

Food for thought for the RBA as CPI falls

Economic research note

25 January 2012

- Australia's headline inflation was flat in Q4 11, taking the annual pace of inflation down to 3.1% from 3.5%.
- However, the measures of underlying inflation rose by an average of 0.55%/qtr, which was above market expectations, albeit lower than the pace recorded in Q1 and Q2 2011.
- This took the annual rate of underlying inflation up to 2.60% from a revised 2.55% (was 2.45%), ie. just slightly above the RBA's 2%-3% target range and from RBA expectations of 2.5% (made in the November Statement on Monetary Policy).
- The low headline Q4 11 CPI reading allows the RBA to continue on their easing bias and reduce the cash rate by 25bp to 4.0% at the next Board meeting.
- In addition, the RBA will also likely revisit their inflation and growth forecasts for the second quarter in a row in the *Statement on Monetary Policy* on 10 February.

Food for thought for the RBA as CPI falls

A lower-than-expected increase in the headline inflation rate of 0.0%/qtr in Q4 11, with the annual rate down to 3.1%/yr **should allow the Reserve Bank of Australia (RBA) to continue its easing cycle by reducing the cash rate by 25bp to 4.0% at the next Board meeting** (on 7 February). It also raises the possibility of a further easing, dependent on the pass through to mortgage rates by the major banks and offshore events, particularly the European sovereign debt crisis.

What could provide the RBA food for thought however, is underlying inflation, which rose a larger-than-expected 0.55%/qtr, taking the annual rate to 2.6%/yr. However it is important to note the underlying inflation is rising at a slower pace than 1H 2011, when underlying inflation was on average +0.8%/qtr.

This easing in headline inflation coupled with global events and benign domestic data (particularly employment and consumption) could see the RBA move interest rates from a roughly 'neutral' position on monetary policy, to a more accommodative setting. The size and number of further easing will be dependent on the pass through to mortgage rates by the major banks as funding costs rise. The RBA has made it clear they are targeting the average lending rate into the Australian economy and will remain watchful of the average variable mortgage rate.

In addition, the RBA will likely revisit their inflation and growth forecasts when they release the latest *Statement on Monetary Policy* on 10 February, however current projections have the headline inflation rate falling sharply to 2%/yr by June 2012, while underlying inflation is in the middle of the target band at 2.5%. Given a weaker economic environment, inflation forecasts could be lowered slightly.

Weakening inflation pressures have also been seen globally, largely driven by falling food prices, but also weaker economic growth. Sharp falls in inflation have been experienced in the UK (now 4.2% down from a peak of 5.2%), the EU (2.7% down from a peak of 3.0%), the US (3.0% down from a peak of 3.9%) and China (4.2% down from a peak of 6.5%).

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Weakening inflation pressures are expected to encourage further easing of policy in emerging economies in 2012, in particularly in Brazil, China and India. While the UK is now expected to undertake a third quantitative easing program over coming months as inflation falls quickly due to a weak economy and base effects from a VAT hike and food and energy prices.

Australia's headline CPI inflation rate was flat over Q4, lower than market expectations of +0.2%/qtr. This took the annual pace of headline inflation to 3.1%, down marginally from 3.5% in Q3 11. Further declines are expected in the quarters ahead as the price spikes caused by the summer floods and cyclone fall out of the calculation, in particular through fruit prices.

Major increases in prices over the quarter were seen in domestic holiday travel and accommodation (+7.3%/qtr), rents (+1.0%/qtr), telecommunication equipment and services (+1.1%/qtr), beer (+1.2%/qtr) and automotive fuel (+0.7%/qtr).

Price declines were seen for fruit (-13.4%/qtr), pharmaceutical prices (-5.6%/qtr), vegetables (-5.0%), audio, visual and computing equipment (-3.4%/qtr), international holiday travel and accommodation (-1.9%/qtr) and motor vehicles (-1.2%/qtr).

