MLC ASSET MANAGEMENT

Australia's sticky inflation problem

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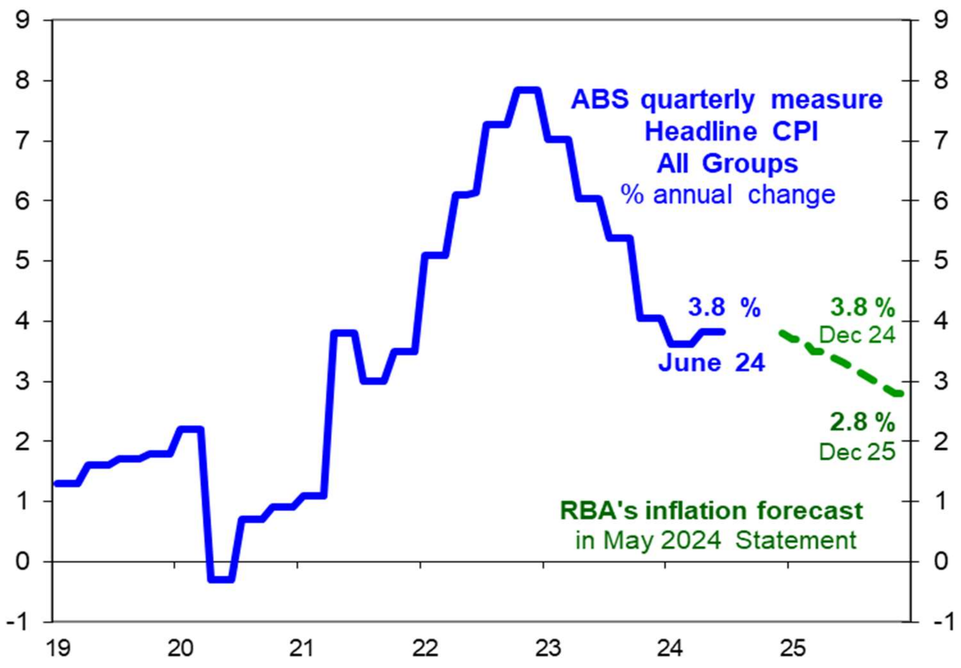
Australia's inflation remains "high" but does this justify another rise in interest rates?

Australia's annual consumer inflation came in at 3.8% in the year to June. While inflation has fallen from a peak of 7.8% in 2022, the most recent readings for inflation have been disappointing. Inflation is not declining as quickly as hoped and has become sticky. The Reserve Bank of Australia (RBA) is forecasting that inflation will eventually get down to 2.8% by December 2025 (Chart 1). However, the RBA's tolerance for inflation is being tested given their most recent assessment that inflation "*remains high*". Financial markets are debating whether the RBA will again raise the cash interest rate in coming months to get inflation down more rapidly.

Chart 1: Australian consumer inflation



Sources: Australian Bureau of Statistics and Reserve Bank of Australia.

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Why is inflation so sticky?

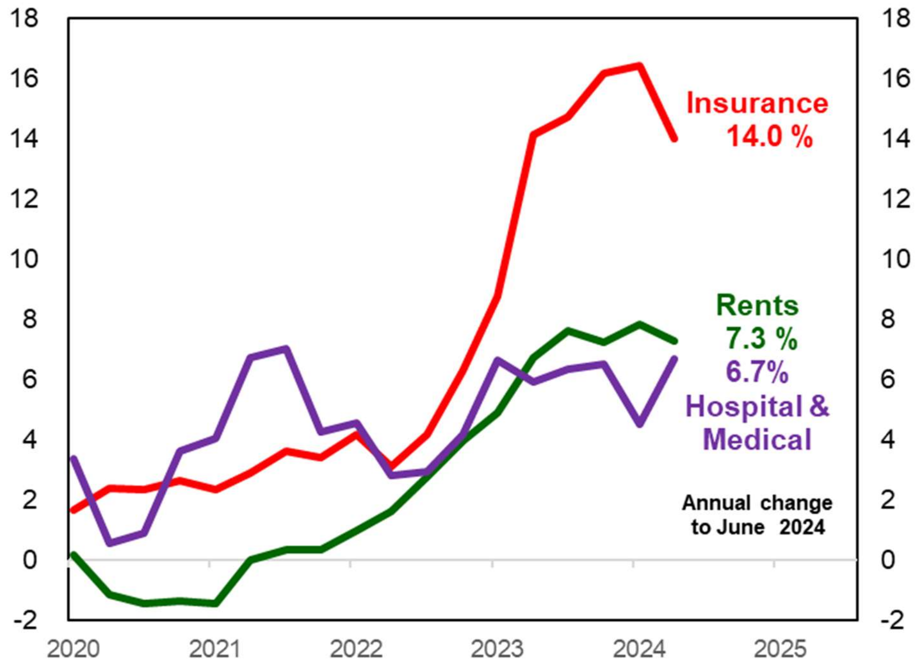
This stickiness in inflation is a result of the more persistent price pressures in health care, insurance, and rents. In the year to June 2024, hospital and medical costs have risen by 6.7%, rents by 7.3% and insurance by 14%. (Chart 2). These services prices have been steadily rising over the past three years and have been resistant to a slowdown in Australia's economic activity. This is puzzling given that Australia's slower economic growth should see inflation pressures moderate. However, the harsh reality for consumers is that these select services have their own peculiarities.

Take medical care costs. There are multiple reasons for this continued price surge. Hospitals are confronting the rising costs of food for their patients, recruitment costs for labour and power charges for their equipment. Add to this an "ageing" population with more complex health needs and there is the diagnosis for rising prices.

Rising rents have their own unique causes. Australia has failed to build enough homes to match its growing population over the past decade. This housing undersupply combined with a recent population surge after the COVID-19 pandemic has seen the rental crisis become even more acute.

For insurance, the persistent price pressure reflects the bushfires and floods of recent years as well as a lack of competition and transparency. As the former Australian Competition and Consumer Commission head Professor Allan Fels noted in March 2024, insurance companies appear to have made "*excessive"* price increases compared to the risks of doing business.

Chart 2: Australia's sticky price pressures



Sources: Australian Bureau of Statistics and Reserve Bank of Australia.

Australia's struggling economy should eventually drive inflation lower.

Australia's economy has been subdued in the past year with sluggish retail spending and weak housing construction. Notably the Australian economy is in a 'per capita' recession where population growth at circa 2.5% exceeds annual real economic growth at 1.1% for the year to March.

For consumer spending, the RBA's May 2024 statement remarked that "*households are budget-conscious and seeking value"* by*" trading down to cheaper products"*. Households are understandably trying to make their dollars go further by being thrifty. In turn, this thriftiness should see retailers and producers either hold or lower prices to support demand. Over time, this should moderate inflation pressures.

There have also been select government measures that can also help keep future inflation in check. The recent Federal and State Government Budget measures such as increased electricity rebates and rent assistance are steps in the right direction on inflation.

Given inflation is still a sticky problem, should the RBA raise interest rates again?

The RBA last raised the cash interest rate to 4.35% back in November 2023. The RBA has held fire for a considerable time hoping that inflation would cool and is understandably frustrated that inflation remains above their 2% to 3% target band. Indeed, the RBA Governor's statement in June 2024 highlighted that the future path of interest rates "*remains uncertain*."

"The path of interest rates that will best ensure that inflation returns to target in a reasonable timeframe remains uncertain and the Board is not ruling anything in or out."

