Westpac

Institutional Bank

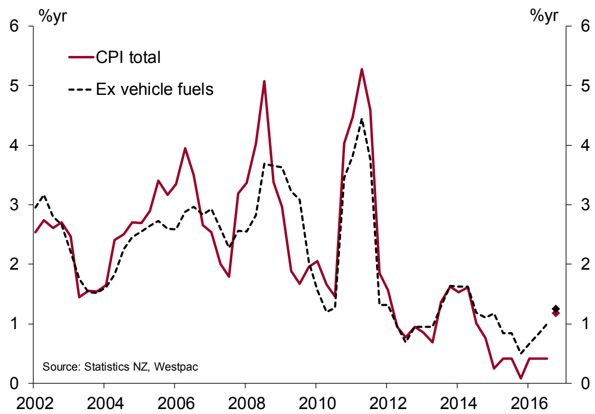
19 Jan 2017

Getting the band back

December quarter CPI preview: 26 January, 10:45am

- We expect a 0.2% rise in the Consumer Price Index for the December 2016 quarter. This would take annual inflation above 1% for the first time in more than two years.
- A rebound in fuel prices accounts for most of the rise in the annual rate. Setting this aside, inflation has been gradually picking up from its lows over the past year.
- The Reserve Bank will take some comfort from a return to the 1-3% target band. But the renewed strength of the New Zealand dollar means that inflation will remain subdued for some time yet.

Annual inflation forecast



The Consumer Price Index (CPI) for the December 2016 quarter will be released next Thursday. We expect a 0.2% increase for the quarter, which would lift the annual inflation rate from 0.4% to 1.2%. This would mark a return to within the Reserve Bank's 1-3% target band after two years straight of sub-1% readings.

The size of the expected turnaround in the annual rate is largely due to fuel prices. World oil prices plunged in 2014 and 2015, contributing to the undershoot in New Zealand's inflation rate over that time. In particular, there was a steep 7% fall in petrol prices in the December 2015 quarter. That number will now be dropping out of the annual calculation, to be replaced by a 4% rise over the December 2016 quarter.

Stripping out fuel prices, as in the chart shown here, gives a slightly smoother path but tells much the same story. Inflation bottomed out at the end of 2015 and has been picking up gradually since, though it remains low relative to history and to the 2% midpoint of the RBNZ's target.

Our forecast for annual inflation of 1.2% is slightly higher than the RBNZ's estimate of 1.1% (our quarterly forecasts are the same at 0.2% after rounding). The difference probably reflects that fuel prices have risen since the RBNZ made its forecast in November; this tends to be treated as a temporary factor and doesn't fundamentally alter the inflation outlook.

Once inflation returns back within the target band, the RBNZ will have less reason to worry about inflation expectations becoming unanchored. But with inflation still dwelling at the lower end of the target range, and likely to do so for a while longer, there's no case for withdrawing the monetary stimulus that the RBNZ has applied over the past couple of years.

Details

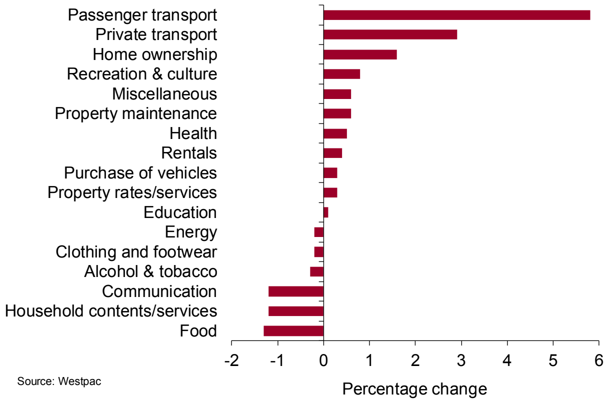
The headline CPI is not seasonally adjusted, so quarterly outturns are often heavily influenced by seasonal patterns. That will be true again of the December 2016 quarter: aside from fuel prices, we expect the biggest positive contribution to come from the seasonal peak in airfares. Notwithstanding that factor, airfares are still facing downward pressure from lower fuel costs and growing competition as new routes are opened up. The other major seasonal pattern in the December quarter is lower food prices, as fresh produce prices come down from their winter highs.

The September CPI featured some sizeable price increases (or smaller than usual price declines) for a number of import-heavy consumer goods. We interpreted that as the delayed pass-through of the sharp drop in the New Zealand dollar in late 2015, as importers' currency hedging eventually ran out. One thing we'll be looking for in next week's figures is whether this effect has further to run. We suspect not – in fact, with the New Zealand dollar having clawed back most of its decline, we expect a fresh wave of downward pressure on imported goods prices over the coming year.

The housing-related groups have been a sustained source of upward pressure on the CPI for several years, though without any sign of them spilling over into price pressures in other areas. For the December quarter, we expect another strong increase in prices for new dwellings, but a relatively modest 0.4% increase in rents. While rents are certainly being pressured higher in Auckland, they are now outright falling in Christchurch, as the housing stock recovers from the earthquakes and the 'scarcity premium' disappears.

Michael Gordon
Acting Chief Economist

Components of quarterly inflation forecast



Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670
Satish Ranchhod, Senior Economist +64 9 336 5668
Sarah Drought, Economist +64 9 336 5696
Any questions email: economics@westpac.co.nz

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