National Australia Bank

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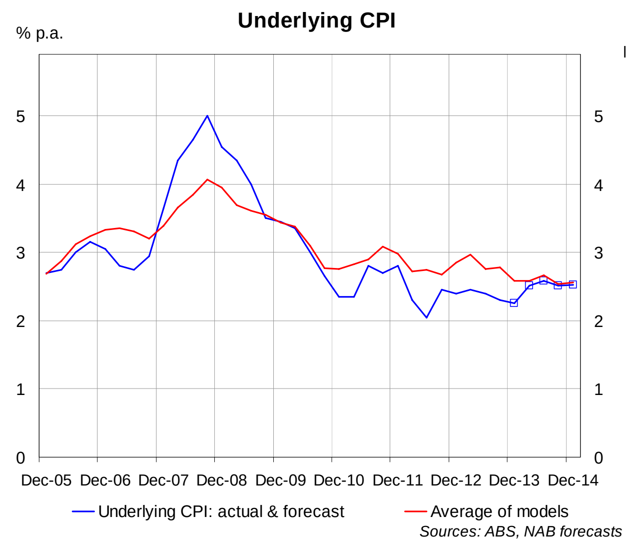
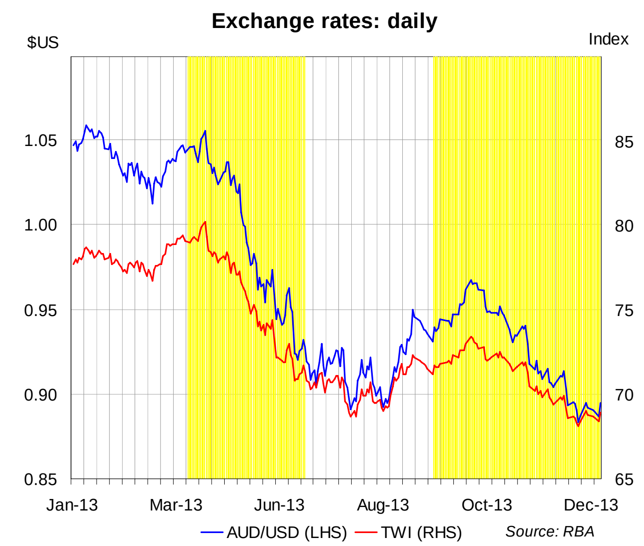
CPI preview

20 January 2014

Wednesday's CPI likely to confirm low inflation environment: still well inside RBA comfort zone.

- We expect Q4 underlying inflation to print at 0.6% (2.3% through the year) on Wednesday. This would be the fifth successive outcome in the bottom half of the RBA target range. Subdued wages growth and weak domestic demand continue to keep core inflation well under control. Although the AUD was 8% lower, on average, in the second half of 2013 than the first half, it is unlikely to have had a significant effect on consumer price inflation in Q4.
- Headline CPI inflation is expected to be 0.5% (2.4% through the year), with the effects of a tobacco excise hike more or less offset by lower fuel prices and a seasonal decline in pharmaceutical costs.
- We expect underlying inflation to gain only a modest amount of momentum over the coming year as the AUD depreciation passes slowly through the wholesale-retail supply chain. A soft labour market restraining wage cost growth and the prospective removal of the carbon tax can be expected to help contain underlying inflation well within the RBA comfort zone.
- For the RBA, these numbers would keep inflation out of play in terms of policy formulation. Rather, the RBA is likely to continue its focus on jawboning the AUD to a lower level and monitoring the rate at which the labour market weakens through the course of the first half of this year.





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Analysis

Drivers of the underlying inflation rate are generally unchanged or slightly softer in Q4. The exception is the AUD, which has averaged more than 8% lower in the second half of 2013 compared with the first half. However, exchange rate impacts on the domestic price level are protracted and tend to be small in the short term. In the case of underlying inflation, the effects of sharp exchange rate changes on sensitive import prices tend to be 'trimmed' out of the inflation measure. More broadly, however, the pass through from the AUD to import prices is less than one for one because the costs of domestic freight, storage and distribution are insensitive to the AUD. Consequently, we do not expect significant exchange rate effects on the underlying CPI.

In addition, wholesalers and retailers have limited scope at present to pass on higher costs of imported merchandise in the current environment of weak domestic demand, and are likely to absorb much of the increased cost in reduced margins. There is considerable evidence from the NAB quarterly business survey (see Business and the dollar) that wholesalers and retailers were badly squeezed by the depreciation in the middle of 2013.

Wages growth has softened in line with the weakening labour market. The employment-population ratio declined in December to its lowest level since early 2005. Since mid-2013, the adult population has increased by 168,000 but the labour force has actually declined slightly. With the unemployment rate hovering around 5.8%, annual growth in the private sector wage cost index has declined to 2.7%, the slowest rate since the GFC.

Automotive fuel prices declined marginally on average in Q4.

The average prediction of our more robust models of the underlying CPI is 0.6%, with individual predictions ranging from 0.55% to 0.67%. At least on this basis, the risks appear well balanced.

An important impact on headline inflation will be a 12.5% increase in excise (and excise equivalent customs duty) on tobacco and related products on 1 December 2013. We estimate that this will add 0.3% to the level of the CPI, with one-third affecting Q4. Thus, the contribution of this excise change to headline inflation is forecast to be 0.1% point in Q4 and 0.2% points in Q1 of 2014.

Overall, headline inflation is expected to be marginally weaker than the underlying rate, at 0.5% (2.4% through the year) as weaker fuel prices and the seasonal effect of the PBS safety net broadly offset the impact of higher tobacco excise.

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