ANZ Research

December 2022 Qtr CPI Review & OCR call change

25 January 2023

Contact

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Data summary

	% qtr	% ann
Headline CPI	1.4%	7.2%
Tradable	1.4%	8.2%
Non-tradable	1.5%	6.6%

Much better than feared

- **On the back of today's CPI data and weaker activity indicators we have revised our OCR call. We now expect a 50bp hike in February and two 25bp follow-up hikes taking the OCR to a peak of 5.25%.**
- CPI inflation remained strong in the December quarter, with consumer prices lifting 1.4% q/q (7.2% y/y), in line with our expectation, but below the RBNZ's November forecast of 1.7% q/q (7.5% y/y).
- Encouragingly, non-tradables inflation was flat at 6.6% y/y, below our forecast of 6.9%, and the RBNZ's 7.0% expectation. And core inflation was encouraging as well. CPI ex-food, fuel, and energy did lift to 6.7% y/y (6.3% previously), but trimmed mean inflation eased to 6.1% (6.4% previously) and weighted median inflation was unchanged at 5.0%.
- Tradables inflation (largely imported) was stronger than expected, but that was thanks in part to a larger increase in international airfares than anticipated, and a smaller fall in petrol prices than implied by weekly fuel price data (small beer from the RBNZ's perspective). Tradables came in at 8.2% y/y (8.1% previously) – a smidgen below the RBNZ's expectation of 8.3%.
- Inflation is clearly still far too strong, but the stabilisation in non-tradables inflation is a welcome development. The inflation numbers clearly weren't as bad as the RBNZ feared in November, and signs that inflation will ease meaningfully over 2023 are becoming increasingly clear.

Key points

Certainly, CPI inflation remained too high in the December quarter, with consumer prices lifting 1.4% q/q (7.2% y/y), in line with our expectation, and slightly higher than the consensus expectation of 7.1%.

But importantly, inflation came in below the RBNZ's forecast of 7.5% y/y. Even more importantly, the bulk of that forecast miss was due to non-tradables inflation (ie the largely domestically generated part) coming in lower than expected, staying flat a still-high 6.6%, versus the RBNZ's expectation of an acceleration to 7.0% (and our forecast of 6.9%). Measures of core inflation compiled by Stats NZ were also a lot less one-sided, with CPI ex-food, fuel, and energy increasing to 6.7% (6.3% previous), weighted median inflation unchanged at 5.0%, and trimmed mean inflation easing to 6.1% (6.4% previous). These numbers are still too strong, but the relentless increase in core inflation looks to be stabilising. The RBNZ's sectoral factor model of core inflation will be released at 3pm today.

Inflation is still far beyond the RBNZ's target band. But it is clear that overall inflation pressures are not as severe as the RBNZ feared at the time of the super-hawkish November Monetary Policy Statement, despite the additional domestic demand created by the revival of international tourism over the 2022/23 summer. Accordingly, the RBNZ now has the luxury of responding in the usual fashion to weakening activity data, reining in its hawkishness to some degree. We now expect a 50bp hike in February and a peak OCR of 5.25% by May (previous forecast: 75bp in February and a peak of 5.75%).

The details

Inflation pressures remain broad-based. Of the 1.4% q/q increase in consumer prices in the December quarter:

- Food prices (18.0% of the CPI basket) lifted 1.8% q/q, adding 0.3ppt to the quarterly print. That was broadly as expected, given the 11.3% y/y increase in the monthly Food Price Index in the year to December 2022. Food prices continue to be pushed higher by supplier costs, labour shortages, and inclement weather.
- For now, housing-related costs (28.3% of the CPI basket) remain a key driver, rising 1.3% q/q and adding 0.4ppt to inflation. Rent prices were up 0.9% q/q, but with rents for new tenancies increasing just 0.8% y/y in December, we should see overall rental inflation ease over 2023. Construction costs rose 2.1% q/q, with ongoing high levels of building activity still putting pressure on costs. That should change over 2023 as the RBNZ's interest rate hikes drive a contraction in construction activity.
- The transport group (14.2% of the CPI basket) was the most significant forecast miss, adding 0.1ppt to headline, with costs rising 0.9% q/q (we had pencilled in a 0.4% fall). Petrol prices were down 7.2% q/q (less than the 11.5% fall we had pencilled in based on weekly petrol prices). This knocked only 0.3ppt off headline inflation in Q4 (we expected -0.5ppt). Domestic airfares were up 14.1% (close to our 15% expectation), but international airfares rose 18.9% q/q, versus our assumption of 15%. Combined, these added 0.4ppt to headline.
- The recreation and culture group (8.5% of the CPI basket) lifted 3.4% q/q (just below the 3.5% we had pencilled in), adding 0.3ppt to headline inflation. The tourism reopening has put a lot of pressure on tourism hotspots, retail, and accommodation, with additional demand running headlong into our critically constrained labour market. That pressure was evident in accommodation services (up 4.7% q/q) and recreational and cultural services (up 2.4% q/q). Audio-visual and computing equipment prices were up 4.8% q/q.
- Household contents and services (4.2% of the CPI) lifted 3.2% q/q, stronger than the 2.5% lift that we had pencilled in, adding 0.1ppt to headline inflation. This component is also heavily weighted towards tradables inflation.

