8 January 2015

RBNZ Impotent As Deflation Looms

- Global spare capacity, oil and the exchange rate driving prices lower
- But no excuse to cut rates
- As spare capacity limited, housing market rampant
- Rate hike postponed
- Monetary policy largely powerless

By the end of the March quarter the level of prices, as measured by the Consumers Price Index, will almost certainly be lower than where it stood in the September quarter. We are now forecasting two consecutive quarters of price declines (December and March) with a cumulative drop of half a percent. Annual CPI inflation, as a consequence, falls to just 0.2% in the March quarter 2015. With petrol prices doing what they are, annual deflation is now a real possibility too.

Deflation as a "good" thing...

Traditionally, deflation has been seen as a "bad" thing. If prices are dropping consumers delay buying things in order to capture lower future prices. As a consequence, economic activity slows – retailers reduce sales, manufacturers supplying to those retailers reduce production and transport requirements diminish. Lower activity sees lower employment which leads in turn to reduced demand and more downward pressure on prices. And so the vicious cycle continues.

Nice in theory, but this couldn't be further from the truth in New Zealand at the moment. There is absolutely no evidence whatsoever of a retrenchment in activity due to the pressure on the general consumer price level. Indicative of the contrary, real retail sales in the September quarter 2014 were 4.9% higher than year earlier levels.

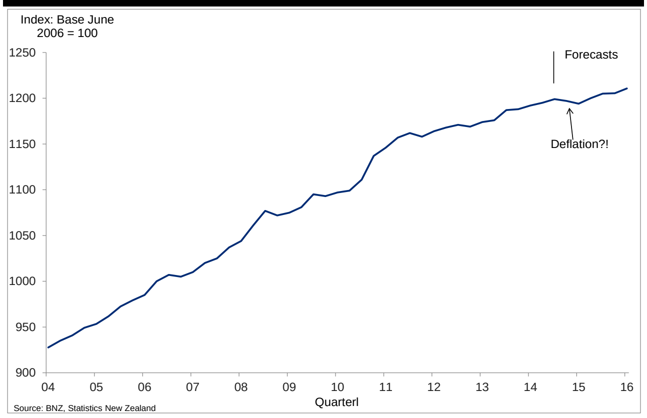
How we think about deflation needs to change – for this particular cycle at least. If domestic prices are falling because there is insufficient demand then the normal vicious deflationary spiral might still hold. If they are falling because of a perfect storm of external shocks – some cyclical, some structural – then the conclusions reached are quite different.

NZ Consumers Price Index

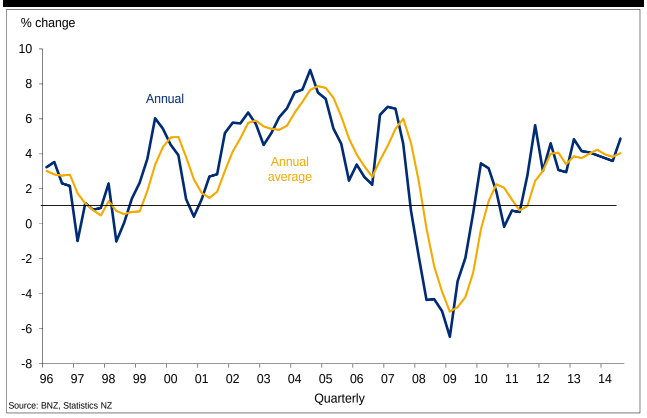
Quarter		Index	Quarterly % Change	Annual % Change	Average Annual % Change
2012	March	1164	0.5	1.6	3.3
	June	1168	0.3	1.0	2.2
	September	1171	0.3	0.8	1.3
	December	1169	-0.2	0.9	1.1
2013	March	1174	0.4	0.9	0.9
	June	1176	0.2	0.7	0.8
	September	1187	0.9	1.4	1.0
	December	1188	0.1	1.6	1.1
2014	March	1192	0.3	1.5	1.3
	June	1195	0.3	1.6	1.5
	September	1199	0.3	1.0	1.4
Forecasts:					
	December	1197	-0.2	0.8	1.2
2015	March	1194	-0.3	0.2	0.9
	June	1200	0.5	0.4	0.6
	September	1205	0.4	0.5	0.5
	December	1205	0.0	0.7	0.4
2016	March	1211	0.4	1.4	0.8
	June	1222	0.9	1.8	1.1
	September	1234	1.0	2.4	1.6
	December	1235	0.1	2.5	2.0
2017	March	1241	0.4	2.5	2.3

Source: Statistics New Zealand, BNZ

Consumers Price Index



Real Retail Sales



To start with, there are clearly some relative price shifts at play here with the drop in oil prices at the forefront of this. But it would be very wrong to conclude that it was relative price shifts and relative price shifts alone that were creating the current environment. A quick glance across the sub-groups of the CPI shows that there are numerous categories where prices are falling. We won't list them all but to name a few:

- Food prices fell 0.6% in the year to September 2014;
- The alcohol and tobacco subgroup rose 2.7% but if you take out the 10% increase in tobacco prices attributable to tax increases there was deflation here too;
- Clothing and footwear prices rose just 0.4% over the period but are still 4.2% below their December 2009 peak and are at broadly the same level as they were in the March quarter 2001;
- Household contents and services prices dropped 0.4%;
- Transport group prices fell 0.5%;
- The communication group deflated by 3.8% over the year; and
- The recreation and culture group saw prices fall 0.5% in the year ended September.

