



# ECONOMIC OVERVIEW

**Staying the course.**

February 2024



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## A NOTE FROM KELLY

Some progress on reducing inflation and economic rebalancing has occurred, but there is still a way to go until the job is done. That's pretty much the theme of our *Economic Overview* this time around. The economy looks quite weak and has been going sideways for the last year or so. The global business environment remains challenging, and the tourism sector is underperforming our more optimistic expectations of last year. There are some tentative signs of improved times for aspects of the economy (for example the dairy sector is seeing better returns now). But for most households and businesses, 2024 looks like a year where we hunker down and complete the job.

Inflation remains uncomfortably high even though there has been a good amount of progress towards the RBNZ's 1-3% target range since our last update in October last year. We now feel more comfortable that inflation will move below 3% by the end of 2024. But stickiness in core inflation suggests it won't be until 2025 before we can confidently say that the inflation dragon has been slain and that 2% inflation will be reached.

In the near term, we see the RBNZ remaining on edge as they need to see those sticky core inflation rates fully normalise. On the positive side, the faster than expected fall in headline inflation has helped to assuage concerns about inflation expectations, and the very weak economic momentum gives confidence that inflation will continue to moderate given time. But a key issue for the RBNZ is how very strong population growth will impact domestic demand, rents, and the housing market. We see some very mixed signals given that rents are running much stronger than what is consistent with a normalisation of domestic inflation, while the housing market has not kicked on from its promising start in mid-2023. Firms are reporting an intention (or is that hope?) that they can continue to push increased costs onto consumers. The labour market is not easing as quickly as might have been hoped, raising the potential that wage growth might not moderate fast enough. Finally, our short-term forecasts for non-tradables inflation suggest it will be mid-2024 before the data will unequivocally show more normal domestic inflation.

We see two-sided risks around our core view that the OCR remains unchanged until early 2025. We feel the more likely scenario is that the OCR will start moving lower at the beginning of 2025 as weak economic momentum and a looser labour market take hold. But the risks of further OCR increases can't be discounted – especially if it starts taking longer for core inflation to adjust, if something such as the tense geopolitical factors currently at play disrupts the disinflation process, or if population growth translates into an earlier pickup in the housing market or consumer demand.



**Kelly Eckhold**  
Chief Economist

# EXECUTIVE SUMMARY

## The big picture

**GDP growth stalled over 2023 and current economic momentum appears limited. Tight financial conditions continue to weigh on demand as reflected in weak household spending and businesses' forward orders, while the housing market has been tracking sideways. However, the headwinds that have buffeted the economy are gradually easing and that will support a recovery in growth over time.**

Economic activity has been tracking sideways over the past year, and we're forecasting the economy will grow by just 0.5% this year.

Households and businesses have been significantly challenged by large increases in consumer prices and operating costs, as well as the related rise in interest rates. Although the intensity of those headwinds is starting to ease, tight financial conditions will continue to be a brake on spending and economic growth over 2024.

An additional challenge is a tough external environment. In addition to shipping disruptions stemming from geopolitical tensions, we continue to see sluggish demand in some key export markets, most notably China. Weak external demand saw prices for our key commodity exports drop by nearly 25% over 2022 and 2023. We expect modest gains in commodity export prices over the coming year, underpinned by a lift in dairy and to a lesser extent meat prices.

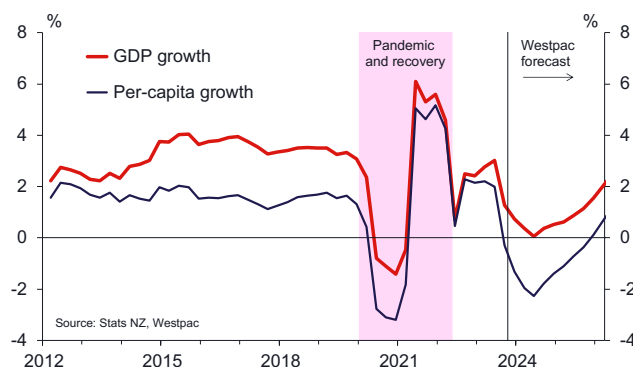
Despite those headwinds, record net migration and a multi-decade high in population growth of 2.6% have provided a floor under activity. That's helped boost the demand for some consumer goods, as well as housing and rental accommodation. Migration has also alleviated staffing shortages that many businesses have struggled with in recent years.

Demand is also being supported by the continuing recovery in international tourism as overseas visitor numbers have now recovered to around 80% of their pre-pandemic levels. That's been a welcome respite for hospitality businesses in many parts of the country, helping to offset the downturn in domestic spending appetites. 2024 is likely to see further increases in international visitors from high spending markets like the US, although flagging momentum in Chinese visitor numbers means we see a more protracted recovery in the tourism sector.

All of this leaves us with a mixed picture of economic conditions. While GDP growth has been weak and should remain subdued over the year ahead, the labour market has not eased by as much. Businesses continue to take on staff and the unemployment rate remains relatively low at just 4%. Importantly, that resilience in the labour

market has likely contributed to persistent domestic inflation pressures. The housing market has moved sideways in the last three months, but should pick up as the year progresses.

**Figure 1: GDP growth (annual average)**



Although New Zealand is on course for another tough year, there is light at the end of the tunnel. The sharp tightening in monetary policy over the past few years has been working, with inflation having already fallen from rates of over 7% in 2022 to 4.7% at the end of 2023. Importantly, inflation is set to continue easing over the year ahead. As that occurs, we're likely to also see borrowing costs starting to come back down.

That eventual easing in interest rates and improvements in households' purchasing power will help to restimulate demand over time. Lower interest rates will also support a reacceleration in the housing market, as well as a related lift in construction activity.

We're forecasting that OCR reductions will begin in early 2025, with GDP growth lifting to 1.6% over the course of that year. However, the scope for interest rate cuts depends crucially on what happens to inflation. As discussed in the *Inflation and the RBNZ* section, domestic inflation has remained 'sticky,' lingering at rates well above the RBNZ's target. If those pressures persist, the RBNZ may need to either keep its foot on the brake for even longer or even raise rates, and the recovery in activity could be delayed.

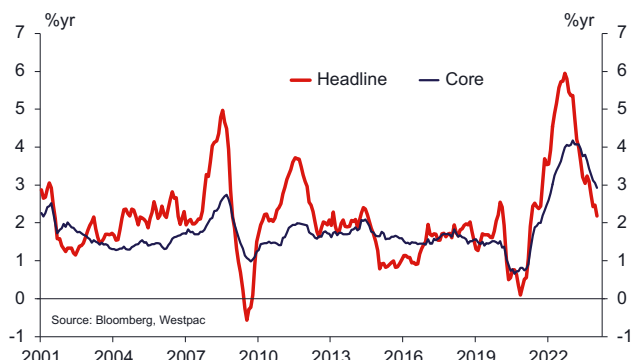
# GLOBAL BACKDROP

## Monetary policy easing draws closer as inflation subsides

The outlook for trading partner growth is fractionally stronger than forecast in our October *Economic Overview*, albeit still somewhat below the long-term trend. But with most central banks making progress in lowering inflation back towards their respective targets, global monetary policy seems likely to become less restrictive from around the middle of this year.

The global economic backdrop that underpins our New Zealand economic forecasts has changed little in recent months. Trading partner growth seems set to remain somewhat below its longer-term trend, restrained by tight monetary policy settings in most countries (with the notable exception of China and Japan). But with global inflation continuing to decline, the outlook for monetary policy is on track to become less restrictive in many advanced economies from around the middle of this year.

Figure 2: Annual inflation, trading partner average



We estimate that New Zealand’s key trading partners grew by an average of 3.4% in 2023. Looking ahead, we expect that they will also grow 3.4% both this year and next – slightly stronger than the outlook contained in our October *Economic Overview*. It is worth noting that while growth has resumed following the pandemic, the level of global GDP remains lower than it likely would have been had growth continued at pre-Covid trends (as also occurred following the Global Financial Crisis shock).

The small upward revision to growth this year owes to a much stronger outlook for the US, which has more than dominated small downward revisions to growth for some other trading partners (notably the euro area). Indeed, we now expect that the US economy will grow 2.6% this year – 1.2ppts more than we had forecast in October – before slowing to 1.3% next year. Despite the greater than expected resilience of the US economy, inflation has continued to show steady progress lower. Indeed, over the past six months, the core PCE deflator – the Federal Reserve’s preferred metric – has increased at

an annualised rate that is consistent with the 2% annual inflation target.

