

WESTPAC WEEKLY ECONOMIC COMMENTARY

Timing is everything.

19 December 2022



Southern rātā

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Reflecting back on 2022, the key themes that we identified at the start of the year were a consistent presence throughout; where they surprised was often in terms of their magnitude. For the year ahead, we expect that the debate about the economy will be increasingly coloured by the fact that monetary policy operates with a lag – in both directions.

We've been running a fairly consistent story about the New Zealand economy over this year. Monetary and fiscal stimulus during the Covid shock bought us a huge lift in demand – but this was in the face of what proved to be largely a supply-side hit. The result was an overheating of the economy and a resurgence in inflation. And over the course of 2022, the bill has come due in the form of higher interest rates.

Even so, the extent of both the inflation surge and the monetary policy response has been a surprise. Early in the year, we forecast that inflation would soon peak at 6.3%, and recede to 3.5% by the end of this year. But by the June quarter, inflation had reached 7.3%. We still think that the peak has now passed. But we now expect that inflation will remain uncomfortably high for longer, not returning within the 1-3% target range until mid-2024.

Similarly, we expected the Official Cash Rate to rise from 0.75% at the start of this year to reach a peak of 3% – a forecast that was market-leading at the time we made it. Instead, the cash rate has ended the year at 4.25%, with a strong chance of further large increases in the early part of next year.

We weren't alone in regard to these surprises – a similar story played out in many other advanced economies over the course of this year. Where New Zealand was different was mostly in terms of timing.

Our Covid elimination response in 2020 meant that we were able to operate for the best part of a year largely without domestic restrictions. (The one, big, remaining restriction was the border closure.) As a result, the New Zealand economy was able to build up more of a head of steam than other countries; economic activity rose above pre-Covid levels sooner than elsewhere.

But this meant that the inflation issue came to a head earlier as well. In that light, while the RBNZ may have been among the first central banks to start tightening monetary policy, it wasn't 'early' in relation to the prevailing economic conditions. As a result, it has found itself playing catch-up just as much as its overseas peers have.

It's well recognised that monetary policy works with a lag. With that in mind, we spent much of this year highlighting the channels through which we'd be watching its progress: from

interest rates to the housing market, to households' willingness to spend, to business activity, to the demand for workers, to wage pressures and ultimately to inflation.

On the first leg, the results have been clear. House prices started to fall at the end of 2021 in response to the rise in fixed-term mortgage rates, and they're now down almost 14% from their peak on average. That still only takes them back to where they were in early 2021, which just goes to show how massive the run-up in prices was in the first place.

Despite this hit to household wealth, consumer spending has been fairly resilient to date. Spending in dollar terms has continued to grow at a solid clip, although increasingly that has reflected rising prices rather than volumes.

What has helped is that household incomes have been growing strongly too. At the start of this year, wage growth was the shoe that had yet to drop in this cycle, prompting questions around whether something had changed in the structure of the labour market. That didn't last long though – wage growth has accelerated sharply in the last few quarters, on some measures reaching its fastest pace in decades. Average wages are now rising fast enough to keep pace with consumer price inflation.

However, there is one area where wage growth is likely to fall short in the year ahead. Mortgage interest payments are set to rise sharply in the coming months, as borrowers who fixed in previous years at mortgage rates below 3% start to roll onto rates that are now well above 6%. That will put a growing squeeze on households' discretionary spending, and in time we think it will provide the necessary braking effect on inflation.

Mortgage fixing is a key reason for the lagged effects of monetary policy – but this point applies in both directions. Our forecasts include an extended series of OCR cuts over 2024 and 2025. On our estimates, this is what it would take just to stabilise the average mortgage rate that borrowers are paying by 2025.

In other words, this lag in the transmission of monetary policy means that the RBNZ will have to do a lot just to take its foot off the brake in time, never mind hitting the accelerator. And given the RBNZ's preferred 'stitch in time' approach – strong early action reduces the risk of having to do even more later – the RBNZ should already be turning its mind to the appropriate timing of OCR cuts. Certainly financial markets will be raring to price in the easing phase of the cycle, especially with economic activity and the labour market set to weaken markedly over the year ahead.

