ANZ Research

NZ Forecast Update: Inflation with a 4-handle

20 July 2021

Contact

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Inflation with a 4-handle

Bottom line

- We expect that CPI inflation will reach a high of 4.2% y/y in Q3 2021, as shipping disruptions, the border closure, materials costs and other one-off factors (eg rates increases) see prices surge. Underneath all this is a strong underlying inflation impulse, driven by the very tight labour market, rising inflation expectations, and firms finding that they have the power to pass on higher costs to consumers.
- We've revisited our assessment of capacity pressure. We expect the output gap will be positive (and close to pre-GFC levels) over 2021 and 2022. The economy is trying to grow faster than supply constraints will allow, and all else equal this will only increase the inflation pressure that's building in the domestic economy.
- We think that the sizeable underlying momentum in inflation and capacity pressure necessitates higher interest rates. We are forecasting the OCR will be lifted 25 basis points at the August MPS, with subsequent hikes at each MPS until the OCR reaches 1.75% in November 2022. However, the strength in inflation means that an October hike is a possibility.
- We continue to expect that inflation will drop to more sustainable levels as we move through 2022, reflecting easing supply disruptions, the unwinding of temporary (but persistent) factors, and as tighter monetary conditions do their thing. We expect inflation to settle at 2% y/y by the end of 2023.

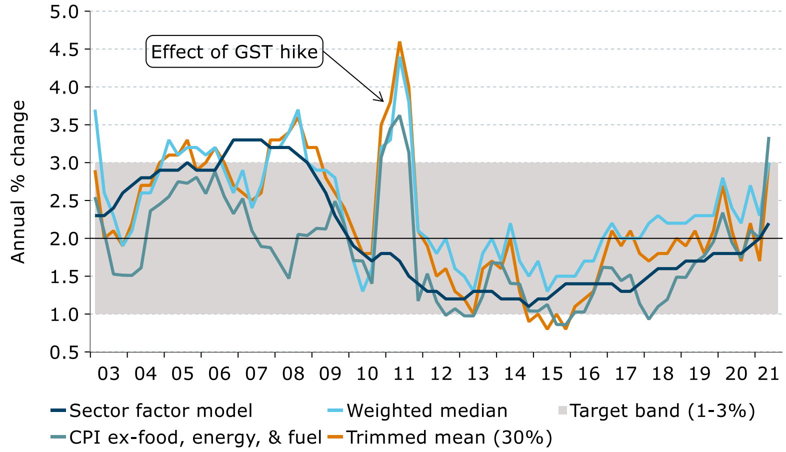
Underlying inflation pressure is building rapidly

Consumer prices increased 1.3% q/q (3.3% y/y) in the June quarter. That was stronger than our already-high forecast of 3.0%, and far stronger than the RBNZ's expectation that inflation would briefly rise to 2.6% y/y, before quickly dropping below the 2% midpoint. While there're definitely a lot of temporary factors pushing up inflation, it's also clear that the underlying inflation pulse is much stronger than anticipated.

A useful marker of this strength is the sharp rise in measures of core inflation we saw in Q2. While some of these measures can be influenced by one-off factors that impact the wider CPI basket (the 2010 rise in GST being a prime example), even the slow-moving sectoral factor model has sharply ticked up to 2.2% y/y, suggesting there's genuine pressure coming through (figure 1).