Figure 3: World growth

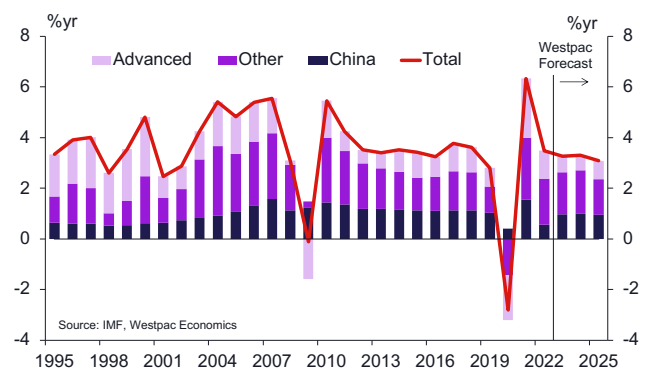
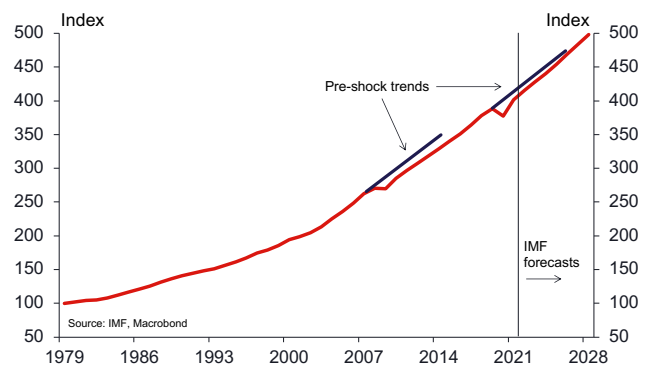


Figure 4: World GDP

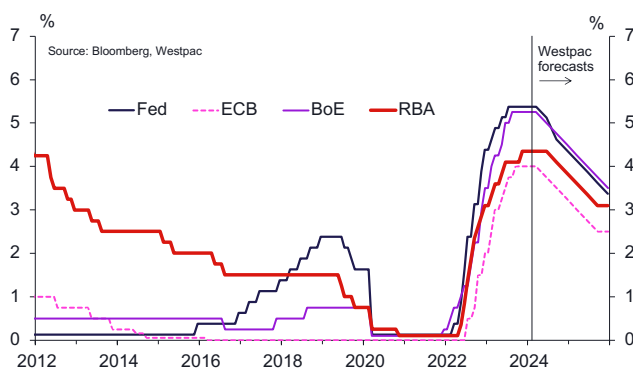


However, as is the case elsewhere, disinflation has been strongly led by goods prices, with disinflation in the services sector showing much less progress. And so, with the US labour market remaining robust, Chairman Powell has noted that Federal Reserve policymakers are yet to gain sufficient confidence to begin a monetary policy easing cycle. That confidence will grow if recent good inflation outcomes are sustained over coming months, as we expect. Westpac Economics forecasts that the Federal Reserve will begin to ease policy in June and reduce interest rates by 100bps this year and a further 100bps over 2025. We expect that this reduction in US interest rates will impact New Zealand’s financial markets – especially the New Zealand dollar.

The Chinese economic outlook is slightly weaker than we had expected in our previous *Economic Overview*. China grew 5.2% in 2023 and that rate of growth is expected to be sustained in 2024, before slowing slightly to 5.0% in 2025. This relatively solid aggregate profile hides some quite disparate conditions across sectors that pose risks to New Zealand’s economic outlook. China has aggressively invested in high-tech industries, and focussed research and development into electric vehicles, batteries and other goods tied to the green transition. However, less helpfully for New Zealand, Chinese consumer demand remains weak reflecting uncertainty around household incomes and wealth, with home prices falling and the domestic equity market trading at a multi-year low. The absence of Chinese demand has contributed to the weakness in many of New Zealand’s key export commodity prices over the past year.

Economic conditions remain much more difficult in Europe. GDP growth in the euro area was just 0.5% in 2023 – with growth between the December quarters of 2022 and 2023 even weaker at just 0.1% – and similarly tepid growth is forecast for the current year. Conditions are even weaker in the UK. Following a disappointing December quarter, in which the economy contracted 0.3%, growth in 2023 was just 0.1%. The good news is that inflation in both economies has declined more rapidly than had been expected some months ago. As a result, Westpac expects that both the European Central Bank and the Bank of England should be in position to begin easing monetary policy from around the middle of this year. Both central banks are expected to reduce their policy rates by 75bps this year and then further towards more neutral levels in 2025.

**Figure 5: Global central bank policy rates**

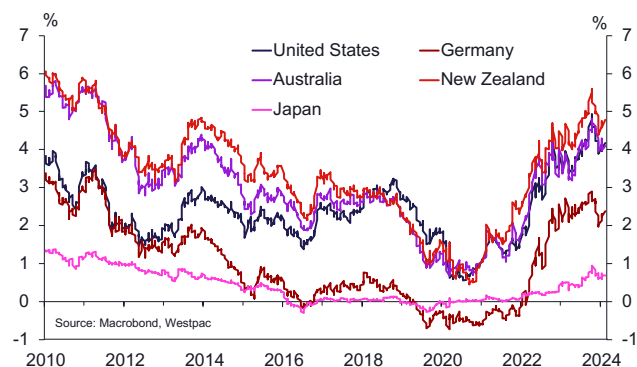


Across the Tasman, we expect the Australian economy to grow just 1.3% this year, down from 2.0% last year. Households remain under considerable pressure from tight monetary policy – especially after the additional rate hike implemented by the RBA late last year – and from the fiscal drag created by high inflation and taxation. The previously tight labour market is easing, with the unemployment rate rising amidst strong growth in labour

supply. Importantly, after peaking at 7.8% in 2022, CPI inflation declined to 4.1% at the end of last year.

Because the rapid unwind in the effect of supply shocks on goods inflation is largely over, the next leg of the Australian disinflation process requires a decline in services inflation, which is likely to be slower. Even so, a further moderation is in prospect for 2024. Westpac forecasts Australia’s CPI inflation to reach 3% by the end of this year – the top of the RBA’s target band. Given this outlook, Westpac expects the RBA to reduce its policy rate by 50bps in the latter part of this year – likely beginning around September – and by a further 75bps over the course of next year. As a result, we expect the Australian economy to gradually gather pace later this year, with growth strengthening to 2.2% in 2025.

**Figure 6: Global 10-year bond rates**



While our baseline global economic outlook is reasonably benign, it is not without risks. Geopolitical risks, such as those associated with the conflicts in the Middle East and Ukraine, and with the outcome of this year’s US presidential and congressional elections, have the potential to both undermine global growth but also boost global inflation. We discuss these risks in more detail as a special topic in the next section of this report.

Economic risks include the possibility that the present downward trend in global inflation will stall, or even reverse, especially if labour markets remain surprisingly resilient. This would cause central banks to deliver less monetary policy easing than presently seems likely, weighing on global growth. While bond yields have fallen in recent months, governments in many jurisdictions remain under pressure to address unsustainable fiscal deficits – the scale and timing of fiscal consolidation is uncertain. And finally, risks to Chinese consumer demand remain skewed to the downside, and if realised would continue to weigh on prices received for key export commodities.

# SPECIAL TOPIC: GEOPOLITICAL RISK

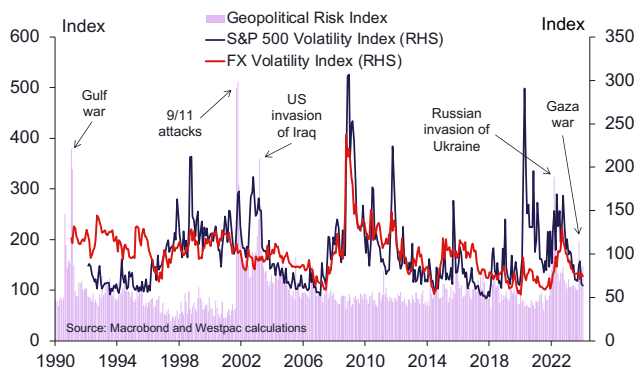
## Geopolitical risks to the New Zealand economic outlook

Geopolitical risks are elevated on several fronts. Currently the key issues are the Russian war in Ukraine and Middle Eastern tensions stemming from Israel's war in Gaza. Right now, the fall-out from these risks is noticeable but modest for New Zealand. But there is potential for more significant impacts on global trade, financial flows and inflation should the existing risks have broader impacts or if simmering tensions with our major trading partner China increase.

Much of the last 35 years after the end of the Cold War has been characterised by placid geopolitical risk conditions. The long period of relative stability has been supportive of global trade and investment flows. Increased globalisation has boosted trade, increased access to financing and helped keep inflation low. Small open economies such as New Zealand benefited significantly due to our reliance on trade and a structural current account deficit.

This placid environment has been changing and geopolitical risk measures have increased to the upper quartile seen since 1990. Key drivers are the ongoing Russian war in Ukraine and the recent war in Gaza. Underneath these higher profile issues, there are rising tensions between the West (especially the US) and China.

Figure 7: Geopolitical Risk Index, FX and Equity Volatility indices



Financial markets don't generally reflect these elevated risks. Implied volatility levels in equity and FX markets are both relatively low. This raises the possibility that financial markets might eventually come to reflect these risks should they grow or broaden. This might have implications for global financial flows and the exchange rate as there is often an inverse relationship between the New Zealand dollar and global risk sentiment indicators.

