ECONOMIC OVERVIEW

We have lift-off.

November 2021

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Note from Michael

The August *Economic Overview* was released just hours before the news of a Covid-19 case in the community and the swift move into a nationwide lockdown. The following three months have been a rollercoaster ride, with the Delta variant proving harder to control, and the Government having to rapidly adjust its strategy to juggle health, wellbeing and economic concerns.

The Delta outbreak was a blow to an economy that had been charging upwards in recent months. Yet in many ways, the economy has remained in good health. Businesses were better positioned to deal with the shift back into lockdown this time, and have continued to push on with investment spending and hiring. At the same time, prices for our key commodity exports have continued to rise, with the farmgate milk price set to reach a record $8.90/kg this season.

Activity was running well above pre-pandemic levels before the latest outbreak, and we expect that it will return there as restrictions are eased. However, the consequence is that the conditions for a sustained rise in inflation have built up in a way that they haven't for many years. And with that, the Reserve Bank of New Zealand has been among the first central banks to achieve interest rate lift-off since the pandemic began. We think that many more interest rate hikes will be needed in the coming years to bring demand and inflation back down to earth.

In our previous issue we looked at the policy responses to Covid that might arise in New Zealand, based on developments overseas. Much of what we talked about has already come to pass, hurried along by the current outbreak. In this issue we turn to how the private sector might respond, as Covid disruptions prompt firms to look at improving their resilience.

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NEW ZEALAND ECONOMY

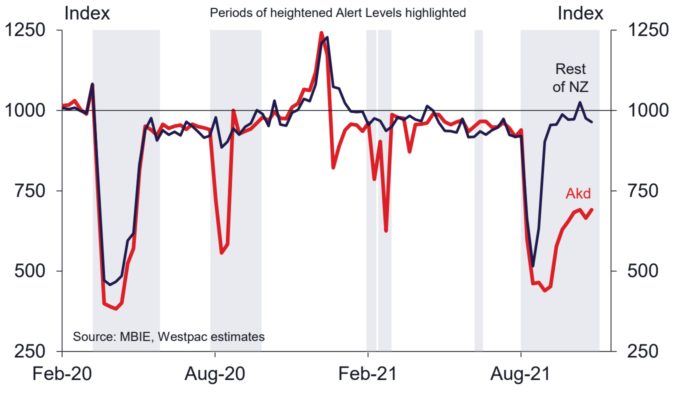
Break my stride.

The Delta outbreak has disrupted economic activity and is set to remain a drag on growth for some time yet. Even so, the New Zealand economy as a whole remains in good health, and we expect a return to firm levels of activity in 2022. But behind the scenes, policy settings are shifting, and interest rates are on the rise. That signals big changes in the economic landscape over the years ahead.

As 2021 draws to a close, New Zealand is continuing to grapple with the impacts of August's outbreak of the Delta variant. Economic output is estimated to have fallen by 6% in the September quarter. And although Alert Levels have generally been dialled down over the past few months, health restrictions have continued to weigh on activity in some parts of the economy.

The impacts of the outbreak have been most pronounced in Auckland, with retail spending in our most populous region running around 30% below pre-Delta levels. However, Delta's reach has been felt across the country, with many businesses in customer-facing industries like hospitality still struggling with significant reductions in demand, even in regions that are at Alert Level 2.

Figure 1: Weekly retail spending



While the Delta outbreak has been a significant drag on some parts of the economy, overall economic conditions have actually remained fairly resilient. In fact, through the September quarter, when Alert Level restrictions were at their most prohibitive, employment levels rose by 2% and the unemployment rate fell to just 3.4% – equal to the lowest level on record. We've also seen firmness in household demand, with retail spending levels in areas outside of Auckland running around 5% above the levels we saw prior to this latest outbreak.

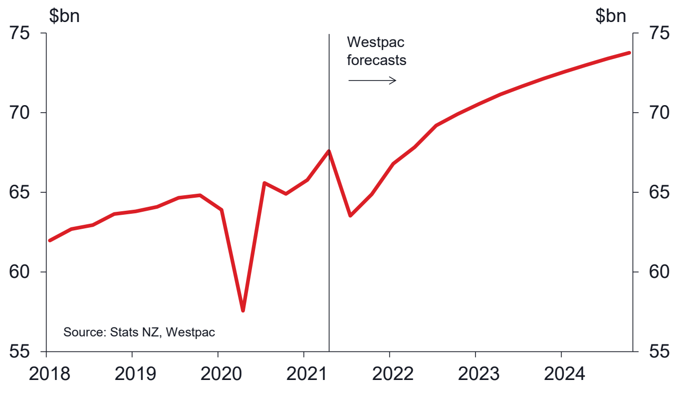
Looking to the coming year, there are positive indications for activity in many key parts of the economy. Of note, there is a large amount of construction work planned across the country with a record 47,000 new dwellings consented over the past year. Similarly, feedback from businesses in the manufacturing sector indicates that demand has remained firm. And as discussed in the *Agricultural outlook* chapter, prices for our key agricultural exports have hit record highs and overseas demand conditions continue to look favourable.

While we expect a return to firm levels of activity in 2022, that doesn't mean it will be smooth sailing for the economy.

With resilience in underlying demand conditions, we expect that unemployment will remain low over the coming months and that economic activity will rise back to firm levels as health restrictions are eased. However, that doesn't mean it will be smooth sailing for the economy. With infection numbers continuing to rise, health restrictions are likely to be wound back only gradually and we don't expect economic output will retrace its pre-Delta levels until mid-2022.

In addition, prior to the latest outbreak the economy was grappling with a cocktail of supply disruptions, material shortages and rising costs. Those conditions are likely to remain a feature of the economic landscape well into the new year. They will also limit the scope for a period of 'catch-up' activity as we saw following the initial Covid outbreak last year.

Figure 2: Quarterly GDP forecasts



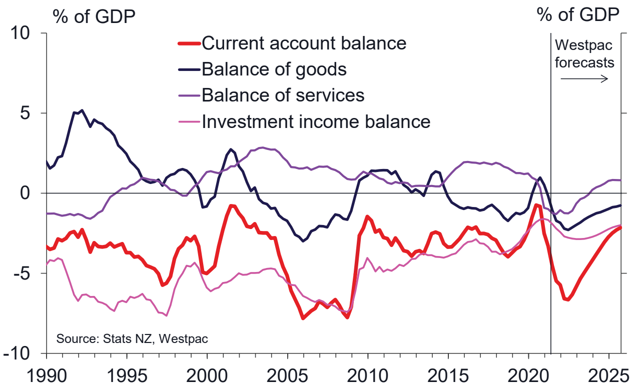
The changing mix of activity in the wake of Covid has seen New Zealand's trade balance deteriorate, with the current account deficit set to reach 6.6% of annual GDP next year. That would be the largest deficit since 2009.

