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Australian Economic Comment

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Economics - Australia

Recession risks rise

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- It is getting harder to believe that Australian inflation can fall back to the central bank's inflation target without the economy tipping into a recession. Although the central bank has been tightening its own policy settings markedly, other arms of policy have not been helping to fight inflation as much as would have been ideal. This is increasing the risk that high inflation becomes embedded, particularly in wage settings, which could mean a larger jobs market retrenchment would eventually be needed to get inflation down. A recession is not our central case, but despite the helpful support of strong population underpinning GDP, we see a 50:50 chance that Australia tips into a recession.

The RBA Governor, Phil Lowe, has aptly described it as a 'narrow pathway' – and it is getting extremely narrow indeed. The hope has been that the RBA's monetary tightening could deliver a slowdown in growth, that weakens demand, without an outright contraction in economic activity, allowing time for the supply-side of the economy to gradually improve. The hope has been that this would allow a gradual return of inflation back to the RBA's target. In short, for a soft landing rather than a hard one.

The risk has always been that the high inflation could start to embed itself in the system. In particular, that the sharp rise in the cost of living (that is, high inflation) would mean workers demanded higher and higher wage rises. And that if wages growth picked up too much, it would become more difficult to get inflation back to the central bank's target.

If this happened, a much sharper decline in demand and a marked rise in the unemployment rate would be needed at some point to get wages growth to cool. After all, once wages growth becomes excessive and if inflation is still too high, how else can wages growth be lowered but by having a bigger rise in the unemployment rate?

This hope is fading. Although the RBA has taken significant action to seek to get inflation to fall, other arms of policy have not been as helpful as would have been ideal. Much of this shift in the risks has happened in just the past six weeks or so.

One element was the Federal budget. On this, there has been much debate amongst Australian economic observers about whether it added to inflation or not. After all, fiscal policymakers saved a large proportion of the revenue upside surprise they received and new policy measures, like energy subsidies, will contribute directly to lower measured inflation in the short-run.

However, the new cost of living support measures are aimed at households that are up against their budget constraints and thus those households are likely to spend the income boost. The budget did not fully offset these measures with cuts elsewhere. On net, we assess that this is likely to have added to some upside risk to inflation. What was really needed was an explicitly contractionary budget. This was not delivered.

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Then, a few weeks later, the minimum wage decision was announced. This saw an outsized increase in the minimum wage of 5.75%. As the RBA has repeatedly noted, 3-4% wages growth could be seen as consistent with a 2-3% inflation target, assuming productivity growth runs at its pre-pandemic average of 1% a year. The minimum wage rise was clearly in excess of this. In addition, the decision did not tie these wage rises to required productivity gains.

This sets a benchmark across the workforce and adds to upside risk to wage growth norms. Tacit acceptance by fiscal policymakers, at both the state and Federal levels, that wage deals can be higher than the 3-4% annual benchmark, likely influenced by the minimum wage deal, also adds to these concerns. Recent state wage deals for health workers and other public servants have exceeded the 3-4% benchmark.

Measured productivity growth has also been very weak recently. This may be related to the pandemic effects, including disrupted supply chains or shifts to more work from home.

It worth noting too, that it is understandable that workers demand higher wages growth, given cost of living pressures. It is also understandable that elected officials seek to assist in achieving this. But it has consequences. The more targeted instruments of policy are the fiscal tools. If they are not sufficiently aimed at helping to get inflation down, then the much blunter instrument of monetary policy tightening will need to be used instead.

Is all hope of a 'soft landing' lost? Not quite. A bit more tightening from the RBA may prove to be just enough to get demand to weaken, but not fall outright and for inflation to come down a bit faster, such that excessive wage claims become more difficult to motivate in the coming period. It may be that the RBA needs to get inflation down faster than it previously thought, to avoid it becoming embedded, and this may still be possible without an outright economic contraction – albeit only just.

A force that could help, although it is highly uncertain, is the current very strong inward migration. This will support GDP growth, helping to prevent a recession. It could also help to contain wages growth, as it also means more workers arrive (that is, more supply). There is a risk though, that the boost to migration adds to inflation by boosting demand by more.

For now, it seems that the RBA has deemed that, as it sees it, even with an increased risk of a recession, the bigger risk is that high inflation becomes embedded. Expect more monetary tightening yet.

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