Economic Note

2019 Inflation Watch

9 July 2019

Low inflation outlook provides a green light for a lower OCR

- We expect annual headline CPI inflation to remain below 2% over 2019, with a low short-term outlook for core and non-tradable inflation.
- The inflation outlook suggests there is no impediment to the OCR moving lower. We expect 25bp OCR cuts in August and November, with the OCR ending 2019 at 1.00%.
- Our view of the floor on the OCR will depend on the global scene, actions of global central banks, the domestic activity and inflation outlook and the degree of spare capacity within the NZ labour market.

Summary and implications

Headline and core inflation has remained low, reflecting offsetting influences and the benign global inflation backdrop. Using a simple components-based approach our analysis highlights recent developments in some of the key drivers of NZ inflation. Our analysis suggests that despite the OCR being at record lows, the inflation outlook remains benign. Annual CPI inflation looks set to end this year well below 2%, while our indicator-based approach suggests that annual non-tradable and core inflation are likely to remain contained. In our view, the inflation backdrop and outlook does not look to be a factor preventing further OCR cuts. We expect a 25bp OCR cut in August and follow up 25bp cut in November. Whether the OCR moves lower than 1.00% crucially depends on the inflation and activity outlook and the RBNZ's view on the magnitude of spare capacity within the economy (most notably the labour market). Over the next few weeks we will be publishing a research note that will outline our thoughts on capacity with the labour market and wider economy.

Background

As we discussed in our note last year, overall CPI inflation has been low and stable, both locally and abroad. However, at that time there were signs that prices were starting to stir and many central banks were signaling pending increases in policy interest rates. Some (most notably the US Federal Reserve) were in the process of raising interest rates so as to meet their price stability objectives. With policy interest rates either at or close to record lows for many OECD economies, there was the risk that inflationary pressures would surface and prompt monetary policy tightening, with the risk of more aggressive tightening if the policy maker falls behind the curve and policy is needed to 'reset'.

There were signs late last year that NZ inflationary pressures were starting to firm. The cocktail of rising global oil prices, a lower NZD, and increasing fuel excise pushed nationwide fuel prices sharply higher. The first in a series of sizeable hikes to the minimum wage took place. Moreover, capacity constraints remained acute in some sectors of the economy (construction and accommodation. **Despite all of these influences, headline inflation has failed to lift, with RBBZ estimates of annual core inflation stuck in a 1½ %-2% range.**

The RBNZ looks to have lost patience and cut the OCR by 25bps in May, with a lower OCR deemed to be "necessary to support the outlook for employment and inflation consistent with its policy remit". In the June OCR Review, the RBNZ held the OCR at 1.50%, but clearly outlined their intent, noting that more policy support was likely to be necessary given the weaker global backdrop and subdued domestic demand.

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We would also add that the RBNZ appears increasingly perplexed by the persisitent weakness in consumer price and wage inflation despite pressures on capacity. In a recent note on productivity, our analysis suggested that the sluggishness in wage inflation could largely be explained by weak labour productivity growth and low consumer price inflation. What about consumer price inflation? There are a host of potential explanations why it has stayed low, including the impact of globalization and technological change. What we also know is that the current episode of low consumer price inflation is not **just a local phenomenon. Of late global pricing metrics have remained benign, with the inflation genie firmly ensconced within the bottle.** This has seen global central banks scale back tightening biases, switch to easing biases, and in some cases (e.g. the RBA and RBNZ) we have seen policy interest rates cut.

Given the recent disconnect between capacity and pricing metrics, our analysis uses non capacity-based indicators for the following broad CPI components:

