

Inflation: not low enough

Q3 CPI 1.3% q/q, 1.7% y/y

- Inflation falls, but not as much as expected.
- Underlying inflation eases, but is not low.
- Close to mid-target-band inflation, despite a deep recession, raises concerns for the medium term price outlook.
- OCR will need to rise before too long.

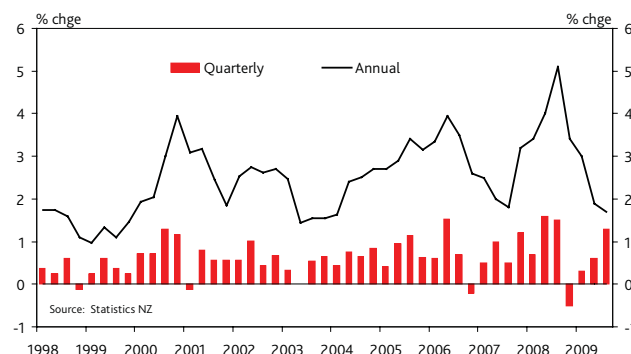
Overall inflation is not falling as fast as expected. Annual inflation came in at 1.7% for Q3, well north of the 1.1% increase expected by the market, the 1.2% expected by the RBNZ and our top-of-market forecast of 1.3%.

On the face of it, a further easing in annual headline inflation to 1.7% (from 1.9%) and non-tradeables inflation to 3.0% (from 3.3%) in Q3 suggest little to fear on the inflation front. Not so. The fact that annual inflation has only just dipped below the middle of the RBNZ's 1% to 3% target range following 5 quarters of deep recession (and with a 19% drop in petrol prices over the year) raises concern about where inflation will head during the economic recovery that is already underway.

It is not that annual inflation will likely lift back above 2% over the next couple of quarters, or even the outlook for 2010 that is of concern. Actually, we think annual inflation could well be below 2% in the second half of 2010 as the downward effects of the recent strengthening in the NZD suppress tradeable inflation. It is inflation in 2011 and beyond that has become a bit more worrisome with the revelation that measures of underlying inflation have only been tempered (from very high levels) by strong recessionary forces, rather than completely squashed. From a year ago, non-tradeables inflation has eased from 4.1% to 3.0%; the weighted median has fallen from 3.7% to 2.8%; and the 10% trimmed mean has retreated from 4.0% to 2.0%. Eased yes, but these measures are hardly low given the economic circumstances.

Certainly there were pockets of the Q3 inflation report that reflected the lagged effects of the recession. In particular, inflation across the housing group was very weak (outside of

Consumer Price Index



CPI components (quarterly % change)

	Sep-08	Dec	Mar-09	Jun	Sep
Food	3.7	1.5	1.2	0.9	1.7
Alcohol & Tobacco	1.3	0.4	1.8	0.5	1.5
Apparel	-0.4	0.9	-0.4	1.8	-0.1
Housing	1.4	0.6	0.3	0.4	0.7
Household Contents	0.8	0.5	0.2	1.5	-0.3
Health	1.4	0.6	0.8	0.9	1.4
Transport	2.0	-7.6	-1.5	0.6	3.1
Communication	-1.1	-0.4	-0.1	0.7	-0.2
Recreation and Culture	0.8	1.5	-0.6	-1.2	0.9
Education	0.1	0.1	4.2	0.0	0.0
Miscellaneous	0.5	0.7	0.9	1.0	0.7
CPI	1.5	-0.5	0.3	0.6	1.3
CPI (ann %)	5.1	3.4	3.0	1.9	1.7
Non-tradeables (ann %)	4.1	4.3	3.8	3.3	3.0
Tradables (ann %)	6.3	2.3	1.7	0.2	-0.1

the 5.4% increase in local authority rates). Over the quarter, rents rose 0.2%, home ownership was up 0.1%, and household energy posted its smallest increase in almost 8 years at 0.2%. Property maintenance fell 0.4% thanks to the effect of the government's subsidies for home insulation and clean heating, though this had much less impact that we expected.

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As far as the details go, the general sources of inflation over the quarter were generally as expected, with a large increase in food prices (thanks to seasonality in vegetable prices) and a host of government related charges coming through in Q3, including increases in local authority rates, alcohol excise tax, and ACC levy on car registrations. The major surprises for us in addition to the mild home insulation effect came via the large (11%) rebound in international airfares and a 2.4% increase in vehicle prices. Importantly, these increases seem real and we do not expect them to unwind in subsequent quarters.

Implications

The genuine and underlying nature of today's inflation surprise has implications for medium term inflation and hence the future track for interest rates. For the RBNZ, the 0.5% surprise on annual headline inflation and the 0.2% surprise on annual non-tradeable inflation will be material. That is certainly the view of the market judging by the approximately 20bps lift in short term wholesale interest rates following the release.

The RBNZ's expectation that the OCR will be at or below its current 2.5% level until the latter part of 2010 looks increasingly unrealistic. Upside surprises in activity (Q2 GDP) and now inflation suggest that the RBNZ will alter that expectation at the October OCR review. We are reviewing our mid-2010 call for the first hike in the OCR, with a view to bringing it forward. That said, market pricing for a hike by January feels a little too early.

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