Week beginning 22 July, 2024

AUSTRALIA & NEW ZEALAND WEEKLY

Analysis and forecasts for this week's key releases.

In this week's edition:

Economic Insight: We're just not that special.

The Week That Was: The emergence of slack.

Focus on New Zealand: RBNZ to deliver some pre-Chrismas cheer in November.

For the week ahead:

Australia: no releases of note.

New Zealand: trade balance, consumer confidence.

United States: Q2 GDP, PCE deflator, personal income and spending, durable goods orders.

Eurozone: IFO business climate survey, consumer confidence.

Global: S&P Global PMIs.

Information contained in this report current as at 19 July 2024

We're just not that special

Luci Ellis
Chief Economist, Westpac Group

Recent inflation data overseas has reminded market participants that sticky inflation need not imply stuck inflation. After a few wobbles, disinflation has resumed in the United States, Canada and New Zealand.

Expectations of near-term cuts in policy rates have therefore come back into frame in the United States and New Zealand; the Bank of Canada has already started cutting, as have the ECB and several other European central banks. Our Chief Economist in New Zealand, Kelly Eckhold, has changed his rate call and now expects the RBNZ to start cutting from November.

The logic behind all these central bank moves is the same. First, tight policy cannot last forever, else inflation would fall continuously and undershoot central banks' targets. Second, because monetary policy affects inflation with a lag, the rate-cutting phase needs to start before inflation has reached target. Otherwise, policymakers will have acted too late. At some point before reaching target, therefore, central banks need to start reducing the restrictiveness of policy and head towards neutral. Australia is no different to its peers in this regard.

As we have previously argued, there is no reason for the RBA to move in lockstep with its peers. At times, the RBA and the Fed have even moved in opposite directions. But there are limits to divergence. In the current inflation episode, most of the surge reflected a common, pandemic-related shock. Most private sector forecasters expect inflation in Australia to decline into the 2–3% target range at a similar pace to the RBA's own forecasts – though there are outliers. Anyone arguing that the RBA is a long way from cutting would need to show why Australia would not follow the same broad disinflation trend as its peers.

Common and uncommon shocks

Australia was later to open up after the pandemic than most other advanced economies, and so was later to see the surge in inflation. The RBA is also deliberately choosing a 'not quite as high for a bit longer' strategy, in order to hold onto the gains made in getting unemployment down. So there is good reason to expect the RBA to be among the last of the advanced economy central banks to start cutting rates.

The question is, how much later than its peers will the RBA move if the forces driving the inflation process are mostly similar?

There are some Australian-specific factors to consider, but they fall on both sides of the ledger. Housing-related costs are clearly an issue. Part of this is the result of pandemic-era supply chain issues lifting materials prices and so the cost of home-building, but that was a common shock. The catch-up surge in population after the international borders reopened was also common to some peer economies including Canada. This catch-up has boosted demand for housing, lifting both home-building costs and rents, but the boost to inflation – and the drag on productivity – will subside over time as population growth normalises.

A possible Australian-specific factor, as we have previously noted, is that home-building cost inflation has remained higher than in some peers. Recent headlines might suggest a partial explanation for this, though of course other Australia-specific factors could also be at play.

On the other side, though, pass-through of policy rates to lending rates is particularly strong in Australia; IMF analysis in its April World Economic Outlook highlighted this. And unlike some peer economies such as the United States and United Kingdom, growth in the labour supply has remained very strong, slightly outstripping that in labour demand. This is partly because recent migration has been even more skewed to working-age people than usual, so growth of the working-age population has outpaced that of the population overall. In addition, as noted by Westpac Economics colleague Ryan Wells yesterday, the participation rate among those working-age residents remains at historically high levels. Most measures of labour market tightness are well off their highs and wages growth in Australia has already peaked.

The Toyota 'Five Whys'

The 'Five Whys' is a tool developed at Toyota for root-cause analysis. It boils down to asking 'why?' at least five times. If your first answer is that B caused A, ask why B happened. And then ask why that happened, and so on. This approach to understanding can be as useful in economics as it is in manufacturing.

In thinking about why the RBA policy path might differ from that of its peers from here, it is sometimes argued that inflation will remain stickier here because the RBA chose that 'not quite as high for longer' policy path.

The difficulty with that argument is that we are only talking about a percentage point or so difference in policy rates, for a year or so. Most models of the Australian economy – including the RBA's main whole-economy model – imply that if the policy rate is 100 basis points higher for a year or so, the peak effect of this on inflation is a reduction of a little less than 0.2 percentage points, about two years later. (If this sounds small to you, you have just discovered the dirty little secret of monetary policy: modest changes in the level of policy interest rates or their timing have only a barely perceptible effect on the policy objective.)

