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News Release

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Déjà-vu for Australia's two-speed economy with inflationary pressures simmering

The Reserve Bank of Australia (RBA) has said it is worried about the booming terms of trade and the eventual emergence of capacity constraints fuelling inflation, but that it also expects near-term inflation to remain high.

However, leading industry analyst and economic forecaster, BIS Shrapnel, says wage pressures fuelling inflation are unlikely to be an issue for at least two years. So where is the near-term inflation threat?

BIS Shrapnel's *Economic Outlook Bulletin* says the answer is that it is not yet demand-side inflationary pressures causing the issue, but rather the perennial problem of supply-side constraints across a range of domestic services, and the end of the free ride provided by a previously appreciating Australian dollar.

Wage pressures will not be a problem for at least two years

"Assuming an average productivity growth rate of 1.5 per cent and an inflation target of 2.5 per cent, which is the mid-point of the RBA's preferred band, wages inflation would have to exceed four per cent before it would even register as a threat to overall price growth," says BIS Shrapnel Senior Economist, Rachael Logie. "In the March quarter of 2010, wages growth increased just 2.9 per cent."

BIS Shrapnel says inflation has been persistently above three per cent for services which are publicly funded, publicly regulated or impacted by changes in public policy – health, education, utilities, urban transport fees, house purchase costs and rents.

The company also says the major driver of inflation for the remaining services (excluding financial and insurance services) is growth in unit labour costs (wages less productivity). Inflation in these categories is therefore likely to be a slow burn in the absence of a sharp jump in the cost of other inputs. However, there are real risks around the tradeables component, which had previously been offsetting the strong price growth in the supply-constrained sectors.

Past and present government policies at the heart of underlying inflation

Recent housing approvals and finance data have painted a conflicting picture of the Australian housing market. While affordability issues are making it increasingly difficult for first-home buyers to break into the property market, the investor and upgrader market remains buoyant.

"A major round of house building is required to take the pressure off rents and house price growth," says Logie. "This is coming, but in the near-term housing inflation is set to build as demand regains momentum."

BIS Shrapnel says inflation in the other public components – health, education, utilities and urban transport fees – has historically always grown above three per cent. An extended period of underinvestment in these four sectors, against a backdrop of strong increases in demand, has led to the current situation. A major phase of investment is required, but this would actually put upward pressure on prices in the short-to medium-term.

Free ride from the Australian dollar coming to an end

BIS Shrapnel says the Australian dollar will struggle to repeat the role it has played since 2004 in dampening imported inflation.

“World inflation is on the rise as the global economy regains momentum,” says Logie. “Rising commodity prices have been pushing up producer prices and this is increasingly flowing on to retail prices. World interest rates are also set to rise now that demand and inflation are strengthening and this will increasingly erode the interest rate differential which has favoured the Australian dollar.”

Tradeables inflation accounts for 43 percent of the total Consumer Price Index (CPI). Over the past decade it has averaged between one and two per cent, partly as a result of weak world inflation (previously disinflation) and, more recently, as a result of an appreciating Australian dollar. BIS Shrapnel says tradeables inflation would have, in fact, been even lower in recent years, but retailers chose to keep some of the benefits of the disinflationary period and the rising Australian dollar to boost margins.

Retail turnover, in real terms, stalled in the March quarter and rising interest rates have eroded household budgets at a time when consumers still remain reluctant to increase debt to boost consumption. It is therefore likely, and the RBA will be hoping, that retailers will take a hit to margins rather than pass on the strong increase in final-stage import prices seen in the March quarter.

“The Australian dollar affects prices with a lag,” says Logie. “A flat Australian dollar in the March quarter and a likely decline in the June quarter, together with rising world inflation, points to strong growth in imported prices for all stages of production in the near-term.”

Not much wriggle room for inflation within the RBA’s target band

BIS Shrapnel says if all these components are added together – rising tradeables inflation, stubbornly high inflation among the supply-constrained sectors, and currently soft inflation for those ‘other services’, underlying inflation will trough at the top end of the RBA’s target in the June quarter of 2010, (held up by the 25 per cent jump in tobacco excise) and then rise from there. BIS Shrapnel expects headline inflation to exceed three per cent throughout 2010/11.

“Given that demand is only just starting to gain momentum, national incomes are set to receive a big boost from the rise in the terms of trade, and there is a housing recovery underway, this doesn’t leave much leeway for monetary policy,” says Logie.

“Add on a new leg to the mining cycle in two to three years, just as labour constraints start to re-emerge, and you can start to understand the headache the RBA is facing,” concludes Logie.

About BIS Shrapnel

BIS Shrapnel is Australia's leading provider of industry research, analysis and forecasting services. BIS Shrapnel helps clients better understand the markets in which they operate, through reliable and detailed market data, analysis of developments and drivers and thoroughly researched forecasts.

BIS Shrapnel compiles accurate, clearly explained and detailed information on industry sectors, markets and industries in which their clients operate. BIS Shrapnel provides market size and segmentation data, market shares, consumer attitudes and supplier reputation information, and regularly conducts both business-to-business and consumer research.

Over the company’s 46-year history, BIS Shrapnel has built up a strong level of expertise and unique methodologies for forecasting.

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