ANZ Research May 2024

# Quarterly Economic Outlook

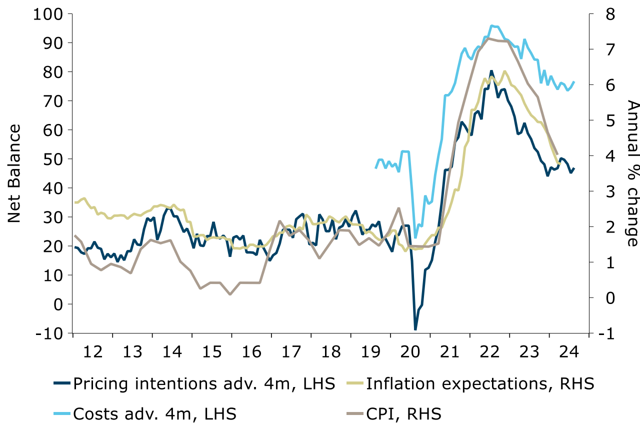
## The ducks are lining up

ANZ

# At a glance

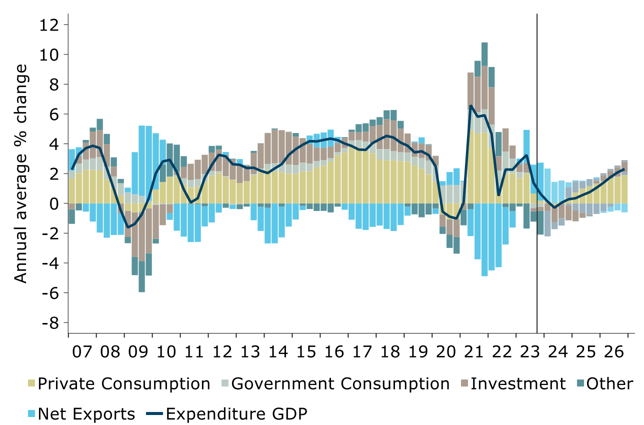
## Sticky inflation risks remain...

Businesses continue to report elevated costs and pricing intentions.



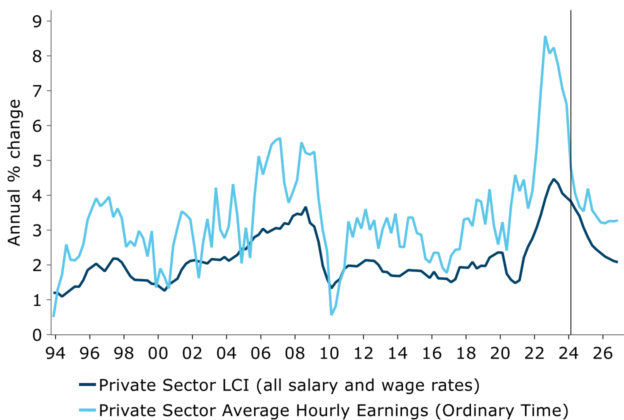

## ...despite the slowing economy

Our outlook for GDP growth reflects very weak domestic demand.



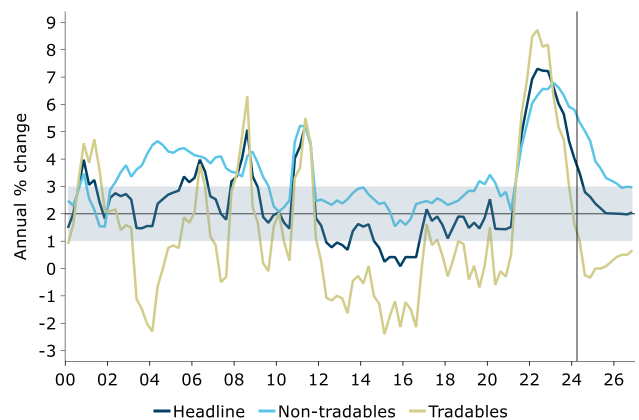

## Wage growth is expected to slow...

As demand for labour softens with the broader economy and migration-driven labour supply growth holds up.



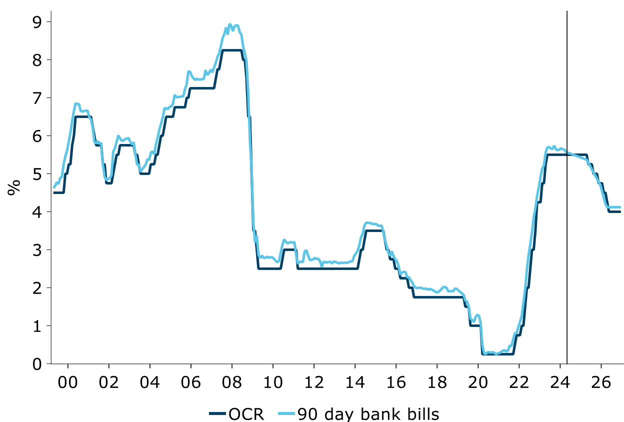

## ...meaning domestic inflation pressure will follow

But right now, non-tradables inflation is a fair distance from where it needs to be.




## We continue to pencil in OCR cuts from May 2025

But risks are skewed towards earlier rather than later.

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Source: Stats NZ, RBNZ, Macrobond, ANZ Research

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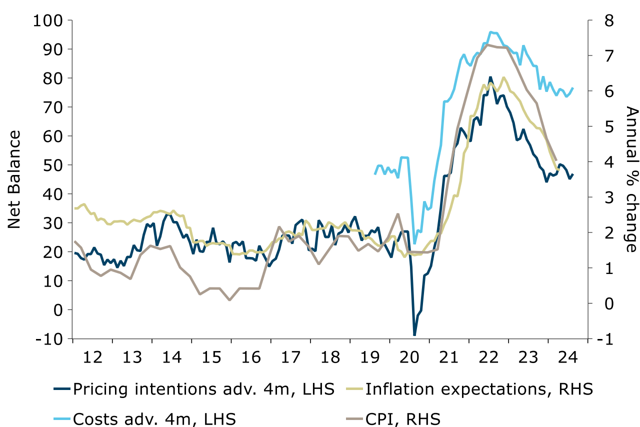
# The big picture

