5. Price and Wage Developments

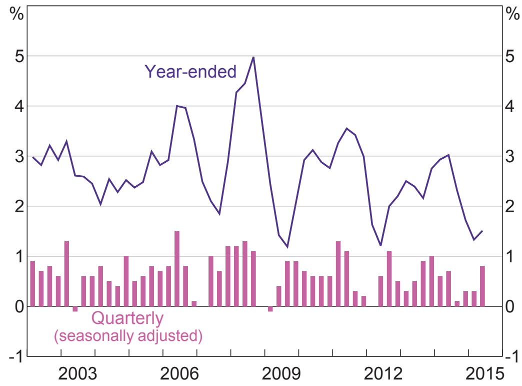
Headline inflation has been low over the past year due to temporary factors, although it has picked up of late. Underlying inflation has been little changed for the past few quarters. Domestic inflationary pressures are well contained, in line with spare capacity in the labour market. Wage growth has declined further in recent quarters, and remains especially low. A key exception to the moderate domestic inflationary pressures is the cost of new dwellings, which has experienced higher inflation associated with strong building activity. Inflationary pressures from imported items are increasing in response to the depreciation of the Australian dollar since 2013.

Recent Developments in Inflation

Consumer price inflation picked up in the June quarter to 0.8 per cent (in seasonally adjusted terms) (Graph 5.1; Table 5.1). Much of this increase was a result of higher prices for automotive fuel. Nevertheless, CPI inflation over the year has been low at 1.5 per cent. Fuel prices remain about 10 per cent lower than a year ago, while the removal of the carbon price in the September quarter 2014 has lowered utility prices over the year.

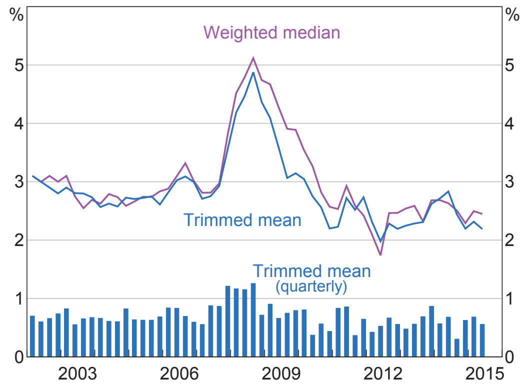
Indicators of underlying inflation were around ½ per cent in the June quarter (Graph 5.2). Over the year, various measures suggest that underlying inflation was about 2¼ per cent, in line with the forecast in the May *Statement*. Interpreting the year-ended pace of underlying inflation continues to be affected by the indirect effects of the repeal of the carbon price last year on a wide range of prices. While the repeal has lowered costs for many businesses, the size of the effect on final consumer prices is difficult to ascertain.

Graph 5.1
Consumer Price Inflation



Source: ABS

Graph 5.2
Measures of Underlying Inflation
Year-ended



Source: ABS

Recent movements in automotive fuel prices have had a noticeable influence upon the CPI. Retail prices for fuel have increased since their low point earlier

Table 5.1: Measures of Consumer Price Inflation
Per cent

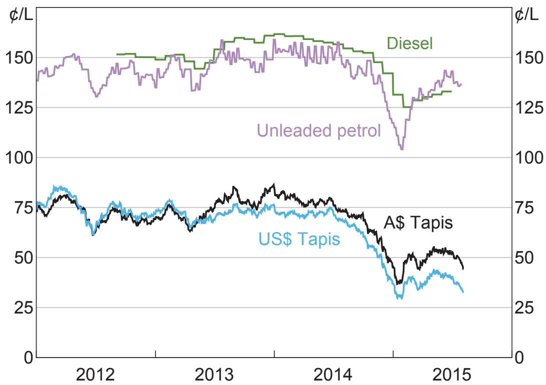
	Quarterly[a]		Year-ended[b]	
	June quarter 2015	March quarter 2015	June quarter 2015	March quarter 2015
Consumer Price Index	0.7	0.2	1.5	1.3
Seasonally adjusted CPI	0.8	0.3	–	–
– Tradables	1.1	-0.6	–0.3	–0.9
– Tradables (excl volatile items and tobacco)[c]	–0.2	0.5	–0.2	0.4
– Non-tradables	0.6	0.8	2.6	2.6
– Non-tradables (excl utilities)	0.6	0.7	2.9	3.0
Selected underlying measures				
Trimmed mean	0.6	0.7	2.2	2.3
Weighted median	0.5	0.8	2.4	2.5
CPI excl volatile items[c]	0.5	0.7	2.0	2.3

