ANZ Research

NZ Insight: The inflation outlook and the balance of risks

6 September 2022

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The inflation outlook and the balance of risks

Summary

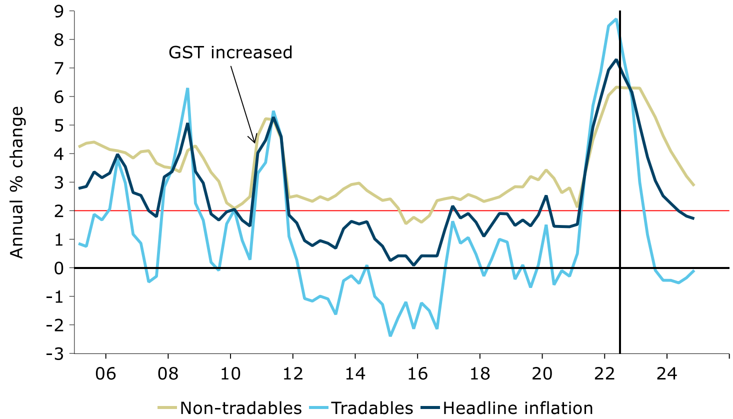
- We think annual CPI inflation peaked at 7.3% in Q2 this year, in part thanks to oil prices coming off their highs in recent months.
- But we also think bringing inflation back to 2% will be a long journey, requiring the RBNZ to lift the OCR to 4% by year-end, and keep it there for several years.
- Inflation risks are firmly to the upside. For example, simple scenario analysis shows that if labour costs surprise to the upside, inflation would be unlikely to return to the RBNZ's 1-3% target band without the OCR rising above 4%.
- Global inflation risks abound too, with extremely tight labour markets, climate change, geopolitical tensions, energy shortages, and trade disruption all having the potential to generate a sustained period of high global inflation going forward. That would also make the RBNZ's job getting inflation back to target much harder.

An overview of our inflation forecast

Our previous Insight outlined how we got to 7.3% inflation. The challenge now is getting back to 2%, the midpoint of the Reserve Bank's target range. It won't be easy. It will probably take several years, and will involve the RBNZ lifting interest rates until they are confident that they've slowed the economy enough to bring down core inflation.

While uncertainty is huge, we are forecasting tradables inflation to drop pretty quickly, from the current peak of 8.7% in Q2 2022, to a low of -0.5% in mid-2024 (figure 1). Lower petrol prices are offering some immediate relief, while over the medium term we assume that a combination of supply-chain adjustment, COVID restrictions continuing to ease, and global central bank interest rate hikes should see global inflation pressures decline. However, we're certainly not forecasting a return to importing deflation, like New Zealand did in the first half of the 2010s. Indeed, as we'll discuss later, there's very much a risk that global inflation is structurally higher in coming decades.

Figure 1. ANZ inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

Domestic inflation pressures are also expected to ease, but it will be a long and difficult battle for the RBNZ to achieve this outcome. We anticipate that surging wage growth and ongoing domestic cost pressures will see non-tradables inflation hold up around current highs until early next year, before gradually easing as the RBNZ's monetary policy tightening takes sufficient heat out of the economy to open up spare capacity. House prices are already on the way down, which at some point should take the pressure off construction costs – anecdotally, this process is starting. That's necessary, but unfortunately not sufficient, for domestic inflation to fall back to target in an acceptable timeframe.

The RBNZ also needs to see the labour market cool significantly. Labour demand has been insatiable, while labour supply is looking increasingly exhausted. The labour force participation rate is close to record highs, while net migration outflows are running at an annual rate of -11.5k. Our analysis also highlights how the rapidly tightening Australian labour market is likely to add fuel to the domestic inflation fire. That said, we anticipate unemployment will start to lift over 2023 as the RBNZ's aggressive interest rate hikes take momentum out of the domestic economy. With unemployment forecast to lift to just under 5% by the end of 2024, domestic inflation pressures should gradually fade.

All up, this brings CPI inflation back into the 1-3% target band at the end of 2023, and back to the 2% target midpoint in the middle of 2024. Certainly not a quick process, and economic surprises will keep happening in the meantime. While there are risks on both sides, we see the risk profile as dominated by the potential to be surprised on the upside by the strength and persistence of inflation.

