

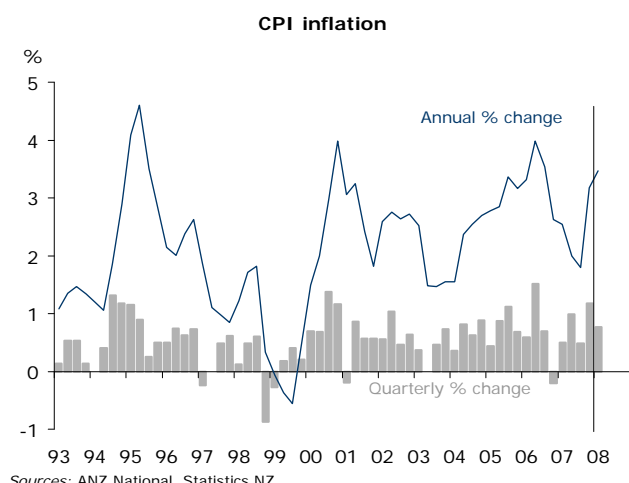
Consumers Price Index Preview: March 2008 quarter (due Tuesday 15 April 10:45am)

Key points

- > **Headline inflation to increase by 0.8 percent, taking the annual rate to 3.5 percent.**
- > **Energy and food prices the main driver, though underlying inflation pressures set to remain high.**
- > **Data to highlight the uncomfortable growth/inflation mix the Reserve Bank faces in the near term.**
- > **This means the Reserve Bank will maintain their stance at the upcoming OCR Review despite clear evidence downside growth risks are materialising.**

	ANZ	RBNZ	Market
Q1 CPI forecast	0.8% qoq 3.5% yoy	0.7% qoq 3.4% yoy	0.8% qoq 3.5% yoy

The Reserve Bank's lack of inflation headroom will be reinforced in next week's CPI report. We are expecting a 0.8 percent increase in the CPI index for the March quarter, taking the annual inflation rate to 3.5 percent, from 3.2 percent in the previous quarter. Our forecast is in line with market expectations, and slightly higher than the Reserve Bank's March projection.



It is the usual suspects keeping inflation high.

Higher food prices, energy prices and government charges continue to drive inflation up. We expect food prices to rise by 2 percent in the quarter, making a 0.3 percentage point contribution to the overall CPI. Petrol prices, which we estimate rose by 3.3 percent (after adjusting for the impact of supermarket discount vouchers), will add a further 0.2 percentage points. Electricity prices likely rose by 4 percent and the annual indexation of excise duty for cigarettes and tobacco from 1 January will see merchants take the opportunity to ramp through higher price increases than just the pure indexation adjustments.

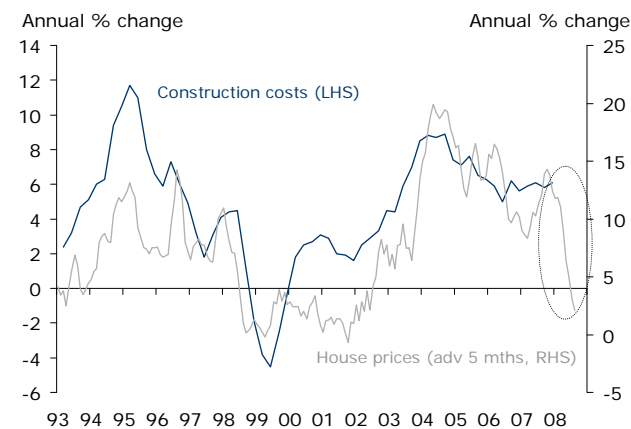
Of course, it is not all one way traffic for price changes. The March quarter sees a seasonal decline in international airfares, and we expect Air New Zealand's reduced domestic airfares will also result in a 7 percent fall in the passenger transport services group. In addition, we expect heavy discounting by retailers throughout the quarter to help keep tradable inflation down. In terms of potential downside surprises, it is the aggressive nature of retail discounting seen after the New Year and which carried on to the early March Easter period that could help cap headline inflation. On the other side of the risk spectrum are growing anecdotes of accelerating rents, and a potential statistical bounce-back from last quarter's somewhat surprisingly weak non-tradable ex-housing result.

CPI Components	Qtrly % chg	%-pt contrib.	Ann % chg
Food	2.0	0.3	5.3
Alcohol and Tobacco	0.6	0.0	2.9
Clothing and Footwear	-0.8	0.0	0.1
Housing and Household Utilities	1.2	0.3	5.4
Household Contents and Services	-0.6	0.0	0.4
Health	1.4	0.1	0.5
Transport	-0.1	0.0	6.0
Communication	-0.3	0.0	-0.6
Recreation and Culture	-0.2	0.0	0.3
Education	4.3	0.1	-1.6
Miscellaneous Goods and Services	1.2	0.1	3.1
All Groups	0.8	0.8	3.5
Tradables	0.5	0.3	3.8
Non-tradables	1.0	0.5	3.4

Non-tradable inflation remains the key measure to watch. There is not much that the Reserve Bank can do to influence the likes of food and energy prices. With ongoing upward pressure coming from those areas, it falls increasingly on non-tradable inflation,

particularly the contestable parts of it, to start easing in order to provide a sufficient offset. There were some encouraging signs that this may be starting to occur, with the December 2007 quarter non-tradable print coming in below expectations at 0.7 percent, though it is too soon to be sure at this stage. We expect March quarter non-tradable inflation to pick-up to 1.0 percent in the quarter, and start to ease only over the second half of this year. With the housing market now correcting and house prices falling (though today's REINZ housing market report showed a tick-up in March house prices), we hope to see some early signs of spillover into easing housing related inflation.

Construction costs and house prices



Sources: ANZ National, Statistics NZ, REINZ

In particular, we will be paying close attention to construction costs, expenses associated with dwelling purchases, and dwelling maintenance services. Yet with a tight labour market, the underlying inflation picture is likely to remain one of elevation across the services components in particular. But when we look at previous non-tradable inflation cycles, we find that it does tend to turn aggressively, though with a lag of a year or so.

Implications

We see the risks to the CPI data as balanced. Inflation remains uncomfortably high, but the Reserve Bank's focus is on the medium-term inflation profile, which is still a (projected) receding one though near-term inflation pressure remains intense. The CPI report is unlikely to alter the Reserve Bank's stance at their upcoming OCR *Review*. Despite acknowledgement by the Governor that economic growth is slowing "markedly", there is simply no inflation headroom for them to respond early (at present).

The market appears positioned for (fearing) a strong headline CPI print, particularly after the spike up in the inflation gauges from this week's NZIER survey. As such, we could see a relief rally even if the data prints in line with expectations. But as always, it will be the composition that is important, and all eyes will be on the non-tradable picture.

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