ECONOMIC UPDATE

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WEEK ENDING 30TH JULY 2021

Summary

- Inflation in Australia is picking up;
- But it remains comfortably below the RBA's target;
- Sustained economic growth domestically and globally growth will be needed to ensure ongoing inflation will be higher;
- Stronger growth will happen, although the Sydney lockdown is a serious bump on that road.

The Q2 CPI number was up a big 0.9% in the quarter (3.9% over the year). You have to go back to the pre-GFC days to see a higher annual number. The size of the increase was not a surprise. Measures such as trimmed mean and weighted median showed underlying inflation has risen from its lows but is well below the RBA's 2-3% target band.

The ongoing inflation rate is currently running at about 1.75% in Australia. This is below the inflation rate the RBA want to see before raising rates. Inflation expectations are consistent with stronger price growth in the short term. But they are not yet consistent with ongoing inflation to be as high as the RBA would like.

The RBA has made wages growth a major factor to be watched. Prices are often set on a cost-plus basis and labour costs are the biggest cost for most firms. And wages growth is the main determinant of the strength of consumer spending. But it is total business labour costs that matter for firms. A more productive firm can afford to pay higher wages.

A chart of wages growth and inflation shows that they have moved together over the past five years. But in the preceding years the relationship was not as tight. Wages growth has its main impact upon domestic-produced service prices. At any one point wages influence on inflation can be overwhelmed by movements in goods prices that are determined by global factors and movements in the exchange rate. And Governments' set the price for a range of important services (childcare, health, utilities, insurance).

The tightest relationship with inflation in Australia is inflation in the other developed countries. Global factors drive important commodity prices (such as oil). Important influences that have kept prices low in one economy (technology, global competition) have kept them low in all. If major developed economies (particularly the US) are having a strong run of economic growth that will likely mean that all countries will benefit. The link between developed economies has only got tighter since the de-regulation of financial markets as money can now flow easily to the regions offering the highest returns.

Once the Sydney lockdown is over (which we all hope is soon) then the economy is likely to bounce-back sharply. For a period of time demand will again be strong and at a time of limitations to supply of labour and some materials. This will mean higher inflation than current RBA expectations. And therefore they will need to move earlier than their current view (H1 2024). But the uncertainty created by the Sydney Lockdown means that they will be in no hurry to change their view, at least for the rest of this year.

Inflation in the June quarter

In most people's lifetimes the main worry has been about inflation being too high. This has changed in more recent years where the discussion has about it being too low. The latest CPI report had a flavour of both.

The Q2 CPI number was up a big 0.9% in the quarter (3.9% over the year). You have to go back to the pre-GFC days to see a higher annual number. The size of the increase was not a surprise. The same quarter last year inflation was artificially low as large slabs of the economy was in shutdown. While lockdowns (unfortunately) remain a part of life, much of the economy (and therefore prices) has moved back towards 'normal'. High petrol prices boosted the number (mainly because of a stronger global economy). As did the end of childcare and Perth electricity subsidies. Increases in the upcoming quarterly CPI numbers will be more modest.

The RBA benchmarks itself on headline inflation. But when setting policy it always tries to look through volatile items to get an understanding of what the ongoing inflation rate will be. 'Mathematical' measures (trimmed mean and weighted median) showed underlying inflation has risen from its low but still below the RBA's 2-3% target band. The vast majority of prices are rising by under 2%, a lot fewer faster than 3%. The increase in goods prices has settled down as the manic demand for computer monitors and toilet paper has abated. With more restaurants, cafes and tourism hubs opening service prices have started to return to normal.

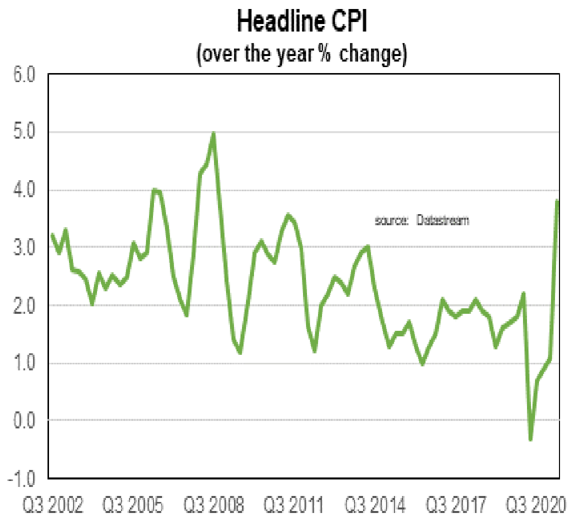
The HomeBuilder subsidies drastically mitigated the rise in housing for the consumer. Without it the 'mathematical' measures of underlying inflation would have been a lot closer to 2% (compared to the actual of rise of 1.6%). The HomeBuilder program also boosted the demand for housing. Without it the pressure on construction costs would not have been as strong.

