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30 November 2023

ECONOMIC UPDATE

Inflation: the short and long run story

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Key Points

- **Inflation is coming down;**
- **The moderation in the October CPI number wasn't as good as the headlines suggested;**
- **There has been speculation that inflation could be higher and/or more volatile in the future;**
- **A structural shift of inflation is not yet clear in the data.**

Latest on inflation

The monthly October CPI data came in lower than expected (it actually declined in the month), leaving the annual inflation rate at under 5%. A low monthly number was consistent with the most recent NAB business survey. The trend decline in 'underlying' inflation though has slowed in recent months and is something worth watching.

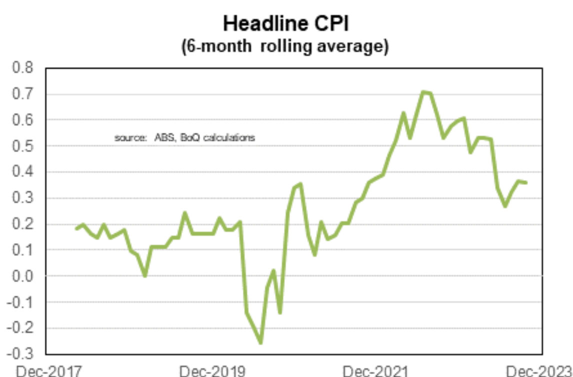
Developments in the global economy suggests that further declines in the annual inflation rate are almost certain in coming months. Indeed, my judgement is that the current inflation run rate in Australia is somewhere between 3-4%. The big question though, is whether inflation will moderate enough to get it back to 2-3% without the need for a significant slowing in economic growth.

Central banks (including the RBA) are currently focussed upon the non-housing service sector (e.g., hairdressers) as a part of the economy where prices are 'sticky'. Maybe this will turn out to be a worry, but the pick-up in service-sector activity lagged that of the goods sector post-COVID. The service sector has also been more heavily impacted by labour shortages. And so, we should expect that service-sector prices would be high now. The extent of the rise of service-sector prices has to date, not been obviously different to goods prices, nor has it yet clearly proven to have been more 'sticky'.

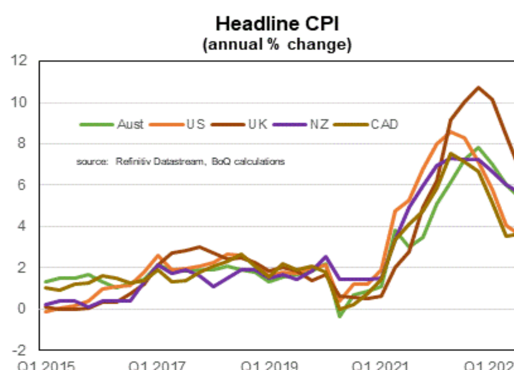
Perhaps a bigger concern has been the rise in financial market inflation expectations. The concern is that higher inflation expectations will be reinforcing: if inflation is expected to stay too high it will be too high.

My view is that the rise of financial market inflation expectations is not reflecting any significant change of investors' central-case outlook on inflation. I think the issue has been financial market uncertainty about the inflation outlook. Inflation has risen and has been away from central banks' targets for a couple of years, with central banks forecasting that it will remain above those targets for at least a couple more. If central banks forecasts are right, that inflation comes back within target by end-2025 (or earlier), then expectations should decline.

Inflation is on the decline. But it is still not low enough.



The decline of inflation in Australia has lagged that in other countries.



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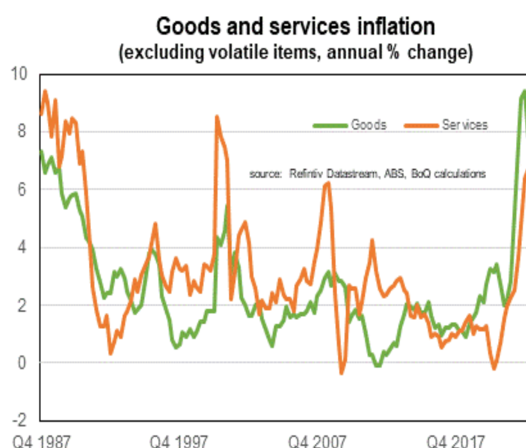
Medium-term inflation expectations are at their highest level in ten years.

