ECONOMIC UPDATE
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WEEK ENDING 5TH FEBRUARY 2021

BOQ GROUP

Summary:

- **Inflation and wages growth is very low;**
- **And all the signs are that in the near term it will remain low;**
- **Making sure that inflation expectations does not decline further will be important;**
- **The cash rate is unlikely to rise for at least the next 3 years.**

The economy has had a good past couple of months. The RBA and consensus thinks this good run has further to run, recently upgrading their GDP and downgrading their unemployment rate forecasts. Although the jobs market has improved substantially over the past six months the level of the underutilisation rate indicates it is far from good enough. The tell-tale sign of a subdued jobs market is that wages growth is at its slowest pace on record.

Inflation is very low. And there is noise in the inflation numbers. What price to put on service activities that have endured COVID restrictions is a particular concern. Another is how much will prove to be 'temporary' inflation and how much 'ongoing' inflation.

The longer inflation stays too low the more likely people will expect it to remain low. Financial markets have already given the RBA's game plan a tick of approval, pricing inflation to return to the middle part of the RBA's target (although not within the next 2-3 years). But consumers and firms have yet to get the same vibe.

What factors might drive inflation higher? The biggest single cost that most businesses face is labour costs. Unit labour costs have declined dramatically over the past year. A fair bit of that is temporary and will be unwound. But as the RBA has noted wages growth is extremely low and expected to stay that way for at least the next couple of years. And Australia is currently not importing inflation.

The RBA is going all in to achieve a stronger economy. With fiscal support and some luck with the virus they are likely to achieve their aim. And in time this will lead to higher inflation. But history has shown that inflation can stay very low for an extended period of time. And most likely that will be the case for at least the next 2-3 years.

The economy is in the early days of spring

The economy has had a good past couple of months. And the financial market consensus is that those good times will last at least through 2021. The RBA agrees, having recently upgraded its GDP and downgrading their unemployment rate forecasts.

