# Australian inflation headline low but underlying rate remains elevated

## Economic note

**28 October 2009**

- Australia's headline inflation rate rose by 1.0% in the September quarter, taking the annual inflation rate down to just 1.3%.
- The news for underlying inflation on an annual basis was not as good, however, rising 0.8%/qtr and 3.5%/yr, to remain outside the RBA's 2%-3% target range.
- The main drivers of inflation over the September quarter were Housing and Transport while Health detracted from inflation.
- The RBA looks to have increased their underlying inflation forecast in recent months, consistent with their desire to return monetary policy to a more 'normal' setting.
- With the real cash rate still close to zero the RBA is likely to continue to monetary policy tightening process at next week's Board meeting and into 2010.

| Sept quarter 2009 | %/qtr | %/yr | June quarter 2009 | %/qtr | %/yr |
|---|---|---|---|---|---|
| Headline CPI | 1.0 | 1.3 | Headline CPI | 0.5 | 1.5 |
| Underlying inflation* | 0.8 | 3.5 | Underlying inflation | 0.8 | 3.9 |

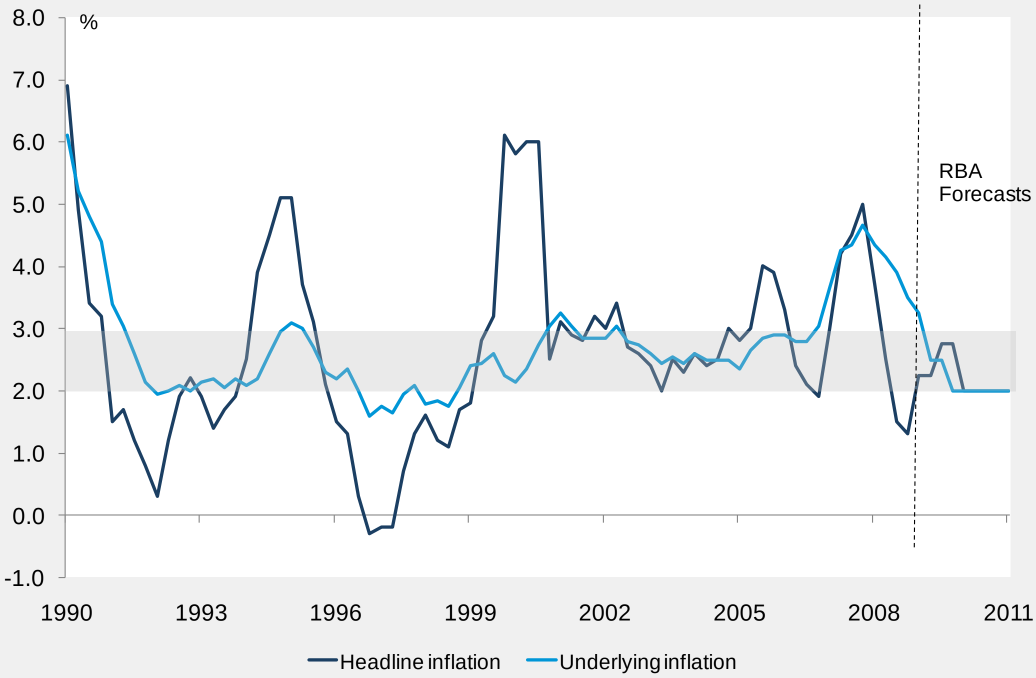
* Underlying is the average of the Trimmed mean and weighted median

**Highlights**

Australia's headline Consumer Price Index (CPI) increased by 1.0%/qtr in the September quarter 2009, slightly above market expectations (0.9%/qtr) and up from the 0.5%/qtr rise of the June quarter. This took the annual rate of inflation down to 1.3%, from 1.5% in the year to the June quarter 2009. This headline inflation rate is obviously well below the RBA's 2%-3% target band and is the lowest annual headline inflation rate since June 1999.

However, as was the case in the June quarter, the inflation news for the Underlying measures, was not as positive with the annual growth rate remaining at elevated levels. The trimmed mean inflation reading increased by 0.8%/qtr, while the weighted median rate also rose by 0.8%/qtr. The annual underlying inflation rate declined to 3.5%, from 3.9%, but remains above the RBA's 2%-3% target range.

**Chart 1: Australia's Headline and Underlying inflation**




Source: ABS and RBA

**Implications for the RBA**

The RBA's expectations for underlying inflation look to have changed in the past few months. In the August "Statement on Monetary Policy" the RBA noted that "overall, the Bank's central forecast is for underlying inflation to decline, reaching a trough of around 2% by mid 2011. This is an upward revision relative to the forecasts at the time of the May *Statement* (which was 1.5%), mainly reflecting the improvement in the outlook for the domestic economy."

