

AN UPDATE ON LIAISON MESSAGES – FEBRUARY 2023

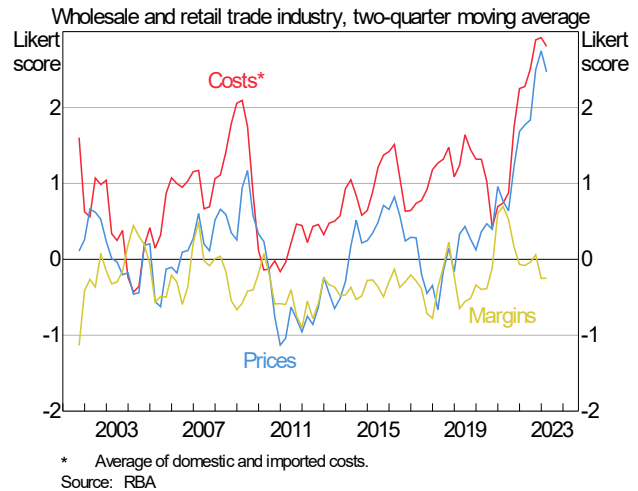
- Most firms continue to report an intention to increase prices further in the period ahead, though the size and frequency of increase has generally levelled out. Intentions are mixed across sectors; some retailers have reported increased discounting or that they are no longer passing through cost increases.

The latest read from liaison

Prices and input costs

- At this stage, firms still expect the costs of materials, energy and freight to increase a little further in levels terms, despite the improvement in the availability of imported goods and cheaper freight costs following the slowing in global demand. Many firms, particularly goods-related firms, have reported an easing in the pace of upstream cost increases in recent months.
- Firms' price intentions for the period ahead are mixed, with wage pressures driving price increases for firms where labour is a large share of their costs. Most firms have reported since end November that they had further price increases planned over the period ahead. For example, many manufacturing and construction firms expect to increase their prices further over coming months to maintain margins. By contrast, several non-food retailers expect to hold prices steady over this year, or at least have planned lower price rises than they implemented last year, and have reported increased discounting.

Liaison Indicators of Non-labour Costs and Prices



Supermarkets and retailers

- Some retailers have also reported increased discounting or that they are no longer passing through cost increases. Contacts continue to take into account their competitors' behaviour and the risk of a more pronounced softening in demand, which could weigh on price increases.

Comment on ‘Profit-Price Spirals: the Truth behind Australia’s Inflation’

The paper argues that growth in aggregate business profits since the onset of the pandemic – and particularly since early 2021 – accounts for a large share of the increase in Australian inflation.

Approach

The study claims to provide an exact decomposition of inflation into separate contributions from the various factors of production – notably labour, capital (profits) and taxes net of subsidies. To do this, they use data on factor incomes from the income side of the national accounts.

Importantly, the measure of inflation they decompose is growth in the GDP deflator, rather than the CPI.

The income side of the national accounts does not include price deflators for the various sources of income (e.g. COE, GOS, GMI). In an attempt to express these various income flows in terms of a ‘price’, the author normalises each by real GDP (e.g. $\text{COE} \div \text{real GDP}$). In the case of COE, this yields a crude measure of nominal unit labour costs. In the case of GOS, it yields a measure of profit per unit of output, which the author refers to as ‘unit profit costs’. Unit costs are also calculated for the other income-side components in the same way, such as public GOS, housing GOS and taxes less subsidies.

The author’s decomposition approach is similar to some earlier analysis by the [OECD \(2006\)](#), which used national accounts data to examine ‘price pressures’ in the euro area in the mid 2000s. But unlike the current study, the OECD did not characterise their analysis as a decomposition of inflation.

In cumulative terms, the GDP deflator rose by 15 per cent between DQ2019 and SQ2022. The paper estimates that half of this increase in ‘inflation’ is mechanically accounted for by the increase in profit per unit of output. This leads the authors to conclude that an increase in ‘excess profits’ account for much of the higher inflation observed in Australia over the past couple of years.

Limitations of the analysis

One limitation of the author’s calculation is that it focuses a measure of profitability – and inflation – that is heavily influenced by commodity prices. While the author notes that ‘record profits on petroleum and mining activities ... led the surge [in aggregate profits]’, they do not quantify its importance.

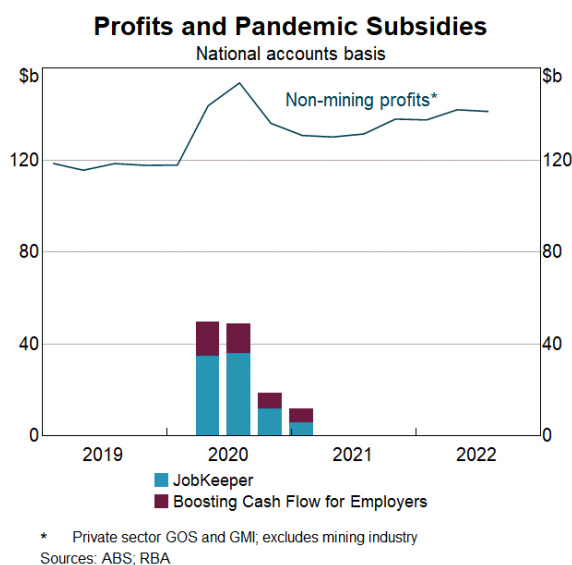
Using the same decomposition approach, we find that higher mining profits account for more than four-fifths of the overall increase in corporate profit per unit of output since late 2019. In contrast, non-mining profit per unit of output grew at a slightly slower rate than unit labour costs over the 2019-2022 period, and is equivalent to less than 10 per cent of the overall increase in the GDP deflator (compared to the 50 per cent attributed to corporate profits in the paper). These results are not surprising, and are consistent with analysis in the November *Statement* showing that the labour share of income has been relatively stable outside the mining sector.

