19 January 2012

Westpac Institutional Bank

Consumers' dividend

Q4 consumer prices down 0.3% q/q, up 1.8% y/y

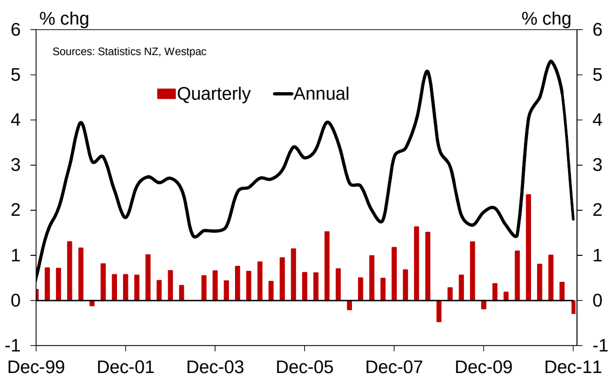
- **Consumer prices fell by 0.3% in the September quarter, weaker than expected. With the GST hike dropping out, annual inflation fell from 4.6% to 1.8%.**
- **The sustained lift in the nation's terms of trade continues to benefit consumers, with the strong NZ dollar keeping import prices down.**
- **Inflation was well below market and Reserve Bank forecasts, and gives the RBNZ more scope to delay interest rates until later in the year.**

Summary

The December quarter CPI painted a very benign picture of inflation pressures at the moment. The enduring impact of a higher New Zealand dollar and the modest pace of demand growth have kept retail price inflation down, and there is little evidence so far of price pressures stemming from a tighter housing market or the impending reconstruction in Canterbury. With the October 2010 GST hike dropping out of the equation, annual inflation dropped into the lower half of the Reserve Bank's 1-3% target range, and we expect it to stay there through most of 2012. That gives the RBNZ more scope to push out the timing of interest rate hikes beyond the June start date that was implied in the December *Monetary Policy Statement*.

But before we focus too much on the surprising negatives in the CPI, let's not forget that well-behaved inflation is actually a good thing, and has been all too rare in the last decade. Consumers are getting the benefits of the sustained lift in the nation's terms of trade, which has promoted a stronger New Zealand dollar and gives us more bang for our buck on imports. Greater competition in some locally-oriented industries is also a welcome recent development. Lower inflation points to lower interest rates, but it also means a greater non-inflationary growth potential for the economy.

NZ CPI Inflation



Details

Consumer prices fell 0.3% in the December quarter, below our pick for a flat outturn and well below the median market forecast of a 0.4% rise. The main negative contribution –although entirely expected – was a 2.2% drop in food prices, and specifically an unusually large seasonal drop in vegetables. Some vegetable prices rose sharply in the first half of last year, as the floods in Australia reduced the supply of imports. This effect was more than fully unwound by the end of the year – in fact vegetable prices are now 8% lower than a year ago.

The other big negative was a 3.5% fall in the communications group. Telecommunication services fell by 3.6% for the second quarter in a row as the per-unit price of home broadband fell sharply – something that we highlighted in our preview, but ended up undercooking in our forecasts.

Aside from these two factors, the downward surprises relative to our forecast fell into two themes. The first was generally weak inflation among the more import-heavy retail categories: clothing and footwear fell 0.3%, household contents (which

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includes furniture and appliances) fell by 1.5%, TVs and computers fell 3.4% and recreational equipment fell by 1.4%. Statistics NZ noted a higher degree of discounting in these groups compared to a year ago.

Much of this price weakness reflects the legacy of a strong New Zealand dollar – while it fell in the December quarter, it reached a new post-float high during the September quarter, and the passthrough to retail prices can take as much as a year to complete. And it appears that consumers are taking full advantage of the downward pressure on prices – electronic card transaction figures suggest that retail spending was up by 1.5% in dollar terms in Q4, which combined with today's price data implies a 2% increase in real terms.

The second theme was a distinct lack of inflation pressures emanating from the housing market at the moment. For the December quarter, rents were up 0.4%, new house prices rose 0.4%, and property maintenance materials were flat. This is not entirely surprising – we've emphasised that the inflationary effects of reconstruction in Canterbury are likely to be drawn out over several years, not months. However, there were some signs of price pressures emerging in the first half of 2011; we thought these would persist a little longer, as the slow pace of building adds to the squeeze on the stock of housing nationwide.

Some of the downward surprise for the December quarter came from factors that also weighed on the September quarter figures. There was a second, rare fall in electricity prices, down 0.5% after a 0.4% drop in Q3. The "What's your number?" campaign, which ended in September, saw a sharp jump in the number of households switching power suppliers to get a better deal; since the switching occurred part-way through the quarter, some of the price impact spilled over into Q4 as well. Ditto for broadband – the 33% price drop during Q3 was partly captured in Q4, on top of the additional 25% price drop during Q4 (which will spill over into Q1 this year).

There were few large price increases, and most of these were seasonal: fruit up 1.7%, accommodation up 3.3%, overseas airfares up 5.8% and package holidays up 3.6%. Used car prices rose 1.8% for the quarter, to be up a total of 6% since March. This will reflect tighter global supply as a result of the Japanese tsunami, though there may have also been a run on pre-2005 cars, which no longer meet the emission standards for imports as of January this year. Dwelling insurance rose 2.9%, as premiums continue to adjust higher in reaction to the Canterbury earthquakes. Petrol prices rose just 0.9%, while diesel prices rose 5%.

Market implications

This was the biggest 'miss' on record relative to the median forecast, and financial markets reacted accordingly. The New Zealand dollar fell 40pts to 0.8030, and the two-year swap rate fell 8 basis points to 2.78%. Interest rate markets are now factoring in half a chance of a 25bp OCR cut by April.

The RBNZ will take comfort from another low inflation outturn, although this will be moderated by the fact that the surprise was entirely on the tradables side (-0.9%qtr, up 1.1%yr) rather than the stickier non-tradables side (up 0.2%qtr, 2.5%yr). The RBNZ won't be looking to an ever-rising currency to keep inflation in check.

Nevertheless, annual inflation is likely to remain low through 2012, which will also go some way towards moderating surveyed expectations of inflation, which have been uncomfortably high up to now. The December *Monetary Policy Statement's* interest rate projections were consistent with OCR hikes resuming around June this year. Today's figures strengthen the case for pushing this timing out further, though not indefinitely – among other things, the RBNZ will be wary that low interest rates are starting to stimulate the housing market again. Our pick for the next OCR move is a 25bp hike in September, with the balance of risks towards later rather than earlier.

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