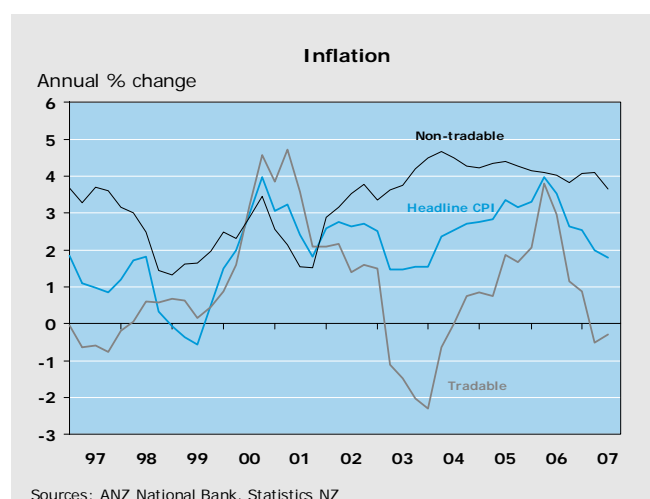


## CONSUMERS PRICE INDEX – SEPTEMBER 2007 QUARTER

Key points

- Increased government subsidies dragged the headline CPI lower, taking annual headline inflation 1.8 percent from 2.0 percent in the previous quarter.
- However, looking through the one-offs, the components still reveal a clear inflationary undercurrent.
- Nonetheless, the more favourable print gives the Reserve Bank some much needed breathing space to wait and assess the upcoming dataflow.

	Headline CPI		Tradable		Non-tradable	
	q/q	y/y	q/q	y/y	q/q	y/y
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
<b>Sep-07</b>	<b>0.5</b>	<b>1.8</b>	<b>0.5</b>	<b>-0.3</b>	<b>0.6</b>	<b>3.7</b>
<b>ANZ</b>	<b>0.8</b>	<b>2.1</b>	<b>0.5</b>	<b>-0.3</b>	<b>1.0</b>	<b>4.1</b>
<b>RBNZ</b>	<b>0.8</b>	<b>2.1</b>	<b>0.5</b>	<b>-0.3</b>	<b>1.0</b>	<b>4.1</b>
<b>Market</b>	<b>0.8</b>	<b>2.1</b>	-	-	-	-



**The September quarter CPI rose 0.5 percent, taking annual inflation to 1.8 percent.** The increase was significantly weaker than expectations of a 0.8 percent increase due to a number of one-offs: the Government's 20 hours free childcare for 3-4 year olds, increased subsidies for pharmaceutical products and GP services. The prices of early childhood education fell 32.4 percent in the quarter, while pharmaceutical product prices and GP fees fell 16.2 percent and 15.4 percent in the quarter, respectively. Offsetting these large falls were increases in the housing and household utilities group, which made the largest upward contribution to the quarterly increase in the CPI (0.4 percentage points) courtesy of a 6.2 percent increase in property rates and related services, and a 1.8 percent increase in home ownership prices. Other groups to record price increases in the quarter were the food group (1.2 percent), alcohol and tobacco group (1.7 percent), transport group (0.4 percent), recreation and culture group (0.3 percent) and miscellaneous goods and services group (0.8 percent). Along with the health and education groups (down 3.1 percent and 5.2 percent, respectively), the clothing and footwear group (-0.5 percent), household contents and services group (-0.3 percent) and communication group (-0.3 percent) were the other groups to record price falls in the September quarter.

**Annual non-tradable inflation fell from 4.1 percent to 3.7 percent in the September quarter.** Non-tradable inflation rose 0.6 percent in the quarter, the smallest quarterly increase since June 2001. Tradable inflation rose 0.5 percent in the September quarter, taking annual tradable inflation to -0.3 percent.

**Core inflation measures remain relatively elevated.** The 10 percent trimmed mean and the weighted median measures both rose 0.7 percent in the September quarter. Annual growth for the trimmed mean measure rose to 2.3 percent from 2.0 percent in June, while the annual increase in the weighted median measure increased to 2.7 percent, from 2.4 percent in the June quarter. The services component of the CPI (an indication of cost-push inflation pressure) rose 0.8 percent in the quarter to be 3.2 percent higher than a year ago.

## Assessment

**Annual inflation is below the mid-point of the Reserve Bank's target band for the first time since the March 2004 quarter.** Ironically, given the increasing pressure that government spending has been placing on monetary policy, it was increased government subsidies in health and early childhood education that resulted in a lower headline CPI print. To be fair, we (and the Reserve Bank) had known about the one-offs and this was factored into our estimates, but the extent of the declines surprised us. By our estimates, excluding the impact of these subsidies would have seen headline inflation come in at 0.8 percent and non-tradable inflation at around 1 percent.

