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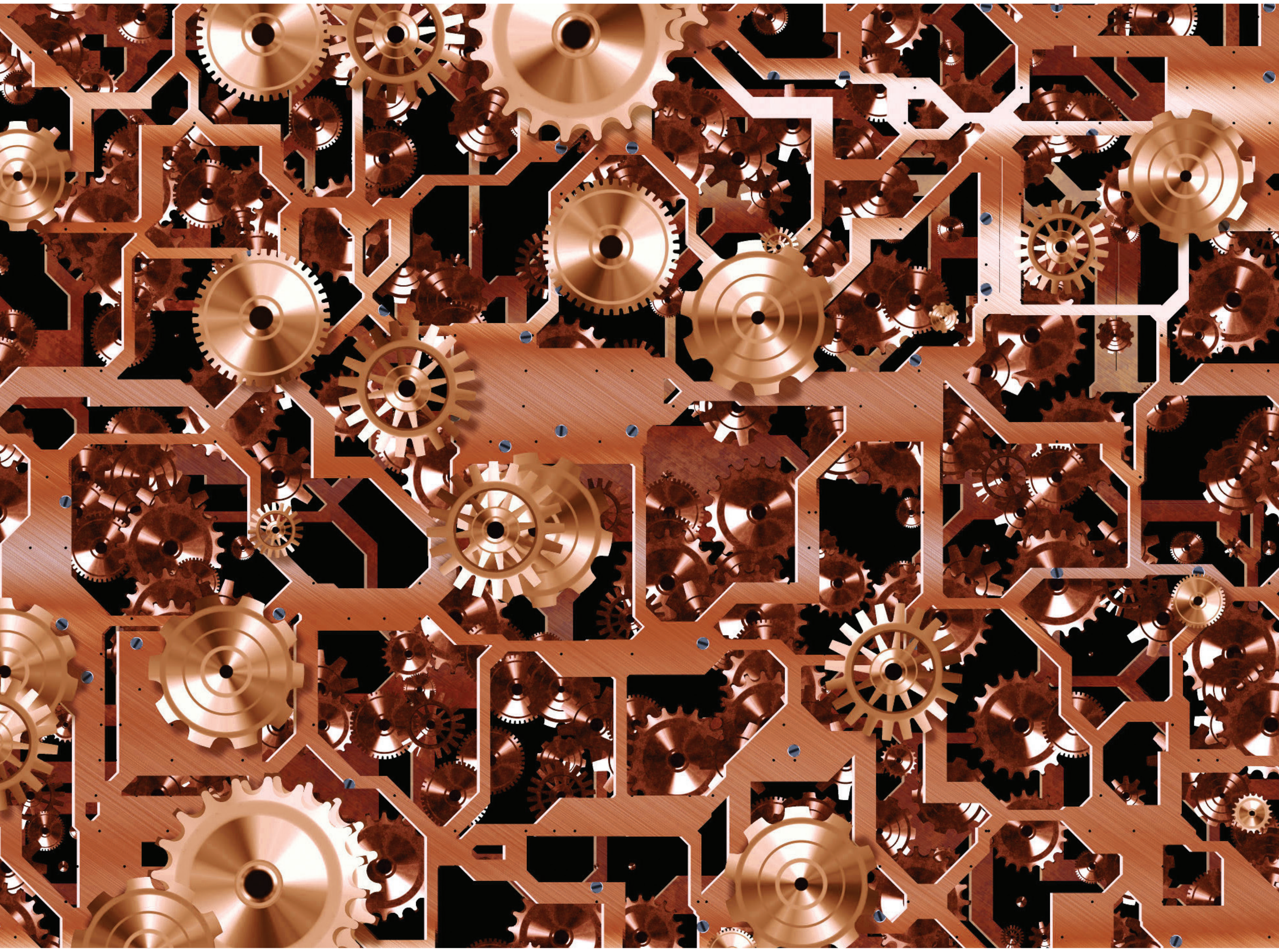

The Return of Inflation: What It Means for Australia

Warren Hogan

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Chapter One: The Pandemic and Global Inflation

Introduction: An Emerging Inflation Problem?

Inflation is rising around the world — the sting in the tail of the pandemic economic stimulus programs unleashed in 2020. The narrative thus far is that this inflation is transitory, even if a little more persistent than first thought; it will disappear within a few years. For some policy analysts, the boost to inflation is to be welcomed, if it can help central banks achieve their inflation targets after a decade of undershooting.

This appears to be the view of Australia's senior economic policymakers at the RBA and Treasury in early 2022. But the global inflation picture is deteriorating rapidly, and although Australian inflation is still comfortably within sight of the RBA's target, we could simply be lagging international developments. Highly accommodative policy settings, headlined by a near-zero RBA cash rate, appear inconsistent with rising inflation risks.

The key to the medium-term inflation outlook is the degree to which the current inflation shock is translated into cyclical price pressures via higher inflation expectations and accelerating labour costs. The US economy is showing worrying signs of rising labour costs in recent months, but for most economies, including Australia's, wage growth remains modest.

The inflation process is complex. Far more nuanced and dynamic that a macroeconomic model can capture. The forces that shape inflation outcomes are an interaction of temporary, cyclical and structural factors that are hard to predict. The current bout of price inflation across the global economy could be simply a short-term phenomenon related to the pandemic. However, it could also be the start of a more profound shift in the price setting environment.

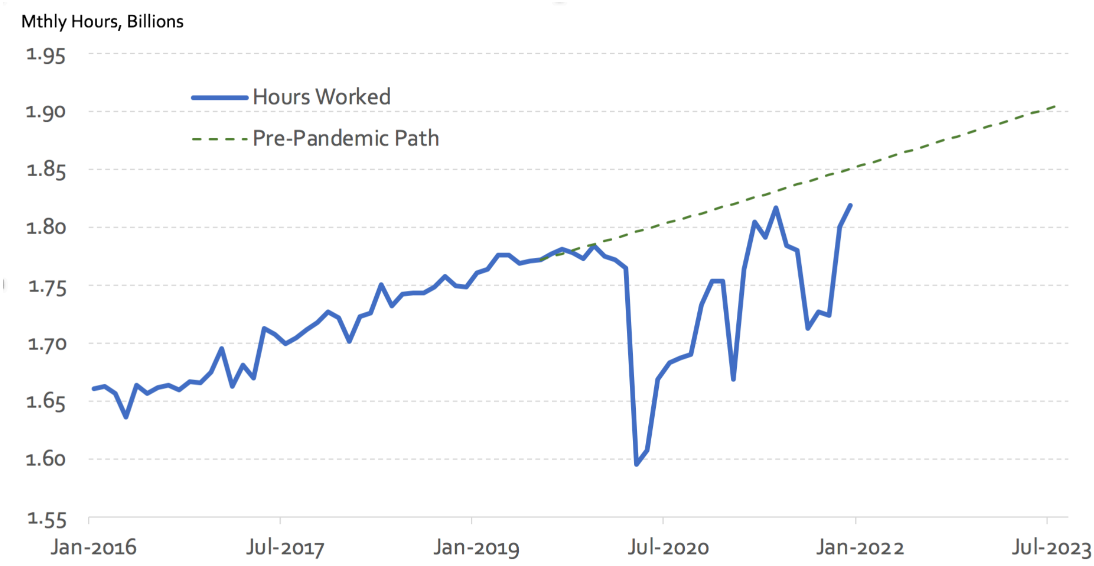
The Biggest Economic Shock Since WWII

The COVID-19 pandemic has been the biggest shock to the world economy since WWII. The imposition of restrictions on mobility and social interaction has seen whole sectors of the global economy shuttered for months on end.

Lost hours of work in Australia in 2020 and 2021 amounted to approximately 2 billion, based on pre-pandemic trends. This is the equivalent of just over a months' worth of hours for the entire Australian workforce (Chart 1). Simply put, we have seen nothing like it in the modern context and we have never seen such a large and co-ordinated government response.

Governments have responded with some of the

Chart 1: Hours Worked Australia (2015-2021)



Sources: Australian Bureau of Statistics (ABS), EQ Economics largest income support programs in history. The Australian Commonwealth Government implemented a broad-based $750 a week wage subsidy in the form of 'JobKeeper'. Around the world, these fiscal initiatives have been effective at supporting household and business incomes through the last two years, maintaining spending in the economy, and reducing the economic and financial uncertainty that often comes with a deep downturn in economic activity.

These fiscal policy initiatives have been the standout feature of the pandemic economic policy response. According to the IMF's Fiscal Monitor (October 2021), advanced economy government deficits that had averaged between 2% and 3% of GDP in the 5 years prior to the pandemic jumped to 10.8% of GDP in 2020, 8.8% of GDP in 2021 and are expected to be a still high 4.8% of GDP in 2022. Government debt levels have soared.

