WESTPAC WEEKLY ECONOMIC COMMENTARY

Inflating inflation.

14 March 2022

Kākābeak/ngutukākā

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Already sky-high inflation is expected to push higher, in part due to the Russian-Ukraine conflict. With that source of inflation outside of the Reserve Bank's sphere of control, this development is making reining in inflation even trickier than it already was.

We have revised up our forecasts for consumer price inflation over this year. We now expect that annual inflation will rise to a peak of 6.8% in the June quarter. Previously we expected to reach a peak of 6.3% in the March quarter.

The key factor driving this revision has been the sharp rise in global oil prices in recent weeks stemming from the conflict in Ukraine. Brent oil prices, for example, have risen above $100 per barrel since the conflict began, currently sitting at around $115 per barrel. And that is being felt at the pump in New Zealand. In many parts of the country, petrol prices have cracked $3 per litre. Those high fuel prices are also adding to transport costs and spilling over into higher costs of production for locally produced goods and services.

The strength in food prices is also adding to the upward pressure on inflation. Prices for our key exports like dairy have risen strongly. We've also seen the international prices for grains rising rapidly as the conflict in Ukraine has escalated, and that will spill over into other food prices, including for staples like bread. Indeed, annual food price inflation hit 6.8% in February, the highest rate since July 2011.

Looking at the broader economic backdrop, businesses are highlighting fierce pressure on operating costs. That's related to the cost of materials, but also rising wage costs. Notably, we're also hearing of growing demands for cost-of-living adjustments to wages.

With the above in mind, the RBNZ now faces a very challenging balancing act. In February, the RBNZ revised up its OCR forecast and signaled a series of rapid interest rate increases over the coming year. That was in response to the buildup of both demand- and supply-side inflation pressures as well as the rise in inflation expectations. But since that time, short-term inflation pressures have materially worsened.

Moreover, cost shocks like oil price spikes are particularly tricky beasts for the central bank to tame. The RBNZ cannot offset the rise in inflation resulting from oil price increases that have already occurred. And if they do increase interest rates, that will affect the exchange rate and parts of the domestic economy. A further complication is that the increase in fuel prices will squeeze household demand, and interest rate increases would compound that pressure on household budgets.

In such a climate, inflation expectations become a key consideration. Expectations are a key influence on how businesses adjust prices and wages. If expectations are closely anchored to the RBNZ's inflation target, the central bank can 'look through' the temporary disruptions associated with an oil price spike. However, if expectations push above the Bank's target, then that can feed into a more generalised series of price increases. And that could leave us facing a protracted period of stronger inflation that could ultimately require larger increases in interest rates to rein in runaway inflation. In the current climate we've already seen expectations rising to elevated levels. And with pressure on food and fuel prices, expectations are likely to stretch even higher.

We already expect a series of OCR increases from the RBNZ. However, the recent increase in inflation pressures does raise questions about how far the cash rate needs to rise. There is also a question about how quickly rates will need to rise. We're forecasting a series of rapid 25bp increases. However, markets are now pricing a sizeable chance of 50bp increases.

Meanwhile, the broader economic picture as always will inform the RBNZ's thinking. Rising Omicron cases and the associated fear of catching Omicron is dampening demand. Indeed, the latest retail sales figures reflected Omicron's impact, with card spending falling by nearly 8% in February. Notably, the impact was seen across spending categories and beyond the sharp impact on hospitality that we have previously seen. At the same time, we're also seeing a sharp rise increase in absenteeism related to Omicron infections. That is weighing on economic activity in a range of sectors, including the transport and distribution sectors. We expect Omicron to continue to disrupt economic activity over the next few weeks, if not longer.

On this front, Australia's earlier Omicron outbreak provides a useful comparison. In January, Australia saw a large drop in spending and a rise in absenteeism as case numbers rose. However, Australian case numbers had clearly peaked by the end of that month, and although daily case numbers remain relatively high, consumer spending has seen a strong rebound. The big difference in New Zealand, however, is where we are in the rates cycle. Interest rates have already been pushing higher and the hot housing market has begun to cool. Combine that with the lift in inflation, and that does raise some questions about whether we'll see the same rapid recovery that Australia did.

