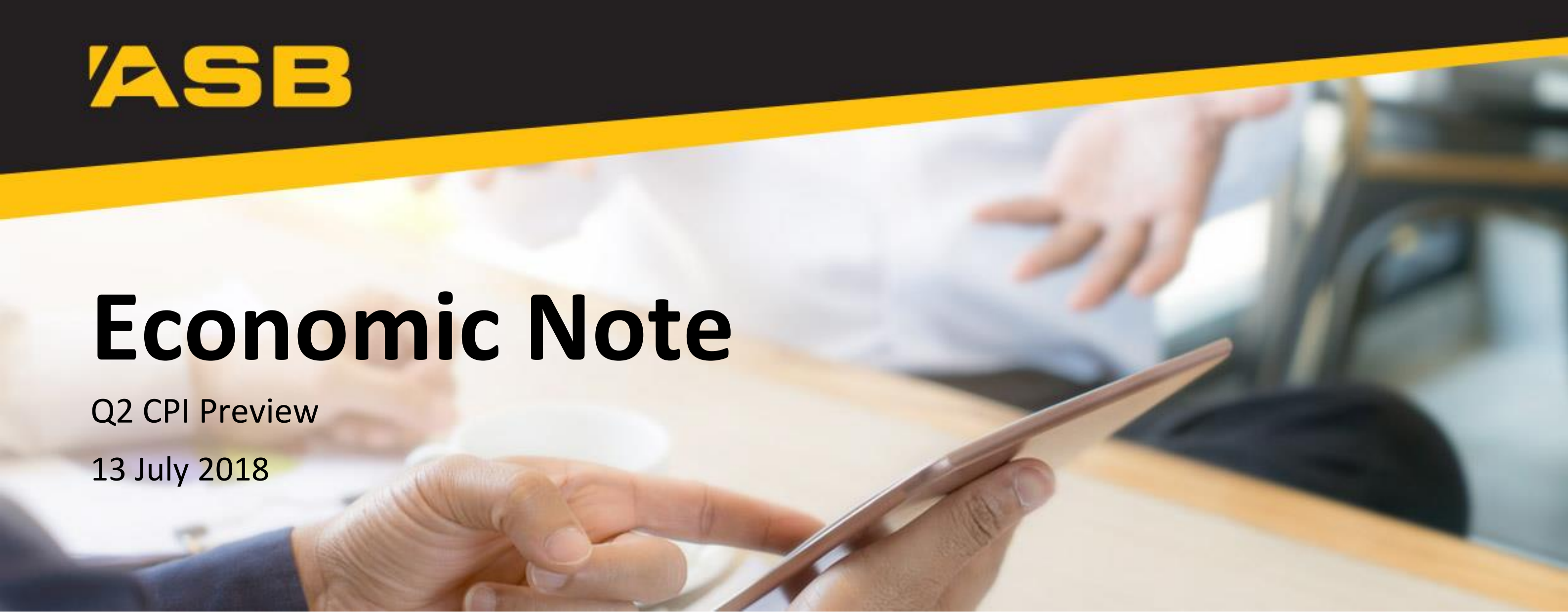

Economic Note

Q2 CPI Preview

13 July 2018

Up, up but not away

- We expect the CPI to rebound to 1.6% yoy (+0.5% qoq) in Q2 with higher oil price increases and the lower NZD bolstering the near-term inflation outlook.
- Other increases will remain constrained to sectors with capacity pressures: housing and tourism.
- While there has been an about-face in headline inflation pressures recently, core pressures remain subdued and downside risks have grown. As a result, we expect the RBNZ to leave the OCR on hold for some time yet.

Summary & implications

We expect the CPI to show a rebound to 1.6% yoy (+0.5% qoq) in Q2. Our forecast is stronger than that published in the RBNZ's February MPS (+0.4% qoq, 1.5% yoy). However, the RBNZ's forecast is unlikely to include the more recent increase in oil prices and the NZD depreciation. The near-term inflation outlook has firmed markedly as a result of higher oil prices, the recent fall in the NZD and incoming petrol taxes. We now expect headline inflation to hit 2% by the end of 2018. However, on the flip side, core inflation pressures remain relatively subdued and downside risks to the outlook have also increased over recent months. As a result, we expect the RBNZ to remain cautious and wait for evidence of a sustained lift in core inflation. We continue to expect the RBNZ to leave the OCR on hold until November 2019.

CPI breakdown Q%	Dec-17	Mar-18	Jun-18
Food	-1.7	0.5	0.8
Alcohol & tobacco	-0.6	4.3	0.3
Clothing & footwear	-1.2	-0.2	0.0
Housing & h/h utilities	0.6	0.6	0.8
H/h contents & services	-1.5	0.7	-0.5
Health	-0.3	0.5	0.1
Transport	3.2	-0.2	1.5
Communication	-1.5	-0.1	-1.0
Recreation and culture	0.8	0.1	-0.4
Education	0.2	-5.6	0.0
Misc.goods & services	0.3	0.8	0.4
CPI	**0.1**	**0.5**	**0.5**
Tradable	**-0.3**	**-0.1**	**0.9**
Non-tradable	**0.5**	**0.9**	**0.3**
CPI Annual	**1.6**	**1.1**	**1.6**

Cost pressures building

Inflation pressures are likely to have lifted again in Q2, following the 0.5% qoq lift in Q1. Higher petrol prices are the key driver of higher inflation pressures over the quarter. The combination of higher oil prices and the recent softening in the NZD has seen kiwis shelling out more at the pump over June. **We expect petrol prices rose 3.6% over Q2.** Further, with ongoing lifts in oil prices expected and both regional and nationwide petrol taxes being implemented in H2 2018, **petrol prices are expected to lift higher still over the coming quarters.** Ongoing pressure on fuel costs suggests that wider transport costs are also likely to start rising.

Outside of transportation, housing is expected to remain a key driver of inflation. We have forecast increases in rent, construction costs and property maintenance, in line with what you would expect from a capacity-constrained sector. Further, a seasonal lift in energy prices is also adding to housing-related inflation pressures in Q2. **Food prices will have also contributed to the CPI lift in Q2, in part due to rising restaurant and takeaway prices. This lift could reflect the 75 cent increase in the minimum wage that took place on 1 April.** There is a risk this increase might also be felt in

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other sectors of the economy in Q2 at the margin, but it is more likely to be a late-2018 story.

RBNZ to remain steady

The short-term inflation outlook has firmed markedly in recent months reflecting the combination of higher oil prices, the lower NZD and incoming petrol taxes. However, despite inflation lifting in Q2 and likely to lift further over the remainder of 2018, **we continue to expect the RBNZ to leave the OCR on hold for a substantial period of time yet.** Core inflation remains relatively subdued as a number of the drivers discussed above do not influence underlying inflation. For example, the lift in fuel and food prices will largely be looked through by the RBNZ. Our rough forecast suggests that core inflation is likely to remain around 1.5% yoy (as measured by the RBNZ's sectoral factor model), below the 2% midpoint of the RBNZ's inflation target band.

Over time, we do expect core inflation pressures to gradually lift, and for the RBNZ to respond to this by eventually increasing the OCR. Higher wage pressures and an improving domestic outlook underpin our assumption that core inflation pressures will gradually lift towards 2% in coming years. **However, the outlook is not without risks.** Soft business confidence risks domestic capacity pressures rising slower than expected, as does the risk of escalating global trade tensions. As a result, we expect the RBNZ to sit tight and wait for solid evidence that core inflation pressures are firming before moving. We do not expect the RBNZ to lift the OCR until November 2019.

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