BUSINESS NZ

PLANNING FORECAST

MARCH 2022

BusinessNZ

NZ Economy: Cross-currents of risk

Executive Summary

NZ faces risks internationally and domestically, with geopolitical risks as the Russian invasion of Ukraine continues apace, while on the domestic front Omicron and widespread inflationary pressures remain front of mind.

Some sectors (tourism and hospitality) have been battered as a result of ongoing Covid restrictions, while other sectors (agriculture and construction) are showing relatively strong growth. However, almost all sectors of the economy are facing supply constraints as a result of domestic regulatory measures, including largely closed borders. This is putting upward pressure on prices, and the ongoing spread of Omicron is seriously impacting on the ability of many businesses to function efficiently, as people self-isolate.

Internationally, rising commodity prices are a two-edged sword. Rising demand for agricultural commodities, along with reduced supply as a result of weather conditions, have brought higher returns for NZ agricultural producers, as evidenced by Global Dairy Trade and Fonterra ratcheting up the expected payout to dairy farmers.

Meanwhile, increased commodity prices are pushing up input prices, particularly following the invasion of the Ukraine by Russian forces, which is affecting the price of international oil. This is flowing through into transport and fuel costs facing many NZ businesses, adding fuel to the inflationary fire which was already well alight, with increasing international demand for oil and other commodities well before the invasion took place.

The impact of hostilities the war and resulting significant overt sanctions on Russia by many Western countries have the potential to disrupt financial and commodity markets, quite apart from the risk of escalation of the war.

While the war is having significant humanitarian impacts on immediately affected parties in Ukraine and to some extent on Russian forces, NZ's distance from the conflict combined with fairly limited bilateral trading relationships with Russa and Ukraine means the direct economic impact on NZ is likely to be very limited. However, the impact of higher fuel prices will add significantly more pressure to NZ's domestic inflation.

The NZ Government has taken tentative steps towards partially dismantling border controls; however, it is not axiomatic that when the NZ Government does eventually open the border to allcomers that there will be a rush to come here, or that citizens currently living in NZ will want to stay here. There are two reasons for this. First, given NZ's conservative approach to opening the borders, many countries have stolen a march on NZ; people will go to countries more open to international capital and labour. Second, given the pent-up demand by Kiwis to see the world, and costs associated with living in NZ, housing in particular, many young skilled NZers may feel the time is ripe to leave.

Although some consider NZ weathered the storm of Covid-19 pretty well by international standards, particularly from a short-term health perspective, the economic costs have been huge, with around $60 billion spent on the Covid-19 response, while easy money from the Reserve Bank has added to the housing frenzy. Government and household debt have risen substantially, and with interest rates rising, increased debt servicing costs are set to bite.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index, a compilation of NZ's major economic indicators, sits at 3 for the March 2022 quarter, up 2 on the previous quarter and down 2 on a year ago. The index overall shows little change for the March 2022 quarter, however this masks large changes in the sub-indices, including improvements in economic growth largely offset by deteriorating monetary policy conditions (higher interest rates and inflationary pressures) and a large dip in business and consumer confidence.

Notwithstanding recent efforts to reduce some border restrictions for NZ citizens, it will be some time before the border is fully open for business. Current restrictions will continue to constrain growth, particularly in sourcing labour, while the ongoing saga of supply chain problems has been well publicised.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) continues to show expansion in the manufacturing sector, however the Performance of Services Index (PSI) continues to show contraction in the services sector.

The construction sector is in expansion mode, however the inability to source key inputs - labour and materials - is constraining output.

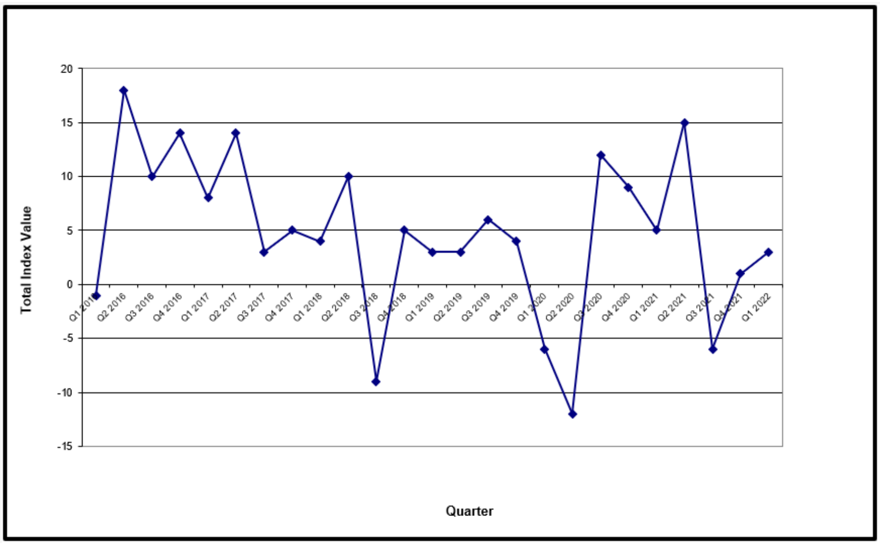
The agricultural sector continues to go from strength-to-strength on the back of continued strong commodity prices, including dairy and sheep meat. Notwithstanding, agriculture like many other sectors will feel the impact of increased input costs, in particular fuel and transport, along with rising debt servicing costs, which will take the edge off improved profit margins. This is reflected in declines in recent confidence surveys for the sector.

