ECONOMIC OVERVIEW

The right amount of pressure.

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Note from Michael

One of the markers of success for monetary policy is that when inflation is low and stable, you simply don't have to think about it on a day-to-day basis. On that measure, we're clearly not in a good place: inflation has risen to its highest rate in a generation, and the public discussion of it reflects a growing fear that it's here to stay.

The prospects for ongoing inflation come down to one thing: whether monetary policy is too loose for the prevailing conditions. That is certainly the case right now. Demand is running too hot compared to the economy's productive capacity – which itself has been diminished by the Covid shock – and higher interest rates will be needed to rein it back to more sustainable levels.

The challenge the Reserve Bank now faces is in applying the right amount of pressure. Too much, and it could inflict significant pain on household budgets and risk tipping the economy into recession. Too little, and inflationary forces could get out of hand, requiring an even more painful adjustment in the future.

As our cover image suggests, it's easier to get the pressure right when you have a gauge that gives you instant feedback. But there's no such luck when it comes to the economy – the data is often noisy, lagging, or both. With that in mind, the things we'll be watching over the coming months for signs of a turn in the economy are house prices, consumer spending and the demand for workers.

We now expect the Official Cash Rate to reach a peak of 3.5% by the end of this year. That will mean some quite aggressive tightening over the coming months, but that just reflects the scale of the inflation challenge. Consequently, we've revised down our growth forecasts for the next couple of years. We're not talking recession, but we do expect some fairly lean growth in consumer spending this year, as other sectors take up the growth baton.

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NEW ZEALAND ECONOMY

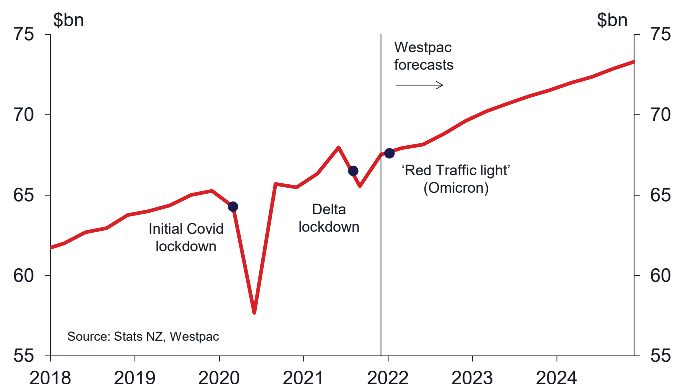
The squeeze.

New Zealand is moving into a new phase of the economic cycle as policy stimulus that boosted demand in recent years is wound back. The impact of this change will be seen most clearly in the household sector, with a further downturn in the housing market and softness in household spending. At the same time, the reopening of the borders signals big changes ahead for the hospitality sector and labour market.

For the past two years, economic activity has been buoyed by unprecedented levels of policy stimulus. That includes the large increases in fiscal spending that braced the economy in the wake of the initial lockdown. Crucially, it also includes the Reserve Bank's reductions in the Official Cash Rate, which provided a large and protracted boost to demand.

Combined with efforts to protect public health, those stimulus measures have resulted in a surprising degree of resilience in economic conditions. In fact, economic output is currently tracking close to where we thought it would have been had the pandemic not occurred. That's a striking result given the loss of international tourist dollars and the sharp downturn in population growth.

Figure 1: Quarterly GDP forecasts



However, while overall activity has held firm, conditions across the economy have been uneven. Customer facing industries, such as hospitality, have struggled with the lack of international tourists and subdued domestic demand. In contrast, conditions in other parts of the economy have charged ahead, with booming construction activity, record prices for our commodity exports and resilient durables spending.

At the same time, businesses across the economy are grappling with some significant challenges. Operating costs (excluding labour) rose by more than 8% over the past year, with ongoing disruptions to global supply chains resulting in continued shortages of materials and many consumer goods. Similarly, shortages of labour have been a handbrake on many firms' activity levels, with unemployment at its lowest level on record at just 3.2%. Against that backdrop, wage inflation has risen to its highest level since the Global Financial Crisis as businesses have struggled to attract and retain staff. We expect that wage increases will become larger and increasingly widespread over the coming year as the tight labour market provides workers with scope to push for cost-of-living adjustments (or more).

Time to pay the bill.

As a nation, we are now 'paying the bill' for the policy stimulus that was put in place to get the economy through the worst of the pandemic. That 'bill' has come due in the form of surging consumer prices, with strong demand compounding the current intense supply pressures to push inflation to a 31 year high of 6.9%. That jump in prices is squeezing households' budgets, which in turn is constraining the level of discretionary spending.

That pressure on households' balance sheets is set to become even more pronounced over the coming months. The Reserve Bank has already reversed the interest rate reductions that occurred when Covid first arrived on our shores. And as discussed in the *Inflation and the RBNZ* section, the Official Cash Rate is set to push into tight territory over the coming months. The resulting increases in borrowing costs will ripple through the economy, with a period of slower economic growth on the cards over the coming years.

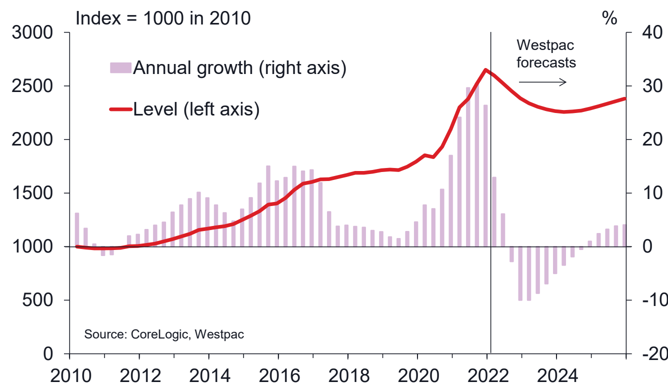
> Households are already being squeezed by the rise in inflation, and that pressure is set to become even more intense as interest rates push higher.

The impact of interest rate increases to date is already clearly evident in the housing market, with nationwide house prices down 5% since November and sales now back around pre-pandemic levels. With the OCR set to continue rising over the coming year, we now expect that house prices will fall by 10% over calendar 2022, with a further 5% drop expected over 2023

(previously, we had forecast house prices to fall by around 10% in total over 2022 and 2023).

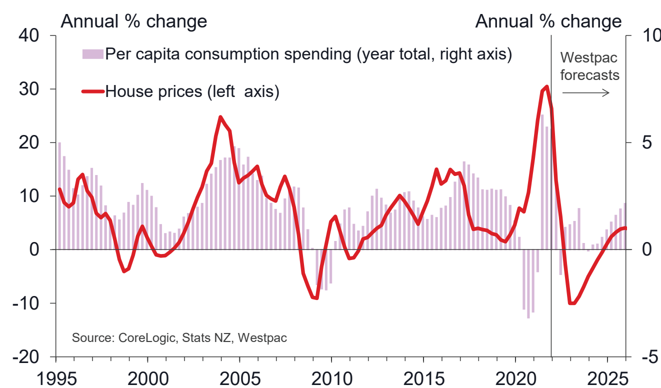
A 15% drop in house prices sounds large compared to history, but to put it in context, it would only take average prices back to where they were at the start of 2021. That illustrates the ferocity of the rise in house prices during what turned out to be a brief period of super-low interest rates.

