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SMARTER BETTER BUSINESS

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ARTICLE OVERVIEW

Here comes the hard landing for the economy, where economic conditions are sufficiently tough to purge inflation. The economic climate has deteriorated further—an evil to get rid of inflation. Those times will also bring opportunities, and we are already seeing evidence that firms with better microeconomic credentials are navigating difficult macroeconomic conditions better. As economic conditions toughen, we are going to see greater pushback, but also demands for doing more with less. It's called raising productivity, which invariably sows the seeds of the next upswing. The seeds are being sown, but there is a large field to plough and clods to turn. 'The last few yards might be difficult'.

Those were the words of the Reserve Bank Governor, describing the task of getting inflation back to 2 percent. Currently, we are at 4 percent, and non-tradable inflation, or domestic inflation, barely budged in the March quarter, moving from 5.9 percent to 5.8 percent year on year. The Reserve Bank was projecting 5.3 percent. Inflation was broad-based. That is a huge problem.

A similar story has appeared in both the United States and Australia. Inflation has recently exceeded expectations, and progress in returning inflation to desired targets has stalled. Expectations of lower interest rates are being replaced by views that they may remain around current levels for longer. The possibility of even higher interest rates in the United States, which greatly influence global interest rates, cannot be ruled out.

New Zealand experienced a recession-lite in 2023. We satisfied the technical definition of a recession as the economy moved backwards. However, it was not a real one. Unemployment remained low, banks were not under a lot of stress, and for many businesses, they were simply less busy.

At the start of 2024, there were widespread expectations that interest rate relief was around the corner. However, the strength and persistence of inflation have dashed that hope.

The economic trajectory of moderation in 2023 has also extended into 2024 and accelerated into weakness. "Less busy" has been replaced by "looking for work" and "more business." This does not apply to all businesses, but to an awful lot of them. The New Zealand Institute of Economic Research's Quarterly Survey of Business Opinion delivered a brutal reality check last month: economic conditions have weakened markedly. The lagged impact of higher interest rates is now starting to bite, with $200 billion of mortgage debt refixing in 2024. The hoped-for sustained bounce and recovery in the housing market has petered out. Cancel-nomics from the government, with lots of big projects on hold, has created uncertainty.

The step-down in growth is likely the only factor preventing the Reserve Bank from further hiking interest rates, especially given the first-quarter inflation figures.

The expectation is that weaker demand/growth will dampen inflation quickly.

When you observe pending local authority rate rises of 15 percent, prospects for strong increases in insurance and energy costs, and Air NZ set to raise airfares significantly, that is evidence of stickiness in inflation. Oil (fuel) prices remain susceptible to geopolitical events, and domestic fuel prices have risen by 25-30 cents per litre since the beginning of the year, contributing to inflation as well as acting as a tax on consumption. Rents continue to rise due to strong migration (demand) and easing building consents (supply). Baby boomers are starting to spend more in retirement, benefiting from higher interest rates.

The coming year was always going to be difficult; inflation was never going to disappear without the economy experiencing real pain. With pain comes discounting and more aggressive pricing for work. Profits drop, and costs/jobs are cut. Wage demands moderate as workers become easier to find.

These are the cyclical things that go with the business cycle.

We are now also seeing four other themes.

Theme one is microeconomic credentials. Who are the strong or better performers in each sector? Just look at Briscoes relative to many other retailers. Dairy and the red meat sectors are seeing some businesses suffer, or their business models exposed, more than others. Welcome to a lot of bifurcation of performance within sectors. Which horse do you back in each sector?

Theme two is the appetite for change. In the political arena, the appetite for change was strong before the last election. The changes being delivered so far, though needed, have largely been of the cancel-nomics variety, and the policy platform is at risk of further dividing New Zealand. A divided society makes economic resets difficult. With economic pain and division, we will see a lot of pushback, and we may start opting for easy and temporary solutions.

Theme three is strategy. Where is it? Either at the national level or within business. The government has a goal to double exports but there's nothing concrete around it apart from gaining more market access, primarily focused on India. Doubling exports will require a significant increase in export volume to meet demand. The strategic planning aspect of governance, as opposed to mere oversight, is resurfacing.

Theme four explores the seeds of a productivity upswing. Recent data shows a significant deterioration in productivity performance. Labor productivity fell by 0.9 percent in the 12 months leading to March 2023, and the numbers for 2024 are expected to be worse. The three-year average is negative. Capital productivity fell by 3.8 percent in the year ending March 2023. Multifactor productivity, which combines labor and capital efficiency, dropped by 2.2 percent. Such performance means we are becoming poorer rather than wealthier, which is one reason people are choosing to head overseas.

Every economic upswing starts with producing more with less. Pain and tough times shake the complacency tree, prompting questions and raising delivery and performance expectations. We are entering that mode, and it's long overdue.