Kahurangi National Park, New Zealand

Weekly Economic Commentary.

A matter of when, not if.

The Reserve Bank has succeeded in bringing interest rates down, but if it's to meet its inflation and employment goals it will need to maintain these conditions for a long time. With the option of a negative OCR off the table until next year, its Large-Scale Asset Purchases (LSAP) programme will be critical to managing market conditions in the coming months. We have introduced forecasts of the RBNZ's bond purchases as part of our regular forecasts.

Last month we predicted that the RBNZ would reduce the OCR to -0.5% in November. However, we were always uncertain of the timing, which we recognised would depend on how long it takes for trading banks to become operationally ready for a negative OCR. We were also uncertain about how the RBNZ would treat its statement on the 13th of March that it did not intend to change the OCR for a year – was this guidance, which can evolve as the circumstances change, or a firm commitment?

The May *Monetary Policy Statement* and a swathe of RBNZ media interviews in the following days have provided definitive answers to both questions. The RBNZ revealed that it has asked the trading banks to resolve any operational issues by the 1st of December (also noting that this was an extension of its initial timeframe). That means a negative OCR will be possible by the start of 2021.

At the *MPS* the RBNZ referred to its "guidance" on how long the OCR would remain at its current level of 0.25%. But officials in subsequent interviews have been much more definitive: they will not be moving to negative interest rates before March next year. Accordingly, we have shifted our forecast of a -0.5% OCR next April (there isn't a scheduled OCR review in March).

Our call for a negative OCR is based on two factors:

(1) Our assessment that inflation will be unacceptably low unless substantial monetary stimulus is delivered over an extended period; and

(2) Our view that the RBNZ's Large-Scale Asset Purchases programme alone will not deliver the required stimulus for the required length of time.

The RBNZ's models suggest that in order to meet its inflation and employment targets, it needs to deliver monetary stimulus equivalent to an OCR of -2% over a period of two years. That doesn't necessarily mean that the OCR will go that low; the required monetary stimulus can be delivered by a combination of OCR cuts and buying Government bonds to drive market interest rates lower.

In the May *MPS* the RBNZ predicted that a $60bn bond purchase programme would be enough to return inflation to 2% over the medium term. But that was based on an assumption that the exchange rate will fall further from here, and that it will stay low for years.

We find that assumption unrealistic. Without negative interest rates or an expansion of the LSAP, we think the exchange rate would more likely rise over time. The New Zealand dollar is currently well below its long-run inflation-adjusted average, and it is likely to strengthen as the Covid-19 crisis fades and global risk sentiment improves.

Without assistance from a lower exchange rate, even more monetary easing will be needed for the RBNZ to meet its targets. And with a negative OCR off the table until next year, we think the RBNZ will need to expand its bond purchase programme in the meantime.

The governance process is that the Monetary Policy Committee announces a total cap on the LSAP – currently $60bn over twelve months. But the cap itself is not the crucial policy decision. It is actually the pace of purchases (relative to the pace of bond issuance by the Treasury) that determines the impact of the LSAP on interest rates and the economy.

Recently, the RBNZ has been buying $1.35bn of bonds per week. That pace has been sufficient to deliver the required monetary stimulus – that is, yields on Government bonds have been driven down to levels that are consistent with an OCR of -2%. However, this pace cannot be sustained without impairing market liquidity. By February next year, the value of bonds held in the rest of the market would have fallen from $73bn to $64bn, and the $60bn cap will have been exhausted.

There may be some scope for the RBNZ to slow the weekly pace of purchases while still keeping interest rates low, as markets continue to calm over the coming months. We are forecasting an average weekly purchase pace of $1.1bn later this year. However, even at that pace the LSAP would soon run out of headroom.

We conclude that the RBNZ is going to have to change the mix of monetary policy tools it is using early next year. It could lower the OCR to -0.5% and at the same time slow the pace of bond purchases to roughly $800m per week. This would continue to deliver monetary stimulus equivalent to an OCR of -2%, without exhausting the scope of the LSAP. Government bond issuance is expected to slow in the fiscal year starting July 2021, which would allow the RBNZ to reduce the pace of bond purchases further.

In total, we expect the LSAP will amount to $100bn by June 2022. However, the MPC need not announce that immediately. If they stick to announcing only what is required for the following twelve months, then we would expect the LSAP to be expanded to $70bn at the June OCR review, to $80bn at the August MPS, and for further gradual expansions to occur later. These gradual expansions will provide a signal to the market that the pace of bond purchases is sustainable, which will help to keep interest rates as low as is needed.

