BUSINESS NZ

PLANNING FORECAST

BusinessNZ

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NZ Economy: Stop-go signs ahead

Executive Summary

Currently, negotiating the NZ economy feels rather like taking a road trip through unchartered territory with numerous stop-go lights in place where the road has been reduced to one lane due to washouts.

While lockdowns are now hopefully in the past thanks to high levels of vaccination uptake, a new variant of Covid (Omicron) has announced its birth to the world with financial markets taking a quick dip before recovering somewhat. More volatility is likely over coming months.

At the time of writing, medical experts have yet to fully assess the impact of the new variant, Omicron, but irrespective of final deliberations, it is fair to say the world economy is continuing to face roadblocks in the recovery process. A resumed tightening of restrictions will damage growth and also drive up inflationary pressures even more than at present.

Likewise, NZ will not likely see as strong an economic upswing as some predicted at the start of the August lockdown. Rather than a short, sharp lockdown, the ongoing effects will be felt well into next year as many businesses try and recover over close to two years' on-again off-again lockdown losses. And there is also the significant issue of increasing government debt which will need to be addressed at some point down the track.

Rightly or wrongly, the NZ Government continues its very cautious approach to opening our borders as recent announcements indicate - allowing NZ citizens from Australia to self-isolate from mid-January 2022 and those from other countries from mid-February. However, at this stage, it seems residents from other countries, including tourists, won't be welcome until late April (and then with a requirement to self-isolate for a week).

Such government decisions will, for two reasons, significantly affect NZ's tourism and other sectors, including higher education. First, many people will simply not want to come here if a self-isolation requirement is in place. Second, given this quite conservative approach to opening the borders, many countries will have stolen a march on NZ; people will go to countries more open, both to international capital and to labour.

Behind the above is the looming rise of inflationary pressures some of which are well beyond the control of either the Government or the Reserve Bank. With supply chain problems still significant worldwide, inflationary pressures are likely to persist for some come to come. Port congestion and shipping delays have led to significant and ongoing supply chain disruptions, while the continuing closed border has major implications in respect to well-publicised labour shortages. As countries increasingly emerge from the effects of Covid, the demand for goods and services will likely rise. As an island nation. it goes without saying New Zealand is heavily dependent on trade to sustain its economic standard of living.

Housing costs are an ongoing issue despite a series of measures to try and rein in demand - from banks restricting credit through to tax changes, such as extending the bright line test. But essentially, it is supply-side issues which need to be addressed and that being the case, it was pleasing to get a rare glimpse of cross-party support for measures allowing for greater housing intensification in some cities without going through all the usual hoops local councils put in place. However, perhaps ironically, assuming the legislation passes with only minor tweaking, it might put more, rather than less, pressure on housing as investors seek to buy property suitable for housing expansion.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at 8 for the December 2021 quarter, up 13 on the previous quarter and down 1 on a year ago (not surprising given the move to L4 lockdown in late August for the entire country which significantly affected economic activity).

Notwithstanding efforts of late to reduce restrictions, with some signaling of more open borders by the middle of next year, current border restrictions are likely to constrain growth, particularly in sourcing labour, while the ongoing saga of supply chain problems has been well publicised.

Some sectors continue to perform well on the back of strong international demand and commodity prices are at historically high levels. This favours NZ exporters, particularly in the agricultural sector with forecast dairy prices again increasing. The building and construction sector is reporting record levels of consenting for residential housing and the value of work undertaken is rising. However, supply chain constraints are causing delays and forcing up prices.

Other sectors by contrast - hospitality, tourism, and retail to name just a few - continue to face a bleak few months.

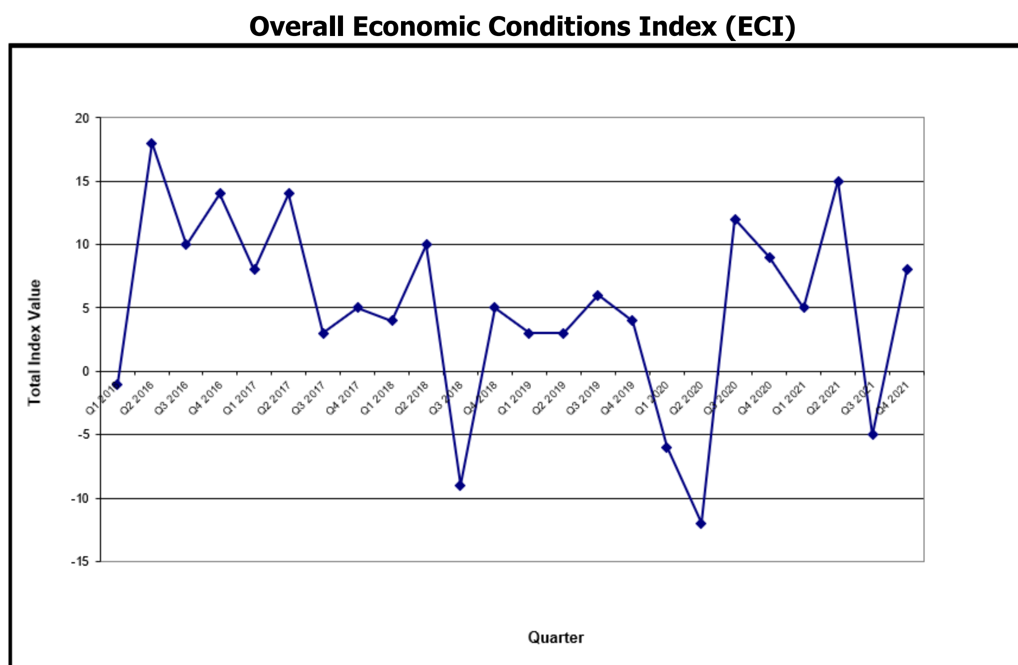
While the Government has shelled out around $60 billion in total Covid-related expenditure over the past couple of years to try and cushion the worst effects of Covid on the community, individuals and businesses, there will come a time when the increased debt must be paid back. And with interest rates on the rise, there will be no such thing a free lunch when it comes to debt servicing costs.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at 8 for the December 2021 quarter, up 13 on the previous quarter and down 1 on a year ago. The rise in activity over the current quarter needs to be put in the context of the significant late August/early September period when the whole of NZ was in hard lockdown and there was a prolonged Auckland lockdown, first at L4 and subsequently at L3.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken up into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Economic growth/performance indicators sit at 5 for the December 2021 quarter, up 6 on the previous quarter and up 1 on a year ago. NZ's terms of trade remain at evaluated levels on the back of continuing support for our key agricultural commodities. Notwithstanding, shipping capacity is still stretched, leading to delays and significant transport cost increases for some sectors.