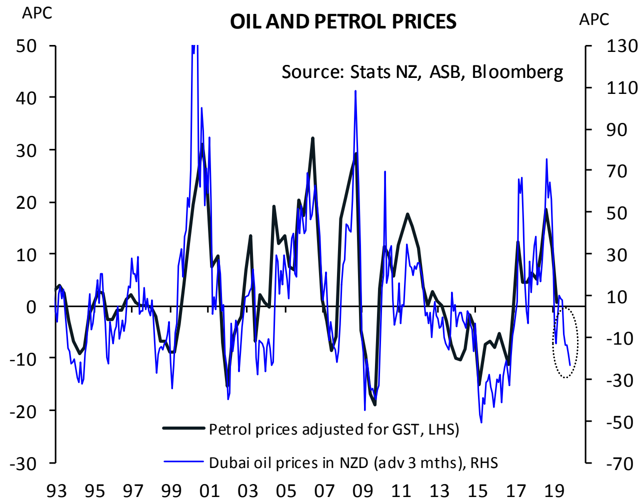
- Commodity price sensitive (30% of the CPI regimen) – prices in this component are usually influenced by movements in global commodity prices and the NZD. It includes a wide range of goods and services including food, vehicle fuels and transport services.
- Housing (17%) – prices relating to the cost of housing tend to climb more quickly than that for the aggregate CPI. It includes construction costs, energy prices and the dwelling rents component.
- Retail related (around 20%) – prices for these goods are sensitive to trends in global retail price inflation (currently very low) as well as to the NZD.
- Labour market sensitive (17%) – miscellaneous goods and services that are sensitive to changes in labour market conditions/wages. It includes miscellaneous services, healthcare.
- Government dominated (16%) – administered charges and retail goods (apart from vehicle fuels) that have a sizeable tax component. It includes goods and services such as local authority rates, tobacco and alcohol prices.

Our categorisation of the components and inflation add-up is ad-hoc but it can be useful for illustrating the direct influences impacting on the overall inflation process within the NZ economy.

Inflation Component Outlook

Commodity price sensitive (30% of CPI weight)

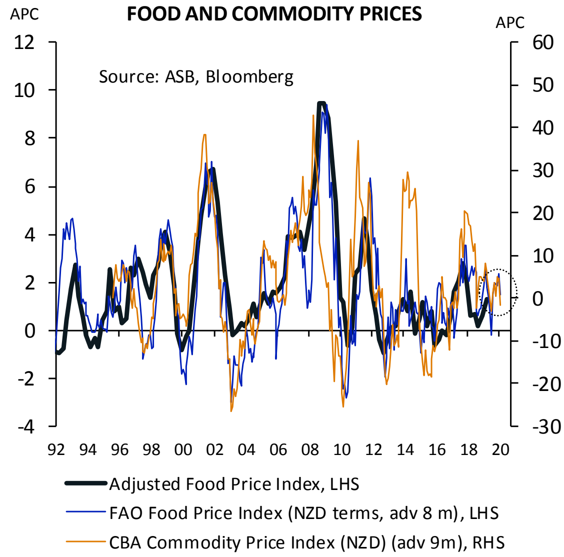
The inflationary signals from this component have changed significantly since our last update.



At that time costs pressures were stirring, with prices for Dubai crude firming , and with contract prices expected to remain elevated. Increasing concerns over the global outlook have sent oil prices lower, with prices for Dubai crude around USD63 per barrel as opposed to close to USD85 last October and nearly USD75 in April this year. Partly offsetting this has been the slightly lower NZD, which has fallen from around 68 USD cents in March to slightly above 66 US cents at present. **We expect continued volatility in quarterly CPI inflation outturns over 2019, partly as a result of swings to retail petrol prices.** Quarterly falls for petrol prices in Q1 and Q3 will contrast with quarterly increases in Q2 and Q4, with the 3.5 cents per litre increase in nationwide fuel excise pushing up retail fuel prices from October. We expect no change in overall retail fuel prices over 2019, with risks tilted to the downside if global oil prices continue to recede. Our analysis assumes that earlier clims in fuel prices are unlikely to filter through into broader consumer prices.

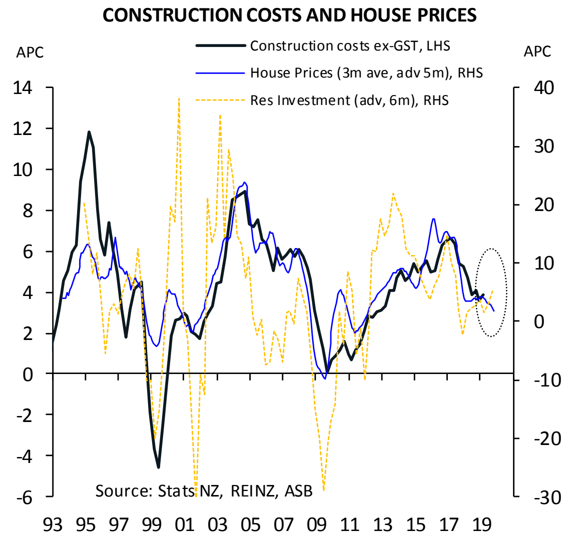
It's a similar story for food commodities. Of late, gains in various food commodity indices have tailed off, with outright falls for some in recent months. Nevertheless, NZD-denominated commodity pric indices are up around 10% since the start of the year. Our expectation is that competitive pressures within the food sector will temper the climb in NZ food prices. We expect annual food price inflation of around 1% over the 2019 calendar year.

