TRANS-TASMAN COMPARISONS

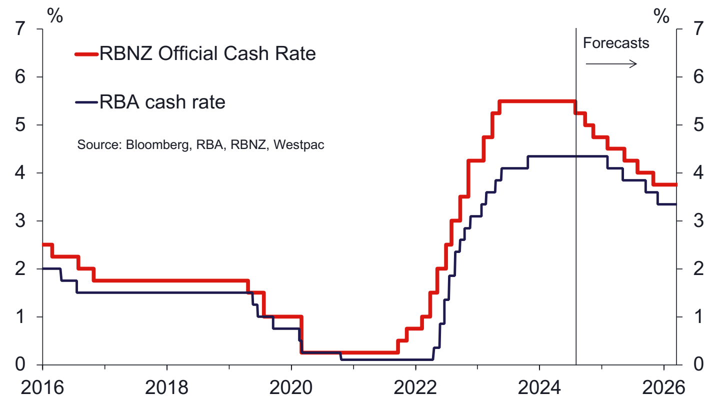
Diverging economic conditions in New Zealand and Australia

August 2024

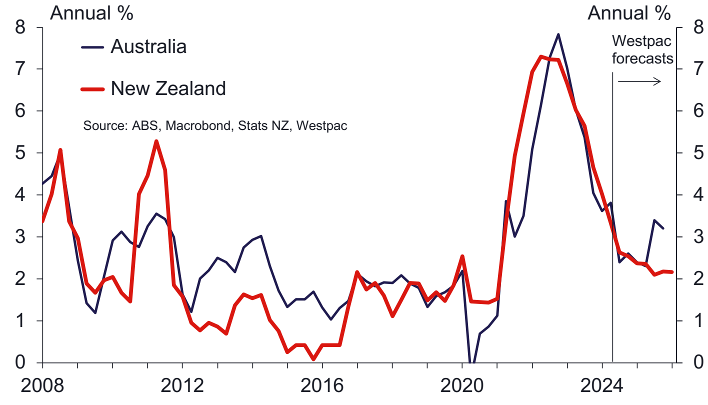
OVERVIEW

- While the Reserve Bank of New Zealand has now begun reducing the Official Cash Rate, the expected start of Australia's monetary policy easing cycle has been pushed back until early-2025.
- Inflation on both sides of the Tasman is dropping back, but the downtrend In core inflation measures in New Zealand looks more pronounced.
  - In New Zealand, headline inflation is on course to fall below 3% in the September quarter and it's expected to trend down towards 2% over the coming year.
  - Headline inflation in Australia will temporarily drop below 3% this year, mainly due to one-off cost of living support measures. As the impact of those policies fades, inflation is set to rise back above 3%. Core inflation is not expected to fall below 3% until the second half of 2025.
- Economic growth in New Zealand has been weaker recently and is set to remain relatively low in 2025. The New Zealand labour market looks likely to remain relatively weak and the unemployment rate will remain (unusually) high.
- Australia has a stronger trade position, underpinned by its focus on hard commodities (in contrast to New Zealand's consumer and food-oriented exports). It also has a stronger fiscal position, with much lower levels of net debt. Those factors are likely to be supportive for Australia's longer-term growth potential relative to New Zealand.

Policy interest rates



Headline inflation



MONETARY POLICY

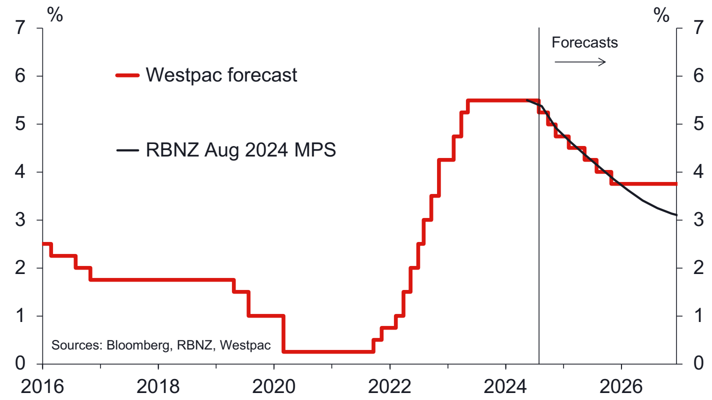
Post-pandemic tightening cycles.