Elevated geopolitical risks could impact New Zealand through shipping costs, inflation and export incomes. Shipping and insurance costs were particularly impacted by the Covid-19 disruptions and contributed to sharply higher inflation in New Zealand 6-12 months after these

began to rise in 2020. The current rise in container shipping costs is more modest as global supply chains have not been as broadly impacted. Increased transportation times associated with re-routing shipping away from the Red Sea and Suez Canal is stretching shipping resources but has only had around a quarter of the impact of the Covid-19 shock (which impacted the entire supply chain). Currently, it seems that increased costs might impact New Zealand import prices around mid-2024 by a relatively modest 0.2-0.3% in CPI terms. The final impact will be attenuated by the size of the final impact and the length of time disruptions persist. Much larger impacts would occur if Middle East tensions impacted global oil prices. New Zealand exporters and importers could end up absorbing some of these costs if it proves difficult to pass them on.

Figure 8: Global shipping costs versus New Zealand shipping costs



While the impact of recent geopolitical risks on New Zealand have been modest so far, a larger impact could occur if New Zealand's largest trading partners become more significantly impacted. Looking forward, New Zealand faces a more direct challenge from rising tensions between two of our largest trading partners: China and the United States. The outcome of the 2024 US presidential election and potential for a rockier trade and capital flow environment could be much more significant for New Zealand's growth, inflation, and exchange rate.

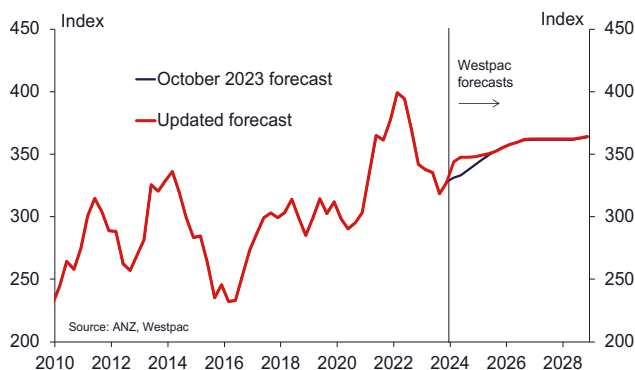
# THE EXPORTS AND CURRENT ACCOUNT OUTLOOK

## A slightly better outlook

Following a tough 2023, during which merchandise export returns were hindered by climatic factors and weak commodity prices, prospects for the coming two years look better. New Zealand’s very large current account deficit should narrow by slightly more than we forecast previously.

Last year was a tough one for many exporters, especially in the last six months, with total merchandise exports almost 11% lower than the comparable period in 2022. Volumes were broadly flat, not helped by poor climatic conditions earlier in the year. More importantly, prices for many of New Zealand’s key export commodities were weak, with softness in consumer spending in key markets, as well as excess supply of some commodities such as dairy products and lamb. Fortunately, the outlook for the period ahead is more favourable, although growth in both export volumes and prices is likely to still be modest.

Figure 9: New Zealand commodity price index



As far as commodity prices are concerned, we expect a 5.3% increase over 2024, with price gains easing into 2025. That reflects a slightly stronger near-term pickup in prices than our previous forecast. In late 2023, we had expected export commodity prices to rise by 4.2%.

Much of that has to do with a lift in dairy prices, which have been trending higher since August 2023. Since early November, dairy auction prices have risen by a cumulative 13%, with gains being seen across all product categories. That said, prices are still only a touch higher than their long-term average, confirming that this is hardly a bumper year for farmers – especially considering the cost increases that farmers have faced over this period.

Meat export prices are expected to edge higher over the next couple of years. For lamb prices, two key dynamics are at play. The first is the supply of lambs being processed and exported from Australia. Dry weather in Australia up until recently had seen an increase in supply of lamb and depressed prices. We see that supply dropping back in coming months which should help support prices. The second factor is that the eventual recovery of Chinese demand should ultimately support lamb and mutton prices in coming years.

### Farmgate milk prices.

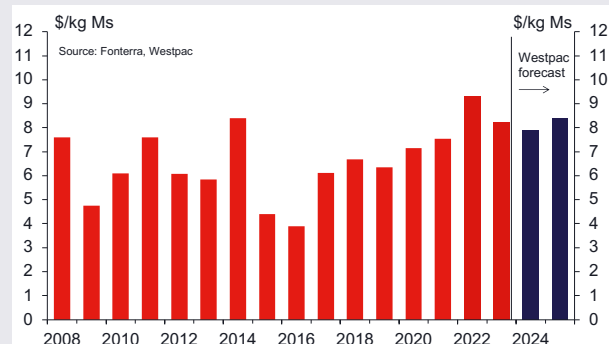
We forecast a 2024/25 farmgate milk price of \$8.40/kg. Combined with an easing in prices for some on-farm inputs, this should leave farmers modestly above breakeven on average.

Near-term, world dairy prices are expected to remain relatively steady. Growth in the Chinese economy is expected to remain subdued, though we have seen this counterbalanced more recently by stronger demand from other regions.

Global milk supply is expected to grow modestly this year, with New Zealand production likely to be slightly up on last year. In contrast, environmental regulations

have driven a substantial drop in European milk production recently.

Figure 10: Milk price forecast





Beef prices are also likely to increase gradually, albeit for different reasons. Although off historical highs, beef prices have performed relatively well in recent years, underpinned by supply shortages and the strength in demand from the US consumer for imported beef. We expect that to remain the case over the next few years. Also, we think prices will increasingly be driven by a recovery in Chinese consumer demand for premium meat products.

Meanwhile, export log prices are likely to consolidate at around current levels in 2024, with Chinese importers expected to continue replenishing port-side log inventories. Thereafter we expect prices to lift on the back of a gradual recovery in China's real estate market which should support log demand from China's huge building and construction sector.

The outlook for the horticultural sector looks increasingly positive following a very challenging 2023. Good weather conditions over the recent spring and summer periods suggests a good level of orchard growth for both green and gold varieties of kiwifruit, with production set to increase by about 29% for the year ending March 2025. Similarly, apple production is forecast to grow 5% in 2024, because of good growing conditions in the Hawke's Bay and Nelson regions and additional plantings in other parts of the country prior to Covid. With supply outpacing demand in key export markets, prices are expected to moderate over the coming year. Thereafter, we expect a recovery in demand to push prices higher.

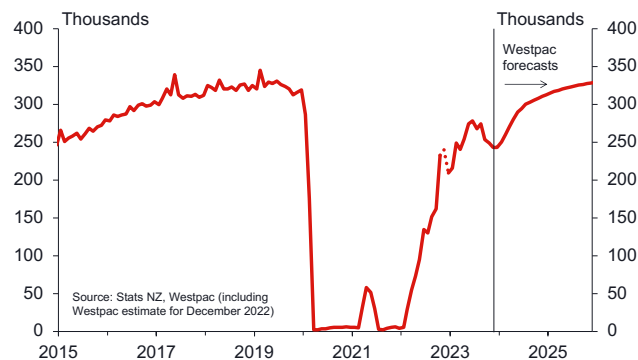
As far as non-food manufactured exports are concerned, growth is likely to remain subdued. Indeed, for some time now, exports of textiles and wood products have been trending lower, while exports of chemicals have trended sideways. As a result, in the most recent quarter, export volumes for non-food manufactured goods were at a similar level to that seen in 2010. Given the relatively subdued global backdrop and our outlook for the exchange rate, there seems little reason to think that this soft trend won't continue.

Growth in service exports has slowed, in part because of an easing of the previously rapid recovery of visitor arrivals to New Zealand. Arrivals have fallen by about 10% since the FIFA women's world cup in July and August and are currently at about 80% of their pre-Covid levels. That said, visitor arrivals from most key source markets continue to grow, but at a slowing pace.

The laggard has been China, our second largest source of international visitors. Visitor arrivals from China seem to have stalled at about 50% of pre-Covid levels. In part that can be attributed to delays in bringing airline capacity on board and the time taken to process travel documents. Furthermore, with the New Zealand summer now largely over, we think that Chinese visitor arrivals will only return in greater numbers next summer. All up we think

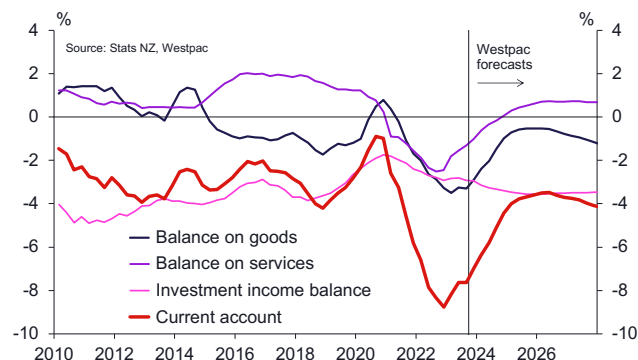
that visitor arrivals will revert to trend, with growth expected to slow over coming years.

**Figure 11: International visitor arrivals**



Our forecasts imply that the annual current account deficit should continue to narrow from the peak of 8.8% of GDP reached at the end of 2022. We estimate that the deficit ended last year at 7.0% of GDP and that it will end this year at around 4.4% of GDP – about 1% lower than we forecast in our October *Economic Overview*. The deficit will narrow further in 2025 but remain a little higher than the 3% of GDP average that was experienced in the decade preceding the pandemic. The improvement since our last forecast is mainly driven by the goods balance, with the deficit shrinking amidst improving commodity prices, a recovery in export volumes and subdued import demand. A slightly lower assumed path for global long-term interest rates also contributes to a smaller worsening of the investment income balance than forecast in October. On the other hand, while the services balance is still forecast to move back into surplus, the slower path to full recovery in the tourism sector in these forecasts provides a small partial offset to the improvement elsewhere.

