Westpac InstitutionalBank

The lowest ebb

Q1 CPI 0.4% q/q, 2.0% y/y

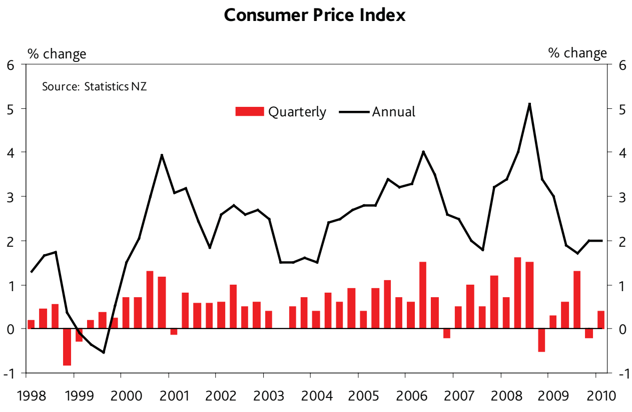
- **Inflation lower than market forecast, higher than RBNZ forecast.**
- **Apart from a few isolated price increases, inflation is very subdued right now.**
- **However, this is the lowest ebb. Quarterly inflation is expected to pick up from here.**

The Consumer Price Index rose 0.4% in the first quarter of 2010. The overall picture was one of generally subdued inflation, except for a few isolated price increases. Quarterly inflation was a touch lower than the market median forecast and significantly lower than our own forecast. However, this was a mild upside surprise for the Reserve Bank.

Looking through the volatility, we believe trend quarterly inflation is now at its lowest ebb following the recession and the huge exchange rate appreciation last year. Base effects will probably push annual inflation lower. But the trend in quarterly inflation will be accelerating from here.

The main areas of strength this quarter were the 7% increase in petrol prices, which added 0.3 percentage points to total inflation, food (+1%) and tobacco (up 1.5% on higher excise tax). There was a normal seasonal jump in education fees, although the seasonal fall in international airfares was quite small. Apart from that, prices actually fell for most tradable goods. The benefit of last year's rising exchange rate came through loud and clear as sharp price declines for clothing and footwear (-1.2%), furniture and floor coverings (-2.1%), appliances (-1.6%), audio-visual equipment (-5.7%) and stationery. The pass-through from the favourable exchange rate to falling prices was fuller and quicker than we anticipated, and was the main source of our forecast error. However, the Reserve Bank must have been expecting the exchange rate to hammer prices even harder, because tradables inflation came in above their forecast.

Non-tradables (domestically generated) inflation was subdued at 0.5%. We were surprised to see construction costs rose only 0.2%. Surveys, company announcements, and anecdotes have all been emphatic about rising construction prices. We now conclude that those price increases will show up next quarter. Rents continued to slowly accelerate, hitting 0.5% this quarter, up from the low of 0.2% back in September. And most services registered another quarter of steady price increases.



CPI components (quarterly % change)

	Mar-09	Jun	Sep	Dec	Mar-10
Food	1.2	0.9	1.7	–2.4	1.0
Alcohol & Tobacco	1.8	0.5	1.5	–1.0	1.3
Apparel	–0.4	1.8	–0.1	1.8	–1.2
Housing	0.3	0.4	0.7	0.2	0.3
Household Contents	0.2	1.5	–0.3	–0.1	–1.3
Health	0.8	0.9	1.4	0.6	0.9
Transport	–1.5	0.6	3.1	1.5	1.1
Communication	–0.1	0.7	–0.2	–0.6	–0.8
Recreation and Culture	–0.6	–1.2	0.9	0.4	–1.4
Education	4.2	0.0	0.0	0.0	4.8
Miscellaneous	0.9	1.0	0.7	0.1	–0.5
Non–tradables	**0.7**	**0.5**	**1.0**	**0.1**	**0.5**
Tradables	**–0.4**	**0.8**	**1.6**	**–0.5**	**0.1**
CPI	**0.3**	**0.6**	**1.3**	**–0.2**	**0.4**
CPI (ann %)	**3.0**	**1.9**	**1.7**	**2.0**	**2.0**

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In the quirks and traps category, there was a 3.8% fall in credit services, coming on top of a 6.9% fall last quarter – when it had been very close to zero every quarter since 2005. The falls have knocked 0.1 ppts off inflation over the past two quarters. There was also an unusual fall in the price of insurance. These price declines are unlikely to be repeated. Indeed, the quirks and traps ahead are all inflation-positive things like rising ACC levies, the Emissions Trading Scheme, and a possible GST hike.

Implications

This CPI release confirms our view that underlying inflation is very low right now, due to the combined effect of the strong exchange rate and last year's recession. The weakness this quarter relative to our forecasts is partly a timing issue. Much of the exchange-rate impact we had pegged in for next quarter has come through already, and it looks as though rising construction costs is a Q2 phenomenon instead of Q1. Consequently, we will be pushing up our Q2 inflation forecast from 0.3% to 0.5%. Even so, annual inflation is set to fall to 1.6% or so by the third quarter of this year.

Markets were primed for a higher quarterly inflation number. Swap rates fell 3 to 4 basis points, and the exchange rate fell 40 pips on the release. Short-term interest rate markets moved from pricing a 50% chance of a June OCR hike to pricing only a 30% chance.

We think markets are far too sanguine about the odds of a June hike. In March, the RBNZ's expectation that it would begin hiking "around the middle of 2010" was unconditional, suggesting that by then it was already satisfied that the recovery was panning out in line with their forecasts. There has been nothing since then to change that plan; if anything, developments since the March *MPS* have been to the upside of expectations. The small upside surprise on inflation came on top of other small upside surprises on NZ and global growth, as well as a large upside surprise on export prices.

Yes, the RBNZ will feel some comfort about the current level of inflation. But the RBNZ is a forward-looking central bank, and future inflation pressures are such that an OCR of 2.5% is now manifestly inappropriate. We continue to expect a June OCR hike.

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