It is not clear that services inflation is not following the same path as goods inflation.



Inflation has been the main economic focus over the past year and that will remain the case in 2024. There has also been discussion that inflation in the future could be higher and more volatile in some sectors of the economy. Below I examine the disaggregated areas of the CPI (ex-finance) and make some comments on the short- and long-term outlook.

Food inflation

Food price inflation jumped sharply in recent years reflecting the impact of the Russia-Ukraine War and poor weather. Supply-chain problems and labour shortages increased the price of manufactured food products. Food inflation has slowed sharply this year as the weather has improved. It will take longer for the higher costs that have hit manufactured food products to work its way through the system.

Over the past thirty years, food price inflation has typically been consistent with the 2-3% inflation target. As would be expected, food price inflation has been more volatile, an inevitable consequence of the vagaries of weather.

It has been suggested that more regular extreme weather events (and potentially geo-politics) could increase the volatility of food prices in the future, and perhaps even raise the level of food price inflation in the future. That seems a reasonable proposition, although so far there has been no clear change in trend in food CPI. Even the recent spike in food prices has occurred on other occasions over the past thirty years.

Weather events have yet to result in any sustained decline in major crop yields (such as wheat). While there has been no notable decline in yields, they do appear to have reached a plateau. It is possible that plateau may reflect the disruptions surrounding COVID. There remains scope for productivity improvements in global agriculture as developing countries catch-up to the techniques used in developed economies.

World population growth is projected to continue to increase in coming decades. So, unless yields rise or more land is set aside for farming, the risk is that global agricultural output may stabilise. And an increase in demand for food at a time of flat supply could drive prices higher.

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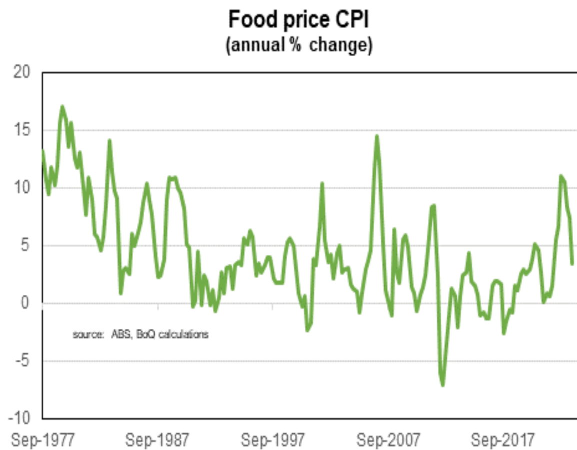
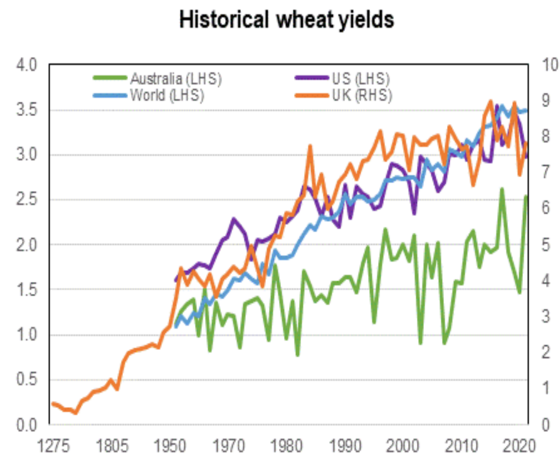
Food price inflation is returning to its normal range.



What yields appear to have reached a plateau.

