Australian inflation shows re-emerging price pressures

Economic Research note

28 April 2010

- Australia's headline inflation rate rose by 0.9%/qtr in the March quarter 2010, taking the annual inflation rate up to 2.9%/yr, from 2.1% previously.
- Underlying inflation rose by 0.8%/qtr and 3.05%/yr, to remain outside the RBA's 2%-3% target range.
- The main driver of inflation over the March quarter was a sharp rise in pharmaceuticals, as well as gains in vegetables, education, electricity and automotive fuel. These were partly offset by price falls in clothing, audio visual and computing equipment and fruit.

Highlights

Australia's headline Consumer Price Index (CPI) increased by 0.9%/qtr in the March quarter 2010, marginally above market expectations (+0.8%/qtr), but up from the 0.5%/qtr rise of the December quarter 2009. This took the annual rate of inflation to 2.9%, from 2.1% in the year to December 2009 and up from the cycle low of 1.3%/yr in September 2009. The headline inflation rate is now back at the upper end of the RBA's 2%-3% target band.

The underlying measures of inflation also showed rising price pressures, with the annual inflation rate remaining at elevated levels. Both the trimmed mean inflation reading and the weighted median rate increased by 0.8%/qtr, making the average underlying rate of 0.8%/qtr. The annual underlying inflation rate eased to 3.1%, from 3.4% but remains above the RBA's 2%-3% target range making it harder for the annual underlying measure to fall to the RBA forecast of 2.5% by June 2010.

With both headline and underlying inflation very near the top end of the RBA 2%-3% target range, today's data adds further support to the RBA desire to return the cash rate to a more 'normal' or 'average' setting. With global financial markets again under significant stress from concerns over sovereign risk in Europe, the RBA may be tempted to pause at the May board meeting but with the inflation outlook key to the RBA's thinking, it seems clear that further policy tightening should be expected in the months ahead, with a 5% cash rate likely well before year-end, with another move possibly in May.

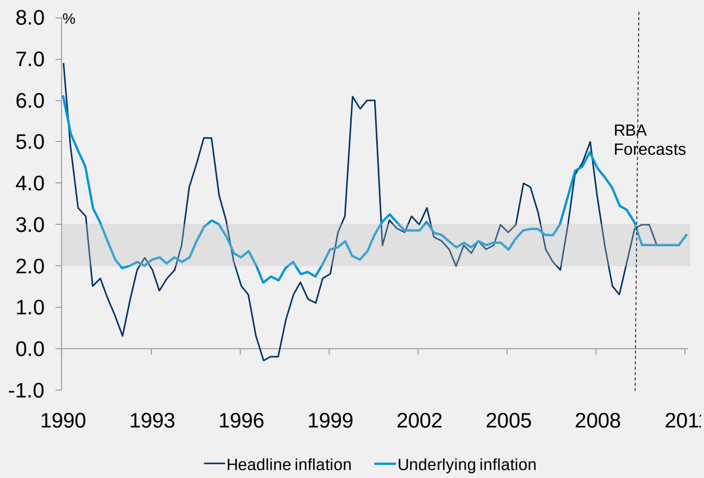
Outlook for inflation

In the latest Statement on Monetary Policy (SMP) in February 2010 (note, the next SMP will be published on 7 May) the RBA forecast Headline inflation to be 3.0% at June 2010, with Underlying inflation forecast at 2.5% (having retreated from 3.4% at end of December 2009).

March qtr 2010	%/qtr	%/yr	December qtr 2009	%/qtr	%/yr
Headline CPI	0.9	2.9	Headline CPI	0.5	2.1
Underlying inflation*	0.8	3.05	Underlying inflation	0.55	3.35

In terms of the outlook, in the February SMP the RBA expected both Headline and Underlying inflation to trend to 2.5% by year-end 2010, before rising to 2.75% by year-end 2011 and into 2012. With expectations for both the domestic and global economy having continued to improve since late last year, this raises the likelihood that the RBA will have to raise its inflation forecast in the May release. This fits in with recent commentary by the RBA of Australia having less spare capacity than normally the case at this stage in the recovery as well as expectations of the re-emergence of wage pressures in parts of the Australian economy as the unemployment rate moves back towards 5%. The re-emergence of prices pressures was also evident in yesterday's Producer Price Inflation release which is expected to flow through into Consumer Price Inflation later in 2010 and into 2011.

Chart 1: Australia's headline and underlying inflation



Source: ABS, RBA.