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 3 for the March 2022 quarter, up 2 on the previous quarter and down 2 on a year ago. The index overall shows little change for the March 2022 quarter, however this masks large changes in the sub-indices, including improvements in economic growth largely offset by deteriorating monetary policy conditions (higher interest rates and inflationary pressures) and a large 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

<u>Economic growth/performance indicators</u> sit at 5 for the March 2022 quarter, up 2 on the previous quarter and down 2 on a year ago. NZ's terms of trade remain strong on the back of continuing international support for our key agricultural commodities. Notwithstanding, shipping capacity is still stretched, leading to delays and significant transport cost increases for some sectors while supply of key inputs (goods and services including labour) to construction and other sectors will continue to constrain growth over the short to medium term.

<u>Monetary policy/pricing indicators</u> sit at -4 for the March 2022 quarter, down 4 on the previous quarter and down 3 on a year ago. Current inflation (both tradeables and non-tradeables) remain at evaluated levels which is now started to be reflected in continued rises in interest rates as the Reserve Bank starts on its track of getting inflation under control. Unfortunately, given that inflationary pressures are largely a result of supply-side constraints (both domestically and internationally) there is little that the Reserve Bank can do through interest rate mechanisms to free up supply chains or increase labour supply.

<u>Business/consumer confidence indicators</u> sit at -2 for the March 2022 quarter, up 1 on the previous quarter and down 3 on a year ago. Both business and consumer confidence indicators have taken a significant dive over recent weeks on the back for significant Omicron in the community, rising geopolitical tensions internationally, and in respect to consumers, higher debt levels and rising interest rates - with more to come. Indications of housing price rises slowing (if not falling) has also weighed on consumer confidence given the tendency for consumers historically to feel more confident when house prices are rising.

<u>Labour market indicators</u> sit at 4 for the March 2022 quarter, up 3 on the previous quarter and the same as a year ago. The economy is now beyond what the Reserve Bank would term sustainable full employment and many businesses are doing their best to retain staff wherever possible. However, on the negative side, a tight labour market is resulting in significant constraints on the ability to grow the economy while record low official unemployment is not being reflected in reduced numbers of those on the Job Seek benefits – quite the opposite. There have been significant rises in Job Seeker numbers since late 2019 despite record low unemployment which is concerning given the risks and costs associated with long-term state dependency.

[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 March quarter 2022 are estimates based on available information to date.

<u>Note</u>: Given a very fluid international and domestic situation at present, the forecasts below, including with respect to economic growth, interest rates, exchange rates, inflation, and unemployment, should be seen for what they are: the best available information to date. Some banks are currently updating their forecasts while other forecasts will likely be subject to significant change as the global and domestic scene continues to evolve over coming months.

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

1.1 Economic growth (GDP) – subdued

NZ faces a number of risks both internationally and domestically, with geopolitical risks as the Russian invasion of Ukraine continues apace, while on the domestic front Omicron and widespread inflationary pressures remain front of mind. Meanwhile, the global shipping industry continues to face challenges, with delays at ports keeping shipping costs elevated.

While some sectors are suffering under Covid restrictions, e.g., tourism and hospitality, other sectors are showing relatively strong growth, e.g., construction and agriculture. However, almost all sectors of the economy are facing supply-side constraints as a result of Covid restrictions (especially largely closed borders), putting upward pressure on prices, and the ongoing impact of Omicron, yet to reach its peak, is seriously affecting the ability of many businesses to function efficiently, as people self-isolate.

Internationally rising commodity prices are a two-edged sword. Rising demand for agricultural commodities, along with reduced supply as a result of weather conditions, have brought higher returns for our agricultural producers, evidenced by Global Dairy Trade and Fonterra ratcheting up the expected payout to dairy farmers.