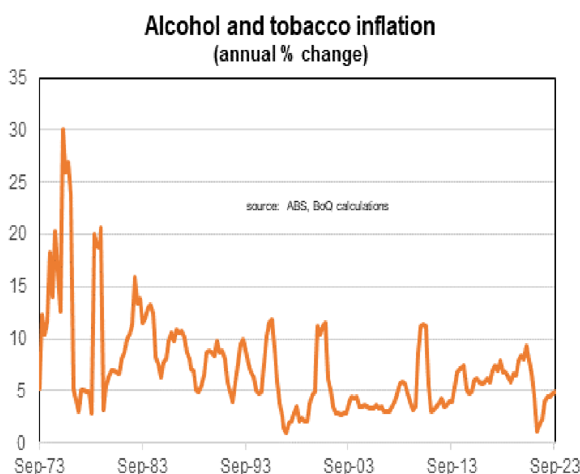


Alcohol and tobacco inflation

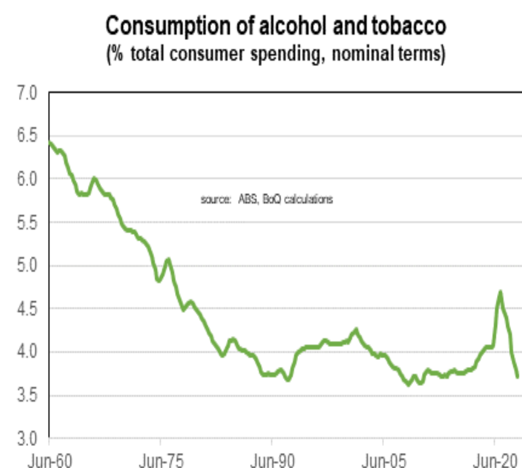
Over the past twenty-five years price rises for alcohol and tobacco have typically risen faster than inflation. Higher prices (and a more educated population) are key reasons as to why the proportion of household incomes spent on tobacco and alcohol has been broadly flat, with less volume of smoking and drinking being offset by a higher price.

Most movements in inflation and tobacco inflation reflect government taxation decisions. And on health (and revenue raising) grounds, tax increases will likely result in tobacco prices rising by more than inflation in coming years.

Alcohol and tobacco price rises has typically been faster than general inflation.



Higher prices and greater health consciousness has led to less tobacco and alcohol consumption.



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Housing inflation

Housing inflation comprises three main areas: the cost of building a new home, rent and maintenance. The ABS also includes rates and charges as well as utility bills, although for analytical purposes I have included those within Administered Prices. Changes in mortgage rates used to be included within inflation but has since been removed on the grounds of circularity (higher inflation leads to higher mortgage rates, that leads to higher inflation). Note that movements in land prices are excluded from the CPI on the basis that it is the housing structure that provides a housing service, not the land (which is treated as an investment).

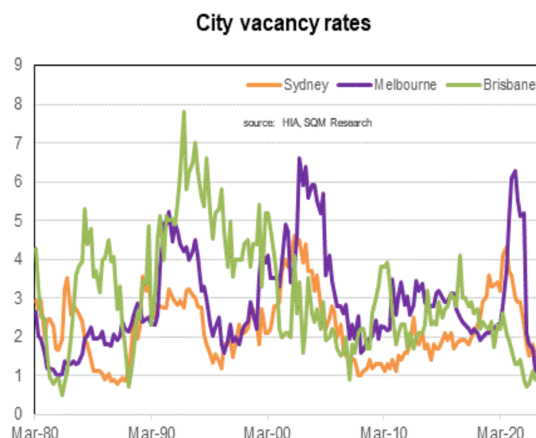
After reaching its highest point in over twenty years, housing inflation has declined sharply mainly reflecting the resolution of global supply chain problems, reducing the growth of building material prices. Further falls are likely in coming months, although the decline in the price of domestically manufactured products could be slower reflecting rising labour and electricity costs.

One area where inflation is likely to remain high over the next year is rents. The combination of strong demand for housing at a time of not enough supply means that rent rises (according to the RBA) could top out at around 10% next year.

Movements in rents are typically tightly correlated with rental vacancies. Vacancy rates are at cyclical lows in most regions, hence the higher rents. This is not the first time that vacancy rates have been this low. Rising rents is leading to a renewed increase in the number of people per household.

Housing inflation has declined sharply this year.

