ASB

Economic Note

Q4 CPI Preview

19 January 2018

Looking through the noise

- We expect the CPI to lift by 0.5% qoq in Q4 (+2.0% yoy), slightly higher than the RBNZ's forecast.
- Petrol, housing and tourism-related sectors are key drivers of inflation, with pressures remaining contained elsewhere.
- With few signs of core inflation lifting yet, we continue to expect the RBNZ to leave the OCR on hold until early 2019.

Summary & implications

We expect the CPI to print at 0.5% qoq in Q4 with annual CPI inflation firming to 2.0% (the second time annual inflation has reached at least 2% in the last year). This lift reflects of a number of one-off movements, rather than stronger underlying inflation. For example, the sharp jump in petrol prices over the quarter accounts for nearly half of the quarter's lift in inflation. On top of that, the shift to updated CPI weightings added to Q4 inflation, at the margin. A contained backdrop for overall inflation should encourage a prolonged period of stability in OCR settings. The next move in the OCR is most likely to be up, but this still looks to be a 2019 story.

CPI breakdown Q%	Jun-17	Sep-17	Dec-17
Food	0.7	1.1	-1.6
Alcohol & tobacco	0.1	0.7	-0.5
Clothing & footwear	-0.2	0.2	0.1
Housing & h/h utilities	0.8	1.0	0.7
H/h contents & services	-0.9	0.7	0.0
Health	0.2	0.5	0.5
Transport	-1.3	-1.1	3.5
Communication	-1.8	-1.3	-1.5
Recreation and culture	-0.7	-0.1	1.5
Education	0.2	0.1	0.0
Misc.goods & services	0.1	1.3	0.6
CPI	**0.0**	**0.5**	**0.5**
Tradable	**-0.2**	**0.2**	**0.4**
Non-tradable	**0.2**	**0.7**	**0.6**
CPI Annual	**1.7**	**1.9**	**2.0**

Stonger than the RBNZ's forecast

The November MPS forecasts expected a 0.3% qoq (1.8% yoy) print for headline inflation. These forecasts were finalised prior to the recent spike in fuel prices. Moreover, the RBNZ forecasts would not have been based on Stats NZ's updated CPI weights.

2017 weights inflationary

Stats NZ have recently updated the CPI basket and weights to reflect changes in household expenditure patterns. The weighting showed proportionally lower expenditures on vehicle fuels (reflecting lower average petrol price since 2014 as well as higher vehicle fuel efficiency), whilst proportionately higher expenditures were devoted to accommodation and international airfares. Adopting the new weightings is estimated to add roughly 0.05 percent to quarterly and annual inflation in Q4, with the more positive contribution from airfares and accommodation offsetting the lower positive contribution petrol prices.

Petrol, housing and accommodation costs higher

Driving much of Q4's 0.5% lift in the CPI are higher petrol prices, construction costs, household electricity prices and accommodation costs. This is a pretty familiar story. Recently, inflation pressures have largely been contained to

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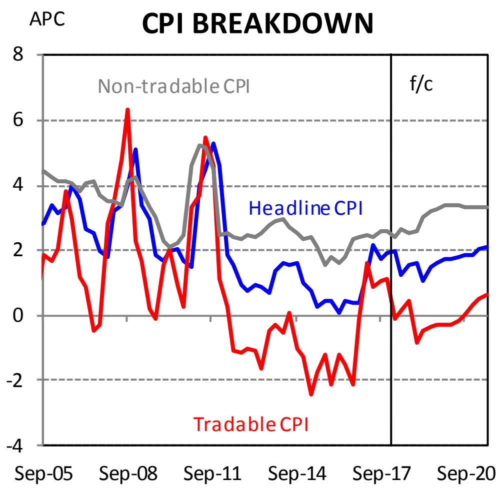
housing and tourism-related sectors as high levels of demand has created capacity constraints. On top of this, fuel prices continue to push headline inflation around, but the temporary nature of the swings mean sharp movements do not translate into more generalised inflationary movements that would have been of concern to the RBNZ. In Q4 we are also expecting to see higher than normal electricity prices as December's dry weather reduced lake levels and pushed up electricity spot prices.

We also expect a number of price falls over the quarter. Food prices fell around 1.6% in Q4. Wet weather caused fruit and vegetable prices to spike throughout much of 2017, while record-high butter prices boosted grocery costs. However, both fruit and vegetables and butter prices gave back some gains towards the end of the year.



Outside of housing and tourism-related costs, domestic inflation pressures are adjudged to remain soft. Our forecast model indicates that annual inflation for 2017 from the RBNZ sectoral factor model will remain at around 1.4%. Soft global inflation will also continue to be a drag on the CPI, with tradable inflation ex-fuel inflation remaining subdued.

Inflation outlook slowly improving

The NZ inflation outlook has improved slightly recently, with measures of core inflation (such as the RBNZ's sectoral factor model) showing underlying inflation pressures have lifted off the lows seen in 2015/16. However, most core measures remain below the 2% midpoint of the RBNZ's inflation target, reinforcing our view that the RBNZ will not lift the OCR this year. While higher wages and an improving domestic outlook will support inflation down the line, we believe the RBNZ will wait for signs of this flowing through into core inflation measures before it considers raising the OCR. In saying that, the recent revisions to GDP suggest that the economy has been operating closer to capacity than official numbers were suggesting. The proof in the pudding, however, will be what happens to the pricing side of the economy. Tightening pressures on good and labour market capacity are expected to push inflation higher. We expect the next OCR hike to be in February 2019, but for a gradual path of policy tightening and low OCR endpoint this cycle.

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