ANZ Research

NZ CPI Forecast Update

8 March 2022

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Contact

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Higher for longer

Bottom line

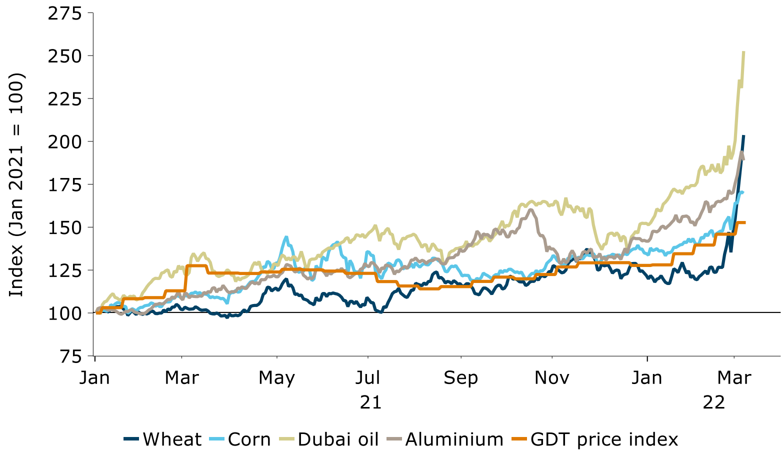
- The tragedy playing out in Ukraine has sent key commodity prices surging in recent weeks. In particular, Global Dairy Trade prices have reached a record high, while the price of oil has surged to around USD120/barrel.
- We've subsequently revised up our forecast for tradables inflation (ie the imported component of inflation). As a result, we now expect annual headline inflation will peak higher and later, at 7.4% in Q2 this year, versus our previous forecast of a 6.4% peak in Q1.
- Sky-high global commodity prices should ease as COVID disruptions fade and geopolitical tensions ease. But it's certainly not looking imminent. We don't know how much further commodities will rise, or when (and how far) they might then fall.
- But what we can say is that with inflation expectations rising, the RBNZ will not be comfortable with these highly visible price spikes. And for a Committee that was already tossing up a 50bp hike in February, we think these developments will be enough to tip them in favour of moving more aggressively. We are now forecasting back-to-back 50bp hikes.

Ukraine crisis driving commodities yet higher

The tragic events in Ukraine are reverberating around the world, on an emotional, political, and economic level. On the economics side, New Zealand's biggest exposure to the crisis is largely through the price channel. Commodity prices have been rising steadily over the past year as rising global demand struggled against COVID disruption – but with the outbreak of war and implementation of sanctions against Russia, those increases have turned vertical.

Futures prices for key commodities have surged – Dubai oil price futures are up over USD120/bbl, with volatility extreme, and key food prices are rising as well (figure 1). Prices for dairy products (our largest export) have surged, with the GDT Price Index up 5.1% in the latest auction – which sent the price level to its highest point on record since the index start in 2008.

Figure 1. Commodity futures prices and GDT Price Index

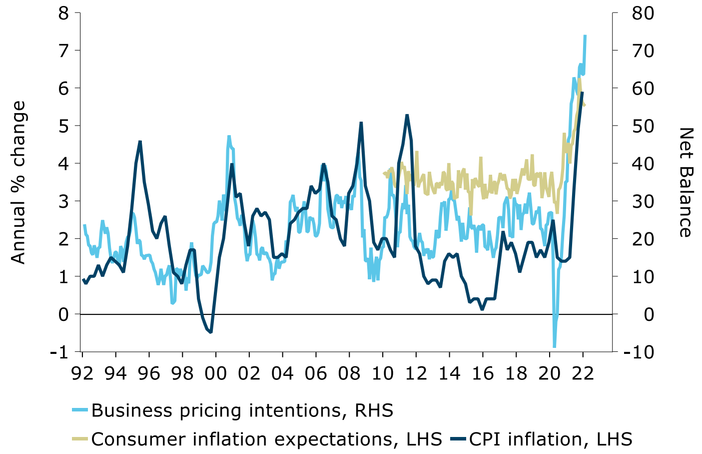


Source: GlobalDairyTrade, Bloomberg, Macrobond, ANZ Research

As a small open economy, New Zealand is exposed to global fluctuations in commodity prices. The most obvious impact for many consumers is through petrol prices. These have a weighting of less than 5% in the CPI, but are still likely to add significantly to inflation over the first half of 2022, given the sheer size of the movement in oil prices we've seen.

The visibility of petrol prices for consumers is one reason for the RBNZ to be concerned – even if ostensibly this looks like a textbook case of something they should 'look through'. Inflation expectations have surged in both our Business Outlook and Consumer Confidence surveys – and it's in this situation where commodity price shocks can translate into price-setting behaviour, and therefore persistently higher inflation (figure 2). Consumer inflation expectations aren't usually a reliable steer on actual inflation outturns – but over 2021 they picked the nearly 6% lift in consumer prices pretty well! Analysis also shows that petrol prices have an outsized impact on consumer inflation expectations – normally just an interesting quirk, but in a labour market this tight, that will feed straight into wage demands.

