



Sunrise over Mt. Ruapehu crater.

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## Hold your horses

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Markets are abuzz with the possibility that the RBNZ could cut the OCR at its upcoming policy announcement. While it's a close decision, we don't think that the case for cuts has been made, and expect that the OCR will remain on hold in June.

The RBNZ's next policy announcement will be on June 11. The RBNZ has noted that they would consider OCR cuts if demand weakened, and if wage and price-setting outcomes settled at levels lower than is consistent with the inflation target. After weighing up the slew of developments in recent weeks, we don't think the case for a rate cut has been made just yet.

Looking first at inflation, developments on this front have been borderline. It's true that consumer price inflation is currently low. But in part, this is due to last year's sharp declines in oil prices. The RBNZ is more concerned about where inflation will be in the future, the key to which is what's happening to inflation expectations.

As we discuss in a recent article,<sup>1</sup> there has been a downshift in inflation expectations in recent years. Notably, this isn't just a response to the recent softness in oil prices. Inflation expectations shifted down several years ago, and the persistent weakness in actual inflation means that expectations have been under downwards pressure ever since.

But even though inflation expectations may have shifted down, it is harder to say that they have settled at levels inconsistent with the RBNZ's target. Surveyed inflation expectations currently vary from 1.6% to 2.5% - straddling the 2% midpoint of the RBNZ's target. And these measures could pop higher next year as the recent fall in petrol prices drops out of annual inflation calculations.

<sup>1</sup> Available here: <http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Whats-been-happening-with-Inflation-Expectations-May-2015.pdf>

# Hold your horses continued

While it's arguable whether the inflation hurdle the RBNZ highlighted has been passed, the second condition that they pointed to - that domestic demand cools - is nowhere close to being met. Recent months have seen continued strength in retail sales and employment growth. Forward indicators for construction activity, including last week's building consent figures, remain firm. And despite pulling back in May, overall business confidence has remained at above average levels. On top of all this, the Auckland housing market has continued to sizzle away.

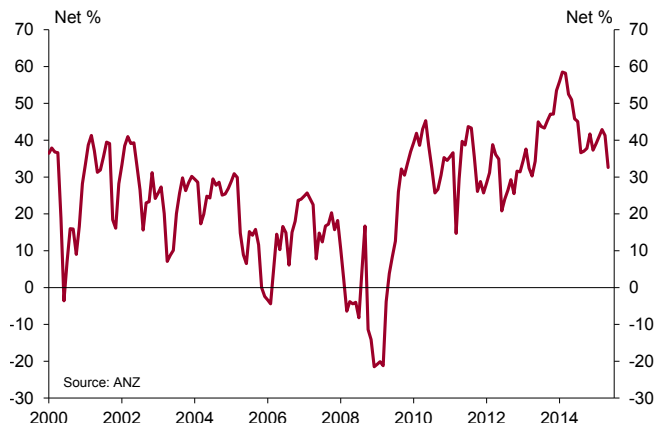
There are some soft spots in the economy. The past week saw Fonterra revise down its payout forecast for this season again to \$4.40/kg, with next year's payout also likely to be sub-par. This has translated into lower confidence and investment intentions in the agricultural sector. In addition, there are questions around the amount of spare capacity in the economy following the softer than expected unemployment result earlier in the quarter. But such concerns don't offset the continued overall positive tone of domestic demand indicators.

Weighing all this up, we're not convinced that the conditions for a rate cut in June have been met.

Looking to the second half of the year, the chances of an OCR cut are higher. If the RBNZ were to cut the OCR, it would most likely happen around September or October. However, we think the odds of this happening are probably a bit shy of fifty-fifty - it is slightly more likely that the OCR will remain on hold all year.

The key to the OCR outlook later in the year is the housing market. The RBNZ has recently proposed restrictions on mortgage lending to property investors, and the Government has tightened the tax rules for property investors. For our part, we're not certain whether these policy changes will cause a material housing market slowdown in the near term. Our working assumption for now is that these new housing policies will have some impact. However, given that underlying momentum in housing market is so strong and mortgage rates have fallen, we still expect Auckland prices to rise vigorously over the remainder of the year.

## Businesses' own activity outlook



If these policies were to succeed in slowing the housing market then domestic demand more generally would probably also cool, and the RBNZ would probably cut the OCR. However, we think that the RBNZ will want to actually observe the housing market cooling before it commits to reducing the OCR.

