ECONOMIC OVERVIEW

The great rebalancing?

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NOTE FROM KELLY

Several imbalances are clearly evident in the New Zealand economy. Most fundamentally, while growth is slowing, the economy is running above its sustainable capacity and inflation is still very high. This is partly why the current account deficit remains very large. Meanwhile, the fiscal position remains in the red despite the unemployment rate sitting near historical lows.

The Reserve Bank of New Zealand (RBNZ) has appropriately tightened monetary policy to bring about a better balance between demand and the economy's productive capacity. Given the marked tightening of monetary policy over the past couple of years, we are now in the period where we should be starting to see tangible progress on the "great rebalancing". The key question is how fast will this rebalancing occur?

There are some encouraging early signs. Inflation is now off its highs (at least on a headline basis). Consumer spending has been weak indicating that households are tightening their belts as interest rates and other cost of living pressures bite.

There are also areas of concern. Domestically generated non-tradables inflation hasn't fallen as fast as expected and core inflation remains high. The fiscal position is not improving as falling profitability is undermining business tax revenue and means the government is not currently assisting with the required rebalancing – its contribution may come in future years. And while the current account deficit has begun to narrow, it will likely remain elevated compared to pre-pandemic levels.

Much will depend on the extent to which slowing growth is reflected in a loosening of the labour market. Forward indicators suggest that employment growth will slow, but there is uncertainty about how quickly this will translate to slower growth in wages. For inflation to fall as quickly as the RBNZ has forecast, wage growth needs to slow towards levels consistent with a sustained low inflation environment and trend growth in productivity.

Our sense is that further monetary policy action is required to provide greater assurance that inflation will fall in a timely manner. This is why we see a further increase in the Official Cash Rate (OCR) later this year and only a slow path downwards in a year's time. But risks are significant in both directions. We will be closely watching the data – both at home and abroad – as we continue to assess where interest rates will need to go.

Kelly Eckhold
Chief Economist

NEW ZEALAND ECONOMY

Sideways

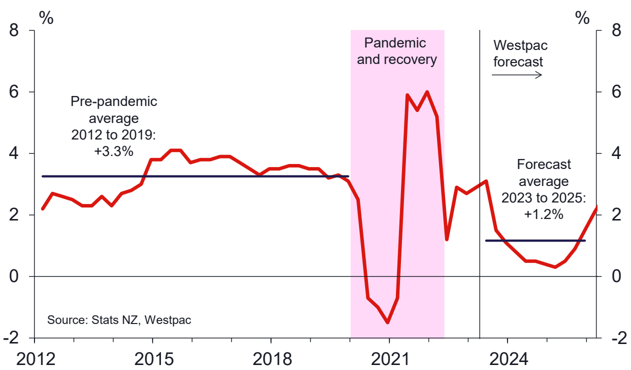
New Zealand is on course for a period of subdued economic growth with a continued tightening in financial conditions, as well as sluggish demand in some key export markets. However, while growth is turning down, the level of activity remains elevated. In addition, the rapid turnaround in migration is adding to consumer demand and is providing a boost to the housing market.

Although the level of activity remains elevated, the wind has clearly come out of the New Zealand economy's sails. Economic activity has effectively been tracking sideways for close to a year now. And in per capita terms, we've been going backwards.

We're expecting GDP growth to rebound in the June quarter. However, that's in part due to a recovery from the severe storms and industrial action in the early part of the year.

Looking at the broader trend in activity, GDP growth is set to remain subdued over the remainder of 2023 and through 2024, with unemployment to rise from 3.6% currently to 5.2% by the end of next year. We still expect New Zealand will manage to avoid a recession in the latter part of this year, and that it is instead on course for a relatively soft landing. However, with powerful domestic and global headwinds blowing in our direction, there are clear downside risks.

Figure 1: GDP growth (annual average)



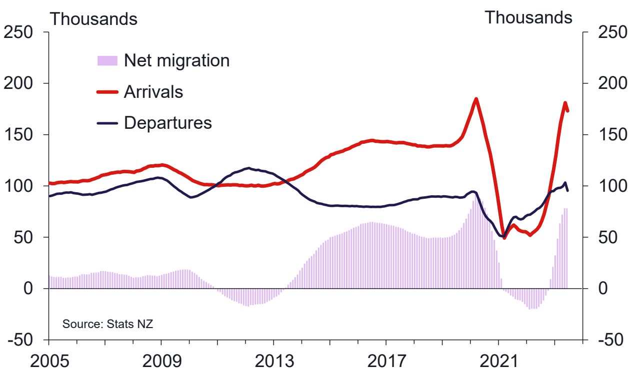
The slowdown in economic growth is mainly due to the continued tightening in domestic financial conditions. High levels of inflation have been eating away at households spending power, with consumer prices rising by 6% in the year to June. There have also been associated large increases in borrowing costs, with the Reserve Bank having lifted the Official Cash Rate by 525bps since late 2021. These factors have been a significant drag on households' spending power and domestic demand.

Adding to the challenges for the economy has been weaker than expected activity in some of our key trading partner economies, most notably China. The related softness in demand is weighing on the prices of some of our key exports, with global dairy prices falling by an average of 21% over the past year. Here in New Zealand, those conditions are flowing through to weaker farm incomes.

While we expect New Zealand will avoid a recession, the economy is still on course for an extended period of subdued growth.

Helping to provide a floor under growth in the face of the above headwinds has been the rapid turnaround in net migration. Inflows of migrants exceeded departures by 78,000 in the year to May (compared to a net outflow of 20,000 people in the previous year). And with new arrivals to the country continuing to lift even as departures rise, net migration is on track to reach 90,000 by the end of this year. This upswing in migration is adding to the size of the labour force, helping to alleviate the staff shortages that many businesses have endured. It's also providing a large boost to demand for many consumer goods, as well as the demand for housing and rental accommodation.

Figure 2: Migration flows (annual)



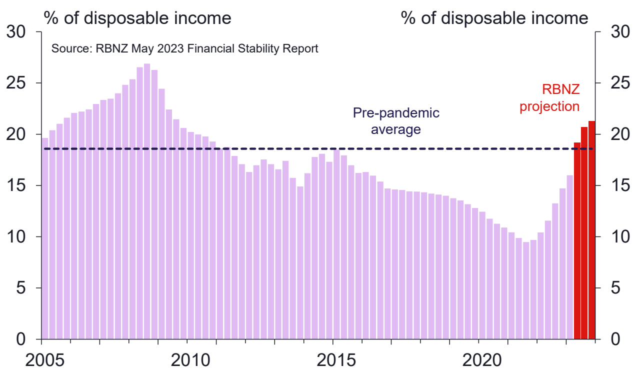
Also helping to support demand is the continuing recovery in international tourism and hospitality exports. Overseas visitor numbers have now recovered to around three-quarters of their pre-pandemic levels. The coming year is likely to see further increases in international visitors from high spending markets like the US.

Importantly, although growth is slowing, the strong domestic inflation pressures that we've been grappling with in recent years are yet to show significant signs of easing. As discussed in the *Inflation and the RBNZ* section, that means interest rates will need to remain at restrictive levels for some time yet.

Households and the great refixing.

The downturn in economic activity has been centred on the household sector. Over the past year, large numbers of borrowers have rolled off the very low fixed mortgage rates that were on offer in the early stages of the pandemic, and on to much higher interest rates. That's seen debt servicing costs climbing rapidly. In fact, according to the RBNZ's May *Financial Stability Report*, households with mortgages have already seen interest costs rising to around 15% of their disposable incomes, and it's set to rise to over 20% by the end of this year.

