Economic Note

2021 Q1 CPI Preview

16 April 2021

Firmer inflation outlook to be accommodated for now by RBNZ

- We expect a 0.8% qoq increase in Q4 headline CPI, with annual headline inflation for 2020 edging up to 1.5%, the fourth consecutive quarterly sub-2% outturn.
- However, we expect annual inflation to push towards 2½% next quarter and to remain above 2% for most of the next year or so due to a combination of cost shocks and increasing capacity pressures in some pockets.
- The inflation outlook is still uncertain, with the RBNZ likely to defer from increasing the OCR until it is confident inflation will trend above 2% and the path of the economy and labour market are on a sound footing.

Summary and implications

Our Q1 pick for the NZ CPI is slightly below RBNZ expectations, with annual CPI inflation below the midpoint of the 1-3% medium-term inflation target. Risks are broadly balanced around our pick, but we admit a greater degree of uncertainty given COVID-19 impacts and the uncertain speed and magnitude at which well-publicised cost shocks will filter through into consumer prices. Looking ahead, we expect annual headline inflation to move above 2% for the rest of this year and next as a perfect storm of stretched capacity, supply bottlenecks, and higher costs flow through in consumer prices. For now, we expect the RBNZ to remain patient and defer from raising the OCR until it is confident the expansion is secure, the economy is close to full employment and medium-term inflation drivers are pointing well above 2%. This still some way away and we have pencilled in August 2022, with risks of a later start to OCR hikes.

CPI outturn to undershoot RBNZ projections

We expect consumer prices to increase 0.8% in Q1 with annual CPI inflation to rise to 1.5%. This is a touch softer than the February Monetary Policy Statement (MPS) pick (see table). There is still a greater degree of uncertainty than usual around our CPI pick given COVID-19 impacts. Moreover, it is still unclear how quickly and to what extent well-publicised issues with the movement of global freight and supply chain disruptions impact on consumer prices.

Q1 2021 CPI %	Previous	**ASB**	RBNZ
CPI qoq	0.5	**0.8**	1.0
CPI yoy	1.4	**1.5**	1.7
Non-tradable qoq	0.7	**0.8**	0.8
Non-tradable yoy	2.8	**2.2**	2.2
Tradable qoq	0.2	**1.0**	1.3
Tradable yoy	-0.3	**0.6**	0.9

The major features of the Q1 outturn include:

- Another 2%+ quarterly rise in the transport group (+0.25% contribution to quarterly CPI). A circa 6% climb in petrol prices and rises for vehicle prices are expected. Following their 14.1% Q4 jump, we have assumed little movement in international airfares (more likely to be more heavily influenced by some Trans-Tasman routes at present according to the current methodology), whilst the usual norm is for large Q1 falls. The impact of the Trans-Tasman bubble on airfares will depend on whether it induces a larger increase in demand than the expected increase in flight capacity.
- Higher housing costs (+0.9 qoq, +0.25% contribution to Q4 CPI). Monthly dwelling rents (which feed into the CPI) rose 0.8% in Q1, according to MBIE figures. Current robust housing market conditions and increases for raw materials and stretched capacity should underpin further increases in construction costs and prices for property maintenance services. Moreover, forthcoming moves to gradually remove interest rate deductibility on mortgage

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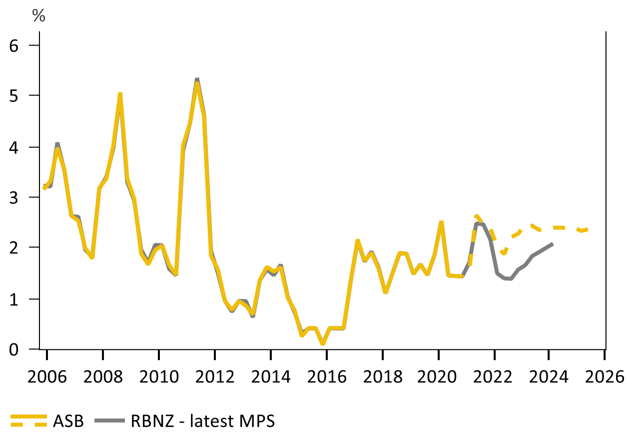
interest payments for residential property investors could push dwelling rents up further over the next few years (adding up to 0.3 percentage points to annual CPI according to our rough estimates).

- Well-publicised issues with the movement of global freight and supply chain disruptions are expected to start to impact. Prices are likely to be higher than otherwise for a number of tradable goods in the recreation & culture, household contents & services and miscellaneous goods & services groups (+0.1% contribution).
- A 0.5% Q1 increase in food prices (+0.1ppt contribution), led by higher prices for grocery food and restaurant meals. Rising global food commodity prices point to a modest pickup in overall food price inflation over 2021.
- Tobacco & alcohol prices are expected to rise a modest 1.2% (+0.1ppt contribution) with the NZ Government only increasing tobacco excise by 1.4% this year as opposed to approximate 10% increases in previous years. This will lower annual CPI inflation over the next year by around 0.3 percentage points, all else equal.
- COVID-19 impacts are continuing to impact the CPI figures. Statistics NZ had earlier made adjustments to the seasonal adjustment methodology to allow for the impact of COVID-19 on seasonal patterns and may make some changes to some historical series in the Q1 data. We envisage these changes will be minor.
- We expect quarterly Q1 inflation readings from the core inflation measures to come in close to the headline rate, with annual core inflation measures to fluctuate either side of 2%. Inflation from the RBNZ Sectoral Factor model is expected to come in slightly below 2% (1.8% in Q4).

But upside risks are building with the focus on the medium term

Upside risks look to be building. As we discussed in our note on the inflation outlook, annual CPI inflation looks set to shortly move above 2% and remain higher than earlier thought due to a combination of positive cost shocks and increasing pressures on (stretched) capacity in some pockets. We have already seen cost and pricing metrics from business surveys lift, with regulatory changes (e.g. removing interest rate deductibility) likely to add to upward pressure. Our CPI profile is noticeably firmer than February MPS forecasts (see chart).

NZ Annual CPI Inflation Forecasts



Source: Macrobond, ASB

Even with these factors, however, there are few signs of the economy overheating, with inflation still looking to be comfortably within the 1-3% inflation target range. Moreover, the further ahead you look the greater the uncertainty and the inflation outlook can move swiftly as developments change. We will be keeping tabs on key medium-term inflationary drivers – including inflation expectations, capacity metrics, and wage growth – and the wider economic and labour market outlook for signs of economic overheating. **The RBNZ can rest easy, for now.**

Market and Policy Implications

Market reaction from the Q1 CPI print should be modest. Our view is that the RBNZ has erred on the side of caution by putting out a high set of Q1 inflation numbers in the February MPS, with risks tilted to the downside. Moreover, the RBNZ and other central banks have been at pains to signal they will accommodate what looks to be a temporary spike in inflation. The RBNZ in Wednesday's Monetary Policy Review expected a "prolonged period to pass" until CPI inflation will be sustained at around 2% and employment will be at (or above) its maximum sustainable level. **To us this looks to be more than a year away: we have penciled in the next OCR hike being in August 2022 or a bit later.**

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