FOI 3517 - Document 1

Australian Government
The Treasury

Ministerial Submission

MS23-001300

FOR INFORMATION - Impacts of global supply-chain and inflation pressures

TO: Treasurer - The Hon Jim Chalmers MP
CC:

KEY POINTS

- The Budget forecasts for headline inflation to ease are predicated on the resolution of recent global supply constraints, particularly for manufactured goods and energy.
  - We estimate that higher import prices and domestic supply constraints accounted for between a third and a half of the 7.8 per cent peak in annual inflation in the December quarter 2022.
  - The forecasts assume an unwinding of this contribution (i.e. disinflation) but do not assume any significant deflationary effects.
- Key indicators suggest that this is occurring largely as expected. Supply bottlenecks for global manufactured goods have now resolved, while energy and commodity markets have adjusted to the reduction in Russian supply.
  - Global shipping costs, after surging by over 700 percent, have returned to pre-pandemic levels and the New York Federal Reserve’s global supply chain pressure index has fallen to below pre-pandemic levels.
  - The global semi-conductor shortage has eased, allowing auto manufacturers to resume a normal pace of production, consistent with a record high volume of new vehicle imports in the March quarter in Australia.
  - Commodity prices, including for energy, have retreated from extreme levels reached in 2022 following the onset of Russia’s invasion of Ukraine.
  - Chinese producer and export prices are also declining, due to lower commodity prices and softening Chinese and global demand.
- The decline in upstream global goods and energy prices is flowing through to moderating consumer prices in most advanced economies.
  - In the US, annual headline inflation has fallen from a peak of 9.1 per cent in June 2022 to 3.0 per cent in June 2023. In the Euro area, it has fallen from a peak of 10.6 per cent in October 2022 to 5.5 per cent in June 2023.
- In Australia, there are also clear signs that easing global supply constraints are bringing down the rate of headline inflation, with disinflation evident in several components of the CPI that

contributed to the inflation spike in 2022. Recent domestic supply disruptions related to flooding have also passed and cost pressures are easing in the housing construction sector.

- Overall import prices fell by around 4 per cent in the March quarter 2023, after quarterly growth peaked above 6 per cent during the pandemic in late 2021.
- Annual price growth for automotive fuel, new dwellings, fruit and vegetables, and broader tradable goods is easing sharply.

- The June quarter CPI provided further evidence of the handover in the drivers of inflation from supply-side disruptions to broader pressures in the services sector. Annual services inflation rose at its fastest pace since 2001 and exceeded goods inflation for the first time since September 2021.
- This easing in global and domestic supply constraints is welcome and consistent with the Budget forecasts, but there remain risks to the outlook.
  - Further risks to global energy and food prices remain if Russia's ongoing war in Ukraine or more extreme weather events see further disruptions to energy and agricultural commodities, or additional energy demand.
    - Renewed global energy price pressures could exacerbate the ongoing passthrough of higher wholesale energy costs to consumer prices in Australia, which is still occurring with a lag due to the prevalence of forward contracting in Australian energy markets.
  - Slower-than-expected easing in groceries and new dwellings price growth in the June quarter 2023 could see greater persistence in goods inflation than anticipated.
  - Outside of supply-side factors, rental price pressure may be greater than forecast, buoyed by ongoing strength in advertised rents and population data.
- More broadly, as supply constraints moderate, the key factors that will determine the outlook for inflation will be movements in wages and productivity *(for further information see MS23-001312)*.

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ATTACHMENTS

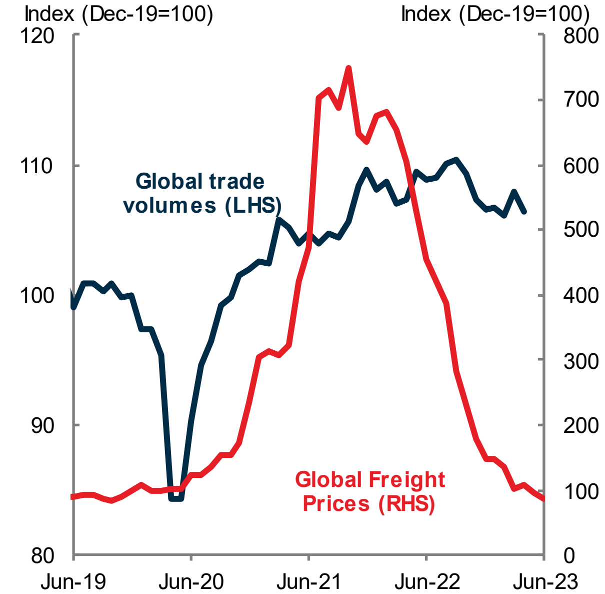
A: Additional Information

ATTACHMENT A – ADDITIONAL INFORMATION

Drivers of international supply and demand imbalances during the COVID-19 pandemic

