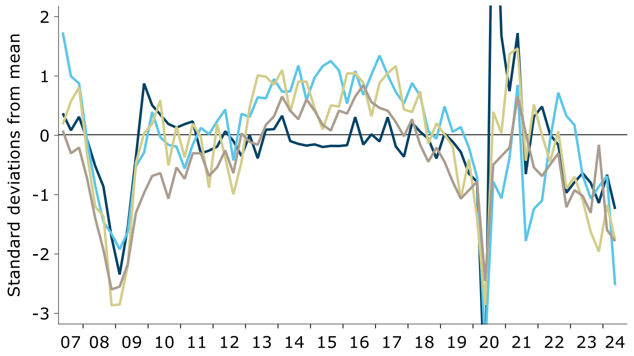
Quarterly Economic Outlook

Tipping point?

At a glance

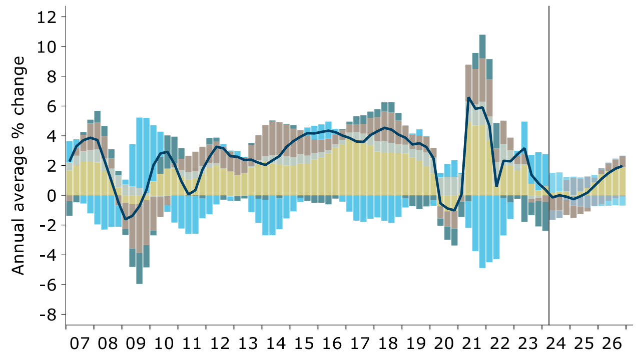
Risks of a deeper downturn have risen…

Activity and labour market indicators have broadly deteriorated in recent months.



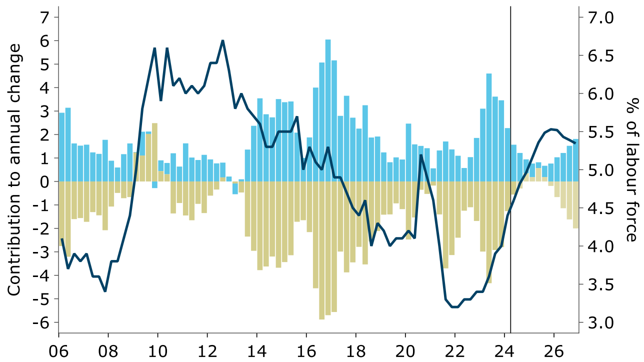
…and a more protracted cycle is expected

Weaker near-term momentum is likely to persist further into 2025.



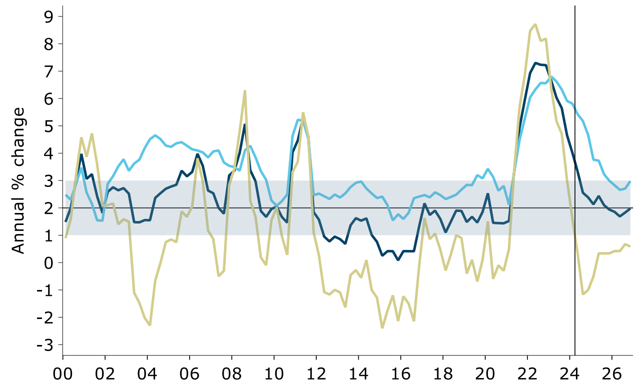
Labour market conditions are increasingly reflecting the weak economic backdrop…

Labour demand is contracting, while the migration cycle turns a little faster.



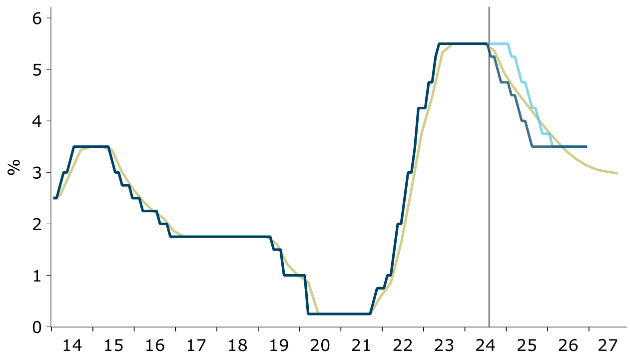
…strengthening confidence in the disinflation path ahead

But the path to 2% is unlikely to be smooth.



We expect a steady stream of OCR cuts to 3.5%.

Though risks to the easing profile are two sided.



Inside

Source: Stats NZ, RBNZ, BusinessNZ, NZIER, Seek NZ, Macrobond, ANZ Research

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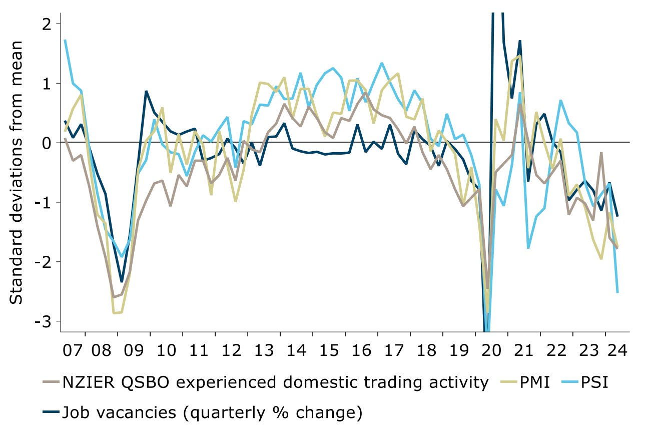
The big picture

Tipping point

Recent high-frequency data suggests the slowdown in the economy is broadening and gathering pace. But there is a risk in taking the full signal from these data, given that GDP, CPI and labour market data have all evolved broadly as expected. While interest rates are heading lower, there are still risks to the disinflation trajectory and the pace of policy easing remains uncertain. The uncertainty is brought about by the fact that by and large this downturn is policy induced. Unlike previous downturns, the economy hasn't experienced a sudden confidence or income shock. Accordingly, as the RBNZ takes the handbrake off, there's a risk that the economy bounces back faster, potentially threatening inflation's descent to 2%. How much damage has been done from past tightening, and how this persists (particularly in the labour market) is likely to define the pace of easing.

Economic momentum has slipped further in recent months. While tier one data (GDP, labour market and CPI inflation data) have all evolved broadly as expected since our last edition, a sharp and synchronous deterioration across high-frequency activity indicators suggests the slowdown in the economy is broadening and gathering pace.

Figure 1. Activity indicators



Source: Stats NZ, BusinessNZ, NZIER, Seek NZ, Macrobond, ANZ Research

The past few months have also provided increasing evidence that monetary policy traction is bringing about lower inflation outcomes. Headline inflation is closing in on the target band and persistence risks to wages and prices via elevated inflation expectations are dissipating rapidly. Domestic inflation remains high, and there are still elements of stickiness in things such as insurance, council rates and utilities. But these are increasingly outliers to a broad downtrend across domestic inflation components, and the deterioration in forward indicators over recent months suggests disinflation progress may be on the cusp of accelerating.