## Lags or traction?

Non-tradable inflation has surprised on the stickier side of expectations of late, suggesting the lags from monetary tightening are lengthier and/or tightening hasn't quite gotten as much inflation-fighting traction as previously assumed. However, economic activity has been on balance weaker than expected and forward-looking indicators suggest things aren't going to pick up any time soon. Indeed, key drivers of economic momentum such as housing, fiscal policy, net migration, and the terms of trade are increasingly playing ball in terms of the slowdown the RBNZ needs to see. Increasing coordination across these drivers could become particularly potent if amplified by households and businesses following through on their reported pessimism. All up, the economy is on the right track for disinflation, but there are still unresolved questions about the speed of the train and whether the track leads all the way to 2% – or for that matter whether we'll overshoot the station. Here and now, inflation is still way too high, and upside risks remain. That's expected to keep the RBNZ in its watch, worry, wait stance for a while yet, standing ready to respond and recalibrate to data surprises in either direction.

Since out last edition, activity indicators have landed on the softer side of our already-soft expectations, but at the same time inflation has proven worryingly sticky, and progress across cost and pricing indicators has outright stalled. That's a bad sign for the evolution of inflation in the near term (figure 1).

Figure 1. ANZBO inflation indicators




Source: Stats NZ, Macrobond, ANZ Research

That begs the question: is slow progress on the inflation front just a timing (lags) story, or has monetary tightening had less bite than expected? Or perhaps it's a bit of both. Time will tell, but provided medium-term inflation expectations remain anchored around the target midpoint and forward-looking activity indicators continue to point to below-trend growth and a loosening labour market, the RBNZ can afford to sit tight and see how things evolve. Disinflation is occurring, it's just not clear that the pace thus far is consistent with reaching the target quickly enough.

But what is an acceptable timeframe? Some would argue that "acceptable" was breached a while ago, while others could counter that by pointing out that speeding up the disinflation process with further hikes could prove to be oversteering that would cause unnecessary economic damage and a possible undershoot in inflation, requiring a correcting monetary stimulus down the track. With activity data now undershooting expectations, waiting for more data to provide clarity before changing stance is appropriate. Afterall, the disinflation process was never likely to be a straight line.

There are good reasons to hope that progress is about to accelerate; that it is a story of long lags, not lack of traction. For starters, there are components of the CPI basket running hot right now because of past inflation, and it'll take time to fix that. Insurance and council rates are good examples: the repair and replacement cost of insured items is higher – and that's being reflected in premiums. Of course, there is also the risk side of the insurance equation to consider, such as the increasing frequency of extreme weather events pushing up reinsurance costs. But this is a relative price shift that the RBNZ will look through. On the council rates side, the cost of delivering key services (including the labour cost component) has lifted meaningfully, and that's now feeding through to higher council rates. Infrastructure woes and climate adaption add another layer of pressure here.

Another good reason to think the transmission from monetary tightening to CPI inflation may be delayed (but not derailed) this cycle is fiscal policy. Perhaps that's not overly surprising given the size and persistence of fiscal expansion in recent years, which is still adding a degree of robustness to employment, where non-cyclical jobs, such as health, education and public administration and safety have been holding up. But with Budget 2024 expected to mark the beginning of the end for upside discretionary fiscal policy surprises, the days of public sector jobs growth offsetting softening labour demand from the private sector appear numbered.

But equally, a glass-half-empty case can be made that monetary tightening isn't getting the traction the RBNZ was expecting. Afterall, non-tradables inflation has surprised the RBNZ's forecast to the upside for four consecutive quarters, and services inflation in Q1 reaccelerated. While many households have felt a rapid squeeze from higher mortgage rates, the aggregate debt-servicing burden is expected to peak well below previous highs. While this is far from the only channel through which monetary tightening impacts the economy, it does beg the question: can we really get on top of a multi-decade inflation surge without a tougher squeeze on household balance sheets?

# The big picture

Hopefully, we can. But one could make a case that so far we've proven without doubt that raising the OCR 525bp quickly is very contractionary for household spending – but how contractionary the *level* of the OCR is is something that will only become clear once that cashflow hit channel is wearing off, as it will over the coming six months as the proportion of people rolling over onto meaningfully higher mortgage rates reduces. The RBNZ would be the first to admit that any estimate of the neutral OCR is highly uncertain.

Further, many Taylor Rule specifications suggest the OCR should have been tightened beyond 5.5%, and that hikes should have kicked off a lot earlier than they did. COVID-related uncertainty meant the path of least regrets was for the RBNZ to err on the side of caution, but least regrets is not *no regrets*, and the cost could well prove to be high inflation becoming more deeply embedded in wage and price setting behaviour than previously thought, meaning the RBNZ needs to cause a deeper slowdown to get inflation back to 2%. In other words, downside activity outturns are not necessarily a slam dunk for imminent cuts.

There are a bunch of other shocks and potential structural changes in the New Zealand and global economies that could mean inflation is higher for a given pace of economic expansion going forward too, such as oil price shocks, geopolitical tensions, trade frictions, productivity challenges, climate change, and demographic change. But the structural elements aren't one-way traffic (eg the AI revolution could be very disinflationary for services), and it's difficult to separate these structural factors from cyclical forces in real time. But the distinction matters: the OCR today should be set based on where we are in the business cycle, while structural forces will determine where the appropriate resting place for the OCR is in the longer run once monetary policy is normalised.