The second 'why' then becomes: why would one think that 100 basis points should make so much difference now? Maybe it does, but what is the mechanism? What makes Australia so special, and why now, not at other times?

As we have previously noted, an unexpectedly ugly June quarter CPI result might make the RBA want to wait even longer. But would it be enough to convince it that Australia is on a completely different path to its peers?

The world has been confronted with some seriously unusual shocks over the past few years. And as we have seen over the past week, there are some situations where a small difference in position can make a huge difference to the outcome.

Looking through the noise, though, it is hard to see why those unusual shocks should play out so differently here than elsewhere.

Perhaps we need to remind ourselves that we are just not that special.

Cliff Notes: the emergence of slack

Elliot Clarke, Head of International Economics
Ryan Wells & Illiana Jain, Economists

It was a relatively quiet week in Australia, with the June Labour Force Survey the only market sensitive date release. The main surprise in the report was labour supply's strength, evinced by the participation rate printing its second-highest read for the cycle at 66.9%. The level of employment also rose at a solid clip in June, up +50.2k for a cumulative gain of a quarter-million over H1 2024, the same pace as H1 2023 when the labour market was much 'tighter'. It is worth noting that employment is behaving as expected given the trend in participation – the percentage increase in both measures over the last three months is well within the historical range. While both were robust, labour supply slightly outstripped demand in the month, resulting in the unemployment rate just rounding up to 4.1%.

"These results are unlikely to drive any material change in the RBA's view of the labour market."

Employment has transitioned from outpacing population growth to now tracking broadly in line, pointing to balance between labour demand and supply. The unemployment rate gradually ticking higher, as a consequence of labour supply outstripping still-resilient labour demand, is consistent with the RBA achieving a 'soft' landing. Looking ahead, the Q2 CPI (due July 31) will prove critical to assessing the near-term outlook for policy. In this week's essay, Chief Economist Luci Ellis discusses recent international developments with disinflation and the similarity of Australia's experience.

Across in New Zealand, this week's Q2 CPI shifted the debate around the policy outlook. The below expectations Q2 print of 0.4% resulted in annual inflation moderating from 4.0%yr in Q1 to 3.3%yr in Q2. Our New Zealand team now expects annual inflation to fall below 3.0%yr in Q3 and to then continue to decelerate towards 2.0%yr into 2025. This trend will allow the RBNZ to place a greater weight on activity data, which has been recessionary for a few months, and to bring forward their first cut to November. Westpac NZ economics sees an earlier cut in October as around a 30% chance.

Further afield, the European Central Bank kept rates steady at their July meeting and made clear policy would be decided meeting by meeting. At this stage, September is regarded as "wide open". President Lagarde also emphasised the ECB is looking at a range of data not one particular variable. The Governing Council view policy as restrictive. The Bank Lending Survey, released earlier in the week, support this perspective, highlighting that credit conditions are tight and loan demand sluggish, particularly among corporates. Going ahead, the ECB will be mindful of underlying strength in the labour market and an expected acceleration in activity growth into 2025; but inflation trending sustainably to target should instil confidence in a succession of rate cuts towards neutral.

In the UK meanwhile, key data ahead of the August meeting made clear the complexity of the task before the Bank of England. The headline CPI rose 2.0%yr in June, consistent with the May print and their medium-term policy target. However, both core inflation and services inflation remained unchanged at an elevated level, 3.5%yr and 5.7%yr respectively. Wages also rose 5.7%yr in May, continuing their downtrend but still elevated versus history. Significant further progress with wages is necessary to quell services inflation. In this light, while annual headline inflation is at target, the Bank of England may choose to hold in August and wait to September to cut.

"The BoE's August decision is likely to be finely balanced; the market views it as such, with a cut seen as a roughly 50/50 proposition."

US retail sales were flat in June after an upward revision in May from 0.1% to 0.3%. The sales control group, which feeds into GDP calculations, was robust at 0.9% in June, up from 0.4% in May. Though, year-to-date, growth in control group sales remains weak, having averaged a gain of around 0.2% per month, less than half of 2023's pace. While decelerating inflation and the promise of rate cuts are supportive of spending, growing uncertainty over the labour market should restrict consumption to a modest pace through the remainder of 2024.

