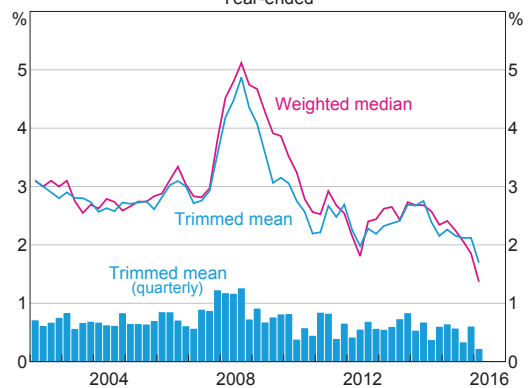


5. Price and Wage Developments

Recent Developments in Inflation

Inflation was low in the March quarter. Measures of underlying inflation declined to a little less than ¼ per cent in the March quarter, to be around 1½ per cent over the year (Table 5.1 and Graph 5.1). The headline consumer price index (CPI) fell by 0.1 per cent (in seasonally adjusted terms) to be 1.3 per cent higher over the year, partly reflecting a decline in fuel prices (Graph 5.2). The March quarter inflation data were lower than the forecast in the February *Statement*. Although some temporary factors contributed to the low result, the data indicate that there has been broad-based weakness in domestic cost pressures, reflecting low wage

Graph 5.1
Measures of Underlying Inflation
Year-ended



Source: ABS

Table 5.1: Measures of Consumer Price Inflation
Per cent

	Quarterly ^(a)		Year-ended ^(b)	
	March quarter 2016	December quarter 2015	March quarter 2016	December quarter 2015
Consumer Price Index	-0.2	0.4	1.3	1.7
Seasonally adjusted CPI	-0.1	0.4		
- Tradables	-0.7	0.3	0.6	0.8
- Tradables (excl. volatile items and tobacco) ^(c)	0.1	0.6	0.5	0.8
- Non-tradables	0.2	0.4	1.7	2.3
<i>Selected underlying measures</i>				
Trimmed mean	0.2	0.6	1.7	2.1
Weighted median	0.1	0.4	1.4	1.9
CPI excl. volatile items ^(c)	0.2	0.7	1.7	2.1

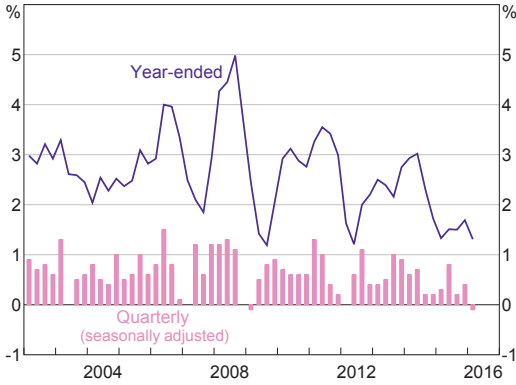
(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the Australian Bureau of Statistics (ABS) are calculated by the RBA using seasonal factors published by the ABS

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median

(c) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

Graph 5.2
Consumer Price Inflation

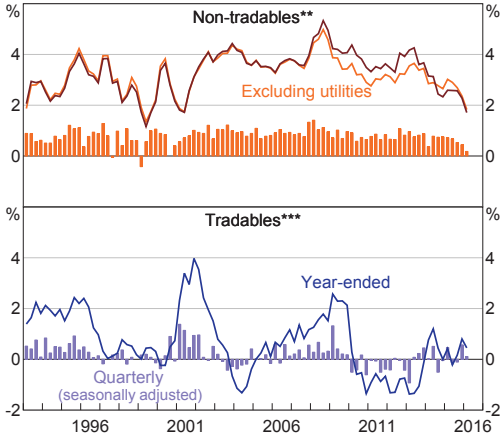


Source: ABS

growth, heightened retail competition, softer conditions in rental and housing construction markets and declines in the cost of business inputs such as fuel and utilities. This has been partly offset by some upward pressure on the prices of tradable items following the depreciation of the Australian dollar over the past few years.

Non-tradables inflation declined further in the March quarter and, in year-ended terms, was around its lowest level since the late 1990s (Graph 5.3). Most components of non-tradables

Graph 5.3
Non-tradables and Tradables Inflation*



* Adjusted for the tax changes of 1999–2000
 ** Excluding interest charges prior to the September quarter 1998 and deposit & loan facilities to June quarter 2011
 *** Excluding volatile items (fruit, vegetables and automotive fuel) and tobacco

Sources: ABS; RBA

inflation were well below their inflation-targeting averages. Market services inflation was particularly low, consistent with low growth in unit labour costs (Graph 5.4). Residential rent inflation was also very low across capital cities (Graph 5.5). Inflation in the cost of new dwellings has also declined over the past few quarters, following a period of higher inflation. Outcomes for housing inflation (including rents and the cost of new dwellings) have been particularly low in Perth, consistent with weaker demand for housing following the end of

