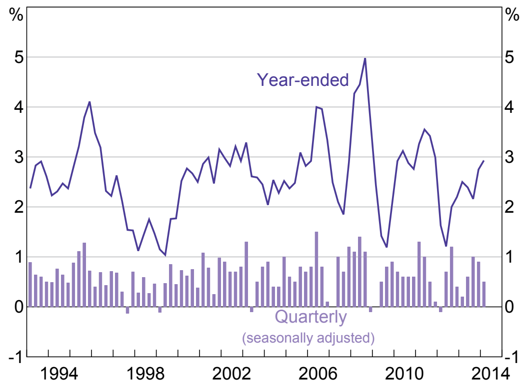
5. Price and Wage Developments

Recent Developments in Inflation

Consumer price inflation declined in the March quarter, after picking up a little over the second half of 2013. The consumer price index (CPI) rose by 0.5 per cent on a seasonally adjusted basis in the March quarter, following an increase of 0.9 per cent in the December quarter, to be 2.9 per cent higher over the year (Graph 5.1; Table 5.1). While the decline in inflation in the quarter was broad based, non-tradables inflation has eased somewhat over the past year while tradables inflation has picked up.

Increases in the prices of volatile items added slightly to headline inflation in the March quarter, with fruit, vegetable and automotive fuel prices each rising by

Graph 5.1
Consumer Price Inflation*



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Table 5.1: Measures of Consumer Price Inflation
Per cent

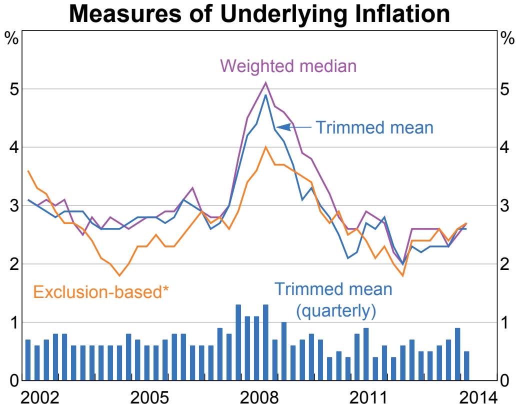
	Quarterly(a)		Year-ended(b)	
	March quarter 2014	December quarter 2013	March quarter 2014	December quarter 2013
Consumer price index	0.6	0.8	2.9	2.7
Seasonally adjusted CPI	0.5	0.9	–	–
– Tradables	0.7	0.8	2.6	1.0
– Tradables (excl volatile items and tobacco)(c)	–0.1	0.5	0.8	–0.1
– Non-tradables	0.4	0.9	3.1	3.7
Selected underlying measures				
Trimmed mean	0.5	0.9	2.6	2.6
Weighted median	0.6	0.9	2.7	2.5
CPI excl volatile items(c)	0.4	0.9	2.7	2.6

(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

around 2 per cent. Inflation in tobacco prices has picked up in the past two quarters, largely reflecting the 12.5 per cent increase in the tobacco excise in December, which has contributed a little under ¼ percentage point to headline inflation over the past year.

The published measures of underlying inflation were around ½ per cent in the March quarter, which was around ¼–½ percentage point lower than underlying inflation recorded in the previous quarter. The pronounced decline in underlying inflation in the quarter may overstate the extent of slowing in inflationary pressures, just as the December quarter may have overstated the pick-up in inflationary pressures. Taken together, the quarterly average pace of underlying inflation over the past two quarters was a little under ¾ per cent, while over the year the various measures indicate that the pace of underlying inflation was between 2½ per cent and 2¾ per cent (Graph 5.2).

Graph 5.2
Measures of Underlying Inflation

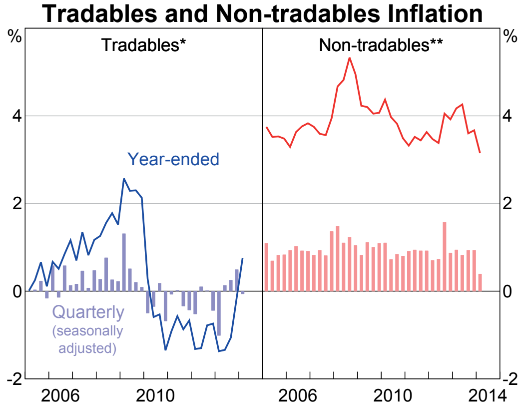


* Excludes fruit, vegetables, automotive fuel (and deposit & loan facilities to June quarter 2011)

