

WESTPAC WEEKLY ECONOMIC COMMENTARY

No end in sight.

7 March 2022



Kākābeak/ngutukākā

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High inflation is increasingly coming to be seen as a pain point for the New Zealand economy, with little sign of relief in sight. The Russia-Ukraine conflict is only likely to deepen the problem.

Last week we published a note on how the conflict could impact on the New Zealand economy. Obviously we can't foresee all of the moves that will ultimately play out, but in terms of our more identifiable exposures, it looks as though the consequences for New Zealand are mostly inflationary ones.

Our direct trade exposure to the region is low. Last year Russia took about 0.4% of our exports, mainly butter and other dairy products. Fonterra has announced that it will suspend shipments to Russia, but it's likely that this product can be diverted to other markets without significantly affecting prices. New Zealand only imports a very small amount of goods from either Russia or Ukraine.

The conflict is unlikely to weigh on world dairy prices, and if anything could push them higher. That's a notable contrast to the Crimean invasion in 2014, when Russia placed a ban on food imports from countries that had placed sanctions on it. While New Zealand wasn't included in that group, it meant that other major food exporters had to find other markets for their product, pushing down prices. Russia has never removed that import ban, which means that it lacks any additional leverage over food-exporting nations this time.

However, Russia and Ukraine are big producers of wheat, and of some of the raw materials used in making fertiliser. Fears of supply disruptions have sent their prices soaring higher, which will add to the cost of producing food around the world. New Zealand's pasture-based farmers will benefit from this to some degree, but consumers here will still feel the effect of those higher world prices.

Then there's energy. Russia is a major exporter of oil and gas, and again we've seen prices surge in the last week on concerns that supply could be disrupted. New Zealand imports all of the petroleum products that it uses, and the resulting surge in fuel prices will add to the costs faced by consumers and businesses.

Rising prices appear to be having a major impact on sentiment, with both business and consumer confidence surveys falling sharply in February. A net 52% of businesses expect that general economic conditions will deteriorate over the coming year, which is approaching what we saw during the depths of the initial Covid lockdown in 2020.

Cost pressures are a major challenge, with 92% of businesses indicating that they expect their operating costs to rise over the coming months. And while that is being passed into higher

prices for consumers, margins are also being squeezed with an increasing number of businesses expecting that their profitability will fall over the coming year.

We're already forecasting that consumer price inflation will peak at 6.3% in the March quarter. The risks to that forecast are clearly towards a higher peak in the near term, with the possibility that it could remain above the Reserve Bank's 1-3% target range for longer.

This makes the RBNZ's balancing act even trickier. Obviously they can't prevent the sorts of price shocks that are emanating from overseas (and higher fuel prices act as a handbrake on activity over the medium term, as well as boosting inflation in the near term). But the bigger issue for them is the extent to which this feeds into local price-setting behaviour, including wages. With the right conditions – in particular a tight labour market – even a temporary price shock can provide the spark for a sustained series of price rises.

The RBNZ at least has an advantage over many of its overseas peers, having already begun tightening monetary policy last year. Moreover, the prospect of an extended series of OCR hikes has already been baked into market interest rates – indeed, we'd argue that fixed-term mortgage rates are already closer to their peaks than their troughs for this cycle.

This in turn is already having a dampening effect on the housing market. Sale prices fell slightly in December and January, and we're likely to see further softness in the February figures, which we expect to be released on Friday. The housing market, while not a direct target for the RBNZ, is a major channel through which monetary policy acts to restrain demand in the economy.

RBNZ officials noted last week that the significant amount of tightening that's already factored into market interest rates was a key reason why they settled on raising the OCR by 25 rather than 50 basis points at last month's *Monetary Policy Statement*.

However, there is a risk that current interest rate pricing may not have enough of a restraining effect to bring inflation under control. Indeed, it's notable that while the RBNZ is now projecting the OCR to peak at around 3.4%, the market hasn't quite been willing to endorse this profile. If the RBNZ does believe that the OCR will ultimately need to go this high, it may need to be a bit more forceful about conveying its intentions, including the possibility of larger OCR moves.

