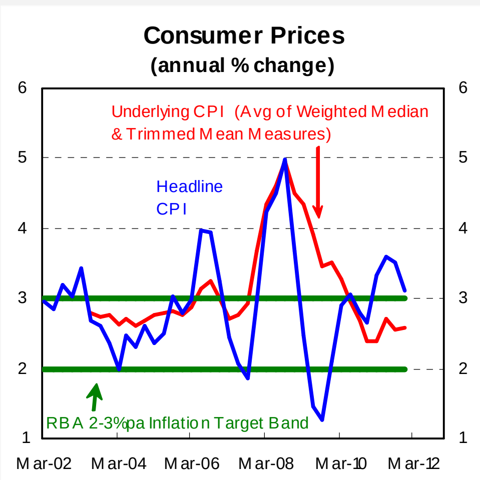
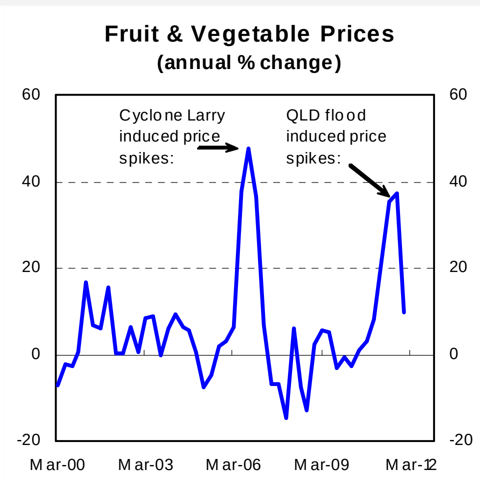
DATA SNAPSHOT

CPI – Keeps the Door Open for More Rate Cuts

25 January, 2012

- **The outcome for underlying inflation was a non-event, rising by 0.6% - in line with our expectations and only slightly above consensus expectations. The annual rate of underlying inflation lifted marginally from 2.55% to 2.60% - remaining relatively contained and within the Reserve Bank's target band. Further, the outcome was consistent with the RBA's most recent implied inflation forecasts.**
- **Headline inflation was flat in the December quarter, the weakest result in three years. It takes the annual growth rate down from 3.5% to 3.1%. A '3' remains in front of the headline rate, but the underlying rate garners more attention. Further, the headline annual rate should ease further in coming quarters.**
- **Seasonal, weather and currency influences dominated the changes in consumer prices in the quarter. The most notable price change was the big drop in fruit and vege prices, reflecting the unwinding of the weather- induced spike. Indeed, fruit prices fell 13.4% - the biggest quarterly percentage decline in four years.**
- **There were some divergent trends in the quarter when scratching beneath the surface. Tradables inflation fell sharply while non-tradables inflation rose. Services inflation climbed and goods inflation decelerated.**
- **The inflation trends evident in today's data will allow the door to remain open for further rate cuts from the RBA.**
- **While inflation is important, top of the agenda for the RBA at the moment are global economic developments, especially European ones. On this front, the clouds remain dark, therefore we expect the RBA to cut rates next month and again in March.**





Underlying Inflation

Underlying inflation gives a truer picture of inflation by stripping out the volatility in the data compared with headline inflation. Therefore, the greater focus for the RBA and on monetary-policy decisions is on underlying inflation. Underlying inflation is the average of the trimmed mean and weighted median measures and this average rose 0.6% in the December quarter, in line with our forecasts (and slightly higher than consensus of 0.5%). The previous quarter's rise was revised a little higher, to 0.4% growth in the quarter (from the previously reported 0.3% quarterly growth rate).

The annual rate of underlying inflation – lifted only marginally from 2.55% to 2.60% - remaining relatively contained and within the Reserve Bank's medium-term 2-3% per annum target band. Further, the outcome today was consistent with the RBA's implied inflation forecasts (published in the most recent November quarterly Statement on Monetary Policy).

Headline Inflation

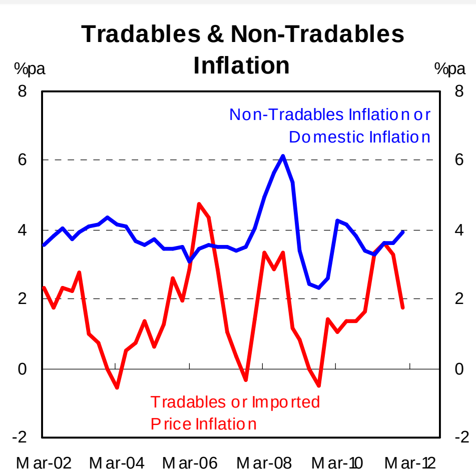
Headline inflation was flat in the December quarter, the weakest result in three years. It takes the annual growth rate down from 3.5% to 3.1%. The headline inflation rate in seasonally adjusted terms rose by 0.2% in the quarter and the annual rate fell to 3.0%.