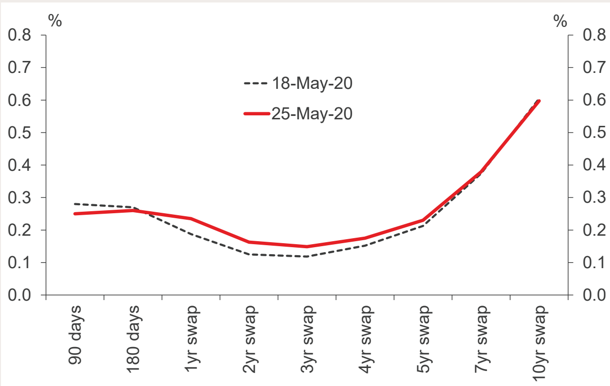
Going forward, we will be producing regular forecasts of the weekly pace of RBNZ bond purchases, as well as the evolution of the cap on purchases announced by the MPC.

Fixed vs Floating for mortgages.

The interest rate outlook is highly uncertain, so trying to guess which fixed term will result in the lowest interest repayments is difficult. It may be better to keep it simple. Borrowers looking for certainty should aim to fix their mortgage rates, while borrowers who need flexibility should float.

Fixed mortgage rates are falling at present, and they probably have further to fall, so those looking to fix may get a lower interest rate if they hold off for a short while. We expect that the RBNZ will lower the OCR to -0.5% next year. If that is correct, then both fixed and floating rates will fall even further next year.

NZ interest rates



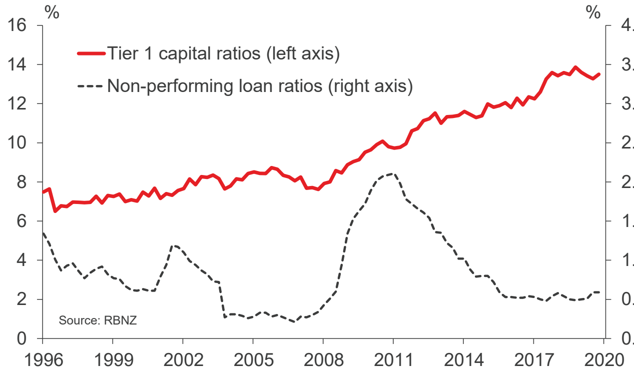
The week ahead.

NZ RBNZ Financial Stability Report

May 27

- The RBNZ's six-monthly report typically incorporates a review of macroprudential policy settings, and progress updates on financial sector regulation. However, both of those are off the table this time. Loan-to-value restrictions on mortgages have been removed, and all regulatory initiatives have been put on hold, as banks work through the impacts of the Covid-19 outbreak.
- With that in mind, the main interest in this report will be around any up-to-date information on how banks and the wider financial system are faring through this crisis.

NZ bank ratios

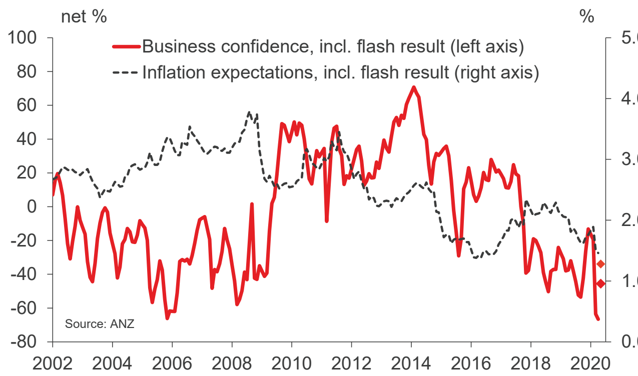


NZ May ANZBO business confidence

May 28, Last: –66.6, Preliminary result for May: –45.6

- Business confidence has fallen sharply since the start of the year as a result of Covid-19 disruptions to economic activity. Now that the Covid alert level has been dialled back, the economy has started to open up again and confidence has picked up, rising from -66.6 in April to -45.6 in the early 'flash' result for May. With more of the economy opening up since the release of the flash result, confidence could rise further when the final result for May is released.
- Nevertheless, confidence remains well down on pre-Covid levels. In addition to nervousness about the general economic backdrop, businesses expect weakness in their own trading conditions. Consistent with that, plans for both hiring and investment have been curtailed. Weakness in economic conditions is also weighing on pricing decisions.

