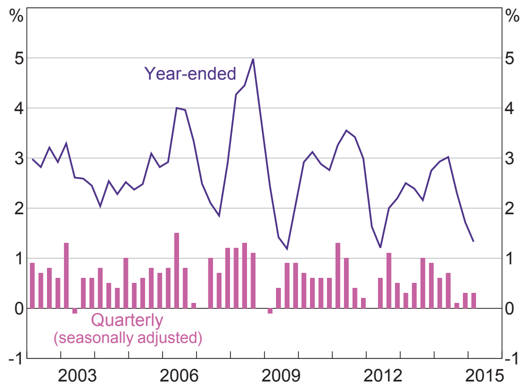
5. Price and Wage Developments

Recent Developments in Inflation

The consumer price index increased by 0.3 per cent in the March quarter (in seasonally adjusted terms) and by 1.3 per cent over the year (Graph 5.1; Table 5.1). The slowing in headline inflation over the past year is largely accounted for by a significant fall in fuel prices over the past two quarters and the repeal of the carbon price in 2014. Various measures suggest that underlying inflation remained around ½–¾ per cent in the March quarter, in line with the forecast in the February *Statement* (Graph 5.2). In year-ended terms, the pace of underlying inflation was around 2¼–2½ per cent.

Graph 5.1
Consumer Price Inflation



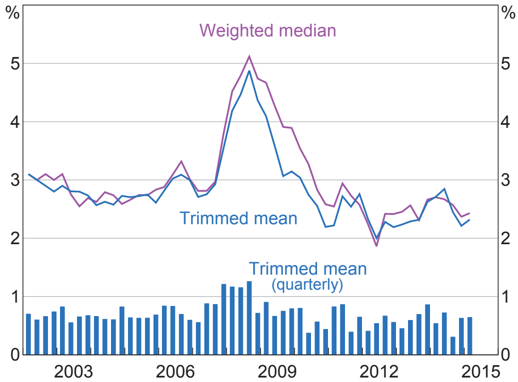
Source: ABS

Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly(a)		Year-ended(b)	
	March quarter 2015	December quarter 2014	March quarter 2015	December quarter 2014
Consumer Price Index	0.2	0.2	1.3	1.7
Seasonally adjusted CPI	0.3	0.3	–	–
– Tradables	–0.6	–0.6	–0.9	0.7
– Tradables (excl volatile items and tobacco)(c)	0.5	0.0	0.4	0.0
– Non-tradables	0.7	0.7	2.6	2.3
– Non-tradables (excl utilities)	0.7	0.8	3.0	2.6
Selected underlying measures				
Trimmed mean	0.6	0.6	2.3	2.2
Weighted median	0.6	0.7	2.4	2.4
CPI excl volatile items(c)	0.7	0.6	2.3	2.1

(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 automotive fuel, fruit and vegetables
Sources: ABS; RBA

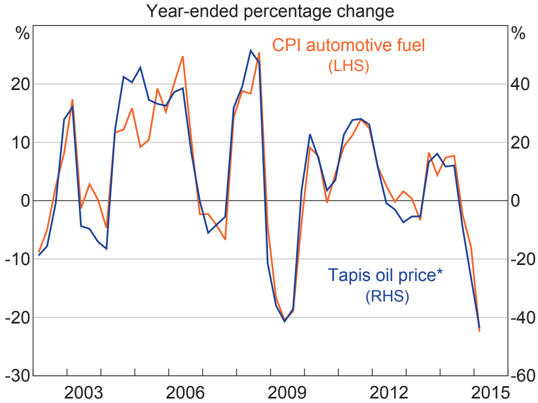
Graph 5.2
Measures of Underlying Inflation
Year-ended



Source: ABS

The large drop in global oil prices in recent quarters has contributed significantly to the decline in headline inflation over this period through its direct effect on the price of automotive fuel. Prices for fuel fell by 13 per cent in the March quarter, subtracting around 0.4 percentage points from headline inflation. Over the year, fuel prices have subtracted about 0.7 percentage points from the pace of headline inflation. The decline observed in domestic fuel prices over this period has been roughly in line with the fall in international prices for crude oil, after accounting for the offsetting effect of the depreciation of the Australian dollar (Graph 5.3).

Graph 5.3
Fuel and Oil Prices
Year-ended percentage change



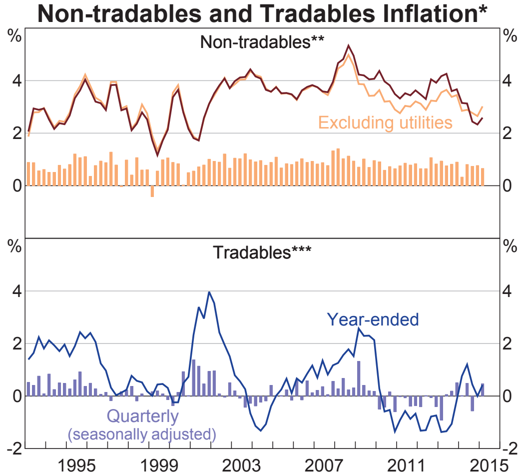
* Australian dollars per barrel; quarter average

Sources: ABS; Bloomberg; RBA

The large decline in crude oil prices may also be exerting some downward pressure on the pace of underlying inflation through its effect on costs for a wide range of businesses. The goods and services consumed by households that are most intensive in their use of oil include the categories of recreation & culture (which covers air travel), public transport fares and food (owing to the cost of diesel for freight). To date, the effect of lower oil and fuel prices on the prices of most of these items appears to have been fairly limited, and liaison with firms also indicates this. However, lower fuel costs are likely to take some time to work their way through the supply chain. It is also difficult to ascertain the extent to which these effects on costs have passed through to inflation amid the usual variation in final consumer prices driven by other factors. The removal of the carbon price has also reduced energy costs for businesses somewhat over the past year.

Spare capacity in labour markets and, more generally, in many product markets has continued to contain domestic inflationary pressures. The pace of non-tradables inflation remained at 0.7 per cent in the March quarter (Graph 5.4). Excluding utility prices,

Graph 5.4
Non-tradables and Tradables Inflation*



* Adjusted for the tax changes of 1999–2000

** Excluding interest charges prior to September quarter 1998 and deposit & loan facilities to June quarter 2011

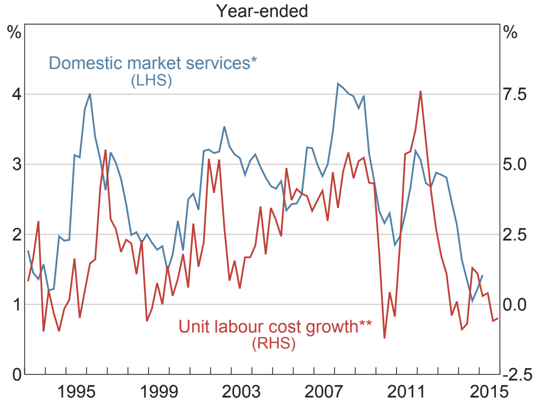
*** Excluding volatile items (fruit, vegetables & automotive fuel) and tobacco

Sources: ABS; RBA

which were affected directly by the repeal of the carbon price in the September quarter, non-tradables inflation was 3.0 per cent over the past year, which is relatively low compared with its average pace over the past decade.

Inflation in the prices of domestic market services (excluding domestic travel & accommodation) remains particularly low at around 1.4 per cent over the year (Graph 5.5). This reflects continued slow wage growth and the related slow growth in unit labour costs, as these services contain a relatively high labour content and have few administered price components.

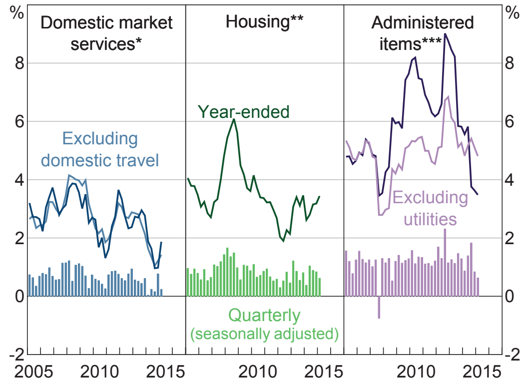
Graph 5.5
Market Services Inflation
Year-ended



* Excludes deposit & loan facilities to June quarter 2011, housing services and domestic travel
** Moved forward by four quarters, non-farm
Sources: ABS; RBA

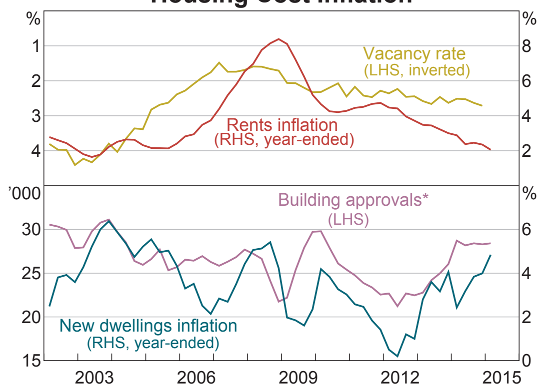
The downward pressure on non-tradables inflation from slow unit labour cost growth has been partly offset by several factors (Graph 5.6). The exchange rate depreciation is providing a boost to domestic tourism demand, and domestic holiday prices increased sharply in the quarter. Stronger demand during recent major sporting events may have also pushed up these prices. Housing inflation remains a little above its historical average, reflecting the high level of activity in the residential construction sector, especially in Sydney. Growth in the cost of new dwellings has remained strong, whereas growth in rents has fallen to its lowest pace in over a decade (Graph 5.7). Inflation in administered prices, for items

Graph 5.6
Non-tradables Inflation



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

Graph 5.7
Housing Cost Inflation



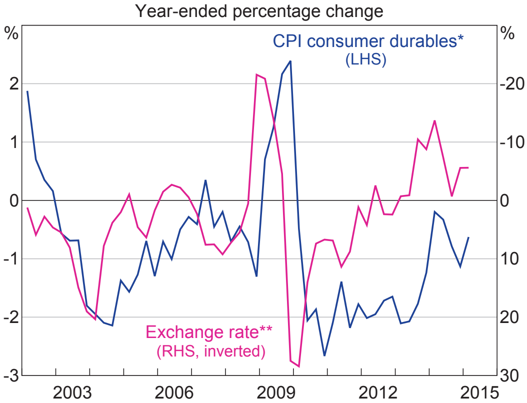
* Private detached houses
Sources: ABS; RBA; REIA

such as health and urban transport fares, has also slowed in recent years (even excluding utilities) but remains high compared with inflation in other non-tradable items.

The prices of tradable items tend to be heavily influenced by movements in the exchange rate, because these items are either imported or have a high degree of exposure to international competition. Tradables prices (excluding volatile items and tobacco) increased by 0.5 per cent in the March quarter and by 0.4 per cent over the year, consistent with some upward pressure from the exchange rate depreciation since mid 2013. This stands in contrast to the decline in these prices seen from 2010 to 2013. It is expected that the exchange rate depreciation since mid 2014 will gradually exert further upward pressure on tradables prices over the next few years.

Many consumer durables, including motor vehicles, furniture & furnishings, clothing & footwear and audio, visual & computing equipment, have a high imported content. Consequently, changes in the prices for consumer durables tend to be particularly closely linked to exchange rate movements (Graph 5.8). However, for much of the past five years or so the pace of deflation for these items had been more than expected given movements in the exchange rate, partly as a result of a reduction of margins along the supply chain.[1]

Graph 5.8
Consumer Prices and the Exchange Rate
Year-ended percentage change



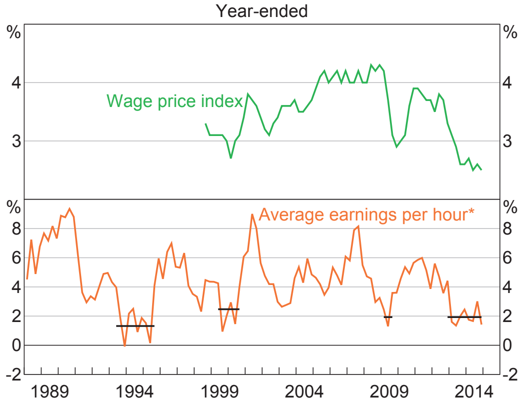
* Retail items (excluding food and alcohol) and motor vehicles and parts
** Import-weighted index, quarter average
Sources: ABS; RBA

Labour Costs

Labour cost pressures remain subdued. Wage growth, as measured by the wage price index (WPI), was 0.6 per cent in the December quarter and 2.5 per cent over the year – the slowest annual pace since the index was first published in the late 1990s (Graph 5.9). Other wage measures suggest that the recent period has been the most protracted episode of slow wage growth since the early 1990s recession, though wage growth has not been quite as low as it was at that time.

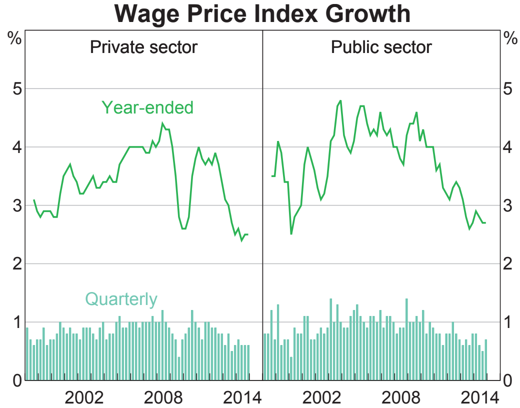
The slow pace of wage growth continues to be broad based. Growth of both the private and public sector WPI remained low over the year to the December quarter, at 2.5 per cent and 2.7 per cent, respectively (Graph 5.10). Year-ended wage growth in most industries has stabilised at levels well below their decade averages and dispersion in growth rates across the states is low. This is consistent with evidence from the Bank's business liaison, which finds that a greater proportion of firms report wage growth of 2 to 3 per cent than in the past, when outcomes in excess of 3 per cent were relatively common.

Graph 5.9
Wage Growth
Year-ended



* The black lines represent the average over the period
Sources: ABS; RBA

Graph 5.10
Wage Price Index Growth



Source: ABS

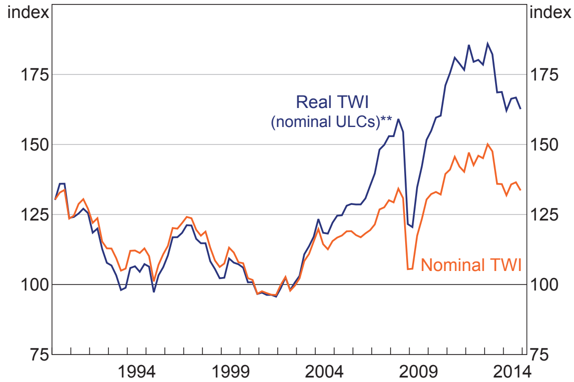
1 See RBA (2014), 'Box C: Recent Developments in Retail Prices and Margins', *Statement on Monetary Policy*, February, pp 56–58.

According to business liaison and surveys of firms and union officials, growth in wages is widely expected to remain low.

These wage outcomes are consistent with other indicators of spare capacity in the labour market (see the 'Domestic Economic Conditions' chapter). Compared with earlier episodes, increased labour market flexibility may have provided firms with more scope to adjust wages and average hours worked by each employee in response to a given change in demand for their goods and services, allowing them to increase employment by more than would otherwise have been the case. This is consistent with business liaison, which suggests that many employees appear to be willing to trade lower wage growth for greater job security.

More generally, employers have remained under pressure to contain costs given spare productive capacity in many product markets and the pressures of international competition. Over the decade to 2011, Australia's real exchange rate – measured on the basis of relative unit labour costs – appreciated significantly, consistent with the rise in the terms of trade and the mining investment boom (Graph 5.11). Much of this adjustment occurred through the appreciation of the nominal exchange rate, but nominal unit labour costs in Australia also rose relative to those of many trading partners (and by more than would be expected given differences in inflation targets). This implied a loss of international competitiveness for many firms. Some of this effect is being reversed now that the terms of trade are declining and mining investment has been falling. Wage growth has slowed and productivity growth has picked up. Both have been growing at about the same pace over the past three years. This has meant that unit labour costs have been little changed over that period and have declined by about 3½ per cent relative to those of Australia's trading partners. These developments, in combination with the depreciation of the Australian dollar, are assisting the non-mining economy to regain some competitiveness and thereby support demand for domestic production and employment.

Graph 5.11
Real Effective Exchange Rate*
Trade-weighted index, 2002 average = 100

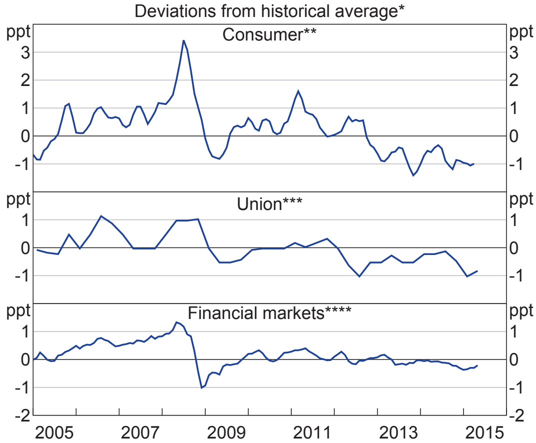


* Excludes China and several other trading partners as unit labour cost data are unavailable
** Nominal trade-weighted index adjusted for ratio of nominal unit labour costs
Sources: OECD; RBA

Inflation Expectations

A number of measures of inflation expectations remain below average (Graph 5.12). Both short-run and long-run financial market measures have increased a little recently but remain lower than mid last year. In recent quarters, market economists

Graph 5.12
Measures of Inflation Expectations
Deviations from historical average*



* Since July 1996
** Three-month moving average of the trimmed mean of inflation expectations over the next year
*** Median of union officials' expectations of inflation over the next year
**** Break-even 10-year inflation rate on indexed bonds; interpolation used to match exact maturity
Sources: Australian Council of Trade Unions; Bloomberg; Employment Research Australia; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

and union officials have also revised down their expectations of inflation for the year ahead. The Melbourne Institute measure of consumer inflation expectations remains about 1 percentage point below its historical average. Longer-run inflation expectations remain well anchored.