18 July 2011

Westpac Institutional Bank

Underlying inflation picking up

Q2 consumer prices up 1.0% q/q, 5.3% y/y

- **Consumer prices rose 1% in the June quarter, above market and RBNZ forecasts. High world commodity prices drove increases in food, fuel and air travel.**
- **Housing-related costs are on the rise again – a serious concern when the task of rebuilding Christchurch has yet to begin.**
- **Domestic conditions increasingly warrant higher interest rates, but global concerns leave us reluctant to bring forward our OCR hike forecasts.**

Summary

Consumer prices rose 1% in the June quarter, slightly ahead of our 0.9% forecast and substantially higher than the Reserve Bank's forecast of 0.7%. International price pressures were apparent this quarter, with price gains for food, fuel, airfares and a range of household items. The RBNZ can tolerate the spike in annual inflation above 5%, which captures a number of one-off government charges in the last year, but there are signs that underlying inflation is on the rise as well. While domestic conditions make the case for higher interest rates, rising tensions overseas are cause for concern, so for now we're sticking with our call for a December OCR hike.

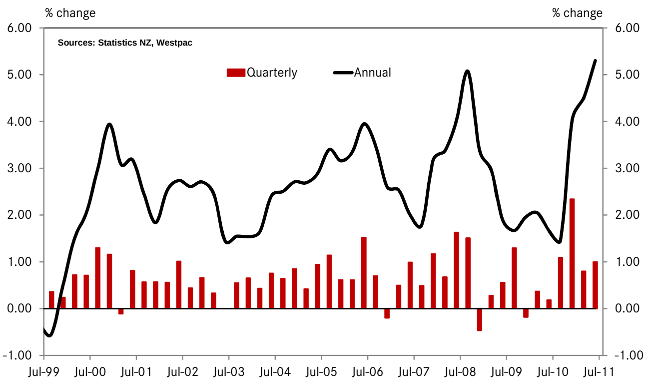
Details

The June quarter CPI showed the expected strong contribution from global commodity prices. Food prices rose 1.1% to be up 7% on a year ago, while higher oil prices boosted petrol (+4%) and airfares (domestic +8%, international +6.8%, and package holidays +1.9%).

What surprised us was the extent of price increases in other 'tradable' goods – those that are either exported, imported or compete with imports. There were sharp increases in a number of household items (carpets +5.9%, textiles +4.6%, glassware and utensils +5.6%); in the case of audio-visual equipment, where prices are in a trend decline, the 2.4% drop was one of the smallest in recent years.

Tradable goods inflation tends to be more volatile, so changes from one quarter to the next shouldn't be overplayed (and it did surprise us on the downside in the previous quarter). That said, we would have expected to see more pass-through from the

CPI Inflation



CPI components **(quarterly % change)**

	Jun	Sep	Dec	Mar-11	Jun 11
Food	–0.9	2.4	2.1	1.2	1.1
Alcohol & Tobacco	3.5	2.3	1.7	3.5	-0.6
Apparel	0.7	–0.8	0.0	-1.1	0.9
Housing	0.5	1.4	1.6	0.4	0.9
Household Contents	–0.4	–0.6	1.9	-1.9	1.4
Health	0.7	1.0	4.4	0.8	0.3
Transport	0.9	1.0	4.3	2.5	2.7
Communication	–0.4	–0.1	0.7	-0.8	-1.2
Recreation and Culture	–0.7	0.3	2.9	-1.7	0.4
Education	0.0	0.3	0.5	5.7	0.1
Miscellaneous	0.3	0.5	1.7	0.4	0.6
Non–tradables	**0.6**	**1.2**	**2.2**	**1.1**	**0.6**
Tradables	**–0.3**	**0.9**	**2.5**	**0.5**	**1.5**
CPI	**0.2**	**1.1**	**2.3**	**0.8**	**1.0**
CPI (ann %)	**1.7**	**1.5**	**4.0**	**4.5**	**5.3**

strong and sustained increases in the New Zealand dollar over the last year or so.

Non-tradables inflation, which tends to be more stable and persistent, was slightly weaker than we expected – but ahead of

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the RBNZ's 0.4% assumption. The detail was a mix of pluses and minuses, with the biggest contribution coming from a seasonal increase in electricity line charges.

The most significant detail for us was that housing-related price pressures are on the rise again. The cost of new homes rose by 0.9% – aside from the GST-induced spike in Q4 last year, this was the biggest increase in nearly three years, and not far from the 1-2% quarterly gains regularly seen during the housing boom. Rents rose 0.5%, and have seemingly picked up the pace in the last two quarters. Property maintenance materials rose another 0.5%, and are up 6.8% on a year ago.

The pickup in rents is much as we expected – last year's tax shakeup meant that landlords will now require higher yields on rental properties, which is likely to be achieved through a mix of 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.

The return of rising building costs is real concern, given the vast rebuilding task in Christchurch that has yet to get under way. The RBNZ's most recent forecasts made a critical assumption that construction cost inflation will be subdued relative to the mid-2000s boom, due to centralised management and the localised nature of the job. That assumption could be sorely tested, especially since the rest of the country is also due for a pickup in the pace of new home building, which currently lags behind population growth.

Annual inflation rose to a 21-year high to 5.3%, though that incorporates a number of government policy changes over the past year – the ETS, the GST hike, and increases in tobacco excise duty – that added around 2.5 percentage points to the headline rate. But that still leaves underlying inflation close to 3%, and what's more, we now expect inflation to be above that mark by the end of this year, when most of the policy effects will have dropped out of the equation. The RBNZ has latitude to look through the current spike in inflation, but it is increasingly harder to assume that wage and price expectations will remain well-contained when observed inflation remains so high for so long.

Market implications

The NZ dollar initially spiked 40pts higher to 0.8490, before offshore concerns dragged it lower for the day. The two-year swap rate rose 9bps to 3.51%, its highest level since the 22 February earthquake.

Interest rates now reflect a 75% chance of an OCR increase by October. Today's release, along with last week's better than expected GDP figures and a host of other more timely activity indicators, certainly strengthens the case for higher interest rates. But unfolding developments overseas could still be a spoiler for New Zealand's recovery – Europe and the US seem far from resolving their government debt woes, and the non-mining parts of the Australian economy are softening faster than expected. For now, we will maintain our pick for a 25bp OCR hike in December.

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