Flashnote

HSBC Global Research

Macro
New Zealand Economics

New Zealand Digest

The 'lowflation' conundrum

- **Despite strong economic growth, New Zealand's inflation has remained low and is currently running at 1.0% y-o-y, which is at the bottom of the RBNZ's target band**
- **This may reflect the on-going effect of the high NZD and that there may be more spare capacity than previously thought, partly due to recent strong inward migration**
- **Nonetheless, our estimates suggest that spare capacity is continuing to be absorbed and, along with a lower NZD, we expect this should push inflation higher in 2015**

How long will inflation keep undershooting?

New Zealand's economy continues to outperform the rest of the OECD, with y-o-y growth running at +3.9% through to the middle of the year. Ordinarily, such strong growth would generate additional inflationary pressures and, indeed, this was expected to occur in New Zealand in 2014. However, inflation has confounded forecasts, falling back to 1.0% y-o-y, which is the lower edge of the RBNZ's 1-3% target band. As a result, we need to reassess the inflation picture. There may also be lessons for other economies from this exercise, given that many countries are seeing inflation surprises on the downside.

In New Zealand, there are a number of factors that have kept the lid on inflation recently. Goods and services that have their prices set in international markets have seen little price growth, with weak global demand producing widespread 'lowflation'. At the same time, the high NZD has pushed down the cost of these imports in local currency terms.

Meanwhile, the domestic economy has exhibited more spare capacity than was expected. This may partly be due to a sudden upswing in net migration, to record highs, that has helped address skill shortages in some sectors. Our estimates also show that there may have been a general underestimation of how much capacity was added in the pre-recession years and, therefore, how high potential output and spare capacity have been in recent years.

These factors help to explain the recent 'lowflation' experience, but they do not suggest that inflation will remain permanently low. The NZD has already fallen, which will raise the cost of imported goods, and even with higher estimates of potential output, it is likely that spare capacity has largely been absorbed over the past year. We expect inflation to rise gradually in 2015, prompting the RBNZ to resume its tightening cycle in the second half of 2015.

26 November 2014

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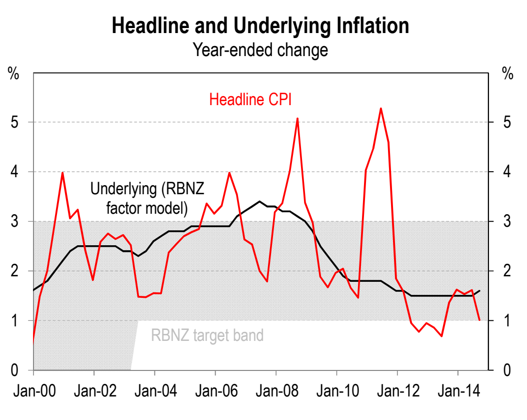
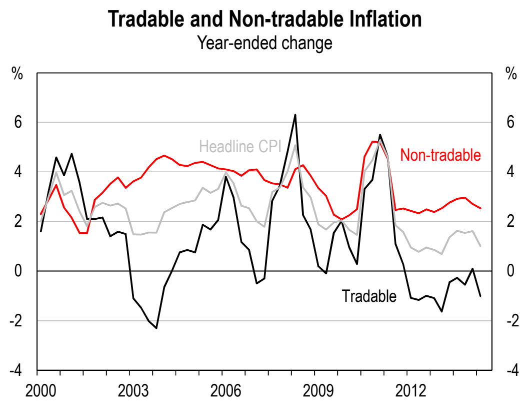
1. Headline inflation remains at the bottom of the target band



Source: Statistics New Zealand, RBNZ

2. Tradable inflation is particularly subdued



Source: Statistics New Zealand

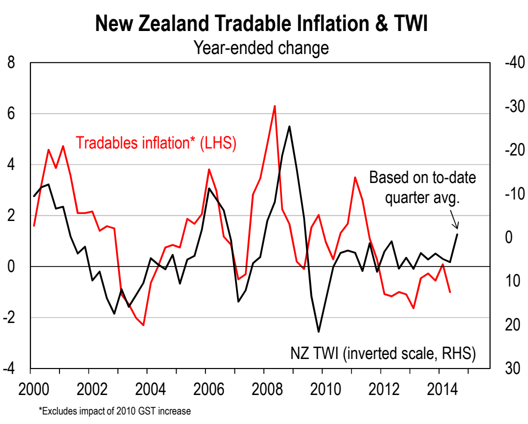
Despite strong growth, inflation remains low

In 2014, New Zealand has been one of the fastest-growing economies in the OECD. In fact, growth has actually been a little stronger than had been generally expected – at the end of 2013 the consensus forecast for 2014 growth was +3.1% and we currently anticipate growth of +3.5%.

