4. Inflation

Inflation was much stronger in the December quarter of 2021 than was expected at the time of the November *Statement*. The pass-through of upstream cost pressures – particularly for new dwellings and durable goods – has occured more quickly than anticipated and accounted for a large portion of the increase in inflation in recent quarters. Inflationary pressures have also broadened a little, with prices picking up for some market services.

Wages growth picked up in the September quarter (as expected in the previous *Statement*), returning to the low rate observed in the years leading up to the COVID-19 pandemic. Wages growth was stronger in those industries where there have recently been reports of labour shortages, notably professional services and construction. However, for most other industries there was little evidence that wages were rising beyond the relatively subdued rates of growth seen in the years leading up to the pandemic. Evidence from the Bank's business liaison program suggests that most firms are not anticipating wages growth to move beyond the 2 to 3 per cent range over the year ahead, although reports of strategies to attract and retain workers other than those involving raising base wages have become more common.

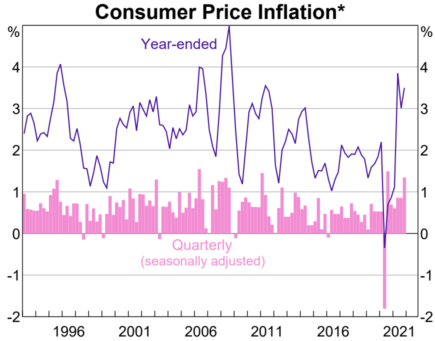
Inflation in the December quarter was much stronger than expected

The headline Consumer Price Index (CPI) increased by 1.3 per cent (seasonally adjusted) in the December quarter and 3.5 per cent over the year (Graph 4.1; Table 4.1). This outcome was higher than the 3¼ per cent annual inflation rate that was expected at the time of the November *Statement*. As was the case in the September quarter, large price movements in a small number of components accounted for a significant share of the increase in headline CPI; price increases for newly constructed dwellings, consumer durables and automotive fuel, which together comprise around one-third of the CPI basket, accounted for around two-thirds of the increase in the headline CPI in the quarter (Graph 4.2).

Although a few items made outsized contributions to growth in the CPI, inflationary pressures have broadened in recent quarters, with price increases picking up for many consumer durables and some market services. Around three-fifths of the CPI basket had an annualised inflation rate above 2.5 per cent in the December quarter, compared with two-fifths in the years leading up to the pandemic (Graph 4.3).

Graph 4.1

Consumer Price Inflation*



* Excludes interest charges prior to the September quarter of 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 2021	September quarter 2021	December quarter 2021	September quarter 2021
Consumer Price Index	1.3	0.8	3.5	3.0
Seasonally adjusted CPI	1.3	0.8	–	–
– Tradables	1.7	0.6	4.9	3.1
– Tradables (excl volatile items)[c]	1.3	0.0	2.2	0.8
– Non-tradables	1.2	0.9	2.8	3.2
Selected underlying measures				
Trimmed mean	1.0	0.7	2.6	2.1
Weighted median	0.9	0.8	2.7	2.2
CPI excl volatile items[c]	1.2	0.6	2.6	2.5

(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

Measures of underlying inflation remove the effect of irregular or temporary price changes in the CPI. These measures indicate that underlying inflation rose by around 1 per cent in the quarter and 2.6 per cent over the year (Graph 4.4; Table 4.1); this was one of the strongest quarterly outcomes in decades and represents a material increase in underlying inflation relative to recent years.

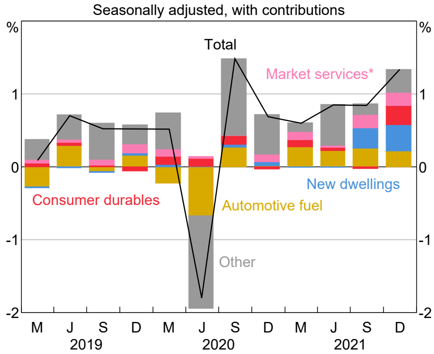
Pass-through of upstream cost pressures has driven the recent pick-up in goods inflation

Prices for new dwelling construction, which make up just under one-tenth of the CPI basket, increased significantly – up by 4.2 per cent in the December quarter. This was driven by further substantial increases in the prices charged by builders (exclusive of government subsidies) in

Graph 4.2

Quarterly CPI Inflation

Seasonally adjusted, with contributions



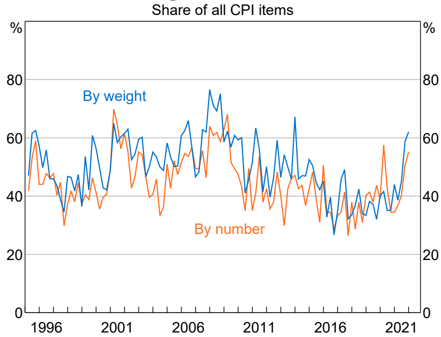
* Excludes domestic travel and telecommunications.

Sources: ABS; RBA

Graph 4.3

CPI Items Rising Faster than 2.5 Per Cent*

Share of all CPI items



* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent.

Sources: ABS; RBA

most capital cities. A key driver of the pick-up in these prices has been the strong rise in the cost of raw materials, which increased by 3.8 per cent in the December quarter and 12 per cent over the year (Graph 4.5). Domestic and global supply shortages have particularly affected prices of timber and steel inputs. Price increases also reflect a surge in construction activity in response to policy inducements – residential building commencements are at a record level, and capacity utilisation in the construction industry has been high (see chapter on 'Domestic Economic Conditions').

In addition, new dwelling inflation increased because fewer government grants were paid out in the December quarter than in the September quarter – this accounted for less than one-fifth of the total increase in new dwelling prices (Graph 4.6). The number of grants paid out is expected to decline over time, which will provide a boost to measured inflation as prices measured in the CPI converge to the prices charged by builders. However, the effect on inflation in a given quarter will vary depending on how many grants are paid out during that period.

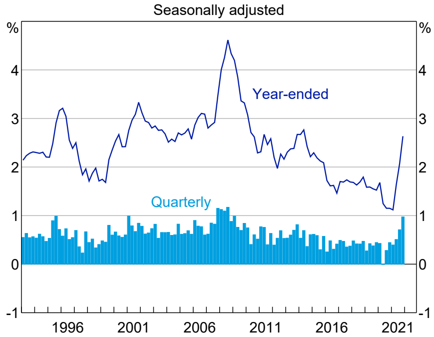
Prices also increased strongly for most consumer durable items on the back of ongoing supply chain disruptions at overseas factories, sustained global and domestic demand, and elevated shipping costs (Graph 4.7). Overall, prices of consumer durables increased by 1.5 per cent in the December quarter – the strongest quarterly outcome since 2009, following the large depreciation in the exchange rate during the global financial crisis. Clothing & footwear prices increased particularly strongly; retailers ceased some of the higher-than-normal discounting undertaken in the September quarter, which was introduced to clear excess winter stock that had built up during the lockdowns in the second half of 2021.

Reports of input cost pressures remain widespread across goods-importing firms and these pressures are expected to persist for a while yet. While some retailers have been

Graph 4.4

Trimmed Mean Inflation*

Seasonally adjusted

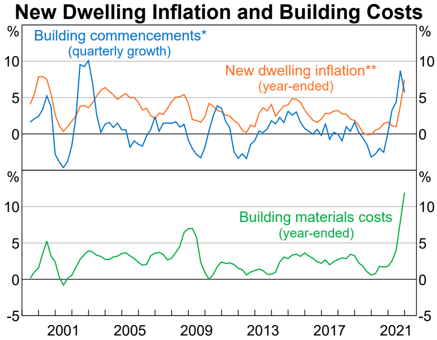


* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.5

New Dwelling Inflation and Building Costs



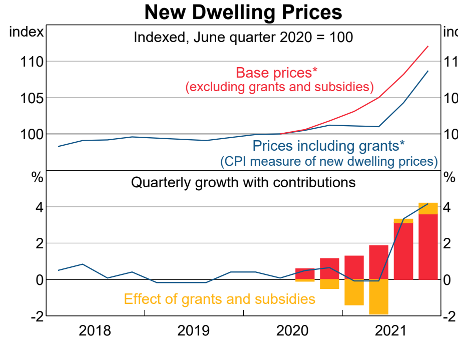
* Six-quarter average lagged by one quarter; detached only prior to 2017.

** Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.6

New Dwelling Prices



* Government housing construction grants include HomeBuilder and state government grants.

Sources: ABS; RBA

reluctant to pass on the higher costs to their customers, liaison reports that the proportion of sellers raising prices in response to sustained cost pressures is increasing. Many durable goods retailers have either increased prices, or are expecting to do so early this year. However, it remains uncertain whether these price increases represented a large, one-off, upward adjustment in prices of durable goods, a temporary increase in prices that will be reversed as a more normal balance between supply and demand is re-established, or the beginning of a series of ongoing price increases. Some firms continue to absorb cost increases for various reasons, including competitive pressures.

