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New Zealand Chartbook

September 2023

Westpac Auckland Business Awards
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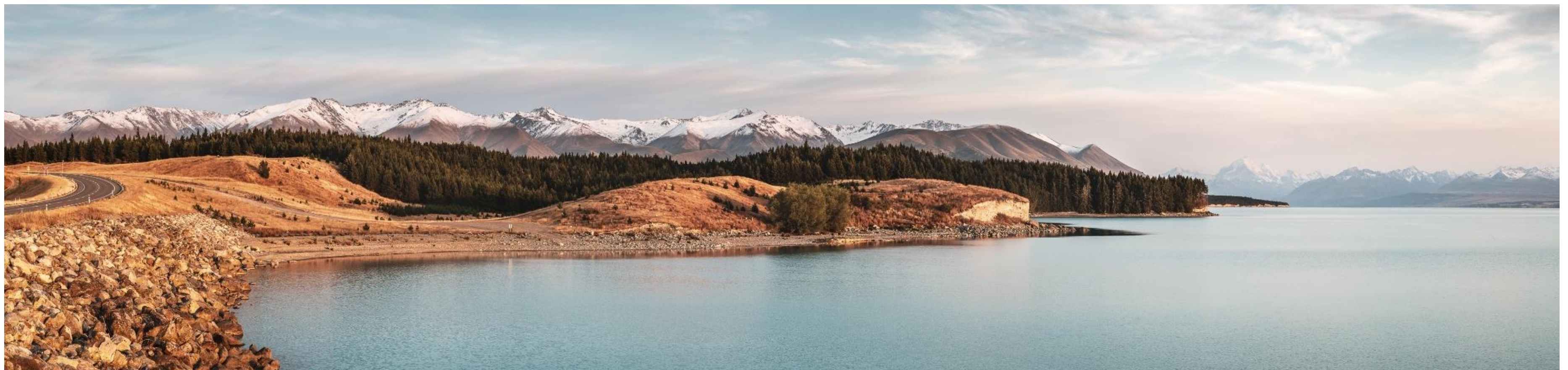
Finalist Excellence in Innovation 2022



Highlights

- The list of negatives for the New Zealand economy continues to grow, making the second half of 2023 and early 2024 the toughest part of the cycle.
- The ongoing transmission of higher interest rates through the economy, weaker commodity prices, lower profits and business investment and slowing employment growth will make it tough going for the economy over the next few months.
- On a brighter note, the housing market appears to be stabilising as prices appear to be finding a base and construction activity appears to be bottoming out.
- The unemployment rate is moving gradually higher, but we expect the pace to quicken on the back of weaker domestic demand in the months ahead.
- Headline inflation has moved lower, and we expect this will continue. However, non-tradeable or domestic inflationary pressures will continue to prove difficult to contain.
- We believe the RBNZ has done enough tightening though they will retain a tightening bias for a few months yet. We do not expect interest rate cuts until the second half of next year.

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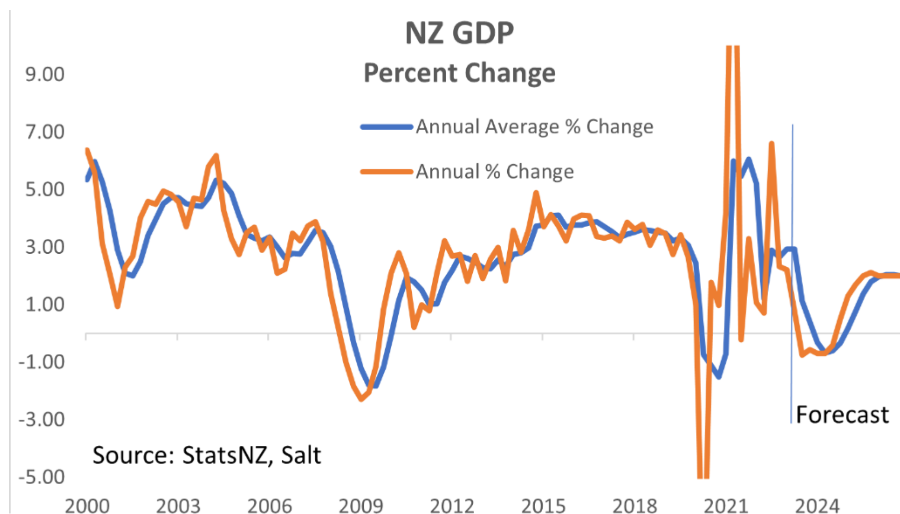
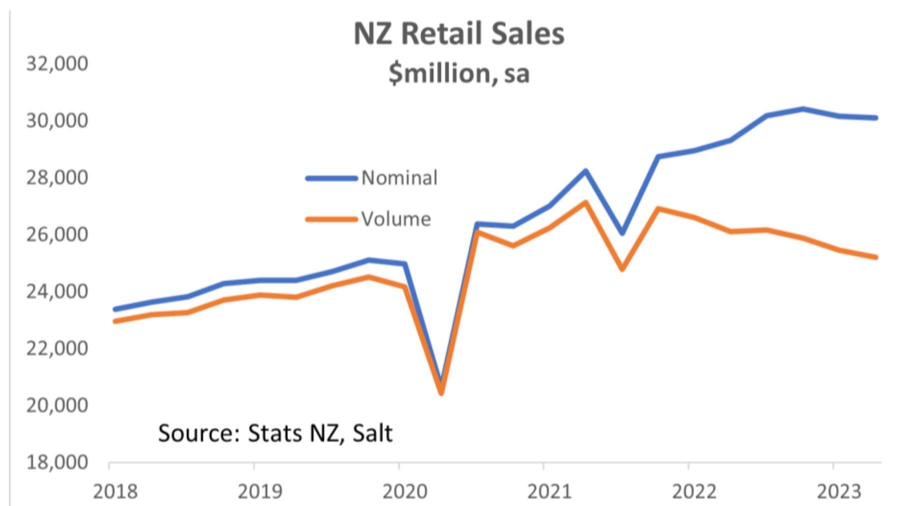
Growing list of negatives for growth

