BUSINESS NZ

PLANNING FORECAST

BusinessNZ

DECEMBER 2020

NZ Economy: Better than expected

Executive Summary

While the ongoing impact of COVID-19 will play out for some time to come, there are several reasons to be positive about the future, despite the economy taking a massive hit mid-year.

- Output has largely bounced back after the 11 percent dive in GDP over the June quarter 2020 – suggesting a V-shaped, rather than a more prolonged U-shaped, recovery. Today's figures from StatsNZ show GDP rebounding 14 percent in the September 2020 quarter, the strongest quarterly GDP growth on record.
- Forward-looking indicators, such as the BNZ-BusinessNZ Performance of Manufacturing Index (PMI), are firmly back in the black.
- The Government's books - outlined in the Half Year Economic and Fiscal Update (December 2020) - while taking a hammering, are not as bad as the pre-Election Economic and Fiscal Update predicted.
- The huge government (taxpayer) fiscal stimulus package of around $50 billion cushioned some of the worst impacts of COVID-19 lockdowns on businesses and households.
- The continued monetary stimulus package (around $100 billion of quantitative easing, the slashing of the OCR and the introduction of the Reserve Bank's Funding for Lending Programme (FLP), which will provide up to $28 billion of cheap funding for the major banks, should ensure both businesses and households can continue to borrow to support growth.
- The recent election of a Labour government with a clear majority (the first ever under an MMP system) should hopefully provide for greater policy-making coherence, without the constraints of minor parties calling the shots. This might mean more extreme policy prescriptions are off the agenda and could provide some comfort for many in the business sector wanting a degree of future certainty.
- Unemployment, while still rising, is unlikely to reach as high as forecast several months ago. Nevertheless, over 30,000 people have lost their jobs since the start of COVID-19. That puts the economic and social costs of the virus, and NZ's response, clearly under the spotlight.
- Probably the best news is positive vaccine results, with some vaccines now being rolled out to particularly vulnerable groups in a number of countries.

Notwithstanding the above, there are still huge risks weighing the NZ economy down. These include, but are not limited to:

- The massive increase in government (taxpayer) debt and rising household debt which will need to be paid off at some stage by current and future generations of New Zealanders. There is no free lunch, and NZ will become vulnerable to further economic shocks.
- The Reserve Bank's very loose monetary policy stance (its "no-regrets" policy) is having a significant impact on asset prices (particularly housing) and will widen the gap between haves and have-nots. Loan to Value Ratios (LVR) and potential Debt to Income Ratios (DIR) are short-term band-aids for the unwillingness or political inability of successive governments over the last couple of decades to address land supply issues and associated building costs.
- Unemployment rates, while not as bad as originally forecast, still represent a massive waste of human resources and capital, although at the same time, tight border controls see many businesses struggling to obtain much needed skilled staff.
- Regulatory policy, over a range of areas, still leaves much to be desired, imposing on businesses increased environmental and labour costs.

HIGHLIGHTS

NZ's economic growth, after taking a pounding mid-year as a direct result of the COVID-19 lock-down, has since shown significant signs of a V-shaped recovery with prospects improving in the out-years.

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at 10 for the December 2020 quarter, up 2 on the previous quarter and up 6 on a year ago. It was inevitable there would be a significant improvement over the second half of the year as businesses and households emerged from various stages of lock-down.

However, while the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) shows solid growth as we head towards the year end, not surprisingly its sister survey the Performance of Services Index (PSI) is, given the ongoing impact of COVID-19 particularly on tourism and hospitality, still in and out of negative territory.

So too, tourism and much of hospitality remain in the doldrums although other sectors are showing solid growth, including construction, with significant pipeline work down the track and record numbers of residential building consents.

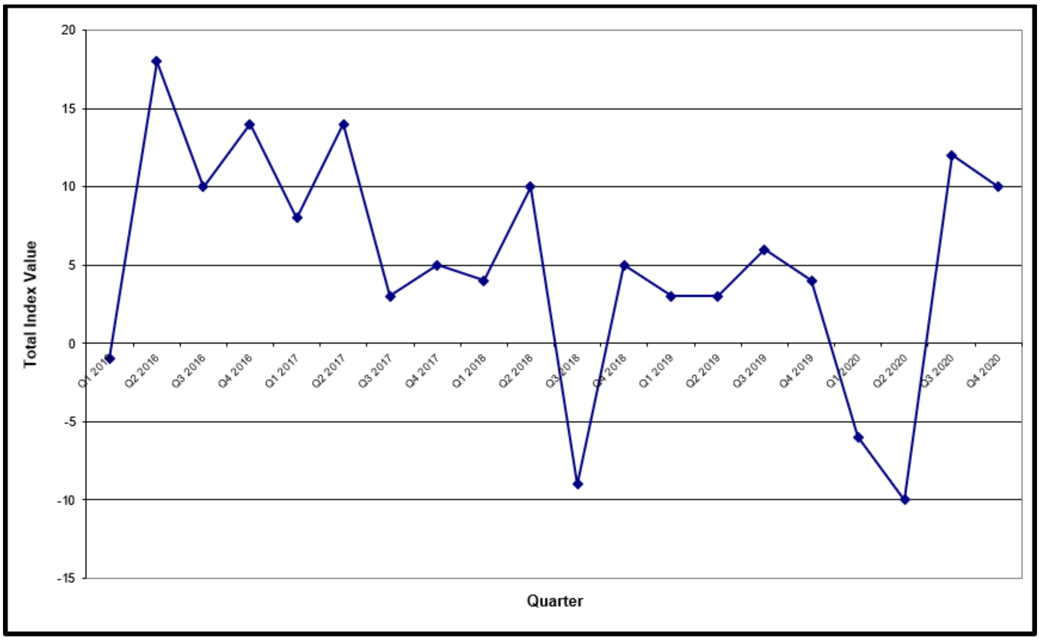
Agricultural sentiment remains downbeat, perhaps surprising as commodity prices, including Fonterra's recent forecast increase for the current year and NZ's major trading partner, China, showing increased demand for product, are at relatively high levels. On the other hand, there is significant concern in the agricultural and mineral extraction sectors about the potential impact of some aspects of freshwater reforms which will adversely affect optimal land use.

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 10 for the December 2020 quarter, down 2 on the previous quarter and up 6 on a year ago. This significant improvement needs to be read in the context of a massive 12.2 percent drop in economic growth over the June 2020 quarter as a direct result of the strict lockdown imposed in late March. As the country came out of lockdown, a significant improvement over the September and December quarters was inevitable, despite Auckland reentering various phases of lock-down over that period.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken 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 5 for the December 2020 quarter, the same as the previous quarter and up 4 on a year ago. Trade flows and prices took a hit over the June quarter and have since somewhat recovered. Supply chains are starting to get back to some semblance of normality despite shipping capacity being currently stretched, leading to delays and potential cost increases.

