Research

Economy Watch

17 October 2023

CPI confirms RBNZ on hold

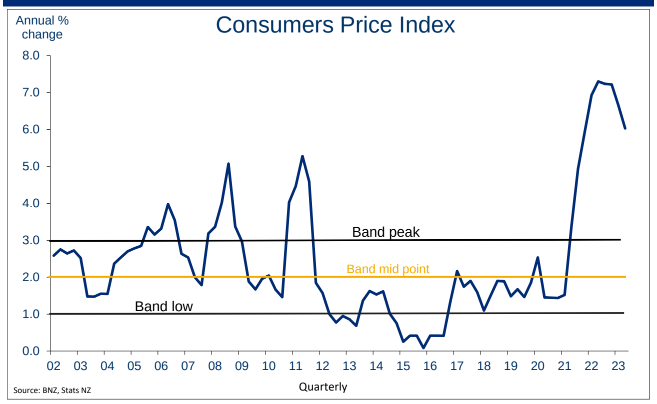
- **Annual CPI 5.6%, RBNZ was at 6.0%**
- **Non-tradables inflation well behaved**
- **But will remain sticky**
- **Strong signs monetary policy biting**
- **Talk of November rate hike fades**

Today's CPI outturn should extinguish any talk the RBNZ might contemplate raising its cash rate when it delivers its November 29 Monetary Policy Statement. The third quarter headline inflation reading of 1.8% was well below the RBNZ's pick of 2.1%. This at a time when the labour market is easing aggressively, and economic activity is under extreme pressure.

We have long said the cash rate would peak at 5.5% though we acknowledged there was some upside risk. That risk has diminished markedly. Equally, the risk the RBNZ might end up easing earlier than it has projected rises.

On an annual basis, headline CPI inflation has fallen to 5.6% from 6.0%. Not only is this 0.4% below the RBNZ's expectation but it continues to paint a picture of rapidly falling inflation. This will help cement in declining inflation expectations which are just as important to the Bank as the published inflation measure.

On track

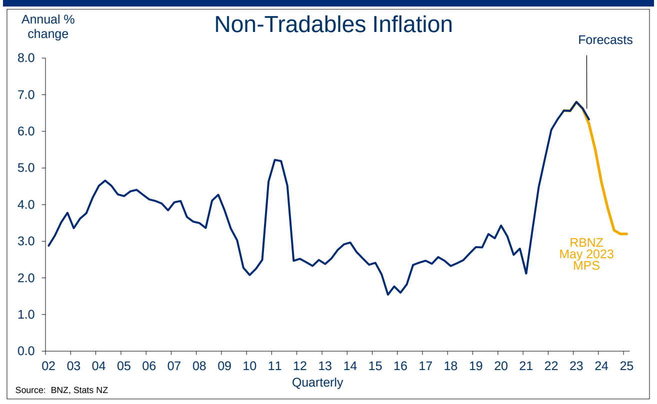


We should note that 0.2% of the RBNZ's "miss" might be attributed to the CPI reweight that was part of today's data. But that doesn't matter because the RBNZ still targets the headline CPI as published. And those forecasting this outturn should have been aware of this change, which was announced recently, so it should already have been included in expectations that were generally higher than the outturn.

We had feared that non-tradables inflation would surprise the RBNZ to the upside and that it might get unnerved by this. As it happens the RBNZ forecast a 1.7% increase and that's what it printed. At an annual 6.3% non-tradables inflation is still uncomfortably high and its just 0.5% down from its 6.8% peak six months earlier.

We forecast non-tradables inflation will trend lower but there are a number of factors that will remain problematic for some time to come such as: rates, rent, insurance and the flow on effects of past wage increases. The impact of these was clear to see in today's outturn.

