



# Weekly Economic Commentary.

**A little less conversation, a little more action.**

There's been a clear shift in the conversation around what's going on in the New Zealand economy. Cost pressures and supply constraints have been apparent for some time, but there's now growing evidence that this is running up against hot demand. We think that this combination will prompt the Reserve Bank into action before the end of the year.

The May *Monetary Policy Statement* left the impression that the RBNZ was quite comfortable with how the economy was tracking. Activity was continuing to recover from the effects of the Covid-19 pandemic, albeit unevenly, and while inflation was expected to lift in the near term, this was viewed as temporary.

It's unlikely that this Wednesday's Monetary Policy Review will be anywhere near as sanguine. In the intervening weeks, we've seen a string of strong activity indicators, the housing market has remained perky even in the face of new restraining measures, and reports of rising prices and labour shortages have escalated dramatically.

It's been apparent for some time that Covid-19 has largely manifested as a supply-side shock in New Zealand's case, with disruptions to supply chains, soaring shipping costs, and

a loss of access to overseas workers. All these things point to a spike in inflation in the near term.

We'll get the first confirmation of this on Friday with the June quarter CPI release. We're currently expecting a 0.8% rise for the quarter (we'll finalise this on Tuesday after the release of the food price and rents data for June). This would see the annual inflation rate jump from 1.5% to 2.9%, some of which is due to base effects (some prices were falling in the June quarter last year, during the Covid-19 lockdown). We expect annual inflation to rise further to 3.3% in September, versus the RBNZ's May forecast of 2.5%.

This, on its own, is not something that the central bank should be responding to. Nor can it – monetary policy tends to work over longer horizons, more like one to two years ahead. The key question for us has been whether the demand conditions



were in place for that initial price spike to evolve into an ongoing series of price increases.

In that respect, last week's Quarterly Survey of Business Opinion was a big deal. There was evidence of strong demand throughout the survey: measures of activity, hiring and investment were all up substantially compared to three months ago, and profitability was seen as improving even in the face of mounting cost pressures. That strength wasn't universal – the building industry is clearly running red-hot, while retailers are struggling to improve their profitability – but it was spread widely enough for us to take notice.

Not surprisingly, firms said that workers are becoming extremely difficult to find. But the key measure was a sharp rise in reported labour turnover – heavily concentrated in the construction sector, though not limited to it. While not firm evidence, this does suggest that employers have been willing to bid up in order to lure workers away from other firms. And the fact that they can afford to do so – an element that's been missing in times past – is another marker of strong demand.

There's still a case to be made that some of the current inflation pressures will be temporary, or at least non-repeating. As the global economy reopens, we'd expect that global supply chain disruptions will be ironed out, demand for physical goods relative to services will normalise, and employers that are paying up to deal with their current labour shortages will look for ways to claw back those higher pay rates. That could set the stage for a period of stubbornly low wage and price growth a few years down the track.

But the question is whether the RBNZ can hold off for that long. With demand running hot, there's a greater risk that recent price hikes feed into people's expectations of inflation, and once that thinking becomes embedded, it's hard to dislodge again.

We've changed our forecasts to reflect this. We now expect the Reserve Bank to start increasing the cash rate from November this year, with a further gradual tightening over the

following years, reaching a peak of 2% in early 2024. Financial markets have come to a similar conclusion on the timing of the first move.

We'd emphasise that the pace of tightening is likely to be gradual. There's still a great number of uncertainties around the economic outlook – especially overseas, with new and more dangerous variants of SARS-CoV-2 coming to the fore. A widespread reopening of the border is looking more distant than it was a few months ago.

We'd also note that when it comes to interest rate hikes, a little is likely to go a long way. Average debt levels among households are higher now than they've been in the past, so even a small rise in mortgage rates will have a meaningful impact on household budgets. And just as lower mortgage rates had a powerful impact on house prices (which are up almost 30% over the last year), the same will be true in the other direction.

While we haven't had an OCR increase since 2014, there's a more recent example that could be instructive. Fixed-term mortgage rates rose between late 2016 and early 2017 in response to global interest rate trends, with the popular one- and two-year rates rising by 30-40 basis points. House price growth slowed markedly in that time, from around 15%/yr in late 2016 to just 4%/yr by the end of 2017. Auckland house prices even fell slightly.

