Far away, so close

New Zealand inflation to linger below 2%

23 April 2018

- Several long lasting factors are continuing to dampen consumer price inflation in New Zealand. Consequently, a sustained return to levels close to the RBNZ's 2% target mid-point looks elusive.
- Pressure on retail margins is continuing to weigh on tradables inflation.
- There are also a number of administered prices, such as tertiary education costs, that are likely to be subdued over the next few years.
- Inflation expectations have fallen, reinforcing the more general softness in consumer price inflation.
- In light of these factors, we expect that the RBNZ will remain on hold until the final quarter of 2019.

Global inflation is rising, and consumer price inflation in New Zealand is set to pick up over the coming year. However, a sustained lift in inflation to levels close to the RBNZ's 2% target mid-point is still looking elusive. Several long lasting factors will continue to dampen inflation over the next few years.

Tradables inflation to remain weak

Much of the recent softness in inflation has been centred on tradables prices. Those are goods or services that are imported or which compete against imports, and that includes the vast majority of retail products. This group accounts for around 45% of the CPI.

Earlier softness in tradables inflation was in part related to weakness in the global economy that dampened the price of imported goods. More recently, the pace of global growth has firmed. The related modest lift in global inflation, along with the earlier fall in the NZ dollar, is a key reason we don't expect a repeat of the negative rates of tradables inflation that we saw between 2012 and 2016 (figure 2).

Figure 1: Headline inflation

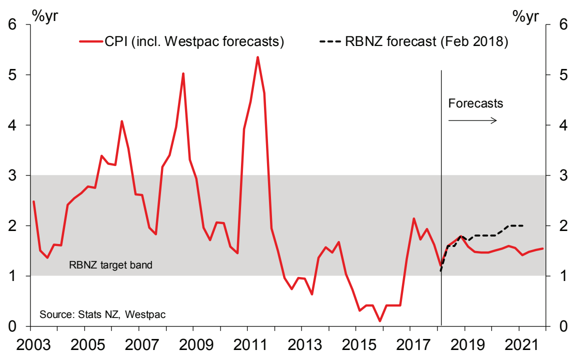
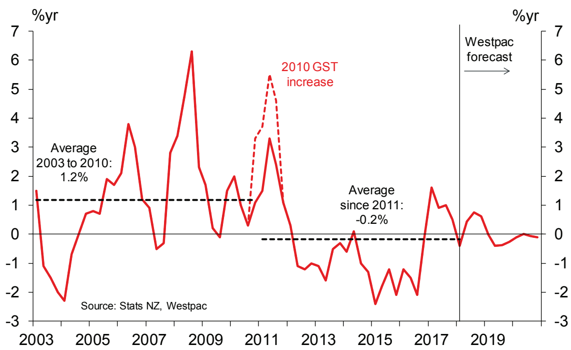


Figure 2: Tradables inflation



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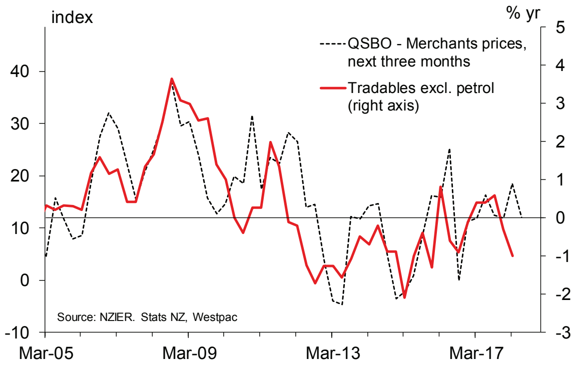
However, this firming in global prices doesn't mean that tradables inflation is about to rise back to the sort of rates that we saw prior to the financial crisis. Strong competitive pressures in the retail sector have squeezed margins in recent years. This has been contributed to by structural changes in the retail landscape including: the growth of online trading; the increased prevalence of large-scale retailers with competitive pricing models; and the entry of global chains into the New Zealand market. Such factors are likely to continue weighing on tradables inflation over the next few years. Consistent with this, recent surveys of business activity point to continued low levels of pricing pressure in the retail sector (figure 3).

