Economic Note

Household Living Cost Outlook

23 March 2022

Under Siege

- Cost increases are escalating and becoming increasingly widespread
- Our estimates suggest higher consumer prices and rising interest rates will add an average of $150 per week of costs to household budgets over 2022. Some households will be paying a lot more
- Weakening household balances sheets and higher living costs look set to exert downward pressure on household spending over 2022, likely tempering the extent of OCR hikes needed

Summary

The household sector has done much of the heavy lifting post-COVID. Respectable income growth, the substitution to spending domestically, low interest rates, government support and sizeable gains in asset values have played a role.

The tables look to be turning in 2022, with some of these tailwinds receding and new headwinds appearing. The rising cost of living – soaring consumer prices and rising borrowing costs – is getting a lot more focus.

Our work suggests higher consumer prices and debt servicing costs could raise household weekly outgoings by an average of around $150 per week over 2022. Impacts will be highly uneven and, with borrowing costs set to move higher still, increases could be much more than this for more heavily-indebted households. With income growth unlikely to keep pace, many households face difficult choices in the year ahead. Consumer spending is unlikely to be as robust or as resilient as it was in 2021. Discretionary spending could be significantly cut back with more economising on essential spending. This may temper the extent of RBNZ hikes required and we expect an OCR endpoint of 2.75% this cycle. The outlook is still inherently uncertain, and a lot can happen over 2022.

Recap

The resilient household sector has helped keep the NZ economy afloat since COVID-19 first hit our shores more than two years ago. Household spending has outpaced broader economic activity. Its buoyancy reflects a combination of income, balance sheet and cashflow-type tailwinds. **Things are looking different now.** The housing market outlook has gone from boiling over to simmering and is now cooling. We expect further house price falls over 2022. Consumer sentiment is hovering around post GFC lows according to the Westpac survey and record lows according to the ANZ survey. Consumers look to have lost much of their mojo and are not looking as bulletproof as they did last year.

Climbing inflation looks to have played a role. Consumer prices have rocketed, with the sources of price rises become increasingly broad-based. After ending 2021 at more than 30-year highs (5.9% yoy) we expect annual consumer price inflation to remain elevated over 2022, coming in just under 6% per annum. Broader living costs for households have also risen, with a less stratospheric 5.2% annual rate over 2021, though with household interest payments advancing at a close to 8% annual rate after troughing at the end of 2020. Viewing the increases (see chart) suggests that the lifts post COVID-19 have been more pronounced for the essentials – food, fuel and shelter – than the nice-to-haves. Further volatility lies ahead, but we expect consumer prices to continue to ratchet higher, with debt-servicing costs sharply increasing. Both will place household budgets under pressure.

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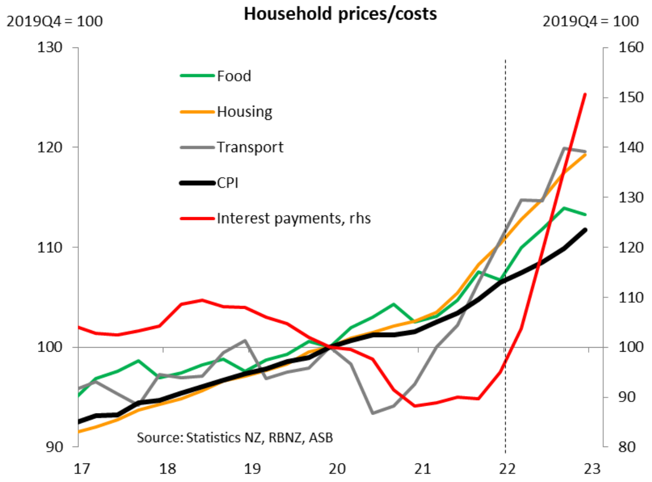
Consumer prices and household borrowing costs are rising

Drivers behind price and cost increases are many, leading to widespread increases across household budgets:



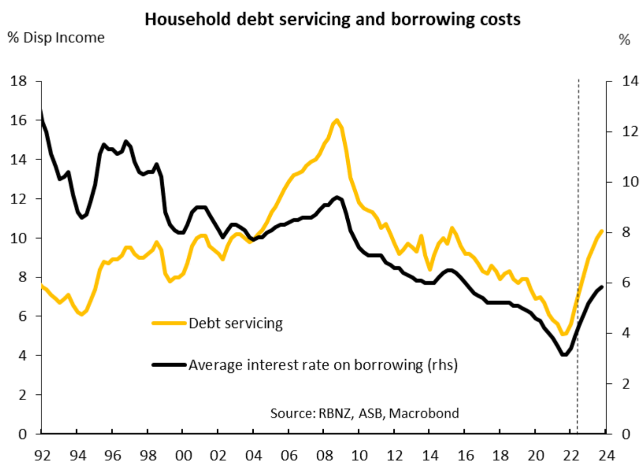
Food prices. Higher global food commodity prices and higher input costs (labour, fertiliser) are expected to push food prices higher still. Rising food prices have also been increasingly broad based. We expect food prices to rise 6-7% over 2022.

Transport costs. Global oil prices have been volatile given the Ukraine conflict but are likely to end this year higher than when they started. Cuts to fuel excise, road user charges and public transport fares will provide a temporary respite. Transport costs as a whole are expected to increase roughly 8% over 2022.

Housing costs. Costs of building a new home have rocketed with higher costs and shortages of labour and materials. There are hefty increases for dwelling maintenance services. Local authority rates look set to rise steeply for a 2nd successive year. What's more, annual dwelling rental inflation looks to be accelerating as landlords recoup rising costs. An 8% annual increase in housing costs looms.