Taking a broader view, the FOMC's Beige Book for July signalled the economy is softening and price conditions are consistent with a return to target inflation. Respondents noted that activity was maintaining "a slight to modest pace" in aggregate, but five districts reported "flat or declining activity". On employment, "Most districts reported employment was flat or up slightly" and wages grew at a "modest to moderate pace", in part because of improved labour availability. Price increases were "modest" overall, with a "couple" of districts noting only "slight increases".

Finally to China, where the economy expanded 0.7%qtr in Q2 and 5.0% year-to-date. This puts the economy on track to achieve the 5.0% growth target set for 2024 overall, even without active government support. Growth is being fuelled by capacity expansion and a drive to increase value add, principally to meet foreign demand. Fixed asset investment growth of 8.5%ytd (excluding property) against a 10% decline in property investment and retail sales growth of just 3.7%ytd highlights that the consumer has, to date, missed out on the dividends from trade.

> **"This situation has to change if downside risks are to abate and the government's medium-term objectives for the whole economy met."**

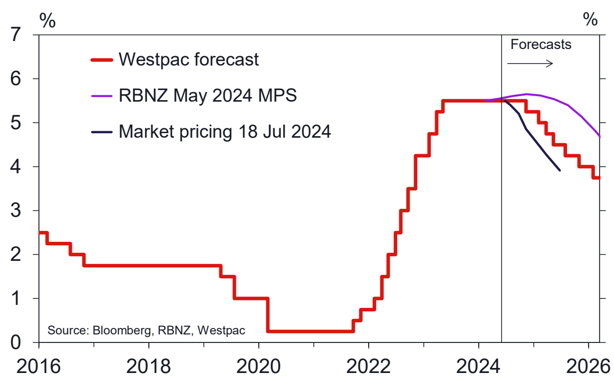
This week also saw the conclusion of China's latest Plenum. There was no change in the priorities of officials, with "high-quality development" remaining the focus and the property market receiving little attention. The reference to "actively expanding domestic demand" does not necessarily mean the consumer will receive immediate or significant support. Rather, it is more likely the central Government will focus on public and private investment, anticipating this activity will support employment and confidence and consequently stronger consumer demand. Further detail is likely to be provided in coming weeks, with a Politburo meeting scheduled for month end.

RBNZ to deliver some pre-Christmas cheer in November

Satish Ranchhod
Senior Economist NZ

We have brought our forecast for Official Cash Rate reductions from the Reserve Bank of New Zealand forward by a few months. We now expect the RBNZ to cut the OCR by 25bp at the November Monetary Policy Statement. Thereafter we expect 25bp cuts at each of the first three meetings of 2025 (February, April, and May) which will take the OCR to 4.5% by mid-2025. After that, we think the RBNZ will take a more cautious data-dependent approach and reduce the OCR gradually to a terminal rate of 3.75% in early 2026.

RBNZ official cash rate



OCR cuts set to come much earlier than the RBNZ previously signalled

Previously, we had forecast that the RBNZ would remain on hold until February 2025. However, with both activity and inflation turning down, and a dovish tilt from the RBNZ themselves, we now expect that policy easing will begin sooner than previously anticipated, with rate cuts now expected to begin in November of this year.

The RBNZ indicated in their July policy review, unexpectedly, a willingness to consider "tempering" the degree of policy restriction. That was a marked shift in tone from their previous policy update just six weeks earlier where they had signalled no rate cuts until August 2025 and a slight chance of another rate hike. As we indicated in our review note, we thought the RBNZ's stark change in tone reflected the much weaker data flow seen in the last few months. The RBNZ also sounded more confident about the outlook for inflation, noting that it is expected to return within the target range "in the second half of the year." Previously, the RBNZ noted that this was expected to occur "by the end of 2024."

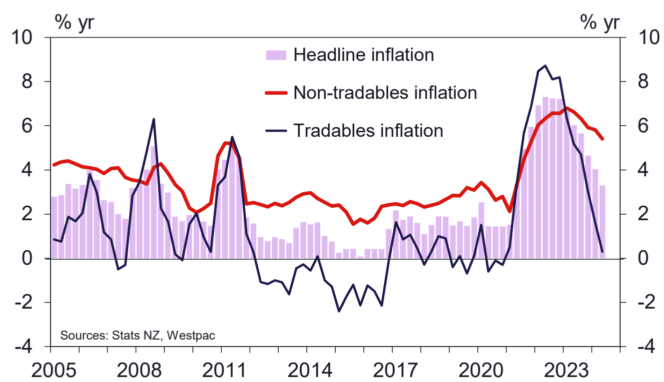
Inflation has dropped back and is set to continue falling

With that change in tone from the RBNZ, the softer than expected June quarter inflation report was a critical development. Consumer prices rose by 0.4% in the June quarter – lower than the 0.6% rise that we and the RBNZ had expected. That saw the annual inflation rate fall from 4.0% in the March quarter to 3.3%.

The details of the inflation report were not a clear green light for immediate rate cuts. The drop in inflation has mainly been a result of lower prices for imported retail goods, like household furnishings and apparel. However, domestic inflation pressures remain strong. And that's not just due to the costs for items like insurance or council rates –prices for domestic services more generally are continuing to rise at a solid pace.

Even so, underlying inflation pressures have been softening, with core inflation measures dropping back from over 4% earlier in the year to around 3.5% now. Looking forward, the trajectory for inflation over the rest of this year is downwards with inflation set to fall back inside the RBNZ's 1-3% target band in Q3.

Domestic components of inflation still strong



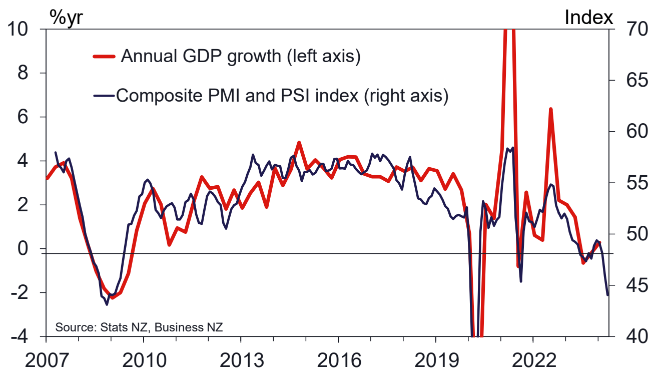
Economic momentum is flagging

There has been a marked downturn in economic activity in recent months:

- In the household sector, New Zealand families have been winding back their spending in response to cost-of-living pressures, high interest rates and a softening labour market. That's seen retail spending falling for the past five months, including a 0.6% decline in June.
- Similarly, businesses across the economy are reporting a softening in demand and orders, with both the PMI and PSI dropping to low levels in June.
- Against that backdrop, job growth has stalled, falling behind the rate of population growth. The number of job advertisements has also fallen.

In light of those developments, we now see significant downside risk to our forecast of a 0.2% fall in June quarter GDP, with the related risk that unemployment rises by more than our forecast of a lift to 4.6%. The RBNZ will also likely be revising down its near-term economic view.

PMI indicators point to weak outlook for GDP



What to watch

This lower inflation/growth combination looks consistent with some past episodes where the RBNZ has begun easing even while inflation was outside of the target range. These have been episodes where growth was weak, and hence there was confidence that inflation would trend significantly lower over time. We think that the RBNZ is close to meeting this threshold now.

The RBNZ will release new forecasts as part of its upcoming Monetary Policy Statement on 14 August. We would expect those forecasts will incorporate a significant downgrade in its inflation and OCR forecasts. In the case of the OCR we expect something closer to the scenario they presented in May 2023. This implied a probability of an easing in October and a very likely easing at the November Statement.

While our central forecast is for a November rate cut, we see a 30% chance of an earlier cut in October. In contrast, financial markets have priced in a roughly 40% chance of a rate cut in August and have more than fully priced in a cut by the time of the October meeting.

We think the RBNZ will be very data-driven in terms of the timing of the first rate cut. Upcoming labour market data will be a key focus (the June quarter update is out on 7 August). We'll also be keeping a close eye on the June quarter GDP report, as well as higher frequency indicators of economic activity like the PMIs, retail sales and business confidence surveys. Finally, Stats NZ's recently introduced monthly Selected Price Indices (which provide timely updates on 45% of the CPI basket) will also merit close attention.