All up, we assume annual consumer price inflation from this sector is likely to be just over 0.5% (0.2 percentage point contribution to annual CPI inflation), less than one-third of that for the 2018 calendar year.

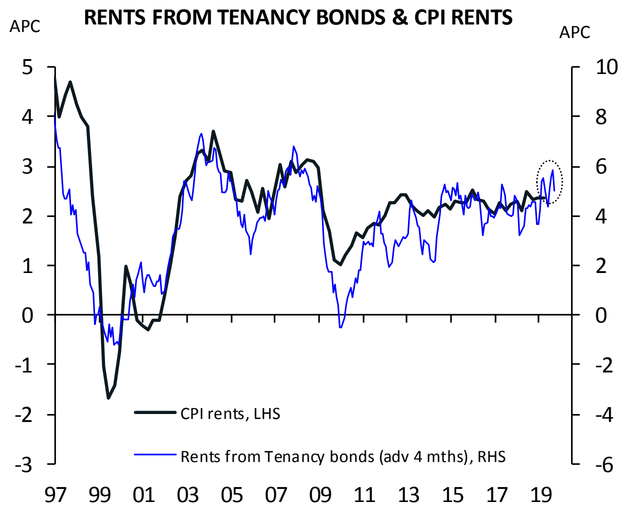


Housing market (17%)

Pricing pressures are expected to cool from this sector, which is linked to the slowing nationwide market for existing dwellings. A considerable pipeline of residential and non-residential construction work remains and capacity constraints and skill shortages continue. The June 2019 QSBO suggested that firms in the sector are under increasing margin pressure, with rising costs, but difficulties in pushing through price increases. Related to this is the cooler nationwide housing market backdrop, but pockets of strength are still apparent. The soft residential property market In Auckland has likely dampened pricing in the sector, with sub 3% annual Auckland construction cost inflation about one-third of what it was a couple of years ago. Construction cost inflation has remained higher outside of the major centres. Despite recent cuts to mortgage interest rates, we only expect a modest pick-up in annual house price inflation over 2019, given policy changes to slow investor demand and stretched affordability in an increasing number of centres.



Regional contrasts have been evident for dwelling rents. Shortages of rental dwellings have translated into steeper increases for dwelling rents in Wellington. It is puzzling that dwelling rental inflation has been so benign in Auckland, despite acknowledged dwelling shortages. We expect annual rental inflation to edge higher over the next 12 months. Rather than signifying a genuine firming in rental prices, part of the change is due to Statistics NZ changing their methodology for measuring dwelling rents within the CPI, which is expected to produce slightly higher rates of rental price inflation in the future[1].

