18 April 2011

Westpac Institutional Bank

Not as ugly as it looks

Q1 CPI 0.8% q/q, 4.5% y/y

- **High headline inflation driven by administrative charges and petrol. Underlying inflation remains subdued.**
- **The strong exchange rate is suppressing inflation.**
- **Low underlying inflation will keep the RBNZ on the sidelines this year.**

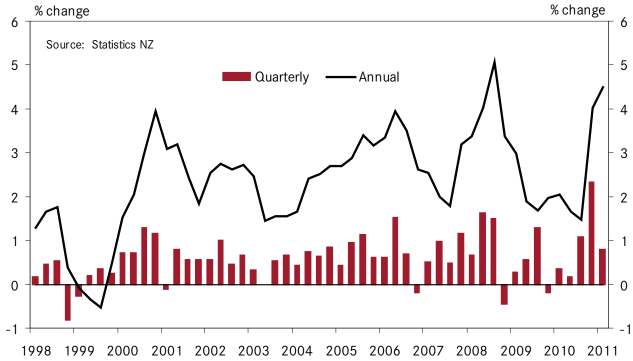
Annual inflation hit 4.5% in the March quarter, while prices rose 0.8% over the quarter.

The main source of inflation was petrol, which rose 9.7% and added 0.5 percentage points to quarterly inflation. Administrative charges were also prominent. A 12% increase in tobacco excise added 0.2 percentage points to quarterly inflation. And last October's GST hike had a lingering impact. The 5.7% increase in the education group was partly due to the higher rate of GST being applied at the annual fee reset for most institutions.

Outside of petrol and administrative charges, inflation is very subdued indeed. The strong New Zealand dollar is continuing to suppress the price of tradable goods and services like clothing (-1.1% quarterly), furniture (-3.1%) and appliances (-1.8%). The high exchange rate is also shielding New Zealand consumers from the worst of global food and fuel inflation. This is no fluke. New Zealand is the world's biggest net exporter of food relative to GDP. When the global price of food rises, New Zealand long-term economic prospects improve, and so the New Zealand dollar tends to appreciate. In such circumstances NZ consumers may find themselves paying more for food and fuel, but they benefit from lower prices in other areas.

It seems the stronger NZD is being passed through to NZ consumers more rapidly than in the past. Tradables inflation has persistently surprised us on the downside over the past year, and the current quarter was no exception. Tradables inflation came in at 0.5%, against our forecast of 1.6%. In part this was due to a surprisingly large drop in international airfares and package holidays, which are notoriously volatile. But the rate of decline in other parts of the tradables regimen was also surprising. The primary cause of this rapid passthrough is probably weak consumer spending, although competition from the internet may also be playing a role.

Consumer Price Index



CPI components (quarterly % change)

	Mar-10	Jun	Sep	Dec	Mar-11
Food	1.0	-0.9	2.4	2.1	1.2
Alcohol & Tobacco	1.3	3.5	2.3	1.7	3.5
Apparel	-1.2	0.7	-0.8	0.0	-1.1
Housing	0.3	0.5	1.4	1.6	0.4
Household Contents	-1.3	-0.4	-0.6	1.9	-1.9
Health	0.9	0.7	1.0	4.4	0.8
Transport	1.1	0.9	1.0	4.3	2.5
Communication	-0.8	-0.4	-0.1	0.7	-0.8
Recreation and Culture	-1.4	-0.7	0.3	2.9	-1.7
Education	4.8	0.0	0.3	0.5	5.7
Miscellaneous	-0.5	0.3	0.5	1.7	0.4
Non-tradables	**0.5**	**0.6**	**1.2**	**2.2**	**1.1**
Tradables	**0.1**	**-0.3**	**0.9**	**2.5**	**0.5**
CPI	**0.4**	**0.2**	**1.1**	**2.3**	**0.8**
CPI (ann %)	**2.0**	**1.7**	**1.5**	**4.0**	**4.5**

Non-tradables inflation was slightly stronger than expected. Rents increased 0.6%, which is the fastest rate since September 2008. We have long been anticipating stronger rents, as last

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year's tax shakeup made property ownership less attractive, especially for landlords. This has simultaneously put downward pressure on house prices and upward pressure on rents. In addition, earthquake destruction in Christchurch and stronger immigration in Auckland may have squeezed the rental markets of NZ's two largest cities. We expect rent inflation to remain elevated for years to come.

Implications

Inflation came in well below the market forecast and our own pick. Consequently, the New Zealand dollar fell by half a cent, and the 2-year swap rate fell five basis points. Markets had been toying with the idea that the RBNZ would begin hiking the OCR earlier than previously signalled. Market pricing backed off a little following the weak inflation print, but still suggests a 60% chance of an OCR hike by December this year.

Our own view is that the OCR will rise only next year. The strong exchange rate and the weak economy will continue to suppress underlying inflation for some time. The headline rate of 4.5% need not faze the Reserve Bank, as it is clearly a short-term spike induced by administrative charges. We expect inflation will drop to 2.2% by June 2012. Admittedly, recent surveys have hinted at high headline inflation feeding through to inflation expectations. But the Reserve Bank would only become concerned if it had conclusive evidence that elevated inflation expectations were affecting wage and price setting behaviour. Such evidence will not be available for many months.

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