Figure 2: House price forecasts



The housing market is a key influence on households' wealth and confidence. And just as the recent period of rapid house price gains boosted spending appetites, the slowdown now in train signals a period of softer spending growth over the next few years.

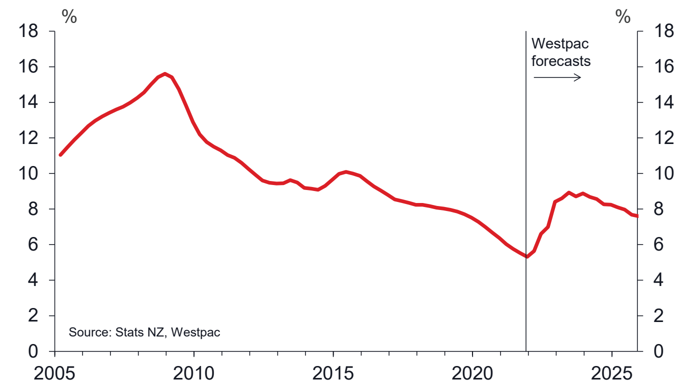
Figure 3: House prices and household spending



The rise in interest rates will also dampen household spending directly through higher debt servicing costs. In addition to those on floating rates, around half of mortgages will come up for repricing over the coming year, and another 20% will come due within two years. Many of those borrowers will face refixing at substantially higher rates. In fact, we estimate that spending on debt servicing is likely to rise from around 5% of households' disposable incomes currently to around 9% by 2023. That would more than reverse the reduction in debt servicing costs seen over the past couple of years. The resulting pressure on discretionary incomes will be a sizeable drag on both household demand and economic growth more generally.

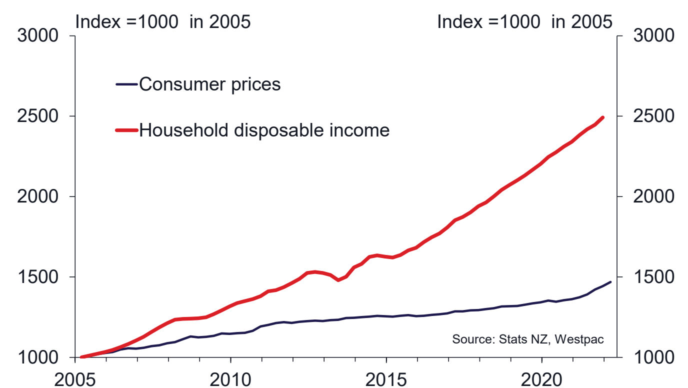
With households being squeezed by both higher consumer prices and higher debt servicing costs, there are concerns the slowdown in household spending could tip New Zealand into a recession. However, we expect that this slowdown will prove to be manageable for the economy.

Figure 4: Debt servicing costs (% of households' disposable income)



A period of slower growth is certainly on the cards. In fact, that is what is needed to dampen the demand-related domestic inflation pressures that are currently bubbling over. Many households are already feeling the pinch on their finances, and that pressure will become more intense over the next few years. However, over the past decade households' disposable incomes have risen by around 5% per annum, far outpacing the increases in the cost of living. We've also seen a rise in household saving rates. Combined, that is providing households with a buffer from the factors that are crimping their discretionary spending. As a result, the slowdown we're forecasting looks more likely to be a 'soft landing,' rather than a 'crash' (though as discussed later in this report, engineering such a slowdown will require careful economic management by the RBNZ and other policymakers).

Figure 5: Consumer prices and household disposable incomes



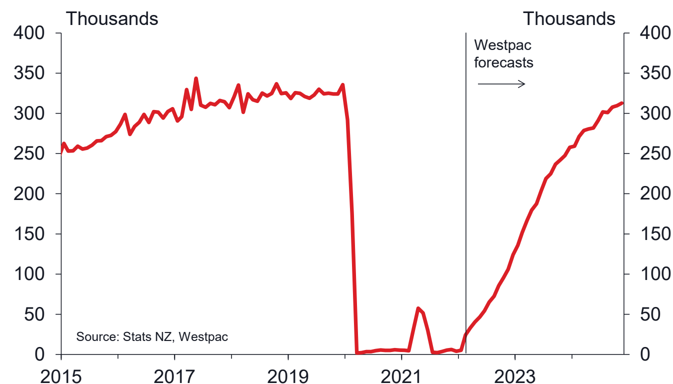
Throwing the doors open.

The downside for economic activity over the coming years will also be limited by a rotation in the drivers of growth, away from domestic spending and towards exports as our borders reopen.

Prior to the pandemic, international tourists spent around $12bn per annum in New Zealand, nearly twice the amount that New Zealanders spent on overseas holidays. The closure of our borders and related net loss of international tourist dollars has resulted in a drag equivalent to around 2% of annual nominal GDP for the past couple of years. However, that drag has already started to reverse, with visitor numbers rising quickly in recent weeks since the reopening of the border with Australia.

It will still take some time for tourist numbers to retrace the levels we saw prior to the pandemic, especially as visitors from the high spending Chinese market are unlikely to return until 2023. Even so, we expect further gains over the coming months as our doors open for visitors from other nations, and that will be a big boost for spending and confidence in our hospitality and accommodation sectors.

Figure 6: Monthly international visitor arrivals, s.a.



The relaxation of border restrictions will also have important implications for net migration and population growth. After dropping sharply over the past year, we expect to see new arrivals pushing higher again over the coming year. However, at least in the near term, we're also likely to see a rise in departures, as many young New Zealanders who have put off OEs start to travel again. That means that net migration is likely to remain negative for some time yet.

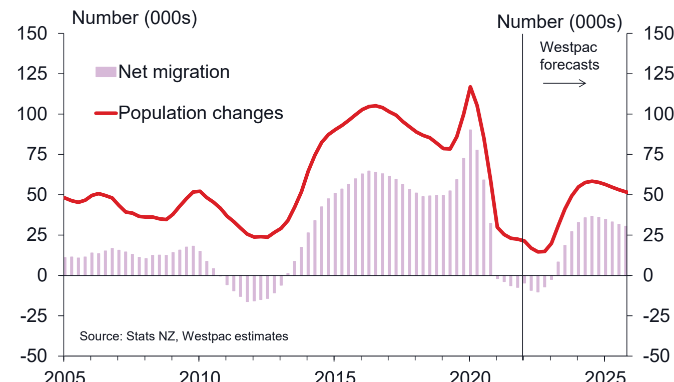
Longer term, net migration will turn positive again as the number of departing New Zealanders returns to more normal levels. Even so, we don't expect that net migration will rise back to the sort of levels that we saw over the past decade with the Government now rolling out a reset of migration policy. While still trying to address current shortages of labour, these changes are focused on supporting job opportunities and skills development among existing New Zealand residents. To achieve that aim, the Government is tightening entry requirements for new arrivals based around skill levels.

