4. Inflation

Inflation was low and stable in 2019

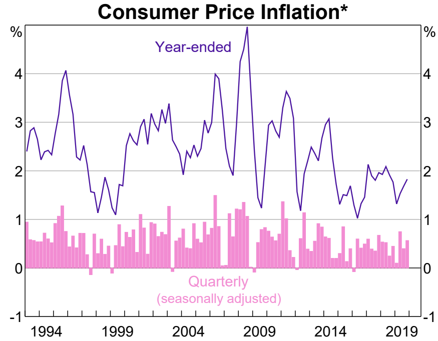
The December quarter inflation outcomes were in line with the forecast in the November *Statement on Monetary Policy*. Headline inflation increased to 0.6 per cent (seasonally adjusted) in the quarter and 1.8 per cent over the year (Table 4.1; Graph 4.1). Headline inflation in the quarter was boosted by a 4½ per cent increase in automotive fuel prices and an increase in the prices of fruit and vegetables. Trimmed mean inflation was unchanged at 0.4 per cent in the quarter and 1.6 per cent over the year (Graph 4.2).

Measures of year-ended underlying inflation were steady at around 1½ per cent in 2019. This is a little lower than in 2018. Continued spare capacity in the economy and associated low wages growth have weighed on inflation outcomes for a number of years. Over 2019, housing inflation declined to historical lows, reflecting a mix of supply- and demand-side developments, and utilities prices fell (Graph 4.3). In contrast, pass-through of the earlier exchange rate depreciation and the ongoing drought have put some upward pressure on retail prices (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Non-tradable inflation increased a little to 0.7 per cent in the December quarter to be 2 per cent over the year (Graph 4.4). Prices for tobacco rose strongly in the December quarter because of the increase in the tobacco excise; tobacco is classified as a non-tradable item because prices predominantly reflect domestic tax arrangements. However, there is broad-based weakness in domestically generated inflation, particularly in housing and utilities price inflation. Prices of tradable items (excluding volatile items) had trended higher since mid 2018 but fell slightly in the December quarter. The boost to retail prices from the earlier exchange rate depreciation appears to have

Graph 4.1

Consumer Price Inflation*

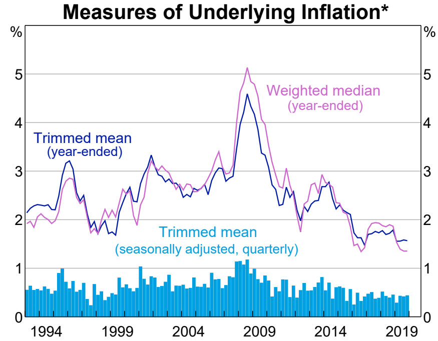


* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 4.2

Measures of Underlying Inflation*



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

Sources: ABS; RBA

Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly(a)		Year-ended(b)	
	December quarter 2019	September quarter 2019	December quarter 2019	September quarter 2019
Consumer Price Index	0.7	0.5	1.8	1.7
Seasonally adjusted CPI	0.6	0.3	–	–
– Tradables	0.4	0.3	1.7	1.2
– Tradables (excl volatile items)(c)	–0.1	0.7	1.3	1.8
– Non-tradables	0.7	0.5	2.0	1.9
Selected underlying measures				
Trimmed mean	0.4	0.4	1.6	1.6
Weighted median	0.4	0.4	1.3	1.3
CPI excl volatile items(c)	0.4	0.5	1.7	1.9

(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

ended; however, drought-related supply shortages continue to put upward pressure on food prices.

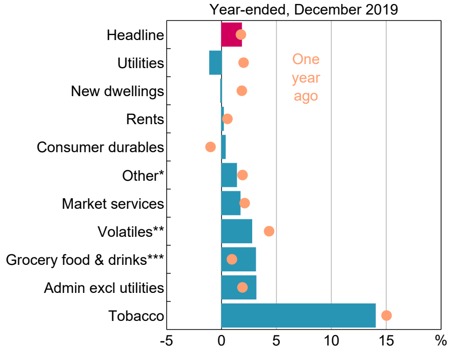
Housing inflation remains low

New dwelling purchases by owner-occupiers and rents are the two largest components of the CPI, together accounting for around one-sixth of the basket. Over the past decade, inflation for each of these components has averaged around

