

Underlying inflation elevated in Q1

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Key Points

- Headline consumer price inflation was surprisingly low at 0.1% in the March quarter, compared with market expectations for 0.5%. This saw the annual rate of inflation ease to 2.5%, half the peak of 5.0% in the September quarter.
- This lower than expected outcome was driven by large falls in a small number of categories including deposit and loan facilities, fuel and travel.
- Price rises on the other hand were relatively broad-based and drove an increase in underlying inflation in the quarter. The RBA's preferred measure (the average of the trimmed mean and weighted median) increased by 1.1% in Q1, compared with expectations for 0.8%.
- There was some evidence of pass-through from the weaker Aussie dollar, with tradables inflation excluding volatile items rising by 1.3%. A number of retail components which usually fall strongly in the March quarter due to seasonal discounting reported rises or only small falls.
- High inflation and a weak economy are not a good mix - just look at the 1970s. Although we doubt stagflation is the main risk at present, there are good reasons why a high underlying inflation pulse is negative for the Australian economic outlook.
- For the RBA the higher inflation number could be used as a good reason (along with many others) to maintain the pause in the easing cycle through the next three to six months. But we don't think it will prevent further rate cuts by year-end.
- Further out, inflation concerns will become less of a problem over 2009 and 2010 as prices eventually respond to weaker demand in both labour and product markets.

Key Figures

	Quarterly % change		Annual % change
	Mar-09	Dec-08	Mar-09
Core CPI	1.10	0.75	4.2
Trimmed Mean	1.00	0.60	3.9
Weighted Median	1.20	0.90	4.4
CPI (All groups)	0.1	-0.3	2.5
CPI ex volatiles*	0.3	0.5	2.5
Tradables	0.5	-1.8	0.8
Tradables ex volatiles	1.3	0.1	2.9
Non-tradables	-0.1	0.6	3.4
Goods	0.7	-1.0	1.9
Services	-0.7	0.6	3.0

* Volatiles are automotive fuels and fruit & vegetables
Sources: ABS, RBA

Mixed messages

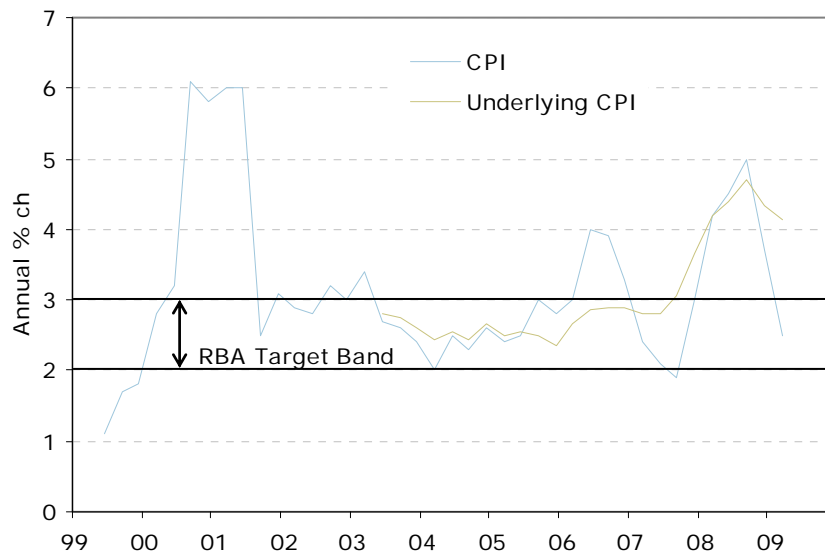
Headline consumer price inflation was surprisingly low at 0.1% in the March quarter, compared with market expectations for 0.5%. This saw the annual rate of inflation ease to 2.5%, half the peak of 5.0% in the September quarter and well within the RBA's 2 - 3% target rate.