Changes in migration policy are expected to have a significant impact. As the current backlog of people waiting to enter and leave the country clears, we expect that net migration will settle at around 30,000 people per annum. That's a big step down from the annual inflows of 50,000 to 60,000 people per annum that we saw in the years leading up to the pandemic. And the effects of that change will be felt across the economy. Notably, for many businesses, especially those selling consumer goods, this change signals much more modest growth in their customer base – while population growth rose to around 2% per annum in the years prior to the pandemic, it's likely to run closer to 1% through the middle part of this decade.

This change will also have important implications for the labour market. However, with a targeted tightening of migration settings, the impacts will be varied across sectors. In particular, we're likely to see fewer lower-skilled workers arriving over the coming years, which will be particularly important in areas like retail.

In contrast, these policy changes are likely to have a smaller impact on the availability of skilled labour. Nevertheless, with the global environment improving, many businesses will still find it tough to attract highly skilled staff. Furthermore, while developing the skills base of New Zealand workers is a laudable aim, retaining those workers is likely to be a challenge with talented New Zealanders having always looked for opportunities abroad.

Figure 7: Population growth (annual)



Shaking the fiscal piggy bank.

The Government's fiscal position proved to be stronger than expected in the early stages of the pandemic, with tax revenue coming in well ahead of the Treasury's forecasts over 2020 and 2021.

Looking ahead, the Government's accounts are on track to return to surplus by 2025. At the same time, the Government has come to the realisation that it has more headroom in terms of its net debt position. That means it can borrow more for longer than it has in the past, while still maintaining its sovereign credit rating. This is providing the Government with a greater licence to ramp up spending to plug the nation's so-called 'infrastructure gap'. However, as we have highlighted before, delivering on infrastructure spending plans is an ongoing challenge, with many planned projects proceeding more slowly than expected in recent years.

In addition to investment in infrastructure, we also expect the coming years will see the Government continuing to increase spending in high priority areas like health, education and climate change.

A period of slower growth is certainly on the cards as interest rates push higher. However, this looks more likely to be a 'soft landing,' rather than a 'crash.'

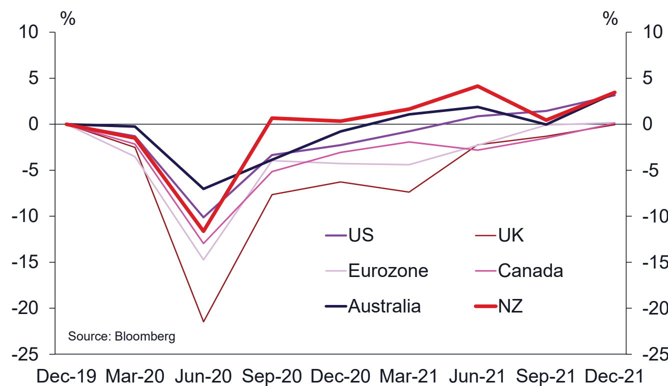
GLOBAL ECONOMY

There is such a thing as too much medicine.

Policy stimulus helped the global economy make an unexpectedly rapid rebound from the Covid recession. Arguably and in hindsight, that stimulus has been overdone, with the global economy now creaking at the seams and inflation touching multi-decade highs in many countries. Either way, the result is an aggressive policy tightening in most key global economies and, by design, a rapid deceleration in global growth.

The global economy has rebounded swiftly from the Covid-induced economic hit. After declining by 3.3% over 2020, global growth surged to 5.5% over 2021. Moreover, most developed economies have now recovered to the point where GDP now actually exceeds or equals its pre-Covid levels. The catalyst for this rapid rebound has been a massive coordinated global monetary and fiscal policy response as well as the easing of Covid restrictions.

Figure 8: GDP vs pre-Covid levels



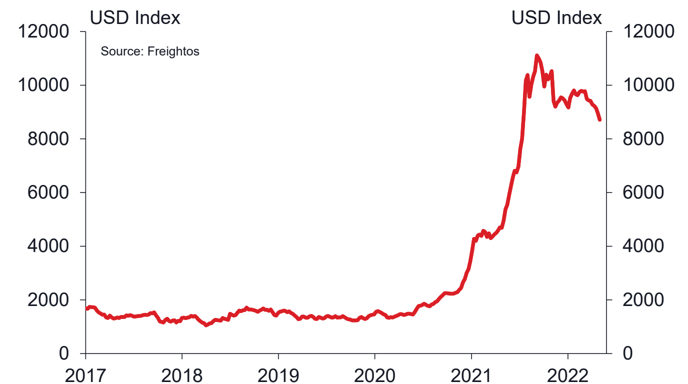
In some ways, the policy stimulus was overdone. Generally, policymakers assumed that the pandemic would mean a hit to demand, so designed policies on that basis. Whereas what the pandemic generated was a sustained hit to global supply, with the hit to demand in most countries proving by and large temporary.

Most developed economies have now recovered to the point where GDP exceeds or equals its pre-Covid levels.

Over the course of 2021, and with demand firmer than policymakers anticipated, capacity constraints quickly became apparent. And that's above and beyond the already well-publicised supply chain issues. For example, worker shortages emerged in the US, with the unemployment rate ending 2021 at 4.2%, some 2.6 percentage points lower than at the end of 2020. And notably, the improvement has continued into 2022, with the rate dropping to a very tight 3.8%.

Meanwhile, supply chain issues remain acute. Anecdotally, container ships remain backed up at major global ports, with Long Beach (Los Angeles) a particular bottleneck. And despite tentative signs of an easing, average container rates for the last four weeks are still sitting some 90% higher than this time a year ago.

Figure 9: Global container rate index



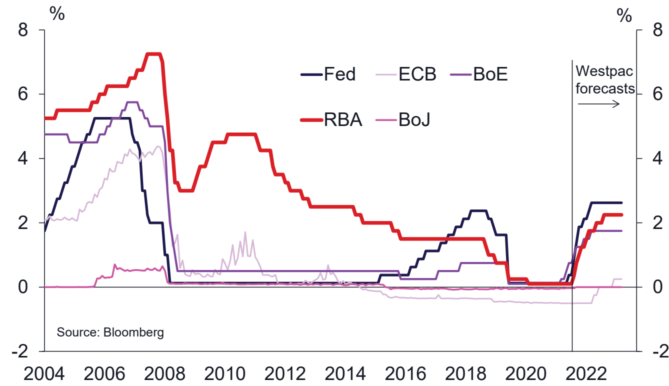
Accordingly, global inflation has spiked. In the US, annual inflation hit 8.5% in March, the highest level in over 40 years. Other countries have posted sharp rises of varying degrees.

