ANZ RESEARCH

NEW ZEALAND ECONOMICS

2011Q4 Consumers Price Index Preview

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NZ ECONOMICS TEAM

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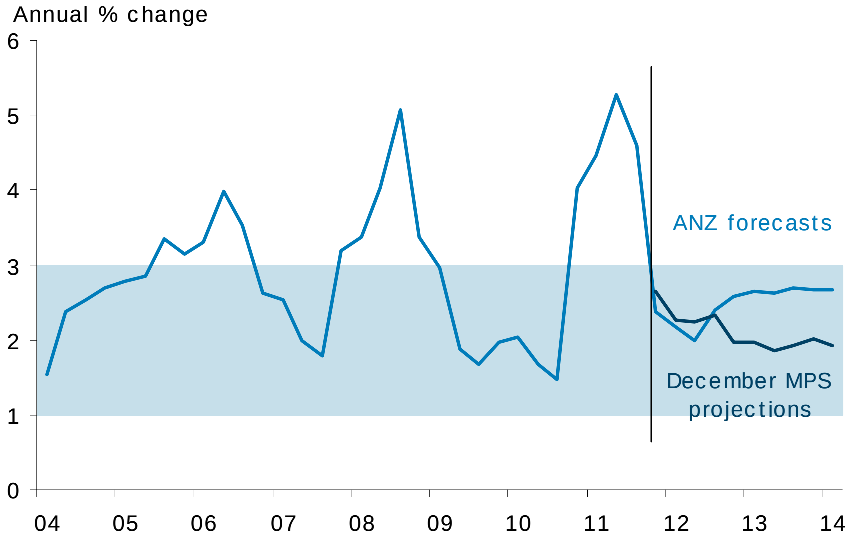
BENIGN INFLATION OFF THE RADAR

KEY POINTS

- We expect a 0.2 percent quarterly increase in Q4 CPI, which is below the median market and December *MPS* pick (both 0.4 percent). We base our forecast on evidence of slowing increases in quarterly non-tradable prices, coupled with a large fall in food prices.
- The risks around our 0.2 percent pick are broadly balanced.
- As GST drops out of the equation, annual headline inflation will move comfortably back into the RBNZ's target range, enabling OCR moves to be determined by other considerations.
- We expect quarterly Q4 core inflation measures to range from 0.3 to 0.6 percent. Inflation expectations are elevated but falling, though we do not expect them to fall as quickly as the RBNZ does.
- The hurdle for a RBNZ move in either direction remains high. Over the next 12 to 18 months there are upside inflation risks from a combination of cost, demand, and inflation expectations angles. Barring global meltdown, the next move in the OCR will be up. However, this might not be for some time. While we are not quite as sanguine on the long-term inflation outlook as the RBNZ, inflation is currently not looking a threat. The RBNZ's current focus on offshore risks remains appropriate.

CPI inflation



Sources: ANZ, National Bank, Statistics NZ, RBNZ

2011Q4 CPI PREVIEW

CONSUMERS PRICE INDEX – DECEMBER 2011 QUARTER

(Due Thursday 19 January, 10.45am)

	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-08	0.7	3.4	0.2	3.4	1.1	3.5
Jun-08	1.6	4.0	2.3	4.8	0.9	3.4
Sep-08	1.5	5.1	1.9	6.3	1.3	4.1
Dec-08	-0.5	3.4	-2.1	2.3	0.8	4.3
Mar-09	0.3	3.0	-0.4	1.7	0.7	3.8
Jun-09	0.6	1.9	0.8	0.2	0.5	3.3
Sep-09	1.3	1.7	1.6	-0.1	1.0	3.0
Dec-09	-0.2	2.0	-0.5	1.5	0.1	2.3
Mar-10	0.4	2.0	0.1	2.0	0.5	2.1
Jun-10	0.2	1.7	-0.3	1.0	0.3	2.2
Sep-10	1.1	1.5	0.9	0.3	0.9	2.5
Dec-10	2.3	4.0	2.5	3.3	0.3	4.6
Mar-11	0.8	4.5	0.5	3.7	0.7	5.2
Jun-11	1.0	5.3	1.5	5.5	0.6	5.2
Sep-11	0.4	4.6	0.1	4.6	0.6	4.5
ANZ	**0.2**	**2.4**	**-0.2**	**1.8**	**0.5**	**2.8**
Market	**0.4**	**2.6**	–	–	–	–
RBNZ	**0.4**	**2.6**	–	–	–	–

We expect a 0.2 percent quarterly increase in the Q4 CPI index, taking annual CPI inflation to 2.4 percent. This compares with a 0.4 percent increase forecast in the December *MPS* (2.6 percent y/y). The sharp drop in annual inflation is due to the increase in GST dropping out of the equation.

