



Weekly Economic Commentary.

Stand by for action.

We now expect the Reserve Bank to increase the OCR at its 18 August *Monetary Policy Statement*, with follow-up hikes at the October and November reviews. Beyond this, we expect a pause to assess the impact of this tightening, with further gradual rate increases from mid-2022.

Last week's events demonstrate how quickly the ground is shifting on the New Zealand economy. Only three months ago, the Reserve Bank was still saying that "it was prepared to lower the OCR if required". Now, not only has the outlook for interest rates flipped in the other direction, but the RBNZ has already delivered its first tightening of sorts. Inflation is spiking higher, as we're seeing in many parts of the world, but the strength of domestic demand here means there's a greater risk that price increases could become persistent.

The RBNZ was much more assertive at last week's Monetary Policy Review than we were expecting at this stage. While the OCR was left unchanged, the RBNZ has called an end to Government bond purchases under its Large-Scale Asset Purchase programme (LSAP), one of the measures that was introduced last year to support the economy through the Covid-19 shock.

The motivation behind this was that the RBNZ has significantly upgraded its assessment of economic activity, in keeping with the recent flow of data. The current spike in inflation wasn't itself a reason – the RBNZ continues to regard this as a temporary factor, driven by Covid-related disruptions. However, with increasing evidence that demand is also running hot, there's a greater risk that an initial price shock could set off a more persistent inflationary spiral.

With that in mind, the RBNZ concluded that it's time to start withdrawing some of the policy stimulus that it put in place last year, to reduce the risk of an overshoot on its inflation mandate.

The RBNZ's statement did not give any guidance on future policy moves. That's not unusual – when the RBNZ loosens or tightens monetary policy, it often focuses on explaining



its latest decision rather than signalling what might come afterwards. Nevertheless, we think it's likely that the RBNZ will be looking to follow up with a further tightening before long.

The key part of the RBNZ's statement is that it believes that the level of stimulus can be reduced now. And by the time that central banks reach the point of action, they've usually decided that a meaningful change in policy settings is required.

So the question is: does the RBNZ believe that ending the LSAP will provide that meaningful tightening? That would be inconsistent with how it has viewed the programme in the past. The RBNZ has already run the weekly pace of purchases down to minimal levels over recent months – from \$650m per week at the start of this year, to \$200m per week now – and it hasn't felt the need to explain this as anything other than an operational decision. In that respect, going from \$200m to zero is much less of a tightening than the RBNZ has already delivered so far this year.

The real significance of ending the LSAP is the message that it sends: that monetary policy is going to get tighter from here. It also reinforces that this Monetary Policy Committee is an activist one (so far that's largely been demonstrated in the other direction). The Committee is willing to do what it thinks is needed when it's needed, and the interim review dates (Apr, Jul, Oct) are just as 'live' as the Monetary Policy Statements (Feb, May, Aug, Nov).

The June quarter Consumers Price Index, released after the RBNZ's policy review, reinforced the view that a reduction in stimulus is needed. Consumer prices rose by 1.3%, well above our forecast and the market average, and much stronger than the 0.6% increase the RBNZ assumed in its last set of published forecasts in May. The annual inflation rate rose to 3.3%, its highest in a decade.

As we noted earlier, this spike in inflation is not in itself a reason for tighter monetary policy. We've been hearing for

some time about the cost pressures faced by businesses, ranging from supply chain disruptions, to soaring shipping costs, to a shortage of skilled workers. These are supply-side shocks resulting from Covid-19 and the health response to it, and are largely unavoidable.

What the inflation figures do reveal is that strong demand has given firms the leeway to pass those higher costs to consumers – something that wasn't apparent in the data even three months ago. But in recent times we've seen renewed strength in household spending, construction activity and surveys of business conditions. As a result, it's now looking likely that the 1.6% rise in March quarter GDP will be followed by another strong print in June.

In addition, we're also seeing related positive indications for the labour market, with strength in hiring intentions and job ads. That points to a continued drop in the unemployment rate along with a lift in wage inflation.

We expect that inflation will linger above the RBNZ's 1 to 3% target band for the remainder of this year and the early part of 2022. And while we do expect some moderation in prices as supply constraints ease, the current strength in inflation is likely to see inflation expectations pushing to levels above the RBNZ's 2% target. Recent months have already seen some measures of expectations starting to creep higher. And if this becomes embedded in wage and price setting decisions, it would be a major concern for the central bank as it could result in a more protracted inflation cycle.

We think that the CPI result, along with other recent developments, will see the RBNZ revising up its assessment of medium-term inflation pressures. And that means that interest rate hikes are also likely to come faster.

Michael Gordon, Acting Chief Economist



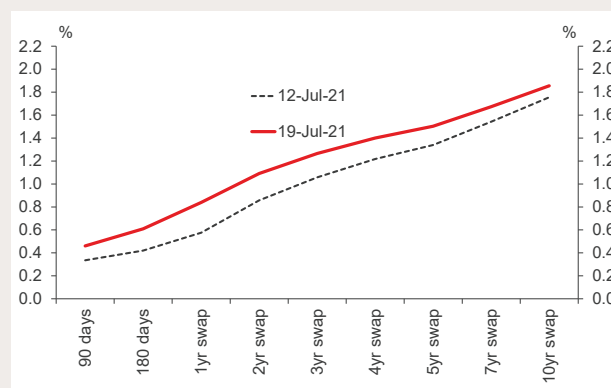
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Fixed vs floating for mortgages.

We now expect the Reserve Bank to start increasing the OCR over the coming months. Fixed-term mortgage rates have already begun to lift in anticipation; floating rates are likely to rise once the OCR does.

Based on our OCR forecasts over the coming years, we think there is value in moving beyond the currently popular one-year fixed term, towards terms of two to three years. Longer terms (out to five years) don't offer additional value, though they may be suitable for borrowers who value more certainty in their repayments.

NZ interest rates



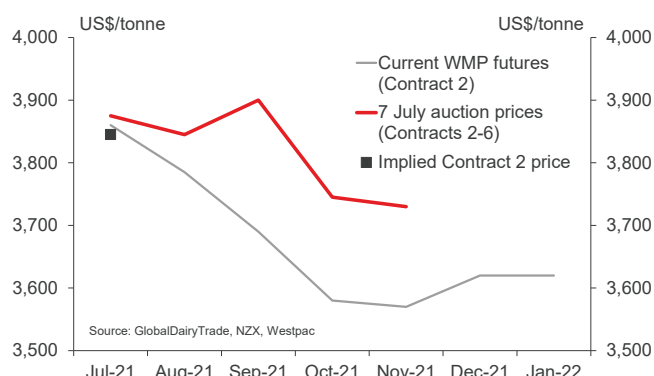
The week ahead.

NZ GlobalDairyTrade auction, whole milk powder prices

Jul 21, Last: -3.0%, Westpac: +1.0%

- We expect whole milk powder prices to rise at the upcoming dairy auction, breaking the run of four consecutive price falls.
- Fonterra has reduced the WMP volumes on offer by 1,000MT or 8% compared to its previous forecast, and an additional 19,500 or 14% in total over the next four months. This reduction will catch buyers on the hop and should thus reverse the downward price trend of recent auctions (note the futures market prices in the chart pre-date Fonterra's announcement).
- However, this move should prove temporary as it involves a shifting of product between sales platforms and not a fundamental change in supply.

