

# Aust 2010Q2 CPI 0.6%qtr, 3.1%yr; avg RBA underlying CPI 0.5%qtr, 2.7%yr

## Marked slowing in core inflation to comfort RBA, removing risk of August & November rate hikes

- **Headline inflation came in well below expectations (consensus 1.0%, Westpac 0.9%) at 0.6%qtr in 2010Q2 (vs 0.9% prev). Annual headline inflation rose to 3.1%yr from 2.9%yr, the highest since 2008Q4.**
- **Underlying inflation also surprised significantly on the downside (consensus 0.8%, Westpac 0.8% with upside), slowing to 0.5%qtr (vs 0.8% prev). Annual underlying inflation fell below the top of the target band for the first time since 2007Q3 to 2.7%yr from 3.0%yr previously, providing comfort for the RBA with their 2¾% 2010 forecast.**
- **The detail saw weak pricing in discounted discretionary items across clothing and footwear; furniture and furnishings; household appliances, utensils and tools; sport and recreational equipment; and toys, games and hobbies – but all largely as expected. The main drivers of the downside shock were: the recreation group, from a much steeper fall in holiday prices; and volatile deposit and loan facilities. Together these explained 0.23ppts of the gap between our headline forecast (0.86% to two decimals) and the 0.6% result.**
- **The RBA will use this data to keep rates on hold on August 3, and now most likely for the remainder of 2010. The extraordinarily low 0.5% underlying print leaves 2010H1 running at a 2.6% annualised pace, comfortably in line with their forecast for 2010 of 2.75%. But, with rates now on hold for the rest of 2010, consumer confidence, business confidence, housing and most likely the labour market will be boosted. With rates currently only neutral, and unemployment set to fall below the NAIRU, that outlook makes it more likely the tightening cycle will resume in 2011. Our forecast for the official cash rate at end 2011 remains at 5.25%, but the tightening is now much more likely to occur in 2011 than being front-loaded in 2010 as we had previously expected.**

### Monetary policy implications – rates to remain on hold for the rest of 2010

This number comes as an extraordinary surprise. Westpac's forecasts for trimmed mean and headline inflation were both at 0.9%qtr. Market consensus was 0.8%qtr and 1.0%qtr respectively. We have to go all the way back to the December quarter of 2006 to recall a similar massive surprise, when the trimmed mean printed 0.5%qtr and the headline printed -0.1%qtr. At the time, the RBA was uncomfortable with the outlook for inflation, but duly kept rates on hold between November 2006 and August 2007. The Bank was later to regret that decision because inflation pressures built through 2007 with core inflation peaking at around 4.7%yr in 2008.

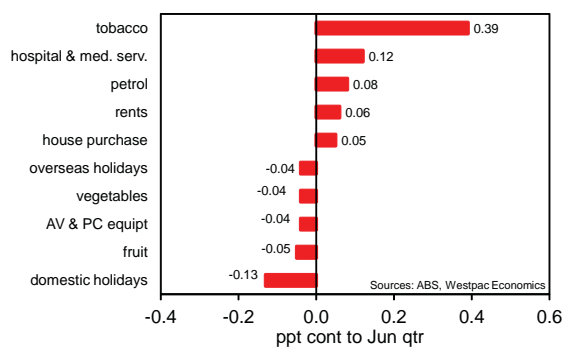
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### Consumer Price Index

		Sep 09	Dec 09	Mar 10	Jun 10
CPI	(index)	168.6	169.5	171.0	172.1
CPI	(%qtr)	1.0	0.5	0.9	0.6
CPI	(%yr)	1.3	2.1	2.9	3.1
Trimmed mean#	(%qtr)	0.8	0.5	0.8	0.5
	(%ann)	3.2	3.1	3.0	2.7
Weighted median#	(%qtr)	0.8	0.6	0.8	0.5
	(%ann)	3.7	3.4	3.1	2.7
Market sector**	(%qtr)	0.6	0.6	0.2	0.6
	(%ann)	1.5	1.6	1.9	2.0
Tradables	(%ann)	-0.5	1.4	1.1	1.4
Non-tradables	(%ann)	2.3	2.6	4.2	4.2

