ECONOMIC OVERVIEW

Weathering the storm.

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Note from Michael

The scale of the devastation caused by Cyclone Gabrielle has been hard to comprehend. Thousands of people are facing a long and arduous journey to get their lives back on track. Estimates of the cost of rebuilding become quickly out of date, but it will clearly be in the many billions of dollars.

In terms of tracing through the consequences for the economy, we have an all-too-recent playbook. As we saw with the Canterbury earthquakes of 2010-11, the initial disruptions will give way to a rebuild that, given the scale of the task, will create a draw on the nation's resources over several years. At the margin, that could mean more inflation pressure and higher interest rates than otherwise.

Yet, we should be careful about making too much of this. Despite the initial fears about the inflationary impact of the Christchurch rebuild, overall inflation was actually persistently on the low side of the Reserve Bank's target throughout. The lesson from this is that the construction tail does not wag the economic dog; conditions in the wider economy are far more important.

Of course, today's conditions are quite different from 2011 – we're starting out with an economy that is already overheating. But we expect that to change significantly in the years ahead. The Reserve Bank's past efforts to tighten monetary policy will really come home to roost this year, as homeowners roll onto much higher mortgage rates than before. That will prompt consumers to rein in their spending, and businesses to scale back their investment and hiring plans.

In time, this will see the inflation rate ease back. But it will be an uncomfortable wait in the meantime, with a number of disruptive forces boosting prices in the near term. And given the inherent lags in monetary policy, the RBNZ should start to take its foot off the brake even before inflation has returned within the target range.

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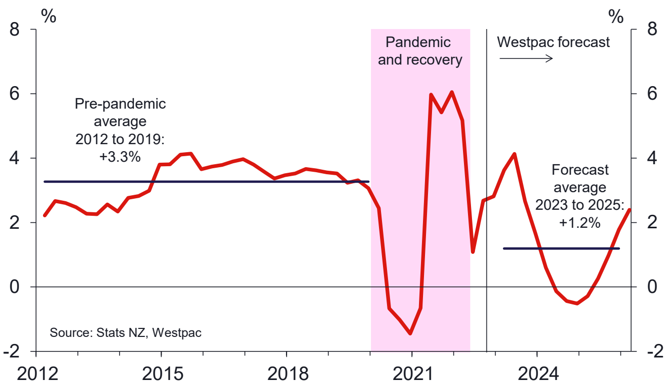
NEW ZEALAND ECONOMY

Under pressure.

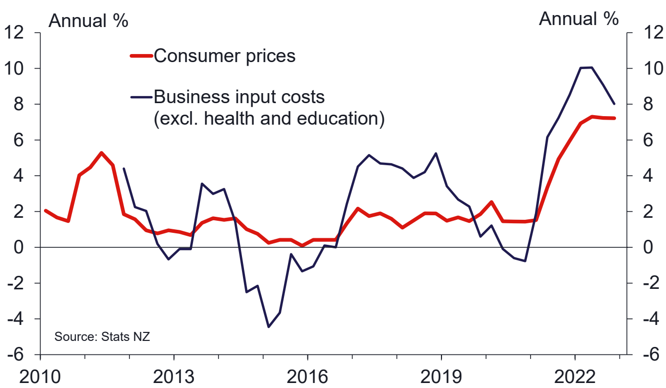
Conditions in the New Zealand economy are changing. High levels of inflation are eroding households' spending power and squeezing businesses' margins. At the same time, the impacts of higher interest rates are now rippling through the economy. Combined, those factors will be a significant drag on domestic demand, with economic activity set to fall sharply over the course of this year.

Figure 1: GDP growth (annual average)



2023 will see significant changes in the New Zealand economy as households and businesses across the nation grapple with increasingly tough financial conditions. That includes high levels of inflation which are eating away at families' spending power, with consumer prices rising by 7.2% over the past year. Those increases have been felt by every family across the country, but they've been especially tough for families on lower incomes due to the large increases in the cost of necessities like food and housing.

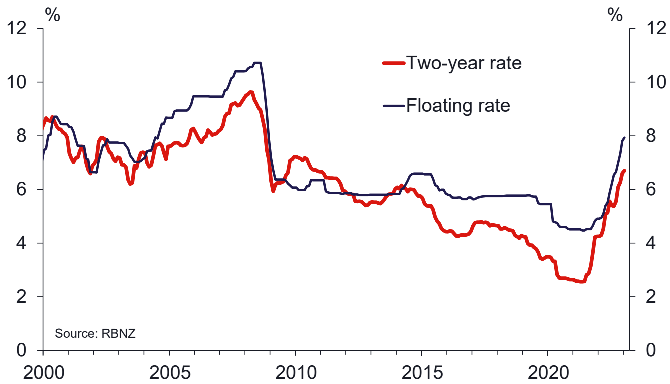
Figure 2: Inflation



And it's not just households that are struggling with higher prices. Businesses across the economy have seen their margins squeezed, with operating costs rising by an average of 8% over the past year. Those pressures have been particularly pronounced in industries like construction and manufacturing, where costs have risen by more than 12%. At the same time, many businesses are reporting a drop in forward orders.

In response to those strong and widespread inflationary pressures, the Reserve Bank (RBNZ) has been hiking the Official Cash Rate (OCR) at a rapid pace to dampen demand. The OCR has now risen by a total of 450 basis points since the tightening cycle began in October 2021, and that's pushed borrowing costs to their highest levels in more than a decade. As discussed in the *Inflation and the RBNZ* section, we expect the RBNZ will deliver a further 75 basis points of OCR hikes over the coming months.

Figure 3: Mortgage interest rates



That tightening in financial conditions comes at the same time as some other important changes in the economic landscape. First, the continuing recovery in international tourism is providing a long-awaited boost to our hospitality sector and is supporting a recovery in service exports.

At the same time, the nation is also dealing with the devastating impacts of January's storms and Cyclone Gabrielle. Those events have resulted in widespread economic disruptions throughout the upper and central North Island, and they have had a particularly large impact on sectors like horticulture. As discussed in our first *Special topic*, extensive reconstruction work will be required and will likely take several years to complete.

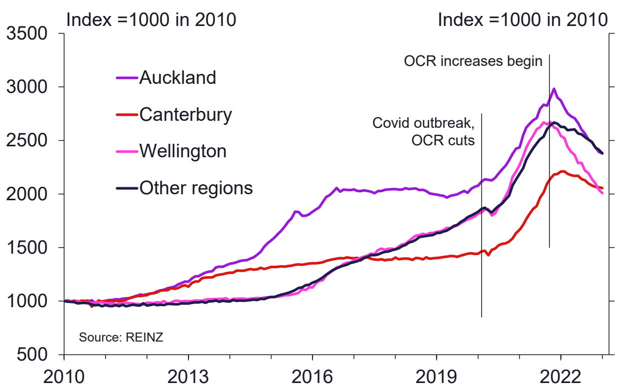
But while post-storm reconstruction and the continuing recovery in services exports will boost spending, they will not be large enough to offset the significant drag on domestic demand from high inflation and rising interest rates. And as households and businesses feel the full brunt of those tighter financial conditions, we expect the economy will slip into recession from late-2023 through to mid-2024. We're forecasting a contraction in economic output of around 1%, along with a related rise in unemployment.