Whole milk powder prices

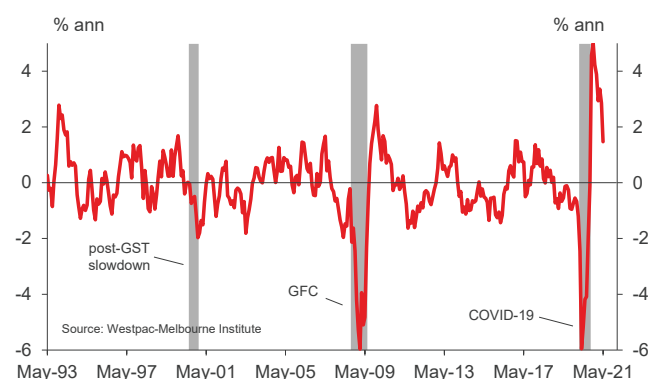


Aus Jun Westpac-MI Leading Index

Jul 21, Last: 1.47%

- The six-month annualised growth rate in the Leading Index eased from 2.86% in April to 1.47% in May. The growth rate is continuing to normalise as it cycles large Covid-related disruptions. Importantly, the pace looks to be settling back to something still well above trend.
- The June update is likely to show a further slowing. It will include some positive component updates: commodity prices continuing to surge strongly (+6.8% in AUD terms), the ASX200 posting another solid gain and US industrial production continuing to lift. Sentiment-related components were also surprisingly resilient in July given rising Covid concerns amid the extended lockdown in Sydney. However, two components saw notable weakness in the month: dwelling approvals, down -7.1% as a massive HomeBuilder driven boost continues to unwind; and total hours worked, which fell -1.8% on a sharp lock-down driven contraction in Victoria.

Aus Westpac-MI Leading Index



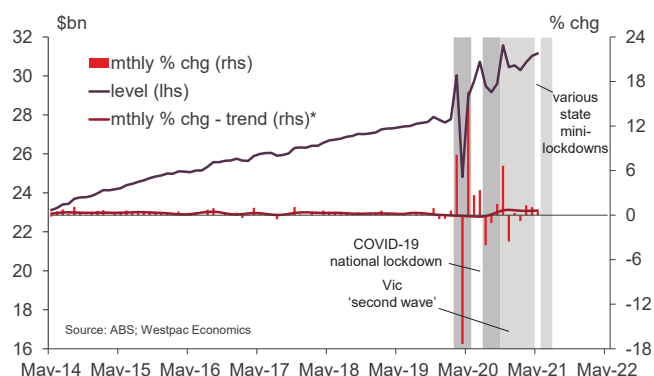
Aus Jun preliminary retail trade

Jul 21, Last: 0.4%, WBC f/c: -0.2%

Mkt f/c: -0.4%, Range: -1.0% to 0.3%

- Retail sales rose 0.4% in May to be up 7.7%yr and 12.2% above their pre-Covid level. Sales continue to be buffeted by multiple state 'mini-lockdowns'. The May month saw Melbourne enter a slightly longer 14 day lock-down at the end of the month that was a material drag on sales (Vic -0.9% in May), although this was more than offset by gains elsewhere, Qld and WA coming out of brief lock-downs in April.
- The full impact of the Vic's restrictions will hit in June while sales in July are set to be clobbered by an extended lock-down in Sydney and another round of mini-lockdowns across multiple jurisdictions (Qld, WA, NT and, just announced, Vic again). Our Westpac Card Tracker suggests sales overall held up reasonably well in June. That said, a sharp contraction in hours worked in Vic points to a material impact on activity. On balance we expect retail sales to show a 0.2% decline. It should be noted that lockdowns tend to generate gains for sectors like basic food which accounts for 40% of total retail sales.

Aus monthly retail sales

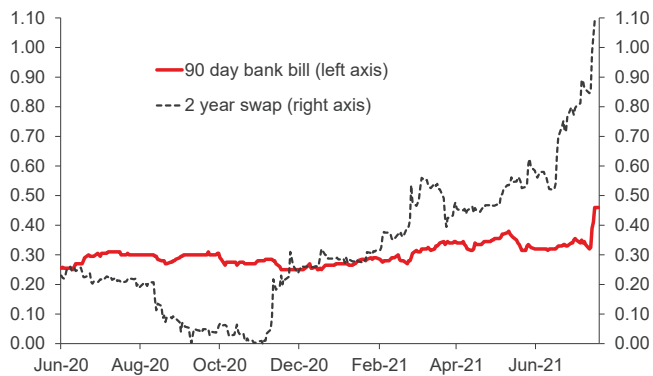


New Zealand forecasts.