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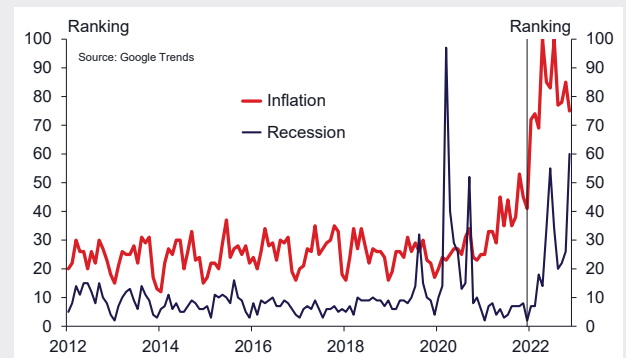
Happy holidays!

This will be the last Westpac Economic Weekly Commentary of 2022 but we will be back again on 23 Jan 2023. Wishing everyone a merry Christmas and a great summer break!

Chart of the year

While inflation was already hitting the headlines last year, 2022 was the year when it really grabbed New Zealanders' attention, with interest peaking at around the same time that the inflation rate peaked at 7.3%. Searches for 'what is inflation' also saw a solid lift, with whole generations encountering the problem for the first time in their lives. Interestingly, 'recession' also got a good airing throughout the year, even outside of the spikes in interest after the soft March quarter GDP release and the RBNZ's warnings of "engineering a recession" in November.

Internet search trends in New Zealand

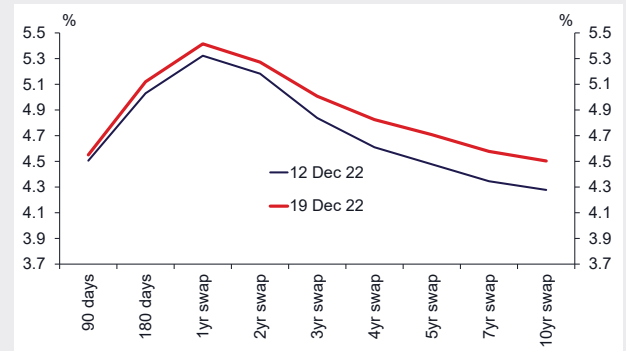


Fixed vs floating for mortgages

We expect the Reserve Bank to lift the Official Cash Rate to 5.5% by early next year, a move that has also been factored into wholesale interest rates. However, we see more scope for reducing the OCR over the longer term as inflation pressures recede.

As a result, we believe that there is value in fixing for terms of up to two years. We would 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

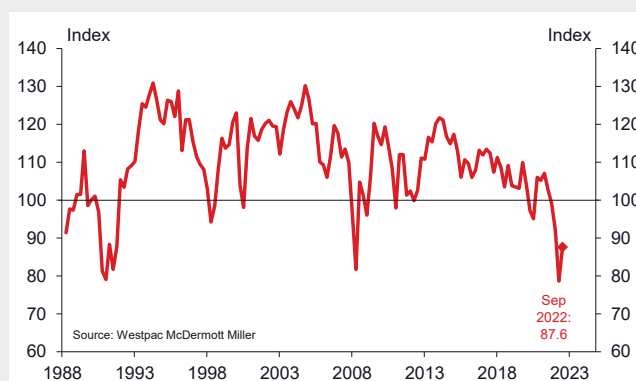
NZ Q4 Westpac McDermott Miller Consumer Confidence

Dec 19, Last: 87.6

Consumer confidence rebounded in the September quarter, with sentiment likely to have been boosted by the firming in economic conditions and easing of health restrictions following the peak in the Omicron wave. Even so, confidence remained very weak, with households reporting ongoing concerns about their financial position as consumer prices and mortgage interest costs pushed higher. There was also continued pessimism around the outlook for economic conditions more broadly.

Since our previous survey, the headwinds buffeting households have remained intense. Mortgage rates have taken another step higher. There's been large increases in living costs. And the housing market has continued to weaken. The combination of those factors points to mounting pressure on households' balance sheets.

