WESTPAC WEEKLY ECONOMIC COMMENTARY

New Zealand inflation down, but definitely not out.

24 July 2023

Southern rātā

Westpac Economics Team
economics@westpac.co.nz
westpac.co.nz/economics

Inflation in New Zealand has slowed from the eye-watering rates of over 7% that we saw last year. However, while inflation is 'lower', it is not 'low' by any stretch of the imagination. Underlying price pressures remain strong, and inflation is set to linger at elevated levels for an extended period. As a result, we continue to forecast that the RBNZ will need to raise the OCR again.

Consumer prices rose by 1.1% in the June quarter. That saw the annual inflation rate dropping to 6.0%, down from 6.7% in the year to March and well below the peak of 7.3% that we reached last year.

At first blush, the June quarter inflation result was close to our own forecast and the RBNZ's expectation. However, digging into the details of the latest inflation report, there were actually a number of red flags for the central bank. The most important of those was the continued strength in domestic inflation (aka non-tradable prices). The RBNZ pays particular attention to non-tradables inflation given its close connection to the strength of domestic economic conditions, and they had expected it to fall from 6.8% in the year to March to 6.3% now. But instead, non-tradables inflation has actually held at higher levels than the RBNZ expected, nudging down only slightly to a still strong level of 6.6% in the year to June. That's despite the sharp rise in interest rates since the RBNZ began raising the OCR more than 18 months ago.

Looking more closely at those domestic inflation pressures, there has been particular strength in the prices of services, which are up an average of 6.1% over the past year. That's consistent with the ongoing tightness in the labour market and related strength in wage growth. We expect those conditions will see domestic inflation remaining elevated well into the new year.

And we're not just seeing strength in the domestic components of inflation. Excluding the volatile food and fuel categories, prices for imported goods have also continued to rise at a rapid pace, increasing 6.5% over the past 12 months. That's despite an easing in supply chain pressures, and it points to ongoing firmness in households spending appetites.

Putting this altogether leaves us with a picture of simmering underlying price pressures. That's been reflected in the various measures of core inflation which are continuing to run at levels of around 6% – well outside the RBNZ's 1% to 3% target band. Notably, the RBNZ's own 'sectoral factor model' of core inflation is yet to show any signs of easing, having remained stubbornly high at 5.8% for three quarters now. (Core inflation measures smooth through the quarter-to-quarter swings in the prices of volatile items like petrol, and instead track the broader trend in prices.)

In their most recent policy update, the RBNZ signalled that they expected to keep the OCR at the current level of 5.50% for some time, noting that they viewed the risks around the inflation outlook as being "broadly balanced." However, with non-tradables inflation surprising to the upside, and price and wage pressures remaining strong, the RBNZ may have a tougher task ahead than they had anticipated.

We actually expect that headline inflation will fall over the remainder of this year. As in other regions, New Zealand's current high levels of inflation are in part a hangover from the disruptions to global supply chains and the related cost increases we saw in the wake of the pandemic. However, with the impact of those factors fading, imported inflation is set to continue easing.

But the current high levels of inflation aren't just a result of supply-side cost pressures. What really lit a fire under inflation over the past couple of years has been the strength of domestic demand. That's meant many local businesses were able to pass on at least some of the increases in their operating costs into output prices. And that is very important for the Reserve Bank because if demand remains firm, inflation is likely to linger at high levels even as cost pressures continue easing.

On this front, we're actually seeing mixed indications regarding the strength of domestic demand. GDP growth has cooled following the sharp rise in interest rates over the past year. In addition, a significant tightening in financial conditions still lies ahead for many households as they roll on to higher fixed mortgage rates.

But while activity is cooling, that's a slowdown after strong growth in recent years. For now, the level of economic activity remains elevated, and the labour market is still stretched. The related firmness in demand and wage growth means that we are continuing to see strong price growth in some parts of the economy. On top of that, there are signs that the economic cycle may still have some legs, such as the turnaround in net migration and related indications that the housing market may be heating up again.

