2. Economic Conditions

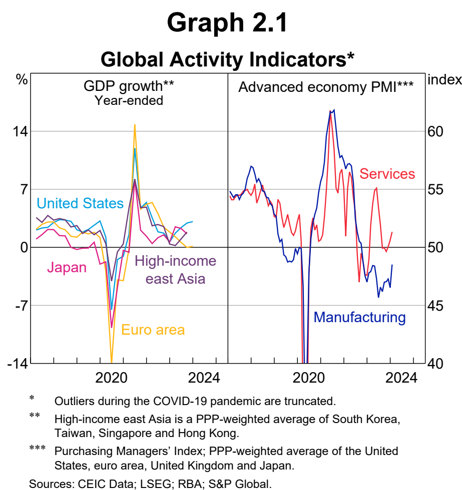
Summary

- **Economic growth softened in many advanced economies from mid-last year, largely in response to the earlier tightening in monetary policy.** The United States was a notable exception, recording robust growth throughout 2023.
- **Inflation remains above central banks' targets in many advanced economies, but has declined further and, in some cases, faster than expected.** The easing in inflation has been largely driven by energy and core goods prices. Core services price inflation has eased more gradually but remains elevated.
- **The Chinese economy rebounded in 2023, but growth is likely to slow in the year ahead.** This reflects weakness in the property market and slowing household consumption growth, despite policy measures expected to support investment. Recent policy measures have supported Chinese steel production and, in turn, the prices of iron ore and coking coal received by Australian exporters.
- **In the Australian economy, we assess that demand has continued to exceed supply, but subdued growth is closing this gap.** Demand has been supported by strong growth in business investment, public sector spending and spending by international students and tourists. But household consumption growth has been weak, as high inflation, higher interest rates and tax payments have weighed on household income.
- **Labour market conditions remain tight, but have continued to ease over recent months.** Slower economic growth has slowed growth in labour demand, while the labour supply has increased. However, the labour market is assessed as still tight relative to what is consistent with full employment. See section 2.4 below for the assessment of spare capacity in the economy and labour market.
- **Wages growth remains robust, reflecting the tight labour market and high inflation.** While aggregate wages grew strongly in the September quarter, there was evidence of wages growth slowing in some parts of the labour market. Growth in unit labour costs remains too high, reflecting weak productivity outcomes.
- **Inflation eased further in the December quarter but remains too high.** Recent high inflation is consistent with excess demand in the economy and strong domestic cost pressures. Services inflation remains high despite having passed its peak, while goods inflation has recorded substantial declines.

2.1 Global economic conditions

Economic growth has softened in many advanced economies, although growth in the United States has been robust.

Growth in economic activity has slowed in many, but not all, advanced economies. In some cases, the slowing has been sharper than expected, and a contrast to the surprising resilience in the first half of 2023. This slowing has been evident both in GDP data and in partial indicators such as retail sales and investment intentions. However, there is some variation across economies, with soft outcomes in the euro area, Canada, United Kingdom and New Zealand contrasting with ongoing resilience in the United States and high-income economies in east Asia (Graph 2.1). Recent survey measures indicate that business conditions in manufacturing sectors of advanced economies remain weak. While the services sector has recovered slightly over recent months, it is not expected to provide the same support to growth as it did during the early post-pandemic reopening period.



Graph 2.1

Global Activity Indicators*

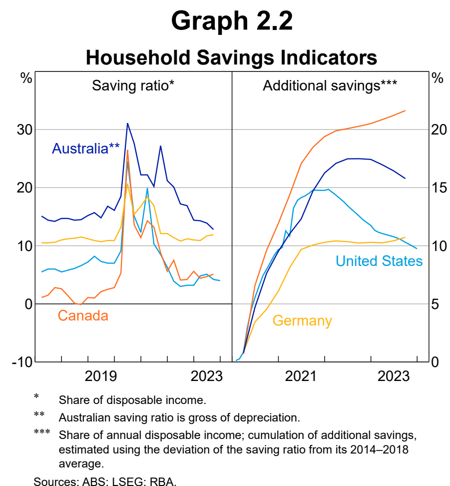
* Outliers during the COVID-19 pandemic are truncated.

** High-income east Asia is a PPP-weighted average of South Korea, Taiwan, Singapore and Hong Kong.

*** Purchasing Managers' Index; PPP-weighted average of the United States, euro area, United Kingdom and Japan.

Sources: CEIC Data; LSEG; RBA; S&P Global.

A common driver of the recent softer growth in economic activity has been weaker household consumption growth, with the United States a notable exception. Consumption growth has been modest in several advanced economies, in part driven by weakness in goods consumption. This is despite positive growth in real household incomes throughout 2023 in many economies and household balance sheets remaining healthy overall. Household balance sheets have been bolstered by stabilising (and, in some cases, rising) housing prices and continued positive rates of household saving. Outside the United States (and Australia), saving rates remain above pre-pandemic norms and the additional savings balances that were accumulated during the pandemic have typically not been drawn down (Graph 2.2). By contrast, US households have been saving at a slower rate than prior to the pandemic and have drawn down some of their additional pandemic savings to support their more robust consumption (these drawdowns are similar to the Australian experience, discussed below). Looking ahead, further moderation in inflation should reduce cost-of-living pressures on household incomes and, in turn, support consumption growth. However, this is likely to be at least partly offset by lower nominal disposable income growth as the cumulative effect of tighter monetary policy leads to further easing in labour market conditions and as higher loan repayments drag on spending power.



Graph 2.2

Household Savings Indicators

* Share of disposable income.

