15 December 2014

Weekly Commentary

Surf break, Piha.

In this issue

Happy holidays!

This is the last Weekly Commentary for 2014.

Weekly Commentary will resume on 12 January 2015.

Greased up

Global oil prices have plunged to a five-year low. This may prove to be a large but temporary dip. Nevertheless, the sheer scale of the recent drop in oil prices, and accompanying decline in petrol prices, will have a profound effect on the economy.

We're now forecasting inflation to fall below the RBNZ's 1 to 3% target band for most of the next year. And although the RBNZ looks through sharp changes in the prices of volatile items such as petrol, the recent declines come on top of a more generalised softness in inflation in recent years.

As a result of this soft inflation environment, we've pushed out our expectations for rate hikes. We now expect the RBNZ will delay hiking the OCR for the whole of 2015 (previously, we anticipated a September OCR hike). We are now forecasting four OCR hikes over 2016, and one in 2017, taking the OCR to a stunted peak of just 4.75%.

At its recent December interest rate announcement, the RBNZ kept rates on hold, but clarified that it is still thinking about eventual rate hikes, noting that 'some further increase in the OCR is expected to be required at a later stage'. The reinsertion of this explicit tightening bias (which was removed at the time of the October announcement) came as a bit of a surprise to markets, and on the day was enough to push the NZD up strongly. However, this doesn't mean that rate hikes are imminent, or that the eventual tightening cycle will be very pronounced. The RBNZ's own forecasts showed only very gradual interest rate increases. Significantly, however, the RBNZ's forecast were finalised in late-November, and will not have factored in the continued sharp declines in oil prices. As a result, conditions favour a later resumption of the tightening cycle than the RBNZ is assuming.

Despite soft inflation, rate cuts are off the table. New Zealand's economy is looking rock solid, and we have recently upgraded our growth outlook. Upcoming GDP figures (out Thursday 18 December) are expected to show the economy continued to grow at an above trend pace of 3.1% in the year to December. Looking ahead, the economy is expected to continue expanding at an above trend pace for the next two years.

Greased up continued

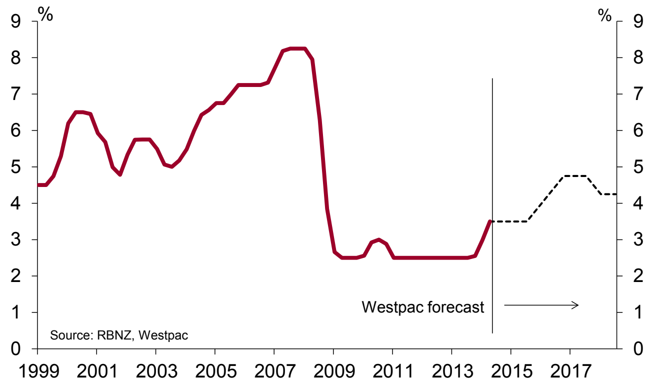
Underpinning this outlook is strong residential construction in Canterbury and Auckland, as well as increases in business investment spending. The outlook for consumer spending is also looking very healthy, supported by strong population growth, increasing employment and gains in households' real purchasing power following recent declines in petrol prices.

This robust outlook is despite the sharp decline in the price of many of our commodity exports since the start of this year. Of particular note, declines in global prices have prompted a marked downwards revision to Fonterra's forecast payout for the 2014/15 season. Compared to the previous record season, this signals a reduction in income of $6.1bn for the dairy industry (equivalent to 2.7% of GDP), which can be expected to flow though to lower consumption and investment spending in rural communities. But even with the drag from lower export prices, we're still expecting the economy to grow at rates of around 3% per annum.

The prospect of an extended period of low inflation might prompt financial markets to price in the possibility of OCR cuts, with related reductions is in fixed term mortgage rates. This would be like pouring fuel on the fire for the housing market. In fact, we are already seeing signs that the housing market is reigniting. REINZ data for the November month showed a 14.2% increase in seasonally adjusted house sales and 2.4% in house prices – both of which were the largest monthly gains in more than five years. Unsurprisingly, Auckland has experienced the biggest lift in house sales. However, most other regions also saw activity levels lift strongly. These data come on top of other signs the housing market is heating up, with solid gains in mortgage approvals and listings on realestate.co.nz in recent months.

As well as reinforcing the more general strength in economic conditions, signs that the housing market is reigniting will raise some flags for the RBNZ in terms of financial stability. But with rates likely to remain on hold, how might the RBNZ respond? One possibility is that the RBNZ will directly address such

Westpac OCR forecast



concerns with macroprudential policy. The RBNZ have noted that they are not contemplating new macroprudential tools at the moment. But that doesn't rule out the possibility of some tightening in the existing policy over the next year. (We note that as late as December 2012 the Governor told Parliament that "as we see the housing market at present on a national basis, and given the credit growth figures that I talked about, we wouldn't see the need to use LV ratios at this point in time". Eight months later the RBNZ introduced a cap on high-LVR lending). In addition, the RBNZ has noted that it is looking at the appropriate micro-prudential settings for lending to investors.

Looking to the week ahead, the balance of payments and national accounts are expected to show that the economy has continued to expand at a solid pace though mid-2014 even as the boost from earlier high export prices fades. The December update on business confidence is expected to reinforce the picture of a robust economy. We'll also receive an update on the government's financial position and spending plans with the release of the 2014 HYEFU.

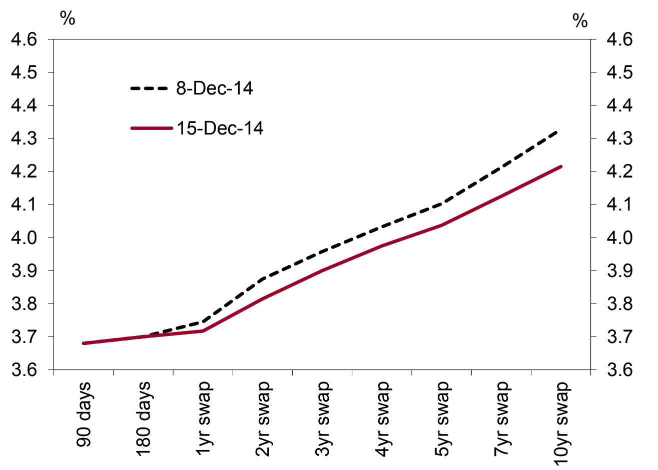
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though they do offer stability.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates

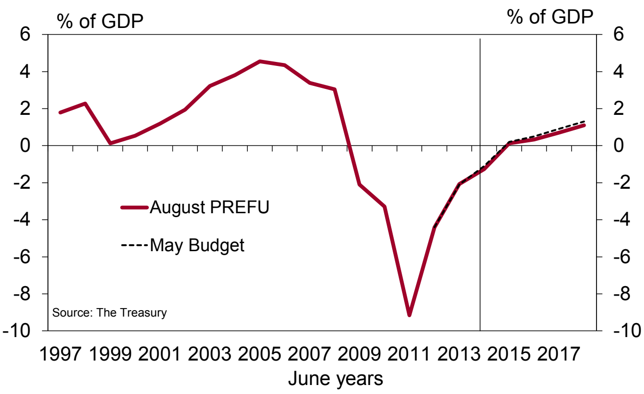


NZ Half-Year Fiscal and Economic Update

Dec 16, Last: $297m

- The pre-election fiscal update in August forecast a narrow operating surplus of $297m for the 2014/15 fiscal year.
- Softer than expected inflation and falling dairy incomes are likely to take a bite out of the Treasury's tax revenue forecasts. This could see the projected balance for the 2014/15 fiscal year slip into deficit, although it would likely be as economically insignificant as the previously forecast surplus was.
- It's unusual for the government to announce any changes in spending plans in the half-year update. However, there may be an increase in the bond programme, to reflect smaller projected surpluses in later years.

Operating balance (excluding gains & losses)

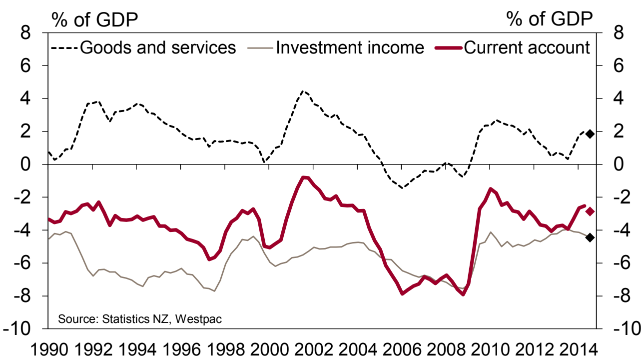


NZ Q3 current account % of GDP

Dec 17, Last: -2.5%, Westpac f/c: -2.9%, Mkt f/c: -2.8%

- We expect the current account deficit to widen to 2.9% of GDP for the year to September. Last year's record dairy exports have now given way to steeply lower world prices, which will start to drag down the annual balance from Q3 and continue for the next year or so.
- Imports rose in the September quarter, much of which was due to large aircraft imports as Air New Zealand upgrades its fleet.
- Rising profits for overseas-owned firms in New Zealand will contribute to a widening of the investment income deficit.

Annual current account balance

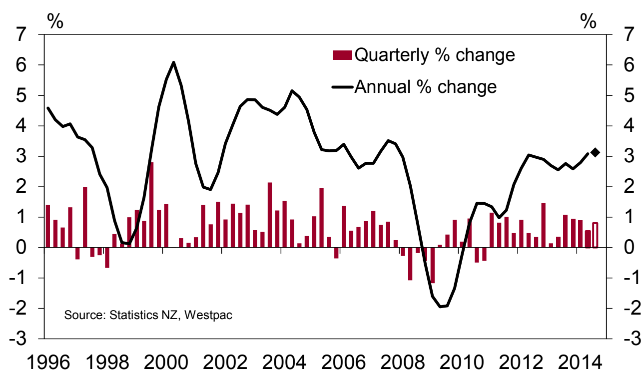


NZ Q3 GDP

Dec 18, Last: 0.5%, Westpac f/c: 0.8%, Mkt f/c: 0.7%

- We expect a 0.8% increase in GDP in the September quarter, an improvement from the 0.5% increase seen in June, but not quite back at the 1% average pace of the nine months to March.
- A rebound in milk production after Q2's decline, a very strong quarter for non-food manufacturing, and continued strong growth in construction and household spending are the main features.
- The Q3 GDP release incorporates annual revisions, which can alter the picture of the economy's recent pace of growth to some degree.

Production based GDP

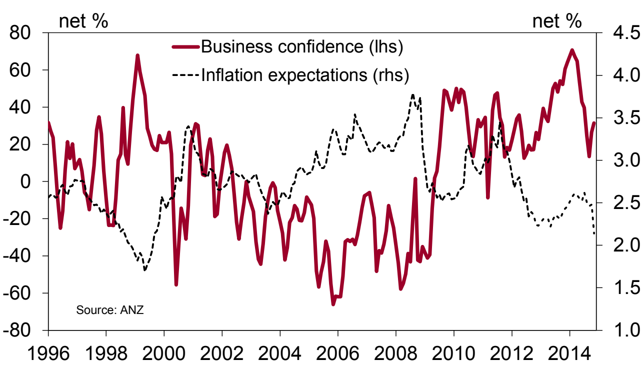


Nov ANZ Business Outlook Survey

Dec 19, Business confidence: Last: 31.5

- Business sentiment is expected to remain robust in the final month of 2014, including solid indications for hiring and investment spending.
- Domestic demand is looking strong, with solid outlooks for construction and household spending. This is offsetting softer conditions in the agricultural sector.
- Low oil prices are boosting spending and are also reducing costs for businesses.

NZ business confidence & inflation expectations



The week ahead

Aus Federal government budget update, AUDbn

Dec 15, Last: –48.5, WBC f/c: –40 Mkt f/c: –37, Range: –40 to –33

- The Federal government underlying cash deficit for 2014/15 is expected to be revised to $40bn (–2.5% of GDP), a $10bn deterioration since the May budget. That follows a deficit of $48.5bn for 2013/14. For 2015/16, the deterioration since May will be around $15bn, resulting in a deficit of $32bn.
- Nominal GDP growth for 2014/15 will be lowered, to around 1.0% from 3.0%, largely reflecting a weaker terms of trade, –13% vs –6.75%. Economic growth forecasts for the following years are expected to be unchanged. That costs the budget $7bn this year and $12bn thereafter. Also, Senate decisions have added around $10bn to the deficit over four years.
- Net debt climbs to $324bn, 17.4% of GDP by June 2018, a $60bn blow-out from $264bn, 14.0% of GDP in May.

Key numbers, $bn	'14/15	'15/16	'16/17	'17/18
Budget				
Cash balance, underlying	–29.8	–17.1	–10.6	–2.8
% of GDP	–1.8	–1.0	–0.6	–0.2
Net public debt	226	246	261	264
% of GDP	13.9	14.4	14.6	14.0
MYEFO*				
Change in cash balance	–10.2	–14.9	–14.4	–15.2
Cash balance, underlying	–40	–32	–25	–18
% of GDP	–2.5	–1.9	–1.4	–1.0
Net public debt	241	276	306	324
% of GDP	15.0	16.4	17.3	17.4

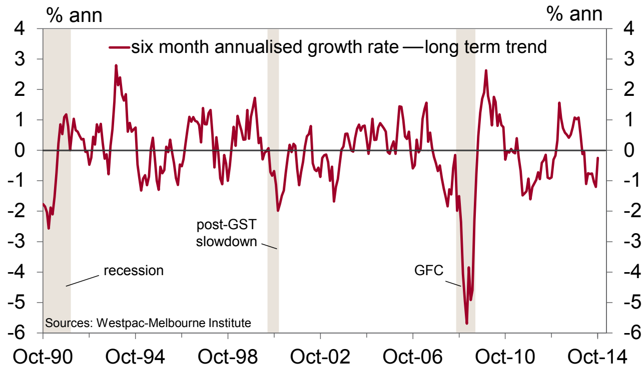
* Westpac's expectation of MYEFO forecasts.

Aus Nov Westpac–MI Leading Index

Dec 17, Last: –0.25%

- The six month annualised growth rate of the Index, which indicates the likely pace of economic growth 3 to 9mths into the future, rose from –1.20% in Sep to –0.25% in Oct. The index continues to point to sub-trend growth, although the near 1ppt improvement month to month gives some cause for optimism that momentum might be lifting.
- That optimism may be doused by the Nov update. It will include sharp reversals in several key components, including the ASX (–3.8% vs +3.9% in Oct); total hours worked (–0.3% vs +1.6% in Oct); and commodity prices (–1.5% vs +1.9% in Oct). Consumer sentiment related components also deteriorated sharply in the last month. Some of this may be offset by a sharp rebound in dwelling approvals (+11.4% vs –11.2% in Sep), but for the most part the picture looks to be weaker.

Westpac-MI Leading Index

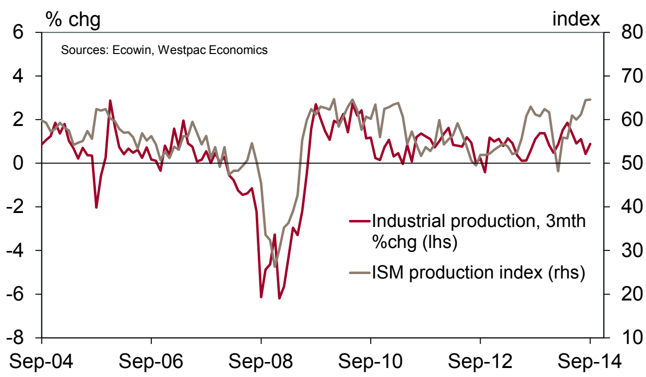


US Nov industrial production

Dec 15, Last: -0.1%, WBC f/c: 0.7%

- US industrial production fell 0.1% in October. There was a modest 0.2% rise in manufacturing constrained by a further decline in auto output (down three months running after July's spike), offset by a 0.7% drop in utility output (mostly natural gas) and an unusual 0.9% mining drag.
- In Aug-Oct, auto assemblies fell below Q2's level, but auto sales surged in Nov as gasoline prices fell and confidence rose. That suggests an auto output bounce. The orders index in the ISM factory survey at 66 in Nov looks very solid, and factory hours worked rose 0.5% concentrated in the non-durables sector; but durable goods orders look to be losing momentum, which is suggestive of a more subdued factory story.
- These mixed signals don't preclude an above-trend IP bottom line in Nov if auto sales spike, utilities demand is boosted by the cold weather and mining bounces back.

US industrial sector activity firming

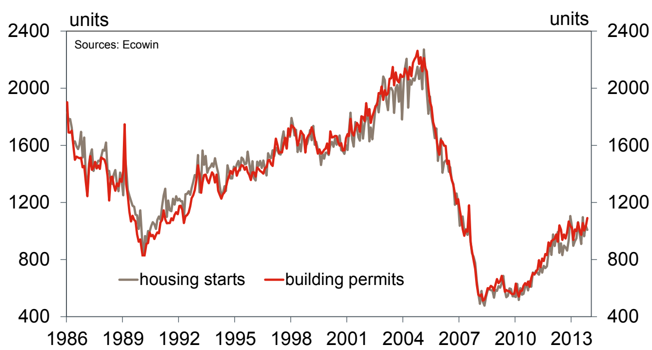


US Nov housing starts and permits

Dec 16, Starts Last: –2.8%, WBC f/c: 1.0%
Permits Last: 5.9%, WBC f/c: –2.0%

- Housing starts fell 2.8% in October, weighed down by multiples; but single-family starts rose 4.2% to a 696k annualised pace, the highest in almost a year. Meanwhile, housing permits rose 4.8%, spread across both single and multiple dwellings.
- Single family permits ran at an annualised pace of 640k in Oct, much lower than starts on 696k, a possible constraining factor on starts later in Q4. Compared to a year ago, single-family permits were 2.4%yr higher versus starts up 15.4%yr, also not supportive of sustained starts growth, bar multiples volatility.
- Other sector indicators have been mixed such as falling pending home sales, rising new home sales and the stalling of the improvement in homebuilder confidence.

US housing starts & permits, uptrend has slowed

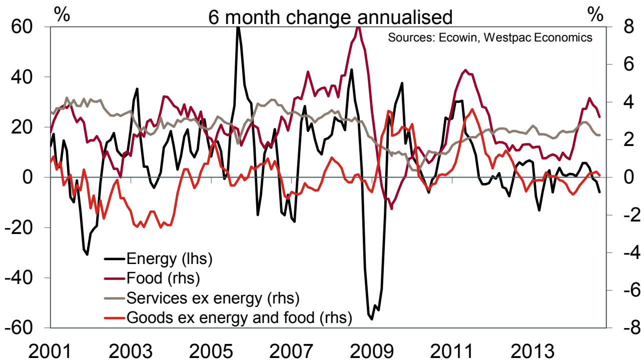


US Nov CPI

Dec 17, Last: 0.0%, WBC f/c: –0.1%

- The Oct CPI printed a flat headline and a 0.2% core rate. Food prices rose a little further, but gasoline kept falling and the stronger dollar revealed itself again in flat/falling clothing prices. For the core rate, these were offset by gains elsewhere, including in airfares.
- Renewed sub-0.2% core outcomes would usually require several of autos, clothing, tobacco, rents and medical care to fall or run below trend. Apparel prices should fall again in Nov and airfares will be constrained by lower fuel prices, but auto prices will likely hold up given demand strength, and there is no obvious reason to expect rent and medical costs to slip back below trend gains (although risks are that way inclined).
- Another negative headline CPI will reflect lower gasoline prices and stalled food prices. The core rate could print 0.1% again, but this would be rounded down from closer to 0.15%.

CPI: key components

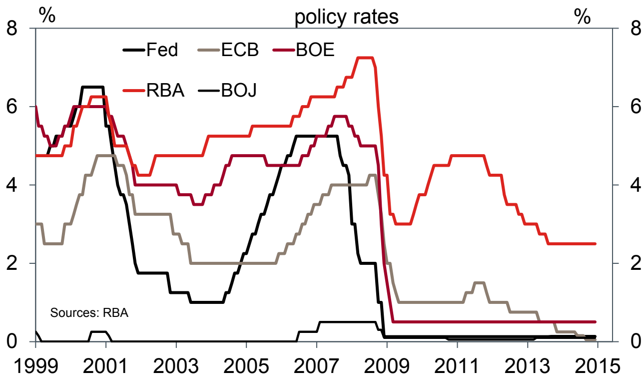


US FOMC policy decision, Yellen presser

Dec 17 Last: 0-0.25%, WBC f/c: 0-0.25%

- The faster pace of hiring so far in Q4 (282k mth avg vs Q3's 239k) would suggest to some FOMC members that the loss of momentum in business investment and household spending in Q3 should soon reverse. Faster hourly earnings growth and hours worked will have boosted household income just as lower gasoline prices freed up cash for increased spending on services and non-durables – lacklustre in the year to date.
- While downside risks have abated, there are still fragilities in the economy's heartland: debt levels for recent homebuyers are burdensome, and potential buyers' creditworthiness is also an issue. Hence, mortgage approvals are in decline and home sales are weaker than in previous cycles. Inflation is still lower than the Fed would like, allowing a cautious approach to tightening policy. We expect the first move in Q3 next year and a careful, staged normalisation thereafter.

Developed world policy interest rates



Data calendar

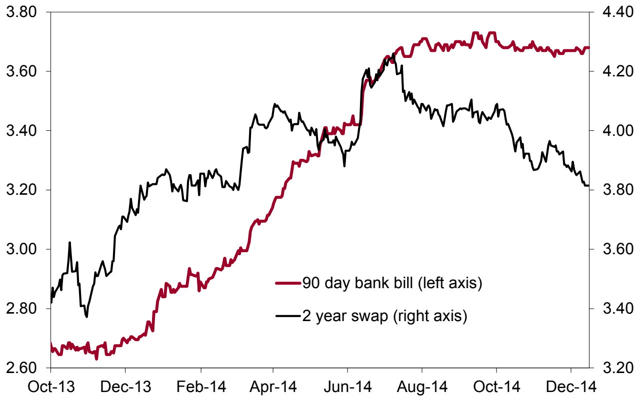
		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Nov Business New Zealand PSI	57.8	–	–	The domestic economy is looking robust.
Aus	Federal budget update, AUDbn	–48.5	–37	–40	2014/15 deficit a $10bn deterioration on May forecast.
	Nov new vehicle sales	–1.6%	–	–0.8%	Sales have been on a slight downtrend over second half of 2014.
UK	Dec house prices, %yr	8.5%	–	–	Rightmove index of asking prices.
	Dec CBI industrial trends survey	3	0	–	Total orders series.
US	Dec Empire manufacturing survey	10.2	12.0	14.0	Partial recovery of mid-year strength.
	Nov industrial production	–0.1%	0.7%	0.7%	ISM survey strong; hours worked in factories up 0.5%.
	Oct TIC data $bn	164	–	–	Net long term flows; Sep's net inflow largest on record.
	Dec NAHB housing index	58	59	56	Upward momentum in housing market through 2011-13 stalled in 2014.
Can	Nov existing home sales	0.7%	–	–	Little history to this series but sales growth solid since early 2014.
Tue 16					
NZ	Half-Year Fiscal and Economic Update	$297m	–	–	Projected surplus for 2014/15 at risk of slipping into small deficit.
Aus	RBA minutes	–	–	–	More perspective on the views of the Board.
	RBA A/G Financial Markets Debelle	–	–	–	Speech at AustralAsian Finance and Banking Conference.
Chn	Dec HSBC manufacturing PMI - flash	50.0	49.8	–	Oct Detail was OK, forward looking bits firmer than coincident ones.
Eur	Dec PMI factory advance	50.1	50.6	–	Business surveys point to some modest recovery in confidence,
	Dec PMI services advance	51.1	51.8	–	consistent with meagre economic growth persisting.
	Oct exports	4.2%	–	–	Exports surged late Q3 after slipping through mid year.
Ger	Dec ZEW survey of analyst expectat.	11.5	20.0	18.0	Sentix has recovered some lost ground in last two months.
UK	Nov PPI %yr	0.9%	1.0%	–	Core output measure.
	Nov CPI %yr	1.3%	1.2%	1.1%	BRC shop prices at cycle low; energy prices falling.
	Oct ONS house prices	12.1%	–	–	Dated relative to private measures, but still accelerating.
US	Nov housing starts	–2.8%	2.5%	1.0%	Single family starts rose sharply in Oct but permits suggest that's not
	Nov building permits	5.9%	–2.9%	–2.0%	sustainable; multiples distort the headline picture.
	Dec PMI factory	54.8	–	–	Markit index back at year ago levels after record high in August.
Wed 17					
NZ	GlobalDairyTrade auction	–1.1	–	–	Mixed results last time, with WMP down but others up sharply.
	Q3 current account % of GDP	–2.5%	–2.8%	–2.9%	Dairy export prices fell sharply in Q3.
Aus	Nov Westpac–MI Leading Index	–0.25%	–	–	Looks set to retrace last month's improvement.
Eur	Q3 labour costs %yr	1.2%	–	–	In renewed downtrend since 2011.
	Nov CPI final %yr	0.3% a	–	0.3%	0.298 before rounding so unlikely to be revised up or down.
UK	Bank of England minutes	–	–	–	Has either of the hawks dropped their immediate hike vote?
	Nov unemployment ch	-20k	–20k	–20k	Claimant count measure.
US	Nov CPI	0.0%	–0.1%	–0.1%	Gasoline prices plunging; core pressures benign with occasional
	Nov CPI core	0.2%	0.1%	0.1%	component spikes quickly reversed.
	Q3 current account deficit $bn	98.5	97.5	–	Trade deficit a little lower in Q3.
	FOMC decision	0-0.25%	0-0.25%	0-0.25%	Downside risks diminished but Fed to tread cautiously.
Can	Oct wholesale trade	1.8%	–	–	Sales constrained by autos pull back.
Thu 18					
NZ	Q3 GDP	0.5%	0.7%	0.8%	A rebound in agricultural production is the swing factor vs Q2.
Aus	Dec RBA bulletin	–	–	–	Statistical and research update.
Chn	Nov 70 city new dwelling prices %net	–100%	–	–	A few cities may stop falling in Nov, tier one the most likely candidates.
	Nov 70 city 2ndary dwelling prices %net	–90%	–	–	Beijing & Shanghai were two of the three cities where prices rose in Oct.
Eur	Oct construction output, %yr	–1.7%	–	–	Sector struggling to grow apart from weather boost last winter.
Ger	Dec Ifo business climate index	104.7	105.5	105.2	Business surveys recovering some recent lost ground.
UK	Nov retail sales incl. fuel	0.8%	0.3%	–	Retailing upswing to help limit extent of GDP growth slowdown in Q4
US	Initial jobless claims w/e 13/12	294k	–	290k	Claims lower again after Nov's weather/holiday seasonal issues.
	Dec PMI services index	56.2	–	56.5	Has not posted a gain since June.
	Dec Philadelphia Fed index	40.8	26.0	20.0	Nov's 21 year high unsustainable.
	Nov leading indicators	0.9%	0.5%	–	Has not posted a decline since Jan.
Fri 19					
NZ	Nov ANZ job advertisements	–0.3%	–	–	Labour demand has been increasing.
	Nov Net immigration	5250	–	5,100	Immigration at record highs, likely to stay high until Aus job prospects firm.
	Nov ANZBO business confidence	31.5	–	–	The favourable economic outlook has boosted business sentiment.
Eur	Oct current account balance €bn	–31	–	–	Record surplus in Sep.
Ger	Nov PPI %yr	–1.0%	–1.1%	–	Energy prices falling offsetting weaker euro.
	Jan GfK consumer confidence	8.7	9.0	–	Surveyed early Dec despite Jan label.
UK	Nov PSNCR, £bn	–2.6	–	–	Public sector net credit requirement. PSNB ex intv'ns £7.7bn in Oct.
	Dec GfK consumer confidence	–2	–2	–	Upswing in sentiment has stalled since mid-year.
	Dec CBI retail survey	27	–	–	Reported sales series.
US	Dec Kansas City Fed factory index	7	–	–	Mid year upswing has since reversed.
	Fedspeak	–	–	–	Evans and Lacker.
Can	Nov CPI %yr	2.4%	2.3%	–	BoC core rate 2.3%yr in Oct.
	Oct retail sales	0.8%	–0.4%	–	Sep retail sales boosted by autos.

New Zealand forecasts

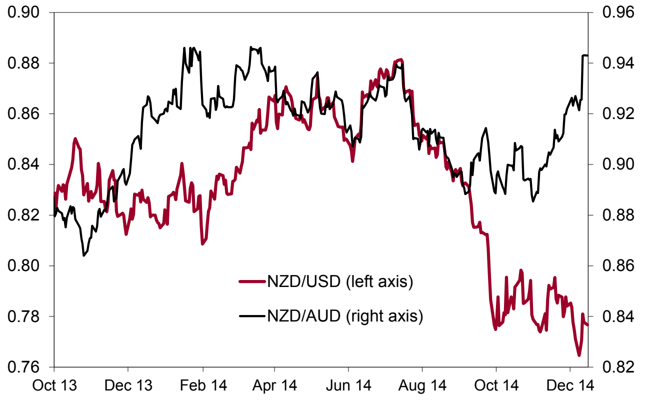
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
GDP (Production) ann avg	2.7	2.8	3.2	3.4	2.6	3.3	3.4	2.9
Employment	0.4	3.8	2.9	2.7	2.9	3.0	3.1	1.8
Unemployment Rate % s.a.	6.2	6.0	5.1	4.5	6.0	5.4	4.6	4.3
CPI	0.9	1.5	0.8	2.2	1.6	0.9	1.6	2.7
Current Account Balance % of GDP	-3.8	-2.7	-5.0	-6.3	-3.3	-3.7	-6.4	-5.5

Financial Forecasts	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Cash	3.50	3.50	3.50	3.50	3.75	4.00
90 Day bill	3.70	3.70	3.70	3.75	4.00	4.25
2 Year Swap	3.70	3.70	3.90	4.20	4.50	4.70
5 Year Swap	4.00	4.10	4.30	4.50	4.60	4.70
10 Year Bond	3.90	4.10	4.30	4.50	4.70	4.80
NZD/USD	0.76	0.74	0.77	0.79	0.81	0.81
NZD/AUD	0.93	0.93	0.93	0.93	0.93	0.91
NZD/JPY	92.0	91.4	96.3	98.8	101.3	102.1
NZD/EUR	0.63	0.62	0.64	0.64	0.65	0.64
NZD/GBP	0.49	0.48	0.49	0.48	0.48	0.47
TWI	77.5	76.7	78.7	79.7	81.0	80.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 December 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.64%	3.65%	3.64%
60 Days	3.66%	3.66%	3.66%
90 Days	3.68%	3.67%	3.67%
2 Year Swap	3.82%	3.88%	3.95%
5 Year Swap	4.04%	4.10%	4.21%

NZ foreign currency mid-rates as at Monday 15 December 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7767	0.7810	0.7922
NZD/EUR	0.6227	0.6265	0.6319
NZD/GBP	0.4937	0.4989	0.5049
NZD/JPY	92.28	92.70	92.33
NZD/AUD	0.9430	0.9221	0.9039
TWI	78.17	78.24	78.35

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014f	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.7	3.5
CPI inflation % annual	3.0	2.2	2.7	1.8	2.6	3.0
Unemployment %	5.2	5.3	5.8	6.3	6.4	6.1
Current Account % GDP	-2.8	-4.4	-3.3	-2.9	-3.2	-0.8
United States						
Real GDP %yr	1.6	2.3	2.2	2.2	2.5	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.8	1.8	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.6	5.1
Current Account %GDP	-2.9	-2.9	-2.4	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	-0.3	1.8	1.6	0.4	1.2	1.6
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.7	0.9	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	3.0	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.5	7.8
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.0	4.9	5.7
World						
Real GDP %yr	4.1	3.4	3.3	3.2	3.7	4.5
Forecasts finalised 8 December 2014						

Interest Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Australia						
Cash	2.50	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.76	2.20	2.20	2.20	2.22	2.25
10 Year Bond	2.89	3.10	3.30	3.35	3.35	3.60
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.500
US 10 Year Bond	2.15	2.40	2.60	2.70	2.75	2.90
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
AUD/USD	0.8274	0.82	0.80	0.83	0.85	0.87
USD/JPY	118.66	123	125	127	129	129
EUR/USD	1.2396	1.21	1.18	1.20	1.21	1.22
AUD/NZD	1.0608	1.08	1.08	1.08	1.08	1.08

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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