Australia has followed the lead of many other nations pushing government spending up by 7 percentage points of GDP in 2020. Australian Treasury estimates the temporary fiscal stimulus at 15% of GDP over the 5 year period from 2019/20.

We now know that income support programs have been instrumental in driving up household sector savings. In Australia, household sector savings increased at about twice the normal pace through the pandemic, adding almost $200bn of extra deposits into banks over and above the pre-pandemic trends.*

One of the least talked about measures that has been employed by governments was the temporary suspension of insolvency proceedings in the first year of the pandemic. This has played a critical role in avoiding a vicious cycle of business failure and mass unemployment often associated with such a large negative economic shock.

Monetary policy has played a big role in the policy response; with interest rates cut to historically low levels in most countries. In Australia, short-term interest rates fell onto the zero lower bound, assessed by the RBA as a cash rate of 0.10%. Unconventional monetary policies were employed for the first time in Australia.

The RBA set up a bank funding facility, extended its interest rate targeting to cover commercial fixed interest rates out to 3 years in maturity, initiated Quantitative Easing (QE) via a state and federal government bond purchase program, and employed Forward Guidance on the cash rate with a gusto that would make the sassiest market economist blush.

Government policy stimulus has proven to be very effective at supporting economies through episodes of lockdown. Heavily impacted sectors hibernated, workers stayed at home and people were able to access the essentials of life.

The stimulus measures also meant that when economies re-opened after lockdowns, economic activity roared back to life. The big impact on consumer spending has been on its composition, rather than its overall magnitude. Lockdowns that shuttered services industries have pushed spending towards goods. Even as lockdowns ended, consumer caution around social distancing has seen services spending remain tepid.

In the United States, which is the biggest consumer market in the world, durable good spending has surged from a monthly average of $1.75trn in 2019 to $2.23trn a month in 2021 according to data from the Federal Reserve Bank of St Louis. A 27% increase in consumer durables spending that is largely the result of fiscal stimulus in the presence of widespread health restrictions.

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* This estimate of excess savings is calculated by taking accumulated household savings through the pandemic (March quarter 2020 to September quarter 2021) and deducting an estimate of household savings that would have happened without restrictions on the economy, which broadly reflects pre-pandemic saving patterns. These estimates have been crossed checked against APRA bank deposit data.

Supply has not been able to keep up with demand

Although the pandemic has been a large negative shock to many service industries, it has been a large positive demand shock to the global manufacturing sector. This positive demand shock was not anticipated by producers. If anything, the initial impact of COVID 19 was a realistic expectation of a contraction in activity as unemployment surged and aggregate demand fell.

Policy success meant that this did not come to pass. Consumers and businesses spent up big despite the constraints on parts of the economy.

The excess demand for consumer goods has interacted with surprisingly strong capital investment to put strains on a whole array of goods markets and production systems across the world economy. Few markets have been spared this positive demand shock. The markets for commodities and raw materials, intermediate goods, and the logistics systems that support the production process have all been put under enormous pressure in 2021.

Health orders and mobility restrictions have also played a role in constraining supply at various times and points across the production chain. To be clear, the imbalances in global goods markets and the associated supply chain disruptions have primarily been the result of fiscal stimulus and demand rather than supply constraints[†].

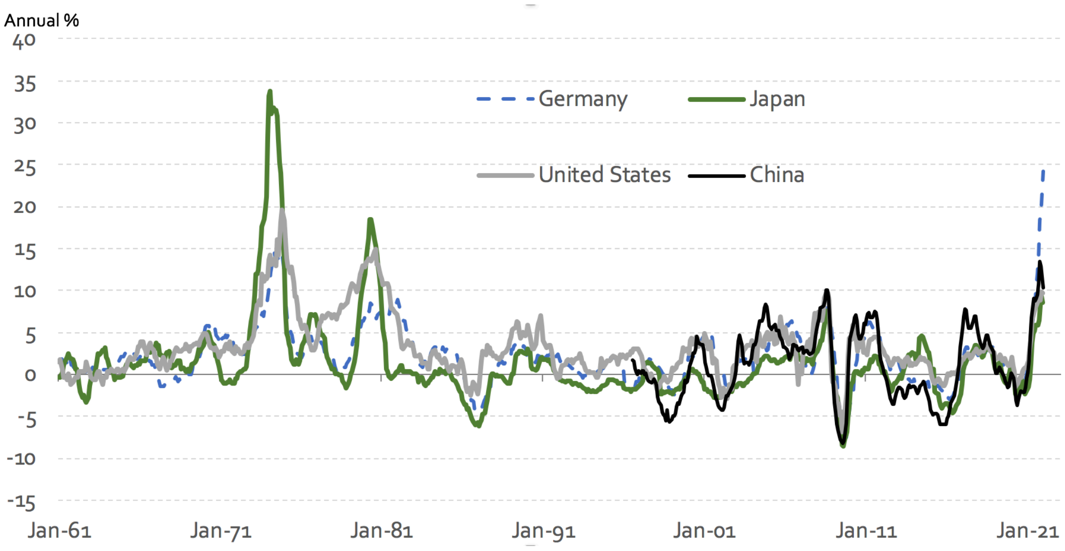
The result of this excess demand for goods has been some of the biggest price increases in 40 years across the global manufacturing sector and associated supply chains. Producer prices in the world's largest economies have risen sharply in 2021 (Chart 2). The German figures are a standout, up 24% in 2021. This is the highest since the 1950s. For Japan and the United States producer price indexes are rising by around 10%, still the highest rate of producer price inflation since the inflation shocks of the 1970s.

The two most prominent supply chain problems have been the global shortage of semiconductors and the surge in the cost of global freight. Both markets have seen outsized price increases over the past two years driven predominantly by a much higher level of demand than previously existed or current supply could accommodate. Global logistics and transport systems have been particularly strained. Not only has air and sea freight capacity lagged demand, but land transport and distribution systems have been overwhelmed.

While shortages and upward price pressures have been the dominant characteristics of the COVID operating environment, the reality is that supply chains have been unpredictable and volatile. This supply chain uncertainty comes after decades of increasingly thin, yet efficient global supply chains that have made a significant contribution to business profitability and lower consumer prices.

As supply chain strains emerged, many firms looked to protect their operational continuity through the hoarding of critical and 'at-risk' inputs. This hoarding has exacerbated the problem. Indeed, it could be a major factor in creating short-term supply chain crisis points. That said, inventory levels across the global economy are not high by any measure.

Chart 2: Global Producer Prices



Sources: Federal Reserve Economic Database (FRED)

† It is quite a reasonable question to ask is if the income support programs had not been as generous, would this inflation shock have emerged with such potency and rapidity

Supply chain pressures are showing up in consumer prices

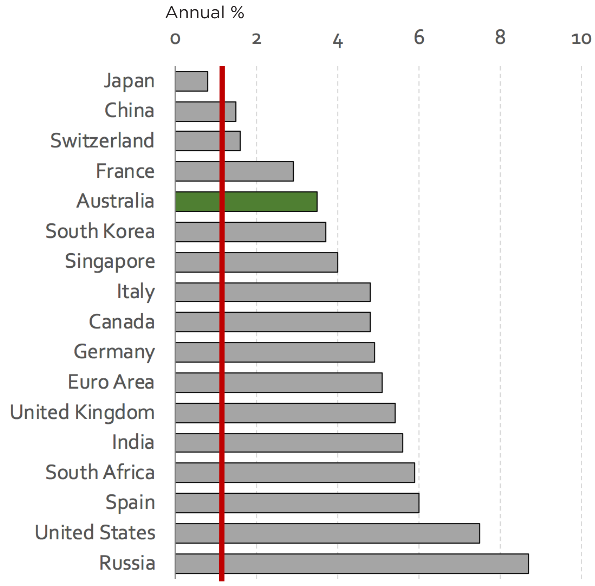
Overall consumer prices are rising around the world economy (Chart 3) and in most countries are well above central banks inflation targets which are typically around 2%. Goods inflation has been the main factor driving up consumer price indexes, although energy services have also played a prominent role in many economies.

Retail goods inflation has surged in 2021 in the United States and Europe. Price increases have been particularly intense in the United States and in the durable goods sector. US durable goods CPI rose by 16.8% in 2021, a 50 year high, and above the peak in durables inflation seen in the 1970s of 14% (Chart 4). European goods inflation has been the highest since the data was first collated in 1997. Retail goods inflation in Europe rose by 6.3% in 2021, which is well above the average goods inflation rate since 1997 of around 1.5%.

The current inflation environment contrasts sharply with the experience of the last 20 years where prices of manufactured goods have been a prominent disinflationary force in the global economy —and a key reason that inflation has undershot central bank targets in the decade since 2010.

