12 July 2013

Westpac Institutional Bank

# Maximum force

## Q2 CPI preview: 16 July, 10:45am

- **We estimate that consumer prices rose 0.2% in the June quarter, taking annual inflation down to 0.7%, a new low point for this cycle.**
- **The steep rise in the New Zealand dollar over the last year created a substantial downdraft on the prices of internationally traded goods.**
- **We believe this effect has now peaked – and if the currency extended its recent decline, it could become a significant inflationary force in coming years.**

With the New Zealand dollar index hitting a new post-float high during the June quarter of this year, another quarter of soft consumer price inflation was all but assured. We expect annual inflation to slow to just 0.7%, compared to 0.9% in the March quarter. Not only would this be the slowest rate of inflation since 1999, it would mark the fourth straight quarter where inflation undershot the Reserve Bank's medium-term target band of 1-3%.

However, it's also likely to be the last. Persistently low inflation requires an ever-rising exchange rate – the trade-weighted index over the June quarter was up 7% on a year earlier – so even if the exchange rate steadies from here, its depressing effect on prices will wane. And if it extends its decline, it could become a major source of inflation. Meanwhile, a strengthening economy, a hot housing market and massive pressures on the building industry are a recipe for higher home-grown inflation in the future.

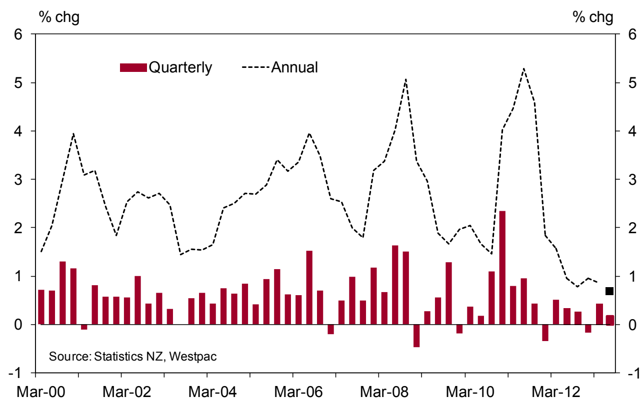
### Details

Quarterly changes in the CPI often tell us more about idiosyncratic factors than about the general trend. In this case, the largest positive contribution will come from electricity prices (up 2.5%). Changes to power prices tend to be lumped into the June quarter, and this year is on a par with increases over the last decade or so.

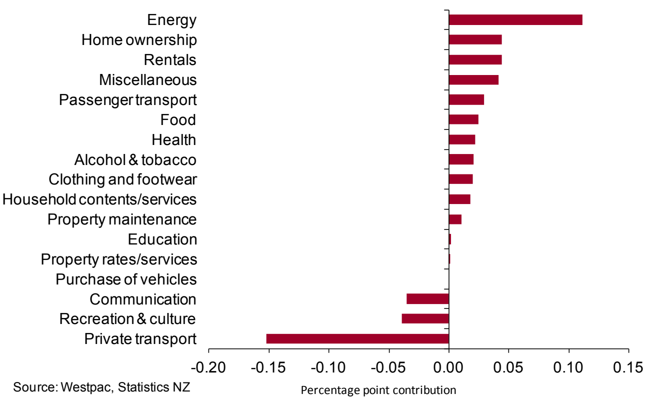
The other standout category is private transport, with petrol prices down 2.6% over the quarter to their lowest since December 2011. That will prove temporary – petrol prices have already established a new record high this month.

Looking beyond these items, there are two themes driving the June quarter figures. The first is the effect of the high New Zealand dollar – while it has started to fall since May, it was still at a record high on average over the quarter. A rising exchange rate puts downward pressure on the prices of imported and import-competing goods, and we suspect that this depressing force reached its peak in the last year. We estimate that tradable goods prices fell 1.3% in the year to June, the steepest decline since 2004 (which in turn was the steepest on record).

**NZ CPI inflation**




**Forecast contributions to quarterly inflation**




The second factor is the pickup in the housing market, which can manifest in a variety of categories: purchase prices for new houses, rents, property maintenance, and legal and real estate agents' fees. We note that housing-related inflation has been modest at a nationwide level (though rampant in Canterbury), but the pace is gradually increasing.

### Market implications

The RBNZ has described its dilemma in terms of low inflation today versus the expectation of higher inflation over the next few years. Consequently, it probably won't be rattled by next week's release – another quarter of sub-1% inflation would be uncomfortable, but not unexpected (its forecast in the June *Monetary Policy Statement* was 0.8%).

As for the prospect of higher future inflation, what happens to the New Zealand dollar is crucial. Even if it were to hold steady, it would be less of a disinflationary force from here on. And if it extended its recent decline, it could become a major *cause* of inflation in coming years. As we've said recently, much of this is in the hands of the US Federal Reserve and the pace at which it draws back from its unconventional monetary policy measures. We think they will move more cautiously than the market is factoring in; if we're right, the NZ dollar could claw back some of its recent losses. Either way though, we suspect that the NZD's long-running uptrend has broken.

A softer exchange rate, a strengthening economy, a hot housing market and massive pressure on the building industry would all point in the same direction for inflation. We think that by next year the RBNZ's 'dilemma' could be looking distinctly one-sided.

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