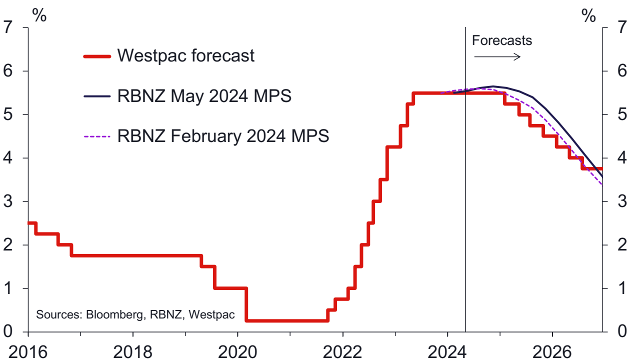
WEEKLY ECONOMIC COMMENTARY

27 May 2024 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz

This is what it sounds like when hawks fly

While delivering the expected on-hold decision at its May policy meeting, the Reserve Bank of New Zealand (RBNZ) hawked up its rhetoric and forward guidance. We continue to expect the first OCR easing in February next year, followed by gradual rate cuts thereafter. However, the tone of the May policy decision indicates the risk that easing comes later than we anticipate.

Official Cash Rate forecasts



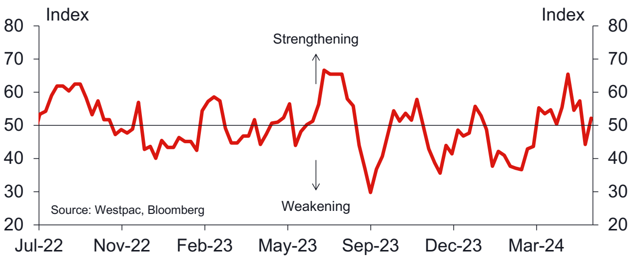
As expected, the RBNZ left the Official Cash Rate unchanged at 5.50% at its May policy meeting. However, in contrast to financial markets pricing for rate cuts by the end of this year, the RBNZ actually revised up its projection for the OCR and pushed out the likely timing of easings. The projected OCR path now peaks at 5.65% (vs. the peak of 5.60% assumed in the RBNZ's previous February forecast). In addition, the updated path is not consistent with a cut until late 2025 (compared to mid-2025 previously).

Underlying the RBNZ's more hawkish stance has been the lingering strength in inflation. The RBNZ now forecasts that inflation will end 2024 at a rate of 2.9%. That's in line with our own forecast, but is considerably higher than their previous forecast of 2.5% inflation. On top of that,

Key views

	Last 3 months	Next 3 months	Next year
Global economy	→	→	↗
NZ economy	→	→	↗
Inflation	↘	↘	↓
2 year swap	→	→	↘
10 year swap	→	→	→
NZD/USD	→	→	↗
NZD/AUD	↘	→	↘

Westpac New Zealand Data Pulse Index

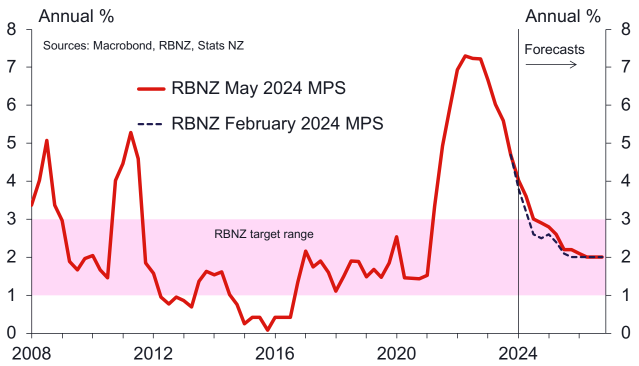


Key data and event outlook

Date	Event
30 May 24	Govt to release Budget 2024
5 Jun 24	Govt financial statements for 10 mths to April
12 Jun 24	FOMC Meeting (Announced 13 June NZT)
14 Jun 24	NZ Selected price indexes, May
18 Jun 24	RBA Monetary Policy Decision
20 Jun 24	NZ GDP, March quarter
2 Jul 24	NZIER QSBO server, June quarter
4 Jul 24	Govt financial statements for 11 mths to May
11 Jul 24	NZ Selected price indexes, June
17 Jul 24	NZ CPI, June quarter
31 Jul 24	FOMC Meeting (Announced 1 Aug NZT)
7 Aug 24	Labour market statistics, June quarter
8 Aug 24	RBNZ Survey of Expectations, June quarter

the RBNZ now expects that it will take even longer to get inflation back to the 2% target mid-point – the May MPS forecasts don't have inflation back at 2% until mid-2026 (compared to late 2025 in their previous forecasts). That's even with the upward revision to their OCR forecasts.