Housing's deepening downturn.

The dampening impact of higher interest rates is already clearly evident in the housing market. Since the RBNZ's tightening cycle began in 2021, house prices have fallen by an average of 15% across the country, with prices in Auckland down 20% and Wellington down 25%. Sales have also dropped sharply and are now at their lowest level since the Global Financial Crisis (barring the lockdown period in 2020).

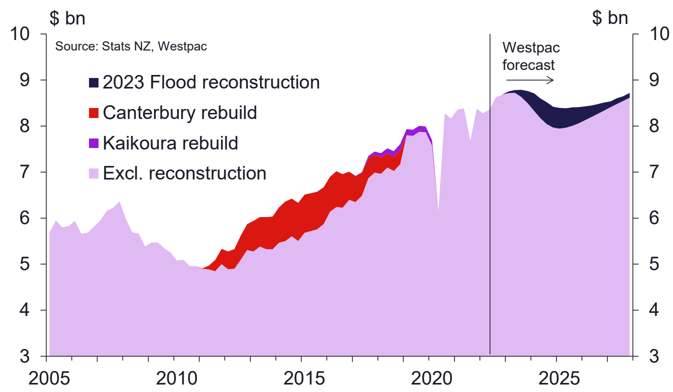
With interest rates continuing to push higher, we're forecasting further falls in house prices over the year ahead. Coming on the back of the declines we've already seen, that will leave nationwide house prices down 21% from the highs reached in 2021. New Zealanders hold a large amount of their wealth in owner-occupied or investment housing. Consequently, the fall in house prices signals a sizeable knock to many households' net worth, and that will weigh on households' spending appetites over the coming year.

Figure 4: House prices by region



As discussed in our second *Special topic*, the deepening downturn in the housing market is also adding to the challenging conditions in our building sector. With sharp falls in house prices, large increases in build costs and higher interest rates, prospective buyers have become increasingly hesitant about purchasing off-plan. Similarly, developers are reluctant to bring new projects to market. As the current pipeline of projects are completed, those conditions will see construction activity trending down over the next few years. That downtrend will be moderated by reconstruction spending following the recent storms. However, that will only slow the pace of decline – we're still looking at tough conditions in the home-building sector over the next few years.

Figure 5: Quarterly construction spending (adjusted for inflation)

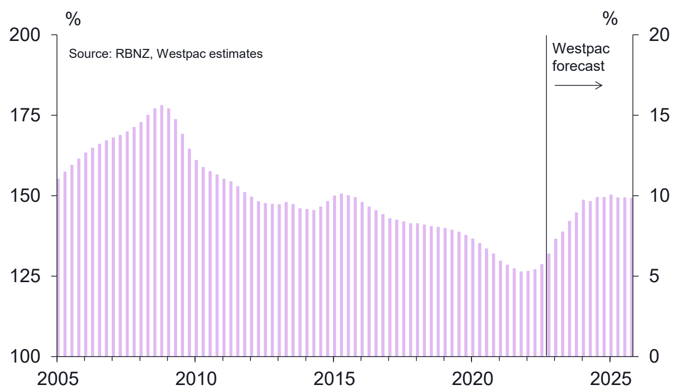


Households squeezed.

Despite higher interest rates and a weaker housing market, household spending has actually remained firm in recent months. That's in part due to the strong growth in incomes, with average hourly earnings rising by 7.2% over the past year. Savings levels have also increased since the start of the pandemic, which has provided many households with a buffer from the headwinds that they are now facing.

Most importantly, around 90% of New Zealand mortgages are on fixed rates. That's shielded many borrowers from the large increases in interest rates over the past year. In fact, accounting for the extent of mortgage rate fixing over the past few years, the 'effective' average mortgage rate that New Zealand borrowers are actually paying is still only around 3.8% – well below the current interest rates that are on offer. As a result, the share of household incomes being spent on debt servicing is still sitting close to multi-decade lows.

Figure 6: Household spending on interest costs (% of disposable incomes)



Conditions for borrowers will become a lot tougher over the coming year. Close to half of all fixed-term mortgages will come up for repricing over the next 12 months. In many cases, borrowers will face refixing at substantially higher interest rates. For example, borrowers who fixed for two years in early-2021 may have secured a rate in the 2.5% to 3% range. Those same borrowers are now looking at a two-year rate that's more than 3 percentage points above what it was back then.

Those large increases in interest rates will take a big bite out of many households' disposable incomes. For example, suppose you purchased an average-priced house in 2021 with an 80% mortgage fixed for two years. Compared to what you were paying in 2021, your minimum fortnightly payments in most parts of the country are set to rise by around $530 per fortnight when you go to re-fix your mortgage. If you live in Auckland, where house prices tend to be higher, that increase in interest costs will be around $900 per fortnight. On average, borrowers in this example would need to spend around 12% more of their disposable income to meet the minimum repayments on their mortgage. For many families, that would more than offset the growth in their incomes over the past two years.

The combined impact of those higher interest costs, large increases in consumer prices and a weaker housing market will be a significant drag on demand. Many households will be forced to wind back their spending due to the mounting pressure on their finances, and many others will do so out of an abundance of caution. Putting that altogether, we expect to see per-capita spending levels falling by around 2% over the next few years.

Rapid price increases are eating away at households' spending power.

Risky business.

Household spending accounts for around 60% of total economic activity, and the expected weakening in demand will drive a broader slowdown in economic growth over the coming years. The majority of businesses in recent surveys have already reported that trading activity has turned down over the past few months, with many builders and retailers also reporting a fall in forward orders. Combined with the mounting pressure on operating costs, those conditions have seen growing pressure on margins and many businesses are now paring back their plans for capital expenditure. We've also seen increased demand for working capital as businesses try to shore up their finances in the face of tougher trading conditions and ongoing economic disruptions.

Work it.

Despite mounting economic headwinds, the labour market has remained in good health thus far, with unemployment still very low at 3.4%. In addition, the strong economic growth in recent years has businesses competing to attract and retain staff, and that has seen wages rising at their fastest pace in decades.

However, signs that the labour market has started to turn have emerged in recent months, with the number of job advertisements trending down since mid-2022. As domestic demand weakens over the next few years, we expect to see a related downturn in jobs growth, along with a rise in the unemployment rate to 5.2% by 2025.

Wage growth is expected to remain strong in the near term. But as the downturn in the economy deepens and the demand for workers softens, wage inflation will also drop back over coming years.

