International Monetary Monitor

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Australian Inflation to Fall below Target

By John Greenwood

Overview

- Australian CPI inflation has fallen for five consecutive quarters from 7.8% at the headline level in 2022 Q4 to 3.6% in 2024 Q1 – the latest quarterly data available from the Australian Bureau of Statistics (ABS). The monthly indicator (which covers two-thirds of the items) showed 4.0% for May.

- Following the latest meeting of the (Monetary Policy) Board of the Reserve Bank of Australia (RBA) on June 18, the decision was to maintain the RBA's cash rate target unchanged at 4.35%.

- Like the US Federal Reserve, the RBA Board said that it "*needs to be confident that inflation is moving sustainably towards the target range*." In its post-meeting statement, the Board reiterated "*the need to remain vigilant to upside risks to inflation.*"

- After a brief historical Introduction, **Section 1** of this Newsletter focuses on the relation between Australian M3 growth and inflation over the past decade. **Section 2** discusses the terms of trade and wages as drivers of inflation.

- **Section 3** discusses the outlook for Australian inflation and interest rates in the light of the relationships reviewed in Sections 1 and 2. This generates an inflation forecast for the remainder of 2024 and 2025.

- **The conclusion** is that Australian CPI inflation is likely to continue to decline in 2024 and 2025. However, because the RBA maintains a hawkish stance on rates, based on its view that there is *"continuing excess demand in the economy, coupled with elevated domestic cost pressures, for both labour and non-labour inputs,"* the main risk is that inflation will fall **below** target. Based on M3 growth in the past year, I think the RBA's fears are exaggerated.

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor. A pioneer of monetary research in Asia, John was also the publisher, editor and lead author of ***Asian Monetary Monitor****, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*
To access my research please email your request to IMM@eri-c.com

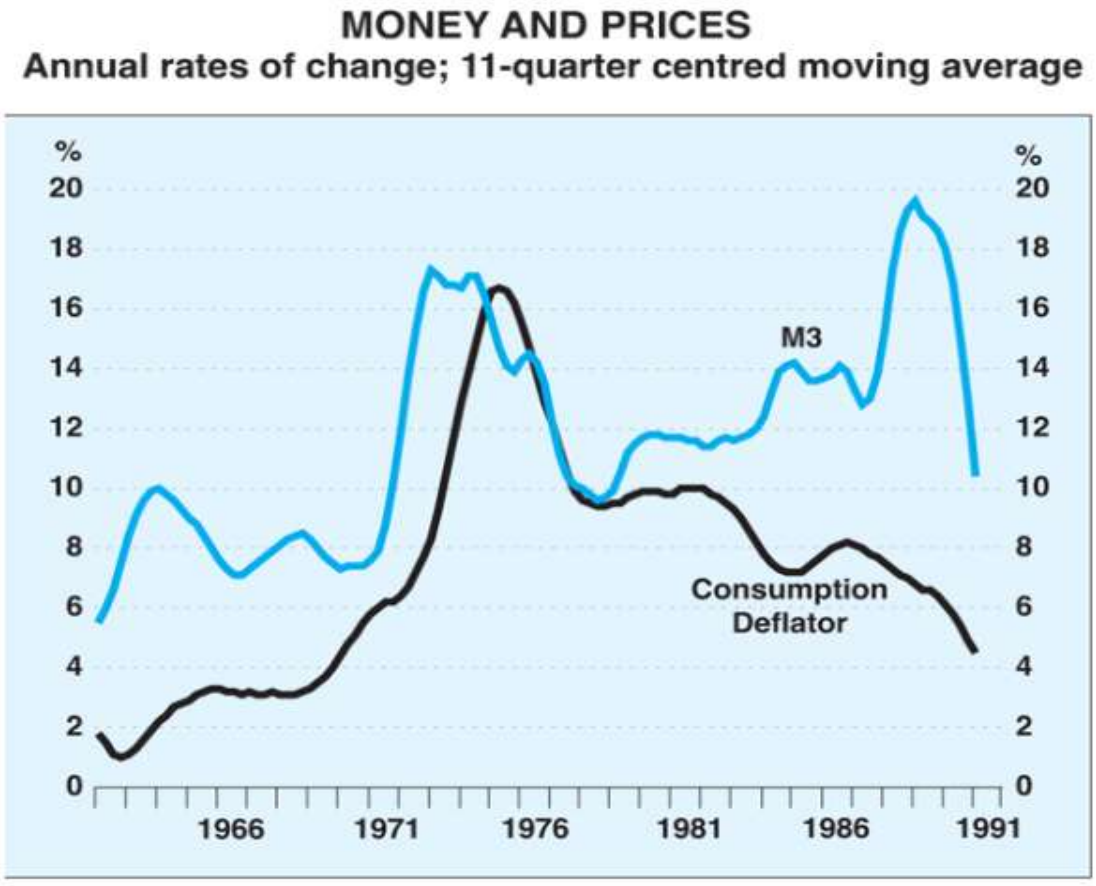
Introduction: Historical Background to Monetary Policy

Historically monetary policy in Australia was implemented jointly by the RBA and the Treasury through a variety of instruments (such as interest rate ceilings, the setting of bond yields, variations in the Statutory Reserve Deposit Ratio, lending controls, a form of monetary targeting between 1976 and 1985, and pegged exchange rates) until the early 1980s. A period of deregulation then followed, during which these various controls were eliminated one by one and monetary policy decision-making shifted from committees in Canberra to the RBA Board in Sydney.