Consumer Confidence



NZ Nov ANZBO business confidence

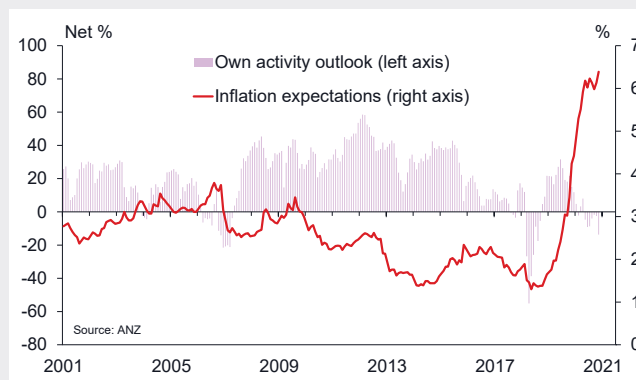
Dec 20, Last: -57.1

Business confidence dropped further into pessimistic territory in November. In addition, increasing numbers of businesses also reported that they expect trading conditions on their own shop floors will deteriorate over the coming months.

Confidence is set to remain low in the December survey. Businesses are grappling with a range of challenges, including rising interest costs and ongoing shortages of staff.

The survey's cost and pricing gauges will be a key focus. In November, large numbers of firms reported continued pressure on operating costs. However, the numbers of businesses who are actually passing on those increases eased back. We'll be watching to see if that pattern has continued.

Business confidence



NZ GlobalDairyTrade auction, whole milk powder prices

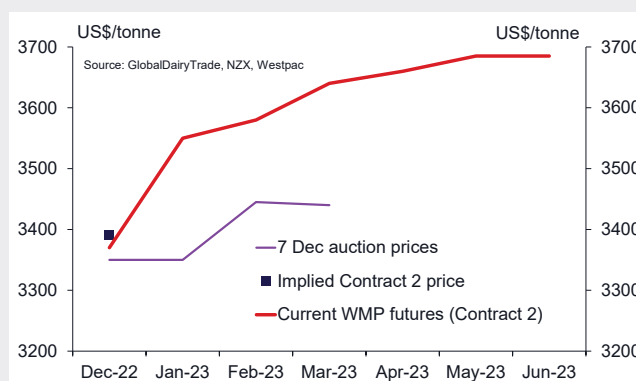
Dec 21, Last: 0.1%, Westpac: +1.0%

We expect whole milk powder prices (WMP) to lift 1% at the upcoming auction. This follows a 0.1% price rise at the previous auction.

Our pick is lower than the circa 3% price rise that the futures market is pointing to (as at 12pm Friday 16 December).

At this juncture and with tight global dairy supply fully priced into the market, the dairy market is focused on Chinese Covid developments. On that front, there have been further easing of restrictions and this is the likely catalyst for the potential auction price strength.

Whole milk powder prices



The week ahead

Aus Q4 ACCI-Westpac business survey

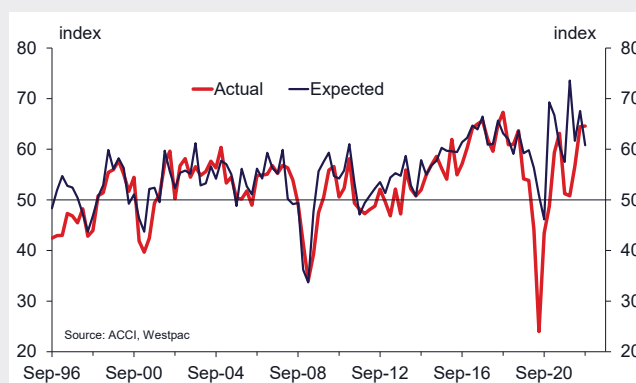
Dec 20, Last: 64.6

The ACCI-Westpac business survey for the December quarter, conducted through November into December, will provide a timely update on manufacturing and insights into economy wide trends.

Momentum in the manufacturing sector held firm in Q3, supported by a reopening burst in demand that led to a surge in new orders and output. The evolution of these reopening dynamics will be of keen interest in the December quarter.

The survey also highlights that the manufacturing sector is facing a broad set of challenges. Labour and material shortages, in particular, are acting as a major drag on business activity. Additionally, soaring input costs are flowing through (in part) to higher prices and squeezing margins.

