



# ECONOMIC BULLETIN

Hawks, doves, and kiwis.



26 Sep 2024 | **Westpac Economics Team** | [westpac.co.nz/economics](https://westpac.co.nz/economics) | [economics@westpac.co.nz](mailto:economics@westpac.co.nz)  
**Kelly Eckhold**, Chief Economist | +64 21 786 758 | [kelly.eckhold@westpac.co.nz](mailto:kelly.eckhold@westpac.co.nz) | X: @kellyenz

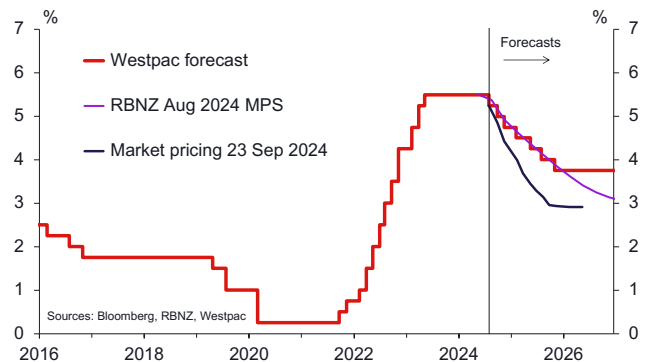
## Overview.

Much has changed since we wrote our last “Hawks and doves” report in May. Events have unfolded in the dove’s favour, with many of the dovish arguments we posed in that report playing out to varying degrees in recent months. Some indicators suggested the economy has weakened sharply, which was a key factor behind the RBNZ’s dovish lurch. Other supporting factors have been a better short term inflation outlook as the prices of imported retail goods have driven a quicker than expected decline in headline inflation, which in turn may have contributed to a further decline in inflation expectations. The RBNZ now feels it can reorientate its reaction function from bringing inflation down to supporting demand and employment.

With an easing cycle underway, the debate now is mainly about the likely speed, duration and depth of that cycle. Hawks will likely be concerned the current decline in inflation will stall out in the top half of the target range. This could especially happen if the domestic economy responds meaningfully to the recent marked easing of monetary conditions or if the substantial tail winds from falling global import and food prices abates. Doves think monetary policy is behind the curve, that conditions remain far too tight, and as such the risks to growth and inflation are significantly to the downside.

With arguments on both sides, the Westpac Economics team has again been considering how the outlook for monetary policy might evolve over the coming year or so. To help organise our thoughts and promote debate, we have marshalled a range of hawkish and dovish considerations that, while not exhaustive, might be debated by those driving the future direction of policy over the coming year and those preparing to deal with it in their businesses. As always, we invite feedback on the perspectives we discuss here and any additional relevant viewpoints.

## Official Cash Rate forecasts

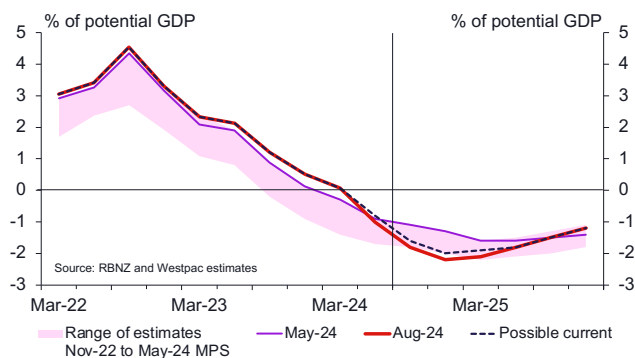


## The Hawk’s Eye View.

The economy was nowhere near as weak mid-year as the RBNZ feared when they pivoted sharply towards aggressive easing.

- High frequency indicators that suggested very weak activity in the June quarter were misleading, with June quarter GDP no weaker than seen since mid-2022.
- This questions the dove’s narrative that recent weak indicators reflect the lags from tight policy settings. We are at peak transmission now so we shouldn’t expect weaker outcomes than we have already seen.
- Consumption and investment spending have been stronger than consistent with very tight policy settings. We are likely close to the bottom of these cycles without a new shock.
- June quarter unemployment was lower than expected, and more recent data don’t indicate that the labour market is weakening any more than forecast. Weekly filled jobs have been flat since July suggesting a stable albeit deteriorating trend.
- The bottom line is that revised forecasts will show less excess capacity than previously assumed – and this was crucial to the case for front loaded easing.

### Range of RBNZ Output gap estimates since end 2022



We are living beyond our means even with interest rates over 5%. This suggests the productive capacity of the economy is weak and significant easing will reignite inflation pressures before long.

