

WESTPAC WEEKLY ECONOMIC COMMENTARY

Stand by for (more) action.

15 August 2022



Harakeke/flax

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Economic news over the past week provided further evidence that demand is cooling. Even so, we're still grappling with strong domestic inflation pressures. As a result, the RBNZ is set to continue raising the Official Cash Rate for some time yet, including a 50bp rise at this week's policy meeting.

We expect that the Reserve Bank of New Zealand will deliver another 50bp increase in the Official Cash Rate at Wednesday's policy meeting. That would be the fourth 50bp rise in a row and would take the cash rate into moderately restrictive territory.

An August rate rise has been well telegraphed by the RBNZ. Their July policy statement reiterated the need to continue hiking the cash rate 'at pace.' That statement also noted that the Monetary Policy Committee remained comfortable with the interest rate projection published in May, which was consistent with ongoing rapid rate increases.

The bigger question for the Reserve Bank, however, is where the cash rate is headed longer term. On this front, recent developments have been mixed, but still leave us expecting further sizeable rate increases before year's end.

Looking first at recent economic activity, the dampening impact of rate hikes to date is becoming increasingly evident, especially in the household sector. The latest REINZ housing market update for July showed that prices have continued to fall, with the nationwide average now down 8% from its peak.

We've also seen the number of house sales continuing to drop, with monthly sales now at their lowest level since 2011 (barring the lockdown period in 2020).

The housing market is a key influence on households' wealth and confidence. And just as the rapid house price gains in recent years boosted spending appetites, the slowdown now in train signals a period of softer demand over the next few years. Consistent with that, we've seen flagging momentum in household spending in recent months. In fact, nominal spending levels have effectively held flat since May. That's despite strong increases in retail prices, meaning that the actual volume of goods that households have been purchasing has gone backwards.

Importantly, the drag on household spending is set to become much larger. While the OCR has been pushing higher since October last year, around 90% of New Zealand mortgages are on fixed rates. As a result, the majority of households have actually been shielded from the impact of rate increases to date. But that picture is going to change dramatically over the coming months. Around a quarter of mortgages will come up

for re-pricing by the end of this year, and another quarter will by mid-2023. In many cases, those borrowers will face refinancing at rates that are 2 to 3 percentage points higher than the rates they are currently on.

But while we are seeing domestic demand cooling, we've yet to see any material signs that pricing pressures are easing off. In fact, inflation rose by more than the RBNZ expected in the year to June, climbing to a three decade high of 7.3%. Importantly, the details of the June quarter inflation report pointed to a strong boost from domestic demand. And it is those domestic price pressures that monetary policy can, and should, respond to.

That picture of bubbling domestic inflation pressures was also evident in the June labour market surveys, with a larger than expected 6.4% rise in average hourly earnings. Notably, the most common reason for wage increases has been the need to attract or retain staff. In other words, wage increases have been due to the demand-pull of intense competition for a fixed pool of workers, not the cost-push of rising living costs. Admittedly the unemployment rate was weaker than forecast, recording a small rise rather than the expected small drop. But that combination of stagnant jobs growth and surging wages will reinforce to the RBNZ that the economy is operating well beyond the 'maximum sustainable' level of employment.

One thing that has gone more the RBNZ's way is expectations of future inflation. The RBNZ's latest survey showed that while expectations for inflation over the coming years remain elevated, the trend higher seen in recent months looks to have been arrested. Notably expectations at medium-term horizons have eased back, with the closely watched two-year ahead measure softening from 3.3% in May to 3.1% in August. That will leave the RBNZ feeling a bit more comfortable that the risks of high inflation becoming embedded in the economy are easing off (or at least, they have not gotten worse).

The strength in domestic inflation pressures highlights that interest rates will need to continue rising after the August policy decision. Furthermore, rates will need to remain at restrictive levels for some time to bring demand back into line with the economy's productive capacity. Any softening in the RBNZ's tone could see market interest rates fall even further, which would risk undermining the good work that they have done so far.

We recently lifted our OCR forecast to a peak of 4% by the end of this year, from 3.5% previously. That was broadly in line with the interest rate track that the RBNZ published in its May Monetary Policy Statement. We expect the RBNZ to run with something similar this time, emphasising that interest rates will need to remain high for longer than the market is factoring in.