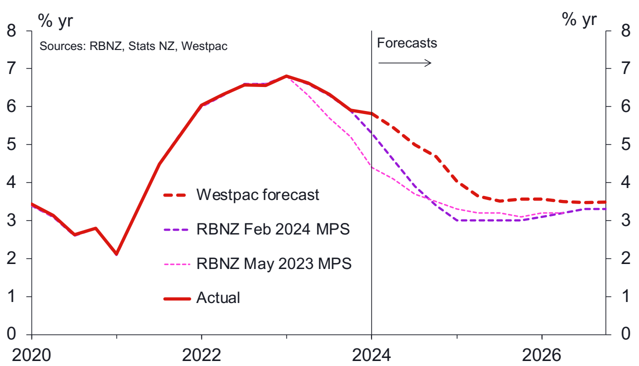
Consumer price inflation –longer to get back in the band, and longer to get back to 2%



That upwards revision to the RBNZ's inflation forecasts is mainly due to the strength of domestic inflation, which has clearly ruffled the feathers of the hawks at the RBNZ. Non-tradables inflation has surprised to the upside of the RBNZ's assumptions for a year now, including a large 0.5ppt surprise in the most recent quarter. The minutes accompanying the May policy decision noted that "persistence in non-tradable inflation remains a significant upside risk."

The RBNZ, like ourselves, expects that non-tradables inflation will drop back over the course of this year, but only gradually. While inflation in interest rate-sensitive areas of the economy (like the cost of property maintenance) is easing back, other prices like rents, insurance charges and local council rates have held at firm levels. Although these sorts of costs might be less responsive to changes in interest rates, those aren't pressures the RBNZ can look through, especially as they can affect inflation expectations and operating cost more generally.

Non-tradable inflation running much hotter than the RBNZ had expected



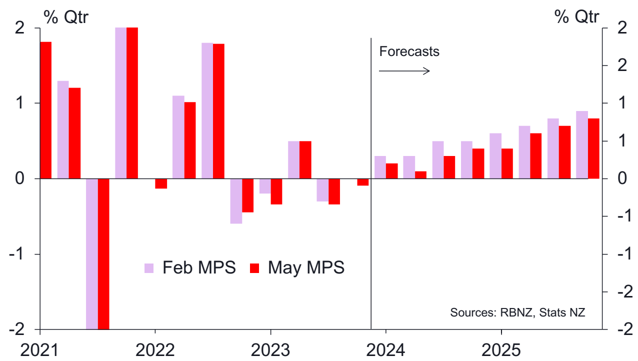
The RBNZ is now factoring in a more gradual easing in domestic prices. Even so, we still think the RBNZ could continue to be surprised to the upside on this front. That would be very important for the RBNZ's stance over the coming quarters.

Balanced against that risk of persistent domestic inflation, imported inflation has fallen well short of the RBNZ's forecasts. We expect that will continue to be the case over the coming year, and that will be important for helping to keep inflation expectations anchored in the face of lingering domestic pressures. Even so, it's now looking like a longer road back to 2%.

The RBNZ has also revised its thinking in a couple of other key areas. First, the RBNZ's growth forecasts have been revised down significantly, which helps them retain confidence that inflation will ultimately fall. However, that is balanced by a downgraded view of the economy's productive potential, meaning the deflationary impact of slower economic growth is likely to be less pronounced than previously assumed. That judgement reflects the ongoing firmness in inflation despite recent softness in GDP, pointing to lower than assumed productivity in the economy.

Second, the neutral OCR has been revised up 25bps to 2.75% - this is a driver of longer-term OCR projections.

RBNZ GDP forecasts revised down



Finally, while Budget 2024 is out later this week, the RBNZ's forecast for government expenditure is still based on the Treasury's Half Year Economic and Fiscal Update 2023. The RBNZ raised the possibility that the timing of signalled changes in government spending and tax cuts might pose an upside risk to its forecasts for aggregate demand. That is, the impact of reductions in government spending to date (albeit those mainly initiated by the previous government) may already be reflected in indicators of activity (which the RBNZ has taken onboard in downgrading its forecasts), whereas impending tax cuts may not yet be factored into spending decisions. We'll have more to say about our view regarding the impact of fiscal policy later this week in our coverage of Budget 2024 (**our preview is available here**).

Overall, recent developments have left the RBNZ with a more challenging inflation outlook –it wouldn't take much for inflation to remain above 3% this year, especially with the risk of large increases in local council rates and tax cuts in the second half of the year, along with ongoing pressure on rents and businesses' operating margins. Combined with the related risk for inflation expectations, there isn't scope for the RBNZ to take their foot off the brake just yet. Consistent with that, the minutes accompanying the May policy decision noted that the Monetary Policy Committee discussed the possibility of tightening, while RBNZ officials have noted that interest rate cuts are not part of the current policy discussion.

