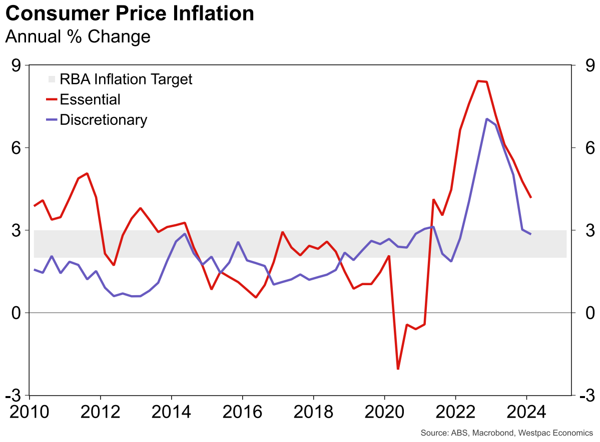
6 June 2024

The Great Divide Complicating the Policy Landscape

The March quarter National Accounts highlighted the growing divide between the 'essential' and 'discretionary' components of the Australian economy. The widening gap complicates the RBA's policy challenge, but it also helps explain why the spending announced in the Federal Budget may not add much to inflationary pressures.

Inflation can be cut-up and rearranged in many ways. Currently, one of the most telling is slicing it between essential and discretionary inflation. As the names suggest, essential items include vital goods and services such as groceries, housing, energy, education and healthcare. The purchase of discretionary items or non essentials can be put off such as holidays, recreation, hospitality and clothing & footwear.

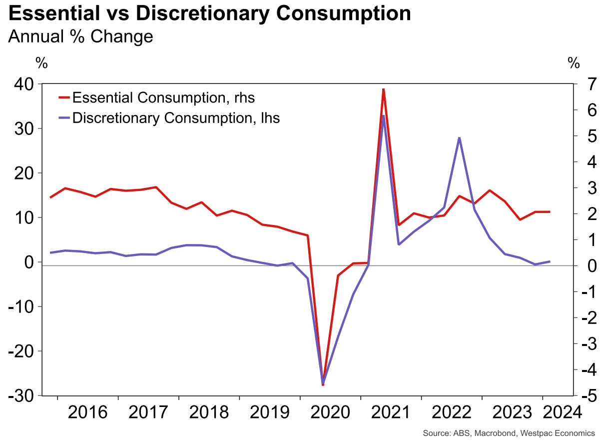
The essential components of the inflation basket are what is keeping aggregate inflation above the RBA's target. In the March quarter, annual growth in discretionary inflation shifted inside the RBA's 2-3% inflation target after peaking at over 7.1% at the end of 2022 and not being within target for almost two years. Essential inflation growth continued to slow but remains elevated at 4.2%.



Monetary policy has the biggest impact on demand for discretionary goods and services and, therefore, discretionary inflation. When responding to pressures on disposable incomes or incentives to save rather than spend, households tend to move from the most discretionary to least the discretionary when deciding where to adjust their spending. Consequently, monetary policy can be more constrained in its ability to manipulate demand for essential goods and services.

This is clearly observed in household consumption data. Over the year to the March quarter, household spending on discretionary items rose 0.1% while spending on essential items was up 2.1% over the same period. This must also be considered in the context of rapid population growth which is adding to demand for goods and services.

Weaker demand in the discretionary economy is translating into softer labour demand. Retail and accommodation & food services industries are among the only industries to have recorded a fall in employment over the last twelve months. In contrast, employment growth has been strongest in the essential industries of healthcare and education – these sectors also feature large public components, another source of resilience in demand.



Limited ability to influence short-run demand for essential goods and services complicates policy decision making for the RBA. It doesn't mean that the RBA can do nothing about inflation, but it does mean that if essential inflation remains too high, discretionary inflation will need to be even lower to offset it.

AN ASYMMETRIC SUPPLY BOOST

An even bigger challenge for the RBA comes from the supply side where monetary policy has even less of a direct impact and where constraints are concentrated in essential sectors.

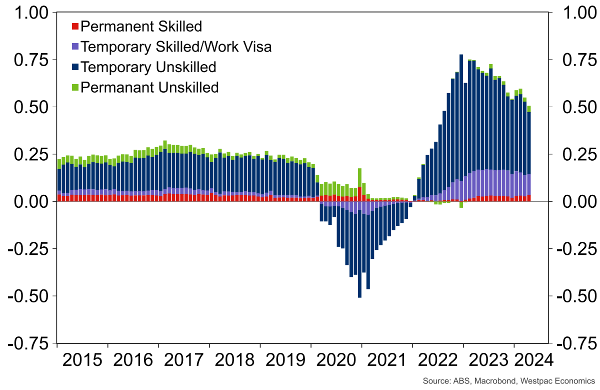
As supply chains have healed from the effects of the pandemic, many of the temporary disruptions to the supply-side of the economy have largely unwound. The availability of many capital and intermediate goods has improved significantly, moving the origin of capacity constraints from sourcing inputs to finding labour.