Monetary policy/pricing indicators sit at -4 for the December 2021 quarter, the same as the previous quarter and down 5 on a year ago. Rising inflationary expectations are beginning to be reflected in higher interest rates as the Reserve Bank starts on its track of raising the OCR back towards more neutral levels. Increased pricing intentions and continuing supply chain issues are now more and more apparent across many sectors with inflation much more than simply in a transitory phase.

Business/consumer confidence indicators sit at 5 for the December 2021 quarter, up 9 on the previous quarter and up 4 on a year ago. Several business and consumer confidence surveys show that business sentiment has held up reasonably well, despite significant uncertainty over when the borders will reopen. Rising interest rates, with more to come, will likely suppress consumer confidence given current high levels of household debt, principally relating to housing.

Labour market indicators sit at 2 for the December 2021 quarter, down 2 on the previous quarter and down 1 on a year ago. The economy is now beyond what the Reserve Bank would term sustainable full employment and many businesses are doing their best to retain staff wherever possible. Businesses are very averse to shedding staff given tight labour market conditions and are effectively closed borders until well into next year.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the December quarter 2021 are estimates based on available information to date.

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

<u>PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?</u>

1.1 Economic growth (GDP) – roller coaster ride continues

While a number of risks will remain over the short to medium term, at the same time there are also a number of positives for NZ's economic outlook.

Looking first at the international scene. There has been reasonably strong economic recovery for a large part of the developed world over the last six months as economies opened up in the realization that Covid was something that had to be lived with, rather than persist with the elimination strategy some countries, including NZ, had tried for a prolonged period.

However, the arrival of a new variant of Covid-19, Omicron, has put a damper on the world recovery to date. Financial markets have bounced around almost daily trying to assess its virulence: to date, the medical jury is still out.

There are several new Covid-19 variant dangers from an international perspective.

First, many third world countries still have very low rates of vaccination so the fast-moving spread of new variants could potentially have significant health effects for large populations – quite apart from the potential for significant deaths amongst the unvaccinated.

Second, and consequent on the above, growth rates across world economies are likely to be very mixed. Low vaccination rates will have potentially damaging economic effects on populations that largely, are already vulnerable.

Third, in terms of the developed world, the impact of new strains of Covid-19 is already resulting in number of countries tightening their borders and restricting the movement of both goods and people, impacting on economic growth.

Fourth, inflationary pressures are likely to be further heightened because of renewed border tightening with supply chains already under the pump. Ironically, inflationary pressures are likely to be more significant than initially forecast when Covid-19 first arrived on the international scene a couple of years ago. Pent-up demand will see pressure on the price of both capital and labour as economies start to open up to more "normal" trading conditions.

Many international reserve banks have now clearly changed their tune from thinking that inflationary pressures were simply a short-term transitionary issue to considering them embedded in economies for the medium term. On-again, off-again restrictions will simply create the potential for stockpiling product.

Fifth, with the world still awash with money as governments pump-primed their economies with cash, the resulting build-up of debt will come back to bite households and businesses as inflationary pressures lead to international efforts to reduce stimulus packages and increase interest rates. NZ won't necessarily be immune from this consequence.

Sixth, given that some major countries, and particularly China, have taken a reasonably robust approach towards eliminating Covid-19 compared with many other countries that have decided Covid-19 is just something they have to live with and manage as best that can, and with the health/economic trade-offs of tight controls, there is potential for China's economy to soften somewhat. This would not be in the interests of world growth, quite apart from being in NZ's interests since China is NZ's largest trading partner and a very important player in ensuring NZ's agricultural producers receive premium prices, particularly for dairy products.

The International Monetary Fund (IMF) in its World Economic Update (Oct 2021) shows the global economy projected to grow by a strong 5.9 percent this year and by the slightly more modest rate of 5.2 percent in 2022.

The IMF also pointed out that economic prospects have continued to diverge across countries, with vaccine access emerging as the principal fault line along which the global recovery splits into two blocs: those that can look forward to further normalisation of activity, and those that will still face resurgent infections and rising Covid death tolls. However, the IMF noted, recovery is not assured, even in countries where infections are currently very low, as long as the virus circulates elsewhere.

