WESTPAC ECONOMIC BULLETIN

Change in OCR forecast and preview of RBNZ October 2022 Monetary Policy Review.

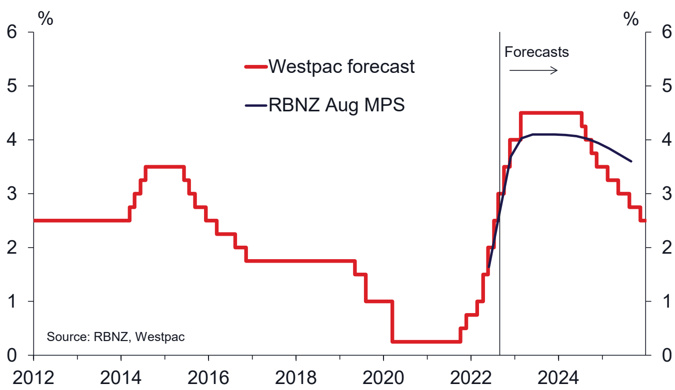
30 September 2022

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

The good, the bad, and the currency.

- We have revised up our forecast to a peak of 4.5% for the Official Cash Rate (previously 4%).
- We expect that to be achieved with three more 50 basis point hikes at the October, November and February reviews.
- Recent developments point to the risks of stronger and more persistent inflation pressures than we anticipated.
- In particular, we now expect the New Zealand dollar to be lower for longer, adding to the pace of inflation in the year ahead.
- In an already-overheated economy – which is proving to be more resilient in the near term than we thought – the risks of second-round inflation pressures are greater.
- At next week's review, we expect the RBNZ to repeat that the OCR will continue to rise "at pace", and to signal a higher peak for this cycle.

OCR forecasts



We've revised up our forecast of how high the Official Cash Rate will need to go in the Reserve Bank's battle against inflation. We now expect a peak of 4.5%, compared to our previous forecast of 4%.

Recent developments have pointed to further upward pressure on inflation over the medium term. In particular, we've made some significant downward revisions to our exchange rate forecasts, which suggest that the imported component of inflation won't recede as quickly as we thought. Meanwhile, the local economy has so far proven to be a little more resilient than expected to the impacts of higher interest rates.

With the OCR currently at 3%, New Zealand's monetary tightening cycle is now well advanced. But a 4.5% peak still implies a substantial amount of work left to do, and with little time to waste. We expect the RBNZ to reach this point with a 50 basis point hike at next Wednesday's review, followed by another 50 basis points at each of the next two reviews in November and February.

The changes to our OCR and exchange rate forecasts will have consequences for our broader views on economic activity and inflation. We'll provide a fuller update following next week's monetary policy decision.

The good, the bad, and the currency.

Developments in the New Zealand economy have been mixed, but on balance have pointed to ongoing resilience in activity.

GDP grew by 1.7% in the June quarter. That was close to our forecast on the day of 1.6%, but was more than the 1% rise that we used in our August *Economic Overview* projections. The main contributor to that growth was a surge across the services sectors, as New Zealand reopened its border to overseas tourists. That pace of growth is unlikely to be repeated, but it's a potent reminder that key parts of the economy are still firmly in recovery mode, even as we see signs of cooling in the parts that had become overheated.

The household sector is bearing most of the brunt of the adjustment, as we expected. House prices have continued to soften in the face of higher mortgage rates, and are now down around 9% from their peak last November. We've also seen a flattening off in nominal consumer spending (at a time that prices have been rising rapidly), and consumer confidence is languishing at low levels. Finally, the effective average mortgage rate that households are paying has continued to push higher, and is set to continue rising over the coming months.

But while some steam has come out of the economy, activity is still trucking along at a solid pace. That's been reflected in the latest PSI and PMI reports, which pointed to resilient demand and a lift in forward orders. Similarly, the labour market remains strong, with continued growth in filled jobs over recent months. We had taken note of a sharp drop in job advertisements in June and July, but they came back strongly again in August. That suggests the initial drop may have had more to do with the second Omicron wave than with a softening in labour demand.

We've also seen positive developments in our export sectors. Prices for our commodity exports have held firm, with world dairy prices rising 7% over the past month alone. At the same time, international visitor arrivals have been climbing rapidly since the reopening of the borders.

The more significant developments for the monetary policy outlook have been on the global stage. With inflation boiling over around the world, policy rates in major economies have been charging higher in recent months. At the same time, geopolitical tensions, including the Ukraine war and an escalation in Russian rhetoric, are rippling through financial markets. And on top of those developments, the sustainability of the UK's longer term fiscal position has been thrown into question following the announcement of significant stimulus measures.

