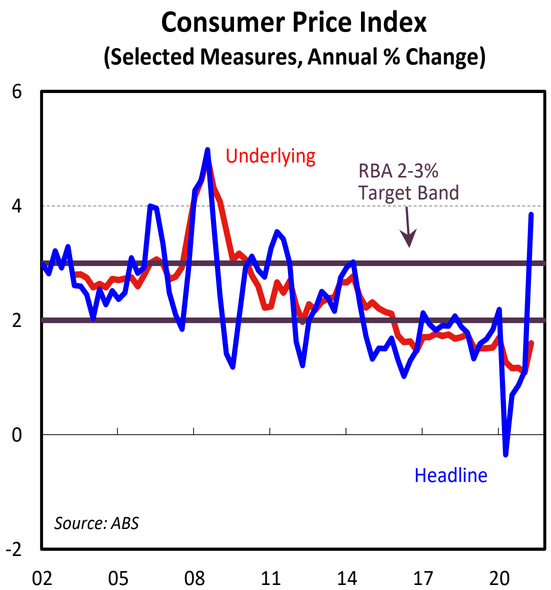
Data Snapshot

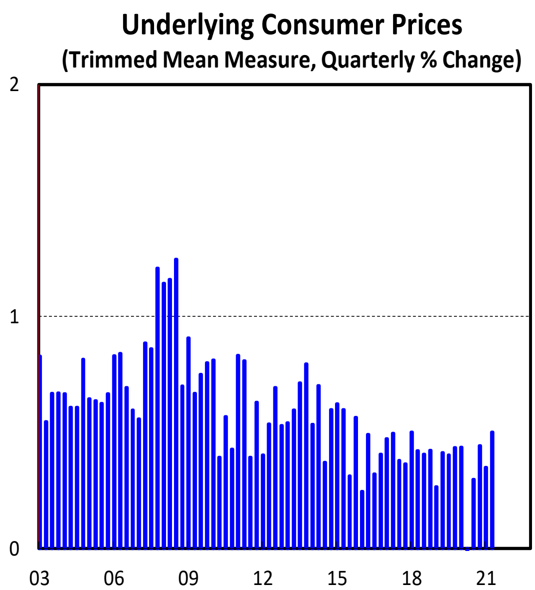
Wednesday, 28 July 2021

Consumer Price Index

Transitory Factors Drive Inflation Spike

- **Inflation overshot the Reserve Bank's inflation target band for the first time in a decade in the June quarter, but this was due to the unwinding of pandemic-related price reductions. These factors are transitory. The RBA will look through the spike when setting policy.**
- **The headline consumer price index rose by 0.8% in the June quarter, a touch stronger than consensus expectations that centred on a rise of 0.7%. The annual rate lifted from 1.1% in the March quarter to 3.8% in the June quarter - the highest annual rate in almost 13 years.**
- **Underlying price pressures were more muted. Trimmed mean inflation rose 0.5% in the June quarter – the biggest quarterly gain since early 2018. The annual rate rose from a record low of 1.1% in the March quarter to a 2½-year high of 1.6% in the June quarter.**
- **Unlike the headline rate, the underlying inflation rate remains under the RBA's 2-3% inflation target band. It has been underneath the band consistently since early 2016.**
- **The quarterly increase in headline inflation was led by a 6.5% jump in fuel prices and to a lesser extent an increase in health costs as private health insurance premiums reset in April.**
- **The sharp increase in annual headline inflation also reflects the unwind of the free childcare policy introduced last year.**
- **We expect the headline rate to drop sharply in the second half of this year and the underlying inflation rate to move gradually higher and into the RBA's band next year.**





Headline and underlying inflation

Today's data showed inflation had done something it has not done in nearly a decade. It overshot the Reserve Bank's inflation target band of 2-3%. However, the overshoot was because of the unwinding of some of the pandemic-related price reductions of last year and the expiry of some government grants and subsidies. That is, the factors pushing up headline inflation are transitory.

Headline inflation is highly unlikely to persistently overshoot the target. In fact, we anticipate it will drop sharply in the second half of this year. As these factors are transitory, the RBA will look through the spike in prices when setting policy.