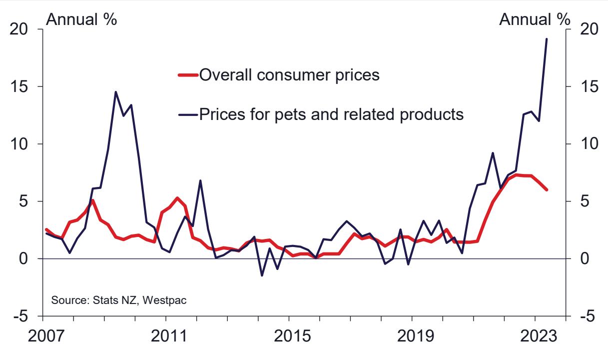
Inflation has already lingered above the RBNZ's target band for over two years now, and the RBNZ's own forecast show it remaining above 3% until the latter part of next year (meaning more than three years away from target). However, with domestic inflation stronger than expected and pricing pressures remaining 'sticky', there's a risk that inflation could take even longer to drop back. As a result, we continue to forecast that the RBNZ will need to raise the OCR again.

Satish Ranchhod, Senior Economist
+64 9 336 5668
satish.ranchhod@westpac.co.nz

Chart of the week

Within last week's inflation update were some shocking numbers about the cost of our four-legged family members. Over the past year, the cost of pets and the related supplies has risen by a massive 19%, while the cost of vet services increased 10%. With those sorts of increases coming at the same time as other significant pressures on households' budgets, Fluffy may soon have to switch from wet-food to dry cat-biscuits for dinner.

Pet cost inflation surging

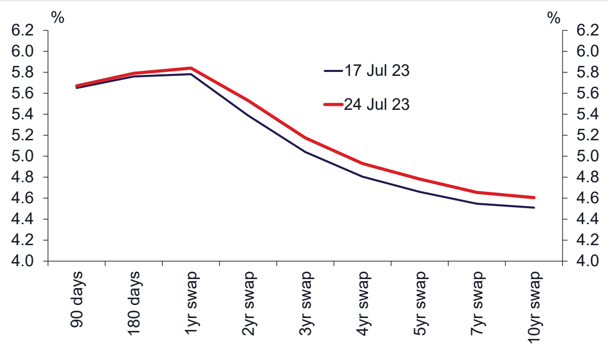


Fixed vs floating for mortgages

The RBNZ has signalled that it expects to hold the cash rate at its current level of 5.50% for an extended period. In contrast, financial markets are pricing in an earlier start to interest rate cuts, from early next year. We see a risk that the OCR could go higher in the coming months, and that interest rate cuts could be some time away.

We see value in fixing for terms as long as two years. Rates for terms beyond two years are still relatively expensive, but would provide more certainty around the size of repayments.

NZ interest rates



The week ahead

NZ June monthly employment indicator

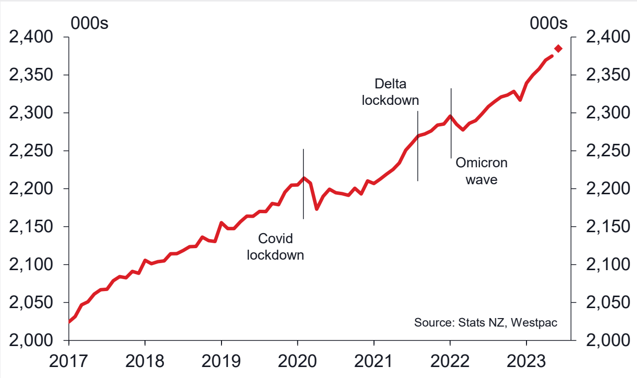
Jul 28, Last: +0.2%, Westpac f/c: +0.4%

The monthly employment indicator is drawn from income tax data, making it a fairly comprehensive record of the number of people in work. Helpfully, this fills a gap in what is otherwise mostly quarterly data on the labour market.

