

## CPI Preview and Forecast Update

15 January 2021



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## Contact

Liz Kendall for more details.

## Better inflation outlook but weak starting point – easing bias remains appropriate

CPI is expected to have been weak in Q4 2020, which is usual for that time of year. We expect CPI lifted 0.3% q/q, with annual inflation dipping from 1.4% y/y to 1.2% following modest prints in recent quarters. Looking forward, cost pressures from supply disruptions will boost inflation, though this is expected to prove temporary and the RBNZ will look through it. We expect a temporary lift in inflation to above 2% mid-2021, followed by a retracement into 2022.

Headwinds from the high TWI and low inflation expectations will be slow to dissipate, but the outlook for inflation over the medium term is now looking more assured, and we have updated our forecasts to reflect this. The outlook for demand is looking better and inflation expectations are on the rise, meaning a persistent lift is looking more achievable. It will be a slow grind higher, but inflation pressures look set to build, with a return to target by mid-2023.

Recent developments reduce the urgency for monetary stimulus, with risks now less clearly skewed to the downside. We **now expect** the RBNZ to cut the OCR to 0.1% in May then hold thereafter. Although there is less need for stimulus, downside risks to the inflation outlook remain a concern and the RBNZ will remain vigilant and poised to act if required. That means continued dovish rhetoric, an easing bias, and an expansionary stance of monetary policy for a long while yet.

### The view

#### A more positive medium-term outlook

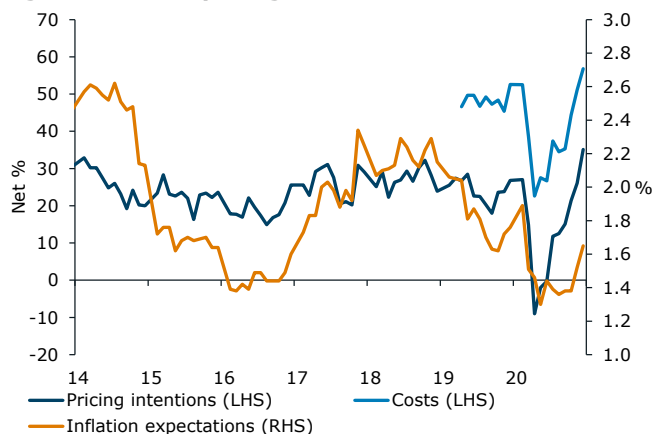
We have updated our inflation forecasts, reflecting a range of developments. These result in a stronger, more assured medium-term outlook, but headwinds remain and inflation will take some time to return to target comfortably.

- **A weak starting point:** We expect that CPI rose 0.3% in Q4, implying annual inflation of a mere 1.2% y/y. Q4 is usually a weak quarter, with seasonal falls in food and grocery prices contributing. But there are some pockets of domestic price increases too (see page 3 for details). This is a touch above the RBNZ's November MPS forecast (0.2% q/q; 1.1% y/y).
- **Supply disruptions:** Cost pressures are evident, leading to pockets of price increases in the near term at least. At this stage we do not expect this to result in significant generalised inflation (and the RBNZ will look through transitory impacts). But inflation expectations are starting to lift from recent lows, especially on the back of cost increases (figure 1). We think these will continue to creep higher, supporting medium-term inflation, and reducing RBNZ concerns about low inflation becoming entrenched.
- **A higher exchange rate:** The NZD has pushed higher, up 5% over the course of Q4. This reflects our strong domestic story, but will weigh on prices nonetheless. Combined with an economic wobble early in 2021 and a low starting point for inflation expectations, this will be a headwind to inflation.
- **Stronger demand:** We expect that the economic recovery will become more challenging early this year, but the rebound so far is nothing short of spectacular, meaning there is less slack in the economy than previously feared. Over the medium term, as spare capacity is eventually absorbed, that means less unemployment and less downward pressure on inflation.