The lower outcome was mainly driven by large temporary price falls for deposit and loan facilities (-14.1%) with lending rates falling by more than deposit rates in the quarter, and for fuel (-8.1%). These categories together subtracted 1.0ppt from the headline CPI. There were also large falls in travel and accommodation prices, both for domestic (-5.1%) and overseas (-4.0%) travel, which took off 0.2ppt from the headline CPI.

Outside of these price falls however were rises across a broad number of categories. These were largely driven by seasonal increases for health (especially pharmaceuticals), education, childcare and electricity. There were also large increases in food prices (+2.2%), with fruit and vegetable prices up 4.8%, and for rents (1.7%) given the continued housing shortage (See *The Finer Detail* below for more information).

With price increases relatively broad-based, underlying inflation was stubbornly high. The RBA's preferred measure (the average of the trimmed mean and weighted median) increased by 1.1% in Q1, compared with expectations for 0.8%. This followed underlying inflation of 0.75% in Q4 2008. These measures exclude categories experiencing the largest upward or downward movements in the quarter. However with so many categories rising, not all were excluded this quarter, thus the increase in underlying inflation. Nevertheless, core inflation has continued to ease in annual terms to 4.15% from a peak of 4.8% in the September quarter.

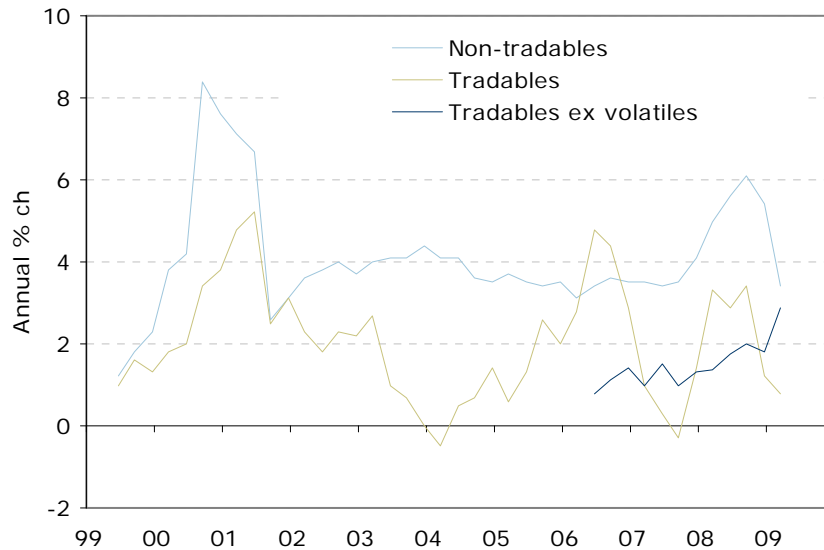
Both headline and core inflation have peaked



Source: ABS, RBA

There was some evidence of pass-through to higher inflation from the weaker Aussie dollar, with tradables inflation excluding volatile items (fuel and fruit & vegetables) rising by a solid 1.3%. Components which usually fall strongly in the March quarter due to seasonal discounting reported rises or only small falls, including furniture and furnishings (0.2%), household supplies (1.4%) and clothing and footwear (-0.5%). It thus appears that firms feel some power to pass on cost increases. Nevertheless, the size of the currency depreciation from a peak of AUD/USD 0.97 to around 0.70 currently suggests that there is margin compression taking place, with firms absorbing a fair chunk of the cost increase from the weaker currency into their margins.

Some evidence of currency passthrough in Q4



Domestically-sourced inflation pressures also remained relatively high in Q1. While non-tradables inflation and services inflation were both negative at -0.1% and -0.7%, this was entirely due to a fall in deposit and loan facilities which is unlikely to be repeated. Excluding deposit and loan facilities, non-tradables inflation and services inflation were both 1.0%. While largely driven by seasonal increases, some more demand sensitive-items such as hairdressing and personal care services (0.7%), clothing services and shoe repair (1.0%) increased relatively solidly as well.

