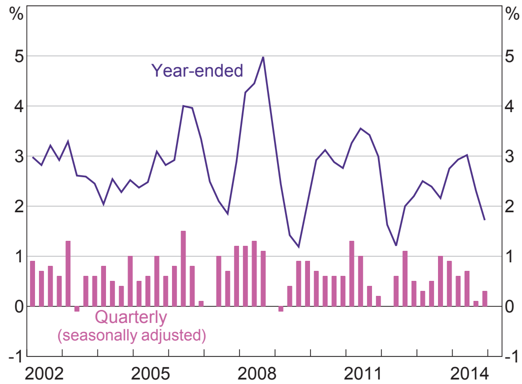
5. Price and Wage Developments

Recent Developments in Inflation

Consumer price inflation slowed over 2014, reflecting downward pressure on wage growth from spare capacity in the labour market, a large fall in oil prices and the repeal of the carbon price. These factors more than offset the effects of the earlier depreciation of the exchange rate and inflation of new dwelling costs.

The consumer price index increased by 0.3 per cent in the December quarter (in seasonally adjusted terms) and by 1.7 per cent over the year (Table 5.1; Graph 5.1). In quarterly terms, this was a little higher than the September quarter outcome, which incorporated the direct effect of the repeal of the carbon price

Graph 5.1
Consumer Price Inflation



Source: ABS

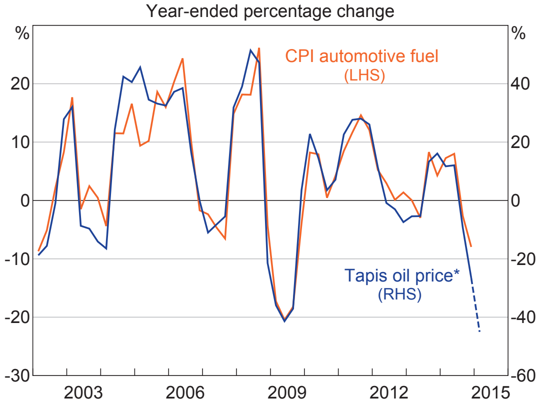
Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly(a)		Year-ended(b)	
	December quarter 2014	September quarter 2014	December quarter 2014	September quarter 2014
Consumer Price Index	0.2	0.5	1.7	2.3
Seasonally adjusted CPI	0.3	0.1	–	–
– Tradables	–0.5	0.0	0.7	2.0
– Tradables (excl volatile items and tobacco)(c)	0.0	–0.6	0.0	0.4
– Non-tradables	0.7	0.3	2.3	2.4
– Non-tradables (excl utilities)	0.7	0.7	2.6	2.8
Selected underlying measures				
Trimmed mean	0.7	0.3	2.2	2.4
Weighted median	0.7	0.5	2.3	2.6
CPI excl volatile items(c)	0.6	0.1	2.1	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 fruit, vegetables and automotive fuel
Sources: ABS; RBA

on utility prices. The recent large fall in crude oil prices resulted in a 5 per cent fall in automotive fuel prices in the quarter, which subtracted a little less than 0.2 percentage points from headline inflation (Graph 5.2). Fruit and vegetable prices also fell in the quarter, while tobacco prices rose as a result of the increase in the tobacco excise in September.

Graph 5.2
Fuel and Oil Prices

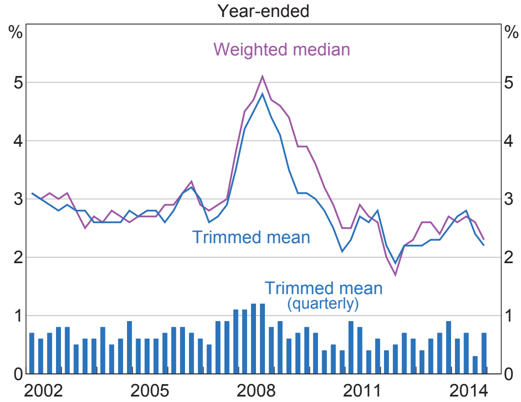


* Australian dollars per barrel; quarter average; dotted line represents March quarter forecast