While we don't expect OCR cuts this year, we do expect that the next move in the OCR will be down. Over the next few years some of the current drivers of growth, in particular the Canterbury rebuild and current strength in immigration, will gradually start to unwind. This will result in growth easing back before inflation reaches levels that will worry the RBNZ. Nevertheless, the cuts we envisage will occur late in the decade, not this year.

Looking to the coming week, we'll receive updates on the terms of trade (Tuesday 2 June) and building work put in place (Thursday 4 June). Both of these are important indicators of the strength of GDP growth in the first quarter of the year. We'll also receive updates on the strength of export prices with the latest GlobalDairyTrade auction results and ANZ commodity price index both out on Wednesday 3 June.

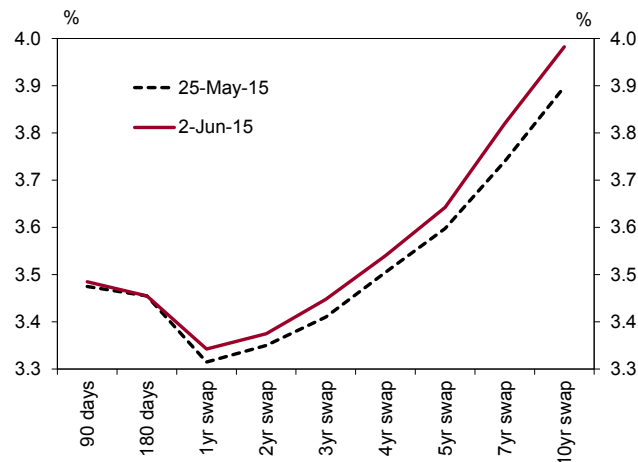
## Fixed vs Floating for mortgages

With short-term interest rates more likely to fall than to rise over the year ahead, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability. For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years, though the gap has continued to narrow.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

## NZ interest rates

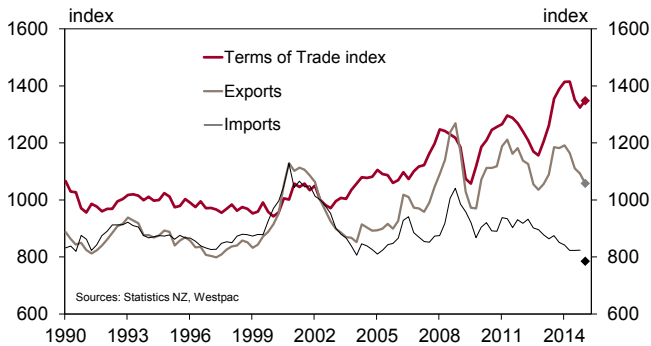


## NZ Q1 terms of trade

Jun 2, Last: -1.9%, Westpac f/c: 1.7%, Mkt f/c: 1.9%

- We estimate that export prices fell 3.1% in the March quarter. The fall in world dairy prices is expected to be less severe than last quarter (we expect a 6.5% drop, compared to a 15% fall in the December quarter). However, it is expected to be accompanied by price declines for other commodities such as meat, wool and aluminium.
- We expect that falls in export prices will be more than offset by a 4.7% fall in import prices, dominated by the plunge in oil prices (down almost 30% in NZ dollar terms).
- Having reached a new four-decade high, the terms of trade fell 6.4% over the second half of last year. While the March quarter bounce is likely to be unwound later this year, we think that the terms of trade is near the bottom of the current cycle. If so, the trough will still exceed the previous peak reached in 2011.