**Figure 12: Current account balance, % of GDP**



# EXCHANGE RATES

## Greenback remains key to NZD/USD trend

**A forecast trend weakening of the US dollar should see NZD/USD post gains over the next two years. However, as the timing of eventual RBNZ easing draws closer, we think the New Zealand dollar (NZD) will begin to weaken against the Australian dollar, the Japanese yen, and Chinese renminbi.**

At the time of our previous *Economic Overview* in late October, the NZD was trading near what proved to be its low point for the year. Since then it has firmed with the trade-weighted exchange rate index climbing to around 72.0 from around 69.5 – an appreciation of around 4%. We think that around half of that rebound can be attributed to the US dollar losing some of its lustre as US inflation has declined faster than expected and as potential Federal Reserve policy easing has drawn closer (the US dollar index – DXY – has depreciated by around 2% over this period).

The remainder of the NZD’s ascent, especially of late, has been due to a re-pricing of expectations for RBNZ policy – specifically, the recognition that policy easing in New Zealand is likely to significantly lag that elsewhere. At the margin, a recovery in prices for New Zealand’s key dairy exports may also have contributed to more positive NZD sentiment.

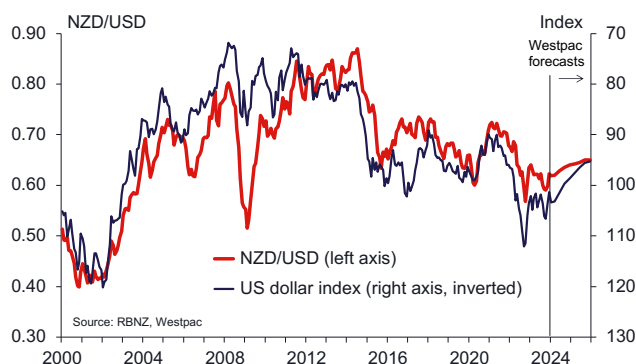
Looking ahead, with the Fed likely to begin easing monetary policy from mid-year, a narrowing of interest differentials against many of its major trading partners should support a downtrend in the US dollar. Specifically, we forecast the DXY to depreciate by around 5% to 99 by the end of this year and by a further 3% by the end of next year. As a result, we expect the NZD/USD to trend somewhat higher, reaching USD0.64 by the end of this year and continuing towards USD0.65 over the course of 2025. These forecasts assume that prices for New Zealand’s key commodity exports will continue their recent recovery. Should that recovery stall (or worse), then the outlook for the economy and the NZD would be weaker.

In the near-term, we expect the NZD/AUD to remain well supported especially with the RBA expected to begin an easing cycle in around 6 months – well ahead of the RBNZ. We expect the cross will weaken over the coming two years, but remain firmer than we had envisaged previously. We have pencilled in a decline to 0.91 by the end of this year and 0.89 by the end of next year. We continue to think that the AUD will benefit more from moves to stimulate the Chinese economy (most directly impacting investment spending) than will the NZD (which would benefit more if stimulus was focused directly on boosting consumer spending). Australia’s far superior

current account and fiscal positions also offer a degree of relative support to the AUD.

Turning to the other main crosses, we see scope for NZD/JPY to weaken noticeably from current levels once the Bank of Japan gains the confidence required to beginning unwinding its ultra-accommodative policy stance. However, this still seems more likely a story for 2025 than this year. Provided that downside risks to China’s economy are not realised, NZD/CNY will likely also move lower over the period ahead from CNY4.40 at present towards CNY4.20. By contrast, we expect the NZD to remain stable against both the euro and sterling.

Figure 13: NZD/USD and US dollar index



Exchange rate forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Mar-24	0.62	0.94	0.57	0.49	91.1	72.2
Jun-24	0.63	0.93	0.57	0.50	90.6	72.3
Sep-24	0.64	0.92	0.56	0.50	89.5	72.0
Dec-24	0.64	0.91	0.56	0.50	88.3	71.7
Mar-25	0.64	0.90	0.56	0.50	86.7	71.1
Jun-25	0.65	0.90	0.56	0.50	85.1	70.7
Sep-25	0.65	0.89	0.56	0.50	83.5	70.3
Dec-25	0.65	0.89	0.56	0.50	81.9	70.0
Mar-26	0.65	0.89	0.56	0.50	80.0	69.9
Jun-26	0.65	0.89	0.56	0.50	79.0	69.7

# DOMESTIC ECONOMY

## It's a long, long road

2024 is set to be another challenging year for the New Zealand economy. While the financial headwinds that have buffeted the economy in recent years are starting to ease, they will remain a drag on growth for some time yet. Households have been winding back their spending, businesses are continuing to report challenging trading conditions, and tight fiscal policy will be a further brake on growth.

### Household budgets continue to be stretched.

Households' finances have been squeezed hard over the past few years. That squeeze will continue over 2024, but at a more moderate pace than in the last two years. Inflation has slowed but remains elevated, especially for necessities such as rents (up 4.5% over the past year) and utilities (up 5.9%).

Many households will also face further increases in borrowing costs. However, those increases will be more moderate than the very large increases in mortgage costs that borrowers have experienced in recent years – after dropping to a low of 3.2% in 2022, the average mortgage rate that borrowers are paying rose to 5.5% in 2023, and it's set to rise to 6.3% by the end of 2024. The full impact of past interest rate increases is yet to be felt with borrowers continuing to roll onto higher fixed rates (around 60% of all fixed rate mortgages will reprice over the coming 12 months).

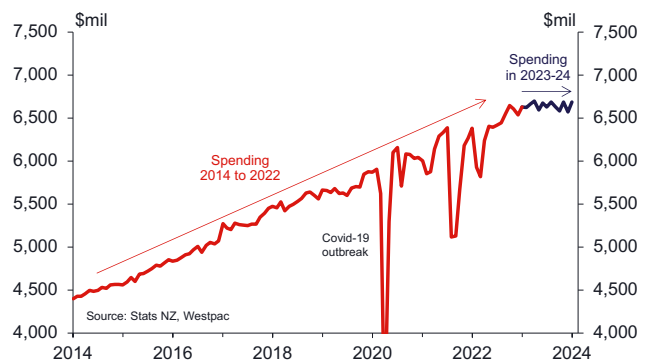
Figure 14: 'Effective' average mortgage rate\*



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

Those mounting financial pressures have seen per capita spending levels fall by more than 2% since the start of 2023. Spending in interest rate sensitive categories, such as furnishings and other household durables, has been especially weak and should remain subdued over the year ahead.

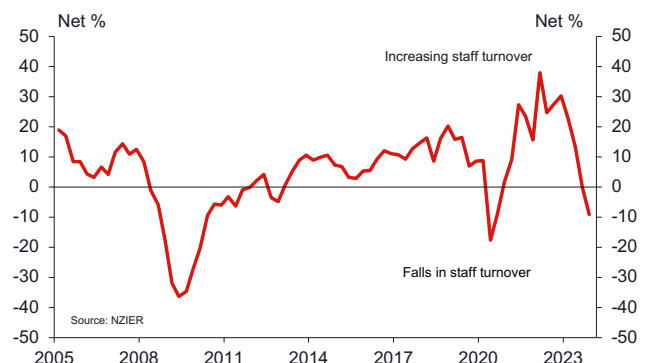
Figure 15: Retail spending levels



A crucial factor that will affect the strength of households' spending appetites is the state of the labour market. The past year has seen high levels of employment and disposable income levels have risen by around 7%. That's helped households to maintain their purchasing power despite increasing financial pressures.

We expect conditions in the labour market will continue to weaken. Employment growth has already slowed, and although unemployment remains low, it has increased. Staff turnover rates have also fallen as workers have become increasingly concerned about their job security. We expect the unemployment rate will rise from 4% currently to 5% by the end of this year, and wage growth will ease. The softer labour market will likely dampen spending appetites over 2024.

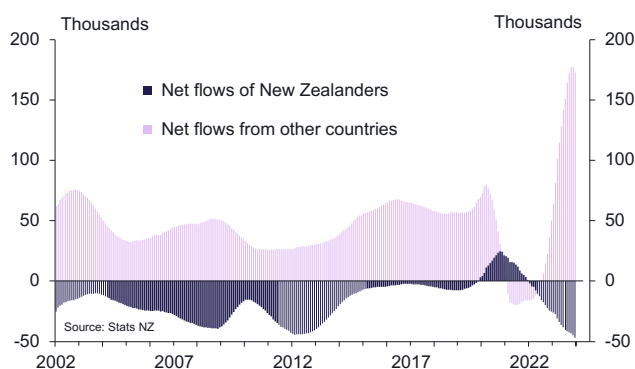
Figure 16: Proportion of business reporting increases/decreases in staff turnover



Demand has been supported by record levels of net migration, with the number of people arriving in the country exceeding departures by 126,000 over the past year. Population inflows are adding to the demand for a range of goods and services, especially for essential items like groceries. They're also adding to the demand for housing, with strong growth in rents in regions like Auckland, which tend to attract large numbers of new migrants.

