ANZ Research

NZ Insight: Inflation rotation

7 March 2023

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Confused by acronyms or jargon? See a glossary here.

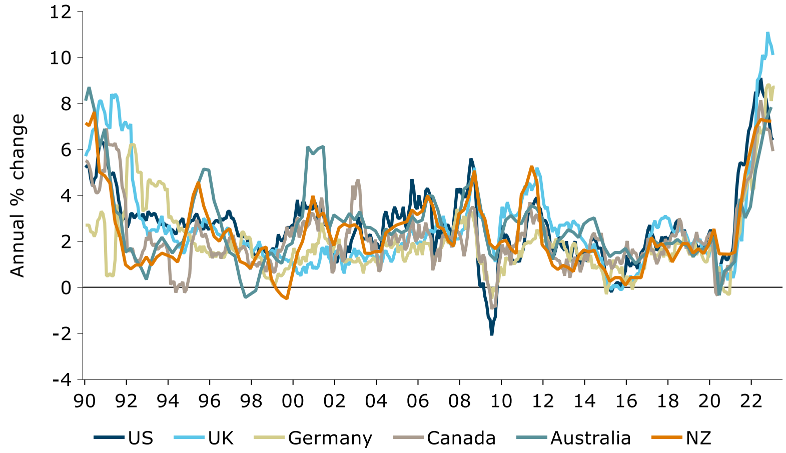
Inflation rotation

- Headline inflation appears to be peaking, both in New Zealand and around the world.
- However, with the inflation pulse rotating away from goods and towards sticky services prices, central banks' inflation fight is not over yet.
- The feedback loop between a tight labour market and rising services inflation will be a key determinant of how high the RBNZ (and other central banks) will lift interest rates, and when and if they will be able to then reduce them over the next few years.
- We continue to see the RBNZ hiking the OCR to a peak of 5.25% by May 2023, and holding it there until at least the end of 2024. But the tight labour market and uncertain cyclone impacts represent upside risks to the outlook for both inflation and the OCR.

All good?

The global inflation pulse appears – touch wood – to have peaked. While some countries are still experiencing rising inflation (eg Australia), key global economies like the US and euro area have seen headline inflation peak in recent months (figure 1). In New Zealand, we are still at the peak of our inflation cycle (which you'd have to say is looking more like a plateau, at this stage), and the impacts of Cyclone Gabrielle will likely see both near- and medium-term inflation pressures coming in hotter than otherwise. But inflation has at least stopped rising.

Figure 1. Global inflation rates



Source: BLS, ONS, DESTATIS, StatCan, ABS, Stats NZ, Macrobond, ANZ Research

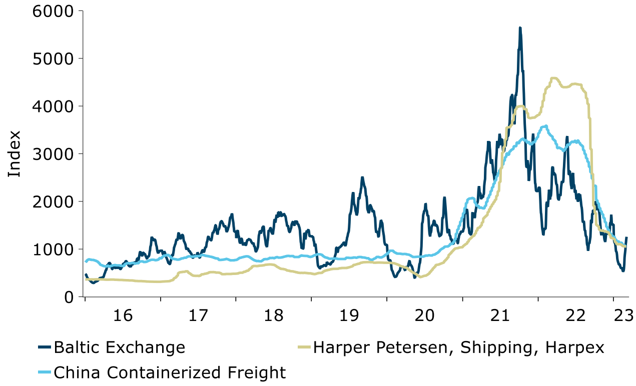
The peak in headline inflation globally is an encouraging development after a series of pretty relentless upside surprises over the past two years. But central banks' campaign against inflation is far from over. One key reason for this is that there is a clear divide in the inflation dynamics of goods and services.

The (very welcome!) disinflation we are seeing globally is coming through the goods side of the equation. That includes items like cars, appliances, furniture, and fuel, a category that represented 62.6% of the New Zealand

CPI in June 2020.[1] Goods inflation tends to be more responsive to global commodity price developments, and tends to be more volatile generally than services inflation is.

