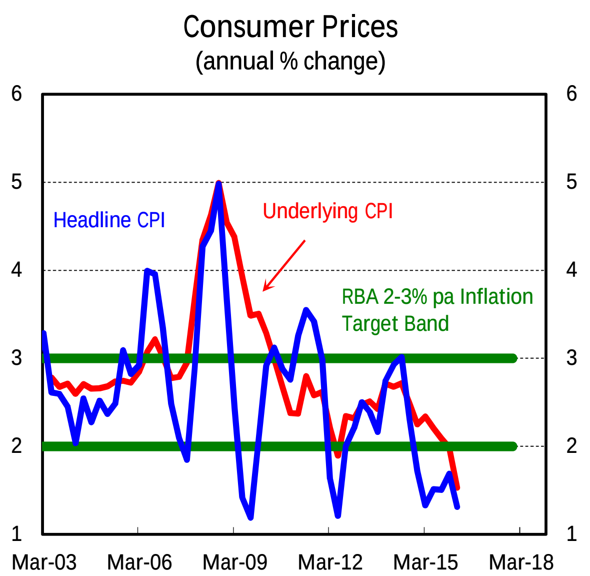
Data Snapshot

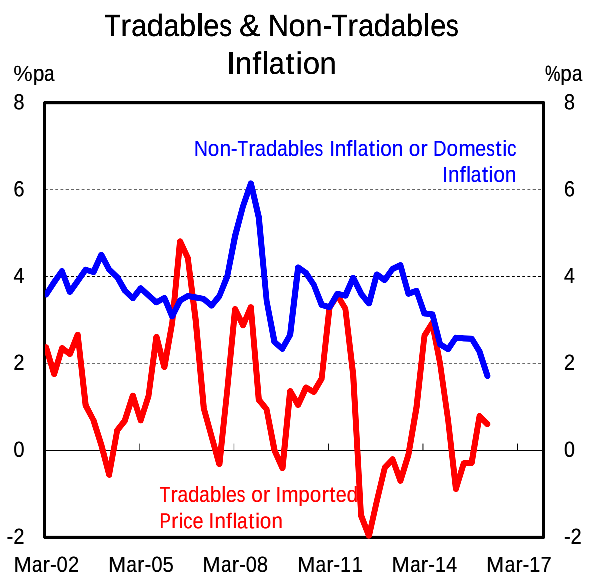
Wednesday, 27 April 2016

Bank of Melbourne

Consumer Price Index
That Sinking Feeling

- Inflation was weaker than expected in the March quarter. Headline CPI fell 0.2% for the quarter, the first decline since the December quarter 2008. The annual rate of headline inflation fell to 1.3% in the year to the March quarter.
- The average of the two underlying inflation measures rose just 0.2% in the March quarter. Meanwhile, the annual rate of underlying inflation slowed to 1.5% in the year to the March quarter, from 2.0% in the year to the December quarter, and sits below the bottom of the RBA's 2-3% annual inflation target band.
- The driving force behind the decline in CPI came from automotive fuel prices, which fell 10.0% for the quarter. Prices also fell for fruit (-11.1%), holiday travel and accommodation (-2.0%) and clothing & footwear (-2.6%) in the March quarter.
- There were some transitory factors pushing down inflation, particularly falling oil prices. However, there are factors which suggest that low inflation is persistent.
- With both headline and underlying inflation running below target and likely to remain so for most of this year, the odds of another RBA rate cut have certainly increased. However, there are signs that non-mining sectors continue to recover and the unemployment rate is likely to remain steady or trend lower. It will be a close decision next week, but on balance, we continue to expect that the RBA will leave the cash rate on hold for the remainder of the year.





Inflation was weaker than expected in the March quarter. Headline CPI fell 0.2% for the quarter, the first decline since the December quarter 2008. The annual rate of headline inflation fell to 1.3% in the year to the March quarter, down from 1.7% in the year to the December quarter. It was the slowest rate of annual headline inflation since June 2012.