Three key changes were (1) the introduction of bond tenders to fully fund budget deficits in 1982, thereby freeing up long-term interest rates, (2) the floating of the currency in 1983, thereby insulating domestic money growth, and (3) ending the "projection" for M3 – normally announced in the Treasurer's annual budget speeches – in January 1985. The last of these steps was in line with the decisions of other central banks in the 1980s and was explained by the Treasury in Statement No. 2 later that year: *"The analytical integrity of simple monetary targeting rests on the existence of a stable relationship between the chosen aggregate and the ultimate policy objectives. That is no longer the case at present in Australia."*

The breakdown of the relation between Australian M3 and inflation in the 1980s is illustrated in Figure 1. Explanation.

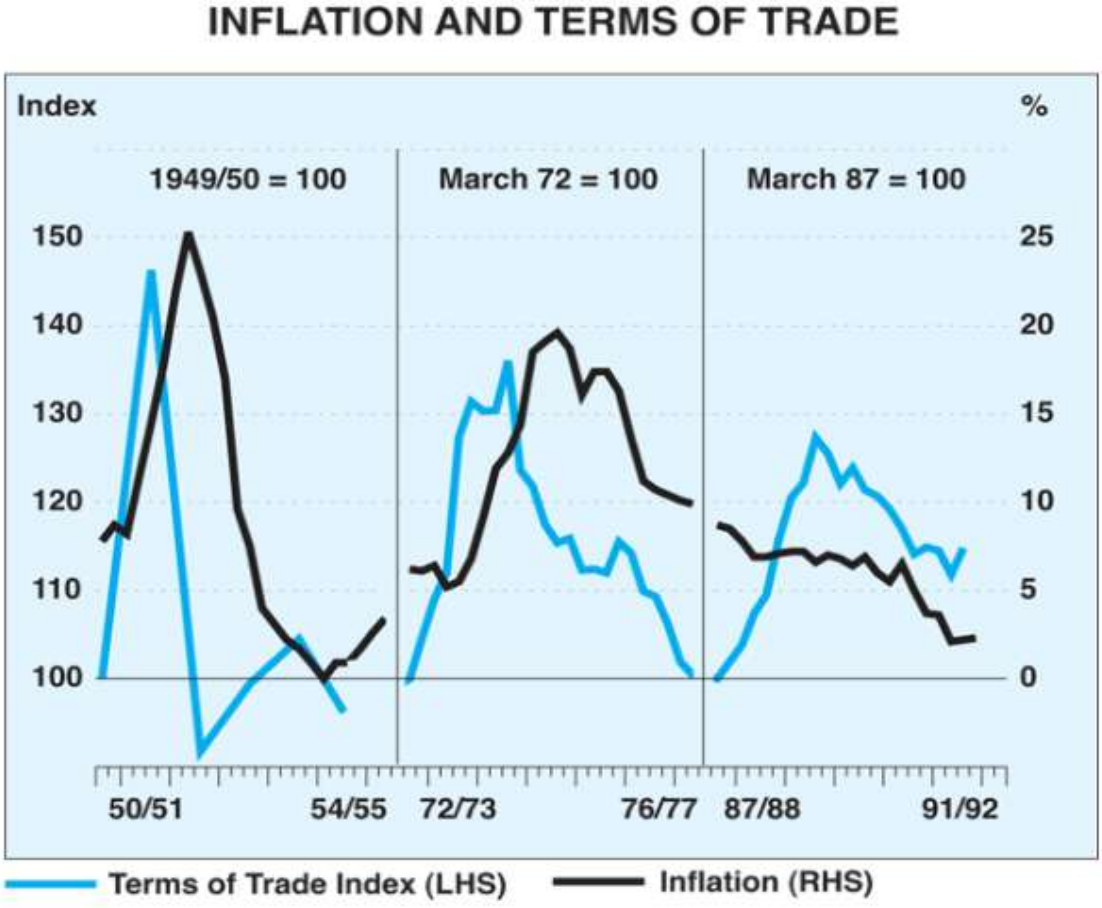
Figure 1. The Divergence between M3 and Inflation in the 1980s



The net result today is that monetary policy is conducted by the RBA using short-term interest rates as virtually the sole policy instrument. The philosophy of the RBA leadership has developed to emphasise the need to manage **aggregate demand**, but not by monetary acceleration or deceleration. Instead, interest rates are used as the primary tool to manage aggregate demand. Inflation is viewed as the result of an excess of aggregate demand over aggregate supply, with the RBA having some degree of control over aggregate demand but very little control over aggregate supply.

However, in addition to aggregate demand/supply factors, other non-monetary factors have been viewed as highly influential for Australia's inflation rate at different times. One example is the changing terms of trade (i.e., the ratio of export prices to import prices). Given Australia's dependence on the export of key commodities such as iron ore, coal, petroleum gas, gold, and agricultural products such as wheat, lamb and dairy products, a significant share of the economy is driven by the international prices for these items. An improvement in the terms of trade will tend to raise prices and incomes in the relevant sectors, and there can be spillovers to other sectors of the domestic economy, e.g., in the 1950s and 1970s, but not in the 1980s (Figure 2).

Figure 2. Improvements in the Terms of Trade have in the Past Led to Episodes of Domestic Inflation.