Migration inflows have also added to the size of New Zealand's labour force, with businesses reporting that it has become much easier to source the staff and skills they have been searching for. Even so, we're not hearing widespread reports of reduced pressure on wages at this stage.

**Figure 17: Annual migration flows**



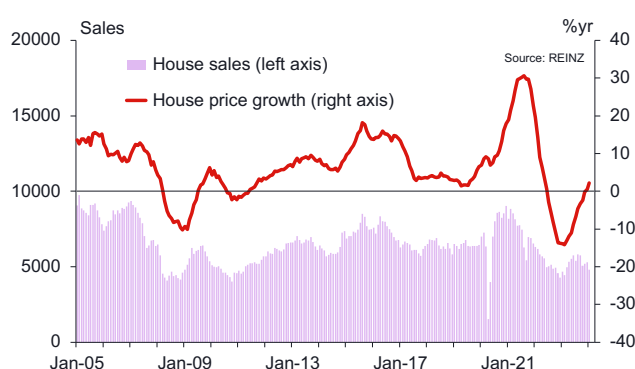
While net migration is set to remain elevated for some time yet, it looks like the cycle may have already peaked and we expect it will drop back from its recent highs over the course of this year. The jobs market is starting to cool, and as that continues it will make New Zealand less attractive to new arrivals. In addition, we're already seeing

large numbers of young New Zealanders moving abroad, and over time many of those who arrived in recent years on temporary visas will depart.

### The housing market remains in holiday mode for now.

While the earlier downturn in the housing market has been arrested, the market is yet to decisively kick on from the progress seen through the middle of 2023. Monthly sales remain very low, and prices are up just 2% over the past year. With interest rates still at relatively high levels, and government investor taxation policies still unresolved, buyers (especially investors) remain on the sidelines, and that suggest that house prices may not rise particularly strongly in the first half of 2024.

**Figure 18: REINZ house prices and sales**



The current softness in the housing market is expected to gradually give way to a period of stronger activity before year's end. In addition to rapid population growth, borrowing costs are expected to gradually ease over 2024. Also, the Government seems set to introduce several

### Home building not keeping pace with population growth.

Over the past year, New Zealand's population increased by around 130,000 people, requiring around 60,000 additional homes. However, we estimate that New Zealand's housing stock only increased by around 30,000 in 2023. While construction activity has been strong, capacity constraints and financial pressures likely have put the brakes on how many homes have been completed.

New Zealand will need to maintain high rates of home building for several years to address existing shortfalls and keep up with population growth. However, with a sharp rise in borrowing costs over the past year and related softness in the housing market, fewer new projects are coming to market, with the number of

new homes consented dropping 25% over 2023. That signals growing pressure on the housing stock and rents. We expect to see building activity picking up again in later years as borrowing costs drop back and house prices begin pushing higher again.

There are some big differences in housing pressures across the country. Auckland has made a lot of progress in addressing the housing shortages that developed in the years prior to the pandemic. However, with around half of all migrants settling in Auckland, there is still strong pressure on rents and the need for continued high levels of home building.

Many other parts of the country are continuing to struggle with the shortages of housing that developed before the pandemic. And with strong population growth and home building turning down, that pressure on housing supply is set to continue for several years.

regulatory changes that will add to investor demand, such as reinstating full interest deductibility for rental properties and reducing the 'Brightline' holding period for taxing capital gains from ten years back to two years.

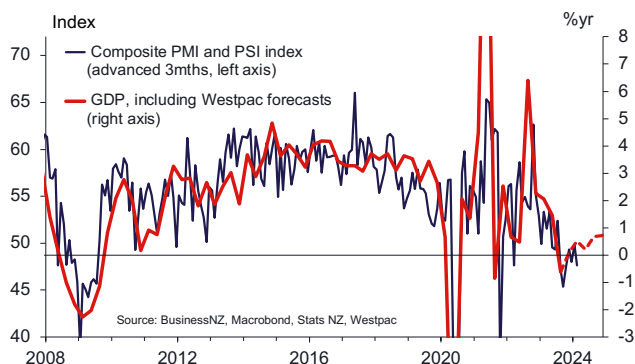
Westpac expects prices across the country to rise by an average of 6% over 2024 (slightly lower than our previous forecast) with a 7% gain expected in 2025.

## A rough start to the year for many businesses.

Business confidence has lifted over the past few months. That's at least in part due to the change in government, with the coalition's policies expected to be more business friendly. But while business sentiment has improved, trading conditions remain subdued.

- **Retailers** have reported continued weak sales in recent months, with nominal spending up only 1.6% over the past year – well below the rate of population growth or inflation. That softness looks set to continue over the coming months, given weakness in forward orders.
- **Manufacturers** have also reported weakness in orders, with the slowdown in the local economy compounded by softness in some export markets. Meanwhile, conditions in the **agricultural sector** are likely to improve over the coming year, with export prices for dairy, meat and softwood logs expected to edge higher.
- The **services sector** has been more resilient, in part due to the recovery in international tourist numbers. However, businesses in other parts of the services sector have reported softness in trading conditions and low levels of forward orders.
- There is still a large amount of **construction** work currently in train but it's likely that a more pronounced slowdown in activity is coming. Residential consent issuance has fallen by 25% over the past year. We're also seeing fewer commercial building projects coming to market, with the amount of non-residential floor-space consented down 14%.

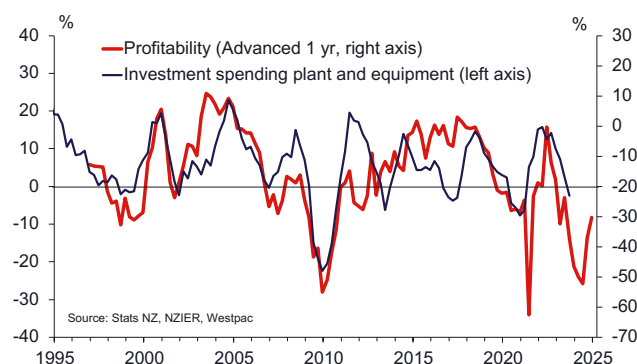
Figure 19: GDP growth and PMI forward orders



Although operating costs aren't rising as quickly as they have in recent years, many businesses are still reporting sizeable increases, with freight and wage costs of particular concern. Importantly, with demand softening, many businesses have reported that it's become increasingly difficult to pass on cost increases into output prices. That's meant ongoing pressures on operating margins.

The combination of softening demand and pressure on margins has seen capital expenditure slowing, with lending to the business sector growing by just 0.6% over the past year. With economic growth expected to remain weak, investment spending levels are expected to drop by around 5% over 2024.

Figure 20: Business investment and profitability



## Longer term fiscal challenges continue to brew.

In contrast to the more stimulatory stance of fiscal policy in recent years, the new Government has signalled that it intends to run more restrained policy that will complement the current stance of monetary policy. We've assumed that the Government will stick close to its announced spending plans over the next two years. However, further ahead, we have factored in a higher track for government consumption than assumed in the Half-Year Economic and Fiscal Update (HYEFU). This reflects our assessment that risks are skewed towards greater spending, with New Zealand's rapidly growing and aging population increasing demand for core public services, including spending on health, superannuation, and education.

Our assumption for government spending means that we continue to forecast that the operating balance will remain in deficit in 2026/27 and 2027/28, albeit by less than 1% of GDP. If the Government desires to return to surplus sooner, we think the Government will need to resist the spending pressures we foresee and/or find additional sources of revenue.

# SPECIAL TOPIC: LABOUR MARKET TRENDS

## The resilient labour market

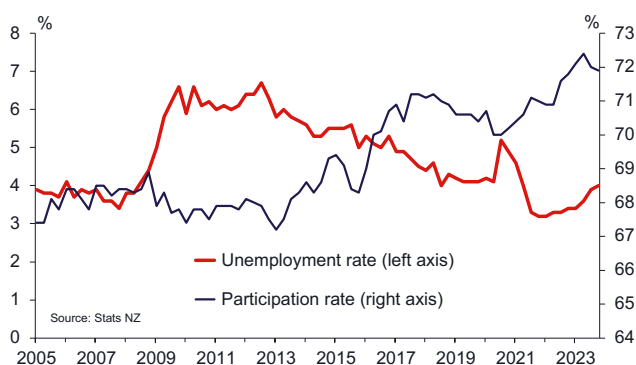
**New Zealand's labour market has gradually softened as the economy has cooled. But it's unclear whether it is proceeding quickly enough to satisfy the Reserve Bank's inflation goals. We expect a further rise in unemployment and a more marked slowing in wage inflation this year.**

The unemployment rate rose to 4% at the end of 2023. This is a meaningful change from the record low of 3.2% that was set in early 2022, but it remains very low compared to history, and in keeping with this, wage inflation has remained unusually high.

