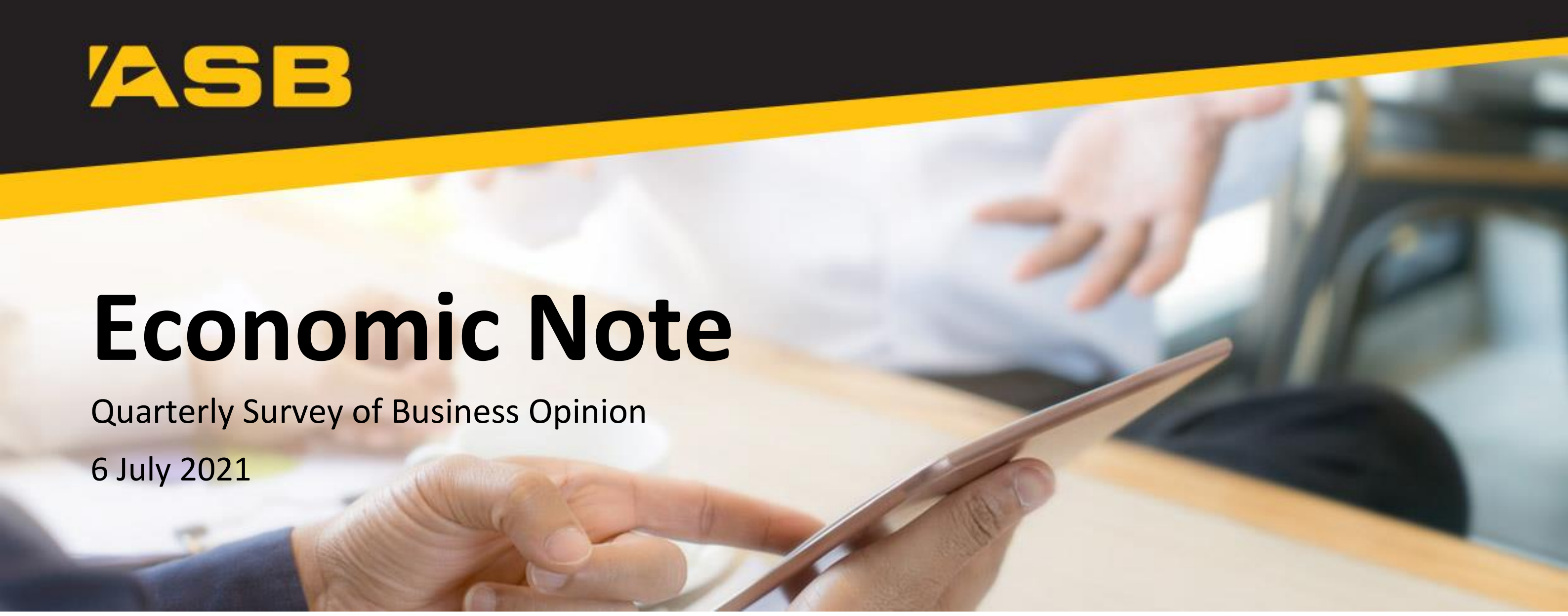


Economic Note

Quarterly Survey of Business Opinion

6 July 2021

Inflation pressures hit rapid boil

- Q2 QSBO confirms extreme labour market capacity pressures, suggesting strong lift in wage inflation.
- Inflation set to lift strongly over the coming year; in aggregate firms appear able to pass on cost increases.
- Stronger wage growth coupled with generalised CPI increases are a risky mix for the RBNZ, we expect the RBNZ to start normalising the Official Cash Rate from November this year.

Summary & implications

The Q2 NZIER Quarterly Survey of Business Opinion was extraordinarily strong. Along with anticipated lifts in demand indicators, capacity pressures squeezed higher and inflation indicators surged. The labour market is exceptionally tight, showing signs the labour market will return to the frothiness of 2005-2006. Difficulty finding labour is at record highs and we expect that wage inflation will soon lift strongly.

It is very clear that record amounts of monetary stimulus are no longer needed to support the economy. With inflation risks getting too high for comfort, we now expect the RBNZ to start lifting the OCR from November this year (previously May 2022).

Demand strong across the board

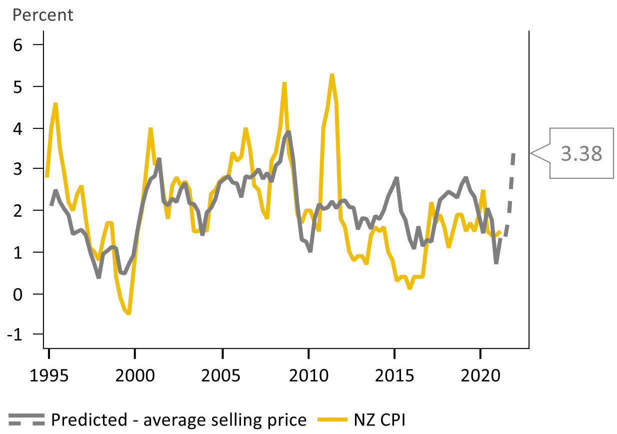
The Q2 NZIER Quarterly Survey of Business Opinion was exceptionally strong across the board. Activity indicators for Q2 suggest quarterly rates of GDP growth of 1%+ and this strength appears to be broad based across sectors, including services, manufacturers, builders, and merchants.