However, increased commodity prices are being felt in input prices, particularly following the invasion of Ukraine, which is affecting international oil prices as Europe and the US have banned oil imports from Russia, and the EU is proposing significantly reducing the purchase of Russian natural gas. This is flowing through into transport and fuel costs facing many NZ businesses and adding fuel to the inflationary fire already alight, with international demand for oil and other commodities increasing well before the invasion took place.

The impact of the invasion of Ukraine and resulting significant overt sanctions on Russia by many Western countries is likely to bring disruption to financial and commodity markets, quite apart from the risk of escalation of the war, following some of the statements coming from President Putin.

Global sharemarkets have taken a beating over recent weeks during the Russian invasion and there are fears that supply chains will be further disrupted, given already stretched networks because of Covid.

While it hasn't been mentioned for a very long time, the risk of stagflation - very low economic growth with high unemployment - cannot be ruled out, at least at an international level.

Over the last six months there has been reasonably strong economic recovery for a large part of the developed world, as economies opened up in the realisation that Covid was something that had to be lived with rather than persisting with the elimination strategy that some countries including NZ have tried. However, recent geopolitical events have raised fears that this international recovery might be derailed.

Historically, recessions have been signaled through a range of factors, but one important one which has generally been accurate is the yield curve (comparing the yield of short-term vs long-term interest rates).

Generally speaking, people and companies will only invest for a longer term if the returns are higher than short-term rates, reflecting the risks associated with investing over the longer term, i.e the yield curve is generally upward-sloping. Recently, at the international level there have been moves to increase short-term rates at a much higher rate than long-term rates, suggesting that investors are more nervous about investing short-term given the international risks at present. While internationally yield curves are still upward sloping, they have levelled off somewhat, which is concerning.

While the concept of stagflation has not been talked about publicly for decades and the world is a much more open place than when stagflation last hit NZ in the 1970s and '80s, the ongoing risks and uncertainty associated with Covid, and risks of potential escalation of war beyond the Russian invasion of Ukraine, provide a perfect storm for prices to increase rapidly while businesses pull back on investment for fear of uncertain returns.

While this might seem almost laughable to some given that NZ is currently experiencing modest growth and historically low unemployment, much of NZ's growth over the last couple of years has been propped up by $60 billion worth of government spending, along with the commodity boom which has particularly assisted the agricultural sector. This won't continue forever.

While some consider that NZ weathered the storm of Covid-19 pretty well by international standards (particularly if one looks at the results purely from a short-term health perspective), the economic costs have been huge, with around $60 billion spent on the Covid response, while easy money from the Reserve Bank helped fuel the housing frenzy. Government and household debt have risen substantially, and with interest rates rising, increased debt servicing costs are set to bite.

Higher levels of household and government debt do impose ongoing risk as interest rates rise, while higher levels of debt also constrain the choices that Governments and households can make in the future due to tighter budgets. Given that around 90 percent of household debt is tied up in various forms of housing, this creates significant risks should interest rates rise markedly as they are likely to do, while the current slowing in house prices will be making some homeowners nervous, particularly if NZ does not continue growing and the labour market shows signs of weakness.

Nevertheless, despite the concerns over the economic outlook expressed above, there are several factors that should provide NZ with some comfort.

First, it appears that Omicron infections are in full swing in NZ, with some commentators suggesting that it may have already peaked, especially in Auckland (although data is a bit ropey in some cases, given hospitalisations may be more useful than case numbers as a proxy for the severity of the pandemic). Hopefully, this signals that the widely desired removal of restrictions on people going about their daily lives will be announced soon, and that the border re-opening will also be announced sooner rather than later so NZ businesses and people can reconnect with the world.

Second, despite some significant build-up of debt, with Government expenditure on Covid-related activities of around $60 million over the past two years, NZ's net debt is currently around 35 percent of GDP, up from around 19 percent at the start of 2020, but pretty good compared to many countries we traditionally compare ourselves to.

Third, despite widespread pessimism evidenced in business and consumer confidence surveys, the February corporate earnings season was one of the strongest in the past couple of years with most NZX-listed companies beating analyst forecasts. Of the 31 companies that had full or half-year results, 21 reported higher earnings per share than forecast. Four were as expected and six missed the mark.

