WESTPAC WEEKLY ECONOMIC COMMENTARY

OCR now expected to peak at 5%.

25 October 2022

Kōwhai

Westpac Economics Team
economics@westpac.co.nz
westpac.co.nz/economics

The September quarter inflation figures were ugly. In every corner of the economy, prices are charging higher. And even though forecasters were braced for a strong number, the result beat all expectations. Coming on top of signs that domestic demand is holding up in the face of interest rate hikes to date, it looks like the Reserve Bank still has a lot more work to do.

We now expect the Official Cash Rate to reach a peak of 5% for this cycle (previously 4.5%). With the cash rate currently at 3.5%, that implies the RBNZ is still some way from where it needs to be, with no room for delay. Consequently, we now expect a 75 basis point hike to 4.25% at the November *Monetary Policy Statement*, a step up from the 50 basis point increases at recent reviews.

Beyond that, we've pencilled in a 50 basis point rise at the following review in February, and another 25 basis points in April to reach a 5% peak. That last move is not a firm forecast, but a reflection of our view that the risks beyond February are for anything between 0 and 50 points.

To its credit, the Reserve Bank has had the right idea with monetary policy this year: strong action early on can reduce the total amount of tightening that's needed to get on top of inflation. But even after all the RBNZ has done so far – a total of 325 basis points of OCR hikes over the past year – it seems that they're still not ahead of the game in the way they would have hoped at this stage.

Inflation refuses to die, activity holding firm.

Underlying the change in our OCR forecast has been the ongoing strength in inflation, as well as resilience in domestic economic activity. Inflation pressures are not showing signs of easing despite the sharp rise in interest rates over the past year. Those developments mean that the RBNZ still has a lot more to do to slay the inflation dragon.

On the inflation front, the September quarter Consumers Price Index result delivered a large upside surprise. Prices rose by 2.2% over the past three months and are up 7.2% over the past year. While that's a touch lower than the 32-year high of 7.3% that was reached last quarter, prices are continuing to rocket higher. Notably, we're seeing ongoing strength in the domestically oriented non-tradable components of inflation.

September quarter inflation was above our forecast for a 1.8%. The result was also well above the RBNZ's last published forecast of a 1.4% rise.

Moreover, the strength in prices hasn't been limited to a few categories. Inflation pressures are broad based and running red-hot right across the economy. That's been reflected in measures of core inflation, which smooth through quarter-to-quarter volatility and track the underlying trend in prices. Most core inflation measures are now running above 6%. And the RBNZ's own 'Sectoral factor model' of core inflation has lifted to 5.4% – well outside the 1-3% target band for inflation.

Importantly, and in contrast to the modest drop in headline inflation, core inflation has actually pushed higher even as headline inflation has softened. That indicates that underlying inflation pressures in the economy are continuing to boil over, a year after the RBNZ's tightening cycle began.

On top of the ongoing strength in inflation, we're continuing to see resilience in domestic economic activity. That's been seen on several key fronts.

First, the labour market remains white hot. Jobs growth remains strong, and wage rates have been rising rapidly as businesses have struggled to both attract and retain staff. Consistent with that, we've seen ongoing strength in job advertisements and high levels of staff turnover. Those conditions do not point to an economy that is coming off the boil.

Next is the strength of household balance sheets. Mortgage rates have been rising for some time, and increasing numbers of borrowers are now rolling off the very low fixed rates that were on offer through the pandemic. However, the drag from those rate increases has not been as stark as we might have expected. Indeed, we're still seeing large numbers of households running ahead on their mortgage payments. Households' finances have come through the pandemic in good shape, with disposable incomes and savings rates pushing higher in recent years. That's providing them with a buffer from headwinds like higher inflation and interest rates. Consistent with that, nominal household spending levels have remained firm.

Lastly, demand in the economy is getting a sizeable boost from the reopening of the borders and the return of international tourists. While visitor numbers are still running below pre-pandemic levels, they have been climbing rapidly, and they are set to continue rising over the months ahead. That's helping to offset any cooling in domestic demand, and is also adding to the demand for workers in labour-intensive industries like hospitality.