In terms of the quarterly movement, headline consumer price index (CPI) rose by 0.8% in the June quarter, which was a touch stronger than consensus expectations that centred on a rise of 0.7%. The annual headline inflation rate lifted from 1.1% in the March quarter to 3.8% in the June quarter. It is the highest annual rate in almost 13 years.

The increase in the CPI in the June quarter was driven by higher automotive fuel prices, an increase in health-related costs and higher food prices, particularly fruits and vegetables. Fuel prices are reverting to pre-pandemic levels. Fruit and vegetable prices were pushed up by weather-related events, although dine and discover vouchers negated some of these price pressures. New dwelling prices would have risen by 1.9% over the quarter absent government grants. However, the impact on the CPI has been dampened by the HomeBuilder scheme and state government grants, resulting in a 0.1% fall.

Importantly, the underlying rate of inflation, and the RBA's preferred measure of price pressures, remains muted and below the central bank's 2–3% target band.

The RBA's preferred measure of underlying inflation is the trimmed mean measure. It rose 0.5% in the June quarter, which is the largest quarterly gain since early 2018, but was in line with consensus expectations. The annual measure rose from a record low of 1.1% in the March quarter to a 2½-year high of 1.6% in the June quarter. The annual rate has been underneath the band consistently since early 2016.

Groups Analysis

Prices increased in eight out of the eleven CPI groups.

The increase in headline CPI was predominantly driven by a 6.5% jump in prices at the petrol pump, alongside a weaker Australian dollar, and to a lesser extent a 1.5% increase in health costs.

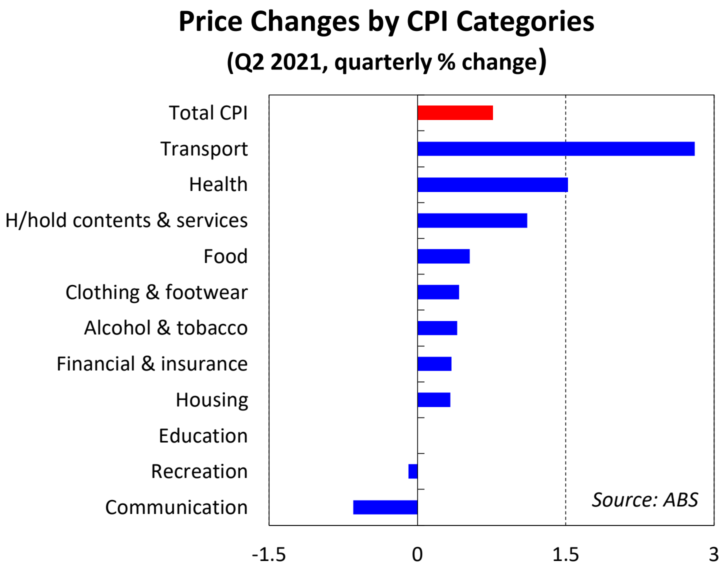
The 2.8% increase in transport prices was largely underpinned by the 6.5% surge in fuel prices. Fuel prices have been pushed higher by the recovery in crude oil prices since late 2020, alongside the global resurgence in demand for oil, as well as the weaker Australian dollar.

There was also a 2.2% increase in the price of new motor vehicles. There has been a sharp increase in demand for cars since the middle of 2020. The rise reflects the substitution towards goods and away from services, wealth effects from rising house prices and tax incentives for businesses. At the same time, supply chain disruptions, including a shortage of semi-conductors, have interrupted production resulting in a global new car shortage. In turn, this has resulted in less discounting of new cars and higher prices. There have also been widespread reports of sharp increases in the price of second-hand vehicles, however, this is not captured by the CPI.

The 1.5% increase in health-related prices was driven by a 2.4% increase in medical and hospital services reflecting the reset in the private health insurance premiums on 1 April.

The housing group increased 0.3%, largely reflecting a 3.3% increase in electricity prices. This is because of a sharp increase in electricity prices in Perth alongside the unwinding of the Western Australian government's $600 electricity credit introduced in the December quarter. Rents rose 0.1%.

