

Some welcome inflation relief

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Key Points

- Australian inflationary pressures have started to dissipate in response to the global recession and weak domestic demand.
- Headline consumer price inflation was negative in the December quarter at -0.3% QoQ. The annual rate of inflation eased sharply to 3.7% from 5.0%.
- While the quarterly drop was largely a response to sharply lower petrol prices, inflation pressures did ease more broadly. The RBA's preferred measure of underlying inflation eased to 0.75% in the December quarter from 1.25% in the September quarter.
- Today's data highlighted three key themes:
 - There was limited evidence of pass-through from the lower currency into consumer price inflation, at least in Q4. This means that importers are running down stocks of goods purchased when the A\$ was at its highs and/or taking a hit on margins in an attempt to keep sale volumes flowing. Importers may also have received some protection from hedging contracts in Q4, although this cover is unlikely to carry over too far into 2009.
 - Inflation is responding to weaker domestic economic conditions. Non-tradables inflation eased significantly in Q4 and there was evidence of discounting in demand-sensitive components.
 - There was some evidence of margin compression, with producer prices or input prices outpacing consumer price inflation.
- Inflation will continue to subside as weak demand conditions limit business pricing power. ANZ expects underlying inflation to return to below 3% by the end of 2009, despite upward pressure stemming from the weaker currency.
- Today's results will not stand in the way of further monetary policy easing over the course of 2009. ANZ expects a 75bp cut to the RBA cash rate at next week's meeting.

Key Figures

| | Quarterly % change | | Annual % change |
|-------------------------|--------------------|-------------|-----------------|
| | Dec-08 | Sep-08 | Dec-08 |
| Core CPI | 0.75 | 1.25 | 4.35 |
| Trimmed Mean | 0.60 | 1.20 | 4.2 |
| Weighted Median | 0.90 | 1.30 | 4.5 |
| CPI (All groups) | -0.3 | 1.2 | 3.7 |
| CPI ex volatiles* | 0.5 | 1.1 | 3.7 |
| Tradables | -1.8 | 0.7 | 1.2 |
| Tradables ex volatiles | 0.1 | 0.3 | 1.8 |
| Non-tradables | 0.6 | 1.6 | 5.4 |
| Goods | -1.0 | 1.0 | 2.5 |
| Services | 0.6 | 1.4 | 5.2 |

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

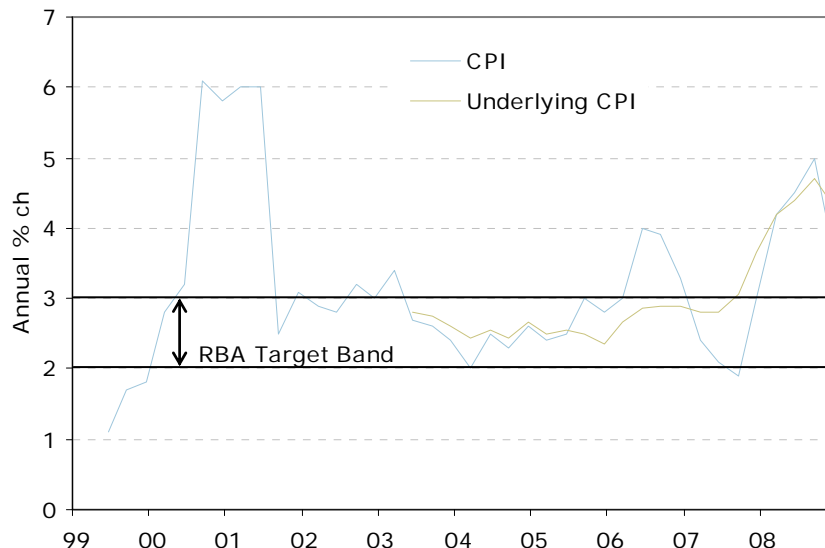
Disinflation begins...

Today's data confirms that Australian inflationary pressures have started to dissipate, with the September quarter 2008 marking the peak for inflation in the current cycle.

Underlying inflation (the average of the RBA's preferred trimmed mean and weighted median measures) rose by just 0.75% in the December quarter, down significantly from 1.25% in the September quarter. This was slightly lower than market expectations for a 0.8% rise and is the lowest quarterly rate since the March quarter 2007. Within the underlying inflation average, the trimmed mean rose by just 0.6% in the quarter, well below expectations for +0.8%. The weighted median was a little higher at 0.9%, although the trimmed mean is generally considered a more statistically robust measure. The annual rate of underlying inflation has started to ease, dropping to 4.35% YoY from 4.8% YoY in the September quarter.

