WESTPAC WEEKLY ECONOMIC COMMENTARY

The Misery Index.

26 April 2022

Mount Cook buttercup

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New Zealand inflation has hit its highest level in more than three decades. Importantly, much of that rise has been related to the prices of necessities like food, housing and transport. That's squeezing households' spending power. It's also got alarm bells ringing at the RBNZ, with a series of interest rate hikes on the cards over the coming months.

Consumer prices have continued to charge higher, rising by 1.8% in the March quarter. Coming on top of the large price increases we saw last year, that took the annual inflation rate to 6.9%. That's the highest annual rate of inflation that New Zealand has seen since 1990.

In part the strength in inflation is due to global factors, including ongoing disruptions to supply chains and high transport costs. Those pressures were reflected in the 8.5% annual rise in tradables prices (which mainly relates to the prices of imported goods).

At the same time, domestic inflation pressures are also running hot, with non-tradables inflation rising to 6% over the past year. New Zealand businesses have been reporting sharp increases in operating costs. That includes mounting upward pressure on wages as businesses struggle to attract and retain staff.

Importantly, the rise in operating costs has been compounded by strong demand in some key parts of the economy. That's notable for two key reasons. First, it's given businesses in sectors like construction greater scope to pass on cost increases into output prices, rather than taking a hit on margins.

Second, if demand is strong, inflation is likely to remain elevated even when the current pressure on operating costs eventually eases off. That's especially important for the RBNZ, as a key factor underpinning the strength of household demand has been stimulus from low interest rates.

And it's not just inflation that is running red hot. Unemployment is just 3.2% - the lowest level on record – and it's set to drop even lower over the coming months. More generally, the New Zealand economy as a whole has come through the Delta and Omicron outbreaks in good shape, though conditions are mixed across sectors: firmness in construction activity, strong commodity export prices and resilient durables spending have all helped to offset the softness in customer facing industries like hospitality.

Given the prevalence of price and cost pressures, inflation is set to remain well above the RBNZ's target band through the remainder of this year, and that's got alarm bells ringing at the central bank.

A particular worry for the RBNZ is that a growing number of both households and businesses expect that inflation will linger at high levels for an extended period. If that spills over into wage and price setting decisions, the strength in inflation could be sustained for even longer. That would mean that even larger interest rate increases are needed to rein the inflation monster in. On this front, it's notable that we're already seeing growing upwards pressure on wage claims. In fact, in a recent Westpac survey of New Zealand households, around half of those aged 25 to 54 had either asked for a pay rise or were considering doing so, with similar numbers looking for a higher paying job.

The RBNZ has tried to get ahead of the risks for inflation expectations, delivering a 50bp increase in the cash rate at their most recent policy meeting. But given the strength of inflation pressures currently buffeting the New Zealand economy, a lot more tightening will be needed. We're forecasting another 50bp rise in the OCR at the RBNZ's May policy meeting, followed by 25bp increases at every meeting in the back half of the year. That would more than reverse the stimulus that the RBNZ introduced in the wake of the initial Covid outbreak and would take the cash rate into tight territory.

The impact of monetary policy tightening is already being felt. House prices have fallen by around 5% since November, with larger falls in Auckland and Wellington. We expect to see further declines through the back half of the year as the cash rate continues to push higher. That will be important for the stance of monetary policy. The housing market plays a key role in shaping the strength of household demand more generally, and we expect that as the housing market continues to cool, demand related inflation pressure will also ease back

But even with signs that interest rate hikes are gaining traction, the RBNZ still faces a challenging balancing act. It may take some time for the rise in inflation expectations that we've already seen to be reversed. That was certainly the experience in the mid-2000s when the central bank was also grappling with price expectations that were well above their target. At that time, expectations did eventually drop back, but not until we saw an extended period where inflation was running below 2%.

However, even given the rise in inflation expectations, there are questions about how much policy tightening is appropriate. Much of the current strong inflation pressures that we're being confronted with are related to offshore factors, such as ongoing disruptions to global supply chains. Such pressures are beyond the RBNZ's control. Furthermore, larger rate increases would add to the pressure on household balance sheets, which are already being squeezed by the rise in consumer prices. It's been particularly tough for those on lower incomes as much of the recent rise in prices has been related to necessities like food, transport and housing.