What are the risks?

We are currently forecasting that the RBNZ will need to lift the OCR to a peak of 4% by year-end, and keep it at this level for some time, to achieve the inflation outcome in figure 1 above. However, in our view, risks are firmly tilted towards more hikes taking the OCR above 4% needing to be delivered to bring inflation down swiftly enough. There's certainly not much wriggle room on that front. Even in our central forecast, inflation would have been above the 2% midpoint of the RBNZ's target band for three years. We see risks around the outlook for both domestic (non-tradable) and global (tradable) components of inflation.

The very near term

In the near-term, we see risks around our inflation forecast as being fairly balanced. It's very likely that inflation will decline at pace over the next couple of quarters. Our forecast is for inflation to fall to 6.7% in Q3, and 6.1% in Q4, but it's certainly possible that we see prices fall even faster. The average retail price of petrol (including discounts) has already declined to about NZD2.5/litre (from a peak of NZD3.10/litre in June). That will take the heat out of inflation directly through the impact of the price at the pump, as well as by reducing costs for transporting goods around the country. We expect oil prices to gradually decline over our forecast, but sharper drops could see the headline inflation print drop more rapidly than forecast.

The key here is to distinguish between the short and medium term. In the very near term, we fully expect inflation to ease, and quickly, particularly thanks to factors like rapidly falling oil prices. But over the medium-term, we see significant risks that inflation will remain too high for too long, which would necessitate further OCR hikes in order to bring inflation back to target within an acceptable timeframe.

Domestic inflation

The home-grown element of inflation that reflects the state of the economy is the component of inflation that the RBNZ cares about most. Partly that's because it's the part of inflation that the RBNZ can actually hope to do something about, but also because it tends to be 'stickier', whereas imported inflation typically washes through quite quickly.

Front and centre on the domestic inflation front is the possibility that rapidly accelerating labour costs (absent a commensurate increase in productivity) could see domestic inflation pressures come in stronger and more persistent than forecast.

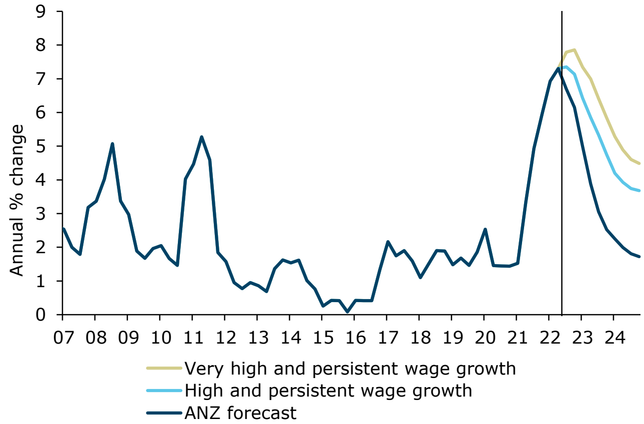
We currently anticipate that annual growth in private sector productivity-adjusted labour costs will peak at 4.4% in the first quarter of 2023 (versus 3.4% in Q2 2022). But wage pressures have surprised recently with their strength. Domestic labour demand remains insatiable, and with the Australian labour market likely to add further heat over the next year, upside surprises feel likelier than downside ones.

In that context, it's useful to explore some scenarios to quantify the risk.

Figures 2 and 3 shows what could happen to CPI inflation if labour cost growth were to prove even stronger and more persistent than currently expected (based on the historical relationship between the two variables). The light blue line shows the impact of labour cost inflation rising to a peak of 5.5% in Q2 2023 (ie peaking a little more than 1% higher than our forecast), while the yellow line shows the impact of labour cost inflation rising to a peak of 6.5% in Q3 2023. In both scenarios, in order to isolate the impact on CPI inflation, we assume the OCR is unchanged relative to our official forecast (ie rising to 4% by year-end, and staying there over 2023 and 2024).

