Economic Note

2021 Q3 CPI Preview

13 October 2021

The Big Bounce

- We expect a 1.7% Q3 increase in headline CPI, lifting annual headline inflation to 4.4% – its highest in a decade.
- Annual CPI inflation looks set to move above 4.5% by the end of the year and remain outside the 1-3% target range until well into 2022, with the risk of a more prolonged overshoot.
- With high inflation running the risk of being entrenched, more OCR hikes are needed over time. However, the RBNZ will likely tread carefully and in small steps.

Q3 2021 CPI %	Previous	**ASB**	RBNZ
CPI qoq	1.3	**1.7**	1.4
CPI yoy	3.3	**4.4**	4.1
Non-tradable qoq	1.2	**1.2**	1.2
Non-tradable yoy	2.8	**3.9**	3.8
Tradable qoq	1.7	**2.3**	1.8
Tradable yoy	1.4	**5.2**	4.7

Summary and implications

Once again, our CPI forecasts are above those of the RBNZ, with our stronger near-term pick due to firmer tradable goods prices. Risks around our Q3 pick are broadly balanced, with a greater degree of uncertainty given COVID-19 impacts and the uncertain speed and magnitude at which cost shocks impact consumer prices. Annual CPI inflation is expected to peak above 4.5% by the end of this year and only slowly subside given stretched capacity. There is the clear risk that the spike in inflation gets engrained in wage and price setting. Higher inflation and an economy close to (or at) full employment over the medium-term horizon necessitates the further winding back of policy stimulus. Still, the RBNZ will likely tread carefully and in small steps. We have pencilled in a further 50bps of OCR hikes by early 2022, with the 1.50% endpoint being reached by late 2022.

Annual CPI inflation above 4%

We expect consumer prices to increase 1.7% in Q3 with annual CPI inflation to rise to 4.4%, the highest since the GST-rise induced 4.6% annual rate in 2011. This is higher than the August Monetary Policy Statement (MPS) pick (see table). Risks around our pick are broadly balanced.

There is still a greater degree of uncertainty than usual around our pick given COVID-19 impacts. The timing of the delta variant lockdown (mid-August) has meant that the good folks at Statistics NZ have gotten more creative. In an updated paper, Statistics NZ outlined a number of adjustments used, including reducing the expenditure weights of items impacted by COVID-19 (airfares, overseas accommodation), more use of administrative data, and imputation for missing items.

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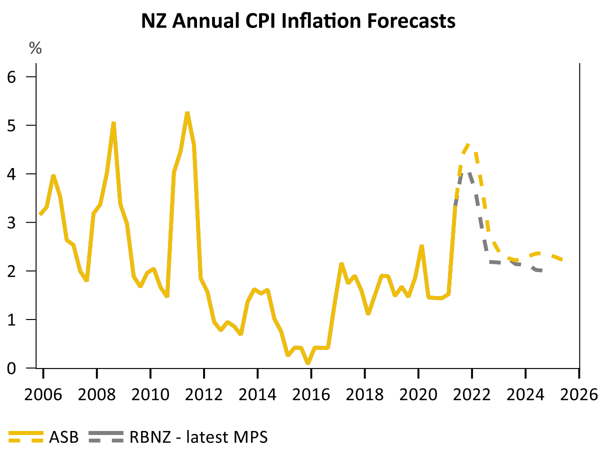
Turning to the details, the major features of the Q3 outturn include:

- A chunky 3.4% quarterly rise for transport prices (+0.4% contribution to Q3 CPI). Fuel excise did not increase in July but surging global oil prices should push up petrol prices by 7.5% in Q3, with more to come in Q4. A small rise is expected for domestic and international airfares. Stock shortages are expected to boost prices for cars and vehicle accessories.
- Higher housing costs (+2.0% qoq, +0.6% contribution). The housing boom and the COVID-19 hit to local authorities are expected to deliver a sizeable circa 7% nationwide increase in local authority rates (+0.2 ppts). Robust housing market conditions, rising prices for raw materials and stretched capacity should further result in sizeable rises for construction costs (2.5% qoq expected) and for property maintenance services. Monthly dwelling rents (which feed into the CPI) rose 0.8% in Q3, according to MBIE figures. However, rising house prices and 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.
- Well-publicised issues with the movement of global freight and supply chain disruptions should become more evident after some tell-tale signs in the Q2 release. 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 (+0.2% contribution).
- A 2.7% Q3 increase in food prices (+0.5ppt contribution), led by higher retail prices for fresh fruit and vegetables (mostly seasonal), and meat, dairy products (linked to high global food commodity prices).
- We expect quarterly Q3 inflation readings from the core inflation measures to come in below the headline rate, but not by much given the multi-faceted sources of price increases. Annual core inflation from the various measures produced by Statistics NZ (10% trimmed mean 3.2% yoy in Q2, 50% weighted median 3.0% yoy, CPI ex food, energy and fuels +3.3% yoy) should move higher still. Inflation from the RBNZ Sectoral Factor model (released at 3pm on Monday) is expected to move above its 2.2% Q2 reading.

Upside risks are building with the focus on the medium term

We have long been wary of two key upside risks. First, that the peak in CPI inflation proves to be higher than considered by the market consensus and the RBNZ. This looks to be happening, with much of the news on the inflation ledger to the upside (including global oil prices at 7-year highs). Our updated forecasts are now pointing to annual CPI inflation exceeding 4.5% by the end of this year.



Source: Macrobond, ASB

The second major risk is that the uplift in inflation ends up having a more persistent impact on consumer prices over the medium term. It is still comparatively early days, but our gut feeling remains that high inflation will stick around for longer. Various cost shocks could easily filter through into widespread price increases. Labour shortages are looking increasingly chronic, with little relief from an open border for a while yet. What's more, consumers (and firms) appear increasingly resigned to having to accept higher prices. Our CPI profile is modestly firmer than the August MPS forecasts (see chart). However, the skew of risks around our point forecasts beyond 2021 are deemed as being more to the upside. The RBNZ has become increasingly attuned to this risk and alluded to the risk of more generalised price increases in the October Monetary Policy Review.

Market and Policy Implications

The RBNZ has (rightly) maintained its focus on the medium term and will 'look through' the near-term spike in inflation. As such, the market relevant aspects of the Q3 inflation print are those that provide clues on the trends in inflation. If core CPI readings and those from analytical measures are weak, some retracement is expected from market pricing. If, however, these measures look like they will continue to build up a head of steam, near-term market pricing will lock in OCR hikes at 25bp increments over the next few meetings, given the RBNZ's 'considered steps' mantra. With possible risks of economic scarring from the delta variant outbreak, 50bp hikes look unlikely in the current juncture. The likelihood is that the RBNZ will be more gradual and less aggressive with OCR moves than the 2.14% mid-2024 OCR endpoint signalled in the August MPS.

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