

Zeroing in

Q4 CPI preview: 20/01 10:45am NZT

- **We expect zero increase in the CPI for the fourth quarter of 2009.**
- **Base effects will push annual inflation up to 2.1%.**
- **Fourth-quarter inflation will be critical for the RBNZ after the shock strength of third-quarter inflation.**

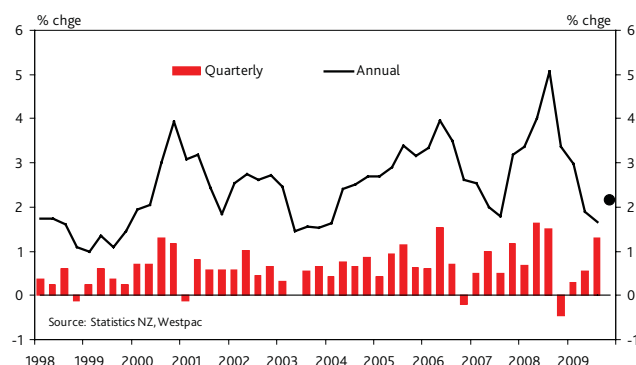
Last quarter's 1.3% quarterly increase in the Consumer Price Index (CPI) was a huge upside surprise. There were a number of one-offs that boosted inflation in the quarter – local body rate increases, a temporary spike in food prices, and higher airfares. But these were mostly anticipated by forecasters. The real surprise, and the real worry for the Reserve Bank, was that general inflation just did not fall as far as anticipated. The central bank had been counting on the severe recession and exchange rate appreciation to knock the stuffing out of prices. So the Bank got quite a shock when it saw that inflation had only fallen to the mid-point of its target band.

Next Wednesday's Q4 inflation number will be critical for telling us whether last quarter's surprisingly strong read was a mere statistical quirk or not. If not, the RBNZ will have cause to worry that inflation is not going to moderate to the required degree, meaning monetary policy will have to be tightened more aggressively, and perhaps earlier, than currently planned.

The RBNZ is currently plumping for the statistical quirk side, forecasting -0.2% quarterly inflation. After perusing the details ourselves, we are forecasting dead flat prices for the quarter, taking annual inflation to 2.1%. The key drag on inflation is food prices, which fell 3.3% from July to November. We expect they ticked back up by 0.5% in December, owing to snow-damage that hit crops a couple of months ago (the December Monthly Food Price Index will be released at the same time as the December quarter CPI). Even so, the overall fall in food prices is expected to knock a whopping 0.4 percentage points off Q4 CPI. A fall in domestic airfares is the other key negative, although that will be offset by a sharp rise in international airfares. Petrol prices have been pretty much flat (for a change).

Outside of these real movers and shakers, general inflation is

Consumer Price Index



expected to have remained in low-but-positive territory, adding just enough to bring the overall index to a zero change. We expect the housing-related parts of inflation were lacklustre. We are picking a 0.0% rise in home ownership, 0.2% rise for property maintenance, and 0.4% for rent. The housing-related segments are important as they tend to be very persistent. It was the persistent strength of housing inflation from 2002 until 2008 that got the Reserve Bank so agitated. So it will be very interesting to see how far housing-related inflation has fallen following the severe recession in the residential construction sector.

Non-tradables inflation is especially important to the Reserve Bank, so it will receive special attention from the market. The RBNZ is forecasting 0.3% non-tradables inflation. We expect non-tradables inflation to come in at just 0.1% for the quarter, due to the aforementioned weakness in housing-related inflation combined with a sharp fall in domestic airfares. That will take annual non-tradables inflation to a nine-year low of 2.3%.

We expect Q4 to be the low-point for quarterly inflation. Over 2010 we expect housing-related prices to begin rising again as the construction sector's recovery gets underway, and as the price-dampening effect of the rising exchange rate wanes. We expect annual inflation to reach 2.6% this year, and 3.0% next year.

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Implications

We currently expect the RBNZ will kick off its hiking cycle in March, while the central bank itself has signalled a flexible start date around the middle of the year. Next week's CPI will be a crucial fork in the road for monetary policy. If it prints weaker than the RBNZ's -0.2% forecast, then the central bank will feel even more comfortable waiting, and our call for a March hike will look unrealistic. In that scenario we would change our call in favour of an April hike, and we suspect market pricing would move significantly too. However, given that our forecast is zero, and the range of economist forecasts is -0.3% to +0.3%, we don't view this scenario as especially likely.

If the CPI prints in line with our zero forecast or stronger, and especially if non-tradables inflation exceeds expectations, then it would be the Reserve Bank reassessing its monetary policy. We would maintain our call for a March hike. The OIS curve, which is already pricing a strong chance of a March hike, would rise only a little, but one- and two-year swap rates could rise more on the possibility of a steeper tightening cycle.

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