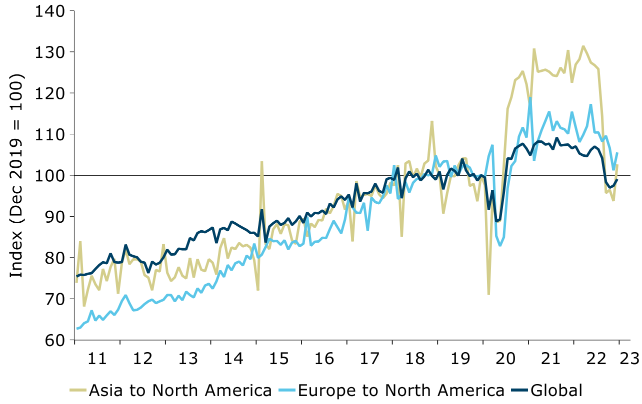
One reason we are seeing goods disinflation is that the intense disruptions triggered by the COVID-19 pandemic (including lockdowns and social-distancing requirements) have faded. Shipping costs have eased substantially relative to the highs seen over 2021 (figure 2). That's partly down to less direct disruption to ports and the like, and partly an unwinding of the global 'I can't go on holiday so I'm getting a spa/car/sofa' phenomenon. The unwinding of the inventory build-up that was seen in response to the shipping disruptions has also contributed to lower goods trade volumes (figure 3).

Figure 2. Global shipping costs



Source: Baltic Exchange, Harper Petersen & Co., Shanghai Shipping Exchange, Macrobond, ANZ Research

Figure 3. Container trade volumes (ANZ seas. adj.)



Source: CTS, Bloomberg, Macrobond, ANZ Research

All this is helping to unwind some of the immense pressures that were put on global goods prices over the course of the pandemic. As a small open economy, this means that New Zealand should be importing less inflationary pressure from overseas as we head through 2023.

Doing central banks no service

So far so 'good'. But unfortunately, services inflation is now picking up the baton from goods. Examples of services prices include residential rents, hairdressing services, vehicle servicing and repairs, housekeeping charges, and real estate services. Given the importance of labour inputs in each of these examples, it's not surprising that services inflation tends to be closely tied to domestic labour market conditions. In June 2020, services made up 37.4% of the New Zealand CPI.

The US is a key example of an economy that has seen headline inflation ease in recent months, but is now facing a persistent services inflation problem. CPI inflation in the US has fallen from a peak of 9.1% in June 2022 to a still-too-high 6.4% in January 2023. That's a big drop. However, it's clear from figure 4 that services inflation is becoming an increasing headache for the US Federal Reserve. And that's partly a symptom of a labour market that is still running very hot, with unemployment at 3.4% (the lowest since 1969) and 1.9 job openings per unemployed person. Wage growth is elevated and workers are hard to find, and that's driving services inflation higher.

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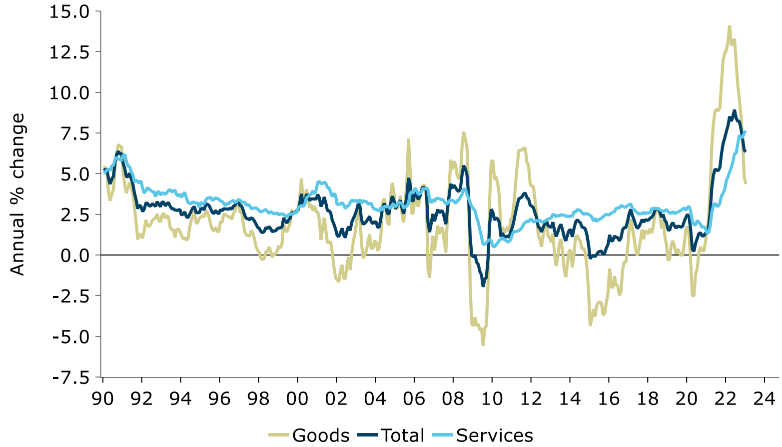
[1] This is in contrast to the US, where services inflation makes up over 60% of the CPI basket. One big reason for the difference is that in New Zealand, home ownership costs (10% of the CPI basket) are measured in terms of the cost of constructing a house. This is classed as a good. In contrast, the US estimates the "implicit rent that owner occupants would have to pay if they were renting their homes, without furnishings or utilities". This is a service.

This interaction between an overheated labour market and too-strong services inflation is a key reason why we expect the US Federal Reserve will lift the fed funds rate (FFR) to 5.5% by mid-2023 (currently 4.75%), and will only gradually cut the FFR back toward 4.5% by the end of 2024.

