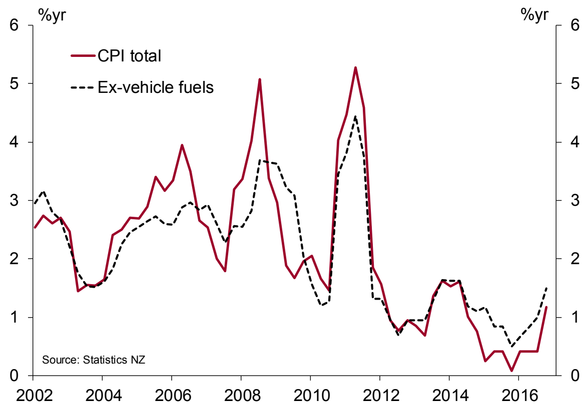
Westpac Institutional Bank

Tis the season

December quarter consumer prices rose 0.4%

- The Consumer Price Index (CPI) rose 0.4% in the last quarter of 2016, ahead of forecasts.
- Annual inflation rose to 1.3%, the highest rate since June 2014. Fuel prices accounted for much of the turnaround in the latest quarter, but the underlying trend has been gradually picking up for the past year.
- While the CPI rose more than we expected, the surprises were fairly isolated and possibly seasonal. Today's results don't suggest that the underlying inflation pulse is running stronger than previously thought.
- With the economy running close to its potential, and a strong rise in the NZ dollar over the last year, we expect that inflation will struggle to move beyond the lower half of the RBNZ's target range this year.
- Consequently, we think the market is getting ahead of itself in pricing in OCR hikes by year-end.

CPI inflation



Consumer prices rose by 0.4% in the December quarter of 2016, slightly ahead of the median market forecast of 0.3% and the 0.2% that we and the Reserve Bank were picking. With fuel prices no longer acting as a significant downward drag, the annual inflation rate jumped from 0.4% to 1.3%, putting it back within the Reserve Bank's 1-3% target range for the first time in over two years.

Crossing back above the 1% threshold may be meaningful to the extent that people's expectations of inflation are backward-looking. The RBNZ no longer needs to fear that expectations could become unanchored from the inflation target, a factor that motivated last year's OCR cuts.

But as a gauge of the state of the economy, it's somewhat behind the curve. Headline inflation has been thrown around by the huge swings in world oil prices over the last couple of years. The various 'core' measures of inflation all more or less agree that inflation bottomed out in late 2015, and has been gradually picking up since. That matches up with other economic indicators: with GDP growing steadily and unemployment dropping below 5%, it appears that the economy has moved beyond operating with spare capacity over the last year or so.

That said, there's a lot more work to go just to get inflation as high as the mid-point of the RBNZ's target band. Per-capita income growth is projected to be only modest from here, and the renewed strength of the New Zealand dollar will put fresh downward pressure on imported goods prices over the coming year. The upside surprises in today's CPI release were limited to a few areas, most of which strike us as likely to be temporary.

Accordingly, we expect inflation to remain in the lower half of the 1-3% target range over 2017. And that makes it unlikely to us that the RBNZ will be stirred into reversing any of its rate cuts any time soon – in contrast to market pricing for a 25 basis point OCR hike before year-end.

Details

The 0.4% increase in the CPI over the December quarter was unusually large, given that December quarters are typically dragged down by seasonal influences such as a decline in fresh produce prices. The seasonally adjusted CPI rose by 0.7%, the biggest quarterly increase since September 2013.

Much of this strength came in the transport-related categories. The 4% rise in petrol and 6% rise in diesel prices was as we expected, and was a marked change from the steep falls in fuel prices that have dragged inflation down over the previous couple of years.

The main surprise for us was an even larger than expected rise in domestic and international airfares. Both of these exhibit strong seasonal patterns, and domestic airfares in particular have shown much more seasonal variation in recent years than they used to. It appears that the resurgence of tourism in the last few years has led to greater use of peak pricing. (This is also apparent in rental car prices, which rose 10.7% in the quarter.) This doesn't mean that the trend in prices has changed, though: airfares are still lower than a year ago, reflecting lower fuel costs and increased competition. We suspect that travel costs are ripe for a sharp seasonal fall over the next quarter or two.

In the September quarter there was a broad-based uptick in tradable goods prices, which we put down to a delayed response to the fall in the NZ dollar over late 2015. The evidence in the latest quarter was far more mixed: we were surprised by gains in clothing and new car prices, but household goods were generally softer than we expected. The currency has since rebounded by about 15% on a trade-weighted basis. This will have a renewed depressing impact on import prices that we think will take the best part of a year to play out.

Once again, domestic price pressures were largely centred around housing. New dwelling prices rose another 1.4% for the quarter and 6.5% over the last year. Prices accelerated in Auckland but slowed in Canterbury, highlighting that the greatest demands on the building industry have clearly shifted north.

Meanwhile, the CPI measure of rents remains at odds with the anecdotes of severe housing shortages. The annual increase in rents slowed to 2%, its lowest in almost three years. That's partly because rents in Canterbury have been falling outright, as the housing stock is restored. But the rate of increase in rents slowed even in Auckland.

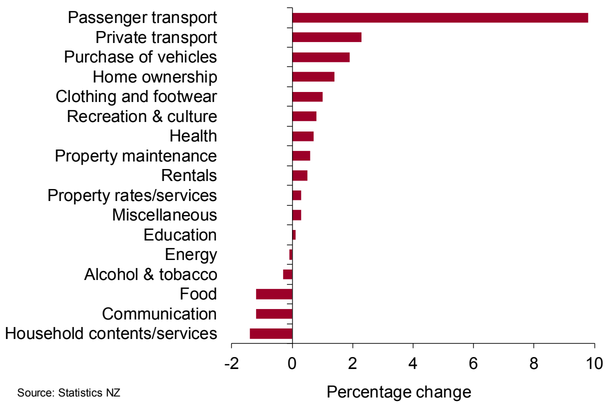
Market implications

The stronger than expected CPI outturn pushed the NZ dollar up from 0.7270 to 0.7300. On a trade-weighted basis, the currency is now at its highest level since April 2015. Interest rates were little changed, and continued to fully factor in a 25 basis point OCR increase by November.

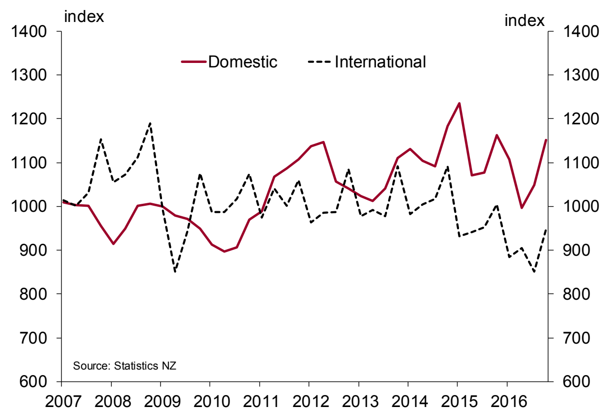
We don't share the market's enthusiasm for rate hikes. The RBNZ's most recent projections suggested that, even if the OCR remained at its current level for years to come, inflation wouldn't reach the 2% midpoint of the target until the end of 2018. The implication is that if interest rates were higher, the inflation undershoot would persist for even longer. We suspect that that assessment won't change in a hurry, especially since the RBNZ is once again facing a much stronger NZ dollar than it was counting on.

Michael Gordon
Acting Chief Economist

Components of quarterly inflation



CPI airfares



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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