

### Consumers Price Index: December 2007 quarter

#### Key points

- > **Headline inflation proved stronger than expected in the December 2007 quarter, taking the annual inflation rate above the RBNZ's target band.**
- > **But non-tradable inflation surprised to the downside, though it is too early to say that the RBNZ have gotten on top of domestic inflation pressure.**
- > **Such a mixed picture gives the RBNZ neither scope for comfort, nor reason to panic. We expect the talk to be tough next week to manage the pipeline tightening. Rates remain set to stay at current high levels for an extended period.**

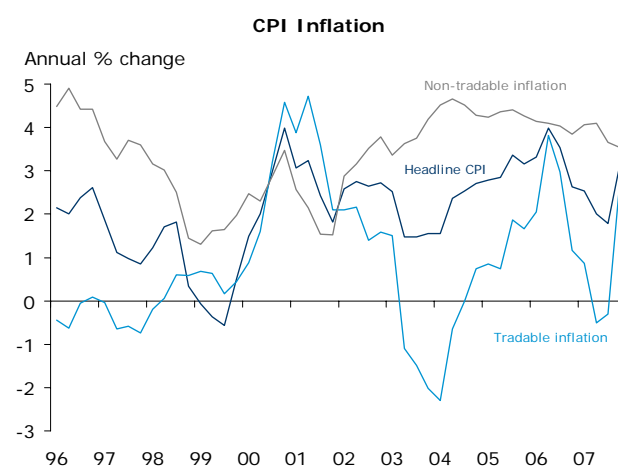
#### Assessment

**Headline inflation surprised on the upside and takes the annual inflation rate above the top of the RBNZ's target band.** The CPI increase in the December quarter (1.2 percent increase vs 1.0 percent expected) was due to much stronger tradables inflation, with higher food prices and less discounting by retailers contributing to the stronger than expected read. In terms of the detail, the largest contributions to the quarterly CPI increase came from the transport group (0.6 percentage points) – largely through a 5.4 percent increase in the price of petrol. Food prices rose 1.5 percent, making a 0.3 percentage point contribution.

**Surprisingly, non-tradable inflation rose a more subdued 0.7 percent in the quarter.** Annual non-tradable growth has now eased to 3.5 percent – the lowest since March 2003. Non-tradable ex-housing inflation – a proxy for inflation expectations – rose 0.6 percent. In other core inflation measures, the 10 percent trimmed mean rose 1.1 percent in the December quarter, and 3.5 percent in annual terms. The weighted median rose 0.7 percent in the quarter – the fourth quarter in a row of a 0.7 percent increase – leaving annual growth at 3.2 percent. The services component of the CPI rose 1.1 percent in the quarter (2.9 percent annually), while the goods component increased 1.3 percent (3.4 percent annually).

**On balance, this is a mixed report for the RBNZ.** The Bank will remain alert to the potential second round effects from a higher headline inflation rate seeping into more generalised wage and price setting behaviour. Core inflation measures remain uncomfortably elevated. Conversely, a softer trend in non-tradable inflation is of some comfort. One-off Government subsidies may have helped in the September quarter with some further spillovers into the December quarter, but housing related inflation also appear to be easing and we were surprised by softness in non-tradable ex-housing related inflation. However, it is still too early to say that the RBNZ have gotten on top of domestic inflation pressure.

	Headline CPI		Tradable		Non-tradable	
	q/q	y/y	q/q	y/y	q/q	y/y
Dec-05	0.7	3.2	0.5	1.7	1.0	4.3
Mar-06	0.6	3.3	-0.1	2.1	1.0	4.1
Jun-06	1.5	4.0	2.3	3.8	1.0	4.1
Sep-06	0.7	3.5	0.3	3.0	1.0	4.0
Dec-06	-0.2	2.6	-1.3	1.2	0.8	3.8
Mar-07	0.5	2.5	-0.4	0.9	1.2	4.1
Jun-07	1.0	2.0	0.9	-0.5	1.1	4.1
Sep-07	0.5	1.8	0.5	-0.3	0.6	3.7
<b>Dec-07</b>	<b>1.2</b>	<b>3.2</b>	<b>1.8</b>	<b>2.8</b>	<b>0.7</b>	<b>3.5</b>
<b>ANZ</b>	<b>1.0</b>	<b>3.0</b>	<b>1.0</b>	<b>2.0</b>	<b>1.0</b>	<b>3.8</b>
<b>RBNZ</b>	<b>1.1</b>	<b>3.1</b>	-	-	-	-
<b>Market</b>	<b>1.0</b>	<b>3.0</b>	-	-	-	-



