WESTPAC WEEKLY ECONOMIC COMMENTARY

The great rebalancing – what it means for you or your business.

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Southern rātā

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In the last couple of weeks both Westpac and the RBNZ provided an update on how the economy is likely to evolve in the coming years. In large part the updates reflected common themes: elevated persistent inflation, an over-heated economy set for a prolonged period of low and below trend growth, a high fiscal deficit in cyclically adjusted terms and an elevated current account deficit. The implication was a need for further policy action to ensure sufficient economic rebalancing occurs so that inflation can return to the RBNZ's inflation target range, either through higher interest rates (Westpac) or maintaining current restrictive interest rates for longer (the RBNZ).

A common theme – growing risks.

Another common and important theme was that of growing risks. To some extent the existing economic imbalances increase New Zealand's exposure to the risk that in correcting the imbalances that we might all be in for a bumpy ride. That means risk for households and businesses and hence the theme of this week's note.

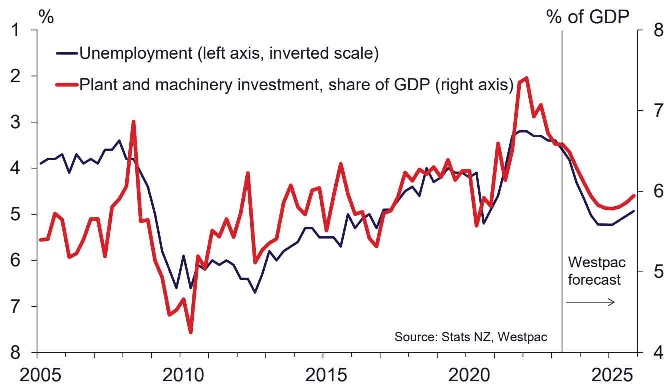
The deal for households.

So, what does the economic outlook imply for households and how should they prepare? The period ahead will be more challenging than recent years. The labour market will be noticeably weaker and wages growth much more moderate. Job security may rate more highly than risk taking in pursuit of new opportunities. Interest rates will be high for an extended period and will take up a larger share of household budgets than we have been used to for a good while. Households will probably need to manage and prioritise spending much more closely and potentially be prepared for still higher interest rates should bringing down inflation take longer than hoped. First home buyers may find affordability more challenging as financing costs will remain high and house prices may be rising (at least modestly). As the RBNZ gets on top of inflation, some relief should come in the form of less rapid growth in household costs.

What about businesses?

For businesses the challenge will continue to shift away from dealing with finding sufficient skilled labour to finding sufficient demand to maintain revenues. Financing costs will continue to be elevated and finding credit could be harder as some firm's face weaker demand and profitability. Firms will need to be proactive in bolstering their balance sheets and working with financiers to ensure that working capital needs continue to be met. The good news is that cost pressures should gradually abate, but the net impact on the bottom line from weaker revenues and a more competitive business environment likely means ongoing pressures on profitability. Investment priorities will need to be carefully specified to ensure needs are balanced with the availability of funds.

Business investment and unemployment

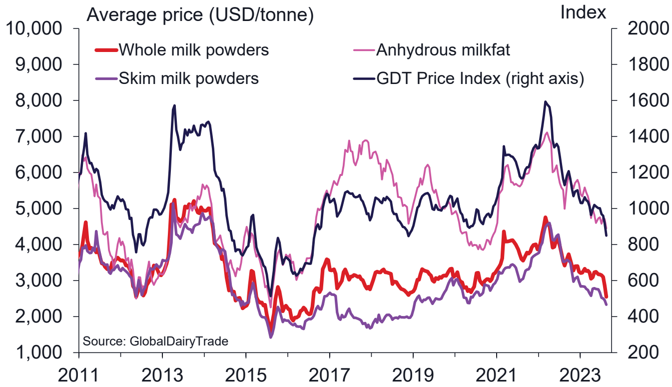


Some firms will have an easier ride than others. For example, those orientated to the tourism sector should continue to benefit from the post Covid bounce-back as tourist numbers recover. These businesses may find some useful ideas for development and maximising their opportunities in Westpac's recent report [Tourism in New Zealand – Leveraging future opportunities](). Exchange rate risks might come more to the fore. While the base case in most forecasts is one of approximate exchange rate stability, the current account imbalances combined with weakness in export incomes raises risks of exchange rate volatility (in particular, depreciation). Businesses exposed to such fluctuations may need to carefully monitor and manage their exposures to ensure balance sheet risks don't grow at a time when general economic conditions may be fragile.

