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Australian Economic Comment

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This disinflation is different

- The last time that Australia's economy was operating as far beyond its capacity as it is right now, was back in 2008, just prior to the Global Financial Crisis. Back then, the eventual disinflation came about because of the sharp global downturn that the GFC delivered, which prompted a sharp rise in the unemployment rate. The shock was a global one, such that local policymakers did not have to drive the economy into a self-generated recession to dis-inflate. Now, with green shoots in the global cycle and an apparent upswing in commodity prices underway, the global backdrop is not delivering like last time. This time could be different.

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As the RBA has very usefully pointed out in a recent Bulletin article, despite the recent growth slowdown, the economy is still operating beyond its full capacity.[1] Chart 1 below is from the article and shows that the economy is the most stretched it has been since 2005-2008 and that there are no other times in the past 40 years when it has been beyond full employment.

Last time the economy was operating this far beyond full capacity, the eventual disinflation of the economy came about with a sharp 1.7ppts rise in the unemployment rate. This, of course, was due to the Global Financial Crisis, with a key trigger being the failure of Lehman Brothers Bank in mid-September 2008.

As we wrote not long after that event, in 2010, this meant that the disinflation of Australia's economy, and economic downturn that was required to make it happen, could be largely attributed to an external shock. Local policymakers did not wear the blame for economic downturn. In short, despite the RBA's aggressive tightening in the lead up, few economic observers suggested that it was the RBA that delivered the eventual economic downturn. Indeed, because Australia did not have a 'technical recession', the policy response to the Global Financial Crisis was generally judged to be a success.

Fast forward to the current situation. This time it is looking increasingly less likely that the global economy will deliver an economic downturn that drives Australia's domestic inflation lower. Indeed, there are 'green shoots' in the global economic cycle, and these are part of the reason we think global commodity prices are likely to be past their trough. If local policymakers, including the RBA, had quietly thought that a GFC-like, global downturn 'do-over' might deliver local disinflation, it's looking less than likely.

The RBA has also taken a different approach this time, with an explicit aim of maintaining close to full employment while still dis-inflating. In 2007 and 2008, the aim was a more singular focus on getting inflation back to target.

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1 See Ballantyne, A., Sharma, A. and Taylor, T. (2024) 'Assessing full employment in Australia', RBA Bulletin, 18 April.

On the fiscal front there are some similarities too. As was the case in the lead up to the Global Financial Crisis, the government is getting upside surprises in its tax revenues and for similar reasons. Commodity prices are surprising to the upside and so is personal income tax revenue, due to full employment. Of course, part of the reason for the commodity revenue upside surprises is persistent downward bias in the Treasury's estimates of iron ore prices - largely a strategic choice.

In both episodes, the government is running fiscal surpluses. But just having fiscal surpluses may not be enough. In 2006 and 2007, fiscal surpluses were running at over 1.5% of GDP and the government had a net asset position, but it is still the case that even more fiscal tightening may have prevented the RBA from needing to lift its cash rate as much as much as it did in late 2007 and early 2008.

A clear lesson from the earlier episode is that even larger fiscal surpluses may have helped. As the Federal budget approaches, due on 15 May, fiscal policymakers ought to consider that a contractionary fiscal setting would help to bring inflation down. Particularly given already legislated tax cuts that are set to arrive on 1 July.

For monetary policy, last week's upside surprise to Q1 inflation supports our long-held view that the RBA will not be cutting its cash rate in 2024.

Inflation is still too high and coming down only slowly (Chart 2). High services inflation is a primary challenge, reflecting a weak supply side of the economy and very weak productivity.

The upside surprise to inflation was 20bp, so it is likely that the RBA will revise up its near-term inflation forecast, likely by this amount. The unemployment rate is also rising more slowly than the RBA had expected, with a tighter than expected labour market likely to mean more upside risk to wages.

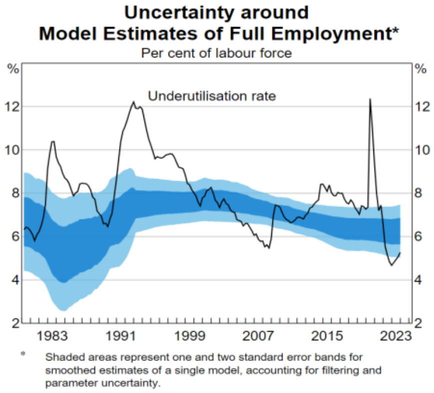
However, the RBA's February forecasts were also conditioned on the average of OIS market pricing and the market economist's consensus at the time, and assumed 75bp of cash rate easing by mid-2025. This easing has now largely disappeared from market pricing - so the RBA is likely to assume fewer rate cuts in its forecasts. In short, 'higher for longer' will likely be the working assumption in the RBA's forecasts.

These tighter financial conditions for longer should allow the RBA to still forecast inflation falling back to the mid-point of the 2-3% target band by mid-2026, as they did in February.

That said, the balance of risks has shifted. The risk has clearly increased that the RBA may have to lift its cash rate further yet. Reflecting this, the OIS market is now pricing a 50:50 chance of a 25bp hike by September.

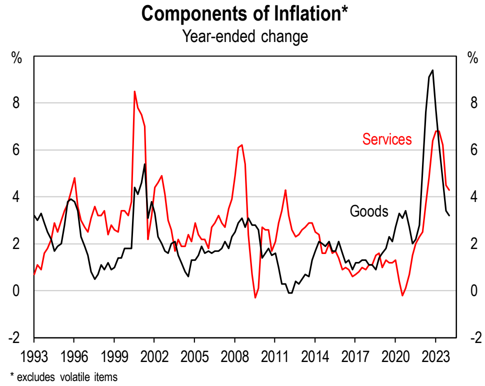
For the RBA, a key focus in the coming period will be on the next employment and monthly CPI figures. The budget and tax cuts will also matter, although the RBA is unlikely to make direct references to these, instead closely following consumer spending indicators for signs of a fiscal-related pick up. Finally, what the US Fed does, and when, is likely to play a role in RBA thinking.

1. Beyond full employment, just like pre-GFC



Source: RBA

2. Services inflation fell significantly in the post-GFC disinflation



Source: ABS

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