

WESTPAC WEEKLY ECONOMIC COMMENTARY

Leader of the pack.

1 February 2022



Hihi

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Consumer price inflation surged over 2021, and we'll soon find out the extent to which wage growth has followed. The Reserve Bank will need to continue raising interest rates to rein in inflation pressures, and it's increasingly clear that they're not alone in that regard.

Last week's inflation figures were about as ugly as expected. Consumer prices rose by 1.4% in the December quarter. That lifted the annual inflation rate to 5.9%, the highest rate going back to 1990 (which itself was temporarily boosted by a lift in the rate of GST).

The surge in inflation has been fuelled by a potent cocktail of supply and demand pressures. The worldwide effects of Covid-19 have led to disruptions in manufacturing and supply chains, abnormally high demand for physical goods over services, rising materials costs and extreme pressure on global shipping capacity. Prices of tradable goods have risen by 6.9% over the last year.

The supply-side factors have collided with strong domestic demand. The New Zealand economy rebounded quickly after the initial Covid lockdown in 2020, and by mid-2021 activity was running well above pre-pandemic levels. As a result, domestic prices are being pressured higher, and the demand for workers has surged even as the border closure has restrained growth in the workforce.

The surge in inflation underscores one of the biggest lessons of the last year: the Covid shock was not like a 'typical' recession,

where the economy suffers a shortfall in demand. Policymakers certainly acted under the view that they would need to stimulate demand, and that support was particularly valuable during the periods of lockdown. But for the most part the pandemic has been a productivity shock, which has weighed on the economy's operating capacity.

New Zealand has been far from alone in terms of the inflationary consequences – indeed, we've noted that our economic situation is different from the rest of the world only by a matter of degree. Our successful Covid elimination strategy in 2020 saw economic activity rebound faster than in most economies, and this was bolstered by generous monetary policy and one of the largest government spending packages in the world (as a share of GDP). As a result, by 2021 there was growing evidence that we had reached the point of overheating. But it was only a question of time as to when other countries would reach that point as well.

That came home to roost for some of the RBNZ's international peers last week. The US Federal Reserve acknowledged that it will need to start raising interest rates soon, with annual inflation reaching 7% and proving to be less 'transitory' than

hoped. And a stronger than expected inflation print in Australia means that the RBA is now expected to change its tune and signal rate hikes this year as well.

The RBNZ has behaved the most like a 'normal' central bank by front-footing the inflation risk, with two rate hikes already under its belt last year. But ultimately it may end up leading the pack by just a few months, whereas at times overseas central banks have implied that the gap could be years.

The last key piece of the inflation picture is wage growth. For an initial price shock to turn into sustained inflation, there needs to be a feedback loop between consumer prices and other prices in the economy, most importantly the price of labour. And when the jobs market is tight, the conditions are ripe for that feedback loop to take hold.

With that in mind, this week's labour market surveys for the December quarter will be crucial. We're expecting an unemployment rate of 3.5%, which is up slightly from 3.4% in the September quarter. However, Stats NZ noted that the previous reading was distorted downward a little by the Covid lockdown during August-September. So implicitly we're saying that the 'true' result will be a decline in December, close to the record low that was reached in 2008.

Stories of labour shortages are widespread, with businesses saying that this is now their single biggest constraint on growth. In these conditions, there's every reason to expect wage growth to accelerate. Yet the hard data on this has been relatively modest so far.

We expect a 0.8% rise in the Labour Cost Index for the quarter, which would lift the annual pace to 2.8%. While that would be the fastest rise since 2009, it would still represent little more than a catch-up after little or no pay rises in the wake of the initial Covid shock. We're still to see how the demand for larger cost-of-living adjustments will be reflected in the data.

Roughly speaking, we see the interaction between inflation and wage growth playing out in two phases. In the current phase, inflation has been driven in large part by a cost shock. In this stage, wage growth will pick up, but will fall behind inflation – in a cost shock, someone has to bear the pain, and even in a tight labour market workers won't be completely shielded from it.

