13 July 2010

# Calm before the storm

## Q2 CPI preview: 16/07 10:45am NZT

- **One last quarter of modest inflation as weak demand and the strong exchange rate continue to suppress prices.**
- **Economic recovery combined with Government charges to push inflation above 5% next year.**
- **Rising inflation expectations will be a headache for RBNZ.**

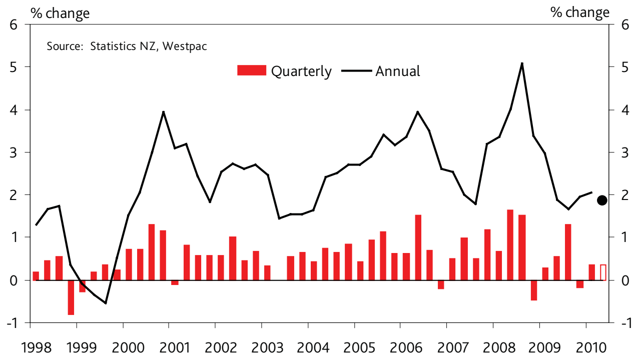
**Q2 CPI forecasts**

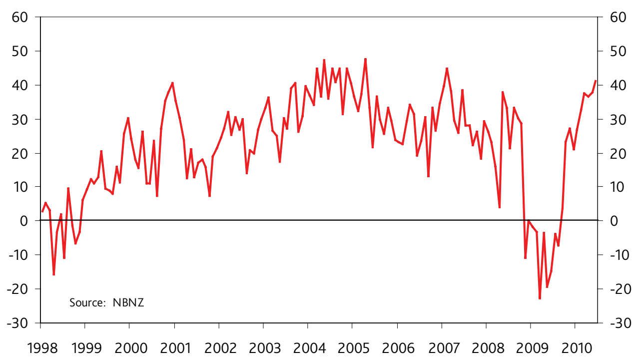
| | % qtr | % yr |
|---|---|---|
| Westpac | 0.4% | 1.9% |
| RBNZ | 0.5% | 2.0% |
| Market | 0.4% | 1.9% |

We anticipate Friday's CPI data will show that June was the last of three subdued quarters for inflation. Prices barely budged in the six months from October 2009 to March 2010, as weak demand kept a firm lid on the price of domestically produced goods and services, and the strong exchange rate forestalled increases in imported or import-competing products.

We expect more of the same occurred in the April to June period. The improvement in domestic demand has only tickled a few prices here and there – there is evidence that builders are hiking their prices and that rents are rising. But for the most part, it is far too early for the recovery to be driving domestic prices higher. We forecast fairly routine seasonal increases or decreases for most non-tradable components of the CPI, such as a 2.3% increase in household energy prices.

Last year's sharp exchange rate appreciation was probably still affecting prices for some imports in the June quarter. The passenger vehicles sector of the CPI could fall 1.6%, and we predict an unseasonably small increment of 0.2% for clothing and footwear. We already know that the price of food fell 0.9% over the quarter – seasonal factors were the main cause, but the strong exchange rate may have helped prevent last year's surge in global food prices from impacting too severely on NZ consumers.




Prices may be subdued right now, but the RBNZ can ill-afford to relax. Q2 will prove the calm before an inflationary storm. First and foremost, the economic recovery is due to feed through to higher inflation in the second half of 2010 and into 2011. Simultaneously, a wide range of Government charges and taxes are set to add around 3 percentage points to inflation over the next year:

- Higher tobacco excise tax will add 0.5% to CPI.
- GST will add 2.02% directly to CPI.
- The Emissions Trading Scheme will add 0.4% directly to CPI, and will add another 0.1% indirectly (eg, taxi fares and courier charges).

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

This veritable maelstrom will push annual inflation to 5.1% by June 2011.[1] The inflation spike on its own is not a problem for the Reserve Bank. The big issue is what happens to "inflation expectations" – the understanding of future average inflation that people take into account when negotiating wages and setting prices. The Reserve Bank and The Treasury have optimistically assumed that inflation expectations will remain contained, and New Zealanders will continue to believe that future inflation will average well below 3%. We are not so sure. By the end of 2011 the 7-year average of inflation will have been 3.1%. Inflation will have been above 3% half of that period. And surveys have already shown a tendency toward higher long-term inflation expectations. We think an increase in inflation expectations is highly likely. It is technically possible for central banks to massage inflation expectations by "talking tough", but that is just not the RBNZ's style – they tend to worry about the impact tough talk would have on the exchange rate. Rising inflation expectations will eventually make the RBNZ's job harder. So we think there is good reason to expect the RBNZ will deliver of their projected 300bp of OCR hikes over the next couple of years, and then some.

## Implications and uncertainties

The financial market implications of this quarter's CPI number are limited, as any surprise will be dwarfed by the upcoming inflation spike. Inflation forecasts come with a margin of error just over 0.2 percentage points. The Reserve Bank's forecast is 0.5%, and market forecasts are mostly bunched between 0.3% and 0.6%.

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[1] The Treasury's estimate is 5.9%, and the Reserve Bank's is 5.3%. The difference between the two official inflation forecasts and our 5.1% is mainly down to differing exchange rate forecasts.