So far in 2023, despite the slowdown in activity, jobs growth has remained very robust. This is no doubt in part because there are more people around to hire – migrant inflows have surged since the reopening of the border, allowing employers to fill longstanding vacancies.

The weekly snapshots provided by Stats NZ suggest that the uptrend has likely continued in June. If confirmed, that would point to the likelihood of another solid lift in the household survey measure of employment (due 2 August), and so at best a modest lift in the unemployment rate.

Monthly filled jobs



Aus June Quarter CPI %qtr

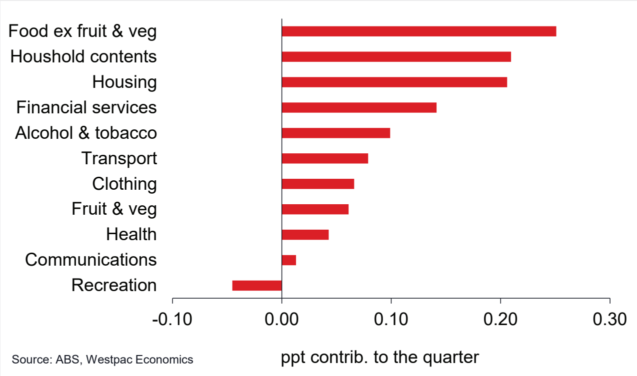
Jul 26, Last: 1.4%, WBC f/c: 1.1%
Mkt f/c: 1.0%, Range: 0.6% to 1.4%

The March quarter CPI rose 1.4% as per the Westpac forecast (market median was 1.3%); the Trimmed Mean was softer than expected lifting 1.2%. Annual inflation eased back to 7.0%yr from 7.8%yr which was the fastest pace since March 1990. It is increasingly clear that the December quarter 2022 was the peak in current inflationary cycle.

Westpac is forecasting a 1.1% rise in the June quarter, taking the annual pace down to 6.3%yr. Power rebates are holding down inflation while goods prices continue to rise. The contribution from utilities falls from 0.22ppt in March to –0.05ppt in June. The Trimmed Mean is forecast to lift 1.1% in June, a moderation from the gains in March (1.2%), December (1.7%) and September (1.9%).

For June Monthly CPI Indicator, we are forecasting 1.0%mth/5.8%yr.

Aus contributions to 2023 Q2 CPI



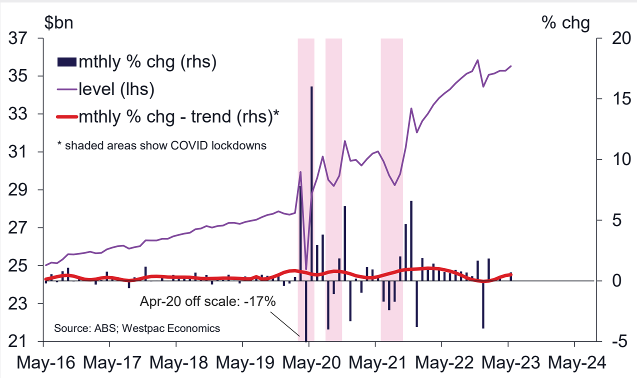
Aus June retail trade

Jul 28, Last: 0.7%, WBC f/c: -0.2%
Mkt f/c: flat, Range: -0.3% to 0.5%

Retail sales posted a surprisingly firm 0.7% rise in May following tepid gains over the previous three months – sales flat in April, up 0.4% in March and 0.2% in Feb – and a sharp 2.2% around the turn of the year. The May detail was less convincing with the much of it likely due to rising prices rather than volumes, and the rise mostly centred on 'small ticket' discretionary categories and led by online sales, which look to have seen a temporary lift due to specific sales events.

Our Westpac Card Tracker suggests retail spending saw a broad-based decline in the June month. Accordingly, we expect the official figures to show a 0.2% decline in June with some downside risks in the mix. Note that this is the preliminary retail release which only includes the top-line results for monthly nominal retail sales. The final report on August 3 will include the full detail including estimates for Q2 real retail sales – an important partial for the Q2 GDP.

