

New Zealand Fixed Income Monthly

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Structural inflation factors to come to fore as domestic drivers ease

By Matthew Johnson, Fixed Income Manager
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Non-tradable factors look set to ease as inflation expectations recede

Although New Zealand's consumers price index (CPI) remained elevated with a 4.0% rise in the year to the March 2024 quarter, the figure was down significantly from the recent peak of 7.3% seen in the 12 months to the June 2022 quarter. Price rises in New Zealand continue to be driven largely by non-tradable inflation, which is seen as an indicator of price rises generated inside the country's economy as it focuses on final goods and services whose prices are not driven by foreign competition, such as insurance and rent. Non-tradable inflation remained significantly elevated in the year to the March 2024 quarter with a 5.8% annual rise. Even so, we feel that contributions may ease from some of the larger components of headline inflation due to domestic developments. For example, rent contributed 0.44 percentage points to the overall figure, but this component could be restrained by the reintroduction of interest deductibility for landlords and downward pressure from a possible decline in migration driven by the government's tighter visa rules. Another example is the purchase of new housing, which contributed 0.32 percentage points. In this area, the government is seeking to deregulate approved building materials and cut consent costs, which could ease price rises. Given non-tradable inflation's large contribution, we feel that a fall in the figure would bring headline inflation much closer to the Reserve Bank of New Zealand (RBNZ)'s 1% to 3% inflation target. It is worth noting that inflation expectations in the RBNZ's survey of the views of forecasters, economists and industry leaders on the outlook for New Zealand's economy are continuing to fall. The overall expectation for annual inflation in one year's time is 3.22% for the March 2024 quarter, well below the recent peak of 5.11% seen for the March 2023 quarter. The expectation for inflation in two years' time has also declined to 2.50% for the March 2024 quarter. This points to lower interest rates over time.

Secular forces set to dominate through structural inflation in long term

Despite the decline in one-year and two year inflation expectations, we feel that the longer term picture is likely to be dominated by broader secular forces, or prolonged trends not necessarily tied to cyclical factors, that structurally drive inflation. These secular forces are termed the "five Ds". The first of them refers to dovish policy shifts and relates to central banks' de facto tolerance of higher-than-target inflation, particularly when it is caused by factors deemed outside their control, such as supply shocks. The remaining four forces are more clearly outside of central banks' influence and therefore appear more thoroughly locked in. The next "D" is deglobalisation driven by onshoring intended to shorten supply chains and mitigate geopolitical risks, which results in production being moved back to higher cost markets. The next force, decarbonisation, reflects the need for massive investment and shifts to more expensive means of producing goods and services as the world transitions to a lower carbon future. This is followed by demographics, which relates to the inflationary impact of the rising dependency ratio as the populations of many developed economies age and their workforces shrink. The final factor is debt and fiscal deficits. This reflects the combination of the unprecedented debt burdens in most major economies combined with primary budget deficits that look increasingly structural in nature. These long-term factors are likely to attract more attention as domestic inflation drivers begin to moderate.

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