BUSINESS NZ

PLANNING FORECAST

JUNE 2022

BusinessNZ

NZ Economy: Prevailing headwinds

Executive Summary

The NZ economy faces significant headwinds over the forecast period out to June 2024.

On the positive side of the equation, NZ currently has low unemployment, and manageable levels of net Crown debt. Meanwhile relatively high commodity prices have, until recently, been providing historically high returns to our agricultural producers. Covid infections also appear to be well past their peak while households and businesses are starting to get back to some sort of normality, despite continuing restrictions affecting everyday activities.

Despite these positives, both business and consumer confidence remain sub-par for a range of reasons. A recession, or at least a technical recession (defined as two consecutive quarters of negative growth), cannot be ruled out.

Borders are finally being reopened in a very measured way. Businesses still face significant supply-side constraints with limited migration and shortages of materials due to constraints on ports and more broadly, on supply chains.

Greater inflationary pressure, the result of domestic policies and international factors (e.g., the Russia/Ukraine conflict) are exacerbating matters, while a number of regulatory proposals in the pipeline will increase costs for both businesses and households.

As the Reserve Bank reins in its quantitative easing (money printing) programme and progressively raises the Official Cash Rate (OCR) towards more neutral levels, households and businesses will be faced with rising interest rates, a shock for many who thought low interest rates were here to stay.

Interest rate hikes still have some way to go but many households will not feel the major effects until mortgages are re-priced later this year when rates payable will likely double from those many have become accustomed to over the past couple of years. Combined with elevated levels of household debt, increased mortgage payments will potentially put significant pressure on budgets, particularly if employment falters down the track. Disposable incomes are increasingly under pressure.

Although the Government has been quick to push the line that extraordinary times require extraordinary measures (e.g. increased fiscal support), it is also important to address the need to significantly prune back many of the things NZers have taken for granted if the Government is to get its books in order over a reasonable period before another "one-off" event hits us. In economic terms, there is no such thing a free lunch.

On the international scene, most international forecasting agencies have downgraded global economic growth for this year and beyond since blockages in supply chains and rising inflation are now global problems. There are still simmering trade tensions together with significant geopolitical uncertainty on several fronts including, but not limited to, the current Russian invasion of Ukraine. Tensions are also rising in our own backyard with concerns expressed about China's intentions in the Pacific region.

Meanwhile China's largest cities are just starting to emerge from the most stringent lockdowns, reflected in a falling and potentially negative growth rate – something unheard of in China for many years. Consequently, numerous commentators have predicted China's growth rate might be negative for the June quarter putting further downward pressure on dairy prices over the coming weeks given this country's reliance on China to take large amounts of our agricultural produce - although acknowledging that current prices are still well above their historical average.

HIGHLIGHTS

The global economic recovery post-covid has taken a hit as both continuing geopolitical risks and supply chain disruption are driving inflationary pressures and investment uncertainty.

The BusinessNZ Economic Conditions Index, a compilation of NZ's major economic indicators, sits at 1 for the June quarter, up 4 on the previous quarter but down 13 on a year ago. The index overall has shown minimal change of late although this masks large changes in the sub-indices, with low business and consumer confidence continuing to take a toll on the index.

Global and domestic pressures are impacting on certain sectors with continued growth in the construction sector, although the inability to source key inputs - labour and materials - is constraining output and forcing up prices.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey - the Performance of Services Index (PSI) show relatively slow growth, although the PSI has now been in positive territory for the last three months after previously being generally negative due principally to Covid-related restrictions from March 2020.

The agricultural sector, after reasonably healthy returns over the last few years, is facing pressure from the hit international commodity prices are taking as China comes out of hard Covid lockdowns. Continuing supply chain issues are badly affecting input costs, such as the cost of fertiliser, with the sector also facing labour shortages.

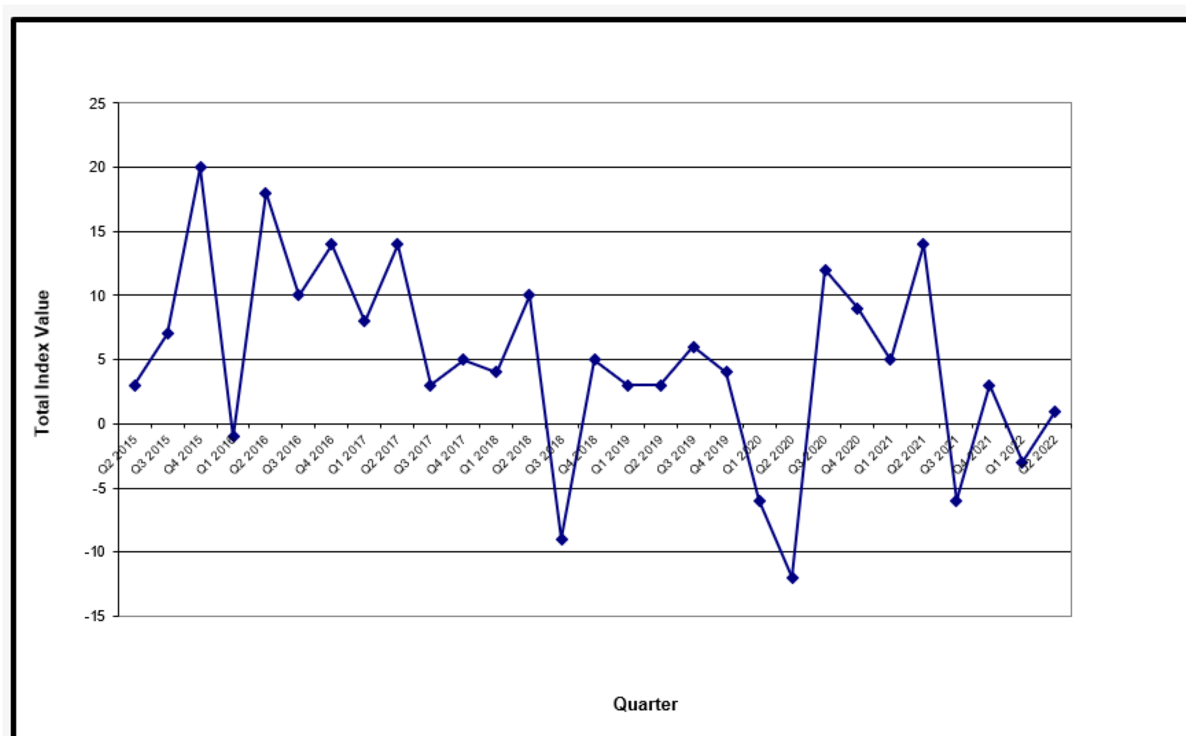
Consumers and households are coming under increased pressure as inflationary pressures erode disposable income. Higher interest rates are starting to bite given high levels of household debt. Meanwhile the Reserve Bank faces the difficult task of trying to suppress inflationary pressures while the main problem is on the supply-side, reflecting resource availability and labour constraints.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 1 for the June 2022 quarter, up 4 on the previous quarter and down 13 on a year ago. The index overall shows little change for the June 2022 quarter, however this masks large changes in the sub-indices, including slight improvements in economic growth but offset by deteriorating monetary policy conditions (higher interest rates and inflationary pressures) and a continuing dip in business and consumer confidence.[1]

