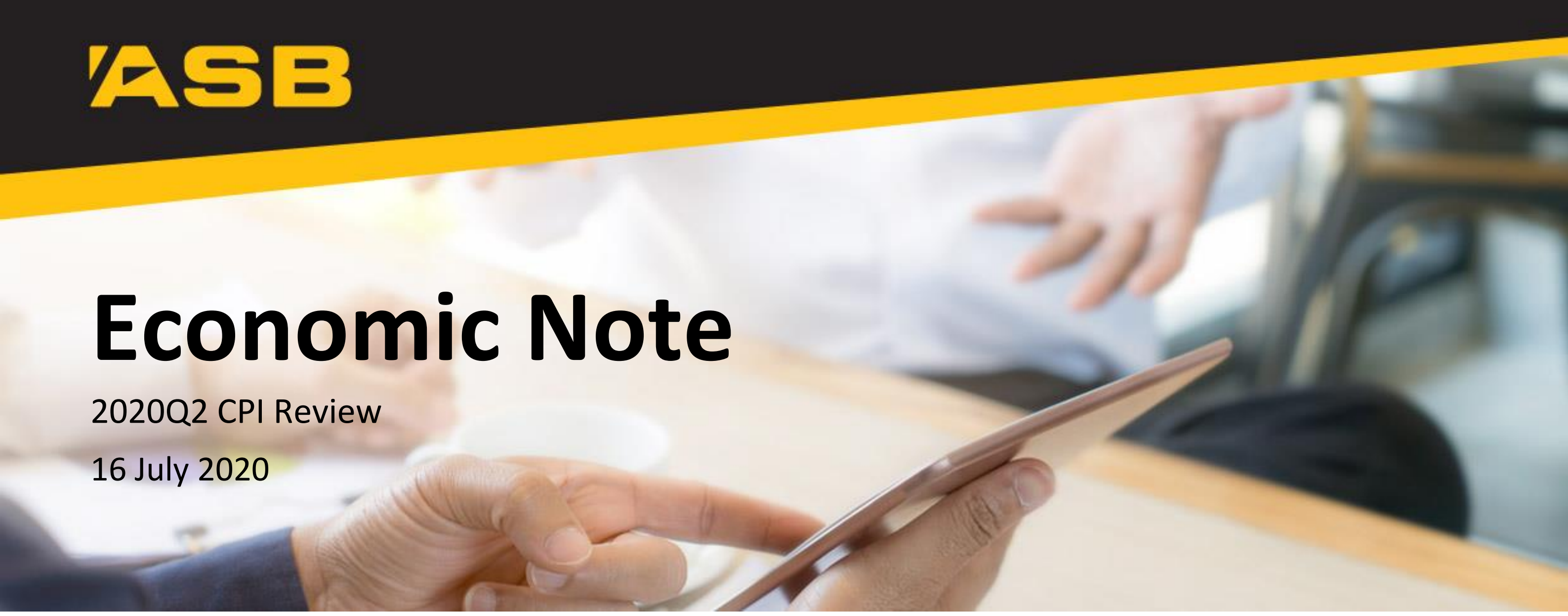


Economic Note

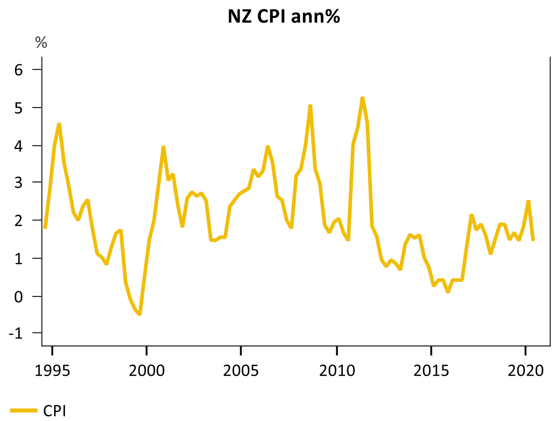
2020Q2 CPI Review

16 July 2020

COVID-19 disrupts inflation

- CPI inflation fell 0.5% qoq in Q2, the fall was less than the RBNZ and the market expected.
- Domestic inflation pressures (non-tradable inflation) fell by more than ourselves and the RBNZ expected.
- We expect annual inflation to dip close to zero over the coming year, and the RBNZ must remain vigilant about deflation risks over 2021.

Q2 2020 CPI %	Actual	ASB	RBNZ	Market
CPI qoq	**-0.5**	-0.4	-0.7	-0.6
CPI yoy	**1.5**	1.5	1.3	1.4
Non-tradable qoq	**0.0**	0.1	0.3	
Non-tradable yoy	**3.1**	3.3	3.4	
Tradable qoq	**-1.2**	-1.2	-1.9	
Tradable yoy	**-0.6**	-0.7	-1.3	



Source: Macrobond, ASB

Summary and implications

Consumer prices fell 0.5% over Q2, the fall was less than the RBNZ have anticipated in its May MPS forecasts and also less than market expectations. Market and policy implications from the Q2 CPI release are minimal. When the RBNZ prepared its May Monetary Policy Statement forecasts, it appears to have built in as much downside risk as it could, with its short-term inflation forecasts very weak. Furthermore, StatsNZ's ability to measure prices was also disrupted by the April lockdown, and there is additional uncertainty around the Q2 estimate and this alone is good reason for market participants and analysts to place less emphasis on today's CPI outturn it than usual.

From the RBNZ's perspective, it's not inflation pressures today, but inflation pressures which prevail over 2021 that the RBNZ will be most concerned about – as inflation is a lagging economic variable. Deflation risks cannot be ruled out, which will make the RBNZ nervous given the limited the effectiveness of the OCR, which is now stuck at its operational lower bound. For now, it appears the economy has recovered from lockdown faster than expected. The key is how well activity and confidence hold up over the rest of the year as the labour market weakens, sending unemployment higher and weighing on wage growth. Should the economic outlook deteriorate more than expected from here, we believe the RBNZ will prefer to use its Large-Scale Asset Purchase programme and other policy options, over a negative OCR.

Details

Consumer prices fell 0.5% over Q2 2020, during the period in which NZ businesses faced lockdown trading restrictions in order to control the spread of COVID-19. The fall in prices was less than the RBNZ and the market expected, but a fraction more than ASB anticipated. In particular, non-tradable prices (domestic inflation pressures) were more

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subdued than we and the RBNZ expected with annual non-tradable inflation falling from 3.4% to 3.1%.

Key drags on Q2 CPI was the plunge in consumer transport prices (down 4.9%), lower clothing and footwear prices (down 3%) and lower prices accommodation services prices (down 5.6%). From ASB's perspective, price declines for NZ passenger transport and domestic accommodation services were larger than we expected, weighing on non-tradable inflation relative to our own forecasts. Some of the falls in passenger transport prices are temporary. Meanwhile, price declines in other areas (particularly accommodation) are likely to be sustained while border closures impact the hospitality and accommodation sectors.

Transport and Accommodation

Global oil prices plunged early in 2020, with the falls exacerbated by a slump in demand due to the COVID-19 pandemic while suppliers were slow to cut production in response. The fall in oil prices flowed through to NZ fuel prices, with retail fuel prices falling 12% in the quarter. Further weighing on transport prices, free access to public transport during Alert Levels 3 and 4, which saw rail passenger prices fall 48% over the quarter. However, with public transport passenger numbers very low at the start of the quarter, actual benefits to consumers were very low. Meanwhile, StatsNZ supressed the movements of domestic air transport to protect the privacy of the limited number of domestic air transport providers during the lockdown, and potentially these prices could have fallen.

Accommodation prices fell 5.7%, weighed by a 13.9% fall in domestic accommodation providers. Accommodation services prices are likely to continue to fall as NZ accommodation providers grapple with the border closure over the coming year.

Measurement challenges and the rent freeze

Statistics NZ have previously acknowledged that COVID-19 has disrupted the flow of statistics and published a paper setting out the potential impacts. It has meant Statistics NZ had to use administrative data or imputation instead of direct surveying of some consumer prices. Stats acknowledged there were challenges in capturing the full extent of the rent freeze due the methodology it uses to estimate nationwide rent price movements. According to StatsNZ, if the impact of the rent freeze was fully captured in Q2 it would have lowered its estimate of rent movements, but it would not have a significant impact on the overall CPI estimate.

Core inflation

Core inflation measures fell as expected, and over the coming year we expect all core inflation measures will fall below the 2% mid-point of the RBNZs inflation target band. The trimmed mean (10%) estimate of annual inflation feel from 2.6% to 1.6%, while the weighted median estimate of annual inflation eased from 2.8% to 2.4%. Excluding food and energy, annual inflation slowed to 1.9% from 2.3%. Market participants are likely to closely watch the RBNZ's own estimate of core inflation, released at 3pm today. However, given the methodology of how this measure is calculated, the RBNZ's core measure can be slower to respond to a change in trend and it may take a few quarters for this measure to fall in response to weaker domestic inflation pressures.

Outlook

Prior to the COVID-19 pandemic, the RBNZ could confidently conclude it was meeting its inflation objective. However, the COVID-19 pandemic has pushed NZ and Global Economy into recession over 2020, and this will directly lower NZ CPI inflation over the coming year through both domestic and imported channels. While we currently expect inflation to remain positive over 2021, we can't rule out the risk of deflation and the RBNZ must remain vigilant. In saying this, the RBNZ (along with most economic forecasters) will be pleased by economic developments to date. We expect GDP to be 5% below year-ago levels by December 2020, which is in line with the RBNZ's May MPS forecasts. However, if the economy proves weaker than expected heading into 2021, and more policy stimulus is required, we believe the RBNZ will opt to increase its Large-Scale Asset Purchase programme or lean on other policy measures and leave the option of a negative OCR as a last resort.

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