NEW ZEALAND ECONOMICS
DATA REVIEW
CONSUMERS PRICE INDEX – DECEMBER 2011 QUARTER

19 January 2012

CONTRIBUTORS

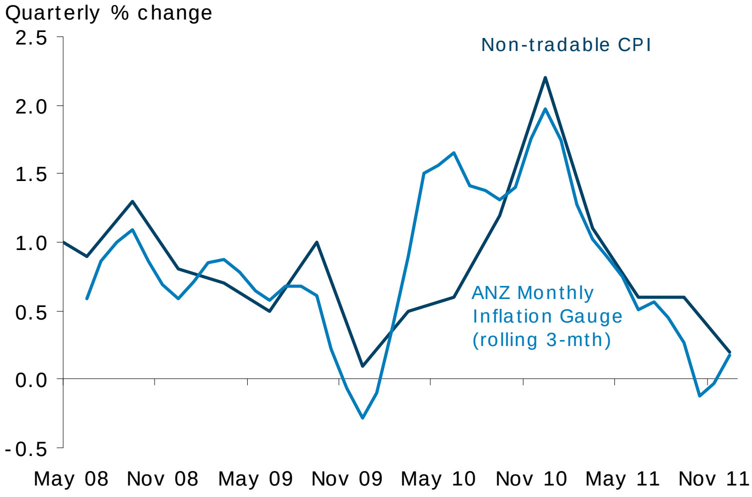
Cameron Bagrie
Chief Economist
Telephone: +64 4 802 2212
E-mail: Cameron.Bagrie@anz.com

Mark Smith
Senior Economist
Telephone: +64 4 802 2199
E-mail: Mark.Smith2@anz.com

BENIGN Q4 CPI REMOVES OCR HIKES FROM THE AGENDA

- Q4 CPI fell 0.3 percent, considerably weaker than market and RBNZ expectations. The combination of weaker than expected headline inflation and GST dropping out of the calculation saw annual CPI fall to 1.8 percent y/y.
- Core measures were subdued, with the weighted median at 0.4 percent and the trimmed mean price increases ranging from +0.1 to +0.3 percent. Annual inflation from core measures hovered around the midpoint of the target.
- The sources of price movements were already well signalled, with lower food prices making a -0.4 percentage point quarterly contribution. However, after excluding fruit and vegetable prices, the CPI was still soft, with prices rising 0.1 percent q/q.
- Our monthly Inflation Gauge has proved to be a good directional indicator of domestically generated inflation, with the benign readings from the gauge preceding the recent run of downward CPI surprises. We will be placing greater weight on the gauge and will be closing monitoring its readings over the next few months.
- Despite the softer than expected CPI print and signs that the economic recovery is losing momentum, the outlook does not yet warrant consideration of a lower OCR, though the market will remain biased this way.
- This data is likely to accentuate the allure of NZ Government Bonds.

ANZ Monthly Inflation Gauge vs Non-tradable CPI



Sources: ANZ, Statistics NZ

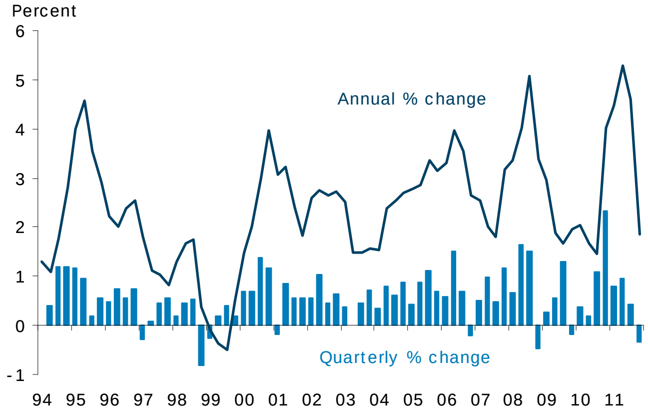
2011Q4 CPI REVIEW

DATA WRAP

	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-10	0.4	2.0	0.1	2.0	0.5	2.1
Jun-10	0.2	1.7	-0.3	1.0	0.3	2.2
Sep-10	1.1	1.5	0.9	0.3	0.9	2.5
Dec-10	2.3	4.0	2.5	3.3	0.3	4.6
Mar-11	0.8	4.5	0.5	3.7	0.7	5.2
Jun-11	1.0	5.3	1.5	5.5	0.6	5.2
Sep-11	0.4	4.6	0.1	4.6	0.6	4.5
Dec-11	-0.3	1.8	-0.9	1.1	0.2	2.5
ANZ	**0.2**	**2.4**	**-0.2**	**1.8**	**0.5**	**2.8**
Market	**0.4**	**2.6**	–	–	–	–
RBNZ	**0.4**	**2.6**	–	–	–	–

