

New Zealand's fragile economic recovery and the challenges facing the next Government

Balancing recovery, inflation and long-term growth

The economic recovery is resuming, but remains fragile

New Zealand is heading into the election with the economy continuing to recover, despite disruption from the fuel crisis earlier this year. Gross domestic product (GDP) rose by 0.2 percent in the June quarter, following a 0.9 percent rise in the March quarter. This marked the fourth consecutive quarterly increase in activity in the New Zealand economy, suggesting that the fuel shock slowed rather than stalled the economic recovery.

However, the composition of growth highlights why the recovery remains fragile and uneven. Robust increases in construction activity, residential investment and exports lifted activity in the June quarter, but household consumption remained subdued. Activity declined in primary industries, retail trade and accommodation, transport, postal and warehousing and arts, recreation and other services.

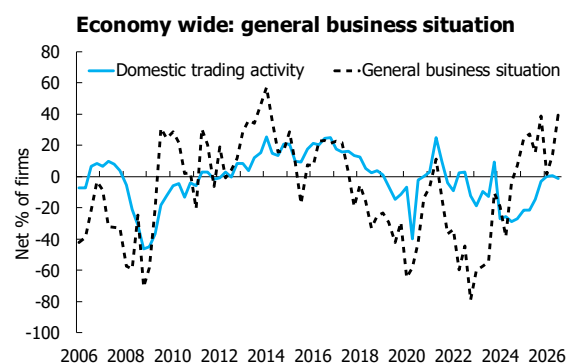
Business confidence is improving, but activity remains soft

The latest NZIER *Quarterly Survey of Business Opinion* (QSBO) showed a further lift in business confidence, despite firms reporting weak demand in the September quarter. A net 40 percent of firms expect an improvement in general economic conditions, up markedly from the previous quarter. Firms' expectations of an improvement in demand ahead have also carried through to their hiring and investment intentions.

However, this optimism has yet to translate into stronger activity, as a net 1 percent of firms reported reduced activity in their own business in the September quarter.

This latest improvement in business confidence is notable, given that the September QSBO was conducted amid renewed conflicts between the US and Iran, which have pushed global oil prices higher again. Although these developments appear to have only a muted effect on business sentiment for now, ongoing volatility in geopolitical conditions and the global fuel supply remains a key source of uncertainty for New Zealand's economic recovery. The continued weakness in actual activity suggests that the recovery remains fragile, even as forward-looking expectations have improved.

Figure 1 Business confidence increased further despite soft activity



Source: NZIER

Inflation and fiscal constraints limit room for manoeuvre

Inflation is another constraint on the recovery. Annual CPI inflation increased to 4.1 percent in the June quarter, largely reflecting higher fuel prices. However, underlying inflation pressures remain relatively contained. Since July, the Reserve Bank of New Zealand (RBNZ) has commenced a tightening cycle of its monetary policy, with the aim of bringing medium-term inflation back towards the inflation target mid-point of 2 percent. The central bank increased the OCR further to 2.75 percent in its September *Monetary Policy Statement* (MPS) (Reserve Bank of New Zealand 2026).

The fiscal outlook will constrain the room for manoeuvre. The Treasury expects OBEGALx (operating balance before gains and losses, excluding ACC) to remain in deficit over the next couple of years before returning to surplus in 2028/29, implying a continued period of fiscal consolidation (NZ Treasury 2026). Fiscal policy also involves trade-offs between supporting economic activity and the risk of adding unnecessary inflationary pressures, particularly while monetary policy is working to bring inflation back towards target.

Taken together, these developments point to an economy that is continuing to recover, but only gradually. Domestic demand remains soft, confidence remains fragile, and inflation remains elevated.

The immediate challenge for the next Government will be to support New Zealand's economic recovery without adding inflation pressures or undermining fiscal consolidation. At the same time, improving productivity and investment will remain important if stronger activity is to translate into more sustained gains in incomes and living standards.

The recovery may take time to be felt by households

One of the clearest messages from the June quarter GDP results is that the recovery in

activity to date has not yet translated into stronger household purchasing power.