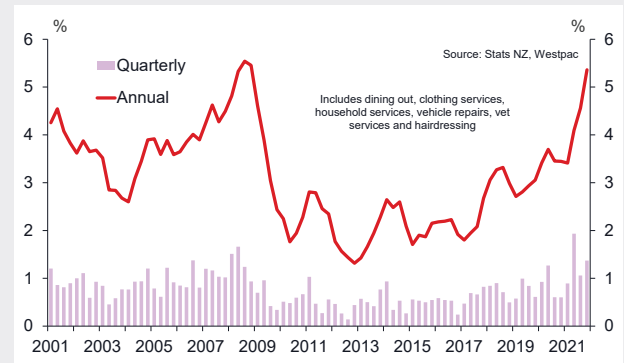
In the second phase – perhaps by the end of this year – Covid-related cost shocks will ease, but domestic pressures will take over as the main driver of inflation. As a result, headline inflation will be lower than today but more persistent, and wage growth is more likely to match or outpace the rising cost of living.

Of course, how this actually plays out will depend on how the Reserve Bank responds. Our forecast remains for a series of 25 basis point OCR hikes, reaching a peak of 3% by the second half of next year.

Chart of the week

Much of the recent inflation surge has been 'imported', reflecting global Covid-19 shocks, but domestic factors are increasingly becoming a driving force. Prices for services where labour is a major input are now rising at a similar pace to their peak in 2008, when the labour market was also extremely tight.

Selected labour-intensive services in the CPI

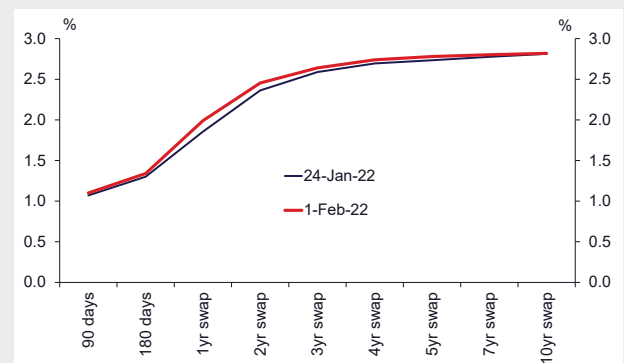


Fixed vs floating for mortgages

Wholesale interest rates are now largely in line with our forecast of a 3% cash rate by mid-2023. That suggests there is no longer an advantage to fixing for longer terms.

While the one-year mortgage rate is likely to rise further in the next couple of years, fixing and rolling for this term is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms are more suited to those who want certainty in their repayments.

NZ interest rates



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The week ahead

NZ GlobalDairyTrade auction, whole milk powder prices

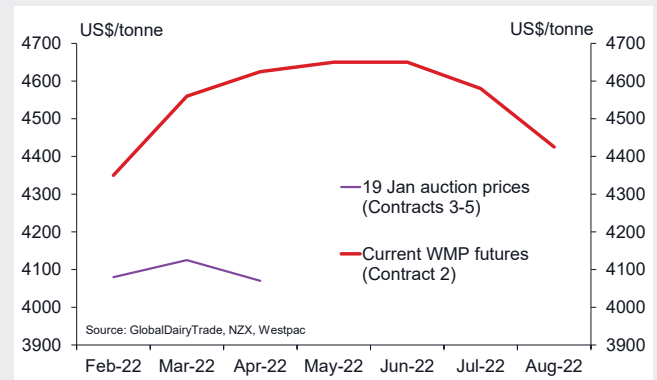
Feb 2, Last: +5.6%, Westpac: 5%

We expect whole milk powder prices (WMP) to jump around 5% at the upcoming dairy auction. A price jump of this magnitude would be similar to the result at the previous auction.

Our pick is slightly more modest than futures market pricing, where a lift of around 7% is expected. We have gone with a more modest lift as some buyers will be out of action for Chinese New Year.

Very weak New Zealand dairy production has given dairy prices fresh impetus this year. December production was 5.5% down on December 2020. We expect this weakness to continue and to support a lift in prices in the short term.

Whole milk powder prices



NZ Q4 Household Labour Force Survey

Feb 2, Employment last: 2.0%, WBC f/c: 0.2%

Unemployment rate last: 3.4%, WBC f/c: 3.5%

We expect an unemployment rate of 3.5% for the December quarter. That would be up slightly from the record-equalling low of 3.4% in the September quarter. However, Stats NZ indicated that the previous reading had been biased downward by some degree by the Covid-19 lockdown that began in August.

Surveys and anecdotes show that the jobs market is very tight, with labour shortages a major constraint. As a result, employment was relatively robust during the Delta lockdown compared to the initial lockdown in 2020. Payroll data suggests that there was no drop in employment, just a slowdown from the previous frenetic rate of growth.

