

Inflation lowdown

Q2 CPI 0.3% q/q, 1.8% y/y

- Inflation currently subdued as last year's recession and the strong exchange rate continue to hobble prices.
- Inflation set to accelerate to 5.1% on economic recovery, GST and ETS.
- RBNZ remains firmly on track to hike the OCR.

The Consumer Price Index increased just 0.3% in the June quarter of 2010, the third successive quarter of low inflation. There were lumps and bumps on either side – an increase in tobacco excise added 0.2% to inflation, while a fall in food prices knocked a similar amount off the index. But the underlying trend is clear. Inflation has been hobbled by the combined effect of last year's recession and the strong exchange rate.

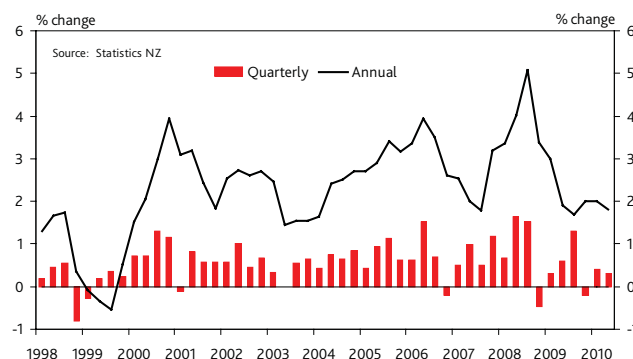
Domestic inflation has risen a little in response to the economic recovery. Housing-related inflation, in particular, is picking itself up off the floor. Construction and property maintenance inflation accelerated, and rents continued to rise at 0.5%, compared to 0.3% a year ago. The strong exchange rate kept tradables inflation low, although not quite to the extent we expected. Food prices fell sharply, but car prices rose 2.4% and appliances were up 1.2%.

The June quarter was the calm before the storm. 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).

This veritable maelstrom will push annual inflation to 5.1% by June 2011,¹ which is highly likely to cause higher inflation expectations and faster wage growth. Higher inflation

Consumer Price Index



CPI components (quarterly % change)

	Jun-09	Sep	Dec	Mar-10	Jun
Food	0.9	1.7	-2.4	1.0	-0.9
Alcohol & Tobacco	0.5	1.5	-1.0	1.3	3.5
Apparel	1.8	-0.1	1.8	-1.2	0.7
Housing	0.4	0.7	0.2	0.3	0.5
Household Contents	1.5	-0.3	-0.1	-1.3	-0.4
Health	0.9	1.4	0.6	0.9	0.7
Transport	0.6	3.1	1.5	1.1	0.9
Communication	0.7	-0.2	-0.6	-0.8	-0.4
Recreation and Culture	-1.2	0.9	0.4	-1.4	-0.7
Education	0.0	0.0	0.0	4.8	0.0
Miscellaneous	1.0	0.7	0.1	-0.5	0.3
Non-tradables	0.5	1.0	0.1	0.5	0.6
Tradables	0.8	1.6	-0.5	0.1	-0.1
CPI	0.6	1.3	-0.2	0.4	0.3
CPI (ann %)	1.9	1.7	2.0	2.0	1.8

expectations could become self-fulfilling, leaving the RBNZ with quite a headache in 2011 and 2012.

Its worth pausing for thought on the current rate of annual inflation: 1.8%. 2009 featured the most severe recession in a generation, and the most rapid exchange rate appreciation, both

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of which are having their maximum impact on annual inflation right about now. This is rock bottom for New Zealand inflation. The top of the range seems to be 4 or 5%. We remain firmly of the view that the official target “band” of 1% to 3% average inflation is irrelevant. The Reserve Bank appears to be targeting 3%.

Financial market implications

The headline will have been comforting to the Reserve Bank, but less so the detail. The surprise relative to their 0.5% forecast was probably in food prices, while the acceleration in non-tradables inflation exceeded their expectations.

The data was the smallest possible increment weaker than our forecast – one index point. We were therefore surprised to note that swap rates fell 3 basis points and the exchange rate fell half a cent on the release.

That said, in recent weeks GDP and inflation data have come in below the RBNZ’s forecast, the TWI has risen, and second-tier data has generally undershot expectations. The RBNZ could well be less strident in its rhetoric at the July OCR review than it was in June. But while they’ll certainly acknowledge the weaker flow of data, we don’t expect any knee-jerk reaction. It would be utterly inappropriate to keep the OCR at 2.75%, given the inflation outlook. That’s why the RBNZ has articulated such a clear plan to return the OCR to a more normal level. There is every reason to expect the RBNZ will stick to that plan.

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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.