

Economic Update

Pushing the comfort zone

Preview of NZ Consumers Price Index – Q1 2010

- We expect Q1 CPI to increase by 0.5% qoq, bringing annual inflation to 2.2%.
- Higher food and petrol prices and housing costs underpin the increase.
- Inflation developments in the pipeline should be of concern to the RBNZ.

We expect higher food and petrol prices and housing costs to drive a 0.5% increase in the CPI in the March quarter, thus bringing annual inflation to 2.2%. The continued increase in petrol prices means that the CPI is likely to be stronger than the 0.3% increase forecast in the RBNZ March *Monetary Policy Statement*. Furthermore, we expect non-tradable inflation will recover faster than the RBNZ expects over the coming quarters, driven by a modest rebound in construction costs.

It appears the RBNZ is now less comfortable with the medium-term inflation outlook. This is unsurprising in light of the fact that even excluding for the price effects of the Emissions Trading Scheme (ETS) the RBNZ forecast annual inflation to track close to the top of the target band of 3% over the coming years. There is now little room for upside inflation surprises, all the more concerning given recent data indicates inflation pressures will build up over the coming year. We expect these inflation pressures will prompt the RBNZ to commence the tightening cycle with a 25 basis point OCR increase in June.

Expectations: annual inflation will rise above 3% over 2011

ASB's expectations:
+0.5% in Q1,
2.2% annual.

Market:
+0.6% in Q1,
2.2% annual.

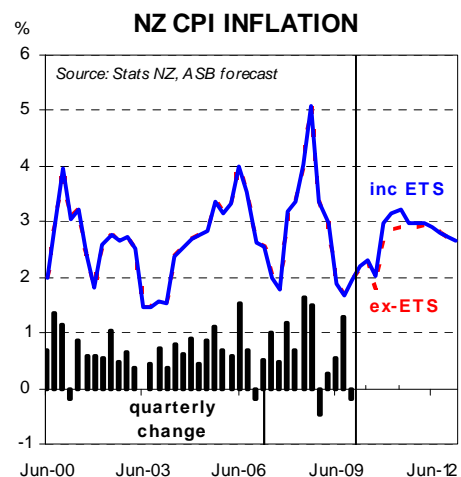
RBNZ:
+0.3% in Q1,
2.0% annual.

The NZ Q1 CPI will be released at 10:45am on Tuesday 20 April. We expect a 0.5% qoq increase, which would bring annual inflation to 2.2%.

The market median expectation is +0.6% qoq, and 2.2% yoy.

The RBNZ's March *MPS* forecast was +0.3% qoq and 2.0% yoy. Since the forecast was published there has been continued increases in petrol prices, which means the RBNZ is likely to have revised up its CPI forecast.

[\[Review of Q4 CPI\]](#)



CPI breakdown Q%	Sep-09	Dec-09	Mar-10
Food	1.7	-2.4	1.1
Alcohol & tobacco	1.5	-1.0	1.0
Clothing & footwear	-0.1	1.8	-0.9
Housing & h/h utilities	0.7	0.2	0.5
H/h contents & services	-0.3	-0.1	-0.7
Health	1.4	0.6	0.8
Transport	3.1	1.5	1.0
Communication	-0.2	-0.6	0.3
Recreation and culture	0.9	0.4	0.0
Education	0.0	0.0	4.0
Misc.goods & services	0.7	0.1	0.8
CPI	1.3	-0.2	0.5
Tradable	1.6	-0.5	0.3
Non-tradable	1.0	0.1	0.7
CPI Annual	1.7	2.0	2.2

Although the appreciation in the NZ dollar over late 2009 is likely to have driven the price of imported consumer goods lower, we expect this to be offset by the increase in petrol prices.

We expect a rebound in non-tradable inflation of 0.7% in the March quarter, following on from the surprisingly subdued Q4 result. Some of this robust increase reflects the typical increases that occur in some groups in Q1, in particular rents and education fees. Added to that, we expect a continued increase in construction costs as spare capacity diminishes in light of the recovery in housing construction activity.

