18 July 2017

Zero inflation

- Flat CPI in Q2 and soft core measures as well
- Headline inflation likely to head lower over the coming year
- A rise in non-tradeables inflation requires higher wage inflation
- Inflation to track below RBNZ's last projections
- So no hurry to remove policy accommodation or even give a nod along those lines

Consumers Price Index - 2017 Q2				
	Actual	Mkt Pick	May MPS	Q1
CPI - qtly % chg	**0.0**	+0.2	+0.3	**+1.0**
CPI - ann % chg	**+1.7**	+1.9	+2.1	**+2.2**

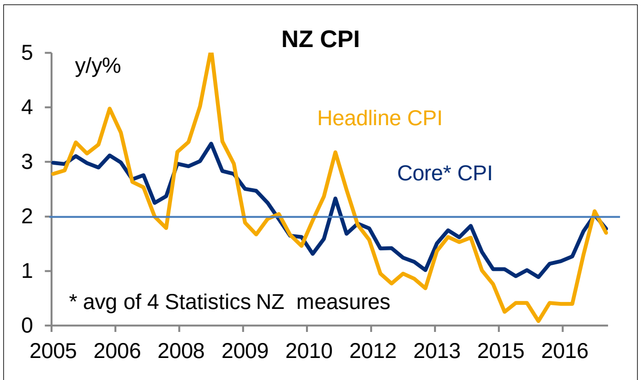
Breaking a run of positive surprises, NZ inflation surprised to the downside, with a flat result for the quarter, below the market consensus of 0.2% and BNZ's pick of 0.1%. There weren't any obvious unexplained forces in the result, with the small miss relative to our expectations representing cumulative undershooting across a range of sub-groups.

The biggest driver of inflation for the quarter came from the housing and household utilities group, a sector that has been running above general inflation for the past seven years, so no surprise there. Food prices made a larger than usual contribution, reflecting the recent poor growing conditions. Apart from that there was scant sign of any inflationary pressure.

There was a soft underbelly to the result, with a weak seasonally adjusted figure, coming in at minus 0.1% q/q.

Core inflation measures showed some slippage, reversing course after a clear upward trend over the past year (see first chart). The four key Statistics NZ measures of core inflation we track all showed weaker quarterly and annual inflation, with trimmed mean estimates (10% trim and 30% trim) of 0.0-0.1% for the quarter, a weighted median of 0.1% and CPI ex food and energy at minus 0.2%. The average of these four measures showed annual inflation dropping from 2.0% to 1.8%. The RBNZ's preferred sectoral factor measure of core inflation will be released later this afternoon. Nothing in the breakdown we see is likely to nudge it higher, after being static at 1.5% for the past eighteen months.

Annual CPI Measures Slip Back Below 2%



Source: BNZ, Bloomberg (ex 2011 GST spike)

After spending much of the past year on an upward trajectory, headline CPI inflation is looking like spending the best part of the coming year on a downward trajectory. The flat Q2 result was the first instalment, taking annual inflation down to 1.7%, down from the 2.2% annual increase in Q1. We project that by the March 2018 quarter, annual inflation will have fallen all the way back down to around the 1% mark.

That CPI profile largely reflects the volatile behaviour of oil prices. On quarterly average data, WTI crude in NZD terms rose by 45% y/y% in the March 2017 quarter. If oil prices and the NZD stabilise at their current level, then WTI crude in NZD terms would be down 14% y/y by the March 2018 quarter. The Tradeables CPI rose by 0.9% y/y in the June quarter, but that was a rare increase. Over the coming year, annual inflation for that sector looks like heading back into negative territory.

Non-tradeables CPI inflation has been held back by particularly soft wage inflation. The annual increase of 2.4% is about a full percentage point below where it "should" be if its historical relationship with capacity pressures was in play (see last chart overleaf).

A breakdown in the usual relationship between tight labour markets and wages is a current global phenomenon, not confined to NZ. Global structural forces, demographics and technology have all been pointed as possible factors behind this trend. In NZ's case we can add strong net immigration as a possible factor weighing on wage inflation. Particularly low headline inflation through 2016 also held back cost-of-living wage adjustments.

Against a backdrop of low wage inflation, domestically driven inflationary pressure has been largely absent outside of the housing market, despite increasing signs of capacity pressures in the economy. The key question is for how long can the wedge between (low) inflation and capacity pressures continue? The US faces the same question.

