RESEARCH

ECONOMY WATCH

17 July 2018

Inflation Provides No Drama

- **Annual inflation lifts to 1.5%**
- **Core measures robust**
- **Defies market fears of downside shock**
- **No change to RBNZ outlook**

There was more than usual interest in this morning's Q2 CPI figures. Markets were cagey, sensing the possibility of a downside shock. In the event, there was no such drama. Sure, the 0.4% q/q and 1.5% y/y inflation rates were a tick under market expectations but not materially so given the general fear of something softer. With downside nervousness prevalent, it wasn't a surprise then to see the NZD and short term wholesale interest rates edge marginally higher in relief post-release (as we contemplated in yesterday's Markets Outlook). Ultimately this disappointed a market looking to price in more chance of an OCR cut.

We were also more wary of undershoot to our forecast of 0.6% q/q than an overshoot, so weren't too surprised by today's outcome. In the detail, the transport group rose by less than we expected weighed down by lower vehicle prices (perhaps some unwind from Q1's lift on supply disruption associated with stink-bugs on car-carrying ships), lower than expected domestic airfares, and fuel prices not rising as much as we anticipated (on more discounts than in Q1).

This saw tradeable prices remaining subdued overall, rising 0.3% in the quarter to be up a mere 0.1% on a year ago. We anticipate some pick up ahead as the effects of a lower NZD filter through.

A lower starting point (and a material drop in oil prices over the past week, including another plunge overnight) sees us nudge down our near term annual inflation forecasts. That said, our broad story of annual inflation nudging above 2% over the coming year remains as capacity constraints continue to press and a softer NZD supports tradeable prices (assuming oil prices don't extend their recent decline).

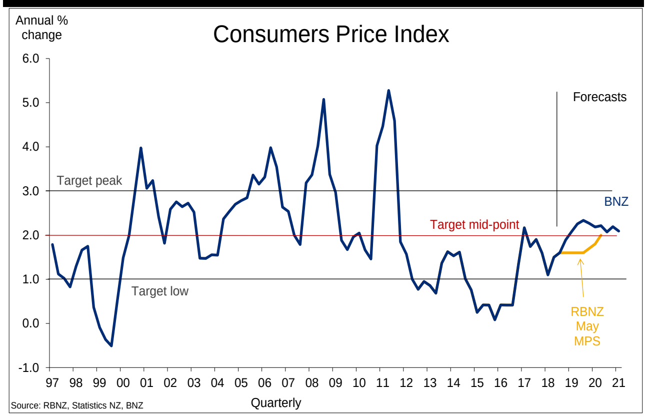
Indeed, our central view of accumulating underlying inflationary pressures was supported by the details in today's data. Various measures of core inflation pushed higher, including:

- 10% trimmed mean up 0.4% q/q, lifting its annual rate to 1.8% from 1.4%
- Weighted median up 0.6% q/q, lifting its annual rate to 2.3% from 2.2%
- Non-tradeable prices up 0.4% q/q, lifting its annual rate to 2.5% from 2.3%.

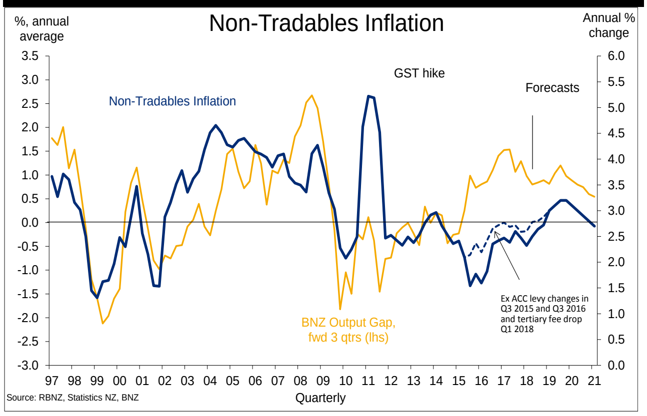
Not quite so supportive of a rising underlying inflation story was CPI excluding food and energy that was flat in the quarter, but even this was enough to see its annual rate push up to 1.1% from 0.9% a quarter ago. All eyes now turn to the RBNZ's sectoral factor models of inflation, due from 3pm this afternoon, to see if this confirms the message of firming core inflation.

