

# WESTPAC WEEKLY ECONOMIC COMMENTARY

## The monetary policy hat-trick.

18 July 2022



### Westpac Economics Team

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Last week the RBNZ delivered a third consecutive 50bp hike in the Official Cash Rate. With inflation pressures still running red hot, we're forecasting another 50bp hike in August. Further ahead, additional rate hikes are on the cards, but those are likely to occur at a more measured pace. We continue to expect that the cash rate will peak at 3.50%, lower than assumed in the RBNZ's last published forecasts.

As expected, the Reserve Bank of New Zealand delivered a third consecutive 50bp hike in the cash rate at last week's Monetary Policy Review. That took the Official Cash Rate to 2.50%. The RBNZ also reaffirmed that they are planning to continue raising the cash rate to a level where they are confident that inflation will settle within the 1% to 3% target range.

While the statement that accompanied last week's rate hike was largely a 'copy and paste' from May, developments in recent weeks have actually been quite mixed. Globally, there are mounting concerns that policy tightening by major central banks to rein in inflation could push many economies into recession. Similarly, here in New Zealand confidence among both households and businesses has plummeted.

However, while the RBNZ did acknowledge those downside risks for growth, those concerns come against a backdrop of red-hot inflation pressures. In fact, we expect that this week's CPI report will show that annual inflation has now risen to 7% (up from 6.9% earlier in the year). That would be the highest level in more than three decades.

It's true that much of the rise in inflation has been due to factors beyond the RBNZ's control. That includes the high level of petrol prices, as well as ongoing disruptions to global supply chains that have resulted in shortages of both raw materials and finished goods.

But what's really lit a fire under consumer prices has been the strength of domestic demand. As we've noted before, demand has been running hot ever since New Zealand first moved out of lockdown, and the economy's productive capacity hasn't been able to keep up. Indeed, if we look at the areas where businesses are reporting significant shortages of supplies, they're predominantly in areas where demand has been strong, like the construction sector.

That strength in demand is a big concern for the RBNZ, because if demand is running hot, inflation is likely to remain elevated even when the current pressure on operating costs (eventually) eases off. And a key factor underpinning the strength of household demand has been stimulus from low interest rates.

Given the continuing strength in inflation pressures, we're forecasting the RBNZ will deliver a fourth 50bp hike at the time of the August policy review. That would bring the OCR up to a level of 3.00%.

However, it's at that point that we might see a change of tone from the RBNZ. Specifically, in August the Monetary Policy Committee could signal that while further OCR increases are still likely, the pace and extent of any additional hikes will be dependent on how the economy is tracking. By that time, the OCR will have moved into 'tight' territory and will be much closer to the 3.9% peak that the RBNZ assumed in their last published projections from May (and which the Monetary Policy Committee confirmed they remain broadly comfortable with last week). That means there will be less urgency to lift the cash rate than in recent months when the RBNZ has been racing to stifle the build-up of inflation pressures.

By August, the RBNZ will also have had time to fully account for the cooling in the global economy, as well as any signs that domestic activity is starting to lose traction. With regards to the latter, the past week saw two notable developments which came a little late for the RBNZ to factor into its July policy review. First, the June housing market update revealed a continued cooling, with house prices now down 6.7% since their peak in November and sales at their lowest level in more than a decade (barring the Covid lockdown period in 2020). Second has been the effective stalling in retail sales: despite continued rapid price increases, nominal spending was up just 0.1% in June, while spending in categories other than fuel was down 0.3%. In other words, while our nominal spending levels may be holding broadly steady, the amount of goods we're actually buying is going backwards. Looking ahead, we expect a further cooling on both of those fronts, and that signals a broader softening in economic activity as we approach year end.

Reflecting the above considerations, we expect that the pace of rate hikes is likely to become more measured in the latter part of the year. We're forecasting 25bp increases in both October and November, which would take the OCR to a peak of 3.50%.