Headline consumer price inflation was negative in Q4 at -0.3% QoQ. This was largely due to a 18.2% drop in petrol prices, although there were also significant price falls for motor vehicles, deposit and loan facilities (which rose strongly in earlier quarters with the gap between lending and borrowing rates widening). This saw the annual rate of inflation ease to 3.7%, well down from 5.0% last quarter.

Inflation has peaked



Source: ABS, RBA

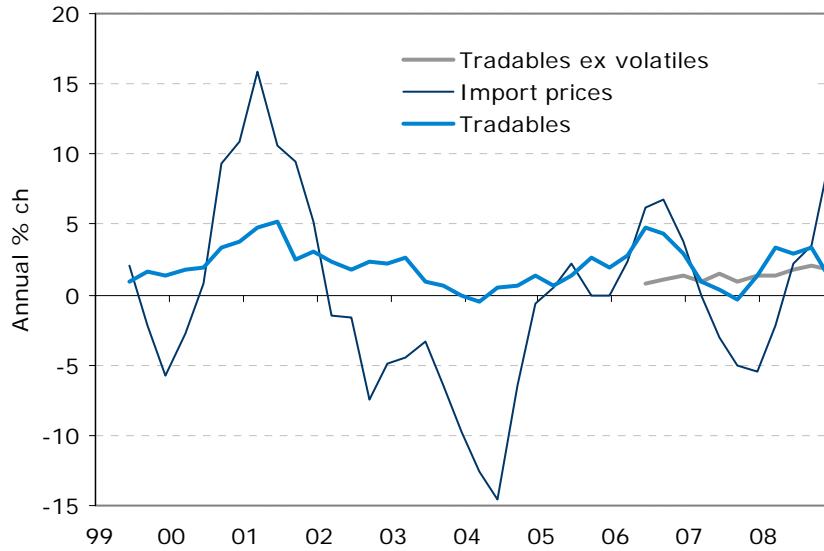
... despite the lower currency

Delving into the detail of the CPI data throws up three key themes which will also be important for inflation going forward:

- There was limited evidence of pass-through from the lower currency into consumer price inflation, at least in Q4;
- Inflation is responding to weaker domestic economic conditions. Non-tradables inflation eased significantly in Q4 and there was evidence of discounting in demand-sensitive components;
- There was some evidence of margin compression, with producer prices or input prices outpacing consumer price inflation. This trend is likely to continue as demand conditions weaken further.

The Aussie dollar depreciated by an average 20% on a trade-weighted basis in the December quarter. This saw import prices rise by 10.8% in the December quarter, following a 5% increase the previous month. However, we did not see this pass-through to final consumers, with tradables inflation excluding the volatile fuel and fruit & vegetable components rising by just 0.1% (see chart below).

Little evidence of currency passthrough in Q4

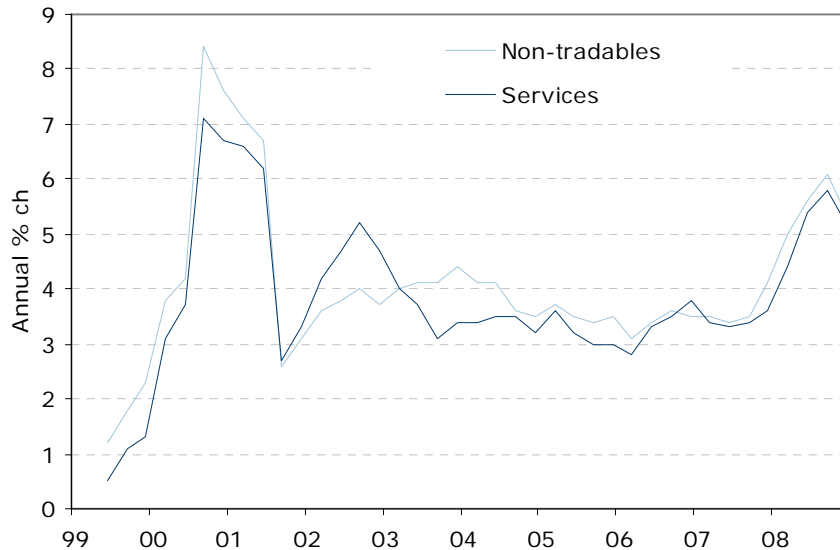


Source: ABS, RBA

There are three possible explanations for the limited exchange rate pass-through, all of which will have been a factor. Firstly, it is likely that firms were running down stocks of goods purchased earlier at a higher exchange rate. In addition, hedging such as forward contracts probably provided some protection to importers in Q4, although we suspect much of this was short-dated cover and will not provide a buffer going forward. And lastly, it appears that there was a degree of margin compression, with input price inflation (as represented by the producer price index) outpacing growth in consumer prices. Either way, this is consistent with history, which shows that the price of retail goods more closely follows trends in private domestic spending than fluctuations in the exchange rate

Indeed, there was some evidence of discounting, with smaller than usual rises in a number of discretionary spending categories such as motor vehicles, recreation goods and household contents (again notwithstanding the higher cost of importing these goods). More broadly, there was a marked slowdown in the pace of non-tradables (or domestically-sourced) inflation as well as services inflation which suggests that prices are starting to respond to weaker demand conditions (see chart below).