Another example of a non-monetary force widely presumed to have an influence on domestic inflation was wage pressure. To cope with this, the Australian Labor Party

(ALP) government negotiated a series of Prices and Incomes "Accords" with the Australian Council of Trades Unions (ACTU) which remained in effect from 1983 to 1996. Whether justified or not, in the 1980s and 1990s the Accords were given significant credit for moderating inflation by a succession of Australian leaders.

Section 1. Longer-Term Perspective on Australian Inflation

Over the past decade and a half since the GFC, how valid are these claims for monetary and non-monetary sources of inflation and what relevance do they have in current circumstances?

Figure 3. Growth of M3 the Dominant Driver of Inflation since the GFC.

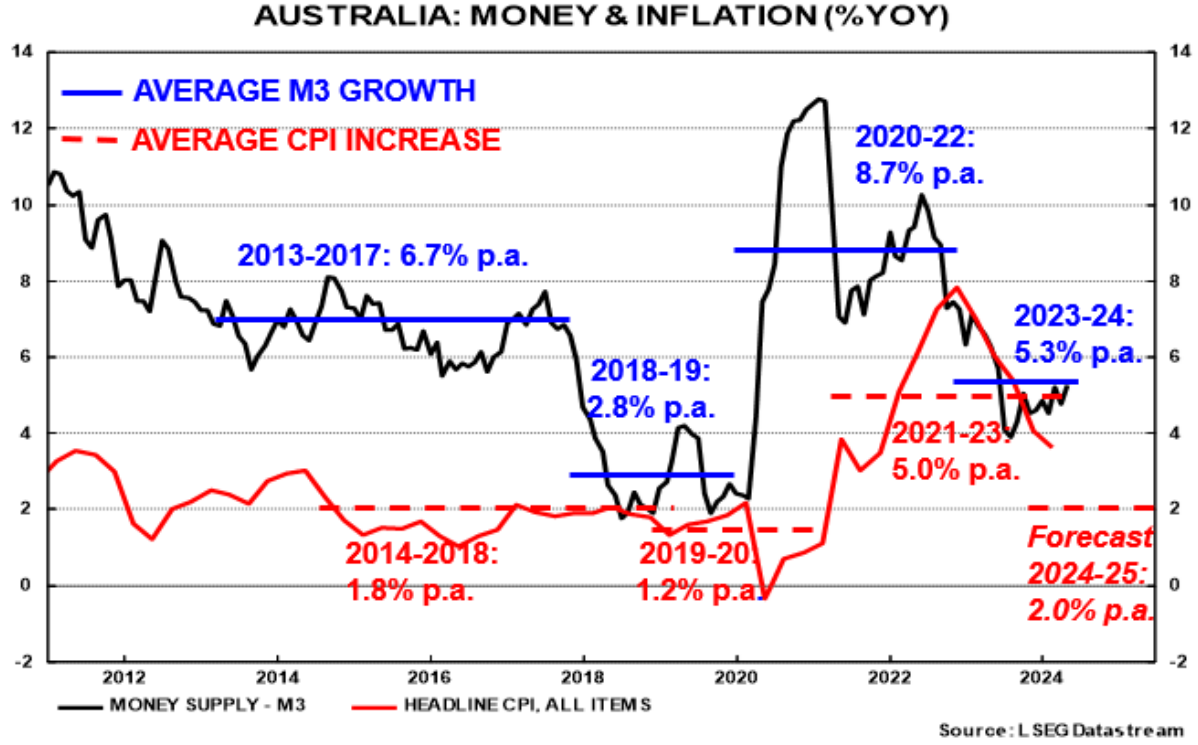
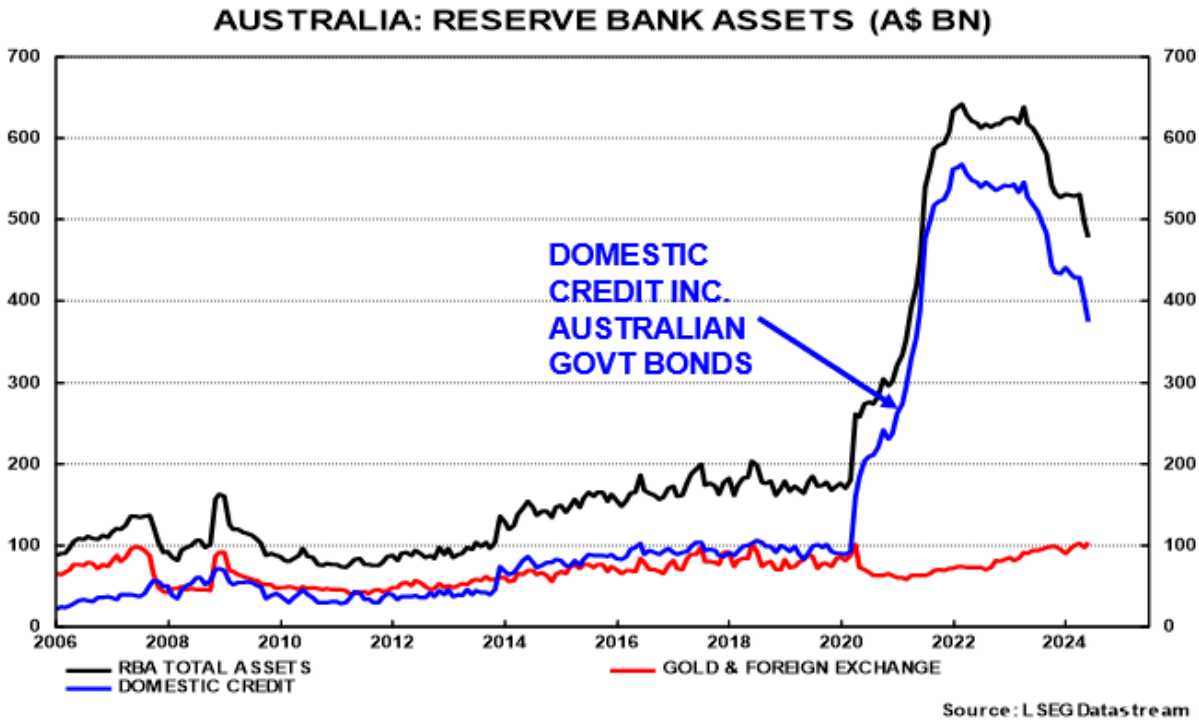