Higher mortgage rates weren't the only thing happening in the housing market at the time – loan-to-value limits were also tightened in late 2016. But the fact that house prices didn't spring back when the LVR limits were loosened again a year later suggests that interest rates were playing the more substantive role.

**Michael Gordon**, Acting Chief Economist

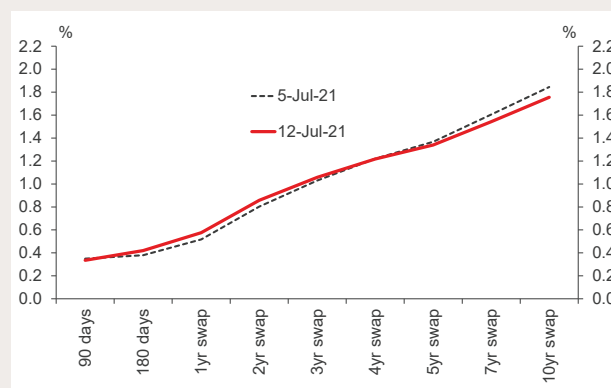
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## Fixed vs floating for mortgages.

We now expect the Reserve Bank to start increasing the OCR by the end of the year. Floating mortgage rates are likely to rise once the OCR does; fixed-term rates could rise earlier in anticipation.

Based on our OCR forecasts over the coming years, we think there is value in moving beyond the currently popular one-year fixed term, towards terms of two to three years. Longer terms (out to five years) don't offer additional value, though they may be suitable for borrowers who value more certainty in their repayments.

### NZ interest rates



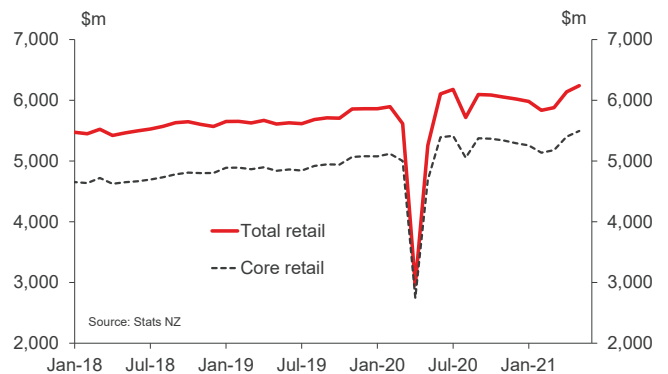
# The week ahead.

## NZ Jun retail card spending

**Jul 12, Last: +1.7%, Westpac f/c: +0.2%**

- Retail spending continued to charge higher in May, rising by 1.7%. That came hot on the heels of a 4% rise in April. Increases in spending have been widespread with particular strength in spending on durables and apparel. However, we have also seen hospitality spending lifting above pre-Covid levels.
- We're forecasting a further 0.2% rise in spending in June. That's expected to be underpinned by ongoing firmness in goods purchases.
- The dialling up of the Covid Alert Level in Wellington in mid-June is expected to have only a limited dampening impact on spending. The Alert Level was increased only for a short period and level 2 restrictions still allow most activity to occur.

## Retail card spending

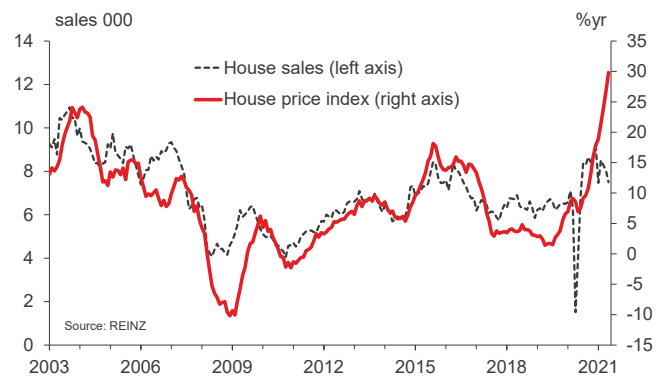


## NZ Jun REINZ house sales and prices

**Jul 13, Sales last: -6.6%, Prices last: +29.8%yr**

- House sales have softened in recent months, though they remain above pre-Covid levels. The reintroduction of loan-to-value restrictions and changes to the tax rules have led to a slowdown in investor demand, but it appears that owner-occupiers have been willing to step into the breach.
- Despite slowing turnover, house prices have continued to rise at a solid pace, with the REINZ price index up almost 30%yooy in May. This is likely to mark the peak in annual growth, as house prices were falling in April-May last year during the Covid lockdown.
- Indicators for June have so far been mixed. Listings data suggest a further drop in sales, but loan demand has been strong and auction clearance rates have picked up again.