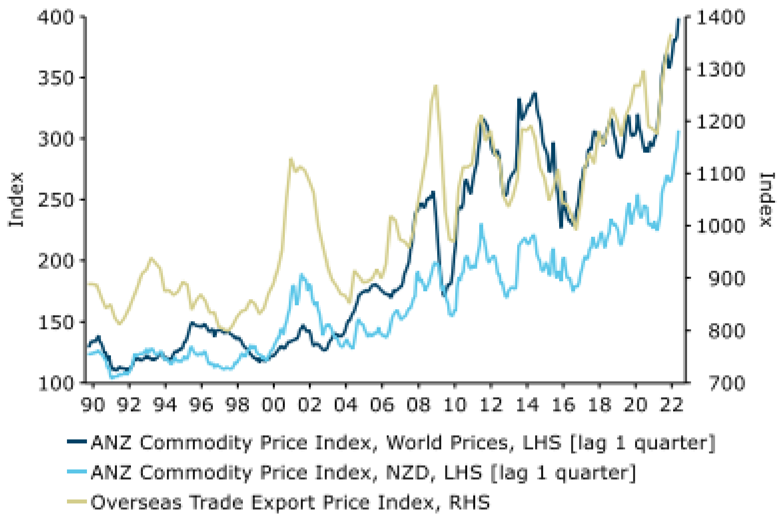
However, it is a less than attractive picture when looking forward, with most companies experiencing significant cost increases, most frequently for labour and freight, with most companies suggesting inflationary pressures would continue unabated in 2022.

Fourth, NZ's Terms of Trade (a measure of the value of exports required for a given number of imports) remain at elevated levels, driven principally by strong prices for traditional agricultural commodities e.g., dairy, beef and lamb.

The latest ANZ Commodity Price Index (see below) shows a lift of 3.9 percent in February 2022 compared to a month earlier, to hit another record high.

Prices lifted across most commodity groups with dairy and aluminum leading the way. In NZ dollar terms, the index increased 4.9 percent, as local returns were assisted somewhat by a 1.2 percent reduction in the Trade Weighted Index.

ANZ Commodity Price Index



Source: Stats NZ, Macrobond, ANZ Research

Fifth, the construction sector continues to go from strength to, with record numbers of dwelling consents and a strong pipeline of further work which will keep the sector busy for a number of years to come. However, short-term, there are major supply-side issues; many key building materials are in short supply, delaying work and driving up prices across the board.

Finally, NZ has secured what appears to be a satisfactory free trade deal with the UK. The UK-NZ FTA was signed on the 1st of March and will now go through parliamentary process to ratify the agreement.

The agreement immediately will remove 99.5 per cent of trade tariffs and customs duties once in force, and save New Zealand exporters $37 million per year. There are significant removals of quotas for access for beef, sheep meat, butter and cheese after 5-15 years.

The trade deal is forecast to boost New Zealand GDP by between $700 million and $1 billion and will help grow New Zealand exports to the UK by 40 per cent.

Notwithstanding this trade deal and others being negotiated, there are risks that the current geopolitical situation and world-wide pandemic will cause countries to become much more insular and concerned about sourcing materials internally. This is likely to add further to costs of production and inhibit innovation, with the costs ultimately passed on to consumers. While management of risk is an issue, particularly for those countries exposed principally to a single market, this has to be weighed up against the downsides of restricting free trade in goods and services.

Forecasts: Real GDP percent Growth

	Years Ending		
	Mar 22	Mar 23	Mar 24
Highest	5.8	4.6	4.1
Average	5.2	3.5	2.7
Lowest	4.1	2.8	1.6

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – multiple objectives make the Reserve Bank's job difficult

Significant changes have been made to how the Reserve Bank operates now its mandate has been radically expanded beyond that of simply targeting inflation.

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.

Furthermore, over the past few years, the Reserve Bank has gone from very much a bit player in the climate change area, to making significant submissions in respect to climate change issues. It is difficult to see how the Reserve Bank might be able to act on this issue, given it has little control over climate change.

Additional new tools such as loan-to-value and debt-to-income ratios will make transparency in decision-making even harder. 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.

However, overall, the Reserve Bank's mandate seems to be expanding rapidly into issues which will have little medium-term impact on the financial system.

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.

The next few months may tell us whether the decision to extend the Reserve Bank's mandate, by legislation and also voluntary measures, was wise.

Inflation – widespread

Current inflation (both tradeables and non-tradeables) remains at elevated levels and is now reflected in continued rises in interest rates as the Reserve Bank starts on its track of getting inflation under control. Unfortunately, given that inflationary pressures are largely a result of supply-side constraints (both domestically and internationally) there is little that the Reserve Bank can do through interest rate mechanisms to free up supply chains or increase labour supply.

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 that input costs will also rise.