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS
(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median
(c) Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

in the year, rising by nearly 12 per cent in the June quarter and contributing 0.3 percentage points to headline inflation. Since its trough in January, the average price of unleaded petrol has increased by around 30 cents per litre. The recent increase is only partly explained by higher international prices for crude oil and the depreciation of the Australian dollar over that period (Graph 5.3). Refining margins have also increased and there has been an increase in retail margins, which had been compressed with the earlier decline in petrol prices.

Despite the recent increase, fuel and oil prices remain lower than a year ago, and will exert some downward pressure on business costs and prices for a time. The price of diesel – which tends to be more important for freight costs than petrol – has been little changed of late and remains around 15 per cent lower than a year ago. Nevertheless, any downward influence on underlying inflation is likely to take some time to work its way through the supply chain, and the size of the effect is difficult to assess.

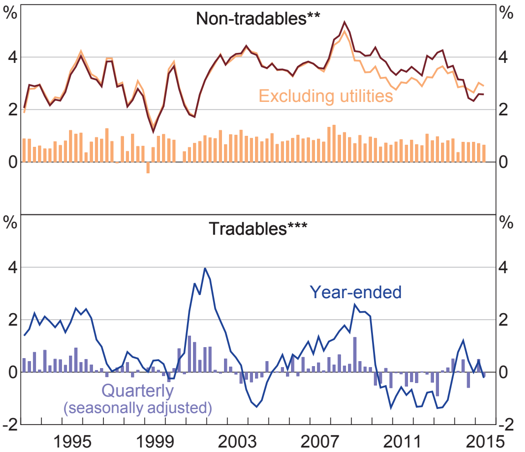
Graph 5.3
Oil and Fuel Prices



Sources: ABS; Australian Institute of Petroleum; Bloomberg; Fueltrac; RBA

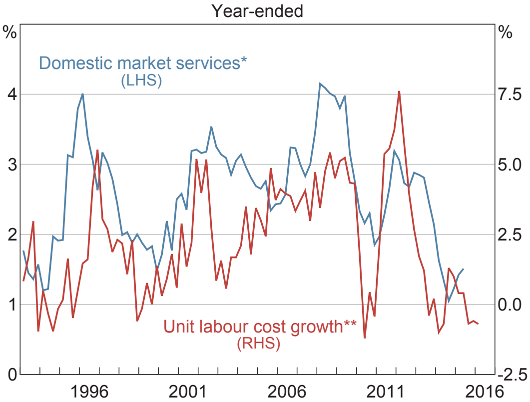
Domestic inflationary pressures remain well contained. Non-tradables inflation was around 2½ per cent over the year to June, below its average over the inflation targeting period (Graph 5.4). Market services inflation remains very low (Graph 5.5). These services contain a relatively high labour content and have few administered components. Therefore, they have been particularly responsive to spare capacity

Graph 5.4
Non-tradables and Tradables Inflation*



* Adjusted for the tax changes of 1999–2000
** Excluding interest charges prior to September quarter 1998 and deposit & loan facilities to June quarter 2011
*** Excluding volatile items (fruit, vegetables & automotive fuel) and tobacco
Sources: ABS; RBA

