

# Australian underlying inflation moderates

## Economic Research note

28 July 2010

- Australia's headline inflation rose by a less-than-expected 0.6%/qtr in Q2 10, although the annual pace of inflation rose to 3.1%.
- The pace of underlying inflation moderated in Q2 10, with a quarterly rise of 0.5% taking the annual pace to 2.7% from 3.05%.
- This moderation in underlying inflation pressures is likely to see the RBA's pause on policy tightening extend into the August meeting and for a few more months yet.
- However, market expectations that monetary policy will remain on hold well into 2011 could be under-estimating the risk of further tightening given the wages pressures likely to flow from the strength in the labour market and the economic impact of further gains in Australia's terms of trade.

### Australian underlying inflation moderates:

Australia's headline CPI inflation rose by a lower-than-expected 0.6%/qtr in Q2 10 (consensus forecast was 1.0%/qtr). The annual pace of headline inflation, however, accelerated to 3.1% from 2.9%.

The more important underlying inflation rate rose by a low 0.5%/qtr (both the trimmed mean and weighted median were up 0.5%/qtr). This took the annual pace of underlying inflation down to 2.7% from 3.05% in Q1 10. This moderation in the underlying CPI is consistent with the RBA's stated view and likely means that the Reserve Bank can continue to hold the official cash rate steady at 4.5% when the Board meets next Tuesday.

Indeed, markets have now priced out any chance of a rate hike next week (down from 8bp or approx. 30%), with only 5bp of tightening priced in by year-end and 12bp i.e. approx. half a tightening, priced in by mid-2011. With the strength of the employment market and the implication for wages of this, as well as the rapid rise of the terms of trade in recent months, current market pricing likely under-estimates the actual tightening path later in 2010 and into 2011.

For Q2 10, the biggest price increases came from alcohol & tobacco prices, due mainly to tax changes, and health costs. On the downside, there were big falls in food, communications and recreation. Interestingly, tradeable goods inflation rose by a strong 1.0%/qtr, with non-tradeables up just 0.3%/qtr. See below for a more detailed breakdown of the data.

Based on the May 2010 *Statement on Monetary Policy*, the RBA expects the underlying inflation rate to remain around 2.75% through to the end of 2011, before moving to 3.0% in 2012. This forecast was also based on a monetary policy tightening profile that has been reduced in markets and, as noted above, given the employment/wage pressures that could be expected to flow through the economy, the risk to inflation over the medium-term, and therefore, interest rates will remain to the upside.

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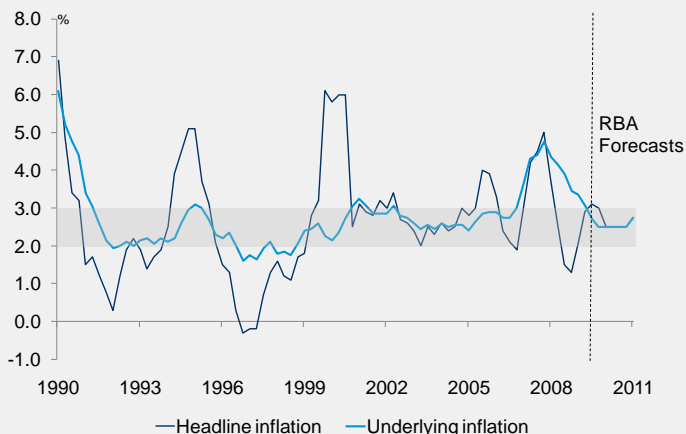
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June qtr 2010	% /qtr	% /yr	March qtr 2010	% /qtr	% /yr
Headline CPI	0.6	3.1	Headline CPI	0.9	2.9
Underlying inflation*	0.5	2.7	Underlying inflation	0.8	3.05

\*Average of trimmed mean and weighted median.  
Source: ABS

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Source: ABS

#### Further details

- The main driver of inflation over Q2 10 was a sharp increase in alcohol and tobacco, which rose 5.9%/qtr.
- This was driven by a large increase in tobacco prices (+15.4%/qtr), which was due to a 25% increase in excise tax on the 30<sup>th</sup> April 2010. According to the ABS this was the largest increase in tobacco since December 1975.
- Health costs also rose a significant 2.2%/qtr, with increases in private health fund premiums from 1 April 2010. There was some offset in pharmaceuticals (-1.3%/qtr) due to the effect of the Pharmaceuticals Benefits Scheme safety net.
- There were also minor price rises in housing (+0.6%/qtr) driven by rising rents (+1.1%/qtr) in Sydney and Darwin, while rises in house purchases costs were particularly strong in Perth (+1.1%). This would be related to the relative housing supply shortage in Sydney and the strength in the resources sector driving Perth house prices higher. Electricity prices (-0.6%) recorded a small fall after very strong price rises over 12 months which are up 18.8%. We do know, however, that electricity prices will rise very sharply in Q3 10.
- Transportation prices also rose (+0.7%/qtr) driven by a rise in automotive fuel (+2.1%/qtr). One offset was falling urban transport fares (-1.6%), one example of where supply side price pressures caused upward price pressures.
- Offsetting these price gains were sharp falls in the prices of recreation items (-1.8%/qtr), which fits in with weaker consumer spending and significant discounting on domestic airfares as well as the low season pricing on holiday accommodation.

- Domestic holiday travel and accommodation fell 6.0%/qtr and audio, visual and computing equipment (-6.3%) continued to show price falls given discounting.
- 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).
- Food prices (-0.3%/qtr) also fell, driven by falls in fruit (-4.8%/qtr) and vegetables (-3.0%) due to seasonal availability and generally favourable weather conditions.
- Clothing and footwear prices were flat, with falls in women's footwear (-3.8%/qtr), but this was offset by gains in children's clothing and accessories.
- Contrary to previous trends, prices for goods and services that are largely determined in global markets (tradeables, which account for 42% of the CPI) rose by 1.0%/qtr, thanks to strong gains in prices for tobacco, automotive fuel, furniture, pets and pet food. This was offset by falls in audio, visual and computing equipment and vegetables.
- Prices for goods and services determined largely by the domestic economy (non-tradeables, 58% of the CPI) rose by a much smaller 0.3%/qtr, with small price gains such as house purchase, beer and gas offset by movements in electricity prices and the sharp fall in domestic holiday and travel.
- What this does highlight is the impact the heavy discounting cycle is having on domestic price pressures, especially in travel, clothing and audio visual. As employment gains continue and wage pressures rise, we would expect to see some relief in this discounting cycle.
- 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 June qtr in Perth (+0.9%/qtr) and Darwin (+0.8%/qtr), which arguably have experienced the strongest growth in recent months. Sydney and Hobart both recorded price gains of 0.4%/qtr.

March qtr 2010	%/qtr	%/yr
Sydney	0.4	2.9
Melbourne	0.6	3.1
Brisbane	0.7	3.2
Adelaide	0.7	2.8
Perth	0.9	3.5
Hobart	0.4	3.0
Darwin	0.8	3.2
Canberra	0.3	2.3
<b>Weighted average</b>	<b>0.6</b>	<b>3.1</b>

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