Lastly, the state of the housing market is an added complication for the RBNZ. We've already seen the housing market cool down in recent months as mortgage rates have pushed higher. We expect that downturn to continue over the coming year. The housing market reports over the next few months will be particularly important for the RBNZ, as the strength of the housing market is a key determinant of household spending and economic demand more generally. While we've been expecting that the housing market would turn down as interest rates rose, the slowdown has arrived sooner than we had anticipated. If that continues, it could have a larger dampening impact on demand, and that would also have implications for the amount of tightening that is required by the RBNZ.

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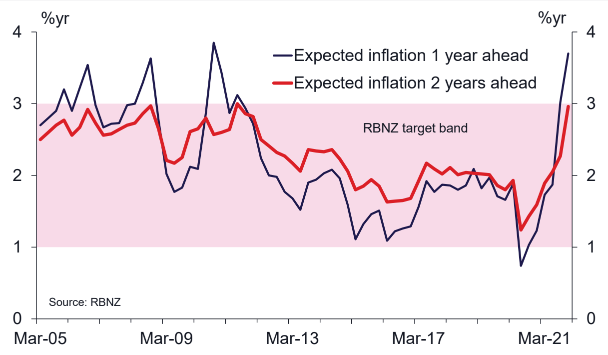
Chart of the week

In taming inflation, the RBNZ will look to put a lid on inflation expectations. Already, expectations have surged to their highest level since 2011, and will no doubt head even higher in the next few quarters, reflecting the jump in fuel and food prices. Raised inflation expectations can lead to a vicious cycle of repeated price increases, ultimately requiring a higher peak in interest rates to bring demand under control.

RBNZ survey of expectations

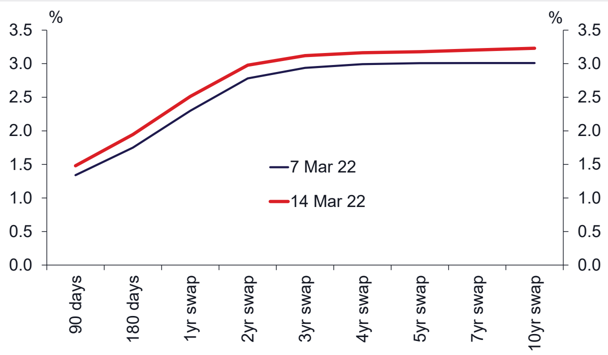


Fixed vs floating for mortgages

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



The week ahead

NZ GlobalDairyTrade auction, whole milk powder prices

Mar 16, Last: +5.7%, Westpac: +4.0%

We expect whole milk powder prices (WMP) to lift a further 4% at the upcoming dairy auction. The lift would be on top of the circa 23% lift to date this year.

Our pick is slightly more modest than futures market pricing, where a lift of around 5% is expected.

The impact of the Russia-Ukraine conflict has given global dairy prices fresh impetus. With global dairy supply also very weak, we expect prices to remain hot in the short term.

Whole milk powder prices

NZ Q4 Current Account Balance, % of GDP

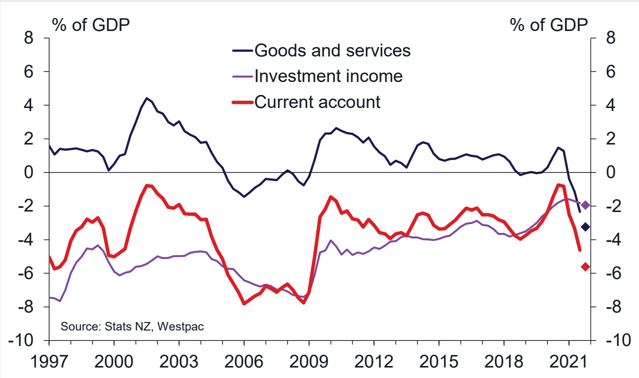
Mar 16, Last: -4.6%, Westpac: -5.6%, Mkt f/c: -5.6%

We expect the annual current account deficit to widen to 5.6% of GDP in the December quarter, from 4.6% in the September quarter.

The widening of the deficit beyond the average level of recent years essentially reflects the hot New Zealand economy – we are, at least temporarily, living beyond our means.

Looking ahead, we expect the current account to widen further on the strength of the domestic economy and the ongoing absence of tourism exports. We expect the deficit to reach its widest point of around 6.6% in the second half of the year, before narrowing.

