Data snapshot

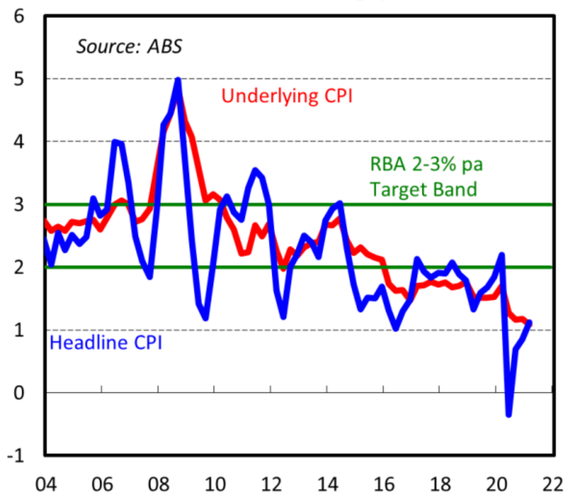
Wednesday, 28 April 2021

Consumer Price Index

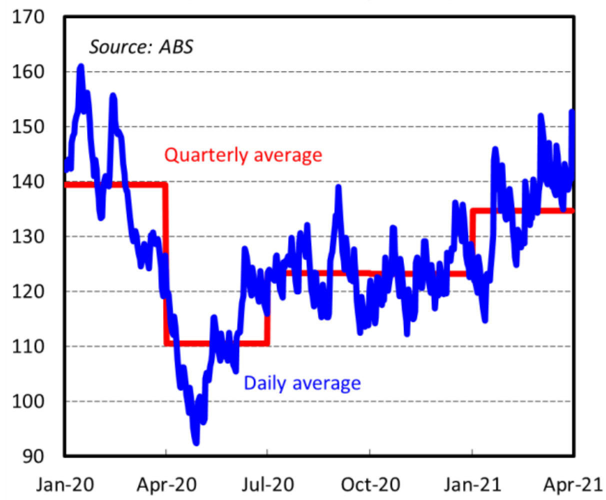
Lethargy Afflicts the Inflation Dragon

- **Lethargy continued to afflict the inflation dragon in the March quarter. The widely anticipated lift in inflationary pressures failed to materialise in a meaningful way.**
- **Headline inflation rose 0.6% in the March quarter. The increase was primarily driven by rising fuel prices alongside the recovery in oil prices. Over the year, headline inflation is up 1.1%.**
- **Trimmed mean inflation, the measure the RBA focused on, increased 0.3% in the March quarter while over the year, growth actually declined from 1.2% to 1.1%. This reading is the lowest annual growth rate on record.**
- **The increase in prices was broad-based across the country, although the larger capital cities displayed weaker price pressures.**
- **But the inflation dragon is set to stir in the June quarter with base effects from last year's falls and the cessation of some government support schemes expected to drive a notable lift in headline inflation. However, we expect this increase will be temporary.**
- **Some investors have been concerned the RBA could be forced to tighten policy sooner than expected because of a surge in inflation. Today's data should dampen such worries and leaves us comfortable with our view that the RBA will not hike the cash rate until 2024.**

Consumer Price Index
(annual % change)



Unleaded Petrol Price
(91 octane, cents per litre)



Headline and Underlying CPI

Worries about a pick up in inflation have been in focus over recent months as record low interest rates, massive fiscal stimulus, pent-up demand and an easing of restrictions drive up inflationary pressures. The Reserve Bank has committed to leave the cash rate at its record low until 2024 at the earliest, although some investors have been concerned the central bank could be forced to move sooner because of a faster-than-expected increase in inflation. However, today's data will dampen such concerns.

Headline inflation rose 0.6% in the March quarter. This result is materially weaker than expected by consensus and ourselves (0.9% and 1.0%, respectively). Over the year, headline inflation is up 1.1%.

The increase was primarily driven by rising fuel prices alongside the recovery in oil prices. Increases in health-related prices also contributed as a result of a cyclical reduction in the share of consumers who qualify for subsidies, the Medicare safety net and Pharmaceutical Benefits Scheme.

Underlying inflation, captured by trimmed mean inflation, increased 0.3% in the March quarter. This measure strips out the most extreme price movements given headline inflation is often volatile. Annual growth in underlying inflation declined from 1.2% to 1.1%. This is the lowest annual pace on record.

The RBA prefers this underlying measure to determine policy settings. Clearly, underlying inflation remains well below the central bank's 2-3% per annum target. The RBA expects inflation will not sustainably return to this target band until 2024 at the earliest.