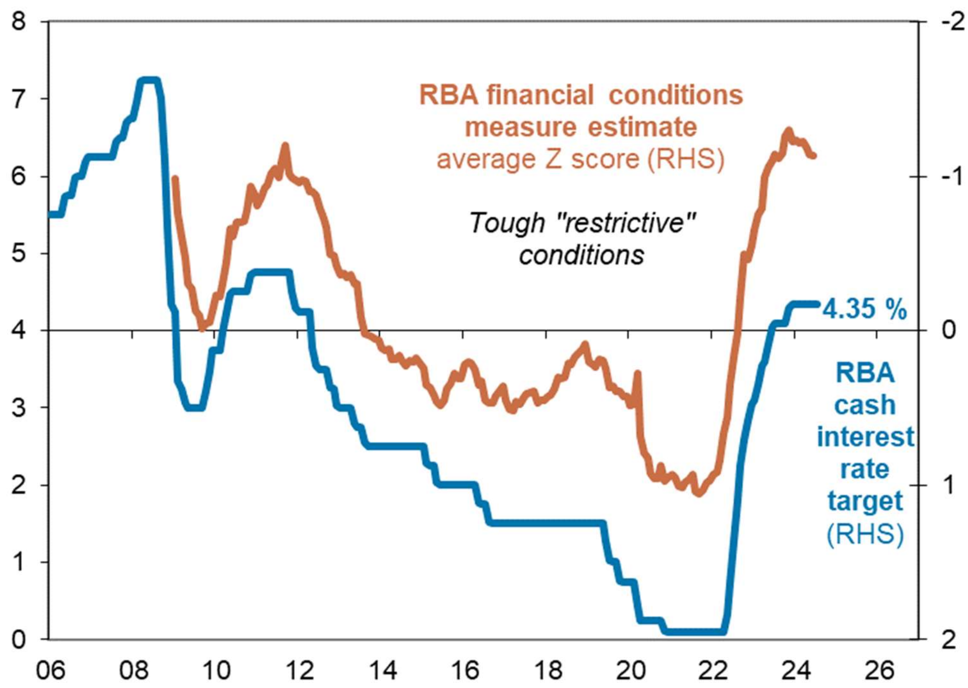
Essentially the RBA does not know exactly how high interest rates need to be to get inflation back to target.

However, there is significant recent research by the RBA that indicates that financial conditions for consumers are already very tough. In a June speech, the RBA's Assistant Governor Dr Christopher Kent noted that:

"*Since May 2022, the RBA has raised the cash rate target by 425 basis points. We know that many are feeling a painful squeeze on their finances because of higher interest rates. High inflation, though, has also reduced people's purchasing power. It has adversely affected all households, but especially those on lower incomes."*

The rise in Australia's cash interest rate from 0.1% in May 2022 to 4.35% currently (Chart 3) has pushed up borrowing rates for housing mortgages and personal loans as well as compelling some landlords to raise rents to cover borrowing costs. When the RBA considers "*a broad set of indicators*" that include borrowing rates and credit growth for consumers as well as for businesses, the RBA concludes that Australia's "*financial conditions*" are "*restrictive*" as in very tough.

Chart 3: RBA's interest rate rises has seen financial conditions become restrictive



Sources: Reserve Bank of Australia and MLC's estimate of RBA's "financial conditions".

According to the RBA, higher interest rates have served to slow Australia's economic activity and is contributing to reducing inflation.

"… *restrictive financial conditions are helping to slow the growth of demand, thereby bringing the level of demand into better balance with supply. This is contributing to the decline in inflation, which is to the benefit of all Australian households and businesses. "*

Another RBA interest rate rise would be a mistake that could risk a recession.

Australia's current sticky inflation problem reflects a mix of causes that primarily relate to supply constraints rather than strong demand. The surge in insurance, medical and rent expenses reflects various long-term challenges such as limited competitive forces (for insurance and health) and chronic undersupply (lack of new housing construction to match population growth is driving up rents). The RBA's primary tool for reducing inflation is to raise interest rates to slow demand. However, raising interest rates again fails to address supply constraints and risks being the catalyst to tipping Australia into recession. A further "*painful squeeze*" for Australian consumers by raising interest rates is the wrong medicine for our current inflation illness.

Sources:

‘Former ACCC chair Allan Fels calls for public inquiry into insurance price rises’, ABC RADIO MELBOURNE, Broadcast Monday 4 March 2024 at 8:30am, abc.net.au/listen/programs/melbourne-mornings/allan-fells-insurance-price-inquiry/103541216.

‘Restrictive Financial Conditions in Australia’, Reserve Bank of Australia, Dr Christopher Kent, Assistant Governor (Financial Markets) speech on Australian Banking Association (ABA) Banking Conference, Melbourne, 26 June 2024.

Statement by the Reserve Bank Board: Monetary Policy Decision, Reserve Bank of Australia, 18 June 2024.

Statement on Monetary Policy, May 2024, Reserve Bank of Australia, Forecasts (page 6) and ‘Insights from Liaison’ (page 36).