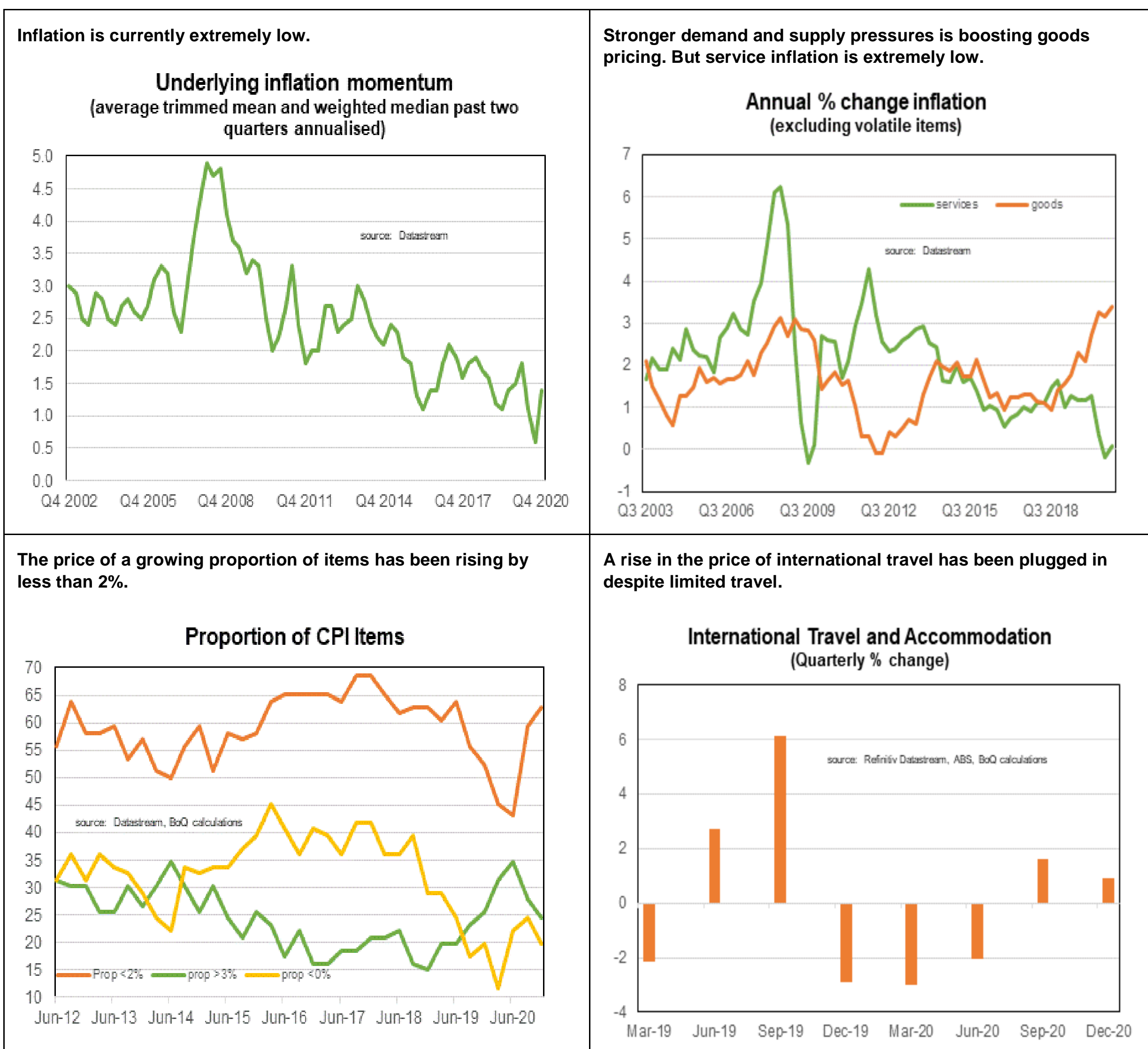
The key message from the RBA is that forecasting a strong economy will not be good enough for monetary policy to change. There will actually need to see proof that the economy is strong, and will be strong for an extended period. This is necessary. Although the jobs market has improved substantially over the past six months the level of the underutilisation rate indicates it is far from good enough. The tell-tale sign (as the RBA noted) of a subdued jobs market is that wages growth is at its slowest pace on record.

And inflation is very low. Headline inflation grew by under 1% in the year to December. The RBA preferred measures of underlying inflation looks to have bottomed, but in the 'low ones'. Other measures of 'underlying' inflation suggests that it could be even lower. The proportion of items that rose by under 2% is on the rise but the proportion rising by over 3% has been on the decline.

Right now there is plenty of noise in the inflation numbers. What price to put on service activities that have endured COVID restrictions is a particular problem. For example over the past couple of quarters the ABS has plugged in a price for international travel despite the borders being closed for the past year.

And then there will be the question of what will be 'temporary' inflation and what might prove to be 'ongoing' inflation. COVID-related restrictions on the service sector (tourism, footy, cinemas) has meant consumers have had more money to spend on computer monitors and 'top-shelf' booze. How much the increased demand for quality gin will last once footy stadiums can again be jam-packed is one cause of uncertainty.