The economy appears to be at a tipping point. The prospect of a deeper slowdown has increased, but ongoing disinflation progress is still conditional on things going right for the RBNZ. Monetary policy is about balancing risks, and those aren't as one-sided as market pricing suggests. A rapid easing in monetary conditions could still see demand recover and disinflation progress stall. As further evidence mounts that economic momentum is slipping, and that weakness is flowing through into lower inflation outcomes, those risks will continue to subside. But there is an unavoidable trade-off between lowering the risks on that score and exacerbating the risk of causing unnecessary damage to the economy.

Weighing those risks here and now, the evolution of GDP, labour market and inflation data over recent months do not suggest the scale has tipped dramatically one way or the other as yet. However, the RBNZ's August Monetary Policy Statement highlighted a dramatic improvement in its confidence in the outlook, putting its faith in the signal from the deterioration in high-frequency indicators.

We are now forecasting the RBNZ to cut in 25bp increments at each meeting from here to a terminal rate of 3.5% in Q3 2025. But there are several scenarios that collectively are far more likely to play out than that middle-of-the-road story.

Should economic conditions deteriorate more rapidly than anticipated, and the RBNZ feels it is behind the curve, more aggressive cuts are likely. And the risks that the RBNZ is already behind the curve are certainly rising, given synchronised weakness across leading indicators in recent months.

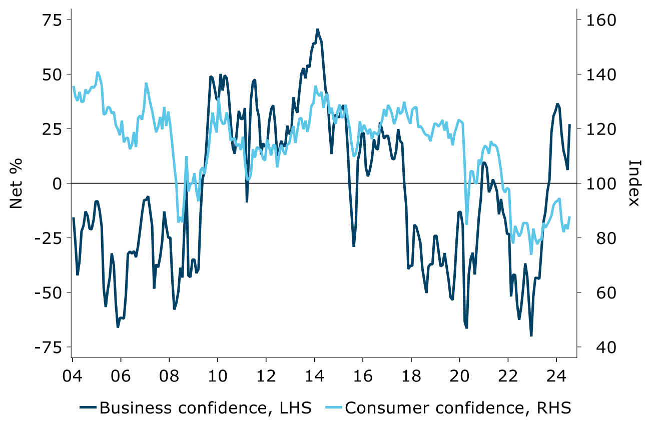
But caution is still warranted in taking the full signal from these data. After all, the significant deterioration in confidence and activity indicators in June came in the wake of the RBNZ's hawkish May MPS. That MPS, which suggested rate cuts were a very long way off, is highly likely to have impacted the confidence of households and businesses who have been holding out for relief.

We certainly aren't suggesting that the economy isn't struggling here and now. It's really tough going out there. But is the deterioration in activity indicators in Q2 the start of an inexorable slide into an ever-deeper hole that warrants aggressive OCR cuts? That's the outcome that financial markets are betting on, but it's not the only possible path from here.

The big picture

Following the rapid easing in financial conditions (interest rates and to some extent credit conditions) over the past month, tentative signs of optimism have returned, with consumer and business confidence lifting. While that largely reflects improving confidence in the outlook – indeed the "here and now" is still going south – it does highlight an important consideration for the RBNZ: how responsive will the economy be to monetary easing? In short, is it a punctured beach ball or a coiled spring?

Figure 2. ANZ Consumer and Business Confidence

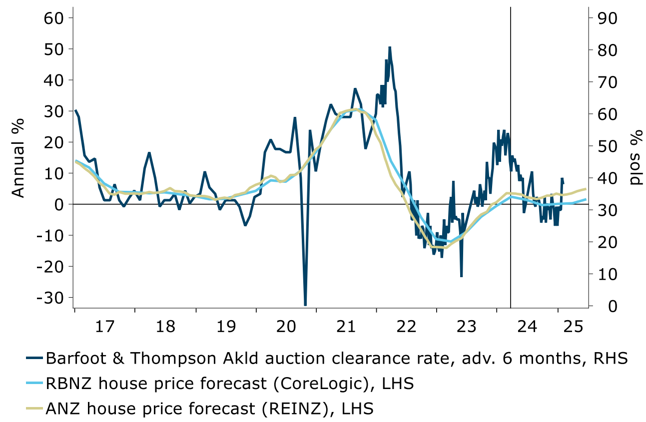


Source: Roy Morgan, Macrobond, ANZ Research

The uncertainty is brought about by the fact that by and large this downturn is policy induced. That's extremely unusual. Compared to previous downturns, external shocks (global financial crises, earthquakes, extreme droughts, pandemics …) are far less of a factor. There has been no sudden income or confidence shock that would suggest the economy should be collapsing even more dramatically than it did in response to the Global Financial Crisis. Momentum is clearly weakening, but the early signs of improvement in sentiment following the easing in monetary conditions suggest there is a chance that the economy could bounce back faster than anticipated. Some activity will have been deferred, not cancelled. The transmission via mortgage rates may also be quicker this cycle, given the shift toward short-term fixed terms in the past six months or so as households have banked on lower rates coming soon.

If the economy bounces back quickly there remains a risk that disinflation progress slows to an unacceptably slow pace. The RBNZ will be wary of this possibility, and the easing cycle may be a little stop-start. The RBNZ could choose to move more slowly with some pauses if, say, a sharp recovery in the housing market were to fuel renewed inflation pressures. And *very* early indicators of housing activity (auction clearance rates) hint at the possibility of a stronger bounceback.

Figure 3. Auckland auction clearance rate vs house prices



Source: CoreLogic, REINZ, interest.co.nz, Macrobond, ANZ Research

Our forecasts make the case that monetary policy has indeed already gained sufficient traction to return inflation to target, but there are always risks surrounding any forecast. The skew of those risks is likely to become much clearer over the next three months, through the evolution of the drivers of economic momentum. Let's go through these in turn.

Housing market activity remains subdued, and weakness is likely to persist in the near term. We've been revising our house price forecasts down over recent months. However, given the rapid easing in financial conditions of late, the housing market remains one to watch for assessing the economy's responsiveness to monetary easing. While falling interest rates and easing credit conditions will provide a strong tailwind to the housing market, those impacts could be more than offset by headwinds from a weakening labour market and a migration cycle that is turning faster than previously thought. We expect house prices will fall 1% in 2024, but near-term weakness increases the scope for a larger recovery in 2025 as interest rates fall. See our latest Property Focus for more.

