Monday, 20 February 2023

Demand-Side Key To Inflation For Future

This month, the Reserve Bank (RBA) increased the cash rate by 25 basis points, as was widely expected. This brought the total amount of tightening in this cycle to 325 basis points in nine meetings – the most aggressive tightening cycle since inflation targeting began in the early 1990s.

However, while this was in line with expectations, the statement included a key hawkish shift which all but confirmed that more hikes are on the way. Specifically, the statement indicated that "the Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary".

Last week, the Governor appeared in front of the Senate Economics Legislation Committee for the Supplementary Budget Estimates, and for the RBA's regular biannual appearance in front of the House of Representatives Standing Committee on Economics.

The Governor faced several lines of questioning and reiterated the inflation challenge facing Australia. Inflation remains very elevated and is increasingly being driven by domestic demand-side factors. While international factors accounted for a large share of the surge in inflation to-date, many of these pressures have peaked overseas and are expected to contribute to disinflation in future. As a result, the key drivers of inflation will increasingly be domestic factors.

Additionally, demand-side factors are not only key in future but have also played an important role so far. In the February Statement on Monetary Policy, the RBA included the results from modelling that suggests that supply-side factors accounted for around one-half to three-quarters of the elevated inflation. Said another way, this means that demand has accounted for around one-quarter to one-half of the inflation. While not as significant as supply, this is still sizeable. Going forward, demand will be the key area to watch as supply-side pressures gradually ease.

Reflecting on this, the Governor made a few notable comments on inflation in the December quarter. Goods inflation remained very elevated in the December quarter, only slowing by 10 basis points in annual terms from 9.6% over the year to the September quarter, to 9.5% over the year to the December quarter. This was at odds with a more material slowing in goods inflation overseas.

In discussing the driver for this strength, the Governor noted that "the most credible explanation is that demand was very strong here in the December quarter".

The Governor also pointed to a few specific categories: "The price of clothing and footwear in the December quarter was up to 2.2% in one quarter. The price of non-durable household goods was up 2.3%. Durable goods prices were still rising strongly in the December quarter. That wasn't the case in many other countries, and it's not the price in global markets."

The Governor also spoke about the rise in services inflation: "The other surprise that we saw in the December quarter was that the prices of many services were rising strongly. The prices of restaurant meals were up 2.1% in the quarter. The prices of domestic travel and accommodation were up 7.5% in the quarter. When we try and unpack why that is, it's because there's strong demand. There's strong demand. We could go on holidays for the first time in years, people could go out with family and friends at restaurants, and prices are going up. While the supply-side factors have been important drivers of inflation, the outcomes in the December quarter had a very strong demand element as well."

Economic Data

RBA Minutes

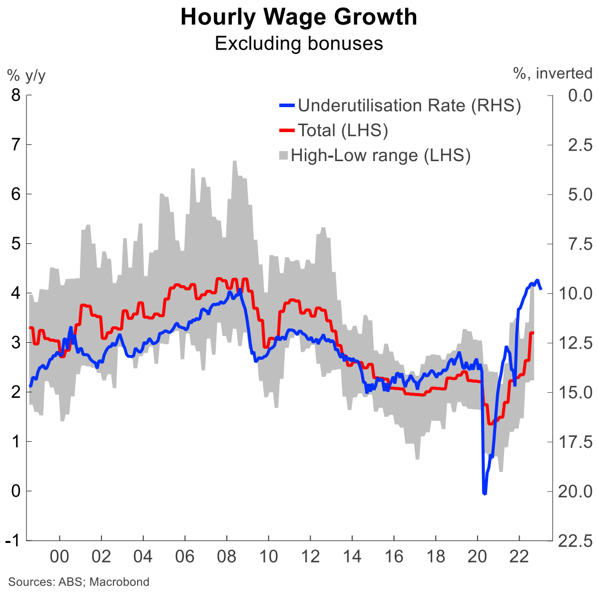
On Tuesday, the Minutes of the February Monetary Policy Meeting will be released. Given the raft of recent communication, the Minutes are unlikely to include any ground-breaking information.

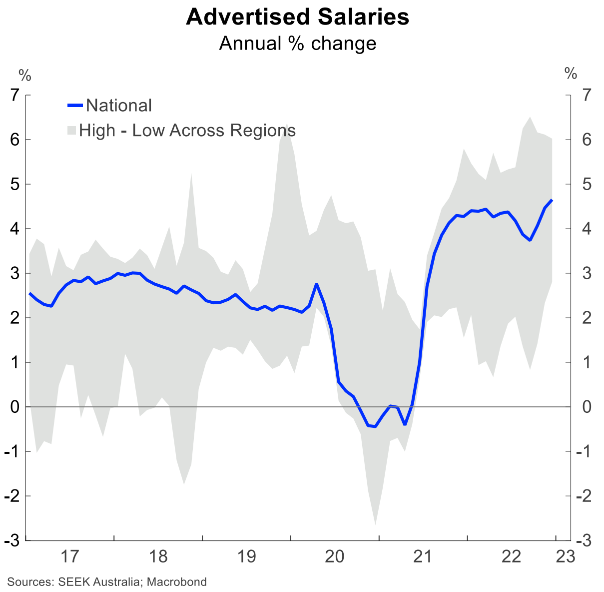
However, they will likely inform us of what options were on the table at the February meeting. In recent meetings, the RBA has considered the case for pausing, hiking by 25 basis points, or hiking by 50 basis points. It will be interesting to see whether all three options were on the table again in February and the arguments for and against the options considered.

Wage Price Index

An important element to understanding demand-driven inflation and particularly services inflation is wages growth. Wages make up a large share of the costs of services so are an important input into final prices. Wages are also key to household income and therefore impact demand.

With a tight labour market, wages growth is expected to accelerate. In fact, historically, wages growth shows a strong relationship with broad measures of labour market tightness, such as the underutilisation rate. The underutilisation rate includes those that are unemployed and underemployed (i.e. people that are employed but would like to work more hours).





The December quarter Wage Price Index (WPI) will be released on Wednesday and will provide key insights into how wages growth evolved in the December quarter. Importantly, the WPI tends to be slow moving as it reflect base wages paid to all employees, including those on enterprise bargaining agreements and award wages, which are typically renegotiated every few years. The headline measure also doesn't include sign on bonuses and other one-off payments that employers may make to attract or keep staff in a tight labour market. Other measures of wages have been suggesting that wage growth is picking up. We expect this to flow through to the WPI over time.

For the December quarter, we expect that wages grew by 1.1%. This would take the annual pace of wages growth to 3.6%, up from the 3.1% annual read in the September quarter.

Capital expenditure (capex)

The latest capital expenditure (capex) survey will be published on Thursday. Through 2022, demand increased strongly as COVID-19 restrictions lifted and consumers unleashed pent up demand. Capacity utilisation rose to record levels as businesses struggled to keep up with this demand. This also contributed to an increase in investment plans as businesses looked to expand their capacity.

In the December quarter, we expect that capex increased by 2.0% in the quarter, reflecting this increased capex spending to take advantage of strong demand. Thursday's data will also provide an update on business spending plans for 2022-23, with the fifth estimate to be published. The survey will also include the first estimate of capex spending plans in 2023-24.

For 2022-23, we expect that spending plans lifted to around $160 billion, up from $155.7 billion for estimate 4. This is likely to have been driven by strong investment plans as demand was still robust, in addition to some lift due to inflationary pressures, as the numbers are reported in nominal terms.

For 2023-24, we project that spending plans will lift to around $132 billion. However, the first estimate of spending plans is typically very volatile and revised heavily in future updates. Revisions are likely in future releases as economic growth is expected to materially slow in 2023, which may not be fully reflected in the first estimate.

Construction Work Done

On Wednesday, the Australian Bureau of Statistics will release the December quarter construction work done survey. This will provide a guide on how construction sector activity is tracking and is an important input into GDP for the December quarter.

There is a large pipeline of construction projects that are being worked through, reflecting the significant stimulus provided during the pandemic. However, the sector has been impacted by weather-related disruptions, including floods, materials shortages, and difficulty sourcing labour.

In the September quarter, a rebound from weather-related in the June quarter contributed to a 2.2% gain in activity. This recovery is expected to have continued in the December quarter. However, the sector is still expected to have faced challenges from materials shortages and labour pressures. On balance, we expect that construction activity expanded by 1.6% in the quarter.

International Data

Internationally, the January release of the core personal consumption expenditure (PCE) deflator, published late Friday night, will be the highlight. This is the Federal Reserve's preferred measure of inflation and will be important for the path of monetary policy in the US. Underlying inflation is expected to remain elevated, with consensus estimates looking for a monthly reading of 0.4%, up from the December outcome of 0.3%. Such an outcome would see the annual number pulling back slightly, to 4.3% in January, from 4.4% in December.

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Forecasts

		2023				2024	
End Period:	**Close (17 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	3.35	3.60	3.85	3.85	3.85	3.60	3.35
90 Day BBSW, %	3.47	3.97	4.05	4.05	3.97	3.72	3.47
3 Year Swap, %	3.94	3.80	3.75	3.70	3.60	3.55	3.50
10 Year Bond, %	3.82	3.45	3.30	3.10	2.90	2.70	2.55
US Interest Rates:							
Fed Funds Rate, %	4.625	4.875	4.875	4.875	4.875	4.375	3.875
US 10 Year Bond, %	3.81	3.40	3.30	3.20	3.10	2.90	2.70
USD Exchange Rates:							
AUD-USD	0.6879	0.70	0.71	0.72	0.74	0.75	0.76
USD-JPY	134.15	132	131	130	129	128	127
EUR-USD	1.0695	1.08	1.09	1.10	1.11	1.12	1.13
GBP-USD	1.2037	1.21	1.22	1.23	1.24	1.25	1.26
NZD-USD	0.6247	0.64	0.65	0.66	0.67	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6879	0.70	0.71	0.72	0.74	0.75	0.76
AUD-EUR	0.6432	0.65	0.65	0.65	0.67	0.67	0.68
AUD-JPY	92.277	92.4	93.0	93.6	95.5	96.0	96.5
AUD-GBP	0.5712	0.58	0.58	0.59	0.60	0.60	0.60
AUD-NZD	1.1013	1.09	1.09	1.09	1.10	1.11	1.13

	2021	**2022 (f)**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	1.0	2.0
CPI (Headline), %	3.5	7.8	3.9	3.1
CPI (Trimmed mean), %	2.6	6.9	3.6	3.1
Unemployment Rate, %	4.7	3.5	4.6	5.1
Wages Growth, %	2.3	3.6	4.5	3.5

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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