WESTPAC WEEKLY ECONOMIC COMMENTARY

Peak practice.

21 November 2022

Kōwhai

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As it prepares this week's *Monetary Policy Statement*, the Reserve Bank finds itself facing the real risk of an inflationary spiral – the very situation it had hoped to prevent with its relatively early start on hiking interest rates. But given the momentum in domestic demand, and the cautious initial pace of rate hikes, the economy has become increasingly overheated and the advantage appears to have been lost. Now a much higher level of interest rates will be needed to bring inflation under control.

As we detailed in our CPI review last month, we now expect the Official Cash Rate to reach a peak of 5%, most likely in the early part of next year. With the cash rate currently at 3.5%, that implies the Reserve Bank is still some way from where it needs to be. And with little room for delay, we think that the RBNZ will deliver a larger 75 basis point increase in the OCR this time, taking it up to 4.25%.

Our pick is in line with the majority of local forecasters. Interest rate markets are priced roughly halfway between a 50 point and a 75 point move, so a larger move would see a modest rise in rates on the day.

However, the real interest will be in what the RBNZ signals for the months ahead. It's not certain whether their projected OCR track will go all the way up to 5% this time, but it is likely to be substantially higher than the 4.1% peak that was projected in August.

Since the last OCR review in October, the economic data has been a stream of uncomfortable news on the inflation front. The September quarter CPI showed that price rises are becoming more widespread, and are increasingly being driven by local forces. The annual inflation rate of 7.2% was down a touch from the peak of 7.3% in the previous quarter, but it was well above the RBNZ's forecast of 6.4%.

The CPI release was followed by a sharp rise in surveyed expectations of inflation, particularly for two years ahead which is essentially the medium-term horizon for monetary policy. While those expectations had actually fallen in the previous survey, that now appears to have been a head-fake; high inflation is steadily eroding people's faith in the medium-term inflation target.

Finally, there is now clear evidence that high inflation is feeding into wage-setting. A growing share of workers are getting cost-of-living increases or more, and employers are willing to pay because they believe they can pass it through into their prices. The RBNZ was already braced for some strong wage figures in the coming quarters, but the September quarter results either met or exceeded even those forecasts.

While we're picking a 75 basis point increase this week, we acknowledge that both a 50 point and a 100 point increase are genuine possibilities as well. In our view, there are a few factors that favour a step up from the 50 basis point increases we've seen at the last few reviews.

First, while the size of any one OCR move isn't crucial for the economy, it does serve as a signal of the central bank's intentions: how far it thinks it needs to go, and how committed it is to meeting its inflation target. The relentless rise in prices is clearly rattling people's confidence in a return to low and stable inflation in the years ahead. A show of force by the RBNZ could help to restore that confidence.

The second issue is that the Monetary Policy Committee's schedule means that there is an unusual three-month gap between next week's review and the following one in February. If the RBNZ is seen as being too timid, the opportunity for a course-correction is some time away. Indeed, even a 75 basis point rise next week would be a slowdown from the RBNZ's recent pace – they have effectively been delivering 100 basis points every three months. It's not ideal that scheduling should play such a role, but nevertheless it is a factor.

Finally, and perhaps most importantly, the Committee has already opened the door to a larger move, revealing that it had debated between a 50 and a 75 point increase in its October review (though it settled on the smaller of the two options that time).

What really piqued our interest was that the Committee again invoked the 'stitch in time' argument: a larger increase in the OCR now would reduce the risk of an even higher peak being needed in the future. This is the same reasoning that led the RBNZ to step up the pace from 25 point to 50 point moves in April this year. The case for this approach was actually laid out in a speech last September, but wasn't acted on until months later – a delay that the RBNZ now regrets.

As we detailed in our latest *Economic Overview*, many households will be refixing at substantially higher mortgage rates in the coming months. That might suggest that now is the wrong time to be piling on with further rises in interest rates. But the 'stitch in time' approach is actually the lesser of the evils. If you're worried about whether households can handle mortgage rates with a 6 in front, you would definitely want to get in front of inflation now and head off the risk that those rates could end up at 7% or more down the line.

