

25 January 2012

Aust 2011Q4 CPI: Inflation pressures fading CPI flat in qtr/3.1%yr: core 0.6%qtr/2.6%yr

- The fear of many, not shared by Westpac, that inflation was about to boil over due to the mining boom MkII has proved to be unfounded. Headline inflation was flat in the December quarter taking the annual pace down to 3.1%yr from 3.5%yr in Q3 and a recent peak of 3.6%yr in Q2.
- As expected the moderation was due, in part, to seasonal factors (health is a big seasonal negative in Q4) but the drop off in the annual pace, and the 0.2%qtr rise in the seasonally adjusted CPI, highlights a real moderation in the pace of inflation.
- The main surprise in Q4 was the 1.2%qtr fall in motor vehicles. Most other components were broadly in-line with our expectations and if there was a variation it was, on average, a touch softer than what we were expecting.
- The main upside surprise was a 7.3%qtr rise in domestic holiday travel & accommodation (we had pencilled in +3.75%qtr) but this was countered to some extent by a 1.9% fall in international holiday travel & accommodation.
- The effect of the strong AUD is coming through. Tradable inflation dipped to 1.8%yr (was 3.3%yr in Q3) compared to 3.9%yr for non-tradable inflation.
- The core measures, which are seasonally adjusted and trim out the largest positives and negatives, rose a modest 0.6%qtr on average (0.5%qtr weighted median, 0.6%qtr for trimmed mean) which saw the annual pace rise very slightly to 2.6%yr from 2.5%yr.
- Core inflation continues to hug the mind point of the RBA inflation target band and the outlook is for it to moderate to the lower end of the band by mid 2012 (excluding the impact of the introduction of the carbon tax).

The CPI for the December quarter was flat, resulting in the annual pace dropping to 3.1%yr from 3.5%yr. Seasonality was a factor behind the soft result but the seasonally adjusted quarterly headline rise of 0.2%qtr was still a modest outcome. This was a bit softer than expectations, although there were no market forecasts for the seasonally adjusted measure.

The underlying inflation measures, which are based on seasonally adjusted data, printed 0.6%qtr/2.6%yr (trimmed mean CPI) and 0.5%qtr/2.6%yr (weighted median). The average was in line with market forecast of a 0.6%qtr rise. Westpac's forecast was also 0.6%qtr with downside risks. The wide gap between the underlying measures and the headline was due to both seasonality issues and the trimming out of the large falls in food

Consumer Price Index

		Mar-11	Jun-11	Sep-11	Dec-11
CPI	(index)	176.7	178.3	179.4	179.4
	(%qtr)	1.6	0.9	0.6	0.0
	(%yr)	3.3	3.6	3.5	3.1
CPI sa	(%qtr)	1.3	1.0	0.5	0.2
	(%yr)	3.3	3.7	3.5	3.0
Trimmed mean#	(%qtr)	0.8	0.8	0.4	0.6
	(%ann)	2.2	2.6	2.4	2.6
Weighted median#	(%qtr)	0.8	0.8	0.4	0.5
	(%ann)	2.6	2.8	2.7	2.6
Tradables	(%ann)	3.3	3.6	3.3	1.8
Non-tradables	(%ann)	3.3	3.6	3.6	3.9

Item	Q4		Q3	
	% qtr	contrib	% yr	contrib
Food	-1.5	-0.25	-0.2	-0.04
of which, fruit & vegetables	-9.6	-0.28	-1.8	-0.05
Alcohol & tobacco	0.9	0.06	0.5	0.04
Clothing & footwear	-0.5	-0.02	1.5	0.06
Housing	0.4	0.09	1.9	0.41
of which, Rents	1.0	0.07	1.2	0.08
of which, House purchases	0.3	0.02	-0.1	-0.01
of which, Utilities	0.3	0.01	7.2	0.26
H/hold contents & services	0.1	0.01	0.2	0.02
Health	-1.2	-0.07	-1.0	-0.05
of which, Pharmaceuticals	-5.6	-0.07	-5.0	-0.06
Transportation	0.0	0.00	0.1	0.01
Communication	1.1	0.03	0.0	0.00
Recreation	0.8	0.10	0.9	0.11
of which, holiday travel	0.0	0.00	0.1	0.00
Education	0.6	0.03	0.7	0.04
Financial & insurance services	0.1	0.00	-0.5	0.00
CPI: All groups	0.00	-	0.62	-
CPI: All groups % year	3.10	-	3.52	-

Seasonally adjusted estimate, **Less volatile items
Sources: ABS 6401, RBA, Westpac.

