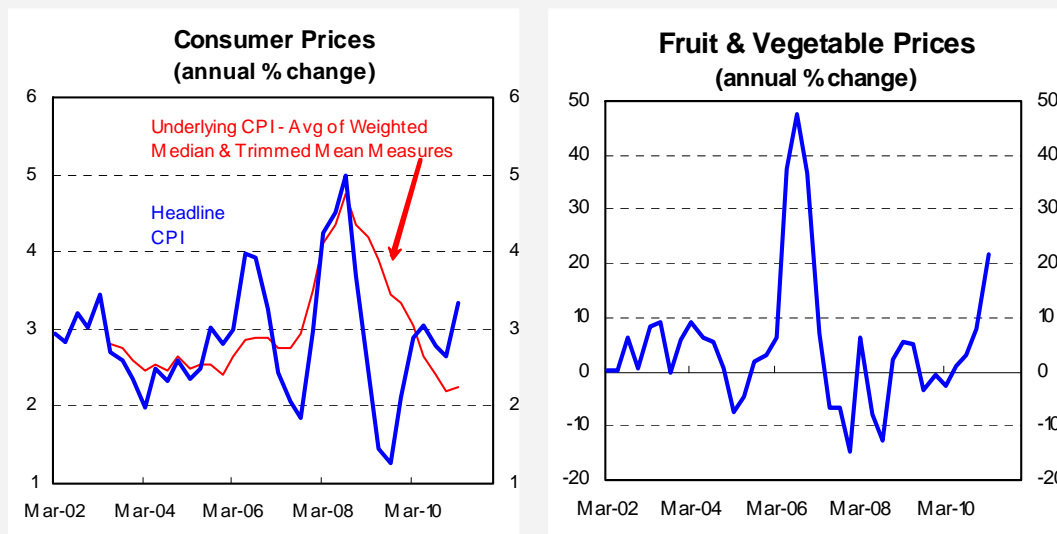


DATA SNAPSHOT

Consumer Prices: Inflation Dragon Starts to Stir

27 April 2011

- Headline inflation spiked 1.6% in the March quarter, taking the annual inflation rate to 3.3%, from 2.7% previously. The average of the underlying measures of inflation grew at 0.9% for the March quarter, taking the annual rate to 2.3%.
- The jump in headline inflation was driven by one-off factors related to the natural disasters earlier this year, seasonal influences and higher fuel prices. The Reserve Bank has made it clear it will look through any temporary fluctuations.
- The underlying inflation rate helps the RBA look through temporary price movements. It is currently sitting in the lower half of the Reserve Bank's 2-3% target inflation band. But it is clear that we are past the low point for underlying inflation. The increase in underlying inflation for the March quarter of 0.9% compares unfavourably with the recent run of relatively benign increases that sat in a range of 0.4-0.6%. Further, today's data also indicated a broadening of price pressures in the economy.
- Today's inflation data still leaves the RBA with some breathing room, but with the RBA expecting underlying inflation to be in the top half of the band at the end of this year, there will be little room for error. Rate hikes later this year, then, remains on the table.



The headline consumer price index spiked 1.6% in the March quarter, pushing the annual rate from 2.7% to outside of the Reserve Bank's target band at 3.3%. This annual rate is the fastest pace in 2½ years. The spike was driven by the impact of the natural disasters, higher fuel prices and seasonal factors. The Reserve Bank has said that it will look through temporary price movements when assessing inflation. In this respect, looking at the underlying inflation rate may be of greater value.

The two key measures of underlying inflation are the trimmed mean and weighted median. The average of these two measures shows that underlying inflation rose by 0.9% in the March quarter and by 2.3% on a year ago. The annual rate has nudged up only slightly from 2.2% in the December quarter.

The annual rate of underlying inflation remains in the lower half of the target band, but it is clear that we are now past the low point. The quarterly rise in underlying inflation of 0.9% was well above the more benign increases witnessed for much of 2010. For the three quarters to the December quarter, growth in the quarter for underlying inflation has sat in the relatively more benign range of 0.4-0.6%. Furthermore, price pressures this quarter appear to be broader based with more categories recording price growth and strong price growth.

Examining the detail, price increases in the March quarter were spread across food, alcohol & tobacco, housing, health, transport, communication, education and financial & insurance services.

WEIGHTED AVERAGE OF EIGHT CAPITAL CITIES	Dec Qtr 2010 to Mar Qtr 2011	Mar Qtr 2010 to Mar Qtr 2011
	% change	% change
Food	2.9	4.3
Alcohol and tobacco	1.1	11.2
Clothing and footwear	-0.7	-1.3
Housing	1.3	4.8
Household contents and services	-1.6	-0.5
Health	3.9	4.1
Transportation	2.7	3.0
Communication	0.1	-0.2
Recreation	-0.6	-1.5
Education	5.7	5.9
Financial and insurance services	2.6	2.8
All groups	1.6	3.3

The natural disasters that struck Australia earlier this year caused production and supply disruptions that pushed up food prices for the March quarter. The food category jumped 2.9% in the March quarter. Within this category fruit prices jumped 14.5%, after a 15% rise in the December quarter, and vegetables jumped 16%, the largest quarterly rise in a decade.

