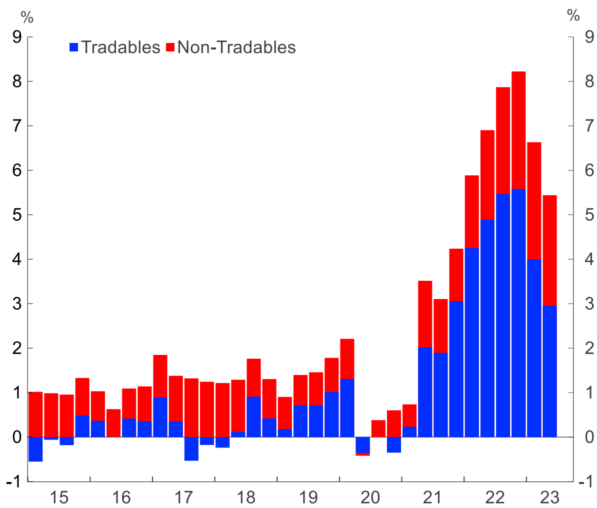
Wednesday, 26 July 2023

Consumer Price Index

Inflation Down But Not Out

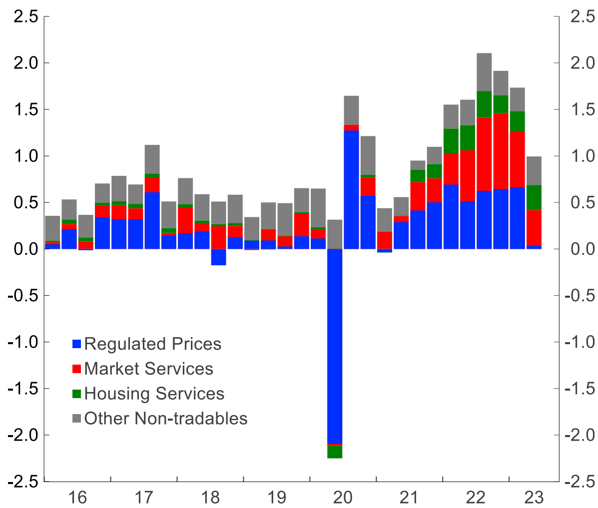
- **The June quarter inflation report showed that inflation is declining at a quicker pace than expected. The consumer price index (CPI) rose 0.8% over June quarter to be 6.0% higher in annual terms – the annual outcome represents a fall of 1 percentage point from the last read. This was the slowest quarterly growth rate since the September quarter 2021.**
- **The RBA's preferred measure of inflation, the trimmed mean or 'core' inflation, moderated by almost 0.75 percentage points to be 5.9% higher in annual terms.**
- **The prices of non-tradable items, which are determined by domestic factors, moderated to increase by 1.0% over the quarter, down from the 1.7% recorded last quarter.**
- **Significantly, the prices of market services that are closely linked to aggregate demand and labour market conditions pulled back significantly, <u>contributing less than 0.4 percentage points to non-tradable inflation, down from 0.8 percentage points recorded last quarter.</u> This suggests that the inflationary impulse related to domestic demand could be moderating and moderating quickly.**
- **With the prices of domestic items still increasing more quickly than tradables, demand could shift towards imports. There could also be supply side implications with lower global prices feeding into domestic items. Both impacts could do some of the heavy lifting for the RBA.**
- **Today's outcome was always going to be a key input into the RBA's next decision. Inflation is falling. The headline and underlying reads were both lower than the RBA's own forecasts. The pullback in the prices of market services would be very pleasing. Today's result increases the risk that the RBA pauses next week to assess the long and treacherous policy lags.**

Tradables vs Non-tradables Inflation
Seasonally Adjusted, Contribution to Annual % Change



