WESTPAC ECONOMIC BULLETIN

CPI preview, March quarter 2023 – Thursday 20 April, 10:45am.

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The devil is in the detail.

- We estimate that New Zealand consumer prices rose by 1.5% in the March quarter.
- That would see annual inflation slipping to 6.9%, down from 7.2% at the end of last year. Even so, that would still leave us with a picture of consumer prices that are continuing to charge higher, with annual inflation remaining close to multi-decade highs.
- The March quarter saw a massive increase in food prices, as well as continued increases in housing related costs. Those increases have been partially offset by falls in fuel prices.
- While there have been large swings in some specific prices, under the surface inflation pressures remain strong and widespread, underpinned by strong demand over the past year.
- Our forecast is lower than the RBNZ's last published projection. A result in line with our estimate would reinforce our expectation for a peak in the OCR after a final hike in May.

Consumer price inflation

	Dec-22	Mar-23	
	Actual	Westpac forecast	RBNZ forecasts
Quarterly	1.4%	1.5%	1.8%
Annual	7.2%	6.9%	7.3%

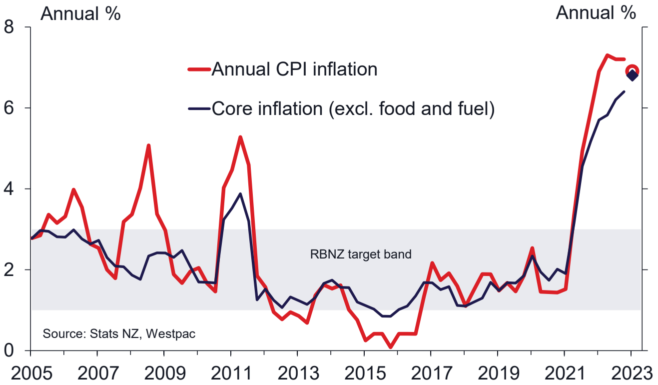
Prices are continuing to rocket higher. We estimate the Consumers Price Index rose by 1.5% in the three months to March.

A result in line with our forecast would see the annual inflation rate slipping to 6.9%, down from 7.2% at the end of 2022. However, the devil is in the detail.

The expected dip in the annual inflation rate is almost entirely due to the fall in petrol prices over the past year. That followed the earlier surge in prices in the wake of the Ukraine-Russia conflict.

Under the surface, inflation pressures remain red-hot. With elevated levels of demand over the past couple of years, capacity in the labour market and the economy more generally have become stretched. That's meant that price rises have become increasingly widespread, with businesses in many parts of the economy reporting large increases in operating costs. Consistent with that, we expect most measures of core inflation (which track the underlying trend in prices) will continue to run at levels of around 6% as they have in recent quarters. That's miles outside the RBNZ's 1% to 3% target band. And we don't expect that inflation will be back inside the target band until the middle of next year.

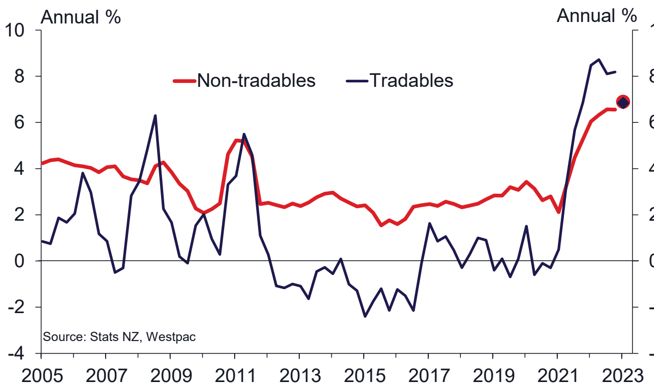
Annual inflation (including Westpac forecasts)



Key drivers

Inflation pressures are widespread. We estimate that domestically oriented non-tradables prices rose 1.7% over the March quarter, and are up 6.8% over the year. That's consistent with the tightness in the labour market and strong wage growth. Tradables prices (sometimes referred to as imported inflation) are estimated to have risen 1.2% over the March quarter and 6.9% in the year to March.