On a broad suite of measures, the labour market is now beyond what the RBNZ would likely regard as 'maximum sustainable employment'.

NZ Household Labour Force Survey



NZ Q4 Labour Cost Index

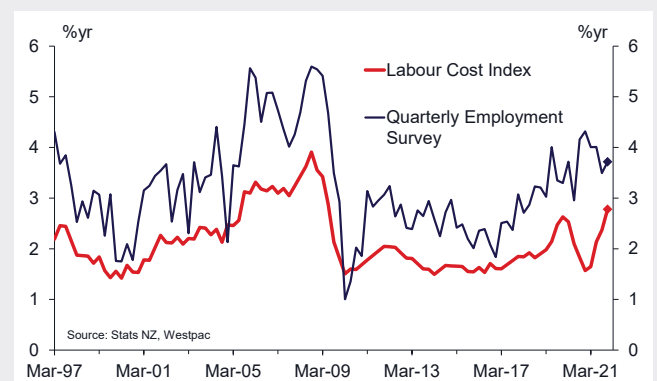
Feb 2, Private sector last: 0.7%, WBC f/c: 0.8%

We expect a 0.8% rise in the Labour Cost Index for the December quarter. This would lift the annual pace to 2.8%, exceeding the pre-Covid high reached in 2019 (when the labour market was also becoming very tight).

To some extent, the rise in wage inflation to date has been a catch-up after little or no pay increases in the wake of the initial Covid shock. How the drum-tight labour market, and demands for higher cost-of-living adjustments, will be reflected in the data still lies ahead of us.

Higher wage growth is the last key piece of the inflation jigsaw – it would provide the mechanism for an initial price shock to turn into sustained inflation.

NZ salary and wage growth, all sectors



The week ahead

NZ Dec residential building consents

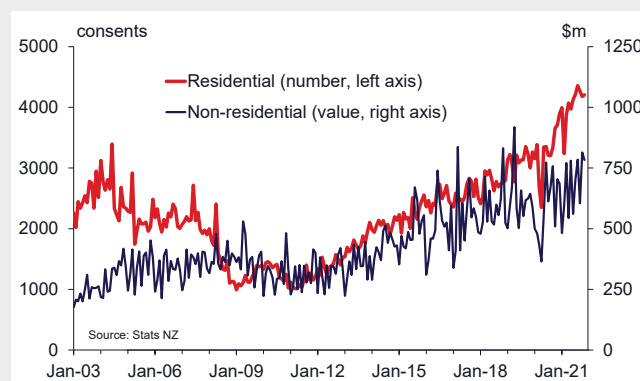
Feb 4, Last: +0.6%, Westpac f/c: Flat

Residential consent issuance rose 0.6% in November. Issuance remained firm across the country with particular strength in medium density consents.

Monthly consent issuance has held at elevated levels since June, with around 4,200 new dwelling consents being issued each month. We expect that will remain the case in December. That would take annual issuance to another fresh high.

While consent issuance remains strong, shortages of staff and materials are providing a brake on the pace of building, with start and completion times stretching out. Those same factors have also contributed to increases in build costs.

NZ building consents



Aus Dec retail trade

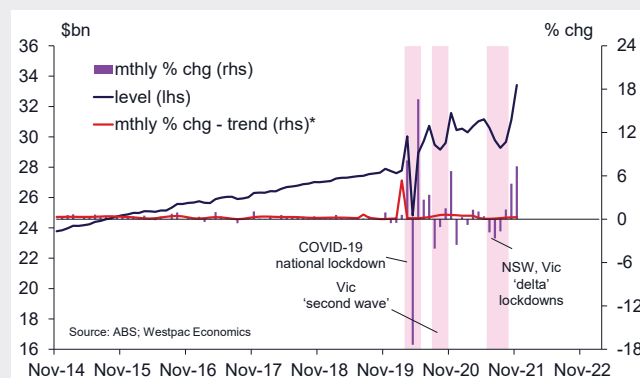
**Feb 1, Last: 7.3%, WBC f/c: -2.0%
Mkt f/c: -2.0%, Range: -4.0% to 2.8%*i***

November was a cracker month for retailers, reopening rebounds, a clear 'catch-up' in some segments and boosts from 'Black Friday' and 'Cyber-Saturday' sales driving another very strong gain, +7.3%*mth* following +4.9% in Oct to be up 5.8%*yr*.

