ANZ Research

# NZ Insight: The real cost of inflation

2 December 2021

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Contact

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## The real cost of inflation


### Summary

- Inflation is running at nearly 5%, driven by essential items like housing, food, and transport. All households are seeing cost increases, but for low-income Kiwis who spend the bulk of their income on essential goods and services, it's particularly hard to make ends meet right now.
- Wages have been slower to adjust than consumer prices. In normal times, that's not a problem, particularly, because inflation is low and stable. But right now, many households are seeing significant falls in their real spending power – and that may be contributing to soggy consumer confidence.
- Higher interest rates are painful in the short term, but they will put a lid on inflation pressures and thereby give household incomes time to catch up with price rises. For some households, higher interest rates will be hard to manage. But with the vast bulk of the CPI basket going up steeply in price, rampant inflation is a much larger threat to households' purchasing power, and needs to be contained with further OCR hikes.

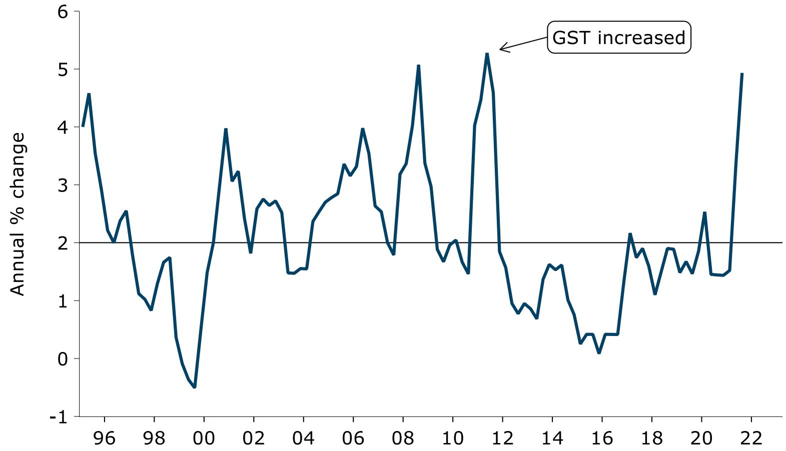

### Introduction

It's no secret that the cost of living has increased sharply in the past 12 months, with inflation now over twice the 2% midpoint of the RBNZ's 1-3% inflation target range (figure 1).

Through the health, fiscal, and monetary policy responses to COVID over 2020, the economy has avoided the extended and deflationary economic recession that was initially feared when we went into lockdown for the first time.

But we're now in a situation where domestic demand is roaring ahead, while supply remains hobbled by materials and labour shortages, and disruptions to domestic and global supply chains. As a result, we've seen CPI inflation rise to 4.9% in Q3 2021 – and both we and the RBNZ expect inflation will get close to 6% over the next few quarters, before things start to settle down. While this overheated economy is better than the alternative (ie an economic recession), it's still tough going for household budgets to make ends meet at a time like this. In this insight we dig into the details of how high inflation is impacting households, and why interest rate rises are so important to bring price increases under control.