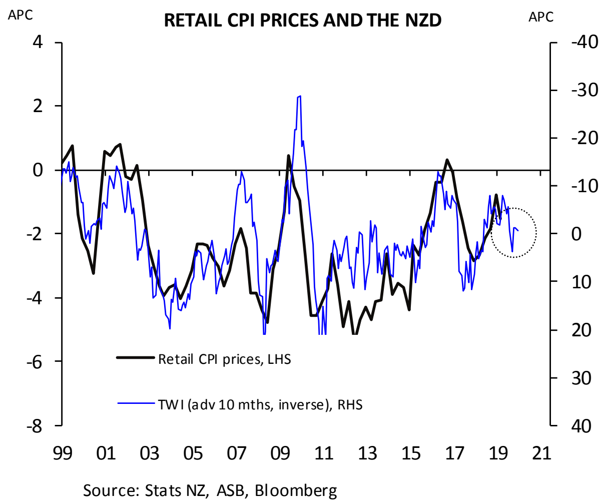


Source: Stats NZ, MBIE, ASB

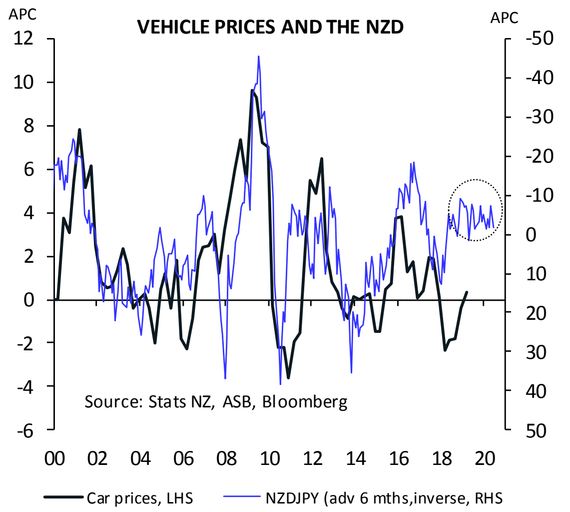
All up, **annual CPI inflation from housing-related measures is expected to remain slightly below 3% over the next 12 months (0.5 percentage point contribution),** below its post-2000 historical average increase of just over 3% per annum.

[1] From the June 2019 quarter Statistics NZ will be using modelling techniques to derive price changes for the stock of dwelling rents from the Tenancy Bond data. Our estimates suggest that the new methodology is likely to add around 0.1 percentage points for annual CPI inflation.

Retail sector (20%)



Global inflation in the retail sector has remained reasonably low, with retail deflation still evident for goods where there is excess global production capacity. The NZD trade-weighted index (TWI) looks to have consolidated of late, after steep falls in April and May. As a result, the **NZD TWI looks to be little changed compared to a year ago, with the NZD about 2% lower against the USD and around 5% lower against the yen.** A simple rule of thumb suggests that a 10% fall in the NZD TWI (if sustained) will add around 1% to overall CPI inflation over the next year. Given the generally low wage levels within this sector, increases in the minimum wage are a cost increase likely to impact on the retail sector. Some retail prices will likely lift as a result. However, as highlighted in our recent note, the productivity performance of the retail sector has been impressive, and if this continues, cost increases can generally be accommodated without flowing through into retail prices.

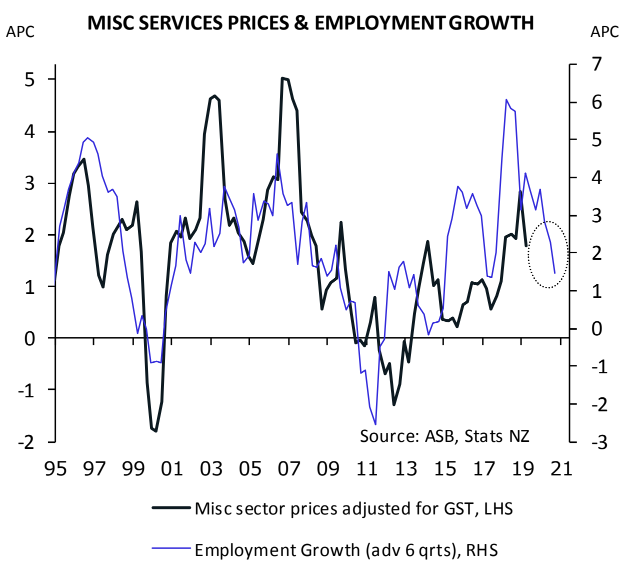


Some part of the retail sector will likely experience higher consumer prices. The close to 5% fall in the NZD relative to the yen since last December suggests that the current bout of annual deflation for new and used cars is likely to prove short-lived. **There is the risk, however, that retailers will struggle to pass on higher costs.** Motor vehicle retail sales volumes have plateaued of late, and vehicle registrations are close to 20% below their late 2017 peaks.

The issue for consumer prices is the extent to which retailers will absorb the increase in costs into their margins. Recent business confidence surveys suggest that firms have been swamped with cost increases and there could be limited scope (or appetite) for retailers to absorb all of the increase. However, pricing power for many firms is low and consumer resistance is high, suggesting the period of retail deflation is likely to continue.

We expect about a 1.0% decline for this component in the 2019 year (-0.2 percentage point contribution).

