Westpac Institutional Bank

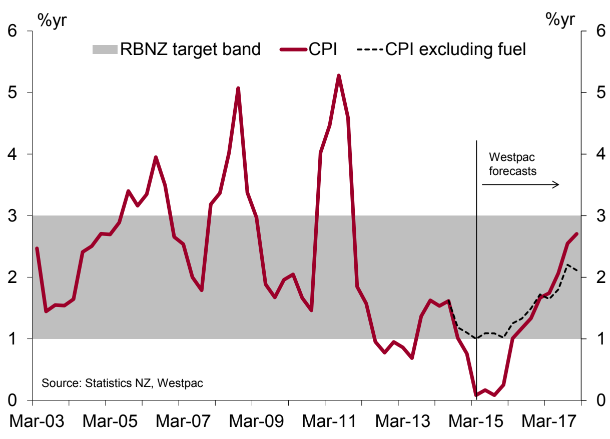
20 April 2015

Increasingly isolated inflation

March quarter consumer prices fell 0.3%, annual inflation 0.1%

- The Consumer Price Index (CPI) fell 0.3% in the March quarter, bringing annual inflation down to just 0.1%. This result was softer than we or the market expected.
- A sharp one-off plunge in fuel prices was the main reason for the quarterly decline in CPI. However, price pressures remain subdued across most categories.
- Even housing-related inflation, a standout in recent years, is turning more mixed. New home prices rose at a slower pace in March, and the rise in rental inflation was limited to Auckland.
- With annual inflation set to remain near zero for the rest of this year, monetary policy should remain easy for some time yet.

CPI inflation forecasts



Annual inflation fell to just 0.1% in the March 2015 quarter, the lowest rate in over 15 years. The result was slightly softer than we or the market expected, though it was a touch higher than the Reserve Bank's forecast of zero inflation.

As expected, the steep fall in fuel prices accounted for most of the decline in the annual inflation rate. But even after we strip out this effect, the picture remains one of subdued inflation pressures across a wide range of sectors. Tradable goods and services prices, excluding fuel, were down 0.9% on a year ago, due to the still-high New Zealand dollar and a general absence of imported inflation. Meanwhile, non-tradables inflation slowed to 2.3%yr, compared to a 3.0% annual pace a year ago.

If there was a note of caution to be struck from today's figures, it was that non-tradables inflation was stronger than we or the Reserve Bank expected. However, it seems that any substantial price increases are occurring in increasingly isolated pockets; there's certainly no sense that the strong economy is translating through into generalised inflation.

Today's figures shouldn't directly influence the RBNZ's thinking at its 30 April OCR review. (Assistant Governor McDermott's speech on Thursday is likely to elaborate on this point.) The RBNZ's concern is more around the risk that consumers and businesses become caught in a low-inflation mindset, after several years of below-target inflation. This can be assessed by various surveys of inflation expectations and pricing intentions, not by the CPI itself.

Still, a further fall in inflation expectations is a genuine risk given that annual inflation is set to remain near zero right through to the end of this year. Changes to government charges mean that we may not have seen the low point in annual inflation yet: from 1 July ACC levies for motor vehicles and fuel will be slashed, which we estimate will knock as much as 0.6 percentage points off the CPI in the September quarter. Like the fall in fuel prices, this is unambiguously a positive 'shock' for the economy, but it will also compound the RBNZ's difficulty in convincing people that inflation will return to 2% over the medium term. We don't expect the RBNZ to cut interest rates this year, as many other central banks have done, but we recognise that the case for doing so is looking more compelling.

CPI details

The CPI fell by 0.3% in the March quarter, in line with our forecast and slightly softer than the median market forecast of 0.2%. However, it was a weak 0.3% before rounding, and the annual inflation rate of 0.1% was below our forecast of 0.2%.

Tradables prices fell by 2.2% over the quarter, even weaker than we expected. This left them down 2.8% on a year ago, the biggest annual decline since the series began in 1999. The main contributor was an 11% fall in petrol prices. In addition, the 14.7% drop in international airfares and 6.6% fall for package holidays – much larger than the usual seasonal declines – point to some knock-on effects from lower oil prices.

Outside of oil, tradables inflation largely remained soft. The still-high New Zealand dollar on a trade-weighted basis shone through in many of the import-heavy categories such as clothing (-1.2%), household contents (-1.3%), recreational goods (-1.1%) and vehicles (-1.5%).

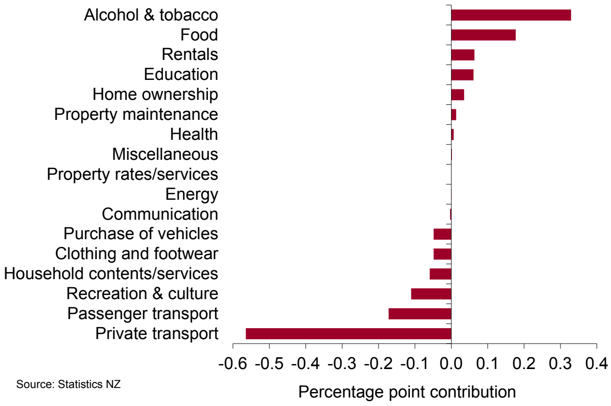
The exception on the tradables side was a 0.9% rise in food prices, due to a larger than usual seasonal increase in fruit and vegetable prices (up 7.4% on a year ago). However, this is typically a reflection of local growing conditions more than anything else, and is unlikely to be repeated on a sustained basis.

Non-tradables prices rose 1.1% for the quarter, compared to our forecast of a 0.9% rise and the RBNZ's estimate of 0.8%. The annual rate of increase slowed marginally from 2.4% to 2.3%, the lowest since September 2012.

There were a few unusual price increases over the quarter, which are unlikely to be sustained. Tobacco prices rose by 12.3%, more than was required by the annual increase in excise duty; the last scheduled increase in excise will be in January 2016, and will drop out of the annual inflation rate from 2017. Communications services saw a rare increase in prices, as a result of the Commerce Commission's recent decision on line pricing (which itself could be short-lived). And there was another sharp increase in domestic airfares; we suspect that lower fuel prices will eventually come to bear here.

For some time we've been highlighting housing-related prices as an exception to the subdued inflation story, as the Christchurch rebuild and population growth in Auckland has put a substantial strain on the building industry. The evidence for the March quarter was mixed. Prices for new homes were up 5% on a year ago, but this was a slowdown from the 5.4% pace in the December quarter, with the slowdown seen across all of the major regions. Meanwhile, there was a notable acceleration in Auckland rents from 2.2%yr to 2.6%yr. However, rental growth in Canterbury slowed from 4.9%yr to 4.2%yr,reflecting the gradual restoration of the region's housing stock.

Contributions to quarterly inflation



Source: Statistics NZ

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