Westpac

Institutional Bank

Will we see a sustained pick-up in inflation?

23 May 2015

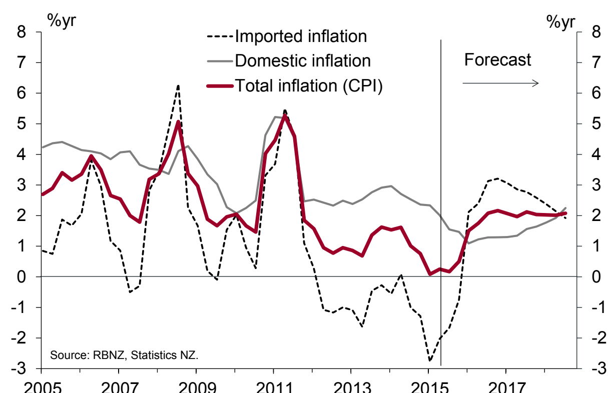
- Inflation will rebound over the coming months, but we don't expect this to be sustained.
- Looking beyond this temporary near-term rebound, we expect that the Reserve Bank will face a number of challenges in terms of achieving its longer-term target of 2% inflation.
- We expect that the Reserve Bank will need to continue cutting the OCR over the coming months.

A key question arising from the Reserve Bank's recent *Monetary Policy Statement* is whether there will be a sustained increase in inflation over the coming years. After lingering at levels below the midpoint of the Reserve Bank's target band for four years, inflation is set to rebound over the coming months. The Reserve Bank's latest forecasts show this lift persisting for some time (figure 1). However, with much of the pick up in inflation related to an increase in imported inflation and the domestic economy set to slow, we have our doubts about its durability. We think the economy will still need a significant boost to ensure inflation aligns with the Reserve Bank's longer-term goals.

Import prices to drive a pick-up in inflation, but this isn't likely to be sustained

In early 2015 inflation fell to its lowest level in over 15 years, dropping to an annual rate of just 0.3%. Over the coming months, inflation is set to rebound and is expected to rise to 1.9% over 2016. There are two key developments underpinning this expected increase in inflation. Petrol prices have risen sharply since the start of this year. In addition,

Figure 1: Reserve Bank inflation forecasts (September *Monetary Policy Statement*)



the New Zealand dollar has fallen by around 15% on a trade weighted basis (figure 2) which will drive a generalised increase in the domestic prices of imported goods.

The decline in the New Zealand dollar is particularly notable. The Reserve Bank's September policy statement highlighted this as a factor that would generate a significant and long lasting pick-up in inflation through until late 2018. Some of this pick-up reflects that the Reserve Bank is expecting the lower exchange rate to boost demand over the coming years.

While we agree with the Reserve Bank that the fall in the NZD will result in a sharp lift in inflation, we're sceptical about how enduring the resulting pick-up will be. Changes in the exchange rate generate only a temporary lift in inflation, with the domestic prices of imported goods typically adjusting

over a period of around 12 to 18 months. That's a lot shorter than assumed in the Reserve Bank's forecasts. In fact, the only time we've seen a pick-up in imported inflation that has been sustained for anything like what the Reserve Bank is projecting was in 2000-01 (figure 3). During that period the currency had fallen to a record low and oil prices had tripled over the previous three years, from $10 to $30 a barrel.

One could argue that the recent fall in the NZD will result in a slightly more persistent boost to inflation than usual as retailers may seize the opportunity to rebuild thin margins. In recent years, tough trading conditions and the lingering strength in the NZD resulted in retail margins shrinking. Now, with the NZD having fallen, the domestic price of imports is set to rise. As retail prices rise in response to the increase in imported costs, we may see some retailers rebuilding margins at the same time.

However, the scope for retailers to claw back margins currently appears limited. Consumer confidence has fallen sharply and businesses have highlighted a limited ability to increase prices compared to average. In addition, the increased prevalence of online purchases in recent years has resulted in a structural change in the retail environment, weighing on margins in some sectors. Furthermore, if retailers do increase margins, this adjustment is likely to occur when import prices rise. Consequently, even if margins do increase, it seems unlikely that this will result in a large sustained boost to inflation.

Achieving a sustained pick up in domestic inflation could also be a challenging task

Overall, it seems doubtful that the fall in the NZD alone will result in the sort of enduring increase in inflation that the Reserve Bank requires to meet its target.

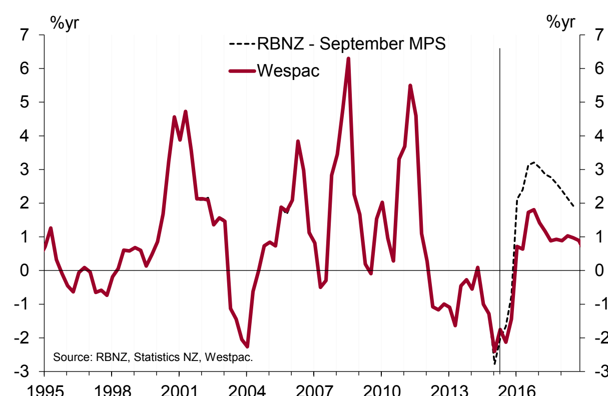
In order to generate a sustained pick-up in inflation, the Reserve Bank needs a sustained increase in domestic demand. This will boost the domestic components of inflation, and will also give domestic sellers of imported goods greater pricing power. However, achieving a sustained lift in domestic demand or inflation over the next few years may be easier said than done.