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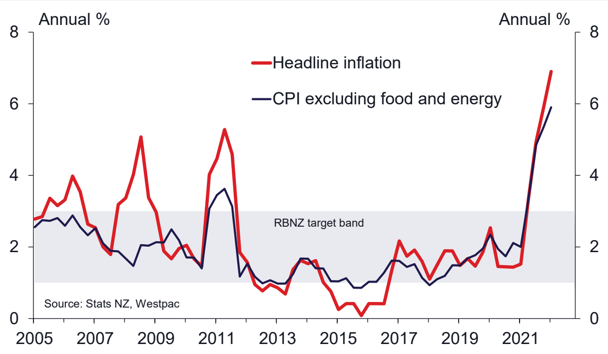
Chart of the week

Much of the rise in consumer prices in recent months has been due to sharp increases in the prices of food and petrol. However, price pressures are bubbling over in every corner of the economy. In fact, even excluding food and energy costs, consumer prices were up 5.9% over the past 12 months.

Annual inflation

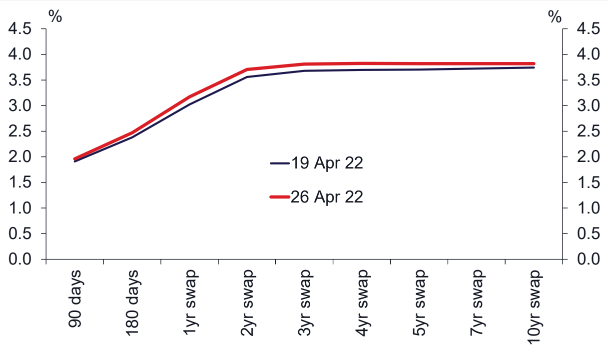


Fixed vs floating for mortgages

Wholesale interest rates have now moved beyond our forecast of a 3% cash rate by mid-2023. That suggests to us that there is no 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 only suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

NZ Mar ANZBO business confidence

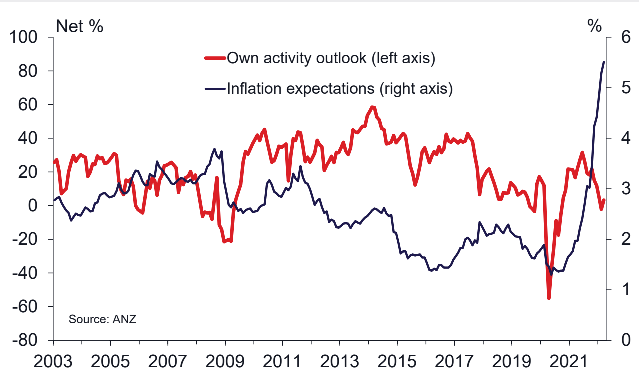
Apr 28, Last: -41.9

Business confidence picked up a little in March but remained at subdued levels as businesses across the country continued to grapple with a range of headwinds. That included the Omicron outbreak and strong cost pressures.

While business confidence is likely to remain low in April, we do expect that some of the recent pessimism will dissipate. Activity restrictions are being rolled back, the borders are reopening, and we are seeing early signs that demand is firming again.

The survey's inflation and price gauges are likely to remain high, with continued pressure on operating costs and growing pressure on wages.

NZ business confidence



Aus Q1 Consumer Price Index

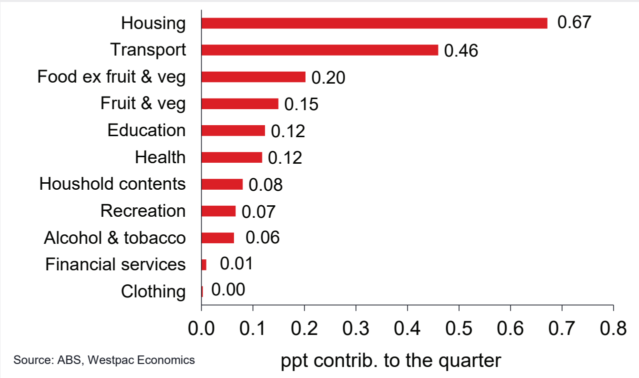
Apr 27 Last: 1.3%, WBC f/c: 2.0%
Mkt f/c: 1.7%, Range: 1.4% to 2.0%

The Dec quarter CPI came in stronger than expected at 1.3% exceeding the top of the range forecast at 1.2%. The annual pace lifted from 3.0% to 3.5% not too far off the June 2021 12yr high of 3.8%. In the December quarter the ending of the HomeBuilder grants were part, but not all, of the inflation story.

