

WESTPAC WEEKLY ECONOMIC COMMENTARY

Overdoing it?

9 May 2022



Mount Cook buttercup

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There's no question that the New Zealand labour market is running hot. Not only is the unemployment rate at a record low, but wage growth is now clearly gathering momentum. This reinforces the scale of the challenge that the Reserve Bank faces in bringing inflation pressures under control. Even so, we think that the market is underestimating just how powerful monetary policy will be.

The unemployment rate held at 3.2% in the March quarter. That was an equal-record in the history of the survey going back to 1986. The result wasn't quite as impressive as our expectation of a further decline to 3.0%, but in the key details it was similar to our view.

The number of people employed was just 0.1% higher for the quarter, similar to our forecast. That was also in line with Stats NZ's monthly filled jobs indicator, which is drawn from tax data and hence provides quite a comprehensive picture. Employment did drop a little in the February and March months, but it was still up for the quarter on average. Disruptions to hiring as the Omicron wave reached its peak may have been a factor here, although the experience overseas suggests that any impact from this will be short-lived.

As the Reserve Bank has noted, the economy is running above the 'maximum sustainable' level of employment. Identifying where that 'maximum' lies is an inexact science – the RBNZ looks at a range of indicators relative to their histories, and whether a consistent message is coming through from them.

But the relevance of this concept is in what it means for wage inflation. And in that respect, last week's figures support the idea that the labour market has become unsustainably tight.

Wages have now built up a head of steam. The Labour Cost Index (LCI) for all sectors rose by 0.8% for the quarter, to be up 3% on a year ago. Broader measures of the pay that workers actually receive are up closer to 5% in the last year.

Moreover, on all of these measures, we're now running at a pace comparable to 2005, which was the last time that the unemployment rate dropped below 4%. On that occasion, wage growth continued to accelerate for a few more years, and consumer price inflation remained stubbornly high relative to the RBNZ's target. It took the Global Financial Crisis in 2008 to bring that wage-price spiral to a halt.

One notable difference between the mid-2000s and today is that this time wages have fallen behind the cost of living, with consumer prices up 6.9% over the same period. That partly reflects the nature of the inflation threat, with global cost

shocks playing a greater role than the demand for labour, at least up until now.

But that's likely to change over the year ahead. Some of the global cost shocks will fade over time, or at least won't be repeated. That will see the headline inflation rate recede from its current highs. But what it recedes back to will be decided by the extent of local inflation pressures, and wage inflation in particular. That would mean lower, but also more persistent inflation in the years ahead.

New Zealand is not alone in facing this issue. Our strong public health response to Covid meant that we were one of the first countries to end up operating above pre-Covid levels of activity (i.e. overheating). But many other regions are now catching up, and are also coming to the recognition that the inflation pressures they face are home-grown and more than just transitory.

For example, the US saw a strong lift in its Employment Cost Index (the equivalent of New Zealand's LCI) in the March quarter. The upcoming figures for Australia are also expected to be solid, although more significantly, the RBA has moved its emphasis away from the slow-moving wage index and more towards the reports from its business liaisons, which point to a widespread lift in wage growth.

The emerging evidence of wage pressures has no doubt played a part in recent central bank decisions to step up the pace of monetary tightening. The RBNZ and the Bank of Canada have lifted their policy rates by 50 basis points at their most recent reviews, the US Federal Reserve followed suit last week, and the Reserve Bank of Australia has begun hiking rates sooner than was expected even a few weeks ago.

It's going to be challenging for central banks to thread the needle of damping down inflation without driving their economies into recession. The RBNZ at least has the benefit of having started on the problem sooner than most others.

Back in November we predicted the Official Cash Rate to rise to a peak of 3% in 2023. By February, the pricing in interest rate markets had risen to be broadly in line with our view. But the market has continued on since then – perhaps led around by overseas trends – and is now factoring in a peak OCR of more than 4%.

That in turn has already lifted fixed-term mortgage rates beyond where we expected them to peak in this cycle. Consequently, we've had to reflect that in our housing market forecasts – we now expect a cumulative 15% drop in prices over the next two years, from a 10% drop previously.

We're still of the view that the market is overcooking it in terms of the OCR outlook. But having got to this point, it's likely to remain there until given a clear reason to think otherwise. That reason will be a major fall in house prices, which we think will be forthcoming long before the OCR actually reaches 4%, thereby making it something of a self-defeating prophecy.