Turning to the cycle, drivers of economic momentum provide confidence disinflation will continue:

- Net migration remains very high, but appears to have turned a corner, and could fall very quickly. But we still need to bear in mind possible lagged impacts on demand.
- Housing appears to be tracking broadly sideways and forward indicators suggest near-term price momentum is soggy (see our Property Focus).
- Business and consumer confidence is dire, and while that as yet hasn't translated into quite as dire economic outcomes as we'd normally expect, that could be changing. For example, renewed consumer pessimism appears to be driven by heightened job insecurity rather than high inflation.
- The terms of trade fell like a stone in Q4, reflecting a nasty combo of higher import prices and lower export prices. Some of this softness will unwind, but the weak global economy, particularly China, suggests upside is limited.
- The government sector is shrinking, but that's to make way for a larger-than-otherwise private sector (via tax cuts). Dollar for dollar, tax and spending cuts are likely slightly contractionary, insofar as households save a portion of their tax relief or spend a greater proportion on imports than the government would have. In addition, the job cuts on the other side of this fiscal reshuffle will certainly detract from demand. While there is a huge amount of pressure on fiscal policy to deliver key public services into a world of climate change, an aging population, and geopolitical insecurity, fiscal consolidation is also very much overdue following the recent pro-cyclical experience. While reducing the tax base doesn't seem like a solution to NZ's long-run problems, reducing government spending will hopefully deliver better value to taxpayers. We may also see further spending cuts in Budget 2025 and beyond. After accounting for the cost of delivering public services, the government sector after spending cuts will still be significantly larger than pre-COVID levels.

All in all, if economic drivers do become more synchronised to the downside over the year ahead, the RBNZ will gain greater confidence that it has done enough to tame inflation. And obviously the deeper the slowdown, the shorter it needs to be to do the job. We continue to pencil in OCR cuts from May 2025, but the data will ultimately determine when the RBNZ pull the trigger. Our sense is that risks are shaded to an earlier start to cuts than forecast, but a lot still needs to go the RBNZ's way.

Table 1. Summary of key forecasts

| Calendar Years | 2020 | 2021 | 2022 | 2023 | 2024f | 2025f | 2026f |
|---|---|---|---|---|---|---|---|
| Real GDP[1] (annual average % change) | -1.4 | 5.6 | 2.4 | 0.6 | 0.5 | 1.5 | 2.5 |
| Unemployment Rate (sa; Dec qtr) | 4.9 | 3.2 | 3.4 | 4.0 | 5.1 | 5.5 | 5.0 |
| CPI Inflation (annual % change; Dec qtr) | 1.4 | 5.9 | 7.2 | 4.7 | 2.6 | 2.0 | 2.0 |
| Official Cash Rate (Dec qtr end) | 0.25 | 0.75 | 4.25 | 5.50 | 5.50 | 4.75 | 4.00 |

[1] Production based

Source: Statistics NZ, REINZ, Bloomberg, ANZ Research

Forecasts finalised 15 May 2024. See page 8 for detailed forecast charts and this link to download tables

# Our forecasts

## Economic activity to remain sluggish…

The economy ended 2023 on the softer side of expectations, with Q4 GDP revealing a small quarterly contraction that brought with it a "technical recession" handle. In annual average terms, the economy grew just 0.6% in 2023. Our forecast for 2024 isn't any better at 0.5%.

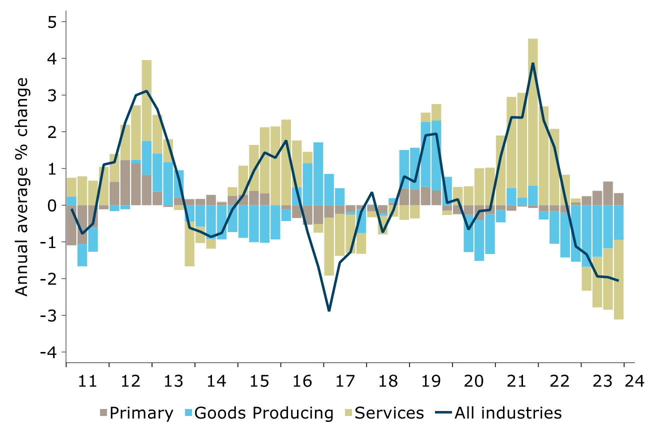
Indeed, the state of domestic demand is expected to remain significantly weaker than the headline GDP figures suggest. Domestic demand is expected to contract nearly 1% over 2024, driven largely by investment and lower government consumption. Net exports are expected to provide an offset, as weak domestic demand weighs on imports and the tourism recovery continues (albeit gradually).

The good news is that once the RBNZ is confident CPI inflation has been beaten into submission, it will be able to ease monetary conditions. OCR cuts from May 2025 are expected to see GDP growth gradually reaccelerate to 1.5% over 2025 and towards trend (2.5%) in 2026.

In per capita terms, our GDP outlook is very weak, and that's a function of headline GDP growth being propped up by rapid population growth. But the supply side isn't all one-way traffic. Normalising implied labour productivity (after COVID initially saw hours worked drop faster than GDP), has been a key drag on GDP growth over the past couple of years, and that's expected to continue a little longer, albeit to a lesser extent than last year.

Digging into the weeds, the surge in GDP per hour worked during COVID was driven largely by services, with retail trade accounting for the lion's share of that. First, households stocked up for lockdowns and set up home offices, gyms, entertainment etc. And second, kiwis with forced savings from lockdowns and sizable government transfers couldn't go overseas to spend – and the domestic economy went kaboom (and so did inflation, as the economy's ability to provide all these goods was compromised). The subsequent decline in output per hour is a mix of the services unwind along with some payback across goods-producing industries. Importantly, while GDP per hour worked is likely to soften a little further (particularly in services industries) we view this as more of a normalisation than a structural change post COVID. We're also cognisant that measurement issues though this period mean we need to be very careful in drawing strong conclusions about what it all means for labour productivity. In theory, it doesn't make a lot of sense that labour productivity is falling as the labour market loosens, given least productive labour is usually the first to exit the labour force in a downturn (lifting average productivity).

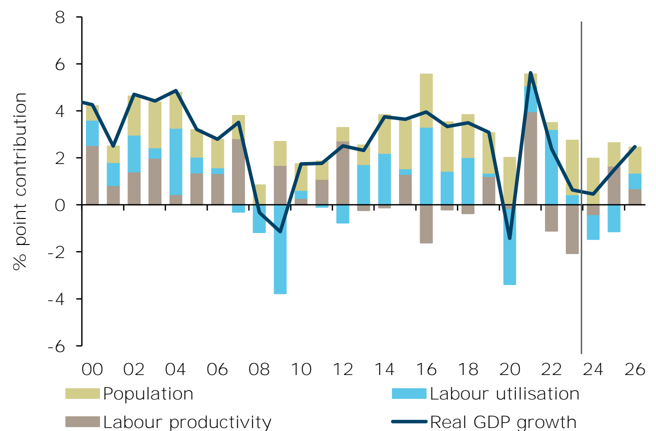
Figure 2. Contributions to growth in GDP per hour worked




Source: Stats NZ, Macrobond, ANZ Research

Speaking of the labour force, labour utilisation is expected to detract from GDP growth this year as the labour market continues to soften. That's expected to provide a partial offset to the persistent bump from migration-driven population growth over our forecast horizon (figure 3).

Figure 3. Supply decomposition of real GDP growth




Source: Stats NZ, ANZ Research

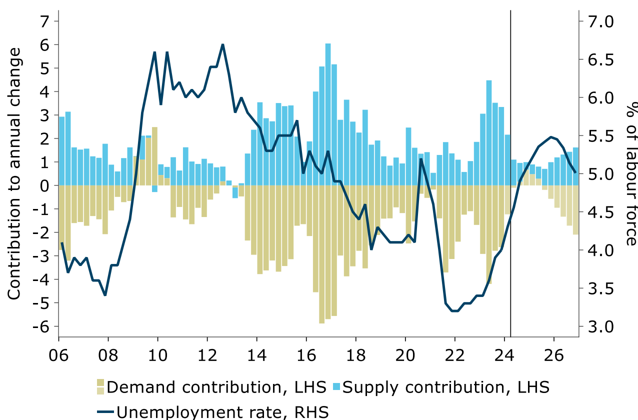
## … as unemployment rate rises…

The next six months will be key for the labour market. Until now, the labour market story has been one of relative resilience. The lag between monetary policy and labour market outcomes has been longer this cycle. That likely reflects the combination of a starting point of intense labour shortages and the subsequent supply recovery from net migration, alongside stimulatory fiscal settings over the past few years. However, with the recovery in employment levels across the economy having largely run its course, and a reduction in government spending from Budget 2024 having rapid (albeit relatively small) flow-on effects to employment, labour demand is likely to deteriorate from here.

# Our forecasts

We expect employment to contract over the remainder of the year, as the past weakness evident in economic activity flows through to the labour market and fiscal settings tighten. Overall, employment is expected to contract 0.7% across 2024, much more modest than the 2.6% contraction seen in 2009 during the Global Financial Crisis (GFC). However, weakness in employment is occurring in the context of continued labour supply expansion. The employment rate is expected to fall around 3%pts to just under 67.0% of the working-age population, which is slightly larger than the fall through the GFC. As labour supply continues to expand and labour demand weakens at the same time, the unemployment rate is expected to breach 5% by year end, rising to a peak of 5.5% in 2025.

Figure 4. Unemployment rate decomposition

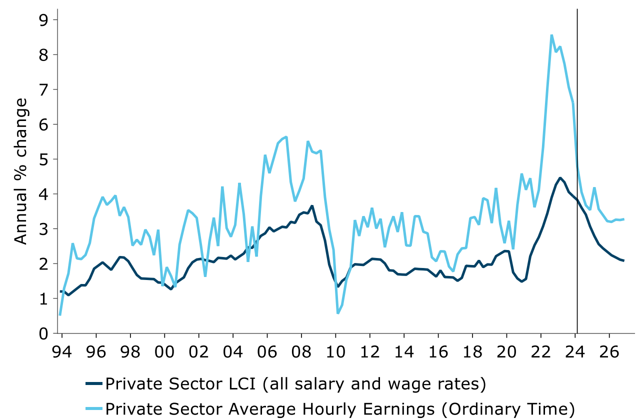



Source: Stats NZ, Macrobond, ANZ Research

There remains considerable uncertainty over the magnitude and pace of the rebalancing occurring in the labour market. Business employment intentions and job vacancies have fallen. With labour demand and supply now rowing in the same direction in terms of opening up capacity, risks are tilting towards the turn in the labour market occurring more aggressively than anticipated, whereas up until the previous data outturn the labour market has surprised with its resilience.

We're now into the phase where broad weakness in sentiment across the economy as unemployment rises itself weighs on demand, and how strong these reinforcing feedback loops will be is difficult to predict with any great degree of certainty. If labour market capacity opens up more quickly than the RBNZ is anticipating, wage growth will fall faster, and OCR cuts are accordingly likely to come sooner than they (and we) currently anticipate as well. All up, it's hard to overstate the importance of labour market data for the monetary policy outlook.

Figure 5. Wage forecast



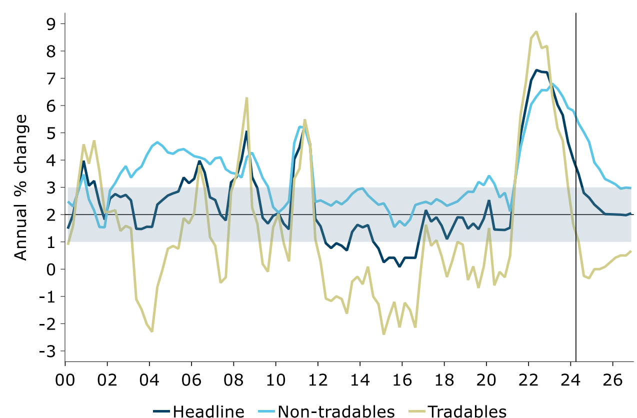

Source: Stats NZ, Macrobond, ANZ Research

A challenging year lies ahead for the economy, but from the RBNZ's perspective, the labour market continues to shift in the required direction. Spare capacity is emerging, and wage growth is moderating. A sustained moderation in labour costs lies ahead, which will reduce domestic inflation pressures. But until the RBNZ has greater confidence in domestic inflation's trajectory, it will continue to restrain demand.

## … and inflation slows

Headline inflation has continued to fall toward the 2% target, and we continue to expect it will be back within the RBNZ's 1-3% target band by Q3 this year. But that doesn't mean the RBNZ can declare Mission Accomplished. The divergence across the CPI basket remains, with domestic inflation continuing to print stronger than the RBNZ have anticipated. The disinflation journey has been two-speed. Tradables inflation, the largely imported and more volatile component of inflation, has fallen sharply, reflecting the unwind of the significant supply-side disruption over the past few years coming from COVID, geopolitical events and weather disruption.

