Westpac Institutional Bank

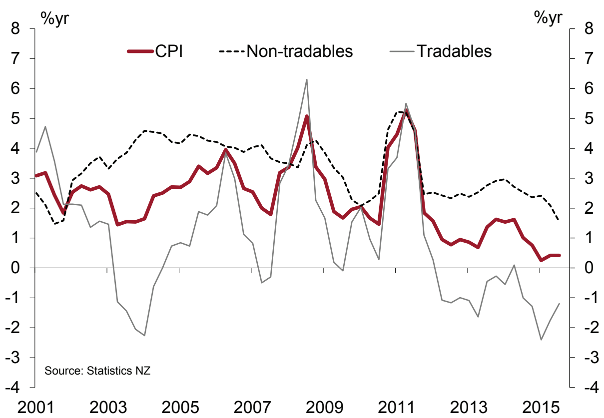
16 October 2015

Signs of life in inflation

Sep quarter consumer prices rose 0.3%, annual inflation 0.4%

- The Consumer Price Index (CPI) rose by 0.3% in the September quarter, slightly more than expected.
- Changes in central government charges reduced the rate of inflation by around 0.4 percentage points.
- The lower New Zealand dollar is gradually putting upward pressure on the prices of tradable goods and services.
- But we remain sceptical that this effect will result in a sustained return to the 2% midpoint of the inflation target.
- We still expect the OCR to be cut further to 2%.
- However, we have changed our forecast of the timing of OCR reductions.

CPI inflation



The 0.3% rise in consumer prices over the September quarter was in line with the Reserve Bank's assessment, but a touch higher than the median market forecast of 0.2%. We were at the bottom of the range with our 0.1% estimate. The rise in prices was entirely on tradable goods and services, as the lower New Zealand dollar gradually filters through into higher retail prices.

Annual inflation remains very low for now at just 0.4%, partly due to factors that will wash out over time, such as cuts to government charges and the sharp fall in fuel prices early this year. Today's figures support the view that inflation is on track to return above 1% by early next year. However, a sustained return to the 2% midpoint of the RBNZ's target band remains a daunting challenge – even more so now that the New Zealand dollar has reversed more than a third of its decline.

Change to OCR forecasts for 2016

We were already of the view that the RBNZ wasn't inclined to cut the OCR again as soon as its 29 October review, and today's figures support the case for a pause this month. But we've also said that in order to return inflation to around 2% on a sustained basis, the RBNZ will ultimately need to deliver more than the single OCR cut that remains in its projections. We continue to expect the OCR to reach a low of 2% in this cycle.

However, this week's speech by Governor Wheeler showed that the RBNZ remains reluctant to consider such a move, especially if the benefits are outweighed by the costs of further inflating the housing market. We are sceptical of the RBNZ's view that a weaker New Zealand dollar will drive a sustained rise in inflation, but we also recognise that the RBNZ will probably need to see some evidence to the contrary before cutting further.

Previously we expected three consecutive OCR cuts in December, January and March; now our view is that these will be staggered over December, March and June. Our next Weekly Commentary will cover this in further detail.

CPI details

The breakdown of the September quarter CPI went against the recent run of play, with very subdued non-tradables prices but a pickup in tradables prices. The latter category provided all of the surprise relative to our forecast, although some of that is likely to be due to timing quirks.

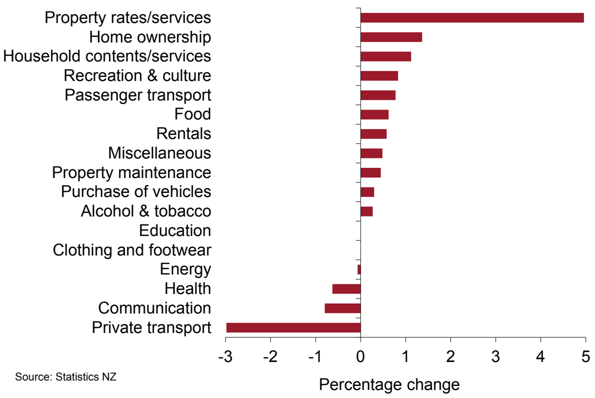
The 0.7% rise in tradables reflects the delayed impact of the fall in the New Zealand dollar over the past year, with rising prices (or at least slower price declines) in import-heavy categories such as household furnishings, appliances, clothing and cars. There were also larger than expected increases in international airfares and package holidays.

However, the bulk of the surprise for us came from just two items. First, petrol prices rose by 1.6%, compared to our estimate of 0.7%. The reduction in regional discounting, which was reported during the June quarter, actually showed up in the CPI in the September quarter instead; this surprise has no bearing on our CPI forecasts from here on. Second, we were surprised to see a 0.7% rise in domestic airfares, given the introduction of Jetstar's sharply lower airfares on some domestic routes in September. We suspect this will show up next quarter instead, and we're inclined to shave down our December quarter CPI forecast by 0.1%.

Non-tradables prices were flat for the quarter, in line with our forecast and a touch softer than the RBNZ's forecast of a 0.1% rise. This category was weighed down by two changes in central government charges: a sharp reduction in the ACC levy component of vehicle registrations, and the provision of free doctors' visits for 6-12 year olds. Together these will shave around 0.4 percentage points off the inflation rate for the next year (and in fact the following year, as a second round of ACC levy cuts is scheduled for July 2016).

Aside from these two factors, the details of non-tradables prices were much as we expected. Local body rates rose by 5.7%, the biggest increase in eight years, led by the Auckland Council's 9.9% increase. Housing-related prices such as rents and new dwelling construction continued to rise, with the centre of gravity continuing to shift from Canterbury to Auckland. Energy prices were again close to flat, and prices for telco services continued to fall.

Components of quarterly inflation



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