**Figure 1. CPI inflation**



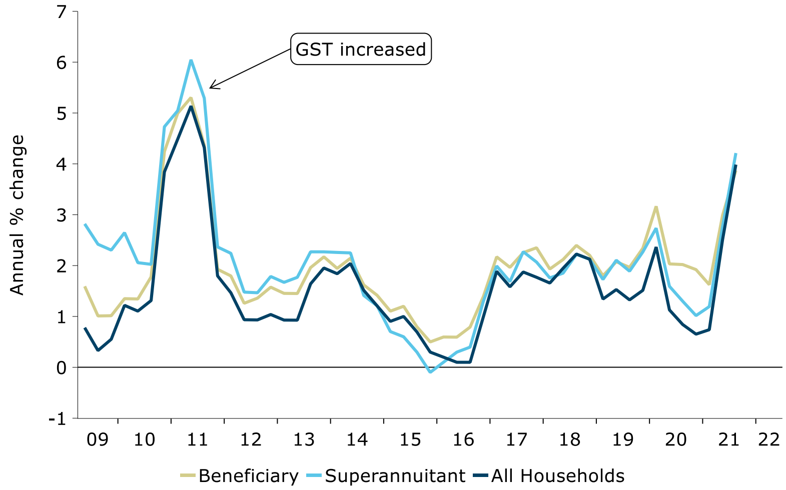

Source: Stats NZ, Macrobond, ANZ Research

## Living costs up for all households

To get a more detailed sense of how different Kiwi households are being impacted by the rising cost of living we can look at the Household Living-Cost Price Indexes (HLPI) published by Stats NZ. These show how living costs are rising for different types of households – including by differing income, and other social indicators. Because households have very different spending patterns, the HLPI for each type of household is weighted to reflect that. For example, the 2021 expenditure weights calculated by Statistics NZ show that 16.4% of expenditure of the lowest-income households went towards rent payments, versus just 6.7% for those on higher incomes. So when the price of renting goes up, that will have a larger impact on the cost of living (and HLPI) of lower-income households than for higher-earnings ones.

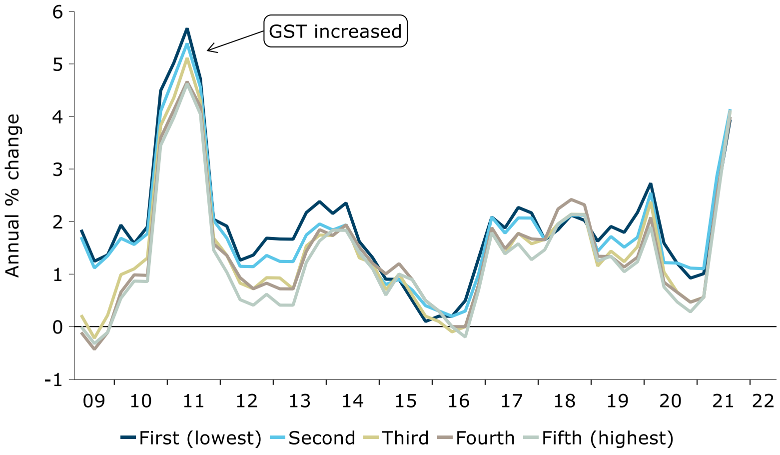
What's immediately clear from the data is that households have historically had varied experiences of inflation. Over most of the last decade, beneficiaries and superannuitants saw their living costs rise at a faster rate than average (figure 2). And that matches up with what you'd expect if we look at the data by household income – the 20% of households with the lowest incomes have tended to see the largest living cost increases, while the richest 20% have seen the smallest increases (figure 3).

**Figure 2. Growth in living costs by household type**




Source: Stats NZ, Macrobond, ANZ Research

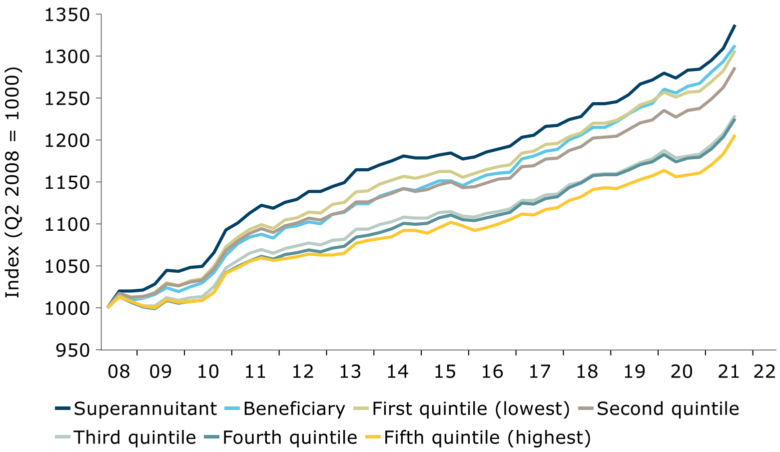
**Figure 3. Growth in living costs by income quintile**




Source: Stats NZ, Macrobond, ANZ Research

The cumulative impact of higher cost increases for some households is actually quite significant. If we plot the level of the HLPIs across income quintiles, it's clearer how much more costs have increased for low-earning households (figure 4). Since Q2 2008, living costs for the top 20% of earners have risen 20%, but for the lowest 20%, the increase has been 30%. Superannuitants have had it the worst in terms of the rising cost of living, with costs up 34% over the same period.