Domestically-sourced inflation eases



Source: ABS, RBA

The inflation outlook

So what does this imply for inflation going forward?

With Australian inflation already responding to weaker demand conditions both here and abroad, it seems likely that we will see a further reduction in firm's pricing power going forward. This dampening impact on inflation is expected to outweigh the upward pressure stemming from the weaker currency and higher import prices, although this is the key uncertainty for the outlook. At this point it looks as if firms will absorb at least part of these cost increases into their margins; this is not unprecedented, with the price of retail goods often moving more closely with trends in private spending rather than being influenced by exchange rate movements, particularly during economic downturns.

Weighing up these factors, ANZ is forecasting annual underlying inflation to return to within the target band of 2 to 3% by the end of 2009. This is earlier than the RBA's most recent forecasts in December which had underlying inflation not returning to 3% until December 2010. Annual headline inflation is expected to return to within the target band in the first half of 2009, although this is largely because of base effects, with the quarterly rate of inflation coming off more gradually.

Inflation no impediment to RBA easing

Today's figures are evidence that the anticipated moderation of inflation in response to the global downturn and weak domestic demand is coming to pass. Indeed it has come a little earlier than the RBA had expected, with the RBA anticipating in December that headline inflation would ease to 4¼% and core inflation would ease to 4½%. Indeed, the better than expected inflation results may force the RBA to bring down its inflation forecast for 2009 and could well see core inflation returning to the band a little earlier than expected.

More broadly, the RBA should be comfortable with the inflation outlook, despite the fact that the full effect of the currency depreciation is highly uncertain and yet to be seen. In conjunction with broader asset price deflation, these results should not stand in the way of easy monetary policy over the course of 2009. In this context, ANZ expects a substantial rate cut of 75bp in February, although market pricing remains fixated on a larger 100bp move.

The finer detail

A look at the main drivers of today's inflation result confirm that the global recession and weak domestic demand is pushing inflationary pressures lower by forcing commodity prices down and prompting discounting across discretionary sectors of spending. Moreover, the data confirms that so far little impact of the sharply weaker A\$ is being passed through to final consumer prices.

Transportation costs had the biggest impact on headline inflation in the December quarter, falling by 6.9% to drag 0.9ppt from the CPI. This was driven by weakness in the global and domestic economies; weaker global oil prices caused an 18.2% drop in automotive fuel prices while weaker household spending is most likely behind the 2.4% drop in motor vehicles prices recorded over the quarter. We expect transportation costs to drag on inflation over the coming six months. Despite a spike in January, we anticipate weaker global demand will see global oil prices resume trending down. Weak household spending meanwhile should keep a cap on motor vehicle prices, despite the weaker A\$.

Also pushing headline inflation lower were **health costs** which fell by 1.2% to subtract around 0.1ppt from the CPI. This was largely due to the cyclical effect of the Medicare Plus safety net and the Medicare rebate, which knocked the price of pharmaceuticals down 4.7% and the price of hospital and medical services down 0.4%.

Financial and insurance services prices also weighed on headline inflation in the December quarter, falling by 0.3% to subtract 0.04ppt from the CPI. This was driven by a 1.9% decline in deposit and loan facilities. This most likely reflected an improvement in wholesale lending rates which in turn allowed banks to reduce variable lending rates by *more* than the RBA cash rate at the start of the quarter. We don't expect financial services to provide any further drag on the CPI in the coming quarters

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and indeed the price of this component may resume rising over the next six months given wholesale funding costs remain relatively elevated.

CPI by major category

| | Quarterly % change | Quarterly %pt contribution | Annual % change |
|---|--------------------|----------------------------|-----------------|
| Food | 2.0 | 0.33 | 5.6 |
| <i>of which: fruit & veg</i> | 5.4 | 0.13 | 2.1 |
| Alcohol & tobacco | 1.4 | 0.10 | 5.8 |
| Clothing & footwear | 0.4 | 0.01 | 0.2 |
| Housing | 0.7 | 0.16 | 6.5 |
| <i>of which: rents</i> | 1.8 | 0.10 | 8.4 |
| <i>of which: utilities</i> | 0.5 | 0.01 | 10.8 |
| <i>of which: house purchase</i> | 0.2 | 0.01 | 4.3 |
| HH contents & services | 0.3 | 0.04 | 0.4 |
| <i>of which: childcare</i> | 1.4 | 0.00 | -17.3 |
| Health | -1.2 | -0.05 | 4.9 |
| <i>of which: pharmaceuticals</i> | -4.7 | -0.05 | 2.7 |
| Transportation | -6.9 | -0.94 | -1.2 |
| <i>of which: auto fuel</i> | -18.2 | -0.88 | -4.4 |
| Communication | 0.4 | 0.01 | 0.5 |
| Recreation | 0.5 | 0.06 | 1.3 |
| <i>of which: holiday travel & accomm.</i> | 1.6 | 0.07 | 3.9 |
| Education | 0.0 | 0.00 | 4.8 |
| Financial & insurance services | -0.3 | -0.04 | 7.0 |
| <i>of which: financial services</i> | -0.8 | -0.06 | 6.5 |
| All groups | -0.3 | -0.3 | 3.7 |

