Alan Bollard: Everyone needs to play their part – inflation and recession in the New Zealand economy

Speech by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Wellington Chamber of Commerce, Wellington, 10 December 2008.

* * *

The world economy faces some significant challenges. Finance markets have been going through turmoil, the pace of global expansion has slowed abruptly, and policymakers have focused on preventing a more pronounced slowdown. For some commentators, concerns over inflation appear to have taken a back seat, for now at least. As the global economy has weakened, commodity prices have fallen, substantially in some cases. Many commentators are of the view that lower commodity prices and weak economic activity will drive inflation significantly lower.

It is worth remembering that for the moment, however, inflation rates in New Zealand (and many of our trading partners) remain very high. In the September 2008 year CPI inflation reached 5.1 percent, the highest rate since 1990. The higher rates of inflation are broad-based. These reflect some common drivers:

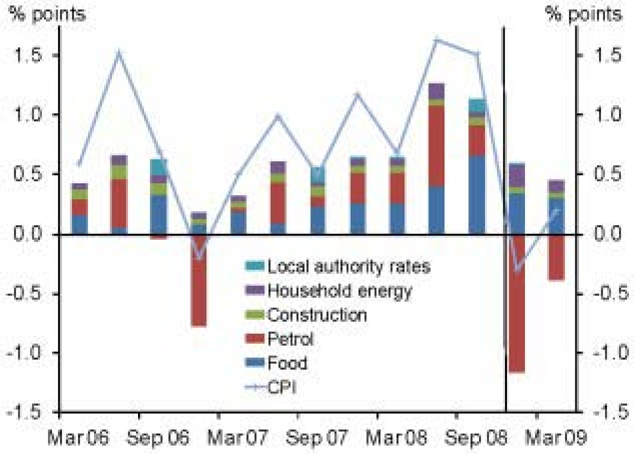
- A strong run-up in world commodity prices, which have had a direct inflationary impact. Oil prices increased nearly tenfold in USD terms in the decade to July 2008, with global food prices also rising strongly. Prices of the milk, cheese and eggs category rose 18 percent over the last year.
- The long-running expansion in domestic demand contributed to a build-up of pressures on capacity and high rates of domestically generated inflation. So far, weaker demand conditions have been slow to feed through into lower domestic inflation. In the building industry for example, rising prices for raw materials and strong wage inflation have continued to underpin high rates of construction cost inflation.
- There have also been sizeable price increases in areas not directly exposed to a high degree of competition over the past few years. Increases in local authority rates have run well in advance of overall CPI inflation for a number of years. Cost increases in some utilities have also been notable, particularly electricity.
- In the banking sector, the cost of international funding has risen significantly and become less assured. However, since July the Reserve Bank has cut the Official Cash Rate by 3.25 percent. Short term mortgage rates have been cut, but not by this much. Banks should not expect to be able to maintain high profit margins in the current environment.

Table 1
Consumer price inflation over the 3 years to 2008Q3

CPI component	Average annual rate for the 3 years to September 2008 quarter	
	Annual percent change	CPI contribution
Food	4.0	1.0
Petrol	14.3	0.5
Construction	5.7	0.3
Household energy	6.6	0.2
Local authority rates	7.0	0.2
Total CPI	**3.2**	**3.2**

Source: Statistics New Zealand, RBNZ estimates.

Figure 1
Some contributions to quarterly CPI inflation



Source: Statistics New Zealand, RBNZ estimates.

As the global economy has weakened, commodity prices have fallen again, substantially in some cases. Since July, global oil prices have declined by two-thirds and are back to mid-2005 levels. Other commodity prices have also eased, including prices for our agriculturally based exports, with international dairy prices now around half of where they were a year ago.

Sharply lower commodity prices are expected to flow through into lower consumer prices. However, the impact on short-term inflation will depend on a number of factors including the exchange rate, other costs, taxes, and firms' margins. In the past, these factors have tended to mitigate the impact on retail prices. Although global oil prices more than doubled between mid-2005 and mid-2008, New Zealand retail petrol prices only increased by around 60 percent over the period. Retail petrol prices have been dropping recently, but we believe they should be dropping further to restore refinery margins.

Similarly, retail dairy prices only increased around 25 percent from early 2007 to October this year, while global dairy prices more than doubled to their peak in late 2007. In addition, there was a lag of more than six months before higher global dairy prices flowed through to the retail level. However, now that global prices have crashed, there is plenty of room for retail price cuts.

The exchange rate has tended to play a buffering role and has helped moderate the impact of large swings in global commodity prices in New Zealand dollar terms. Despite the substantial appreciation of the New Zealand dollar between 2002 and 2007, tradable CPI inflation has remained quite high. This may partly reflect trends in global import prices, but it is also likely to reflect some importers widening their margins when the NZD was going up and demand conditions were more favourable. While the lower NZD will eventually lead to higher inflation, this will be tempered by lower global import prices and a narrowing in firms' margins to reflect the current demand climate. The prevalence of discounting and reports of high retail stocks suggest some temporary respite for retail prices from the lower dollar.

As a result of all this, the Bank's December *Monetary Policy Statement* projections are for annual CPI inflation to trough around 1½ percent in the September 2009 quarter, before lifting slightly above 2 percent thereafter.

Headline CPI and inflation expectations
(annual)

Source: Statistics New Zealand, RBNZ estimates.

We need to see inflationary pressures reducing significantly across the board, if we are to keep on easing monetary policy, thus helping the New Zealand economy to recover. That depends on all sectors of the economy responding to the reduced demand and not adding inflationary pressures to the system.

Some examples: we would hope that the electricity industry does not take advantage of its market position and keep increasing rates, that local authorities realise they need to set rates increases below inflation for a change, that the construction materials industry respond to much weaker demand, that the food industry react to lower international commodity prices with price cuts, that petrol companies keep cutting forecourt prices, that the transport industry pass on fuel price cuts, and that the banks pass on interest rate cuts. Only then will all these firms be playing their proper role in New Zealand's recovery.