Figure 3: Retail sector pricing



Reinforcing the expected softness in tradables inflation is an expected easing in consumption spending growth over the next few years. While still strong, population growth peaked in mid-2017 and is gradually easing back. In addition, the housing market – which is closely related to the strength of spending by New Zealand households – is set to slow over the next few years in response to major changes in housing market policy (such as changes in the taxation of interest rate costs and capital gains associated with investment properties).

Non-tradables softness to persist

Non-tradables inflation, which accounts for around 55% of the CPI, has also been subdued since 2010. This group includes domestically produced goods and services that face little import competition. Prices for such items are typically thought of as having a close relationship with the strength of domestic demand, and are a key focus for the RBNZ.

We expect that non-tradables inflation will remain substantially below its pre-financial crisis average for some time (figure 4). Capacity pressures in New Zealand have firmed in recent years, and the unemployment rate has trended downwards. However, the economy as a whole is not stretched in terms of resource pressures, with the output gap lingering well below the levels seen in the years leading up to the financial crisis (figure 5).[1] In part, this is because much of the increase in economic growth in recent years came on the back of record net migration that boosted not only demand, but also our supply capacity. In addition, growth has been easing off in recent months, and we expect a further softening over the coming years.

Figure 4: Non-tradables inflation

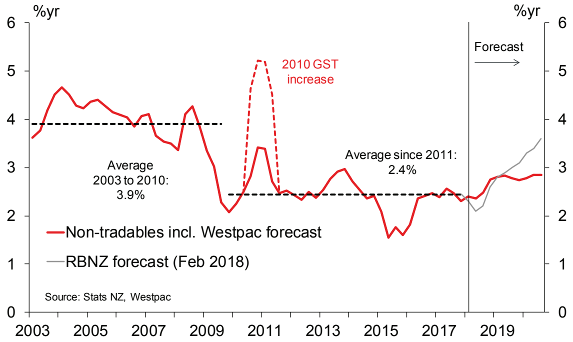
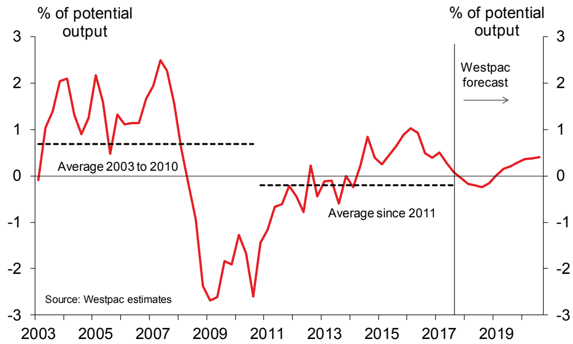
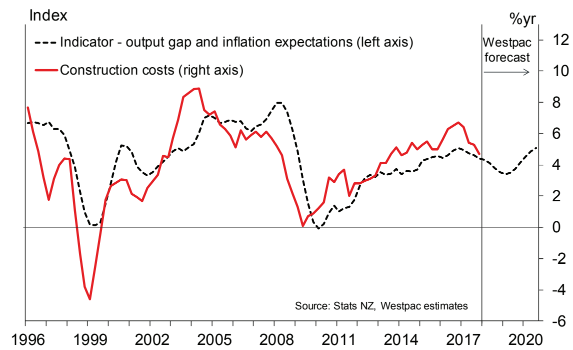


Figure 5: Output gap



While the output gap and capacity pressures are often compared to aggregate non-tradables inflation, this hides a lot of important detail. In New Zealand, the output gap has a very close relationship with inflation in the construction sector (figure 6), which accounts for 5% of the CPI. Firmness in construction activity is expected to be an important upside contributor to inflation over the coming years.

Figure 6: Construction costs

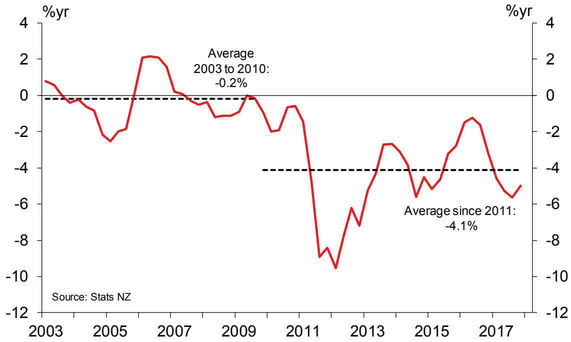


However, there is a much more muted relationship between cyclical pressures and many other components of non-tradables inflation. In fact, inflation for a number of

[1] The output gap measures how economic activity compares to the economy's trend level of output.

non-tradable items has taken a step down in recent years, even as the output gap has closed. Of note are prices in the communications group, which account for 3% of the total CPI. Technological changes mean that prices for many telecommunications services have been falling at a rapid pace in recent years (for instance, mobile data plans which now offer more data at a lower price). This has been a significant drag on non-tradables inflation since 2011 (figure 7).

