

NEW ZEALAND ECONOMICS

CONSUMERS PRICE INDEX – DECEMBER 2010 QUARTER

20 January 2011

CONTRIBUTORS

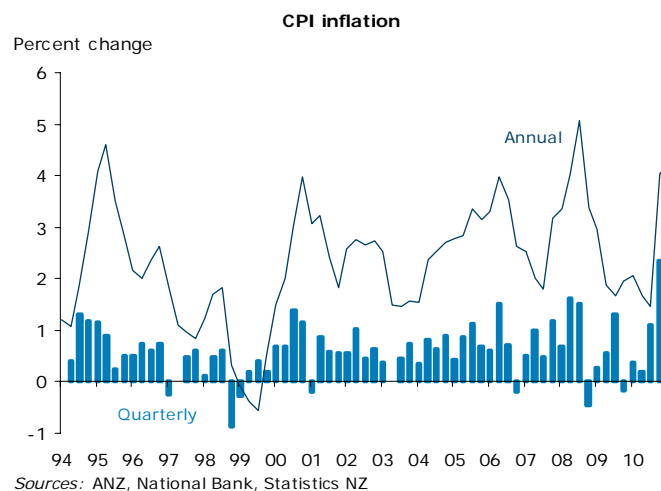
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GST BOOSTS INFLATION BUT WATCH FOR FUTURE PRICE INCREASES

KEY POINTS

- Today's CPI outturn was in line with the RBNZ's December MPS pick of a 2.3 percent quarterly increase, but slightly weaker than market expectations. Annual CPI inflation rose to 4.0 percent, the highest rate since September 2008.
- We estimate that the increase in GST contributed 2 percentage points of the 2.3 percent increase. Our estimate of underlying CPI inflation, which excludes the direct impact of GST and other one-off government charges, show a more sedate 0.3 percent quarterly rate. Annual inflation on this measure, at 1.6 percent, remains well within the 1 to 3 percent RBNZ target range.
- There were widespread increases across the regimen with 74 percent of the 694 national item-level index increasing. Core inflation measures were also boosted by the GST increase, with quarterly increases for the various trimmed means and weighted medians ranging from 2 to 2.3 percent. However, the soft retail environment is having a dampening impact, with Statistics NZ reporting that prices for half of the individual items collected from retail outlets were unchanged for the quarter.
- While there is little in today's CPI report to counter the December MPS view, we believe potential upside medium-term inflation risks will be influential in the RBNZ decision to lift the OCR later in 2011. However, the path of policy tightening will be a gradual one.



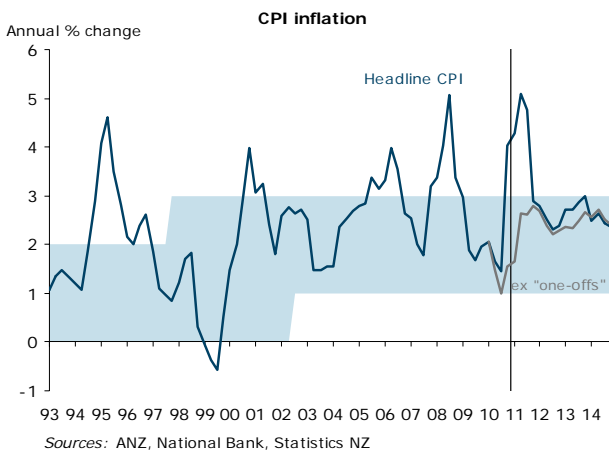
2010Q4 CPI REVIEW

DATA WRAP

The CPI rose by 2.3 percent in the December quarter, taking the annual inflation rate to 4.0 percent. This was in line with the *December MPS* forecasts and our Q4 pick, but slightly weaker than market expectations.