A broader limitation of the author’s analysis is that a simple decomposition of national accounting identities is not an appropriate way of identifying whether higher profits are actually a determinant of inflation.¹ Profits and inflation do not have a direct accounting relationship. To examine the profit-inflation relationship properly, one requires a model and a measure of markups.

¹ Chris Edmond had a similar reaction ([Twitter thread](#))

The role of JobKeeper

As the paper suggests, JobKeeper provided a large and temporary boost to GOS and GMI during the period JQ20 to MQ21. However, it is not straightforward to identify the precise contribution. While we have ABS special request data on the overall size of the JobKeeper subsidies (and other economic support programs), it is unclear how much of the program benefits flowed to workers rather than firms. The graph below provides a rough sense of the possible magnitudes (again, noting that we don't know the profit counterfactual or how much of the benefit went to COE rather than profits).



In any case, because the author's headline estimate of the profit-inflation relationship is based on a comparison of flows in DQ2019 and SQ2022, it does not capture any of the temporary boost to profits during the period of JobKeeper

Some other issues

1. The paper uses growth in the GDP deflator rather than growth in the CPI to measure inflation. There are significant scope, coverage and conceptual differences between these measures. The CPI grew by less than the GDP deflator (10½ per cent versus 15 per cent) over the period from 2019Q4 to 2022Q3, driven in large part by the 23 per cent increase in the terms of trade over that period (commodity export prices are captured in the GDP deflator but not the CPI). A national accounts price measure that is closer to the CPI than the GDP deflator in terms of scope and coverage is the implicit price deflator for consumption.
2. The paper refers to GMI as 'small business profits'. While it is correct that small business profits are a component of GMI, at least some of Gross Mixed income is a return to labour effort. Previous research attempts to address this issue by apportioning GMI to capital and labour.

AN UPDATE ON LIAISON MESSAGES – MARCH 2023

- Liaison contacts report that conditions are quite challenging for many small businesses, including managing the impact of the sharp increase in costs and how to manage their pricing (see the [Box](#) for further details).

Prices and input cost inflation is decelerating, although domestic cost pressures remain

- Price growth is expected to moderate over the year ahead but remain above pre-pandemic growth rates, driven by easing input costs and lower demand. For example, construction and manufacturing firms expect smaller price increases compared to the past year but will maintain or recover margins. Relatedly, several non-food retailers expect to hold prices steady over this year or will try to maintain margins in line with costs. For some firms where labour is a relatively large share of their costs, higher labour costs are placing upward pressures on prices. Firms note the recent easing in upstream costs will likely take time to flow through to prices.

- Retailers continue to highlight costs and competitor behaviour (rather than margin expansion) as the major drivers of their pricing strategies, although some retailers also mention the expected downturn in demand as an increasingly important factor.

BOX A: SMALL BUSINESS LIAISON

- small businesses have found it difficult to price in the current high inflation environment and often have limited financial literacy, which has led to unanticipated margin compression.

From:
Sent: Friday, 3 March 2023 5:43 PM
To: Notes policy groups
Cc: EA - RIA
Subject: Note EA: Retail Liaison Summary – February 2023 [SEC=OFFICIAL]

Reports of an easing in the pace of upstream cost increases have become more common across retailers, particularly for imported goods and international freight. However, upward domestic cost pressures – notably labour, utilities and logistics – persist for some. Retailers continue to highlight costs and competitor behaviour (rather than margin expansion) as the major drivers of their pricing strategies, although some retailers also mention the downturn in demand as an increasingly important factor. Several retailers expect to hold prices steady over this year, or will try to maintain margins in line with costs.

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ABC – Economic Background Briefing