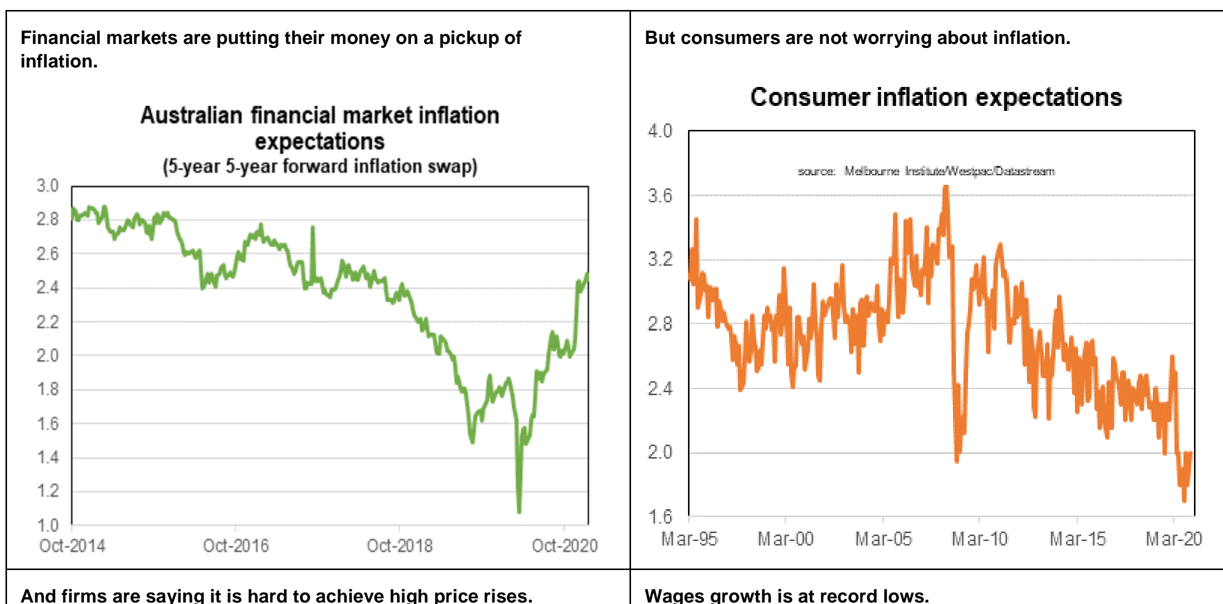
Another is how long supply-chain problems caused by COVID and creating pricing pressures will last. Much of it is likely to be temporary. But some of the pricing pressures could end up being becoming permanent if firms decide they need to pay up to reduce supply problems exposed by COVID (or changes in the international political situation).

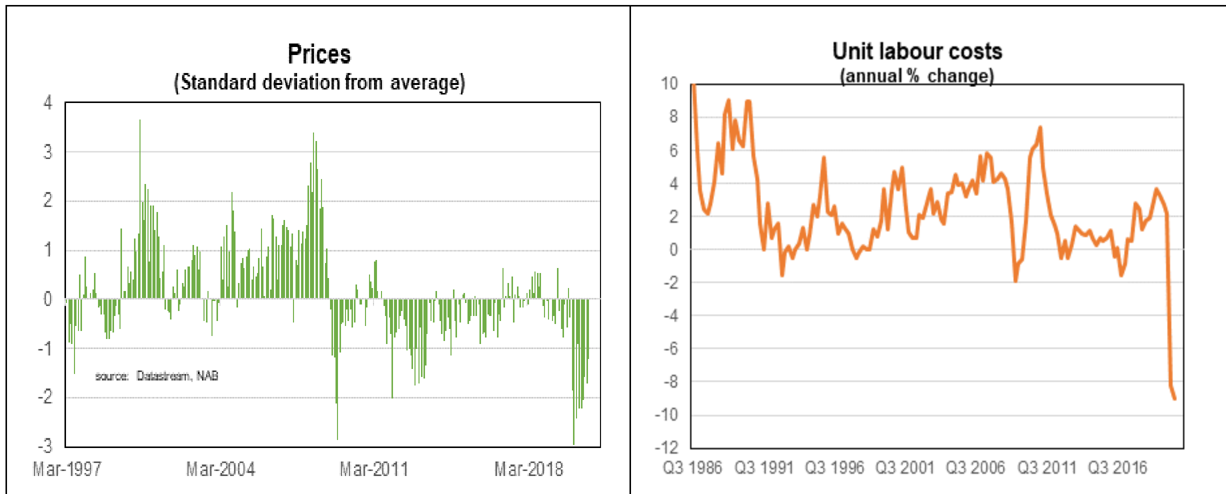


By both action and deed the RBA has made it clear that inflation will need to be above 2% before interest rates will be raised. This is a change from the past when movements in monetary policy followed changes of inflation *forecasts*. One reason for the change in policy is that there is so much spare capacity the economy can roar ahead for some time without creating inflation problems. But I think another reason is that (underlying) inflation has not been within the RBA's 2-3% target band for at least the past five years. And the longer inflation stays too low the more likely people will expect it to remain low. And this would make it more difficult to get inflation to rise again (as Japan has found out).