As stated earlier, there is also the real problem for the Reserve Bank in how far and how fast it raises interest rates in response to elevated inflationary pressures, given how this may impact on its other objective of employment.

Inflationary pressures are now widespread, with shipping capacity constraints, material supplies and labour shortages increasing costs and restricting overall growth in the NZ economy. 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 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.

The Reserve Bank's very loose 'no-regrets' monetary policy stance over the last two years is significantly impacting on asset prices, particularly housing, which has encouraged the further buildup of household debt. NZ household debt is not at an historic high, much of it tied into the housing market, and while debt servicing costs are at their lowest level for well over two decades, the tide is clearly turning.

Perhaps the only bright spot on the inflationary front is that it appears that secondhand house price rises have ground to a halt after rising the best part of 30 percent over the past year alone. The problem is that with building materials in short supply, the ability to build new houses is constrained and also much more costly. Recently there was talk about gib board being sold on Trade Me for around 4 times the normal market price.

Despite some moderation in house prices of late, housing affordability remains a massive issue in NZ. The recently released Demographia Housing Affordability survey makes for sober reading. While there has been a world-wide deterioration in housing affordability during the pandemic, NZ remains one of the most unaffordable countries of all.

Median house prices in NZ were 11.2 percent of gross median household income pre-tax, compared to 8 percent for Australia, 6 percent for Canada, 5.1 percent for the United Kingdom, and 5 percent for the United States.

Given higher levels of inflation are eroding real incomes of the labour force, we also face the risk of a wage-price spiral, unheard of since the 1970s and '80s. This underlines the need to get inflation under control soon as possible.

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 regulation and levies on businesses and households.

While some regulatory costs on businesses over the past several years may have been justified, there are a lot of costs which are unjustified and counterproductive in terms of improving New Zealanders' prosperity and potential.

The changes to the Credit Contracts and Consumer Finance Act have tended to be counterproductive. 'Responsible lending' requirements were designed to protect vulnerable borrowers from loan sharks, but have seriously affected other borrowers, including small businesses who often use their home as security - yet another case of well-intended legislation bringing unintended consequences. It is noted that the Government is currently reviewing some of the regulations on bank lending requirements which may lessen some of the more draconian requirements currently in place.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Mar 22	Mar 23	Mar 24
Highest	7.2	4.4	2.9
Average	6.7	3.5	2.4
Lowest	6.3	2.7	1.7

Source: ASB, BNZ, Kiwibank and Westpac

Interest Rates – higher, faster

The Reserve Bank has started on a path of increasing the OCR with a number of further rises in the pipeline.

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

Given NZ's so-called 'fortress' approach to its borders, constraints on the provision of goods and services will continue, as traditional sources of labour from overseas are closed off and many businesses are unable to operate to capacity, with constrained supply of basic materials in particular making building even more difficult and costly than previously.

Given recent events internationally, with oil and other commodity prices increasing, and domestically, with tight labour markets placing strain on supply chains, it is important that the Reserve Bank acts decisively on Official Cash Rate increases to prevent inflation from getting out of control. A number of commentators, including some banks, have ramped up their views on how far and fast the Reserve Bank should move to increase the OCR.

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

There is some support for this view, given house prices are already falling and some surveys suggest consumers are prepared to cut their spending over the next year. Further, given the high level of household debt with around

90 percent tied directly to housing, any increase in interest rates will hit some highly leveraged households hard. Also, the recent steep rises in fuel costs will act as a tax on businesses and households, further constraining activity. Finally, business and consumer confidence survey results have fallen off a cliff which is another reason that the economy may cool without the need for significant interest rate hikes. This is not an easy time for the Governor of the Reserve Bank in determining the optimal path forward in respect to interest rates.

The Reserve Bank, in its February monetary policy review, clearly signaled its intention to return monetary policy to a more neutral state. That review is now likely to be out of date with greater inflationary pressures, geopolitical and domestic, evident over recent weeks. Interest rates will continue to rise, as can be seen from the forecasts below, and with historically high levels of household debt, those rises might not need to be significant before starting to impact on households' disposable incomes.

Nevertheless, some households will be sheltered from interest rate rises until late this year as around 60 percent of mortgages are not due for re-pricing for another six months at least. Many households will regret not locking in 4 percent rates for three or even five years before the latest hikes took effect. Short-term rates of say one year are not always best given they leave households exposed to significant increases when they come to re-price their mortgage.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Mar 22	Mar 23	Mar 24
Highest	1.4	2.9	3.3
Average	1.3	2.8	3.0
Lowest	1.2	2.7	2.7

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – a dollar each way

The NZ dollar is likely to be supported over coming months due to a range of factors, including continuing improvements in commodity prices.

