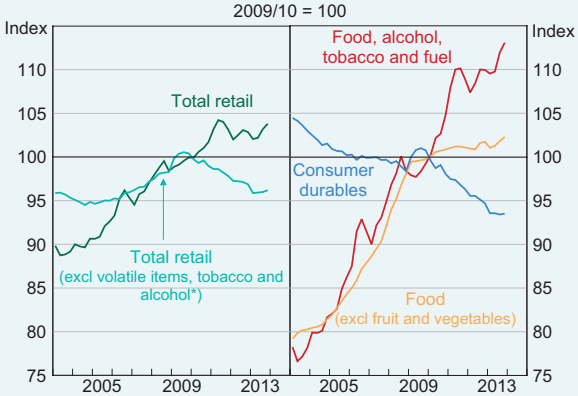
Box C

Recent Developments in Retail Prices and Margins

Retail goods are an important component of the Consumer Price Index (CPI), accounting for around 40 per cent of the CPI basket. These goods include consumer durable items, food, alcohol & tobacco and fuel. Overall, the prices of retail goods have been little changed over recent years, reflecting declines in the prices of consumer durables and relatively modest increases in most food prices (Graph C1). This stability in overall retail prices has been quite unusual and has made a significant contribution to the moderate CPI inflation outcomes observed during this period.

Graph C1
Retail Prices
2009/10 = 100



* Volatile items are fruit, vegetables and automotive fuel
Sources: ABS; RBA

To understand the drivers of retail prices, it is useful to split them into several components (Figure C1):

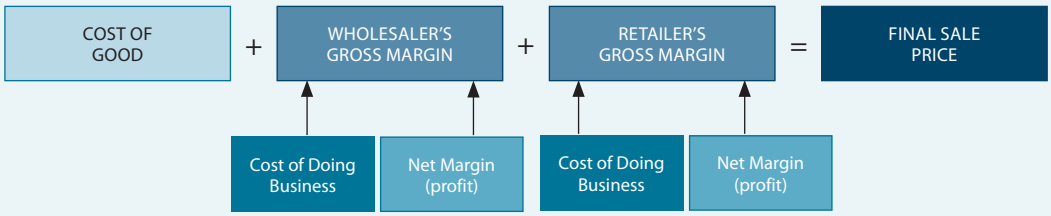
- Cost of goods sold: this includes all costs associated with purchasing stock, such as the price paid to the producer of the good, as well as tariffs and the cost of transport (to the wholesaler). Information from liaison and input-output table analysis suggests that, on average, these costs account for around half of the final sale price of a good.[1]
- Wholesalers' gross margins: the difference between the price of the good sold by the wholesaler (typically to retailers) and the cost of the good sold. This covers the wholesaler's cost of doing business – labour costs, rent, freight, and inventory holding costs – as well as a profit or 'net' margin.
- Retailers' gross margins: the difference between the final sales price and the sum of the cost of the good sold and the wholesaler's gross margin. Retailers' gross margins cover their own costs of doing business, with the remainder earned as profit. Estimates suggest that, on average, retailers' gross margins account for around one-third of the final sale price of a good.

A significant influence on the cost of goods sold component of final retail prices is the exchange rate. Around three-quarters of retail goods in the CPI basket – mainly durable items, fuel and tradable food items – are either imported or exposed to international competition. Accordingly, the appreciation of the exchange rate from 2009 to 2011 helps to explain why there was little inflation in final retail prices over the past few years. However, the persistence and extent of the decline in the prices of durable goods in particular over this period has been greater than that implied by historical relationships between retail prices and the exchange rate or import prices.[2] So the appreciation of the exchange rate up to 2011 does not appear to account in full for the low rate of retail price inflation over recent years.

1 See D'Arcy P, D Norman and S Shan (2012), 'Costs and Margins in the Retail Supply Chain', RBA *Bulletin*, June, pp 13–22.

