

Consumers Price Index: March 2008 quarter

Key points

- > **Headline CPI came in slightly weaker than our and market expectations at 0.7 percent for the quarter, taking the annual inflation rate to 3.4 percent.**
- > **Food and petrol prices accounted for the bulk of the increase in the quarter.**
- > **Non-tradable inflation was strong at 1.1 percent, with strong rent increases being slightly offset by some potential early signs construction costs are easing.**
- > **While there looks to be some positive demand-linked aspects to today's data, medium term cost push inflation risks remain, and will reinforce the Reserve Bank's inflation concerns.**
- > **Looking forward, the unemployment rate – as a key driver of medium term inflation - remains key to watch.**

Assessment

The CPI index rose by 0.7 percent in the March quarter, taking the annual headline inflation rate to 3.4 percent. The increase was slightly weaker than our and the market's expectations, though in line with the Reserve Bank's March projections.

Unsurprisingly, higher food (up 1.8 percent) and petrol prices (up 4.0 percent) were the main driver of the CPI increase in the quarter, accounting for 0.5 percentage points of the 0.7 percent increase.

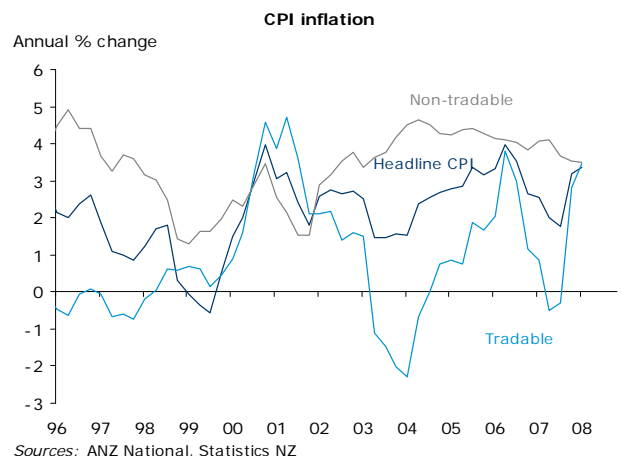
Softer tradable inflation offset by stronger non-tradable. Tradable inflation rose by a weaker than expected 0.2 percent in the quarter. High petrol prices have been partly offset by aggressive retail discounting. If petrol prices were excluded, tradable prices would have fallen by 0.3 percent in the quarter. The retail discounting was across the board, likely as a consequence of the slowing in non-food related retail sales, leading to excess inventories. As such, we can expect further retail discounting to come over the June quarter, helping to cap tradable inflation.

Strong rental increases adding to non-tradable inflation pressure. Rent prices rose 1.2 percent in the quarter (adding 0.15 percentage points to non-tradable inflation), the strongest quarterly increase since the March 2004 quarter. With landlords no longer enjoying capital gains and interest costs rising, rents are now playing catch-up. This will be a source of upward non-tradable inflation pressure over the coming quarters.

However, there are tentative signs that the correction in the housing market may be having some impact on other housing related inflation. Construction costs grew at their lowest quarterly rate (at 0.9 percent) since September 2002. The housing cycle and construction costs have shown a close correlation in the past. Given the sharp drop seen in house sales and easing house prices, this is an area

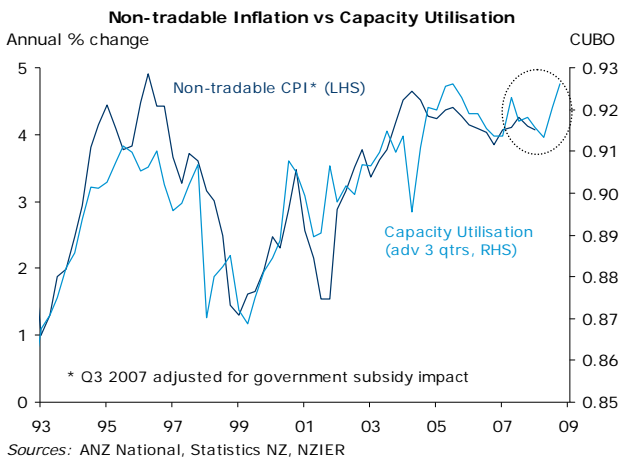
where we expect to see a further softening in inflation pressures.