Since New Zealand reopened its border over 2022, we've seen a faster than expected turnaround in net migration. The balance of migrant flows has turned from a modest outflow through 2021, to strongly positive again by the end of 2022. The revival has been in both directions, with both inflows and outflows of migrants now exceeding their pre-Covid levels. This suggests that some pent-up demand to travel during the Covid restrictions is being unleashed.

With the New Zealand economy and the labour market still in good shape for now, we expect net migration to remain firm over the months ahead. That will be welcome news for many businesses who have been crying out for skilled workers. The related lift in population growth will also provide a boost to demand.

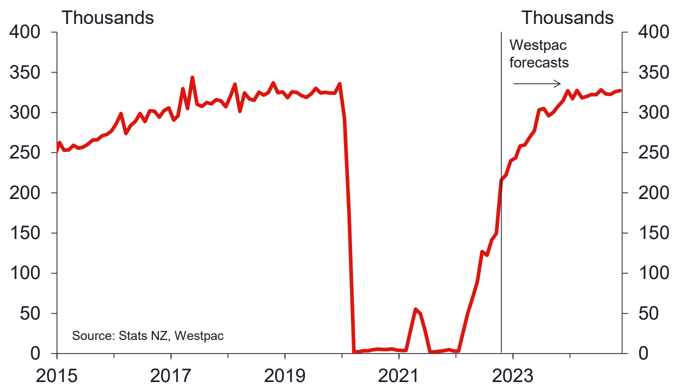
However, as economic activity softens and employment opportunities reduce, New Zealand is likely to look less attractive to both new migrants and existing residents. As that occurs, the recent uptick in net migration is set to moderate again.

We've missed you.

Providing some offset to the softening in domestic demand is the post-pandemic recovery in international tourism and other services exports. International visitor numbers have climbed rapidly since the border reopened and have now retraced around two-thirds of their pre-pandemic levels. We expect to see further increases in visitor numbers over the coming months, with positive indications for visitor numbers from high spending markets like the US and China.

The outlook for the export education sector, which accounted for around 5% of New Zealand's total exports prior to the pandemic, is also looking firmer. The Chinese government has recently mandated that its students must study in-person (as opposed to online) for their overseas qualifications to be recognised. That requirement signals a sharp recovery in student numbers over the coming months.

Figure 7: Monthly international visitor arrivals, seasonally adjusted



SPECIAL TOPIC 1

In the wake of January's floods and Cyclone Gabrielle.

Our country has been struck by two devastating natural disasters in a matter of weeks. These events have resulted in loss of life and will have a significant ongoing impact on the lives of many New Zealand families. There will also be economic consequences. Those costs are secondary to the human toll of these events, but we will briefly try to summarise some of those impacts here.

The combined impact of January's floods and Cyclone Gabrielle have resulted in extensive damage through large swathes of the North Island. They have had a particularly severe impact on Gisborne/Tairāwhiti, the Bay of Plenty, and Hawke's Bay, as well as in Northland, Auckland, the Waikato, and the Tararua District. These regions are home to around 60% of the population.

A full assessment of the damage will take some time. The Minister of Finance has indicated that the cost could be in the vicinity of $13bn (equivalent to around 3.5% of annual nominal GDP). That would make it New Zealand's second-costliest natural disaster, following the Canterbury earthquakes in 2010 and 2011.

In the wake of the storms there will be significant economic disruptions, including reduced spending by both households and businesses. Those impacts will be compounded by damage to transport networks and other infrastructure, which has hampered the recovery.

However, over the coming weeks we will see a lift in spending associated with clean-up work, as well as spending to replace damaged household items and vehicles. And as both the flooding and much of that early repair spending will occur in the March quarter, the impact on spending over the quarter as a whole may be limited. We saw a similar pattern following the Canterbury earthquakes, with overall spending rising strongly after the February quake.

In contrast to the Canterbury earthquakes, the recent flooding has caused extensive damage to some of our key growing regions and farmland. Hawke's Bay and Gisborne were among the worst-affected regions, and there is likely to be an especially large impact on our horticulture sector. Some fruit crops like apples are likely to see significant losses given Gabrielle has hit during the picking season.

The disruptions to production in the horticulture sector and other export industries will linger for an extended period. As a result, we've revised down our forecast for nominal exports by $1.2bn this year, with a small hit also expected in 2024.

Over the coming years, we will see a large amount of spending on repairs to roading and other infrastructure, along with repairs to damaged housing. There will also be spending to remediate the damage to business assets, as well as replanting of horticultural stock like apple and other trees.

While some more moderate repair work may proceed fairly quickly, large scale reconstruction and some major projects are unlikely to begin for many months. Even when reconstruction does get underway, this work will take years to complete. The storms hit at a time when our building sector is already stretched, with ongoing shortages of staff. That means there is limited scope for a significant ramp up in building activity. It also means that some existing planned work is likely to be delayed or cancelled as staff and resources are diverted to essential repairs.

The recent storms will also add to inflation. That will be seen most immediately in food prices, with the damage to crops signalling shortages of some fruit and vegetables over the coming months. We are also likely to see a range of other storm-related price increases over the coming year, such as increases in rents, insurance premiums, vehicle prices, and potentially increased pressure on local council rates. Combined, we expect that those disruptions will add around 0.7 percentage points to inflation over 2023, with the bulk of that due to higher food prices. However, those increases are not an ongoing source of inflation, so they don't require a response from the RBNZ. And in the case of fruit and vegetables, much of the expected price rises will gradually reverse over time as production recovers.

There will also be a more protracted boost to activity from reconstruction spending, and that could add to medium-term inflation pressures. However, this is still a temporary boost. In addition, prior to the storms we were forecasting a downturn in homebuilding and other construction work over the coming year. That's due to the tightening in interest rates over the past year and the increasingly challenging financial conditions in the building sector. Reconstruction activity will moderate that decline, but it won't completely offset it. And that broader slowdown in construction activity will help to limit the extent of any price rises.

AGRICULTURAL OUTLOOK

Twin peaks.

After peaking in early 2022, New Zealand's commodity prices are ascending again. The price trend links back to rebounding Chinese demand following the recent sudden end to China's Covid Zero policy. While this spells good news for commodity prices, damage from this year's storms and ongoing high input cost inflation temper the overall agriculture outlook.

2022 was a year of peaks and steep descents. Overall commodity prices peaked in early 2022, with record highs set across beef, dairy and sheepmeat farmgate prices. But by year end, commodity prices were falling steeply. The best example of this dynamic was farmgate lamb prices. After peaking at a record high of $9.52/kg in September, lamb prices plunged by $2.70/kg or around 28% over the next four months.

From here, we expect prices to head back up again. In that sense, prices are likely to reach a new peak at or near record highs later this year.