The IMF highlights several future potential problems for the world economy, including the probability of rises in headline inflation in some developed countries, particularly the United States. Headline inflation is also increasing in some emerging economies. Second, the IMF points out that the balance of risks for growth is tilted towards the downside at this stage. In this respect, inflationary pressures are considered skewed to the upside and that it is important to continue multilateral efforts to speed up global vaccine efforts, and provide liquidity and debt relief to constrained economies.

While the IMF is of the view that policy responses to the Covid-19 pandemic should reflect local circumstances and economic conditions and promote maximum sustainable employment, it points as well, as Covid-19 is brought under control and the world economy moves towards greater opportunities, to the need to maintain credible policy frameworks in respect to fiscal and monetary policy.

Source: IMF World Economic Outlook Update (Oct 2021)

NZ as an island nation, heavily dependent on international trade in goods and services, including for labour, is not immune from what is happening in the world economy. Nevertheless, despite the concerns over the world economic outlook expressed above, there are several factors that should provide the country with some comfort.

First, around 90 percent of eligible New Zealanders (those over 12 years of age) have already been vaccinated while the intent is to roll out vaccinations to those 5-12 years old early next year.

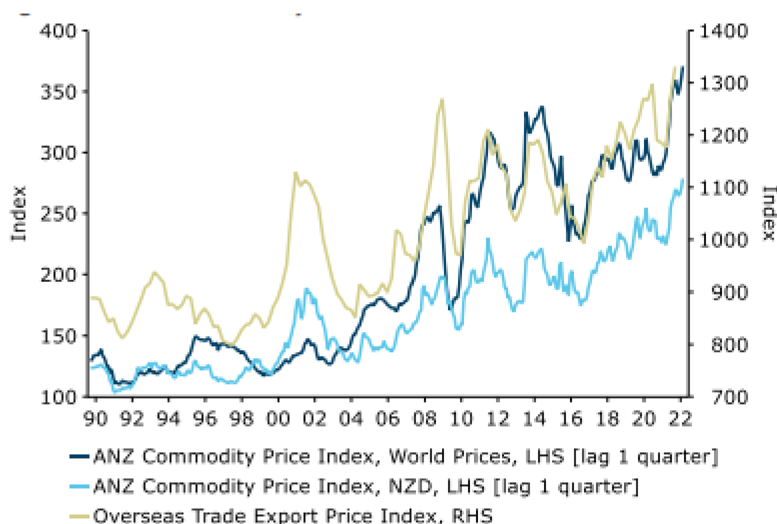
In this respect, NZ has done as much as is reasonably possible to ensure a level of vaccination that should minimise pressure on the health system and progressively allow for a move back towards a sense of normality asap, including reopening borders to both capital and labour.

Second, despite some significant build-up of debt, with Government expenditure on Covid-related activities of around $60 million over the past two years, NZ's fiscal and monetary policy framework remains internationally sound. This is so notwithstanding some fraying around the edges and some concern over regulatory policy implementation (more on this later under downside risks).

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

The latest ANZ Commodity Price Index (see below) shows a lift of 2.8 percent in November – a new record. Dairy price increases are prominent, while meat also showed an increase. When converted into NZ dollars, the index gained 3.1 percent, similarly a record high. Strong increases for dairy and meat were offset to some extent by declines in forestry and aluminum prices.

ANZ Commodity Price Index



Fonterra has recently firmed up its price to farmers for this season to the highest level since it was founded 20 years ago, lifting and narrowing its forecast payout for the 2021/22 to between $8.40 and $9 per kilogram of milk solids.

Global dairy prices have been supported this season by weaker milk production due to poor weather and higher feed costs. Fonterra's New Zealand milk supply is down about 3 per cent on the same time last season but improving weather conditions mean the co-operative has retained its expectation for milk collections to end the season down just 0.9 per cent at 1525 million kgMS.

According to Fonterra, driving the milk price is the consistently strong demand for dairy at a time of constrained global supply.

"We've seen the impact of a number of events play out this first quarter. That includes the high price of feed in the US which has seen milk production growth stall and a lower-than-expected supply picture in Europe.

"While we've seen demand soften slightly in China, global demand remains strong, and we think that will remain the case for the short to medium term.

"We know that a strong milk price has the potential to squeeze margins, and, because of this, we've also revised our **earnings guidance to 25-35 cents per share** from 25-40 cents per share"

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

On the negative side of the equation, there are risks likely to have an adverse effect on NZ's growth potential, at least over the short to medium term (2-3 years):

First, while NZ has entered the new "traffic light system," with Auckland and various other hotspots in red and the rest of the country in orange, how or when NZ will open up to the rest of the world is still unclear. The cost has been significant with around $60 billion spent on various Covid-related programmes. Loose monetary policy has supported continuing growth, but with the undesirable outcome of inflating asset prices (particularly housing). This has the potential to result in significant inequity, creating a population of two halves – the haves and have nots.

Second, rightly or wrongly, the NZ Government continues to take a very cautious approach to opening up new Zealand's borders as can be seen from recent announcements that NZ citizens from Australia will be able to self-isolate from mid-January 2022 with those from other countries able to do likewise from mid-February 2022. However, at this stage, it appears other countries' residents, including tourists, won't be welcome here until late

April (and then with a requirement to self-isolate for a week).