Michael Gordon, Acting Chief Economist

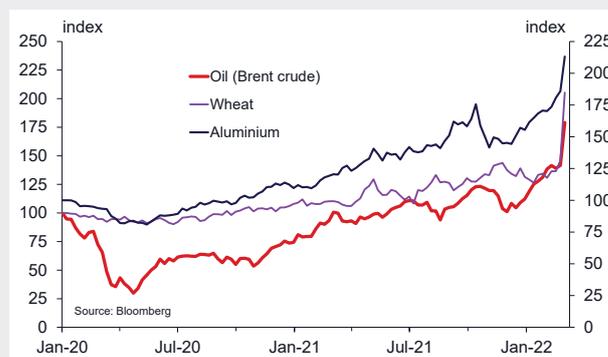
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Chart of the week

Commodity prices were in many cases already on the rise before the Russia-Ukraine conflict, where fears of supply disruptions have seen a surge in prices for oil, wheat and industrial metals. It's not just due to concerns that Russia may withhold supply; the shipping, insurance and finance sectors are increasingly withdrawing from servicing the region.

World commodity prices (indexed, Jan 2020 = 100)

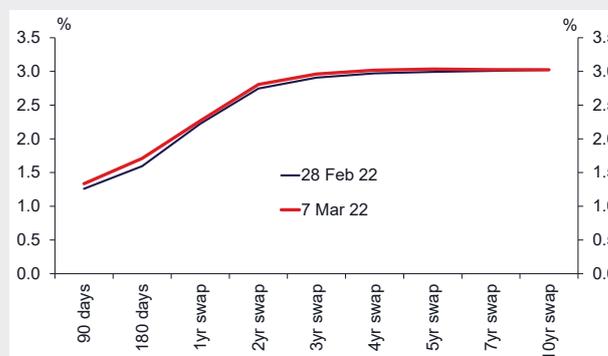


Fixed vs floating for mortgages

Wholesale interest rates are now largely in line with our forecast of a 3% cash rate by mid-2023. That suggests there is no longer an 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 more suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

NZ Q4 Building work put in place

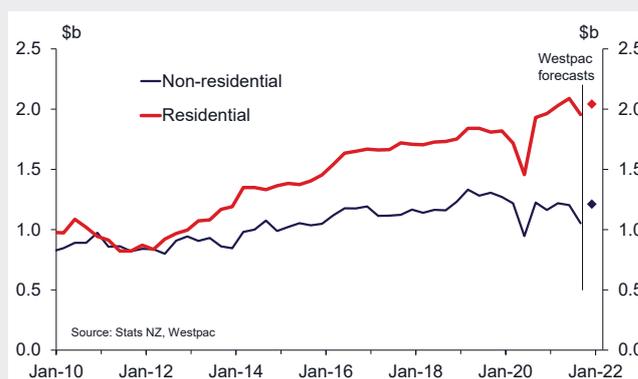
Mar 8, Last: -8.6%, Westpac: +8.0%

Total construction fell by 8.6% in the September quarter in the wake of New Zealand's Delta outbreak. Underlying that drop were declines in both the amount of residential building (-6.4%) and non-residential work (-12.4%).

With an easing in activity restrictions over the December quarter, we're forecasting an 8% bounce. That would reverse nearly all of the earlier softness.

We expect that construction activity will remain strong over the year ahead, with a large pipeline of planned work. However, shortages of materials and labour are acting as a handbrake. That's resulting in widespread delays, with completion times stretching out.

NZ real building work put in place



NZ Feb retail card spending

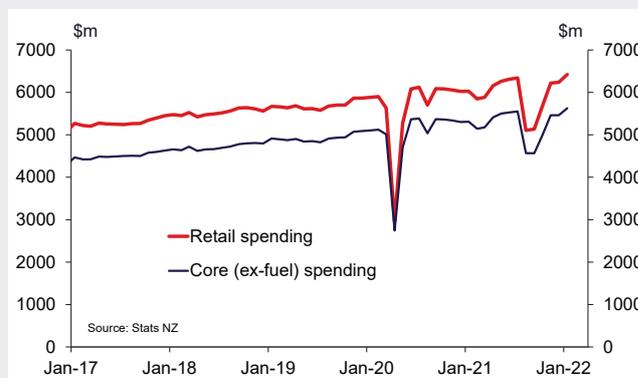
Mar 10, Last: +3.0%, Westpac: -0.4%

January saw a solid 3% rise in retail spending. Much of that rise was due to a recovery in hospitality spending as health restrictions were eased. We also saw ongoing firmness in durables spending.