- The COVID-19 pandemic significantly disrupted global supply chains, with increased demand for consumer goods as mobility restrictions reduced services activity, and as large fiscal stimulus support boosted aggregate demand.
  - Global goods trade volumes have eased from their peak in September 2022 and global container shipping costs have returned to pre-pandemic levels as congestion in supply chains has been resolved (Chart 1).
  - The New York Federal Reserve's global supply chain pressure index has fallen steeply after peaking in December 2021, indicating broader disruptions to goods supply have been resolved (Chart 2).
  - Falling Chinese producer and export prices are putting downward pressure on imported goods prices in advanced economies.
  - Easing in global semi-conductor shortages has helped to normalise automotive production rates, while major semiconductor manufacturers in Taiwan and South Korea have begun reducing production due to waning demand for consumer electronics.

Chart 1: Global trade volumes and freight prices



Source: Netherlands Bureau for Economic Policy Analysis, Freightos, Refinitiv.

Chart 2: Global supply chain pressure index

Source: Federal Reserve Bank of New York.
Note Index reflects standard deviations above average (zero).

Global energy prices have corrected from record highs following the Russian supply shock, as restructuring of trade flows and favourable weather ease tensions in energy markets

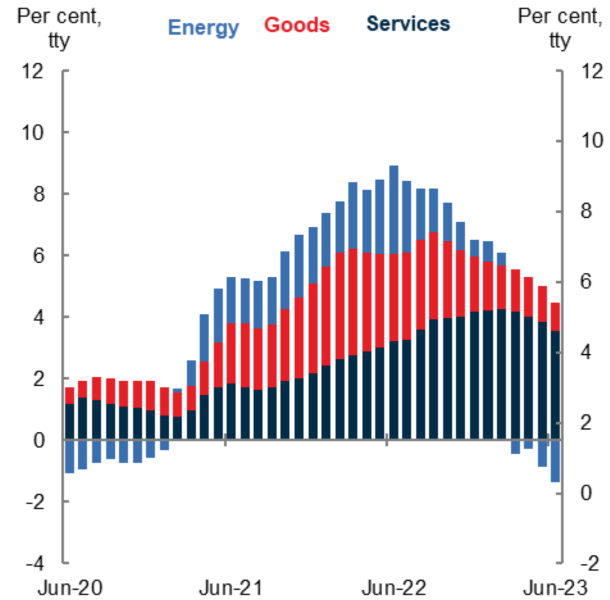
- Russia's invasion of Ukraine disrupted global energy trade, leading to a large reduction in coal and gas supply to global markets and a reorientation of Russian oil trade.

- Energy commodity prices have declined from their peaks in 2022, as the re-routing of trade flows and additional supply have allowed coal and LNG markets to adjust.
  - Easing demand from more favourable weather in the Northern hemisphere over winter have also helped to ease coal and gas prices.
  - Oil prices have unwound from highs in early 2022 and despite renewed upside risks from OPEC+ production cuts, this has been balanced by softer global demand growth.

Unwinding goods inflation and energy price deflation have seen headline consumer price inflation in advanced economies decline from their peaks

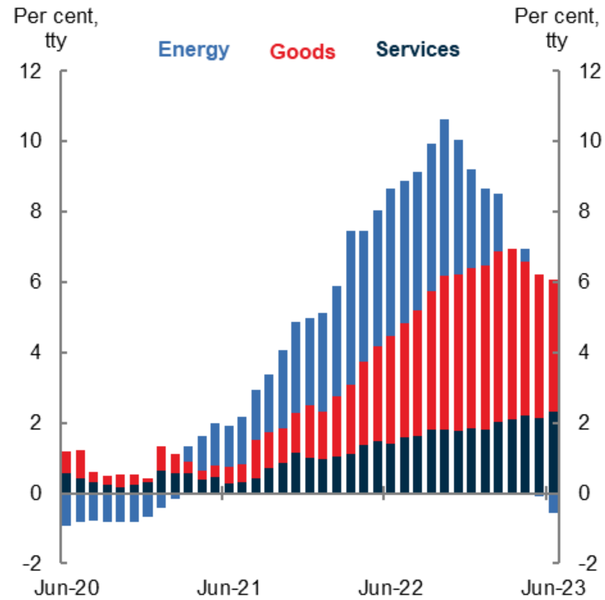
- Headline inflation in many advanced economies has fallen sharply from their mid-to-late 2022 peaks. Consumer energy prices have fallen in many countries, with lower oil prices feeding into lower vehicle fuel prices. In some countries, household gas prices have also fallen (Charts 3 and 4).
  - Core inflation is proving to be stickier, underpinned by elevated services inflation, including significant growth in rents in some countries such as the US and Canada.

