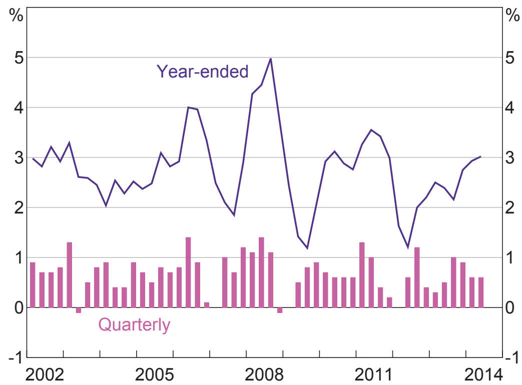
5. Price and Wage Developments

Recent Developments in Inflation

Consumer price inflation was 3.0 per cent over the year to the June quarter, with seasonally adjusted inflation in the quarter at 0.6 per cent, the same rate as in the March quarter (Graph 5.1; Table 5.1). Some temporary factors have added to inflation over the year, so this rate slightly overstates the underlying inflationary pressures in the economy. Nevertheless, measures of underlying inflation have increased over the past year, with higher tradables inflation offset in part by lower domestic inflation pressures.

Declines in the prices of volatile items subtracted from headline inflation in the June quarter, mostly owing to a 2½ per cent fall in automotive fuel

Graph 5.1
Consumer Price Inflation



Sources: ABS; RBA

Table 5.1: Measures of Consumer Price Inflation
Per cent

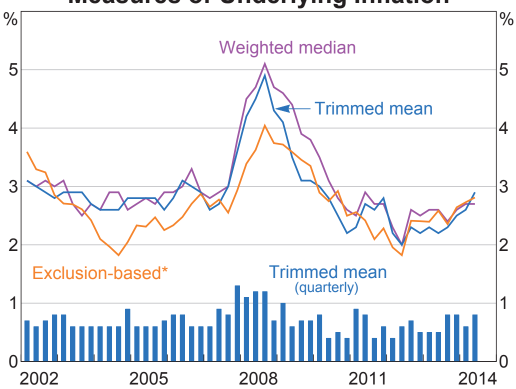
	Quarterly(a)		Year-ended(b)	
	June quarter 2014	March quarter 2014	June quarter 2014	March quarter 2014
Consumer Price Index	0.5	0.6	3.0	2.9
Seasonally adjusted CPI	0.6	0.6	–	–
– Tradables	0.4	0.7	2.9	2.6
– Tradables (excl volatile items and tobacco)(c)	0.5	0.0	1.2	0.8
– Non-tradables	0.7	0.5	3.1	3.1
Selected underlying measures				
Trimmed mean	0.8	0.6	2.9	2.6
Weighted median	0.6	0.6	2.7	2.7
CPI excl volatile items(c)	0.7	0.5	2.8	2.7

(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

prices. However, over the past year volatile items and tobacco have added to headline inflation, largely reflecting the effects of the 12.5 per cent increase in the tobacco excise in December last year. The increase in excise contributed a little under ¼ percentage point to headline inflation over the year; most of this occurred in the December and March quarters.

The pace of underlying inflation increased in the June quarter, with the published measures around ¾ per cent compared with around ½ per cent in the previous quarter (Graph 5.2). More generally, the pace of year-ended underlying inflation has increased, to around 2¾ per cent over the year to the June quarter, around ½ percentage point higher than over the previous year.

Graph 5.2
Measures of Underlying Inflation

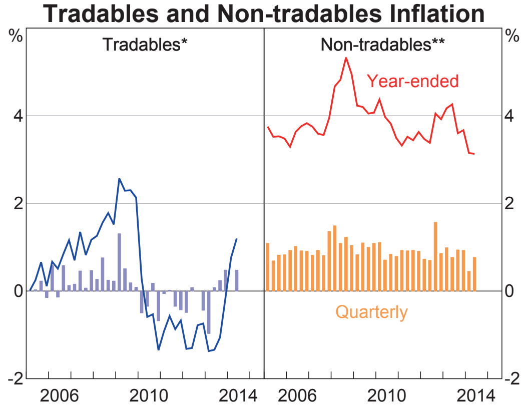


* Excludes fruit, vegetables, automotive fuel (and deposit & loan facilities to June quarter 2011)
Sources: ABS; RBA

The increase in underlying inflation over the past year has reflected a pick-up in tradables inflation. Prices of tradable items (excluding volatile items and tobacco) increased by 0.5 per cent in the June quarter, to be around 1.2 per cent higher over the year (Graph 5.3). This is the highest rate of year-ended tradables inflation in around four years, and contrasts with the declines in tradables prices seen over most of that period.

