10 July 2014

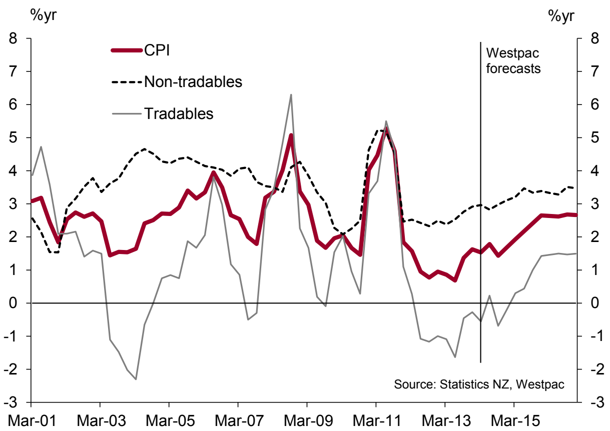
Westpac Institutional Bank

Approaching target

Q2 CPI preview: 16 July, 10:45am

- We expect a 0.4% rise in the Consumer Price Index (CPI) for the June quarter, lifting annual inflation to 1.8%.
- Food and electricity prices were the main contributors over the quarter.
- Elsewhere, we expect to see a continuation of the rise in non-tradables prices, partly counteracted by the high New Zealand dollar depressing tradables prices.
- The Reserve Bank views the economy as running above its non-inflationary potential, and as such will be increasingly sensitive to signs of a re-emergence of general inflation pressures.

CPI inflation



Inflation concerns are coming to the fore again. The Reserve Bank is firmly of the view that the economy is now running ahead of its non-inflationary potential, however you might measure it. The high New Zealand dollar has helped to depress the prices of imported goods, but its influence is waning. And as this week's *Quarterly Survey of Business Opinion* showed, a growing number of firms are saying that they not only intend to raise their prices, but are successfully doing so.

The June quarter CPI, due on Wednesday, will be the last major data release before the 24 July OCR review. Our sense is that the RBNZ intends to get at least one more OCR hike under its belt before assessing the impact of the hikes to date. But any surprises in the inflation figures could have a bearing on the tone of the RBNZ's statement: a softer than expected outcome might see the RBNZ signal an extended pause going forward, while a stronger than expected result could raise concerns about the RBNZ falling behind the curve.

We're expecting a 0.4% rise in the CPI for the June quarter, which would lift the annual inflation rate from 1.5% to 1.8%. While this is still below the RBNZ's medium term target midpoint of 2%, it would be the highest rate since the December 2001 quarter. Our forecast is slightly higher than the RBNZ's estimate of 0.3% for the quarter (1.7% annual). However, we put the difference down to the extra information received on food and fuel prices since the June *Monetary Policy Statement*. These factors tend to be transitory, so the RBNZ may be more willing to look through any surprises.

Turning to the details, we expect the main positive contributions to come from food and electricity prices. We expect a 0.9% rise in food prices (subject to the figures for the June month, which are published this Friday), a slightly larger than usual increase for this time of year. Food price inflation was more or less flat over the last couple of years, but it has started to pick up modestly in recent months. Annual changes in electricity prices typically occur in the June quarter; our estimate of a 2.7% increase is on a par with last year's increases.

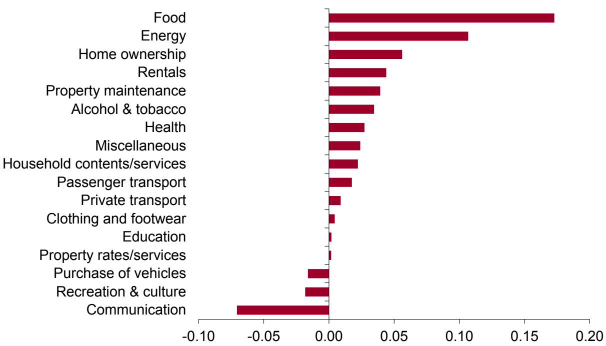
We also expect substantial, and ongoing, contributions from the housing-related categories: new dwelling prices, property maintenance and rents. The first two have been accelerating in line with the upswing in house prices and construction activity; in contrast, rental growth (which has quite a high weight in the CPI) has remained subdued at around 2%yr.

The upward trend in the NZ dollar means that tradable goods inflation is likely to have remained subdued in the June quarter. We expect only small price increases for household contents and clothing, and lower prices for cars and electronic goods.

The wild card this time is in telecommunications. During the quarter, the major internet service providers started to offer uncapped data plans for the first time. While it's a welcome and overdue move, we really don't have a sense of how this will be treated in terms of 'price per unit' (which is straightforward to calculate for capped data plans). Secondly, the effect on the CPI will depend on the uptake of these new plans. As such, the recent history of price declines in this area (when better deals were given to all existing customers) may not be a useful guide. We've assumed a 2% fall in the communications category, but the bound of uncertainty here (and hence for the CPI forecast as a whole) are fairly wide.

On our forecast, the rise in the annual inflation rate is largely down to two factors. The first is the slightly larger than usual rise in food prices, compared to a smaller than usual increase in the June quarter last year. The second is that petrol prices were roughly unchanged on average over the quarter, compared to a 2.5% drop last year. Outside of those two items, we don't see much evidence that price increases became more widespread over the quarter.

Contributions to quarterly inflation



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