13 January 2011

Westpac InstitutionalBank

Getting the GiST

Q4 CPI preview: 20/01 10:45am NZT

- **GST and higher petrol prices are the big factors behind the expected 2.3% quarterly increase in consumer inflation.**
- **Annual inflation will spike from a 7-year low of 1.5% in Q3 to 4.0% in Q4.**
- **Timing of GST pass-through is a significant uncertainty.**
- **The massive amount of spare capacity in the economy will leave the RBNZ comfortable accommodating a spike in headline inflation to around 5% this year.**

CPI expectations

	% qtr	%yr
Q3 actual	1.1%	1.5%
Q4 Westpac forecasts	2.3%	4.0%
Q4 RBNZ forecasts	2.3%	4.0%

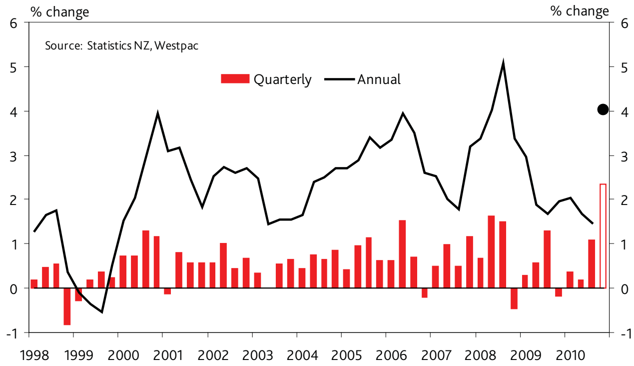
December 2010 quarterly consumer price inflation (released Thursday 20 January) will spike to 2.3%. This will carry the annual rate to 4.0%, quickly making the 7-year low (1.5%) inflation delivered just one quarter prior a distant memory. The main factors driving inflation higher are the increase in the Goods and Service Tax on 1 October from 12.5% to 15%, and the rapid march higher in petrol prices. A modestly higher exchange rate and continued weakness in consumer demand are the main moderators.

GST

The increase in the rate of GST equates to a 2.22% increase in the price of goods that are subject to the tax. However, 9% of goods and services in the CPI are not subject to GST (e.g., housing rents, credit services, school donations). If there was full pass-through of GST from 1 October, the CPI would go up by 2.0%. But some seasonal goods (e.g. winter clothing, 1% of the CPI basket) will not register the GST increase until they are surveyed. And there is considerable uncertainty as to the timing of the impact of GST on goods and services where there is a mixture of annual, periodic, and pre-payments. As examples:

- Some of the GST increase was recorded in the Q3 CPI (for electricity and telecommunication consumed in the September month but billed in October).

Consumer Price Index



- Prepaid services (e.g. a portion of local authority rates, insurance, telecommunication) will not record the GST increase until those contracts are renegotiated.
- The GST increase on most education services will not be recorded until the new education year.

We expect the GST increase to ultimately be fully passed through and add 2.0% to the CPI. Exactly how much of this occurs in Q4 (we are assuming 1.7%) is a moot point and the key area of uncertainty around this quarterly outturn.

Petrol

Petrol prices have been sprinting ahead. They rose 6.4% in Q4 (a mixture of higher international prices, GST, ETS, and levies). Petrol is 5.47% of the regimen, so this will contribute 0.35% to the CPI this quarter.[1]

While higher fuel prices will be adding substantially to annual inflation this year, the RBNZ will largely ignore it. Higher petrol prices are a drain on consumers' purchasing power of other goods, and this weakened demand lowers inflation pressure elsewhere in the economy. Electronic card transactions for the month of December amply demonstrated the sapping effect of

[1] If petrol stays unchanged (from today's average price of 198c per litre) until end March, petrol prices will rise 5.9% in the March quarter, contributing 0.33% to the Q1 CPI.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email brendan_odonovan@westpac.co.nz

higher fuel prices. Fuel was the only category where spending rose, while core retail sales were down 0.9% in the month (seasonally adjusted).

Other

A brief mention of some other categories:

- Outside of the full pass-through of GST, food prices will be a minor contributor to inflation this quarter. Fruit and vege prices fell hard in November, as production recovered from earlier storms (and normal seasonality). However, coming quarters are likely to see currently high commodity prices flow through into higher CPI food inflation.
- Alcohol and tobacco will also be minor contributors (ex GST) as there was no change in excise tax this quarter and the wine glut led to aggressive pre-Christmas discounting.
- Housing rents have been picking up, and we expect the Canterbury earthquake to have further boosted rents in the quarter.
- There will be a large (but less than usual) seasonal jump in international airfares.
- Inflation will continue to be low (outside GST) in electronics and durables due to a modestly higher trade weighted exchange rate and a hesitant consumer.

Implications and uncertainties

Our forecast is the same as the RBNZ's expectation of a 2.3% increase. Given that the higher inflation is being driven by GST and petrol, the RBNZ will "look through" the spike in headline inflation. The yawning amount of spare capacity in the economy means that medium term inflation risks are currently modest.

The RBNZ is in no hurry to restart their tightening programme and September looks most likely for the resumption of a tentative and stuttering series of increases.

With the uncertainties around the degree of GST pass-through in the quarter, and the current weak state of the economy, we would expect the market to be unresponsive to a wider than normal range of outcomes.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250
Michael Gordon, Markets Economist, Ph: (64-4) 381 1412