## REINZ house prices and sales

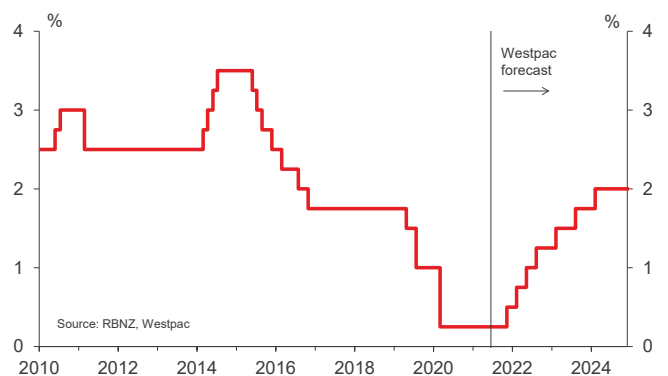


## NZ RBNZ Monetary Policy Review

**Jul 14, Last: 0.25%, WBC f/c: 0.25%, Market f/c: 0.25%**

- Since the RBNZ's last policy statement in May, GDP growth has come out well ahead of the RBNZ's expectations and other data are pointing to increasing strength in demand conditions. On top of that, inflation pressures have strengthened considerably.
- There will be no new published forecasts at this review. However, the forward guidance in the press release (which previously signalled that current levels of stimulus will remain in place for a 'considerable' time) is likely to be altered. The RBNZ is likely to start setting the scene for a normalisation of monetary policy, without committing to a particular timing.
- We have brought forward our forecast for rate hikes, and now expect the first OCR increase in November 2021 (previously August 2022).

## RBNZ Official Cash Rate



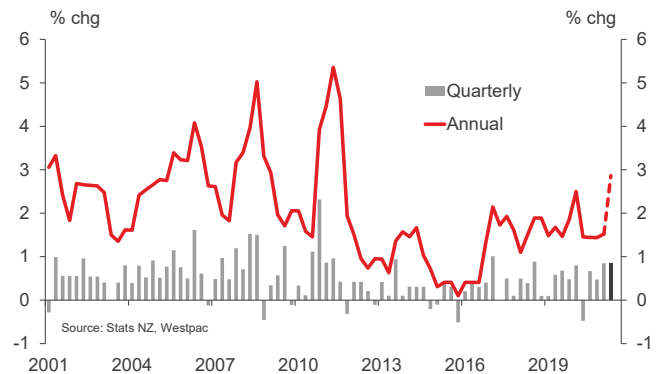
# The week ahead.

## NZ Q2 CPI

**Jul 16, Last +0.8%, WBC f/c: +0.8%, Market f/c: +0.7%**

- Consumer prices rose by 0.8% in the March quarter. That took the annual rate to 1.5%.
- Since the March release, inflation pressures have continued to intensify. Cost pressures have been rising with shortages of some goods and growing tightness in the labour market. Importantly, consumer demand has also strengthened, which is allowing firms to pass on cost increases.
- We expect quarterly inflation of 0.8%, which would see the annual rate rising to 2.9% (well above the RBNZ's last published forecast).
- In terms of specifics of the June report, we expect particular strength in food prices (in part due to the recent increase in the minimum wage), higher construction costs and a further rise in used car prices.

