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Weekly economics podcast: Inflation conundrum

By Perpetual Corporate Trust

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Australian inflation is rekindling more strongly than expected previously. The upward blip in annual inflation could be temporary, that is temporary in the sense that after travelling above 3% over the next year so, it falls back towards the middle of the RBA's 2-3% target band at some point in 2027. But there is also a case for calling above 3% inflation to persist for longer, a development that would require the RBA to start hiking the cash rate in 2026. For the time being, the RBA is forecasting that the surprisingly big lift in inflation shown in the Q3 CPI report is temporary and will fade in 2027 presenting a case for the cash rate to stay on lengthy hold at 3.60%. To stick with this forecast, the RBA will need to see corroborating data over many months relating to demand and supply in the economy, labour market conditions, and inflation.

The current inflation story is complicated. Part of the reason for the lift in inflation in Q3 was because of the effect of the ending of various State Government electricity support schemes on July 1st. That boosted the rise in the electricity price component of the CPI to more than 23% y-o-y. Electricity prices are captured within the broader housing component of the CPI which rose by 4.7% y-o-y. The Federal Government's electricity rebate scheme is set to end on 31st December, although there is some talk that might be extended another 6 months to 30th June 2026. Whenever it ends, that will also contribute to a big rise in electricity price measured within the CPI housing component.

Removal of electricity rebates can be considered rightly as adding temporarily to the annual inflation rate. However, other price increases showing in the CPI housing component are looking like they will stay longer. Property rates and charges were up 6.3% y-o-y in the Q3 CPI, the biggest annual increase since Q3 2014. The mounting demands and cost pressures facing local councils point to another big rise in charges next year.

Staying within the housing component of the CPI, housing rental cost was up 3.8% y-o-y in Q3 and down from 4.5% y-o-y in Q2. Given the mounting shortage of rental accommodation it is unlikely that annual change in rental cost will moderate further. More likely it will start edging higher. New dwelling prices were up a comparatively low 0.9% y-o-y in Q3, a little higher than in Q2, but again housing demand is lifting and is likely to add pressure to new house prices. It is hard to see how the housing component of the CPI will reduce much below 4% y-o-y over the next year or two, a significant hurdle to getting the CPI inside 2-3% target band.

Other areas of the CPI now lodged above 3% y-o-y and likely to stay above for the next year or two include health costs, up 4.2% y-o-y in Q3, and education costs, up 5.3%. Both the health and education sectors are facing big upward cost pressures, mostly from wage deals well above CPI together with pressure to lift staffing ratios.

In other components of the CPI, it is the more general lift in demand in the economy relative to limited supply that is adding to inflation. The household sector has had a material lift in real household disposable income over the past year or so coming from wages rising faster than inflation; lower interest payments after the three RBA rate cuts; lower income tax; and higher payments and subsidies from government in many areas from childcare and home -buying through to electricity. As a result, growth in household spending has been lifting erratically to over 5% y-o-y.

That lift in demand in the economy is running up against stagnant productivity limiting growth in supply. It should not really surprise, therefore, that the moderation in inflation that came with a lag after the period of weak demand in the economy in 2023 and the first half of 2024, is now turning to accelerating inflation. The evidence of that broader inflation acceleration shows starkly in both goods' inflation, up to 3.0% y-o-y in Q3 from 1.1% in Q2 and services inflation, up to 3.5% y-o-y from 3.3% in Q2.

If the current upward inflation blip is to fade away below 3% y-o-y after 2026 as the RBA's latest economic forecasts show (CPI inflation peaking at 3.7% y-o-y in June 2026 ahead of moderation to 3.2% in December 2026 and 2.6% in December 2027) household spending must not grow more strongly than it is currently and the unemployment rate needs to stay around the current 4.5%. These are the conditions that might mean the RBA can consider another cash rate cut in mid-2026.

The risk is that conditions will be a little stronger and inflation stays higher. That would mean the RBA will hold the cash rate at 3.60% ahead of a new cycle of rate hikes starting probably in

late-2026. The data reports over the next few months will help to determine which of these two scenarios for the cash rate outlook is the more likely.

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