

NEW ZEALAND ECONOMICS DATA REVIEW

CONSUMERS PRICE INDEX – JUNE 2011 QUARTER

18 July 2011

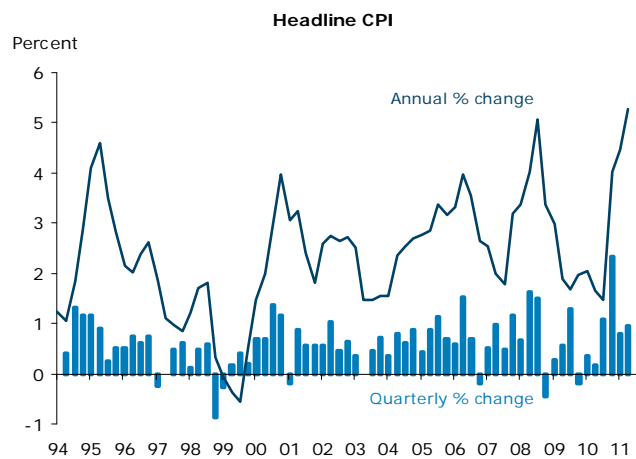
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INFLATION SURPRISE UPS THE RISK OF AN EARLIER RATE HIKE

- **The stronger than expected 1.0 percent increase in the Q2 CPI leave us in no doubt that the 2.5 percent OCR emergency setting is on borrowed time.**
- **The various core measures were mixed, ranging from 0.5 percent to 0.9 percent.** But the fact is that with a headline inflation rate of 5.3 percent (and even with GST excluded it is above the top of the RBNZ's target band at 3.3 percent) and growth momentum picking up (from a stronger base), the risks to the inflation outlook are skewed to the upside.
- **There is no room for the RBNZ to absorb any more upside surprises to inflation, or its medium term drivers.** With inflation expectations already at elevated levels, and recent evidence pointing to less spare capacity in the economy than initially thought, we struggle to see how the RBNZ's June *Monetary Policy Statement* projections of inflation heading towards 2 percent by early next year can be achieved.
- **As such, a 2.5 percent OCR is looking increasingly inconsistent with the inflation outlook.** We are not overly hawkish on the outlook for monetary policy, and acknowledge that the global situation remains challenging. But the recent run of data confirms that the economic recovery in New Zealand is on track, with inflation pressures starting to emerge earlier than expected.
- **Our central view is for a December hike. But an earlier move cannot be ruled out. Indeed, strong upside surprise to upcoming labour market data and inflation expectations survey could well see a September hike becoming our central case.**



Sources: ANZ, National Bank, Statistics NZ

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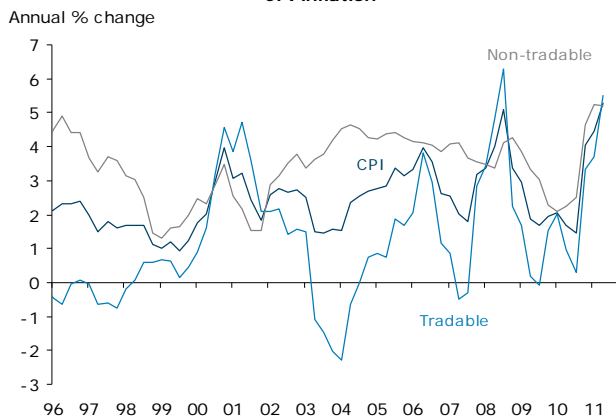
DATA WRAP

The Consumers Price Index (CPI) rose by 1.0 percent in Q2 2011, taking the annual rate of headline inflation to 5.3 percent. The annual rate is the highest since the 7.6 percent increase recorded in Q2 1990, which included the rise in GST from 10 to 12.5 percent on 1 July 1989. The increase in the CPI was higher than market expectations for a 0.8 percent quarterly increase, and the RBNZ's June *Monetary Policy Statement* forecast of 0.7 percent.

Half of the increase in the CPI during the quarter was driven by higher prices for food (up 1.1 percent in the quarter), petrol (up 4 percent) and electricity (up 2.7 percent) – all essential everyday items. Other strong upward contributions came from higher domestic and international airfares.

	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Dec-08	-0.5	3.4	-2.1	2.8	0.8	3.5
Mar-09	0.3	3.4	-0.4	3.4	0.7	3.5
Jun-09	0.6	4.0	0.8	4.8	0.5	3.4
Sep-09	1.3	5.1	1.6	6.3	1.0	4.1
Dec-09	-0.2	3.4	-0.5	2.3	0.1	4.3
Mar-10	0.4	3.0	0.1	1.7	0.5	3.8
Jun-10	0.2	1.9	-0.3	0.2	0.6	3.3
Sep-10	1.1	1.7	0.9	-0.1	1.2	3.0
Dec-10	2.3	2.0	2.5	1.5	2.2	2.3
Mar-11	0.8	2.0	0.5	2.0	1.1	2.1
Jun-11	1.0	1.7	1.5	1.0	0.6	2.2
ANZ	0.8	5.1	0.8	4.8	0.8	5.5
RBNZ	0.7	5.0	-	-	-	-
Market	0.8	5.1	-	-	-	-

CPI inflation



Sources: ANZ, National Bank, Statistics NZ

Looking across the range of price changes, most of the upside surprise in the CPI relative to our expectations came from the higher airfares, and less retail discounting than we had factored in.