## NZ CPI inflation

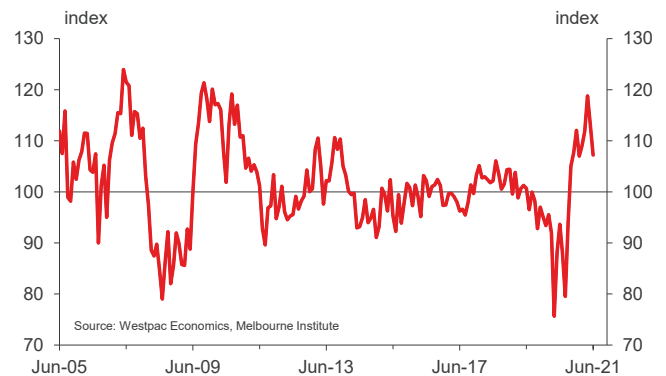


## Aus Jul Westpac-MI Consumer Sentiment

**Jul 14, Last: 107.2**

- Sentiment fell 5.2% to 107.2 in June, led by a sharp drop in Melbourne as the city entered a two week lockdown. While the national index was still above 100 the June read was nearly 10% below the eleven-year high set in April.
- Covid disruptions are set to feature heavily again in July. While Melbourne has emerged from its June restrictions, Sydney entered an extended lockdown in late June that remains firmly in place, with Brisbane, Perth and Darwin all seeing brief 'mini-lockdowns' that have now lifted. The wider incidence and longer duration of disruptions and the limited traction measures have had in bringing Sydney's outbreak under control may also fuel concerns about Australia's ability to continue containing the virus, particularly with the new, more transmissible 'delta' variant circulating. A slow vaccine rollout and mixed messages on the AstraZeneca dose may also undermine confidence. Other factors - booming housing and equity markets, a labour market in good shape - will be supportive but Covid developments are likely to dominate.

## Aus Consumer Sentiment Index

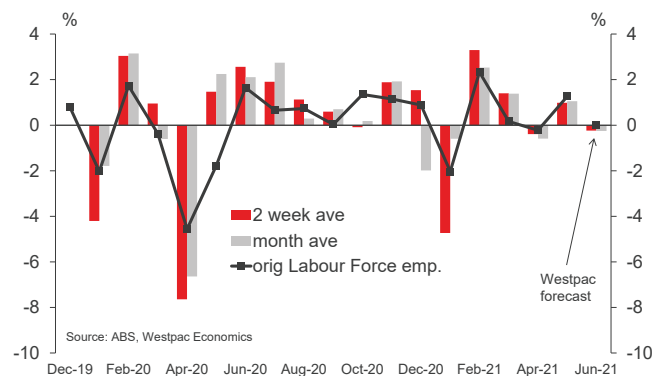


## Aus June labour force, employment change

**Jul 15, Last: 115.2k, WBC f/c: 45k  
Mkt f/c: 20k, Range: -25k to 45k**

- May employment surged well above expectations (+115.2k vs. market median 30.0k), due mostly to the reversal of stronger-than-usual seasonality around the Easter/school holidays which suppressed April employment.
- Some argued that the May surge was due to sample rotation and as such, we should see a reversal in June. However, our analysis of the matched sample confirmed an underlying weak print in April, related to the school holiday effect, followed by a stronger than just a corrective bounce in May. As such, we argue the May result was more than just a statistical correction to a weak April print.
- June Weekly Payrolls confirmed a recovery from the May Victoria lockdowns. The June Labour Force survey was conducted too early to pick up NSW lockdown. Payrolls point to a 0.2% fall in original terms but is likely to be revised up. Our 45k forecast is consistent with a flat print in original terms.

## Aus payrolls and labour force employment



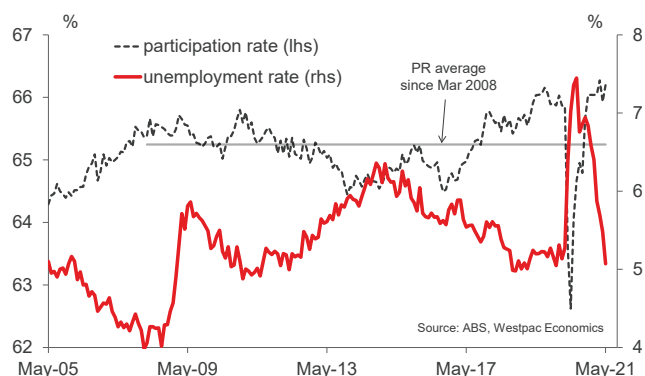
# The week ahead.