NZ annual current account balance



NZ Q4 GDP

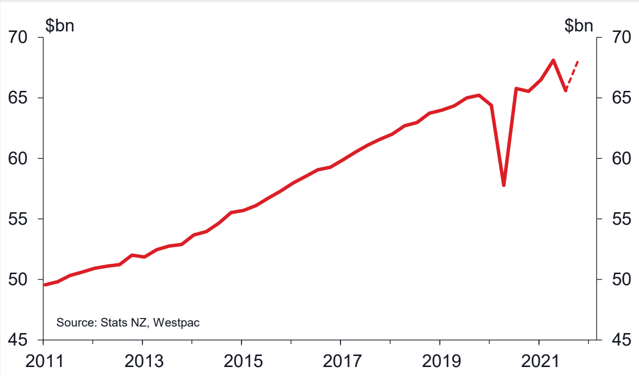
Mar 17, Last: -3.7%, WBC f/c: +3.8%, Mkt f/c: 3.1%

We expect a 3.8% rise in GDP for the December quarter, almost fully reversing the drop that followed the Delta-induced lockdown during the September quarter.

Production of physical goods saw the biggest rebound, while in-person services were more subdued, reflecting the ongoing public health restrictions over the quarter.

We expect GDP growth to exceed the Reserve Bank's forecast of 2.3%. However, we think this reflects less of a drag from health restrictions than anticipated, rather than stronger than expected demand.

NZ production-based GDP



The week ahead

Aus Q1 ACCI-Westpac business survey

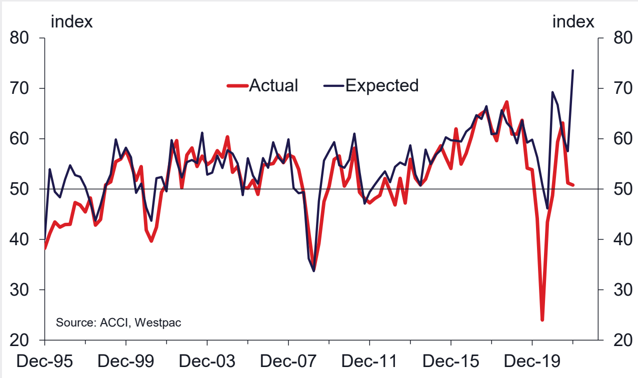
Mar 15, Last: 50.8

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

Manufacturing output stalled over the second half of 2021, dented by delta lockdowns, the survey reports. The reopening will facilitate a lift in activity, albeit omicron disruptions were a complication. The pace of that recovery will be of keen interest.

The survey also highlights that the manufacturing sector (as well as the economy more broadly) is challenged by labour and material shortages. These supply headwinds are acting as a handbrake on growth. Input costs are rising at a rapid pace, flowing through (in part) to higher prices and squeezing margins. Of interest, have these pressures intensified further early in 2022?

Aus Westpac-ACCI Composite indexes - Actual and expected, sa



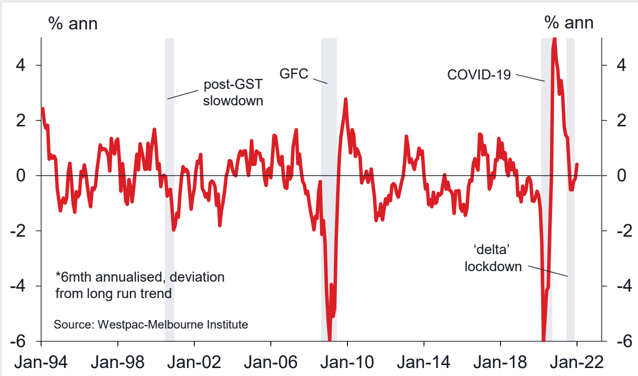
Aus Feb Westpac–MI Leading Index

Mar 16, Last: +0.4%

The six-month annualised growth rate rose from –0.1% in Dec to +0.4% in Jan, marking the first positive, above trend, read since the 'Delta' lockdowns impacted in August last year.