Aus Westpac-ACCI Composite indexes (actual & expected, sa)



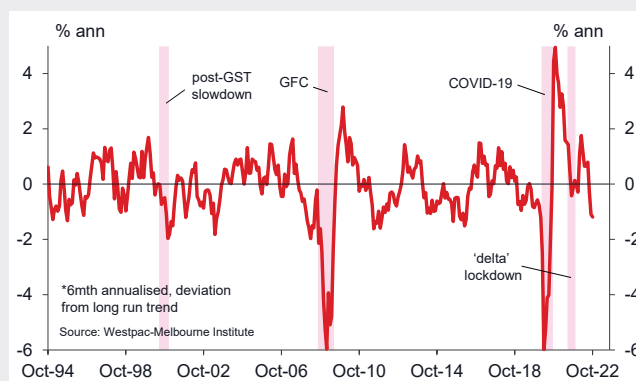
Aus Nov Westpac-MI Leading Index

Dec 21, Last: -1.19%

The six-month annualised growth rate in the Leading Index fell to -1.19% in October, pointing to a material loss in momentum to a below-trend growth pace heading into 2023.

The November update is likely to show another weak read. It will include positive updates for some components: the ASX200 up a further 6.1%; the Westpac-MI Consumer Expectations Index up 4%. But this is likely to be offset by weak updates on dwelling approvals (-18.5%) and a slightly softer tone around the labour market. Other components – including US industrial production, commodity prices and the yield spread, and the Westpac-MI Unemployment Expectations Index – look to be largely unchanged.

Aus Westpac-MI Leading Index



Aus Nov private sector credit

Dec 23, Last: 0.6%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.5% to 0.6%

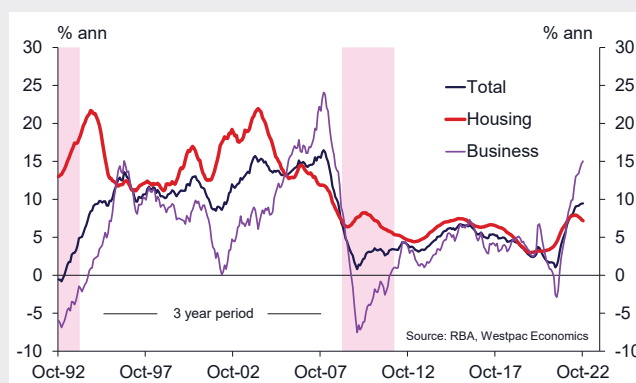
A gradual slowing in the monthly pace of credit growth is underway – as rapidly rising interest rates reduce the borrowing capacity of households, and the economy more broadly loses momentum.

This comes after a period of strong credit growth, as households and businesses responded to earlier policy stimulus. Over the year to October, credit grew by 9.5%, the fastest annual pace since 2008.

Monthly credit growth has eased from 0.9% throughout the June quarter to 0.8% for July and August, a 0.7% result for September and then 0.6% for October.

We anticipate that credit growth will edge down to 0.5% in November, led by housing, as well as some easing in the recent strong pace of business lending. New lending for housing is in fast retreat, contracting by 23% over the 9 months to October. Annual growth eases to 9.0%, moderating from the October cycle peak.

