ECONOMIC OVERVIEW

Trick or treat?

October 2023

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NOTE FROM KELLY

Trick or treat! The cover of this edition of the *Economic Overview* is fitting given the Halloween release date and the possible paths ahead for the economy – some good, some not so good. Indeed, there are significant changes afoot with plenty of potential to change the economic outlook in the years ahead. A key question on everyone's mind is whether the policy mix under the new centre-right government will deliver New Zealanders a trick (perhaps in the form of a prolonged weak fiscal outlook with low growth and high inflation) or a treat in the form of policies that help the economy more quickly overcome past imbalances and bring us back to a sustainable growth path.

For now, we are very much in 'wait and see' mode as we don't know the exact nature of the final coalition government and the policies they will pursue. Our sense is the fiscal stance will tilt to the more conservative side, which in the medium term might slow growth and help bring inflation down a bit. This would be somewhat of a treat for the economy given the still elevated and sticky inflation environment. Interest rates are expected to remain relatively high and for longer than we thought back in August. This is also in tune with global trends, as most advanced economies face similar pressures. The local data also shows persistent aggregate inflation pressures even though interest rates have been significantly increased in the last couple of years.

Core inflation pressures are proving difficult to reduce. In our opinion, eliminating these pressures is going to require a prolonged period of high interest rates, including a further adjustment higher next year. As a result, growth will remain below trend even though the economy is being supported by record net migration and a recovery in tourism. We expect population growth to have a noteable impact on house prices, which are set to extend their recovery next year, as well as in rents as our migrants find a place to live.

Significant risks abound. Higher long-term interest rates are supporting the RBNZ's policy stance, and could lead to a faster easing in inflation pressures. This could especially be the case if the outlook for our trading partners darkens – especially in China – and pushes back the recovery in the primary sector we expect next year. And of course, there is still a lot of cost to pass through to household budgets from past interest rate increases. We will be watching the data carefully to see if it shows enough evidence to push the RBNZ over the high hurdle it sees to raise interest rates further.

Kelly Eckhold
Chief Economist

NEW ZEALAND ECONOMY

Squeezing them in

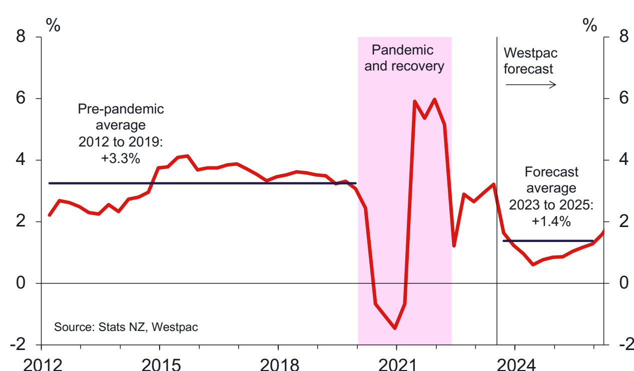
With financial conditions continuing to tighten, New Zealand is on course for a period of subdued economic growth over the coming year. The rapid recovery in net migration and related firming in the housing market is providing an offset. Even so, there are tough times ahead for many households and businesses.

New Zealand is now in a tougher phase of the economic cycle. The past year has seen a significant tightening in financial conditions with continued high inflation and increases in borrowing costs. Households have reigned in spending, and businesses are reporting increasingly tough trading conditions and related pressure on operating margins. GDP growth is estimated to have slowed to just 0.2% in the year to September.

Demand has also weakened in some key export markets, most notably China. Lower commodity prices are weighing on export earnings, and that's flowing through to reduced spending in the agricultural sector and rural communities more broadly.

It hasn't all been bad news though. Tourism continues to be a bright spot with a continuing recovery in international visitor numbers. In addition, the labour market remains in good health, with unemployment still relatively low and wages rising at a brisk pace. On top of that, the housing market has found a base and is starting to turn upwards again.

Figure 1: GDP growth (annual average)



October's General Election delivered a change in New Zealand's government with centre-right parties securing a majority of seats in parliament. At the time of writing, we're still waiting for the results of special votes (which will determine the exact make-up of parliament) and the outcome of coalition negotiations. The National Party will lead the new government, but it will need support from the ACT party and (likely) the New Zealand First party.

The change in government and policies will have important implications for the economic landscape. Notable areas where the potential coalition partners agree include:

- Tax cuts / lifting of tax brackets (New Zealand First favours a zero-rate bracket for incomes <$14,000).
- Easing of tax obligations on property investors.
- Reduced regulatory burdens, with a particular focus on the agricultural sector and less ambitious climate change policies.
- Focusing the RBNZ on inflation control, rather than its current dual mandate.

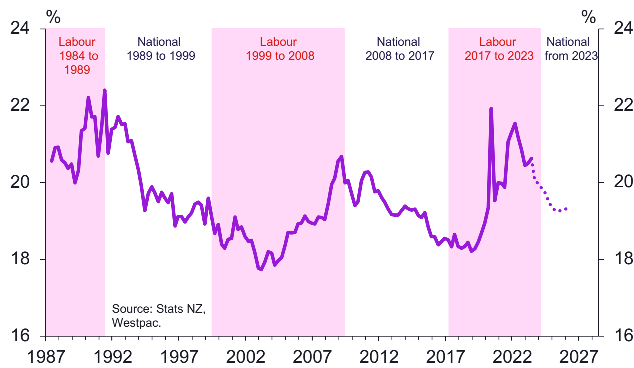
In essence, the likely suite of policies will see a smaller role for government with lower taxes, less regulation and lower government spending. In terms of fiscal policy, that is likely to see the new government run a similar (or slightly higher) operating balance as under the previous government, but with roughly equal cuts to tax revenue and government expenditure.

More broadly, the new government's policies are likely to be supportive for businesses. Notably, by reducing red tape the new government is aiming to lower businesses' costs, and thus lift incomes while also encouraging hiring and investment.

While the change in government signals greater restraint in spending over the next few years, governments of all stripes continue to face tough longer-term choices. New Zealand's population is growing rapidly as well as ageing, increasing the demand for core public services, including spending on health, superannuation, and education. Also, in the short term at least, high inflation is putting further pressure on government spending. Unless governments are prepared to run higher operating deficits and higher levels of debt, future budgets will likely require further cuts to spending and/or additional sources of revenue.

Businesses across the country are reporting softer demand and pressure on margins.

Figure 2: Government spending (share of GDP)



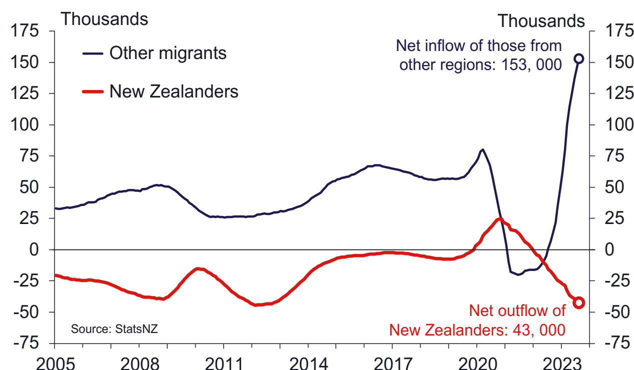
Note: The dotted line shows Westpac's expectation for government spending (rather than a government forecast).

Migration continuing to break records.

One of the most important developments in recent months has been the continued surge in net migration which has surpassed all expectations. Over the past year, 110,000 more people arrived in the country than left. And at its current pace, net migration is on course to reach a fresh record of 120,000 before the end of this year. That will have important implications for economic conditions.

As discussed in our *Special Topic* on migration, it's not clear that the average wealth of those migrants who are entering the country now is as high as it has been during previous cycles. Nevertheless, we're still looking at a significant inflow of people, with population growth set to reach 2.4% by the close of this year. That would be the fastest rate of population growth New Zealand has seen in decades, and it signals a large increase in the economy's demand base. That will be particularly important for businesses selling fast moving consumer goods like groceries. However, it will also add to demand for a range of other consumer goods and services.

Figure 3: Annual net migration flows (arrivals less departures)



With New Zealand's migration policies tuned towards bringing in those of working age, the increase in net migration is also having an important impact on the labour market. Businesses in nearly every region have told us that it has become easier to find staff since the border had reopened, including those with more specialised skills. Even so, at this stage were not hearing widespread reports of reduced pressure on wages.

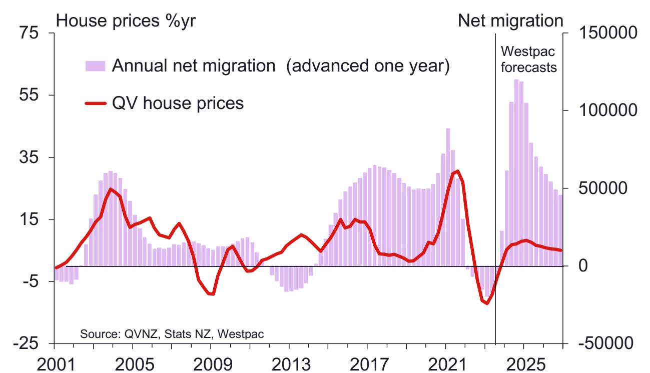
Record net migration has pushed population growth to its highest level in decades. As well as adding to the labour force, that's helping to provide a floor under spending. It's also adding to the demand for housing.