The RBNZ's updated thinking is very consistent with that in **our recently updated Economic Overview** – that is, there are still "hard yards" to be done to bring inflation down to the 2% target midpoint in a timely and sustainable manner. As a result, monetary policy will need to remain tight for some time yet. Our baseline view remains that the first 25bp policy easing won't occur until February next year, to be followed by a series of gradual (once a quarter) 25bp reductions that will eventually lower the OCR to around 3.75% in 2026. That's a later start to the easing cycle than implied by financial market's pricing, which is consistent with rate cuts from November.

We now find a large gap between our own OCR forecast of an easing in February 2025 and the RBNZ's August 2025 view, and there is some risk that our forecast proves to be too optimistic. With economic activity and the labour market cooling, another hike looks unlikely. However, should inflation pressures prove to be stronger than we or the RBNZ expects, the RBNZ may keep the OCR at its current level for even longer. We'll make an assessment after reviewing the Q2 CPI in July and the RBNZ's updated view in the August Statement.

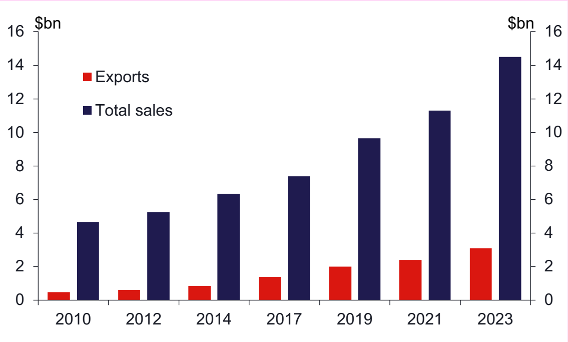
Satish Ranchhod, Senior Economist

Chart of the week.

New data released by Statistics NZ last week highlighted the growing contribution of the software and IT service sector to the New Zealand economy. Total sales of information and communication technology software and services increased to almost $14.5bn in the 2023 financial year – close to double the sales recorded six years earlier and more than triple the sales achieved in 2010. The latter represents an average annual growth rate of just over 9%, with growth of 28% achieved between 2021 and 2023 alone.

Of total sales in this sector, export sales amounted to just over $3.1bn in 2023. Since 2010, exports have grown at an average annual growth rate of over 15%. By contrast, total exports of goods and services have grown at an average rate of less than 4% per annum over this period. Given constraints in other sectors, such as agriculture, the software and IT service sector will likely be one the industries playing an important role if the Government is to meet its ambitious target of doubling export values over the next decade.

Software and IT services

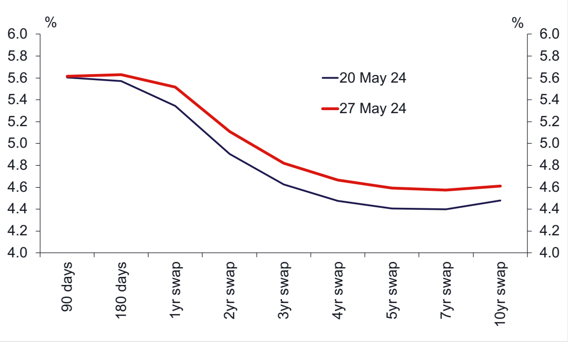


Fixed versus floating for mortgages.

The RBNZ left the OCR on hold in May and signalled that rate cuts are stills some way off. Westpac is not forecasting OCR reductions until early 2025.

For borrowers favouring certainty, at current fixed rates we see value in fixing for as long as two years.

NZ interest rates



Global wrap

North America.

Last week's Fed commentary continued to downplay the likelihood of near-term policy easing. Indeed, the minutes from the latest FOMC meeting noted that various participants mentioned a willingness to tighten policy further should upside risks to inflation materialise. On the data front, existing home sales edged lower in April. However, led by a sharp improvement in the services sector, the flash composite PMI rose to a 25-month high of 54.4 in May. Following today's Memorial Day holiday, most interest will be centred on the back end of the week, with Thursday bringing the second reading on Q1 GDP growth (likely to be revised down slightly) and Friday seeing the release of the core PCE deflator for April (core inflation seems likely to edge lower from the 2.8%y/y pace seen in March). With the market currently expecting a mid-year policy easing by the BoC, Canada's Q1 GDP report will also be of interest late in the week.

Europe.

Comments by ECB officials, noticeably President Lagarde, continue to point to the likelihood that the central bank will ease its policy rate next month. But the chance of a mid-year rate cut across the Channel were dented after UK CPI inflation printed higher than expected in April, with service sector inflation holding up at 5.9%y/y. The flash PMIs pointed to a further improvement in conditions in the euro area, with the composite index rising to a 12-month high of 52.3. The UK's composite PMI slipped 1.2pts to 52.8 but remained in expansionary territory for a seventh consecutive month. The coming week will bring more national business survey data in Europe, while Friday's flash euro area CPI data for May is expected to provide a green light for policy easing.

Asia-Pacific.