Sources: ABS; Macrobond

Non-tradable Inflation
Contribution to Quarterly % Change



Sources: ABS, Macrobond

Headline and Underlying Inflation

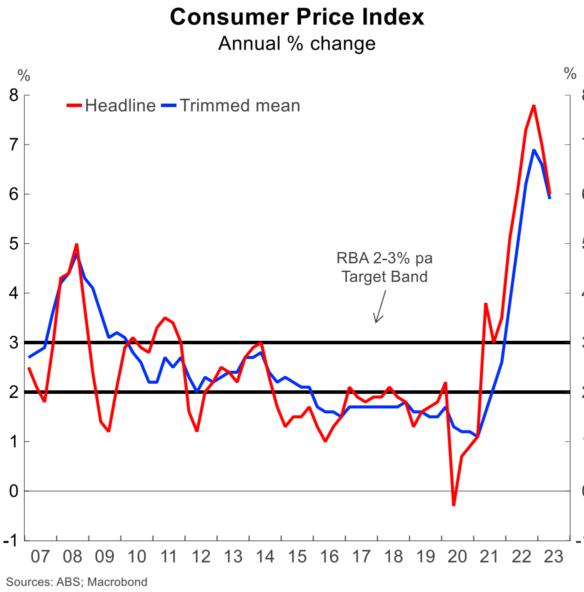
The June quarter inflation report showed that inflation continues to decline at a quicker pace than expected, and that the drivers of inflation continue to shift to domestic factors. The Reserve Bank (RBA) Board likely let out a reserved sigh of relief on the result, though it is only a little win in what is and will be a long and bumpy battle against inflation.

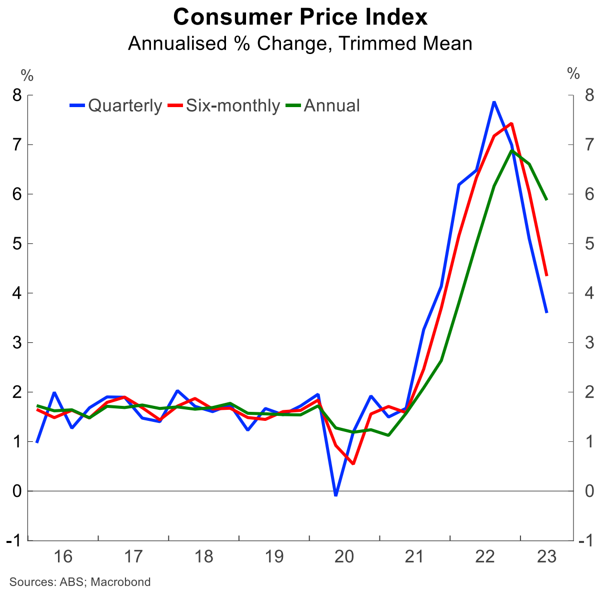
The consumer price index (CPI) rose 0.8% over June quarter to be 6.0% higher in annual terms – the annual outcome represents a decline of 1 percentage point from the last read. It is also lower than the growth of 6.3% the RBA had previously forecast, nothing that they will release updated numbers next week.

The RBA's preferred measure of inflation, the trimmed mean or 'core' inflation, which trims out the largest and smallest price increases at both ends of the distribution, struck a similar tone – that is, a welcomed moderation in inflationary pressures. The trimmed mean rose 0.9% in the June quarter to be 5.9% higher in annual terms.

This represents a moderation of almost 0.75% percentage points compared with the read last quarter. In fact, if core inflation continues to run at the current pace for the next three quarters, core inflation would be around 3.5% in annualised terms - almost touching the top of the RBA's target band.

This will be a positive development for the RBA, as the overseas experience has shown core inflation to be very sticky. The US for example currently has headline inflation running below its core measure of inflation which has only receded marginally from its peak.





Special focus: The prices of tradable and non-tradable items

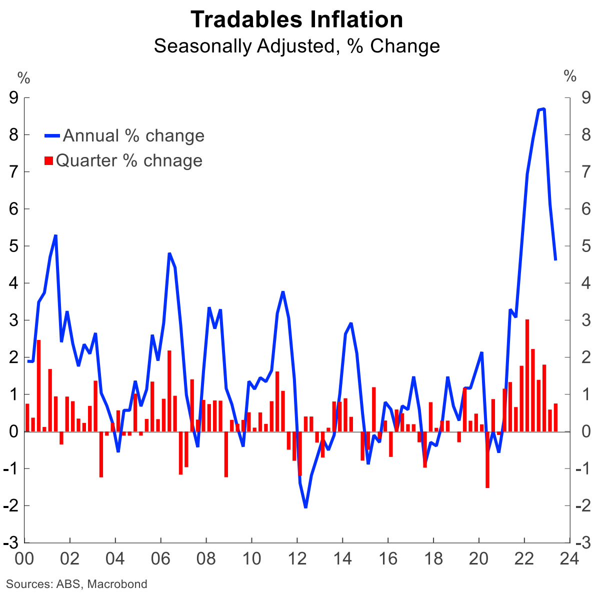
The prices of goods and services we consume can either be determined in global or domestic markets. The distinction has been important for policymakers during the recent bout of inflation as many of the drivers of inflation have been global forces. But as we approach the peak of rate hiking cycles and these global forces subside, it's the domestic drivers of inflation which become the most important. The Australian Bureau of Statistics (ABS) breaks these forces down in to tradable (global) and non-tradable (domestic) inflation.