Tradable items are either imported or relatively exposed to international competition and, as a result, their prices tend to be heavily influenced by movements in the exchange rate. The current level of tradables inflation appears to be broadly in line with what historical relationships would suggest following the depreciation of the exchange rate since early 2013. On average, a depreciation of the exchange rate affects tradables prices for a period of 2–3 years. However, the speed and size of pass-through varies between episodes, and quarter-to-quarter volatility in tradables inflation can be expected because pass-through typically does not occur in a smooth fashion. In addition, it is difficult to gauge the extent of pass-through precisely, as other factors – such as labour costs, productivity and demand – also affect tradables prices and these effects may vary across items.

Graph 5.3
Tradables and Non-tradables Inflation

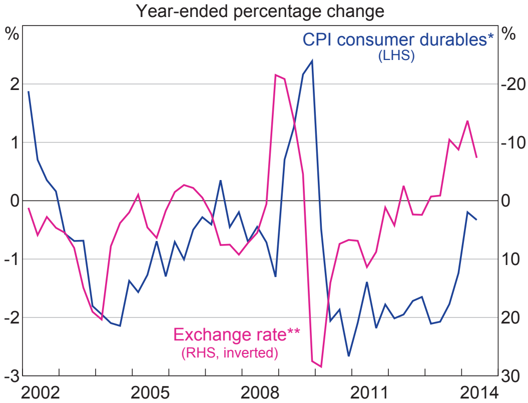


* Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco
** Excluding deposit & loan facilities to June quarter 2011
Sources: ABS; RBA

Indeed, recent movements in tradables prices have varied across different expenditure groups. In the June quarter, traded food and international travel & accommodation prices increased noticeably. In contrast, consumer durables prices declined modestly, although the rate of decline recently has been substantially less than it was a year or so ago. Typically, the prices of consumer durable items tend to move more closely with the exchange rate than do those of most other tradable items. This reflects a relatively high share of imported inputs, and the fact that durable goods are more readily transportable and are less subject to supply shocks than, say, food items, which are regularly affected by weather conditions (Graph 5.4). However, liaison suggests that retailers have been reluctant to pass on price increases due to weak consumer sentiment and the continued competitive environment. At the same time, firms in the domestic distribution and manufacturing sectors have been engaged in cost reduction efforts for some time, possibly tempering the pass-through of input cost increases to output prices. These factors may have moderated inflationary pressure on consumer durable items stemming from the depreciation of the exchange rate.

Graph 5.4
Consumer Prices and the Exchange Rate

Year-ended percentage change



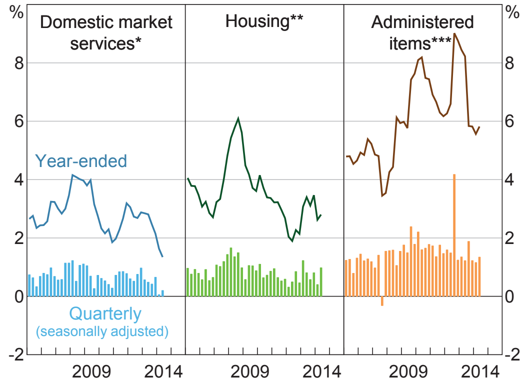
* Retail items (excluding food and alcohol) and motor vehicles and parts

** Import-weighted index, quarter averages

Sources: ABS; RBA

Inflation in the prices of non-tradables items has slowed over the past year, in contrast to tradables inflation. Non-tradables inflation was 0.7 per cent in the June quarter, although this was above the particularly low outcome seen in the March quarter. Over the past year, non-tradables inflation was 3.1 per cent, its lowest rate in over a decade. In part, the slowing in non-tradables inflation is likely to reflect the subdued conditions in the labour market. This is perhaps most evident in market services, which tend to have a larger labour cost component than many other non-tradable items (Graph 5.5).

Graph 5.5
Non-tradables Inflation



* Excludes deposit & loan facilities to June quarter 2011, housing services and domestic travel

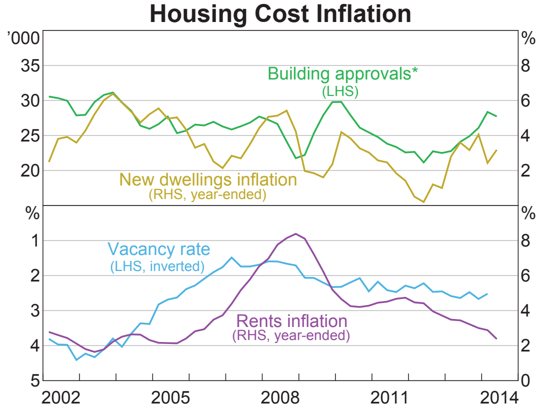
** Includes rents, dwelling maintenance and new dwelling purchases; excludes administered items

