Westpac Institutional Bank

What's been happening to retail prices?

8 December 2015

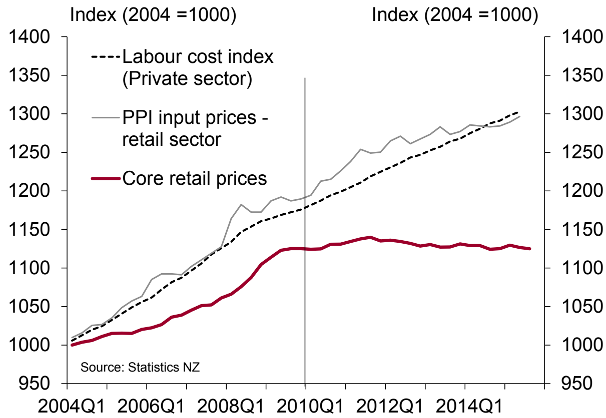
- Since 2010 the average price of goods that New Zealand's purchase in retail stores has been flat. That's a big change from the preceding years when retail prices were rising by around 2% per annum.
- Retail prices have been weighed down by the strength of the NZD, and modest increases in both imported and domestic costs. But these factors don't explain why prices have been as low as they have been in recent years.
- The key change that we have seen in recent years has been a strong increase in price competition in the retail sector, which has resulted in downward pressure on margins. A significant contributor to this has been the increased prevalence of online trading.
- The fall in the NZD in recent months will result in some increase in retail prices in the near term. Nevertheless, enduring competitive pressures mean that retail prices are set to remain low for some time, and that margins will remain under pressure.

Retail prices have been subdued in recent years...

Inflation in New Zealand has been low for some time, and there has been particular weakness in retail prices. Retail prices are the prices of the goods that consumers purchase in stores, and account for a significant share of household spending. They include the prices of goods purchased in traditional 'brick and mortar' stores and those purchased online.[1]

Since 2010, the overall level of retail prices in New Zealand has essentially been flat. That's a big change from the preceding years when retail prices were rising by around 2% per annum (figure 1).

Figure 1: Retail prices, input prices[2] and wage rates



[1] Retail prices differ from the Consumer Price Index (CPI) that is often used to look at inflation in New Zealand. As well as retail prices, the CPI also includes other costs such government charges and rents. Since 2010, the CPI has increased by an average of 1.4% per annum (excluding 2010's GST increase).

[2] The input prices in figure 1 are taken from Statistics NZ's Producer Price Index (PPI). The PPI measures the cost of goods and services that businesses use in their operations. It excludes expenses such as labour costs and capital expenditure.

Of course, aggregate numbers can hide a lot of important details. While the overall level of retail prices in New Zealand has been flat, prices for some items such as food and fuel have continued to climb. However, even for these goods, inflation has been lower in recent years. In fact, inflation across all retail categories has pulled back by around 2% since 2010, with the prices for many goods (such as clothing and recreational equipment) actually falling.

Part of the reason that retail prices have been low is that there has been downward pressure on the cost of importing or producing goods, as well as the cost of retailing itself. But as we discuss in this article, changes in costs aren't the whole story. In fact, as shown in figure 1, while retail prices have been flat in recent years, input prices and wages in the retail sector have actually continued to climb (albeit at slower rates than in earlier years).

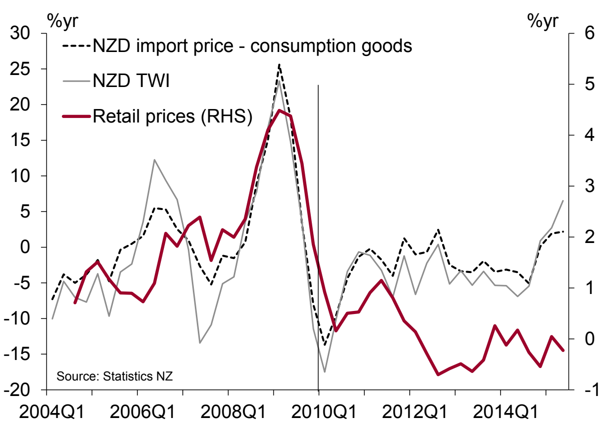
In recent years, there has been a significant increase in competition in the retail sector. This has resulted in downward pressure on prices and compression of retail margins. Contributing to this increase in competitive pressure has been sluggish demand, as well as structural changes in the retail sector.

As a result of the changes in the retail environment in recent years, we expect that prices will remain low for some time and that there will be continued downward pressure on margins.

...dampened by softness in operating cost...

Since 2010, costs in the retail sector have been rising at a more gradual pace than in earlier years, and this has dampened retail prices. In part, this is because the landed prices of many imported goods have been damped by lingering softness in global demand and strength in the New Zealand dollar (figure 2). That includes the prices for industrial commodities that are used in the production of other goods, such as fuels and metals. It also includes the prices for consumer goods that New Zealand imports, such as electronics and furnishings.

Figure 2: Import prices and retail prices



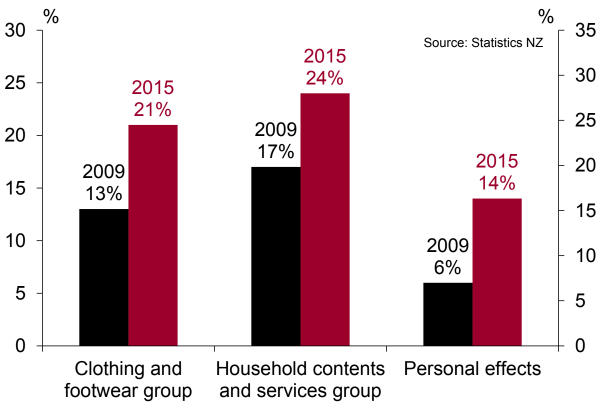
Domestic costs, such as transport and wages, have also been rising at a more muted pace than prior to 2010. In fact, in the case of wage inflation, we haven't seen any material acceleration since the economy exited recession in 2011 (figure 3).

