WESTPAC ECONOMIC BULLETIN

New Zealand economic forecast update.

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Michael Gordon, Acting Chief Economist
+64 9 336 5670
michael.gordon@westpac.co.nz

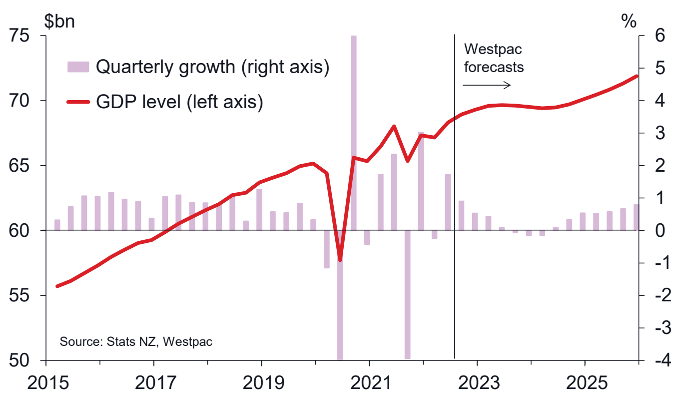
Slowing pains.

- We've downgraded our forecasts of the New Zealand economy, to align them with the higher expected peak in the Official Cash Rate.
- For now, the economy still has some solid momentum, with the return of overseas tourists providing a fresh boost to demand. We expect next Thursday's GDP release to show a strong 0.9% lift in activity.
- But we now expect GDP growth to stall over the following year, with a small contraction in activity over late 2023 and early 2024.
- Discretionary spending will be squeezed a lot harder in 2023 than it has been in 2022, as more mortgages come up for refixing at substantially higher interest rates.
- Monetary policy always comes with lags – that applies in both directions. While the RBNZ has further to go to bring inflation under control, it will need to start thinking about when to take its foot off the brake.

Since our November *Economic Overview* we've made some revisions to our economic forecasts, to align them with our view that the Reserve Bank is likely to take the Official Cash Rate to a higher peak. We now expect that GDP growth will drop to stall speed over the coming year, with a mild contraction in late 2023 and early 2024 as the full brunt of higher interest rates ripples through the economy.

The downturn is not expected to be deep – we're forecasting a total decline of 'only' 0.3%. The more important part is what happens beyond that. Like the RBNZ, we're expecting a flattening off in activity rather than a strong rebound, with economic growth falling well below trend. That weakness in economic conditions will result in unemployment rising from 3.3% currently to around 4.8% by the end of 2024.

GDP forecasts

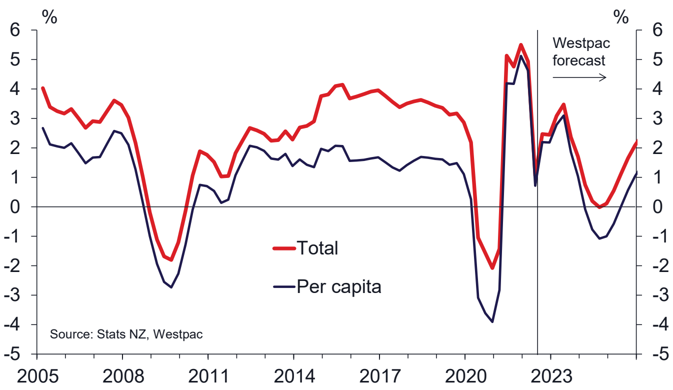


In its November *Monetary Policy Statement* the RBNZ delivered a jumbo-sized 75 basis point hike in the OCR, and signalled that it expects further increases to a peak of 5.5% in the first half of next year. Given the RBNZ's clear determination to get on top of inflation, we're assuming that it will follow through with its plans in the near term. Wholesale interest rates have priced in a similar profile, and in turn mortgage rates have been ratcheted higher.

Higher mortgage rates will add even more pressure on households than we had previously factored in. Firstly, New Zealanders hold a large amount of their wealth in their own homes or in investment properties, and falling house prices have taken a sizeable bite out of many households' net worth. We expect a peak-to-trough fall in house prices of just over 20%, with the weakness in prices continuing through 2023 and into early 2024.

Secondly, household budgets will be squeezed even harder. Around half of all mortgages will come up for repricing over the coming year, and borrowers will face refixing at rates that are significantly higher than those they are currently on. That signals an even larger drag on discretionary spending than we had previously anticipated. We're now forecasting outright falls in per-capita spending over 2023, with total spending expected to fall by around 1% compared to 2022. As a comparison, household spending rose by an average of 4% per annum in the years leading up to the pandemic.

GDP growth, annual average



Household spending accounts for around 60% of total economic activity, and the expected fall in demand will drive a broader downturn in economic activity, including capital spending by businesses. As activity weakens, we're likely to see unemployment trending higher, which will further compound the pressure on some households' finances.