# RBA seasonally adjusted estimate, \*Less food and petrol, \*\*Less volatile items  
Sources: ABS 6401, RBA, Westpac

### Major factors in 0.6% rise in Q2 CPI



Nevertheless, the RBA is set to use the information from this release to keep rates on hold at the meeting on August 3, and most likely for the remainder of 2010. Our previous view had been that a high print today would have indicated uncomfortably strong momentum in inflation which would have required rate hikes in both August and November. This extraordinarily low print means that momentum in 2010H1 is running at a 2.6% annualised pace, comfortably in line with the Bank's forecast for 2010 of 2.75%. Even if the September quarter report shows a return to that 0.8%qtr pace (recall that before today, ten of the last twelve quarterly underlying inflation prints were 0.8% or higher) the evidence would not be sufficiently convincing from the inflation profile alone to raise rates in November.

It has to be our view therefore that **rates will now remain on hold for the remainder of the year.**

Our previous view had been that the economy is currently facing a range of headwinds including constrained credit growth, contractionary fiscal policy, a more cautious consumer, a higher Australian dollar, and a surprising reversal in confidence about the housing market. However, we expected that the dominant headwind was going to be a central bank dealing with short term inflation concerns and raising rates by another 50bp over the course of the remainder of 2010. That range of headwinds would have been sufficient, despite a resurgence in business investment, to keep rates largely on hold through the course of 2011.

Now, with rates on hold for the foreseeable future, consumer confidence, business confidence, housing and most likely the labour market will be boosted. Interest rates are still only at neutral levels, so given this scenario, it is now much more likely that the tightening cycle will resume sometime in 2011. By then, the Chinese economy will have restored its upward momentum, labour markets will be uncomfortably tight, and housing is likely to be staging a resurgence. Even economies like the US and Europe will have had another six to twelve months to work through their chronic imbalances.

It is likely that the remainder of 2010 will be quite boring for markets, but **rate pressures should reemerge in 2011.** Our forecast for the official cash rate by the end of 2011 of 5.25% remains, but the monetary tightening is now much more likely to occur through the course of 2011 than being front loaded in 2010 as we had previously expected.

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### The detail

The 0.6%qtr headline CPI result was well below consensus (1.0%) and our Westpac forecast (0.9%; 0.86% to two decimals), following a 0.9%qtr result previously. Still, with a lower 0.5%qtr result from 2009Q2 dropping out, annual headline inflation rose to 3.1%yr from 2.9%yr previously, the highest since 2008Q4.

Looking through the headline CPI group breakdown, downside surprises relative to our forecasts were seen in nine of the eleven groups (although only slightly for six of these), partially offset by upside surprises in two groups.

The three groups providing the greatest downside surprise were food; recreation; and financial and insurance services. Following a 1.4% rise in Q4 and 1.1% rise in Q1, we had expected markedly softer food price inflation in Q2 of +0.1%. The result was even weaker than this at -0.3%. That 0.4ppt gap in a group with a 16.4% CPI weight explained 0.07ppts of the 0.3 ppt gap between our 0.9% headline forecast and the 0.6% outcome. Within the food group, pricing was weaker than expected in dairy (mainly milk and cheese); breads and cereals (cakes and biscuits and 'other'); meat and seafoods (beef; bacon and ham; seafood); fruit and vegetables; meals out and takeaway (mainly restaurant meals); and 'other' food.

The greatest group downside surprise was recreation (-1.8% vs -0.6% f/c). That 1.2ppt gap in a group with a 10.6% CPI weight explained 0.13ppts of the forecast error. That in turn stemmed from an unexpectedly sharp fall in holiday prices (-4.2% vs -0.1% f/c). We had expected a sharp fall in domestic holiday prices of

3.5% with significant discounting on domestic airfares and low season accommodation pricing. The actual result was even weaker at -6.0%. But we expected an offsetting 4.2% rise in overseas holiday prices with the weaker currency, anecdotes of higher international airfares (in particular around the time of the Iceland volcanic eruption) and 'high' season Northern Hemisphere pricing. Surprisingly, overseas holiday prices fell 1.9% - unfortunately, the ABS provided no commentary on this item. Across other items in recreation, audio, visual and computing actually fell less than we expected, and sport and other recreation was also stronger than expected.