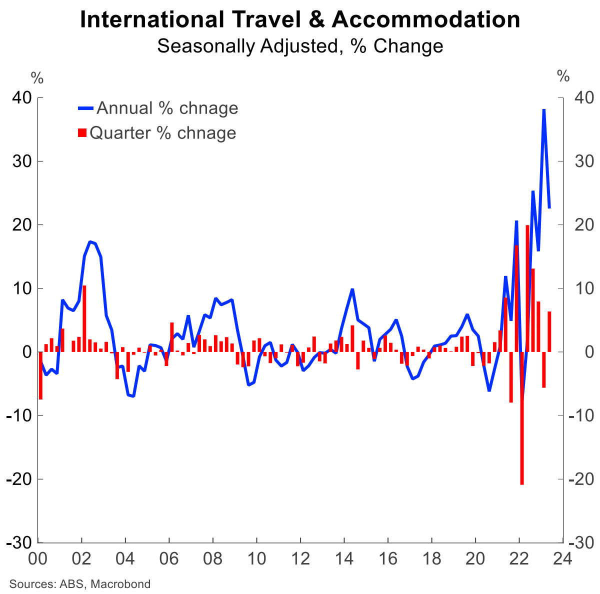
Tradables

The prices of tradable goods and services increased by 0.8% over June to be 4.6% higher in annual terms. While tradable inflation increased slightly from the 0.6% recorded last quarter, today's outcome is a significant step down from the quarterly growth rates of around 3% recorded last year. The rebound in the prices of international travel and accommodation was one of the main drivers of the quarterly increase.

The disinflation impulse reflects several underlying drivers which are combing to shift the global supply curve back to where it was before the pandemic. For example, we have seen a sharp reduction in shipping and freight costs, delivery times have fallen below pre-pandemic levels, supply chains - including due to the reopening of China - are coming back online, and there is a global slowdown which is reducing demand for internationally traded goods. This disinflationary pulse is well-advanced across the globe.

The prices of tradable goods and services are determined by international supply and demand conditions. Australia as a small open market economy usually must take these prices as given. And given the huge hit to the supply curve from the pandemic and the war in Ukraine, these prices skyrocketed. Tradables mainly include goods like fuel, clothing, and footwear, but also includes a small number of services such as international travel and accommodation.





Non-tradables

The prices of non-tradable goods and services increased by 1.0% over the June quarter to be 6.9% higher in annual terms. This was the weakest growth rate since the September quarter 2021.

The prices of non-tradable goods and services are mostly determined by domestic factors such as level of wages growth and government policy. In Australia non-tradables tend to be services and includes items such as household services (i.e. personal grooming), education and housing.

Non-tradables inflation is a crucial metric for the Reserve Bank (RBA) when considering monetary policy settings. Elevated and accelerating rates of non-tradables inflation are a red flag for the RBA, but the headline figure can be misleading.

While the prices of non-tradables are determined by domestic factors, not all components are highly sensitive to domestic economic conditions, particularly in the short run.

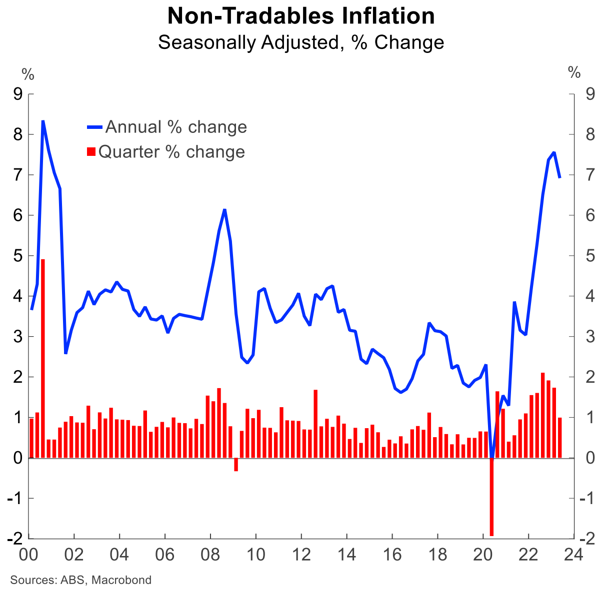
Non-tradables includes regulated prices that are largely influenced by government policy. Take for example childcare, governments have altered the rebate level on childcare fees impacting the out-of-pocket childcare costs measured by the CPI. Governments across all levels have recently announced several measures set to impact regulated prices over the next few quarters including changes to the childcare rebates, transport fare concessions for certain cohorts and electricity rebates.