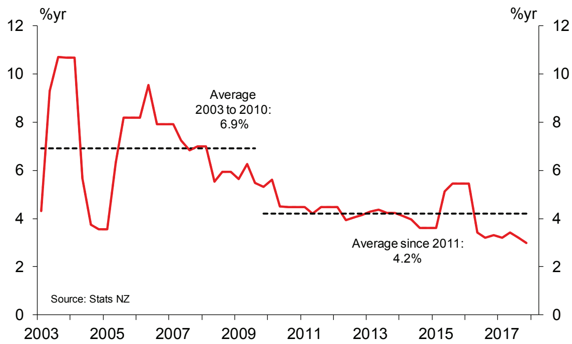
Figure 7: Communications group prices



Non-tradables also includes many 'non-market' or administered prices, such as local body rates (figure 8). Such costs have been rising at a much more modest pace in recent years, in some cases as a result of statutory changes (for instance, since 2012 there has been a cap on increases in tertiary education charges).

Over the next few years, we will see changes in the political backdrop that may affect some government charges (for instance, the proposed Local Government (Community Wellbeing) Amendment Bill will affect the focus of local authorities). However, a return to the sort of cost increases we saw prior to 2010 looks doubtful. In addition, we will see reductions in the prices for some government charges, including tertiary education fees and doctors visits.

Figure 8: Local authority rates



Inflation expectations have taken a step down

A further, and very significant factor that is dampening both tradables and non-tradables inflation is inflation expectations. Expectations are a significant influence on wage and price setting decisions, and as a result play an important role in determining actual inflation.

Prior to 2012, expectations were running at levels consistent with inflation of 2.6% - in line with actual inflation that was persistently above the mid-point of the RBNZ's target band. However, since 2012 there has been a marked decline across the range of inflation expectations measures in New Zealand. That includes direct survey measures of inflation expectations (figure 9), as well as surveys of price setting behaviour and costs. This follows the extended period of significant weakness in headline inflation in recent years. It also corresponds with the change in the RBNZ's Policy Targets Agreement to include an explicit focus on the 2% midpoint of the target range for inflation.

Figure 9: RBNZ 2-year ahead inflation expectations

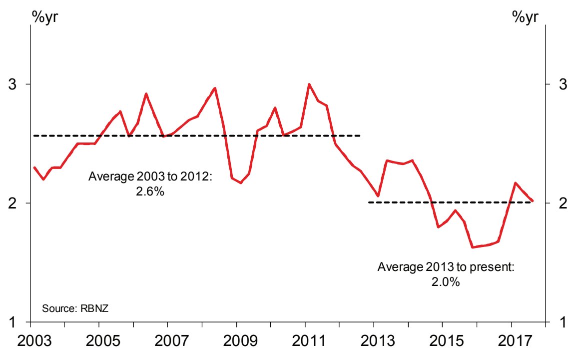
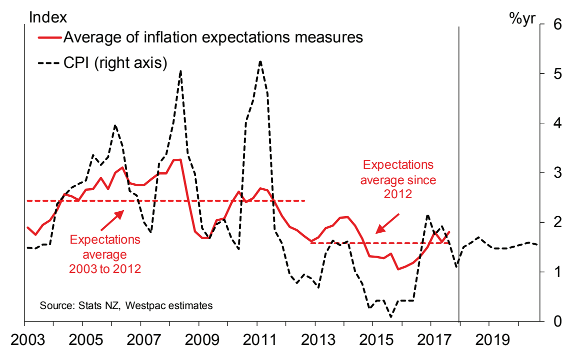


Figure 10: Inflation expectations estimates & CPI inflation



Note: The "Average of inflation expectations measures" is an index that combines 10 survey measures of expected inflation, wages, prices and costs.