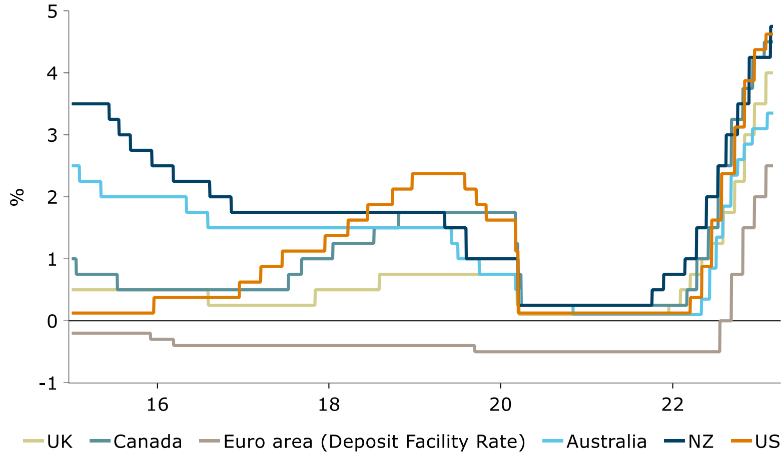
Figure 4. Goods and services inflation in the US



Source: Stats NZ, BLS, NZIER, Macrobond, ANZ Research

Central banks globally are entering a new stage of the hiking cycle. Having rapidly lifted rates to a level that is broadly considered to be contractionary (figure 5), many central banks have slowed the pace, as they enter the 'fine tuning' stage, as opposed to 'urgent catch-up'. But it remains highly uncertain how high interest rates need to be (and for how long) to ensure inflation returns to target. Goods disinflation is real, but for services inflation to fade, we need to see a realignment of labour demand with supply. This inflation rotation into services and away from goods will set the scene for monetary policy around the world as 2023 unfolds.

Figure 5. Global central bank policy rates

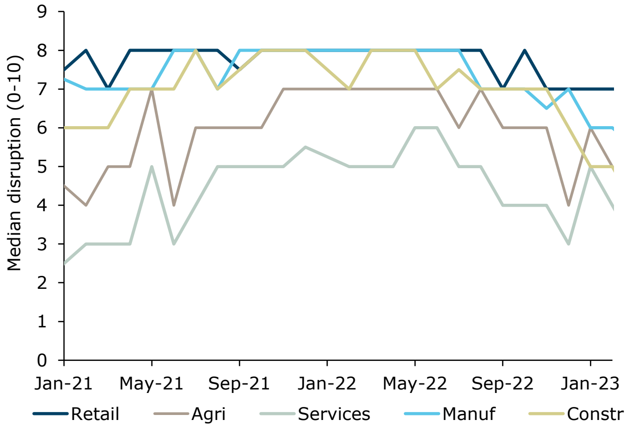


Source: BoE, RBA, RBNZ, Fed, ECB, BoC, Macrobond, ANZ Research

New Zealand is also doing the 'inflation rotation'

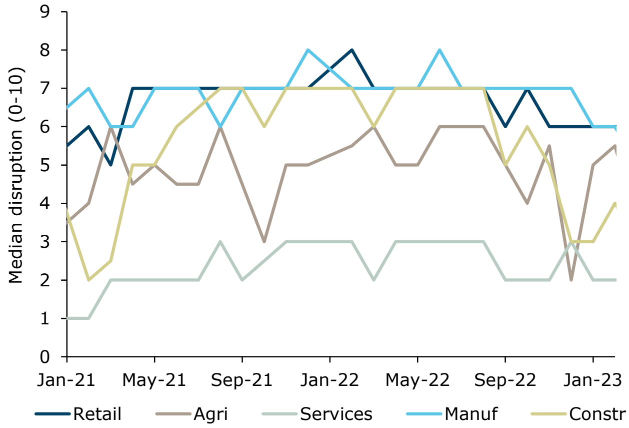
In New Zealand, domestic inflation developments are closely mirroring those seen overseas. Firstly, we've seen signs that the peak disruption to supply chains seen over 2021 is easing. Firms surveyed in our Business Outlook survey note that we have seen some improvements to inward and outward freight disruption (figures 6 and 7), although manufacturing and retail firms are yet to see a significant improvement.

