National Australia Bank

18 January 2013

CPI preview - December quarter 2012

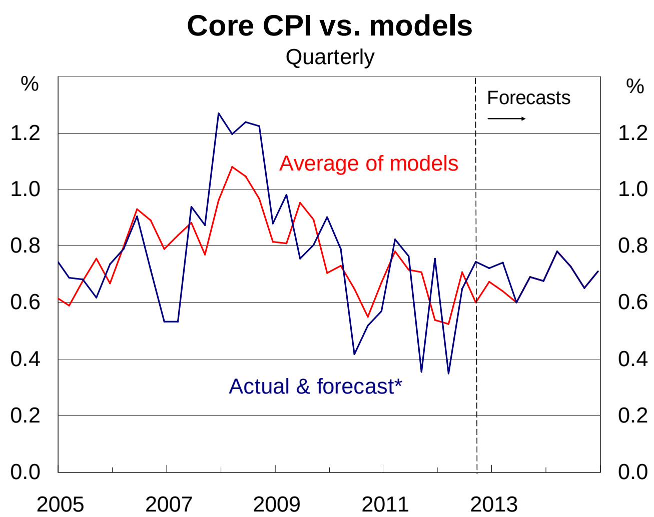
- We expect the December quarter CPI release (due 23 January) to confirm that inflationary pressures remained moderate in the final months of 2012.
- We expect a core inflation rate of 0.7% (2.4% through the year; including the impact of carbon), which is unchanged from the September quarter outcome and well within the RBA's comfortable range. Headline CPI inflation is expected to be softer, at 0.4% (2.4% through the year), largely reflecting weakness in fruit & vegetable prices. Petrol will be relatively neutral.
- The continued strength of the Australian dollar together with a weakening economy and price discounting means that near term inflation remains moderate. Consistent with those forces NAB business survey data also show subdued price pressures at end 2012.
- While a February rate cut will be discussed at the next board meeting, they already have done a lot. A low core CPI would probably be needed. We see the tipping point at 0.6% or lower (or 0.5% ex carbon). Hence we still see a March cut as more likely but it will be a close run thing.
- Looking further ahead, the weaker activity outlook for the domestic economy is expected to help contain inflation to below 3%, even when the impact of carbon pricing is taken into account. That will allow the RBA to focus more on cutting to help non mining sectors of the economy.
- With the unemployment rate expected to rise to near 5¾% by mid year, we still see the need for three 25 bps cuts, which we have tentatively pencilled in for March, May and August.

CPI Forecasts

	Quarterly % change			*Year to December quarter % change*			
	Jun-12	Sep-12	Dec-12 (f)	2011	2012 (f)	2013 (f)	2014 (f)
Headline CPI	0.5	1.4	0.4	3.0	2.4	2.9	3.1
Core CPI (inc carbon tax)*	0.6	0.7	0.7	2.7	2.4	2.6	2.9

** Core CPI is the average of trimmed mean and weighted median CPI*

Underlying/core inflation[1]



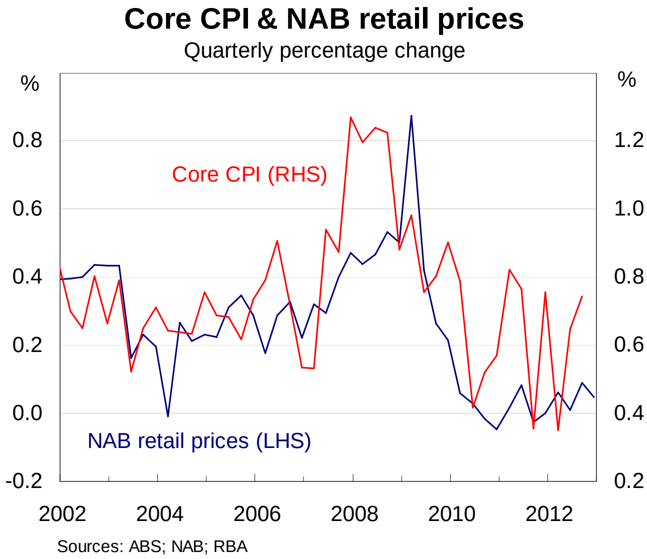
* Includes impact of carbon pricing
Sources: ABS; NAB; RBA