Global central banks are reacting in force. Of the major central banks we follow, the Bank of England led the way, starting its hiking cycle back in December 2021. Now the Federal Reserve is setting the pace. After a 50 basis point hike already this month, we anticipate follow-up 50 basis point hikes in June and July and three further 25 basis point hikes later in the year.

As global central banks tame the inflation beast, global growth is set to slow. We should note of course that this is by design. While central banks can't alleviate cost pressures from supply chain bottlenecks, they can ease the demands on those supply chains via interest hikes. All up, we expect global growth to slow to 3.4% and 3.3% over 2022 and 2023, respectively. Notably, we expect growth in the major advanced economies (the US, Europe and Japan) to step down a notch over 2023,

with annual growth dipping below 2%. In contrast, and notably for New Zealand's primary export demand, 2023 growth holds up better in China and other East Asian economies (excluding Japan).

Figure 10: Global central bank policy rates



The Reserve Bank of Australia was one of the last central banks to join the fray. It started its hiking cycle in May by lifting its policy rate by 25 basis points to 0.35%. From here, we expect regular hikes, with the policy rate set to peak at 2.25% in May 2023.

Until recently, the Australian economy had seemed to avoid the worst of the global surge in inflation. But that's no longer the case, with annual inflation spiking to 5.1% in the March quarter. And strong conditions in the domestic economy mean that inflation in Australia still has some way to go before it reaches its peak. We also expect the Australian unemployment rate to dip as low as 3.2% by the end of this year, from 4% currently.

As global central banks tame the inflation beast, global growth is set to slow.

For New Zealand, relative Australian economic and labour market strength matters. A strong Australian economy and a tight Australian labour market generally means Australian firms competing hard for workers on both sides of the Tasman. This means that with the border now open again, pay rates in New Zealand will increasingly be determined in a trans-Tasman market.

Meanwhile, the outlook for Chinese economic growth is mixed. China has been battling an Omicron outbreak over recent months. Initially, the outbreak was centred in Shanghai, but now the epicentre has shifted to Beijing. At one stage, up to 400 million Chinese were reportedly under some form of Covid restrictions.

Accordingly, we anticipate that Omicron outbreak will slow Chinese growth noticeably over the June quarter. The Shanghai port is the largest seaport in the world, so Covid restrictions there can impact demand in other parts of the Chinese economy. On this basis, we have seen prices for commodities like oil soften, and similarly and importantly for New Zealand, global dairy prices have slipped too.

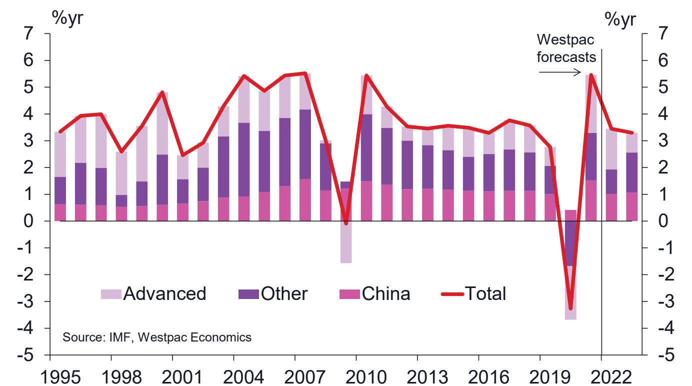
However, in the second half of 2022 we expect Chinese growth to rebound. The experience in other countries has been that Omicron waves have passed reasonably quickly. Moreover, the Chinese government's unmatched ability to stimulate the economy as necessary should further ensure Chinese growth recovers.

In turn, we expect New Zealand's commodity prices to reflect the growth path in the Chinese economy. Indeed, we've already seen global dairy prices dip over April and May on the back of the Omicron outbreak. But as discussed in the *Agricultural outlook* section, we expect that price weakness to prove temporary and for meat and dairy prices to regain some lost ground over the second half of 2022.

Meanwhile, the Russian invasion of Ukraine is also weighing on European growth and casting a long shadow on global commodity markets. Europe remains highly dependent on Russian energy supplies. And while it endeavours to diversify its energy supply, Europe is stuck with Russian oil and gas, plus it's paying higher prices for it. Unsurprisingly, this is weighing on business confidence in Europe and in turn economic activity.

The invasion is also impacting global food markets. Both Russia and Ukraine are very large grain and vegetable oil exporters, so the invasion has seen prices for both surge. With grains also an input into livestock production, there has been a similar spike in meat and dairy prices (earlier) this year. Interestingly, for New Zealand producers, higher feed grain prices actually make them more competitive as their pasture-based systems mean they can pocket more of the increase in meat and dairy prices.

Figure 11: World GDP growth



All up, not only has the global growth picture deteriorated over the last three months, but risks to the outlook have increased. In particular, global central banks face a delicate balancing act of leaning against rampant inflation without completely derailing economic growth. With this in mind, we're forecasting a period of tight global monetary policy to deal with the current bout of high inflation, but for interest rates to fall over the longer term.

INFLATION AND THE RBNZ

The needle and the damage done.

We now expect the Official Cash Rate to peak at 3.5% by the end of this year. Inflation has risen to a multi-decade high, and is increasingly a reflection of the accommodative monetary policy settings to date. The Reserve Bank faces a major challenge in threading the needle between imposing too much pain on the economy in the near term, and forcing an even harsher adjustment in the future.

The inflation targeting framework that has guided monetary policy in New Zealand for more than three decades is facing its greatest challenge yet. The inflation rate surged to 6.9% in the year to March, from a tame 1.5% just a year earlier. What's more, the seemingly relentless rise in prices is shaking people's confidence in a return to low and stable inflation over the medium term.

That surge in inflation reflects a number of factors all coming together at the same time. A large part of it has been due to cost shocks emanating from overseas, initially from Covid disruptions, and more recently other developments such as the Russia-Ukraine conflict. But it's clear that inflation has also been a product of conditions in the domestic economy, and that includes the legacy of past policy decisions.

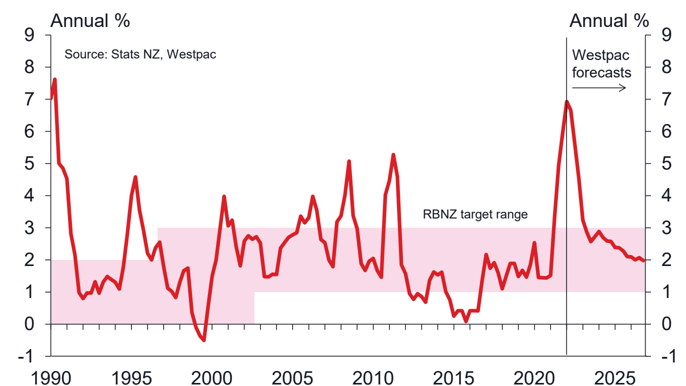
Inflation will recede from its current highs, but what it recedes to will be increasingly determined by local factors.