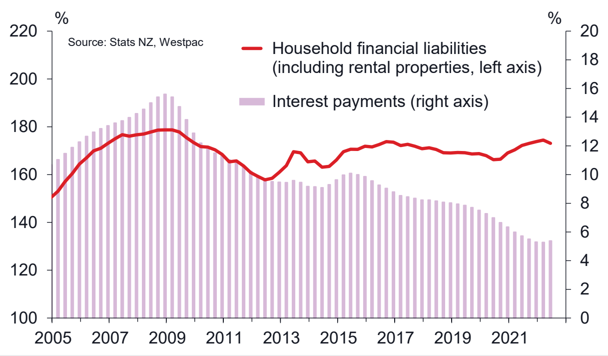
With resilient economic activity, the current strong inflation pressures are likely to be with us for some time yet. We're also likely to see further increases in wage rates, which would reinforce the pressure on domestic prices. Against this backdrop, the RBNZ will need to take the cash rate much further into tight territory than they had previously anticipated. Indeed, the battle against inflation is far from over.

Satish Ranchhod, Senior Economist
+64 9 336 5668
satish.ranchhod@westpac.co.nz

Chart of the week

While mortgage rates have been pushing higher, on average households are still spending a very low share of their income on interest payments. That's due to the very low fixed rate mortgages that were on offer in recent years which are still shielding many households from recent rate increases. However, there are big differences across the economy, with new borrowers and those who have re-fixed their mortgages recently rolling on to much higher borrowing rates.

Household debt (share of disposable income)

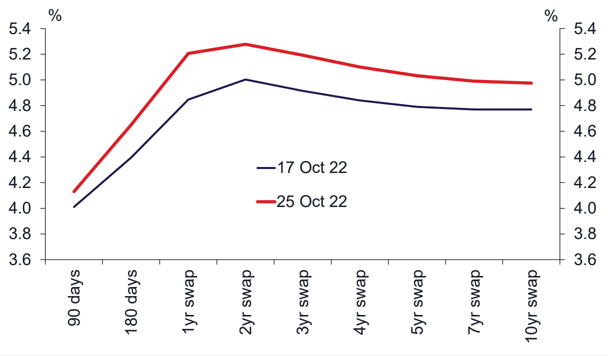


Fixed vs floating for mortgages

We expect the Reserve Bank to lift the Official Cash Rate to 5% and to hold it there for the next couple of years, before reducing it to a more sustainable level in the following years. In contrast, wholesale interest rate markets are priced for a sustained higher level of the OCR for many years to come.

As a result, we believe that there is value in fixing for terms of up to two years. We would regard fixing for terms longer than this as expensive, but this option may suit those who want more certainty in their repayments.

NZ interest rates



The week ahead

NZ Oct ANZBO business confidence

Oct 26, Last: -36.7

Business confidence nudged higher again in September. Nevertheless, New Zealand businesses remain deeply pessimistic about the economic outlook. Businesses have been grappling with shortages of staff, strong cost pressures, and the rise in interest rates. We expect those factors will continue to weigh on confidence in the October survey.

The survey's cost and pricing gauges will again be worth keeping a close eye on. Despite softening in recent months, those measure have remained elevated. We expect that pattern will be repeated in the October survey, consistent with our forecast for only a gradual easing in inflation.

NZ business confidence

NZ Sep monthly employment indicator

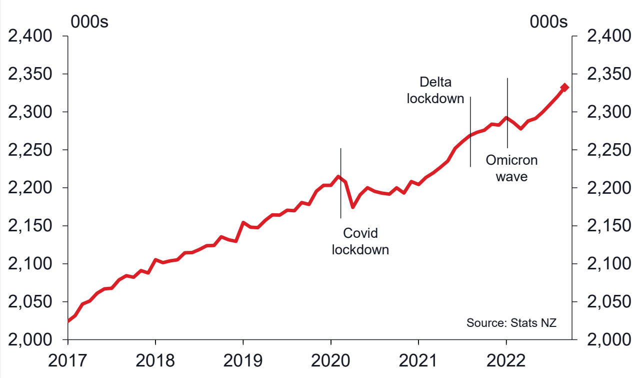
Oct 28, Last: 0.4%, Westpac f/c: 0.5%

Weekly jobs numbers have continued to push higher, indicating that job creation is continuing at pace. That's consistent with other labour market indicators, such as job advertisements, which remain elevated. At the same time, wage rates have been rising rapidly as businesses have struggled to attract and retain staff.