NZ Terms of Trade

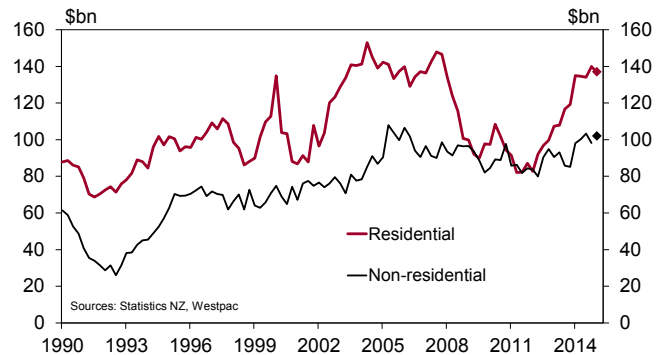


## NZ Q1 building work put in place

Jun 4, Last: 0.3%, Westpac f/c: 0.5%, Mkt f/c: 0.8%

- We expect a 2% fall in residential building work for the March quarter. The monthly building consents figures suggest that quake-related housing construction in Canterbury is peaking, which fits with our long-held view on the profile of the quake rebuild. Consents in Auckland were also troublingly soft in the early part of the year, although they have rebounded since.
- In contrast, there is a significant pipeline of non-residential building work in both Canterbury and elsewhere. We expect a 4% rise in the March quarter, with risk of a larger catch-up bounce after a 5% decline in the December quarter.
- Statistics NZ is adopting a new methodology for the building work series, relying less on postal surveys and more on estimates modelled from the consents data. This should make it easier to forecast in the future.

NZ real building work put in place

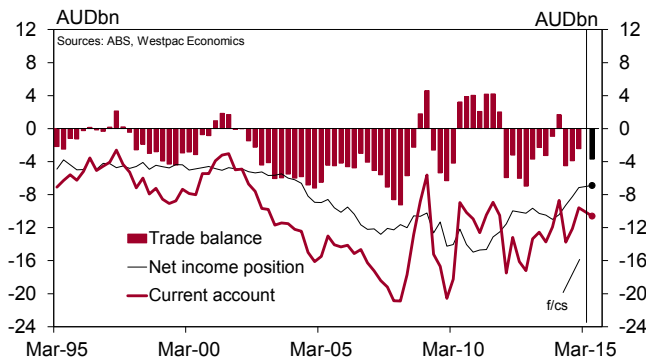


## Aus Q1 current account, AUDbn

Jun 2, Last: -9.6, WBC f/c: -10.6  
Mkt f/c: -10.8, Range: -4.4 to -14.0

- Australia's current account deficit is expected to widen by \$1.0bn to \$10.6bn in Q1. That partially reverses a \$2.5bn improvement in Q4.
- The trade deficit was \$3.7bn in the opening quarter of 2015, widening from a \$2.4bn deficit in Q4 (revised to -\$2.7bn). The import bill rose by 3.0% in the period, outstripping a 1.9% rise in export earnings.
- On the trade front, weakness was centred on export prices, dented by a further fall in global commodity prices. The terms of trade declined by an estimated 1.2% in the quarter.
- The income deficit is expected to narrow a little, moderating to a forecast -\$6.9bn from -\$7.2bn in Q4, thereby extending the recent trend improvement.

Current account: f/c -\$10.6bn in Q1

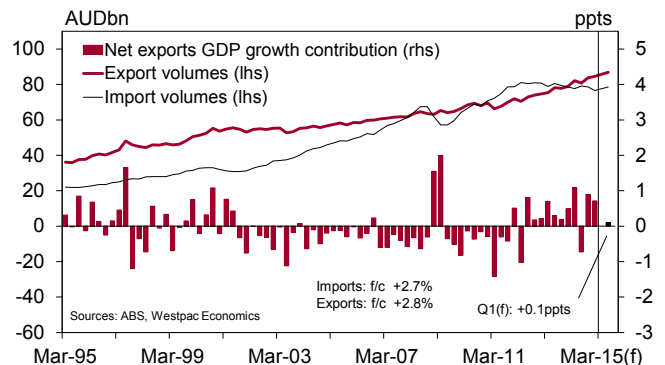


## Aus Q1 net exports, ppt cont'n

Jun 2, Last: 0.7, WBC f/c: 0.1  
Mkt f/c: 0.0, Range: -0.2 to 0.3

- Net exports are expected to add 0.1ppts to Q1 GDP growth. That follows a 0.7ppt positive contribution in Q4. However, with imports the key swing factor in this instance, net exports and inventories have largely cancelled each other out.
- Import volumes rebounded an estimated 2.7% in the quarter, reversing a 2.5% decline in the final three months of 2014. A 4.0% broadly-based bounce in goods imports outweighed a further decline in services. Annual import growth turned positive in the quarter, to +1.4%, the first positive annual read since the end of 2012.
- Export volumes advanced by 2.8%, we estimate, which would have annual growth at 6%. Strength is centred on increased shipments of iron ore, coal and LNG, as additional capacity comes on stream.

