NEW ZEALAND ECONOMICS

CONSUMERS PRICE INDEX – MARCH 2011 QUARTER

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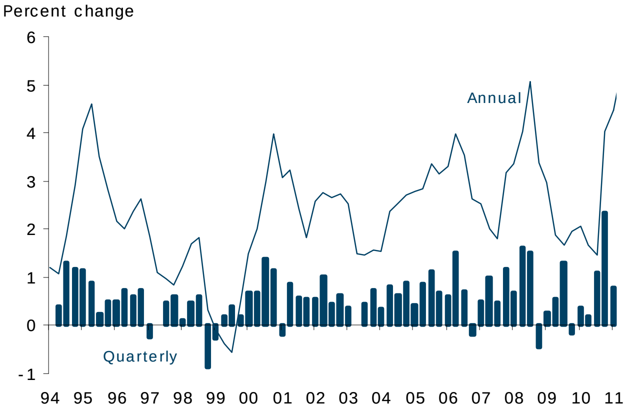
INFLATION CONTAINED BUT FOR HOW LONG?

KEY POINTS

- Today's CPI outturn was in line with the RBNZ's March MPS pick of a 0.7 percent quarterly increase, but slightly weaker than market expectations. Annual CPI inflation rose to 4.5 percent, the highest rate since September 2008.
- Higher petrol prices contributed 0.5 percentage points, and higher tobacco prices a further 0.2 percentage points.
- Core measures were a mixed bag. The weighted median registered a 0.3 percent quarterly increase and service sector inflation rose 0.1 percent. However, the various trimmed means returned quarterly inflation rates in the 0.7 to 0.9 percent range. The soft retail environment is continuing to prevent a broadening of pricing pressure at the retail level, with Statistics NZ reporting that prices for 254 of the approximately 700 individual items collected actually fell in the March quarter.
- Our estimate of underlying annual CPI inflation, which excludes the direct impact of GST and "one-off" government charges, rose to 1.8 percent from 1.6 percent last quarter. This remains in the middle of the 1 to 3 percent RBNZ target range but looks to have turned up.
- Despite the headline inflation rate being in line with the March *MPS* projections, future inflation does not look as benign, with clear upside risks. As the year progresses we believe it will become obvious that a 2.5 percent OCR is not sustainable given the inflation outlook.
- We continue to look for a 25 basis point hike in the December *MPS*, with a gradual path of policy tightening thereafter.

CPI inflation



Sources: ANZ, National Bank, Statistics NZ

2010Q4 CPI REVIEW

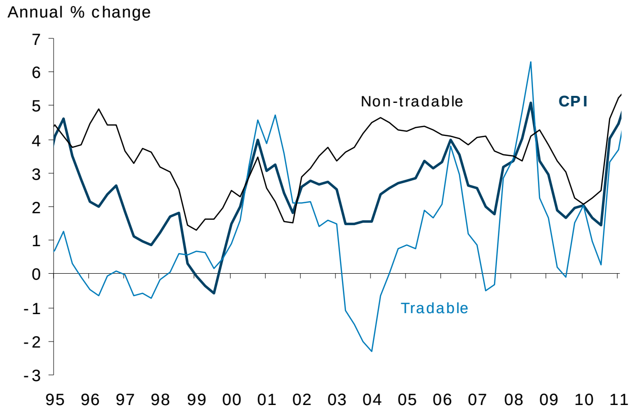
DATA WRAP

The CPI rose by 0.8 percent in the December quarter, taking the annual inflation rate to 4.5 percent. This was in line with the March *MPS* forecasts, but slightly weaker than market expectations for around 1.0 - 1.1 percent.

	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**	**4.6**	**0.5**	**3.7**	**1.1**	**5.2**
NBNZ	***1.0***	***4.6***	***0.9***	***4.1***	**1.1**	**5.2**
RBNZ	***0.7***	***4.4***	-	-	-	-
Market	***1.0***	***4.7***	-	-	-	-

The headline inflation rate was boosted by a 10 percent increase in petrol prices, which contributed 0.5 percentage points. Increases in tobacco prices from the excise increase contributed a further 0.2 percentage points. **Excluding petrol the CPI would have risen 0.4 percent.** Excluding food, it would have risen 0.7 percent. Excluding food, household energy and vehicle fuels, which admittedly represents no one's typical spending patterns, the CPI rose a mere 0.1 percent.