The issues for exporters.

Some sectors were already doing it tough and needed to recover from recent weather events (horticulture) and so a bumpy recovery will make that recovery still harder. For others, who perhaps had better years of late (dairy for example) there will be a need to carefully plan for a tough year – especially if the bounce back in China ends up being further delayed. A weaker exchange rate could provide some respite in a downside scenario but there are no guarantees. There could be opportunities to re-direct activity to stronger markets (the US for example seems to be holding up relatively well at least for now). Cost control, prioritisation of investment spending and proactively managing financing needs will be critical. A silver lining is that on-farm costs are coming down.

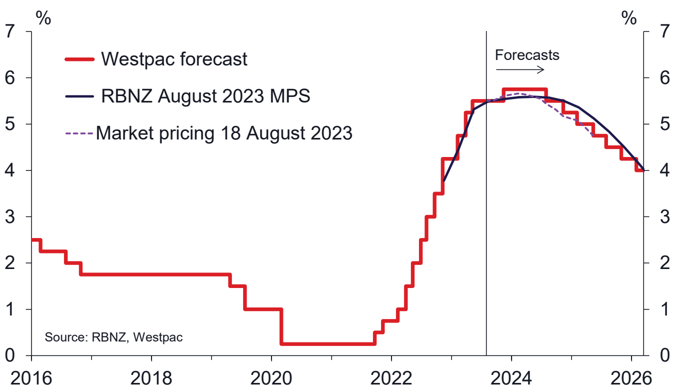
GlobalDairyTrade auction prices



The challenge for the authorities.

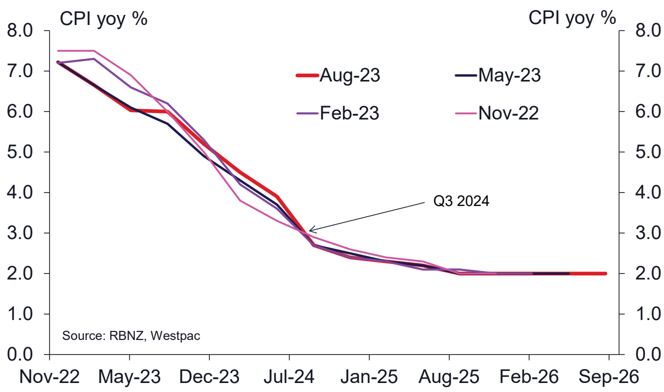
Economic rebalancing often requires or is at least assisted by policy action. For this year, fiscal policy will be focused on engaging the "automatic stabilisers". In future years the fiscal authorities will be facing some more difficult choices to prevent excessive debt accumulation and to encourage an eventual better balance in the external accounts. Monetary policy will be focused on controlling inflation. This is a hugely important task that must be got right. The broadening in the range of potential outcomes for the economy and inflation outlook will demand a flexible data driven policy approach. The RBNZ looks to be heading in the right direction on that score.

Official Cash Rate forecasts

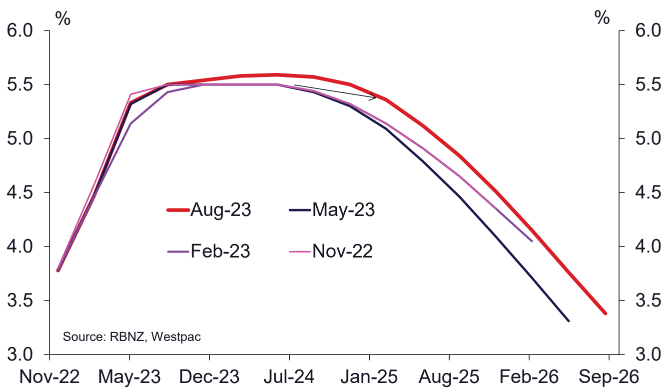


But it will be critical for the RBNZ to be successful bringing inflation to heel expeditiously. Any further delay in returning inflation to target raises risks of an even more protracted and bumpy ride. The risks need to be well managed here and, on that score, we have growing concerns on the RBNZ's monetary policy strategy and risk management approach. Since the December 2022 Statement, the Bank indicated a clear strategy of getting the OCR to and keeping it at 5.5% until the September quarter of 2024 before easing. This strategy has not been adjusted to reflect some significant changes in the outlook which add inflation pressure – for example the migration cycle and the expansionary 2023/24 budget. Now, when faced with concerns of more persistent inflation the RBNZ is choosing to extend the on-hold period and are betting that an OCR of 5.5% is sufficiently restrictive to compensate. However, if this judgement is wrong, then New Zealand could be facing a protracted period of strong domestic inflation pressures. In turn, that could feedback back into higher inflation expectations, which would make it harder to eventually bring inflation down.