Implications and outlook

High inflation and a weak economy are not a good mix - just look at the 1970s. Although we doubt stagflation is the main risk at present, there are good reasons why a high underlying inflation pulse is strongly negative for the Australian economic outlook.

This is despite one view that says that the best way to get out of a debt problem is through inflation. However, this relies on wages matching the increase in CPI. But if inflation is high and this translates into higher wages, this will increase the chance that corporates lay off more workers as nominal labour costs rise through a period of falling nominal revenues (the economic downturn). This risk from higher inflation in this circumstance is that the unemployment rate rises more than it otherwise would.

If higher inflation doesn't translate into higher wages (our forecast), this implies lower real wages which in turn puts pressure on household balance sheets and spending. Again, not good for the economic growth.

Either way high inflation is not good when the economy is weak.

While we are concerned about the impacts on demand from higher inflation, for the RBA today's higher number could be used as a good reason (along with many others) to maintain the pause in the easing cycle through the next three to six months. This suggests the chance of a rate cut in May (given what we know now) is extremely low. However, it does nothing to the view that rates could fall further later in the year if the economy remains weak or indeed, weakens further. We continue to expect the RBA to cut the cash rate to 2% by the end of 2009.

Indeed while today's data suggests that inflation pressures cannot be ignored, we expect **inflation to become less of a problem over 2009 and 2010 as it eventually responds to weaker demand in both labour and product markets.** It will be a slow gradual grind however, particularly if our forecast for further AUD depreciation and higher import prices is realised. We are forecasting underlying inflation to ease to around 3¼% by the end of 2009 and to 2½% by the end of 2010.

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The finer detail

When looking at the finer detail of today's CPI result, it's important to try to sift through some of the large 'one-off' and seasonal moves across some of the major components. If we look through these, we can see that to date, the impact of weaker global and domestic demand is having only a modest dampening impact on prices. Partly, this is due to the weaker AUD, which is pushing up import prices. While retailers appear to be absorbing much of this cost increase, some of it is being passed on, perhaps because to date retail sales (and thus consumer demand) here in Australia has held up better than most other parts of the world.

Financial and insurance services costs were the biggest drag on headline inflation, falling by 6.3% and dragging a huge 0.6ppt from the CPI. This was driven by an 8% fall in financial services charges, as cuts in official interest rates saw lending rates fall faster than deposit rates (which didn't fall as sharply due to increased competition in the sector for deposits). These sorts of big falls in financial services prices are unlikely to be sustained and indeed, with global funding pressures remaining elevated, we could see some increase in these prices going forward.

As expected, **transportation** costs dragged on inflation last quarter, falling 1.5% to drag 0.2ppt off the headline CPI. This was driven by an 8.1% fall in **petrol** prices, which offset a 3.3% rise in **public transport fares** and a surprising 1.3% rise in **motor vehicle prices**. The rise in motor vehicle prices suggests continued collapses in domestic demand has not been enough to offset the impact on prices from the weaker AUD. This will be an ongoing theme for inflation going forward, and supports our view that the weaker AUD will prevent sharp falls in inflation (and certainly deflation) in Australia over 2009-10.

CPI by major category – March quarter 2009

	Quarterly % change	Quarterly %pt contribution	Annual % change
Food	2.2	0.37	5.7
<i>of which: fruit & veg</i>	4.8	0.11	5.6
Alcohol & tobacco	1.0	0.07	5.7
Clothing & footwear	-0.5	-0.02	2.1
Housing	0.9	0.19	5.5
<i>of which: rents</i>	1.7	0.10	8.1
<i>of which: utilities</i>	2.7	0.10	9.7
HH contents & services	0.8	0.07	1.9
<i>of which: childcare</i>	3.0	0.01	-18.5
Health	4.4	0.20	5.3
<i>of which: pharmaceuticals</i>	13.0	0.13	2.6
Transportation	-1.5	-0.20	-4.6
<i>of which: auto fuel</i>	-8.1	-0.33	-16.7
Communication	0.4	0.01	1.0
Recreation	-1.1	-0.12	0.5
<i>of which: holiday travel & accomm.</i>	-4.5	-0.19	-0.3
Education	5.4	0.15	5.0
Financial & insurance services	-6.3	-0.60	-1.4
<i>of which: financial services</i>	-8.0	-0.64	-3.6
All groups	0.1	0.1	2.5