Meanwhile, new dwelling purchase prices fell 0.1% in the June quarter. New dwelling prices have continued to lift alongside the housing boom. However, the HomeBuilder scheme and grants from the Western Australian and Tasmanian state governments have muted the impact of this increase on the CPI. In the absence of government support, new dwelling purchase prices would have increased 1.9%. The Australian Bureau of Statistics (ABS) expects these schemes will continue to impact measurement of CPI over the coming period as applications are processed and grants are paid out.



The household contents and services group rose 1.1% in the June quarter. Furniture increased 3.8%, as solid demand for timber and supply constraints pushed up prices. In year ended terms, this group rose 16.9%. The main driver of the increase was childcare, due to the unwinding of the free childcare policy introduced in the June quarter of last year. Excluding childcare, the group would have increased 1.0% over the year.

The food and non-alcoholic beverages group rose 0.5%, although there are several moving parts underpinning the result. On the one hand, there was a 5.2% increase in the price of fresh fruits and vegetables alongside labour shortages and extreme weather. And beef and veal prices rose 3.6% in the quarter, as farmers continued to rebuild herds after the drought. In turn, this has weighed on supply while there is rising demand from emerging Asia. On the other hand, NSW 'Dine & Discover' and Victoria 'Melbourne Money' vouchers have resulted in a 0.7% decline in the price of takeaway fast foods and 0.6% decline in the price of restaurant meals. This is because the voucher schemes reduce out-of-pocket costs for consumers.

There were also increases in the prices of alcohol and tobacco, clothing & footwear and insurance & financial services. The education group was flat.

Meanwhile, the communications group declined 0.6% because of discounting on phones.

The recreation and culture group slipped 0.1% in the quarter due to a 1.3% in the prices of domestic holiday travel and accommodation. This was driven by decreases in the price of domestic airfares, while accommodation prices increased. The relaxation of restrictions and closed international borders saw many Australians with itchy feet spending more on domestic travel, particularly to Queensland destinations. However, this has been offset by the Federal government's tourism package, which included subsidies for half price airfares to selected destinations.

The fall in the price of domestic travel was partly offset by an 8.6% increase in international holiday travel and accommodation following the opening of the travel bubble with New Zealand in April. However, this has a small impact on the series as international travel is currently so limited.

Tradables and non-tradables inflation

Tradables inflation grew at a much faster rate than non-tradables inflation in the June quarter. Indeed, the gap between the quarterly growth rates of tradables inflation and non-tradables inflation was at its highest level in 14 years.

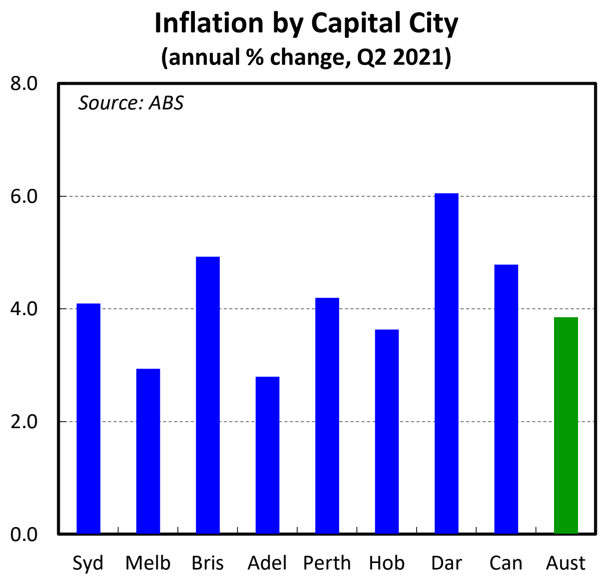
Tradables inflation continued to pick up in the June quarter, rising by 1.5%, driven by an increase in the price of automotive fuel. This was up from 1.1% growth in the March quarter.