The rapid turnaround in population growth has been especially important for the housing market. The sharp downturn in house prices over the past few years has now been arrested, and prices in regions like Auckland have begun edging upwards again. Similarly, house sales have picked up, though they remain at relatively low levels. This firming in conditions is particularly notable as it's occurred at the same time as borrowing costs have been pushing higher.

The recent increase in mortgage rates will moderate the pace of house price growth over the coming year to a degree. Even so, with population growth surging we're continuing to forecast an 8% rise in house prices over 2024. We've also revised up our forecast for house price growth over 2025 slightly, from 5% to 6%.

Reinforcing that firm outlook for house price growth, the incoming government is expected to introduce several key regulatory changes that will make rental property more attractive to investors. Most notably, interest deductibility for rental properties is likely to be fully restored. We're also likely to see the 'Brightline' holding period for taxing capital gains reduced back from ten years to two years.

Figure 4: House price growth and net migration



Over time, the lift in population growth and strengthening in house prices will also help to encourage the building of new homes. However, in the near term we're forecasting that residential construction levels will drop back, with dwelling consent numbers having already fallen close to 20% over the past year. That downturn follows the 17% fall in house prices since late 2021, along with the related increases in build costs and interest rates. Against that backdrop, developers have been reluctant to bring new projects to market, and prospective buyers have been

nervous about making purchases. Those conditions will continue to dampen building activity over the coming year.

This combination of strong population growth and slowing home building means that we're likely to see growing pressure on the housing stock, especially in larger regions like Auckland. It also means that rents in those regions are likely to continue rising at a brisk pace.

We still see weakness in the interest-sensitive sectors.

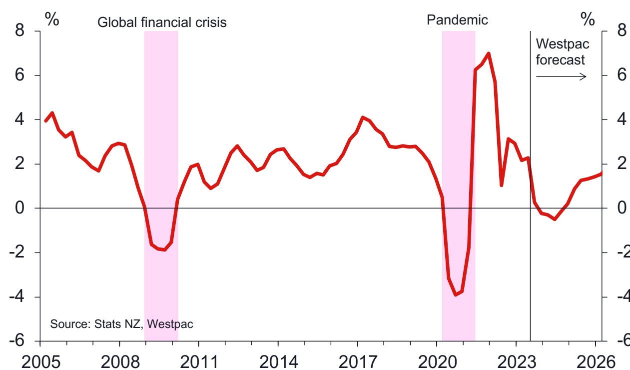
The rapid rise in migration and the related strength in the housing market will provide a sizable boost to demand. As a result, we've slightly revised up our forecast for GDP growth over the year ahead. Even so, New Zealand is still on course for a period of subdued growth. This reflects the impact of interest rates n households and the business sector.

Households.

There's been a sharp tightening in financial conditions over the past year, and that's still expected to be a significant drag on demand. Adjusting for the impact of price changes, we've effectively seen no growth in per capita spending since the middle of last year.

Financial conditions are continuing to tighten, and that means the softness in spending is set to continue through the New Year. Increasing numbers of households will have to wind back their spending, and many others will do so out of an abundance of caution. There's likely to be weakness in interest rates sensitive areas, like spending on furnishings and other household durables.

Figure 5: Per capita spending (annual average growth)

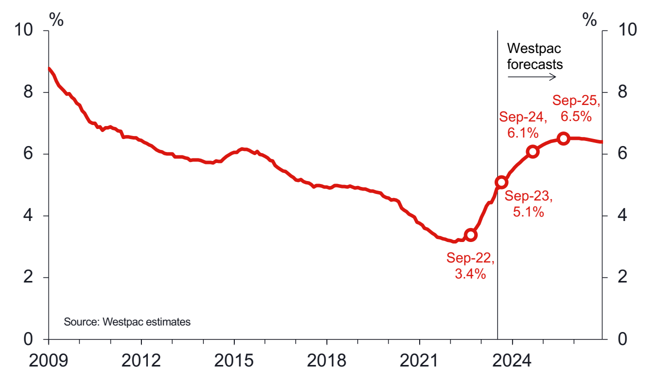


The pressure on households' finances is coming through on two big fronts. First are the continued large increases in living costs, which are eroding households' spending power. Consumer prices rose by 5.6% over the past year, including large increases in the cost of necessities. Those increases have been felt by every family across the country. We expect inflation to persist and maintain pressure on household budgets.

Second, household finances continue to be pressured by increases in debt servicing costs. Many borrowers have now rolled off the very low fixed mortgage rates and onto much higher rates. Hence, households' spending on debt servicing costs has increased. As many borrowers remain insulated from the rate rises seen so far, the average interest rate that borrowers are paying now has 'only' risen by 170bps. That's obviously still a significant rise, but much less than the 525bp increase in the OCR since the start of the tightening cycle.

Over the coming year around 60% of all fixed rate mortgages will come up for repricing. Importantly, with increases in offshore funding costs pushing local borrowing rates higher in recent months, the coming rise in interest costs will now be larger than we had previously assumed. We expect that the average mortgage rate paid will rise by another 100bps over the coming year. For households with mortgages, that will see the share of their disposable incomes spent on interest costs rising to 20% by the end of next year (up from just 10% in 2022).

Figure 6: 'Effective' average mortgage rate



* The 'Effective mortgage rate' is an estimate of the average interest rate borrowers are currently paying. It accounts for the fact that most borrowers fix their mortgages, rather than paying the interest rates that are currently on offer.

Helping households to maintain their spending in the face of those mounting financial headwinds has been the strength of the jobs market. The past year has seen the number of people in employment rise by 4%, and average hourly earnings have risen by close to 7%.

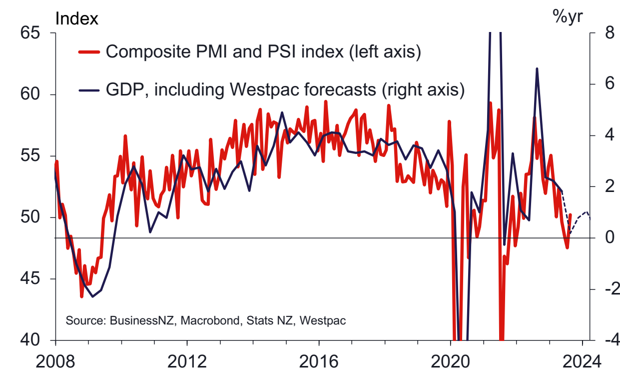
But while the labour market has remained in good health, it has started to soften. Businesses have scaled back their plans for hiring as economic growth has slowed, and the turnaround in net migration has seen the number of applicants per job rise. Unemployment is

set to rise to 5.2% by the end of next year. Wage growth is also expected to gradually slow. Hence weaker in labour market conditions will reinforce the slowdown in household spending.

Businesses.

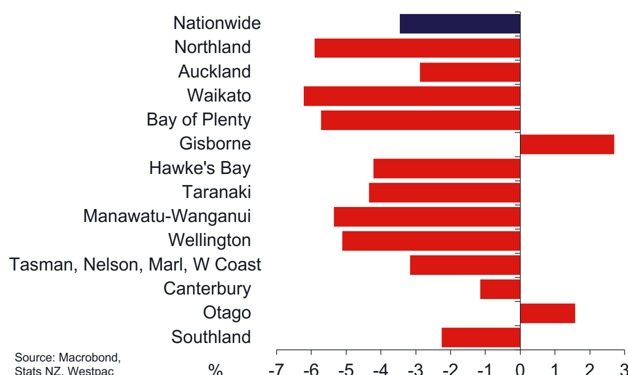
With domestic spending turning down and weak demand in some key export markets, businesses across the country have reported a downturn in trading activity and forward orders. That downturn has been widespread across industries, but it's been especially pronounced in the construction and manufacturing sectors.

Figure 7: GDP growth and the PMIs



Looking across regions, businesses in the Waikato and Northland have reported weakness in demand. There's also been softness in many rural regions, where falls in commodity prices have been weighing on incomes. In contrast, activity has been more resilient in regions such as Auckland, Canterbury, and Otago, which are benefiting from the recoveries in net migration and international tourism. Gisborne and the Hawke's Bay have bucked the trend. While these regions are still recovering from Cyclone Gabrielle, recovery efforts are supporting construction activity and spending. Even so, there are still some challenging conditions ahead for these regions.

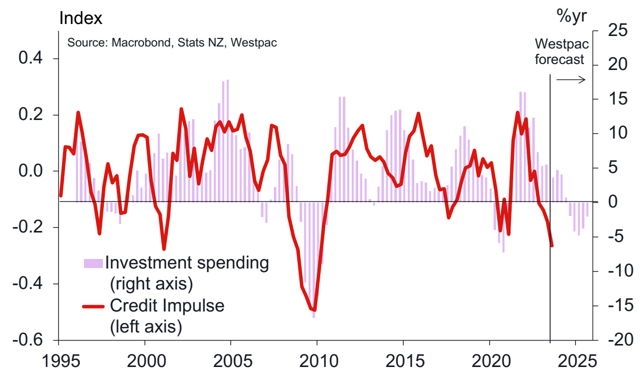
Figure 8: Retail spending volumes (annual growth)



A key theme we're hearing from businesses is continued pressure on operating costs. Although some of the very large cost increases that we saw in the wake of the pandemic have eased (such as the cost of global freight), other operating expenses are continuing to rise. That includes large increases in financing costs and some commercial rents. Importantly, many businesses have reported that it's becoming increasingly difficult to pass on cost increases into output prices. That's squeezing operating margins.