The rise in fruit prices was mainly due to an increase of 100% in the price of bananas in the quarter. The increase in vegetable prices was driven by rises in cauliflowers, broccoli, lettuce, pumpkin and potatoes.

The natural disasters were an overwhelming influence in the March quarter but there were some price falls that appeared in the food category. The biggest fall within the food category was for milk with the price wars over milk helping drive the decline. Milk prices fell by 6.2% in the March quarter, the biggest quarterly price fall as far back as at least late 1980.

Tensions in the Middle East and in North Africa have driven up world oil prices and caused a lift in automotive fuel. It rose by 8.8% in Q1, the fastest quarterly rate of increase since Q2 2006. The strength of the Australian dollar, however, is helping limit the growth in fuel prices.

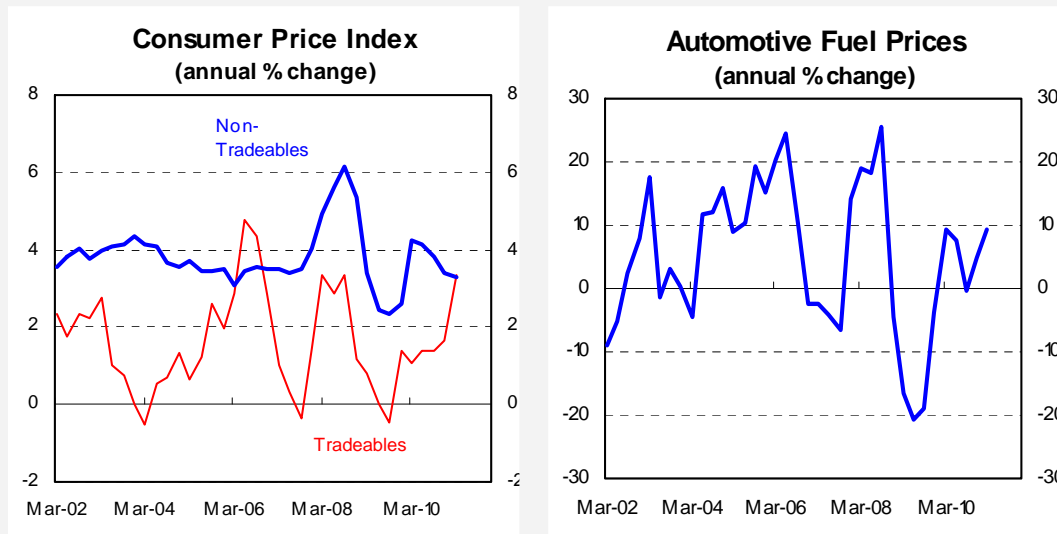
The seasonal influences largely appeared in education and health. Education recorded the biggest upward movement for the quarter across the major eleven categories. Education showed a 5.7% increase in the quarter. The education component typically sees a large seasonal increase in Q1 because the new school year begins. A breakdown of the numbers showed increases at all stages of education, with preschool and primary education (5.4%), secondary education (6.8%) and tertiary education (4.9%), posting sizeable increases.

Health was the other large contributor (up 3.9%), and again this reflected a seasonal increase, with the pharmaceuticals up 12.5% for the quarter. The rise in this component reflects the cyclical reduction in the proportion of consumers who qualify for subsidised medications under the Pharmaceuticals Benefit Scheme at the beginning of each year.

Price falls in the March quarter meanwhile were largely limited to imported goods and services.

Usually when the Australian dollar strengthens, as it did over the March quarter, imports become cheaper in Australian dollars and this is reflected in low tradeable inflation (which reflects inflation for imported goods and import-competing goods). Surprisingly, given the strong Australian dollar over the March quarter, tradeables inflation rose 1.8% for the quarter. This took the annual rate of tradeables inflation up to 3.3%.

When we look deeper into the CPI numbers, the rise in tradeables inflation likely reflects higher inflation for pharmaceuticals (12.5% for the March quarter), many of which are imported, vegetables and fruit (up a combined 15.3% for the quarter) and automotive fuel (8.8% for the March quarter). These price increases occurred despite the stronger Australian dollar, thereby negating the continuing price declines seen in components such as audio, visual and computing equipment (-7.2% for the quarter). Non-tradeables inflation, which reflects domestic price pressures, also increased 3.3% in the year to March, with a smaller 1.4% quarterly increase.



Implications for Monetary Policy:

The Reserve Bank has raised interest rates pre-emptively over the last year and a half. Taken together with the short-term flood-related disruption to economic growth, today's data allows the Reserve Bank some space to "wait and see" on future interest rate hikes. But it is clear that underlying inflation has moved past the low point. With underlying inflation expected to hit the top half of the target band later this year, the RBA is unlikely to sit on the sidelines for long. We continue to expect the Reserve Bank to raise interest rates again in August, followed up by another move in November. Financial markets in the wake of the data have moved to price in a greater chance of a rate rise from the Reserve Bank by the end of October.

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