The message from the Australian CPI data is the same as the inflation numbers for other developed countries. While the prices for some goods have jumped sharply they are a lot more modest for most other goods and service. Countries with an inflation rate closest to their central bank targets (the US, New Zealand and Canada) are the ones that financial markets expecting to see rates rise rates first (with New Zealand potentially going as early as next month).

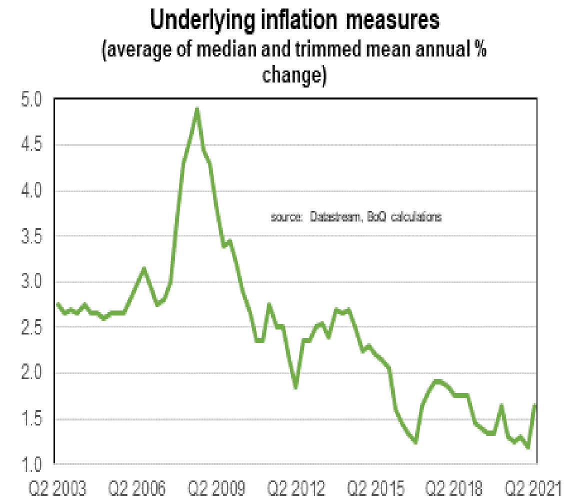
Ongoing inflation is currently running at about 1.75% in Australia. This is a little higher than what the RBA expected when it last published a forecast (May). But still well below the inflation rate they will want to see before raising rates.

Once the Sydney lockdown is over (which we all hope is soon) then the economy is likely to bounce-back sharply. For a period of time demand will again be strong and at a time of limitations to supply of labour and some materials. This will mean higher inflation than current RBA expectations. And therefore they will need to move earlier than their current view (H1 2024). But the uncertainty created by the Sydney Lockdown means that they will be in no hurry to change their view, at least for the rest of this year.

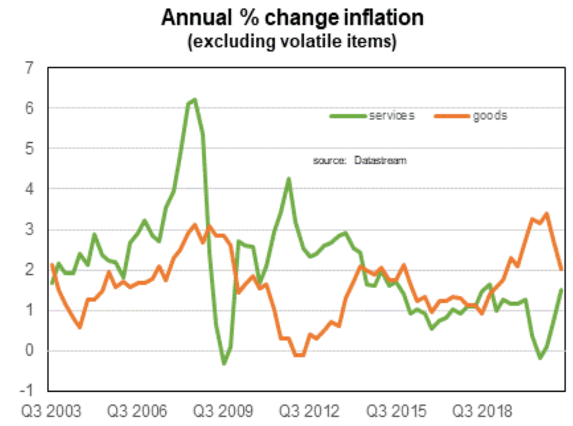
Inflation has risen to its highest level in over one decade.



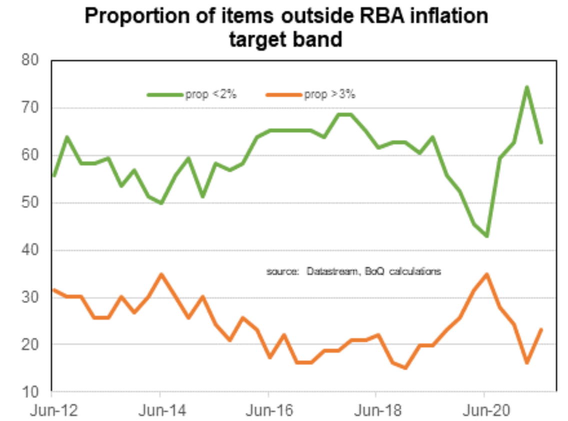
'Underlying inflation has also risen, but far more modestly.



The price rises for both goods and services is returning to normal.



For most goods and services the prices rises have been only modest.



Drivers of inflation

What factors should be watched to see whether ongoing inflation is rising to within the RBA's 2-3% target? One is inflation expectations. If households and firms expect prices to be high, they are more likely to be high.

Consumer inflation expectations has picked up in recent months although are at the low end of their range of the past twenty-five years. Financial market inflation expectations have also recently risen. But they expect inflation to only rise to the bottom half of the RBA's target range. If that happened that would be a disappointing outcome for the RBA. While businesses expect high price rises over the next quarter we don't have a good measure of what their medium- to longer-term views are. Overall, inflation expectations are consistent with higher inflation in the short term. But they are not yet consistent with ongoing inflation to be as high as the RBA would like.