**Figure 4. Level of living costs by household type and income quintile**




Source: Stats NZ, Macrobond, ANZ Research

In a break from historical patterns, cost increases have been of about the same magnitude for all households in recent quarters. That likely reflects the fact that inflation has been very broad-based – the only component of the CPI that didn't rise in Q3 was communication (just under 3% of the total basket). On average, households saw living costs rise 4.0% in the year to September 2021[1], and we don't expect cost pressures to moderate on an annual basis until the June quarter of 2022.

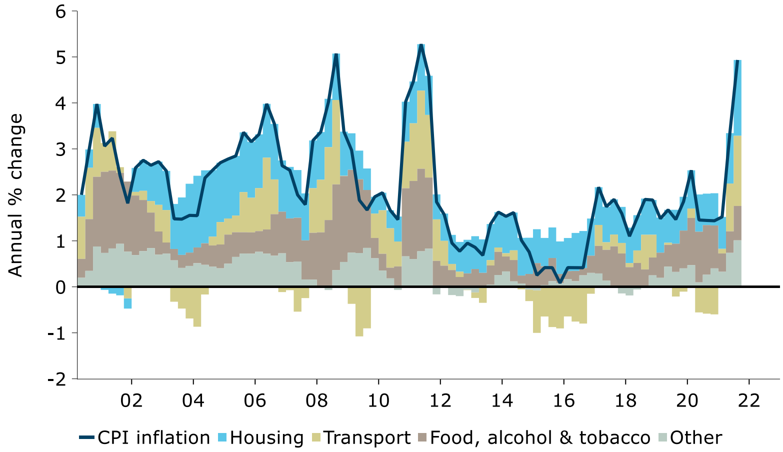
On paper it looks like everyone's hurting from the same strong inflation currently. But when we dig into the details, it's clear that for poorer households, high inflation is particularly hard to deal with.

[1] That's obviously lower than the 4.9% CPI print in Q3, and reflects that the HLPI is constructed slightly differently. Eg interest payments are not included in the CPI, and given recent OCR cuts, these have been at a very low level recently. Expect that to change in coming quarters.

## Price lifts in essential items difficult for poor households

The biggest drivers of strong inflation in recent quarters have been housing, transport, and food (figure 5). Of the 2.2% increase in consumer prices in the September quarter 2021, 0.7ppts came from housing (eg rents, building costs, council rates), 0.5ppts came from food, and transport added 0.5ppts (60% of that from petrol alone). These are all essential items - and that makes absorbing price rises more difficult for poorer households, since a larger share of their expenditure goes towards essential goods and services. It's easier for higher-income households to cope with price rises because they can simply cut back on more discretionary spending (eg not eating out as much). But for a poor household whose budget can barely cover the essentials even when inflation is low, the choice quickly becomes: do I have lunch this week or pay the rent?

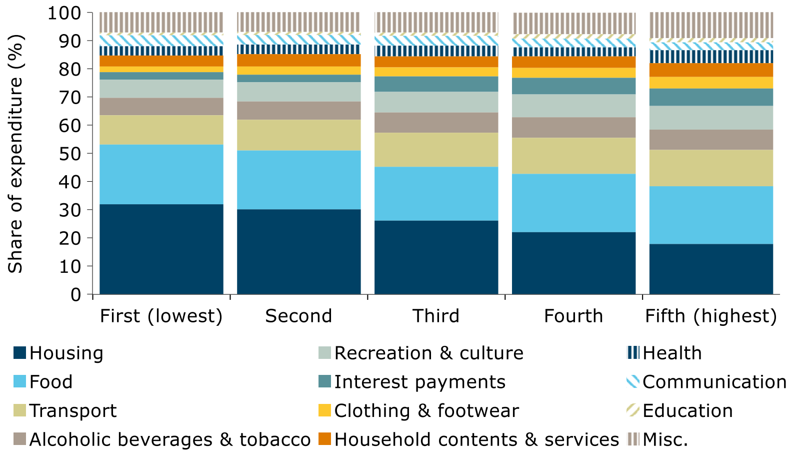
**Figure 5. Contributions to annual CPI inflation**