Monetary policy/pricing indicators sit at 1 for the December 2020 quarter, down 2 on the previous quarter and up 2 a year ago. Interest rates are now at historic lows while pricing intentions remain downbeat. Commodity prices, including dairy, are holding up well internationally but compared with our major trading partners' currencies are being offset to some degree by a rising $NZ dollar.

Business/consumer confidence indicators sit at 7 for the December 2020 quarter, up 2 on the previous quarter and up 2 on a year ago. Business confidence indicators are showing significant improvement of late, although generally coming off an extremely low base.

Labour market indicators sit at -3 for the December 2020 quarter, down 2 on the previous quarter and the same as a year ago. Unemployment continues to increase as government initiatives, such as wage subsidies and assistance packages, run out, although projections of the unemployment peak have been substantially scaled back. Job ads have essentially dried up as businesses reassess their business plans to reflect ongoing uncertainty. Nevertheless, businesses are having extreme difficulty in securing skilled migrant labour on the back of essentially closed borders.

[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 December quarter 2020 are estimates based on available information to date.

Note: Given the very fluid international and to some extent 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 both the global and the domestic scenes continue to evolve over coming months.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – Increasing light at the end of the tunnel

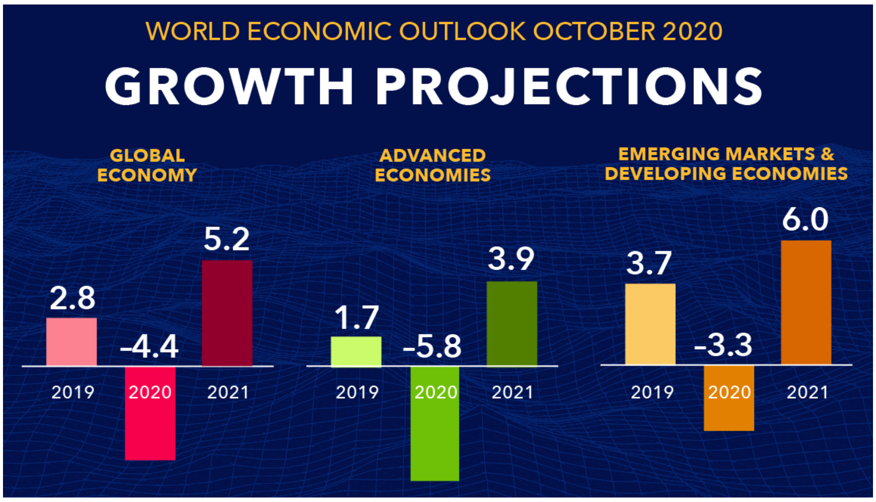
Forecasts out to December 2022 show economic growth, after taking an early and massive hit in mid-2020, improving to reach a respectable 3.3 percent in the year ending December 2022.

Notwithstanding the positive signs noted below, it is important not to lose sight of the fact that this has been NZ's sharpest recession ever and output is only likely to return to pre-COVID-19 levels by 2022. The impact has yet to be fully felt and the flow-on effects will be with us for several years.

The above said, there are some positive signs that COVID-19's impact on the NZ economy, while significant, has not been as dramatic as predicted six months ago.

Looking first at the international scene then moving on to the domestic situation.

The International Monetary Fund (IMF) has upgraded earlier forecasts somewhat with global economic growth predicted to be over 5 percent per annum in 2021, after a sizeable slump of -4.4 percent in 2020.



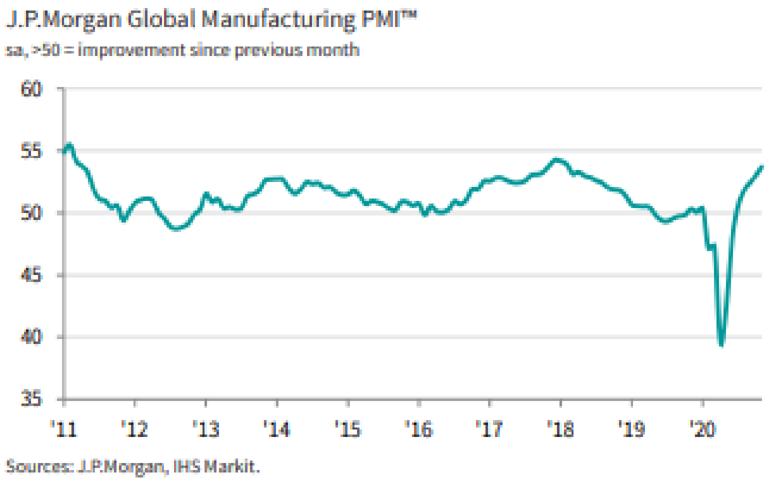
Internationally, the impact of Covid-19 has been significant, not only in terms of health-related issues and deaths, but on countries' broader economic performance. At the time of writing, several countries, among them the United States, have record numbers of infections along with record numbers of deaths. However, there is hope.

By far the biggest news on the international front is the apparently successful development of several vaccines, with one (Pfizer) currently being rolled out in a number of countries. Preference will be given to the most vulnerable (the elderly and health sector employees) before moving on to other populations.

The issue of vaccine rollouts is interesting, with each country generally adopting its own rules and processes. Some are taking a more conservative approach to potential rollouts than others with some commentators suggesting NZ is
unlikely to have a significant vaccine rollout before the end of the first quarter of next year at the earliest. This has a potential economic downside (shut borders and the like) if the country fails to go early and hard in driving vaccination. It also raises interesting issues such as how the NZ Government will approach re-opening its borders and/or whether those vaccinated overseas will be free to enter the country without quarantine etc. A lot of food for thought there.

While the IMF has pointed out that a recovery is now underway following the easing of strict confinement measures and the re-opening of businesses, uncertainty remains high and confidence is still very fragile. But the good news for NZ is that the pickup in demand, particularly in China, has helped some commodity prices to remain firm and has improved the appetite for risk in financial markets. This is particularly good news for NZ's agricultural production.

The latest J.P Morgan Global Manufacturing PMI (Performance of Manufacturing Index) shows the global manufacturing output expanding at the fastest pace since 2018 and demand continuing to revive following earlier COVID-19 lockdowns, including a further rebound in international trade flows. However, improvements notwithstanding, it is important, coming off such a low base, to understand that given the hammering global manufacturing production took over the first and more importantly second quarter of 2020, some upswing was almost inevitable.