Figure 6. Inward freight disruption in New Zealand



Source: ANZ Research

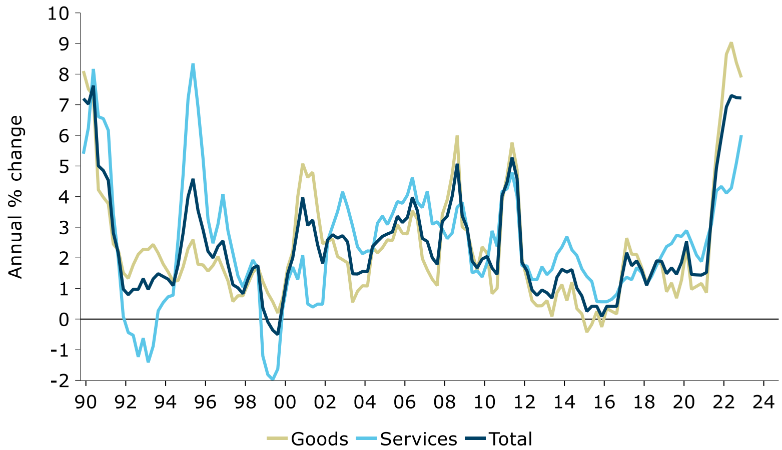
Figure 7. Outward freight disruption in New Zealand



Source: ANZ Research

Also mirroring the global picture, goods inflation in New Zealand has peaked (albeit not as convincingly as in the US, partly due to supply shocks to food production). Services inflation, however, has continued to build (figure 8). This really highlights the risk that even as the global inflation pulse starts to fade, domestically generated inflation and our super-tight labour market will keep the pressure on the RBNZ to remain tough on inflation.

Figure 8. Goods and services inflation in New Zealand

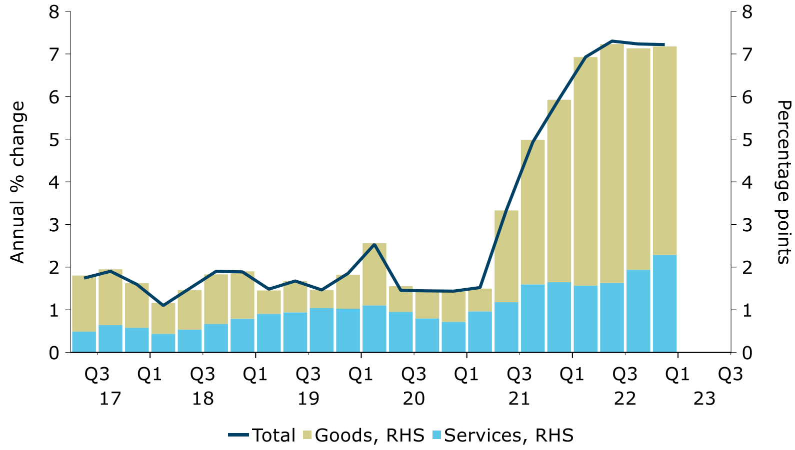


Source: Stats NZ, Macrobond, ANZ Research

Figure 9 (over) plots the contributions of goods and services prices to overall CPI inflation in New Zealand over the past few years. Clearly, goods inflation has dominated services since the COVID-19 pandemic started. That's no surprise, given that goods inflation encompasses construction costs, petrol prices, and most food prices – large CPI items that have all experienced substantial price increases.

But services prices are now contributing more than 2ppt to annual CPI inflation, and are showing no signs of slowing. Should that continue, we could see CPI inflation get 'stuck' above the RBNZ's 1-3% target band, even if goods inflation returns to historically average levels. It's on the RBNZ's radar: the February Monetary Policy Statement (MPS) noted "services sector prices have accounted for an increasing share of price growth in recent quarters".