Figure 6. Inflation component forecast

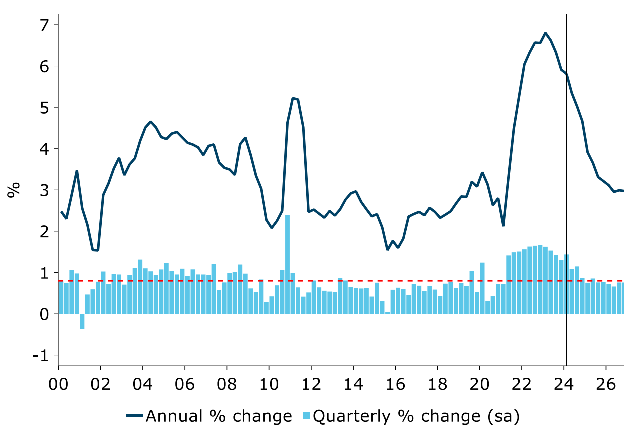



Source: Stats NZ, Macrobond, ANZ Research

# Our forecasts

However, the domestic component of inflation that the RBNZ has more influence over, and which to a greater reflects the period of excess demand in the economy from loose monetary and fiscal policy settings, has yet to show significant disinflation progress. We do expect this to occur, though the timing of monetary policy transmission to domestic inflation this cycle has been slower than expected. Annual non-tradables inflation of around 3.2% has historically been consistent with headline inflation at 2%. That equates to a seasonally adjusted non-tradables inflation impulse of around 0.8% q/q. On our forecasts, we don't expect annual non-tradables inflation to return to 3.2% until the end of 2025.

Figure 7. Non-tradables inflation forecast




Source: Stats NZ, Macrobond, ANZ Research

Spare capacity has emerged across the economy, particularly in the labour market, and economic conditions have deteriorated significantly, but businesses continue to report an inflationary environment. In our April ANZ Business Outlook survey, cost expectations rose to their highest level since September 2023, while pricing intentions remained well above levels historically consistent with inflation at 2%. While the economy is undisputedly weak, it remains highly uncertain how much the economy needs to slow by to return inflation to target. On our forecasts, the RBNZ will need to keep the pressure on for a while yet to squeeze out the last excess inflation pressures from the system.

## … paving the way for OCR cuts…

With inflation forecast to be back inside the RBNZ's 1-3% target band by the third quarter and forecast to be back at the mid-point of the band around mid-2025, monetary policy is on track to normalise with the first cut expected to be delivered in May 2025.

While our sense is that the risks are shaded to earlier, rather than a later, start to cuts, a lot still needs to go the RBNZ's way, including things that are out of their control, such as oil prices and the exchange rate. How the data pans out will ultimately dictate when cuts can be delivered, so if there are surprises, things could change. But for now, while things are going the RBNZ's way, they need to be more confident that the fight against inflation is won before easing. As noted, growth is soft, but inflation has been slower to come down.

For their part, financial markets won't wait for data to confirm their view, nor wait for the RBNZ to openly endorse the view that rate cuts are around the corner. Markets are more than prepared to extrapolate trends and front-run the RBNZ, and that is why bellwether short-end interest rates like the 2yr swap rate are already around 50bp below the OCR. There have been a number of false starts here and overseas, but our expectation is that from here, the passage of time will make markets more confident that cuts are coming, and that will propel short-end rates lower. Upside surprises could result in pullbacks, and cuts may be slower to come than markets currently think, but we should still see short-end interest rates trend lower.

Long-end interest rates are expected to fall, but by less, resulting in a steeper yield curve over time. Not only have 10yr bond yields already fallen by more than their 2yr equivalents in anticipation of eventual cuts, limiting how much further they can go, but the long end is more sensitive to moves in US 10yr bond yields, which are expected to fall a little further before stabilising. The main reason for the lesser fall in US and NZ bond yields is because we expect the Fed to ease later now (in September, rather than July). Fiscal risks are also weighing on investor sentiment at the long end – more so in the US than here, but it's being felt here nonetheless.

## … but RBNZ cuts will follow the Fed, and that is expected to lend the NZD a helping hand.

We have revised our global FX forecasts, which now have the USD remaining stronger for longer, which is consistent with a view of a later start to the US easing cycle. But even after that revision, the Fed is still expected to beat the RBNZ (and for that matter, the RBA) to the first cut. And as NZ/US cash rate spreads widen, we expect that to lend the NZD a helping hand.

Our FX forecasts are also guided by our fair value models, which pulls in our forecasts for interest rate differentials, commodity prices, terms of trade, productivity and the like. They put fair value for the Kiwi at 0.61/0.62, which is not far from – but importantly, above – current market levels.

But while the NZD is expected to eke out small gains against the USD, the NZD/AUD cross is expected to decline gradually, to around 0.89 by year end. That largely reflects better growth prospects for Australia, and its budget and current account surpluses (versus deficits on both fronts here).

# Forecast charts

Figure 1. Production GDP level (headline vs per capita)

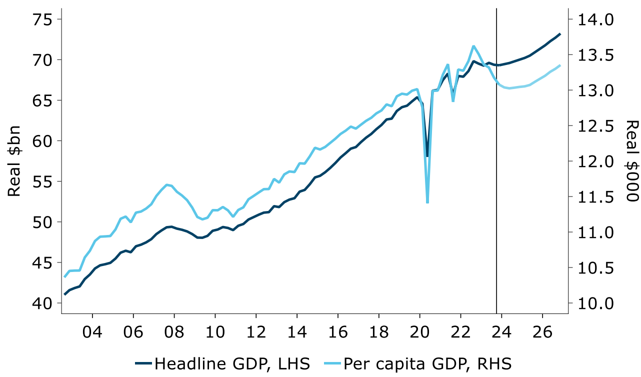



Figure 2. Production GDP growth

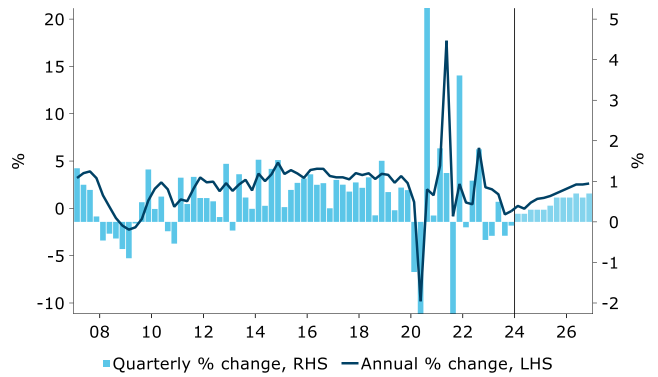



Figure 3. Contributions to GDP growth (detailed)