The widespread expectation was that strong economic growth would generate inflationary pressure. In the December 2013 consensus survey the median forecast for headline inflation in 2014 was +2.0% and by March 2014, the RBNZ was also forecasting inflation to rise by around +2.0% y-o-y.

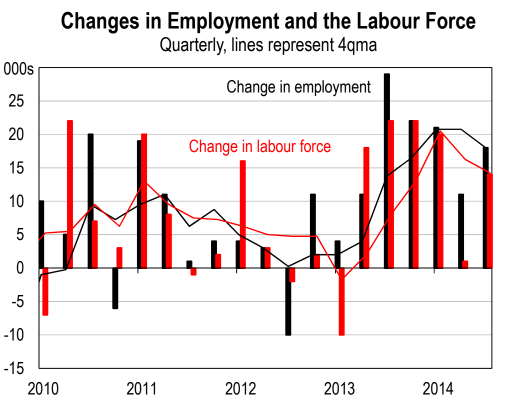
While the growth path in 2014 has turned out approximately as expected so far, inflation has consistently undershot forecasts. In September, the headline CPI fell to just +1.0% y-o-y, at the bottom of the RBNZ's 1-3% target band (Chart 1). As a result, the RBNZ's tightening cycle has had to be re-assessed and the key question has become: why has inflation remained so low in the face of rapid growth and how long is 'lowflation' likely to last?

3. The high NZD has kept tradable inflation low



Source: Statistics New Zealand, RBNZ, Bloomberg

4. Employment has risen, but so has the supply of workers



Source: Statistics New Zealand

High NZD has kept tradable inflation low

Looking at the inflation mix, domestic ('non-tradable') price increases have been fairly steady over recent years, averaging +2.6% y-o-y since the beginning of 2012 (Chart 2). This is not far below the average over the last decade or so. However, the factor keeping overall inflation low has been unusually subdued tradable inflation – the prices of imported and import-competing goods.

There are a number of factors that are likely to have been working to keep tradable inflation in negative territory. The most significant has been the persistently strong NZD (Chart 3). On average, the NZD was 5.1% higher in 2013 than in the previous year and over the first three quarters of 2014 the currency was on average 4.3% higher than in 2013. A higher NZD reduces the cost of imported goods and also puts downwards pressure on the price of locally made import-competing goods.

In addition, tradable inflation has been influenced by the generally low global inflation environment. Global demand growth has been weak, which has resulted in low inflation in many areas – and a threat of deflation in some. At the same time, many of the goods New Zealand imports are subject to technological advances, which lead to steady price declines. The classic example is flat-screen televisions, where prices for the same standard of equipment are continually falling.

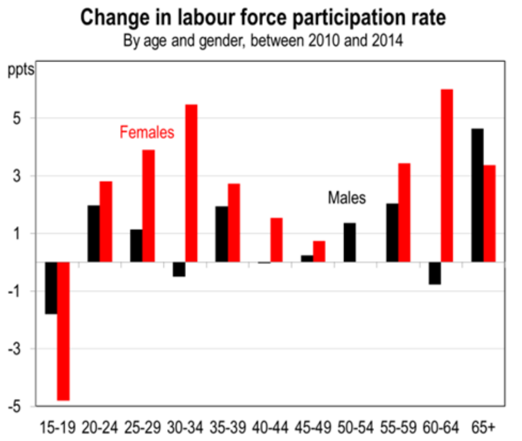
Spare capacity has restrained domestic price pressures

As mentioned above, non-tradable inflation – those prices largely determined in the domestic market – has remained fairly stable over the past couple of years and at 2.5% y-o-y in Q3 is still below the long-run average. Over much of the 2000s, non-tradable inflation averaged around 4.0% a year. The major determinant of non-tradable inflation is typically the degree of spare capacity in the domestic economy. Over the past year, New Zealand's economy has shown a surprising degree of spare capacity and, as a result, the previously expected lift in non-tradable inflation has not materialised.

