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Inflation surprise: Rates now in focus

Consumer Price Index

- *The main measure of inflation in Australia – the Consumer Price Index (CPI) rose by 0.9 per cent in the June quarter, above economist expectations focussed on an increase of 0.7 per cent. The annual rate of inflation rose from 3.3 per cent to 3.6 per cent.*
- *Higher prices for fruit, petrol, medical costs, furniture, financial services and rents were only partially offset by lower prices for electrical and technology goods, vegetables, milk, electricity, domestic holiday costs and toiletries.*
- *The Reserve Bank focuses on three “underlying” price measures – trimmed mean, weighted median and CPIX (CPI less fruit, vegetables, petrol and deposit and loan facilities). The trimmed mean rose by 0.9 per cent (2.7 per cent annual); the weighted median rose by 0.9 per cent (2.7 per cent) and we estimate that CPIX rose 0.5 per cent (2.4 per cent).*
- *The average of the Reserve Bank’s preferred “underlying” measures of inflation – weighted median, trimmed mean and CPIX – rose from 2.4 per cent to 2.6 per cent in annual terms.*
- *Interestingly two other measures of “underlying” inflation printed on the low side. The All groups measure excluding ‘volatile’ items rose by 0.5 per cent in the June quarter with the annual rate falling from 2.6 per cent to 2.5 per cent. And the measure of “Market goods and services excluding ‘volatile’ items” rose 0.6 per cent in the June quarter with the annual rate steady at 1.8 per cent.*
- *In response to the inflation data the Aussie dollar hit a 29-1/2 year high of US110.61 cents.*

What does it all mean?

- *The latest inflation result is certainly on the high side of expectations, with the quarterly increase of 0.9 per cent following the 1.6 per cent rise in the March. Having said that it is important not to get overly excited by the high inflation readings. One-off items like higher fruit prices due to the natural disasters have artificially inflated results over the past couple of quarters. In addition there is not much the Reserve Bank can do about the recent surge in oil prices and the flow on effect to domestic pump prices.*
- *In an environment where retailers are falling over themselves to trim prices in order to get consumers to spend, it is certainly difficult to believe that inflation is a problem – but the latest result*

certainly seems to suggest that is the case. And the latest figures validate the Reserve Bank's vigilant stance on inflation.

- Interestingly there was also a broad range of results across the different inflation measures. The Reserve Bank's preferred readings were on the high side, while other measures like market goods and services were much more sedate printing at just 0.5 per cent for the quarter. In addition annualised underlying inflation still remains within the Reserve Bank's 2-3 per cent target band. In fact the average of the three key underlying inflation measures stands at 2.6 per cent – in the middle of the RBA target band.

- There is no doubt the latest inflation reading will muddy the waters ahead of the next rates decision, and certainly provides the Reserve Bank Board members with a conundrum- to raise interest rates or not. There are an array of sectors that are showing significant levels of weakness. In addition the Australian dollar has hit fresh 29 year highs – not only further reducing the competitiveness of exports in coming months but also curbing imported inflation.

- Having said that, ironically clothing prices recorded the biggest quarterly increase in three years in the June quarter. The rise in prices may have more to do with the cold weather and consumers demand for warmer clothing rather than any significant cost pressures. There was some good news due to the Aussie dollar strength with the index of motor vehicle prices falling to the lowest levels in 22½ years, while the index of women's shoe prices was at the lowest levels in almost 23 years.

- It's always important to remember that the Reserve Bank sets interest rates by looking forward, not backwards. Provided that Australian businesses are forced to keep prices low to move stock then inflation will continue to ease. In the next few quarters lower fruit and vegetable prices will also assist in keeping prices of domestic goods low and, as a result, overall inflation.

- The \$64 question is how long the Reserve Bank can stay on the interest rate sidelines. The short answer is: for as long as underlying inflation is expected to stay in the 2-3 per cent target band. We expect that the strong job market and record wealth levels would entice consumers to spend again in the latter part of 2011 and early 2012, meaning that rates are still more likely to rise in the next 6-12 months rather than fall. We are pencilling the next rate hike to take place in November. The risk is that the Reserve Bank moves earlier, rather than later.