Graph 4.3

Inflation by Component

Year-ended, December 2019



* Includes alcoholic beverages, travel, telecommunications and pet products

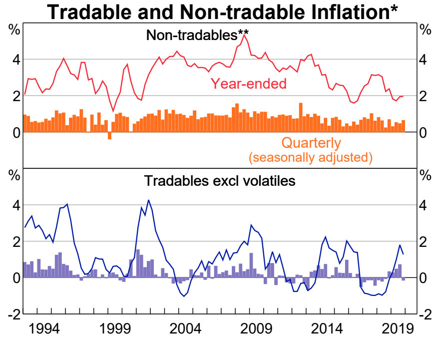
** Includes automotive fuel, fruit and vegetables

*** Excludes alcoholic beverages, fruit and vegetables

Sources: ABS; RBA

Graph 4.4

Tradable and Non-tradable Inflation*



* Adjusted for the tax changes of 1999–2000

** Excludes interest charges and indirect deposit & loan facilities

Sources: ABS; RBA

2½ per cent. Inflation in these housing components has been well below average recently and has contributed notably less to CPI inflation; new dwelling inflation has averaged 1¼ per cent and rent inflation only ½ per cent over the past two years (Graph 4.5). Inflation in both of these components was around historical lows in the December quarter.

The prices of newly built dwellings increased modestly in the December quarter, but were broadly flat over the year (Graph 4.6). A decline in building activity over 2019 has led to weaker demand from developers for building materials, resulting in lower costs, and thus price inflation. During 2019, liaison reports suggested developers had increased discounts and bonuses in response to weaker demand for new housing, but these incentives (which lower the measured price of constructing a new dwelling) were partly unwound in the quarter.

Rents were flat in the December quarter to be 0.2 per cent higher over the year. Various supply- and demand-side developments have placed downward pressure on rents over the past few years. In particular, growth in the housing stock has outpaced population growth and household disposable income growth has been low. Low rents growth could also partly reflect indexation of some rents to CPI inflation. Newly advertised rents, which are a leading indicator of CPI rents, have been little changed over the past year, suggesting that rent inflation is likely to remain subdued over the year ahead. In Sydney, CPI rents declined over the year to December, along with an increase in the vacancy rate (Graph 4.7). In Perth, the vacancy rate has declined further and rent deflation has continued to moderate, although rents are still around 20 per cent lower than in 2014. Rent inflation remains low in Brisbane but advertised rents have picked up recently given the fall in the vacancy rate. Rent inflation has been fairly stable in Melbourne in recent years despite slower growth in advertised rents, while rents in Hobart increased by 6 per cent over 2019.

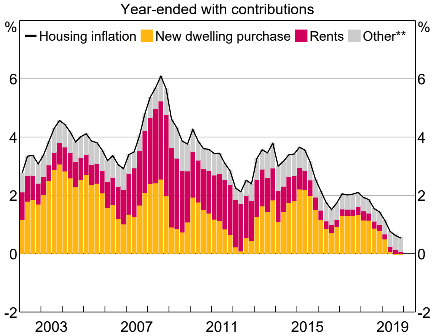
Utilities prices declined over 2019

Utilities prices declined by 1 per cent over the year, which was the fastest pace of decline since 2015 (Graph 4.8). Electricity prices fell by 3.5 per cent over the year driven by regulated changes in standing offer prices, as well as declines in market offer prices. In particular, the introduction of the Default Market Offer and Victorian Market Offer on 1 July lowered standing offer prices for many consumers in New South Wales, southern Queensland, South Australia and Victoria. Gas price inflation remains

Graph 4.5

Housing Inflation*

Year-ended with contributions



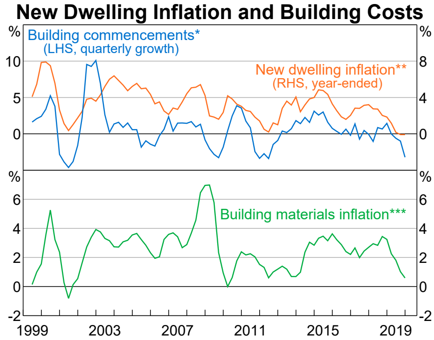
* Excludes utilities

** Includes dwelling maintenance and property rates & charges

Sources: ABS; RBA

Graph 4.6

New Dwelling Inflation and Building Costs



* 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

low, while water & sewerage price inflation has risen slightly.

Prices for other administered items increased by 3.1 per cent over the year to December. In non-seasonally adjusted terms, the prices of most administered items were broadly unchanged in the quarter because few regulatory or government price changes occur in the December quarter.