Financial and insurance services were also much softer than expected (0.2% vs 1.5% f/c). Insurance services (effectively premiums) had risen every quarter since 2007Q1 and we expected a 1.0% rise after a 1.6% rise previously, which would have been the smallest rise since 2007Q2. However, the ABS reported a 0.5% fall (weakest outcome since 1999Q1!), citing increased competition in motor vehicle insurance in some cities. The major surprise though was the always volatile deposit and loan facilities item. Our modelling on the basis of observed deposit and loan product rates suggested a 2.5% rise after a 3.4% rise previously. The ABS reported a 0.1% fall. That 2.6ppt gap in an item with a 4.0% CPI weight explained 0.10ppts of the forecast error.

So in summary, the 0.3ppt gap between the headline result and our forecast can be explained by the food group (0.07ppts), the recreation group (0.13ppts, mainly holidays), and deposit and loan facilities (0.10ppts).

With the earlier than usual June department store discount sales, we had expected historically weak pricing across discretionary sale items, and that proved to be the case across clothing and footwear; furniture and furnishings; household appliances, utensils and tools; sport and recreational equipment; and toys, games and hobbies.

The clothing and footwear group saw a flat result (vs -0.3% f/c). Pricing was weaker than expected in men's clothing, children's clothing, and accessories and clothing services, but more than offset by firmer pricing in women's clothing, and footwear. With the department store discount sales cycle and important driver of pricing in this group (usually down Q1, up Q2, down Q3, up Q4) we analyse pricing across two quarters to assess pricing trends. With the flat Q2 result following a 4.3% fall previously, the net two quarter change to Q2 was -4.3%. The comparable 2009 change was +1.6% and +0.5% in 2008, and the 2010 move was the weakest result in the post-GST period (since 2001).

Two other discretionary areas demonstrating weak pricing were in the household contents and services group, namely furniture and furnishings, and (to a lesser extent) household appliances, utensils and tools. These areas are also effected by the discount sales cycle, so we look at two quarter moves to assess trends. Furniture and furnishings prices rose 1.4% after a 3.8% fall previously for a net two quarter change to Q2 of -2.5%. The 2009 change was +3.6% and -0.2% in 2008, and the 2010 change was the weakest in the post-GST period. Household appliances, utensils and tools prices rose 1.8% after a 2.1% fall previously for a net two quarter change to Q2 of -0.4%. The 2009 change was +2.4% and +0.3% in 2008, and the 2010 change as the weakest since 2004 (-1.9%).

In recreation, sport and other recreational equipment prices fell 1.7% after a 1.2% fall previously for a net two quarter change to Q2 of -2.9%. The 2009 move was +4.6% and -0.2% in 2008, and the 2010 move was the weakest in the post-GST period.

Toys, games and hobbies saw prices fall 0.2% after a flat result previously, for a net two quarter to Q2 change of -0.2%. The 2009 change was +1.3% and +0.4% in 2008. The 2010 change was the weakest since 2006 (-0.6%) but only the second negative two-quarter to Q2 change in the post-GST period. Audio, visual and computing equipment prices fell 6.3% after a 5.9% fall previously, for a net two quarter to Q2 move of -11.8%. The 2009 move was -3.6% and -7.6% in 2008, and the 2010 change was the weakest in the post-GST period.

In terms of other major groups and items, alcohol and tobacco was stronger than expected at +5.9% (vs +4.2% f/c). Tobacco surprised on the upside with a 15.4% jump. We expected a 10.3% rise due to the 25% excise hike in late April, but the ABS noted there were additionally "some price rises" in tobacco outside of the excise hike.

Within the housing group, an upside surprise in rents was offset by a downside surprise in house purchase costs. PPI data implied a rise in house purchase costs of 0.7%, while the outcome was 0.6%. Paradoxically, the weak overall CPI result raises risks of this item accelerating over the medium term – with rates now on hold for the rest of 2010, confidence in housing is likely to benefit, improving the pricing environment for project home builders, giving greater freedom to pass on likely rising wage pressures in 2011. Rents reaccelerated earlier than expected to 1.1% (f/c 0.9%) from 1.0% previously, the strongest since 2009Q3. Our modelling of REIA data on new rents point to greater rent price pressures in 2011.