According to Tourism Industry Aotearoa (TIA), the tourism sector has lost around $26 billion in earnings since NZ's border restrictions began in February 2020 with heavily tourist-oriented towns such as Queenstown, Taupo and Rotorua, the hardest hit.

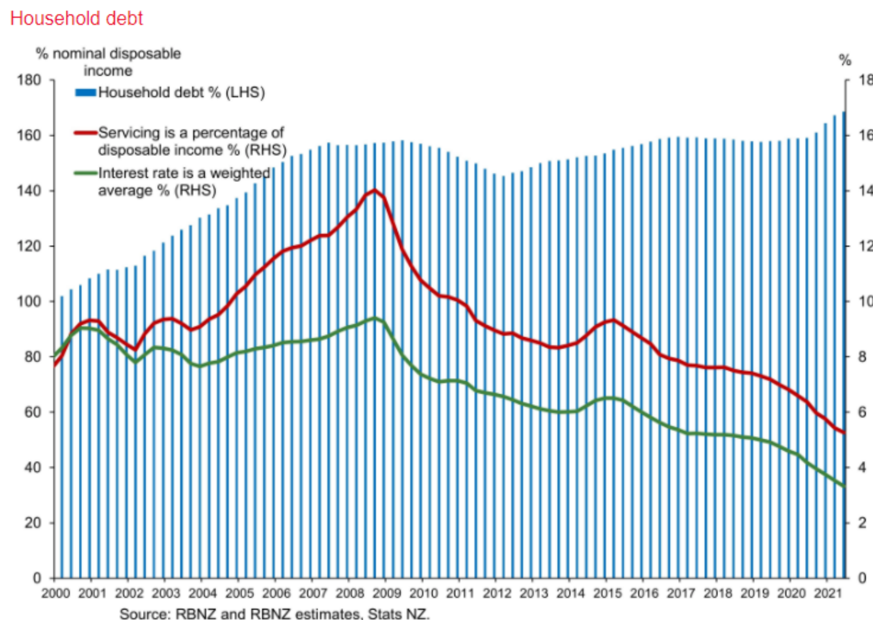
Third, there are looming inflationary pressures some of which are well beyond the control of either the Government or the Reserve Bank. Supply chain issues are still a significant problem worldwide and inflationary pressures are likely to persist for some come to come. Port congestion and shipping delays have seen significant and ongoing supply chain disruption, while closed borders have major and well-publicised labour shortage implications. As countries increasingly throw off the effects of Covid, the demand for goods and services will likely rise.

Global shipping costs have recently decreased slightly but are still at elevated levels. Some volatility is likely in 2022 as well.

While there tends to be a focus on the Consumer Price Index (CPI) as a measure of inflation, it is important that other inflation indicators, such as the Producers Price Index (PPI) which measures both input and output prices for businesses, are also considered in the overall context of inflation. In this respect, while producer prices (outputs) have increased strongly of late so too have input prices, to some extent making businesses less profitable than they might be otherwise. A number of industries, including construction and agriculture, are facing significant cost increases, including transport and material costs, alongside increased fertiliser costs for the agricultural sector. These inflationary pressures will be played out through higher interest rates as, over time, the Reserve Bank moves the OCR towards a more neutral level.

Fourth, household debt has continued to rise of late and with the potential for a significant further increase in interest rates towards more historically neutral levels, it is likely that household disposable incomes will be constrained given the higher levels of debt tied up in housing overall.

As the graph below shows, while debt servicing and interest costs are still relatively low currently, they are set to move on up substantially over the next year or so.



Fifth, housing costs are an ongoing problem despite a series of measures aimed at reining in demand when, essentially, supply-side issues need to be addressed. It was therefore pleasing to get a rare glimpse of cross-party support for measures that would change the Resource Management Act (RMA) to allow for greater housing intensification in some cities without having to go through all the usual hoops local councils put in place. Perhaps ironically, assuming the legislation is passed with only some minor tweaks, pressure on housing might actually increase as investors seek to buy property suitable for subdivision for up to 3-storey housing development.

Sixth, while the Government's core Crown net debt has increased significantly in response to various Covid-19 support measures (and will continue to do so for the next couple of years with the Government pumping another $7 billon into the Covid fund), overall, debt levels are still relatively manageable. However, there is no free lunch, and the debt will need to be paid back at some stage, reducing the choices NZers can make, and potentially raising the risk profile (interest rates) required for investment in NZ.

Seventh, while some government decisions in relation to the country's fiscal and monetary policy settings have come in for scrutiny of late (provision made for an increased Reserve Bank mandate, to be discussed further under "Monetary Policy" below), the Government's regulatory policy setting remains problematic, particularly given the current Covid-19 pandemic.

The advent of Covid-19 and, possibly, the need for fast-track legislation in some cases, has at times meant important checks and balances have, at least temporarily, been absent from regulatory decision-making, including the Regulatory Impact Statement (RIS) requirement. A RIS at least provides a description of the nature of the problem legislation is intended to address, and the potential costs and benefits of taking particular action. Absent a more structured Regulatory Responsibility Act (or similar) with mandated requirements on legislators, there is little in the way of scrutiny of legislation, apart, arguably, from the Select Committee process. Several Acts have passed under Urgency over the past 18 months with little, if any, public input into the Select Committee process, much less, earlier consideration of regulatory proposals before they gain traction.