NAB's models of underlying or core inflation are based on the size of the output gap, labour costs growth, productivity growth, currency movements, fuel prices and error correction mechanisms. In addition to our own models, we also monitor a model based on published RBA research, based

[1] The RBA targets an underlying rate of inflation, which is measured using the 'trimmed mean' and the 'weighted median' inflation rates. Both of these series are used by the RBA to assess the underlying rate of inflation in the economy. They do not represent an unchanging sub-group of goods and services. Trimmed mean inflation is defined as the average rate of inflation after 'trimming' away 15% of price changes at both ends of the distribution, while weighted median inflation is the rate of change in the item in the middle of the distribution.

principally on unemployment and import prices. The chart shows the fit of the average of NAB and RBA models is reasonably close. At least they seem to explain the core drivers of underlying inflation. The reason why our forecast for the December (and March 2013) quarters are somewhat higher than predicted by the models (see the chart above), is our judgement of what the indirect impact of the carbon tax might imply.

There is, however, evidence from the *NAB Quarterly Business Survey* that retail inflation remains even more subdued - pointing to core inflation of around 0.6% in the December quarter (see Graph below). Retail margins appear to have remained tight, while official ABS data suggest that wage inflation drifted down over the September quarter. The annual growth rate of the wage price index (including bonuses) of 3.7% in the September quarter is well below levels three years earlier, when inflation was seen as a problem.



The possibility of a lower than expected core CPI outcome, as implied from the Survey, shows that a February cut could be a close run thing and certainly will be discussed at the February board meeting. Our judgment is that the tipping point for a cut in February is probably around the 0.6% mark in core terms – which could be alternatively interpreted as 0.5% ex carbon. Both NAB and the RBA are expecting contributions from carbon of around 0.1% per quarter over the December / March quarters (or around ½% over the financial year).

However as noted above, the RBA has cut in two out of the last three meetings and will probably feel more comfortable sitting and watching if the core inflation outcome is around 0.7% - as we expect. In many ways we may be about to see a rerun of the November 2012 meeting outcome – where with hindsight the RBA appeared to be a touch concerned by a higher than (market) expected inflation outcome (albeit, like now, one in line with model based expectations).

Headline inflation

Headline CPI inflation is expected to have been somewhat softer than the underlying rate in the December quarter. This largely reflects the weakness in fruit & vegetable prices, which are expected to have fallen quite significantly through the December quarter. We anticipate headline inflation to slow to 0.4% (2.4% through the year).

Other specific factors impacting the December quarter headline CPI outcome

- **Housing costs** growth is likely to have softened from its robust pace in the September quarter, when utilities prices (3.6% of spending) rose by a considerable 12.2%, largely reflecting the large, direct, first-round impact of carbon pricing. Indirect effects in the December quarter are likely to be less pronounced. Preliminary results from the *NAB Residential Property Survey* suggest a fairly soft 0.4% rise in national housing rents in the December quarter, while the *NAB Quarterly Business Survey* also showed only modest growth in construction costs and transport & utilities prices. Taken together, it appears that housing cost inflation is unlikely to have provided much of a boost to overall inflation in the December quarter.
- **Fruit & vegetable** prices (3.0% of spending) are estimated to have fallen back sharply over the December quarter, down by between 10-15% (not seasonally adjusted), unwinding a solid rise (10.2%) in the September quarter.

- **Transportation costs** appear to have risen modestly over the December quarter, excluding seasonality. Automotive fuel prices at the pump (3.6% of household spending) are estimated to have increased by between 1-1½% in the quarter, partly unwinding a decline of 3.9% in petrol prices in the September quarter.
- The **Australian dollar** remained strong in the final quarter of 2012, easing only marginally over the quarter in trade weighted terms. This is likely to have kept import price pressures fairly subdued. Having said that, currency changes do take some time to flow through to prices, so it is likely that we are still seeing the deflationary impacts of currency appreciation over the past year or so.

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