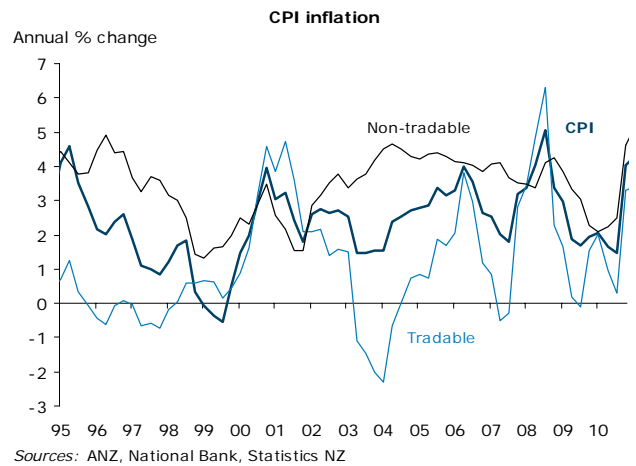
	Headline CPI		Tradable		Non-tradable	
	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg	Qtrly % chg	Ann % chg
Mar-09	0.3	3.0	-0.4	1.7	0.7	3.8
Jun-09	0.6	1.9	0.8	0.2	0.5	3.3
Sep-09	1.3	1.7	1.6	-0.1	1.0	3.0
Dec-09	-0.2	2.0	-0.5	1.5	0.1	2.3
Mar-10	0.4	2.0	0.1	2.0	0.5	2.1
Jun-10	0.2	1.7	-0.3	1.0	0.6	2.2
Sep-10	1.1	1.5	0.9	0.3	1.2	2.5
Dec-10	2.3	4.0	2.5	3.3	2.2	4.6
ANZ	2.3	4.0	2.4	3.1	2.3	4.7
RBNZ	2.3	4.0	-	-	-	-
Market	2.4	4.1	-	-	-	-

The October increase in GST was the major culprit. We estimate that the increase in GST contributed 2 percentage points of the 2.3 percent increase. Our estimates of underlying CPI inflation, which exclude the direct impact of GST and "one-off" government charges, show a more sedate 0.3 percent quarterly rate. Annual inflation on this measure, at 1.6 percent, remains well within the 1 to 3 percent RBNZ target range.

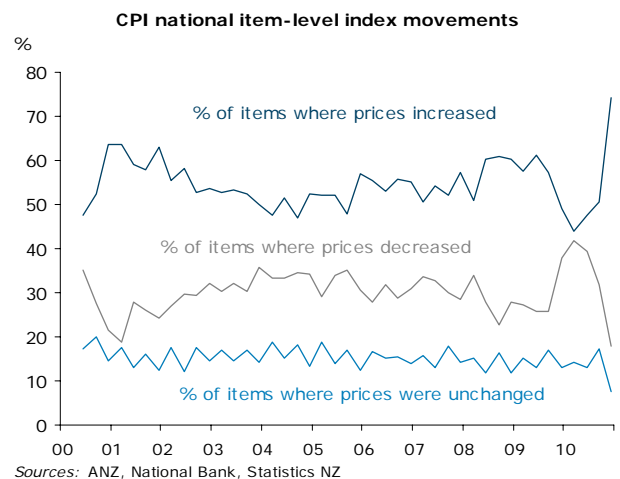


Largely as a result of higher GST, prices in ten of the eleven groups in the CPI registered quarterly increases. Of the individual components, higher petrol (up 6.8 percent), package holidays (up 15.6 percent), purchases on new housing (up 2 percent), medical services (up 5 percent), international air transport (up 5.5 percent), and property maintenance services (up 4.4 percent) were influential. A 3.3 percent fall in vegetable prices provided a slight offset.

Core inflation measures were also affected by the GST rise, with the weighted median and various trimmed inflation measures delivering quarterly increases in the 2 to 2.3 percent range. Quarterly non-tradable CPI rose by 2.2 percent. Higher quarterly tradable inflation (up 2.5 percent) than non-tradable inflation was to be expected given the rise in fuel prices and the fact that items not liable to GST (notably dwelling rents) are in the non-tradable regimen.



The distribution of national movements at the item-level showed widespread price increases. This was to be expected, given that more than 91 percent of the CPI regimen is liable for GST. Of the 694 items-levels in the CPI regimen, 516 registered price increases, 53 were unchanged, and 125 showed price falls.



Price increases were also evident in less contestable pockets of the economy. Prices in the health group rose 4 percent, underpinned by a 5.0 percent increase in medical services prices. With the government seeking to increase revenue and restore public finances, higher inflation from the



2010Q4 CPI REVIEW

non-contestable part of the economy is likely to be ongoing.

CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	2.1	0.4	4.6
Alcohol and Tobacco	1.7	0.1	9.0
Clothing and Footwear	0.0	0.0	-1.3
Housing and Household Utilities	1.6	0.4	3.8
Household Contents and Services	1.9	0.1	-0.4
Health	4.4	0.2	7.2
Transport	4.3	0.7	6.6
Communication	0.7	0.0	-0.6
Recreation and Culture	2.9	0.3	1.1
Education	0.5	0.0	5.7
Miscellaneous Goods and Services	1.7	0.1	2.1
All Groups	2.3	2.3	4.0
Tradables	2.5	1.2	3.3
Non-tradables	2.2	1.2	4.6
Trimmed Mean	2.2		3.9
Weighted Median	2.0		3.2

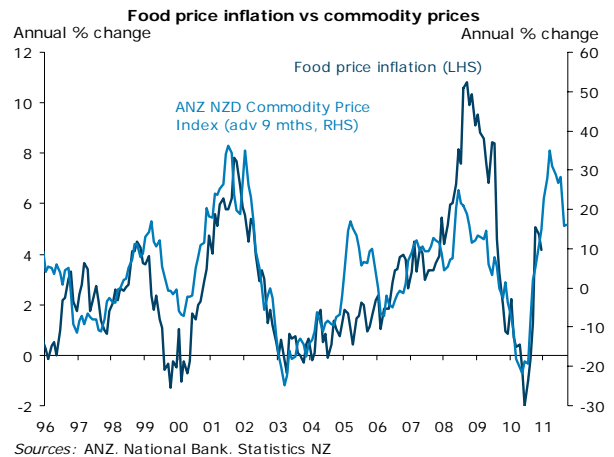
However, the soft demand environment is restricting price increases in contestable parts of the economy. Of the prices collected from retail outlets by Statistics NZ, prices rose 2 to 2.5 percent for 1 in 10 items (consistent with the GST increase), prices for 1 in 4 items rose more than 2.5 percent, with prices for half of the items unchanged for the quarter. This is consistent with anecdotal reports of retailers having to work hard to entice wary consumers into shops. Of the prices collected by postal survey, about 1 in 5 prices rose 2 to 2.5 percent, one-third rose more than 2.5 percent, and about one-third recorded no change. This indicates a fair amount of businesses partially or fully absorbing the GST rise.

More moderate price increases were evident in apparel, with clothing prices actually falling. Prices for some household contents and some durable goods also fell. The retail environment has remained challenging, with the consumer no longer the major source of growth in the economy.

Inflation from the housing group remained contained. Rents, which do not attract GST, barely moved, increasing by 0.2 percent. Based on this there is certainly no evidence of a looming housing shortage. Construction costs rose by 2 percent, implying further reduction in building margins.

Despite the December CPI report showing a contained inflation picture, there are some concerning signs on the short-term inflation front. The RBNZ's pick of a 0.6 percent increase in Q1 CPI is looking a bit light. With prices for 91 Octane Petrol now around \$2 per litre, we expect higher petrol prices will contribute an additional 0.3

to 0.4 percent to the Q1 CPI. Higher food prices could also become more evident given the strength in commodity prices.



IMPLICATIONS

The CPI was in line with the December MPS projections, with no immediate monetary policy implications.

Key for the RBNZ will be the extent to a higher headline inflation rate will spill over into generalised inflationary pressure. The RBNZ's December MPS assessment is that the subdued domestic demand environment will keep a lid on medium-term inflationary pressure. At present, there is little to challenge that assessment.

The true test will be what happens over the next 12-18 months. **We remain mindful of upside inflation risks to the medium-term inflation profile due to pricing pressures from a number of sources.** The expansion in economic activity over the second half of 2011 is likely to be stronger than assumed by the RBNZ. Rising food and commodity prices will provide a double inflation whammy for New Zealand, with the boost to incomes for NZ producers compounding the direct price impact of higher food prices in the CPI regimen. With retail margins already wafer thin, there could be an "inflation payback" as firms seek to recover profitability, with anecdotal reports suggesting this has already started. **With annual headline CPI inflation set to surpass 5 percent by mid 2011, it will be a challenge for the RBNZ to contain the flow-on to prices and wages throughout the economy.**

We still expect upward inflation risks to the medium-term inflation outlook to prompt the RBNZ to raise the OCR later in 2011. The exact timing will depend on the economic recovery

2010Q4 CPI REVIEW

becoming more evident by then. Given the structural tensions facing the economy, the path of policy tightening is likely to be considerably more gradual than past episodes, with a number of pauses along the way.

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- Financial Markets Operations Association; and
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- Placed in statutory management or receivership.

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IMPORTANT NOTICE

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