Net migration inflows have fallen sharply in recent months as departures surge while arrivals ease, reflecting that firms don't need as many new workers and are also finding it easier to recruit workers locally. Net migration impacts inflation via both increasing labour supply (lowering wage growth) and adding to demand (increasing inflation pressure). How these supply-demand effects net out (and hence the overall implications for inflation) depends on a bunch of things, including how well the skills of the incoming migrants are matched to employers' needs, but also the prevailing economic conditions. This migration cycle has probably been more disinflationary than usual because the starting point of intense labour shortages meant the dampening of (extreme) wage pressures outweighed the impacts of increased demand. But now, with significant spare capacity in the labour market, a sharper reduction in net migration inflows isn't likely to make it significantly harder for firms to find the workers they need. But the drag on growth for the likes of retail will still be just as real.

Confidence (particularly for households) is also likely to be driven by the evolution of the labour market. Labour market developments always lag activity, given firms take some convincing to hire or fire. Therefore, how much the labour market will continue to soften even after monetary conditions ease is a key source of uncertainty. A sharper deterioration in labour market conditions could more than offset the impacts of falling interest rates, weighing on confidence and slowing the economy's recovery. But if less damage has been done to the labour market than expected, falling interest rates could drive a sharper recovery in confidence and stronger spillovers to demand.

Fiscal policy settings are becoming less expansionary relative to where they have been, but are forecast to remain stimulatory over the coming years. The impacts of income tax cuts from 31 July are yet to be seen. Our sense is that any upside to demand will be offset by the impact of public sector spending cuts and job losses, given that labour market conditions are already weak. Fiscal consolidation is likely to be a slow grind over the coming years. The weaker economic outlook means the Government is likely to face pressure from reduced tax revenues, putting pressure on the operating balance. Maintaining its commitment to fiscal consolidation may ultimately require more restraint on spending.

The **terms of trade** made back some ground in Q1 after a sharp fall in Q4, but they are still well off their peak. Import prices continue to ease as the global economy has slowed and supply recovers. But export returns remain under pressure due to the structural slowdown in China's property sector. That has weighed heavily on household confidence and spending, impacting our export returns. With the downturn in China's property sector likely to persist for some time, the recovery in the terms of trade is likely to be gradual.

All up, while a weaker economic outlook justifies an earlier start to easing, there's still plenty of uncertainty about the timing and pace of the economic recovery. How much transmission from past tightening is yet to flow through, and how quickly the economy will respond to interest rate cuts remains uncertain The policy rate path is unlikely to be smooth. Monetary policy won't be on a preset course from here; the data, as always will ultimately decide.

Table 1. Summary of key forecasts

Calendar Years	2020	2021	2022	2023	2024f	2025f	2026f
Real GDP[1] (annual average % change)	-1.4	5.6	2.4	0.6	-0.1	0.8	2.2
Unemployment Rate (sa; Dec qtr)	4.9	3.2	3.4	4.0	5.0	5.5	5.3
CPI Inflation (annual % change; Dec qtr)	1.4	5.9	7.2	4.7	2.4	1.9	2.0
Official Cash Rate (Dec qtr end)	0.25	0.75	4.25	5.50	4.75	3.50	3.50

[1] Production based

Source: Statistics NZ, REINZ, Bloomberg, ANZ Research

Forecasts finalised 15 August 2024. See page 8 for detailed forecast charts and this link to download tables

Our forecasts

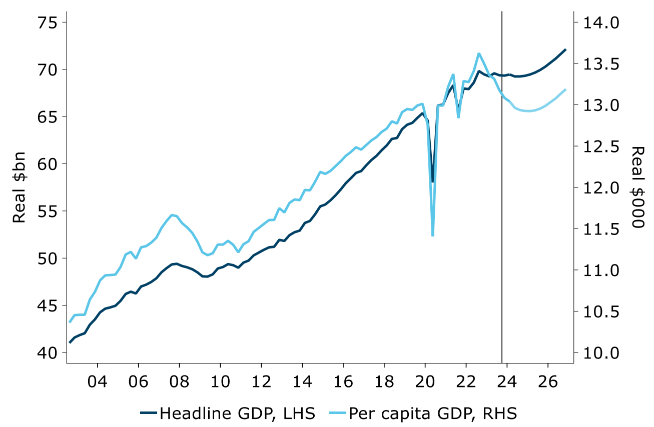
Economic momentum has slipped further…

Taking signal from the forward indicators, we have downgraded our GDP outlook. We now expect the economy to contract 0.3% q/q in Q2, and growth to stall across the second half of the year, with the economy to contract 0.1% on an annual average basis over 2024.

Restrictive interest rate settings look to be biting a little harder than previously thought, particularly in interest rate sensitive sectors such as residential and business investment, and household spending on durable goods, in particular. While easing monetary conditions will enable a recovery in growth over 2025, that's expected be a little more gradual.

The cycle in per-capita terms is expected to be as severe as during the Global Financial Crisis (GFC). Population growth has boosted headline GDP growth over the past few years, though with the migration cycle now turning faster, that support is likely to soften. A cyclical improvement in implied labour productivity (output per hour worked) provides a partial offset with labour hoarding dynamics unwinding as the labour market catches up to the broader economic cycle.

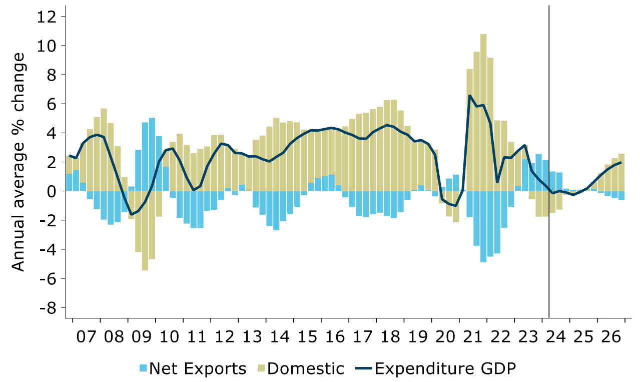
Figure 4. GDP and GDP per capita



Source: Stats NZ, Macrobond, ANZ Research

Domestic demand continues to be the driver of weakness, with a partial offset from net exports. That doesn't reflect an improved outlook for exports, but rather weaker demand for imports. Ultimately, that's a necessary part of the economy's adjustment towards a more sustainable external position. But even so, the waning tourism recovery and subdued demand from China for primary exports mean the annual current account deficit only narrows to 5% of GDP by the end of 2026, still too wide to be called sustainable.