Source: Stats NZ, Macrobond, ANZ Research

Looking at the composition of household spending across different income groups, we can see that for the bottom 20% of households in New Zealand, housing, food, and transport make up a much bigger share of their expenditure than for the top 20% (figure 6). It's also interesting to note that for wealthier households, interest payments make up a larger share of their expenditure – because they'll be much more likely to have a mortgage on an owner-occupied home (and/or investment property).

**Figure 6. Composition of household expenditure by income quintile**




Source: Stats NZ, Macrobond, ANZ Research

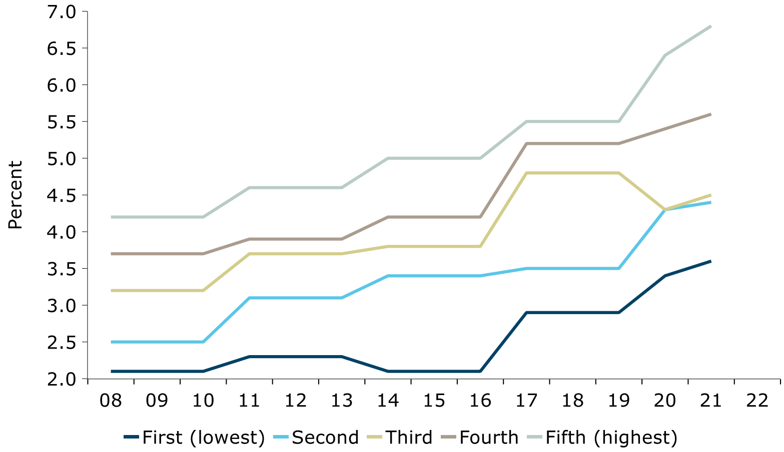
Adding up the numbers, 63.5% of expenditure goes towards food, housing, and transport for lower-income households, compared with 51.2% for the highest earners (table 1). And that underweights the importance of 'essential' spending for poor households, since they also have to fork out for essential clothing and footwear, insurance, health, education, and other items – which have all gone up in price. Plus, within groups like food expenditure, higher-income households tend to spend more on more 'optional' items, like restaurant meals and takeaways. Figure 7 shows that the share of expenditure going on restaurant meals and ready-to-eat meals has increased in recent years over all income quintiles, but that it has remained broadly true that the top-income group spends roughly twice the proportion of their income on this category as the lowest-income group does. That means they have considerably more flexibility in their spending choices.

**Table 1. Share of expenditure going towards food, housing, and transport**

| Income quintile | Food | Housing | Transport | Combined |
|---|---|---|---|---|
| First (lowest) | 21.2 | 31.9 | 10.4 | 63.5 |
| Second | 20.9 | 30.1 | 10.9 | 61.9 |
| Third | 19.1 | 26.1 | 12.1 | 57.3 |
| Fourth | 20.7 | 22.0 | 12.8 | 55.5 |
| Fifth (highest) | 20.5 | 17.8 | 12.9 | 51.2 |

Source: Stats NZ, ANZ Research

**Figure 7. Expenditure on restaurant meals and ready-to-eat food (% of total)**




Source: Stats NZ, Macrobond, ANZ Research

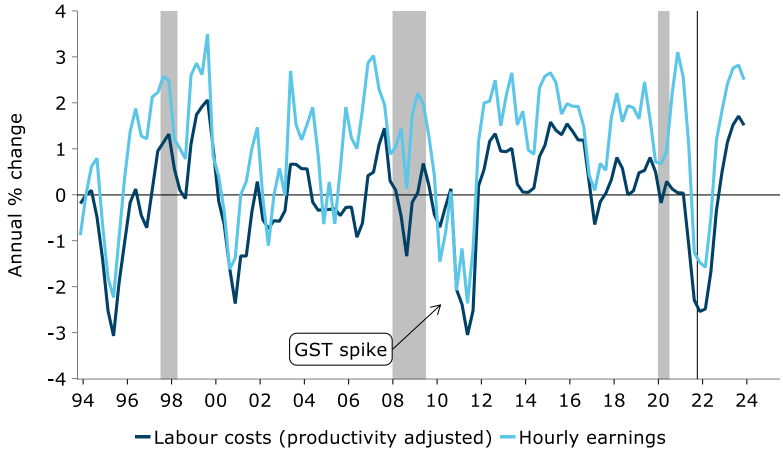
Finally, even though the HLPI does a better job of showing how households are differently affected by inflation, income quintiles can still mask extreme outcomes. As an example, the New Zealand Food Network reported that the August to October 2021 period saw a 504% increase in food being given to communities compared with the same time in 2020. Clearly, for the very poorest people in New Zealand, life is even tougher than official data captures.

The bottom line is that for poorer households who spend a lot more of their constrained budgets on essential goods and services, the current composition of strong inflation is particularly hard to bear. Higher-income households may be able to more easily absorb price rises by simply cutting back on non-essential spending, but for poorer households, there's simply not much fat to trim.

## Real wages are falling (for now)

Households can keep ahead of inflation via higher incomes – through higher labour force participation by household members, rising wages, or working longer hours. Wage growth may have been lower in nominal terms after the 2008-09 recession (something that the RBNZ and other central banks fretted about for most of the 2010s), but in real terms (ie after accounting for low CPI inflation), hourly earnings growth was actually pretty solid over the 2010s (figure 8). It just might not have felt that way since house prices went up so much, which is much more visible to the average consumer than the CPI is.

**Figure 8. Real average hourly earnings and real labour costs**




Source: Stats NZ, Macrobond, ANZ Research

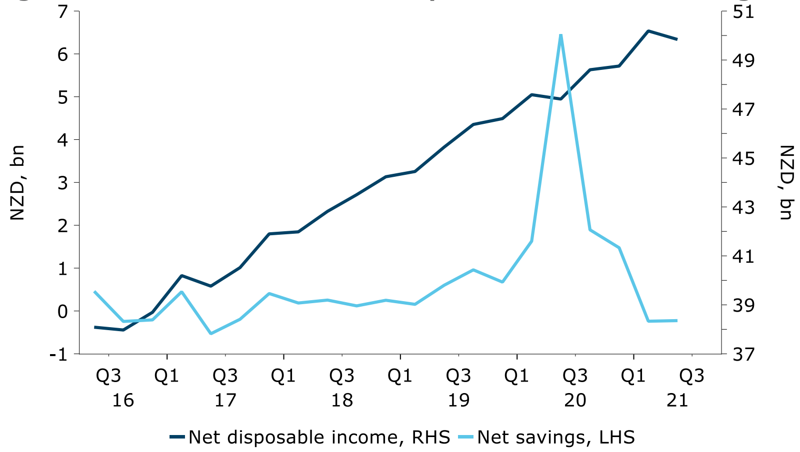
Unfortunately, hourly wage growth is now languishing behind CPI inflation, with real wages falling the most in Q3 since GST was increased in 2010. That's to be expected, since wage adjustments are often indexed to previous outturns, and usually occur annually, and forecasters (including us) have seriously underestimated the speed at which consumer prices would rise in the wake of COVID. Normally, indexing wages to inflation once a year works pretty well, since inflation is usually low and stable, meaning last year's CPI inflation isn't a bad forecast of the next year. But when prices are rising so quickly, such backward-looking and infrequent adjustments can actually have big impacts on household purchasing power.