Chart 3: Contributions to US headline CPI



Source: Refinitiv, Bureau of Labour Statistics.

Chart 4: Contribution to euro area headline HICP

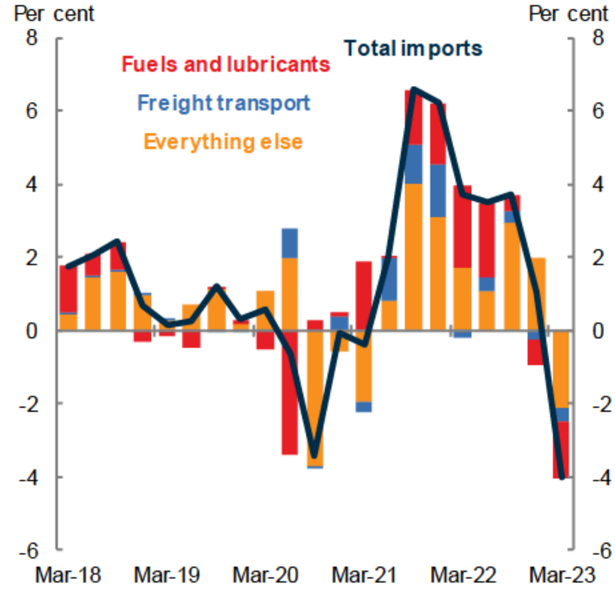


Source: Refinitiv, Eurostat.

Australian inflation has eased from its late 2022 peak, as global factors have seen fuel and imported goods prices decline. Improved domestic supply conditions have aided disinflation

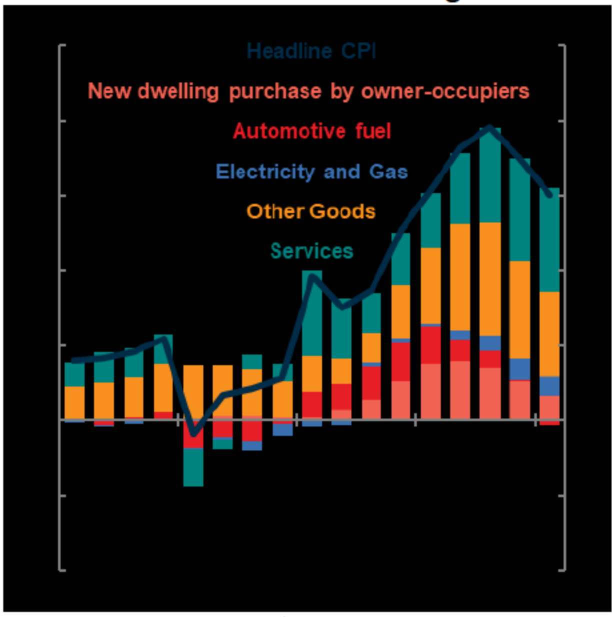
- Import prices have fallen in line with easing supply conditions globally and domestic headline inflation moderated further to 6.0 per cent through the year to the June quarter 2023, with disinflation evident in a range of components, reflecting improved supply (Charts 5 and 6).

Chart 5: Quarterly growth in import prices



Source: ABS Balance of Payments and International Investment Position, Australia

Chart 6: Contributions to CPI growth



Source: ABS Consumer Price Index, Treasury
Note: Contributions are back-cast using 2022 CPI expenditure weights.

– Australian petrol prices have fallen as oil prices have retreated significantly from their recent peak in early 2022 (Chart 7). In the June quarter 2023, fuel prices experienced an annual fall of 3.6 per cent, the first annual decline since early 2021.

– The impact of severe flooding over 2022 on agricultural and logistic supply chains has started to abate, with annual fruit and vegetables price growth moderating in recent quarters.