Although GDP per capita edged up by 0.1 percent in the June quarter, real gross national disposable income per capita fell by 0.6 percent as increases in prices of imports outpaced increases in export prices. Private consumption was unchanged over the quarter.

This helps explain why households have not yet felt the recovery. Higher prices for fuel and other imported goods have squeezed the purchasing power of New Zealand households. This caution about discretionary spending is also reflected in weaker activity in the broad retail trade and accommodation sector.

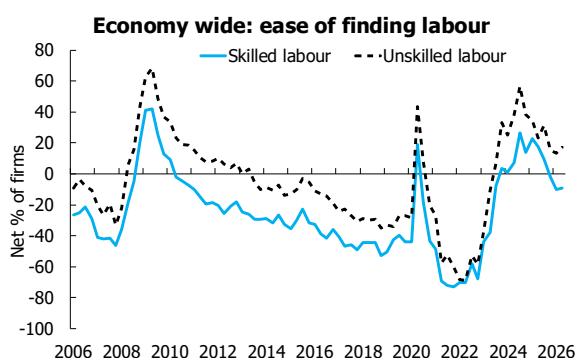
A soft labour market adds to household caution

Continued softness in the New Zealand labour market is also driving continued caution amongst households and will likely weigh on household spending over the coming year. The June quarter Stats NZ labour market data points to continued spare capacity in the New Zealand labour market, with the unemployment rate edging up to 5.6 percent and wage growth remaining subdued.

This labour-market weakness has been particularly pronounced for young people, with a recent NZIER Insight highlighting elevated rates of youth unemployment and underutilisation (Hogan and Hamill 2026).

However, the latest NZIER QSBO labour market indicators suggest that some of the spare capacity in the New Zealand labour market may be starting to dissipate. Although a small proportion of firms cut staff numbers in the September quarter, many plan to hire in the next quarter. When firms were asked how hard or easy it is to find workers compared with three months ago, firms reported it is more difficult to find skilled workers. Only a small proportion of firms reported it being easier to find unskilled workers.

Figure 2 NZIER QSBO suggests spare capacity in the labour market is dissipating



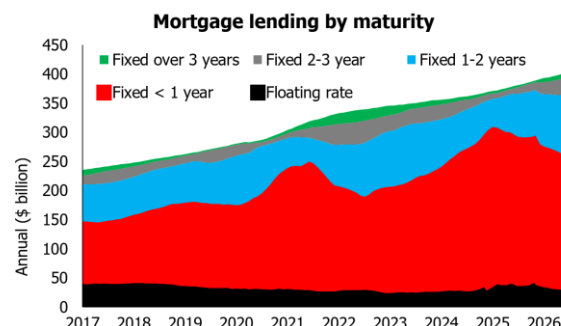
Source: NZIER

Overall, the New Zealand labour market remains soft. This creates uncertainty about job and income prospects, which has been driving caution among households, particularly when it comes to big-ticket purchases.

Higher interest rates may become another headwind

Interest rates may once again become a headwind. As the RBNZ has begun to tighten its monetary policy to increase the OCR towards more neutral levels, many households will face higher mortgage repayments as their mortgages come up for repricing. The latest RBNZ data on mortgage lending suggests that about 64 percent of mortgages are due for repricing within the coming 12 months. This increase in financial pressure from higher mortgage repayments could crowd out household discretionary spending, even if fuel prices start to ease and wage growth begins to pick up again.

Figure 3 Over 60 percent of mortgages are due for repricing in the next 12 months



Source: RBNZ

Overall, the factors discussed above suggest that continued GDP growth will take some time to translate into a meaningful improvement felt by households. A more sustained recovery in household consumption will likely depend on an easing in cost-of-living pressures and greater confidence in employment and income prospects.

Business confidence has improved, but underlying activity remains soft

Similarly, the business sector has not yet fully felt the economic recovery.

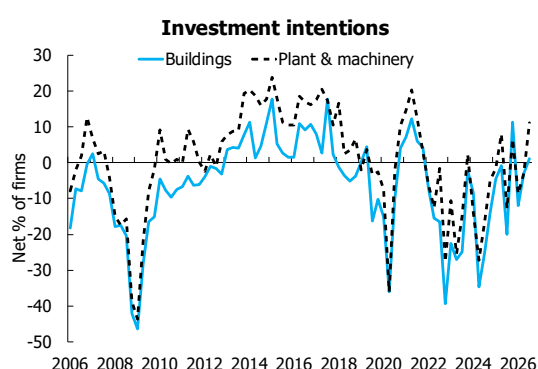
The September quarter NZIER QSBO showed a marked improvement in business confidence, but firms' own trading activity remained soft. A net 40 percent of firms expect an improvement in general economic conditions, while a net 15 percent expect an improvement in activity in their own business. This optimism also supported improved hiring and investment intentions. However, lack of demand remained the key concern for firms and profitability remained weak over the quarter. These results highlight the gap between improving expectations and still-soft underlying business conditions.

Uncertainty is an important part of this story. Firms are currently making investment and hiring decisions against a backdrop of highly volatile geopolitical conditions, ongoing uncertainty over future fuel and input costs,

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changing interest rates and uncertainty over the strength of domestic demand. Although the upcoming general election adds to these uncertainties, the September quarter NZIER QSBO suggests that caution towards spending and investment by businesses appears to be easing on expectations of improved demand ahead.

Figure 4 Firms feel more positive about investment as business confidence lifts



Source: NZIER

Investment remains cautious despite improving confidence

Despite this latest improvement in business investment intentions, a recent NZIER analysis on firms' investment appetite (Kulwant and Bui 2026) found that the investment environment had become more cautious in recent years, with firms placing greater value on flexibility and stronger balance sheets. This suggests that heightened uncertainty increases firms' tendency to delay major capital commitments until future conditions are clearer.

Another NZIER Insight highlighted that the slow economic recovery has made employers more cautious about investing not only in capital, but also in people. Uncertainty around technological change, including AI, may also be contributing to weaker hiring of new labour market entrants and greater uncertainty about investment in education and training (Hogan and Hamill 2026).

More broadly, these findings are particularly relevant in the current environment. Even though firms are feeling positive about the general economic outlook, subdued demand, weak profitability and heightened uncertainty may still temper the pace of the recovery in investment and hiring.

The latest RBNZ data on lending by sector points to growing credit demand in the business sector. However, new business lending remains volatile. Although business borrowing is recovering, it has not yet translated into a broad-based lift in business investment.

Some parts of the economy show encouraging signs

Nonetheless, the June quarter GDP data shows some improvement in parts of the New Zealand economy. Construction was the largest contributor to the 0.2 percent increase in economic activity, up 2.7 percent over the quarter. Meanwhile, investment in fixed assets rose 1.5 percent, led by a 4.4 percent increase in spending on residential building work. The Stats NZ dwelling consent issuance data shows encouraging signs of a recovery in residential construction demand, with a 21 percent increase in the number of new dwellings consented in the year to August 2026. This increase was broad-based across most New Zealand regions.

In line with the rise in building consent issuance, the NZIER QSBO also showed signs of improved construction demand. Building firms reported increases in new orders and output in the September quarter, which supported a recovery in the building sector's confidence. However, the NZIER QSBO architects' measure of work in their own office suggests a soft construction outlook. Based on work in their own office, architects expect the pipeline of housing construction to remain flat over the coming 24 months, while expectations for commercial and Government construction remain weak.

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Exports continued to be an important source of support for New Zealand's economic recovery, with the June quarter GDP data showing a 3.3 percent increase. Dairy and meat exports largely drove this result.

Taken together, the recovery in the New Zealand economy has been uneven. Construction is improving, and export conditions are strong, but household spending and much of the economy exposed to domestic demand remain weak.

A more sustained recovery will depend on whether these pockets of improvement translate into stronger spending and investment over the coming year.

