

# Australian inflation accelerates

## Economic research note

27 July 2011

- Australia's headline inflation rose by a larger-than-expected 0.9%/qtr in Q2 11. This took the annual pace of inflation to 3.6% from 3.3% – well above the top of the RBA's 2% to 3% target range.
- Both the measures of underlying inflation also rose by a large 0.9%/qtr in Q2 11 – indicating that price increases were broad based over the period.
- The annual rate of underlying inflation jumped to 2.7% from 2.25%. Although this remains within the RBA's target band, the trend in inflation is clearly turning up at a faster pace than the RBA's current forecasts.
- The Q2 11 CPI report poses a challenge for the RBA. Inflation pressures are rising, even with the clear softness in the consumer and the strong AUD. At the same time, the level of global uncertainty remains high and financial markets look fragile.
- It seems clear, however, that the next move in monetary policy in Australia remains a tightening. A move before year-end is a real possibility if some of the global uncertainties fade in coming months.

### Australian inflation accelerates

Australia's headline CPI inflation rate rose by a larger-than-expected 0.9%/qtr in Q2 11 (consensus 0.7%/qtr). This took the annual pace of headline inflation up to 3.6% from 3.3% – well above the top of the RBA's 2% to 3% target band.

Major increases in prices over the quarter were in fruit (with ongoing effects from the severe weather events earlier in the year), automotive fuels, health costs and furniture (end of discounting). For price declines, the largest moves were seen in vegetables (which have been volatile), audio, visual and computing equipment (again), electricity (although we know this will be up sharply in Q3 11) and domestic holiday and travel costs. See below for further details.

Interestingly, tradables inflation (ie. items with prices set in global markets, which account for about 40% of the CPI basket) rose a strong 1.3%/qtr, despite the higher AUD. Non-tradables (the 60% of the basket with prices set domestically) rose by a much more modest 0.6%/qtr.

Perhaps the most significant part of the Q2 11 CPI report is, however, that both measures of underlying inflation, the trimmed mean and weighted median, also rose 0.9%/qtr – indicating that price pressures were very broad-based in this period.

As a result the pace of underlying inflation accelerated from 2.25% in Q1 11 to 2.7% in Q2 11. This is above the RBA's forecast of 2.5% for Q2 11.

The RBA currently expects the underlying inflation rate to rise to 3.0% by December 2011, and remain at this level until mid-2013. These forecasts were published, however, in May and will likely be updated at the next 'Statement on Monetary Policy', which will be published on 5 August 2011.

For monetary policy, therefore, today's higher-than-expected Q2 11 CPI poses a challenge for the RBA. Inflation in Australia's is now clearly trending higher and monetary policy will need to be tightened at some stage to help the economy adjust to this environment. At the same time, key parts of the global economy are experiencing ongoing concerns that could weigh on global growth and create further market volatility. The conclusion we draw from this is that the next move in interest rates in Australia remains up, with a move before year-end (ie. November) a real possibility.

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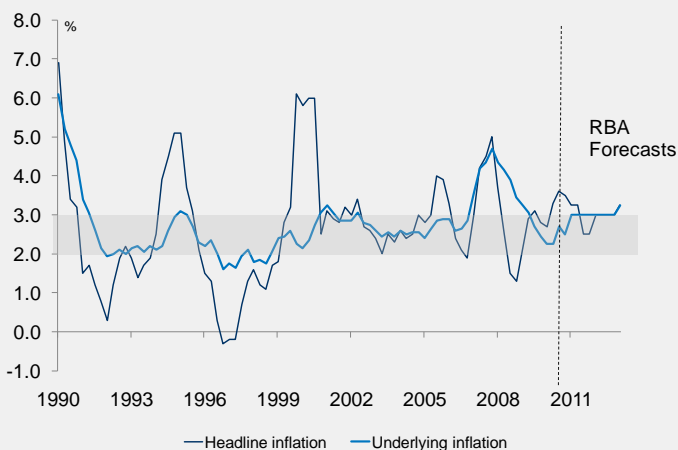
**Australian inflation – Quarterly and annual changes**

Q2 11	% /qtr	% /yr	Q1 11	% /qtr	% /yr
Headline CPI	0.9	3.6	Headline CPI	1.6	3.3
Underlying inflation*	0.9	2.7	Underlying inflation	0.85	2.25

\*Average of trimmed mean and weighted median.

