ASB

Economic Note

2020Q1 CPI Preview

16 April 2020

OK for now, but potential deflation looms

- We expect a 0.4% qoq increase for the CPI in Q4, with annual CPI inflation ticking up to 2.2%.
- There will be few signs of a COVID-19 impact in the Q1 data. It will be a different story beyond then.
- We expect annual CPI inflation to test the bottom of the 1-3% medium-term target band given lower commodity prices, policy changes and growth headwinds from the virus outbreak impact.
- We expect macroeconomic policy-makers to remain steadfast in their commitment to prevent outright deflation emerging.

Q1 2020 CPI %	Previous	**ASB**	RBNZ
CPI qoq	0.5	**0.4**	0.4
CPI yoy	1.9	**2.2**	2.2
Non-tradable qoq	0.6	**1.0**	1.0
Non-tradable yoy	3.2	**3.0**	3.0
Tradable qoq	0.4	**-0.3**	-0.2
Tradable yoy	-0.7	**1.1**	1.2

Summary and implications

Our Q1 pick for the NZ CPI is in line with RBNZ expectations, and well within the inflationary sweet spot for the NZ economy. This snapshot was largely applicable to a pre-COVID-19 world. However, COVID-19 represents a massive deflationary shock for the economy and it likely to push headline and core inflation lower over the next one to two years, before recovering economic activity pushes inflation gently higher. The impacts of COVID-19 have added another layer of uncertainty to the inflation outlook, with risks tilted to the downside. We expect macroeconomic policy-makers 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. It could move lower if this was shown to be feasible to do so.

Most Q1 CPI data predate the lockdown

We expect consumer prices to climb 0.4% qoq in Q1, with annual CPI inflation ticking up to 2.2%. This is line with the February Monetary Policy Statement (MPS) pick.

The bulk of the consumer price information for Q1 would have been obtained prior to NZ moving to Alert Level 4 and going into lockdown. Few goods - including vehicle fuels and fresh fruit and vegetables – are surveyed weekly, but even here prices for the quarter will be dominated by movements earlier in the quarter. As such, information from the pricing side of the economy will depict a 'business as usual' inflationary backdrop with annual headline and core inflation sticking close to the midpoint of the inflation target, annual non-tradable inflation at around 3% and with annual tradable inflation hovering around 1%.

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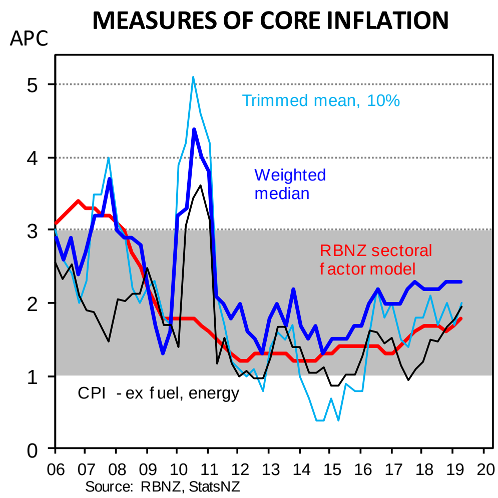
The CPI groups will capture the usual offsetting impacts on the inflation process:

- **The firmer than usual seasonal rise for food prices (1.9% 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.
- **The 10% tobacco excise increase and seasonal increases in prices for alcohol** are expected to lift prices in the tobacco and alcohol group by around 4% (+0.3% contribution to quarterly CPI inflation).
- **Rising housing-related costs (+0.5% qoq, +0.15 percentage points)**. Solid quarterly increases for construction costs, dwelling rents and dwelling maintenance services should keep annual inflation from this group at around 3%. Inflation from this component looks set to sharply cool, with the 6-monthly freeze on residential rental increases set to come into effect from April.
- **Lower transport costs (-2.7% qoq, -0.4 percentage point contribution)**. Petrol prices are expected to fall around 4% in Q1, with a seasonal fall expected for international airfares. We expect some modest falls for domestic airfares after the sharp 2019H2 rises that followed the scaling back of regional Jetstar flights. We expect small rises in vehicle prices given the lower NZD/JPY.
- **The usual scattering of rises and falls throughout the CPI regimen (flat CPI contribution).** Seasonal falls for apparel prices, audio visual equipment and books & stationery would largely be offset by rises for tertiary education, accommodation, insurance and recreation & culture.



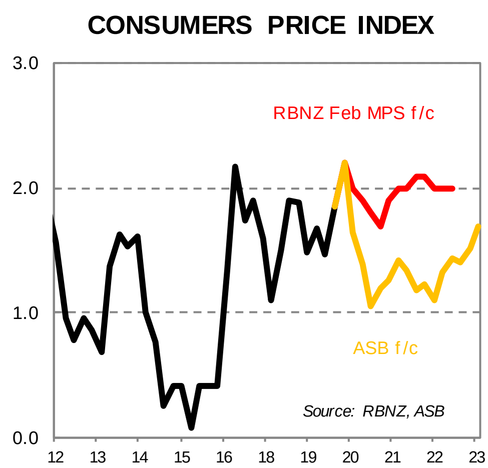
Stable core inflation expected

We expect annual inflation for both the 10% trimmed mean and 50% weighted median to remain close to the 2% inflation target midpoint. Annual inflation from the RBNZ's sectoral factor model ticked up to 1.8% in calendar 2019, the firmest in close to 9 years and well within cooee of the inflationary target midpoint. We expect similar readings for the March quarter figures (the sector factor model will be released by the RBNZ at 3pm on Monday April 20).

COVID-19 clouds lie further ahead.

The Q1 inflation figures will be business as usual, but it will be anything but that going forward. COVID-19 represents a massive deflationary shock for the economy, and we expect its impacts to become evident via the following channels:

- **Lower commodity prices.** USD denominated oil prices have halved since the start of the year. Low retail fuel prices are expected to knock about more than 0.5 percentage points off annual CPI in the June quarter alone. Thankfully, for NZ commodity producers, export commodity prices have not shared a similar fate.
- **Policy changes**. The decision to freeze residential rent increases for 6 months from April will be welcome for struggling renters, less so for struggling landlords. Our estimates suggest that the freeze on CPI rents will shave about 0.2 percentage points off annual inflation in the September 2020 year. We don't expect the household sector to be a healthy enough state to absorb catch-up rental increase after the rental freeze ends.
- **Economy-led impacts**. The NZ economy is set to go into a deep hole and it will be a long-time before the economy recovers its mojo. A large and persistently negative margin of spare capacity and tepid wage inflation are expected to push core and non-tradable inflation lower.



All up, annual headline inflation looks set to fall towards the bottom of the 1-3% inflation target band (and potentially below it). We expect core inflation outturns to move into a 1-1½% zone, with annual non-tradable inflation set to fall to around 2% by the end of the year. Our forecasts assume that recovering economic activity will trigger a turnaround in inflation outturns from 2022, with annual CPI inflation outturns set to lift thereafter. There is considerable uncertainty around the economic and inflationary outlook, with

COVID-19 an added factor to consider. Risks to our inflation outlook are tilted to the downside, particularly if the economic downturn and associated deflationary impulse from COVID-19 turns out to be deeper and more protracted than what we assume.

Statistical challenges galore

Not only is COVID-19 provided substantial challenges to the economy and policy-makers, but the lockdown is also throwing up fresh statistical challenges. Rather than visiting premises and obtaining price quotes, Statistics NZ notes that it is receiving electronic data directly from some large retailers and is working with others to expand coverage. We will be on the lookout for any statistical quirks that may emerge.

Policy Implications

It is fair to say that the monetary policy implications from a pre-lockdown CPI release are minimal at best. Any upward surprises will likely be brushed off given the change in economic landscape. Downside risks will likely be of greater concern. **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 – it is real interest rates that matter after all.** If the inflation outlook deteriorates further, we expect the RBNZ and the NZ Government to further step up policy stimulus measures. Let's hope we don't have to go there. We expect the OCR will not move above operational lows (currently 0.25%) until 2024. If it was technically feasible to do so and it did not harm the financial system, the OCR could potentially move lower still.

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