ECONOMICS & GLOBAL MARKETS RESEARCH
AUSTRALIAN ECONOMIC UPDATE

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CONTRIBUTORS

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CPI PREVIEW: Q4 2010

- Australian policymakers will face some difficult decisions from the second quarter of 2011. In the short-term, the shock to the economy from widespread flooding will clearly keep the RBA, which was already on the sidelines, from further tightening. But, **the medium-term inflation outlook remains fundamentally problematic.** Reconstruction following the Queensland floods is expected to add further to capacity pressures as the mining boom gathers steam in the second half of 2011 and 2012. Indeed ANZ now expects core inflation to reach 3% by end 2011 and to remain above 3% for the remainder of 2012. This is clearly an outlook consistent with further monetary policy tightening.
- **For the first half of 2011 however, interpretation of economic indicators will be complicated by the impact of the floods** (see page 3 for further discussion surrounding the temporary impact on inflation in Q1 and Q2). This will make it difficult for the RBA to build a strong case for further tightening, with any such move to be justified entirely on the RBA's forecasts.
- **This is particularly the case given that a range of economic indicators for Q4 prior to the floods have been relatively subdued** (with the key exception of employment). This includes retail sales, exports and the NAB Business Survey.
- Next week's inflation data are unlikely to buck this trend of subdued data reads. **ANZ is forecasting the headline CPI to rise by 0.6% QoQ and 2.9% YoY.**
- The largest contributions in the quarter will come from fruit & vegetables (+0.1ppt), auto fuel (+0.1ppt), housing (+0.1ppt), holiday, travel & accommodation (+0.1ppt) and financial & insurance services (+0.1ppt). However the impact of these rises will be tempered by a seasonal fall in pharmaceutical prices (-0.05%) and flat to lower prices for a number of discretionary retail components. This includes clothing, toys and audio visual equipment due to the combined effect of the higher AUD, poor weather and discounting. There are few seasonal price rises in the December quarter.
- **Underlying inflation meanwhile** (as measured by the average of the trimmed mean and weighted median) **is forecast to be even more benign at just 0.55% QoQ**. This will be the third consecutive quarterly outcome below 0.6% QoQ and will take the annual rate of growth down to 2.4% YoY, the lowest since the December quarter 2005.

FIGURE 1: Q4 CPI FORECAST

	Quarterly % change		Annual % change
	Dec-10	Sep-10	Dec-10
Core CPI	**0.55**	**0.5**	**2.4**
Trimmed Mean	0.6	0.6	2.5
Weighted Median	0.5	0.5	2.3
CPI (All groups)	**0.6**	**0.7**	**2.9**
CPI ex volatiles*	0.4	1.0	2.9
CPI ex housing and financial & insurance services	0.5	0.3	2.1

Source: ABS, RBA and ANZ

Q4 2010 - THE DETAIL

Food prices are expected to rise 1.1% QoQ, contributing 0.2ppt to the headline CPI. This is largely in response to seasonal increases in fruit & vegetable prices (+5.5%) and to a lesser extent meat prices (+1.0%). Prices elsewhere are expected to be subdued, consistent with ongoing price competition in supermarkets (although we don't expect the same degree of discounting evident in Q3).

Alcohol & tobacco prices are expected to rise by 0.7% QoQ. While largely driven by a seasonal increase in alcohol prices (+0.9% QoQ), a smaller than usual increase is factored in due to the impact of the high AUD on wine prices and weak anecdotal reports of liquor sales.

