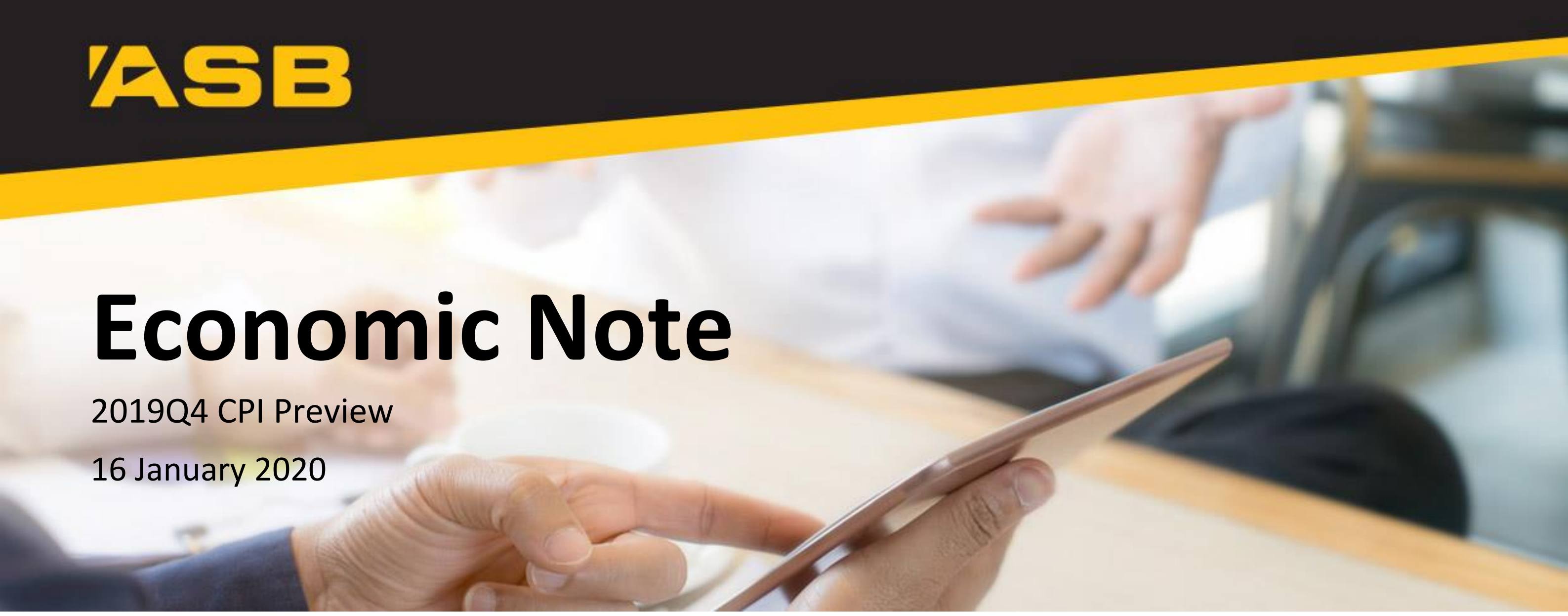

Economic Note

2019Q4 CPI Preview

16 January 2020

In the inflationary sweet-spot

- We expect a 0.4% qoq increase for the CPI in Q4, with annual CPI inflation ticking up to 1.8 %. Risks are broadly balanced.
- Annual core inflation measures are expected to remain clustered around 2%.
- The economy looks to have turned the corner, but a moderate inflation backdrop suggests the RBNZ can be patient in its OCR deliberations.

Q4 2019 CPI %	Previous	**ASB**	RBNZ
CPI qoq	0.7	**0.4**	0.2
CPI yoy	1.5	**1.8**	1.6
Non-tradable qoq	1.1	**0.6**	0.6
Non-tradable yoy	3.2	**3.1**	3.1
Tradable qoq	0.1	**0.2**	-0.2
Tradable yoy	-0.7	**-0.1**	-0.5

Summary and implications

Courtesy of stronger tradable prices we expect CPI inflation in the December 2019 quarter to deliver another modest upward surprise to the RBNZ. Much like the Q3 GDP print, however, the details should provide more reassurance to the RBNZ and we do not expect the Q4 CPI outturn to reveal an inflationary smoking gun. Annual headline inflation could move higher in the coming quarters, but it should remain close to the midpoint of the 1-3% medium-term inflation target range. Core inflation outcomes are expected to remain clustered around 2%. We have pencilled in a 25bp OCR cut for 2020, but acknowledge that the odds of the OCR moving lower have reduced in recent months. With inflation seemingly entrenched close to the inflation target midpoint and the labour market looking well behaved, the OCR could stay at 1% for a while yet.

Upward surprise to CPI inflation

We expect consumer prices to climb 0.4% qoq in Q4, with annual CPI inflation ticking up to 1.8%. This is above the +0.2% qoq (+1.6% yoy) November MPS pick, but it still marks the 12th successive quarter that annual headline CPI inflation has come in below the midpoint of the 1-3% inflation target.

The following influences underpin our CPI pick:

– **Higher transport costs (+1.2% qoq, +0.3 percentage point contribution)**. Petrol prices are expected to move higher in Q4, with a seasonal rise expected for international airfares. Domestic airfares should largely hold onto their sizeable Q3 rise, as the scaling back of regional Jetstar flights starts to impact. We expect small rises in

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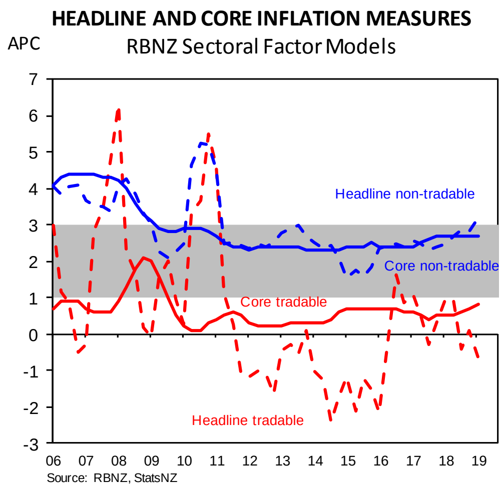
vehicle prices given the lower NZD/JPY, with firming vehicle registrations pointing to recovering consumer demand.

- **Rising housing-related costs (+0.6% qoq, +0.15 percentage points)**. Solid quarterly increases for construction costs, dwelling rents and dwelling maintenance services should keep annual inflation from this group at around 3%. We will be looking for signs of more sizeable pick-ups in housing costs outside of the major centres, consistent with the strengthening trends in regional housing markets.
- **A milder than usual seasonal fall in food prices (-0.6% qoq, -0.10 contribution).** Higher global good commodity prices in NZD terms points to a pick-up in annual food price inflation over 2020.
- **The usual scattering of rises and falls throughout the CPI regimen (flat CPI contribution).** Accommodation and recreational services prices and charges for insurance premiums are likely to continue to move higher, with mild increases expected for other miscellaneous goods and services prices. Lower prices for tradeable goods, including audio visual equipment, apparel and communications, should mostly offset this.

Contained backdrop for non-tradable prices evident

We expect annual non-tradable prices to rise 0.6% in Q4, with annual non-tradable inflation at just over 3% (3.1% yoy). This is consistent with the November MPS forecasts. **The economy looks to have turned the corner in the second half of the year, but we don't expect annual non-tradable inflation to accelerate from here.** Annual non-tradable CPI inflation did hit an 8-year high in 2019 Q3 (3.2%), with higher housing costs and a scattering of price increases throughout the non-tradable regimen evident (including firmer prices for recreation and cultural, higher private transport services, insurance and early childhood education). However, much of the increase looks to be transitory, driven by regulatory drivers and higher costs, rather than signalling a broadening front of price increases. Of note, the core domestic inflationary measures were stable.

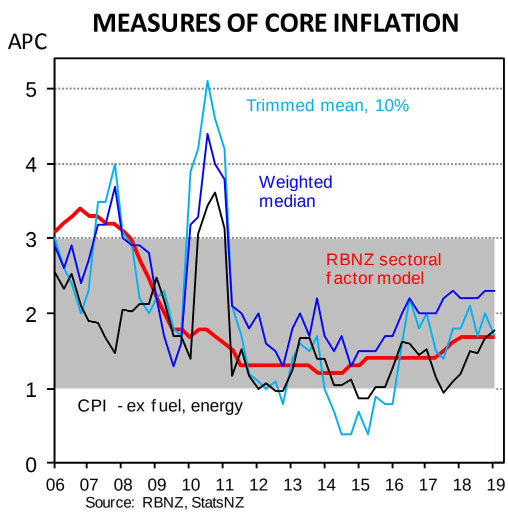


Still-low tradable inflation expected

Higher fuel prices, the lagged impact of the lower NZD, seasonal lift in international airfares and modest falls in food prices should deliver a mildly positive print for tradable inflation (+0.2% qoq, -0.1% yoy). **The wider tradable regimen, however, is expected to display a softer underbelly.** Admittedly, the NZIER Quarterly Survey of Business Opinion (QSBO) did show a lift in firms' selling price expectations in Q4. However, net balances for both experienced and expected selling price expectations remained well below historical averages. In short, we expect the low global inflation backdrop, competitive pressures and sale-focused consumers to keep retail discounts coming.

Stable core inflation expected

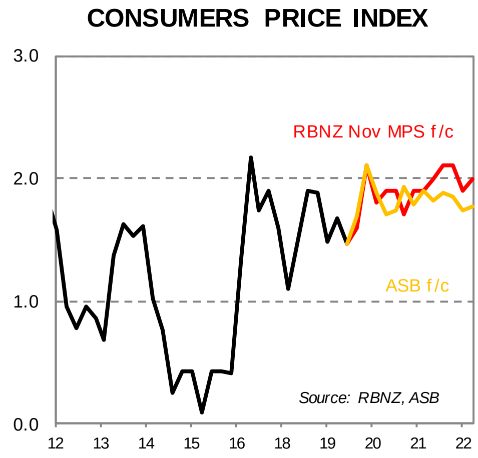
We expect annual inflation for both the 10% trimmed mean and 50% weighted median to remain fractionally above headline CPI at around 2%. Annual inflation from the RBNZ's sectoral factor model (released Friday 24 January at 3pm) has not been above 2% for 10 years. We expect another 1.7% yoy print. **Low readings for core consumer price inflation suggest there is a structural (long-lasting) element to the inflation process.**



Remaining in the groove

The RBNZ remains confident that the economy will respond to the policy stimulus delivered, which should eventually push inflation higher. There is mounting evidence that the NZ economy has turned the corner, with a number of key supports still evident. We don't expect the economy to race away just yet given the risks to the outlook, and structural impediments posed by weak productivity growth, capacity constraints and high household indebtedness.

Our short-term outlook is for annual CPI inflation to move above 2% in early 2020, which should provide little cause for concern given the symmetric medium-term focus of the 1-3% inflation target and the fact that we then expect headline inflation to dip below 2%. **We still have pencilled in a 25bp cut for 2020, but acknowledge that if the economy continues to display resilience then 1% will be the lull in the OCR this cycle.** The next move in the OCR could well be up. However, **with inflation looking to be entrenched close to the inflation target midpoint and with the labour market backdrop displaying similar Goldilocks-type characteristics, the RBNZ has the luxury of waiting.**



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