The run of successive large rate hikes over the past year means that the gap between where the RBNZ is and where it needs to be has narrowed significantly. That could allow for a return to normal-sized 25 basis point OCR moves later this year. However, we think that the RBNZ will favour getting the job done quickly rather than dragging it out into next year.

Satish Ranchhod, Senior Economist

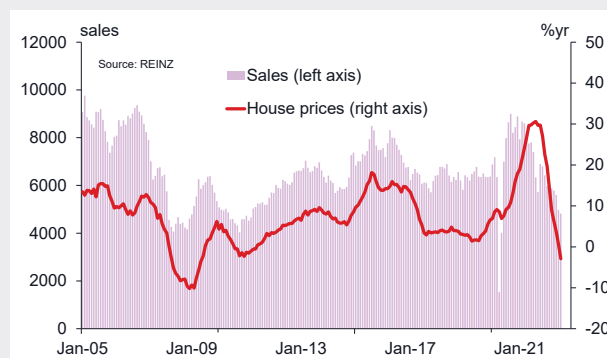
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Chart of the week

The REINZ house price index fell another 1.7% in July with prices down 3% compared to the same month last year. We have not seen year-on-year house price falls since 2011, when the housing market was still suffering from the after-effects of the Global Financial Crisis. Since peaking in November, prices have now fallen 8%. We have seen some easing in fixed mortgage rates in early August, and that should help to slow the rot in the coming months. Even so, we think prices have further to correct and are forecasting a total decline of 15% over this year and next year.

REINZ house prices and sales

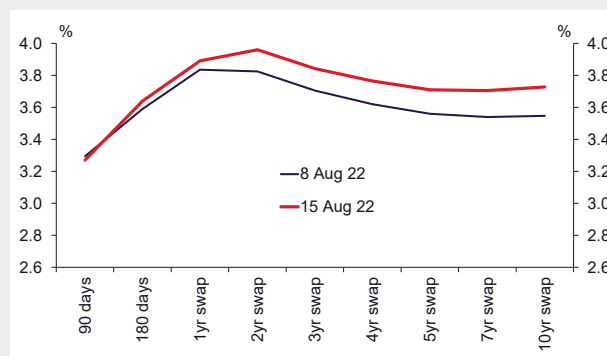


Fixed vs floating for mortgages

Wholesale interest rates have fallen from their highs in recent weeks, as markets have reassessed the prospects for the global economy. That in turn has seen fixed-term mortgage rates fall from their highs. At the same time, we've lifted our forecast to a 4% peak in the Official Cash Rate at the end of this year.

As a result, we believe that there is now value in fixing for terms out to two years. We would still regard fixing for terms longer than this as expensive, but this option may suit those who want more certainty in their repayments.

NZ interest rates



The week ahead

NZ GlobalDairyTrade auction, whole milk powder prices

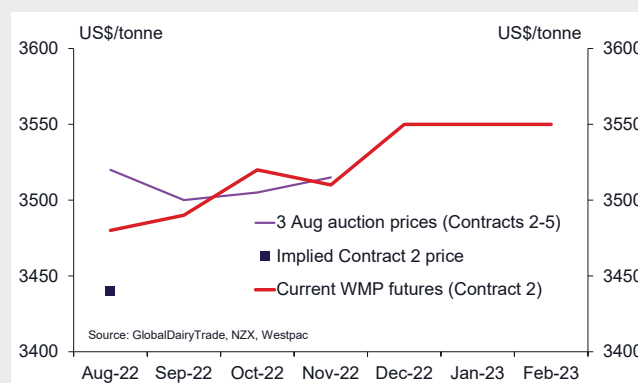
Aug 17, Last: -6.1%, Westpac: -1%

We expect whole milk powder prices (WMP) to drop by around 1% at the upcoming auction. This follows a 6.1% price slide at the previous auction.

In the short term, commodity prices are under pressure and global dairy prices are being similarly impacted. In addition, Fonterra lifted WMP auction volumes for August and September. This move may have increased the downward pressure on prices at least temporarily.

However further out, we anticipate that very weak global supply combined with rebounding Chinese demand will support global dairy prices.