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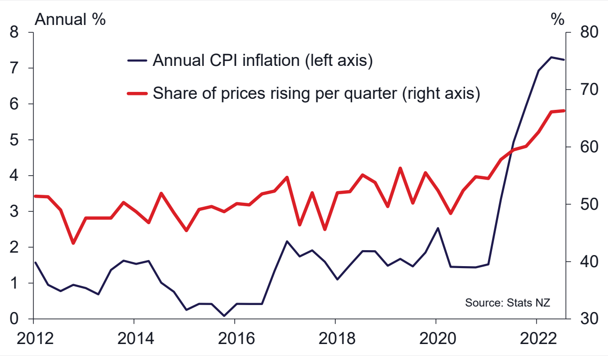
Chart of the week

High inflation is broad inflation. Around two-thirds of the items in the Consumers Price Index are rising each quarter, compared to around half of them in the pre-Covid years. It's increasingly clear that the current bout of inflation is not the result of price shocks for particular items, but is being driven by a common cause.

Consumer price inflation

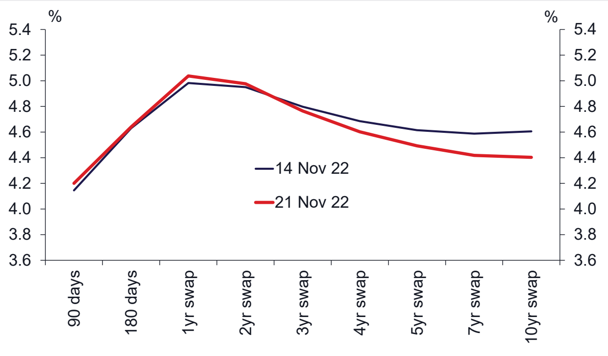


Fixed vs floating for mortgages

We expect the Reserve Bank to lift the Official Cash Rate to 5% and to hold it there for the next couple of years, before reducing it to a more sustainable level in the following years. Wholesale interest rate markets are pricing in a similar peak, but a higher level of the OCR over the longer term.

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 Nov RBNZ Monetary Policy Statement

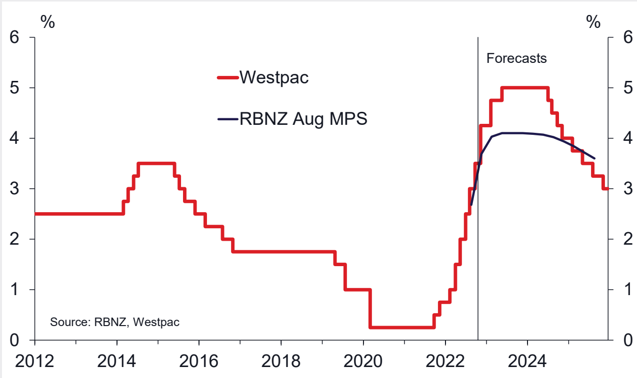
Nov 23, Last: 3.50%, Westpac f/c: 4.25%, Market f/c: 4.25%

We expect the Reserve Bank to raise the Official Cash Rate by 75 basis points to 4.25% at next Wednesday's Monetary Policy Statement.

Recent data has pointed to mounting inflation pressures, raising concerns that the Reserve Bank has fallen behind the pace despite its relatively early start to rate hikes.

We expect the OCR to peak at 5% by early next year. And the Reserve Bank's preferred 'stitch in time' approach means that it will be looking to head off the risk of an even higher peak.

RBNZ Official Cash Rate



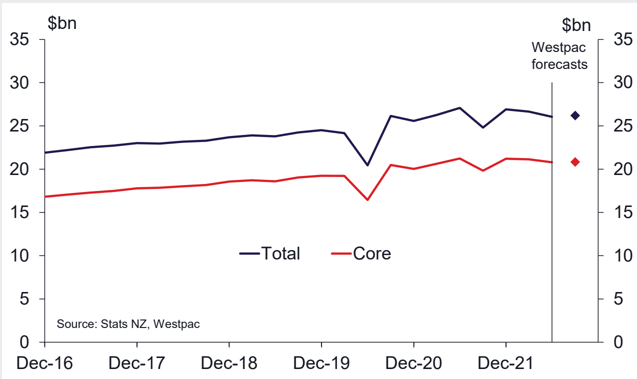
NZ Q3 retail spending (volumes)

Nov 25, Last: -2.3%, Westpac f/c: +0.5%

Retail spending was much weaker than expected in the June quarter, with the volume of goods sold falling by 2.3%. Households have been winding back their spending on items like household durables and motor vehicles. Those are the same categories where spending rose strongly when Covid-19 first arrived on our shores and measures to protect public health prompted a shift away from spending on services.

