



NEW ZEALAND
FOREIGN AFFAIRS & TRADE
Manatū Aorere

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How trade is a force for good in a cost of living crisis

A MARKET INTELLIGENCE REPORT

Summary

- New Zealanders are experiencing annual rates of inflation above 7%. Rates of inflation not seen in a generation. At the same time household incomes are still playing catch-up to the rise in living costs. The result for many is a significant squeeze in living standards.
- Imported inflation has had an outsized impact on New Zealand's headline inflation over the last 18 months. However, forecasts from the likes of the Reserve Bank of New Zealand (RBNZ) point to imported inflation easing rapidly over 2023.
- Open trade and globalisation have been a driving force in lowering New Zealand's underlying cost of living. Tapping into modern global supply chains, reducing import tariffs, increasing local competition, and technology transfer have all helped to lower costs for both New Zealand's firms and households.
- As the global economy recovers from the major supply shocks of recent years, open trade should once again see low imported inflation being a counterbalance to New Zealand's typically persistent domestic inflation.
- However, risks are emerging that may erode the benefits of trade built up over decades. Benefits that include low imported inflation. An increase in a range of barriers to global trade, and the reengineering of modern supply chains will lead to a rise in costs of doing business across borders. Unfortunately, we may not totally appreciate the gains from open trade until it's gone.

Report

Like many of our international partners, New Zealand is experiencing a surge in the cost of living. **Inflation, or a general rise in the prices of goods and services we consume, is running at a pace that hasn't been experienced in a generation.** At the end of 2022, inflation was running at 7.2%, down only slightly from a 32-year high of 7.3% seen in the June quarter. Not since the RBNZ's inflation targeting mandate was formalised in the early 1990s has inflation run this hot and is well above the RBNZ's 1-3% inflation target band. At the same time, wage growth for many is still playing catch-up to the rising cost of living, meaning real incomes are being squeezed.

This report provides a short explainer on the role of international trade in the current cost-of-living crisis. It provides evidence that post-COVID global economic developments have seen import prices play a major role in recent inflation data, but that imported inflationary pressures are abating and the long-run benefits of trade for the cost of living are significant.

International price movements have recently contributed to New Zealand's soaring inflation...

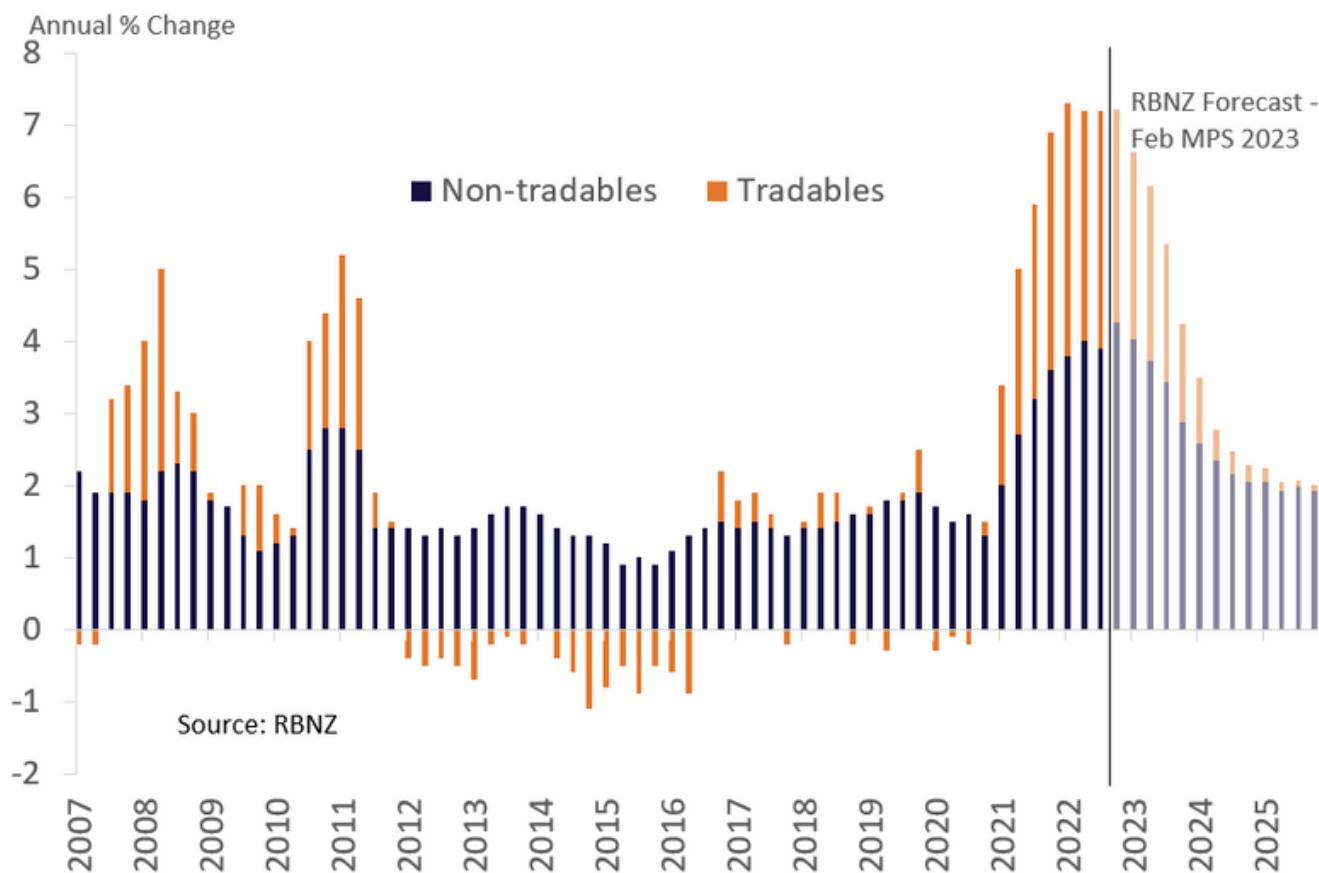
The causes of the recent rapid rise in the cost of living are multifaceted. While the strength of domestic demand has certainly played a role by putting significant pressure on domestic resources, particularly given lingering pandemic-related constraints, inflationary pressures have been compounded by global conditions. Massive COVID-era fiscal and monetary policy stimulus (both at home and abroad), global supply-chain bottlenecks, and a jump in energy and food prices related to the war in Ukraine, have all contributed.

We can see the impact of international price pressures on New Zealand's inflation rate by scratching a little under the surface. Items measured in the consumers price index (CPI) can be placed into two main categories: "tradables" and "non-tradables". Tradable items are goods and services that are either traded internationally, or face international competition. Examples include: fuel prices, the price of electronic goods, and international travel fares. Non-tradable items are those that are not traded internationally or do not face international competition. Typical examples include local council rates, and the price of haircuts. While tradables account for around 40% of the CPI's basket of goods and service, non-tradables forms the bulk at around 60%.

As Figure 1 shows, imported inflation made an outsized contribution to headline inflation over 2022 (shown in Figure 1). A surge in global commodity prices was a feature of tradables inflation in 2022 and translated to higher prices at the till for New

Zealand consumers. However, the rising commodity prices are a double-edged sword for the New Zealand economy. Strong commodity prices also underpin the incomes of many of our commodity-based exporters – and the communities that support them.

Figure 1: Tradables inflation has had an outsized effect on the headline CPI



...but over the long term, New Zealand's open trade has significantly helped to lower the cost of living.

Despite these recent development, **open trade has helped to keep imported inflation in check for New Zealand consumers over recent decades.** MFAT analysis of the economic impacts of New Zealand's FTAs, has found that a significant source of economic gains from our FTAs since 1999 have come via the import side in the form of lower consumer prices. While the export benefits of trade often receive most attention, international trade delivers unprecedented access to affordable goods and services that can sometimes be overlooked. As Figure 1 illustrates, periods when tradables inflation has made a sizable contribution to the headline CPI since 2007 have been sporadic and fleeting. Even more so if we exclude the hike in GST from 12.5% to 15% in October 2010.

Open trade and the forces of globalisation have helped reduce prices faced by New Zealand households in a range of ways. **Aotearoa has tapped into global supply chains, particularly those across the Asia-Pacific region, lowering the cost of many**

imported goods such as manufactured wares. The reduction and removal of trade barriers, such as tariffs, lowers the cost of imported goods to New Zealand households and businesses. For local producers, cheaper imports also lower costs of production – lower costs that are passed on to New Zealand consumers. Moreover, cheaper imports provide outsized benefits for lower-income households that spend a large share of their income, particularly on heavily traded staples such as food and clothing.

Opening up to offshore markets increases local competition too. Competition that sharpens New Zealand businesses and offers consumers increased choice at lower prices. In fact, in the decade between the Global Financial Crisis and the COVID-19 pandemic, inflation ran stubbornly low in many countries, prompting significant debate among economic policymakers about why. One of the key drivers behind this period of structurally low inflation is believed to be the increased competition faced by local firms due to the rapid expansion of online global channels.

In addition, **open access to global markets have given Aotearoa access to cutting-edge technology that contributes to productivity growth and lower prices.**

Improvements in technology, such as improved functionality of goods, mean that consumers and businesses get more bang for their buck. Think, for example, about the superior features available on your TV or smartphone that weren't there a decade ago, and for roughly the same price. The way these technology improvements (quality adjustments) are treated in measures of inflation often leads to a net fall in the price of a particular item.

The benefits of open trade in New Zealand are not just limited to export growth and cheaper imports, as **higher incomes from trade help to cushion the blow of rising costs of living.** Research by MFAT (for example [here](#)) has confirmed that **exporting firms tend to be more productive, and their employees enjoy higher incomes than their non-exporting equivalents.** The analysis of the distributional impacts of trade is underpinned by MFAT's Productive, Sustainable and Inclusive Trade Channels framework (presented [here](#)).

Research by MFAT mentioned above has revealed that higher exporter incomes are distributed across society. For instance, despite a slightly larger earnings gap between men and women among goods-exporting firms, women employed in goods exporting firms earn on average 10% more than women in non-exporting firms. Across ethnicities, people employed by goods exporters consistently earn more than those from the same ethnic group employed in non-exporting firms. Including a 13% and 12% exporter pay premium among Pacific peoples and Māori respectively.

Tradables inflation is expected to recede this year as domestic price pressures again drive the cost of living.

The contribution of tradables inflation is also predicted to ease rapidly in 2023 as many of the factors mentioned above abate (also seen in Figure 1). In fact, data so far in 2023 suggest imported inflation is already receding as global shipping costs fall, supply-chain disruptions ease, and major global central banks cool demand by rapidly raising interest rates. The war in Ukraine still poses risks to energy and food prices. But the initial shock in these markets has abated, and a northern hemisphere 2022/23 winter energy crisis failed to materialise on account of mild-winter weather. While the fallout from Cyclone Gabrielle is likely to generate some upside risks to tradables inflation given the damage wrought on agriculture production, this is expected to be temporary.

Cost of living pressures will persist in the year ahead, but **inflation will increasingly be led by domestic price pressures** as economic demand still outstrips the New Zealand economy's ability to meet it. This is being driven in a large part by capacity constraints in the labour market where the unemployment rate, at 3.4%, is not far from the recent record-equalling low of 3.2%. With firms continuing to note difficulties finding the staff they need firms are lifting wages to retain and attract workers. As labour is the largest input cost for many industries, rising wage pressures continues to put upward pressure on the costs of delivering goods and services. Wage inflation, as measured by the labour cost index (LCI), hit 4.1% at the end of 2022. The result was the strongest LCI gain in the measure's 30-year history, but still short of the rise in the cost of living. The RBNZ is responding to uncomfortably high inflation by lifting the official cash rate (OCR) to cool spending and investment activity. Consequently, mortgage holders are facing an added squeeze on incomes – not captured in the CPI – as the cost of servicing debt is pushed higher.

As the global supply shocks of recent years abate, **New Zealand's connections and access to international markets should once again provide a counterbalance to persistent domestic inflation.** In this respect, MFAT's efforts to strengthen our international trading connections and support cross-border flows of goods and services remain as important as ever.

We risk taking the sizable benefits of open trade for granted.

Over the last decade the social licence underpinning the rules-based global trading system has been tested. Antipathy towards globalisation, and the perceived grievances thrown up by free trade, were seen as contributing factors to the United Kingdom's

Brexit referendum outcome and the United States' shift to more protectionist trade policy. However, the opening up of cross-border trade has produced often overlooked benefits that have been spread widely. In particular, globalisation has exposed small-open economies like Aotearoa to the economies of scale offered by modern global supply chains and provided unprecedented access to lower-cost goods and services. **In turn, open trade has led to the pass through of lower prices for many of the goods and services New Zealand firms and households consume.**

Global shocks, such as the COVID pandemic and ongoing war in Ukraine, have shown the fragility of global supply chains. As a result, there are moves to increase resilience of supply chains by undertaking such activity as onshoring production. Combined with a re-emergence of protectionism these drivers will inevitably add to the cost of doing commerce internationally. **As the benefits of trade are large but spread thinly, it is easy to take open trade for granted and overlook the fundamental role it plays in reducing the prices we face every day.** In this sense, there is a risk that with growing fragmentation of global trade and supply chains and rising post-COVID protectionism, we may not truly understand the benefits of open trade on the cost of living until it is gone.

The challenges now faced by the international trade system risk adding to New Zealander's cost of living pressures. Consequently, the continued building of our trade architecture, with new trade agreements, and the defence of the international rules based system in fora such as the WTO are critical.

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