- Recent current account data show the deficit is structurally weak even while interest rates have been at peak transmission.
- Domestically generated inflation is hence still far too high – even after considering more exogenously driven factors such as local authority rates and insurance.
- This all strongly suggests weak productivity and potential output growth. Even though the economy has been slowly drifting backwards since mid-2022 by a total of 0.8% of GDP, this hasn't opened a sufficiently negative output gap.
- Deep, front loaded interest rate cuts may reignite inflation as even a modest boost in growth will eliminate the required negative output gap.
- Lower interest rates can't solve structural growth problems - they will just make the consequences worse.

Domestic inflation pressures remain elevated, suggesting that the RBNZ should take a cautious approach to policy easing.

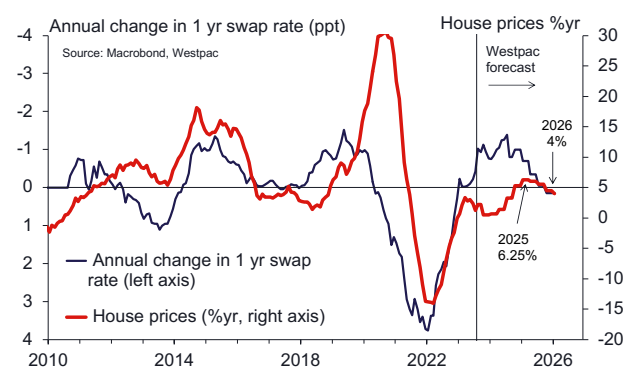
- While headline inflation will soon be back inside the target range, this mostly reflects weak prices for internationally traded goods.
- In contrast, domestic inflation remains elevated. So, although headline inflation is set to drop below 3% later this year, a return to 2% is still some way off, especially if global economic growth strengthens and begins to lift tradables prices.
- Costs and pricing intentions indicators are still elevated suggesting a rump of businesses with pricing power remain who will deploy that power on recovery of demand.
- Construction costs are a good example – despite the sector being at cyclical lows, construction costs have been increasing in recent quarters.

- The RBNZ will be mindful of the risks that easing policy too quickly could prevent the further disinflation that is needed in the non-tradables sector. Consequently, they will retain a cautious approach even as headline inflation declines to the midpoint or even into the lower half of the target range.

A key lesson from the pandemic is that monetary policy works and rapid changes in interest rates can generate large changes in demand and inflation. There has already been a marked easing of financial conditions since June, which means many borrowers already are benefitting from at least neutral financial conditions. Further sharp reductions in interest rates would throw petrol on the simmering embers of the housing market and reignite inflation.

- Corporate and agriculture sector borrowers can now access forward starting borrowing rates at levels not seen since 2021. The easing in rates to date has already supported a lift in business sentiment.
- Housing market participants are set to benefit relatively quickly given **a large portion of mortgages are repricing over the next six months.**
- Conditions that will support a bounce back in the housing market are already in place. There is a large cohort of buyers who have been on the sidelines for 2-3 years. In addition, investors now have a much more advantageous tax environment. And banks are ready and keen to lend.

### The lower OCR should support housing – based on current OCR forecast



Rising commodity prices already point to an improved outlook for the rural sector.

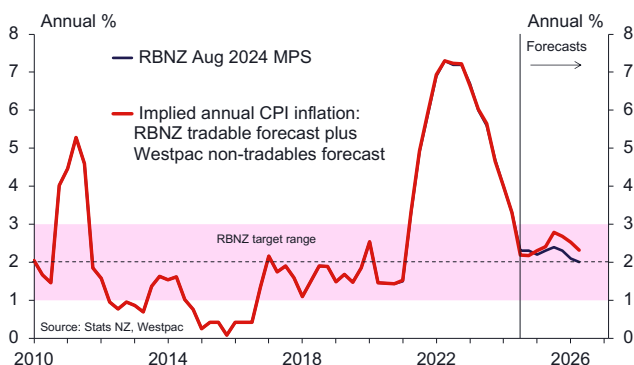
- Significant increases in dairy prices combined with falling energy and manufactured goods prices have boosted the terms of trade.
- Meat prices are now rising from low levels due to weak supply conditions among competitors.
- Lower global interest rates will ultimately add demand to this constrained supply picture.
- Confidence is stronger in the regions than urban areas reflecting the more positive outlook.

- The stronger primary sector seems likely to add income to the economy that will eventually spread to the urban areas. We are on the upswing now even though the Chinese economy is structurally weak.

