ASB

Economic Note

Inflation Watch: A perfect storm

5 March 2021

How prolonged will the lift in inflation be?

- We expect annual headline CPI inflation to end up close to 2½% by the end of 2021 as cost shocks and demand pressures from selected pockets filter through into consumer prices.
- Overall annual headline Inflation is set to cool over 2022 as some transitory influences fade, although we don't think the fall in inflation will be as marked as the RBNZ assumes.
- The inflation outlook beyond 2021 is highly uncertain. We will be keeping close tabs on surveyed inflation expectations, capacity gauges and other indicators of pricing pressures.

Summary

Using a simple components-based approach our analysis highlights recent developments in some key drivers of NZ inflation. These point to a 'perfect storm' of looming price increases that will push annual headline CPI inflation towards 2½% by the end of this year. Some of these direct influences are expected to lose their potency (or reverse) which will see CPI inflation ease to around 2% next year. Risks to the RBNZ's inflation outlook over 2021 appear to be balanced but we can see clear upside risks over 2022. The RBNZ are expected to 'look through' the near-term spike in CPI inflation with the OCR to remain on hold at 0.25% over 2021. If, however, inflation holds up over 2022 at a time when the economy is strengthening OCR hikes from next year look more likely. ASB expects the OCR to start moving up from August 2022. We will be focusing on surveyed inflation expectations, capacity gauges and other indicators of trend inflation to ascertain whether our views or those of the RBNZ on inflation turn out to be closer to the mark.

Up, up and away

The inflation outlook has changed markedly compared to six or so months ago when it was believed that weak demand would see deflationary currents reduce economy-wide inflationary pressure. Fast forward to today where we have been pleasantly surprised by the resilience of the NZ economy. In fact, things look to have gone so well that concerns are growing that the NZ and global economies are on the cusp of overheating.

Here we use a simple components-based approach to assess what are the risks of economic overheating in the NZ economy. The approach is ad-hoc but is useful in highlighting some of the key drivers and channels in the inflation process. These include:

- Commodity price sensitive (28% of the CPI regimen). Climbing oil and other commodity prices are expected to flow through into the retail level, with only a partial offset from the strong NZD.
- Retail related (around 17%). Rising costs for freight and raw materials are more likely to show at the retail levels for these goods. We assume that the recent spike in global shipping rates will remain for at least the next six months and will then gradually abate.
- Housing (23%). The booming housing market for existing dwellings is expected to impact housing-related components, including rents, construction costs and dwelling maintenance services. We expect circa 15% annual house price inflation over 2021, which will keep CPI housing indicators elevated.
- Labour market sensitive (19%). Prices for services are particularly sensitive to changes in labour market conditions/wages. Increases to the minimum wage, low labour productivity growth and tightening labour market

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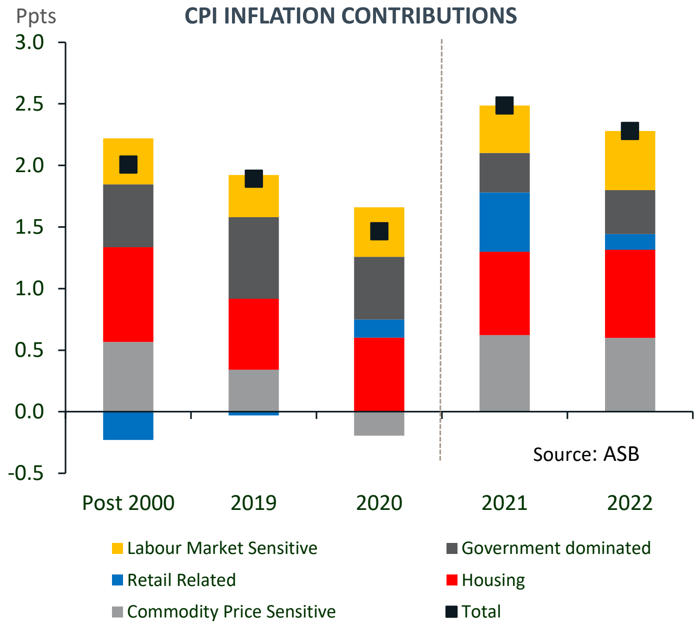
capacity will push prices for goods and services up.