December is likely to see some give-back on this extraordinary surge, particularly as 'catch-up' spending cycles out. Our Westpac Card Tracker points to a retracement of around 2% in the month. Omicron impacts, set to come through in January, are likely to see a more meaningful weakening.

Note that the full detail including Q4 real retail sales estimates will be released on Feb 7. These will show a very strong gain for the quarter as a whole – with nominal sales up about 9.5%*qtr* and the Q4 CPI pointing to about a 1% gain for retail prices, 'real' retail sales volumes are set to record an 8.5% jump for Q4.

Monthly retail sales



Aus RBA policy decision

**Feb 1, Last: 0.1%, WBC f/c: 0.1%
Mkt f/c: 0.1%, Range: 0.1% to 0.1%**

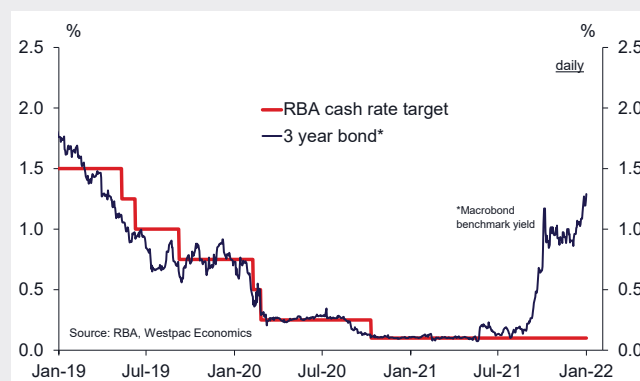
The initial RBA Board meeting for 2022 promises to be an interesting one. The RBA will announce that the QE government bond buying program will come to an end in February.

The cash rate will be held at the record low of 0.1% at this meeting. However, some shift in language is likely in the decision statement. Westpac expects the RBA to begin a tightening cycle this August.

The RBA will acknowledge that inflation is now back in the target band and that the unemployment rate is nearing full employment. The RBA expects wages growth to lift - but will highlight uncertainty around the speed and timing of that likely acceleration.

The Governor's speech on the following day, and the associated Q&A, will be critically important in providing a clearer and more complete understanding of the RBA's current thinking.

RBA cash rate and 3 year bonds



The week ahead

Aus Dec dwelling approvals

Feb 3, Last: 3.6%, WBC f/c: 3.0%

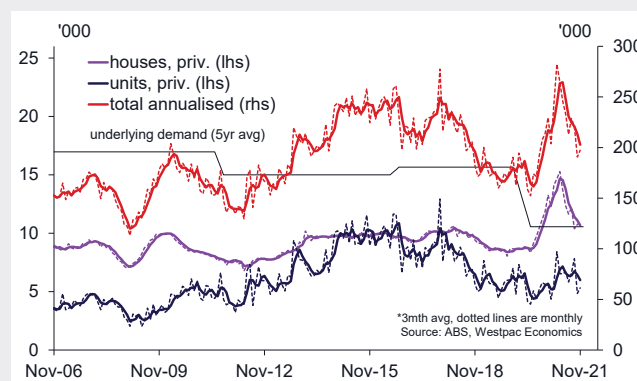
Mkt f/c: -1.0%, Range: -3.0% to 3.0%

Dwelling approvals posted a modest 3.6% gain Nov, consistent with an end to the drag from unwinding HomeBuilder-related 'pull-forward' effects.

New home sales suggest this unwind effect ended in Oct with sales posting solid gains since then. That points to a solid rise for detached houses. The volatile unit component is harder to get a handle on but should stabilise/firm a little given the sharp pull-back through Oct-Nov.

The combination should see a 3% rise in total dwelling approvals, leaving total approvals for calendar 2021 at around 227k – not far off the 235-240k registered at the heights of the Sydney and Melbourne high rise construction boom in the middle of last decade.

Dwelling approvals



Aus Dec trade balance, \$bn

Feb 3, Last: 9.4, WBC f/c: 8.3

Mkt f/c: 9.9, Range: 8.3 to 11.0

Australia's trade surplus has narrowed, down from a July record high of \$13.7bn. The iron ore price is well off its peak and imports are lifting as the economy reopens from delta lockdowns.