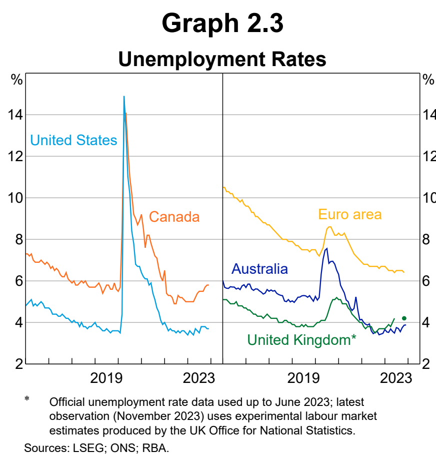
** Australian saving ratio is gross of depreciation.

*** Share of annual disposable income; cumulation of additional savings, estimated using the deviation of the saving ratio from its 2014–2018 average.

Sources: ABS; LSEG; RBA.

Labour market conditions are easing gradually, but remain tight overall.

Unemployment rates have increased from their recent lows in most advanced economies. Unemployment rates have increased noticeably in the United Kingdom and Canada, while others have recorded modest increases in recent quarters (Graph 2.3). Job vacancy-to-unemployment ratios, which are another key measure of labour market tightness, have declined from their peaks, though they generally remain above pre-pandemic levels. Consistent with this, wages growth has declined from its peaks in a number of advanced economies but remains strong in most.



* Official unemployment rate data used up to June 2023; latest observation (November 2023) uses experimental labour market estimates produced by the UK Office for National Statistics.

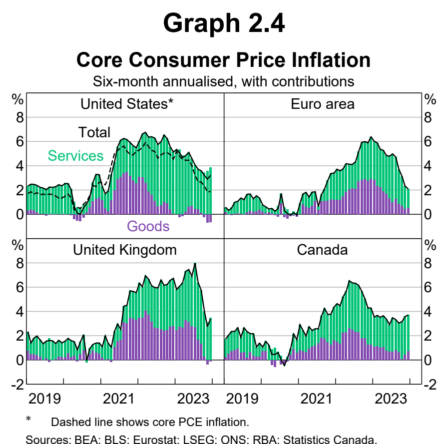
Sources: LSEG; ONS; RBA.

Inflation remains above target in advanced economies, but has declined, faster than expected in some cases.

Lower energy and core goods price inflation have been the main drivers of easing inflation in advanced economies. In a number of economies, headline and core inflation rates have declined to around 2–3 per cent on a six-month-ended annualised basis, though they remain slightly higher in Canada and New Zealand. Recent inflation outcomes in some advanced economies have also surprised central banks to the downside. Consistent with this, several central banks have acknowledged that policy rates are likely to have peaked (see Chapter 1: Financial Conditions).

Headline inflation has declined as energy prices have eased from their September quarter peaks. In turn, the decline in energy prices reflects ample supply of oil and gas. Food price inflation has also been easing, though it remains high, especially in Europe.

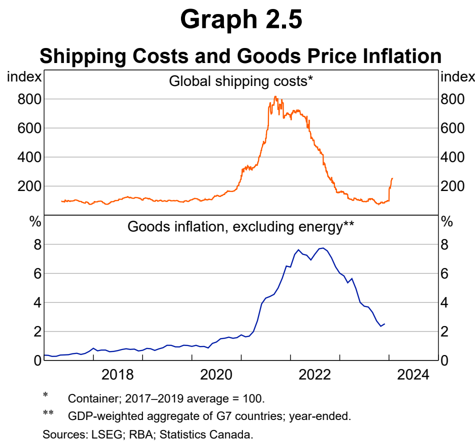
A significant slowing in core goods price inflation has seen core inflation moderate further, but core services price inflation remains relatively elevated (Graph 2.4). In the United States and the United Kingdom, core goods prices have recorded outright declines in recent months. By contrast, core services price inflation has continued to ease more gradually across most advanced economies. Rent inflation is yet to show clear signs of easing (outside of the United States) and could remain high for some time as the supply of housing can be slow to respond to changes in demand. Non-housing services price inflation has eased from its peaks, consistent with gradual easing in labour market tightness and an improvement in the balance of demand and supply for services, but is still elevated relative to pre-pandemic rates.



* Dashed line shows core PCE inflation.

Sources: BEA; BLS; Eurostat; LSEG; ONS; RBA; Statistics Canada.

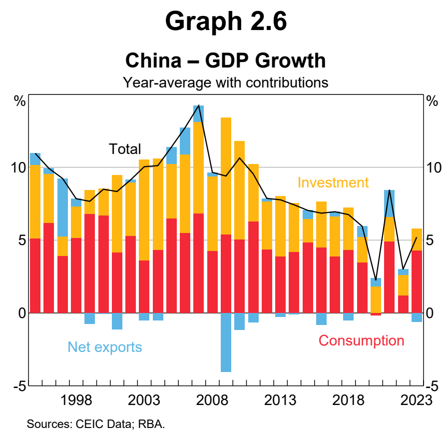
Global shipping costs have increased recently as attacks on vessels in the Red Sea and capacity restrictions in the Panama Canal have resulted in some ships using longer, more costly shipping routes (Graph 2.5). While this poses some upside risk to tradable goods inflation, the increases to date have been small relative to those seen during the pandemic, when supply chain disruptions were much more widespread.



* Container; 2017–2019 average = 100.
** GDP-weighted aggregate of G7 countries; year-ended.
Sources: LSEG; RBA; Statistics Canada.

Chinese economic growth rebounded in 2023, with supportive fiscal measures and some easing of financial conditions offsetting ongoing weakness in the property market.

