Westpac

Institutional Bank

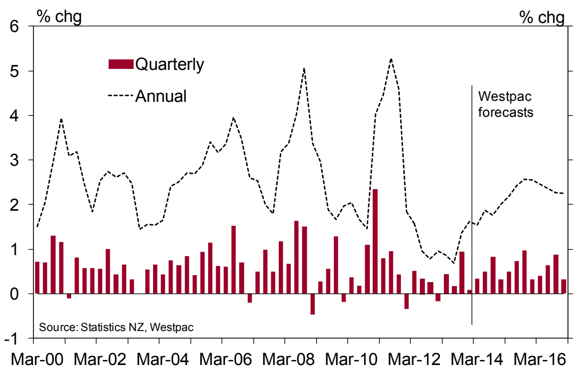
21 January 2014

Cat among the pigeons

Q4 consumer prices rise 0.1% q/q, annual inflation 1.6%

- The Consumer Price Index (CPI) rose 0.1% in the December quarter, against forecasts of a small decline. Annual inflation rose from 1.4% to 1.6%.
- Lower fuel prices and a seasonal drop in food prices dampened the headline increase.
- However, price pressures stemming from the buoyant housing market are on the rise, and the dampening effect of the strong NZ dollar is waning.
- The recent run of strong economic data seals the case for interest rate hikes this year; the remaining question is whether to begin in January or March.
- We continue to favour a March hike for now, but will review our call over the next few days.

CPI inflation



Today's Consumer Price Index (CPI) report upped the stakes in the debate about the timing of interest rate increases. The index rose 0.1% in the December quarter, beating market forecasts of a 0.1% decline and our forecast (shared by the Reserve Bank) of a 0.2% drop. While annual inflation remains below the 2% target midpoint for now, this was the second time in a row that the quarterly outturn has exceeded the RBNZ's forecasts. Moreover, there are two elements of the latest report that will give the RBNZ cause for concern: the strong New Zealand dollar is providing less of a dampening effect, and housing-related price pressures are becoming more prevalent.

Our core view has long been that the Canterbury rebuild would strain the economy's resources and generate inflationary pressures, forcing the RBNZ into a substantial OCR hiking cycle. That view now looks to be coming to fruition. We expect the first OCR increase to come in March, but we acknowledge that next week's OCR review is now 'live'.

Details

The 0.1% quarterly rise in the CPI is a relatively strong outturn given that seasonal factors tend to drag the index lower in the December quarter. In fact, aside from 2010, when the rate of GST was increased, this was the first time in six years that the CPI has risen in a December quarter.

The seasonal effect is strongest in food prices, which were the biggest restraining factor in the latest report (down 1.3%). However, it's worth noting that food prices are now heading higher again on an annual basis (up 1.3%yr), having been more or less flat over the previous two years. The other dampening factor was a 3.5% fall in petrol prices, partly reversing a 5.6% rise in the September quarter.

The biggest upside surprises were concentrated in internationally-traded goods and services (down 0.5%, versus our forecast of -1.0% and the RBNZ's forecast of -0.9%). Part of this was due to large seasonal increases in international airfares (up 11.7%) and package holidays (up 7.3%). While these were larger than we've seen in the last few years, they were comparable with the seasonal increases that we would typically see prior to the recession.

However, there were also larger than expected price increases (smaller than usual price decreases) across a range of imported and import-competing items: household contents, recreational goods, clothing and vehicles. The rising New Zealand dollar has helped to depress these prices over the last few years, but there is evidence that this effect is starting to wane – either the foreign currency prices of imports are starting to rise, or, more likely, the effects of cheaper imports are being passed on to consumers to a lesser degree.

The 0.5% rise in prices of non-tradable goods and services was in line with the RBNZ's forecasts, but the details could be of some concern. Prices of new houses rose 1.1% for the quarter and were up 4.7% on a year ago, the fastest pace since June 2008. What's more, construction cost pressures are now clearly becoming a nationwide feature – while prices are still rising fastest in Canterbury on an annual basis (up 9.5%), the quarterly increase was for the first time greater in Auckland (1.5%) than in Canterbury (1.3%). Property maintenance prices and real estate fees continue to rise sharply, although growth in rents remains subdued outside of Canterbury. As we've noted before, this supports our view that the buoyant housing market has more to do with financial factors (namely low interest rates) than with physical supply shortages.

Statistics NZ's smoothed measures of inflation (trimmed mean and weighted median) told much the same story as the headline figure. This indicates that the latest results were not dominated by a few large items, but rather that the acceleration in annual inflation was widespread.

Implications

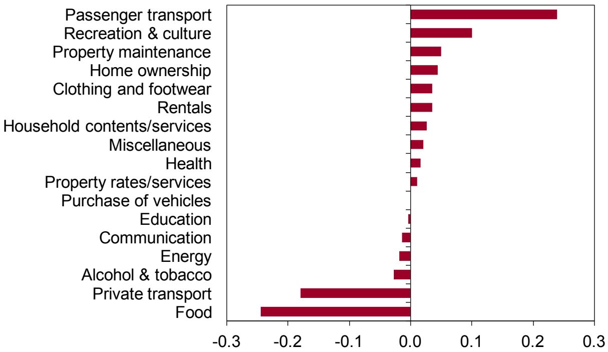
This release was a substantial upside surprise, and comes on top of stronger-than-expected data on economic activity in recent weeks. The market reaction was appropriately powerful – the New Zealand dollar rose 0.6 cents, while two-year and ten-year swap rates rose five basis points each.

The case for higher interest rates now looks well and truly sealed. While current inflation is still below the RBNZ's midpoint target of 2%, it is accelerating, and a monetary policy response today is warranted in order to keep inflation under control a year or two from now. It's notable that the RBNZ has been prepared to lay out the case for interest rate hikes even though its inflation forecasts have been among the lowest in the market – it is well aware that monetary policy operates with lags, and that in past cycles failing to act pre-emptively has probably resulted in a higher peak in interest rates than was otherwise needed.

The compelling question is now around the timing of the first OCR hike. The RBNZ's most recent projections suggested a March starting date. But with the evidence since then showing faster than expected growth, faster than expected inflation, the housing market slowing no more than expected, and the NZ dollar only a little higher than assumed, there are now strong grounds for asking whether the RBNZ will hike at next Thursday's OCR review.

The best argument for waiting until March is around communication. The RBNZ under Governor Wheeler has been putting more emphasis on transparency and public communication, and it may prefer to use its March *Monetary Policy Statement* to elaborate on its reasons for taking such a significant step. We continue to favour a March hike over January for now, but our call will be finalised over the next few days.

Contributions to quarterly inflation



Source: Statistics NZ

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