There is one final aspect of the RBNZ's forecast (and ours) that hasn't garnered much attention yet: once the OCR does peak, it's likely to fall again in the years to come as inflation pressures ease back. That idea hasn't really been reflected in longer-term market interest rates, which are more consistent with the OCR rising and staying there. If the economic outlook does turn gloomier from here, there's plenty of scope for a fall in longer-term interest rates – and a de facto easing in monetary conditions – without the RBNZ having to do anything differently. So for now the RBNZ can afford to keep up its inflation-fighting message, without making concessions to the market's worries.

**Satish Ranchhod**, Senior Economist

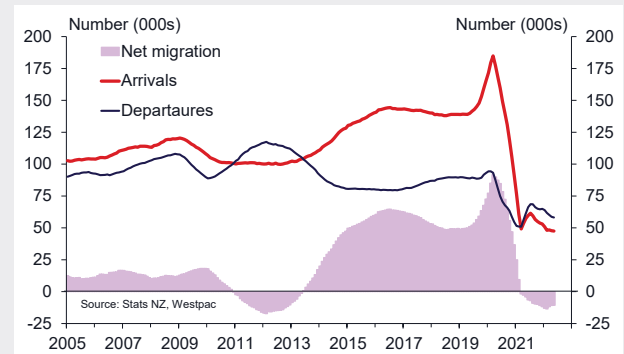
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## Chart of the week

New Zealand has continued to see an outflow of people. In the year to May the number of people departing on a permanent or long-term basis exceeded new arrivals by around 10,000 (and we suspect that estimated outflow is likely to be revised even higher as more up to date data on New Zealanders' travel comes to hand). While we do expect arrivals will push higher from here, net migration is likely to remain negative at least for the next year.

Net migration (annual)

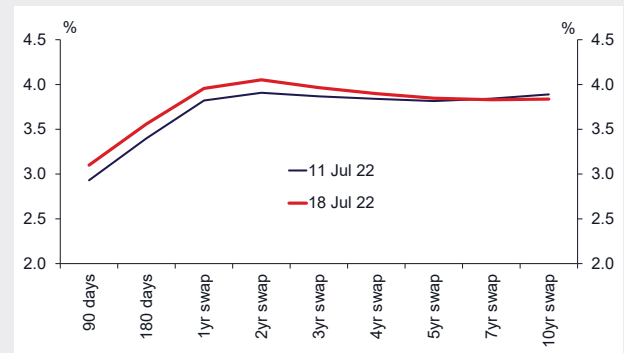


## Fixed vs floating for mortgages

Wholesale interest rates have fallen from their highs in the last few weeks, as markets have reassessed the prospects for the global economy. That in turn has seen cuts to some fixed-term mortgage rates.

Even so, market pricing remains above what would be consistent with our forecast of a 3.5% peak in the Official Cash Rate this year. This suggests to us that fixing for a short period and rolling is still likely to produce a lower borrowing cost on average over the next few years. Fixing for a longer term could prove more expensive, but may suit those who want more certainty in their repayments.

NZ interest rates



# The week ahead

## NZ Q2 Consumer price inflation

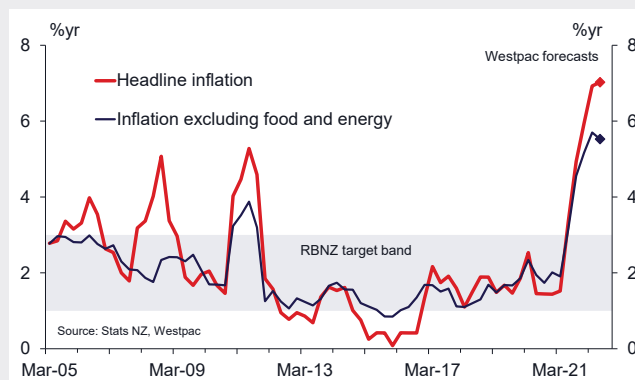
July 18, Last: +1.8%, Westpac: +1.4%, Market f/c: +1.5%

We expect a 1.4% increase in consumer prices in the June quarter. That would take annual inflation to 7.0%, up from 6.9% last quarter and the highest annual inflation rate in more than three decades. Our forecast is in line with the RBNZ's last set of published forecasts.

There have been particularly large increases in the prices of food, fuel and housing related costs. However, price pressures are bubbling over in every corner of the economy. Both tradables (imported prices) and non-tradables (domestic prices) are running hot.

Businesses are continuing to grapple with shortages of staff and supplies. But what has really lit a fire under consumer prices has been the strength of demand.

## NZ Consumer Price Inflation



## NZ GlobalDairyTrade auction, whole milk powder prices

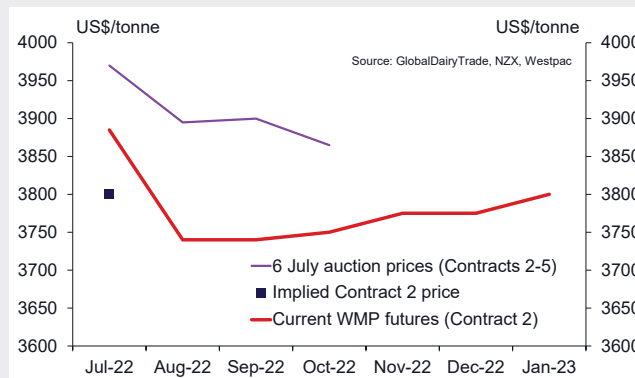
Jul 20, Last: -3.3%, Westpac: -4%

We expect whole milk powder prices (WMP) to drop by around 4% at the upcoming auction. This follows a 3.3% price dip at the previous auction.

In the short term, commodity prices are under pressure and we expect global dairy prices to be similarly impacted. In addition, Fonterra is offering more WMP on the auction platform. This move will increase 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



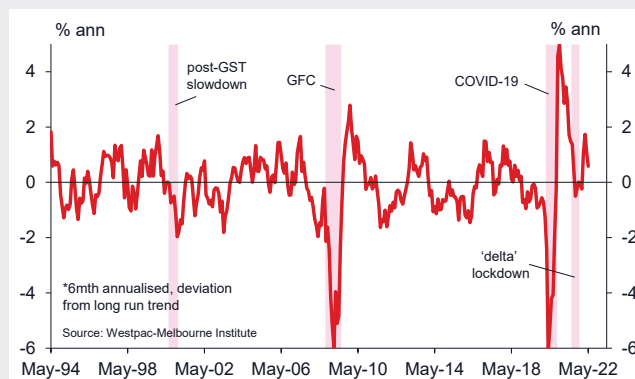
## Aus Jun Westpac-MI Leading Index

Jul 20, Last: 0.58%

The six-month annualised growth rate slowed further to 0.58% in May but remained consistent with above trend growth momentum sustaining into the second half of 2022 and early 2023.

The June update is likely to see a further moderation. Most monthly component updates will again be on the soft side, the ASX200 down -8.9%; the Westpac-MI Consumer Expectations Index down another -3.7%, commodity prices edging down -1.5% in AUD terms and hours worked holding flat. Dwelling approvals bucked the wider trend with a surprise 9.9% gain in May.