Overall Economic Conditions Index (ECI)



Data in the ECI is broken up into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Economic growth/performance indicators sit at 3 for the June 2022 quarter, up 2 on the previous quarter and down 2 on a year ago. Key commodity prices for agricultural commodities are coming off their highs, largely on the back of reduced demand from China following their recent severe Covid elimination strategy lockdowns.

Monetary policy/pricing indicators sit at - for the June 2022 quarter, down 4 on the previous quarter and down 6 on a year ago. Current inflation (both tradeable and non-tradeable) remains well outside the Reserve Bank's target band of 1 – 3 percent with continuing rises in the OCR despite the fact that the inflationary pressures are largely a result of supply-side constraints essentially beyond the Reserve Bank's control.

Business/consumer confidence indicators sit at 1 for the June 2022 quarter, up 1 on the previous quarter and down 5 on a year ago. Both business and consumer confidence indicators remain sub-par, affecting investment intentions. High levels of household debt, rising interest rates, and sustained inflationary pressures are having a negative effect on confidence.

Labour market indicators sit at 5 for the June 2022 quarter, up 5 on the previous quarter and the same as a year ago. While the unemployment rate remains at an historic low, rising inflationary pressures are eroding disposable incomes, along with significant rises in interest rates. Businesses are still crying out for staff, with shortages a major constraint on growth.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the June quarter 2022 are estimates based on available information to date.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?

1.1 Economic growth (GDP) – Slow

While the key economic and fiscal indicators contained in the recent Budget 2022 (19 May) currently look reasonable, there are still significant risks to these forecasts being realised.

NZ's net Crown debt is still relatively low leaving the Government with some headroom, if necessary, to spend even more than it has to date before NZ's credit rating comes under attack. But with the country's reliance on international trade and its vulnerably to natural hazards, reining in expenditure would be wise.

The Government has been quick to push the line that extraordinary times require extraordinary measures (e.g. increased fiscal support) but also needs to address the other side of the coin. Many of the things NZers take for granted might have to be rigorously pruned back if the Government is to get its books in order over a reasonable time period before another "one-off" event hits us. In economic terms, there is no such thing as a free lunch.

The Government's continued spend makes reining in expenditure difficult. Too many households, and even businesses, have become dependent, at least to some extent, on taxpayer support payments of one form or another.

It is unrealistic to assume the Government will be able to turn the tap off on future expenditure in the outyears even although the last couple of years' extraordinary expenditure increases were a direct result of fiscal initiatives taken to soften the blow of Covid.

All Government (taxpayer) funded projects should require sound cost/benefit analysis given the potential cost of poor decision-making. This is an issue about which Auditor-General John Ryan has had some strong words to say about the quality and transparency of expenditure decisions.

Ryan wrote to the Treasury (4 May 2022) stating he wants more accountability for how the $74.1 billion Covid Response and Recovery Fund (CRRF) is being spent. In his letter he noted the fund is so big it will have an impact on Government Finances and debt for years to come.

It should be noted that the Government recently changed its definition of net Crown Debt to ensure it is more in line with international measures. This includes incorporating a broader range of Government financial assets within the debt measure (for example the Government's Superfund).

There are legislative proposals coming down the track with similar potential to reduce NZ businesses' flexibility and competitiveness. For example, recent employment relations initiatives (Fair Pay Agreements in particular) will, if implemented, lead to greater centralisation when it comes to determining wages and conditions.

To add to this, climate change proposals, while well-intended, have the potential to impose increased costs on businesses and households during the transition phase. However, Government must remain committed to ensuring NZ businesses and households can meet their international commitment to net carbon emissions' reduction at least overall cost to the economy.

NZ faces additional risks over the forecast period to June 2024 - geopolitical risks as the Russian invasion of Ukraine continues apace with widespread inflationary pressures front of mind on the domestic front.

Looking at the international scene and moving on to the domestic scene.

Most international forecasting agencies have downgraded global economic growth for this year and beyond as blockages in supply chains and rising inflation are now global problems. Tensions are also rising in our own backyard with concerns expressed in respect to China's intentions in the Pacific region.

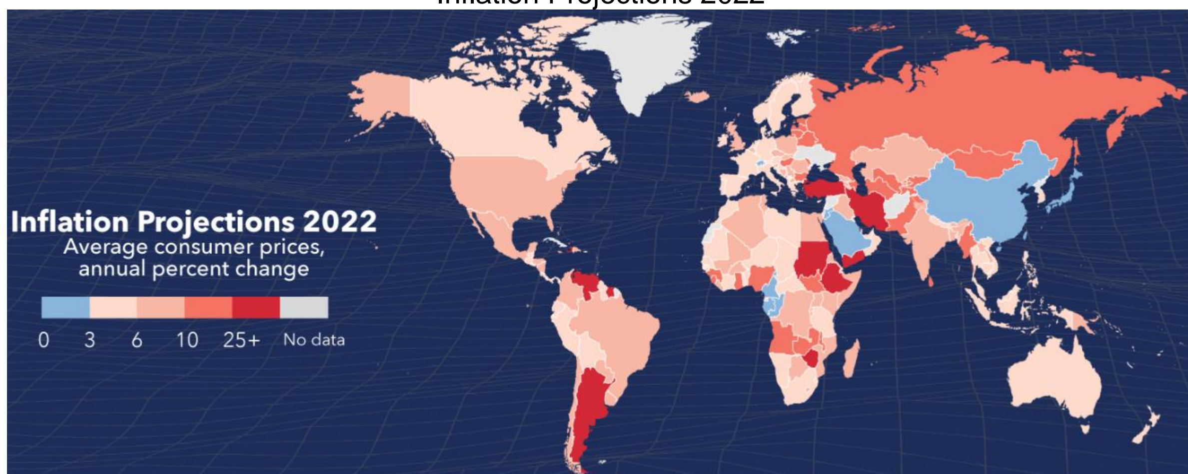
The International Monetary Fund (IMF) World Economic Outlook, April 2022 has suggested the economic damage from the war in Ukraine will contribute to a significant slowdown in global growth in 2022 and add to inflation.