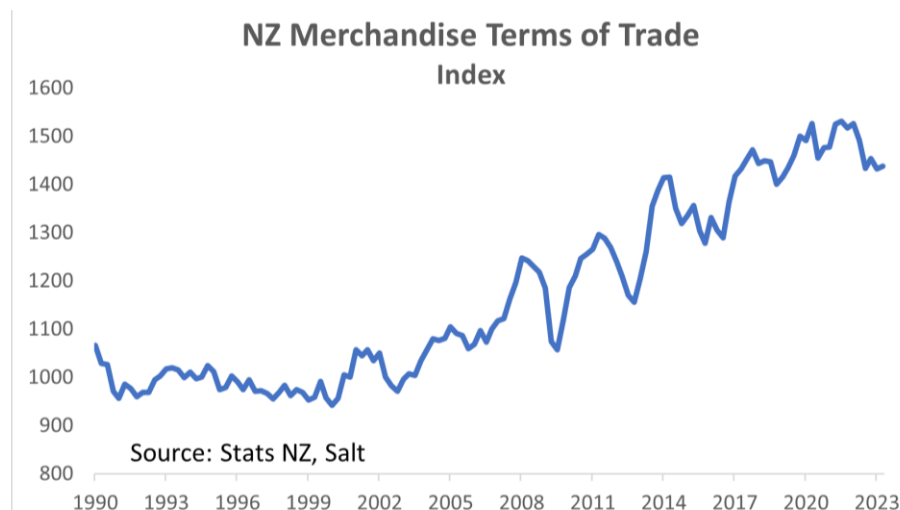


The list of negatives for GDP growth continues to expand. Ongoing pass-through of higher interest rates, slowing employment growth, weaker profits and business investment, the fall in dairy prices and weaker terms of trade, likely softer migration after the recent surge and softer global growth are all conspiring to paint a picture of broad-based weakness in activity in the back half of the year.

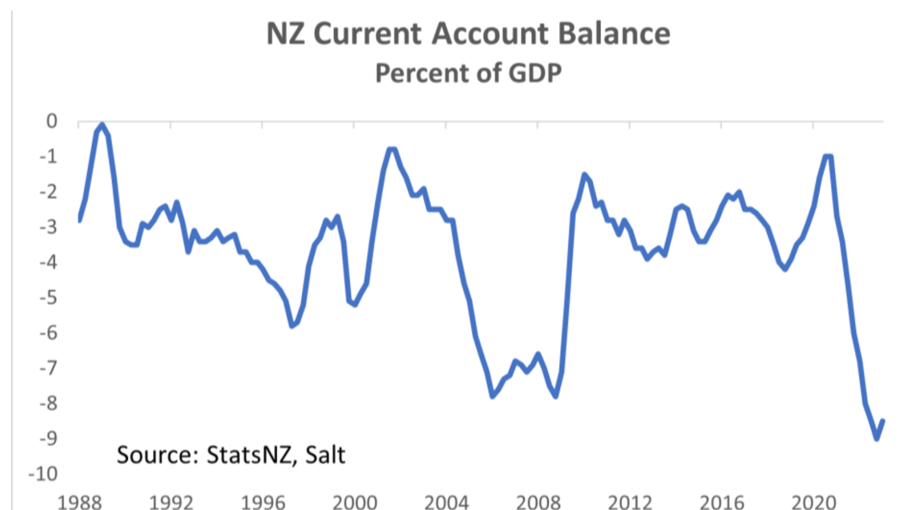


Retail trade was softer than expected in the June quarter. The expected "bump" from the FIFA women's world cup, stronger population growth and the immediate post-flood recovery in spending were collectively swamped by underlying weakness. Retail sales volumes fell 1.0% over the quarter and are now down 3.5% over the year. We expect even weaker results in the 3rd and 4th quarters of the year.

Weakness in the external sector



While recent stronger export volumes may yet save the economy from a third consecutive negative GDP result in the June quarter, the resulting fall in prices is impacting the Terms of Trade (ToT). Bigger falls in import prices saw the ToT rise slightly in the June quarter, but we expect a weaker ToT in the second half of the year as export prices continue to fall and import (oil) prices rise.



New Zealand's current account deficit improved slightly to 8.5% of GDP in the March quarter from it's worst ever result in December 2022 of 9.0% of GDP. But there's still a long way to go before it gets anywhere close to a level that could be described as sustainable and off the watch list of the analysts at the rating agencies.