Net exports: f/c +0.1ppts in Q1

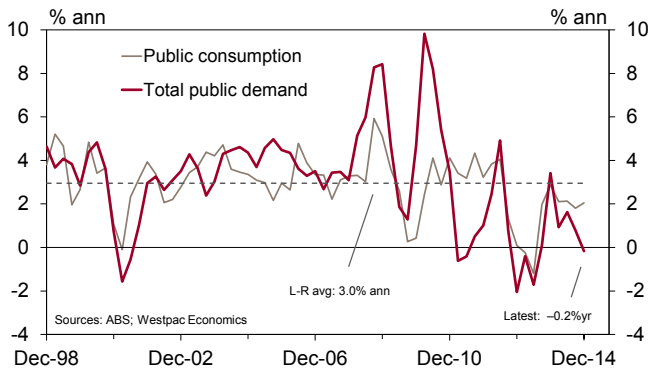


## Aus Q1 public demand

Jun 2, Last: 0.4%, WBC f/c: 0.4%

- Public demand is expected to edge higher in Q1, increasing by 0.4%. That would match the outcome for Q4, but still leave public demand flat over the past year.
- Public consumption, which includes staffing of the public sector, is running at a subdued annual pace of 2%. We expect this to continue near-term as governments keep a lid on expenditures.
- Public investment, which accounts for around 20% of public demand, weakened in 2014 given the focus on spending restraint. We expect a broadly flat Q1 result, in line with that for Q4, which came on the back of a sharp fall in Q3, the initial quarter of the new financial year.

Public demand: stalled in 2014

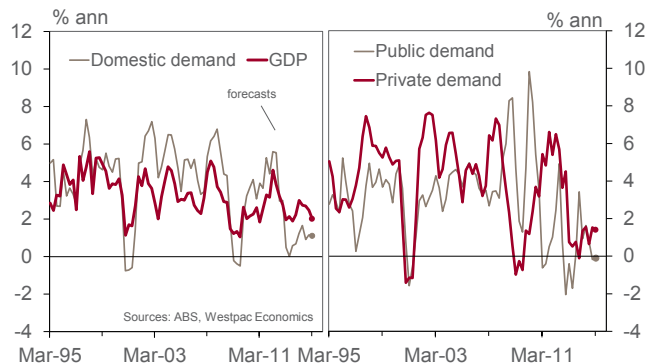


## Aus Q1 GDP

Jun 3, Last: 0.5%qtr, 2.5%yr, WBC f/c: 0.6%qtr, 2.0%yr  
Mkt f/c: 0.6%qtr, 2.0%yr, Range: 0.3% to 1.0%

- Australia's economy is expected to record a fourth consecutive quarter of subdued growth, with Q1 GDP growth forecast to be 0.6%. That would see annual output growth slow to 2.0% from 2.5%, a below-par performance.
- Overall, domestic demand is sluggish at a forecast 0.3%qtr, 1.1%yr. A key uncertainty is the strength of total consumer spending. We anticipate a lukewarm quarter, at 0.7%.
- Home building, f/c +4.3%qtr, is benefitting from the strong tailwind of low interest rates. However, business investment weakness, f/c -3%, centred on the mining investment downturn and sluggish public demand are key headwinds.
- Exports are a positive, as resource exports expand. In total, net exports and total inventories add a f/c 0.3ppts to Q1 growth.

Australian economic conditions

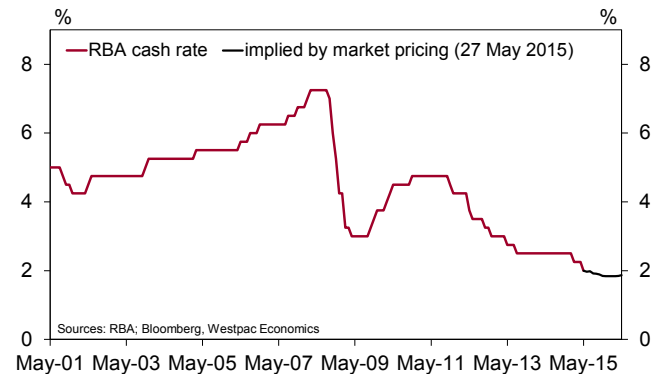


## Aus RBA policy decision

Jun 2, Last: 2.00%, WBC f/c: 2.00%  
Mkt f/c: 2.00%, Range: 2.00% to 2.00%

- The RBA cut the cash rate by 25bps at its May meeting, delivering on the strong easing bias adopted after its previous rate cut in Feb. The Governor's statement accompanying the May decision adopted a more upbeat tone, with no forward guidance. However, the Bank's downgraded 2016 forecast for underlying inflation in the May Statement on Monetary Policy – to a range with a mid-point in the lower half of the 2-3% target band – and the phrasing used in the 'Considerations for policy' section of May meeting minutes, presented a clear 'implicit' or 'soft' easing bias.
- Either way, a June move is not on the cards. The Bank will now wait to assess the impact of its moves. Its hope is that the extra boost to household expenditure will encourage businesses to invest and employ, setting the economy on a path to at-or-above trend growth in 2016. How this forecast evolves will be key to future policy decisions.

RBA cash rate

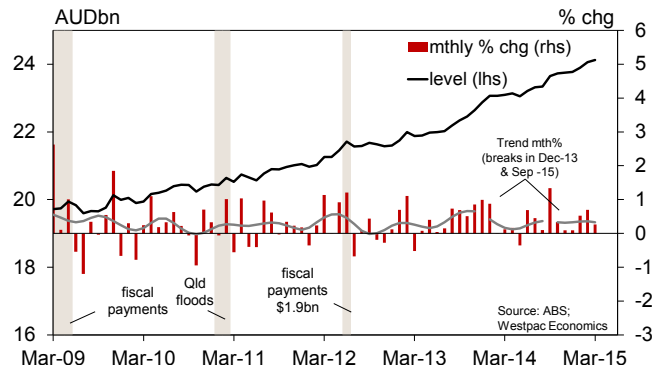


## Aus Apr retail trade

Jun 4, Last: 0.3%, WBC f/c: 0.3%  
Mkt f/c: 0.3%, Range: 0.1% to 0.6%

- Retail sales rose 0.3% in March following rises of 0.7% in Feb and 0.5% in Jan. The March result was a touch below expectations with the detail also 'cyclically soft' (basic food up, but several discretionary categories down). The boost from the RBA's February rate cut and lower petrol prices earlier in the year appears to have waned a little.
- Conditions were mixed in April. While the February rate cut and housing upturn would have still been positives, sentiment hit something of a pot-hole, with renewed concerns about job security a clear factor. Although the official data on jobs and hours worked has been fairly positive in 2015, this slip in confidence is likely to have seen some of the March softness in retail extend into April. We expect a similar 0.3%qtr gain. The RBA's May rate cut and the post-Budget bounce in consumer sentiment make for a better backdrop in May-June, although labour market concerns remain a headwind.

Monthly retail sales

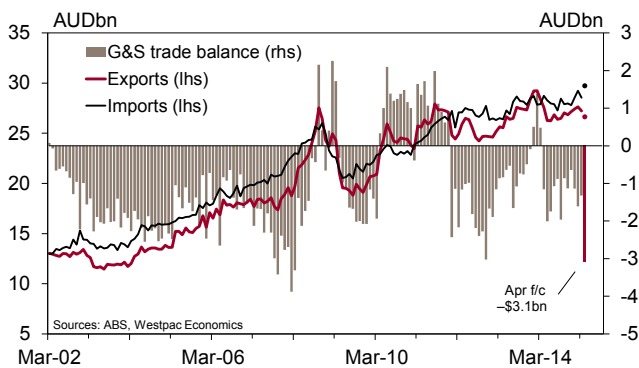


## Aus Apr trade balance, AUDbn

**Jun 4, Last: -1.3, WBC f/c: -3.1**  
**Mkt f/c: -2.1, Range: -1.2 to -3.1**

- Australia's trade balance has been in deficit for the 12 consecutive months to March, with export earnings dented by falling global commodity prices.
- We anticipate a blow-out in the deficit in April, as a weakening of export earnings coincides with a jump in imports. The deficit is forecast to widen to \$3.1bn from \$1.3bn in March. Such a result would eclipse the November 2012 deficit of \$3.0bn to be the largest since the GFC of early 2008.
- Imports jumped in April, up a forecast 4%, with the ABS advising that goods rose 5% on higher fuel and equipment.
- Exports are forecast to fall by 2%, led lower by weaker iron ore and coal prices, as well as weaker coal volumes, but with a partial offset from gains across other exports.