Whole milk powder prices



RBNZ Monetary Policy Statement

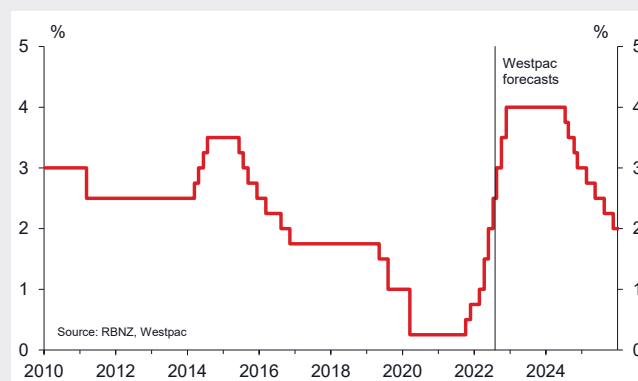
Aug 17, last: 2.50%, Westpac f/c: 3.00%, Market f/c: 3.00%

We expect the Reserve Bank to raise the Official Cash Rate by another 50bps to 3% at the August policy meeting. While we are seeing some signs that demand is cooling, domestic inflation pressures remain strong.

The RBNZ's projection for the OCR is likely to remain similar to the path from May. That is in contrast to financial markets which have moved to pricing in a lower peak for this cycle and an earlier start to interest rate cuts.

Continuing to tighten monetary policy "at pace" would send a message that while the fight against inflation is well under way, a declaration of victory is a long way off.

RBNZ Official Cash Rate



Aus Jul overseas arrivals and departures, prelim'

Aug 16, Arrivals, Last: 736.7k

Aug 16, Departures, Last: 885.3k

In June, arrivals posted a similar monthly gain as May, lifting to 736.7k, but the lift in departures accelerated, rising to 885.3k. This gap likely reflects previous visitor inflows (which ran ahead of departures) now cycling out as departures with the bulk of recent visitor arrivals reporting an intention to stay less than two months.

For the July preliminary estimate, we anticipate that the pace of recovery continues to forge ahead. There is still plenty of capacity for overseas travel figures to lift given that arrivals and departures are sitting at 40% and 50% of their pre-pandemic levels respectively.

The visa detail will be of keen interest. Compared to Dec-19, the current stock of temporary working/skilled visa holders in Australia is down by over 100k. Including students, that number is roughly 225k. Given the historic tightness of the labour market, gauging the recovery in net visa arrivals will provide some insight into the evolution of pressures and longer-term health of the labour market.

Total overseas arrivals and departures



The week ahead

Aus Q2 Wage Price Index %qtr

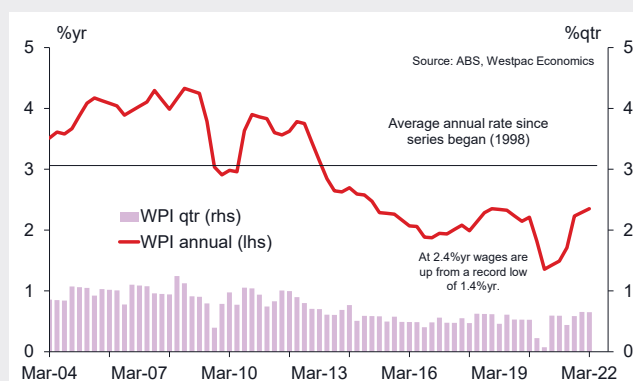
Aug 17, Last: 0.7%, WBC f/c: 0.9%

Mkt f/c: 0.8% Range: 0.7% to 2.7%

The Wage Price Index (WPI) gained 0.7% in the March quarter, on par with the rise in the December quarter. The annual pace lifted to 2.4%/yr from 2.3%/yr, and is the highest since Q4 2018. Back then wages were consistently under-performing broader economic indicators. We feel if there was ever a time for wages to regain some relationship with broader labour market indicators, late 2022 and into 2023 must be it.

Anecdotes suggest wage pressures have strengthened as employers have bid up wages in an effort to attract workers in a very tight labour market. But the WPI is a very pure quality-adjusted measure of hourly wage rates, and can be slow to move compared to broader measures of labour costs. As such, we have pencilled in a 0.9% rise in June but suggest the risks are to the downside. Should the WPI print a larger number, this would be a surprise suggesting we are indeed in a very strong wage inflationary period.