INFLATION INDICATORS	Jun-21	Mar-21	Hist ave
Capacity Utilisation (%)	*94.9*	93.3	90.2
Costs (Past 3 Months, s.a.)	*52.7*	35.0	27.5
Costs (Next 3 Months, s.a.)	*49.9*	46.6	27.0
Selling Prices (Past 3 Months, s.a.)	*38.5*	6.7	11.7
Selling Prices (Next 3 Months, s.a.)	*53.2*	27.4	19.5

Inflation pressures heat up

Our focus for this quarter's survey was the degree to which capacity pressures have tightened and inflation pressures are rising. A net 39% of firms increased selling prices over Q2 – up from net 7% in Q2 – and a larger lift than we had expected. This indicator is consistent with annual CPI inflation lifting to around 3.4%. We feel the risk is that inflation pressures will move higher.

NZ CPI and NZIER Pricing Outcomes



Source: Macrobond, ASB

A rise in cost pressures is driving pricing higher – but with profitability measures also improving there is little sign that firms

Jane Turner – Senior Economist (649) 301 5853 jane.turner@asb.co.nz

(in aggregate) are needing to absorb these higher costs.

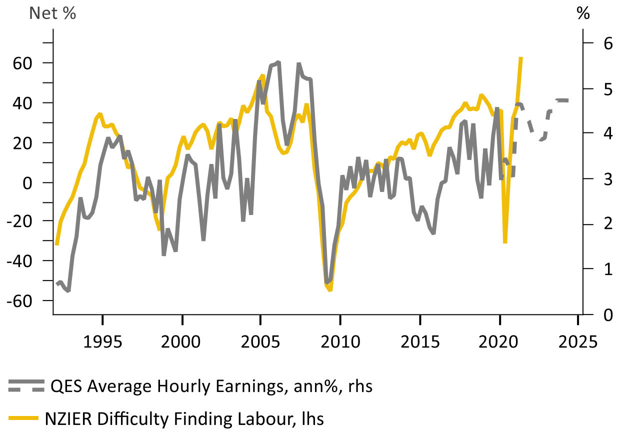
The great debate among economists, both domestically and abroad, is if the current increase in cost pressures due to the COVID-19 induced supply shock are transitory or permanent. While global economic supply will eventually catch up to demand, we have yet to see any sign that this has happened quite yet, and the risk is that 'transitory' becomes a process which lasts at least a year, if not longer. In the meantime, a sustained lift in inflation over the coming year is likely to drive inflation expectations higher.

Labour market hot like it's 2005

LABOUR MARKET INDICATORS	Jun-21	Mar-21	Hist ave
Number Employed (Past 3 Months, s.a.)	*15.3*	4.8	0.1
Number Employed (Next 3 Months, s.a.)	*24.1*	20.3	4.1
Labour Shortages (Skilled)	*69.6*	49.2	27.3
Labour Shortages (Unskilled)	*56.5*	26.4	4.5
Factor Constraints (Labour)	*25.1*	18.3	11.7

From a domestic perspective, the key red flag in the QSBO was the extent of tightening in labour market pressures. Difficulty of finding labour and labour as a limiting factor are at record highs. Labour turnover surged in Q2, evidence that firms are now poaching staff off each other. NZ's domestic demand is strong, fuelled by a strong fiscal and monetary policy response to COVID-19 pandemic, and subsequently resulting in resilient household income growth and household demand. However, the supply of labour is constrained by necessary border restrictions, and labour supply cannot easily grow to meet strong economic demand in the short term. As a result, we expect wage inflation to lift strongly over the coming year. Indicators clearly suggest the labour market is likely to return to the frothiness of 2005-2006.

Difficulty Finding Labour and Average Hourly Earnings



Source: Macrobond, ASB

RBNZ needs to normalise rates to keep inflation expectations in check

The heady mix of strong household income growth, underpinned by stronger wage inflation, coupled with generalised and broad-based CPI price increases is a wage-inflation spiral waiting to happen. Inflation expectations have started to creep higher and will likely continue to lift over the coming year. Against of backdrop of higher inflation expectations, the RBNZ is likely to become increasingly uncomfortable leaving the OCR at emergency settings. We now expect the RBNZ to start lifting the OCR from November this year (previously May 2022).

ASB Economics & Research			**Phone**
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Jane Turner	Jane.turner@asb.co.nz	(649) 301 5957
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
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
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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

Any valuations, projections and forecasts contained in this document are based on a number of assumptions and estimates and are subject to contingencies and uncertainties. Different assumptions and estimates could result in materially different results. ASB does not represent or warrant that any of these valuations, projections or forecasts, or any of the underlying assumptions or estimates, will be met.