(real GDP, annual percent change)	2021	2022	2023
World Output	**6.1**	**3.6**	**3.6**
Advanced Economies	**5.2**	**3.3**	**2.4**
United States	5.7	3.7	2.3
Euro Area	5.3	2.8	2.3
Germany	2.8	2.1	2.7
France	7.0	2.9	1.4
Italy	6.6	2.3	1.7
Spain	5.1	4.8	3.3
Japan	1.6	2.4	2.3
United Kingdom	7.4	3.7	1.2
Canada	4.6	3.9	2.8
Other Advanced Economies	5.0	3.1	3.0
Emerging Market and Developing Economies	**6.8**	**3.8**	**4.4**
Emerging and Developing Asia	7.3	5.4	5.6
China	8.1	4.4	5.1
India	8.9	8.2	6.9
ASEAN-5	3.4	5.3	5.9
Emerging and Developing Europe	6.7	-2.9	1.3
Russia	4.7	-8.5	-2.3
Latin America and the Caribbean	6.8	2.5	2.5
Brazil	4.6	0.8	1.4
Mexico	4.8	2.0	2.5
Middle East and Central Asia	5.7	4.6	3.7
Saudi Arabia	3.2	7.6	3.6
Sub-Saharan Africa	4.5	3.8	4.0
Nigeria	3.6	3.4	3.1
South Africa	4.9	1.9	1.4
Memorandum			
Emerging Market and Middle-Income Economies	7.0	3.8	4.3
Low-Income Developing Countries	4.0	4.6	5.4

Global growth is forecast to slow from an estimated 6.1 percent in 2021 to 3.6 percent in 2022 and 2023. This is 0.8 and 0.2 percentage points lower for 2022 and 2023 than projected in January.

Inflationary pressure is not only an issue for a select few countries but is now widespread throughout the world, as can be seen from the International Monetary Fund (IMF) graph below. At the same time, many central banks are reining in their loose monetary policy settings, while governments are also trying to pull back on expenditure consequent on the recent Covid pandemic. The day of reckoning has arrived faster than many anticipated.

Inflation Projections 2022



Source: IMF

Inflationary pressures are being reflected in both the costs facing consumers and households in NZ and in increasing costs to particular sectors, e.g. fertiliser and freight costs in the case of agriculture.

According to the IMF, war-induced commodity price increases and increasing price pressures have led to 2022 inflation projections of 5.7 percent in advanced economies and 8.7 percent in emerging and developing economies – 1.8 and 2.8 percentage points higher than projected last January.

In another international publication – Business at OECD 2022 Business Barometer, business respondents voiced significant concerns both on the war in Ukraine and on its economic impacts, including sharp rises in price indices and estimated declines in investment rates.

The Business at OECD publication found the energy sector is the most affected by current geopolitical tensions, closely followed by commerce and shipping. The findings also show that compared with other sectors, chemicals, metals and agriculture are all more exposed to the impact of the war, implying that both inflation and supply chain disruptions could ensue.

On the domestic scene, businesses and households are increasingly nervous for a range of reasons, impacting on confidence across the board.

First, interest rates are starting to ramp up, and with high levels of household debt, will adversely impact on household disposable income given the extraordinarily rapid rise in house prices in 2020 and 2021 in particular. Ironically, while debt servicing costs are only now starting to ramp up, having been at their lowest level for many years, high household debt makes household disposable income particularly sensitive to rising interest rates.

High levels of household debt make individuals vulnerable should circumstances change rapidly, for example, the employment outlook.

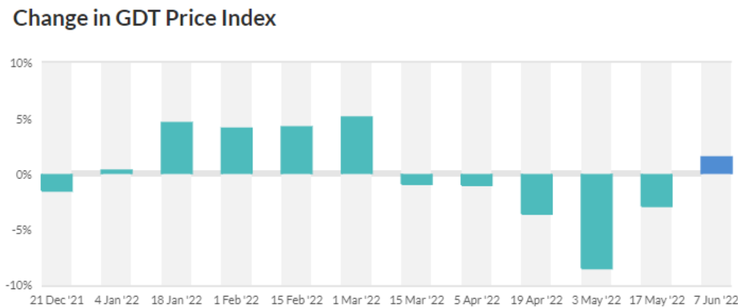
Second, inflationary expectations continue to remain at elevated levels and might not subside as rapidly as Treasury's Budget 2022 forecasts would suggest.

Third, house prices have taken a tumble over the last quarter for a range of reasons, but the real effect is likely yet to come given a number of would-be sellers have withdrawn their houses from the market due to a reduction in prices offered. Housing markets are therefore likely to be much stickier compared with other markets, such as equities where prices chop and change almost on a daily basis.

