

Going, going...

Q4 CPI -0.5% q/q, 3.4% y/y

- Annual inflation retreats due to lower petrol prices.
- Much more disinflation ahead on weak economy.
- Green light for more aggressive interest rate cuts.

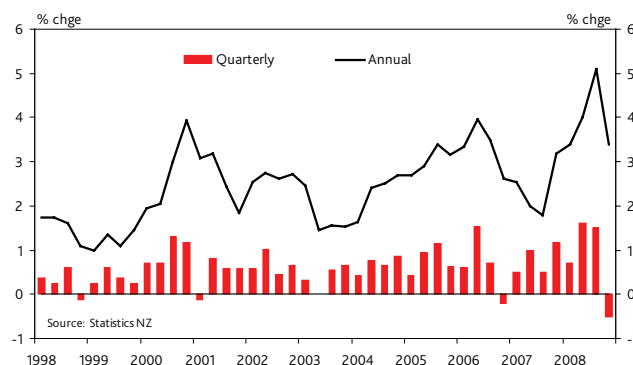
To the casual observer, the world of economics must be puzzling. Annual inflation hit an 18 year high of 5.1% in Q3 2008 and latest figures show annual inflation at 3.4% in the final quarter of last year – still above the top of the Reserve Bank's target range. Surely with such high inflation, interest rates would be rising. Not so. The RBNZ has slashed rates in recent months taking the OCR 3.25% lower since July last year and further large cuts are expected.

It is all about the economy. Weak economic conditions today will see inflation back within the RBNZ's target range next quarter and below the bottom of the band by Q3 this year. The RBNZ cannot change history so there is little point reacting to last year's inflation. Focus is where it should be – on the economic outlook and the implications for inflation ahead.

To cover off the current quarter, lower petrol prices (-22.4%) drove the overall 0.5% drop in the CPI. No surprises there. For the record, if petrol (and diesel) prices had remained constant from the September 2008 quarter to the December 2008 quarter, the CPI would have increased 0.9%. So, outside of fuel prices declines inflation was still high. Of course, when you abstract from the prices that declined you tend to find the remainder was stronger than the headline! The key driver of the 0.9% (and the biggest positive group contribution to the overall CPI) came from a 1.5% rise in food prices. Looking forward, food inflation is expected to diminish quickly over coming quarters given large falls in international commodity prices to date. The 0.2% decline in food prices in the month of December may well prove a pre-cursor to what lies ahead in 2009.

Non-tradeable inflation came in at 0.8% in Q4, at touch stronger than we expected. Rents rose a modest 0.4% in the quarter while the purchase of new housing costs fell 0.2%. This is the first decline in the purchase of new housing since 1999. Quality adjustments for new dwellings in Auckland and further north exaggerated the weakness this quarter, but movements

Consumer Price Index



CPI components (quarterly % change)

	Dec-07	Mar-08	Jun	Sep	Dec
Food	1.5	1.8	2.2	3.7	1.5
Alcohol & Tobacco	0.3	1.1	-0.2	1.3	0.4
Apparel	0.5	-1.0	0.6	-0.4	0.9
Housing	0.9	1.0	1.2	1.4	0.6
Household	0.1	-0.8	0.3	0.8	0.5
Health	0.4	0.4	1.0	1.4	0.6
Transport	3.2	0.8	4.9	2.0	-7.6
Communication	-0.5	-0.1	0.5	-1.1	-0.4
Recreation and Culture	1.0	-1.2	-0.5	0.8	1.5
Education	-0.3	3.9	0.0	0.1	0.1
Miscellaneous	0.4	1.0	0.4	0.5	0.7
CPI	1.2	0.7	1.6	1.5	-0.5
CPI (ann %)	3.2	3.4	4.0	5.1	3.4
Non-tradables (ann %)	3.5	3.5	3.4	4.1	4.3
Tradables (ann %)	2.8	3.4	4.8	6.3	2.3

in construction cost across other regions and other indicators suggest there is a substantial softening in trend construction costs. This will be encouraging for the RBNZ. Still, another round of increases in electricity prices and other non-housing related non-tradeable inflation will not be so welcome. All up, annual non-tradeable inflation at 4.3% was a touch weaker than the 4.4% forecast by the RBNZ in their December *Monetary Policy Statement*, providing no restraint on cutting interest rates further on the deteriorating economic outlook.

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A 0.9% increase in clothing and footwear prices and a 0.5% increase in the household contents and services group are contrary to the anecdotes of widespread discounting by retailers. We suspected this would be the case as negotiated discounts are typically not picked up by the CPI and also the lower NZD is putting upward pressure on prices of imported goods. This latter point is one to be wary of through 2009.

Implications

Today's inflation data will not change the RBNZ's modus operandi. Focus will remain on the international situation, weak domestic economy and low inflation outlook. The economy is in reverse and with spare capacity increasing and labour market deteriorating we expect further substantial cuts in interest rates. Starting with at least 100 basis points next Thursday, we expect the OCR to get to 2.5% over coming months.

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