Low vacancy rates are the driver behind higher rents.



Goods inflation

Goods inflation picked up strongly in 2021, reflecting strong demand and supply-chain problems. With demand for goods slowing and global supply chain problems largely resolved price growth is slowing sharply. Further moderation is on the cards in coming months.

On average goods inflation was typically negative in the years leading into the pandemic and played an important role in keeping inflation in the 2-3% target band. Global supply chains increased the efficiency of production and so played a crucial role in keeping inflation low. The longer-term question is whether the de-globalisation results in higher goods prices. There have also been several snarls impacting global

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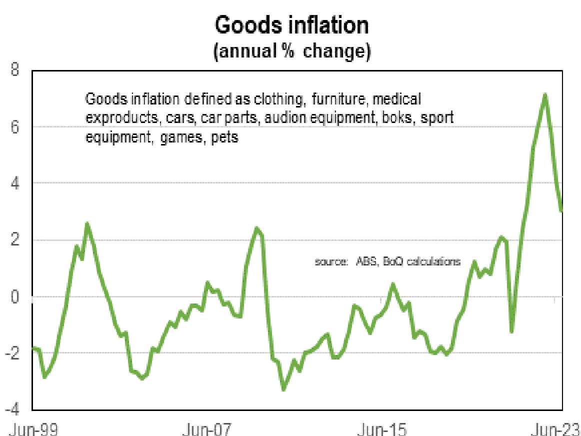
supply chains in recent years that have made firms think about the need to diversify their sources of production.

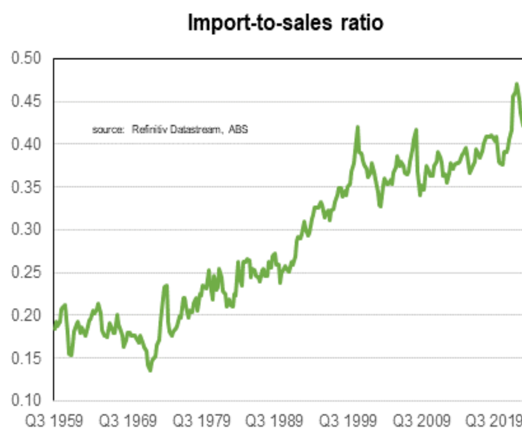
There was already a shift taking place in the manufacturing of the lowest-priced goods away from China as its cost structure rose. While geo-politics is leading to the relocation of some sectors (green energy, health, military) that has not (yet at least) been the case with consumer goods.

It is not yet clear whether these changes will increase the costs of production. If they do, firms can offset the higher costs either through increasing productivity (or reducing margins). That the trend in the import-to-sales ratio is still up suggests that there still is competitive tension in the supply of goods to households.

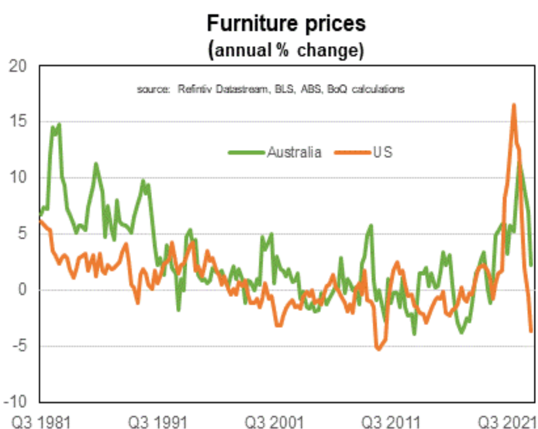
Goods pricing has played a key role in keeping inflation low.



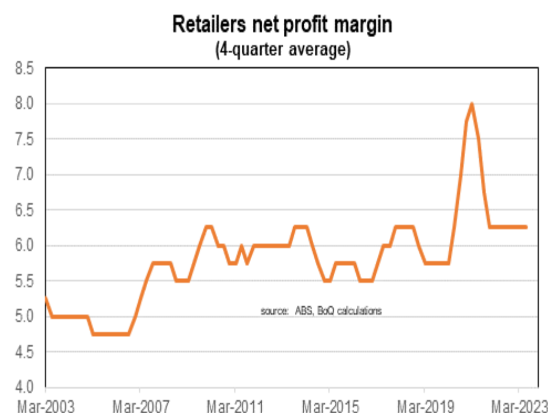
The import-to-sales ratio remains on an upwards trend.