## Aus June labour force, unemployment rate

**Jul 15, Last: 5.1%, WBC f/c: 5.0%**  
**Mkt f/c: 5.1%, Range: 4.9% to 5.2%**

- The 115.2k May surge in employment was offset by only a partial reversal of the April correction in the participation rate, which lifted 0.3ppts to 66.2% compared to 66.3% in March. This resulted in a 66.2k rise in the labour force and a 0.4ppt decline in the unemployment rate to 5.1%.
- Accepting the strong May update points to robust underlying momentum in employment that is likely to have continued into June. With a significantly stronger starting point, and no reason to change the medium-term outlook, we revised our end 2021 unemployment forecast to 4.4% from 5.0%.
- The recovery in employment has also seen participation surge to a record high, with a lot more women entering the workforce. We forecast a new record participation rate of 66.3%, limiting the fall in unemployment to 0.1ppt to 5.0%.

## Aus unemployment and participation rates



## China Q2 GDP

**Jul 15, annual growth Last: 18.3%, WBC f/c: 8.3%**

- Expectations around China's outlook have soured over the past month as a result of some disappointing partial data made a lot worse by the optics of coming off peak growth from the pandemic recovery.
- We believe this weakness will affect Q2 GDP, with a quarterly growth result a little below potential likely. However, annual growth is still expected to be above 8.0%/yr; and through the second half of 2022, the quarterly growth pulse should firm back to trend.
- If we are correct, then year-average growth for 2021 will still be circa 9.5%, with growth in 2022 around 5.8%. Amid uncertainty related to COVID-19 and given the strength of their economy, China will continue to outperform the rest of the world. The reforms put in place and still in progress will allow this strength to be sustained for years.

## China GDP

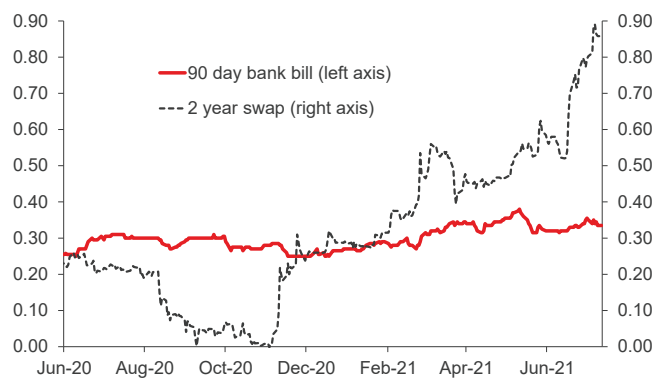


# New Zealand forecasts.

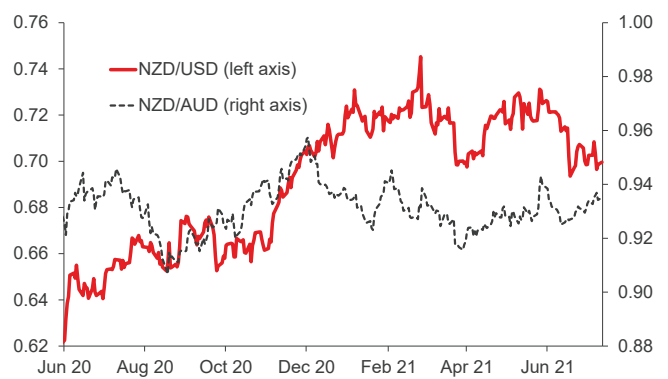
Economic forecasts	Quarterly				Annual			
	2021				2019	2020	2021f	2022f
% change	Mar (a)	Jun	Sep	Dec				
GDP (Production)	1.6	0.6	0.9	1.3	2.4	-2.9	5.8	4.5
Employment	0.5	0.4	0.3	0.4	1.2	0.8	1.7	2.1
Unemployment Rate % s.a.	4.7	4.5	4.4	4.2	4.1	4.9	4.2	3.9
CPI	0.8	0.8	1.1	0.3	1.9	1.4	3.1	2.0
Current Account Balance % of GDP	-2.2	-3.4	-4.5	-5.0	-3.3	-0.8	-5.0	-4.2