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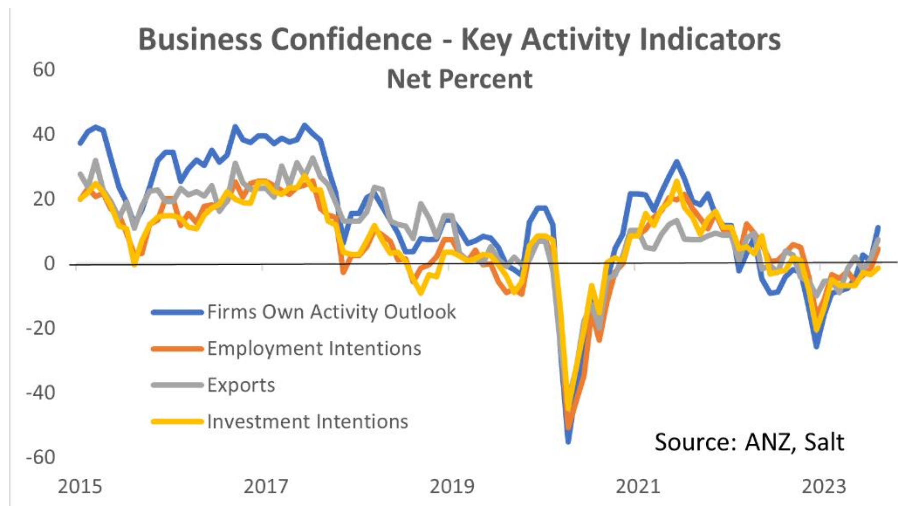
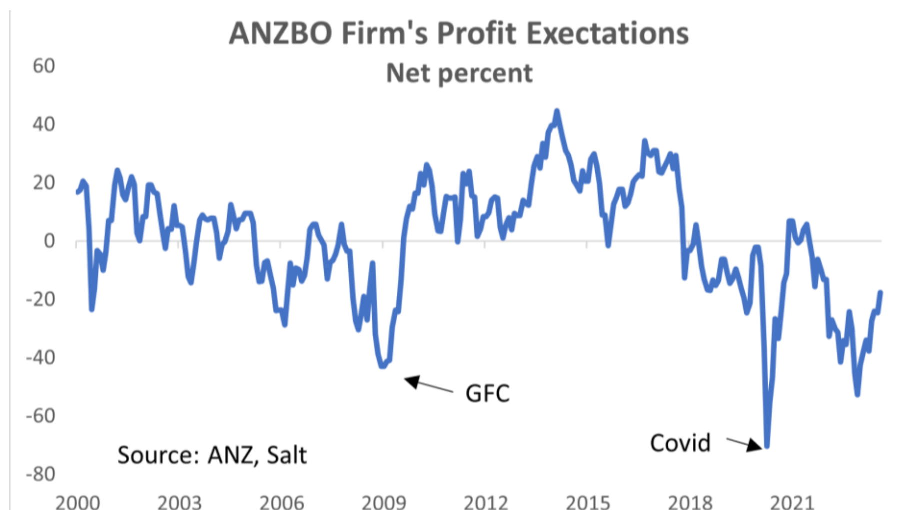
Business confidence – it's all relative

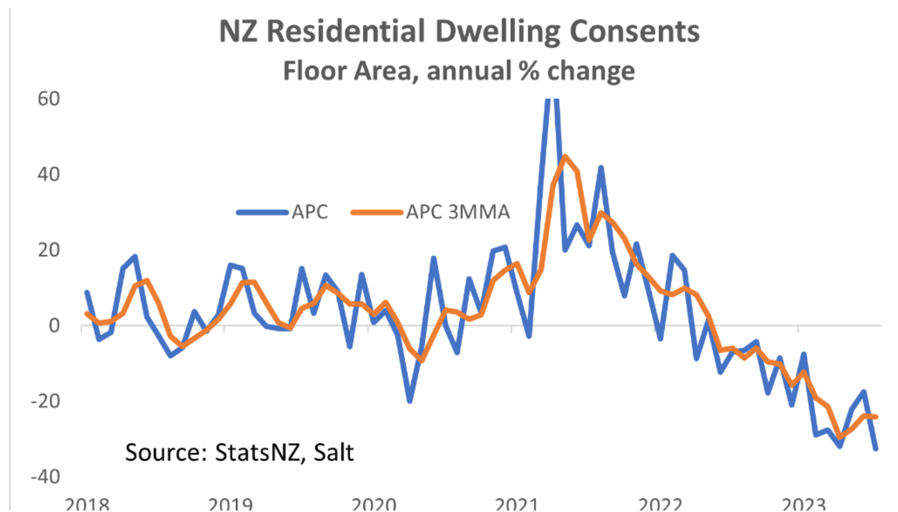


We have been surprised by the recent recovery in business confidence in the ANZ Business Outlook survey, given our view that it's getting tougher out there. But let's remember it's all relative when it comes to confidence. Perhaps the stabilisation in the housing market, combined with interest rates having more than likely peaked has been enough for businesses to feel a bit more upbeat.

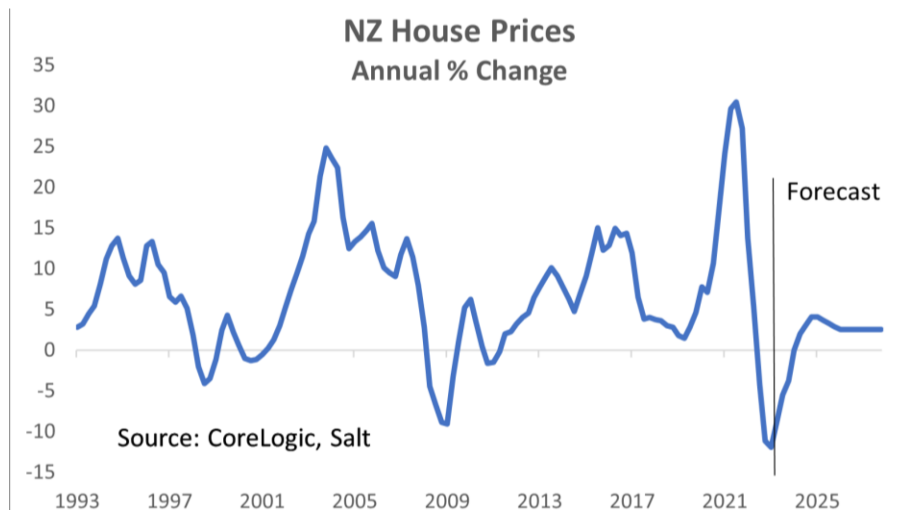


That said, while firms profit expectations have improved in line with general confidence, sentiment remains negative at a net -17.6% in August. That suggests margins are still being squeezed and that taking the next step to implementing new investment initiatives is still a big ask.