A major factor that has boosted the economy's spare capacity has been growth in the labour force (Chart 4). In particular, just as the need for additional workers was rising in New Zealand, the Australian labour market was softening as the mining boom ended. As a result, fewer New Zealanders left for Australia and many, who had left in the past, began to return. Inwards migration from other parts of the world has also increased. Annual net migration is currently running at its highest level on record. The mix of migration is also somewhat different than in the past, with more new arrivals on short-term work visas, rather than seeking long-term residency. As a result, net migration appears to have added less to demand, particularly in the housing market, than might have been expected, based on historical relationships.

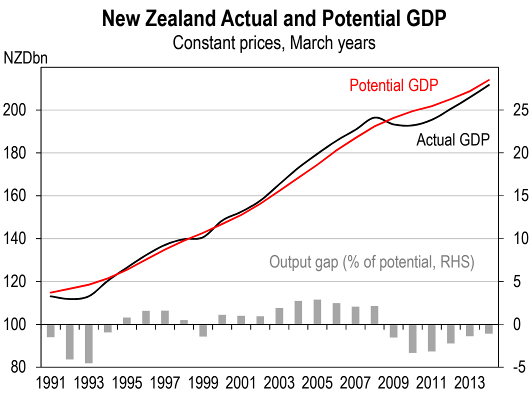
Not only has New Zealand's labour force been growing strongly, but, in stark contrast to many other developed nations, labour market participation has also risen to record levels. There are a number of factors that are have likely to contributed to increased participation, including greater availability of work, migration trends, reduced job opportunities overseas, government benefit reforms and the increasing number of people working past retirement age, either by choice or due to economic necessity. Increases in participation have been largest amongst females, younger (20-40) and older (60+) workers (Chart 5).

5. Labour force participation has risen to record levels



Source: Statistics New Zealand

6. Spare capacity may have been underestimated



Source: Statistics New Zealand, HSBC

More spare capacity than expected: but it's still running out

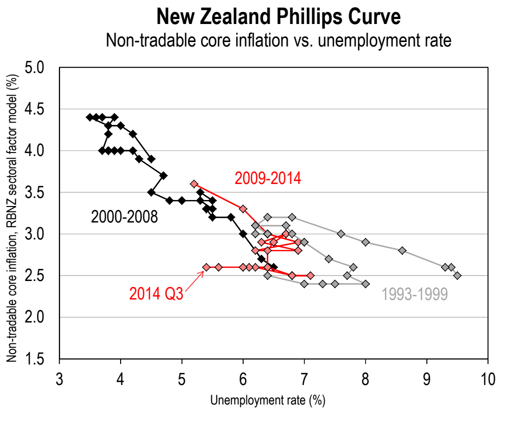
At its current strong pace of growth, it seems likely that New Zealand's economy is growing above its 'potential' growth rate. But, in general, to generate inflation economic activity must not only be growing quickly but must be doing so in an environment of low spare capacity. In other words, the level of output must be greater than potential output, or the 'output gap' must be positive.

Potential output is impossible to observe, so it is usually estimated using the 'trend' rate of growth in actual output or in the factors of production (capital and labour). We have estimated a simple production-function model of potential output using the labour force (actual working age population multiplied by trend participation rate) as the measure of labour supply and the actual capital stock as the measure of capital supply. This model allows potential output to be determined to a greater degree by the available factors of production, rather than being influenced by the level of *actual* output, as models that rely on estimates of trends can be. It also allows potential output to be more responsive to changes in the factors of production than most trend estimates would allow.

The model suggests that potential output grew strongly in the years before the financial crisis and slowed only a little during and after the 2008-09 recession. As a result, a large gap opened up between actual and potential output – a gap that may only just be closing (Chart 6). Potential output growth has recently accelerated again, as the labour force and capital stock have expanded more rapidly. We estimate that potential growth may currently be around 2.75-3.00% a year.

