Gliding Down The Disinflationary Path

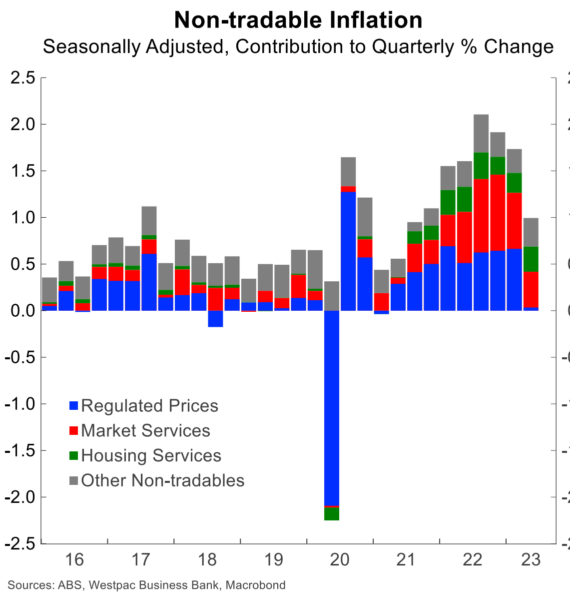
When the Reserve Bank (RBA) paused for the second month in a row in early August, the policy statement made it clear that the Board sees the balance of risks between inflation on the one hand, and the real economy on the other, as more even. Incoming data would need to show that this balance is shifting, or we are being knocked off the disinflationary path, to trigger further rate hikes. The release of key labour market and wage indicators this week will provide a steer on how these risks are evolving, and whether we continue to glide down the disinflationary path.

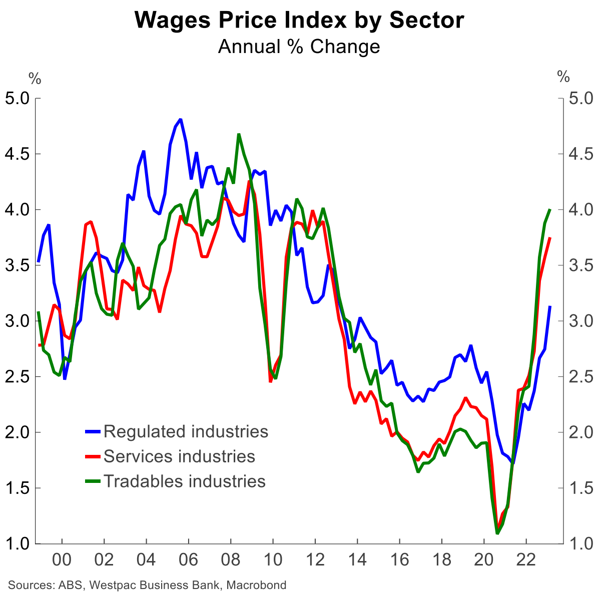
Wage Price Index – June quarter 2023

A de-anchoring of inflation expectations is one factor which could shift the balance of risks. However, wages outcomes in the leadup, and following, the Fair Work Commission's (FWC) 2023-24 minimum and award wage decision are not showing signs that expectations have become unanchored. This is consistent with the inflation reading for the June quarter, which would have pleased the RBA – not only because the headline number was softer than expected, but because the makeup suggested that the disinflationary impulse is spreading from the prices of goods determined in global markets to the prices of market services (excluding housing) which are determined domestically.

Are businesses losing their price setting power?

We have seen growth in the prices of market services (excluding housing) decelerate over the past six months. The costs of providing these services (such as haircuts, accommodation, or recreational activities) are largely made up of wages.





<u>This week's wages read should help us gauge whether the moderation we saw in the prices of market service reflects a decline in cost pressures (i.e. wages growth decelerating) or there is</u>

<u>implied margin compression (i.e. it's becoming more difficult to pass on higher costs).</u>

This is not a trivial difference– it goes to the heart of the risk assessment the RBA is making. Margin compression implies that demand is slowing, and it's becoming more difficult for businesses to pass on higher costs. Declining cost pressures imply that supply side constraints, including labour constraints, are easing and that inflation expectations are remaining in check. Ideally, you have both – a slowdown in demand and a bounce back in supply. However, margin compression would help confirm the RBA has rates at restrictive enough levels to get inflation back to target, reducing the risk of a re-acceleration in inflation.