Market services inflation remains subdued

The prices of market services were 1.7 per cent higher over the year to December. 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. Growth in unit labour costs has picked up over the past year which, if sustained, could put some upward pressure on market services inflation. Prices of meals out & takeaway rose by 1 per cent in the December quarter, partly reflecting pass-through of higher input costs arising from the drought (Graph 4.9).

Retail prices have increased owing to higher import prices and the drought

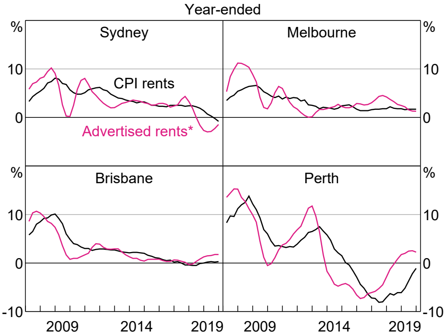
Retail prices increased by 1.3 per cent over 2019. Over the past decade, retail inflation has been very low as a result of heightened competition from new foreign entrants, technology and changing business models. Weaker household demand has also contributed to downward pressure on prices, particularly for consumer durables.

Year-ended inflation in consumer durables prices is close to its highest in a decade, consistent with the pass-through of the earlier exchange rate depreciation to higher import and consumer retail prices (Graph 4.10). However, consumer durables prices fell in the

Graph 4.7

Rent Inflation

Year-ended

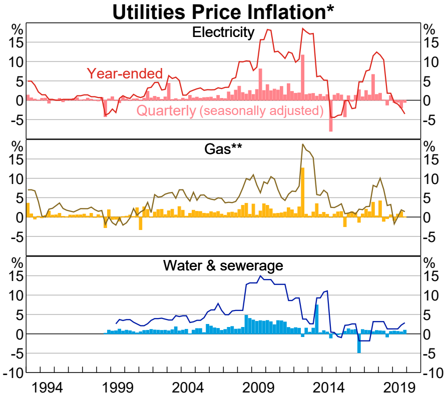


* Hedonic three-month average

Sources: ABS; CoreLogic; RBA

Graph 4.8

Utilities Price Inflation*



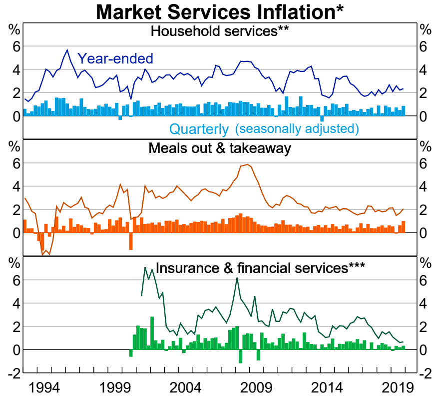
* Adjusted for the tax changes of 1999–2000

** Includes other household fuels

Sources: ABS; RBA

Graph 4.9

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

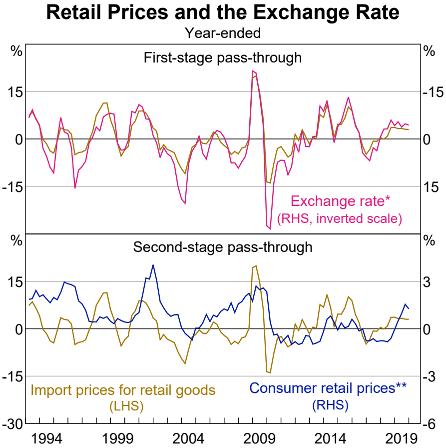
December quarter. Although the timing and speed of exchange rate pass-through is uncertain, it is likely that the pass-through of the late 2018 exchange rate depreciation is now largely complete. This is consistent with estimates that most pass-through occurs within a year and with liaison reports that most large retailers hedge their exchange rate exposure around six to twelve months in advance.

Grocery price inflation was subdued throughout much of the 2010s because of changes to business models and the entry of new supermarket chains. Prices for dairy products fell over the past decade, while prices for bread & cereal and other food items rose only slightly (Graph 4.11). Meat & seafood prices were fairly steady over the early part of the 2010s but increased over the second half of the decade. In contrast, even abstracting from a temporary increase in prices from Cyclone Yasi in 2011, fruit & vegetable prices rose fairly strongly over the decade.

Over the past year and a half, drought-related supply disruptions have put upward pressure on food prices. Grocery prices increased in the December quarter and year-ended grocery price inflation is also around its highest rate since 2009. The drought has particularly affected prices for bread & cereal products (through higher grain input costs) and meat (through higher wholesale prices). Strong international demand, especially for lamb and beef, has also put upward pressure on meat prices over this period. The outbreak of African swine fever in China has led to higher international pork prices over the past six months. Inflation in the prices of other food items has picked up a little recently but remains fairly subdued. Liaison information suggests that retailers have been more willing to pass cost increases through to consumer prices over the past couple of quarters.