With softening demand, pressure on margins and increases in borrowing costs, businesses across the economy have been scaling back their plans for capital expenditure. Demand for credit has already slowed sharply, and we expect that investment spending will decline by close to 5% over the coming year.

Figure 9: 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.

With the record level of net migration boosting demand, the economy looks likely to skirt recession. However, as the discussion above highlights, there are still some big risks around the outlook. With financial conditions continuing to tighten, we could see an even sharper slowdown in household and business activity. In addition, as discussed later in this report, we're still looking at tough conditions in some of our key export markets, and further weakness offshore could compound the headwinds for the domestic economy.

Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Sep-23	5.6	5.50	5.66	5.53	4.90
Dec-23	5.1	5.50	5.85	5.79	5.34
Mar-24	4.7	5.75	5.85	5.67	5.22
Jun-24	4.3	5.75	5.85	5.50	5.08
Sep-24	3.5	5.75	5.85	5.29	4.95
Dec-24	3.2	5.75	5.75	5.08	4.82
Mar-25	3.0	5.50	5.50	4.86	4.69
Jun-25	2.6	5.25	5.20	4.65	4.58
Sep-25	2.5	5.00	5.00	4.46	4.47
Dec-25	2.5	4.75	4.75	4.29	4.35

SPECIAL TOPIC: MIGRATION

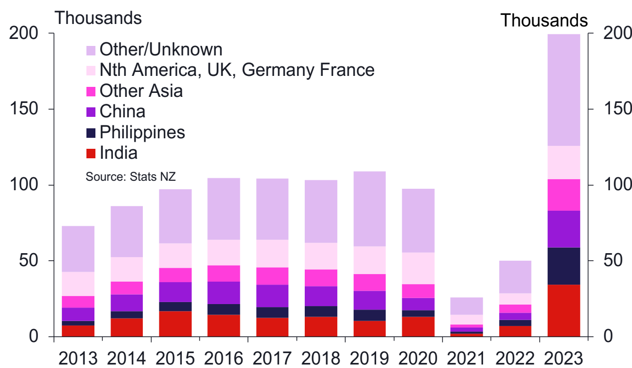
Who is coming?

Over the past year migrants have arrived in New Zealand in record numbers. In this section we take a closer look at the characteristics of this inflow.

According to the latest estimates, a net 110,000 people came to New Zealand in the year to August with the likely intention of remaining for at least 12 of the subsequent 16 months – the timeframe required for a visitor to be considered a long-term migrant. Disentangling this flow, more than 225,000 long-term migrants arrived over this period, including around 26,000 returning New Zealanders. That inflow was only partly offset by the departure of around 68,000 New Zealanders and around 47,000 foreigners.

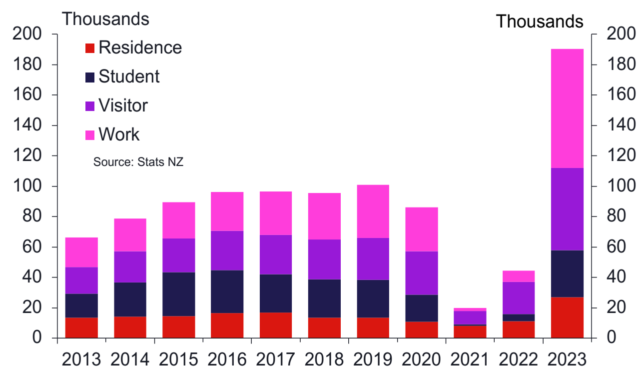
Just over 60% of the long-term arrivals into New Zealand were in the 15-39 age group, with a further 20% in the 40-64 age group. The median age was just over 30 years – a couple of years older than typically seen prior to the pandemic. Around 65% of the long-term departures were in the 15-39 age group, with a further 18% in the 40-64 age group. As with arrivals, the median age currently sits at just over 30 years, which is about three years higher than was seen prior to the pandemic.

Figure 10: Migrant arrivals, by citizenship, year to August



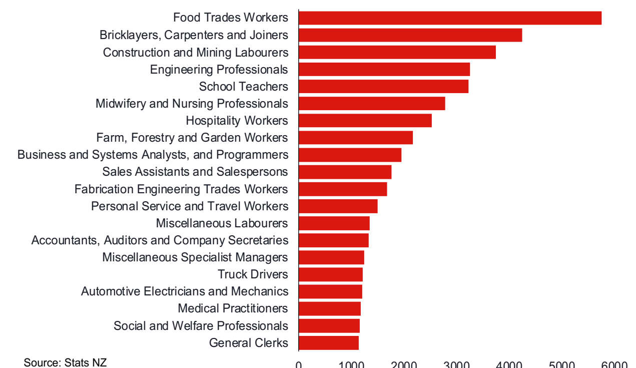
The inflow of almost 200,000 non-New Zealand citizens is dominated by arrivals from Asia, including over 34,000 arrivals from India, almost 25,000 from the Philippines, over 24,000 from China and over 20,000 from elsewhere in Asia. Other significant nationalities include over 8,000 arrivals from both Fiji and South Africa. The number of arrivals from North America, the UK, Germany and France stood at just over 21,000 combined – only slightly larger than typically seen prior to the pandemic. Given that mix, it seems reasonable to think that the wealth of today's average migrant might be lower than seen in the past, with probable implications for the 'rent vs house purchase' choice made on arrival, as well as migrants' propensity to spend vs save. Nonetheless the scale of the inflows are significant.

Figure 11: Migrant arrivals, main visas, year to August



Of the near 200,000 non-New Zealand citizens that entered in the year to August, over 78,000 (39%) arrived on a work visa while over 54,000 (27%) arrived on a visitor visa (later upgraded to allow the visa holder to remain in New Zealand for longer than 9 months). In addition, there were more than 31,000 (16%) entrants on a student visa and almost 27,000 (13%) entrants on a residence visa. Information on migrants' occupations is incomplete. However, where identified, the top professions are consistent with previously reported skill shortages i.e., hospitality and food preparation, builders and engineers, teachers and healthcare workers. This likely explains some of the easing in skills shortages reported in surveys since earlier in 2023.

Figure 12: Migrant arrivals, top 20 occupations, year to August



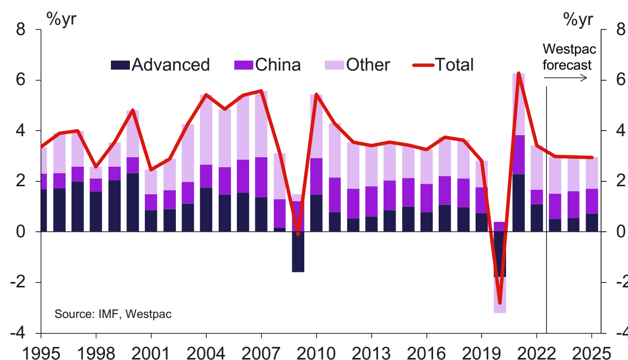
GLOBAL BACKDROP

Central banks gaining policy traction as longer-term interest rates lift

Growth in many of New Zealand's key trading partners remains constrained by tight monetary policy as central banks strive to lower inflation from still elevated levels. Recently, higher longer-term interest rates have further tightened financial conditions and will help sustain the current downtrend in inflation. However, given resilient labour markets, most central banks are unlikely to consider easing off the brake before the second half of next year.

In many respects, the global economic backdrop that underpins our New Zealand economic forecasts has changed little in recent months. With the notable exceptions of China and Japan, growth in our key trading partner economies remains constrained by central bank policies aimed at lowering inflation from the very high rates seen since the pandemic. Disinflation in the goods sector, assisted by the resolution of earlier supply chain problems, has continued to play the lead role in lowering headline inflation. At the same time, inflation in the services sector has remained much more entrenched, in part reflecting the resilience seen in labour markets and the rotation of demand back into this sector in the wake of the pandemic.

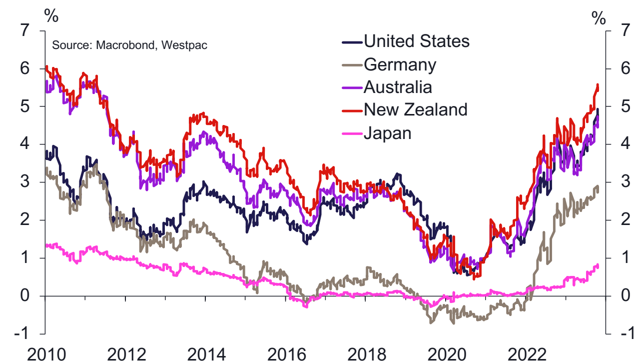
Figure 13: World growth



One notable development in recent months has been a marked lift in longer-term interest rates across almost all trading partner economies. Previously, market expectations of an early policy easing were working against central banks' goal of tightening financial conditions. However, the views of market participants and central banks have become better aligned of late. At the margin, the tightening of financial conditions brought about by higher longer-term interest rates has reduced pressure on central banks to lift their policy rates further.

