Q1 inflation spike on tobacco tax increase

- We expect Q1 CPI to lift 0.6%, bringing annual inflation to 1.1%.
- Tobacco tax increase spikes Q1 CPI, while continued lift in construction costs/rents offset by subdued tradable inflation.
- Subdued inflation pressures for now, but RBNZ wary of construction cost spillover over the coming year.

We expect Q1 CPI to increase 0.6%, bringing the annual rate of inflation to 1.1%. This is above the RBNZ's March MPS forecast of 0.4% qoq. Behind the Q1 increase, we expect a lift in non-tradable inflation led by increased taxes on tobacco, increased prescription charges, a lift in food prices and continued growth in construction costs and rents. Providing some offset will be the subdued tradable inflation as a result of the high NZD. However, we are assuming some unwinding of the strong discounting in the December quarter. If this does not come through there is some downside risk to our forecast. To date there has been limited spillover of the higher construction costs from rebuilding in Canterbury, which we assume will continue. But potential for construction costs spillover, as well as supply shortages in Canterbury and Auckland, present some upside risk to housing-related components.

Overall, inflation pressures remain subdued and at the bottom of the RBNZ's target band. The RBNZ may choose to look through the increase in Q1 non-tradable inflation, given higher taxes and charges are key contributions to the increase. However, with the economic recovery broadening we expect generalised inflation pressures will begin to lift from the second half of 2013. We continue to expect the RBNZ to lift the OCR in March 2014.

Q1 CPI to lift 0.6%, bringing annual rate of inflation up to 1.1%.

Expectations: CPI to increase 0.6%

The NZ March quarter CPI will be released at 10.45am on Wednesday the 17th April. We expect the CPI will increase 0.6% over Q1, which will see the annual rate of inflation lift to 1.1%, from 0.9% in Q4. We expect the Q1 lift will be underpinned by a 1.3% increase in non-tradable inflation, while the NZD-impacted tradable component will remain subdued, down 0.3%.

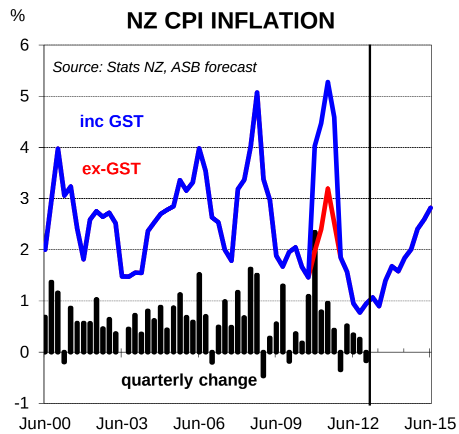
Tobacco tax increase and reduced prescription subsidy lift Q1 prices.

Tax increase, reduced subsidies and food prices.

We expect much of the Q1 lift will be attributed to the 10.9% increase in tobacco excise duty on 1 January which adds around 0.3 percentage points to CPI over the quarter. In addition, prescription charges on fully subsidised pharmaceutical products increased on 1 January, to $5 from $3 per script, which will contribute to an increase in health prices.

Lift in food prices to add 0.2pp to Q1 CPI.

A 0.8% increase in food prices will contribute another 0.1 percentage point to the CPI increase over Q1. The increase in food prices was led by an increase in grocery prices. Food prices had been a source of deflation over 2012, largely due to a fall in fruit and vegetable prices as well as lower prices for dairy. We expect that grocery prices will increase over the coming year, reflecting increased export prices for dairy gradually flowing through to the retail level. However, meat prices are likely to temporarily fall over Q2 as farmers brought forward livestock slaughter as the drought intensified.



CPI breakdown Q%	Sep-12	Dec-12	Mar-13
Food	1.1	-1.8	0.8
Alcohol & tobacco	0.3	-0.4	3.7
Clothing & footw ear	-0.3	-0.1	-0.3
Housing & h/h utilities	0.8	0.6	0.7
H/h contents & services	0.4	-1.8	-0.5
Health	0.9	1.1	2.5
Transport	-1.1	0.6	-0.5
Communication	-1.6	-2.0	-1.0
Recreation and culture	-0.1	0.5	-2.0
Education	0.1	0.2	3.0
Misc.goods & services	1.1	0.1	0.7
CPI	**0.3**	**-0.2**	**0.6**
Tradable	**0.0**	**-0.7**	**-0.3**
Non-tradable	**0.5**	**0.3**	**1.3**
CPI Annual	**0.8**	**0.9**	**1.1**

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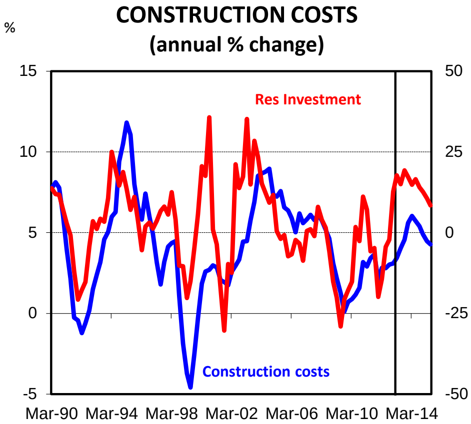
Continued upward lift in construction costs, rents.

