WESTPAC ECONOMIC BULLETIN

NZD update.

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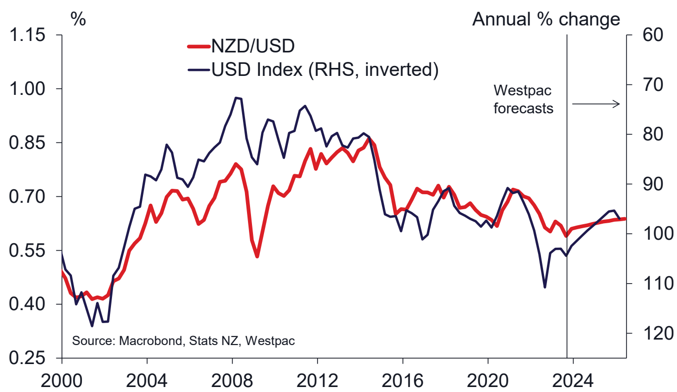
Risks for the New Zealand dollar looking forward.

- We see risks to the view that the NZD appreciates over the next year despite expected USD weakness.
- Increasing signs that growth is slowing combined with the weak commodity price outlook is a key risk.
- Further depreciation of 10% on a trade weighted basis is plausible.
- The performance of the Chinese economy next year will likely be key in determining the extent of the downside risks to the NZD.
- An increase in risk perceptions could also add to downside risks – particularly in light of New Zealand's large current account deficit.
- New Zealand's relatively high interest rates could provide some support at the margin if New Zealand's yield advantage persists in a weak terms of trade situation.

Context and Westpac's medium term New Zealand dollar view.

Our baseline NZD/USD view has been for gradual appreciation over the coming years. This is because we anticipate depreciation of the US dollar from its relatively elevated levels as the Fed's easing cycle comes into view. The generally strong inverse relationship between the US dollar and the NZ dollar supports that broad view. New Zealand interest rates are expected to remain elevated for a while as the RBNZ fights to bring the still too high level of inflation back to its 1-3% target which also provides support for the NZD.

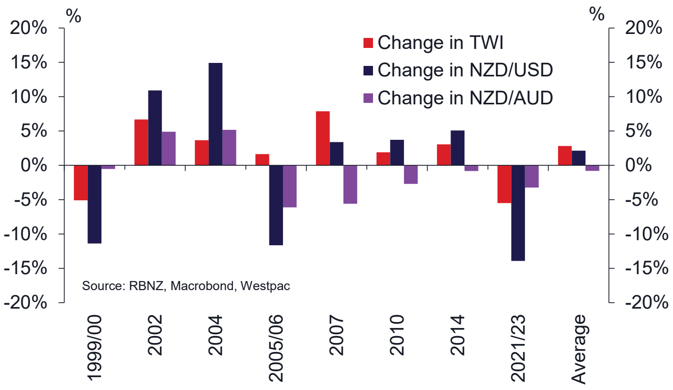
NZD/USD versus the USD Index



The RBNZ's task in controlling inflation pressures in this cycle has been complicated by the weakness in the NZD even while the RBNZ has increased the Official Cash Rate (OCR) by an unprecedented amount since 2021. In this tightening cycle the

NZD has fallen by over 5% on a trade weighted basis and by around 14% and 3% versus the key USD and AUD currencies. This is a weaker performance than the historical average NZD performance in past tightening cycles over the OCR period.

The exchange rate often rises when rates rise

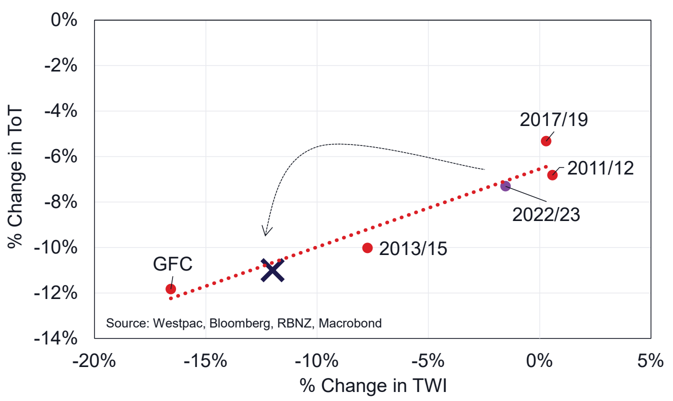


Some potential risks to the core view.