Figure 3: LCI private sector wage inflation

...and an increase in domestic competitive pressures

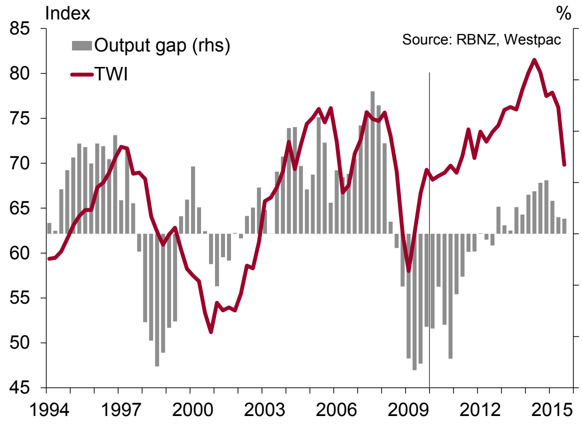
While both domestic and imported costs have dampened retail prices in recent years, a more significant factor that has weighed on prices is the extent of price competition in the New Zealand retail sector. Over the past few years, retail price competition has been fierce, resulting in downward pressure on margins – a situation that mirrors conditions in many other economies. This has been reflected in a sharp increase in the proportion of goods that retailers discount each quarter since 2009 (figure 4).

Figure 4: Proportion of prices discounted (September quarters)



This increase in price competition is a result of the tough trading conditions that many retailers have faced in recent years. As well as periods of weakness in household spending (particularly in the immediate aftermath of the financial crisis), retailers have had to confront an unusual currency cycle (figure 5). Typically, when economic conditions in New Zealand weaken, a related depreciation in the NZD helps to support economic activity. However, since 2010 the NZD has lingered at high levels compared to the strength of economic activity. This has meant that competition from imports has been particularly strong in recent years.

Figure 5: NZD TWI and output gap[3]



On top of the above conditions, the past few years have seen structural changes in the retail landscape that have affected businesses' pricing decisions. One of the most significant has been the increased prevalence of online trading. In many sectors, this has increased the amount of competition from offshore. In addition, the relative ease of comparing prices across sellers has resulted in increased competitive pressures, even for businesses that face little competition from imports.

Increases in online retailing have also resulted in changes in business models for many retailers. This includes a shift away from traditional brick-and-mortar stores, to online platforms that allow for greater efficiencies in relation to rents and distribution chains. It also means that many retailers with physical stores have reoriented their operations, with changes in the services provided to customers and an increased focus on using physical locations to support online transactions.

The New Zealand retail landscape has also been affected by the increased prevalence of large scale retailers, particularly in fields such as home appliances and hardware. Larger retailers tend to have greater negotiating power with suppliers, and often benefit from some form of vertical integration. Such features can provide larger retailers with advantages in terms of costs and pricing power. In addition, many larger businesses have the financial resources to absorb a short term squeeze on earnings associated with increases in price competition.

Will retail prices pick up?

Over the coming year, we do expect to see some pick-up in retail price inflation. The NZD has fallen by more than 10% since mid-2015, and the price of imports has been climbing. This will gradually flow through to higher prices on shop floors.

However, while the lower NZD will push up import prices in the near term, the scope for large or continuing increases in retail prices looks doubtful. In fact, we anticipate that the extent of price increases in the retail sector over the next few years will remain modest, and that pressure on margins will persist.

The key reason we expect that retail price inflation beyond the near-term will remain modest is the strength of domestic demand. Over the coming year, GDP growth is set to slow as the economy confronts a number of significant headwinds. These include drought, lower dairy prices, a softening in the housing market, and the levelling off in reconstruction activity in Canterbury. These conditions will result in unemployment rising and consumption spending growth easing back. Against this backdrop, it will be hard for retailers to push through price increases.

At the same time, while the lower NZD will push up some operating and input costs, lingering weakness in the global economy and the related softness in the global prices of many international traded goods will provide some offset. In addition, slow GDP growth domestically will mean that wage inflation isn't likely to pick up for some time.

Finally, the structural changes that have been affecting the retail industry – especially the increased prevalence of online trading – mean that the increase in price competition in recent years is likely to be enduring.

	Average price increase per year		
Product type	**2004 to 2009**	**2010 onwards**	**Change since 2010**
Supermarket and grocery stores	3.3	1.7	-1.5
Specialised food retailing (excluding liquor)	3.4	1.6	-1.8
Liquor retailing	2.4	0.8	-1.6
Food and beverage services	3.8	1.9	-2.0
Non-store and commission based retailing	1.3	-0.8	-2.0
Department stores	-0.5	-2.1	-1.7
Furniture, floor coverings, houseware and textile goods retailing	0.7	-0.2	-0.9
Hardware, building and garden supplies	2.9	1.0	-2.0
Recreational goods retailing	1.8	-0.9	-2.7
Clothing, footwear and personal accessory retailing	0.8	-0.5	-1.3
Electrical and electronic goods retailing	-5.0	-6.9	-1.9
Pharmaceutical and other store based retailing	1.1	-0.1	-1.2
Accommodation	3.2	0.7	-2.5
Motor vehicle and parts retailing	1.0	-0.2	-1.1
Fuel retailing	7.3	2.4	-4.9
Core (ex-fuel and motor vehicles)	**2.1**	**0.0**	**-2.1**
Total	**2.3**	**0.2**	**-2.2**

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[3] The output gap measures how strong (or weak) economic activity is relative to the economy's productive capacity. Higher reading signal stronger economic conditions.

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