Housing market stabilising

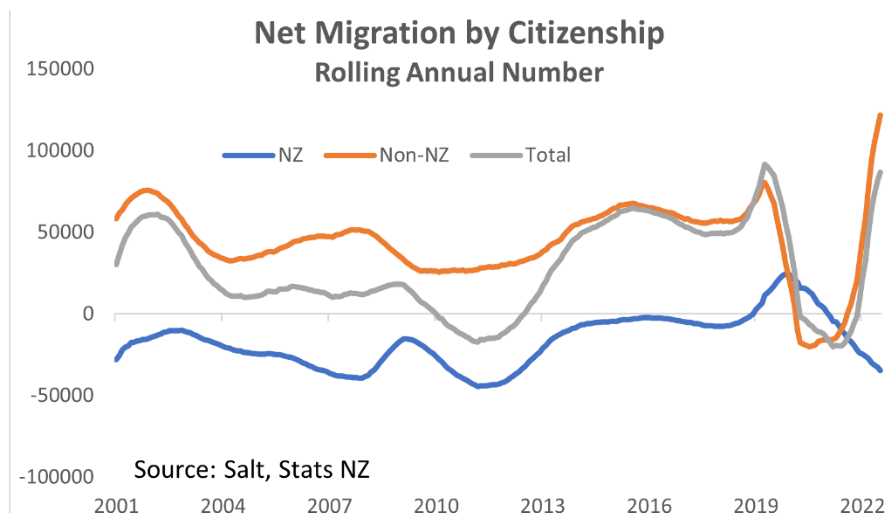


The decline in residential construction activity appears to be bottoming out. The negatives of rapidly rising interest rates, falling house prices and closed borders are now being replaced by rapidly rising net migration, stabilising house prices and at least the perception, if not the reality, that interest rates have peaked. Still, total residential floor area permitted is down around 24% on year ago levels.

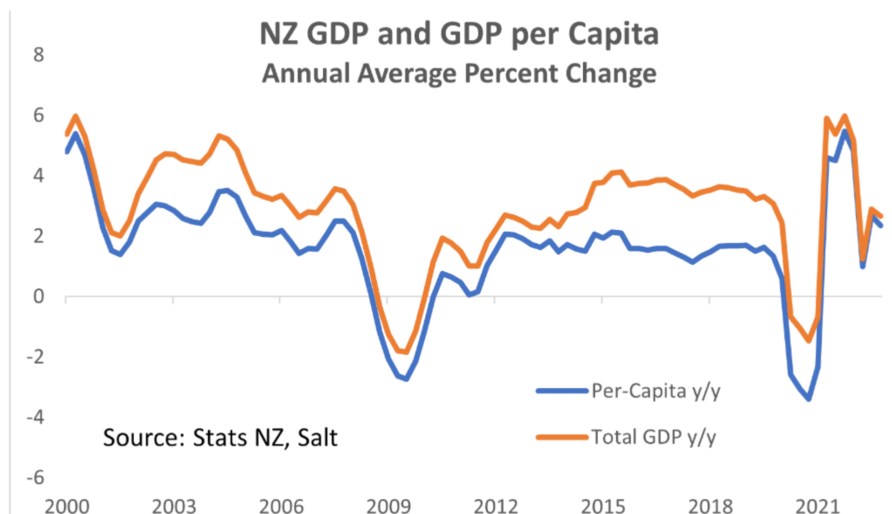


Falls in house prices also appear to be leveling off. Stronger population growth via net migration, the likely peak in mortgage interest-rates and perhaps the fear of missing out on a bargain by new home buyers has led to a halt to the rapid price falls. However, we don't believe that conditions are in place for a rapid recovery in prices - we're expecting more of a bounce along the bottom.

Close to a peak in net migration



The annual net inflow of migrants was just under 87,000 in the year to June. While monthly net inflows look to have peaked in March this year, the annual total can be expected to move even higher in the next few months as lower numbers from a year ago drop out of the annual calculation. From there we expect net inflows to moderate to our estimate of the "new normal" of around 35,000 per annum.



Net migration of 87,000 adds 1.7% to population growth which means to get a real picture of the performance of the economy we need to look at per capita GDP growth. Unfortunately, the Covid period makes any observation post 2019 a bit difficult, however we can still draw the conclusion that our real economic challenge is still productivity growth.

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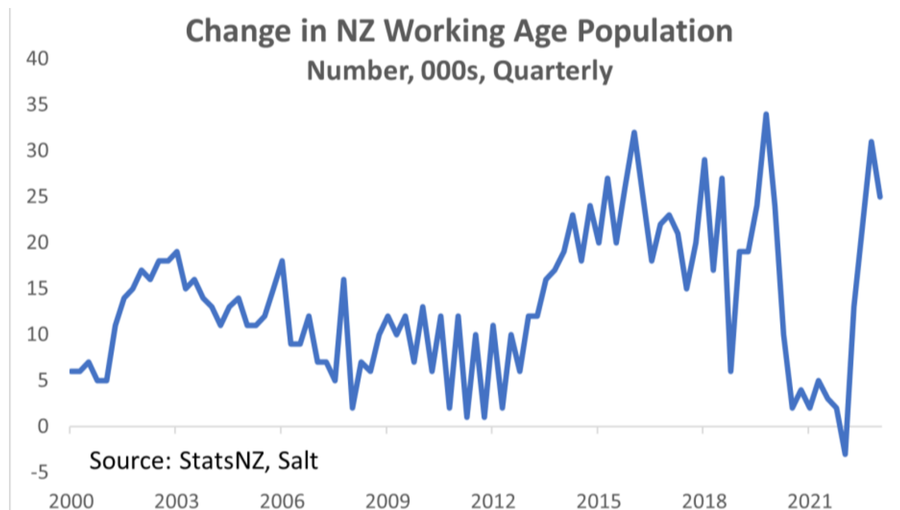
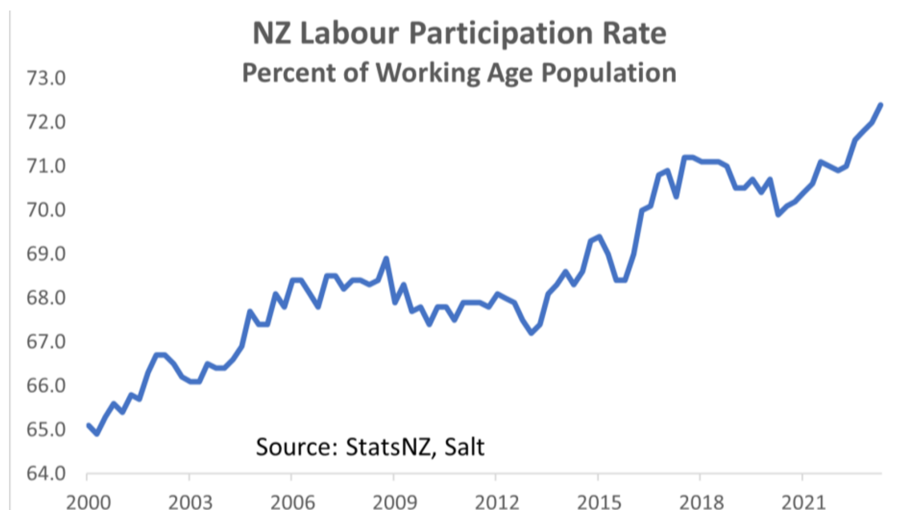
Rapid growth in working age population