Graph 4.10

Retail Prices and the Exchange Rate



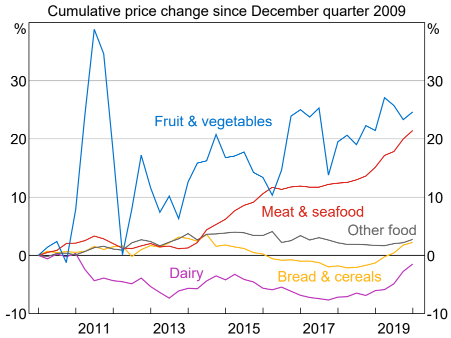
* Import-weighted index; quarter average
** Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Most measures of inflation expectations are low

Wage- and price-setting behaviour can be affected by expectations about the future rate of inflation. Both short- and long-term market-based measures of inflation expectations have increased since mid 2019 (Graph 4.12 and Graph 4.13). However, both measures remain low. Unions and market economists expect inflation to be around 2 per cent over the next year. Long-term survey-based measures of inflation expectations are between 2-2½ per cent and remain consistent with the Bank's medium-term inflation target.

Graph 4.11

Food Prices



Sources: ABS; RBA

Wages growth has been stable at low levels …

After increasing modestly over 2017 and 2018, growth in the wage price index (WPI) has stabilised at around 2¼ per cent over the year to September. The low rate of wages growth implies that there is spare capacity in the labour market (Graph 4.14). Despite strong employment growth, the unemployment rate is around the same level as one year ago and the underemployment rate remains elevated. This is because employment growth has largely been met by a rise in labour force participation. A prolonged period of low inflation and wage outcomes may have also led firms and workers to adjust their wage expectations to low levels.

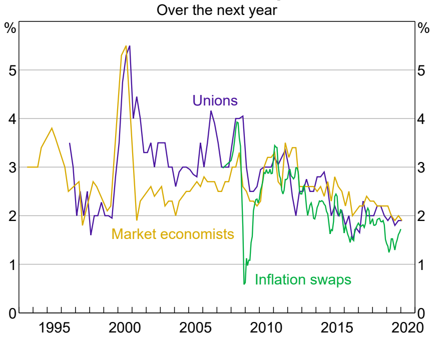
Private sector WPI growth edged lower to 2.2 per cent in year-ended terms (Graph 4.15). However, private sector wages growth including bonuses & commissions rose to 3 per cent over the year. This measure, while more volatile, has tended to be above the measure excluding bonuses over recent years. The share of jobs that receive a bonus has increased steadily in recent years, with information from the liaison program suggesting that businesses may be using bonuses to reward workers without locking in larger changes to base pay. Public sector WPI growth has been steady at around 2½ per cent in recent years, consistent with wage policies across federal and state governments.

Wages growth remains strongest in the health care industry, consistent with strong employment outcomes over recent years. Wages growth is lowest in goods-related industries such as construction, manufacturing and mining (Graph 4.16). While there are some clear differences across industry wage outcomes, the distribution of wages growth across jobs has been more compressed over the prolonged period of low wages growth than it was during the 2000s. Information from the Bank's liaison program suggests that the share of workers that

Graph 4.12

Short-term Inflation Expectations

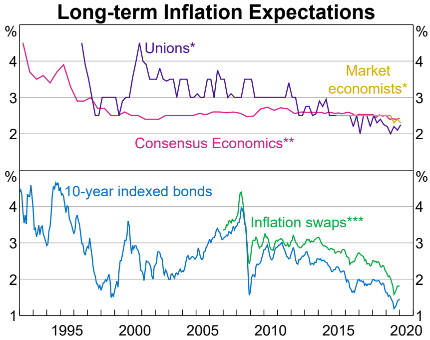
Over the next year



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

Graph 4.13

Long-term Inflation Expectations



* Average over the next five to ten years

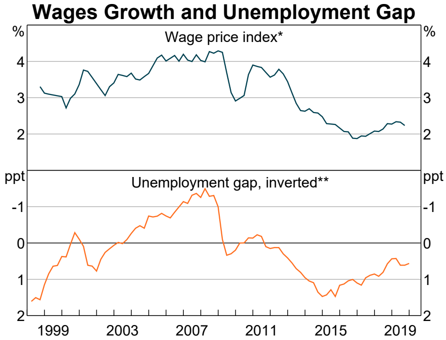
** Average over six to ten years in the future