Figure 2. Labour cost index scenarios

Figure 3. CPI inflation scenarios



Source: Stats NZ, Macrobond, ANZ Research

Figures 2 and 3 highlight the risk posed by the highly inflationary labour market. With wage inflation far exceeding productivity growth and other business costs soaring, firms have to either absorb the cost into their margins (not a long-term solution) or pass those costs on to consumers. A third, less inflationary possibility is some companies may also go insolvent if transaction volumes start to fall. In both the scenarios considered above, CPI inflation does not return to the RBNZ's 1-3% target band before the end of our forecast horizon (Q4 2024). Clearly, therefore, in that scenario the RBNZ would need to lift the OCR even higher than the 4% that we're currently forecasting.

This highlights the double-edged sword that is sharply rising wages. It sounds like great news for households, and it's no doubt a relief for workers, particularly those on lower incomes, who have been watching inflation eat away at their real purchasing power. But for the RBNZ, strong wage growth means that household demand is more resilient to the aggressive interest rate hikes that they have delivered – ie that more OCR action could be required to slow spending sufficiently to bring inflation down.

As surging inflation gets factored into wage- and price-setting behaviour, it raises the risk that a 4% OCR is no longer as much of a brake on the economy as previously thought. In other words, high inflation expectations and wage growth mean the neutral OCR could currently be creeping higher (the neutral OCR is the level of the OCR that is neither contractionary nor expansionary for the economy). In coalface terms, people's idea of what a "reasonable" mortgage rate is might be gradually lifting again, just as it gradually fell as inflation and nominal interest rates trended lower over years and decades.

The RBNZ's latest estimate of the neutral OCR is 2%, but they have already said that they are revisiting their models, and some members of the Monetary Policy Committee have given a range of 2-3% as their sense for where neutral is. It's a big deal, as changes in the neutral OCR go 1:1 into the required OCR. If the neutral OCR is 3% rather than 2%, then an OCR closer to 5% rather than 4%would be needed to deliver the monetary tightening required to bring inflation back to 2% within an acceptable timeframe, all else equal. Sounds high, but so is inflation. And it's still well-below the 8.25% OCR peak seen before the GFC (although the housing market was still in full bubble mode at that point, whereas currently house prices are falling).

Global inflation

Inflation risks are not just domestic. It's clear global growth is slowing as central banks raise rates and other headwinds weigh. It's therefore entirely reasonable to build a fall in global inflation pressures (particularly for commodities) into inflation forecasts.

However, the war in Ukraine continues to send tremors through global commodity markets. More countries are putting up barriers to trade, and the costs of climate change (both the direct costs, and the costs of transitioning to a more sustainable economy) are likely to be immense. All of these factors have the potential to make the period of global inflation last longer than is currently expected. Indeed, it quite reasonably raises the question of whether global inflation will return to its previous lows at any time in the foreseeable future.

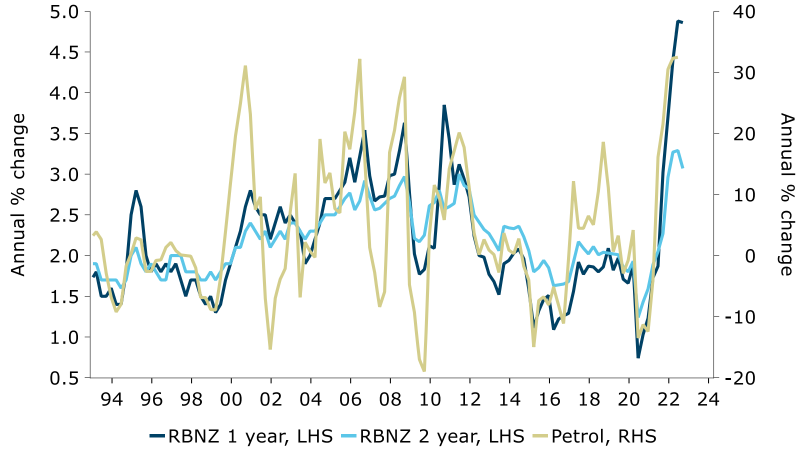
The global backdrop is dominated by geopolitical tension and war. As discussed in our previous insight note, this has caused big spikes in global commodity and energy prices, and that's contributed to surging CPI inflation in Europe (9.1%) and the UK (10.1%). Heatwaves and drought across large swathes of the Northern Hemisphere and flooding in Pakistan and elsewhere have also caused significant disruption.