The Q4 CPI outturn was much weaker than market expectations, falling 0.3 percent in the quarter. This is the second successive negative surprise for the RBNZ, and the fall in consumer prices was weaker than our below consensus +0.2 percent pick. Annual CPI inflation eased to 1.8 percent, comfortably within the 1 to 3 percent target, with the GST impact dropping out of the annual comparison.

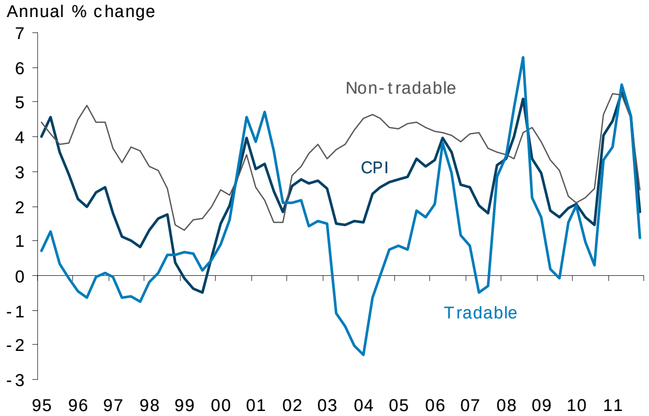
CPI inflation



Sources: ANZ, National Bank, Statistics NZ

Non-tradable CPI rose 0.2 percent in the quarter (2.5 percent y/y), while tradable prices fell 0.9 percent (1.1 percent y/y), despite an increase in fuel prices. Both were weaker than we had expected. Core measures were subdued, with the weighted median at 0.4 percent and the trimmed mean prices rises ranging from +0.1 to +0.3 percent. Annual inflation in from these measures hovered around the midpoint of the target. **We await the RBNZ's estimates of core inflation with interest to see whether annual core inflation has fallen from the 2.2 percent estimate for Q3.**

CPI inflation

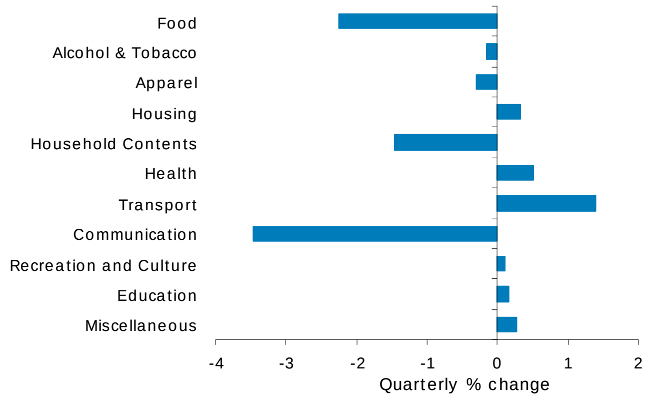


Sources: ANZ, National Bank, Statistics NZ

With Q4 food prices already released, much of the downside influences to Q4 CPI inflation was already known. Even allowing for this, the CPI outturn was soft. Prices fell in 5 of the 11 CPI groups, suggesting that lower food prices were not the sole culprit. Large negative quarterly contributions were evident for communications (due to lower internet charges), and household contents and services.

There was clear evidence of the soft retail environment weighing on prices. Prices fell for furniture, kitchenware and appliances, which pushed down prices in the household contents band services group. Audio-visual prices fell a sizeable 3.4 percent. Even prices for apparel and recreational and cultural equipment bucked the usual seasonal pattern and fell.