High inflation complicates the recovery

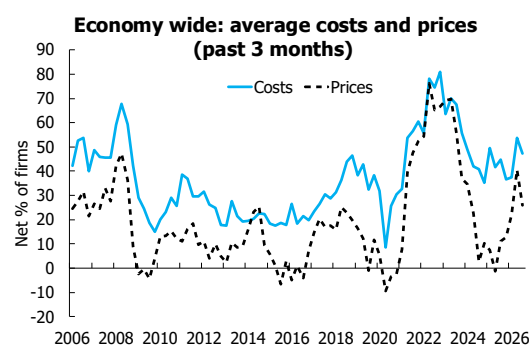
The earlier fuel shock has also complicated the outlook for inflation.

Annual CPI inflation rose further to 4.1 percent in the June quarter, largely reflecting higher fuel prices. However, underlying inflation pressures remain relatively contained. Non-tradable inflation eased slightly to 3.4 percent, while CPI inflation excluding food, household energy and vehicle fuels remained within the RBNZ's 1–3 percent inflation target band. These measures suggest that much of the increase in headline inflation reflects higher energy prices rather than a broad-based increase in underlying inflation.

The latest NZIER QSBO offers some reassurance that the earlier fuel shock has not yet translated into broader underlying inflation pressures. The proportion of firms reporting higher costs fell in the September quarter, albeit from a high level, and the proportion of firms raising prices in the September quarter fell noticeably. Firms' expectations for cost and price increases over the next quarter also eased. Soft demand continues to constrain firms' ability to pass on higher costs by raising prices. Nonetheless, the key risk remains whether higher fuel prices spill over into broader price- and wage-setting behaviour. Renewed increases in

global oil prices will remain a key upside risk to the inflation outlook.

Figure 5 Cost and pricing indicators eased in the September quarter



Source: NZIER

This combination of elevated inflation and a fragile economic recovery creates a difficult backdrop for the next Government. As the RBNZ is increasing the OCR towards more neutral levels, higher interest rates may pose a greater headwind for household spending and business investment. At the same time, fiscal policy involves a similar trade-off between supporting economic activity and the risk of adding to inflation pressures. This means the Government's fiscal choices will be shaped not only by the state of its books but also by the inflation outlook.

The Government's fiscal choices remain constrained by inflation and the fiscal outlook

The Treasury's Pre-election Economic and Fiscal Update (PREFU) (NZ Treasury 2026) shows an improvement in the fiscal outlook relative to Budget 2026, reflecting stronger-than-expected fiscal outturns and a continued, albeit gradual, recovery in economic activity. OBEGALx is still forecast to return to surplus in the 2028/29 fiscal year, but the projected surplus is now larger than in Budget 2026. The cumulative OBEGALx deficit over the forecast period is also about \$11.5 billion smaller than previously expected. Nonetheless, the Government's fiscal position remains

constrained overall, and returning its books to surplus will still require continued fiscal consolidation.

There remains a high degree of uncertainty about this fiscal outlook, and we see risks skewed to the downside. It is important to note that the PREFU forecasts were finalised on 21 August, before the more recent re-escalation of global oil prices. Therefore, the PREFU does not fully capture the potential effects of renewed fuel-price pressures on inflation and broader economic activity. If sustained, these pressures could also weaken the fiscal outlook beyond the near term by weighing on economic activity and tax revenue while increasing cost pressures on government spending.

Limited fiscal room constrains Government spending choices

The relatively tight budget operating allowances also suggest limited scope for significant new spending, increasing the need to reprioritise existing spending. At the same time, the Government's capital allowances provide some scope for new capital investment, but any new capital spending will still need to be weighed against the Government's wider borrowing and debt constraints (New Zealand Government 2026).

At a time when inflation remains elevated, fiscal policy measures that materially increase aggregate demand could add to inflationary pressures and make monetary policy tighter than it otherwise would be.

The composition of fiscal support matters

Budget 2026 highlighted the importance of keeping support targeted and temporary in response to the fuel shock. Focusing support on those most affected can help cushion the impact of higher fuel prices while limiting additional pressure on aggregate demand, inflation and the Government's books. The fuel-shock-related support measures include temporary support for low- to middle-income working families and fuel-exposed essential services (New Zealand Government 2026).

