Economic Analysis

CPI report confirms disinflationary headwinds building

Nathaniel Karp / Boyd Nash-Stacey

May 12, 2020

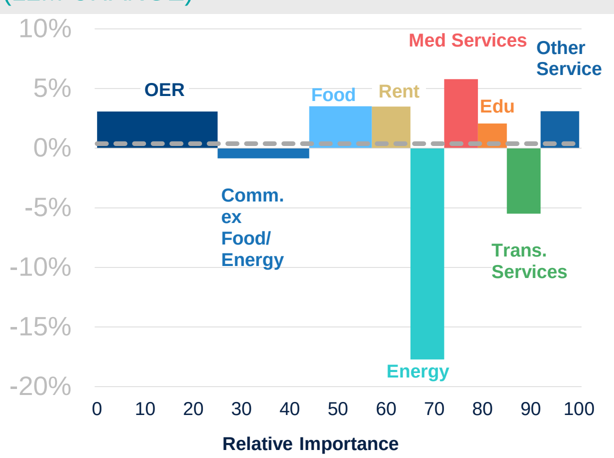
In April, consumer prices declined 0.8% over-the-month, in the first signs of a major downdraft in inflation. Today's numbers were significantly below expectations and marked the lowest monthly decline since December 2008. The change in headline CPI over the last twelve months was 0.3% vs. 1.5% in March. Moreover, core inflation fell more than any time in history, down 0.4% in April, but was up 1.4% from a year ago (2.1% in March).

Given the unprecedented demand-side shock to energy prices from the decline in travel and transportation, gasoline prices fell 20.6% in April. Similarly, prices for apparel, motor vehicle insurance, airline fares and lodging away from home fell substantially while food at home rose by the most since 1974.

Disentangling the effects of the sector specific supply and demand shocks and the directional impact they will have on prices can be challenging, particularly when there are very few transactions and minimal price discovery. On the one hand, massive layoffs, social distancing restrictions and behavioral responses to the threat of infection from COVID-19 have pushed demand in some sectors to their effective lower bound, leading to disinflationary pressures. In the last two months, airline fares have dropped 26%, sending the index to levels not seen since the late 90s.

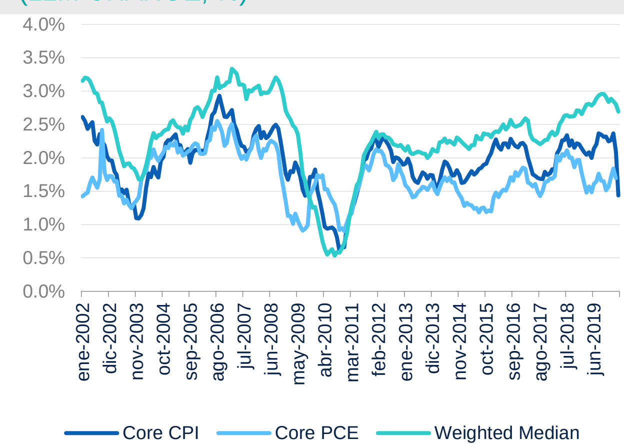
On the other hand, the implication of living in a post-lockdown world with varying degrees of social distancing and supply side impacts suggests upward price pressures. For example, dine-in restaurants that are only allowed to operate at fractions of their physical capacity will have to raise prices to absorb the drop in revenues and fixed costs to

Figure 1. **CONSUMER PRICE INFLATION (12M CHANGE)**



Source: BBVA Research, BLS & Haver Analytics

Figure 2. **CORE INFLATION MEASURES (12M CHANGE, %)**



Source: BBVA Research, BLS & Haver Analytics remain solvent with no material change in quality. In addition, some manufacturing industries have seen a spike in the number of COVID-19 cases, possibly pointing to factory shutdowns or reduced operating capacity as a result of enhanced social distancing. Prices for meat, poultry, fish and eggs increased 4.3% in April, the highest monthly change in 45 years, reflecting plant closures and bottlenecks in meat and livestock supply chains.

Thus far, the demand shock seems to be overpowering the supply shock. While this could exacerbate disinflationary pressures, the probability of outright deflation remains low. Nonetheless, if inflation remains low for long, it could lower inflation expectations and impact consumer and business spending, which in turn could affect pricing behavior, thereby creating a feedback loop resulting in persistent anemic inflation.

While today's report will not come as a surprise to the Fed given the all-out approach to the monetary policy response up to this point, persistent disinflationary headwinds and further deterioration in inflation expectations could prompt further action. That being said, the Fed's traditional playbook to boost inflation expectations is not well equipped to handle the nuances of the COVID crisis. As a result, a stronger focus on the loan facilities, which can help alleviate some of the demand-side pressures and enhanced forward guidance are possible.

Nevertheless, our baseline assumes headline prices will decline in 2020, before rebounding in 2021, and for core inflation to remain low in both 2020 and 2021, suggesting that the Fed can be patient, buying time to monitor the crisis and assess the impact of its existing policies. This implies that the policy rate could remain at the zero lower bound for several years.