Westpac Institutional Bank

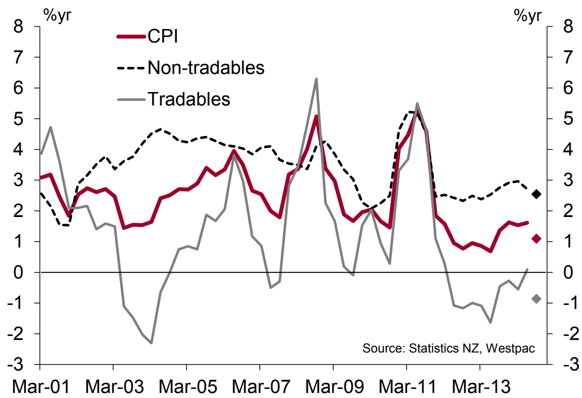
16 October 2014

Taking a step back

September quarter CPI preview: 23 October, 10:45am

- We expect a subdued 0.4% rise in the Consumer Price Index (CPI) for the September quarter, taking annual inflation down to 1.1%.
- Unusually low food prices this winter, and a smaller increase in fuel prices compared to last year, explain most of the drop in the annual inflation rate.
- The underlying story is one of still-subdued inflation pressures outside of housing, and with the legacy of past strength in the New Zealand dollar weighing on tradable goods prices.

CPI inflation



The momentum on inflation that was building earlier in the year appears to have fizzled out more recently. We estimate that consumer prices rose 0.4% in the September quarter – an unusually subdued outturn, given that this quarter tends to be the seasonal high point for inflation. In fact, with a substantially stronger number from last year dropping out of the calculation, our forecast sees annual inflation fall from 1.6% to 1.1%, which would be the slowest pace since the lurch down to 0.7%yr last June.

Our forecast is lower than the 0.7% quarterly increase (1.3% annual) that the Reserve Bank forecast in the September *Monetary Policy Statement*. Some of the difference will be due to more up-to-date information on food prices, which were unusually subdued over the September quarter but may yet pick up again. Nevertheless, we've already seen that the persistently low rate of inflation to date has prompted the RBNZ to review some of its assumptions about how economic activity, interest rates and the exchange rate feed into inflation. Another unexpectedly soft quarterly outturn, and the prospect that annual inflation will remain below the 2% target for even longer, would argue for an extended pause before resuming interest rate hikes.

Food prices (already published) are the biggest seasonal influence on the CPI, and are also the main factor behind the sharp drop in the annual inflation rate. Food prices rose by 0.4% in the September quarter – but a 'normal' increase over the winter months is usually well in excess of 1%. The more subdued rise in prices this year compared to last year shaves 0.25ppts off the annual inflation rate.

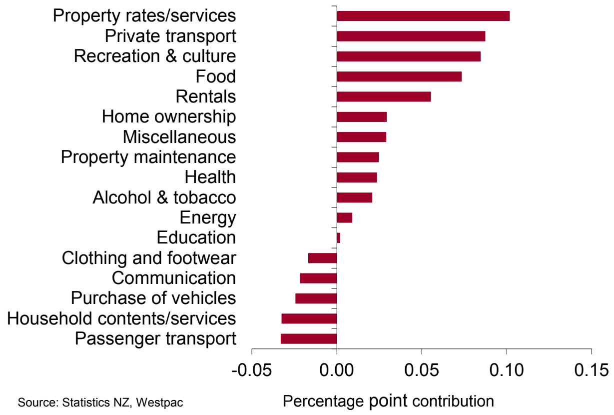
Some of the shortfall in food prices this year was due to vegetables, reflecting favourable growing conditions over winter. If so, this effect should reverse in the next quarter or two – lower than usual prices in winter doesn't mean that they will be lower in summer. But there have been other factors that could linger for longer, such as the supermarkets' price war on bread, and cheaper dairy products as world prices have fallen to unusually low levels.

The other factor behind the fall in annual inflation is petrol prices. While pump prices rose 1.6% in the September quarter this year, that compares to a 5.6% increase at the same time last year. With petrol making up 5% of the CPI, that difference reduces annual inflation by 0.2ppts.

The remainder of our forecast features the usual suspects: rising prices for domestically-focused goods and services (especially relating to housing), while the still-high New Zealand dollar dampens prices for internationally-traded goods such as clothing, vehicles and household contents. The NZ dollar was slightly lower on average over the September quarter, but it was still almost 6% higher than a year ago. We find that the passthrough from exchange rate movements to inflation occurs with a substantial lag (except for fuel prices), so the impact of past gains in the NZD will be a factor behind low inflation for a little while longer.

The annual increase in local authority rates is expected to make the largest single contribution to the rise in the CPI over the September quarter. We estimate a 3.5% increase this year, compared to a 3.8% rise last year. Increases in local authority rates continue to exceed general inflation, but the pace has steadily slowed in recent years. Other housing-related costs such as new dwelling prices and rents are expected to continue their steady climb (though there's no real sign that rent inflation has accelerated).

Forecast contributions to quarterly inflation



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