Sources: ABS; Bloomberg; RBA

Various measures suggest that the pace of underlying inflation in the December quarter was 0.7 per cent, around the rates recorded in the first half of 2014, following an unusually low outcome in the September quarter (Graph 5.3). Underlying inflation slowed over the course of 2014 to around 2¼ per cent. The removal of the carbon price may have dampened inflation in a wide range of consumer prices in the September and December quarters, to the extent that it affected costs for businesses. However, it is difficult to ascertain the size of such an effect amid the usual variation in consumer prices driven by other factors. The large fall in crude oil prices, if sustained, can also be expected to have some downward influence on business costs and so underlying inflation outcomes. This is expected to take some time to work its way through the supply chain, so it is likely to have had a negligible impact on the recent outcomes for underlying inflation (see 'Economic Outlook' chapter and 'Box C: The Effects of the Fall in Oil Prices' for further details).

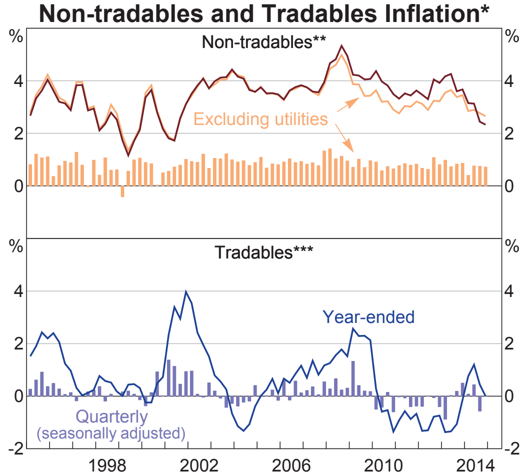
Graph 5.3
Measures of Underlying Inflation



Source: ABS

Overall, domestic inflationary pressures remain moderate compared with their average over the inflation-targeting period. Non-tradables inflation picked up to 0.7 per cent in the December quarter, following a low outcome in the September quarter owing to the effects of the repeal of the carbon price (Graph 5.4). Excluding utility prices, non-tradables inflation in the quarter was unchanged, and year-ended inflation eased to 2.6 per cent – a slow pace relative to history.

Graph 5.4
Non-tradables and Tradables Inflation*



* Adjusted for the tax changes of 1999–2000

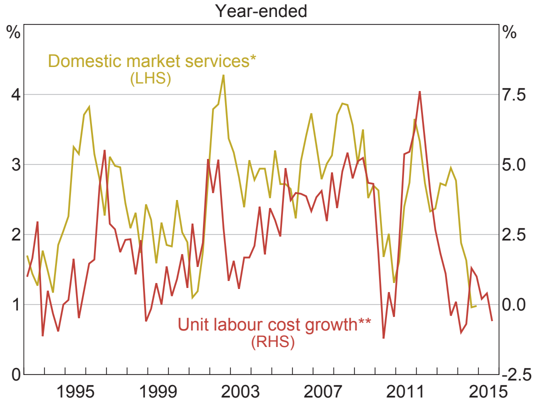
** Excluding interest charges prior to the September quarter 1998 and deposit & loan facilities to June quarter 2011

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

Sources: ABS; RBA

Slow growth in labour costs over the past few years has helped to contain non-tradables inflation. This is most apparent for the prices of market services, which have a relatively high labour content, are somewhat sheltered from international competition and include few administered price components. While market services inflation picked up in the December quarter, over the year it was around 1 per cent – its lowest in the past two decades (Graph 5.5).

Graph 5.5
Market Services Inflation
Year-ended

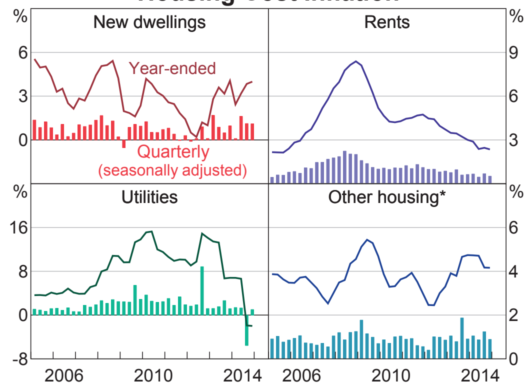


* Excludes deposit & loan facilities to June quarter 2011 and housing
** Moved forward by four quarters, non-farm