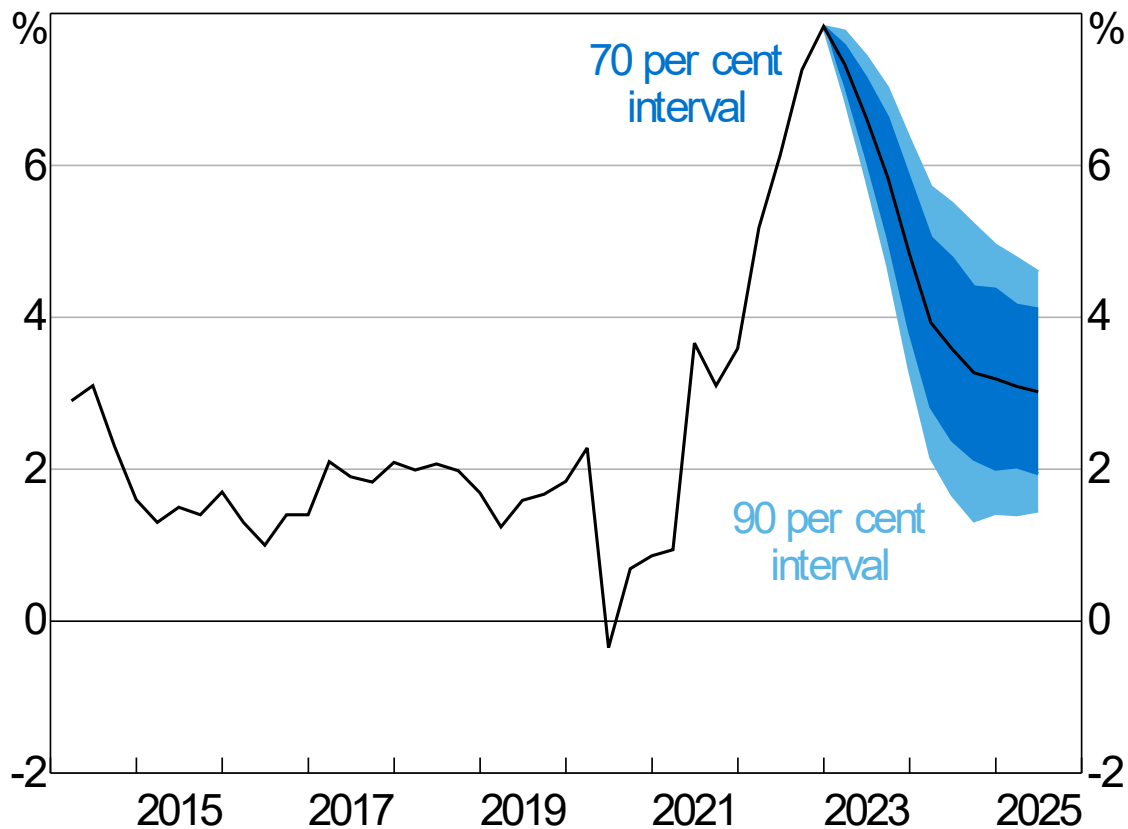
Luci Ellis

Assistant Governor, Economic

14 March 2023
ABC Ultimo Studio

Headline Inflation Forecast*

Year-ended

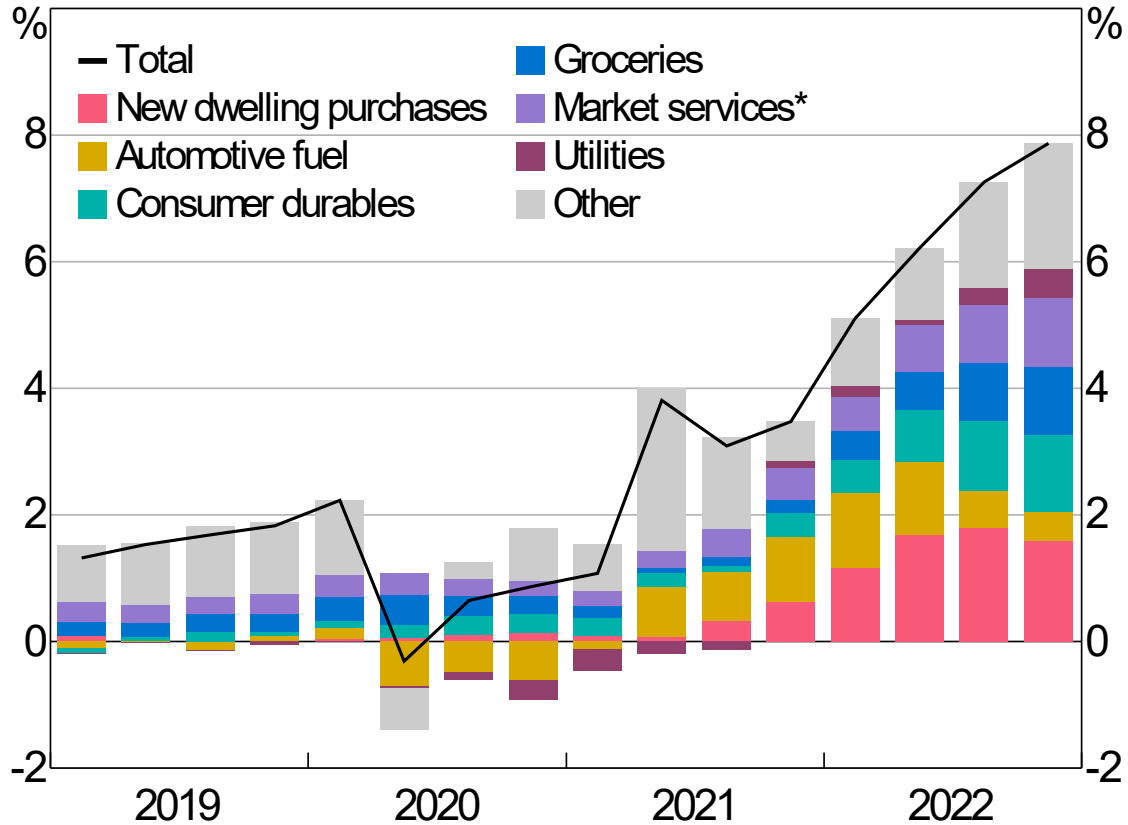


* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

CPI Inflation

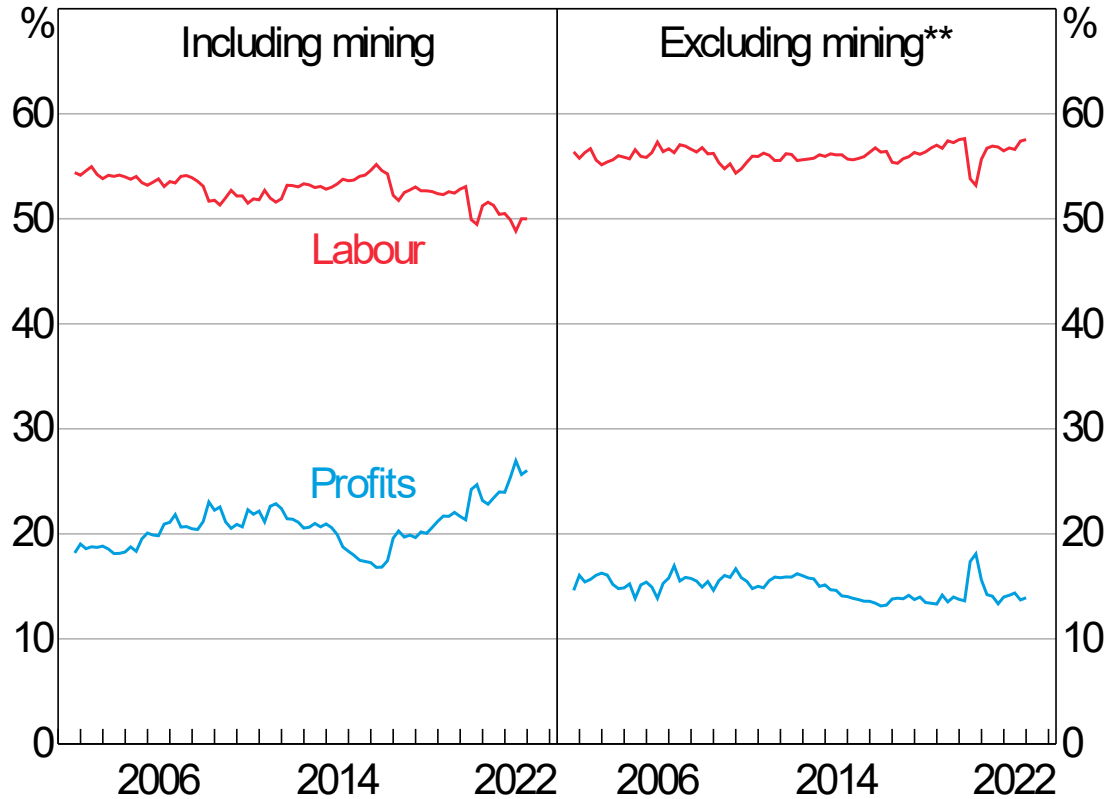
Year-ended with contributions



* Excludes domestic travel and telecommunications.

Sources: ABS; RBA

Labour and Profit Share of Income*