The minutes from this month's RBA Board meeting confirmed that policymakers considered a rate hike, but ultimately stood pat with inflation still forecast to return to target over a reasonable timeframe – albeit assuming a higher path for interest rates than was previously the case. In a quiet week for data, consumer confidence edged lower for a third consecutive month in May, likely reflecting expectations that interest rates will remain high for longer than previously foreseen. This week the focus will be on Tuesday's preliminary retail sales data for April and Wednesday's monthly CPI for April. Construction and capex reports will provide insight into Q1 GDP growth.

The focus in Japan this week will be on Friday's usual end-of-month dump of data, including news on IP, retail sales, the labour market and inflation. China will print its closely watched official PMI reports on Friday.

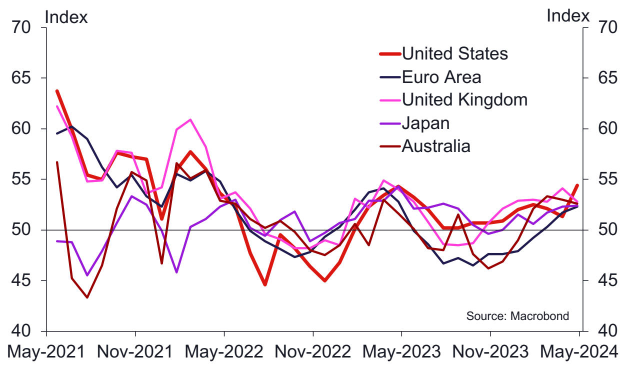
Trading partner real GDP (calendar years)

	Annual average % change			
	2022	2023	2024	2025
Australia	3.8	2.1	1.3	2.2
China	3.0	5.2	5.2	5.0
United States	2.1	2.5	2.5	1.5
Japan	1.0	2.0	0.7	1.0
East Asia ex China	4.5	3.4	4.1	4.2
India	7.2	7.7	6.5	6.7
Euro Zone	3.3	0.4	0.5	1.5
United Kingdom	4.1	0.4	0.5	1.3
NZ trading partners	3.3	3.4	3.4	3.4
World	3.5	3.3	3.3	3.1

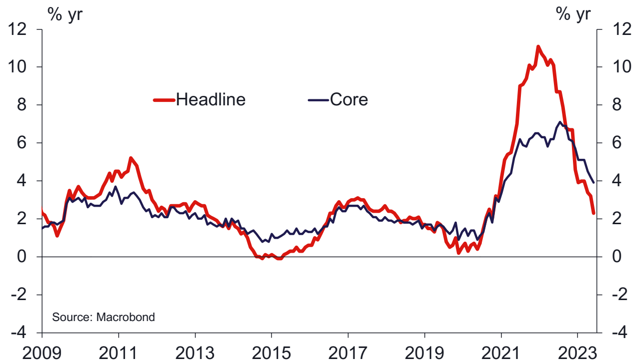
Australian & US interest rate outlook

	24 May	Jun-24	Dec-24	Dec-25
Australia				
Cash	4.35	4.35	4.10	3.10
90 Day BBSW	4.34	4.37	4.17	3.30
3 Year Swap	4.14	4.10	3.90	3.50
3 Year Bond	4.00	3.90	3.70	3.30
10 Year Bond	4.32	4.35	4.25	4.00
10 Year Spread to US (bps)	-15	-15	-5	0
US				
Fed Funds	5.375	5.375	4.875	3.875
US 10 Year Bond	4.47	4.50	4.30	4.00

S&P Global composite PMI readings



UK CPI inflation



Financial markets wrap

Interest rates.

NZ swap rates rebounded sharply last week and are back to levels that prevailed at the beginning of May. The main catalyst was the RBNZ's MPS which delivered a hawkish surprise to markets, with the RBNZ raising its OCR forecast and saying it did consider hiking. The RBNZ is clearly concerned about domestic inflation, which has been higher than forecast.

The 2yr swap rose from 4.89% to 5.12%, and it could reach 5.20% during the week ahead as markets take heed of the RBNZ's more hawkish stance.

There's not much in the NZ data calendar to ruffle swap rates this week (though the Budget on Thursday could move NZGB yields), but US PCE inflation on Friday will be watched closely.

Market pricing for the first OCR cut has been pushed out to a 70% chance in November (from October) in the wake of last week's RBNZ MPS. We continue to forecast no cut until February 2025.

Foreign exchange.

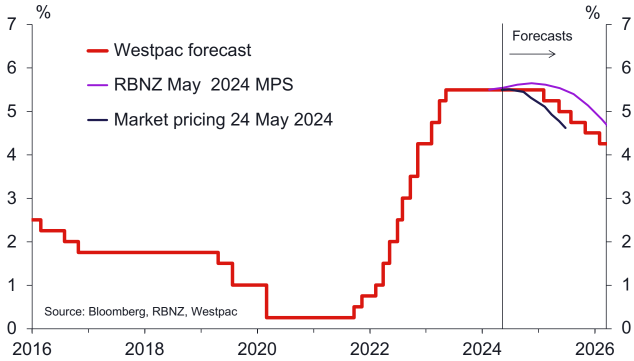
Following a 3c rally over the past month, NZD/USD took a breather last week, consolidating in the low 0.61s. There remains potential for another leg higher to 0.6200.

The RBNZ's hawkish shift last week is supportive (via NZ-US yield spreads), while US data this week will be important. In particular, PCE inflation is expected to soften slightly.

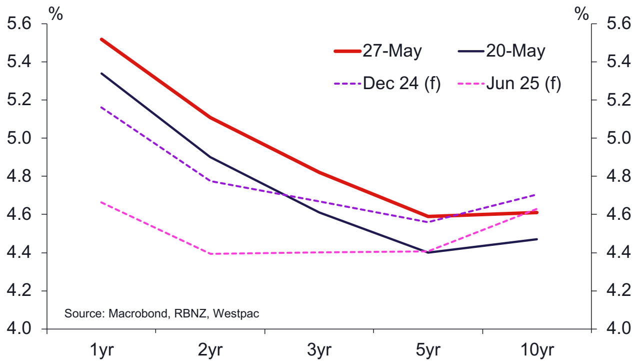
Looking further ahead to the September quarter, if our economists' forecasts for the Fed and RBNZ (easing to start in September 2024 and February 2025, respectively) are eventually priced by markets, NZD/USD could exceed 0.6200. A major risk to this outlook is the Fed delaying its easing cycle because inflation remains too high.

NZD/AUD's rebound accelerated last week following the RBNZ's hawkish surprise, rising to a two-month high of 0.9244 (compared to 0.9067 in early May). We see potential for further gains to 0.9265 this week if NZ-AU yield spreads move towards Westpac's forecasts for the RBA and RBNZ.

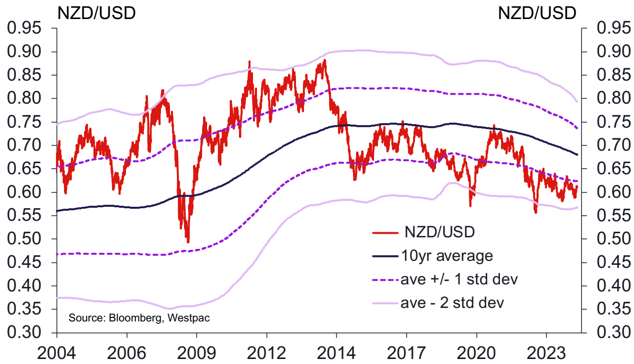
Official Cash Rate forecasts



Swap rates



NZD/USD vs rolling 10yr average



FX recent developments

	Historical data				F'cast
	Spot	3mth range	5yr range	5yr avg	Dec-24
USD	0.612	0.586-0.619	0.555-0.743	0.648	0.61
AUD	0.923	0.907-0.944	0.873-0.992	0.932	0.91
EUR	0.564	0.552-0.572	0.517-0.637	0.583	0.55
GBP	0.480	0.471-0.490	0.464-0.544	0.506	0.48
JPY	96.1	90.2-95.8	61.3-95.8	79.0	93.9

The week ahead

NZ Apr monthly employment indicator

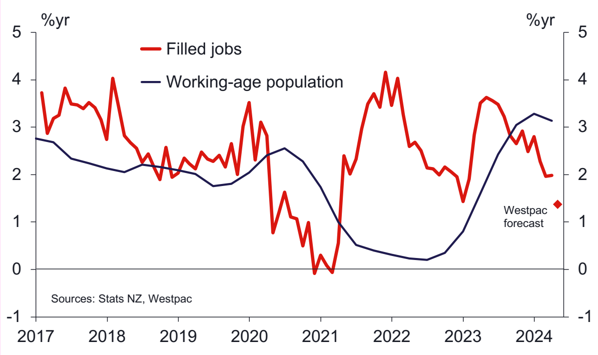
May 28, Last: +0.4%, Westpac f/c: -0.2%

The monthly employment indicator is drawn from income tax data, making it a comprehensive record of the number of people in work. While there are conceptual differences, it generally does a good job of predicting the more widely followed quarterly household survey measure of employment.

Job growth has been slowing since mid-2023, and has now fallen behind the pace of population growth, which continues to be boosted by record net inward migration. Surveys suggest that businesses are no longer struggling to find more workers, and job advertisements have fallen substantially below pre-Covid levels.

The weekly snapshots provided by Stats NZ are incomplete for April, but they have been losing momentum in recent weeks. We expect to see a modest 0.2% decline in jobs for the month, along with a likely downward revision to the initially reported 0.4% rise in March.

Monthly filled jobs growth



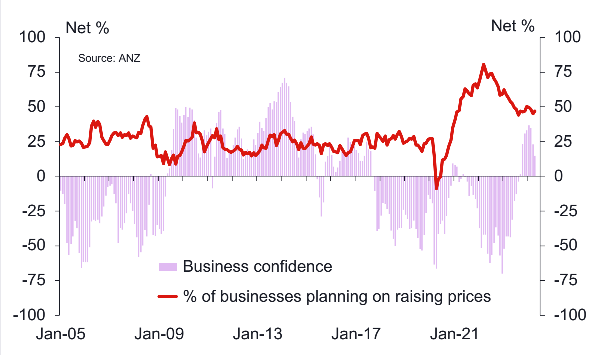
NZ May ANZ business confidence

May 29, Last: 14.9

The April business outlook survey was effectively the worst of both worlds. Business confidence fell further, effectively giving back all of the initial post-election bounce as the reality of a slowing economy set in again. At the same time, more firms reported a rise in their operating costs, and pricing intentions remained at a relatively high level.

There has been little in the last month that is likely to have changed the mood. The survey's price and inflation gauges will remain a key focus – note that the May survey follows the March quarter CPI release, where headline inflation slowed from 4.7% to 4.0% but the domestically-driven components remained uncomfortably high.

Business confidence and pricing intentions



NZ Apr building consents

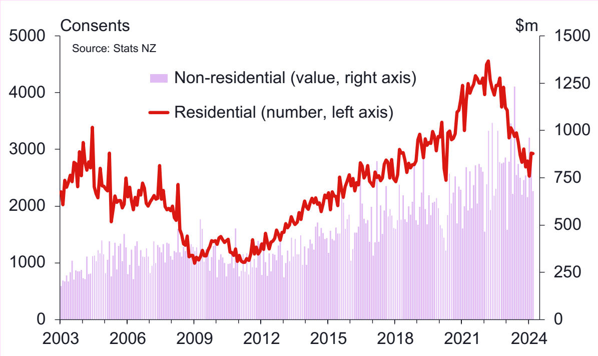
30 May, Last: -0.2%. Westpac f/c: -5%

Consent issuance is down 25% over the past year. However, it looks like issuance is finding a floor. Consents for standalone houses (around 40% of the total) have held around current levels for more than six months now. The more volatile multi-unit category has been dropping back over the past year, however that downtrend is showing signs of flattening off.

We're forecasting a further 5% fall in April. That's mainly due to falls in the lumpy apartment and retirement village categories. In contrast, issuance in other categories is expected to track around recent levels.

Even with signs that consents are stabilising, residential construction is set to trend down this year.

Building consents



The week ahead

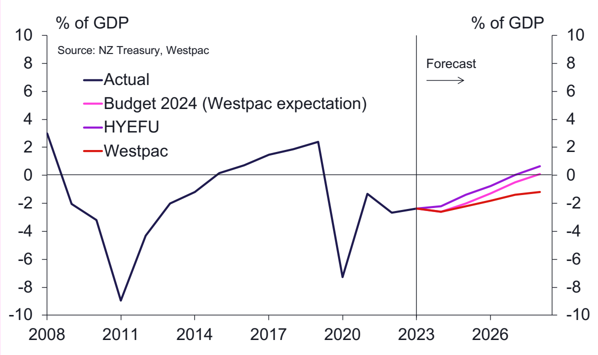
NZ Government Budget 2024

May 30, released at NZ 2:00pm

The first Budget of the new Government will provide the first official costings of the spending and taxation policies set out in the coalition agreements. However, while the size of tax cuts will be of key interest to the public, the dominant driver of revisions to the fiscal outlook will be the deterioration in the economy since the last forecasts were made in December.

We expect that the Treasury will forecast a cumulative $NZ11bn deterioration in the operating surplus across the forecast period. So with capital spending needs also to be funded, we expect the NZGB borrowing programme to be raised by around $NZ15bn. The Treasury may be able to forecast a small surplus in '27/28 – one year later than previous – but we have doubts that this will be delivered given ongoing spending pressures.

Operating Balance (OBEGAL)