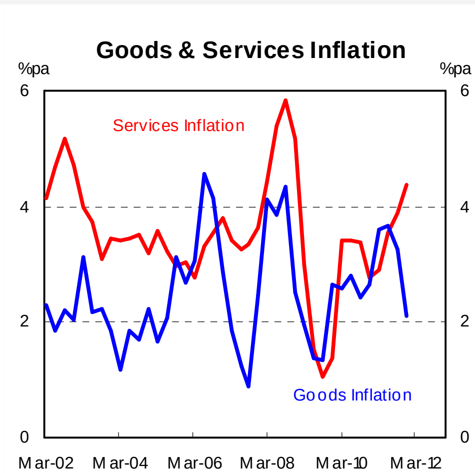
A '3' remains in front of the headline rate, but the underlying rate is what garners more attention. Further, we expect the headline annual inflation rate to ease further as we move through the first half of this year.

Some of the key upward influences on prices in the quarter came from domestic holiday travel & accommodation (up 7.3%), rents (up 1%), telecommunication equipment & services (up 1.1%), beer (up 1.2%) and fuel (0.7%).

One of the key downward influences on prices came from a fall in fruit & vege prices, reflecting the unwinding of the weather-induced spike in fruit & vege prices in early 2011. Fruit prices fell 13.4%, the largest quarterly fall in four years. A 46% drop in banana prices led this decline. Vegetable prices also fell 5.0% in the quarter.

Seasonal factors played a part in some of the other major downward influences on prices in the quarter – for example, the fall in pharmaceutical products (of 5.6%). The other key fall was in audio, visual & computing equipment (down 3.4%) with the earlier strength of the Aussie dollar likely helping push down price pressures here.





There was some divergent trends when scratching beneath the surface:

Goods vs Services: Goods inflation fell by 0.6% in the December quarter, the first fall in this segment in three years. The annual inflation rate for goods stepped down sharply, from 3.2% to 2.1%. Meanwhile, services inflation climbed. Services inflation rose by 0.8% in the December quarter and the annual rate rose to a three-year high of 4.4%.

Tradables vs Non-Tradeables: Tradables prices fell 1.2% in the December quarter - the largest quarterly fall in three years. It suggests that the appreciation of the Australian dollar earlier in the year is still keeping price pressures at bay. However, on average, the Australian dollar has fallen in the September and December quarters in trade-weighted terms. It suggests that the disinflationary impact of the AUD on inflation will begin to wane. Producer prices data released on Monday showed an acceleration in import prices, which could eventually flow through to consumer prices.

Non-tradables inflation rose by 0.7% in the December quarter, down from a 1.2% rise in the previous quarter, but the annual rate lifted to 3.9%. This was the fastest annual pace in 1½ years and suggests that domestic prices have been the main source of price pressures.

Market Goods and Services Excluding Volatile Items

Another measure of "core" inflation is the prices of market goods and services excluding volatile items. It is an alternative measure that the RBA looks at.

This index rose a modest 0.3% in the December quarter while the annual rate stood at 1.9%. It further suggests that underlying inflation remains within the RBA's comfort zone.

Inflation on a State basis

Inflation was quite subdued across all capital cities. Darwin (-0.4%), Brisbane (-0.2%), Sydney (-0.1%) and Adelaide (-0.1%) all recorded declines in headline inflation in the December quarter.

Meanwhile, prices in Melbourne (0.1%), Hobart (0.1%) and Perth (0.2%) rose slightly.

In annual terms, inflation in Brisbane eased significantly, likely reflecting the unwinding of the price spikes from the flood impact. The annual rate fell to 2.4% from 3.1% in the previous quarter, and has the lowest annual inflation rate in the country, along with Darwin.

Among other capital cities, inflation in Perth stood at 2.9%, in Melbourne 3.1%, Sydney prices were up 3.2% and in Hobart they were 3.2% higher. Price pressures were strongest in Adelaide and Canberra with annual inflation rising by 3.6%.

Cash Rate Outlook

Overall, today's data reveals inflation remains contained and comfortably within the RBA's target band. The inflation trends evident in today's data will allow the door to remain open for further rate cuts from the RBA.

While inflation is important in guiding interest-rate decisions, top of the agenda for the RBA at the moment are global economic developments, especially European ones. On this front, the clouds remain dark, therefore, we expect the RBA to cut rates next month and again in March.

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