We think the 6.9% inflation rate in March will mark the peak for this cycle. That would have likely occurred in June instead, if not for the temporary reduction in fuel excise which we estimate will take about 0.6% off the CPI. Even as inflation recedes from its highs, we expect to remain outside the Reserve Bank's 1-3% target range until the middle of next year, and to occupy the upper half of that range for a few years after that.

Our forecast implicitly assumes that the Reserve Bank will successfully thread the needle between doing enough to uphold its credibility as an inflation fighter, while not overdoing it and sending the economy into recession. That's going to be extremely challenging, and it will require a careful understanding of the factors that have contributed to inflation, how persistent they will be, and how they will respond to monetary policy.

Consumer prices can be separated into tradables and non-tradables, broadly corresponding to those that are largely determined by international versus domestic factors. In the year to March, tradables prices rose by 8.5%, while non-tradables rose by 6.0%. That highlights the extent to which the surge in inflation has been driven by overseas forces: tradables inflation is normally much lower, reflecting the nature of those items (more goods than services) and the role of international competition.

Figure 12: Consumer price inflation



The drivers of imported inflation are well-documented by now. Covid has disrupted production around the world, at the same time that demand has shifted sharply towards physical goods over in-person services. That has put additional pressure on global shipping and transport, where it can take years to add to capacity.

We've also seen a strong lift in commodity prices from their lows, most notably oil. As world oil demand has recovered, the major producers have been slow to add to supply. Crude oil prices had already risen to a seven-year high before the Russian invasion of Ukraine, which has further exacerbated concerns about oil supplies.

We expect that some of these price pressures will fade over time, or at least won't repeat their recent rates of increase. We're forecasting tradables inflation to recede to around zero by the end of 2023, as the earlier rise in oil prices drops out of the calculation. However, under the surface we still expect to see pressure on prices across a range of industries.

That brings us to non-tradables inflation, which is also elevated and tends to be more persistent. The biggest contributor has

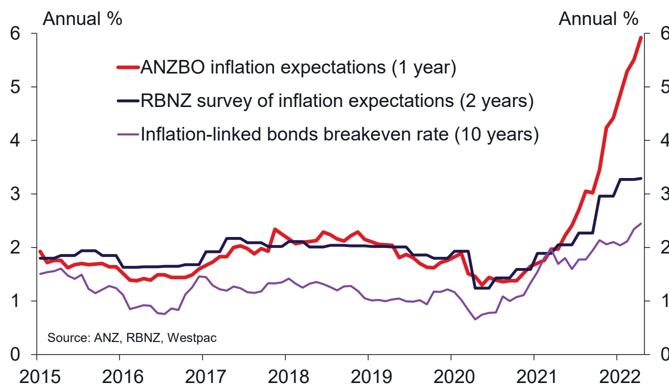
been prices for new home builds, up 18.3% in the last year. However, the past year has seen domestic price pressures becoming more widespread, especially in labour-intensive services. Strong demand for workers means that wage growth is now on the rise, and demands for cost-of-living adjustments are likely to gain momentum.

Identifying the items that have contributed to inflation is important, but it risks missing the wood for the trees. Much of the strength in non-tradables prices, and in the retail prices of imported goods, is a reflection of strong domestic demand. And a key factor behind that demand has been highly accommodative monetary policy.

While it's important to understand the individual drivers of inflation, it is ultimately a product of monetary policy.

The RBNZ has placed an emphasis on the role of inflation expectations in its recent statements. Both surveys and market-based measures have escalated over the last year. And while short-term expectations tend to be influenced by the most recent inflation result, the RBNZ will not be pleased to see that longer-term expectations are moving above the 2% target midpoint. Expectations over long time horizons are less of a forecast and more of a poll on the central bank's commitment to its inflation target.

Figure 13: Inflation expectations



As we note in the *Global economy* section, many central banks have now realised that inflation pressures are not as transitory as they hoped, and that they will now need to move aggressively to catch up. The RBNZ at least has the advantage of having started the process earlier than many of its peers. But that's only a marker of relative performance; the RBNZ will ultimately be judged on its response to New Zealand's specific conditions.

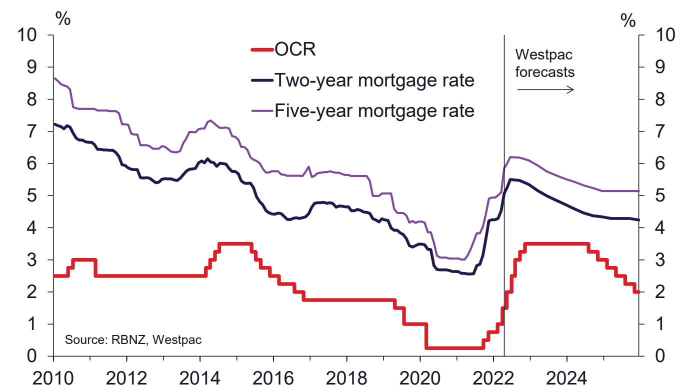
And despite a strong start, it seems that the RBNZ has erred in not following its own reasoning. In a speech last September, the RBNZ laid out a framework for when it would move the OCR in steady, gradual increments, and when it would step up the pace. The conditions for faster action were: that monetary settings were a long way from where they needed to be, that the risks to the economy were becoming skewed one way, and that there was a meaningful risk of not meeting its inflation and employment mandate over the medium term. All of those conditions had arguably been met by the time that speech was delivered. Yet the RBNZ then proceeded with cautious 25 basis point OCR hikes at the next three reviews, only stepping up the pace with a 50 basis point hike in April.

Consequently, we think that the RBNZ's focus over the coming months will be on making up lost ground. We expect further 50bp hikes at the upcoming reviews in May, July and August. We acknowledge that four in a row would be virtually unprecedented in the era of inflation targeting – but then, so is much of what central banks are facing today.

We've also lifted our forecast of the peak OCR for this cycle from 3.0% to 3.5%. We expect that to be reached by the end of this year, with two more 25bp hikes at the October and November reviews.

Our forecast is similar to the 3.4% peak in the RBNZ's most recent published projections, but it's still some way below financial market pricing, which has implied a peak of well over 4% at times. Obviously we think that market pricing is overdone – the high degree of leverage in the housing market means that a little will go a long way when it comes to raising interest rates. Even so, our forecasts agree that more will be needed than we thought a few months ago.