RBNZ CPI inflation projections since November 2022



RBNZ OCR projections since November 2022



Given that risk, an alternative strategy would be to raise rates earlier and then ease earlier should negative risks take hold. If there were downside risks to the RBNZ's assessment of the inflation outlook then the RBNZ's approach would be more understandable – but the RBNZ doesn't currently see the risks this way.

In any case, inflation is so elevated the prospects of an undershoot of the inflation target seem remote. As we noted in our Economic Overview, there is a widening of the distribution of future OCR paths emerging. It will be important for the RBNZ to act early should it become clear that the upside risks to inflation become more dominant.

Let's both plan for as well as hope for a smooth transition.

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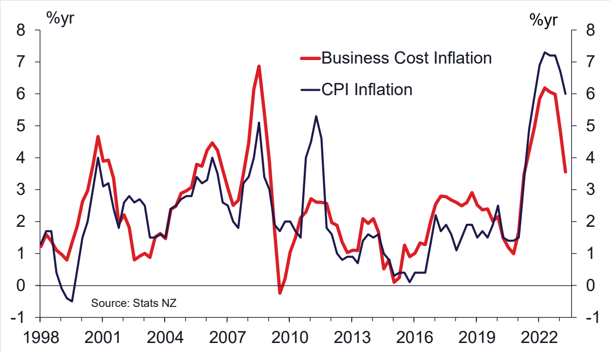
Chart of the week

Last week Statistics New Zealand released the Business Price Indexes for the June quarter. By combining information on producer and capital goods prices, alongside the labour cost data released earlier this month, we can get a feeling for how overall business cost inflation is tracking.

Using this data, our measure of annual business cost inflation – which has tracked well with CPI inflation over the past two decades – slowed to 3.5% in the June quarter from 6.0% in the March quarter. This largely reflects the material slowdown in non-labour input cost inflation, which is likely to extend when the September data is released.

The RBNZ will be hoping that CPI inflation begins to show a similar easing over coming quarters.

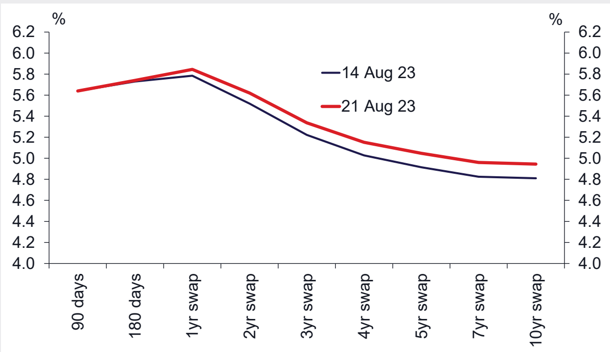
Business cost and consumer inflation



Fixed vs floating for mortgages

We think the current best value for borrowers is fixing for one year and rolling for this term. That is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms would be more suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

NZ Q2 retail spending (volumes) %qtr

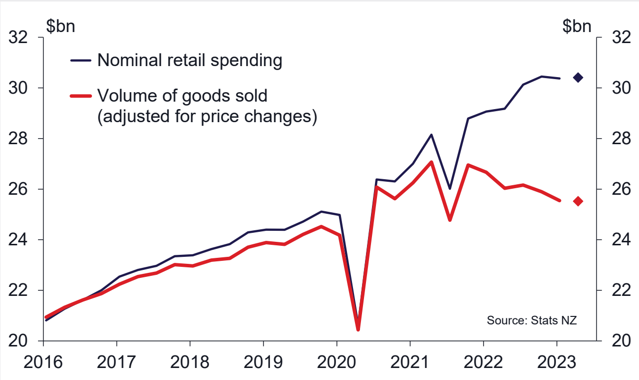
Aug 23, Last: -1.4%, Westpac f/c: -0.1%

Retail spending was weak in the March quarter. While nominal spending levels rose by 0.3%, that lift was entirely due to a sharp rise in prices. The volume of goods that households took home fell by1.4%.