*** Includes utilities, education, child care, health services, property rates, urban transport fares, postal services and some motor vehicle services

Sources: ABS; RBA

Housing cost inflation appears to be only weakly related to broad measures of labour costs, with changes in the demand and supply of new housing and rental properties more important determinants. Housing cost inflation rose in the June quarter, driven by a pick-up in inflation in the cost of new dwellings, consistent with the high level of building approvals for detached houses (Graph 5.6). Over the year, new dwelling cost inflation has been strongest in Sydney and Perth, in line with the larger pick-up in construction apparent in those states. Meanwhile, quarterly rent inflation declined to its slowest pace

Graph 5.6
Housing Cost Inflation



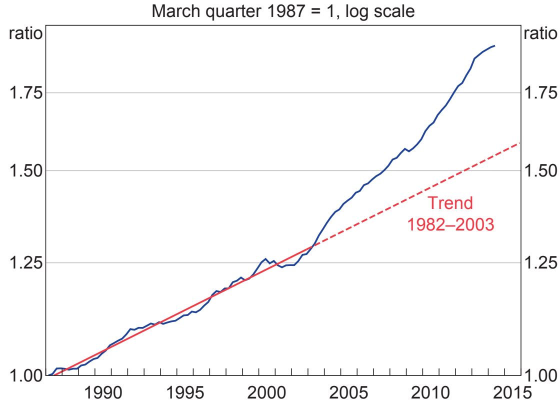
* Private detached housing

Sources: ABS; RBA; REIA

since 2003, despite vacancy rates remaining fairly steady at a below-average level in recent quarters. Inflation in the prices of 'administered' items – those with regulated prices or for which the public sector is a significant provider – increased in the quarter, driven by changes to private health insurance premiums and rebates in April.

The divergent trends in tradables and non-tradables inflation have seen an adjustment in relative prices, which is expected to continue for some time. This is an important aspect of the rebalancing of demand and prices given the decline in the terms of trade and the ongoing transition from the investment to the production phase of the mining boom. Non-tradables prices typically grow at a faster rate than tradables prices and so the ratio of non-tradables to tradables prices rises over time (Graph 5.7). Over the past decade, the difference between the average inflation rates of non-tradables and tradables prices was larger than in the past. In large part, this change in the trend of relative prices was in response to the substantial rise in the terms of trade over that period. The higher terms of trade acted to bolster demand for labour while the addition to incomes increased demand for non-tradable goods and services. In addition, the associated appreciation of the nominal exchange rate reduced demand for some domestically produced tradable items and also

Graph 5.7
Ratio of Non-tradables to Tradables CPI*
March quarter 1987 = 1, log scale



* Tradables inflation excludes volatile items (fruit, vegetables and automotive fuel) and tobacco; non-tradables inflation excludes deposit & loan facilities to June quarter 2011

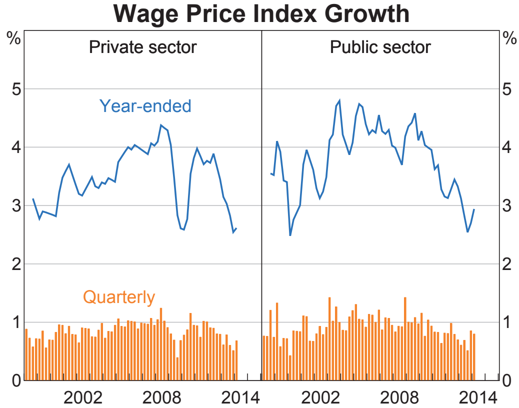
Sources: ABS; RBA

lowered import prices and tradables inflation. Over the past year, however, these forces have partially reversed, as the terms of trade declined and the exchange rate depreciated somewhat. In response, tradables prices have increased, while weak growth in unit labour costs has contributed to a decline in non-tradables inflation. As a result, the ratio of tradables to non-tradables prices has increased at a rate more in line with the trend prior to the resources boom.

Costs

Wage growth has remained low, with the wage price index increasing by 2.6 per cent over the year to March, which was around 1 percentage point below its decade average growth rate. In the quarter, private sector wage growth remained subdued, with reports from liaison continuing to suggest that labour is readily available and the rate of employee resignations is low (Graph 5.8). Although public sector wages grew at a slightly faster pace than expected in the December and March quarters, growth over the past year has been around the lowest in over a decade.