Within the transport group, overall pricing was only slightly softer than expected (+0.7% vs +0.8% f/c). Car prices fell 0.2% (as forecast) after a 0.6% fall previously, the strongest outcome since 2009Q3 and consistent with less dealer discounting with this being one area of solid consumer demand in 2010. Petrol prices rose, but by 2.1% (vs 2.5% f/c). With the introduction of the MyZone public transport ticketing system in NSW, we expected a rare 1.0% fall in urban transport fares (which would have been the first fall since 2004Q3 and weakest outcome since 1976Q3!) – the result was even lower at -1.6%.

### The average RBA underlying CPI

The published (to one decimal place) underlying CPI results showed a trimmed mean CPI of +0.5%qtr and a weighted median CPI of +0.5%qtr, giving an average RBA underlying rate of 0.5%qtr (vs 0.8%qtr previously). This saw an unexpectedly large slowing in annual underlying inflation to 2.7%yr from 3.05%yr previously (average of 3.1% weighted median and 3.0% trimmed mean), the lowest since 2007Q2. With the annual rate at 2.7% and the two quarter annualised pace at 2.6%, the RBA can be comfortable with their end-2010 underlying inflation forecast of 2.75% now.

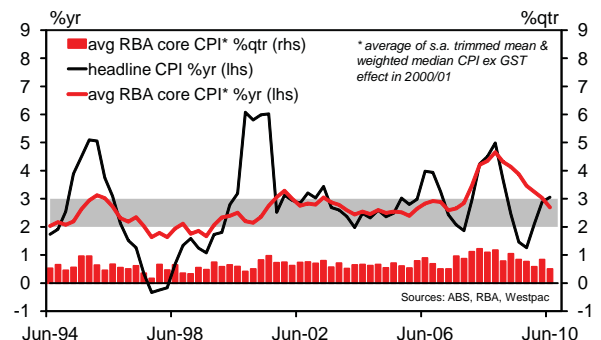
On our calculations, the quarterly underlying rates were neither 'hard' nor 'soft'. We cannot estimate a two decimal place weighted median, as the index levels it derives from are only published to one decimal place. We calculate the trimmed mean was 0.52%qtr to two decimal places.

What acted to drive a much lower trimmed mean pace in Q2 versus Q1? In Q2, with all the department store discounting in June, prices fell in 35 items (vs 39 in Q1). Outside of sale items, price falls included fruit; domestic holidays (SAdj); bacon and ham; vegetables; sandwich spreads; overseas holidays; cakes and biscuits; other cereal products; 'other' food; food additives; fats and oils; urban transport fares (SAdj); insurance services; beef; breakfast cereals; spirits; cars; pharmaceuticals (SAdj); and deposit and loan facilities. With some of the greatest price falls in

relatively high weight items (fruit; domestic holidays; vegetables; overseas holidays; furniture; and audio, visual and computing), only 22 of the price falls were removed from the trimmed mean in the first 15% of the distribution (vs 25 in Q1) and 13 price falls remained in the trimmed mean (similar to Q1 when 14 items recording price falls remained in the trimmed mean). So similar to Q1, the Q2 trimmed mean distribution began with the weakest price move being a -0.7% (vs -0.6% in Q1). However, at the top end of the distribution, without the increases in overseas holidays and deposit and loan facilities we expected (two high weight items), instead of these two items combining with hospital and medical services and tobacco to account for all of the top 15% of the distribution removed from the trimmed mean (which would have left more strong increases in the trimmed mean), another 10 items with strong increases were required to be removed to make up the top 15% (including gas; petrol; electricity). Consequently, 12 items were removed from the top of the distribution (vs 10 in Q1) acting to cut the trimmed mean. In Q1, the highest price rise in the trimmed mean was +3.0%; in Q2, the highest increase in the trimmed mean was much lower at +1.7%.

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### CPI inflation: RBA underlying falls sharply



### Domestic vs imported inflation