Source: ABS

**Australian inflation – Headline and underlying**



Source: ABS

**Further details:**

- All but one of the key groups of inflation accelerated in Q2 11, indicating that pricing pressures were broad based in the economy during the quarter.
- The only key group to record a fall was recreation (-0.6%/qtr), largely driven by a fall in prices for domestic holiday travel and accommodation (-1.5%/qtr).
- The strongest price gains were in clothing and footwear (+2.5%/qtr), which rose after two quarters of falls. This seems at odds with anecdotal reports from retailers that the large discounting cycle was continuing. It does appear based, however, on a number of price moves in the CPI data that the discounting cycle moderated over the June quarter.
- Once again food was a major contributor to the CPI, rising 1.4%/qtr. The breakdown within this sector was quite diverse. Fruit prices rose 26.9%/qtr. Banana prices, for example, rose 138% during the quarter, taking the total increase in the past six-months due to shortages caused by Cyclone Yasi to 470%. The CPI does not account for the substitution impact of people switching bananas for a cheaper piece of fruit. In contrast, vegetable prices fell 10.3%/qtr due to favourable growing conditions (after being up 16% in Q1 11), helping to offset rises in fruit prices.

- Health (+2.0%/qtr) and transportation (+1.2%/qtr) costs also rose significantly. In the health sector, the main contributor was hospital and medical services (+3.4%/qtr), due to increases in private health funds effective 1 April 2011. In the transportation sector, automotive fuel rose 4.0%/qtr despite a fall in global oil prices.
- Another interesting contributor to higher prices was household contents and services (+1.5%/qtr). This was driven by furniture (+6.0%/qtr) and towels and linen (+7.5%/qtr). The ABS makes note that these increases were “largely due to the cessation of specials offered in the March quarter 2011”. Furniture and linen had been heavily discounted in the post Christmas sales.
- Housing costs rose 0.4%/qtr, the main contributor being rents (+1.1%/qtr). Contrary to expectations, electricity prices fell 1.5%/qtr, although we do know that electricity prices will be up sharply in Q3 11.
- Price falls continued to occur in audio, visual and computing equipment (-6.3%/qtr). Gains in the Australian dollar continued to promote the deflationary cycle, as did technological development.
- Milk prices fell 4.6%/qtr due to increased competition among the major supermarkets.
- In terms of tradables versus non-tradables inflation, both components saw price gains. Pricing pressures were stronger in the tradables component (+1.3%/qtr) due to rising food prices, automotive fuel and furniture. Non-tradables rose 0.6%/qtr and reflected prices determined in the domestic economy. Increases were largely attributable to gains in prices for services rather than goods.
- On a city by city basis, and as shown in the table below, price rises were fairly consistent across the board. The greatest price increases in Q2 11 were in Perth (+1.3%/qtr) and Canberra (+1.1%/qtr). Sydney, Brisbane, Adelaide and Darwin all saw price gains of 1.0%/qtr, while Melbourne and Hobart rose 0.7%/qtr and 0.9%/qtr respectively.
- The annual pace of inflation is currently highest in Adelaide, Sydney and Brisbane. Perhaps surprisingly, less price pressure has been evident in Perth and Darwin.

**Australian inflation – Capital city breakdown**

Q2 11	%/qtr	%/yr
Sydney	1.0	3.8
Melbourne	0.7	3.6
Brisbane	1.0	3.8
Adelaide	1.0	3.9
Perth	1.3	3.0
Hobart	0.9	3.4
Darwin	1.0	3.1
Canberra	1.1	3.7
<b>Weighted average</b>	<b>0.9</b>	<b>3.6</b>

Source: ABS

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