Monetary policy implications

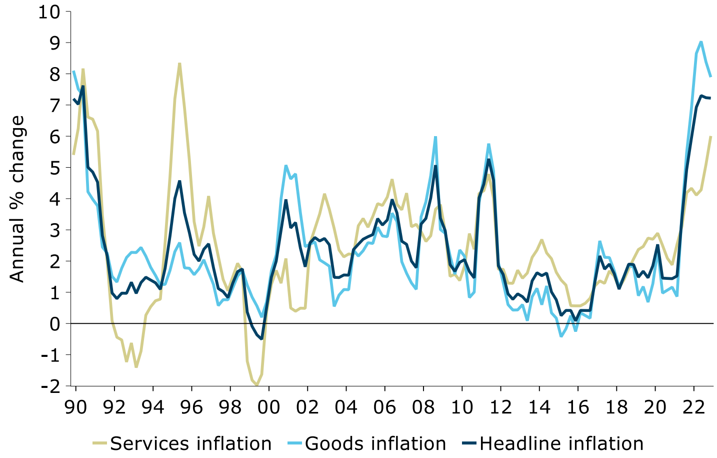
Inflation is clearly still far too strong. But things are looking a lot better than the RBNZ feared at the November meeting, where the Monetary Policy Committee hiked the OCR 75bp, published an OCR track that implied another 75bp hike in February, and even noted that the discussion had been between a 75bp or 100bp hike. Hard to get much more hawkish than that!

But with Q4 CPI data under our belts, and timely measures of economic and labour market activity all heading south, we're becoming more confident in our expectation that domestically generated inflation will ease in a meaningful way over 2023, and faster than the RBNZ expects.

In terms of domestic inflation drivers, easing CPI rental inflation is foreshadowed by the slowdown in rents for new tenancies, and the continued deterioration in the housing market points to further relief on construction cost inflation. The reopening of international tourism is putting pressure on domestic inflation, but that should be a temporary dynamic that fades as the peak summer season ends (assuming no lasting impact on inflation expectations).

As the global inflation pulse turns, New Zealand inflation is rotating into services prices and away from goods. That's seen in ongoing increases in services inflation, even as goods inflation falls quickly (figure 1). Services inflation tends to be directly more driven by labour market pressures. As such, it can be quite persistent and hard to bring down. We probably won't see it in next week's Q4 labour market data, but forward indicators of labour demand (including employment intentions and online job ads) point to a significant reduction in demand for workers as we head through 2023. That should take the heat out of wage-price spiral dynamics that have become increasingly established in New Zealand.

Figure 1. Goods and services inflation



Source: Stats NZ, Macrobond, ANZ Research

All up, while the inflation environment is certainly still concerning, and does not yet point to imminent rate cuts (as markets are pricing), things are looking much better than the RBNZ feared. There is strengthening evidence that domestically generated inflation will start to ease significantly in 2023, especially once the temporary impact of restarting international tourism fades.

Given this evidence, we have revised our OCR forecast, and now expect 50bp in February, and two final 25bp hikes in April and May, taking the OCR to a peak of 5.25%.

While our forecast is by necessity a point estimate of what we consider to be the single likeliest outcome, we'd be doing readers a disservice to not highlight the extreme uncertainty that remains regarding the outlook. Despite the slowing economic indicators it would be risky to assume it'll be one-way traffic from here. There are still upside risks to the medium-term inflation outlook and therefore to interest rates:

- China's rapid reopening could meaningfully lift commodity prices – of which energy is the most crucial for global inflation.
- Geopolitics and climate change could impact energy and food prices. More weather events could hold up local food prices.
- Inflation expectations could still stubbornly refuse to fall (and they feed directly into the RBNZ's estimate of how much effective tightening they are delivering), and feed into both price and wage-setting behaviour for longer than expected.