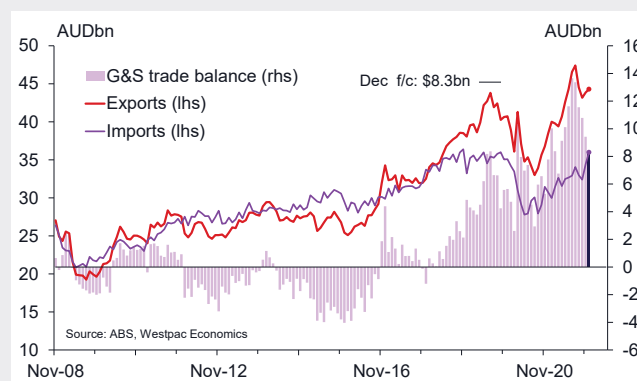
In November, the surplus printed at \$9.4bn, down \$1.4bn on October, with imports up 6.3% and exports 1.6% higher.

For December, we anticipate a surplus of \$8.3bn.

Imports likely made further strong gains, on higher prices and volumes. We've factored in a rise of 4.5%, +\$1.5bn.

Export earnings look to have been a mixed bag. On balance we anticipate a rise in the order of 1%, +\$0.4bn. The iron ore price moved a little higher, and there is potential upside on rural goods (associated with positive seasonal conditions).

Australia's trade balance



US Jan employment report

Feb 4 nonfarm payrolls,

Last: 199k, WBC f/c: 200k, Mkt f/c: 178k

Feb 4, unemployment rate,

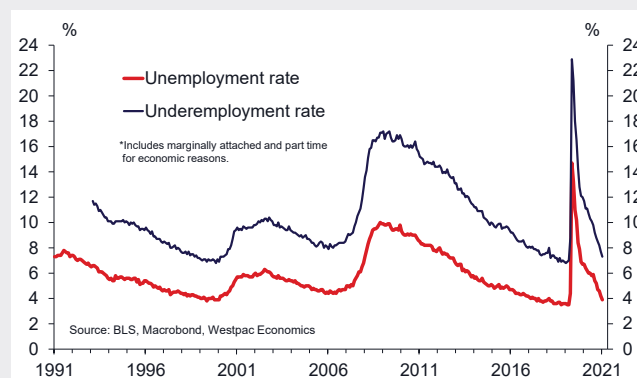
Last: 3.9%, WBC f/c: 3.9%, Mkt f/c: 3.9%

The US labour market is historically tight, in part due to the strong employment gains seen through the recovery, but also as a result of weak participation.

A material rise in participation is unlikely in January or the months that follow as the US battles to contain Omicron and its effect on health and education -- requiring would-be workers to remain out of the workforce. As a result, despite softer employment growth, the unemployment rate is likely to continue tracking lower through Q1, with risks skewed towards a larger fall back towards the pre-pandemic level of 3.5%.

Strong support for wages is therefore expected to persist through 2022. Note however this will, most likely, only offset the purchasing power lost to inflation over the period.

US full employment attainable



New Zealand forecasts

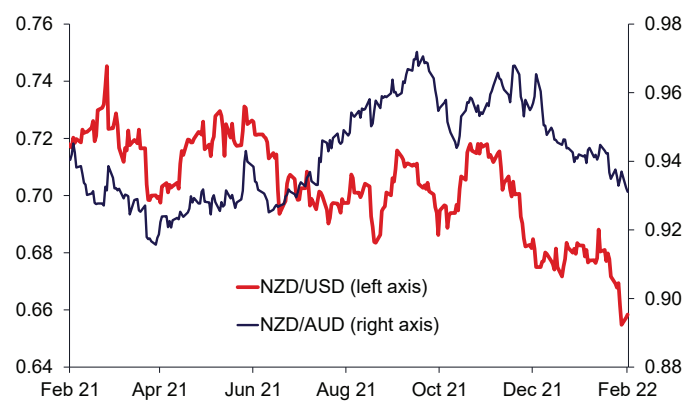
Economic forecasts		Quarterly				Annual			
		2021		2022					
% change		Jun (a)	Sep (a)	Dec	Mar	2020	2021f	2022f	2023f
GDP (Production)		2.4	-3.7	1.1	1.6	-1.9	5.1	4.4	4.7
Employment		1.0	2.0	0.2	0.2	0.6	3.8	0.6	1.2
Unemployment Rate % s.a.		4.0	3.4	3.5	3.5	4.8	3.5	3.3	3.4
CPI		1.3	2.2	1.4	1.1	1.4	5.9	3.1	2.7
Current Account Balance % of GDP		-3.3	-4.5	-5.3	-5.4	-0.8	-5.3	-5.7	-3.9

Financial forecasts	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	1.00	1.50	2.00	2.25	2.50	2.75	3.00	3.00
90 Day bill	1.40	1.90	2.20	2.45	2.70	2.95	3.10	3.10
2 Year Swap	2.55	2.75	2.90	2.95	3.00	3.00	2.95	2.90
5 Year Swap	2.80	2.95	3.05	3.10	3.15	3.15	3.15	3.10
10 Year Bond	2.80	2.85	2.90	3.00	3.00	3.00	3.00	2.95
NZD/USD	0.67	0.66	0.67	0.69	0.70	0.71	0.72	0.72
NZD/AUD	0.94	0.94	0.94	0.95	0.93	0.93	0.94	0.92
NZD/JPY	77.7	76.6	78.4	80.7	82.6	83.8	85.7	85.7
NZD/EUR	0.61	0.61	0.61	0.63	0.63	0.63	0.64	0.63
NZD/GBP	0.49	0.48	0.49	0.50	0.51	0.52	0.53	0.53
TWI	72.1	71.2	71.7	73.1	73.5	74.1	75.0	74.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 1 February 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	0.75%	0.75%	0.75%
30 Days	0.85%	0.82%	0.80%
60 Days	0.98%	0.93%	0.88%
90 Days	1.10%	1.02%	0.97%
2 Year Swap	2.46%	2.24%	2.17%
5 Year Swap	2.78%	2.67%	2.55%

NZ foreign currency mid-rates as at 1 February 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6585	0.6810	0.6825
NZD/EUR	0.5859	0.5963	0.6011
NZD/GBP	0.4895	0.4978	0.5051
NZD/JPY	75.75	77.95	78.55
NZD/AUD	0.9311	0.9431	0.9414
TWI	70.95	72.82	73.08