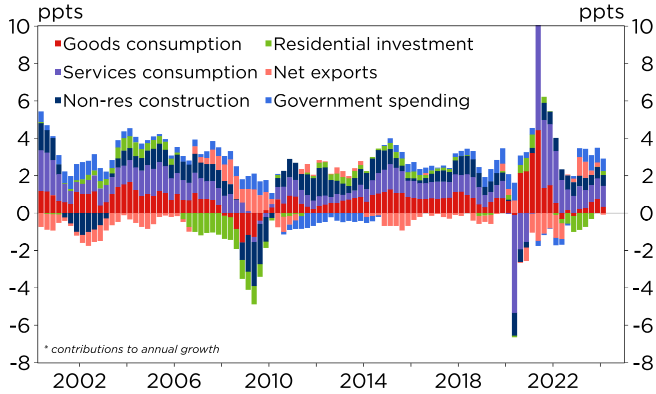
US: Q2 GDP (%qtr annualised)

Jul 25, Last: 1.4%, Market f/c: 1.8%, Westpac f/c: 2.2%

US GDP is expected to strengthen in Q2. However, growth in domestic demand will soften as consumer demand and investment growth moderate. Labour market slack is beginning to build at the margin, creating a degree of uncertainty over the outlook.

Leading indicators of business investment also point to a circumspect view. The FOMC wants to see growth slow near trend, which it is. Downside risks are present, but limited heading into the second half of the year.

US growth moderating to around trend



Source: BEA, Macrobond, Westpac Economics

Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

What to watch

	For	Data/Event	Unit	Last	Market f/c	Westpac f/c	Risk/Comment
Mon 22							
NZ	Jun	Trade Balance	$mn	204	–	100	Exports are moving past their seasonal peak.
US	Jun	Chicago Fed Activity Index	pts	0.18	–0.06	–	The economy has moved into balance.
Tue 23							
Eur	Jul	Consumer Confidence	pts	–14.0	–13.8	–	Rate cuts are supporting confidence.
US	Jul	Richmond Fed Index	pts	–10	–7	–	Manufacturing conditions remain weak across the board.
	Jun	Existing Home Sales	%mth	–0.7	–2.7	–	Low inventory is weighing on sales.
Wed 24							
Jpn	Jul	Jibun Bank Manufacturing PMI	pts	50.0	–	–	Japan's manufacturers are losing competitive advantage…
	Jul	Jibun Bank Services PMI	pts	49.4	–	–	… despite the weak Yen which is aiding services.
Eur	Jul	HCOB Manufacturing PMI	pts	45.8	46.3	–	Europe's manufacturing sector is also experiencing tough…
	Jul	HCOB Services PMI	pts	52.8	53.0	–	… conditions, but tourism is attracting robust demand.
UK	Jul	S&P Global Manufacturing PMI	pts	50.9	51.2	–	Election result provides greater certainty over political…
	Jul	S&P Global Services PMI	pts	52.1	52.5	–	… outlook and chances of fiscal support if necessary.
US	Jul	S&P Global Manufacturing PMI	pts	51.6	–	–	Mixed conditions are being seen across industry sectors.
	Jul	S&P Global Services PMI	pts	55.3	–	–	Political certainty and monetary easing necessary.
	Jun	Wholesale Inventories	%mth	0.6	–	–	Uncertain demand, a challenge for inventory management.
	Jun	New Home Sales	%mth	–11.3	3.4	–	New builds dissuaded by high financing costs.
		Fedspeak	–	–	–	–	Bowman, Logan
Thu 25							
Eur	Jun	M3 Money Supply	%yr	1.6	1.8	–	Easing policy should support M3 growth.
Ger	Jul	IFO Business Climate Survey	pts	88.6	89.0	–	Confidence returning, but slowly.
US	Q2	GDP (Annualised)	%qtr	1.4	1.8	2.2	Growth has slowed to near trend in H1 2024.
	Jun	Durable Goods Orders	%mth	0.1	0.5	–	Investment outlook challenged by politics and cycle.
	Jul	Kansas City Fed Index	pts	–8	–6	–	Regional surveys showing considerable volatility.
	Jul 20	Initial Jobless Claims	000's	243	–	–	To remain low, for now.
Fri 26							
NZ	Jul	ANZ Consumer Confidence	pts	83.2	–	–	Household budgets remain under pressure.
Jpn	Jul	Tokyo CPI	%yr	2.3	2.3	–	Momentum in inflation abating.
US	Jun	Personal Income	%mth	0.5	0.4	0.3	Softer labour market to weigh on income growth…
	Jun	Personal Spending	%mth	0.2	0.2	0.2	… and, in time, on consumption…
	Jun	PCE Deflator	%mth	0.0	0.1	0.1	… allowing inflation to converge with target.
	Jul	Uni. of Michigan Sentiment	pts	66.0	–	–	Final estimate.