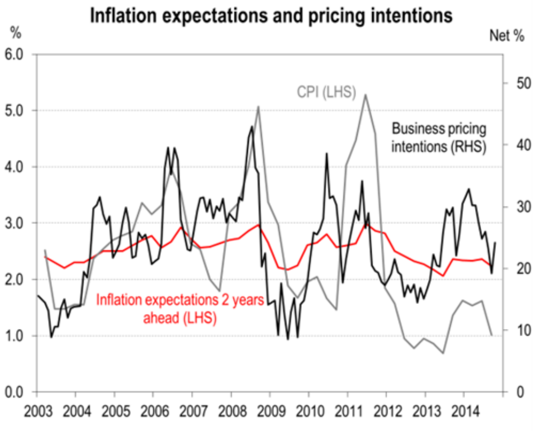
This should be interpreted as illustrative rather than as a concrete estimate of the state of the economy. Much depends on a number of assumptions made and it is possible to come up with an output gap of any size, positive or negative, depending on the methodology used. However, our scenario does fit with an environment of low inflation. Indeed, it may be the case that the shortfall in output over recent years has been underestimated. But, importantly, the model does not suggest that low inflation will continue for much longer, as the output gap already appears to be almost closed.

7. Tighter labour market should mean higher inflation



Source: Statistics New Zealand, RBNZ, HSBC

8. Pricing intentions have eased since early 2014



Source: RBNZ, Thomson Reuters Datastream

Inflation still set to rise, but slowly

Clearly, there are a number of reasons why inflation, both tradable and non-tradable, has remained so low over recent quarters. The key question for the RBNZ is how long the current 'lowflation' environment will persist?

The global environment of insufficient demand and low inflation is unlikely to change any time soon. This is expected to continue to have a dampening effect on New Zealand's inflation environment by restraining price increases amongst those goods and services whose prices are set in international markets. However, we do expect tradable inflation to rise over the coming year, due to a falling NZD. Given our forecasts for further modest declines in the exchange rate, tradable inflation could lift to 1-1.5% a year by late 2015, purely due to the currency impact.

For domestic cost/price pressures, the labour market outlook remains the key factor. Strong migration looks set to continue for some time yet, which suggests that the labour market will tighten only gradually. Employment growth may also have peaked already. However, even so, we still expect the unemployment rate to fall further and we (conservatively) forecast it will reach 5% by late 2015, down from 5.4% in Q3. Historical relationships suggest that as this happens non-tradable inflation will lift (Chart 7). Indeed, at the current juncture, the combination of the inflation and unemployment rate is well below the historical levels of the 'Phillips curve'. As we believe there are good reasons to expect the unemployment rate to fall further in coming quarters, the upside risks to domestically produced inflation are expected to rise.

Our simple model of potential output also shows that, even when more generous estimates of potential output are used, the output gap has most likely been closed by now. At current rates of growth, actual output will be surpassing potential, which should generate additional inflationary pressures over time.

Near-term indicators of firms' pricing intentions and difficulty finding labour confirm that near-term inflation pressures remain low (Chart 8). But we expect inflation to rise gradually in 2015, potentially approaching 2% in late 2015. In response, we expect that the RBNZ will still need to lift rates further, although we do not see the next move until H2 2015.

