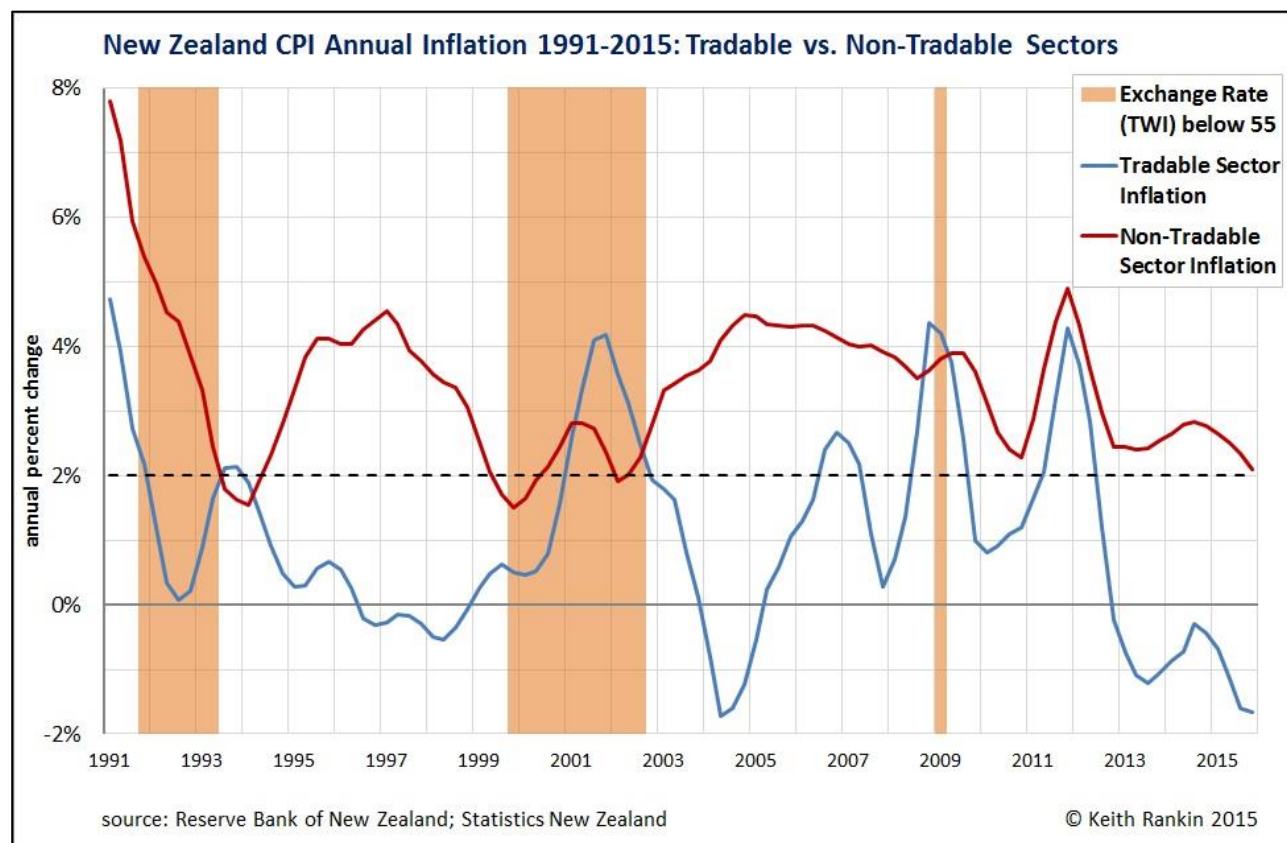


Chart for this Week: New Zealand Inflation 1991-2015

Keith Rankin, 4 November 2015



[Inflation in New Zealand's Tradable and Non-Tradable Sectors](#)

Since the 1980s, inflation has been the policy bogey issue in New Zealand and in many other developed countries. The irony is, now that we are moving into deflationary times, the rules that we created to give priority to suppressing inflation now require us to do our very best to create it.

The global recessionary environment of 1991-92 put a final end to the inflationary era that peaked globally around 1980. So this chart essentially covers New Zealand inflation in the low inflation era.

What is particularly interesting is the divergent experience of inflation in the country's tradable and non-tradable sectors.

Each of these sectors represents essentially half of a developed country's economy. Industries are in the tradable sector if they represent part of a global market. So all primary products, manufactured products, and a few service industries (eg international transport) for the tradable sector. The non-tradable sector, on the other hand, is made up of public utilities, construction, and most services including public administration.

As we would expect, tradable inflation largely reflects the realities of a highly competitive global marketplace. Hence tradable inflation tends to be lower, on average, than non-tradable inflation.

A country's exchange rate also strongly influences tradable inflation. A falling exchange rate raises the domestic prices of traded goods and services. We see this in 1992-93, in 2000-2001, and in 2008-09. (In 2001 we also see an inflation peak, this time in both sectors. It's due to the increase in Goods and Services Tax to 15%.)

The more interesting puzzle is to explain the fact that inflation in the less competitive non-tradable sector tends to be highest when the exchange rate is rising, and hence when tradable-sector inflation is lowest.

Many costs incurred in the non-tradable sector are tradable inputs, which should mean low inflation there also when the exchange rate is appreciating.

It would appear that rising interest rates which attract a lot of foreign savings into New Zealand (as NZ private sector debt) – much of it for speculative purposes – create a superficially buoyant economy in which public utilities, construction companies, and business/financial services simply raise prices because they can.

In more recessed times, when foreign money does not flow into New Zealand and the New Zealand dollar depreciates, the non-tradable sector faces more challenging market conditions, and focusses on reducing labour costs as an alternative to the routine price hikes that it would otherwise indulge in.

The pattern since 2009 is becoming clear, although we need to mentally abridge the 2011 GST spike; global deflation in the tradable sector and steady inflation of around 2½ percent in the non-tradable sector. Indeed the latest fall in the New Zealand dollar exchange rate – largely precipitated by falling world commodity prices (including dairy and coal) – has not so far yielded an inflationary bounce.

The penultimate point to note is that, for the most part, the experience of inflation of individual industries is far from that of "stable prices" with steady annual inflation of two percent, as prescribed in the Reserve Bank Act. For large amounts of time, sectoral inflation has been below one percent or above three percent. The two percent target has been achieved simply by averaging these diverse actual experiences. (Like the joke about the hunter economist who spots two deer. He aims precisely between the two animals, misses both, and exclaims 'gotcha'!)

My final point is that it is extremely hard to raise annual inflation to two-percent using low interest rate monetary policies. Low interest rates do not send us on a borrowing spree. They simply reduce costs.