It's going to be much harder to reduce headline inflation from here.

- We are now almost past the period where the headline inflation rate is flattered by older very high quarterly outcomes dropping out of the calculation.
- Forecasts for average quarterly inflation over 2025 and 2026 are in line with outcomes seen since late 2023. Those 2023 and 2024 outcomes were mainly driven by falling imported inflation which is now running at very low levels. This likely won't continue.
- Combining the RBNZ's less sanguine forecasts for tradables inflation with Westpac's forecasts of non-tradable inflation highlights the risk that, without a reduction in domestic pricing behaviour, inflation could bounce off 2% and head higher as the economy strengthens.

### The headline CPI may struggle to fall from here



### The Dove's Tale.

Inflation is no-longer a barrier to rate reductions. This means the RBNZ can reorient its focus to avoiding unnecessary instability in output and employment (as referred to in its remit). Moving quickly could help to fend off a deeper than needed slowdown in activity, the labour market or inflation that could necessitate a deeper easing cycle down the line.

- Inflation is set to be comfortably within the RBNZ's target band over the coming year. Inflation has already fallen from over 7% in 2022 to 3.3% in the June quarter. It's set to drop to 2.4% in the September quarter and continue softening over the year ahead. Measures of inflation expectations have already dropped back and are consistent with the 2% target mid-point.
- Weakness in demand has seen significant slack in the economy opening up. GDP has been nudging down since late 2022 and the negative output gap

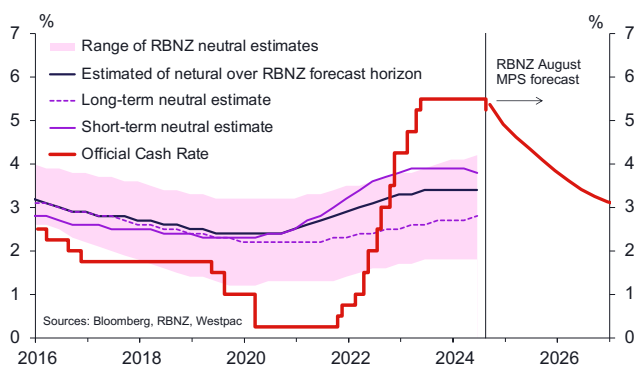
is estimated to have increased to around >1%. With demand likely to remain muted through the back part of 2024, spare capacity is set to continue building.

- Slack is also accumulating in the labour market, with unemployment pushing above the NAIRU. The unemployment rate rose to a three-year high of 4.6% in the June quarter. Since then, monthly filled jobs and job advertisements have fallen. Unemployment is set to rise to 5% by the end of this year.

The OCR needs to continue to move lower to preserve the necessary easing of financial conditions that has occurred since July.

- The OCR and shorter-term interest rates remain at levels that are continuing to significantly restrain demand at a time when the CPI will soon be close to the target midpoint and when the economy is increasingly operating with spare capacity.
- Cutting the OCR in line with market expectations is required to ensure that financial conditions don't retighten, dashing fragile business and consumer confidence.
- A faster reduction in rates would help to return domestic demand to normal levels over the year ahead, rather than pushing it into a position of excess demand / strong inflation pressures as hawks' fear.
- A series of frontloaded 50bps easings would open the possibility of returning the OCR to more neutral levels over the next six months, with the ability to slow the speed of easing next year if the economy responds strongly to the initial easings.

### Official Cash Rate and RBNZ estimates of neutral



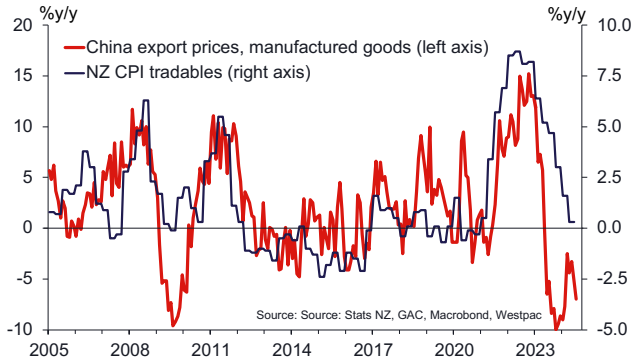
China poses a significant global deflationary risk, just as it did in the 2010s.

- The Chinese economy has slowed this year as structural factors, especially in the property market, have continued to weigh. Geopolitical tensions have the potential to exacerbate pressures on the Chinese economy over the coming year.
- China is likely to export its excess capacity to the world, putting downward pressure on inflation. If China's exports are blocked or impeded by tariffs in the

US in Europe, the downward pressure on prices will be even greater.

