Economic Update

Q4 2012 CPI Preview

11 January 2013

ASB Institutional

Inflation pressures to remain muted

- Q4 CPI expected to remain flat, with the annual pace of inflation lifting to 1.1% (from 0.8%).
- Seasonal decline in food prices, the elevated NZD and continued discounting to keep inflation pressures muted.
- Construction costs likely to accelerate as rebuild commences, but price spill-overs remain contained for now.

The December quarter CPI index is released on Friday 18th of January. We expect the CPI index remained unchanged in the December quarter, bringing the annual rate of inflation up to 1.1% (from 0.8%). This will also see inflation move back inside the RBNZ's inflation target band (of 1-3%).

December is a seasonally-weak quarter for inflation, largely due to the seasonal decline in fruit and vegetable prices heading into summer. Food items make up 19% of the CPI basket, and as a result food prices tend to have a large impact on the quarter-to-quarter movements in inflation.

Beyond food prices, we expect tradable inflation to remain subdued, reflecting the elevated NZD. Meanwhile, non-tradable inflation should continue to show signs of picking up, albeit from a low rate. Continued increases in construction costs, rents and insurance premiums are likely to remain key drivers of this lift.

With inflation at the bottom of the RBNZ target band, and the pace of economic recovery remaining subdued, there is little urgency to increase the OCR. As a result we expect the RBNZ will leave the OCR unchanged at 2.5% until December. However, there are upside risks to the inflation outlook, which the RBNZ will watch carefully. The key ones are, the second-round inflation pressures from the Canterbury rebuild and the recent pick up in housing market pressures.

Q4 CPI to remain flat, annual inflation at 1.1%.

Expectations: CPI to remain flat in Q4

The NZ Q4 CPI will be released at 10.45am on Friday the 18th October. We expect the CPI will remain unchanged over the December quarter, which will see the annual rate of inflation lift to 1.1%, from 0.8% in Q3.

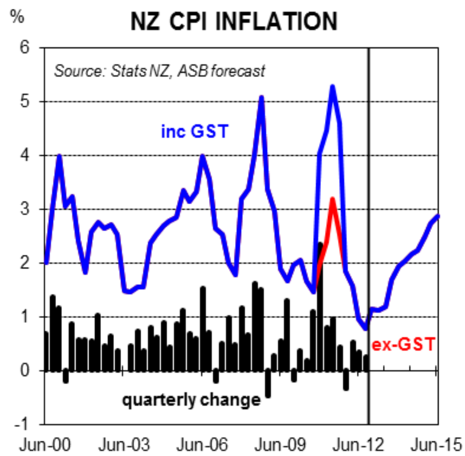
Seasonal fall in food prices behind Q4 decline.

Food price deflation to ease in 2013

We expect food prices to fall 1.8% over the December quarter, led by a 9.5% seasonal decline in fruit and vegetable prices. At the time of writing, the December month food price index had yet to be released: we have assumed the index remained unchanged over the December month. While food prices have fallen over recent months, the decline has been slightly less than usual (with prices up 4% on year-ago levels). This is due to reduced crop yields for certain food items, including avocados.

Lower dairy and meat prices underpin food price deflation over 2012 – food prices likely to recover in 2013.

The food price index is 0.7% below year-ago levels, and food price deflation has been a key contributor to the current weakness in headline inflation. Much of this decline has been in meat and grocery prices (in particular dairy prices) – and this reflects falls in global food commodity prices in early 2012 from very elevated levels at the end of 2011. During the middle of the 2012, the US and other northern hemisphere regions suffered a severe drought, resulting in large crop failures which have lifted the price of grains. For now meat and dairy prices have stabilised, but we expect some increase in prices over the coming year.



CPI breakdown Q%	Jun-12	Sep-12	Dec-12
Food	0.1	1.1	-1.8
Alcohol & tobacco	0.7	0.3	-0.1
Clothing & footwear	0.2	-0.3	0.3
Housing & h/h utilities	1.0	0.8	0.7
H/h contents & services	0.0	0.4	0.0
Health	0.4	0.9	0.5
Transport	0.2	-1.1	0.6
Communication	-2.5	-1.6	-1.0
Recreation and culture	-0.3	-0.1	0.5
Education	0.1	0.1	0.2
Misc.goods & services	0.7	1.1	0.8
CPI	**0.3**	**0.3**	**0.0**
Tradable	**0.1**	**0.0**	**-0.5**
Non-tradable	**0.5**	**0.5**	**0.4**
CPI Annual	**1.0**	**0.8**	**1.2**

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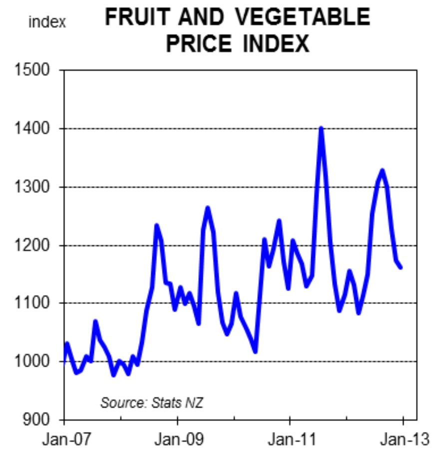
Continued declines in communications prices.