NZ business confidence

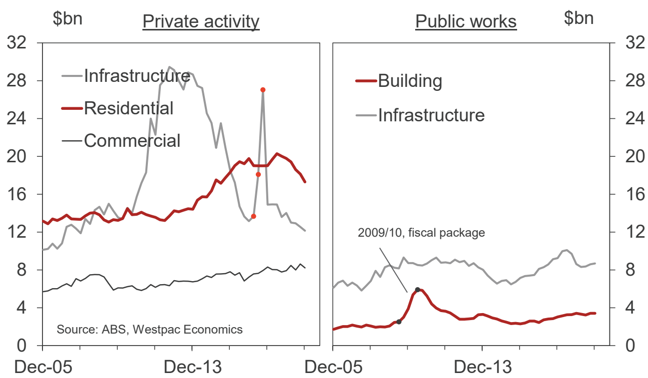


Aus Q1 construction work

May 27, Last: –3.0%, WBC f/c: –1.4%
Mkt f/c: –1.5%, Range: –5.0% to +1.0%

- Construction work weakened ahead of COVID-19, moving lower from mid-2018; down by -12% (-$6.8bn) over 6 quarters.
- March 2020 will see a further fall, reflecting underlying weakness and some disruptions (bushfires and COVID). Our Q1 forecast is a -1.4%, with risks to the downside.
- Private new home building work (-5%qtr, -13.7%yr in Q4) has further to fall (a forecast -3.5%) given the drop in approvals.
- Private non-residential construction (-3.8%qtr, -7.2%yr in Q4) is also likely to fall further given lacklustre infrastructure commencements in the non-mining sector.
- Public works (25% of the total) rebounded over the second half of last year. This improvement likely extended into 2020 with governments adding new projects to the pipeline.

Construction work: by segment



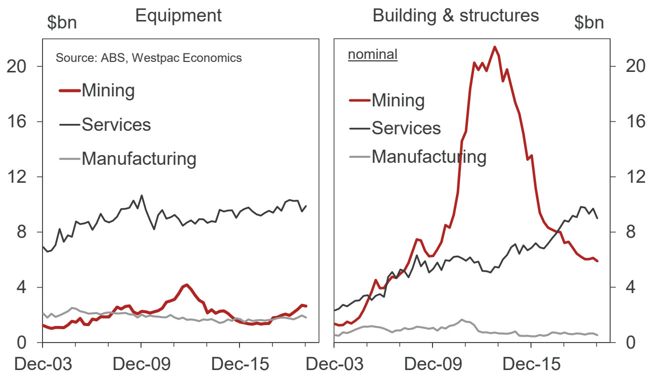
The week ahead.

Aus Q1 private business capex

May 28, Last: –2.8%, WBC f/c: –1.0%
Mkt f/c: –2.8%, Range: –5.0% to +1.0%

- Private business capex spending retreated in 2019, –5.8%, led lower by the further moderation in Building & Structures, –9.6%yr, and with equipment spending mixed, –1.4%yr.
- For the March quarter, we anticipate a fall of 1%, with risks firmly to the downside.
- This is ahead of a plunge in capex spending as firms shift to survival mode in response to the COVID–19 recession.
- Building & structures to fall further, down a forecast 2% in Q1, with a moderation in non–mining infrastructure as commencements fell back.
- Equipment spending is forecast to be flat – with risks to the downside. Mining equipment spending may well have continued its recent uptrend, offset by a softening across the non–mining sectors. The question – how quickly could firms delay or cancel orders in response to COVID?

CAPEX: by industry by asset

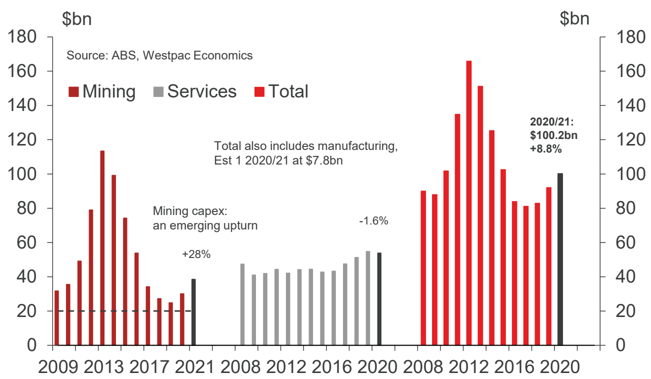


Aus 2019/20 capex plans

May 28, Last: Est 5 2019/20: $120bn, +2.1% vs Est 5 a yr ago
Est 1 2020/21: $110bn, +8.8% vs Est 1 a yr ago

