16 July 2013

Westpac Institutional Bank

No time to relax

Q2 consumer prices 0.2% q/q, annual inflation 0.7%

- **The Consumer Price Index (CPI) rose 0.2% in the June quarter, in line with our forecast and slightly below market expectations. Annual inflation slowed to 0.7%, its lowest since 1999.**
- **The rise in the New Zealand dollar has done much to suppress the prices of tradable goods over the last year. But with the currency no longer rising, this effect will fade and perhaps even reverse course from here.**
- **Meanwhile, evidence of housing-related price pressures – and not just in Christchurch – is an upside risk to the Reserve Bank's benign inflation outlook.**

Consumer prices were just as subdued as we expected them to be in the June quarter, with annual inflation falling to its lowest rate in nearly 14 years. The headline figure, however, hides a yawning gap between falling prices for tradable goods and a gradual uptick in prices for non-tradable goods and services. That mix will not be cause for comfort for the Reserve Bank – lower tradables prices are the product of a rising exchange rate, which may now be turning course, while non-tradables inflation is more a reflection of domestic conditions, including current interest rate settings – and it tends to be far more persistent once it takes hold.

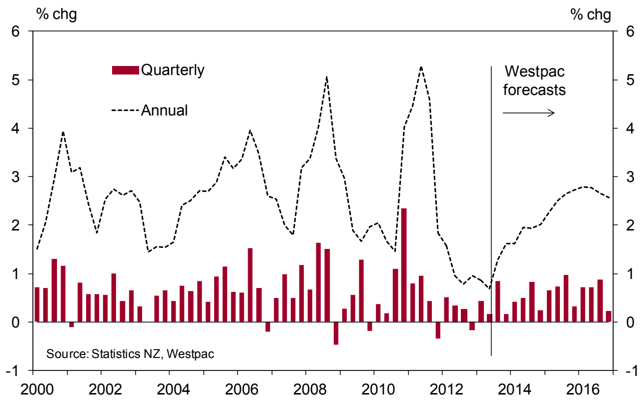
Details

The CPI rose 0.2% in the June quarter, in line with our forecast but a touch below the market median and the RBNZ's pick of 0.3%. Tradable goods prices fell 0.5%, leaving them down 1.6% on a year ago – the steepest annual fall since March 2004, when prices were 2.3% down on a year earlier. The persistent rise in the New Zealand dollar over the last few years has done much to depress the prices of imported and import-competing goods, and we suspect that this effect reached its peak in the latest quarter. Meanwhile, prices for non-tradable goods and services rose 0.6% for the quarter, nudging the annual rate up from 2.4% to 2.5%.

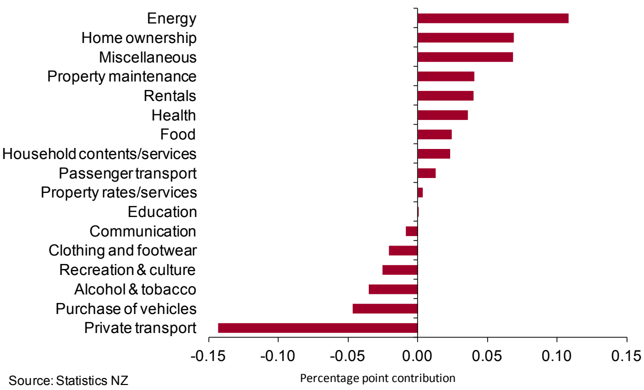
As we expected, the largest positive contribution was from electricity prices. These are most commonly reviewed in the June quarter of the year, and the 2.6% rise this year was similar to previous years. The standout category on the downside was private transport, with petrol prices down 2.5%. That could be more than reversed next time – while it's still early in the September quarter, petrol prices have reached a new record high.

The effects of the strong exchange rate were apparent across a range of categories. As well as contributing to the fall in fuel prices, there was a 1.5% drop in car prices (the sharp fall in the yen was likely a factor here), ongoing falls in clothing and electronic goods, and a smaller than usual 0.2% rise in food prices.

NZ CPI inflation



Contributions to quarterly inflation



The surprise for us was the extent of housing-related inflation in the June quarter. We've been arguing for some time that this would be an inevitable product of the Canterbury rebuild and the upturn in the housing market, but the evidence has been patchy from one quarter to the next. This time it came through strongly across a range of categories.

New house prices rose 1.7% for the quarter and 4.1% on a year ago, the fastest annual pace since 2008. House prices in Canterbury continued to rise sharply, up 2.9% for the quarter and 11.7% on a year ago. That's been an ongoing story since the post-quake rebuild began; what's more notable is that prices in Auckland rose 1.6% for the quarter, having only risen 1.2% in the preceding year. There were also sizeable quarterly price increases for property maintenance (1.1%) and real estate and conveying services (1.3%). One group that didn't join in was rentals – while they are accelerating in Canterbury (up 4.4%yr), the rate of increase is actually slowing in the rest of the country. That suggests more of a cost-push story than a demand-driven one.

While the record to date on housing-related inflation has been patchy, the latest reading backs our view that construction cost inflation will spread more broadly as the Christchurch rebuild progresses. There may be reason to expect an ongoing wage premium to attract workers into the region, but building materials and equipment operate in a nationwide market and there's no reason to expect 'Christchurch prices' to persist.

Implications

The CPI outturn was slightly below the average market forecast, sending the NZ dollar about 20pts lower to 0.78, though this was short-lived. Interest rate markets are pricing in an 80% change of an OCR hike by March next year, which is in line with our view.

While headline inflation was slightly weaker than the RBNZ forecast back in the June *Monetary Policy Statement* – and below the 1-3% target range for the fourth quarter in a row – the details of the report will offer little comfort. Low headline inflation to date has relied on an ever-rising exchange rate – while the NZ dollar has fallen since May, the average trade-weighted index over the June quarter was still up 7% on a year ago. That disinflationary effect will fade even if the currency steadies from here; and if it falls further in the near term (which we should note is not our central view) then inflation could be back in the upper half of the target range a lot sooner than the RBNZ was expecting.

Meanwhile, domestic inflation is slowly but steadily rising on the back of building activity in Canterbury and Auckland – in much the same way as in previous construction booms. In contrast, the RBNZ has taken the view that housing-related inflation will be relatively contained this time, due to the localised and co-ordinated nature of the Christchurch rebuild. It could take some time to persuade the RBNZ otherwise, but today's CPI report was one step in that direction.

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