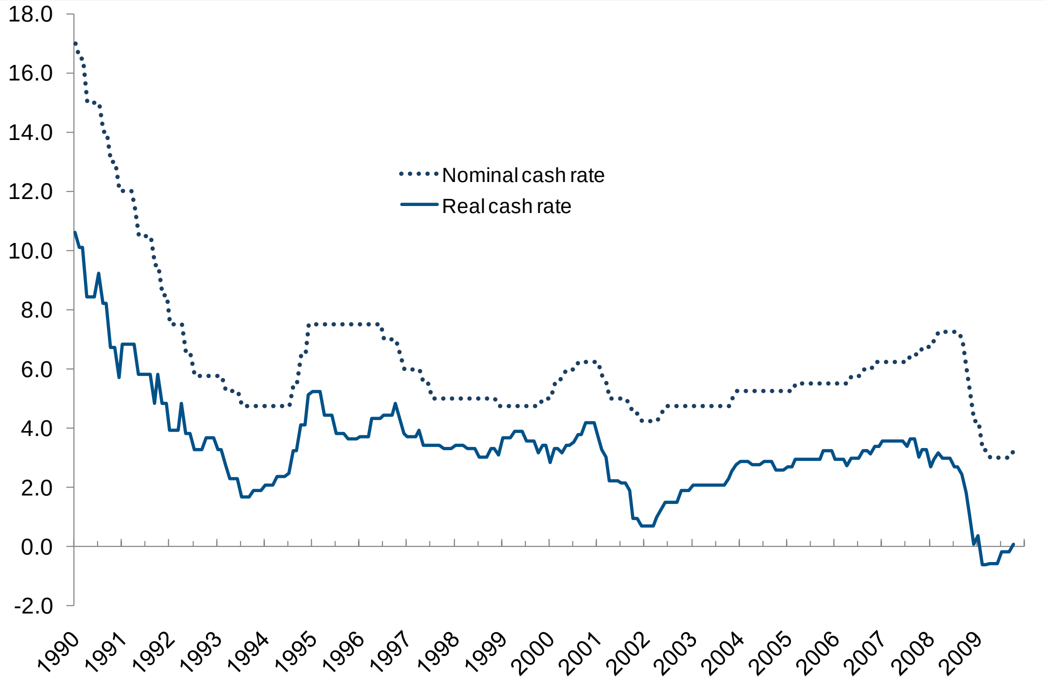
By the time the RBA tightened policy at the October Board meeting the Bank stated that "underlying inflation was still, on the latest data, above the target and, while current forecasts suggested it would fall in the coming year, the expected trough in inflation was significantly higher than earlier thought." This suggests that at the November "Statement on Monetary Policy" the RBA could revise their Underlying inflation forecast higher again to a trough of around 2.5%, ie. the mid-point of the target range.

Today's inflation news provides support to the RBA's decision to begin the process of returning monetary policy to a more 'normal' setting. In essence, an outlook for mid-target range inflation is not consistent with an extremely stimulatory setting of monetary policy. Indeed, using the Trimmed-mean underlying inflation rate, the current 3.25% real cash rate is close to zero, although is on the rise.

As shown in Chart 2, the real cash rate remains among the lowest level in the RBA's inflation targeting regime (which can be dated from 1993) and does not seem consistent with the RBA's latest views on the outlook for underlying inflation.

Hence, market expectations continue to be centred on a further monetary policy tightening at next week's (Melbourne Cup day) RBA Board meeting, with a 25bp rise to 3.5% the consensus view. The consensus view is then for an increase in the cash rate to 3.75% in December, 4.5% by mid-2010 and close to 5.0% by year-end 2010.

## Chart 2: RBA nominal and real cash rate




Underlying inflation rate is All groups – ex volatile items from 1990 to 2003 and Trimmed mean from 2003 to 2009
Source: RBA, ABS and Colonial First State Global Asset Management

**Further details**

- The most significant price increases in the September quarter 2009 were in: Water and sewerage (+14.1%) and Electricity (+11.4%), explaining the strong contribution from housing to the headline measure. Other strong price gains were seen in property rates and charges (+5.7%), pets, pet foods and supplies (+5.4%) and automotive fuel (+4.0%). Offsetting these increases were falls in vegetables (-5.6%), fruit (-5.4%) and pharmaceuticals (-4.4%) reflecting the strong currency.

- For the broad prices categories, the biggest increases on the quarter were in the prices of Housing (+2.9%) and Transport (+1.9%). These were offset by Health (-1.0%), after a strong gain in the June quarter, and Food (-0.8%). Education costs were flat over the September quarter.

- Over the year to the September quarter, the main price increases were Education (+5.6%), Housing (+5.5%), Health (+4.4%), Alcohol and Tobacco (+4.0%) and Household contents and services (+4.0%). These were offset by falls in Financial and insurance services (-7.2%) and Transportation (-5.1%).

- It is interesting to note that the biggest price increases in the September quarter were in ‘non tradeables’, ie. goods and services that are influenced by domestic pressures and not subject to prices on the world market. Prices for non tradeables rose 1.5% in the September quarter, driven by a rise in the domestic goods component (+2.6%) arising from higher prices for rents, electricity and water. The tradeables component rose 0.2%.

- On a state by state basis, the biggest price increase in the September quarter was Darwin at +1.9%/qtr, mainly due to housing and recreation with Brisbane the next strongest at 1.3%/yr. Melbourne recorded the weakest growth rate over the quarter of 0.6%.

- On an annual basis, then highest inflation rates are in Darwin (+2.7%/yr), Brisbane (+1.9%/yr) and Hobart (+1.8%/yr). Melbourne has recorded a low annual growth rate of 0.6%/yr. See table for details.

| Sept quarter 2009 | %/qtr | %/yr |
|---|---|---|
| Sydney | 1.1 | 1.3 |
| Melbourne | 0.6 | 0.6 |
| Brisbane | 1.3 | 1.9 |
| Adelaide | 1.1 | 1.4 |
| Perth | 0.8 | 1.2 |
| Hobart | 1.2 | 1.8 |
| Darwin | 1.9 | 2.7 |
| Canberra | 0.9 | 1.4 |
| **Weighted average** | 1.0 | 1.3 |

Source: ABS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