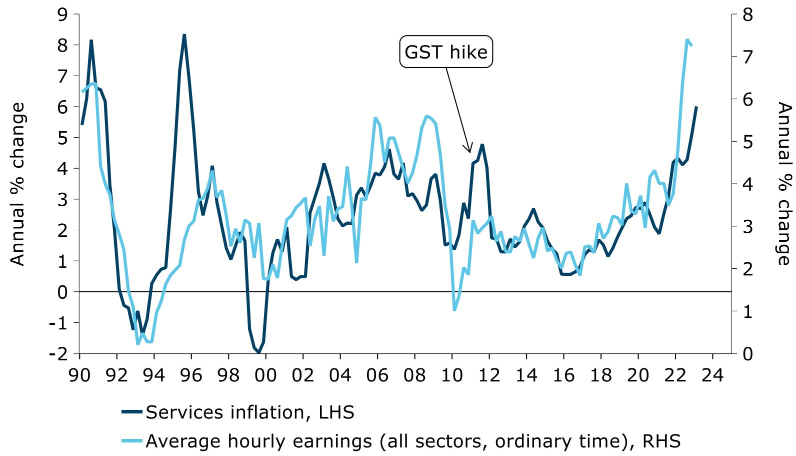
Figure 9. Goods and services contributions to CPI inflation



Source: Stats NZ, Macrobond, ANZ Research

Why might services inflation remain stubbornly high? One reason could be if the domestic labour market remains hot. Figure 10 highlights the close relationship between wage growth and services inflation. The causality in this relationship will run both ways (higher wages will see service providers raise prices, but higher prices will also influence wage demands). The interplay between services and wage inflation means that for this component of inflation to ease, we need to see demand and supply in the labour market become better aligned. Until this happens, we run the risk of seeing inflation remaining too high over the medium term (even if it eases from current levels).

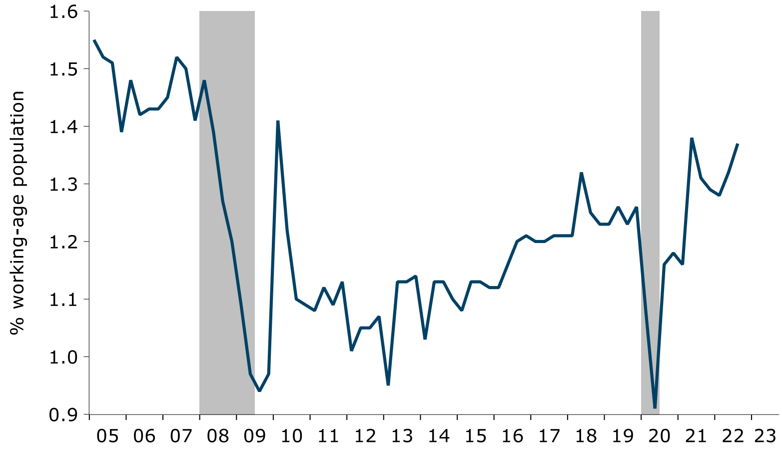
Figure 10. Services inflation and wage growth



Source: Stats NZ, Macrobond, ANZ Research

The RBNZ did a deeper dive into labour market dynamics in the February MPS. Job-to-job movements have increased sharply (especially versus the post-GFC period – figure 11). Previous RBNZ research has shown that job switchers tend to receive significantly larger wage increases. Not surprisingly, it has also been shown that job-to-job transitions significantly outperform standard measures of labour market slack (like the unemployment rate) when it comes to predicting wage growth and domestic inflation in New Zealand. The data only go up to September 2022, but they highlight that with demand running far in excess of supply, churn in the labour market has increased significantly, helping to send wage pressures to fresh record highs in the second half of 2022.

Figure 11. Job to job transitions

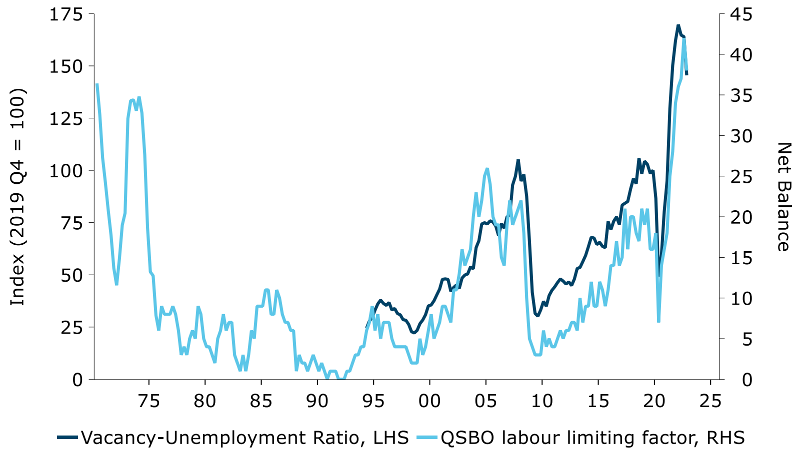


Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Note: Grey shading indicates recessions in New Zealand

