Economic Note

2020Q2 CPI Preview

9 July 2020

Deflation risks linger

- We expect a 0.4% qoq decline in headline CPI in Q2, with annual CPI inflation falling to 1.5%.
- Annual CPI inflation is expected to dip toward zero in early 2021 before recovering local and global momentum gradually push it higher. We do not expect 2%+ annual CPI inflation anytime soon.
- Low inflation means that monetary policy settings will likely remain highly expansionary for a concerted period.

Summary and implications

Our Q2 pick for the NZ CPI is firmer than RBNZ expectations, but it is still the lowest quarterly print in close to 5 years. The March 2020 year experience of 2%+ annual CPI inflation looks to be short-lived. Sharply lower fuel prices will weigh on Q2 consumer prices and we will be looking for signs of moderating core and non-tradable CPI inflation. Risks are broadly balanced, but we admit a greater degree of uncertainty than usual around our CPI pick and would not rule out a weaker set of inflation numbers emerging. Policymakers in NZ and abroad have pulled out all of the stops and will maintain highly stimulatory settings until they are confident economic activity and inflation has turned the corner. We expect inflation to remain low, with the OCR not moving above its current 0.25% operational low until 2024.

Plunging fuel prices deliver negative Q2

We expect consumer prices to fall 0.4% in Q2 with annual CPI inflation falling to 1.5%. This is stronger than the May Monetary Policy Statement (MPS) pick of a 0.7% qoq fall (1.3% yoy). Much of the difference is attributable to our expectation that falls in tradable prices will not be as acute (see table). Risks are broadly balanced, but we admit a high degree of uncertainty around our CPI pick and would not rule out a weaker set of inflation outcomes emerging.

Q2 2020 CPI %	Previous	ASB	RBNZ
CPI qoq	0.8	**-0.4**	-0.7
CPI yoy	2.5	**1.5**	1.3
Non-tradable qoq	1.4	**0.1**	0.3
Non-tradable yoy	3.2	**3.3**	3.4
Tradable qoq	0.1	**-1.2**	-1.9
Tradable yoy	-0.7	**-0.6**	-1.3

The COVID-19 restrictions would have impacted the Q2 figures. To recap, NZ started Q2 at Alert Level 4, moved to Alert Level 3 on midnight April 27, moved to Alert Level 2 in stages from midnight May 13, with the move to Alert Level 1 on June 8th. Statistics NZ acknowledged that COVID-19 has disrupted the flow of statistics and published a paper setting out the potential impacts. It has meant Statistics NZ having to use administrative data or imputation instead of direct surveying of some consumer prices. Statistics NZ remains confident it will be able to obtain price quotes that will be representative of most goods and services in the CPI the June 2020 quarter. Despite this assurance, we will be on the lookout for statistical quirks.

The CPI groups will capture COVID-19 impacts in varying degrees. The major movements by CPI group in Q2 include:

- Lower transport group prices (4.3% Q2 fall, -0.7% contribution to Q2 CPI). Global oil prices plunged, flowing through to NZ fuel prices. Our Q2 estimates point to a 14% Q2 decline in retail fuel prices. Free access to public transport during Alert Levels 3 and 4 could potentially flow through into the CPI as could discounting on domestic airfares for essential workers. However, with passenger numbers very low at the start of the quarter, actual benefits to consumers were very low. Offsetting this will be higher ACC levies for vehicle licenses.

Mark Smith – Senior Economist (649) 301 5657 mark.smith4@asb.co.nz

- Lower recreational goods prices (1.2% Q2 fall, -0.1% contribution). Restrictions on the NZ border and other COVID-19 restrictions have hit the accommodation sector hard. Some additional discounting is to be expected over the winter months to lure domestic tourists. Anecdotes suggest that accommodation prices have not fallen as much as one would expect. We will have to wait and see.
- Higher housing costs (+0.4% Q2 rise, +0.1% contribution). Mild quarterly increases are expected for dwelling rents and construction costs. Despite a 6-monthly rental freeze being in place since March 23, the monthly stock measure of dwelling rents (which feed into the CPI) have continued to rise. However, rents on dwellings that have just lodged a tenancy bond have been falling since April and we expect this to eventually to dampen overall rents. We also expect construction cost inflation to cool over 2020.
- Higher food prices (1.2% Q2 rise, +0.2% contribution). We expect a circa 1% rise in food prices that mostly looks seasonal. Global food prices have gone considerably off the boil and point to a more benign outlook for grocery food inflation than seemed apparent just a few months ago.

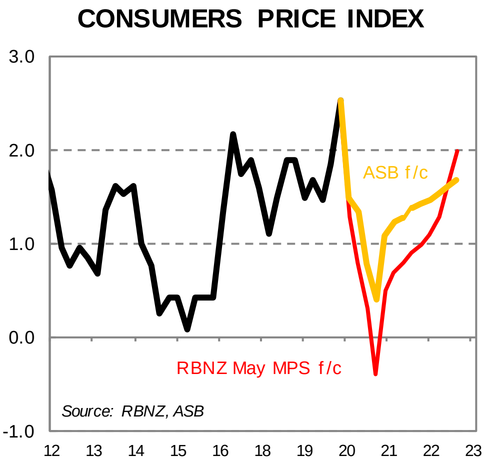
The RBNZ has taken a glass-half empty view forecasts to limit downward surprises

You got the sense that when the RBNZ was putting together its MPS forecasts in May that it took a glass half empty view of the outlook, erring on the pessimistic side and hoping to be surprised on the high side if things turned out to be different from its published view.

This looks to have occurred. Global data and financial market sentiment have noticeably improved, partly as a result of the kitchen sink actions taken by global central banks. NZ has emerged from lockdown considerably earlier than the RBNZ had assumed in May (NZ was still assumed to be in Alert Level 2 into early next year), even though NZ border restrictions are likely to remain for a while yet. Q2 GDP will undeniably be very weak, but recent indicators – including sentiment measures, filled jobs and card spending – suggest the NZ economy could rebound faster than we (and the RBNZ) had previously expected from a very weak April. Oil prices are currently close to USD42 per barrel as opposed to being sub-30 USD at the time the RBNZ forecasts were finalised. The higher NZD has partly offset this.

The RBNZ is likely to be quietly chuffed but will be mindful that the burgeoning local and global recovery is in its infancy and it would not take much for deflation risks to resurface. Rising global COVID-19 cases are a worry.

Downward pressure on inflation



The negative Q2 CPI print will lower annual inflation readings through to early next year and we expect annual headline CPI inflation to ease towards zero by early 2021. This largely reflects Q2 falls and the soft outlook for tradable CPI prices, but domestically-generated inflationary pressure is expected to be soft. After spiking to their highest levels in 9 years at the start of this year, we expect annual inflation for both the 10% trimmed mean and 50% weighted median to move closer to the 2% inflation target midpoint in Q2. By contrast, annual inflation from the RBNZ's sectoral factor model (1.70% in 2020Q1) has been considerably more stable. We don't expect much movement from this measure in Q2 but acknowledge the risk it could fall below 1½% over the next year or so as disinflationary pressures build.

We then expect recovering domestic and global economic activity and firming wages help gradually push prices higher. **Our view is that the gradual nature of the local and global recovery will result in annual CPI inflation remaining below 2% over the next few years.**

Policy Implications

Market and policy implications from the Q2 CPI release are minimal at best. The RBNZ looks to have built in as much downside as it could, with its short-term inflation forecasts weak. With medium-term inflationary drivers – economic activity, wage growth and expected inflation – looking subdued, the RBNZ is unlikely to be troubled by a stronger than expected outcome. **Downside risks will likely be of greater concern given they blunt the effectiveness of the record low OCR – it is real (i.e. inflation-adjusted) interest rates that matter after all.** Our baseline forecasts have the OCR on hold at 0.25% until 2024. We would not rule out the OCR going lower given the downward skew to the risk profile and with the RBNZ requiring banks to be operationally ready for a negative OCR by as soon as December this year. However, this will take a concerted weakening of the economic outlook and/or reduced effectiveness of other RBNZ policy levers, including its Large-Scale Asset Purchase programme, to see the RBNZ walk down the negative OCR path.

ASB Economics & Research			**Phone**
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5957
Senior Economist	Mike Jones	mike.jones@asb.co.nz	(649) 301 5661
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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