Muted inflation despite solid growth

- We expect the Q3 CPI release to show a 0.5% increase over the quarter.
- Local authority rates and construction costs key drivers of non-tradable inflation, but underlying inflation contained.
- Lagged effects of NZD depreciation will come through in higher tradable inflation next year.

We expect the Q3 CPI release to show another modest increase of 0.5% over the quarter (released 10.45am Thursday 23rd October). The Housing and Household Utilities group is expected to be the key driver of Q3 inflation, largely reflecting the increase in local authority rates that typically come through this quarter. On top of that, we expect construction costs will continue to rise steadily. Beyond these increases, non-tradable inflation is expected to remain contained despite strengthening economic activity. Inflation indicators, such as pricing intentions and capacity utilisation eased slightly over the past quarter. A 0.5% quarterly increase will see annual inflation ease back to 1.1% - just a touch above the bottom of the Reserve Bank's inflation target band.

Our forecast is softer than the RBNZ's September MPS forecast of a 0.7% quarterly increase for Q3. At the September MPS, the RBNZ highlighted the muted transmission of economic growth to inflation pressures. We expect non-tradable inflation will remain fairly contained over the second half of this year, before gradually rising next year as continued solid growth sees spare capacity diminish in the NZ economy. For now, the low inflation environment suggests little urgency for the RBNZ to resume its tightening cycle. We continue to expect the RBNZ will keep the OCR on hold until March 2015, before undertaking gradual tightening with an OCR peak of 4.5% expected to be reached in March 2016.

Housing-related and utilities key drivers

Q3 CPI: +0.5% qoq, 1.1% yoy.

We expect the Q3 CPI to show a modest 0.5% increase over the quarter, to bring annual inflation to 1.1%, from 1.6% in the previous quarter.

Local authority rates increase in Q3.

Higher prices in the Housing and Household Utilities group are likely to be the key contributors to the Q3 increase. Local authority rates go up in the September quarter each year.

Steady lift in construction costs expected as house-building continues to ramp up.

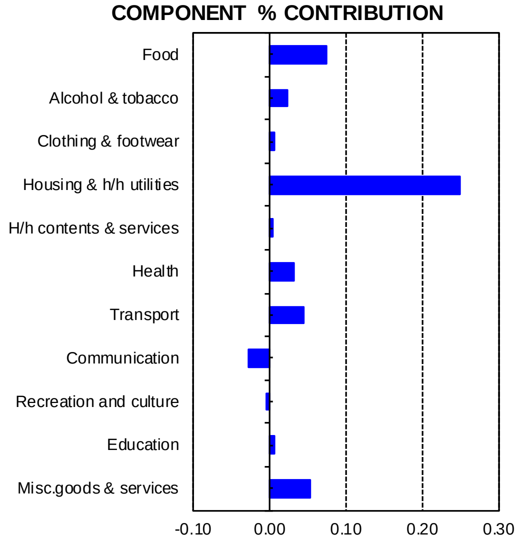
Meanwhile, we expect construction costs will continue to rise steadily given strong house-building demand. There have been solid increases in construction costs since 2013 as residential construction activity ramped up. Building consents and architects' outlook point to firm house-building demand over the coming year. We expect Auckland and Canterbury will remain the key drivers of residential construction activity, reflecting the relatively tighter housing markets in these regions.

Strong net migration mitigates some of the capacity pressures in the building sector.

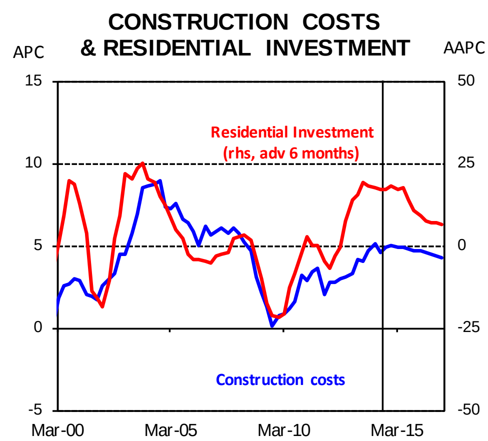
Nonetheless, we do not expect construction cost inflation will rise to the same extent as the ramp-up in construction activity. Strong net migration over the past year has increased labour supply, and mitigated the increase in capacity pressures normally associated with such strong activity. Indeed, the Q2 Labour Cost Index show a slowing in construction labour cost inflation, particularly in Canterbury.

Underlying inflation contained.

Recent inflation indicators point to underlying inflation remaining contained over the remainder of 2014 despite strong economic growth over the past year.



Source: ASB



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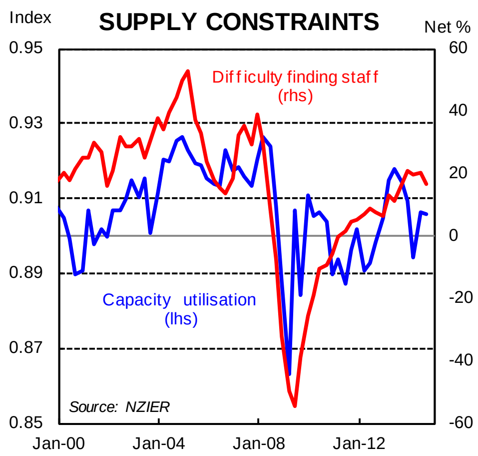
Firms' reported skills shortages ease.