Much of the widening in the current account deficit stems from the closure of our borders and related loss of international tourist dollars. Prior to the outbreak, New Zealand was a net exporter of tourism and other services. However, with international tourists now shut out of the country, our previous services trade surpluses have given way to sizeable deficits over the past year.

At the same time, Covid has resulted in significant changes in what New Zealand households are purchasing. With international travel off the cards and health restrictions limiting spending on domestic recreational activities, households have instead been spending more on goods like furnishings and appliances, the bulk of which are imported. That's been amplified by the significant amounts of monetary and fiscal stimulus introduced in response to the pandemic, and the related strong levels of domestic demand.

While the deterioration in our international trade position has been stark, we expect that this will be temporary and that the current account balance will return to healthier levels over the coming years. As vaccination rates continue to rise, Covid-related restrictions here and abroad will be wound back over time and many of the shifts in demand we have seen over the past year will start to reverse. On this front, we expect that New Zealand will begin a staggered reopening of the border in early 2022 based on different countries' Covid risk level. At the same time, we're likely to see households spending less on imported goods and more on services like dining out as the health situation allows the hospitality sector to gradually open up again.

Figure 3: Current account balance and components

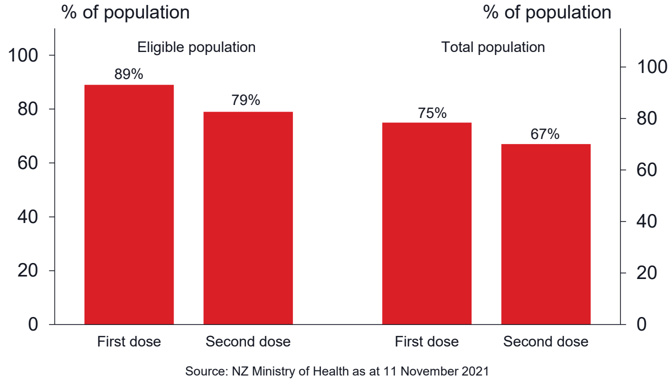


The shifting policy landscape.

While we expect a return to firm economic conditions over the coming year, behind the scenes, some of the key policy settings that have shaped the post-Covid economic environment are now changing.

First of these is the Government's approach to the Covid outbreak itself. It has not been possible to halt the spread of the Delta outbreak. As a result, the Government has moved away from its previous 'elimination' strategy to managing Covid in the community. Under the Government's new approach, the country will move to a 'traffic light' system once vaccination rates hit 90% of the eligible population in every region. This will involve public health measures, like social distancing requirements, being dialled up or down as necessary to manage the pressure on the healthcare system, but without resorting to lockdowns in the future. A key feature of this new framework is that there will now be more restrictions on the unvaccinated, while households and businesses that make use of vaccination certificates will be subject to fewer restrictions.

Figure 4: Vaccination rates



The shift to the traffic light system signals an important change in the economic landscape for many businesses, especially those in close-contact industries such as hospitality. As we've seen over the past year, health restrictions and social distancing requirements do dampen demand to some degree, and there's a chance that restrictions could be in place for an extended period. However, the resulting drag on demand from such restrictions is much less severe than when the economy has been pushed back into lockdown. Furthermore, with a growing proportion of the country fully vaccinated, fewer households will be subject to strict activity restrictions if case numbers flare up again.

It was always going to be the case that once the vaccination programme was sufficiently advanced, New Zealand would need to determine how to live with Covid over the longer term. Consequently, although the current outbreak has forced the country to confront these issues sooner than otherwise, the change in approach from the Government has not meaningfully altered our outlook for the economy in 2022 and beyond.

However, as a result of the Delta outbreak, the Government has again had to spend several billion dollars on measures to support households and businesses in recent months. That includes the reintroduction of the wage subsidy scheme, as well as new initiatives such as the Resurgence Support Payment. This additional pressure on the Government's finances will limit the amount of new Government spending over 2022 fiscal year. Nonetheless, the surprisingly strong 2020/21 fiscal accounts combined with the mostly unchanged fiscal outlook for 2023 and beyond means we still expect the Government will continue with its longer-term focus on enhancing social and economic wellbeing. Indeed, the Government has already continued down this path in early November, announcing spending of $272m to boost the Working for Families package.

Increases in borrowing costs will squeeze discretionary incomes over the coming years, dampening both household demand and economic growth more generally.

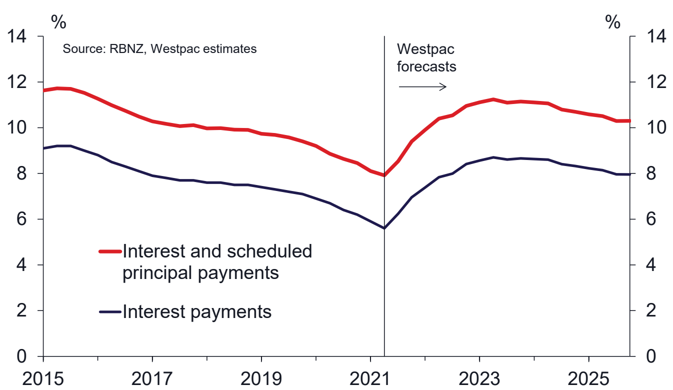
The other key area where significant changes are in train is monetary policy. Interest rate reductions since the start of the pandemic have played a pivotal role in supporting New Zealand's recovery, with much of the resulting boost to demand coming through the household sector. In fact, since March 2020 reductions in borrowing costs have put around $380m back into households' wallets each quarter. At the same time, household balance sheets have been boosted by a 40% rise in house prices over the past 18 months.

Combined with other support measures and firmness in the labour market, those developments have super-charged household spending over the past year. However, household debt levels have also risen rapidly over this period: New Zealand households are now carrying debt that's equivalent to 169% of their disposable incomes, with most of the rise related to mortgage debt on owner occupied or investment properties.

As discussed in the *Inflation and the RBNZ* section, the Reserve Bank has now begun to lift the Official Cash Rate. That follows the faster than expected recovery in economic activity over the past year and the related build-up of strong inflation pressures. We expect that the RBNZ will continue to raise the OCR over the coming years, taking it into 'tight' territory by the end of 2022. The resulting increases in borrowing costs will reverberate through all parts of the economy, with the current strong economic conditions set to give way to a period of modest economic growth through 2023 and 2024.

Mortgage fixing will blunt the impact of rate rises for a time. Even so, we estimate that spending on debt servicing is likely to rise from just under 8% of households' disposable incomes currently to around 11% in 2023. That would more than offset the increase in households' spending power seen over the past year, and the resulting squeeze on discretionary incomes will dampen both household demand and economic growth more generally over the coming years.