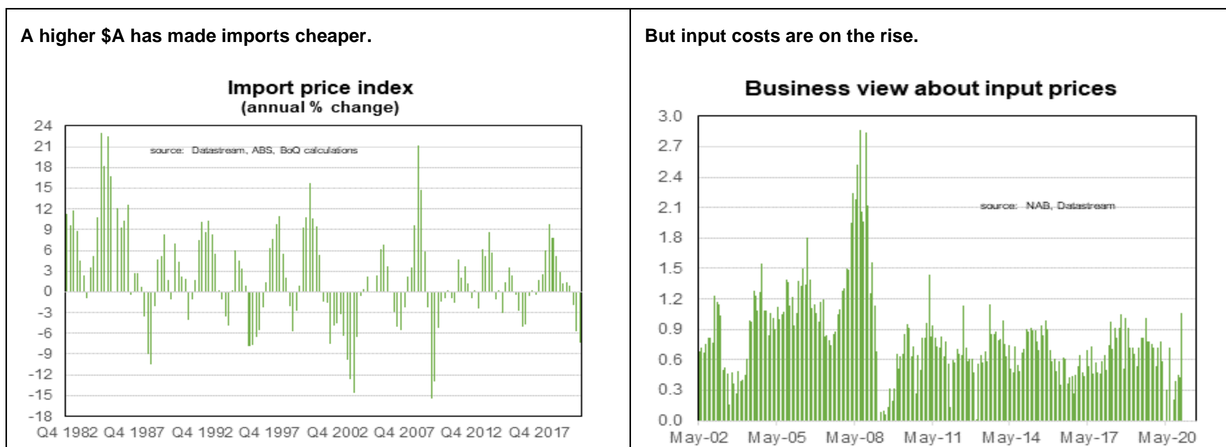
Financial markets have already given the RBA's game plan a tick of approval, pricing inflation to return to the middle part of the RBA's target (although not within the next 2-3 years). But consumers and firms have yet to get the same vibe. Their price expectations have risen a little in recent months but remain historically low. For consumers and firms it likely will be a case of seeing is believing. If prices rise high enough for long enough consumers and businesses will get the message.

What factors might drive inflation higher? The biggest single cost that most businesses face is labour costs. If wages growth is strong enough and can't be offset by productivity rises (unit labour costs) then firms either have to absorb those higher costs or pass them onto consumers. But unit labour costs have declined dramatically over the past year. A fair bit of that is temporary and will be unwound. But as the RBA has noted wages growth is extremely low and expected to stay that way for at least the next couple of years. And firms are still on the look-out for ways to boost productivity.