Aus monthly retail sales



The week ahead

US July FOMC meeting

Jul 25-26: Last: 5.125%, Mkt f/c: 5.375%, WBC: 5.375%

Since the FOMC's last meeting, we have begun to see much clearer evidence of an entrenched downturn in inflation. The 2.0%yr medium-term target is still a way off, but there is a clear path to get there by sometime in 2024 on current trends.

While certainly not time for rate cuts, soon it will be appropriate to enter a sustained pause to fully assess not only the upside risks for inflation but also the downside risks for growth.

We see the 25bp hike forecast for the July meeting as the last for this cycle. Chair Powell won't be in a position to confirm this at the press conference, but is likely to emphasise the data dependent nature of policy. From here, another modest inflation print and further deceleration in employment growth before the September meeting should confirm 5.375% as the peak.

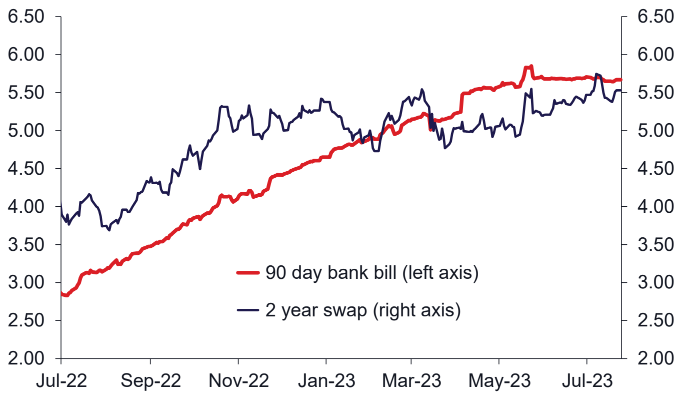
US labour market

New Zealand forecasts

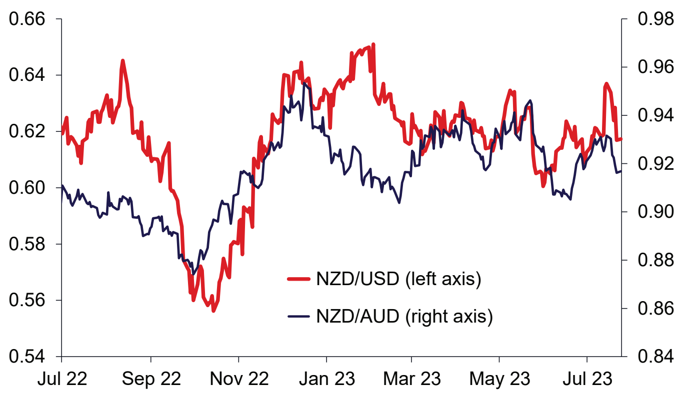
Economic forecasts	Quarterly				Annual			
	2022	2023						
% change	Dec	Mar	Jun	Sep	2021	2022	2023f	2024f
GDP (Production)	-0.7	-0.1	0.5	0.5	6.0	2.7	1.2	0.5
Employment	0.5	0.8	0.4	0.0	3.3	1.6	1.2	-0.4
Unemployment Rate % s.a.	3.4	3.4	3.5	3.7	3.2	3.4	3.9	4.9
CPI	1.4	1.2	1.1	2.0	5.9	7.2	4.9	2.9
Current Account Balance % of GDP	-9.0	-8.5	-8.2	-7.9	-6.0	-9.0	-6.8	-4.0

