17 October 2017

Rate Increase Closer

- **CPI inflation surprises**
- **Will put upward pressure on wages and expectations**
- **But no sign of a target breach in the foreseeable future**
- **And NZ institutional arrangements currently confused**
- **So policy uncertainty abounds**

New Zealand consumer price inflation has soared well above RBNZ expectations. At 0.5% for the third quarter, 1.9% for the year, the rate of price increase was 0.3% above that projected at the time of the August Monetary Policy Statement. Some of this can be put down to factors that will be quickly played down such as stronger-than-expected petrol and food prices. But other aspects of the data, such as the above-forecast increase in non-tradables inflation (0.7% for the quarter, 2.6% for the year) should be greeted with greater consternation.

Importantly, we doubt the slump in inflation the RBNZ forecast back in August will eventuate. Back then the Bank forecast annual CPI inflation to drop to 0.7% by March 2018. We were sceptical at the time and are even more so now. Barring any slump in petrol prices, we are forecasting annual CPI inflation to drop to a low of 1.5% at that time. This is important as inflation expectations will not fall in the manner they would have had the RBNZ's estimates proven accurate. And bear in mind the RBNZ has just acknowledged that these expectations are now highly adaptive in nature.

With the labour market tightening, we believe today's outcome will put more pressure on wages than many care to believe which will, in turn, prop up future inflation. So too will the current level of the exchange rate and likely future fiscal easing, no matter the hue of Government.

All this has us believing that annual inflation will soon be settling near the mid-point of the RBNZ's target band. We are relatively confident of this but what we are less confident in is how the Reserve Bank will respond.

There are two approaches it could take:

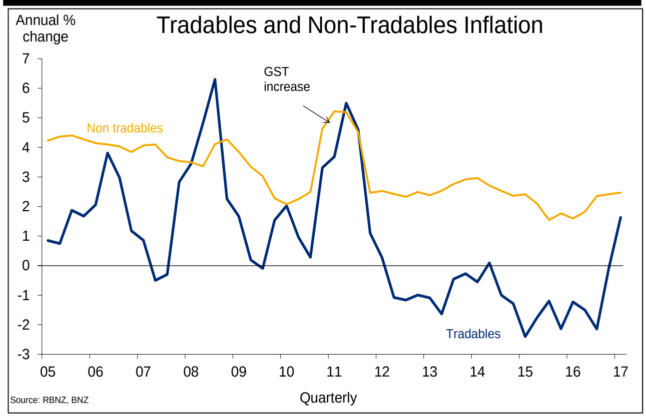
- headline inflation still doesn't look like threatening the top end of its target range for the foreseeable future so one could argue there is no need to shift rates for inflation-targeting purposes;

- alternatively, one could contend that if the economy and inflation are basically running around equilibrium levels, is there any need for the cash rate to be at emergency settings particularly when there is an increasing body of evidence that suggests that very low interest rates are threatening future financial stability.

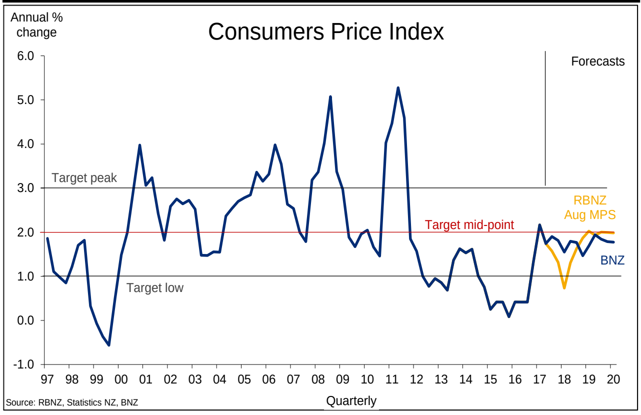
This debate is not peculiar to New Zealand. The same questions are being asked in many jurisdictions. What is peculiar to New Zealand, however, is the very confused governance picture we have at the moment. Not only do we have a caretaker governor but we also don't know who the incoming government is or what its expectations are for future fiscal stimulus, the Policy Targets Agreement and the Reserve Bank Act itself. Until these questions are answered it is very difficult to make any meaningful comment on future RBNZ action with any degree of certainty.

To cap things off, we haven't yet seen the Reserve Bank's sectoral factor model estimation of inflation. The Bank has

Tradables and Non-tradables trending higher



Inflation holding up



said that this is its preferred measure of core inflation. The other measures of core have trended higher but the factor model has not. We will watch for today's 3.00pm RBNZ release of this data with interest. We can only assume that the annual reading for this variable will climb modestly from the 1.4% reported for the year ended June.

All that said, we can be relatively safe in saying that today's CPI outturn brings us closer to a rate increase than we were before its announcement. Accordingly, we maintain our view that the RBNZ will end up raising interest rates sooner, and more, than the late 2019/early 2020 built into its August MPS.

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