

# ECONOMICS NOTE: AN INFLATION PERSPECTIVE

May 2008

Monday, 5<sup>th</sup> May 2008

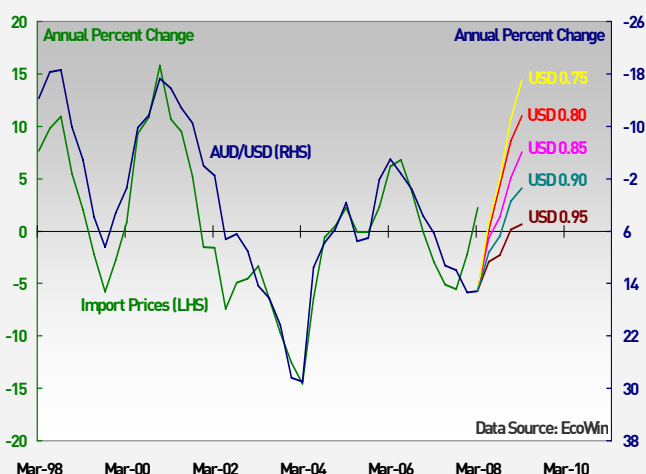
Inflation has accelerated over the past 12 months, taking the rate well above the RBA's 3% target ceiling. An examination of the influences which have contributed to the lift in inflation shows that both local items (housing costs and pharmaceuticals) and tradable goods (fuel and other energy) are amongst the key factors driving prices. While higher international commodity prices are clearly contributing to the rise in inflation, there has been little discussion of the role the strong Australian Dollar has played in preventing even higher inflation. Below, we discuss the impact of the currency on inflation and draw some conclusions regarding the outlook for the CPI and for interest rates.

Last month, the Australian Dollar (AUD) rallied to a 24 year high of over US95c. A range of factors have contributed to the rally in the currency over the past 2 years, including the robust domestic economy, the global commodity boom and high domestic interest rates. Over the past 12 months alone, the currency has appreciated by 13% against the US Dollar (USD) and by a lesser 6% against the Trade Weighted Index. The difference reflects the decline of the USD against most other currencies. However, because global commodities are generally priced in US Dollars (and because Australia, being a small trading nation, is normally a price taker in world markets) it is the AUD/USD exchange rate that is of most interest in the current environment.

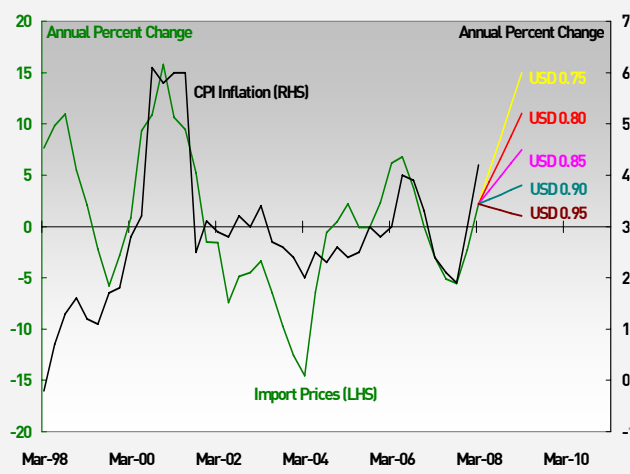
To what extent has the increase in the AUD/USD exchange rate protected the domestic economy from the gains in commodity prices? We can answer this by looking, for example, at the oil price. The USD oil price has increased by 73% over the past 12 month yet, in AUD terms, the increase has been a lower 52%. Looking instead at the ABS Import Price series, this increased by 2.2% over the 12 months to March, compared to 4.2% for the overall CPI<sup>1</sup>. However, as the Reserve Bank (RBA) notes, the more subdued gains in import prices cannot be entirely attributed to just a strong currency: *'Tradables inflation is likely to have been restrained somewhat by the trend appreciation of the exchange rate over the past few years and by declines in the prices of many manufactured goods.'*<sup>2</sup>

Looking forward, and as discussed in our current *Australian Dollar Outlook*, we are forecasting a weaker AUD as the interest rate differential between Australia and the US stabilises and as the USD puts in a base after a major depreciation. We project the AUD to drift off over the next 12 months, to around US84c. Given the discussion above, a key issue, therefore, is the extent to which this currency depreciation exacerbates the current inflation problem?

