

Cheaper food keeps inflation low

Q4 CPI -0.2% q/q, 2.0% y/y

- Inflation surprises on the downside due to falling food prices.
- Support for the RBNZ's plan to hike the OCR around the middle of 2010.
- March OCR hike becomes a distant prospect.
- We now expect a 25bp hike at the April OCR review.

The Consumer Price Index fell 0.2% in the fourth quarter of 2009, mainly due to a 12% fall in fruit and vegetable prices. Food prices are falling sharply as a return to normal growing conditions unwinds the winter price spike.

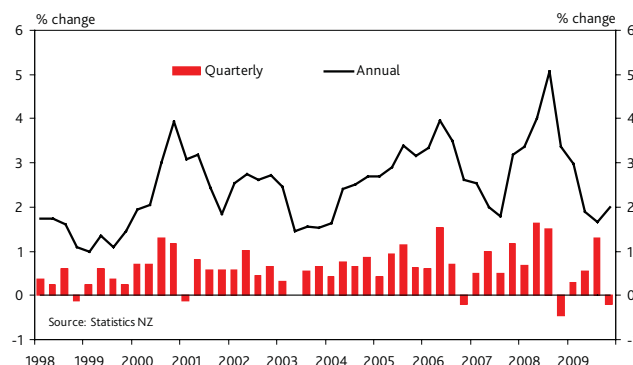
Inflation undershot our forecast, mainly because food prices fell even further than anticipated. However, inflation was in line with the RBNZ's forecast and the detail was mixed. This data will bolster the RBNZ's view that the best time to hike the OCR is "around the middle of 2010". Financial markets, and we, have been forced to revise our more hawkish OCR expectations.

Non-tradables inflation was subdued at 0.1%, with the weakness very generalised. Annual non-tradables inflation fell to 2.3%, the lowest it has been since 2001. This was all very much in line with our expectations. The recession that ended in mid-2009 has definitely reduced domestic inflation, with the maximum effect felt in Q4 2009. If anything, we remain surprised that non-tradables inflation did not fall further, considering the severity of the recession.

There was one important exception to the weak non-tradables inflation theme. Inflation in the "home ownership" category, which reflects the price of building a new house, accelerated to 0.4% from 0.1%, instead of falling to zero as we expected. That's important as the persistence of construction-cost inflation was a key driver of inflation in the last economic cycle. We expect construction cost inflation to ramp up again in 2010, as the residential building industry recovers.

The benefit of the higher exchange rate showed up loud and clear as a 0.5% fall in the price of tradable goods and services.

Consumer Price Index



CPI components (quarterly % change)

	Dec	Mar-09	Jun	Sep	Dec
Food	1.5	1.2	0.9	1.7	-2.4
Alcohol & Tobacco	0.4	1.8	0.5	1.5	-1.0
Apparel	0.9	-0.4	1.8	-0.1	1.8
Housing	0.6	0.3	0.4	0.7	0.2
Household Contents	0.5	0.2	1.5	-0.3	-0.1
Health	0.6	0.8	0.9	1.4	0.6
Transport	-7.6	-1.5	0.6	3.1	1.5
Communication	-0.4	-0.1	0.7	-0.2	-0.6
Recreation and Culture	1.5	-0.6	-1.2	0.9	0.4
Education	0.1	4.2	0.0	0.0	0.0
Miscellaneous	0.7	0.9	1.0	0.7	0.1
Non-tradables	0.8	0.7	0.5	1.0	0.1
Tradables	-2.1	-0.4	0.8	1.6	-0.5
CPI	-0.5	0.3	0.6	1.3	-0.2
CPI (ann %)	3.4	3.0	1.9	1.7	2.0

To name a few of the sectors in which the cost of living fell, grocery food fell 1%, petrol fell 1% (despite the higher price of oil), alcoholic beverages fell 1%, glassware, tableware and household utensils fell 4.2%, tools and household equipment fell 1.2%, cleaning products fell 3.1%, and audio-visual and computing equipment fell 6.1%. Sharp price declines for many

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

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tradable goods were offset by a (seasonal) 13.9% increase in international airfares, which added 0.2 percentage points onto inflation.

We think inflation has now passed its lowest ebb. We already know that the prices of dairy products and petrol have risen in the early part of 2010, reflecting resurgent global demand. Barring a further appreciation of the exchange rate over 2010, the prices of tradable goods and services are more likely to rise than fall. And as the economy regains its footing we'd expect non-tradables inflation to accelerate. We forecast 2.6% inflation for full-year 2010.

Implications

There was nothing in the headline or the balance of details to prompt a change of plan from the RBNZ. When it reviews the OCR next week, the RBNZ is likely to reiterate its intention to kick off a rapid tightening cycle around the middle of 2010.

We have long been expecting an earlier kick-off to the OCR hiking cycle, in March. However, today's data makes that seem unlikely. We still think the OCR is too low and needs to be normalised sooner rather than later. But there simply will not be enough data between now and March to alter the RBNZ's stance. We are therefore revising our OCR call. We now expect a 25 basis point hike at the April OCR review. We expect 25 basis point hikes at each subsequent meeting this year, although the clear risk is that the RBNZ hikes by 50 basis points at one or more meetings.

Financial markets were also forced to revise their hawkish stance after this data. Market pricing suggests the odds of a March hike fell from 40% to 20%, 2-year swap rates fell 10 basis points, and the exchange rate fell almost half a cent.

Dominick Stephens, Research Economist, Ph: (64-4) 381 1414