Economic research note

29th January 2009

Disinflation provides some welcome relief

- **The Consumer Price Index (CPI) fell 0.3% between September and December 2008 and the annual rate of inflation slowed to 3.7% from 5.0%.**
- **We expect inflation will reach at least 2.5% by mid-year. In the medium term a recovery in demand will see a re-emergence of upward pressure on prices.**
- **The disinflation environment enables the Reserve Bank of Australia (RBA) to pursue further cuts to interest rates. However, a low interest rate environment presents a risk to inflation in the medium term.**

Headline CPI is the most common measure of consumer price movements in Australia. It is the basis for the RBA's inflation target and, consequently, is of importance in setting monetary policy.

The Data

Headline CPI fell 0.3% in the three months to 31st December 2008. The annual rate of inflation slowed to 3.7% from 5.0%. This is the fastest deceleration in inflation since the start of the decade when the Goods and Services Tax (GST) was introduced. Notably, CPI inflation remains above the RBA's target zone of 2-3%. The market consensus believes CPI inflation will fall to within the RBA band by 2H09.

Within the CPI there are divergent trends between tradable and non-tradable prices as highlighted in Figure 1. The tradable (those goods and services that are subject to international competition) sector fell -1.8% in the quarter while in the non-tradable sector prices rose 0.6%. This reflects falling global prices as a result of slower demand growth but continued price pressures in the domestic economy due to capacity constraints and remaining bottlenecks.

Annual change in the major components of headline CPI is shown in Figure 2. The biggest falls in prices over the quarter were in transportation -6.9% due to falling oil prices, health -1.2% due to falling pharmaceutical prices and financial and insurance services -0.3% due to the falling cost of borrowing. The largest increases in prices over the quarter were in food +2.0% due to rising fresh food prices and alcohol and tobacco +1.4%.

Figure 1

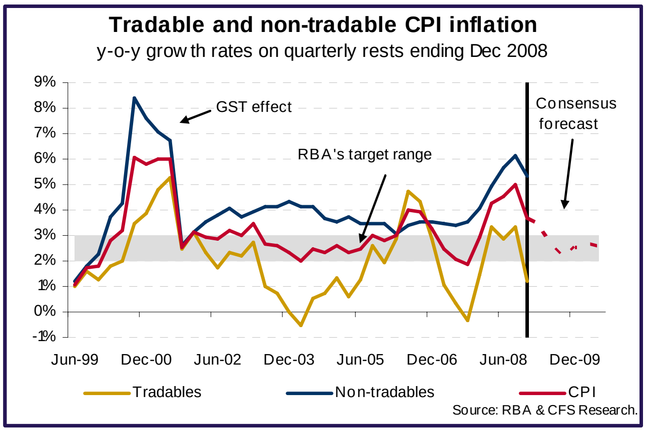
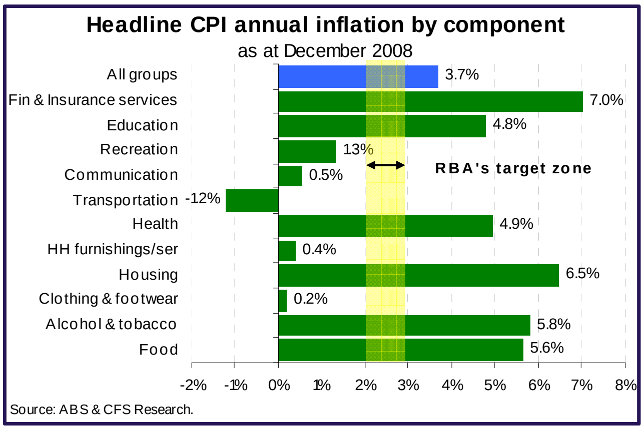


Figure 2



Analysis

The rapid slowdown in inflation raises the importance of distinguishing between deflation and disinflation. Deflation occurs when a contraction in demand leads to a fall in prices. This has been Japan's experience over the nineties and early part of this decade. Disinflation is a decline in the rate of increase in prices.

The softening in annual price growth is characterised by disinflation. This is due to falling oil prices and cuts to lending costs. Consequently, this has improved household purchasing power. The emergence of deflation in aggregate prices would require a sustained contraction in domestic demand with unemployment rising further than expected (see Labour market will deteriorate over 2009) and persistently low prices for global commodities.

Inflation will ease further over 1H09 as global demand weighs on commodity prices and domestic demand eases price pressures. We expect inflation to reach at least 2.5% by mid-year with a sharper fall likely if there is ongoing improvement in the Australian dollar via lower import prices. This enables the RBA to continue cutting the official cash rate during 1Q09 to between 3% and 3.5%.

However, price pressures have not disappeared; demand for commodities should return and businesses and governments have not yet used this period of weaker prices to address key bottlenecks. As first domestic and then global demand returns these price pressures are likely to re-emerge and require RBA policy making to revert to a tightening stance.

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Contact details

Anthony De Francesco	Head of Research	+612 9303 3598
James White	Investment Economist	+612 9303 2645
Mary Bonello	Research Assistant	+612 9303 3518