### Australia's trade position



## US May ISMs

**Jun 1, ISM manufacturing Last: 51.5, WBC f/c: 52.2**  
**Jun 3, ISM non-manufacturing Last: 57.8, WBC f/c: 57.2**

- The ISM manufacturing index has clearly been impacted by the stronger US dollar and weak oil price in recent months, falling from 58.1 in Aug 2014 to 51.5 in Mar. In Apr, the headline measure was unchanged, but new orders firmed and inventories fell. This points to an improvement in May, to 52.2. Of the detail, new orders and employment are key.
- In contrast, the non-manufacturing ISM has continued to print very robust outcomes through 2015. The past year has seen an average read of 57.3, and the index sat at 57.8 in Apr. One suspects the US dollar will begin to have an impact; this is why we expect a (still strong) May reading of 57.2. Again, forward looking indicators of activity and the employment sub-index will be the focus amongst the detail. Services jobs are the driving force behind the labour market at present.

### US ISMs

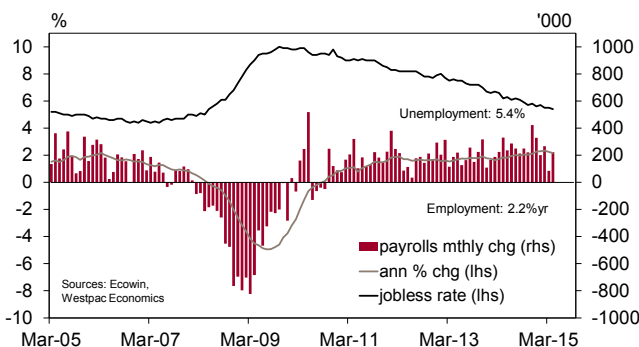


## US May employment report

**Jun 5, Payrolls: Last: 223k, WBC f/c: 225k**  
**Jun 5, Unemployment rate: Last: 5.4%, WBC f/c: 5.4%**

- The Apr employment report had something for everyone. The headline 223k result was in line with the market; but, including the 39k downward revision to the prior two months, the result was in line with our forecast. Job shedding remains at historically low levels (sans the oil sector); while the services sector continues to drive robust job creation. Doubts linger over the level of pay and conditions that go with these jobs, but there is no question over the robust pace of job growth.
- From the household survey, we note that the unemployment rate is now at the top end of the range typically expected with full employment, circa 5.0–5.5%. However, that the employment-to-population ratio remains near its historical lows implies a fair degree of slack is available. This suggests that wage pressures are unlikely to rise rapidly in coming months.