The only real areas of inflationary pressure are in housing and household utilities (+3.5%) and education (+3.5%). Rather than talking about why relative price shifts are causing inflation to be so low perhaps one should instead be focused on the fact that a small number of relative price increases are artificially inflating the headline CPI?

That said, it is most definitely plummeting oil prices that are causing us to revise downward our short term CPI forecasts by the day. It helps that the direct effect of these price movements is observable but it is clear that there will also be downstream impacts that we are probably underestimating.

Should we be worried about deflation caused by falling oil prices? Probably not. If the correction was a reflection of a sudden downward adjustment to global growth expectations then it might be more concerning but the adjustment looks to be more a belated acknowledgement of the massive increase in supply that we have been seeing over the last few years plus the ongoing improvement in energy efficiency across the planet.

This being the case, the drop in oil prices is turning out to be a windfall gain for consumers. Consumers are certainly not delaying fuel consumption in expectation of future declines in prices. Instead, as fuel consumption is fairly inelastic to prices, households have ended up with extra money in their pockets to spend on other goods and services instead boosting, rather than contracting, future activity.

A shrinking world means imported spare capacity…

The theory of falling prices reducing future activity falls into a deep, dark hole when one considers what is happening in the technology market. Has anyone heard of folk postponing the purchase of the new iPhone 6 because it will inevitably be cheaper tomorrow? Symptomatic of the effect technology has had on prices:

- The cost of household appliances has fallen 10.5% since Q4 2009;
- Car prices have dropped 7.2% since March 2012; and the winner is . . .
- The price of telecommunications equipment which has fallen 94% since Q4 1999!, while
- Telecommunications services prices have also fallen 19.0% since Q2, 2007; and
- The price of audio-visual and computing equipment has fallen 77.9% since Q2 1999.

Some of these moves will be currency related but the majority is not. Again, is this the sort of deflation we should be concerned about? We think not.

All this said, perhaps the biggest impact on deflation is largely ignored by most commentators who simply do not know how to put this phenomenon into their models. In short, the combination of internet selling and relatively cheap and efficient freight systems is having an unprecedented impact on the price and availability of the goods and services that we now purchase. No longer is the competing price the retailer down the road but, rather, the distributor anywhere in the world.

This being so, tradables goods inflation is now less and less influenced by domestic demand conditions and more and more influenced by spare capacity in global markets than has ever been the case before. So, with bucket loads of spare capacity globally, there is simply no room for domestic sellers to push prices higher, especially with the NZD remaining as lofty as it is.

This is not to claim that everything in New Zealand is being purchased across the internet and being imported from offshore. This is clearly not the case but what is the case is that local sellers can't afford to price their goods excessively when they know that prospective purchasers can easily access prices elsewhere. The cost of gaining this information and access to goods for the purchaser has plummeted. In addition, local distributors are able to reduce their own overheads and, hence, selling prices because wholesalers can now effectively sell direct to the public without the middle man.

New Zealand given its small population and geographic characteristics probably has more to gain from these developments than many.

This is a structural change that will weigh down on inflation for some time to come allowing unlimited access to all to the lowest cost manufacturers, distributors and retailers around the world.

Is this the sort of deflation that we should be worried about? Will it reduce current consumption? We think not.

Clearly, though, there will be casualties. If you are a manufacturer, distributor or retailer that can't access these falling prices – or you are unable to differentiate your offering so significantly that these developments don't matter – then you will have a problem.

As an aside, the internet revolution is one of the reasons why provincial communities are struggling. In the good old days if you wanted to do your Christmas shopping in provincial New Zealand you simply had to purchase from the limited selection of retailers in your community – no matter the selection or the price. If you were really lucky you got a trip to one of the big cities to spend up large. Now you have the same access to lower prices and selection that everyone else does. And it is probably the selection opportunities that will hurt regional retailers the most. Small operations simply cannot bear the cost of carrying sufficient stock to provide the shopper with the selection that is now available to them.

Clearly, taking all these things into consideration, downward pressure on the general price level is here to stay for some time yet. And the processes that are at work may require a major rethink by all and sundry as to how the world now works, how prices are set, how businesses should respond to this and the impacts of all this on policy makers – both fiscal and monetary.