Household contents and services prices rose by 0.3% in the December quarter. These prices are now just 0.4% higher than a year ago, despite household contents being heavily imported and thus vulnerable to the weaker A\$. There is also a suggestion of some bring-forward of the usual post-Christmas discounting in this sector with this quarter's 0.4% rise smaller than the 0.8% rise experienced in the December quarter of 2007. Going forward, we expect the price of these goods will remain subdued, at least in the short-term, as businesses seek to keep volumes buoyant amidst slowing demand. Nevertheless, with the A\$ likely to weaken further below US\$0.60c by year-end, some portion of these higher import prices will inevitably start to flow through to household contents prices.

The full impact of the weaker A\$ is also yet to flow through to **clothing and footwear prices**, which rose by just 0.4% in the December quarter. Again, we expect concerns about weaker spending prompted discounting across this sector, particularly, it would seem in women's clothing; these prices fell by 1.2% in the December quarter, the biggest December quarter drop in four years. We expect clothing and footwear prices will remain a tug-of-war between the inflationary impact of the weaker A\$ and the disinflationary impact of weaker spending. Global disinflation will also likely be a drag on these prices. While overall we expect the weaker A\$ will cause these prices to rise, it should be fairly modest.

Recreation prices were also lower than usual for a December quarter, rising by just 0.5%. The usual seasonal spike in holiday travel and accommodation (+1.6%) was largely offset by a big 2.9% fall in the prices of audio, visual and computing equipment. Again, we suspect this price fall reflects either a bring-forward of discounting or a run-down of existing stocks. Going forward, we expect global disinflation to keep a lid on these prices.

The big price rises in the December quarter were mainly the non-tradables components of inflation. **Food prices** were up 2.0%, mainly due to an 8.0% surge in fruit prices and the price of **alcohol and tobacco** rose by 1.4%. The ABS partly blames these price increases on the cessation of specials, confirming this is largely a seasonal Christmas effect. These price rises should therefore be partly unwound in the March quarter.

Housing costs were up a solid 0.7% in the quarter. This was well down on the 2.6% rise last quarter, which was pushed up by seasonal increases in utilities prices. Indeed, it was the smallest quarterly rise in housing prices since June 2007. The price of rents eased from 2.1% in the September quarter to 1.8% in the December quarter while house purchase costs rose by just 0.2% in the December quarter, having averaged growth of 1% of greater since December 2006. A weakening housing market should keep a cap on housing prices going forward, although the potential for a sharp easing in these prices will probably be limited by rental price growth, which should remain buoyed by continued low vacancy rates.

The States

Headline inflation fell across all of the capital cities. The biggest fall was in Melbourne (-0.5%), mainly reflecting a smaller increase in housing prices and a bigger decrease in health costs than other cities. Melbourne also now has the lowest annual rate of inflation in the country of just 3.2%. The smallest quarterly falls in inflation were in Sydney, Brisbane and Hobart (which all fell by 0.2%). Yearly inflation is weakening across all the capital cities and is now below 4.0% for every capital city except Brisbane. Brisbane's higher annual inflation rate of 4.3%, according to the ABS, mainly reflects higher than average housing price rises (driven by double-digit annual rental growth).

Headline inflation by capital cities

| | Dec-08 | Sep-08 | Dec-08 YoY |
|----------------|-------------|------------|------------|
| Sydney | -0.2 | 1.1 | 3.8 |
| Melbourne | -0.5 | 1.2 | 3.2 |
| Brisbane | -0.2 | 1.4 | 4.3 |
| Adelaide | -0.3 | 1.3 | 3.8 |
| Perth | -0.3 | 1.0 | 3.7 |
| Hobart | -0.2 | 1.1 | 3.3 |
| Darwin | -0.4 | 1.7 | 3.7 |
| Camberra | -0.4 | 1.5 | 3.7 |
| Average | -0.3 | 1.2 | 3.7 |

Source: ABS and ANZ



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