Sources: ABS; RBA

Prices of tradable items (excluding volatile items and tobacco) declined slightly in the March quarter, after rising in the previous three quarters (Graph 5.3). In the March quarter, lower inflation was observed across the basket of tradable items, with traded food and consumer durables prices declining in the quarter, and international travel & accommodation prices rising only modestly. In part, the decline in the quarterly rate could reflect statistical noise in the data. Alternatively, it could be that firms attempted to recoup higher imported costs or increase margins in the December quarter, but did not do so again in the March quarter.

Graph 5.3
Tradables and Non-tradables Inflation



* Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco

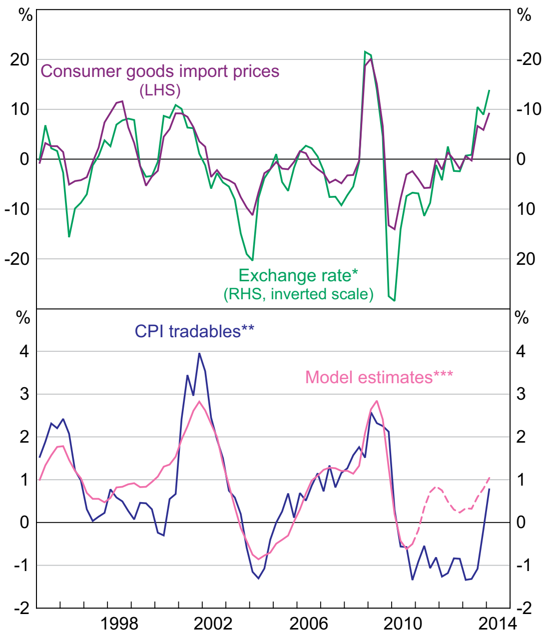
** Excluding deposit & loan facilities to June quarter 2011

Sources: ABS; RBA

Over the year, tradables prices rose by 0.8 per cent, consistent with the depreciation of the exchange rate since early last year. Because tradable items are either imported or exposed to international competition, their prices tend to be heavily influenced by movements in the exchange rate. Changes in import prices typically work their way through the domestic supply chain with a long but variable lag, owing to the effects of fixed contracts, hedging practices, firms' inventory management, and the ability of distributors and retailers to partially absorb the impact of exchange rate movements in their margins. Historical relationships suggest that in response to a 10 per cent depreciation, tradables prices will increase by around 2–3 per cent over a period of two to three years on average. Just as there is uncertainty about the overall magnitude of pass-through, there is uncertainty about the exact quarterly profile as pass-through does not necessarily proceed smoothly from one quarter to the next. In the Bank's liaison, retailers have generally indicated that they have been reluctant to pass on imported cost increases due to competitive pressures. This reluctance may be no different to usual as the amount of pass-through to tradables prices over the past year or so from the depreciation of the exchange rate appears to have been consistent with the average historical relationship. This is indicated by tradables inflation over the year to March 2014 being close to model-implied estimates (Graph 5.4). In contrast, over the preceding few years, tradables prices experienced persistent declines despite a relatively stable exchange rate, possibly reflecting a compression of margins along the supply chain or improvements in the efficiency of distribution.

A decline in the pace of non-tradables inflation has helped to partially offset the pick-up in tradables inflation over the past year. In the March quarter, non-tradables inflation declined to 0.4 per cent and the year-ended rate was 3.1 per cent, the lowest rate in over a decade. This followed a number of quarters for which non-tradables inflation was recorded as

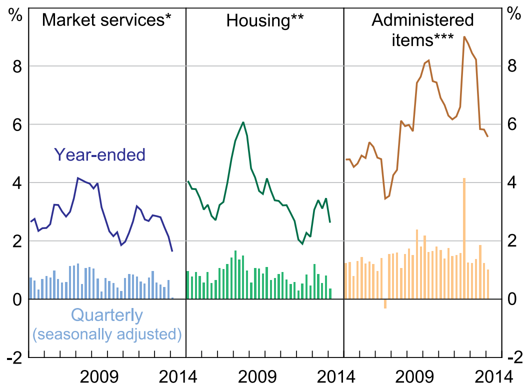
Graph 5.4
Consumer Prices and the Exchange Rate
Year-ended percentage change



* Import-weighted index, quarter averages
** Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco
*** The model is estimated from 1990:Q1 to 2010:Q4; model-implied estimates, using actual data for the independent variables (unit labour costs, import prices and inflation expectations), are shown from 2011:Q1 to 2014:Q1
Sources: ABS; RBA

being relatively stable, at around 0.9 per cent. While inflation slowed in the March quarter for the majority of non-tradable items, the largest effect was from market services and new dwelling costs (Graph 5.5).