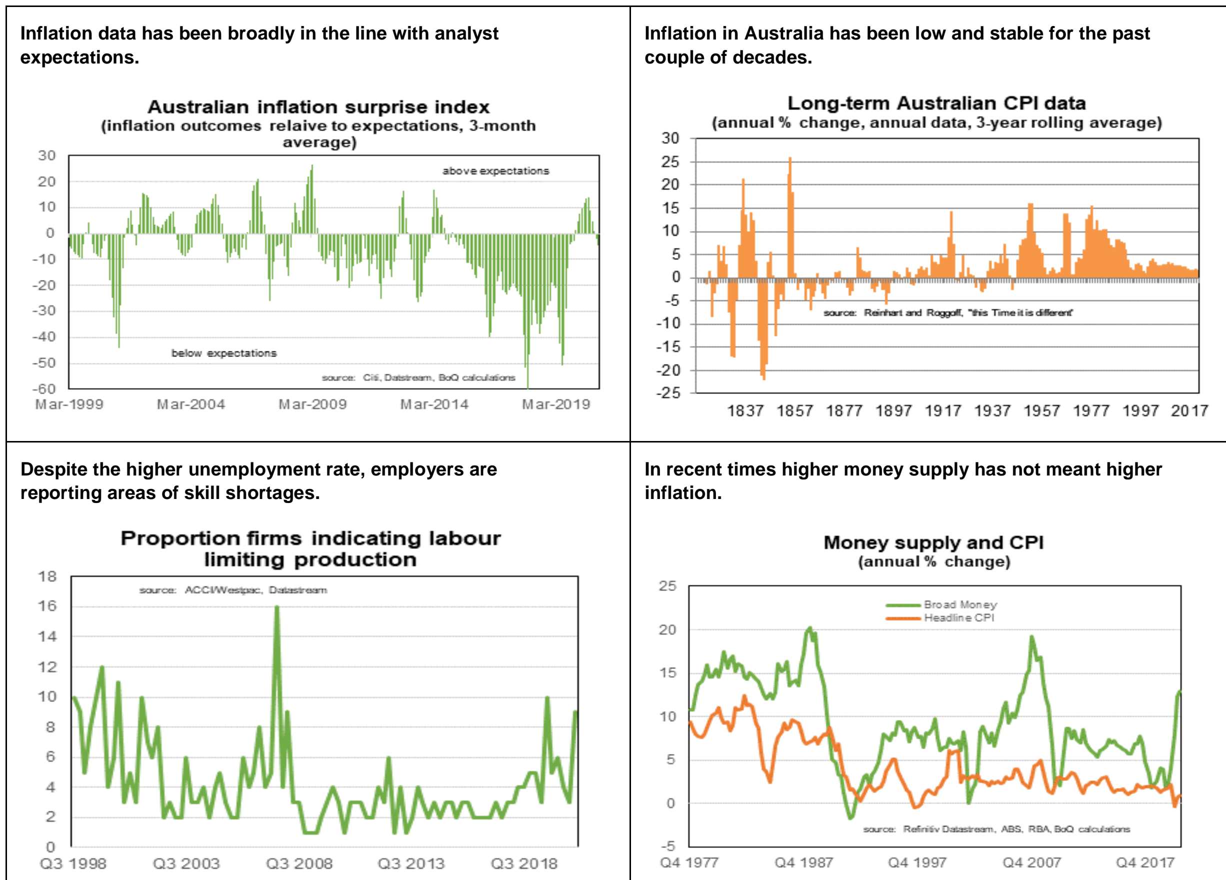
And Australia is certainly not importing inflation. Globally inflation remains subdued reflecting the sombre state of the world economy. The strength of the $A over the past 6-9 months has also made it cheaper to import. Firms are saying that input costs are on the rise, likely reflecting supply-chain problems. But the rise of input costs is seen as substantially less than experienced during the pre-GFC salad days.



The most likely driver of higher inflation will be sustained strong demand. And while there are reasons for caution on the economic outlook there are also reasons for optimism. The biggest potential positive is the mountain of household and business saving waiting for consumers and business to become confident enough to spend.

Some analysts have suggested that the big rise in the money supply could be a signal that higher inflation is on the way. The money supply is defined as currency in circulation (cash in the wallet) plus money in bank accounts. So practically it is the same as saying there is a mountain of saving that could be spent. And over the past couple of decades the relationship between changes in the money supply and inflation has been muted.

Regardless of what happens in the wider economy there are likely to be pockets of inflation over the next year or two. The housing sector (outside of unit construction) is roaring ahead, turbo-boosted by the Governments' HomeBuilder program. And despite the elevated unemployment rate firms are reporting that it increasingly difficult to find people with the right skills.



The RBA is going all in to achieve a stronger economy. With fiscal support and some luck with the virus they are likely to achieve their aim. And in time higher inflation. But history has also shown that inflation can stay very low for an extended period of time. Their latest forecasts indicate that the RBA does not expect that underlying inflation will get to 2% for at least the next three years. I agree.

We live in interesting times.

Regards

Peter Munckton
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