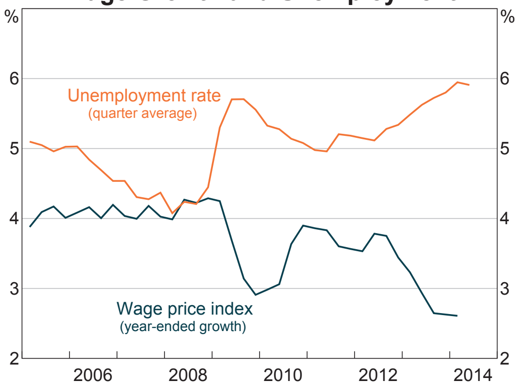
Graph 5.8
Wage Price Index Growth



Source: ABS

The increase in spare capacity in the labour market over the past two years or so, as indicated by the increase in the unemployment rate and various measures of underemployment, has contributed to the significant reduction in wage growth over this period (Graph 5.9). Concurrently, there has been

Graph 5.9
Wage Growth and Unemployment



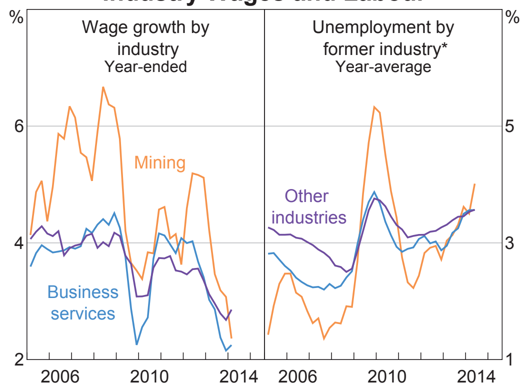
Sources: ABS; RBA

a decrease in workers' sense of job security, which may be contributing to lower wage demands, while employers have faced increased pressure to contain labour costs. In particular, in a number of private sector industries, subdued trading conditions and pressures to improve competitiveness may have limited firms' capacity to increase wages. In the public sector, the decline in wage growth over recent years is consistent with an environment of fiscal restraint. Business surveys indicate that wage growth remained subdued in the June quarter, while expectations for the September quarter suggest that wages will continue to grow at a relatively slow pace.

The pace of wage growth remains subdued across the economy, although it appears to be stabilising in many industries. Wage growth in the mining and business services industries slowed particularly sharply over the past two years (Graph 5.10). This was consistent with a larger increase in estimated unemployment for workers from these industries. However, more recently, wage growth appears to be stabilising in the business services sector, consistent with signs of an increase in employment in the industry this year.

Over the past year, wages grew at a similar pace in New South Wales, Victoria, Queensland and Western Australia (Graph 5.11). While wage growth in some

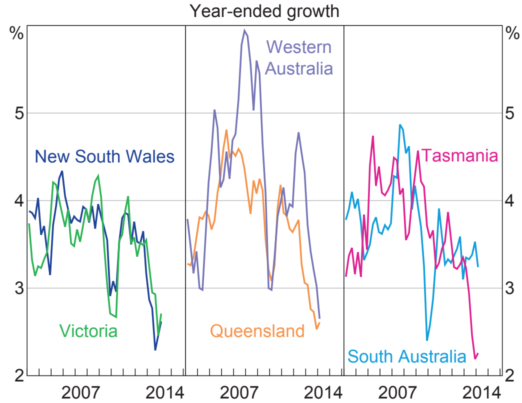
Graph 5.10
Industry Wages and Labour



* Unemployed persons that formerly worked in an industry, as a share of the estimated industry 'labour force' (including both currently employed and former workers)

Sources: ABS; RBA

Graph 5.11
Wage Price Index by State
Year-ended growth

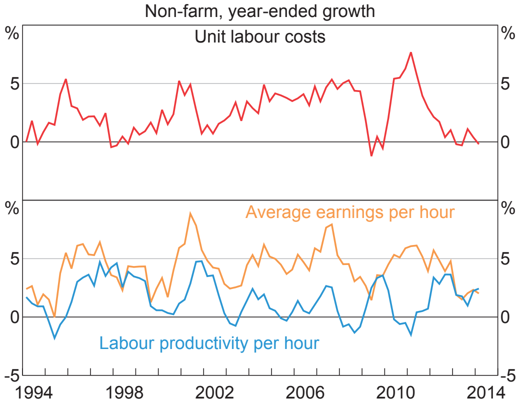


Source: ABS

of these states looks to have stabilised in recent quarters, it has continued to slow in Western Australia, largely reflecting the downturn in mining investment and the spillovers to other parts of the state's economy. Year-ended wage growth remained weakest in Tasmania, 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.