Perhaps more importantly, NZ has been one of the first countries to start increasing interest rates which will likely tempt investors seeking higher returns in NZ.

Also, there is the potential for Kiwis to return from overseas and for an increased number of immigrants potentially later this year, which would put upward pressure on the NZ dollar as foreign funds are converted to NZ dollars.

However, current geopolitical risks mean there is likely to be a move towards safe haven currencies such as the US dollar and Japanese yen. This makes forecasting exchange rates even more difficult than usual and is 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, as inflationary pressures increase.

Probably the only certainty at present is that many short- to medium-term forecast of exchange rates are likely to be wrong. Things are simply too volatile to make rational decisions in this space.

Forecasts: Exchange Rates

AUD (cents)			
	Mar 22	Mar 23	Mar 24
Highest	0.96	0.94	0.94
Average	0.94	0.93	0.93
Lowest	0.93	0.92	0.91

USD (cents)			
	Mar 22	Mar 23	Mar 24
Highest	0.71	0.73	0.73
Average	0.68	0.72	0.71
Lowest	0.65	0.69	0.70

TWI			
	Mar 22	Mar 23	Mar 24
Highest	75.6	75.6	75.0
Average	72.8	74.2	73.2
Lowest	70.1	72.5	72.0

Source: ASB, BNZ, Kiwibank and Westpac

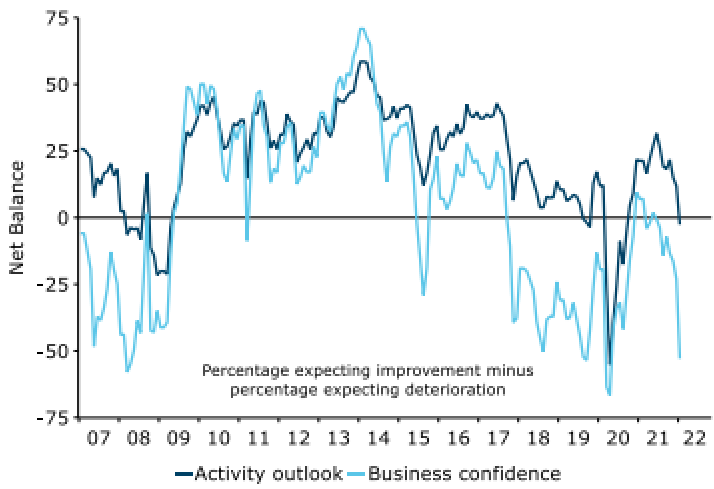
1.3 Business activity and confidence – down the gurgler

Recent surveys show business and consumer confidence have tanked.

The ANZ Business Outlook for February 2022 showed headline confidence plummeting from -23.2 to -51.8, the biggest decline since March 2020.

The 'own activity' measure, perhaps a better predictor of future growth, also declined, dropping from 11.8 in December 2021 to -2.2 in February, not too surprising given expectations of widespread Omicron-related disruption on the economy, the ratcheting up of interest rates, along with continued cost pressures and labour shortages.

ANZ Business Confidence Index



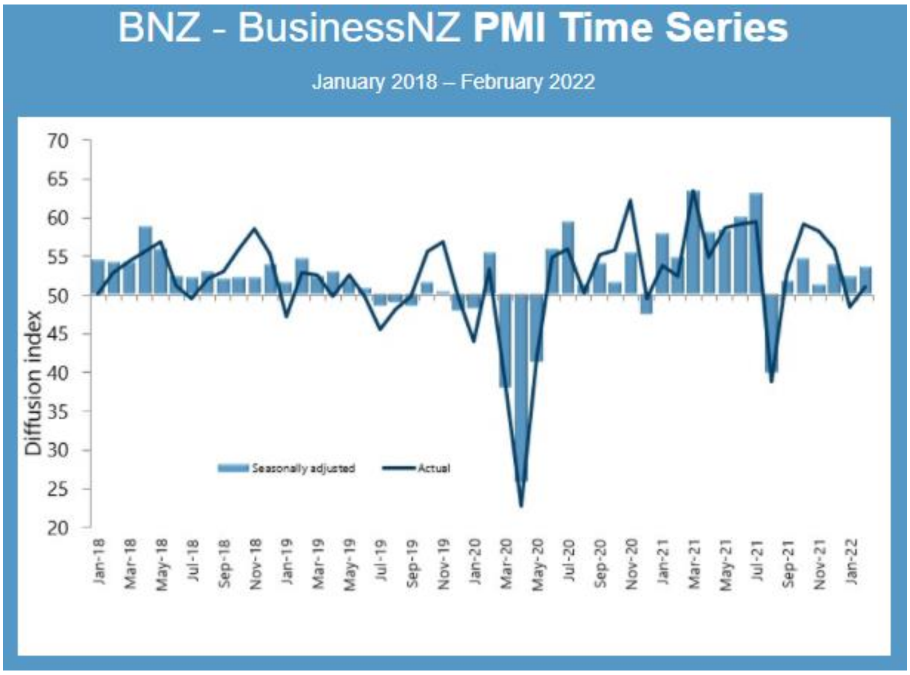
The results of this survey are likely to have been received largely before the Russian invasion so it is likely, had this been included, that the results would have been even worse.