#### Consumers Price Index – December 2020 Quarter

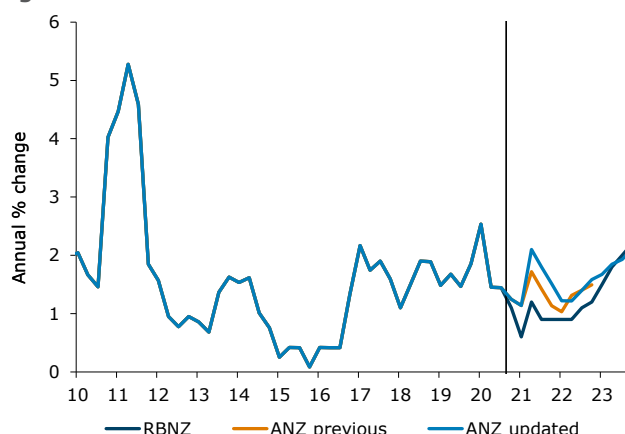
	Expected	Prev
CPI – q/q	0.3%	0.7%
CPI – y/y	1.2%	1.4%
Tradable – q/q	-0.4%	0.6%
Tradable – y/y	-0.9%	-0.1%
Non-tradable – q/q	0.7%	0.6%
Non-tradable – y/y	2.8%	2.6%

**Figure 1. ANZBO pricing indicators**



Source: ANZ Research

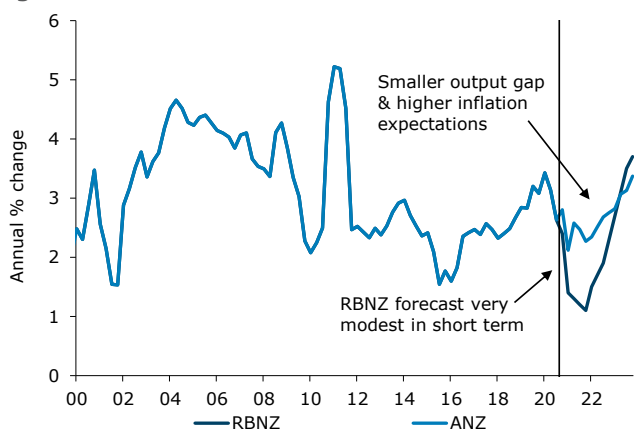
**Figure 2. Inflation forecasts – ANZ and RBNZ**



Source: Stats NZ, RBNZ, ANZ Research

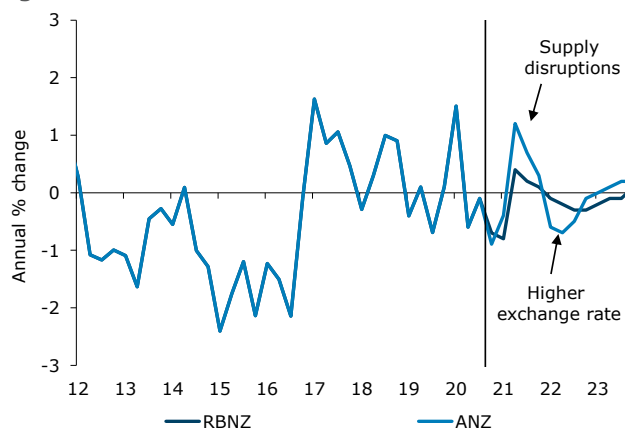
Our revised CPI outlook is slightly stronger than the RBNZ’s November MPS forecasts (figure 2). However, the outlook for domestic inflation – which the RBNZ cares most about – is meaningfully stronger (figure 3). This reflects our view that there is less spare capacity in the economy than the RBNZ is assuming and that inflation expectations will be less of a drag. Conversely, we are assuming a weaker profile for tradable inflation than the RBNZ, partly due to the higher NZD (figure 4). Developments clearly point to a stronger domestic inflation picture and we expect the RBNZ will revise up their forecasts for inflation at the February MPS. However, they will likely remain cautious in their assumptions, especially in the short term, meaning we expect to see a profile that is weaker than our own.

**Figure 3. Non-tradable inflation – ANZ and RBNZ**



Source: Stats NZ, RBNZ, ANZ Research

**Figure 4. Tradable inflation – ANZ and RBNZ**



Source: Stats NZ, RBNZ, ANZ Research

**Risks in both directions**

Risks to the inflation outlook now appear to be less clearly skewed to the downside than previously. Because inflation is so low already, downside inflation risks remain more problematic for the RBNZ than upside ones. But the trend towards higher inflation expectations has taken the pressure off to some degree. Although inflation is set to remain low for a long while, risks are receding that even lower inflation becomes entrenched.

Downside risks to the GDP outlook are ever-present, of course, and the RBNZ are conscious of this. Our fortunes could turn on a dime if COVID were to return to our shores. But the bounce that we have seen in activity has been impressive, and is expected to set households and firms up to manage some stagnation in the economic recovery as our lost summer of tourism is felt.

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There are also more reasons to be conscious of upside risks, which could conceivably see inflation even stronger than we are currently forecasting. At this stage we are assuming that cost pressures do not pass through into widespread inflation. This seems a reasonable assumption, given that pressures so far appear concentrated in certain pockets and there are other offsetting headwinds. But to the extent that cost pressures spill over more widely and lead to upward pressure on inflation expectations, this could pose upside risk.

Yet it is very difficult to imagine an environment where the recent low inflation dynamic changes abruptly. The global economic environment is challenging, inflation expectations are low and the NZD continues its upward march – all of these headwinds are expected to weigh on the inflation outlook and could prove more of a battle to offset than expected.

### **Policy implications**

The outlook for medium-term inflation is now looking more assured, and that will take the pressure off the RBNZ to provide more monetary stimulus. There is less spare capacity in the economy, inflation expectations are on the rise and risks are less clearly skewed to the downside – giving the RBNZ scope to pause and see how developments unfold. Inflation pressures look set to build and see CPI inflation return to target more comfortably over the forecast horizon.

But it will take some time for this improvement to manifest and downside risks remain a concern, meaning the RBNZ has good reason to remain wary about the outlook. Inflation looks set to be low over the coming year, given the weak starting point, meaning continued dovish rhetoric from the RBNZ will be justified beyond the final 15bp OCR cut we are forecasting in May.

The RBNZ will want to be assured that inflation is close to target before contemplating policy normalisation and it won't be until 2022 that we will see that manifest. In that environment, it is hard to imagine interest rates going higher any time soon. Until an improvement in inflation is finally seen, risks will remain skewed towards interest rates going lower, not higher – and the RBNZ will continue to reiterate a willingness to do more if required. That means an easing bias and stimulatory stance of policy for a long while yet.

Although New Zealand is charting its own course and the RBNZ will set policy for the domestic economy, some of the same themes are evident in other economies. Globally, expectations for inflation have been trending higher (based on market pricing, for example), but this upwards trend has been from a very low base. There is a widespread desire amongst central banks to keep policy stimulatory until inflation at (or even above) target is evident. The recent increase in expectations will be a relief for central banks, taking pressure off them to provide even more stimulus – but that's a far cry from motivating an imminent move towards policy normalisation, especially with the economic outlook still dire in many places. It's all a recipe for interest rates remaining low for a long while yet.

### **2020Q4 CPI – the details**

December quarter CPI figures will be released on Friday 22 January. Tradable prices are expected to fall 0.4% q/q (-0.9% y/y), while non-tradable prices are expected to lift 0.7% q/q to tick up from 2.6% to 2.8% y/y. Core inflation measures are expected to remain muted.

Of the 0.3% q/q increase in headline CPI:

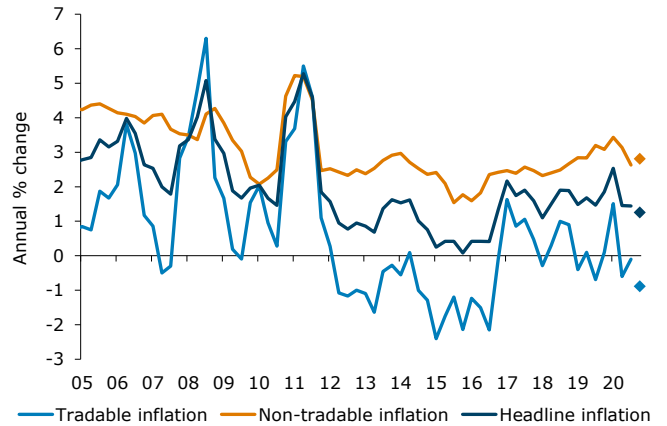
- Food prices and alcoholic beverage prices are usually a drag in the December quarter and this time is no exception, subtracting 0.30%pts.
- Transport is expected to contribute 0.1%pt, with used car and air travel prices seeing some upward pressure, while petrol prices fell.
- Housing and related prices are expected to have contributed 0.2%pts, with construction costs rising.

- Recreational and cultural prices are expected to contribute 0.25%pts. Accommodation prices will see seasonal strength (+10.3%), partially retracing declines earlier in the year to still be below pre-COVID levels.
- Other miscellaneous prices are expected to be a bit higher than usual, with less discounting for clothing, footwear and some durables. There are also seasonal price increases expected for insurance and some other services. All of this totals roughly 0.1%pt.

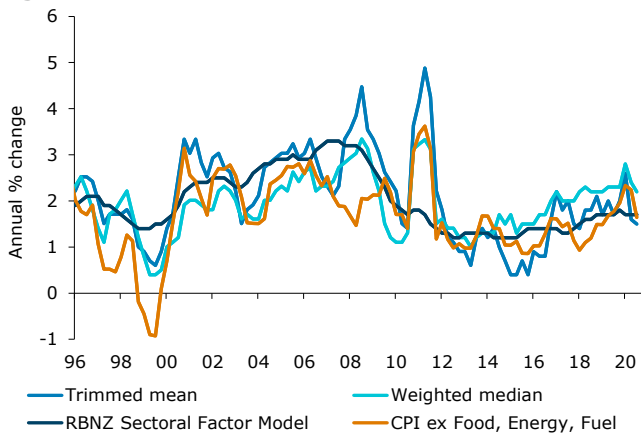
**Table 1. ANZ Q4 CPI component-level forecast**

Groups	q/q%	%pt cont.
Food	-1.8	-0.28
Alcoholic beverages and tobacco	-0.6	-0.04
Clothing and footwear	0.5	0.02
Housing and household utilities	0.6	0.20
Household contents and services	0.1	0.01
Health	0.3	0.01
Transport	1.4	0.10
Communication	-1.3	-0.03
Recreation and culture	3.4	0.24
Education	0.1	0.00
Miscellaneous goods and services	0.7	0.06
<b>Total</b>	<b>0.3</b>	<b>0.3</b>

**Figure 5. CPI inflation measures**

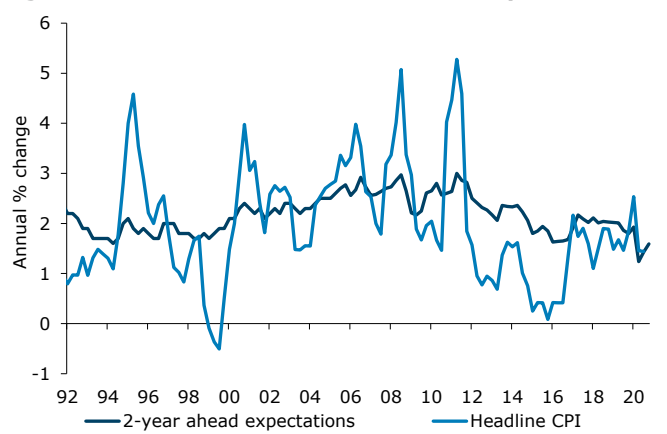


**Figure 6. Selected core inflation measures**



Source: Statistics NZ, RBNZ, ANZ Research

**Figure 7. Headline inflation and inflation expectations**





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