Figure 2. Consumer and business inflation expectations



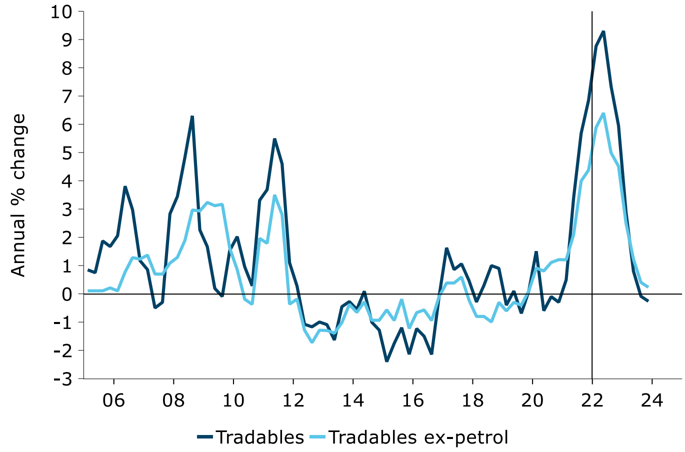
Source: Stats NZ, Macrobond, ANZ Research

Even excluding the impact of oil, commodity prices can still have a significant and persistent impact on inflation in New Zealand. Previous research by the RBNZ, for example, shows that a sudden spike in commodity prices (ex-oil) is more like a positive demand shock for New Zealand – supporting domestic consumption and investment, sending both tradables and non-tradables inflation higher over about a year, and generating a positive interest rate response to the higher inflation. Higher commodity prices also usually cause an appreciation in the New Zealand dollar – providing some inflation offset by making imported goods cheaper-than-otherwise in NZD terms. But we haven't seen a significant appreciation yet, especially relative to the surge in commodities. That likely reflects the impact of war on global risk sentiment.

In the domestic data, the Food Price Index also rose an unseasonably strong 2.7% m/m in January. And that was on top of the 0.6% m/m rise in December (when prices usually fall). While there's always the possibility that food prices retrace some of that unseasonal gain, everything we're seeing in terms of Omicron disruption, commodity prices, and rising costs suggests further upside risk. The Q2 minimum wage rise will likely add further strength to domestic food price inflation in mid-2022 as retailers pass on the higher wage bill.

Given these developments, we've revised up our forecast for tradables inflation. A large chunk of this revision reflects the surge in oil prices over recent weeks – but there's a broader global inflation pulse coming through as global inflation pressures continue to surprise to the upside, and commodity prices rise (figure 3).

Figure 3. Tradables inflation components



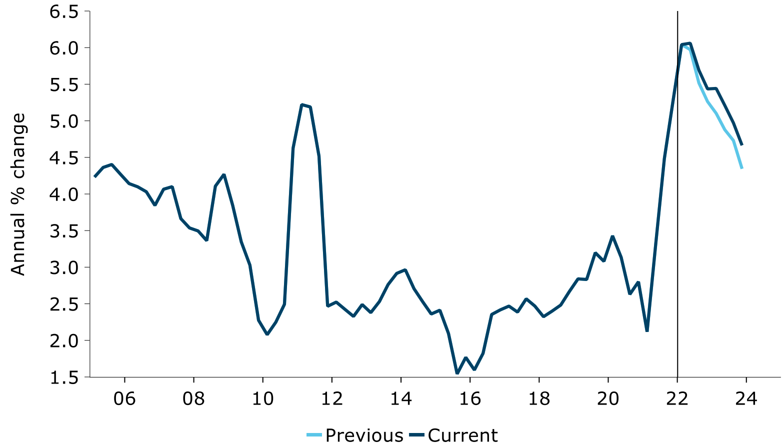
Source: Stats NZ, Macrobond, ANZ Research

We still expect to see tradables inflation slow significantly over the medium term, and likely turn negative beyond 2023, as supply disruptions and geopolitical tensions should ease at some point. When that happens is impossible to guess – so the timing of our tradables inflation forecast is very much an assumption that we will tweak as we observe new developments.

Domestic inflation risks more balanced

We have slightly revised up our outlook for non-tradables inflation as well (figure 4). But it's largely a mechanical change – reflecting that higher headline inflation prints will feed into pricing behaviour in the economy, and impact administrative prices that are tied to previous CPI prints.