Westpac continues to see inflationary pressures building due to continuing supply disruptions, rising commodity and energy prices and robust domestic demand. Our forecast is for a 2.0% rise in the March quarter CPI taking the annual pace to 4.9%yr from 3.5%yr.

Core inflation, as measured by the trimmed mean, is set to rise 1.2% lifting the annual pace from 2.6%yr to 3.4%yr.

Aus CPI contributions



Aus Mar private sector credit

Apr 29, Last: 0.6%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.6% to 0.7%

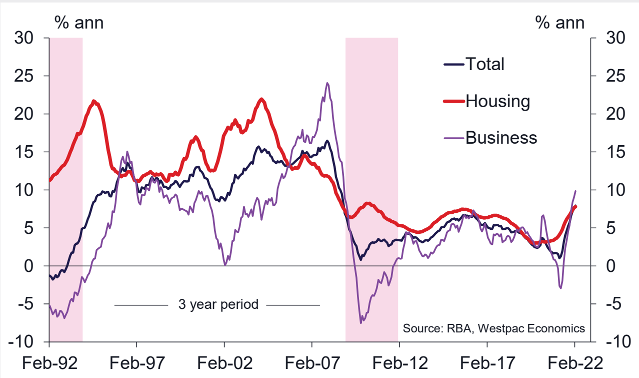
Credit to the private sector expanded by 7.9% over the past year, to February. That is the fastest annual pace since November 2008 but is still well below the December 2007 peak of 16.5%, pre-GFC.

Households and businesses alike are borrowing more, responding to considerable policy stimulus. Record low interest rates fired up the housing market, firms accessed lines of credit to improve cash flows to navigate lockdowns and firms are also borrowing to invest.

The February result was a 0.6% rise, including: residential 0.6%, 7.8%/yr; personal 0.0%, -3.0%/yr; and business 0.8%, 9.8%/yr.
For March we anticipate another 0.6%, lifting annual growth to 8.0%, and for the detail to be broadly in line with that of February.

Looking ahead, a looming RBA tightening cycle will cool housing and the May Federal election will add to uncertainty, potentially triggering a dip in business borrowing.

Aus credit growth



The week ahead

US Q1 GDP

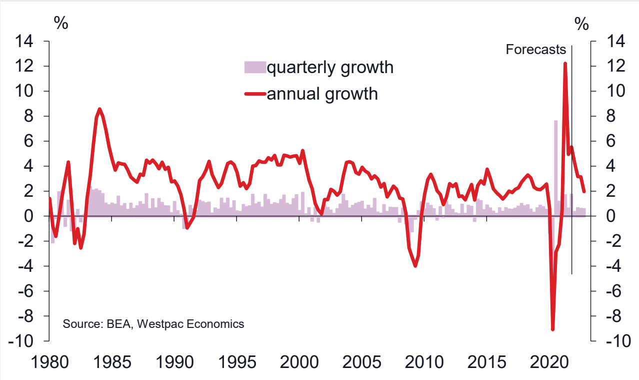
Apr 28, annualised, Last: 6.9%, WBC f/c: 1.5%, Mkt f/c: 1.0%

The US economy experienced a dramatic deceleration in Q1 2022, with annualised growth slowing from 6.9% to 1.5% on our forecast – or to 1.0% as expected by the market.

The slowdown is the consequence of a large negative contribution from trade, with exports soft and imports strong over the three months to March, as well as a significant reduction in the pace of inventory accrual over the period.

Through mid-2022, growth will bounce back. However, each quarter that passes will see support from income growth slow; any remaining fiscal cash spent; and tighter financial conditions bite. So into end-2022, we expect growth to slow towards trend and, come 2023, for it to fall below that mark.

