Inflation 101

New Zealand's inflation rate rose to 4.9 per cent in the third quarter of 2021, its highest rate in a decade. This has prompted fears of runaway inflation and even the dreaded spectre of stagflation -- when inflation is high but economic growth slows -- from some, but experts largely expect the economy to return to normal in the coming year. To better understand why that is, we need to understand more about how inflation works, and what's happening in the economy right now.

When it comes to inflation, it isn't just the current rate that we need to consider, but also why inflation is occurring in the first place. All inflation isn't alike, and New Zealand has a variety of issues affecting both supply and demand in different ways.

After the global supply shocks and stagnant growth of 2020, Kiwis and consumers around the world have resumed spending in 2021, driving prices up as businesses scramble to meet demand. At the same time, global supply chains are struggling to recover. For investors, this represents an additional degree of uncertainty. Should they try to take advantage of growing market volatility, or is it better to stick with a long term investment strategy?

What is inflation, really?

Inflation describes the increase in the price of products and services in an economy. As long as this occurs in a balanced manner, so that the costs of consumer goods and wages rise at a similar rate, this isn't very noticeable. That isn't always the case, though. There are two main types of inflation, and we're seeing elements of both in New Zealand right now:

- Demand pull inflation - When prices rise due to an increase in demand for products or resources
- Cost push inflation - When prices rise because of an increase in supply costs.

The critical difference between these two is what they mean for consumers. Demand-pull inflation normally matches economic growth. As productivity goes up, businesses, investors and workers earn more money and can afford to buy more. With cost-push inflation, prices for products and resources rise regardless of whether consumers can afford them, meaning that people and businesses are able to buy less. That reduces economic activity overall, and drives down productivity.

To prevent that (or any other) decline in economic activity, central banks normally increase the supply of money available to consumers and businesses. That additional liquidity stimulates demand, and keeps economic activity up. In the longer term it also devalues the currency, but it provides the economy with critical time to recover and re-enter a growth phase.

What is causing inflation in 2021?

The onset of the COVID pandemic led to stagnant global and domestic growth in 2020, and slowed production greatly in many major manufacturing economies. The impacts of this, as well as governmental responses to the situation have led to multiple inflationary pressures on New Zealand and economies around the world.

1. *Recovering demand at home and abroad*

New Zealand, along with its largest trading partners, has experienced a significant recovery in terms of spending in 2021. People and businesses are buying more products and services compared to 2020, resulting in increased demand for goods and services. This naturally drives up prices, and also increases the velocity of money in the economy.

2. *Increased money supply*

Lower production in 2020 due to COVID lockdowns in China and other manufacturing economies wasn't as big a problem as it might seem at first, as consumers heavily reduced spending in the face of the crisis. However, low spending isn't good for the economy. It slows the velocity of money, which can stall growth, so the government had to act.

To keep people spending and the economy running, New Zealand launched the Large Scale Asset Purchase (LSAP) programme in 2020. This is set to inject $100 billion into the economy by next June. As consumers and businesses have begun to spend more aggressively, the total amount of money in circulation has increased, driving prices up.

3. *High supply costs*

The largest cost-push issue currently is the global energy and supply crunch. Gasoline prices have risen 45 per cent in New Zealand in the past year. At the same time, New Zealand and major trading partners around the world are suffering from a supply chain crisis. Container shipping prices have reached all-time highs and lead times are unreliable at best. Dock workers and truck drivers are also in short supply, leading to even more delays and driving up costs.

As a result, businesses are spending more and waiting longer to acquire parts and raw materials and to ship finished products to market. Moreover, the time it takes businesses to get from their initial investment to bringing their product to market is longer than ever. That can lead to liquidity issues and slow production overall.

Are we experiencing a return to stagflation with COVID?

So, we experienced stagnant growth in 2020, and a major increase in inflation in 2021. Is that bad? To some, it might look like a return to the stagflation era of the 70s and 80s. So far, though, this doesn't appear likely.

Stagflation occurs when prices rise while productivity stagnates and unemployment increases. Eventually, businesses and workers begin to anticipate inflation regardless of other factors, with one setting ever higher prices and the other demanding higher wages to match. All the while,

hiring stops, profits decrease, and businesses lay off workers in an attempt to get costs under control.

That's not what's happening right now, though. Demand is up and businesses are scrambling to find workers as consumers increase spending. That, fortunately, represents a clear opportunity for growth, not stagnation.

How is inflation affecting Kiwis?

Increased inflation ultimately translates to a higher cost of living for Kiwis everywhere. Some, however, are affected more strongly than others. Homeowners, for example, saw a significant increase in their overall wealth because of the rapid rise of real estate prices. Renters, on the other hand, face increased rent prices alongside other rising costs.

Homeowners, and real estate investors face additional risks as well, though. With home prices at all-time highs, it's unclear whether investments made in this unprecedentedly hot market will pay off. Ultimately, they are placing a bet that prices will continue to rise.

How should investors respond?

Rising prices should be no great surprise to investors after the economic shocks that markets faced in 2020. That doesn't mean that it's necessarily wise to revise your investment portfolio in expectation of further inflation, though. The potential for inflation is something that major investors are aware of when trading, so the associated risk is already accounted for in the price of various securities. Because of that, using a market timing strategy in hopes of benefitting from a market correction is unlikely to yield the desired results.

Historically, even the brightest financial minds in the world have a poor track record when it comes to predicting major inflation events. Because of that, it's generally best to stick with a longer term strategy that takes advantage of more reliable and inevitable market forces.

Periods of increased inflation are a normal part of an economy in motion. Understanding why inflation is happening, though, is important when it comes to knowing how to respond. If you'd like to learn more about building and protecting wealth, whatever the economic climate, reach out to one of our representatives today!