Until recently it was looking like the gap between labour demand and labour supply was starting to close. Labour market indicators had slowed in the final months of 2022, after what seemed like unstoppable momentum over the past few years (figure 12). The share of firms reporting that shortages of labour are the main factor limiting production has flattened off (albeit at extremes), while job vacancies are now falling relative to the number of unemployed people. However, both of these measures are still extremely elevated by historical standards, and far beyond levels seen at the end of 2019, when the RBNZ assessed the labour market was at or even slightly above maximum sustainable employment. And, as we discussed in an Insight note last week, labour market indicators over January and February 2023 point to the labour market getting something of a second wind.

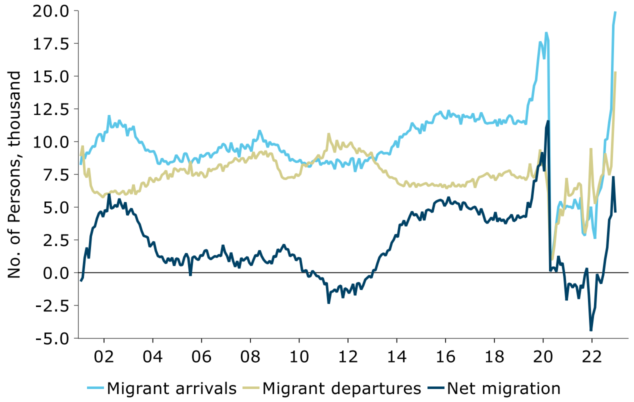
Figure 12. Labour market tightness measures



Source: Stats NZ, NZIER, Macrobond, ANZ Research

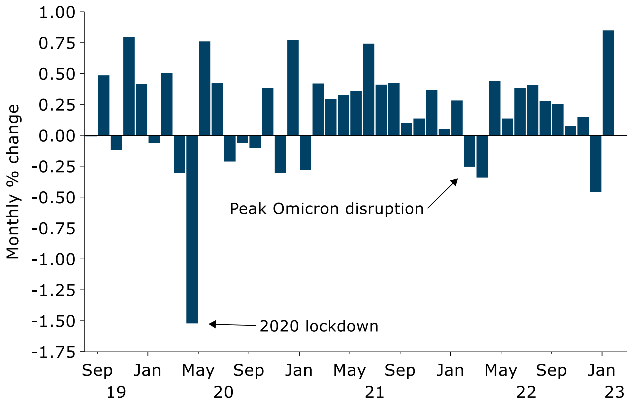
The spectacular increase in net migration in recent months does point to an improvement in the availability of workers, which should ease some of the logjam in the labour market (figure 13). Some caution is warranted when looking at recent net migration data, as the data are subject to significant revisions. However, even if the migration pulse isn't quite as strong as the initial data suggest, it still represents a massive increase in labour supply relative to the past few years of closed borders. This seems likely to have been a big driver of the lift in filled jobs seen in January (figure 14). To the extent the employment lift has been driven by availability of workers, it shouldn't be particularly inflationary. But if it also represents a lift in labour demand, it could be. Add it to the (already large) 'wait and see' pile.

