

Inflation at 7-year low; rate cut on the agenda

Consumer Price Index

- The main measure of inflation in Australia – the Consumer Price Index (CPI) rose by just 0.4 per cent in seasonally adjusted terms in the September quarter. Economists had focussed on an increase of 0.6 per cent. The annual rate of inflation fell from 3.6 per cent to 3.5 per cent.
- Higher prices for utilities (electricity, gas & water), clothing & footwear and rents were partially offset by lower prices for fruit & vegetables and health care.
- 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 0.3 per cent (2.3 per cent annual); the weighted median rose by 0.3 per cent (2.6 per cent) and we estimate that CPIX rose 0.8 per cent (2.3 per cent).
- The 0.3 per cent quarterly increase in the trimmed and weighted median measures were the lowest quarterly readings since records began 9 years ago.
- The average of the Reserve Bank’s preferred “underlying” measures of inflation – weighted median, trimmed mean and CPIX – fell from 2.7 per cent to 2.4 per cent in annual terms – the lowest result in 7 years.
- The index of car prices has fallen to the lowest levels in 23 years.

What does it all mean?

- Well the Reserve Bank can certainly rest easy on the inflation front. The recently reweighted CPI data has confirmed that inflation is well and truly contained. The reweighting of the CPI index could not have come at a more opportune time, providing the Reserve Bank with a more up-to-date picture of the inflation landscape, at a time when the downside risks to the global economy remain elevated.
- A closer look at the inflation figures confirmed what we have been saying for some time. That is, the CPI had been pushed up by one-off items like fruit and vegetable prices in the past couple of quarters and the underlying picture was much more benign. Certainly in an environment where retailers are falling over themselves to trim prices in order to get consumers to spend, it would have been difficult to believe that inflation was a problem. And the latest data has confirmed that the price of imported goods remains low thanks to the strength of the Australian dollar.
- Not only was the headline inflation rate below economist expectations, so were the closely-watched underlying measures. Certainly the Reserve Bank’s preferred readings were on the low side. In addition annualised

The Seven RBA Inflation Measures

	Quarterly		Year-ended	
	Jun Qtr 11	Sep Qtr 11	Jun Qtr 11	Sep Qtr 11
CPI - seasonally adjusted	1.0	0.4	3.6	3.5
– Tradables	1.3	-0.2	3.6	3.3
– Tradables (ex food, fuel & tobacco)(b)	0.5	na	-1.0	na
– Non-tradables (excl.deposit & loan facilities)	0.6	1.2	3.6	3.6
<i>Selected underlying measures</i>				
Trimmed mean	0.8	0.3	2.6	2.3
Weighted median	0.8	0.3	2.9	2.6
CPI ex volatile items(a) and deposit & loan facilities(b)	0.5	0.8	2.5	2.3

(a) Volatile items are fruit, vegetables and automotive fuel (b) CommSec estimate Sept qtr

Source: ABS, CommSec

Savanth Sebastian – Economist (Author)
(612) 9118 1805 (work)

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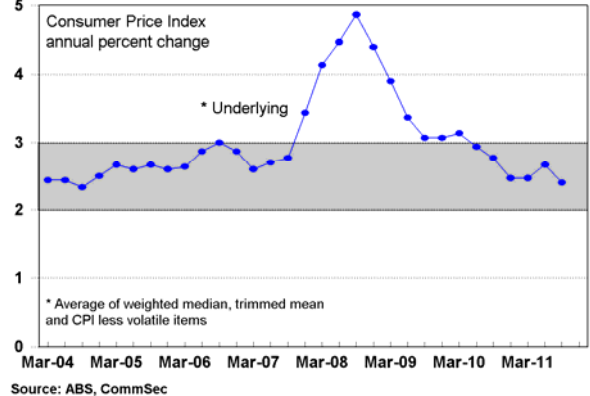
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underlying inflation remains solidly in the middle of the Reserve Bank's 2-3 per cent target band. In fact the average of the three key underlying inflation measures stands at 2.4 per cent.

- It's always important to remember that the Reserve Bank sets interest rates by looking forward, not backwards. While inflation is now comfortable in the middle of the Reserve Bank's target band, in recent times policy officials have highlighted that financial conditions have already eased somewhat since the start of the year with the slide in market interest rates and the Aussie dollar providing a marginal degree of stimulus. So it is by no means assured that the RBA will definitely cut rates next week.
- What is clear is that domestic inflation will not stand in the way of a rate cut, however the focus now shifts to Europe. If the European summit is unable to provide a definitive solution to the sovereign debt crisis then it is looking likely that the Reserve Bank will move to shore up confidence and provide stimulus by cutting rates by 25 basis points on Melbourne Cup day.
- Consumers are big winners at present, particularly car buyers. Cars are at the cheapest levels since the late 1980's and this is even before taking into account that wages have risen significantly over that time. Even health costs have eased growing at the slowest annualised rate in seven years.