As a result, global investors have flocked to the perceived safe haven of the US dollar. That's come at the expense of currencies such as the New Zealand dollar in particular – we've fallen by more than 10% against the USD in recent weeks, and have lost ground to a smaller degree against others like the euro and the Australian dollar.

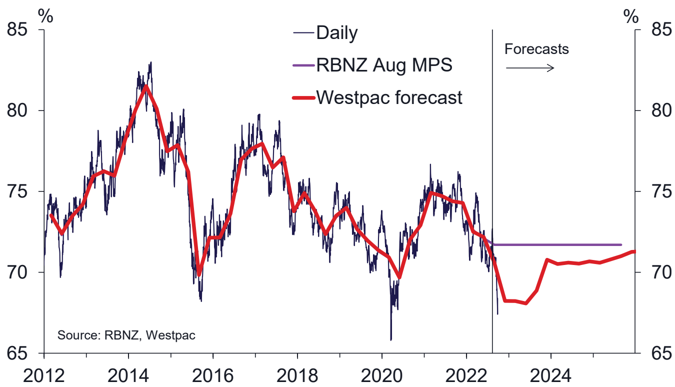
From our point of view, we had been forecasting the US dollar to ease back again over the next couple of years, as worldwide inflation rates passed their peaks and global markets became more comfortable that central banks were getting on top of the problem. However, that point is now looking more distant.

So in addition to the lower starting point, we now expect a later and more subdued recovery in the New Zealand dollar. We expect the NZD to remain below 0.60 against the USD through to the middle of next year, only rising to 0.67 by 2024.

A lower New Zealand dollar does come with some benefits to the economy, boosting our export earnings and providing some insulation from the headwinds to global growth. But it also means higher costs for imported consumer goods and production inputs, adding to inflation over the year or so ahead.

As a rule of thumb, a sustained 10% drop in the New Zealand dollar would add around 0.4% to the rate of inflation for the following year. This comes at a time when inflation was already expected to be outside the RBNZ's medium-term target range of 1-3% – we were forecasting inflation to have slowed to 3.6% by the end of 2023, only dropping below 3% on a sustained basis from 2024. Bumping up the 2023 forecast on its own wouldn't make much difference in terms of the monetary policy response.

NZD Trade Weighted Index



The real issue is the risk of second-round effects, as higher headline inflation acts as a catalyst for further price increases. The risk of that occurring is much greater when the economy is stretched thin, or if there is a large and persistent rise in inflation. And that's exactly what we're seeing now. In addition to businesses raising their prices to maintain margins, wage growth has risen sharply as workers have sought compensation for the large increases in the cost of living. Wage growth is now running at its fastest pace since the financial crisis in 2009, with average hourly earnings rising by 6.4% over the past year.

Even before we revised down our outlook for the New Zealand dollar, we were forecasting a lift in wage pressures over the coming year. And now, with a stronger outlook for consumer prices, that pressure on wages (and other operating costs) is likely to be even more intense.

Like the RBNZ, we judged that an OCR of around 4% would be enough to bring inflation back to the target range within a medium-term horizon – but only barely. There was little room for the RBNZ to absorb any further upside surprises on inflation before it would have to revise its OCR track higher as well.

RBNZ to continue raising rates "at pace".

With inflation risks escalating and domestic activity remaining resilient, another 50 basis point rise in the cash rate is in the bag for next Wednesday's review.

The RBNZ's projections in its August *Monetary Policy Statement* were consistent with 50 basis point increases at both the October and November reviews, with some risk that further increases might be needed next year. Next week's decision won't include a new set of forecasts, so any change in the projected path for the OCR will have to be conveyed verbally. We expect the RBNZ to repeat its recent language that it will continue to tighten monetary policy "at pace", and may say that the Committee anticipates a higher OCR path than what was projected in the August statement.

Markets have priced in some possibility of a 75 basis point increase, in keeping with the supersized moves by other central banks like the US Federal Reserve in recent months. We can't completely rule that out: with the OCR currently at 3%, our updated forecast implies another 150 basis points to go, and with no time to be complacent about it.

But on balance we think it's more likely that the RBNZ will stick with 50 basis point steps. We think the RBNZ is justified in believing that the monetary tightening cycle is much more mature in New Zealand compared to other major economies, and doesn't require the same degree of urgency to 'catch up'. What's more, stepping up to a 75 basis point pace at this late stage of the cycle, without providing more explicit guidance about the OCR track, would risk letting the market's imagination run riot about how high interest rates will ultimately need to go.

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

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. 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.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking and Insurance Regulatory Commission (CBIRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment recommendations disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;
(ii) physical separation of various Business/Support Units;
(iii) and well defined wall/cell crossing procedures;
(iv) a "need to know" policy;
(v) documented and well defined procedures for dealing with conflicts of interest;
(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.