Figure 14: OCR and indicative mortgage rates



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Jun-22	6.7	2.00	2.70	4.00	4.10
Sep-22	5.6	3.00	3.40	4.00	4.00
Dec-22	4.5	3.50	3.60	3.90	3.90
Mar-23	3.2	3.50	3.60	3.70	3.70
Jun-23	2.9	3.50	3.60	3.50	3.50
Sep-23	2.6	3.50	3.60	3.30	3.35
Dec-23	2.7	3.50	3.60	3.10	3.20
Mar-24	2.9	3.50	3.60	2.90	3.05
Jun-24	2.7	3.50	3.50	2.70	2.90
Sep-24	2.6	3.25	3.25	2.55	2.80

AGRICULTURAL OUTLOOK

Speed wobbles.

So far, 2022 has been an exceptional year for agriculture. Export prices hit record highs. At the same time, input prices have spiked to extreme levels. These moves come as crises strike Ukraine and Sri Lanka, and as an Omicron wave sweeps China. While there are a lot of moving parts, we expect the key dairy and meat sectors will generate record returns over 2022.

Commodity prices started 2022 with a hiss and a roar. Prices in world terms sped ahead by 9.1% in the first three months, setting a new record high in the process. But since then, export prices have suffered a speed wobble. The source of the wobble is the Omicron outbreak in China and the resulting Covid restrictions, centred first in Shanghai and then Beijing. Dairy auction prices have been hardest hit – we've trimmed this season's farmgate milk price forecast by 30 cents to $9.30/kg following the price falls.

Ultimately, we expect the Chinese Omicron outbreak to prove short-lived, and as restrictions ease in the second half of 2022 we expect export prices to recover some lost ground. Indeed, this pattern has been the Omicron experience in most countries. If this assumption proves correct, we expect weak global supply will resume as the main driver of global meat and dairy prices. These supply constraints which have persisted through the pandemic and are now being compounded by the Ukraine war, have pushed global grain and other farm input prices to extreme levels. In turn, high input prices have squeezed profitability and production in our key competitor markets.

New Zealand farmers have benefitted from the squeeze on production costs relative to our competitors. Here, farmers have limited exposure to grain feed prices, so have been able to pocket more of the surge in farmgate meat and dairy prices. In addition, due to our relative success in containing Covid, there have been fewer disruptions to farm operations here than in competitor markets.

For meat, farmers are likely to see an additional tail wind from improving processing capacity. We expect this boost to lead farmgate beef and lamb prices to fresh record highs. Over the year to date, capacity dropped as low as 40% in some cases as Omicron laid low many workers in processing facilities across the country. Now, while some bottlenecks remain, capacity is returning closer to normal, and we expect further improvements over the second half of the year.

Elsewhere, the picture is less uniform. In the kiwifruit sector, local and offshore supply has surged through the pandemic. This extra supply put downward pressure on gold kiwifruit export prices last year, and we expect this downward trend to continue this year. Meanwhile, the apple sector has struggled the most with the border closure and the subsequent lack of workers. Indeed, while apple export prices have remained firm, this has not offset the revenue impact from lower apple production. Lastly, the forestry sector is different again. Forestry export prices peaked around a year ago, falling around 14% at one stage. From here, we expect prices to remain modest, although any pickup in the Chinese economy over the second half of the year may flow through to improved log export prices.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	Dairy prices surged and then wobbled over recent months. Looking through the noise, we forecast the farmgate milk price to be at or near record highs this season and next (9.30/kg and $9.25/kg, respectively).	High	↓
Lamb/Mutton	Farmgate lamb prices are at seasonal record highs. Moreover, we expect prices to reach fresh highs over the second half of 2022 as processing capacity returns to normal.	High	→
Beef	Farmgate beef prices are at average levels for this time of the year. However, as processing capacity normalises we expect prices to surge to record levels in the second half of 2022.	Average	↑
Forestry	In the short term, and with soft growth in China, we expect forestry export prices to remain low. Prices may improve modestly later in 2022 as Chinese growth improves.	Low	→
Horticulture	We expect gold kiwifruit prices to ease further this year on growing local and global supply. Apple prices are likely to remain at healthy levels, though that's on the back of a disappointingly small crop.	Above average	→
Wool	Fine wool prices remain firm as global apparel demand recovers. In contrast, rising Australian wool production is keeping a lid on other wool prices.	Low	→

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

EXCHANGE RATES

Grounded.

After soaring earlier in the year, the New Zealand dollar has crashed back down to earth in recent weeks as global risk sentiment has turned increasingly negative. We expect the Kiwi will regain some ground against the US dollar and other major currencies over the coming months. However, the potential for gains relative to the Australian dollar looks more limited.

After rising through the early part of the year, the New Zealand dollar has tumbled in recent weeks, giving back most of its earlier gains. The New Zealand dollar has fallen particularly sharply against the US dollar, dropping by around 10% to below 63 US cents at the time of writing.

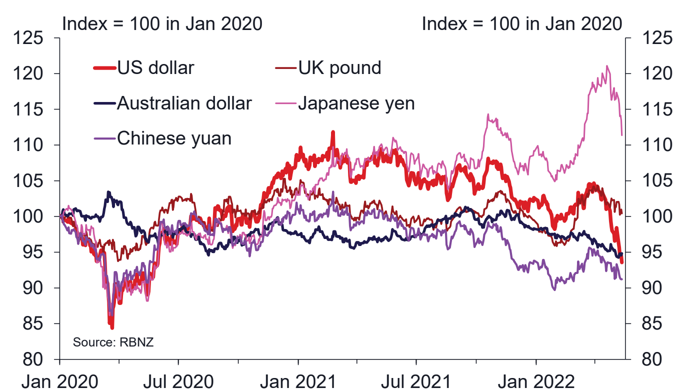
For the most part, the weakness in the New Zealand dollar has actually been a reflection of broader US dollar strength. Global risk sentiment has turned increasingly negative in recent months in response to the ongoing conflict in Ukraine, as well as more general concerns about global growth. The related nervousness has seen investors shunning riskier currencies, like the New Zealand dollar, in favour of the perceived safe haven of the US.

The US dollar has been further boosted by the growing upside risk for inflation, which has seen markets pricing in a rapid tightening in US monetary policy over the coming months.

Similarly, inflation concerns have also seen markets repricing the chance of rate hikes from other central banks across the globe. That has seen the New Zealand dollar also losing ground to the pound, the euro and Australian dollar in recent weeks.

The downward pressure on the Kiwi has also been reinforced by the recent easing in prices for some of our key commodity exports (discussed in the *Agricultural outlook* section).

Figure 15: NZ dollar exchange rate vs major currencies



The New Zealand dollar is expected to reclaim some ground against the US dollar and other currencies through the back half of the year. Relative to fundamentals, such as the strength of our commodity prices, the fall in the New Zealand dollar already looks overdone. And with demand for our commodity exports set to remain firm, we expect the New Zealand dollar will be well supported over the coming months. We also expect the strength in the US dollar to fade towards the end of the year as some of the recent sharp increase in expectations for tightening by the Fed is scaled back.