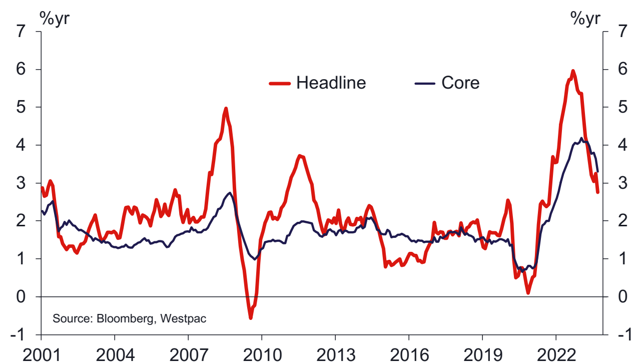
This has been reflected in comments made by prominent central bank policymakers across several jurisdictions, including Federal Reserve Chair Jerome Powell and European Central Bank President Christine Lagarde.

Figure 14: Global 10-year bond rates



There has been little change in the outlook for global GDP growth since we published our last *Overview* in August. In aggregate, Westpac forecasts that New Zealand's major trading partners will grow 3.4% this year and 3.3% next year, which is a similar pace of growth to that recorded last year. In the detail, our forecast includes a more positive picture in the US. Indeed, we now expect the US economy to grow 1.4% next year – 1.0ppts stronger than we had previously factored. This reflects the apparent resilience of the US economy in the face of monetary policy tightening, while US inflation has nonetheless continued to decline much as forecast (at least so far). Our forecast for growth in Australia is also modestly firmer than was the case a couple of months ago.

Figure 15: Annual inflation, trading partner average



On the other hand, while we have modestly upgraded our forecast for growth in China this year (following recent stronger-than-expected data for Q3), we have modestly downgraded our forecast for growth in 2024. Westpac now expects China to grow 5.3% next year reflecting ongoing risks associated with the housing sector and consumer spending. Even so, our forecast for China remains well above the consensus estimate and above recent forecasts made by the likes of the IMF and the World Bank. And as we discuss in the *Export and Current Account Outlook* section of this report, the composition of China's growth is more important than its aggregate rate considering the consumer-centric nature of New Zealand's exports to that country.

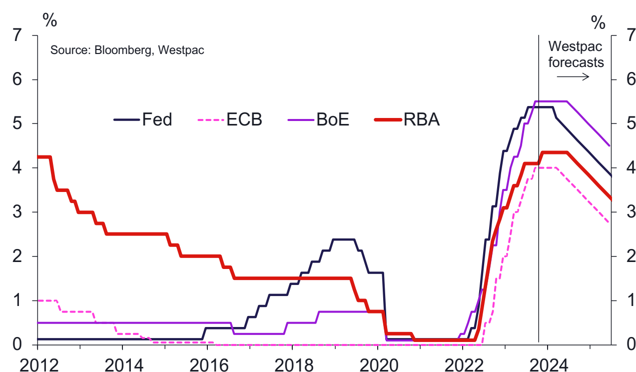
As always, decisions made by offshore central banks – especially the Federal Reserve – will play an important role in determining the financial conditions that households and businesses will face in New Zealand. Progress in reducing inflation appears more advanced in the US than elsewhere and so we continue to anticipate that the Fed will begin easing policy from March next year. However, we acknowledge that the risks around our view are skewed to a later start – as indicated by the Fed's own most recent forecasts – especially if the tone of US data maintains its recent strength (and particularly if the labour market remains tight). If so, total Fed policy easing over 2024 will likely be less than the 100bps we have pencilled in these forecasts, which itself is 50bps less than we had factored in our previous Overview.

Looking elsewhere, amidst weak growth in the euro area, the European Central Bank (ECB) has recently paused its tightening cycle, with the policy rate now assessed to be at a level sufficient to return inflation to the target range. If inflation in the euro area continues to decline, a gradual easing cycle may become possible from around the middle of next year.

Greater inflation pressures remain evident in the UK, and so there remains some risk that the BoE may be forced to take further action over coming months. But regardless, with the economy clearly softening, inflation should continue to track lower and so pave the way for a policy easing in the second half of next year.

Across the Tasman, following a recent stronger than expected CPI report, we now think that the Reserve Bank of Australia (RBA) will lift its policy rate by a further 25bps to 4.35% at the November Board meeting. Thereafter, the near-term risks are skewed towards a further policy tightening, especially with the RBA expressing little appetite to accommodate a slower return of inflation to the Bank's target than already envisaged. However, as stronger signs of disinflation emerge, we expect the RBA to begin a gradual easing cycle from late next year. Finally, there is growing confidence that Japan's long-desired inflation upswing will be sustained. As a result, the Bank of Japan is likely to take further gradual steps to normalise its policy settings over the coming year, including moving its short-term policy rate out of negative territory for the first time since 2016.

Figure 16: Global central bank policy rates



Our baseline outlook for the global economy is reasonably benign, but it is not without risks. Geopolitical risks remain front of mind, including those associated with the ongoing Ukraine conflict and those that have arisen because of recent disturbing developments in the Middle East. In addition to the human tragedy, such conflicts weigh on sentiment and risk appetite. Meanwhile, the associated upward pressure on the price of oil is holding headline inflation higher than would otherwise be the case. Economic risks include the possibility that inflation in the services sector might prove more persistent than expected, especially if labour markets remain resilient, forcing central banks to tighten policy settings substantially further. Alternatively, the lagged impact of co-ordinated monetary policy tightening could yet lead to a deeper global slowdown than we have forecast, especially if the market discipline brought by higher bond rates forces governments to suddenly adopt a tighter fiscal policy stance. Finally, as already noted, the risks around the outlook for China remain skewed to the downside, especially insofar as the outlook for consumer spending is concerned.

EXCHANGE RATES

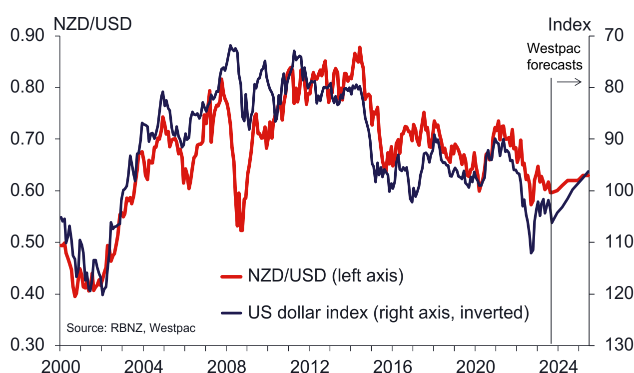
US dollar fortunes remain key to NZD/USD

Of late the NZ dollar has been on the back foot, reflecting a stronger US dollar, the perceived end to the RBNZ's hiking cycle and increased risk aversion. All going well, the NZ dollar should lift against the US dollar, but it will most likely lose ground against the major crosses.

The NZD/USD exchange rate has fallen since our previous *Economic Overview* in early August, declining to an 11-month low of USD 0.58 in late October. The NZ dollar has also lost ground against the Chinese Renminbi (CNY) given the latter's stabilisation against the US dollar. Against other currencies the NZ dollar is little changed from where it stood in August, but down a bit from the levels reached during the first half of October. As a result, the trade-weighted exchange rate index (TWI) is down only modestly from its early August level.

Much of the weakness in the Kiwi dollar can be traced to strength in the US dollar, with the recent perkiness of US economic data catching markets by surprise. However, domestic developments have also played a role. In particular, the RBNZ's October policy review was less hawkish than the market expected and was followed by a softer than expected September quarter CPI report. This has led the market to reduce its assessment of the risk of further domestic monetary policy tightening, at the margin reducing support for the NZ dollar. Finally, recent developments in the Middle East have led to an increase in general risk aversion, which has probably also weighed on risk-sensitive assets such as the NZ dollar.

Figure 17: NZD/USD and US dollar index



Looking ahead, a key driver of our forecast is our expectation that the US dollar will lose its lustre. With the Fed likely to be able to ease monetary policy sooner than most other central banks, a narrowing of interest differentials of the US relative to its major trading partners should support a downtrend in the US dollar. We expect the US dollar index (DXY) to weaken from its current level of around 106 towards 99 by the end of 2024, before declining further in 2025. Hence, we expect the NZD/USD to trend modestly higher, reaching USD 0.62 by the end of next year and continuing towards USD 0.64 over the course of 2025. These forecasts assume little further weakness in commodity prices which could occur should the China recovery stall. Hence there are some downside risks should the external outlook prove weaker than hoped.

By contrast, we expect the NZD/AUD cross rate will weaken over the coming two years, especially if the RBA elects to restart its tightening cycle over coming months (as we now expect). We have pencilled in a decline to 0.89 by the end of next year and 0.87 by the end of 2025. In the near-term, we also think that the AUD will benefit more from recent moves to stimulate the Chinese economy (most directly impacting infrastructure spending) than will the NZD (which would benefit more if stimulus was focused on boosting consumer spending). Australia's far superior current account position also offers a degree of support to the AUD.