The decline in goods price inflation in Australia has lagged that of other economies.



Retailors margins could narrow, although they remain low by economy-wide standards.

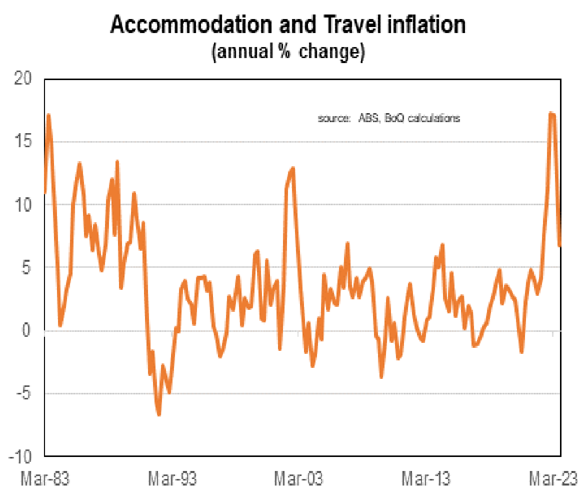


Travel and Accommodation inflation

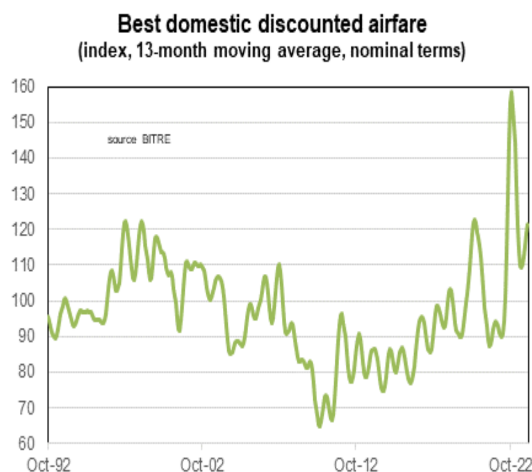
There was a sharp spike in travel and accommodation inflation post COVID reflecting supply problems (lack of flights, not enough staff) at a time of elevated demand. Price growth in this category has slowed sharply this year, and in October was up only 1.3% over the past year, as labour shortages started to get resolved and consumer discretionary spend has slowed.

Travel and accommodation inflation has grown broadly in line with the general CPI over the past twenty years. There has been an upward trend in domestic airfares over the past ten years. I think it is unlikely that travel inflation will rise sustainably higher than CPI in the future given that it is one of the most discretionary spending items.

Travel inflation typically rises in line with the wider CPI.



There appears to have been an upward trend in domestic airfares in recent years.



Services inflation

Services inflation has picked up strongly this year in line with strong demand and labour shortages. As consumer spending on services slows in line with weaker discretionary spending services, inflation will likely slow. The question the RBA is asking is whether services inflation can slow enough given the current strong growth in unit labour costs (the largest cost for firms and the most significant historical driver of price rises).

I think the answer will be yes, as I expect unit labour cost growth to slow in coming quarters. Wages growth is currently around 4% and does not appear to be accelerating further despite the low unemployment rate. In time the slowing economy will likely lead to a weaker jobs market and lower wages growth. That may not happen until 2025. I think that the minimum wage (a key driver of wage increases in the services sector) will rise by less next year. The magnitude of this years' increase was partly as compensation for higher expected inflation, and inflation will very likely be lower next year.

The strong growth unit labour costs also reflects very weak recorded productivity growth. But as previously noted, I think much of the cyclical weakness in productivity reflects distortions surrounding COVID.