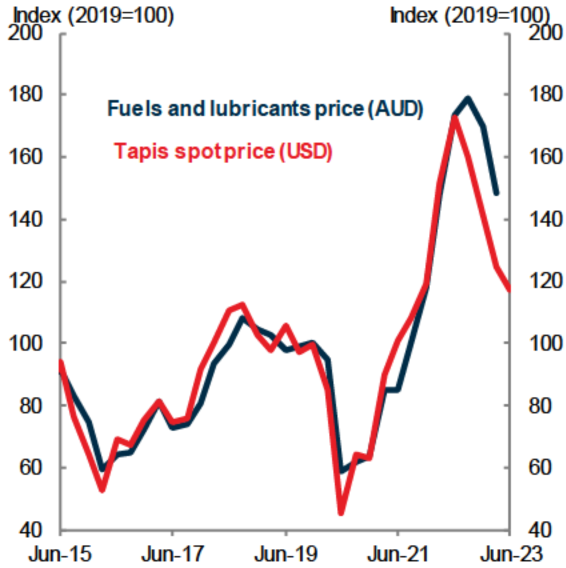
– Broader goods inflation declined from its peak of 9.6 per cent through the year to the September quarter 2022, to 5.8 per cent to the June quarter 2023.

– The strong growth in residential construction costs has started to moderate, although remains elevated, as easing global supply chain disruptions and softening demand growth have curtailed further price increases in the sector (Chart 8).

  : Annual new dwellings price growth eased from 20.7 per cent in the September quarter 2022 to 7.8 per cent in the June quarter 2023.

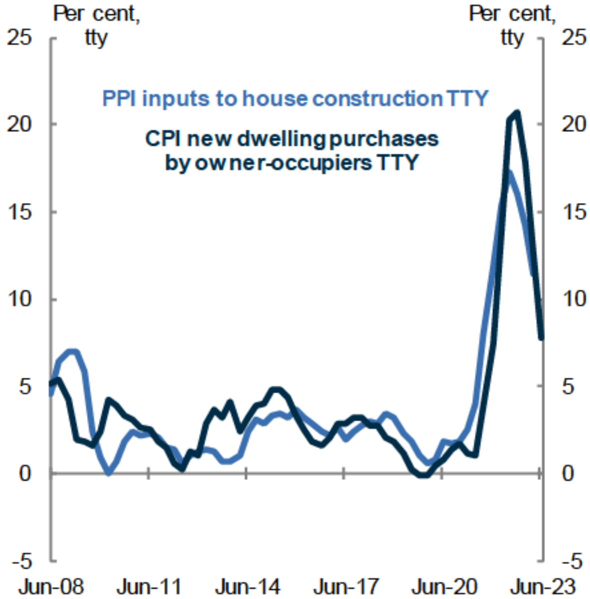
– A fall in the price of motor vehicles in the June quarter 2023 is consistent with moderating vehicle supply backlogs, following the record high volume of new vehicle imports in the March quarter 2023. This is the first quarterly decline in the price of motor vehicles since March 2020.

Chart 7: Oil and Australian fuel import prices



Source ABS Balance of Payments and Bloomberg.

Chart 8: Housing construction costs



Source: ABS Producer Price Indexes, ABS Consumer Price Index
Note: PPI only available to March 2023

The near-term outlook is for improved supply conditions but risks to inflation remain in energy, food and housing

- Further disruptions to global energy and food prices remain a risk given Russia's ongoing war in Ukraine. Energy and commodity markets are also vulnerable to adverse weather events.
  - The expiration of the Black Sea Grain Initiative on 17 July is likely to see wheat price spikes in the short-term. However, the global wheat market is better placed to absorb this shock than before the invasion and prices are not expected to reach 2022 peaks.
  - Ongoing weather-related disruptions to agricultural supply could see renewed upwards pressure on global food prices. Additional energy demand from more extreme weather such as the recent heatwaves in the US and Europe may also see renewed upward pressure on energy prices.
- Domestically, higher energy costs for households are expected to see further contributions to headline consumer price inflation over the forecast period. This reflects the lagged pass through of wholesale energy costs to regulated annual increases in consumer tariffs.
  - At Budget, the Government's Energy Price Relief Plan, through wholesale price caps and household bill rebates, was expected to reduce inflation by ¾ of a percentage point in 2023-24 and add around ¼ of a percentage point to inflation in 2024-25.
    - The Queensland Government's recent announcement of further electricity subsidies presents some downside risks to 2023-24. Early assessment suggests these could result in a lower average electricity price rise of between 5-10 per cent through-the-year to June 2024, before adding to measured CPI in 2024-25.
- Rental price growth was marginally stronger than expected in the June quarter 2023 and continues to present an upside risk to the outlook, given stronger-than-expected population growth and stronger advertised rents.