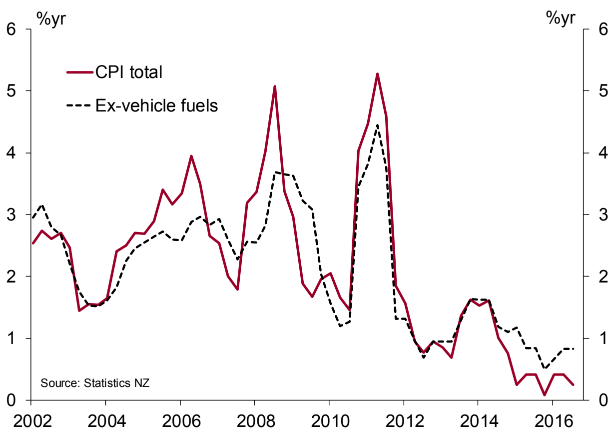
18 October 2016

Past the worst

September quarter consumer prices rose 0.2%

- The Consumer Price Index (CPI) rose 0.2% in the September quarter, in line with our forecast.
- Inflation was held down this quarter by some temporary factors such as ACC levies and fuel prices.
- Domestic inflation pressures are largely limited to housing.
- And the pass-through from last year's fall in the exchange rate has probably run its course now.
- While the result was slightly stronger than the Reserve Bank expected, the details are unlikely to dissuade the RBNZ from further easing in November.

CPI inflation



Consumer prices rose by 0.2% in the September quarter, in line with our expectations but ahead of the median market forecast for a flat outturn. The Reserve Bank had forecast a 0.1% increase in its August *Monetary Policy Statement.* The annual inflation rate slowed from 0.4% to 0.2%, just above the record low of 0.1% that it briefly touched in December last year.

Today's release doesn't fundamentally change the picture for the RBNZ. Inflation was already expected to slow this quarter due to some temporary factors such as fuel and ACC levies. By the same token, the annual inflation rate is expected to pick up over coming quarters as some earlier disinflationary factors drop out of the calculation. The various 'core' measures of inflation were generally steady and off their lows for this cycle.

That said, the return to the 2% midpoint of the inflation target is still shaping up to be uncomfortably slow. And inflation expectations, to the extent that they are backwards-looking, could take a further hit from today's result, which would make it that much harder to keep actual inflation on target. For those reasons, the RBNZ has more or less committed itself to a further OCR cut, most likely at the November *Monetary Policy Statement.*

Details

The main factors behind the soft September quarter outturn were in the transport categories. Most prominently, the second of two scheduled cuts to ACC levies on car registrations knocked 0.3 percentage points off the CPI. In addition, lower world oil prices led to a modest 1.7% fall in petrol prices, and further declines in international airfares and package holidays (although domestic airfares rose).

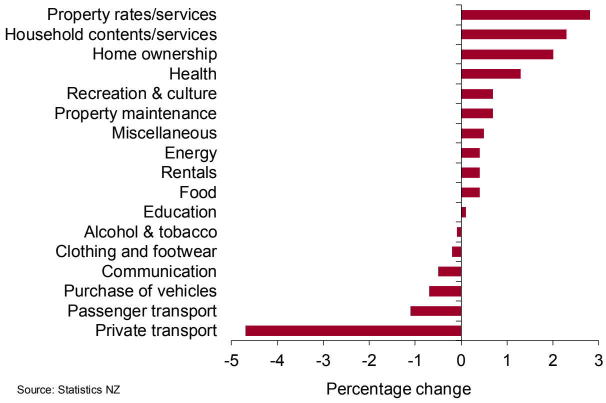
The major price increases were mainly related to housing. Local body rates rose by 3%, though that compares to a 5.7% rise last year. New dwelling prices continued to surge higher, particularly in Auckland, to be up 6.3% on a year ago. Real estate services prices actually rose even faster, up more than 10% on a year ago.

Meanwhile, rents rose 0.4% over the quarter. The annual rate of increase in rents actually slowed to 2.1%, largely due to rents falling outright in Canterbury as the housing stock has been replaced and the 'scarcity premium' has disappeared.

The main surprise for us was the rise in prices in some of the import-heavy categories, particularly household contents and recreational goods. That probably reflects a belated impact from the sharp fall in the New Zealand dollar over the second half of last year. Indeed, looking back at our earlier CPI forecasts suggests that the surprise for us was in the timing rather than the magnitude of the currency's impact.

It seems that exchange rate passthrough is alive and well, albeit with a long lag – and that's good and bad news for the RBNZ. The good part is that it indicates that firms do have the power to pass on increases in input costs. The bad part is that the currency's subsequent rebound, especially in the last few months, has not yet begun to have its impact on consumer prices. We expect tradable goods inflation to remain weak over the next year.

Components of quarterly inflation



Source: Statistics NZ

Looking ahead

For now, the Reserve Bank's main concern is that this sustained run of below-target inflation could drag wage and price expectations even lower, making it that much harder to engineer a return to the inflation target. For that reason, the RBNZ has signalled that it's prepared to do what's needed to keep inflation on track, including repeated comments that further monetary policy easing is likely. We expect the RBNZ to cut the OCR another 25 basis points at the November *Monetary Policy Statement,* while leaving the door open for more easing if needed.

Beyond that, though, we don't think that further cuts will prove necessary. We expect a 0.2% rise in the December quarter CPI, which will be published in late January. The December quarter is typically a subdued one, largely due to seasonal declines in fresh food prices. However, for the last several years it's also been characterised by a sharp drop in fuel prices, whereas this year it's shaping up to be a sizeable increase.

With an extremely weak -0.5% print from last December dropping out of the calculation, this would see the annual inflation rate rise to 1.0%, back within the 1-3% target range for the first time in over two years (admittedly on the back of a temporary factor, the rise in fuel prices).

If that forecast – one which is shared by the RBNZ – comes to fruition, then by early next year we should be seeing inflation expectations stabilise or even recover. A return to the 2% midpoint of the inflation target will still be some time away, but the case for the RBNZ to take active measures to keep inflation on track will have diminished.

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