Figure 3 shows that in the immediate aftermath of the GFC from 2011 onwards there was comparative monetary stability when assessed by the growth of M3. The 6.7% p.a. average growth of M3 in 2013-17 generated an average CPI inflation rate of just 1.8% p.a. over the years 2014-18. The decline in M3 growth in 2018-19 to an average of 2.8% p.a. produced an even lower rate of inflation in 2019-20. (At that time I had written articles warning that Australian money growth was too low.) This phase of abnormally low M3 growth and its correspondingly low inflation rate did not last long, however, because in early 2020 the Covid-19 pandemic struck, and the RBA executed a sudden and drastic change in monetary policy.

Like other leading central banks, the RBA addressed the pandemic by lowering rates, with a big expansion of repo operations initially, followed by "term funding" for banks, as well as by vigorous quantitative easing (QE) from November 2020, implemented via purchases of Australian Commonwealth, state & territory bonds from non-banks. Total RBA credit created between March 2020 and February 2022

amounted to A$475 billion, with domestic holdings peaking at A$568 billion (see blue line in Figure 4.)

Figure 4. The RBA Implemented QE by Purchasing A$475 bn AGBs.



The effect of these credit operations and asset purchases on M3 was that broad money accelerated through 2020-21, with M3 averaging 8.7% in 2020-22 and peaking at 12.8% year-on-year in 2021 Q1 (Figure 3). CPI inflation surged to average 5.1% inflation in 2021-23, peaking at 7.8% in 2022 Q4, just over a year and a half later – exactly what one would expect from a monetary model of inflation.

At this point it is appropriate to digress to discuss the optimum rate of money growth for Australia to hit its 2-3% inflation target. Drawing on the equation of exchange, MV= PY, a suitable growth rate of Australian M3 for hitting the inflation target of 2-3% p.a. is given by m = -v +p + y where the lower-case letters represent the average percent growth rates of the variables. Using data from 2000-2019 we have:

$$m = -(-2.2\%)+2.5\%+2.5\% = 7.2\%.$$

The 7.2% can be rounded to a desirable M3 growth range of 6-8% p.a. The appropriateness of a 6-8% M3 growth rate can be seen visually from the period 2013-17 in Figure 3 when M3 growth averaged 6.7% p.a. and inflation in the following years (2014-18) averaged 1.8% p.a., a little below the 2-3% target range.

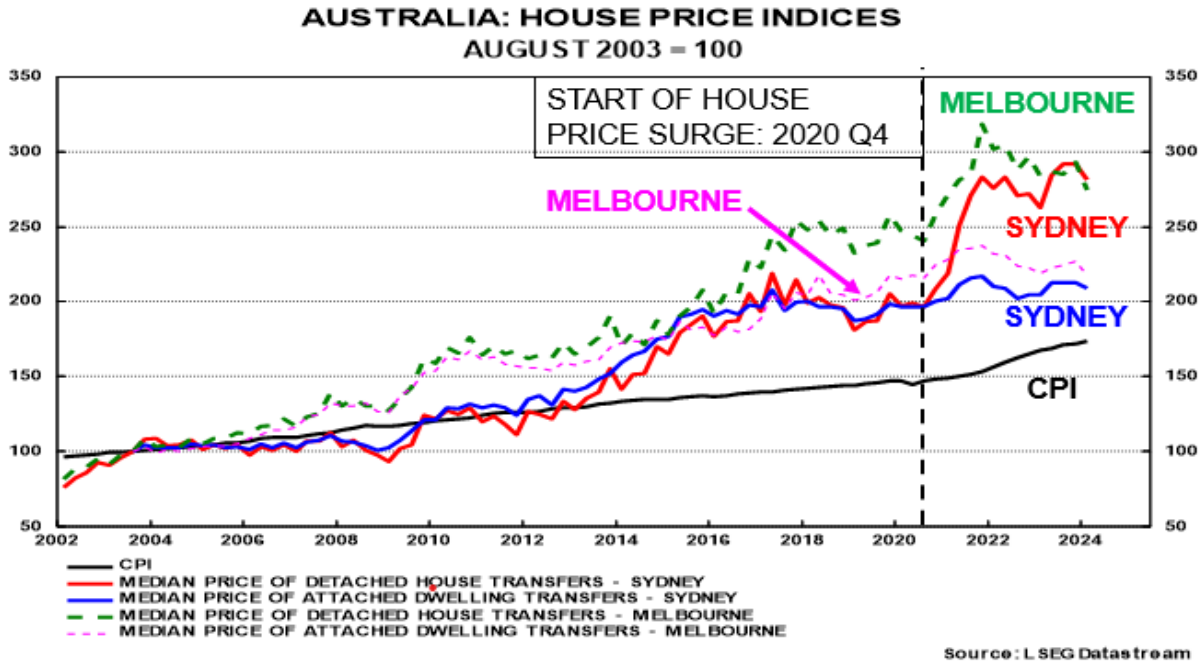
In summary, the Covid episode was clearly a drastic departure from a relatively stable monetary growth rate. The decisions to supply credit to different sectors and to make asset purchases were justified by the RBA as a means of "*lowering funding costs and supporting the supply of credit to the economy…The functioning of major government bond markets has been impaired, which has disrupted other markets given their important role as a financial benchmark.*" It was in this spirit that in March 2020 the RBA set "*a target for the yield on 3-year Australian Government bonds of around 0.25 per cent.*"

Management of short-term rates, the yield curve, and credit conditions were the over-riding priorities. Lower rates boosted the cash flow of indebted businesses and mortgage borrowers in the household sector. They also helped Australia's trade-exposed industries through weakening the exchange rate.

In common with other central banks, the RBA basically ignored a crucial side-effect – the rapid increase of M3. As Governor Philip Lowe said on 19 March 2020, "*Rather than quantities or the size of our balance sheet, our focus is very much on the price of money and credit. Our objective here is to provide support for low funding costs across the entire economy. By lowering this important benchmark interest rate [the 3-year AGS yield], we will add to the downward pressure on borrowing costs for financial institutions, households and businesses. We are prepared to transact in whatever quantities are necessary to achieve this objective.*"[1]

A notable feature of the Australian experience was that house prices started rising well ahead of goods and service prices in the CPI (Figure 5). This reflects the tendency, well-known to monetarists following large and sustained changes in broad money growth, for portfolio re-balancing – part of the transmission process – to show up in asset prices well before excess money impacted goods and service prices.

Figure 5. House prices started rising from 2020 Q4, well before the energy price shock or CPI surge.



The subsequent and unexpected steep rise in Australia's CPI inflation from the targeted 2-3% to 7.8% in 2022 Q1 shows that a monetary policy conducted without reference to money can go seriously astray.

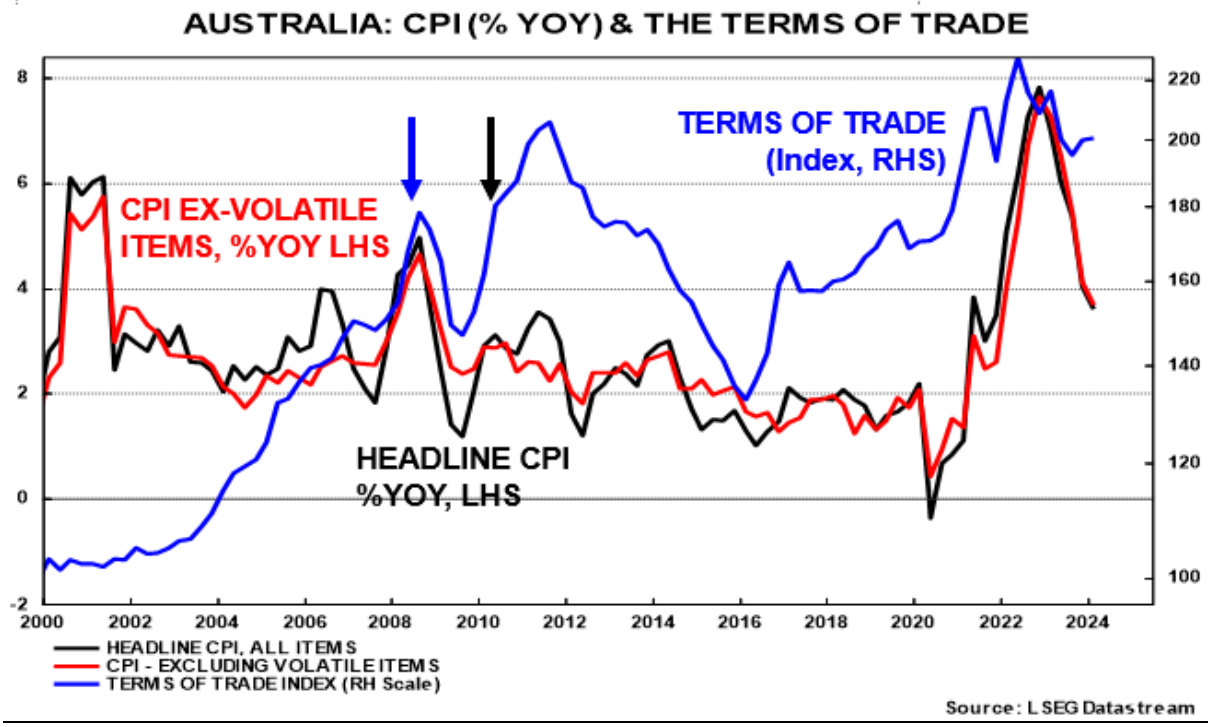
[1] Responding to the Economic and Financial Impact of COVID-19 | Speeches | RBA

Stated differently, the post-Covid inflation was indeed a monetary phenomenon – meaning that it was the result of an excessively rapid growth of broad money in relation to real output – not a product of either supply chain disruptions or the war in Ukraine or food or energy price shocks, all of which produced relative price changes but not overall inflation.