The Feb read looks likely to be a weak one with several components hit by significant omicron-related disruptions early in the year and the timing of updates set to see sentiment and financial hits from Russia's invasion of Ukraine but not the sizeable boost this has given to Australia's commodity prices. Component-wise, sharp omicron-related declines in dwelling approvals (–27.9% in Jan) and hours worked (down –8.8%) will clearly reverse while a dip in commodity prices in Feb (down -2.3% in AUD terms) will give way to a very strong gain next month (commodity prices already up 25-30% since the onset of the war). While the Leading Index measure smooths out monthly variations in order to pinpoint ongoing trends, the scale of these swings will still create significant volatility in early 2022.

Aus Westpac-MI Leading Index



Aus February overseas arrivals and departures, preliminary

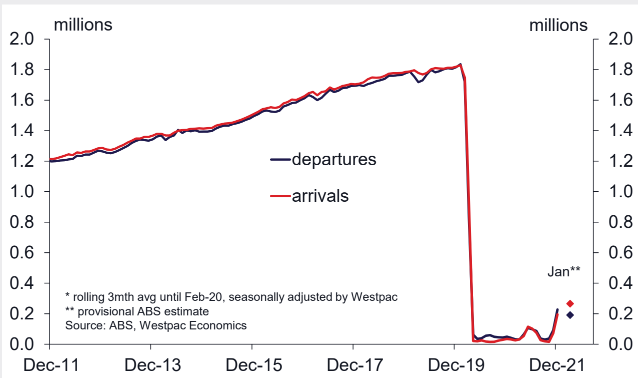
Mar 16, Arrivals, Last: 265.5k
Mar 16, Departures, Last: 190.5

Prior to the pandemic, arrivals and departures averaged 1.8mn and 1.7mn per month. However, the border closure in early 2020 saw a sharp decline in both measures.

The January preliminary estimate had arrivals and departures to lift to 265.5k and 190.5k respectively, owed largely to the easing of border restrictions for Australian citizens and permanent residents in early November. This may have been partially offset by the emergence of omicron in December, with multiple countries declaring Australia a hotspot.

With the border reopening to fully vaccinated individuals on 21 February, the preliminary estimate will provide a gauge of the strength of travel into Australia and trips taken abroad. In particular, the arrival of foreign students and holiday workers should continue to be supported with the reimbursement of visa application fees and a relaxation of work hour restrictions.

Total overseas arrivals and departures



The week ahead

Aus Feb Labour Force Survey, employment '000

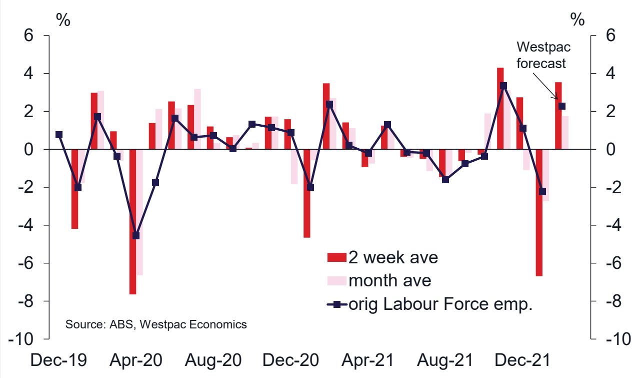
Mar 17, Last: 4.2%, WBC f/c: 4.1%
Mkt f/c: 4.1% Range: 4.0% to 4.3%

Jan was the 3rd consecutive upside surprise for employment. The very solid 366.1k gain in Nov was followed by a sound 64.8k gain Dec and then a softer, but still positive, 12.9k gain in Jan. The market had been expecting a flat print following a weak Weekly Payrolls while we had retained our +30k forecast as we did not know how much of the hit would come via hours worked rather than employment. Hours worked fell 8.8% in Jan.

In regards to the recent floods in NSW and Qld, they came late in the month missing the Feb reference period. While there will be some impact in Mar, most of the impact will appear in hours worked with a modest temporary hit to employment.

Remembering that payrolls are not seasonally adjusted the 3.5% rise from the Jan to Feb reference periods is the same magnitude as the rise in 2021 when employment rose 2.4% in original terms. Our +60k forecast (seasonally adjusted) is a 2.3% rise in original terms.

