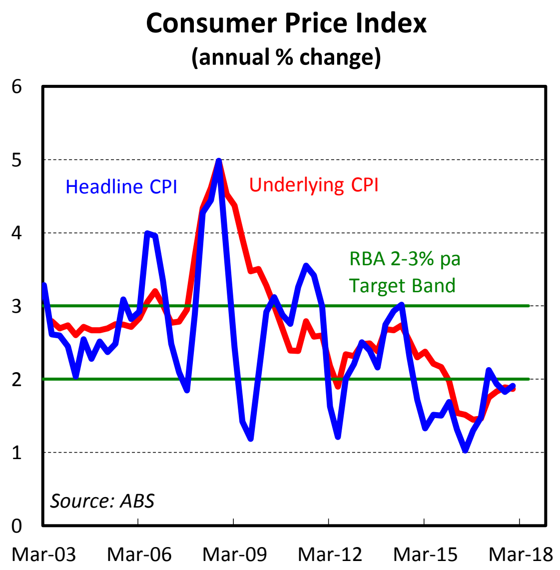
Wednesday, 31 January 2018

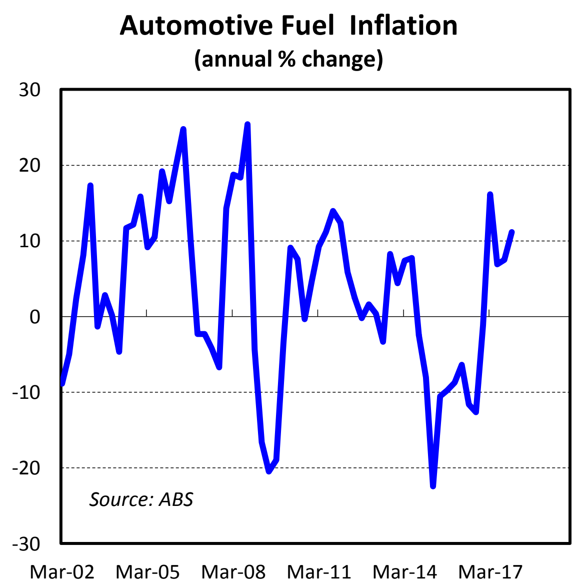
Bank of Melbourne

# Consumer Price Index

## Inflation Still MIA

- **Inflation pressures were still MIA (missing in action) in the December quarter. Annual growth in headline inflation edged up to 1.9% and the underlying annual growth rate was steady at 1.9%. Crucially, both outcomes remain below the Reserve Bank's 2-3% per annum target band.**
- **A strong increase in the oil price over the quarter led to higher prices for automotive fuel (10.4%). Price growth was also high in tobacco (8.5%) reflecting the continued impact of the increase in the federal excise tax at the beginning of the September quarter. Despite large price increases in some areas, overall inflation was muted.**
- **Inflation is expected to remain low over the medium term. The RBA is not anticipating annual underlying inflation to return to its target band until June 2019.**
- **Despite the weak outlook for inflation, the improving labour market could become of greater focus and a bigger potential trigger for an RBA rate hike. There is a strong prospect that the unemployment rate will edge lower and the labour market will tighten over the course of this year. That said, spare capacity in the labour market remains, and points to wages and inflation remaining subdued for some time. This would suggest little need to be hiking rates any time soon.**



Inflation remained low in the December quarter.

Headline consumer prices rose just 0.6% in the quarter, which was slightly below consensus expectations and our own forecast of an increase of 0.7%. The annual rate of headline inflation edged up to 1.9% in the year to the December quarter, from 1.8% in the September quarter, although it was again slightly below consensus expectations.

The average of the Reserve Bank's two preferred underlying inflation measures, the trimmed mean and weighted median, rose 0.4% in the quarter in line with our expectations, but a touch below consensus. The annual growth rate was steady at 1.9%.

Both the headline and underlying rates of inflation remain below the Reserve Bank's 2-3% per annum target band. The headline inflation rate has sat under this band for three consecutive quarters while the underlying inflation rate has stayed below the band for just over two years.

Inflation has remained low for some time now and this problem is not unique to Australia. Globally central banks are addressing the same issue. Wages growth is very weak in Australia, at 2.0% in the year to the September quarter. This is hindering household spending and keeping CPI inflation in check. We are unlikely to see higher inflation until we see a significant pick up in the pace of wages growth.

**CPI Groups Analysis**

A strong increase in the oil price over the quarter led to higher prices for automotive fuel (10.4%). Price growth was also high in tobacco (8.5%) reflecting the continued impact of the increase in the federal excise tax at the beginning of the September quarter. Prices for domestic holiday travel & accommodation rose by 6.3% and the price of fruit increased by 9.3% in the December quarter. Prices for domestic holiday travel tend to rise in the December quarter, reflecting both the October school holidays and the lead-up to the peak summer holiday period.

Despite large price increases in some areas, overall inflation was muted. In the December quarter declining prices for international holiday travel & accommodation (-1.7%), audio visual and computing equipment (-3.5%) and telecommunication equipment and services (-1.4%) all weighed on inflation.