We're expecting a pullback in spending in February. Omicron cases have surged and spending on hospitality has taken another knock. At the same time prices for necessities like fuel and food are rising at a rapid pace. That's squeezing households' disposable incomes, restraining spending in other areas.

On the firmer side of the ledger, we're continuing to see strong demand for durables as households switch spending away from hospitality activities.

NZ retail card spending



NZ Feb REINZ house sales and prices

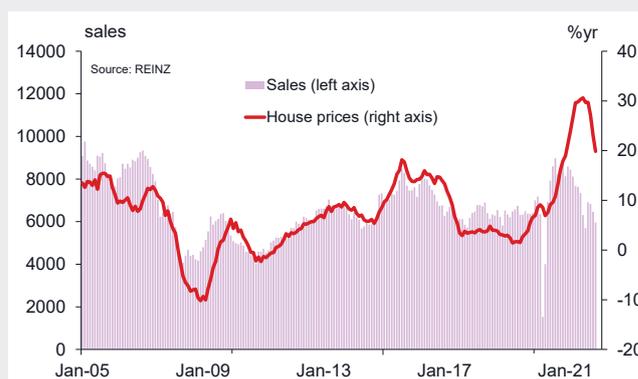
Mar 11 (TBC), Sales last: -7.7%, Prices last: +19.9%yr

The housing market is now clearly cooling. Sales have fallen below pre-pandemic levels, the number of unsold homes continues to rise, and sale prices fell slightly in December and January.

Our view is that higher mortgage rates have been the main driver of this slowdown, and as such, it is likely to persist for some time. In our latest forecasts we expect house prices to drop by almost 10% over the next couple of years. This would still only take prices back to where they were in early 2021.

A tightening of loan-to-value limits, and more prescriptive responsible lending rules, have also been weighing on the housing market. However, we think these will be less restrictive over time than they have been in the last couple of months, while the changes were still being bedded in.

REINZ house prices and sales



The week ahead

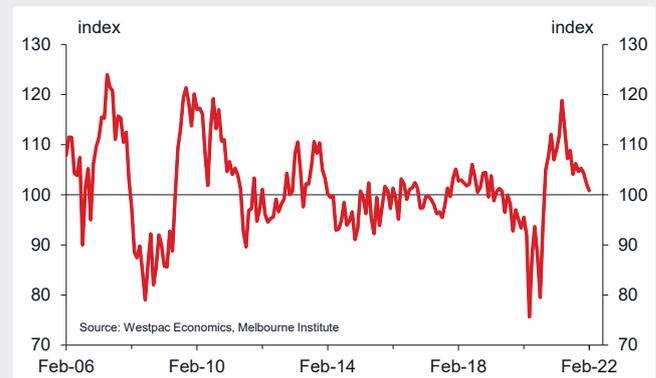
Aus Mar Westpac-MI Consumer Sentiment

Mar 9, Last: 100.8

Consumer Sentiment fell 1.3% in Feb, concerns about rising living costs and a potential interest rate tightening cycle more than offsetting a clear easing in the omicron outbreak locally. While optimism has faded since late last year, sentiment in Feb was neutral rather than outright pessimistic.

Sentiment is likely to be buffeted by several factors in March including Russia's invasion of Ukraine and severe flooding across much of Australia's eastern seaboard. Russia's move and the heavy sanctions imposed in response have roiled financial markets with a further sharp lift in oil prices. While there have been some positive developments locally – around COVID, the economy's post-delta rebound and the RBA's intention to be patient on interest rate – these are likely to take a back seat to the geopolitical situation in March.

