July Insights

with Cameron Bagrie

MALLOCH McCLEAN
SMARTER BETTER BUSINESS

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ARTICLE OVERVIEW

Bad news is setting the scene for good news. A weak economy is building disinflationary pressure as firms sharpen their pricing to seek work and shift goods. This is building the case for lower interest rates in early 2025. This downturn is more than your typical economic cycle. The magnitude of economic recovery and firm profitability—when it comes—will be dictated not just by lower interest rates, but by rebuilding the economy's productive capacity, including lifting productivity.

There has been no shortage of bad news. It is apparent in earnings reports from listed companies and economic data, with gross domestic product (GDP) in the March quarter rising an anemic 0.2% and down 2.4% year on year when adjusted for population growth. In the year ending April 2024, the number of new dwellings consented was 35,401, down 23% from the prior year. Some consents issued are not making it to the build stage either. In the March 2024 quarter, the volume of ready-mixed concrete produced was down 12% compared with the March 2023 quarter. Fewer foundations mean less building work. The retail environment remains tough, and cost pressures continue to hurt profitability.

New Zealand continues to run a gargantuan current account deficit, a combination of trade in goods and services and net investment income, equivalent to -6.8% of GDP. Exports of goods have decreased from 22% of GDP in 2013 to 18% of GDP now. Environmental restrictions, China's economic woes, and protectionism have contributed to this decline. Our current account position is unsustainable.

We are not the small open trading nation we claim to be; we are seventh from the bottom of the OECD in total exports as a share of GDP. We slipped below the OECD average in 2015, and the gap is now around 8 percentage points. Exports need support from relative prices (a low currency) and policy.

The roading network is a myriad of potholes and inefficiency. The OECD's recent economic survey of New Zealand noted that the decline in education achievement between 2006 and 2018 will eventually reduce aggregate productivity levels by close to 4 percentage points.

There are encouraging signs. Bad economic news can sometimes be good news. Economic weakness is increasing disinflationary pressure across the economy. After a shocking first-quarter inflation print, where non-tradable or domestic inflation came in at 5.8%, the inflation signals over April and May have been lower. There are anecdotes of more aggressive pricing for work in the construction sector, a byproduct of less work.

Lower inflation fosters greater confidence in the possibility of lower interest rates. While there is still pressure on inflation from areas such as local authority rates, insurance, and energy, a weak economy appears to be more influential in driving pricing.

Firms need to be wary of falling into the pricing for work trap and compressing margins. Margins are at the epicentre of business health and profitability. Productivity is the protector of margins if you can achieve it.

The so-called good news in the form of tax relief announced in the 2024 Budget, if it boosts the economy, could also be bad news if it pushes out interest rate relief prospects. That money would have been better directed at infrastructure.

The penny has dropped on the importance of productivity. Without productivity, living standards stagnate. New Zealand's 10-year track record on productivity, averaging 0.2% per year, is dismal. This has not been helped by exports declining as a share of the economy, with agriculture (a sector with 2% per year productivity) stagnating and low productive investments (housing and construction) rising.

The economy may grow through population increases (such as the migration of 100,000 people in the past year), but living standards do not rise unless productivity improves. Firms cannot wait for the government to "fix" New Zealand's productivity issues. They need to take the lead by investing in better ways of doing business, digitisation, AI and seeking efficiencies by investing in capital over labour.

The upcoming inquiry into banking by the Finance and Expenditure Committee will serve as a benchmark for assessing our readiness to address problem areas. Home lending has increased from 57% to 63% of bank lending in the past six years. A key question that needs to be answered is whether banks are pricing for and taking on risk. Strong bank profits, relative to low profit volatility, suggest otherwise.

Relative price signals are beginning to support the redirection needed for the economy. A low New Zealand dollar against the US dollar (alongside redirected trade from China) has elevated the USA to become our second-largest export destination, surpassing Australia, which now ranks third. Trade with Australia could see a boost in the coming years if the NZD/AUD continues to ease, as it has recently. It appears Australia is facing more inflation than the Reserve Bank of Australia had anticipated, necessitating higher interest rates

We aspire to double exports within a decade. Simply having market access won't achieve this goal. The government's focus needs to shift towards expanding exports from the supply side. Natural resources, including water and irrigation, hold immense potential for boosting growth; what's needed is to unlock the enabling functions. The same applies to sectors like aquaculture and renewable energy. Tough and difficult times are fostering a greater appetite to accelerate these opportunities.

The bottom line is that we are starting to see a light at the end of the inflationary tunnel in the form of interest rate relief. This will support better prospects by late 2025. However, the true magnitude of these improved prospects will be determined by a myriad of other factors, many of which are structural.