Inflation remains below target range

The pattern of low inflation, which has been dominant in most developed economies over recent years, continued in Australia over the course of 2017. Australia’s Consumer Price Index (CPI) for the 3 months to December 2017 showed that prices rose by 0.6%. This brought the annual rate of inflation up to 1.9%, which compares with 1.8% in the September quarter.

Two major contributors to inflation over the December quarter were increases in the price of fuel and tobacco. Strengthening oil prices on global markets pushed petrol prices 10.4% higher over the quarter. An 8.5% jump in tobacco prices followed an increase in the federal excise tax in September last year. Partially offsetting these increases were falls in the price of clothing (down 0.3%), household textiles (down 5.7%), communications (down 1.3%) and pharmaceutical products (down 2.0%). The fall in the cost of pharmaceutical products was largely seasonal with an increase in the proportion of individuals exceeding the Pharmaceutical Benefits Scheme (PBS) safety net level towards the end of the calendar year.

One off or “outlier” impacts on the CPI, such as a spike in tobacco prices, can be removed in calculations of the “underlying rate of inflation”, which are intended to provide a more accurate assessment of the trend and longer-term position of inflation. In the year to December 2017, the underlying level of inflation was calculated as being the same as the “headline” rate at 1.9%. This rate of inflation is just below the bottom of the Reserve Bank’s 2% to 3% target range for the average level of inflation over the medium term. As shown on the above chart, underlying inflation has been below the target range since late in 2015, after a steady decline in the previous decade.

The low inflation that has prevailed in the Australian economy in recent years has been a characteristic of most developed economies. Following the Global Financial Crisis, demand was generally weak with producers having excess capacity (i.e. operating at a lower than maximum level of output given their capital and labour resources).

However, despite some recent improvement in global economic growth and tightening labour markets (i.e. where demand for labour has grown relative to supply), there has been little response in terms of higher wages across many economies (outside of the U.S.). This lack of growth in wages has continued to result in an absence of any significant “cost push” inflation. The chart below shows inflation rates in selected economies. As shown, Australia’s inflation rate is above that of some of the major developed economies.
Q1: Define the Reserve Bank’s target range for inflation.

Q2: Describe the impact that a tightening of labour markets would be expected to have on inflation.

Wages growth records marginal increase

The lack of any cost pressure on inflation from wages growth continued into the December quarter last year. Over the 3-month period, the seasonally adjusted Wage Price Index rose by 0.6%, resulting in the annual rate of wages growth increasing from 2.0% to 2.1%. This is the second consecutive quarter in which a 0.1% increase has been recorded in the annual growth rate. (The Wage Price Index measures changes in the price of labour across the Australian economy).

With underlying inflation in the year to December at 1.9%, the latest wages data suggests there has been only a modest increase in wages in real, after inflation, terms. This is an unusual situation as wage costs will typically rise at a higher rate above inflation. Improving labour productivity (i.e., the level of output generated by each unit of labour) will normally create capacity for businesses to support real wage growth. Since 1997, the Wage Price Index has increased at an average annual rate some 0.6% above the rate of inflation.

![Wage Price Index - Annual Growth](image)

Source: Australian Bureau of Statistics 6345

Movements in wages growth will typically reflect changes in the balance of supply and demand for labour. For example, throughout much of the mining boom there was a shortage of labour in the mining sector. This resulted in rising mining sector wages, which peaked at a growth rate of 6.7% per annum in June 2008. In contrast, with the mining boom now ended, annual wage growth rates in the sector are currently below the national average at 1.4%. Industries with the highest rate of growth in wages are Health (up 2.8% over the year to December) and Arts & Recreation services (up 2.6%).

Employment data suggests that there remains spare capacity in the labour force. As discussed below, although the number of workers employed has increased over the past year, falls in unemployment have been limited, thereby maintaining an overall surplus of labour. With this surplus in place, there may be less scope for upward pressure to be placed on wages.

Of note this month, was the release of data in the United States, which showed the annual growth rate of growth in wages there increasing from 2.7% to 2.9% - the highest growth rate since June 2009. News of the higher wages growth in the U.S. was the catalyst for a fall on global share markets and may be a result of the steady falls in unemployment experienced in the U.S. economy.

In addition to spare capacity in the labour force, the Reserve Bank has highlighted that certain structural changes could also be impacting on wages growth as indicated in the following extract from the Bank’s February 2017 “Statement on Monetary Policy”:

> “The recent labour cost growth outcomes were slightly weaker than expected and could suggest that structural forces, such as global competitive pressures and technological advances, are putting downward pressure on wage growth.”

Technological changes, referred to in the statement above, could be reducing the demand for labour. In some occupation types, new forms of automation are being developed that can replace functions previously carried out by labour. Secondly, the above reference to “global competitive pressures” could be describing the increasing ease in which production can be shifted across the globe to the most efficient location; thereby reducing the scope for higher wages to make any individual location a more expensive place to produce.

Q3: Explain why wages are less likely to increase when unemployment rates are high.
Q4: Describe two structural changes that could potentially be reducing the scope for real wages growth.

Only minor falls in unemployment despite strong employment growth

Over the past 12 months, Australia has experienced a significant pick up in the rate of growth in employment. Over the year to January 2018, the number of workers employed rose by 3.3%. This is the equal highest rate of growth since late 2007.

Unemployment will decrease when the number of workers employed grows faster than the size of the workforce population. Over the past year, the workforce population has increased by 3.2%. As the 3.3% increase in employment has been only slightly above the rate of increase in workforce population, the rate of unemployment has fallen only marginally. During January, the unemployment rate was 5.5%, down from 5.7% one year earlier.

The small fall in unemployment over the past year is consistent with a period of relatively modest economic growth. Employment is generally considered to be a "lagging" indicator of economic growth. That is, movements in employment will follow movements in the rate of economic growth. This is because firms often delay making decisions to change employment levels until they perceive that changing economic conditions have a degree of permanency. High costs (e.g. training costs) associated with either increasing or reducing employment are an important factor in creating this "lag".

Although being a "lagging" indicator, unemployment trends can also influence the direction of future economic growth. For example, rising unemployment can create a negative feedback loop or "vicious cycle" whereby consumption spending declines as a result of unemployment. This drop in spending can then lead to lower economic growth and further unemployment. It is this threat of a "vicious cycle" that adds to the importance policy makers place on the goal of avoiding high rates of unemployment.

Q5: Define the term “participation rate”.

Q6: Outline why unemployment is considered to be a “lagging” indicator of economic growth.

Monetary policy on hold

As has been the case for the past 18 months, monetary policy has remained unchanged, with the overnight cash interest rate being held at 1.5% following the Reserve Bank’s February Board meeting. As shown on the chart below, the current period of record low interest rates follows a series of interest rate cuts from a peak of 4.75% in October 2011.
The Reserve Bank can implement the target cash interest rate by buying and selling securities or bonds on the open market. This influences the supply of cash in the financial system, thereby “managing” the price of cash (i.e. the interest rate) to the target level. This activity by the central bank brings about its monetary policy changes and is known as “Open Market Operations”.

By keeping interest rates low, the Reserve Bank is aiming to decrease the incentive to save and increase the incentive to borrow and spend - thereby creating a stimulus to economic growth. In addition, a lower interest rate may reduce the attractiveness of Australia as an investment destination for offshore investors. This may take some demand pressure off the $A and contribute to a depreciation in the currency. This can also help stimulate economic growth by making Australian industries more internationally competitive.

Although the extended period of low interest rates may have contributed to improved employment and some increase in inflation, the following extract from the Reserve Bank’s February Board meeting minutes suggests that the impact of low interest rates is expected to continue to be very gradual:

“Over 2017, progress had been made in reducing the unemployment rate and bringing inflation closer to target. The low level of interest rates was continuing to play a role in achieving this outcome. Further progress on these goals was expected over the period ahead but the increase in inflation was likely to occur only gradually as the economy strengthened.”

Q7: Evaluate whether the Reserve Bank would maintain existing interest rate settings if the underlying inflation rate was expected to rise above the target rate for a significant period of time.

Mixed overseas policy settings

A continuation of loose monetary policy and an absence of cost pressures are characteristics that Australia currently shares with many developed economies around the world. Whereas the Australian central bank has restricted its policy implementation to traditional means, via cash interest rate targeting, less traditional policy has been adopted overseas.

As interest rates approached zero across Europe, Japan and the United States, these central banks were faced with the prospect of having no further scope to lower interest rates to stimulate their economies. As a result, they embarked on alternative approaches in their attempts to loosen policy. Non-traditional monetary policy has been implemented in the form of an asset purchase program, often termed “Quantitative Easing” (QE). Whereas traditional monetary policy aims to bring about a specific target for the short-term cash interest rate, QE policies involve the central bank injecting a specific quantity of funds into financial markets by purchasing financial assets such as government bonds and other securities.

In addition to lowering targeted bond or security yields across the yield curve (i.e. lower longer term, as well as short term, interest rates), QE programs help stimulate economic activity by providing the private sector with more fund availability (financed by the expansion of central bank balance sheets). Significant QE programs have been adopted in the United States (now completed), Europe and Japan over recent years.

However, whilst central banks in Europe and Japan are maintaining extremely loose monetary policies, the United States is now in a tightening phase. With U.S. economic growth improving and labour markets tightening, there is now less of a case for the U.S. Federal Reserve to run excessively loose policies. Since December 2015, the U.S. Federal Reserve has increased the benchmark Federal Reserve interest rate by 0.25% on 5 occasions. At 1.38%, the maximum Federal Reserve benchmark rate is now close to the equivalent Australian cash rate of 1.5%.

Q8: Explain why some central banks have opted to use non-traditional forms of monetary policy over recent years.

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<tr>
<th>Stats on Australia</th>
<th>Latest</th>
<th>Previous Year</th>
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<tbody>
<tr>
<td>Economic Growth</td>
<td>2.8% (Year to Sep)</td>
<td>2.1%</td>
</tr>
<tr>
<td>Inflation</td>
<td>1.9% (Year to Dec)</td>
<td>1.5%</td>
</tr>
<tr>
<td>Unemployment</td>
<td>5.5% (Jan)</td>
<td>5.7%</td>
</tr>
<tr>
<td>Employment Growth</td>
<td>3.3% (Year to Jan)</td>
<td>1.0%</td>
</tr>
<tr>
<td>Wage Price Index</td>
<td>2.1% (Year to Dec)</td>
<td>1.9%</td>
</tr>
<tr>
<td>Exchange Rate (TWI)</td>
<td>63.6 (28th Feb)</td>
<td>66.7</td>
</tr>
<tr>
<td>Cash Interest Rate</td>
<td>1.50% (Feb)</td>
<td>1.50%</td>
</tr>
<tr>
<td>Current Account Deficit</td>
<td>$29.1 bn (Year to Sep)</td>
<td>$66.8 bn</td>
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<tr>
<td>Current Acct (% GDP)</td>
<td>2.0% (Year to Sep)</td>
<td>2.9%</td>
</tr>
<tr>
<td>Foreign Debt (% GDP)</td>
<td>55.5% (End Sep)</td>
<td>61.9%</td>
</tr>
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Source: Australian Bureau of Statistics & Reserve Bank

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