There was also seasonal impact from a fall in the price of pharmaceutical products (-2.0%), reflecting the annual pattern where subsidies kick in for the Pharmaceutical Benefits Scheme (PBS) safety net as a greater proportion of consumers reach the threshold.

**Tradables and Non-Tradables Inflation**

Tradables inflation measures the prices of goods and services that are imported (and those which compete with imported goods and services). It comprises around 35% of the weight of the CPI, and is influenced by movements in the Australian dollar. The Australian dollar weakened in trade weighted terms in the December quarter. A weaker currency has an inflationary effect, although it would take some time to impact prices.

Tradables inflation rose by 0.5% in the December quarter, which was the first increase in five quarters. The increase was mainly due to higher prices for automotive fuel and fruit in the December quarter. International holiday travel & accommodation provided some offset.

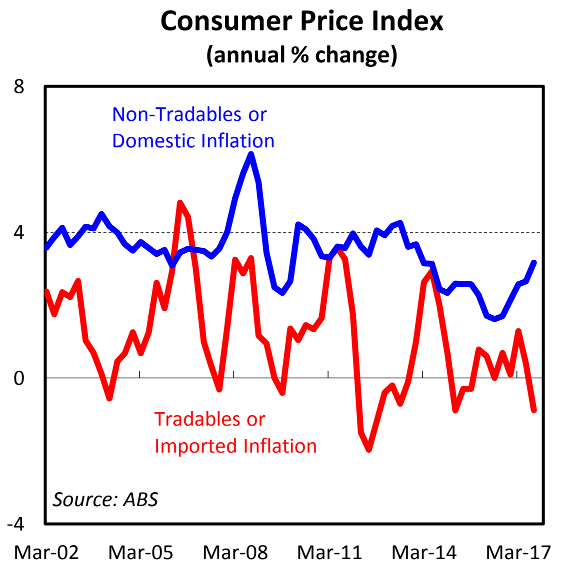
On a year ago, tradables inflation is down 0.3% for the December quarter, the second consecutive quarter of decline.

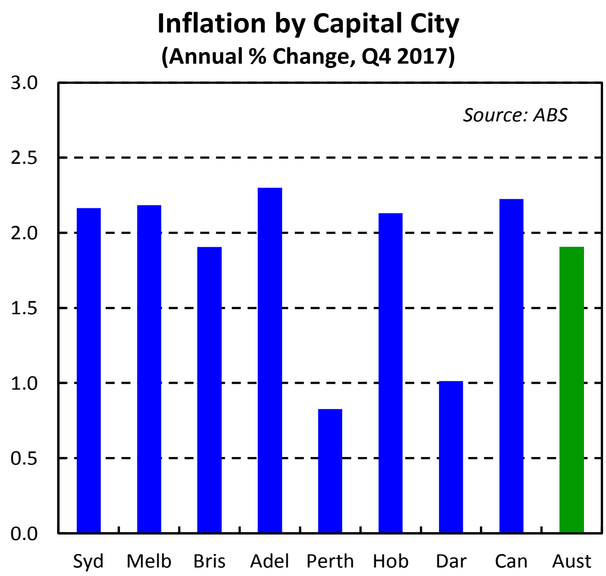
Non-tradables consumer prices, which reflect domestic prices not subject to international or import competition, rose 0.8% in the December quarter.  The increase in non-tradables inflation was driven by higher tobacco prices. The annual growth rate eased slightly to 3.1% in the December quarter, from 3.2% in the September quarter.

**Inflation by State**

In the December quarter, consumer price increases were within the 0.6-0.8% range for most capital cities, including Sydney (0.7%), Melbourne (0.7%), Brisbane (0.8%), Adelaide (0.7%) and Canberra (0.6%). The outliers were in Perth (0.4%) where prices were held down by falling rents. Growth in Darwin's CPI was also subdued (0.3%). Prices in Hobart rose 1.0% in the quarter, boosted by increased demand from tourism.

In annual terms, inflation pressures remain muted across capital cities. Inflation in Sydney (2.2%), Melbourne (2.2%), Adelaide (2.3%), Hobart (2.1%) and Canberra (2.2%) are sitting towards the lower half of the RBA's 2 to 3% per annum target band. Meanwhile, inflation in Brisbane (1.9%), Perth (0.8%), and Darwin (1.0%) all have inflation sitting below the 2-3 per cent per annum band. The weakness in inflation in Perth and Darwin is continuing to reflect the impact of the mining investment downturn on Western Australia and the Northern Territory.




**Outlook**

Inflation remains low, and is expected to remain so over the medium term. Both the headline and underlying annual rates of inflation continue to sit below the RBA's 2 to 3 percent target band. Indeed, the RBA is not anticipating underlying inflation to return to its target band until June 2019.

Despite the weak outlook for inflation, the improving labour market could become of greater focus and a bigger potential trigger for an RBA rate hike. There is a strong prospect that the unemployment rate will edge lower and the labour market will tighten over the course of this year. That said, spare capacity in the labour market remains, and points to wages and inflation remaining subdued for some time. This would suggest little need to be hiking rates any time soon.

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