Economic Note

2021 Q2 CPI Preview

13 July 2021

Persistently higher inflation becoming more difficult for the RBNZ to look through

- We expect a 0.8% qoq increase in Q2 headline CPI, lifting annual headline inflation to 2.8% – its highest in a decade and with upside risk.
- Annual CPI inflation looks set to move above 3% over the second half of this year and remain stuck well above 2% next year due to a combination of cost shocks and increasing capacity pressures.
- With inflation set to settle above the midpoint of the 1-3% inflation band and with the economy at (or close to) full employment, we expect the RBNZ to hike the OCR before the end of the year (likely November).

Q2 2021 CPI %	Previous	**ASB**	RBNZ	Market
CPI qoq	0.8	**0.8**	0.6	0.7
CPI yoy	1.5	**2.8**	2.6	2.7
Non-tradable qoq	0.7	**0.7**	0.7	
Non-tradable yoy	2.8	**2.8**	2.9	
Tradable qoq	0.9	**1.0**	0.3	
Tradable yoy	1.4	**2.7**	2.0	

Summary and implications

Courtesy of higher tradable prices, our Q2 pick for the NZ CPI is above RBNZ expectations and the market consensus, with annual CPI inflation towards the top of the 1-3% medium-term inflation target. Annual core inflation measures should remain clustered around 2% but are biased to move higher. Risks are tilted to the upside. There is a greater degree of uncertainty around our pick given COVID-19 impacts and the uncertain speed and magnitude at which well-publicised cost shocks will filter through into consumer prices. Annual CPI inflation is expected to move above 3% over the remainder of this year and remain well above the 2% midpoint of the inflation target over 2022 given stretched capacity, supply bottlenecks, and higher costs. Higher inflation and an economy close to (or at) full employment necessitates the winding back of policy stimulus. ASB expects the RBNZ to raise the OCR by 25bps before the end of this year (likely November), following by a gradual path of OCR hikes and an historically-low 1.50% endpoint.

Annual CPI inflation to get close to 3%

We expect consumer prices to increase 0.8% in Q2 with annual CPI inflation to rise to 2.8%, the highest since the GST-rise induced 4.6% annual rate in 2011. This is higher than the May Monetary Policy Statement (MPS) pick and the market consensus (see table). **Risks around our pick are skewed to the upside** and there is still a high greater degree of uncertainty than usual given COVID-19 impacts. 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.

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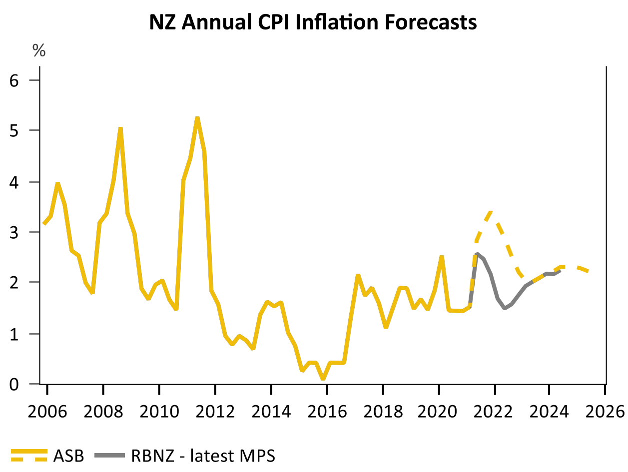
The major features of the Q2 outturn include:

- Higher housing costs (+1.0% qoq, +0.3% contribution to Q2 CPI). Current robust housing market conditions and increases for raw materials and stretched capacity should underpin further increases in construction costs (1.5% expected) and prices for property maintenance services. Monthly dwelling rents (which feed into the CPI) rose 1.0% in Q2, according to MBIE figures. Moreover, forthcoming moves to gradually remove interest rate deductibility on mortgage interest payments for residential property investors could push rents higher still in the coming years. Steep increases in local authority rates alone could add a further 0.2 percentage points to Q3 CPI.
- Another solid quarterly rise for transport prices (+1.7% qoq, +0.2% contribution). A circa 4% climb in petrol prices and rises for vehicle prices are expected, along with increases for used car prices and vehicle accessories. We have assumed little movement in international airfares (more likely to be more heavily influenced by a growing number of Trans-Tasman routes and some to the Pacific according to the current methodology), whilst the usual norm is for modest Q2 increases.
- A 1.6% Q2 increase in food prices (+0.2ppt contribution), led by higher prices for fresh fruit and vegetables (mostly seasonal) and higher prices for takeaways (linked to minimum wage increases). Rising global food commodity prices point to a modest pick-up in overall food price inflation over the next 12 months.
- Well-publicised issues with the movement of global freight and supply chain disruptions should start to become evident. 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).
- We expect quarterly Q2 inflation readings from the core inflation measures to come in below the headline rate, but for annual core inflation measures to edge up, with more moving above 2%.
- Inflation from the RBNZ Sectoral Factor model (currently 1.9% yoy, released at 3pm on Friday) is likely to be closely watched. There is a decent chance in our view that this moves to 2%, or slightly higher – if not in the Q2 CPI print then in subsequent quarters.

Upside risks are building with the focus on the medium term

Upside risks look to be building. As we discussed in our June inflation update, annual CPI inflation looks set to shortly move above 3% and remain higher than previously thought due to a combination of positive cost shocks and increasing pressures on (stretched) capacity. Furthermore, our research highlights that pressures on economy-wide capacity have become more widespread and look set to intensify over the next year or two. Capacity pressures are particularly intense in the labour market, with the economy effectively at (or close to) maximum sustainable employment, notwithstanding some residual weakness in some pockets. Combined with a solid, but uneven, pace of demand-side expansion this will push up medium-term inflation. Our CPI profile over 2021 and 2022 is noticeably firmer than May MPS forecasts (see chart).



Source: Macrobond, ASB

Market and Policy Implications

As a gesture that near-term inflation outcomes don't matter for monetary policy settings, the RBNZ July review will be published just two days *earlier* than the release of the CPI data.

The RBNZ will want to convey its medium-term focus and intent to 'look through' what it believes to be a short-term inflation spike. If the market buys into this, we expect an inflation outcome close to market expectations to attract modest market reaction. Moreover, market pricing could be scaled back, and the NZD drop, from a low CPI print. **If, however, CPI surprises to the upside and higher inflation looks set to stick around, OCR hike odds (currently about 70% priced in for a 25bp hike in November) will firm and the NZD will lift.**

In our view, a solid pace of demand-side expansion (notwithstanding COVID-19 risks), higher inflation and the NZ economy looking to be at (or close to) full employment necessitates the winding back of policy stimulus**. ASB expects the RBNZ to raise the OCR by 25bps before the end of this year (likely November), following by a gradual path of OCR hikes and an historically-low 1.50% endpoint from late 2023.**

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