Greater divergences are evident between the performance of different countries. Of the 30 countries for which data were available, 19 registered expansions and 11 contractions. Growth was led by strong and accelerated increases in output in both China and the United States (US).

It is of great significance for NZ that combined, China and Australia account for around 40 percent of its trade. NZ is therefore heavily reliant on the fortunes of both countries. Australia now has COVID-19 outbreaks under control but a truly functioning trans-Tasman border remains some months away.

Internationally, while financial markets took a pounding as they struggled to comprehend the implications of the coronavirus and its impact on potential future earnings, it is surprising how rapidly they have, in general, improved, no doubt boosted by a large government fiscal stimulus globally and the resultant monetary policy stimulus. The world is awash with money looking for a home.

Turning to international trade policy, the election of President Biden in the US (within the constraints of a possible Republican Senate) is, on balance, positive news for NZ's future trade arrangements. A divided Congress will limit any Democrat efforts to raise taxes substantially or to increase regulation. At the same time, Biden will likely bring a more inclusive approach to foreign and trade policy.

It is early days, and Biden's full team has yet to be identified. However, we do know he is proposing to nominate Antony Blinken as Secretary of State. Blinken is a strong supporter of multilateralism and has publicly supported the TPP and other trade agreements. So, this is a good start. Biden himself has very similar views.

However, while the tone of the new Administration might revert to something more like that of pre-Trump US Administrations, not all tensions in the global trade environment can be expected to disappear. The US will still have concerns about the operation of the WTO Dispute Settlement system and will still be wanting other WTO reforms. And concern about China will not go away and tariffs will remain in place

The big question for New Zealand is whether the Biden Administration will want to return the US to the TPP (now CPTPP) family. It is too early to answer this. Biden and Blinken are TPP supporters but attitudes in the President-elect's Party vary and we do not yet know the final make-up of the Senate, nor what the Republican Party will think about trade policy without Trump in the White House. Will it to be Trumpist and protectionist or will it revert to the position it has taken since WW2? What we do know is that the new Administration will take some time to settle down and determine priorities while closely watching the make-up of House and Senate and testing Republican attitudes.

As many have been predicting for some time, the Regional Comprehensive Economic Partnership (RCEP) was signed in mid-November but without India. The absence of India reduces the value of the agreement to New Zealand (as New Zealand already has FTAs with all the other participants), but the Agreement is still good news. There are new market access gains into Indonesia for goods' exporters and Thailand has made improved services commitments to New Zealand. But the real gains are simplified rules of origin, increased certainty for exporters, and the agreement's impact on the regional economy. This is the first FTA linking China, Japan and Korea.

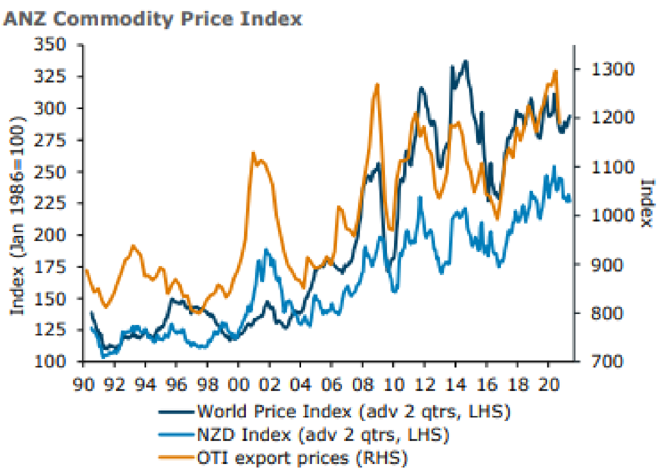
The Agreement must be ratified before it comes into force. Many are hopeful it will achieve sufficient ratifications to allow it to enter into force by early 2022.

Turning now to the domestic scene: while the impact of COVID-19 will play out for some time to come, and it is likely to be well into 2022 before output is back to pre-COVID-19 levels, there are several reasons to be positive about the future of the NZ economy despite it taking a massive hit mid-year.

- Output has largely bounced back after the 11 percent dive in GDP over the June quarter 2020 – suggesting a V-shaped, rather than a more prolonged U-shaped, recovery.

- World commodity prices remain at healthy levels, with protein (including dairy) prices holding up well. This was reinforced recently by Fonterra announcing an upward firming in the expected milk payout for the current 2020/21 season.

The latest ANZ Commodity Price Index graph below indicates the above, posting a modest 0.9 percent gain in November. Higher prices for aluminium, beef, wool, and butter helped push the index higher.



Source: ANZ, Stats NZ

When converted into $NZs, the index fell 2.3 percent as the NZD generally strengthened against the currencies of our major trading partners, particularly the US.

- The world economic outlook has improved over recent weeks, no doubt underpinned by the potential vaccine breakthrough, while NZ's largest trading partner, China, continues to go from strength to strength after taking an early bath in the first quarter of this year.

- The recent 2020 DHL Export Barometer Report shows that most exporters came through COVID-19 in pretty good shape. The 2020 report finds the number one barrier to exporting is the high cost and lower frequency of the transport required to get products to market, largely due to the impact of COVID-19 on supply chains around the world.

The dramatic reduction in commercial air passenger travel has increased the cost of air freight and forced more exports on to ships, ultimately affecting supply chains globally. According to research conducted among more than 270 New Zealand exporters, top barriers to doing business have changed substantially from previous years, with the cost of logistics and transport shooting into the top spot, followed closely by COVID-19-related costs and the general costs of doing business. However, when looking more closely into the impact COVID-19 has had on NZ exporters, most were on the positive side of the ledger, with two thirds (66%) of respondents surveyed noting they had not felt a negative impact on their export opportunities due to COVID-19. Furthermore, whilst NZ exporters are cautious, over 84% of respondents are not expecting a decrease in business orders in 2021, although there is no denying a dip in export orders this year compared with 2019 for about twice the number of exporters than usual (35% vs 15% in 2019). But despite a degree of caution, it is promising to see NZ exporters still relatively optimistic for the year ahead.

- Forward looking indicators such as the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) are firmly back in the black although not surprisingly, its sister survey, the Performance of Services Index (PSI) has struggled owing to reduced activity, including fewer events.

- While tourism and hospitality remain in the doldrums because of ongoing restrictions on foreign tourists, other sectors are showing solid growth, including construction, with significant pipeline work down the track and record numbers of building consents indicating future growth.

- Business Opinion Surveys show, in general, business sentiment improving, albeit off a comparatively low base. Key indicators, such as investment and employment, are improving, which is positive.

