20 October 2017

# Inflation – A Core Problem

- **CPI says tighten sooner**
- **RBNZ's core measure says quite the opposite**
- **But core outcomes validate past actions more than they dictate future policy**
- **Headline increase will pressure wages**
- **We still have a tightening bias**

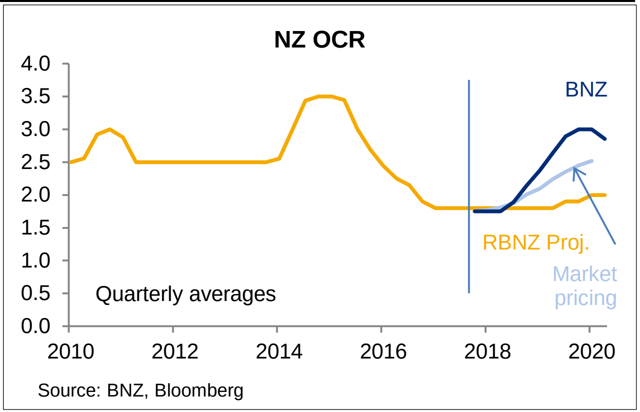
Recent consumer price inflation suggests that monetary conditions might need to firm faster than the RBNZ has assumed and, perhaps, even faster (or further, at least) than the market has priced. Not only was the headline pace of price expansion higher than expected but the source of the surprise was, in part, due to a rise in non-tradables inflation – the bit of inflation that the RBNZ, in theory, has more control over.

In addition, Statistics New Zealand's measures of core inflation predominantly settled around the 2.0% mark and were up, in some cases well up, on year earlier levels.

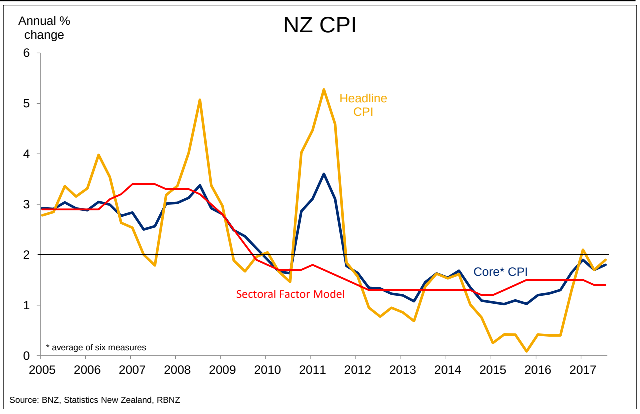
But just when it looked like the worm might be finally turning, along came the release of the Reserve Bank's sectoral factor model of inflation. In stark contrast to almost every other measure, this view of price pressure showed annual inflation not only unchanged but well shy of the RBNZ's target of 2.0%. Whatever its merits, this news is very important as the sectoral factor model is the RBNZ's preferred measure of central tendency for inflation. Accordingly, it might be argued that this news will dominate the Bank's thinking.

This may well be the case, but we would caution that it is not a given. It will only be to the extent that the data influence the Bank's forecasts that this outturn matters. The low core rate will certainly add weight to the Bank's perception that past policy settings were appropriate but

### Upward pressure on rates grows




### Sectoral Factor Undershoots Core



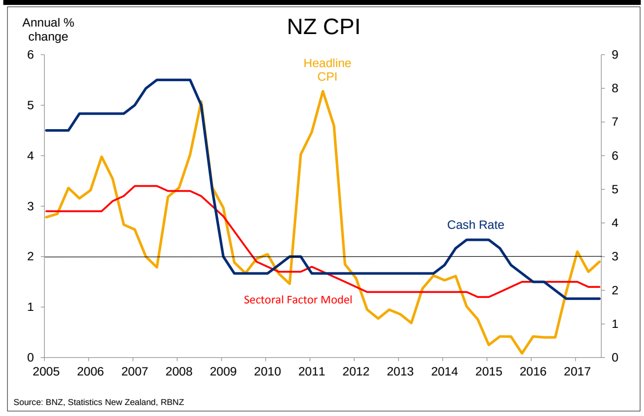

this says nothing about the appropriateness, or otherwise, of maintaining current settings.

History shows us that the Bank has been willing to shift policy, sometimes aggressively, even when core inflation has deviated substantively from its target:

- interest rates were slashed in 2008 and 2009 even as core inflation held up;
- the cash rate was increased in 2010 and 2014/15 when core inflation was below target; and
- the cash rate was progressively reduced through 2015 and 2016 even as the sectoral factor model showed no change in inflation.

Indeed the cash rate has ranged between 1.75% and 3.50% during a period when the sectoral factor model of inflation has been in a very tight range of 1.2 to 1.5%.

### Inflation forecasts drive cash rate



One could argue that with core inflation moderating to 1.4% the balance of risk has shifted toward a rate cut. We don't see it that way. Indeed, this is where the headline rate comes in. We believe that the tightness in wage pressure is beginning to finally reveal itself in wage negotiations. Recently, we have had far more enquiry about current and prospective inflation by those involved in wage setting processes than has routinely been the case. Accordingly, we can only assume that rising headline inflation will start to feed through into wages. To the extent that this impacts demand and/or restricts corporate margins it could well add to future CPI inflation. (As an aside, we are also hearing anecdotes about some businesses contemplating paying Auckland allowances to compensate for the increased cost of living in that city.)

In a similar vein, falling headline inflation across 2014 drove inflation expectations lower and generated a RBNZ response.

More generally, we quite like the idea of the sectoral factor model as it does provide a stable view of the general movement in prices and should help prevent knee-jerk reactions from policy makers. On the other hand, it is difficult to replicate, even more difficult to forecast and, conceptually, very difficult to "sell" to the wider population.

Be that as it may, it is central to the RBNZ's thinking but, we reiterate, it is not the be all and end all in its decision making process. Treat its message with importance but with equal amounts of caution.

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