WESTPAC ECONOMIC BULLETIN

Households' finances and rising interest rates.

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From 'squeeze' to 'crush'.

- Households' finances are being squeezed. High levels of inflation are eroding our spending power. Borrowing costs are pushing higher. And many families have seen the value of their assets tumbling over the past year.
- The pressure on household finances is set to become much more intense over the year ahead with many borrowers due to roll off earlier low fixed mortgage rates. The resulting large increase in fortnightly interest payments will take a large bite out of many households' disposable incomes.
- As interest rate increases ripple through the economy, house prices will continue to fall and domestic spending is set to decline. That will underpin a broader slowdown in economic growth, with unemployment set to trend higher over the coming years.
- The impact of those tougher financial conditions will be felt across the economy. However, there will be some big differences across household groups. Notably, those who purchased their first home in the past couple of years could see their finances being squeezed especially hard.

Households' finances are being squeezed. And for many of us, those financial pressures are going to become much more intense over the year ahead.

The pressure on household finances is coming on several fronts. First is the sharp rise in consumer prices that has been eating away at households' spending power. The past year has seen particularly large increases in housing costs (up 9%) and petrol prices (up 19%), while food price inflation hit a 14 year high of 11% in November. Those price increases are being felt by every family across the country. They've been particularly tough on those families on lower incomes, who tend to spend a larger share of their earnings on necessities.

We're forecasting further large increases in consumer prices over the year ahead. In fact, we don't expect inflation to be back inside the RBNZ's 1% to 3% target band until mid-2024.

Adding to the pressure on households' finances have been large increases in borrowing costs. The Reserve Bank has been hiking the Official Cash Rate at a rapid pace, with the cash rate rising by a total of 400 basis points since October last year. That includes a jumbo sized 75 basis point increase at the November policy meeting – the largest single increase on record.

The RBNZ has signalled that further large increases in borrowing costs are on the cards in the coming months. We're forecasting that the RBNZ will deliver another 75 basis point hike in February, and expect that will be followed by a 50 basis point rise in April. Those increases would take the cash rate to 5.50%, its highest level since 2008.

The good, the bad and the ugly of household finances.

The good

- Employment up 5% on pre-pandemic levels.
- Unemployment 3.3%.
- Average hourly earnings up 7.4% in the 12 months to September.

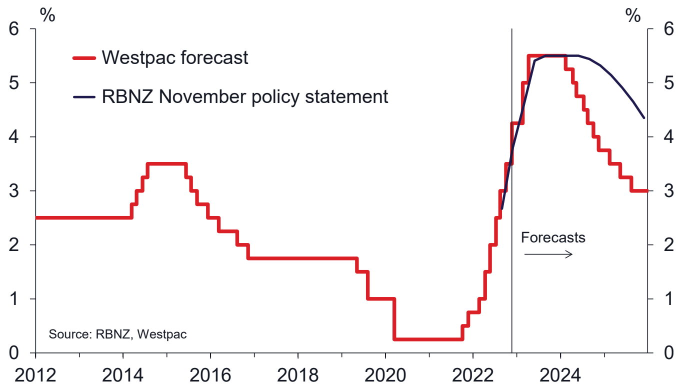
The bad

- Overall consumer prices up 7.2% in the year to September including:
  - 9% increase in housing costs
  - 19% increase in petrol prices
- Food prices up 10% in the year to October.

The ugly

- Two-year fixed mortgage rate up more than 3.5 percentage points since May 2020.
- Nationwide house prices down an average of 12% since their peak in 2020.
  - Auckland prices down 17%
  - Wellington prices down 20%
  - Canterbury prices down 6%
  - Other parts of the country down 7%

Official Cash Rate



The dampening impact of interest rate hikes is already being felt in the housing market. Since the RBNZ's tightening cycle began in 2021, median house prices have fallen by an average of $112,000 across the country, a drop of 12%. We've also seen house sales dropping to their lowest level in more than a decade (barring the lockdown period in 2020). The weakening in the housing market has been widespread and has been especially stark in larger centres. Notably, prices in Auckland have fallen around $230,000 from their peak, while prices in Wellington are down $201,000.

With interest rates continuing to push higher, we're forecasting that nationwide house prices will fall by a further 10% over 2023 and 2024 combined. Coming on the back of the falls we've already seen, that will leave prices down 21% from their peak in 2021.