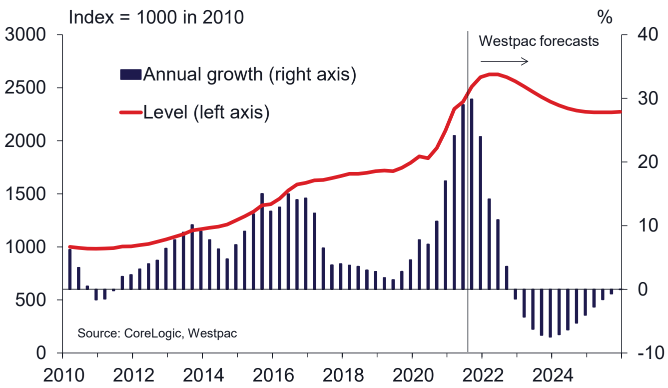
Figure 5: Debt servicing costs (% of households' disposable income)



A cooling in the housing market and the subsequent slowing in the rapid increases in household wealth will also dampen household demand. As mortgage rates rise, we expect a substantial slowing in house price growth over the coming months, turning to modest price declines by the second half of 2022. That slowdown will likely be compounded by a tightening in lending regulations, with the RBNZ currently consulting on debt-to-income limits on mortgage lending.

While we expect an easing in house prices over the coming years, recent increases in prices have been dramatic. The expected price declines would only reverse a small portion of the gains seen in recent years, meaning that housing affordability is set to remain stretched relative to incomes in many parts of the country.

Figure 6: House price forecasts



Checking the foundations.

New Zealand's residential construction sector has been a major driver of GDP and employment growth, and we expect that home building levels will remain very strong over the next few years. However, under the surface, some of the key factors that have supported the lift in home building have been shifting.

First is population growth. For much of the past decade, very high levels of net migration meant that home building failed to keep pace with increases in the population. However, since the borders have closed, population growth has plummeted and the shortages of homes that have developed in many regions over the past decade are now being rapidly eroded (especially in Auckland). Even when the borders do reopen, we expect that population growth will remain lower than it was over the past decade. The Government is currently reviewing migration policy, and this is likely to lead to tighter entry conditions than in the past.

The financial incentives for developers are also likely to be eroded over the coming years. Material and labour costs have been rising rapidly. And borrowing costs are now also on the rise. Combined with a cooling in house price growth, it's likely that the number of new projects coming to market will ease back from the current record levels as we approach the middle part of the decade.

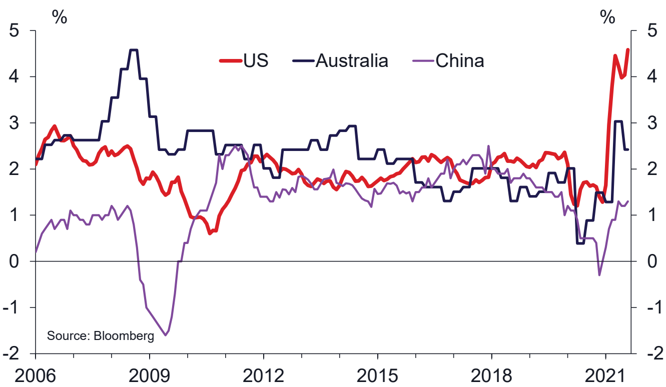
GLOBAL ECONOMY

Inflation check, lift-off in T minus...

Inflation has proven to be more persistent rather than transitory for some of our major trading partners. As a result, markets have priced in more policy rate increases than before as they believe that central banks will need to act. While inflation in countries like Australia and the US has been driven by strong demand, China's inflation has mainly been driven by rising input costs.

Inflation has continued to rise globally due to both supply and demand dynamics. Bottlenecks in supply chains have persisted for longer than expected, as illustrated by the continued elevated cost of moving goods around the world. In addition, prices of commodities used as raw inputs have held at high levels. Demand has also led inflation higher for developed economies as both employment and growth have continued to recover.

Figure 7: Core inflation

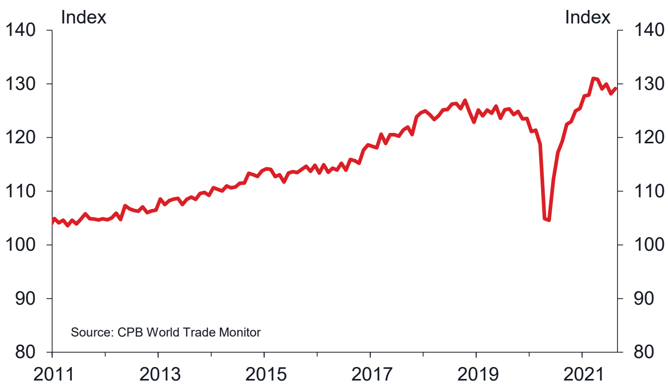


The re-opening of economies globally due to higher vaccination rates has boosted demand. Governments have shifted their focus from case numbers to hospitalisations. However, governments are still trying to balance the easing of restrictions with the possible pressure on the healthcare system, resulting in a gradual approach to easing restrictions.

As economies continue to re-open there has been some reallocation of spending away from goods and back towards services. However, given the generally gradual pace of easing Covid restrictions, the shift in spending has been much slower than we expected, as seen in the slow decline in world trade volumes from record highs.

The reallocation of spending away from goods to services has been slower than anticipated.

Figure 8: World trade volumes



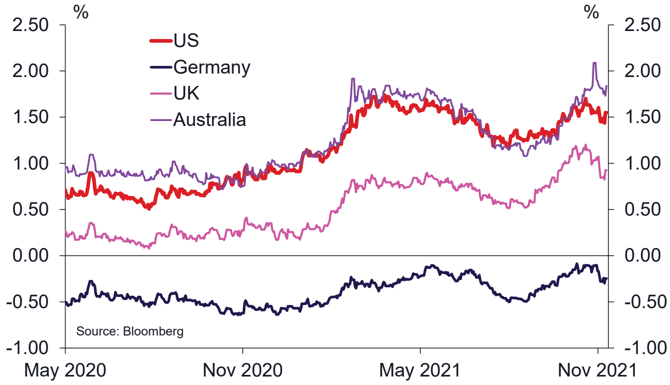
The increasing demand side pressure on economies has seen markets pricing in more aggressive actions for central banks since the last *Economic Overview*. Most of the moves in interest rates have been driven by markets pricing in higher policy rates, as central banks will likely need to raise policy rates sooner to keep inflation in check. Markets are also now increasingly confident that demand-driven inflation is likely to prove more persistent (rather than transitory), and that central banks will react by raising policy rates.