Household consumption was the main driver of economic growth in China in 2023, led by a recovery in demand for services after pandemic restrictions were lifted in late 2022 (Graph 2.6). Accordingly, services price inflation picked up in 2023, but has been more than offset by declines in food prices, resulting in deflation in headline year-ended terms in recent months. Consumption growth slowed significantly at the end of last year, suggesting that the rebound in consumption has largely run its course. Persistently low consumer confidence, partly related to weakness in property market conditions, likely also contributed. Investment contributed positively to economic growth in 2023, supported by policy measures that boosted infrastructure and manufacturing investment. This support has offset significant weakness in real estate investment over the past two years. Chinese authorities have stepped up their support for the economy through fiscal and monetary policy, especially through the issuance of government bonds to finance infrastructure investment (see Chapter 1: Financial Conditions). However, policy support for investment is likely to be offset by slowing consumption growth and ongoing property sector weakness, leading to slower growth in the Chinese economy this year and next (see Chapter 3: Outlook).



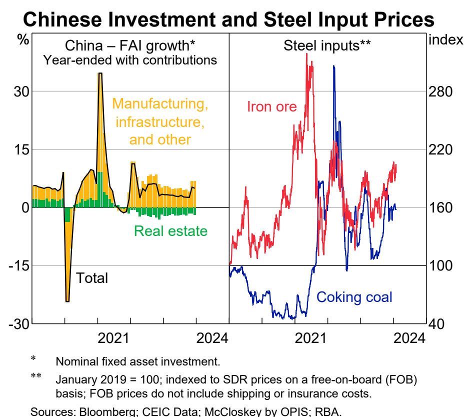
Sources: CEIC Data; RBA.

Policy stimulus in China continues to support iron ore and coking coal prices.

Chinese steel production has remained resilient for most of 2023 despite the weakness in the property sector, reflecting policy support for infrastructure and manufacturing investment (Graph 2.7). This ongoing strength in Chinese demand for steel, and expectations of ongoing policy measures, has continued to support iron ore and coking coal prices. In turn, this is supporting Australia's terms of trade, which are expected to have increased in the December 2023 quarter, with higher LNG prices and lower import prices also contributing.

Graph 2.7

Chinese Investment and Steel Input Prices



* Nominal fixed asset investment.
** January 2019 = 100; indexed to SDR prices on a free-on-board (FOB) basis; FOB prices do not include shipping or insurance costs.
Sources: Bloomberg; CEIC Data; McCloskey by OPIS; RBA.

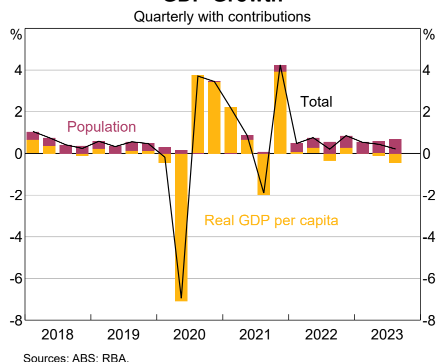
2.2 Domestic economic activity

Growth in the Australian economy remains subdued.

Our assessment is that the level of demand continues to exceed the economy's ability to supply goods and services (see 2.4 Assessment of spare capacity for more details). However, similar to many other advanced economies, growth slowed over 2023 and this is helping to lessen the imbalance between demand and supply (Graph 2.8). GDP per capita declined over this period.

Graph 2.8

GDP Growth



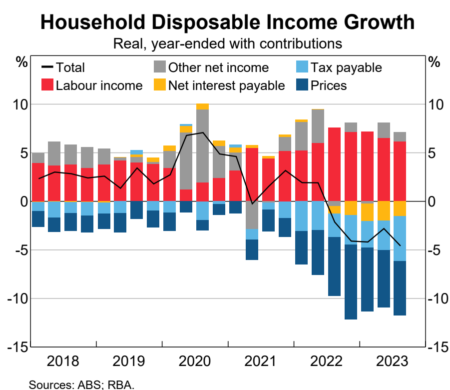
Sources: ABS; RBA.

The slowing in GDP growth over the past year has primarily been driven by weak growth in household consumption amid cost-of-living pressures. Growth in dwelling investment was also subdued due to ongoing labour constraints in the residential construction sector. This was partly offset by strong growth in business and public investment, supported by a large pipeline of work and easing supply constraints.

Household consumption growth remains weak amid high inflation, strong growth in tax payments and higher interest rates.

Real disposable incomes have been declining for around two years and this has put pressure on household budgets. Strong growth in nominal labour incomes has been more than offset by the high rate of inflation, tax payments growing faster than incomes and the effects of higher interest rates (Graph 2.9).

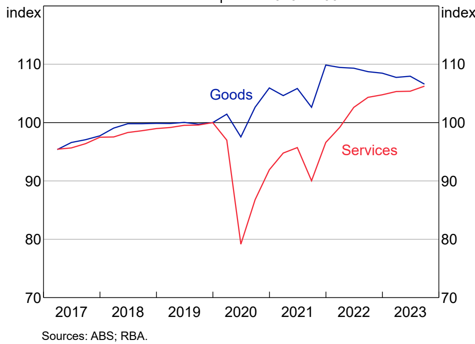
Graph 2.9



Sources: ABS; RBA.

Many households have responded to budget pressures by curbing their spending, particularly for discretionary items. Consumption growth was weak over the past year and consumption has declined in per capita terms. This slowdown has been driven by a decline in goods purchases; car sales have been an exception, though this largely reflects the delivery of earlier orders as supply constraints have eased (Graph 2.10). By contrast, consumption of services has been more resilient, consistent with services inflation remaining elevated (see below). Retail sales and other timely indicators show that consumption

growth remained weak in the December quarter. Retail sales temporarily picked up in November as 'Black Friday' promotions brought forward spending from the Christmas sales.



