ANZ RESEARCH

NEW ZEALAND ECONOMICS
2011Q2 Consumers Price Index Preview

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NZ ECONOMICS TEAM

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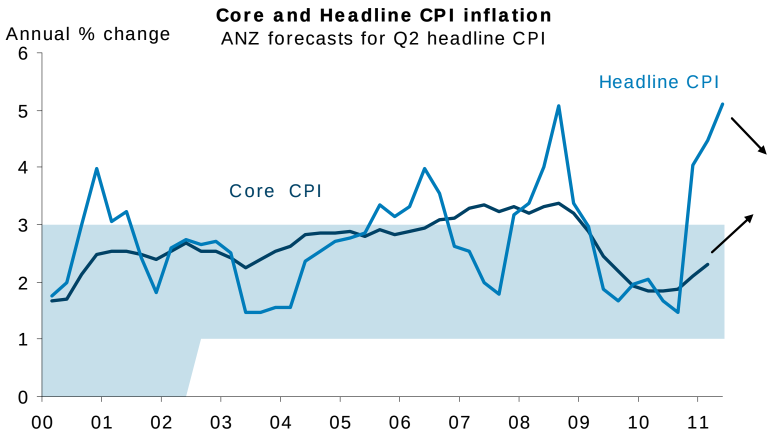
CONTAINED CORE INFLATION BUT WORRYING SIGNS AHEAD

KEY POINTS

- We expect a 0.8 percent quarterly increase in the Q2 CPI, taking annual CPI inflation to 5.1 percent. Higher petrol prices should contribute 0.2 percentage points, with food adding another 0.2 percentage points.
- The higher annual headline rate is not an immediate cause for concern, as it is strongly influenced by a number of one-off factors.
- However, core measures are expected to be above the midpoint of the policy band, which begs the question of how long can the OCR remain so low? We think not long, particularly after today's surprisingly strong Q1 GDP outturn.
- We envisage considerable tension between the traditional cost-push inflation dynamic and the ability of firms to pass on price increases to a deleveraging consumer as 2011 progresses.
- Developments in inflation expectations will be a key battleground. We do not expect wage and price setting to be as benign as the RBNZ asserts.
- A 2.5 percent OCR is looking inconsistent with the inflation outlook. We are not overly hawkish on the outlook for the OCR. Huge global challenges remain. Our core view is simply that the front-part of the yield curve is under-pricing the potential for the reversal of the March 2011 cut and future small moves beyond that.



Sources: ANZ, National Bank, RBNZ, Statistics NZ

2011Q2 CPI PREVIEW

CONSUMERS PRICE INDEX – JUNE 2011 QUARTER

(Due Monday 18 July, 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	0.6	2.2
Sep-10	1.1	1.5	0.9	0.3	1.2	2.5
Dec-10	2.3	4.0	2.5	3.3	2.2	4.6
Mar-11	0.8	4.5	0.5	3.7	1.1	5.2
Jun-11	**0.8**	**5.1**	**0.8**	**4.8**	**0.8**	**5.5**
ANZ	***0.8***	***5.1***	***0.8***	***4.8***	***0.8***	***5.5***
RBNZ	***0.7***	***5.0***	-	-	-	-
Market	***0.8***	***5.1***	-	-	-	-

We expect a 0.8 percent quarterly increase in the Q2 CPI index, taking annual CPI inflation to 5.1 percent. This compares with a 0.7 percent increase forecast in the June *MPS* (5.0 percent y/y).

There are a number of cost-push elements in our Q2 pick. A 4 percent rise in petrol prices is set to contribute 0.2 percentage points to the quarterly CPI increase. Higher food prices will also add a further 0.2 percentage points. Higher fuel prices were the main reason given for announced increases in domestic and international airfares for the quarter. Announced increases in electricity prices and home and contents insurance will also feature.

Signs of demand-led price pressures are not as evident. We have assumed the soft demand environment will lead to further retail discounting for household contents, consumer durables and apparel. Inflation in the housing group is expected to remain moderate, with only a modest increase in rents and construction costs assumed.

What is uncertain is the extent of retail discounting. Our Q2 pick assumes more modest retail discounting is prevalent, particularly for tradeable goods. Retail margins are already wafer thin with most retailers not having the pricing power to push through price increases. We assume the retail environment will remain tough for the time being, which will restrict the extent to which rising costs become apparent at the retail level.

Core inflation readings are somewhat mixed. Core inflation readings from the March CPI provided something for everyone, with various "trimmed means" coming in a 0.8 to 0.9 percent quarterly range, and the 50th percentile "weighted median" delivering a soft 0.3 percent increase. The RBNZ made reference to a factor model of core inflation in the June *MPS*, which has risen from 1.8 to 2.3 percent. Our Monthly Inflation Gauge is continuing to show limited evidence of widespread price increases though neither is it really depicting inflation below the midpoint of the 1-3 percent inflation target (which is what a 2.5 percent OCR would normally be consistent with).