Graph 5.5
Market Services Inflation
Year-ended

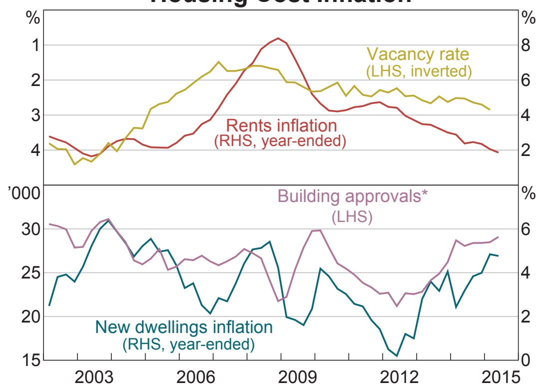


* Excludes deposit & loan facilities to June quarter 2011, housing services and domestic travel
** Moved forward by four quarters, non-farm
Sources: ABS; RBA

in the labour market and low growth in unit labour costs.[1] Rent inflation has decreased to its lowest pace in around 12 years (Graph 5.6). This decline can be broadly explained by the trend increase in rental vacancy rates over recent years, although it has been a bit weaker than would be expected based

1 Jacobs D and T Williams (2014), 'The Determinants of Non-tradables Inflation', RBA *Bulletin*, September Quarter, pp 27–38.

Graph 5.6
Housing Cost Inflation



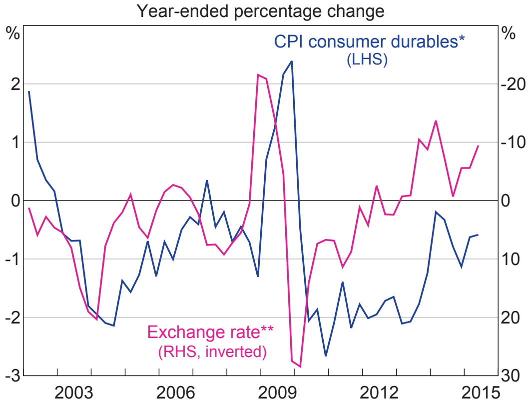
* Private detached houses
Sources: ABS; RBA; REIA

on historical relationships. The weakness in rent inflation has been broad based across capital cities, but has been particularly pronounced in Perth and Canberra over the past year, where vacancy rates are the highest.

However, several factors have continued to hold up non-tradables inflation, notably inflation in new housing costs and the prices of some administered items. Inflation in new dwelling costs remained relatively high at 1.5 per cent in the June quarter and 4.8 per cent over the year. The largest price increases have been in Sydney, consistent with high levels of building activity and reports of diminishing spare productive capacity in the local construction industry. Price setting for administered items is less affected by spare capacity in the economy than other non-tradable items. Inflation in administered items picked up in the quarter, largely driven by an increase in private health insurance premiums. Overall though, year-ended inflation in a range of administered items is around its historical average. While utilities inflation remains low in year-ended terms due to the removal of the carbon price, it has returned to be around its historical average level in recent quarters.

Inflationary pressures from the prices of tradable items remain stronger than a few years ago, although they look to have moderated a little over the past year. The prices of tradable items (excluding volatile items and tobacco) declined modestly in the June quarter and over the year. The prices of many consumer durable items, including clothing & footwear and motor vehicle prices, fell modestly (Graph 5.7). In contrast, the prices of household appliances increased in the quarter, possibly related to strong activity in the housing market.

