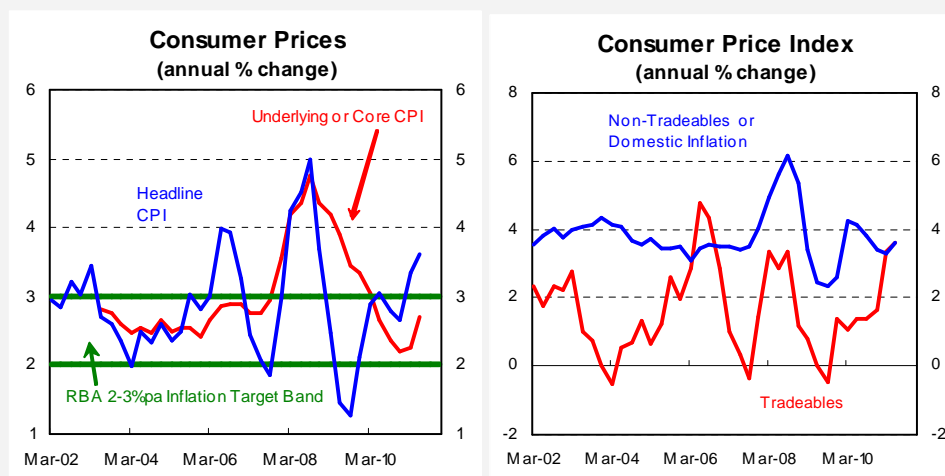


DATA SNAPSHOT

CPI – Between a Rock and a Hard Place

Wednesday, 27 July 2011

- Underlying inflation rose by 2.7% per annum in the June quarter, moving to the top half of the RBA's inflation target band. Underlying inflation is set to move higher in coming quarters and the annual rate is likely to have a '3' in front by the end of this year.
- Today's inflation outcome then likely makes the RBA's decision on interest rates tougher than at any time this year. It comes at a time when downside risks to the world economy have noticeably lifted and the different speeds of the domestic economy are increasingly disparate. It leaves the RBA between a rock and a hard place
- We think there are enough worries about the world economy to keep the RBA on the sidelines in the next few months. But the back-to-back high quarterly outcomes for underlying inflation means we cannot rule out a rate hike within the next twelve months.
- Melbourne was the only capital city to record an inflation increase in the quarter of under 0.9%. All other cities recorded increases above 0.9%, except Hobart (at 0.9%).



Headline Inflation

Headline inflation rose by 0.9% in the June quarter, taking the annual rate from 3.3% to 3.6%, a near 3-year high. The headline annual rate is affected by the impact of the floods and the cyclone earlier this year.

To put the quarter-on-quarter result in context, an outcome of 0.9% or more is considered to be on the strong side of the ledger.

Underlying Inflation

It is more useful to look at the underlying inflation rate because it looks through the volatility (for example, from the floods) and gives a truer picture of inflation in the economy. The underlying or core inflation rate is the average of the weighted median and trimmed mean measures. It rose by 0.9% in the quarter. It follows a strong rise of 0.85% in the previous quarter and confirms that underlying inflation has passed the low point. The annual growth in underlying inflation picked up from 2.25% to 2.70%, a one-year high.

Tradeables vs Non-Tradeables Inflation

Breaking the inflation data down into the tradeables (imported goods and services) and non-tradeables (domestically-produced goods and services) components does not provide

us with any relief on inflation.

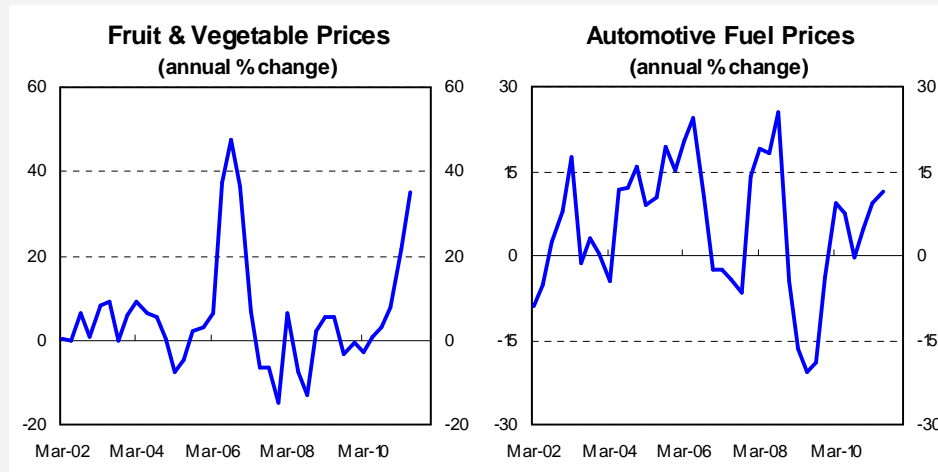
Tradeables inflation grew by 1.3% in the June quarter and a near 5-year high of 3.6% on a year ago. A strengthening Australian dollar is a strong downward influence on this component of inflation. However, the Aussie dollar has appreciated considerably since early 2009 and much of the benefit from this appreciation has already passed through to the inflation rate. It helps explain why tradeables inflation grew by 1.3% quarter-on-quarter in Q2, after growth of 1.3% in Q1.