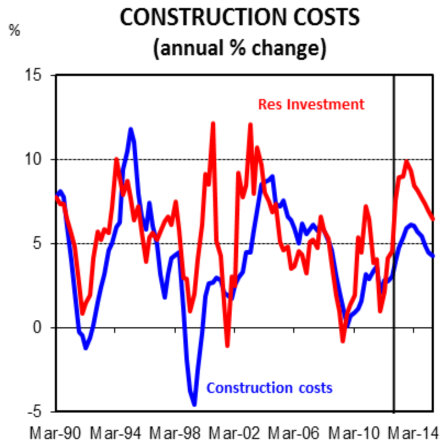
Continued declines in some areas
Beyond decline in food prices, we also expect to see a 1% decline in communications. Much of the fall in these components reflects the trend of declines in technology prices in these categories (i.e. prices for smart phones falling as new models are introduced) as well as competition between telecommunication providers.



Increased housing and utility prices, led by construction costs and rents.

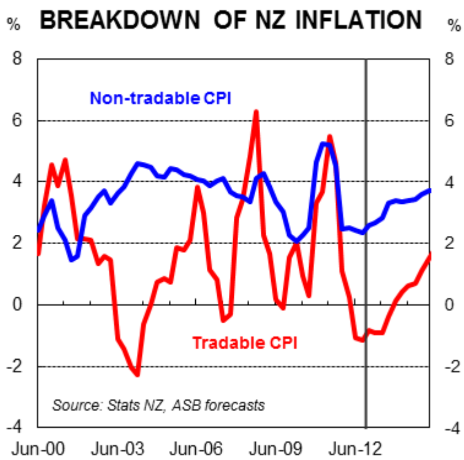
Downward inflation influences to ease
Offsetting the declines are increased prices in housing and utilities, insurance and a seasonal lift in international airfares, accommodation and package holidays.

We expect that construction cost inflation will continue to accelerate as residential construction activity lifts (led by the Canterbury reconstruction). Canterbury construction inflation is current running at an annual rate of almost 10%. However, there has been limited flow-through impact on prices to the rest of the country so far. As construction activity continues to grow (in Christchurch and, to a lesser extent, Auckland) and demand for construction resources increases, we expect stronger price increases will start to be recorded outside of Canterbury.



Non-tradable inflation subdued for now, to pick up as economic recovery gains traction.

Beyond the price increases related to housing shortages and insurance premiums, non-tradable inflation remains contained. This is consistent with the subdued pace of economic recovery. Over time, we do expect these pressures will increase. As the economy recovers and unemployment declines, increased demand will start to place pressure on resources, while a lift in wages will also contribute to a lift in services inflation. However, for the time being these inflation pressures remain well in check.



Inflation likely to remain low over 2013, no urgency to lift the OCR.

Implications
The RBNZ forecast a 0.1% increase in Q4 CPI. The market median forecast is also for a 0.1% increase.

Inflation is likely to remain at the bottom of the RBNZ's 1-3% target band over the coming year. We expect inflation will continue to hover around the 1% mark for a number of quarters – largely reflecting the weakness in tradable prices owing to the elevated NZD. We do expect that, over time, as the economy recovers, underlying inflation will pick up. Without further appreciation in the NZD, tradable inflation will strengthen. The lift in domestic inflation pressures will further boost inflation toward the upper end of the RBNZ's inflation target over 2014.

However, for now, the weaker pace of GDP growth, as evident in the Q3 GDP release, implies underlying pressures on resources are muted (beyond the Canterbury rebuild). This suggests the RBNZ is likely to leave to OCR on hold until December this year.

RBNZ to remain watchful of upside risks.

Nonetheless, there remains some clear upside risks to the inflation outlook, which the RBNZ will remain vigilant in watching for. One is the second-round inflation impact from the Canterbury rebuild. This has been contained for now, but the RBNZ will become more concerned should it see evidence of spill-over starting to occur. In addition, the current pressure in the housing market is likely to be of some discomfort – indeed the RBNZ did highlight the risk of stronger consumer demand as a result of the wealth effects as being a risk to its central inflation projections.

If housing market dynamics continue unabated, we see growing possibility the RBNZ may look to housing-targeted macro-prudential tools to take some of the heat out of the housing market, whilst leaving the OCR unchanged to support the wider economy a little longer.

Background to the data

CPI key measure of inflation in the NZ economy.

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.

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