First of all, the economy is facing significant headwinds. Internationally, growth has slowed in our two largest trading partners, and global financial conditions have become a lot rockier. Domestically, a second low payout season is on the cards in the dairy sector, and the resulting falls in earnings are likely to weigh on activity across the economy. On top of this, the levelling off of the Canterbury rebuild will dampen growth in construction activity over the coming years. These headwinds have already been passing through to lower consumer and business confidence, and are expected to dampen both employment and spending growth.

A further concern is the composition of domestic inflation (sometime referred to as non-tradable inflation). Around 18% of non-tradables inflation is related to central and local government charges, such as charges for education and

Figure 2: TWI forecasts

Figure 3: Imported (tradables) inflation forecasts



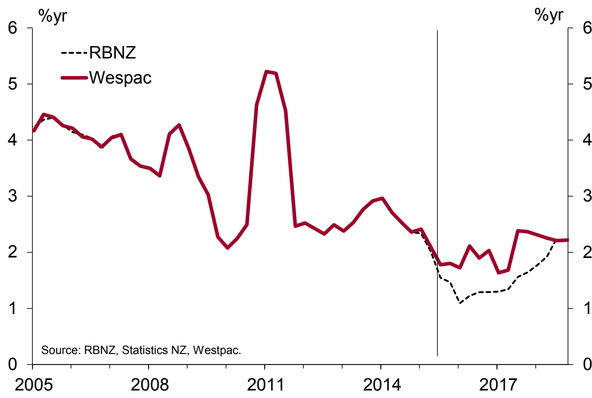
health care. Changes in such costs are largely independent of the economic cycle. And as it happens, over the next few years changes in some of these costs will actually be subdued relative to recent history. For instance, upcoming reductions in ACC levies will shave around 0.3 percentage points off annual inflation. Similarly, the annual increase in the tobacco excise tax will be smaller than in recent years.[1]

The components of domestic inflation that have the closest relationship with the strength of economic activity tend to be related to housing and construction, such as the cost of building new houses. However, an increase in domestic inflation due to stronger housing and construction inflation would be a double edged sword for the Reserve Bank. While their primary aim is keep inflation near 2%, they will be loath to overstimulate the housing market with lower interest rates given their macro-prudential concerns around overheating in the Auckland housing market (which is also where much of the growth in construction is expected to be).

Even if housing related inflation does increase in most regions, we're going to see an easing back of cost inflation in Canterbury as the rebuild first plateaus, then eventually winds down.

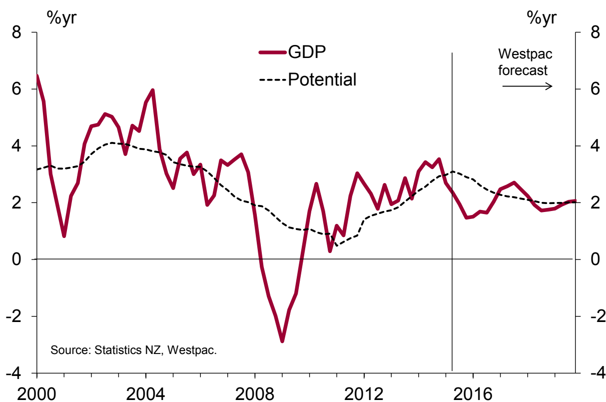
1 The Reserve Bank looks through the initial impact of changes in government policy on the level of prices, such as the upcoming reductions in ACC charges. However, the Reserve Bank is still mindful of how a low inflation environment can affect wage and price setting behaviour.

Figure 4: Domestic (non-tradables) inflation



In addition to the above conditions, in recent years there has been strong growth in the economy's productive capacity as a result of increases in the population and capital investment by businesses. This means that there is increased scope for the economy to grow without significant increases in costs and prices (figure 5).

Figure 5: GDP growth – actual and potential



Finally, we've seen household and businesses' inflation expectations taking a step down in recent years. These are key determinants of wage and price setting decisions, and their recent falls may mean that prices won't rise as quickly as they have in the past. This risk has been reflected very clearly in wage inflation which hasn't shown any material pick-up since 2011 despite firm GDP growth in recent years (figure 6).

Figure 6: Wage inflation

On balance

Putting it altogether, we're left with an uncomfortable picture. Inflation will certainly pick up in the near term as a result of the lower NZD and higher import prices. But this won't result in an enduring lift in inflation. On top of this, the Reserve Bank will face a number of obstacles to generating an increase in the domestic components of inflation.

It's a combination of conditions that leads us to expect that the Reserve Bank will need to cut rates by more than they signalled at the time of their September *Monetary Policy Statement.* We continue to expect that the Reserve Bank will need to reduce the OCR to 2% over the coming year. And even then, boosting inflation may not be a simple task. A further complicating factor is that, with inflation set to temporarily rise back close to 2%, there is uncertainty around when the Reserve Bank will change its view.

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