Payrolls vs Labour Force Employment



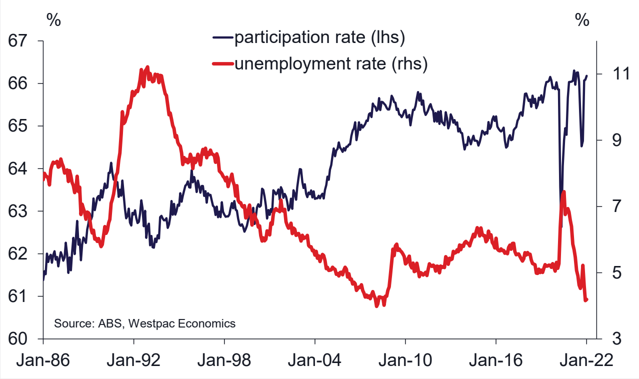
Aus Feb Labour Force Survey, unemployment %

Mar 17, Last: 4.2%, WBC f/c: 4.1%
Mkt f/c: 4.1% Range: 4.0% to 4.3%

The other positive surprise in the Jan Labour Force was the relative strength in the labour force. Participation lifted from 66.09% to 66.18% representing a 0.1% rise in the labour force hence the 12.9k lift in employment was enough to hold the unemployment rate flat at 4.2%. The unemployment rate did rise slightly at two decimal places from 4.16% to 4.19%. With all that was being thrown at Australians in January that participation held up should be seen as a positive for the Australian economy.

We expect participation to lift from 66.2% to 66.4% for a 45k gain in the labour force. This will temper the fall in unemployment to just 0.1ppt to 4.1%. Why not a bigger jump in participation? The jump in participation to 66.4% will be a new record high. The previous high was 64.3% in March 2021. We are cautious about how far participation can be pushed in any one month these levels. The risk is for a small rise in participation and a larger fall in unemployment.

Participation set to print a new record high



US Mar FOMC meeting

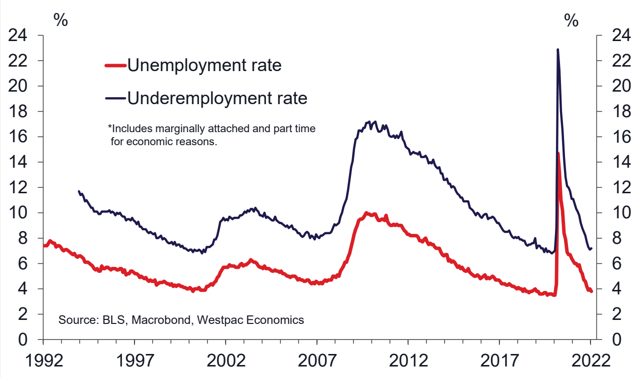
Mar 15-16, fed funds rate, Last: 0.125%, WBC f/c: 0.375%, Mkt f/c: 0.375%

At the March FOMC meeting, the first 25bp rate hike of this tightening cycle will be delivered to be followed by successive 25bp hikes at the May and June meetings.

It is also likely that the Committee will give guidance after this meeting on their intentions with respect to balance sheet normalisation, which we expect to begin in the June quarter.

The numerical forecasts and qualitatitve guidance provided by the Committee in March will also be important. In short, these views will guide on the Committee's expected path into 2023 and beyond, including the timing and height of the cycle peak as well as the risks.

