2.0% CPI inflation Won’t Deter RBNZ Doves

- Q3 CPI 0.7%, 1.5% for the year
- Annual non-tradables inflation bursts through 3.0%
- Both significantly higher than RBNZ expectations
- But RBNZ will be spooked by weak leading indicators
- OCR cut(s) still on the table

The big question that hangs in the air after today’s CPI release is: what will it take for the RBNZ to concede that inflation is near enough to target for it to relax a tad? Sure, the annual increase in the CPI (as reported today) is a mere 1.5% but this is likely to be the lowest annual reading witnessed for some time. And more to the point, the portion of inflation that most reflects domestic demand conditions (non-tradables) has soared through 3.0%.

It is also worth noting that the September quarter outcome of 0.7% was 0.2% above the RBNZ’s August MPS pick. Even more importantly, we think the Q4 CPI outcome will “surprise” by at least as much again. Our initial pick for Q4 is 0.5%, compared with the 0.2% penciled in by the Bank. If we are right then the annual reading for calendar 2019 will be 1.9% against the RBNZ’s 1.4%. To be fair to the RBNZ, we forecast in real time whereas the Bank’s forecasts are published with quarterly breaks. Consequently, their forecasts will probably not include recent increases in food and petrol prices or the weaker NZD. That said, we suspect the RBNZ will look through some of these factors anyway as being transitory. Be that as it may, if the headline CPI reading moves towards 2.0% then it would be reasonable to assume that inflation expectations shift in that direction too, in so doing fulfilling one of the Reserve Bank’s “requirements”. In this regard, we note that our forecasts see annual inflation climbing to 2.2% in the March quarter 2020.

Non-tradables inflation accelerating

We continue to highlight the fact that tradables inflation is holding CPI inflation at low levels and that this is due to weak global prices, particularly for manufactured and technology goods. Indicative of this, tradables inflation for the quarter was just 0.1% delivering an annual reading of -0.7%. It remains our view that this should be of no concern. In fact weak imported inflation provides a windfall gain to New Zealanders.

What is of concern to us is that non-tradables inflation is accelerating reflecting the lack of capacity in the domestic economy. Non-tradables inflation was 1.1% in the quarter to be 3.2% for the year – well above the RBNZ’s 2.7% expectation. There were a number of one-offs that contributed to the quarterly increase but these only explain 0.1 to 0.2% of the difference.

And to put the 3.2% annual increase in perspective, if you exclude the GST hike in late 2010, it was the fastest pace of annual inflation in this category since Q2 2009. We continue to question the wisdom of pushing on capacity any further in a bid to generate even more inflation in this space.

So will today’s outcome be enough to prevent the RBNZ from cutting rates again? No. We will stick to our view that a further 0.25% rate cut will be delivered in November and that the RBNZ will maintain an easing bias at that time. At the margin it may slightly rebalance the weights towards neutrality but only modestly.

In August the RBNZ slashed rates because it feared that growth would eventually fall sufficiently below potential to generate a higher unemployment rate and decreasing inflationary pressure. While today’s inflation number may be an upside surprise, we suspect that leading indicators are portending a potentially much greater downside surprise to the RBNZ’s growth projections. We are forecasting growth averaging 2.1% per annum for the two years ended March 2022. The RBNZ’s last set of forecasts assumed growth nearing 2.9% per annum over the same period. And the leading indicators suggest 1.5% might be a better bet.

Our suspicions on this front were lent further support by the RBNZ’s Deputy Governor, Geoff Bascand, who was reported as telling an audience in Sydney today that...
there is a “reasonable prospect” that the OCR goes lower. He may not have seen all the CPI details at the time but the message as to the Bank’s intent was clear.

Inflation’s upside surprises

But growth goes t’other way

stephen_toplis@bnz.co.nz