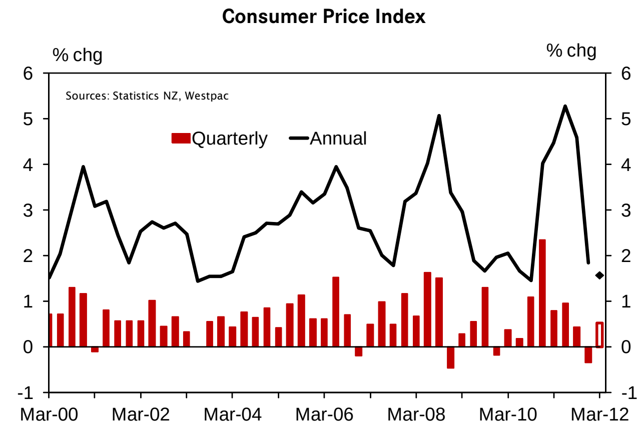
13 April 2012

Westpac Institutional Bank

Up in smoke

Q1 CPI preview: 19 April, 10:45am

- **We estimate that consumer prices rose 0.5% in the March quarter, taking annual inflation down from 1.8% to 1.6%.**
- **A sharp hike in tobacco excise accounts for a large share of the increase. Food and fuel also made positive contributions, albeit smaller than usual.**
- **Given the Reserve Bank's concerns about the strength of the NZ dollar, we will be paying close attention to the currency's ongoing impact on inflation.**



Summary

Our forecast of a 0.5% rise in consumer prices is around the average pace for a March quarter, which tends to be dominated by once-a-year price adjustments. Annual inflation is set to drop to 1.6%, and the legacy of the surprisingly soft outturns in the second half of 2011 means that inflation is likely to remain well below 2% for most of this year.

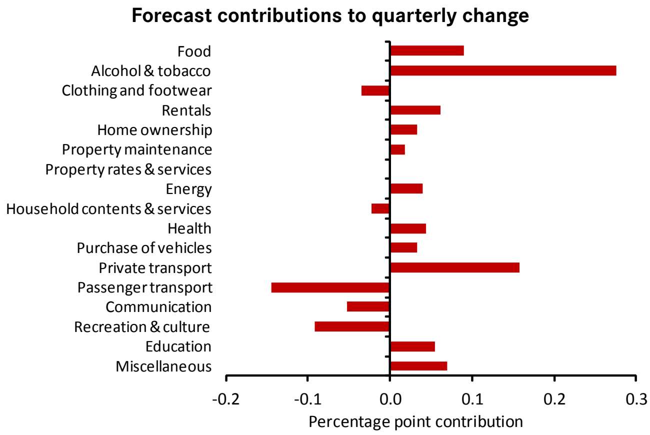
Given the Reserve Bank's heightened concerns about the exchange rate in its recent statements, our particular interest in the March quarter figures will be in whether the strong New Zealand dollar is having a prolonged depressing effect on the prices of tradable goods. Any such evidence could shift our view on how long the RBNZ will delay interest rate hikes.

Details

The drivers of the CPI in any given quarter are typically idiosyncratic, and this time is no exception. Nearly half of the estimated rise comes from the largest annual increase yet in tobacco excise duty: 10% plus the rate of inflation in the year to September 2011 (4.6%, including the impact of the October 2010 GST increase).

The other major positive contributions are from food and fuel – albeit less than usual in both cases. Food prices saw subdued seasonal gains in the first two months of the quarter (March figures are due next Monday but are unlikely to shift our overall CPI forecast). Petrol prices are approaching record highs in level terms, but they appear to have picked up some seasonality in recent times; the 2.5% increase in the March quarter was actually less than the 4% average over the last decade.

The remainder of the 'knowns' for the quarter are due to either annual price adjustments (school and university fees) or seasonal factors (health, accommodation and electricity tend to go up; airfares, clothing and a range of household items tend to go down).



The CPI has delivered some major surprises over the last year, overshooting forecasts in the first half of 2011, then undershooting at least as much in the second half. So we should note that there are a number of 'known unknowns', identifiable risks around our forecast, for the March quarter:

Exchange rate passthrough: Much of the volatility in last year's inflation outturns was in tradable goods, where the impact of the strengthening NZ dollar on consumer prices was surprisingly small in the first half of the year, then caught up with a vengeance in the second half. With the NZD's upward trend having halted in the last six months, we'd expect its inflation-dampening effect to start to fade. In contrast, the RBNZ's most recent forecasts assume that the high level of the exchange rate will depress the rate of inflation for years to come. One quarter's worth of price data is obviously not going to solve the matter one way or another, but nevertheless we'll be taking a close look at the impact of the currency on tradables prices.

Housing-related costs: Prices for new houses, building materials and maintenance rose surprisingly quickly in the wake of the September 2010 earthquake, but petered out in the second half of 2011 (although they didn't fall back). As repairs and rebuilding in Canterbury ramp up, we'll be looking for signs of renewed cost pressures. (Incidentally, housing carries a much lower weight in the CPI today than it did going into the previous two construction booms; the issue of whether construction costs can be contained though centralised buying is perhaps less crucial than it would have been in the past.)

Rents: There's been plenty of reporting about sharp rent increases in Christchurch and Auckland (the latter seems partly a seasonal phenomenon). However, the CPI covers not just new tenancies but existing ones as well, so the rate at which marginal rent increases contribute to the average is slow and difficult to predict.

Used cars: Tougher emissions standards since the start of the year have restricted the supply of imported used cars, and are likely to have some impact on prices. That said, used car prices have already risen 6% since last March, most likely to due supply constraints as a result of the Tohoku earthquake and tsunami, and this effect may be starting to unwind by now.

Market implications

Our forecast is below the RBNZ's pick of a 0.7% quarterly increase. An outturn below the RBNZ's forecast (or ours) would play further into market expectations of a long-delayed and extremely shallow tightening cycle. For us, though, it will depend on the composition of any surprises – whether they reflect one-off factors or persistent exchange rate effects.

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