Aus credit growth

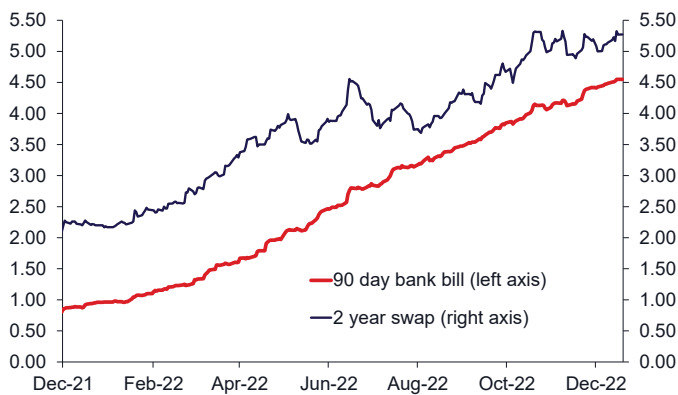


New Zealand forecasts

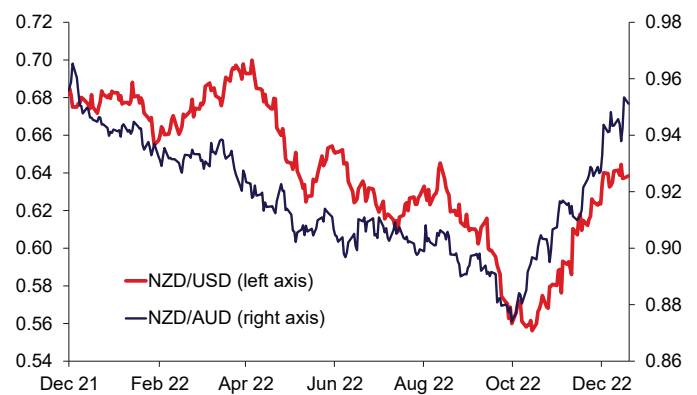
Economic forecasts	Quarterly				Annual			
	2022		2023		2021	2022f	2023f	2024f
% change	Sep	Dec	Mar	Jun				
GDP (Production)	2.0	0.5	0.4	0.0	6.1	2.9	2.2	0.0
Employment	1.3	0.1	0.1	0.1	3.3	1.3	0.1	0.0
Unemployment Rate % s.a.	3.3	3.3	3.4	3.5	3.2	3.3	3.9	4.8
CPI	2.2	1.1	1.6	1.0	5.9	6.9	4.4	2.4
Current Account Balance % of GDP	-7.9	-7.3	-5.9	-5.2	-6.0	-7.3	-4.5	-3.5

Financial forecasts	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24
Cash	5.00	5.50	5.50	5.50	5.25	4.75	4.25
90 Day bill	5.50	5.60	5.60	5.50	5.05	4.55	4.05
2 Year Swap	5.00	4.90	4.70	4.50	4.20	3.90	3.70
5 Year Swap	4.40	4.35	4.25	4.15	4.05	3.90	3.80
10 Year Bond	4.00	3.95	3.90	3.80	3.70	3.60	3.50
NZD/USD	0.64	0.65	0.66	0.67	0.68	0.68	0.68
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89	0.89
NZD/JPY	87.0	87.8	88.4	88.4	87.8	86.4	85.1
NZD/EUR	0.60	0.61	0.61	0.60	0.60	0.60	0.59
NZD/GBP	0.52	0.53	0.54	0.54	0.54	0.54	0.53
TWI	73.3	73.5	73.2	73.1	73.0	72.4	71.9

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 19 December 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	4.25%	4.25%	3.50%
30 Days	4.32%	4.32%	4.16%
60 Days	4.44%	4.38%	4.20%
90 Days	4.55%	4.45%	4.23%
2 Year Swap	5.27%	5.01%	5.02%
5 Year Swap	4.71%	4.38%	4.53%

NZ foreign currency mid-rates as at 19 December 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6384	0.6397	0.6121
NZD/EUR	0.6029	0.6071	0.5978
NZD/GBP	0.5250	0.5223	0.5179
NZD/JPY	86.77	86.61	86.71
NZD/AUD	0.9512	0.9411	0.9244
TWI	73.41	73.28	71.93