Graph 5.4
Market Services Inflation
Year-ended

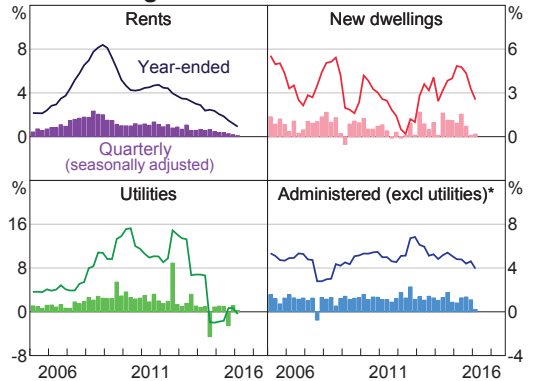


* Excludes deposit & loan facilities to June quarter 2011, housing services and domestic travel; adjusted for the tax changes of 1999–2000

** Non-farm, moved forward by four quarters

Sources: ABS; RBA

Graph 5.5
Housing and Administered Inflation



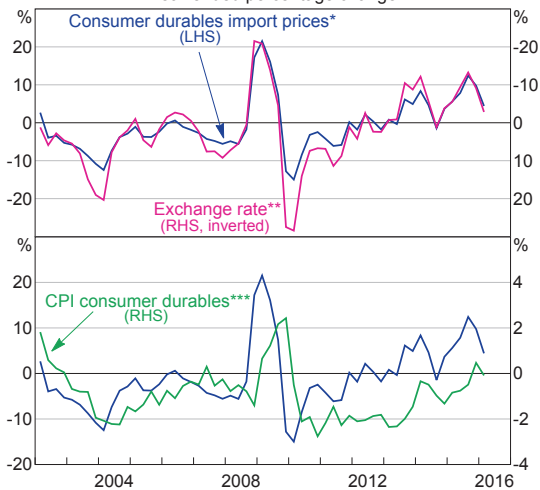
* Includes education, child care, health services, property rates, urban transport fares, postal services, some motor vehicle services and pharmaceutical products

Sources: ABS; RBA

the mining investment boom and the large fall in commodity prices over recent years. Inflation in items with administered prices was also low in the quarter; urban transport fares, education and pharmaceutical prices all declined (in seasonally adjusted terms), in part due to temporary factors.

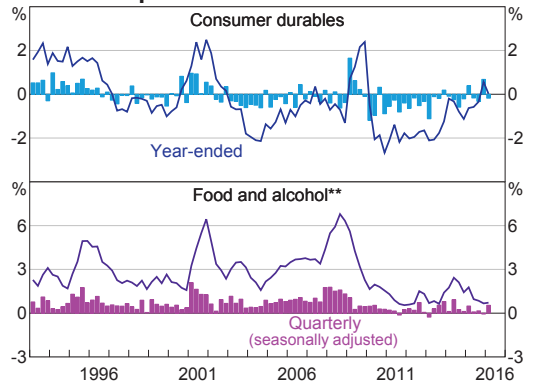
The prices of tradable items (excluding volatile items and tobacco) were little changed in the March quarter and were 0.5 per cent higher over the year. The final prices of tradable items are influenced by external factors as they are exposed to international trade via imports and exports. The substantial depreciation of the exchange rate over the past few years has increased import and export prices in Australian dollar terms, placing upward pressure on the final prices of tradable items (Graph 5.6). On the other hand, low wage growth and heightened retail competition have placed downward pressure on retail prices. The net effect has been subdued inflation in consumer durables, following price falls for several years, and continued subdued inflation in food and alcohol (Graph 5.7).

Graph 5.6
Consumer Prices and the Exchange Rate
Year-ended percentage change



* Consumption goods (excluding food and beverages), reweighted using CPI weights
 ** Import-weighted index, quarter average
 *** Retail items (excluding food and alcohol)
 Sources: ABS; RBA

Graph 5.7
Components of Retail Inflation*

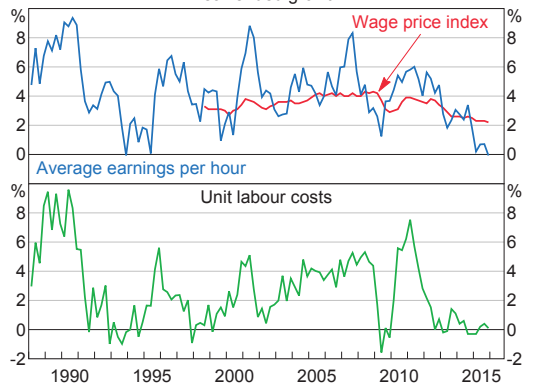


* Adjusted for the tax changes of 1999–2000
 ** Excluding fruit, vegetables, and meals out and take away foods
 Sources: ABS; RBA

Labour Costs

Labour cost pressures remain weak. The wage price index (WPI) increased by 0.5 per cent in the December quarter, to be 2.2 per cent higher over the year (Graph 5.8). Average earnings per hour from the national accounts (AENA) – which captures a broader range of payments to labour as well as the effect of changes in the composition of employment – declined in the December quarter and was little changed over the year. This growth is comparable to the period of weakness in the early to mid 1990s at a time of considerably higher unemployment.

