5. Inflation

Inflation increased a little over the year to the March quarter …

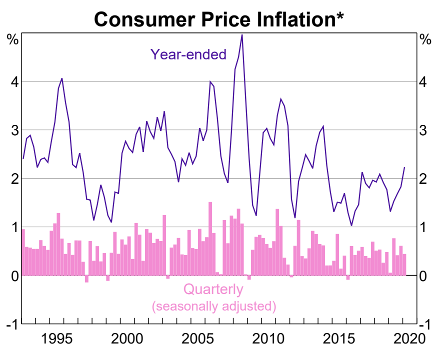
Headline inflation increased to 2.2 per cent over the year to March, despite a large fall in automotive fuel prices in the quarter (Table 5.1; Graph 5.1). Trimmed mean inflation was 0.5 per cent in the quarter and 1.8 per cent over the year (Graph 5.2). The March quarter outcomes were slightly higher than forecast in the February *Statement on Monetary Policy*. As expected, the summer bushfires did not have a major impact on CPI inflation in the March quarter. However, the various international travel bans in place from January and social distancing measures in place from mid March did affect some parts of the CPI basket during the quarter. In particular, there were strong price increases for products subject to COVID-19-related stockpiling behaviour such as rice, pasta and personal care products.

… but inflation will be lower in the near term due to COVID-19

The outbreak of COVID-19 and the related containment measures will reduce inflation in the near term. A sharp drop in demand for some goods and services will lead to lower inflation for many components of the CPI such as fuel and rents. A number of government policies will lead to temporarily lower prices for some services, most notably child care has been made temporarily free (see 'Outlook' chapter for more details). At the same time, supply chain disruptions, the slightly lower exchange rate and increased demand for essential goods during the containment period will put upward pressure on some prices.

There will be practical challenges to measuring inflation during the containment period. Typically, the ABS collects prices using a combination of in-person price collection, telephone interviews, online price collection and administered data sources. Following the

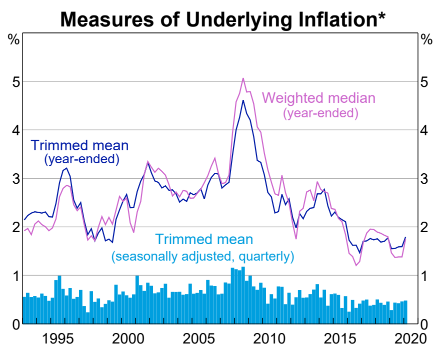
Graph 5.1



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

Sources: ABS; RBA

Graph 5.2



* Excludes interest charges prior to the September quarter 1998; 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 2020	December quarter 2019	March quarter 2020	December quarter 2019
Consumer Price Index	0.3	0.7	2.2	1.8
Seasonally adjusted CPI	0.4	0.6	–	–
– Tradables	0.1	0.5	2.1	1.7
– Tradables (excl volatile items)(c)	0.6	–0.1	1.6	1.3
– Non-tradables	0.6	0.7	2.3	2.0
Selected underlying measures				
Trimmed mean	0.5	0.5	1.8	1.6
Weighted median	0.5	0.4	1.7	1.3
CPI excl volatile items(c)	0.6	0.4	2.1	1.7

(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

introduction of social distancing measures in mid March, the ABS stopped collecting prices in person and has shifted, where possible, to collecting prices using online data and telephone interviews.[1] However, only a small number of prices will be affected by this change as less than two per cent of the CPI basket was previously collected in person. In addition to challenges in data collection, social distancing measures could result in some items no longer being transacted for some time, which means there is no 'price' to measure. Items for which prices are likely to be unavailable include international airfares and some sporting and cultural events. The ABS will construct price estimates for any items where prices cannot be collected, using prices for similar products where possible, or by imputation methods.[2]

COVID-19 containment measures are also affecting consumer spending patterns. For example, travel restrictions are likely to result in consumers spending more on home entertainment and groceries instead of purchasing international holidays and dining out. Because the CPI is based on a fixed basket of goods and services (representing the things that households typically buy), the weights applied to the most affected categories will not reflect these large changes in spending patterns. This may mean care will need to be taken when interpreting the trends in aggregate CPI measures.