Lowest underlying inflation in 7 years

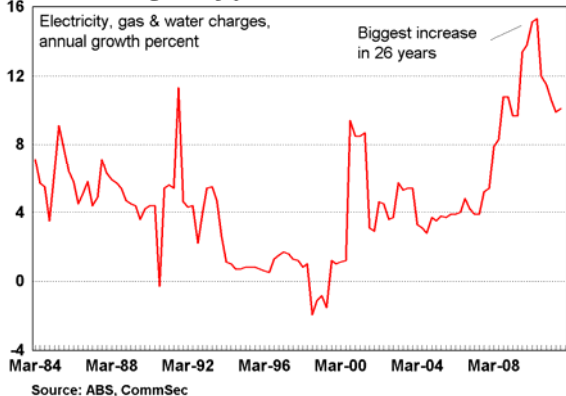


What do the figures show?

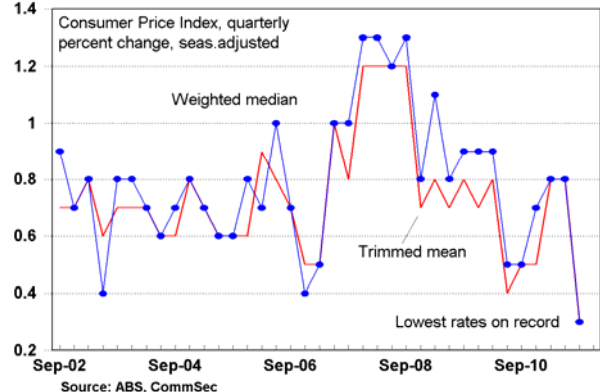
Consumer Price Index

- The All Groups Consumer Price Index (CPI) rose by 0.4 per cent in seasonally adjusted terms in the September quarter after rising by 1 per cent in the June quarter. In original terms the CPI index rose by 0.6 per cent in the September quarter.
- In the September quarter the ABS notes that “*The most significant price rises this quarter were for electricity (+7.8 per cent), international holiday travel and accommodation (+5.1 per cent), rents (+1.2 per cent), water and sewerage (+8.6 per cent) and property rates and charges (+5.2 per cent). The most significant price falls this quarter were for pharmaceutical products (-5.0 per cent), audio, visual and computing equipment (-3.3 per cent), automotive fuel (-1.4 per cent), vegetables (-2.5 per cent), motor vehicles (-1.0 per cent) and fruit (-1.2 per cent).*”
- The annual rate of inflation fell from 3.6 per cent in the June quarter to 3.5 per cent in the September quarter.
- **Underlying measures** of inflation were also lower in the September quarter. The **weighted median** measure rose by 0.3 per cent in the quarter, with the annual rate falling from 2.9 per cent to 2.6 per cent. Similarly the **trimmed mean** measure rose by 0.3 per cent in the quarter with the annual rate falling from 2.6 per cent to 2.3 per cent. And CommSec estimates that the **CPI excluding fruit, vegetables, petrol and deposit and loan facilities (CPIX)** rose by 0.8 per cent in the quarter with the annual rate easing from 2.5 per cent to 2.3 per cent.
- **Prices of tradables** fell by 0.2 per cent in the September quarter, with lower pharmaceutical products, audio, visual and computing equipment, automotive fuel, vegetables, motor vehicles, fruit and audio, visual and computing media and services, partially offset by tobacco, accessories, footwear for women and glassware, tableware and household utensils. The annual growth rate of tradables fell from 3.6 per cent to 3.5 per cent.
- **Prices of non-tradables** rose by 1.2 per cent in the September quarter. Price increases for electricity, water and

Still soaring utility prices



Record slowdown in inflation



sewerage, gas and other household fuels, and take away and fast foods drove the higher result. The annual rate of non-tradables inflation held steady at 3.6 per cent in the September 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?

- At present the domestic economy is going sideways while there are heightened risks of a global economic downturn. If the Reserve Bank believes that the Australian economy needs an additional degree of stimulus it certainly has the capacity to provide it - especially given that inflation looks to be well contained in the mid-term. 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.

The focus now shifts to the global economy and in particular the sovereign debt issues emanating out of Europe. If a definitive solution to the debt crisis is not agreed upon then it is likely the Reserve Bank will look to support confidence and activity by cutting rates on Melbourne Cup day.

Savanth Sebastian, Economist, CommSec
 Work: (612) 9118 1805

