Westpac

Institutional Bank

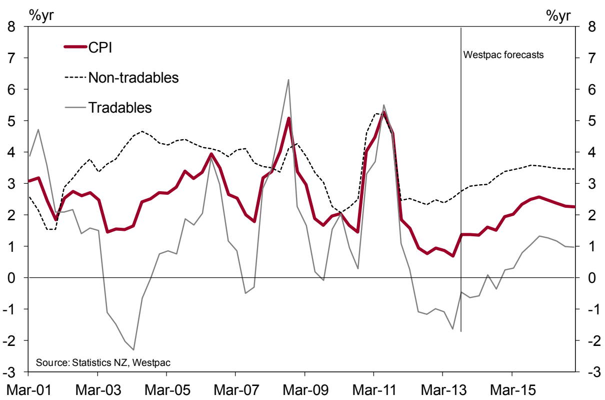
16 January 2014

Waiting in the wings

Q4 CPI preview: 21 January, 10:45am

- We expect a 0.2% fall in consumer prices for the December quarter, holding annual inflation at 1.4%.
- Lower fuel prices and a seasonal drop in food prices are the main reasons for the quarterly decline.
- However, the underlying picture is that home-grown inflation pressures are gradually ticking higher.
- Barring a substantial upside surprise next week, we don't expect the CPI figures to push the Reserve Bank towards a January OCR hike.

CPI inflation



We estimate that consumer prices (released next Tuesday) fell 0.2% in the December quarter, a normal seasonal decrease that would keep annual inflation at 1.4%. Our forecast is right in line with the Reserve Bank's most recent projections, and market forecasts are likely to be in a similar range.

With the Reserve Bank having signalled that it's prepared to start raising interest rates soon, there is growing speculation as to whether it could be forced into action as soon as the next OCR review at the end of January. Our view is that the CPI figures alone are unlikely to be the catalyst for an early move. Inflation is below the 2% target, and we share the RBNZ's assessment that it is likely to remain so over the course of 2014. Domestic inflation pressures are gradually re-emerging, but barring a substantial upside surprise in next week's inflation figures, the RBNZ will have time to respond at a measured pace. We expect the first OCR hike to come in the March *Monetary Policy Statement.*

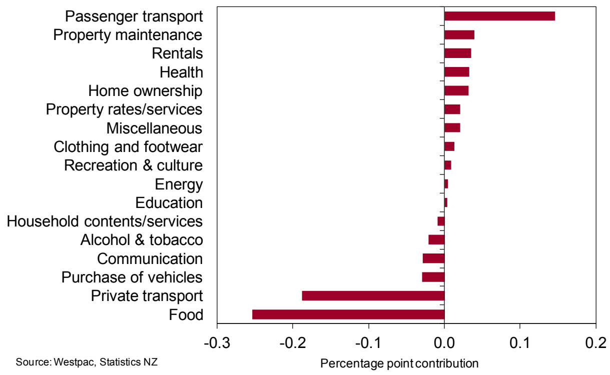
Details

Our forecast of a 0.2% decline in the CPI is fairly typical for a December quarter, when seasonal price effects are at their lowest ebb. In particular, fruit and vegetable prices tend to fall sharply in the December quarter, making them by far the single biggest contributor to the drop in the CPI. That said, it's notable that food price inflation is starting to creep up again on an annual basis, having been more or less flat over the past two years.

The other major negative contributor was a 3.4% fall in petrol prices, largely reversing a short-lived spike in prices during the September quarter. We also expect to see further declines in car prices (a result of the New Zealand dollar's sharp rise against the yen in the last year) and in telecommunications as mobile/broadband pricing continues to improve.

A seasonal increase in international airfares is expected to be the single largest positive contribution to the quarter. It's also the biggest potential source of error in our forecast; airfares tend to rise substantially in the December quarter, but the extent varies a great deal from year to year.

Forecast contributions to quarterly inflation



The subdued headline inflation rate masks a sharp divergence in the price trends for internationally tradable and non-tradable items, something that's more apparent on an annual basis. The ongoing rise in the NZ dollar (the trade-weighted index was up 5% on a year ago) has helped to depress the prices of imported goods, leaving tradables prices down an estimated 0.6% on a year ago. In contrast, non-tradables inflation is expected to accelerate slightly to 2.9%yr. The resurgent property market has played a part in this, with rising prices for new houses, property maintenance and real estate fees (though growth in rents has actually slowed).

Market implications

The CPI is the last official data release before the Reserve Bank's OCR review on 30 January (there's also the REINZ house sales figures for December, due in the next few days). While the RBNZ's most recent statements suggested an OCR increase in March, financial markets are giving about a 40% chance of a hike this month, and are looking to the CPI release as a potential catalyst.

Though we can't at all rule out a January OCR hike, we think that an as-expected CPI outturn, or even a small upside surprise, wouldn't be enough on its own to prompt an early move (though the RBNZ would use the January statement to warn of an impending hike in March). Annual inflation is still below the 2% target midpoint, and with the NZD trade-weighted index flirting with new post-float highs, both we and the RBNZ expect headline inflation to remain subdued over the next year.

However, any evidence that domestically-generated inflation is picking up much faster than expected could prompt the RBNZ to skip the warnings and move straight to an OCR hike in January. Conversely, a softer than expected outturn could give the RBNZ room to delay rate hikes a little longer.

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