Figure 13. Monthly net migration



Source: Stats NZ, Macrobond, ANZ Research

Figure 14. Monthly filled jobs



Source: Stats NZ, Macrobond, ANZ Research

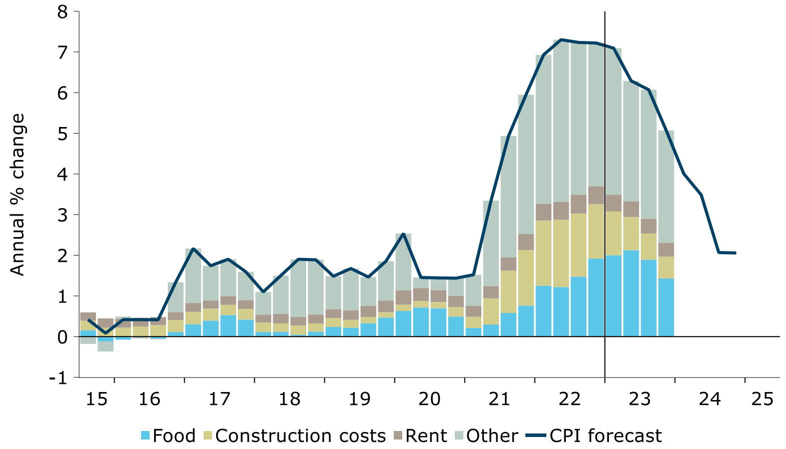
Monetary policy implications

The evolution of labour market pressures over 2023 will be key for understanding the likely path of interest rates over the next few years. Should the labour market remain tight, despite the RBNZ's rapid rate hikes and high levels of net migration, it would be difficult to see the RBNZ feeling comfortable easing up on the hawkishness much any time soon. Feedback loops between wage growth and the cost-of-living have the potential to see inflation remain high without making the average worker any better off in real terms.

As the inflation pulse shifts towards services, that interaction between the labour market and services inflation will become increasingly important for the RBNZ (and its international peers).

The devastating impacts of Cyclone Gabrielle are another complicating factor for the RBNZ. While the full cost of this disaster will not be known for some time, it's clearly going to be inflationary both in the near and medium term. The very items in the CPI which were expected to help drive disinflation over 2023 (construction costs, food prices, and rents – figure 15) now face significant upside risks due to immediate cyclone impacts (at least at a regional level), as well as what's looking like a significant and lengthy repair job to houses and infrastructure.

Figure 15. Contributions to CPI inflation forecast



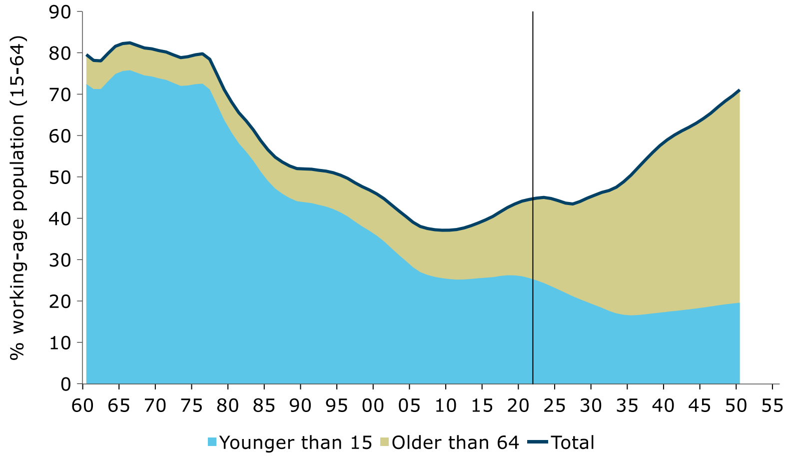
Source: Stats NZ, Macrobond, ANZ Research

Goods inflation could yet make a comeback

While global goods inflation is currently easing, it could make an unwelcome return for a number of reasons.

- China has now abandoned it's zero-COVID policy, which should provide some support for global commodity prices as Chinese consumer demand recovers. It's good for New Zealand export prices too, but that would reinforce rather than offset any inflation impacts.
- Geopolitical tensions have been a particularly important driver of global markets since Russia's invasion of Ukraine a year ago. The prices of key inputs to production, including energy and fertiliser, have been buffeted by geopolitical headlines, and may continue to be. That's the kind of thing central banks would normally 'look through', but it's harder to do that when you're already in a high inflation environment.
- Trends towards 'near-shoring' and 'friend-shoring' of supply chains also have the potential to drive goods prices higher, as countries seek to make supply chains more resilient to disruption. The pandemic was already driving movement towards 'just-in-case' rather than 'just-in-time', and simmering global tensions may entrench that trend. Supply chain resilience does have a cost in terms of day-to-day efficiency (and therefore prices).
- Climate change is an ongoing challenge for central banks focused on price stability. The mitigation of climate impacts and the reinforcement of global infrastructure will be resource intensive and expensive. Meanwhile, the impacts of a warmer and more volatile atmosphere will continue to add to food supply disruptions. As a net exporter of food, New Zealand is at least on the right side of this from a national income point of view. But it's still inflationary (and not a 'good news' story).
- While slow burn, demographics are also not working in our favour. China's workforce is already shrinking, down by more than 41 million over the past three years to 733.5 million in 2022. The World Bank estimates that the age dependency ratio (the ratio of people younger than 15 and older than 64, relative to the 15-64 year-old working-age population) could rise to over 70% by the end of the 2050s, versus 44.5% in 2021 (figure 16). That's one of the more extreme cases, but many countries are now experiencing demographic challenges. There are countries with more favourable demographic profiles (eg India), but again, reworking supply chains typically isn't cheap or fast.

