Economic Note

2020 Q3 CPI Review

23 October 2020

Subdued

- Q3 headline CPI came in considerably softer than market expectations, with annual readings for the headline and most measures for core inflation falling further below 2%.
- It is unclear whether the soft CPI result is due to more subdued than expected inflationary pressure or the CPI rebase that incorporated the new expenditure weights. We will have to wait until the next CPI outturn in January to find out which of these possibilities is the more valid.
- An uncertain inflation outlook adds to the challenges being faced by the RBNZ, which is facing a highly uncertain outlook for economic activity, notwithstanding brighter signs of late. We have pencilled in a negative OCR from April next year but note this is conditional on a number of factors being met.

Summary and implications

NZ CPI came in below market and RBNZ expectations. Annual readings for headline and core inflation fell further below 2%. Downward surprises were generalised across the CPI regimen, which looks to be either the (temporary) result of the CPI rebase or reflective of longer-lasting influences. Both have different implications for subsequent inflationary pressures within the economy and OCR settings. We will have to wait till the Q4 CPI reading in January to find out.

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. However, the economic upswing unfolding still looks highly uneven, we are still in the midst of a global pandemic. If the period of weak inflation proves to be enduring, the RBNZ will likely increase policy stimulus, but also reimpose LVR restrictions on investor lending to take the housing market off the boil. We have pencilled in a negative OCR from April next year but note future OCR settings will be contingent on the economic outlook, operational hurdles being cleared, and the RBNZ being confident this is the best policy option available.

Downward surprises to Q3 recoil from weak Q2

Q3 2020 CPI %	**Actual**	ASB	RBNZ	Market
CPI qoq	**0.7**	0.9	1.1	0.9
CPI yoy	**1.4**	1.7	1.8	1.7
Non-tradable qoq	**0.6**	0.9	1.1	
Non-tradable yoy	**2.6**	2.9	3.1	
Tradable qoq	**0.6**	1.0	1.0	
Tradable yoy	**-0.1**	0.3	0.3	

NZ consumer prices rose 0.7% qoq in Q3 with annual CPI inflation edging down to 1.4%. This was considerably softer than the August Monetary Policy Statement pick (1.1% qoq, 1.8% yoy) and market expectations. Of note, the turnaround from the -0.5% qoq Q2 decline in headline CPI prices (+1.5% yoy) was milder than expected, with both tradable prices (+0.6% qoq, -0.1% yoy) and non-tradable prices (+0.6% qoq, 2.9% yoy) undershooting our and the RBNZ's expectations.

The Q3 inflation figures incorporated the new expenditure weights which were based on the 2019/20 Household Economic Survey (HES). Weights for housing were revised up (from 24.5% to 28%) whereas weights for transport group prices (from 14% to 11.9%) and other CPI groups were

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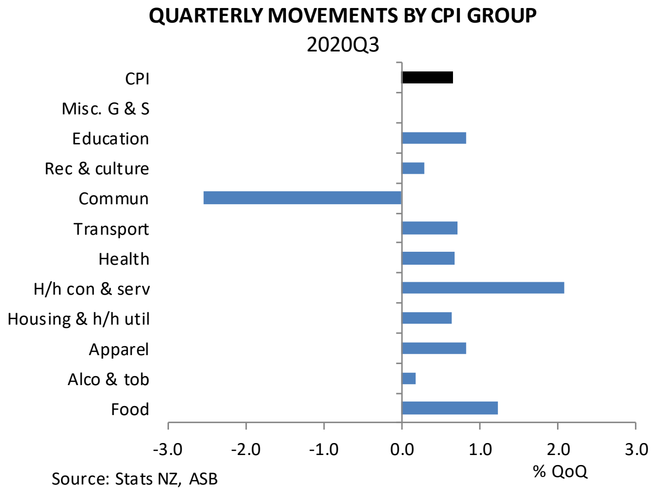
revised down. A cursory check of today's figures indicates that the rebase looks to have had a generalised dampening impact on the Q3 figures, with readings for tradable, non-tradable and most CPI group prices undershooting our expectations. Either that or the amount of inflationary pressure within the economy looks to be significantly lower than what we (and the RBNZ) had expected.

The quarter also had a few COVID-19 related adjustments: the imputation by Statistics NZ of missing values for international airfares and overseas accommodation looks to have had a modest impact on the figures.

The Q3 outturn showed a weaker than expected rebound from the weak Q2 outturn. This was most evident in the transport group, where prices rose just 0.7% in Q3 after the large 4.9% Q2 fall, with petrol prices up just 1.7% in Q3. For most groups price increases were lower than expected across most groups. Household contents and services (+2.1% qoq, 1.0% yoy) were the sole exception, given the larger than expected rebound in household appliances (up 5.5% qoq).

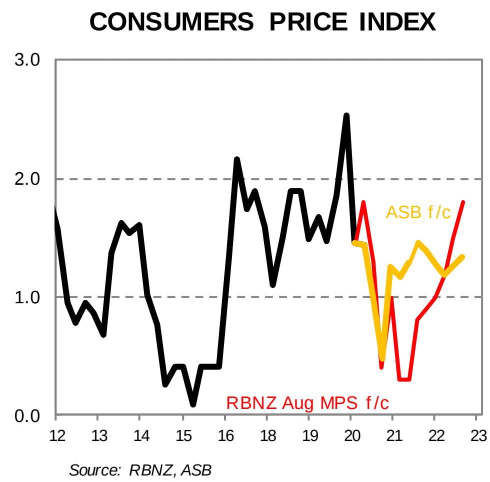


Pricing pressures in the housing group (0.6% qoq, 2.6% yoy) were not as pronounced as illustrated by a booming domestic housing market. Despite the rental freeze, dwelling rents managed a solid 0.5% qoq increase (3.1% yoy). Local authority rates continued to march higher, with a chunky 2.9% qoq increase. Despite the strengthening housing market, construction cost inflation was a muted 0.3% qoq (2.5% yoy), with a modest 0.5% qoq increase for property maintenance services (3.0% yoy).

Core inflation measures were generally soft. Prices from the trimmed mean (10%) estimates rose just 0.4% qoq (1.5% yoy), while the 50% weighted median estimate showed a 0.3% quarterly climb (+2.4% yoy). Excluding food, fuel and energy, annual inflation eased from 1.9% to 1.7%. Market participants are likely to closely watch the RBNZ's own estimate of core inflation, released at 3pm today. **This measure tends to be slow-moving but, given the general softness of the Q3 figures, there is some downside risk from the 1.8% Q2 reading.**

The future path of inflation remains unclear

Looking ahead, we expect annual headline inflation to dip at the start of next year but for annual CPI deflation to be avoided**. The inflation outlook remains highly uncertain and it is unclear how much of the Q3 downward surprise reflects one-offs versus more enduring influences.** Medium-term inflation will hinge on the path of the economy, which remains uncertain, with the profile of economic activity looking highly uneven. Of note, the drag from weaker net tourism looks set to intensify heading into the summary months.



Statistical factors will help stabilise the inflationary picture, although this will be at the margin. Of note, the larger weight of non-tradable prices in the CPI regimen (60.08% versus 57.5% in the previous CPI regimen) will result in steadier and slightly higher future inflation on average, all else equal. Our estimates suggest this could add 0.1% to 0.2% to annual CPI inflation outturns, all else equal. What's more, lower weights on more volatile items (such as petrol and international airfares) will likely reduce volatility.

Low Q3 inflation highlights the dilemma facing the RBNZ

Low readings for inflation have come at a time where the economic outlook is looking considerably brighter than seemed the case six or so months ago. 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.

However, the outlook for the NZ economy remains highly uncertain considering we are in the midst of a global pandemic. **The recovery in NZ's economic activity looks to be uneven and risks to the NZ economy are still skewed to the downside.** What's more, there were few signs today suggesting that inflation will take off any time soon, with current readings likely to be softer than the RBNZ would feel comfortable with.

Of note, the RBNZ has other policy tools in the kitbag – including LVR restrictions on mortgage lending for property investors – that could be deployed to target areas of concern. We expect the Funding for Lending Programme, which looks to be unveiled towards the end of the year, to provide support at the margin, but the impacts on lowering borrowing costs are likely to more of slow burn rather than a big bang.

All up, we have pencilled in a negative OCR from April next year given the soft outlook for inflation and expectations that the unemployment rate will move up. **Nothing is certain in the current juncture and OCR settings look to be contingent on the economic outlook, operational hurdles being cleared, and the RBNZ being confident this is the best policy option available.**

Market reaction

Despite the weaker than expected Q3 print, market reaction was muted, with a fleeting 10pip fall in the NZD, with NZ swap rates little changed.

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