

# Australian inflation eases marginally

## Economic note

27 January 2010

- Australia's headline inflation rate rose by 0.5%/qtr in the December quarter 2009, taking the annual inflation rate up to 2.1%/yr, from 1.3% previously.
- Underlying inflation rose by 0.65%/qtr and 3.4%/yr, to remain outside the RBA's 2%-3% target range. Nevertheless, the underlying inflation increase in the December quarter 2009 was the lowest since the March quarter 2007.
- The main driver of inflation over the December quarter was a sharp rise in food prices, as well as gains in holiday expenses, house purchase costs, rents and beer. These were partly offset by price falls in petrol, TVs, computers and pharmaceuticals.
- Significantly, prices in those parts of the economy subject to global forces (tradeables) rose just 0.1%/qtr, thanks in part to the strong AUD, while prices determined largely in the domestic economy (non-tradeables) rose a much stronger 0.8%/qtr.
- Given the weakness of the economy over 2009, earlier falls in capacity use and the rise in the AUD, underlying inflation could be expected to continue to moderate in the year ahead and this remains the RBA forecast.
- In tightening policy last year, however, the RBA expressed concern that with the economy now improving again and with underlying inflation likely to trough near the mid-point of the target range, the time had come to return monetary policy to a more 'normal setting'. This process is expected to continue over 2010, most likely resuming at the February board meeting.

December qtr 2009	%/qtr	%/yr	September qtr 2009	%/qtr	%/yr
Headline CPI	0.5	2.1	Headline CPI	1.0	1.3
Underlying inflation*	0.65	3.4	Underlying inflation	0.8	3.5

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

**Highlights**

Australia's headline Consumer Price Index (CPI) increased by 0.5%/qtr in the December quarter 2009, marginally above market expectations (0.4%/qtr), but down from the 1.0%/qtr rise of the September quarter. This took the annual rate of inflation up to 2.1%, from a cyclical low of 1.3% in the year to the September quarter 2009. The headline inflation rate is, therefore, back into the RBA's 2%-3% target band for the first time since the March quarter 2009.

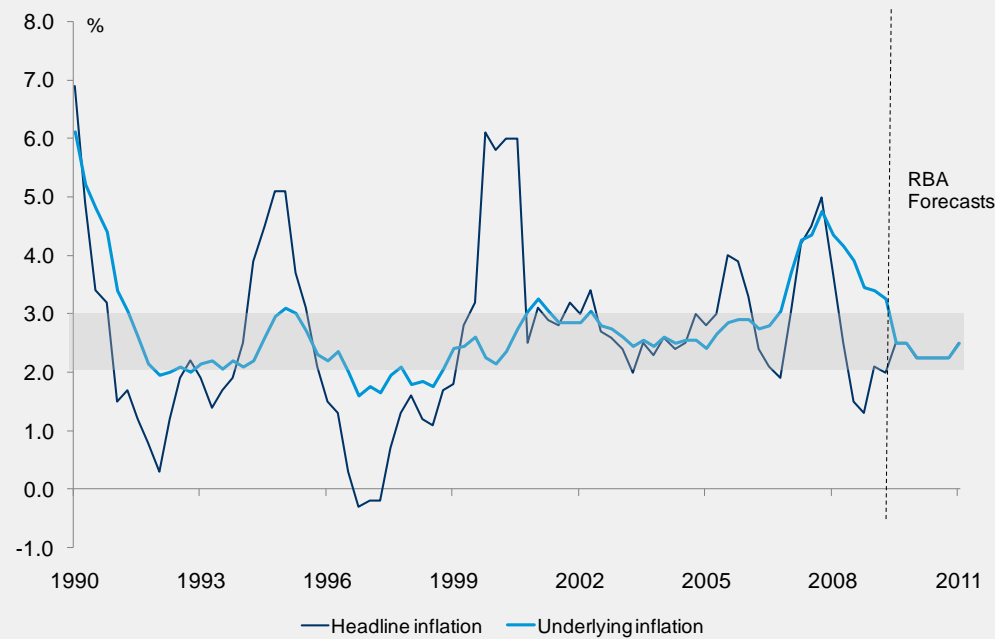
The inflation news for the underlying measures, however, was more mixed, with the annual inflation rate remaining at elevated levels. The trimmed mean inflation reading increased by 0.6%/qtr, while the weighted median rate rose by 0.7%/qtr, to give an average underlying rate of inflation of 0.65%/qtr. The annual underlying inflation rate, therefore, eased only marginally to 3.4%, from 3.5% and remains above the RBA's 2%-3% target range. It is worth noting, however, that the December quarter underlying increase of 0.65%/qtr was the lowest since the March quarter 2007 and well down on the 1.1%/qtr and 0.8%/qtr gains seen earlier in 2009.

**Outlook for inflation**

In the latest Statement on Monetary Policy (SMP) in November 2009 (note, the next SMP will be published on 5 February) the RBA forecast Headline inflation to be 2.0% at the end of 2009, with Underlying inflation forecast at 3.25%. Today's data therefore puts both the headline and underlying inflation rate slightly above the RBA's own forecasts.

In terms of the outlook, in the November SMP the RBA expected both Headline and Underlying inflation to trend to 2.25% by year-end 2010, before heading back to 2.5% by year-end 2011 and into 2012. With expectations for both the domestic and global economy having continued to improve since late last year, it is likely that the February 2010 SMP will again see the RBA revise up its inflation expectations for 2010 and beyond.