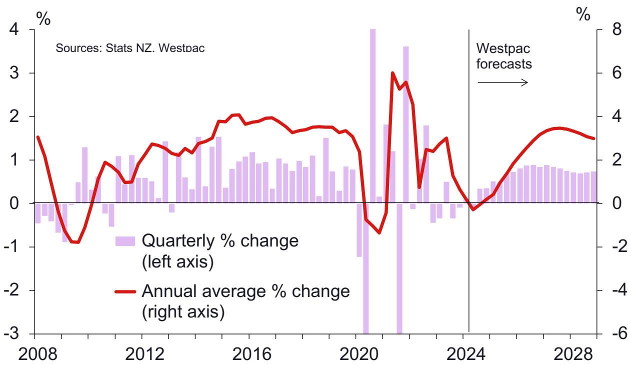


Economic and financial forecasts

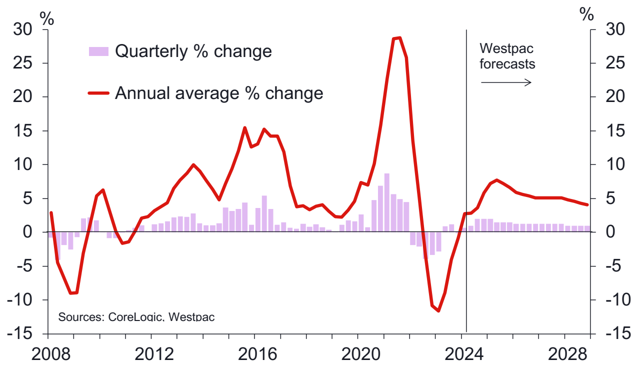
Economic indicators	Quarterly % change				Annual % change			
	Dec-23	Mar-24	Jun-24	Sep-24	2022	2023	2024	2025
GDP (production)	-0.1	0.1	-0.1	0.3	2.4	0.6	0.2	1.8
Consumer price index	0.5	0.6	0.8	1.1	7.2	4.7	2.9	2.2
Employment change	0.4	-0.2	0.2	0.1	1.7	2.7	0.1	0.9
Unemployment rate	4.0	4.3	4.6	4.9	3.4	4.0	5.2	5.4
Labour cost index (all sectors)	1.0	0.9	0.9	0.8	4.1	4.3	3.4	2.5
Current account balance (% of GDP)	-6.9	-6.2	-5.7	-5.1	-8.8	-6.9	-4.4	-4.1
Terms of trade	-7.8	4.6	1.9	1.3	-4.2	-10.6	8.1	0.8
House price index	-0.1	0.7	1.0	2.0	-10.8	-0.9	5.8	6.7

Financial forecasts	End of quarter				End of year			
	Dec-23	Mar-24	Jun-24	Sep-24	2022	2023	2024	2025
OCR	5.50	5.50	5.50	5.50	4.25	5.50	5.50	4.50
90 day bank bill	5.65	5.67	5.60	5.60	4.26	5.65	5.50	4.50
2 year swap	5.28	4.92	5.10	5.00	5.10	5.28	4.80	4.15
5 year swap	4.84	4.40	4.75	4.65	4.67	4.84	4.55	4.30
10 year bond	5.09	4.69	5.00	4.90	4.31	5.09	4.80	4.50
TWI	70.8	71.6	70.3	70.4	70.8	70.8	70.8	72.0
NZD/USD	0.60	0.61	0.60	0.60	0.60	0.60	0.61	0.65
NZD/AUD	0.93	0.93	0.91	0.91	0.92	0.93	0.91	0.91
NZD/EUR	0.56	0.56	0.55	0.55	0.59	0.56	0.55	0.57
NZD/GBP	0.49	0.48	0.47	0.47	0.51	0.49	0.48	0.49

