RESEARCH

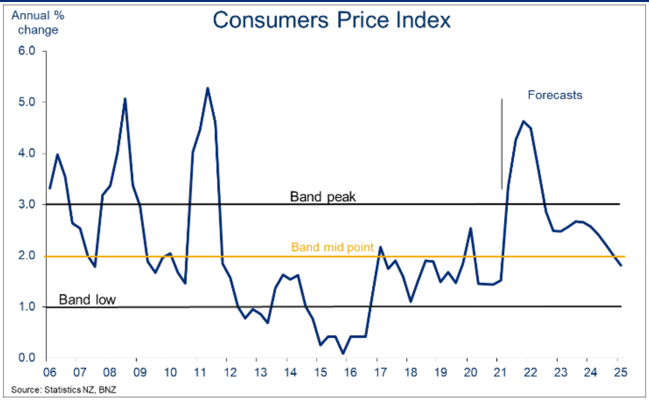
Economy Watch

12 October 2021

Inflation spikes

- **4.0%+ inflation will be here for a while**
- **It's transitory**
- **But the inflation tail will be long**
- **As excess demand sustained**
- **RBNZ adjustment has only just started**

Inflation spikes



New Zealand's annual consumer price inflation will burst through 4.0% in the September quarter 2021. Moreover, it will stay above 4.0% into 2022. That's long enough to feed into adaptively-formed inflation expectations.

Yes, the spike in inflation we are currently witnessing is transitory. But what's important is not that it is transitory or not but what makes it transitory and where it settles once that transition is over.

In large part the downward correction in inflation will be driven by an inevitable softening in the pace of commodity prices (especially fuel) but unless the central bank tightens monetary policy (which it is doing) there is a very real risk that the currently heightened price increases become self-sustaining, particularly in an environment where the labour market remains so tight. Workers are currently in a very strong bargaining position which is unlikely to change any time soon.

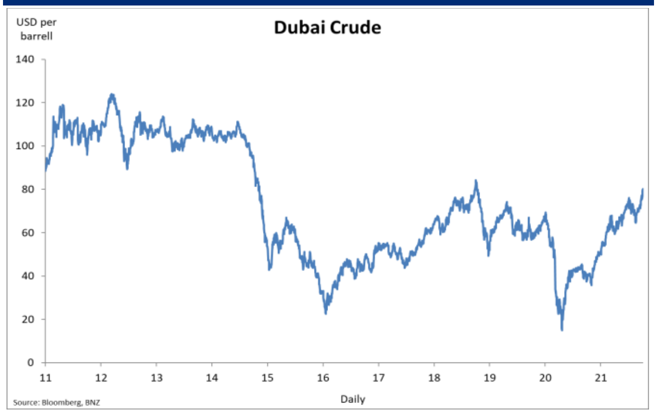
On a quarterly basis, September is likely to represent the peak in price momentum. We are forecasting a 1.6% increase for the quarter taking annual inflation to 4.3% from 3.3% in June. Three sub-groups of the CPI will account for 85% of the quarterly increase: food, housing and household utilities, and transport.

NZ Consumers Price Index

Quarter		Index	Quarterly % Change	Annual % Change	Average Annual % Change
2018	March	1011	0.5	1.1	1.6
	June	1015	0.4	1.5	1.5
	September	1024	0.9	1.9	1.5
	December	1025	0.1	1.9	1.6
2019	March	1026	0.1	1.5	1.7
	June	1032	0.6	1.7	1.7
	September	1039	0.7	1.5	1.6
	December	1044	0.5	1.9	1.6
2020	March	1052	0.8	2.5	1.9
	June	1047	-0.5	1.5	1.8
	September	1054	0.7	1.4	1.8
	December	1059	0.5	1.4	1.7
2021	March	1068	0.8	1.5	1.5
	June	1082	1.3	3.3	1.9
Forecasts:					
	September	1099	1.6	4.3	2.6
	December	1109	0.9	4.7	3.5
2022	March	1117	0.7	4.6	4.2
	June	1123	0.5	3.8	4.3
	September	1132	0.8	3.0	4.0
	December	1136	0.4	2.4	3.4
2023	March	1145	0.8	2.5	2.9
	June	1152	0.6	2.6	2.6
	September	1162	0.9	2.7	2.5
	December	1166	0.4	2.6	2.6
2024	March	1174	0.7	2.6	2.6

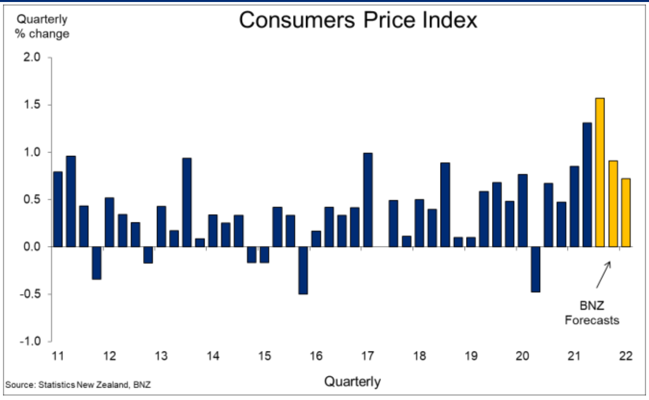
Source: Statistics New Zealand, BNZ

Waiting for a correction?



The December quarter should see the peak in the annual reading with CPI inflation climbing to 4.7%. Housing and transport will again play a big part in the overall Q4 increase in prices, which should moderate to 0.9%, thanks largely to the expected seasonal decline in food prices.

Peaking

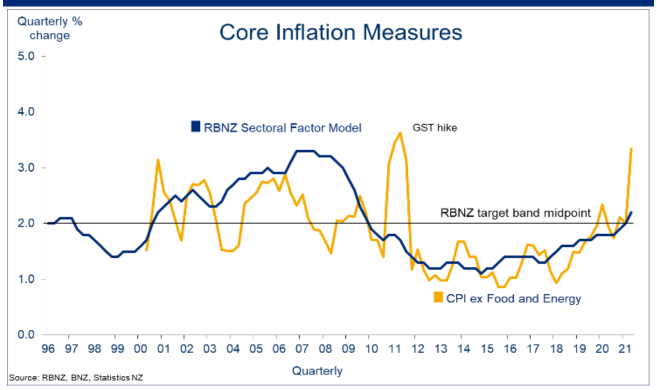


4.7% will be the highest annual CPI increase since 2011 but at that time inflation was exaggerated by the increase in GST to 15%, a hike in ACC levies and ETS impacts on fuel prices. Prior to this, you have to go back to 2008 to see readings as strong as we now expect.

In our opinion, the risk to these near-term forecasts is weighted to the upside. A 5.0% annual reading certainly can't be ruled out.

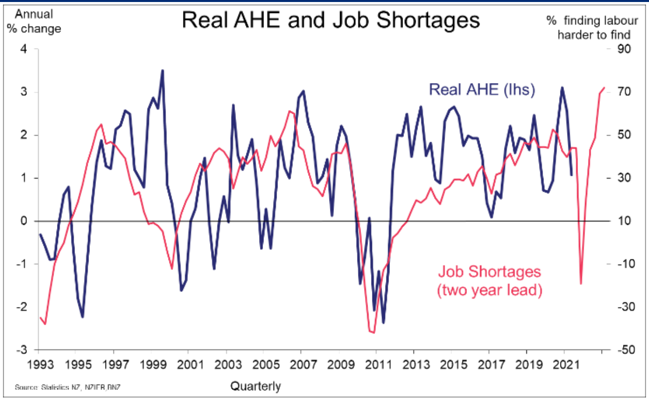
It is true there are a number of rapidly moving price categories that are "artificially" inflating the headline number at the moment but core measures are also strong and rising. For example, as at June the annual increase in CPI ex food and energy was 3.3%, we estimate that this will rise to 3.7% in the September quarter. If so it will be the highest reading for this series since it first started being published in 2000. Indeed, every core measure the RBNZ defers to is already above the central bank's 2.0% target-range mid-point and these measures are all trending higher.

Core accelerating



The timing of the surge in inflation couldn't be worse as far as the RBNZ is concerned. With the labour market wickedly stretched there is a much greater chance that heightened CPI inflation will flow through into wage negotiations. As it stands, annual average wage inflation (as measured by the Quarterly Employment Survey) is already over 4.0% and that's before the big CPI numbers hit the headlines. And the degree of job shortage that is currently being experienced by the economy is consistent with real wage growth rising to 3.0%!

Wage pressures significant



Looking further out, we do expect inflation to moderate. The main reason for this is that we do not believe tradables inflation will be sustained at current levels. Not only is general commodity price inflation likely to moderate but we would also expect freight costs, which are having a significant impact on selling prices at the moment, to ease back in due course. Indeed, there is an outside chance tradables inflation could turn temporarily negative if there was a major global commodity price correction.

However, once the noise abates we still believe there are a number of factors that will, on average, keep tradables inflation well above zero for a sustained period of time. To start with, it shouldn't be overlooked that, as at the June quarter, annual tradables inflation had increased to 3.4% over a period of time when the currency (TWI) had appreciated 7.2%. Without that currency appreciation tradables inflation could well have been double digit. It is highly unlikely the currency will appreciate by the same amount over the next twelve months so, to the extent that commodity prices moderate, the currency offset will do so as well.