Spending appetites remained subdued through the June quarter. We're forecasting another muted gain in nominal spending (+0.1%), with the volume of goods sold expected to have fallen 0.1%. Excluding the lumpy fuel and motor vehicle categories, we estimate that the volume of goods sold in 'core' retail categories fell by 1% over the June quarter.

As we've seen in recent quarters, the softness in retail spending reflects that households' purchasing power has been squeezed by both high inflation and interest rate rises.

Retail spending (including forecasts)

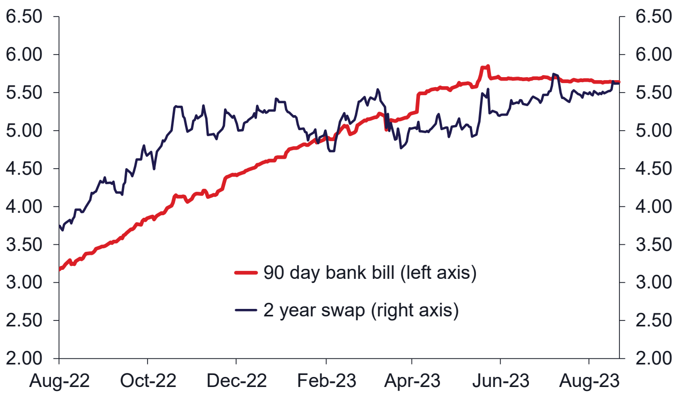


New Zealand forecasts

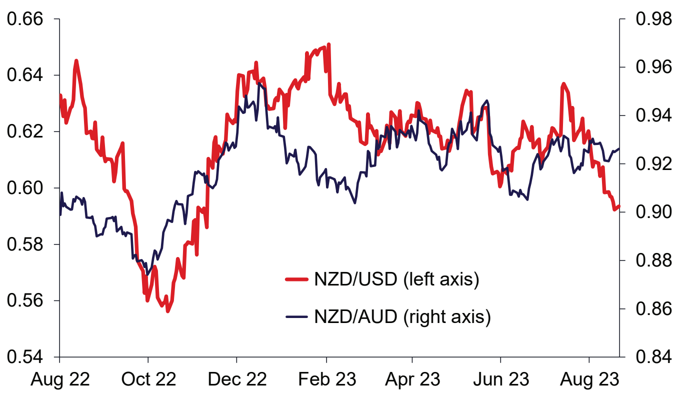
Economic forecasts	Quarterly				Annual			
	2022	2023						
% change	Dec	Mar	Jun	Sep	2021	2022	2023f	2024f
GDP (Production)	-0.7	-0.1	0.8	0.1	6.0	2.7	1.1	0.3
Employment	0.7	1.1	1.0	0.3	3.3	1.7	2.4	0.1
Unemployment Rate % s.a.	3.4	3.4	3.6	3.8	3.2	3.4	4.3	5.2
CPI	1.4	1.2	1.1	2.0	5.9	7.2	4.9	2.9
Current Account Balance % of GDP	-8.7	-8.2	-8.0	-8.2	-5.7	-8.7	-7.8	-6.0

Financial forecasts	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
Cash	5.50	5.75	5.75	5.75	5.50	5.25	5.00
90 Day bill	5.70	5.85	5.85	5.85	5.60	5.35	5.10
2 Year Swap	5.64	5.49	5.29	5.06	4.81	4.58	4.37
5 Year Swap	4.84	4.74	4.62	4.51	4.41	4.31	4.23
10 Year Bond	4.50	4.45	4.30	4.15	4.05	3.95	3.85
NZD/USD	0.62	0.63	0.63	0.64	0.65	0.66	0.66
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89	0.88
NZD/JPY	87.4	86.9	85.6	85.0	85.0	84.5	83.3
NZD/EUR	0.56	0.56	0.57	0.57	0.57	0.57	0.57
NZD/GBP	0.49	0.49	0.49	0.50	0.50	0.51	0.51
TWI	71.5	71.5	70.9	71.0	71.1	71.0	70.4

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 August 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.50%	5.50%	5.50%
30 Days	5.61%	5.61%	5.61%
60 Days	5.63%	5.63%	5.63%
90 Days	5.64%	5.64%	5.66%
2 Year Swap	5.62%	5.48%	5.48%
5 Year Swap	5.05%	4.82%	4.73%

NZ foreign currency mid-rates as at 21 August 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.5935	0.6088	0.6200
NZD/EUR	0.5459	0.5548	0.5589
NZD/GBP	0.4659	0.4783	0.4831
NZD/JPY	86.23	86.66	87.50
NZD/AUD	0.9262	0.9283	0.9188
TWI	69.80	70.84	71.37