The main factor driving prices higher is the same factor that drove them lower in the first place – fluctuating Chinese demand. For much of last year, tight Covid restrictions crimped consumer demand for many of our exports as households were confined to their homes for long periods of time. Chinese officials abruptly abandoned this policy late last year, and as Chinese enjoy their newly found freedoms, we expect consumer demand to lift and for our export prices to follow.

Looking at global dairy markets, prices began to shift higher during February as Chinese buyers returned, and we expect this uplift to continue over coming months. On this basis, we have held our 2022/23 farmgate milk price forecast at $8.75/kg despite the price weakness back in 2022. Moreover, we have set our 2023/24 forecast at a bullish $10.00/kg on the view that prices will hit a fresh peak during the new season. Indeed, we expect global dairy prices to return to similar levels to those seen through the 2021/22 season, with a more favourable NZD/USD lifting the farmgate price above the $9.30/kg for that season.

Turning to global meat markets, tight US beef supply on the back of lingering drought is adding to the upward price pressure from recovering Chinese meat demand. Given this dynamic, we expect farmgate beef prices will head back towards $6.00/kg over coming months. Meanwhile, we expect sheepmeat prices to buck the normal autumn downturn. And, with ample feed delaying supply, we expect lamb and mutton prices will lift towards $7.00/kg and $4.00/kg, respectively.

Similarly, we expect forestry prices will lift this year as the Chinese economy improves. That said, with the Chinese government reining in previous Chinese housing market excesses, we expect a modest lift in construction activity and for log price gains to also prove moderate.

The outlook for fruit export prices is also strong. However, that is tempered by the prospect of small crops following damage from Cyclone Gabrielle and other weather events. Some growers are likely to experience extremely tough times over 2023 and, in the worst cases, significantly longer (see *Special topic 1* for more discussion).

Lastly, on-farm margins remain under pressure as inflation continues to run hot. In December 2022, annual farm input cost inflation was 15.3%, more than double a year earlier. As such, managing cost pressures will remain a challenge for all.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	With the Chinese economy reopening and global dairy demand set to lift, we have kept our 2022/23 milk price forecast at $8.75/kg. We have also maintained our bullish forecast of $10.00/kg for next season.	Average	↑
Beef	Farmgate beef prices are bottoming at around $5.50/kg to $5.60/kg. With Chinese demand set to lift and US supply very tight, we expect prices to head back towards $6.00/kg over coming months.	Low	↑
Lamb/Mutton	We expect farmgate lamb prices to rebound over coming months. Recovering Chinese demand will be the key catalyst, while ample feed will limit lamb supply.	Below Average	↑
Forestry	With the Chinese economy reopening and construction likely to pick up, we expect log prices to pick up steadily over the year.	Low	↑
Horticulture	Cyclone Gabrielle has hit fruit and particularly apple production hard. Meanwhile, the kiwifruit crop is likely to be down on last season's. With fruit supply dropping, we expect fruit prices to spike this season.	Average	↑

1 New Zealand dollar prices adjusted for inflation, deviation from 10 year average.

INFLATION AND THE RBNZ

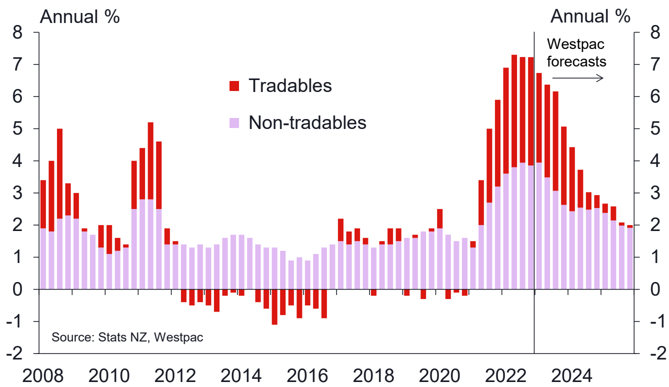
Riding it out.

Inflation remains uncomfortably high, and disruptions from Cyclone Gabrielle are likely to slow its decline over 2023. The inherent lags in monetary policy mean that the tightening to date is just starting to produce results. The Reserve Bank will also need to consider those lags when it comes to taking its foot off the brake.

Inflation in New Zealand has remained stubbornly high, and higher than forecast, holding at 7.2% in the year to December. While there are some early signs that the most persistent components of inflation have passed their peaks, they are still running well above what would be consistent with the Reserve Bank's target.

The inflation that we've seen to date has been due to both domestic and international forces. Prices for internationally-traded goods and services (tradables) rose by 8.2% in 2022, led by categories such as food, fuel and household goods. Even this is somewhat understated, due to the temporary reduction in fuel excise duty, which is currently scheduled to end in the middle of this year.

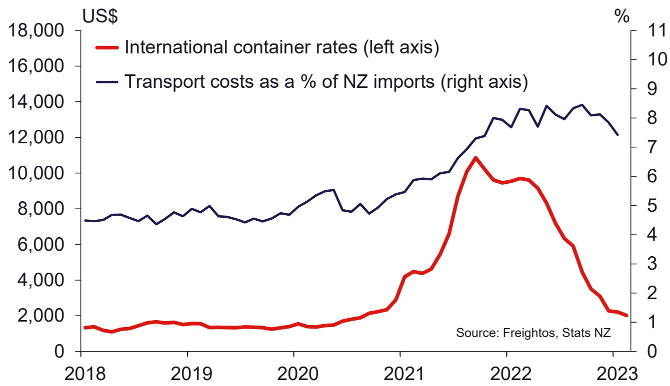
Figure 8: Contributions to inflation



Notably, New Zealand does not yet appear to have benefited from the easing in inflation in other economies like the US and Europe, as noted in our *Global economy* section. In part, that may be simply a function of more frequent reporting in other regions (quarterly in New Zealand, monthly in most other countries).

But it may also be something that New Zealand will experience with a lag. For instance, one of the most striking examples of Covid-related inflation was the steep rise in international shipping costs over 2020 and 2021, as reduced capacity in the shipping industry met with a resurgence in global demand (and a shift towards physical goods over services). That rise in shipping costs largely unwound on the major global routes over 2022, but it's only in the last few months that we've seen it easing on the New Zealand routes as well. If this continues, it will help to moderate imported inflation in the year ahead.