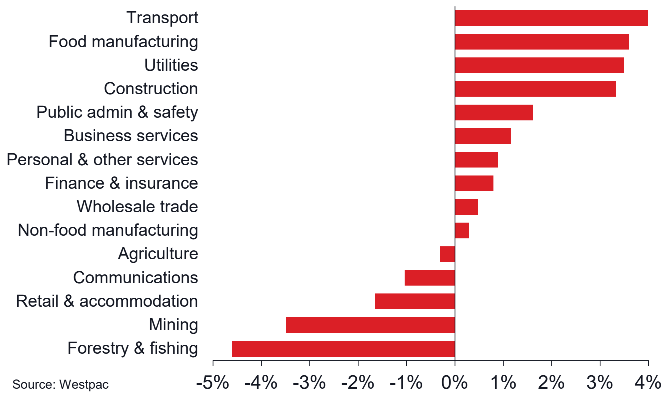
That slowdown in domestic demand and the labour market is actually what is needed – and what the RBNZ has been trying to engineer – to dampen the inflation pressures that have been boiling over in every corner of the economy. Even so, we don't expect inflation will be back inside the RBNZ's 1-3% target band until mid-2024.

What to watch for next.

The RBNZ's warning that they will engineer a recession to dampen inflation has caught many people's attention. However, it's worth noting that the central bank is still expecting some solid growth in the economy in the near term. The reopening of the border and the resumption of international tourism is providing a fresh source of demand, offsetting some of the pressure on domestic activity. It's also left some employers scrambling to meet that extra demand, in a labour market that's the tightest it's been in decades.

We've actually lifted our forecast for September quarter GDP (released next Thursday), from 0.4% to 0.9%. That follows a 1.7% surge in the June quarter, led by tourism-related areas such as transport, accommodation and recreational activities. Tourist numbers are still picking up strongly, but with the level already having lifted from near-zero, the rate of increase won't be as strong this time. We've also seen strong gains in areas such as construction, with a substantial pipeline of consented activity still being worked through; food manufacturing, particularly meat processing; and electricity generation, with a strong shift back to cheaper renewable energy as the hydro lakes have refilled.

Q3 GDP forecast by production

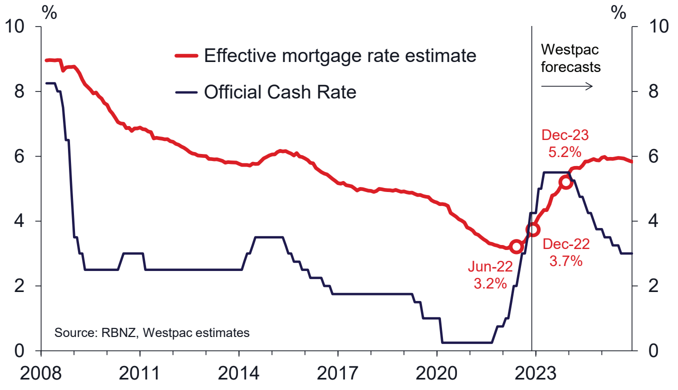


Beyond the tourism factor, domestic demand has remained fairly robust so far in the face of the rapid rise in interest rates. That is in part because monetary policy always comes with lags – as a rule of thumb, it takes about 1-2 years for a change in interest rates to have the bulk of its impact on activity and inflation pressures. Around 90% of New Zealand mortgages are on fixed-term mortgage rates, which has shielded many homeowners – and their spending power – from interest rate increases up until now.

That will change once those loans finally come due for refixing though. Over the coming months, we'll be watching for signs that consumer spending is cooling, that businesses are experiencing a drop in orders and sales, and ultimately that they're no longer competing as hard to attract or retain workers. In time that should also see the heat come out of wage increases. However, wage inflation tends to be the most lagging part of the economic cycle, so we don't expect the RBNZ will be getting any signs of relief on that front in the coming quarters.

Finally, while we've lifted our forecast for the peak in the OCR, we've also brought forward the expected timing of interest rate cuts, starting from early 2024. The point that monetary policy operates with a lag applies in both directions – borrowers will continue to roll onto higher interest rates long after the OCR itself has passed its peak. On our estimates, the series of OCR cuts that we're projecting over 2024 and 2025 is what would be needed just to stabilise the effective average mortgage rate paid by homeowners by the end of that period.

Effective average mortgage rate



For now, the RBNZ's message will remain that it is determined to get back to low and stable inflation. But its 'stitch in time saves nine' approach – that is, strong early action reduces the need for even more aggressive moves in the future – means that it should be turning its collective mind towards the timing of OCR cuts before too long.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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