### US: unemployment declines to 5.4%



# Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
<b>Tue 2</b>					
<b>NZ</b>	Q1 terms of trade	-1.9%	1.9%	1.7%	Cheaper oil imports outweighed the fall in dairy export prices.
<b>Aus</b>	Q1 current account balance, AUDbn	-9.6	-10.8	-10.6	Deficit to widen on weaker trade numbers.
	Q1 net exports, ppts cont'n	0.7	0.0	0.1	Only a small positive contribution as imports rebound.
	Q1 public demand	0.4%	-	0.4%	To edge higher but be flat over the year – focus on budget consolidation.
	RBA policy announcement	2.00%	2.00%	2.00%	RBA on hold, with mild easing bias, following cuts in Feb & May.
<b>Eur</b>	May CPI, flash estimate %yr	0.0%	0.1%	0.1%	Inflation returning to the European continent.
	Apr PPI %yr	-2.3%	-2.1%	-	Upstream price pressures still nonexistent.
<b>Ger</b>	May unemployment change 000's	-8k	-10k	-	German labour market historically strong.
<b>UK</b>	Apr lending sec. on dwellings £bn	1.8	-	-	Consumer credit rose £1.2bn in Apr.
<b>US</b>	Apr factory orders	2.1%	-0.1%	0.0%	Durables surprised to upside in Apr, but investment trend still weak.
	Jun IBD/TIPP economic optimism	49.7	49.8	-	Fell below neutral level in May following Apr's gas price rise.
<b>Wed 3</b>					
<b>NZ</b>	GlobalDairyTrade auction	-2.2%	-	-	Prices fell to a new cycle low in the last auction.
	May commodity prices	-7.4%	-	-4.5%	Declines in dairy, beef, log prices.
<b>Aus</b>	Q1 GDP	0.5%	0.6%	0.6%	Demand subdued (0.3%), investment falls. Annual growth slows to 2.0%
<b>Chn</b>	May HSBC services PMI	52.9	-	-	Real estate off the canvas & financial services pumped up by equities?
<b>Eur</b>	May Markit composite PMI, final	53.4	53.4	53.4	Services has lost some momentum in recent months but still at 53.3.
	Apr unemployment rate	11.3%	-	11.3%	Job shedding has abated, but job creation still lacking.
	Apr retail sales %yr	1.6%	1.3%	-	Lost some momentum in recent months, sales fell 0.8% in Mar.
	ECB policy decision	-	-	-	Press conference to again highlight ECB intent to persist with plan.
<b>UK</b>	Apr BRC shop prices %yr	-1.9%	-	-	Non-food prices were down 2.5% in Mar.
	May Nationwide house prices	1.0%	0.3%	-	Softer growth of late; annual momentum slowed to 4.8% in Apr.
<b>US</b>	May ADP private payrolls 000's	169k	200k	195k	Has underperformed payrolls of late; likely to persist.
	Apr trade balance \$bn	-51.4	-44.2	-45.0	USD having notable impact; so too soft global demand.
	May non-manufacturing ISM	57.8	57.0	57.2	Has shown substantial momentum, but services now slowing.
<b>Thu 4</b>					
<b>NZ</b>	Q1 building work put in place	0.3%	0.8%	0.5%	The level of quake rebuild activity is starting to level out.
<b>Aus</b>	Apr retail sales	0.3%	0.3%	0.3%	Sentiment's pre-Budget 'wobble' to see Mar softness extend into April.
	Apr trade balance, AUDbn	-1.3	-2.1	-3.1	Deficit blow-out on a jump in imports (4%) and export weakness (-2%).
<b>US</b>	Weekly initial jobless claims	282k	-	290k	Sub-300k trend firmly entrenched.
<b>UK</b>	BoE policy meeting	-	-	-	On hold well into 2016.
<b>Can</b>	May Ivey PMI	58.2	-	-	Saw a sharp jump in Apr from 47.9 in Mar.
<b>Fri 5</b>					
<b>Eur</b>	Q1 GDP, second estimate	0.4%	-	0.4%	Component detail. France surprised to upside; Germany to downside.
<b>Ger</b>	Apr factory orders	0.9%	0.5%	-	Production momentum has been softer of late than would be hoped.
<b>UK</b>	May Halifax house prices	1.6%	0.4%	-	8.5% annual pulse stronger than Nationwide, but down from 10.2%yr peak.
<b>US</b>	May nonfarm payrolls	223k	225k	225k	Month to month momentum to persist; but watch for revision volatility.
	May unemployment rate	5.4%	5.4%	5.4%	Now at or near 'full employment'; what does that mean for wages?
	Apr consumer credit \$bn	20.5	16.0	-	Student and auto loans remain the primary drivers of credit.
<b>Can</b>	May unemployment rate	6.8%	-	-	19.7k jobs lost in Apr; result driven by part-time decline.