Downward pressure on house prices is likely to continue for a range of reasons including:

- Net migration is still negative despite a gradual re-opening of the borders and expectations are for a number of young people to exit the country given the high cost of living (particularly housing) and relatively lower income growth compared with other countries
- Recent tightening of Loan to Value Ratios (LVRs) impacting on credit availability
- Uncertainty about the impact of the Credit Contracts and Consumer Finance Acts and banks' willingness to lend despite some tweaking of the original rules. Many, including the NZ Bankers' Association, consider most people seeking credit won't see much difference as most existing requirements remain in place and customers will still have to provide detailed information about their spending - a more painstaking process with more loan applications declined
- Rapidly rising interest rates pricing many out of the market (with more rises to come)
- Individuals taking a more "wait and see" approach to whether they enter the market with the market slowing suddenly. Fear of missing out (FOMA) has been replaced by Fear of overpaying (FOOP). Over recent months, real estate agents have reported a significant reduction in interest from buyers across the board while buyers now have significantly more options
- Finally, the risk of a recession, at least a technical recession (which is considered two consecutive quarters of negative economic growth) cannot be totally ruled out

Fourth, China's largest cities are just emerging from the most stringent of lockdowns, reflected in falling and potentially negative growth rates – something unheard of in China for many years. Numerous commentators have considered China's growth rate might be negative for the June quarter as a result and with NZ relying on China to take a large amount of our agricultural produce, this could put further downward pressure on dairy prices over the coming weeks - although acknowledging current prices as still well above their historical average. Since early March, the Global Dairy Trade (GDT) Price Index has generally been trending down, although the latest auction shows a slight upward movement.



Meanwhile, the ANZ World Commodity Price Index fell a further 2.8 percent in May, driven down by weakness in aluminum, dairy and forestry. But when converted to NZ dollars, the index gained 2.0 percent after the NZ dollar appreciated sharply on a trade weighted index (TWI) basis.

Given NZ's significant trading relationship with China, it is important to its economic well-being for both countries to succeed. In this respect, it is concerning that China has taken a very draconian lock-down approach to the control of Covid infections, rather than embracing the widely held view that since Covid is here to stay for a while, there is a need to decide how best to manage it and at the same time maintain an open economy.

Fifth, the challenge associated with future infrastructure needs has been firmly outlined in the recent NZ Infrastructure Commission publication - NZ Infrastructure Strategy 2022-52.

There are many issues to be faced but some key issues outlined in the strategy include:

- $90 billion needed to fix water networks
- 115,000 more homes needed to fix the current housing crisis
- The exposure of $5 billion of council infrastructure to sea level rise
- Electricity generation capacity needing to increase by 170%
- Infrastructure construction costs rising 60% faster than prices elsewhere in the economy
- A shortfall of 118,500 construction workers by 2024
- The 75% chance of an Alpine Fault earthquake by 2070

While some of the above issues are not necessarily of immediate concern, they nevertheless indicate the many and varied risks arising from NZ's current infrastructure deficit.

Sixth, NZ potentially faces significant risks from climate change, and on this issue, it is noted the Government recently released papers looking at possible National Adaptation Plans (NAP) to be used if it proves necessary in future to address the need for a managed retreat in light of potential future sea level rises.

It is acknowledged that early consideration of policies relating to a possible managed retreat from sea encroachment is important, but it is also important, both for regulators and for affected property owners, that such policies are based on better data and provide better guidance than at present. Responding to the Ministry for the Environment's (MfE) draft National Adaptation Plan for climate change, BusinessNZ, in its recent submission, indicated the need for more data on risk levels, with a technical working group to consider, for example, what an appropriate threshold for requiring people to move in response to climate change would be, how to ensure compensation for removal, or for restrictions on land use, and how to incentivise households and businesses to make good long-term decisions on development (current or future) in risk areas.

Managed retreat is a very complex issue and with its significant implications for property rights, needs to be carefully thought through.

Seventh, regulatory risks are also focusing the minds of businesses and households, as there is the potential for regulatory takings (reducing the value of property rights) without adequate, or indeed any, compensation.

It is noted that three councils have launched legal action against the Government's Three Waters reforms. The Timaru, Waimakariri and Whangarei District councils are asking the High Court to declare councils own the water infrastructure assets for storm, rain and drinking water and having exclusive possession and control over them, have the exclusive ability to prevent others from interfering with such assets. This, they argue, bestows property rights that preclude government from rationalising water services into four entities.

Mayors Nigel Bowen, Dan Gordon and Sheryl Mai said in a release this *"is expropriating council-owned property*

without conceding that it is a taking, and without fair compensation being paid to communities for their property"

Irrespective of the final outcome, this case would suggest the issues relating to regulatory takings are potentially much bigger than just those associated with the Three Waters Reforms but go to the heart of all private property ownership. As such, they have implications for all property owners.

The above would suggest NZ's regulatory system needs more checks and balances to ensure serious analysis of the wider implications of legislative decision-making. These were particularly needed during Covid, when a number of laws and regulations were effectively fast--tracked through Parliament without adequate public consultation or input from experts in specific fields. While many matters fast-tracked then might have been considered essential and logical, a number of changes reduced property rights without any form of compensation being considered. There is a risk that if fast-tracking becomes widespread, business and household incentives to invest and build-up assets will be constrained. There must be adequate safeguards against government (local or central) reducing the rights that owners should legitimately expect to have over the use of their property.

Forecasts: Real GDP percent Growth

	Years Ending		
	Jun 22	Jun 23	Jun 24
Highest	1.5	3.9	2.8
Average	1.4	3.0	1.5
Lowest	1.3	2.0	0.6

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – all things to all people?

The role of the Reserve Bank is expanding almost by the day – but not without associated risks starting to come home to roost.

When the Reserve Bank Act 1989 came into force with its sole focus on inflation targeting it was widely seen as being world best practice.

In the Muldoon era, prior, the Reserve Bank had multiple and conflicting objectives, often overridden by government legislation of the day.

There is now a danger of the Reserve Bank going back to some of the failed policies of the early 1980s, where monetary policy became the whipping boy for any political itch.

Many, including BusinessNZ, opposed the Government's decision some years back to give the Reserve Bank two differing key priorities – price stability and maximum sustainable employment – and now question how these can be juggled or traded-off if NZ enters a period of stagflation down the track - potentially a real issue.

Not content with stopping at price stability and maximum sustainable employment (however defined), the Reserve Bank is taking a more active interest in climate change issues and housing policy and how potentially these should influence interest rate settings. Housing affordability and climate change issues are critically important but are not necessarily within the monetary policy framework the Reserve Bank is meant to operate under.