Exchange Rate vs Import Prices



Import Prices vs CPI Inflation



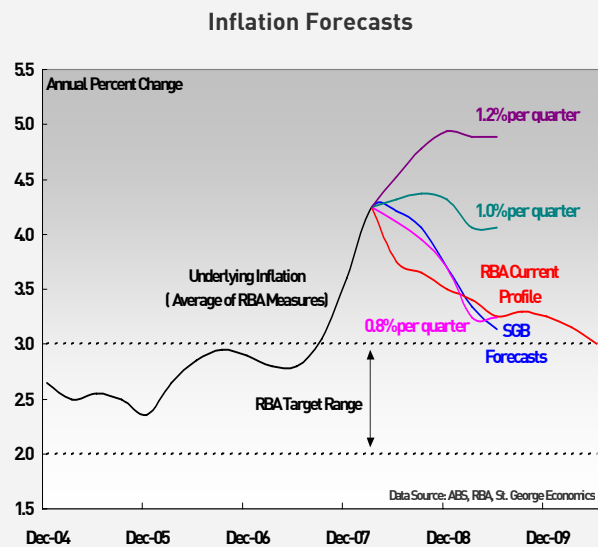
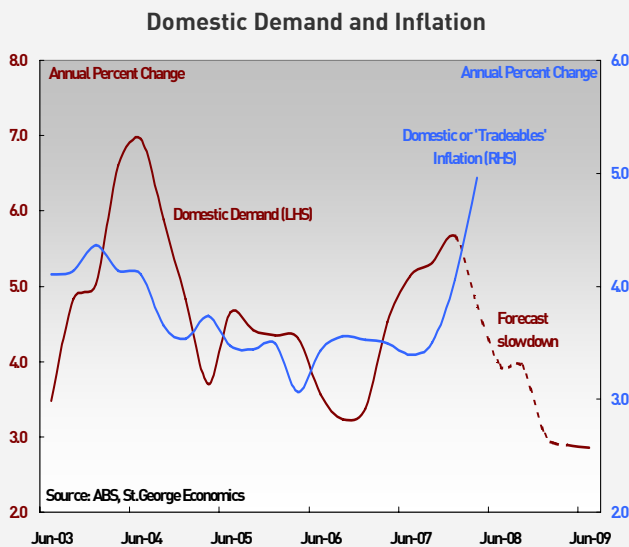
We have sought to quantify this using the charts above. The left hand chart shows a close relationship between movements in the AUD (which are plotted inversely) and import prices (with a correlation coefficient of 0.91). We have then added a range of scenarios for the AUD for the next 12 months (the RBA notes that an exchange rate depreciation takes four quarters to pass through to import prices)<sup>3</sup>.

As shown, if the AUD remains around current levels (US93-95c), import prices should remain subdued. However, as the currency depreciates to US90c or lower, import price inflation accelerates. Indeed, our AUD/USD target of US84c would equate to import price inflation of around 8% per annum - other things being equal. The right hand chart then translates these import price conclusions to the rate of consumer price (CPI) inflation, as discussed on the next page.

From the second chart, we observe a reasonable relationship between import and consumer prices (with a correlation coefficient of 0.36) which allows us to take our various AUD/USD scenarios one step further. The chart shows that if the AUD remains in the US90-95c range, the relatively low rate of import price growth could help to lower CPI inflation over the next 12 months. However, as the currency moves into the mid-US80c range, consumer price inflation accelerates further – again assuming other things equal. From this chart, we can develop a broad rule of thumb: each US5c off the currency adds around 0.7 percentage points to the annual inflation rate.

Returning to our forecasts (see table next page), as discussed, we expect a currency depreciation to around US84c over the next 12 months yet, at the same time, we anticipate a decline in the inflation rate, from above 4% to a little over 3%. In each case, our forecasts are broadly in line with the consensus but, given the analysis above, are forecasts of a significantly weaker AUD and lower inflation consistent? The above analysis suggests not. However, the assumption of other things equal rarely applies and the RBA reminds us that depreciation episodes are not all the same, due to *'the state of demand in the economy; the factors causing the exchange rate to depreciate; and the general inflationary environment.'*<sup>3</sup> In the current environment, we expect the slowing of the economy and some easing of global commodity prices to make the difference. How likely is this?

