OPTIMAL ECONOMICS

Weekly Economic Update

House price declines to continue … as core inflation accelerates

Australia's cranky inflation dragon hasn't been slain. While headline inflation dipped to 4.0% in the year to May, the all-important trimmed mean rate – the core measure favoured by the Reserve Bank – *accelerated* to 3.6%. The Treasurer mentioned the war, but there were other drivers, including higher building costs and residential rents. The (now extended) cut to the federal fuel tax kept headline inflation from being worse.

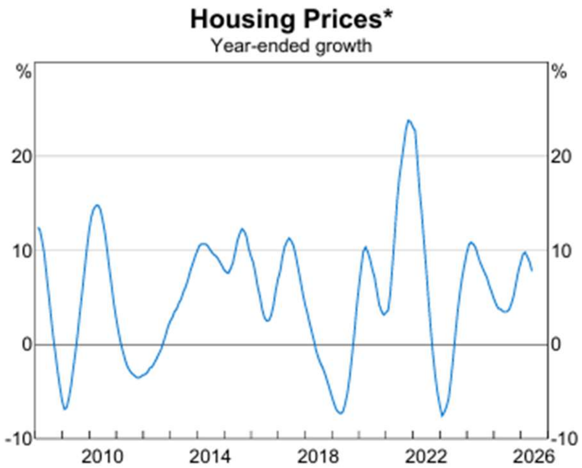
The fact that core inflation is above target and, apparently, yet to peak means the next cash rate move probably still is a hike, not the cut some economists are forecasting. Markets price only a 1-in-four chance of a hike at the next RBA Board meeting in August, but a two-in-three chance by the end of the year. That seems about right. After all, the Bank's statement earlier this month retained an overt "tightening bias".

The likelihood that interest rates may rise again was reinforced by yesterday's healthy May jobs report. The unemployment rate fell back to 4.4% thanks to a gain of 40,300 jobs – this reversed the shock fall in April. The resilience of the labour market contrasts with sluggish economic growth but can be explained by booming public sector employment and poor productivity. That is, firms need to hire more people to lift output.

On fiscal policy, the government succeeded in jamming its contested tax increases through the upper house of Parliament as planned, albeit with a few more tweaks. The latest changes included a ban on self-managed superannuation funds borrowing to buy homes. Given the rushed gestation and passage of the tax changes, there are sure to be more unintended consequences.

Meanwhile, away from Canberra, the impact of the budget measures is playing out in the real world. Since the budget, home auction clearance rates have cratered to below 40% in the big cities. These are the lowest rates of auction success since the dark days of the pandemic, when none of us could go outside.

The now legislated changes to negative gearing and capital gains tax can be blamed for the latest troubles in housing, but not in isolation. The three rate hikes by the RBA this year constricted the amount people can borrow and upended sentiment. So, too, did the recent regulatory change for borrowers with small deposits.



* Monthly hedonic price index; non-seasonally adjusted.
Sources: Cotality; RBA.

The failure of the majority of home auctions over recent weekends reflects wide price disagreement between (hopeful) sellers and (cautious) buyers and hints at further house prices falls from here. The RBA's chart of house prices above shows that house prices in Australia can, and do, fall regularly. Some economists predict price falls of up to 10% from the peak. Yes, that's a "correction", but this would not be too far out of line with previous episodes of falling prices.

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The biggest house price falls so far have been in the more affluent suburbs of the largest cities, which may reflect some investors fleeing. Home affordability for first time buyers may improve at significantly lower price points, in line with the government's objective. But this economist is unconvinced the rest of the population will celebrate lower prices for their biggest asset.

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