Sources: ABS; RBA

Inflation in the housing-related components of the CPI remained moderate overall in the December quarter (Graph 5.6). Inflation in the price of new dwellings remained above the average of recent years, consistent with strong residential building activity (Graph 5.7). The Bank's liaison suggests that the upswing in residential construction activity has allowed some builders to increase margins over the past year or so. Combined with an increase in the cost of building materials, this has contributed to higher inflation in the prices for new dwellings. In contrast, rents inflation remained slow in the quarter, consistent with the increase in vacancy rates over recent years. Utility prices increased slightly, after falling in the September quarter due to the repeal of the carbon price.

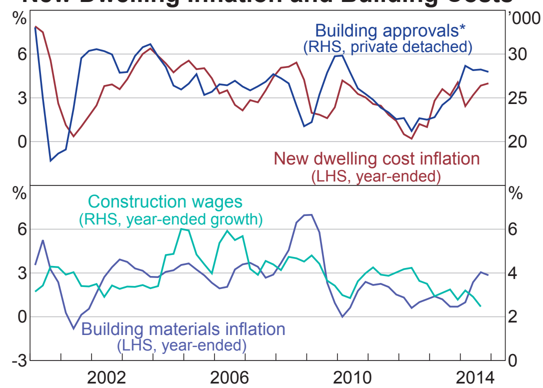
Graph 5.6
Housing Cost Inflation



* Includes maintenance & repairs to dwellings and property rates & charges

Sources: ABS; RBA

Graph 5.7
New Dwelling Inflation and Building Costs

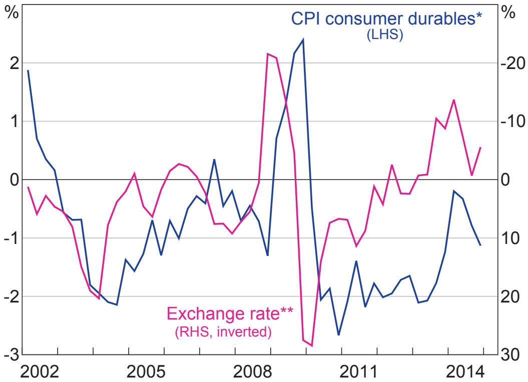


* Three-month rolling sum

Sources: ABS; RBA

The prices of tradable items (excluding volatile items and tobacco) were little changed overall in the December quarter and over the year, which is in contrast to the declines in these prices seen from 2010 to 2013. The prices of these items tend to be heavily influenced by movements in the exchange rate, as they are either imported or more exposed to international competition than non-tradable items (particularly for consumer durables) (Graph 5.8). Accordingly, the exchange rate depreciation since early 2013 has led to higher prices of imported items 'across the docks'.

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



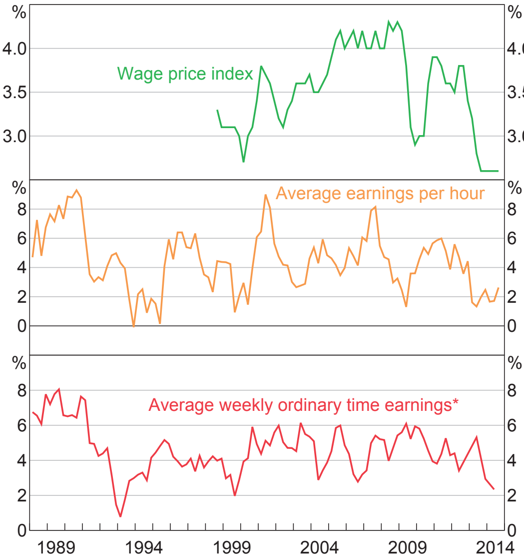
* Retail items (excluding food and alcohol) and motor vehicles and parts
** Import-weighted index, quarter average
Sources: ABS; RBA

However, recent outcomes suggest somewhat less of an increase in the final prices of tradable items than might normally be expected given the historical relationship with the exchange rate. Consumer durables prices fell for the third consecutive quarter, with large declines in the prices of appliances and electronic equipment offsetting price rises for clothing & footwear and several household goods. Liaison suggests that retailers have been constrained in passing on price increases due to the strength of competitive pressures and subdued demand. Nevertheless, looking ahead, it is expected that the exchange rate depreciation will exert gradual upward pressure on prices faced by consumers for several years (see 'Economic Outlook' chapter).

