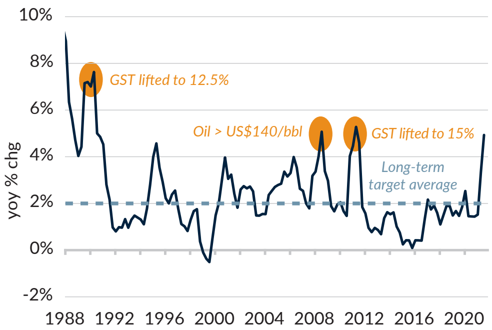
focus

Inflation soaring like it's 1989

This week the Consumer Price Index (CPI), New Zealand's principal measure of inflation, hit 4.9%. Outside of when oil briefly exceeded US$140/bbl in 2008 and the impact of GST hikes in 2010, you'd have to go back to the late 1980s to see headline inflation at higher levels.

New Zealand isn't the only country facing heightened inflation pressures, but we are near the front of the pack. Economically, we are a small open nation, which, prior to COVID, had largely relied on migration to drive economic growth. While shut borders and supply chain disruptions are impacting countries everywhere, the impact here has been even more pronounced.

SURGING INFLATION: NEW ZEALAND CPI



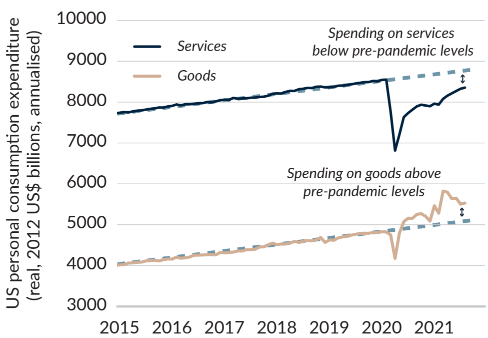
Source: Statistics NZ, Forsyth Barr analysis

Economics 101

The first thing any student of economics learns is the price of any good or service reflects the balance between demand and supply. Too much demand or not enough supply and prices rise. Falling demand or a supply glut and prices fall.

Around the world, huge economic support from governments and central banks has ensured demand has bounced back strongly from the COVID crash. This is particularly the case for goods – consumers have switched much of their spending away from services (particularly the likes of travel and hospitality) towards goods – tangible items such as cars and appliances. Global industrial production (manufacturing goods) has bounced back and beyond pre-COVID levels.

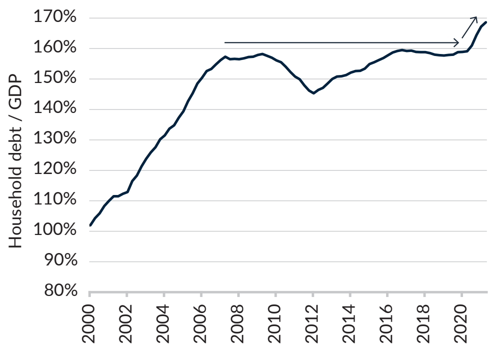
CONSUMERS HAVE SWITCHED SPENDING FROM SERVICES TO GOODS: UNITED STATES CONSUMPTION EXPENDITURE



Source: US Department of Commerce, Forsyth Barr analysis

This spending boom has been strong in New Zealand. Until recently, we have had to grapple less with restrictions and lockdowns compared to most other countries. Consumers — with a lesser burden from COVID fears — have broken out the credit cards. One driver of New Zealand's economic strength over the past 18 months has been consumer spending, much of it funded from debt.

NEW ZEALANDERS HAVE BEEN BREAKING OUT THE CREDIT CARDS: HOUSEHOLD DEBT/ GROSS DOMESTIC PRODUCT



Source: RBNZ, Forsyth Barr analysis

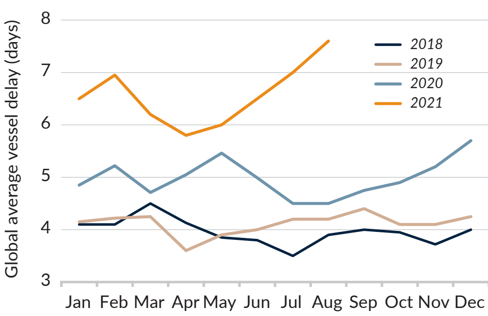
Supply can't keep pace

At the same time as demand across economies bounced back, COVID-disrupted supply failed to keep pace.

The global economy is more integrated than ever before. Take an Apple iPhone for example. The hundreds of individual components in each phone are sourced from suppliers in 43 different countries across six continents. Parts are sent to factories to be assembled, and the completed iPhones are shipped to retailers around the world. A delay in any single item can disrupt the entire supply chain.

COVID has disrupted many businesses, many industries, and many supply chains. Probably grabbing the most headlines has been the global freight industry. The domino effect of COVID restrictions – factory and port closures, labour shortages, social distancing — often at different times across different countries, all compounded by greater demand for goods (you don't ship services!), has resulted in massive shipping congestion and delays.

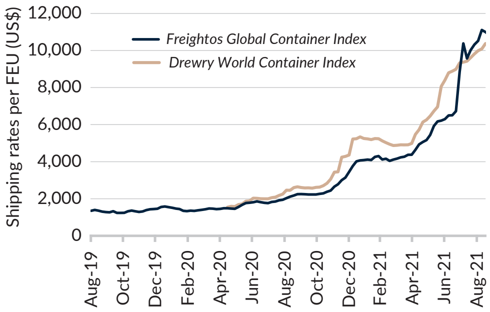
SUPPLY CHAINS ARE CLOGGED: VESSEL DELAYS



Source: Sea-Intelligence, Forsyth Barr analysis

FREIGHT COSTS HAVE SOARED:

SHIPPING RATES



Source: Drewry, Freightos, Forsyth Barr analysis

Businesses around the world are also struggling to find workers. In many countries the labour force has shrunk. Some people have opted for early retirement. Others are reluctant to take up jobs that expose them to the virus. Closed borders have reduced labour mobility. Lack of labour limits output and typically pushes up wage costs.

Energy costs also surging

Surging energy prices have also lifted costs for households and businesses. Energy demand has been boosted by strong industrial production, and impacted by the perfect storm of unusual weather events – more extreme (hot and cold) Northern Hemisphere temperatures lifted demand and depleted inventories coming into winter, less wind lowered output from European wind farms, floods in China and Indonesia reduced coal output, while droughts in Brazil, China, Europe, and North America all impacted hydro output. In many cases higher costs for businesses are being passed on through higher prices.

OIL PRICES HAVE RALLIED: BRENT CRUDE PRICES

Source: Refinitive, Forsyth Barr analysis

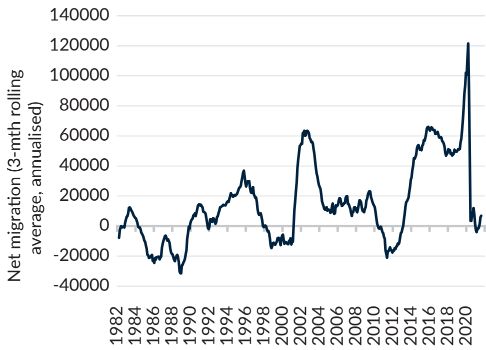
New Zealand both importing inflation and creating its own

As a small open nation, a long way from most trading partners, we are heavily influenced by the global economy. The cost of the imports we consume is rising. (Soaring) freight costs often make up a greater proportion of the cost (and therefore price) of goods in New Zealand relative to other countries. Furthermore, it is competition from imports which often constrains prices across many New Zealand industries. So we are importing global inflation – on the last read "tradeable" inflation was running at a lofty 5.7%.

In addition (and perhaps even more significant in the medium-term) are the demand-supply imbalances that have built up domestically. Over the past eight years the biggest driver of economic growth has been the tidal wave of new migrants. A rising population boosts demand for all goods and services, but supply cannot always respond quickly – housing is a key example – we don't have enough houses or sufficient tradespeople to build new ones quickly. Prior to COVID that same migration helped to grow supply and keep a lid on wages. But now, with borders shut, the capacity constraints are biting – "non-tradeable" inflation is also running at a sizeable 4.5%.

FROM A DELUGE TO A TRICKLE:

NEW ZEALAND NET MIGRATION



Source: Statistics NZ, Forsyth Barr analysis

RBNZ has no choice but to respond

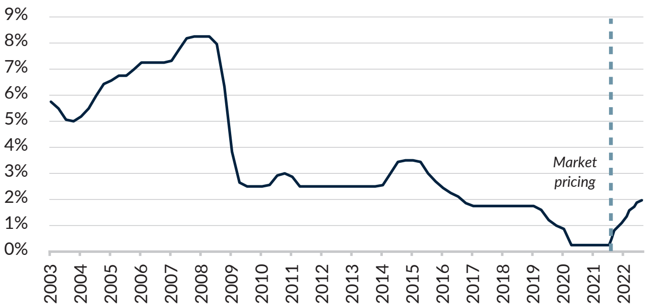
Globally the debate within markets has not been about whether we'll see higher inflation, but rather will it be temporary or will it persist. Most central bankers around the world have been singing from the same hymn sheet, saying they expect it to be largely "transitory" caused by disruptions to production and supply chains which eventually will be alleviated.

Whilst we agree that many of the current inflationary pressures are short-term factors, the longer that they persist the more likely they will become self-sustaining – higher prices and tight labour markets allow workers to push for wage rises; wage rises, in turn, lift costs for businesses; strong demand and tight supply allows these costs to be passed on through higher prices; people become accepting of increasing prices ... that is how an inflation cycle becomes entrenched.

...The magnitude of current inflation has forced our Reserve Bank to act...

The magnitude of current inflation has forced our Reserve Bank to act. The 6 October hike in the Official Cash Rate (OCR) was the first since 2014. The market is pricing, that by October next year, we will see six more rate hikes lifting the OCR to 2%.

HIGHER INTEREST RATES AHEAD: NEW ZEALAND OCR



Source: RBNZ, Bloomberg, Forsyth Barr analysis

As we look out toward the economic horizon there are plenty of uncertainties ahead. When and how will countries emerge from lockdowns? How much will delta weigh on consumer and business sentiment? How will our highly indebted households and overinflated house prices respond to rising mortgage rates? To what extent will governments continue to support economies? How quickly will supply chains readjust? Will New Zealand once again welcome new migrants in droves? And will they want to come? There are more.

We can see a scenario where in 18 months or so the New Zealand economy has slowed, and inflationary pressures have waned. But for now, the Reserve Bank can't afford to wait and see. Borrowers and investors will experience the first meaningful interest rate tightening cycle in nearly 15 years.

Matt Henry
Head of Wealth Management Research

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

0800 367 227
forsythbarr.co.nz