The modest rise in unemployment to date is somewhat surprising, in an economy that has reportedly shrunk by 3% in per capita terms over the past year. Part of the reason is that some of the adjustment has occurred through a drop in participation – that is, people choosing to exit the labour force altogether, rather than being 'unemployed' and actively looking for work. This is a natural part of how the labour market flexes with the economic cycle, and shouldn't be thought of as hiding the extent of the weakness.

Notably, the labour market has had to flex to an unusual degree in recent years. The economy was running hot through much of 2021 and 2022, but employers were unable to draw on migrant workers. Instead, they looked to where there was scope to bring more people into the workforce – mostly teenagers, and retirees to a lesser degree. Now that the border has reopened and those positions can be filled from overseas, those groups are moving out of the labour force again.

**Figure 21: Unemployment and participation rates**



The resilience in wage growth partly reflects that this is one of the most lagging aspects of the economic cycle. Workers initially took a substantial real pay cut when inflation took off in 2021; it was in the following years, in the context of a tight labour market, that they were able to force a catch-up in pay rates. And while consumer

price inflation peaked in mid-2022, wage growth didn't reach its peak until early 2023.

Even accounting for this lag, wage growth has been slower to recede than expected. And the breakdown by sector shows a very mixed picture: some have seen wage inflation rise and fall in line with the economic cycle, but some are still seeing very rapid increases. There are three, sometimes overlapping, forces that are in play here:

- **Government's role in pay rates:** The last two quarters included the impact of pay agreements for schoolteachers and nurses, boosting public sector wage growth to a record high. The 7.1% minimum wage increase that took effect last April also added to wage growth in sectors with a relatively high prevalence of minimum-wage roles, such as hospitality, retailing and recreational services.
- **The tourism recovery:** As the border was reopened to international visitors over 2022, sectors such as transport, hospitality and recreation have embarked on a re-hiring boom. In contrast, more domestically-focused sectors saw their heyday around 2021 when the economy was at its most over-stimulated.
- **Migrant workers:** Work visas suggest that migrant workers have been moving into a range of areas, but with a significant share going into hospitality, healthcare and social assistance, and construction. There has been no obvious downward pressure on wage growth in these areas, as the above two factors may be dominating.

There is good reason to expect the balance of these pressures to change in the year ahead. The Government has already announced a 2% minimum wage rise for this year – well below inflation – and is likely to push for more restraint in public sector pay rates going forward. Tourism is no longer in a strong growth phase, as visitor numbers have returned closer to pre-Covid levels. And without these forces, the impact of migration on labour shortages and pay rates may become more apparent.

Based on our forecasts of very weak GDP growth, we expect the unemployment rate to rise further to 5% by the end of 2024. And given the lags involved in wage inflation, we expect to see a more meaningful decline over the year ahead.

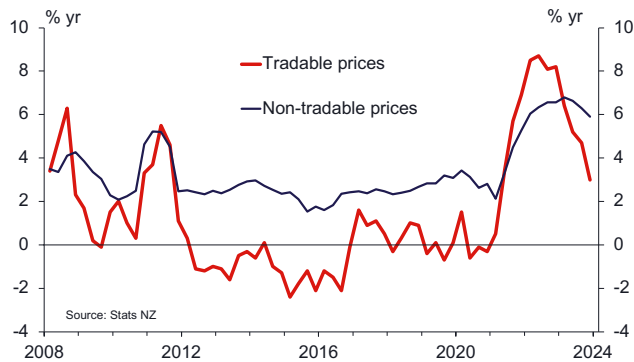
# INFLATION AND THE RBNZ

## Staying the course

**Inflation took a welcome step down but remains uncomfortably high. The top of the RBNZ’s 1-3% target range is now tantalisingly within reach and we may get there in 2024. But much depends on whether core domestic inflation can continue to slow. The RBNZ will stay the course until it is sure inflation will sustainably return to 2%.**

Overall inflation moved down relatively quickly at the end of 2023 to 4.7%. This was the lowest annual inflation level seen since late 2021 and was considerably lower than forecast by most commentators (and the RBNZ) in November last year. The key driver of lower inflation reflected non-domestic factors that were expected to ultimately move inflation lower at some point in the next year, but which came through in the last quarter of 2023. Food prices especially fell hard (the annual rate almost halved to around 4% from September 2023 to January 2024) as the impact of better climatic conditions and lower international commodity prices flowed through to store shelves. Easing global supply chains and improved airline capacity also reduced imported goods prices, while international and domestic airfares eased towards more normal levels.

**Figure 22: Tradable and non-tradable inflation**

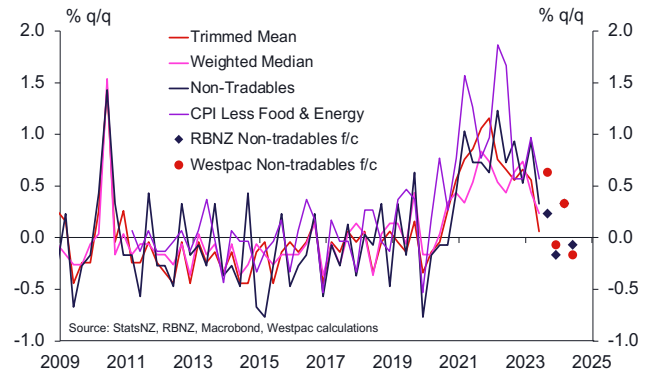


Core inflation pressures also moderated, but by much less. And on some measures, there is very little sign of significant disinflation in domestic prices at all. Non-tradables inflation fell slightly to 5.9% in December and excluding construction costs (which have normalised now that Covid-19 supply shortages of materials have eased) it has lingered at levels over 6%.

Considerable uncertainty remains on how quickly core inflation pressures will moderate. Some core inflation measures such as weighted median and the CPI ex-food and energy stepped down to annual rates of around 4-4.5% in the December quarter, while others such as the trimmed mean and non-tradables inflation remain at or above 5%. Hence quarterly overall core inflation remains

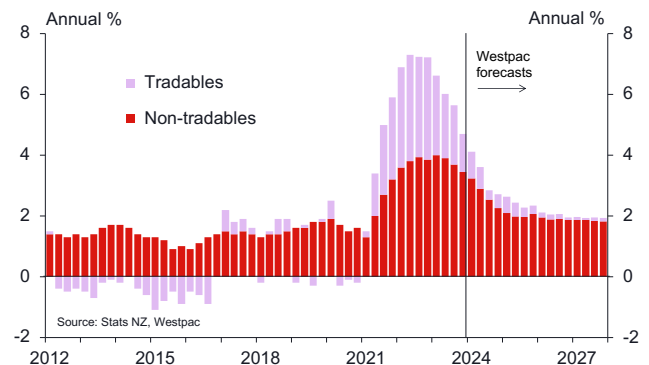
above the long-term historical average. The distribution of price changes within the CPI is consistent with a moderation in inflation as the number of individual items rising in price has reverted to long term averages while the number of items falling in price is steadily increasing.

**Figure 23: Core inflation indicators relative to 1995-2019 average**



Our forecasts reflect uncertainty around the speed that disinflation in core inflation will occur. In the short term we see scope for another quarter of above average non-tradables inflation, but thereafter forecast a fast reversion to more normal levels. This leaves us with a slightly lower forecast for overall inflation over 2024, with inflation dipping inside the RBNZ’s 1-3% target range in the second half of the year. However, progress back to the RBNZ’s 2% target is likely to be gradual.

**Figure 24: Contributions to inflation**



Key factors that determine the speed at which core inflation will revert to more normal levels will be: the

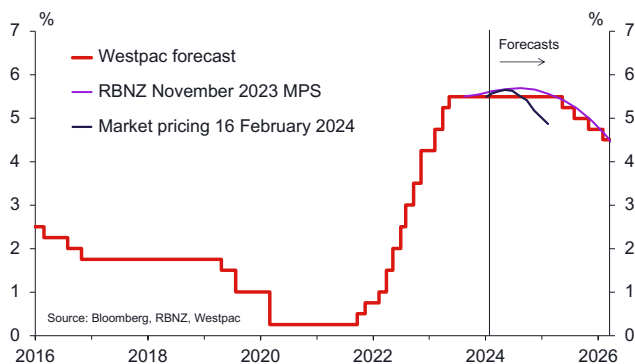
speed of labour market adjustment and hence wages growth; the extent of the recovery in the housing market (and hence construction costs); and the extent to which recent very weak economic momentum flows through to consumer prices.

Risks around the forecast seem balanced. Upside risks include indicators suggesting firms still plan to increase prices in the period ahead. Those indicators might be consistent with inflation getting “stuck” above 3%. Meanwhile, there are both upside and downside risks coming from the labour market. Upside risks come from the relatively slow rise in the unemployment rate and related resilience in wages seen in recent data. Downside risks come from the relatively low adjustment in the minimum wage this year compared to recent years. It is also possible that weak economic growth is increasingly reflected in slack in the labour market in coming quarters and a sharper rise in the unemployment rate might occur.

Fiscal policy is expected to be more supportive of disinflation compared to the last two years where fiscal stimulus imparted a significant boost to the economy and inflation pressures (public sector wage growth for example has been especially strong but should moderate).