FIGURE 2: Q4 CPI QUARTER INFLATION BY CPI GROUP

	Quarterly % change	Quarterly %pt contribution	Annual % change
Food	1.1	0.17	1.3
of which: fruit & veg	*5.5*	*0.12*	*0.5*
Alcohol & tobacco	0.7	0.06	11.4
Clothing & footwear	-0.4	-0.02	-3.5
Housing	0.6	0.13	5.0
of which: rents	*1.0*	*0.06*	*4.3*
of which: utilities	*0.6*	*0.03*	*11.8*
of which: house purchase	*0.4*	*0.04*	*2.8*
HH contents & services	0.2	0.02	0.6
of which: childcare	*1.3*	*0.00*	*7.2*
Health	-1.0	-0.05	5.2
of which: pharmaceuticals	*-5.1*	*-0.05*	*2.0*
Transportation	0.9	0.12	2.4
of which: auto fuel	*2.3*	*0.09*	*4.9*
Communication	0.3	0.01	-0.2
Recreation	0.7	0.08	-1.4
of which: audio, visual and computing equipment	*-2.2*	*-0.01*	*-16.1*
of which: holiday travel & accommodation	*2.1*	*0.08*	*-1.9*
Education	0.0	0.01	6.0
Fin. & insurance services	1.4	0.12	4.1
All groups	**0.6**	**0.64**	**2.9**

Source: ANZ, ABS

Clothing & footwear prices are expected to fall modestly (-0.4% QoQ) due to reports of weak sales and discounting prior to Christmas and poor weather impacting on demand for summer clothes. This component usually posts a small increase in the December quarter.

Housing costs are forecast to increase 0.6% QoQ, largely due to another solid increase in rents (+1.0% QoQ and 4.3% YoY). Rises for utilities and house purchase costs are forecast to be more subdued.

Household contents and services (+0.2% QoQ) are expected to be soft with the exception of a seasonal rise in childcare (+1.3%). Small price falls are assumed for furniture and appliances, consistent with soft conditions in the retail sector generally and the higher AUD.

Health costs will be dragged down by a seasonal decline in pharmaceutical costs (-5.1%) due to the operation of the PBS. Price changes for health services will be negligible.

Transportation costs will increase solidly (+0.9% QoQ) due to a 2.3% increase in observed petrol prices across the major capital cities. Urban transport fares will also increase solidly (+0.7 QoQ).

Communication costs will continue their recent subdued trend, with quality improvements (ie. greater download allowances for internet access) and competitive pressures continuing.

Recreation prices will be stronger overall (+0.7%). However, the typical seasonal increase for holiday travel and accommodation in Q4 will be smaller than usual (+2.1% QoQ), with international travel costs reduced due to the higher AUD and domestic accommodation prices under downward pressure from increased competitiveness with offshore. Meanwhile, goods such as toys and sports and recreational equipment are expected to ease slightly in line with the forecast weakness in discretionary retail components.

Education prices will be flat with price increases not scheduled for the December quarter.

Financial & insurance services will increase strongly (+1.4%) due to an increase in deposit & loan facilities. This series is highly correlated with the RBA cash rate as well as the difference between lending and deposit rates, both of which increased in Q4 according to RBA data.

Q4 2010 – THE RISKS

The risks to our Q4 forecasts appear broadly balanced for underlying inflation but could be slightly tilted to the upside for headline inflation. This is largely because at 0.64% QoQ our headline forecast is near the rounding barrier and could sneak up to 0.7%.

A larger than expected increase in the deposit & loan facilities category of financial services is also an upside risk. This is intended to capture the price of financial intermediation services to households for deposit and loan facilities, including explicit fees on products and the indirect price charged through interest rate margins. But it contains a number of sampling and methodological issues as the recent CPI review outlined and is notoriously difficult to forecast. (Note that this category will be removed from the CPI from Q3 2011 onwards).

The outcome is also highly sensitive to the degree of discounting assumed for discretionary retail items. There are no accurate leading indicators of this. While we have factored in small price falls given widespread media reports of weak sales and discounting in the lead up to Christmas, it is difficult to assess the accuracy of these reports given the high-profile media campaigns against online retailers being waged at the present.

FLOODS AND INFLATION

The inflation impact of the Queensland floods will be wide ranging and could last a number of years.

