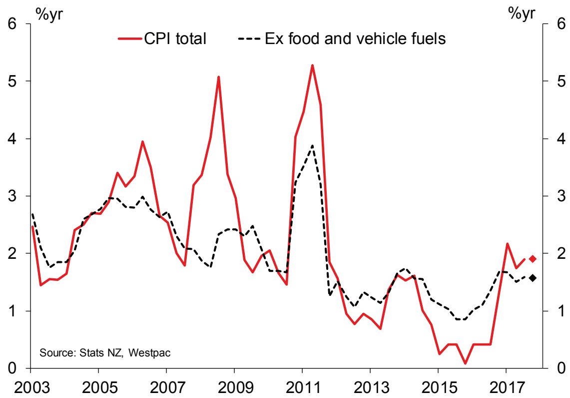
Fuelled up and on the go

December quarter CPI preview: 25 January, 10:45am

17 January 2018

- We expect a 0.4% rise in the Consumer Price Index (CPI) for the December quarter, keeping the annual inflation rate at 1.9%.
- Higher fuel prices are expected to make the biggest positive contribution.
- The December quarter tends to have strong seasonal influences, with lower fresh food prices and higher prices for airfares and accommodation.
- We estimate that the updates to the CPI weights will have only a small bearing on the inflation rate over the next year.

Annual inflation forecast



We estimate that consumer prices rose by 0.4% in the December quarter, led by higher fuel prices and other transport costs. This would maintain the annual inflation rate at 1.9%, very near the 2% midpoint of the Reserve Bank's target range. Excluding the volatile food and fuel categories, we expect annual inflation to remain at a more modest 1.6%.

We shouldn't see much market reaction if the inflation figures turn out as we expect, as market forecasts appear to be in a similar range. Our forecast is slightly higher than the Reserve Bank's pick of 0.3% for the quarter, although the difference is in the more persistent non-tradable categories where an upside surprise would be more significant.

The December quarter release will incorporate Stat NZ's three-yearly reweighting of the basket of goods and services that make up the CPI. The new weights have very little bearing on our inflation forecast, but we'll provide some detail on this for interested readers.

Forecast details

The most significant price increases over the December quarter were related to travel. Petrol prices were up 6% over the quarter, and diesel prices rose 10%, reflecting a rise in world oil prices and a weaker New Zealand dollar. Petrol prices are at their highest since the September 2015 quarter.

The other major contributors that we expect are the usual seasonal increases in airfares, car rentals and local accommodation. Rising fuel costs over the last year will also have put some upward pressure on airfares.

The largest negative contribution will be from a 1.6% drop in food prices, led by an 18% drop in vegetable prices. This is entirely a seasonal phenomenon – in seasonally adjusted terms, we estimate that food prices were up 0.3% for the quarter. Food price inflation picked up over 2017, but much of that was due to poor weather playing havoc with some crops. We don't see this as a sustained source of price increases.

Aside from fuel and food, we expect that tradables prices remained subdued. It's likely that the rise in the New Zealand dollar earlier in 2017 was still suppressing import prices at the end of last year.

Housing-related costs will make up much of the rise in non-tradables prices. Nationwide rents have been rising at a steady pace for several years, though that masks a divergence across the main centres: accelerating rents in Wellington, slower increases in Auckland and outright declines in Christchurch. Prices for newly-built homes have been rising strongly, though there are signs that the rate of increase may have peaked.

CPI reweighting

Every three years Stats NZ updates the basket of goods and services that make up the CPI, to reflect changes in actual spending patterns. This helps to deal with substitution effects: over time, people will buy less of those items where prices have gone up by more than average, and more of those items where prices have gone up by less than average or have fallen. Without accounting for these shifts, the CPI would become biased upward compared to the 'true' price level.

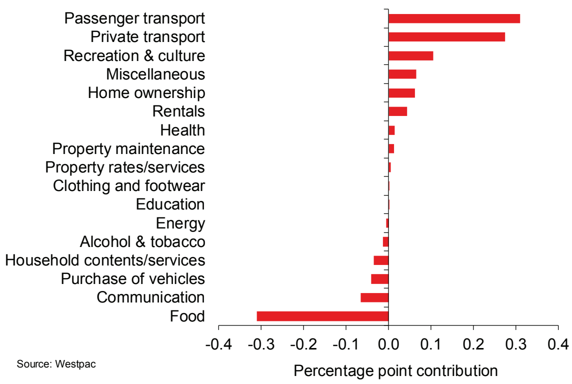
However, the implications for our inflation forecast are not so straightforward, as substitution isn't the only effect going on. Some items where prices have risen by more than average, such as local body rates, can't be substituted away. And there are other items (such as newly-built homes, accommodation and dining out) where rising prices have been a product of strong demand, so their weight in the CPI basket has actually increased this time.

We have produced line-by-line forecasts of each CPI item for the year ahead, calculated the expected CPI under the new weights, and compared this to what would have happened to the CPI without the reweighting. The net impact on our forecasts is small: we estimate that annual inflation over 2018 will be just 0.1% lower as a result of the reweighting.

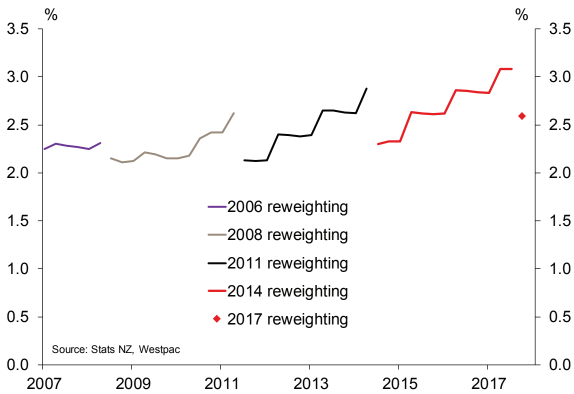
Moreover, nearly all of the difference comes from one item: tobacco. Steep increases in tobacco excise duty (10% plus the inflation rate each year) have led to a fall in smoking rates compared to three years ago. As a result, tobacco's weight in the CPI has been reduced. The latest excise increase, which came into effect on 1 January, will have a smaller impact on the March quarter CPI than it would have without the reweighting.

Michael Gordon
Senior Economist

Components of quarterly inflation forecast



CPI weight for cigarettes and tobacco



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