While there will always be the odd occasion where passing legislation under urgency might be necessary, given a government with a clear majority in the house, it could be time to question whether NZ's development of legislative proposals constitutes world best practice. Recent events suggest there should be a re-think of whether improvements should be made – independent scrutiny of Bills before they enter the House, making more use of "sun-set" clauses (legislation that applies only for a certain period before automatically expiring) or introducing a more forward-thinking regime such as a comprehensive Regulatory Responsibility Act to improve both the development of, and thinking around, legislation before it makes it to the House. There is certainly food for thought, particularly where a legislative proposal has potentially significant implications for personal freedom and the ability to go about normal activities. The probability of unintended consequences from bad law is always greater without adequate scrutiny when the law is introduced. Even the Speaker of the House recently raised concerns over fast-tracked legislation without adequate time for Select Committee consideration of the issues.

Forecasts: Real GDP percent Growth

	Years Ending		
	Dec 21	Dec 22	Dec 23
Highest	5.7	4.8	4.5
Average	5.4	4.4	2.8
Lowest	4.9	3.9	1.6

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – Reserve Bank spreading its wings

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

New tools such as Debt-to-Income (DTI) Ratios have been given the green light to try and stem housing demand by restricting capital availability. However, such factors do not take account of the financial situation of people wanting to borrow money or their unique circumstances. Furthermore, trying to constrain housing prices while minimising the impact on first home buyers is far from easy.

The Reserve Bank is also aiming to reduce risky mortgage lending by further reducing high Loan-to-Value Ratio (LVR) lending to owner-occupiers, restricting this to 10 percent of all new loans to owner-occupiers above a LVR of 80 percent, down from 20 percent.

Arguably some of the above mechanisms can perhaps be justified because New Zealand households have significant debt tied up in housing – much more than in many of the other countries we traditionally compare ourselves to – therefore potentially affecting the soundness of the financial system. However, the Reserve Bank's

mandate seems to be expanding almost by the day into other longer-term issues which will have little medium-term impact on the financial system – such as climate change.

Over the past few years, the Reserve Bank as gone from very much a bit player in the climate change area, to making significant submissions in respect to climate change issues.

While it is very clear that temperatures are rising and that sea levels will rise with them, with obvious consequences for storms and beachfront properties, evidence of immediate risk to the financial system is wanting.

Not everything that is a globally consequential risk is also a risk to the financial system. Systemic financial risk requires a particular kind of fragility.

The danger from the Reserve Bank having so many balls in the air is that it will no longer concentrate on the prime purpose of monetary policy which is to ensure a relatively stable price level over time. This would be unfortunate and could reduce New Zealanders' confidence in the independence and predictability of the Bank's monetary policy settings.

Interest Rates – moving up towards more neutral levels

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

Ironically, the prolonged lockdowns from late August through to early December for parts of the country have placed even further pressure on the need to address increasing inflationary pressures, given constraints on the ability to supply the goods and services demanded by businesses and consumers.

While NZ looks to move tentatively towards opening its borders early next year, the arrival of Omicron will potentially result in an even a more cautious approach to normality.

The Reserve Bank, in its last review, clearly signaled the pathway to returning monetary policy to a more neutral state. Interest rates will continue to rise, as can be seen from the forecasts below, and with historically high levels of household debt, those rises might not need to be significant before starting to impact on households' disposable incomes.

The importance of the Reserve Bank getting on top of inflation should not be underestimated given that rather than a transitory issue, inflation is here to stay for some time yet. Perhaps more importantly, it is significantly a world-wide phenomenon and not focused only on a few economies.

Given NZ's rather fortress approach to opening its borders, constraints on the provision of goods and services will continue as traditional sources of labour from overseas are closed off and many businesses are unable to operate at near full capacity or even close to capacity, with the supply of some basic building materials constrained effectively making building even more difficult and costly than previously. Delays are the name of the game currently.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Dec 21	Dec 22	Dec 23
Highest	1.0	2.5	3.1
Average	1.0	2.4	2.7
Lowest	1.0	2.3	2.3

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – supported

The NZ dollar is likely to be supported over coming months due to a range of factors, including the fact that continuing improvements in commodity prices normally go hand-in-hand with greater support for trading nations such as NZ.

Perhaps more importantly, NZ has been one of the first countries to start ratcheting up interest rates which will likely mean increased support for investors seeking higher returns in NZ.

Also, there is the potential for Kiwis to return from overseas and for an increased number of immigrants (sometime next year) which will put some upward pressure on the NZ dollar as foreign funds are converted to NZ dollars.

However, the speed at which interest rates rise around the world will also have an impact on future currency movements. Central banks are at present reviewing their stance on monetary policy settings, and it is likely that in a range of countries, interest rate rises will occur sooner than originally intended despite the recent arrival of Omicron and its impact on how some countries approach the reintroduction of border restrictions and place greater controls on activity. Certainly, financial markets remain volatile as information on Omicron changes almost daily.

