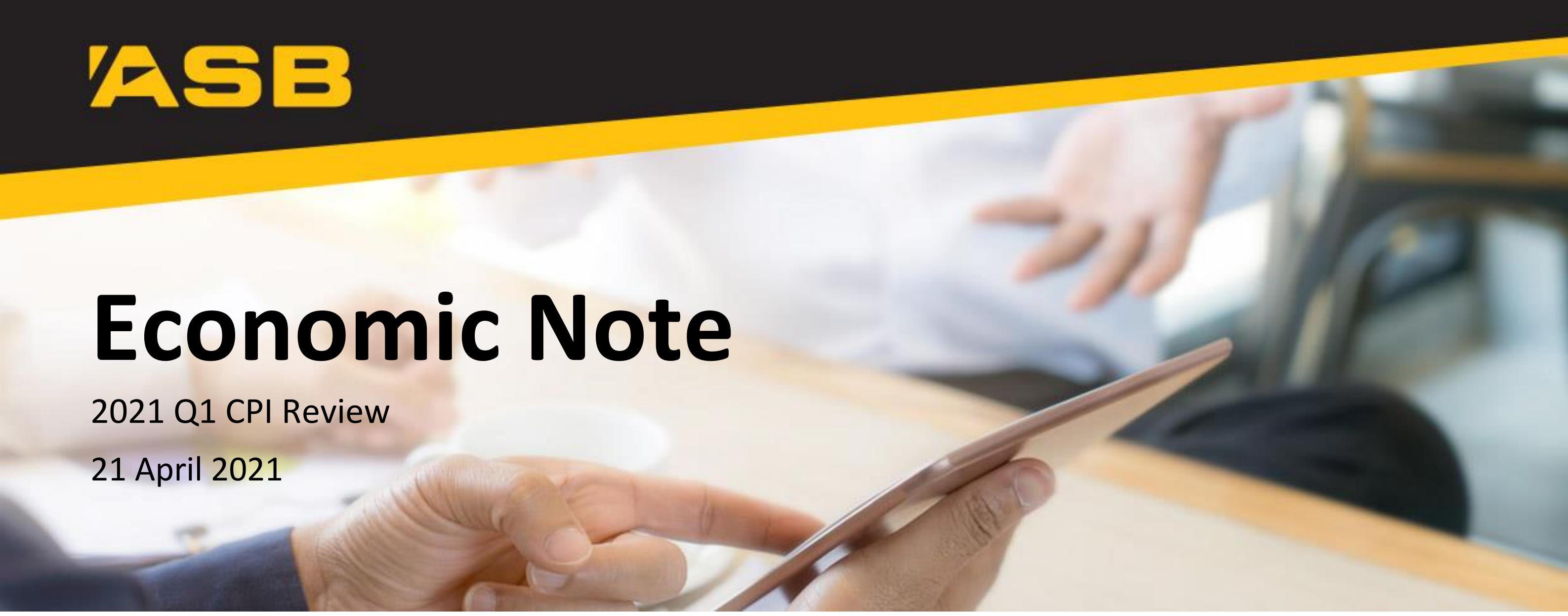


# Economic Note

2021 Q1 CPI Review

21 April 2021

## Lower than expected starting point for RBNZ, but price pressures to build

- Q1 CPI inflation in line with ASB and market expectations, but below the RBNZ pick. Tradable CPI increase was generally softer than the RBNZ expected.
- Looking ahead, we expect annual headline inflation to move above 2% for much of 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 later next year.

**2021Q1 Consumers Price Index**

| | Actual | Market | ASB | RBNZ |
|---|---|---|---|---|
| CPI - qoq | 0.8 | 0.8 | 0.8 | 1.0 |
| CPI - yoy | 1.5 | 1.5 | 1.5 | 1.7 |
| Non-tradable - qoq | 0.7 | | 0.8 | 0.8 |
| Non-tradable - yoy | 2.1 | | 2.2 | 2.2 |
| Tradable - qoq | 0.9 | | 1.0 | 1.3 |
| Tradable - yoy | 0.5 | | 0.6 | 0.9 |

### Summary and implications

Q1 CPI inflation figures were in line with ASB and market expectations and below the RBNZ February Monetary Policy Statement pick. The surprise for the RBNZ was weaker than expected tradable goods prices with well-publicised freight disruptions yet to have much of an impact on consume prices. Nevertheless, we still expect annual headline inflation to move above 2% for much of the rest of this year and next, as a perfect storm of stretched capacity, supply bottlenecks, and higher costs flow through. However, the inflation outlook is still inherently uncertain and there are few signs of the economy overheating, with inflation still looking to be comfortably within the 1-3% inflation target range over the medium term. 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 is still some way away. We have pencilled in August 2022, with risks of a later start to OCR hikes.

### CPI outturn in line with market expectations but undershoots RBNZ projections

Consumer prices rose 0.8% qoq in Q1, bang in line with ASB and market expectations, with annual CPI inflation ticking up to 1.5%.  Looking at the tradable (0.9% qoq, 0.5% yoy) and non-tradable split (0.7% qoq, 2.1% yoy) suggested that the surprise relative to RBNZ expectations were more concentrated in tradable prices.

Mark Smith – Senior Economist  (649) 301 5657  mark.smith4@asb.co.nz

There were only mixed signs of supply chain disruptions impacting on consumer prices. Prices in the recreation & culture (-0.9% qoq), apparel (-0.7% qoq), household contents & services (-1.0% qoq) groups fell despite anecdotes to the contrary. Statistics NZ figures showed that a net 14% of items were discounted in Q1, the same as the March 2020 quarter. A look through the discounting trends by CPI subgroup showed no break on usual seasonal norms. However, we still expect supply disruptions to filter through into consumer prices over the remainder of 2021.