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 31					
Aus	Jan MI inflation gauge	2.8%	–	–	Material inflation pressures set to extend into 2022.
	Dec private sector credit	0.9%	0.6%	0.5%	November result inflated by spike in business lending.
Eur	Q4 GDP	2.2%	0.4%	–	Spread of COVID and restrictions to weigh on growth.
US	Jan Chicago PMI	63.1	62.0	–	Supply chain disruptions remain a headwind.
	Jan Dallas Fed index	8.1	–	–	Will provide a timely update on manufacturing in Texas.
	Fedspeak	–	–	–	Daly to speak at a Reuters live event.
Tue 1					
Aus	Jan CoreLogic home value index	0.6%	–	0.9%	Gains moderating and becoming more varied by city.
	Dec housing finance, total	6.3%	–0.8%	8.0%	Total value of sales surged very strongly in Q4 ...
	Dec housing finance, owner occ.	7.6%	–	7.5%	... with HomeBuilder-related drags also ending ...
	Dec housing finance, investor	3.8%	–	8.5%	... finance figures capturing the shift with a bit of a lag.
	Dec retail sales (prelim' est.)	7.3%	–2.0	–2.0%	Some give-back on 12.6% reopening surge through Oct–Nov.
	RBA policy decision	0.10%	0.10%	0.10%	An end to QE and a shift in language.
Eur	Jan Markit manufacturing PMI	59.0	–	–	Final release for the month.
	Dec unemployment rate	7.2%	7.2%	–	Expected to remain steady as activity slowed into year end.
UK	Dec net mortgage lending £bn	3.7	–	–	Softer lending indicates cooling housing demand.
	Jan Markit manufacturing PMI	56.9	–	–	Final release for the month.
US	Jan Markit manufacturing PMI	55.0	–	–	Final release for the month.
	Dec construction spending	0.4%	0.7%	–	Expected to lift given housing strength.
	Jan ISM manufacturing	58.7	58.0	–	Manufacturing strong despite omicron disruptions.
	Dec JOLTS job openings	10562k	–	–	Emergence of omicron to weigh on job creation.
Wed 2					
NZ	GlobalDairyTrade auction	5.6%	–	5.0%	Dairy prices surging on very weak New Zealand production.
	Q4 unemployment rate	3.4%	3.3%	3.5%	The labour market remains tight (despite Covid restrictions)...
	Q4 employment	2.0%	0.4%	0.2%	...and firms are struggling to find workers.
	Q4 labour cost index (pvt, ordinary time)	0.7%	0.8%	0.8%	Wages on the rise, but lagging the rise in inflation.
Aus	RBA Governor Lowe speaking	–	–	–	Annual “Year Ahead” speech.
Eur	Jan CPI %/yr	5.0%	4.0%	–	Recent surge in inflation pressures seen by ECB as temporary.
US	Jan ADP employment change	807k	208k	–	Omicron has slowed employment momentum.
Thu 3					
NZ	Jan ANZ commodity prices	–0.2%	–	–	NZ commodity prices lifting on a dairy price surge.
Aus	Dec dwelling approvals	3.6%	–1.0%	3.0%	Solid rise likely given end to HomeBuilder unwind effect.
	Dec trade balance \$bn	9.4	9.9	8.3	Surplus narrows as imports rise on reopening from lockdowns.
Eur	Jan Markit services PMI	51.2	–	–	Final release for the month.
	ECB policy decision	0.0%	0.0%	–	Focus now on path towards a rate hike cycle.
UK	Jan Markit services PMI	53.3	–	–	Final release for the month.
	BoE policy decision	0.25%	0.50%	–	Expected to raise bank rate by 25bps.
US	Q4 productivity	–5.2%	2.3%	–	Volatile through 2021; to remain so.
	Initial jobless claims	260k	–	–	Expected to gradually decline after recent omicron up-tick.
	Jan Markit service PMI	50.9	–	–	Final release for the month.
	Jan ISM non-manufacturing	62	59.6	–	Service sector set to remain strong despite omicron.
	Dec factory orders	1.6%	0.1%	–	Capital investment slowed at end-Q4...
	Dec durable goods orders	–0.9%	–	–	... due to supply constraints and questions over growth outlook.
Fri 4					
NZ	Dec building permits	0.6%	–	0.0%	Monthly issuance has flattened off at firm levels.
Aus	RBA Statement on Monetary Policy	–	–	–	Forecast update, colour around risks to the outlook.
Eur	Dec retail sales	1.0%	–0.5%	–	Covid restrictions to weigh on retail activity at year end.
US	Jan non-farm payrolls	199k	178k	200k	Omicron stunted employment growth momentum...
	Jan unemployment rate	3.9%	3.9%	3.9%	... though full employment...
	Jan average hourly earnings %/mth	0.6%	0.5%	–	... and robust wage growth should persist.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.3	5.5	3.5
CPI inflation %yr	1.8	1.8	0.9	3.0	2.5	2.6
Unemployment rate %	5.0	5.2	6.8	5.3	3.8	3.8
Current account % of GDP	-2.1	0.7	2.6	3.9	0.9	-2.2
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	4.3	2.7
CPI inflation %yr	2.4	1.9	1.2	5.0	3.1	2.3
Unemployment rate %	3.9	3.7	8.1	5.4	4.2	3.8
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	0.3	-4.8	2.3	2.7	1.5
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	4.4	2.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	6.7	5.2	3.0
China						
Real GDP %yr	6.7	5.8	2.3	8.5	5.7	5.6
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	3.8	4.8	5.0
World						
Real GDP %yr	3.6	2.8	-3.3	5.4	4.6	3.6

Forecasts finalised 8 December 2021

Interest rate forecasts	Latest	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia									
Cash	0.10	0.10	0.10	0.25	0.50	0.75	1.00	1.25	1.50
90 Day BBSW	0.08	0.10	0.10	0.35	0.60	0.95	1.20	1.45	1.65
10 Year Bond	1.97	2.15	2.40	2.40	2.50	2.50	2.40	2.30	2.20
International									
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375	1.625	1.875	1.875
US 10 Year Bond	1.82	2.00	2.30	2.40	2.50	2.50	2.40	2.30	2.20

Exchange rate forecasts	Latest	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7044	0.71	0.70	0.71	0.73	0.75	0.76	0.77	0.78
USD/JPY	115.41	116	116	117	117	118	118	119	119
EUR/USD	1.1156	1.10	1.08	1.09	1.10	1.11	1.12	1.13	1.14
GBP/USD	1.3404	1.36	1.37	1.38	1.38	1.37	1.37	1.36	1.35
USD/CNY	6.3569	6.35	6.35	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0701	1.06	1.06	1.06	1.06	1.07	1.07	1.07	1.08

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