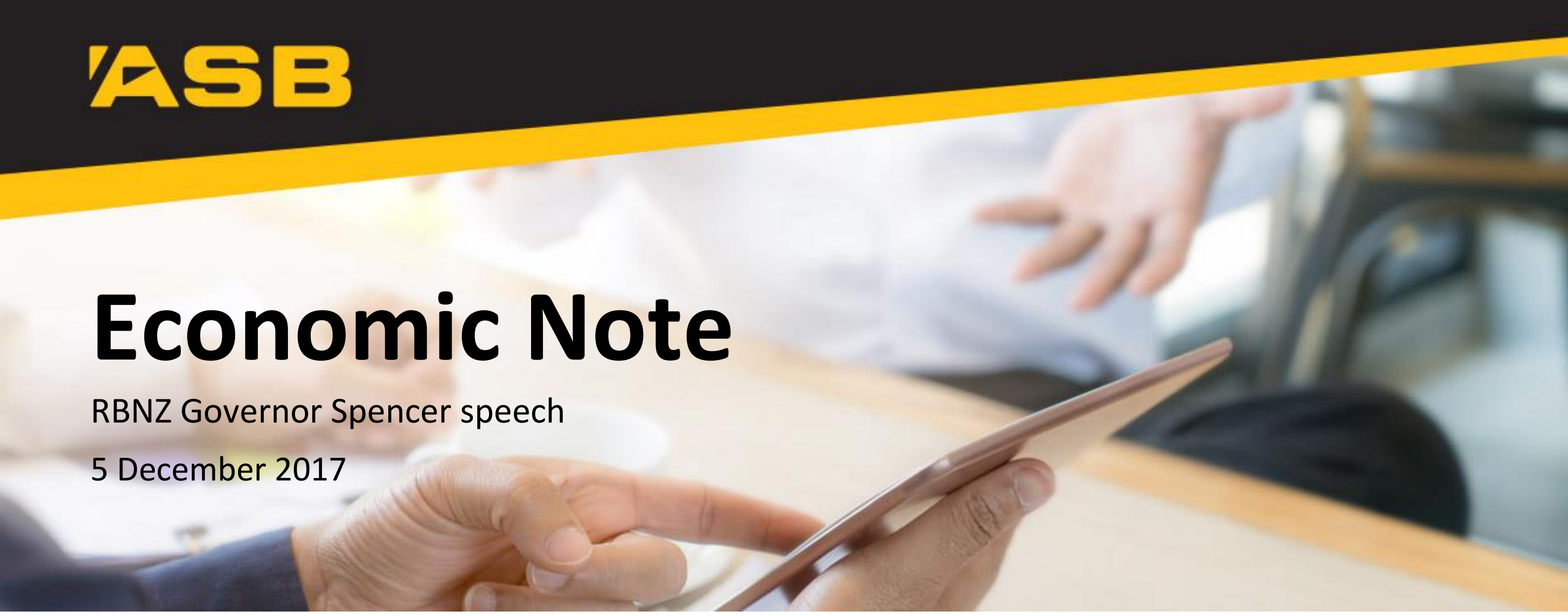

# Economic Note

RBNZ Governor Spencer speech

5 December 2017

## Flexibly flexible

- The RBNZ discusses key uncertainties around drivers of inflation.
- Risks to key assumptions are in offsetting directions.
- The RBNZ is now putting a larger amount of weight on output and employment stability.

### Implications

**The RBNZ used the speech to emphasise that its approach to monetary policy has become increasingly flexible, and that it is putting more weight on output and employment outcomes in the face of added uncertainties about the drivers of inflation.** It is important to note the RBNZ's caveat: the added weight on the real economy can only be sustained if inflation expectations remain well anchored. That theme comes against the backdrop of the new Government intending to explicitly add an employment objective alongside the RBNZ's current price stability objective.

A key conclusion from the speech is the RBNZ needs to be flexible and patient in its actions to get inflation back to around 2%. That balances against being too rigid in driving inflation back to target, and embraces the avoidance of unnecessary economic volatility. But, **in the absence of a pick-up in non-tradables inflation over late 2018, as the RBNZ currently forecasts, the RBNZ would "have to consider" further easing**, particularly if the global inflation backdrop remained weak.

The speech makes clear the RBNZ is, in particular, balancing two offsetting risks at present:

- The risk that global inflation accelerates, against its new assumption that persistent weak global inflation will continue;
- The risk that drivers of weak domestic inflation pressures persist, meaning that non-tradable inflation would not rise as soon as the RBNZ is currently assuming.

It will take time for uncertainties around these key inflation drivers to become more apparent. Meanwhile the RBNZ has plenty of time – we continue to see the RBNZ remaining on hold until early 2019.

### Changes in global inflation drivers

The RBNZ points to changing global factors as one of the key reasons inflation remains soft in advanced economies. **The RBNZ highlights three key facets of globalisation that have particularly weighed on prices**. First, the expansion of global supply chains (or outsourcing) has "lowered the price of a wide range of manufactures sold across the world." Second, China's rapid growth was, in part, driven by high levels of investment which have resulted in excess

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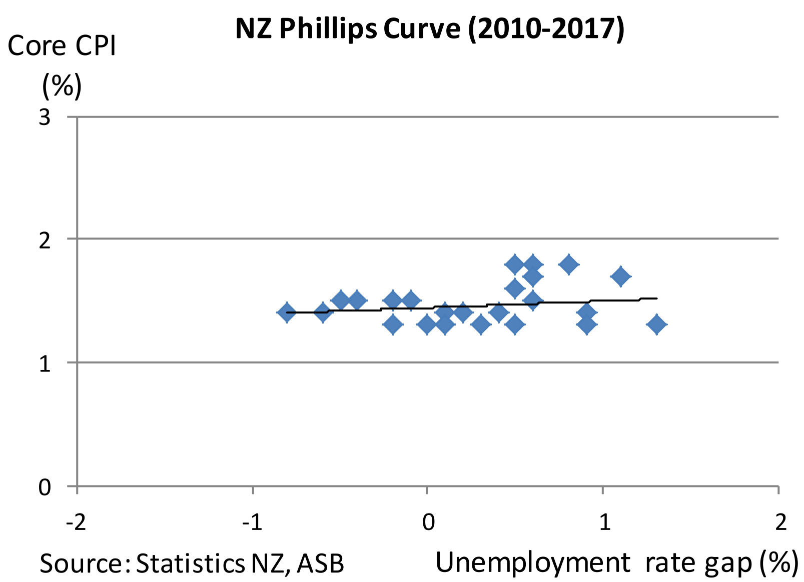
capacity in a number of key sectors such as steel. This has, in turn, restrained the price of industrial materials and further, manufactured goods.

Finally, inflation is also being impacted by the rise of the digital economy. ICT prices (information, communications and technology) have been driven down on lower unit costs and greater supply. Technological advancements also mean consumers are now getting more for less, further supressing prices. The RBNZ also notes how changing distribution channels have lowered the barriers to entry across a range of products (allowed for online sales), increasing competition and, therefore, putting downward pressure on prices. Grant Spencer also comments on how this has increased competition in traditionally non-traded sectors, which is further weighing on prices as a result. Looking ahead, the RBNZ expects this phenomenon to continue, stating that increasing labour mobility and globalisation will increasingly make NZ a "price-taker" in non-tradable goods and services.

## Changes in domestic inflation drivers

Spencer noted that the link between measures of capacity usage/slack and inflation has proved "elusive in recent years". Instead of the inverse relationship between high rates of labour underutilisation and inflation, the speech notes that inflation is now lower for a given rate of unemployment and the relationship between unemployment and inflation is "quite weak". Spencer cites recent RBNZ research highlighting the importance of global and other domestic factors in influencing the domestic inflation process. This is consistent with our research suggesting that the traditional "Phillips Curve" type relationship between capacity measures and inflation looks to have broken down over the last decade or so.

Either this, or shifts in technology and strong inward migration, have increased the speed-limit of the economy, by more than suggested by traditional measures. These drivers would result in a greater margin of economic slack than measured by conventional output gap approaches, which would be consistent with the low observed rates of wage and consumer price inflation. Given low rates of consumer price and wage inflation world-wide, explaining what is causing very low inflation despite high levels of resource utilisation is not confined to NZ.




## The resultant policy considerations

**The RBNZ is now assuming that weak global inflation will persist.** This sets it up to be more in line with the recent trend, though does open up exposure to the opposite risk, that global inflation picks up and lifts NZ inflation with it. The RBNZ noted that this risk would be similar to its upside scenario from November's Monetary Policy Statement.

On the flatter Phillips Curve – or **reduced responsiveness of domestic inflation pressures to monetary policy** – the RBNZ sees the conclusion as unclear whether the change is temporary or permanent. If it proves to be permanent, then the NZ dollar's influence on inflation pressures will be greater.

**Finally, low inflation expectations may need bigger policy movements** and consequent bigger shifts in spare capacity within the economy in order to bring inflation back to the 2% target mid-point. But bigger policy shifts run into conflict with the desire to avoid unnecessary instability in output (and, hence, employment) and the NZ dollar. The RBNZ's preference is to allow itself time for policy to work through, rather than trying harder to chase inflation's tail.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