ECONOMICS

15 Jan. 10

Economic Update

Subdued for now

Preview of NZ Consumers Price Index – Q4 2009

- **We expect the Q4 CPI to decline by 0.2% qoq, bringing annual inflation to 1.9%**
- **Driven by the retracement in vegetable prices from previous quarter's weather-affected strength**
- **We expect this easing in inflation to be short-lived**

Falling food prices are expected to drive a 0.2% decline in Q4 CPI, thus bringing annual inflation to 1.9%. Leaving aside this volatile component, CPI is expected to have increased 0.2% for the December quarter. This reflects our expectations that inflation will be subdued in the near term. A large part of this easing in inflation can attributed to a decline in tradable inflation given strength in the NZ dollar over the second half of 2009, such that we expect tradable inflation to have declined by 1.0% in Q4. In addition, we expect an increase in non-tradable inflation of only 0.4% in Q4 given evidence of excess capacity in early 2009.

Beyond Q4, more recent surveys of businesses point to a building up of inflation pressures. Over the past year firms have cut back on investment, which likely exacerbated the recent reported drop in spare productive capacity. Furthermore, inflation expectations ticked up in the December quarter.

In its December *MPS*, RBNZ expressed concern at the lack of disinflation in the non-tradable sector during the recession. Hence it will be wary of the potential for rising inflation pressures to build up beyond 2010 as the global recovery gets underway. We continue to expect the RBNZ to increase the OCR by 50 basis points at the April OCR Review.

Expectations: annual inflation rate should fall in near-term

ASB's expectations:
-0.2% in Q4,
1.9% annual.

Market:
0.0% in Q4,
2.1% annual

RBNZ:
-0.2% in Q4
2.0% annual.

The NZ Q4 CPI will be released at 10:45am on Wednesday 20 January.

We expect a 0.2% qoq decline, which would bring annual inflation to 1.9%.

The market median expectation is 0.0% qoq, and 2.1% yoy.

The RBNZ's December *MPS* forecast was -0.2% qoq and 2.0% yoy (with the difference to our forecast being in rounding). Since the forecast was published there has been little to suggest the RBNZ will have subsequently altered its view.

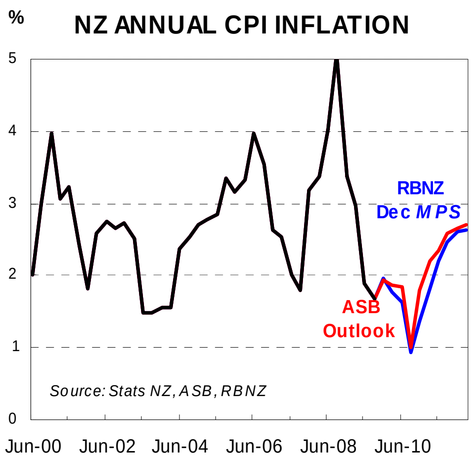
[Review of Q3 CPI]

Food prices expected to make a large negative contribution

In contrast to the previous quarter, we expect food prices to make a substantial *negative* contribution to CPI for the December quarter. This largely reflects the unwinding of the weather-affected strength in vegetable prices that occurred in June, as shown in the monthly Food Price Index in recent months. Furthermore, we expect retail meat prices to decline over the December quarter reflecting the fall in NZ dollar meat prices in international markets.

Some offset from housing component

We expect some of this weakness to be offset by ongoing persistence in inflation in the housing component.



CPI breakdown Q%	Jun-09	Sep-09	Dec-09
Food	0.9	1.7	-2.2
Alcohol & tobacco	0.5	1.5	0.1
Clothing & footwear	1.8	-0.1	0.3
Housing & h/h utilities	0.4	0.7	0.5
H/h contents & services	1.5	-0.3	-0.6
Health	0.9	1.4	0.5
Transport	0.6	3.1	0.4
Communication	0.7	-0.2	-0.2
Recreation and culture	-1.2	0.9	0.9
Education	0.0	0.0	0.0
Misc.goods & services	1.0	0.7	0.1
CPI	**0.6**	**1.3**	**-0.2**
CPI Annual	**1.9**	**1.7**	**1.9**