Financial forecasts	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
Cash	0.25	0.50	0.75	1.00	1.25	1.25	1.50	1.75
90 Day bill	0.45	0.70	0.95	1.20	1.35	1.45	1.70	2.00
2 Year Swap	1.00	1.20	1.40	1.55	1.70	1.80	2.00	2.15
5 Year Swap	1.40	1.60	1.80	1.95	2.10	2.20	2.40	2.55
10 Year Bond	1.70	1.90	2.05	2.15	2.20	2.30	2.45	2.55
NZD/USD	0.72	0.74	0.76	0.78	0.78	0.77	0.75	0.72
NZD/AUD	0.92	0.93	0.93	0.92	0.92	0.92	0.91	0.92
NZD/JPY	78.5	80.7	83.6	85.8	86.6	85.5	81.8	77.8
NZD/EUR	0.59	0.60	0.61	0.62	0.61	0.61	0.59	0.57
NZD/GBP	0.51	0.52	0.53	0.54	0.54	0.53	0.52	0.50
TWI	74.0	75.2	76.6	77.7	77.5	76.4	74.7	72.2

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 July 2021

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.27%	0.27%	0.27%
60 Days	0.30%	0.30%	0.30%
90 Days	0.34%	0.33%	0.32%
2 Year Swap	0.86%	0.77%	0.52%
5 Year Swap	1.34%	1.38%	1.17%

NZ foreign currency mid-rates as at 12 July 2021

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6996	0.7071	0.7135
NZD/EUR	0.5892	0.5926	0.5893
NZD/GBP	0.5035	0.5090	0.5060
NZD/JPY	77.07	78.32	78.24
NZD/AUD	0.9351	0.9329	0.9266
TWI	73.97	74.36	74.23

## Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 12</b>					
NZ	Jun retail card spending	1.7%	-	0.2%	Continued firmness in demand, esp. for durables.
US	Fedspeak	-	-	-	FOMC's Kashkari speaks at a virtual townhall event.
<b>Tue 13</b>					
NZ	Jun REINZ house sales	-6.6%	-	-	Due this week. Lending restrictions have slowed sales ...
	Jun REINZ house prices %yr	29.8%	-	-	... but prices have still risen at a solid clip.
	Jun food price index	0.4%	-	0.7%	Seasonal lift in fruit and vegetable prices.
Aus	Jun NAB business survey	37	-	-	Conditions up 21pts ytd to a record +37; reading overstated?
Chn	Jun trade balance USDbn	45.53	45.30	-	Exports gradually stabilising, but remain elevated.
US	Jun CPI	0.6%	0.5%	0.5%	Another strong monthly print should see 4.9%yr growth.
	Jun monthly budget statement	-132.0	-	-	To remain volatile on waves of stimulus.
	Jun NFIB small business optimism	99.6	100.0	-	Will be paying close attention to hiring intentions/wages.
	Fedspeak	-	-	-	FOMC event including Kashkari, Bostic and Rosengren.
<b>Wed 14</b>					
NZ	May net migration	1,037	-	-	First full month of the trans-Tasman travel bubble.
	RBNZ policy decision	0.25%	0.25%	0.25%	RBNZ to signal a path to normalising monetary policy.
Aus	Jul WBC-MI Consumer Sentiment	107.2	-	-	Latest lockdown disruptions to hit.
UK	Jun CPI	0.6%	-	-	Monthly prints buoyant on reopening - looks to be transitory.
Eur	May industrial production	0.8%	-	-	Mfg sector remains a source of strength for Europe.
US	Federal Reserve's Beige book	-	-	-	To provide an update on conditions across the Fed districts.
	Jun PPI	0.8%	0.5%	-	Upstream price momentum likely cresting on annual basis.
	Fed Chair Powell	-	-	-	Semi-annual testimony to House Fin. Services Committee.
	Fedspeak	-	-	-	FOMC's Kashkari to take part in panel.
<b>Thu 15</b>					
Aus	Jun employment	115.2k	20k	45k	June was not a statistical anomaly but a solid bounce from ...
	Jun unemployment rate	5.1%	5.1%	5.0%	... a seasonally weak April so the robust trend to continue.
	Jul MI inflation expectations	4.4%	-	-	June saw largest monthly increase in four years.
Chn	Q2 GDP %yr	18.3%	8.0%	8.3%	Q2 quarterly growth likely to be a touch below trend.
	Jun retail sales ytd %yr	25.7%	22.8%	-	Consumers have been impacted of late by small outbreaks.
	Jun fixed asset investment ytd %yr	15.4%	12.1%	-	Quality of investment key. It remains strong.
	Jun industrial production ytd %yr	17.8%	16.0%	-	Deceleration to run for a number of months.
UK	May ILO unemployment rate	4.7%	4.8%	-	Furlough scheme continues to support the labour market.
US	Initial jobless claims	373k	-	-	Downtrend to accelerate as unemployment benefits roll off.
	Jun industrial production	0.8%	0.6%	-	Factory output to forge ahead on robust consumer spending.
	Jul Fed Empire state index	17.4	18.7	-	Regional surveys to provide insights into ...
	Jul Philly Fed index	30.7	28.0	-	... bottlenecks and upstream price pressures.
	Fed Chair Powell	-	-	-	Semi-annual Testimony to Senate Banking Committee.
	Fedspeak	-	-	-	FOMC's Evans discusses the economy.
<b>Fri 16</b>					
NZ	Jun manufacturing PMI	58.6	-	-	Remains strong driven by domestic demand.
	Q2 CPI	0.8%	0.7%	0.8%	Increases in food prices, construction cost and transport.
Eur	May trade balance €bn	9.4	-	-	Coming off peak as conditions normalise.
US	Jul Uni. of Michigan sentiment	85.5	86.5	-	Sentiment has lagged broader recovery, but now picking up.
	May business inventories	-0.2%	0.4%	-	Inventories volatile, but should add to growth over year.
	Jun retail sales	-1.3%	-0.5%	-	At elevated level on reopening, but pivoting to services.
	May total net TIC flows	101.2	-	-	Has been choppy on net flows from Asia.
	Fedspeak	-	-	-	FOMC's Williams partakes in event on culture in workplace.

