Economic Note

Inflation Watch and the OCR

21 October 2021

Higher for longer

- Annual CPI inflation will reach close to 6% at the end of this year and is likely to remain persistently elevated well into 2022.
- **We have revised up our interest rate forecasts, with the OCR to peak at 2% in late 2022 (previously 1.5%).**
- Going forward, we will be keeping close tabs on the labour market and inflation anchors for signs of a concerted shift.

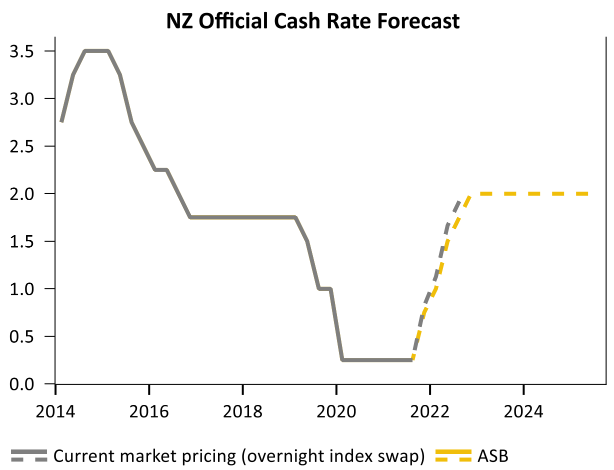
Summary

The inflation outlook has significantly deteriorated in recent months, reflecting a perfect storm of demand, supply and cost influences. Our analysis points to a higher peak in near-term inflation and for elevated inflation pressures to persist through into much of 2022 (and possibly beyond). Annual CPI inflation is expected to end 2021 at close to 6% and may still be above the RBNZ's target band over the first half of 2023. Higher and more persistent inflation pressures will make the job of reining in inflation that much more challenging for the RBNZ. **We now expect a steady sequence of 25bp hikes from the RBNZ, with the OCR to peak at 2% by late 2022**, versus a 1.5% peak previously. However, there remains a significant amount of uncertainty over the outlook, particularly further into 2022. Going forward, we will be keeping close tabs on the labour market and inflation anchors.

Up, up and away on inflation with a higher OCR peak

In a series of notes (see here and here) we flagged the risks of a strong and broad-based pick-up in inflation from a widespread series of demand and supply sources. **This looks to be underway, and to be fair the suddenness and strength at which inflationary pressures have surfaced has shocked even us.** With CPI inflation set to peak higher than previously expected and to remain more persistent, we expect medium-term inflation expectations could also continue to lift. Stronger and more engrained inflation pressures mean the RBNZ now has more work to do to achieve necessary levels of real interest rates that are required to bring inflation back towards target. In addition, the step higher in inflation expectations looks to have (as least temporarily) halted the downward trend evident in our estimated neutral OCR (currently 1.75%), which is now actually edging up. If our neutral OCR estimates are on the money, this means that the RBNZ now has to lift the OCR by more to achieve the same braking impact on inflation pressures.

In recognition of both of these factors, we have revised up our OCR profile and expect a steady series of 25bp hikes, with the OCR to reach a peak of 2% in late 2022, as compared to 1.5% previously.



Source: Macrobond, ASB

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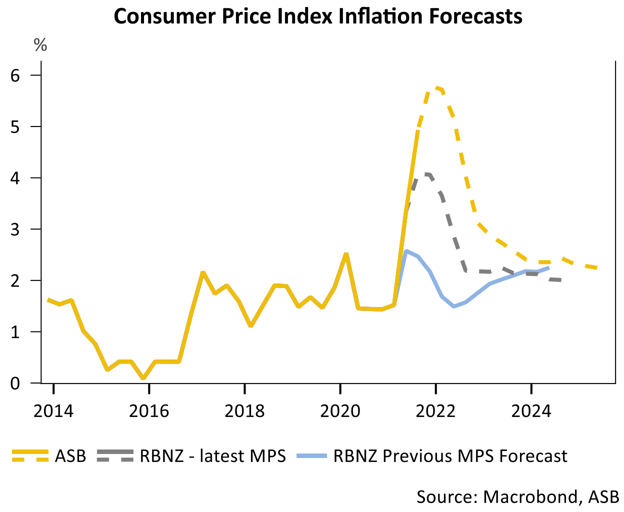
Inflation pressures stronger and more persistent