And we're now heading into the Northern Hemisphere winter during a full-blown energy crunch. Germany is looking at having to choose between heating houses, and keeping key global industrial powerhouses in operation. New Zealand is insulated from turmoil in gas markets, but we are very reliant on oil imports. In that energy environment, it's very possible that oil prices may remain high for some time – or even increase above current levels.

Normally, central banks wouldn't worry too much about an increase in oil prices. It is, after all, the quintessential example of a transitory, supply-side-driven spike in inflation that they can't do anything about, directly. However, to be able to ignore it is a luxury that is only afforded to the RBNZ if inflation expectations are well-anchored close to the 2% midpoint of the RBNZ's target band.

And it would be a stretch to say that is currently the case. Sure, the 5- and 10-year inflation expectations measures from the RBNZ's Survey of Expectations are still within coo-ee of 2%, but in our latest Business Outlook survey, one-year-ahead inflation expectations in August remained troublingly high at 6.1% (down just 0.1ppts on the previous month). Further increases in inflation, whatever the source, only increase the risk of inflation expectations resuming their previous upward trend, or at least not falling sufficiently quickly back towards something more consistent with low and stable inflation (figure 4).

Figure 4. Inflation expectations and petrol price inflation



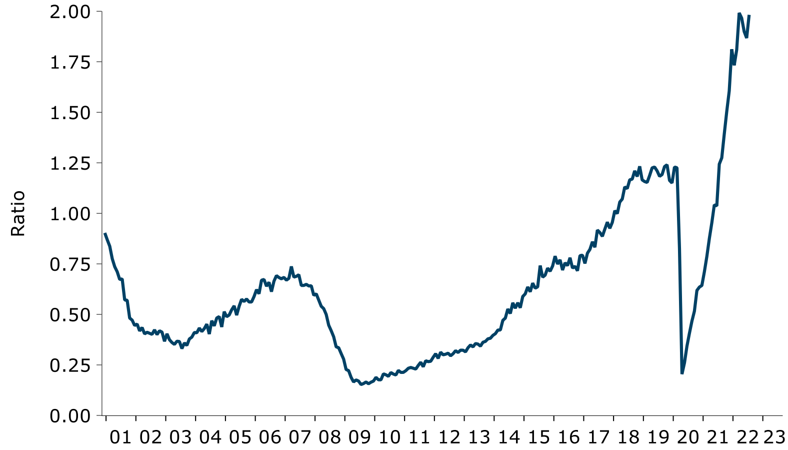
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

News stories about workers explicitly demanding inflation compensation in their wage reviews also highlight how high CPI inflation prints can become ingrained in underlying inflation, even if the cause is something like a temporary spike in global energy prices. During periods of low inflation, the size of wage increases tends to be fairly stable, since moderate increases in nominal wages are enough to keep up with living costs. But right now, workers are factoring high actual and expected inflation directly into their wage demands, and fair enough too. With unemployment close to record lows, they are in a more advantageous bargaining position. So in that kind of environment, even one-off spikes in inflation can quickly get passed on into wages, with these higher labour costs then passed on in higher prices, which drives inflation higher. A vicious cycle of inflation can emerge.

Unfortunately, those one-off spikes in inflation look likely to become more common. While COVID appears to be in retreat as a global disruptor (touch wood), geopolitical tensions continue to raise the risk of ongoing commodity price surges, or a retrenchment of global trade. And the ongoing costs of adverse weather conditions continue to mount as climate change rolls inexorably forward. All of these factors mean the era of New Zealand importing global deflation through our import prices is probably behind us.

Global labour markets are also incredibly tight right now. In a separate note we showed how the rapidly tightening Australian labour market could flow through into further wage pressure in New Zealand. It's not just Australia though – in the US, there are still around two job openings per unemployed person (figure 5). That's an unprecedented level of labour market tightness that will drive persistent strength in domestic inflation in the US, without ongoing rate hikes from the US Fed.

Figure 5. Job openings per unemployed person



Source: BLS, Macrobond, ANZ Research

Bringing it all together

All in all, it's an inflation soup out there, both domestically and internationally. We've seen a perfect storm of supply-side impacts through COVID-19 and the supply chain chaos it has unleashed, combined with what turned out to be overly powerful fiscal and monetary stimulus (given how unexpectedly resilient economies turned out to be over the past few years). While we are forecasting that a 4% OCR will be enough to achieve a return to 2% inflation over the next two years, there are clearly significant risks that interest rates will need to go higher to engineer a timely return to target.