We're expecting a modest gain of 0.5% in the volume of goods sold in the September quarter. Increases in prices and interest rates are continuing to erode households' spending power, and those factors will be a particular drag on durables spending. Providing an offset to that softness has been the recovery in hospitality spending, which has been boosted by the return of international tourists.

NZ retail spending volumes

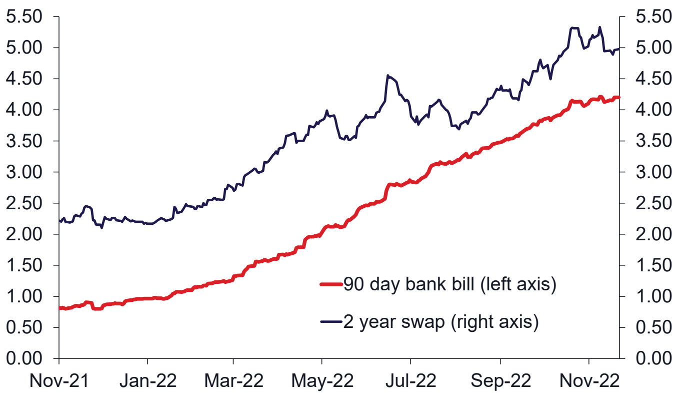


New Zealand forecasts

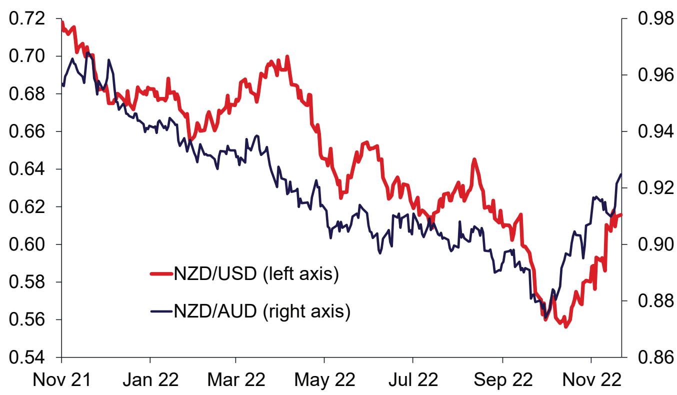
Economic forecasts	Quarterly				Annual			
	2022			2023				
% change	Jun (a)	Sep	Dec	Mar	2020	2021	2022f	2023f
GDP (Production)	1.7	0.4	0.4	0.9	-2.1	5.5	2.2	1.9
Employment	0.0	1.3	0.1	0.1	0.6	3.3	1.3	0.5
Unemployment Rate % s.a.	3.3	3.3	3.3	3.4	4.9	3.2	3.3	3.8
CPI	1.7	2.2	0.8	1.2	1.4	5.9	6.5	3.9
Current Account Balance % of GDP	-7.7	-8.0	-7.5	-6.4	-0.8	-6.0	-7.5	-4.7

Financial forecasts	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Cash	4.25	4.75	5.00	5.00	5.00	5.00	5.00
90 Day bill	4.55	5.00	5.10	5.10	5.10	5.10	4.80
2 Year Swap	5.00	4.90	4.80	4.60	4.40	4.15	3.90
5 Year Swap	4.70	4.60	4.50	4.35	4.20	4.05	3.90
10 Year Bond	4.50	4.50	4.30	4.20	4.00	3.80	3.70
NZD/USD	0.59	0.60	0.61	0.63	0.65	0.66	0.66
NZD/AUD	0.91	0.91	0.91	0.91	0.90	0.90	0.89
NZD/JPY	86.7	87.0	87.2	88.2	88.4	87.1	85.8
NZD/EUR	0.59	0.59	0.60	0.61	0.61	0.60	0.60
NZD/GBP	0.52	0.53	0.53	0.53	0.54	0.54	0.53
TWI	69.5	69.6	69.6	70.3	71.1	70.8	70.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 November 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	4.10%	3.92%	3.63%
60 Days	4.15%	4.05%	3.88%
90 Days	4.20%	4.17%	4.13%
2 Year Swap	4.98%	5.20%	5.31%
5 Year Swap	4.49%	4.88%	5.07%

NZ foreign currency mid-rates as at 21 November 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6157	0.5914	0.5688
NZD/EUR	0.5962	0.5925	0.5791
NZD/GBP	0.5175	0.5164	0.5032
NZD/JPY	86.35	86.76	84.97
NZD/AUD	0.9248	0.9153	0.9032
TWI	71.95	70.65	68.70