New Zealanders hold a large amount of their wealth in owner occupied or investor housing. Consequently, the fall in prices now in train represents a sizeable knock to many households' net worth. Combined with the related impact on confidence, this will be a large drag on spending appetites. The downturn in the housing market will also add to the increasing headwinds in our residential construction sector.

House prices by region

Region	Peak	Nov-22	Change since peak	% change since peak
Northland	$822,000	$730,000	-$92,000	-11%
Auckland	$1,265,000	$1,035,000	-$230,000	-18%
Waikato	$846,000	$766,000	-$80,000	-9%
Bay of Plenty	$929,000	$848,000	-$81,000	-9%
Gisborne	$697,000	$641,000	-$56,000	-8%
Hawkes Bay	$806,000	$666,000	-$140,000	-17%
Manawatu-Whanganui	$643,000	$563,000	-$80,000	-13%
Taranaki	$647,000	$602,000	-$45,000	-7%
Wellington	$985,000	$784,000	-$201,000	-20%
Nelson	$835,000	$699,000	-$136,000	-16%
West Coast	$372,000	$409,000	$37,000	10%
Canterbury	$697,000	$651,000	-$46,000	-7%
Otago	$783,000	$665,000	-$118,000	-15%
Southland	$478,000	$460,000	-$18,000	-4%
New Zealand	**$901,000**	**$789,000**	**-$112,000**	**-12%**

Source: REINZ median house prices, seasonally adjusted by Westpac.

Why hasn't spending slowed (yet)?

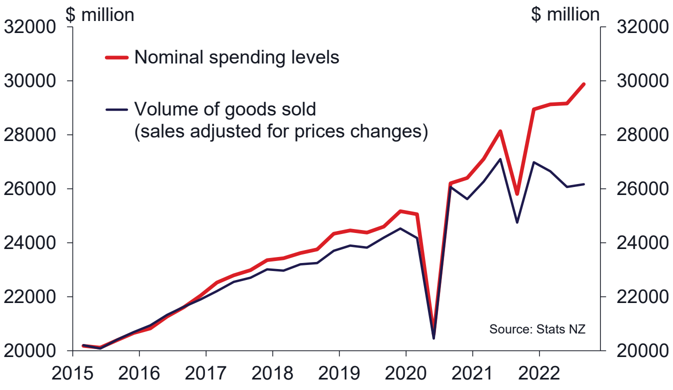
Despite those mounting headwinds, households have not been reining in their spending. In fact, spending levels have continued to charge higher since the start of the RBNZ's tightening cycle, rising by 2.5% in the September quarter alone.

Much of the rise in spending that we've seen over the past year has been due to price increases. In fact, the actual amount of goods we're purchasing has remained fairly steady since early 2021 (in other words, while households are splashing out more cash, we're actually getting a lot less bang for our buck). But even in the face of those large price rises, we're still seeing resilience in spending appetites. Notably, discretionary spending – which is more likely to be affected by changes in prices and households' finances – has continued to climb.

Helping to support spending appetites in the face of the above headwinds has been the red-hot labour market. With elevated levels of economic activity and strong demand for staff, unemployment has fallen to just 3.3%. At the same time, average hourly earnings have risen by 7.4% over the past year as businesses have struggled to attract and retain workers in the midst of a hot domestic economy.

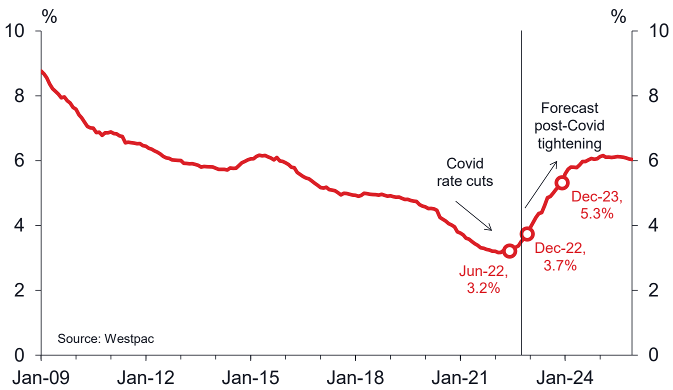
Saving levels also rose sharply through the pandemic. That's provided many households with a buffer from some of the other headwinds that they are now facing.