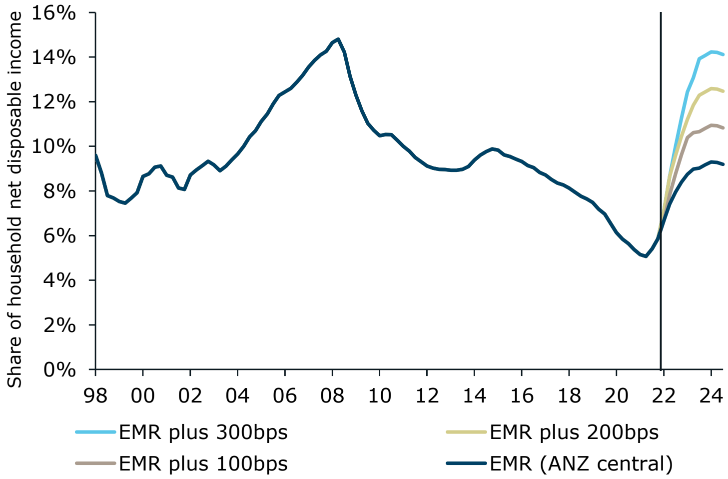
Regardless of the original source of inflation, be it domestic and/or global factors, we need real interest rates (which have been deeply negative) to return to positive territory before too long; otherwise those rate hikes that we've seen simply won't have teeth. In our current forecast, a lot of that rise in real interest rates is driven by inflation falling rapidly from here. But if even just a few of the risks we've highlighted come to pass, higher nominal interest rates (ie more OCR hikes beyond 4%) will be needed to do the work to bring real interest rates into positive territory, and put the inflation genie back in its bottle.

In that context, it is worth asking why interest rates won't need to go back to pre-GFC levels (when the OCR peaked at 8.25%), given that wages are currently growing faster, inflation is stronger, and the unemployment rate is lower than over the 2000s.

One possible candidate that leaps to mind is household debt. But aggregate debt hasn't increased as much as you might think given how house prices shot up. While there's certainly been a significant transfer of wealth between generations, bank lending standards have remained prudent, and overall debt is only back around 2007 levels. That level of debt brought about a long and painful deleveraging in the subsequent recession, so it's certainly not great, but it didn't stop the OCR reaching levels far higher than anyone is forecasting today.

Indeed, when we look at household debt-servicing costs, they remain historically low, and won't actually increase that much under our central scenario for the OCR (figure 6) – especially compared with the 2000s.

Figure 6. Household debt servicing costs (share disposable income)



Source: Stats NZ, RBNZ, ANZ Research

Note: EMR = effective mortgage rate, an estimate of the average mortgage rate households will face over time (which is different to current advertised rates).

Another candidate is the rapidly slowing housing market. House prices are down 8% - surely that has to hurt? Yes, cooling house sales and the sharply weaker outlook for construction will dampen activity and inflation pressure – that's built into our forecast. But even there, building activity is taking a while to roll over, and if wages keep growing like they have been, those higher mortgage rates will be less of a constraint on potential buyers.

Globally, growth is also weakening, including in our key trading partner, China, and a sharp deterioration in the terms of trade could drive a significant slowdown in the New Zealand economy. That's how both the 1990s and the 2000s expansions were killed off, and it remains a very pertinent risk today, given the significant challenges faced by the world's major economies. But again, most of the global risks we're looking at are also quite inflationary. War, geopolitical tensions, and climate change mean the risks are tilted towards global inflation remaining structurally higher incoming decades, even as they pose clear downside risks to global growth over the next year or two.

In sum, it's not all one-way traffic for interest rates, but the balance of risks remains firmly tilted towards more hikes being needed than less. While headline inflation numbers look like they may have peaked in several countries, including New Zealand, that's not sufficient. Central banks need to ensure inflation gets all the way back to their targets, and in a reasonable timeframe (ie within a couple of years). If the process is too slow, neutral interest rates will rise significantly, and central banks could find themselves on a treadmill of ever-higher rates just to stay still in terms of the real level of tightening they are delivering.

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