2 For more details, see RBA (2013), 'Box B: The Recent Deflation in Consumer Durables Prices', *Statement on Monetary Policy*, May pp 57–59, and Chung E, M Kohler and C Lewis (2011), 'The Exchange Rate and Consumer Prices', RBA *Bulletin*, September, pp 9–16.

Figure C1
The Supply Chain for Retail Goods

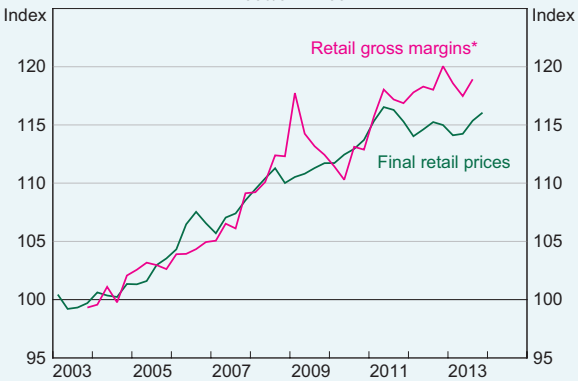


Source: Adapted from Figure 1 in D'Arcy P, D Norman and S Shan (2012), 'Costs and Margins in the Retail Supply Chain', RBA *Bulletin*, June, p 15

It does not appear that the low rate of retail price inflation has been due to a decline in retailers' gross margins. Recently released data from the ABS provide a new measure of changes in retailers' gross margins. The Experimental Producer Price Index for the Output of the Retail Trade Industry (RTPI) is constructed using data (starting in 2003) on retailers' total sales and cost of goods sold (as faced by the retailer, thereby including wholesaler gross margins). This series, available up to the September quarter 2013, can be used to measure the change over time in the dollar value of retailers' gross margins on a fixed quantity of retail goods.[3] According to the RTPI, over most of the 2000s, gross margins increased roughly in line with inflation in final retail prices (Graph C2). Over the past six years or so, retail gross margins appear to have increased slightly more than final retail prices, although in recent years (during which final retail prices have been little changed), retail gross margins have been relatively stable or increased only slightly.

Further evidence regarding retail margins can be drawn from data provided in retailers' annual reports. These data, which are based on a sample of 21 firms accounting for around 40 per cent of retail sales, do not align perfectly with the RTPI data. Nevertheless, they have a similar trend and suggest that the retail 'gross margin share' (i.e. the proportion of final sale prices accounted for by gross margins) may have increased somewhat over the past six years (Graph C3).

Graph C2
Retail Margins and Final Prices
2003/04 = 100



* Seasonally adjusted by the RBA
Sources: ABS; RBA

While changes in retailers' gross margins do not appear to explain the weak growth in overall retail prices over recent years, it may be that there has been downward pressure on gross margins further up the supply chain. Liaison suggests that many domestic retailers have tried to reduce the prices paid to wholesalers in recent years, by sourcing from cheaper suppliers, negotiating lower prices with existing suppliers, or purchasing stock in larger volumes. Other retailers say that they have attempted to reduce their reliance on wholesalers

3 The RTPI is a chain-weighted index, with the weights (which reflect the retail trade margin shares of each product group) updated annually. Data are collected by the Australian Bureau of Statistics for those products that make the highest contribution to total retail margins, and where data collection is feasible. These products account for around two-thirds of total retail trade margins.

by importing directly from producers. These efforts may indeed have contributed to some compression of gross margins at the wholesale level, although it is difficult to find data that would allow confirmation of this hypothesis.

While the recent pick-up in inflation in some retail prices may reflect some noise in the data, it is likely to incorporate some pass-through of the recent exchange rate depreciation. It may also suggest that any downward pressure on margins further up the supply chain has lessened somewhat in recent quarters, or that retail margins might have risen in the December quarter.

Graph C3

Retail Gross Margin Share*

Sample of listed retailers, 2003/04 = 100

* Calculated as the sum of gross margins across a sample of 21 listed retailers, divided by the sum of their sales revenues

Sources: Morningstar; RBA; annual reports and company data