The RBA has made wages growth a major factor to be watched. There is something to that view. Prices are often set on a cost-plus basis. Labour costs are the biggest cost for most firms. And wages growth is the main determinant of the strength of consumer spending.

A focus purely on wages growth misses the point thought that it is total business labour costs that matter for firms. This not only includes movements in non-wage labour costs (superannuation, payroll tax) but also changes in productivity. A more productive firm can afford to pay higher wages. The view that wages growth is the only variable to be watched assumes that profit margins stay unchanged.

A chart of wages growth and inflation shows that they have moved together over the past five years. But in the preceding years the relationship was not as tight. Wages growth has its main impact upon domestic-produced service prices. At any one point wages influence on inflation can be overwhelmed by movements in goods prices that are determined by global factors and movements in the exchange rate. On a shorter term basis shifts in the prices for 'volatile items' (petrol, fruit and veg, meat) can also impact inflation. And Governments' set the price for a range of important services (childcare, health, utilities, insurance).

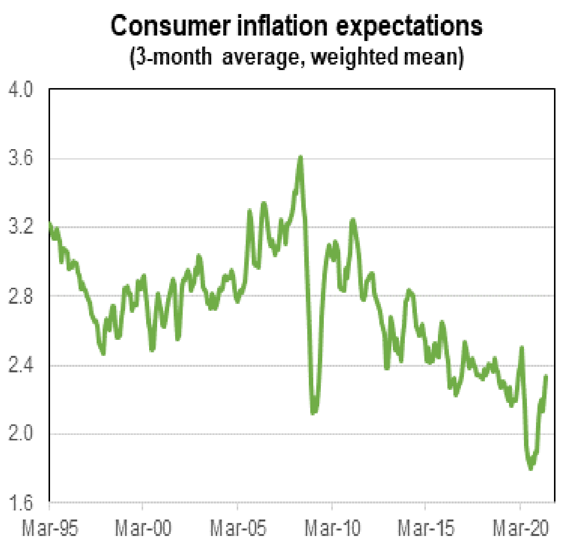
One factor that used to be discussed as a key driver of inflation was the money supply. This view was made famous by the observation from the well-known economist Milton Friedman that 'inflation is always and everywhere a monetary phenomenon'.

Up to the early 1990s there was a close relationship between inflation and the money supply. But that relationship has broken down over the past three decades. Some analysts have suggested that the breakdown was a result of the increase in the money supply sitting in bank accounts and not being spent. But the relationship between the money supply and credit growth remains unchanged suggesting that the rise in the money supply did enter the economy. But it is true that the 'velocity' of money (how often each $ is spent in the economy) has declined substantially over the decades.

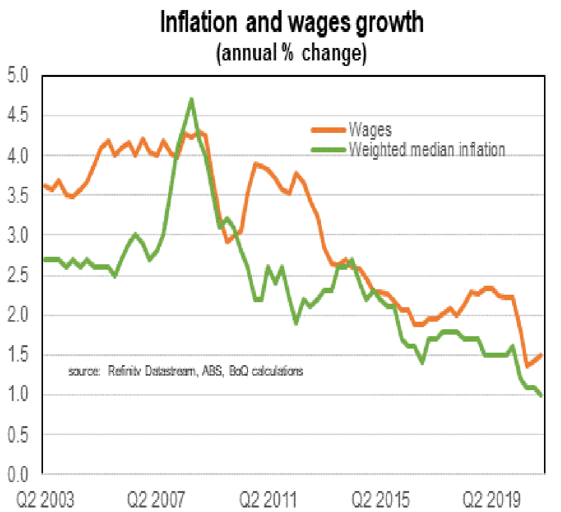
Other analysts believe that while the increase in money supply while not impacting the price of consumer goods and services has influenced the price of assets. But the relationship between excess money supply (the growth of money supply above nominal income growth) and changes in the Australian sharemarket has been mixed over the past 40-50 years.

The tightest relationship with inflation in Australia is inflation in the other developed countries. Price rises can differ between countries depending upon how their CPI is measured and the state of each country's economic cycle. But over time the fate of developed economies are linked. Global factors drive important commodity prices (such as oil). Important influences that have kept prices low in one economy (technology, global competition) have kept them low in all. If major developed economies (particularly the US) are having a strong run of economic growth that will likely mean that all countries will benefit. The link between developed economies has only got tighter since the de-regulation of financial markets as money can now flow easily to the regions offering the highest returns.