Other consumer prices. We are seeing a broadening in consumer price lifts throughout the economy. Supply chain frictions look set to remain troublesome with the Ukraine conflict the latest disruptor.

Borrowing costs are also ratcheting up and are expected to move sharply higher over the course of 2022. The household sector is a net debtor on average, with RBNZ figures showing total household debt exceeds household deposits by around \$130bn (around \$70,000 per household). Mortgage debt currently averages about \$170,000 per private dwelling, with debt holdings highly uneven.[1] Some households with high interest-bearing deposits and little debt will actually experience a positive impact on after-tax cashflows from higher interest rates. This group, however, is largely in the minority.



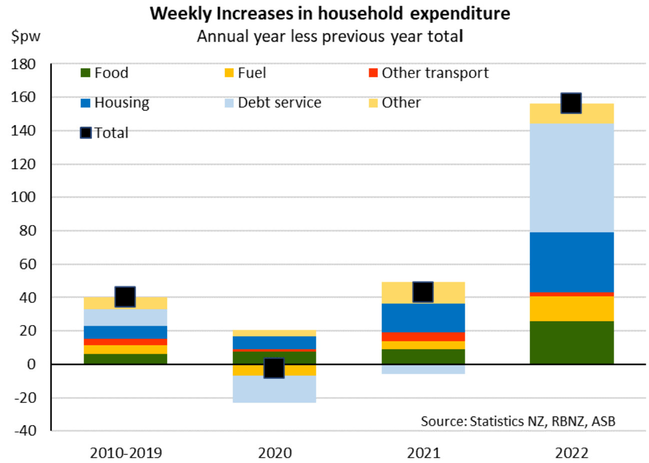
RBNZ figures suggest that the average mortgage interest rate charged on the total stock of mortgage debt troughed at around 2.83% in September 2021. Average borrowing costs are now on the way up, with carded mortgage interest rates rising and approximately 60% of current fixed-rate loans due to be reset over 2022, often at much higher rates. Our latest mortgage interest rate forecasts flag further increases ahead. All up, the average mortgage interest rate facing borrowers will likely increase by roughly 150bps over 2022, ending the year at just over 4½%. That would push household debt servicing back towards historical averages from a record low share of household income.

[1] Statistics NZ figures suggest around two-thirds of the close to 2 million privately-owned dwellings are owner-occupied, with about half of those have an outstanding mortgage. According to Statistics NZ figures, the top 40% of households by income hold about 70% of total household debt (45% of the top income quintile) as opposed to less than 15% of debt by the lowest 20% income earning households. Latest RBNZ figures place the value of outstanding mortgages secured over owner occupier dwellings at a shade under \$240bn, which equates to an average loan of \$370,000 per dwelling.

What is the impact on household budgets?

To estimate the cashflow impact we use **the NZ household economic survey, which records what households typically spend each week.**

The latest survey was taken in the March 2019 year, but we have updated the figures to reflect more recent spending patterns using a combination of consumer spending and consumer price data. Household spending patterns have clearly been impacted by COVID-19. For example, retail sales and traffic mobility data indicate lower household fuel usage. Household debt has rocketed since early 2019, tempering the benefit provided to debt-servicing costs (including principal repayments) provided by lower borrowing costs.

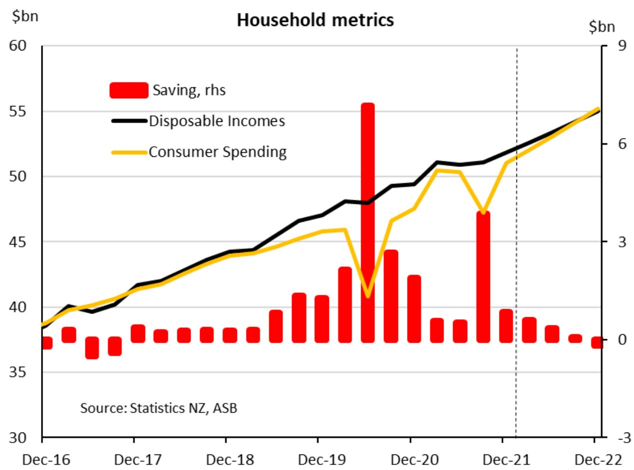


Going forward we are assuming households will try to maintain their current spending habits over the remainder of the year. In aggregate, households built up a larger saving buffer in the 2020 and 2021 lockdowns. Household deposits have jumped by about $25bn since early 2019. The build-up in savings is unlikely to have fully dispersed across the household sector and many households would still be living pay cheque to pay cheque.

Nevertheless, if current spending patterns are broadly maintained, rising costs look set to place a significant dent in household budgets. For the average household, the increase for calendar 2022 is expected to come in at an average of $150 per household per week compared to 2021. This would equate to an extra $15bn per annum or equivalent to 7% of household disposable incomes. Some households would experience much steeper increases, including more heavily-indebted households. Others would not see as sizeable an increase.

The Upshot

For most households, we don't expect household disposable income growth to increase by as much as the cost of living. With a shrinking savings buffer, difficult choices and potential trade-offs lie ahead. Households will either have to dig into their saving, sell assets, increase their borrowing or cut back on spending. Discretionary (i.e. non-essential) spending is likely to be the first in the firing line and consumers will also look to economise spending on the essentials. **We suspect the penny is starting to drop now.**



With household balance sheets no longer benefitting from rising asset values, consumer spending is unlikely to be as robust or as resilient as it was in 2021. **The economy will need another driver of economic activity.**

A more sluggish outlook for household spending may well temper the extent of OCR tightening required by the RBNZ. We expect consecutive 25bp hikes and an OCR peak of 2.75% this cycle. Still, there is the clear risk that the RBNZ hikes by more if they deem their inflation mandate to be under threat.

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