Turning to the other main crosses, we see scope for NZD/JPY to weaken noticeably from current levels as the Bank of Japan gradually takes additional steps to unwind its ultra-accommodative policy stance, but this is more likely a story for 2025 than next year. Provided that China's economy remains in recovery mode, NZD/CNY will likely also move lower over the period ahead. By contrast, we expect the NZD to hold up relatively well against the euro and sterling.

Exchange rate forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Sep-23	0.61	0.92	0.56	0.48	87.4	70.6
Dec-23	0.60	0.91	0.56	0.49	88.6	70.3
Mar-24	0.61	0.91	0.56	0.49	88.5	70.3
Jun-24	0.62	0.90	0.55	0.49	87.9	69.8
Sep-24	0.62	0.90	0.55	0.49	87.4	69.5
Dec-24	0.62	0.89	0.55	0.49	86.1	69.2
Mar-25	0.63	0.88	0.55	0.49	84.6	68.8
Jun-25	0.63	0.87	0.54	0.48	83.1	68.3
Sep-25	0.63	0.87	0.54	0.48	81.6	68.0
Dec-25	0.64	0.87	0.54	0.48	80.0	67.8

THE EXPORT AND CURRENT ACCOUNT OUTLOOK

Cautiously optimistic

Our key goods export industries have had a tough 2023 so far. Weak Chinese demand has been a key driver for this underperformance over the year. We are cautiously optimistic that goods exports will improve over 2024 as the Chinese economy recovers. We expect services exports (tourism) to rebound to around their pre-Covid levels over the next year. A gradual improvement in the performance of the external sector should see our current account deficit narrow somewhat, but it will likely remain relatively high.

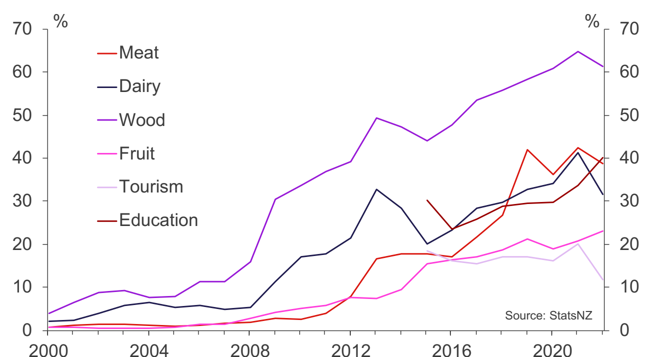
Goods export performance has been weak this year. Indeed, the latest trade data show that September quarter export values fell $2.3bn or 13.2% compared with a year earlier. Export values to China have been especially weak. Over the same period, exports destined for China fell over $1bn or 21.4%.

This weakness in exports to China reflects the underwhelming economic performance of the Chinese economy. Indeed, since June, we have progressively cut our outlook for growth in China this year. From 6.2% initially, our forecast now sits at 5.3%. Forecasts compiled by Consensus Economics have stepped even lower, notably for 2024 with the forecast presently sitting at around 4.4%.

The path ahead for New Zealand's key exports remains inextricably linked to the performance of the Chinese economy and particularly Chinese household demand.

China is a key export market for many New Zealand export sectors (see chart following). However, Chinese household demand has been a key source of weakness. Chinese households have been suffering a crisis of confidence. The housing market remains key to the Chinese economic psyche and any potential pickup in activity. It remains very weak following the bursting of its speculative bubble and the Chinese government's housing market reforms. Moreover, the Chinese construction sector has a direct bearing on demand for New Zealand logs. With the above in mind, the chart below shows the importance of the Chinese market for New Zealand export sectors.

Figure 18: Share of export values to China by export sector

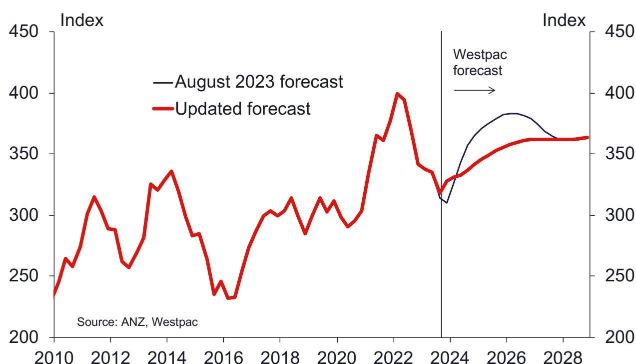


As highlighted in the *Global Backdrop* section, outside of China and Japan, generally tight monetary policy and high inflation is weighing on growth across our key trading partners. Forecasts for trading partner growth, compiled by Consensus Economics reflect this softness, sitting at 3.1% and 2.7% for 2023 and 2024, respectively.

Heading into 2024, we expect a gradual improvement in our goods exports. Crucially, we expect the Chinese economy to move closer to potential. Chinese data over the September quarter have already hinted at an improvement, with year-to-date growth now standing at 5.2%. Importantly for New Zealand, retail sales in China have grown by 5.5% in the year to September, while food service sales growth has jumped to nearly 14% over the same period. However, there remains risk that will need to be closely monitored.

Turning to export commodity prices, we expect a 4.2% increase over 2024, followed by a similar increase over 2025. This represents a gradual recovery, especially in comparison with our previous forecast. Indeed, back in August we had expected export commodity prices to lift by around 17% over this period.

Figure 19: New Zealand commodity prices



Global dairy prices have already bottomed and begun to turn a corner. Dairy auction prices have lifted a cumulative 17% from their August lows over September and October. Looking ahead, we expect dairy prices to increase by 7.5% and 5.3% over 2024 and 2025, respectively. Gradually improving Chinese dairy demand will account for much of this recovery along with relatively tight global dairy export supply.

Meat export prices, while grinding higher, are likely to lag dairy prices over the years ahead. Notably, Australian lamb supply has surged following several years of wet weather and excellent growing conditions. This surge combined with soft global demand has suppressed export prices. If El Niño and drought risks crystalise, then farmers in Australia and/or New Zealand may increase slaughter, which will further stymy lamb prices over the coming summer and/or autumn of 2024. In contrast, beef export prices have fared better, with US demand holding up and offsetting some of the weakness in the Chinese market. In the US, dry conditions have prevailed over recent years, constraining beef production. We expect these conditions to continue and for beef export prices to hold up relatively well.

The outlook is weakest for the forestry sector. Its fortunes are inextricably linked to the Chinese construction industry. On that front, we don't anticipate any material improvement over the years ahead. As a result, we expect export prices and volumes to remain weak over 2024 and 2025.

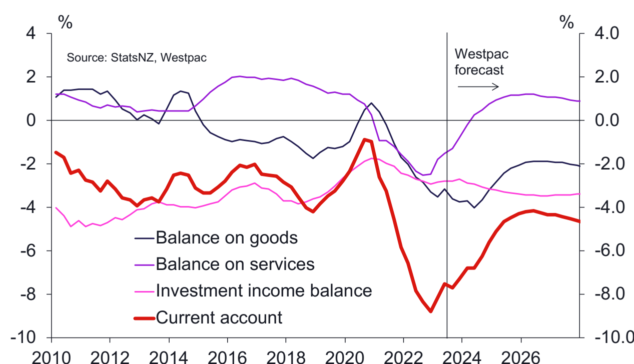
Coming from a weak base, the horticulture sector outlook is positive. After a very tough 2023, with crops destroyed by storms and frost, we expect the 2024 year to show a material improvement. The 2024 kiwifruit crop is likely to be a bumper one as large gold kiwifruit plantings come online. The crop may also get a second wind from a better spring, assuming less impact from frost compared to last season. The apple sector is also likely to see a recovery in its crop after Cyclone Gabrielle impacted the 2023 crop. Of course, we expect prices to fall, reflecting higher supply; however, the significant lift in export volumes should see export values in total move higher over 2024.

Turning to our manufactured goods exports, these have performed relatively well over the past year. This export category is less exposed to the Chinese market. In addition, a weaker New Zealand dollar has boosted manufactured goods export receipts. Indeed, exports of machinery and equipment, including medical equipment, lifted 6.7% in the September quarter compared to the September 2022 quarter.

The star export performer over the past year has been services exports. Services exports have rapidly rebounded over the past 18 months or so following the reopening of the border. As mentioned in the *Tourism Special Topic*, tourist arrivals have rebounded to around 85% of their pre-Covid levels and we expect them to fully rebound at some stage over 2024. Education exports have taken longer to recover, nonetheless we expect the education sector to continue to pick up over 2024 and 2025.

The current account deficit has begun to narrow after hitting a record high of 8.8% of GDP in the December 2022 quarter. The reopening of the border and increasing services exports has been the catalyst for the narrower deficit. From here, we expect an ongoing recovery in exports of services and a narrowing goods deficit from the second half of 2024 to lead to a smaller current account deficit. We expect the deficit to reach around 4% of GDP by 2026 and then slowly widen from this point. While this level is unlikely to spook investors, we note that this is larger than the 10-year average prior to Covid-19 of around 3% of GDP.