## Westpac-MI Leading Index

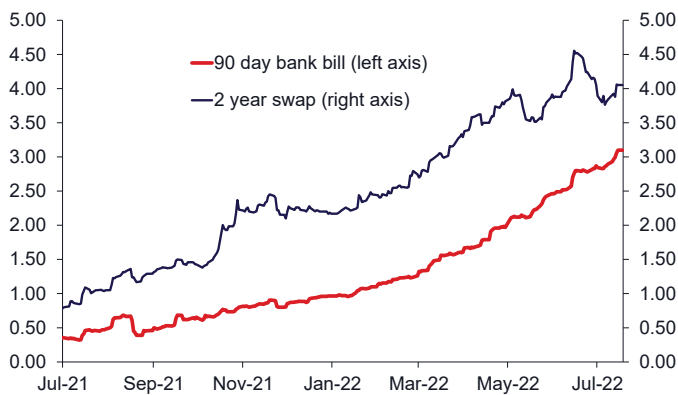


# New Zealand forecasts

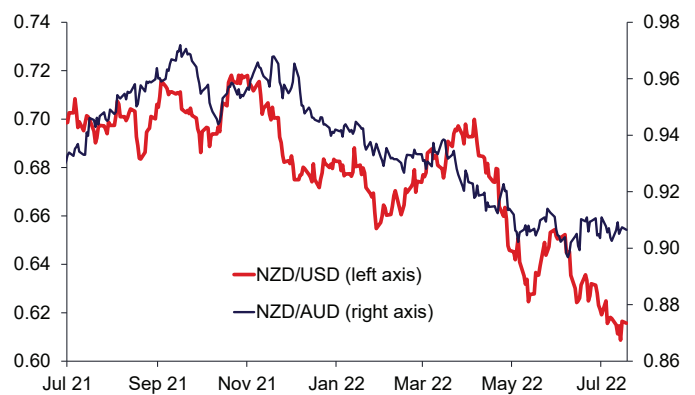
Economic forecasts	Quarterly				Annual			
	2022				2020	2021	2022f	2023f
% change	Mar (a)	Jun	Sep	Dec				
GDP (Production)	-0.2	1.0	0.7	1.2	-2.1	5.6	2.1	3.3
Employment	0.1	0.2	0.2	0.2	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.8	1.4	2.0	0.1	1.4	5.9	5.3	2.8
Current 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	3.50	3.50	3.50	3.50	3.50	3.50
90 Day bill	3.40	3.60	3.60	3.60	3.60	3.60	3.60
2 Year Swap	4.30	4.10	4.00	3.80	3.50	3.20	2.90
5 Year Swap	4.30	4.10	3.95	3.75	3.50	3.30	3.05
10 Year Bond	4.00	3.80	3.60	3.40	3.20	3.00	2.90
NZD/USD	0.65	0.68	0.70	0.71	0.72	0.72	0.72
NZD/AUD	0.90	0.91	0.91	0.91	0.91	0.90	0.90
NZD/JPY	85.8	87.7	88.9	88.0	87.2	87.1	86.4
NZD/EUR	0.61	0.62	0.63	0.63	0.63	0.63	0.62
NZD/GBP	0.52	0.54	0.55	0.55	0.54	0.54	0.53
TWI	71.6	73.3	74.4	74.7	74.5	74.7	74.5

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 18 July 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.00%	2.00%
30 Days	2.59%	2.40%	2.25%
60 Days	2.85%	2.62%	2.52%
90 Days	3.10%	2.83%	2.79%
2 Year Swap	4.05%	3.80%	4.47%
5 Year Swap	3.85%	3.79%	4.47%

NZ foreign currency mid-rates as at 18 July 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6157	0.6249	0.6357
NZD/EUR	0.6108	0.5979	0.6035
NZD/GBP	0.5188	0.5148	0.5189
NZD/JPY	85.33	84.61	85.74
NZD/AUD	0.9065	0.9077	0.9095
TWI	70.61	70.70	71.62

# Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 18</b>					
NZ	Jun BusinessNZ PSI	55.2	-	-	Business conditions have started to soften.
	Q2 CPI	1.8%	1.5%	1.4%	Domestic and imported price pressures running hot.
UK	Jul Rightmove house prices	0.3%	-	-	Demand to soften as rate hikes take effect.
US	Jul NAHB housing market index	67	66	-	Outlook for builders to deteriorate given rates & uncertainty.
<b>Tue 19</b>					
Aus	RBA minutes	-	-	-	Colour around July 50bp hike, and risks to outlook.
	RBA Deputy Governor Bullock	-	-	-	Speaking at ESA Business Lunch, Brisbane.
Eur	Jun CPI	0.8%	0.8%	-	Final; driven by soaring food and energy prices.
UK	May ILO unemployment rate	3.8%	3.9%	-	Holding near pre-pandemic level.
US	Jun housing starts	-14.4%	2.7%	-	Input supply the primary constraint for current construction...
	Jun building permits	-7.0%	-1.7%	-	... tighter financial conditions to weigh on pipeline.
<b>Wed 20</b>					
NZ	GlobalDairyTrade auction prices (WMP)	-3.3%	-	-4.0%	We anticipate a second successive global dairy price fall.
Aus	RBA Governor Lowe speaking	-	-	-	Australian Strategic Business Forum, Melbourne.
	Jun Westpac-MI Leading Index	0.58%	-	-	Losing altitude but still tracking above trend.
Eur	Jul consumer confidence	-23.6	-25.0	-	Energy security and inflation weighing heavily on confidence.
UK	Jun CPI	0.7%	0.5%	-	Energy remains key driver.
US	Jun existing home sales	-3.4%	-0.2%	-	Affordability locking many out of market.
<b>Thu 21</b>					
NZ	Jun trade balance \$mn	263	-	-100	Agri exports slowing down seasonally; oil prices still high.
Eur	ECB policy decision, refi rate	0.00%	0.25%	-	Clear guidance for the first 25bp rate hike in July.
US	Jul Philly Fed index	-3.3	1.7	-	Regional surveys have deteriorated materially of late.
	Initial jobless claims	244k	-	-	Remain near historic lows.
	Jun leading index	-0.4%	-0.5%	-	Growth outlook deteriorating.
<b>Fri 22</b>					
Eur	Jul S&P Global manufacturing PMI	52.1	51.0	-	Supply and cost pressures weighing on mfg activity...
	Jul S&P Global services PMI	53.0	52.0	-	... as services lose momentum from inflation pressures.
UK	Jul GfK consumer sentiment	-41	-	-	Confidence collapsed amid inflation pressures...
	Jun retail sales	-0.5%	0.1%	-	... restricting consumer's spending capacity.
	Jul S&P Global manufacturing PMI	52.8	52.0	-	UK manufacturing and services...
	Jul S&P Global services PMI	54.3	54.0	-	... to face a sharp slowdown over 2022.
US	Jul S&P Global manufacturing PMI	52.7	51.0	-	Broad-based deterioration in activity across industry...
	Jul S&P Global services PMI	52.7	52.0	-	... coming to US economy.

# International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
<b>Australia</b>						
Real GDP %yr	2.8	2.0	-2.1	4.8	4.5	2.7
CPI inflation %yr	1.8	1.8	0.9	3.5	6.6	3.0
Unemployment rate %	5.0	5.2	6.8	4.7	3.3	3.5
Current account % of GDP	-2.1	0.7	2.6	3.5	1.7	-1.2
<b>United States</b>						
Real GDP %yr	2.9	2.3	-3.4	5.7	2.0	0.8
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
<b>Japan</b>						
Real GDP %yr	0.6	-0.2	-4.5	1.6	1.7	1.8
<b>Euro zone</b>						
Real GDP %yr	1.8	1.6	-6.4	5.3	2.2	1.5
<b>United Kingdom</b>						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.3	0.0
<b>China</b>						
Real GDP %yr	6.8	6.0	2.2	8.1	5.3	5.5
<b>East Asia ex China</b>						
Real GDP %yr	4.5	3.8	-2.3	4.1	4.5	4.6
<b>World</b>						
Real GDP %yr	3.6	2.9	-3.1	6.1	3.4	3.2

Forecasts finalised 8 July 2022

Interest rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
<b>Australia</b>								
Cash	1.35	2.10	2.35	2.60	2.60	2.60	2.60	2.60
90 Day BBSW	2.15	2.55	2.72	2.80	2.80	2.80	2.80	2.80
10 Year Bond	3.42	3.60	3.50	3.35	3.15	2.90	2.65	2.50
<b>International</b>								
Fed Funds	1.625	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.94	3.10	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	0.6749	0.72	0.75	0.77	0.78	0.79	0.80	0.80
USD/JPY	139.02	134	132	130	127	125	123	121
EUR/USD	1.0021	1.05	1.09	1.11	1.13	1.14	1.15	1.16
GBP/USD	1.1826	1.23	1.26	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.7563	6.55	6.35	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.1018	1.11	1.10	1.10	1.10	1.10	1.11	1.11

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