

Consumers Price Index: June 2008 quarter

Key points

- > Annual headline inflation hits 4 percent, and likely to test 5 percent later this year.
- > Food and petrol prices the main driver, along with higher household energy costs.
- > Remainder of the components mildly encouraging on balance.
- > July rate cut remains a 50-50 call but the reality is that it is still very tough for the RBNZ to deliver.

Assessment

The CPI index rose a stronger than expected 1.6 percent in the June quarter, taking the annual headline inflation rate to 4.0 percent. The quarterly increase is the highest since the June 1990 quarter. Unsurprisingly, food (up 2.2 percent) and petrol prices (up 12.8 percent) combined accounted for 1.1 percentage points of the quarterly increase. The housing group also made a strong contribution (up 1.2 percent) mainly due to a 3.6 percent increase in electricity prices.

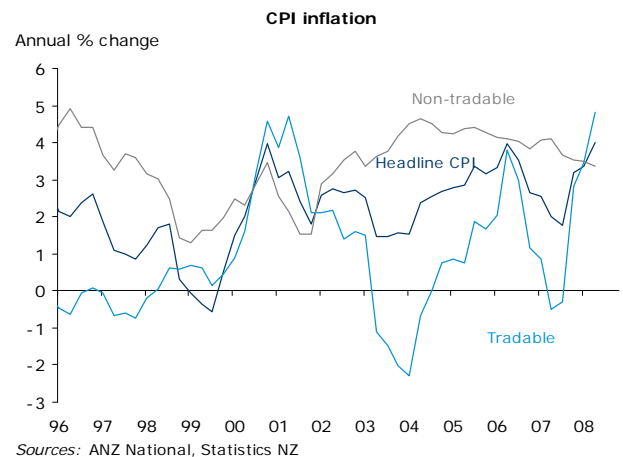
The composition of price increases was a mixed bag. The main drivers of the price increases in the June quarter were as expected. However, we were surprised that anecdotes of big retail sector discounting did not flow through more in the June quarter. While prices for electronic goods (down 4.4 percent), recreational equipment (down 0.4 percent) and motor vehicles (down 0.7 percent) fell, clothing/footwear, furniture and household appliances prices rose. This suggests to us that the bulk of the discounting will be picked up in the September quarter CPI report, which will help offset oil related price increases in other areas (petrol and airfares).

Non-tradable inflation eases gradually but other core inflation measures remain elevated. While the 0.9 percent increase in non-tradable CPI was slightly lower than expected, the trimmed mean measure picked up to 1.2 percent from 0.8 percent in the previous quarter. However, the weighted median increase in the June quarter was 0.8 percent, unchanged from the March quarter. Averaging across the three gives an elevated one percent increase.

The sharp slowdown in domestic demand to date is not yet having a material dent on pricing.

Despite the sharp slump in the housing market, home ownership costs (i.e. construction costs) picked up in the June quarter to 1.1 percent. That 93 percent of respondents cited higher prices for construction components as a contributing factor suggests an element of cost-push inflation still at play, which means activity in the construction sector is not sufficiently depressed yet for margins to be cut. However, there is also nothing in the data to suggest

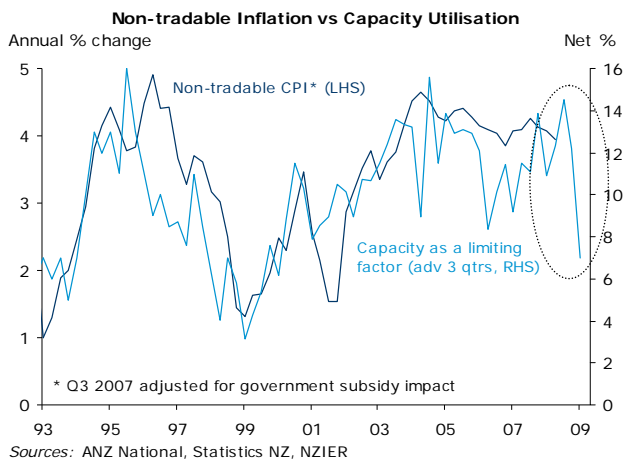
	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-06	0.6	3.3	-0.1	2.1	1.0	4.1
Jun-06	1.5	4.0	2.3	3.8	1.0	4.1
Sep-06	0.7	3.5	0.3	3.0	1.0	4.0
Dec-06	-0.2	2.6	-1.3	1.2	0.8	3.8
Mar-07	0.5	2.5	-0.4	0.9	1.2	4.1
Jun-07	1.0	2.0	0.9	-0.5	1.1	4.1
Sep-07	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
Jun-08	1.6	4.0	2.3	4.8	0.9	3.4
ANZ	1.4	3.8	1.9	4.4	1.0	3.5
RBNZ	1.4	3.8	2.0	4.6	1.0	3.4
Market	1.4	3.8	-	-	-	-



that medium-term inflation pressure is becoming more broad-based either.

