Economic Preview

New Zealand

10 July 2008

Consumers Price Index Preview: June 2008 quarter

(due Tuesday 15 July 10:45am)

Key points

> **Headline inflation rate to rise to 3.8 percent, boosted by food and petrol prices.**

> **Data largely historical and RBNZ already prepared to look through it.**

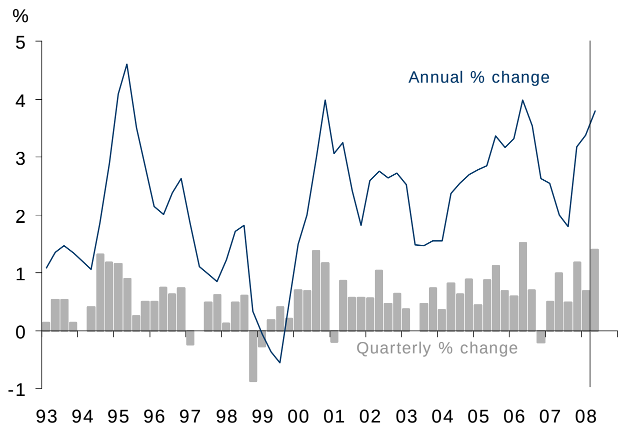
> **However, RBNZ will still be wary of any signs of inflation pressure broadening.**

> **While the market (and economists) will obviously look to the CPI as the make or break cue for a July move, we are increasingly of the view that developments across other areas have moved so far that a historical CPI print should not hold sway.**

	ANZ	RBNZ	Market
Q2 CPI forecast	**1.4% qoq** **3.8% yoy**	1.4% qoq 3.8% yoy	1.4% qoq 3.8% yoy

Headline inflation is expected to rise to 3.8 percent in the June quarter, and could yet hit 5 percent later this year. There is general consensus over the June quarter CPI print. We, the market and the RBNZ are all expecting a 1.4 percent increase in the CPI index for the June quarter, taking the annual inflation rate to 3.8 percent. This is up from 3.4 percent in the previous quarter. We see the risks as balanced, with retail sector discounting providing some offset to potentially stronger than expected services sector inflation.

CPI inflation



Sources: ANZ National, Statistics NZ

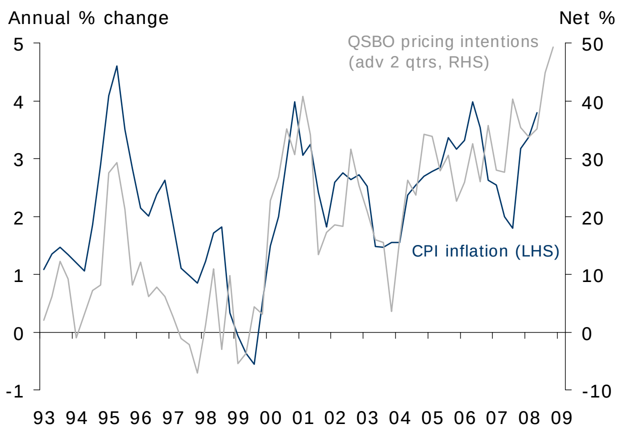
Petrol and food price increases to dominate again. Combined, they are expected to contribute 1 percentage point to the quarterly CPI increase (0.7 percentage points from petrol, and 0.3 percentage points from food). Housing related inflation is expected to add a further 0.2 percentage points, with a 2.5 percent rise in energy prices and a 1 percent rise in rents driving most of that increase. Home ownership costs (construction costs) are expected to show the lowest quarterly increase in years on the back of the sharp slowdown in housing activity. But rising costs for building materials limits the extent of the slowdown in price rises. Other notable price increases include domestic and international airfares due to higher fuel costs, and increased postal charges.

Retail sector deflation to help cap overall price rises. Given the sharp slowdown in sales and high stock levels in the retail sector, aggressive discounting has been the norm throughout the June quarter. This has the potential to provide a downside surprise to the CPI print. Indeed, judging by some of the advertisements by major retailers, we could well see an even bigger price decline for retail related goods in the June quarter than what we saw in the March quarter. Increased childcare subsidy rates will also see a price decline in the early childhood education subgroup, although this will not have a significant overall impact.

CPI Components	Qtrly % chg	*%-pt contrib.*	Ann % chg
Food	1.9	*0.3*	6.5
Alcohol and Tobacco	0.4	*0.0*	3.6
Clothing and Footwear	-0.5	*0.0*	-1.5
Housing and Household Utilities	1.1	*0.2*	4.9
Household Contents and Services	-0.3	*0.0*	-1.3
Health	0.8	*0.0*	-1.6
Transport	4.3	*0.7*	8.9
Communication	0.8	*0.0*	-0.1
Recreation and Culture	-0.7	*-0.1*	-0.6
Education	-0.3	*0.0*	-2.1
Miscellaneous Goods and Services	1.8	*0.1*	4.0
All Groups	**1.4**	***1.4***	**3.8**
Tradables	**1.9**	***0.9***	**4.4**
Non-tradables	**1.0**	***0.5***	**3.5**

In terms of the composition, non-tradable inflation remains the key read. High petrol and food prices are well known, and there is nothing the RBNZ can do to influence them. The RBNZ's focus is on non-tradable inflation, specifically whether the sharp slowdown in domestic demand we have seen to date is starting to see domestic inflation pressures ease. The March quarter non-tradable inflation reading was elevated at 1.1 percent, and we expect the June quarter to show a 1 percent increase (same as what the RBNZ is forecasting), leaving the annual rate unchanged at 3.5 percent. Recent business surveys show that pricing intentions have picked up strongly, suggesting that firms are increasingly trying to pass on price increases onto their customers in response to rising input costs. Such cost-push behaviour is exactly what the RBNZ is trying to discourage, and it remains to be seen whether we do see a broadening in inflation pressure across non-tradable prices. If the pricing intentions of firms come to pass, the RBNZ could be looking at an annual inflation rate in excess of 5 percent by the end of this year.

CPI inflation vs pricing intentions



Sources: ANZ National, Statistics NZ, NZIER

We continue to expect demand-pull forces to dominate, particularly given the suddenness of the turn in the economic cycle. At present the economy looks to be at a delicate juncture where, facing higher input costs and no demand, hiking prices (which we are seeing via pricing intention gauges) is the first natural response. We struggle to see this taking hold in such a weak macro environment. With clear evidence mounting that the economy is moving backwards and the labour market is starting to loosen, an aggressive turn in non-tradable inflation could be just around the corner. However, history suggests it is likely to be late this year or early next year before we really see inflation pressure ease. We will be closely eyeing demand linked pockets of non-tradable inflation for potential early signs of the demand picture dominating, although we suspect this dynamic is still too early to manifest.

Implications

With the RBNZ already prepared to look through the near-term spike in inflation (they forecast inflation to peak at 4.7 percent in the September quarter), the June quarter CPI print should not derail expectations of lower rates this year.

While the market (and economists) will obviously look to the CPI as the make or break cue for a July move, we are increasingly of the view that developments across other areas have moved so far that a historical CPI print should not hold sway.

The aspect to this, which the RBNZ may find challenging, is the communication surrounding cutting rates in a rising inflation environment. Strictly speaking, a full *Monetary Policy Statement* would be the preferred vehicle to start the easing cycle given the current growth-inflation mix. However, we suspect the RBNZ can ill afford to wait.

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- Placed in statutory management or receivership.

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- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
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- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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