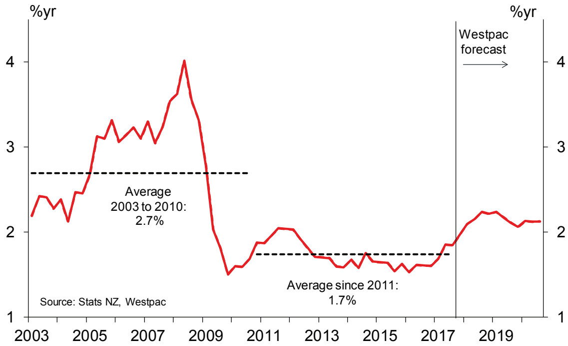
Inflation expectations have picked up a little since mid-2016, but only to levels consistent with inflation of around 2% per annum. Looking ahead, it's hard to see inflation expectations returning to anything close to their pre-financial crisis averages in the foreseeable future, especially with headline inflation lingering below 2% (figure 10).

Upside wage pressures, but muted CPI pass through

Providing some offset to the aforementioned downside influences on inflation are expected increases in wage costs. That includes planned large increases in the minimum wage over the next few years. It also includes an assumed lift in wages in some public sector areas. In light of these increases, we expect that wage inflation will lift from rates of around 1.7% per annum in recent years, up to rates of around 2.1% through 2019 and 2020 (figure 11).

The impact on the CPI is expected to be much smaller than the increase in wage costs. Increases in the minimum wage are expected to add an additional 0.3 percentage points to the CPI, spread over the next four years.[2] While some industries (such as hospitality) may increase prices due to minimum wage changes, competitive pressures are keeping a cap on many prices. In addition, in many affected industries, there is not a close relationship between wage costs and the prices faced by consumers (e.g. health care services).

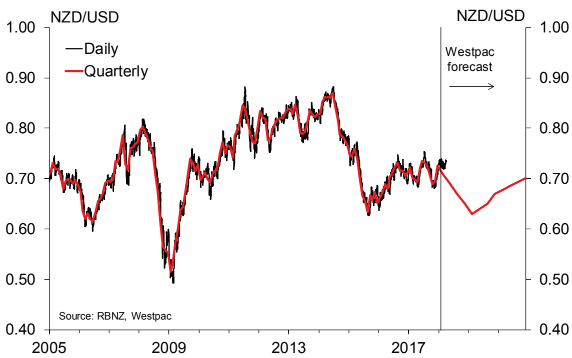
Figure 11: Labour cost index wage inflation, all sectors



NZ dollar assumed to fall

Our relatively modest forecast for inflation assumes a fall in the NZ dollar over the coming year, which would boost import prices (figure 12). However, in recent weeks, the NZ dollar has actually shown unexpected strength. If this is sustained, it's likely that inflation will struggle to rise even to the subdued levels we expect.

Figure 12: New Zealand Dollar

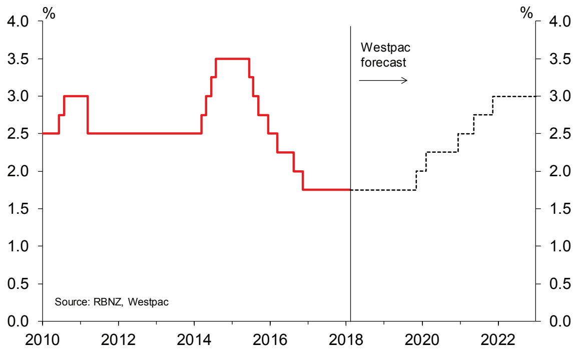


Official Cash Rate to remain on hold until 2019 Q4

We expect that the coming year will see inflation lifting from its current low levels. However, with a range of factors continuing to weigh on prices, the RBNZ will be facing an uphill battle to keep inflation back to the 2% mid-point of its target band on a sustained basis. To achieve this, the RBNZ needs the economy to continue expanding at a brisk pace, and that will require continued low interest rates.

We expect that the RBNZ will keep the OCR on hold until the final quarter of 2019. In contrast, market pricing is consistent with at least one rate hike by June 2019. But given the number of factors dampening inflation, that still seems too soon to us.

Figure 13: Official cash rate



[2] We look at effects of upcoming changes to the minimum wage in depth here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Raising-the-bar-April-2018.pdf

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