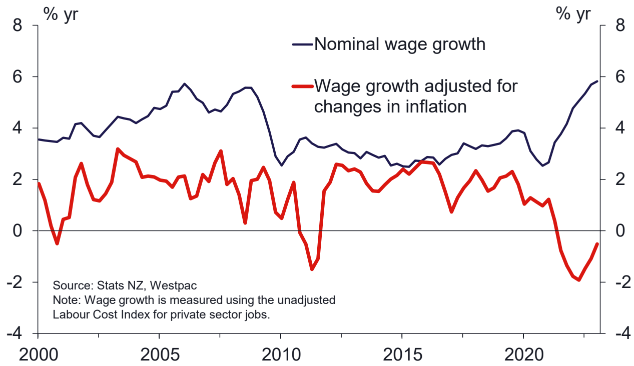
Figure 3: Spending on interest costs (households with mortgages)



Only about one-third of families have a mortgage on their home. However, every family across the country has seen their spending power squeezed by the large increases in living costs over the past year. That's been especially tough for those families on lower incomes as much of the rise in inflation has been due to higher prices for necessities – food prices are up 12% over the past year, housing and utility costs are up 6%, and petrol prices have been charging higher in recent weeks. We expect that inflation will remain elevated over the coming year, meaning ongoing pressure on households' budgets.

The impact of higher consumer prices is being felt by every family across the nation, and it's been especially tough for those families on lower incomes.

Figure 4: Wage growth and purchasing power



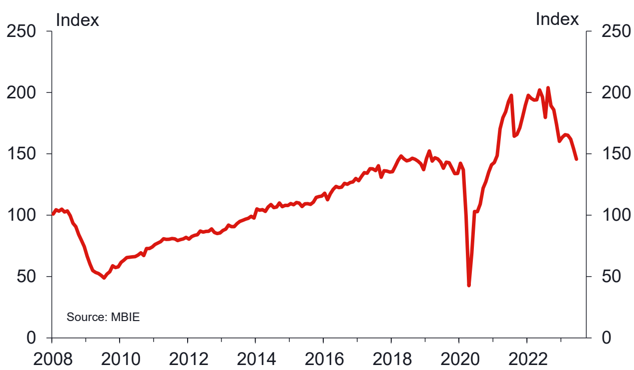
Working 9 to 5.

Another key factor that has underpinned spending appetites has been the strength of the labour market. Employment levels have risen by 4% over the past year, and average hourly earnings are up 7%. That's helped households to maintain their purchasing power and has also given them the confidence to continue spending.

But while the labour market remains in good health for now, there are signs that the heat will soon come out of the market. Businesses have been scaling back their plans for hiring as GDP growth has slowed. At the same time, the turnaround in net migration has seen the number of applicants per job rising.

With GDP growth to remain sluggish for some time, unemployment is set to rise from its current low level of 3.6% to 5.2% by the end of next year. Wage growth is also expected to gradually slow from its recent highs. Combined, that weakening in labour market conditions will reinforce the slowdown in household spending.

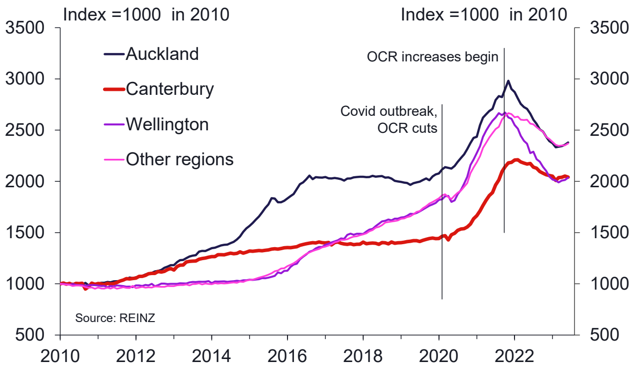
Figure 5: Online job advertisements (seasonally adjusted)



Housing market finding a base.

With population growth surging and expectations that borrowing costs are close to their peak, the sharp fall in house prices that began in late-2021 has now been arrested. We've also seen sales rising from their post-pandemic lows. In light of the stabilisation over the past few months, we've revised up our forecasts for house prices. We now expect prices across the country to rise by almost 8% over 2024 (up from our previous forecast for a rise of 2.5%).

Figure 6: House prices by region



The combination of higher interest rates and higher living costs will be an increasing drag on households' purchasing power, and many households will need to rein in their spending.

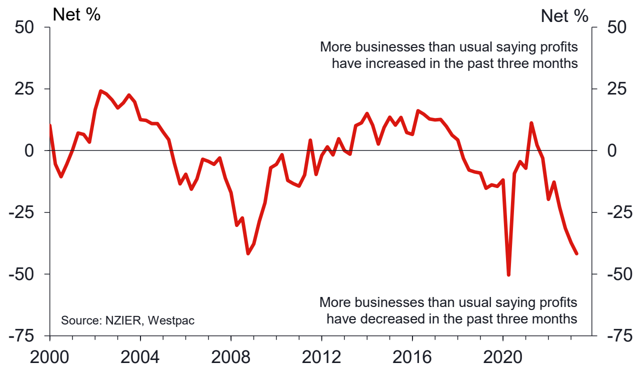
Mixed business.

Businesses across the economy have reported a downturn in trading activity, however conditions are uneven across sectors.

- Businesses in the **construction sector** have seen a particularly sharp drop in forward orders, with residential consent numbers down 12% over the past year. We expect home building activity will drop back over the year ahead. However, that will be a decline from elevated levels. And with a large pipeline of projects in the works, that downturn is expected to be gradual (rather than a crash).
- **Manufacturers** have also reported a downturn in orders, with the slowdown in the local economy being compounded by softening activity in some export markets. Similarly, as discussed in the *Agricultural outlook* section, many of our **commodity exporters** are dealing with soft demand and weakness in output prices at the same time as operating costs are continuing to push higher.
- Despite large price rises for some items, spending levels in the **retail sector** have held up through the first half of 2023. But looking to the back half of the year, increasing numbers of firms are now reporting a downturn in orders, especially those selling household durables.
- Businesses in the **service sector** are reporting greater resilience in demand, in part due to the recovery in international tourist numbers. However, even in these sectors, many businesses are still seeing softness in sales.

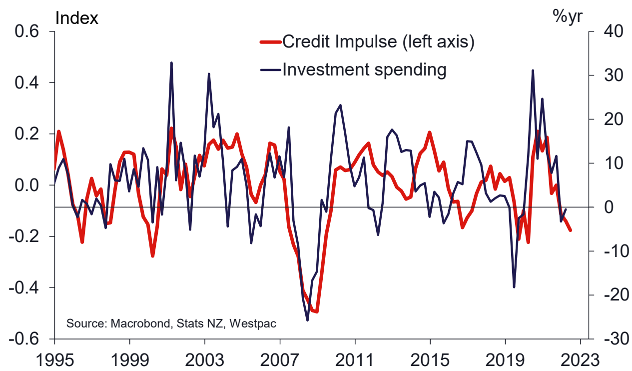
A common theme across all sectors is pressure on operating margins. Although some of the large cost increases we saw in the wake of the pandemic have eased (including transport and shipping costs), most businesses continue to report sizable increases in operating expenses. The past year has seen particularly large increases in staffing costs, with average wage rates rising by around 6% to 7%. In addition, financing costs have been rising as interest rates have pushed higher. Cost pressures have been especially strong in the agricultural sector (up 12% over the past year) and in the construction sector (up 9%).