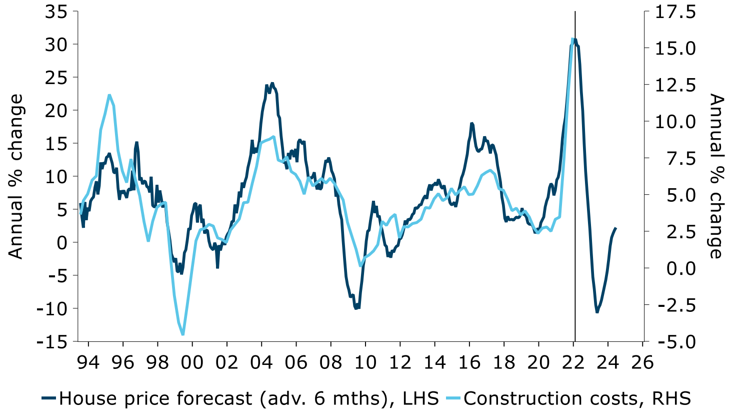
Figure 4. Non-tradables inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

In contrast to tradables inflation, the non-tradables outlook is a bit more balanced. On the downside, the construction sector and housing market are showing signs that a significant slowing is due. In light of our updated, more aggressive OCR forecast track with back-to-back 50bp hikes in April and May we're now forecasting house prices will fall about 10% over calendar year 2022 (previously about 7%). Building consents fell 9.2% in January, suggesting that demand for new builds has peaked. The housing market has been a key driver of inflation pressures over the past year – and while we're expecting some moderation in inflation pressures as house prices fall (figure 5), a harder-than-expected landing for housing in New Zealand could see inflation fall away much faster.

Figure 5. House prices and construction cost inflation



Source: Stats NZ, Macrobond, ANZ Research

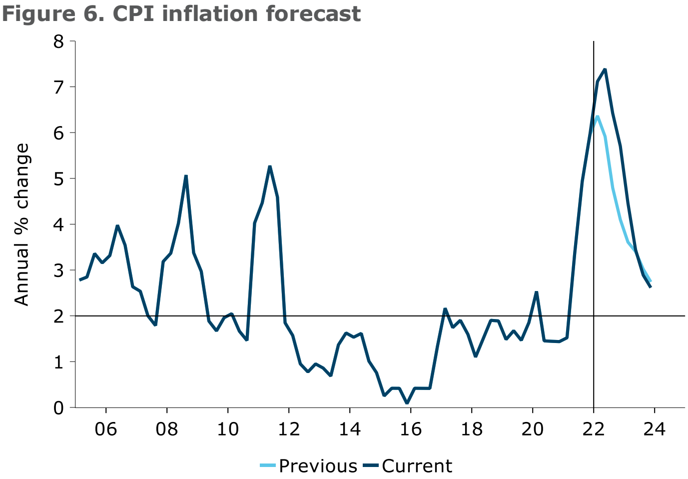
On the upside, the labour market is incredibly tight – and we think it will tighten further over 2022 (particularly if the staggered timing of the reopening plan sees Kiwis head overseas *en masse* before foreign arrivals can enter the country). The sheer mismatch between domestic labour supply and demand means we're expecting a considerable amount of domestic inflation to come from the labour market over 2022. And if the war for talent really starts to heat up, then wages could rise in a way that we just haven't seen this side of the year 2000. The continuing rise in pricing intentions in our Business Outlook Survey means that the vast majority of firms will be likely to pass on those higher costs to consumers – and that's a recipe for a wage-price spiral if the RBNZ aren't careful. From the next read of the ANZ Business Outlook survey onwards we'll have a measure of wage-setting intentions.

Inflation to peak above 7%

We were previously forecasting that annual CPI inflation would peak at 6.4% in Q1 this year, before gradually starting to drop towards the RBNZ's target band as supply chain disruptions unwound and monetary policy tightening started to reduce the mismatch between supply and demand in the economy.

However, given recent developments, we're now forecasting that inflation will peak at 7.4% in Q2 this year (figure 6). That's well above the RBNZ's February MPS forecast that inflation would peak at 6.6% in Q1 – a forecast that was made before Russia invaded Ukraine.

Figure 6. CPI inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

All up, it's clearly an even more inflationary picture than at the February MPS – where the Monetary Policy Committee were obviously concerned, given their comments about many members seriously considering a 50bp hike. Usually, a commodity price shock like this wouldn't be something to which the RBNZ would react. It should be temporary – and it should unwind at some point. Oil prices are the classic supply shock that monetary policy prefers to ignore because it's already bad for growth without adding tighter monetary conditions into the mix. But the fact is, inflation expectations are already worryingly high, and the domestic inflation pulse has shown no signs of slowing. And the Omicron wave breaking upon us only adds to the domestic supply-chain chaos – exacerbating the cost pressures facing consumers.

Given these developments, we think that there's significant upside risk to the RBNZ's already strong inflation forecast. The RBNZ has to forecast inflation coming back to target within their forecast horizon if they want to maintain their inflation targeting credibility – and we think it'll take 50bp hikes at both the April Monetary Policy Review and the May MPS to do it. Yes, the risk of a hard landing for the economy is absolutely real. But when it comes to it, the RBNZ has to respond to what's in front of them right here right now. And that's a wall of inflation.

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