WESTPAC ECONOMIC BULLETIN

CPI review, June quarter 2022

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Here comes the pain again.

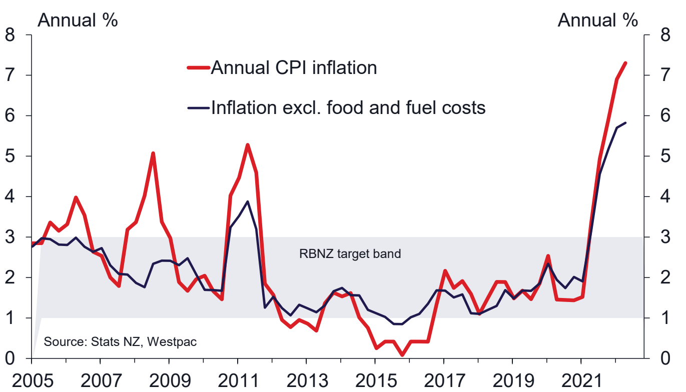
- Consumer prices rose 1.7% in the June quarter. That took the annual inflation rate to 7.3%, its highest level since 1990.
- Today's result was much stronger than our own and market expectations. Today's result was also stronger than the RBNZ's forecast.
- Price pressures are boiling over in every corner of the economy, boosted by a cocktail of supply-side cost increases and hot consumer demand.
- We aren't forecasting inflation to return back within the RBNZ's target band until the middle of next year at the earliest.
- We're expecting a fourth 50bp increase in the cash rate at the upcoming August decision and a peak of 3.50% in the cash rate.
- However, if we don't see signs of a moderation in inflation or domestic demand over the coming months, the risks are that the RBNZ may look to take the cash rate even higher.

There's been no let-up in the intense price pressures that have been buffeting New Zealand households, with consumer prices rising at their fastest annual pace in 32 years.

Consumer prices rose 1.7% in the June quarter. Coming on top of the strong price rises in previous quarters, that took the annual inflation rate to 7.3% (up from 6.9% in the March quarter). The last time annual inflation was this high was in 1990 following the hike in GST.

Today's result was much stronger than our own and market forecasts. As discussed below, the result was also stronger than the RBNZ's forecast. Upside surprises to our own forecast were spread across domestic and imported categories, with a notable upside surprise in building costs.

Consumer price inflation



Much of the strength in consumer prices has been due to large increases in the price of food, petrol and housing costs. However, the high level of inflation isn't just due to a few specific items. Price pressures have been boiling over in every corner of the economy. That was reflected in the suite of core inflation measures released by Stats NZ today, which smooth through the quarter-to-quarter swings in prices and track the underlying trend in inflation. Most core inflation measures are now running above 6%.

Underlying that broad-based strength in inflation has been a cocktail of supply-side cost pressures and firm consumer demand.

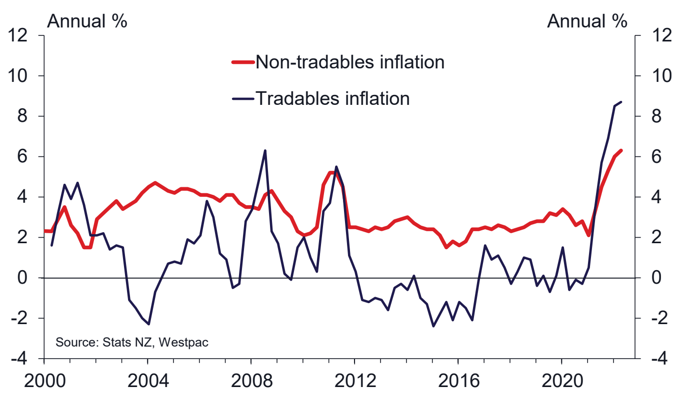
On the cost side of the ledger, continued disruptions to global and local supply chains have resulted in shortages of both production inputs and consumer goods. There has also been increasing upwards pressure on local wages.

But what's really lit a fire under consumer prices has been the strength of domestic demand. Indeed, if we look at the areas where businesses are reporting significant shortages of supplies, they're predominantly in areas like the construction sector where demand has been strong. That is a big concern for the RBNZ, because if demand continues to run hot, inflation is likely to remain elevated even when the current pressure on operating costs (eventually) eases off. And a key factor underpinning the strength of household demand has been stimulus from low interest rates.

Looking across the broad product groups, imported prices (sometimes referred to as tradables) rose by 1.9% over the past three months, and are up 8.7% over the past year. While much of that was due to fuel costs, other tradable prices are up 5.4% over the past 12 months. Notably, the June quarter saw larger than expected increases in the prices of a range of durables like furnishings.