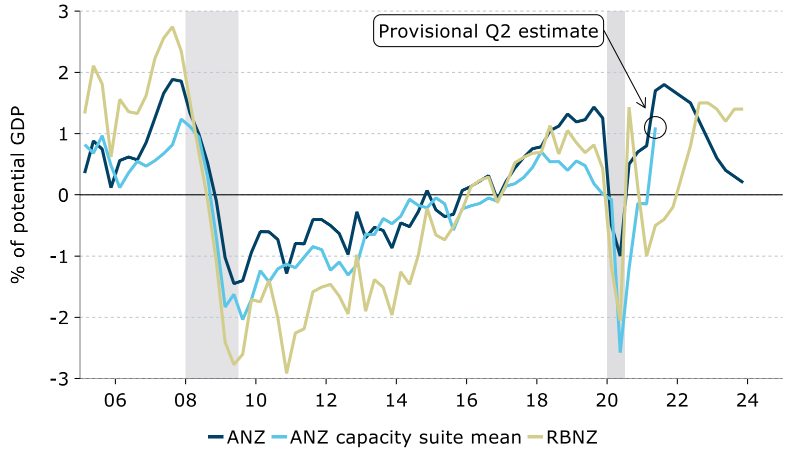
There's still a lot of noise in the data, but it's clear that the economy as a whole is very supply-constrained at the moment, and this is pushing the underlying inflation trend higher. We've revisited our assessment of capacity pressure in the economy in the wake of strength in recent data on prices (CPI) and capacity constraints (eg ANZBO, QSBO, and job ads). We think the output gap is currently well-above zero, and likely to remain so over the next year (figure 2). That is, the economy is currently trying to grow faster than COVID disruptions and labour shortages will sustainably allow. With goods in short supply, the labour market at or around full employment, and labour demand continuing to rise, demand in the economy is surging ahead of supply (ie a positive output gap). That puts a lot of pressure on costs, and importantly, we've seen firms passing on these rising costs to consumers.

Figure 1. Core inflation



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Figure 2. Output gap



Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond

Inflation over the next year

In the near term we expect very strong inflation of 4.2% y/y (1.5% q/q) in the September quarter (figure 3). This reflects a continuation of the drivers we've seen recently: housing costs, transport costs (in particular petrol and car prices), and food prices. In Q3 we can also add larger-than-usual council rate rises to the mix too. And the shipping disruptions from COVID are showing no signs of slowing, with costs continuing to surge at an almost exponential pace. Obviously that can't continue forever, and we do expect a sizeable retracement of some of these price increases in the future. But for now, these costs continue to put pressure on consumer prices.

A big source of uncertainty is the path of oil prices over the quarter. In recent days oil prices have taken a hammering, as OPEC+ agreed to increase output, and concerns about the spread of the Delta COVID variant have started to weigh on trading-partner growth expectations. If sustained, weaker oil prices could see inflation come in a touch below what we're forecasting in Q3.

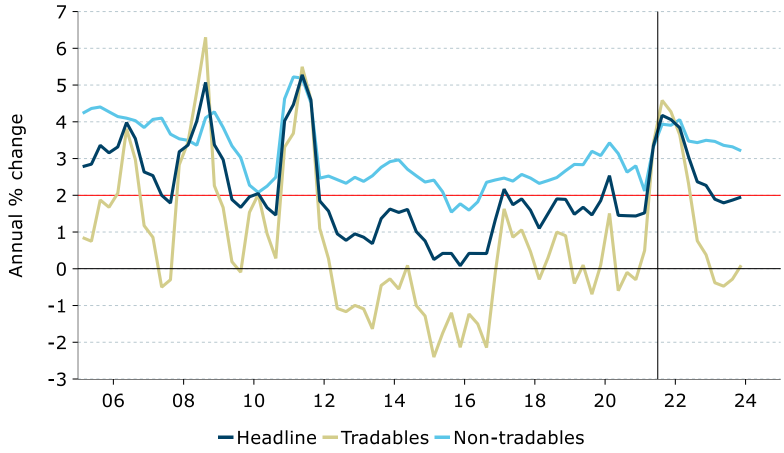
Underlying all of these details we also have a tight labour market, positive output gap, rising inflation expectations, and firms finding that they are able to pass on higher costs to consumers. When we add everything together, it's hard not to conclude that the strong inflation prints have only just begun. Without an immediate reduction in the level of monetary stimulus (which starts this week with the end of the LSAP), it's quite likely that inflation will continue to build, and inflation expectations could become dis-anchored from the 2% target midpoint.

We expect that the RBNZ will lift the OCR 25 basis points at the August meeting, and at subsequent MPS releases until the OCR reaches a terminal rate of 1.75% at the end of 2022. But, the very strong inflation momentum that's coming through in the data means that an October hike can't be ruled out. There is still some need for caution though – extreme household indebtedness means that even small interest rate rises could be very potent, and the resurgence in COVID cases around the world and their potential impact global activity is another reason to remain cautious.

Inflation over the medium term

While we have incorporated a much stronger inflation outlook over the next year, we continue to expect price rises to return to a more normal level over the next few years (figure 3). This reflects two key factors.