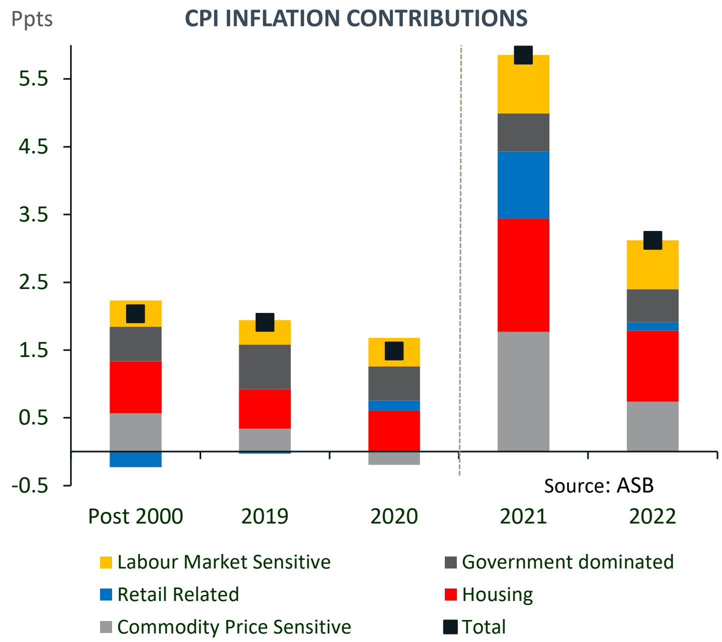
Our updated forecast now suggests annual CPI inflation should rise to towards 6% by the end of this year. This reflects a myriad of demand, supply and market/non-market influences that are pointing in the same direction (upwards).

Our forecast also has CPI inflation moderating more gradually than previously – and CPI inflation is still above 3% - the top end of the inflation target - in early 2023. Persistently higher costs from a number of sources, increasing pressures on (reduced) productive capacity, and the likelihood that higher headline inflation filters through into inflation expectations also point to the uplift in inflation persisting. **The more prolonged that some of these disturbances last, the greater the potential impact they will have on wage and price setting.** It is possible that high inflation outcomes could persist well into 2023 and beyond. This would be problematic for the RBNZ.



Key drivers of NZ CPI inflation and recent changes to the outlook

- **Commodity price sensitive components** (28% of the CPI regimen). Strengthening energy and other commodity prices are expected to flow through into the consumer level, with only a partial offset from the NZD. *Inflation from this source looks to have increased compared to our last update back in June.*
- **Retail-related components** (around 17%). Rising costs for freight and raw materials are more likely to put upward pressure on retail goods. We had earlier assumed that the recent spike in global shipping rates would abate as 2021 ends. *Sadly, there are few signs this is occurring, and stock shortages/higher retail good prices are likely to be feature of the landscape for a while yet. The situation could get worse before it gets better.*
- **Housing** (23%). Rising costs for raw materials, stock shortages and intensifying capacity constraints are expected to boost construction costs and dwelling maintenance fees. Rental inflation to date has been moderate and is expected to nudge higher given the resilient housing market backdrop and the gradual reduction of interest rate deductibility for investor borrowing. *All up, housing-related inflation looks set to be firmer.*
- **Labour market sensitive components** (19%). Prices for services are particularly sensitive to changes in labour market conditions/wages. Elevated labour shortages, low labour productivity growth and tightening labour market capacity has already pushed prices for goods and services up and is likely to continue to do so as workers demand compensation for higher living costs. *Recent anecdotes suggest inflation from this channel will likely be more marked and persistent than what we had earlier expected.*
- **Government-dominated components** (16%). These include administrative charges and retail goods that have a sizeable tax component. These items include 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, although it is looking increasing likely that the 2021 jump in local authority rates is not a one-off.*



Additonal factors for the RBNZ to consider

The RBNZ is mandated to look at medium-term inflation, so a short-term spike in inflation should not be an issue if wage- and price-setters are confident that inflation will settle within the 1-3% target range. **The trouble is that the medium-term horizon is not known with any degree of certainty at the time that the RBNZ makes it monetary policy decisions.** It can be difficult to discern whether the lift in inflation will be persistent, given that uncertainty tends to climb the further ahead you look. Our watchlist includes the following:

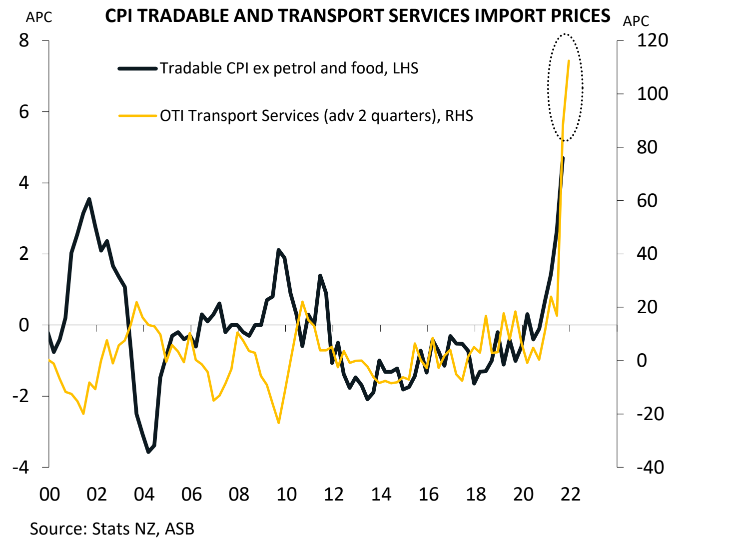
- **The labour market** – the other key monetary policy objective. The labour market was effectively at full employment prior to the recent delta outbreak. Some job losses and economic scarring from the recent delta outbreak are to be expected, but courtesy of truncated labour supply and fiscal policy support, the unemployment rate is expected to remain in the low to mid-4s heading into 2023.
- **Inflation expectations** – 2-year-ahead inflation expectations have already edged higher and, with inflation set to remain persistently elevated, further increases in inflation expectations are likely. If inflation expectations become unanchored from the 2% mid-point, this will be problematic to the RBNZ.
- **Capacity gauges** – elevated capacity metrics are a key indicator of firming medium-term inflationary pressure. The Q3 NZIER Quarterly Survey of Business Opinion survey showed that, prior to COVID hitting NZ, labour shortages and surveyed capacity utilisation was at (or close to) record highs. While the NZ COVID outbreak could result in a temporary dip, it's likely to be small relief relative to the extreme pressure there has been on capacity through the first half of 2021.
- **Economic momentum** – the economy has surprised with its resilience with a sizeable bounce from the 2020 lockdown. Delta is a different ballgame and Auckland is set to spend a long time in restrictive Alert Level 3 settings. There are growing concerns around long-lasting scars and a slower economic recovery as a result. In saying that, NZ's vaccination progress has been promising, and high levels of vaccination are key for the economy getting back on track in early 2022.