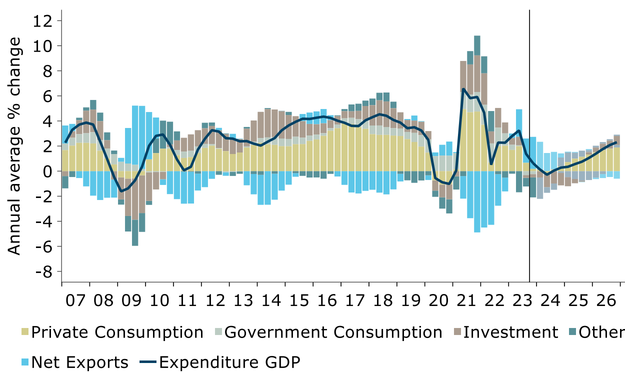



Figure 4. Real investment

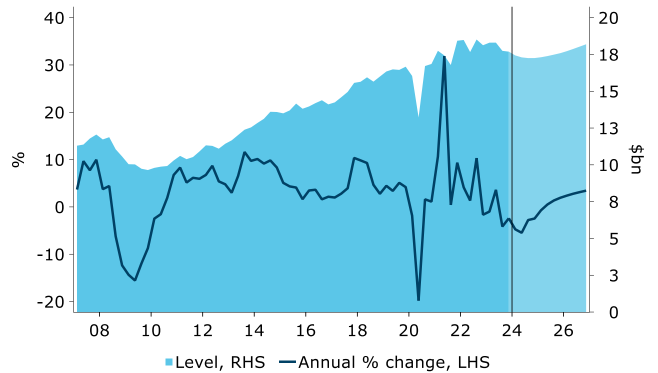



Figure 5. Real private consumption

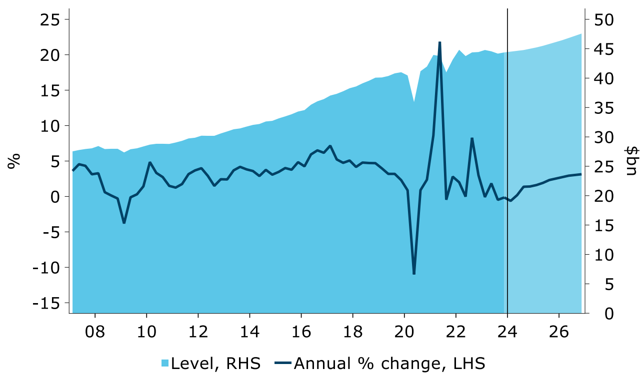



Figure 6. Real government consumption

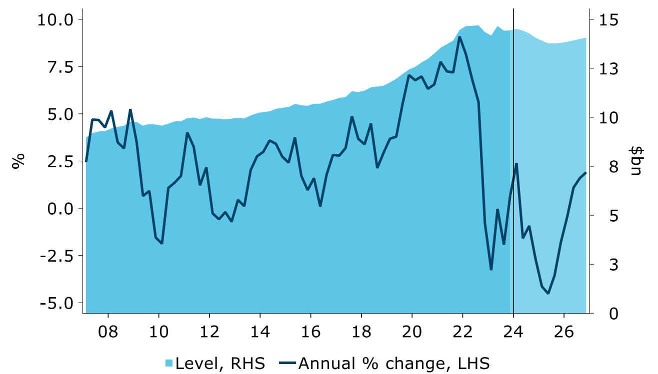



Figure 7. Real exports (goods and services)

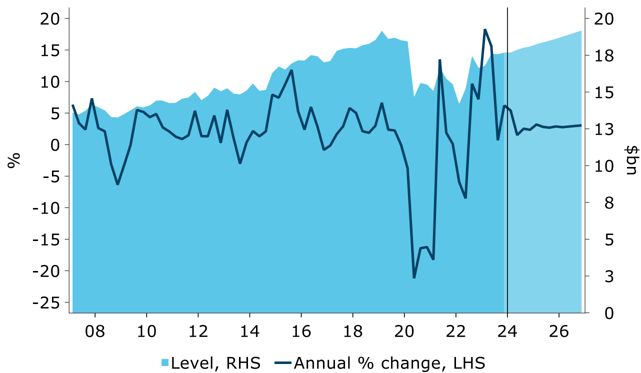
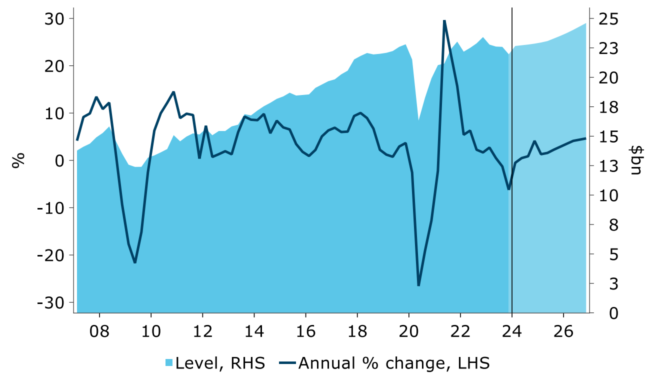



Figure 8. Real imports (goods and services)