Low wage growth has contributed to an extended period of low growth of unit labour costs. The national accounts measure of unit labour costs has been little changed over the past two years, with average earnings and labour productivity having grown at around the same pace (Graph 5.12). Domestic labour costs have declined slightly relative to labour costs in many of Australia's major trading partners, suggesting some modest improvement in international competitiveness of late over and above the impact of the earlier depreciation of the nominal exchange rate.

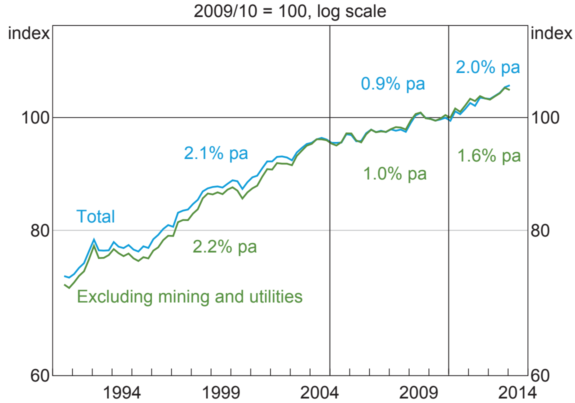
Graph 5.12
Unit Labour Costs
Non-farm, year-ended growth



Sources: ABS; RBA

Recent growth in labour productivity has actually been above its average of the past decade. In part, this has reflected the large contribution of resource exports to recent economic growth and the low labour intensity of resource production. However, measured labour productivity growth has improved over the past few years across a broad range of industries, following a period of quite weak growth in the latter half of the 2000s (Graph 5.13). Outside of the mining sector, the general improvement in productivity growth may have been in response to heightened competitive pressures, including from the high level of the exchange rate.

Graph 5.13
Labour Productivity*
2009/10 = 100, log scale



* Figures represent trend growth during the period shown
Sources: ABS; RBA

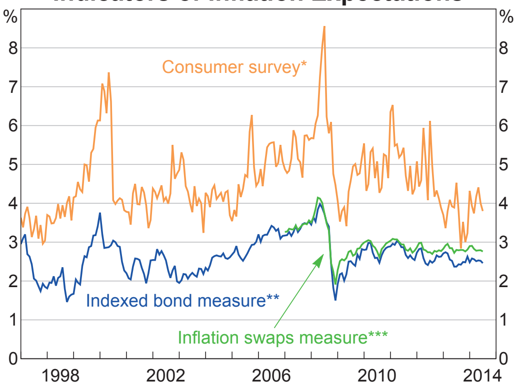
Producer price data suggest that over the past year, domestic inflation pressures have remained relatively moderate across all stages of production, while import price inflation has picked up. In broad terms, this is consistent with the increase in tradables inflation relative to non-tradables inflation in the CPI, though there are a number of differences between producer and consumer prices that complicate such a comparison.

ABS data indicate that the number of working days lost per employee as a result of industrial disputes fell in the March quarter to remain well below its decade average. This fall was driven by declines in the number of disputes and the average number of employees involved per dispute, which were partly offset by a rise in the average duration of each dispute.

Inflation Expectations

Indicators of inflation expectations remain consistent with the inflation target, and are generally around or a little below their long-term averages (Graph 5.14; Table 5.2). Since the May *Statement*, market economists lowered their forecasts for inflation over

Graph 5.14
Indicators of Inflation Expectations



* Trimmed mean expectation of inflation over the next year

** Break-even 10-year inflation rate on indexed bonds; interpolation used to match exact maturity

*** Expectations of average annual inflation over the next 10 years

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

2014, which is likely to reflect the effect of the repeal of the carbon price. Expectations for inflation over 2015 are little changed. Union officials' forecasts for inflation have risen slightly over the past two quarters, to be 3 per cent over both 2014 and 2015. Financial market measures of inflation expectations were little changed in the quarter and continue to be around their long-run averages. The Melbourne Institute has revised the history of the trimmed mean series of consumer inflation expectations. This revision has increased the mean of the series by 1.3 percentage points, although the profile of the series remains similar to the pre-revision data. The consumer measure of inflation expectations for the year ahead decreased modestly in the June quarter and remains low relative to its long-run average. ✠

Table 5.2: Median Inflation Expectations
Per cent

	Year to December 2014			Year to December 2015	
	February 2014	May 2014	August 2014	May 2014	August 2014
Market economists	2.5	2.4	2.2	2.7	2.6
Union officials	2.8	3.0	3.0	2.9	3.0

Sources: RBA; Workplace Research Centre