Figure 20: Current account balance, % of GDP



Our view is contingent on gradually improving Chinese export demand. While our baseline forecast is that this recovery will play out over 2024, it will be well into next year before we are fully confident that this is indeed the case. There are also other risks to our export and current account outlook. There is potential for El Niño and drought to hit the meat sector, reducing both export prices and increasing costs (note the impact on the dairy sector is less negative as higher export prices can offset higher costs). In addition, geopolitical risks, including the Ukraine-Russia and Middle East conflicts, are high and have the potential to disrupt both export and financial markets. In that sense, we are cautiously optimistic on the export and current account outlook, while keeping one eye on the risks.

SPECIAL TOPIC: TOURISM

A little ray of sunshine

Overseas visitor arrivals remain below pre-pandemic levels but are providing support to tourism dependent sectors and regions. The recovery will continue but, beyond next year, the industry's challenge will be to sustainably grow while adding value.

Since the borders re-opened 18 months ago, tourism has steadily recovered. Australasian visitors returned first, followed by travellers from far off markets in Europe and North America.

Conditions have now normalised. New Zealand and Australian visitors are now around 85% of pre-pandemic levels, while other visitor arrivals have grown more and reached pre-pandemic levels during the Women's Football World Cup. Chinese tourists continue to lag at about 40% of 2019 levels.

The return of foreigners has been a ray of sunshine in what is a decidedly gloomy economic picture that features slowing economic activity, which we expect to persist for a while yet (see the discussion in the New Zealand Economy section of this report).

It's been good news for our more tourism dependent regions such as Otago, and to a lesser extent Southland. Our recent **Regional Roundup**, reported that hospitality providers and tourism operators in both regions saw improved operating conditions.

We expect visitor arrivals to continue to grow and return to pre-pandemic levels by the second half of 2024. Trends in airline forward capacity suggest further tourism growth. For example, United, Air China, China Southern and Air Canada have expanded capacity on existing routes and/or are adding new routes in anticipation of additional demand. More uncertainty relates to Chinese tourist volumes where the recovery has stuttered, despite China being our second largest source of visitors prior to Covid-19. It has taken some time for the Chinese tourism sector to overcome the administrative hurdles presented by the post-pandemic environment, but a reported pick up in outbound travel during Golden week in October suggests better times ahead.

Some headwinds could slow the pace of visitor arrivals. The cost-of-living crisis playing out in several key source markets looms large in this regard. Geo-political tensions in Eastern Europe and Middle East may also force some to re-think their travel plans.

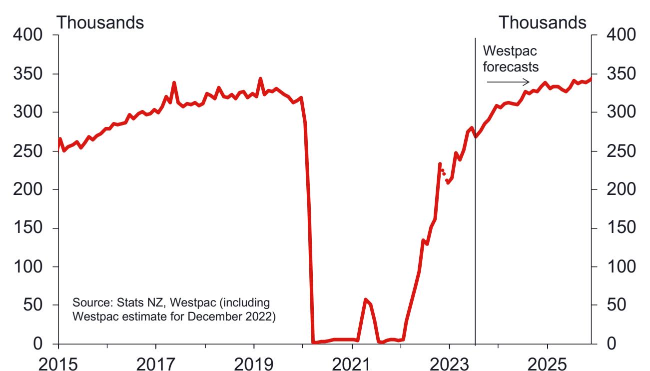
However, getting visitor arrivals back to pre-pandemic levels is likely to be the easy bit. The bigger question is how the industry can add value and grow sustainably once visitor arrivals reach the 3.9m pre-pandemic norm.

Prior to Covid-19, New Zealand was struggling to sustainably accommodate the volume of people wanting to visit these shores. Problems like congested national parks, degraded natural attractions and creaking local infrastructure led to a poor visitor experience, placing an unfair burden on small communities and, to some extent, the New Zealand taxpayer.

The key question will be how the industry will grow and add value without imparting externalities to communities and the environment. A Tourism Industry Transformation Plan on how to achieve this is already underway[1]. As our recent report on the **tourism sector** points out, operators will need to improve how they seize and sense opportunities, as well as increase their adaptability to changing circumstance if they are going to succeed. Digital technologies will be key, including the use of Artificial Intelligence (see our special topic in this *Economic Overview*).

Significant growth in tourist volumes might yield short-term gains at the long-term cost of having historic problems re-emerge, leading to a degraded tourism offering. To manage these risks, the industry may need to consider having tourists cover some of the costs associated with their activities they currently get for free. The tight fiscal situation may make this inevitable as central and local government resources may not be available to cover the burden of keeping facilities and infrastructure up to standard. Such changes could better manage the externalities of tourism and could entice more tourists that are willing to pay extra for New Zealand's world class tourist attractions.

Figure 21: International visitor arrivals



[1]Tourism Industry Transformation Plan | Ministry of Business, Innovation & Employment (**mbie.govt.nz**)

INFLATION AND THE RBNZ

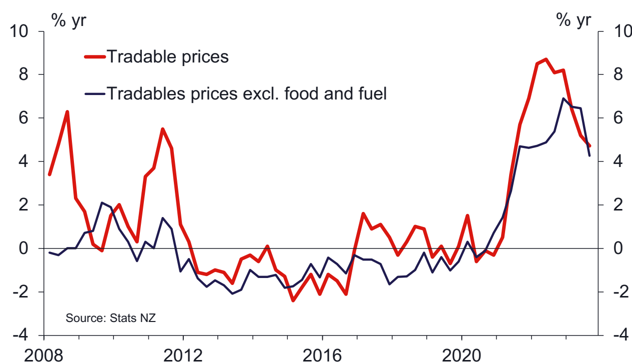
Watching, worrying but still waiting

Inflation remains persistently high but there has been enough progress to keep the RBNZ on the sidelines for now. However we still expect a further tightening in February 2024. We no longer expect inflation to move back inside the target range in 2024. The extent to which historic population growth drives housing markets over the busier summer period and how quickly wage inflation recedes will be crucial for determining how quickly stickier services and broader non-tradables inflation decelerates.

Overall inflation has continued to move lower in line with trends which have become well established since inflation peaked over 7% in early 2022. In the September quarter annual headline inflation fell by 0.4ppts to 5.6% - broadly in line with our forecasts but noticeably lower than that expected by the RBNZ back in August. This was despite a significant lift in oil and petrol prices over the quarter driven by increased geopolitical concerns and reduced oil supply.

Some of the recent softness in inflation has been because earlier weather-related increases in food prices have eased. But also, we now see lower imported goods prices as the past easing in global supply chains filters through to prices here – somewhat assisted by reduced margins in the durable goods sector as the housing market has remained subdued. We are now see increasing numbers of prices being reduced each quarter, along with fewer price increases.

Figure 22: Tradables inflation



However, underneath this welcome disinflationary trend, there remains signs of persistent domestic inflation pressures. Non-tradable inflation continues to run at high levels and is yet to show tangible signs of significant decline. In aggregate, non-tradables inflation has fallen a touch in annual growth terms to 6.3% from its peak of 6.8% in early 2023, in large part reflecting reduced inflation in construction costs as supply constraints on materials abated post Covid-19 and as the housing market declined from late 2021-mid 2023. But, abstracting from construction costs we continue to see strong and still peaking domestically generated price pressures. Non-tradables inflation excluding construction costs is yet to peak and services prices more generally are still rising strongly at 5.6% annually.

Figure 23: Non-tradables inflation

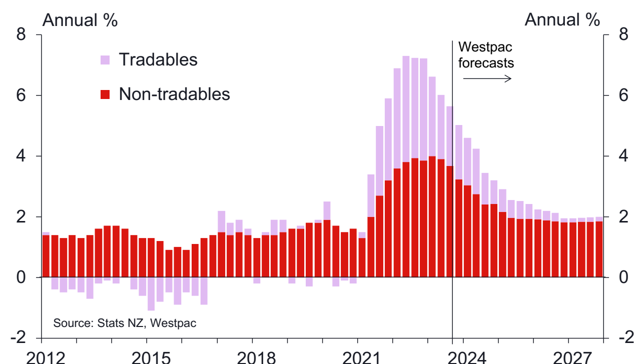
Ongoing costs and especially wages pressures remain important drivers of domestic core inflation. While recent business surveys point to some reduction in cost pressures from the peaks seen a year or so ago, most of these indicators remain well above levels that are consistent with the RBNZ's inflation target.

The strength of the labour market will be key in determining how quickly inflation will ease. Without a significant reduction in wage inflation, it may take some time for domestic inflation to return to levels consistent with the RBNZ's 1-3% inflation target. Recent indicators suggest that the labour market is easing, which gives us some optimism that the related wage pressures will begin to dissipate over the year ahead. That said, for now the labour market remains relatively tight. Therefore we are cautious about overly extrapolating the recent modest signs of reduced core inflation into more pronounced and prolonged disinflation.