- Government dominated (16%). Administrative charges and retail goods that have a sizeable tax component. It includes goods and services such as local authority rates, tobacco and alcohol prices. No increase in tobacco excise in 2021 and 2022 will likely keep inflation from this component below average.

2½ inflation expected for 2021

The accompanying chart and the summary table and charts at the end of this note summarise trends in the various inflation components. These are almost universally upwards, reflecting a combination of cost-push and demand-pull influences. It is not just a housing market or commodity price story. The usual global disinflationary impacts and high NZD dampening impact look to have been overtaken by higher external costs and prices.



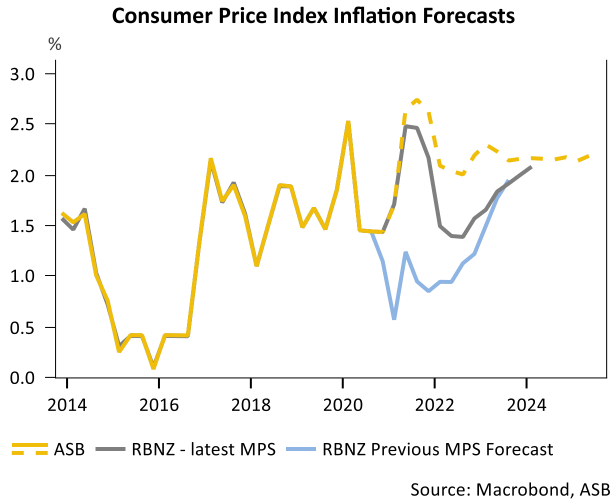
2022 outlook is less clear

Our inflation indicators have more of a short-term focus, and the further ahead you look the greater the uncertainty. Nevertheless, it is the fact that rising prices are a combination of widespread influences that underpins our expectation that supposedly transitory inflation influences have a more enduring impact on inflation.

This might not necessarily mean that the RBNZ will put up interest rates. The RBNZ's inflation target is flexible (i.e. over a medium-term horizon) and symmetric (inflation outcomes above the inflation target midpoint should be treated the same as inflation undershoots). Higher costs are a medium-term inflation suppressant as they weigh on economic activity. As such, even if inflation lifted by more than what we expect in the short term, the RBNZ will likely 'look through' the spike in inflation if it was confident it was transitory. This is hard to know in advance and a leap of faith is required.

What could go wrong and what are we watching?

The risk is that inflation does not ease over 2022 if what at first seems a temporary spike in inflation turns out to be more enduring. In this case the OCR goes up, likely in 2022 when medium-term inflationary pressures are likely to be increasing. ASB expects an August 2022 start to RBNZ hikes.

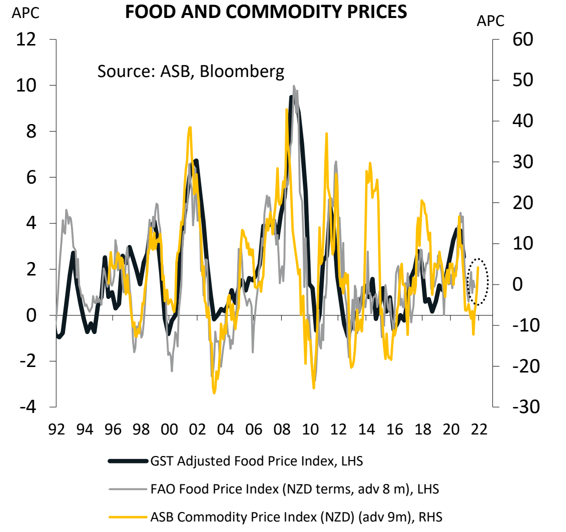


In advance it can be difficult to discern whether the lift in inflation will be persistent, particularly when inflation drivers are pointing in the same direction. Our watchlist includes the following:

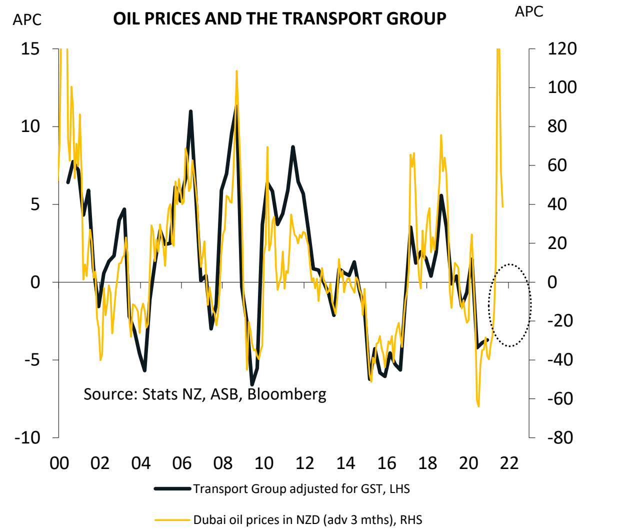
- Inflation expectations – Surveyed costs and pricing intentions have spiked (to an elevated 71.9% and 46.2%, respectively, in the February ANZ Busines Outlook), but surveyed inflation expectations from business surveys have remained mostly around 2%. If short-term pricing metrics remain elevated and inflation expectations firm it suggests we may not see actual inflation dip that much over 2022.
- Capacity gauges – The economy has been through the ringer and the inflationary speed limit may be lower as a result. A tightening in capacity metrics in the labour market and economy in general could be the forerunner to a firming in medium-term inflationary pressure.
- Economic momentum – The economy has surprised with its resilience. It could surprise again, considering the extent of pent-up demand that could be unleashed when COVID-19 is finally brought under control.

SELECTED CHARTS

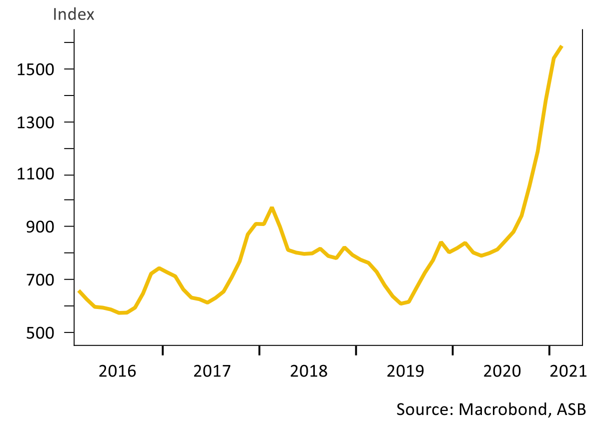
FOOD AND COMMODITY PRICES



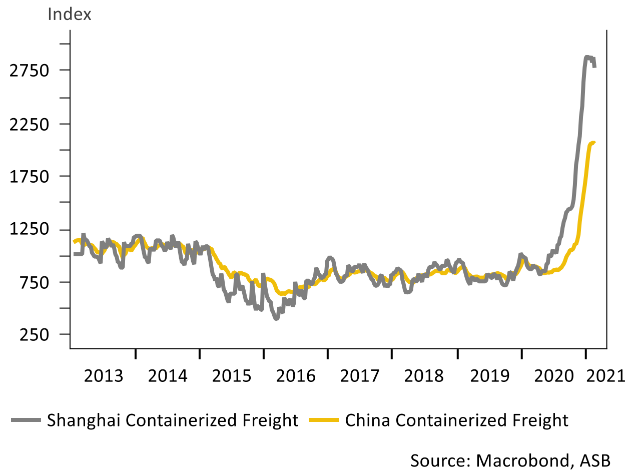
OIL PRICES AND THE TRANSPORT GROUP



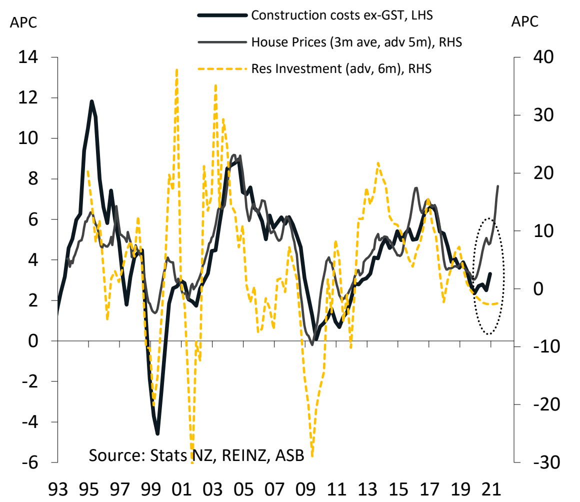
China, Freight Indicators, China Container Freight Rate, Australia/New Zealand Service, Index



