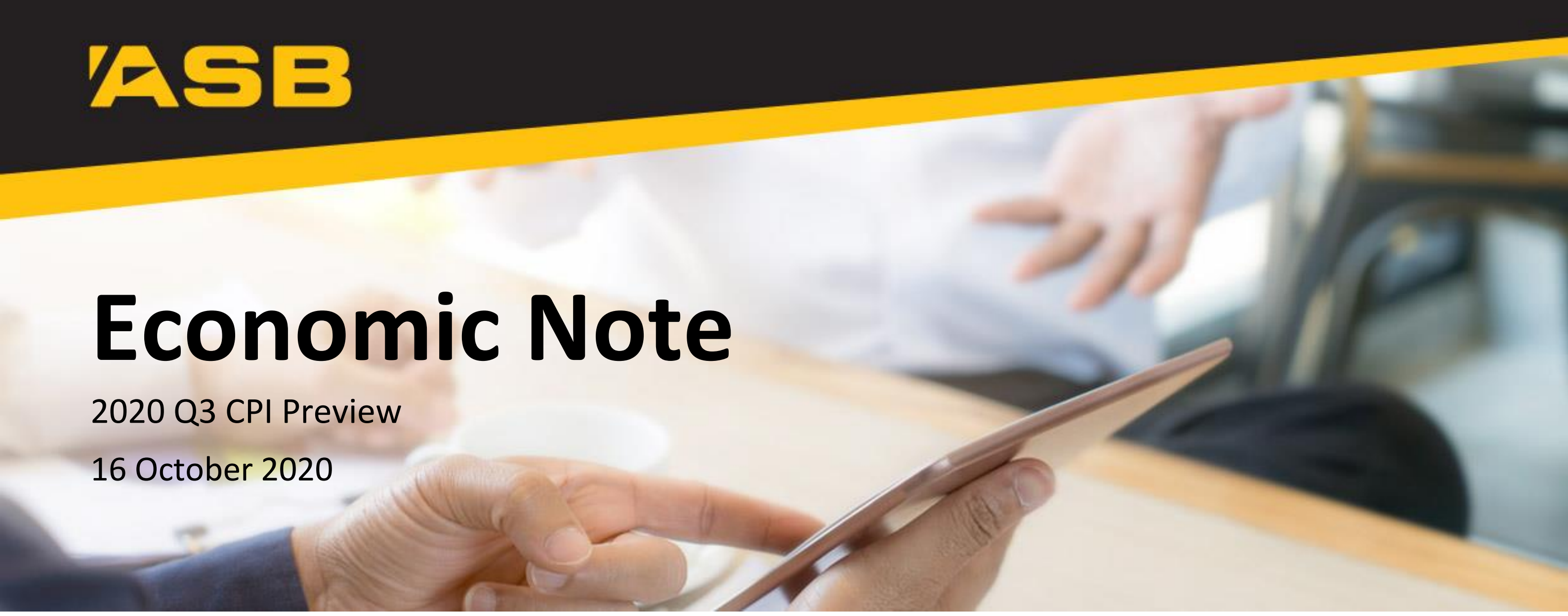

Economic Note

2020 Q3 CPI Preview

16 October 2020

Middling headline and core inflation

- We expect a 0.9% qoq increase in Q3 headline CPI, with annual headline inflation rising to 1.7%.
- The short-term outlook for inflation looks to have modestly improved compared to a few months ago, although the outlook for medium-term inflation remains highly uncertain.
- Entrenched low inflation provides a free hit and allows the RBNZ to deploy additional policy stimulus. We have pencilled in a negative OCR from April next year but note this is conditional on the economic outlook, operational hurdles being cleared, and the RBNZ being confident this is the best policy option available.

Summary and implications

Our Q3 pick for the NZ CPI is marginally below RBNZ expectations. Annual readings for headline and core inflation are expected to be close to 2%. The Q3 outturn reflects an element of recoil from the very weak Q2 print, seasonality, and our expectation that pricing pressures are not entirely dormant in some key pockets, notably housing. Risks are broadly balanced, but we admit a greater degree of uncertainty than usual around our CPI pick given the impacts of COVID-19 and the CPI rebase being introduced in the Q3 data. Looking ahead, we expect annual headline inflation to dip at the start of next year but for annual CPI deflation to be avoided. The NZ economy has proved to be more resilient than we expected, the housing market is booming, and some of the downside risks for the economy and medium-term inflation look to have dissipated. Nevertheless, uncertainty is pronounced, and economic headwinds posed by COVID-19 remain sizeable.

Policymakers in NZ and abroad have pulled out all the stops and will maintain highly stimulatory settings until they are confident economic activity has turned the corner. This will mean tolerating higher inflation if need be. We expect the RBNZ to introduce a funding for lending programme before the end of the year, to maintain a sizeable pace of asset purchases under the LSAP programme and to continue to flag the likelihood of a lower OCR. Whether the RBNZ will actually go down the negative OCR route is still unclear and will be contingent on the economic outlook. We have pencilled in a -0.50% OCR by April next year, but the risk is shifting towards the RBNZ doing less.

Q3 recoil from weak Q2

We expect consumer prices to increase 0.9% in Q3 with annual CPI inflation edging up to 1.7%. This is slightly below the August Monetary Policy Statement (MPS) pick of a 1.1% qoq increase (1.8% yoy). Much of the difference is attributable to our lower expectation for non-tradable inflation (see table). We admit a high degree of uncertainty around our CPI pick given the impact of COVID-19 and the CPI rebase that will be introduced in the Q3 data.

Q3 2020 CPI %	Previous	ASB	RBNZ
CPI qoq	-0.5	**0.9**	1.1
CPI yoy	1.5	**1.7**	1.8
Non-tradable qoq	0.0	**0.9**	1.1
Non-tradable yoy	3.4	**2.9**	3.1
Tradable qoq	-1.2	**1.0**	1.0
Tradable yoy	1.5	**0.3**	0.3

To some extent, the Q3 outturn represents some recoil from the weak Q2 outturn and seasonality. The major movements

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by CPI group in Q3 include:

- Higher transport group prices (2.7% qoq, +-0.3% contribution to Q3 CPI). Rising global oil prices is expected to lift domestic petrol prices by close to 3%. The relaxation of Alert Level restrictions in Q3 has seen an end to discounted travel for public transport. We also expect a strong seasonal lift for domestic airfares.
- Higher housing costs (+1.0 qoq, +0.3% contribution). Rising local authority rates seem to be fact of life and we expect a 4% increase in Q3. 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 and increased 0.6% in Q3 according to MBIE figures. The strengthening housing market and rebounding construction sector activity should underpin further increases in construction costs and property maintenance services.
- Higher food prices (1.4% qoq, +0.3% contribution). This looks to be mostly seasonal and is driven by sharp increases in fruit & vegetable prices. Global food prices continue to point to a benign outlook for grocery food inflation over the next 12-18 months.
- A scattering of other price movements in other groups. We expect NZ border restrictions to weigh on tourism-related pricing, although increased domestic tourism has provided a lifeline to struggling tourism and accommodation providers. Some additional discounting is to be expected over the winter months to lure domestic tourists. The impact of COVID-19 and the CPI rebase (see below) could result in some variation in other components.

COVID-19 Presents Statistical Challenges

COVID-19 disruptions would have impacted the Q3 figures. NZ started the quarter at Alert Level One, but then restrictions were tightened midway through the quarter, before being relaxed at the latter stages of the quarter. Statistics NZ have released a paper outlining how they will address the methodological challenges posed by COVID-19. It included similar measures to that were employed during the June quarter, including point of sale data, with approximately 30% of prices obtained from administrative data and online collections. Moreover, Statistics NZ have used the headline CPI to impute missing values for international airfares and overseas accommodation. 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 September 2020 quarter. Nevertheless, we remain on the lookout for statistical quirks.

CPI rebase could provide some surprises

The September quarter CPI print will also incorporate new CPI weights, which are based on the 2018/19 Household Economic Survey (HES). The updated expenditure weights will be released on Wednesday 21st October, two days before the CPI release date, which gives us little time to ascertain the impact on our Q3 pick and subsequent inflation readings. We have assumed that changes to the expenditure weights will largely reflect relative price shifts rather than a change in expenditure patterns. As such, the rebase is unlikely to significantly alter the contributions of various CPI components and our Q3 CPI pick. Groups, such as housing and miscellaneous goods and services are expected to attract higher weights as opposed to smaller weightings for apparel, communications and education. However, CPI rebases have sometimes thrown up a few surprises and we would not rule out a similar occurrence this time around.

Core inflation readings to remain close to 2%

We expect annual core inflation prints to cluster around 2% in Q3. After spiking to their highest levels in 9 years at the start of this year, annual inflation for both the 10% trimmed mean (1.6% yoy) and 50% weighted median (2.4% yoy) both eased in Q2 and have averaged 2%. Annual inflation from the RBNZ’s sectoral factor model has proved to be considerably more stable and at 1.8% yoy in Q2 was hovering just below the 1-3% inflation target midpoint.

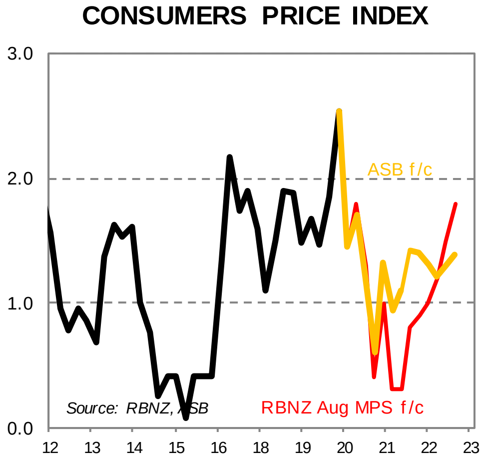
Reduced downside risk to inflation outlook

Looking ahead, we expect annual headline inflation to dip below 1% in early 2021 as the weak Q2 2020 CPI print stays in the annual window. **However, risks of outright deflation look to have receded in recent months and we don’t expect as much downside risk over the inflation outlook** given the improved outlook for both the labour market and economy in general. Medium-term inflationary drivers – economic activity, wage growth and expected inflation – do not look to be as weak as appeared to be the case a few months ago. Nevertheless, the inflation outlook still looks to remain sub-2%, with little on the horizon that would help concertedly push wages and prices higher.

Market and Policy Implications

We expect market reaction from the Q3 CPI print to be modest. Unlike the Q2 CPI print – where the RBNZ appeared to aim low so as to mitigate the chances of a downward CPI surprise, risks around the RBNZ's forecasts appear to be more balanced, although the RBNZ's pick looks to be fractionally on the high side according to our forecast view.

In term of policy implications, it is very much a game of wait and see. Deflation risks look have receded, but the inflation outlook still looks to be highly uneven and uncomfortably low in most areas. Uncertainty is pronounced, but we see little in the economic tea leaves that suggest that CPI inflation readings are due to concertedly strengthen.



The focus for the RBNZ is likely to remain on the labour market and broader economy, with the Bank seeking to limit the fallout from COVID-19 and prop up the economy. Record low mortgage interest rates and interest rates at historic lows across the curve are the result. This has boosted interest-rate sensitive pockets of the economy and we have upgraded our housing market and labour market forecasts accordingly. **Whether the white-hot housing market will be enough to sustain the economic rebound we see unfolding is another matter.** We are still in the midst of a global pandemic and around 5% of the economy is expected to remain offline given the border restrictions.

We expect the RBNZ to increase policy stimulus. The economic headwinds posed by COVID-19 still look to be sizeable. Recent comments by RBNZ officials suggest they remain committed to keeping the foot on the gas pedal. In the November MPS details of a Funding for Lending Programme (FLP) are due to be announced, with the FLP to be introduced before the end of the year. The FLP would provide banks with a stable and low-cost source of form of funding, although the devil will be in the detail. We do not expect the FLP to have a sizeable impact on credit availability and pricing straight away as the impacts of the FLP will take time to accrue as banks substitute from other sources of funding. Moreover, similar schemes overseas are modest in size (accounting for 10% or less of bank lending). We also expect the RBNZ to maintain a sizeable pace of asset purchases under the LSAP programme over the next few months and to continue to flag the likelihood of a lower OCR.

Our baseline forecasts have the RBNZ frontloading policy easing after the period of forward guidance ends. Specifically, we have assumed a 75bps OCR cut will be delivered in the April MPR that will take the OCR to -0.50%. This has largely motivated by the conviction that the RBNZ would frontload policy stimulus to support the economy after their forward guidance of holding the OCR at 0.25% until early 2021 expires. It also assumed that that operational hurdles to introducing a negative OCR are cleared. The September MPR made some encouraging noises to that effect but we may have till wait until the end of the year for confirmation.

Events over recent months are testing this view and risks are tilting towards the RBNZ doing less on the OCR front. Adding the FLP to the policy arsenal provides the RBNZ with another policy option. The NZ economy and labour market have proved to be more resilient than what we had envisaged a few months ago. The housing market is booming. The degree of downside risk to the short-term inflation outlook looks to have eased, although inflation in different sectors of the economy still looks to be highly uneven, with the medium-term aggregate inflation outlook still highly uncertain. Whether the RBNZ does go down the negative OCR route will be contingent on the economic outlook and whether the Bank deems the OCR to be the preferable policy lever to pull.

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