CPI inflation



Sources: ANZ, National Bank, Statistics NZ

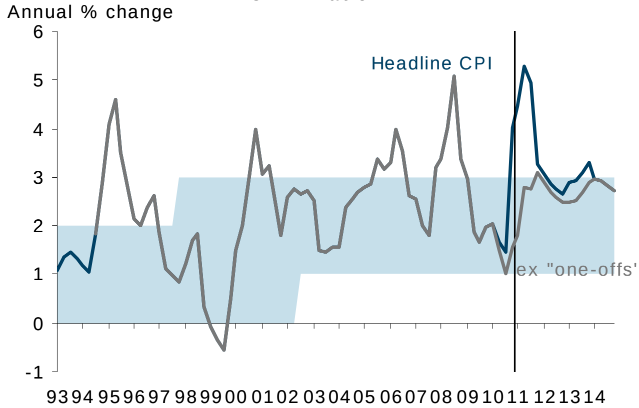
Tradable inflation increased 0.5 percent, while non-tradable inflation rose 1.1 percent. Tradable inflation excluding petrol fell 0.9 percent, despite the exchange rate on a trade-weighted basis falling 1 percent. Seasonal discounting explains quite a bit of this, with the seasonal fall in international airfares alone contributing around -0.3 to tradables inflation for the quarter.

At the group level, seven rose and four fell. Rising (main driver in brackets) were food (widespread), alcohol and tobacco (excise tax), housing and household utilities (rentals), health (outpatient services), transport (petrol), education (GST) and miscellaneous goods and services (insurance). Falling were clothing and footwear (men's clothing), household contents and services (furniture and furnishings), and communications (telecommunication services).

Official core measures of inflation were mixed. Quarterly inflation rates for the trimmed means were in a 0.7 to 0.9 percent range for the 5 to 20 percent trims. The 0.3 percent increase in the weighted median CPI measure was lower than we had expected, but this is likely to reflect seasonal discounting having a larger impact than we had assumed.

Our estimate of annual underlying CPI inflation, which excludes the direct impact of GST and "one-off" government charges, rose to 1.8 percent from 1.6 percent last quarter. This remains in the middle of the 1 to 3 percent RBNZ target range but looks to have turned up.

CPI inflation

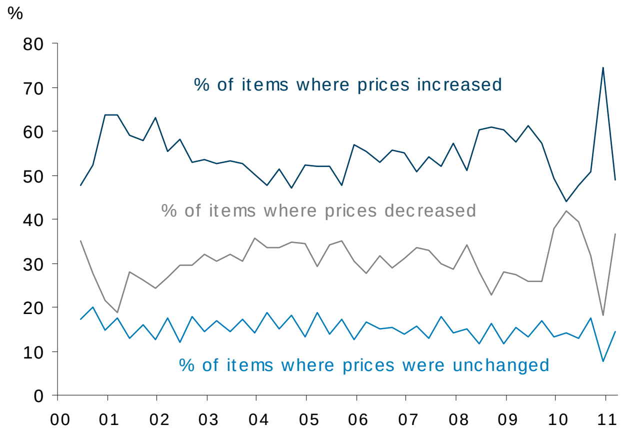


Sources: ANZ, National Bank, Statistics NZ

Analysing individual price movements suggests price movements are very polarised at extremes. Of the 694 items in the CPI regimen 340 increased, 100 were unchanged and 254 fell. For the moment the difficult retail environment is limiting the pass-through of higher costs to the retail level. This is welcome for now but cannot continue indefinitely.

2010Q4 CPI REVIEW

CPI national item-level index movements



Sources: ANZ, National Bank, Statistics NZ

Price increases were also evident in less contestable pockets of the economy. Prices in the health group rose 0.8 percent, and education 5.7 percent. The latter was partly a delayed GST impact (as tertiary fees are set in Q1) but also influenced by a rise in early childhood education costs due to a reduction in government funding. With the government seeking to increase revenue and restore public finances, higher inflation from the non-contestable part of the economy is likely to be ongoing.

CPI Components	Quarterly % change	*%-point contrib.*	Annual % change
Food	1.2	*0.2*	4.8
Alcohol and Tobacco	3.5	*0.2*	11.4
Clothing and Footwear	-1.1	*0.0*	-1.2
Housing and Household Utilities	0.4	*0.1*	4.0
Household Contents and Services	-1.9	*-0.1*	-1.0
Health	0.8	*0.0*	7.1
Transport	2.5	*0.4*	8.2
Communication	-0.8	*0.0*	-0.6
Recreation and Culture	-1.7	*-0.2*	0.8
Education	5.7	*0.1*	6.6
Miscellaneous Goods and Services	0.4	*0.0*	3.0
All Groups	**0.8**	***0.8***	**4.5**
Tradables	**0.5**	***0.2***	**3.7**
Non-tradables	**1.1**	***0.6***	**5.2**
Trimmed Mean	**0.9**		**3.0**
Weighted Median	**0.3**		**3.1**

Despite higher petrol prices, seasonality contributed to lower rates of tradable inflation. Excluding vehicle fuels quarterly tradable inflation fell 0.9 percent. A 9.2 percent fall in international airfares and widespread retail discounting was influential.