- This survey, conducted in April and May will provide an update on capex plans for 2020/21, as well as for 2019/20.
- The COVID–19 recession will see businesses cut non–essential capex – particularly equipment in the non–mining sectors. The outlook for mining capex has also been hit, with LNG projects to be delayed in response to lower prices
- The downgrading of plans will be evident in this update and potentially more so in 3 months time, when firms have had a chance to more fully revise their investment budgets.
- By industry, Est 1 was: mining, $38.5bn, +28% vs a yr ago; services, $53.8bn, –1.6% vs a yr ago; and manufacturing, $7.8bn, +6.8% vs a yr ago.

Capex plans, by industry: Estimate 1

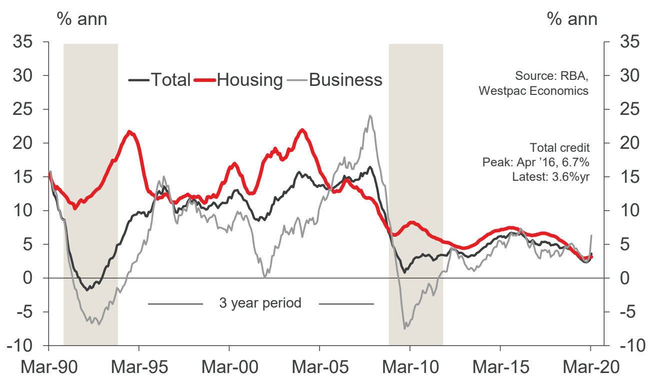


Aus Apr private credit

May 29, Last: 1.1%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.0% to 2.5%

- Credit grew by only 2.4% in 2019, slowing from 4.3% for 2018.
- In 2020, credit growth will be hit by the recession. However, the initial reaction to COVID–19 led to a temporary spike.
- In March, credit rose by 1.1%. Business jumped by 2.9% with firms drawing down existing lines of credit to boost liquidity ahead of the looming cash flow squeeze.
- This dynamic likely extended into April – a month of heightened pressure on businesses. Notably, the initial JobKeeper Payment to firms was not until the start of May
- Housing grew by 0.3%, 3.1% in March. The 3 month annualised pace lifted to 3.6%, up from the mid–2019 low of 2.7% as new lending rebounded on easier lending conditions. Going forward, housing credit growth is set to slow with the sector hit by COVID–19.

Credit: spike at outset of COVID pandemic

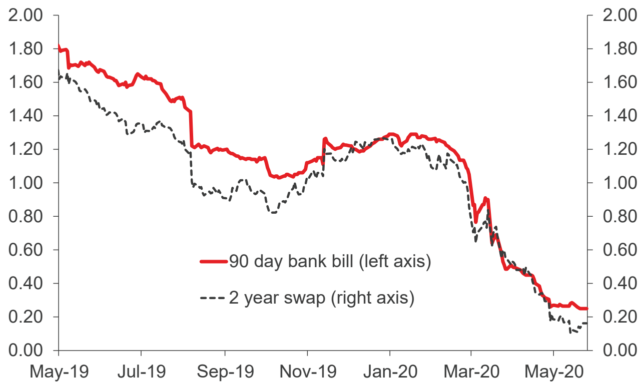


New Zealand forecasts.

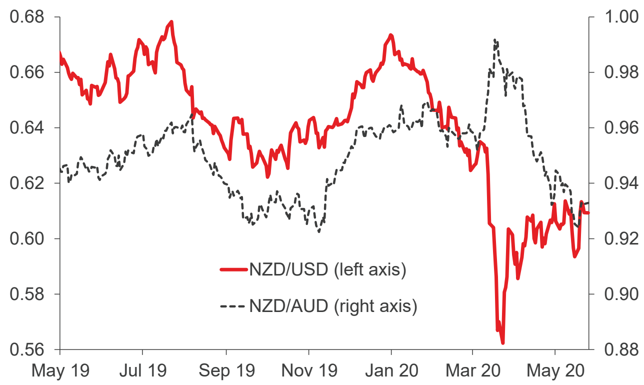
Economic forecasts	Quarterly				Annual			
	2019	2020						
% change	Dec (a)	Mar	Jun	Sep	2018	2019	2020f	2021f
GDP (Production)	0.5	-1.0	-17.0	14.5	3.2	2.3	-6.3	6.5
Employment	0.1	0.7	-9.4	3.1	1.9	0.8	-4.2	3.4
Unemployment Rate % s.a.	4.0	4.2	9.5	8.5	4.3	4.0	7.5	6.3
CPI	0.5	0.8	-0.4	0.8	1.9	1.9	1.1	0.9
Current Account Balance % of GDP	-3.0	-2.6	-2.3	-1.9	-3.8	-3.0	-2.0	-2.7

