Economic Bulletin.

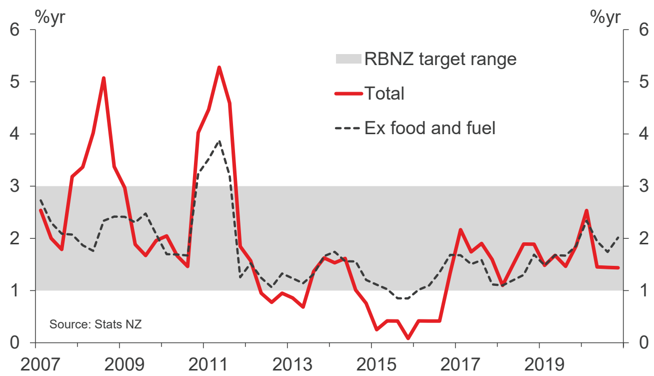
22 January 2021

No bargains this Christmas – CPI rose 0.5% in December quarter, annual inflation 1.4%.

- The Consumer Prices Index (CPI) rose 0.5% in the December quarter, a much stronger result than we expected.
- Covid-19 disruptions have lifted some prices in the near term. In particular, prices for some big-ticket items were squeezed higher ahead of Christmas.
- We expect some of these price pressures to ease over time. Nevertheless, the risk of an undershoot on inflation is diminishing.
- This backs our recent forecast of no further OCR cuts this year.

Michael Gordon, Senior Economist
+64 9 336 5670

Annual inflation



Consumer price inflation was more active than we expected at the end of 2020. The Covid-19 shock has created a number of distortions in the New Zealand economy that have added to inflation on balance, at least in the short term.

We expect that some of the impact will be reversed in time. Even so, it's looking less likely that inflation will remain uncomfortably low for the Reserve Bank over this year. That's consistent with our change of call yesterday, where we no longer expect the Official Cash Rate to go below its current level of 0.25%.

The 0.5% rise in prices for the December quarter was above market and Reserve Bank forecasts of a 0.2% increase, and much higher than our forecast of a flat result. The annual inflation rate remained at 1.4%, still in the lower half of the RBNZ's 1-3% target range. However, the various measures of 'core' inflation, which exclude volatile prices, were closer to the 2% midpoint.

For us, the surprise was largely on the tradables side, and in particular for big-ticket imported items. Two factors have come together to squeeze prices higher. First, with overseas holidays off the table, many Kiwis have diverted their spending towards items like used cars, furniture, TVs and mobile phones. Second, the flow of imports has been disrupted for various reasons, leading to shortages of some goods.

These two factors came to a head in particular during the pre-Christmas rush, putting upward pressure on prices for many items – if not outright price increases, then certainly a lack of the usual discounting at this time of year. (It's worth noting that most prices are surveyed mid-quarter, i.e. in November, so the CPI may not have even picked up the worst of the pre-Christmas squeeze.) We did see this as a risk for inflation in the short term, but clearly didn't build enough into our forecast.

We expect that some of this effect will be unwound now that the Christmas rush has passed. However, it's not clear how long it will take to iron out the disruptions to imports, and to global supply chains as a result of Covid-19.

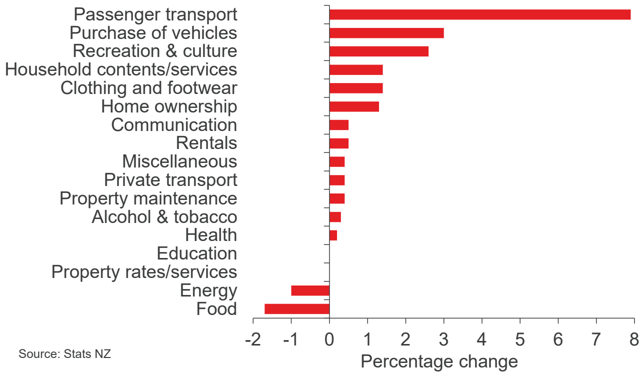
The border closure has also affected the CPI on other, sometimes surprising, ways. Prices for domestic accommodation rose by 20%, much larger than the usual seasonal increase, and were up 6% on a year ago. While accommodation was discounted during winter to try to attract more domestic tourists, there was no such effort required in summer.

Overseas airfares rose by 14% for the quarter, which on its own added 0.1pts to the inflation rate. In the previous two quarters Stats NZ had removed overseas airfares from the CPI basket, reflecting the lack of available flights. For this quarter, only the Auckland to Sydney route has been reintroduced, but the fares for this route are reportedly much higher than they were pre-Covid. (In contrast, domestic airfares and vehicle rentals remain lower than a year ago.)

Looking ahead, we still expect inflation to drop in the early part of this year. Some of the price pressures that related to the Christmas/summer period are likely to fade. The renewed strength of the New Zealand dollar will depress import prices. And the string of large annual increases in tobacco tax has ended, which alone will knock around 0.4pts off the inflation rate from the March quarter.

Nevertheless, we are likely to revise our inflation forecasts higher for this year, given the improving economic outlook and the higher than expected starting point. Our previous forecasts had inflation remaining stubbornly around 1% over the next couple of years. We still think it will remain low, but not uncomfortably so for the RBNZ.

Quarterly price changes



Source: Stats NZ

Contact the Westpac economics team.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior 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

Any questions email:
economics@westpac.co.nz

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