The firmness in the jobs market signals that the economy has not lost much steam despite the rise in interest rates over the past year.

This indicator will be of particular interest to the Reserve Bank, given their heightened concerns about labour market tightness as a source of ongoing inflation.

NZ monthly filled jobs



Aus Federal Budget 2022/23, $bn

Oct 25, Last: –31.9, WBC f/c: –45

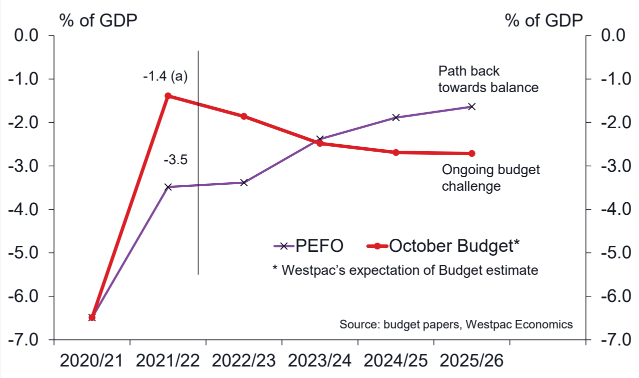
The recently elected government will release another budget update, on Tuesday October 25, refreshing the fiscal projections.

For 2021/22, the budget deficit came in at $31.9n (1.4% of GDP), some $47.9bn below that in the Pre-election Economic and Fiscal Outlook (PEFO). Revenue surprised to the high side by $27.6bn and expenses were $20.3bn lower than forecast (partly due to delays).

For 2022/23, we anticipate that the October Budget will forecast a widening of the deficit to $45bn, 1.9% of GDP impacted by upward pressure on expenses. That would still be $32.9bn below PEFO.

From 2023/24, the budget deficit profile is likely to deteriorate – increasing each year and being above that in PEFO. This reflects the crimping of revenue from the emerging economic slowdown and upward pressure on expenses (from higher inflation, rising interest rates and escalating program cost).

Aus Budget deficit profile



The week ahead

Aus Consumer Price Index %qtr

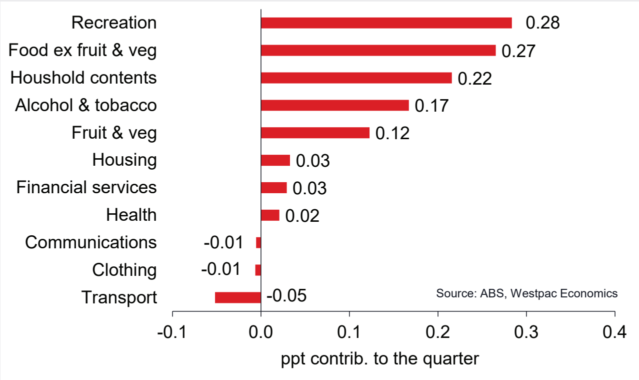
Oct 26, Last: 1.8%, WBC f/c: 1.1%
Mkt f/c: 1.6%, Range: 1.1% to 2.0%r

Westpac is forecasting a 1.1% print, lifting the annual pace 0.4ppt to 6.5%. The reason for the step down from 1.8%qtr print in Q2 are the significant state energy rebates, particularly in WA and Victoria. Due to these rebates, utility cost are forecast to fall 10.5% subtracting 0.48ppt from the September quarter CPI.

Without the rebates our CPI forecast would have been 1.8%qtr.

The Trimmed Mean is forecast to lift 1.5% in September, matching the March and June quarters, taking the annual pace to 5.6%yr from 4.9%yr, well up from the March 2021 low of 1.1%yr. Our forecast peak is 5.8%yr in December 2022.