- Monetary policy in New Zealand was tightened more aggressively compared to Australia. The RBNZ increased its OCR to 175bp above our assumed long-run neutral level of 3.75% whereas the RBA increased the cash rate to 85bps above Westpac's long run estimate of 3.50%.
- Australia's less pronounced tightening cycle reflects their higher inflation target (2.5% midpoint vs 2% in NZ), a higher proportion of floating rate lending and an increased focus on preserving employment in the Australian case.
- Australian GDP and labour market have consequently been stronger but inflation more persistent.

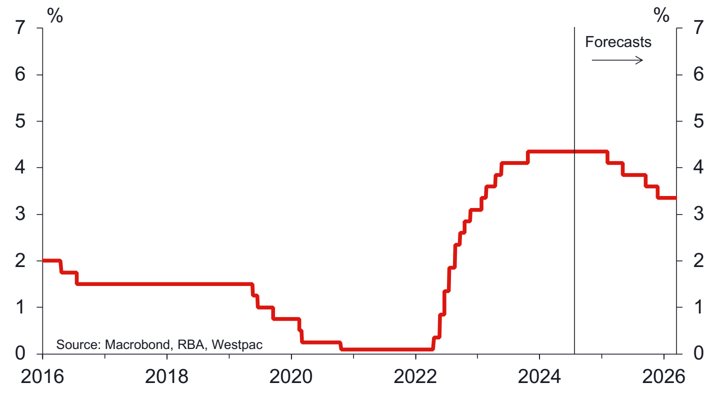
Forecast easing cycles.

- The RBNZ has begun cutting the OCR and will continue cuts over the coming year. The OCR is forecast to reach a terminal rate of 3.75% (a fall of 175bps) by the end of 2025.
- In contrast, we've pushed back our expectations for the start of rate cuts from the RBA from November to February, with 100bps of cuts expected over 2025.
- The differing approaches imply different risks. Australian inflation may take longer to fall. In contrast, in New Zealand there may be larger risks of inflation undershooting 2% and the unemployment rate will peak higher.