Figure 7: Business profitability



With profit margins being squeezed and interest costs pushing higher, businesses have scaled back plans for capital expenditure. That's seen system-wide lending to the business sector slowing from over 9% per annum last year to just 3% now. Investment intentions have fallen especially sharply in the manufacturing and construction sectors. Similarly, on farm spending (including capital expenditure) has been wound back.

Figure 8: Credit Impulse and investment spending



Note: The credit impulse measures the change in businesses credit growth. It provides an indication of strength of economic demand.

Decision 2023.

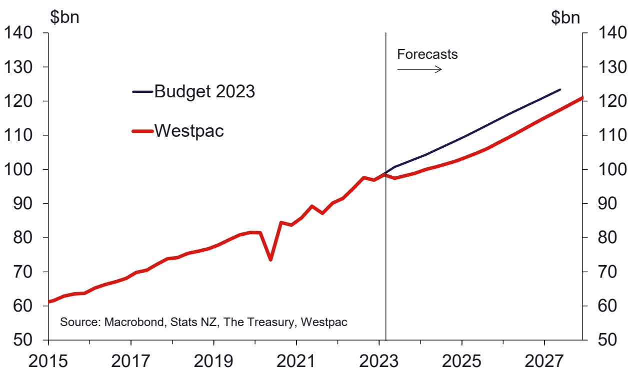
One of the factors that will shape the economic landscape over the coming years will be the outcome of October's election. At the time of writing, polling between the two sides of the aisle remains close. And while polls suggest we're almost certain to see a shift to some form of coalition government, its make-up, and whether it'll be left or right of centre, isn't clear.

Following the election, we could see changes in some important policy areas, including potential changes to the tax system and further changes to environmental policies. Another key area where we could see big changes are regulations related to property investment, such as the rules around interest deductibility or the 'bright line' test for taxing capital gains on investment properties. As we've frequently highlighted, such financial factors play a major role in determining what happens to house prices. We're currently forecasting moderate house price gains over the next few years but we'll revisit that outlook if new policies are implemented.

Regardless of who is in power after 14 October, New Zealand will face some tough fiscal decisions. Back in May, the 2023 *Budget* already pointed to mounting pressure on the Government's finances, with the Treasury pushing out the time it's expected to take for the operating balance to return to surplus by one year to 2026.

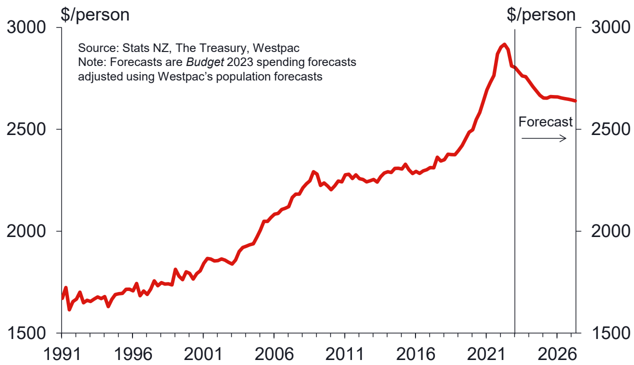
We think the pressure on the Government's finances could be even starker than the Treasury expected in May. Tax revenue over recent months is already falling behind *Budget* forecasts. On this basis, and factoring in our weaker outlook for nominal GDP growth (and hence the tax base), we anticipate that the 2023 and 2024 operating balances are likely to be a combined $9bn below the Treasury's *Budget* 2023 forecasts.

Figure 9: Nominal GDP forecasts



In addition, the Treasury's forecasts show real Government consumption spending (i.e. the amount of services the Government provides) basically tracking sideways over the next few years. That's despite increases in New Zealand's population. In other words, the Treasury expected that the Government will be spending less on public services on a per-capita basis. And since those numbers were finalised, population growth has been much stronger than the Treasury had assumed.

Figure 10: Real government consumption per person



On top of that, the Government's spending forecasts are not automatically adjusted for inflation. This is not usually a problem in times of low and stable inflation, but in the current inflationary environment, that will put considerable pressure on existing fiscal spending plans.

Putting this all together means that future Governments will likely face politically unpalatable choices between:

- Reprioritising existing services to fund new Budget decisions i.e. cut spending; and/or
- Introducing policy decisions to change revenue settings i.e. increase taxes.

Alternatively, the Government could also borrow more and push out the projected return to operating surplus, but that would risk breaching previously stated fiscal targets. Whatever the case, these will be tough decisions for future governments.

With demand softening and continued pressure on operating margins, businesses are scaling back their plans for both hiring and investment spending.

GLOBAL ECONOMY

Central banks close to the turning point?

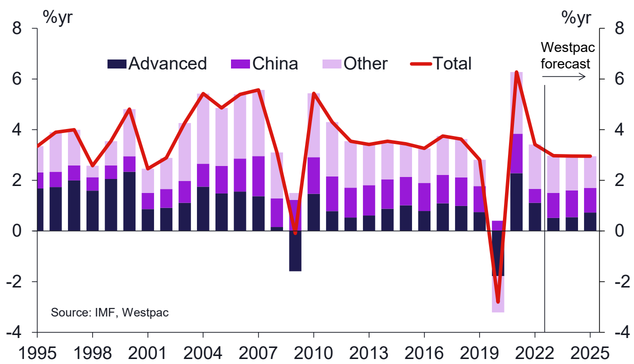
There are tentative signs that monetary policy is gaining traction across the globe. Labour markets generally remain tight, which has fed services inflation. Central banks have responded to the challenge by tightening but are likely to change gear over the coming year as rising interest rates finally bring down inflation.

There are tentative signs that the turning point in the global monetary policy cycle is nearing. Central banks have continued to raise policy rates recently, but more slowly than before amidst a general sense that policy is sufficiently restrictive. Interest rates will need to remain high for some time to allow monetary policy to bring still elevated inflation down to target. All going well, inflation should ease and allow most central banks to start easing interest rates sometime next year.

Global growth is slowing broadly as expected, but unevenly across advanced economies compared to emerging markets and across the services versus goods sectors. A key feature of this slowdown has been a shift in consumption towards services and away from goods since lockdown restrictions eased. Reduced goods demand has seen global manufacturing weaken and global trade flows decline.

Weaker trade has been reflected in softer forecast growth for emerging markets such as China, which are more focussed on goods production. By contrast, growth has been stronger than expected in OECD countries, leading us to revise up our growth forecast this year from 0.9% to 1.2%. Looking ahead, overall growth in consumption is expected to ease as saving buffers accumulated during the pandemic diminish. Therefore, we expect OECD growth to weaken to 0.8% next year.

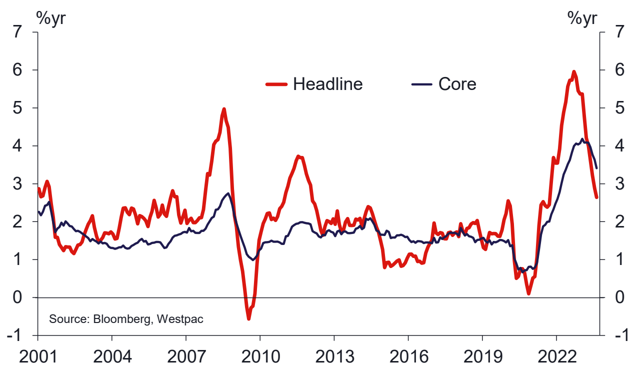
Figure 11: World growth



The turning point in this global monetary policy cycle is nearing as headline inflation falls.