Labour market sensitive (17%)

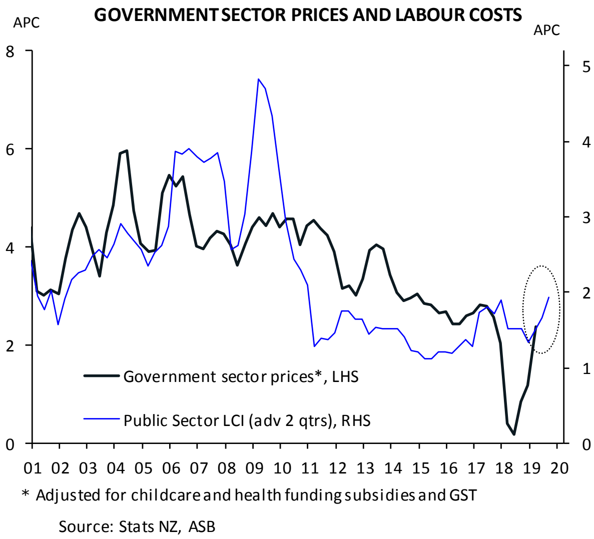


This includes goods and services that have a large labour component and whose price movements tend to reflect labour market conditions and developments in wages. Aggregate wage inflation has remained low despite the historically low unemployment rate. With the demand for labour slowing and with few signs that wage inflation will escalate, consumer price inflation from this sector looks to remain contained.

We expect annual increases of around 2%-2½% over the next 12 months (+0.4 percentage point contribution).

Government influenced (16%)

Prices for these goods and services are either administered government charges or have a significant tax component[2]. This includes tobacco and alcohol (whose prices are impacted by changes in excise duty), tertiary fees, and local authority rates. The lack of competitive pressures has typically resulted in price increases from this sector considerably outstripping that of overall inflation. Excise increases on tobacco and alcohol and increases in local authority rates are likely to ensure that price increases from these sources add to overall CPI inflation. The rolling out of lower tertiary fees – the signalled move to three-years of fee free tertiary study by 2024 - will likely add to annual volatility of this component over the next few years. There is also a rough relationship between public sector wage inflation and consumer price inflation in this component. We expect public sector wage inflation to outstrip those in the private sector as increased activism of the public sector unions translates into higher wage settlements.



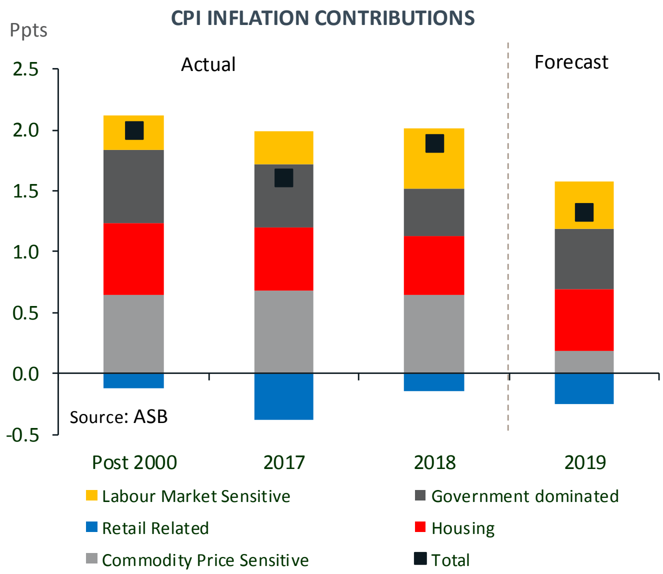
All up, we expect inflation in this component to rose towards 3% by the end of the year (0.5 percentage point contribution).