RBNZ Official Cash Rate



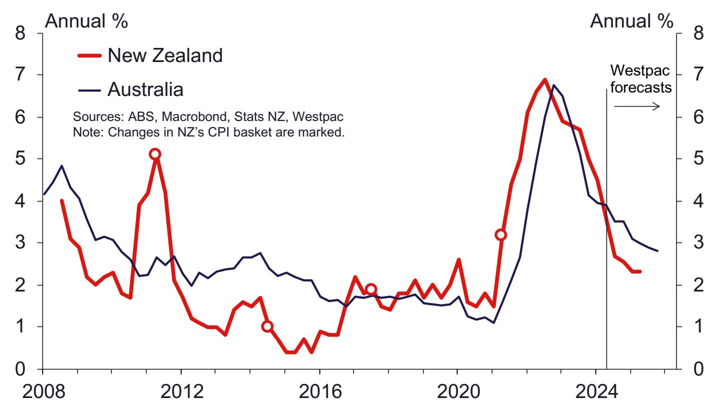
RBA Cash Rate



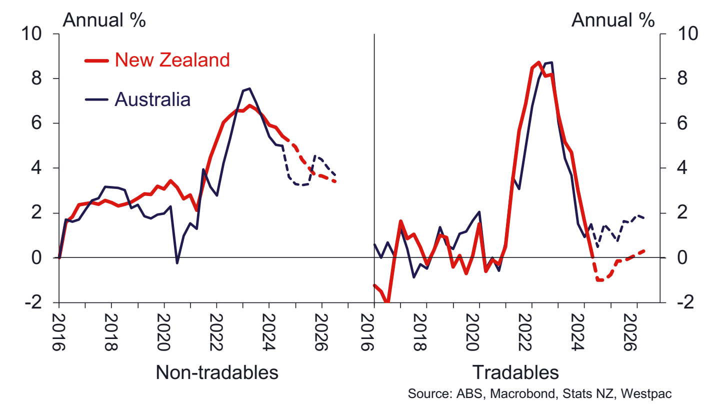
INFLATION

- Core inflation is cooling in both countries, but more gradually in Australia.
  - Quarterly trimmed mean inflation in Australia has flattened off at rates of around 0.8% in recent quarters. In annual terms, it's not expected to drop below 3% until the second half of 2025.
  - In contrast, in New Zealand while quarterly non-tradables inflation remains elevated, it is steadily easing and should moderate in the year ahead. Trimmed mean inflation is similar in both countries (despite NZ having a lower inflation target) but is moderating more slowly in Australia in recent quarters and is forecast to continue to drop more slowly.
- Looking under the surface, over the past year New Zealand has recorded sharper falls in the prices for some tradable items like food, apparel and furnishing.
- Trends in non-tradables prices over the past year have been more mixed. New Zealand has recorded larger increases for items like insurance and local council rates. In contrast, Australia has had larger increases in housing rents and the cost of new homes consistent with Australia's stronger housing market.

Core inflation (trimmed mean)



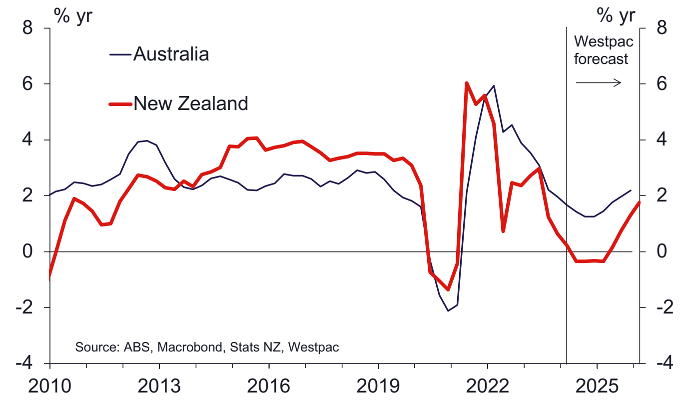
Inflation components
(Westpac forecasts shown as dashed lines)



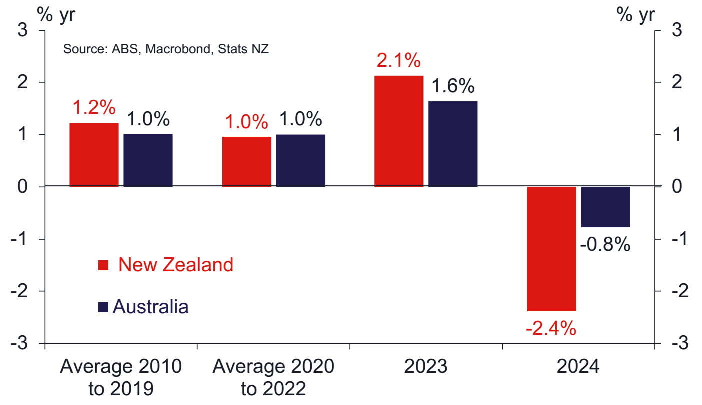
ECONOMIC GROWTH

- New Zealand is in a shallow but prolonged recession while growth continues in Australia.
  - In New Zealand, GDP has fallen 0.5% over the past 18 months. We estimate that activity contracted a further 0.6% in the June quarter, with a 0.2% fall expected in the September quarter.
  - In contrast, while GDP growth in Australia has slowed, it remains positive.
  - This is despite NZ population growth running slightly more strongly than in Australia (2.9% vs 2.5% yoy).
- The Australian economy is expected to continue outperforming New Zealand over the coming year.
  - We're forecasting the New Zealand economy will contract by 0.3% over 2024 and that it will grow 1.3% in 2025.
  - The Australian economy is forecast to grow 1.6% in 2024 and 2.3% in 2025.
- While per capita GDP growth was similar prior to the pandemic, it has slowed more sharply in New Zealand over the past year. In the year to March 2024, per capita GDP in New Zealand fell 2.4%, with Australia recording a more modest 0.8% drop.

GDP growth



Per capita GDP growth (March year, constant prices)



SECTORS

Households.

- Household spending has been slowing on both sides of the Tasman, but the downturn in New Zealand has been more pronounced. Retail spending levels in New Zealand have fallen nearly 4% since the start of the year. In contrast, retail spending levels in Australia were up 1.3% over the same period. Household spending in Australia is expected to continue outpacing New Zealand over the year ahead.