Nick Tuffley – ASB Chief Economist – 649 374 8604 – nick.tuffley@asb.co.nz

Christina Leung – ASB Economist – 649 369 4421 – christina.leung@asb.co.nz

General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Tradable inflation underpinned by higher food and petrol prices

Capacity pressures beginning to emerge

Risk administrative inflation will spill over to core inflation expectations

Higher food, petrol and housing costs drive Q1 CPI

We expect an increase in food prices to have been a key driver behind the increase in the Q1 CPI. The strong increase in the monthly Food Price Index in January was surprisingly broad-based and, while there was some retracement in February, we still expect food prices to be higher over the March quarter.

Petrol prices – which we estimate to have increased around 6% in Q1 – are also expected to make a substantial positive contribution to tradable inflation and the overall CPI.

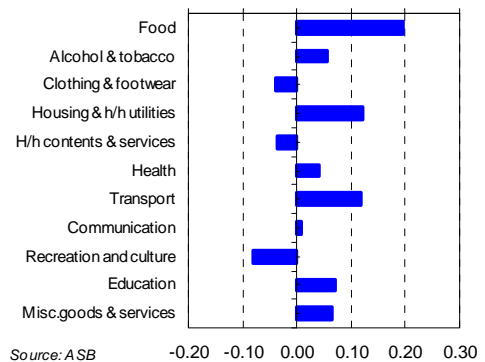
Outside of petrol, tradable inflation is expected to decline in Q1 as the strength in the NZ dollar late last year flows through to lower prices for imported consumption goods at the retail level. Non-tradable inflation was surprisingly muted in the December quarter. We expect a reasonably strong increase in non-tradable inflation of 0.7% in Q1. Although part of this reflects some typical increases for a March quarter – primarily rents and education fees – we believe construction costs will also be a key driver of non-tradable inflation. Business surveys have shown an increase in recent months in pricing intentions in the construction sector back to pre-recession levels. We are forecasting a modest rebound in construction costs in Q1, and further increases over the coming years as excess capacity in the sector diminishes in light of a recovery in housing construction activity. We expect population growth will underpin demand for housing and thus support persistent housing-related inflation more generally.

Outside of housing, we expect non-tradable inflation to rise over the coming years as firms increase output in response to a recovery in demand. Given the substantial cut-backs firms made to investment over 2009 – which will likely exacerbate the resource pressures in the economy – we expect non-tradable inflation will remain persistently high. While the NZIER capacity utilisation measure has been unusually volatile over the past few quarters as a result of sporadic activity in the primary sector, overall this measure has been trending up. This suggests a building up of capacity pressures over the coming years. Emerging inflation pressures is also reflected in Q1 two-year ahead inflation expectations, which remain elevated at 2.7%.

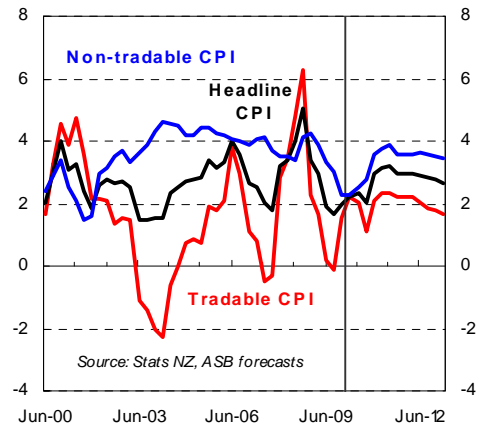
‘One-off’ developments will leave the RBNZ with little inflation breathing space

Adding to the emerging capacity pressures in the economy will be administrative inflation that will come through in Q3 this year. The recently announced increases in ACC levies will mean a higher increase in vehicle licensing fees than is typical for a September quarter.