Figure 9: International transport costs

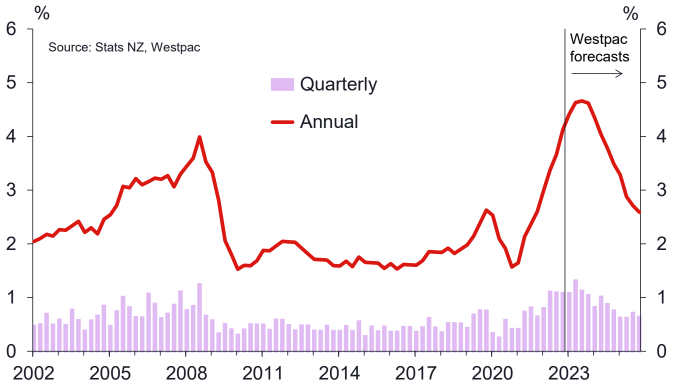


But as tradables inflation eases, local conditions will account for a growing share of overall inflation. In that respect, New Zealand is likely to find itself in a similar position to other countries. Getting rid of the first few percentage points of inflation is fairly straightforward; it's squeezing out the last couple of percent that will prove much more difficult, and central banks around the world are having to make some tough decisions about how hard they pursue this.

The non-tradables component of inflation is weighted more towards services and to more labour-intensive activities, which means that it's closely tied to wage pressures. The very tight labour market in recent times has put pressure on employers to bid up wages to attract or retain workers. That's seen a sharp lift in wage growth over the last year, exceeding the previous record high that we saw in 2008. To the extent that employers offer these higher pay rates because they feel they can pass it on into their own prices, this creates the conditions for a sustained period of higher inflation.

As we've noted before, this dynamic will continue unless there's a circuit-breaker, typically in the form of monetary policy. And indeed, monetary policy has been tightening up since late 2021. However, the degree of overheating in the economy, plus the slow initial pace of tightening, mean that the RBNZ has found itself having to move much faster to catch up in recent months.

Figure 10: Labour Cost Index, all sectors

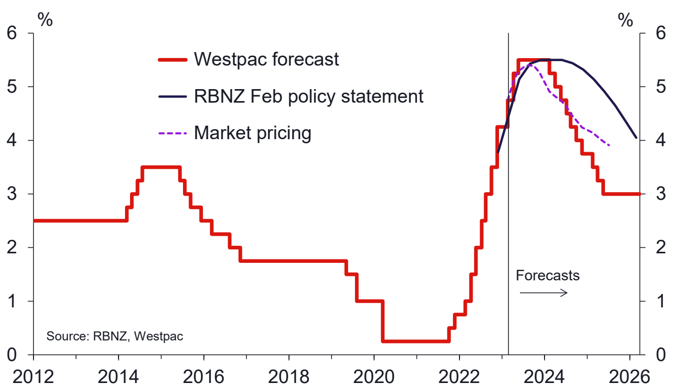


Moreover, it's well understood that monetary policy works with a lag – a rule of thumb is that it takes between one and two years for a change in interest rates to have the bulk of its impact on inflation. For instance, as we detail in the *New Zealand economy* section, mortgage fixing means that it takes time for a rise in interest rates to flow through into the average rate that borrowers are actually paying.

It's this lagged effect that also gives us some confidence that the RBNZ is nearing the peak of its tightening cycle. The effects of the RBNZ's cumulative monetary tightening will be much more apparent in the year ahead than they were in the year just passed. Consumer spending is set to slow as households' budgets are squeezed, businesses will find themselves less capable of passing on cost increases, and they will rein in their hiring and expansion plans. Over time, unemployment will rise from its lows, and wage growth, while it probably hasn't peaked just yet, is expected to cool off over 2024 and beyond.

We expect the cash rate to reach a peak of 5.5% in the next few months, from 4.75% currently. That broadly matches the RBNZ's latest projections, at least for the year ahead. Where we differ, though, is in what the next stage of the monetary policy cycle will look like. The RBNZ's projections suggest that the cash rate will remain at its highs for an extended period, with little prospect of an easing before late 2024.

Figure 11: OCR forecasts



In contrast, we think the RBNZ will need to start thinking about when to take the foot off the brake long before then. The point that monetary policy works with a lag holds true in both directions. For instance, our forecast of an extended series of OCR cuts over 2024 is what it would take just to stabilise the average effective mortgage rate by 2025, let alone provide any relief to borrowers. Delaying OCR cuts for longer would risk creating a deeper downturn than what's needed to bring inflation under control.

Monetary policy works with a lag in both directions. The RBNZ will soon need to consider how to take its foot off the brake.

Cyclone Gabrielle has somewhat clouded the picture for the RBNZ. In the short term, there is likely to be some additional upward pressure on prices. Crop damage and transport disruptions will boost food prices in particular, while items such as household goods and cars could be bid higher as people look to replace what was lost in the flooding. The standard advice is that monetary policy should look through these kinds of price movements. Nevertheless, for the RBNZ it will mean an even more uncomfortable wait until inflation is clearly tracking down towards the 1-3% target range.

The rebuild effort will create an additional draw on the nation's resources in the years ahead, which may require interest rates to be higher than otherwise. Even so, we need to keep this in perspective. The rebuild after the 2010-11 Canterbury earthquakes was also widely expected to be inflationary. Yet overall inflation remained stubbornly on the low side of the target range throughout that period. The RBNZ underestimated the degree of spare capacity in the wider economy, which was still just emerging from the Global Financial Crisis.

Of course, things are quite different this time, with the economy coming from an already-overheated starting point. But that is set to turn sharply over the next couple of years, as a result of the policy tightening that the RBNZ has done to date. Indeed, by its own estimates, by 2024 the economy will be left with at least as much spare capacity as it had at the start of the Canterbury rebuild.

Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-23	6.7	4.75	5.40	5.30	4.80
Jun-23	6.4	5.50	5.60	5.10	4.60
Sep-23	6.2	5.50	5.60	4.80	4.40
Dec-23	5.1	5.50	5.50	4.40	4.20
Mar-24	4.4	5.25	5.05	4.10	4.00
Jun-24	3.7	4.75	4.55	3.80	3.80
Sep-24	3.0	4.25	4.05	3.60	3.70
Dec-24	2.9	3.75	3.75	3.40	3.65
Mar-25	2.7	3.50	3.30	3.35	3.60
Jun-25	2.6	3.00	3.10	3.30	3.60

GLOBAL ECONOMY

Reaching the zenith.

The global growth outlook isn't quite as bad as feared. Indeed, an unusual combo of better-than-expected growth and lower-than-expected inflation over recent months has been a welcome development. This surprise has increased the possibility of a soft global landing and also hints that the global central bank policy tightening cycle is reaching its zenith. Meanwhile, the sooner-than-expected reopening of the Chinese economy is a welcome boost for all economies, with New Zealand a clear beneficiary.

Global inflation remains uncomfortably high, but data over recent months suggest that central banks are making are some headway in this protracted battle. For example, US annual CPI inflation dipped to 6.4% in January from its mid-2022 peak of 9.1%. Similarly, Europe has seen annual inflation slip back below 10% to stand at 8.5% in January. While still a long way off central banks' mandated targets, these moves are at least in the right direction.

