

Producers Price Index: June 2008

Key points

- > **Big rises in wholesale electricity and oil prices drove the larger than expected increases in input and output prices in the quarter.**
- > **Margins once again contracted, highlighting the challenging earnings environment facing firms.**
- > **Though there are limited monetary policy implications, today's data is a timely reminder of lingering cost-push inflation pressures within the economy.**
- > **Reinforces to us the likelihood that the easing cycle will be staggered, with rate cuts for the rest of this year, followed by a pause, then a resumption from mid-2009.**

Assessment

Both the PPI input and output prices rose by more than expected in the June quarter. Input prices were up 5.6 percent, while output prices rose 3.5 percent. The increase in the former was the largest quarterly increase since the March 1980 quarter, while for the latter it was the largest increase since June 1985.

Low lake levels and high world oil prices responsible for the large increases. High spot prices for electricity saw the electricity generation and supply input index up a massive 50.8 percent. Higher oil prices, which rose over 26 percent in the quarter in USD terms, led to a 6.4 percent increase in the wholesale trade input index (mainly in the mineral, metal and chemical wholesaling subgroup). We estimate that the electricity and wholesale groups contributed over two-fifths of the total increase in the input index during the quarter.

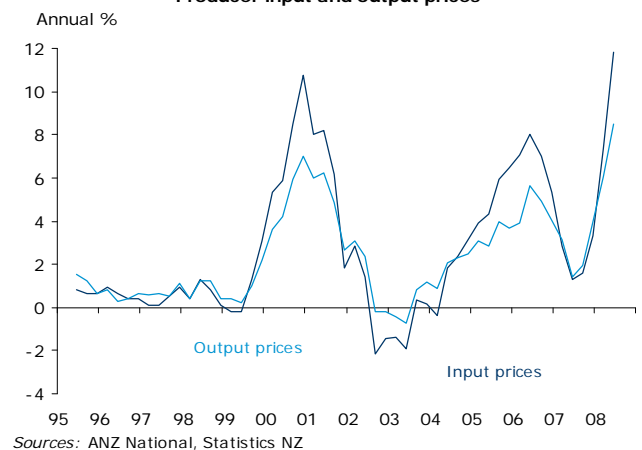
Nonetheless, underlying PPI still high. It is easy to dismiss the PPI numbers as being inflated by electricity and oil prices, both of which has fallen since, which can be expected to result in a partial unwinding in the September quarter. However, even excluding the electricity generation and wholesale industries, we estimated that input prices were still up strongly at 3.3 percent in the quarter, and output prices by around 2.0 percent. Still a hint of an undercurrent of pipeline inflation pressure in the system which will continue to keep the RBNZ wary.

Not all the increases in input prices being passed on, leading to margin contraction. In aggregate, businesses have been unable or unwilling to fully pass on the increases in input costs onto their customers. Even in the electricity industry, the 30.9 percent increase in output prices, though large, was only less than two-thirds the increase in input prices. Output prices lagged behind input prices particularly for those industries that are exposed to the domestic economy. By our estimates, output prices for the non-tradable sector rose 7.3 percent from a year ago, but their

input prices were up by 13.9 percent. In contrast, output prices in the tradable sector was up 9.4 percent from a year ago compared to a 11.9 percent increase in their input prices.

	Input Prices		Output Prices		Margins	
	QoQ	YoY	QoQ	YoY	QoQ	YoY
Jun-06	2.9	8.0	2.9	5.7	0.0	-2.2
Sep-06	1.8	7.0	1.0	4.9	-0.8	-2.0
Dec-06	-0.3	5.3	-0.6	4.1	-0.3	-1.2
Mar-07	-1.6	2.8	-0.2	3.1	1.4	0.3
Jun-07	1.4	1.3	1.2	1.4	-0.2	0.1
Sep-07	2.1	1.6	1.6	2.0	-0.5	0.4
Dec-07	1.4	3.3	1.4	4.0	0.0	0.6
Mar-08	2.3	7.3	1.8	6.1	-0.5	-1.2
Jun-08	5.6	11.8	3.5	8.5	-2.0	-3.0
ANZ	2.6	8.8	2.3	7.3	-	-
Market	2.6	8.8	2.1	7.3	-	-

Producer input and output prices

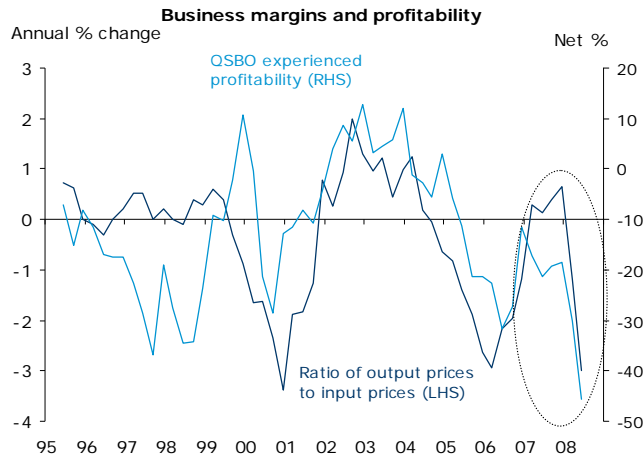


Earnings environment tough, likely to get tougher in the near term. Today's PPI data reinforces what recent business surveys have been telling us about profitability. Margin compression, coupled with a reduction in volumes due to the slowdown in the economy, is leading to falling profits. The corporate earnings environment is likely to remain challenging over the coming 12 months. With the demand environment still soft, but cost pressures still

intense, it is not surprising to see firms are still trying to pull the price lever to recover margins (based on pricing intentions). The extent to which firms are able to pass on price increases will depend on the competitive environment and how price sensitive their customers are. The most likely outcome, as seen in today's PPI data, is for further margin liposuction and an increasing focus on costs – particularly staffing levels.

Implications

Though there are limited monetary policy implications from today's data, it is a timely reminder that lingering inflation pressures remain. Growth may be slowing rapidly, but we are still getting upside inflation surprises. This is partly due to lags – it takes time for weak growth to ease inflation pressure. Nonetheless, it does highlight that the RBNZ is running a risk in starting the easing cycle early. This reinforces our view of a staggered easing cycle, where the RBNZ cuts rates for the rest of this year, pauses to reassess the growth and inflation outlook, before resuming the easing cycle from mid-2009. A more aggressive easing cycle is still ultimately predicated on the global picture and the outlook for commodity prices in particular.



Sources: ANZ National, Statistics NZ, NZIER

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