Economic Update

Australian Producer Prices Surge

21 April 2008

Key points

- The Q1 Final Stage PPI surged to a quarterly increase of 1.9% after rising by 0.6% in 2007:Q4. This was much higher than the market median forecast of a 1% increase. The annual rate jumped to 4.8%, the highest since the series began in 1998. Price pressures are broad based across both industry segments as well as through the production chain. Imported and domestic inflation both made contributions to the overall result.
- The Q1 PPI suggests an intensification of inflationary pressures in the economy in 2008. While inflation lags economic activity, and the domestic economy appears to be reacting to tighter financial conditions this year, we are concerned that inflation dynamics at present are not typical of a normal business cycle.
- House construction costs surprised on the upside forcing up both the core and headline inflation forecasts for Wednesday's Q1 CPI. We have pushed both up by 0.1% in the quarter; to +1% for core inflation and +1.3% for headline inflation.
- ANZ expects the RBA to remain on hold in 2008, largely because we are seeing the economy respond to past rate hikes and tighter financial conditions through softer consumer demand. Today's PPI result suggests, however, that if rates are going to move in the next six months, the risk is that they go up.

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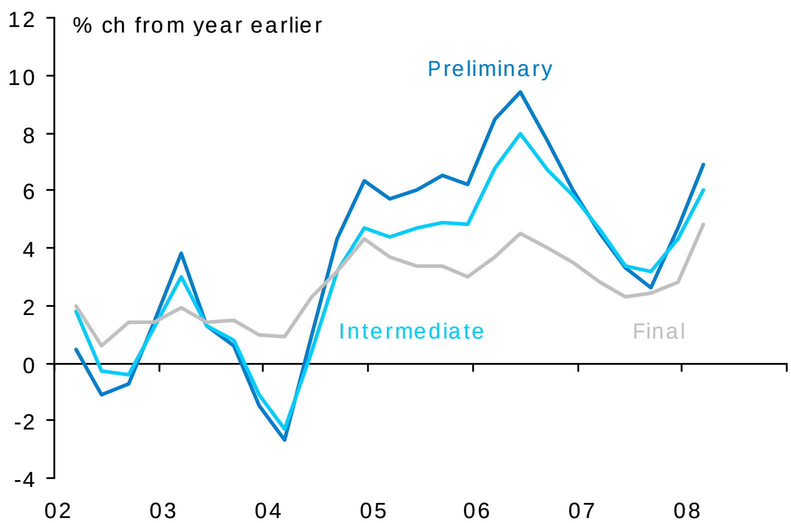
Producer prices by stage of production



Upstream producer price pressures intensify…

Final stage producer price inflation was much higher than expected in the March quarter 2008 at 1.9%. This was the highest quarterly increase since the series began in 1998 and saw annual growth pick up to 4.8% from 2.8% in the previous quarter.

The largest increase was in the domestically-sourced component, which surged by 2.0% to be a massive 6.1% higher over the year. Price increases in building construction (+1.9%), petroleum refining (+10.5%) and electricity, gas and water (+3.1%) made the largest contributions.

Higher prices for imported items also added to the final stage PPI, rising by 0.6% in the quarter (-3.8% over the year). This was the first rise since the June quarter 2006, with the appreciating AUD driving prices down in previous quarters. The largest contributions to the imported component of the final stage PPI were from dairy product manufacturing (+32.9%), motor vehicle parts and manufacturing (+1.4%) and petroleum refining (+8.2%).

… as do downstream price pressures

Price pressures further up the production chain also accelerated in the March quarter. The intermediate index rose by 2.0% to be 6.0% higher over the year and the preliminary index rose by 2.3% in the quarter to be 6.9% higher over the year. Imported prices surged in both instances (up by 3.7% for the intermediate index and 4.9% for the preliminary index), largely due to price increases for petroleum refining and oil and gas extraction. Domestically-sourced producer price inflation was also high at earlier stages of production, with the domestic component of the intermediate PPI (+1.8%) and the preliminary PPI (+2.0%) up strongly.

Elevated price pressures further down the production chain present risks to both final stage producer price inflation and consumer price inflation in the quarters ahead. We will wait for the CPI on Wednesday, but this may force some small upward adjustment to our inflation forecasts through the middle of 2008.

The relationship between the PPI and the CPI

In the past, the relationship between the PPI and the headline CPI has been fairly loose. However, quarterly movements in the two series have tracked reasonably closely over the past eighteen months[1] (see chart below). Looking at annual growth rates, the correlation between the headline CPI and the PPI over the past 10 years is +0.55. The correlation has increased to +0.83 since the start of 2005.