The left hand chart below shows the impact of domestic demand on the domestic component of inflation. Our forecast is for the economy to slow (yet achieve a 'soft landing') and there is little doubt that this is now underway. This should, in time, produce a slowing in domestic inflation. Indeed, de Brouwer<sup>4</sup>, in his inflation research, states that inflation is still best modelled by reference to the economy's 'output gap' (the difference between demand and the productive potential of the economy or, alternatively, the extent of spare resources available). Accordingly, a slowing in the economy, by lowering resource utilisation, would normally be expected to lower inflation. This is the key basis for our projected fall in the inflation rate. It also appears that the RBA holds a similar perspective on inflation.



At the same time, a firmer USD may help facilitate a decline in key commodity prices, including oil. Indeed, the recent April 22 peak in the oil price, at just below USD120 per barrel, coincides, to the day, with a trough in the USD Index.

Bringing this together, the right hand chart above illustrates, in blue, our inflation projections for the coming 12 months. We expect the recent March-08 data to mark the high point in the inflation cycle (with our June-08 quarterly forecast for underlying inflation being 0.9%, compared to the March-08 gain of 1.3%). However, alternative scenarios are, of course, possible and the chart shows that an inflation track of 1% per quarter or higher will confound our (and the RBA's) expectation that inflation will soon begin to return to target.

Accordingly, a 1% increase in underlying inflation could be regarded as the 'tipping point' for a rate increase at the August-08 meeting, after the release of the June-08 CPI on July 23.

To conclude, the odds seem stacked against inflation at present and a weaker currency won't help; that is, high commodity and import prices could prevent a decline in inflation, prompting further action from the RBA. Alternatively, the economy could slow more sharply than our 'soft landing' scenario leading to a more rapid decline in inflation than expected and, therefore, to early interest rate cuts. However, the third alternative, which we see as most likely, is that the slowing in the economy will lower inflation gradually. This should see us (narrowly) avoid another rate increase this cycle. At the same time, however, it is unlikely to lead to interest rate cuts within our 12 month forecast horizon.

#### Footnotes

1. The Import Price series includes consumer and non-consumer items.
2. RBA Statement on Monetary Policy, February 2008.
3. 'Devaluation and Inflation', RBA Bulletin, May 1993.
4. Gordon de Brouwer, Discussion of Inflation in Australia: Measurement and Modelling, 2004.

## Forecasts (end of quarter)

	2007			2008			2009	
Forecasts	Q2	Q3	Q4	Q1	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)
GDP qtr/qtr	0.9	1.1	0.6	0.6f	0.7	0.7	0.7	0.8
GDP yr/yr	3.9	4.3	3.9	3.2f	3.0	2.6	2.7	2.9
Core CPI qtr	1.0	1.0	1.1	1.3	0.9	0.8	0.7	0.9
Core CPI yr	2.8	3.1	3.6	4.3	4.2	4.1	3.7	3.3
Cash Rate	6.25	6.50	6.75	7.25	7.25	7.25	7.25	7.25
3 Yr Bond	6.46	6.45	6.91	6.21	6.60	6.50	6.30	6.10
10 Yr Bond	6.26	6.16	6.34	6.06	6.20	6.10	6.00	5.90
S&P/ASX200	6275	6568	6340	5356	5500	5700	5900	6100
AUD / USD	0.8486	0.8872	0.8757	0.9127	0.92	0.90	0.88	0.85
AUD / NZD	1.0998	1.1718	1.1423	1.1629	1.23	1.23	1.26	1.25
AUD / EUR	0.6267	0.6217	0.6002	0.5786	0.61	0.60	0.60	0.59
AUD / YEN	104.50	101.84	97.49	99.81	99	99	99	97
AUD / GBP	0.4224	0.4334	0.4412	0.4603	0.48	0.47	0.46	0.45

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