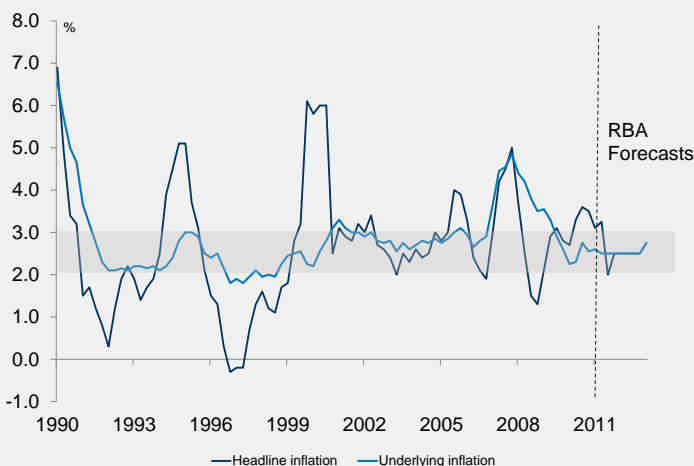
The new seasonally adjusted headline CPI rose 0.2%/qtr and 3.0%/yr with seasonal impacts from pharmaceutical products likely reducing this measure compared to the non-seasonally adjusted headline measure.

Australian inflation – Quarterly and annual changes

Q4 11	%/qtr	%/yr	Q3 11	%/qtr	%/yr
Headline CPI	0.0	3.1	Headline CPI	0.6	3.5
Underlying inflation*	0.55	2.6	Underlying inflation	0.4	2.55

*Average of 16th series seasonally adjusted trimmed mean and weighted median.
Source: ABS

Australian inflation – Quarterly and annual changes



Source: ABS & RBA. RBA forecasts as at November 2011.

In addition, the tradables component of inflation (ie. the 40% of the basket where prices are largely determined in global markets) actually fell by 1.2%/qtr. The most significant contributors to this fall were fruit, pharmaceutical products, vegetables and audio, visual and equipment.

Non-traded prices (ie. the 60% of the index determined domestically) rose by a solid 0.7%/qtr. See below for further details.

Further details:

- Over the quarter, five groups recorded falls or flat price moves, while six groups recorded price gains, indicating the divergence of price pressures in the Australian economy.
- The key group recording falls were food and non-alcoholic beverages (-1.5%/qtr), largely driven by a fall in fruit (-13.4%, with banana prices down 46%/qtr) & vegetables (-5.0%/qtr) due to improved supply and good weather conditions.
- Health (-1.2%/qtr), fell due to a decline in pharmaceutical products as a greater proportion of consumers exceeded the Pharmaceutical Benefits Scheme safety net when compared to Q3.
- Clothing and footwear (-0.5%/qtr) continued to show deflation and discounting in Q4. The main contributor being accessories (-3.7%/qtr) driven by pre-Christmas sales. This year saw Christmas sales start earlier than normal given the weak consumer environment.
- Transport prices were flat over Q4, with a 0.7%/qtr gain in automotive fuel largely offset by a fall in the price of motor vehicles by 1.2%/qtr.
- Education prices were flat over Q4, with Q1 largely seeing the bulk of price gains in this category.
- The strongest price gains were in communications through telecommunication equipment and services (+1.1%/qtr).
- Alcohol and tobacco rose, largely due to beer prices (+1.2%) as the flow on effects from higher excise taxes continued.
- The recreation and culture group saw prices rise 0.8%/qtr. The main contributor of this was a 7.3%/qtr gain in domestic holiday travel and accommodation.
- This was partially offset by continued deflation in electrical goods with audio visual and computing equipment falling 3.4%/qtr. Games, toys and hobby equipment also fell 2.7%/qtr. This category is expected to face deflationary conditions in 2012 due to large amount of imports from a strong Australian dollar and large inventory levels due to weak sales.
- On a city by city basis, and as shown in the table below, prices varied across the board. The largest price increases in Q4 11 were in Perth (+0.2%/qtr), largely due to an increase in rents and higher domestic travel costs.
- Melbourne (+0.1%/qtr), Hobart (+0.1%/qtr) and Canberra (+0.3%/qtr) also saw price gains
- Darwin saw the largest price fall (-0.4%/qtr) due to falling food prices while Sydney and Adelaide both saw prices fall by 0.1%/qtr.

Australian inflation – Capital city breakdown

Q4 11	%/qtr	%/yr
Sydney	-0.1	3.2
Melbourne	0.1	3.1
Brisbane	-0.2	2.4
Adelaide	-0.1	3.6
Perth	0.2	2.9
Hobart	0.1	3.2
Darwin	-0.4	2.4
Canberra	0.3	3.6
Weighted average	0.0	3.4

Source: ABS

For further information

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