While prices for whiteware (-0.6 percent) and audio-visual & computing equipment (-2.2 percent) continue to fall, other retail related prices recorded stronger increases. Winter related products, which were not included in the CPI in the last two quarters but are included in Q2 (which is how Statistics NZ treats seasonal items), have seen their prices pushed higher by the GST increase.

On balance though, we detect signs that the aggressive retail discounting of the past year that has helped to hold tradable inflation lower is coming to an end. Given the strong NZ dollar, we could see further passthrough into retail prices to come. But we suspect that with retail margins already wafer thin, any passthrough from the currency will be slower in coming, as firms seek to rebuild margins.

The impact of the Christchurch earthquake was apparent in the prices for the purchase of new housing, which rose 0.9 percent in the quarter. According to Statistics NZ, the increase was influenced by rises for Canterbury and the rest of the South Island. As the earthquake rebuilding effort eventually gets going, this will only add further upward pressure on this component. We also know that higher premiums for house and contents insurance are looming. These have not been evident in today's CPI number (dwellings insurance up 0.2 percent and contents up 0.4 percent) but we know they are coming.

Another area worth watching is rents, which rose by 0.5 percent in Q2, driven by rises in Auckland. With housing shortages in Auckland set to become worse given the low number of consent issuance, further rental inflation look to be in the pipeline.

The price level data also provided disconcerting signs. The distribution of item-level movements shows that the number of items that rose in price (363 versus 340 in Q1), and the percentage of the CPI they make up (66 versus 59 percent) increased. Downside price movements were fewer. This will be concerning for the RBNZ. As mentioned earlier, evidence of ongoing retail discounting were not as prevalent as we had expected. This implies suppressing factors are easing while inflating factors are rising. And this is before the recovery has really gotten underway.

The various core measures of inflation are mixed. Non-tradable CPI increased by 0.6 percent in the quarter, in line with our inflation gauge which was pointing towards 0.5 percent. The weighted median was 0.5 percent while the trimmed mean

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was strong at 0.9 percent for the second quarter running.

We will be paying close attention to the RBNZ's structural factor model of core inflation, which is due to be released on their website later this afternoon. In the June *Monetary Policy Statement*, the RBNZ noted that this core inflation measure (which excludes the GST impact) rose above 2 percent in Q4 2010 and Q1 2011, with the last reading at 2.3 percent. A further increase in this measure will not be welcomed by the RBNZ.

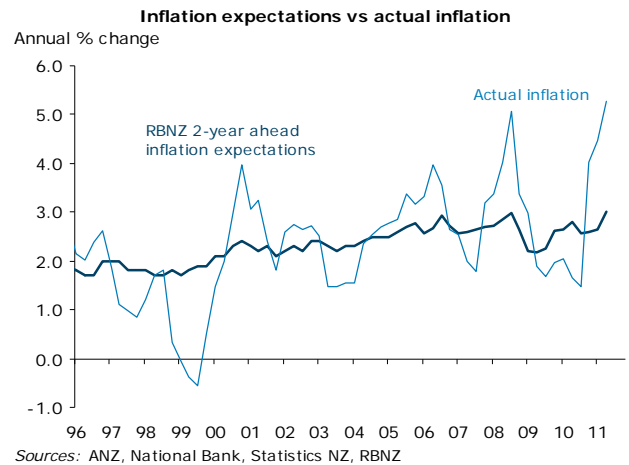
ASSESSMENT

Today's CPI report in itself is not a show stopper. The headline number was stronger, but the core measures are mixed, ranging from 0.5 to 0.9 percent for quarterly movements. However, for annual readings, collectively the core measures are clearly running above 2 percent. If we exclude GST from the headline rate, inflation is still above the top of the RBNZ's target band at 3.3 percent. Even if we were to strip out the tobacco tax increases, fuel excise increase and impact of the Emissions Trading Scheme, underlying inflation would still come in at 2.8 percent.

	Underlying CPI		One-off	Headline CPI		Notes
	QoQ	YoY		QoQ	YoY	
Mar-10	0.4	2.0		0.4	2.0	
Jun-10	0.0	1.5	0.2	0.2	1.7	Tobacco tax increase
Sep-10	0.9	1.0	0.2	1.1	1.5	ETS round 1
Dec-10	0.3	1.6	2.0	2.3	4.0	GST rise and fuel excise
Mar-11	0.6	1.8	0.2	0.8	4.5	Tobacco tax increase
Jun-11	1.0	2.8		1.0	5.3	

There is no room for the RBNZ to absorb any more upside surprises to inflation, or its medium term drivers. With inflation expectations already at elevated levels, and recent evidence pointing to less spare capacity in the economy than initially thought, we struggle to see how the RBNZ's June *Monetary Policy Statement* projections of inflation heading towards 2 percent by early next year can be achieved.

A major consideration for the RBNZ will be the extent to which the near-term spike in headline inflation and higher commodity prices affect wage and price setting behaviour. The June *Monetary Policy Statement* made the explicit assumption that "recent increases in surveyed inflation expectations will be short-lived". Our research suggests that surveyed measures of inflation expectations are unlikely to retreat as quickly as the RBNZ asserts.



As such, a 2.5 percent OCR is looking increasingly inconsistent with the inflation outlook, and we believe is on borrowed time.

We are not overly hawkish on the outlook for monetary policy, and acknowledge that the global situation remains challenging. But the recent run of data confirms that the economic recovery in New Zealand is on track, with inflation pressures starting to emerge earlier than expected.

Our central view is for a December hike. But an earlier move cannot be ruled out. Indeed, strong upside surprise to upcoming labour market data and inflation expectations survey could well see a September hike becoming our central case.

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