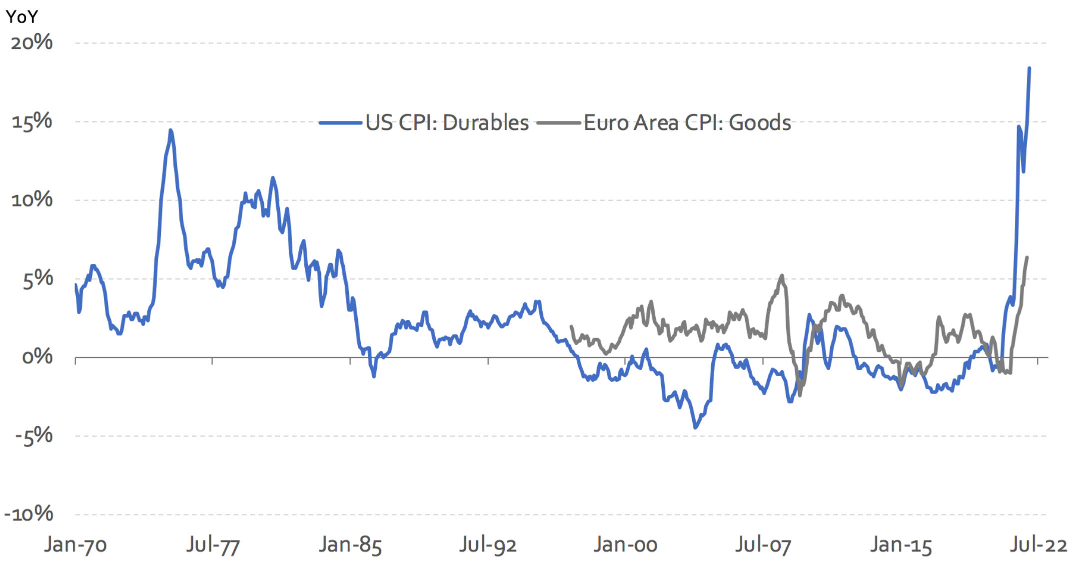
Most countries are now reporting the highest rates of consumer price inflation in decades. The United States

Chart 3: Inflation Around the Globe, 2021



Sources: Various National Statistical Agencies, Trading Economics, EQ Economics

Chart 4: US Durable Goods CPI and Euro Goods CPI



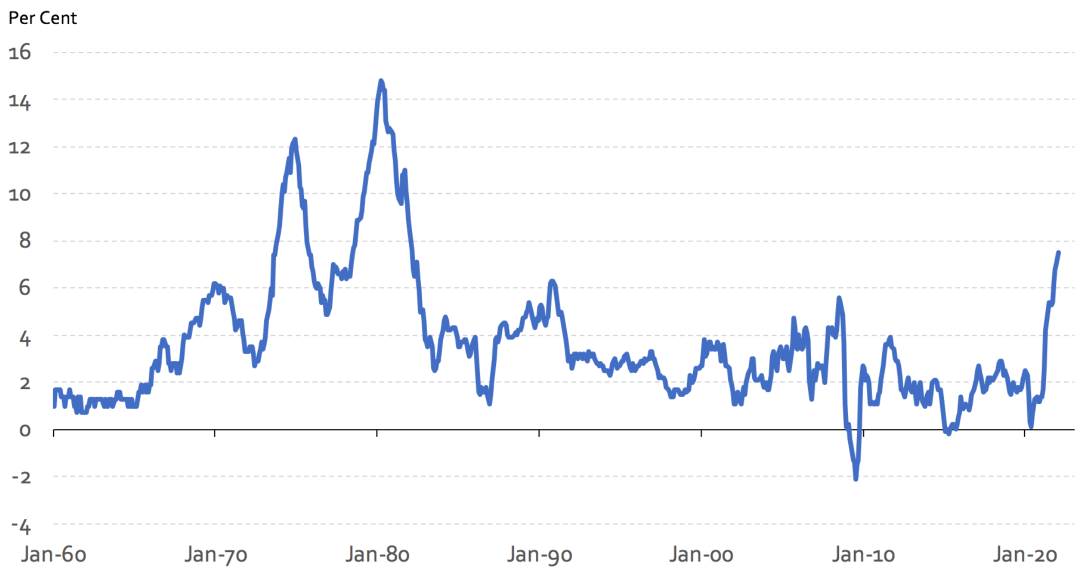
Sources: FRED

is one of the worst impacted economies, with annual consumer price inflation rising to 7.5% in January 2022. This is well above anything we have seen in the inflation targeting era. Indeed, we have to go back to 1981 to match the current inflation rate (Chart 5).

There is a notable geographic dispersion of inflation outcomes around the world (Chart 3). Inflation has remained relatively low in some Asian countries. Chinese and Japanese inflation has started to rise over the second half of 2021 but at 1.5% and 0.8% respectively, are low by global standards. Some other large emerging Asian countries are also experiencing low inflation: Vietnam (1.8%), Indonesia (1.9%), Thailand (2.2%) are stand outs.

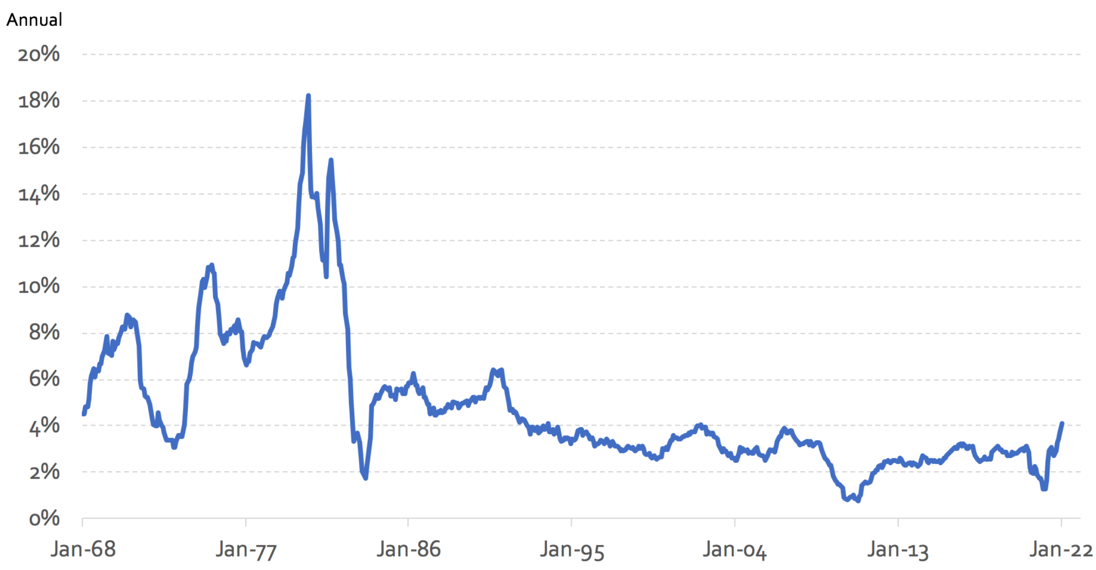
Services inflation has not accelerated at anywhere near the same pace as goods, particularly when excluding energy services (Chart 6). In most large economies services inflation is a little higher than the average pace of the last decade, but this could easily reflect catch-up from the dip seen in 2020. The most important driver of services inflation is nominal wage growth, which in most countries has remained relatively well-contained over the past two years.

Chart 5: US Inflation History



Sources: FRED

Chart 6: Services CPI in Europe and US



Sources: FRED

Is Australian Inflation Lagging the Rest of the World, or is it Just Lower?

Global retail inflation pressures appear to have come in two waves in 2021. The initial wave occurred through the June quarter, largely in April and May. The second was in the December quarter with consumer prices accelerating once again in October and November. There have been few signs of a moderation since.

