4.9
NZ Financial Markets (end of December quarter)							
NZD/USD	0.72	0.68	0.64	0.63	0.63	0.64	--
NZD/AUD	0.94	0.94	0.93	0.93	0.90	0.89	--
NZD/EUR	0.59	0.60	0.59	0.57	0.55	0.54	--
NZD/JPY	74.6	78.6	83.3	89.1	85.7	83.2	--
NZD/GBP	0.53	0.51	0.52	0.50	0.47	0.47	--
NZD/CNY	4.74	4.35	4.38	4.48	4.41	4.42	--
NZ$ TWI	75.2	73.2	72.1	72.5	70.4	70.2	--
Official Cash Rate	0.25	0.75	4.25	5.50	6.00	3.50	3.50
90-day bank bill rate	0.27	0.97	4.65	5.64	5.50	3.62	3.72
2-year swap rate	0.29	2.17	5.38	4.64	4.21	3.68	3.72
10-year government bond rate	0.99	2.39	4.47	4.32	4.25	4.25	4.25

[1] Percentage point contribution to growth

Forecasts finalised 19 February 2024

Source: Statistics NZ, REINZ, Bloomberg, ANZ Research

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