Westpac Institutional Bank

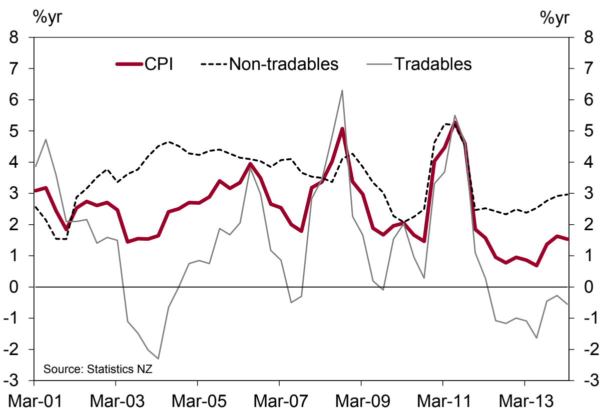
16 April 2014

Zig-zag

Q1 consumer prices rise 0.3% q/q, annual inflation 1.5%

- The Consumer Price Index (CPI) rose 0.3% in the March quarter, falling short of market forecasts and taking annual inflation down a touch to 1.5%.
- Slow growth in food prices and the strong New Zealand dollar have continued to dampen the overall pace of inflation.
- Housing-related price pressures have continued to build, and are now the greatest contributor to the annual inflation rate.
- A 25bp hike still looks the most likely outcome for next week's OCR review, but today's outturn along with other recent developments could elicit a more cautious tone from the RBNZ.

CPI inflation



Consumer prices rose just 0.3% in the March quarter, slow enough to bring the annual inflation rate down a notch after two straight increases. That will have come as a mild shock to markets, where the narrative that seemed to be developing was that inflation will only go higher from here, cementing the case for higher interest rates over the next few years. The reality, though, is more likely to be a gradual and halting rise in inflation, with the high New Zealand dollar providing a significant headwind for a while longer.

Today's result on its own is unlikely to prevent another OCR hike next week by the Reserve Bank, which will have an eye towards how the economy and inflation are developing over the medium term. However, softer than expected inflation, combined with a higher NZ dollar and lower dairy export prices in recent weeks, could see next week's OCR statement come with a more cautious tone on the required pace of tightening.

Details

The 0.3% rise in consumer prices for the March quarter was below the market median and RBNZ forecasts of 0.5%. Our forecast of 0.4% was at the bottom end of the market range of market forecasts (and we saw the risks to the downside). The annual inflation rate ticked down from 1.6% to 1.5%.

For the quarter, the single biggest contributor was a 10.2% rise in cigarette and tobacco prices, reflecting the regular hefty increase in tobacco excise at the start of the year. Bear in mind that these excise increases have been a feature for several years now; as such they have had no bearing on the changes in the annual inflation rate.

There were also significant increases in fuel prices, housing costs, and education fees during the quarter. On the downside, overseas airfares unwound their seasonal December quarter jump, ongoing competition in broadband and mobile phone services drove prices lower, and a stronger New Zealand dollar continued to depress prices for many household items.

For the RBNZ, the downward surprise was almost entirely on tradable items, down 0.7%, compared to its forecast of a 0.3% fall. Some of this will have been due to food prices, with recent monthly prints showing a smaller than usual rise in prices for this time of year. (The RBNZ finalised its forecasts in late February, before the soft Food Price Index was published.) And some may have been due to the NZ dollar, which has been tracking higher than assumed over the last month or so. However, the RBNZ is more likely to treat these kinds of surprises as transitory.

In contrast, non-tradables – those items generally not subject to overseas competition – were close to expectations, rising 1.1% for the quarter and 3.0% for the year. In particular, housing-related prices pressures have picked up substantially. The price of new dwellings has risen 5.1% nationwide in the last year, and this trend is clearly spreading beyond quake-related cost pressures in Christchurch – house prices rose 5.9%yr in Auckland, compared to 7.6%yr in Canterbury. Prices for property maintenance, real estate fees and house insurance have also continued to rise.

Notably, rental growth actually continued to slow, down to 2.0%yr, with the slowdown seen nationwide. As we've been saying for some time, the fact that rents are rising so slowly puts paid to the idea that the cause of rising house prices is a shortage of physical supply – if that were really the case, rents ought to be rising too.

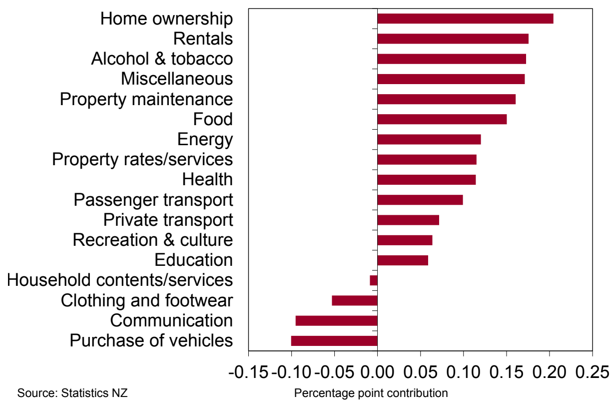
Implications

The NZ dollar is down half a cent since the release, while the two-year swap rate has fallen by five basis points. However, near-term market pricing is little changed, with a 25 basis point OCR hike next week still fully priced in.

Most of the downside surprise for the RBNZ was on transitory factors, whereas there is still plenty of evidence that domestically-generated inflation is continuing to gradually rise – and that is the part that can become persistent if the RBNZ doesn't act. So the case for an extended series of rate hikes over the next few years remains intact.

However, lower-than-expected inflation today, combined with a higher than expected exchange rate and falling dairy prices, does reduce the degree of urgency for the RBNZ to hike rates. We continue to expect 25bp hikes at the April and June review dates, but there's a question mark over our forecast for a fourth consecutive hike in July.

Contributions to annual inflation



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