Graph 5.5
Non-tradables Inflation

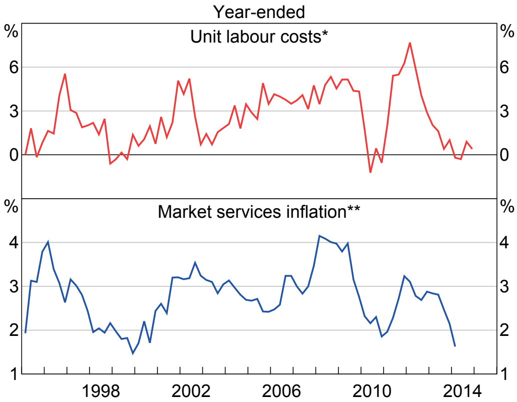


* Includes most household and personal services, meals out & takeaway food and insurance & financial services; excludes deposit & loan facilities to June quarter 2011
** Includes new dwelling purchases, rents and dwelling repair & maintenance; excludes utilities and property rates & charges
*** Includes utilities, health services & equipment, education, some motor vehicle fees, property rates & charges, child care, urban transport fares and postal services
Sources: ABS; RBA

Non-tradables prices tend to be less affected by movements in the exchange rate, and are quite dependent on domestic labour costs. However, the influence of labour costs is more pronounced for some non-tradable items than for others, and it often operates with a lag. Labour costs are likely to be a particularly important component of the cost of production for many types of market services – in particular, household services, meals out & takeaway food, and insurance & financial services. For these items, inflation was negligible in the March quarter and has declined over the past couple of years to be very low by historical standards, consistent with the slowing growth in unit labour costs over the past couple of years (Graph 5.6).

In contrast, inflation for non-tradables items other than market services has been quite elevated for some time, despite the slowing in wage growth and firms' efforts to improve productivity. For many of these goods and services, prices are likely to be significantly affected by factors in addition to

Graph 5.6
Wage Growth and Inflation



* Moved forward by four quarters
** Includes most household and personal services, meals out & takeaway food, and insurance & financial services; excludes deposit & loan facilities to June quarter 2011

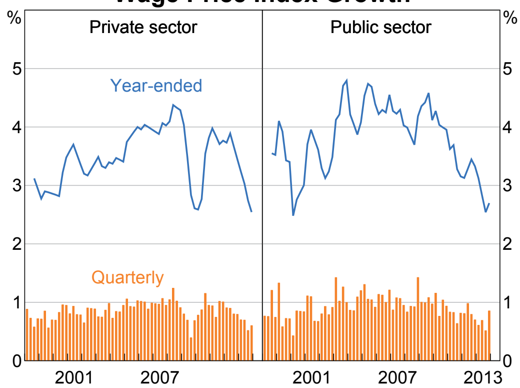
Sources: ABS; RBA

domestic labour costs. For example, housing inflation appears to be only weakly related to changes in labour costs, with demand for new housing and the balance of supply and demand in the market for rental properties more important determinants. Inflation in the cost of new dwellings fell sharply in the March quarter, in part reflecting a surprising decline in new dwelling costs in Melbourne, which have been volatile of late. Nevertheless, new dwelling cost inflation remains somewhat higher than a year and half ago, consistent with recent strength in building approvals for detached houses. Similarly, the prices of some 'administered' items – those with regulated prices or for which the government is a significant provider – have historically been less sensitive to changes in labour costs. Inflation for these items, which include utilities, health and education services, has been well above that of other non-tradables in recent years.

Costs

Wage growth remained weak in the December quarter, with the year-ended growth in the wage price index continuing to slow to 2.6 per cent, around 1 percentage point below its average of the past decade. In the December quarter, private sector wage growth remained weak, with reports from liaison continuing to suggest that labour is readily available and the rate of employee resignations is low (Graph 5.7). Public sector wage growth, while surprisingly strong in the December quarter, has also been weak over the year, consistent with ongoing fiscal restraint. Forward-looking indicators of wage growth, including surveys of firms' wage expectations and information from Bank liaison, indicate that wage pressures are likely to remain subdued over the next year.

