Weekly Economic Outlook

Monday, 26 April 2021

Is the Inflation Dragon Stirring?

The big event this week is inflation data out on Wednesday. It is a big deal for economists.

In Australia, and around the world, the inflation dragon appears to be stirring from its slumber. Inflation is picking up, as record low interest rates, massive fiscal stimulus, pent-up demand and an easing of restrictions drives up inflationary pressures.

However, policymakers expect this lift in inflation to be transitory. Policymakers look through temporary effects. The bond market is not convinced the rise is entirely temporary, which means the debate over the path of inflation is only likely to intensify.

Improvements in the growth outlook – offshore and domestically – have lifted Australian government bond yields across the curve from their lows last year. However, the three-year bond yield is held down at 0.10% by the Reserve Bank's yield-curve-control program. And the RBA's separate bond-buying program for bond maturities of 5 to 10 years has kept rates lower than otherwise has been the case at the longer end of the curve.

An important bit of information to remember is that the Reserve Bank (RBA) last year changed the way it considers inflation in setting the cash rate. Previously, it placed more importance on projected inflation. Now it emphasises actual inflation outcomes and will only move the cash rate when actual inflation is sustainably in its 2-3 per cent target band. The crux of this shift in emphasis is that rates are likely to be low for longer. The RBA has spelt out it does not anticipate conditions will be met to hike the cash rate before 2024.

The run of economic data has been strong. It suggests a move before 2024, most likely 2023, cannot be fully ruled out. In the minutes from this month's RBA board meeting, the RBA was more upbeat about the economic outlook. But the RBA is still expecting subdued wages and inflation for several years. The inflation data on Wednesday is likely to give us more colour and clues.

The headline measure of the consumer price index (CPI) should show a jump of 1.0% in the March quarter, lifting the annual rate to a one-year high of 1.5%. There are several other measures of the CPI that are reported. The one we eye most closely and what the RBA pays most attention to is the trimmed-mean measure. This measure tries to strip out some of the volatility prevalent in inflation to give us a truer picture of underlying price pressures. We expect this measure rose 0.6% in the quarter and by 1.4% in the year – also the fastest annual rate in a year.

It comes as no surprise that the March quarter CPI is being impacted by COVID-19 and associated government stimulus. One of the big drivers of inflation in the quarter should be new dwelling costs. New dwelling prices are likely to have lifted in the quarter. Another big influence in the March quarter is likely to have been the price of petrol at the bowser. We estimate petrol prices spiked nearly 10% in the quarter.

There are also the expected price gains in health, childcare, education as well as the usual seasonal increases in fresh fruit & vegetable prices. There is some risk that the flooding on the east coast also caused prices to lift. Meanwhile, prices for clothing & footwear, recreation and household contents are likely to have dropped in the quarter.

For actual inflation to move sustainably into the RBA's 2 to 3 per cent target range, wages will need to rise, as wages are a major component of prices. Unemployment has fallen faster and earlier than widely anticipated. Indeed, the unemployment rate dropped to 5.6% in March and we now expect the unemployment rate to be at 5.0% by the end of this year with a '4' in front of it by the end of 2022.

However, spare capacity continues to be a feature of the labour market. The RBA now believes the rate of unemployment consistent with full employment is somewhere between the high 3s to low 4s. It means the unemployment rate has much further to fall before generating significant wages pressures. Without significant wage pressures any time soon, actual inflation is unlikely to be sustainably in the RBA's target band and so a move in the cash rate before 2024 is less likely.

The Australian Bureau of Statistics survey of business conditions and sentiments is due on Friday and it might give us some insights around employment and wage pressures from businesses.

In recent months, businesses have reported labour shortages, including skills mismatches. However, international border closures are likely contributing to some of these pressures. These might be alleviated once international borders reopen. However, the COVID-19 outbreak raging in India is a reminder that it might some time before for Australia's borders fully reopen. Although the developments in India have likely been exacerbated by the fact that only a small share of the population is vaccinated. Encouragingly, countries with the highest shares of their population vaccinated, like the US and UK, are showing that hospitalisation and death rates are declining.

A common theme in this business survey in recent months has been the improving business outlook, especially around financial circumstances. This theme is likely to feature firmly again based on the results of other business surveys. Last month the NAB business survey showed business conditions rose to a record high. Business confidence also remained elevated.

Private-sector credit for March is also released on Friday. Credit to the private sector remains soggy, but there is a slow uplift happening with housing credit in an upswing and business credit stabilising. We are looking for a rise of 0.3% in private-sector credit in March, which would take the annual pace to 0.8%.

Offshore, the US Federal Reserve is meeting on Thursday morning AEST. The Fed is likely to provide a more positive assessment of the US economy but stress that risks remain and further progress in its goals are needed before shifting policy.

Geopolitical tensions may also bubble away and be worth watching, especially after the Australian Federal government cancelled Victoria's Belt and Road Initiative with China.

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Forecasts

		2021			2022		
End Period:	**Close (23 April)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.10
90 Day BBSW, %	0.04	0.05	0.07	0.09	0.10	0.10	0.10
3 Year Swap, %	0.33	0.40	0.40	0.45	0.60	0.80	0.90
10 Year Bond, %	1.74	1.85	1.95	2.10	2.20	2.30	2.40
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond, %	1.56	1.75	1.85	2.00	2.10	2.20	2.30
USD Exchange Rates:							
AUD-USD	0.7739	0.79	0.80	0.82	0.85	0.85	0.84
USD-JPY	107.88	109	110	111	112	111	111
EUR-USD	1.2097	1.20	1.21	1.23	1.25	1.26	1.27
GBP-USD	1.3876	1.40	1.40	1.41	1.41	1.41	1.42
NZD-USD	0.7199	0.72	0.73	0.74	0.76	0.76	0.75
AUD Exchange Rates:							
AUD-USD	0.7739	0.79	0.80	0.82	0.85	0.85	0.84
AUD-EUR	0.6405	0.66	0.66	0.67	0.68	0.67	0.66
AUD-JPY	83.6	86.1	88.0	91.0	95.2	94.4	93.2
AUD-GBP	0.5583	0.56	0.57	0.58	0.60	0.60	0.59
AUD-NZD	1.0760	1.10	1.10	1.11	1.12	1.12	1.12

	2019	**2020**	**2021 (f)**	**2022 (f)**
GDP, %	2.2	-1.1	4.5	3.0
CPI (Headline), %	1.8	0.9	3.1	2.2
CPI (Trimmed mean), %	1.5	1.2	2.0	2.0
Unemployment Rate, %	5.2	6.8	5.0	4.7
Wages Growth, %	2.2	1.4	1.8	2.0

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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