In the near term, the most notable effect will be on fruit & vegetable prices with flood-affected areas in Queensland producing 28% of Australia's fruit & vegetables. (Note that the current Victorian floods are not expected to have a large impact on fruit & vegetable production, although it is a major wheat growing region). The ultimate inflationary impact will be difficult to gauge until floodwaters recede. Not only will this help determine the extent of the crop damage, but it will also provide a clearer picture on permanent damage to transport links and whether the floods will interrupt plantings of fruit & vegetables usually harvested in Q2 and Q3.

For the time being however, **our working assumption is that the floods will increase fruit & vegetable prices nationwide by approximately 20% overall** over Q1 and Q2 and to stay at a high level in Q3. This is based on the expectation that 40% of fruit and vegetable varieties in the CPI will be affected, with a 50% price rise expected for each. **This will add approximately 0.45ppt to the CPI over Q1 and Q2.** Substitution towards cheaper fruit and vegetables will not provide an offset here, given that the CPI is a fixed weight index.

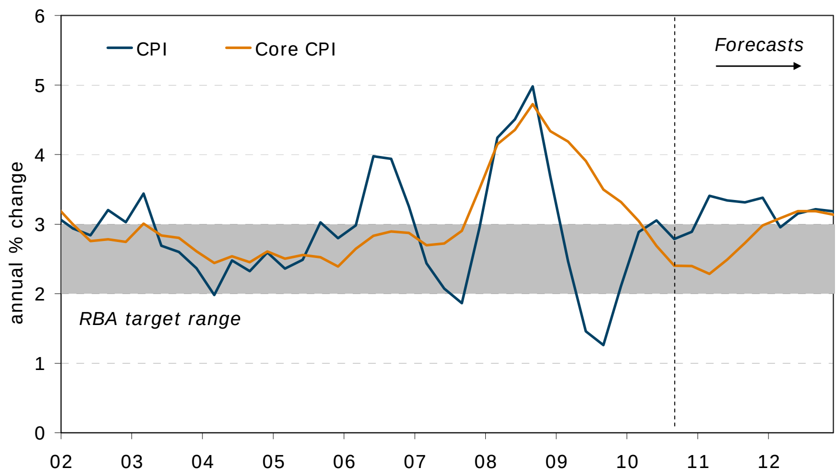
Such temporary price increases will ultimately be looked through by the RBA. However we note that there may be some temporary spillover into the RBA's favoured underlying measures, which will make interpretation of this data more difficult. This is particularly the case in Q1, when fruit and vegetable prices will be pushed up at the same time that prices for a wide variety of other prices are experiencing large rises. This includes large seasonal increases for childcare, education, pharmaceuticals and utilities, not to mention expected higher petrol prices. In this instance, it is likely that some strong items which would normally be stripped out of the underlying measures will remain in the calculation.

In the medium-term, the Queensland floods are expected to exert a more persistent upward impact on underlying inflation. The reconstruction effort will boost dwelling and non-dwelling construction for at least two years and will require a vast amount of resources (both in terms of labour and raw materials). Unfortunately, this will occur in tandem with an acceleration in mining investment. Such capacity constraints will ultimately put upward pressure on wages and inflation and/or lead to some crowding out of some projects.

The Queensland floods are also occurring at a time of higher global agricultural commodity price inflation. By the end of last year the UN World Food Price index had hit a new record high, having risen 14% in Q4 (and a full 32% over the second half of 2010). The Queensland floods, together with these higher global agricultural commodity prices, will ultimately feed through into a broader range of local fresh and processed food products. This will also find its way into underlying inflation.

As a result of these influences, ANZ is now forecast underlying inflation to reach 3% in late 2011 and to stay above 3% for the remainder of 2012 and into early 2013 (see Figure 3 below).

FIGURE 3: ANZ CPI FORECASTS: ANNUAL INFLATION RATES



Source: ABS, RBA and ANZ

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