Economy Watch

bnz

5 February 2016

Inflation Targeting (and Rates) On Hold?

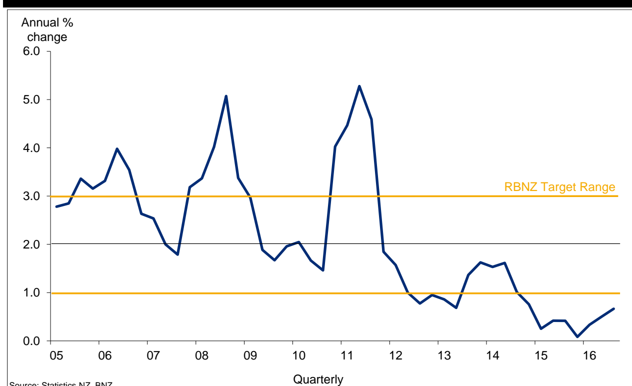
- Inflation dragon slayed by offshore attack
- Costs of inflation generation must be weighed against benefits
- Current flexible RBNZ approach laudable
- But core has its problems
- Growth, not inflation, may determine RBNZ response

It may be considered sacrilegious to say this but . . . . in the current environment, inflation targeting is probably a waste of time. The evidence shows that achieving an inflation target has been more than a little problematic and the prognosis for the way ahead looks no better. The case for extreme stability in the mandate of price flexibility is now extremely high.

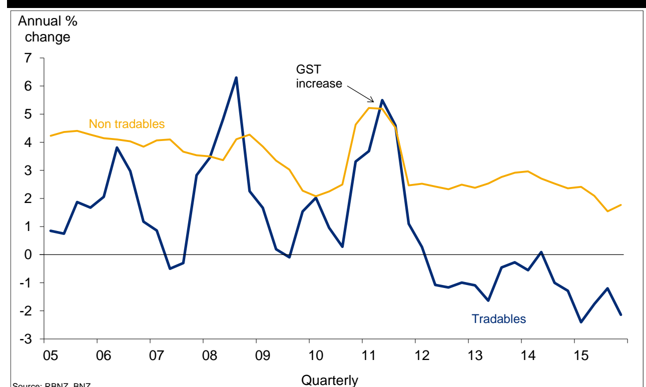
First, the apparent evidence of success (or lack thereof): annual headline CPI inflation fell below the mid-point of the RBNZ's target band in December 2011; it has been there ever since. Moreover, if our forecasts are correct it will stay that way until the September quarter 2017 – at the earliest. Worse than that though, annual inflation fell to the lower extreme of the target range in the June quarter 2012. In only four of the next 15 quarters was it above 1.0% and it's unlikely to return above 1.0% until the December quarter of this year. Currently annual CPI inflation sits at just 0.1%.

How could a central bank governor get it all so wrong? Consistently forecasting rising inflation, consistently failing to achieve it. The answer is: easy really. The world simply conspired to ensure the "Governor's failure". In the first instance, the NZD refused to roll over, putting downward pressure on import prices. And when the NZD did finally submit, global commodity prices and global inflation, more generally, dropped precipitously alongside growing excess capacity internationally. More recently, struggles in Emerging Markets and further oil price weakness are exacerbating the process.

Consumer Price Index



Tradables and Non-Tradables Inflation

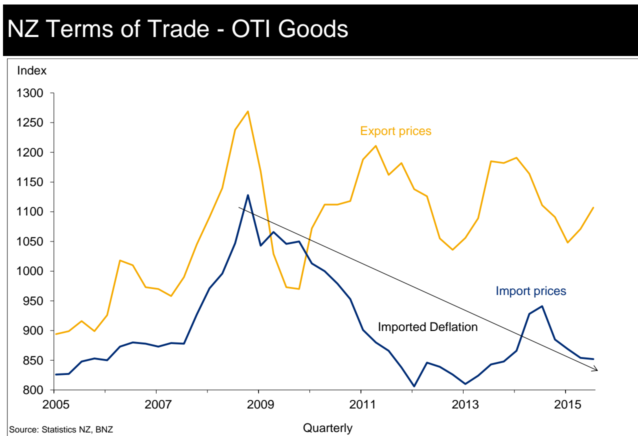


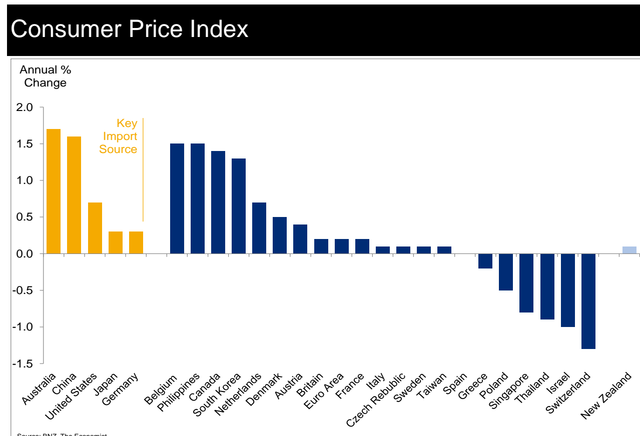
To put the cumulative impact of these developments in some perspective, the price of imports in the September quarter 2015 was 18.6% below the peak of Q4, 2008. We reckon a further 6.0% fall has occurred over the last six months and that prices will remain subdued for the foreseeable future. Between late 2008 and September 2015 export prices also fell 12.8%, putting further downward pressure on the domestic price structure.

It should thus be of little surprise that tradables prices have fallen steadily for the last four and a half years. Peak to trough that movement has been a drop of 5.5%. With tradables prices accounting for 46% of the total CPI, it's no wonder that annual headline inflation has been so low.