Figure 5. Contributions to GDP growth



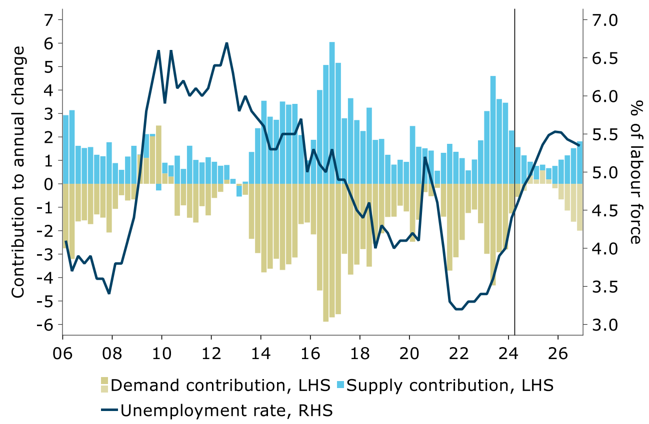
Source: Stats NZ, Macrobond, ANZ Research

All up, things are likely to feel worse before they feel better, and interest rate relief will take time to be reflected in activity. We're doing the hard yards now, but that's ultimately what's required to get the economy back on a sustainable footing, in terms of not only inflation but also external imbalances.

… flowing through to the labour market

The drivers of loosening in the labour market have shifted. In the past year, the bulk of the increase in spare labour market capacity has reflected labour supply expansion from net migration. However, the migration cycle appears to be turning a little faster than previously assumed, and that is the result of weakening labour demand. Despite a slightly stronger starting point for the labour market in Q2, forward indicators of labour demand suggest the impacts of past weakness in economic activity are now flowing through to lower employment. While our unemployment rate forecast remains broadly unchanged, the drivers of loosening paint a slightly more pessimistic outlook.

Figure 6. Unemployment rate decomposition



Source: Stats NZ, Macrobond, ANZ Research

Our forecasts

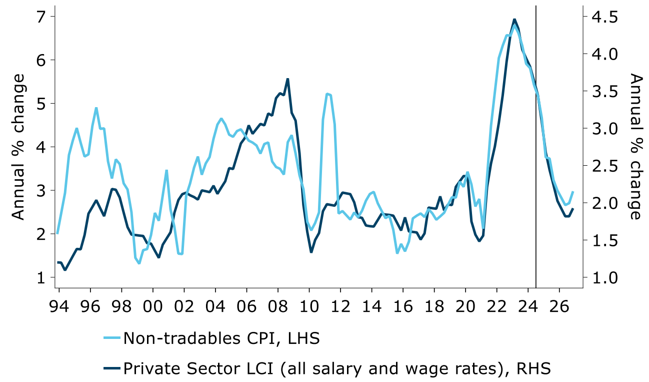
Labour market loosening driven by weak labour demand carries greater risks of spillover effects to household confidence and spending than does positive job growth that isn't keeping up with growth in labour supply. The former implies job security fears will rise. Growth in filled jobs in the private sector is already in contractionary territory, though this has been offset by continued strength in public sector employment. However, given the changes to fiscal policy settings in Budget 2024, with reduced public sector employment, the downturn in labour demand is likely to accelerate across the second half of the year. However, in our forecast, falling participation from discouraged worker effects as the labour market becomes more competitive slows the increase in the unemployment rate.

Given the labour market responds with a lag to changes in the broader economy, the extent of residual weakness still to flow through after interest rates ease and the economy begins to recover remains uncertain. The impact of government demand for labour together with the starting point of intense labour shortages mean it has taken a long time for weaker activity to flow through into softer labour demand. The next few months will be key for gauging the extent of residual loosening that's still in the pipeline.

Given the recent weakness in forward indicators, we expect a slightly more protracted labour market cycle, with unemployment falling more gradually from its peak in the medium term, despite an earlier start to easing.

Reflecting the slightly weaker outlook for the labour market, wage pressures are expected to a fall a little faster over the medium term, consistent with non-tradable inflation slowing adequately to keep headline CPI around the centre of the 1-3% target band. In our assessment, sufficient spare capacity has already been generated in the labour market to unwind excess strength in wages, though provided inflation expectations stabilise at the target midpoint, risks of a sharper correction are likely to be contained.

Figure 7. Wage and non-tradable inflation

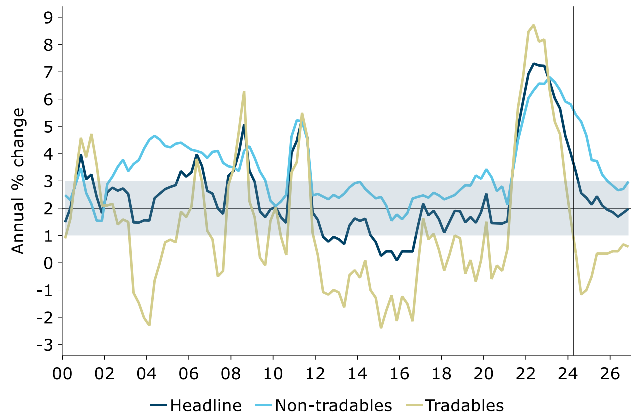


Source: Stats NZ, Macrobond, ANZ Research

… and returning inflation to target

Recent inflation data has been more encouraging. A lower headline inflation starting point, again driven by weaker tradable inflation, has all but confirmed a return to the 1-3% target band next quarter. While non-tradable inflation at 5.4% y/y remains very high, data over the past few months have highlighted a shift in inflation risks, and we have downgraded our medium-term inflation forecast slightly.

Figure 8. Inflation component forecast

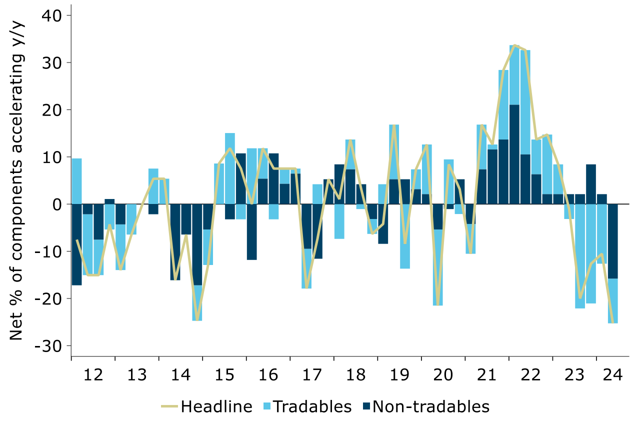


Source: Stats NZ, Macrobond, ANZ Research

Increasingly, persistence in non-tradable inflation reflects a select few components such as council rates, insurance and utilities, which monetary policy settings today won't affect much. Outside of these components a generalised downtrend has emerged. Q2 marked the first time since the initial inflation surge that there were more non-tradable inflation components decelerating than accelerating on an annual basis. Domestic inflation dynamics appear to be shifting and progress may be on the cusp of accelerating.

Our forecasts

Figure 9. Share of inflation components accelerating



Source: Stats NZ, Macrobond, ANZ Research

Confidence that inflation will return to target has risen, but the path to 2% is nonetheless likely to be bumpy. Risks to the inflation outlook certainly aren't one-sided. The surge in wholesale electricity prices in recent weeks serves as a timely reminder on that front. And electricity bills were already set for a big jump from Q2 2025 reflecting the increase in the regulated cap on price increases for distribution charges.