Aus contributions 2022 Q3 CPI 1.1%qtr forecast



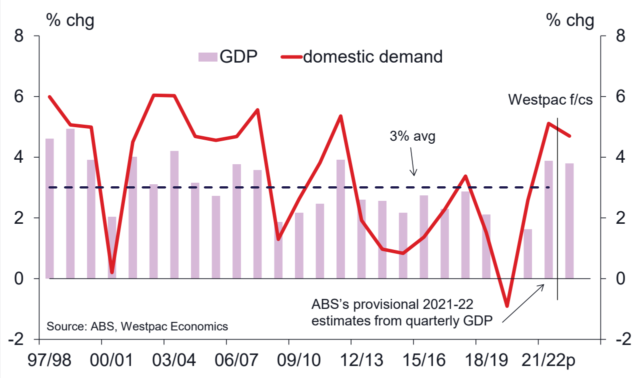
Aus 2021-22 national accounts

Oct 28, Current estimate: 3.9%

The June quarter national accounts showed the economy kicking clear of Covid disruptions, growth lifting to a robust 3.9% pace in annual average terms, up from 1.6% in the year to June 2021 despite a hit from delta disruptions through the second half of last year.

The annual national accounts provide new 'benchmark' estimates of income, expenditure, production and balance sheets with more detail on sectors, industries and aspects such as net additions to the capital stock and productivity growth. This often leads to significant revisions to previously published estimates – revisions that only get incorporated into the quarterly GDP data with the Q3 release in December. These can be most pronounced for areas that rely on annual survey sources where quarterly indicators are unavailable, such as consumer spending on services. Given the 'reopening rebound' dynamics driving growth there is a clear risk that the annual benchmarks lead to significant upward revisions to spending and growth estimates for 2021-22.

Aus annual economic performance

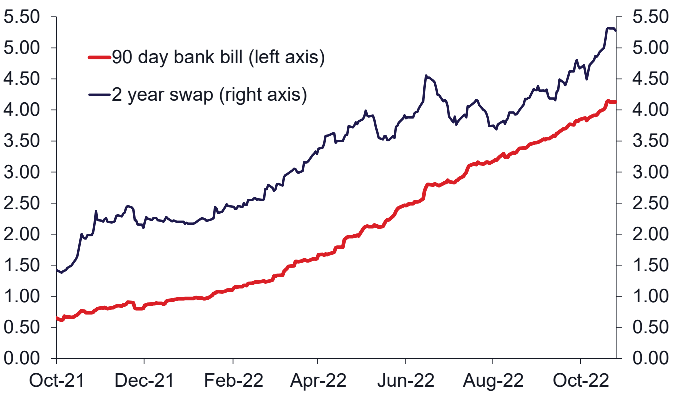


New Zealand forecasts

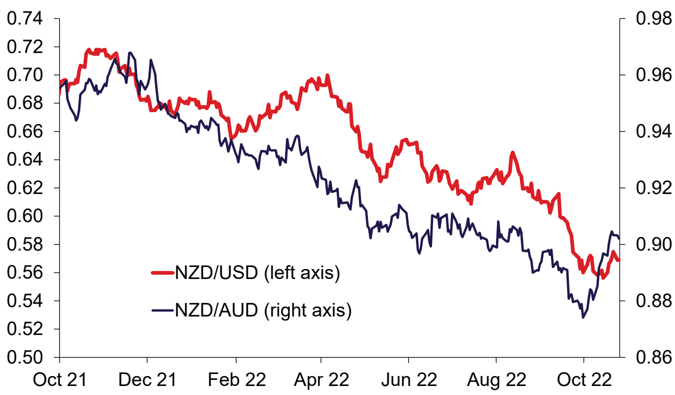
Economic forecasts	Quarterly				Annual			
	2022			2023				
% change	Jun (a)	Sep	Dec	Mar	2020	2021	2022f	2023f
GDP (Production)	1.7	0.4	0.6	0.6	-2.1	5.5	2.2	2.2
Employment	0.0	0.1	0.1	0.1	0.6	3.4	0.2	0.8
Unemployment Rate % s.a.	3.3	3.3	3.4	3.5	4.9	3.2	3.4	3.8
CPI	1.7	2.2	0.5	1.3	1.4	5.9	6.2	4.1
Current Account Balance % of GDP	-7.7	-7.7	-7.1	-6.0	-0.8	-6.0	-7.1	-4.4

