

Core inflation to print 0.9%qtr for Q2 – expect rate hike in August

In a Report on the Governor's Statement following the July Board meeting we made the observation that, "It now appears likely that a 0.7%qtr print for core inflation would see policy unchanged at the August meeting, whereas we think a 0.8%qtr result would still see a rate hike."

We continued, "The last sentence in the Statement is ambiguous. On the one hand, there was a significant change from June. In June, policy was described as "appropriate for the near term", whereas in this Statement, it is described as "appropriate". That can reasonably be interpreted as the Bank buying some extra time. However, unlike in June, when the Governor broadly referred to "all the available information", this time, he notes "Pending further information about international and local conditions for demand and prices". This clear reference to local conditions for prices provides flexibility for the Bank to respond to an unfriendly CPI. Short of a further substantial deterioration in the global economy, we think that a print of 0.8%qtr on underlying inflation (trimmed mean) will be enough to trigger another rate hike."

Yesterday's release of the employment report showing that employment increased by 45,900 with the unemployment rate holding at 5.1% (only 0.1% above where we assess the RBA sees the NAIRU) will certainly qualify as important information on "local conditions for demand". Dismissing employment as merely a lagging variable overlooks the important feedback effects on incomes and confidence. However, the inflation picture will dominate the Bank's thinking on the next move.

We have now received all necessary data to calculate our CPI forecast for the June quarter which will be released on July 28.

Our forecast for the increase in both the trimmed mean and the weighted median is 0.9%qtr. That is consistent with a rate hike of 0.25% to be delivered on August 3.

If this forecast prints on the day then the annual increase in the trimmed mean will print 3% – the same print as the annual rate to the March quarter.

The most recent growth forecasts from the Bank anticipate growth at 3.25% in 2010; 3.75% in 2011; and 4% in 2012.

With growth expected to increase markedly in 2011 and 2012 it is reasonable to assume that the Bank would see the 3% current annual read as the low point in the cycle for underlying inflation.

However, note that the Governor has forecast that underlying inflation will track "in the upper half of the target zone over the next year". The low point being at the actual top of the zone hardly qualifies for that description.

Recall that the Bank assesses that currently, interest rates are around neutral. If the Bank is setting policy with inflation in mind then it will have little choice but to nudge rates into the contractionary zone.

The Bank would have much more flexibility if it has substantially revised down its growth forecasts to reflect a much weaker outlook for the world economy. Westpac's growth forecasts for 2011 and 2012 are significantly lower than the forecasts we saw from the Bank in its latest Statement on Monetary Policy (see above). We expect growth in 2011 and 2012 around trend pace of 3.2%. If the Bank were to lower its forecasts to those levels then it might assess that it has flexibility to stare down this high CPI.

Unfortunately we will not see these forecasts until August 6 – 3 days after the Board meeting in August. The Governor's Statement gave us little guidance in that regard but there may be more information in the Board minutes which are released July 20 – the same day that the Governor addresses the Australian Business Economists in Sydney.

Despite 10 of the last 12 prints of the trimmed mean being 0.8%qtr or higher we are still surprised that our trimmed mean estimate is so high. It is not because we have forecast excessive numbers for the major items in the CPI – house purchase (8% weight); rents (5.8%); motor vehicles (4.2%) and deposit and loan facilities (4%).

The trimmed mean is calculated after "cutting off" the lowest 15% and highest 15% (by weighting) of price changes of the 90 components of the CPI. Our calculations expect that the top 15% will be covered by only 4 large items including tobacco (2.5% weight). That keeps a lot of items with increases of 2% or more within the 70% group. On the downside we do not expect more than 20 items to register price falls. Only 3 of these items spill over into the 70% group which is used to calculate the trimmed mean. In previous quarters the trimmed mean has tended to include considerably more "negative" items. A full analysis of our calculations will be released in our normal detailed Preview Bulletin on July 15.

Of course there are the normal major uncertainties with these calculations – particularly surrounding the notoriously volatile "deposit and loan facilities". A sensitivity analysis on this variable highlights the possibility that the trimmed mean could print "only" 0.8%qtr. It is possible but unlikely that this highly unreliable component of the CPI could result in an even lower reading.

Our forecast for headline quarterly CPI is also 0.9%qtr. That would push the annual rate to 3.3%. Note that the Governor anticipated that headline inflation will be high. In his Statement he noted, "The rate of CPI increase is likely to be a little above 3% in the near term." Accordingly we expect that the Bank is not anticipating a number as high as 3.3% even for the headline rate.

The other factor that raises the probability of a rate hike in August is around the recent calm that appears to be settling on global markets. For us the best measure here is LIBOR. In May we were bombarded with forecasts that LIBOR was heading for 100bp's from its current 53bp's. In the event LIBOR has defied these warnings and settled around those May levels. The results of the European banks' stress tests which are expected later in the month will be a huge factor in determining these prices. A well presented set of results highlighting those banks which require more capital and describing the source of that capital (individual governments; the EUR 440bn SPV; IMF) will, as was the case in the US, go a long way to settling fears. On the European growth front we are already detecting the trend to discuss improving growth prospects for northern Europe.

Bill Evans, Chief Economist