Oil price declines are putting downward pressure on fuel prices

The sharp decline in oil prices earlier in the year led to a 6 per cent decline in automotive fuel prices in the March quarter (Graph 5.3). These declines have continued into the June quarter as COVID-19 containment measures have suppressed global demand for oil. At current levels, automotive fuel prices are expected to subtract one percentage point from headline CPI in the June quarter. If the decline in oil prices is sustained, lower fuel prices may put downward pressure on prices more broadly by reducing businesses' transport costs.

New government policies to support households will reduce inflation

A number of recent government policy decisions in response to the COVID-19 pandemic will have a significant impact on consumer prices over the coming year. The most significant of these for the CPI is the introduction of free child care services from early April to end June. Preschool fees have also been temporarily waived in New South Wales and Victoria. These changes are expected to reduce CPI inflation by around 1½ percentage points in the June quarter, followed by a large rebound in prices once the policies end.

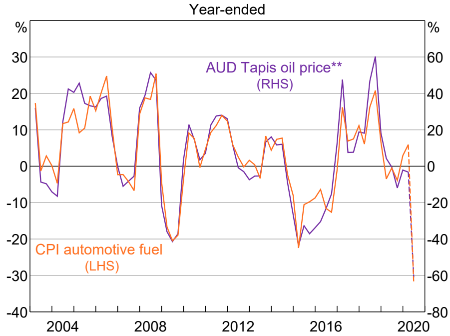
A number of state governments have announced price freezes for state-administered charges until 2021. These freezes, along with delays in the finalisation of government budgets, are likely to lead to property rates, motor vehicle-related charges and public transport fares remaining steady throughout most of the year.

Private health insurance premiums had been scheduled to increase by 2.9 per cent in April. However, most private health insurers have deferred these increases for at least six months, which will lead to lower medical & hospital services inflation in the June quarter.

Graph 5.3

Fuel and Australian Dollar Tapis Oil Prices*

Year-ended



* June quarter 2020 figures are estimates constructed using prices for April and early May

** Australian dollars per barrel

Sources: ABS; RBA

Housing inflation increased a little in March but could slow in coming quarters

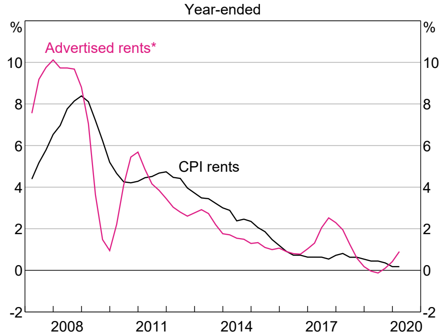
Housing-related inflation increased a little in the March quarter but remained around historical lows. Rent inflation remained around its lowest rate since the series began, although leading indicators such as newly advertised rents had started to increase in early 2020 (Graph 5.4). However, from mid March, the supply of rental properties started to increase; the introduction of travel restrictions encouraged some landlords who were previously supplying short-term holiday accommodation to instead put their properties on the longer-term rental market. The deterioration in labour market conditions during March is likely to have reduced demand for rental properties. State governments have introduced new mechanisms to enable tenants who have become unemployed or lost income due to COVID-19 to negotiate rent reductions. Information from liaison contacts in the real estate industry suggests that rents have already been reduced for a small number of tenants. Rent reductions for existing tenancies will directly reduce measured rent inflation because the CPI captures rents paid on the stock of existing rental properties.

New dwelling prices rose for the second consecutive quarter in March. Increased

Graph 5.4

Rent Inflation

Year-ended



* Capital cities; hedonic three-month average

Sources: ABS; CoreLogic; RBA

demand for new housing in early 2020 had allowed builders to pass on higher input costs to base prices, while bonus offers and purchase incentives had become less prevalent (Graph 5.5). Going forward, increased import prices due to supply disruptions in other economies and the recent depreciation of the exchange rate could lead to further increases in building material costs over the next couple of quarters. However, leading indicators suggest that demand for newly built dwellings is likely to remain weak for some time; this will limit the degree to which builders can pass higher input costs through to final prices.

Utilities prices increased modestly in the March quarter, driven by a rise in electricity prices as a result of a scheduled increase in the Victorian Default Offer (Graph 5.6). The Victorian Default Offer, which covers all standing offer customers in Victoria, was increased by 7.8 per cent in January. Market offer electricity prices in Victoria also increased in the quarter. Despite these increases, utilities inflation has been subdued for the past year and is likely to remain low for some time. Wholesale electricity prices have declined in most states since early 2019 because renewable energy projects have increased generation capacity. Wholesale gas prices have also fallen in recent months alongside lower international prices. The Australian Capital Territory, Northern Territory, Tasmanian and Western Australian governments have also announced utility-price freezes until 2021 and additional utilities rebates have been introduced in several states.