While we will get a better read on the possibility of a sustained rise in inflation later in the year, the message from today's numbers is that low rates look here to stay for some time yet.

Groups Analysis

Prices increased in nine out of the eleven CPI groups.

A 3.2% rise in transport costs was the main driver of the pick up in headline inflation. This was underpinned by an 8.7% increase in fuel costs. Prices have been increasing at the petrol pump as oil prices recover from their large falls in early 2020, which were associated with global lockdowns.

An increase in health-related prices was also a notable contributor to the overall lift in inflation. This reflected a cyclical fall in the proportion of consumers that qualify for subsidies under the Medicare safety net and Pharmaceutical Benefits Scheme. These thresholds reset on 1 January, meaning very few households have spent enough to gain access to the support programs.

The housing group rose only 0.1%, but this masks a range of underlying movements influenced by state and federal government assistance schemes:

- Maintenance and repair of dwellings rose 1.1% as prices returned to normal levels after the conclusion of the Northern Territory's Home Improvement Scheme.
- Meanwhile, electricity prices fell 0.9%, although this varied considerably by state. Prices fell in Melbourne following a review of Victorian electrical prices. But they surged 41.6% in Perth, returning to more normal levels after a subsidy was introduced by the WA government in December.
- New dwelling purchases by owner-occupiers in fact declined 0.1% in the March quarter,

despite the huge surge in house prices. This reflects HomeBuilder and construction grants in WA and Tasmania. In the absence of government grants, this category would have increased 1.9%.

- Rents were unchanged.

There were also price gains in clothing and footwear, communication and education. Food prices increased; there was a notable pick up in beef and veal prices – farmers are rebuilding herds after a prolonged drought and have solid demand from emerging Asia. A return to eating out as lockdowns eased also contributed to a pick up in the prices of takeaway and restaurant meals. Alcohol prices increased while tobacco prices declined – an unusual occurrence.

The furnishings, household equipment and services group declined. Furniture fell 3.0% because of post-Christmas discounting, which more than offset a seasonal increase in childcare prices.

There was also a fall in recreation and culture underpinned by a decline in domestic holiday travel and accommodation. At face value, this is surprising given we know Australians are holidaying more at home, and there have been widespread reports this has pushed up accommodation prices. And accommodation prices did rise, however, this increase was offset by a decline in airfares. The entrance of a new player in the airline market, Regional Express, led to discounting between domestic carriers.

Other recreational, sporting and cultural services saw increases in prices as easing restrictions bolstered the sector. The relaxation of capacity limits in venues has provided welcome relief to industries which have been hard hit by the pandemic.

March quarter, 2021

Headline Consumer Prices	Quarterly % Change
Transport	3.2
Health	2.0
Clothing and footwear	0.5
Communication	0.5
Education	0.4
Food and non-alcoholic beverages	0.4
Alchohol and tobacco	0.3
Insurance and financial services	0.1
Housing	0.1
Furnishings, household equipment and services	-0.2
Recreation and culture	-0.2
Total CPI	**0.6**

Source: ABS

Tradables and Non-Tradables Inflation

Tradables inflation lifted 1.1% in the March quarter, after a fall of 0.6% in the December quarter. 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 5.6% against the US dollar and lifted 4.5% in trade-weighted terms. World oil prices also ascended over the quarter. The West Texas Intermediate price of oil rose 36.2% when using quarter averages, as pent-up demand propelled prices higher.

On a year ago, the annual pace of tradables inflation rose from a contraction of 0.6% in the December quarter to a rise of 0.7% in the March quarter.

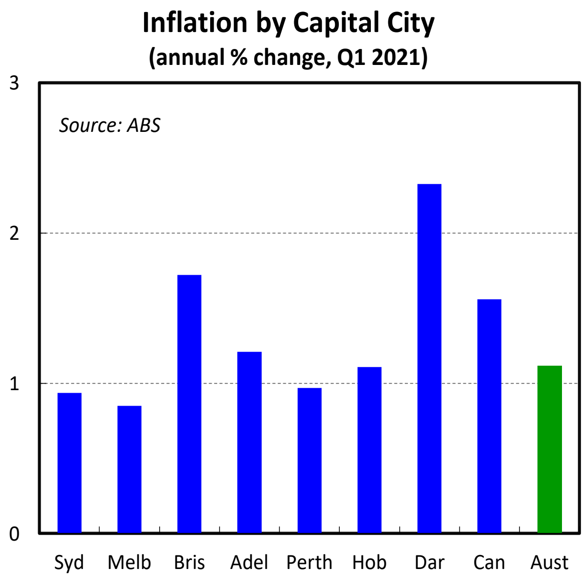
Price pressures for domestically produced goods and services rose only 0.4% in the March quarter, causing the annual rate of inflation to slow from 1.5% in the December quarter to 1.3% last quarter.