Yes – runaway housing inflation is obviously an issue that should concern the Reserve Bank, but what, if anything, the Reserve Bank can do about it is another question. Housing affordability has very much to do with overburdensome land supply planning, lack of financial options for funding new infrastructure, and a broad range of regulatory requirements regarding what, and how, something, should be built rather than meeting reasonable building standards and not adversely affecting others in the community.

Additional new tools, such as loan-to-value and debt-to-income ratios, will make achieving transparency in decision-making even harder although arguably, these mechanisms can perhaps be justified because New Zealand households have significant debt tied up in housing (currently around 90 percent of household debt), potentially affecting the soundness of the financial system.

Meanwhile, the Reserve Bank's large-scale asset purchase programme (LSAP) - in effect printing money - has come under some fire from credible individuals such as the former Bank of England (BOE) governor, Mervyn King, labelling such moves a mistake.

Governments around the world effectively shut-down large parts of their economies to try and prevent the spread of Covid, flooding the financial system with cash (through large scale bond buying programmes).

Although approving of fiscal stimulus measures to cushion economies from the worst effects of Covid, King was critical of central banks effectively printing a money on top of significant fiscal stimulus packages.

The Reserve Bank of NZ effectively pumped about $55 billion into the LSAP before that stopped last year. Recently it was calculated the bonds were worth over $8 billion less than the Reserve Bank paid for them, ultimately exposing taxpayers to a risk of loss.

In addition, the Reserve Bank has gone from very much assuming that climate change issues have little to do with the overall stability of NZ's financial system, to making significant submissions in respect to climate change. The bank has done so in its recent public consultation paper on the five-year review of the *Remit* that guides monetary policy decisions, asking whether greater consideration should be given to housing sustainability, inequality and climate change when setting monetary policy. It is difficult to see how the Reserve Bank could act on these issues, given it has little control over them. The Reserve Bank has at least come out in the consultation document stating that *"It is not clear that monetary policy can influence climate change or its economic impacts."*

These caveats notwithstanding, the danger from the Reserve Bank having so many balls in the air is that it will no longer concentrate on the prime purpose of monetary policy which is to ensure a relatively stable price level over time. This would be unfortunate and could reduce New Zealanders' confidence in the independence and predictability of the Bank's monetary policy settings. Doing its principal job (maintaining price stability) is probably asking enough of the Reserve Bank. Even then, the Reserve Bank needs mates to help it perform its functions at least in regard to overall costs to the economy. This implies developing sound fiscal and regulatory policies.

Inflation – higher for longer

Current inflation (both tradeable and non-tradeable) remains at elevated levels and is now reflected in continued interest rate rises as the Reserve Bank starts on its track of getting inflation under control. The March 2022 Consumer Price Index (CPI) shows annual inflation rising to 6.9 percent – well above the Reserve Bank's target range of 1-3 percent. While there is a range of reasons for the recent hike in inflationary pressures, there is a danger of inflationary expectations remaining at elevated levels in the outyears.

Business opinion surveys now consistently show stronger inflationary expectations with most respondents reporting an intention to raise prices over the next year. At the same time, even more respondents are expecting input costs will also rise.

As outlined earlier, inflationary pressure is not only a NZ phenomenon but is being felt more and more around the world as expansionary monetary and fiscal policies bring a growing demand for goods and services, fuelled by historically low interest rates. The boost to oil prices in light of restrictions on supplies coming out of Russia adds to the inflationary mix along with constraints on the supply of cereal from both Russia and Ukraine.

Global shipping prices have eased slightly of late as the export of goods out of China has slowed as a consequence of China's major lockdowns over recent weeks. Notwithstanding, the price paid by local NZ exporters continues to be high with refrigerated shipping containers in tight supply and obtaining shipping space in general an ongoing challenge.

The Reserve Bank is winding back the very loose "no-regrets" monetary policy stance taken over the last two years as this is now significantly affecting households with high levels of debt. The latest Reserve Bank Monetary Policy Statement was more strident than usual, promising the Bank will do what is necessary to get inflation back within the 0-3 percent target range. This means going harder, and perhaps for longer, on interest rates.

Possibly the only bright spot on the inflationary front is the plateauing of housing prices over the past few months which are now showing significant signs of decline. Unfortunately, building costs are still rising with building materials in short supply, and a continuing inability to source skilled and even unskilled labour. As a result, a great deal of building work is sitting in a half-finished state and a number of builders are saying that supply constraints could be with them for years to come.

Despite a significant moderation in house prices of late, housing affordability remains a massive issue for NZ. Policies are needed that free up resources, free up movement of people across the border, provide for easier development of land and business activity, and reduce unnecessary regulations and levies on businesses and households.

While over the past several years some regulatory costs on businesses might have been justified, there are many unjustified costs which are counterproductive when it comes to improving New Zealanders' productivity and hence long-term economic potential.

The Government also needs to play its part in reducing inflationary pressures and not undermine monetary policy by driving up expenditure beyond prudent levels, as mentioned earlier.

The Organisation for Economic Cooperation and Development (OECD) in its recent *Economic Outlook 2022* warns of NZ's inflation risk and recommends the country curb spending and fiscal stimulus. Noting the Government's recent short-term moves in relation to fuel tax, road user charges, public transport and additional income support, the OECD says future support should be more targeted to avoid fuelling inflation.

The recent Budget included some support to help New Zealanders meet cost-of-living pressures through a targeted ($ 1 billion) package focusing on low and middle-income earners.

The overall cost of living package includes:

- an extension to the reduction of fuel excise duty, introduced in March, by two months until mid-August
- an extension of the road user charges (RUC) cuts, introduced in April, until mid-September, and
- an extension of half-price public transport fares, introduced on April 1, until the end of August

There will also be a short-term targeted support payment to low and middle-income earners through a $350 Cost of Living Payment across three monthly instalments from August 1. This works out at about $27 per week for an estimated 2.1 million New Zealanders.

While such initiatives might be appreciated by those eligible for them, they do have a distinctly ad hoc flavour. Rather than focusing on factors driving inflationary pressures, it might have been better to look at whether longer-term proposals, such as the indexing of tax thresholds, would be more appropriate.

Temporarily reducing the fuel excise duty and RUCs is simply moving the deck chairs since either less money will be available for roading projects and/or the Government will have to divert other taxpayer money to make up the shortfall.

Reducing the excise duty and RUCs will be welcomed by road users but tends to work against the Government using the Emissions Trading Scheme (ETS) as a mechanism to change behaviour by lessening the use of fossil fuels. At the same time, the Government has reduced (subsidised) the cost of public transport.

As mentioned earlier, as households and businesses become dependent on government (taxpayer) subsidies, rolling these back will become extremely difficult. Assuming petrol prices continue to rise over the next couple of months, it will be (politically) hard for the Government to remove current subsidies on petrol and public transport – good luck with that.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Jun 22	Jun 23	Jun 24
Highest	7.1	4.0	2.8
Average	7.0	3.3	2.4
Lowest	6.7	2.8	1.7

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – higher with more to come

The importance of the Reserve Bank getting on top of inflation should not be underestimated given that rather than transitory, inflation is here to stay for some time. Importantly, it is a world-wide phenomenon, not confined to just a few economies.

In light of recent events internationally, with oil and other commodity prices increasing, and domestically, with tight labour markets placing a strain on supply, it is important the Reserve Bank acts decisively on Official Cash Rate increases to prevent inflation from getting out of control.

On the other hand, that interest rate increases take around a year to really bite (particularly as many households have short-term mortgages at low interest rates which will only be re-priced near the end of the year) could mean rates might not rise as fast as some predict.

There is some support for the above view, as house prices are already falling, and some surveys suggest consumers are prepared to cut their spending over the next year. But with the high level of household debt of which around 90 percent is tied directly to housing, any increase in interest rates will hit some highly leveraged households hard. Also, recent steep rises in fuel costs will act as a tax on businesses and households, further constraining activity. And business and consumer confidence survey results have fallen off a cliff, another reason the economy might cool without the need for significant interest rate hikes.

It should also be noted that interest rate rises will not unblock supply chains or increase production where both are desperately needed. Unfortunately, since inflationary pressures are largely the result of supply-side constraints (both domestically and internationally), there is little the Reserve Bank can do through interest rate mechanisms to free up supply chains or increase the labour supply. Sound monetary policy needs to be supported by equally sound fiscal and regulatory policies to avoid monetary policy (interest rates) having to do all the hard lifting to suppress inflation.

The risk with further interest rates rises is that they will restrict growth making the risk of at least a technical recession more likely. This is not an easy time for the Governor of the Reserve Bank and his Monetary Policy Committee to try to determine the optimal path forward in respect to interest rate movements.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Jun 22	Jun 23	Jun 24
Highest	2.7	3.8	3.7
Average	2.5	3.7	3.3
Lowest	2.2	3.6	2.8

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – mixed signals

The NZ dollar is likely to be supported over coming months due to a range of factors, including continuing and significant interest rate rises.

Perhaps more importantly, NZ was one of the first countries to start increasing interest rates, likely tempting investors to seek higher returns here. Nonetheless, other countries are rapidly following suit as central banks around the world try and tame the inflation beast.

And concern about NZ's future growth outlook in the wake of sharp interest rate rises will act to temper any move higher for the NZ dollar.

Current geopolitical risks also mean there will likely be a move towards safe haven currencies such as the US dollar and Japanese yen combined with more hawkish tones from the Federal Reserve in the US. This makes forecasting exchange rates even more difficult than usual, as reflected in the relatively wide range of forecasts, particularly for the short-term (see below).

The speed at which world-wide interest rates rise will also have an impact on future currency movements. Central banks are at present reviewing their monetary policy settings and it is likely that in a range of countries, interest rate rises will occur sooner than originally intended, if inflationary pressures increase and persist.

Forecasts: Exchange Rates

AUD (cents)			
	Jun 22	Jun 23	Jun 24
Highest	0.93	0.95	0.97
Average	0.91	0.92	0.93
Lowest	0.90	0.91	0.89

USD (cents)			
	Jun 22	Jun 23	Jun 24
Highest	0.71	0.74	0.73
Average	0.66	0.71	0.71
Lowest	0.62	0.67	0.68

TWI			
	Jun 22	Jun 23	Jun 24
Highest	76.3	77.3	75.0
Average	72.8	74.8	73.5
Lowest	71.1	73.2	72.4

Source: ASB, BNZ, Kiwibank and Westpac

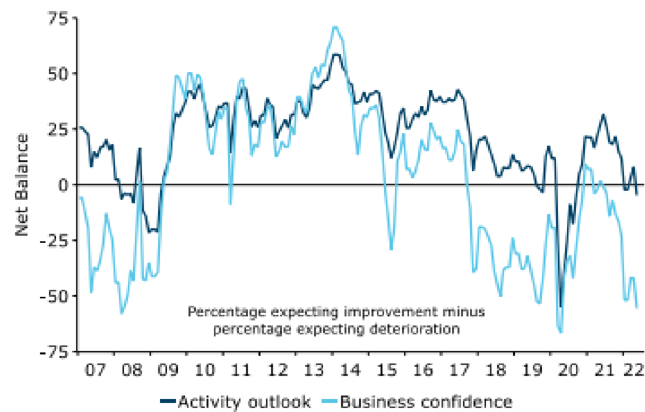
1.3 Business activity and confidence – way down

Both business and consumer confidence remain at historically low levels.

The ANZ Business Outlook for May 2022 showed headline confidence falling 14 points to -55.6

The own activity measure, which is perhaps a better predictor of future growth, also declined, dropping 13 points to -4.7, possibly not surprising given the international and domestic pressures facing businesses and households. Continuing Omicron-related disruption to the economy, the ratcheting up of interest rates, runaway inflation, high levels of household debt, together with labour shortages and resource constraints don't paint a pretty picture for a number of sectors. The continuing Russian war in Ukraine is also contributing to a significant lowering in global economic output, while China's recent hard lockdowns have impacted on supply chains and demand for product.