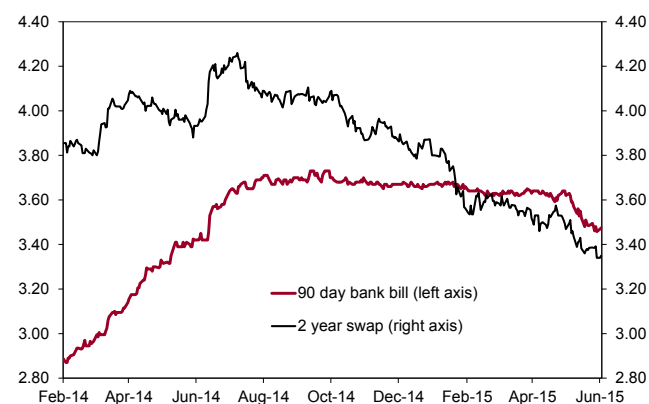


# New Zealand forecasts

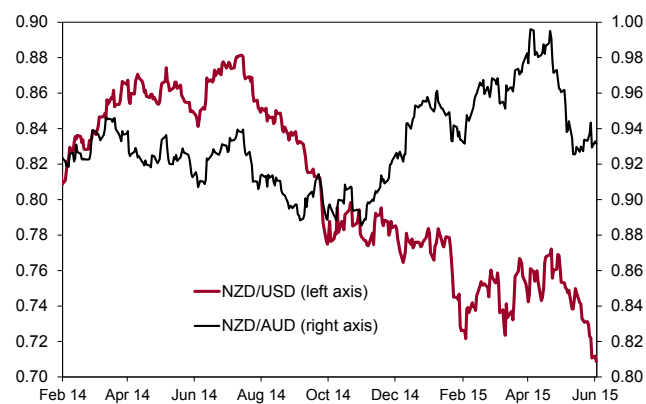
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	2.9	2.3	3.3	3.0	3.0
Employment	0.2	3.8	3.2	2.8	2.9	3.6	2.7	2.9
Unemployment Rate % s.a.	6.3	6.0	5.8	5.1	6.1	5.8	5.2	4.5
CPI	0.9	1.5	0.1	1.3	1.6	0.8	0.4	2.1
Current Account Balance % of GDP	-3.7	-2.6	-4.0	-4.9	-3.3	-3.3	-4.8	-4.6

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.50	3.50	3.50	3.50	3.50	3.50
90 Day bill	3.60	3.65	3.70	3.70	3.70	3.70
2 Year Swap	3.40	3.50	3.60	3.70	3.80	3.80
5 Year Swap	3.50	3.60	3.70	3.80	3.90	4.00
10 Year Bond	3.50	3.50	3.60	3.70	3.80	3.90
NZD/USD	0.75	0.74	0.72	0.71	0.71	0.71
NZD/AUD	0.96	0.98	0.98	0.98	0.98	0.97
NZD/JPY	90.0	90.0	88.8	88.6	89.3	89.5
NZD/EUR	0.69	0.71	0.70	0.70	0.70	0.70
NZD/GBP	0.50	0.51	0.50	0.49	0.48	0.47
TWI	79.4	80.0	78.9	78.7	78.6	78.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 2 June 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.54%	3.58%	3.61%
60 Days	3.51%	3.55%	3.62%
90 Days	3.48%	3.52%	3.62%
2 Year Swap	3.35%	3.37%	3.49%
5 Year Swap	3.60%	3.64%	3.63%

NZ foreign currency mid-rates as at Tuesday 2 June 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7088	0.7443	0.7532
NZD/EUR	0.6487	0.6507	0.6726
NZD/GBP	0.4662	0.4730	0.4975
NZD/JPY	88.47	88.79	90.53
NZD/AUD	0.9316	0.9254	0.9610
TWI	74.57	76.50	78.04

# International forecasts

## Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014	2015f	2016f
<b>Australia</b>						
Real GDP % yr	2.7	3.6	2.1	2.7	2.2	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.3	2.6
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.5
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.2	-2.8
<b>United States</b>						
Real GDP %yr	1.6	2.3	2.2	2.4	2.2	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.1	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.3	5.0
Current Account %GDP	-2.9	-2.9	-2.4	-2.4	-2.5	-2.5
<b>Japan</b>						
Real GDP %yr	-0.5	1.8	1.6	-0.1	1.0	1.7
<b>Euroland</b>						
Real GDP %yr	1.6	-0.8	-0.4	0.8	1.2	1.1
<b>United Kingdom</b>						
Real GDP %yr	1.6	0.7	1.7	2.6	2.5	2.7
<b>China</b>						
Real GDP %yr	9.3	7.8	7.8	7.4	7.0	7.0
<b>East Asia ex China</b>						
Real GDP %yr	4.4	4.5	4.3	4.1	4.4	5.0
<b>World</b>						
Real GDP %yr	4.2	3.4	3.3	3.4	3.2	4.0
Forecasts finalised 8 May 2015						

Interest Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
<b>Australia</b>						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.13	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.73	2.90	2.90	3.00	3.10	3.30
<b>International</b>						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.13	2.20	2.30	2.50	2.70	3.00
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
AUD/USD	0.7660	0.78	0.73	0.73	0.73	0.73
USD/JPY	123.90	120	122	124	124	125
EUR/USD	1.0950	1.09	1.05	1.02	1.02	1.02
AUD/NZD	1.0720	1.07	1.02	1.02	1.02	1.02



## Westpac economics team contact details

**Dominick Stephens**, Chief Economist  
+64 9 336 5671

**Michael Gordon**, Senior Economist  
+64 9 336 5670

**Felix Delbrück**, Senior Economist  
+64 9 336 5668

**Satish Ranchhod**, Senior Economist  
+64 9 336 5669

Any questions email:  
economics@westpac.co.nz

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