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Jul trade balance $mn	9	–	–	Improving a touch as the heat comes out of import demand.
UK	Aug Rightmove house prices	–0.2%	–	–	Rising rates quells new demand for homes.
Tue 22					
US	Jul existing home sales	–3.3%	–0.2%	–	Sales weak and fragile as rates hold back supply.
	Aug Richmond Fed index	–9	–	–	Manufacturing weakness to persist.
	Fedspeak	–	–	–	Goolsbee & Bowman.
Wed 23					
NZ	Q2 real retail sales	–1.4%	–	–0.1%	Cost of living pressures remain a significant drag.
Jpn	Aug Nikkei manufacturing PMI	49.6	–	–	Japanese manufacturers to benefit from Asian demand.
	Aug Nikkei services PMI	53.8	–	–	Weak domestic demand points to risks for services spending.
Eur	Aug HCOB manufacturing PMI	42.7	–	–	Muted demand will drag on manufacturing outlook...
	Aug HCOB services PMI	50.9	–	–	... services faces a similar fate, given the emerging fragility...
	Aug consumer confidence	–15.1	–	–	... in consumer sentiment as a consequence of higher costs.
UK	Aug S&P Global manufacturing PMI	45.3	–	–	Manufacturing sentiment flailing...
	Aug S&P Global services PMI	51.5	–	–	... consumer demand also under pressure.
US	Aug S&P Global manufacturing PMI	49	49	–	Outlook remains cloudy for manufacturers.
	Aug S&P Global services PMI	52.3	52	–	Flow through of rates will see services demand dampen.
	Jul new home sales	–2.5%	1.40%	–	Sales remain fragile as policy stands restrictive.
Thu 24					
US	Jul Chicago Fed activity index	–0.32	–	–	Emerging risks will see activity stagnate.
	Jul durable goods orders	4.60%	–4.0%	–	Broader economic weakness starting to materialise.
	Initial jobless claims	239k	–	–	Likely to remain near its lows, for now.
	Aug Kansas City Fed index	–11	–	–	Price detail will be of key importance.
	FOMC Jackson Hole Symposium	–	–	–	24-26 August; Chair Powell to speak on August 25.
Fri 25					
US	Aug Uni. of Michigan sentiment	71.2	71.2	–	Final estimate.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022	2023f	2024f
Australia						
Real GDP %yr	1.9	-1.8	5.2	3.7	1.6	1.0
CPI inflation %yr	1.8	0.9	3.5	7.8	3.9	3.2
Unemployment rate %	5.2	6.8	4.7	3.5	3.8	4.7
Current account % of GDP	0.7	2.4	3.1	1.2	1.0	0.3
United States						
Real GDP %yr	2.3	-2.8	5.9	2.1	1.8	0.4
CPI inflation %yr	1.9	1.2	7.2	6.4	2.5	2.0
Unemployment rate %	3.7	8.1	5.4	3.6	3.6	4.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	-4.3	2.1	1.1	1.4	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.4	3.5	0.6	1.2
United Kingdom						
Real GDP %yr	1.6	-11.0	7.6	4.0	0.3	0.5
China						
Real GDP %yr	6.0	2.2	8.4	3.0	5.2	5.5
East Asia ex China						
Real GDP %yr	3.8	-2.3	4.3	4.5	3.7	4.3
World						
Real GDP %yr	2.8	-2.8	6.3	3.4	3.0	3.0

Forecasts finalised 7 August 2023

Interest rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia							
Cash	4.1	4.1	4.1	4.1	4.1	3.85	3.6
90 Day BBSW	4.15	4.3	4.3	4.3	4.22	3.97	3.72
10 Year Bond	4.24	3.75	3.55	3.45	3.3	3.25	3.2
International							
Fed Funds	5.375	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond	4.24	3.8	3.6	3.4	3.2	3.1	3

Exchange rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6402	0.67	0.68	0.69	0.71	0.73	0.74
USD/JPY	145.39	140	138	135	132	130	128
EUR/USD	1.0884	1.11	1.12	1.12	1.13	1.14	1.15
GBP/USD	1.2742	1.28	1.28	1.29	1.29	1.3	1.3
USD/CNY	7.2825	7.1	7	6.8	6.7	6.6	6.5
AUD/NZD	1.0802	1.07	1.08	1.09	1.1	1.12	1.12

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