On this basis, today's PPI result suggests upside risks to the market expectation of a 0.9% rise in core CPI and a 1.1% rise in headline CPI on Wednesday. Indeed, we have revised our Q1 CPI forecasts up (see below) and would expect the market median forecast to rise in the wake of today's PPI result.

ANZ Q1 CPI revised higher

Our analysis of the broad relationship between the quarterly PPI ad CPI suggests upside risk to our forecast of a +1.2% headline CPI rise. What has surprised us is the broad-based increase in prices evident in the PPI, both across stages of production as well as industries. For example, not a single sub component of the manufacturing output price index declined in the quarter.

Of particular note this quarter was the sharp rise in the home building construction component of the final stage PPI (+1.2% qoq). This has a very close relationship with the relatively large house purchase component of the CPI which makes up 8% of the index. This surprise alone is enough for us to revise up our forecasts for the headline

[1] The September quarter 2007 was an exception, with the headline CPI was pushed down by a once-off change to childcare eligibility criteria which stripped off 0.3ppts, resulting in the headline CPI rising by 0.7% compared with a 1.1% rise for the PPI.

and core CPI. We are now expecting core inflation of +1.0% in the quarter, up from +0.9%. This will leave the annual rate at +4.0%. The headline inflation forecast has been pushed up from +1.2% to +1.3% in the quarter taking the annual rate to +4.2%.

More generally, higher rates of producer price inflation, both upstream and downstream, are a concern for consumer price inflation beyond the March quarter. This of course depends on the extent to which businesses are willing to pass on higher prices to consumers, rather than to absorb these costs into their margins. Our forecast incorporates some margin compression given that our CPI forecast of 1.3% is still well below the PPI rise of 1.9%. We assume that against a backdrop of softening demand for consumer goods, it may be the case that firms are reluctant to pass on these input costs in full. However, with input prices rising so sharply, it is likely that at least some of these increases will be passed on to consumers. This adds to further evidence that consumer price inflation will remain unacceptably high through the remainder of 2008.

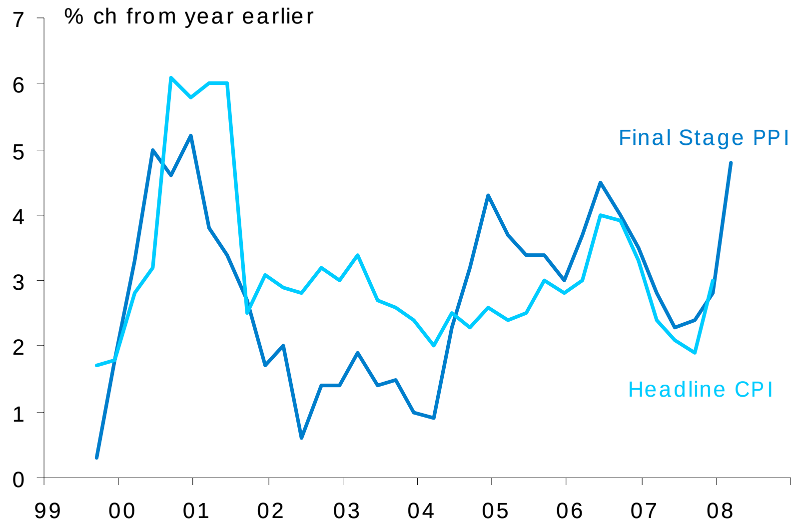
No rate cuts in sight as inflation intensifies in early 2008

The Q1 PPI suggests an intensification of inflationary pressures in the economy in 2008. While inflation lags economic activity, and the domestic economy appears to be reacting to tighter financial conditions this year, we are concerned that inflation dynamics at present are not typical of a normal business cycle. Specifically, global food and energy inflation combined with a stretched labour market and rising inflation expectations may cause inflation to remain sticky within the economy. Another way of looking at this is to say that the RBA may need a much more significant slowing in the non-farm, non-mining economy to achieve a material easing of inflation pressures over the next year or so.

With pipeline inflation on the rise and the labour market tight, we think that the RBA will remain on a tightening bias for the next six months at least. Indeed, if the PPI result is reflected in a higher than expected CPI on Wednesday, the market will become very nervous about the possibility of another rate hike should the Q2 CPI in late July also surprise to the upside.

ANZ expects the RBA to remain on hold in 2008, largely because we are seeing the economy respond to past rate hikes and tighter financial conditions through softer consumer demand. Today's result suggests, however, that if rates are going to move in the next six months, the risk is that they go up.

Annual movements in consumer and producer price inflation



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