US GDP

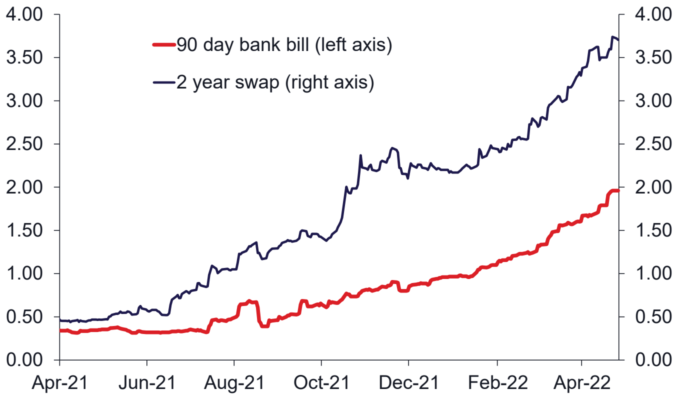


New Zealand forecasts

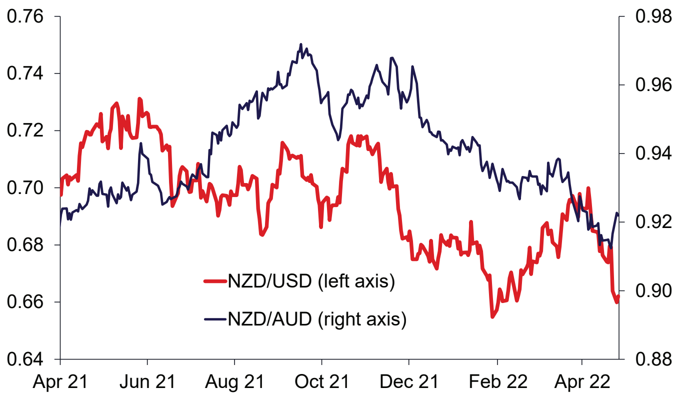
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.3	0.7	2.3	-2.1	5.6	3.4	4.8
Employment	0.1	0.4	0.3	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.8	0.8	1.1	1.4	5.9	4.3	2.7
Current Account Balance % of GDP	-5.6	-5.8	-6.5	-6.5	-0.8	-5.6	-6.1	-5.5

Financial forecasts	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	2.00	2.50	3.00	3.00	3.00	3.00	3.00
90 Day bill	2.40	2.90	3.10	3.10	3.10	3.10	3.10
2 Year Swap	3.70	3.80	3.80	3.70	3.50	3.30	3.10
5 Year Swap	3.80	3.80	3.80	3.65	3.50	3.35	3.20
10 Year Bond	3.60	3.60	3.40	3.30	3.20	3.10	3.00
NZD/USD	0.69	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	85.6	86.1	86.6	86.5	86.4	86.3	86.9
NZD/EUR	0.63	0.63	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.52	0.52	0.53	0.53	0.53	0.53	0.54
TWI	74.0	74.6	75.1	75.0	74.9	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 26 April 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.00%	1.00%
30 Days	1.59%	1.45%	1.25%
60 Days	1.78%	1.58%	1.43%
90 Days	1.96%	1.71%	1.61%
2 Year Swap	3.71%	3.62%	3.30%
5 Year Swap	3.82%	3.75%	3.49%

NZ foreign currency mid-rates as at 26 April 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6621	0.6839	0.6898
NZD/EUR	0.6181	0.6293	0.6245
NZD/GBP	0.5196	0.5255	0.5267
NZD/JPY	84.79	85.89	85.20
NZD/AUD	0.9219	0.9197	0.9203
TWI	73.06	74.07	74.27

