

# Low Australian inflation gives the RBA room to ease

## Economic research note

26 October 2011

- Australia's headline inflation rose 0.6%/qtr in Q3 11, taking the annual pace of inflation down marginally to 3.5% from 3.6%.
- More importantly, the measures of underlying inflation rose by a lower-than-expected 0.3%/qtr for both the seasonally adjusted trimmed mean and weighted median.
- This took the annual rate of underlying inflation down to just 2.45% from 2.75%, ie. the middle of the RBA's 2%-3% target range.
- The low Q3 11 CPI reading should see the RBA follow through on their easing bias and reduce the cash rate by 25bp to 4.5% at next Tuesday's Board meeting.
- In addition, the RBA will also likely reduce their underlying inflation forecasts significantly from the current 3%-3.25% out to end 2013 at the *Statement on Monetary Policy* on 4 November.

### Low Australian inflation gives the RBA room to ease

A lower-than-expected increase in the underlying inflation rate of just 0.3%/qtr in Q3 11, taking the annual rate down to the middle of the 2%-3% target range at 2.45% from a revised 2.75%, **should allow the Reserve Bank of Australia (RBA) to follow through on their recent easing bias and reduce the cash rate by 25bp to 4.5% at next Tuesday's Board meeting** (this will be the 6<sup>th</sup> year in a row that monetary policy has been altered on Melbourne Cup day).

**This easing would be consistent with the RBA moving back towards a 'neutral' position on monetary policy**, rather than the currently 'mildly restrictive' setting.

An easing next week would also be consistent with the comments from the RBA after the October meeting that "an improved inflation outlook would increase the scope for monetary policy to provide some support to demand, should that prove necessary."

In addition, the RBA will likely revise downwards their underlying inflation forecasts when they release the latest *Statement on Monetary Policy*, due 4 November, as the current forecasts of 3%-3.25% underlying inflation out to end 2013 now look too high.

The new 16<sup>th</sup> series seasonally adjusted trimmed mean CPI rose by just 0.3%/qtr in Q3 11, with an annual rate of 2.3%, well down from the revised 0.8%/qtr, 2.6%/yr rate of Q2 11. The weighted median CPI also rose by a low 0.3%/qtr and 2.6%/yr, down from a revised 0.8%/qtr and 2.9%/yr in Q2 11.

Australia's headline CPI inflation rate rose by an as-expected 0.6%/qtr in Q3 11. This took the annual pace of headline inflation to 3.5%, down marginally from 3.6% in Q2 11. Further declines are expected in the quarters ahead as the price spikes caused by the summer floods-cyclone fall out of the calculation.

Major increases in prices over the quarter were seen in utilities (electricity 7.8% & water 8.6%), overseas holiday travel and accommodation (5.1%), property rates and charges (5.2%) and rents (1.2%). Price declines were seen for pharmaceutical products (-5.0%), audio visual and computing equipment (-3.3%) fuels (-1.4%) and fruit (-1.2%) & vege (-2.5%) prices.

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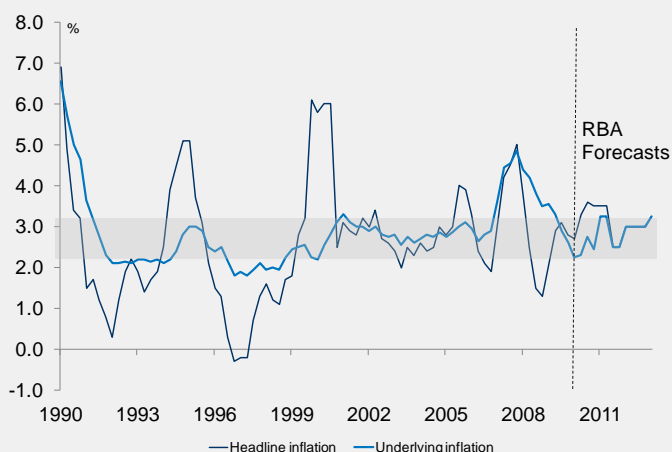
In addition, the tradables component of inflation (ie. the 40% of the basket where prices are largely determined in global markets) actually fell by -0.2%/qtr.