Michael Gordon, Acting Chief Economist

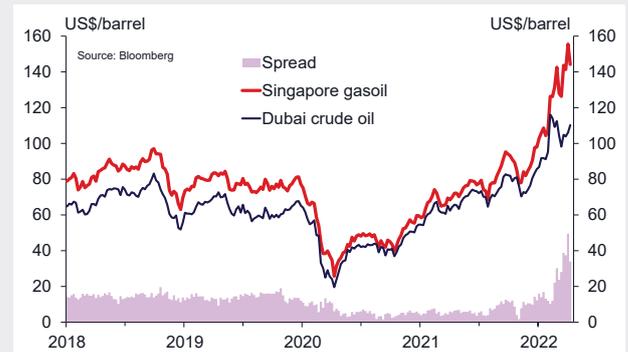
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Chart of the week

Petrol prices at the pump have been climbing higher again in recent weeks, undoing some of the relief provided by the cut in fuel excise taxes in April. The Russia-Ukraine conflict has continued to disrupt the patterns of trade in global energy markets. One consequence is that while crude oil prices have moderated a little since the start of the conflict, the gap between crude and refined product prices has blown out to unprecedented levels.

World oil prices

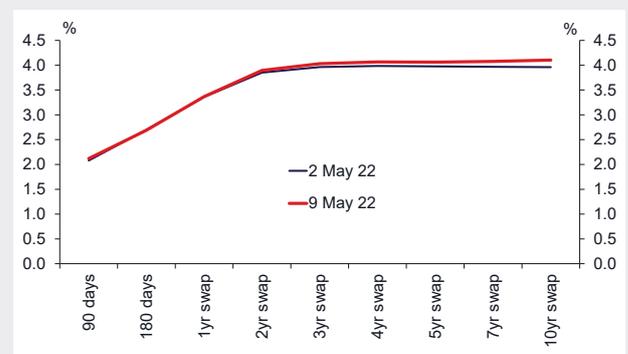


Fixed vs floating for mortgages

Wholesale interest rates have now moved substantially beyond our forecast of a 3% peak in the cash rate by the end of this year. 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 year ahead, fixing and rolling for this term is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms would be more suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

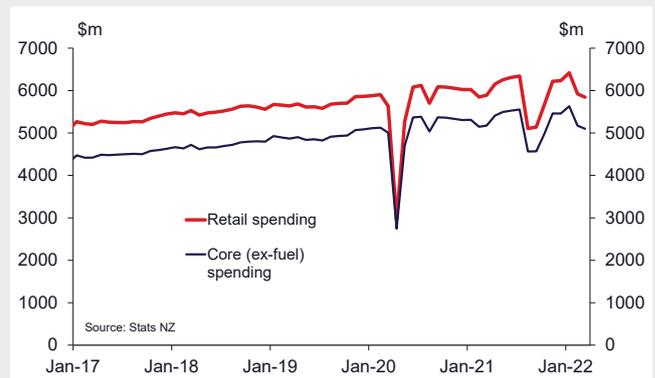
NZ Apr retail card spending

May 10, Last: -1.3%, Westpac: +3.5%

Retail spending fell by 1.3% in March. In part, that soft result was related to the sharp rise in petrol prices which limited spending in other areas. We've also seen increases in mortgage interest rates and a range of other costs for households. And on top of those factors, the Omicron outbreak was a drag on demand in the early part of the year.

We expect to see a recovery in spending in April. While petrol prices are still high, the reduction in fuel taxes has provided some relief. We've also seen a lift in hospitality spending as activity restrictions have been relaxed and spending appetites have recovered.

NZ retail card spending



NZ Apr REINZ house sales

May 12, Sales last: -2.9%, Prices last: -1.4% mom, +9.0%/y

The housing market has been cooling rapidly in recent months as fixed mortgage rates have pushed higher. Nationwide prices are now down 5% from their peak in November, with larger declines in Auckland and Wellington. Similarly, sales have fallen below pre-pandemic levels.

We expect that the April housing market report will show that the market has continued to cool. Indicators such as listings on realestate.co.nz and the Auckland sales figures from Barfoot & Thompson suggest that the market remains in decline. Both sellers and buyers are stepping back from the market, but the latter are stepping back faster. The net effect has been that the stock of unsold homes has risen to a three-year high.

REINZ house prices and sales



NZ Q2 RBNZ survey of expectations

May 12, Two-year ahead inflation expectations, Last: 3.27%

Inflation expectations jumped higher in the RBNZ's March quarter survey of expectations. That jump was a key factor that underpinned the 50bp OCR hike in April.