Despite the recent massive drop in overall business confidence, some sectors are doing reasonably well while others continue to struggle.

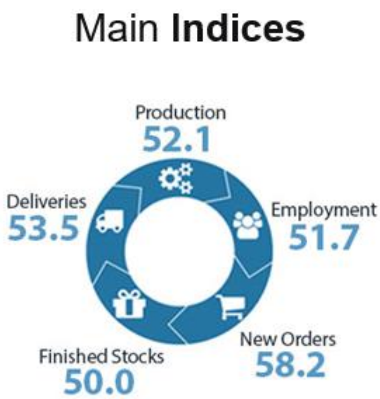
New Zealand's manufacturing sector saw a lift in the level of expansion for February according to the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally-adjusted PMI for February was 53.6 (a reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 1.3 points higher than January and above the long-term average of 53.1 for the survey.

While there were certainly some positive signs with the February result, this needs to be balanced with the wide spread of Omicron potentially affecting business plans in the months ahead, as well as comments from manufacturers still firmly in negative territory (69.9%)



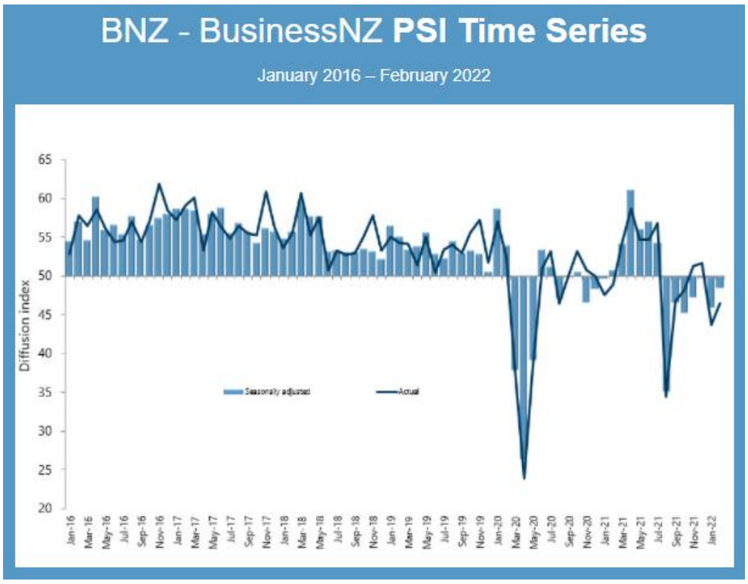
In terms of the main sub-indices, New Orders (58.2) increased to its highest level since July 2021, while Production (52.1) experienced a slight improvement, although still at its second lowest value since September 2021. Employment (51.7) rose back into expansion, while Finished Stocks (50.0) dropped to its lowest result since November 2021.



Activity levels in New Zealand's services sector saw a continuation of contraction for the second month of 2022, according to the BNZ BusinessNZ Performance of Services Index (PSI).

The PSI for February was 48.6. While this was up 2.6 points from January, it was still well down on the long-term average of 53.6 for the survey.

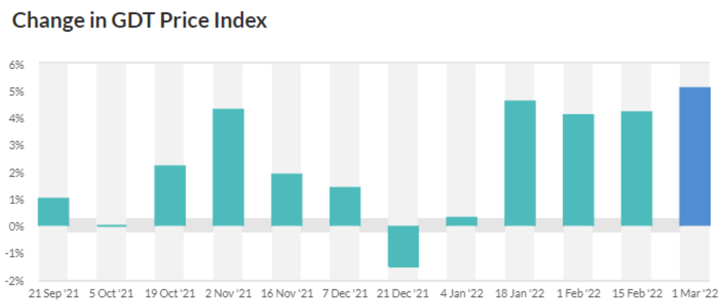
The ongoing trend of contraction was largely expected given the current restrictions and interference many businesses in the service sector are experiencing at present.