We have adjusted our projections for inflation in response to recent trends. In light of their recent softening, we now expect an even faster decline in the imported tradable components of the CPI. However, the persistence in core inflation pressures has prompted us reassess the pace at which non-tradables inflation will fall back. This leaves us

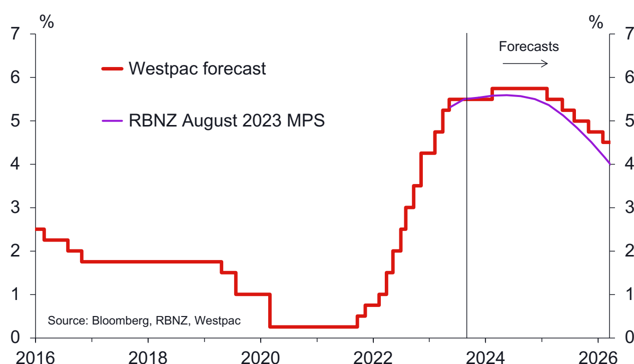
with a forecast that suggests that the RBNZ will not see inflation back inside the target range in 2024.

Figure 24: Contributions to inflation



Our central view remains that some further tightening by the RBNZ will be required to ensure inflation returns to the inflation target sometime in 2025 – still more than a year away. We see the OCR peaking around 5.75% and remaining there through 2024 before a measured easing cycle occurs through 2025 and 2026.

Figure 25: Official Cash Rate forecasts – watching, worrying but still waiting



Updates on economic conditions since our last *Economic Overview* have pointed to stronger demand pressures than we previously assumed. While significant risks remain on the international outlook, especially for China, the dataflow in recent months has not been unexpectedly weak and commodity prices have increased relative to their troughs. For example, both we and Fonterra have increased forecasts for incomes in the dairy sector for the current season.

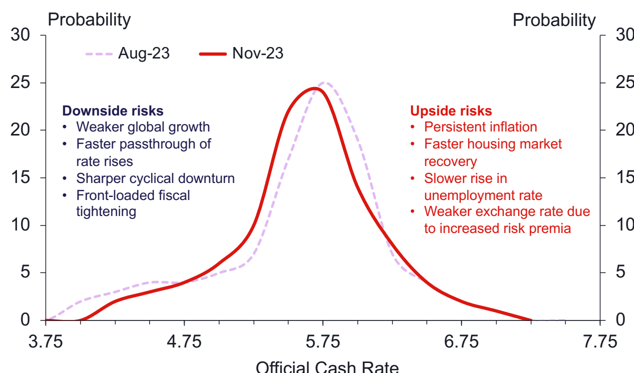
The housing market has now found a base and prices have started rising again. Post election, sentiment should improve as uncertainty fades and as investors look forward to a more supportive set of policies that should boost after-tax returns. While the labour market is easing, it remains in good health and seems capable of absorbing much of the significant new supply of labour being injected through record inward migration. If this remains the case, then there are reasonable prospects that growth bottoms out at low positive levels and that a significant recession might be avoided. Given this relatively sanguine backdrop, it's possible additional increases in the OCR – perhaps to the 6-6.5% level - might ultimately be required to ensure inflation falls to target.

Nonetheless, material downside risk factors also exist. Most cyclical indicators suggest growth in the second half of 2023 and beyond will be weaker than earlier in the year. Some, such as the PMI/PSI indicators could be consistent with negative growth. The labour market could also soften quickly if demand for labour weakens in the face of ongoing migrant driven labour supply. Further weakness in the global economy could easily eventuate as central banks remain concerned about persistent inflation pressures and are determined to keep interest rates "higher for longer". The situation in China is especially uncertain and growth estimates for next year from international agencies and markets are weak, which might see further weakness in New Zealand's commodity export prices. Hence, in a year's time its plausible some reduction in the OCR could occur.

The RBNZ seems very attentive to both the upside and downside risks and is content to leave the OCR at 5.5% for now. This is especially the case given that longer term interest rates have risen to the extent that the market is doing some of its work for it. The RBNZ's reaction function to persistent core inflation and upside demand/migration/housing market factors has been to wait and see if the 5.5% OCR will prove sufficient to sustainably reduce inflation pressures. The New Year will help clarify the extent to which the OCR is appropriately calibrated in light of housing market trends in the busier summer period, the direction of the labour market, core inflation pressures (the December quarter CPI will be available in January) and updated cyclical demand indicators (Q3 GDP in late December, business and consumer confidence indicators and PMI/PSI).

Importantly, the new government's fiscal stance will be clearer next year. The pre-election positions of the major parties suggested ongoing fiscal deficits that probably would not significantly change the medium-term inflation outlook. However, the final coalition government policy mix may be more conservative and could assist with disinflation. After coalition negotiations conclude, the pre-Christmas HYEFU will help clarify the future fiscal stance.

Figure 26: OCR Risk Scenarios - November 2024



SPECIAL TOPIC: ARTIFICIAL INTELLIGENCE

The thinking person's machine

Firms that embed Artificial Intelligence (AI) will generate productivity and efficiency imporovements and gain a competitive edge. AI will change the nature of work, changing the way labour is used and how workers are developed. Firms that most effectively incorporate AI have a bright future due to improved productivity, competitiveness, and agility.

Artificial Intelligence (AI) is here. Machines that think like humans, able to perceive, recognise, solve, and learn can be found in our smartphones, digital voice assistants, smart home devices and navigation applications. They power up our social media interactions, our streaming services, and are in many of the games that we play on consoles.

AI can also be found in every sector of the economy, from public to private, from agriculture and manufacturing to services, and everywhere in between.

Despite this, the adoption of AI in New Zealand has lagged. In 2021, for example, only 19% of firms in New Zealand[1] had fully embraced AI, compared to 25% in Australia, US and UK. Most firms here are still trying to work out what AI is and how it might be used. Some have started to experiment with it, while others have dabbled with AI applications like ChatGPT, BARD and DALL-E.

There are some exceptions. Many larger firms in New Zealand, for example, have been active adopters, but tend to use AI in specific end uses. AI powered Chatbots bear testimony to this. Firms are also using AI in other areas of their business, such as procurement, inventory management, processing, distribution, and marketing.

For a minority of firms, AI is more instinctive. What sets these mostly small tech-savvy firms apart is their willingness to put algorithms and big data at the core of their business. AI determines what is produced, how it is produced, for which customer and at what price. Together with technologies such as robotics process engineering and Internet of Things, AI drives the machinery that turns widgets into products.

To that extent, we think that AI has the potential to level the competitive playing field. AI is not only encouraging new market entrants, it's allowing smaller firms within the same industry to compete head-on with larger firms. Whether this poses a threat to larger players is uncertain as large firms have the access to massive proprietary data sets, a large customer base and an established market presence that AI could leverage more.

The benefits of AI depend on the extent to which it has been adopted. In general, firms that transform themselves and put AI at the core of their business are likely to see more benefits than those that limit AI to specific use areas. Much though depends on the quality of implementation and the sophistication of AI tools employed, as well as the cost.

These benefits are typically couched in terms of productivity gains at the firm level that deliver a competitive edge and better profitability. AI, for example, is good at repetitive tasks, such as data entry, report generation and customer service queries. Businesses can also use AI to predict demand more accurately and gain greater efficiencies in procurement and inventory management. Other applications include preventative maintenance, which reduces equipment downtime.

Further efficiencies will be achieved by changing the role of humans in the production process, freeing up workers to focus on higher value-added work. This will require workers to develop different skills and competencies. In an AI-driven world, EQ counts just as much as IQ, with a premium placed on workers that are creative, collaborative and show empathy. Workforce management and development approaches will need to evolve to build a workforce with skills to add value in an AI-centric production process.

Despite these benefits, adopting AI can be challenging for many businesses. Some have an inbuilt resistance to change. Discarding tried and trusted practices requires a big change in mindset. There is also the issue of when to invest, given how quickly AI is moving and the risks of obsolescence. And that is before we get to the technical challenge of integrating AI within existing data and systems architecture. The cost of incorporating AI, could be prohibitive, especially for sophisticated customised solutions. Lastly, it can take time for AI to bed in and deliver the value needed to push returns on investment above the hurdle rate.

However, for those that get AI right, the future looks good. Firms that don't are likely to struggle against rivals that use AI to reduce their unit costs of production, while at the same time delivering products and services tailored to unique customer requirements.