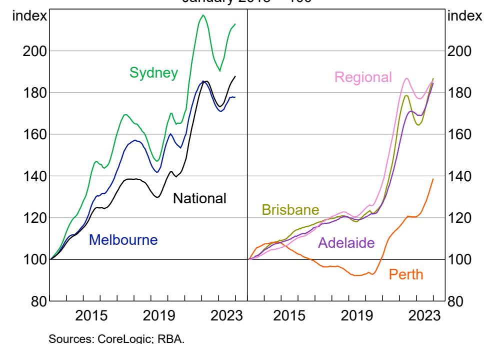
Households have also responded to lower real incomes by saving less or in some cases drawing down on their savings. The household savings ratio has declined in recent quarters and is below pre-pandemic levels. However, households' deposits and other liquid assets remain large in aggregate, supported by the additional savings accumulated during the pandemic. This suggests there is scope for savings rates to decline further to support consumption (see Chapter 3: Outlook).

Timely transaction-based spending data suggest that nominal spending growth has slowed across most households. While mortgagors have faced a large increase in their mortgage payments, many have been able to offset the impact of this on their spending by saving less or drawing down on their savings.[1] For lower income households and renters, the strong labour market has helped to support spending. Nonetheless, many households have had to make difficult adjustments in response to the challenging conditions, particularly households with lower financial buffers.

Growth in total consumer spending in Australia – which includes spending by temporary residents such as foreign students – has slowed recently after growing strongly in early 2023. Total spending determines the demand conditions that feed into the price-setting behaviour of Australian consumer-facing businesses. The increase in temporary residents has also been supporting the supply side of the economy as many students participate in the labour force. The slowdown in spending growth has been partly driven by a moderation in the pace of overseas visitors arriving in Australia, as well as Australian residents spending less domestically as they return to travelling abroad.

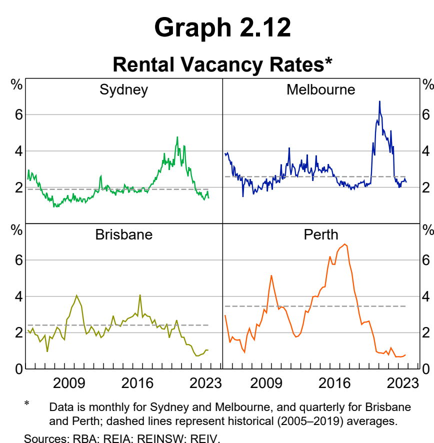
The rebound in housing prices has continued to support household wealth, although growth has slowed.

National housing prices increased strongly over 2023 to be above their April 2022 peak (Graph 2.11). Prices have increased across most capital cities and regional areas, supporting household wealth, although price growth has slowed more recently in Sydney and Melbourne. The rebound in housing prices reflected a combination of stronger demand for established housing (partly due to strong population growth) and a limited supply of dwellings.



The rental market remains tight and the ongoing weakness in dwelling investment suggests this is unlikely to ease in the near term.

Rental vacancy rates remain low in most areas (Graph 2.12). This is consistent with a limited supply of new dwellings, strong population growth and a shift in preferences during the pandemic towards more residential space that has led to a lower average household size. Although average household size has increased in capital cities over the past year, it remains well below pre-pandemic levels.



Graph 2.12

Rental Vacancy Rates*

* Data is monthly for Sydney and Melbourne, and quarterly for Brisbane and Perth; dashed lines represent historical (2005–2019) averages.

Sources: RBA; REIA; REINSW; REIV.

The supply of new dwellings has remained constrained, with dwelling investment below pre-pandemic levels. Quarterly commencements are at their lowest level in over a decade and capacity constraints have continued to limit the pace at which builders can work through the existing pipeline of residential construction, with labour shortages acute in the latter stages of construction.

Demand to purchase new dwellings has remained subdued. Uncertainty around higher interest rates, elevated construction costs and longer building times have weighed on buyer sentiment. However, some firms in the RBA's liaison program expect demand for new dwellings to increase over the coming year, supported by inward migration and low rental vacancy rates (see Box A: Insights from Liaison for an overview of liaison messages). This is consistent with the pick-up in greenfield lot and new home sales observed over 2023.

Business investment has grown strongly over the past year, supported by an easing in international supply chain disruptions and a large pipeline of construction work.

Business investment has grown strongly in both the mining and non-mining sectors. A backlog of orders and further easing in supply chain disruptions has supported increased expenditure on machinery and equipment over recent quarters. Non-residential construction has also increased, reflecting continued progress on the still-elevated pipeline of yet-to-be-done construction work as well as investment in offshore LNG projects. Spending on software, alongside projects for automation and digitisation, has also supported growth in investment.

Growth in business investment is likely to slow. Investment intentions reported by firms in the RBA's liaison program have softened over recent months and are around their long-run average. This is consistent with the recent easing in surveyed measures of business conditions, which are around their longer run averages. Some firms have cited high prices for construction, rising financing costs and uncertainty around the outlook as weighing on their investment plans.

2.3 Labour market and wages

Labour market conditions are continuing to ease gradually but remain tight.

A broad range of labour market indicators have eased further over recent months, as growth in labour demand has responded to a slowing economy and labour supply has increased. Despite the easing from the very tight conditions of late 2022, the labour market is assessed as tight relative to what is consistent with full employment – that is the maximum level of employment consistent with low and stable inflation. (For more details, see 2.4 Assessment of spare capacity, below, and Chapter 4: In Depth – Full Employment.)

The unemployment rate was 3.9 per cent in December, ½ percentage point above its 50-year low of 3.4 per cent in late 2022. Underemployment has also edged up further, with the hours-based underutilisation rate – a broader measure of labour market spare capacity – also around ½ percentage point higher than its late-2022 trough. Components of unemployment that tend to better reflect cyclical labour market conditions – like the medium-term unemployment rate and the youth unemployment rate – have risen alongside the aggregate unemployment rate.

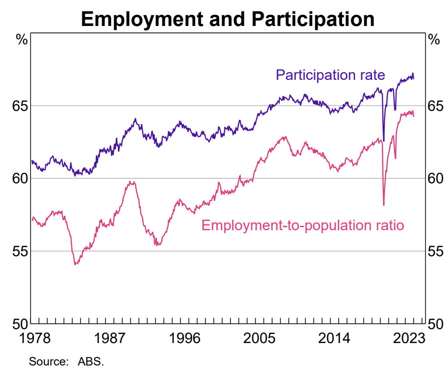
Indicators of labour demand have also eased further over recent months. Job ads and vacancies continue to trend lower from their 2022 highs but remain above pre-pandemic levels. Hiring intentions of firms in the RBA's liaison program have declined further to be around their long-run average levels. Consistent with an easing in labour demand, the share of voluntary resignations has decreased, while the proportion of employed persons switching jobs has declined to its pre-pandemic average.

Hours worked have continued to act as an important margin of adjustment to the moderation in labour demand growth in recent months. In line with this, average hours worked have fallen from their recent peak in April 2023.

Elevated population growth and record high labour force participation are boosting labour supply, though population growth also adds to demand. Information from the RBA's liaison program and business surveys point to improvements in the availability of labour. Employment has been increasing at a broadly similar pace to the working-age population over the past 18 months such that the employment-to-population ratio has remained relatively steady (Graph 2.13). That said, growth in employment in recent months has largely been driven by part-time workers, unlike the recovery from the pandemic when full-time employment accounted for almost all employment growth.

Graph 2.13

Employment and Participation



Source: ABS.

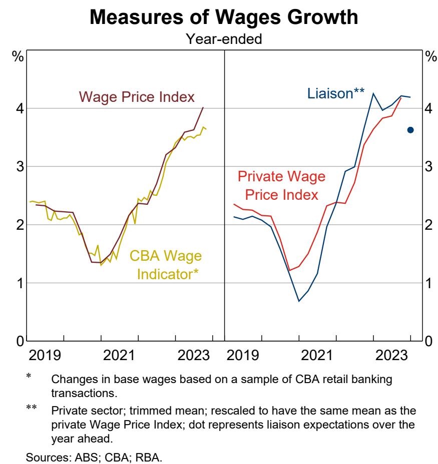
Growth in the working-age population was at a multi-decade high of around 3 per cent over 2023, owing to strength in net overseas migration. The resumption of migration following the pandemic period has added to labour supply and helped relieve labour shortages in some industries, although migrants also add to overall demand in the economy. Recent migrants tend to have a high rate of labour force participation relative to the general population. Cost-of-living pressures and a strong labour market have also likely contributed to the labour force participation rate remaining near record highs, with a notable increase in participation for females aged over 25 years.

Wages growth picked up further in the September quarter, but it has begun to moderate in some industries and there are indications of a broader moderation over the year ahead.

The Wage Price Index (WPI) recorded its largest quarterly increase since the beginning of the series in the late 1990s. The WPI grew by 1.3 per cent in the September quarter, to be 4 per cent higher in year-ended terms (Graph 2.14). Strong growth in the quarter resulted from the Fair Work Commission's decision to increase award wages by 5.75 per cent generally and 15 per cent for aged care workers. On the whole, wages growth has been robust because of the tight labour market and high inflation outcomes. WPI growth increased in both the private and public sectors.

Graph 2.14

Measures of Wages Growth



* Changes in base wages based on a sample of CBA retail banking transactions.

** Private sector; trimmed mean; rescaled to have the same mean as the private Wage Price Index; dot represents liaison expectations over the year ahead.

Sources: ABS; CBA; RBA.

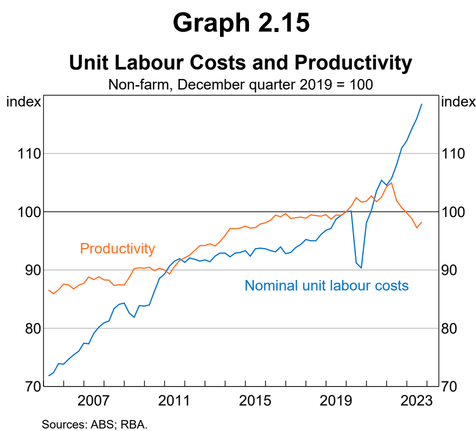
Wages growth remained robust across all methods of setting pay, though growth has moderated in parts of the private sector. Wages growth was strongest in the September quarter in industries with a high share of award workers, such as accommodation and food, retail, and health care. By contrast, wages growth has stabilised for workers on individual arrangements and moderated a little in some industries with a higher share of these workers, such as in business services.

Wages growth in the outstanding stock of enterprise bargaining agreements (EBAs) increased in the September quarter, with newly lodged EBAs pointing to another firm outcome in the December quarter. Wages growth in EBAs tends to be affected by the labour market with a lag; the strong labour market conditions of recent years are continuing to flow through to EBA wages growth as multi-year agreements are reset. Recently, there has been an increased share of agreements being lodged with higher wage increases in their first year than in later years, implying that these agreements are contributing more to current wages growth than they will in a year's time.

Some indicators suggest that wages growth is likely to ease a little over the year ahead. Market economists and firms in the RBA's liaison program expect wages growth to decline a little, with average wage expectations around 3½ to 3¾ per cent for the year ahead. Firms that expect a decline in wages growth have noted declining inflation, an improvement in labour availability and an increased focus on cost control as reasons for this.

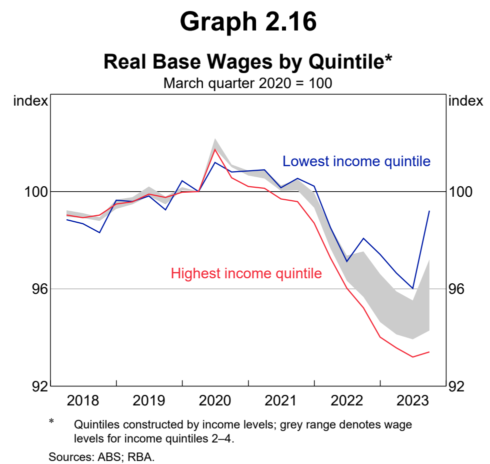
Unit labour cost growth remained very high in the September quarter, and remains a source of upward pressure on inflation.