Non-traded prices (ie. the 60% of the index determined domestically) rose by a solid 1.2%/qtr. See below for further details.

**Australian inflation – Quarterly and annual changes**

Q3 11	% /qtr	% /yr	Q2 11	% /qtr	% /yr
Headline CPI	0.6	3.5	Headline CPI	0.9	3.6
Underlying inflation*	0.3	2.45	Underlying inflation	0.8	2.75

\*Average of 16<sup>th</sup> series seasonally adjusted trimmed mean and weighted median.  
Source: ABS



**Australian inflation – Headline and underlying (RBA forecast expected to be revised down)**

Source: ABS & RBA

**Further details:**

- All but three of the key groups of headline inflation accelerated in Q3 11, indicating that headline pricing pressures were relatively broad based during the quarter.
- The key groups recording falls were food and non-alcoholic beverages (-0.2%/qtr), largely driven by a fall in fruit & vegetables prices, and health (-1.0%/qtr), driven primarily by declines in pharmaceutical products. Communication remained unchanged for the quarter.
- The strongest price gains were, not surprisingly, in utilities, especially electricity (+7.8%/qtr), water and sewerage (+8.6%/qtr) and property rates and change (+5.2%/qtr). International holiday travel and accommodation prices also rose strongly over the quarter (+5.1%/qtr).
- Unlike last quarter, food was not a major contributor to the CPI, falling -0.2%/qtr, after a 1.4% rise in Q2 11. Fruit (-1.2%/qtr) and vegetable (-2.5%/qtr) prices both moderated in Q3 11, mainly due to seasonal factors and favourable weather conditions.

- Fruit prices have, however, risen +65.8% for the 12 months to Q3 11 mainly driven by the shortages in bananas caused by Cyclone Yasi. Note that the CPI does not account for the substitution impact of people switching bananas for a cheaper piece of fruit. Take-away and fast foods (+1.0%/qtr) offset falls in fruit and vegetables.
- Housing was again a significant contributor to higher prices (+1.9%/qtr). This was primarily due to previously mentioned rises in utilities, property rates and rental prices (+1.2%/qtr) in Canberra and Sydney.
- Clothing and footwear also contributed significantly to the CPI (+1.5%/qtr), partly due to a rebound from sales in Q2 11.
- Insurance and financial services (+0.7%/qtr) rose modestly in Q3 11, mainly resulting from high premiums for house and household content insurance.
- Transport (+0.1%/qtr) rose only slightly after prices declines in automotive fuel (-1.4%/qtr) and motor vehicles (-1.0%/qtr) was offset by rises in maintenance and repair (+3.8%/qtr) and other services relating to motor vehicles (+2.1%/qtr).
- As noted above, pricing pressures were strongest in the domestic or non-tradables component of inflation (+1.2%/qtr). Price pressures were greatest for electricity, water and sewerage, gas and other household fuels and take-away and fast foods.
- On the other hand, Tradables prices fell 0.2%/qtr and reflected prices determined in the on the world market and the ongoing strength of the AUD. Among other categories, falls were largely attributable to declines in prices for pharmaceutical products, audio, visual and computing equipment and automotive fuel and were offset by rises in tobacco, accessories and footwear.
- On a city by city basis, and as shown in the table below, price rises varied slightly across the board. The largest price increases in Q3 11 were in Adelaide (+1.0%/qtr) and Hobart (+0.8%/qtr). Sydney, Darwin, and Canberra all saw price gains of +0.7%/qtr, while Melbourne rose 0.6%/qtr. Perth (+0.2%/qtr) and Brisbane (+0.3%/qtr) experienced the smallest gains.
- The annual pace of inflation is currently highest in Adelaide, Sydney, Melbourne and Canberra. Perhaps surprisingly, less price pressure has been evident in Perth and Darwin.

Australian inflation – Capital city breakdown

Q3 11	%/q tr	%/yr
Sydney	0.7	3.7
Melbourne	0.6	3.6
Brisbane	0.3	3.1
Adelaide	1.0	4.0
Perth	0.2	2.8
Hobart	0.8	3.2
Darwin	0.7	2.8
Canberra	0.7	3.7
<b>Weighted average</b>	<b>0.6</b>	<b>3.5</b>

Source: ABS

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