US 'maximum employment' achieved

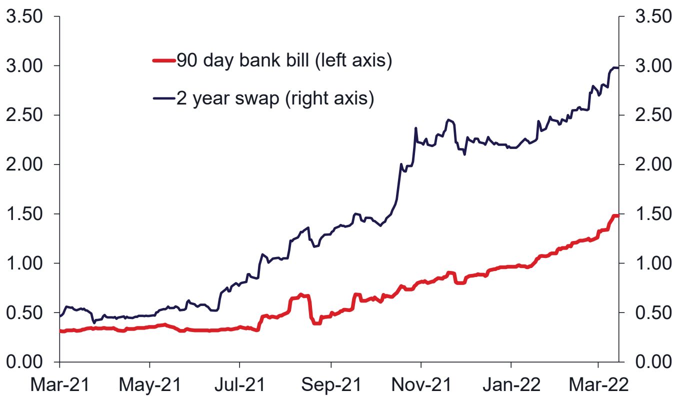


New Zealand forecasts

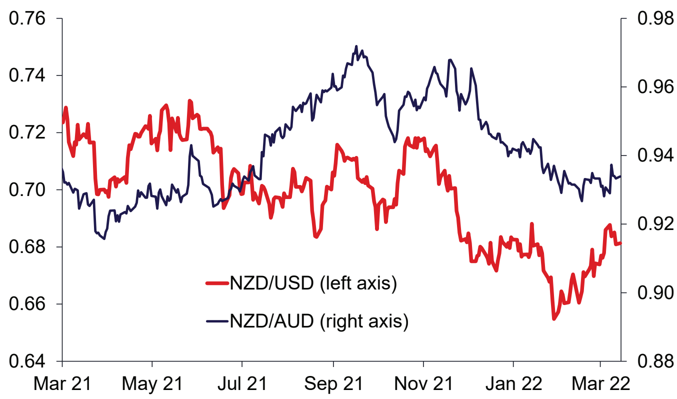
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Sep (a)	Dec	Mar	Jun	2020	2021f	2022f	2023f
GDP (Production)	-3.7	3.8	0.3	1.0	-1.9	5.8	3.8	4.5
Employment	1.9	0.1	0.5	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.3	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	2.2	1.4	1.5	1.5	1.4	5.9	4.5	2.8
Current Account Balance % of GDP	-4.5	-5.4	-5.6	-6.4	-0.8	-5.4	-6.6	-6.0

Financial forecasts	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	1.50	2.00	2.25	2.50	2.75	3.00	3.00
90 Day bill	1.90	2.20	2.45	2.70	2.95	3.10	3.10
2 Year Swap	2.90	3.00	3.05	3.05	3.05	3.00	2.90
5 Year Swap	3.10	3.15	3.20	3.20	3.20	3.15	3.10
10 Year Bond	2.95	3.05	3.10	3.10	3.10	3.10	3.05
NZD/USD	0.68	0.70	0.71	0.72	0.72	0.73	0.73
NZD/AUD	0.93	0.93	0.93	0.93	0.92	0.92	0.91
NZD/JPY	79.2	81.9	83.8	84.4	85.7	86.3	86.9
NZD/EUR	0.62	0.63	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.51	0.52	0.53	0.53	0.53	0.53	0.54
TWI	72.8	74.4	74.9	74.9	74.8	75.1	75.3

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 14 March 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	0.75%
30 Days	1.05%	1.04%	1.00%
60 Days	1.27%	1.15%	1.11%
90 Days	1.48%	1.26%	1.21%
2 Year Swap	2.98%	2.75%	2.55%
5 Year Swap	3.18%	2.99%	2.90%

NZ foreign currency mid-rates as at 14 March 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6813	0.6739	0.6605
NZD/EUR	0.6240	0.6001	0.5838
NZD/GBP	0.5220	0.5025	0.4886
NZD/JPY	79.96	77.87	76.05
NZD/AUD	0.9339	0.9333	0.9302
TWI	73.49	72.22	71.01