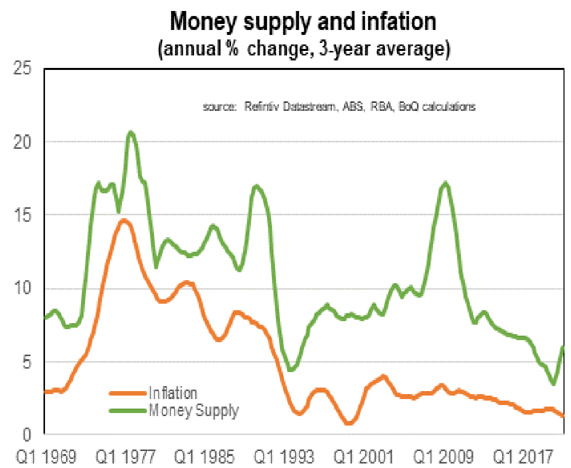
Consumer inflation expectations are low. But they have picked up



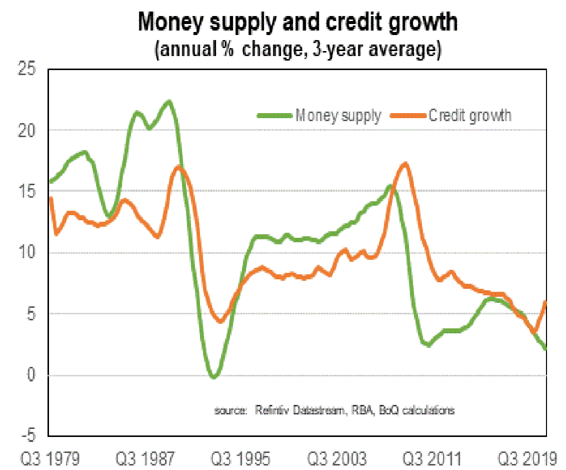
Wages growth is important for inflation. But it is not the only factor.



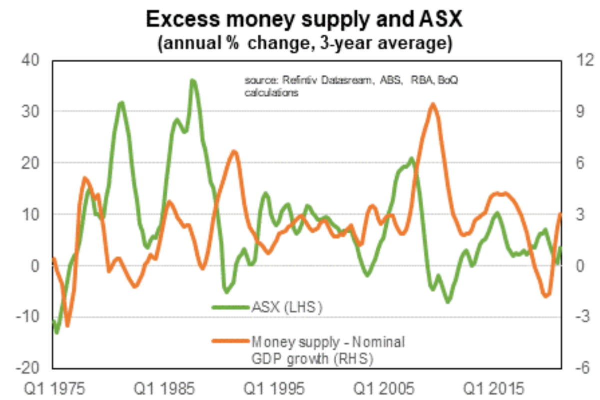
The link between money supply and inflation has broken down over recent years.



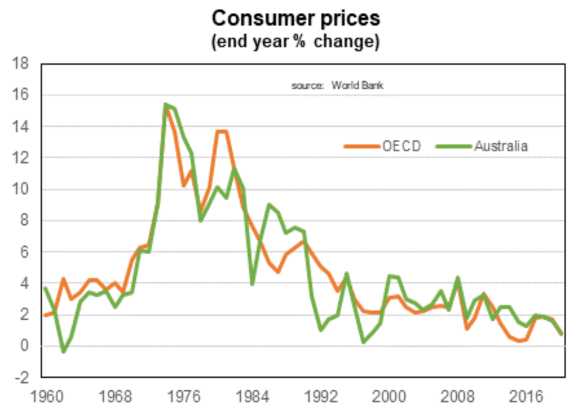
The link between money supply and credit growth has not.



Movements in the money supply are not always correlated with movements in the sharemarket.



But there is a tighter link between changes in domestic and international inflation.



The bottom line. In the short term inflation in Australia can be influenced by a range of factors, including the weather, government policies and the exchange rate. But over any extended period of time it is developments in the domestic and global economy that matters most. If economic growth is strong enough for long enough, the unemployment rate will fall, wages will rise and so will prices.

How strong demand needs to be for how long does depend upon developments on the supply-side of the economy. Over the next 1-2 years there will be constraints on supply reflecting the closed international border and supply-chain problems. In the longer term it will be determined by how big the changes end up being that are taking place in the international trading system.

For now, overall demand is still too low to make inflation a pressing concern. It is likely to remain so while lockdowns remain in place. But at some stage in the next couple of years demand will become too strong for the available supply. That will be the time for RBA action.

We live in interesting times.

Regards,

Peter Munckton
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