16 April 2014

Giddy TWI Blurs Inflation Incline

- Inflation lower than RBNZ anticipated
- As strong NZD squashes tradable prices
- It may interrupt OCR tightening
- Especially if commodity prices keep falling, regardless
- Macro outlook, domestic inflation still point to higher OCR

Consumers Price Index - 2014 Q1

	Actual	Mkt Pick	Mar MPS	Previous
CPI - qtly % chg	**0.3**	0.5	0.5	**0.1**
CPI - ann % chg	**1.5**	1.7	1.7	**1.6**

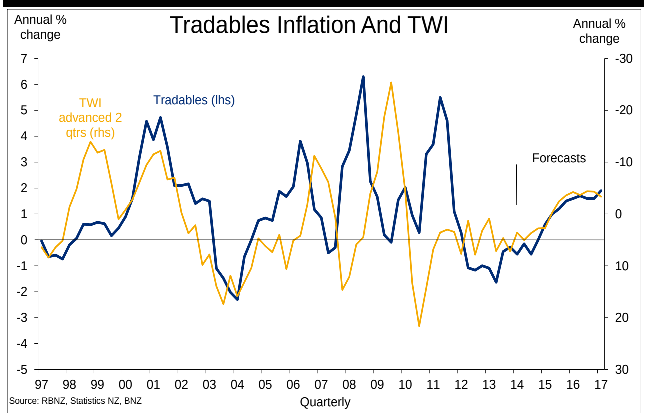
Q1 CPI inflation at +0.3% q/q and +1.5% y/y came in lower than market and RBNZ expectations of +0.5% and +1.7%. This is meaningful to the extent that the starting point of inflation is lower than the central bank had factored into its projections back in March.

Everything else equal, it raises the possibility that the OCR will not need to be lifted as much as has been previously projected, or at least, interrupt the tightening process at some stage. In isolation today's figures will see the RBNZ's forecast of 1.9% annual inflation by the end of year nudged down.

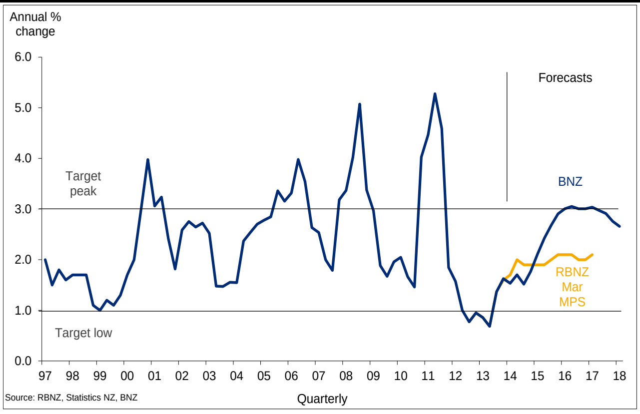
The downside surprise to the RBNZ was entirely confined to tradable prices. These prices fell 0.6% y/y compared to the bank's expectation of a 0.2% decline. Declines in tradable goods prices were widespread, indicating the broad downward price pressure being exerted from the strong NZ dollar.

As we pointed out in Monday's weekly, we were set to revise down our near term CPI forecast on account of the

Tradables Inflation and TWI



Consumer Price Index



persistent strength in the NZ dollar. So even though today's result was only a tick lower than the 1.6% y/y we anticipated, with solid confirmation of exchange rate pass through to retail prices we formally nudge down our near term CPI. So we now have Q2 CPI at +0.3% q/q and 1.7% y/y from prior estimates of +0.4% and 1.8% respectively. We see annual inflation at 1.8% by Q4 this year and lifting through 2015, partly the result of a forecast lower NZ dollar.

From a policy outlook perspective the trajectory of the NZD relative to falling commodity prices (like this morning's dairy auction) is very important. If the current mix of lower commodity prices and a generally elevated NZ dollar persists, the risk of a pause in the tightening cycle later this year increases. As we have been highlighting, this is a key risk ahead and will be all the talk following today's inflation figures. Fair enough.

But it would be remiss to not point out the opposing risk with regards to the currency's influence on policy deliberations. If the NZ dollar was to drop sharply, significantly extending the decline that followed this morning's inflation figures it could quickly become a source of inflation rather than deflation with the opposite implication for RBNZ policy. It all depends on why the NZ dollar was moving of course.

Through the gyrations, 'home grown' domestic inflation is accelerating. Non-tradable prices rose 1.1% q/q to be up 3.0% y/y. This matched RBNZ (and our) expectations. Some of it was the anticipated lift in tobacco excise tax. But do not overlook the strengthening inflationary pulse coming through the house construction sector. Indicative of this are house construction costs are up 5.1% y/y and property maintenance price up 4.5%. Further price increases are likely here.

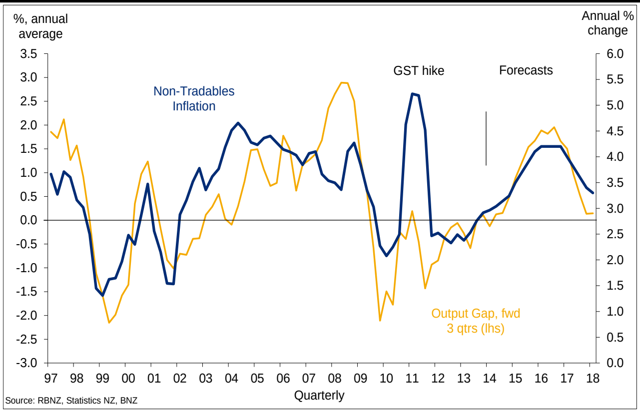
Amongst all of this we should point out that low inflation is a good news story. Low inflation relative to wages increases the purchasing power of incomes. The soft tradable inflation result is part of the very high terms of trade (and associated high NZD) benefits being transmitted to consumers. It means the solid nominal spending numbers we are seeing is being driven by more activity not higher prices.

With this in mind, rather than getting buried in the latest quarterly price wriggle, it is useful to see overall inflation within the bigger macroeconomic picture and what it all means for policy considerations. A brief top down look reveals:

- Annual inflation at 1.5% is not that far from the mid-point of the RBNZ target band, especially considering the temporary effect that an appreciating currency has on headline inflation. Core inflation measures are similar, even a touch higher.
- The economy has limited spare capacity – capacity utilisation is close to long term average and firms are having more difficulty than normal in finding labour.
- Economic growth is above trend and looks set to push further above trend this year.
- Interest rates are well below normal.

The first three of these features indicate an economy that is not broken. Given this, it is logical that interest rates should be heading towards normal.

Non-Tradables Inflation



Monetary policy is, or should be, more concerned with the inflation outlook rather than the previous three months. Medium term inflation indicators are still pointing upward.

But there are many moving parts to the inflation and policy outlook. In addition to the currency's trajectory and construction sector inflation pulse, don't take your eye off retail mortgage and deposit rates either. There are signs of increased competition that may blunt the impact of any OCR increase, potentially invoking more punch from the RBNZ other things constant.

For now, we are keeping our interest rate forecasts unchanged, including a highly likely 25 basis point hike in the OCR next week. But, as ever, there are many things to watch regarding the broader interest rate outlook.