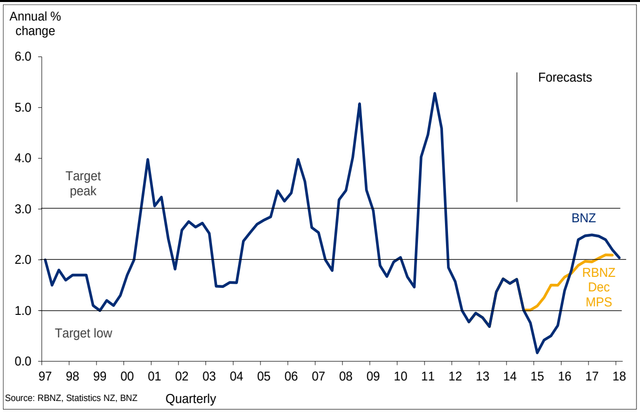
For the fiscal authorities, revenue will be harder to find because revenue is a function of the nominal economy – not the real. A bit of inflation is good news for the tax take, not bad.

A monetary policy headache…

For the central bank, the changes open a huge can of worms.

New Zealand's situation is particularly enlightening. We have an economy that is operating at or above potential and is set to stay that way for some time. Yet CPI inflation is absent, partly because of the strength in the currency and partly because of falling oil prices, but, more generally, because it's the global output gap that is the source (or lack thereof) of inflation in the domestic economy.

Consumer Price Index



This goes a long way to explaining why, even as domestic capacity pressures intensify later in the year, we still see annual inflation staying below 1.0% until early 2016. Only in late 2016 does annual CPI inflation push up to the mid-point of the RBNZ's target band. Even then, we accept that the risks are to the downside and the forecast is heavily dependent on a slump in the NZD.

With annual inflation set to stay at or below the bottom end of the RBNZ's target band for around 18 months and with there being the possibility of measured annual deflation during this period, shouldn't the RBNZ be cutting interest rates?

In short, no!

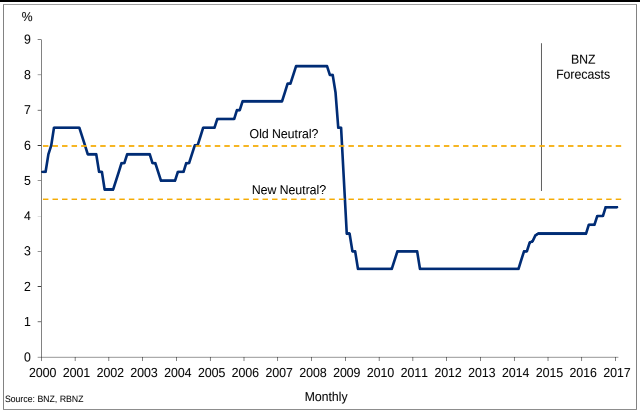
Lower interest rates might help the NZD lower and that would most certainly be beneficial in terms of helping to rebalance the economy and creating some inflationary pressure but lower interest rates also heighten demand. With capacity utilization in New Zealand where it currently is that would be most unwelcome. Moreover, house price inflation is still too high and turnover data suggest it is about to take another leg up. The last thing the economy needs now is more stimulus for the housing market. Deflation in New Zealand is not the same as deflation in Europe!

Moreover, the RBNZ will want to look through the oil price impact. After all, lower oil prices might lower short term inflation but they actually increase medium term pressures via the effective increase in real disposable income that such declines provide to the household sector.

And lastly, if the Bank still has the view, as do we, that the NZD will eventually come underpressure then it won't want the extra stimulus accruing to lower interest rates combining with the impact of a lower currency.

That said, while the argument for a rate cut is flawed, it is going to be very difficult for the RBNZ to raise rates until

NZ Cash Rate



such time that it actually sees measured inflation rising to threaten the mid point of its band. And that won't happen until mid-2016.

We have long stated that the risk to our interest rate track was that the resumption of the tightening cycle might be later than we had forecast. We think that risk has now got so great that we have no option but to postpone our expectations accordingly. Consequently, we have pushed back our first rate hike to March 2016. We still have three rate hikes in our track but we have to state strongly that that we have no strength in conviction on either the start date of the movement or the extent of it. Indeed, we are not even entirely convinced there will be one.

What we are convinced of is the following:

- The economy is performing well and there's not a lot of spare capacity;
- The housing market threatens to take off again;
- There is no room for a rate cut anytime soon;
- Inflation is dead – for the time being;
- But it's global spare capacity, a strong exchange rate and falling oil prices that are the reasons for such;
- Domestic monetary policy is currently impotent.

stephen_toplis@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Kymberly Martin
Senior Market Strategist
+(64 4) 924 7654

Raiko Shareef
Currency Strategist
+(64 4) 924 7652

Main Offices

Wellington
60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
81 Riccarton Road
PO Box 1461
Christchurch 8022
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891