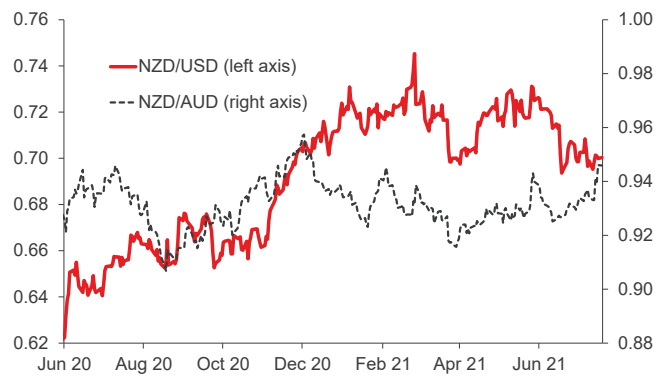
Economic forecasts		Quarterly				Annual		
	2021							
% change	Mar (a)	Jun	Sep	Dec	2019	2020	2021f	2022f
GDP (Production)	1.6	0.6	0.9	1.3	2.4	-2.9	5.8	4.5
Employment	0.5	0.4	0.3	0.4	1.2	0.8	1.7	2.1
Unemployment Rate % s.a.	4.7	4.5	4.4	4.2	4.1	4.9	4.2	3.9
CPI	0.8	1.3	0.9	0.2	1.9	1.4	3.3	2.0
Current Account Balance % of GDP	-2.2	-3.4	-4.4	-4.8	-3.3	-0.8	-4.8	-3.9

Financial forecasts	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
Cash	0.50	1.00	1.00	1.00	1.25	1.25	1.50	1.75
90 Day bill	0.90	1.10	1.10	1.20	1.35	1.45	1.70	2.00
2 Year Swap	1.30	1.40	1.50	1.60	1.70	1.80	2.00	2.15
5 Year Swap	1.60	1.75	1.90	2.00	2.10	2.20	2.40	2.55
10 Year Bond	1.80	1.95	2.10	2.15	2.20	2.30	2.45	2.55
NZD/USD	0.71	0.74	0.76	0.77	0.77	0.77	0.75	0.72
NZD/AUD	0.95	0.95	0.95	0.94	0.94	0.94	0.94	0.92
NZD/JPY	78.8	82.1	85.1	86.2	86.2	87.0	85.5	82.8
NZD/EUR	0.59	0.61	0.62	0.63	0.64	0.64	0.63	0.61
NZD/GBP	0.50	0.52	0.53	0.53	0.53	0.53	0.52	0.50
TWI	73.9	76.0	77.1	77.5	77.4	77.3	75.7	73.0

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 19 July 2021

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.31%	0.27%	0.27%
60 Days	0.39%	0.31%	0.30%
90 Days	0.46%	0.35%	0.33%
2 Year Swap	1.09%	0.80%	0.68%
5 Year Swap	1.50%	1.37%	1.34%

NZ foreign currency mid-rates as at 19 July 2021

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.7003	0.7026	0.6942
NZD/EUR	0.5930	0.5921	0.5856
NZD/GBP	0.5080	0.5081	0.5027
NZD/JPY	77.05	77.99	76.54
NZD/AUD	0.9459	0.9335	0.9275
TWI	74.39	74.09	73.23

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Jun BusinessNZ PSI	56.1	–	–	Upside risk, continuing the trend of strong data.
US	Jul NAHB housing market index	81	82	–	Homebuilding conditions buoyant, but a notch below peak.
Tue 20					
Aus	RBA minutes	–	–	–	Minutes of July meeting, which included key policy changes.
US	Jun building permits	–3.0%	0.4%	–	Seeing signs that input costs, particularly lumber prices...
	Jun housing starts	3.6%	1.2%	–	... are constraining housing construction.
Wed 21					
Aus	Jun Westpac-MI Leading Index	1.47%	–	–	Slowing as Covid rebound cycles, but still well above trend.
	Jun retail sales	0.4%	–0.4%	–0.2%	Melbourne's 14-day lock-down to impact.
NZ	GlobalDairyTrade auction (WMP)	–3.0%	–	1.0%	Prices to break downward trend as Fonterra cuts volumes.
UK	Jun public sector borrowing £bn	23.6	–	–	Monthly deficit to remain wide on record peacetime spend.
Thu 22					
Aus	Jul 3 Weekly payroll jobs	–	–	–	To overlap early stages of Greater Sydney lock-down.
Eur	ECB policy decision	0.0%	0.0%	–	Important update on future of emergency instruments.
	Jul consumer confidence	–3.3	–3.0	–	Advancing briskly as the reopening materialises.
US	Jun existing home sales	–0.9%	2.6%	–	Moderated in recent months on low supply/higher prices.
	Jun leading index	1.3%	0.9%	–	Declining jobless claims making significant contribution.
	Initial jobless claims	360k	–	–	Downtrend to accelerate as u/e benefits roll off.
	Jun Chicago Fed activity index	0.29	–	–	Activity well above trend, but pace will begin to moderate.
	Jul Kansas City Fed index	27	25	–	To guide on the status of bottlenecks and price pressures.
Fri 23					
Eur	Jul Markit PMIs	–	–	–	For the Euro Area, Germany and the UK.
UK	Jun retail sales	–1.4%	0.4%	–	To see some switching to services as reopening progresses.
	Jul GfK consumer sentiment	–9	–8	–	Restrictions relaxing, but rising cases may test confidence.
US	Jul Markit manufacturing PMI	62.1	62.1	–	June was the highest read since series began in May 2007.
	Jul Markit services PMI	64.6	64.5	–	Has pulled back from May record high - still very elevated.