What do the figures show?

Consumer Price Index

- The All Groups Consumer Price Index (CPI) rose by 0.9 per cent in the June quarter after rising by 1.6 per cent in the March quarter.

- In the June quarter the ABS notes that "The most significant price rises this quarter were for fruit (+26.9%), automotive fuel (+4.0%), hospital and medical services (+3.4%), furniture (+6.0%), deposit and loan facilities (+2.1%) and rents (+1.1%). The most significant offsetting price falls were for vegetables (-10.3%), audio, visual and computing equipment (-6.3%), electricity (-1.5%), domestic holiday travel and accommodation (-1.5%), milk (-4.6%) and toiletries and personal care products (-2.3%)."

- The annual rate of inflation rose from 3.3 per cent in the March quarter to 3.6 per cent in the June quarter.
- Underlying measures of inflation were also higher in the June quarter. The weighted median measure rose by 0.9 per cent in the quarter, with the annual rate rising from a ten-year low of 2.2 per cent to 2.7 per cent. The trimmed mean measure rose by 0.9 per cent in the quarter with the annual rate rising from 2.3 per cent to 2.7 per cent. And CommSec estimates that the CPI excluding fruit, vegetables, petrol and deposit and loan facilities (CPIX) rose by 0.5 per cent in the quarter with the annual rate easing from 2.6 per cent to 2.4 per cent.
- Prices of tradables rose by 0.9 per cent in the June quarter, with higher prices for fruit, automotive fuel, furniture, accessories, tobacco, towels and linen, glassware, tableware and household utensils and pets, pet foods and supplies, partially offset by vegetables, audio, visual and computing equipment, toiletries and personal care products, food n.e.c. and other household supplies. The annual growth rate of tradables rose from 3.3 per cent to 3.6 per cent.
- Prices of non-tradables rose by 0.5 per cent in the June quarter. Price increases for house purchase and take away and fast foods were offset by price for electricity and milk. The annual rate of non-tradables inflation rose from 3.3 per cent in the March quarter to 3.5 per cent in the June quarter.
- Tradable goods are those items whose prices are largely determined on the world market. Non-tradable prices are more affected by domestic economic conditions.

What is the importance of the economic data?

- The Consumer Price Index (CPI) is regarded as Australia's premier measure of inflation. The CPI is published quarterly and measures price changes for a 'basket' of goods and services that dominate expenditure of metropolitan households. The "All Groups" index is the main focus, but other inflation measures are also published such as so-called 'underlying' measures. These include measures that abstract from price changes in volatile price items such as fresh food and petrol.
- The Reserve Bank aims to keep the headline inflation rate between 2-3 per cent over an economic cycle. If inflation is high and expected to rise, the Reserve Bank may elect to raise interest rates in order to constrain price pressures. Conversely, if inflation is low and expected to remain low, the Reserve Bank may elect to cut interest rates if it believes the growth pace of the economy is in need of strengthening.

What are the implications for interest rates and investors?

- The domestic economy is expected to pick up speed in the latter part of the year and into 2012. No doubt the concern for policymakers will be if the higher inflation reading becomes entrenched and feeds through the economy. There is no question that inflationary pressures will remain the hot button issue for the Reserve Bank over the midterm, and the key will be how quickly labour markets tighten up.
- However it is important to highlight that at present the economy is going sideways, while consumers are remaining conservative and refusing to spend unless goods are on special. As long

as consumers remain conservative and businesses have to shave margins to move stock then underlying inflation should remain within the Reserve Bank's target band of 2-3 per cent. In addition interest rates are already restrictive and as such CommSec expects the Reserve Bank to remain on the interest rate sidelines until the latter part of the year, with a rate hike pencilled in for November.

Source: Savanth Sebastian Economist, [CommSec](#)

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