- The Government's books, as outlined in the Half Year Economic and Fiscal Update (December 2020), while taking a hammering, are not as bad as predicted in the pre-Election Economic and Fiscal Update.

- The huge government (taxpayer) fiscal stimulus package of around $50 billion cushioned some of the worst potential impacts of Covid-19 lockdowns on businesses and households.

- The continued monetary stimulus package (around $100 billion of quantitative easing, the slashing of the OCR and the introduction of the Reserve Bank's Funding for Lending Programme (FLP), which will provide up to $28 billion of cheap funding for the major banks) should ensure both businesses and households can continue to borrow to support growth.

- The recent election of a Labour Government with a clear working majority (the first ever under MMP), should provide for greater policy-making cohesion without the constraint of minor parties calling the shots. This may mean more extreme policy prescriptions are off the agenda possibly providing some comfort for many in the business sector wanting a degree of future certainty.

- Unemployment, while still rising, is unlikely to reach levels forecast several months ago. Over 30,000 people have lost their jobs since the start of COVID-19. Although unemployment reached 5.3 percent in the September quarter, the Treasury outlined seven economic scenarios back in April, five of which saw the unemployment rate hitting double-digits in the September quarter, including a worst-case scenario of 23 percent. Despite a much better than expected outcome, the economic and social costs of COVID-19 and NZ's response, are clearly under the spotlight.

- Finally, and probably the best news, are the positive results from several vaccines, with some (e.g., Pfizer) now being rolled out across a number of countries.

While the development of vaccines is great news, the idea that everything will be back to normal in a short space of time is highly unlikely given some countries' massive populations, the availability of a vaccine at reasonable cost and the potential reluctance, for varying reasons, of some people to be vaccinated. This time next year is probably a more realistic scenario for the opening-up of borders to something resembling normality. Having come so far, NZ particularly is likely to take a very cautious approach – certainly, its response to the pandemic to date.

Given NZ's unique position of being effectively COVID-19-free (apart from a few imported cases contained in isolation facilities at the border), maybe now is the opportune time for the country to cash-in on its COVID-19 free status, ramping up the ability of skilled migrants, international students, and high economic value individuals to come here (either after an appropriate quarantine period and/or proof they have received the appropriate vaccine(s)) to boost those sectors hardest hit by COVID-19. Closed borders for the next year until the international all-clear is given would essentially mean throwing a golden opportunity down the drain. The big question is whether the Government (and New Zealanders) are up for border opening.

But the positives notwithstanding, there are still huge risks weighing the NZ economy down. These include, but are not limited to:

- The massive increase in both government (taxpayer) debt and rising household debt which will both need to be paid off at some stage by current and future generations of NZers. There is no free lunch here, making NZ vulnerable to further shocks.

- The NZ government's debt level has increased massively in a short space of time with over $50 billion spent on various support packages over the past year (although by international standards it still sits below just about that of all other developed countries).

The International Monetary Fund (IMF) suggests Australia's government debt is around 57 percent of GDP, Europe's is sitting at over 100 percent and the United States' at around 140 percent. At the far end of the spectrum is Japan, which for many years has consistently had government debt of more than 200 percent. While many argue that with interest rates so low, debt serviceability is not a problem, increasing government and household debt can cause difficulty. As a small, open economy, facing certain potential risks, it is desirable NZ has relatively low levels of debt so it can deal with events such as the current global pandemic, earthquakes etc. and others which have come the country's way over recent times and required very significant fiscal policy responses.

NZ household debt now sits at an historic high with much of it tied into the housing market. Ironically, at the same time, debt servicing costs are at their lowest level for well over two decades.

With agricultural debt and relatively large percentages of farm debt related to dairy (although commodity prices are still at satisfactory levels, given current circumstances), recent government interventions - to regulate water quality and restrict land-use changes, for example - could add to the banks' nervousness about lending further to this sector. Sources in the agricultural sector have already stated that the banks are taking a harder line on debt and rather than simply rolling over loan facilities as generally in the past, are requiring some farmers to reduce their debt levels.

- The Reserve Bank's very loose monetary policy stance (the "no-regrets policy") is having a significant impact on asset prices (particularly housing) that will open up the gap between the haves and have nots.

For the first time, Auckland's median house price has increased to $1 million making "housing history" in October, according to reports of the Real Estate Institute of NZ. This was a 16.3 percent leap up from the previous year.

Ten regions also hit record median price highs – Gisborne grew a whopping 34.1 percent in October 2020 compared with the same time in 2019, and Wellington saw a 20.8 percent year-on-year increase. Nationally, the median house price rose 19.8 percent to $725,000.

Loan-to-Value Ratios (LVR) and potential Debt to Income Ratios (DIR) are simply short-term band-aids for the unwillingness or political inability of successive governments, over the last couple of decades, to address land supply issues and associated building costs.

If individuals are reasonably aware of known and potential risks, they should be free to go about their lawful business. This can, for example, include developing housing on potentially flood-prone land provided any possible impacts on third parties are effectively mitigated.

Notwithstanding the above, there will be cases where individual councils might need to make decisions restricting building sites and/or land use options if there is a clear public benefit in doing so – in the above case, such as the potential impact on communities and third parties should significant flooding occur. However, such restrictions should be imposed only on a local case-by-case basis, not nationally.

Restrictions of this sort should be based on sound scientific evidence taking account of costs and benefits of restricting land use. Before restrictions are imposed, those who would be affected should be consulted and compensated for losses relating to land use options.

Increasing obligations on the Reserve Bank to be all things to all people, in terms not only of price stability objectives but with add-ons such as full-employment, climate change mitigation and now potentially housing/land costs, are blurring the waters when it comes to what monetary policy can hope to achieve.

- Unemployment rates, while not as bad as originally forecast, still represent a massive waste of human resources and capital while at the same time, given tight border controls, many businesses struggle to obtain much needed skilled staff.

- Supply chains, while still problematic for some freight movements, are generally supporting the export of NZ's key commodity products. However, delays at several international ports and at Ports of Auckland have resulted in product being slow to arrive to its destination. Shipping container availability remains very tight and the effect of this will flow through to households and businesses via an increased product cost.

- Regulatory policy – over a range of areas - still leaves a lot to be desired, particularly as it will impose further environmental and labour market costs on businesses.

Issues associated with the effect of labour market regulation on business costs are addressed later in this paper. In relation to environmental matters, unreasonable restrictions on land activity will potentially affect not only farmers' use of land but also the mining and extractive sectors where obtaining resource consents such as for gravel for roading - also a key input in the concreting process - could be jeopardised through overly prescriptive regulation pertaining to wetlands, with companies prohibited from any draining activity associated with wetlands of any description. Thankfully, the Government seems willing to listen to business community concerns so hopefully some sillier rules will be peeled back and there will be a greater focus on realism.