Tradables and non-tradables inflation



There have been some particularly large rises in some specific areas over the past three months.

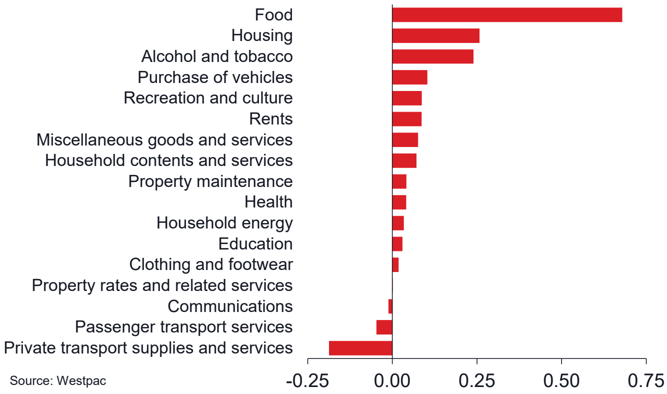
First up are food prices, which rose by 3.7% over the past three months and are up a massive 11% over the past year. In part, that strength is due to disruptions stemming from January's storms and Cyclone Gabrielle, which resulted in significant damage to some crops. At the same time, we also seen large increases in the prices of items like groceries (including eggs).

The recent storms have also added to inflation in a range of other areas. Spending to replace damaged items has boosted the demand for durable goods and motor vehicles. There's also been increased demand for tradies / property maintenance services at a time when the construction sector is already stretched. And on top of that, there's been increased demand for rental accommodation in areas like Auckland.

March quarter inflation will also be boosted by the annual increase in the tobacco excise tax. That increase is linked to the rise in overall consumer prices over the past year. And with inflation pushing over 7% in mid-2022, this year's increase in the excise tax will be large. We're forecasting that prices for cigarettes and tobacco will be up by 6.7%.

Providing an offset to those increases has been the sharp fall in petrol prices, with prices at the pump dropping by around 4% through the early part of this year.

Contributions to March quarter inflation forecast (percentage points)



Where could we be surprised?

There are some key areas of uncertainty that could throw around the March quarter inflation result.

First are the prices for services associated with travel and hospitality. Covid-19 and the resulting disruption to travel has meant that prices haven't been following the seasonal patterns we saw prior to the pandemic. At the current time, with global tourism rebounding and a recovery in domestic hospitality spending, we're expecting larger than usual price rises in categories like airfares and accommodation. Even so, there is a risk that price rises in these areas could be even larger than we've allowed for.

There have also been some big swings in the cost of purchasing a newly built dwelling in recent years, and this will be an area of particular interest for the RBNZ. Over the past couple of years, when house prices were charging higher, the cost of purchasing a new home also rose rapidly, climbing at an eye watering rate of over 4% per quarter. Those large increases reflected increases in the costs of materials and labour, and (crucially) strong demand. However, the past year has seen a sharp downturn in the housing market as interest rates have risen. We're also hearing increasing reports from those in the construction sector that demand for newly built houses is dropping back. Consistent with that, price rises in this area have slowed sharply in recent months. If that trend continues, it would be an important signal to the RBNZ that the steam really is coming out of a key sector of the economy.

Downside risk for the RBNZ's forecast, but inflation pressures still red hot.

Our forecast for March quarter inflation is lower than the RBNZ's last published forecast, which was released back in February. At that time, the central bank expected the annual inflation rate would push higher to 7.3%.

A March quarter inflation result in line with our forecast would still leave the RBNZ with a picture of strong and widespread price pressures. However, the fact that annual inflation is not continuing to push higher will be an important signal for the central bank. Interest rates have been on the rise for more than 18 months now and signs that demand is cooling are mounting. We’re forecasting one last 25bp rate hike in May.

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