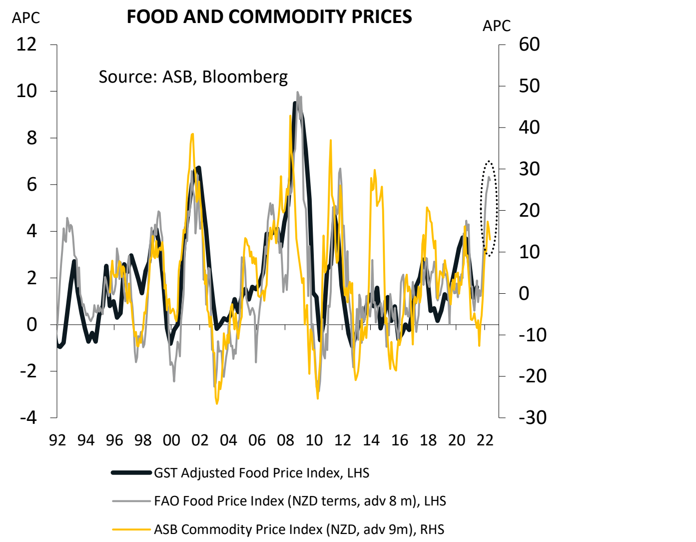
SUMMARY TABLE

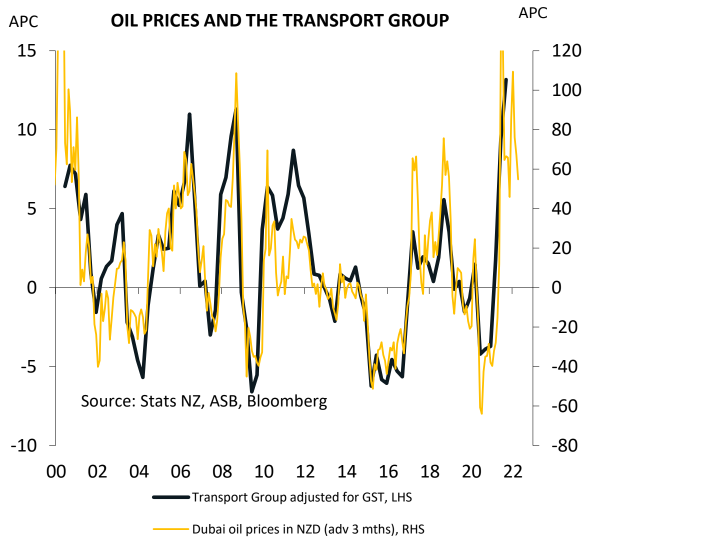
CPI Annual % Change (ex-GST change)	CPI Weight	Post 2000 average increase	ppt	*End 2020*	*ppt*	*End 2021 (est)*	*ppt*	*End 2022 (est)*	*ppt*
Commodity Price Sensitive	**27.7**	**1.9**	***0.5***	**-0.5**	***-0.2***	**6.6**	***1.8***	**2.7**	***0.7***
Food prices	18.7	2.2	*0.4*	*2.5*	*0.5*	*3.5*	*0.7*	*2.5*	*0.5*
Petrol	3.6	3.9	*0.1*	*-12.4*	*-0.4*	*25.0*	*0.9*	*3.0*	*0.1*
Transport services	5.4	-0.5	*0.0*	*-3.2*	*-0.2*	*5.0*	*0.3*	*3.0*	*0.2*
Housing	**22.5**	**3.2**	***0.7***	***2.7***	***0.6***	***7.4***	***1.7***	***4.6***	***1.0***
Rents	10.3	2.2	*0.2*	*2.9*	*0.3*	*3.5*	*0.4*	*3.5*	*0.4*
Construction costs	8.7	4.2	*0.4*	*3.3*	*0.3*	*15.0*	*1.3*	*7.5*	*0.6*
Other	3.6	3.8	*0.1*	*0.5*	*0.0*	*0.5*	*0.0*	*1.0*	*0.0*
Retail Related	**17.1**	**-2.5**	***-0.2***	***0.9***	***0.1***	***5.8***	***1.0***	***0.8***	***0.1***
Retail goods excl cars	12.9	-3.8	*-0.4*	*1.2*	*0.1*	*6.0*	*0.8*	*1.0*	*0.1*
Car prices	4.3	1.5	*0.1*	*0.0*	*0.0*	*5.0*	*0.2*	*0.0*	*0.0*
Government dominated	**16.0**	**3.8**	***0.5***	**4.2**	***0.5***	**3.5**	***0.6***	**3.1**	***0.5***
Government dominated sectors	5.9	3.7	*0.2*	*1.9*	*0.1*	*4.5*	*0.3*	*3.8*	*0.2*
Alcohol and tobacco	7.5	3.9	*0.3*	*6.0*	*0.4*	*2.8*	*0.2*	*2.5*	*0.2*
Labour Market Sensitive	**19.2**	**2.0**	***0.4***	**2.2**	***0.4***	**4.5**	***0.9***	**3.8**	***0.7***
Private sector services	19.2	2.0	*0.4*	*2.2*	*0.4*	*4.5*	*0.9*	*3.8*	*0.7*
TOTAL	**100**	2.0	***2.0***	***1.4***	***1.4***	***5.8***	***5.9***	***3.1***	***3.1***
Non-tradable CPI		**3.0**		***2.8***		***5.8***		***4.4***	
Tradable CPI		**0.7**		***-0.6***		***5.8***		***1.2***	
Core Measures									
Sectoral Factor Model		**2.1**		***2.0***		***3.1***		***2.9***	

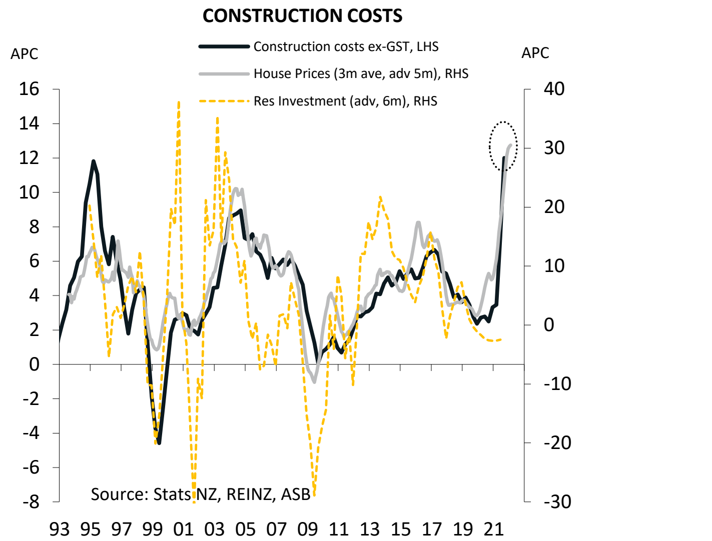
Source: Statistics NZ, RBNZ, ASB

SELECTED CHARTS









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