Wage inflation below average, for now



Aus Jul Labour Force Survey, employment chg

Aug 18, Last: 88.4k, WBC f/c: 50k

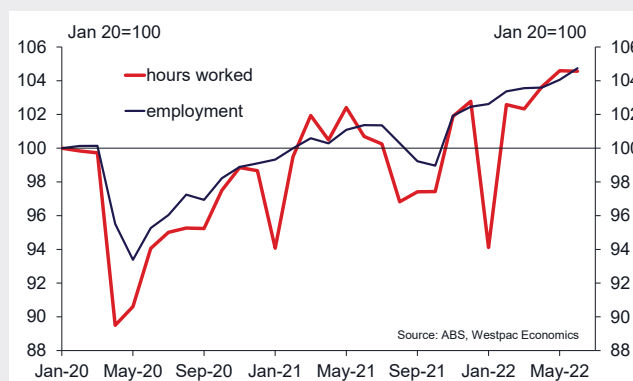
Mkt f/c: 25k Range: -10k to 60k

Total employment lifted 88.4k/0.7% in June while hours worked was flat (-0.02%). Employment is up 438.0k or 3.3% in the year - hours worked is up 3.8% in the year. Full-time employment continues to dominate, up 52.9k in the month, to be up 5.2% in the year. Part-time employment lifted 35.5k but is still down -0.8% in the year.

Female employment again outpaced male employment lifting 55.7k/0.9% to be up 3.8% in the year. Nevertheless, male employment was still solid lifting 32.7k/0.5% to be up 2.9%/yr.

Business surveys, consumer sentiment surveys and job vacancies all point to continuing solid demand for labour. Weekly payrolls for July did reveal some weakness but these are not seasonally adjusted and the ABS noted higher than usual absences for illness and holidays which will affect hours worked rather than employment. As such we have an around trend forecast of +50k.

Hours worked recovered to employment



Aus Jul Labour Force Survey, unemployment rate

Aug 18, Last: 3.5%, WBC f/c: 3.4%

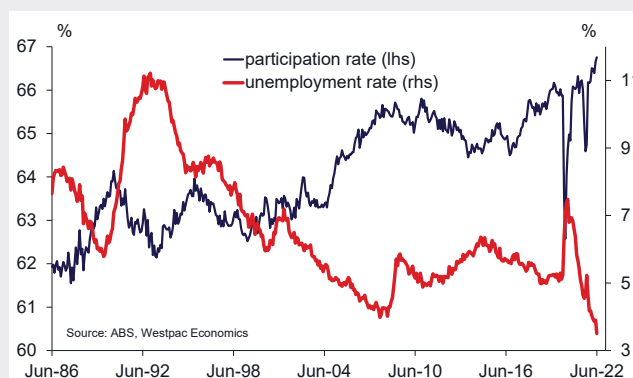
Mkt f/c: 3.5% Range: 3.4% to 3.5%

The solid demand for labour continues to draw more workers into the workforce and in June participation lifted 0.1ppt to 66.8%, representing a robust 34.1k rise in the labour force. Nevertheless, the even stronger 88.4k gain in employment saw the unemployment rate fall 0.4ppt to a new 48-year low of 3.5%.

In June, female participation lifted to 62.5%, a new record high, while male participation was flat at 71.2%, the highest rate since January 2021. Both are starting to push the boundaries of participation but we do expect to see this lift a little further at least for the near term.

The volatility in weekly payrolls due to illness and holidays is unlikely to have a meaningful impact on seasonally adjusted participation. As such, we look for a further 0.1% increase in participation to 66.9% limiting the fall in unemployment to 0.1ppt to 3.4%.

