ANZ

Economic Review
NEW ZEALAND

DATE 13 February 2007

Producers Prices – December Quarter 2006

Key points

- **Producer input prices fell by 0.3 percent in the December quarter, while output prices fell by 0.5 percent.**
- **Lower oil prices, a higher NZD and lower electricity prices helped drive the falls in input prices, although this overshadows continued underlying cost and inflationary pressures.**
- **Firms' margins clearly remain under pressure with a further fall recorded in the quarter, despite lower input costs and oil price relief.**
- **A key issue going forward is when this margin pressure results in a stronger focus on costs, especially labour costs.**
- **Construction prices remain elevated and will continue to concern the Reserve Bank given the momentum in the housing market.**
- **Today's release is unlikely to sway the Reserve Bank from raising interest rates in March.**

The headlines

	Actual	ANZ-National	Market
Input Prices	**-0.3% q/q 5.3% y/y**	-0.6% q/q	-0.1% q/q
Output Prices	**-0.5% q/q 3.6% y/y**	-0.3% q/q	0.2% q/q

Specifics

- **Input prices fell 0.3 percent in the quarter (more than the 0.1 percent expected by the market), to be up 5.3 percent on a year ago.** Key contributors to the fall in prices in the quarter included electricity and supply (down 11.4 percent due to higher lake levels) and air transportation (down 3.9 percent due to lower fuel prices and a higher NZD). These price falls were partly offset by increases in construction input prices (up 0.4 percent) – driven by international copper prices.

- **Producer output prices fell 0.5 percent in the quarter and were up 3.6 percent on December 2005.** The largest contributors to the quarterly fall came from electricity generation and supply (down 5.8 percent), meat and meat product manufacturing (down 6.1 percent), and dairy product manufacturing (down 4.6 percent). Construction output prices rose by 1.0 percent, the 31st consecutive quarterly rise.

Assessment and implications

Producer prices are, at best, a contemporaneous indicator of the CPI, which was released last month. Similar themes are present in today's release as was the case in the CPI. That is, lower oil prices and a higher NZD resulted in the headline inflation figures falling. However, this overshadows the general inflation undercurrent that is present in the economy.

Although overall costs eased in December, they remain elevated. The Reserve Bank will take no comfort from the 1.0 percent increase in construction output costs recorded over the quarter, particularly given the elevated level of construction cost within the CPI.

There is limited new information in this release for the Reserve Bank. Given the movements in the indices were dominated by falls in electricity prices, oil prices and the impact of a higher currency, the Bank is not likely to take too much from this release. As with the CPI last month, the Bank is likely to look through the short-term impact and concentrate more on the medium-term pressures. If the effects of the oil and currency are removed, cost pressures clearly remain elevated.

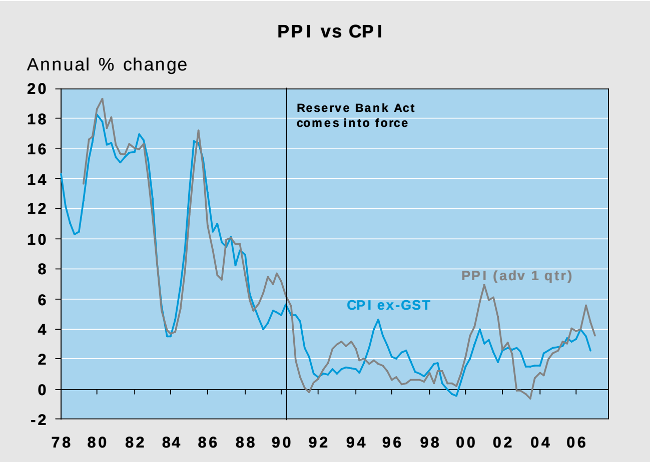
Margins remain under pressure. An interesting aspect of the PPI is that input price growth continues to outstrip output growth - a feature in 9 out of the past 11 quarters (with one quarter flat). Margins fell in the December quarter and have fallen by over 5 percent since March 2004. This tells us two things:

- There is an element of pipeline inflation pressure, which the Reserve Bank will remain wary of.
- Firms are facing profitability pressure, which eventually implies pressure on costs.

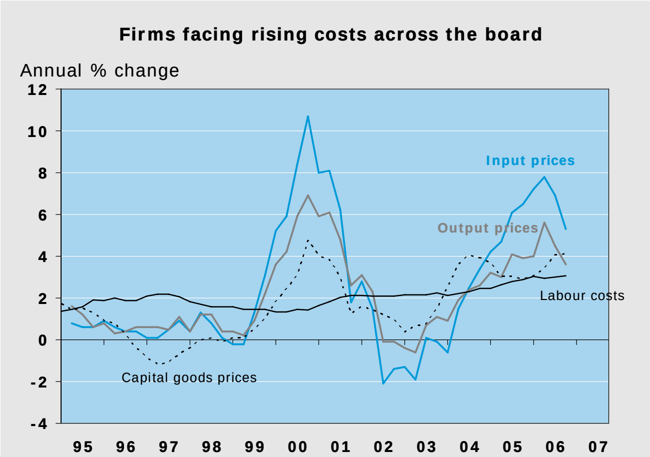
We expect the later force to dominate. Competitive forces are capping pipeline inflation pressure, and the relationship between the PPI and future inflation has broken down when monetary policy shifted to adopting a specific inflation target. Key here is that inflation expectations remain well anchored, and in New Zealand's case inflation expectations have eased over the past six months. We expect to see a strong cost theme to emerge as a significant shaper of the business cycle over 2007. The million dollar question is when a stronger focus on costs will diffuse to the labour market. Robust labour demand indicators are currently giving the Reserve Bank little comfort that this will emerge any time soon, although we believe it will be a key theme that will play out this year.

Until an easing in labour demand occurs, the moderation in the housing market and consumer spending, that the Reserve Bank is looking for, is unlikely.

Today's release is unlikely to sway the Reserve Bank from raising interest rates in March. Last week's labour data, particularly the acceleration in wage inflation, sealed the fate for a move up in interest rates. However, the fact that firms did not take the fall in input prices as an opportunity to increase output prices will give the Reserve Bank some comfort. Firms continue to absorb cost movements in their margins therefore dampening the pass through to domestic CPI inflation. Although we see an interest rate hike in March as a fait accompli, we remain coy about the need for a follow-up move.



Sources: ANZ National Bank, Statistics NZ



Sources: ANZ National Bank, Statistics NZ

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