Inflation from the housing group remained contained. Rents rose 0.6 percent, but a third of this came from increases in boarding school fees, which one suspects is largely capturing food price inflation. The latter is an example how second round effects can creep into other areas. The home ownership subgroup, which largely reflects construction costs, fell 0.1 percent.

Despite the small downward surprise in today's data the Q2 inflation outlook is in fact looking troublesome. Higher petrol prices look set to add at least an additional 0.4 percent to Q2 inflation, and possibly more. There are other costs increases on the horizon, with announced increases for dairy prices and electricity set to boost aggregate consumer prices. International airfares will reverse the usual March seasonal fall, and fuel price hikes will show up here too.

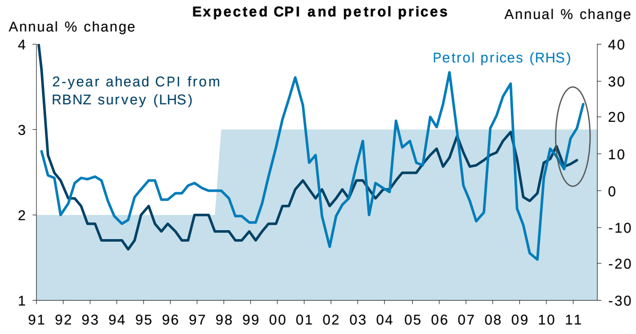
IMPLICATIONS

The CPI was in line with the December MPS projections, and has no immediate monetary policy implications. Today's data give the Reserve Bank continued scope to take a patient position in regard to the real economy, though the true inflationary test is going to be what happens over the next 12 to 18 months.

The March MPS did build in a fairly hefty Q2 (+1.1 percent) but the benign CPI numbers thereafter look too optimistic to us. We are mindful of upside inflation risks to the medium-term inflation profile from a number of sources. The expansion in economic activity over the second half of 2011 is likely to be stronger than assumed by the RBNZ. Rising food and commodity prices will provide a double inflation whammy for New Zealand, with the boost to incomes for NZ producers compounding the direct price impact of higher food prices in the CPI regimen. Oil prices are extremely high. We are wary of price increases from the non-contestable sector as the Government seeks to raise revenue. Earthquake-related cost increases, ranging from insurance to dwelling rents and construction costs are on the horizon. The high NZD/USD is helping to restrain increases in retail prices, but there must eventually be an "inflation payback" as firms seek to recover profitability.

Key for the RBNZ will be the extent to a higher headline inflation rate will spill over into generalised inflationary pressure. The RBNZ's March *MPS* assessment is that the subdued domestic demand environment will keep a lid on medium-term inflationary pressure. This assumption is looking riskier by the day, as margins cannot be infinitely squeezed.

The key battleground will be inflation expectations. The March *MPS* noted that surveyed measures of inflation expectations had remained relatively stable up to that point. However, with annual headline CPI inflation set to surpass 5 percent by mid 2011, it will be difficult for the RBNZ to contain the flow-on to prices and wages throughout the economy. Given the rising short-term annual inflation trajectory and the number of cost increases on the horizon we wonder how long it will be before wages and prices start to respond.



Sources: ANZ, National Bank, RBNZ, Statistics NZ

While the immediate monetary policy implications of today's release are limited, **we still expect upward inflation risks to the medium-term inflation outlook will prompt the RBNZ to raise the OCR by 25 basis points in the December MPS.**

Despite our call for an earlier-than-consensus resumption in rate hikes, for now the path of policy tightening is likely to be considerably more gradual than past episodes, with a number of pauses along the way. **However, if these medium-term inflationary pressures intensify the RBNZ will have to move more forcibly from the accelerator to the brakes.** This has typically been the norm with past tightening cycles.

MARKET REACTION

The market was attuned to the possibility of a higher Q1 inflation print, and the result came as something of a relief. The weaker than expected CPI print saw wholesale interest rates fall 6 to 7 points, with the NZD 40 points lower.

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IMPORTANT NOTICE

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