Research

Economy Watch

18 January 2024

Inflation decline accelerating

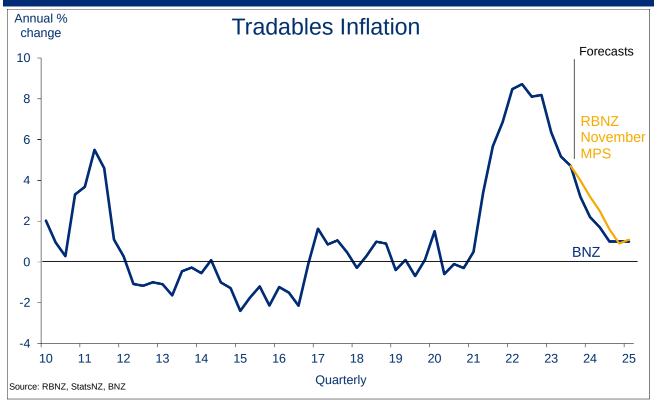
- **We pick 0.5% for Q4 CPI**
- **Non-tradables still too high for RBNZ**
- **But should it really be so concerned?**
- **We lower our Q1 CPI forecast**
- **Back into the target band before too long**

Our expectations for next week's Q4 Consumer Price Index are unchanged following the release today of December month selected price indexes by Statistics New Zealand. There were the usual unders and overs in the outcomes relative to our forecasts but, on balance, nothing to change our view of a 0.5% quarterly increase for the quarter, delivering a 4.7% annual movement.

As we have noted previously, if we are right the quarterly outturn will be 0.3% below the RBNZ's 0.8% pick. This is a meaningful difference. Those unaware of the idiosyncrasies of the Reserve Bank of New Zealand might easily conclude that such a difference would have our central bank moving towards a more dovish tilt. But, following the downside surprise to the Q3 CPI, the RBNZ played down the outcome because it was driven by inflation declines in the tradables sector.

It will be no different this time around. Our tradables/non tradables breakdown has been adjusted slightly in light of today's data but it's still tradables doing most of the work in getting headline inflation down. We are looking for tradables prices to fall 0.1% in the quarter. This is miles away from the RBNZ's November MPS forecast of 0.7%. In contrast, we think non-tradables inflation will be 0.1% higher than the RBNZ's 1.0% projection.

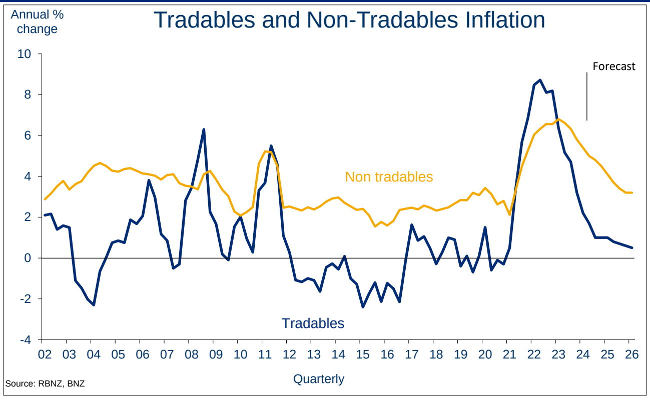
All about tradables



In short, don't expect the Q4 outturn to have the RBNZ rushing to lower rates. Indeed, we wouldn't be surprised if we get some push back from the Bank when Chief Economist Paul Conway delivers his January 30 speech.

We continue to question the value of the non-tradables\tradables split. We think the difference between the two is too blurred in many instances. Even in the non-tradables sector, tradables prices can have a substantial impact on non-tradables prices. Moreover, a significant proportion of non-tradables prices are unrelated to the domestic demand conditions that the RBNZ can influence. And here's an interesting stat for you, since the beginning of the century non-tradables inflation has averaged 3.4% while tradables has averaged just 1.4%. Surely there must be some acceptance that non tradables will tend to remain stickily high?

Non-tradables always a worry

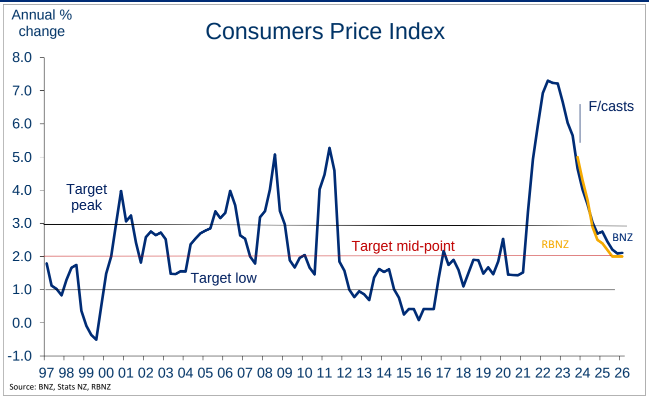


Now we are not arguing that the RBNZ should ignore the price pressures from this sector, nor are we suggesting it should be comfortable with inflation at current lofty levels, but we do believe it should focus less on non-tradables. As an aside, we don't see many central banks around the planet talking about the importance of this split. Indeed, we can't think of any that have made much of it in the recent past.

We are, however, very much believers in the importance of core inflation in its various guises and are keen to see what comes of these measures when the data are published next week.

While the December month data has not changed our view of this quarter's CPI it has, nonetheless, caused us to revise down our forecasts for Q1. That's because the starting point for the quarter is lower than we had anticipated albeit not enough to move the dial for Q4. We are thus lowering our Q1 CPI forecast to 0.6% (from 0.9%) which drops the annual to 4.0%. This does not meaningfully change our medium-term view but does increase the chances that annual inflation will be back within the target band before the end of this year.

Target here we come!



So far this year's data have been on the soggy side in terms of economic activity and is broadly suggestive of a lower headline inflation profile than was previously the case. The good news is that this should be sufficient to stop the Reserve Bank from hiking rates at its February meeting but, given the way that it appears to be interpreting the data at the moment it seems unlikely the Bank will want to condone in any way the almost 100 basis points of rate cuts currently priced in by the market for the remainder of this year.

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