Financial forecasts	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Cash	0.25	0.25	0.25	0.25	-0.50	-0.50
90 Day bill	0.25	0.25	0.20	-0.10	-0.20	-0.20
2 Year Swap	0.10	0.05	0.00	-0.10	-0.10	-0.10
5 Year Swap	0.20	0.20	0.20	0.20	0.25	0.30
10 Year Bond	0.60	0.55	0.55	0.55	0.60	0.70
NZD/USD	0.59	0.60	0.61	0.62	0.62	0.63
NZD/AUD	0.92	0.91	0.90	0.89	0.89	0.89
NZD/JPY	63.1	63.0	64.7	66.3	66.3	68.0
NZD/EUR	0.55	0.57	0.58	0.58	0.57	0.58
NZD/GBP	0.48	0.49	0.49	0.50	0.50	0.50
TWI	67.1	67.3	67.8	68.2	67.8	68.4

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 25 May 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.26%	0.27%	0.28%
60 Days	0.26%	0.27%	0.30%
90 Days	0.25%	0.26%	0.31%
2 Year Swap	0.16%	0.17%	0.29%
5 Year Swap	0.23%	0.31%	0.46%

NZ foreign currency mid-rates as at 25 May 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6093	0.6155	0.6055
NZD/EUR	0.5592	0.5684	0.5590
NZD/GBP	0.5001	0.4961	0.4871
NZD/JPY	65.56	65.59	64.94
NZD/AUD	0.9329	0.9419	0.9365
TWI	69.16	69.54	68.81