Markets are pricing in higher policy rates, as they anticipate central banks will need to hike sooner to keep inflation in check.

Central banks, as a result, have signalled that they are willing to tighten monetary policy sooner than what they had stated earlier in the year. However, when the tightening will occur, and by how much, still varies from country to country.

We expect that the US Federal Reserve will be the next major central bank to tighten monetary policy. They have already reduced the rate of bond purchases in their latest review, and we expect purchases to halt by the middle of 2022. We then expect the Fed to begin lifting its policy rate in December 2022.

Figure 9: 10-year government bond yields



Despite these moves, we think that the Fed is still likely to remain very accommodative in its settings. The peak in its policy rates is likely to be lower than what it is has traditionally been in the past. As a result, we expect US rates of growth and inflation to remain higher than their long-term trends. Indeed, the Fed's forecasts for its preferred measure of inflation range from 3.4% to 4.2% for 2022-2024, well above its target of 2%.

Developments in the labour market will also be key for US inflation outcomes. Factors holding back labour supply such as lack of childcare support, schools being closed, and Covid cases are all diminishing. Bringing back additional labour supply will be needed to meet this hot demand, and in doing so, wage growth should ease.

The Reserve Bank of Australia has also taken its first steps to unwind stimulus. They have already ended their yield curve control programme, noting that as other interest rates had risen the effectiveness of the programme has diminished. In addition, the guidance on the first increase in the cash rate acknowledged that it could be sooner than 2024. We remain more optimistic about the outlook for next year, and we expect the RBA to start lifting its policy rate in February 2023.

Our difference in view notably stems from differences in the outlook for the labour market. Activity is likely to bounce back due to pent-up demand in New South Wales and Victoria. In addition, the move away from trying to eliminate Covid to mitigating the risk of it decreases the likelihood of restrictive lockdowns. As a result, the RBA's inflation and employment objectives are likely to be met by the end of 2022.

China's inflation has been due to higher input costs rather than pressure from demand.

The European Central Bank is taking a more tentative approach to removing stimulus. Within the next few months, they intend to slow the pace of its bond purchases. Their latest monetary policy statement reiterated that the first increase in policy rates would not occur until around 2024, whereas market implies pricing a small chance of a rate hike in late 2022.

The reluctance for the ECB to become more hawkish like the RBA and Fed likely stems from the fact that they view high inflation as temporary. The labour market still has considerable slack as unemployment is still higher than pre-Covid and participation is yet to recover. While the economy is expected to maintain above-trend growth 5% in 2021, 4.6% in 2022 and 2.1% in 2023, inflation is still expected to sit below target. Our forecast of CPI ex-energy peaks at 1.9% for 2021 before reducing to 1.7% in 2022 and 1.5% in 2023.

While China has also faced inflation, we view this as more due to higher input costs rather than pressure from demand. This contrasts to the demand-driven inflation that our other major trading partners such as Australia and United States are facing.

Indeed, rising prices for oil and coal have undoubtedly been a headwind for China's energy hungry economy. The impact of high and rising coal prices was felt particularly acutely as it contributes to a large portion of electricity generation in China. Sharply rising input costs with limited ability to pass it onto their consumers has meant a shortage in the supply of electricity. This led to power rationing which has limited manufacturing activity.

Figure 10: Chinese producer prices

In addition to those supply side headwinds, economic growth has also been negatively impacted by fresh Covid outbreaks and subsequent lockdowns in some regions. However, the non-manufacturing PMI showed a bounce in September and held firm in October, indicating that the lockdown disruptions to the economy may be limited.

Turbulence in the Chinese property sector may prove a longer-term issue for the Chinese economy and policymakers. This has mainly come in the wake of regulatory changes which aim to reduce leverage and reduce wastage, while the financial struggles of Evergrande, the world's largest property developer, have added to the sector's headwinds. Given a large portion of Chinese wealth is tied up in real estate, this could reduce future consumption. To offset the drag from the property sector, business investment will need to make up a bigger portion of total investment.

The higher global inflation we're seeing is likely to be a tailwind for New Zealand. This would provide a boost to exporter incomes, as discussed in the *Agricultural outlook* section. In addition, we could see ongoing higher tradables inflation, in contrast to what we saw in the 2010s when tradables prices were a persistent drag on headline inflation.

INFLATION AND THE RBNZ

The only way is up (for now).

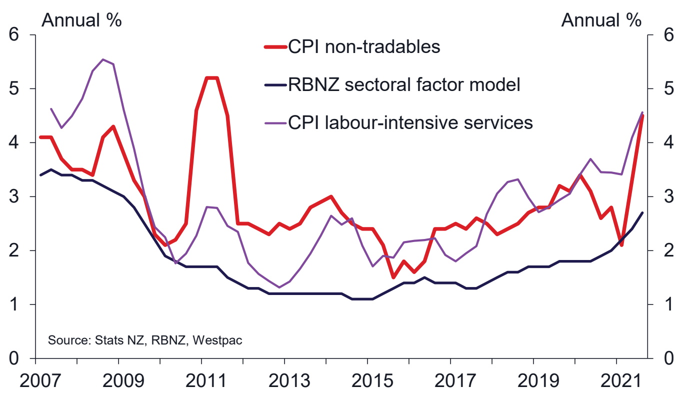
Inflation in New Zealand has been running hot, boosted by a potent cocktail of supply-side cost pressures and strong demand. We expect that those pressures will remain intense for some time, and that the Reserve Bank will need to take the cash rate into 'tight' territory to rein inflation in. We're forecasting a series of OCR hikes over the coming years, with the cash rate to peak at 3% in 2023.

As we've seen elsewhere in the world, the inflation rate in New Zealand has blown out beyond expectations in recent months. Consumer prices rose 4.9% in the year to September, a pace that we've rarely seen, and then only briefly, in the era of inflation targeting.

The current spike in inflation is the result of a range of domestic and global supply-side pressures, as well as strong demand, coming together at the same time. The intersection of those factors has resulted in widespread – and often large – increases in the prices for many consumer goods and services. That has been further compounded by base effects, with some prices having rebounded from Covid-depressed levels a year earlier. It's not a stretch to say that inflation won't remain this high forever, but that still leaves open a wide range of possibilities.

One of the challenges in the outlook for inflation is disentangling the extent to which these forces will be short-lived or more persistent. For example, Covid restrictions have skewed global demand away from services and towards physical goods, which has strained the capacity of both the manufacturing and transport industries. We expect these pressures to ease as economies reopen and spending patterns normalise. Indeed, there are signs that they've now passed their worst, although we're cautious about predicting how quickly they will recede.

Figure 11: Indicators of persistent inflation



The greater concern is the extent to which home-grown inflation pressures are emerging. Whichever measure of 'core' inflation you might use, stripping out the influence of more volatile items, a clear uptrend has been emerging – and arguably was even before the pandemic.

New Zealand's Covid response limited the potential scarring from lockdowns, allowing demand to recover quickly, and fiscal and monetary stimulus added further fuel to the fire. By the middle of this year, it was apparent that the greater risk for inflation was that demand was outstripping the economy's capacity to meet it.

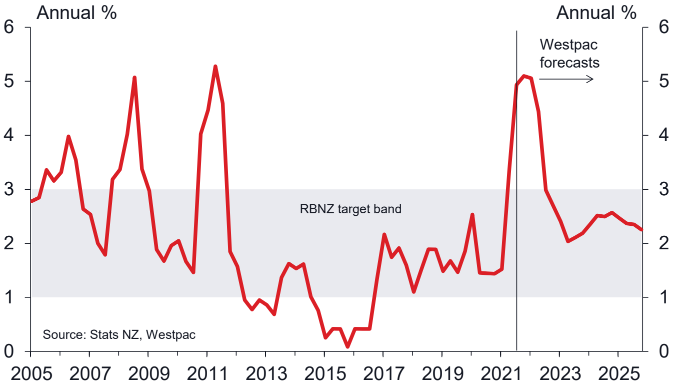
In that respect, the debate over whether recent price shocks will prove 'transitory' is beside the point. When demand is running hot, a temporary price shock can provide the catalyst for an ongoing series of wage and price increases, even once the initial shock recedes. Once that point is reached, monetary policy will need to step in as a circuit-breaker.

Debate about whether recent price shocks are 'transitory' is beside the point – strong demand presents the greater risk for ongoing inflation.

We're forecasting the inflation rate to peak at 5.1% in the December quarter, and remain elevated over the coming year. As the recent price spikes drop out of the equation, we expect the annual rate to drop back into the Reserve Bank's 1-3% target range – albeit in the upper half of the range – in 2023 and beyond.

This would mark quite a change from the previous decade, which was characterised by stubbornly low inflation both in New Zealand and around the world. During that time, fiscal austerity created an additional headwind for monetary policy, and inflation expectations were at risk of becoming unanchored to the downside of central banks' targets. Those two factors have certainly turned around in the post-Covid era. In addition, the drive towards hyper-optimisation of global supply chains, which had been a disinflationary force over the last decade, may be rethought in the wake of Covid disruptions.

Figure 12: Inflation forecasts



Up, then down.

While we expect inflation to settle within the target range over the medium term, that is of course contingent on the path of monetary policy. In our August *Economic Overview*, we took the view that a gradual glide path up towards a 'neutral' level of the OCR, generally estimated to be around 2%, would be enough to keep inflation in check. But the accumulated evidence on the economy since then suggests that more will be needed.

We expect the Reserve Bank to lift the OCR to a peak of 3% by the third quarter of 2023, which would take monetary policy settings beyond 'neutral' and into 'tight' territory, at least for some time. As demand is reined in and inflation pressures cool, we've then pencilled in a series of OCR cuts back to 2% in 2025. Admittedly, predicting the next phase of interest rates is hard enough, let alone the next two phases, but we're really trying to convey the general direction of policy rather than the exact timing.

With so much monetary tightening to do over the next couple of years, the question of tactics naturally crops up. Our view is that moving in increments of 25 basis points would be sufficient. But we'd emphasise that there is a meaningful risk that the Reserve Bank could choose to go in larger 50 basis point steps at any given time.

There is a meaningful risk that the Reserve Bank could move in larger 50bp steps.

The RBNZ itself said that it actively considered a 50 basis point hike in August – at a time when the economic evidence for doing so was less compelling than it is now. A subsequent speech set out the framework under which the RBNZ might take bolder action – when 'the kōtuku would take flight', to use their analogy. It's possible to argue that all of the given conditions are being ticked off:

- The starting point for the economy is wildly different to what the RBNZ expected.
- The risks are becoming skewed, towards persistently higher rather than lower inflation.
- There is a meaningful risk of not meeting their inflation and employment mandates over the medium term – relative to their current projection for a gradual pace of tightening.

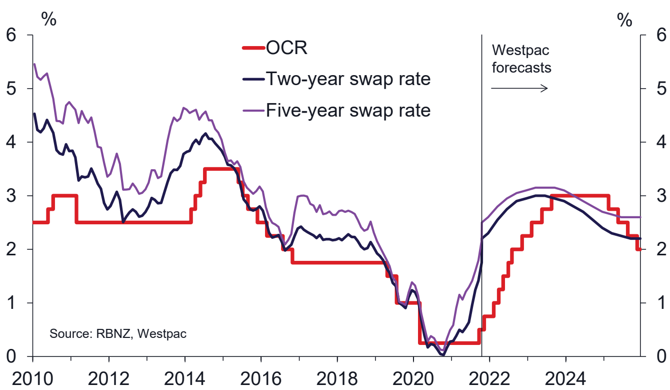
Against this, the strongest argument for a more cautious approach is the uncertain impact of the latest Covid restrictions. While the RBNZ probably used last year's successful lockdown as the template for this time around, that hasn't proven to be the case. The lengthier period of restrictions, and their more gradual withdrawal, could have more lasting effects on firms' balance sheets and consumer behaviour than we've seen up until now.

Baked in.

Our OCR forecast track implies that the floating interest rates faced by borrowers have quite some way to rise from here. Fixed-term rates, however, are another matter. While most forecasters – and the RBNZ's August projections – suggest a peak in the OCR of around 2%, wholesale interest rates are already consistent with a peak closer to our view of 3%. That might be a genuinely-held belief by traders, or it could be an overreaction to recent data in a volatile market. Either way, those wholesale rates are in turn reflected in today's retail interest rates.

Fixed-term mortgage rates have risen sharply across the board in recent months – even the popular one- to two-year fixed rates, the lowest points on the curve, have risen more than a percentage point from their lows in July. Our OCR track does suggest that the upswing in fixed-term rates has further to go, but is already well-advanced.

Figure 13: OCR and swap rate forecasts



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Dec-21	5.1	0.75	0.95	2.30	2.60
Mar-22	5.1	1.00	1.40	2.55	2.80
Jun-22	4.4	1.50	1.90	2.75	2.95
Sep-22	3.0	2.00	2.20	2.90	3.05
Dec-22	2.7	2.25	2.45	2.95	3.10
Mar-23	2.4	2.50	2.70	3.00	3.15
Jun-23	2.0	2.75	2.95	3.00	3.15
Sep-23	2.1	3.00	3.10	2.95	3.15
Dec-23	2.2	3.00	3.10	2.90	3.10
Mar-24	2.3	3.00	3.10	2.80	3.00

AGRICULTURAL OUTLOOK

To the moon and some way back.