Surprisingly, global growth has also come in a touch stronger than expected. Notably, European growth has defied the odds. Indeed, a mild winter has meant that energy costs and tight energy supply have not squeezed the European economy as much as first feared. As a result, economic growth stayed in positive territory, albeit just, rising 0.1% in the December quarter and leaving annual growth at a relatively healthy 1.9%.

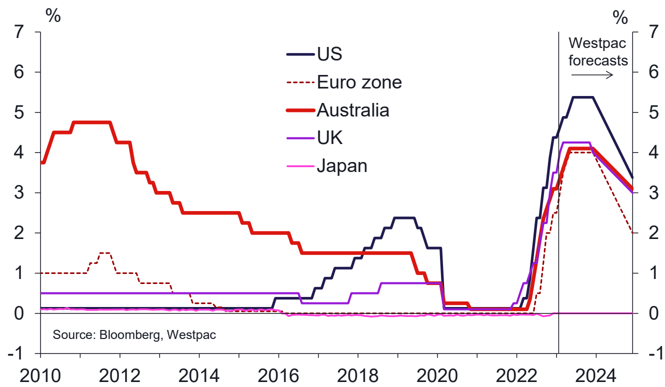
In addition, as the global growth outlook has improved, volatility in financial markets has eased and global sharemarkets have rallied. For example, the MSCI World Index is currently up around 18% from its lows back in October 2022. Similarly, risk assets such as the New Zealand dollar have strengthened, with the Kiwi up around 10 US cents at one stage in early February from its October lows.

With the above in mind, we believe that the global monetary policy cycle is reaching its zenith. For the Federal Reserve, we expect three more 25 basis point hikes, taking the Fed Funds rate to a peak of 5.375%. From there, we anticipate the Fed to pause for an extended period before rate cuts begin in 2024.

In growth terms, we expect the US economy will slow. However, with easing inflation there isn't the need for the Federal Reserve to drive the economy into a deeper recession. On that basis, we expect the US economy will grow by 0.9% and 1.0% over 2023 and 2024, respectively.

Looking across the Tasman, we expect the Australian economy to avoid a technical recession, although over the second half of 2023 we anticipate that growth will slow to near stall speed. All up, we expect annual economic growth of 1.8% and 1.2% over calendar 2023 and 2024, respectively.

Figure 12: Global central bank policy rates



Turning to monetary policy, we expect the Reserve Bank of Australia (RBA) to raise its cash rate to a peak of 4.1%, with three more 25 basis point increases from March to May. While we think that rate hikes and easing supply-side pressures will be sufficient to bring inflation back under control, the tone of recent RBA commentary suggests that the risks lie in the direction of more hikes than we have factored in.

Meanwhile, China is back open for business following the reopening of its economy. Chinese officials abruptly abandoned their Covid Zero policy late last year. On the back of this development, we expect the Chinese economy's growth to more than double to 6.2% over calendar 2023, after the Covid Zero policy and the associated restrictions had crimped Chinese economic growth to an anaemic 3% over 2022.

The reopening Chinese economy is a welcome development for New Zealand Inc. China is the key market for our main exports. In calendar 2021 (before the severe Covid restrictions), China accounted for over 40% of meat and dairy exports and circa 60% of our forestry exports. It follows that as the Chinese economy rebounds, we expect that to lift demand for our exports and similarly to take our export prices higher (see the *Agricultural outlook*).

EXCHANGE RATES

Right on cue.

As expected back in November, the New Zealand dollar has lifted off its lows as concerns about global inflation and central bank interest rate hikes have eased. Over the coming year, as the global interest rate cycle peaks and then moves into the rear-view mirror, we expect the New Zealand dollar will strengthen further.

Since the November *Economic Overview* and as predicted, the New Zealand dollar has strengthened on cue. From the low point of US$0.55 in mid-October, the NZD/USD has steadily gained ground, reaching as high as US$0.653 in early February.

The catalyst for the rise was a collective market sigh of relief. Global inflation has peaked. Accordingly, the global monetary policy cycle is close to reaching its zenith. On the inflation front, US annual CPI inflation fell to 6.4% in January from its mid-2022 peak of 9.1%, and we expect just one more US Federal Reserve hike in March (see *Global economy* section for more details).

Markets acted on these developments by selling off their US dollar holdings. That is, investors sold safe haven currencies such as the US dollar in favour of riskier currencies like the Australian, Canadian and New Zealand dollars, amongst others. At one stage, the US dollar index fell 11.5% between late September and early February.

The reopening of the Chinese economy has also further underpinned the strength of the New Zealand dollar. China is New Zealand's key goods export market, accounting for as much as 40% of New Zealand's dairy exports in recent years (see *Agricultural outlook*). In addition, the return of Chinese tourists to our shores will give the tourism sector recovery a second wind over the year.

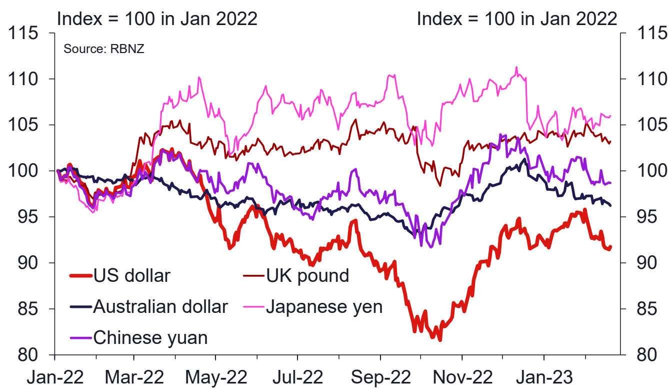
Within this broader upward trend, recent developments have seen the NZD/USD pull back to around US$0.62. US labour market data, in particular, was strong over January and this saw risk aversion increase in currency markets, with investors favouring the US dollar again.

However, we anticipate that this move in currencies is likely to prove temporary and that recent trends will reassert themselves over the course of the year. With that in mind, we expect that the NZD/USD will strengthen further over 2023 and 2024. We forecast the NZD/USD will lift from its current level of US$0.62 to US$0.67 by year end and will tick up to US$0.68 by the end of 2024.

Essentially, this view is predicated on the view that global central banks win the inflation battle over the coming years. And that as this happens, riskier currencies like the New Zealand dollar regain further strength at the expense of safer currencies like the US dollar.

The same view also holds for the Australian dollar. In fact, if anything, the prospects for the Australian economy are even stronger. The Australian economy is poised to benefit relatively more from the reopening of the Chinese economy than New Zealand. With that in mind, we expect the NZD/AUD to weaken over 2023 and 2024. Specifically, we forecast the NZD/AUD to fall to AU$0.88 by the end of 2024.