Global inflation has eased from very elevated levels. The primary driver has been falling commodity prices as global supply pressures ease. However, while falling headline inflation has provided some reassurance to central banks, core inflation remains elevated and of concern. Resilient core inflation reflects stickiness in service sector inflation, stemming from stronger services demand and cost structures that are more heavily weighted towards labour costs.

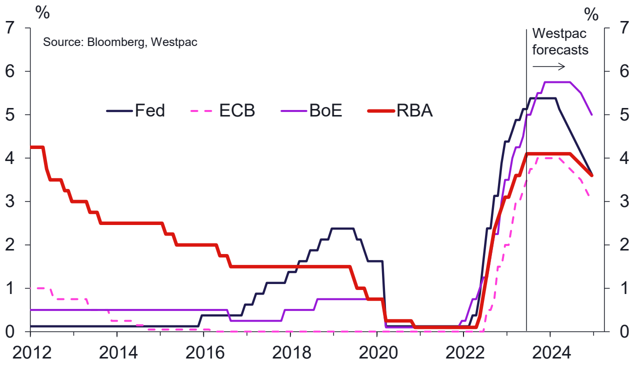
Figure 12: Annual inflation, trading partner average



Global labour markets have so far been resilient to monetary policy tightening and slower output growth. Unemployment rates remain very low and strong demand for workers has helped spur historically high wage growth. Even though large migrant inflows to some advanced economies has improved labour supply, backlogs of vacancies accumulated during the pandemic remain and the vacancy to unemployment ratio remains elevated in many countries. For central banks to reach their inflation targets, removing the heat from wages is key and will require central banks to hold their policy rates high for an extended period.

For central banks to reach inflation targets, removing the heat from wages is key.

Figure 13: Global central bank policy rates



The monetary policy cycle appears most advanced in the US. The Federal Reserve may begin to ease their policy rate in March next year once inflation eases in both the goods and services sectors. Significantly depleted households' savings buffers should further reduce consumption growth and help ease labour markets. That said, we think that the balance of risks around our forecast of 150bps of Fed policy easing next year is skewed towards less easing rather than more. As in other countries, we will be monitoring labour market conditions closely in coming months.

The European Central Bank (ECB) is not out of the woods yet. The ECB has been raising interest rates to tighten credit conditions to bring down very high inflation. Even though headline inflation has fallen from 10.6% in October 2022 to 5.5% in June 2023, their fight against elevated services sector inflation continues. Stronger tourism spending and record low unemployment rates are contributing to these inflationary pressures. Ultimately, inflation pressures should subside but before then we expect another 25bp increase in the ECB's policy rate to a peak of 4%, before policy begins easing around the middle of next year.

The Reserve Bank of Australia (RBA) has held its policy rate at 4.1% since its May *Statement*. While its most recent forecasts indicate that inflation will not return to target until the end of 2025, the RBA presently appears reticent to take additional action to achieve a more rapid convergence. However, the Board remains open to the possibility of raising policy rates with concern around the labour markets contribution to persistently strong services inflation. We do expect services inflation to ease, with the full impact of high interest rates yet to be seen as households move onto higher mortgage rates and as real incomes fall. However, the RBA's easing cycle is likely to lag that of the US and euro zone, with an initial rate cut only likely in the second half of next year.

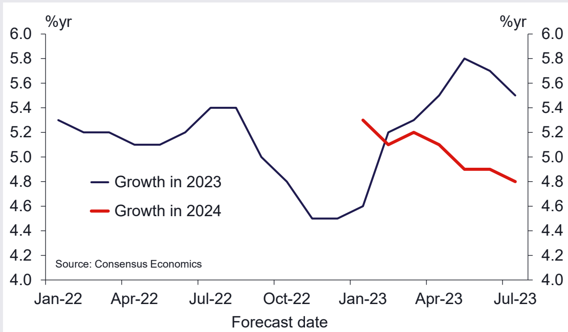
China – marching to the beat of its own drum.

Unlike most economies, China's post lockdown growth bump has underwhelmed expectations. Indeed, since the May *Overview*, we have progressively cut our outlook for Chinese growth for 2023. From 6.2% in June, we have sliced our forecast to 5.7%, and then to 5.2%. If anything, consensus forecasts have stepped even lower, notably for 2024 with the forecast presently sitting at around 4.8%.

Curiously, rising costs of living and/or interest rates do not explain the underperformance of the economy. Indeed, consumer prices were unchanged over the June year. Rather Chinese businesses and households are suffering a crisis of confidence. The housing market remains key to the Chinese economic psyche and any pickup in activity. It remains very weak following the bursting of its speculative bubble and the government's housing market reforms, contributing to weak demand and prices for New Zealand logs. Officials have begun to incrementally loosen lending policy settings. But further measures are likely necessary. Indeed, we expect additional stimulus, focused on encouraging first home buyers and smaller investors back into the market.

At the same time, we expect that Chinese officials will try to strike a balance, kickstarting growth in the economy without undoing the hard-won gains from previous reforms. Too little stimulus and the economy may stall; too much and a speculative bubble may return. This delicate balancing act results in clear risks to our forecasts for Chinese growth. If anything, we suspect that the Chinese government may favour less rather than more stimulus than we have factored in. And it is far from clear to what degree stimulus will benefit our dairy sector, with growth in China's domestic milk supply also a factor reducing demand.

Figure 14: China GDP growth – market forecasts



INFLATION AND THE RBNZ

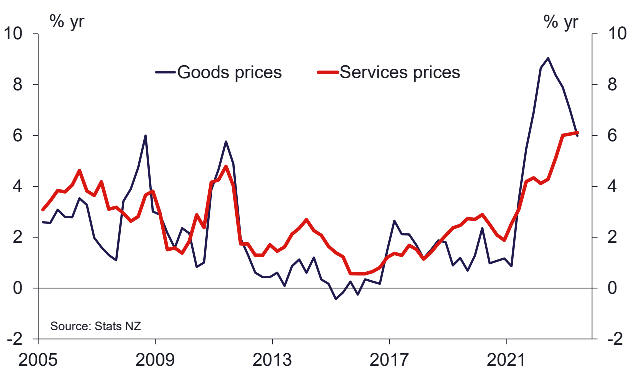
Tightening delayed, not cancelled

We continue to expect the RBNZ will need to raise the OCR, with a final 25bp hike expected in November. Domestic inflation pressures have persisted for longer than the RBNZ has anticipated, and a period of below trend growth is needed to bring inflation back to target. However, there are risks on both sides.

The last few months have revealed that, in common with other advanced economies, inflation pressures remain hot. The fall in inflation in the June quarter from 6.7% to 6% was encouraging in the sense that it was in line with expectations. However, the underlying picture was more concerning as the decline owed largely to weaker tradables good prices. By contrast, inflation in the domestically influenced non-tradables components fell only slightly from 6.8% to 6.6%.

Lower tradables inflation has been long anticipated as it stems from the easing of global supply chain and geopolitical stresses that played a key role in propelling inflation higher through 2021-22. Much of this inflation has now washed out of the system. However, that's left a harder core of sticky inflation pressures that may prove more difficult to eradicate in the absence of a protracted period of tight domestic monetary policy and sub-trend economic growth.