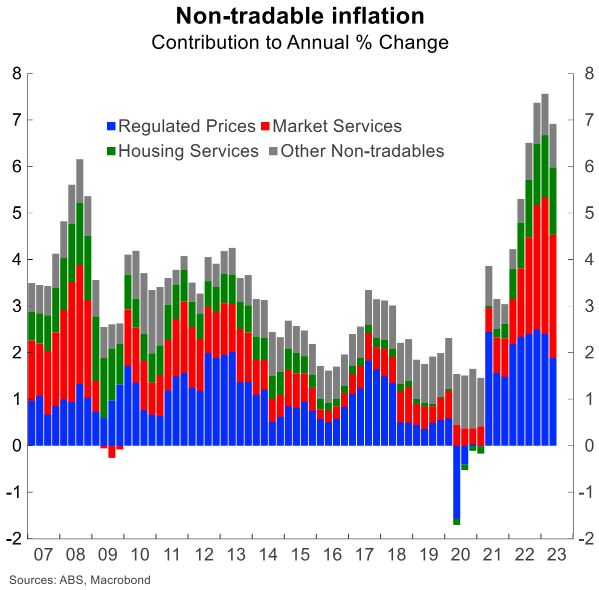
This introduces a considerable amount of noise making it difficult to get a read on underlying inflationary pressures. We have isolated regulated prices to help see through the impact of policy. Regulated prices include utilities, medical and dental services, transport fares, childcare and education. When excluding the impact of regulated prices, non-tradable inflation increased by around 5.0% in annual terms.

Non-tradables also include housing services, namely rents and the cost of building a new dwelling. Rents are determined by the demand and supply balance in the housing market. The record influx of migrants has pushed up against a relatively fixed supply of dwellings leading to an increase in rental costs – this will continue to increase as the higher advertised rent flow into the total stock of rental properties once agreements come up for renewal.

Additionally, the price of constructing new dwellings has been pushed up by higher input and labour costs. As input costs moderate, we are seeing this component ease. Housing is essential, making housing demand inelastic to interest rates. Monetary policy is therefore not an effective tool for addressing housing market inflation and considering the housing component of non-tradable inflation could prompt a non-optimal policy response.

Finally, there are market services, this includes services such as domestic travel and accommodation, restaurant meals, maintenance of motor vehicles, recreational and sporting services. Labour is the main input used to provide these services, and therefore wages are an important determinant of market services prices. This is the component of non-tradable inflation that should be of most interest to the RBA. The prices of market services pulled back significantly, contributing less than 0.4 percentage points to non-tradable inflation, down from the 0.8 percentage point recorded last quarter.





Disinflationary impulse will send households and businesses a price signal!

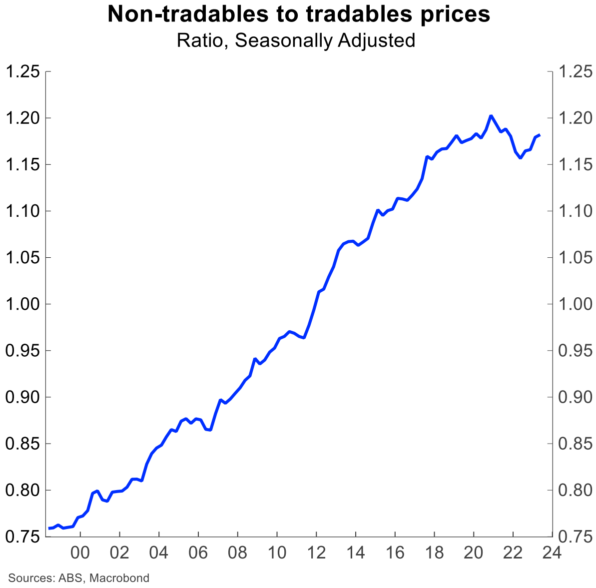
Over the past few years, for the first time on record (since the early 2000s) the prices of tradables have increased by more than the prices of non-tradables. This potentially saw demand for domestic goods (such as domestic travel) increase leading to more domestic demand.