The June survey came hot on the heels of the March quarter inflation report, which showed inflation has risen to a 31-year high. There have also been continued reports of strong cost pressures across the economy.

With that in mind, we expect the June quarter survey will show a further sharp rise in inflation expectations for near-term horizons (one- and two-years ahead). A result in that vein would support our forecast for another 50bp OCR hike in May.

RBNZ survey of expectations



The week ahead

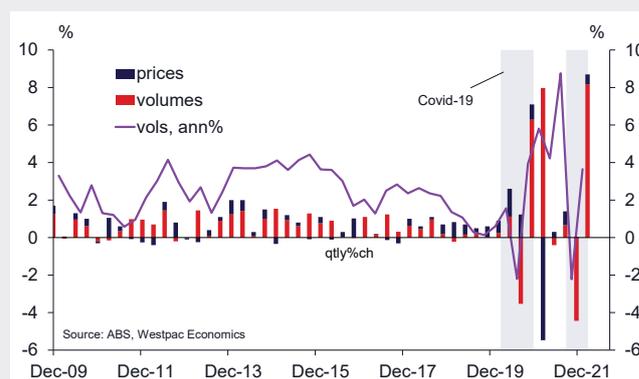
Aus Q1 real retail sales

May 10, Last: 8.2%, WBC f/c: 1.2%
Mkt f/c: 1.0%, Range: -0.7% to 1.6%

Real retail sales soared 8.2% in Q4, rebounding strongly from the delta lock-down driven 4.4% contraction in Q3.

Q1 is set to see a more mixed result with a variety of headwinds – including from the omicron outbreak, weather events and a surge in fuel prices – and a big lift in prices muting what would have otherwise likely have been another big quarterly reopening-driven gain. Monthly retail sales still show nominal sales up 2.9% for the quarter. The detail from the outsized Q1 CPI gain suggests around 1.6% of this was due to higher retail prices. That in turn points to a 1.2%qtr rise in volumes.

Aus quarterly retail volumes and prices



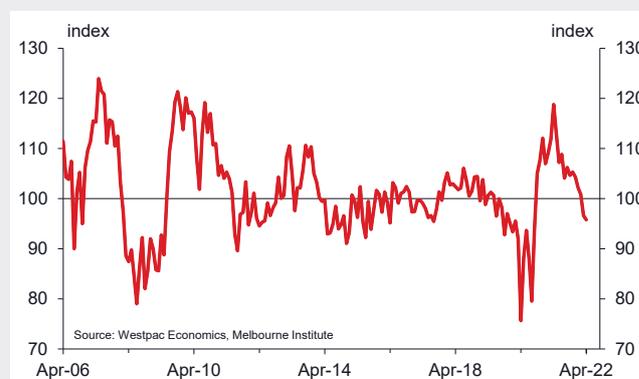
Aus May Westpac-MI Consumer Sentiment

May 11, Last: 95.8

Consumer Sentiment fell 0.9% to 95.8 in April following a 4.2% fall in March. Confidence has flagged on concerns about high inflation and prospective interest rate increases, compounded by severe weather events in NSW and Qld and Russia's invasion of Ukraine. That said, a strong labour market and a relatively well-received Federal budget have provided some offsetting support.

Sentiment is set to see a bigger shock in May following the RBA's 25bp rate hike and indication of further rises to come – the move coming after a surprise surge in CPI inflation to 5.1%yr, reported in late April. While most consumers already expected rates to increase over the next year, the move is coming earlier and looks set to be sharper than most anticipated, reflecting a more challenging and threatening starting point for inflation. Other factors – weather, labour markets, petrol prices, house price and financial market developments etc. – are also in the mix but will take a back seat to interest rate news.

Aus Consumer Sentiment Index



Aus April overseas arrivals and departures, preliminary

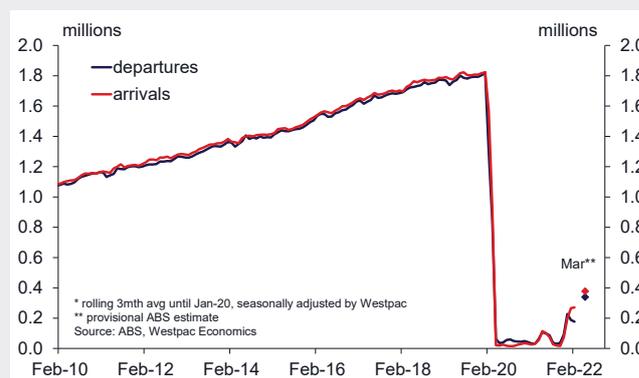
May 12, Arrivals, Last: 376.7k
May 12, Departures, Last: 338.9k

Prior to the pandemic, arrivals and departures averaged 1.8mn and 1.7mn per month respectively. The border closure in early 2020 saw sharp declines in both, to near zero for much of 2020-21.

The March estimate indicated a clear improvement in overseas travel, with arrivals lifting to 376.7k and departures rising to 338.9k, although both components still sit roughly 1.5mn below pre-Covid levels. The return of Australians from short-term trips continues to account for the bulk of arrivals, although short-term visitor arrivals have shown a definite lift from their post-delta/pre-omicron levels.

The April preliminary estimate will provide a gauge of whether the lift in momentum is continuing. The key focus will be on the rebound of visitor arrivals and the visa detail breakdown, each of which are an important component to the strength of local demand and labour supply.

Aus total overseas arrivals and departures

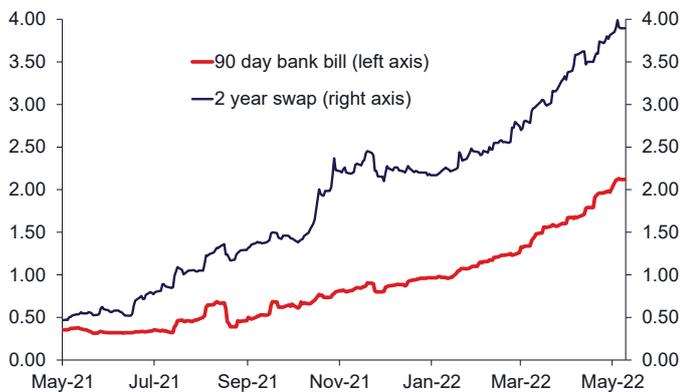


New Zealand forecasts

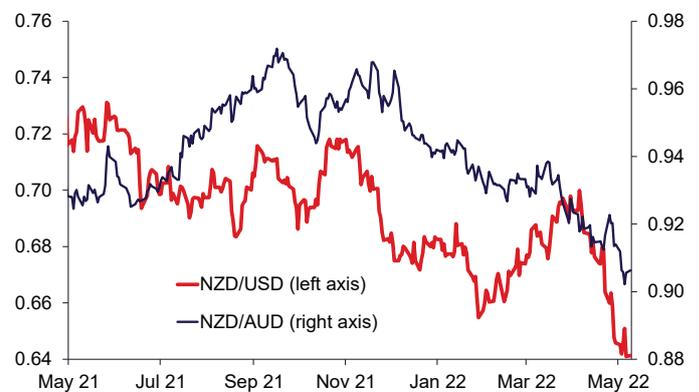
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.3	0.7	2.3	-2.1	5.6	3.4	4.8
Employment	0.0	0.1	0.3	0.3	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.8	0.8	1.1	1.4	5.9	4.3	2.7
Current 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	4.00	4.00	3.90	3.70	3.50	3.30	3.10
5 Year Swap	4.10	4.00	3.90	3.70	3.50	3.35	3.20
10 Year Bond	3.80	3.70	3.50	3.30	3.20	3.10	3.00
NZD/USD	0.67	0.68	0.69	0.70	0.71	0.72	0.72
NZD/AUD	0.91	0.91	0.91	0.91	0.91	0.91	0.90
NZD/JPY	86.4	87.0	86.9	87.5	88.0	87.2	87.1
NZD/EUR	0.63	0.63	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.54	0.54	0.54	0.55	0.55	0.54	0.54
TWI	73.2	73.5	73.8	74.0	74.4	74.4	74.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 9 May 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.50%	1.00%
30 Days	1.77%	1.59%	1.44%
60 Days	1.95%	1.78%	1.57%
90 Days	2.12%	1.96%	1.70%
2 Year Swap	3.90%	3.72%	3.62%
5 Year Swap	4.06%	3.83%	3.74%

NZ foreign currency mid-rates as at 9 May 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6413	0.6599	0.6846
NZD/EUR	0.6076	0.6153	0.6273
NZD/GBP	0.5190	0.5192	0.5248
NZD/JPY	83.69	84.58	85.90
NZD/AUD	0.9063	0.9227	0.9190
TWI	71.73	72.99	74.00

