ECONOMIC BULLETIN

Hawks, doves, and kiwis.

21 May 2025 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz
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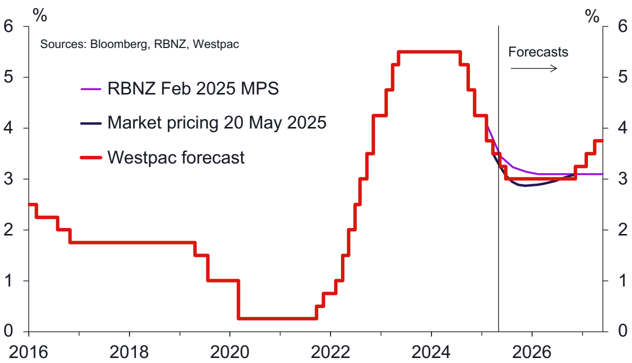
Overview.

Official Cash Rate forecasts



It's been a tumultuous few months since our last update, with plenty of news to ruffle the feathers on all sides of the monetary policy debate.

Of course, much of the focus for financial markets has been on the changes in global trade policy. On this front we have seen some big swings in both sentiment and markets in a very short space of time, and uncertainty around the path for trade policy in the US and elsewhere remains high. This has added to uncertainty about the outlooks for financial conditions and economic growth.

Here at home the data flow has been mixed, with risks on both sides. Economic activity is gradually picking up but is still narrowly based and could be prone to set-backs. The labour market remains weak although the unemployment rate didn't rise as expected in Q1. On the inflation front, the inflation dragon could be emerging from its cave again.

Against this backdrop, we expect the RBNZ will deliver another 25bp rate cut at next week's policy review. We also expect that they will signal the likelihood – or at least the chance – of some further reduction in the OCR this year. However, there are some big questions about the extent and timing of future rate cuts, and whether they are even required.

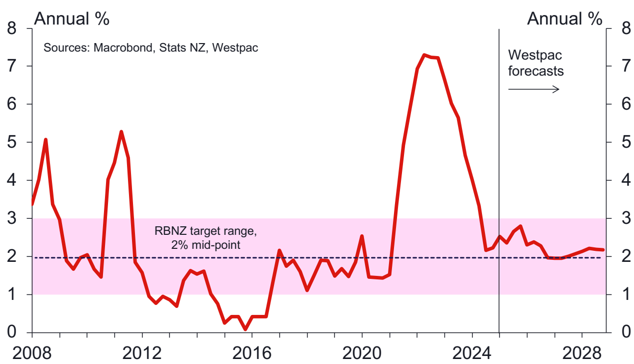
With all that in mind, in this note we explore some of the hawkish and dovish arguments that might shape discussion regarding the outlook for policy over the coming months.

The Hawk's Eye View.

Inflation remains elevated and set to remain at the top of the RBNZ's target band this year.

- The downturn in inflation seen over the past couple of years has been arrested. Inflation rose to 2.5% in the year to March, up from 2.2% at the end of last year.
- Food prices continue to rise rapidly, including a larger than expected 3.7% rise in the year to April.
- We're continuing to see large price increases in parts of the economy that are less exposed to competition, such as electricity and government charges, including local council rates. And with central and local government both signalling ongoing restraint in spending, the rising cost of providing services will continue to be reflected in higher costs for consumers (e.g. passport fees, charges for services).

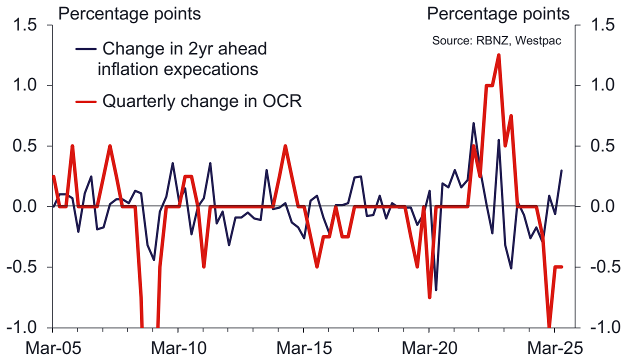
Consumer price inflation



Inflation expectations have picked up again.