- Agricultural sentiment remains downbeat, perhaps surprising given relatively high levels of commodity prices, including Fonterra's recent forecast increase for the current year. From a milk price perspective, Fonterra is narrowing and lifting the bottom end of the forecast Farmgate Milk Price range from $6.30 - $7.30 per kgMS. This means the midpoint will increase to $7.00 per kgMS, a reasonably solid number compared to historic payouts over time. On the other hand, there is significant concern within the agricultural community and the mineral extraction sector (as outlined above) about the potential effect of those aspects of freshwater reform which will adversely impact on the ability to use land in an optimal manner.

- There is potential for economies to become more nationalistic in their approach to trade as, rightly or wrongly, they decide to "buy local". In some ways this could be a positive if done for the right reasons. But there is a danger of countries becoming increasingly inward looking - not good for the overall future of the international trade on which NZ heavily depends.

- Finally, the recent pandemic has thrown up important questions as to how best NZ should respond to other risks facing its shores, health-related earthquake risks but also risks such as climate change mitigation and the appropriate levels of action which should be taken given the limited resources available, the wants and needs of society and the trade-offs people are prepared to accept. These are not easy questions to consider and require careful analysis, not the ad hoc decision-making which has tended to be the order of the day over many years.

While NZ has received international praise for its "health response" to COVID-19, some initial analysis would suggest the cost per value saved through hard lock-down has far exceeded the amount spent on other interventions targeted at reducing the risk of death, on roading, for example. There will likely, therefore, be a need to give controversial issues such as the valuation of life and the cost of interventions intended to save lives and/or protect property greater consideration. Insurers, quite correctly, are increasingly taking a risk-based approach to premium setting, with those with properties that could be affected by more extreme weather events and/or earthquake related risks facing significant premium rises. In some cases, where there are more extreme risks, insurance will likely be phased out – as research reports have indicated.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 20	Dec 21	Dec 22
Highest	-3.8	6.1	4.5
Average	-4.2	4.4	3.3
Lowest	-4.5	3.5	2.1

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – changing times

The Reserve Bank has made some significant changes to monetary policy settings this year (with probably more to come) to ensure the NZ financial system remains in a solid position to weather both the significant economic impact of COVID-19 and to support NZ's recovery. Taking the slasher to the Official Cash Rate (OCR), removing restrictions on loan-to-value ratios (but reinstating them early next year although the banks have already voluntarily imposed their own restrictions – some above likely Reserve Bank requirements) and delaying certain regulatory changes for the immediate future are all part of the mix. Quantitative easing is now a significant aspect of the Reserve Bank's weaponry in its attempt to keep interest rates at historic lows, while the around $28b Funding for Lending Programme (FLP) has just kicked off, providing cheap finance to banks for on-lending to customers. Potential Debt to Income Ratios (DIR) are also on the agenda.

The FLP will see the Reserve Bank offer loans to banks for three-year terms against high quality collateral. The loans will be lent at floating rates linked to the prevailing OCR. Loans will be available for the next 18 months, with additional allocation available for an extra six months.

The Reserve Bank is not targeting the FLP to specific sectors, such as businesses and/or agriculture, rightly considering this to be the role of the banking sector rather than of centrally driven directives. However, it is to be hoped this does not simply see even more money poured into the housing market.

It is interesting to note that the Reserve Bank's latest published figures show net bank lending to government increasing by $29b between September 2019 and September 2020 while lending on housing rose by $13b. By contrast, lending fell in every other category, including to consumers, businesses, and agriculture.

The Treasury and the Reserve Bank have been consulting on the Third Round Consultation of Phase 2 of the Reserve Bank Act Review Consultation Paper dealing with the prudential framework for deposit takers and deposit protection.

It is of some concern that the Government has chosen to make an "in principle" decision to remove the "efficiency" of the NZ financial system as an objective of the Reserve Bank Act.

In BusinessNZ's view, potentially, the changes referred to will have unintended consequences, removing from the Reserve Bank to need to adequately consider the efficiency cost implications of its decision-making.

To take a current example. One of the perhaps unintended consequences of having historically low interest rates and plentiful capital looking for a home is that the gap between the "haves" and "have nots" will likely increase as asset prices, particularly housing, are forced up. This is unfortunate for those who want to obtain a first home and to get on the housing ladder.

It is noted that the Reserve Bank in its recent proposals is looking to take a least regrets approach. Running the risk of providing too much stimulus is considered less costly than doing too little. No doubt the Bank is cognisant of the risk from rapidly rising asset prices, specifically house prices, but perhaps a fragile economy is seen as more of a risk to financial stability than locking out first home buyers from the market.

Interest Rates – bottoming out?

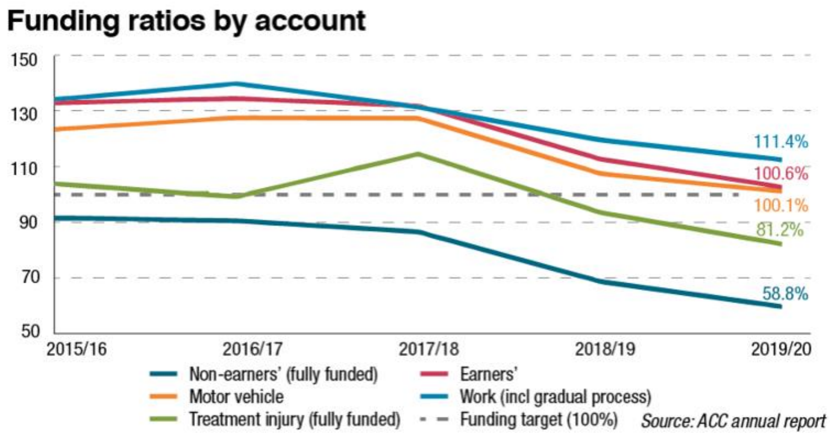
As expected, the raft of instruments rolled out by the Reserve Bank (outlined above) has seen interest rates plummet to their lowest levels in over 50 years with 90-day bank bills expected to hover just above zero out to December 2022. While earlier in the year there was talk of potentially negative interest rates, it would be fair to say that the Reserve Bank's appetite for such policies may have waned somewhat given the NZ economy has proved more resilient to the effects of COVID-19 than perhaps most forecasters earlier contemplated. Nevertheless, they cannot be ruled out, despite their potential for unintended consequences, their effect on households' saving and expenditure decisions (saving more or delaying expenditure assuming prices will drop even further) and the likelihood of further fuelling asset price rises (particularly in respect to housing).