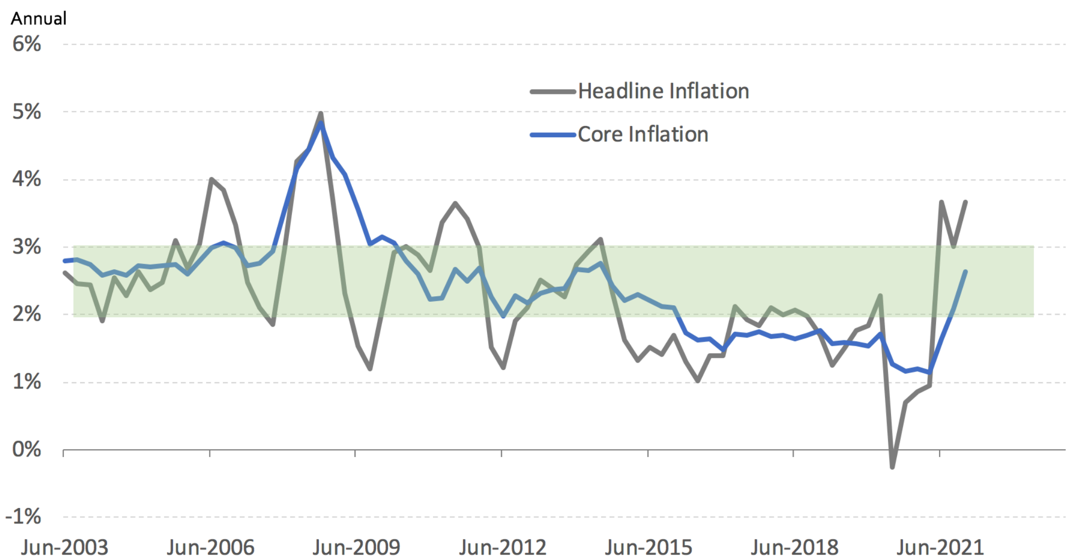
Australia is the only G-20 nation not to release a monthly CPI, but it looks like Australian inflation remained modest until mid-year before picking up in the September quarter and then accelerating sharply in the final three months of 2021 (Chart 7). Australia's inflation rate was 3.5% in 2021, lower than the global average of about 4.5% but above the RBA's 2%-3% target band. Importantly, we have seen most of the core measures of inflation accelerate through the final six months of 2021.

The Trimmed Mean measure of inflation increased by 1% in the December quarter for an annual rate of 2.6% in 2021. Most of that 'core inflation' happened over the second half of 2021, with the Trimmed Mean measure increasing at a 3.5% annualised pace over the final six months of 2021.

Three key points from the latest Australian inflation results:

- Three components of the CPI account for two thirds of the increase in the CPI in 2021. These are petrol prices, consumer durables and housing construction. Global supply chain pressures have played a role in each of these, including house building where steel and timber prices have increased in line with international trends. In all likelihood these price pressures will ease in 2022, although the timing and extent is uncertain.
- Price pressures are broadening with 60% of items in the CPI basket rising by 2.5% or more in 2021. This indicator of the breadth of inflation pressures, much like a diffusion index, is now at its highest level in six years. Broad-based inflation pressure is typical of cyclical inflation rather than a price shock, or at the very least, suggests that the price shock is having a widespread impact on prices across the economy. A further increase in the proportion of above target price increases in 2022 could be indicative of a shift in the 'inflation mentality' of consumers and business in the post pandemic economy.

Chart 7: Australian Inflation



Sources: ABS, RBA

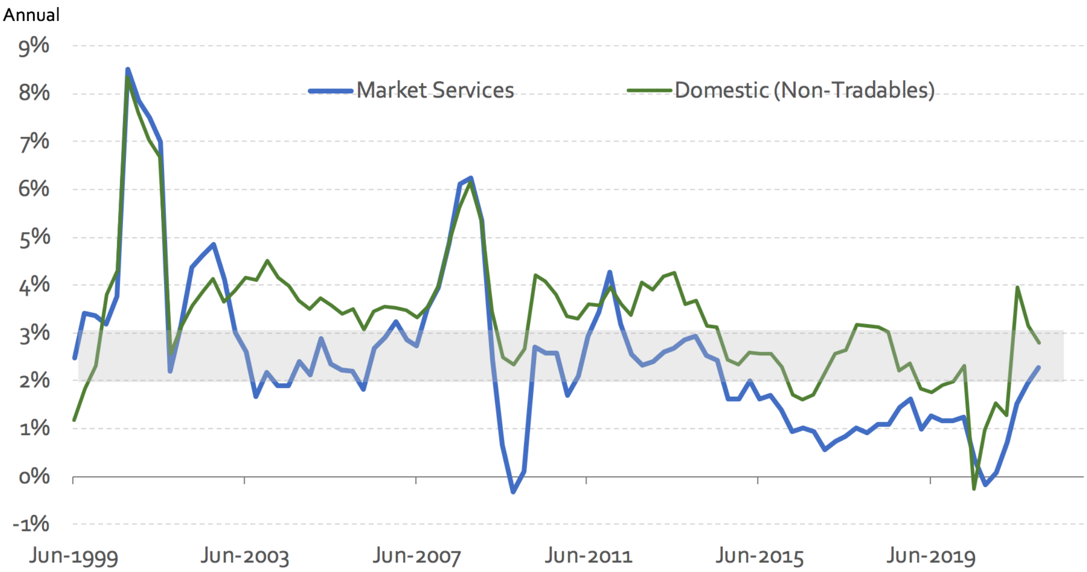
- Domestic services inflation is starting to lift despite moderate wages growth (Chart 8). With the pandemic shock having its biggest impacts on goods prices and energy markets, domestic services inflation in most countries remains contained along with nominal wage growth. The recent rise in services inflation in Australia may be picking up labour costs that formal wage measures are not, i.e., a leading indicator of wage growth. Alternatively, the increases could reflect pandemic disruptions such as lockdowns, reduced operating capacity or labour shortages. This will need to be watched closely.

Australia's inflation outcomes are not that different to what we are seeing overseas. At this stage, it is just as likely that we are simply lagging the global trend as judging our inflation situation to be fundamentally different to what is happening in other economies. Australia is certainly in a different economic situation to China, Japan and Switzerland — the economies of note with still low inflation.

To characterise Australia as being in a low inflation environment is concerning. That may have been the case in the years leading up to the pandemic, but there is nothing in the emerging trends of 2021 and 2022 that can justify this conclusion. It is almost completely reliant on the view that the disinflationary forces impacting the inflation process, that were in place prior to the pandemic, will remain in place for the foreseeable future.

Inflation is alive and well across the global economy in early 2022. With monetary settings providing abundant liquidity to the economy and financial system, the question is how much of a problem does the recent spike in consumer prices really pose to economies that for most of the last decade have been more worried about low inflation?

Chart 8: Australian Services Inflation



Sources: ABS, RBA

Chapter Two: Perspectives

The Importance of Relative Price Changes and Price Stability

There are two types of price changes that economists care about: relative price changes and changes to the overall price level. In practice, disentangling the two is not easy, but conceptually they are two very different things.

- Relative price changes are essential to a well-functioning market economy. The change in the price of a good or service relative to others is what drives economic behaviour.
- A change in the absolute price level is inflation. Inflation is effectively a fall in the price of money, which can be thought of directly as a fall in the purchasing power of money or a decline in the real interest rate.

While relative price changes are driven by shifting economic conditions, pure inflation is predominantly the result of monetary conditions.

Inflation targeting emerged in the late 1980s in response to the persistently high inflation of the 1970s and a breakdown of previous monetary policy regimes. Inflation targeting by central banks recognised the need to anchor inflation expectations (and inflation) but also recognised that a little bit of inflation is a good thing. Indeed, a small amount of inflation is critical to the efficient operation of a market economy.

In practice, the response of producers and consumers to relative price changes is not instantaneous. As prices and quantities change across the economy, other prices tend to be sticky, particularly in a downward direction. Economic reality means that price changes take time, often years, to work through the economy. Across the millions of goods and services in the economy, relative prices are always changing.

A central bank that hits its inflation targets will effectively anchor inflation expectations and achieve price stability. In the early years of inflation targeting central banks settled on an inflation rate of 2% as being achievable, consistent with price stability as well as facilitating the effective operation of the price system.

When the economy is exposed to large relative price changes, like we have witnessed through the COVID-19 pandemic, it is desirable to run an even higher rate of inflation to facilitate the necessary adjustments occurring within the economy.

Price Volatility, Inflationary Shocks and Relative Price Changes: The Short-Term

It is clear to most economists that the large price movements we have seen over the past 18 months are relative price changes. Many of the price movements we are witnessing are in highly volatile markets for primary commodities or the result of an unexpected increase in demand in goods markets.

The pandemic inflation shock has largely been the result of fiscal policy actions in the context of heavy restrictions on the economy that have led to an excess demand for goods across the global economy.

Temporary price shocks happen regularly; which puts a high value on well-anchored inflation expectations. If businesses and consumers understand the transitory nature of these price shocks, there is less chance they will make costly alterations to their own price structures.

Businesses have employed increasingly sophisticated financial products to manage liquidity and hedge price exposures, to help them absorb the ups and downs of volatile input prices rather than pass them onto consumers. This can explain some of the disinflation and reduced inflation volatility in recent decades.

The expectation is that current price pressures will ease over the course of 2022 as impacted markets rebalance, either through a moderation in demand, an increase in supply, or some combination of both.