Figure 16. Age dependency ratio in China



Source: World Bank, Macrobond, ANZ Research

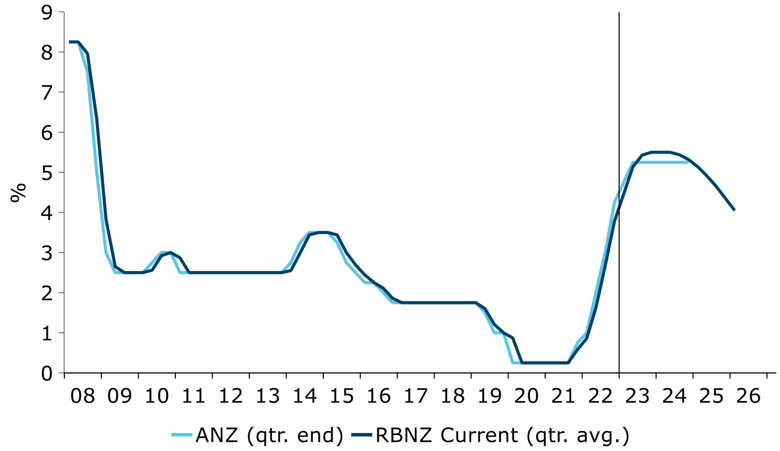
In short, while it's not unreasonable to assume ongoing goods disinflation, it's not a given, and to some extent does feel like a bit of a best-case scenario. Any combination of the factors listed above could arrest the downtrend in goods inflation, kicking off second round impacts via inflation expectations, and see global inflation pressures remaining stuck at high levels. It's another reason why central banks can't rest easy just yet.

Pulling it together

Combine a sticky services inflation pulse, with the risk of stubbornly high goods inflation due to the cyclone or a renewed round of global goods inflation, and it's worryingly easy to imagine overall CPI inflation remaining above the RBNZ's 1-3% target range over the next few years.

All up, we are clearly not out of the inflation woods yet. The relentless upside surprises of 2021 and 2022 are hopefully over. But it's a long journey from 7.2% inflation back to the 2% midpoint of the RBNZ's target band. And there are already significant bumps in that road. All of this points to the risk that interest rates will remain high for longer than markets currently anticipate. We therefore continue to expect the RBNZ will hike the OCR to a peak of 5.25% by May 2023, before holding rates at this level until at least the end of 2024 (figure 17).

Figure 17. ANZ OCR forecast



Source: RBNZ, Macrobond, ANZ Research

As discussed in our latest Quarterly Economic Outlook, there are plausible scenarios in which the OCR ends up significantly higher or lower than our baseline forecast. However, with global economic momentum picking up again in early 2023, the labour market still beyond maximum sustainable employment, and Cyclone Gabrielle posing further upside risk to domestic inflation pressures, it's fair to say that we see the risks being tilted firmly towards the OCR being lifted higher than our current expectation of a 5.25% peak.

That's not to suggest the risks are one-sided. Monetary policy acts with a lag, and its impact on the housing and construction sector is just getting going. The spill-over impacts of this could be larger than we are reckoning on. Globally, the end of the era of practically-free and certainly easy money is unlikely to be all smooth sailing, and that could at some point make a more abrupt and deep hole in demand than expected. But assuming the wheels stay on, we do see the risks as tilted towards inflation not falling either as fast or as far (or both) as we and the RBNZ are forecasting, which is pretty much a straight line back to 2%. Real life tends to get in the way of tidy stories like that.

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