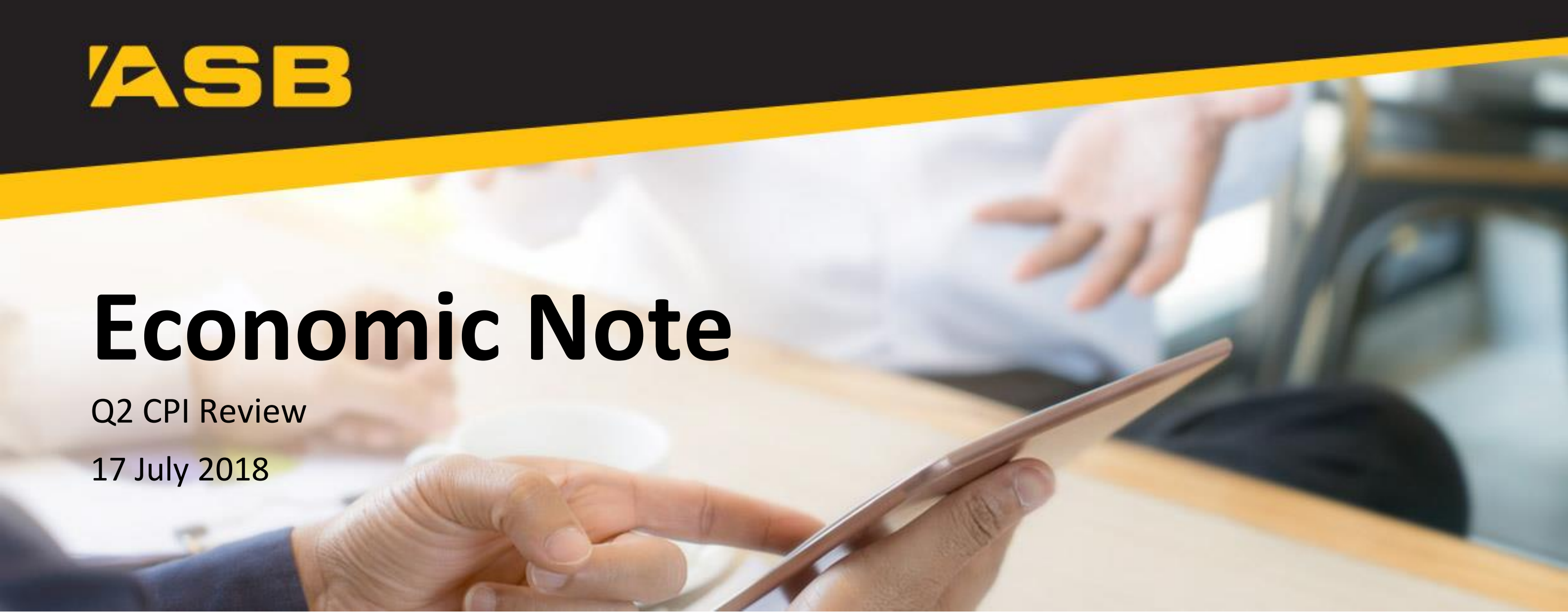


Economic Note

Q2 CPI Review

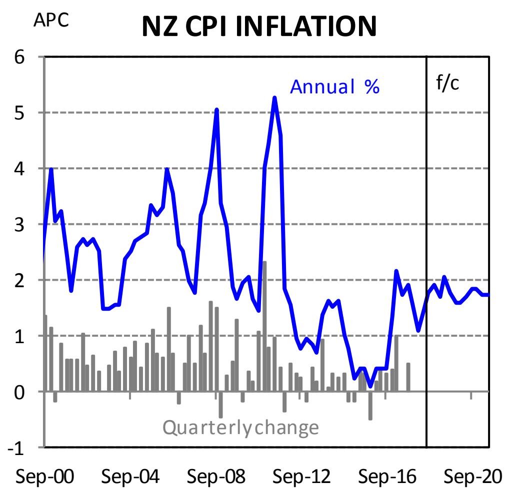
17 July 2018

No rush for the RBNZ

- The CPI rose by 0.4% in Q2, marginally lower than ourselves and the market were expecting. The annual rate of inflation rebounded to 1.5%.
- Housing and fuel costs were the key drivers of the lift, with cost pressures remaining soft outside of these sectors.
- Q2's result reiterates our view that the RBNZ will leave the OCR on hold well into 2019.