Economic & financial forecasts

Interest rate forecasts

Australia	Latest (19 Jul)	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
Cash	4.35	4.35	4.10	3.85	3.60	3.35	3.10	3.10	3.10	3.10	3.10
90 Day BBSW	4.47	4.42	4.19	3.96	3.75	3.55	3.30	3.30	3.30	3.30	3.30
3 Year Swap	4.07	4.10	4.00	3.85	3.70	3.60	3.50	3.50	3.50	3.55	3.60
3 Year Bond	4.01	3.90	3.80	3.65	3.50	3.40	3.30	3.30	3.30	3.35	3.40
10 Year Bond	4.29	4.30	4.25	4.20	4.10	4.00	4.00	4.00	4.05	4.10	4.15
10 Year Spread to US (bps)	8	-10	-5	0	0	0	0	0	0	5	5
United States											
Fed Funds	5.375	5.125	4.875	4.625	4.375	4.125	3.875	3.625	3.375	3.375	3.375
US 10 Year Bond	4.21	4.40	4.30	4.20	4.10	4.00	4.00	4.00	4.05	4.05	4.10
New Zealand											
Cash	5.50	5.50	5.25	5.00	4.50	4.25	4.00	3.75	3.75	3.75	3.75
90 day bill	5.54	5.50	5.25	4.80	4.50	4.25	4.00	3.85	3.85	3.85	3.85
2 year swap	4.34	4.30	4.20	4.00	3.90	3.80	3.80	3.85	3.95	4.00	4.00
10 Year Bond	4.37	4.40	4.35	4.30	4.25	4.20	4.20	4.25	4.30	4.30	4.35
10 Year spread to US	16	0	5	10	15	20	20	25	25	25	25

Exchange rate forecasts

	Latest (19 Jul)	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
AUD/USD	0.6701	0.66	0.67	0.68	0.69	0.70	0.71	0.72	0.72	0.73	0.73
NZD/USD	0.6028	0.60	0.61	0.62	0.63	0.64	0.65	0.65	0.65	0.65	0.65
USD/JPY	157.83	159	158	156	153	150	147	144	141	138	135
EUR/USD	1.0888	1.09	1.10	1.11	1.12	1.13	1.14	1.14	1.14	1.15	1.15
GBP/USD	1.2938	1.27	1.28	1.29	1.30	1.31	1.31	1.31	1.31	1.31	1.31
USD/CNY	7.2675	7.20	7.10	7.05	7.00	6.90	6.80	6.70	6.60	6.55	6.50
AUD/NZD	1..1116	1.10	1.10	1.10	1.10	1.10	1.10	1.11	1.11	1.12	1.12

Australian economic growth forecasts

	2024				2025				Calendar years			
% Change	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	2023	2024f	2025f	2026f
GDP % qtr	0.1	0.3	0.6	0.5	0.5	0.6	0.6	0.7	–	–	–	–
%yr end	1.1	1.0	1.4	1.6	2.0	2.2	2.2	2.3	1.6	1.6	2.3	3.5
Unemployment rate %	3.9	4.0	4.2	4.3	4.4	4.5	4.6	4.6	3.9	4.3	4.6	4.5
Wages (WPI)	0.8	0.8	0.7	0.7	0.7	0.8	0.8	0.8	–	–	–	–
annual chg	4.1	3.9	3.4	3.0	2.9	2.8	2.9	3.0	4.2	3.0	3.0	3.3
CPI Headline	1.0	1.0	0.1	0.8	0.7	0.8	0.9	0.6	–	–	–	–
annual chg	3.6	3.8	2.7	2.9	2.7	2.4	3.2	3.1	4.1	2.9	3.1	2.8
Trimmed mean	1.0	0.9	0.8	0.7	0.7	0.7	0.7	0.6	–	–	–	–
annual chg	4.0	4.0	3.6	3.5	3.2	3.0	2.8	2.8	4.2	3.5	2.8	2.6

New Zealand economic growth forecasts

	2024				2025				Calendar years			
% Change	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	2023	2024f	2025f	2026f
GDP % qtr	0.2	-0.2	0.3	0.3	0.5	0.5	0.7	0.7	–	–	–	–
Annual avg change	0.2	-0.2	0.0	0.2	0.4	0.9	1.3	1.8	0.6	0.2	1.8	3.2
Unemployment rate %	4.3	4.6	4.9	5.2	5.3	5.4	5.4	5.4	4.0	5.2	5.4	4.7
CPI % qtr	0.6	0.4	1.1	0.4	0.4	0.4	0.8	0.5	–	–	–	–
Annual change	4.0	3.3	2.6	2.5	2.3	2.3	2.0	2.1	4.7	2.5	2.1	2.2

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