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 26					
US	Mar durable goods orders	–2.1%	1.0%	–	Supply chain still a headwind.
	Feb FHFA house prices	1.6%	1.5%	–	Strong demand and limited supply...
	Feb S&P/CS home price index	1.79%	1.50%	–	... to drive house price growth before rate hikes take effect.
	Apr consumer confidence index	107.2	108.4	–	Inflation worries offsetting strength of labour market.
	Apr Richmond Fed index	13	8	–	Sourcing materials and labour still a challenge.
	Mar new home sales	–2.0%	0.3%	–	Rising mortgage rates set to slow sales activity.
Wed 27					
Aus	Q1 CPI	1.3%	1.7%	2.0%	Dwelling price surge as grants end adding to auto fuel...
	Q1 CPI %yr	3.5%	4.6%	4.9%	... increase & rising pressure on food prices.
	Q1 trimmed mean CPI	1.0%	1.2%	1.2%	The lift in core inflation reflects a more broadspread pressure...
	Q1 trimmed mean CPI %yr	2.6%	3.4%	3.4%	... as supply lines remain disrupted & robust domestic demand.
Chn	Mar industrial profits %yr	4.2%	–	–	Profit g'th will build as Covid-19 disruptions fade.
US	Mar wholesale inventories	2.5%	–	–	Stocks are being replenished as supply allows.
	Mar pending home sales	–4.1%	–1.0%	–	Higher rates to cool demand.
Thu 28					
NZ	Mar trade balance $mn	–385	–	–200	Oil price surge will flow through to March trade deficit.
	Mar employment indicators	–0.3%	–	–	Dipped slightly in Feb during Omicron disruptions.
	Apr ANZ business confidence	–41.9	–	–	Confidence is still low, but is expected to firm.
Aus	Q1 import price index	5.8%	7.0%	3.2%	Higher energy prices, world prices and a slightly lower AUD.
	Q1 export price index	3.5%	11.0%	11.0%	Sharply higher commodity prices.
Eur	Apr economic confidence	108.5	108.0	–	Soaring energy and commodity prices...
	Apr consumer confidence	–16.9	–	–	... are a key concern.
UK	Apr Nationwide house prices	1.1%	–	–	Momentum should cool over '22 given rising mortgage rates.
US	Initial jobless claims	184k	–	–	Set to remain near record lows.
	Q1 GDP	6.9%	1.0%	1.5%	Q1 hit by trade deficit and supply-chain issues for inventory.
	Apr Kansas City Fed index	37	–	–	Manufacturing outlook very strong.
Fri 29					
NZ	Apr ANZ consumer confidence	77.9	–	–	Rising prices are a key concern weighing on confidence.
Aus	Mar private sector credit	0.6%	0.6%	0.6%	Robust momentum in business, housing potentially cresting.
	Q1 PPI	1.3%	–	–	Significant upward pressure on input prices
Eur	Apr CPI %yr	2.4%	–	–	Energy inflation to remain strong.
	Q1 GDP	0.3%	0.3%	0.3%	Russia-Ukraine conflict to impact at least Q1 and Q2.
US	Q1 employment cost index	1.0%	1.1%	1.0%	Tight labour market to support robust wages growth.
	Mar personal income	0.5%	0.4%	–	Purchasing power is becoming more of a concern...
	Mar personal spending	0.2%	0.6%	–	... but services spending should remain a positive.
	Mar PCE deflator	0.6%	0.9%	–	PCE inflation has reached a 40-year high...
	Mar core PCE deflator	0.4%	0.3%	–	... price pressures will only slowly abate through 2022.
	Apr Chicago PMI	62.9	61.0	–	Supply issues an ongoing concern.
	Apr Uni. of Michigan sentiment	65.7	65.7	–	Expectations have improved, but inflation a persistent risk.

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	4.3	2.3
Unemployment rate %	5.0	5.2	6.8	4.7	3.2	3.4
Current account % of GDP	-2.1	0.7	2.6	3.5	3.7	-0.4
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	3.1	1.8
CPI inflation %yr	2.4	1.9	1.3	7.1	3.7	2.3
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.1
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	2.2	1.4
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	3.0	2.3
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	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	3.7	3.5

Forecasts finalised 8 April 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.10	0.50	1.00	1.50	1.75	2.00	2.00	2.00
90 Day BBSW	0.46	0.70	1.20	1.70	1.95	2.20	2.20	2.20
10 Year Bond	3.15	3.20	3.10	2.80	2.65	2.50	2.35	2.20
International								
Fed Funds	0.375	1.375	1.875	2.375	2.375	2.375	2.375	2.375
US 10 Year Bond	2.94	2.90	2.80	2.50	2.40	2.30	2.20	2.10

Exchange rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7336	0.74	0.75	0.76	0.77	0.78	0.79	0.80
USD/JPY	128.28	124	123	122	121	120	119	119
EUR/USD	1.0845	1.10	1.11	1.12	1.13	1.14	1.15	1.15
GBP/USD	1.3023	1.33	1.34	1.35	1.36	1.37	1.37	1.36
USD/CNY	6.4689	6.30	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0959	1.07	1.07	1.07	1.08	1.08	1.09	1.10

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