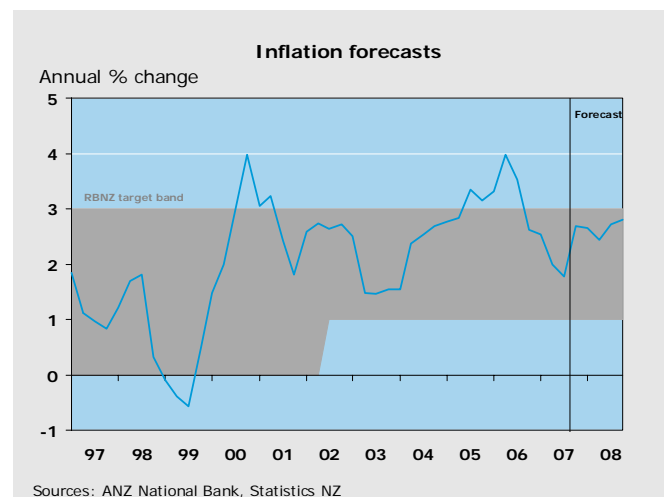
**Abstracting from the one-offs, the details still show a clear inflationary undercurrent.** The housing group continues to lead price increases, with the main contribution coming from local authority rates and construction costs. In particular, we note that construction costs continue to accelerate despite clear evidence that the housing market has turned. Core inflation measures showed an increase, with the trimmed mean rising from 2.0 percent to 2.3 percent while the weighted median measure rose from 2.4 percent to 2.7 percent. However, the quarterly increase in the weighted median has remained unchanged at 0.7 percent over the previous three quarters, pointing to a degree of stickiness in overall inflation pressure. Looking at the distribution of price movements, 66.3 percent of items (by expenditure weight) showed increases. While this is slightly lower than the 68.6 percent of items last quarter, it remains elevated.

**The overall message from today's inflation report is that it buys the Reserve Bank some breathing space to watch the lags between monetary policy and the economy work through.** Inflationary pressure is strong and today's figures understate the true level of pricing pressure, which will continue to concern the Reserve Bank. Confidence remains resilient and resource pressures are still tight. However, given the stronger than expected economic activity over the first half of this year, today's CPI print nonetheless provides some relief (despite being helped by one-offs) via the opening position within the Reserve Bank's modelling framework. While one-offs are obviously tempting to look through, the fact they are also a key source of upside inflation pressure and risks (food, petrol, emissions charges, other government charges), means that it would be inconsistent to discount them completely when they head in the other direction. The reality is that the headline inflation rate is a key influence on inflation expectations, and the fact the headline inflation rate has now been below 3 percent for four quarters is likely to help dampen price and wage setting behaviour via inflation expectations. But equivalently, there is a huge pipeline of inflationary pressure still around given a tight labour market, margin pressure and strong commodity prices.

With inflation now likely to remain within the 1-3 percent target band over the coming quarters (absent a substantial surge in world oil prices), the Reserve Bank has some breathing space to wait and assess the upcoming dataflow, particularly the full impact of its monetary policy tightening this year. Specifically, they will want to see the moderation in domestic demand extend more broadly and lead to easing inflation pressure.

**Market reaction was severe, with the NZD off 50pips and the swaps curve rallying as much as 8bps.** Today's aggressive movements need to be put in context following last week's aggressive moves higher in rates and the currency on speculation, and perhaps fear, of further policy tightening in response to rampant inflation pressure. With the Q3 inflation figures not providing a smoking gun (although certainly continued cause for concern), the market will be back to trading partial data on the state of domestic demand, which we expect to show continuing moderation. However, the key remains whether this will translate into receding inflationary pressure, particularly with partial indicators still tracking in line with a fabled soft-landing.

CPI Components	Qtly % chg	%-pt contrib	Ann % chg
Food	1.2	0.2	3.3
Alcohol and Tobacco	1.7	0.1	3.5
Clothing and Footwear	-0.5	0.0	0.3
Housing & Household Utilities	1.8	0.4	5.1
Household Contents & Services	-0.3	0.0	-0.1
Health	-3.1	-0.2	0.0
Transport	0.4	0.1	-1.4
Communication	-0.3	0.0	0.1
Recreation and Culture	0.3	0.0	0.3
Education	-5.2	-0.1	-2.4
Miscellaneous Goods & Services	0.8	0.1	3.3
<b>All Groups</b>	<b>0.5</b>	<b>0.5</b>	<b>1.8</b>
<b>Tradables</b>	<b>0.5</b>	<b>0.2</b>	<b>-0.3</b>
<b>Non-tradables</b>	<b>0.6</b>	<b>0.3</b>	<b>3.7</b>



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