Labour Costs

Growth of labour costs remains subdued. Wage growth appears to have stabilised at a low rate; the wage price index (WPI) increased by 0.6 per cent in the September quarter, and by 2.6 per cent over the year, its slowest pace since the index was first published in the late 1990s (Graph 5.9). A range of other measures of wage growth, which have a longer history, also indicate that the current pace of wage growth is subdued, albeit not as low as it was during the early 1990s recession.

Graph 5.9
Wage Growth
Year-ended

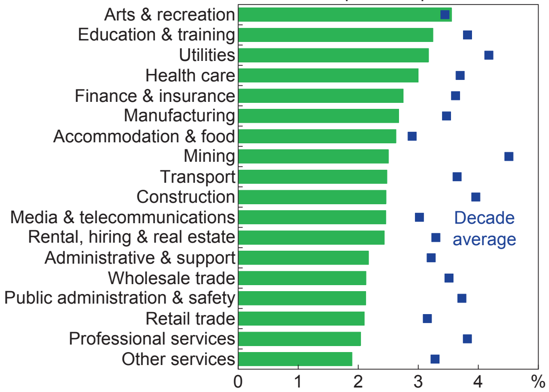


* Quarterly data to May 2012; biannual since November 2012
Sources: ABS; RBA

Low wage growth has been broad based. Growth of both the private and public sector WPI remained low over the year to September, at 2.5 per cent and 2.7 per cent, respectively. Year-ended wage growth has slowed significantly across all states and territories, and has stabilised at around 2–3 per cent in most industries, well below decade averages (Graph 5.10). This is consistent with evidence from business liaison, which suggests that, while wage growth has slowed, many firms are reluctant to offer wage increases below the expected rate of inflation.

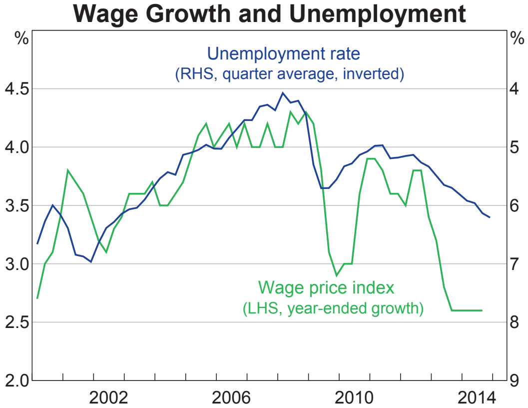
These subdued wage outcomes are largely consistent with other indicators of spare capacity in the labour market (see the 'Domestic Economic Conditions' chapter). However, the extent of the slowing in wage growth has been a little more pronounced than would have been expected based on its historical relationship with the unemployment rate (Graph 5.11). A number of possible factors may have contributed to the extent of slowing in wage growth. Compared with earlier episodes, increased labour market flexibility may afford

Graph 5.10
Wage Growth by Industry*
Year to September quarter 2014



* Wage price index
Sources: ABS; RBA

Graph 5.11
Wage Growth and Unemployment

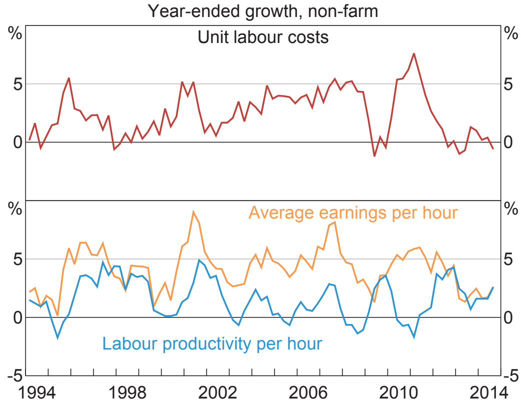


Sources: ABS; RBA

firms greater scope to adjust wages in response to a given change in demand for their goods and services, allowing them to employ more staff than would otherwise be the case. This is consistent with business liaison that suggests employees appear to be willing to trade lower wage growth for greater job security. Moreover, consumers' and unions' inflation expectations have declined somewhat over the past few years, implying that employees may have been more willing to accept lower nominal wage increases. It is also possible that the recent rise in the unemployment rate does not fully reflect the increase in spare capacity in the labour market; for example, in terms of shorter working hours or additional discouraged workers who would like to work but have given up searching for a job.