In contrast, the New Zealand dollar is set to hold around 91 cents against its Australian counterpart through to the end of the year. That reflects a combination of factors. Prices for Australian commodities have risen by a much greater extent than those for New Zealand's key exports, and Australian export volumes have surged on the back of strong demand. Consequently, Australia is now running trade surpluses (in contrast to New Zealand's continued deficits). However, balanced against that firmer trade position, financial markets appear to be significantly overpricing the extent of likely interest rate hikes from the RBA (and by a greater extent than in New Zealand). The eventual unwinding of those positions will leave the Australian dollar weighed down relative to its New Zealand counterpart.

Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Jun-22	0.65	0.90	0.61	0.52	83.9	71.3
Sep-22	0.67	0.91	0.62	0.53	85.8	72.6
Dec-22	0.69	0.91	0.63	0.54	86.9	73.8
Mar-23	0.70	0.91	0.63	0.55	87.5	74.0
Jun-23	0.71	0.91	0.63	0.55	88.0	74.4
Sep-23	0.72	0.91	0.63	0.54	87.2	74.4
Dec-23	0.72	0.90	0.63	0.54	87.1	74.6
Mar-24	0.72	0.90	0.62	0.54	86.1	74.2
Jun-24	0.72	0.89	0.62	0.54	85.1	73.7
Sep-24	0.71	0.89	0.61	0.53	84.1	73.3

SPECIAL TOPIC

Professional services on the cusp of change.

Professional services will play an important role in helping businesses to find new efficiencies in this Covid-disrupted environment, as well as ways to address changing customer and societal demands. Digital technologies threaten to disrupt existing business models, and challenge firms to find new ways to add value for their customers.

The professional services sector has consistently outperformed the wider economy in recent years, even during the Covid lockdown in 2020 when activity shrank by less than national GDP. That experience underscored the perception of this sector being 'recession proof', with different services in demand at different points in the economic cycle.

As the country moves beyond the initial strong public health response and adapts to living with Covid on an ongoing basis, we think that demand for professional services will continue to outperform. Previously shelved projects are starting to make their way back on the table. A sharper focus on improving resilience to external shocks and positioning for growth is also expected to fuel demand for additional services.

Much of these gains will be due to customers looking to get the best out of the investments they have previously made in new digital technologies, such as artificial intelligence, robotics automation, blockchain and cloud computing. That investment accelerated during Covid as firms sought to mitigate the operational impacts of social distancing and remote working requirements. Ensuring competitiveness and filling capacity gaps will continue to be a key driver of demand for professional services.

Other areas of growth are likely to include providing advice on environmental, social and governance issues. Businesses are already under pressure to ensure their views on these issues align with those of their stakeholders, customers and employees. In the future, those demands will mean that firms will have to show they have taken practical steps to limit the impact of their activities on the environment. They will also have to show how they have supported efforts to increase diversity and equality, and have operated in a clear transparent manner.

Advances in digital technology create both challenges and opportunities for professional service providers. Ease of access to information is already raising customer expectations as to what professional services can offer. The ability to compare competing offerings only adds to the competitive pressures that professional services providers face. At the same time, these technologies are allowing the entry of new market players capable of delivering low-cost substitutes, putting further heat on firms within the sector.

These dynamics are set to accelerate change within the sector. As competition increases and industry rivalry intensifies, professional services firms are likely to automate and commoditise an increasing range of services. Either that or they will outsource the provision of these low margin services to third party vendors better placed to deliver them.

The focus will shift towards delivering added value to customers. Professional service firms will be judged less on the services they provide and more on how they help customers achieve the outcomes they seek. Customer success will become the new measure which professional service products will use to assess their own performance.

In the first instance, that will mean having ready access to right quantity and quality of factor inputs. The ability to attract the right skills and knowledge will be critical, especially in an environment where competition for talent is intensifying and the requirement for skills is expanding well beyond technical competencies. Technology can help by facilitating access to talent wherever it might be, and by enabling the creation of virtual teams that can be tailored to specific tasks.

Successful firms also need to be able to ride the digitisation wave. Investment in new digital technologies is a must, although that does not mean that service providers need deep pockets. Indeed, many providers are likely to outsource their technology requirements by purchasing information, platform capabilities and software as a service.

In the second instance, that will mean having the wherewithal to combine human capital and technology to deliver services that customers want. Digital technologies are again likely to loom large, as service providers move from traditional hierarchical operating models where teams work in silos towards network-based models where flexible, scalable, multi-disciplinary teams take on end-to-end accountability for service delivery. That in turn is likely to promote empowerment, collaboration and entrepreneurship, all of which are critical for delivering improved value to the customer.

ECONOMIC AND FINANCIAL FORECASTS

New Zealand forecasts

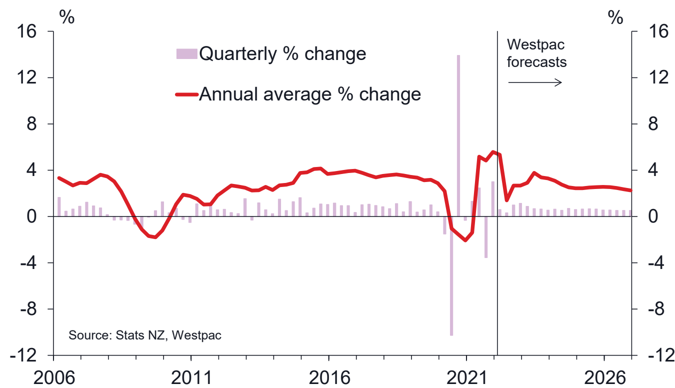
GDP components	Quarterly % change				Annual average % change			
	Mar-22	Jun-22	Sep-22	Dec-22	2020	2021	2022	2023
GDP (production)	0.6	0.3	1.0	1.1	-2.1	5.6	2.7	3.3
Private consumption	2.3	-1.5	0.9	0.1	-1.1	6.2	1.5	0.6
Government consumption	-2.0	-1.5	0.3	0.2	6.8	10.2	2.1	0.6
Residential investment	3.0	2.0	1.5	1.3	-3.2	10.8	6.8	4.1
Business Investment	-3.7	2.0	1.7	2.0	-8.7	9.1	5.3	5.3
Exports	-3.1	0.6	6.9	4.1	-12.7	-3.0	2.1	13.9
Imports	-1.7	0.7	1.5	1.5	-16.1	15.7	5.2	5.0
Economic indicators	**Quarterly % change**				**Annual % change**			
	Mar-22	Jun-22	Sep-22	Dec-22	2020	2021	2022	2023
Consumer price index	1.8	1.1	1.2	0.4	1.4	5.9	4.5	2.7
Employment change	0.1	0.3	0.2	0.2	0.6	3.5	0.8	0.9
Unemployment rate	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
Labour cost index (all sectors)	0.8	1.1	1.1	1.0	1.6	2.6	4.0	4.3
Current account balance (% of GDP)	-5.9	-6.8	-6.9	-6.6	-0.8	-5.8	-6.6	-5.6
Terms of trade	1.4	0.5	-0.7	-1.5	-1.6	2.6	-0.3	-0.3
House price index	-2.0	-2.8	-2.9	-2.7	17.0	26.4	-10.0	-5.0
Financial forecasts	**End of quarter**				**End of year**			
	Mar-22	Jun-22	Sep-22	Dec-22	2020	2021	2022	2023
90 day bank bill	0.98	2.70	3.40	3.60	0.27	0.69	3.60	3.60
5 year swap	2.93	4.10	4.00	3.90	0.31	2.46	3.90	3.20
TWI	72.5	71.3	72.6	73.8	72.9	74.3	73.8	74.6
NZD/USD	0.68	0.65	0.67	0.69	0.69	0.70	0.69	0.72
NZD/AUD	0.93	0.90	0.91	0.91	0.94	0.95	0.91	0.90
NZD/EUR	0.60	0.61	0.62	0.63	0.58	0.61	0.63	0.63
NZD/GBP	0.50	0.52	0.53	0.54	0.52	0.52	0.54	0.54