- Pricing and cost gauges in some recent business surveys have pushed higher.
- Notably the RBNZ's own measure of expectations two years ahead posted a large 23bps rise in its latest survey, leaving it at 2.29%.
- It's unusual for the RBNZ to cut rates at a time when inflation expectations are pushing higher. Generally, this has only happened in times of crisis such as Covid or the Global Financial Crisis. Its not obvious we are in such a situation now.

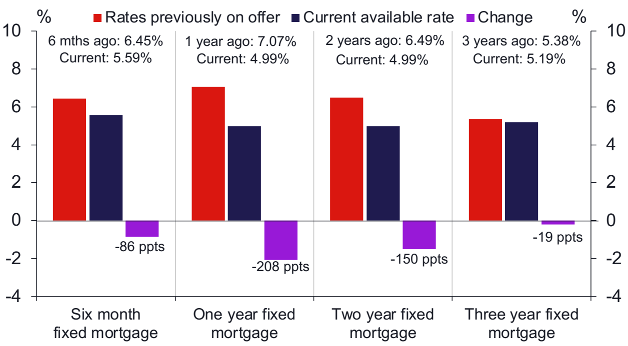
Changes in the OCR vs changes in inflation expectations



With large reductions in interest rates already working their way through the economy, additional cuts now could risk overstimulating demand, and that could require a sharper tightening cycle down the line.

- There has already been a large reduction in borrowing costs. However, the full impact of those reductions is yet to be felt due to the degree of mortgage fixing.
- Over the next six months, around half of all mortgages will come up for repricing, and many borrowers will be able to refix at much lower rates (compared to this time last year, mortgage rates are around 170 to 200 bps lower).
- As increasing numbers of borrowers come up for re-fixing over the coming months, many households will see a sizeable lift in their disposable incomes. This positive impulse is large relative to past easing cycles (outside the GFC period).

Change in borrowing rates

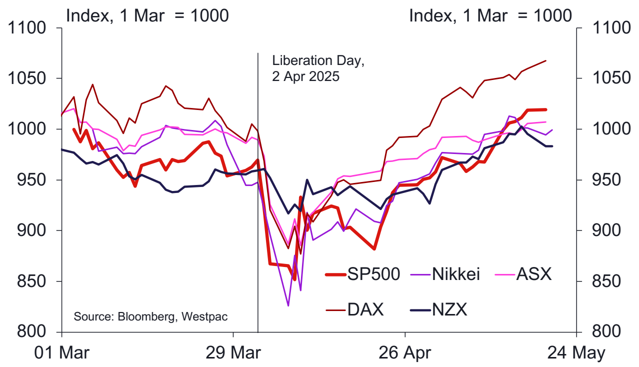


Source: RBNZ data for borrowers with over 20% equity. Current rates on offer from Westpac as at 19 May 2025.

The downside risks for global growth are receding. It's possible we'll avoid a very sharp and disruptive downturn in global growth.

- The US has made significant progress in reducing the very high tariffs imposed in the immediate wake of "Liberation Day" and have begun trade negotiations with China and other large trading partners.
- New Zealand might negotiate some concessions with regards to US trade access. It's possible we may benefit from negotiations concluded with other strategically aligned nations to the extent these bring the floor on tariff rates down.
- Asset markets have recovered their losses as risk aversion has reduced which has eased the tightening in financial conditions coming from the earlier shock.

Equity market recovery since Liberation Day

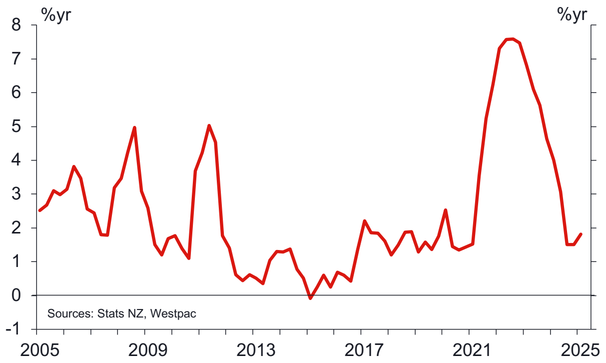


The Dove's Tale.

Inflation in the market sector of the economy is already contained.

