WEEKLY ECONOMIC COMMENTARY

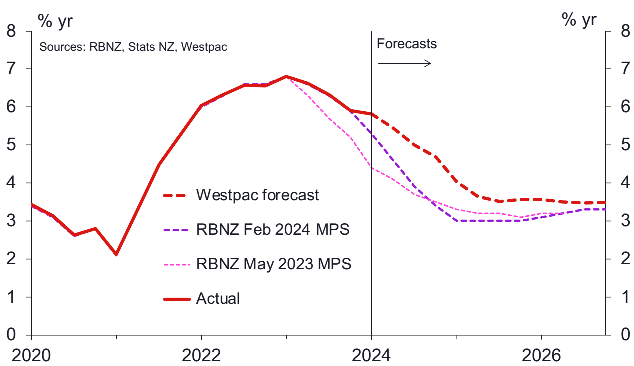
20 May 2024 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz

Persistent inflation to keep the champagne stoppered

New Zealand is now doing the hard yards that are needed to bring the economy back into balance. That follows the rapid growth and related red-hot inflation that we saw over the past few years in the wake of the pandemic. However, as we discuss in **our latest Economic Overview**, that rebalancing means that growth is set to remain subdued this year, unemployment is set to push higher, and interest rate reductions are still some way off.

Higher interest rates are already weighing on activity, and the economy is moving back into a position of better balance, with capacity pressures easing as demand has cooled. Over time that will push inflation back down. However, with lingering strength in domestic inflation, OCR reductions are still not expected until early 2025. Consistent with that, we don't expect any significant change to the RBNZ's "Watch, Worry and Wait" strategy in this week's May *Monetary Policy Statement*, although markets remain primed for an eventual dovish tilt.

RBNZ and Westpac non-tradable inflation forecasts

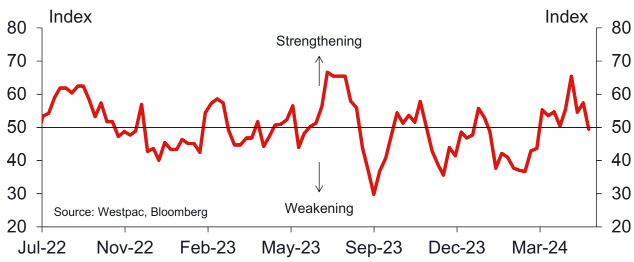


As we **noted in our preview**, we expect the RBNZ to keep the OCR at 5.5% and reiterate its view that the OCR will need to remain at 5.5% for "a sustained period" to bring inflation back within the 1-3% target range. The

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
22 May 24	RBNZ Monetary Policy Statement and OCR
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 surver, 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

RBNZ will likely note that while economic growth remains weak, inflation pressures remain elevated. Inflation will be forecast to return close to 2% by the end of 2025 contingent on a forward OCR profile close to that shown in the February *Statement* (which implied around a 40% chance of a further OCR increase in 2024 but an initial cut to the OCR to 5.25% by mid-2025).

We noted at the time of the April *Monetary Policy Review* that relatively little data has come to light since the February *Statement* to disturb the RBNZ's view on the inflation outlook. We think that the general tone of activity and sentiment data since the February meeting will have helped balance the very strong inflation data which indicated unexpectedly persistent domestic inflation pressures. It's likely still the case that there is little to support the idea that interest rates can be cut earlier than the RBNZ previously assumed. We think the RBNZ will be reluctant to reduce the pressure on the economy to adjust while inflation remains elevated.

To summarise, the key developments since the February *Statement* have been: slightly weaker Q4 2023 GDP and associated revisions; weak forward indicators for GDP growth in H1 2024; lower business inflation expectations but still elevated household inflation expectations and sticky price intentions indicators; a slightly weaker labour market in Q1; a stronger than expected Q1 CPI inflation outcome, driven by sharply higher non-tradable inflation; higher oil prices; and a weaker terms of trade in Q4 2023. The new forecasts will likely also assume a slightly lower NZD TWI, although in recent days the TWI has moved back into line with the RBNZ's February forecast.

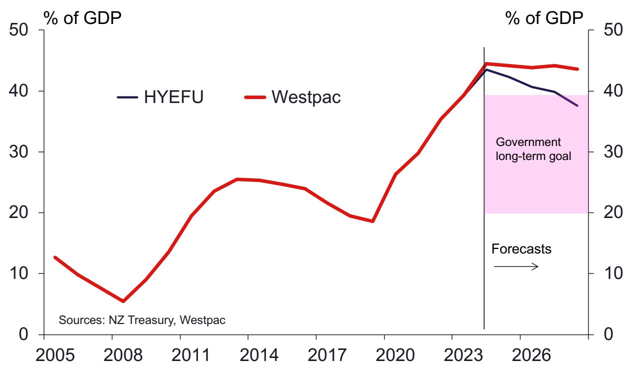
The RBNZ's formal projections won't be based on Budget 2024 as this isn't released until 30 May. But the Treasury will have briefed the RBNZ on the key macro features of Budget 2024, so any deviations from expectations will feed into the rhetoric the RBNZ chooses to describe the policy outlook. The RBNZ noted in the February *Statement* that preliminary analysis concluded it was unclear whether the net effect of the new Government's policies would be inflationary or deflationary. As we don't expect any big surprises in Budget 2024, the RBNZ should continue with this line in the May *Statement*. A more definitive quantitative assessment of the impact of Budget 2024 on the RBNZ's projections will occur in the August *Statement*. By that time, the details of policy changes – such as income tax cuts and investor housing policy – and the reaction of the economy will begin to become clearer.

We think the RBNZ will be happy with the current level of financial conditions. Markets have backed off the near-term easing expectations they held early in 2024, but similarly are not pricing in OCR increases either. They will want the market to respond to the data – especially the inflation data – that emerges over the next 6 months. We don't think they will want to give the market a sense that their strategy has changed from that of holding the OCR at current levels for the foreseeable future.

We also don't think the RBNZ will want to fan expectations of near-term policy easing – we think they will want to see a couple of quarters of well-behaved inflation data, at the very least, before considering moving to a less restrictive stance. In the April *Review* the RBNZ signalled that their views hadn't changed much by issuing a very short press release. We see similar potential this time around.

We see three main scenarios. Our baseline case (70% probability) is that the RBNZ retains a similar OCR track as in the February *Statement*. A hawkish scenario (20% probability) would see the RBNZ revise up its OCR profile to recapture the 75% chance of a rate hike that they included in the November 2023 *Statement*. This would occur if the RBNZ concludes that domestic inflation is sufficiently sticky such that a return of inflation close to 2% in 2025 now looks remote. A dovish case (10% probability) could be the RBNZ downgrading its outlook for growth and bringing forward forecast OCR cuts to Q1 2025. The earlier start to easing could imply an OCR at 4.5% by year end 2025. This would occur if the RBNZ is confident that weak growth momentum and a widening output gap will generate lower non-tradable inflation outcomes as the year progresses. The RBNZ would implicitly leave open the possibility of a November easing should their forecast of low non-tradable CPI outcomes eventuate in Q2 (data released July) and Q3 (data released October) and if further downside risks to growth were to emerge.

Net core Crown debt



Looking further ahead, the Government is also set to begin fiscal consolidation which will aid the rebalancing of the economy. However, it's going to be a long grind back to fiscal balance. Budget 2024 will be tabled by the Minister of Finance on 30 May and will provide the first complete official costings of the new Government's spending and revenue initiatives. As we **discussed in our preview**, a weaker outlook for nominal GDP and thus a smaller tax take will be the key driver of revisions to the OBEGAL balance and the government borrowing programme. Starting from a worse position in the current year, we expect the Treasury to forecast a gradual decline in the deficit, perhaps sufficient to generate a tiny OBEGAL surplus in 2027/28. Even so, net core Crown debt will likely remain above the Government's long-term goal of 20-40% of GDP.

A weaker track for the operating balance and a topped-up capital allowance will likely increase the government's borrowing requirement by about $15bn over the four-year forecast period. The increase in the borrowing requirement could be smaller if tax cuts have been scaled back or spending control is assumed to be tighter than we have assumed. But it could also be larger if the Treasury's growth forecasts are revised down more than we have assumed.

Beyond the worse starting point associated with a weaker than expected economy, we think that forecast rate of fiscal consolidation will be similar to that depicted in the HYEFU. Importantly, we think that sustained spending restraint may well prove more difficult than is likely to be depicted in Budget 2024. As a result, the path to surplus may be longer and more uncertain.

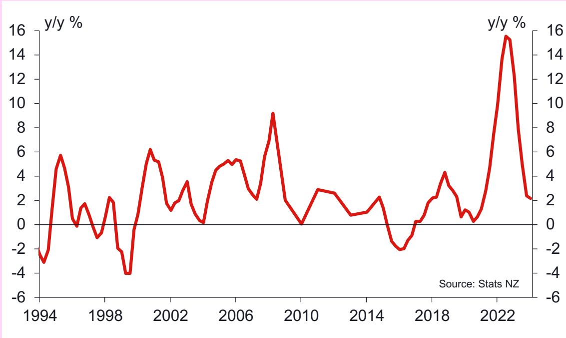
Kelly Eckhold, Chief Economist

Chart of the week.

In common with other businesses, farmers have been battling significant cost inflation in the wake of the pandemic. But data released last week indicates that average on-farm cost inflation (excluding livestock) declined to 2.2%y/y in the March quarter – a far cry from the 12% inflation experienced a year earlier and a peak of mor than 15% in 2022.

But conditions remain tough on the farm. While costs are no longer growing rapidly, they remain 28% higher than prior to the pandemic. This is keeping pressure on profitability at a time when average prices for many of our key export commodities – especially sheep meat – remain low. So farmers will be hoping that inflation trends ease across the broader economy, permitting the interest rate easing that would help lower costs and restore margins.

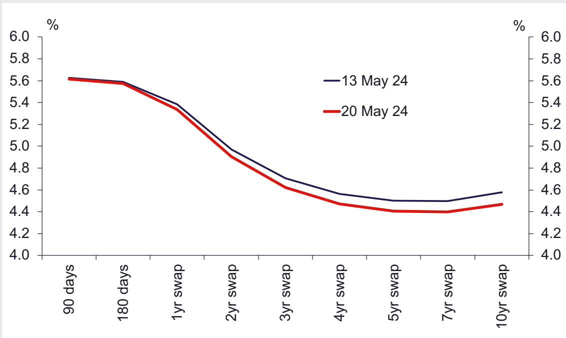
Inflation pressures easing on the farm



Fixed versus floating for mortgages.

The RBNZ left the OCR on hold in April. While further OCR hikes don't look likely in the current cycle, easings are still some way off. For borrowers favouring certainty, at current fixed rates we see value in fixing for as long as two years.

NZ interest rates



Global wrap

US.

Softness in key data releases over the past week added to market expectations for earlier rate cuts from the Fed. US consumer prices rose 0.3% in April (below expectations for a 0.4% rise). That saw the annual inflation rate slip to 3.4% from 3.5% previously. Similarly, annual core inflation fell to 3.6% from 3.8% – the lowest it's been in three years. Softness was also evident in April retail spending figures, with total spending flat over the month and spending excluding fuel and motor vehicles down 0.1%. However, Fed Chair Powell downplayed the likelihood of imminent rate cuts, highlighting the slower progress on inflation in the early part of the year and noting "we'll need to be patient and let restrictive policy do its work." That sentiment was echoed by other Fed speakers including Williams, Mester and Barkin.

Australia.

The latest Federal Budget revealed an improved near-term fiscal outlook, along with sizeable increases in planned government spending over the coming years. Budget 2024 showed that a second consecutive surplus is now projected for the 2023/24 fiscal year, though the government's books are expected to slip back into deficit further ahead. Around AU$24.4b of additional stimulus was announced, including spending in areas like housing, infrastructure and the care sector, with much of that spending front loaded. While some of that stimulus aims to limit cost of living pressures (such as expanded rent and energy bill relief), the increases in spending may add to longer term demand and inflation pressures. The latest labour market report revealed a stronger than expected 0.3% lift in employment in April. However, with the participation rate also pushing higher, unemployment rose to 4.1% (up from 3.9%). Wage growth has also softened slightly. Overall, labour market conditions remain healthy, with signs of slack emerging only gradually.

Asia.

Japan's GDP contracted 0.5% in the March quarter, its second decline in three quarters. While some of that softness was due to temporary disruptions, it has raised questions about the pace of tightening from the BOJ, especially given the signs of softness in the household sector. In China, conditions remain uneven across the economy. Industrial production growth accelerated to 6.7% over the past year. However, domestic demand has remained soft. Retail spending growth slowed more than expected, falling to 2.3%. Similarly, fixed asset and real estate investment were also softer than anticipated. With softness in domestic demand, the government has indicated additional support is coming.

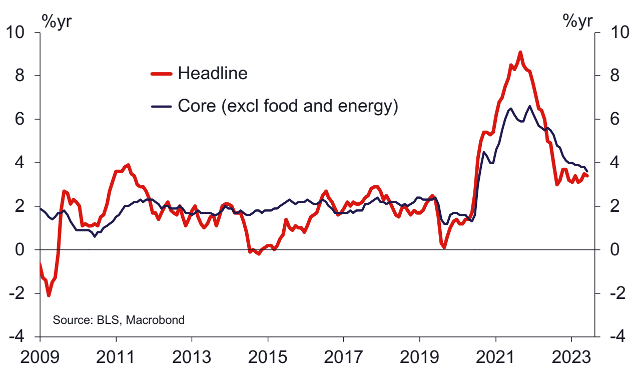
Trading partner real GDP (calendar years)

	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

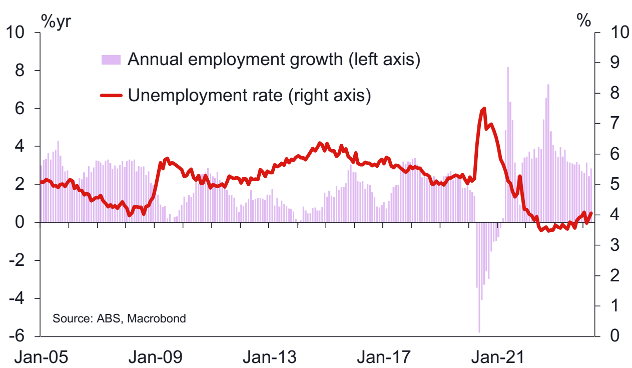
Australian & US interest rate outlook

	17-May	**Jun-24**	**Dec-24**	**Dec-25**
Australia				
Cash	4.35	4.35	4.10	3.10
90 Day BBSW	4.35	4.37	4.17	3.30
3 Year Swap	4.40	4.10	3.90	3.50
3 Year Bond	3.85	3.90	3.70	3.30
10 Year Bond	4.21	4.35	4.25	4.00
10 Year Spread to US (bps)	-16	-15	-5	0
US				
Fed Funds	5.375	5.375	4.875	3.875
US 10 Year Bond	4.37	4.50	4.30	4.00

US CPI inflation



Australian labour market



Financial markets wrap

Interest rates.

NZ swap rates fell last week, following US and Australian markets which had reacted to some negative data surprises (US CPI, AU labour data). The 2yr fell from 5.03% to 4.87% - the lowest level reached over the past month.

The highlight for the NZ interest rate markets this week will be the RBNZ MPS on Wednesday. The OCR is widely expected to remain on hold, and we don't expect a major shift in stance (as expressed in the statement's guidance paragraphs as well as the OCR forecast). Relative to the RBNZ's February MPS forecasts, developments have been mixed and roughly net neutral, the main ones being higher non-tradables inflation but lower economic growth and a renewed decline in sentiment indicators.

Market pricing for the first OCR cut remains settled on October. We continue to forecast no cut until February 2025, noting core inflation remains sticky. Our expected range for the 2yr swap for the week ahead is 4.80%-5.05%, with the RBNZ MPS posing risks in both directions.

Foreign exchange.

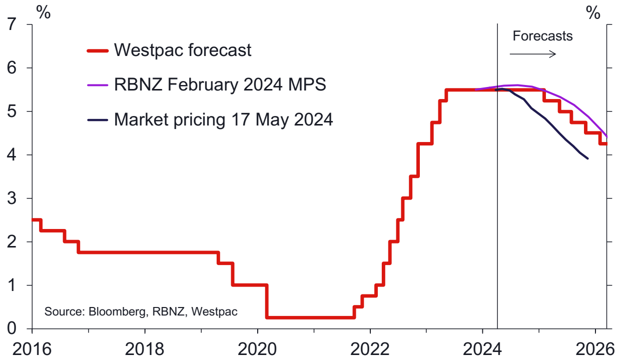
NZD/USD rose further last week, extending a rally which started in April at 0.5852 to a two-month high of 0.6141. We see potential for it to reach 0.6200 during the week ahead.

The main driver has been the US dollar which has weakened due to some negative data surprises, as well as upbeat risk sentiment. Momentum in these should spill over to this week, assuming no surprises from the RBNZ MPS, given the US data calendar is mostly second tier.

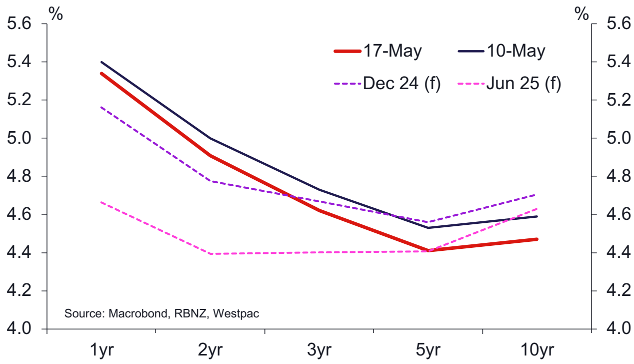
Looking ahead to Q3, if our forecasts for the Fed and RBNZ (easing to start in Sep 2024 and Feb 2025, respectively) are eventually priced by markets, NZD/USD could exceed 0.6200. A major risk to this outlook is markets shifting expectations and expecting the Fed to delay its easing cycle.

NZD/AUD's rebound gathered pace last week, rising to a one-month high of 0.9182 (it was 0.9067 in early May). We see potential for further gains to 0.9200 this week. Apart from the RBNZ MPS, markets could react to the minutes of the RBA's recent meeting on Tuesday.

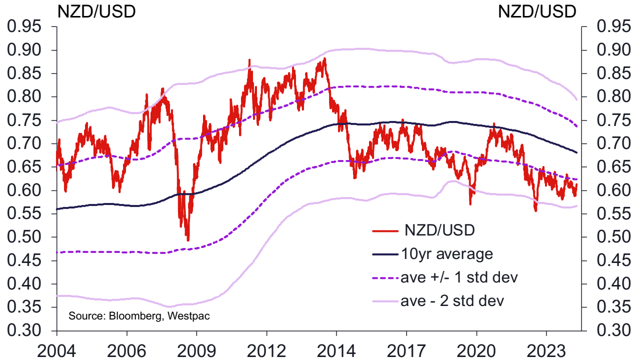
Official Cash Rate forecasts



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	0.613	0.586-0.619	0.555-0.743	0.648	0.61
AUD	0.916	0.907-0.944	0.873-0.992	0.932	0.91
EUR	0.565	0.552-0.572	0.517-0.637	0.583	0.55
GBP	0.483	0.471-0.490	0.464-0.544	0.506	0.48
JPY	95.5	90.2-95.2	61.3-95.2	78.9	93.9

The week ahead

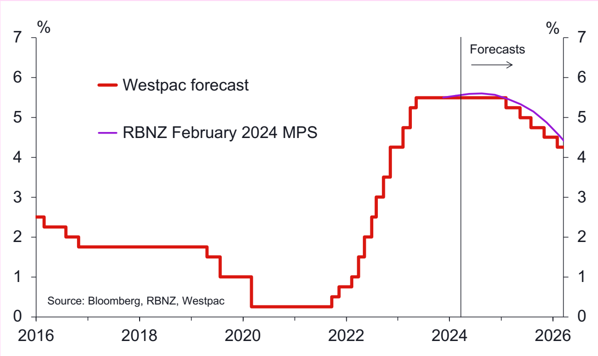
RBNZ May Monetary Policy Statement

May 22, Official Cash Rate – Last: 5.50%, Westpac forecast: 5.50%, Market: 5.50%

We expect the RBNZ will leave the OCR at 5.5% at its May Monetary Policy Statement, and we don't expect significant changes in the RBNZ's projections for the OCR. The RBNZ is likely to reiterate its view that the OCR will need to remain at 5.5% for "a sustained period" to bring inflation back within the 1-3% target range.

On balance, the flow of data in recent weeks will likely have left the RBNZ comfortable with the forward outlook communicated in their February Monetary Policy Statement. Weaker than expected GDP growth and numerous indications of a flat economy should trigger a downward adjustment in the 2024 growth profile. But the inflation outlook remains challenging as a non-tradables driven upward inflation surprise in Q1 2024 likely implies a still elevated near-term inflation outlook, as well as the need for ongoing policy restraint.

Official Cash Rate forecasts



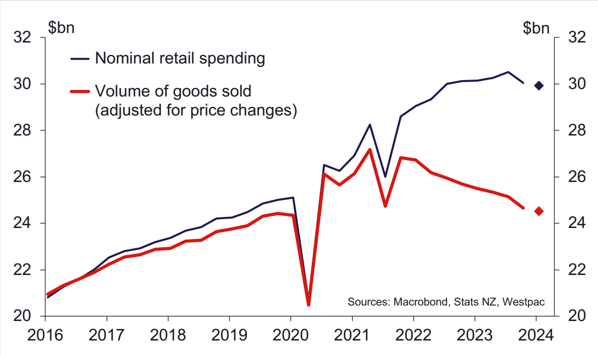
NZ Q1 retail spending

May 23, Volumes – Last: -1.9%, Westpac forecast: -0.5%

Nominal retail spending levels have flattened off over the past year, while the amount of goods that households have actually been taking home has been trending down for two years now. That softness reflects the ongoing pressure on households' finances as a result of large increases in consumer prices and the related rise in borrowing costs.

That weakness in spending has continued in the early part of 2024, with monthly retail spending trending down in recent months. We're forecasting a 0.4% fall in nominal spending over the March quarter, with the volume of goods sold down 0.5%. That's largely related to falls in discretionary areas like household durables and motor vehicles.

Retail spending (including Westpac forecasts)

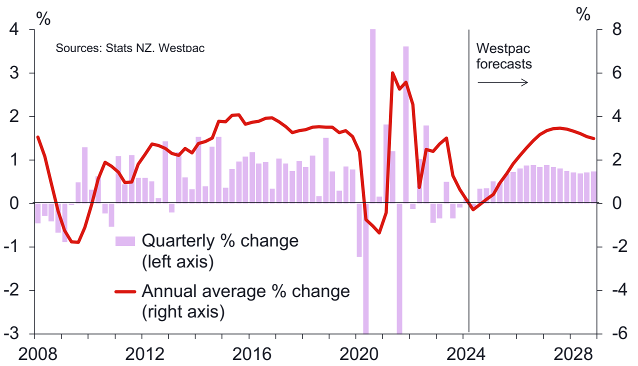


Economic and financial forecasts

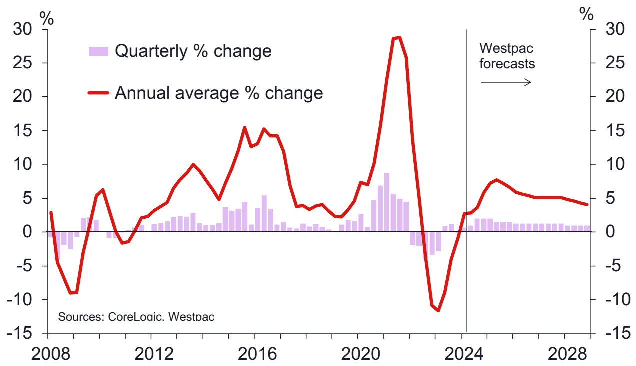
Economic indicators	Quarterly % change				Annual % change			
	Dec-23	Mar-24	Jun-24	Sep-24	2022	2023	2024	2025
GDP (production)	-0.1	0.1	-0.1	0.3	2.4	0.6	0.2	1.8
Consumer price index	0.5	0.6	0.8	1.1	7.2	4.7	2.9	2.2
Employment change	0.4	-0.2	0.2	0.1	1.7	2.7	0.1	0.9
Unemployment rate	4.0	4.3	4.6	4.9	3.4	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

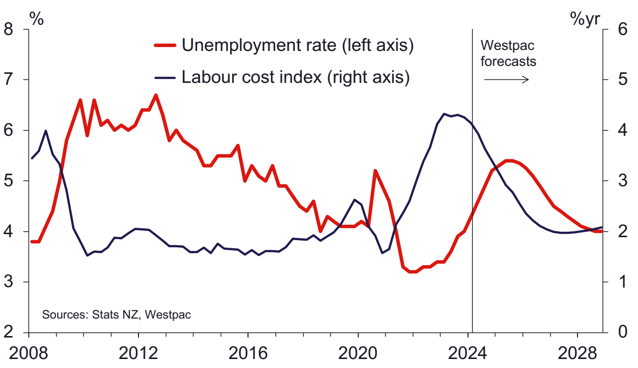
GDP growth



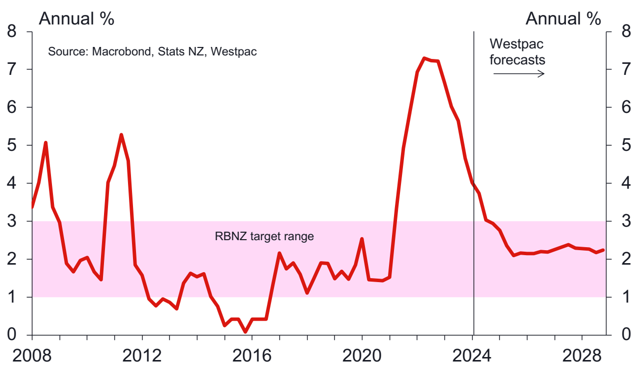
House prices



Unemployment and wage growth



Consumer price inflation



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
US	Fedspeak	–	–	–	Bostic, Barr. Chair Powell to give commencement speech.
Tue 21					
Aus	May Westpac-MI Consumer Sentiment	82.4	–	–	How did the budget go over with consumers?
	RBA May Meeting Minutes	–	–	–	More colour on balance of risks.
Eur	Mar trade balance €bn	17.9	–	–	Asia growth and global investment presents opportunities.
US	Fedspeak	–	–	–	Bostic, Barkin, Waller, Williams.
Wed 22					
NZ	GlobalDairyTrade auction (WMP)	2.4%	–	–	Recent auctions have outperformed futures market pricing.
	RBNZ policy decision	5.50%	5.50%	5.50%	Sticky domestic inflation against a weaker economy.
Jpn	Mar core machinery orders %mth	7.7%	–2.0%	–	Growth likely to remain fickle.
UK	Apr CPI %yr	3.2%	–	–	Inflation tending to target despite services momentum.
US	Apr existing home sales %mth	–4.3%	–0.7%	–	Lack of inventory limiting activity.
	FOMC May Meeting Minutes	–	–	–	Guidance on evolving risks key.
	Fedspeak	–	–	–	Bostic, Collins & Mester on panel. Goolsbee too.
Thu 23					
NZ	Q1 real retail sales	–1.9%	–0.3%	–0.5%	Cost of living pressures dampening discretionary spending.
Aus	May MI inflation expectations	4.6%	–	–	Provides a general view on risks.
Jpn	May Jibun Bank manufacturing PMI	49.6	–	–	Growth outlook uncertain with consumers under...
	May Jibun Bank services PMI	54.3	–	–	... pressure and trade opportunities limited.
Eur	May HCOB manufacturing PMI	45.7	–	–	Starting to see signs of improving underlying momentum...
	May HCOB services PMI	53.3	–	–	... across the Euro Area economy.
	May consumer confidence	–14.7	–	–	Will take time and economic gains to heal.
UK	May S&P Global manufacturing PMI	49.1	–	–	Deceleration in inflation will benefit sentiment...
	May S&P Global services PMI	55.0	–	–	... and activity as it proves a lasting change.
US	May S&P Global manufacturing PMI	50.0	50.2	–	Business surveys offering a range of signals on US...
	May S&P Global services PMI	51.3	51.6	–	... growth, from soft to outright weak.
	May Kansas City Fed index	–8	–	–	Points to lingering risks for regional manufacturing...
	Apr Chicago Fed activity index	0.15	–	–	... as broader activity continues to move towards trend.
	Apr new home sales %mth	8.8%	–1.9%	–	Supply and affordability are challenges.
	Initial jobless claims	222k	–	–	Very low and likely to remain so.
Fri 24					
NZ	May ANZ consumer confidence	82.1	–	–	Sentiment remains soft, in the face of financial headwinds.
	Apr trade balance $mn	588	–	717	Surplus due to seasonal strength in exports, soft imports.
Jpn	Apr CPI %yr	2.7%	2.4%	–	Inflation target coming into view even with rates at 0%.
UK	May GfK consumer sentiment	–19	–	–	Healing to take time.
	Apr retail sales	0.0%	–	–	Consumer to remain under pressure.
US	Apr durable goods orders	0.9%	–0.7%	–	Equipment investment lacks construction’s momentum.
	May Uni. of Michigan sentiment	67.4	67.4	–	Final estimate.
	Fedspeak	–	–	–	Waller.

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