All this suggests no change to the outlook for RBNZ monetary policy. This should be of no great revelation given the CPI exactly matched the central bank's forecast. But one could argue that this actually represents a degree

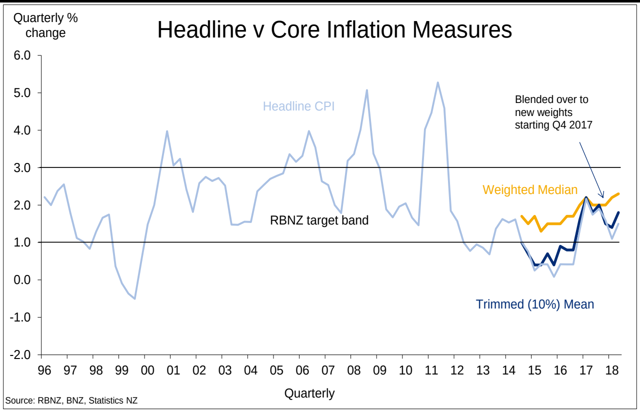
Outlook Vulnerable If Oil Prices Extend Recent Decline



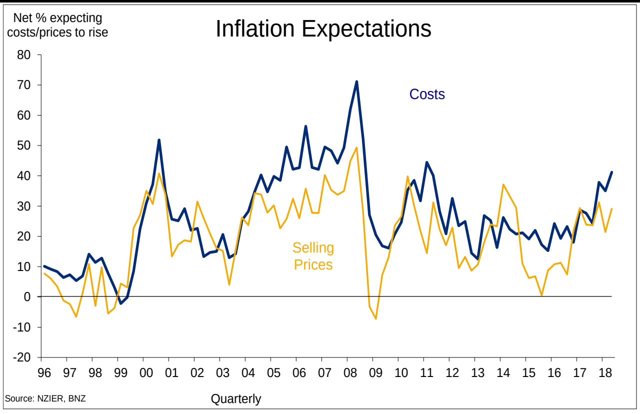
Edging Higher



Strengthening Core



Cost Pressures Rising



of undershoot to the central bank's latest thoughts, given its forecasts were put together before a surge in fuel prices late in Q2. Even if this was the case, important from a monetary policy point of view is the fact that non-tradeables inflation came in a touch higher than the Bank anticipated. This is inflation of the domestic and more durable kind running a touch hotter than expected. It counsels against a rate cut, as does the unemployment rate running below the Bank's estimate of NAIRU. Also, a push higher in headline inflation is more likely to lift inflation expectations than not.

In any case, more important is the outlook given the lags involved. That is where the economy's current capacity pressures are important and worth watching going forward. At this point, these are putting upward pressure on costs including wages. The latter is positive for consumers but a challenge for business as margins come under downwards pressure. Upcoming labour market data will be important to monitor in this regard. Higher wage inflation, without accompanying productivity gains, is synonymous with slower growth and rising inflation. It is precisely this scenario that the latest Quarterly Survey of Business Opinion suggested is getting underway.

A 2% q/q lift in alcoholic beverage prices this quarter is noteworthy in this regard. This is the strongest quarterly price jump in this category since 2009. It is possible this reflects the hike in the minimum wage on 1 April. If so, further increases are likely over coming years as the minimum wage is set to rise further.

Housing related prices underpinned inflation this quarter. Prices in the housing group rose 0.9% q/q, maintain annual inflation at 3.1% y/y. Rents rose 0.8% q/q taking annual inflation to 2.5%, its equal highest rate since 2008. House construction costs rose in the quarter, albeit driven by the regions rather than the main centres (in a similar pattern to existing house price inflation rates that we saw in this morning's REINZ data for June). We expect these broad trends to continue.

Other notable price changes included ongoing upward pressure on insurance premiums (up 1.3% q/q), a bigger-than-usual 7.6% q/q decline in audio-visual and computing, and a 1.9% decline in recreation and culture services (related to recent changes in SkyTV pricing).

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