

Australia: May inflation drop should be enough to keep policy rates unchanged in July

If the June Reserve Bank of Australia (RBA) rate decision was a finely balanced one, pushed over the edge by a spike in April's inflation to 6.8% YoY, then by the same logic, the plunge in inflation in May should result in a "hold" decision in July



Source: Shutterstock

5.6% May inflation
YoY%

Lower than expected

May inflation plunges

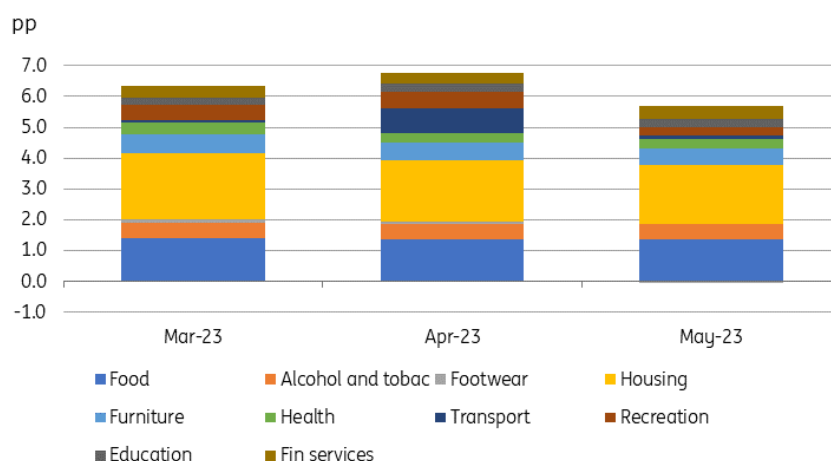
With only retail sales and home loan data due before the next RBA decision on 4 July, it looks

extremely unlikely that Governor Lowe and his colleagues will be able to do anything other than hold rates steady at that meeting.

We had expected a decent pullback in the inflation rate in May due to base effects from last year, as well as lower retail gasoline prices. But the adjustment was much more dramatic than we or the consensus had envisioned. At -0.42% MoM (our calculations), the CPI index fell considerably more than seemed likely, even with transport costs dropping 2% thanks to a 6.7% MoM decline in motor fuel. What we had not bargained on, was a 0.2% MoM fall in tobacco prices, a 1.9% MoM reversal in last month's clothing price gains, and a 4.4% MoM reduction in recreation costs, driven by an 11.1% fall in holidays (hotel room rates and airline tickets most likely).

That resulted in not only a fall in the headline rate of inflation but also pulled the measure excluding volatile items down to 6.1%YoY from 6.8% - a very healthy fall.

Contributions to May inflation rate (pp)



Source: CEIC, ING

It wasn't all one way though...

But it would be wise not to get too carried away. Certainly, a number of outsize declines in some components drove today's big fall in inflation. But this was a messy release, with a number of interesting increases as well as decreases. Food and beverages rose 1.05% MoM, much faster than the recent trend increase. Rents, an important contributor to the housing component, continued to rise at a 0.8% MoM pace, and are showing no signs of slowing. And there was a large 1.1% MoM increase in financial prices.

In short, there was a lot of volatility in this release, and a slightly different spread of outcomes could have seen the numbers go the opposite way. So while today's numbers show a welcome moderation in inflation, especially in the core series, it is harder to pull out of this release anything that confirms that the trend in the months ahead will also remain more moderate. Retail gasoline prices in June will average higher than in May, so the transport element of today's fall will likely reverse. And in July, we will have to deal with much higher electricity tariffs (a 20% YoY increase or even more is anticipated), which will push up the utilities part of the housing component.

Base effects will continue to help the year-on-year comparisons, so we see June inflation slipping further to 5.2% YoY. But inflation in July may go sideways, or even rise slightly, and this could be

enough to persuade the RBA of the merits of a further 25bp rate hike at their September meeting, taking the cash rate to 4.35%. That decision will also likely be influenced by developments in housing and the labour market, and if these have softened substantially by then, it won't be such an obvious call.

The AUD dropped sharply on the release, which is a perfectly reasonable response, as markets pared back their expectations for RBA tightening to just over one more rate hike by the end of the year. That has a little further to be reduced in our view and could keep the AUD in this sort of range over the coming months until there is a clearer sign on the direction for US rates. The long-awaited dollar weakness is taking a while to arrive as the US economy doesn't seem to want to lie down despite the best efforts of the Federal Reserve Bank.

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