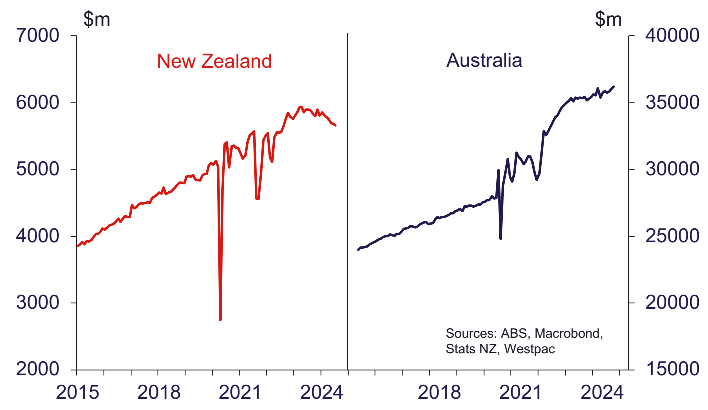
Businesses.

- Recent surveys, such as the PMIs, have shown a downturn in trading conditions in both New Zealand and Australia. Investment spending has been weaker in New Zealand.

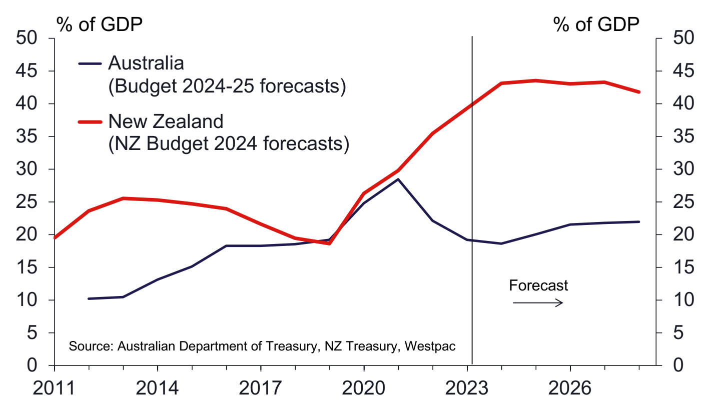
Fiscal policy.

- Budget 2024 marked a shift to more restraint in New Zealand although the operating deficit is expected to remain around 2 to 3% of GDP and net debt will remain above the long run target range of 20% to 40%. NZ tax cuts occurred from end July but are smaller than in Australia.
- Australia's fiscal position is much stronger. The Australian Treasury is forecasting a smaller structural deficit of around 1% of GDP over the coming years. And net debt is projected to remain below 22% of GDP. Tax cuts and household support payments are much larger at the Federal and State level.

Core retail spending (monthly)