Figure 13: New Zealand dollar exchange rate vs major currencies



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-23	0.64	0.91	0.59	0.53	84.5	71.7
Jun-23	0.65	0.92	0.60	0.53	85.2	72.3
Sep-23	0.66	0.92	0.60	0.54	85.8	72.6
Dec-23	0.67	0.91	0.60	0.54	86.4	72.8
Mar-24	0.68	0.90	0.60	0.54	86.4	72.6
Jun-24	0.68	0.89	0.60	0.54	85.7	71.8
Sep-24	0.68	0.89	0.59	0.53	85.1	71.3
Dec-24	0.68	0.88	0.59	0.53	84.3	71.1
Mar-25	0.68	0.88	0.59	0.53	84.3	71.1
Jun-25	0.68	0.88	0.59	0.53	84.3	71.1

SPECIAL TOPIC 2

Residential building sector – bracing for the downturn.

Contractors need to get their financial affairs in order now if they want to get through a predicted slowdown in activity over the next couple of years. Those that haven't got a good handle on their costs, and/or diversified their revenue streams are likely to struggle once work begins to dry up. Many will end up leaving the building sector as a result.

New Zealand's residential building sector is notoriously volatile, experiencing much larger booms and busts than the economy as a whole. At the moment the sector is running hot, with activity levels and consent issuance at record highs.

That, however, is unlikely to last. Operating and borrowing costs have risen, while sale prices for existing homes have tumbled across the country. As prospective buyers of new builds become increasingly nervous and property developers more cautious about bringing new projects to market, we're forecasting a drop in building work of around 15% by 2025.

Many of the 24,000 firms that build houses in New Zealand are small, poorly capitalised operators that exist on a project-by-project basis, and even in the best of times the industry accounts for a disproportionate share of business failures. With the prospect of a downturn looming, there are a few key factors that will determine the odds of survival.

In the short term, it's about making sure that the finances are in order. That means having a really good understanding of cost and revenue. Builders best able to navigate a slowdown know exactly what their outgoings and incomings are at any point in time and can make informed decisions on that basis.

It also means reducing costs. Retrenching staff is usually the go-to option – it is after all the biggest cost item. Selling off underutilised equipment, plugging profit leaks that occur in every business, and shutting down poorly performing profit centres are also viable options. Builders might also look to reduce costs by pursuing easy and low-cost efficiency gains. For example, using inexpensive mobile tablets to help minimise the time taken for onsite decision making.

Builders should also look at ways to protect revenue. At the very least, builders should be pursuing projects that preserve the gap between revenues and costs. The trend away from fixed to variable price contracts in recent years, where the risk of cost fluctuations is borne by the customer, is an example of that. The same applies to sunset clauses that apply to "off the plan" sale and purchase agreements.

Alternatively, builders could try and diversify their revenue sources. That might mean diversifying into projects that are less sensitive to the interest rate cycle, such as renovations that support independent living for older people, and government maintenance, and remodelling work. In a similar vein, builders facing a drop in privately funded building work might go after projects funded by government agencies like Kāinga Ora, which has almost $14bn worth of funding available over the next five years. Alternatively, contractors might look to offer complementary services, such as plumbing, drainage and gas services, as long as they are registered to do so.

Irrespective of what form diversification takes, builders should only pursue work that leverages off existing strengths. If they do not, they are more likely to find that they cannot deliver to standards, timeframes, and budgetary constraints. In an environment where there is less work, a resulting lack of competitiveness is likely to prove disastrous.

Builders should also be taking steps to ensure there is cash running though the business. Even during the good times, about half of all builders that employ five or less people will face ongoing cashflow difficulties in New Zealand. And it's not just smaller firms that are affected. Project delays and cancellations, late or missed payments from customers, or a sudden increase in the cost of building materials, can quickly undermine cashflows and threaten the viability of even the largest firms.

The best way to boost cash flow and preserve cash reserves is to make sure that systems and processes are in place to ensure invoices are paid in full and on a timely basis. That is particularly relevant during a downturn when under-duress purchasers are much more likely to delay or default on payment. By monitoring cash flow, a company can better predict its needs, flag potential problems, and ultimately grow the business.

Builders that are not in a position to take these actions will struggle in the coming downturn, and in an industry that has low barriers to entry and exit, many will go out of business. However, some are likely to return in another guise when the building cycle turns, and conditions improve.

ECONOMIC AND FINANCIAL FORECASTS

New Zealand forecasts

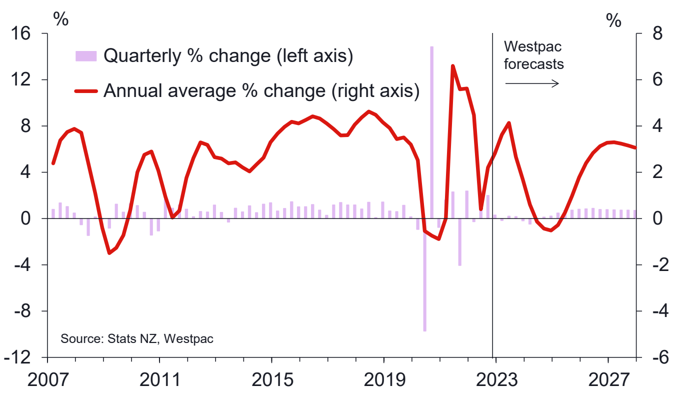
GDP components	Quarterly % change				Annual average % change			
	Dec-22	Mar-23	Jun-23	Sep-23	2021	2022	2023	2024
GDP (production)	0.3	-0.2	0.2	0.2	6.1	2.8	1.7	-0.5
Private consumption	0.0	-0.1	0.0	-0.1	7.4	2.3	-1.0	0.7
Government consumption	-0.5	-0.5	-0.5	-1.0	8.2	4.4	-2.4	-1.1
Residential investment	0.5	0.7	-0.5	-1.8	8.0	2.7	1.1	-9.5
Business Investment	0.5	0.2	0.7	0.0	14.1	5.3	1.3	-2.7
Exports	0.2	-0.8	4.0	3.6	-3.6	0.0	12.4	5.2
Imports	2.7	1.5	1.1	0.6	14.9	2.3	5.3	2.5
Economic indicators	**Quarterly % change**				**Annual % change**			
	Dec-22	Mar-23	Jun-23	Sep-23	2021	2022	2023	2024
Consumer price index	1.4	1.3	1.3	1.9	5.9	7.2	5.1	2.9
Employment change	0.1	0.3	0.2	0.1	3.3	1.3	0.5	-0.3
Unemployment rate	3.4	3.5	3.6	3.8	3.2	3.4	4.0	5.1
Labour cost index (all sectors)	1.1	1.1	1.3	1.1	2.6	4.1	4.6	3.5
Current account balance (% of GDP)	-7.6	-6.8	-6.4	-6.3	-6.0	-7.6	-5.8	-4.5
Terms of trade	0.5	-0.5	2.3	1.5	2.8	-4.6	4.6	1.2
House price index	-4.4	-3.3	-2.6	-2.0	27.1	-12.0	-9.0	1.0
Financial forecasts	**End of quarter**				**End of year**			
	Dec-22	Mar-23	Jun-23	Sep-23	2021	2022	2023	2024
90 day bank bill	4.26	5.40	5.60	5.60	0.81	4.26	5.50	3.75
2 year swap	5.09	5.30	5.10	4.80	2.08	5.09	4.40	3.40
5 year swap	4.66	4.80	4.60	4.40	2.46	4.66	4.20	3.65
10 year bond	4.30	4.60	4.50	4.20	2.39	4.30	4.00	3.50
TWI	70.8	71.7	72.3	72.6	74.3	70.8	72.8	71.1
NZD/USD	0.60	0.64	0.65	0.66	0.69	0.60	0.67	0.68
NZD/AUD	0.92	0.91	0.92	0.92	0.95	0.92	0.91	0.88
NZD/EUR	0.59	0.59	0.60	0.60	0.61	0.59	0.60	0.59
NZD/GBP	0.51	0.53	0.53	0.54	0.52	0.51	0.54	0.53