**Chart 1: Australia's headline and underlying inflation**



Source: ABS and RBA

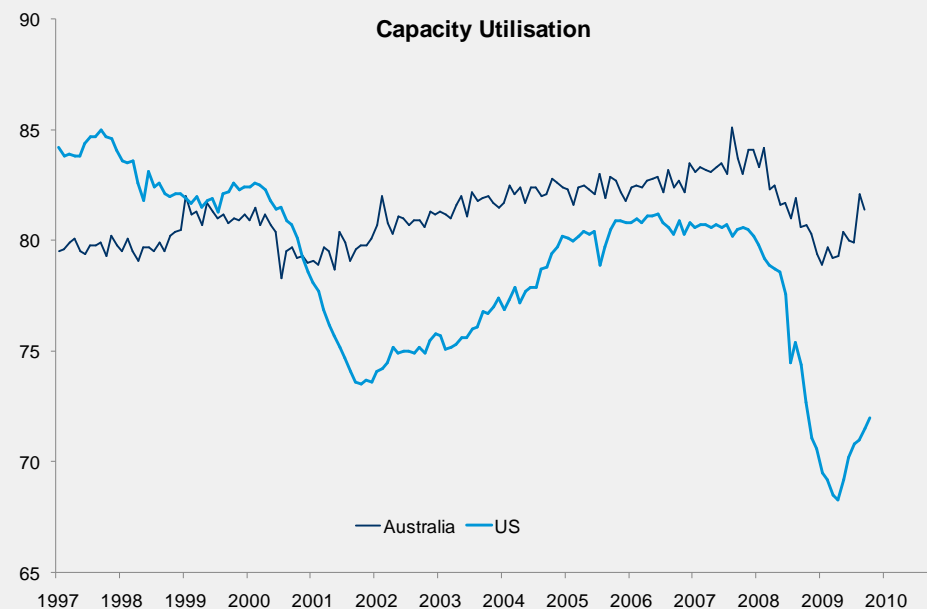
### Implications for the RBA

Having tightened monetary policy in the last three meetings of 2009, taking the cash rate to 3.75% from 3.0%, the market remains focused on next Tuesday's first RBA Board meeting for the year. Given the RBA's stated goal to return monetary policy to a more 'normal' setting, the December quarter 2009 CPI does not appear to have been sufficiently low enough to see the RBA pause in its policy path next week. As such, markets are priced for a 75% chance of a 25bp rate hike next week, an opportunity the RBA is unlikely to forego.

The willingness of the RBA to move ahead of just about all other developed nations in tightening policy (but not some developing nations, such as China and, likely later this week, India) can be neatly summed up by the chart below. It shows the difference between Australian and US capacity use over the past 13 years. Quite clearly the Australian economy is running much closer to capacity constraints than the US, a fact that can also be seen in the relative unemployment rates, 5.5% vs. 10%.

Given this, the local markets are priced for a cash rate of 4.75%-5.0% by year-end 2010, a rate widely considered to be close to 'normal'.

Chart 2: Australia and US capacity use



Source: Bloomberg

### Further details

- The main driver of inflation over the December quarter was a sharp increase in food prices, which rose 1.4%/qtr. This was driven by a large increase in fruit prices (+15.9%/qtr), which was due to “adverse weather in some growing areas, which resulted in lower yields and short supplies.” Significantly, however, the Housing component saw an increase in prices of 0.8%/qtr, driven by both house purchase prices (1.0%/qtr) and rents (1.0%/qtr). Recreation prices were also up a strong 1.5%/qtr, led by gains in domestic holiday travel and accommodation (+6.6%/qtr) and overseas holiday travel and accommodation (+2.3%/qtr). Not surprisingly, given the recent sharp appreciation of the AUD, this was partly offset by a sharp 7.1%/qtr fall in the prices for audio, visual and computing equipment.
- Other significant price increases in the December quarter were seen for the price of insurance services (1.3%/qtr), beer (2.1%/qtr), spirits (0.8%/qtr), men's clothing (1.1%/qtr), furniture (1.4%/qtr) and tools (1.3%/qtr). These increases were partly offset by declines in the prices of petrol (-2.8%/qtr), motor vehicles (-0.3%/qtr), pharmaceuticals (-5.3%/qtr), children's footwear (-3.4%/qtr) and major household appliances (-2.8%/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 very muted 0.1%/qtr, thanks largely to the fall in prices for petrol, electronic equipment and pharmaceuticals. The strong appreciation of the AUD over 2009 is clearly having an impact here. But with the strength of the AUD now seemingly stalled, this could be an issue for tradeables inflation going forward.

- Prices for goods and services determined largely by the domestic economy (non-tradeables, 52% of the CPI) rose by a much larger 0.8%/qtr, led by price gains for house purchase, beer, gas, electricity, domestic holiday travel, rents insurance and other financial services.
- On a state by state basis, and as shown in the table below, the biggest price increase in the December quarter were in Sydney, Melbourne, Perth and Hobart. On an annual basis, the highest inflation rates are in Darwin, Hobart and Brisbane.

December qtr 2009	%/qtr	%/yr
Sydney	0.6	2.2
Melbourne	0.6	1.8
Brisbane	0.3	2.5
Adelaide	0.3	2.0
Perth	0.6	2.1
Hobart	0.6	2.6
Darwin	-0.1	3.0
Canberra	0.4	2.3
<b>Weighted average</b>	0.5	2.1

Source: ABS

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