CPI groups



Sources: ANZ, National Bank, Statistics NZ

Sources of cost pressures were more restrained. Increases in the insurance component were a relatively modest 0.7 percent q/q, following the 2.4 percent increase in Q3. Encouragingly, for the RBNZ, inflation in the housing components was

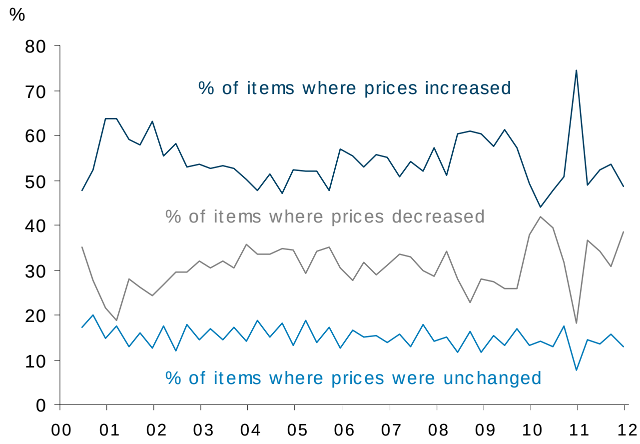
2011Q4 CPI REVIEW

moderate, with construction costs posting a 0.4 percent increase and rents up 0.4 percent.

There was not much evidence of a Rugby World Cup premium being charged, with international airfares (up 5.9 percent q/q) and accommodation costs (up 3.3 percent q/q) showing not much more than the usual seasonal increase.

Viewing the distribution of price movements confirmed a benign quarterly CPI reading, with a fall in the number of price increases as well as a greater number of price falls. This suggests a smaller front of price increases could be emerging, but we are mindful of a possible reversal in the next few quarters.

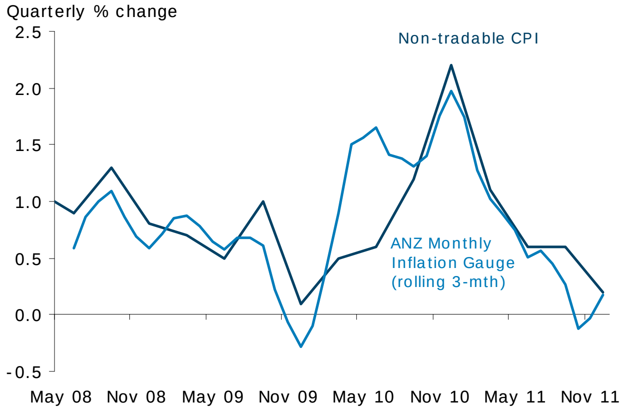
CPI national item-level index movements



Sources: ANZ, National Bank, Statistics NZ

Moderating inflation pressure in the non-tradable sector had already been signalled by our Monthly Inflation Gauge. The Q4 reading for the gauge (+0.2 percent q/q) was exactly in line with the quarterly increase in non-tradable CPI prices**. We will be placing greater weight on the gauge given it is more timely and will be closely monitoring its readings over the next few months.**

ANZ Monthly Inflation Gauge vs Non-tradable CPI



Sources: ANZ, Statistics NZ

The key focus of the RBNZ will remain the medium-term inflation. Encouragingly for the RBNZ, the domestic activity and near-term inflation outlook looks to be even weaker than assumed in the December *MPS*. The world outlook is also arguably weaker, while the NZD TWI (currently 71.9) is well above the 67 assumption for Q1 in the *MPS* (67).

Despite this, much of the downward price influences do not appear persistent, which raises the possibility of a reversal of price falls in subsequent quarters. The fall in food prices could quickly reverse and there remain a number of cost increases (higher petrol prices, EQC premiums and the tobacco excise) that look set to push Q1 inflation higher than the +0.4 percent December *MPS* forecast. However, the RBNZ has a good starting position and time is on its side.

There are still some risks around the December *MPS* judgement that inflation expectations will quickly fall back to the middle of the target in the first half of this year. The recent fall in surveyed pricing intentions witnessed of late has been encouraging but they still remain considerably above 2%. It remains to be seen whether inherently persistent inflation expectations will fall towards the midpoint of the inflation target, particularly given recent increases in petrol prices and indications of a smaller margin of spare capacity within the economy.