Participation surges to record high

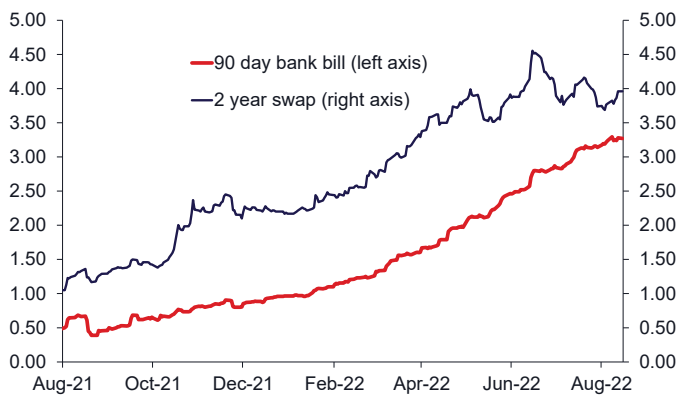


New Zealand forecasts

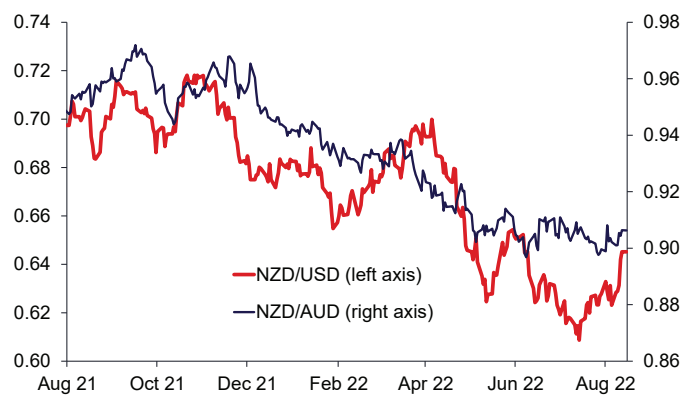
Economic forecasts	Quarterly				Annual			
	2022				2020	2021	2022f	2023f
% change	Mar (a)	Jun	Sep	Dec				
GDP (Production)	-0.2	1.0	0.7	1.2	-2.1	5.6	2.1	3.3
Employment	0.0	0.0	0.1	0.1	0.6	3.4	0.2	0.8
Unemployment Rate % s.a.	3.2	3.3	3.3	3.4	4.9	3.2	3.4	3.8
CPI	1.8	1.7	1.6	0.1	1.4	5.9	5.2	3.3
Current Account Balance % of GDP	-6.5	-7.5	-7.8	-7.5	-0.8	-5.8	-7.5	-6.1

Financial forecasts	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Cash	3.00	4.00	4.00	4.00	4.00	4.00	4.00
90 Day bill	3.70	4.10	4.10	4.10	4.10	4.10	4.10
2 Year Swap	3.90	3.90	3.80	3.70	3.50	3.30	3.10
5 Year Swap	3.70	3.70	3.60	3.50	3.35	3.20	3.05
10 Year Bond	3.40	3.50	3.40	3.30	3.15	3.00	2.95
NZD/USD	0.64	0.66	0.68	0.69	0.70	0.71	0.71
NZD/AUD	0.90	0.90	0.91	0.91	0.91	0.91	0.91
NZD/JPY	84.5	87.1	88.4	87.6	87.5	87.3	85.9
NZD/EUR	0.61	0.61	0.61	0.61	0.61	0.62	0.61
NZD/GBP	0.52	0.52	0.53	0.53	0.53	0.53	0.53
TWI	71.6	72.5	73.6	73.7	73.9	74.2	73.9

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 15 August 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.96%	2.83%	2.65%
60 Days	3.12%	3.00%	2.89%
90 Days	3.27%	3.18%	3.13%
2 Year Swap	3.96%	3.75%	4.11%
5 Year Swap	3.71%	3.57%	3.88%

NZ foreign currency mid-rates as at 15 August 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6452	0.6329	0.6176
NZD/EUR	0.6291	0.6174	0.6080
NZD/GBP	0.5312	0.5170	0.5154
NZD/JPY	86.15	83.70	85.36
NZD/AUD	0.9063	0.8989	0.9036
TWI	72.78	71.67	70.54