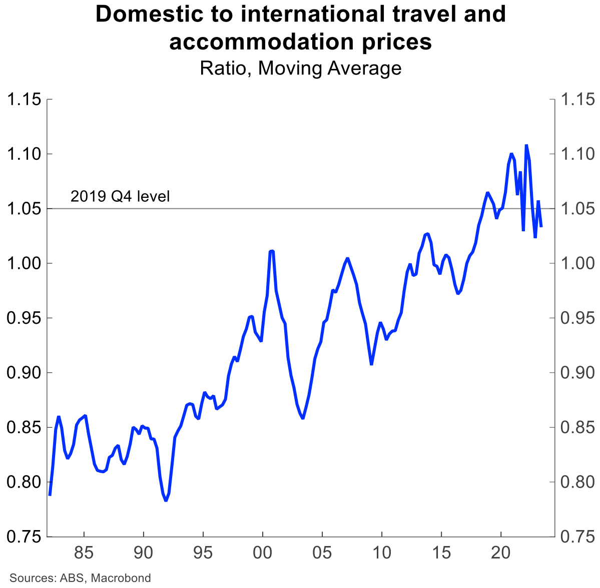
However, we are now seeing this revert with the prices of domestic goods outpacing the growth in tradables. This large change in relative prices could impact demand and supply going forward, without the need for the Reserve Bank to intervene.

On the demand side we could see a shift to tradable goods and services. This could mean households are more inclined to buy overseas goods or services. This will reduce demand for Australian services and therefore domestic economic activity.

On the supply side, while the costs of producing non-tradables is mainly comprised of labour, imports are also used. For example, an office worker will use a computer that will likely be fully imported. In fact, research shows that around 15% of the cost of producing non-tradables come from imports. If these imports are now relatively cheaper, it could reduce domestic inflation pressures.

As a special case, the prices of domestic travel and accommodation increased relative to international prices during the pandemic when boarders were closed. Even though international prices have increased sharply, we are around the same level as the pre pandemic period, which may still encourage some Australians to travel overseas rather than domestically.





Inflation Categories

Reflecting the breadth of the moderation in prices pressures, only three of the eleven major CPI groups accelerated over the June quarter. Indeed, there were five categories that recorded quarterly declines. This indicates that most major CPI categories are now trending in the right direction.

Housing remained the biggest driver of inflation in the June quarter, rising 8.1% in annual terms and contributing 1.8 percentage points to the headline reading. However, a rotation between the housing sub-categories accelerated as cost pressures for new dwelling purchases continued to abate, while rents are storming higher at an alarming pace. This rotation is expected to continue as construction input costs come off the boil and the construction downswing deepens, while there is no near-term reprieve in sight for renters.

Headline Consumer Prices	Quarterly Change (% March Qtr)	Quarterly Change (% June Qtr)	Annual Change (%)
Food & Non-alcoholic Beverages	1.6	1.6	7.5
Alcohol & Tobacco	1.1	1.0	4.7
Clothing & Footwear	-2.6	0.6	0.3
Housing	1.9	0.8	8.1
Furnishings, Household Equipment & Services	-0.5	2.1	6.3
Health	3.8	-0.1	4.9
Transport	0.6	-0.1	1.9
Communication	0.1	-0.4	0.7
Recreation & Culture	0.2	-0.2	6.8
Education	5.3	-0.2	5.2
Insurance & Financial Services	1.9	3.0	8.5
Total CPI (Original)	**1.4**	**0.8**	**6.0**
Total CPI (Seasonally Adjusted)	**1.3**	**0.9**	**6.1**
Trimmed Mean	**1.3**	**0.9**	**5.9**

Inflation by Capital Cities

The quarterly pace of inflation decelerated across all capital cities, also reflecting the breadth of the moderation in prices pressures.

Headline Consumer Prices	Quarterly Change (% March Qtr)	Quarterly Change (% June Qtr)	Annual Change (%)
Sydney	1.4	1.0	5.6
Melbourne	1.2	0.6	6.3
Brisbane	1.9	1.0	6.9
Adelaide	1.2	1.1	4.9
Perth	0.9	0.8	5.5
Hobart	1.2	0.4	5.3
Darwin	1.3	1.2	5.7
Canberra	1.4	1.1	6.0
Total CPI	**1.4**	**0.8**	**6.0**

Monthly CPI Indicator

The monthly CPI indicator showed a continued easing in the pace of monthly inflation. Over the year to June, inflation slowed to 5.4%. This contrasts with outcomes of 6.7% and 5.5% over the year to April and May, respectively.

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