Westpac

Institutional Bank

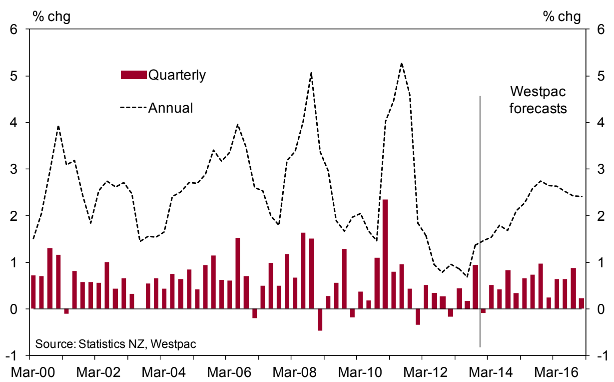
16 October 2013

Twice the price

Q3 consumer prices 0.9% q/q, annual inflation 1.4%

- The Consumer Price Index (CPI) rose 0.9% in the September quarter, lifting the annual inflation rate from 0.7% to 1.4%.
- A spike in fuel prices was the main contributor to the lift in annual inflation for the quarter.
- However, rising housing-related costs and the waning impact of a high New Zealand dollar are becoming recurring themes.
- With inflation returning to within the 1-3% target band, the RBNZ will be assertive about the case for interest rate hikes next year.

NZ CPI inflation



Consumer prices rose 0.9% in the September quarter, lifting annual inflation to 1.4%, from a 14-year low of 0.7% in the June quarter. The annual outturn was slightly ahead of our forecast of 1.3% (the quarterly change was in line with our forecast, after rounding to one decimal place) and above the Reserve Bank's estimate of 1.2%.

As we noted in our preview last week, this doubling of the annual inflation rate overstates the pace at which inflation pressures are picking up. But inflation pressures are on the rise nonetheless, as the domestic economy picks up and the dampening effect of a strong New Zealand dollar starts to wane. With inflation now comfortably back within the 1-3% target range, the RBNZ will feel more emboldened to discuss lifting interest rates from their very stimulatory current levels.

Details

The 0.9% rise in prices for the September quarter comprised a 1.2% rise in tradable goods and services prices and a 0.7% rise in non-tradables, both slightly ahead of the RBNZ's forecasts. Tradables prices were down 0.5% on a year ago, the slowest rate of decline in six quarters – partly reflecting a spike in fuel prices, and partly a smaller disinflationary impact from the strong New Zealand dollar. Non-tradables prices were up 2.8% on a year ago, the fastest pace since September 2011 (which was partially distorted by the 2010 GST hike). This component will be of particular interest to the RBNZ, as non-tradables inflation tends to be both more persistent and more directly related to domestic conditions, including monetary policy settings.

The single biggest contribution to the rise in the annual inflation rate was a spike in fuel prices, with petrol up 5.6% and diesel up 6.1% on average over the quarter. Note, though, that the peak came in late July and that prices have now fully unwound the spike. For that reason, we don't think that annual inflation in the next quarter will advance much further, if at all, from the current 1.4% pace.

Some of the other major contributors to the quarterly increase reflected the CPI's seasonal patterns. Food prices rose 1.7%, led by a 20% rise in vegetable prices – which is fairly normal for this time of year. However, there are some signs that food price inflation is picking up again, having been effectively flat in seasonally adjusted terms over the last two years.

Another major seasonal factor was the annual increase in local body rates – up 4.6% for this year, of which a 3.8% increase was captured in the September quarter. This was substantially higher than our estimate of a 3.3% annual increase, though it still stands as one of the smallest increases over the last decade.

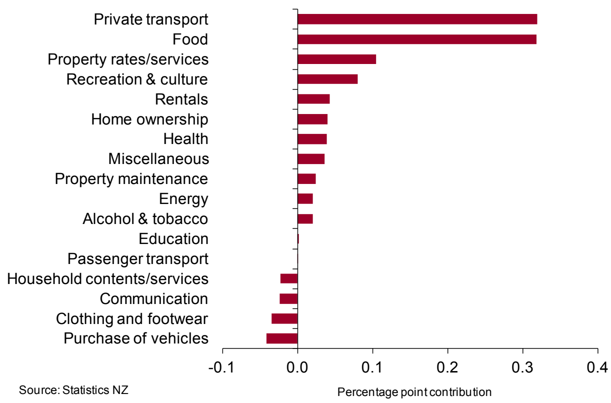
Setting aside the one-offs and seasonal regularities, we've been watching the CPI for two developments: a waning of the disinflationary effects of the high exchange rate, and a rise in housing and construction costs as the housing market and the Canterbury rebuild gather pace. Both of these were present in the latest figures.

While the New Zealand dollar has risen over the last year, the rate of increase has slowed compared to the previous few years – which implies that while the prices of imported and import-competing goods are still being pressured lower, this pressure is less now than in the past. In fact, the degree of passthrough from the exchange rate to prices was a touch less than we expected over the September quarter.

Meanwhile, construction cost inflation is clearly gathering momentum, with purchase prices for new houses and property maintenance both up by more than 4% over the last year. What's more, there was further evidence that construction cost inflation is spreading beyond the Canterbury region (though the gap is still massive – up 9.8%yr in Canterbury compared to 3.1%yr in the rest of the country). This is consistent with our long-held view that the Canterbury rebuild will provoke more inflation pressure than the RBNZ has allowed for.

Residential rents rose 0.5% for the quarter and 2.0% for the year, the third quarter in a row where the annual rate of increase has slowed. This supports another key aspect of our views – that the buoyant housing market has more to do with financial factors than physical shortages (with the exception of Canterbury, where rents accelerated to 5.0%yr).

Contributions to quarterly inflation



Source: Statistics NZ

Implications

Annual inflation was higher than the median market forecast of 1.2%, sending the New Zealand dollar 0.2 cents higher and the two-year swap rate up five basis points. Interest rate markets are almost fully pricing in a 25bp OCR increase in March next year, with further increases in June and July.

The CPI report was consistent with our core views on the New Zealand economy. We expect that the burgeoning construction industry, combined with rising house prices, will push the economy beyond capacity and generate inflation pressures that require the RBNZ to increase interest rates.

However, this will remain a slow process. We don't expect annual inflation to return to the RBNZ's medium-term target of 2% until the end of next year. So while being 'back in the band' will make it easier for the RBNZ to sell the message of interest rate hikes, we think it will deliver those hikes at a measured pace. We continue to expect the first OCR hike in March next year, with 25bp increases once a quarter from there on.

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