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1. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2014	2015	2016	Q214	Q314e	Q414e	Q115e	Q215e	Q315e	Q415e
%*										
AUSTRALIA										
GDP	2.9	3.2	3.0	3.1	2.9	2.5	2.5	2.9	3.4	4.0
Consumption	2.4	2.5	2.5	2.5	2.2	2.1	2.3	2.4	2.6	2.7
Public consumption	1.4	1.6	1.9	1.4	1.2	1.4	1.5	1.6	1.7	1.6
Investment	-1.3	1.0	3.4	-1.3	-1.6	-0.9	-0.7	-0.1	1.6	3.0
- Dwelling	9.6	6.6	4.3	8.6	11.4	10.5	7.1	6.4	6.1	6.7
- Business	-4.5	-2.0	1.8	-4.4	-6.2	-3.6	-4.0	-3.3	-1.3	0.4
- Public	-0.1	6.0	8.2	0.2	3.1	-2.9	3.4	4.5	7.7	8.2
Final domestic demand	1.3	1.9	2.6	1.4	1.1	1.2	1.3	1.6	2.1	2.5
Domestic demand	1.5	2.2	2.5	1.6	1.8	1.6	2.4	1.6	2.1	2.5
Exports	7.0	9.1	8.9	5.4	6.3	6.8	5.8	9.3	10.2	11.2
Imports	0.8	5.1	7.8	-1.1	2.4	4.0	6.3	3.8	4.9	5.5
GDP (% quarter)	--	--	--	0.5	0.5	0.5	1.0	0.9	0.9	1.0
CPI**	2.5	2.6	2.8	3.0	2.3	1.9	2.4	2.7	3.1	3.1
Trimmed mean**	2.8	2.7	2.8	3.0	2.6	2.3	2.4	2.5	2.8	2.8
Unemployment rate	5.9	5.8	5.5	5.9	6.2	6.1	6.0	5.8	5.7	5.6
Labour price index	2.6	3.1	3.6	2.6	2.6	2.6	2.7	2.9	3.2	3.4
Current A/C (%GDP)	-3.0	-2.7	-2.4	-3.4	-3.5	-3.3	-3.0	-2.7	-2.5	-2.4
Terms of trade	-6.1	-2.7	-0.4	-7.9	-6.3	-6.5	-6.2	-2.1	-0.7	-1.5
Budget balance (%GDP)	-3.1	-1.8	-1.0	--	--	--	--	--	--	--
Capital city house prices	10.0	8.4	4.6	10.1	10.4	8.8	9.3	9.5	8.2	6.7
Private sector credit	4.4	5.9	6.5	3.9	4.5	4.8	5.1	6.1	6.1	6.1
USD/AUD (end period)	0.86	0.82	0.82	0.93	0.87	0.86	0.85	0.84	0.83	0.82
Cash rate (end period)	2.50	3.00	3.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00
%*										
NEW ZEALAND										
GDP	3.5	3.0	2.8	3.9	3.4	3.2	2.9	3.0	3.2	3.1
Consumption	3.1	3.1	2.1	3.0	3.4	3.1	3.8	3.1	2.9	2.4
Govt consumption	2.9	2.0	2.0	3.5	2.1	2.9	2.0	2.0	2.0	2.0
Investment	8.1	7.5	5.4	7.2	6.9	8.3	8.0	8.2	7.1	6.6
Final domestic demand	4.2	4.0	2.9	4.1	4.0	4.3	4.5	4.2	3.8	3.4
Domestic demand	5.2	4.1	2.9	5.3	4.5	5.7	5.2	4.1	3.8	3.4
Exports	2.5	2.4	4.1	2.9	3.8	0.6	-1.2	2.8	3.9	4.1
Imports	8.1	5.9	4.1	9.2	6.8	8.3	7.9	5.9	5.2	4.6
GDP (% quarter sa)	NA	NA	NA	0.7	0.6	0.8	0.7	0.8	0.8	0.7
CPI	1.6	1.8	2.1	1.6	1.0	1.3	1.6	1.8	1.9	2.0
Unemployment rate	5.7	5.2	4.8	5.6	5.4	5.4	5.3	5.3	5.2	5.0
Labour price index	1.7	2.2	2.4	1.8	1.9	1.8	2.0	2.1	2.2	2.3
Current A/C (%GDP)	-3.1	-4.6	-5.0	-3.4	-3.6	-4.2	-4.4	-4.5	-4.6	-4.7
NZD/USD (end period)	0.77	0.75	0.75	0.85	0.86	0.77	0.76	0.75	0.75	0.75
Cash rate (end period)	3.50	4.00	4.50	3.25	3.50	3.50	3.50	3.50	3.75	4.00

Source: ABS, RBA, Statistics New Zealand, HSBC forecasts
*Unless otherwise specified. **Includes the effect of the carbon tax from Q312 and its removal from Q314

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