

### Consumers Price Index: December 2008 quarter

#### Key points

- > A significant fall in petrol prices sees the headline CPI fall sharply in the December quarter.
- > Relatively soft core measures and a fall in construction costs suggest early evidence of easing inflation pressure.
- > With the economy weak and the labour market turning rapidly, the medium-term inflation outlook has vastly improved.
- > Inflation looks set to head towards the bottom of the RBNZ's target band by mid-year.

#### Assessment

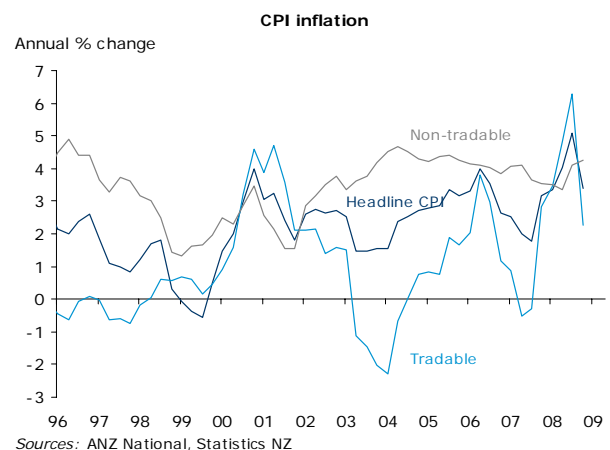
**The CPI fell 0.5 percent in the December quarter, taking the annual headline rate to 3.4 percent.** As expected, a 22.4 percent fall in petrol prices was the key driver of the sharp fall in the CPI in the quarter. If petrol prices were unchanged, the CPI would have increased by 0.9 percent. However, some – but not universal – retail discounting also helped pull the CPI lower. Household appliances (-0.3 percent), audio visual equipment (-4.0 percent) and telecommunication equipment (-7.0 percent) were some retail components to record price falls over the quarter. But the major surprise in the release was the 0.2 percent fall in the home ownership (or construction price) category. This is the first time it has fallen since 1999 – a sign that builders are finally having to respond to the significant drop off in activity.

**Core and underlying inflation measures have also shown signs of easing.** While the fall in petrol prices contributed 1.2 percentage points to the fall in the headline CPI, underlying inflation measures show that softness was more broad-based (or at least early signs of it). Non-tradable inflation rose by 0.8 percent (a reasonably small increase by recent standards), the weighted median rose by 0.5 percent and trimmed mean rose by just 0.2 percent. The latter is the smallest quarterly increase since June 2003. It does appear that demand-pull forces – as the economy continues to weaken – are beginning to see inflation pressures subside.

**But some price stickiness remains.** The comments from RBNZ Governor Bollard late last year about price rises from some non-contestable pockets of the economy still applies. Food prices are yet to respond to the slump in world commodity prices (rising 1.5 percent in the quarter). Electricity prices rose 2.0 percent in the quarter and services inflation remains elevated, rising by 1.2

percent. In addition, local and central government charges rose 1.2 percent, to be up 6.5 percent on a year ago. This is the highest rate of annual growth since 2004.

