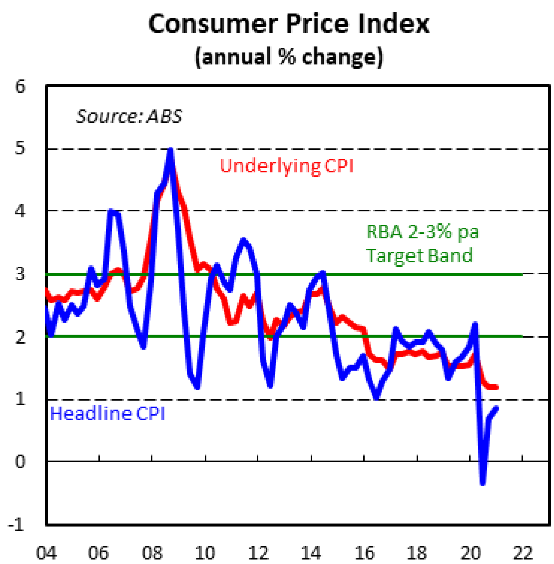
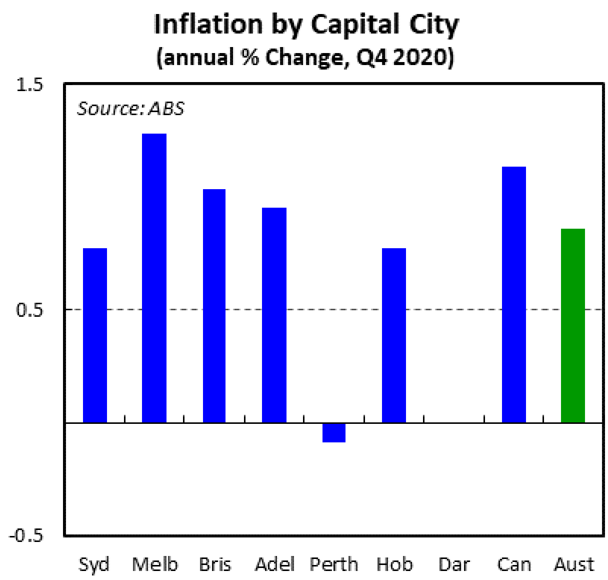
Wednesday, 27 January 2021

# Consumer Price Index

## Government Polices Impact the CPI

- **Headline CPI rose 0.9% in the December quarter. The result was impacted by a range of State and Federal government policies associated with child-care, excises, housing and electricity.**
- **The annual headline rate of inflation picked up from 0.7% in the September quarter to 0.9% in the December quarter. Inflation in Australia remains subdued.**
- **Underlying (trimmed mean) inflation in the December quarter rose by a modest 0.4% for an annual rate of just 1.2%. Underlying inflation is clearly well below the Reserve Bank's 2-3% per annum target band.**
- **A factor that could put upward pressure on prices would be a stronger economic recovery than is currently expected. This could flow from the opening of international borders and the wide and rapid rollout of vaccines against COVID-19. Working against this could be a firmer Australian dollar.**
- **Difficult economic conditions in 2020 have contributed to weak inflation outcomes. While we expect the economy to pick up in 2021, we do not expect this to have a substantial impact on the CPI. We expect underlying inflation to stay below the 2-3% per annum target band at least until 2023.**



**Headline and Underlying CPI**

Headline CPI rose 0.9% in the December quarter, a touch higher than our forecast. Putting upward pressure on the CPI were a 10.9% hike in tobacco prices and a spike of 37.7% in out-of-pocket expenses for child-care as fees moved back to pre-COVID-19 levels.

The annual headline rate of inflation picked up from 0.7% in the September quarter to 0.9% in the December quarter. Inflation in Australia remains subdued.

As with the June (-0.3%) and September (1.6%) quarter 2020 results (-1.9%), the December quarter result has also been distorted by government policy actions. Excise tax increases on tobacco and alcohol added to inflation as did the above-mentioned changes to child-care subsidies. Government housing grants in Western Australia and Tasmania placed downward pressure on housing costs in those States and on the overall CPI index.

Underlying inflation, measured by the trimmed mean, rose by a modest 0.4% for an annual rate of just 1.2%. This is the same annual pace as in the previous quarter and the slowest pace since the measure was introduced in 2003. Underlying inflation removes extreme and volatile items and is a better guide to trends in price changes. The trimmed mean is the measure preferred by the Reserve Bank of Australia (RBA) when deciding monetary policy.

Underlying inflation is clearly well below the RBA's 2-3% per annum target band and suggests that monetary policy will not be eased in the near term and likely not until at least 2023.

The low annual rate for headline CPI (0.9%) and for underlying inflation (1.2%) reflect general weakness in wage growth induced by conditions in the labour market. Job insecurity, the elevated level of unemployment and ongoing COVID-19 related uncertainties provide a poor climate for wage increases.

Federal and State government policies, as well as the RBA's policy settings, are targeted at generating economic growth and job creation. Despite these efforts, it could be several years before inflation sits sustainably in the RBA's inflation target band. Until then, interest rates will stay low and the government plans to continue supporting the economy.

**Groups Analysis**

Of the eleven key CPI groups, seven categories saw prices increase.

Childcare was a major contributor to stronger price increases in the quarter as fees returned to pre-COVID levels. Prices rose a further 37.7% following even larger increases in the previous quarter. The government provided free childcare services for families from April 6 until July 12. However, there were subsidies still in place in Victoria beyond July 12. These ended during the December quarter.

These increases led to an increase of 3.4% in the furnishings, household equipment & services sub-sector. Without the influence of childcare fees, furnishings, household equipment and services would have fallen 0.7% as the prices of personal care products and furniture fell 1.8% and 1.1% respectively.

Easing of State border restrictions and bans on outward international likely contributed toward a 6.3% lift in the recreation and culture group. Interestingly, there was no increase in prices in the group over the year.

Movements within the housing group were of interest. Electricity prices fell 7.5% in the quarter, the largest fall since the series began in 1980. The decline was driven by a household electricity subsidy introduced by the WA government. There was a 0.7% rise in the price of new owner-occupied dwellings and a 0.1% lift in rents during the quarter. Over the year, rents have fallen 1.3%.

Only three groups - communications, housing and clothing & footwear - reported reductions in prices in the December quarter. Telecommunication equipment and services fell 0.4% and over the past twelve months, prices in the communications group have fallen 2.7%. The housing group fell 0.6% driven lower rents and government grants towards electricity and home building prices. Clothing and footwear prices fell 1.0% in the December quarter to be down 1.3% over the year.

**December quarter, 2020**

| Headline Consumer Prices | Quarterly % Change |
|---|---|
| Alchohol and tobacco | 4.2 |
| Furnishings, household equipment and services | 3.4 |
| Recreation and culture | 1.6 |
| Health | 1.3 |
| Education | 1.2 |
| Transport | 0.9 |
| Food and non-alcoholic beverages | 0.2 |
| Insurance and financial services | 0.1 |
| Communication | -0.4 |
| Housing | -0.6 |
| Clothing and footwear | -1.0 |
| **Total CPI** | **0.9** |

*Source: ABS*

**Tradables and Non-Tradables Inflation**

The annual pace of growth between tradables and non-tradables inflation widened further in the December quarter. The divergence between the two is now the largest in nearly six years.

Tradables inflation fell 0.4% in the December quarter, the third fall in four quarters. In annual terms, tradables inflation declined 0.6% - the weakest rate in three years. Tradables inflation measures the prices of imported goods and services and is influenced by global factors, including movements in the currency and oil. In quarterly average terms, the Australian dollar (AUD) appreciated 2.0% against the US dollar, although retreated 0.5% in trade-weighted terms. World oil prices ascended over the quarter; the West Texas Intermediate price of oil lifted 4.7% when using quarter averages.

Non-tradables inflation, which measures the prices of domestically produced goods and services, strengthened 1.5% in the December quarter, close to the 1.6% pace of the September quarter. In annual terms, non-tradables inflation expanded at a rate of 1.5%, the firmest in three quarters.

**Inflation by Capital Cities**

The largest increases in the capital city CPI measures for the December quarter were in Melbourne (1.5%), Brisbane (1.1%) and Sydney (1.0%). Canberra and Hobart saw prices increase 0.8% while Adelaide (0.7%) and Darwin (0.6%) saw more modest increases. Consumer prices fell 1.0% in Perth and were down 0.1% over the year.

On an annual basis, inflation increased in all capital cities except in Perth (-0.1%) and Darwin

(0.0%). Melbourne experienced the largest increase (1.3%), followed by Canberra (1.1%), Adelaide and Brisbane (each 1.0%), Sydney and Hobart (each 0.8%). The weighted average of the eight capital cities was 0.9%.

**Outlook**

Difficult economic conditions in 2020 have contributed to weak inflation outcomes. While we expect the economy to pick up in 2021, we do not expect this to have a substantial impact on the CPI.

Factors that could put upward pressure on prices would be a stronger economic recovery than is currently expected. This could flow from the opening of international borders and the wide and rapid rollout of vaccines against COVID-19.

Elevated unemployment levels tell us that spare capacity exists in the labour market. Under these conditions there is less scope for wages growth. With wages forming a large part of the costs of production, it suggests that prices are not set to rise rapidly in the near term.

It remains to be seen if the Federal government will introduce a modified employment support program beyond the end of March 2021 when the current JobKeeper program ends. A spike in unemployment, post 31 March 2021 would keep upward wage pressures to a minimum.

Also adding some downward pressure on prices would be a rising AUD. While the benefits of a firmer AUD are not always passed on in full, they can assist in subduing inflation. We expect the AUD to firm over the course of 2021.

We expect underlying inflation to stay below the 2-3% per annum band for at least three years.

Given that the underlying measures of inflation are well below 2%, it is reasonable to expect that the RBA will not increase the cash rate for quite some time, at least, not before 2023.

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