Financial forecasts	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
Cash	5.75	5.75	5.75	5.75	5.25	4.75	4.50
90 Day bill	5.85	5.85	5.85	5.55	5.05	4.75	4.30
2 Year Swap	5.30	5.00	4.70	4.40	4.20	4.00	3.90
5 Year Swap	4.80	4.60	4.45	4.30	4.15	4.05	3.95
10 Year Bond	4.60	4.40	4.20	4.00	3.90	3.80	3.70
NZD/USD	0.62	0.62	0.63	0.64	0.65	0.66	0.66
NZD/AUD	0.90	0.90	0.89	0.89	0.89	0.89	0.89
NZD/JPY	86.8	85.6	85.7	85.1	84.5	84.5	83.5
NZD/EUR	0.56	0.56	0.56	0.57	0.57	0.57	0.57
NZD/GBP	0.49	0.49	0.49	0.50	0.50	0.51	0.51
TWI	70.9	70.3	70.1	70.4	70.7	71.0	70.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 24 July 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.50%	5.50%	5.50%
30 Days	5.61%	5.62%	5.60%
60 Days	5.64%	5.66%	5.65%
90 Days	5.67%	5.70%	5.69%
2 Year Swap	5.53%	5.72%	5.42%
5 Year Swap	4.78%	5.06%	4.66%

NZ foreign currency mid-rates as at 24 July 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6173	0.6183	0.6167
NZD/EUR	0.5548	0.5642	0.5656
NZD/GBP	0.4802	0.4835	0.4852
NZD/JPY	87.48	88.08	88.24
NZD/AUD	0.9168	0.9310	0.9240
TWI	71.02	71.85	71.68

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
NZ	Jun trade balance $mn	46	–	–450	Meat commodity prices slumped over June.
Eur	Jul HCOB manufacturing PMI	43.4	–	–	German weakness dragging on manufacturing sentiment...
	Jul HCOB services PMI	52.0	–	–	... services at risk of following soon.
UK	Jul S&P Global manufacturing PMI	46.5	–	–	Pessimism to remain for manufacturing while...
	Jul S&P Global services PMI	53.7	–	–	... services show resilience.
US	Jun Chicago Fed activity index	–0.15	–	–	Seeping pessimism slowing activity
	Jul S&P Global manufacturing PMI	46.3	46.1	–	The US is likely to experience similar outcomes...
	Jul S&P Global services PMI	54.4	54.1	–	... though risks for services are greater.
Tue 25					
US	May FHFA house prices	0.7%	0.6%	–	Prices have found their floor...
	May S&P/CS home price index	0.9%	0.7%	–	... as inventories dry up.
	Jul consumer confidence index	109.7	112.0	–	Renewed confidence as FOMC slows hikes.
	Jul Richmond Fed index	–7	–10	–	Manufacturing hit by demand and uncertainty.
Wed 26					
Aus	Q2 CPI %qtr	1.4%	1.0%	1.1%	Power rebates holding back inflation while food prices...
	Q2 CPI %yr	7.0%	6.3%	6.3%	... continue to rise. Inflation peaked in late 2022 but it is...
	Q2 trimmed mean %qtr	1.2%	1.1%	1.1%	... uncertain just how disinflationary clothing & household...
	Q2 trimmed mean %yr	6.6%	6.0%	6.0%	... goods will be. The Monthly Indicator is a rich source of data...
	June Monthly CPI Indicator %yr	5.6%	5.5%	5.8%	... but survey timing means it has to be used with caution.
US	Jun new home sales	12.2%	–5.4%	–	Prices have found a floor; lack of existing supply a positive.
	FOMC policy decision, midpoint	5.125%	5.375%	5.375%	Likely to prove last hike of cycle before lengthy pause.
Thu 27					
Aus	Q2 import price index	–4.2%	–0.8%	–0.8%	Some downward pressure on world prices.
	Q2 export price index	1.6%	–6.7%	–7.2%	Sharply lower commodity prices in Q2, -9.3%.
Chn	Jun industrial profits %yr	–12.6%	–	–	Losses to continue as expenses go up.
Eur	ECB policy decision, deposit rate	3.50%	3.75%	3.75%	Strong underlying inflation prompts further action.
US	Q2 GDP, annualised	2.0%	1.8%	–	Growth subsiding as consumer spending moderates.
	Jun durable goods orders	1.8%	1.0%	–	Weaker business sentiment to dampen demand.
	Jun wholesale inventories	0.0%	–	–	Slowly stagnating as businesses hold back new orders.
	Initial jobless claims	228k	–	–	Volatility keeping pundits on toes over outlook.
	Jun pending home sales	–2.7%	0.3%	–	Supply a more critical factor than rates.
	Jul Kansas City Fed index	–12	–	–	Blank backlogs bludgeon manufacturing.
Fri 28					
NZ	Jul ANZ consumer confidence	85.5	–	–	Still low with ongoing pressure on household finances.
	Jun employment indicator	0.2%	–	0.4%	Weekly data hint that jobs growth remains robust.
Aus	Q2 PPI	1.0%	–	–	Is the improvement in supply chains still flowing through?
	Jun retail sales	0.7%	0.0%	–0.2%	Consumers responding to cost-of-living and int. rate pressures.
Eur	Jul consumer confidence	–15.1	–	–	Consumers down as rate hikes weigh in...
	Jul economic confidence	95.3	–	–	... businesses feeling much the same.
UK	Jul Nationwide house prices	0.1%	–	–	High rates dissuade new borrowing for housing.
US	Q2 employment cost index	1.2%	1.1%	–	Little signs of slack point to higher wages ahead.
	Jun personal income	0.4%	0.5%	–	Strong wages growth supporting incomes gains overall...
	Jun personal spending	0.1%	0.4%	–	... allowing spending momentum to hold up.
	Jun PCE deflator	0.1%	0.2%	–	PCE outcomes likely to match CPI result...
	Jun core PCE deflator	0.3%	0.2%	–	... though technical differences a marginal upside risk for core.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022	2023f	2024f
Australia						
Real GDP %yr	1.9	-1.8	5.2	3.7	1.4	0.5
CPI inflation %yr	1.8	0.9	3.5	7.8	4.2	3.2
Unemployment rate %	5.2	6.8	4.7	3.5	4.2	5.3
Current account % of GDP	0.7	2.4	3.1	1.2	0.8	0.4
United States						
Real GDP %yr	2.3	-2.8	5.9	2.1	1.6	0.3
CPI inflation %yr	1.9	1.2	7.2	6.4	2.5	2.0
Unemployment rate %	3.7	8.1	5.4	3.6	3.6	4.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	-4.3	2.1	1.1	1.2	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.4	3.5	0.6	1.2
United Kingdom						
Real GDP %yr	1.6	-11.0	7.6	4.0	0.3	0.8
China						
Real GDP %yr	6.0	2.2	8.4	3.0	5.7	5.5
East Asia ex China						
Real GDP %yr	3.8	-2.3	4.3	4.5	3.7	4.3
World						
Real GDP %yr	2.8	-2.8	6.3	3.4	3.0	3.0

