

WESTPAC WEEKLY ECONOMIC COMMENTARY

That's a wrap.

20 December 2021



Hihi

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It's been quite a journey for the New Zealand economy over 2021, and our views have ended up in a very different position to what we expected at the beginning of the year. Supply-side shocks resulting from the Covid-19 pandemic have been a talking point throughout the year, but the greater challenge has been getting to grips with the role that strong demand is playing.

In some respects, the conditions were already falling into place at the start of the year. New Zealand's successful approach to eliminating the first Covid outbreak had allowed the economy to quickly regain momentum, largely without restrictions on domestic activity. Substantial monetary and fiscal stimulus also played a major role, particularly in terms of income replacement and maintaining jobs during the lockdown period.

Early in the year, we moved away from predicting that further OCR cuts, including a move into negative territory, would be needed to support the recovery. Nevertheless, some substantial challenges still lay ahead, including a relatively more fragile recovery among our major trading partners, and the risk of further lockdowns while our vaccination rates remained low. What's more, it was not clear how the economy would handle the loss of its biggest export sector – international tourism – during what would have been the peak summer period.

As a result, we thought that the economy would continue to operate with spare capacity for some time. That meant that monetary policy would need to remain supportive, with the

housing market being a major channel of transmission. The housing market was already running red-hot at the start of the year – in late 2020, when mortgage rates reached their low point, prices were rising as much as 3% a month. With interest rates remaining favourably low, we forecast that house price inflation would peak at 20% this year (the actual peak was 30%).

Right from the start of the year there were concerns about escalating costs, largely as a result of Covid. There were stories of supply chain disruptions, soaring shipping costs and delayed deliveries, as well as skill shortages as the border closure cut off access to migrant workers.

But what was lacking was the evidence that businesses had the pricing power to pass on these cost increases. With the economy still operating below full capacity, we expected inflation to remain muted for some time as well. In fact, inflation was still low in the early part of this year, reaching just 1.5% in the March quarter, which was in line with forecasts.

However, in the following months the evidence was clear to see for all in the data, with inflation surging to 4.9% by the

September quarter. Debate raged as to whether these price pressures would be transitory or longer-lasting, but much of the discourse continued to treat this as a supply-side shock.

We've maintained that demand is the greater determinant of inflation (in the sense of repeated price increases). And while the evidence of demand as a driver was initially lacking, it came through with a vengeance over the course of the year. Economic activity continued to surge, and by mid-year the level of GDP was 4.3% above its pre-pandemic level – even with lower population growth and the absence of international tourists. Similarly, demand for workers was surging. Job advertisements were far above pre-Covid levels, and by September we saw both record lows for unemployment and record highs for labour force participation.

Consequently, we now recognise that the monetary stimulus put in place in response to Covid will need to be withdrawn – and beyond to the point where monetary policy is outright tight. We expect the cash rate to reach 3% by late 2023. That doesn't represent a permanently higher level of interest rates, but rather a temporary peak in the cycle, in order to cool demand back down to more sustainable level.

So looking to the year ahead, the key things we'll be watching are:

Will wage growth accelerate? This is the other shoe that has yet to drop in this cycle. In a labour market this tight, you would normally expect to see upward pressure on (inflation-adjusted) wages, albeit with a lag. And while we have seen some uptick in recent months, it's consistent with no more than a catchup after little or no pay increases during last year's Covid shock. The demands for cost-of-living adjustments are only just beginning. And once they take hold, there's a growing risk of an upward spiral in wages and prices, which could prove difficult for the Reserve Bank to dislodge.

How will the housing market respond to higher mortgage rates? We expect house price growth to slow substantially in the coming months, turning to modest declines from late 2022. Higher mortgage rates won't be a strain for the majority of property owners, but they will significantly change the arithmetic for new purchases.

Can we safely reopen the borders? With the housing market, and therefore household consumption, expected to step down as drivers of growth next year, a key question is whether something else will step up – namely, international travel. Unfortunately, global trends in Covid make it uncertain as to when we'll see tourists return in meaningful numbers. But even going from nothing to something will make a difference in terms of overall GDP growth next year.

Michael Gordon, Acting Chief Economist

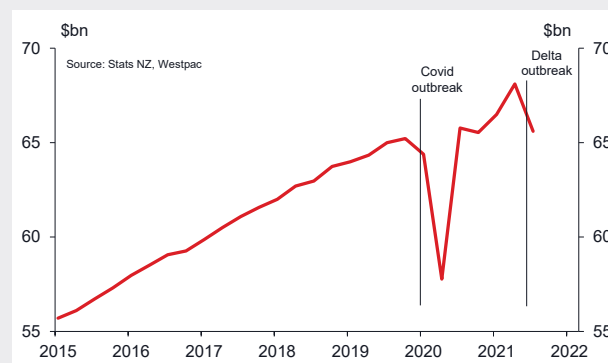
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Chart of the week

GDP surged over the first half of the year, and even with the lockdown in August, it was still slightly above pre-Covid levels. That's with only modest population growth and the loss of our largest export sector (tourism). That points to solid strength in underlying demand.

Production-based GDP

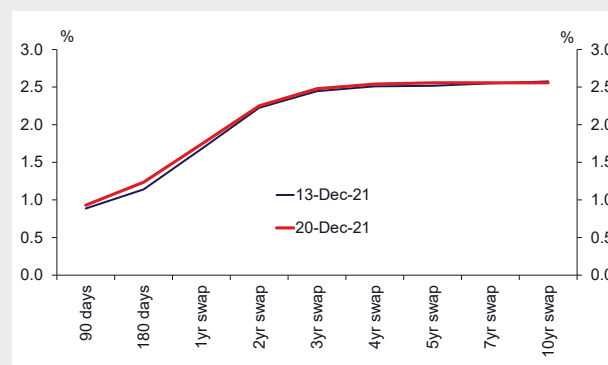


Fixed vs floating for mortgages

We expect the Reserve Bank to increase the OCR further at its upcoming reviews, reaching a peak of 3% by mid-2023.

Based on these OCR forecasts, we think there is value in extending fixed-rate terms as far out as 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

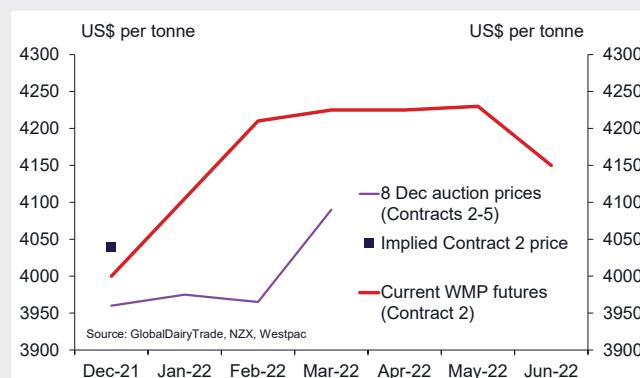
Dec 22, Last: +0.6%, Westpac: No change

We expect whole milk powder prices (WMP) to be largely unchanged at the upcoming dairy auction. Even with our forecast for no change, prices are ending the year on a high, with WMP sitting above US\$4,000/MT.

Our pick is more modest than futures market pricing, where a lift of around 2% is expected.

Over recent months, soft global supply has been translating into higher global dairy prices. Heading into 2022, we expect prices to moderate as global supply eventually rebounds.

Whole milk powder prices



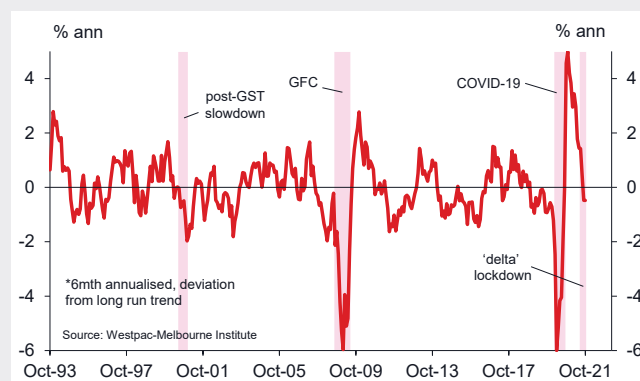
Aus Nov Westpac-MI Leading Index

Dec 22, Last: -0.5%

The six-month annualised growth rate held at -0.5% in October, unchanged from September, marking two consecutive months of negative, below trend growth. That said, the Index has held up quite well given two major cities were locked down for most of the September quarter and into October.

The Nov Index should show a decent improvement. Monthly component updates will include a very strong rebound in total hours worked (4.5% vs -0.2% last month). Other components have been more mixed: the ASX200 down -0.9%; commodity prices down -0.6% in AUD terms; sentiment-based measures off a bit, especially the Westpac-MI Unemployment Expectations Index which deteriorated 9.3% (albeit from a very strong starting point); and dwelling approvals recording a sharp -12.9% drop. However, the stellar rebound in hours worked should hold sway for the month.