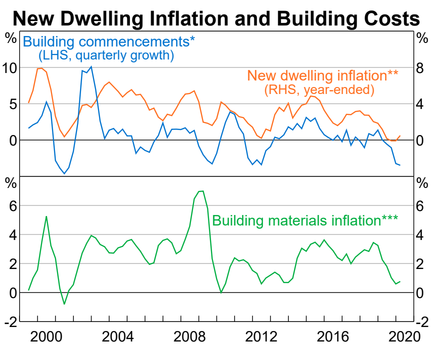
Market services inflation was little changed in the March quarter

Market services inflation, which includes household services such as hairdressing, as well as financial services and meals out & takeaway, was steady in the March quarter (Graph 5.7). Low labour cost growth has constrained market services inflation in recent years; labour costs account for around two-fifths of final prices for market services. Early evidence from other advanced economies suggests that market services inflation is likely to remain subdued for some time as social distancing measures suppress demand for household services and meals out & take away.

The impact of COVID-19 on retail prices will be mixed

Retail prices increased in the March quarter. Prices for non-durable household goods such as toilet paper and cleaning products rose strongly;

Graph 5.5



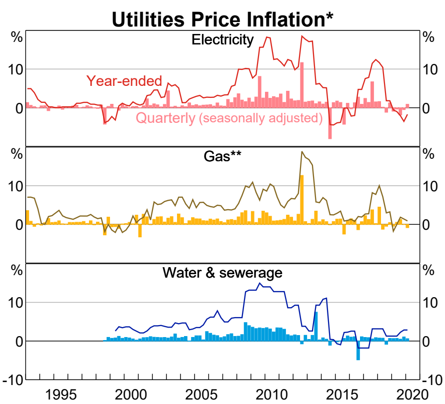
* Volumes; six-quarter average lagged by one quarter; detached only prior to 2017; thereafter attached included with a 20 per cent weight

** Adjusted for the tax changes of 1999–2000

*** Year-ended change in producer prices for inputs to house construction

Sources: ABS; RBA

Graph 5.6



* Adjusted for the tax changes of 1999–2000

** Includes other household fuels

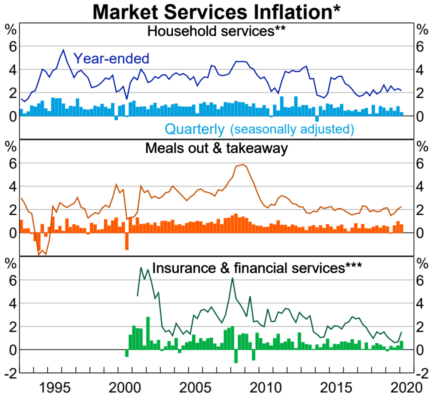
Sources: ABS; RBA

some supermarkets stopped discounting on the back of increased demand for these items as households prepared for an anticipated period of social distancing. In contrast, prices for motor vehicles and furniture declined (Graph 5.8). Motor vehicle prices typically rise in the March quarter as new models are introduced at higher prices. However, fewer new models were introduced this year, resulting in measured price falls.

Food prices increased in the March quarter owing to supply disruptions from the drought and bushfires, and strong demand from consumer stockpiling late in the quarter (Graph 5.9). Price rises were particularly noticeable for cereal products, such as pasta and rice. Meat prices remained high in the quarter as improved rainfall conditions early in the quarter induced some farmers to restock, reducing the supply of meat. Liaison reports indicate that supply chain disruptions put some upward pressure on prices for food towards the end of the March quarter. Most food sold in Australia is produced domestically, however, so international supply chain disruptions resulting from COVID-19 containment measures are likely to add only a little to ongoing food price pressures.

