Westpac Institutional Bank

A gradually turning tide

Q4 consumer prices -0.2% q/q, annual inflation 0.9%

- **The Consumer Price Index (CPI) fell 0.2% in the December quarter, a bit softer than expected. Annual inflation rose slightly from a 13-year low.**
- **The legacy of a higher New Zealand dollar has suppressed tradable goods prices, though its effect on the rate of inflation is ebbing.**
- **Housing-related inflation is gradually re-emerging, though the effects of the Christchurch rebuild seem fairly contained so far.**

Summary

All signs pointed to inflation remaining at an historically low ebb in the December quarter, and today's result was once again on the lower side of forecasts. Even so, we don't think the Reserve Bank will be alarmed yet about the risk of undershooting its medium-term inflation target. The strong New Zealand dollar is dampening prices for internationally-traded goods, but there are signs that its peak effect has passed. Meanwhile, construction costs are rising as the Christchurch rebuild progresses, and while they have been contained so far, the RBNZ will stay alert for signs that they are spreading

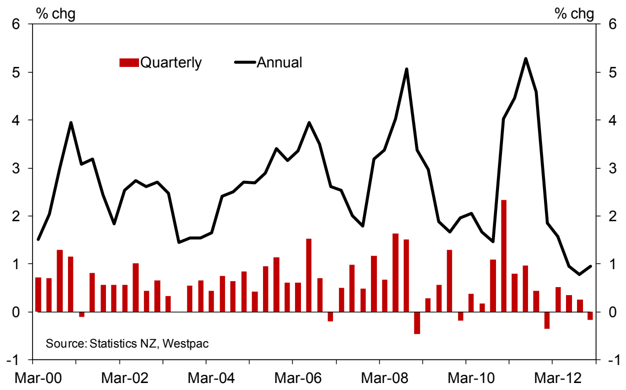
Details

Consumer prices fell 0.2% in the December quarter, compared to our forecast of a 0.1% drop (revised down from 0% after Tuesday's food price figures). A small drop in the December quarter is not unusual: food prices usually see a large seasonal fall (-1.8% this time), and unlike other quarters there are no annual price reviews such as for local body rates, alcohol and tobacco excise or school fees. For that reason it's more useful to focus on the trend in the annual inflation rate, which rose slightly from a 13-year low of 0.8%.

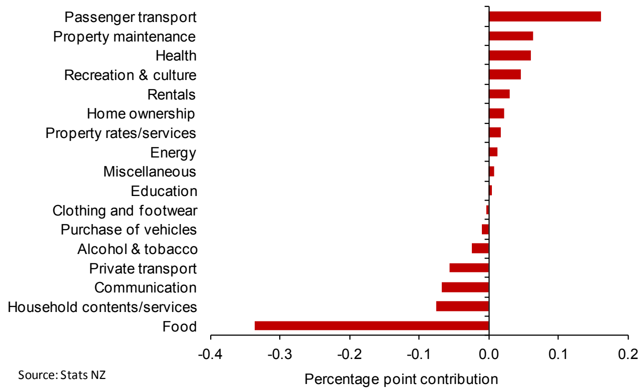
In fact, most of the CPI groups are now showing an upturn in the annual rate of price changes. The major exception is food prices, which were down 0.5% on a year earlier – and since this makes up nearly a fifth of the CPI, it has a significant impact on the total. The lagged effect of lower world food prices worked in consumers' favour in 2012; by the same reasoning, 2013 is unlikely to be as hospitable.

Compared to our forecasts (and the RBNZ's), the downside surprise was in tradable goods, as has been the case for the last several quarters. The persistently high exchange rate has been a significant factor here, depressing the prices of imported and import-competing goods. However, the currency is no longer rising as swiftly as it was in recent years, and there are signs that its peak impact on consumer price *inflation* has passed.

Consumer Price Index



Contributions to quarterly change



One possibly related issue is the prevalence of temporary discounts. Statistics NZ reports that the share of items on discount at the time they were surveyed has risen over the last year, especially for appliances and clothing. It's not apparent which of these 'discounts' reflect a genuine squeeze on margins, versus simply passing on a cost decrease. It also tells us little about to what extent discounting is even necessary. Our provisional forecast of retail spending for the December quarter is a 2% rise in nominal terms; falling prices would imply an even greater increase in volumes.

Housing-related inflation is an important component of the CPI survey – the RBNZ is on alert for signs that the perkier housing market and the Canterbury rebuild are starting to generate broader-based price pressures. Today's figures show that these pressures are present, but fairly well contained so far. The cost of new housing was up 3.1%yr nationwide, but with starkly different experiences: up 10%yr and rising in Canterbury, but only 1.5%yr and slowing in Auckland. Similarly, rents are accelerating in Canterbury and Auckland, but more subdued in the rest of the country. Prices for property maintenance services (i.e. builders and handymen) are on the rise again, although only modestly, up 2.1% on a year ago.

Market implications

Financial markets seemed to react to the fact that annual inflation was unexpectedly outside the RBNZ's 1-3% target range for a second quarter. The NZ dollar fell 60pts to 0.8360 and the two-year swap rate fell 3 basis points to 2.79% after the release.

Despite the discomfort of appearing to undershoot its inflation target again, we don't think the RBNZ will be swayed too much by today's release. Much of the downside surprise on inflation in recent times has been a product of upside surprises on the exchange rate; in the absence of further substantial gains in the currency, this disinflationary force will continue to fade. The other key issue is housing-related inflation. This has been contained so far, but the risk of a breakout will remain throughout the multi-year Christchurch rebuild – and would clearly be a risk if the housing market were egged on further by lower interest rates.

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