The latest NZIER Quarterly Survey of Business Opinion shows firms' reported slightly less difficulty in finding skilled workers despite added employment demand. Similarly, firms' capacity utilisation also eased slightly in the latest quarter.



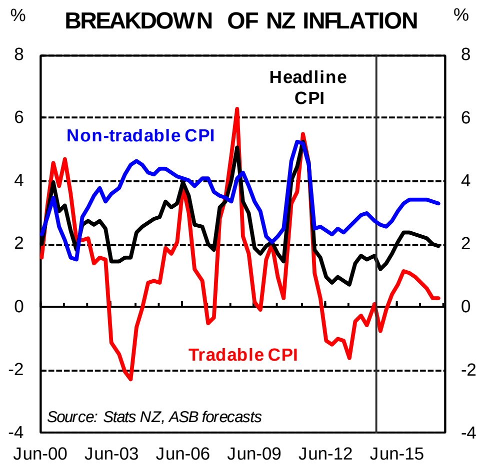
Spare capacity will diminish.

We expect a gradual lift in non-tradable inflation over 2015 as continued economic growth sees spare capacity in the NZ economy diminish.

Tradable inflation subdued for now

Seasonal increase in fruit and vegetable prices drive tradable inflation higher.

We expect a fairly subdued increase in tradable inflation of 0.3% in Q3. A large part of this increase in tradable inflation reflects a seasonal increase in the price of fruit and vegetables. Fruit and vegetable prices increased by nearly 6% in Q3. That increase was partly offset by lower meat, dairy and bread prices, as the declines in global commodity food prices earlier this year flowed through.



Petrol prices edge up modestly.

We estimate petrol prices increased just over 1.5% in Q3, largely reflecting the depreciation in the NZD over the quarter. This drop in the currency offset the fall in crude oil prices.

Effects of NZD drop will flow through to tradable inflation next year.

By contrast, we expect the effects of the recent drop in the NZD on other areas of tradable inflation will not become fully apparent until 2015. It typically takes one to three quarters for changes in the NZD to flow through to the price of most imported household goods. Hence we expect the strength in the NZD over the first half of 2014 will continue to constrain tradable inflation over the remainder of the year.

Retailers also face pressure on margins.

On top of the currency effects, the competitive retail environment has also weighed on the price of many imported household goods. Retailers' pricing intentions indicate further pricing pressures for the remainder of 2014.

Outlook: broadly higher

We expect annual inflation to peak at 2.4%at the end of 2015.

We expect annual inflation will pick up next year, reflecting an increase in both tradable and non-tradable inflation. The recent sharp drop in the NZD should flow through to an increase in the price of imported household goods next year. At the same time, we expect a lift in non-tradable inflation as continued solid economic growth whittles away spare capacity in the NZ economy. We forecast annual headline inflation will reach the RBNZ's 2% mid-point target in mid-2015, and peak at 2.4% by the end of next year.

New weights for the Q3 CPI

As part of its three-yearly CPI review, StatsNZ will be applying new weights to the Q3 CPI. The update of the CPI basket has little implication for the Q3 outcome and inflation outlook.

Implications

Our 0.5% qoq forecast below the RBNZ's 0.7% forecast.

Our forecast of a 0.5% increase in the Q3 CPI is below the RBNZ's September MPS forecast of a 0.7% increase. At the September MPS, the RBNZ forecast headline CPI to reach its 2% mid-point target in Q3 2016, and highlighted the muted pass-through of economic activity to inflation pressures. The central bank is likely to have revised up its tradable inflation forecast slightly in light of the softening of the NZD. Regardless, any market reaction to the Q3 CPI release will depend on the tone set by offshore markets that Thursday morning. Markets are more likely to react to a softer than expected result given the recent focus on downside risks to the global growth outlook.

Little urgency for RBNZ to resume tightening cycle.

We expect the RBNZ will leave the OCR on hold until March 2015, as it assesses the effects of the 100bp of tightening it has put through in 2014. Beyond that, we expect a fairly protracted tightening cycle for an OCR peak of 4.5% to be reached in March 2016. By contrast, markets are not expecting an OCR increase until at least September next year, and expect an OCR of 4% in mid-2016. A Q3 CPI result below 0.5% could see markets further price out the chances of an OCR increase over 2015.

CPI the key measure of inflation in the NZ economy.

Background to the data

The Consumer Price Index (CPI) measures the weighted average price change of a fixed basket of goods and services, which represents the average expenditure pattern of New Zealand households. The CPI is one important measure of inflation, and is often used in wage and rent reviews. The CPI is also used by central banks as a target for control of inflation. The Reserve Bank of New Zealand (RBNZ) currently has a target of keeping CPI increases within 1-3% per annum on average over the medium term. Hence, the RBNZ monitors potential impacts on the CPI very closely.

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