There is the prospect of a so-called 'bullwhip' effect from supply chain hoarding. The hoarding of critical inputs into production to ensure business continuity has added to strains in supply chains. However, as imbalances ease, we could see a sudden liquidation of inventories that adds to downward price pressures.

While this bullwhip effect may play out in certain industries or at certain points of the supply chain, there is little evidence of widespread inventory build-up across the global economy.

Policymakers continue to expect producer price inflation to ease across the global manufacturing sector as markets rebalance through 2022. There is less conviction about the role of the bullwhip effect. Many central bankers are hopeful there will be a material easing of goods demand as service industries re-open.

Cyclical Inflation in an Expanding Economy: The Medium-Term

The difference between a price shock and a cyclical increase in inflation is persistence. Persistence is driven by a self-reinforcing cycle of rising wages and prices.

Allowing a relative price change to work its way through the economy is nice in theory. But if the shock is large and persistent, it raises the risk of stoking cyclical inflation. A necessary condition for this transmission of a price shock into the broader economy is strong demand and tightening labour markets.

This makes the setting of both monetary and fiscal policy critical to the prospect of rising inflation over the medium term. The extraordinary policy settings of the pandemic period must be re-calibrated to the evolving economic environment. The strong recovery emerging in most economies around the world suggests that both monetary and fiscal policy stimulus must be reduced.

Ongoing fiscal deficits not only add to the cost of fighting the pandemic for future generations but increase the pressure on monetary policy to address inflation risks. Fiscal consolidation as much as monetary normalisation, will be an essential part of reducing inflation risk in the economy over the next three years.

Cyclical inflation is generated by elevated inflation expectations, rising unit labour costs and higher retail prices. If a wage price spiral is allowed to take hold, it is usually eradicated by an economic slowdown.

Even if the current burst of inflation proves temporary, it has emerged just as labour market conditions are tightening. If higher inflation impacts inflation expectations and wage claims, and these can be translated into higher actual wages, the first step in a cyclical lift in inflation pressures will be upon us in 2022.

Timid central banks, rightly worried about slowing economic activity so early in the post-pandemic recovery, can play a role in fostering cyclical inflation pressures. Initial attempts at removing monetary stimulus may do little to moderate demand in the economy, partly due to the normal lags in monetary policy but also because central banks cannot get the real interest rate up. If central banks cannot raise the nominal short-term interest rate by more than the rise in inflation, the real interest rate is unchanged and efforts to slow demand in the economy will go unrewarded.

Political leaders are in no rush to reduced structural budget deficits. Over the past 12 months the Australian government has recycled the financial gains to their budget from a stronger than expected recovery back into the economy through more spending initiatives. When the government deliberately impedes the natural budget repair process in this way it is a backdoor fiscal stimulus and adds to demand in the economy.

Whether or not this was appropriate in 2021 is not up for debate. What matters is policy actions from here. As more and more evidence accumulates of a robust recovery in domestic demand and rising inflation pressures, the government should, at the very least, allow a natural budget repair process to commence, even if they are not prepared to make explicit policy changes that will assist a quicker consolidation of fiscal deficits.

The interaction of the cyclical and temporary dynamics impacting inflation is the focus of policymakers and markets in 2022. The balance of risks has shifted over the northern summer as a renewed wave of consumer price inflation has emerged and labour markets have tightened further.

So far, central banks have focused on removing unconventional monetary policy stimulus. There has been no rush to raise short-term interest rates. Policymakers appear to be drawing comfort from the long-run secular disinflation processes that have been at work in the economy for the past decade.

It is quite clear that most central banks are relying on this long-term secular trend to reassert itself once the temporary supply chain squeeze has worked its way through the economy. If cyclical inflation pressures emerge, they are confident that a light tap on the monetary brake will be effective at addressing inflation risks.

This raises what could be the most important risk factor for central banks and policymakers in dealing with the recovery from the COVID-19 pandemic: a shift in the secular inflation backdrop.

Structural Features of the Price-Setting Environment: The Long-Term

The long-term reflects structural or secular forces shaping the economic landscape. The inflation process has secular features with long wave cycles identifiable through history. The most recent long wave cycle has been in place since the early 1980s and is best characterised as disinflationary. Inflation has consistently fallen since the 'stagflation' of the 1970s, only interrupted by periodic bouts of cyclical price pressures.

Initially the disinflation was the result of policymakers' efforts to stabilise the nominal economy around an inflation rate of 2%. They had great success, and this was largely achieved by the turn of the century. The most recent phase has been more confounding to economists and the community more generally. Powerful disinflationary forces have become entrenched within the global economic system due to a range of factors including demographics, globalisation, a positive global labour supply shock, technology and economic reform.

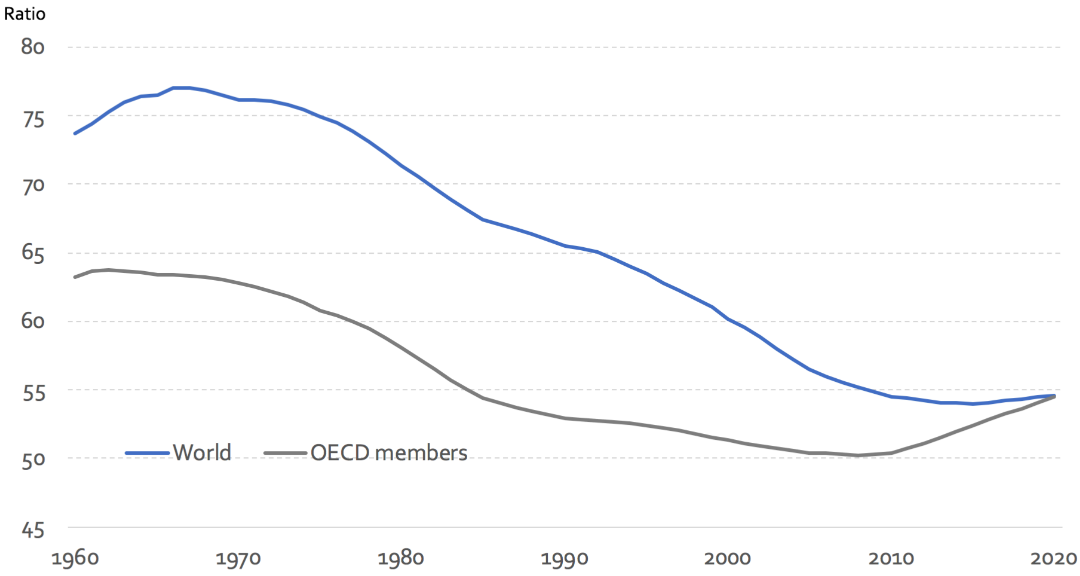
All these underlying forces that are shaping the secular backdrop are playing a role in the price-setting environment of the early 21st century. However, there is a strong argument that at the centre of the global disinflation has been labour market developments. A shift in the supply/demand balance for workers across the global economy has reduced the bargaining power of workers and put downward pressure on real wage growth, particularly for low- and semi-skilled workers in advanced economies. Low real wage growth has boosted the returns to capital while helping to keep consumer price inflation low.

In the advanced economies the dependency ratio fell from a high point of 65% in the late 1960s to a low of 50% in 2010 according to OECD data (chart 9). This is the ratio of the young and old who don't work to the working age population. This gradual demographic cycle was augmented by two factors within the advanced economies: rising female participation in the workforce and rising participation among those over 55 years of age (delayed retirement).

Along with these demographic trends, globalisation had a powerful positive impact on the labour supply. There were two major 'shocks' that added millions of extra workers to the global economic system. The fall of the Berlin Wall in 1989 brought 200 million working-age Eastern Europeans into the global labour market. Twelve years later, China joined the World Trade Organisation (WTO). Over the following decade, hundreds of millions of Chinese workers became a prominent factor in global supply chains.

Global labour supply shocks were augmented by an array of political, technological and financial forces that reinforced the low wage dynamic as well

Chart 9: Dependency Ratio



Sources: Organisation for Cooperation and Development (OECD)

as reducing the amount of inflation the economy would generate for any given level of output or unemployment.

Globalisation has increased scale efficiencies across many industries, most importantly goods production. This has increased competition and allowed the development of sophisticated global supply chains.

The secular backdrop is therefore a complex mix of factors that has had a profound effect on labour costs and can explain both cyclical wage restraint in advanced economies as well as the long-term shift in the wage-profit share.

A shift in the secular backdrop will alter the balance of risks around the current inflation outlook across the global economy. It not only increases the probability that troublesome cyclical inflation could emerge over the next two years, but it could increase the cost of eradicating that inflation.

Is the secular backdrop shifting?

Ageing populations are pushing dependency ratios higher in advanced economies. This process is expected to continue for decades. Governments are vigorously pursuing policies that mitigate the economic consequences of rising dependency including encouraging workforce participation and targeted immigration. It is not clear that the trend will be arrested in a meaningful way.