Agricultural commodity prices are shooting for the moon. Prices have hit unprecedented levels across most sectors at different parts of the year. And we expect overall there is more to come in 2022. However, input prices are mirroring this strength. Indeed, keeping costs in check where possible will prove key to making this season a record one in not just price, but profit terms too.

New Zealand's commodity prices have skyrocketed over 2021. In world price terms, the ANZ Commodity Price Index has set a string of records, with October setting the latest of five record highs this year.

The latest record comes as global dairy prices get a second wind. Notably, global dairy production has slowed this year, and poor weather has put New Zealand production on the back foot over winter and spring. As a result, global prices have again lifted, leading us to revise our 2021/22 farmgate milk price forecast up by 40 cents to $8.90/kg.

Not to be left behind, meat prices have also taken off. Farmgate beef, lamb and mutton prices have all knocked off record highs over recent months. Increasing freedoms in our key markets and the renewed ability to eat out has driven the surge in meat prices, although some supply constraints such as very high feed grain prices have also been a factor.

In other sectors, demand and supply have been more mixed. The 2021 kiwifruit crop jumped a massive 16% compared to the 2020 crop, and this has dampened export prices from record highs to mere healthy levels. Meanwhile, after hitting giddy heights in June, demand has cooled for forestry exports. The Chinese economy has come off the boil, plus the struggles of Evergrande, the world's largest property developer, have further reduced demand for wood. With still very high shipping costs also weighing on log export markets, log prices have fallen to around long-run average levels.

Nonetheless, we expect the overall commodity price strength to continue in the short term. We expect the weakness in global dairy production to persist into the new year and for this to lead global dairy prices higher over coming months. Similarly, ongoing strength in global feed grain prices is likely to keep meat export prices elevated. Allowing for the normal seasonal price patterns, we expect farmgate beef and lamb prices to remain at or near record highs through summer and into the autumn.

Farm and orchard input prices are, however, mirroring skyrocketing farmgate prices. Indeed, the price rises are broad-based, with input prices such as fertiliser, feed, wages and fuel all shooting for the stars. Moreover, we expect that like farmgate prices, input prices are likely to remain very high well into 2022.

On balance, surging farm and orchard farmgate prices should more than offset rising costs. That said, farmers and growers alike will need to keep their eye on the cost ball to ensure that they keep as much as possible of these record returns.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	Soft global dairy production, including a weak start to the New Zealand season, has given dairy prices a second wind. We've lifted our 21/22 forecast to $8.90/kg.	Above average	↗
Beef	Rebounding demand has led farmgate beef prices to record highs. Allowing for the normal seasonal patterns, we expect prices to remain very healthy.	Above average	→
Lamb/Mutton	Farmgate lamb prices have set fresh record highs. Allowing for the normal seasonal downturn, we expect prices to remain historically high.	High	→
Forestry	Forestry prices are well past their peak and are being weighed down further by softening Chinese demand and the ongoing blowout in shipping costs.	Average	↘
Horticulture	Kiwifruit prices have eased on extra supply but remain very high. With less supply, apple prices have remained at very healthy levels.	Above average	↘
Wool	Fine wool prices have continued to lift on the back of improved global apparel demand. The earlier improvement in coarse wool prices has stalled.	Low	→

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

EXCHANGE RATES

Stuck on the launchpad.

The New Zealand dollar has continued to be volatile, initially falling after the return of Covid restrictions. However, the underlying economy remains strong as we move towards a gradual easing in restrictions. We expect the currency to appreciate against the US dollar due to it being undervalued for some time based on fundamentals.

The New Zealand dollar has seen some volatility since the August *Economic Overview*. It initially fell after the announcement of a return to Alert Level 4 for the country after a community case of Delta was detected. That also saw the Reserve Bank delay the policy rate hike that had been fully priced in by the market for the August *Monetary Policy Statement*.

Once the initial shock had passed, high-frequency data pointed to the economy bouncing back quickly again as restrictions were eased. It has also become more apparent that the economy was running hot before we went into lockdown, as demonstrated by the CPI and labour market data for the September quarter.

We expect the NZD to gain ground against the US dollar over the next year, reaching an average of 74 cents by the end of 2022. Our assessment is that the NZD is undervalued, and indeed has been for some time. Indeed, relatively high interest rates and record-high commodity prices both argue for a stronger NZD.

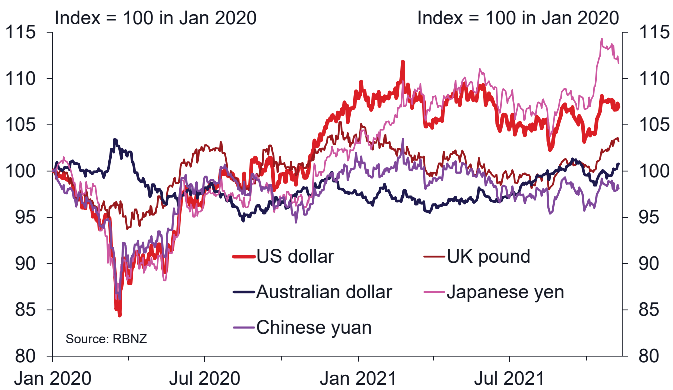
We expect the NZ dollar to rise to 74 cents next year, supported by interest rates and commodity prices.

However, that represents a downgrade compared to our view in August, when we expected a peak of US 77 cents next year. That mainly reflects a more resilient US dollar rather than a weaker NZD. Expectations for US monetary policy have shifted as activity has picked up and inflation has proven to be more than just transitory. The Federal Reserve has begun to tighten policy by reducing its purchases of bonds, and we expect it to halt purchases by mid-2022, before it starts to raise the policy rate from December 2022.

Against the Australian dollar, the NZD remains high relative to its historic average. As in New Zealand, interest rates have also moved in the AUD's favour against the US dollar recently. We don't expect the Reserve Bank of Australia to start lifting its cash rate until early 2023, but longer-term interest rates have already risen sharply as the RBA has brought its 'yield curve control' programme to an end.

We expect both currencies to continue benefitting from high commodity prices, although Australia's largely industrial commodity exports leave it more exposed to the risk of a slowdown in China compared to New Zealand's agricultural exports. In addition, we expect both economies to perform well in the near term, as discussed in the *New Zealand economy* and *Global economy* sections. On balance, we expect the NZD/AUD exchange rate to hold broadly steady over the coming year.