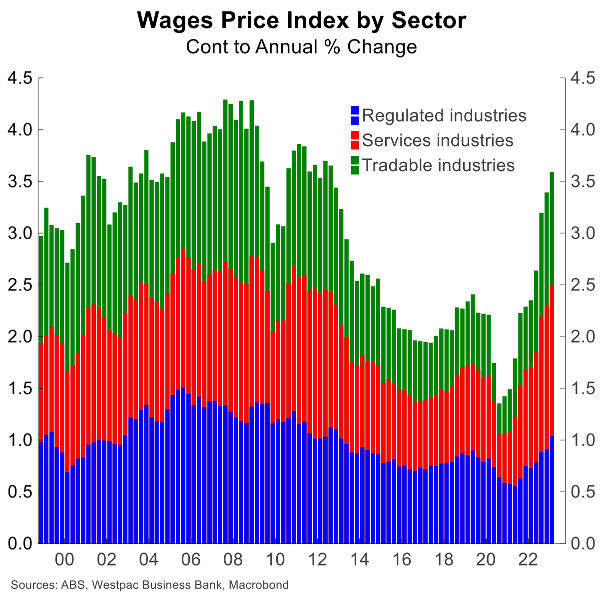
<u>Our analysis suggests that the price setting power of firms in some sectors peaked in the second half of last year in the, namely the wholesale and retail sectors. The wages read will give us a steer on whether this is expanding more broadly to the services sector.</u>

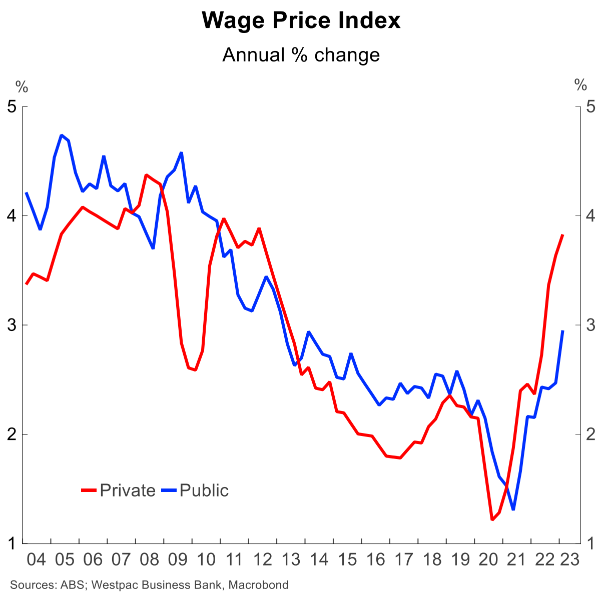
Which sectors will drive wages growth?

Consensus among economists is for wages growth of around 1.0% over the June quarter. Up until now, a large part of the pickup in wages growth has been driven by the industries where prices are determined by international forces, such as mining and manufacturing (or the tradables sector). Wages growth in the services-based industries have also picked up on the back of stronger economic activity. Now we are seeing those industries with regulated prices (i.e. child care and education services) which are predominantly in the public sector start to make amends.

<u>The question becomes whether wages growth will moderate in the tradable and services sectors to accommodate the stronger growth in the regulated sectors. Our central case is, yes. We see wages growth topping out at around 4.0% in annual terms.</u>

This is consistent with limited signs of wage acceleration from approved enterprise bargaining agreements and other partial wages indicators. We think there is downside risks to wages growth the market is expecting over the June quarter. An outcome closer to the 0.8% growth recorded over the March quarter cannot be ruled out. This would see wages growth running around 3.6% in annual terms, which is consistent with the RBA's inflation target.





While this is the central case, we are living through volatile times and given the tightness in the labour market there is always the possibly that wages growth and inflationary pressures surprise on the upside. We know there are short term pressures building – the FWC's 2023-24 minimum and award wage decision was stronger than expected and commodities including the price of oil and certain raw food items, have recently shown some strength. If these factors lead to an unexpected acceleration in wages growth, inflationary pressures could remain elevated for longer.