Recent weak productivity outcomes have contributed to very strong growth in unit labour costs, placing upward pressure on inflation (Graph 2.15) (see Chapter 3: Outlook for further discussion of productivity). Growth in nominal unit labout costs was around 7 per cent over the year to the September quarter, and continues to be well above its average over the inflation-targeting period.



Real base wages increased in quarterly terms, following large declines.

Real wages increased in the September quarter for the first time since early 2021 (as measured by the difference between the seasonally adjusted WPI and Consumer Price Index (CPI)). Households in the lowest income quintile have seen the highest real base wages growth over the past year, largely due to the recent award increases. Real base wages for the lowest income quintile are slightly below their pre-pandemic level, whereas real base wages for other income quintiles remain well below their earlier level (Graph 2.16). Real employment income – which includes base wages as well as the effects of changes in jobs or promotions or hours worked – increased over the past year across all quintiles.

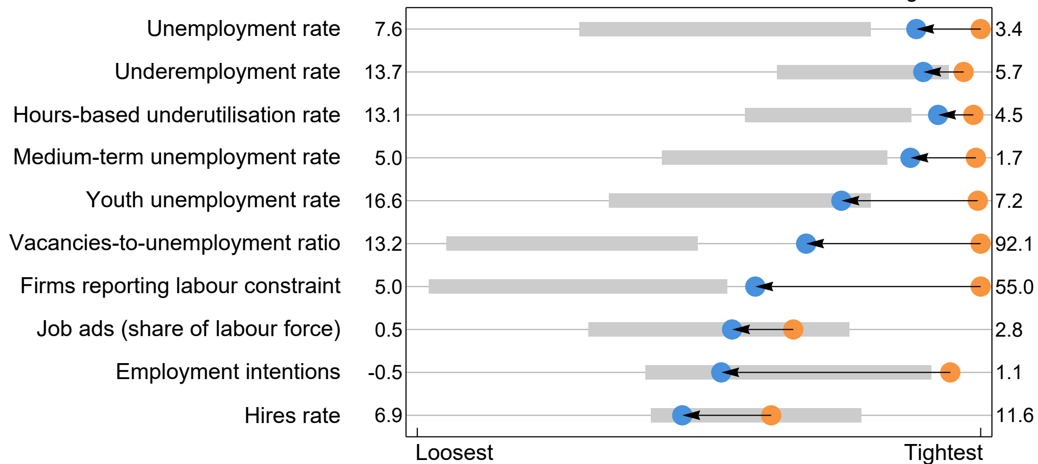


2.4 Assessment of spare capacity

As outlined in the recently agreed *Statement on the Conduct of Monetary Policy*, the RBA will regularly publish its assessments of full employment and potential output.

The labour market is assessed to be tight relative to full employment.

The labour market is tight, but conditions have continued to ease over recent months based on a broad range of indicators (see Chapter 4: In Depth – Full Employment for more detail on how this assessment is made). A range of indicators provide a consistent message that labour market conditions have eased since late 2022, at which time many measures were around their tightest levels of the past 50 years (Graph 2.17). The easing in conditions is most evident in job ads and employment intentions, which tend to be leading indicators. Overall, most indicators appear 'tight' relative to historical norms (with the historical range given for each indicator by the span of the graph). But there is nevertheless a degree of uncertainty around this assessment, which is likely to increase as the economy moves closer to balance.

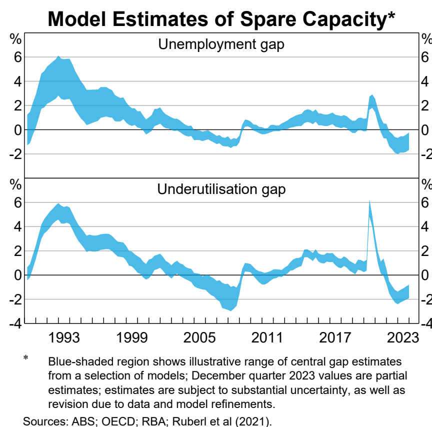


* Blue dots represent current outcomes, orange dots show outcomes at October 2022 and light grey shaded regions cover the middle 80 per cent of observations since 2000.

Sources: ABS; JSA; NAB; RBA.

Model-based estimates suggest labour market conditions are still tighter than full employment, consistent with elevated domestic inflationary pressure and robust wages growth. Both the unemployment rate and the broader hours-based underutilisation rate remain lower than a range of model-based estimates indicate is consistent with low and stable inflation, resulting in negative 'gaps' (Graph 2.18).[2] These estimates of the unemployment and underutilisation gaps have narrowed in recent quarters, indicating that the labour market is moving towards full employment but is still tight. Given the substantial uncertainty involved with each of the model estimates, it is possible that labour market conditions are already consistent with full employment, but the probability is relatively modest.

Graph 2.18



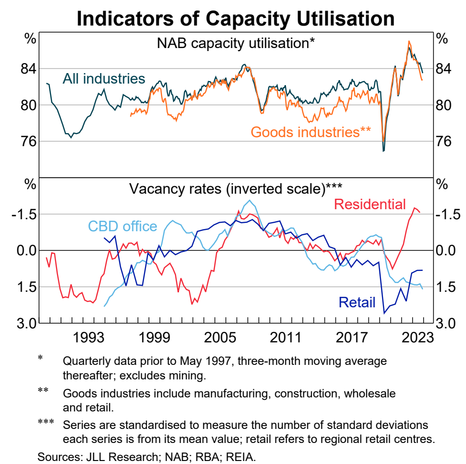
* Blue-shaded region shows illustrative range of central gap estimates from a selection of models; December quarter 2023 values are partial estimates; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

Sources: ABS; OECD; RBA; Ruberl et al (2021).