Graph 5.7

Market Services Inflation*



* Adjusted for the tax changes of 1999–2000

** Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services

*** Excludes deposit & loans to June quarter 2011

Sources: ABS; RBA

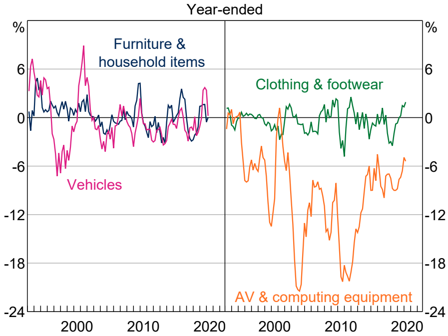
Inflation expectations have declined since the outbreak of COVID-19

Wage- and price-setting behaviour can be affected by expectations about the future rate of inflation. Both unions and market economists have revised down their inflation expectations for the remainder of 2020, with unions expecting inflation to remain well below 2 per cent in June 2021 (Graph 5.10). The share of households expecting prices to rise over the next year is now at its lowest level since 2008. Long-term survey-based measures of inflation expectations are little changed around 2-2½ per cent and remain consistent with the Bank's medium-term inflation target.

Graph 5.8

Consumer Durables Price Inflation*

Year-ended



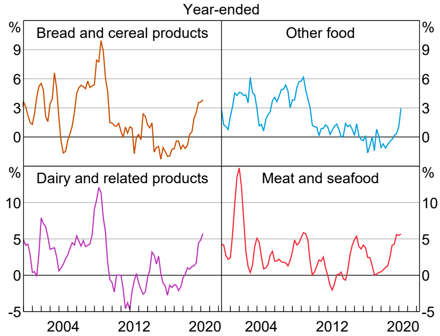
* Adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 5.9

Food Price Inflation*

Year-ended



* Adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Both short- and long-term market-based measures of inflation expectations have declined since the widespread outbreak of COVID-19 in early 2020; however, it is difficult to interpret the magnitude of these declines because functioning in these markets has been significantly impaired recently.

Wages growth was subdued ahead of COVID-19

The wage price index (WPI) grew by 2.2 per cent over 2019. Wages growth was lower in most industries than it had been one year earlier. Liaison evidence had continued to suggest that there was little upward pressure on wages into early 2020, with businesses reluctant to add to their permanent cost base. In lieu of increasing wages growth, some businesses were using bonuses or other allowances to retain staff and reward performance. Consistent with this, broader measures of wages had been growing at a faster pace than the WPI (Graph 5.11).

Early evidence suggests that wages growth will slow due to COVID-19

Survey evidence and payroll data show that the containment measures associated with the COVID-19 pandemic have led many businesses to reduce their labour costs. A lot of the adjustment to date has been through a reduction in hours and the number of employees (see 'Domestic Economic Conditions' chapter).

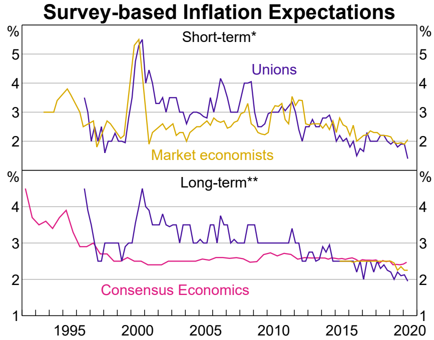
Temporary changes have been made to the *Fair Work Act 2009* to support the JobKeeper wage subsidy program by allowing employers to reduce the hours and to vary the work locations and responsibilities of employees receiving the JobKeeper Payment. Similar provisions have also been inserted into some modern awards by the Fair Work Commission (FWC).

The JobKeeper program will support employee earnings by reducing job losses. The program also provides a wage floor for eligible employees that will increase income in the near term for lower-paid employees and limit the decline in income for those who have had their hours reduced or been stood down.[3] In the most-affected industries, a little over half of employees would have their usual wage income more than replaced under the JobKeeper program (Graph 5.12).

The ABS payroll data show that the decline in total weekly wages paid to all employees was a similar magnitude to the decline in jobs since mid March. As a result, average weekly earnings declined only a little over the period. But compositional effects are likely to mask any

Graph 5.10

Survey-based Inflation Expectations



* Over the year ahead

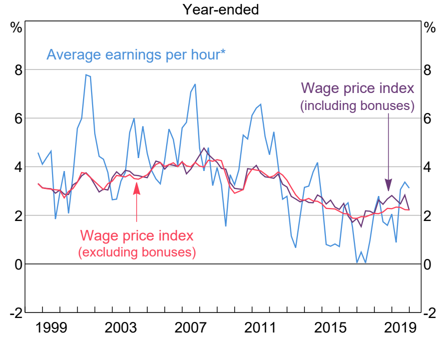
** Average over the next five to ten years for market economists and unions; average over six to ten years in the future for Consensus

Sources: Australian Council of Trade Unions; Consensus Economics; RBA; Workplace Research Centre