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
Aus	Apr Merchandise trade, prelim	–	–	–	Update on trade in goods, customs basis, not s.a.
US	Memorial Day	–	–	–	Public holiday. Unofficial start of summer.
Tue 26					
NZ	Apr trade balance $m	672	1270	1270	Imports fell sharply during NZ's lockdown.
US	Apr Chicago Fed activity index	–4.19	–	–	April saw activity collapse to lowest level since the GFC.
	Mar FHFA house prices	0.7%	0.6%	–	March house price data will provide the first...
	Mar S&P/CS home price index	0.45%	0.30%	–	...read of COVID's impact on housing wealth.
	May consumer confidence index	86.9	87.0	–	Confidence expected to remain low after sharp fall in Apr.
	Apr new home sales	627k	490k	–	Lockdown measures have stifled turnover.
	May Dallas Fed index	–73.7	–65.0	–	Production subindex fell to record low on oil prices collapse.
	FOMC's Kashkari	–	–	–	Will take part in a virtual panel on Covid.
Wed 27					
NZ	RBNZ Financial Stability Report	–	–	–	Regulatory initiatives put on hold during COVID crisis.
Aus	Q1 construction work	–3.0%	–1.5%	–1.4%	Underlying weakness + some disruptions. Downside risks.
Chn	Apr industrial profits %yr	–34.9%	–	–	Oil, metals and motor vehicle profits very weak in Mar.
US	May Richmond Fed index	–53	–40	–	Shipments, new orders and conditions were soft in April.
	Federal Reserve's Beige book	–	–	–	Gauge of COVID shock across the 12 districts.
	FOMC's Bullard	–	–	–	To discuss the economy during the pandemic.
Thu 28					
NZ	Apr monthly employment indicator	0.1%	–	–	A timely indicator of jobs during the lockdown.
	May ANZ business confidence (final)	–45.6	–	–	Confidence is still low, but has picked up.
Aus	Q1 private new capital expenditure	–2.8%	–2.8%	–1.0%	Building & Structures down further. Risks to downside.
	2019/20 capex plans, AUDbn	110	–	–	Est 1 +8.8% vs yr ago. Recession to see capex cut sharply.
	May, Business impacts of COVID	–	–	–	Update as at week commencing May 13.
Eur	May economic confidence	67.0	72.5	–	Will be supported by stimulus and relaxation of lockdowns.
	May consumer confidence	–18.8	–	–	Final read to confirm soft print from the flash.
UK	May Nationwide house prices	0.7%	–	–	Upside surprise in March & April; reversal looks imminent.
US	Q1 GDP annualised QoQ	–4.8%	–4.8%	–	Second estimate expected to confirm advance read.
	Apr durable goods orders	–14.7%	–18.0%	–	Airline industry orders have been hit particularly hard.
	Initial jobless claims	2438k	–	–	Market expects claims to continue dropping.
	Apr pending home sales	–20.8%	–15.0%	–	Usually peak selling season, but turnover has been smashed.
	May Kansas City Fed index	–30	–	–	Production, shipments and orders all under pressure.
	FOMC's Williams	–	–	–	Will take part in a virtual discussion.
Fri 29					
NZ	May ANZ consumer confidence	84.8	–	–	Will get a boost from the easing of Covid-19 restrictions.
Aus	Apr private sector credit	1.1%	0.6%	0.6%	Near-term, firms drawing down existing lines of credit.
	May 12–15, H'hold impacts of COVID	–	–	–	Survey update on COVID impacts.
Eur	Apr M3 money supply %yr	7.5%	–	–	Spiked in March as easing began to take effect.
	May CPI %yr	0.4%	0.4%	–	Should remain stable in May, but price growth sluggish.
US	Apr wholesale inventories	–0.8%	–	–	Continue to wind down as business brace for demand shock.
	Apr personal income	–2.0%	–7.0%	–	Income to be hit by job loss in months ahead...
	Apr personal spending	–7.5%	–12.6%	–	... COVID-19 restrictions also to act as a headwind.
	Apr core PCE deflator	–0.1%	–0.3%	–	Moderation in March set to be compounded in April.
	May Chicago PMI	35.4	40.0	–	Set to recover slightly after tumbling in the April update.
	May Uni. of Michigan sentiment	73.7	73.7	–	Final read; prelim showed slight uplift on stimulus.
	Fed Chair Powell	–	–	–	Will take part in a virtual discussion.
Sun 31					
Chn	May manufacturing PMI	50.8	51.0	–	Mfg and services made up significant ground in March and...
	May non-manufacturing PMI	53.2	–	–	...appear to have stabilised in marginally positive territory.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019	2020f	2021f
Australia						
Real GDP % yr	2.8	2.5	2.7	1.8	-5.4	4.0
CPI inflation % annual	1.5	1.9	1.8	1.8	0.3	2.4
Unemployment %	5.7	5.5	5.0	5.2	7.6	6.3
Current Account % GDP	-3.1	-2.6	-2.1	0.5	0.5	-0.8
United States						
Real GDP %yr	1.6	2.4	2.9	2.3	-6.0	1.1
Consumer Prices %yr	1.4	2.1	2.4	1.8	1.4	1.6
Unemployment Rate %	4.9	4.4	3.8	3.7	18.0	8.2
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.5	2.2	0.3	0.7	-5.0	1.0
Euro zone						
Real GDP %yr	1.9	2.5	1.9	1.2	-8.5	1.7
United Kingdom						
Real GDP %yr	1.9	1.9	1.3	1.4	-7.0	2.5
China						
Real GDP %yr	6.8	6.9	6.8	6.1	0.1	10.0
East Asia ex China						
Real GDP %yr	4.1	4.6	4.4	3.7	-2.6	5.8
World						
Real GDP %yr	3.4	3.9	3.6	2.8	-3.0	4.8
Forecasts finalised 8 May 2020						

Interest rate forecasts	Latest	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
Australia								
Cash	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
90 Day BBSW	0.10	0.10	0.10	0.15	0.20	0.25	0.30	0.35
10 Year Bond	0.87	0.85	0.90	0.95	1.00	1.10	1.20	1.30
International								
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	0.64	0.60	0.65	0.70	0.75	0.80	0.90	1.00

Exchange rate forecasts	Latest	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
AUD/USD	0.6539	0.64	0.66	0.68	0.70	0.70	0.71	0.72
USD/JPY	107.44	107	105	106	107	107	108	110
EUR/USD	1.0928	1.07	1.06	1.06	1.07	1.08	1.09	1.10
GBP/USD	1.2212	1.22	1.23	1.24	1.25	1.25	1.26	1.27
USD/CNY	7.1201	7.02	6.90	6.85	6.80	6.75	6.70	6.60
AUD/NZD	1.0701	1.08	1.10	1.11	1.13	1.13	1.13	1.13

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

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer.