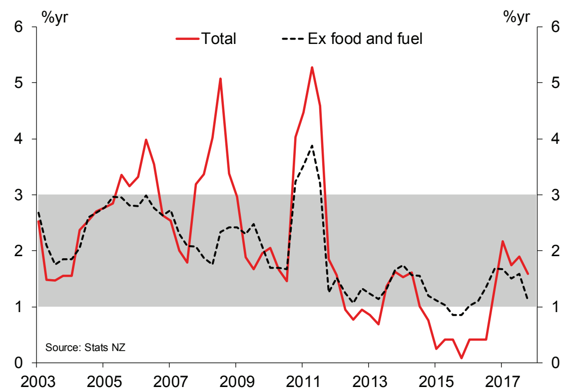
Imported inflation remains absent

CPI rose 0.1% in Dec quarter, annual inflation 1.6%

25 January 2018

- The Consumer Price Index (CPI) rose by 0.1% in the December 2017 quarter, less than expected. The annual inflation rate fell from 1.9% to 1.6%.
- Prices for a wide range of imported items were lower than we expected, suggesting that global inflation pressures remain subdued.
- We expect inflation to remain in the lower half of the Reserve Bank's target range over this year, implying no urgency to raise interest rates.

Annual inflation



Inflation was more subdued than expected at the end of 2017, largely reflecting a lack of price pressures for internationally-traded goods. The Consumer Price Index rose by 0.1% in the December quarter, bringing the annual inflation rate down from 1.9% to 1.6%.

Market forecasts were fairly closely clustered around our expectation of a 0.4% rise for the quarter (the Reserve Bank forecast a 0.3% rise in its November Monetary Policy Statement). However, financial markets seem to have been counting on an even stronger result. The New Zealand dollar fell by almost a cent against the US dollar, unwinding some of the gains it has made in recent days. The two-year swap rate fell by six basis points.

Today's result reinforces our view that the need for OCR hikes is a long way off. Despite an improving global economy, inflation – particularly in terms of the manufactured goods that New Zealand imports – remains largely absent. Meanwhile, domestic inflation has picked up from its lows but is still well below pre-financial crisis levels. We expect the RBNZ to remain on hold until late 2019.

Details

Some of the biggest price moves in today's release were already known. There was a 1.7% seasonal fall in food prices, partly offset by a 6% rise in fuel prices. There were also the expected large seasonal increases in airfares, car rentals and accommodation as we entered the peak travel period.

However, there was a large number of downside surprises in the tradables components – those items that are exported, imported or compete with imports. The biggest price falls were in household contents, clothing and new cars, but almost every item with some imported content came in below our forecasts.

There are two possible culprits here. The first is the New Zealand dollar, which strengthened through the middle part of 2017. Exchange rate movements affect the cost of imported goods, with the impact on retail prices typically coming with a lag of two to four quarters. That said, the rise in the exchange rate last year wasn't a particularly large or sustained one.

The other, more likely reason is that the international prices of imported goods remain subdued. The softness in global inflation has puzzled forecasters for many years since the global financial crisis. With the world economy now on a stronger footing, many have been expecting higher inflation to follow – and a few central banks such as the US Federal Reserve have already started to lift interest rates in anticipation.

Yet there is little evidence of that inflation emerging yet. It's true that inflation rates have risen from the near-zero levels that prevailed a couple of years ago, as oil prices have been rising sharply instead of falling. But there is little sign of price pressures spreading to the manufactured goods that New Zealand imports.

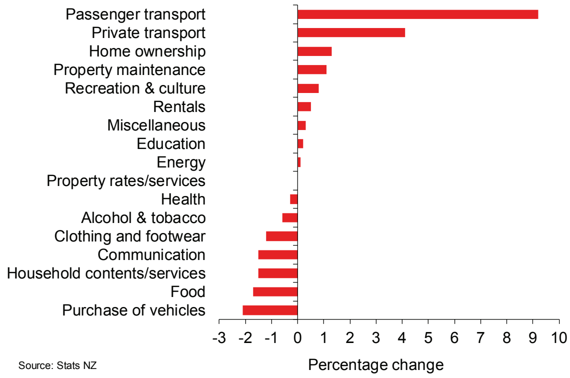
Back in New Zealand, non-tradables prices rose by 0.5% in the December quarter. Housing-related prices such as rents and newly-built homes continued their steady rise, but we haven't really seen them accelerate. Rents were up 2.3% on a year ago, much the same rate of increase that we've seen over the last six years. New dwelling prices were up 5.3% year on year, but that compares to a peak rate of 6.7% in March last year.

Overall, an inflation rate of 1.6% is consistent with the Reserve Bank's 1-3% target range, albeit towards the lower end. The various measures of 'core' inflation tell a similar story: close to the 2% midpoint of the target, but erring to the lower side.

We expect annual inflation to remain below 2% over the course of 2018 as well. The economy is expected to continue growing, but at a modest pace that is unlikely to put it at risk of overheating. The global economy is improving, but the weakness of global inflation suggests that some spare capacity remains. In such an environment, it is hard to see the Reserve Bank coming under pressure to lift the OCR.

Michael Gordon
Senior Economist

Components of quarterly inflation



Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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