We stick with our broad view that non-tradeables inflation will ultimately increase as wage inflation eventually picks up. Certainly, we are hearing anecdotal evidence of higher wage inflation that various businesses are facing. The recent significant government settlement for rest home workers should ultimately feed into higher wage inflation elsewhere. And higher inflation expectations, after their weak run until recently, add to chance of higher actual inflation as well.

That said, with tradeables inflation set to weaken, CPI inflation is more likely to fall than rise from here.

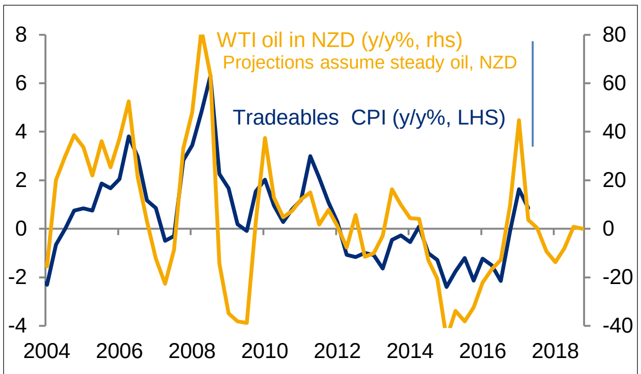
The RBNZ's May Monetary Policy Statement already showed a weak track for inflation over the coming year. And that assumed oil prices a lot higher than they currently sit and an NZD a lot softer. The RBNZ's 0.3% pick for the June quarter didn't have the benefit of seeing the late-Q2 plunge in oil prices. But today's result still likely surprised the Bank to the downside.

When the RBNZ comes to revise its inflation projections next month, it is going to be looking at a much weaker track, as it builds in a lower oil price track and a higher NZD track. Also, one of the few recent areas of higher inflationary pressure – the housing market – looks to be a weaker contributor to overall inflation in the period ahead.

The weight of evidence therefore supports the RBNZ's view that monetary policy "will remain accommodative for a considerable period". There is nothing to suggest the Bank will hint of less policy accommodation ahead as other central banks have done so recently. This helps anchor the short end of the curve around current levels and at least from a relative monetary policy perspective the Bank's stance won't be lending any support to the NZD.

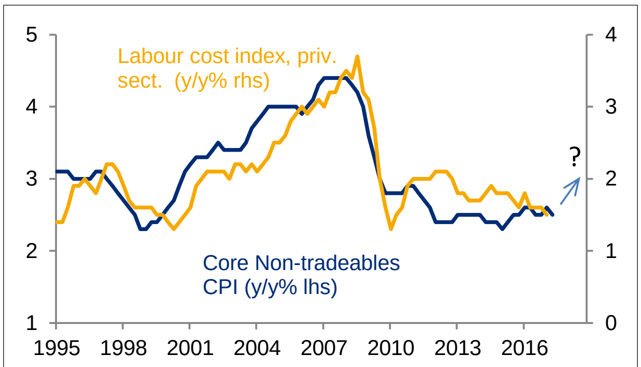
jason.k.wong@bnz.co.nz

Tradeables CPI Softer Ahead If Oil, NZD Remain Steady



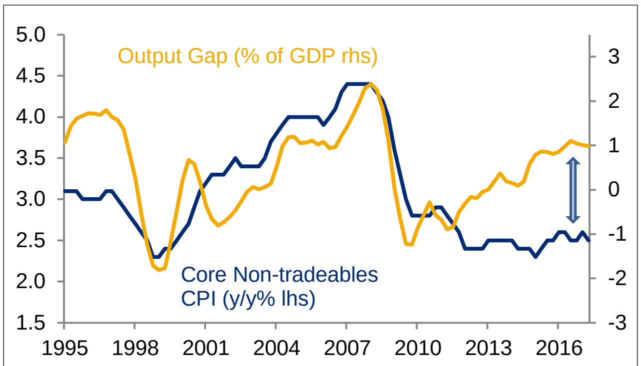
Source: BNZ, Bloomberg

Non-Tradeables CPI Weighed Down by Weak Wages



Source: Statistics NZ, RBNZ

Inflation Unresponsive to Rising Capacity Pressures



Source: Statistics NZ, RBNZ

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Senior Market Strategist
+(64 4) 924 7652

Main Offices

Wellington
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891