* Shares do not sum to 100 per cent due to the exclusion of gross mixed income, and the gross operating surplus of public corporations, financial corporations, general government and dwellings.

** Excluding mining sector profits and mining sector labour income.

Sources: ABS; RBA

From:

Sent: Thursday, 16 March 2023 10:14 AM

To:

Cc: EA - PWL Prices

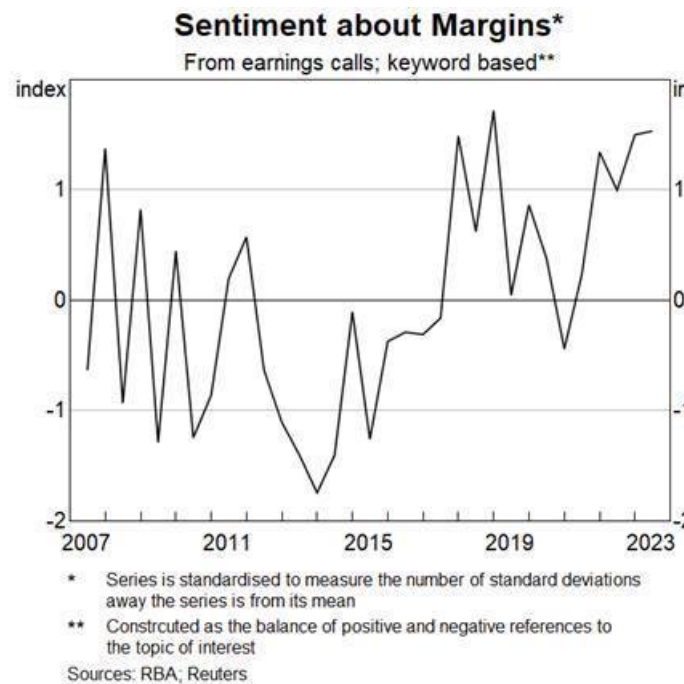
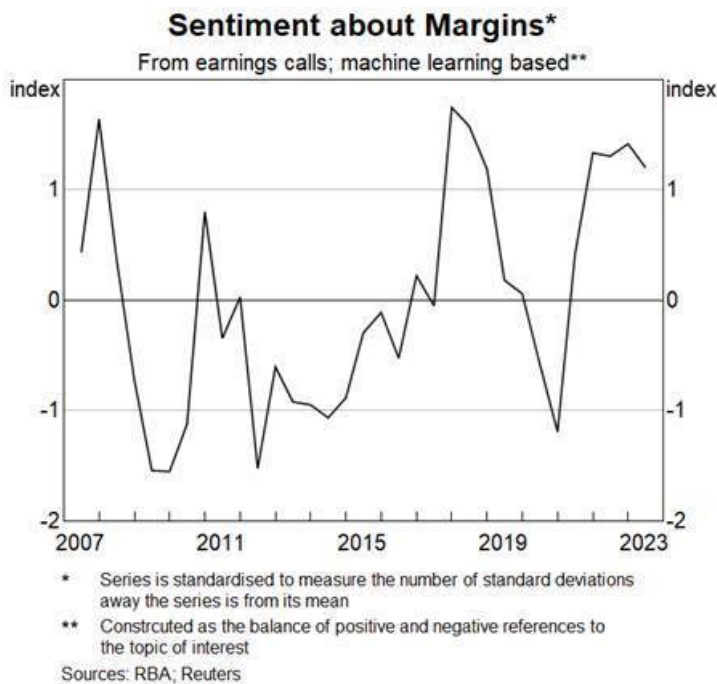
Subject: RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