Aus Westpac-MI Leading Index

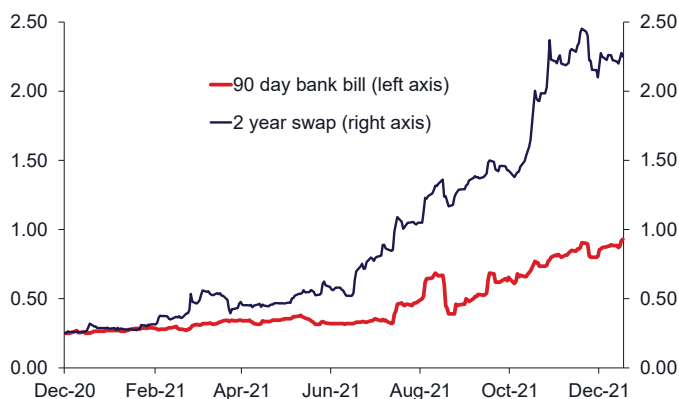


New Zealand forecasts

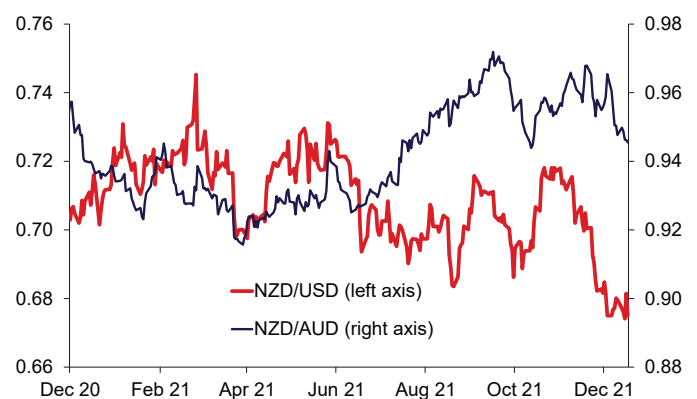
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Jun (a)	Sep	Dec	Mar	2020	2021f	2022f	2023f
GDP (Production)	2.4	-3.7	1.1	1.6	-1.9	5.1	4.4	4.7
Employment	1.0	2.0	0.2	0.3	0.6	3.8	0.6	1.2
Unemployment Rate % s.a.	4.0	3.4	3.6	3.5	4.8	3.6	3.3	3.4
CPI	1.3	2.2	0.8	0.9	1.4	5.3	3.1	2.7
Current 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 20 December 2021

Interest rates	Current	Two weeks ago	One month ago
Cash	0.75%	0.75%	0.50%
30 Days	0.80%	0.78%	0.83%
60 Days	0.87%	0.83%	0.87%
90 Days	0.93%	0.87%	0.91%
2 Year Swap	2.25%	2.25%	2.44%
5 Year Swap	2.56%	2.56%	2.80%

NZ foreign currency mid-rates as at 20 December 2021

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6750	0.6762	0.7010
NZD/EUR	0.5995	0.5965	0.6211
NZD/GBP	0.5086	0.5105	0.5210
NZD/JPY	76.72	76.25	79.83
NZD/AUD	0.9455	0.9649	0.9676
TWI	72.71	72.97	75.11

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Nov trade balance \$m	-1286	-	-870	Import values still on a tear, fifth monthly deficit in a row.
US	Nov leading index	0.9%	0.8%	-	Robust economic momentum set to continue.
Tue 21					
NZ	Nov credit card spending	8.4%	-	-	Timely update on consumer spending.
Aus	RBA minutes	-	-	-	Focus on the inflation debate and the timing of the taper.
Eur	Dec consumer confidence	-6.8	-8.5	-	Omicron and inflation to weigh on confidence.
Wed 22					
NZ	GlobalDairyTrade auction prices (WMP)	0.6%	-	0.0%	Dairy prices ending the year on a high.
Aus	Nov Westpac-MI Leading Index	-0.5%	-	-	Reopening rebound should start to show through this month.
UK	Q3 GDP	1.3%	-	-	Final estimate to confirm component detail.
US	Nov Chicago Fed activity index	0.76	-	-	To provide a timely update on activity in the region.
	Q3 GDP, annualised	2.1%	2.1%	-	Third release of GDP; to be in line with prior estimate.
	Nov existing home sales	0.8%	2.8%	-	To lift further given strong underlying demand.
Thu 23					
US	Initial jobless claims	206k	-	-	Should remain near historic lows.
	Nov personal spending	1.3%	0.5%	-	Gains across goods and services to continue after robust Oct.
	Nov personal income	0.5%	0.5%	-	Threat of reduced purchasing power from persistent inflation.
	Nov PCE deflator	0.6%	0.6%	-	PCE inflation to rise to its highest level since the 1980s.
	Nov durable goods orders	-0.4%	2.0%	-	Expected to bounce back; transport volatility to remain.
	Dec Uni. of Michigan sentiment	70.4	70.4	-	Final est; COVID-19 and inflation weighing.
	Nov new home sales	0.4%	3.2%	-	Set to rise as supply constraints are worked through.

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	0.10	0.10	0.25	0.50	0.50	0.75
90 Day BBSW	0.07	0.10	0.15	0.20	0.40	0.65	0.70	0.95	0.95
10 Year Bond	1.57	2.15	2.30	2.30	2.30	2.30	2.25	2.25	2.20
International									
Fed Funds	0.125	0.125	0.375	0.625	0.875	0.875	1.125	1.125	1.375
US 10 Year Bond	1.41	2.00	2.20	2.30	2.30	2.30	2.25	2.25	2.20

Exchange rate forecasts	Latest	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7180	0.71	0.70	0.71	0.73	0.75	0.76	0.77	0.78
USD/JPY	113.79	116	116	117	117	118	118	119	119
EUR/USD	1.1327	1.10	1.08	1.09	1.10	1.11	1.12	1.13	1.14
GBP/USD	1.3327	1.36	1.37	1.38	1.38	1.37	1.37	1.36	1.35
USD/CNY	6.3682	6.35	6.35	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0565	1.06	1.06	1.06	1.06	1.07	1.07	1.07	1.08

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