Charles Goodhart and Manoj Pradhan[‡] have put forward a compelling analysis of long-term demographic trends and the potential impact on the global economy. Their most powerful conclusion is that the disinflationary global economy of the past 40 years will soon become inflationary. This process is well advanced, and the pandemic has fast tracked a number of inflationary forces that are likely to emerge over the next decade.

Central to their view of the changing labour supply and demand balance is that there is little prospect of another injection of new labour into the global economy like we saw with the collapse of the Iron Curtain and the opening of the Chinese economy at the turn of the century. There are several large population masses with favourable demographics in Africa and South Asia, but the integration of these workers into the global economy will be gradual.

‡ Goodhart, C and Pradhan, M (2020) "The Great Demographic Reversal. Ageing societies, Waning Inequality and an Inflation Revival". Palgrave Macmillan, Switzerland.

We are likely to be at a long-term turning point for global labour market dynamics, and this could herald a secular shift in the global inflation environment. In the short-term, the pandemic appears to be accelerating this trend towards labour scarcity and an increase in worker bargaining power across the advanced economies.

Other elements of the global disinflationary environment appear to be changing. Actions to strengthen supply chain resilience mean more onshoring of production as well as increased supplier options. This will increase costs.

Business costs could be structurally higher as businesses manage risks associated with a less stable geo-political environment.

Business will attempt to mitigate higher costs through further innovation and investment, but automation through software and robotics has a long way to run. The question is whether technical progress can outrun the rising demographic tide.

It is impossible to know for sure how these secular forces will evolve and what the impact will be on the inflation process. Central banks that draw comfort from the long-term disinflationary trend when running ultra-easy monetary policies should be careful. Backward-looking assumptions that prove to be misplaced could be very costly to the economy.

Chapter Three: The Outlook for Inflation in Australia

> *"In the short run, things clearly turned out quite differently than I and many others had expected, with higher and more persistent inflation taking hold in many economies. There are grounds for optimism, though, as the pandemic's bottleneck effects will dissipate at some point, secular disinflationary effects remain in place and central banks are there to prevent uncomfortably high inflation from becoming entrenched."*
>
> — Claudio Borio, Head of Monetary and Economic Department, Bank for International Settlements January 2022

The Optimal Path

The inflation outlook is heavily dependent on the course of both monetary and fiscal policy. The RBA must face the dual challenges of normalising policy settings as the economy recovers, as well as managing the price shock generated by the pandemic.

Budget deficits at both the state and federal level remain large by historical standards. Fiscal consolidation is unpopular and economic reform is politically difficult. The extent of fiscal normalisation will have an influence on the strength of demand in the economy. The current fiscal trajectory in Australia in no way reflects the strength of the economic recovery underway nor the rapid shift in the balance of risks to the inflation outlook.

Unlike monetary policy, fiscal policy is slow to adjust and heavily influenced by the political cycle. But given the foundational role fiscal policy has played in generating the initial inflation shock, it is hard to believe that government budget strategy will not also have a role in managing the recovery.

At first glance, it looks like the biggest risk to the inflation outlook is the misjudgement of cyclical inflation risks. Many economists believe the Federal Reserve is already well behind the game on this. The realisation that the US labour market is much tighter than traditional estimates of full employment would indicate implies that they have left extraordinary policy settings in place for too long. The year ahead will be telling.

The real risk to inflation is not cyclical price pressures becoming entrenched. It is that central banks and governments are not open to the idea that the secular backdrop has shifted, and more importantly, that the secular backdrop is shifting.

The desirable path for the economy, inflation and interest rates is best outlined by the RBA in their latest Statement on Monetary Policy.§ Inflation 'peaks' in 2022 as the pandemic price shock works its way through the economy. The economic recovery gains traction in 2022. GDP growth accelerates and output nears its potential by 2023. Australia achieves full employment in the next two years.

Wages growth accelerates, but well-anchored inflation expectations and a softening of labour demand in 2023 cap wage growth at a rate consistent with the RBA's 2%-3% inflation target.

Strong business investment through the pandemic stokes productivity growth. Unit labour costs remain contained. The nominal economy stabilises in 2023 and 2024 around the RBA's inflation target.

Throughout this process, the RBA is able to gradually lift the cash rate towards 2%, or even 3% if they are lucky. By 2025 a new growth path is established defined by 3% real growth, 2% inflation and a 3% cash rate. Unemployment remains low and steady at around 4%.

Sounds too good to be true. It is a plausible scenario that would be a great outcome for Australia. It is worth hoping for. But there are many risks to this forecast, not least of which is a more troublesome inflation environment.

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§ See "Quarterly Statement on Monetary Policy", February 2022, Reserve Bank of Australia, Sydney. The detailed forecasts for the Australian economy are, in my judgement a realistic representation of the optimal path for economic normalisation. The only missing piece of the puzzle is the RBA Cash Rate required to achieve this outcome.

Australian Inflation in 2022: Heading for 5%?

The RBA has gone to great lengths to tell us that when it comes to inflation, Australia is different from the US and Europe. We are not experiencing the same rise in electricity costs as the Europeans or Americans, nor are our wages rising in a threatening way.

Some of Australia's largest trading partners in the Asia-Pacific region, including China and Japan, have kept inflation low through the pandemic. Even in Europe, where inflation is now registering 5% rates, the cyclical inflation risk posed by a tight labour market appears to be much less than in the US and the UK where wage growth is starting to accelerate. In most countries around the world, nominal wage growth remains moderate and domestic services inflation remains contained.

Australian inflation is expected to remain above the RBA's target band in 2022. This is the expectation of most mainstream forecasters following the release of the December quarter CPI in late January. There is little debate that inflation will rise further before it falls. Even the RBA has inflation nearing 4% this year and core inflation rising to 3.25% by June 2022.

Few forecasters believe that Australian inflation can rise towards the 5% to 7% rates seen in the US and Europe. The consensus view is that inflation will reach a high point in 2022 somewhere below 4%. But Australia could be lagging the outcomes seen in other advanced economies. There are plausible scenarios that could see an Australian inflation surprise to the upside in both 2022 and over the medium-term.

Global companies have a significant presence as either retailers in Australia, or suppliers to retailers in Australia. History shows that global retail price trends will eventually show up in Australia, usually with a lag.

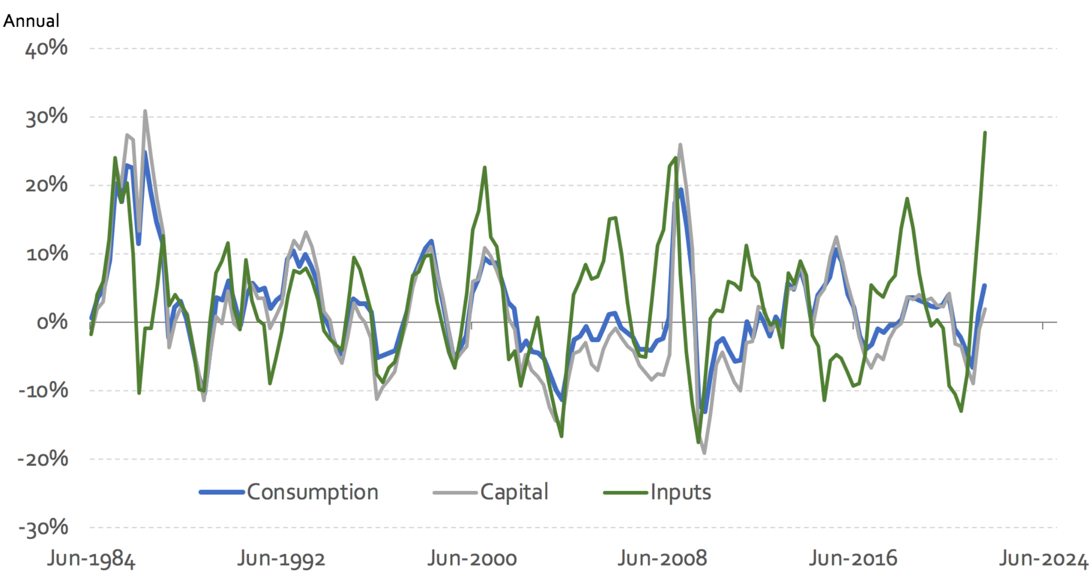
Another factor in 2021 that may have delayed price increases was the outbreak of the delta variant of the coronavirus in the middle of the year. The lockdowns in NSW and Victoria were severe and effectively put the economy into hibernation. Retailers and suppliers may have delayed price rises during the delta lockdowns, uncertain of the impact on customers and their brand.

A rise in Australian inflation above 5% in 2022 cannot be ruled out.