Source: ABS and ANZ

Recreation prices were the other notable drag on inflation in the March quarter, falling 1.1% to subtract 0.1ppt from the headline CPI. This was driven by a sharp 4.5% fall in **holiday travel and accommodation**, the biggest fall in holiday prices

since March 1992. This is clearly one sector hurting from the global and domestic recession, with domestic sector price falling 5.1% and international sector prices falling 4.5%. We would expect further discounting in this sector for at least the next quarter and suggest there is little prospect for much exchange rate pass through to international fare prices at least in the short-term.

As already noted, it appears that despite weak demand, *some* of the impact of the weaker AUD is being passed through to households. This is keeping broad-based price pressures relative elevated. **Clothing and footwear** prices fell by just 0.5% in the March quarter, a much smaller fall than usual for the March quarter, with a 1.4% rise in women's clothing offsetting modest price falls across other components.

Household contents and services prices were also robust, rising by 0.8%. Although this was led by a seasonal 3.0% rise in **childcare** prices, the prices of **household supplies** (+1.4%) and **furniture and furnishings** (+0.2%) were a higher than expected given the slowdown in the domestic economy. Going forward, we would expect chances of sharp discounting in these sectors will come under increasing pressure from a further depreciation in the AUD.

The biggest positive impact on headline inflation in the March quarter came from **food** prices, which rose 2.2% to add 0.4ppt to the CPI. This was driven by a 4.8% rise in **fruit and vegetable** prices. **Housing prices** also rose by a solid 0.9%, to add 0.2ppt to the headline CPI. This was driven by a 2.7% rise in **utility prices** as well as a strong 1.7% rise in rents. Rental price growth is now down from its peak of 2.2% in 2008 and we could see further easing from here, given the surge in first home buyers over recent months. **Education** prices were also up a strong 5.4% in the March quarter, adding 0.2ppt to the CPI. This is a seasonal start of year rise and so won't be repeated until Q1 next year. The other big seasonal mover was health prices, up a solid 4.4%, driven by a seasonal reduction in the number of consumers qualifying for subsidised pharmaceuticals and health services under the Pharmaceutical Benefits Scheme and the Medicare safety net.

The States

Headline inflation rose across all capital cities except Perth, which fell 0.1%, mainly due to a comparatively large fall in transportation, and Adelaide where the CPI was unchanged. The biggest rise was in Canberra (+0.4%). Sydney and Darwin both rose 0.1%, the average of all the states, whilst Melbourne, Brisbane and Hobart rose 0.2%. According to the ABS, the food group was the largest positive contributor in all states except Darwin while the financial and services group was the largest negative contributor. Melbourne continues to hold the lowest annual rate of inflation at +2.1% with Perth and Hobart following closely at +2.2%. Yearly inflation has fallen below +3.0% in all states except Brisbane which has been propped up by higher than average rises in housing costs such as rents and utilities.

Headline inflation by capital city - % change

	Mar-09	Dec-08	Mar-09 YoY
Sydney	0.1	-0.2	2.4
Melbourne	0.2	-0.5	2.1
Brisbane	0.2	-0.2	3.1
Adelaide	0.0	-0.3	2.3
Perth	-0.1	-0.3	2.2
Hobart	0.2	-0.2	2.2
Darwin	0.1	-0.4	2.8
Canberra	0.4	-0.4	2.7
Average	0.1	-0.3	2.5

Source: ABS and ANZ



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