ANZ Research

NZ Insight: Non-tradable disinflation: a waiting game

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Non-tradable disinflation: a waiting game

Summary

- Since the RBNZ delivered its last OCR hike in May 2023, it has had four consecutive upward surprises to its non-tradable inflation forecasts, suggesting on the face of it that monetary policy isn't getting the traction expected and/or the transmission lags to inflation this cycle are longer.
- However, breaking non-tradable inflation down into its key drivers highlights good reasons to think that the progress on getting domestic inflation down is likely to improve moving forward.

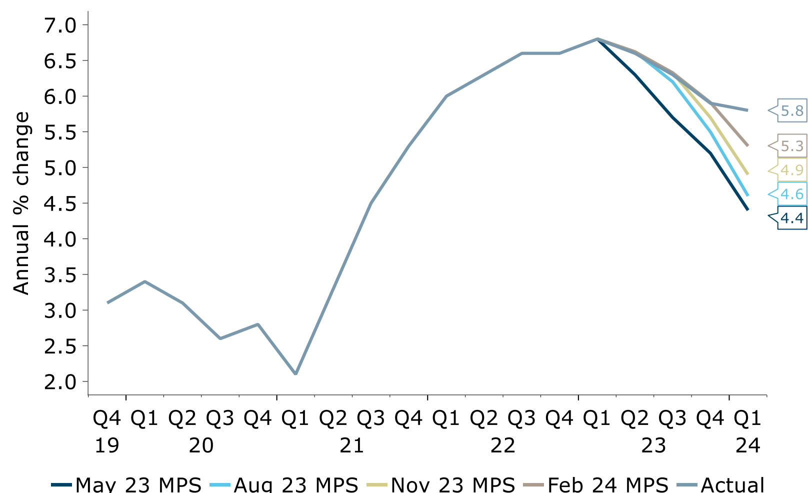
Playing the waiting game

Non-tradable inflation has surprised the RBNZ to the upside for four consecutive quarters since it called a halt to hikes in May 2023. Tradable inflation has offset that at the headline level, but it's volatile and the RBNZ has much less influence over it, so on its own it won't be sufficient for the RBNZ to get *sustainably* back to 2%.

So how are things going on the domestic inflation front?

The RBNZ has clearly been successful at restraining domestic demand – the economy is undisputably weak, whatever indicator you look at. But the transmission of weak demand to domestic inflation hasn't occurred nearly as quickly as the RBNZ (or, to be fair, most anyone else) anticipated when they called a halt to rate hikes (figure 1).

Figure 1. Evolution of non-tradable inflation since the RBNZ's last hike



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

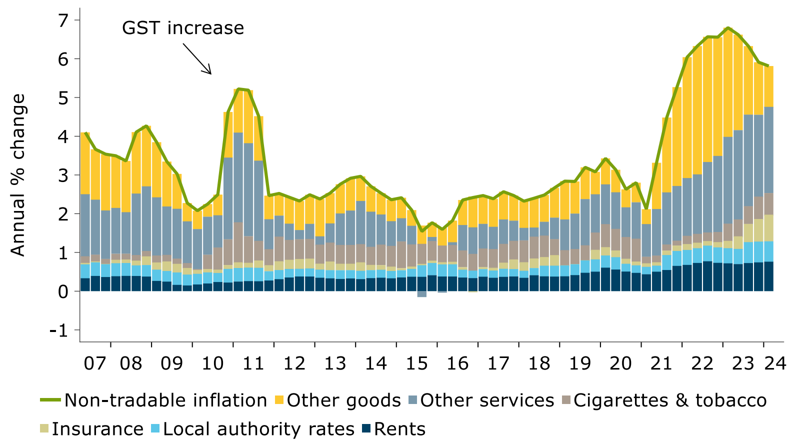
So does this mean that policy tightening hasn't had (and, crucially, won't have) as much traction as expected? Or do we just need to be patient? As we discussed in our recent Quarterly Economic Outlook – and as was clear in the RBNZ's most recent Monetary Policy Statement (MPS) – this question is front of mind for policymakers currently. Decomposing non-tradable inflation into its drivers can offer some insight.

Breaking down non-tradable inflation

Figure 2 shows that while inflation in the goods in the non-tradable basket (primarily construction costs) has retreated significantly, services inflation pressures remain broad-based. However, given the close links between wage growth and services inflation, we expect that a sustained moderation in services inflation lies ahead. The labour market is already firmly in disinflationary territory. Wages respond to changing labour market conditions with a lag, but forward-looking indicators in our Business Outlook survey suggest the adjustment is occurring at pace.

But there are four specific drivers of domestic inflation that warrant discussion and have been separated out in the chart: local authority rates, insurance, cigarettes & tobacco, and rents. Let's go through each in turn.