A number of offsetting influences underlie our Q4 forecast:

- The usual seasonal fall plus the unwinding of an earlier weather-related spike is behind our 2.0 percent fall in **food prices**. This will contribute -0.4 percentage points to quarterly CPI inflation.
- Inflation in the **housing component** is forecast to increase 0.7 percent, underpinned by a 0.9 percent increase in construction costs and a 0.5 percent increase in rents. Local authority rates are expected to post a small increase after the Q3 lift, with our Monthly Inflation Gauge suggesting a close to 1 percent increase in property maintenance services.
- Prices in the **transport** group are expected to rise around 2 percent. A seasonal lift in airfares, higher prices for used cars, and a 1 percent lift in petrol prices will be influential.
- The regular seasonal pattern is expected to contribute to a 1.1 percent lift in **clothing and footwear** prices.

A key judgement we have made is that the soft retail environment will exert downward pressure on prices, particularly for consumer durables. We have also assumed a relatively modest increase in dwelling insurance, with much of the impact assumed to be already captured in the 2.4 percent lift in the insurance component observed in Q3.

We do not expect the Q4 CPI to show much evidence of a "Rugby World Cup" premium being charged. Accommodation services and package holidays, as well as domestic and international airfares, are expected to show a "typical" seasonal increase.

We expect quarterly Q4 core inflation measures to range from 0.3 to 0.6 percent. Our own estimates suggest annual underlying inflation of around 2.2 percent in Q4. The RBNZ's factor model of core inflation is expected to deliver an annual rate a touch lower than the 2.2 percent seen in 2011Q3. That underlying inflation is within the 1 to 3 percent target band will provide the RBNZ with comfort over the short-term inflation outlook and provide them with more flexibility on future OCR settings.

The risks around our 0.2 percent pick for the Q4 CPI are broadly balanced. Although our pick is below market, we are putting stock in the non-tradable inflation signal provided by our Monthly Inflation Gauge (broadly flat in Q4), and the possibility of more retail discounting than usual, particularly given the build-up in retail and wholesale stocks in Q3.

However, there are upside risks to the picture over the coming year or two:

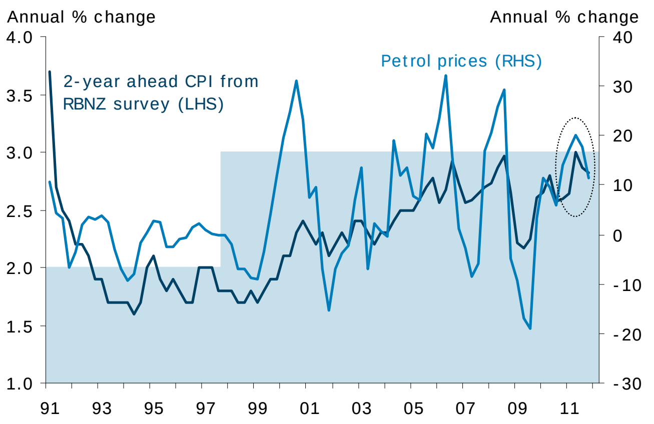
- **Inflation expectations are persistent.** They may not fall from their still-elevated levels as quickly as the RBNZ would prefer.
- **Construction costs.** While these are subdued for now, the Auckland housing market is strengthening markedly, and Christchurch will suck up a growing proportion of New Zealand's building sector capacity. A year from now the picture could look quite different. Insurance premiums and local authority rates provide further **earthquake-related risks.**
- **Energy prices.** If it weren't for the headlines being generated out of Europe, the world would be focusing far more attention on the increasing tensions between Iran and the West. With threats to close the Strait of Hormuz, through which 40 percent of traded oil flows, there is clear upside risk to oil prices. Our analysis shows that petrol prices have an outsize impact on inflation expectations, beyond what their

considerable weight in the CPI regimen would imply.

- **Global inflation.** It isn't on the radar now, and it's a longer-term issue. But the basic facts are 1) the Western world's governments have far too much debt, and; 2) The politically expedient solution to this is to inflate it away, and this has historically been the eventual outcome. The risks are clear. In theory of course, New Zealand can target and achieve any inflation rate it wants, and the nominal NZD will simply adjust to suit. But in practice, it's much easier to target a low rate of inflation if your trading partners are too.

Offsetting all of these upside risks, however, is the big black cloud hanging over Europe's growth prospects, and its implications for global growth. The Reserve Bank is appropriately focusing on the downside risks this poses to New Zealand's export-earning capacity and general economic situation. But should some of these upside inflation risks eventuate, some unpleasant trade-offs may loom.

Expected CPI and petrol prices



Sources: ANZ, National Bank, RBNZ, Statistics NZ

THE UPSHOT

With global concerns remaining front and centre, next week's inflation data is unlikely to generate as much market reaction as usual. The focus of policymakers is likely to remain on medium-term inflation drivers, which will determine the timing and magnitude of future OCR moves. **The hurdle for OCR moves in either direction remains high.**

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