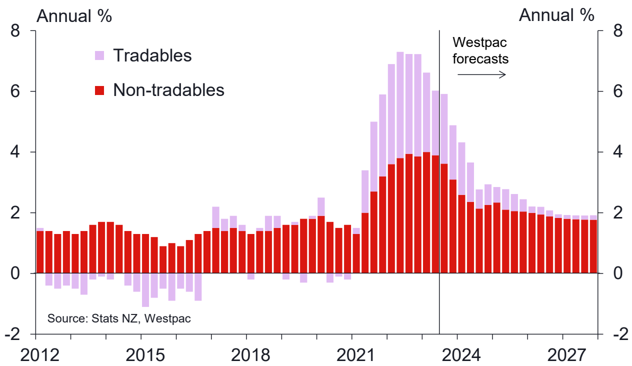
Figure 15: Goods and services inflation



The divergence in inflation in goods versus services prices nicely illustrates the underlying nature of the remaining inflation pressures. Goods inflation was particularly impacted by supply chain influences and peaked much higher than overall inflation in 2021, but it is now in a rapid downturn. This will continue in coming quarters as the very high quarterly inflation rates seen just over a year ago drop out of the annual calculation. In contrast, services inflation is still at its peak, consistent with a still overstretched economy and associated tightness in the labour market. Services inflation needs to fall considerably to be consistent with the Reserve Bank's 1-3 % target range. In the services sector, wages are the key driver of costs, and so reducing wage inflation back towards levels consistent with productivity growth is crucial if core inflation is to fall sustainably. This is likely to require that the unemployment rate rises somewhat from current historically low levels.

The situation in New Zealand mirrors the experience of other advanced economies. For example, in Australia, goods and services annual inflation is running at similar levels (at around 6%) with goods inflation falling fast. Interestingly, and of concern, is that core inflation measures in New Zealand have remained elevated, and in some cases have continued to push higher. In contrast, in Australia measures of core inflation are generally trending lower. That's particularly notable given the earlier start of the rate hiking cycle by the RBNZ and higher interest rates in New Zealand.

Figure 16: Contributions to inflation

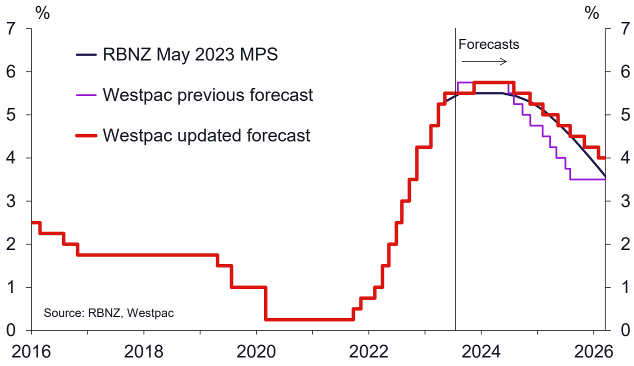


We anticipate a further significant fall in inflation in the quarters ahead. An important driver will be a continued fall in tradables inflation as remaining supply chain pressures are squeezed from the system. One factor that will reinforce that downtrend in imported inflation is the flow through of lower shipping prices to the CPI, which thus far has been slow to pass through to prices in New Zealand. Weaker commodity prices should also push tradables inflation lower.

Non-tradables inflation should also fall in the short term as easing supply chain pressures and the slowdown in the housing market weigh on housing-related costs. However, it will take quite some time more for non-tradables inflation to return to levels usually consistent with the inflation target. That will require a sustained period of below trend growth, with an easing in capacity and labour market pressures.

Throughout this process we assume that inflation expectations remain well anchored by the RBNZ's inflation target. However, the longer inflation remains elevated, the greater the risk that expectations move higher.

Figure 17: Official Cash Rate forecasts



In our central scenario, the case for some further tightening by the RBNZ remains strong. This is despite the weaker March 2023 GDP outcome which took the economy from an overheated to less overheated starting position and gives us greater confidence that the cyclical downturn is upon us.

Migration driven population growth and fiscal policy are boosting growth right when the RBNZ would otherwise be banking on steady falls in inflation. The housing market has turned the corner and is taking the first tentative steps higher, and that has occurred sooner than the RBNZ would have hoped. Business and consumer confidence has found a base (albeit from a low level) and is rising - unusually for the end of the tightening cycle. The labour market has remained robust and is not yet showing signs of the rapid easing the RBNZ expects in late 2023. While we are flirting with recession, the near-term growth outlook seems more positive than the RBNZ expected in May.

Crucially, inflation here is showing the same signs of stickiness seen offshore, and that is not surprising given the starting point and strong labour market. The upside surprise on June quarter non-tradables inflation provides a warning on the risks here.

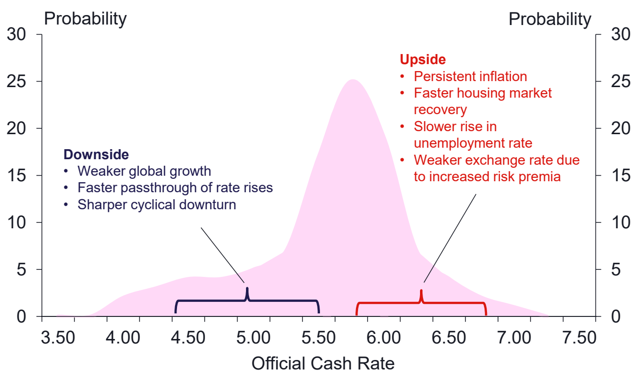
With the above factors keeping inflation at high levels, we expect the RBNZ to deliver another 25bp hike in November. The next hike is coming more slowly than we previously forecast and reflects the RBNZ's strong signal of an on-hold stance for now. After November, we see an extended pause to hammer inflation decisively lower. A cautious easing cycle can begin from the August 2024 *Monetary Policy Statement* provided the CPI has fallen through 4% by then. A slower fall in inflation from late 2024 than we previously expected means it may take until mid-2026 for interest rates to return to 3.5%.

If inflation pressures remain strong, then interest rates will need to remain higher for longer.

Significant risks remain. On the upside, inflation could prove to be stronger than expected if we see continued strength in the labour market or an earlier cyclical recovery in demand. The housing market recovery could reignite demand in an economy where the population is growing quickly. Oil prices are now rising and could add to tradables inflation. A further move of the OCR to the 6-6.5% range can't be ruled out.

But downside risks are also present. The reality is that the OCR is well above neutral, and thus the probability distribution of the OCR a year ahead is likely skewed downwards. At present, weaker foreign demand especially from China is the key risk, which would weigh further on key export commodity prices. There is the potential for a sharp weakening in household incomes, the labour market, and a stronger than anticipated pass through of past rate hikes that reduce inflation sooner. However, even in these weaker scenarios, the high starting point for inflation constrains the extent of rate cuts, leaving interest rates elevated for some time.