Figure 2. Contributions to non-tradable inflation*

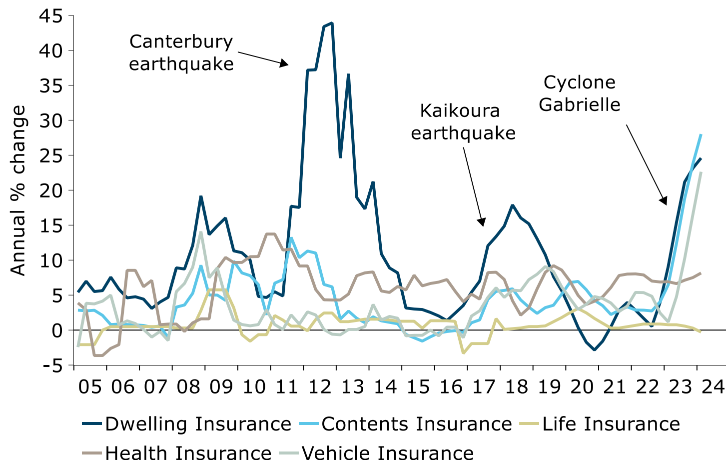


Source: Stats NZ, Macrobond, ANZ Research

* We categorise non-tradable inflation components in accordance with Stats NZ's services and goods definitions.

Insurance costs have risen dramatically. The period of high inflation has seen insurance replacement costs surge (both construction costs and broader labour costs), while the repricing following last year's severe weather events has also added to pressures. Contents insurance is up 28% y/y, dwelling insurance 24.6% y/y and vehicle insurance 22.6% y/y. Health insurance is up 8.2% y/y, likely reflecting the impact of higher healthcare labour costs on service provision. The overall insurance component has risen 14.6%, weighed down by life insurance, which has seen no increase.

Figure 3. Insurance inflation



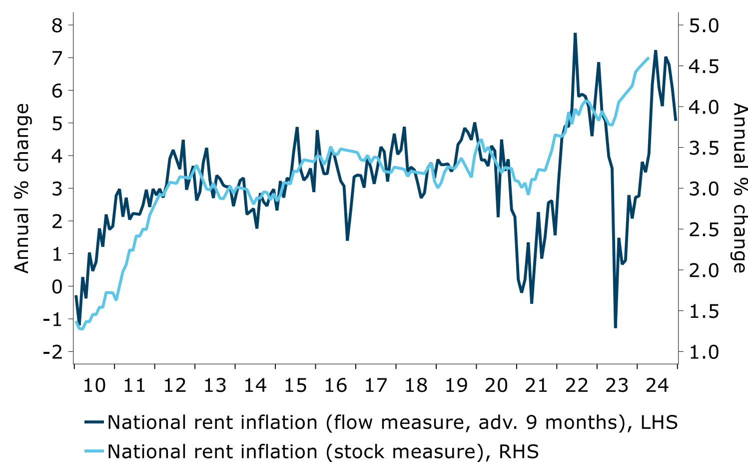
Source: Stats NZ, Macrobond, ANZ Research

Local authority rates enter the CPI in the September quarter each year. Councils, like everyone else, have been challenged by high inflation in recent years, with the cost of delivering goods and services increasing at the same time revenue was constrained during the pandemic. Alongside the requirements for significant infrastructure investment, and higher interest rates increasing debt-servicing costs, the past few years have been a perfect storm, culminating in significant increases in rates. We estimate the local authority rates component of CPI will rise around 13% in the September quarter, and large increases have been signalled for the coming years as well.

Cigarettes and tobacco inflation is currently running at 10.6% y/y. The majority of this reflects the fact that tobacco excise increases are indexed to annual headline inflation in the September quarter of the preceding year. This indexation does not go the full way to explaining recent strength of tobacco price increases; there was an unusual increase in the December quarter of last year, unrelated to tax changes. But it tends to be the predominant driver. We are forecasting annual headline inflation will fall to 2.8% in the September quarter this year, well below the 5.6% y/y increase last year.

Rent inflation receives a significant amount of airtime as a driver of domestic inflation. The record surge in net migration inflows over the past few years has added significant housing demand at a time where new housing supply has slowed. However, the migration cycle is showing clear signs of turning, quite possibly very sharply, and wage inflation is also slowing (ability to pay is also a key driver of rent inflation). Annual inflation for new tenancies has already fallen from around 7% y/y in December to 4.2% y/y in April, but the stock measure of rents used in the CPI tends to lag the signal from the flow measure by around nine months, suggesting that elevated rental inflation in the CPI will persist across the remainder of 2024 before declining.

Figure 4. Rent inflation



Source: Stats NZ, Macrobond, ANZ Research

Collectively, these four components account for 2.5%pts or 44% of current annual non-tradable inflation of 5.8%, punching well above their collective weight of less than a third of the non-tradable basket. And on our forecasts, while other sources of non-tradable inflation retreat, inflation in these components will not peak until Q3. At that point it will be responsible for around 2.7%pts or 54% of total non-tradable inflation.

Of course, persistence effects are not limited to these four components. One more example of inflation persistence, albeit not quite indexation, emerged last week when the Commerce Commission announced its draft decision to increase revenue limits for Transpower and local electricity distributors from

Q2 2025. The new revenue limits would result in an average annual increase of $180 (+GST) to household power bills adding roughly 0.25%pts to annual headline inflation and 0.45%pts to non-tradable inflation, all else equal. The increase will support the sector to deliver network investment and reflects significant costs increases over the past few years.

Cyclical vs structural

The increases in the above four components naturally aren't just due to the lagged impact of previous high inflation. One question we've been asked recently is the role of structural drivers. Relative price changes that are structural (rather than cyclical) in origin present a particular challenge to policymakers, as they are outside the influence of monetary policy. And there are certainly some structural factors limiting the RBNZ's influence over these components:

- The impact on insurance premiums of the repricing of weather risk, which seems highly unlikely to be done and dusted any time soon.
- Local councils' infrastructure challenges, which are adding to funding pressures and won't be resolved quickly.

So when figuring out the inflation outlook, a key question is how much of the recent increases in these two components is structural, and thus beyond the impact of monetary policy, versus how much reflects past high price and wage inflation.

Since the initial inflation surge from March 2021, the cost of building a new home as measured in the CPI has increased around 36%. Dwelling insurance as measured in the CPI has increase by around 40% over the same period. Certainly, premiums have and will continue to rise to reflect the increasing risk of loss, but if construction costs are a proxy for insurers' dwelling replacement costs, the bulk of dwelling insurance increases thus far actually reflects past inflation outcomes, rather than structural factors.

How about vehicle insurance? Since March 2021, vehicle insurance costs are up nearly 31%. Over the same period, vehicle prices have risen 7.3%, vehicle parts and accessories have risen 26%, and vehicle servicing and repairs have risen 18.8%. Clearly there has been a more substantial increase here that likely reflects more structural elements. Last year's severe weather events are certainly a factor, and insurance companies have also reported a sharp increase in vehicle thefts over the past few years. Broad-based inflation explains less of the increase in vehicle insurance premiums, but it's still part of the story.

That story also holds for local authority rates. Like consumers, councils have faced higher costs of delivering goods and services due to inflation over the past few years, and the infrequency of price adjustment means there is an element of catchup at play. As inflation pressures moderate, cost pressures for councils and insurance companies will too, moderating the inflation rate in these components.

Monetary policy implications

One could take a hawkish or a dovish view of these dynamics. It's obviously unhelpful that the persistence in these components is set to continue for a while yet. But in a glass-half-full view, this baked-in persistence (the impact of which is exacerbated by the unusual highs seen in CPI inflation), is very likely one of the reasons why monetary policy lags are proving longer this cycle. That's preferable to the alternative explanation: that monetary policy isn't working, either because of a change in the transmission mechanism or because the speed limit for the economy is lower than previously envisaged, as the RBNZ concluded in the May MPS. That implies more pain is required,

whereas this explanation implies that we just have to be patient.

The RBNZ has to weigh up the risk of holding policy too tight for too long against the risk that disinflation peters out before the job is done. Diagnosing whether the strength seen in non-tradable inflation will persist into the medium term is a crucial part of that assessment. For our part, we don't view recent strength as signalling less spare capacity across the economy currently. Labour market and activity indicators imply a sustained moderation lies ahead, and downside risks are rising.

But the RBNZ is responsible for hitting its inflation target, and therefore needs more runs on the board to feel comfortable, particularly given risks that persistence spills over into elevated inflation expectations. A lower non-tradable inflation starting point looks to be required for the RBNZ to contemplate OCR cuts. However, we expect that over the coming months, confidence that the job is done will grow rather than recede.

What about tradable inflation?

Ultimately, where non-tradable inflation needs to settle to be consistent with overall CPI inflation at 2% will depend on the outlook for tradable inflation. The RBNZ certainly has some influence over tradable inflation: importer margins aren't immune to domestic demand conditions, and monetary policy affects the exchange rate, directly feeding into import costs. But the RBNZ's influence on tradable inflation is much less, and as the initial COVID surge in inflation showed, as a small open economy dependent on foreign goods, we are at the mercy of global forces.

Historically, weaker tradable inflation has enabled domestic inflation to run hotter than 2% while still maintaining headline inflation near the 2% target midpoint. Annual non-tradable inflation of 3.2% has been historically consistent with headline inflation at 2%. However, to achieve that, annual tradable inflation is required to run around 0.3%-0.4%.

There are certainly some long-term structural factors on the horizon that suggest we may be moving into a period of higher global inflation than in the decade preceding COVID: heightened geopolitical tensions, trade fragmentation and the associated lengthening of global supply chains, climate change and more frequent supply-side shocks. Even more so if politicians go for the short-term wins by making inflation targets squidgier. Countering that are the possibilities of deflationary pressures from technological change (AI) and near term, the increase in spare capacity in China due to the structural slowdown in its domestic economy and deleveraging from property-led development.

The future is, of course, uncertain, and these structural challenges aren't and shouldn't be the RBNZ's focus until they materialise. That said, if tradable inflation settles higher in the coming years once the current normalisation cycle washes through, for the RBNZ to maintain inflation at 2% it will require lower non-tradable inflation. That translates to more restraint on domestic demand and a higher neutral OCR.

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