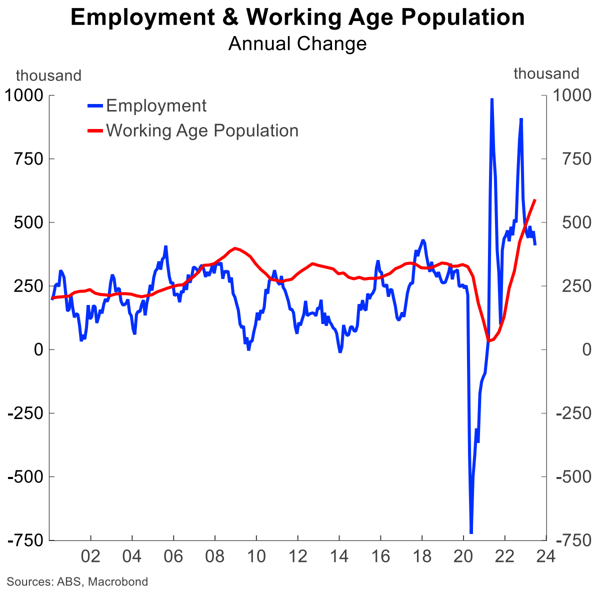
Labour force survey – July 2023

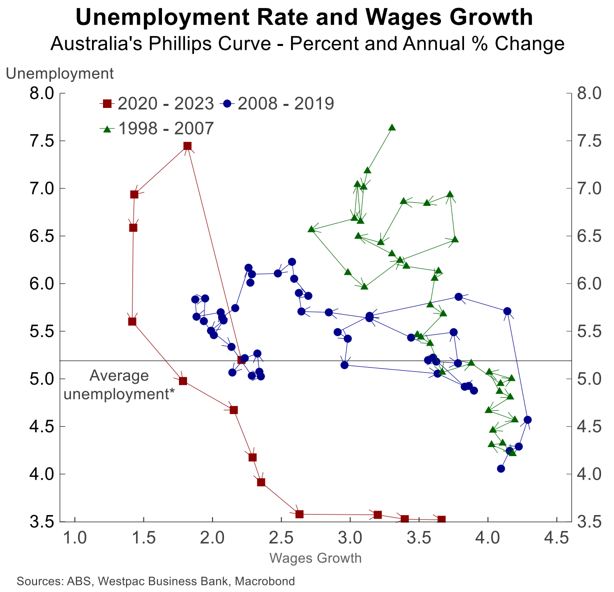
<u>There are also has implications for labour demand. At some point higher wages, lower labour productivity, and a constrained ability to pass on higher costs will mean that it will become less profitable for businesses to hire more workers. We are likely to see labour demand ease while growth in labour supply will continue to grow in line with high net overseas migration numbers.</u>

There are early signs that labour demand is easing. Forward indicators of labour demand are turning – for example the number of job ads has declined and the number of applicants per ad has increased. We expect that given the large backlog in labour demand the labour market will continue to accommodate the higher supply by creating around 25,000 jobs and for the unemployment rate to hold steady at 3.5% in June.

Importantly, over the last year or so, labour market indicators suggest that the market remains resilient and able to accommodate more foreign labour, but it hasn't got tighter. Combined with other factors including the inertia in our wage setting system and elevated labour force participation, this helps explain why we have not seen the excessive wages growth recorded during other comparable periods of labour market tightness. Over the last two decades, an unemployment rate below 5¼ per cent has seen wages growth accelerate to be between 4-5%.

<u>This is the other side of the migration equation. The larger population has seen the prices of essential goods and services, such as housing, increase rapidly. But the larger population has also increased labour supply and allowed us to deal with skills shortages more effectively. This reduces inflationary pressures – the other side of the equation. Its less obvious because the counter factual (i.e. higher wages) is not immediately obvious.</u>





Reserve Bank Board Minutes: Final phase of the tightening cycle

Finally, the RBA will release its minutes from the August meeting.

Last Friday, during Governor Lowe's last appearance before the House of Representatives Standing

Committee on Economics, he outlined the three phases of the current tightening cycle. Phase one was the withdrawal of stimulus – that is, getting rates back to neutral (or roughly, hiking from 0.1% in May 2022 to around 3.0% by the end of 2022). Phase two was getting rates above neutral and into contractionary territory to slow demand and achieve a better balance with supply (hiking from 3.0% to 4.10% over 2023).

The final calibration phase is where rates will be tweaked according to the signals provided by the incoming data. We are now in that final stage. We will be looking for any further hints on key indicators the RBA will be monitoring to assess whether we remain on the disinflationary path.

<u>It's our assessment that the economy will remain on the disinflation pathway - it won't be a linear glide and might get bumpy, but the global disinflationary impulse through improved supply chains, coupled with contractionary interest settings which will weigh on domestic demand, should be sufficient to get us back to target.</u>

Other domestic economic news

National cabinet will meet this Wednesday. A key point of discussion will be policy settings to boost housing supply. Renters' rights will also be on the agenda. Reporting suggests there could be announcements around land release and easing of planning restrictions, a grand bargain between states and the commonwealth. The housing market imbalance will only be resolved though greater supply. We will circulate our views on the supply impacts of any major announcements.

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Group Forecasts

		2023		2024			
End Period:	**Close (11 Aug)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	4.10	3.85	3.60
90 Day BBSW, %	4.17	4.30	4.30	4.30	4.22	3.97	3.72
3 Year Swap, %	4.13	4.00	3.95	3.90	3.80	3.70	3.60
10 Year Bond, %	4.11	3.75	3.55	3.45	3.30	3.25	3.20
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond, %	4.15	3.80	3.60	3.40	3.20	3.10	3.00
USD Exchange Rates:							
AUD-USD	0.6496	0.67	0.68	0.69	0.71	0.73	0.74
USD-JPY	144.96	140	138	135	132	130	128
EUR-USD	1.0949	1.11	1.12	1.12	1.13	1.14	1.15
GBP-USD	1.2696	1.28	1.28	1.29	1.29	1.30	1.30
NZD-USD	0.5984	0.62	0.63	0.63	0.64	0.65	0.66
AUD Exchange Rates:							
AUD-USD	0.6496	0.67	0.68	0.69	0.71	0.73	0.74
AUD-EUR	0.5934	0.60	0.61	0.62	0.63	0.64	0.64
AUD-JPY	94.16	93.8	93.8	93.2	93.7	94.9	94.7
AUD-GBP	0.5119	0.52	0.53	0.53	0.55	0.56	0.57
AUD-NZD	1.0853	1.07	1.08	1.09	1.10	1.12	1.12

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	1.0	1.4
CPI (Headline), %	3.5	7.8	3.9	3.2
CPI (Trimmed mean), %	2.6	6.9	3.8	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	4.1	3.3

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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