Summary & implications

The CPI rose by 0.4% qoq, taking the annual rate of inflation up to 1.5%. Although higher tradable inflation (petrol prices) looks set to lift headline CPI back up towards 2% by the end of the year, **evidence of a sustained lift in *underlying* inflation pressures remains elusive**. Further, the recent increase in downside risks stemming from soft business confidence and trade tensions means the RBNZ is likely to remain cautious for now. As a result we do not expect the RBNZ to change any policy settings as a result of the Q2 release. **We continue to expect the RBNZ to leave the OCR on hold until November 2019.**



Details

The CPI rose by 0.4% qoq in Q2, marginally lower than ASB's and the market's expectations, but in line with the RBNZ's forecast. As widely expected, higher fuel costs drove much of the lift in tradable inflation over the quarter. The remaining strength was largely contained to housing costs (e.g. rent, construction costs and electricity prices). So far, the lift in petrol prices (the third quarter in a row for which petrol prices have increased) does not appear to have flowed through into other areas of the CPI. For example, passenger transport services costs fell over the quarter. We had been expecting the seasonal decline in domestic airfares to be more muted than normal, given the higher fuel costs and Air New Zealand lifting domestic prices in April. However, the 12.5% fall in domestic airfares was a lot sharper than we had anticipated. Road passenger transport also fell 5.9% qoq.

Outside of the lift in fuel prices, however, **tradable inflation pressures were muted in Q2**. Tradable ex-fuel prices fell 0.1% over the quarter to be -1.1% lower than in Q2 2017. Audio-visual equipment remains a key drag on tradable inflation pressures. However, according to Stats NZ, the outsized 15% fall was driven by quality improvements in televisions reflected as an effective price fall.

On the domestic, or non-tradable, side of the equation, **housing costs continue to be a key driver of inflation.** The 0.9% lift in the housing and household utilities group was largely in line with our 0.8% forecast. Rental prices lifted

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0.8% over the quarter, with solid increases registered in most regions. In Wellington annual rental price growth lifted to 4.2%, the highest level since September 2008. This is in line with anecdotes of a particularly tight Wellington housing market. Rent growth was the mildest in Canterbury, where rents rose just 0.2% over the quarter. Interestingly, construction costs appear to be accelerating in the smaller regions, while they continue to ease on an annual growth basis in Auckland and Wellington. Overall construction costs rose 1.1% qoq in Q2. Auckland construction costs rose 0.6% qoq whereas they rose 1.2% qoq for the rest of the North Island. In the South Island excluding Canterbury, construction prices are up 7.2% yoy.

Accommodation prices dipped in Q2, but remain higher on an annual basis. Accommodation costs fell 1.7% qoq, but were 11% higher than in Q2 2017, the highest annual rate of increase on record (dating back to June 2000). This highlights not only that capacity constraints are boosting accommodation prices, but suggests that tight capacity is now pushing demand into the shoulder seasons as well.

As we stated in our preview, **core inflation remains the key measure from a policy point of view.** In Q2 the 10% trimmed mean measure lifted from 1.4% to 1.8% and the weighted median increased slightly to 2.3%. However, **the headline CPI excluding food, energy and fuel measure was flat over the quarter and only up 1.1% over the year.** That measure highlights that the current inflationary environment remains one that is contained to only a few sectors. We continue to expect the RBNZ to tread carefully until it sees evidence of widespread pricing pressures building. The RBNZ will release the Q2 sectoral factor model (another gauge of underlying inflation) at 3pm this afternoon.

All up, today's release reinforces that the RBNZ will be comfortable leaving the OCR on hold for some time yet. The combination of increased downside risks and the offsetting lower NZ dollar suggests that the RBNZ will feel little pressure to adjust monetary policy settings any time soon. We continue to expect the RBNZ to leave the OCR on hold until November 2019.

Q2 2018 CPI %	**Actual**	ASB	RBNZ	Market
CPI qoq	**0.4**	**0.5**	0.4	0.5
CPI yoy	**1.5**	**1.6**	1.5	1.6
Non-tradable qoq	**0.4**	**0.3**	0.3*	
Non-tradable yoy	**2.5**	**2.4**	2.4	
Tradable qoq	**0.3**	**0.9**	0.6*	
Tradable yoy	**0.1**	**0.7**	0.4	

**ASB estimate*

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