WESTPAC ECONOMIC BULLETIN

Q4 GDP review and OCR forecast update.

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Coming in for landing.

- GDP fell by 0.6% in the December quarter, a bigger drop than was expected. The growth in previous quarters was revised down as well.
- The economy is coming from a much less overheated starting point than the Reserve Bank was expecting.
- In turn this suggests that the degree of slowing needed to bring inflation under control is also less than thought.
- We now expect the Official Cash Rate to peak at 5% this year, with one final 25 basis point increase in April.

Key results	Dec 22	Sep 22	Westpac f/c	RBNZ f/c
GDP qtr %	**-0.6**	1.7	-0.2	0.7
GDP ann %	**2.2**	6.4	3.3	4.2
GDP ann avg %	**2.4**	2.7	2.7	2.9

Today's GDP figures were a major downside surprise to our understanding of the state of the economy. The 0.6% drop in activity was weaker than both we and the market expected, and even more so once we take into account the downward revisions to growth in the previous quarters.

Crucially, these add up to a huge miss for the Reserve Bank – GDP is running almost two percent below what the RBNZ was expecting in its February *Monetary Policy Statement*. It's still true that the economy is coming from an overheated starting point, but not nearly to the degree that the RBNZ thought. And that matters for how much of a slowdown will be needed from here to bring inflation back under control.

We've revised our OCR forecast down to a peak of 5.00%, from 5.50% previously. That implies only one more 25 basis point increase left in this cycle, which we still think will be delivered at the April OCR review. The RBNZ won't necessarily call time on the tightening cycle at that point – and since it won't be publishing new forecasts at the April review, it doesn't have to be explicit about the path forward. Rather, it could shift its language towards noting that a substantial amount of tightening has been put in place over the last 18 months, and that any further moves will be data-dependent.

Details.

The New Zealand economy's seemingly strong run through the middle part of 2022 was punctured at the end of the year. GDP fell by 0.6% in the December quarter, against our forecast of a 0.2% drop. Market forecasts were in a similar range.

In fact the result was even softer than the headline number suggests. Stats NZ has updated the way that it calculates the seasonal factors – a thorny issue in recent times, as the Covid pandemic has thrown off the usual seasonal patterns in activity. In particular, the border closure meant that the usual summer rush of overseas tourists was absent for a couple of years.

As a result of this change, June and September quarters have been revised lower, while December quarters have been given a boost. If Stats had used the old seasonal factors (as we did in our forecast), today's result would have been more like a 1.2% drop.

It might seem strange that our understanding of the economy should hinge so much on a technicality. We should firstly note that what Stats has done is perfectly valid. There's no one 'right' way to seasonally adjust economic data – there is a generally agreed method, but the exact settings can be tweaked to suit the circumstances. And in the case of the Covid restrictions, it's very difficult to know how to adjust the data for something that has no precedent.

What's more, the calculation of the seasonal factors always evolves over time as we add more data. Indeed, last quarter we puzzled over the strength in the travel-related areas of the economy, given that overseas visitor numbers were only halfway back to pre-Covid levels. Today's revisions have narrowed the gap a little, but there may be more to come in the years ahead.

Given the uncertainty around quarterly growth rates, we can get a better sense of the scale of today's surprise by looking at the annual rate of growth instead. This slowed to 2.2% in the December quarter, more than a percent below our forecast of 3.3%, and a whopping two percent lower than the RBNZ's forecast of 4.2%.

The details of the December quarter release show that the weakness was more broad-based than we expected, with declines in both the goods and services sectors. The biggest drag on activity was in manufacturing, down by 1.9%. Retail and accommodation, transport, and personal services – all areas that would have benefited from the rebound in tourism – were also down overall, highlighting the degree of softening in domestic demand.

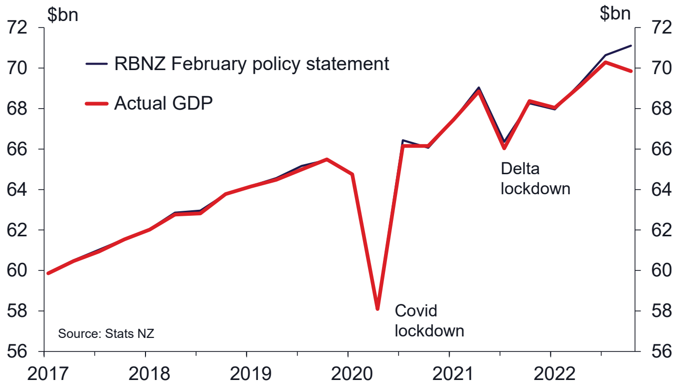
Government spending is now turning from a boost to a drag on GDP. This was even more apparent on the expenditure measure of GDP, with central government consumption spending down by 2.8% in the December quarter on top of a 1% fall in September. This most likely reflects the wind-down of the Covid response such as vaccinations and testing.

On the positive side, construction activity was a bit perkier than earlier indicators had suggested, rising by 1.6%. Professional services continued to record solid growth, although not as much as we expected.

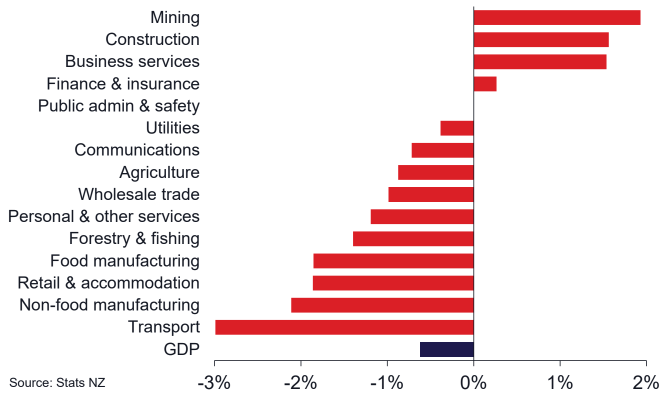
The New Zealand economy is widely expected to slip into recession this year as higher interest rates bite. However, today's result was not necessarily the start of that. Some of the higher-frequency data that showed some genuine softness at the end of last year – such as card spending and the PMI manufacturing survey – have actually picked up again in the first two months of this year. Plus, the clean-up from Cyclone Gabrielle will generate extra activity that will add to measured GDP in the coming months.

So we suspect that the December quarter was more of an air-pocket during our descent, rather than an earlier and harder landing than the RBNZ was aiming for. Even so, the RBNZ will need to adjust its flight path accordingly.

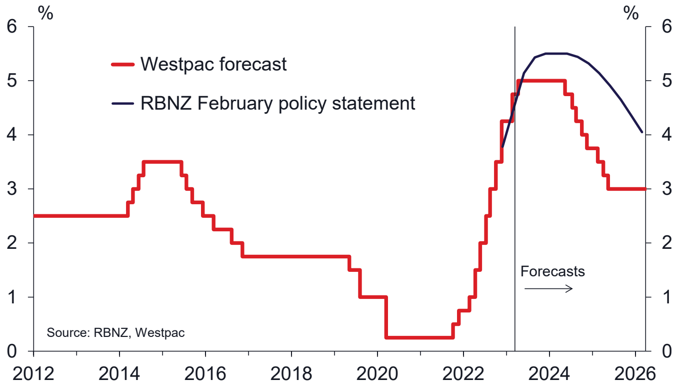
Level of quarterly GDP



Q4 GDP change by production



OCR forecasts



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