It is important to realise that most businesses and households welcome lower mortgage interest rates which have resulted in debt servicing costs being the lowest for a very long time (despite household debt levels being the highest they have ever been). Low interest rates will not necessarily encourage businesses and households to start investing; low interest rates have their own risks.

There is perhaps a naïve assumption that lowering interest rates further will stimulate productive investment; businesses just need that extra reduction to make things happen and restore business confidence. However, business confidence to invest has little to do with interest rates, already at historic lows. Business confidence to invest has much more to do with regulatory and international uncertainty as to future demand.

Also, returns from sizeable bank deposits have often been used to supplement income for those in their later years but current low interest rates mean many people will now have to eat into capital or try less conventional policies, such as reverse mortgages, to supplement income flows. Many elderly people have often been averse to reverse mortgages even though these allow money to be freed up, particularly for asset rich but income poor households.

Low interest rates can also significantly change discount rates, affecting assets required to pay for future costs, such as the cost of the Accident Compensation Corporation scheme. Reduced discount rates as a direct result of lower risk-free interest rates have resulted in the ACC scheme going from more than fully funded to a situation where current assets are seen to be falling short of what is needed to deliver on future liabilities across several accounts (see below). This will likely result in employers (in respect to work accidents), earners (in respect to non-work accidents) and motorists (in respect to Motor Vehicle Accidents) facing a significant increase in levies over the next few years.



With low interest rates likely to stay around for some time, the Government may be encouraged to introduce greater premium-smoothing over ACC accounts to allow for potential interest rate fluctuations, although smoothing premiums also comes with its own set of problems, including less transparency about the actual cost of accident claims over particular periods. There is a fine line between ensuring relative stability in premiums and at the same time ensuring the various ACC accounts do not dip into the red, imposing costs on future generations. Given the hard-won gains from achieving a fully funded ACC model, now would not be the time to throw these out and revert to the failed pay-as-you-go (PAYG) scheme of the past with its hidden inefficiencies and lack of transparency for premium payers in respect to risk-taking.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Dec 20	Dec 21	Dec 22
Highest	0.3	0.3	0.3
Average	0.3	0.1	0.1
Lowest	0.3	-0.2	-0.2

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – in the zone

The NZ dollar fell earlier this year as the Reserve Bank unleashed a substantial amount of stimulus on the economy in the form of quantitative easing, indicating the potential for the OCR to head into negative territory next year. However, more recently, the resilience of the NZ economy to COVID-19 and the possibility the Reserve Bank might not go ahead with further interest rate cuts has put slight upward pressure on the $NZ dollar.

While exchange rates have not necessarily been front of mind for most exporters right now, any exchange rate increases will put downward pressure on prices to NZ producers, including agriculture, when converted back into NZ dollars. This may also make it harder for the Reserve Bank to keep inflation within the broader target band of 1-3 percent per annum.

Notwithstanding the above, picking where the NZ dollar might go is fraught with uncertainty given current international circumstances. The effectiveness (or otherwise) of the international roll-out of vaccines across countries may have more impact on currencies than interest rates per se.

Irrespective of the above, NZ's relatively stable and transparent fiscal and monetary policy framework and its success in effectively containing any Covid-19 outbreaks, mean wild swings in the NZ dollar are unlikely.

Forecasts: Exchange Rates

	AUD (cents)		
	Dec 20	Dec 21	Dec 22
Highest	0.95	0.94	0.93
Average	0.94	0.93	0.92
Lowest	0.93	0.91	0.91

	USD (cents)		
	Dec 20	Dec 21	Dec 22
Highest	0.71	0.75	0.73
Average	0.70	0.73	0.71
Lowest	0.69	0.71	0.70

	TWI		
	Dec 20	Dec 21	Dec 22
Highest	75.1	76.0	73.6
Average	72.5	73.5	72.4
Lowest	71.0	71.8	71.3

Source: ASB, BNZ, Kiwibank and Westpac

Inflation – a game of two halves?

Inflation as measured by the Consumers' Price Index is likely to remain well within the Reserve Bank's target band of 1-3 percent out to December 2022.

While most commentators have focused on the potential downside risk of inflation tracking below the 1-3 percent target, there is the possibility of inflation from an increase in new housing-related costs (land and second-hand houses are not included the CPI) with the potential for significant increases in insurance premiums as a result of a numerous factors, e.g. earthquake and climate change risks and a broader move towards more risk-based pricing for those properties seen as vulnerable. Some risks will likely also be felt in other insurance areas, spilling over into health-related insurance policies and life cover.

On the other hand, insurers could pull back from insuring potentially vulnerable to higher risk activities rather than face public backlash for raising premiums commensurate with risk. But if insurers pulled back significantly, this would mean more vulnerable asset classes would naturally decline in value given the need for individuals to self-insure.

There are also questions over supply chain cost increases which will ultimately feed through into consumer costs. The recent 2020 DHL Report finds the number one barrier to exporting is the high cost and lower frequency of transport options for getting products to market, largely due to the impact of COVID-19 on supply chains around the world.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Dec 20	Dec 21	Dec 22
Highest	1.6	1.3	1.6
Average	1.1	1.1	1.4
Lowest	0.9	0.9	1.2

Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – improving off a low base

Recent surveys of business activity and confidence show significant improvement from the doom and gloom experienced earlier this year. However, while business confidence has improved, it has done so off an extremely low base and therefore needs to be put in context.

As a rule, business confidence slows or falls during the lead up to a general election, reflecting general uncertainty over the outcome and resulting in businesses holding off making important investment decisions. Combined with the ongoing effects of COVID-19, pessimism was rampant until a few short months ago.

The election of a Labour Government with a clear working majority (the first ever under an MMP system), and with the economy still relatively fragile, it seems likely there will be no major changes in policy direction. Without the need to take account of various coalition partners, as in the past, it is also possible such changes as are made will, hopefully, follow a more coherent path.

The increase in support from "middle NZ" would similarly suggest dramatic policy changes this term are unlikely. It helps that key Ministers have largely held on to the important policy areas such as Finance and the Environment, suggesting a "business as usual" path will be trodden. This should give some confidence to the business sector, and indeed to households in making investment decisions.

That said, the environmental controls mentioned earlier and the potential impact of wider labour market regulatory initiatives (see later section on Labour Market) remain a concern.