Source: Stats NZ, Macrobond, ANZ Research

# Forecast charts

Figure 9. Terms of trade

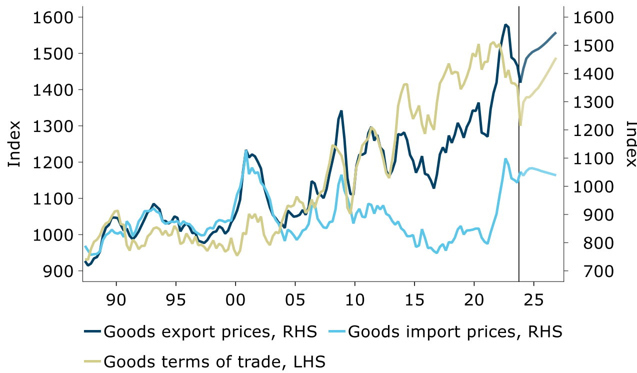



Figure 10. Current account balance

Figure 11. Output gap

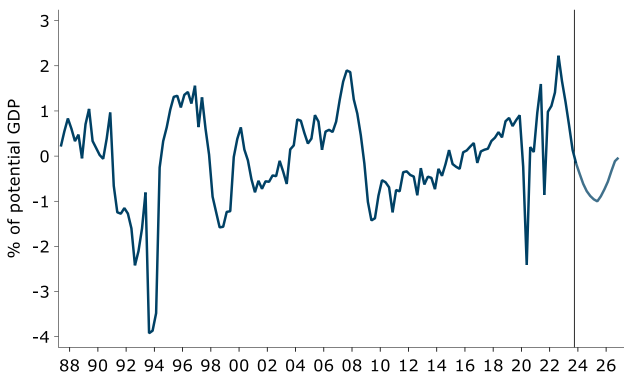



Figure 12. House prices (REINZ HPI)

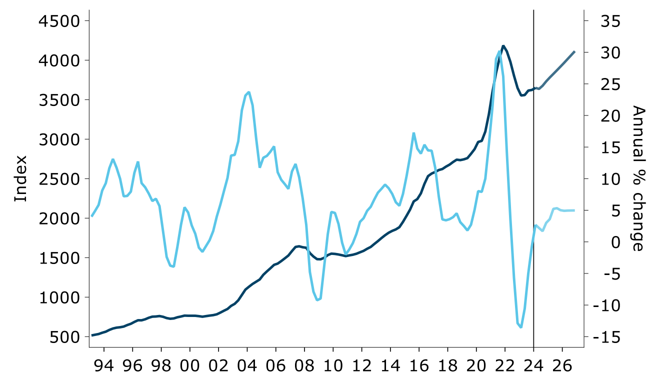



Figure 13. Annual migration

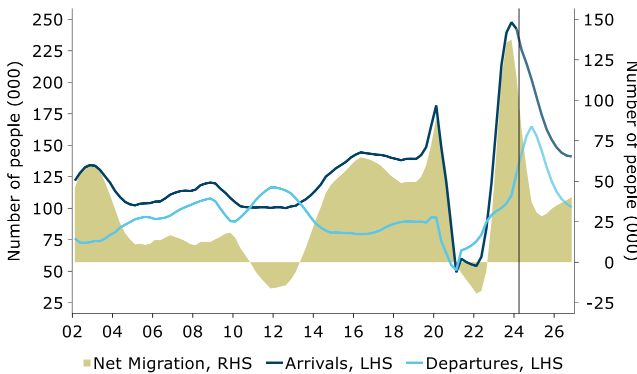



Figure 14. Resident population

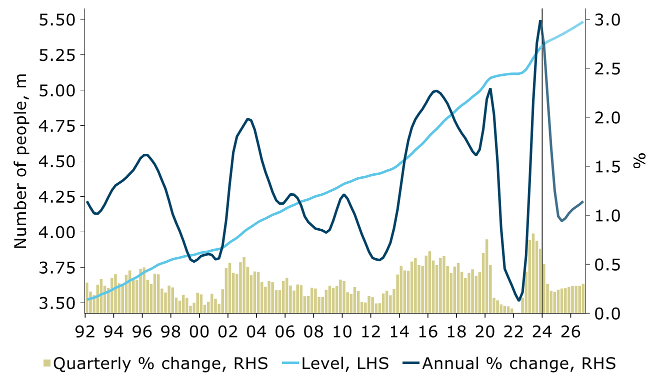
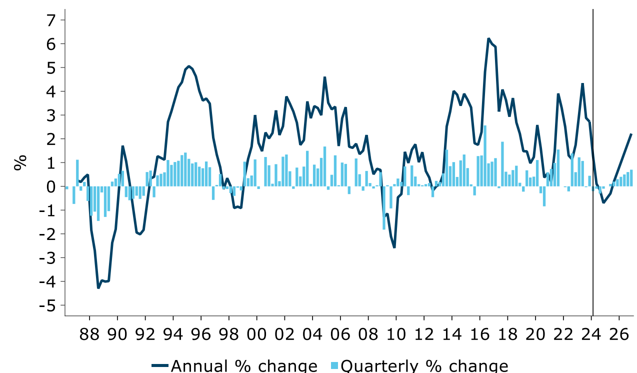