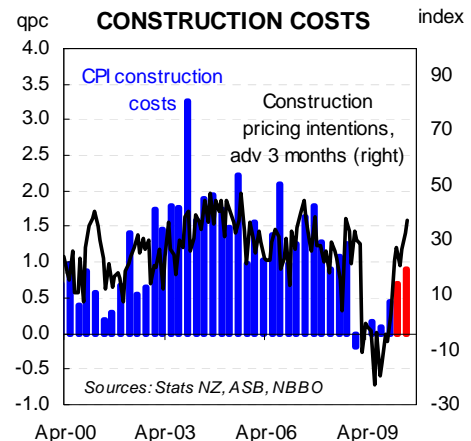
COMPONENT % CONTRIBUTION



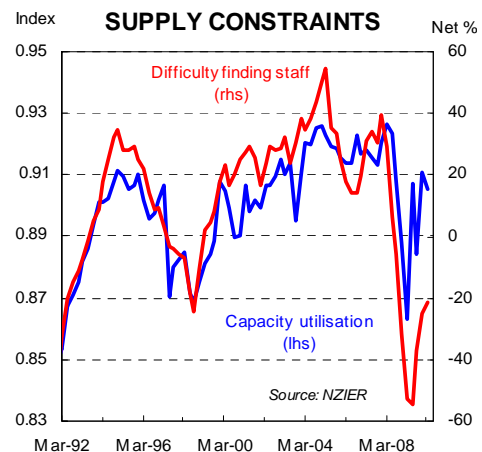
BREAKDOWN OF NZ INFLATION



PRICING INTENTIONS & CONSTRUCTION COSTS



SUPPLY CONSTRAINTS



Furthermore, the implementation of the Emissions Trading Scheme (ETS) will flow through to higher petrol and electricity prices directly, and raise the price of energy-intensive goods and services more indirectly. We believe this administrative inflation will push annual inflation up above the top of the RBNZ target band of 3% and, more worryingly, keep non-tradable inflation elevated over the coming years.

In addition, the Government has raised the possibility of an increase in GST, which will provide a further boost to CPI inflation. While all these things are one-off in nature, the risks that the higher headline inflation will spill over to inflation expectations – and thus affect wage and price setting behaviours – leave the RBNZ with little inflation breathing space. This is particularly the case when the RBNZ is already forecasting annual inflation will track just below the top of the target band over the medium term even without allowing for the price effects of the ETS.

Implications: RBNZ will need to keep inflation pressures in check

While inflation is well-behaved for the time being, we expect the building up of inflation pressures and administrative inflation over the coming year will see annual CPI rise above 3% in 2011. Of particular concern is the persistence in non-tradable inflation we expect over the medium term. The RBNZ will need to commence the tightening cycle in June with a 25 basis point increase in order to keep these inflation pressures in check. Even with OCR increases starting from June, stimulatory short-term rates are likely to prevail into early 2011 to still provide some support to the economy during much of the tightening cycle.

Stimulus to start being withdrawn soon given 2011 inflation outlook

Some background to the data.

The Consumer Price Index (CPI) measures the weighted average price change of a fixed basket of goods and services, which represents the average expenditure pattern of New Zealand households. The CPI is one important measure of inflation, and is often used in wage and rent reviews. The CPI is also used by central banks as a target for control of inflation. The Reserve Bank of New Zealand (RBNZ) currently has a target of keeping CPI increases within 1-3% per annum on average over the medium term. Hence, the RBNZ monitors potential impacts on the CPI very closely.

CPI the key inflation rate measure.

ASB ECONOMICS & RESEARCH			PHONE	FAX
Economics				
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604	(649) 302 0992
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 369 4421	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	

DISCLAIMER

Views expressed in this report are those of the authors as at the date of this report and are based on information and sources believed but not warranted to be correct. Any views or information, while given in good faith, do not necessarily reflect the views of ASB and are subject to change without notice. Neither ASB Bank Limited nor any person involved in preparing this report accepts any liability for any loss or damage whatsoever that may directly or indirectly result from any views, information or omission contained in this report.