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 09					
Chn	Apr trade balance USDbn	47.38	50.65	-	Trade has been a key support through the lockdowns...
	Apr new loans, CNYbn	3130.0	1550.0	-	... but credit momentum is now building...
	Apr M2 money supply %yr	9.7%	9.9%	-	... on support from authorities.
Eur	May Sentix investor confidence	-18	-20	-	Russia-Ukraine severely clouds the outlook.
US	Mar wholesale inventories	2.3%	2.3%	-	Final estimate; restocking at a robust pace.
Tue 10					
NZ	Apr retail card spending	-1.3%	-	3.5%	Hospo spending firming, but high fuel prices still a drag.
Aus	Apr NAB business survey	18	-	-	Reopening momentum, significant price pressures.
	Q1 real retail sales	8.2%	1.0%	1.2%	Nominal sales reported up 2.9%qtr but most of this price-led.
Eur	May ZEW survey of expectations	-43	-	-	Confidence on par with pandemic lows.
US	Apr NFIB small business optimism	93.2	92.9	-	Cost pressures are the key concern of small businesses.
	Fedspeak	-	-	-	Williams, Barkin, Waller, Kashkari and Mester.
Wed 11					
Aus	May WBC-MI Consumer Sentiment	95.8	-	-	Rate hike reaction to dominate.
Chn	Apr PPI %yr	8.3%	7.8%	-	Elevated commodity prices buoying producer inflation...
	Apr CPI %yr	1.5%	1.9%	-	... but limited pass through to consumers.
US	Apr CPI	1.2%	0.2%	0.3%	Energy a negative for April.
	Fedspeak	-	-	-	Bostic.
Thu 12					
NZ	Apr REINZ house sales	-2.9%	-	-	Slowdown in the market to continue...
	Apr REINZ house prices %yr	9.0%	-	-	...in response to higher mortgage rates.
	Apr food price index	0.7%	-	0.8%	Minimum wage rise to boost takeaway food prices.
	Mar net migration	-593	-	-	Borders reopened in March, net flows still low.
	Q2 RBNZ inflation expectations	3.3%	-	-	Set to rise sharply following the strong Q1 inflation result.
Aus	May MI inflation expectations	5.2%	-	-	Elevated and likely to mirror the 5.1%yr lift in Q1 CPI.
	Apr overseas arrivals, prelim. 000's	376.7	-	-	Travel lifted in March but there is still a long way to go.
UK	Q1 GDP	1.3%	1.0%	-	BoE warns Q1 strength to be followed by a sharp slowing.
	Mar trade balance £bn	-9261	-	-	Below average export volumes have widened the deficit.
US	Apr PPI	1.4%	0.5%	-	Supply issues are supporting producer prices.
	Initial jobless claims	200k	-	-	Set to remain at a very low level.
	Fedspeak	-	-	-	Daly.
Fri 13					
NZ	Apr manufacturing PMI	53.8	-	-	Conditions have been firming, but businesses still cautious.
Aus	RBA speak	-	-	-	RBA's Bullock-Panel
Eur	Mar industrial production	0.7%	-0.5%	-	Supply pressures are an ongoing headwind.
US	Apr import price index	2.6%	0.6%	-	Import prices to hold at an elevated level.
	May Uni. of Michigan sentiment	65.2	63.7	-	Inflation and rate concerns are still front of mind.
	Fedspeak	-	-	-	Kashkari and Mester at different events.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.7	4.5	3.5
CPI inflation %yr	1.8	1.8	0.9	3.5	5.6	2.6
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	1.9	-1.8
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	2.6	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	2.2	1.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	3.7	0.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.3	5.5
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.5	4.7
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	3.4	3.3

Forecasts finalised 6 May 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.35	0.75	1.25	1.75	2.00	2.25	2.25	2.25
90 Day BBSW	0.92	0.95	1.45	1.95	2.20	2.45	2.45	2.45
10 Year Bond	3.51	3.30	3.15	2.90	2.65	2.50	2.40	2.30
International								
Fed Funds	0.875	1.375	2.125	2.625	2.625	2.625	2.625	2.625
US 10 Year Bond	3.07	2.90	2.80	2.60	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	0.7125	0.74	0.75	0.76	0.77	0.78	0.79	0.80
USD/JPY	130.43	129	128	126	125	124	122	121
EUR/USD	1.0542	1.07	1.08	1.09	1.11	1.13	1.14	1.15
GBP/USD	1.2373	1.25	1.26	1.27	1.28	1.30	1.32	1.34
USD/CNY	6.6556	6.55	6.45	6.35	6.25	6.20	6.15	6.15
AUD/NZD	1.1072	1.10	1.10	1.10	1.10	1.10	1.10	1.11

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- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
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