Moreover, there is potential that the NZ dollar might ease as economic conditions improve globally and central banks embark on monetary policy tightening.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 21	Dec 22	Dec 23
Highest	0.97	0.95	0.94
Average	0.96	0.94	0.93
Lowest	0.94	0.93	0.92

USD (cents)			
	Dec 21	Dec 22	Dec 23
Highest	0.70	0.75	0.74
Average	0.69	0.72	0.73
Lowest	0.68	0.69	0.71

TWI			
	Dec 21	Dec 22	Dec 23
Highest	75.2	77.6	75.5
Average	73.8	75.3	74.6
Lowest	72.7	73.1	73.2

Source: ASB, BNZ, Kiwibank and Westpac

Inflation – more significant than transitory

Inflationary pressure is starting to rear its head through more than one channel, with shipping capacity constraints, material supplies and labour shortages increasing costs and restricting overall growth in the NZ economy. Inflationary pressure is not only a NZ phenomenon but is being felt more and more around the world as the impact of expansionary monetary and fiscal policies encourages a growing demand for goods and services, fuelled by historically low interest rates.

The Reserve Bank's continuing very loose monetary policy stance (the "no-regrets policy") is having a significant impact on asset prices (particularly housing) that will extend the gap between the haves and the have nots and has encouraged the further buildup of household debt. NZ household debt now sits at an historical high with much of it tied into the housing market. Ironically, at the same time, debt servicing costs are at their lowest level for well over two decades although the tide is turning

Notwithstanding the above, business opinion surveys now consistently show stronger inflationary expectations with most respondents reporting an intention to raise prices over the next year – an elevated result compared with historical survey results. At the same time even more respondents are expecting input costs will also rise.

It is instructive that while the focus is mostly on what is happening to headline inflation as measured by the Consumers Price Index (CPI), prices charged by companies and businesses for their goods and services jumped by 6.2 percent in the year to the end of September 2021. At the same time, input costs rose a significant 7 percent.

According to StatsNZ, these increases in the two "producer price" indices were the largest in more than 12 years.

While it is fair to say that the CPI and the Producers Price Index (PPI) measure different things and are therefore not necessarily correlated, the latest rises will be of concern to the Reserve Bank as it navigates further rises in the OCR over the coming year. Even the Reserve Bank, in its latest Monetary Policy Statement, has raised its predictions of what consumers can expect inflation to be in 5 years' time.

Though expectations of house price rises have eased slightly, projections are still for rises of over 5 percent in the coming year. Nevertheless, instead, some banks see prices falling (slightly) as the rampant price rises seen over the past 2 years are clearly unsustainable. Uncertainty and higher interest rates will put a damper on further price hikes, together with the Reserve Bank, and subsequently the trading banks, tightening credit availability.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Dec 21	Dec 22	Dec 23
Highest	6.1	3.2	2.6
Average	5.8	2.7	2.4
Lowest	5.2	2.4	2.2

Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – drifting

Recent surveys of business activity and confidence show confidence has slipped somewhat, although it is still holding up surprisingly well given recent and ongoing uncertainty.

Sentiment waned in the final ANZ Business Outlook for November 2021. Headline confidence fell to -16.4, down from -13.4 in October. Businesses' own measure of activity fell to +15.0, down from +21.7 and the lowest in 12 months. Cost expectations and pricing intentions remained extremely high, with a net 89% of firms reporting higher costs and a net 67% intending to raise prices. Inflation expectations increased to 4.24% (up from 3.45% in October).

ANZ Business Confidence Index

Source: Macrobond, ANZ Research

While many businesses are still suffering from the impact of Covid and the various restrictions imposed by government, many have adapted significantly in terms of how they operate, putting in place new and improved systems and making increased use of technology.

The Government's various business assistance programmes have helped to lessen the financial blow, but nothing

is a substitute for businesses doing what they do best – offering households and other businesses what they want, when they want it. Any significant restrictions will, by definition, restrict consumption and raise the cost of operating, cost which ultimately will be passed on to consumers one way or another.

But despite reasonably positive results from recent business confidence surveys, given the problems businesses continue to face, the surveys also contain some worrying statistics, particularly regarding continuing evaluated risks, notably over future pricing expectations.

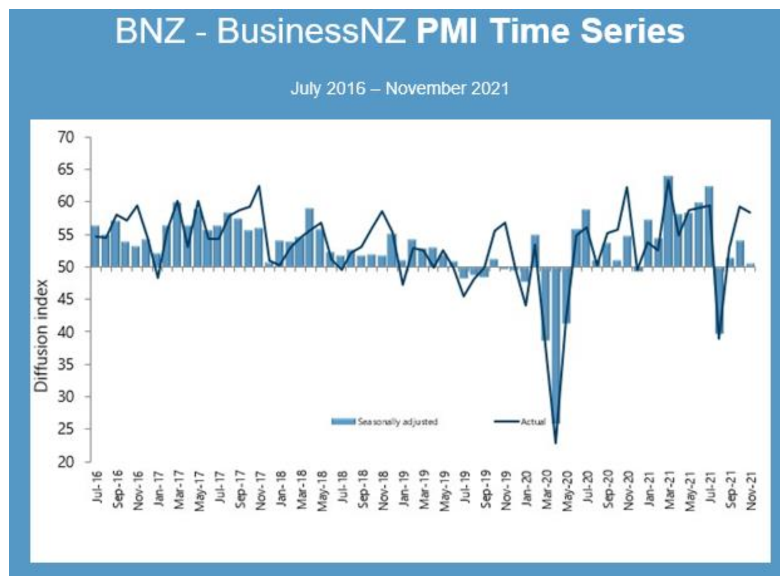
Tight constraints on the supply of goods and labour are putting upward pressure on prices while at the same time affecting NZ's ability to grow. Nevertheless, most surveys point to improved labour market outcomes and unemployment rates lower than expected.