In addition, firms have remained under pressure to contain costs and increase efficiency in response to subdued domestic demand and the still-elevated level of the real exchange rate. Australia's unit labour costs have been broadly stable for more than two years, as labour productivity has grown at around the same pace as average earnings (Graph 5.12). This relatively slow growth in unit labour costs, as well as the depreciation of the nominal exchange rate since early 2013, is improving Australia's international cost competitiveness.

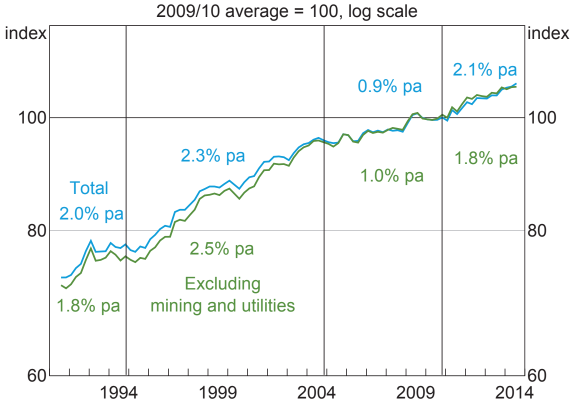
Graph 5.12
Unit Labour Costs
Year-ended growth, non-farm



Sources: ABS; RBA

Labour productivity growth has been higher over recent years than over much of the previous decade (Graph 5.13). Recent improvements partly reflect the transition of the resources sector to a phase of strong growth in output, which is much less labour intensive than the earlier period of significant investment. Growth rates of labour productivity and multifactor productivity in most other industries are also higher than the average pace recorded through much of the 2000s.

Graph 5.13
Labour Productivity*

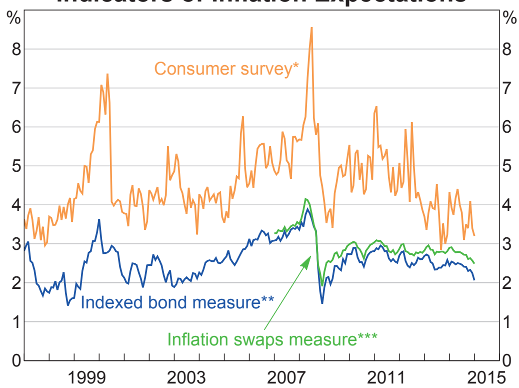


* Figures represent trend growth during the period shown
Sources: ABS; RBA

Inflation Expectations

Various measures of inflation expectations have declined a little further and are now a bit below their long-run average levels (Table 5.2; Graph 5.14). The large declines in oil prices are likely to have lowered inflation expectations over recent months. Financial market measures of inflation expectations have declined since November, reflecting lower expected inflation in the next few years rather than in the long term, to be a bit below their historical averages. These measures have not declined to the same extent seen in other major economies in recent months (see 'International and Foreign Exchange Markets' chapter). Since the November *Statement*, market economists and union officials have revised lower their forecasts for inflation over 2015 and 2016. The Melbourne Institute measure of consumer inflation expectations, which has historically responded to large fuel price changes, has also declined, but this is a very volatile series and it remains within the range of recent years. ✠

Graph 5.14
Indicators of Inflation Expectations



* Trimmed mean expectation of inflation over the next year
** Break-even 10-year inflation rate on indexed bonds; interpolation used to match exact maturity
*** Expectations of average annual inflation over the next 10 years
Sources: Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations
Per cent

	Year to December 2015			Year to December 2016	
	August 2014	November 2014	February 2015	November 2014	February 2015
Market economists	2.6	2.7	2.3	2.8	2.7
Union officials	3.0	2.6	2.0	2.5	2.3

Sources: Employment Research Australia; RBA