WESTPAC ECONOMIC BULLETIN

CPI review, March quarter 2023.

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The slow thaw.

- Inflation was weaker than we and other analysts expected in the early part of this year. Crucially, it has fallen well short of the RBNZ's forecasts for a second quarter.
- This still leaves us with a picture of strong price pressures, including strong domestic inflation. However, inflation has now peaked and signs that rate hikes are weighing on demand are mounting.
- Against this backdrop, we expect only more one 25bp rate hike from the RBNZ. However, interest rates will need to remain high for some time yet.

Consumer price inflation

	Actual	Westpac forecast	RBNZ forecast (February MPS)
Quarterly	1.2%	**1.5%**	1.8%
Annual	6.7%	**6.9%**	7.3%

Consumer prices rose by 1.2% in the March quarter. That was a little lower than our forecast and saw the annual inflation rate dropping from 7.2% at the end of last year to 6.7% now. That's the lowest annual inflation has been since the end of 2021.

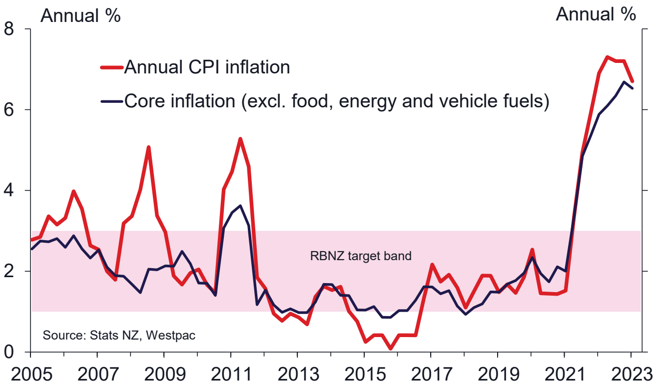
Importantly, inflation has now fallen well short of the RBNZ's forecasts for the past two quarters. The central bank was actually forecasting that annual inflation would rise to 7.3% in early 2023.

Inflation can be thrown around by big swings in a small number of items. And that certainly was the case in recent months. Notably, food prices were up a massive 3.7% in the March quarter, underpinned by large increases in the prices for fresh produce following the recent storms in January and February. Similarly, the annual increase in tobacco taxes was larger than usual this year, with prices for cigarettes and tobacco rising by 7.6%. Those rises more than offset the 2.6% fall in petrol prices.

But what's more important is the underlying trend in prices. And here's where things get interesting. Inflation pressures are still running hot. After strong growth in recent years, capacity in the economy – especially in the labour market – has become increasingly stretched. That's seen operating costs, including wages, and output prices rising rapidly. That's been seen most clearly in the domestically oriented components of inflation (sometimes referred to as non-tradables) which are continuing to rise at a rapid pace – up 1.7% in March and 6.8% over the past year.

Crucially, however, while those prices remain strong, they aren't continuing to acclerate. That was also reflected in the range of 'core' inflation measures which Stats NZ released today (which smooth through the quarter-to-quarter swings in prices and track the underlying trend in inflation). Most measures of core inflation are continuing to track around 6%, with some measures starting to ease back.

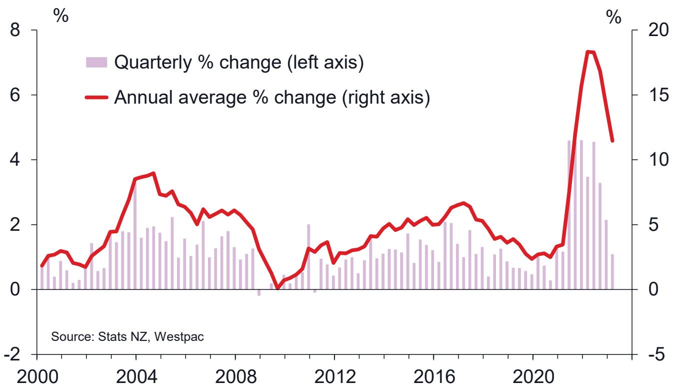
Annual inflation



The past quarter also saw widespread falls in the prices of many imported durable items, like furnishings and appliances. That's consistent with the feedback were getting from many retailers, who are telling us that demand for durable items has been waning.