The full impact of the global goods inflation has not shown up in Australia. Durables goods prices have not gone up to the same extent as other markets. Early reports from the corporate earnings season suggest price pressures from global supply chains are continuing in the first quarter of 2022.

Import price data for the December quarter, which was released a few days after the CPI, shows some concerning trends. While imported capital and consumption goods prices remain well contained as of December 2021, imported intermediate goods inflation has risen to the highest rate since the data was first collated in 1984 (Chart 10).

Chart 10: Import Prices



Sources: ABS

Intermediate goods are inputs into local production covering everything from food and beverages to chemicals, steel, and transport equipment. In value terms, intermediate goods make up 45% of total goods imports, compared with 31% for consumption goods and 24% for capital goods. The pandemic price shock looks like it will continue to push up retail prices in Australia in 2022.

Another unique feature of the current situation is the breakdown in the relationship between US dollar commodity prices and the Australian dollar–US dollar exchange rate (chart 11). Typically, when commodity prices rise, so too does the Australian dollar. This is an important feature of the macroeconomic environment in Australia that has helped to maintain broader economic stability.

The apparent weakness in the Australian dollar in the face of high commodity prices is inflationary. Not only are mining companies generating huge economic surpluses, but government revenues are receiving a sizeable boost. This income shock is not being offset by a high exchange rate.

Food and grocery prices were soft in 2021, rising less than 2%. In 2020, we saw a spike in food and grocery prices after a decade of modest price increases.

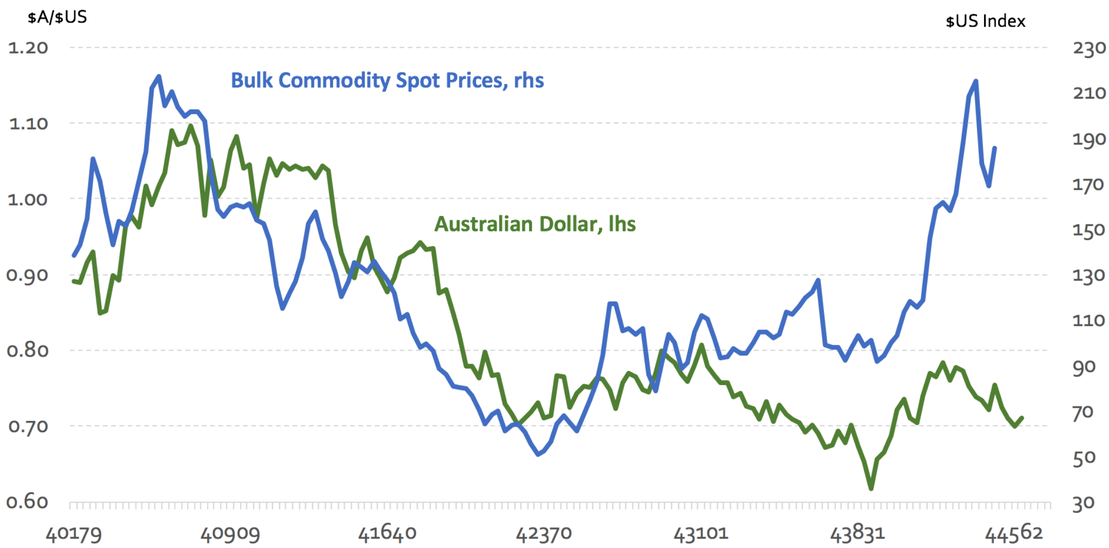
Although fresh food prices are largely determined by weather, manufactured food and grocery products, which make up the great bulk of supermarket spending, have the potential to rise substantially in 2022 as manufacturers look to protect margins from rising costs.

Upward pressure on residential rents is clear from market data, but changes in market conditions take time to filter through to the CPI. The Australian Bureau of Statistics rent estimate reflects the price for all existing tenants, not just those that sign a new rental agreement in the quarter. Advertised rents rose approximately 10% in 2021, according to industry estimates, while the CPI measure of rents rose just 0.4% over the same period.

Even if Australian inflation rises to 5% in 2022, the fact remains that these price increases are largely related to the pandemic. The policy challenge does not change, although higher inflation will put more upward pressure on inflation expectations and wage claims.

What will determine whether inflation in Australia sustains a lift above the RBA target band for a number of years will come down to what happens in Australian labour markets, and how Australian businesses respond to rising nominal wage growth.

Chart 11: Australian Dollar and Commodity Prices



Sources: RBA, EQ Economics

Australia's Cyclical Inflation Risk: Wages, Labour Costs and Productivity

After a decade of unexpectedly weak wages growth, most economists see the risk of a sudden wage outbreak as low.

To get wage growth pushing materially higher, strong labour demand must be sustained and workers must be prepared to seek higher wages — either with current employers or by changing jobs. Labour supply constraints, either in the form of low unemployment, high participation, or restrictions on the inflow of workers from overseas will add to wage pressures.

Labour market tightness certainly looks like it has the potential to deliver a lift in wages. The job vacancy ratio has surged through the pandemic and is now more than twice the average rate of the last 20 years (Chart 12).

It is the RBA's view, supported by many labour market experts, that wage-setting practices will mute the extent to which labour market tightness is translated into higher wages. Not only is there an institutionalised lag in wage-setting due to contracts, but worker bargaining power appears to be the weakest in the modern era in no small part due to low rates of union membership.

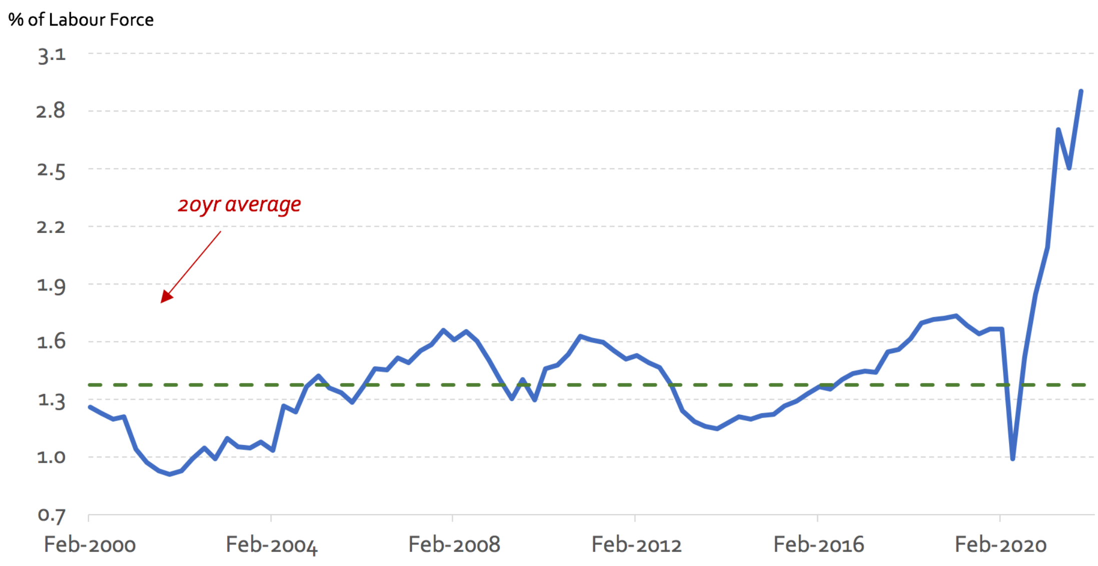
Anecdotally, there are many signs that wages are rising but it is hard to say that this is more than isolated examples by geography, industry, or skill set. The unemployment rate is forecast to fall to 50 year lows in 2022 and 2023 (Chart 13). Importantly, progress in combating the pandemic has allowed for a re-opening of Australia's international border. This should see a lift in labour supply in 2022.

The RBA will not be pre-emptive on wages or inflation and have outlined a definition of the inflation objective as being 'sustainably in the band', which requires wages growth above a 3% annual rate. This assumes productivity growth of about 1% a year.

The latest wage data is showing a gentle acceleration in private sector wages in Australia over the second half of 2021, broadly in line with the rise in domestic inflation pressures, but at a rate which would be of little concern to policymakers.

Wage inflation is rising from very low levels in 2020, heavily impacted by the pandemic. Private sector wages rose by 2.4% in 2021 according to the ABS Wage Price Index (WPI). Just like rents in the CPI, this index measures all workers' wages, not just those that

Chart 12: Job Vacancy Ratio



Sources: ABS, RBA, EQ Economics

negotiated new wage contracts in the period. As such, most wage measure and certainly the WPI will lag not only developments in the broader economy, but changes in labour market conditions.