Section 2. The Terms of Trade and Wage Push Factors in Inflation

In the Introduction we saw how the terms of trade appeared at times to be a factor affecting inflation in Australia (Figure 2, p. 3). The chart showed two historical episodes – at the time of the Korean War and the First Oil Crisis – when inflation had increased following improvements in the terms of trade. The explanation for these two episodes is that under fixed exchange rates a boom in Australian commodity prices led to large surpluses in the balance of payments which were accommodated by the central bank converting the foreign proceeds into domestic currency and hence pushing up the rate of monetary growth.

Figure 6. No Longer Any Relation Between Terms of Trade and Inflation.



Since the shift to floating exchange rates in 1983 there has been no reason for the same relation to hold, and this was why the third panel in Figure 2 showed no relation between the terms of trade and inflation.

Turning to more recent history, during the so-called commodity super-cycle (2003-2008 Q3) there was almost no relation between the terms of trade and money growth or inflation in Australia until the final blow-off in 2007-08 (blue arrow in Figure 6).

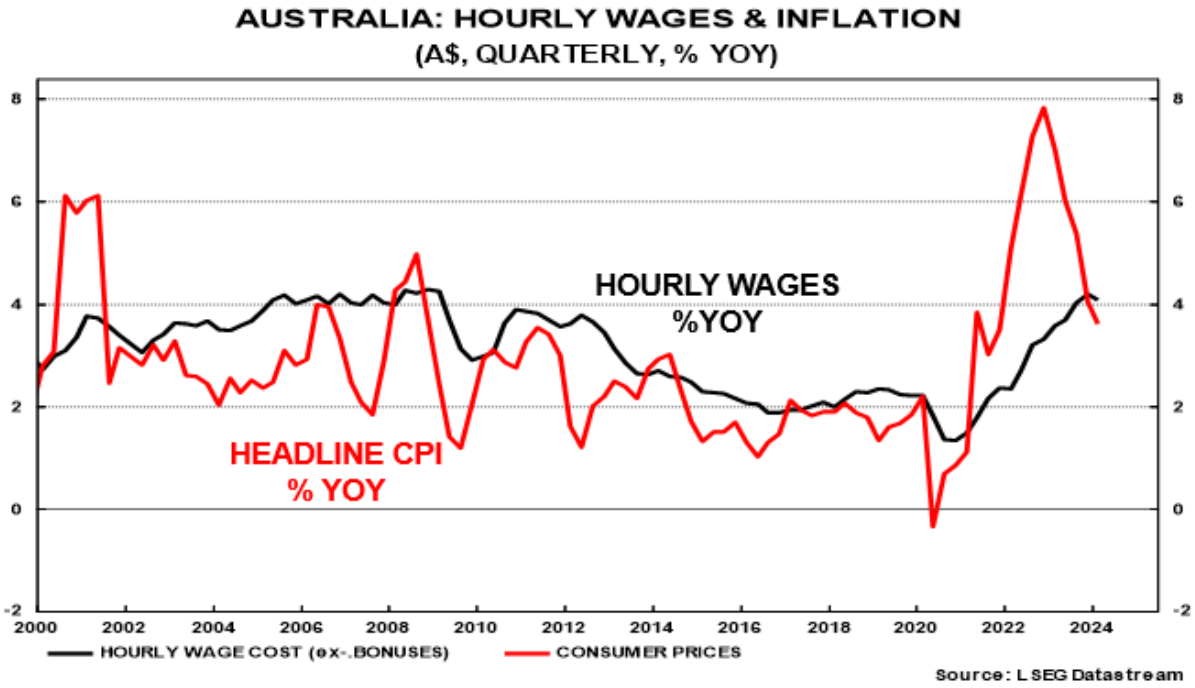
China's stimulus policy in 2008-10 and the boost it gave to global commodity prices in 2009-11 (black arrow) helps explain Australia's relatively rapid recovery in these years and why there was no GFC recession in Australia. However, for the rest of the

decade of the 2010s until the onset of Covid in 2020 there was once again no relation between the terms of trade and Australia's inflation.

Finally, the surge of inflation from 2021 onwards was entirely the result of excess money growth generated by central banks during Covid. Money in turn pushed up the global demand for commodities. Australia was part of this broad trend: rapid money growth led to strong domestic demand across many economies and fuelled commodity price increases in the energy and food sectors.

A second theme in the Introduction was how wages had frequently been viewed as a separate source of inflation in Australia – so much so that Australian Labor governments signed a series of Accords with trades unions in an attempt to keep wages under control.

Figure 7. Australian wages have tracked CPI inflation over the past two decades.