Upward pressure on construction costs, rents
Housing and household utilities will continue to be a source of increased inflation, reflecting the continued lift in Canterbury construction costs as the rebuild places further strain on resources. Over time, the increase in construction costs may start to spillover to the rest of the country, but for now the spill-over appears to remain reasonably contained. Q1 is also a seasonally strong quarter for rental increases and ongoing supply shortages in Canterbury and Auckland are likely to place upward pressure on rental growth.

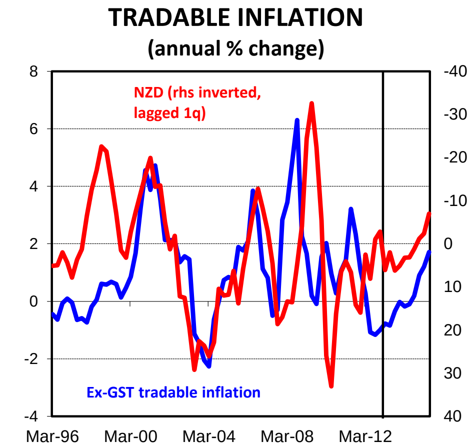
We expect continued insurance premium increases (in the miscellaneous category), although anecdotes suggest reinsurance cost increases are starting to ease. There is also scope for some reversal of the previous quarter's discounting in personal effects (largely jewellery).



Elevated NZD to continue to downward influence, although scope for reduced discounting.

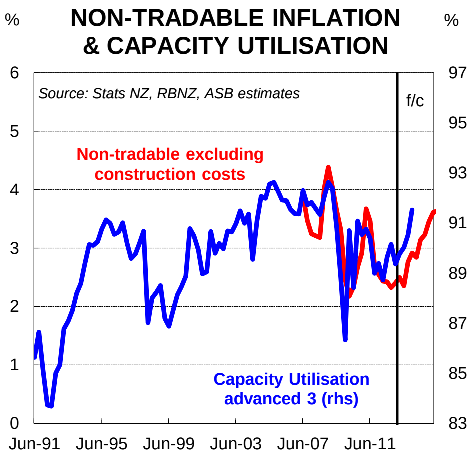
NZD continues to have downward influence
Providing an offset to these increases, we expect to see continued discounting on tradable prices reflecting the continued lift in the NZ dollar. Nonetheless, there were some large discounts recorded in household contents and recreational equipment over Q4. As such, there is scope for retailers to recoup some margin, limiting the extent of further price declines in Q1 (particularly in light of the recent lift in consumer confidence).

Meanwhile, seasonal discounting in international airfares will drive much of the decline in transport costs over Q1. Continued price declines are likely in communications. There has been a steady fall in prices since late 2009, due to increased competition in the telecommunications industry.



RBNZ may look through Q1 non-tradable increase, but wary of further increase.

We expect the composition of Q1 CPI will highlight the divergence between tradable and non-tradable inflation. As a result of the elevated NZD, tradable inflation remains very subdued. In addition, competitive pressures have put substantial downward pressure on areas such as communications. However, non-tradable inflation pressures have started to lift, particularly as the Canterbury rebuild commenced. For the time being, the RBNZ has scope to look through this increase in non-tradable prices, particularly considering the sources of the increase over Q1. The lift in Canterbury construction costs is a relative price shift to attract additional resources to the region. As yet, there is little sign of any spillover to construction costs beyond Canterbury. Beyond construction, much of the increase in non-tradable inflation is not related to demand pressures. Increased tobacco taxes and reduced health subsidies are administrative charges and will have the impact of reducing disposable income for those affected. Increased rents are a result of housing supply shortages in Auckland and Canterbury which, in theory, will be remedied by increased housing construction over the coming years. Increased reinsurance premiums reflect increased global insurance industry risk aversion following a number of costly natural disasters in recent years. None of these factors can be influenced/tempered by the RBNZ lifting the OCR.



However, over the coming year as the economic recovery starts to broaden, we expect to see a more generalised increase in non-tradable inflation. This will likely prompt the RBNZ to move away from accommodative monetary policy. Indeed, at the March Monetary Policy Statement, the RBNZ noted that experience has shown that once inflation pressures in the housing and construction sectors start to become established they can be difficult to offset.

RBNZ to lift OCR from March 2014.

Implications.

Our Q1 forecast of 0.6% is above the RBNZ's 0.4% March MPS expectation. However, as discussed above, the factors driving stronger non-tradable inflation are unlikely to be worrisome to the RBNZ, as they are either Canterbury-rebuild-specific or due to an increase in government charges. Meanwhile, the continued lift in the NZD implies tradable inflation will remain very subdued for some time. We expect non-inflation pressures will start to increase on a broader basis over the second half of 2013. As a result, we continue to expect the RBNZ will start to lift the OCR in March 2014.

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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