The lagged adjustment to the past period of high inflation is still occurring in some components. But given the weaker outlook for activity and the labour market and the reassurance provided by recent inflation data that traction from past monetary tightening is flowing through to inflation as expected, the RBNZ can afford to look through strength in these components. Inflation expectations are converging on the target midpoint, meaning spillover impacts from sticky components are far less likely to materialise, and there is greater scope to absorb positive inflation surprises. We expect inflation will settle near 2% by the end of 2025.

… paving the way for more OCR cuts, and slightly lower short end rates ...

With OCR cuts set to continue for the foreseeable future, term rates are expected to continue grinding lower. But whereas to this point, short end rates have been falling rapidly in anticipation of cuts, the outlook from here is one of rates falling more gradually with the passage of time, as more cuts get delivered. In essence, it's less about markets taking a leap of faith that cuts are coming, and more about confirmation as they are delivered. And given that financial markets are pricing in cuts of a similar magnitude as what we expect, we expect rates to follow a similar path to what is implied by forward rates over the next year or so. But beyond that, our expectation that the OCR bottoms out at 3.5% (rather than 3% as the RBNZ's track and market forward rates imply) means we also expect short end swap rates like the 2yr to come to settle at around 3.6%. We discuss the risk later, but one driver of this is the idea that having started cutting earlier, the RBNZ may not need to cut by as much, or as quickly as they might had they waited for longer.

Of note, our forecast imply that we are already much of the way through the adjustment lower in short end swap rates. This is because interest rate markets are, by their nature, forward-looking. As such, they have been anticipating cuts for some time, hence the bellwether 2yr swap rate was already at 4% before the RBNZ cut this month (i.e. 1.5% below the OCR before the cut).

While pinpointing precisely where the OCR will end up is nigh-on impossible to do this far out, based on our macro forecasts, we think it's likely that the RBNZ will need to deliver successive cuts until the OCR gets to around 3.5%. We'd characterise the risks around that endpoint (and thus the risks for short end interest rates) as balanced. On one hand, markets may overshoot again (as they often do), or more cuts may be needed if a shock were to come along, but on the other, the OCR may not need to be cut by as much if the economy starts to respond more positively to cuts than we anticipate.

…long end rates are forecast to fall initially, then rise as economies respond to cuts …

Long-end interest rates are also expected to fall from here, with 10yr bond yields expected to bottom out at around 4% (vs around 4¼% now). Like their 2yr equivalents, 10yr rates are also forward looking, but they tend to be driven more by fiscal policy, long-term expectations of inflation, and where the OCR will average over the long term (rather than just what the next 2 years has in store). New Zealand 10yr rates tend to also fluctuate in tandem with movements in comparable global 10yr rates (which may come as no surprise given that around two-thirds of New Zealand government bonds are held by foreigners). The upcoming easing cycle is also set to be reasonably globally synchronised.

With global bond yields expected to fall a little further over coming quarters, New Zealand long-end rates are expected to follow suit and edge a touch lower. But as economies around the world respond to monetary policy easing, global long-term rates are expected to rise in late 2025, taking their New Zealand equivalents with them. This will see yield curves steepen, consistent with the historic tendency for yield curves to steepen as rate cuts are delivered, and as economies respond to those cuts.

Our forecasts

…there are risks around our view, and plenty of scope for volatility…

Risks abound, and one factor limiting how much further long-end bond yields can fall is the outlook for government bond issuance. Issuance volumes have grown sharply since the onset of COVID, and the lack of meaningful fiscal consolidation has been a constant bugbear for many bond buyers (or would-be buyers). Treasury forecasts for New Zealand government bond issuance do tail off into the future, but many investors fear that slower growth may put pressure on tax revenues and force the government to borrow more. If that were to eventuate, yields may not fall as far as we envisage, and may need to rise to attract investors. This risk is far from unique to New Zealand. The US bond market – the most important and developed bond market in the world – is in a similar position. It therefore may not be something home-grown that catches markets by surprise – something "imported", such as an unexpected fiscal surprise in the US, could have just as much of an impact.

Further volatility is also likely along the way. At any point in time, there is a wide range of factors that have the potential to spark volatility, with geopolitics, adverse positioning and data surprises all creating havoc – to varying degrees – over recent months. Additionally, given how eager market expectations for OCR cuts are, there is scope for markets to be disappointed if data comes in slightly stronger than expected, and the RBNZ is forced to ease more gradually. That doesn't seem likely now, but it is a risk. But even so, if there is one saving grace to this particular source of potential volatility, it is that markets tend to move on quickly, and unless the outlook changes, disappointment on any given day is likely to be "recycled" into expectations of cuts being delivered later. What that means is that we may see very short-term rates like 1mth OIS rates and 3mth bank bill rates rise if the RBNZ doesn't cut by as much as markets expect them to over the next year, but the impact on 2-5yr rates is likely to be lesser and more temporary as markets look further into the future.

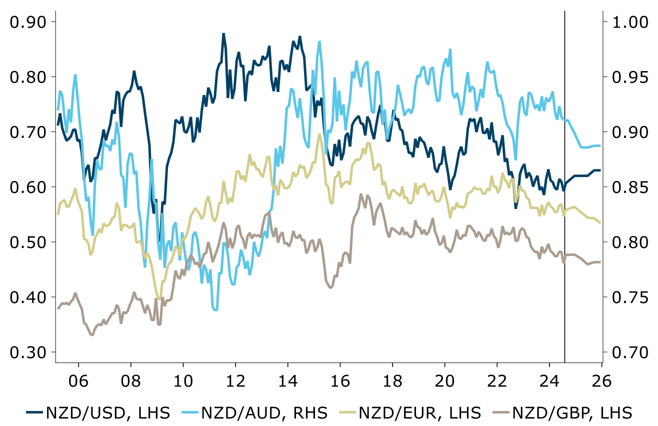
With rate cuts coming here and in the US, the NZD outlook is more subdued

New Zealand has the highest interest rates in the G10, but with US interest rates not that much lower across the yield curve, and the Fed and RBNZ both on track to cut this year, interest rate differentials aren't at standout levels and thus aren't expected to be a supporting factor (or for that matter, a disadvantage) going forward.

On the macroeconomic fundamentals side, although growth has been slowing in New Zealand and is expected to continue to do so, much of the developed world faces the same outlook, removing that as one potential negative factor for the NZD.

Our FX forecasts reman guided by our fair value models, which pull in our forecasts for interest rates, commodity prices, terms of trade, productivity and the like. They put fair value for NZD/USD at around 0.61, which like last quarter, is not far from current market levels, leaving us neutral on the outlook.