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Feb REINZ house sales	-7.7%	–	–	Higher mortgage rates and tighter lending regulation…
	Feb REINZ house prices %yr	19.9%	–	–	…have seen sales and prices fall in recent months.
	Jan net migration	-539	–	–	Borders remained largely closed.
Eur	Jan industrial production	1.2%	0.3%	–	Broad-based easing of supply pressures yet to come.
Tue 15					
NZ	Feb BusinessNZ PSI	45.9	–	–	Omicron concerns likely to have weighed on services.
Aus	Q1 ACCI-Westpac business survey	50.8	–	–	Activity boost from delta reopening. Supply headwinds intense.
	RBA minutes	–	–	–	More colour to the RBA Boards deliberations.
Chn	Feb industrial production YTD %yr	9.6%	4.0%	–	Power outages less of a concern but supply issues remain.
	Feb fixed asset investment YTD %yr	4.9%	5.0%	–	Infra. and business investment to offset weaker res. investment.
	Feb retail sales YTD %yr	12.5%	3.0%	–	Slow start to '22 with omicron; underlying strength clear.
Eur	Mar ZEW survey of expectations	48.6	–	–	Russia-Ukraine conflict clouding the outlook.
UK	Jan ILO unemployment rate	4.1%	4.0%	–	Recovery continues to edge unemployment lower.
US	Feb PPI	1.0%	1.0%	–	Ongoing supply issues to support producer prices.
	Mar Fed Empire state index	3.1	7.2	–	To provide a timely update on NY manufacturing sector.
Wed 16					
NZ	GlobalDairyTrade auction prices (WMP)	5.7%	–	4.0%	Russia-Ukraine conflict boosting already hot dairy prices.
	Q4 current account % of GDP	-4.6%	-5.6%	-5.6%	Q4 current account widening on strong domestic demand.
Aus	Feb Westpac-MI Leading Index	0.4%	–	–	Omicron and Ukraine turbulence to hit in Feb.
	Feb overseas arrivals, prelim. '000s	265.5	–	–	Gauging the border reopening - pre-Covid avg ~1.8m/month.
US	Feb retail sales	3.8%	0.4%	–	Broad-based consumption rebound points to solid demand.
	Feb import price index	2.0%	1.6%	–	Import prices set to remain elevated.
	Jan business inventories	2.1%	1.1%	–	Businesses pushing through supply issues at robust pace.
	Mar NAHB housing market index	82	81	–	Stable at a high level so far in 2022.
	FOMC policy decision, midpoint	0.125%	0.375%	0.375%	Will raise the Fed Funds rate by 25bps. Guide on bal. sheet.
Thu 17					
NZ	Q4 GDP	-3.7%	3.1%	3.8%	Strong rebound from Covid lockdown in Q3.
Aus	Feb employment	12.9k	40.0k	60.0k	Pre dating the floods means a solid rise in employment,…
	Feb unemployment rate	4.2%	4.1%	4.1%	…hours worked and a decline in unemployment.
	Q3 population estimates, %yr	0.2%	–	–	Q3 'delta' hit could see dip in to annual contraction.
	RBA Bulletin	–	–	–	RBA research articles.
Eur	Feb CPI	0.9%	0.9%	–	Final estimate; energy inflation is a key concern.
UK	BoE policy decision	0.50%	0.75%	0.75%	Expected to raise bank rate by 25bps.
US	Feb housing starts	-4.1%	3.5%	–	Robust underlying demand still apparent…
	Feb building permits	0.7%	-1.6%	–	… sourcing labour and high material costs are barriers.
	Initial jobless claims	227k	–	–	To remain at a low level.
	Mar Phily Fed index	16	15	–	Will offer a gauge of business activity in the region.
	Feb industrial production	1.4%	0.5%	–	Volatility lingers as firms navigate supply issues.
Fri 18					
Eur	Jan trade balance €bn	-9.7	–	–	Elevated import costs set to sustain the trade deficit.
US	Feb existing home sales	6.7%	-4.6%	–	Buyers are eager given low inventory and rising rates.
	Feb leading index	-0.3%	0.3%	–	Robust economic momentum set to continue through '22.
	Fedspeak	–	–	–	Barkin to discuss economic outlook. Bowman.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.7	5.2	3.9
CPI inflation %yr	1.8	1.8	0.9	3.5	4.1	2.3
Unemployment rate %	5.0	5.2	6.8	4.7	3.8	3.9
Current account % of GDP	-2.1	0.7	2.6	3.5	4.1	-1.5
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	3.2	2.3
CPI inflation %yr	2.4	1.9	1.3	7.1	4.0	2.3
Unemployment rate %	3.9	3.7	8.1	5.4	3.6	3.3
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	1.8	2.4	1.3
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	3.2	2.1
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.3	3.7	2.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.7	5.6
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.7	4.6
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	4.0	3.5

Forecasts finalised 11 March 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.10	0.10	0.25	0.50	0.75	1.00	1.25	1.50
90 Day BBSW	0.15	0.20	0.35	0.60	0.95	1.20	1.45	1.70
10 Year Bond	2.40	2.40	2.40	2.50	2.50	2.40	2.30	2.20
International								
Fed Funds	0.125	0.875	1.125	1.375	1.625	1.875	1.875	1.875
US 10 Year Bond	1.98	2.10	2.20	2.30	2.30	2.30	2.30	2.20

Exchange rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7367	0.73	0.75	0.76	0.77	0.78	0.79	0.80
USD/JPY	116.20	117	117	118	118	119	119	119
EUR/USD	1.1014	1.10	1.11	1.12	1.13	1.14	1.15	1.15
GBP/USD	1.3104	1.33	1.34	1.35	1.36	1.37	1.37	1.36
USD/CNY	6.3223	6.30	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0715	1.07	1.07	1.07	1.08	1.08	1.09	1.10

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