Graph 5.7
Consumer Prices and the Exchange Rate
Year-ended percentage change



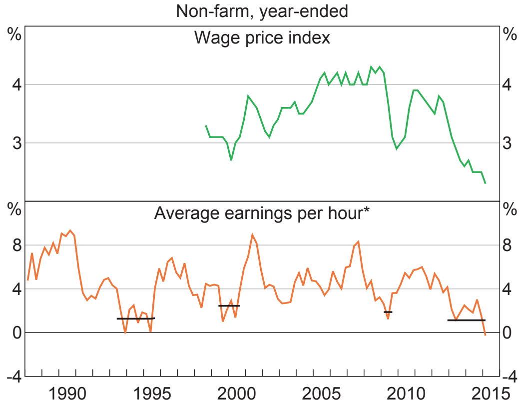
* Retail items (excluding food and alcohol) and motor vehicles and parts
** Import-weighted index, quarter average
Sources: ABS; RBA

The prices of tradable items tend to be heavily influenced by movements in the exchange rate, as they are either imported or more exposed to international competition than prices for non-tradable items. The exchange rate depreciation in early 2013 and again since late 2014 has led to an increase in the prices of imported items when measured 'across the docks'. The generally low outcomes for final prices over the past year could suggest that exchange rate pass-through has been tempered by heightened competitive pressures and a subdued retail environment. However, tradables inflation is volatile and remains higher than in 2010–13. The lower exchange rate is expected to continue to place upward pressure on the prices of tradable items over the next few years. Indeed, liaison suggests that some firms may now be starting to pass on their higher costs to rebuild or retain margins.

Labour Costs

Labour cost pressures are weak and most indicators of wage growth have declined further in recent quarters. The Wage Price Index (WPI) increased by 0.5 per cent in the March quarter and by 2.3 per cent over the year – the lowest annual pace since the index was first published in the late 1990s (Graph 5.8). Other wage measures, such as average earnings per hour, suggest that the recent period has been the most protracted episode of low wage growth since the early 1990s.

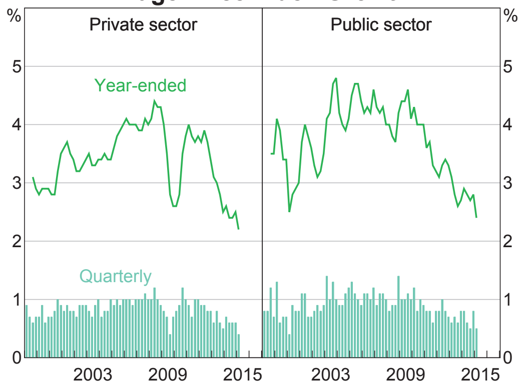
Graph 5.8
Wage Growth
Non-farm, year-ended



* The black lines represent the average over the period
Sources: ABS; RBA

Low wage growth continues to be broad based across sectors, industries and states. In the March quarter, the private sector WPI recorded its lowest quarterly pace of growth since the global financial crisis, to be 2.2 per cent higher in year-ended terms (Graph 5.9). Public sector wage growth was also low at 2.4 per cent over the year. Public sector wage growth has been particularly low in the Australian Capital Territory, although this is partly temporary as many federal public sector workers have not had wage increases since their enterprise bargaining agreements expired last year. New agreements are now being reached in some cases, although negotiations are ongoing for others. Nationally, wage growth has continued to decline in a range of

Graph 5.9
Wage Price Index Growth

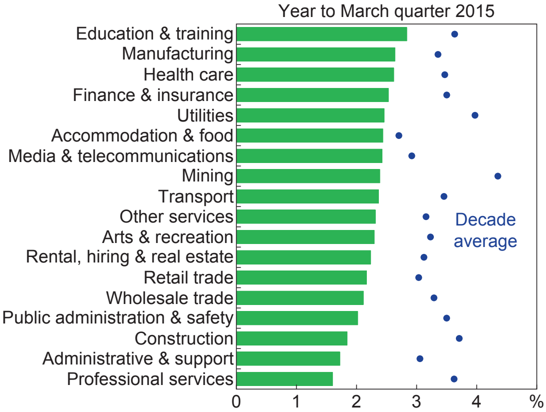


Source: ABS

industries, and all industries have experienced wage growth below their decade averages (Graph 5.10). According to business liaison and surveys of firms and union officials, growth in wages is widely expected to remain low over the year ahead.

