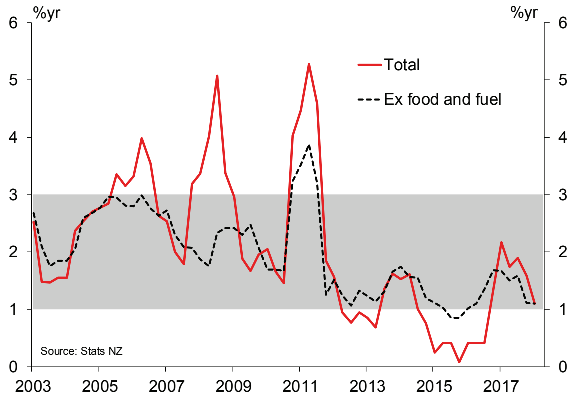
Inflation to remain subdued

CPI rose 0.5% in March quarter, annual inflation 1.1%

19 April 2018

- The Consumer Price Index (CPI) rose by 0.5% in the March quarter, as we expected. Annual inflation fell from 1.6% to 1.1%.
- Tradables inflation remains weak, due to a lack of global inflation pressures.
- Non-tradables inflation has picked up from its lows, notwithstanding the drag from the partial removal of tertiary study fees this quarter.
- But there is little impetus for inflation to reach the 2% midpoint of the Reserve Bank's target on a sustained basis.

Annual inflation



The 0.5% rise in consumer prices in the March quarter was right in line with our forecast, but a touch below the Reserve Bank's expectation of a 0.6% rise. With a 1% jump in prices in the previous March quarter now dropping out of the calculation, this saw the annual inflation rate fall from 1.6% to just 1.1%.

This was by no means a weak result for the quarter – in fact it was one of the stronger quarterly outturns in recent times. The low level of annual inflation is more a reflection of soft inflation through the middle part of 2017.

Moreover, the details were a little firmer than we expected on balance, with tradables inflation remaining soft, but the more persistent non-tradables components a little higher than we (and the Reserve Bank) were forecasting.

Tradables prices fell 0.1% for the quarter, and were down 0.4% on a year ago. The decline was even more significant if we exclude prices for food (which have been pushed up by poor weather and higher world prices for dairy products) and fuel (as world oil prices have rebounded from their lows).

Prices in import-heavy categories such as clothing, furnishing and electronics were all softer than we expected, highlighting the ongoing lack of price pressures among our trading partners and the ongoing squeeze on New Zealand retailers' margins. The New Zealand dollar hasn't provided much of an assist to import prices, with only a slight decline in the exchange rate over the last year.

One of the most notable facets of the weakness in tradables was a 14% drop in overseas airfares. Prices typically fall in the March quarter as we pass the peak holiday travel period, but this year's fall was unusually large. Overseas airfares have continued to fall on an annual basis, despite the fact that oil prices have been rising for the last two years.

Non-tradables prices rose 0.9% for the quarter, to be up 2.3% on a year ago. That includes the impact of the new Government's introduction of a year's free tertiary education, which knocked 0.24% off non-tradables and 0.14% off the total CPI. The impact was a bit smaller than we assumed, but there was always some uncertainty around how much weight this would carry in the CPI, given that it only affects a portion of students.

Notably, the housing-related components of the CPI, which usually make a strong positive contribution to inflation, were relatively subdued this quarter. Rents rose by 0.6%, with a further slowdown in Auckland offsetting a pickup in other parts of the country, especially in Wellington.

Meanwhile, new dwelling prices rose just 0.4%, the smallest quarterly rise in over six years. This highlights that rising building costs are not just a product of capacity constraints; builders have more scope to raise their prices when existing home prices are running hot. The cooling in the housing market over the last year or so has been followed by a slowdown in construction cost inflation.

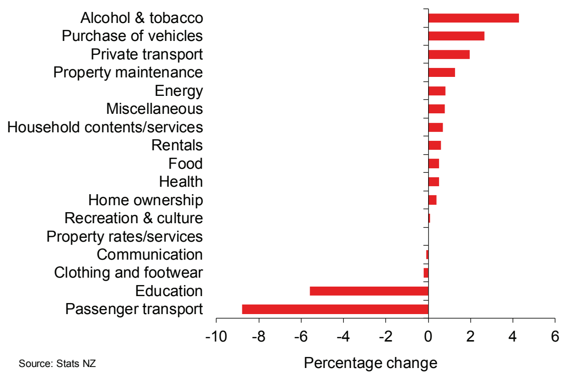
The dip in annual inflation towards the lower edge of the Reserve Bank's 1-3% target range is likely to be temporary. We expect that a lower New Zealand dollar will give a boost to tradables prices (or lead to smaller declines) over the rest of this year. And as the weak inflation through mid-2017 drops out, the year-on-year comparison will become more favourable for the RBNZ.

However, we don't see inflation reaching the 2% midpoint of the target any time soon. Weak tradables inflation is a global trend, and the boost to import prices that we expect from a lower New Zealand dollar won't persist into next year. If imported price pressures are missing in action, then home-grown inflation will have to pick up a lot more than it has to date. And the looming policy headwinds for house prices mean that housing-related inflation may have already passed its peak.

All together, there is little support for a rise in interest rates any time soon, even as annual inflation picks up from its lows. We continue to expect no change in the Official Cash Rate until late 2019.

Michael Gordon
Senior Economist

Components of quarterly inflation



Source: Stats NZ

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