Westpac InstitutionalBank

Inflation on the wane

Q1 CPI preview: 17/4 10:45am NZT

- **We expect Q1 CPI to rise by 0.3%.**
- **Annual inflation to pull back to 3.0%, and heading much lower.**
- **Non-tradeable annual inflation now easing.**
- **The soft medium-term inflation outlook warrants more monetary easing.**

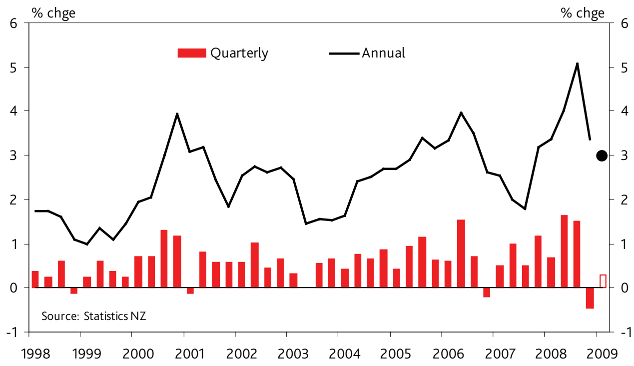
We expect the CPI to rise 0.3% in Q1 2009, bringing annual inflation down to 3.0% from 3.4% in late 2008. Disinflation will be the theme of 2009. Economic contraction for more than a year now has generated significant economic slack; capacity utilisation is falling and unemployment is rising. Inflationary pressures dissipate under such conditions. That will be the story for later in the year though – as usual, the current quarter CPI is more about specific price changes rather than the general inflation environment.

Food still a major positive influence on the CPI

The major movers in the CPI over the quarter are expected to be:

- ***Food prices.*** The food group is expected to make the strongest positive contribution (0.20 percentage points (ppts)) to inflation in Q1. Food prices are expected to rise 1.1% in the quarter, led by groceries.
- ***Housing-related prices.*** We expect a 0.12 ppt contribution to the CPI, largely driven by higher electricity prices, with limited inflation elsewhere in the housing group.
- ***Transport prices.*** A range of influences summing to a -0.22 ppt contribution. Despite rising during the quarter, petrol prices on average were lower in Q1 than in Q4. Meanwhile, diesel prices were significantly lower. International airfares will show a seasonal decrease, although we suspect it will be larger than usual given weak demand and the retreat in fuel costs. The wild card in transport is vehicle prices. There is upward price pressure from a lower exchange rate, but downward pressure from high stocks, weak demand and tight credit. We have factored in a 1.0% increase over the quarter.

Consumer Price Index



Lower international airfares and lower fuel prices are behind our forecast of a 0.3% quarterly drop in tradeable prices. Inflation for consumer durables is likely to be low, reflecting the usual seasonality and widespread reports of discounting given weak demand. However, we are wary that the 7% fall in the NZD over the quarter and 25% drop over the past year could put more upward pressure on imported product prices than we have factored in.

On the non-tradeables side, the annual tobacco excise tax increase and changes in education fees will be notable features, in addition to higher electricity prices. We forecast non-tradeable inflation to be 0.8% in Q1, pulling annual non-tradeable inflation down to 3.9% from 4.3% in Q4 2008. This view mirrors the RBNZ's forecast in the March *Monetary Policy Statement*.

Implications

Inflation follows the economic cycle, so current inflation outcomes have limited implications for policy. That said, we'll be looking for any early signs that the year-long recession is more rapidly pulling down domestic inflation, as well as getting a gauge on the balance of influence on tradeable prices from weak demand and a lower NZD.

Like the RBNZ, we expect annual inflation to be below the bottom of the 1-3% target band by Q3 2009. The large unwind

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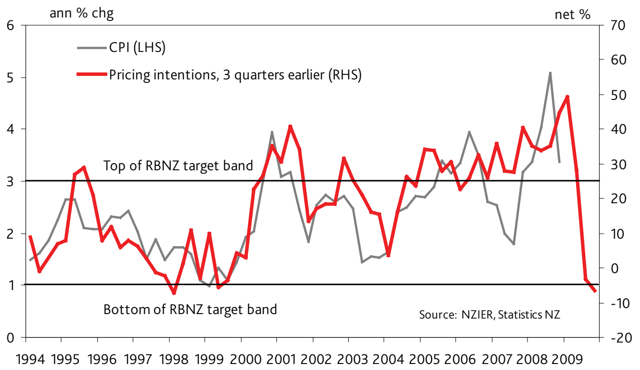
in petrol prices from their peak of $218.9 per litre in July 2008 is a key part of this story. Annual inflation in Q3 excluding petrol is expected to be 2.2%. More important for policy is the outlook for the following year, where we anticipate annual inflation for both headline and ex-petrol CPI to be around the bottom of the target band. Indicators from this week's *Quarterly Survey of Business Opinion* certainly support that view – reports of extremely weak activity, increasing spare capacity and negative pricing intentions all point to a weak inflation outlook. This outlook, much more so than the confirmation that current inflation is easing, gives the RBNZ licence to walk the walk after talking the talk on interest rates last week. We expect a 50 bps cut in the OCR at the 30 April review.

Pricing intentions vs CPI



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