Additionally, it seems likely global demand will continue to rise, albeit at a slowing pace, and that this will underpin a more inflationary global environment than we have become accustomed to. And last but not least, we think there may be some relatively long lags in the system:

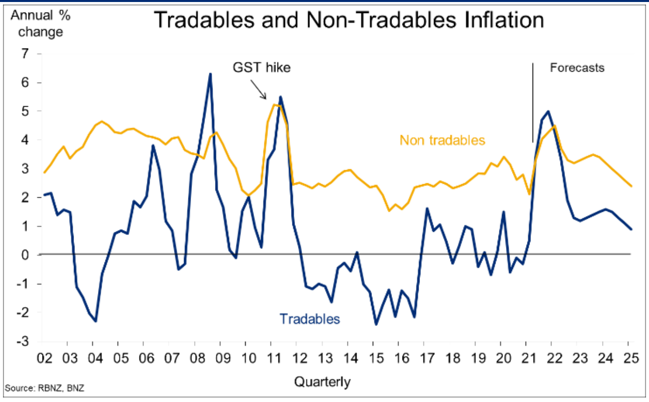
- selling prices will take some time to fully reflect business input cost pressure
- labour cost inflation will remain elevated for some time
- freight costs and other global supply shock issues may be with us for longer than many assume.

We repeat that all the above won't prevent tradables inflation falling but it should prevent it returning to the largely deflationary status it held for much of the last decade.

The peak in non-tradables inflation is likely to be slightly later than the peak in tradables. This is largely because of ongoing housing related inflation. Generally, non-tradables inflation adjusts more slowly anyway and will be particularly slow to adjust this time around given that the

New Zealand economy is expected to continue operating in a state of excess demand for some time to come. It's worth noting that since 1992, non-tradables inflation has averaged 3.1%. It's hard to see why it would fall below this average anytime soon.

Elevated for longer



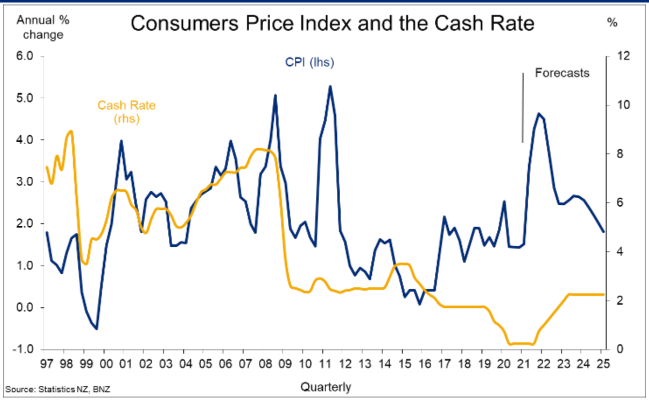
From the Reserve Bank's perspective, all this suggests interest rates need to keep rising. Our forecasts are predicated on a series of rate increases which ultimately slow the economy sufficiently to alleviate inflationary pressures such that inflation comes back to the mid-point of the Reserve Bank's target band. The RBNZ's forecasts, as published at the August MPS, were similarly constructed. So please don't look at our forecasts, see that inflation gets to 2.0% and therefore assume no rate increase is required.

Of course, if the wheels fall off we will adjust our forecasts accordingly, but this is not our central view even in a COVID-endemic environment. And don't forget COVID is currently creating much more of a supply shock than a demand shock. In the event supply is further constrained then lower levels of growth than we are forecasting will create a similarly bothersome inflation response.

Near term there are those who are starting to believe the expected spike in inflation could create a knee jerk reaction from the RBNZ when the numbers are published. We do not buy into that. As far back as August, the RBNZ was forecasting annual CPI inflation would exceed 4.0% in the second half of this year. Since then it would be well aware that heightened fuel, food, car and rental prices will result in a higher headline CPI than was foretold back in August. Had it been fazed by this it would have said so when it released its October MPR review. Clearly it wasn't.

And don't forget, rising fuel prices ultimately have a significant negative impact on aggregate demand which tends to lower future inflationary pressure.

More rate hikes ahead



stephen_toplis@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis	**Craig Ebert**	**Doug Steel**	**Jason Wong**	**Nick Smyth**
Head of Research	Senior Economist	Senior Economist	Senior Markets Strategist	Senior Interest Rates Strategist
+64 4 474 6905	+64 4 474 6799	+64 4 474 6923	+64 4 924 7652	+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Ivan Colhoun	**Alan Oster**	**Ray Attrill**	**Skye Masters**
Global Head of Research	Group Chief Economist	Head of FX Strategy	Head of Fixed Income Research
+61 2 9237 1836	+61 3 8634 2927	+61 2 9237 1848	+61 2 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+61 2 9295 1100
Fixed Income/Derivatives	+61 2 9295 1166

London

Foreign Exchange	+44 20 7796 3091
Fixed Income/Derivatives	+44 20 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+85 2 2526 5891
Fixed Income/Derivatives	+85 2 2526 5891