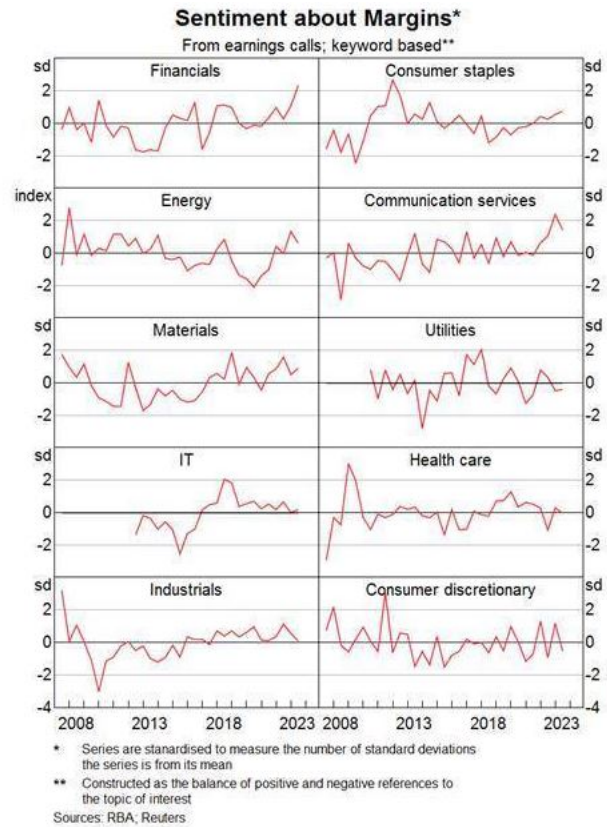
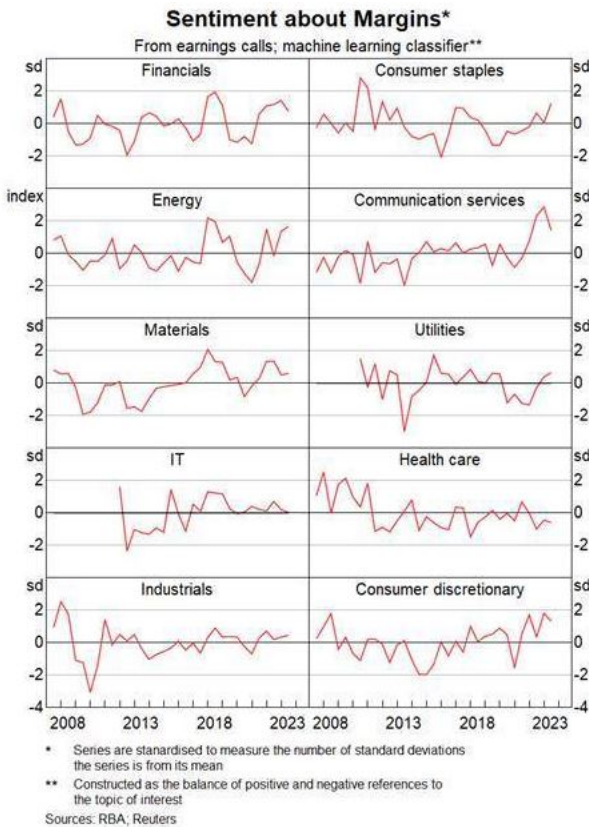
Hi

As requested, please see the ML indices below (left-hand side; keyword-based indices are also shown for reference). Results look pretty similar, except for consumer discretionary. Just let me know if you want to see anything more.

(NB: for the ML classifier the index is showing the balance of paragraphs about “business margins increasing” and “business margins decreasing”. We tried a few variants on a random sample, and this seemed to produce the most accurate results.)

Cheers,





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From:
Sent: Thursday, 2 March 2023 5:16 PM
To:
Cc: EA - PWL Prices
Subject: RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

I'd say expanding and contracting, but that is not based on anything concrete. Could you see which terminology is used most frequently in the transcripts and base it off that?

From:
Sent: Thursday, 2 March 2023 5:05 PM
To:
Cc: EA - PWL Prices
Subject: RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

Sure thing. (NB: I've looped out DM from here).

From:**Sent:** Thursday, 2 March 2023 5:01 PM**To:****Cc:** DM Securities Markets - Equities
EA - PWL Prices**Subject:** RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

Chiming in here – interesting work as usual DAT is also working on this topic, would you mind if I forward this to DAT (DAT management and if you could keep us in the loop on the industry splits?

Cheers,

From:**Sent:** Thursday, 2 March 2023 4:14 PM**To:****Cc:** DM Securities Markets - Equities
EA - PWL Prices**Subject:** RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

Hi

Good to hear you found it interesting. Yes, we can send the splits by industry. And yes, we can get the ML indices prepared by 15 March (they are already available for our pre-existing series, it's just generating the history for margins that will take time).