International forecasts.


Economic Forecasts (Calendar Years)	2017	2018	2019	2020	2021f	2022f
Australia						
Real GDP %/yr	2.4	2.8	1.9	-2.4	5.4	3.8
CPI inflation %/yr	1.9	1.8	1.8	0.9	2.5	2.4
Unemployment rate %	5.5	5.0	5.2	6.8	4.4	3.8
Current account % of GDP	-2.6	-2.1	0.7	2.6	4.2	2.6
United States						
Real GDP %/yr	2.3	3.0	2.2	-3.5	6.5	4.1
CPI inflation %/yr	2.1	2.4	1.9	1.2	2.9	2.1
Unemployment rate %	4.4	3.9	3.7	8.1	5.4	3.8
Current account % of GDP	-2.3	-2.3	-2.6	-2.5	-2.4	-2.4
Japan						
Real GDP %/yr	1.7	0.6	0.3	-4.8	2.7	2.3
Euro zone						
Real GDP %/yr	2.6	1.9	1.3	-6.6	4.5	4.4
United Kingdom						
Real GDP %/yr	1.7	1.3	1.4	-9.9	6.2	5.0
China						
Real GDP %/yr	6.9	6.7	5.8	2.3	9.5	5.8
East Asia ex China						
Real GDP %/yr	4.7	4.4	3.7	-2.4	4.9	5.0
World						
Real GDP %/yr	3.8	3.6	2.8	-3.3	5.8	4.6
Forecasts finalised 9 July 2021						

Interest rate forecasts	Latest	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
Australia									
Cash	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.75
90 Day BBSW	0.02	0.04	0.07	0.10	0.15	0.20	0.40	0.70	0.95
10 Year Bond	1.29	1.70	1.90	1.95	2.00	2.05	2.10	2.20	2.30
International									
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.375	0.875	0.875
US 10 Year Bond	1.32	1.70	1.90	1.95	2.00	2.05	2.10	2.20	2.30


Exchange rate forecasts	Latest	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jun-23	Dec-23
AUD/USD	0.7435	0.75	0.78	0.80	0.82	0.82	0.82	0.80	0.78
USD/JPY	109.96	111	111	112	112	112	113	114	115
EUR/USD	1.1812	1.21	1.22	1.23	1.22	1.21	1.21	1.20	1.19
GBP/USD	1.3835	1.41	1.42	1.43	1.44	1.45	1.44	1.44	1.43
USD/CNY	6.4652	6.35	6.25	6.15	6.10	6.05	6.00	6.00	5.95
AUD/NZD	1.0592	1.06	1.05	1.05	1.06	1.06	1.06	1.07	1.08

Contact the Westpac economics team.


Michael Gordon, Acting Chief Economist

 +64 9 336 5670

Satish Ranchhod, Senior Economist

 +64 9 336 5668


Nathan Penny, Senior Agri Economist

 +64 9 348 9114


Paul Clark, Industry Economist

 +64 9 336 5656

Gregorius Steven, Economist

 +64 9 367 3978

Any questions email:

 economics@westpac.co.nz

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