Figure 10. NZD against USD, AUD, EUR and GBP



Source: Bloomberg, Macrobond, ANZ Research

Table 1: Forecasts (end of quarter)

FX Rates	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26
NZD/USD	0.610	0.620	0.620	0.620	0.630	0.630	0.630
NZD/AUD	0.910	0.899	0.886	0.886	0.887	0.887	0.887
NZD/EUR	0.560	0.564	0.554	0.544	0.543	0.534	0.534
NZD/JPY	91.5	91.8	89.3	88.0	88.2	85.7	85.7
NZD/GBP	0.477	0.477	0.470	0.459	0.463	0.463	0.463
NZ$ TWI	71.0	71.4	70.6	70.2	70.8	70.4	70.4
Interest Rates	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Jun-25	Sep-25
NZ OCR	5.25	4.75	4.50	4.00	3.50	3.50	3.50
NZ 90-day bill	4.89	4.69	4.20	3.70	3.62	3.62	3.62
NZ 2-yr swap	3.86	3.77	3.67	3.62	3.62	3.62	3.62
NZ 10-yr bond	4.25	4.00	4.00	4.00	4.00	4.50	4.50

Source: Bloomberg, ANZ Research

Forecast charts

Figure 1. Production GDP level (headline vs per capita)

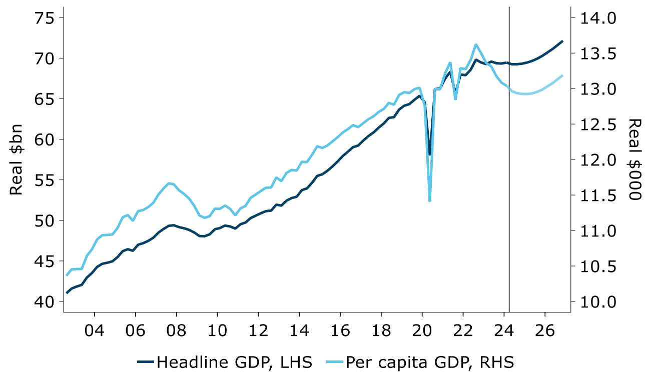


Figure 2. Production GDP growth

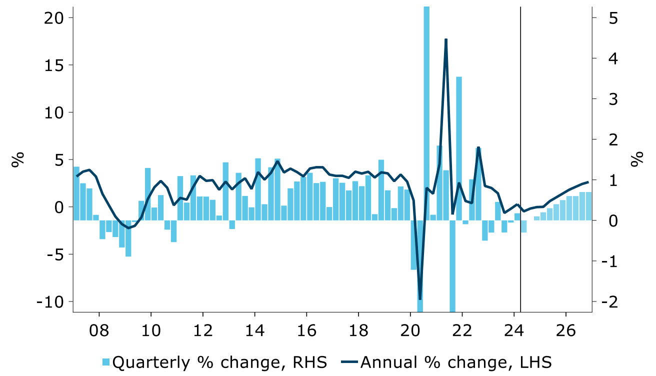


Figure 3. Contributions to GDP growth (detailed)

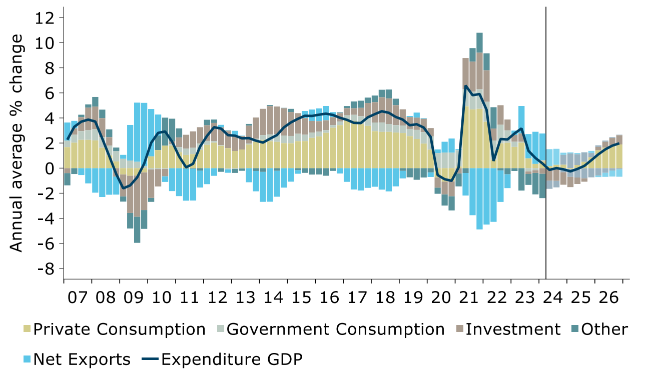


Figure 4. Real investment

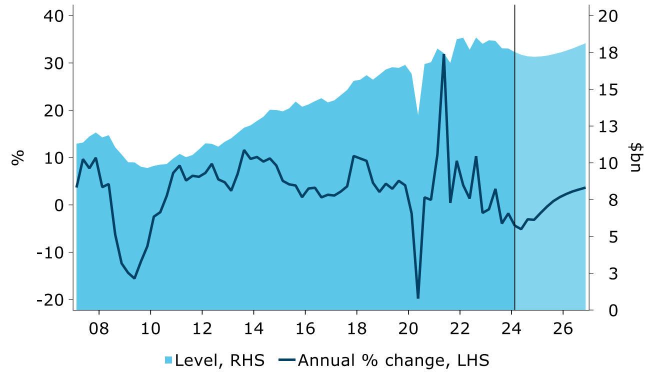


Figure 5. Real private consumption

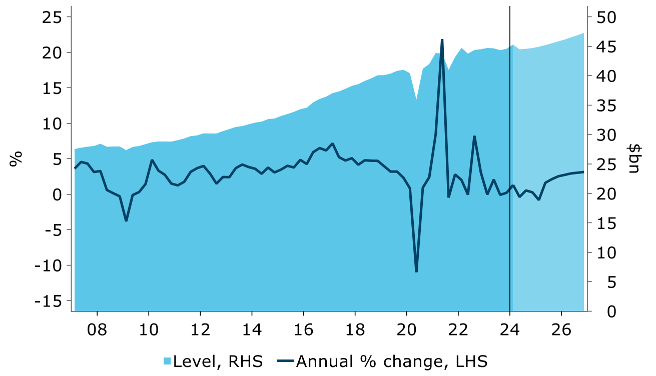


Figure 6. Real government consumption

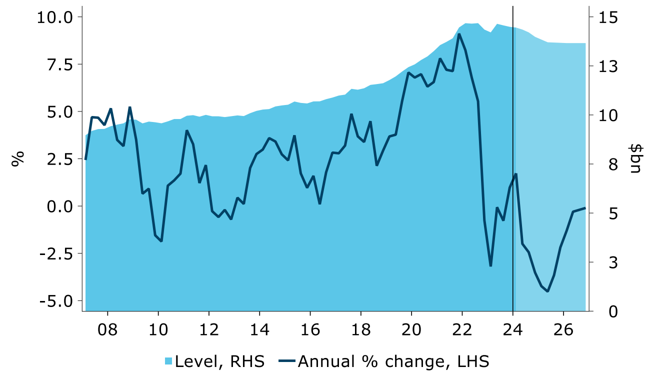


Figure 7. Real exports (goods and services)