Figure 18: OCR risk scenarios - August 2024



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Sep-23	5.9	5.50	5.70	5.64	4.84
Dec-23	4.9	5.75	5.85	5.49	4.74
Mar-24	4.4	5.75	5.85	5.29	4.62
Jun-24	3.7	5.75	5.85	5.06	4.51
Sep-24	2.7	5.50	5.60	4.81	4.41
Dec-24	2.9	5.25	5.35	4.58	4.31
Mar-25	2.8	5.00	5.10	4.37	4.23
Jun-25	2.7	4.75	4.85	4.19	4.16
Sep-25	2.6	4.50	4.60	4.06	4.10
Dec-25	2.5	4.25	4.35	3.94	4.06

AGRICULTURAL OUTLOOK

Battling on both fronts

The agricultural sector is battling both falling commodity prices and hot input price inflation. The squeeze from these factors means that most farmers and growers are likely to run operating deficits this season. While input cost inflation is currently high, we expect it to ease over the coming year, eventually driving a recovery in farm profits. However, with commodity prices getting worse, before they get better, a recovery in profits is still a way off.

After a brief pause early in the year, the downtrend in New Zealand commodity prices has resumed. Since March, prices have fallen 5.6% in world terms, and they are now 22% below the record highs seen in early 2022.

The main catalyst for those price falls has been the sluggish Chinese economy and the related weak demand for our agricultural exports. Since June, we have sliced one percentage point off our 2023 forecast for Chinese economic growth so it now stands at 5.2%.

By themselves, these price declines would normally be manageable. But when coupled with very high input inflation, farmers' margins are under severe pressure. For example, in the March year, rural input cost inflation was still running hot at an annual pace of around 12%.

Looking at the dairy sector, many farmers are likely to run at below break-even points this season. Indeed, most break-even estimates stand north of $8.00/kg. That's well above our 2023/24 milk price forecast, which we have lowered further in this *Economic Overview* to $7.50/kg.

It's a similarly tough picture for the meat sector. Weakness in Chinese demand is weighing on global beef and lamb prices, and that downwards pressure has been compounded by increases in both global and local supply. With input cost inflation on sheep and beef farms also running hot, many farmers are likely to run operating deficits this season. Meanwhile, growers are under pressure as damage to this season's crop stemming from storms and frost earlier this year flow through to lower earnings. Fruit prices are high, but that's only providing a modest offset.

The forestry sector outlook may well be the weakest of all. Demand from the key Chinese construction sector remains very weak, and we don't expect a turnaround until well into next year. As a result, forestry prices are likely to remain under prolonged downward pressure. In turn, these factors are likely to reduce the log harvest to historically low levels. Uncertainties around the regulation of post-harvest clean up and Emissions Trading Scheme reforms are adding to already very subdued sector sentiment.

Stepping back, we are nearing the low point for profits in the current cycle. That's mainly due to an easing in input cost inflation. The prices of key inputs like feed, fertiliser and fuel have peaked, if not fallen in recent months. And by the end of this year, we expect annual input cost inflation will slow to low single digit levels. However, we expect commodity prices to get worse, before they get better, with a material recovery unlikely until from 2024. All up, that means a recovery in overall farm profits is still a way off.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	We have further revised down our 2023/24 milk price forecast to $7.50/kg. Combined with very high costs, many farmers will be operating below break-even this season.	Average	↘
Beef	Prices have fallen as global beef supply has lifted and Chinese demand has remained weak. We expect those conditions to remain in play, keeping farmgate beef prices at or below $6.00/kg for the rest of 2023.	Low	↘
Lamb/ Mutton	Prices have fallen as global and local lamb supplies have increased while Chinese demand has remained weak. We expect prices to remain soft over the rest of the year, at around $7.00/kg.	Below average	↘
Forestry	The Chinese economy, including the construction sector, remains weak. We don't expect a turnaround until 2024 and thus forestry prices are likely to remain under pressure over the rest of 2023.	Low	↓
Horticulture	Growers are under pressure as damage to this season's crop from the storms and frost flow through to lower incomes. Fruit prices are high, but this is only providing a modest offset to overall incomes.	Above average	→

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

EXCHANGE RATES

The kiwi can fly as the US dollar falls

The New Zealand dollar (NZD) has traded sideways since the RBNZ declared an end to its tightening cycle in May. Over the coming year, a weaker US dollar (USD) is expected to see the NZD strengthen against most major currencies but underperform against the Australian dollar (AUD) given Australia's stronger external position.

The NZD/USD exchange rate has been largely rangebound between $0.60 and $0.63 since our previous *Economic Overview* in May. In the wake of the RBNZ's relatively dovish May *Monetary Policy Statement*, the NZD weakened and tested the bottom of its trading range versus the USD. It has also generally weakened against our European trading partners but strengthened against some key Asian currencies (especially the Chinese renminbi and Japanese yen). On a trade weighted basis, the NZD has been stable to slightly weaker since May.

Trend weakness in the USD continues to support the NZD with shorter term fluctuations often being driven by changes in risk sentiment. Many of these shorter-term trends have stemmed from fluctuating uncertainty around growth prospects, US recession risks and changing views on the likelihood of policy rate cuts next year.

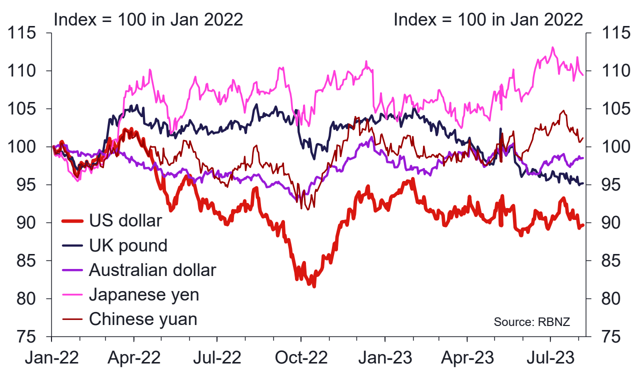
Weakening commodity prices associated with a delay in the expected Chinese economic rebound has tended to hold back the NZD despite New Zealand's relatively high interest rates. We believe Chinese consumer confidence will ultimately improve and help boost New Zealand's commodity prices, but the timing of that rebound remains uncertain. This will support economic activity through increased tourism arrivals, demand for and prices of exports, and thus likely strengthen the NZD over time.

Continued USD weakness is a key element of our forecasts over the next few years. We expect the USD index to continue to weaken towards 97 by the end of 2024 and further in 2025. Growth in the euro zone is expected to outperform the US from 2024, as Europe benefits from global demand for high-value manufactured goods and greater exposure to growing emerging markets. A narrowing in the interest rate differential of the US relative to its major trading partners should support the downtrend in the USD.

Turning to the crosses, our views reflect New Zealand's relative exposure to emerging markets and its export portfolio. Beyond this year, we expect stronger demand for New Zealand's commodity export mix relative to demand for European and UK's exports. As a result, we see the NZD strengthening modestly against the euro and sterling in 2024. Specifically, we see the NZD appreciating to EUR 0.57 and GBP 0.51 by late next year (from EUR 0.56 and GBP 0.49 currently).

Our approach to prospects for the NZD/AUD cross is driven by the same considerations. While both the Australasian currencies will benefit from general USD weakness, Australia will benefit relatively more from the rebound of the Chinese economy as its export portfolio is better aligned to China's focus on investment, compared to New Zealand's food-based export mix. The interest rate differential to Australia should narrow through 2024, and Australia's much stronger current account position may also support the AUD versus the NZD. Therefore, we expect the NZD to weaken from AUD 0.93 at present to AUD 0.89 by end of 2024.