As mentioned earlier, some sectors are doing okay while others continue to struggle.

New Zealand's manufacturing sector saw a lower level of expansion for November, according to the latest BNZ – BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally-adjusted PMI for November was 50.6 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was 3.6 points lower than October.

The up and down nature of the key sub-indices that make up the overall result shows that the sector has some way to go to get back to what we saw during the first half of 2021.

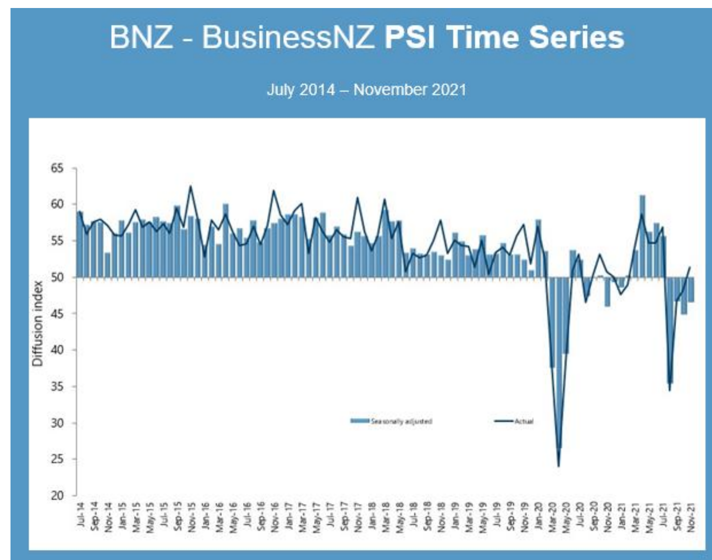


New Orders (54.7) has remained very consistent over the last three months. Production (52.2), while positive, has remained somewhat lacklustre. Employment (48.2) fell back into contraction for the first time since December 2020, while Finished Stocks (48.3) and Deliveries (42.9) both returned to contraction after exhibiting expansion October.

In addition, the proportion of negative comments from respondents rose to 57.6% in November, compared with 55.4% for October and 71% in September.

The PMI implications for economic growth seem clear – soft. But with obvious difficulties remaining on the supply side, inflation is still rising.

Activity level in New Zealand's services sector improved slightly during November, although still remained in overall contraction, according to the BNZ – BusinessNZ Performance of Services Index (PSI).



The PSI for November was 46.5 (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). This was up 1.6 points from October, and almost identical to the September result.

The stagnant nature of recent results exemplifies the difficult trading conditions many businesses current find themselves in.

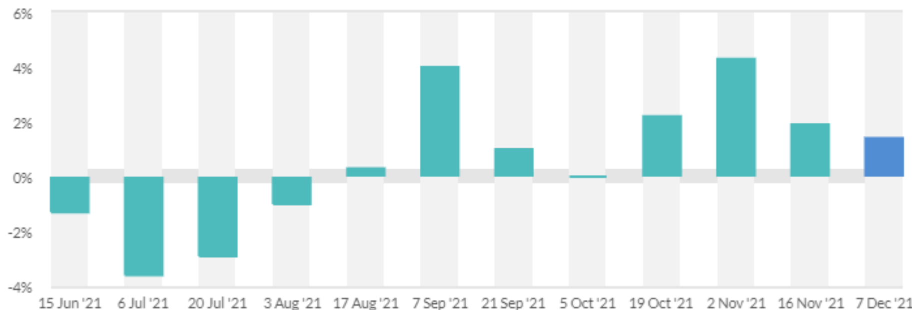
The key sub-index of Activity/Sales (45.6) remains in contraction, although continues to improve slightly from its low in August. More encouraging, New orders/Business (54.4) returned to expansion for the first time since July, which was likely due to easing of lockdown conditions. While Employment (50.3) remains close to no change, both Stocks/Inventories (46.7) and Supplier Deliveries (37.8) have yet to show expansion since the 2021 nationwide lockdown.

Main **Indices**

We can surely expect the PSI, and even the PMI, to improve in December, given New Zealand's move into the less-restrictive "traffic-light" system of Covid 19 management near the start of the month. Still, the latest PSI and PMI results warn against taking a strong bounce in GDP for granted, at this point.

Meanwhile, on a more positive note, the agricultural sector continues to perform well, largely on the back of solid

global demand and commodity prices holding up reasonably well despite some declines in international dairy prices mid-year. There has been some recovery since, as can be seen from the graph below which shows recent movements in the Global Dairy Trade (GDT).



Source: Global Dairy Trade (GDT)

But notwithstanding the solid performance of agriculture over recent times, there is significant concern in the agricultural community over the uncertainty surrounding a number of environmental-related regulations either in the pipeline or which have recently taken effect. Also, the constraints on processing meat are taking its toll with suitable people available for processing jobs at freezing works constrained through lack of ability to take on migrant labour which traditionally assists when processing is at peak capacity (over summer).

There is still plenty of room to improve regulatory processes, including the impact of decision-making on the broader economy and on business confidence. Rapid, and in some cases, debatable regulatory interventions will not necessarily assist businesses with large sunk costs when making investment decisions. The quality of regulatory decision-making is still NZ's Achilles heel and where sizeable improvements should be made.