Forecasts finalised 7 July 2023

Interest rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia							
Cash	4.10	4.60	4.60	4.60	4.35	4.10	3.85
90 Day BBSW	4.36	4.80	4.80	4.63	4.38	4.13	3.88
10 Year Bond	4.04	3.90	3.70	3.50	3.30	3.20	3.10
International							
Fed Funds	5.125	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond	3.85	3.70	3.50	3.30	3.10	3.00	2.90

Exchange rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6779	0.69	0.69	0.71	0.72	0.73	0.74
USD/JPY	140.12	138	136	134	132	130	128
EUR/USD	1.1140	1.11	1.12	1.12	1.13	1.14	1.15
GBP/USD	1.2884	1.28	1.28	1.29	1.29	1.30	1.30
USD/CNY	7.1701	7.10	7.00	6.80	6.70	6.60	6.50
AUD/NZD	1.0890	1.11	1.11	1.13	1.13	1.12	1.12

Contact the Westpac economics team

Kelly Eckhold, Chief Economist
+64 9 348 9382

Satish Ranchhod, Senior Economist
+64 9 336 5668

Darren Gibbs, Senior Economist
+64 9 367 3368

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Shania Bonenkamp, Graduate
shania.bonenkamp@westpac.co.nz

Any questions email:
economics@westpac.co.nz

Disclaimer