## International forecasts.

Economic Forecasts (Calendar Years)	2017	2018	2019	2020	2021f	2022f
<b>Australia</b>						
Real GDP %/yr	2.4	2.8	1.9	-2.4	5.4	3.8
CPI inflation %/yr	1.9	1.8	1.8	0.9	2.5	2.4
Unemployment rate %	5.5	5.0	5.2	6.8	4.4	3.8
Current account % of GDP	-2.6	-2.1	0.7	2.6	4.2	2.6
<b>United States</b>						
Real GDP %/yr	2.3	3.0	2.2	-3.5	6.5	4.1
CPI inflation %/yr	2.1	2.4	1.9	1.2	2.9	2.1
Unemployment rate %	4.4	3.9	3.7	8.1	5.4	3.8
Current account % of GDP	-2.3	-2.3	-2.6	-2.5	-2.4	-2.4
<b>Japan</b>						
Real GDP %/yr	1.7	0.6	0.3	-4.8	2.7	2.3
<b>Euro zone</b>						
Real GDP %/yr	2.6	1.9	1.3	-6.6	4.5	4.4
<b>United Kingdom</b>						
Real GDP %/yr	1.7	1.3	1.4	-9.9	6.2	5.0
<b>China</b>						
Real GDP %/yr	6.9	6.7	5.8	2.3	9.5	5.8
<b>East Asia ex China</b>						
Real GDP %/yr	4.7	4.4	3.7	-2.4	4.9	5.0
<b>World</b>						
Real GDP %/yr	3.8	3.6	2.8	-3.3	5.8	4.6

Forecasts finalised 9 July 2021

Interest rate forecasts	Latest	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
<b>Australia</b>									
Cash	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.75
90 Day BBSW	0.03	0.04	0.07	0.10	0.15	0.20	0.40	0.70	0.95
10 Year Bond	1.34	1.70	1.90	1.95	2.00	2.05	2.10	2.20	2.30
<b>International</b>									
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.375	0.875	0.875
US 10 Year Bond	1.33	1.70	1.90	1.95	2.00	2.05	2.10	2.20	2.30

Exchange rate forecasts	Latest	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
AUD/USD	0.7418	0.78	0.80	0.82	0.85	0.85	0.84	0.82	0.78
USD/JPY	109.93	111	111	112	112	112	113	114	115
EUR/USD	1.1836	1.21	1.22	1.23	1.22	1.21	1.21	1.20	1.19
GBP/USD	1.3774	1.41	1.42	1.43	1.44	1.45	1.44	1.44	1.43
USD/CNY	6.4855	6.35	6.25	6.15	6.10	6.05	6.00	6.00	5.95
AUD/NZD	1.0694	1.08	1.08	1.08	1.09	1.09	1.09	1.10	1.08



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