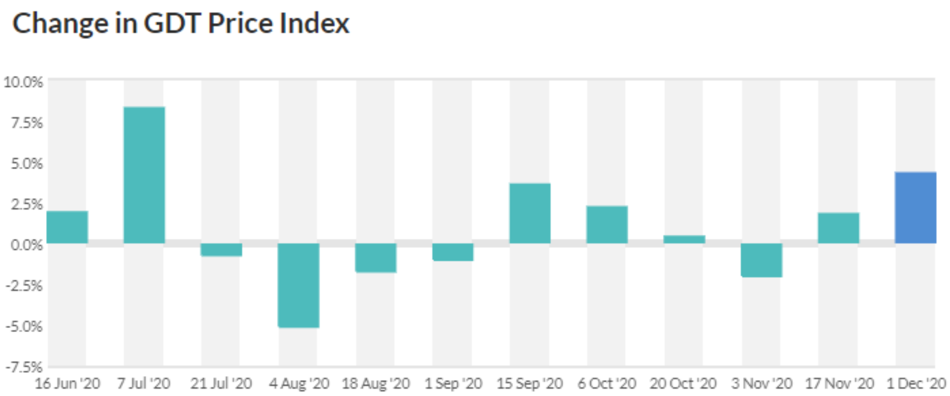
As stated in this report's Executive Summary, the effects of COVID-19 have been extremely uneven across NZ's various sectors.

The impact of the lack of international inbound tourists on tourist-dependent towns such as Queenstown and Rotorua has been massive. While domestic tourists have been out and about, they are no substitute for inbound tourists' deep pockets and those tourists' willingness to pay for an adrenaline rush while staying at exclusive NZ resorts. Post-Christmas holidays, the future looks increasingly bleak for many tourism operators unless, NZ opens its borders (in a safe manner) as soon as possible.

Likewise, the hospitality sector has been massively affected with the lack of traditional events adding to the sector's current pessimistic outlook.

Agricultural sentiment remains downbeat, perhaps surprising given relatively high levels of commodity prices, including Fonterra's recent forecast increase for the current year and China, NZ's major trading partner, showing increased demand for product.

The Global Dairy Trade (GDT) has continued some upward improvement of late

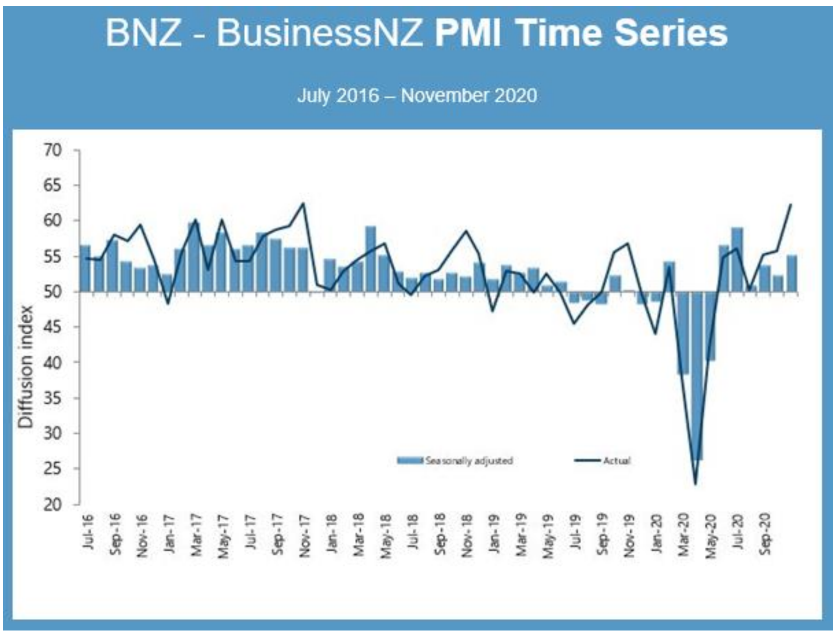


Source: GDT

On the other hand, there is significant concern in the agricultural community and the mineral extraction sector about the potential impact of some aspects of freshwater reform which will adversely affect the ability to use land in an optimal manner.

By contrast, the construction sector is showing real strength, with record numbers of building consents and a particular focus on the Government's massive infrastructure spend down the track. The outlook for construction looks positive both in respect to residential buildings and the Government's recently announced large infrastructure investment.

The seasonally adjusted BNZ – BusinessNZ Performance of Manufacturing Index (PMI) for November 2020 was 55.3 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was up 2.9 points from October, and the highest level of expansion since July.



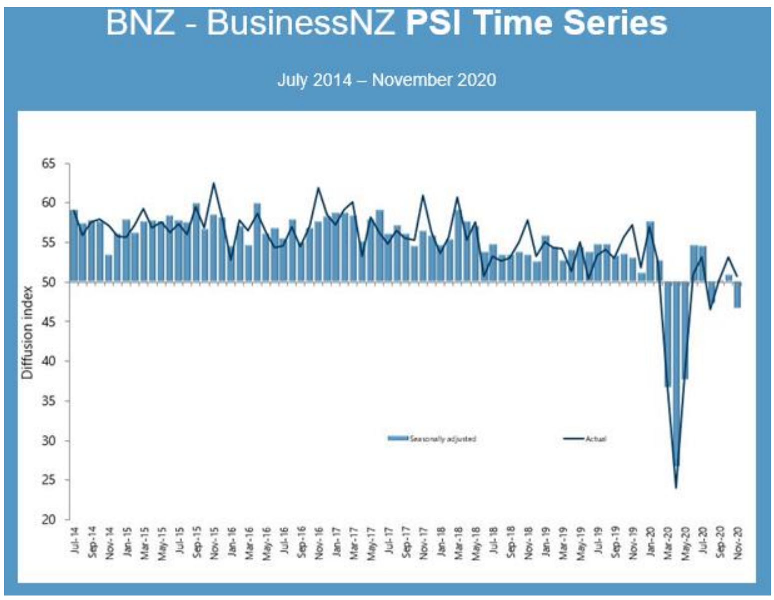
The sector has now remained in positive territory for the sixth consecutive month, despite swings in actual activity levels.

The key indices of production (55.4) and new orders (57.6) both displayed healthy levels of expansion during November, while employment (51.5) eased back to September levels. Interestingly, finished stocks (59.0) recorded its highest value since the survey began, which may be due to COVID-19-related delayed activity and the distribution issues that have plagued 2020.

Meanwhile, activity in NZ's services sector fell back into contraction during November according to the BNZ-BusinessNZ Performance of Services Index (PSI).

The PSI for August was 46.7, down 4.1 points from October (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). This was the lowest level since May 2020.

The drop in activity was disappointing to see but not necessarily unexpected given the significant disruption throughout most of 2020 caused by Covid-19.