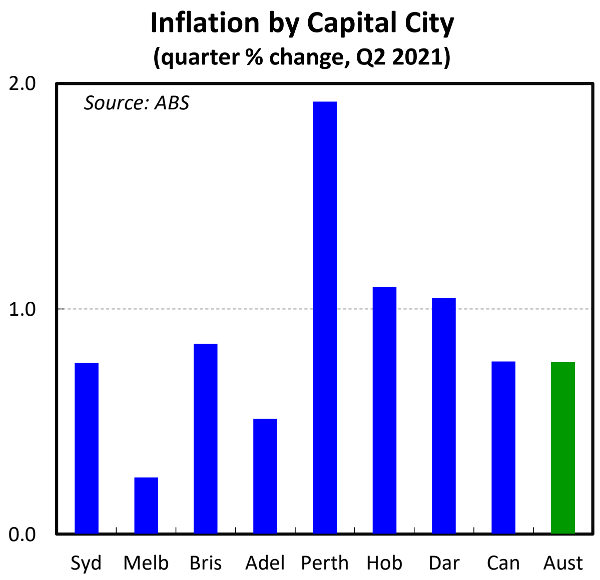
On an annual basis, tradables inflation rose by 3.6% over the year to June. This was the highest annual growth in tradables inflation in over 14 years. Tradables inflation measures the prices of imported goods and services and is influenced by global factors, including movements in the currency and oil.

Non-tradables inflation, which is a measure of the prices of domestically produced goods and services, rose by 0.3% in the quarter. The increase was driven by the increases in electricity prices and medical and hospital services. On an annual basis, non-tradable inflation rose by 4.0% over the year to June. This is the highest annual growth rate in 8 years.

Inflation by capital cities

By capital city, inflation increased the most in the June quarter in Perth (1.9%) and Hobart (1.1%), followed by Darwin (1.0%). Melbourne recorded the smallest quarterly rise (0.3%), followed by Adelaide (0.5%) and Sydney (0.8%). Melbourne was in lockdown in late May to early June. This likely placed downward pressures on price growth in the quarter.





The price of fuel, medical and hospital services, and fruits and vegetables rose across all capital cities. The difference in price increases across cities was largely due to differences in the housing group. This reflects the impact of grants from the Federal and State governments, which subsidised the cost of building new homes, including HomeBuilder.

For the housing group, Perth saw the largest price increase (6.5%), followed by Hobart (1.6%) and Canberra (0.6%). At the opposite end, Melbourne saw the smallest impact (-1.3%), followed by Adelaide (-0.4%) and Sydney (0.2%).

Annual growth was the firmest in Darwin (6.1%), followed by Brisbane (4.9%) and Canberra (4.8%). The slowest annual growth rate was seen in Adelaide (2.8%), followed by Melbourne (2.9%).

Like the overall CPI series, annual growth rates were impacted by the unwinding of COVID-19-related disruptions a year ago. Annual growth rates are not expected to remain at these elevated levels going forward.

Outlook

We expect the underlying inflation rate to move gradually higher over this year and next year. We are forecasting an underlying annual inflation rate of 1.7% in the December quarter of 2021, rising to 2.2% in the December quarter of 2022. The upward pressures will stabilise in 2023 but we are still anticipating the underlying inflation rate to be in the low 2s, within the RBA'S 2-3% target band over 2023.

Pent-up demand from last year's lockdowns and very stimulatory conditions in the economy are pushing up prices, particularly goods prices. These goods prices include prices for raw materials, which are also being impacted by disruptions to global supply chains. Freight costs have recorded incredible gains with no let-up in sight in the near term. The longer the disruptions last, the greater the risk that these price pressures will have to be absorbed into final prices.

The RBA has been at pains to suggest that it does not expect conditions in the economy will be met to warrant a rate hike before 2024. We think the tightening of the labour market and the underlying inflation rate moving into the band will help build the case for an earlier move in 2023. We had pencilled in the tightening cycle starting in early 2023, but the extended lockdown in NSW means there is a risk that it starts later in 2023. Much will depend on how long it takes for NSW to come out of lockdown and if further spillovers of the outbreak to other states can be prevented.

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