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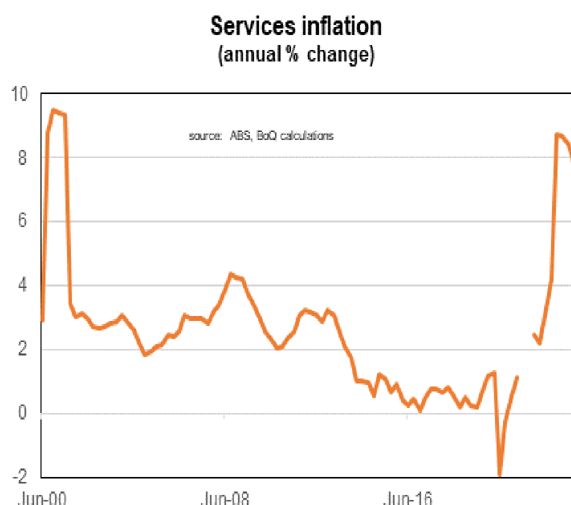
Services inflation this year reached its highest point since the introduction of GST.



Unit labour cost growth is high, but that partly reflects the suspiciously low productivity growth.

Administered prices

Administered prices (prices largely set by governments) has typically risen faster than the general inflation rate. The big increase this year has mainly reflected higher electricity and gas prices, although health (and childcare) prices also typically rise by more than inflation. Movements in wholesale prices suggests that electricity price rises could be lower next year. This will be partially offset by higher Council rates in NSW.

A longer-term question is how the significant investment into clean energy will be funded. Typically investment in the electricity sector has been funded by users through higher electricity bills. If that is the case again then electricity price rises might typically be faster than inflation in the future. If there is substantial Government financing then that will need to be funded through some combination of reduced spending, higher taxation or increased debt. What policy choice governments make will have distributional and (potentially) inflation consequences.

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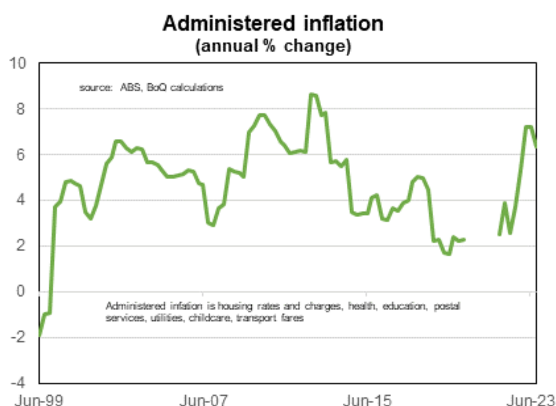
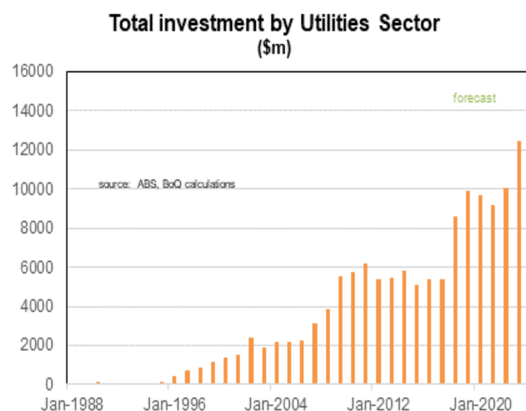
Administered prices have typically risen by more than the CPI.



There is very strong investment into clean energy.



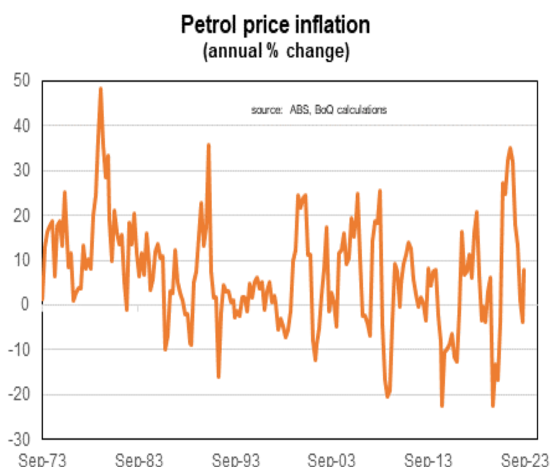
Petrol price inflation

Petrol prices last year rose by their most in over thirty years. The impact of Russia-Ukraine War on oil prices was one factor, but so was the jump in refining margins (due to problems associated with COVID and the War) as well as the weaker $A.