International economic forecasts

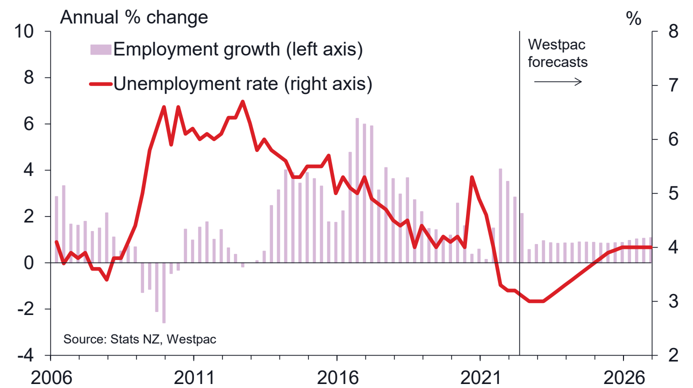
Real GDP (calendar years)	Annual average % change					
	2018	2019	2020	2021	2022f	2023f
Australia	2.8	2.0	-2.2	4.7	4.5	3.5
China	6.7	5.8	2.3	8.1	5.3	5.5
United States	3.0	2.2	-3.5	5.7	2.6	1.8
Japan	0.6	0.3	-4.8	1.8	2.2	1.4
East Asia ex China	4.4	3.7	-2.4	4.2	4.5	4.7
India	6.5	4.0	-8.0	9.0	8.0	6.5
Euro Zone	1.9	1.3	-6.6	4.9	2.2	1.5
United Kingdom	1.3	1.4	-9.9	7.2	3.7	0.0
NZ trading partners	4.1	3.4	-1.8	5.8	4.2	3.8
World	3.6	2.8	-3.3	5.5	3.4	3.3

THE ECONOMY IN SIX CHARTS

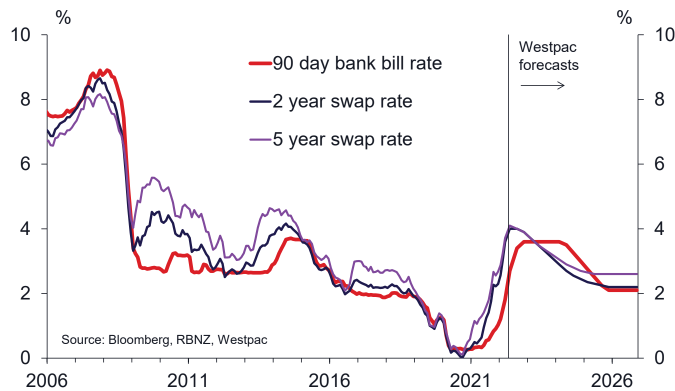
New Zealand GDP growth



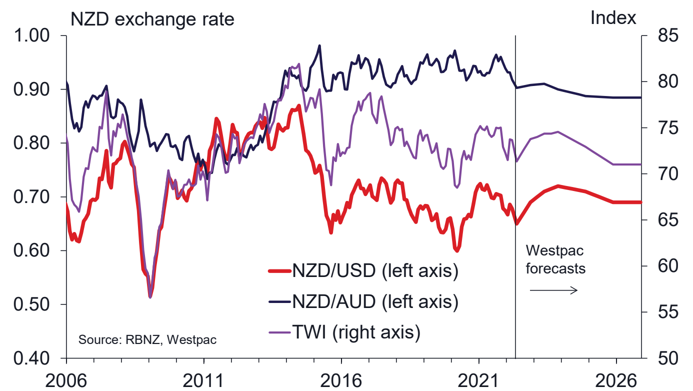
New Zealand employment and unemployment



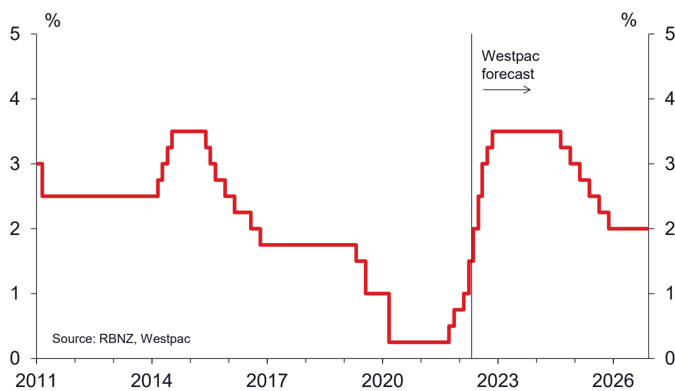
90 day bank bills, 2 year swap and 5 year swap rates



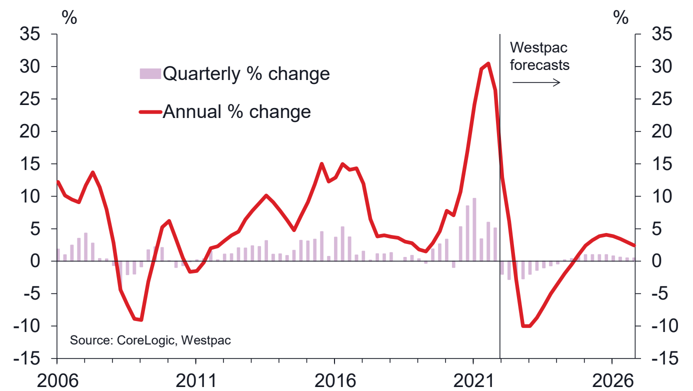
Exchange rates



Official Cash Rate



New Zealand house prices



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