

Australian CPI Preview, Q1 2008

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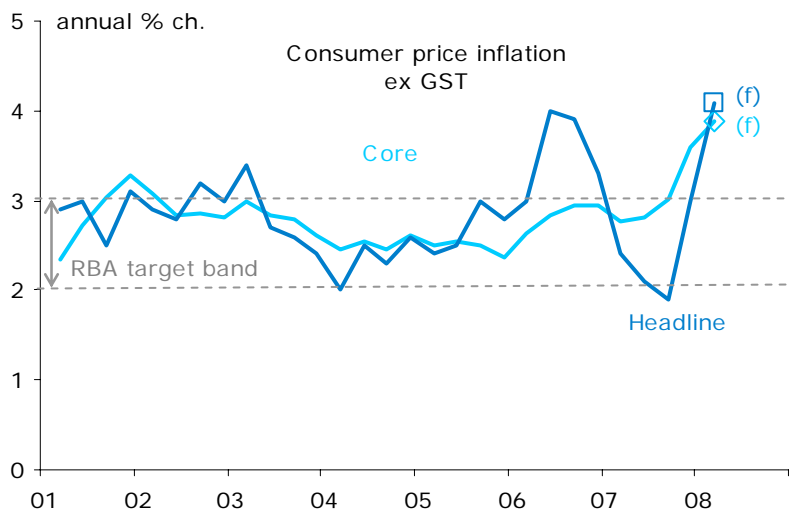
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- Expect some high figures in next week's CPI release for the March quarter. ANZ is forecasting the annual rate of both core **and** headline to exceed the top of the RBA's 2-3% target band for the first time since the December quarter 2001.
- Core inflation – the average of the RBA trimmed mean and weighted median measures – is expected to be elevated at 0.9% in the quarter and 3.9% over the year.
- The headline CPI is forecast to come in at 1.2% in the quarter, giving an annual inflation rate of 4.1%, driven by higher prices for petrol, rents, food, utilities and education.
- Such high outcomes will be tolerated by the RBA. The expected high inflation is to a large extent a legacy of past high economic growth rates, and the Reserve Bank is now more focused on signs that domestic demand is responding to the aggressive interest rate tightening of the past 9 months. It would require an extremely high core inflation reading of around 1.3% to prompt the Reserve into hiking rates again.
- The market is currently attaching a 73% probability of a rate cut by the end of the year. This seems overly optimistic, with inflation unlikely to return to within the 2–3% target band until mid 2009 at the earliest. This sentiment has been reinforced by recent developments on commodity markets, with recent surges in crude oil and global agricultural commodity highlighting the abundance of near-term upside risks to inflation, notwithstanding the downside risks further out stemming from slower domestic demand growth.

Headline and core inflation to be above the target band in the March quarter



CPI forecasts

	Quarter % ch		Annual % ch
	Dec-07	Mar-08 (f)	Mar-08 (f)
Headline (All groups)	0.9	1.2	4.1
RBA core	1.1	0.9	3.9
Trimmed Mean	1.1	0.9	3.8
Weighted median	1.0	0.9	4.0

Sources: ABS, RBA, ANZ

The finer detail

Headline inflation

The March quarter usually throws up a relatively strong headline inflation figure (the headline CPI is not seasonally adjusted), with seasonal price rises for a number of goods and services such as education, utilities and pharmaceuticals occurring at the start of the calendar year. In addition, there are a large number of non-seasonal factors, such as higher petrol prices, food prices and rental growth which will have contributed to headline inflation in the quarter. On the downside, seasonal discounting and the appreciation of the A\$ will have depressed the price of clothing & footwear and household contents.

Of the components affected by regular annual increases, health and education are likely to have made the largest contribution to the headline CPI (0.18 and 0.15ppt respectively). Education fees have increased by an average of 5½% in each of the past three March quarters to coincide with the start of the school year and all evidence suggests this pattern will have continued into 2008. Similarly, the annual resetting of the Pharmaceutical Benefits Scheme (PBS) will push up the cost of pharmaceuticals by almost 15%. The bi-annual increase in excise rates for alcohol and tobacco will also have contributed to the headline CPI. Utility prices tend to increase in the March quarter as well, with state government announcements implying larger increases than usual for electricity and gas.

March quarter inflation by CPI group

	Quarter		Annual
	% ch.	Cont. to % ch.	% ch.
Food	1.3	0.21	4.9
Alcohol & tobacco	1.2	0.08	4.0
Clothing & footwear	-1.4	-0.04	0.8
Housing	1.3	0.25	5.1
Household contents & services	-0.5	-0.05	-0.6
Health	3.8	0.18	4.4
Transportation	1.9	0.26	6.8
Communication	0.4	0.01	0.5
Recreation	0.5	0.05	2.2
Education	5.5	0.15	4.7
Finance & insurance services	1.3	0.12	6.4
All groups	1.2	1.2	4.1

Note: contribution points may not sum to All groups quarterly inflation rate due to rounding.

Source: Economics@ANZ

Outside the usual seasonal increases, other upward price movements worth watching out for will be in petrol prices, rental prices and food. We already know that petrol prices rose by 5% in the quarter, contributing 0.22ppt to the headline CPI. Food prices are expected to rise by 1.3% in the quarter, adding 0.21ppts to the headline CPI. Price rises are expected in components for which grains are either a direct or indirect input such as bread, cereals, eggs and poultry. High feed costs, together with reduced water allocations are also expected to prompt an increase in dairy prices. There may also be some second-round impact on the price of meals out and takeaway foods.

Historically low vacancy rates continue to put upward pressure on rents and we are forecasting an increase of 2% in the December quarter, up from 1.6% in the December quarter. This should contribute 0.10ppt to the headline CPI. There may even be some upside risk to this figure, with the Residex measure of newly advertised rentals growing by between 13% in Brisbane and 24% in Melbourne over the year to December. This will slowly start to filter more broadly through the stock of rental

properties. Financial services prices are also likely to have risen strongly, with higher borrowing rates leading to a widening in net interest margins paid by households in Q1.

Unfortunately, many of these pressures are unlikely to dissipate any time soon. High global agricultural commodity prices and the low level of water allocations in the Murray-Darling Basin will exert even greater pressure on food prices. Crude oil prices have surged so far in April with WTI crude oil prices just under US\$115/bbl at the time of writing, foreshadowing higher petrol prices in the June quarter. And further interest rate hikes will delay any pickup in dwelling construction and rental markets are expected to tighten even further.

On the downside, seasonal discounting and the high level of the A\$ will have decreased the price of clothing & footwear and household contents such as furniture and appliances in the quarter. The long-standing downward trend in audio, visual and computing good prices is also likely to continue.

Core inflation

While headline inflation is not seasonally adjusted, this is not the case for the calculation of the RBA's core measures. A large number of components deemed to be seasonal are adjusted in this instance, and this by design pushes down some quarters (including the March quarter) and pushes up other quarters. This process is expected to remove some of the heat from core inflation this time around. However, there are also a large number of price rises for non-seasonal components of the CPI such as petrol and rents this quarter. Not all of these will be stripped out of the trimmed mean and weighted median measures, and there is thus some upside risk to our core CPI forecast of 0.9% in the quarter.

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