After briefly contracting in the June quarter of 2022, growth in New Zealand's working age population has surged along with the return to strong levels of net migration. This has vastly improved supply conditions in the labour market, allowing pent-up demand for labour to be satisfied and take some of the pressure off wage growth.



At the same time, New Zealand's already high participation rate (by OECD standards) has moved even higher over the last three years. On one level that is the sign of a well-functioning labour market, but also more recently of the increasing financial stress households have been under on the back of the "cost-of-living crisis" and higher mortgage rates.

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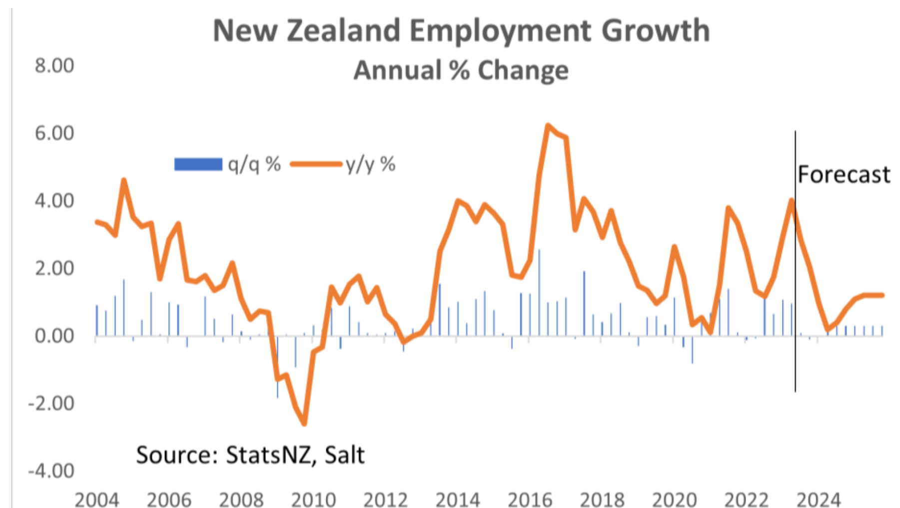
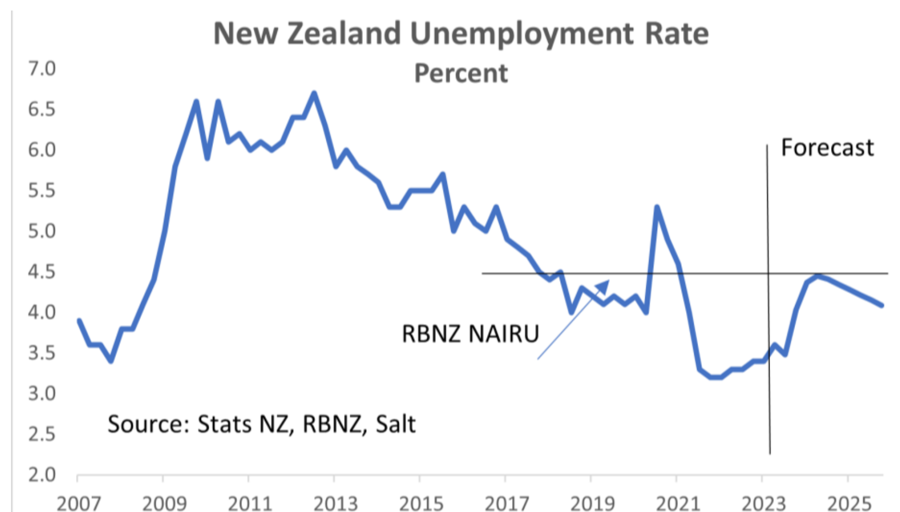
Jobs growth a function of pent-up demand



Recent strong employment growth that has seen the annual rate of growth exceed 4% is peaking as pent-up demand has run its course and as demand weakens across the economy. We see employment growth slowing to an annual rate of around zero over the next four quarters. A degree of labour hoarding given ongoing skills shortages will likely prevent a sharper downturn in the labour market.



Slowing employment growth will see a more dramatic rise in the unemployment rate over the next few quarters. At 3.6% it is already off its recent lows of 3.2%, but is projected to rise to 4.5%, or around the RBNZ's current estimate of the Non-Accelerating Inflation Rate of Unemployment (NAIRU), as growth in the working age population exceeds employment growth.