ANZ Business Confidence Index

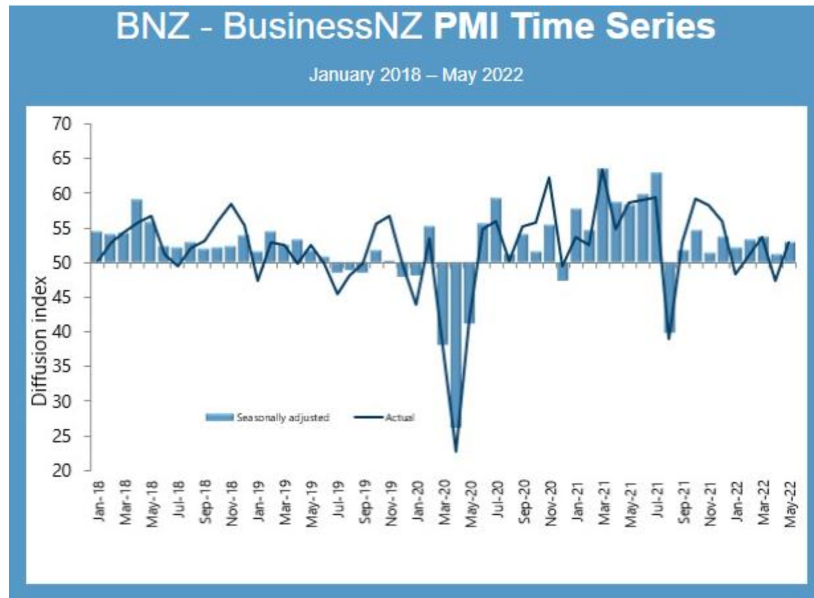


Despite the headwinds facing the NZ economy, some sectors are still performing reasonably well although others continue to struggle.

New Zealand's manufacturing sector remained under its long-term average level of activity for May, according to the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally-adjusted PMI for May was 52.9 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining) and while this was 1.7 points higher than April, it was still below the long-term average of 53.1 for the survey.

The pick-up in activity for May continued the recent trend of results where activity remains within a relatively narrow band of expansion.

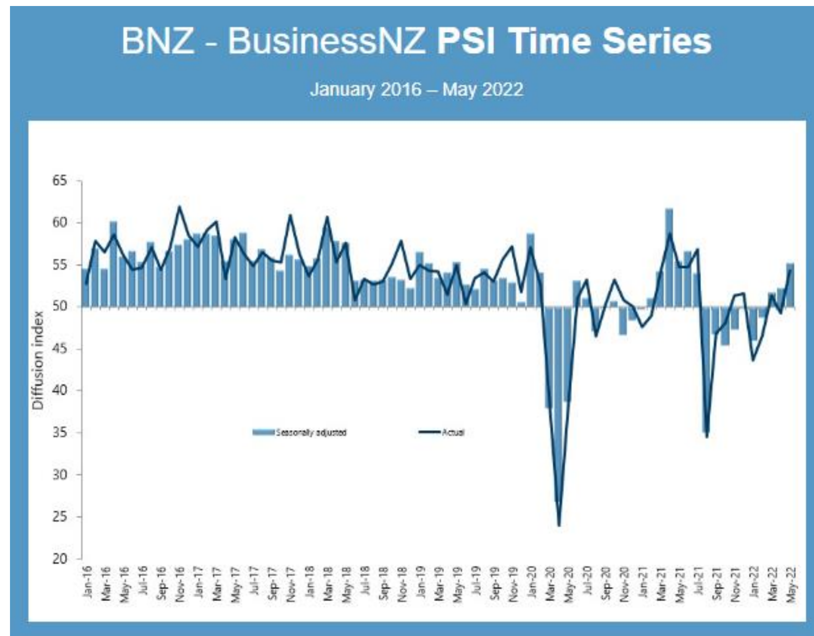


While both production (52.8) and delivery of raw materials (55.4) managed to return to expansion for May, the other key sub-index of New Orders (53.0) recorded its lowest level of activity since the August lockdown in 2021. Overall, any sustained move towards historical levels of expansion requires a healthy level of new orders, which have averaged 55.0 since the survey began.

Manufacturers continued to have a more negative mindset during May, with the proportion of negative comments at 72.7%, compared with 70.3 in April and 64.2% in March. While Covid and related issues remain a key influence, skill/labour shortages are also regularly mentioned.

Meanwhile activity levels in New Zealand's services sector displayed upwards momentum according to the BNZ BusinessNZ Performance of Services Index (PSI).

The PSI for May was 55.2 - A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining. This was up three points from April, and above the long-term average of 53.6 for the survey.



The May result represented the highest monthly result since June 2021, and the fourth consecutive amount of time showing increased activity from the previous month. But obviously any rush to conclude the sector is now firmly back on track needs to the tempered by the fact that there are potentially a number of headwinds still to come, both domestically and internationally.

The key sub-indexes of new orders/business (62.0) and activity/sales (59.6) both experienced a healthy pick-up in activity to lead the way in overall expansion. While employment (48.5) went back into contraction during May, Supplier Deliveries (45.0) recovered somewhat from earlier lows.

With the pick-up in expansion, the proportion of negative and positive comments was exactly even for May, compared with 61.9% of negative comments in April.

The agricultural sector continues to be a bright light in terms of output, and relatively high global commodity prices (although for a number of reasons these have recently come off their peak) are being reflected in increasing returns for agricultural producers. Global dairy prices have been supported this season by weaker milk production due to poor weather and higher feed costs in key milk producing regions of the world.

Fonterra has recently released its opening forecast for the farmgate milk price for the 2022/23 season which is set at between $8.25 -$9.75 per kgMS with a midpoint of $9.00 per kgMS. In making the forecast, Fonterra stated that the relatively high price for the coming season reflects continued global demand for dairy coupled with a constrained global supply. Fonterra considers the long-term outlook for dairy remains positive despite recent geopolitical and Covid-related events affecting global demand in the short-term.

Despite the relatively positive outlook for agriculture, the sector is still facing risks as indicated below.

First, given China's apparent recent success in getting Covid infections under control through a strict lockdown regime, it is not beyond the realms of possibility that it might institute further future lockdowns which will impact not only on the supply of products from China, but also on the demand for protein supplies. This will affect NZ agricultural producers, notwithstanding that despite some slippage of late, world global dairy prices remain high.

The annual Ministry of Primary Industries Situation and Outlook report, recently released, states that food and fibre exports made up over 80% of NZ's merchandise exports and that these agricultural exports overwhelmingly went to China. With its reliance on China (and Australia) it is imperative for NZ's future standard of living that both China and Australia continue to perform well.