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
US	Oct Chicago Fed activity index	0.10	–	–	Growth outlook clearly subdued.
Tue 22					
Aus	RBA Governor Lowe speaking	–	–	–	Price Stability, the Supply Side and Prosperity.
NZ	Oct trade balance $mn	–1615	–	–	Export prices have eased, import cost pressures continuing.
Eur	Nov consumer confidence	–27.6	–	–	Consumers are feeling the heat from inflation and rates.
US	Nov Richmond Fed index	–10	–6	–	Regional surveys are broadly reflecting weak conditions.
	Fedspeak	–	–	–	Mester, George and Bullard.
Wed 23					
NZ	RBNZ policy decision	3.50%	4.25%	4.25%	RBNZ to deliver large rate hike due to strength of inflation.
Eur	Nov S&P Global manufacturing PMI	46.4	–	–	Broad-based weakening in demand beginning to take hold...
	Nov S&P Global services PMI	48.6	–	–	... leaving mfg and services in a very fragile state.
UK	Nov S&P Global manufacturing PMI	46.2	–	–	Similar risks are also present in the UK as inflation...
	Nov S&P Global services PMI	48.8	–	–	... continues to restrict real spending capacity.
US	Oct durable goods orders	0.4%	0.4%	–	Core orders pointing to subdued investment spending.
	Initial jobless claims	222k	–	–	Likely to remain at low levels for the time being.
	Nov S&P Global manufacturing PMI	50.4	50.0	–	Mfg activity is soft but fragile...
	Nov S&P Global services PMI	47.8	48.0	–	... S&P points to clearer risks for services.
	Nov Uni. of Michigan sentiment	54.7	55.5	–	Final estimate.
	Oct new home sales	–10.9%	–4.6%	–	Weakness in sales volumes set to persist.
	FOMC November meeting minutes	–	–	–	Focus is on discussion of path for policy for 2022/23.
Thu 24					
US	Thanksgiving Day	–	–	–	Public holiday; markets closed.
Fri 25					
NZ	Nov ANZ consumer confidence	85.4	–	–	Set to remain low reflecting mounting financial pressures.
	Q3 real retail sales	–2.3%	–	0.5%	Softness in durables balanced against recovery in hospitality.
Sun 27					
Chn	Oct industrial profits %yr ytd	–2.3%	–	–	Policy support will aid profit growth into 2023.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.9	4.2	1.9
CPI inflation %yr	1.8	1.8	0.9	3.5	7.9	4.1
Unemployment rate %	5.0	5.2	6.8	4.7	3.3	4.5
Current account % of GDP	-2.1	0.7	2.4	3.2	1.3	-0.9
United States						
Real GDP %yr	2.9	2.3	-3.4	5.7	1.9	0.4
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	4.8
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	-0.4	-4.6	1.7	1.7	1.5
Euro zone						
Real GDP %yr	1.8	1.6	-6.1	5.2	3.2	0.4
United Kingdom						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.6	-0.2
China						
Real GDP %yr	6.8	6.0	2.2	8.1	3.5	6.0
East Asia ex China						
Real GDP %yr	4.5	3.8	-2.3	4.2	4.5	4.4
World						
Real GDP %yr	3.6	2.8	-3.0	6.0	3.2	3.0

Forecasts finalised 4 November 2022

Interest rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Australia								
Cash	2.85	3.10	3.60	3.85	3.85	3.85	3.60	3.35
90 Day BBSW	3.05	3.55	3.97	4.05	4.05	3.97	3.72	3.47
10 Year Bond	3.64	3.80	3.80	3.60	3.40	3.20	3.00	2.90
International								
Fed Funds	3.875	4.375	4.625	4.625	4.625	4.625	4.375	3.875
US 10 Year Bond	3.77	4.00	4.00	3.80	3.60	3.40	3.10	2.90

Exchange rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
AUD/USD	0.6709	0.65	0.66	0.67	0.69	0.72	0.73	0.74
USD/JPY	139.90	147	145	143	140	136	133	130
EUR/USD	1.0369	1.00	1.01	1.02	1.04	1.07	1.09	1.10
GBP/USD	1.1893	1.13	1.14	1.16	1.18	1.20	1.22	1.24
USD/CNY	7.1538	7.20	7.00	6.80	6.60	6.50	6.40	6.30
AUD/NZD	1.0893	1.10	1.10	1.10	1.10	1.11	1.11	1.12

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