It is encouraging to see the key sub-indexes of New Orders/Business (53.6) and Activity/Sales (50.7) both return to positive territory. However, Employment (45.0) dropped to its lowest result since May 2020, while Supplier Deliveries (34.4) was at its lowest point since August 2021.

February marks the PSI's seventh consecutive month below the breakeven 50 mark. Pain is accumulating. While there were some overs and unders in the components, all remain below their respective long-term averages.

As mentioned earlier, increased global commodity prices are being reflected in increasing returns for agricultural producers in NZ. Global dairy prices have been supported this season by weaker milk production due to poor weather and higher feed costs. Fonterra has continued to upgrade its projected pay-outs to dairy farmers as the Global Dairy Trade continues to go from strength to strength as can be seen below.



Source: Global Dairy Trade (GDT)

But notwithstanding the solid performance of agriculture over recent times, there is significant concern in the agricultural community over the uncertainty arising from a number of recent and proposed environment-related regulations. As well, constraints on processing meat are evident without the migrant labour which traditionally assists when processing is at peak capacity.

The latest Federated Farmers Mid-Season Confidence Survey released 8 March 2022 reveals farm confidence at its lowest since Federated Farmers began twice-a-year surveys in 2009, and shows that despite high commodity prices, farmers are still very concerned about the future outlook. Of responses from nearly 1,000 farmers, a net 7.8 percent considered current economic conditions to be good, a 10.1-point decline from the July 2021 Survey, when 17.9 percent considered conditions to be good. Looking forward, a net 64 percent of farmers considered general economic conditions would worsen over the next 12 months, a 25-point deterioration from the 39 percent in the July survey.

Asked to list their greatest concerns, respondents chose climate change policy and ETS (18.7 percent of respondents), followed by regulation and compliance costs (13.1 percent) and freshwater policy (9.5 percent).

Commenting on the survey, Federated Farmers President Andrew Hoggard said, *"We're getting strong returns on meat and dairy right now thanks to high global demand and food security concerns but clearly farmers are seeing a lot of that revenue going right back out again with higher fuel and fertiliser prices, rising labour costs, and the hot inflation that is affecting every other New Zealander."*

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 materials which are available.

Other sectors, retail, tourism and hospitality, continue to do it tough for three main reasons. First, largely closed borders. Second, constraints on the ability to freely move around or allow large-scale events given Covid restrictions. Third, consumers starting to shut their wallets in response to rising interest rates and increased costs along with a general drop in real (inflation-adjusted) household income. This is being reflected in a significant drop in consumer confidence in a number of recent confidence surveys.

1.4 Labour market – tight as a drum but state dependency an issue

Unemployment remains at historically low levels according to the Household Labour Force Survey for the December 2021 quarter. Given effectively closed borders and the inability to source labour, this is not unexpected.

However, while official unemployment as measured by the HLFS remains very low, there appears to be a significant disconnect between official unemployment numbers and numbers receiving the Job Seeker benefit, suggesting a number of people have left the labour market and become dependent on state welfare support longer-term. There are now around 40,000 more people on the Job Seeker benefit than there were at the end of 2019, despite current record low unemployment recorded by the HLFS.

At the same time, it is disheartening to hear from businesses desperate to secure skilled labour from overseas, that with the Government's closed-door policy, they are effectively unable to grow or provide the goods and services demanded in a first world economy. Many sectors and businesses are frustrated that production output is being curtailed due to the inability to source labour in order to maximise output. Ultimately this will impact on economic growth and living standards.

There does not appear to be a clear plan from the Government, at least one that has been communicated to the public, as to how and when NZ as a country is to completely reopen to the world.

The danger is that NZ's risk-averse and conservative approach to opening our borders has allowed many other countries to steal a march on 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.

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.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Mar 22	Mar 23	Mar 24
Highest	3.3	3.7	3.8
Average	3.1	3.4	3.6
Lowest	2.9	3.1	3.4

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – on the move higher

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 from overseas 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 that allow individuals and companies to agree arrangements best suited to their individual circumstances. Moves back towards more centralised wage bargaining do not take account of the unique pressures facing individual companies in particular markets and the risk remains that some people might exit the labour market altogether and become dependent on the state. While it is early days, increased numbers on the Job Seeker benefit are not encouraging given the current very tight labour market.

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

	Years Ending		
	Mar 22	Mar 23	Mar 24
Highest	3.4	3.6	3.4
Average	3.1	3.4	3.0
Lowest	2.9	3.0	2.6

Source: ASB, BNZ, Kiwibank and Westpac