Figure 14: NZ dollar exchange rate vs major currencies



Exchange rate forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Dec-21	0.71	0.95	0.60	0.51	79.5	74.6
Mar-22	0.72	0.95	0.60	0.52	80.6	75.2
Jun-22	0.73	0.95	0.61	0.52	82.5	75.9
Sep-22	0.74	0.95	0.63	0.52	83.6	76.6
Dec-22	0.74	0.95	0.63	0.52	84.4	76.4
Mar-23	0.74	0.94	0.63	0.53	84.4	76.3
Jun-23	0.74	0.93	0.64	0.53	85.1	76.0
Sep-23	0.74	0.93	0.64	0.53	84.5	75.8
Dec-23	0.73	0.94	0.63	0.53	84.7	75.3
Mar-24	0.72	0.93	0.63	0.52	83.8	74.6

SPECIAL TOPIC

Positioning industry for a post-Covid future.

The saying goes that necessity is the mother of invention. And that certainly has been the case with Covid, as firms have scrambled to mitigate the more disruptive aspects of the virus. In this chapter, we consider some of the changes firms have made to get themselves through the pandemic and assess whether they are likely to remain in place once a sense of normalcy returns.

Covid reveals kryptonite.

Covid has laid bare some deep-seated structural vulnerabilities in many industries, resulting in big changes in how many businesses operate internationally. Some of these changes were already in train prior to the outbreak, and as such were evolutionary rather than transformative. The pandemic, however, has accelerated matters. Many of the changes that have occurred are now irreversible and are set to shape industry fortunes for years to come.

Key here has been the accelerated pace of technology adoption with firms scrambling to mitigate the worst impacts of Covid. In a global McKinsey survey undertaken in 2020, about two-thirds of surveyed firms indicated that they had brought forward their deployment of digital technologies by up to four years because of the pandemic.

And it seems that New Zealand firms have also been quick on the uptake. A 2020 survey undertaken by Microsoft indicated that a similar proportion of firms in this country were actively speeding up the adoption of digital services because of Covid, with a third viewing innovation as being critical for building resilience and recovery in the post virus era.

From evolution to transformation.

Digital technologies are being used to change how firms interact with customers. Unable to interact with firms in a physical sense because of lockdown restrictions, customers have shifted en masse to online digital channels to purchase goods and services. Firms have responded in kind, upgrading their e-commerce offerings to deliver seamless customer shopping experiences, while using social media and artificial intelligence driven "bots" to interact with customers in real time.

To that end, Covid has been a game changer. Indeed, according to NZ Post, online retail revenues rose by a whopping 25% in 2021. While that sort of growth is unlikely to be repeated once in-store shopping returns, there is little doubt that online digital channels are here to stay.

Other big changes are happening at an operational level. Existing business models are being upended, factory layouts revamped and work organisation methods transformed, with many of these changes underpinned by the adoption of increasingly sophisticated robots. With the differential with labour costs narrowing to the advantage of robots, and with processes like 3-D printing on the rise, these innovations are encouraging some firms to relocate production facilities from low wage economies back home.

Aligned to these changes is a move towards more flexible work arrangements, which have become the norm in many countries, and that's likely to remain the case for the foreseeable future. According to a UK poll, half of British workers are still working from home at least some of the time (up from 37% prior to the pandemic). That's despite lockdown restrictions having been lifted in July this year.

Flexible working arrangements are also likely to remain a key feature of the New Zealand labour market, despite elevated vaccination rates and a resulting push by firms looking to get people back in the office. That, together with the emergence of non-traditional leasing models, such as the co-sharing of office space, is affecting the demand for commercial space.

Firms are also looking to improve the resilience of their supply chains, with digital supply networks now replacing many traditional linear supply chains. That's allowing firms to tap into multiple suppliers, rather than just relying on a single supplier. At the same time, they are also using automation and sensor technologies to gain an end-to-end view of supply chains, allowing them to anticipate issues before they occur.

This focus on supply chain resilience has prompted a shift away from globalisation, with many businesses opting for onshoring and nearshoring of their supply networks. According to Thomas Insights, about 69% of US manufacturers were actively looking at bringing production back to North America at the height of the pandemic. Recent research by McKinsey suggests that as much as 25% of world exports could be affected by the relocation of productive activities by 2025.

A shift of this scale could have macroeconomic implications. Over the last decade or so, the ability to draw on global capacity has weakened the link between demand and domestic prices and wages in advanced economies. But as supply chains shift from global to more regional settings, a reversal of this trend could mean more sensitivity in inflation, and a need for more active monetary policy.

ECONOMIC AND FINANCIAL FORECASTS

New Zealand forecasts

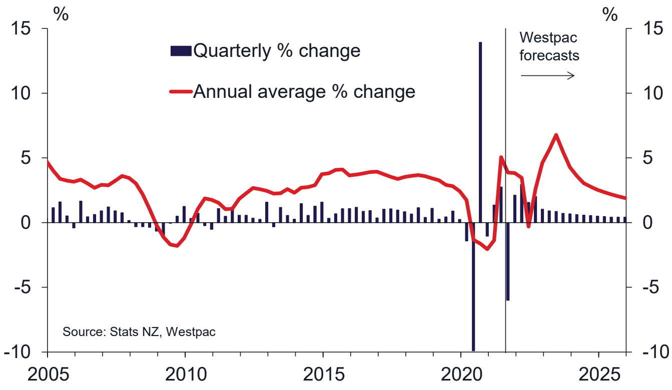
GDP components	Quarterly % change				Annual average % change			
	Sep-21	Dec-21	Mar-22	Jun-22	2020	2021	2022	2023
GDP (production)	-6.0	2.1	2.9	1.6	-2.1	3.8	4.6	4.3
Private consumption	-4.9	4.2	3.1	0.3	-1.3	7.0	4.4	2.0
Government consumption	1.0	0.7	0.4	0.2	6.3	7.6	2.2	2.1
Residential investment	-15.0	15.0	4.0	2.5	-4.1	10.1	9.4	1.5
Business Investment	-0.5	-1.1	5.2	2.6	-8.4	7.5	7.0	6.0
Exports	-4.9	-1.9	2.1	3.3	-12.6	-4.1	7.5	10.9
Imports	5.9	2.7	2.4	0.3	-16.0	15.5	8.3	3.8
Economic indicators	**Quarterly % change**				**Annual % change**			
	Sep-21	Dec-21	Mar-22	Jun-22	2020	2021	2022	2023
Consumer price index	2.2	0.6	0.8	0.7	1.4	5.1	2.7	2.2
Employment change	2.0	0.0	0.2	0.1	0.6	3.5	0.5	1.2
Unemployment rate	3.4	3.8	3.7	3.6	4.8	3.8	3.5	3.6
Labour cost index (all sectors)	0.8	0.8	0.4	0.6	1.6	2.7	2.3	2.8
Current account balance (% of GDP)	-4.5	-5.5	-5.7	-6.6	-0.8	-5.5	-6.3	-4.6
Terms of trade	2.0	0.5	-1.2	-1.7	-1.6	5.9	-4.4	2.4
House price index	6.0	3.6	1.0	0.0	17.0	24.0	-1.5	-7.5
Financial forecasts	**End of quarter**				**End of year**			
	Sep-21	Dec-21	Mar-22	Jun-22	2020	2021	2022	2023
90 day bank bill	0.36	0.95	1.40	1.90	0.27	0.95	2.45	3.10
5 year swap	1.60	2.60	2.80	2.95	0.31	2.60	3.10	3.10
TWI	74.4	74.6	75.2	75.85	72.92	74.6	76.4	75.3
NZD/USD	0.70	0.71	0.72	0.73	0.69	0.71	0.74	0.73
NZD/AUD	0.95	0.95	0.95	0.95	0.94	0.95	0.95	0.94
NZD/EUR	0.59	0.60	0.60	0.61	0.58	0.60	0.63	0.63
NZD/GBP	0.51	0.51	0.52	0.52	0.52	0.51	0.52	0.53
Net core Crown debt (% of GDP)	33.1	37.6	41.0	44.7	32.4	37.6	45.7	46.4