On the domestic inflation measure (the non-tradeables component), growth quarter-on-quarter was only 0.6% but the annual rate has lifted for the first time in five quarters – from 3.3% to 3.6%.

CPI Categories

There were price rises recorded in nine of the eleven categories.

The largest contributor to the increase in CPI for the quarter, by category, was food (1.4%). Fruit prices continued to rise in Q2 (26.9%) and restaurant meals increased (1.3%), although this was offset by a fall in vegetable prices (-10.3%), due to favourable growing conditions. Banana prices alone rose 138% in the June quarter, due to the decimation of the banana crop by Cyclone Yasi back in February. It is clear the natural disasters earlier in the year continued to impact the CPI in Q2, driving food prices higher still. It is expected this category will moderate as the impact of the floods works its way out of the CPI numbers. For the year to June, higher fruit and vegetable prices pushed food prices higher, with some offsetting impact from lower milk prices.



By category, the second largest contribution to the quarterly increase in the CPI came from the transportation component, which gained 1.2%, led by increases in automotive fuel prices (4.0%) and urban transport fares (1.1%). The increase in transportation costs reflects higher petrol prices, although the full impact of this was somewhat offset by the increase in the Australian dollar.

Financial and insurance services showed a 1.6% increase in the quarter, driven by an increase in the deposit and loan facilities component (2.1%). This reflected an increase in prices derived from interest rate margins. Direct fees fell for the quarter. The rise in prices in this category appears to be a delayed impact from last year's increase in mortgage interest rates and it impacted both the headline and core CPI numbers. An increase in insurance premiums for house insurance and household contents insurance saw the insurance services component rise 1.6% in the June quarter.

A pick up in prices for household contents and services (1.5%) was due to price increases in furniture (6.0%) and towels and linen (7.5%), as discounting from the previous quarter was discontinued. Over the year, prices for household contents and services were little changed.

The housing component showed a 0.4% increase for the June quarter, with an increase in rents (1.1%) the main contributor. For the year to June, the housing component rose 4.6%, driven by increases in rents (4.5%), electricity (10.7%) and house purchase costs (2.4%).

The seasonal influences are not traditionally as pronounced in Q2, as in Q1, however, a 2.0% rise in the health category was mainly attributable to a 3.4% increase in hospital and medical services, which largely reflects the increases in private health fund premiums, effective from 1 April this year.

The alcohol and tobacco category rose 0.7% for the quarter, reflecting an increase in tobacco prices (1.4%), partly due to the flow on effect from the increase in the federal excise on tobacco in February.

The education category, which showed a spike in Q1 for the start of the new school year, showing no change in Q2, with all three components; primary, secondary and tertiary education, unchanged.

CPI By Capital City

The national CPI is the weighted average CPI of the eight capital cities in Australia. Melbourne pulled the overall inflation rate down in Q2 else the inflation rate might have been even stronger. Melbourne was the only city to record an inflation increase in the quarter of under 0.9%.

While Melbourne recorded a relatively subdued quarterly outcome in the June quarter of 0.7%, it followed a rise of 1.7% in the March quarter, which was the sharpest quarterly rise in 10½ years. Melbourne's annual CPI rate edged up to a near three-year high of 3.6%.

All other cities recorded increases above 0.9%, except Hobart (at 0.9%).

The quarterly rise in inflation among the cities was highest in Perth at 1.3% but the Perth annual rate was the lowest at 3%.

In terms of the annual rate, Adelaide has the highest at 3.9%.

Outlook for the Cash Rate

Today's inflation outcome makes the RBA's near-term decision on interest rates tougher than at any time this year because it comes at a time when downside risks to the world economy have noticeably lifted and the different speeds of the economy are becoming more disparate.

We think there are enough worries about the world economy to keep the RBA on the sidelines in the next few months. But the back-to-back high quarterly outcomes for underlying inflation means we cannot rule out a rate hike within the next twelve months.

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