Westpac Institutional Bank

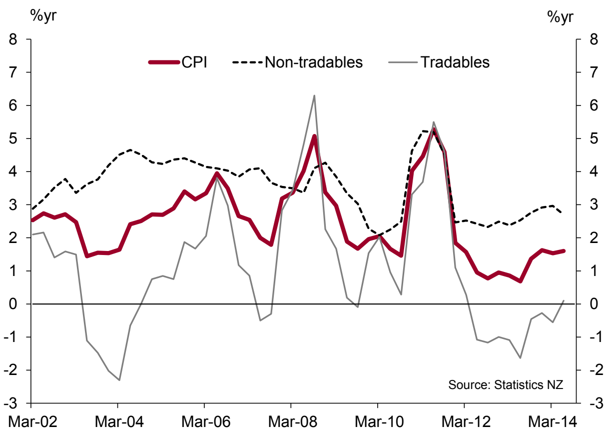
16 July 2014

Food for Thought

Q2 consumer prices rise 0.3% q/q, annual inflation 1.6%

- The Consumer Price Index (CPI) rose 0.3% in the June quarter, just a touch short of market forecasts.
- The underlying details painted a more benign inflation picture than expected.
- This weak inflation report comes on top of a string of weaker data. The RBNZ may now be reconsidering the number of OCR hikes that will be required over the coming two years.

CPI inflation



Headline inflation for the June quarter was a little weaker than markets or the RBNZ had expected, with consumer prices rising 0.3% over the quarter and 1.6% over the year.

While the headline surprise was a small surprise, the details of the report will be meaningful for the Reserve Bank. The Reserve Bank has long been concerned that the construction boom will push up housing-related inflation. And once entrenched, this type of inflation can persist for a long while. Today's data will have eased the Reserve Bank's concerns a little – there was little sign of housing-related inflation accelerating. Furthermore, prices for a number of imported goods and services such as cars and package holidays continued to fall, suggesting that the high exchange rate is still acting to dampen inflation.

Meanwhile, the stronger parts of today's inflation report were mainly transitory elements such as food and energy prices. This type of inflation is less likely to bother the Reserve Bank.

On balance then, this inflation data represents a small downside surprise to the Reserve Bank. Taken in combination with recent signs that domestic economic growth is slowing, tumbling dairy and log prices, and the stubbornly high exchange rate, the Reserve Bank is probably reconsidering how many OCR hikes will be necessary over the next two years. We will write more on the Reserve Bank's reaction to this run of weak data later this week.

Details

The 0.3% rise in consumer prices in the June quarter was a touch below the median forecast of 0.4%, and in line with the RBNZ's forecasts in its June *Monetary Policy Statement*. The annual inflation rate inched up from 1.5% to 1.6%.

As expected, the biggest contributors to the rise in prices were food – up 0.9%, as signalled by monthly data – and energy, where prices rose an unexpectedly sharp 3.7%, largely on the back of the annual reset in electricity prices.

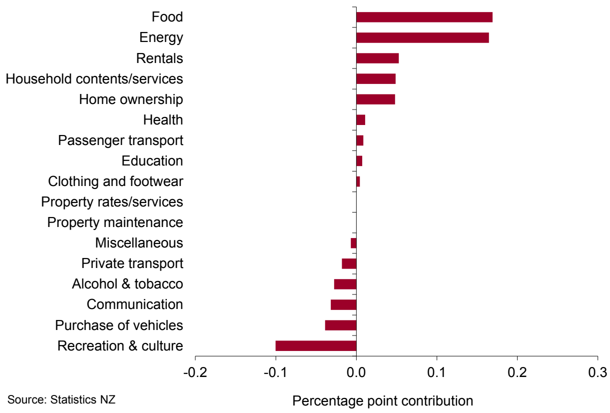
Another wild card this quarter was telecommunications – the introduction of uncapped broadband plans raised the tricky issue of how to come up with a 'price per unit' for an 'all you can eat' service. Without any more information we assumed a 2% fall in the communications category, but in the event Statistics NZ decided that prices in this area had fallen only 0.9%.

These volatile items aside, we were on the alert for any signs of a shift in the two major drivers of New Zealand's current inflation trend: housing-related inflation, which has been rising on the back of the construction boom, and the dampening effect of the high NZ dollar.

On the housing front, the inflation trend has if anything moderated a little. The biggest surprise to us here was a drop in home maintenance cost inflation, from 4.5%yr last quarter to 3.7%. But the cost of buying a new home – which reflects the state of the housing market as well as construction costs – also slowed more than expected, with inflation continuing to come off last year's extreme highs in Canterbury, but slowing a little in Auckland as well (to an admittedly still very robust 5.5%). Rent inflation also slowed further in Auckland, to a very benign 2.2%yr.

Meanwhile, the prices of a range of internationally traded goods and services have continued to fall – on balance a bit more than we were expecting. For some items, such as clothing, the annual rate of decline is now moderating (and prices for furniture and other household contents even rose slightly over the past year. But for cars (down 2.9%yr), audio-visual and computing equipment (down 9.8%yr) and package holidays (where annual inflation plunged from 6.5%yr in the March quarter to 0.3%) the disinflationary impulse from low global inflation and the high NZ dollar is clearly not over just yet.

Contributions to annual inflation



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