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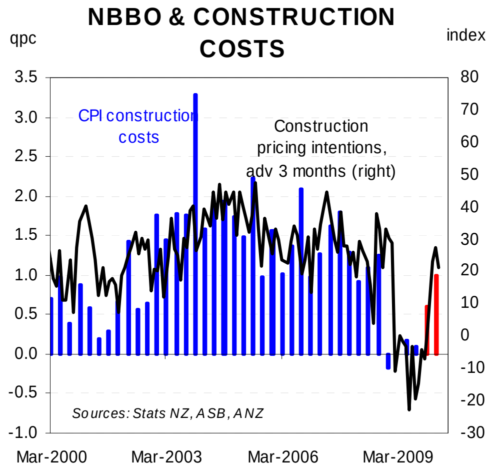
Easing in non-tradable inflation expected to be short-lived

Brief easing in non-tradable inflation

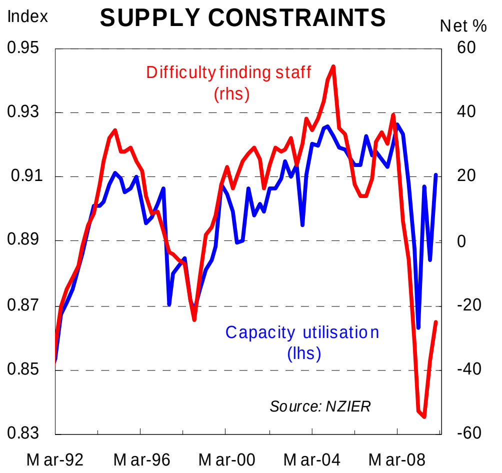
While we expect an easing in non-tradable inflation in Q4, we do not expect non-tradable inflation to remain low beyond early 2010. As the RBNZ noted in the December *MPS*, non-tradable inflation has been surprisingly persistent through the recession. In particular, the decline in construction costs was muted given the extent of the contraction in the building sector. Business surveys in recent months have shown a rebound in building activity, with pricing intentions in the sector almost rising back to pre-recession levels in recent months. As such we expect a modest rebound in construction costs over the coming year. In addition, rental inflation is expected to lift in light of population growth which will underpin demand for housing.



…as capacity pressures begin to emerge

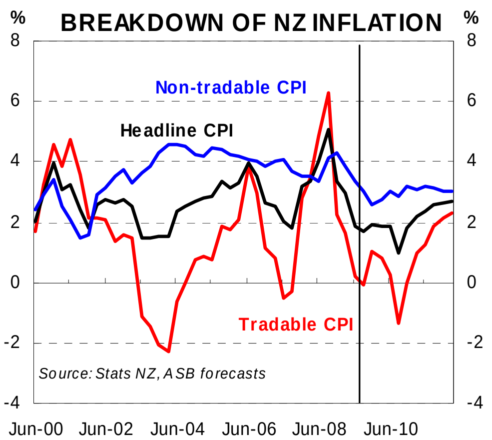
Outside of housing, the lingering effects of excess capacity earlier in 2009 will likely weigh on non-tradable inflation in Q4. However, there are signs this excess capacity has been diminishing. The December quarter NZIER QSBO showed a rebound in capacity utilisation. While this measure has been volatile over recent quarters as a result of sporadic activity in the primary sector, overall capacity utilisation has been edging up over 2009.

The increase in difficulty finding staff also points to a tightening in the labour market, thus suggesting wage pressures will emerge over 2010. There was evidence of labour hoarding throughout the recession, with the adjustment occurring largely through very weak wage growth. We expect wage growth to pick up as firm profitability improves over the coming year.



Meanwhile, the substantial cut-backs to investment in 2009 is likely to place resource pressures on firms as they increase output in response to a recovery in demand.

Turning to tradable inflation, we expect the strength in the NZ dollar over the second half of 2009 to weigh on tradable inflation over much of 2010. Beyond that, we expect the depreciation in the NZ dollar to push up the price of imported goods, thus underpinning tradable inflation.



Overall, we expect headline inflation to remain in the top half of the target band from the beginning of 2011.

Implications: RBNZ will be wary of inflation pressures building up

Stimulus to start being withdrawn soon given 2011 inflation outlook

Annual inflation will look well behaved over 2010, influenced by the lingering impacts of recession (as well as reversal of food price increases). But the recession didn't dent inflation as much as would normally be expected and some of the disinflationary forces are already starting to unwind. The tide of underlying inflation pressures will begin turning as the economy continues to gradually recover. Over 2011 inflation is likely to once more reside in the top half of the inflation target band. Against that outlook, the RBNZ will need to start reducing monetary stimulus relatively soon – we continue to expect a 50bp lift in April. Even then stimulatory short-term rates are likely to prevail into early 2011, still providing support to the economy during much of the tightening cycle.

Some background to the data.

CPI the key inflation rate measure.

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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