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prices.

Annual headline inflation is now 3.5%yr but at 2.6%yr, the average annual underlying inflation continues to hover around the midpoint of the RBA's 2 to 3% target band.

Overview of components

In original terms, that is not seasonally adjusted, the component moves were broadly in line with Westpac's forecasts.

Housing, which includes rents, the cost of building a house (house purchase) and utilities, rose 0.4%qtr (contributing 0.09ppt) compared to our forecast of 0.6%qtr. Dwelling purchase costs were a touch softer than expected (0.3%qtr vs. our forecast of +0.5%qtr) as were utilities (0.3%qtr vs. our forecast 0.5%qtr). Rents did moderate a little, 1.0%qtr in Q4 vs. 1.2%qtr in Q3, but they remain the key force in housing inflationary pressures and contributed 0.07ppt to the rise in the CPI.

The correction to fruit & vegetables was a little greater than we had expected (-9.6%qtr vs. forecast -6.8%qtr) which saw food prices fall 1.5%qtr. Food contributed -0.25ppt to the CPI.

Following the jump in clothing & footwear prices of 1.5%qtr in Q3, which followed a 2.2%qtr jump in the June quarter, we had expected a soft Q4 print (-0.5%qtr) which is seasonally unusual given that clothing prices tend to rise in Q4 prior to the post Christmas sales discounting of Q1. This expectation was met with the ABS reporting a 0.5%qtr fall.

The other main downward surprise came in the transport sector with a 1.2%qtr fall in car prices. Following the reported 1.1%qtr fall in Q3 we had been looking for a more modest 0.2%qtr fall. The last time we have seen a six month fall as large as this was in the second half of 2009 following the impact of the GFC. This time, demand for motor vehicles is holding up a much better in Australia so we suspect that the intense competition in the global car market, along with the robust AUD, is helping to drive Australian car prices lower.

As expected, there was a significant seasonal fall in pharmaceutical products (-5.6%qtr which was very close to Westpac's forecast for -6.0%qtr) which took 0.07ppt off the CPI.

The main upward surprise this quarter came from holiday travel due to a robust 7.3%qtr rise in domestic holiday travel & accommodation. Given the reports of a struggling tourism industry, and the solid 1.7%qtr rise in Q3, we are surprised by the magnitude of the price jump this quarter. In fact, it is the strongest quarterly rise in this series since the 7.7%qtr rise in Q4 2001. Unless there has been a significant turnaround in the fortunes of the domestic tourism industry we would expect to see some, if not all, of this jump corrected in the March quarter. There was a modest offset the fall in international holidays (-1.9%qtr) so overall holiday travel prices rose 2.8%qtr contributing 0.13ppt to the CPI.

Seasonal adjustment

The seasonality in the data does account for some of the gap between the flat headline print and more solid 0.6% rise in the core measures. The ABS now adjusts 62 of the 87 expenditure classes vs. 20 previously.

The resulting changes are informative. They show that: 1) large falls in fruit & vegetables is not a normal seasonality but a response to the disruptions of earlier this year (both have a small +ve seasonality in Q4); 2) the fall in pharmaceuticals was broadly consistent with the ABS seasonal factors (seasonally adjusted the fall turned into a modest 0.1%qtr rise) and 3) that the apparent

strong 7.3%qtr rise in domestic holiday travel was a more modest but still quite robust +2.5%qtr once seasonal effects are removed.

Core measures

The seasonally adjusted CPI rose 0.2%qtr as the positive boost to pharmaceuticals more than offset the downward adjustments to holiday travel and clothing. The annual pace of the seasonally adjusted CPI was 3.0%yr down from 3.5%yr in Q3.

The RBA core measure did show a slightly brisker pace of an average of 2.6%yr (vs. 2.5%yr in Q3) but they are still around the midpoint of the RBA target band and not showing any signs of accelerating. We would expect to see a moderation in core inflation from here but there are two factors that suggest to us that we should be careful not to overstate the downside risks to core inflation.

The first is that non-tradable inflation is currently running at 3.9% year and the great disinflationary impulse is coming through from the tradable side (1.8%yr and -1.3% over the last six months). As the AUD peaked in Q2 we suspect that while the strength of the AUD will be helping to hold prices down, the force to drive prices even lower may now be starting to fade.