Financial forecasts	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Cash	4.25	4.75	5.00	5.00	5.00	5.00	5.00
90 Day bill	4.55	5.00	5.10	5.10	5.10	5.10	4.80
2 Year Swap	5.30	5.20	5.10	4.90	4.70	4.40	4.10
5 Year Swap	5.00	4.90	4.80	4.60	4.40	4.20	4.00
10 Year Bond	4.70	4.60	4.50	4.30	4.10	3.90	3.80
NZD/USD	0.58	0.59	0.60	0.62	0.65	0.66	0.66
NZD/AUD	0.89	0.89	0.90	0.90	0.90	0.90	0.89
NZD/JPY	82.9	83.2	83.4	84.9	87.1	86.5	85.8
NZD/EUR	0.59	0.60	0.59	0.60	0.61	0.60	0.60
NZD/GBP	0.51	0.52	0.53	0.53	0.54	0.54	0.53
TWI	68.3	68.5	68.4	69.1	71.0	70.7	70.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 25 October 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.00%
30 Days	3.63%	3.54%	3.44%
60 Days	3.88%	3.73%	3.63%
90 Days	4.13%	3.91%	3.81%
2 Year Swap	5.28%	4.87%	4.74%
5 Year Swap	5.03%	4.64%	4.56%

NZ foreign currency mid-rates as at 25 October 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.5692	0.5592	0.5706
NZD/EUR	0.5765	0.5755	0.5928
NZD/GBP	0.5048	0.5051	0.5284
NZD/JPY	84.80	81.44	82.33
NZD/AUD	0.9020	0.8916	0.8793
TWI	68.69	67.30	68.28