	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
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
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
ANZ	0.8	3.5	0.5	3.8	1.0	3.4
RBNZ	0.7	3.4	0.2	3.4	1.1	3.5
Market	0.8	3.5	-	-	-	-

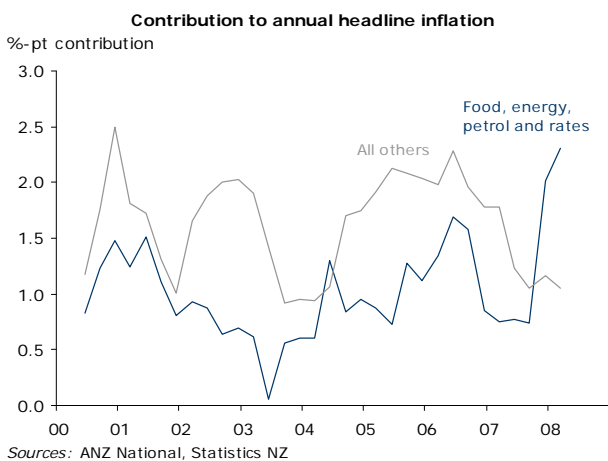


The other core inflation measures did not contain any surprises, with both the trimmed mean and weighted median up by 0.8 percent in the quarter. The annual trimmed mean and weighted median

measures were 3.5 percent and 3.2 percent respectively, both unchanged from the previous quarter.



On balance, today's inflation report is in line with the Reserve Bank's thinking at the time of the March MPS. Given the increase in petrol prices since the Reserve Bank finalised their March projections, today's data likely came in slightly below their expectations. There is unlikely to be anything that will cause them too much grief. However, the strong non-tradable inflation print and recent increases in pricing intentions and capacity utilisation mean they will remain on alert to further pipeline inflation pressure. The spike up in the NZIER's latest capacity utilisation measure may have been influenced by meat processing works due to the dry weather conditions, but the Reserve Bank will want to be sure that this was indeed the case and that it does not lead to a renewed pick-up in non-tradable inflation.



The Reserve Bank needs inflation pressure from contestable areas to ease sufficiently to offset price rises from areas outside of their control. A lot of inflation pressure is coming from areas that the Reserve Bank cannot do much about, such as food, energy and petrol. The Government's emissions trading scheme will only see higher energy and petrol prices at the end of the year. Looking at the

contribution that those items have had on overall inflation, shows that they now make up a large proportion of the price increases compared to previous years. For the Reserve Bank to bring headline inflation back to within their target band, they need inflation pressures from contestable areas (housing, services and retail related) to ease further. There may be tentative signs of this occurring with softer construction costs as noted above, but the Reserve Bank will want to see it develop into a sustained trend.

Implications

Today's inflation print will not change the Reserve Bank's stance at next week's OCR Review. While the weight of new "news" since the March Statement has largely been towards a markedly weaker growth profile for the New Zealand economy, there is not the inflation headroom to take a softer tone. Stepping back, we can see some encouraging signs in today's inflation report in the form of easing construction costs and retail discounting, testament to traditional demand-pull forces. Yet at the same time, upside inflation risks (emission trading, a low unemployment rate) remain and the bottom line is that the headline inflation rate looks set to stay high over the coming 2 quarters. For now we see a continuation of their status quo and inflation wary demeanour. A weaker growth profile by itself is not a sufficient prerequisite for the Reserve Bank to change their stance. They need to see it translate through into easing inflation pressure, and for that to be sustained.

Looking forward, the unemployment rate – as a key driver of medium term inflation - remains key to watch.

We continue to look for an end of year easing, largely in our view that growth is materially weaker than the Reserve Bank's projections were assuming in March, and we expect the labour market to turn as weaker growth manifests.

CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	1.8	0.3	5.1
Alcohol and Tobacco	1.1	0.1	3.5
Clothing and Footwear	-1.0	0.0	-0.1
Housing and Household Utilities	1.0	0.2	5.1
Household Contents and Services	-0.8	0.0	0.2
Health	0.4	0.0	-0.5
Transport	0.8	0.1	7.0
Communication	-0.1	0.0	-0.5
Recreation and Culture	-1.2	-0.1	-0.7
Education	3.9	0.1	-2.0
Miscellaneous Goods and Services	1.0	0.1	2.9
All Groups	0.7	0.7	3.4
Tradables	0.2	0.1	3.4
Non-tradables	1.1	0.6	3.5
Trimmed Mean	0.8		3.5
Weighted Median	0.8		3.2

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