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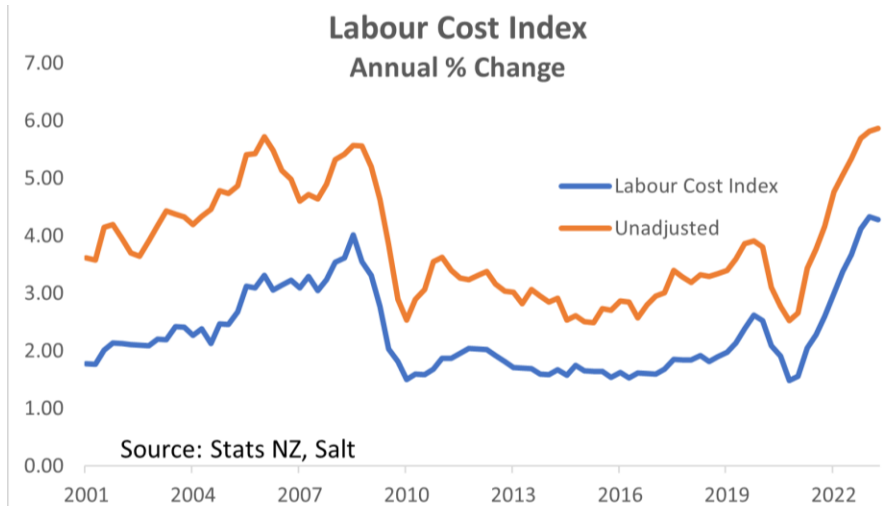
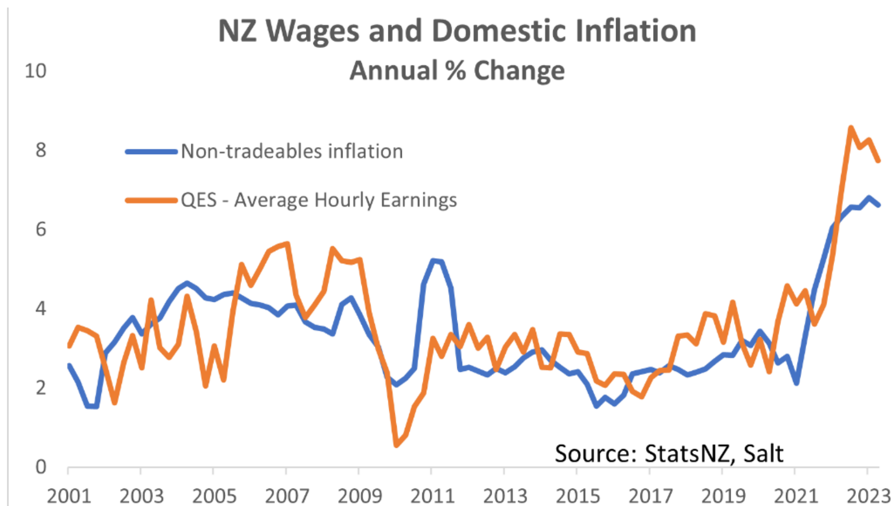
Wage growth has likely peaked





As the unemployment rate has slowly lifted from its lows, wage inflation appears to be moderating. The annual rate of increase in the Labour Cost Index, a measure of wage inflation that adjusts for the quality of work done making it a unit labour cost type measures, dipped lower in the June quarter. But at 4.3%, it's a long way from the 2% that would make it consistent with the RBNZ's inflation target.

Likewise nominal wage growth is also moderating. After peaking at 8.6% in September last year, this measure has since fallen to 7.7%. Again, that is a long way from the 3% (allowing a generous 1% for productivity growth) that would give the RBNZ comfort.

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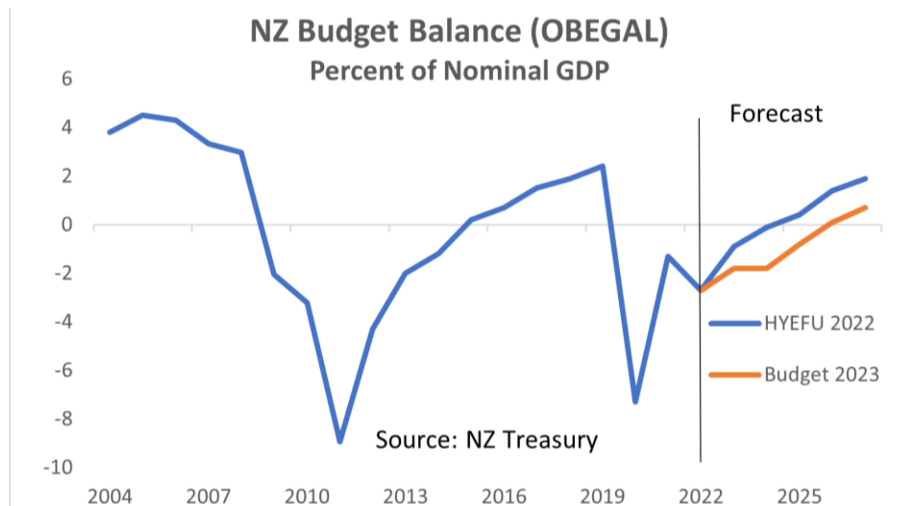
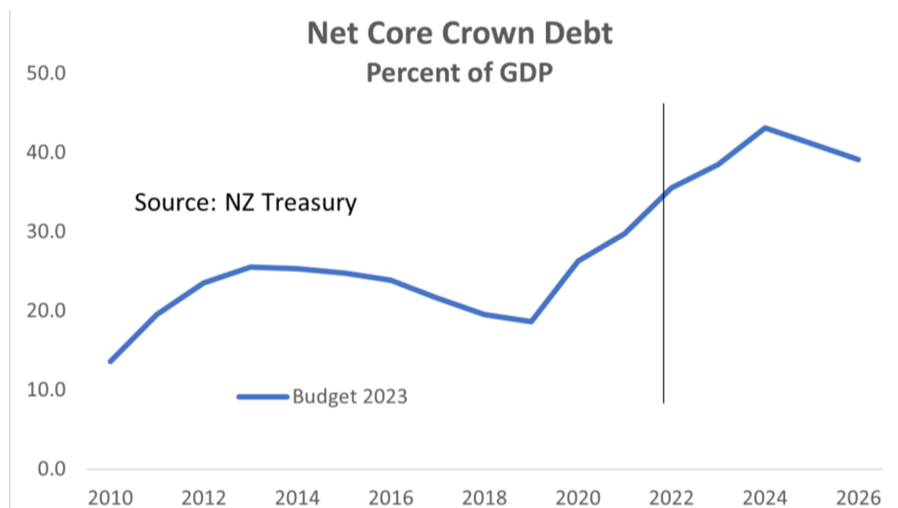
PREFU to show fiscal deterioration relative to the Budget



At the time of the Budget, we signalled the projected return to surplus in FY2026 was built on optimistic economic foundations. Indeed, data for the 11-months to May show the tax take running around $2 billion below forecast. The upcoming Pre-Election Economic and Fiscal Update (PREFU) will therefore likely show the return to surplus pushed out another year to FY2027…



…requiring a further lift in bond issuance of around $8 billion over the next 4 years. That's on top of the surprise $20 billion increase at the time of the Budget. Market "indigestion" pressures are building and will serve to underpin higher for longer bond yields. The relative fiscal positions of each of the major political parties will be of more than passing interest this election.

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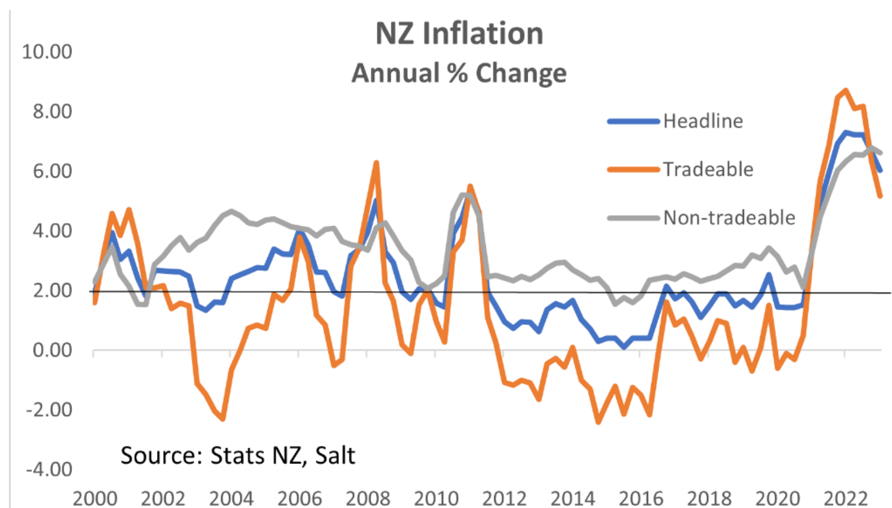
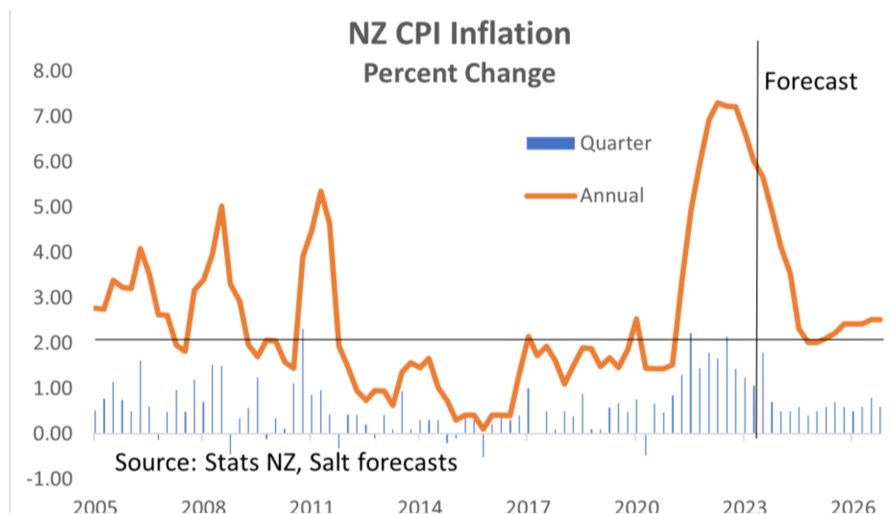
Not out of the woods on inflation



The disinflation process is off to a good start but mostly at the headline level. After peaking at 7.3% in June last year, the headline CPI had fallen to 6.0%. Still disconcertingly high but heading in the right direction. Domestic inflation (as measured by the non-tradeable index) didn't reach quite the same dizzying heights but is also proving harder to turn around.



The trend lower in headline inflation is expected to continue with the rate of increase back inside the RBNZ's target band in the second half of next year. The risk is that domestic inflation remains sticky, especially if wage inflation remains strong. We are not completely out of the woods yet.