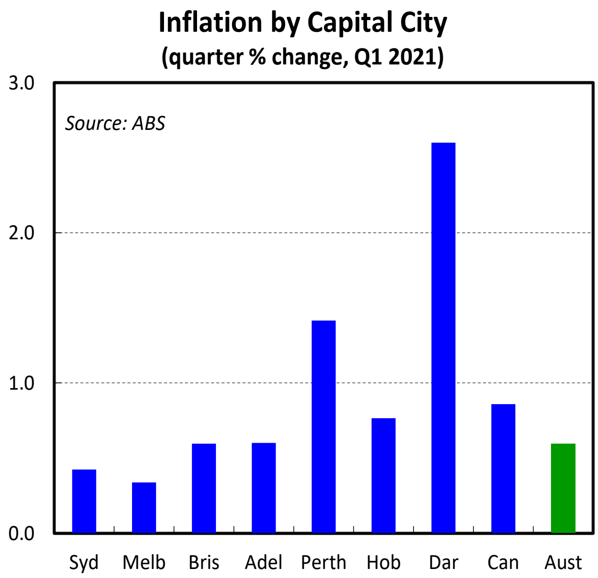
Inflation by Capital Cities

The largest increases in the capital city CPI measures for the March quarter were in Darwin (2.6%) and Perth (+1.4%). The smaller capital cities of Canberra and Hobart also recorded solid quarterly gains of 0.9% and 0.8%, respectively.

The larger capital cities displayed the smallest price pressures. Melbourne recorded the slowest pace of increase in the quarter of 0.3%, followed by Sydney where the CPI rose 0.4%.

In year-on-year terms, the firmest annual growth rate occurred in Darwin with a pace of 2.3% - the fastest clip in 6½years. The slowest annual rate occurred in Melbourne (0.8%).





Outlook

Lethargy continued to afflict the inflation dragon in the March quarter. The widely anticipated lift in inflationary pressures failed to materialise in a meaningful way.

But the inflation dragon is set to stir in the June quarter with base effects from last year's falls in consumer prices feeding through to the CPI. Moreover, the cessation of some government support schemes, such as HomeBuilder and utilities rebates, should cause a notable lift in price pressures next quarter. However, policymakers expect this lift in inflation will be transitory and we know policymakers look through temporary effects. In other words, this will not prompt a response from the RBA.

Over the year ahead, pent-up demand, accommodative policy settings and an easing of restrictions will also help drive inflationary pressures.

The bond market is not convinced that the coming pick-up in inflation is entirely temporary. Today's data will leave the bond market a little more convinced. Nevertheless, the debate over the path of inflation is still likely to intensify as we move through 2021.

As this discussion continues, it is important to keep in mind that the RBA is focused on actual inflation. It made this pivot last year. In speeches and statements this year, the RBA has been at pains to stress actual inflation needs to move sustainably into the RBA's 2 to 3% target range before conditions can be met to raise the cash rate. For this to happen, wages growth needs to grow at 3% or more per annum.

Unemployment has fallen faster and earlier than widely anticipated. Indeed, the unemployment rate dropped to 5.6% in March and we now expect the unemployment rate to be at 5.0% by the end of this year and have a '4' in front by the end of 2022. But spare capacity continues to be a feature of the labour market.

The momentum in the labour market means this spare capacity will be reduced over this year and next year, but it will not be erased. The RBA now believes the rate of unemployment consistent with full employment is somewhere between the high 3s to low 4s. It means the unemployment rate needs to fall to the low 4s or high 3s before significant wage pressures can build.

Today's data then leaves us comfortable with our view around future policy settings.

- No lift in the cash rate of 0.10% before 2024.
- The yield-curve control (YCC) program to be directed from the April 2024 bond to the November 2024 bond, most likely announced in August 2021. YCC involves the RBA buying bonds to maintain a 3-year government bond yield of around 0.10%.
- An extension of the quantitative easing (QE) program (or bond-buying program) for government bond maturities of 5 to 10 years. The second tranche of the RBA's $100 billion QE program (i.e. QE2) is due to end in late August 2021. We expect a third tranche of $100 billion to be announced before QE2's expiry. We also think QE4 will follow QE3, but that tapering will commence with QE4. We expect QE4 will be $50 billion in size and it is likely to be the last tranche.

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