Figure 15. Participation and employment rate

Figure 16. Employment




Source: Stats NZ, REINZ, Macrobond, ANZ Research

# Forecast charts

Figure 17. Unemployment rate decomposition

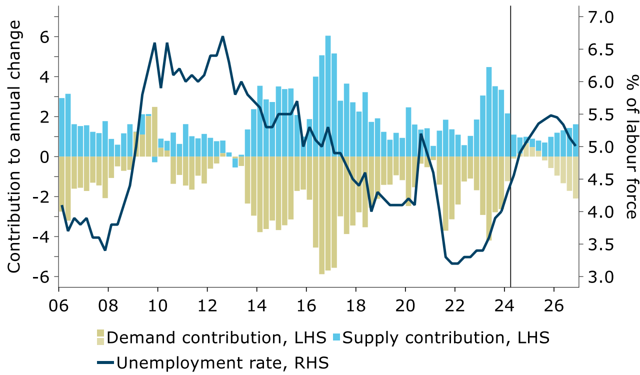



Figure 18. Wages and labour costs

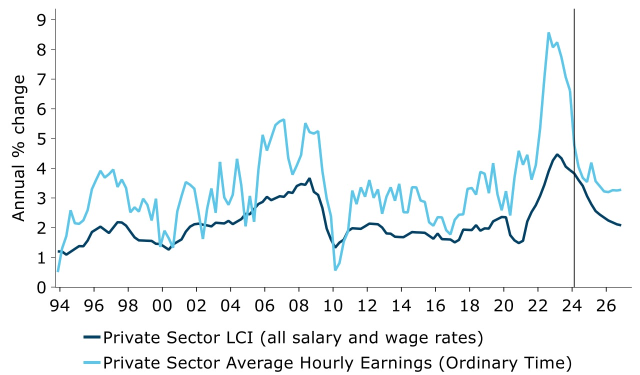



Figure 19. Inflation forecasts

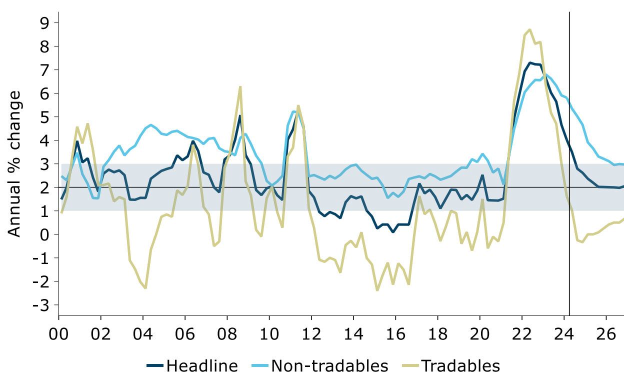



Figure 20. Headline inflation forecast decomposition

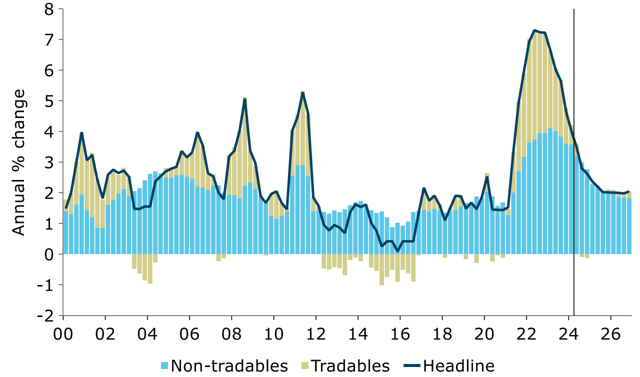



Figure 21. OCR and 90-day rate

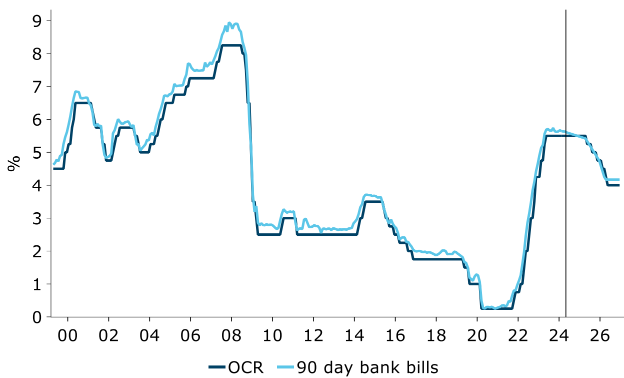



Figure 22. 2-year swap rate and 10-year bond yield

Figure 23. NZD against JPY and CNY, and TWI basis

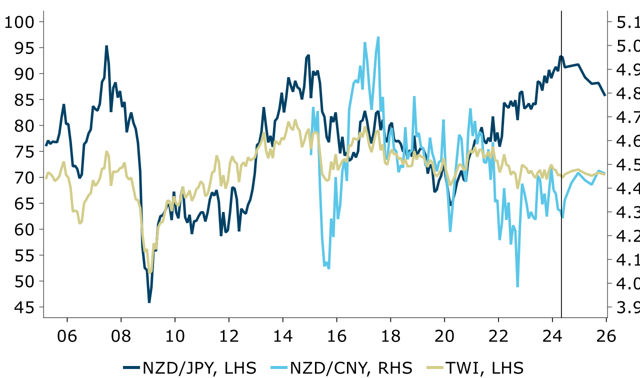
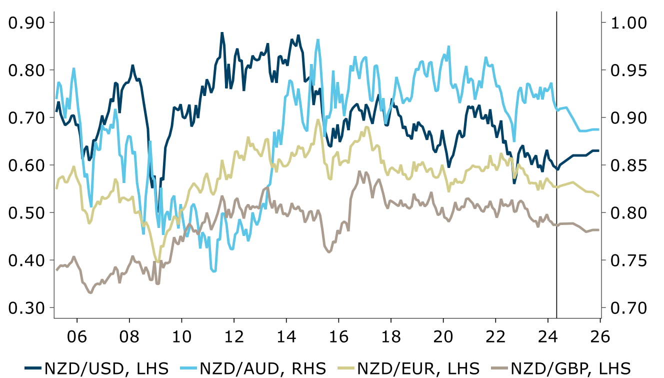



Figure 24. NZD against USD, AUD, EUR and GBP




Source: Stats NZ, Bloomberg, Macrobond, ANZ Research

# Contact us

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### Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 9 357 4094
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

### David Croy
Senior Strategist


Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.


Telephone: +64 4 576 1022
Email: david.croy@anz.com

### Susan Kilsby
Agricultural Economist


Primary industry developments and outlook, structural change and regulation, liaison with industry.


Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

### Miles Workman
Senior Economist


Macroeconomic forecast co-ordinator, economic developments, GDP and activity dynamics, fiscal and monetary policy.


Telephone: +64 21 661 792
Email: miles.workman@anz.com

### Henry Russell
Economist


Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.


Telephone: +64 21 629 553
Email: henry.russell@anz.com

### Natalie Denne
PA / Desktop Publisher


Business management, general enquiries, mailing lists, publications, chief economist's diary.


Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

### Kyle Uerata
Economic Statistician


Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.


Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

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