However, it was particularly encouraging to see services inflation contained (up 0.6 percent in the quarter). Outside of food, fuel and energy, everything else seems reasonably well behaved. CPI ex-food, petrol and energy increased 0.4 percent. Recreation, miscellaneous services and household services were all subdued. On the assumption that demand sensitive pockets do turn, and service sector inflation remains contained, the implication is that non-tradable inflation

has the potential to turn down very rapidly (as it has tended to do in the past).



Net on net, we suspect today's data still leaves the market (and ourselves) scratching our heads over the path for monetary policy. Given the sharp slowdown in the economy and signs that the labour market is easing (based on hiring intentions and difficulty finding labour gauges from the latest OSBO survey), the RBNZ can have greater confidence that medium-term inflation pressures will ease. As noted above, non-tradable inflation has the potential to turn rapidly given the current mix. But given where the headline inflation sits, the RBNZ will need to be absolutely certain that this will occur as we remain in a situation where second round pricing effects are a key risk.

Implications

Our personal bias is that there have been sufficient developments across the global economy, confidence, labour market sentiment (based on anecdotes) and credit dislocation that one can justify a rate cut next week. After all, a rate cut will only neutralise tighter financial conditions that are flowing through from other areas, such as a

higher cost for global capital. This is an area we are placing considerable weight on. Yet equally, it is hard to go past the reality of high oil prices, elevated inflation expectations and a headline inflation rate that is set to breach 5 percent later this year. Hence, a July rate cut call is a view that we lack conviction towards. This reflects the difficult environment the RBNZ faces as it tries to navigate through weakness in the domestic property market alongside the twin global inflation (commodity) and credit shocks.

Whatever path the RBNZ pursues, we need to be mindful of a couple of things. First, these are the most challenging economic times for any central bank in more than 30 years. Second, whichever path is chosen (cut next week or hold for a while longer) is not without risk. Cut early and you risk further inflation by allowing inflation expectations to drift higher, which requires a bigger growth sacrifice down the track. Cut too late and you risk missing a crucial inflection point, and a severe downturn. So while we would certainly like to see rates move lower earlier, it will be hard to quibble if this does not manifest and the RBNZ decides that caution should prevail.

CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	2.2	0.4	6.9
Alcohol and Tobacco	-0.2	0.0	3.0
Clothing and Footwear	0.6	0.0	-0.4
Housing and Household Utilities	1.2	0.2	5.0
Household Contents and Services	0.3	0.0	-0.7
Health	1.0	0.1	-1.4
Transport	4.9	0.9	9.6
Communication	0.5	0.0	-0.4
Recreation and Culture	-0.5	-0.1	-0.4
Education	0.0	0.0	-1.8
Miscellaneous Goods and Services	0.4	0.0	2.5
All Groups	1.6	1.5	4.0
Tradables	1.9	0.9	4.8
Non-tradables	1.0	0.5	3.4
Trimmed Mean	1.2		3.8
Weighted Median	0.8		3.4

Gauge	Quarterly % change				Direction		Comment
	Q3 07	Q4 07	Q1 08	Q2 08	Current	Next six months	
Headline	0.5	1.2	0.7	1.6	↑	↑	Tradable inflation driving it higher
- ex-petrol	0.4	0.9	0.5	0.9	↑	↑/↔	Petrol has made a large contribution
- ex-food, petrol & energy	0.1	0.6	0.1	0.4	↔	↔	A much better story
Tradable	0.5	1.8	0.2	2.3	↑	↑	Food and petrol, need we say more?
Non-tradable	0.6	0.7	1.1	0.9	↑/↔	↔	Still a degree of persistence
Non-tradable less home ownership	0.4	0.6	1.1	0.8	↑/↔	↔	No longer a housing problem
Housing and household utilities	1.8	0.9	1.0	1.2	↓	↔	Still elevated
Housing ex-energy	1.6	0.7	0.8	0.5	↓	↔/↓	Energy prices are heading one way
Goods	0.4	1.3	0.9	2.1	↑	↑	Food and petrol again
Services	0.8	1.1	0.4	0.6	↓	↓	Remarkably well behave
Trimmed mean 10%	0.7	1.1	0.8	1.2	↑	↔	Wrong direction
Weighted median	0.7	0.7	0.8	0.8	↑	↔	Wrong direction

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ANZ, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639 <http://www.anz.co.nz> e-mail ecnmcs@anz.com