Transport group prices surged 3.9% in Q1, the second consecutive large quarterly increase. Prices for petrol rose (7.2% qoq), with vehicles prices up 2.6% qoq, courtesy of higher prices for used cars. Largely reflecting the return of the trans-Tasman routes, prices for international airfares climbed 10.1% in Q1 after their 14.1% 2020Q4 jump (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. Nevertheless, we don't expect international airfares to return to pre-Covid-19 levels for quite a while yet (if at all). Domestic airfares fell in Q1 (-1.9% qoq).

Housing costs rose (+0.9 qoq, 2.6% yoy). Rents (1.0% qoq), construction costs (1.2% qoq) and property maintenance services (0.8% qoq) all firmed. 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. While forthcoming moves to gradually remove interest rate deductibility on mortgage interest payments for residential property investors should help slow housing market momentum, dwelling rents look set to move higher over the next few years (adding up to 0.3 percentage points to annual CPI according to our rough estimates).

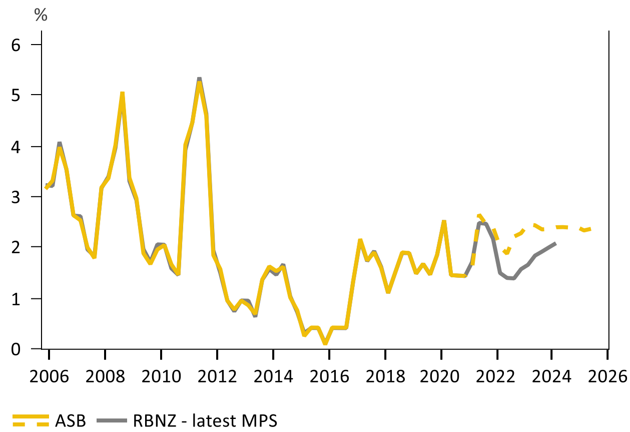
There were other areas where inflation readings were tamer. Food prices rose just 0.6% qoq (1.1% yoy), although rising global food commodity prices point to a modest pick-up in overall food price inflation over 2021. Moreover, the more modest 1.4% increase in the tobacco excise contributed to milder than usual increases for tobacco & alcohol prices (1.6% qoq, 2.5% yoy). All else equal, the lower tobacco excise will dampen annual CPI inflation by around 0.2 to 0.3 percentage points over 2021.

Inflation readings from the core inflation measures were contained, with quarterly increases close to the 0.8% headline CPI print. Annual inflation for both the 10% trimmed mean (1.5% yoy in Q1) and 50% weighted median (2.3% yoy) clustered either side of the 1-3% inflation target midpoint. Excluding food, fuel and energy, annual CPI inflation came in exactly at 2.0% yoy from 2.1% yoy in Q4. Inflation from the RBNZ Sectoral Factor model (released at 3pm today) is expected to come in close to its 1.8% yoy value.

## Outlook and implications

Despite today's contained inflation outturn, upside risks to the inflation outlook are building, as a perfect storm of stretched capacity, supply bottlenecks, and higher costs flow through in consumer prices. As we discussed in our recent note on the inflation outlook, the trajectory for inflation is noticeably firmer than thought to be the case at the end of last year. We expect annual CPI inflation to peak close to 2½% in the June 2021 year and then to spend much of the next few year's hovering just above 2%. However, the inflation outlook is still inherently uncertain.

**NZ Annual CPI Inflation Forecasts**




Source: Macrobond, ASB

What are the RBNZ likely to do? The Q1 CPI inflation outturn was weaker than expected and it showed little evidence of the NZ economy overheating, with inflation still looking to be comfortably within the 1-3% inflation target range over the medium term. However, the RBNZ will be acutely aware that the short-term inflation drivers are still pointing up and that annual CPI inflation is likely to move above 2%.

As such, we expect that the RBNZ will keep close tabs on key medium-term inflationary drivers – including inflation expectations (which have started to tick up), capacity metrics, and wage growth – as well as the wider economic and labour market outlook for signs of economic overheating. In our view this looks some way off and the RBNZ can rest easy for now. This wait, however, will not be forever, and we envisage that the economy will be in sound enough shape and economy-wide and labour market capacity pressures tight enought to warrant the OCR moving up from record lows. However, the RBNZ will take their time and will need to be confident that the expansion is secure, the economy is close to full employment and medium-term inflation drivers are pointing well above 2% before raising the OCR. We have pencilled in August 2022, with risks of a later start to OCR hikes.

## Market Reaction

There was minimal market reaction to the CPI pick, with NZ swap yields up fractionally (2Y +1bp) in the period following the CPI release, with 10-year NZ swap yields about 1bps lower as the CPI release provided no inflationary smoking gun. The NZD had been easing leading up to the CPI release and is currently 10pips lower against the USD.


| **ASB Economics & Research** | | | **Phone** |
|---|---|---|---|
| Chief Economist | Nick Tuffley | nick.tuffley@asb.co.nz | (649) 301 5659 |
| Senior Economist | Mark Smith | mark.smith4@asb.co.nz | (649) 301 5657 |
| Senior Economist | Jane Turner | jane.turner@asb.co.nz | (649) 301 5853 |
| Senior Economist | Mike Jones | mike.jones@asb.co.nz | (649) 301 5661 |
| Senior Economist, Wealth | Chris Tennent-Brown | chris.tennent-brown@asb.co.nz | (649) 301 5915 |
| Economist | Nat Keall | nathaniel.keall@asb.co.nz | (649) 301 5720 |
| Publication & Data Manager | Judith Pinto | judith.pinto@asb.co.nz | (649) 301 5660 |

**www.asb.co.nz/economics**

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