As mentioned, wage increases aren't the only way to raise household incomes. Working longer hours and/or having more members of the household enter the labour force are also (obviously less desirable) options. While average hours worked haven't risen significantly above pre-COVID levels yet (especially during the latest lockdown), the labour force participation rate was back at its previous record high of 71.2% in Q3. If the rise in participation reflects households compensating for the drop in real wages, then even if overall income earned across all households is holding up okay, households may understandably feel like they're going backwards at an individual level. The value of time with the family is not measured in GDP or income statistics.

We don't have income GDP data for Q3 yet, but in Q2, household net disposable income fell 0.7% q/q (figure 9). Given how much real wages fell in Q3, the only things standing in the way of further income falls for the household sector as a whole are the wage subsidy for workers affected by the latest lockdown, as well as the 2.0% quarterly jump in employment during the quarter. The original wage subsidy was incredibly effective at supporting household income by keeping workers attached to jobs – and even saw net saving surge in the June 2020 quarter. But it's only a temporary measure, and a much smaller number of households ended up on the scheme in 2021.

In short, the only realistic way that aggregate household purchasing power won't fall in the next few quarters is if the surge in participation has been enough to offset the drop in real wages. But even then, while households as a group might be earning more, they're working harder and giving up leisure, and there is most certainly a real cost to that. It's not all bad though, not at all – the plethora of job opportunities available at present is drawing people in, forcing employers to take a punt, and thereby giving people upskilling opportunities that have the potential to benefit them for the rest of their working lives. The point is just that we need to bear in mind that traditional economic measures are a pretty narrow lens when it comes to household wellbeing.

**Figure 9. Household nominal net disposable income and saving**

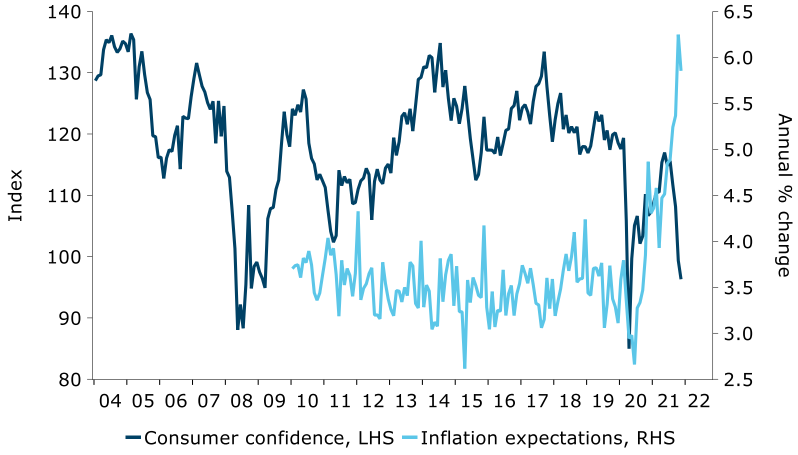



Source: Stats NZ, Macrobond, ANZ Research

Though rising living costs mean many households are doing it tougher currently, there is reason to be optimistic about household incomes in the medium term. It may take some time, but wages will adjust, and the tight labour market will give workers more bargaining power to lock in cost of living adjustments. Our forecasts for inflation and wages imply respectable real wage growth from around the second half of 2022 (figure 7).

But our expectation of stronger real wage growth over H2 2022 won't make it any easier for households who need to meet those higher prices here and now. While there are many reasons why consumer confidence may be weak right now (including higher mortgage rates and the ever-mutating variants of COVID), it's very possible a contributing factor is that households are having to work harder just to maintain the same standard of living as inflation surges (figure 10).

**Figure 10. Consumer confidence and inflation expectations**




Source: Macrobond, ANZ Research

Sagging confidence is a downside risk to the economy if it sees consumers pull back on spending. Some reduction in demand is needed for the RBNZ to bring us back to a more sustainable growth path, but it's a delicate balance between putting a lid on a bubbly economy and pouring cold water over everything. High inflation is an unpleasant thing to go through – it's eroding purchasing power, stretching the budgets of poor households, and possibly contributing to a deterioration in consumer sentiment that could weigh on economic momentum, even as COVID restrictions continue to be relaxed.