*** Five- to ten-years forward

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

Graph 4.14

Wages Growth and Unemployment Gap



* Year-ended growth

** Difference between the unemployment rate and RBA estimate of the 'non-accelerating inflation rate of unemployment'

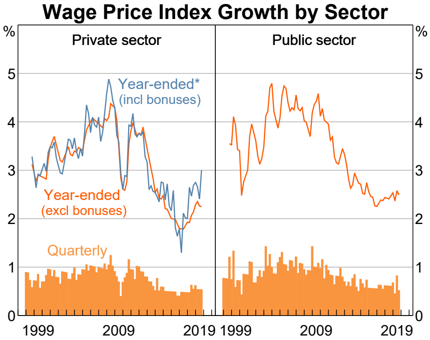
Sources: ABS; RBA

have been receiving wage growth outcomes above 3 per cent has declined to around 20 per cent. Instead, close to half of the wages outcomes are now between 2–3 per cent. This is also consistent with the wage outcomes in current private sector enterprise bargaining agreements (EBAs).

Over recent years, annual wages growth for award-reliant workers has been between 3–3½ per cent as a result of annual decisions by the Fair Work Commission (FWC). This directly affects wages growth for around 20 per cent of employees who are on an award wage. There has also been an increase in recent years in the number of wages outcomes in EBAs that are in some way linked to the FWC decision.

Graph 4.15

Wage Price Index Growth by Sector



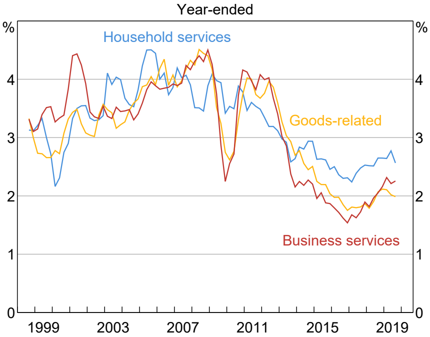
* Non-seasonally adjusted; bonuses include commissions

Source: ABS

Graph 4.16

WPI Growth by Sector*

Year-ended



* Non-seasonally adjusted; excluding bonuses

Sources: ABS; RBA

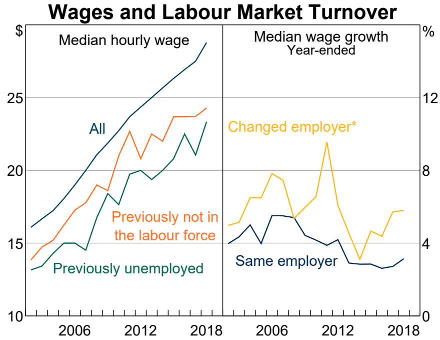
… but broader measures of earnings growth have picked up

Growth in average earnings per hour in the national accounts (AENA) has increased to around 3 per cent over the year to September. AENA is a broader, but more volatile, measure of labour costs because it captures non-wage payments such as allowances, superannuation and bonuses, as well as changes in the composition of employment.

Over recent years, AENA growth had tended to be lower than WPI growth, which is consistent with workers moving away from higher-paying jobs in mining-exposed industries over this period. The share of people voluntarily changing jobs or receiving a promotion has also declined. Data from the Household, Income and Labour Dynamics in Australia (HILDA) survey show that wages growth is typically higher for workers that change jobs or receive a promotion (Graph 4.17). Furthermore, the gap between the wages of those already working and those entering into employment, whether from unemployment or outside the labour force, had widened over the years to 2017/18. However, the most recent pick-up in AENA growth is consistent with stronger growth in bonuses and may also suggest that the drag on average earnings growth from these compositional effects has started to wane.

Graph 4.17

Wages and Labour Market Turnover



* Smoothed with a three-year-centred moving average

Sources: HILDA Release 18; RBA

Wages growth is expected to remain stable

The proportion of firms in the liaison program expecting stable wages growth in the year ahead is close to 80 per cent, and only around 10 per cent anticipate stronger wages growth. Unions' expectations for wages growth have declined a little recently and do not suggest a pick-up in wages growth over the year ahead. The proportion of new EBAs with a term of three years or more has also increased; the average wage outcome in these agreements is around 2½ per cent. By locking in lower wage outcomes for longer, these EBAs could contribute to wages of EBA-covered workers being slower to pick up than was the case in the past. ✠