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Nov BusinessNZ PSI	57.4	-	-	Has picked up with improving conditions in hospitality.
	Q4 Westpac-MM consumer confidence	87.6	-	-	Financial pressures have continued to build.
US	Dec NAHB housing market index	33	34	-	Housing market under significant and lasting pressure.
Tue 20					
NZ	Nov trade balance \$mn	-2129	-	-1800	Export prices have eased, import cost pressures continuing.
	Dec ANZ business confidence	-57.1	-	-	Set to remain low in response to tighter financial conditions.
Aus	RBA minutes	-	-	-	More colour on the December decision.
	Q4 ACCI-Westpac business survey	64.6	-	-	Manufacturing supported by reopening through mid-year.
Eur	Dec consumer confidence	-23.9	-	-	Confidence is consolidating but still at historic lows.
US	Nov housing starts	-4.2%	-1.5%	-	Demand is being crimped by rising interest rates...
	Nov building permits	-3.3%	-1.0%	-	... limiting near-term support for residential construction.
Wed 21					
NZ	GlobalDairyTrade auction (WMP)	0.1%	-	1.0%	Global dairy prices lifting as China's Covid restrictions ease.
	Dec ANZ consumer confidence	80.7	-	-	Continues to be weighed down by financial concerns.
Aus	Nov Westpac-MI Leading Index	-1.19%	-	-	Pointing to a material loss in momentum heading into 2023.
US	Nov existing home sales	-5.9%	-5.2%	-	Declines in sales volumes are well entrenched.
	Dec consumer confidence index	100.2	101.0	-	Rates and inflation offsetting labour market optimism.
Thu 22					
UK	Q3 GDP	-0.2%	-	-	Final estimate.
US	Q3 GDP, annualised	2.9%	2.9%	-	Final estimate.
	Initial jobless claims	211k	-	-	To remain at relatively low levels for now.
	Nov Chicago Fed activity index	-0.05	-	-	Growth outlook...
	Nov leading index	-0.8%	-0.4%	-	... clearly deteriorating.
	Dec Kansas City Fed index	-6	-	-	Regional surveys generally showing weakness.
Fri 23					
Aus	Nov private sector credit	0.6%	0.5%	0.5%	Gradual slowdown: impacted by higher rates & slowing economy.
US	Nov durable goods orders	1.1%	-0.8%	-	Core orders pointing to subdued investment spending.
	Nov personal income	0.7%	0.2%	-	Nominal income growth surprisingly robust but inflation...
	Nov personal spending	0.8%	0.2%	-	... pressures will limit real spending capacity into 2023.
	Nov PCE deflator	0.3%	0.2%	-	Close attention on core PCE inflation...
	Nov core PCE deflator	0.2%	0.2%	-	... as tightening pace begins to slow.
	Dec Uni. of Michigan sentiment	59.1	59.1	-	Final estimate.
	Nov new home sales	7.5%	-5.1%	-	Return to sizeable declines widely expected.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022f	2023f	2024f
Australia						
Real GDP %yr	1.9	-1.8	5.2	3.6	1.8	1.2
CPI inflation %yr	1.8	0.9	3.5	7.5	3.9	3.0
Unemployment rate %	5.2	6.8	4.7	3.3	4.6	5.1
Current account % of GDP	0.7	2.4	3.1	0.5	-1.0	-1.5
United States						
Real GDP %yr	2.3	-3.4	5.7	2.0	0.5	1.3
CPI inflation %yr	1.9	1.2	5.1	7.4	2.3	2.1
Unemployment rate %	3.7	8.1	5.4	3.7	4.8	5.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	-4.6	1.7	1.6	1.5	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.2	3.2	0.4	1.5
United Kingdom						
Real GDP %yr	1.7	-9.3	7.4	4.0	-0.7	1.5
China						
Real GDP %yr	6.0	2.2	8.1	3.5	6.0	5.5
East Asia ex China						
Real GDP %yr	3.8	-2.3	4.2	4.5	4.3	4.4
World						
Real GDP %yr	2.8	-3.0	6.0	3.3	2.9	3.2

Forecasts finalised 12 December 2022

Interest rate forecasts	Latest	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia									
Cash	3.10	3.60	3.85	3.85	3.85	3.60	3.35	3.10	2.85
90 Day BBSW	3.19	3.97	4.05	4.05	3.97	3.72	3.47	3.22	2.97
10 Year Bond	3.44	3.20	3.10	3.00	2.90	2.80	2.70	2.60	2.50
International									
Fed Funds	4.375	4.875	4.875	4.875	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.48	3.40	3.30	3.20	3.10	2.90	2.70	2.60	2.50

Exchange rate forecasts	Latest	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6717	0.69	0.70	0.72	0.74	0.75	0.76	0.76	0.77
USD/JPY	137.23	136	135	134	132	130	128	126	124
EUR/USD	1.0647	1.06	1.07	1.09	1.11	1.12	1.13	1.14	1.15
GBP/USD	1.2210	1.22	1.22	1.23	1.24	1.25	1.26	1.27	1.28
USD/CNY	6.9709	6.90	6.80	6.60	6.50	6.40	6.30	6.20	6.10
AUD/NZD	1.0568	1.08	1.08	1.09	1.10	1.11	1.13	1.13	1.13

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- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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