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Jul BusinessNZ PSI	55.4	-	-	Has held firm despite the headwinds in the economy.
Chn	Jul retail sales ytd %yr	-0.7%	0.1%	-	Momentum in consumption starting to build...
	Jul fixed asset investment ytd %yr	6.1%	6.3%	-	... ongoing strength in investment...
	Jul industrial production ytd %yr	3.4%	3.5%	-	... and trade key to recovery.
UK	Aug Rightmove house prices	0.4%	-	-	Rate hikes beginning to slow price momentum.
US	Aug Fed Empire state index	11.1	5.0	-	NY mfg supported by new orders growth; outlook gloomy.
	Aug NAHB housing market index	55	55	-	Builders face intense cost and supply pressures.
Tue 16					
Aus	RBA minutes	-	-	-	Colour around Aug 50bp hike, and risks to outlook.
	Jun overseas arrivals, prelim. 000's	736.7	-	-	Sitting at roughly 40% of pre-pandemic levels.
Eur	Aug ZEW survey of expectations	-51.1	-	-	Confidence has slipped below pandemic lows.
	Jun trade balance €bn	-26.0	-	-	Import demand for energy-related goods driving deficit.
UK	Jun ILO unemployment rate	3.8%	3.8%	-	Holding firmly at pre-pandemic levels.
US	Jul housing starts	-2.0%	-1.2%	-	Demand is being hit by tightening financial conditions...
	Jul building permits	0.1%	-2.7%	-	... while input constraints limit supply.
	Jul industrial production	-0.2%	0.3%	-	Supply headwinds still impacting production.
Wed 17					
NZ	GlobalDairyTrade auction - WMP	-6.1%	-	-1.0%	Global dairy prices remain under pressure.
	RBNZ policy decision	2.50%	3.00%	3.00%	RBNZ to signal tight policy will be required for some time.
Aus	Jul Westpac-MI Leading Index	0.4%	-	-	Above trend but showing a clear moderation.
	Q2 wage price index	0.7%	0.8%	0.9%	How much of reported wage pressure will appear this quarter?
Eur	Q2 GDP	0.7%	0.7%	-	Upside surprise in Q2; second estimate to give more colour.
UK	Jul CPI	0.8%	-	-	Energy inflation remains the key driver.
US	Jul retail sales	1.0%	0.2%	0.0%	Rising rates and inflation is a key risk to consumption.
	Jun business inventories	1.4%	1.4%	-	Businesses rebuilding inventory at robust pace.
	FOMC July meeting minutes	-	-	-	Focus is on discussions of the path for policy in 2022/23.
Thu 18					
Aus	Jul employment, '000 chg	88.4k	25k	50k	Labour demand is very robust in the face of a record...
	Jul unemployment rate	3.5%	3.5%	3.4%	... tightness in the labour market. Will the Covid hit the data?
Eur	Jul CPI, final	0.1%	-	-	Inflation broadening to food and services.
US	Aug Philly Fed index	-12.3	-5.0	-	Regional surveys painting a bleak picture for growth.
	Initial jobless claims	262k	-	-	Slowly lifting from historic lows.
	Jul existing home sales	-5.4%	-5.3%	-	Affordability locking many out of market.
	Jul leading index	-0.8%	-0.5%	-	Growth outlook deteriorating.
	Fedspeak	-	-	-	George and Kashkari.
Fri 19					
NZ	Jul trade balance \$m	-701	-	-1250	Agri exports slowing down seasonally; oil prices still high.
UK	Aug GfK consumer sentiment	-41	-	-	Confidence sunk to series low amid inflation concerns.
	Jul retail sales	-0.1%	-	-	Spending capacity restricted by rising prices.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.8	4.9	2.1
CPI inflation %yr	1.8	1.8	0.9	3.5	7.6	3.1
Unemployment rate %	5.0	5.2	6.8	4.7	3.0	4.2
Current account % of GDP	-2.1	0.7	2.6	3.5	1.6	-1.0
United States						
Real GDP %yr	2.9	2.3	-3.4	5.7	1.7	0.6
CPI inflation %yr	2.4	1.9	1.2	5.1	7.1	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.1
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	-0.2	-4.5	1.6	1.7	1.7
Euro zone						
Real GDP %yr	1.8	1.6	-6.4	5.3	2.2	1.5
United Kingdom						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.3	-1.0
China						
Real GDP %yr	6.8	6.0	2.2	8.1	3.5	7.0
East Asia ex China						
Real GDP %yr	4.5	3.8	-2.3	4.1	4.5	4.6
World						
Real GDP %yr	3.6	2.9	-3.1	6.1	3.0	3.4

Forecasts finalised 5 August 2022

Interest rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Australia								
Cash	1.85	2.35	3.10	3.35	3.35	3.35	3.35	3.10
90 Day BBSW	2.30	3.05	3.55	3.55	3.55	3.55	3.38	3.13
10 Year Bond	3.40	3.20	3.40	3.30	3.10	2.90	2.65	2.50
International								
Fed Funds	2.375	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.87	2.80	3.00	2.90	2.70	2.50	2.30	2.20

Exchange rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.7108	0.71	0.73	0.75	0.76	0.77	0.78	0.78
USD/JPY	133.30	132	132	130	127	125	123	121
EUR/USD	1.0317	1.05	1.09	1.11	1.13	1.14	1.15	1.16
GBP/USD	1.2193	1.23	1.26	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.7366	6.70	6.60	6.50	6.40	6.30	6.20	6.15
AUD/NZD	1.1018	1.11	1.11	1.10	1.10	1.10	1.10	1.10

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