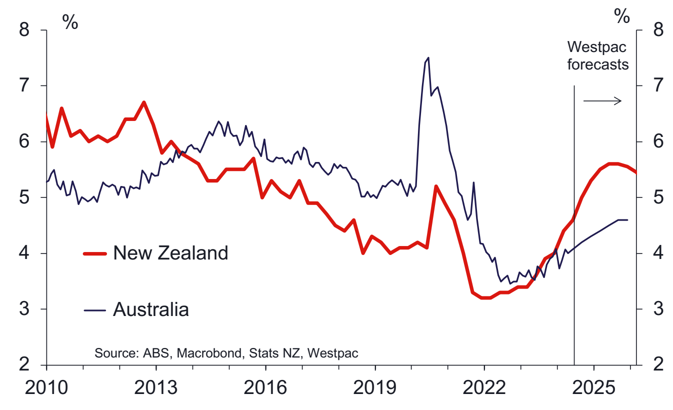
Net core Crown debt



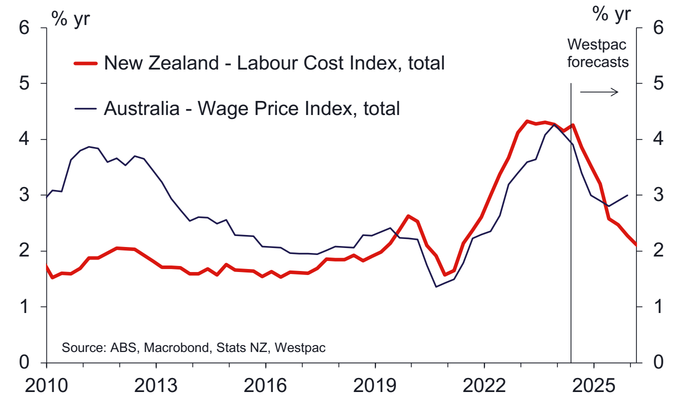
LABOUR MARKET

- With a sharper downturn in economic activity, New Zealand's labour market has softened by more than in Australia. And in a reversal of the trend seen over the past decade, unemployment in New Zealand is expected to linger at higher levels than in Australia over the coming years.
  - Unemployment in New Zealand has risen from a low of 3.2% to 4.6% currently, and it is expected to rise to 5.6% over the year ahead (well above trend levels of around 4.5%). Employment levels have fallen 0.6% since March, and job advertisements have fallen sharply.
  - Unemployment in Australia has risen from a low of 3.5% to 4.1% in the March quarter. Unemployment is expected to rise to 4.6% over 2025 – a little above trend levels.
- Wage growth in New Zealand has remained firm at this stage (with some of that strength due to public sector pay agreements), but it is expected to slow more materially over the year ahead. Wage growth in Australia has been slightly more modest, in part due to the impact of enterprise agreements.

Unemployment



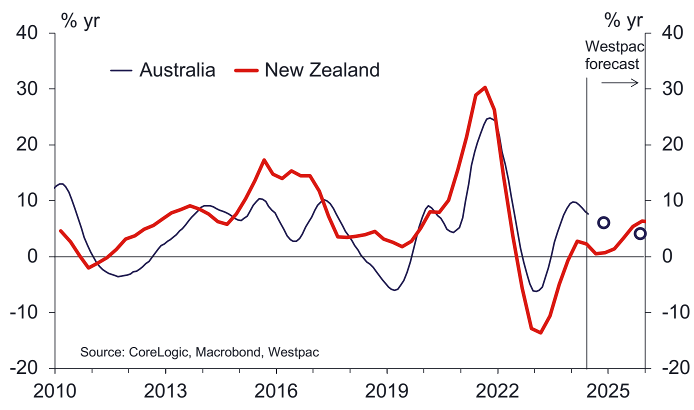
Wage growth



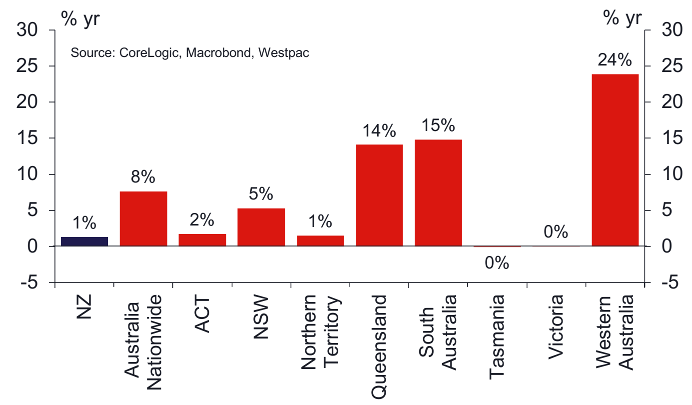
HOUSING MARKET

- Housing market activity in New Zealand has been subdued over the past two years, with low sales and prices effectively remaining flat. House price growth in New Zealand is expected to remain muted over the remainder of 2024, with a recovery taking hold over 2025 as borrowing costs decline.
- Australia's housing market has been more resilient, with more modest falls in prices in the wake of the pandemic and a faster recovery more recently. Australian house prices are up close to 8% over the past year.
- Consistent with its softer housing market, housing credit growth has been lower in New Zealand. Housing lending in New Zealand rose 3.3% in the year to June, compared to a rise of 4.7% in Australia.
- While around 90% of New Zealand mortgages are fixed for a period, less than a third of Australian mortgages are on fixed rates. As a result, interest rate changes tend to flow through to households more quickly in Australia than in New Zealand.

