WESTPAC ECONOMIC BULLETIN

CPI preview, December quarter 2021 – Thursday 27 January, 10.45am.

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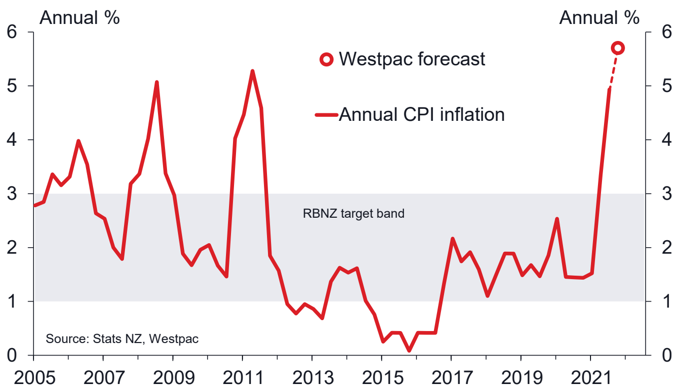
Satish Ranchhod, Senior Economist
+64 21 131 3433
satish.ranchhod@westpac.co.nz

Inflation to hit highest level in more than 30 years.

- We expect the upcoming Consumers Price Index will show that New Zealand consumer prices rose by 1.2% in the December quarter.
- That would see annual inflation rising to 5.7%, up from an annual rate of 4.9% last quarter and the highest annual inflation rate in 31 years.
- Inflation is being boosted by a perfect storm of supply-side pressures and strong domestic demand.
- Our forecast is in line with the RBNZ's last set of published forecasts.

Annual inflation forecast



The price of consumer goods and services in New Zealand is continuing to charge higher. We're forecasting quarterly inflation of 1.2% for the three months to December. Coming on top of large price rises earlier in the year, that would take the annual inflation rate to 5.7%, up from 4.9% in September and the highest annual rate since June 1990.

New Zealand is in the midst of a perfect storm of inflation pressures. Much of this is a result of offshore factors. Disruptions to global manufacturing chains have resulted in shortages of many consumer goods and production inputs. The resulting upwards pressure on prices has been compounded by increases in international transport costs, with both shipping rates and oil prices rising rapidly over the past year.

Domestic cost pressures are also on the rise. Most notably, many New Zealand businesses are struggling to source workers, and wage costs have been pushing higher as businesses compete to attract staff.

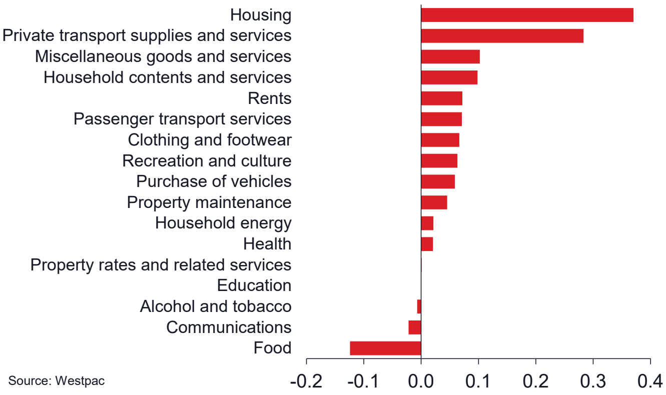
But the rise in inflation is not just due to supply-side cost pressures. Demand in some key parts of the domestic economy has also been running hot. In particular, residential construction is booming. We've also seen households spending up on items like furnishings and recreational equipment. This strength in demand has meant that businesses have greater scope to pass on cost increases into final prices, rather than taking a hit on margins.

Putting this altogether has left us with a potent cocktail of cost-push and demand-pull inflation pressures that is resulting in widespread price rises. Consistent with that, measures of underlying or 'trend' inflation are also likely to continue pushing higher this quarter. Most core inflation measures are already running above 2%, with several approaching or already above the 3% upper bound of the RBNZ's target band.

Our forecast for December quarter inflation is in line with the RBNZ's latest published forecast. Like us, the RBNZ is expecting strong inflation pressures over the coming year, and as a result they have signalled the likelihood of further rate hikes over the coming months. Westpac is expecting a 25bp increase in the OCR at the upcoming February policy decision. We expect that will be followed by a series of OCR hikes over the coming year, with the cash rate peaking at 3% in 2023.

A key uncertainty around our forecasts is how last year's Delta outbreak and the dialling up of activity restrictions has affected prices. Although demand in sectors like hospitality took a knock, spending on items like home furnishings remained firm. Similarly, Delta-related disruptions to travel may see some volatility in the prices of items such as domestic airfares. However, even if there are some Delta related swings in prices, underlying inflation is set to remain strong for some time.

Contributions to Q4 CPI forecast (percentage points)



Source: Westpac

Details.

Housing and construction costs are again set to be major drivers of the rise in overall inflation. We've pencilled in a 4.0% increase in building costs for the quarter, down just slightly on the rapid pace seen in June and September. To put that sort of rise in context, over the past 20 years, building costs have typically risen by only 1% a quarter. Building activity has been charging higher over the past year, with low interest rates and the strong housing market encouraging development activity. At the same time, acute shortages of materials and staff have seen input costs climbing rapidly, along with related pressure on margins. Combined, those conditions have seen the cost of building a new home rocketing higher over the past year.

Petrol prices have also risen strongly in recent months, with local pump prices up 5.8%. Global oil prices rose strongly through the final months of 2021, and the related increase in transport costs is also boosting prices in the economy more generally.

While increases in housing and transport costs are likely to account for the lion's share of this quarter's rise, inflation pressures are widespread. We expect to see firmness in the prices for a range of goods, including prices for many durable household items like furnishings and recreational equipment. Retailers continue to report difficulties sourcing stocks, as well as rising import costs in the face of strong demand.

Providing a partial offset to the strong rises in other prices, we're expecting a 0.7% fall in food prices due to the usual seasonal decline in the prices of fresh vegetables. However, that's actually a fairly modest fall in overall food prices for this time of year, with prices for groceries and takeaways/dining out pushing higher in recent months.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Gregorius Steven, Economist
+64 9 367 3978

Any questions email:
economics@westpac.co.nz