Similarly, the cost of purchasing a newly built home (which drove much of the rise in overall inflation over the past year) has dropped back sharply. Demand for new builds has tumbled as interest rates have pushed higher and existing house prices have fallen.

Cost of purchasing a newly built dwelling



That stabilisation in underlying inflation pressures and easing in some categories is a key development for the RBNZ. Interest rates have been on the rise for over 18 months now. But as we've highlighted before, it takes time for those rate hikes to be reflected in household demand. That's in part due to widespread mortgage fixing in the New Zealand housing market.

However, increasing numbers of borrowers are now rolling on to higher interest rates. And as that's happening, we're seeing signs that inflation in demand sensitive areas, like durables spending, is easing back.

Furthermore, the coming year will see increasing numbers of households rolling on to higher mortgage rates with around 50% of all mortgages coming up for repricing over the next 12 months. And as the full impact of interest hikes is felt, demand will soften further. Over time that will also be reflected in the labour market and wage growth, and eventually domestic inflation.

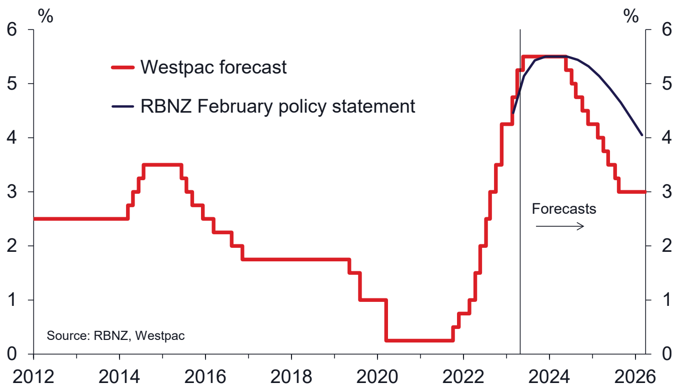
So what does this mean for the RBNZ?

Inflation is still uncomfortably high, and we don't expect that it will be back below 3% until the latter half of 2024. As a result, we continue to expect that the RBNZ will deliver another 25bp hike in the OCR at its May policy meeting. That would take the cash rate to 5.50%.Interest rates will need to remain high for some time yet, and the RBNZ is likely to maintain a hawkish stance in order to avoid an unwanted drop in borrowing rates.

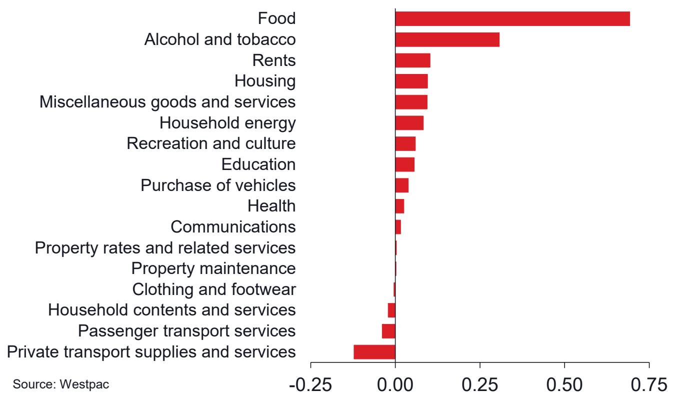
However, with inflation falling well short of the RBNZ's forecasts, the chances of the central bank needing to take the OCR above 5.50% have fallen.

The RBNZ will still be keeping a close on some key factors that could boost inflation over the coming year. That includes the strength of the labour market, as well as increases in fiscal spending and spending on post-cyclone reconstruction. However, today's downside surprise will also help to balance the RBNZ's concerns about the potential inflationary impacts of those factors.

OCR forecasts



Contributions to March quarter inflation forecast (percentage points)



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