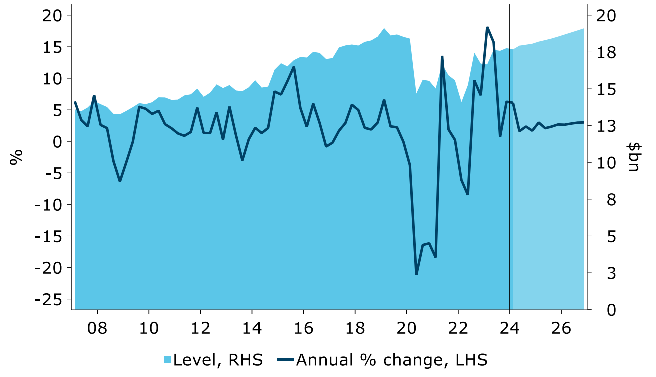
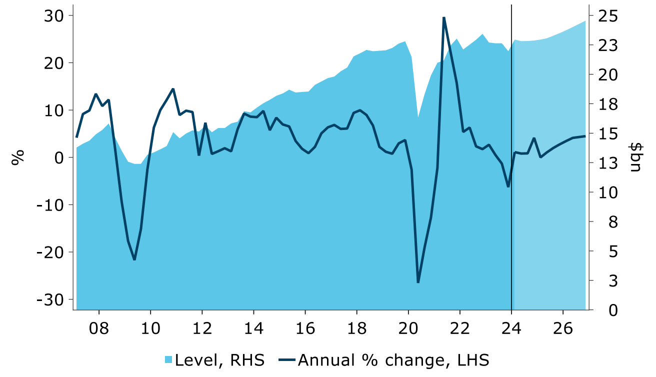


Figure 8. Real imports (goods and services)



Source: Stats NZ, Macrobond, ANZ Research

Forecast charts

Figure 9. Terms of trade

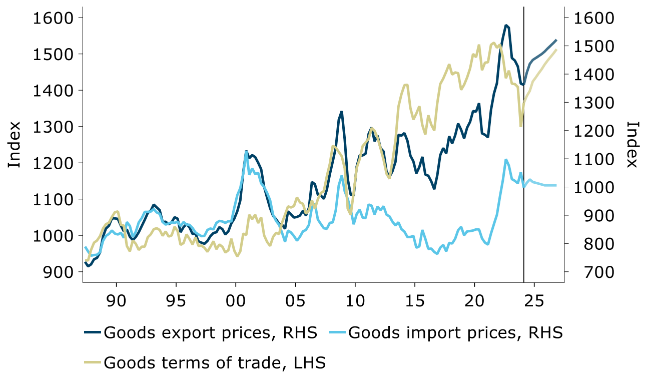


Figure 10. Current account balance

Figure 11. Output gap

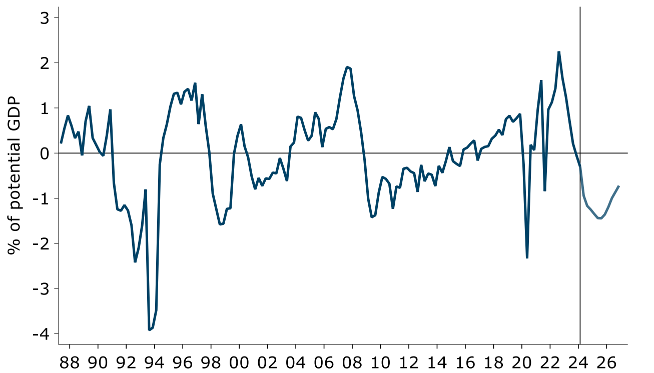


Figure 12. House prices (REINZ HPI)

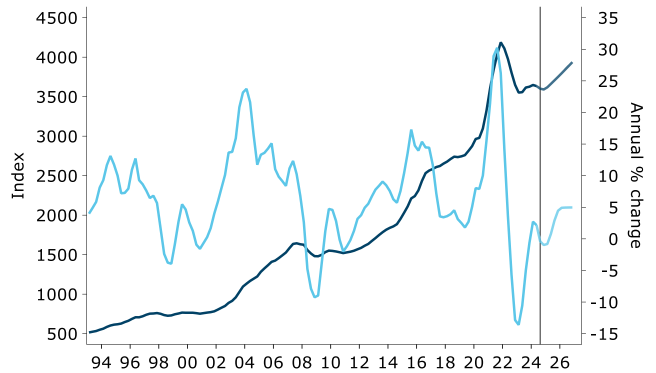


Figure 13. Annual migration

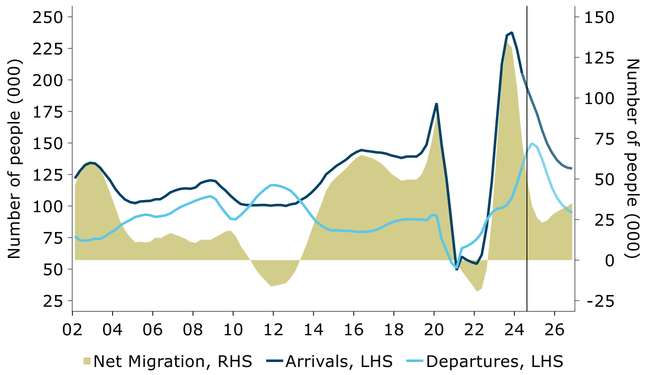


Figure 14. Resident population

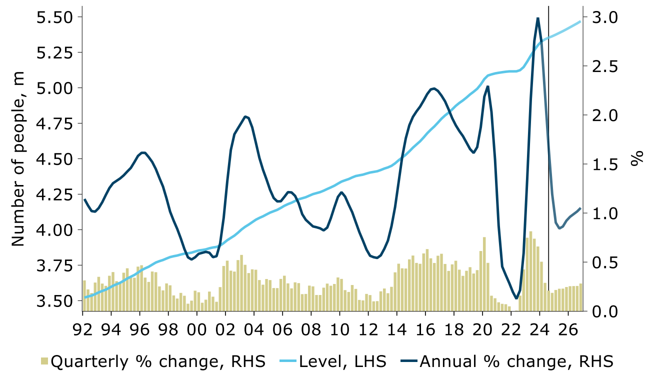
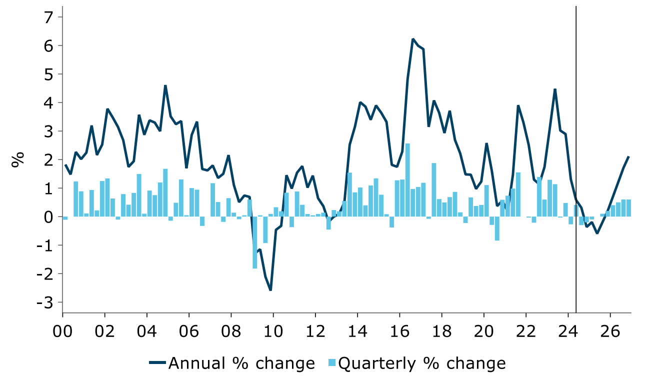