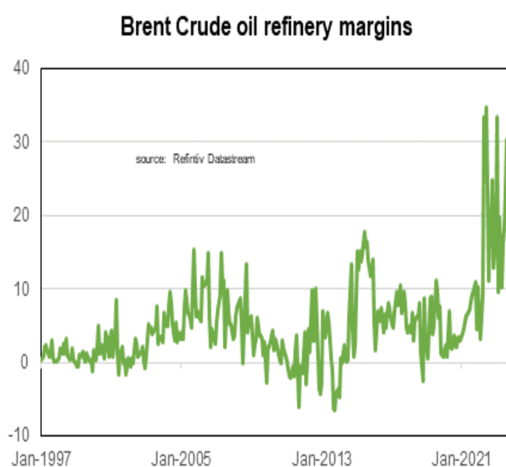
The good news is that these factors now point to a decline in petrol prices. Concerns about weaker global growth has seen a fall in oil prices (despite cuts in production by OPEC). Refining margins have returned to their pre-COVID level. The $A has also started to climb higher, principally because the $US is falling against all currencies given expectations that the US central bank might be cutting interest rates next year.

But there is less investment in the oil industry given the energy transition taking place globally. That transition will take many years which will mean that there will be a period when the demand for petrol (albeit slowing) will take place at a time of potentially constrained supply. The result could be that oil prices are structurally higher in the future. Whether that turns out to be the case will depend upon how quick the demand for oil declines and by how much oil supply declines.

Petrol prices are typically very volatile.



Refined margins have declined sharply.



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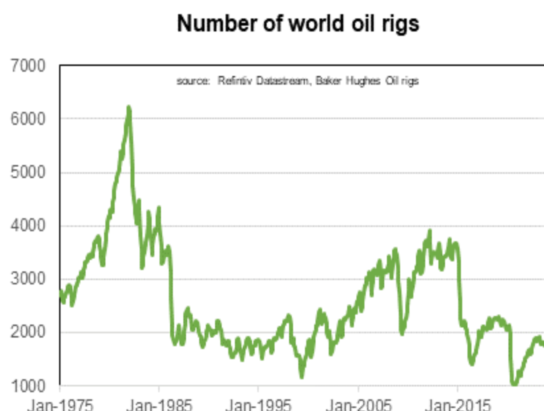
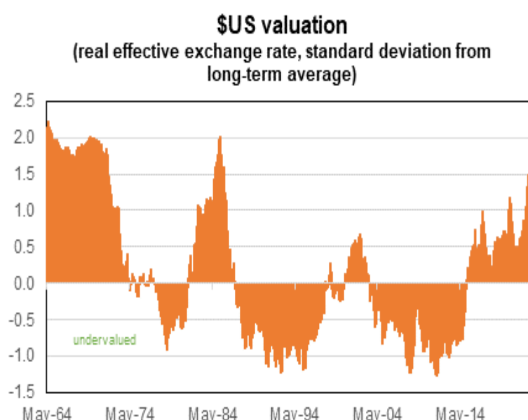
Investment into the oil industry is likely to decline.



On some metrics the $US is over-valued.



In the short term inflation is heading lower. The main question is how much the economy needs to slow (and the unemployment rate rise) to return inflation to 2-3%. That is the big question for 2024.

But there is also the long-term question over the inflation outlook. Recent inflation developments have been overwhelmingly influenced by the interactions of COVID with recent weather events and the Russia-Ukraine War. The questions are whether extreme weather events are going to be more common in the future (probably) and will there be more major geo-political events like Russia-Ukraine (maybe). The impacts of these events get magnified if they happen at the same time as a major supply disruption (COVID) or big increase in demand (very strong economy).

We really do live in interesting times.

Regards

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