We expect core readings for Q2 to move towards the upper part of the 1 to 3 percent range. Stripping out the October increase in GST and the January tobacco tax increase, we estimate that annual underlying CPI inflation rose to 2.6 percent in Q2, from the 1.8 percent annual increase in Q1. Other core measures are expected to be in the upper part of the target range. This immediately begs the question of how long the OCR can remain so far below neutral settings (commonly perceived to be in a 4 to 5 percent zone) as the RBNZ weighs up growth and inflation trade-offs, with the volatile NZD and a fickle global scene to boot.

The risks around our 0.8 percent pick for the Q2 CPI are slightly on the downside, given the potential for more retail discounting than what we have assumed. **However, looking over the next 12 to 18 months there are upside inflation risks from a number of sources:**

- **Inflation expectations.** Key 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 MPS 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.
- **Labour market.** The strengthening demand for labour is expected to see wage pressures firm. While the RBNZ's upward revision to their wage forecasts are close to ours in spirit, we believe there is scope for construction costs to move higher than what the RBNZ suggests.
- **Energy and food prices.** While global oil and food prices have already peaked, past increases could still filter through into consumer prices.

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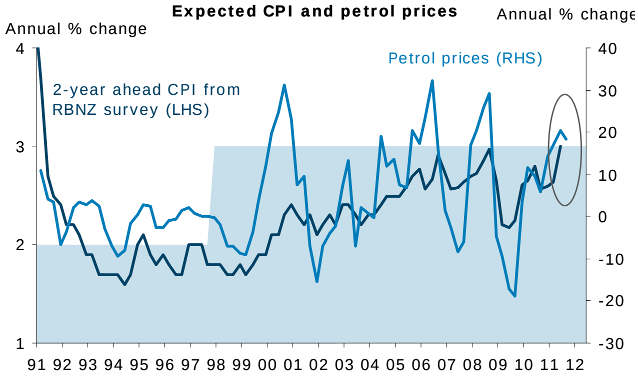
Petrol prices rose 4 cents/litre this week, a reminder that recent falls to prices can be quickly erased.

- **Earthquake-related.** Increases in dwelling rents and construction costs look inevitable. Further increases in insurance premiums look likely, and local authority rates also look set to increase to recoup costs.
- **Stronger rebound in activity.** There is a strong springboard from which activity will pick up from over the latter half of the year. The terms of trade are at multi-decade highs and look set to move higher, which will provide more support to domestic spending. Financial conditions are very accommodative, with greater activity associated with the Canterbury rebuild and the Rugby World Cup providing further impetus. Interest rate sensitive pockets, particularly retail, are showing signs of resilience.

Of course all of these risks are conditional. However, the key point is simple. There is very limited scope to accommodate rising domestically generated inflation. A weak consumption environment is needed to offset other forces. While this could eventuate, we would not have it as our central case. **NZ seems to have a bit more going for it than to simply muddle through.** Hence, we see some real delicate monetary policy decisions over the coming years.

Key to the inflation outlook over the next year will be the NZD. The NZD/USD is hovering around post float highs, which will be doing a fair bit to contain import prices and to slow export sector activity. For the moment the high NZD/USD is playing a useful role in containing inflation. The deflationary exchange rate impact could quickly turn around if the USD strengthens. The larger the climb in the NZD, the greater the potential fall.

The focus for the RBNZ will remain on the medium-term inflation outlook. The June *MPS* projections have annual CPI inflation setting in the low 2 percent range at the end of the projection period. While we expect annual inflation to quickly drop from the 5 percent rate at present, we believe inflation will hover around the top of the 1 to 3 percent target range over the next few years. Today's stronger than expected Q1 GDP print, alongside upward revisions to previous quarters, suggest the size of the negative output gap in the economy is smaller than what the RBNZ assumed at the June MPS. This suggests that inflation pressures could emerge sooner than expected as the recovery progresses. This is likely to highlight some tough decisions in regard to growth and inflation trade-offs.



Sources: ANZ, National Bank, RBNZ, Statistics NZ

THE UPSHOT

A 2.5 percent OCR is looking inconsistent with the inflation outlook. We are not overly hawkish on the outlook for the OCR. Huge global challenges remain. Our core view is simply that the front-part of the curve is under-pricing the potential for the reversal of the March 2011 cut and future small increases beyond that.

Current market pricing appears to have backed away from a late 2011 move by the RBNZ, with the first hike not fully priced in until March 2012. We expect a December 2011 start to the tightening cycle, with the OCR set to reach 4 percent by the end of 2012 and peak at around 4.75 percent by mid 2013. Compared to past policy tightening this is low and slow. But we will not rule out an earlier move following today's GDP release.

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