Figure 15. Participation and employment rate

Figure 16. Employment



Source: Stats NZ, REINZ, Macrobond, ANZ Research

Forecast charts

Figure 17. Unemployment rate decomposition

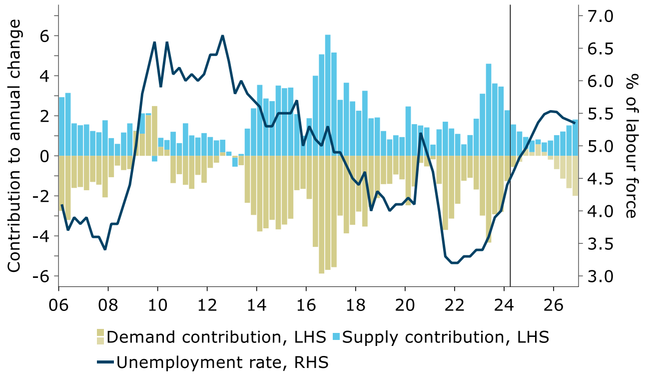
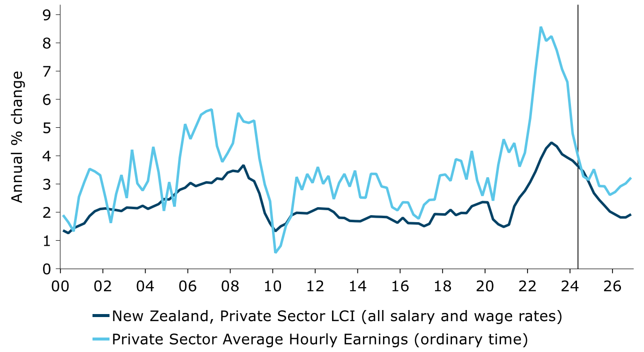


Figure 18. Wages and labour costs



Source: Stats NZ, Macrobond, ANZ Research

Figure 19. Inflation forecasts

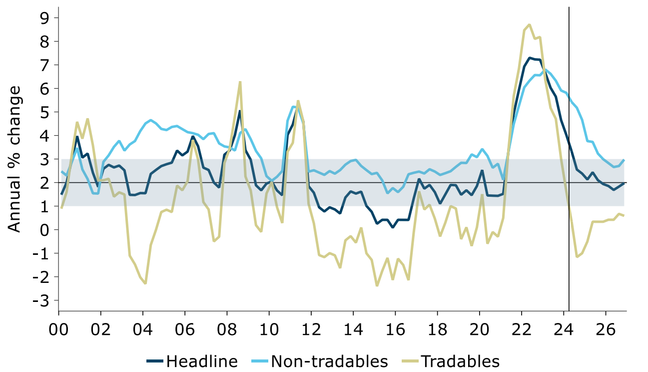


Figure 20. Headline inflation forecast decomposition

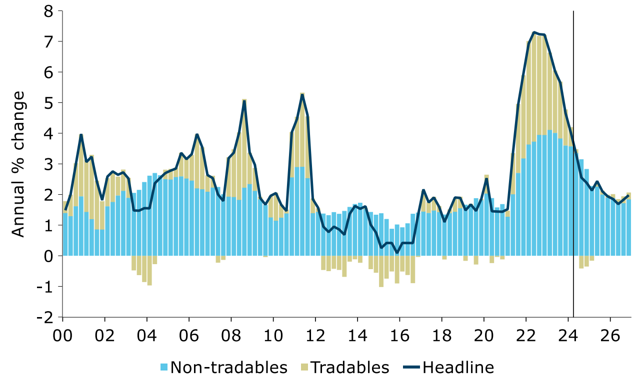


Figure 21. OCR and 90-day rate

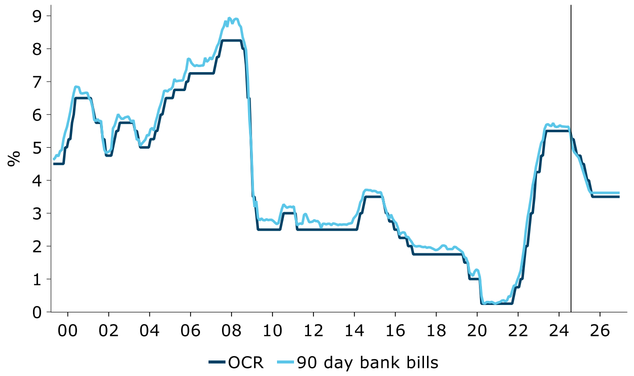


Figure 22. 2-year swap rate and 10-year bond yield

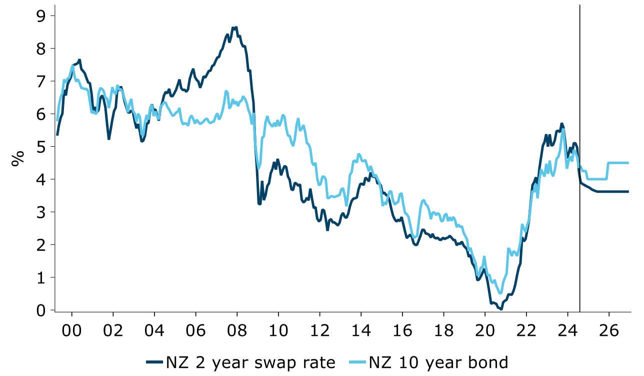


Figure 23. NZD against JPY and CNY, and TWI basis

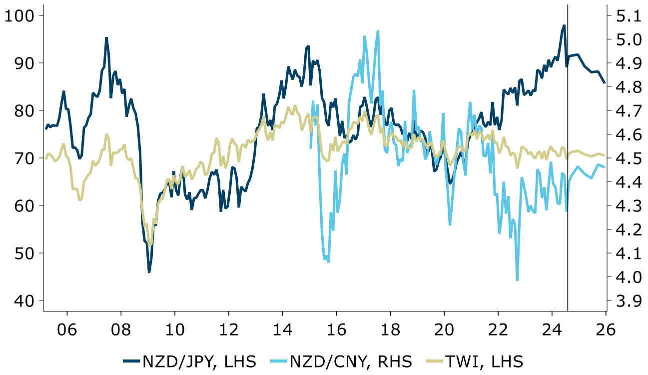
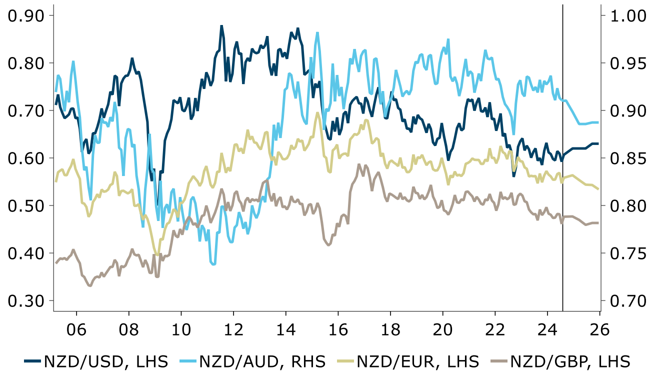


Figure 24. NZD against USD, AUD, EUR and GBP



Source: Stats NZ, Bloomberg, Macrobond, ANZ Research

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