Non-tradables behaving



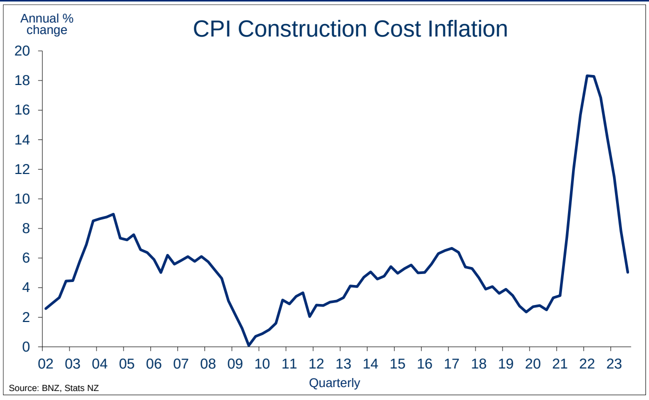
The cost of restaurant meals, impacted by all the above, rose another 1.7% for the quarter to be up 8.9% for the year. Household rates rose 9.4% for the quarter (and year) – a record high. Insurance costs rose 3.3% for the quarter, 9.6% for the year – also a record high. Household rents rose 1.2% for the quarter, 4.4% for the year.

It should be noted, however, that there is not much that the RBNZ can do about these factors. It can't stop local government from hiking rates, it can't prevent climate change and natural disasters from impacting insurance and rates. And it can do little to improve the supply of rental accommodation. Ironically, tight monetary policy might impede this.

Where we have seen monetary policy at work is through the retail sector where prices are clearly under pressure as demand wilts, inventories build and supply chains ease. There were outright declines in the quarter for the prices of footwear, furniture, furnishings and flooring, household textiles, household appliances, and glassware, tableware and household utensils.

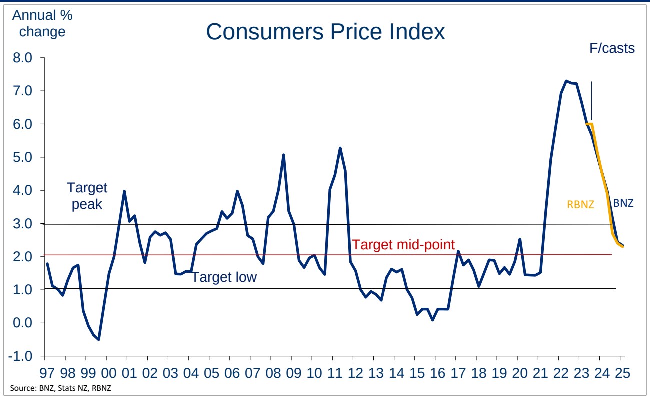
Note the preponderance of interest rate and housing sensitive goods in the retail list. As for housing specifically, there are clear indications that construction cost inflation is fading rapidly. The costs of home ownership rose just 0.6% in the quarter to be 5.0% up on year earlier levels. Average annual growth in this component is 5.5% so this is a genuinely low number which is set to go even lower still.

Monetary policy bites



We will now go through the CPI components with a fine tooth comb to see if we need to adjust anything in light of these data. Assuming we don't, our current pick for Q4 inflation of 0.9% would see annual inflation fall to 5.1%. By December 2024 inflation is expected to be well within the RBNZ's target band.

On track



Monetary policy is set with inflation roughly 18 months ahead in mind. With inflation behaving at least as well as the RBNZ has forecast it should see no reason to raise rates further. And don't forget that the 25 basis point increase back in May already had some insurance built into it, and the Reserve Bank has been basing its recent statements on the assumption that there was some near-term upside risk to its inflation outcomes. The Bank will not yet be in any greater hurry to lower rates but it will certainly be feeling very relaxed that its game plan is working.

Not surprisingly, interest rates fell today. The perceived chance of a rate hike in November dropped from around 34% to 10% and the chance of any further rate hike dropped from around 84% to 40%. A first rate cut is now priced in for February 2025, a few months earlier than previously. This now matches the timing of the RBNZ's first cut but we continue to think it will be earlier than this, maybe as early as mid-2024. Reflecting the lower interest rate expectations the NZD dropped around 30 basis points to 59 US cents.

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