Unlike the headline rate, underlying inflation abstracts volatile items such as petrol and food prices. The underlying rate of inflation is the major focus for the RBA. This measure further confirms that there is currently little upward pressure on inflation. The average of the two underlying inflation measures rose just 0.2% in the March quarter. This was the smallest quarterly lift in underlying inflation since this measure began in 1982.

The annual rate of underlying inflation slowed to 1.5% in the year to the March quarter, from 2.0% in the year to the December quarter. This was also the lowest since at least 2003 when these official measures of underlying inflation began. The annual rate of underlying inflation is now well below the bottom of the RBA's 2-3% annual inflation target band. Given where underlying inflation now sits, it would require a relatively high inflation outcome in the June quarter, for annual underlying inflation to meet the RBA's forecast for the year ending June.

CPI Groups Analysis

The driving force behind the decline in inflation came from automotive fuel prices, which fell 10.0% for the quarter. Prices also fell for fruit (-11.1%), holiday travel and accommodation (-2.0%), reflecting price declines for both domestic and international travel, and clothing & footwear (-2.6%) in the March quarter.

These price declines were partially offset by price increases in other categories, including secondary education (4.6%) and health, with prices for medical & hospital services (1.6%) and pharmaceutical products (4.8%) rising. There was a seasonal component to upward price pressures for the quarter, with rising education prices reflecting the lift in school fees which usually occurs at the start of the school year. The price increase for the health group reflects the cyclical reduction in the proportion of patients qualifying for subsidies under the Pharmaceuticals Benefits Scheme (PBS) and Medicare Benefit Scheme (MBS), as well as the co-payment indexation for PBS at the start of each calendar year.

	March quarter 2016, %	
Consumer Prices	Quarterly change	Annual change
Food and non-alcoholic beverages	-0.2	0.0
Alcohol and tobacco	0.9	6.1
Clothing and footwear	-2.6	-0.8
Housing	0.3	1.7
Furnishings, household equipment and services	-0.4	2.0
Health	1.9	4.6
Transport	-2.5	-0.5
Communication	-1.5	-6.4
Recreation and culture	-1.0	0.1
Education	3.1	3.3
Insurance and Financial Services	0.6	2.3
Total CPI	-0.2	1.3

Over the last twelve months, softness in inflation was driven by ongoing price declines in communication (-6.4%), reflecting lower prices for audio, visual & computing equipment, clothing

& footwear (-0.8%) and transport (-0.5%), assisted by a 6.4% fall in fuel prices.

Price growth was strongest for alcohol & tobacco (6.1%), health (4.6%, reflecting higher prices for medical & hospital services) and education (3.3%) in the year to the March quarter.

Tradables and Non-Tradables Inflation

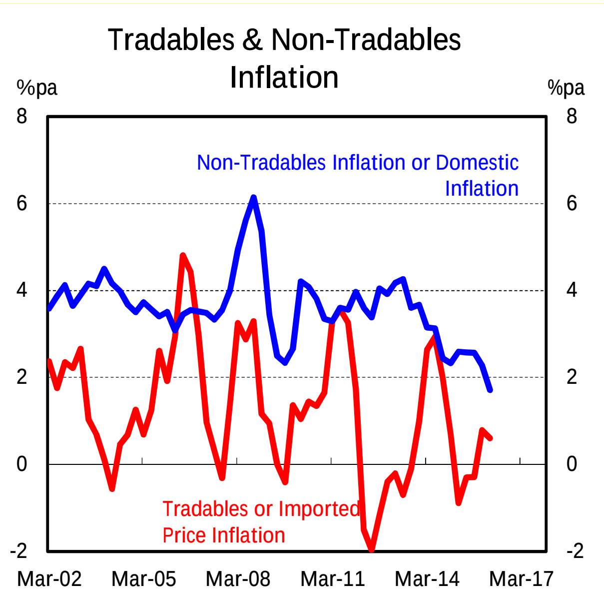
Much of weakness in overall inflation was driven by prices of tradables. Tradables inflation includes the prices of goods and services which are imported or compete with imported goods and services.