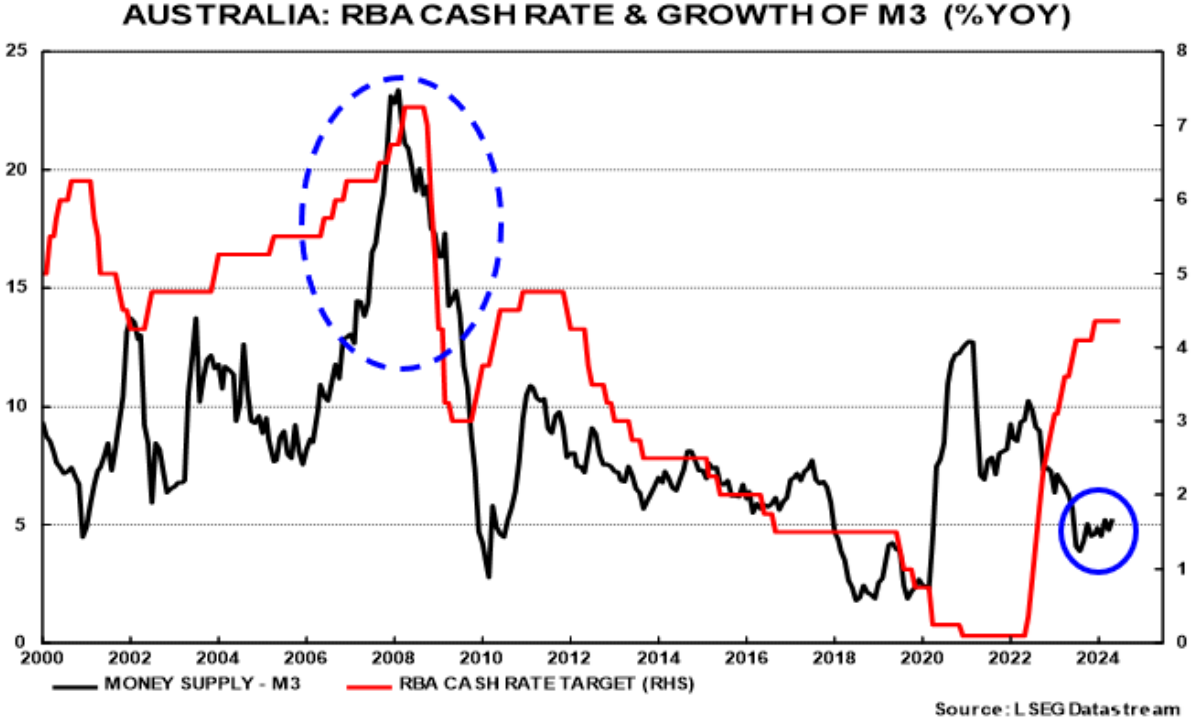
In a monetary framework, wages are simply one of the elements in the transmission process of monetary policy. Like other prices, nominal wages will be influenced upwards or downwards by the underlying rate of inflation, but they will tend to lag many other prices that are subject to inflation. In Figure 7 we can see that from 2003 onwards until 2021 wages generally increased by a small margin over CPI inflation, no doubt reflecting productivity gains.

Following the onset of the Covid inflation, however, wages have fallen behind and consequently one would expect them to continue to grow faster than inflation for a while until workers feel that their real earnings have been restored. But this is not a new source of inflation. Furthermore, if wages were pushed up too much, firms would reduce hiring. In other words, market forces would come into operation to limit their upswing.

Section 3. Near-Term Perspective on Australian Inflation.

In the period ahead, Michele Bullock, the RBA's new governor since September 2023, and her Board must decide how far to lower interest rates.

Figure 8. Australia's money growth is already at a low rate.



The Board will be aware of cases like the 2006-07 surge in M3 growth (shown by the dashed circle in Figure 8) when inflation remained subdued. It is because of episodes like this that they shy away from adopting a monetarist rule for M3 growth. But can they always ignore money?

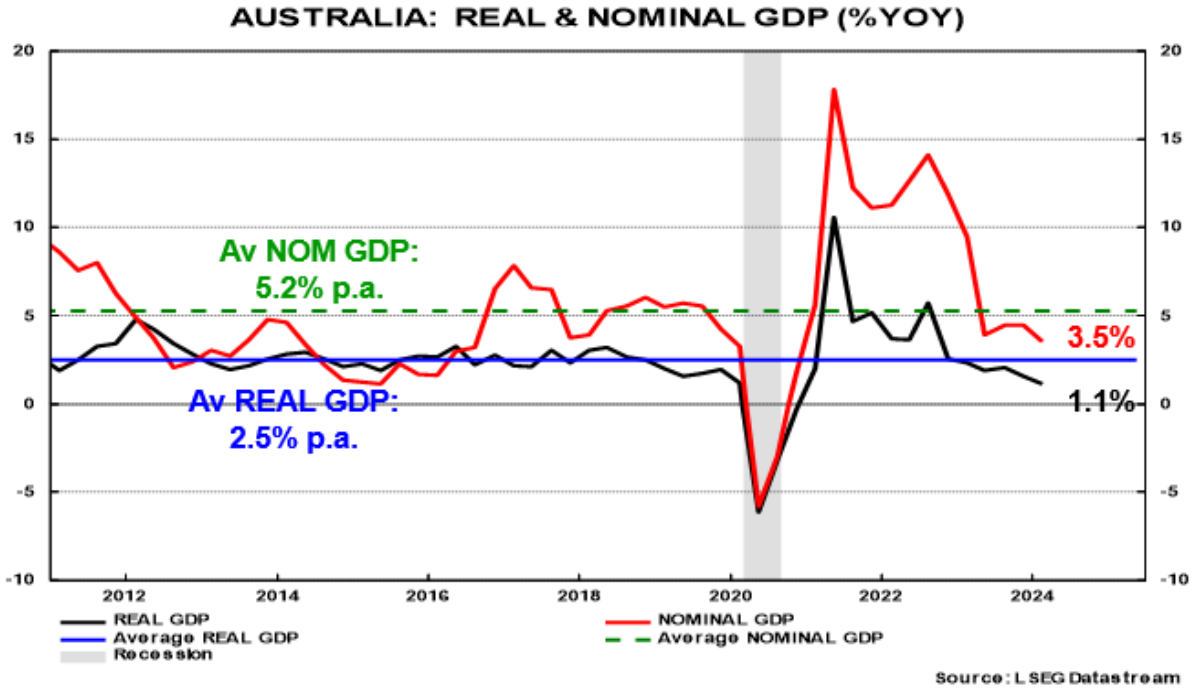
Based on my calculation of the optimum money growth rate for meeting the inflation target (see above, p. 5), M3 growth at 5.3% year-on-year in April 2024 was already below the 7.2% optimum estimate or the 6-8% guideline suggested there. Moreover, M3 growth has averaged 5.3% year-on-year since June 2023 (solid circle in Figure 8), implying that monetary policy is already slightly too tight and needs to be relaxed.