In this respect, the New Zealand Infrastructure Commission has recently expressed concern about the growing $1.29 billion annual costs of resource consents in the country, due in large part to consultants and legal fees.

The results of this study, which is conducted by research firm Sapere and commissioned by the NZ Infrastructure Commission, is concerning.

The report suggests that the consenting process also unduly penalises smaller communities and projects and noted clear differences in how consenting cost burdens fall across different sectors. Investors face materially higher consenting costs when investing in waste and coastal transport infrastructure, and lower relative costs when investing in roading, rail and large-scale subdivisions.

The Sapare report said on average about 5.5% of total project costs go towards the consenting process; that those costs have risen by 70% over the past seven years and the time taken for approval has nearly doubled over the past five years.

The construction sector has faced some setbacks over the past quarter with an inability to source materials affecting the ability to complete work and driving up the price of those materials which are available.

There have been numerous articles written of late as to whether house prices will continue their upward spiral or will begin to show some constraint. Dwelling consents remain at very high levels by historical standards while the strong pipeline of construction work is good news for continuing economic recovery.

The jury is still out, although one can fairly safely assume the rate of growth experienced over the past couple of years is truly unsustainable in anyone's language.

A range of measures has been introduced to affect the demand side of the equation e.g., extending the bright-line test, banks taking a stricter approach to credit availability for first home buyers, increasing interest rates, and on the supply-side, greater moves to enable building in existing residential areas, all of which should act to constrain

further house price rises. Nevertheless, recent surveys still see further growth over the next year despite an increasing number of commentators saying the peak is near, if not indeed passed.

1.4 Labour market – tight

Unemployment fell to 3.4 percent in the September quarter 2021 according to the Household Labour Force Survey (HLFS). Given effectively closed borders and the inability to source labour, businesses appear desperate to retain staff wherever possible.

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

Given there is a global market for capital and labour, NZ cannot afford to keep its head in the sand over the need to address its medium-term border reopening to the world. Continued border restrictions are keeping net migration inflows to a trickle. In fact, the latest estimates from StatsNZ shows a provisional net loss of 1,700 people in the year ended October 2021. This compares with strong net gains from 2013 through to the start of 2020, and effectively reverses the pattern of the previous 40 years, reflecting the fact that NZ has maintained effectively closed borders for close to 2 years now.

While the latest government announcements of changes to the self-isolation requirements for fully vaccinated travellers from next year should see some rise in net migration levels, it is hard to see the Government accepting the levels of net migration inflows which occurred some 5 years ago.

Significant concerns remain about employers' ability to source skilled labour from overseas so that projects and seasonal activities can proceed. There does not appear to be a plan from the Government as to how NZ as a country is to reopen to the world beyond the tentative moves to allow NZers returning from Australia to self-isolate from mid-January 2022 and from other countries from mid-February 2022. Effectively it will be late April 2022 before tourists or other people will be allowed in, and then, only to be forced into isolation for a week. Not the type of welcome one would expect from a country desperate to obtain much needed revenue from foreigners wanting to visit our part of the world.

The danger is that NZ's very risk averse and conservative approach to opening our borders will allow many other countries to steal a march on us in terms of gaining valuable capital and labour expertise as economies rebuild their momentum. The fact that New Zealanders are having to wait for a significant period for often basic goods and services or cannot travel on basic public transport because of the many services are cancelled due to a shortage of bus drivers does not provide a great deal of faith in our policy makers.

However, it is far from certain that NZ will necessarily face a large influx of people seeking employment here once the borders open because of the potential for New Zealand citizens to want to seek greener pastures elsewhere. How many New Zealanders are waiting to move overseas is uncertain but given the risk averse approach taken by government to date and the fact that many countries will have stolen a march on NZ when it comes to opening their borders early, it is possible that others will already have taken the cream of the crop, as it were. Also, other factors, such as the cost of living (and housing costs in particular) may discourage some people from coming here as a choice of residence. One has to remember that labour, like capital, is now highly mobile, and will more likely gravitate to destinations where it is made most welcome (i.e., where investment returns are most attractive). In this respect NZ must compete with the rest of the world.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 21	Dec 22	Dec 23
Highest	3.8	3.8	4.2
Average	3.6	3.6	3.9
Lowest	3.3	3.5	3.6

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – higher

It is not surprising that with NZ's extremely tight labour market, forecasts below show some upward movement in labour costs.

A relatively modest growth in forecast wage rates in aggregate over the forecast period tends, however, to mask significant gains for specific sectors and for individuals within sectors. The inability to source skilled immigrants from overseas might see some job-hopping as businesses compete to obtain required expertise from a diminished pool.

The impact of impending regulatory cost increases also needs to be thrown into the mix of factors driving changes in labour costs. While overall, the proposed reforms might result in increased wage rates for some, they will also mean reduced job opportunities, if not actual job losses, for others. The Government must recognise the need for flexible labour market practices that allow individuals and companies to agree arrangements best suited to their individual circumstances. Moves back towards more centralised wage bargaining do not take account of the unique pressures facing individual companies in particular markets.

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

	Years Ending		
	Dec 21	Dec 22	Dec 23
Highest	2.9	3.6	3.0
Average	2.8	3.1	2.9
Lowest	2.6	2.3	2.8

Source: ASB, BNZ, Kiwibank and Westpac