Graph 5.8
Labour Costs
Year-ended growth

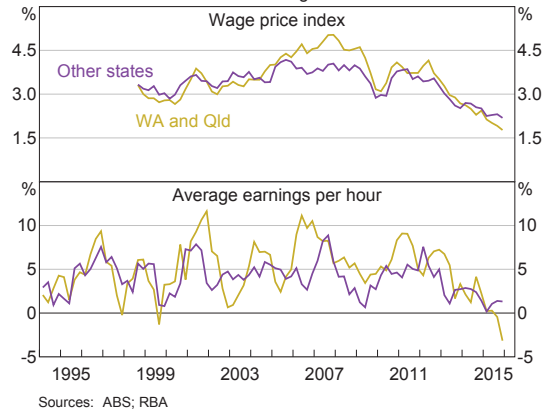


Sources: ABS; RBA

Growth in AENA has been much weaker than WPI growth over the past year, as was the case in previous episodes of declining wage growth. Most of the decline in earnings growth of late appears to have been driven by changes that are occurring within industries, rather than shifts in employment between industries. One factor contributing to this is the movement of some workers from high-paying jobs in mining-related activities to similar work in lower-paying positions in the non-mining economy. For example, liaison suggests that many workers employed in construction during the investment phase of the mining boom have returned to jobs in civil and residential construction at lower wage rates. In addition, liaison suggests that spare capacity in the labour market more generally is allowing firms to replace workers who leave their jobs with new employees on lower salaries, while promotion rates may also be below average. Low growth in AENA may also reflect changes in non-wage payments. For example, liaison suggests that firms have been able to reduce allowances for travel and accommodation.

Wage growth is low in all states and industries (see 'Box B: Wage Developments by Industry' for further detail). Nevertheless, the largest declines in wage growth over recent years have taken place in the mining states, where wage growth had previously been above the national average for some time (Graph 5.9). AENA has fallen more sharply relative to the WPI in the mining states, consistent with compositional change in employment and weakness in non-wage payments being most pronounced in those states.

Graph 5.9
Labour Costs
Year-ended growth



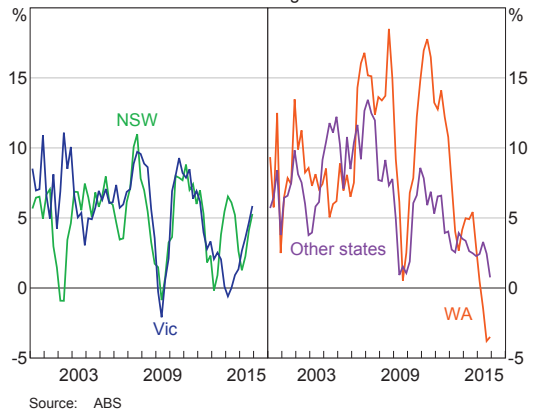
Low wage growth is consistent with a degree of spare capacity in the labour market. However, wage growth has been lower than implied by its historical relationship with the unemployment rate. Several factors may have contributed to this, including the decline in inflation expectations over recent years and the significant fall in the terms of trade, which implies a decline in national income.¹ Increased labour market flexibility over the past few decades may have also provided firms with greater scope to adjust wages in response to a given change in demand for their goods and services. Moreover, low wage growth has been evident in a range of advanced economies, even where unemployment rates have fallen significantly (see 'International Economic Developments' chapter).

Firms' unit labour costs have been little changed for around four years, as any growth in average earnings per hour has been broadly matched by growth in labour productivity (output per hour worked). Together with the depreciation of the nominal exchange rate over recent years, low unit labour cost growth is helping to improve the international competitiveness of Australia's labour, following a period of relatively strong growth in unit labour costs.

¹ For a more detailed discussion of these factors, see Jacobs D and A Rush (2015), 'Why is Wage Growth So Low?', *RBA Bulletin*, June Quarter, pp 9–18.