Cheers,

From:**Sent:** Thursday, 2 March 2023 3:39 PM**To:****Cc:** DM Securities Markets - Equities
EA - PWL Prices**Subject:** RE: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

Thanks this is super interesting.

Could we see a split of margins by industry? (the strength in that series is guaranteed to generate interest and it would be good to know if anything in particular is driving it). and I thought it might be worth sending this material to senior management once we have the industry splits, along with a couple of dot points.

More generally, would it be possible to get an update of the machine learning indices by around 15 March? We are hoping to include something on this in our Board paper contribution for the April meeting.

From:

Sent: Wednesday, 1 March 2023 3:32 PM

To:

Cc: DM Securities Markets - Equities

Subject: Chartpack: Updated Insights from Firms' Earnings Calls [SEC=OFFICIAL]

Hi all,

Please see some updated charts that capture the February half-year earnings season. Just let us know if you have any questions.

Cheers,

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From:

Sent: Tuesday, 28 February 2023 4:39 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Looks great, thanks

From:

Sent: Tuesday, 28 February 2023 4:37 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Thanks the expanded list looks great to me. No additions from me.

From:

Sent: Tuesday, 28 February 2023 4:34 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Hi all,

From:

Sent: Monday, 27 February 2023 3:37 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Good idea – we can separate net margins and gross margins into separate tabs.

From:

Sent: Monday, 27 February 2023 2:54 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Thanks Do we want to try and distinguish between net margins and gross margins, given they can often be doing different things?

From:

Sent: Monday, 27 February 2023 2:49 PM

To:

Cc: DM Securities Markets - Equities

Subject: RE: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Great, thanks for letting us know

I've added in additional tabs for margins and company outlook/guidance (see attached spreadsheet). Happy to discuss them if there are any questions.

Cheers,

From:

Sent: Monday, 27 February 2023 2:21 PM

To:

Cc:

Sub

Thoughts on running something specifically for margins/mark-ups, rather than as a component of input costs as is the case currently? SMS will probably have a better idea than us about which terms are likely to best capture this in companies communication.

From:

Sent: Monday, 27 February 2023 11:56 AM

To:

Cc:

Subject: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Hi

Sure. We'll be updating on 1 March and will send the charts over shortly thereafter. Would you like us to search over any other specific terms related to the specific themes you're interested in? If so, all we need is a new tab in here ([D22/220550](#)) that defines your theme in the same way as the other tabs. Just send it back as an attachment. Looping in PWL in case they are interested too.

Cheers,

From:

Sent: Monday, 27 February 2023 11:43 AM

To:

Cc:

Subject: RE: Note ER/EA: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

Hi

I work on the equities desk in Domestic Markets (DM) and we've been looking at the February half-year earnings season. I thought your note using natural language processing techniques to listed Australian companies' earnings calls was very interesting.

I was wondering whether you are planning to update the graphs to incorporate the February earnings call data? We've been getting questions on listed companies' profit margins and how much margins have added to inflation, so those graphs could be useful for us.

Regards,

Domestic Markets Department
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From:

Sent: Friday, 2 September 2022 2:13 PM

To: Notes policy groups

Cc:

Subject: Note ER/EA: Firms' Price-setting Behaviour: Insights from Earnings Calls [SEC=OFFICIAL]

We develop aggregate and disaggregated sentiment indexes for firms' input costs, demand and final prices by applying natural language processing techniques to listed Australian companies' earnings call transcripts. These indexes are available at a much more granular level than other data sources and are easy to update. The signal from these measures – which include the August earnings season – is similar to that provided by other data sources and liaison information, particularly over the past year. Going forward, PWL will use these indexes alongside other indicators to monitor inflationary pressures in the economy.

For more information, see: [Firms' Price-setting Behaviour: Insights from Earnings Calls](#)

Aggregate Sentiment Indexes

From earnings calls; zero-shot text classification



Sources: RBA; Reuters

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Guardian – Economic Background Briefing