The level of overall demand remains above the economy's level of potential output.

Our overall assessment is that aggregate demand remains above the economy's capacity to supply goods and services thereby putting pressure on inflation. This assessment of capacity utilisation is informed by a range of indicators, including inflation outcomes, survey measures of capacity utilisation (which have been easing from their historical highs but remain elevated). Vacancy rates for residential real estate – buildings are part of the economy's capital stock – also suggest high utilisation, which is placing pressure on residential rents (Graph 2.19).

Graph 2.19



* Quarterly data prior to May 1997, three-month moving average thereafter; excludes mining.

** Goods industries include manufacturing, construction, wholesale and retail.

*** Series are standardised to measure the number of standard deviations each series is from its mean value; retail refers to regional retail centres.

Sources: JLL Research; NAB; RBA; REIA.

A range of model-based estimates of potential output also suggest the level of economic demand is above its supply capacity. Potential output is a measure of the productive capacity of the Australian economy to supply goods and services; it is the highest level of economic activity consistent with maintaining low and stable inflation over the medium term. Like full employment, potential output cannot be measured directly. The productive capacity of the economy evolves with trends in the labour force, capital stock and technological change. The 'output gap' is the difference between the level of actual and estimated potential output and a positive gap indicates that there is excess demand in the economy.

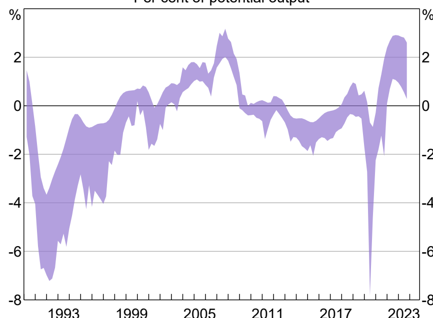
A range of model estimates suggest that the output gap has been positive since late 2021, consistent with excess demand in the economy contributing to elevated domestic inflationary pressures (Graph 2.20). The RBA's assessment is that the level of output remained above

potential in the September quarter of 2023 – both labour and capital resources were being utilised beyond the maximum levels that can be sustained without creating inflationary pressures. However, the output gap has narrowed over the past year, suggesting demand and supply in the economy are moving closer to balance. This has occurred as earlier disruptions to supply have continued to be resolved and as demand growth in the economy has slowed in response to higher interest rates and other headwinds. The extent of spare capacity contributes to the overall assessment of pressures on inflation, which are discussed in the next section.

Graph 2.20

Model Estimates of Output Gap*

Per cent of potential output



* Violet-shaded region shows illustrative range of central gap estimates from a selection of models encompassing different measures and definitions of the output gap; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

Sources: OECD; RBA.

2.5 Inflation

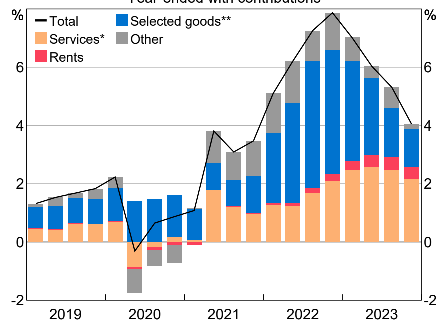
Inflation eased further in the December quarter, but remains too high.

Inflation eased in the December quarter, driven by a further easing in goods inflation and some moderation in services inflation from its high level. The CPI increased by 0.7 per cent in the quarter to be 4.1 per cent higher over the year, down from 5.4 per cent in the September quarter (Graph 2.21). Measures of underlying inflation (which are designed to better capture the trend in inflation) also eased; trimmed mean inflation was 0.8 per cent in the quarter to be 4.2 per cent over the year (Graph 2.22). These outcomes were lower than expected three months ago, and show further progress in the decline in inflation from its peak in late 2022. Nevertheless, the rate of inflation remains well above target. Services price inflation in particular remains high, consistent with the assessment that there is excess demand in the economy and strong domestic cost pressures.

Graph 2.21

CPI Inflation

Year-ended with contributions



* Includes market services and administered items; excludes rents and holiday travel & accommodation.

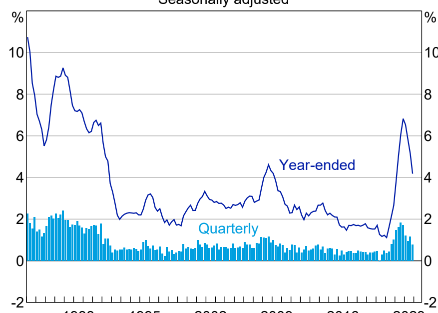
** Includes groceries, alcohol & tobacco, consumer durables and new dwellings.

Sources: ABS; RBA.

Graph 2.22

Trimmed Mean Inflation*

Seasonally adjusted



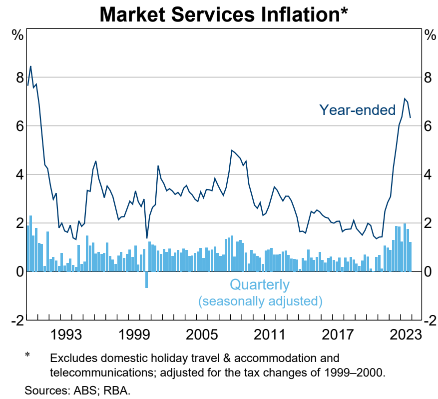
* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Inflation outcomes for volatile items and those influenced by changes in government policies helped to moderate inflation in the December quarter. Government electricity rebates for some households came into effect this quarter, partly offsetting the impact of higher electricity prices; increased Commonwealth rent assistance also lowered rental price inflation. Fuel prices declined, after increasing sharply in the previous quarter, and will subtract further from inflation in the March quarter if they remain around their current level.