Second, there is significant concern in the agricultural community over the uncertainty arising from a number of recent and proposed environment-related regulations including, but not limited to, how greenhouse emission charges will affect the agricultural sector.

In this respect, a recent article by Economist Dr Eric Crampton (Pricing agricultural emissions) makes the very good point that most other countries are doing little if anything in respect to agriculture. *"Leakage risk is particularly high in agriculture. Nobody else puts a price on agricultural emissions. If emissions pricing results in fewer cows and sheep on New Zealand pastures, and more in feedlots overseas instead, global emission could wind up going up rather than down. And the climate doesn't care where a cow burps.*

So any good system needs a way of dealing with leakage.

It also has to recognise that short-lived gases like methane need to be treated differently from long-term gas like carbon dioxide."

Third, and not necessarily restricted to the agricultural sector, but constraints on human resource capability and capacity are evident in the meat processing sector which lacks the migrant labour that traditionally assists with processing of stock.

Fourth, inflationary pressures (input costs) are weighing heavily on the agricultural sector. For farmers, higher interest rates are coming on top of significant hikes in the cost of other farm inputs, including freight, fertiliser, fuel and labour. Information from Beef+Lamb NZ's Economic Service shows that on-farm inflation has hit 10.2 percent – the highest it has been since 1985-86. Ultimately all this will continue to impact on food prices now and in the future.

The construction sector has faced setbacks over the past quarter, with an inability to source materials affecting the ability to complete work and driving up the price of those materials which are available.

Record housing consents and building activity (despite significant issues relating to the supply of materials, principally Gib Board, and labour which are putting a number of projects on hold) are forcing up new build costs. Unfortunately, this is having an adverse impact on some building contractors with many going to the wall.

A number of builders/developers are so frustrated by the lack of Gib plasterboard they are importing containers of alternative products from Asia in an attempt to break the supply chain deadlock. Some developers are saying there is an eight-month delay in sourcing Gib in NZ compared with around eight weeks sourcing supplies from overseas. Getting council approval for different overseas materials is also an issue in view of the general requirements to meet building standard assessments for differing products.

Other sectors including retail, tourism and hospitality, continue to do it tough. Consumers are starting to shut their wallets in response to rising interest rates and increased costs along with the general drop in real (inflation-adjusted) household income, reflected in the significant drop in consumer confidence demonstrated in a number of recent confidence surveys.

1.4 Labour market – tight

Unemployment remains at historically low levels according to the Household Labour Force Survey for the March 2022 quarter. The inability to source labour from overseas is an ongoing concern despite moves to open up the borders in a measured way.

Skills shortages are resulting in some companies employing staff based overseas. Employing people overseas to work remotely for companies here in New Zealand is one way of responding to labour shortages and the higher

wage thresholds required under Immigration NZ visa regulations. NZ's population size means skill shortages are inevitable as it is often difficult to grow scaled-up businesses off the back of a small population. Employers, therefore, have to look at all options for obtaining staff.

NZ's risk-averse and conservative approach to opening our borders has allowed many other countries to advance past us in terms of gaining valuable capital and labour expertise as economies rebuild their momentum. The fact that New Zealanders are having to wait for a significant period for often basic goods and services is ominous in a first world country. NZ had a net outflow of 8,700 long-term migrants for the year ended April 2022.

Job check applications opened on the 20 June for employers wishing to hire workers from overseas. Employers must be accredited and have advertised the role in NZ before applying for a job check, requiring a position to pay more than $27.76 per hour unless it's on an exemption list. Immigration NZ says the process ensures employers hire New Zealanders first before considering migrants, and that only viable businesses with good practices are able to hire migrants. Applications for the new Employer Accredited Work Visa open on 4 July.

The Productivity Commission's recent report on immigration setting makes some damning findings, including the key finding that there is a lack of long-term planning and integration of immigration policy with other areas of government policy.

The Commission's report also pointed out the contribution migration makes to the NZ economy, debunking the myth that overseas persons simply take jobs from NZers and drive down wages.

At the end of the day, labour, like capital, is now highly mobile, and will more likely gravitate to destinations where it is made most welcome (i.e., where investment returns are most attractive). In this respect NZ must compete with the rest of the world for labour. Ad hoc responses are not the way forward.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 22	Jun 23	Jun 24
Highest	3.2	3.7	4.2
Average	3.1	3.4	4.0
Lowest	3.1	3.1	3.5

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – some upward movement

It is not surprising that with NZ's extremely tight labour market, forecasts below show some upward movement in labour costs.

A relatively modest growth in forecast wage rates in aggregate over the forecast period tends, however, to mask significant gains for specific sectors and for individuals within sectors. The inability to source skilled immigrants might see some job-hopping as businesses compete to obtain required expertise from a diminished pool.

The impact of impending regulatory cost increases also needs to be thrown into the mix of factors driving changes in labour costs. While overall, a number of labour market reforms (some proposed and some enacted) might result in increased wage rates for some, they will also mean reduced job opportunities, if not actual job losses, for others. The Government must recognise the need for flexible labour market practices allowing individuals and companies to agree arrangements best suited to their individual circumstances. Moves back to more centralised wage bargaining (Fair Pay Agreements, FPAs) do not take account of the unique pressures facing individual companies in particular markets. The risk remains of people exiting the labour market and becoming dependent on the state.

A survey of employers conducted by law firm Simpson Grierson indicates significant unease with the prospect of Fair Pay Agreements. Simpson Grierson's survey of business clients shows 81% of respondents consider their business will be impacted by FPAs, noting the workload, cost, pay relativity and competitive challenges FPAs will create. *"The consequence of this may also mean that employers, and likely small businesses, may need to reduce the number of employees they employ in order to keep up with the FPA process,"* Simpson Grierson's FPA submission states.

Forecasts: Labour cost index percentage change (wages and salaries)

	Years Ending		
	Jun 22	Jun 23	Jun 24
Highest	3.4	4.4	3.7
Average	3.3	4.1	3.3
Lowest	3.1	3.8	2.3

Source: ASB, BNZ, Kiwibank and Westpac