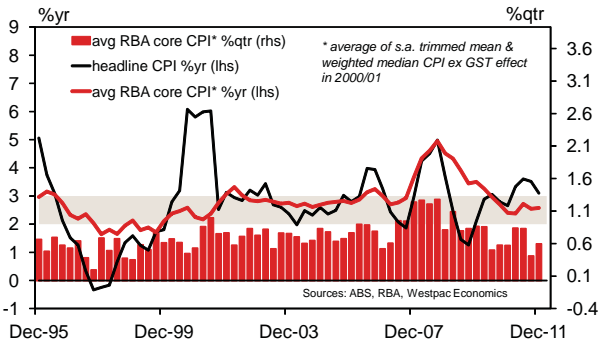
The second is that housing is a key driver of non-tradable inflation. Ex housing the CPI fell 0.1%qtr in Q4 and is up just 1.7%yr. While utilities cost pressures remain, and the pressure on rents are yet to ease in any meaningful way, we still see dwelling purchase costs remaining quite contained. So while housing may not act as a significant near term disinflationary drag, nor will they return to the significant inflationary driver they were though 2008 and 2009.

Westpac's preliminary forecast for the 2012Q1 CPI is a 0.7%qtr rise which would see the annual rate dip to 2.2%yr. The seasonally adjusted CPI is forecast to rise 0.5%qtr (2.2%yr) while the forecast for the average of the core measure is 0.7%qtr/2.4%yr. Excluding the impact of the carbon tax, we see core inflation bottoming around 2%yr in mid 2012.

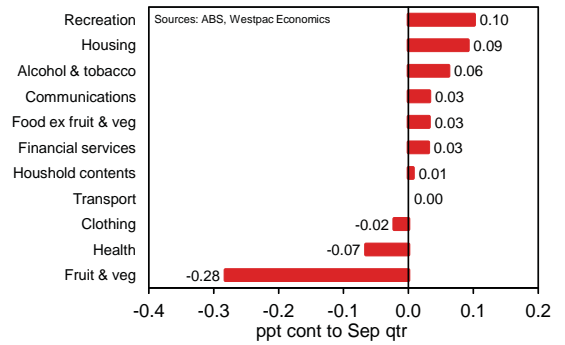
Justin Smirk, Senior Economist



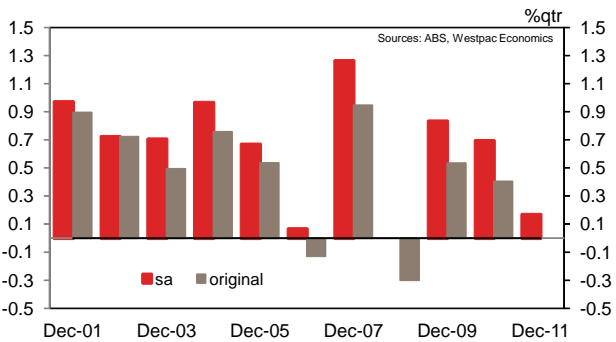
Headline CPI running 3.1%yr; core 2½%yr



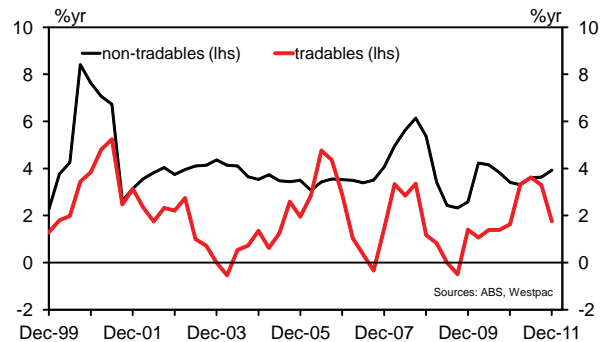
Contributions to the flat Q4 CPI



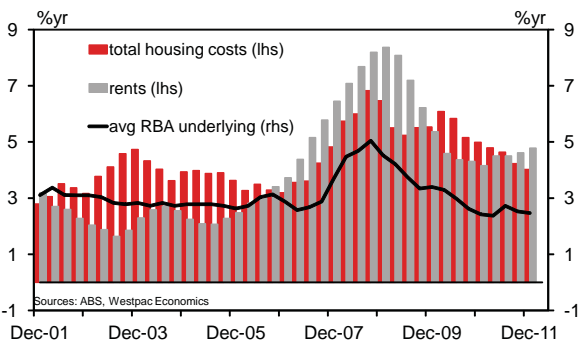
December seasonality is a drag on CPI



Tradable vs. non-tradable inflation



Core inflation and selected housing items



Carbon tax hits headline while core moderates