Figure 19: NZ dollar exchange rate vs major currencies



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-23	0.62	0.93	0.56	0.49	87.4	71.5
Dec-23	0.63	0.93	0.56	0.49	86.9	71.5
Mar-24	0.63	0.92	0.57	0.49	85.6	70.9
Jun-24	0.64	0.91	0.57	0.50	85.0	71.0
Sep-24	0.65	0.90	0.57	0.50	85.0	71.1
Dec-24	0.66	0.89	0.57	0.51	84.5	71.0
Mar-25	0.66	0.88	0.57	0.51	83.3	70.4
Jun-25	0.66	0.88	0.57	0.51	82.2	70.0
Sep-25	0.66	0.89	0.57	0.51	81.0	69.8
Dec-25	0.67	0.89	0.57	0.51	79.8	69.5

SPECIAL TOPIC

Foreigners still picking up the tab

National savings are currently falling well short of investment spending. We expect the current account deficit to narrow from here, but in the absence of further belt tightening it will likely remain above pre-pandemic levels.

Large and persistent current account deficits have long been a feature of the economic landscape, indicating that NZ Inc is relying on financing from foreigners to meet some of its investment spending needs. The deficit tracked at around 3% of GDP in the lead up to the pandemic. Since then, a large deficit has emerged and at the end of 2022 it had ballooned to almost 9% of GDP – the largest since 1975.

Over the past year the household, corporate and general government sectors contributed broadly equally to the current account deficit, which each sector's net lending (or savings shortfall) amounting to around $8-11bn. And given this deficit, New Zealand's net external liabilities, almost all of which take the form of debt, has increased by more than $27bn to $189bn. These accumulated liabilities need to be financed in future years, posing an additional ongoing burden. Net international liabilities now stand at almost 49% of GDP. While down from a peak of almost 85% of GDP in 2009, this remains high compared to most other industrial nations.

The comparison between New Zealand and Australia is especially stark right now. While historically both nations have had similar current account positions (i.e. a bias towards net borrowing) right now Australia is enjoying a significant current account surplus versus New Zealand's large deficit. Australia's export performance has been much stronger in recent years due to a hugely favourable developments in its terms of trade and sharply higher export volumes following substantial investment in the resources sector. As a result, Australia's net external liabilities have fallen to around 35% of GDP and are on a sharp downward trajectory.

An external deficit is no bad thing if foreign financing is supporting productive investment in the economy (as opposed to consumption, which provides no future return to help finance the associated increase in liabilities). But very large and persistent external deficits over time can leave a country exposed to a deterioration in global market sentiment and financing conditions, and thus the need to undergo a painful period of adjustment should financing costs rise suddenly.

The recent lift in the external deficit is symptomatic of a country living beyond its means i.e. domestic demand running well beyond the economy's sustainable productive capacity (as also indicated by high inflation). The exceptional circumstances associated with the pandemic also contributed with tourism revenue collapsing following the closing of New Zealand's borders and supply bottlenecks and elevated freight costs helping to lift imports of services. The increase in the external deficit would have been larger still had low global interest rates not lowered the cost of funding New Zealand's net external debt.

Many of these drivers are now working in reverse. Overseas visitor arrivals are in recovery following last year's reopening of the border and freight costs have largely returned to pre-pandemic levels. As a result, we expect the services balance to move back into surplus next year. The merchandise trade balance should also improve as weaker domestic demand slows imports. In the near term China's slow recovery may weaken the terms of trade, through lower prices for key export commodities. However, next year we expect the terms of trade to resume its two-decade uptrend as the price rises for New Zealand's food-dominated exports outpace those of our largely manufacturing-dominated imports. Less helpfully, global interest rates are likely to remain well above pre-pandemic levels, even as central banks begin easing, and hence the cost of funding foreign debt will likely rise and undermine the potential improvement in the current account position.

All up, our forecasts imply a narrowing of the external deficit. However, we think it will remain well above the pre-pandemic average, settling at around 5% of GDP – insufficient to generate a downtrend in the ratio of net international liabilities to GDP. Some combination of the household, business and/or government sectors actively reducing their net lending, either by cutting investment spending or increasing the proportion of income saved, will be required to improve the position further. Tighter monetary policy would assist the required adjustment by encouraging increased net saving in the household and corporate sectors, while also providing greater assurance that inflation will return to the RBNZ's target. The government could also do its bit by acting more ambitiously to restore an operating surplus (our forecasts point to ongoing deficits until at least 2027).

ECONOMIC AND FINANCIAL FORECASTS

New Zealand forecasts

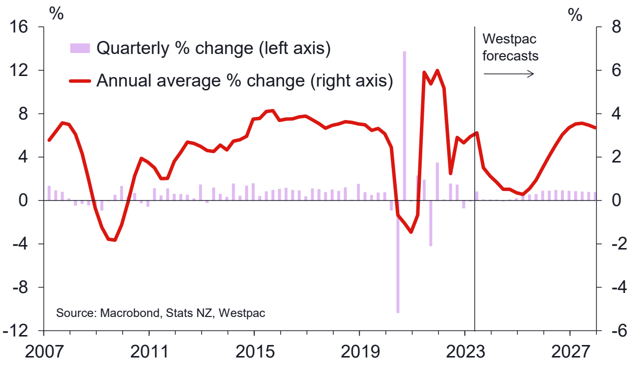
GDP components	Quarterly % change				Annual average % change			
	Jun-23	Sep-23	Dec-23	Mar-24	2021	2022	2023f	2024f
GDP (production)	0.8	0.1	0.0	0.0	6.0	2.7	1.1	0.3
Private consumption	-1.1	0.5	0.4	0.3	7.5	3.0	1.3	1.2
Government consumption	-0.2	-0.3	0.3	-0.5	8.2	4.5	-2.0	-0.3
Residential investment	-0.5	-0.9	-2.5	-3.0	8.0	1.1	-1.2	-8.7
Business Investment	3.7	0.1	-0.7	-1.1	14.6	5.2	6.1	-2.2
Exports	11.0	-2.4	1.3	1.9	-2.7	0.0	11.6	6.2
Imports	-0.5	0.9	1.1	1.0	15.1	5.3	1.7	3.8
Economic indicators	**Quarterly % change**				**Annual % change**			
	Jun-23	Sep-23	Dec-23	Mar-24	2021	2022	2023f	2024f
Consumer price index	1.1	2.0	0.5	0.7	5.9	7.2	4.9	2.9
Employment change	1.0	0.3	0.0	0.0	3.3	1.7	2.4	0.1
Unemployment rate	3.6	3.8	4.3	4.7	3.2	3.4	4.3	5.2
Labour cost index (all sectors)	1.1	1.1	1.0	0.8	2.6	4.1	4.2	3.3
Current account balance (% of GDP)	-8.0	-8.2	-7.8	-7.3	-5.7	-8.7	-7.8	-6.0
Terms of trade	-2.5	-2.0	0.8	2.5	2.8	-4.2	-5.2	5.2
House price index	0.5	1.1	0.7	1.5	27.1	-11.2	-1.0	7.7
Financial forecasts	**End of quarter**				**End of year**			
	Jun-23	Sep-23	Dec-23	Mar-24	2021	2022	2023	2024
90 day bank bill	5.62	5.70	5.85	5.85	0.82	4.26	5.85	5.35
2 year swap	5.18	5.64	5.49	5.29	2.08	5.10	5.49	4.58
5 year swap	4.44	4.84	4.74	4.62	2.46	4.67	4.74	4.31
10 year bond	4.27	4.50	4.45	4.30	2.39	4.31	4.45	3.95
TWI	70.9	71.5	71.5	70.9	74.3	70.8	71.5	71.0
NZD/USD	0.62	0.62	0.63	0.63	0.70	0.60	0.63	0.66
NZD/AUD	0.93	0.93	0.93	0.92	0.95	0.92	0.93	0.89
NZD/EUR	0.57	0.56	0.56	0.57	0.61	0.59	0.56	0.57
NZD/GBP	0.49	0.49	0.49	0.49	0.52	0.51	0.49	0.51

International economic forecasts

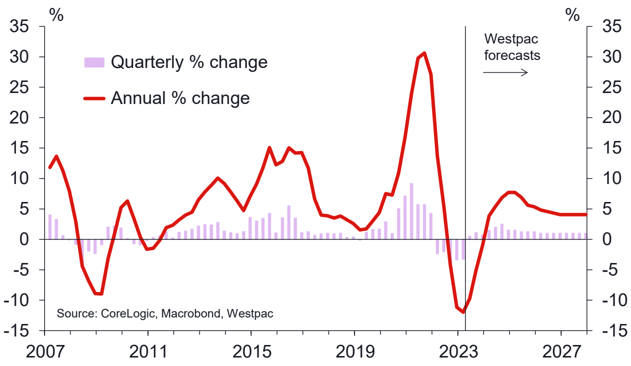
Real GDP (calendar years)	Annual average % change					
	2019	2020	2021	2022	2023f	2024f
Australia	1.9	-1.8	5.2	3.7	1.6	1.0
China	6.0	2.2	8.4	3.0	5.2	5.5
United States	2.3	-2.8	5.9	2.1	1.8	0.4
Japan	-0.4	-4.3	2.1	1.1	1.4	1.0
East Asia ex China	3.8	-2.3	4.3	4.5	3.7	4.3
India	3.9	-5.8	9.1	6.8	6.1	6.3
Euro zone	1.6	-6.1	5.4	3.5	0.6	1.2
United Kingdom	1.6	-11.0	7.6	4.0	0.3	0.5
NZ trading partners	**3.5**	**-1.4**	**6.2**	**3.2**	**3.3**	**3.2**
World	**2.8**	**-2.8**	**6.3**	**3.4**	**3.0**	**3.0**

THE ECONOMY IN EIGHT CHARTS

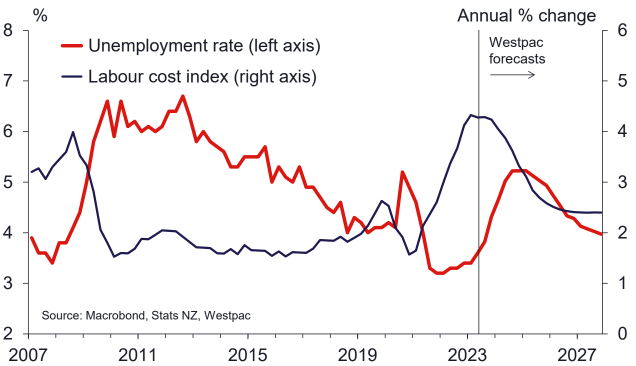
GDP growth



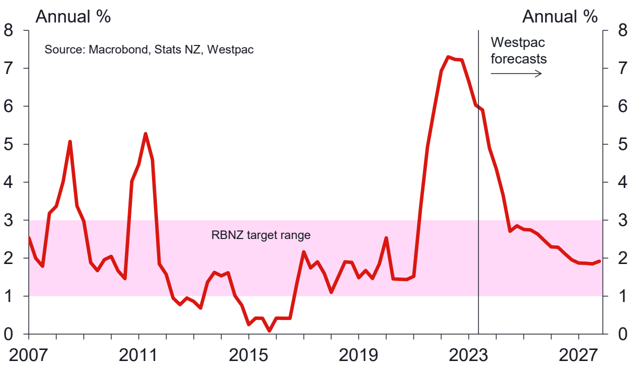
House prices



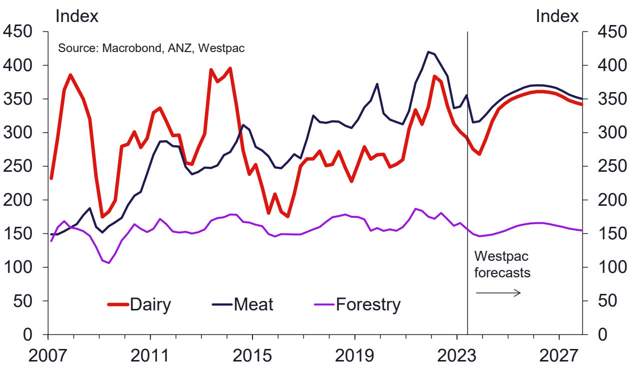
Employment and wage growth



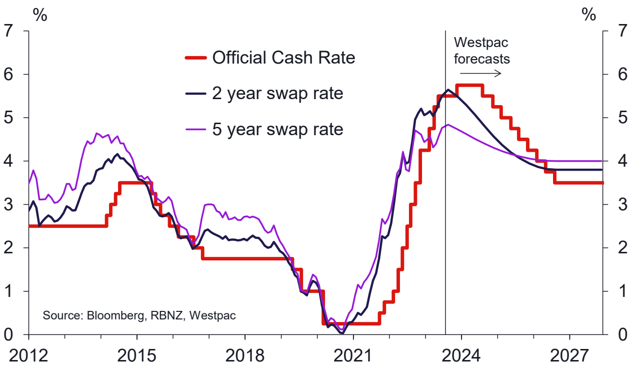
Consumer price inflation



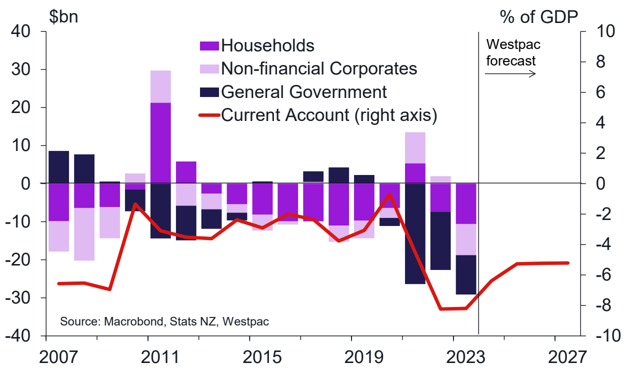
New Zealand commodity prices – world terms



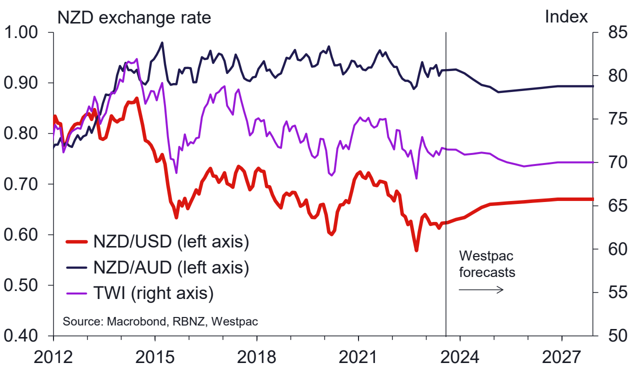
Official Cash Rate, 2 year swap and 5 year swap rates



Net lending by sector and current account



Exchange rates



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