Aus Consumer Sentiment Index

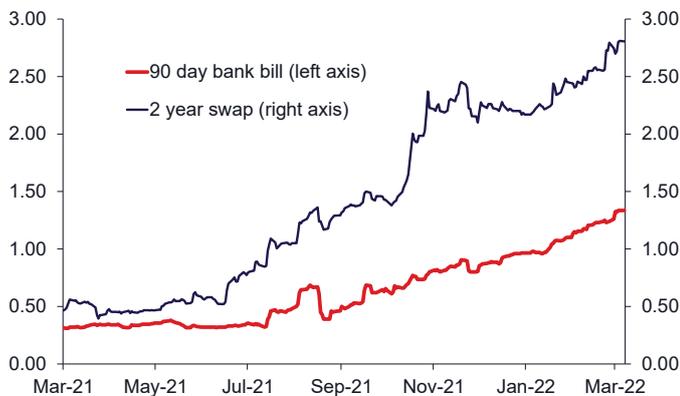


New Zealand forecasts

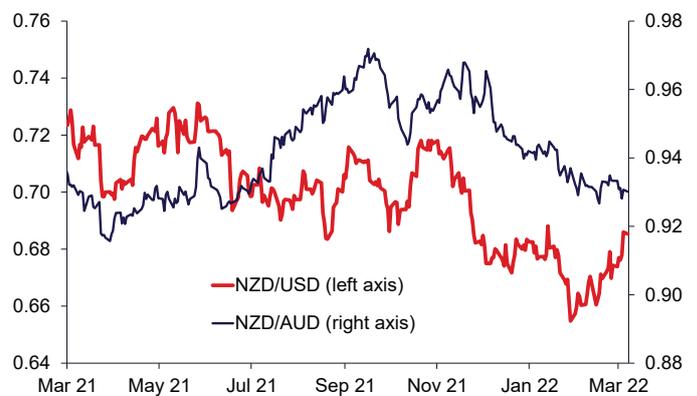
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Sep (a)	Dec	Mar	Jun	2020	2021f	2022f	2023f
GDP (Production)	-3.7	0.5	0.9	2.6	-1.9	4.9	3.0	4.7
Employment	1.9	0.1	0.5	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.3	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	2.2	1.4	1.2	1.0	1.4	5.9	3.5	2.8
Current Account Balance % of GDP	-4.5	-5.5	-5.8	-6.6	-0.8	-5.5	-6.8	-6.3

Financial forecasts	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	1.50	2.00	2.25	2.50	2.75	3.00	3.00
90 Day bill	1.90	2.20	2.45	2.70	2.95	3.10	3.10
2 Year Swap	2.75	2.90	2.95	3.00	3.00	2.95	2.90
5 Year Swap	2.95	3.05	3.10	3.15	3.15	3.15	3.10
10 Year Bond	2.85	2.90	3.00	3.00	3.00	3.00	2.95
NZD/USD	0.65	0.66	0.68	0.69	0.70	0.71	0.71
NZD/AUD	0.93	0.93	0.93	0.92	0.92	0.92	0.91
NZD/JPY	75.4	77.2	79.3	81.4	82.6	83.9	84.5
NZD/EUR	0.60	0.61	0.62	0.62	0.63	0.62	0.62
NZD/GBP	0.47	0.48	0.49	0.50	0.51	0.52	0.53
TWI	70.1	70.7	71.9	72.5	73.1	73.4	73.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 7 March 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.00%	0.75%	0.75%
30 Days	1.05%	1.06%	0.94%
60 Days	1.20%	1.16%	1.05%
90 Days	1.34%	1.24%	1.16%
2 Year Swap	2.81%	2.55%	2.44%
5 Year Swap	3.03%	2.88%	2.75%

NZ foreign currency mid-rates as at 7 March 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6853	0.6722	0.6606
NZD/EUR	0.6279	0.5919	0.5784
NZD/GBP	0.5179	0.4932	0.4895
NZD/JPY	78.66	77.21	75.98
NZD/AUD	0.9301	0.9329	0.9318
TWI	73.49	71.90	71.01

