

NEW ZEALAND ECONOMICS

CONSUMERS PRICE INDEX PREVIEW – 2010Q3

12 October 2010

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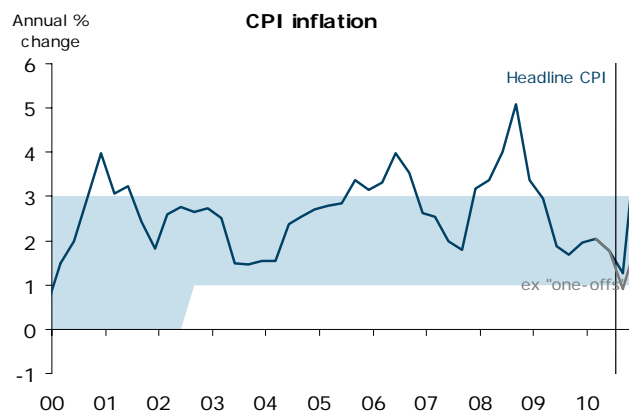
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LOW CPI INFLATION TO BE SHORT-LIVED

KEY POINTS

- We expect a 0.8 percent quarterly increase in the Q3 CPI index. This will take the annual rate of CPI inflation to 1.3 percent, down from 1.8 percent in the previous quarter. This is as low as it gets for the current cycle, with annual CPI inflation set to surpass 4 percent by the end of the year due to the GST increase.
- Government related charges are expected to contribute 0.4 percentage points to the CPI. Contributing a further 0.4 percentage points will be the impact of higher food prices, which mostly reflect higher prices for fresh fruit and vegetables.
- Non-tradable inflation is likely to significantly outstrip quarterly tradable inflation. In part this reflects government charges being levied predominantly on the non-tradable part of the regimen. However, we also assume that intensive retail discounting will weigh down prices for tradable goods.
- With little inflation headroom in our forecasts, risks around our Q3 pick are on the upside, particularly if September's food prices surprise on the upside, or Statistics New Zealand do not pick up the extent of discounting in the retail sector.
- Given the soft near-term economic outlook and the RBNZ on hold until Q1 next year, we are not anticipating much market reaction to the CPI release. It would take a large and broad-based increase in the CPI numbers to cause a reassessment of the policy outlook. We think the risk of this is slim.



SEPTEMBER 2010 QUARTER CPI PREVIEW

CONSUMERS PRICE INDEX – 2010Q3 (DUE MONDAY 18 OCTOBER, 10.45AM)

We expect a 0.8 percent quarterly increase in the CPI index. This will take annual CPI inflation down to 1.3 percent. Large positive contributions from food, local authority rates, transport and alcohol and tobacco will be evident. In an underlying sense inflationary pressures are expected to remain contained. However, the short-term profile for inflation remains steeply upwards with annual inflation surpassing 4 percent by the end of the year due to the GST rise. The challenge for the RBNZ over 2011 will be ensuring that inflationary pressures remain contained against a backdrop of improving economic activity.

THE DETAILS

We expect a 0.8 percent quarterly increase in the Q3 CPI index, taking annual CPI inflation to 1.3 percent. This is slightly below the RBNZ September MPS projections of a 0.9 percent quarterly increase (1.4 percent y/y), and market expectations of a 1.0 percent quarterly rise.

	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	0.3	1.8	-0.1	1.1	0.6	2.2
Sep-10	0.8	1.3	0.5	0.0	1.2	2.4

Government related charges will contribute about 0.4 percentage points to the quarterly CPI increase. The July impact of the annual inflation adjustment to alcohol excise and the remainder of the late April tobacco excise increase pushed up tobacco and alcohol prices in Q3. The July 1 increase in vehicle registration and driver licensing fees will lift transport prices. The introduction of the Emissions Trading Scheme in July will contribute towards a small increase in household energy and petrol prices.

The usual Q3 rise in local authority rates will be evident. With local authorities surveyed once a year and around 80 to 90 percent of the weight of rate increases captured in Q3, we are unlikely to see the full GST impact on local authority rates until

next year. We expect other components in the housing group to deliver low but positive quarterly increases.

Higher food prices are expected to add a further 0.4 percentage points to the CPI rise, of which higher prices for fresh fruit and vegetables contribute around two-thirds. Fresh fruit and vegetable prices normally rise in the September quarter but the wetter than usual winter has pushed prices higher than implied by the usual season influences. Anecdotal reports highlight the possibility of a steeper increase eventuating, which poses upside risk to our CPI forecast.

The Q3 CPI will show higher rates of non-tradable inflation. Our pick of a 1.2 percent quarterly increase is the same quarterly rate as indicated by our Monthly Inflation Gauge and the highest quarterly rate in two years. In part the higher non-tradable inflation is the result of government charges which contribute more than half of the rise in non-tradable inflation.

We expect quarterly tradable CPI inflation to increase by 0.5 percent. Strip out the impact of higher food prices and seasonal increases in international airfares and the spirit of our assessment is one of flat to falling retail prices.

We assume the soft demand environment has eroded pricing power for firms. Anecdotal reports suggest retail volumes continued moving in the September quarter, but that firms were discounting to achieve the sale. We expect signs of retail discounting to be evident with larger than usual price falls for consumer durables, clothing and footwear.

The timing of GST is also expected to be influential. Many firms that would ordinarily increase prices at this time of the year are assumed to have held off price increases until October. This is expected to temporarily hold down prices but suggests a larger spike in Q4 CPI for these components than implied by the rise in GST from 12.5 percent to 15 percent.

The Canterbury earthquake is expected to have a minimal impact on consumer prices in Q3. There is likely to be some impact on September food prices for a few South Island centres but this is expected to be modest.

With the rise in GST and the vehicle excise tax (by 3 cents a litre from 1 October) set to boost Q4 CPI, the 1.3 percent annual inflation is as

SEPTEMBER 2010 QUARTER CPI PREVIEW

low as it gets for the current cycle. We expect annual CPI inflation to exceed 4 percent by the end of the year and peak at around 5 percent by mid 2011. Key for the RBNZ will be the extent to which administered price increases spill over into generalised inflationary pressure. While the September MPS asserted that the weak state of domestic demand will be enough to temper a more enduring price impact from these one-offs, we are not so sure, given our more bullish assessment for 2011 and concerns we have about the supply-side capacity of the economy.

Risks around our 0.8 percent quarterly pick for Q3 are on the upside. Abstracting from food and government induced charges we have assumed that the subdued retail environment and a GST induced delay in price changes will be enough to cap measured price increases. There is not a lot of headroom in our forecasts and if **tomorrow's Food Price Index is significantly above our pick of a 0.3 percent monthly increase, we will revise up our CPI pick to a 0.9 percent quarterly increase.**

FINANCIAL MARKET IMPLICATIONS

With the RBNZ likely to remain on hold until early 2011 there is likely to be less market reaction than usual to this CPI print. GST induced rises from October make it almost inevitable that annual headline CPI inflation will rise over the next 12 months. The key for monetary policy settings being maintained at current levels will be the degree to which inflation one-offs from higher GST and other government one-offs remain just that.

The RBNZ remain confident that the subdued demand environment will limit the impact of inflation one-offs on medium-term inflation. It would require a large and broad-based increase in the CPI numbers to cause a reassessment of the policy outlook. We think the risk of this in the Q3 CPI numbers is slim.

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New Zealand Disclosure information

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

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This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

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Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

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- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

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- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
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- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

Procedures for dealing with investment money or investment property

If you wish to pay investment money to the Bank you can do this in several ways such as by:



IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

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