Economic Note

Inflation Watch

26 July 2018

Pipeline price pressures will test RBNZ's mettle

- Reflecting a combination of the inflationary and waning deflationary impacts, annual CPI inflation is likely to move towards 2% by the end of the year.
- There is the risk that the spill-overs from the spike in inflation into broader prices and wages could be more significant than we have allowed for.
- The challenge for the RBNZ will be in keeping expectations for wage and price setters consistent with the 1-3% medium-term inflation target. We expect a stepping up in RBNZ communications to that effect.

Summary and implications

Using a simple components-based approach our analysis highlights recent developments in some of the key drivers of NZ inflation. The lower NZD, higher oil prices, increases in fuel excise and the minimum wage point to a lift in annual CPI inflation, which looks set to approach 2% by the end of the year.

There are gaps and limitations with our analysis and there is the risk that the spill-overs from the spike in inflation into broader prices and wages could be more significant than we have allowed for. If inflation does prove to be stronger, the next 12 months will provide a test for the medium-term focus of the RBNZ policy-makers and how symmetrically they will treat the 1-3% inflation target. We expect a pick-up in RBNZ communications over the coming months to remind wage and price setters that expectations need to be consistent with the 1-3% inflation target.

The RBNZ is likely to wait to see evidence in the actual inflation data before deciding on its course of action. Given the surprising persistence of low inflation since the Global Financial Crisis, we expect the RBNZ to be understandably cautious about acting pre-emptively.

Background

In recent years overall CPI inflation has been low and stable, both locally and abroad. As is the case with New Zealand, there have been a number of offsetting influences. The last few months have signalled that the goldilocks period of solid growth but low inflation may be nearing an end given sharp increases in USD-denominated oil prices and the lower NZD. Moreover, capacity constraints remain acute in some sectors of the economy (construction, accommodation), which, along with prospective increases in the minimum wage and some administered price increases, point to a firming in NZ CPI inflation.

Here we decompose overall CPI inflation into the following 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

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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.
- 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.
- Labour market sensitive (17%) – miscellaneous goods and services that are sensitive to changes in labour market conditions/wages. It includes miscellaneous services, healthcare.

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.

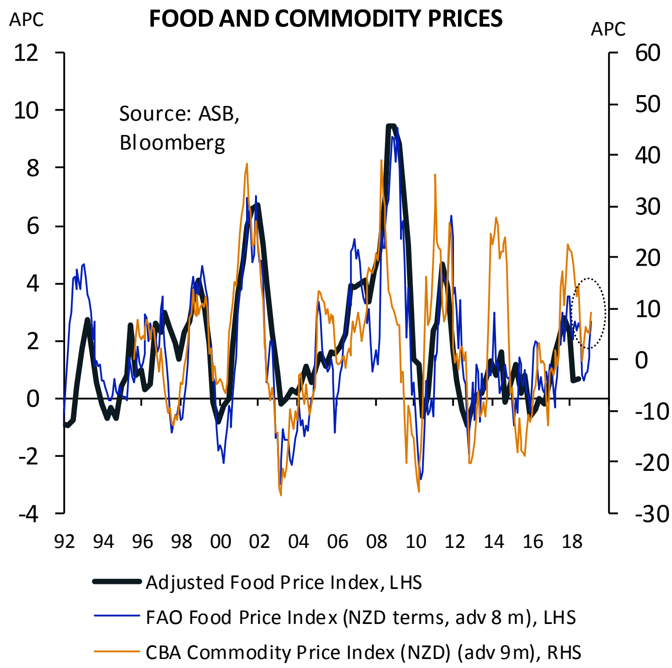
Inflation Component Outlook

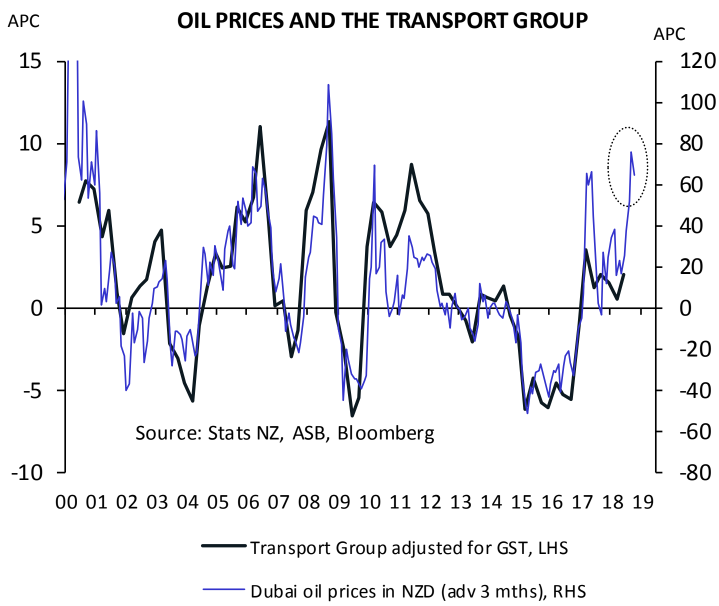
Commodity price sensitive (30% of CPI weight)

This looks set to be a major source of inflationary pressure over the next year or so. USD strength has been the predominant theme, which has pushed up NZD-denominated commodity food prices. The NZD has fallen from above 73 cents in mid-April to around 68 US cents at present. Movements in global food prices have been modest but the weaker NZD has pushed up NZD-denominated food price indices.

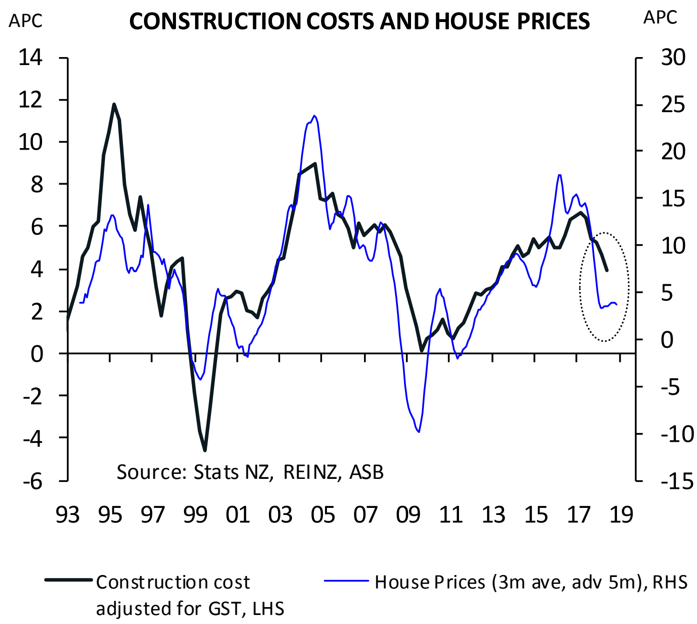
Compounding the impact of the lower NZD have been sharp increases in oil prices, with USD prices for the Dubai grade around 40% higher than 12 months ago, with the lower NZD taking the NZD-denominated increase close to 65% over this period. Adding to vehicle fuel prices will be higher regional petrol tax in Auckland (July) and annual increases in the nationwide fuel excise from October. Higher oil prices have already resulted in some price increases - Air NZ increased domestic airfares by 5% in May and retail petrol prices have already increased by around 20% over the last 12 months. And, although CPI prices from the Transport Group were broadly unchanged in Q2, fuel-related increases are in the pipeline.

Higher NZD-denominated oil prices are expected to boost prices in the transport group, and are likely to filter through into broader consumer prices. Our analysis only captures the indirect and second-round impacts of higher fuel prices only so far as they affect the historical relationships. The full impact could be significantly larger if firms pass on higher costs to consumers. **We assume annual inflation from this sector will approach around 3½% by the end of the year, contributing roughly 1 percentage point to annual CPI inflation.**





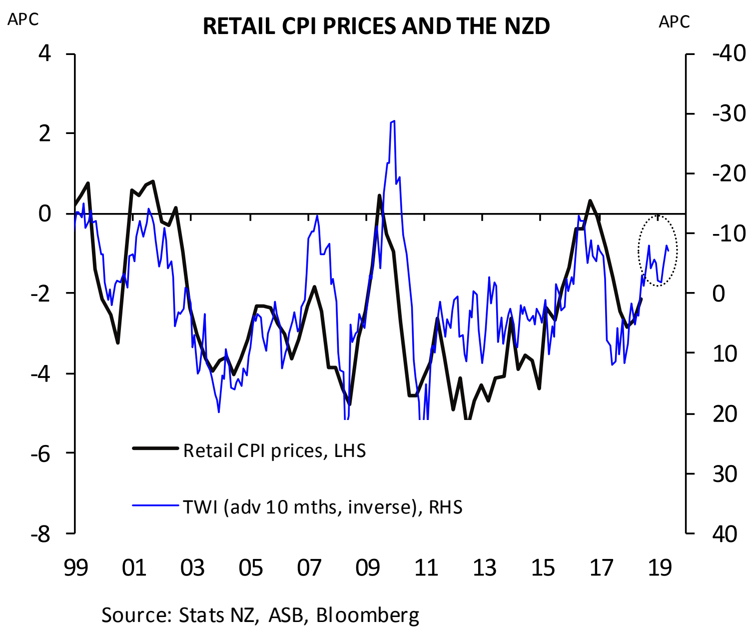
Housing market (17%)



By contrast, cost pressures look to be abating from a sector that has historically been a beacon for inflationary pressure. This moderation is likely to be driven by slowing construction cost inflation. There remains a large amount of residential and non-residential construction work in the pipeline and capacity constraints and skill shortages remain rife. However, the cooling residential property market looks to be having an impact on pricing decisions in the sector. Cost increases from residential consent issuance look to have slowed and average prices for the construction sector from the 2018Q2 QSBO remained below historical averages with firms absorbing cost increases in their margins. Annual CPI construction cost inflation slowed to a five-year low in the June 2018 quarter and is expected to remain below historical averages over at least the next 12 months.

We expect annual rental inflation to remain moderate. There are conceptual differences between the Tenancy Bond and Statistics NZ rent measures, and the two series do not always line up perfectly. According to the tenancy bond data, increases in rents look to have slowed in recent months, which is in contrast to the modest firming evident in the CPI measure. All up, **annual CPI inflation from housing-related measures is expected to slow to around 2½% over the next 12 months,** below its post-2000 historical average increase of 3.2% per annum.

Retail sector (20%)

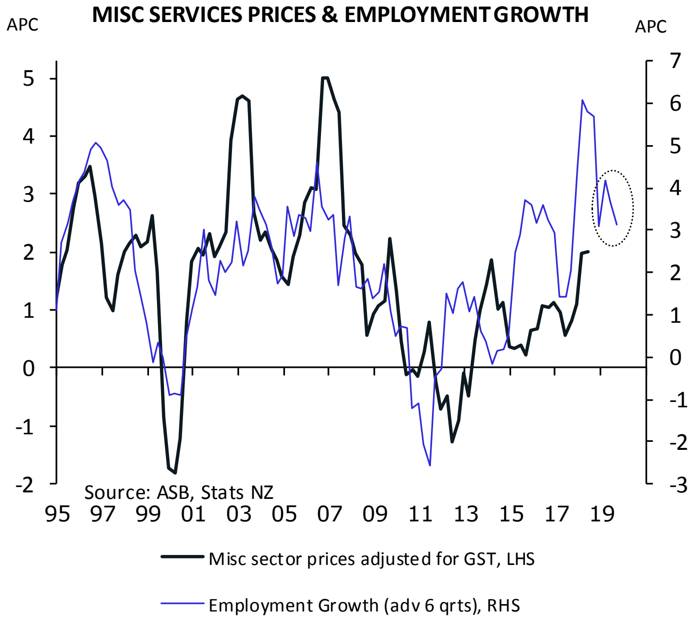


Global inflation in the retail sector has remained reasonably low, with retail deflation still evident for goods where there is excess global production capacity. **The deflationary impulse of earlier NZD strength looks to be abating, with the NZD Trade weighted index down around 7% compared to 12 months ago.** A simple rule of thumb suggests that a 10% fall in the NZD (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 another cost increase likely to impact on the retail sector. Moreover, the close to 10% fall in the NZD relative to the yen suggests that the current bout of annual deflation for new and used cars is likely to prove short-lived.

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 there is limited scope (or appetite) for retailers to absorb all of the increase. Hence, some of the increase in costs is likely to filter through into the retail level. **For the retail component, we expect considerably more modest annual deflation after a period of more sizeable price declines.**

Government influenced (16%)

Prices for these goods and services are either administered government charges or have a significant tax component[1]. 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. The rolling out of lower tertiary fees is currently dampening annual inflation from this component. However, 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. **All up, we expect inflation in this component to remain in a 2½%-3% range over the next year or so.**



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. However, with the labour market tightening and the expectation that wage inflation will start to pick up it seems likely that inflation from this sector will also gradually firm. **As such, we have pencilled in 2%-2 ½ % annual increases over the next 12 months.**

Add-up suggests around 2% annual CPI inflation by year end

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 CPI inflation could reach 2% by the end of the year.** This lift reflects a combination of the *inflationary* impact of higher commodity prices and the lower NZD, with the *deflationary* impulse of past NZD strength abating.

Adding up the various influences suggests the following:

- **Commodity-price related influences are expected to directly contribute around 1 percentage point to annual CPI inflation over 2018.** The direct impact is expected to wane.
- The period of retail deflation looks like it might be coming to an end. The lower NZD and pending increases in wage costs could see this component add to inflation. **The extent to which prices will firm will depend on retail margins.**
- Administered price increases will add roughly half a percentage point to annual inflation despite the impact of the free tertiary fees policy. 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 labour market is likely to become more of a source of price increases. **We note that higher wages need not impact on consumer prices if they are offset by a corresponding increase in labour productivity/trimming in producer margins.**
- Price increases from the housing group are expected to subside. **It is no longer a sellers' market for existing dwellings. The balance of power for building work looks to be increasingly shifting towards the customer and away from the provider.** Rental dwelling inflation is expected to remain moderate.

Our analysis is ad-hoc and employs a number of assumptions. The price increases suggested by our approach are largely in the pipeline and assume that the typical historical relationships apply. In some cases, for example, oil prices

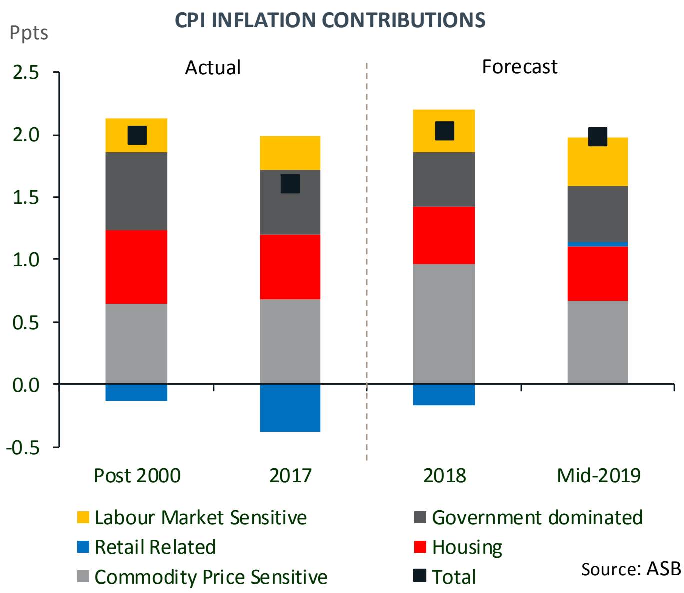
[1] Vehicle fuels have a large tax component but their movements typically tend to reflect NZD and global oil prices.

and the NZD, the leads provided by our indicators are less than 12-months ahead. As such, we assume that the current spot values are expected to persist over the analysis period. Moreover, our approach only captures indirect and second-round effects insofar as they are captured in historical relationships. **There could well be greater total inflation impacts from higher petrol prices and minimum wage increases than what our analysis assumes.**

Policy Implications

Our add-up of some of the key influences suggests that the outlook for CPI inflation has significantly firmed over the last few months. Annual CPI inflation is expected to push towards 2% given the boost provided by the lower NZD and higher oil prices. There is the risk that inflation outcomes could ratchet up if the spike in inflation flows through into generalised wage and price settings. Widespread capacity constraints within the economy and pending increases in the minimum wage increase the odds of this occurring.

The RBNZ will look to accommodate the temporary spike in inflation. A low inflation starting point and the RBNZ's flexible approach to inflation targeting provide some wiggle room. **However, the challenge will be in keeping expectations for wage and price setters consistent with the 1-3% medium-term inflation target.** We expect the RBNZ's communications strategy to increasingly emphasise the importance of keeping wage and price settings consistent with its price stability mandate. **Given the surprising persistence of low inflation since the Global Financial Crisis, we expect the RBNZ to be understandably cautious over whether to pre-emptively tighten policy. The RBNZ may opt to wait to see evidence in the actual inflation data before deciding on its course of action.** Forthcoming readings for actual inflation and inflation expectations over the next 12 months will be key.



SUMMARY TABLE

CPI Annual % Change (ex-GST change)	CPI Weight	Post 2000 average increase	ppt	*2017 (act)*	*ppt*	*2018 (est)*	*ppt*	*Mid-2019 (est)*	*ppt*
Commodity Price Sensitive	**29.6**	**2.0**	***0.6***	**2.3**	***0.7***	**3.3**	***1.0***	**2.3**	***0.7***
Food prices	19.0	2.3	*0.4*	*2.3*	*0.4*	*1.7*	*0.3*	*2.0*	*0.4*
Petrol	4.0	4.7	*0.2*	*6.5*	*0.3*	*12.0*	*0.5*	*4.0*	*0.2*
Transport services	6.6	-0.2	*0.0*	*-0.1*	*0.0*	*2.5*	*0.2*	*2.0*	*0.1*
Housing	**17.5**	**3.2**	***0.6***	***2.9***	***0.5***	***2.6***	***0.5***	***2.5***	***0.4***
Rents	9.1	2.1	*0.2*	*2.3*	*0.2*	*2.5*	*0.2*	*2.5*	*0.2*
Construction costs	4.2	4.4	*0.2*	*5.3*	*0.2*	*3.0*	*0.1*	*2.5*	*0.1*
Energy	4.1	4.2	*0.2*	*2.0*	*0.1*	*2.5*	*0.1*	*2.5*	*0.1*
Retail Related	**19.7**	**-1.7**	***-0.1***	***-1.9***	***-0.4***	***-0.8***	***-0.2***	**0.2**	***0.0***
Retail goods excl cars	16.3	-2.4	*-0.3*	*-2.4*	*-0.4*	*-1.0*	*-0.2*	*0.0*	*0.0*
Car prices	3.5	1.7	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*1.0*	*0.0*
Government dominated	**16.0**	**3.9**	***0.6***	**3.3**	***0.5***	**2.7**	***0.4***	**2.8**	***0.4***
Government dominated sectors	9.0	4.0	*0.4*	*2.5*	*0.2*	*1.7*	*0.2*	*2.0*	*0.2*
Alcohol and tobacco	7.1	3.7	*0.3*	*4.2*	*0.3*	*4.0*	*0.3*	*3.8*	*0.3*
Labour Market Sensitive	**17.1**	**1.6**	***0.3***	**1.6**	***0.3***	**2.0**	***0.3***	**2.3**	***0.4***
Private sector services	17.1	1.6	*0.3*	*1.6*	*0.3*	*2.0*	*0.3*	*2.3*	*0.4*
TOTAL	**100**	**2.0**	***2.0***	***1.6***	***1.6***	***2.0***	***2.0***	***2.0***	***2.0***
Non-tradable CPI		**3.0**		***2.5***		***2.7***		***2.8***	
Tradable CPI		**1.0**		***0.5***		***1.2***		***1.0***	

Source: Statistics NZ, ASB

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