The surge in labour supply following the reopening of international borders has gone a long way in alleviating labour shortages. However, the boost to labour supply from population growth has not been evenly distributed.

A disproportionate share of the migration intake has comprised of low skill visa holders, predominantly students. The influx of low-skilled workers has funnelled towards low skilled roles including in industries like retail, hospitality and administration. The rapid increase in migration has not had the same labour supply boost in high skilled areas needed in healthcare, education and construction.

Broadly speaking, discretionary segments of the economy rely more on low skilled labour and imported manufactured goods where there has been a more meaningful improvement in sup-

Net Overseas Arrivals by Visa Type
Rolling 12-month Sum, Millions



ply. Combined with weaker demand, market fundamentals have moved into better balance in the discretionary areas of economy, and this better balance is reflected in the discretionary inflation measure.

In contrast, demand in the essential areas of the economy is still running beyond capacity. This is partly because of relatively more resilient demand, but also because of a more gradual recovery in supply. The high skilled workers needed in essential areas such as healthcare, construction and education have not increased rapidly enough to meet demand.

The effects of the pandemic have also been more persistent in some essential sectors such as housing and insurance. Housing inflation, whilst grounded in supply and demand mismatches, is being exacerbated by the elevated level of construction costs, elongated and uncertain build times, and a spike in corporate insolvencies. These pandemic legacies are delaying the usual supply response needed to rebalance demand and supply. Similarly, the sharp rise in the price of vehicles, healthcare and dwelling construction after the pandemic is feeding back into insurance prices with a lag. The dollar value of cover needs to go up to match the higher cost of goods and services, meaning a larger nominal exposure for insurers. Combined with more frequent natural disasters, this is putting significant upward pressure on insurance premiums.

As the supply-side continues to expand, it is only a matter of time before supply and demand in many of these essential sectors becomes better balanced, allowing inflation to reach the RBA's target. However, time is not on the RBA's side and it's uncertain exactly how long it will take for some of these constraints to ease.

This is the quandary facing the RBA.

A slower expansion of supply in these essential segments of the economy risks inflation staying too high for too long, potentially risking a de-anchoring of inflation expectations. Encouragingly, current measures of inflation expectations remain well anchored over the medium term. But hiking interest rates further to bring inflation down only serves to hit the discretionary side of the economy harder, potentially risking a bigger economic slowdown and a larger deterioration in the labour market.

The RBA is taking the sensible approach of setting sufficiently restrictive policy to ensure the discretionary sector of the economy is not adding to the inflation problem, but not too tight that it strangles the economy. And, importantly, maintaining this policy stance for long enough for supply constraints in the essential part of the economy to be ironed out. There is a risk that this supply improvement takes too long and forces the RBA's hand, but there is equally a chance that supply recovers more quickly and inflation moderates faster.

IMPLICATIONS FOR FISCAL POLICY

Fiscal policy should ideally run in the same direction as monetary policy, especially when inflation is elevated. The cost-of-living support package announced in the Federal Budget has received considerable attention in this context. The package included the revised stage 3 tax cuts, a $300 energy rebate for every household, a boost to rent assistance and a freeze on indexation for some items on the pharmaceuticals benefits scheme (PBS).

An important feature of these last three measures is that they directly reduce the out-of-pocket expenses of households on electricity, rent and pharmaceuticals. This mechanically reduces inflation as measured by the consumer price index (CPI). Treasury estimates this will reduce the headline CPI by around 0.5 percentage points over the year to June 2025.

Many economists have been quick to point out that the subsidies also free up income which would have otherwise been spent on these items, which can now be deployed elsewhere, adding to demand. Additionally, it has been argued that the net effect of the mechanical drag on inflation and the boost to demand from the subsidies will add to inflation.

However, these arguments ignore the fundamental structure of the inflation challenge outlined above. If you look closer, you will notice that the cost-of-living subsidies directly reduce measured inflation in essential categories (housing, energy, healthcare), buying the RBA more time for the underlying supply-demand dynamics to continue to improve.

Additionally, the boost to demand from the resulting 'savings' is most likely to be concentrated on discretionary rather than essential goods and services, as many households are already outlaying what's needed for essentials. This will dilute the impact on inflation as it adds to demand in sectors where there are not currently capacity constraints but rather, emerging slack.

However, there is a strong possibility that at least some of the savings are directed towards more spending on housing, including rents and renovations. The risks here flow in the opposite direction, adding to demand in an area of the economy where capacity constraints are arguably the most significant.

OUTLOOK

Contrasting dynamics in the essential and discretionary areas of the economy highlight the challenge for the RBA – monetary policy is least effective for areas of the inflation basket which are responsible for keeping inflation high, and most effective in areas of the economy where there is already emerging weakness. A patient and data-dependent approach is the RBA's strategy for minimising the risk of a policy mistake in this environment.

We, like the RBA, see a credible path to a soft-landing. But as our Chief Economist, Luci Ellis, pointed out in last week (see The grumpy hawk and other scenarios) , there remains plenty of known and unknown risks which could still knock the RBA off its tricky and narrow path.

Jameson Coombs, Economist

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