Rising cost of living pressures and widespread labour shortages in the Australian economy in 2022 will undoubtably lead to higher wage growth. The RBA is looking for Goldilocks – a little bit of wage growth, say a 3% annual rates, but not too much. We will have to see. If the US is any guide, the rise in 2022 could be significant. The US Employment Cost Index rose from an annual rate of 2.6% in 2020 to 4.4% in 2021.

Even as a fully employed economy translates into rising nominal wages, there remains some uncertainty about the precise pass through of nominal wage outcomes into final prices. The wage and profit shares have been drifting in favour of capital for the past three decades. A sustained increase in labour costs could be partially absorbed in lower profitability rather than higher prices.

Another consideration is productivity. The impact of higher nominal wages on inflation can be offset by rising productivity growth that keeps real unit labour costs in check. The hope is that strong business investment over the last two years will lift productivity in the short-term.

There are many moving parts to the cyclical inflation outlook. The RBA Governor has gone as far to say that they cannot precisely define what 'sustainably in the band' means. Ultimately it will be a judgement call on the part of the RBA's senior economists and the Board.

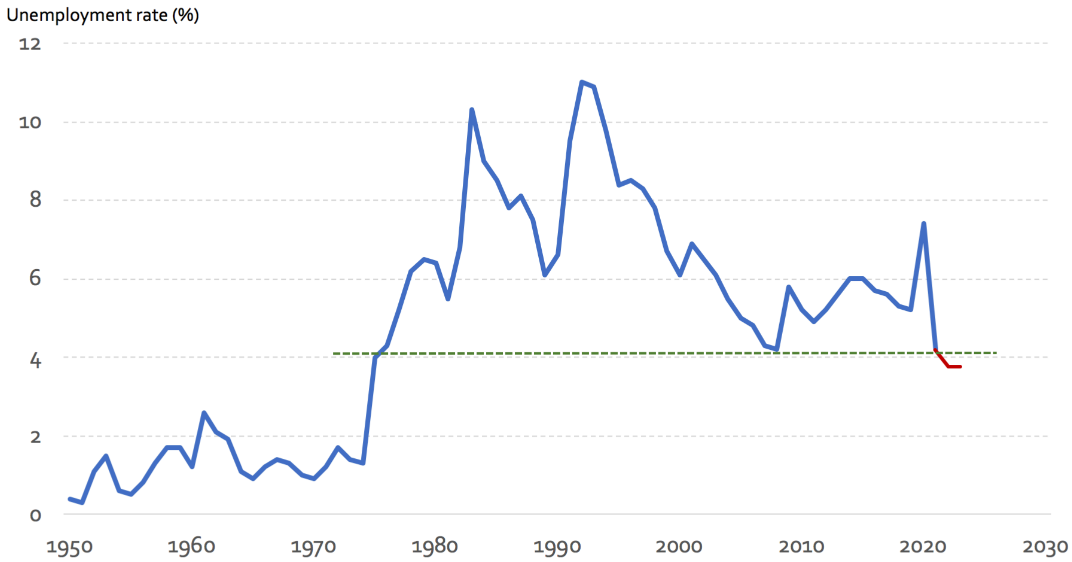
It is clear from recent communications that the RBA is not worried about a cyclical rise in wage and inflation pressures in Australia. Indeed, they welcome it. The RBA appears to have adopted the view that any unwanted inflation can be swiftly dealt with via higher interest rates.

The RBA's comfort with the current inflation outlook also reflects the disinflationary backdrop which has been responsible for the undershooting of the inflation target in the five years immediately prior to the pandemic.

After much criticism of missing their target prior to the pandemic the RBA Board appears to be keen not to make that mistake again.

Forecasters are underestimating the potential for higher wages and inflation in Australia in both 2022 and over the medium-term. Hopefully the RBA is not overestimating their capacity to manage it.

Chart 13: Unemployment Rate Forecast



Sources: ABS, RBA, EQ Economics

Are Central Banks Playing with Fire? An Unanticipated Shift in the Secular Backdrop

Central banks that take comfort from the past disinflationary trend could risk entrenching inflation within the economy over the next three years. Following a global pandemic and a period of undershooting inflation targets, the appetite for tightening monetary conditions is lower than usual. Central banks will tippy toe their way through the initial lift in cyclical inflation pressures which seem all but inevitable unless the economy takes a turn for the worse.

If there is a secular shift in the inflation environment underway, it is hard to believe that central banks will recognise the new operating environment. It is this lack of recognition that raises the risk of a troublesome inflation outbreak over the next 3-5 years.

The inflation risk scenario could play out as:

- Central banks will be late to start raising interest rates and once they do get started, they will be cautious. The worst case is that they will not be able to get real interest rates up quickly enough to slow strong demand and halt rising prices.
- There is no shortage of liquidity in the system. Rapid growth in various measures of the money supply may not have had much of an impact on inflation outcomes over the past decade, but abundant liquidity and vigorous credit creation may add to the potency of the inflationary pulse in the post pandemic economy.
- The economy may prove more resilient to higher interest rates than is generally appreciated, even if financial markets are not. A financial wobble may give central banks pause during their tightening cycle, but it is unlikely to alter the strong underlying fundamentals driving a robust expansion in economic activity.
- Business failure could start to rise in 2022 and 2023 after two years of extraordinarily low rates of insolvency. Business failure will raise concerns about the resilience of the broader economy to less accommodative policy settings. Insolvency will free up labour and capital for other purposes, which should reduce capacity constraints across the economy.
- The policy starting position is a long way from a neutral setting. Monetary policy is highly accommodative and will remain so through the first phase of raising the short-term interest rate. Economists can debate the level of the neutral real interest rate, but it is highly unlikely that it is a negative real short-term interest rate as now exists in most markets, including Australia's.
- For most central banks, the RBA included, secular disinflation will be assumed as the structural backdrop. From competition and price sensitive consumers to anchored inflation expectations and sticky wages, central banks will feel they can be cautious in their tightening cycle given the operating environment is inherently disinflationary.
- In the worst-case scenario, the secular backdrop shifts. Deglobalisation, a demographic tipping point, the rebuilding of supply chain resilience, and a fundamental change in the global labour market supply/demand dynamic ends up turning a traditional cyclical inflation lift into a troublesome inflation problem.

Conclusion

The reality is that we just don't know how this complex mix of forces will interact with the policy settings. None of this necessarily means inflation will become a major problem. The world economy may find the desired path for inflation, economic activity and interest rates over the course of the next 3 to 5 years.

If inflation continues to surprise, central banks may need to play catch-up at some stage which could slow the economy more than otherwise. There is always the concern that an overly aggressive monetary tightening could take us back to where we were pre-pandemic; anaemic growth, spare capacity in the labour market, and inflation below central bank targets. That seems to be a dominant concern for the RBA.

Bearing this in mind, the most likely policy error from the RBA is for too little, rather than too much, monetary tightening over the next few years. In this case, central banks will give inflation a decent chance to take hold and in the case of a shifting secular backdrop will raise the risk of having to put the economy into a damaging downturn at some stage.

About the Author

Warren Hogan

Warren Hogan is the Managing Director and Founder of EQ Economics, a consultancy specialising in economic, market and industry analysis. Warren is also an economic advisor to Judo Bank, a recently listed specialist SME focused bank.

Warren is a regular in Australian and international media. He is a columnist for the *Australian Financial Review* and a contributor to *Sky News Australia*. He is regarded as one of Australia's top economic analysts and commentators. His focus is on the Australian economy and supporting business decision making.

Warren's career started in banking and financial markets where he held various roles as an economist and financial market strategist. He has worked for the NSW Treasury Corporation, Westpac Banking Corporation, Credit Suisse and the ANZ bank where he held the position of Chief Economist from 2009-2016.

As Chief Economist of ANZ Bank Warren was on the leadership team for the Global Markets business, a $2bn plus revenue line for the bank, a member of the Group Asset Allocation Committee and advisor to the bank's management board and CEO.

Warren was appointed a Principal Advisor to The Australian Government Treasury in 2016, supporting various Treasury functions including the Macroeconomic Group and the Foreign Investment Review Board.

Warren was an Industry Professor at UTS Business School from 2018-2020 supporting the University in its teaching, research and pubic engagement activities.

With a strong focus on forecasting and prediction Warren values open-mindedness, critical thinking, and plain speaking. Theoretical foundations, historical precedent and statistical evidence are at the centre of Warren's approach to economic problem solving.

Warren lives in Sydney with his wife and two daughters.

Related Works

Robert Carling, *The Looming Iceberg: Australia's post-pandemic debt risk*, POLICY Paper 35, 28 January 2021.

Warren Hogan, *The End of Monetary Policy?*, CIS Analysis Paper 16 (AP16), 29 October 2020.

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Level 1, 131 Macquarie St, Sydney NSW 2000 • **phone:** 02 9438 4377 • **email:** cis@cis.org.au