Nationwide house prices



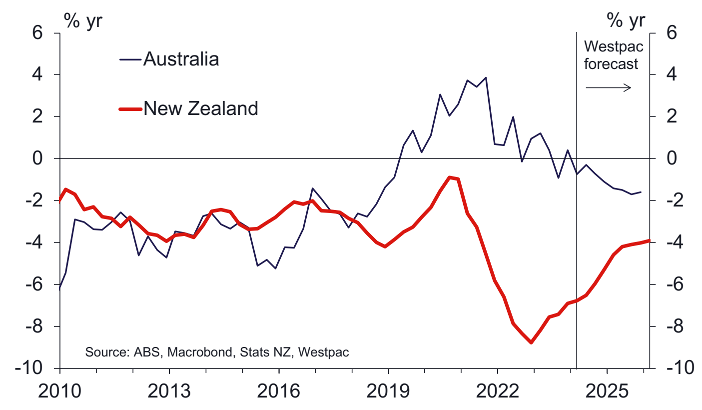
House price growth – past 12 months



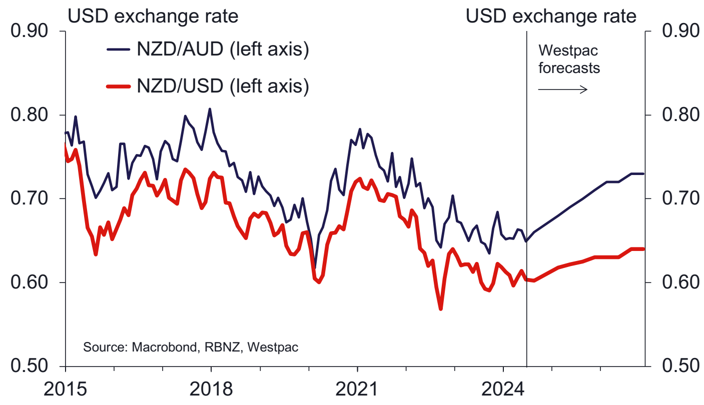
CURRENT ACCOUNT AND THE EXCHANGE RATE

- Australia currently enjoys a stronger trade position than New Zealand, and that's set to continue.
- New Zealand's current account narrowed to 6.8% of GDP in the March quarter. It's expected to continue shrinking over the coming year as the recovery in tourism exports continues, and as soft domestic demand dampens spending on imports. That will see New Zealand's current account deficit trending to around 4% of GDP.
- Australia's current account deficit was just 0.7% of GDP in the March quarter. While it's expected to widen modestly over the next few years, it's set to remain much smaller than in New Zealand. That's because Australia's exports are heavily oriented towards hard commodities, while New Zealand's exports mainly relate to food products and consumer goods. Consequently, Australia has been better positioned to weather the current softness in global consumer demand, especially in key markets like China. The prospects for Australia's exports earnings are also more favourable over the longer term.
- New Zealand's large twin deficits – fiscal and current account – and weaker growth outlook will weigh on the NZ dollar. And as policy easing from the RBNZ reduces New Zealand's yield advantage, we see scope for the NZ dollar to weaken against the AUD.
- Both the NZD/USD and AUD/USD are expected to appreciate over the coming year, but there is likely to be a more pronounced rise in the AUD.

Current account balance



Exchange rates



TAKE OUTS

The diverging trends in economic activity in New Zealand and Australia stem heavily from the different monetary policy strategies being pursued, each with its own risks and benefits.

The RBNZ tightened to a greater extent, and that has resulted in a sharper slowdown in activity, along with more tangible signs that inflation pressures are dissipating. That's also meant the RBNZ was able to begin cutting rates sooner.

In contrast, policy has been tightened by less in Australia. That's seen a more resilient labour market and economic growth. But it's also resulted in a more gradual easing in underlying inflation, with rates remaining on hold for longer.

Both nations have a strong trade focus and China is a key trading partner. However, Australia's focus on hard commodities (in contrast to New Zealand's focus on food and consumer exports) has helped to underpin stronger growth in its export earnings, especially given the current softness in global consumer spending. That advantage is likely to persist over the coming years.

Australia also has a much stronger fiscal position, with smaller operating deficits projected over the coming years and much lower levels of net debt.

Combined, Australia's superior fiscal and current account positions are likely to be supportive of its longer-term growth potential relative to New Zealand.

Those factors also mean that Australia is viewed as 'lower risk' by financial markets, with higher borrowing costs in New Zealand. However, that difference is set to narrow over the coming year given the diverging trends in inflation and activity, with interest rate cuts expected sooner in New Zealand.

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