19 April 2012

Westpac Institutional Bank

Devil in the details

Q1 consumer prices up 0.5% q/q, 1.6% y/y

- **Consumer prices rose 0.5% in the March quarter, as expected. Annual inflation slowed from 1.8% to 1.6%.**
- **Compared to the downside surprises of the last two quarters, housing-related inflation made a comeback and there was limited evidence of pass-through from the strong New Zealand dollar.**
- **The RBNZ will be comfortably on hold for now, but the details of today's figures argue against the RBNZ's assumptions about subdued price pressures over an extended period.**

Summary

The 0.5% rise in March quarter consumer prices was bang in line with our forecast and the market median, and less than the 0.7% rise that the Reserve Bank estimated in the March Monetary Policy Statement. Yet the details gave the data more of the feel of an upside surprise. Compared to what we saw in the previous two quarters, housing-related cost pressures have made a comeback, and the inflation-dampening effect of the high New Zealand dollar seems less pervasive.

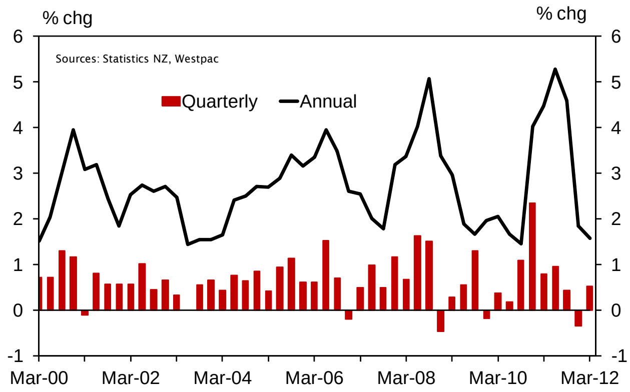
We wouldn't start sounding the alarms bells on inflation based on this result alone. The various measures of 'underlying' inflation remain well-behaved, and the experience of last year cautions against extrapolating too far from the most recent signs of price pressures. But overall, there's enough in this report to back our view over the RBNZ's – that annual inflation is more likely to be above 2% than below it a year from now, as the economy's recovery and the rebuild of Christchurch pick up the pace.

Details

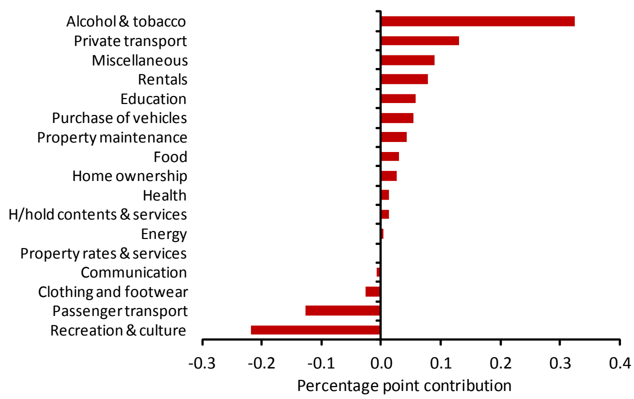
The overall rise in the CPI was as we expected, but the details threw out a few surprises. Non-tradable items, which are generally considered to be more under the command of monetary policy, were up by 1.2%, in line with the RBNZ's estimate and more than our 0.9% pick. In contrast, tradable items, which are more heavily influenced by the exchange rate, fell by 0.4%, softer than we or the RBNZ expected.

Yet the surprise on tradables inflation largely boiled down to two items. Book prices had an unprecedented 14% drop, but Statistics NZ attributed this to a change in the mix of popular fiction titles rather than an outright fall in prices; this could well be reversed next quarter. And package holidays fell by 11% – this category is extremely seasonal and would've fallen in any case, but it was out of proportion with the more 'normal' drop in international airfares.

Consumer Price Index



Contributions to quarterly inflation



Outside of these two items, there was limited evidence of downward pressure on tradable goods prices. Household contents and services – a relatively import-heavy group – rose by 0.3%; TV and computer prices continued their structural decline, but no faster than usual. That stands in contrast to sharp fall in tradables prices in the December quarter, which had raised the risk that the strong New Zealand dollar was having a large and prolonged dampening effect on prices. With hindsight, it seems that some of the credit can be shifted away from the exchange rate and towards temporary discounts on some large items.

The pickup in non-tradables inflation was particularly notable in one area: housing. Rents rose 0.9% – the largest quarterly rise in four years – new house prices rose 0.7%, property maintenance rose 1.2%, and conveyancing and real estate services rose 1.2%. We've long anticipated stronger housing-related inflation in the wake of the Canterbury earthquakes, while the RBNZ has tended to expect such pressures to be well-contained.

That said, we'd be careful about extrapolating from today's figures. Construction-related inflation picked up immediately after the September 2010 Canterbury earthquake, but seemed to peter out by the second half of last year. It's reasonable to assume that construction cost inflation is not going to move in a straight line. And bear in mind that the rebuild of Christchurch is far more foreseeable than the previous two construction booms; it's plausible that the associated price pressures could emerge relatively early in the cycle this time.

Elsewhere, there was also the usual host of price movements in both directions that bear little relationship to monetary conditions. The 14.5% increase in tobacco excise duty was almost entirely reflected through to retail prices (and accounted for more than half of the quarterly increase in the CPI). Used car prices rose 2.7% for the quarter, and were up 8.9% on a year ago; this surely reflects the new emissions standards as well as supply shortages following the Japanese tsunami. Dwelling insurance rose 18.5%, including the increase in EQC levies. And on the softer side, electricity prices rose just 0.1% as Stats NZ continued to make adjustments for customer switching between suppliers.

Market implications

While markets were bracing against the risk of a weaker than expected outturn, there was no reaction in either the NZ dollar or interest rates after the release. Interest rate markets are not fully factoring in an OCR hike until around June next year.

There's no question that inflation remains well-contained right now, and today's results will only reinforce the RBNZ's sense that it is under no pressure to start paving the way for interest rate hikes.

The debate remains around the outlook for inflation next year and beyond. Most private sector forecasters expect inflation to pick up from its currently subdued pace as the economy gathers speed and the Christchurch rebuild gets into full swing. In contrast, the RBNZ is forecasting stronger GDP growth but little change in inflation, based on two assumptions: that centralisation and co-ordination will help to mute construction cost inflation relative to past cycles, and that the high level of the exchange rate will dampen the rate of tradables inflation for years to come.

Today's CPI figures are more in favour of our view than the RBNZ's. We're seeing early-stage housing cost inflation, and the exchange rate – which is no higher now than it was six months ago – does not appear to be having an outsized or prolonged dampening effect on inflation. We expect annual inflation to trough at 1.2% in the June quarter, before picking up to 2.2% by the end of the year as last December's extremely weak result drops out, and to hold above 2% in coming years.

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