Westpac InstitutionalBank

Inflation bottoming out

Q3 CPI preview: 15/10 10:45am NZT

- **We expect Q3 CPI to rise by 1.0%.**
- **Annual inflation to pull back to 1.4%.**
- **Annual headline disinflation coming to an end.**
- **Non-tradeable annual inflation to continue easing.**

We expect the CPI to rise 1.0% in Q3 2009. This will bring annual inflation down to 1.4% from 1.9% in Q1, a world away from the 5.1% recorded a year ago. For the current quarter, it is more about specific price changes rather than the general inflation environment.

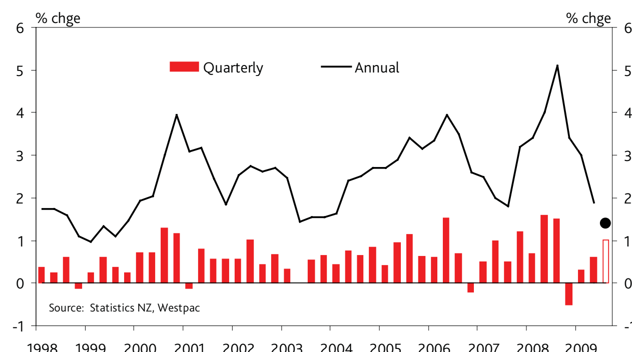
Food, fuel and government charges to push up quarterly CPI

Major points of note for the CPI over the quarter are:

- Food prices. The usual winter lift in vegetable prices will see the food group make the strongest positive contribution (0.37 percentage points) to the CPI in Q3.
- The transport group is expected to make a 0.24 percentage point contribution, led by a 2% lift in petrol prices and an ACC levy increase on car registrations.
- Higher government charges will also boost the CPI elsewhere, including the annual increase in alcohol excise tax and local authority rates. As a result, the alcohol and tobacco group and the housing group are expected to make a 0.13 and 0.12 percentage point contribution respectively.

Q3 will mark the end of the strong disinflation theme in the headline figures we have been discussing for sometime. This is largely the result of the spike in petrol prices in mid-2008 dropping out of the annual calculations – petrol prices will be around 19% lower than a year ago in Q3.

Importantly, various measures of underlying inflation are expected to show continuing disinflation. We expect annual inflation excluding petrol to drop to 2.7% in Q3 from 3.8% a year ago. Market focus will be on the non-tradeable and core inflation measures as much as the headline results. We anticipate non-tradeable prices to post a 0.7% gain over the quarter, boosted by various annual government charges coming through at this time of year. Still, annual non-tradeable inflation is expected to dip below 3% for the first time since early 2002, with our 2.8% annual non-tradeable inflation forecast matching the RBNZ's view in their September *Monetary Policy Statement*.



The lift in food and petrol prices point to chunky tradeable inflation over the quarter. But pinning down a point estimate for tradeable inflation requires an assessment of how the wild fluctuations in the NZD over the past year affected consumer prices. For Q3, we expect to see the last of the upward pressure on domestic prices from the falling NZD early in 2009, such are the lags involved. The strong appreciation of the NZD since early 2009 will dampen prices over coming quarters. All up, we have pencilled in a 1.2% lift in tradeable prices in Q3. Note though, on an annual basis, tradeable inflation is expected to be -0.5% thanks to the large drop in petrol prices over the year.

The biggest uncertainties are around airfares and the influence of the currency (especially the timing) on domestic prices. These uncertainties create risks on both sides of our 1.0% forecast. On balance, the upside risks feel a little larger than the downside risks. This equates to some upside risk to the RBNZ's 0.9% forecast for quarterly headline inflation.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bodonovan@westpac.co.nz

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Implications

Inflation follows the economic cycle, so current inflation outcomes have limited implications for policy. That said, we are looking for clear signs of the lagged effects of the recession on domestic inflation. We anticipate underlying inflation to continue easing as economic slack created by the 5-quarter recession and a strong appreciation of the New Zealand dollar over the past 6 months take effect.

This short-term outlook suggests no urgency to hike interest rates. The level of economic activity in Q2 2009 was still 2.8% below its peak in Q4 2007, suggesting it will take some time before any recovery generates significant inflationary pressure. The key for monetary policy is to begin removing stimulus before the slack actually dissipates, given the lags involved. With the economy now in recovery mode and forward looking indicators sharply higher, we think rate hikes will be on the agenda around mid-2010 or a touch earlier, not later.

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