Inflationary pressure in market services picked up in the second half of 2021

Inflation in the prices of market services, which accounts for a little over one-fifth of the CPI basket, picked up in the second half of 2021 to be 2.4 per cent higher over the year – the fastest annual increase since 2013 (Graph 4.8). The prices of these services are generally driven by domestic factors such as labour costs and other domestically sourced inputs.

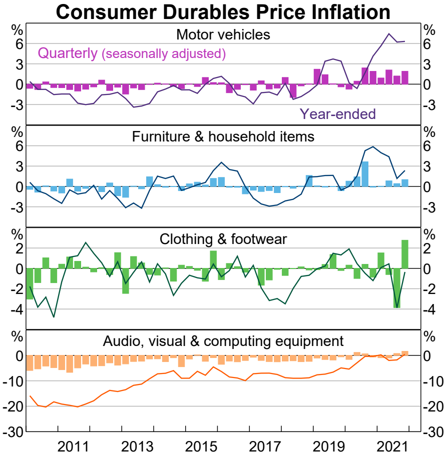
Prices of meals out & takeaway increased by 1 per cent in the quarter as firms sought to recoup increased labour and non-labour costs (Graph 4.9). The use of state government vouchers such as the NSW 'Dine & Discover' voucher weighed a little on measured hospitality prices in the December quarter. However, many of these vouchers are yet to be redeemed and will temporarily weigh on measured market services inflation as they are used in the first half of 2022. Prices for domestic travel and accommodation services decreased a little in seasonally adjusted terms, despite the strong increase in demand for domestic holidays as states emerged from lockdowns and borders reopened. Higher real estate agent fees, due to strength in the established housing market in late 2021, drove insurance & financial services prices higher in the quarter.

Rent inflation remained weak, although there are large differences across cities

Rents, which account for around 6 per cent of the CPI basket, increased by 0.1 per cent in the December quarter. CPI rents – which cover the entire stock of rental properties – declined a little in Sydney and Melbourne but increased in other capital cities (Graph 4.10). Following a strong increase in advertised rents for new tenants across most cities over 2021, the gap between advertised rents and CPI rents remains large by historical standards (see chapter on 'Domestic Economic Conditions'). This reflects

Graph 4.7

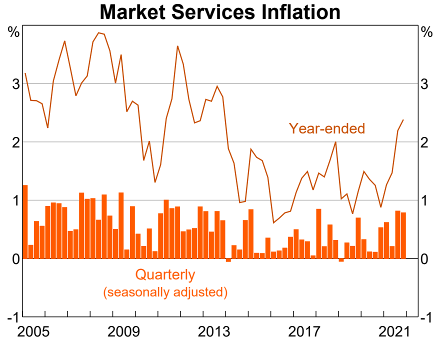
Consumer Durables Price Inflation



Sources: ABS; RBA

Graph 4.8

Market Services Inflation



Sources: ABS; RBA

the ongoing impact of pandemic-related discounts, greater-than-usual discounting of advertised rents and the small share of rentals that are leased to new tenants each quarter. Stronger advertised rents are expected to contribute to a pick-up in CPI rent growth over 2022, although the timing and extent of this pass-through remains uncertain.

Grocery prices rose modestly

Grocery prices (excluding fruit & vegetables) increased by 0.6 per cent in the quarter to be 1.9 per cent higher than a year ago (Graph 4.11). While lockdowns in 2020 and the sharp increase in 'at home' food consumption contributed to a marked rise in grocery inflation, prices did not respond similarly during the lockdowns in the second half of 2021; liaison information suggests that supermarket discounting behaviour remained in line with pre-pandemic patterns. Growth in dairy prices increased, while growth in meat prices moderated somewhat. Price increases for most other fresh food categories were generally strong.

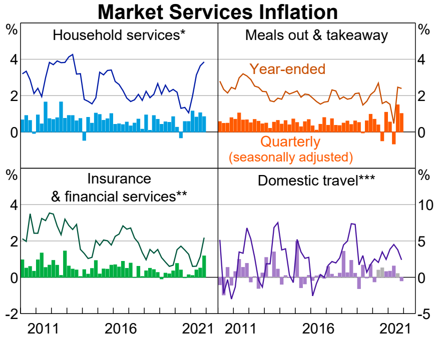
Prices of fruit & vegetables declined by 0.8 per cent in the quarter to be 0.2 per cent higher over the year. Favourable growing conditions have supported lower prices for fruit over recent quarters.

Fuel prices continued to increase, making a large contribution to headline inflation

Fuel prices increased by 6.6 per cent in the December quarter, contributing 0.22 percentage points to headline inflation (Graph 4.12). Over 2021, fuel prices rose by 32 per cent – the largest annual increase since 1990. Fuel prices have increased a little further since the beginning of 2022, and at current levels would make another positive contribution to quarterly headline inflation in the March quarter.

Graph 4.9

Market Services Inflation

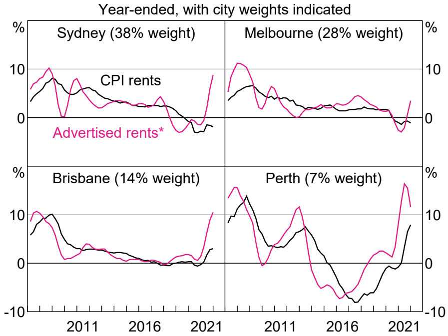


* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services.
** Excludes deposit & loans to June quarter of 2011.
*** Imputed using headline CPI in the June and September quarters of 2020 and September quarter of 2021.
Sources: ABS; RBA

Graph 4.10

Rent Inflation

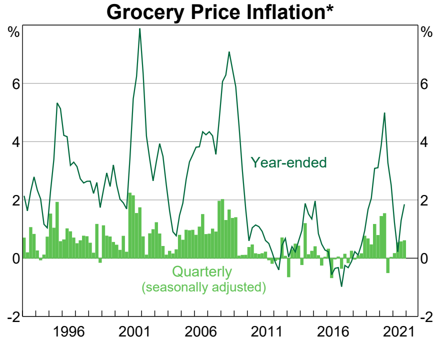
Year-ended, with city weights indicated



* Hedonic three-month average.
Sources: ABS; CoreLogic; RBA

Graph 4.11

Grocery Price Inflation*



* Excludes fruit & vegetables; adjusted for the tax changes of 1999–2000.
Sources: ABS; RBA

Growth in administered prices has returned to pre-pandemic rates

Administered prices (excluding utilities) rose by 0.6 per cent in the December quarter and 2.4 per cent over the year; these increases were broadly in line with pre-pandemic trends (Graph 4.13). Increases in child care and school education prices, as well as prices for medical and hospital services, were also broadly in line with pre-pandemic rates.

Retail electricity prices declined slightly in the December quarter, continuing the downward trend of recent years; prices are now around 10 per cent lower than their peak at the end of 2018, in part reflecting increased supply of renewable energy (Graph 4.14). Retail gas prices increased by 1.5 per cent in the quarter, following a spike in wholesale gas prices in the second half of 2021 that was driven partly by constrained supply. According to liaison information, the increase in wholesale prices is expected to be temporary.

Short-term inflation expectations have increased further in recent months

Survey-based measures of short-term inflation expectations have increased further over recent months to around their highest levels in some years (Graph 4.15). However, survey measures of long-term inflation expectations have remained around 2½ per cent, consistent with the Bank's medium-term inflation target (Graph 4.16). Long-term market-based measures of inflation expectations were also little changed over recent months.

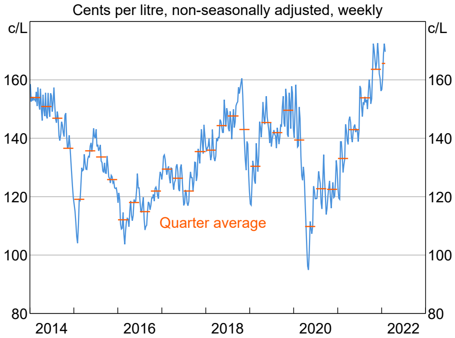
Wages growth returned to pre-pandemic norms in the September quarter

The Wage Price Index (WPI) grew by 0.6 per cent in the September quarter, and 2.2 per cent in year-ended terms. Private sector wages increased by 2.4 per cent over the year, which is slightly above its pre-pandemic growth rate (Graph 4.17). Most industries saw a return to the low level of wage increases observed in the years leading up to the COVID-19 pandemic,

Graph 4.12

Unleaded Petrol Prices

Cents per litre, non-seasonally adjusted, weekly

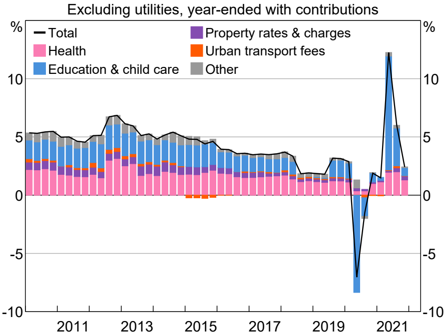


Sources: Australian Institute of Petroleum; RBA

Graph 4.13

Administered Price Inflation

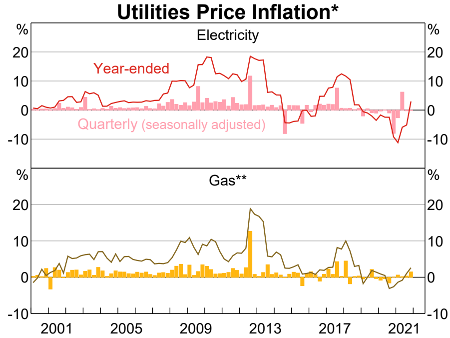
Excluding utilities, year-ended with contributions



Sources: ABS; RBA

Graph 4.14

Utilities Price Inflation*



* Adjusted for the tax changes of 1999–2000.

** Includes other household fuels.

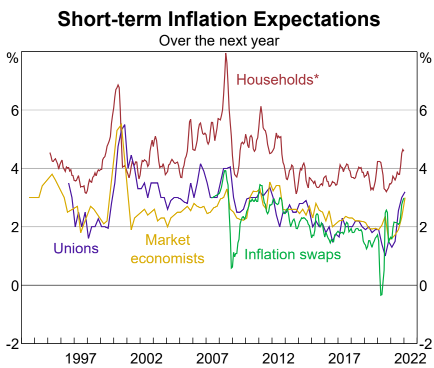
Sources: ABS; RBA

with only the professional services industry recording wages growth in excess of 3 per cent. Public sector wages growth remained subdued at 1.7 per cent, as public sector wages policies continued to weigh on outcomes.

Wages growth has varied by pay-setting arrangements over the past year (Graph 4.18). Wages growth for workers on individual arrangements with their employer bounced back sharply in the year to the September quarter, reflecting the reversal of large wage cuts for a small number of jobs in 2020 and a faster response to the tightening labour market than other pay-setting methods; liaison reports suggest that some jobs in high demand have been receiving very large wage increases. WPI growth in the year to the September quarter was also boosted by award wage increases in many industries, including the delayed implementation of some increases announced in 2020. By contrast, aggregate WPI outcomes have continued to be weighed down by slower growth in wages for jobs covered by public and private enterprise agreements. These subdued outcomes are consistent with announced government wages policies and the multi-year duration of many private sector agreements.

Although the share of jobs subject to wage freezes declined in the September quarter, it remained at the upper end of its historical range

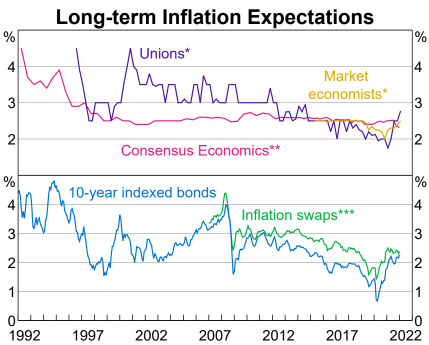
Graph 4.15



* Smoothed.

Sources: Australian Council of Trade Unions; Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

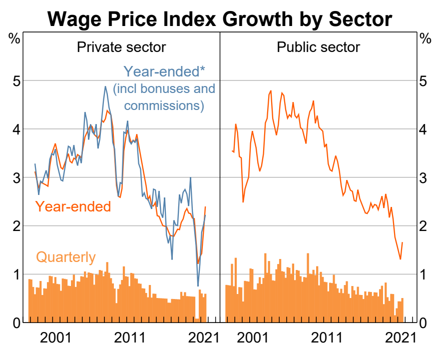
Graph 4.16



* Average over the next 5 to 10 years.
** Average over 6 to 10 years in the future.
*** 5- to 10-years forward.

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

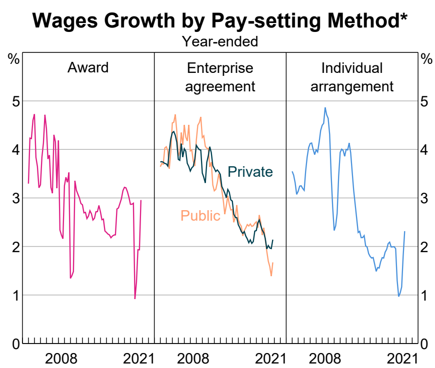
Graph 4.17



* Non-seasonally adjusted.

Source: ABS

Graph 4.18



* Excludes bonuses and commissions.

Sources: ABS; RBA

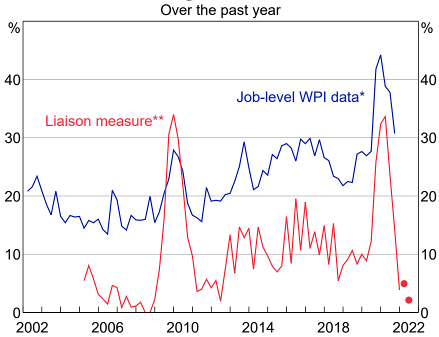
(Graph 4.19). However, information from the Bank's liaison program suggests that the use of wage freezes declined further in the December quarter and few firms expect to have wage freezes in place over the year ahead.

Growth in private sector WPI showed little variation across the states and territories (Graph 4.20). States that were less affected by the Delta-related lockdowns in 2021, such as Western Australia and South Australia, did not experience a noticeable increase in wages growth despite a tightening in labour market conditions. Aggregate wages growth in these states was also restrained by weak growth in public sector wages.

Graph 4.19

Wage Freezes

Over the past year



* Share of all jobs.

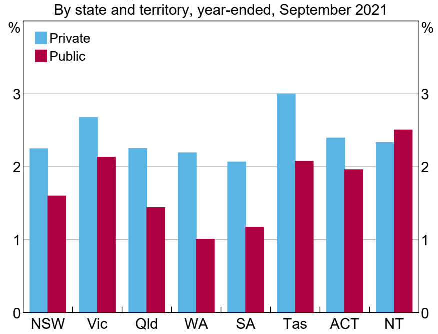
** Share of liaison firms with a recorded wage outcome; dots represent firms' expectations for March and June quarters of 2022.

Sources: ABS; RBA

Graph 4.20

Wage Price Index Growth*

By state and territory, year-ended, September 2021



* Non-seasonally adjusted; excluding bonuses and commissions.

Source: ABS

With consumer price inflation picking up faster than wages growth over the second half of 2021, real (inflation-adjusted) wages have declined. Households whose spending is concentrated in the categories where prices have risen the fastest – such as fuel, some durables and dwelling construction – have experienced a larger decline in real purchasing power. However, growth in households' real incomes overall also depends on other income sources, including superannuation payments, which have increased significantly. Broad measures of growth in average earnings have remained highly volatile in recent quarters, due to large compositional changes in the workforce caused by the pandemic.

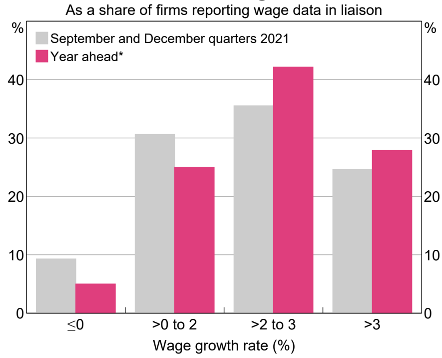
Despite ongoing reports of labour shortages, most firms in the Bank's liaison program are not anticipating wage increases to move beyond the 2 to 3 per cent range over the coming year (Graph 4.21). This is consistent with other surveys of wages growth expectations (Graph 4.22).

Instead of increasing growth in base wages, many firms continue to respond to labour shortages by implementing a range of non-base wage strategies – including targeted bonuses, flexible work policies (including work from home), more internal training and hiring staff

Graph 4.21

Distribution of Wages Growth

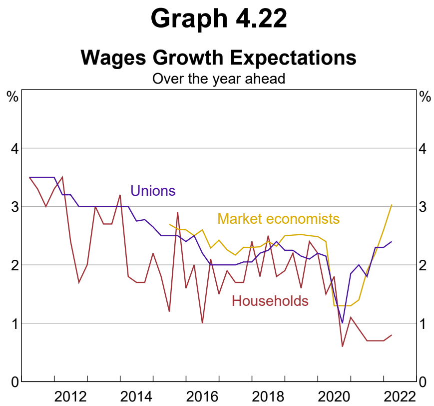
As a share of firms reporting wage data in liaison



* Expectations for the year ahead for firms reporting in the September and December quarters of 2021.

Source: RBA

with less experience. In some industries, this has been in response to an increase in voluntary staff turnover, particularly in professional services and some construction and mining-related roles.



Sources: Australian Council of Trade Unions; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre