Annual inflation rate lifts ahead of shutdown

Australia's annual rate of inflation rose ahead of the Coronavirus related shutdowns in March. The Consumer Price Index (CPI) showed a 0.3% rise in prices over the 3-months to March, resulting in the annual rate of inflation rising from 1.8% to 2.2%. As shown on the chart below, this is the highest annual rate of increase recorded since September 2014.

Source: Australian Bureau of Statistics 6401.

Although the annual rate of inflation has moved higher, the quarterly result of 0.3% suggests that inflation trends have remained relatively muted. Lower global oil prices contributed to the low inflation reading in the March quarter, with the price of petrol falling 6.0%. As has been the trend over recent years, prices for items predominantly manufactured overseas, such as clothing and footwear (down 0.7%) and telecommunication equipment and services (down 0.3%), recorded price falls. Holiday, travel and accommodation costs were also lower as both domestic and international prices may have weakened as demand declined alongside the rising concern over the Coronavirus spread.

Offsetting the price falls described above was a 6.0% jump in the cost of fruit & vegetables and a 2.0% rise in meat & seafood prices. Drought and bushfires have played a role in constraining the supply of food items; whilst towards the end of the quarter increased demand in response to the Coronavirus concerns may have had a price impact. Higher household spending on other selected items, such as toilet paper, also appeared to have an impact with the “other non-durable household goods” category recording a 3.4% price rise over the quarter. Service items, such as education (up 2.6%) and health (1.7%), also recorded price increase, although these categories were impacted by standard seasonal factors.

After adjusting for the effect of one-off “outlier” price movements (such as the fall in the price of petrol), the underlying rate of inflation is now calculated to be 1.75% per annum. Although higher than the 1.45% recorded in the year to the end of December 2019, the current underlying rate is still below the Reserve Bank’s (RBA) medium-term target 2% to 3% range.

The short-term outlook for inflation remains weak. In the June quarter, the CPI will be impacted by historically low global oil prices as well as the Commonwealth Government’s decision to temporarily reduce the cost of childcare services to zero. With inflation expected to remain below the Reserve Bank’s target range, in the short term at least, there is little pressure on the central bank to shift its monetary policy position of holding overnight cash interest rates at the record low level of 0.25%. Also potentially contributing to lower inflationary pressures in the near term is the expected weakening state of the economy and higher levels of unemployment. With rising unemployment, there may be lower pressure on wages to rise, which may in turn lower costs and inflationary price pressures.

Q1: Describe the factors that contributed to the 0.3% rise in prices recorded over the March quarter.

Q2: Evaluate the merits of the central bank maintaining record low interest rates in response to the outlook for inflation.
$A$ bounces back from March lows

One factor that may at least partially offset some of the negative influences on inflation discussed above is the recent decline in the Australian dollar. After trading at close to U.S. 70 cents at the start of January, the $A$ fell sharply over the March quarter, reaching a low of U.S. 55.7 cents in mid-March. A recent recovery has seen the $A$ bounce back to U.S. 65.4 cents.

Similarly, on the Trade Weighted Index (TWI), the $A$ has moved from 60.3 points at the start of January to 57.7 points currently – after reaching a mid-March low of 49.9 points. (The TWI measures the $A$ against a basket of other currencies, weighted according to their importance in trade with Australia)

The depreciation in the $A$ appeared to be partially a result of the worsening outlook for global economic growth. As a commodity exporter, the Australian economy is more sensitive than some others to global economic growth cycles, as the demand for commodities is highly cyclical. In addition, the sharp fall in interest rates domestically, as a result of both the lower cash interest rate and the Reserve Bank targeting 3-year government bonds to trade at a yield of 0.25%, may have impacted the currency value. Lower Australian interest rates make $A$ domiciled investments less attractive for overseas investors to purchase.

A lowering in the $A$ exchange rate can have a positive impact on inflation as imports become more expensive to purchase. This may also allow domestic producers who are competing with imports to raise prices.

The tendency for the $A$ to depreciate when interest rates are lowered is one of the reasons why looser monetary policy may help stimulate domestic economic activity. A lower exchange rate makes both Australian exporters and Australian import competing industries more competitive. As a result of being more competitive, production volumes in Australia may subsequently increase.

Q3: Explain why a lower Australian exchange rate could add to inflationary pressures.

Q4: Describe how a lower $A$ could lead to higher levels of economic activity in Australia.

Consumer confidence plummets

Despite the unprecedented economic policy stimulus measures announced in March (see Issue 3 of Plain English Economics), Australian consumer confidence has plummeted over the past month. One measure of consumer confidence is the “Index of Consumer Sentiment” published by Westpac and the Melbourne Institute. The Index, which measures the results of a survey into various aspects of how consumers feel about their future financial prospects, fell by 16.3 points to 75.6 in April. This represents the largest monthly fall in the 47-year history of the index. Coronavirus related shutdowns and job losses appear to have had a greater negative impact on sentiment than did the Global Financial Crisis or the recession in the early 1990s. The latest score of 75.6 points for the index compares with an average score over the longer term of 100 points.

Typically, there is a strong relationship between consumer confidence and the propensity of households to spend on consumption items. The longer-term correlation between these two variables can be seen on the chart below.

![Consumer Confidence & Spending Chart](chart.png)


However, there has been a marked divergence in the longer-term relationship between confidence and retail spending over the past month. Although the April consumer confidence survey implied that sentiment had plummeted, the preliminary retail sales data for the month of March suggested a record surge of 8.2%. This was the largest ever single monthly gain in the series and brought the annual growth in sales up to 9.8%. The divergence in trends is likely to reflect widespread “stocking up” of household supplies and food as fears of Coronavirus shutdown...
related shortages took hold. It appears the strength of supermarket sales more than offset the decline in trade in restaurants and cafes. The Australian Bureau of Statistics reported the following observations from the retail sales data:

“Analysis of supermarket and grocery store scanner data shows that monthly retail turnover for perishable groceries and all other groceries increased in original terms by 21.6% and 35.6% respectively in March compared to February. Monthly turnover doubled for products such as toilet and tissue paper, flour, rice and pasta between February and March. While monthly turnover for canned food, medicinal products and cleaning goods increased by more than 50%. The rise in supermarket retail turnover reached a peak in mid-March before levelling off at the end of the month.”

Prior to the surge in retail sales in March, consumer spending had been relatively subdued. The annual rate of growth in the year to February was just 1.8%, implying negative growth on an inflation adjusted per person basis. This low rate of growth in sales coincided with consumer sentiment readings below 100 on the Westpac / Melbourne Institute measure. Possible causes of the lower than average rates of consumer sentiment recorded over much of the past 3 years could include the very low real wages growth being experienced, whilst declining housing affordability (due to higher house prices, particularly in Sydney and Melbourne) may also have had an impact. In addition, low interest rates, although normally considered positive for consumer confidence due to the favourable impact on borrowers, could be creating difficulty for those consumers relying on investment earnings to fund their living expenses.

It is widely expected that the surge in retail sales recorded in March was one-off response to the Coronavirus shutdowns. If the current lack of positive consumer sentiment continues, there may be a material impact on economic growth. Given that consumer spending is the largest component of demand in the Australian economy, changes in consumption propensity can have significant impacts on the rate of economic growth. The fact that the retail sector is the second largest employer in Australia also strengthens the link between retail spending and economic growth generally.

Q5: Describe the possible link between consumer sentiment and the rate of economic growth.

Q6: Discuss some possible explanations for the low level of consumer confidence recorded both pre and post the outbreak of the Coronavirus.

Household savings propensity will be a key variable

An important policy response by the Commonwealth Government to the Coronavirus related shutdowns has been to increase the size of social welfare payments and also provide some income continuity via the Job Keeper program. These initiatives are design to support household disposable income levels at a time when business closure and rising unemployment would otherwise result in substantial household income decline. However, whether or not these policy support initiatives will be successful at maintaining reasonably normal rates of consumption expenditure will depend heavily on the extent to which household income is spent and not saved.

Movements in the propensity of households to save are often tracked by the “Household Savings Ratio.” This ratio measures the percentage of household disposable income that is saved rather than spent on consumption items. Over the 3 months to December 2019, the Household Savings Ratio was 3.6%. This was above the 3.0% recorded in the same quarter of 2018. As shown on the chart below, the household savings ratio is well below its sharp cyclical peak of 10.9% reached at the height of the Global Financial Crisis in December 2008.

![Household Savings Ratio Chart](chart.png)

Despite the steady decline over much of the past 6 years, the above chart indicates the Household Savings Ratio is still above levels recorded in the period around the early 2000s when the household sector had negative savings. The chart
highlights the significant rise in the savings ratio over 2008. Some of this rise in the propensity to save is thought to reflect a change in attitude of consumers post the Global Financial Crisis (GFC), when consumers may have become more cautious in their spending patterns.

Hence, as was the case in 2008, it is possible that the uncertainty and concern generated by the Coronavirus crisis may result in a lower propensity to spend and higher propensity to save. If this were to take place, the rise in the savings ratio may provide a further source of economic contraction. An increase in the propensity to save reduces the amount of funds allocated to spending, thereby lowering aggregate demand across the economy.

Q7: Describe how a rise in the propensity of households to save can lead to lower rates of economic growth.

Government new bond issuance to rise

The substantial fiscal stimulus program put in place by the Commonwealth Government (see Issue 3 of Plain English Economics) will result in a very large deficit between government expenditure and revenue this financial year. Whenever the Commonwealth Government is in deficit, it needs to borrow in order to fund the deficit. This borrowing adds to the Government’s debt position. The main mechanism the Government has available to generate the finance required to fund its budget deficit is to issue (sell) Commonwealth Government Securities (CGS), which are also referred to as Government bonds. By issuing bonds, the Government receives money (effectively a loan) from the buyers of the bonds. The Government then promises to pay regular interest and a repayment of the bond principal (the loan amount) on the bond maturity date.

The chart below shows the annual growth in Government (securities) bonds on issue that has occurred over recent years, covering all levels of government. At the end of March 2020 there was $831 billion in long-term bonds on issue. It can be seen from the chart that the rate of increase in bonds on issue significantly spiked around the time of the Global Financial Crisis in 2008/09, when the Commonwealth Government last embarked on a major stimulus program.

When a government issues more bonds to fund a deficit, the supply of bonds is increased. Generally, a rise in the supply of bonds issued by the Government will increase the interest rate that is required to be paid by the Government. This is because more investors need to be enticed to purchase bonds to take up the larger supply. In this way, the movement in the price or yield on the bonds brings about equilibrium between the supply and demand for bonds.

This impact that Government borrowing can have on interest rates is sometimes referred to as “crowding out”. The additional supply of bonds soaks up available funds in money markets due to the higher interest rates on offer, making it more difficult and expensive for the private sector to access and pay for borrowings. However, over recent years, there has been minimal evidence of this “crowding out” effect, with bond yields being kept near historical lows despite their rising supply. One factor that may have contributed to this lack of “crowding out” could be the large proportion of Australian Government bonds that are currently held by foreigners, thereby reducing the call on domestic savings to fund the deficit. In addition, the Reserve Bank is now active in bond markets and aiming to keep the 3-year Government bond yield at 0.25%. This central bank action is also expected to minimise any “crowding out” effect.

Source: RBA. Long Term Securities Only.

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<th>Stats on Australia</th>
<th>Latest</th>
<th>Previous Year</th>
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<tr>
<td>Economic Growth</td>
<td>2.2% (Year to Dec)</td>
<td>2.2%</td>
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<tr>
<td>Inflation</td>
<td>2.2% (Year to Mar)</td>
<td>1.3%</td>
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<tr>
<td>Unemployment</td>
<td>5.2% (Mar)</td>
<td>5.1%</td>
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<tr>
<td>Employment Growth</td>
<td>1.8% (Year to Mar)</td>
<td>2.4%</td>
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<tr>
<td>Wage Price Index</td>
<td>2.2% (Year to Dec)</td>
<td>2.3%</td>
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<tr>
<td>Exchange Rate (TWI)</td>
<td>57.8 (30th Apr)</td>
<td>60.5</td>
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<tr>
<td>Cash Interest Rate</td>
<td>0.25% (April)</td>
<td>1.50%</td>
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<tr>
<td>Current Account Surplus</td>
<td>$10.2 bn (Yr to Dec)</td>
<td>-$39.0 bn</td>
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<tr>
<td>Current Acct (% GDP)</td>
<td>0.5% (Year to Dec)</td>
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<tr>
<td>Foreign Debt (% GDP)</td>
<td>57.3% (End Dec)</td>
<td>58.8%</td>
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Source: Australian Bureau of Statistics & Reserve Bank

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