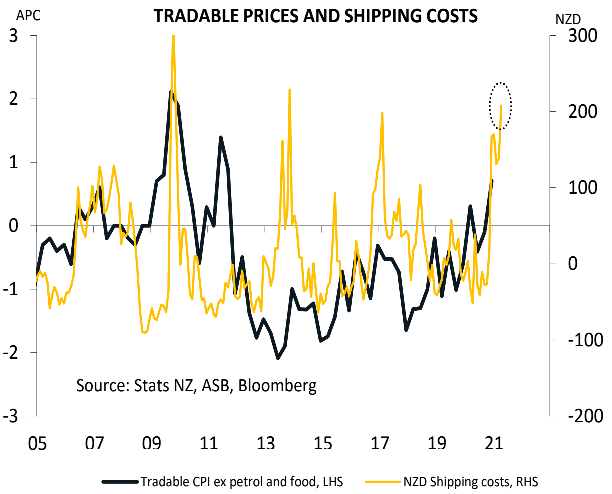
China, Shanghai Shipping Exchange, Shipping, Index



CONSTRUCTION COSTS AND HOUSE PRICES



TRADABLE PRICES AND SHIPPING COSTS



SUMMARY TABLE

CPI Annual % Change (ex-GST change)	CPI Weight	Post 2000 average increase	ppt	*End 2020 (est)*	*ppt*	*End 2021 (est)*	*ppt*	*Mid 2022 (est)*	*ppt*
Commodity Price Sensitive	**27.7**	**1.9**	***0.5***	**-0.5**	***-0.2***	**2.4**	***0.6***	**2.2**	***0.6***
Food prices	18.7	2.2	*0.4*	*2.5*	*0.5*	*1.0*	*0.2*	*2.0*	*0.4*
Petrol	3.6	3.9	*0.1*	*-12.4*	*-0.4*	*6.0*	*0.2*	*2.5*	*0.1*
Transport services	5.4	-0.5	*0.0*	*-3.2*	*-0.2*	*5.0*	*0.3*	*2.5*	*0.1*
Housing	**22.5**	**3.2**	***0.7***	***2.7***	***0.6***	***3.2***	***0.7***	***3.2***	***0.7***
Rents	10.3	2.2	*0.2*	*2.9*	*0.3*	*3.3*	*0.3*	*3.3*	*0.3*
Construction costs	8.7	4.2	*0.4*	*3.3*	*0.3*	*4.0*	*0.3*	*4.0*	*0.3*
Other	3.6	3.8	*0.1*	*0.5*	*0.0*	*1.0*	*0.0*	*1.0*	*0.0*
Retail Related	**17.1**	**-2.5**	***-0.2***	***0.9***	***0.1***	***2.8***	***0.5***	***0.8***	***0.1***
Retail goods excl cars	12.9	-3.8	*-0.4*	*1.2*	*0.1*	*2.8*	*0.4*	*1.0*	*0.1*
Car prices	4.3	1.5	*0.1*	*0.0*	*0.0*	*3.0*	*0.1*	*0.0*	*0.0*
Government dominated	**16.0**	**3.8**	***0.5***	**4.2**	***0.5***	**2.0**	***0.3***	**2.2**	***0.4***
Government dominated sectors	5.9	3.7	*0.2*	*1.9*	*0.1*	*2.0*	*0.1*	*2.5*	*0.1*
Alcohol and tobacco	7.5	3.9	*0.3*	*6.0*	*0.4*	*2.0*	*0.1*	*2.0*	*0.1*
Labour Market Sensitive	**19.2**	**1.9**	***0.4***	**2.1**	***0.4***	**2.0**	***0.4***	**2.5**	***0.5***
Private sector services	19.2	1.9	*0.4*	*2.1*	*0.4*	*2.0*	*0.4*	*2.5*	*0.5*
TOTAL	**100**	2.0	***2.0***	***1.4***	***1.4***	***2.5***	***2.5***	***2.2***	***2.2***
Non-tradable CPI		**3.0**		***2.8***		***2.7***		***2.9***	
Tradable CPI		**0.7**		***-0.6***		***2.3***		***1.2***	
Core Measures									
Sectoral Factor Model		**2.0**		***1.8***		***2.2***		***2.4***	

Source: Statistics NZ, RBNZ, ASB

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