It is important that any monetary easing occurs before the demand for credit falls much further. If rates are not lowered in a timely fashion, credit demand could fall requiring a larger decline in rates to stimulate any growth in bank lending or debt issuance, and hence money growth. The result would be a downward spiral in both bank credit and money growth.

However, the RBA is watching aggregate demand rather than money, and they tend to focus on service prices, the labour market – both lagging indicators of inflation -- and inflation expectations as sources of inflation rather than purely monetary factors. We do not know exactly how the RBA quantifies aggregate demand, but a

sensible way to consider it is by using year-on-year percentage changes in nominal GDP. This is shown in Figure 9.

Figure 9. Nominal GDP is slowing in line with M3 growth.



Over the four quarters 2023 Q2 to 2024 Q1, nominal GDP slowed to an average of 4.1%, falling to just 3.5% in 2024 Q1 (shown in Figure 9). Real GDP slowed to 1.1% year-on-year in 2024 Q1. Bearing in mind the typically close relation between M3 growth and nominal GDP growth ***and*** the fact that M3 growth is now below its optimum growth rate, the monetary slowdown would appear to have done its job. Although the M3 growth rate is not as low as it was in 2018-19 (Figures 3 & 6), any upside risks to inflation are surely minimal and the inflation risks must now be considered mainly on the downside – at least over the 2-year ahead period that central banks normally use for forecasting.

A further factor pointing towards lower than desirable M3 growth and falling inflation in the future is the planned balance sheet shrinkage of the RBA. Disposals of securities in its portfolio or reduced lending either to banks or non-banks will – other things equal – lower the rate of broad money growth because the private sector must become the residual purchaser of the government securities disposed of by the central bank. In doing so the private sector must transfer deposits to the central bank, effectively reducing the supply of broad money in the financial system.

All these considerations suggest that the RBA is likely to fall "behind the curve" in the period ahead. Inflation will fall and the economy will weaken due to the monetary squeeze, even if rates are gradually lowered, meaning in turn that the RBA Board will need to respond at some stage by cutting rates more quickly than Board members currently expect.

The conclusion is that Australian inflation over the next two years will fall to an average of just 2% (as in Figure 3), which in turn means that some of the time it will be **below** the RBA's 2-3% targeted range.

Summary and Investment Conclusions

- Australian CPI inflation has fallen for five consecutive quarters from 7.8% at the headline level in 2022 Q4 to 3.6% in 2024 Q1 – the latest quarterly data available from the Australian Bureau of Statistics (ABS). The monthly indicator (which covers two-thirds of the items) showed 4.0% for May.

- Following the latest meeting of the (Monetary Policy) Board of the Reserve Bank of Australia (RBA) on June 18, the decision was to maintain the RBA's cash rate target unchanged at 4.35%.

- Like the US Federal Reserve, the RBA Board said that it "*needs to be confident that inflation is moving sustainably towards the target range*." In its post-meeting statement, the Board reiterated "*the need to remain vigilant to upside risks to inflation.*"

- **Section 1** of this Newsletter showed a solid relation between Australian M3 growth and inflation over the past decade. **Section 2** pointed out that there had been some episodes in the past when the terms of trade and wages appeared to be drivers of inflation, but that these were not relevant today.

- **Section 3** considered the outlook for Australian inflation and interest rates in the light of the slow or sub-optimum growth of M3 over the past year. Added to the on-going shrinkage of the RBA's balance sheet, this environment implies continued sub-optimum M3 growth in 2024.

- **The economic conclusion,** based on M3 growth in the past year and the prospects for slow M3 growth in 2024, is that Australian CPI inflation is likely to continue to decline in 2024 and 2025. Further, because the RBA maintains a hawkish stance on rates, the main risk is that inflation will fall **below** the lower end of the 2-3% target range in 2025.

- **The investment implications** are favourable for long-dated Australian bonds, though they should be hedged against weakness in the AUD. The reason is that global demand for commodities, especially from China, will likely remain subdued even in a falling interest rate environment. Weak global demand for commodities will mean downside risks for the AUD.

- Australian equities should perform reasonably well in a low interest rate, low inflation world, but growth prospects for sales or earnings will inevitably be limited. This is because rates will be falling for reasons primarily of weak demand (i.e., low spending growth) rather than strong supply of credit or money growth.

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