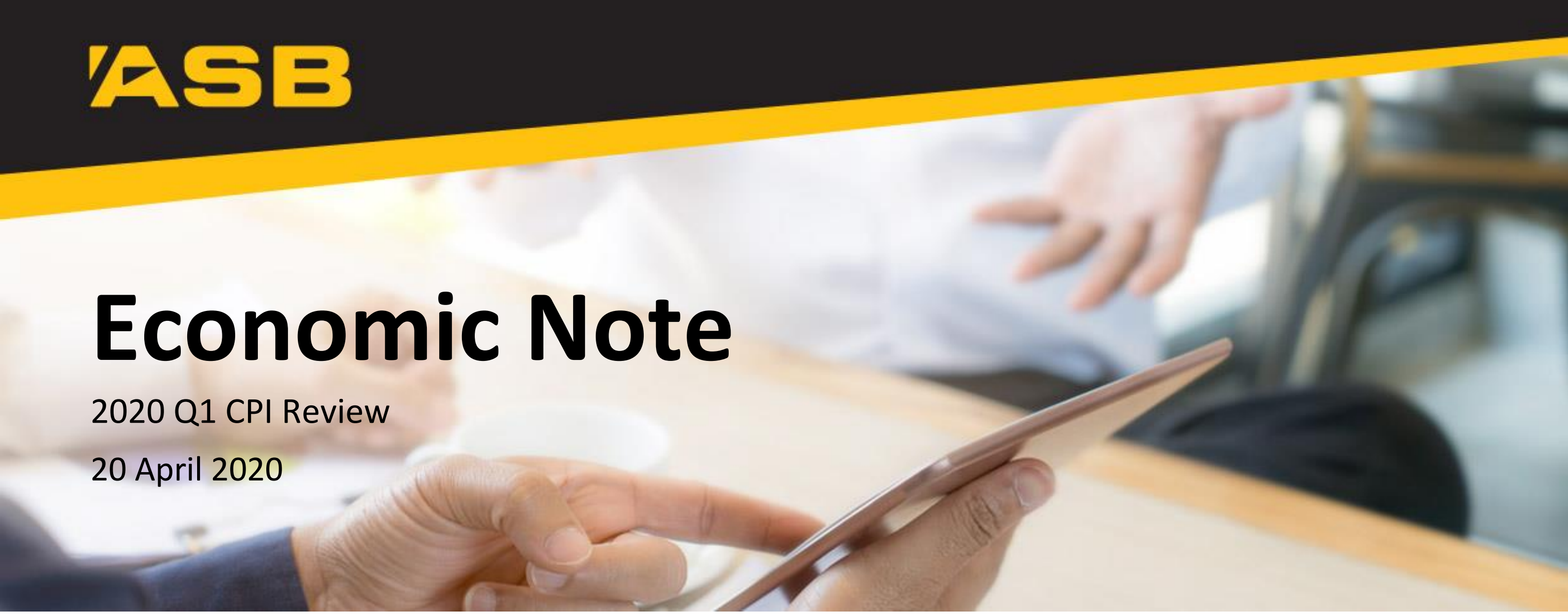

Economic Note

2020 Q1 CPI Review

20 April 2020

Strong starting point for inflation, but COVID-19 softens the outlook

- NZ consumer prices rose 0.8% qoq in Q1 (2.5% yoy), considerably firmer than RBNZ and market expectations.
- Annual headline and non-tradable inflation hit nine-year highs, with a scattering of upside surprises throughout the CPI regimen.
- Core inflation also rose to nine-year highs, pointing to considerable upside risk to RBNZ measure of core inflation published today at 3pm.
- The Q1 CPI snapshot was largely applicable to a pre-COVID-19 world. If it was not for COVID-19 pandemic the RBNZ would likely be contemplating OCR hikes rather than further policy easing.
- However, COVID-19 represents a massive deflationary shock for the economy and is likely to push headline and core inflation lower over the next couple of years.

Q1 2020 CPI %	Actual	ASB	RBNZ	Market
CPI qoq	**0.8**	0.4	0.4	0.4
CPI yoy	**2.5**	2.2	2.2	2.1
Non-tradable qoq	**1.4**	1.0	1.0	
Non-tradable yoy	**3.4**	3.0	3.0	
Tradable qoq	**0.1**	-3.0	-0.2	
Tradable yoy	**1.5**	1.1	1.2	

Summary and implications

The 0.8% qoq increase in Q1 CPI (+2.5% yoy) was considerable firmer than market and RBNZ expectations. The upward drift in inflation was broad-based and not attributable to any one-offs. Annual headline CPI inflation, key core inflation measures and non-tradable inflation were all at nine-year highs. The Q1 CPI snapshot was largely applicable to a pre-COVID-19 world, and if was not for the pandemic the RBNZ would likely be contemplating OCR hikes rather than further policy easing. However, COVID-19 represents a massive deflationary shock for the economy and is likely to push headline and core inflation lower over the next one to two years. We expect macroeconomic policymakers to remain steadfast in their commitment to prevent outright deflation emerging. We do not expect the OCR to move above its 0.25% operational low until 2024.

Strong Q1 CPI print predates the COVID-19 lockdown

The CPI rose 0.8% qoq in the March quarter, considerably firmer than the market median and the February Monetary Policy Statement pick. Annual CPI inflation ticked up to 2.5% (compared to 1.9% yoy in 2019Q4), the highest annual rate since mid-2011. Quarterly non-tradable inflation rose 1.4% qoq, the largest quarterly increase since the lift in GST in late 2010. Annual non-tradable CPI inflation rise to 3.4%, the highest in nine years.

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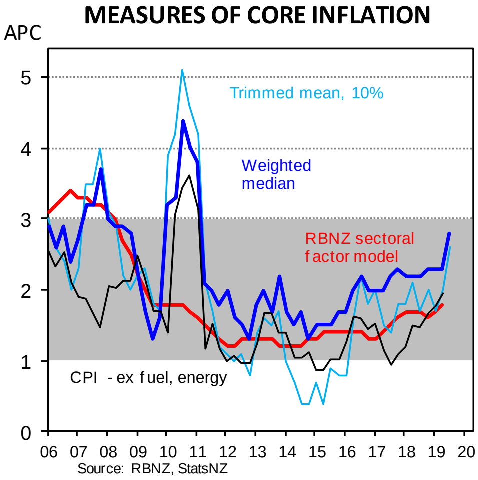
The CPI was considerably firmer than our expectations, with a number of upward surprises scatted throughout the CPI regimen.

- **Firmer than expected housing-related costs (+0.9% qoq, +0.25 percentage points)**. Solid quarterly increases for construction costs (+1.0% qoq), dwelling rents (+1.2% qoq), electricity (+1.3% qoq) and dwelling maintenance services (+0.8% qoq) pushed annual inflation from this group up to 3.3%, the highest in close to 6 years. The annual rental inflation rise to 3.7%, the highest since 2004, was led by strong increases outside of Auckland and Canterbury. Inflation from this component looks set to sharply cool, as a 6-monthly freeze on residential rental increases came into effect from April.
- **Larger than usual seasonal rise for food prices (2.0% qoq, +0.40 contribution).** Of note, meat and grocery food prices have had a strong start to the year. This looks to be commodity-price related, for now at least.
- **Lower than expected falls for transport costs (-1.7% qoq, -0.25 percentage point contribution)**. The 2.3% fall in petrol prices was more modest than we had expected, with a larger Q2 fall in the cards. Falls in domestic (-1.2% qoq) and international airfares (-10.9% qoq) were in line with expectations, with vehicle prices (1.0% qoq) and prices for parts and accessories (2.7% qoq) firmer than expected, consistent with the lower NZD/JPY.
- **Higher than expected prices for tobacco and alcohol.** The 10% tobacco excise increase and seasonal increases in **prices for alcohol lifted** prices for tobacco (11.1%) and alcohol (+1.1% qoq) group by 5.0% in Q1 (+0.4% contribution to quarterly CPI inflation).
- **The usual scattering of rises throughout the CPI regimen (+0.1 percent point contribution).** Higher prices for household contents and services (+1.7% qoq), healthcare (+1.7% qoq), miscellaneous goods and services (+2.9% qoq) and recreation and culture (+2,3% qoq) were notable. Apparel prices rose 1.8% qoq, despite prices for this component usually falling. There were only a few downside surprises, with tertiary education prices up just 0.8% qoq, with the 0.1% quarterly climb in education prices.
- **Lower discounting.** Although 14% of prices collected from retail outlets were discounted (13% in 2019Q4), the average discount (-10%) was the lowest in three years.

Rising core inflation

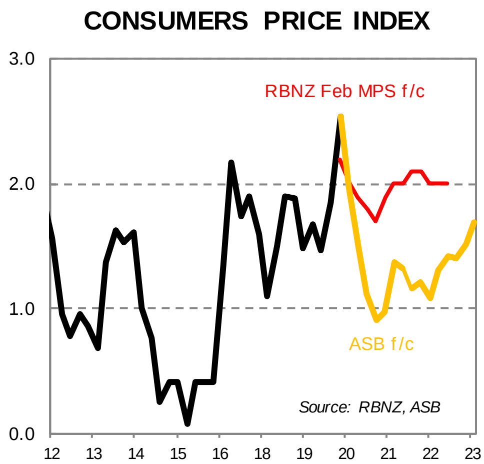
Annual core inflation measures rose to the upper part of the RBNZ's 1-3% inflation target. Annual inflation for the 50% weighted median (2.8% yoy), and the 10% trimmed mean (2.6% yoy) were the firmest since the September 2011 quarter. The RBNZ factor model estimates will be released at 3pm today, but on the basis of the core measures produced by Statistics NZ looks set to move considerably above 2%. **Given the generalised firming in inflation evident in the Q1 data, it seems likely that in the absence of COVID-19, the RBNZ would likely be contemplating potential OCR cuts rather than further policy easing following the release of this data.**



Statistical challenges galore

Not only has COVID-19 provided substantial challenges to the economy and policy-makers, but the lockdown is also throwing up fresh statistical challenges. Earlier, Statistics NZ confirmed that as a result of the Level 4 lockdown it had temporarily stopped collecting data directly from stores, instead using data collected from store websites or other online sources. Price collection for fresh fruit & vegetables, fuel, and international airfare and accommodation was affected, accounting for less than 3% of all prices collected. **Looking through the March CPI report did not yield many potential deflationary surprises, with the surprises/quirks predominantly to the upside.** Let's hope we soon emerge from lockdown, with the risk of a more drawn out lockdown significantly impacting prices in the June quarter. Statistics NZ have pledged to provide an updated paper before the June 2020 quarter release (16 July 2020), outlining the sources and methods is has adopted, and what this means for the June quarter CPI results. We will be on the lookout for any statistical quirks that may emerge.

Market and policy implications.



Despite the sizeable upward inflation surprise, market reaction was modest, with very little impact in the NZ rates market, and with a temporary 20 pip blip in the NZD. The market focus quite rightly looks to be on the inflation outlook. Our CPI preview highlighted a significantly lower future inflation path given the combination of lower commodity prices (oil prices have roughly halved since the start of the year), policy induced changes (the 6-monthly rental freeze commenced in April) and the weaker economic backdrop (we expect a 6% fall in NZ GDP over 2020). **All up, annual headline inflation looks set to fall towards the bottom of the 1-3% inflation target band by the end of the year despite starting 2020 closer to 3%.**

The RBNZ will be keen to prevent annual inflation outcomes from easing too far, running the risks of the NZ economy entering a deflationary spiral and blunting the effectiveness of the record low OCR. If the inflation outlook deteriorates further, we expect the RBNZ and the NZ Government to further step up policy stimulus measures. We expect the OCR will not move above operational lows (currently 0.25%) until 2024.

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