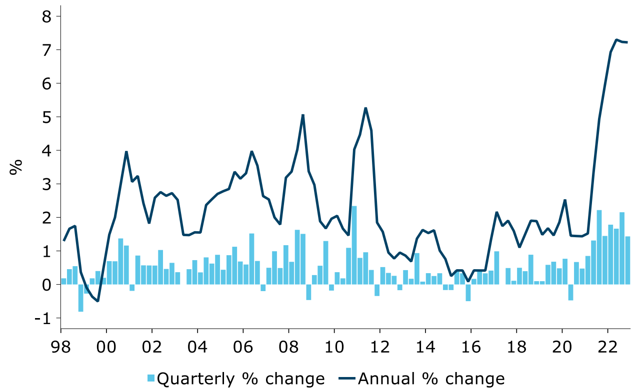
Indeed, there's still a plausible scenario where the RBNZ just has to keep on delivering a series of 'last' 25bp hikes in order to convince themselves and others that they're staying ahead of the inflation game. However, our base case is that the slowing economy will indeed see headline inflation drop away steadily – not particularly rapidly, but fast enough to keep the RBNZ in "watch, worry and wait" mode from mid-year.

Sticky indicators of inflation pressure will keep the RBNZ wary for a while yet. As we said in our November MPS Review, "This inflation problem is unlikely to be beaten until retail interest rates have spent a decent amount of time sitting considerably higher than CPI inflation." If inflation doesn't in fact fall steadily, there is upside risk to the OCR endpoint. Weakening job ads will reassure the RBNZ to some extent, but here and now, it's far too soon to declare wage-price spiral risks vanquished.

On the other side, there is of course a clear risk that momentum surprises on the downside and the RBNZ calls a halt earlier than we are forecasting. But it's far from a given that economic momentum is about to hit some kind of wall. It's worth remembering that only a third of households have a mortgage. And many of them are still on fixed rates much lower than the rates available today. The average rate actually being paid has gone through 4%, but the proportion of household income being sucked out by mortgage interest payments is still only around half where it peaked in 2008.

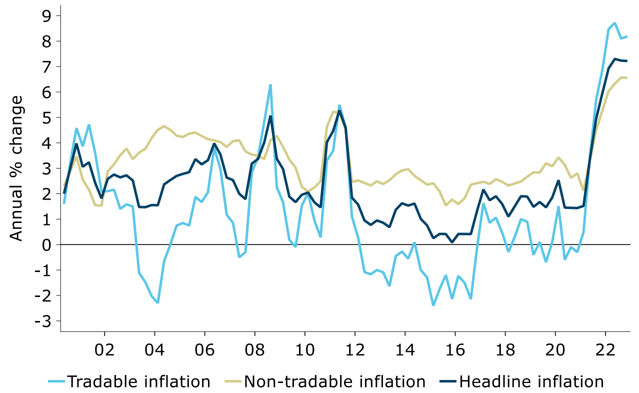
The RBNZ will be wary of giving markets a free rein to start pricing in cuts, which could see fixed mortgage rates fall meaningfully. After all, services inflation is still increasing. In our view, cuts remain firmly off the agenda for the foreseeable future unless some left-field event happens, tightening financial conditions (which is a risk that should be acknowledged, given abruptly tighter global liquidity and interest rates).

Figure 2. Headline CPI inflation



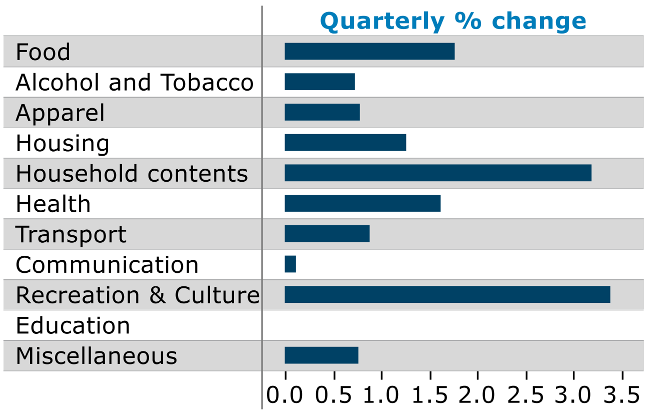
Source: Stats NZ, Macrobond, ANZ Research

Figure 3. CPI inflation components



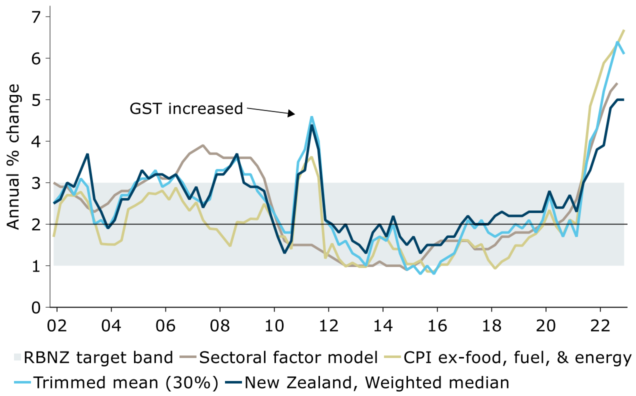
Source: Stats NZ, Macrobond, ANZ Research

Figure 4. CPI groups – December 2022 quarter



Source: Stats NZ, Macrobond, ANZ Research

Figure 5. Core inflation measures



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

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