One factor that has undermined the NZD this cycle has been weakness in the Chinese economy which has driven a significant fall in New Zealand's commodity export prices – particularly for dairy products and in the logging industry. Thus far in this cycle export prices have fallen by around 8% from the peak of the price cycle back in early 2022 while the terms of trade more broadly have fallen by 7%. Given recent changes in commodity prices, these declines are likely to extend in the September quarter.

Thus far the exchange rate has broadly tracked what might have been expected given the fall in the terms of trade. The chart above shows the historical relationship between changes in the terms of trade and the New Zealand dollar Trade weighted Index from peak to trough in terms of trade cycles experienced since the 2000's. As should be expected there is a positive relationship between the terms of trade and the exchange rate with the experience this time sitting "right on the line".

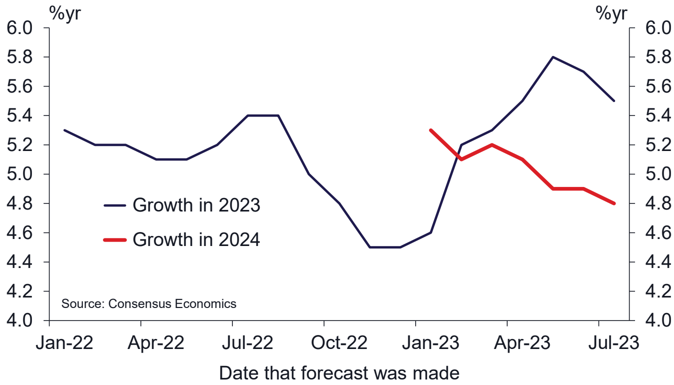
Change in terms of trade vs % change in TWI



However, it is useful to consider the future risks here. Most forecasters currently see commodity prices and the terms of trade bottoming out close to the current level and some improvement towards the end of 2024. In that scenario it's easy to see how the bulk of the exchange rate adjustment might be behind us.

However, this might not be the case given the significant uncertainties in the Chinese economy as well as the potential for weaker global growth coming from past (and potential future) monetary tightening required to bring down persistently elevated inflation. Forecasts for the Chinese economy continue to be uncertain and are being revised down. Much hinges on the capacity and willingness of the Chinese authorities to take substantive policy steps to offset what appears to be significant weakness among Chinese consumers, high unemployment and a large negative output gap that is generating deflation.

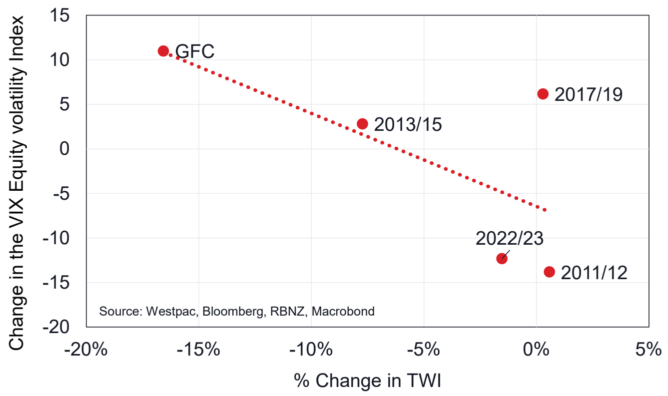
China GDP growth – market forecasts



So, what might that downside risk mean for the NZD? We can get a clue by considering that historical relationship between changes in the terms of trade and the exchange rate in down-cycles. So far, the cycle we are experiencing has been fairly moderate – similar to the falls seen in 2011/12 but less than experienced in the Global Financial Crisis period and in 2013/15 (when dairy prices, in particular, fell significantly). If we were to see export prices and the terms of trade fall further in line with those episodes – i.e., by another 4% or so – then the implication would be further weakening of the NZD. In such a scenario, we could see another 10% fall in the TWI and NZD/USD.