International economic forecasts

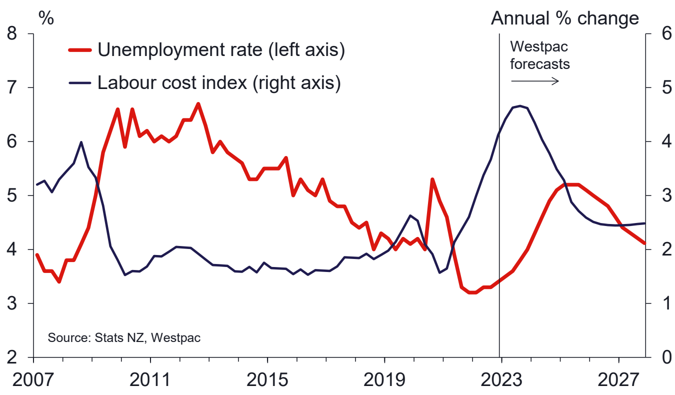
Real GDP (calendar years)	Annual average % change					
	2019	2020	2021	2022f	2023f	2024f
Australia	1.9	-1.8	5.2	3.6	1.8	1.2
China	6.0	2.2	8.4	3.0	6.2	5.5
United States	2.3	-3.4	5.7	2.1	0.9	1.0
Japan	-0.4	-4.6	1.7	1.6	1.5	1.0
East Asia ex China	3.8	-2.3	4.2	4.6	4.2	4.3
India	3.7	-6.6	8.7	7.0	5.8	6.5
Euro Zone	1.6	-6.1	5.2	3.5	0.6	1.4
United Kingdom	1.7	-9.3	7.4	4.0	-0.5	1.5
NZ trading partners	3.5	-1.5	6.1	3.3	3.6	3.4
World	2.8	-3.0	6.0	3.3	3.0	3.1

THE ECONOMY IN SIX CHARTS

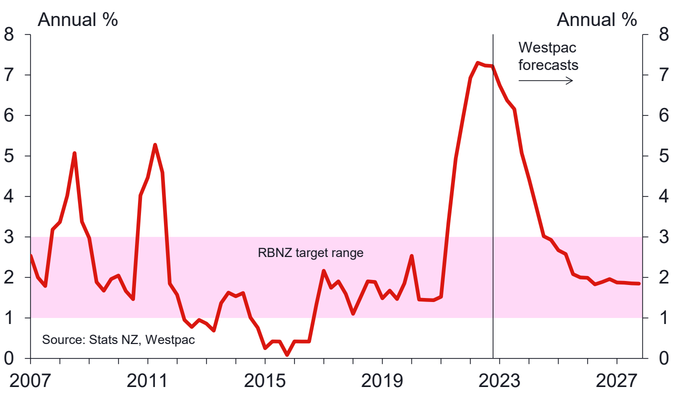
GDP growth



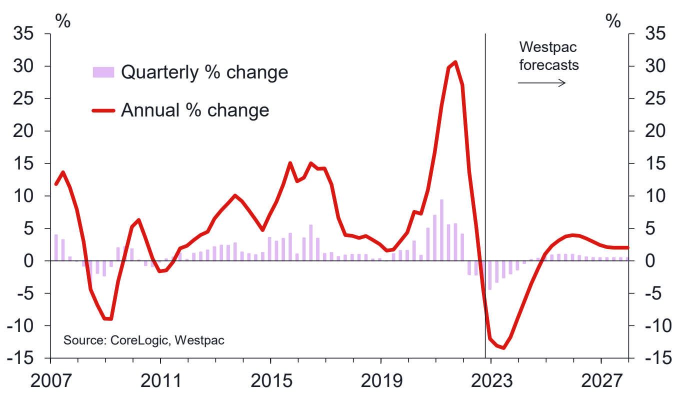
Employment and wage growth



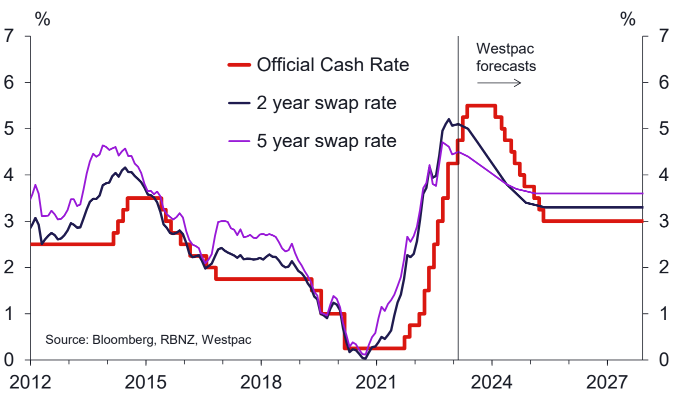
Consumer price inflation



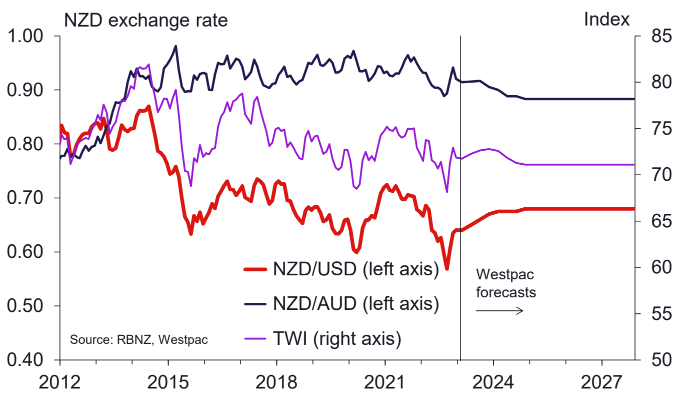
House prices



Official Cash Rate, 2 year swap and 5 year swap rates



Exchange rates



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