Graph 5.10
Wage Price Index Growth by Industry

Year to March quarter 2015



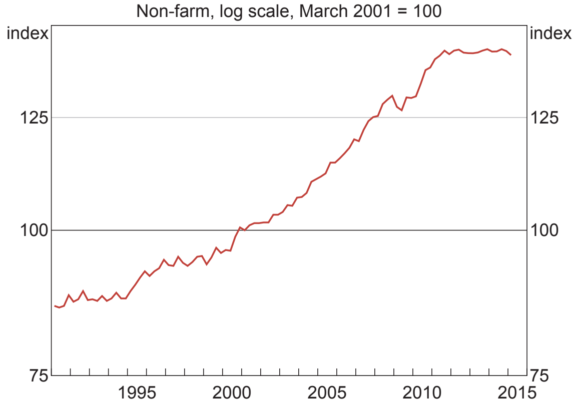
Sources: ABS; RBA

Several factors explain the decline in wage growth, including an increase in spare capacity in the labour market, low inflation expectations, the substantial decline in the terms of trade over the past couple of years and the need for the real exchange rate to adjust to improve international competitiveness. Nevertheless, the extent of the decline in wage growth has been unusually large relative to changes in measures of spare capacity in the labour market, such as the unemployment rate. Compared with previous episodes, increased labour market flexibility may have provided firms with more scope to adjust wages in response to a given change in demand for their goods and services.[2] In any case, very low wage growth appears to have contributed to more employment than would otherwise have been the case.

Unit labour costs, which adjust wage growth for changes in labour productivity, have been little changed for almost four years, as productivity growth has broadly matched earnings growth (Graph 5.11). The fact that unit labour costs have not changed significantly is assisting with the process of the economy adjusting to the lower terms of trade. There was little growth in measured labour productivity over the year to the March quarter, although average productivity growth has been higher since the start of 2011 than it was over much of the previous decade. Information from liaison suggests that firms continue to focus on cutting costs and improving productivity.

Graph 5.11
Unit Labour Costs

Non-farm, log scale, March 2001 = 100



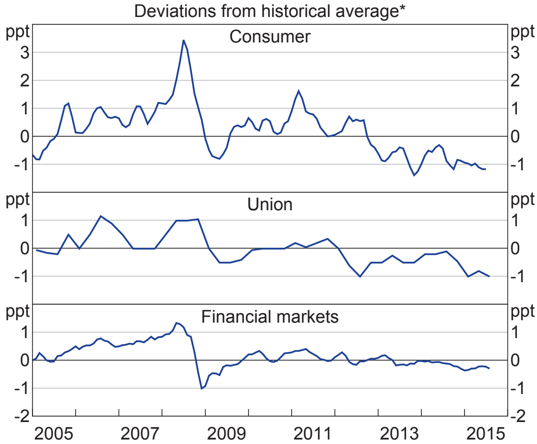
Sources: ABS; RBA

2 For a more detailed discussion see Jacobs D and A Rush (2015), 'Why is Wage Growth So Low?', RBA *Bulletin*, June Quarter, pp 10–18.

Inflation Expectations

Measures of inflation expectations remain around or below average (Graph 5.12).[3] Both short-run and long-run financial market measures remain a little lower than mid last year. In recent quarters, market economists and union officials have revised down their expectations of inflation for the year ahead. The Melbourne Institute measure of consumer inflation expectations remains around 1 percentage point below its historical average. Longer-run expectations remain well anchored. ✠

Graph 5.12
Measures of Inflation Expectations
Deviations from historical average*



* Since July 1996; see footnote 3 for details

Sources: Australian Council of Trade Unions; Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre; Yieldbroker

3 Consumer expectations are the three-month moving average of the trimmed mean of inflation expectations over the next year; union expectations are the median of union officials' expectations of inflation over the next year; financial market expectations are the break-even 10-year inflation rate on indexed bonds (with interpolation used to match exact maturity).