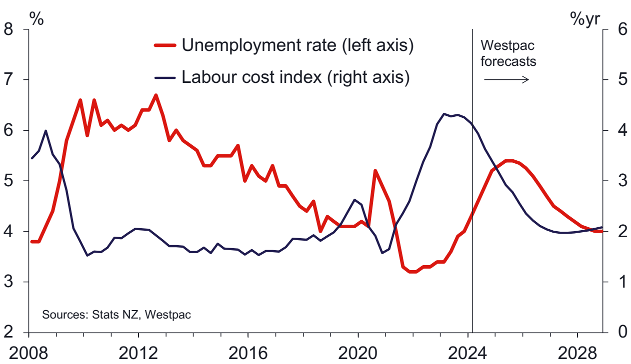
GDP growth



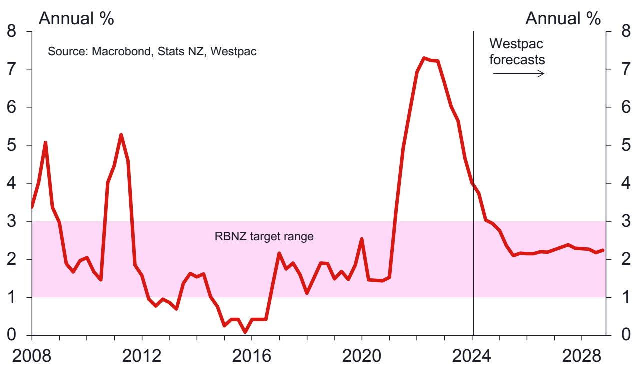
House prices



Unemployment and wage growth



Consumer price inflation



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Chn	Apr Industrial Profits %yr	–3.5%	–	–	Falling producer-gate prices a key drag on profitability.
Tue 28					
NZ	Apr Employment Indicator %mth	0.4%	–	–0.2%	Signs that hiring has lost momentum.
Aus	Apr Retail Sales %mth	–0.4%	0.2%	0.6%	April looks a slightly better month but trends still very weak.
US	Mar S&P/CS Home Price Index %mth	0.61%	0.30%	–	Near-term momentum depends critically on turnover.
	May Consumer Confidence Index	97.0	96.0	–	Highly sensitive to developments in employment outlook.
	May Dallas Fed Index	–14.5	–	–	Conditions soft across the regions.
	Fedspeak	–	–	–	Mester at BoJ event. Kashkari too.
Wed 29					
NZ	May ANZ Business Confidence	14.9	–	–	Businesses pressured by both soft demand and rising costs.
Aus	Apr Westpac–MI Leading Index	–0.23%	–	–	Below-trend growth run set to continue throughout 2024.
	Apr Monthly CPI Indicator %yr	3.5%	3.4%	3.5%	The end of energy rebates increases monthly uncertainty.
	Q1 Construction Work Done %qtr	0.7%	0.5%	0.0%	Easing that emerged over H2 2023 to persist into 2024.
US	May Richmond Fed Index	–7	–	–	Conditions soft across the regions.
	Federal Reserve's Beige Book	–	–	–	An update on economic conditions across the regions.
	Fedspeak	–	–	–	Williams.
Thu 30					
NZ	Apr Building Consents %mth	–0.2%	–	–5.0%	The decline in issuance is starting to slow.
	Budget 2024	–	–	–	NZGB borrowing programme to rise by around $NZ15bn.
Aus	RBA Assistant Governor (Economic)	–	–	–	Hunter, fireside chat at AIRA Conference.
	Q1 Private Capital Expenditure %qtr	0.8%	0.7%	1.6%	Capex spending level remains elevated.
	2024/25 Capex Plans, Est 2 $bn	145.6	–	–	Plans point to a slowing in CAPEX into 2024/25.
	Apr Dwelling Approvals %mth	1.9%	1.5%	4.0%	HIA new home sales point to gains over the coming months.
Eur	May Economic Confidence	95.6	–	–	Optimism gradually returning in anticipation of rate cuts.
	Apr Unemployment Rate %	6.5%	–	–	Holding steady at a historic low.
US	Q1 GDP (Annualised)	1.6%	1.2%	–	Small revision anticipated in the second estimate.
	Apr Wholesale Inventories %mth	–0.4%	–	–	Inventory management remains a key challenge.
	Apr Pending Home Sales %mth	3.4%	0.3%	–	Sales volumes bouncing around at very weak levels.
	Initial Jobless Claims	215k	–	–	Very low and likely to remain so.
	Fedspeak	–	–	–	Bostic, Williams, Logan.
Fri 31					
Aus	Apr Private Sector Credit %mth	0.3%	0.4%	0.4%	Growth stuck around 5% annual pace.
Jpn	Apr Jobless Rate %	2.6%	2.6%	–	Labour market tight, supportive of wage gains.
	May Tokyo CPI %yr	1.8%	2.2%	–	Sustaining services inflation critical to achieving target.
	Apr Industrial Production %mth	4.4%	1.5%	–	Factory output growth struggling to remain afloat.
Chn	May NBS Manufacturing PMI	50.4	50.4	–	Broadly consistent with long-run average levels for industry.
	May NBS Non–Manufacturing PMI	51.2	51.5	–	Signs of optimism returning to a challenged services sector.
Eur	May CPI %yr	2.4%	2.6%	–	Last inflation read prior to a likely June ECB rate cut.
US	Apr Personal Income %mth	0.5%	0.3%	0.4%	Wages growth is moderating...
	Apr Personal Spending %mth	0.8%	0.3%	0.4%	... services demand is holding up spending.
	Apr PCE Deflator %mth	0.3%	0.3%	0.3%	Any deviation from consensus will be closely scrutinised.
	May Chicago PMI	37.9	40.8	–	Pointing to downside risk for manufacturers.
	Fedspeak	–	–	–	Bostic.

CONTACT

Westpac Economics Team | **westpac.co.nz/economics** | economics@westpac.co.nz

Kelly Eckhold, Chief Economist | +64 9 348 9382 | +64 21 786 758 | kelly.eckhold@westpac.co.nz

Satish Ranchhod, Senior Economist | +64 9 336 5668 | +64 21 710 852 | satish.ranchhod@westpac.co.nz

Darren Gibbs, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Michael Gordon, Senior Economist | +64 9 336 5670 | +64 21 749 506 | michael.gordon@westpac.co.nz

Paul Clark, Industry Economist | +64 9 336 5656 | +64 21 713 704 | paul.clark@westpac.co.nz

Imre Speizer, Market Strategist | +64 9 336 9929 | +64 21 769 968 | imre.speizer@westpac.co.nz

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