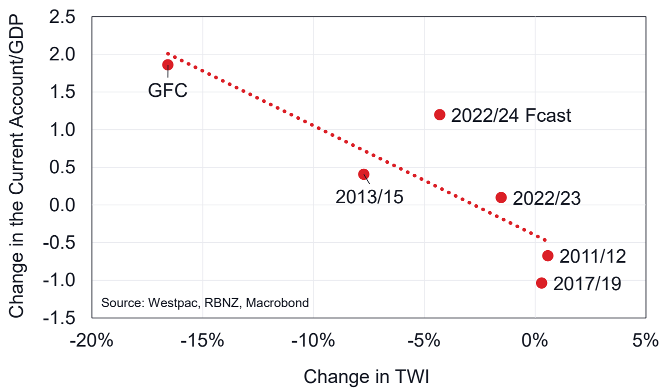
The risk environment might also help motivate NZD depreciation. We can see an inverse relationship between increased risk aversion in markets and the performance of the NZD. Its plausible that the scenario of an increase in risk aversion offshore, combined with ongoing weakness in the terms of trade and New Zealand's high current account deficit, could prompt investors to reassess the risks of investing in the NZD. This would lead to a depreciation of the NZD to equalise the expected return from investing in New Zealand compared to comparable investments offshore.

Change in Equity market volatility vs % change in TWI



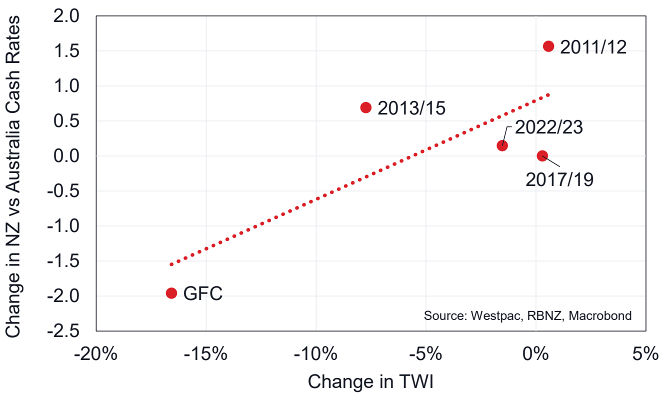
The silver lining of such a scenario could be to promote faster and more significant economic rebalancing and a reduced current account deficit. We can see this in past downturns in the terms of trade where episodes involving larger NZD adjustments are associated with greater current account adjustment. This is because the underlying shock driving both the terms of trade and the exchange rate prompts weakness in domestic consumption and ultimately reduced imports and an improved trade balance.

Change in Current Account vs % change in TWI



So, might the relatively high level of New Zealand interest rates hold the NZD up? The answer to that is "perhaps at the margin". We can certainly see a positive relationship between the changes in the New Zealand-Australia cash rate differential and the performance of the NZD during episodes of terms of trade weakness. Westpac's forecast is for New Zealand interest rates to remain high compared to Australian interest rates for the foreseeable future. We still see a further rate hike from the RBNZ in November and then unchanged interest rates until August 2024 while in Australia the RBA cash rate is expected to have peaked at 4.1% and not likely to fall until September 2024. However, this yield advantage is not expected to significantly grow from here which might limit the extent of additional support we might expect for the NZD. And in any case, it's possible that scenarios involving a significantly weaker terms of trade than currently forecast might not be ones where the New Zealand-Australia cash rate differential remains as high as we currently forecast.

Change in RBNZ-RBA cash rate spread vs % change in TWI



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