- Chinese inflation is already weakening with the PPI deflating and monetary indicators suggesting that the pace of deflation could pick up in coming months and exceed the already significant disinflation implied by our forecasts.

**China is once more a source of downside CPI risk**



Broader downside risks to global growth are also in play and could exacerbate an already soft domestic economy.

- While global monetary policy easing is expected to support growth over the coming year or so, monetary policy could be working against significant headwinds.
- The US economy has outperformed in the post-Covid era, supported by expansionary fiscal policy, excess savings accumulated during the pandemic and households' willingness to reduce their savings rate to a low level. There is limited scope for these factors to continue to drive growth.
- Investors have driven stock prices to high levels, especially for AI and tech-related companies. If these levels prove not to be supported by future earnings, a correlation in the stock market could be the catalyst for an economic downturn.

Fiscal policy is likely to remain on a tightening path for an extended period. If it needs to tighten more than currently anticipated, monetary policy may need to eventually play a positive role in maintaining aggregate growth at trend levels to avoid a build-up of economic slack.

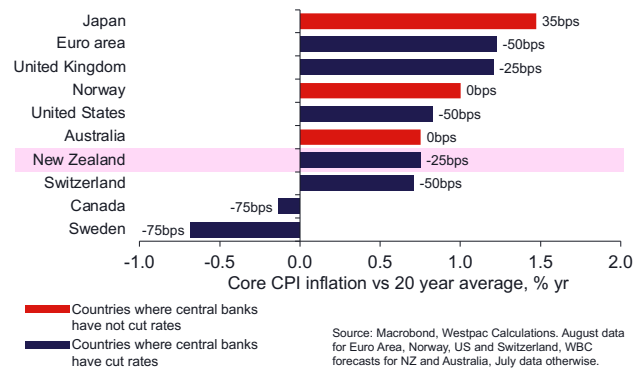
- While tax cuts are providing an offset to government expenditure cuts in the current fiscal year, the outlook for future years is for a concerted tightening of fiscal policy as the Government aims to restore an operating surplus by 2027/28 – a goal that the credit rating agencies will be watching closely.
- Given the weaker performance of the economy relative to Budget forecasts, the degree of fiscal tightening required to achieve this goal is likely greater than previously forecast. This might cause the Government to take an even more disciplined approach to spending or seek new revenue.

- Constraints on government spending will be greater still if productivity growth and thus trend economic growth remains weak, causing tax revenue to continue to fall short of forecasts.

The global interest rate cycle is turning decisively lower and New Zealand interest rates will follow suit.

- The US Federal Reserve has started easing with a large cut and has indicated an intention to reduce its policy rate by 100bps by Christmas.
- Many other advanced economies have cut policy rates by at least as much as the RBNZ even though the New Zealand growth data looks relatively weak.
- The RBNZ may need to step up the pace of easing to ensure the degree of policy restrictiveness doesn't get out of line with other jurisdictions, thus putting unwanted upward pressure on the NZ dollar.
- If the US takes its policy rate 100bps lower by Christmas, then the RBNZ should have at least that much off its rate. Two 50bp cuts might be necessary, especially if the economy doesn't respond quickly to the change in stance already signalled.

**Core CPI inflation vs 20-year average & 2024 change in policy rate**



# CONTACT

**Westpac Economics Team** | [westpac.co.nz/economics](https://westpac.co.nz/economics) | [economics@westpac.co.nz](mailto:economics@westpac.co.nz)

**Kelly Eckhold**, Chief Economist | +64 9 348 9382 | +64 21 786 758 | [kelly.eckhold@westpac.co.nz](mailto:kelly.eckhold@westpac.co.nz)

**Satish Ranchhod**, Senior Economist | +64 9 336 5668 | +64 21 710 852 | [satish.ranchhod@westpac.co.nz](mailto:satish.ranchhod@westpac.co.nz)

**Darren Gibbs**, Senior Economist | +64 9 367 3368 | +64 21 794 292 | [darren.gibbs@westpac.co.nz](mailto:darren.gibbs@westpac.co.nz)

**Michael Gordon**, Senior Economist | +64 9 336 5670 | +64 21 749 506 | [michael.gordon@westpac.co.nz](mailto:michael.gordon@westpac.co.nz)

**Paul Clark**, Industry Economist | +64 9 336 5656 | +64 21 713 704 | [paul.clark@westpac.co.nz](mailto:paul.clark@westpac.co.nz)

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