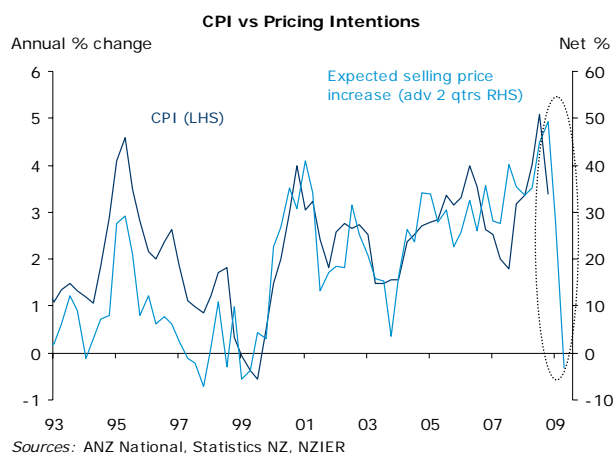
	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Sep-06	0.7	3.5	0.3	3.0	1.0	4.0
Dec-06	-0.2	2.6	-1.3	1.2	0.8	3.8
Mar-07	0.5	2.5	-0.4	0.9	1.2	4.1
Jun-07	1.0	2.0	0.9	-0.5	1.1	4.1
Sep-07	0.5	1.8	0.5	-0.3	0.6	3.7
Dec-07	1.2	3.2	1.8	2.8	0.7	3.5
Mar-08	0.7	3.4	0.2	3.4	1.1	3.5
Jun-08	1.6	4.0	2.3	4.8	0.9	3.4
Sep-08	1.5	5.1	1.9	6.3	1.3	4.1
<b>Dec-08</b>	<b>-0.5</b>	<b>3.4</b>	<b>-2.1</b>	<b>2.3</b>	<b>0.8</b>	<b>4.3</b>
<b>ANZ</b>	<b>-0.3</b>	<b>3.6</b>	<b>-1.5</b>	<b>2.8</b>	<b>0.8</b>	<b>4.3</b>
<b>RBNZ</b>	<b>-0.3</b>	<b>3.6</b>	<b>-1.5</b>	<b>2.9</b>	<b>1.0</b>	<b>4.4</b>
<b>Market</b>	<b>-0.4</b>	<b>3.6</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>



**Nevertheless, domestic weakness should start to offset price pressures from non-contestable pockets.** Local authority rates increases will remain high this year, given the pressures on council budgets. Electricity prices also look set to increase in the near-term based on recent

announcements by some power companies. There is even the potential that another leg lower in the NZD could see some imported inflation seep through, although we expect the pass-through to be muted given the weak demand environment. However, we expect strong demand-pull forces to dominate this year, resulting in easing price pressures in the contestable areas, and sufficient to offset lingering price increases from non-contestable areas.

**The medium-term inflation outlook has vastly improved.** With the current domestic petrol price 11 percent below the December quarter average (despite last week's 10c/ltr increase), petrol prices look set to also see the March quarter post a negative headline CPI result. Weak domestic demand, excess capacity and an increasing unemployment rate should also see headline annual inflation fall rapidly in the coming quarters. We expect annual inflation to temporarily fall below the bottom of the RBNZ's target band by the September quarter. However, we would characterise this as dis-inflation rather than deflation for the time being. Even some of the troublesome price pressures still evident in the December quarter are expected to wane. Food prices should eventually begin to respond to international commodity price developments and services inflation should ease as the labour market weakens further.



## Implications

**Inflation is no longer a roadblock to further aggressive monetary policy actions.** RBNZ communication late last year made it clear that the Bank remains concerned over domestic inflation pressures. Today's data, while unlikely to completely ease the RBNZ's inflation concerns, nonetheless suggest there is more evidence that inflation pressures are starting to wane. Certainly, together with recent pricing intentions surveys, the RBNZ can be more confident that inflation look set to stay well within the target band over this year and next. Hence, we expect the RBNZ to continue easing policy aggressively, and expect a 100bp cut at next week's *OCR Review*.

CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	1.5	0.3	9.4
Alcohol and Tobacco	0.4	0.0	2.7
Clothing and Footwear	0.9	0.0	0.1
Housing and Household Utilities	0.6	0.1	4.3
Household Contents and Services	0.5	0.0	0.8
Health	0.6	0.0	3.4
Transport	-7.6	-1.2	-0.3
Communication	-0.4	0.0	-1.1
Recreation and Culture	1.5	0.1	0.6
Education	0.1	0.0	4.1
Miscellaneous Goods and Services	0.7	0.0	2.5
<b>All Groups</b>	<b>-0.5</b>	<b>-0.5</b>	<b>3.4</b>
<b>Tradables</b>	<b>-2.1</b>	<b>-0.9</b>	<b>2.3</b>
<b>Non-tradables</b>	<b>0.8</b>	<b>0.4</b>	<b>4.3</b>
<b>Trimmed Mean</b>	<b>0.2</b>		<b>3.1</b>
<b>Weighted Median</b>	<b>0.5</b>		<b>3.0</b>

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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 [ecnmcs@anz.com](mailto:ecnmcs@anz.com)

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