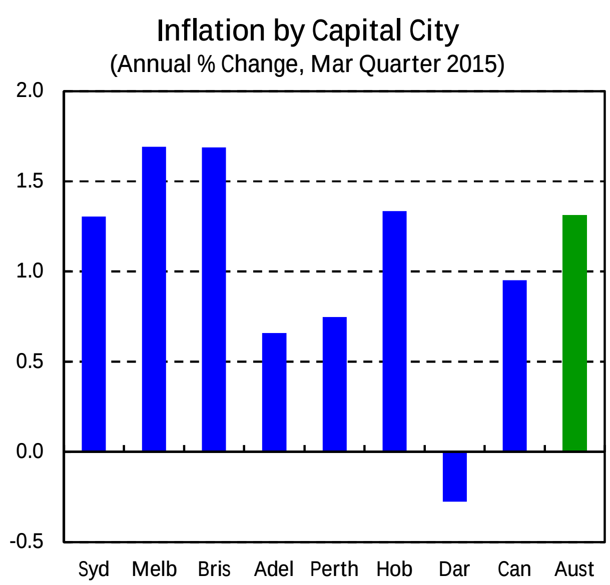
Tradables CPI fell 1.4% in the March quarter, which was the largest quarterly drop in four years. The decline was driven largely by the sharp drop in fuel prices, while prices of international holiday travel and accommodation also declined. In addition, it is possible that any inflationary impact from the depreciating Australian dollar is easing. In the March quarter, the Australian dollar rose 0.4% against the US dollar and 0.6% in trade-weighted terms.

In annual terms, tradables inflation remains subdued, but still positive. In the year to the March quarter, tradables inflation stood at 0.6%.

Non-tradables inflation, which reflects domestic prices, was also weak. Non-tradables CPI rose just 0.4% in the March quarter, the third consecutive quarter at this pace. Annual tradables inflation was running at 1.7% in the March quarter, the lowest since 1999.

The soft pace of non-tradables inflation coincides with a slow pace of wage growth in the economy. An extended period of subdued growth in domestic demand is also likely contributing to low domestic inflation. We would need to see further momentum in the economy and wage growth before non-tradables inflation picks up.





Inflation By State

For the March quarter, prices declined in most capital cities. Darwin had the largest fall in the quarter (-0.9%). Perth (-0.6%), Adelaide (-0.3%), Sydney (-0.2%), Hobart (-0.2%) and Melbourne (-

0.1%) also had prices decline in the quarter, while Brisbane prices were flat. CPI in Canberra was the only capital city to witness an increase in the quarter of 0.2%.

In annual terms, inflation in all capital cities has fallen below the RBA's 2-3% target band. Darwin has slipped into deflation (-0.3%). Inflation in Melbourne and Brisbane was at an annual rate of 1.7%. CPI in Sydney and Hobart rose 1.3% in the year to the March quarter. Prices in Canberra rose 1.0%. Meanwhile, inflation in Adelaide and Perth, where their State economies are relatively weak, is running at 0.7%.

Outlook

There were some transitory factors pushing down inflation, particularly falling oil prices. The large drop in prices of fruit and holiday travel & accommodation are seasonal and should tend to be transitory.

However, there are factors which suggest that low inflation will persist. Most notably, underlying inflation and non-tradables inflation have been subdued over the last year. Global factors, soft domestic demand and weak wage growth are all playing a part in keeping inflation low.

Given these factors are unlikely to turnaround anytime soon, there is a strong possibility that underlying inflation will not return within the RBA's target band until the end of this year at the earliest.

With both headline and underlying inflation running below target and likely to remain so for most of this year, the odds of another RBA rate cut have certainly increased.

However, more important for the RBA is the medium-term outlook for inflation. Indeed, it should be enough for the RBA to keep rates on hold if it expects that inflation will return to target over the medium-term (two to three years).

Taking the above into consideration, given signs that non-mining sectors continue to recover and the unemployment rate likely to remain steady or trend lower, it will be a close decision next week. On balance, we continue to expect that the RBA will leave the cash rate on hold next week and for the remainder of the year.

Contact Listing

Chief Economist

Hans Kunnen
kunnenh@bankofmelbourne.com.au
(02) 8254 8322

Senior Economist

Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Senior Economist

Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898

The Detail