Retail spending (seasonally adjusted)



Most importantly, many households have been shielded from the large increases in borrowing costs over the past year. Around 90% of New Zealand mortgages are on fixed rates, and many borrowers are still on the very low rates that were on offer in the early stages of the pandemic. In fact, accounting for the extent of mortgage rate fixing over the past few years, the 'effective' average mortgage rate that New Zealand borrowers are actually paying is still only around 3.7% – well below the current interest rates that are on offer. As a result, the share of household incomes being spent on debt servicing is sitting close to multi-decade lows.

Effective mortgage rate*



* The 'Effective mortgage rate' is an estimate of the average interest rate borrowers are actually paying. It accounts for the fact that the vast majority of borrowers fix their mortgages, rather than paying the interest rates that are currently on offer.

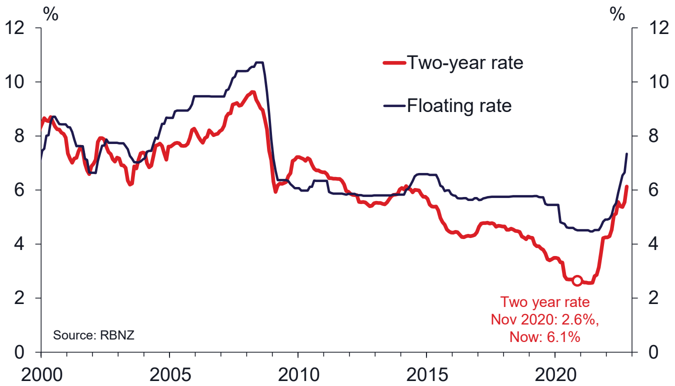
Financial pressure will be a lot tougher in 2023.

Conditions for borrowers are set to become a lot tougher over the coming year. Close to half of all fixed-term mortgages will come up for repricing over the next 12 months. In many cases, those borrowers will face refixing at substantially higher interest rates. For example, borrowers who fixed for two years in 2020 may have secured a rate in the 2.5% to 3% range. Those same borrowers are now looking at a two-year rate that's more than 3 percentage points above what it was back then.

As shown in the table on the next page, the resulting increase in debt servicing costs will take a large bite out of many households' disposable incomes. For instance, suppose you purchased an average-priced house in 2020 and took out an 80% mortgage fixed for two years. Compared to what you were paying in 2020, your minimum fortnightly payments in most parts of the country are set to rise by around $470 per fortnight when you go to re-fix your mortgage today. If you live in Auckland, that increase in debt servicing costs will be around $800 per fortnight. On average, the borrowers in this example would need to spend around 12% more of their disposable income to meet the minimum repayments on their mortgage.

Notably, for many borrowers, that increase in mortgage payments will more than offset the strong growth in incomes that we've seen over the past two years.

Mortgage rates



As interest rate increases ripple through the economy, domestic demand will fall sharply.

The combined impact of higher interest rates, large increases in living costs and a weaker housing market signals a significant drag on household spending over the coming year. We are also likely to see a fall in economic confidence, with many households winding back their spending out of an abundance of caution.

Putting that altogether, we're forecasting outright falls in per-capita spending over 2023, with total spending expected to fall by around 1% compared to 2022. As a comparison, household spending rose by an average of 4% per annum in the years leading up to the pandemic.

Household spending accounts for around 60% of total economic activity, and the expected fall in demand will drive a broader downturn in economic conditions. And as activity weakens, we're likely to see unemployment trending higher, rising from 3.3% currently up to 4.8% over the next few years. For the affected households, that will further compound the pressure on their finances.

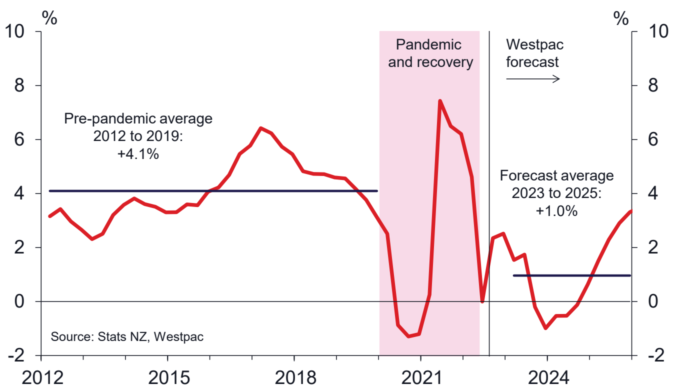
Mortgage repayments

Region	House prices		Fortnightly mortgage payments (30 year term)		
	Median house prices Nov 2020	80% Mortgage	2 year fixed rate Nov 2020 2.6%	2 year fixed rate Nov 2022 6.3%	Change
Northland	$589,000	$471,200	$873	$1,337	$464
Auckland	$1,030,000	$824,000	$1,526	$2,337	$811
Waikato	$670,000	$536,000	$993	$1,520	$527
Bay of Plenty	$750,000	$600,000	$1,112	$1,702	$590
Gisborne	$530,000	$424,000	$786	$1,203	$417
Hawkes Bay	$660,000	$528,000	$978	$1,498	$520
Manawatu-Whanganui	$505,000	$404,000	$749	$1,146	$397
Taranaki	$496,000	$396,800	$735	$1,126	$391
Wellington	$790,000	$632,000	$1,171	$1,793	$622
Nelson	$670,000	$536,000	$993	$1,520	$527
West Coast	$245,000	$196,000	$363	$556	$193
Canterbury	$525,000	$420,000	$778	$1,192	$414
Otago	$620,000	$496,000	$919	$1,407	$488
Southland	$397,000	$317,600	$589	$901	$312
New Zealand	**$747,000**	**$597,600**	**$1,107**	**$1,695**	**$588**
NZ excl. Auckland	$594,000	$475,200	$880	$1,348	$468

	2020	2022	Change
Median fortnightly household income	$3,932	$4,254	$270
% of income spent on debt servicing	28%	40%	12%

Notes and sources: We looked at the mortgage payments for a home purchased in November 2020 based on the REINZ's median house prices data for each region. We assumed a borrower takes out an 80% mortgage for a term of 30 years. The mortgage rates used were based on interest rates data from the RBNZ. For simplicity, we've assumed that the amount of borrowing is the same in 2020 and 2022. Median income data are Westpac estimates based on data from Stats NZ.

Household spending growth (annual average)



Same, same… but different.

While the tightening in financial conditions will be felt across the economy, the impacts will be very different across households.

For those households who took out a mortgage several years ago, the fall in interest rates in recent years has been a sizeable financial windfall. It's allowed them to increase their savings while also spending more. For example, last year the NZ Bankers' Association reported that almost half of borrowers were ahead of their scheduled loan repayments. That increase in savings is now providing a buffer from the other factors that are squeezing their purchasing power. In addition, while these borrowers are looking at potentially large increases in their interest payments, that is a rise from historically low levels – interest rates are 'only' going back to the sort of levels these borrowers faced during the past decade.

In contrast, for those households who first took out their mortgage over the past one to two years, the interest rate increases now in train signal a much larger squeeze on their finances. In addition, these borrowers will not have had the same chance to rebuild their savings since purchasing a home. Consequently, the rise in borrowing costs is likely to impose a much larger drag on their spending. Compounding the financial pressure on these households, many of them will have seen the value of their homes falling since taking out a loan.

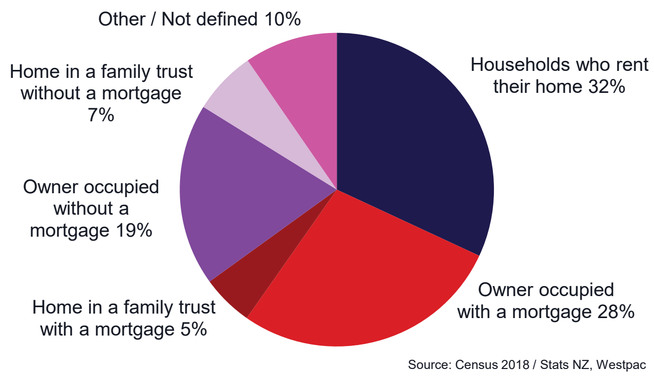
Only around one-third of homes have mortgages. However, other households are also likely to be affected by the tightening in financial conditions already in train.

– For those who own their home outright or have a mortgage-free investment property, the falls in house prices that we're seeing as interest rates push higher signals a sizeable fall in the value of their assets. That's likely to have a dampening impact on their confidence and spending.

– Those households who rent are not directly exposed to either the rise in interest rates or the fall in house prices. However, they could still be affected if higher financing costs pass through to housing rents (which have already risen 4.6% over the past year). Tighter financing conditions could also make it tougher for these households to purchase a home.

- Furthermore, all households are being affected by the recent rapid increases in living costs. In addition, the weakening in the labour market could have wide reaching implications for jobs and earnings growth for many households across all parts of the economy.

Household groups with and without mortgages



Note: Figures do not add to 100% due to rounding.

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