Westpac Institutional Bank

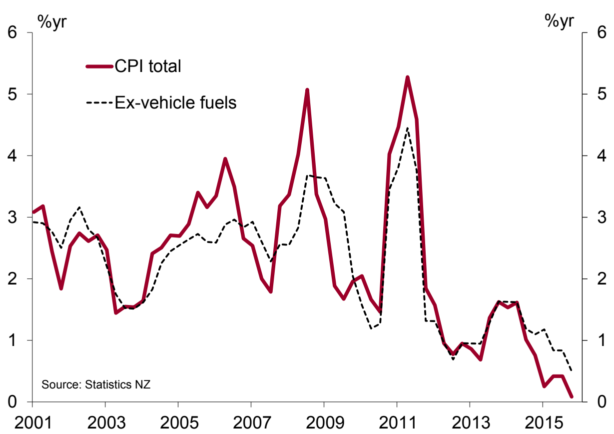
20 January 2016

Down low, too slow

December quarter consumer prices fell 0.5%, annual inflation 0.1%

- Consumer prices were even softer than expected, falling 0.5% over the December quarter. The annual inflation rate fell to a new 16-year low of 0.1%.
- Lower fuel prices were a driver in the latest quarter, but by no means the only one. The ex-fuel inflation rate also fell to a new low.
- Tradable goods prices were particularly soft, despite the fall in the New Zealand dollar over the last year.
- It now seems unlikely that inflation will return above 1% at any point this year.
- We expect the OCR to be cut further to 2% this year. We had pegged June as the most likely date for the next cut, but a March move is now a serious consideration.

CPI inflation



The Consumer Price Index (CPI) fell by 0.5% in the December quarter, even softer than our below-market forecast of a 0.4% decline. The annual inflation rate fell from 0.4% to just 0.1%, which is the slowest pace since September 1999. Lower fuel prices were a significant factor for the quarter, albeit a known one; the more notable feature for us was the widespread softness in tradable goods prices, despite the cumulative fall in the New Zealand dollar over 2015.

Today's outcome will be a material surprise to the Reserve Bank, which had been expecting the annual inflation rate to hold steady at 0.4% and then return above 1% in the early part of this year. That latter part is now firmly off the table. And if oil prices remain low, there's a real chance that inflation could drop below zero at some point this year.

The persistent undershoot of the inflation target reinforces our long-held view that the RBNZ will cut the OCR further this year, from 2.5% to 2.0%. Late last year we noted that we saw the June *Monetary Policy Statement* as the most likely start date for further cuts, but that the March review was certainly 'live'. Today's developments – weaker than expected inflation, lower dairy prices, and ongoing evidence that the Auckland housing market has cooled off – mean that a March rate cut is now a serious consideration. Next week's OCR review, and a major speech by the Governor the following week, provide the RBNZ with an opportunity to shift towards an explicit easing bias.

Financial markets have responded accordingly. The NZ dollar fell from 0.6470 to 0.6400 after the CPI release, and interest rates are now fully pricing in a 25 basis point OCR cut by June, with some chance of a second rate cut.

Details

While the CPI typically falls in the December quarter due to seasonal factors, today's outturn was particularly weak. The two biggest contributors to the decline (which were already known) were a larger than usual fall in food prices, particularly in grocery items, and a 7% fall in petrol prices as world oil prices once again fell sharply.

However, the weakness in inflation can't be entirely pinned on lower fuel prices – or, at least, not directly. The ex-fuel measure of inflation also slowed sharply from 0.8% to 0.5%, the lowest on record going back to 1999. In particular, we were struck by the widespread softness in the prices of tradable goods. Given the sizeable fall in the New Zealand dollar over 2015, we've seen much less upward pressure on tradables prices than we would have expected.

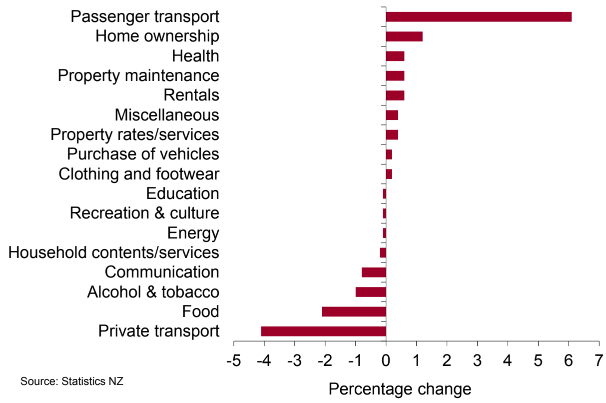
It may be that lower transport costs are going a long way towards keeping tradable goods prices in check (less obviously for services). If that's the case, it's likely to have a sustained dampening effect on overall inflation, especially with the renewed decline in world oil prices this year.

In contrast, non-tradable prices provided an upside surprise to our forecast, rising by 0.5% for the quarter and lifting the annual rate of increase from 1.5% to 1.8%. However, the surprise for us was entirely on domestic airfares, which we expected to fall given the sharp drop in fuel prices and new competition on some routes; instead, they rose 8% for the quarter. Statistics New Zealand attributed this to holiday period demand, and inspecting the data suggests that this seasonal pattern has only emerged in the last few years. So our view remains that airfares have scope to fall further this year.

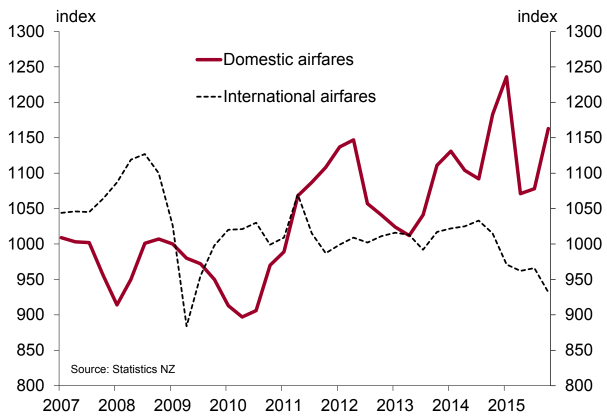
Outside of airfares, non-tradables inflation continues to be dominated by the housing-related categories. Rental inflation accelerated slightly to 2.5%yr, led by Auckland (while slowing in Canterbury), and prices of newly-built homes continued to rise at a 5% annual clip (again with Auckland running at the fastest pace).

Michael Gordon
Senior Economist

Components of quarterly inflation



CPI air travel components



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