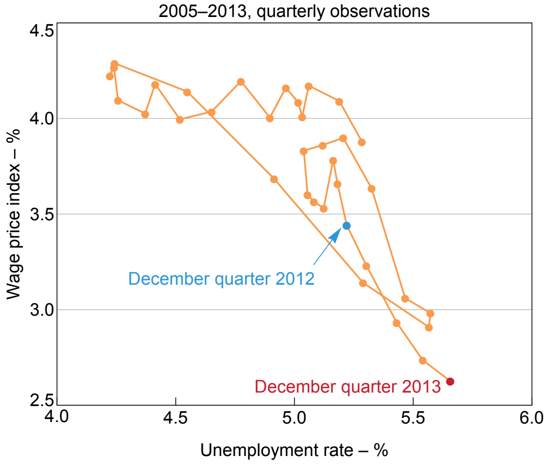
Graph 5.7
Wage Price Index Growth



Source: ABS

A number of factors are likely to have contributed to the significant moderation in wage growth over the past year and a half. First, there has been an increase in spare capacity in the labour market, as indicated by the increase in the unemployment rate (Graph 5.8). Second, consumer price inflation over the past year or so has been lower than the average of the preceding decade, and consumer and union inflation expectations have been relatively low; however, this can only explain part of the slowing in nominal wage growth observed in recent years, as evidenced by the fact that growth in the real purchasing power of wages from the perspective of consumers has also slowed (Graph 5.9). Finally, firms have faced continuing pressures to contain costs. From the perspective of producers, subdued trading conditions have limited the ability of firms to raise output prices. Accordingly, producer real wages (i.e. wages adjusted for firms' average output prices) have risen in recent years, after being little changed over the preceding decade.

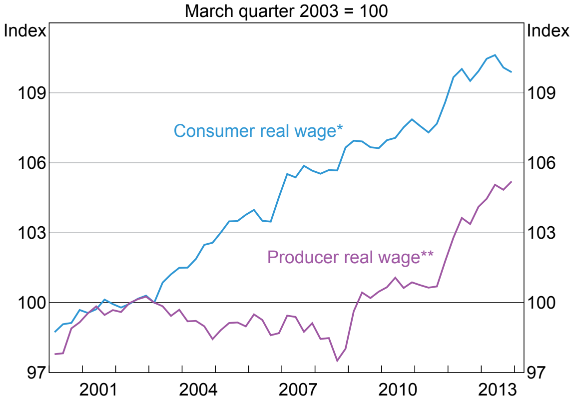
Graph 5.8
Wage Growth and Unemployment*
2005–2013, quarterly observations



* Wage price index growth (year-ended) and unemployment rate (year-average) from March quarter 2005 to December quarter 2013

Sources: ABS; RBA

Graph 5.9
Real Wage Price Index
March quarter 2003 = 100



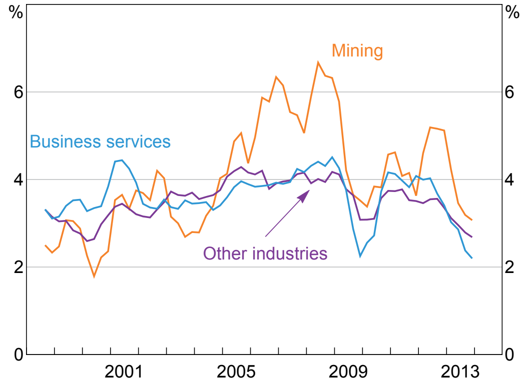
* Wage price index deflated by the consumer price index (excluding deposit & loan facilities to June quarter 2011 and adjusted for the tax changes of 1999–2000)

** Wage price index deflated by the producer price index (domestic, final stage of production, excluding exports and oil)

Sources: ABS; RBA

The slowing in wage growth has been broad based across industries; only 2 out of 18 industries – retail trade and health care & social assistance – have not experienced a reduction in year-ended wage growth since mid 2012. However, the slowing has been somewhat more pronounced in mining and business services, reflecting the marked reduction in demand for labour from these industries (Graph 5.10). Wage growth fell particularly sharply in the professional, scientific and technical services industry over the year to December, with a number of firms in this industry highly exposed to weaker resource investment activity.