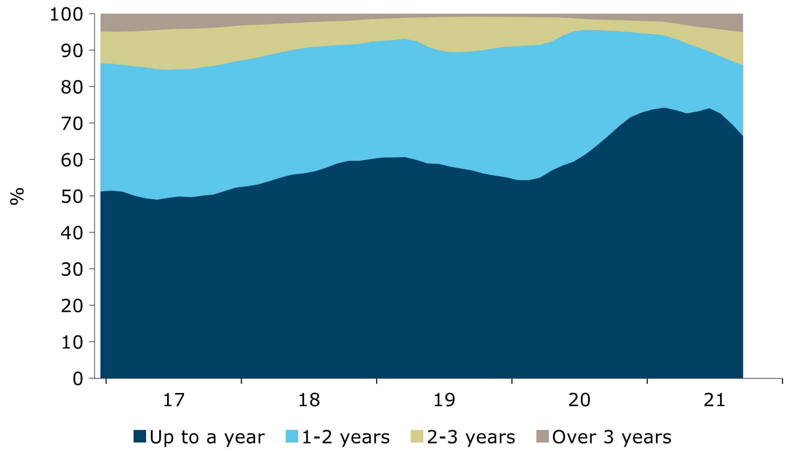
## The path to low inflation isn't easy

Unfortunately, the tonic for overly high underlying inflation is higher interest rates, which isn't a barrel of laughs in a net-debtor economy either. We're forecasting that the RBNZ will continue to lift the OCR in 25bp increments to a peak of 2% in August 2022 – and we think that will be enough to bring CPI inflation back to a more-manageable level.

One reason why we think the OCR will 'only' need to go to 2% is that the New Zealand economy (in particular the housing market) is very sensitive to higher interest rates right now. For example, mortgage rates have surged in recent months as expectations for OCR hikes pushed up wholesale rates and therefore retail rates. With around two thirds of fixed mortgage lending about to reprice within the next year (figure 11), higher debt-servicing costs will help to quickly take the heat out of this sizzling economy.

Our Property Focus outlines this in more detail - but for some context, the 1-year special mortgage rate dropped to a low of 2.21% in June 2021, and as of November, was about 130bps higher at 3.49%. If a hypothetical household with an $800,000 mortgage experienced the same increase in their mortgage rate, then all else equal their weekly payments would increase by roughly $115 (assuming a 25-year mortgage). That's going to hurt – and when you multiply across hundreds of thousands of borrowers, it's a lot of disposable income that's suddenly taken up with increased mortgage payments.

**Figure 11. Share of fixed mortgage lending by date of repricing**




Source: RBNZ, Macrobond, ANZ Research

How could this possibly make things better for households? It'll be a rough adjustment for some for sure – especially those who have leveraged up to the hilt to jump into the frothy housing market over the past year. But it's worth noting that overall, interest payments are just 2.7% of expenditure for lower income households, and 6.2% for the highest earners (figure 7). Debt servicing has gotten more expensive (and will likely continue to in coming quarters), but out-of-control inflation would deal a much more devastating blow to household purchasing power. And of course, some households are net savers, particularly older ones, and they stand to benefit from higher interest rates. Kiwi households have around $210bn on deposit at banks in New Zealand, versus $326bn of mortgage debt. That's a decent offset. But overall, New Zealanders have a tendency to spend beyond our means, as demonstrated in our persistent current account deficits, so higher interest rates do suck income out of the economy overall.

High inflation is not just a theoretical problem. It's a real problem, especially for low-income households. And while the medicine (higher interest rates) isn't pleasant for borrowers, it's far better than seeing living costs spiral out of control and real incomes collapse. We've spent a long time in New Zealand getting used to low and stable inflation, but it's worth remembering that high inflation can be extremely damaging, and that's why the RBNZ has acted (much faster than many of its international peers) to protect the value of money in New Zealand.

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