Almost all the sub-indices were in contraction during November. Activity/Sales (45.5) went further into contraction from last month, while New Orders/Business (52.6) experienced lower expansion levels. Employment (49.1) remained in contraction for the 9th consecutive month, while logistical disruptions continued with Supplier Deliveries (39.8) at its lowest level since April 2020.

Main **Indices**

1.2 Labour market – risks remain

Unemployment, while still rising, is unlikely to reach the dizzy heights forecast several months ago. The Treasury outlined seven economic scenarios back in April, five of which saw the unemployment rate hitting double-digit figures in the September quarter, including a worst-case scenario of 23 percent. Nevertheless, despite a much better outcome than expected with unemployment hovering at 5.3 percent for the September quarter (the latest official information available) over 30,000 people have lost their jobs since the start of COVID-19. That puts the economic and social costs of Covid-19, and NZ's response clearly under the spotlight.

While 5.3 percent unemployment might represent something of a let-off, digging a little deeper into the figures, there is a significant concern that individuals might have exited the labour market altogether as labour force participation rates have fallen.

Also, a major concern is that it is those in the most vulnerable areas who have tended to lose their jobs, e.g., in hospitality and tourism and for many it might be difficult to move readily into other avenues of employment.

Forecasts show the real impact of COVID-19 is yet to be reflected in official figures, with official unemployment likely to peak at over 6 percent before slowly dropping again.

The Government correctly and rapidly tried to ensure employees, during earlier lockdowns, could remain attached to a business operation to the extent possible by providing wage subsidies and other assistance measures to businesses directly, e.g., low interest loans. This has not been without cost. Around $14b flowed through to keep employees working in the hope of ensuring businesses could get up and running as soon as possible after the various stages of lockdown ended - an appropriate response at the time.

A reduced ability to source labour from overseas is also affecting productivity as there are fewer skilled people in NZ able to do specialist and other necessary tasks. Net migration has effectively reduced to a trickle, limiting the ability of many seasonal operations, dependent on foreign-sourced labour, to operate as effectively and efficiently as in the past.

It is important for policy makers to understand the contribution migrant employees make to the NZ economy and to specific sectors. Now is not the time to put up the shutters on skilled migration, as the NZ economy depends on the skills provided by a diverse and flexible migrant workforce. These skills cannot, in many if not most, cases, simply be replaced by employing NZ citizens made redundant from their current employment.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 20	Dec 21	Dec 22
Highest	6.6	6.5	5.5
Average	6.1	6.1	5.2
Lowest	5.6	5.8	4.6

Source: ASB, BNZ, Kiwibank and Westpac

Proposed Regulatory Changes

Of significant concern to the business community is the potential for added costs to be loaded on to businesses at a time when they need as much assistance as possible to take on, or continue to employ, staff.

The NZ government has committed to making changes to employment laws and policies during its current term, some already well under way. The following provides a brief description of the proposed changes being promoted.

A short analysis of the proposed changes can be found here.

While some of the proposed changes look superficially benign, most, if not all, will have significant unintended consequences which will add to the uncertainty and the cost of employing labour. Given a limited ability to pass on costs, many employers may simply choose to move to more capital-intensive ways of working and/or reduce their demand for labour or – in the worst case – go out of business. This is generally in no one's interests.

Sick Leave

A Bill to increase minimum sick leave entitlements from 5 to 10 days a year was introduced to Parliament on 30 November 2020.

Minimum Wage

A 2021 increase in the minimum wage, raising it to $20 an hour with a balanced approach to minimum wage increases beyond 2021.

Living Wage

Public service contracted security guards, cleaners, and caterers to be paid a living wage with the requirement progressively expanded, as the Covid-19 recovery allows, to cover workers contracted to the wider state service, including through the DHBs.

Pay Equity

Improved transparency for women by ensuring better pay records across New Zealand, including by ethnicity and age as well as gender.

Fair Pay Agreements

The introduction of Fair Pay Agreements in line with the recommendations of the Fair Pay Agreements Working Group.

a. The agreements would cover both employees and dependent contractors
b. Workers would be represented by registered unions during bargaining and only unions would be able to initiate bargaining for the first agreement
c. Concluding an agreement would need over 50% support from workers and over 50% support from employers
d. Once agreed, Fair Pay Agreements would cover all employers in a sector but regional variations and exemptions of up to 12 months for employers facing severe financial hardship could be negotiated.

Holidays Act

The implementation of the Holidays Act Working Group's recommendations to reform the Holidays Act, including:

a. introducing legislation to simplify employers' leave calculations
b. allowing employees to take sick and annual leave when needed with their leave accruing over time instead of becoming available as a block between 6 to 12 months' employment
c. allowing employees to take bereavement and family violence leave as needed

This is good news. However, introducing a simpler approach for the future does not solve the current issues many businesses face in endeavouring to calculate and remedy errors in holiday pay calculations over several years. This process has proved and is proving time consuming and costly. There is a real need to "wrap up" the existing exercise to permit employers to focus more exclusively on the future.

Employment Relations Act

a. Strengthen section 59b of the Employment Relations Act so unions do not have to establish the "intent" of employers who automatically pass on gains from collective bargaining to non-union workers

b. Add security guards to Schedule 1A of the Employment Relations Act to provide additional workplace protections for the 5,500 security guards many of whom will be affected when firms undergo restructuring.

Dependent Contractors

Collective bargaining and other basic employee rights to be extended to dependent contractors including:

a. allowing contractors to bargain collectively
b. requiring written contracts
c. introducing a duty of good faith for dealings between contracting parties.

Health and Safety

The age for entry into hazardous work to be raised from 15 to 16 to align with the school leaving age, consistent with International Labour Organisation Recommendation 190 on the Worst Forms of Child Labour.

Labour Costs – on hold

Forecasts below show labour cost increases to remain largely on hold.

Increases last year and earlier this year to an extent reflected significant and continuing rises in the minimum wage, while settlements in the public sector (health, education, and police) put some upward pressure on labour costs overall.

Notwithstanding the above, the game has changed massively over recent months with significant labour-shedding, particularly in the sectors most adversely affected by border closures, such as tourism and hospitality, and associated industry sectors such as transport. As a result, labour costs are likely to remain flat, with minimal increases expected over the coming year.

Notwithstanding the above, the impact of the impending regulatory cost increases outlined above will likely be increased wage rates for some but reduced job opportunities for others - not a desirable outcome.

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

	Years Ending		
	Dec 20	Dec 21	Dec 22
Highest	2.0	1.8	2.1
Average	1.6	1.6	1.7
Lowest	1.4	1.4	1.4

Source: ASB, BNZ, Kiwibank and Westpac