Graph 5.11

Labour Income Growth

Year-ended



* Non-farm

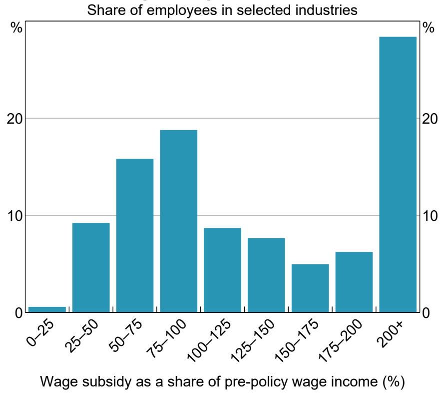
Source: ABS

decline in average weekly wages of those who remained in work because job losses have been more prevalent in lower-paid industries such as accommodation & food services and arts & recreation. In some industries such as finance, weekly wages have declined much more than jobs, suggesting more of the adjustment has come through a reduction in either hours worked or wages than through job losses (Graph 5.13).

Graph 5.12

JobKeeper Replacement Rates*

Share of employees in selected industries



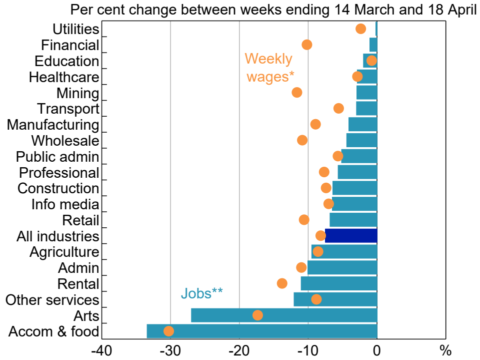
* Selected industries are store-based retail (excl food and fuel), arts & recreation, accommodation & food services and other services

Sources: HILDA 18; RBA

Graph 5.13

Jobs and Weekly Wages by Industry

Per cent change between weeks ending 14 March and 18 April



* Total value of wages for all employees during the reference week

** Number of jobs where a payment was made during the reference week

Source: ABS

Liaison information suggests a widespread increase in wage freezes across businesses affected by COVID-19. The Australian Government deferred agreed pay increases scheduled in the 12 months from 14 April by 6 months for Australian Public Service employees; there will be some catch up in wages growth for affected employees at the end of the deferral period. There have also been some reports of wage cuts, with very senior staff being more affected. So far, wage cuts are mostly temporary and do not appear to be widespread.

The industries most affected by COVID-19 and related social distancing have a relatively high share of employees paid according to awards and collective agreements. Wages growth in these industries has been supported in recent years by FWC award wage decisions that have delivered above-average wages growth. As a result, the gap in wage rates between enterprise agreements and the relevant award has compressed for many employees and some businesses have shifted away from enterprise agreements to the award, or explicitly tied future wage increases to FWC decisions.

The uncertainty around the COVID-19 pandemic has meant that FWC has delayed its annual wage determination for 2019/20 until June. A key input to the FWC's deliberations is the evidence on the effects of minimum wages on employment. In recent decisions, the FWC's assessment has been that modest changes to award wages have not had a noticeable adverse effect on employment. However, during the economic slowdown in 2009, the Australian Fair Pay Commission (the predecessor to the FWC) decided to freeze the federal award wage rates, citing a reduction in the ability of employers to offer sufficient work during that period.

Endnotes

[1] The ABS released a note on the impact of COVID-19 on the CPI in the March quarter CPI release: <abs.gov.au/ausstats/abs@.nsf/Latestproducts/6401.0Main%20Features4March%202020?opendocument&tabname=Summary&prodno=6401.0&issue=March%202020&num=&view=>

[2] Where there are no similar products available, the ABS has two main options for estimating prices. It could estimate a quarterly price change for each category based on historical price changes in that category. Alternatively, an estimate could be constructed using a weighted average of all available prices in the CPI in the quarter. Using the average of all other prices ensures that any missing categories do not affect measured headline inflation. The ABS is yet to announce which approach it will adopt.

[3] The JobKeeper wage subsidy introduces a range of definitional complications for measures of wages growth and it is as yet unclear how the wage subsidy will be treated in the WPI. These decisions will have a material effect on measured wages growth, and may mean that measures reflect changes in the business costs of wages or wages as income, but obscure changes to agreed hourly wages while the JobKeeper program is in place.