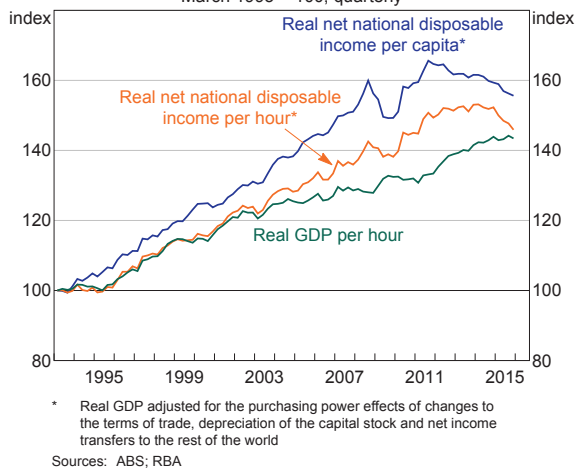
While low wage growth has directly contributed to low growth in household disposable income, lower growth in labour costs may have encouraged firms to employ more people than otherwise, thereby supporting growth in overall household spending. Growth in total compensation of employees – which reflects growth in both earnings and the number of employees – has picked up to around its long-run average in New South Wales and Victoria over the past year (Graph 5.10). In contrast, compensation of employees declined in Western Australia over 2015, after growing strongly during the mining investment boom, and growth has been low in the other states over recent years.

Graph 5.10
Compensation of Employees
Year-ended growth



A broader indicator of living standards is net national disposable income (NNDI) per capita. This takes into account changes to national income due to movements in labour productivity, the terms of trade, depreciation of the capital stock and the share of the population in paid employment. NNDI per capita has declined over recent years, after growing relatively strongly during the terms of trade boom (Graph 5.11). The effect of the sharp fall in the terms of trade over 2015 was offset to some extent by an increase in hours worked as the employment-to-population ratio rose, while labour productivity was little changed.

Graph 5.11
Productivity and Income
March 1993 = 100, quarterly



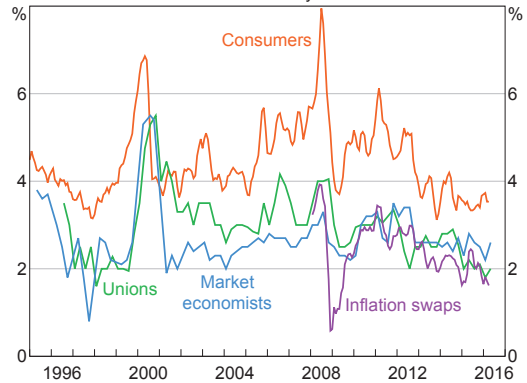
* Real GDP adjusted for the purchasing power effects of changes to the terms of trade, depreciation of the capital stock and net income transfers to the rest of the world

Sources: ABS; RBA

Inflation Expectations

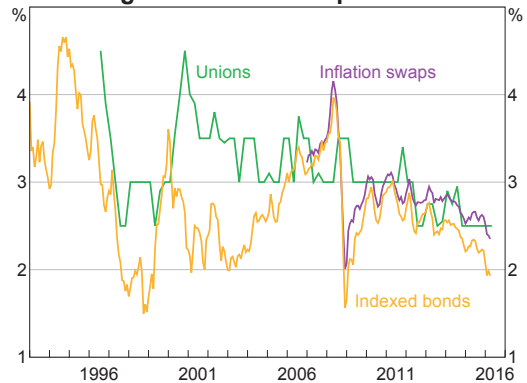
Measures of inflation expectations – from consumers, market economists, union officials and inflation swaps – remain below average (Graph 5.12 and Graph 5.13).² Long-term financial market measures of inflation expectations have declined noticeably over the past few months, although they may have been affected by other developments in financial markets. The expectations of consumers and market economists have been little changed over the past year or so. Unions’ short-term inflation expectations have declined of late, but their longer-term expectations remain anchored at 2½ per cent. Inflation expectations in Australia have not fallen to the same extent as they have in a range of other advanced economies (see ‘International Economic Developments’ chapter). ↗

Graph 5.12
Short-term Inflation Expectations
Over the next year



Sources: Australian Council of Trade Unions; Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

Graph 5.13
Long-term Inflation Expectations



Sources: Australian Council of Trade Unions; Bloomberg; RBA; Workplace Research Centre; Yieldbroker

² Of the short-term measures: the series for consumer expectations is the three-month moving average of the trimmed mean of individuals’ inflation expectations over the next year; union expectations are the median of union officials’ expectations of inflation over the next year; market economist expectations are the median of market economists’ expectations of inflation over the next year; inflation swap expectations are those implied by one-year zero-coupon inflation swaps. Of the long-term measures: union expectations are the median of union officials’ expectations of inflation on average over the next five to 10 years; inflation swap expectations are those implied by 10-year zero-coupon inflation swaps; the series for indexed bonds is the break-even 10-year inflation rate on indexed bonds (where interpolation is used to match exact maturity).