[1]State of AI in NZ 2021 (**qrious.co.nz**)

ECONOMIC AND FINANCIAL FORECASTS

New Zealand forecasts

Economic indicators	Quarterly % change				Annual average % change			
	Jun-23	Sep-23	Dec-23	Mar-24	2022	2023f	2024f	2025f
GDP (production, annual average)	0.9	-0.1	0.1	0.2	2.7	1.2	0.9	1.3
Consumer price index	1.1	1.8	0.9	0.9	7.2	5.1	3.2	2.5
Employment change	1.0	0.5	0.0	0.2	1.7	2.6	0.2	0.6
Unemployment rate	3.6	3.9	4.3	4.5	3.4	4.3	5.2	5.3
Labour cost index (all sectors)	1.1	1.1	0.9	0.8	4.1	4.1	3.4	2.6
Current account balance (% of GDP)	-7.5	-7.7	-7.3	-6.8	-8.8	-7.3	-5.6	-4.3
Terms of trade	0.4	-4.8	-1.7	2.9	-4.2	-7.5	9.5	5.8
House price index	0.5	2.1	1.0	1.5	-11.2	1.0	8.0	6.4

Financial forecasts	End of quarter				End of year			
	Jun-23	Sep-23	Dec-23	Mar-24	2022	2023f	2024f	2025f
90 day bank bill	5.62	5.66	5.85	5.85	4.26	5.85	5.75	4.75
2 year swap	5.18	5.53	5.79	5.67	5.10	5.79	5.08	4.29
5 year swap	4.44	4.90	5.34	5.22	4.67	5.34	4.82	4.35
10 year bond	4.27	4.87	5.45	5.45	4.31	5.45	5.15	4.60
TWI	70.9	70.6	70.3	70.3	70.8	70.3	69.2	67.8
NZD/USD	0.62	0.61	0.60	0.61	0.60	0.60	0.62	0.64
NZD/AUD	0.93	0.92	0.91	0.91	0.92	0.91	0.89	0.87
NZD/EUR	0.57	0.56	0.56	0.56	0.59	0.56	0.55	0.54
NZD/GBP	0.49	0.48	0.49	0.49	0.51	0.49	0.49	0.48

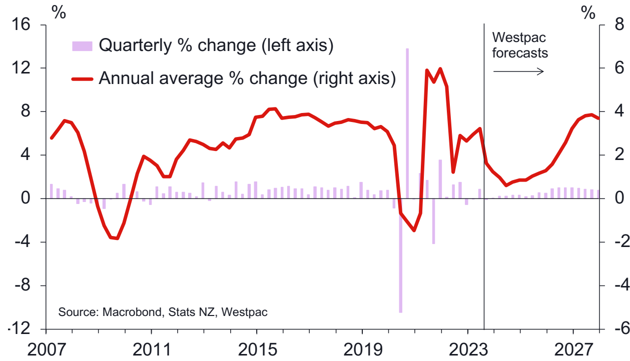
Fiscal indicators	June years						
	2021	2022	2023	2024f	2025f	2026f	2027f
Total government revenue ($bn)	129.3	141.6	152.5	166.2	174.7	186.3	195.7
- % of GDP	37.7	38.9	38.5	39.3	39.5	40.2	39.7
Total government spending ($bn)	133.7	151.0	161.9	178.1	180.8	188.8	197.1
- % of GDP	39.0	41.5	40.9	42.1	40.9	40.7	40.0
Operating balance excl. gains and losses ($bn)	-4.4	-9.3	-9.4	-11.9	-6.1	-2.5	-1.4
- % of GDP	-1.3	-2.6	-2.4	-2.8	-1.4	-0.5	-0.3
Net government debt ($bn)	35.9	61.9	71.4	94.0	100.3	105.1	106.5
- % of GDP	10.5	17.0	18.0	22.2	22.7	22.7	21.6

International economic forecasts

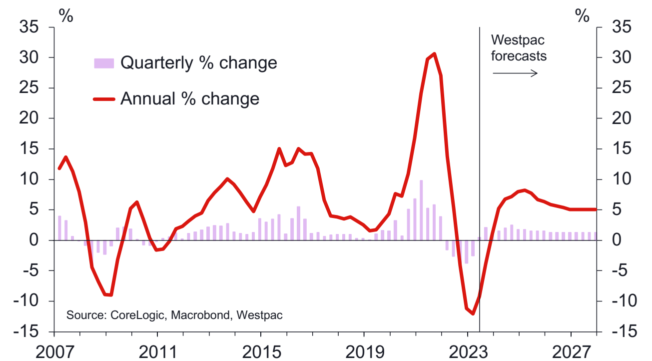
Real GDP (calendar years)	Annual average % change					
	2019	2020	2021	2022	2023f	2024f
Australia	1.9	-1.8	5.2	3.7	1.9	1.2
China	6.0	2.2	8.4	3.0	5.3	5.3
United States	2.3	-2.8	5.9	2.1	2.2	1.4
Japan	-0.4	-4.3	2.1	1.1	1.6	1.0
East Asia ex China	3.8	-2.3	4.3	4.5	3.5	4.3
India	3.9	-5.8	9.1	6.8	6.4	6.4
Euro zone	1.6	-6.1	5.4	3.5	0.6	1.1
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**	**3.4**	**3.3**
World	**2.8**	**-2.8**	**6.3**	**3.4**	**3.0**	**3.1**

THE ECONOMY IN EIGHT CHARTS

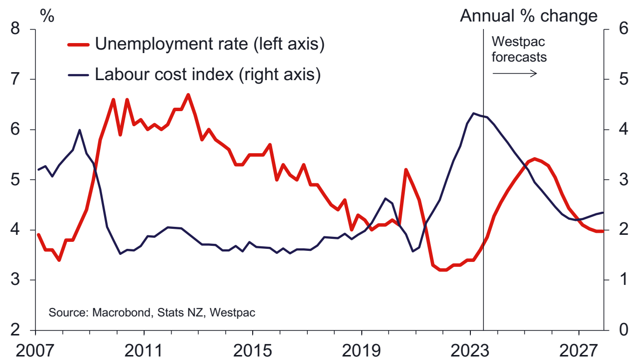
GDP growth



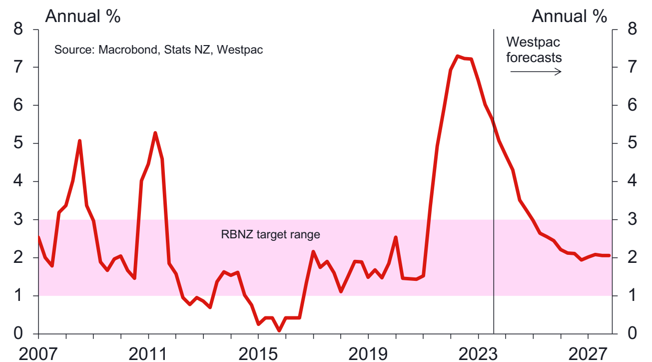
House prices



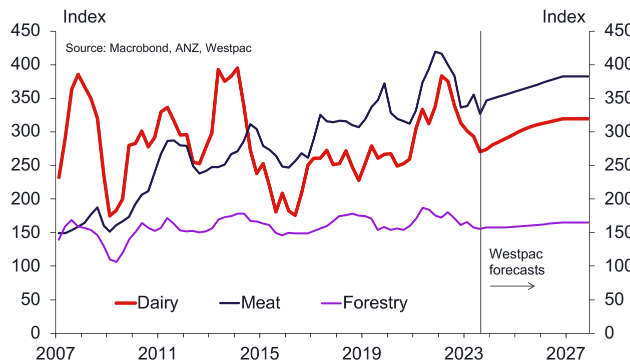
Employment and wage growth



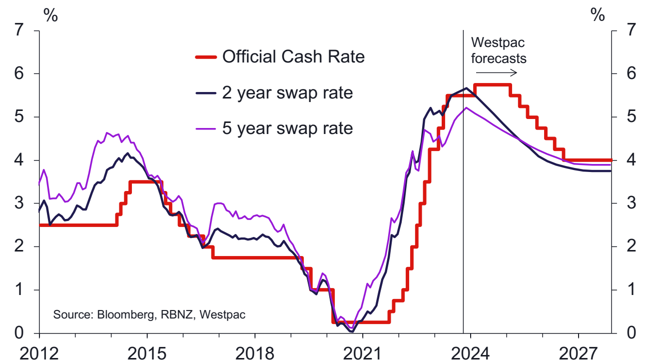
Consumer price inflation



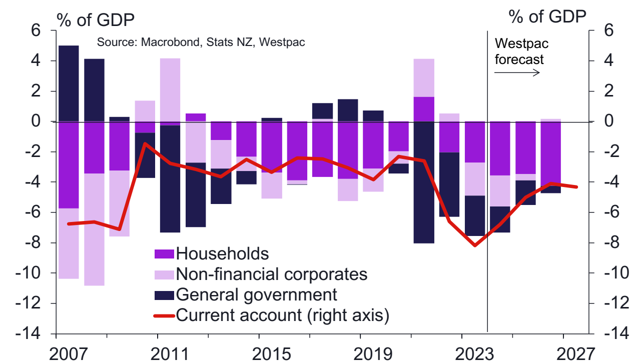
New Zealand commodity prices – world terms



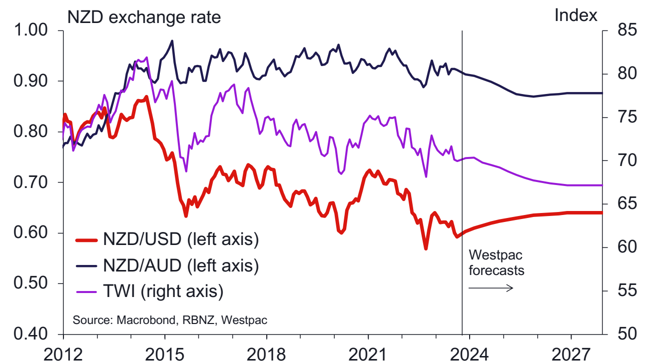
Official Cash Rate, 2 year swap and 5 year swap rates



Net lending by sector and current account



Exchange rates



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