Travel journal

Observations from my recent tour of Europe

27 March 2018

I have recently returned from a two week tour of Europe (including the UK), where I visited a range of customers to discuss the outlook for the New Zealand economy.

I have done this tour more-or-less annually since 2012. Sometimes I get a distinct sense of heightened interest in New Zealand among European investors, and other times I notice that New Zealand has shifted off their radar. This time was somewhere in between those two extremes – there was a moderate level of interest in New Zealand.

My basic narrative was that New Zealand's OCR is less likely to rise over the coming year than markets expect. Inflation is currently below the RBNZ's target, and we doubt that there will be enough growth in the economy to rectify that any time soon. This is mainly because we expect a weak housing market to impact consumer spending. So we think New Zealand's OCR will remain on hold until late-2019. With New Zealand lagging the rest of the world in terms of interest rate increases, we also expect that the New Zealand dollar will fall over the year ahead.

As always, there was a range of reactions to our views. A few people were more hawkish. Some argued that upcoming Government decisions to curb migration, lift the minimum wage, impose environmental constraints on farmers and move toward more institutional wage bargaining would reduce aggregate supply in the economy, thereby creating inflation.

But more frequently, I found that people were sympathetic to our dovish view. Most people tended to agree that New Zealand would experience lacklustre aggregate demand and would lift interest rates more slowly or later than elsewhere in the world.

The biggest area of disagreement with my narrative concerned the exchange rate. The majority of people I visited were doubtful that the US dollar would strengthen in response to rising US interest rates, as we are expecting. The flip side of that is that many people doubted that the New Zealand dollar would fall, at least not against the US dollar.

I found it interesting to consider the implications of that. If the New Zealand economy remains fairly slow and the exchange rate fails to fall, then inflation will be even lower than we are currently forecasting. In that world, the Reserve Bank might even have to cut the OCR. In other words, those who expect a weak US dollar have more reason to expect a dovish Reserve Bank of New Zealand.

Against currencies other than the US dollar, most people did seem to agree that there was some scope for the New Zealand dollar to fall. In particular, a number of customers thought the New Zealand dollar should fall versus the Australian dollar.

One oddity I have noticed over the years is the waxing and waning of interest in New Zealand's fortnightly dairy auctions. In the early 2010s, I recall having great trouble trying to convince sceptical market participants that global milk prices were important for the New Zealand dollar. So I was very surprised a couple of years later when I found that almost every European interested in Kiwi was an expert in the fortnightly GlobalDairyTrade auction. I faced incredibly detailed questions on auction volumes, weather conditions etc. I felt that among European market participants, interest in dairy had grown out of proportion with its role in the New Zealand economy. I am pleased to report that the degree of interest in dairy among European market participants has now moderated to something more proportionate.

Finally, I was particularly interested in how customers would react to our view that US 10-year government bond yields will be higher than the New Zealand equivalent at some point this year, for the first time since 1994. A few people doubted that this would happen, arguing that demand for New Zealand bonds would dry up, pushing yields higher. But by and large, most customers had no problem with the idea. Of course, upon arriving home I found that US 10-year yields had already risen slightly higher than New Zealand 10-years.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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