Graph 5.10
Wage Growth by Industry
Year-ended



Sources: ABS; RBA

Over the past year, the combinations of wage growth and unemployment rates in New South Wales, Victoria and Queensland have been quite similar (Graph 5.11). In contrast, wage growth remains relatively strong in Western Australia, consistent with the state having the lowest unemployment rate in the country, but it has slowed markedly since mid 2012, reflecting the downturn in mining investment and the spillovers to other parts of the state's

Graph 5.11
Wage Growth and Unemployment by State*
2013

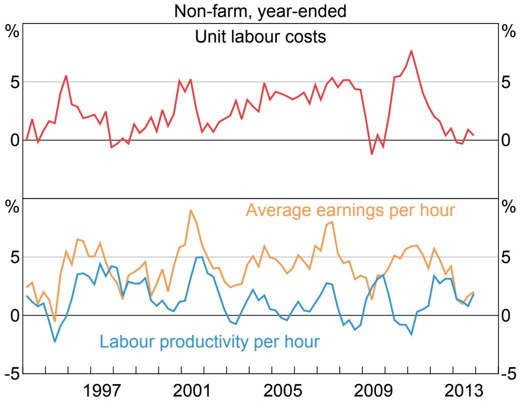
* Wage price index growth (year to December quarter 2013) and unemployment rate (2013 year-average)

Sources: ABS; RBA

economy. Wage growth was weakest in Tasmania over 2013, consistent with its high unemployment rate, while wage growth in South Australia has been relatively strong and has not slowed in recent years, somewhat at odds with the continuing weak labour market conditions in the state.

The national accounts measure of average earnings per hour picked up in the December quarter, after weak growth over the previous three quarters, to be 2.0 per cent higher over the year to December. Measured growth in labour productivity over the year was below its relatively fast pace in 2012. With average earnings growing at a similar pace to labour productivity in year-ended terms, growth in unit labour costs is estimated to have remained subdued (Graph 5.12).

Graph 5.12
Unit Labour Costs Growth
Non-farm, year-ended



Sources: ABS; RBA

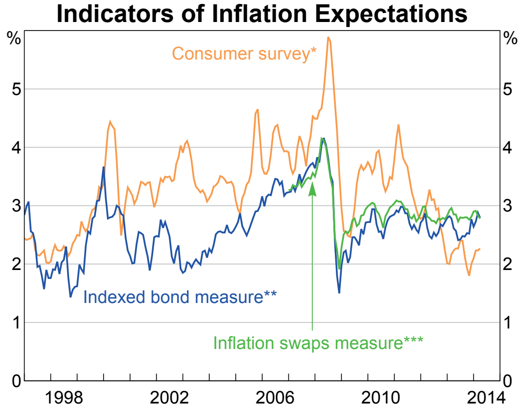
Producer price data suggest that domestic inflation pressures have remained relatively moderate across all stages of production over the past year, although import price inflation picked up in the March quarter.

ABS data indicate that the number of working days lost per employee as a result of industrial disputes has remained at a low level, notwithstanding a slight increase in the December quarter. The average number of employees involved per dispute increased in the quarter, but was partly offset by declines in the number of disputes and the average duration of disputes.

Inflation Expectations

Measures of inflation expectations remain consistent with the inflation target, and are generally around or a little below their long-term averages (Graph 5.13; Table 5.2). Since the February *Statement*, market economists have revised down their expectations for inflation over 2014, while expectations for 2015 have been revised up a little, and union officials' forecasts for inflation have been revised up somewhat. Financial market measures of inflation expectations were little changed over the quarter and remain close to their historical average levels. The Melbourne Institute measure of consumers' inflation expectations for the year ahead has also increased modestly but remains low relative to its history. ✈

Graph 5.13
Indicators of Inflation Expectations



* Three-month moving average of the trimmed mean expectation of inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Expectation of average annual inflation over the next 10 years

Sources: Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations

Per cent

	Year to December 2014			Year to December 2015	
	November 2013	February 2014	May 2014	February 2014	May 2014
Market economists	2.6	2.5	2.4	2.6	2.7
Union officials	2.5	2.8	3.0	2.8	2.9

Sources: RBA; Workplace Research Centre