ASSESSMENT

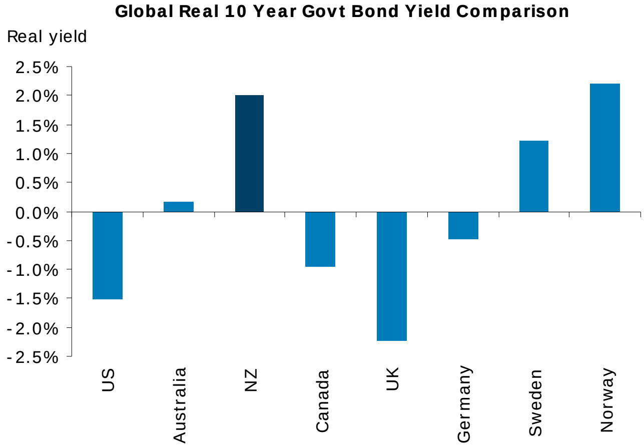
In short, today's softer than expected CPI is likely to encourage the RBNZ to remain on the sidelines for longer and will provide them with more scope to cut the OCR should the global outlook deteriorate further. But the hurdle to such an outcome is high in our mind given the stickiness of some medium-term inflation drivers and the likelihood of a reversal in some of the Q4 price falls.

2011Q4 CPI REVIEW

WHAT SHOULD THE MARKET MAKE OF ALL THIS?

A couple of weak CPI outturns begs the obvious question: will the next move in the OCR be down? Certainly the asymmetric risk profile for the global economy points this way, and will keep the market biased towards a cut. However **in our mind the hurdle for an OCR cut remains pretty high**. With annual core inflation running around 2 percent at present the real OCR is 0.5 percent. This represents powder that should be kept pretty dry as a sort of insurance policy against extreme tail-risk outturns. This doesn't mean the RBNZ is doing nothing. **Each day the OCR remains on hold lowers the effective borrowing rate**. Indeed, we estimate the average fixed mortgage rate rolling off at present is around 6.7 percent - a sizable gap from where current floating rates are at the moment (ANZ's carded variable rate is 5.74 percent). **So policy is easing - by stealth, and the housing market is responding.**

This data is also likely to have a positive impact on the bond market. The collapse in the annual CPI reading (from 4.6 to 1.8 percent) will also put the NZ bond market back on the radar for global investors, and those focussed on real yield. Indeed, **on paper, the real yield on NZ 10yr bonds has jumped from -0.7 percent to +2.1 percent.** Of course, a large part of the fall (around 2 percent) was technical, and simply reflects the October 2010 GST increase dropping out of the calculation, a good chunk of it also reflects the downside surprise in the headline data as well. We would have ignored this had it not been for the fact that we have seen numerous reports over the past year from analysts bagging NZ for it's negative real yields (when of course this was the GST effect). Whatever the case, value has now been "restored" and a 2.1 percent real yield is high by global comparison.



Sources: ANZ, Bloomberg

The NZD has reacted negatively so far, and may remain under pressure in the very short term. In our view, this is largely a knee-jerk reaction to weak data, and the likelihood that we are likely to see OCR cuts priced in with greater intensity over coming days. **However, we'd caution against getting too bearish from the NZD side** - as noted, with real yields on bonds now "restored", and New Zealand well away from the troubles in Europe, **increased demand for NZ bonds (not to mention Fonterra's announcement earlier today of record December export volumes) has the potential to put upward pressure on the NZD**. Of course, such NZD support needs to be assessed against the global scene and Europe holding together in a semi-stable fashion still looks a big ask.

IMPORTANT NOTICE

NEW ZEALAND DISCLAIMER

This publication is for information purposes only. Its content is intended to be of general nature, does not take into account your financial situation or goals, and is not a personalised adviser service under the Financial Advisers Act 2008. It is recommended you seek advice from a financial adviser which takes into account your individual circumstances before you acquire a financial product. This publication does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this publication can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of ANZ National Bank Limited (the "Bank").

This publication is a necessarily brief and general summary of the subjects covered. The information contained in this publication 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 publication. To the extent permitted by law, neither the Bank nor any other person involved in the preparation of this publication accepts any liability for the content of this publication (including the accuracy or completeness thereof) or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This publication is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this publication and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This publication is issued on the basis that it is only for the information of the particular person to whom it is provided. This publication may not be reproduced, distributed or published by any recipient for any purpose. This publication does not take into account your personal needs and financial circumstances. Under no circumstances is this publication to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this publication (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this publication. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this publication accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this publication and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this publication. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

This document has been prepared by ANZ National Bank Limited. ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639 http://www.anz.co.nz e-mail nzeconomics@anz.com