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 07					
Aus	Feb ANZ job ads	-0.3%	-	-	Job ads up strongly, further evidence of a tight labour market.
Chn	Feb foreign reserves \$bn	3221.63	3220.00	-	Little need for authorities to be active in market in 2022.
Eur	Mar Sentix investor confidence	16.6	10.0	-	Geopolitical tensions are a risk; economy otherwise healthy.
Tue 08					
NZ	Q4 building work	-8.6%	10%	8.0%	Recovery following Q3's lockdown.
Aus	Feb NAB business survey	3	-	-	Conditions/confidence, likely rebound from omicron disruption.
Eur	Q4 GDP	0.3%	0.3%	-	Third estimate to confirm component detail from second.
US	Jan consumer credit	18.898	24.000	-	Robust demand for credit as pandemic savings worked down.
	Feb NFIB small business optimism	97.1	97.4	-	Omicron has temporarily dampened confidence.
	Jan trade balance US\$bn	-80.7	-87.2	-	Deficit to remain wide on demand and inventory rebuild.
	Jan wholesale inventories	0.8%	0.8%	-	Final estimate; supply issues are being worked through.
Wed 09					
Aus	Mar WBC-MI Consumer Sentiment	100.8	-	-	-4.3% vs Nov, omicron, inflation, rates. Now, floods & Ukraine.
	RBA Governor Lowe	-	-	-	Speech to AFR Business Summit, Sydney.
	RBA Deputy Governor, Debelle	-	-	-	Panel, Digital Economy conference, Sydney.
Chn	Feb PPI %/yr	9.1%	8.6%	-	Persistent upstream price pressures...
	Feb CPI %/yr	0.9%	0.8%	-	... have not passed through to consumer inflation.
	Feb new loans, CNYbn	3980.0	1400.0	-	Authorities are committed to ensuring credit...
	Feb M2 money supply %/yr	9.8%	9.5%	-	... and liquidity remain ample as demand builds in 2022.
US	Jan JOLTS job openings	10925k	10968k	-	Continues to point to extraordinary demand for workers.
Thu 10					
NZ	Feb card spending	3.0%	-	-0.4%	Softness in hospitality dampening overall spending.
Aus	Mar MI inflation expectations	4.6%	-	-	Elevated, mirroring lift in official estimates of CPI.
Eur	ECB policy decision	0.0%	0.0%	-	Focus on updated forecasts and views on risks.
US	Feb CPI	0.6%	0.8%	-	Price pressures to hold annual inflation at 40-year highs.
	Initial jobless claims	232k	-	-	To remain at a very low level.
Fri 11					
NZ	Feb REINZ house sales	-7.7%	-	-	Higher mortgage rates and tighter lending regulation...
	Feb REINZ house prices %/yr	19.9%	-	-	... have seen sales and prices fall in recent months.
	Feb manufacturing PMI	52.1	-	-	Business conditions have softened as Omicron has spread.
	Feb food price index	2.7%	-	0.6%	Prices for groceries continuing to firm.
Aus	RBA Governor Lowe	-	-	-	Panel, Banking conference, Sydney.
UK	Jan trade balance £bn	-2337	-	-	COVID-19 and Brexit continue to create trade instability.
US	Mar Uni. of Michigan sentiment	62.8	62.8	-	Inflation/rate concerns have hit confidence hard.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.4	4.4	4.0
CPI inflation %yr	1.8	1.8	0.9	3.5	3.3	3.5
Unemployment rate %	5.0	5.2	6.8	4.7	3.8	3.9
Current account % of GDP	-2.1	0.7	2.6	3.7	1.3	-3.1
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	3.4	2.5
CPI inflation %yr	2.4	1.9	1.2	5.1	5.2	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.9	3.6
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	4.1	2.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.0	4.5	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	3.9	4.7	4.7
World						
Real GDP %yr	3.6	2.8	-3.3	5.4	4.4	3.6

Forecasts finalised 4 February 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.10	0.10	0.25	0.50	0.75	1.00	1.25	1.50
90 Day BBSW	0.08	0.10	0.35	0.60	0.95	1.20	1.45	1.70
10 Year Bond	2.23	2.40	2.40	2.50	2.50	2.40	2.30	2.20
International								
Fed Funds	0.125	0.875	1.125	1.375	1.625	1.875	1.875	1.875
US 10 Year Bond	2.02	2.30	2.40	2.50	2.50	2.40	2.30	2.20

Exchange rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7308	0.70	0.71	0.73	0.75	0.76	0.77	0.78
USD/JPY	115.33	117	117	118	118	119	119	119
EUR/USD	1.1018	1.11	1.12	1.13	1.14	1.15	1.15	1.16
GBP/USD	1.3327	1.37	1.38	1.38	1.38	1.37	1.37	1.36
USD/CNY	6.3203	6.30	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0783	1.08	1.08	1.08	1.09	1.09	1.09	1.10

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