Implications for the RBA

The RBA has lifted the official cash rate in five of its last six meetings as it continues the process of moving interest rates back towards normal levels. The market continues to be focussed on the pace of this move back to normal and what the cash rate will be at the end of 2010. Given the RBA's stated goal to return monetary policy to a more 'normal' setting, with economic growth around average and inflation in the target, the March quarter CPI does not alter this objective by the RBA but may even speed up this move back to normal.

Currently markets are priced for roughly a 30% chance of a 25bp rate hike next week, but this now seems low considering the inflation pressures re-emerging in the Australian economy. This may be offset by renewed sovereign risk concerns in Greece and Portugal, and the delivery of the Federal Government Budget on 11 May.

Regardless of this it does appear that the RBA will move the official cash rate back to 5% before year-end (currently 4.25%). The next stage is whether the RBA takes the official cash rate into restrictive territory towards 6% in 2011. The RBA could signal a move to a restrictive policy stance by the end of 2010. The RBA is focussed on the large terms of trade impact to flow through into nominal GDP due to recent large gains in contract prices for iron ore and coal.

The RBA is not alone in tightening policy. The Reserve Bank of India has tightened its official interest rate twice in the last month while Israel continues to tighten policy and the Bank of Canada has signalled it is getting ready to remove policy stimulus given the strong recovery within the Canadian economy.

Further details

- The main driver of inflation over the December quarter was a sharp increase in Health costs, which rose 4.2%/qtr.
- This was driven by a large increase in Pharmaceuticals (+13.3%/qtr), which was due to "cyclical reduction in the proportion of consumers who qualify for subsidised medications under the Pharmaceuticals Benefit scheme at the start of each calendar year". There were also smaller contributions from hospital and medical services (+2.9%/qtr) for similar seasonal reasons, with fewer consumers qualifying for assistance at the start of the calendar year.
- Education costs also rose a significant 5.6%/qtr with the start of a new school year. Price rises were seen in tertiary education (+5.9%/qtr), secondary education (5.7%/qtr) and preschool and primary education (+4.5%/qtr). Education has been one of the sectors within the Australian economy that has consistently seen employment gains with wage pressures likely a key driver.
- Significantly, however, the Housing component saw an increase in prices of 1.5%/qtr, driven by both electricity (+5.9%/qtr) house purchases (+1.2%/qtr), rents (+1.0%/qtr) and gas &other household fuels (+3.6%/qtr).

- Food (+1.1%/qtr) and alcohol & tobacco (+1.3%/qtr) were up strongly while Financial and Insurance Services also recorded strong gains, up 2.0%.qtr. This was primarily driven by an increase in deposit and loan facilities (+3.4%/qtr).
- Offsetting these price gains were sharp falls in the prices of clothing and footwear (-4.3%/qtr), which fits with the recent discounting cycle by retailers and a 1.0%/qtr fall in Recreation.
- Other key price falls included furniture (-4.6%/qtr), fruit (-5.7%/qtr), towels and linens (-7.0%) and Audio, visual and computing equipment (-5.9%/qtr).
- Significantly, prices for goods and services that are largely determined in global markets (tradeables, which account for 42% of the CPI) rose by a muted 0.2%/qtr, thanks largely to the fall in prices for furniture, fruit, men's outerwear, audio, visual and computing equipment and overseas holiday travel and accommodation. The strong AUD has been a positive influence on the tradeables component of inflation for over 12 months now, but with the strength of the AUD now seemingly stalled, this could be an issue for tradeables inflation going forward. This was seen in the release of March quarter 2010 PPI data with imported inflation occurring for the first time in over 12 months.
- Prices for goods and services determined largely by the domestic economy (non-tradeables, 58% of the CPI) rose by a much larger 1.5%/qtr, led by price gains for house purchase, beer, gas, electricity, hospital and medical services and education.
- On a state by state basis, and as shown in the table below, price rises showed a considerable range, with the biggest price increase in the March quarter in Melbourne and Perth which arguably have experienced the strongest growth in recent months. Brisbane and Adelaide showed more muted gains. On an annual basis, the highest inflation rates are in Perth, Darwin and Hobart.

March qtr 2010	%/qtr	%/yr
Sydney	0.8	3.0
Melbourne	1.3	2.8
Brisbane	0.7	3.0
Adelaide	0.6	2.6
Perth	1.1	3.4
Hobart	0.8	3.2
Darwin	0.5	3.5
Canberra	0.6	2.5
Weighted average	**0.9**	**2.9**

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