**Looking forward, we are likely to see headline inflation remaining above 3 percent for the rest of the year** as the combination of strong commodity prices and still elevated non-tradable inflation persist. Such a trajectory will have the RBNZ on inflation alert. The inflation mix of easing non-tradable but rising tradable inflation is a double-edged sword for the RBNZ. On the one hand, it presents some comfort and

tradable inflation pressure should be left to take care of itself via the global growth cycle and exchange rate. Yet on the other, if non-tradable inflation were to reaccelerate (such as was implied in the QSBO survey) at a time tradable inflation is rising, the inflation pressure will intensify considerably. The inflation mix also implies that to get the inflation rate to within the target band this year would require slower growth in the period ahead. This will largely depend on how the global economic cycle (as a key driver of tradable and commodity price inflation), and the decoupling theme in particular, plays out.

**Inflation expectations need to remain anchored in the current environment.** Near-term risks to the inflation outlook appear tilted to the upside, despite moderating housing activity. Further food price inflation is expected, together with regional petrol tax increases and the prospect of higher prices from the Government's emissions trading scheme. While the RBNZ can look through these as "one-offs", the reality is that they can ill afford to relax, and will be closely watching how measures of surveyed inflation expectations evolve.

### Implications

**Collectively, today's inflation report maintains the status quo for the RBNZ as expressed in their December Statement.** A high inflation rate will likely require rates remaining high for an extended period, but not a further upward move in the Official Cash Rate. Indeed, after looking through a low headline inflation rate but hiking in response to rising non-tradable inflation in 2007, it would be an interesting PR exercise for the RBNZ to now hike when we are now seeing the reverse in 2008.

**The bottom line is that today's figures reinforce the view that the RBNZ can ill afford to relax, but it is not sufficient to cause them to panic.** Expect

the talk to remain tough. The challenge for them now is to manage inflation expectations and ensure that they get the pipeline tightening now flowing through from higher fixed mortgage rates. In the absence of a global event, easings are a long way off, and rates look set to stay at current high levels for an extended period.

**Market reaction to the CPI data was mixed**, with swap yields and the NZD rising immediately on the higher headline number, but unwinding once the composition was digested. Markets have been quick to latch onto the weaker non-tradable number, in part reflecting the NZ market playing catch-up to offshore sentiment. With the RBNZ set to maintain a stern line, we expect any rally to be capped on the downside.

CPI Components	Qtrly % chg	%-pt contrib.	Ann % chg
Food	1.5	0.3	4.4
Alcohol and Tobacco	0.3	0.0	3.3
Clothing and Footwear	0.5	0.0	0.4
Housing and Household Utilities	0.9	0.2	5.2
Household Contents and Services	0.1	0.0	0.0
Health	0.4	0.0	0.2
Transport	3.2	0.5	5.9
Communication	-0.5	0.0	-0.3
Recreation and Culture	1.0	0.1	-0.2
Education	-0.3	0.0	-2.5
Miscellaneous Goods and Services	0.4	0.0	3.2
<b>All Groups</b>	<b>1.2</b>	<b>1.2</b>	<b>3.2</b>
<b>Tradables</b>	<b>1.8</b>	<b>0.8</b>	<b>2.8</b>
<b>Non-tradables</b>	<b>0.7</b>	<b>0.4</b>	<b>3.5</b>

### Disclaimer

This document has been prepared by ANZ National Bank Limited (the "Bank"), is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of any opinions or information contained in it. The information contained in this document is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

ANZ, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639  
<http://www.anz.com/nz> e-mail [ecnmcs@anz.com](mailto:ecnmcs@anz.com)