So where to next for the RBNZ? Our forecasts are consistent with the OCR remaining at 5.5% for 2024 and then a slow easing cycle over 2025 as inflation gradually moves towards the RBNZ’s 2% target mid-point. We anticipate inflation pressures will remain persistent and will preclude near term or significant interest rate cuts. We remain more pessimistic than financial markets on the scope for OCR cuts in coming years.

**Figure 25: Official Cash Rate forecasts**

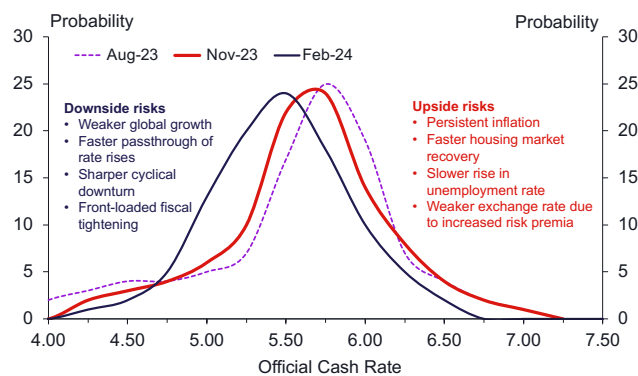


Recently some commentators and markets have moved from expecting a near-term easing to a tightening (or two). We think the middle path is most likely right now and is consistent with the RBNZ’s preference so far to hold the OCR at current levels for “longer” as opposed to raising them further. Our increased confidence that inflation will return to the target range this year, expectations that fiscal policy will be tighter and that the labour market will ultimately adjust to allow wages and inflation to fall are key to that view. Also, the housing market hasn’t kicked on strongly in recent months.

Appreciable risks of a higher OCR remain. The time is shortening for the data to show signs of significant easing in the labour market and for core inflation pressures to sustainably recede. In the absence of further adjustment quite soon, a higher rate may well be required as the work done by interest rates in the next six months will be critical in determining inflation outcomes in the second half of 2025.

With lingering strength in domestic inflation, we think the RBNZ will remain on edge, and they will likely leave the threat of further tightening on the table for some time yet. We are conscious that the RBNZ’s new mandate allows little scope for further waiting and hoping. Hence a change in RBNZ strategy to further increase the OCR shouldn’t be ruled out. But in the end, we think the RBNZ will be happy to encourage monetary conditions to fully reflect their view that the OCR will remain at the current level this year. The RBNZ still has a little time to let the data talk given economic momentum is very weak, the possibility of a rapid labour market adjustment remains real, and the Government’s fiscal policy is currently unclear. If tightening comes then it’s more likely in mid-2024 when these factors will be clearer.

**Figure 26: OCR Risk Scenarios – February 2025**



**Financial market forecasts (end of quarter)**

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
<b>Mar-24</b>	4.1	5.50	5.60	5.10	4.60
<b>Jun-24</b>	3.6	5.50	5.60	4.95	4.50
<b>Sep-24</b>	2.8	5.50	5.60	4.75	4.45
<b>Dec-24</b>	2.7	5.50	5.50	4.50	4.40
<b>Mar-25</b>	2.6	5.25	5.25	4.40	4.30
<b>Jun-25</b>	2.4	5.00	4.95	4.15	4.25
<b>Sep-25</b>	2.3	4.75	4.75	4.10	4.15
<b>Dec-25</b>	2.3	4.50	4.50	4.00	4.10
<b>Mar-26</b>	2.1	4.25	4.25	3.90	4.05
<b>Jun-26</b>	2.0	4.00	3.95	3.80	4.05



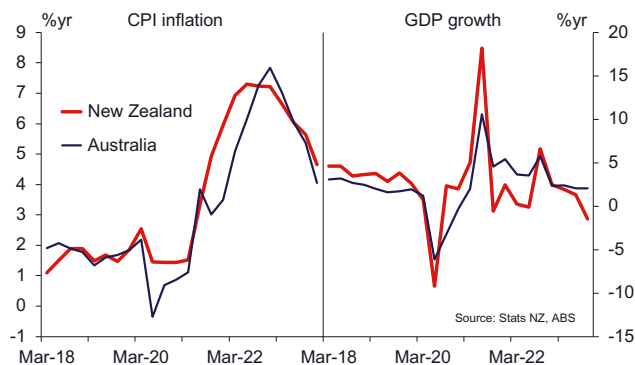
# SPECIAL TOPIC: TRANS-TASMAN COMPARISON

## Eyeing across the ditch

**New Zealand and Australia have faced similar challenges in recent years as they have looked to bring inflation to heel. But there have been some differences in their economic performance, reflecting a mix of wage trends, the fiscal stance, and different central bank preferences.**

New Zealand and Australia have faced a similar series of inflationary shocks in the last few years – both the Covid disruptions to global supply chains, and the strong fiscal and monetary policy responses to boost demand. But as both countries have battled to bring inflation back under control, Australia seems to be earning its title as the lucky country again. Inflation has cooled off to a similar degree, but interest rates haven't reached the same heights, the slowdown in GDP growth has been more modest, and unemployment has remained remarkably low.

**Figure 27: Economic performance in New Zealand and Australia**



Is there anything we can learn from how the two countries have handled this cycle? While our economies have much in common, there have also been some notable differences at work – in the economic backdrop, in the timing, and in the policy responses.

What the two countries have had most clearly in common is that monetary policy is working through the channels that we would expect: mostly consumers and housing. A sharp rise in mortgage rates has squeezed households' disposable incomes, which in turn has seen a substantial slowdown in retail spending growth (even more so after accounting for rising prices). Higher interest rates also dragged house prices down over 2022, putting the 'wealth effect' on consumer spending into reverse. Finally, higher funding costs have put the brakes on a homebuilding boom, with consents well down from the peaks reached in 2021.

Some of the difference in performance reflects that the two countries are in slightly different stages of their cycles. High inflation emerged as a concern much earlier in New Zealand, and consequently the RBNZ was among

the first central banks to start lifting its policy rate. The RBA did not start tightening policy until May 2022, although the higher prevalence there of floating-rate mortgages meant that, once they began, the effects flowed through relatively quickly to households.

As with inflation, wage growth took substantially longer to pick up in Australia. This was despite both countries dealing with severe labour shortages, as hot demand ran up against a loss of access to migrant workers during the Covid border restrictions. Different wage-determining processes in Australia may have meant that they were slow to reflect the balance of pressures on labour supply and demand; this may also explain why wage growth in Australia had yet to peak in late 2023, while New Zealand appears to have passed that point now.

There have also been some specific headwinds for the RBNZ. One is that fiscal spending in New Zealand has remained elevated since the Covid shock, whereas in Australia the Covid stimulus has effectively been unwound. The new Government's first Budget in May will be closely watched for how it plans to bring spending back towards pre-Covid trends.

One last, important difference is that the two central banks are pursuing different tactics in their fight against inflation. The RBNZ continues to emphasise a return to the 2% midpoint of its target range. For the past year, its projections have shown inflation falling below 3% in the September 2024 quarter and reaching 2% in September 2025 – dates that are now looming up quite quickly. In contrast, the RBA has been plotting a much flatter glidepath back to its target range, with its most recent forecasts showing inflation still above 3% until the end of 2025.

Which approach proves to be 'better' is a matter for hindsight; what we can say at the moment is that they each carry a different balance of risks. By looking to bring inflation down as gradually as possible, the RBA leaves itself with little room to absorb any unpleasant upside surprises on inflation. The RBNZ, by aiming for a swifter return to the middle of its target range, intends to put itself in a position to be able to deal with any future shocks in either direction.