Services inflation has passed its peak, but remains elevated due to the still-robust level of demand and strong domestic cost pressures.

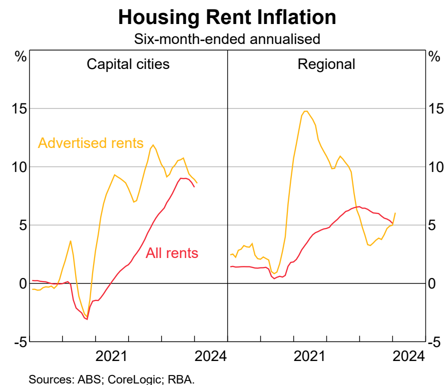
Market services inflation remains high and broadly based across categories (Graph 2.23). Inflation remains above its historical average in dining out and takeaway, insurance and financial, telecommunications, and a range of other household services. High inflation in market services reflects the strong level of demand exceeding supply and continued pressure from both labour and domestic non-labour input costs such as insurance, legal, accounting and administrative services. Retail and office rents are some of the few non-labour costs that are not adding materially to inflationary pressures. Unit labour costs represent a large share of input costs for market services firms and have grown strongly of late, as discussed above.



* Excludes domestic holiday travel & accommodation and telecommunications; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Rent inflation remains high, and this is expected to persist because of the ongoing tightness in rental market conditions. Rent inflation for the stock of rents captured in the CPI (which excludes regional areas) was 0.9 per cent in the quarter and 7.3 per cent over the year (Graph 2.24). This would have been 1½ percentage points higher over the year if not for the increase to Commonwealth Rent Assistance that came into effect in September 2023. Tight rental market conditions across the capital cities are expected to contribute to continued high rent inflation, as recent increases in monthly advertised rental growth flow through to CPI rents.



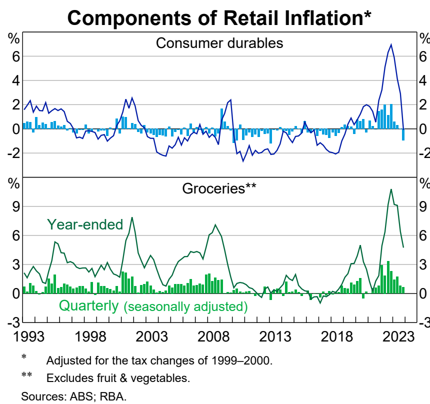
Sources: ABS; CoreLogic; RBA.

Goods price inflation declined further in the December quarter as earlier issues in global supply chains improved and goods demand moderated.

Goods price inflation eased in the December quarter for both consumer durables and groceries (Graph 2.25). The easing in goods inflation is consistent with the moderation in demand for goods and an easing in price inflation of imported consumption goods as global supply chain issues improved last year. Shipping costs remain far below their pandemic peak despite a recent increase (see 2.1 Global economic conditions). Nonetheless, domestic labour and non-labour costs continue to put some offsetting upward pressure on final goods prices. As with firms in the services sector, firms selling goods have faced increases in some domestic costs, including for electricity, services inputs and warehousing and logistics rents, though retail rents have remained subdued.

Graph 2.25

Components of Retail Inflation*



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

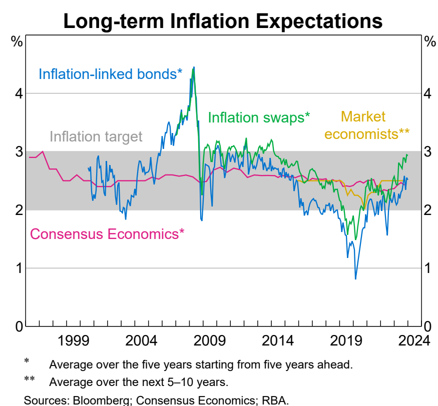
Consumer durables prices declined in the December quarter. Information from the RBA's liaison program suggests that demand for discretionary items has moderated and competition among retailers has increased over the past year, making it harder for retailers to raise prices. Grocery price inflation (excluding fruit and vegetables) has eased considerably over the past year, and meat prices declined in the December quarter. Nevertheless, grocery prices are considerably higher than they were a few years ago; grocery prices have increased by 20 per cent since early 2020, compared with an increase of 8 per cent over the prior decade.

New dwelling cost inflation has stabilised in recent quarters, above its inflation-targeting average. Liaison suggests that labour costs and energy-intensive materials are driving ongoing cost growth, partly driven by the large pipeline of work and ongoing capacity constraints in residential construction (as discussed above). Even so, inflationary pressures have eased from their peak in mid-2022.

Inflation expectations remain consistent with achieving the inflation target over time.

Measures of short-term expectations have declined notably from their mid-2022 peaks, though they continue to suggest that inflation over the next year is expected to remain above the RBA's inflation target. Measures of medium- and long-term expectations remain consistent with the inflation target (Graph 2.26).

Graph 2.26



* Average over the five years starting from five years ahead.
** Average over the next 5–10 years.
Sources: Bloomberg; Consensus Economics; RBA.

Endnotes

[1] See Beckers B, A Clarke, A Gao, M James and R Morgan (2024), 'Developments in Income and Consumption Across Household Groups', RBA *Bulletin*, January.

[2] The suite of models primarily comprises models developed within the RBA – such as Cusbert T (2017), 'Estimating the NAIRU and the Unemployment Gap', RBA *Bulletin*, June – but also includes RBA estimates of Ruberl H, M Ball, L Lucas and T Williamson (2021), 'Estimating the NAIRU in Australia', *Treasury Working Paper* 2021-01, and estimates from the OECD.