Non-tradable (domestic) prices were up 1.4% in the June quarter and have risen by 6.3% over the past year. That is the fastest annual pace of non-tradables inflation since records began in 2000. The RBNZ pays particular attention to non-tradables inflation, and it is currently running at around twice the pace we've seen over the past two decades.

Tradables and non-tradables inflation



Has inflation peaked?

We think that the June quarter will mark the high point in the current inflation cycle (though given the extent of upside surprises over the past year, we're aware that is a bold call).

Much of the rise in prices that we've seen over the past year has been due to factors that we don't expect to repeat, especially in terms of import prices. For instance, as the global economy moved out of lockdown, we saw major supply disruptions and big increases in the prices of many internationally traded goods (e.g. international oil prices more than doubled over the past year). Looking ahead, while we expect prices to remain high, they're not increasing at the same pace that we saw last year. In fact, in the case of oil prices, they've actually fallen in recent weeks.

In addition, those earlier large price rises will start to drop out of the annual calculations over the next few months. And as that occurs, it will pull down the current sky-high rate of tradables inflation.

Nevertheless, underlying inflation pressures are expected to remain strong, especially on the domestic front. Notably, in the construction sector (which has been the major driver of the overall rise in the CPI) we're seeing no signs that inflation pressures are abating. More generally, the labour market is stretched drum tight and high levels of worker absenteeism are adding to the pressure on wages.

In light of those simmering domestic price pressures, we expect that inflation will remain elevated over the remainder of this year. In fact, we aren't forecasting a return back within the RBNZ's target band until the middle of next year at the earliest. That signals an ongoing squeeze on households' purchasing power.

What does today's result mean for the RBNZ?

Today's result was stronger than the RBNZ's latest published forecast for a 1.4% rise (though, since that forecast was published in May, the RBNZ had noted the upside risk for prices).

Last week, when delivering its third consecutive 50bp hike, the RBNZ reaffirmed that they are planning to continue raising the cash rate to a level where they are confident that inflation will settle within the 1% to 3% target range. And with price pressures continuing to sizzle, there was nothing in today's report to dissuade them from that course.

The big question is how far and how fast will the RBNZ need to raise the cash rate?

We're expecting the RBNZ will deliver a fourth 50bp hike at the time of the August policy review. We expect that to be followed by 25bp hikes in both October and November, taking the OCR to a level of 3.50% by year's end.

However, given the continuing and widespread strength in inflation pressures, markets have moved to price in the chance that the cash rate could rise above 4% and that we could see a 75bp move in August.

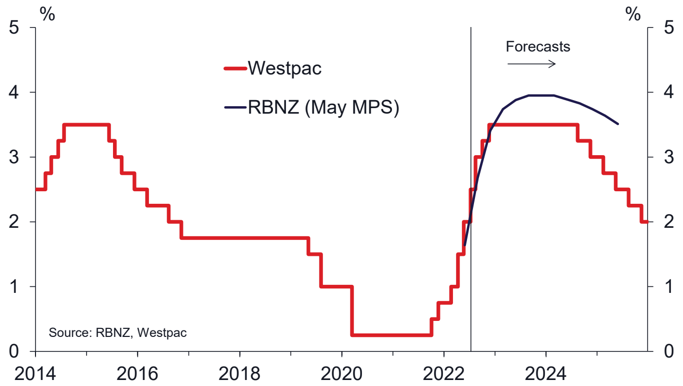
While we won't completely rule out a super-sized 75bp move from the RBNZ (as we've seen recently from the US Federal Reserve) we still think that a 50bp increase is most likely. Compared to other economies, New Zealand's tightening cycle started earlier and is now more advanced. In other words, even though rates still need to move higher from here, there's less urgency to do so than in markets that started raising their policy rates later in the cycle.

In addition, the sources of inflation matter. While the RBNZ is trying to lean against domestic inflation pressures, much of the increase in consumer prices has been to due fuel prices and offshore supply disruptions – neither of which the RBNZ can offset with higher interest rates.

In terms of the peak in the cash rate, the key concern for the RBNZ is whether there are signs that OCR hikes to date are gaining traction. Today's CPI result certainly would have got alarm bells ringing at the central bank that more action is needed. From here, the next big markers for the cash rate ahead of the August policy statement will be the labour market and wage figures (due 3 August) and the next survey of inflation expectations (8 August). We're already factoring in strong reads on those fronts. But if they are even hotter than expected, we could see the RBNZ revising up the projected peak in the cash rate from the level of 3.9% in their last published projections from May.

However, signs that the economy is cooling have already started to emerge. Notably, both the housing market and retail spending have slowed. Looking ahead, we expect a further cooling on both of those fronts, especially given the squeeze on household budgets that's now occurring. As evidence of that cooling in demand becomes clearer in the latter part of the year, we expect that the pace of rate hikes is likely to then become more measured.

Official Cash Rate forecasts



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