

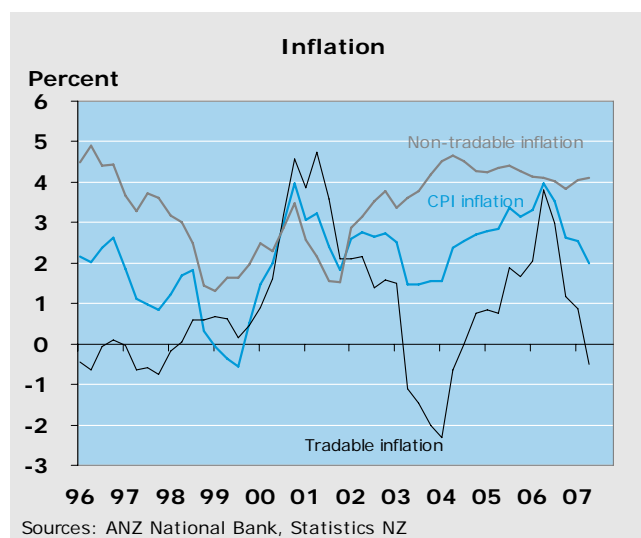
CONSUMERS PRICE INDEX – JUNE QUARTER 2007

Key points

- **Headline inflation came in stronger than expected at 1.0 percent for the June quarter, driven by higher petrol prices, taking the annual headline inflation rate to 2.0 percent.**
- **Most of the upside surprise to today's inflation print came from the tradable side. Petrol prices and a more muted currency pass-through will not worry the Reserve Bank too much.**
- **However, non-tradable inflation still came in stronger than the Reserve Bank's projections and given the lack of inflation headroom, is likely to be view disconcertingly.**
- **Other core measures of inflation were mixed, with the trimmed mean and the weighted median annual inflation rate both down, though the trimmed mean picked up in the June quarter.**
- **With market pricing now moving to a 65 percent chance of a hike in July, we suspect such pricing may prove too tempting for the Reserve Bank.**
- **The bias is now for a further move from the Reserve Bank although the pending inquiry into monetary policy and the level of the currency may well be sticking points.**

The headlines

	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-05	0.4	2.8	-0.5	0.8	1.1	4.2
Jun-05	0.9	2.8	0.6	0.7	1.1	4.4
Sep-05	1.1	3.4	1.1	1.9	1.1	4.4
Dec-05	0.7	3.2	0.5	1.7	1.0	4.3
Mar-06	0.6	3.3	-0.1	2.1	1.0	4.1
Jun-06	1.5	4.0	2.3	3.8	1.0	4.1
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
ANZ	0.8	1.8	0.6	-0.8	1.0	4.0
RBNZ	0.7	1.7	0.5	-0.9	0.9	3.9
Market	0.8	1.8	-	-	-	-



- **The June quarter CPI rose by 1.0 percent, taking annual inflation to 2.0 percent.** This increase was stronger than both market expectations of 0.8 percent and the Reserve Bank's June *Monetary Policy Statement* forecast of 0.7 percent. The transport group made the largest contribution to the quarterly increase in the CPI (0.4 percentage points) courtesy of an 8.0 percent increase in petrol prices. The second largest contribution came from the housing and household utilities group, which rose 1.3 percent in the quarter (a 0.3 percentage point contribution). This increase was driven by home ownership prices (1.6 percent), energy prices (2.6 percent) and property maintenance prices (1.2 percent). Of respondents reporting increases in the June 2007 quarter for home ownership prices, 97.1 percent cited higher prices for construction components and 82.9 percent cited increased subcontractors' charges. Home ownership (or construction) prices have now increased for 33 consecutive quarters, and at an increasing rate over the past three quarters. This illustrates the significant capacity constraints still present in the building industry. Other groups to record price increases in the quarter were the health group (1.9 percent), the food group (0.5 percent), household contents and service group (1.2 percent), miscellaneous goods and services (0.8 percent), clothing and footwear (0.9 percent), alcohol beverages and tobacco (0.3 percent) and communication group (0.4 percent). The education group (-0.2 percent) and the recreation and culture group (-0.8 percent) were the two groups to record price declines in the June quarter.