- Inflation excluding government charges is already low, sitting at 1.8% in the year to March.
- Softness in domestic demand and the labour market (including wage growth) means that the more cyclical components of inflation which the RBNZ has a greater influence on are continuing to cool. That will keep overall inflation contained – headline inflation is set to track close to 2%, even with continued increases in government charges.
- Increases in government charges are reducing household disposable incomes, helping to subdue inflation elsewhere in the economy. This should help restrain inflation expectations and second round effects from higher headline inflation in 2025.
- If we assume inflation expectations remain anchored, squeezing the market sector of the economy to offset inflation in the government sector might reduce inflation towards 2% more quickly but incur unnecessary output costs and a weaker labour market. Such a trade-off is undesirable as inflation would ultimately fall anyway.

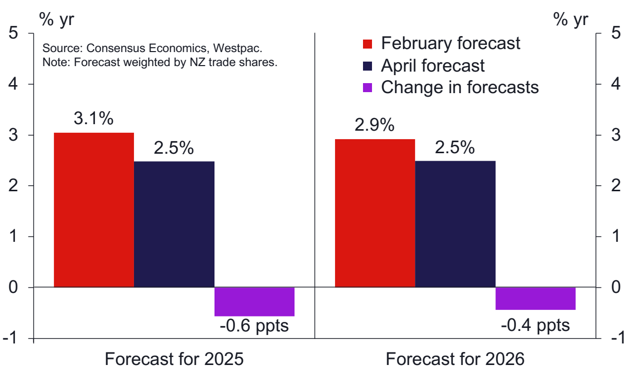
Inflation less central and local government charges



US trade policy poses significant downside risks to NZ growth and inflation.

- The US has paused some tariffs while negotiating, but tensions remain particularly high between the US and China, with the outcome uncertain.
- There are risks of a deeper downturn should negotiations not go well, and especially if growth in China and our other trading partners in Asia is less resilient.
- Even if trade negotiations are successful, the new trade landscape is likely to be less favourable for New Zealand exporters. Of particular concern, the US' more protectionist stance is likely to dampen activity in other economies also, including China. That's likely to reduce demand for our exports and lead to a downturn in commodity export prices.
- Although trade frictions might add modestly to supply chain costs, softer global growth is likely to mean lower inflation in the prices of many imported consumer goods from Asia (as in the wake of the Global Financial Crisis).
- The diversion of exports from the US to elsewhere is likely to add to disinflationary pressure in those countries not imposing retaliatory tariffs.

Revisions to global growth forecasts since the February MPS



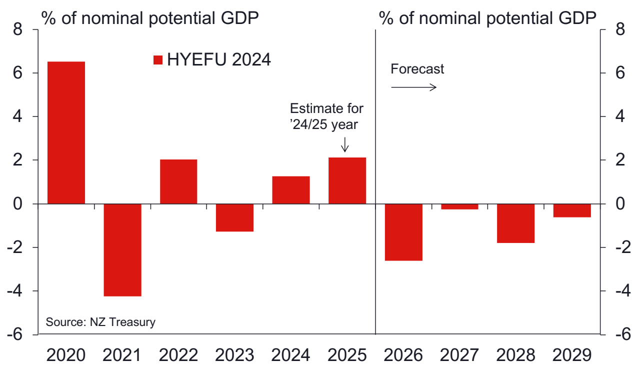
Uncertainty about the trading landscape could lead to the deferral of investment and hiring decisions in New Zealand, slowing the economic recovery.

- Businesses have noted continued nervousness about the economic outlook, notwithstanding expectations that the outlook is better than last year. Consequently, they have been hesitant to undertake significant capital expenditure or take on additional staff.
- Uncertainty about economic conditions and a weaker outlook for the labour market could also weigh on consumer confidence and spending.

Monetary policy settings need to be clearly stimulatory to drive a period of above-trend growth and a timely decline in the unemployment rate.

- While returning the OCR to a broadly neutral rate of 3% (the RBNZ's central estimate) should be sufficient to allow the economy to return to positive growth, given other factors influencing the economy it probably won't be sufficient to generate the growth required to eliminate the negative output gap and ensure a timely return of the unemployment rate to the low 4s.
- Fiscal policy is now entering a contractionary phase, with spending to remain restrained over the coming years and so decline as a share of GDP.
- Trading partner growth is sub-par and is expected to remain so over 2026.
- While improving commodity export earnings are boosting incomes in some regions, the exchange rate has depreciated much less than in some past easing cycles and so is providing less support to the broader export sector.
- With the balance of supply and demand in the housing market leading to anaemic growth in house prices, the lack of positive wealth effects is also contributing to continued sluggishness in demand and softness in the construction sector.

Fiscal Impulse



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