Figure 3. Inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

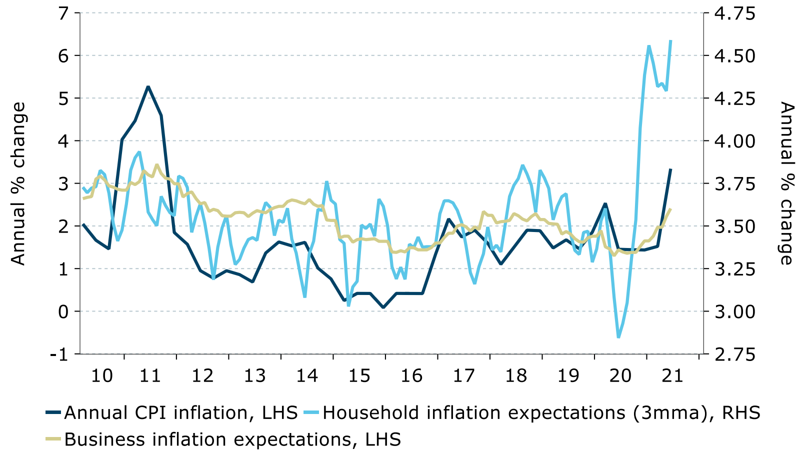
Firstly, we think that OCR hikes will be very effective at taking some of the wind out of the economy's sails. That should put a dampener on domestic inflation pressures, and help to contain rampant household inflation expectations. But the tight labour market should still keep non-tradables running slightly over 3% y/y. This will be essential for meeting the 2% inflation target in the longer run, given that the removal of large tobacco excise tax rises is expected to knock 0.2-0.3 percentage points off headline inflation.

Secondly, significant disruptions to the global economy caused by COVID are expected to dissipate. While slow vaccination progress and the ongoing development of new COVID variants has slowed this process down, eventually things should start to normalise, although what the post-COVID "normal" looks like and when we get there are both very uncertain. We do expect to see some of the crazier price increases reversed (at least partly), especially around global shipping. So while we're forecasting very large rises in tradables prices over the next year, we're also very likely to see prices fall further out.

Overall, we now see balanced risks to our inflation outlook (previously risks were strongly to the upside). On the downside, there's risk that a global normalisation in prices and shipping costs could see tradables inflation fall significantly enough to drag overall inflation well-below 2%. This wouldn't be a permanent drop though – just a return to normal, that the RBNZ would likely look through (provided expectations remain well-anchored). We have incorporated this to some extent into our main forecast, but prices could easily fall by more than anticipated. And, a surge in the TWI in the wake of an OCR hike could also put significant downwards pressure on tradables inflation. The TWI has stubbornly refused to budge, even as markets have priced increasingly imminent OCR hikes, but this may not last forever.

On the upside, there's the risk that the extremely strong price rises we're expecting in coming quarters cause inflation expectations to become significantly detached from the 2% midpoint of the RBNZ's target range. Were that to happen, and if it were to be sustained, inflation could quickly get out of control and require a more aggressive monetary policy response than otherwise. This is one reason for the RBNZ to start removing stimulus soon, so as to head off runaway inflation expectations (which have already surged in recent months, particularly on the household side – figure 4).

Figure 4. Consumer and business inflation expectations



Source: Stats NZ, ANZ Research, Macrobond

Table 1. Inflation forecasts

	Actual		Forecast						
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
CPI (% qoq)	0.8	1.3	**1.5**	**0.4**	**0.6**	**0.5**	**0.8**	**0.3**	**0.3**
CPI (% yoy)	1.5	3.3	**4.2**	**4.1**	**3.8**	**3.0**	**2.4**	**2.3**	**1.9**
Non-tradables (% qoq)	0.7	1.2	**1.2**	**0.7**	**0.9**	**0.6**	**1.2**	**0.8**	**0.8**
Non-tradables (% yoy)	2.1	3.3	**3.9**	**3.9**	**4.1**	**3.5**	**3.4**	**3.5**	**3.5**
Tradables (% qoq)	0.9	1.7	**1.7**	**-0.1**	**0.3**	**0.4**	**0.2**	**-0.5**	**-0.5**
Tradables (% yoy)	0.5	3.4	**4.6**	**4.3**	**3.6**	**2.3**	**0.8**	**0.4**	**-0.4**

Source: Stats NZ, ANZ Research

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