- **Annual non-tradable inflation remains elevated at over 4 percent.** Non-tradable inflation increased by 1.1 percent in the June quarter after increasing by 1.2 percent in March. This kept the annual growth elevated at 4.1 percent. If the price of home ownership is excluded, non-tradable ex-housing inflation rose by 1.0 percent in the June quarter (1.2 percent in March). Tradable inflation rose by 0.9 percent in the June quarter courtesy of strong petrol price increases. If petrol prices had remained unchanged in the June quarter, tradable inflation would have increased by 0.1 percent and the headline rate would have shown a more modest 0.6 percent increase.

Assessment and implications

Inflationary pressure remains strong. The 1.0 percent quarterly increase in headline CPI was at the top end of expectations and well above the Reserve Bank's 0.7 percent forecast. The non-tradable print at 1.1 percent is also higher than the 0.9 percent increase that the Reserve Bank was expecting. Strength in non-tradable inflation remains housing centric, a reflection of the strong activity percolating from the sector. In addition, the Reserve Bank will not welcome the pick-up in home ownership costs (formerly known as construction costs), which has accelerated for the second consecutive quarter.

However, some of the details will be of mild comfort for the Reserve Bank. Petrol prices were the main contributor to the upside surprise to headline CPI, contributing 0.4 percentage points. We (and the Reserve Bank) were expecting supermarket petrol discount vouchers to have a larger dampening effect on petrol prices, but this did not prove to be the case. Another factor in the higher headline CPI figure was the more muted pass-through from the exchange rate to consumer prices. Despite a strong currency, businesses seem to be building up their margins rather than passing on the benefits straight to consumers. Such upside surprises will not overly concern the Reserve Bank, as it implies businesses will have some capacity to absorb any future depreciation in the currency should that happen. Significantly for the Reserve Bank, the core measures of inflation have not deteriorated. While the quarterly increase in both the weighted median (up 0.7 percent) and trimmed mean (up 0.9 percent) were mixed, the annual rate for both at least have eased to 2.4 percent and 2.0 percent respectively (from 2.9 percent and 2.4 percent). Importantly for the Reserve Bank, today's data did not show an acceleration in non-tradable ex-housing inflation. This is the type of slow-burn inflation that is slow to rise and hard to contain. It is also a proxy for inflation expectations. In fact, this showed a slight easing from the 1.2 percent increase in the March quarter to 1.0 percent in the June quarter. This leaves the annual rate unchanged at 3.6 percent, still elevated but at least it is not accelerating. Service sector inflation (a by-product of unit labour costs) rose 0.4 percent, taking the annual movement to 3.1 percent.

On balance, and with limited inflation headroom, the bias now shifts to a further hike from the Reserve Bank and sooner rather than later. Stepping back, the market looks to have jumped on today's inflation figures as being consistently poor, which in our view is not the case. However, with the market now pricing in a 65 percent chance of a hike in July, we suspect such pricing may prove too tempting and we now expect the Reserve Bank to hike at the July *Review*. The only areas likely to be standing in the way of a further late cycle move look to be some potential sensitivity surrounding the pending inquiry into monetary policy and level of the NZ dollar.

CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	0.5	0.1	4.1
Alcohol and Tobacco	0.3	0.0	3.4
Clothing and Footwear	0.9	0.0	0.1
Housing and Household Utilities	1.3	0.3	5.2
Household Contents and Services	1.2	0.1	1.1
Health	1.9	0.1	2.4
Transport	2.4	0.4	-3.0
Communication	0.4	0.0	0.2
Recreation and Culture	-0.8	-0.1	-0.1
Education	-0.2	0.0	3.2
Miscellaneous Goods and Services	0.8	0.1	3.3
All Groups	1.0	1.0	2.0
Tradables	0.9	0.4	-0.5
Non-tradables	1.1	0.6	4.1
Trimmed Mean	0.9		2.0
Weighted Median	0.7		2.4

	Non-tradable ex-housing		Trimmed mean		Weighted median	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-05	1.1	3.6	0.7		0.5	
Jun-05	0.7	3.5	0.8		0.5	
Sep-05	0.7	3.6	0.9		0.9	
Dec-05	0.9	3.4	0.5		0.5	
Mar-06	1.0	3.4	0.8		0.7	
Jun-06	1.0	3.7	1.1		0.6	
Sep-06	0.6	3.6	0.5	3.0	0.4	2.9
Dec-06	0.8	3.4	0.1	2.6	0.6	2.6
Mar-07	1.2	3.6	0.6	2.4	0.7	2.9
Jun-07	1.0	3.6	0.9	2.0	0.7	2.4

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