ASB

Economic Note

Q4 2019 CPI Review

24 January 2020

Mooching around the mid-point

- CPI inflation lifted by more than we, the market and the RBNZ expected. All of the upside was in tradable inflation.
- Core measures of inflation are currently clustered around 2% - the midpoint of the RBNZ's inflation target band.
- Domestic inflation pressures may ease over the coming year as a result of the 2019 economic growth deceleration, and the RBNZ must remain vigilant of the downside risks to the outlook. We continue to expect one further rate cut in 2020.

Summary and implications

Consumer inflation was stronger than the RBNZ anticipated over the final quarter of the year. However, most of the surprise was due to stronger tradable inflation, likely as a result of stronger-than-expected food, airfares and fuel prices. **Food and fuel inflation, in large part, have been driven by recent global events** – in particular, African swine fever lifting meat prices and a rise in Middle East tensions impacting oil prices. **We expect the RBNZ will largely look through these lifts and remain focused on core inflation pressures, which remain clustered around 2% - the RBNZ inflation target mid-point.**

Over the past year, inflation outcomes have moved closer to the RBNZ's inflation-target mid-point. But at the same time, **economic growth has decelerated and softer economic demand could potentially weigh on domestic inflation pressures going forward.** The RBNZ cut the OCR by 75 basis points over 2019 to provide support to the economy and meet its inflation and employment targets. However, we continue to see some risk that economic growth may not recover as fast as we and the RBNZ expect, and we still pencil in one additional rate cut for in 2020 (likely in May, although the risks are skewed to a later move).

Food and air fares stronger than usual in Q4

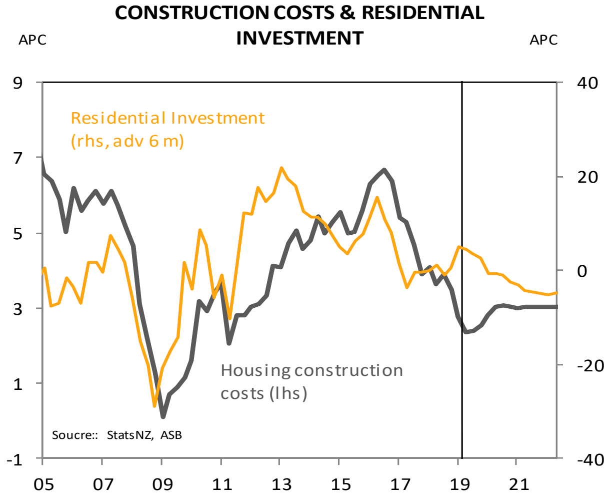
The CPI index lifted 0.5% over Q4 2019, slightly stronger than we, the market and the RBNZ expected. Stronger tradable inflation was the key source of the upside surprise. From the RBNZ's perspective, **food and transport were likely key contributors to the slightly stronger tradable result.** The seasonal fall in food prices was less than usual in Q4, with food prices up 2.5% on year-ago levels. Strong food price inflation has been led mostly by meat, poultry and fish prices, which are up 4.2% on year-ago levels in the December month, with African swine fever lifting meat prices globally.

Meanwhile, **transport prices lifted due to higher domestic and international air fares.** Air fares typically rise in Q4 as a result of increased demand for holiday travel. In saying this, domestic air fares lifted by more than expected, and the stronger lift was likely influenced by the November exit of JetStar on some NZ regional routes.

Jane Turner – Senior Economist (649) 301 5853 jane.turner@asb.co.nz

Housing costs drive domestic inflation pressures

Non-tradable inflation lifted as expected, up 0.6% over the quarter. This lift was **underpinned by a strong lift in rents, with annual rental inflation accelerating over the past year** and rents now 3.1% higher than a year ago. Meanwhile, housing construction costs lifted modestly, up just 0.5%, with annual housing construction cost inflation slowing to 2.4%. The recent fall in mortgage rates has stimulated housing demand and is likely to support house building activity. Housing construction costs may reaccelerate over the coming year.



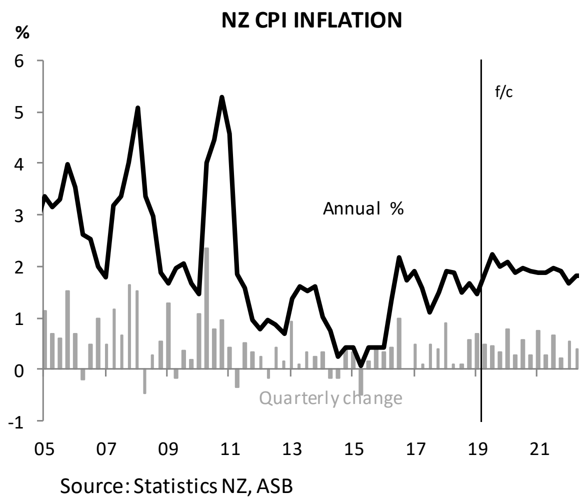
Annual non-tradable inflation remains above 3%. However, this strength looks to be transitory, driven by regulatory drivers and higher costs, rather than signalling a broadening front of price increases. Furthermore, with economic growth decelerating sharply over 2019, cyclical drivers may not support further domestic inflation pressure and non-tradable inflation may start to slow.

Core inflation clustered around target

Core inflation measures are now tightly clustered around 2% – the mid-point of the RBNZs inflation target band. The trimmed mean (5%) estimate of annual inflation lifted to 2% from 1.7%, while the weighted median estimate of annual inflation remained steady at 2.3%. Excluding food and energy, annual inflation is also sitting at 2%. The RBNZ's sectoral factor model now estimates core annual inflation of 1.8% in Q4, up from 1.7% in Q3. Looking at the range of core measures of inflation, the RBNZ can now conclude it is currently meeting its inflation objective. However, with economic growth decelerating sharply over 2019, domestic inflation pressures are likely to slow over the coming year and the RBNZ must remain vigilant.

Inflation outlook

Looking ahead on the tradable side, **we do expect a transitory lift in tradable inflation to continue in the short term**, largely led by a rise in global fuel and food inflation. Higher prices are largely a result of supply shocks (in particular, largely as a result of African swine fever and increased Middle East tensions), and these types of price shocks will have an offsetting impact by dampening disposable incomes and broader economic demand.



Our short-term outlook is for annual CPI inflation to briefly move above 2% in early 2020 due to a transitory lift in tradable inflation, with headline inflation then likely to dip back below 2%. **The deceleration in economic growth over 2019 will likely weigh on future inflation pressures.** Recent growth indicators have been mixed, with business confidence surveys suggesting growth has stabilised, but at weak levels. While we expect the economy to respond to the RBNZ's recent policy stimulus, the economic outlook remains marred by numerous risks that economic growth does not recover as fast as we and the RBNZ expect. We continue to pencil in one further 25bp Official Cash Rate cut for 2020.

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 Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
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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