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
NZ	Labour Day	–	–	–	Markets closed.
Aus	RBA Assist' Governor, Financial Mkts	–	–	–	Kent speaking at Global Markets Conference, Sydney.
Eur	Oct S&P Global manufacturing PMI	48.4	48.0	–	A broad-based weakening in demand across manufacturing...
	Oct S&P Global services PMI	48.8	48.5	–	... and services is beginning to materialise.
UK	Oct S&P Global manufacturing PMI	48.4	–	–	Similar risks are also present in the UK as inflation...
	Oct S&P Global services PMI	50.0	–	–	... continues to restrict spending capacity.
US	Sep Chicago Fed activity index	0.0	–	–	Growth outlook clearly subdued.
	Oct S&P Global manufacturing PMI	52.0	51.0	–	Mfg activity is soft but fragile...
	Oct S&P Global services PMI	49.3	49.4	–	... S&P points to clearer risks for services.
Tue 25					
Aus	2022/23 Federal budget, $bn	-31.9	–	-45	Deficit widens on expenses, but still well below PEFO f/c.
US	Aug FHFA house prices	-0.6%	-0.7%	–	Correction set to deepen...
	Aug S&P/CS home price index	-0.44%	-0.80%	–	... as rate hikes take effect.
	Oct consumer confidence index	108.0	105.5	–	Confidence starting to consolidate; similar to UoM.
	Oct Richmond Fed index	0	-5	–	Regional surveys showing weakness.
Wed 26					
NZ	Oct ANZ business confidence	-36.7	–	–	Activity indicators to remain weak, inflation gauges elevated.
Aus	Q3 CPI	1.8%	1.6%	1.1%	Food, dwellings, electricity and domestic holiday all driving...
	Q3 CPI %yr	6.1%	7.0%	6.5%	... headline inflation higher. There is significant uncertainty...
	Q3 trimmed mean CPI	1.5%	1.5%	1.5%	... regarding the impact of the electricity rebates. We expect...
	Q3 trimmed mean CPI %yr	4.9%	5.5%	5.6%	... they will be significant, holding the increase to just 1.1%.
US	Sep wholesale inventories	1.3%	1.1%	–	Unwarranted inventory accrual a risk given end demand.
	Sep new home sales	28.8%	–15.3%	–	Clearer weakening to crystalise into year-end.
Thu 27					
Aus	Q3 export price index	10.1%	–	-7.0%	Commodity prices down from highs on global growth fears.
	Q3 import price index	4.3%	–	0.8%	Gasoline prices off highs. Non-fuel prices continue to rise.
Chn	Sep industrial profits %yr	–	–	–	Virus risks will loom over profit growth into year-end.
Eur	ECB policy decision	1.25%	2.00%	2.00%	Another 75bp hike needed to quell inflationary pressures.
US	Q3 GDP, annualised	-0.6%	2.3%	2.1%	Domestic demand weak; but inventory and trade big +'ve.
	Initial jobless claims	214k	–	–	Likely to remain at low levels for time being.
	Sep durable goods orders	-0.2%	0.6%	–	Investment spending clearly subdued.
	Oct Kansas City Fed index	1	–	–	Regional surveys showing weakness.
Fri 28					
NZ	Oct ANZ consumer confidence	85.4	–	–	Expected to remain subdued.
	Sep employment indicator	0.4%	–	0.5%	Jobs growth has picked up momentum in recent months.
Aus	Q3 PPI	1.4%	–	–	Will take a close look at construction input costs.
	2021–22 Annual National Accounts	–	–	–	Annual benchmarks can result in material revisions.
Eur	Oct economic confidence	93.7	–	–	The highly uncertain outlook has left...
	Oct consumer confidence	-27.6	–	–	... consumer confidence at historic lows.
UK	Oct Nationwide house prices	0.0%	–	–	Annual growth cooling as rate hikes impact.
US	Q3 employment cost index	1.3%	1.2%	1.2%	Tight labour market supporting robust wage/benefit g'th.
	Sep personal income	0.3%	0.3%	0.2%	Real income will remain under pressure...
	Sep personal spending	0.4%	0.4%	0.3%	... while inflation puts consumption at risk.
	Sep PCE deflator	0.3%	0.3%	0.3%	Strength seen in CPI report...
	Sep core PCE deflator	0.6%	0.5%	0.6%	... also to show in PCE inflation.
	Sep pending home sales	-2.0%	-5.3%	–	Housing market under significant and lasting pressure.
	Oct Uni. of Michigan sentiment	59.8	59.6	–	Final estimate.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.9	4.2	1.9
CPI inflation %yr	1.8	1.8	0.9	3.5	7.5	3.8
Unemployment rate %	5.0	5.2	6.8	4.7	3.1	4.3
Current account % of GDP	-2.1	0.7	2.4	3.2	1.1	-1.0
United States						
Real GDP %yr	2.9	2.3	-3.4	5.7	1.6	0.4
CPI inflation %yr	2.4	1.9	1.2	5.1	7.1	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.7
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	-0.2	-4.5	1.6	1.7	1.7
Euro zone						
Real GDP %yr	1.8	1.6	-6.4	5.3	2.9	0.5
United Kingdom						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.4	-0.5
China						
Real GDP %yr	6.8	6.0	2.2	8.1	3.0	7.0
East Asia ex China						
Real GDP %yr	4.5	3.8	-2.3	4.1	4.5	4.5
World						
Real GDP %yr	3.6	2.9	-3.1	6.1	3.0	3.3

Forecasts finalised 7 October 2022

Interest rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Australia								
Cash	2.60	3.10	3.60	3.60	3.60	3.60	3.35	3.10
90 Day BBSW	3.03	3.80	3.80	3.80	3.80	3.63	3.38	3.13
10 Year Bond	4.14	3.70	3.50	3.40	3.20	3.00	2.80	2.70
International								
Fed Funds	3.125	4.375	4.625	4.625	4.625	4.625	4.375	3.875
US 10 Year Bond	4.22	3.80	3.60	3.50	3.30	3.10	2.90	2.70

Exchange rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
AUD/USD	0.6266	0.65	0.66	0.67	0.69	0.72	0.73	0.74
USD/JPY	150.35	143	141	139	137	134	132	130
EUR/USD	0.9771	0.99	0.99	1.02	1.04	1.07	1.09	1.10
GBP/USD	1.1201	1.14	1.14	1.14	1.17	1.20	1.22	1.24
USD/CNY	7.2469	7.00	6.80	6.60	6.40	6.30	6.20	6.15
AUD/NZD	1.1077	1.12	1.12	1.12	1.11	1.11	1.11	1.12

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

Any questions email:
economics@westpac.co.nz