This trade-off between inflation and fiscal policy is particularly difficult when inflation is driven in part by an external supply shock. Higher fuel prices simultaneously push up inflation, reduce household purchasing power and squeeze firms' operating margins. This can create pressure for fiscal support, even as high inflation and a constrained fiscal position limit how broad that support can be.

Therefore, the composition of fiscal policy matters. Fiscal consolidation does not remove the need for public investment, but it increases the importance of prioritising spending and investment that support the New Zealand economy's productive capacity over the longer term. This rationale was consistently reflected in the Government's fiscal strategy in Budget 2026 (New Zealand Government 2026).

The next Government's challenge will be to maintain a credible path to a budget surplus in a highly uncertain economic environment, while ensuring that limited fiscal resources are directed towards areas that support longer-term economic growth without adding unnecessary inflationary pressures.

Productivity and investment will be vital to long-term growth

Beyond the near-term economic recovery, New Zealand continues to face a longstanding productivity challenge. The Treasury's ongoing analysis has highlighted that sustainable improvements in living standards depend on productivity growth, while also noting that New Zealand's productivity performance has slowed markedly over the past decade (Cook et al. 2024). The Treasury identified a range of possible drivers for New Zealand's productivity slowdown, including weak investment, low productivity gains from innovation and technology diffusion, and slow trade and international connections.

Recent NZIER productivity research (Bui 2026) points to a combination of longstanding structural constraints, including New Zealand's small scale and distance from major markets,

as well as weak investment and uneven diffusion of technology and business practices.

Investment is an important part of the productivity challenge

Investment plays an important part in lifting productivity performance. More recent analysis by the Treasury (Winter et al. 2025) points to New Zealand's relatively low levels of capital available to workers and the potential for investment in more advanced equipment and technology to support productivity. Previous NZIER (2024) research on business productivity highlighted the importance of investment, innovation and exposure to international competition in supporting stronger business productivity.

Infrastructure investment can support productivity

Infrastructure also plays an important role. Recent work by the New Zealand Infrastructure Commission (2026) highlights that infrastructure can support productivity by making it easier for new ideas and technologies to spread, helping people and businesses connect more efficiently, and allowing economic activity to concentrate where it generates benefits. However, the gains from infrastructure investment depend on whether it addresses genuine constraints and provides value for money.

Taken together, this suggests that improving productivity is not simply about investing more. It is also about where investment is directed and how widely new technologies and better business practices are adopted across firms (Bui 2026). These considerations will be particularly important as public and private investment decisions are made in an environment of constrained resources.

Uncertainty may continue to weigh on investment

However, in the near term, continued uncertainty over demand, costs and the broader global and domestic economic outlook may still hold back business investment. As discussed earlier, NZIER's

previous work on business investment (Kulwant and Bui 2026) highlighted how heightened uncertainty can encourage firms to delay major capital commitments.

The longer-term challenge for the next Government will be to provide greater clarity and stability around key policy settings so businesses have more confidence to make long-term investment decisions, while ensuring infrastructure and other investment is directed towards areas that can enable productivity growth and provide value for money. Stronger productivity growth would ultimately provide greater scope for sustained increases in real incomes and living standards (Cook et al. 2024).

The next Government will inherit a challenging economic environment

New Zealand's economic recovery is continuing, but it remains fragile and uneven. Cost-of-living pressures and still-soft labour-market conditions are weighing on household consumption. Meanwhile, business confidence and forward-looking hiring and investment intentions have improved, but this optimism has yet to translate into a broad-based recovery in activity.

Inflation also remains elevated, although underlying inflation pressures remain relatively contained for now. The key risk is whether higher fuel prices spill over into broader price- and wage-setting behaviour that could make high inflation persistent. At the same time, higher interest rates could weigh on spending and investment as the RBNZ brings the OCR to more neutral levels.

For the next Government, these factors create difficult policy trade-offs. Fiscal choices remain constrained by the inflation outlook and the Government's fiscal position, while measures that materially increase aggregate demand could further intensify inflation pressures. These constraints complicate efforts to support a more sustained economic recovery. Beyond the near-term recovery, greater policy certainty and well-targeted

investment will be important for raising productivity and supporting stronger growth in incomes and living standards over the longer term.

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