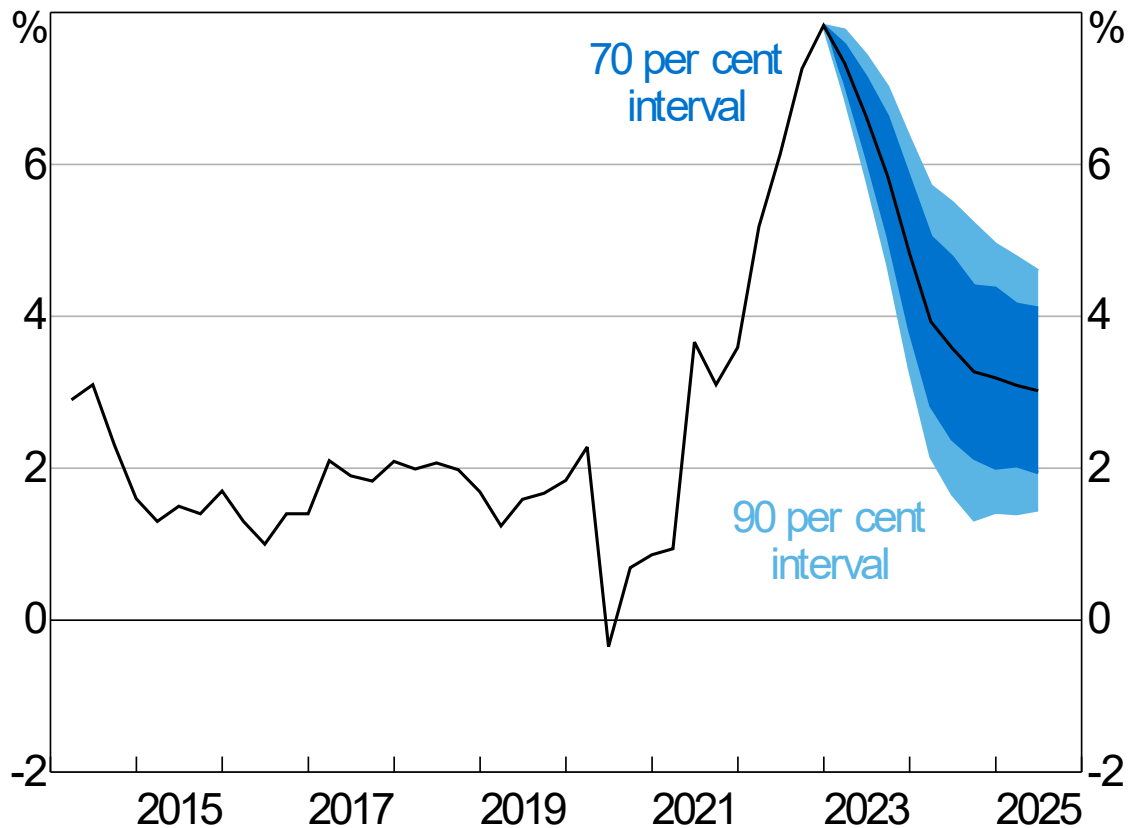
Luci Ellis

Assistant Governor, Economic

21 March 2023
RBA
65 Martin Place, Sydney

Headline Inflation Forecast*

Year-ended

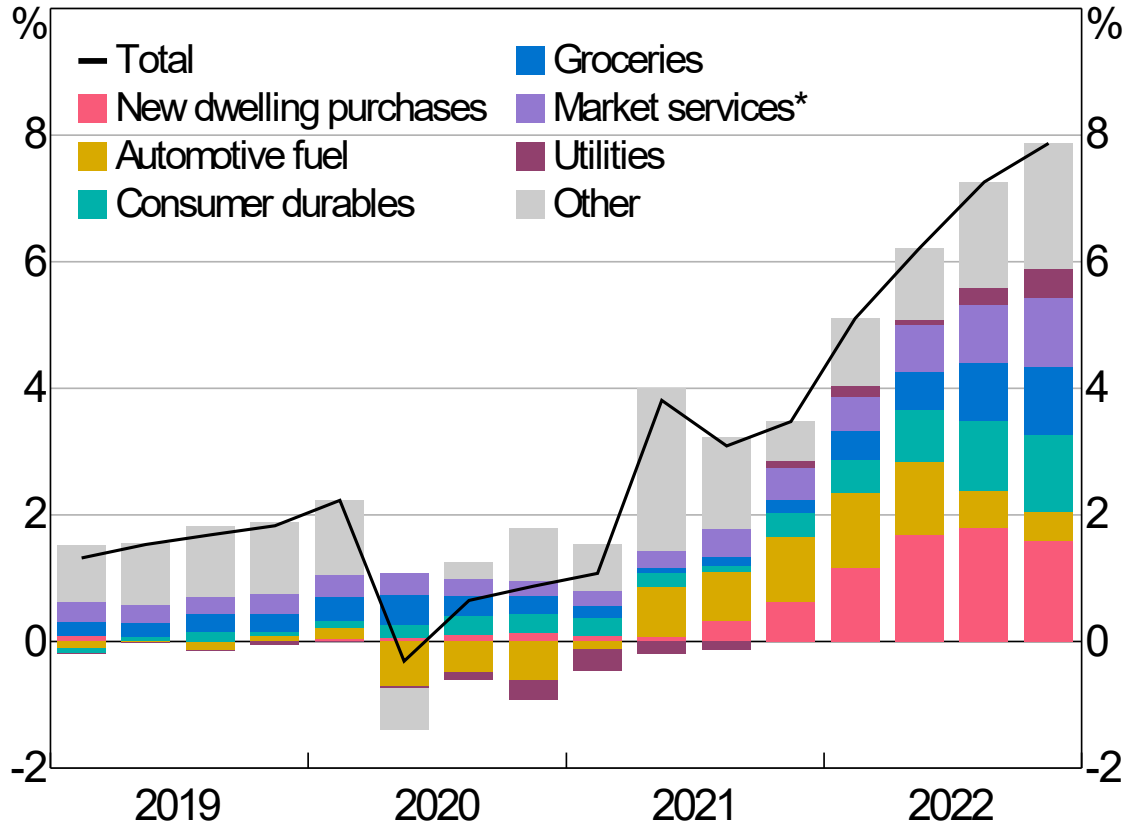


* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

CPI Inflation

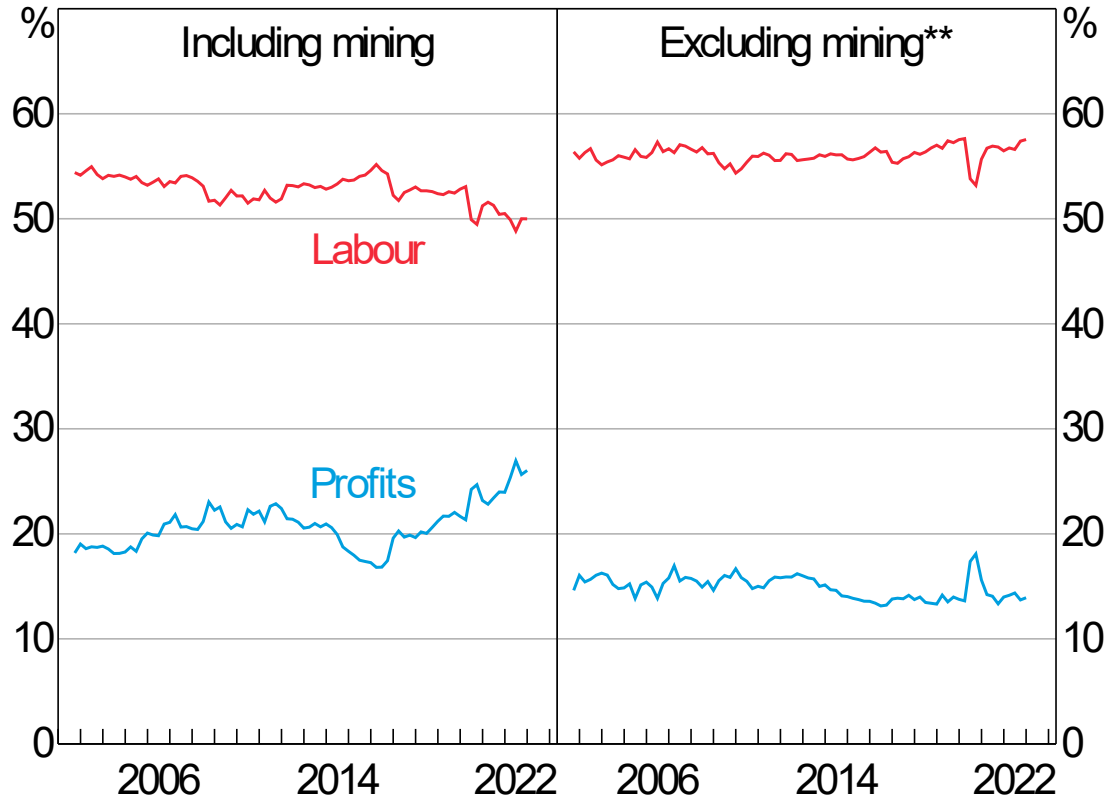
Year-ended with contributions



* Excludes domestic travel and telecommunications.

Sources: ABS; RBA

Labour and Profit Share of Income*



* Shares do not sum to 100 per cent due to the exclusion of gross mixed income, and the gross operating surplus of public corporations, financial corporations, general government and dwellings.

** Excluding mining sector profits and mining sector labour income.

Sources: ABS; RBA

From:
Sent: Tuesday, 28 March 2023 1:00 PM
To:
Cc:
Subject: RE: Common Core Goods Inflation Note [SEC=OFFICIAL]

A few other points that are a mix of questions and comments, all in the 'in case useful' spirit.

Thanks again for engaging RIA!

From:
Sent: Tuesday, 28 March 2023 11:19 AM
To:
Cc:
Subject: RE: Common Core Goods Inflation Note [SEC=OFFICIAL]

Hi

Thank you for sharing this note with us. We have put our comments in **red** below.
Happy to chat.

Regards,

From:
Sent: Monday, 27 March 2023 4:41 PM
To:
Cc:
Subject: Common Core Goods Inflation Note [SEC=OFFICIAL]

Hi

- perhaps falling global goods prices are not being passed through to Australian consumers. – we are sending a supply chain analytical note today that could be useful. The sense from liaison is that domestic cost pressures such as energy, wages, and logistics could be offsetting the lower import costs. We also have heard several retailers expect to hold prices steady over this year, or will try to maintain margins in line with costs.

Kind regards,

| Economic Group
