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FX Focus: NZD likely to underperform AUD on growth, rate differentials and external drivers

NZ growth is stalling amid a sharply weakening labor market whereas Australia's growth has likely troughed. Australia's labor market is also expected to remain within the bounds of full-employment estimates. Externally, Australia has a higher beta to China in comparison to NZ and the de-escalation in US-China trade tensions raises the prospect for some RMB strength as part of a broad trade/currency agreement with the US. This also likely benefits AUD more than NZD over the medium-term.

- After having commenced its rate cut cycle a full 12 months sooner than its own projections, the Reserve Bank of New Zealand (RBNZ) has cut its overnight cash rate (OCR) by 250 basis points since August 2024. The OCR has fallen from a peak of 5.50% to the current 3.00% with both RBNZ projections and market pricing implying a further 50 bps in cuts to a 2.5% terminal rate before year-end. But the RBNZ may need to engage in deeper cuts to a potential 2.00% terminal rate to prevent a double dip recession in New Zealand. Should NZ rates head towards 2.00% over the course of the next 12 months, it would make RBNZ responsible for the biggest rate cut cycle within G10, lowering rates from one of the highest among its peers at 5.5% to one of the lowest at 2.0%.
- It is notable that ex-RBNZ Governor Orr, who presided over the 525 bps tightening from October 2021 to May 2023, taking rates to a 14-year high, resigned in March 2025 during the RBNZ's rate cutting cycle. Then, Gov. Orr intended to bring inflation back to within RBNZ's 1-3% tolerance band. With inflation now back to within the RBNZ's tolerance band, new RBNZ governor Christian Hawkesby has been quick to acknowledge the disinflationary trends facing New Zealand through significant spare capacity in the economy resulting in a negative output gap. Economists think that the overly restrictive RBNZ rates risk another GDP contraction in Q2'2025, potentially resulting in a double dip recession.
- Meanwhile, the Reserve Bank of Australia's (RBA) is likely to cut from a peak of 4.35% to an expected terminal rate of 3.1%. With the current cash rate at 3.60% following two cuts this year, the RBA's August minutes point to just another 25 bps cut with data dependency the key. The RBA's year-end cash-rate assumption of 3.4% is not far from market pricing of ~3.15% (discounting 2 more cuts) as Australia's domestic growth has likely already troughed with Q2 GDP posting a solid 0.6% rebound. This is above RBA's implicit forecast and lifts annual GDP growth from 1.3% to 1.8%, the highest pace since Q4'2023. The result adds to evidence of a U-shaped improvement in Australia's aggregate activity.
- By the time both central banks end their easing cycle in 2026, RBA rates are likely to finish higher. This complete reversal in short rate differentials in favor of AUD reflects Australia's much stronger domestic fundamental backdrop. The external backdrop too also favors AUD against NZD on 2 fronts:
 1. Australia's higher beta to China puts AUD in a more favored position in a Chinese recovery than NZD.
 2. The stronger correlation between AUD and RMB compared to NZD and RMB should see AUD continue to outperform as the Peoples Bank of China allows RMB to strengthen to maintain stability of capital flows amid an anemic domestic recovery and broaden and deepen RMB internationalization.
- Growth differentials, relative interest rates and external fundamentals continue to favor AUD over NZD, raising potential targets on the AUDNZD cross to 1.12 – 1.13 or even higher towards 1.1500 with solid support now seen at 1.08 – 0.9. For RBNZ, the main concern now is how to prevent a possible double dip recession in New Zealand whereas the key concern for the RBA is how to prevent the U-shaped recovery from generating excessive inflationary pressures that take current underlying inflation back above the RBA's 2-3% tolerance band.

FIGURE 1: The trend in the AUDNZD cross since late April looks likely to continue



Source: Bloomberg, September 2, 2025. **Past performance is no guarantee of future results.** Real results may vary.

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