Sub-2% CPI inflation for a while yet

The table at the end of this note summarises what our indicators are signalling for the CPI inflation components. **At present the indicators suggest that annual headline CPI inflation is expected to remain well below 2% over 2019.**

Adding up the various influences suggests the following:

- Commodity-price related influences are expected to directly contribute around 0.2 percentage points to annual CPI inflation over 2019. This about one-third half of their direction contribution over 2018
- Retail deflation looks set to continue. Sizeable global manufacturing capacity for retail goods and the sale-focused nature of the NZ consumer mean it will prove difficult for retailers to push through price increases. The strong productivity performance of this sector will likely support profitability, despite anecdotes of increasing pressures on margins.
- Administered price increases will add roughly half a percentage point to annual inflation. Higher prices for tobacco and local authority rates seem to be a fact of life: one driven by health objectives, the other by perennial infrastructure demand and a lack of competitive pressure. The extension of the free tertiary fees policy could add to some volatility in future years.
- The labour market is likely to remain a source of price increases, although not to the same extent as we thought last year. We have revised down our outlook for wage inflation. Moreover, higher wages need not impact on consumer prices if they are offset by a corresponding increase in labour productivity or cut in producer margins.

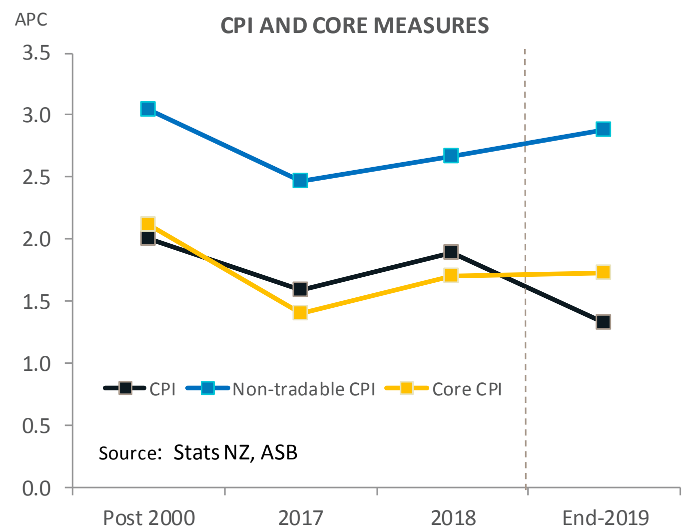


[2] Vehicle fuels have a large tax component but their movements typically tend to reflect NZD and global oil prices.

- Price increases from the housing group are expected to subside. **It is becoming more of a buyers' market for existing dwellings in Auckland, notwithstanding the resilience in evidence in some regional areas. This shift in the balance of power towards the customer and away from the provider is also expected to become present for building work in some regional areas (e.g. Auckland).** Methodological changes and still-solid population growth are expected to keep rental dwelling inflation above historical averages.

Core Inflation outlook - sub 2%

We have taken our component estimates and have used optimisation techniques to project inflation readings for the RBNZ's sectoral factor model estimate of core inflation. This is a broad-brush approach, but given the 'back box' nature of the RBNZ's core inflation estimates it is useful for illustrating influences on the core inflation process and outlook. We have also used a similar approach to forecast non-tradable inflation. To cross-check the results, we have reweighted our component forecasts with CPI non-tradable weights.



Our analysis highlights some modest firming in domestically-generated inflationary pressure, driven by the (very) gradual pick-up in wage inflation. Despite this, annual non-tradable inflation still looks set to remain below 3%, with annual core inflation from the sectoral factor model below 2%. Capping core inflation looks to be cooling inflation in the services sector, linked to decelerating growth in that sector. Another year of outright deflation in the tradable sector also looms.

Policy Implications

Our inflation add-up is ad-hoc, but is useful in highlighting some of the key drivers in the inflation process. **Annual CPI inflation is expected to remain below 2% at the end of this year despite the OCR being at record lows and with various cost-push influences at play.** Volatility in the annual inflation readings, over the next year or so is likely considering the offsetting shocks hitting the economy. **We also expect the RBNZ's estimates of core inflation to remain below the midpoint of the 1-3% inflation target.** As such, persistent low CPI inflation and the weaker outlook for economic growth and employment likely necessitate further policy accommodation. **For NZ, monetary policy still looks to be the first cab off the rank. We expect a 25bp OCR cut in August and a follow-up 25bp cut in November, taking the OCR to another record low of 1% by the end of the year.**

The persistence of low inflation since the Global Financial Crisis suggests the presence of a structural element to the inflation process. The output and inflation trade-off looks to have changed, not only here but abroad as well. The penny appears to have finally dropped in the global central banking community, with the Reserve Bank of Australia having cut the cash rate to a record low of 1.00% in July, with our expectation of a further 25bps of RBA interest rate cuts by the end of the year. We also expect a 25bp interest rate cut by the US Federal Reserve in late July (100bps in cuts by mid-2020).

