

# Australian economic update

## Q4 CPI outcome

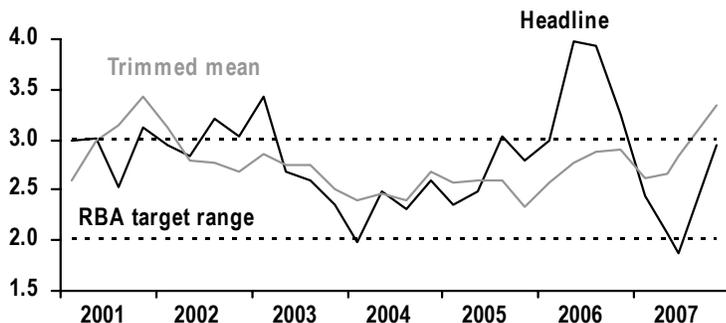
Today's 4Q CPI data showed that Australia's already serious inflation problem has become even more acute. At 3.0%oya, annual headline inflation now is running at the top of the RBA's 2-3% target range. More importantly, core inflation has breached the upper limit of the target range for the first time since 2002 - the average of the RBA's preferred underlying measures rose 1.05%q/q in the December quarter, the largest on record, and is running at 3.6%oya. On our forecasts, core inflation will average 3.5%oya - well above target - for an extended period.

Today's upside surprise on the core measures and the deteriorating inflation outlook mean we are sticking with our call for the RBA to raise the cash rate 25bp on February 5, even after taking account of the Fed's surprise rate cut overnight and the extreme volatility in global financial markets. There are, however, key events ahead of the next Board meeting that could derail our rate hike call, including the behaviour of global financial markets, how aggressively, if at all, central banks act in coming days and weeks, and how the US economic data, in particular, prints.

Normally, a 1%-plus quarterly print on Australia's core CPI and a clear breach of the inflation target would make an RBA rate hike at the next Board meeting a near certainty. This time, however, the water flowing under the RBA's policy bridge is particularly muddy. The domestic case for a rate rise remains compelling - Australia's economic growth is above potential, so the economy has little spare capacity and inflation is running above target, the labour market is tight, so wage pressure is building, there is another round of personal income tax relief coming through from July, and the soaring terms of trade is providing a substantial boost to national income.

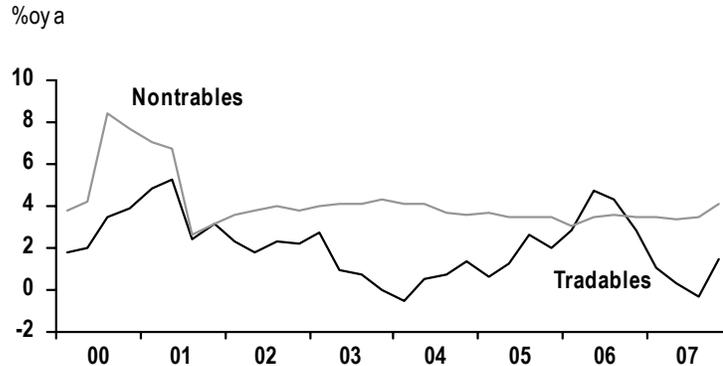
**Australia: headline and core CPI**

% oya (ex. GST)



Right now, though, the strong domestic case for a rate rise is being undermined by rapidly moving events. Plunging equity markets mean there is significant wealth destruction taking place, which may curb household spending patterns and damage both consumer and corporate confidence. Also, the unexpected 75bp inter-meeting rate cut by the Fed signals that the outlook for the world's largest economy is darkening; RBA officials place significant weight on developments offshore when assessing the domestic policy stance.

#### Australia: tradables and nontradables inflation



Indeed, rapidly evolving developments in global financial markets and the Fed's rate cut mean the chances of RBA Board members taking a more cautious approach next month have risen. Delaying the rate hike that domestic economic conditions suggest is needed, though, carries significant risk. Waiting allows the RBA to see how aggressively the Fed acts from here - we expect another 75bp of Fed easing by March - and to see how financial markets behave. Delaying the rate hike, though, makes it more likely that the inflation genie escapes from the bottle - if it hasn't already - which means the RBA later would have to respond more forcefully than if it acted now.

The main drivers of inflation in the December quarter were broadly as expected. The largest rises were for automotive fuel (up 7%), the cost of household finance (up 3%), house purchase costs (up 1%), residential rents (up 2%) and the price of domestic holidays (up 4%). These were offset to some extent by a plunge in the price of fruit (down 13%), vegetables (down 7%), drugs (down 5%), and electronic equipment (down 4%). Ex. food, the headline CPI rose 1.1%q/q in the quarter. Tradeables inflation picked up to 1.4%oya in the December quarter; non-tradeables inflation accelerated to 4.1%oya, the highest since 2004.

## Australian CPI

	Q4 2007	
	% q/q	% oya
Food	-0.1	1.2
Alcohol and tobacco	1.3	3.6
Clothing and footwear	0.2	1.6
Housing	1.1	4.8
Household furnishings, etc	0.8	-1.0
Health	-1.0	4.1
Transportation	2.4	5.6
Communication	0.0	0.4
Recreation	0.8	1.0
Education	0.0	4.1
Financial and insurance services	2.1	4.9
<b>All groups</b>	<b>0.9</b>	<b>3.0</b>
<i>Trimmed mean</i>	<i>1.0</i>	<i>3.4</i>
<i>Weighted median</i>	<i>1.1</i>	<i>3.8</i>