# ECONOMIC AND FINANCIAL FORECASTS

## New Zealand forecasts

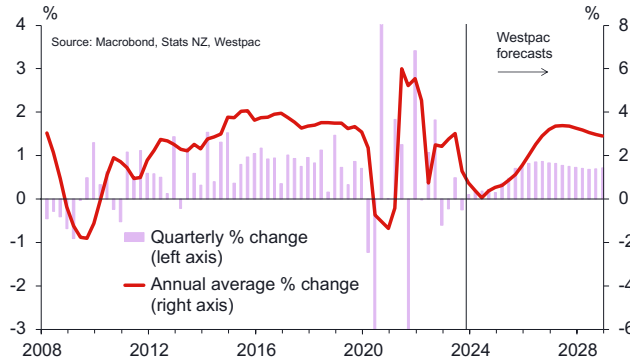
Economic indicators	Quarterly % change				Annual % change			
	Sep-23	Dec-23	Mar-24	Jun-24	2022	2023	2024	2025
GDP (production, annual average)	-0.3	0.1	0.2	0.2	2.4	0.7	0.5	1.6
Consumer price index	1.8	0.5	0.7	0.6	7.2	4.7	2.7	2.3
Employment change	-0.1	0.4	0.0	0.2	1.7	2.4	0.3	1.0
Unemployment rate	3.9	4.0	4.3	4.6	3.4	4.0	5.1	5.2
Labour cost index (all sectors)	1.1	1.0	0.8	0.8	4.1	4.3	3.4	2.5
Current account balance (% of GDP)	-7.6	-7.0	-6.4	-5.8	-8.8	-7.0	-4.4	-3.6
Terms of trade	-0.6	0.3	2.0	2.0	-4.2	-1.5	6.1	3.4
House price index	1.0	-0.2	0.5	1.3	-11.2	-1.1	5.9	6.7
Financial forecasts	End of quarter				End of year			
	Sep-23	Dec-23	Mar-24	Jun-24	2022	2023	2024	2025
90 day bank bill	5.66	5.65	5.60	5.60	4.26	5.65	5.50	4.50
2 year swap	5.53	5.28	5.10	4.95	5.10	5.28	4.50	4.00
5 year swap	4.90	4.84	4.60	4.50	4.67	4.84	4.40	4.10
10 year bond	4.87	5.09	4.85	4.70	4.31	5.09	4.60	4.25
TWI	70.6	70.8	72.2	72.3	70.8	70.8	71.7	70.0
NZD/USD	0.61	0.60	0.62	0.63	0.60	0.60	0.64	0.65
NZD/AUD	0.92	0.93	0.94	0.93	0.92	0.93	0.91	0.89
NZD/EUR	0.56	0.56	0.57	0.57	0.59	0.56	0.56	0.56
NZD/GBP	0.48	0.49	0.49	0.50	0.51	0.49	0.50	0.50
Fiscal indicators	June years							
	2021	2022	2023	2024	2025	2026	2027	
Total government revenue (\$bn)	129.3	141.6	153.0	166.9	171.4	179.8	189.2	
- % of GDP	37.7	38.9	38.7	39.9	39.4	39.5	39.4	
Total government spending (\$bn)	133.7	151.0	161.8	176.1	178.4	185.1	192.7	
- % of GDP	39.0	41.5	40.9	42.1	41.5	41.2	40.3	
Operating balance excl. gains and losses (\$bn)	-4.4	-9.3	-8.8	-9.2	-7.0	-5.2	-3.5	
- % of GDP	-1.3	-2.6	-2.2	-2.2	-1.6	-1.1	-0.7	
Net government debt (\$bn)	35.9	61.9	71.4	95.3	101.8	109.1	112.8	
- % of GDP	10.5	17.0	18.0	22.8	23.4	23.9	23.5	

## International economic forecasts (finalised 9 Feb 2024)

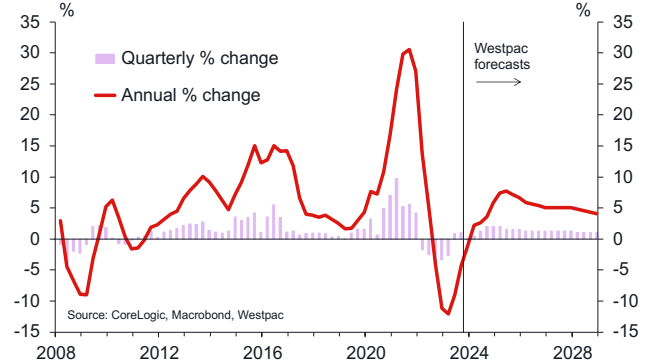
Real GDP (calendar years)	Annual average % change					
	2020	2021	2022	2023f	2024f	2025f
Australia	-2.1	5.6	3.8	2.0	1.3	2.2
China	2.2	8.4	3.0	5.2	5.2	5.0
United States	-2.8	5.9	2.1	2.5	2.6	1.3
Japan	-4.2	2.2	1.0	2.0	0.9	0.9
East Asia ex China	-2.3	4.3	4.5	3.4	4.1	4.2
India	-5.8	9.1	7.2	7.0	6.3	6.5
Euro zone	-6.1	5.6	3.3	0.5	0.6	1.5
United Kingdom	-11.0	7.6	4.1	0.4	0.5	1.3
NZ trading partners	-1.5	6.3	3.3	3.4	3.4	3.4
World	-2.8	6.3	3.5	3.3	3.3	3.1

# THE ECONOMY IN EIGHT CHARTS

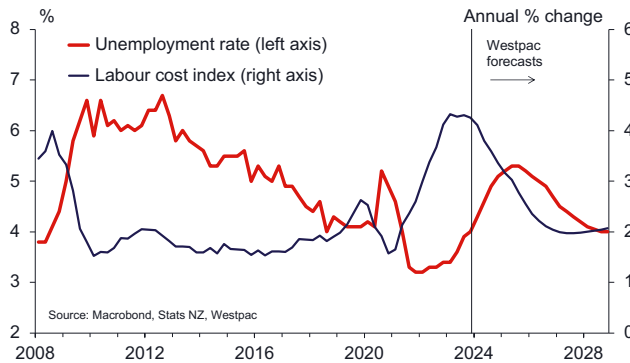
**GDP growth**



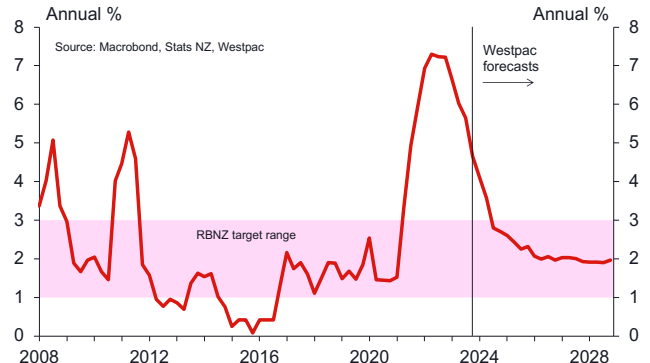
**House prices**



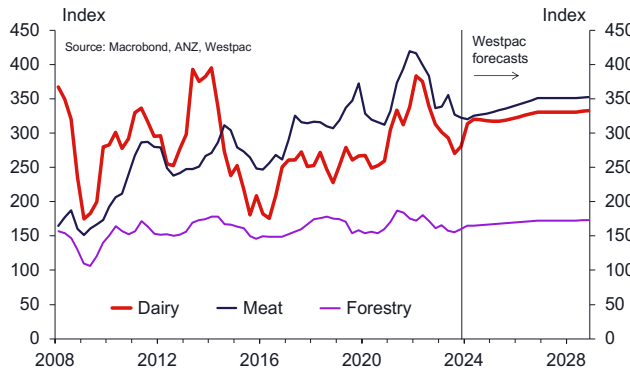
**Employment and wage growth**



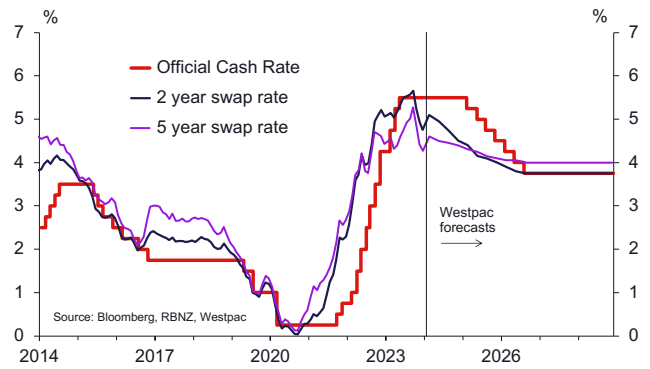
**Consumer price inflation**



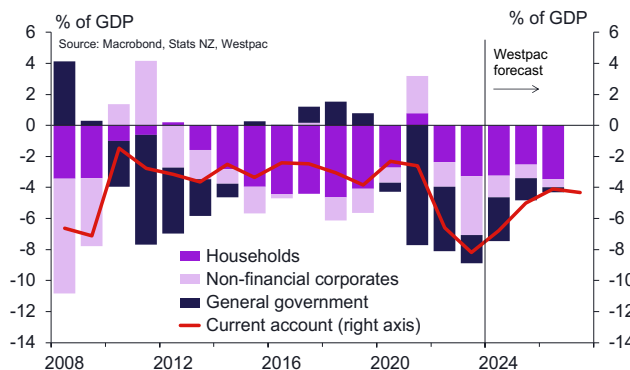
**New Zealand commodity prices - world terms**



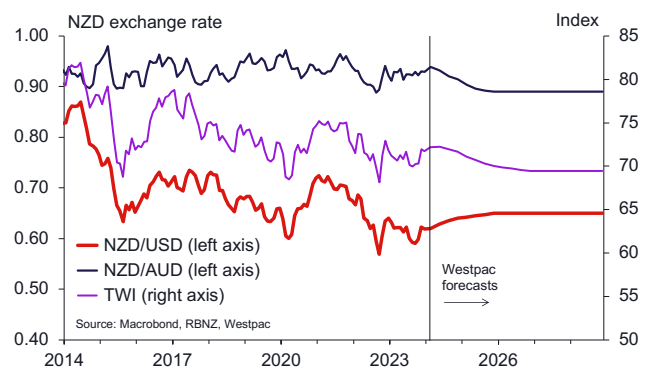
**Official Cash Rate, 2 year swap and 5 year swap rates**



**Net lending by major sector and current account**



**Exchange rates**



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