We believe a similar phenomenon has likely occurred in the labour market. Our view is that the Non-accelerating inflation rate of unemployment (NAIRU) for New Zealand now looks to be lower and maximum sustainable employment (MSE) likely higher than what it was previously. **How much lower is an open question at present and we will be publishing a research note on our views on the NZ NAIRU and MSE over the next few weeks.**

What are the policy implications from a different output and inflation trade-off? One option is to ignore inflation outcomes and instead concentrate on keeping economic activity and employment close it trend level. This can be tricky to do as the trend level of output is unobservable and could actually be higher than conventional estimates suggest. There is also the view that monetary policy is becoming increasingly ineffective and that central banks have little influence in determining future inflation outcomes. Moreover, the remaining monetary policy ammunition should be saved for when it is really needed. **We don't believe this is the case.** Monetary policy still works, but it needs to be cognisant of the new landscape in which it operates. New Zealand and Australia also have the luxury of easing fiscal policy given their comparable low levels of net public debt. Another option for New Zealand would be to ease the LVR restrictions on housing lending, although we concur with the RBNZ's assessment that they have proved useful in supporting financial stability.

The issue is how low the OCR will go this cycle. Our forecasts have the OCR plateauing at 1.00%, but we acknowledge the risk that it could move lower still. Actions by global central banks and future readings for actual and expected NZ inflation will be key. Our work on NZ labour market capacity will also help guide our OCR view.

SUMMARY TABLE

CPI Annual % Change (ex-GST change)	CPI Weight	Post 2000 average increase	ppt	2017 (act)	ppt	2018 (act)	ppt	End 2019 (est)	ppt
Commodity Price Sensitive	**29.6**	**2.0**	**0.6**	**2.3**	**0.7**	**2.2**	**0.6**	**0.6**	**0.2**
Food prices	19.0	2.2	0.4	2.3	0.4	0.6	0.1	1.0	0.2
Petrol	4.0	5.0	0.2	6.5	0.3	11.1	0.4	0.0	0.0
Transport services	6.6	-0.2	0.0	-0.1	0.0	1.3	0.1	0.0	0.0
Housing	**17.5**	**3.1**	**0.5**	**2.9**	**0.5**	**2.8**	**0.5**	**2.9**	**0.5**
Rents	9.1	2.1	0.2	2.3	0.2	2.4	0.2	2.8	0.3
Construction costs	4.2	4.4	0.2	5.3	0.2	3.6	0.2	3.5	0.1
Other	4.1	4.1	0.2	2.0	0.1	3.0	0.1	2.5	0.1
Retail Related	**19.7**	**-1.6**	**-0.1**	**-1.9**	**-0.4**	**-0.7**	**-0.1**	**-1.0**	**-0.2**
Retail goods excl cars	16.3	-2.3	-0.3	-2.4	-0.4	-0.8	-0.1	-1.8	-0.3
Car prices	3.5	1.6	0.1	0.1	0.0	-0.4	0.0	2.3	0.1
Government dominated	**16.0**	**3.8**	**0.6**	**3.3**	**0.5**	**2.4**	**0.4**	**3.0**	**0.5**
Government dominated sectors	9.0	3.8	0.3	2.5	0.2	1.3	0.1	2.5	0.2
Alcohol and tobacco	7.1	3.8	0.3	4.2	0.3	3.8	0.3	3.7	0.3
Labour Market Sensitive	**17.1**	**1.6**	**0.3**	**1.6**	**0.3**	**2.9**	**0.5**	**2.3**	**0.4**
Private sector services	17.1	1.6	0.3	1.6	0.3	2.9	0.5	2.3	0.4
TOTAL	**100**	**2.0**	**2.0**	**1.6**	**1.6**	**1.9**	**1.9**	**1.4**	**1.4**
Non-tradable CPI		**3.0**		**2.5**		**2.7**		**2.8**	
Tradable CPI		**1.0**		**0.5**		**0.9**		**-0.4**	
Core Measures									
Sectoral Factor Model		**2.1**		**1.4**		**1.7**		**1.7**	

Source: Statistics NZ, RBNZ, ASB

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