International economic forecasts

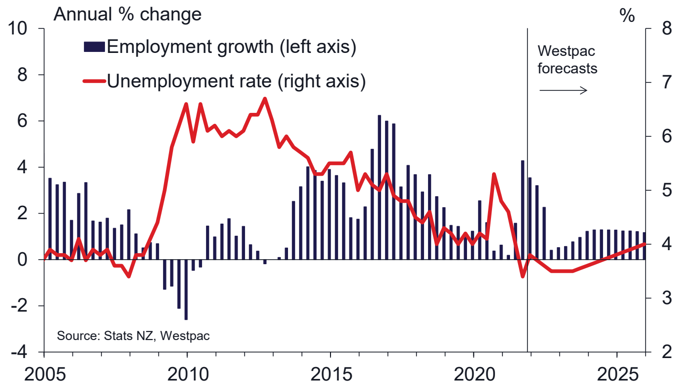
Real GDP (calendar years)	Annual average % change					
	2017	2018	2019	2020	2021f	2022f
Australia	2.4	2.8	1.9	-2.4	3.0	5.0
China	6.9	6.7	5.8	2.3	8.5	5.7
United States	2.3	3.0	2.2	-3.5	5.6	4.0
Japan	1.7	0.6	0.3	-4.8	2.3	2.7
East Asia ex China	4.7	4.4	3.7	-2.4	3.8	4.9
India	6.8	6.5	4.0	-8.0	9.0	8.0
Euro Zone	2.6	1.9	1.3	-6.6	4.9	4.4
United Kingdom	1.7	1.3	1.4	-9.9	6.7	5.5
NZ trading partners	4.1	4.1	3.4	-1.8	5.5	4.9
World	3.8	3.6	2.8	-3.3	5.4	4.6

THE ECONOMY IN SIX CHARTS

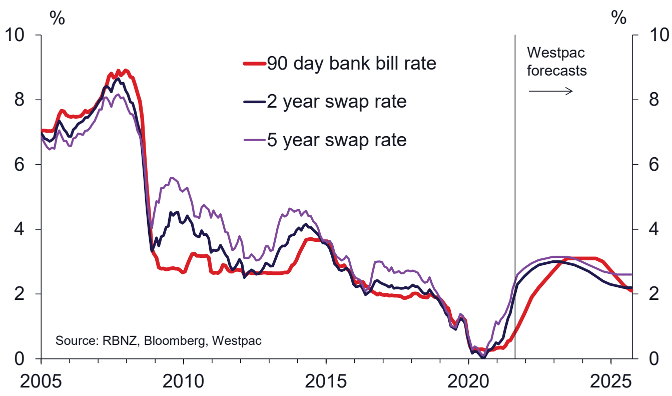
New Zealand GDP growth



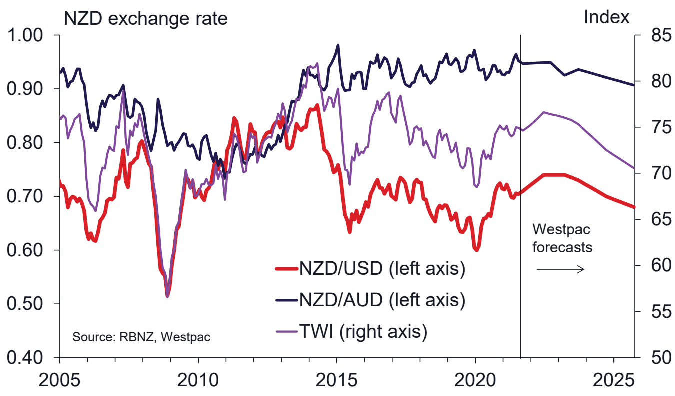
New Zealand employment and unemployment



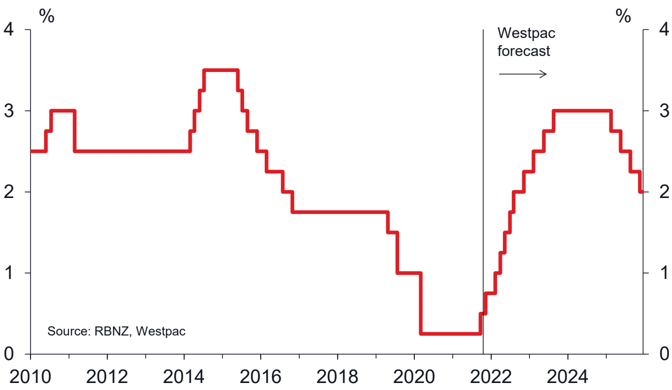
90 day bank bills, 2 year swap and 5 year swap rates



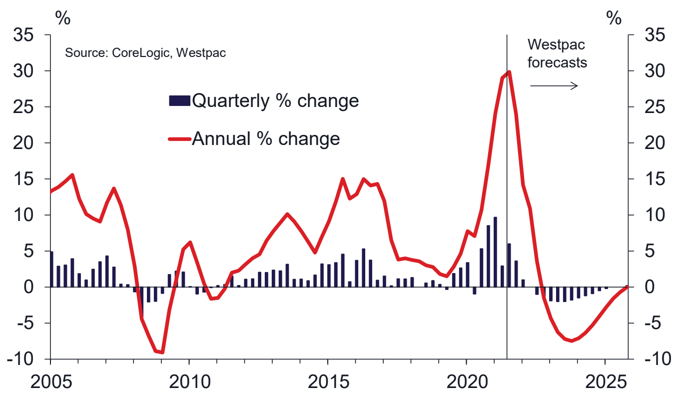
Exchange rates



Official Cash Rate



New Zealand house prices



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