

# Economic Note

Q1 CPI Preview

16 April 2018

## Government giveth and taketh in Q1

- We expect the CPI to lift by 0.4%\* qoq in Q1 (+1.0% yoy), slightly below the RBNZ's forecast.
- Housing costs remain a key driver of inflation, while policy changes suggest education costs will be a drag on inflation pressures over Q1.
- With little evidence of core inflation lifting yet, we expect the RBNZ to leave the OCR on hold until August 2019.

### Summary & implications

**We expect the CPI to have lifted 0.4% qoq in Q1, with annual inflation a subdued 1%.** Our forecast is weaker than the RBNZ's inflation forecast published in the February MPS of +0.6% qoq, 1.1% yoy. Despite still-strong housing-related inflation and a 10% lift in the tobacco excise tax, underlying inflation pressures are expected to remain weak. Further weighing on inflation in Q1 is the introduction of one year's free tertiary education. With the annual CPI likely to fall back to the bottom of the inflation band, the RBNZ will be feeling little rush to change policy settings. However, we do expect inflation pressures to increasingly build over the coming years and for the RBNZ to respond by lifting the OCR in the second half of 2019.

CPI breakdown Q%	Sep-17	Dec-17	Mar-18
Food	1.1	-1.7	0.5
Alcohol & tobacco	0.7	-0.6	4.0
Clothing & footwear	0.2	-1.2	0.6
Housing & h/h utilities	1.0	0.6	0.7
H/h contents & services	0.7	-1.5	0.8
Health	0.5	-0.3	0.0
Transport	-1.1	3.2	-0.7
Communication	-1.3	-1.5	-1.0
Recreation and culture	-0.1	0.8	0.2
Education	0.1	0.2	-3.0
Misc. goods & services	1.3	0.3	0.3
<b>CPI</b>	<b>0.5</b>	<b>0.1</b>	<b>0.4</b>
<b>Tradable</b>	<b>0.2</b>	<b>-0.3</b>	<b>-0.1</b>
<b>Non-tradable</b>	<b>0.7</b>	<b>0.5</b>	<b>0.8</b>
<b>CPI Annual</b>	<b>1.9</b>	<b>1.6</b>	<b>1.0</b>

### Tobacco, rent and construction costs up

**Breaking our forecast down, the key drivers of inflation pressures over Q1 are expected to come from higher tobacco prices, higher rent costs and a further lift in housing construction costs.**

Higher tobacco costs reflect another round of the Government's 4-year annual 10% excise tax which was announced in the 2016 budget. Rent costs are also expected to have lifted in Q1. Rent costs tend to have a seasonal peak in Q1 (in line with the start of the school and university year). However, this year rent costs appeared to be particularly high in centres like Wellington as a shortage of rental properties impacted prices. Construction costs are also expected to continue to lift as capacity constraints in the construction sector continue to push prices higher. Construction costs in the CPI (which represent the cost of building a new home excluding the land) are currently running at over 5% per annum, far higher than Q4's 1.6% headline CPI.

### But overall pressures still soft

**This discrepancy between annual construction costs and the headline CPI highlights that although some prices are running away others remain flat or are even falling.** For example, annual communication costs have been largely falling since 2007 and audio-visual equipment prices have been falling since 2000. Even international travel is getting

increasingly inexpensive with annual international travel costs falling since March 2015.

## Education, international flights and communication key drags

**More specifically, in Q1 we are expecting education costs, communication costs and the cost of international flights to be the key drags on inflation.** The fall in education costs reflects the first step in Labour-NZ First's free tertiary education policy, with the first year of study becoming free this year. The Labour-NZ First coalition is expected to make the second year free in 2021 and the third in 2024. Falling communication costs continue to reflect the impact of technological improvements and increased competition. On the other hand, seasonal weakness is behind the forecast fall in international airfares over the quarter.

## Inflation outlook slowly lifting

**There will be a lot of noise impacting Q1's result.** For example, while the Government's tobacco tax will boost inflationary pressures, on the other hand the changes to tertiary education costs in 2018 will be a drag on inflation. **Putting these one-off movements to the side, the picture is likely to be one of still-subdued core inflation pressures.** As a result, we think the RBNZ will tread cautiously and wait for sustained evidence of rising core inflation pressures before raising the OCR. **Looking forward, we expect that higher wages and an improving domestic outlook will support inflation, and that the RBNZ will lift the OCR once it sees evidence of these factors lifting core inflation.** However, we believe it will take some time yet for these pressures to show up convincingly in the CPI and, as a result, do not expect the RBNZ to lift the OCR until August 2019.

\*Please note that this forecast could be revised slightly as a result of the changes to the CPI expenditure weights.

### ASB Economics & Research

Chief Economist  
Senior Economist  
Senior Economist  
Senior Rural Economist  
Senior Economist, Wealth  
Economist  
Data & Publication Manager

Nick Tuffley  
Mark Smith  
Jane Turner  
Nathan Penny  
Chris Tennent-Brown  
Kim Mundy  
Judith Pinto

[nick.tuffley@asb.co.nz](mailto:nick.tuffley@asb.co.nz)  
[mark.smith4@asb.co.nz](mailto:mark.smith4@asb.co.nz)  
[jane.turner@asb.co.nz](mailto:jane.turner@asb.co.nz)  
[nathan.penny@asb.co.nz](mailto:nathan.penny@asb.co.nz)  
[chris.tennent-brown@asb.co.nz](mailto:chris.tennent-brown@asb.co.nz)  
[kim.mundy@asb.co.nz](mailto:kim.mundy@asb.co.nz)  
[judith.pinto@asb.co.nz](mailto:judith.pinto@asb.co.nz)

### Phone

(649) 301 5659  
(649) 301 5657  
(649) 301 5957  
(649) 448 8778  
(649) 301 5915  
(649) 301 5661  
(649) 301 5660

[www.asb.co.nz/economics](http://www.asb.co.nz/economics)

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