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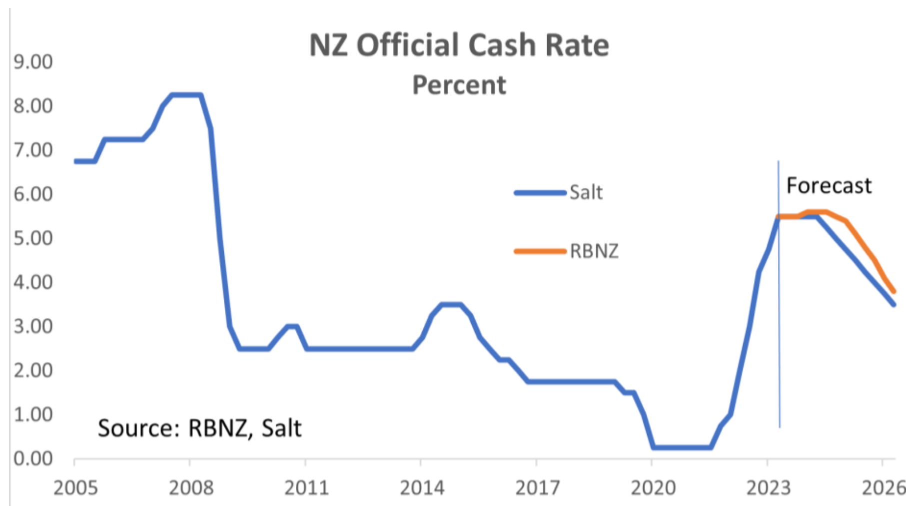
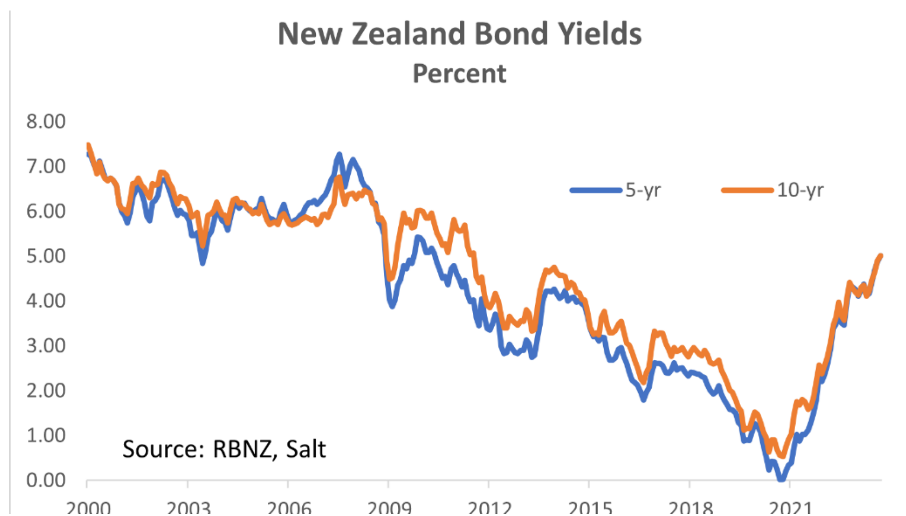
OCR has (probably) peaked



The RBNZ left the OCR unchanged at the August MPS but made a minor tweak to the projected OCR, pushing it higher by 10 basis points. We're not getting too excited by this, rather seeing it as a sign that the RBNZ retains a bias to tighten. Right now, we think things are heading in the right direction for the RBNZ and they have done enough but concur we won't see rate cuts until around this time next year.



Bond yields have moved higher around the world since our last report and New Zealand has not been immune. Concerns about further hikes from key central banks, rising debt issuance and Fitch's rating downgrade of US sovereign debt at the start of August have all transpired to push yields higher.

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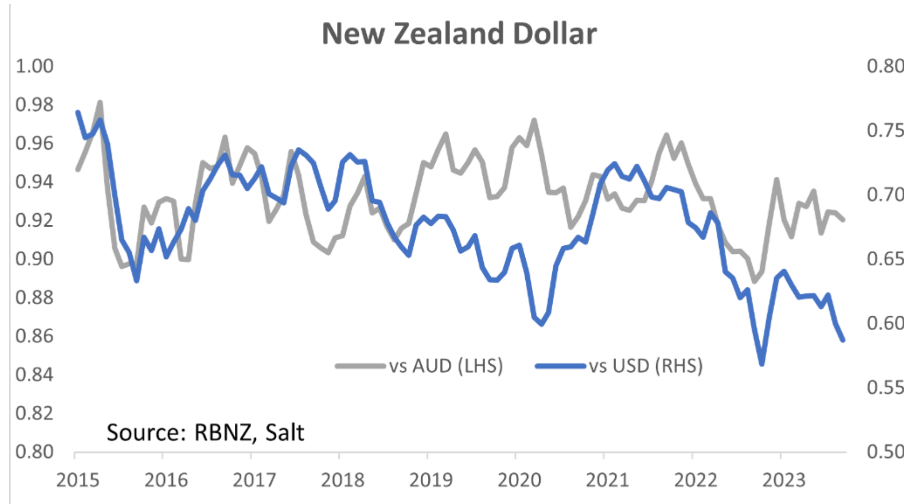
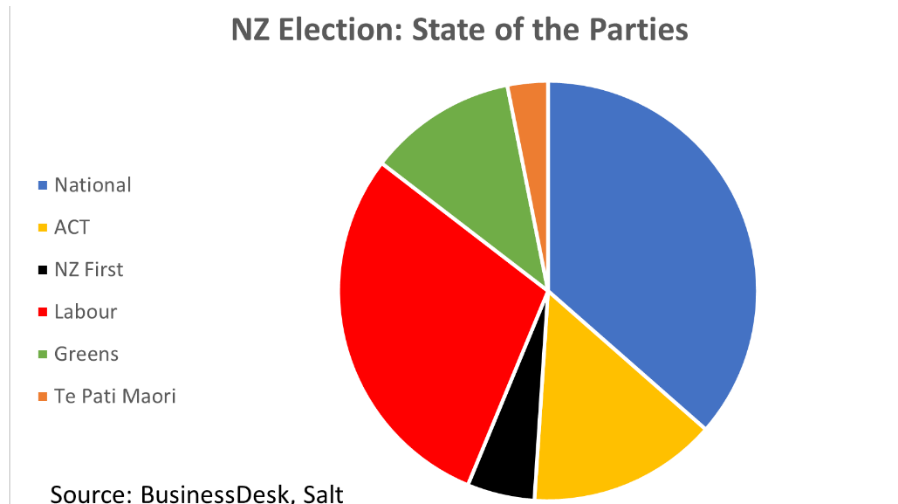
Exchange rates and politics



Worries about the Chinese economy hit the NZD and AUD's during August. This and weaker commodity prices will likely be the dominant factors for the NZD/USD in the near-term. Weakness is also likely for NZD/AUD on a relative economic performance story. Longer term we see a weaker USD/stronger NZD as the US economy slows and Fed speculation turns to rate cuts.



As the saying goes, a week is a long time in politics but right now the momentum appears to be with the parties of the right. There is a long way to go in the campaign ahead of the October 14th election and a lot can, and most likely will, change.

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