Most importantly, tradables inflation is largely beyond the control of the RBNZ. Sure, the Bank has a modicum of short term influence over the currency but the extent of this influence is probably overstated. Moreover, even if it was influential, the extent of commodity price movements would most likely swamp the currency impact anyway.

This being so, the only possibility in this environment for the RBNZ to achieve its target is to stimulate domestic demand so aggressively that non-tradables inflation rises to compensate. In large part, that's what has happened with domestic demand running very aggressively. But even this has not created price pressure, except in the price of housing, which has little direct impact on the CPI anyway.





Pushing on this piece of string any harder courts potential disaster. Excess domestic demand means: ongoing upward pressure on house prices; increasing leverage in an already overly-leveraged household sector; a higher demand for imported goods; a deteriorating current account balance; a weakening external debt position; and, so, a heightened chance of a future sudden stop and significant economic volatility.

Should the RBNZ be taking this risk in the blind pursuit of an inflation target? We think not.

It's worth noting that this is a dilemma being faced around the globe. It is not exclusive to New Zealand. Take the United States for example where the price of imported goods from China, Emerging Asia, Japan, Korea, Taiwan, Mexico and Germany are all deflating in USD terms. And these are the manufacturing centres of the world. Throw in the commodity exporters and inflation is nowhere to be seen.

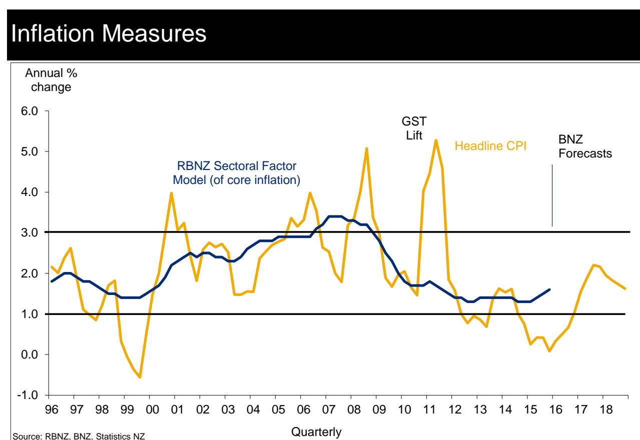
And then look at headline CPI across the planet. In all of the following countries annual headline inflation is below the mid-point of the RBNZ's target band: United States; China; Japan; Britain; Canada; the entire Euro area (including Austria, Belgium, Germany, Greece, Italy, Netherlands and Spain); Czech Republic; Denmark; Poland; Sweden; Switzerland; Australia; Philippines; Singapore; South Korea; Taiwan; Thailand; and Israel. There will be more! All these countries can't depreciate their currencies at the same time, they can't all keep easing monetary policy, and their combined weight in the global economy means fighting the disinflation tide is a futile effort. In yesterday's speech Governor Wheeler noted that "in the history of the world as we know it, monetary conditions have never been easier" – and, yet they haven't created inflation. Nor will easier monetary conditions do so here.

Fortunately, the RBNZ has largely come around to this way of thinking and has started to focus more on core inflation than the headline measure. This is entirely appropriate in our view. And with core inflation currently sitting at 1.6%, the RBNZ is defending its current stance not to cut interest rates again.

This approach does not, however, come without its own set of difficulties. In particular, the Reserve Bank uses its own sectoral factor model of inflation as its preferred core measure. For the vast majority of us, the calculation of this measure is way beyond our capability. And even if you could work it out there is no way it can be forecast. We don't deny it's a useful benchmark but it will be an uphill battle for the Reserve Bank to convince all and sundry of its appropriateness.

The other question we should perhaps be readdressing, in this environment, is the specification of the inflation target at the headline level. At its roots inflation targeting is actually price stability targeting with a bit of flexibility added in. Historically, inflation targeters have been given upside leeway in their mission as it was felt that the inflation measures had upside biases and deflation (associated with recession) was a thing to avoid.
But, perhaps in this environment of globalisation, communications advancements, heightened price discovery and the technological advancements greater leeway should be provided to the downside of the price stability target – especially if price containment is not associated with recession, as is currently the case in New Zealand.

Last but not least, any policy implementation usually has costs associated with it. When implementing policy,



policymakers should always be cognisant that the benefits of its implementation should outweigh the negatives. We believe this is the real bind faced by the RBNZ at the moment. And, indeed, this was highlighted by Graeme Wheeler in yesterday's speech where he highlights the fact that the Policy Targets Agreement contains "A requirement that the Bank monitor asset prices, have regard to the efficiency of the financial system and seek to avoid unnecessary instability in output, interest rates and the exchange rate". The RBNZ is certainly taking this to heart at the moment and, for all intents and purposes, has made the decision that, while inflation outcomes and forecasts, at least at face value, demand further easing, the costs of doing so are just too great and the chances of success (getting inflation higher) are simply too low.

With this in mind, for the time being, we think that forecasters need, also, to take a slightly different approach in predicting prospective RBNZ actions. Weak inflation readings should be seen as a necessary, but not sufficient, condition for easing monetary policy. The catalyst for action will be when either (a) inflation expectations fall precipitously such that the chance of entrenched deflation becomes real or (b) real economy conditions deteriorate in such a way that the RBNZ believes lower interest rates might help avoid a period of sub-trend growth. In our opinion the latter poses more of a risk than the former.

With all this in mind, we will stick to our view that the cash rate is on hold for the foreseeable future. If we end up further lowering, our already low, headline inflation forecasts it is unlikely that we will change our RBNZ view. However, if international events look set to undermine the economy or the negative flow on effects from the dairy sector's current demise significantly threaten New Zealand's growth path, we will be happy to revise our call accordingly. While not our central scenario this is a tangible risk.

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