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From:

Sent: Tuesday, 28 March 2023 4:18 PM

To: EA - DAT - Management

Subject: FW: For input: Michele Bullock panel talking points [SEC=OFFICIAL]

The questions for us:

3. To what extent are recent inflation outcomes due to the highly concentrated nature of Australian industry? To what extent do higher profit margins explain inflation? (for Begona) [DAT]

From: KOHLER, Marion
Sent: Thursday, 2 March 2023 11:18 AM
To: ROSEWALL, Tom
Cc: COCKERELL, Lynne
Subject: National accounts [SEC=OFFICIAL]

Hi

First of all, thanks again – the team has done a stellar job this week in getting through this amount of data and providing analysis and briefing! Well done to all

I was very well prepared for the 8.05 today (and pdg yesterday). Two things came out of the 8.50 this morning – I emphasised that the team has been under the pump, and said it will take a couple of days to get to this:

- Profit shares: the material provided was good. I said that I would like the team to have time to look at different cuts of the profit shares, to see whether we can find **any evidence of increasing profit shares that would line up with strength in prices**. So, some graphs to gauge just how volatile the industry numbers are; maybe we need to aggregate groups. Maybe we can square some of these away with listed profit results. Energy was strong, and airfare sector. Also, we are excluding a share of income in our normal graph. Can we have a look at financial services, and also GMI? Is indirect net tax the residual?

Thanks again – the team has done a stellar job this week in getting through this amount of data and providing analysis and briefing! Well done to all

Thanks

Marion Kohler | Head | Economic Analysis
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