

Myth of Inflation

27 June 2007

A lot of people are concerned about the outlook for inflation because the unemployment rate is low. They are worried because they believe in a myth that says low unemployment leads to inflation; I don't and instead I believe inflation will remain contained; let me explain why their fears are false and also discuss the most important day in the last 30 plus years of Australia's economic history. Others believe in a story that says as the unemployment rate falls, wages grow faster and these higher costs are passed on in higher consumer prices. But reality doesn't support this; there is no evidence that the unemployment rate (or "capacity utilisation" to use their jargon) is a key determinant of aggregate wages growth (the so-called theory behind it is equally weak, more on that later). Over the past 30 years there is virtually no relationship between wages growth and the unemployment rate. The first chart shows annual wages growth in each quarter with the unemployment rate at the time; for example in the six years from 1983 to 1989 the unemployment rate nearly halved but wages growth remained virtually unchanged. Also in the last five years the unemployment rate has fallen from around 7% to about 4½% but wages growth has remained almost constant.

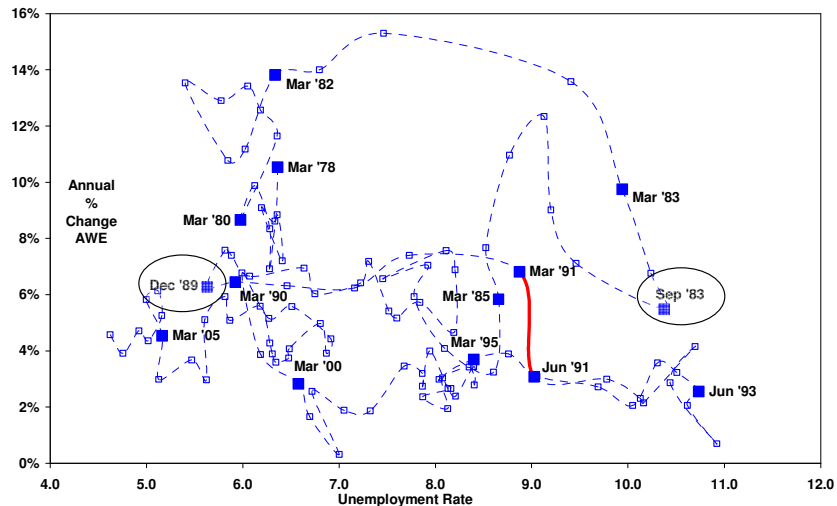


Chart 1

Staring into the first chart you will find it difficult to discern a pattern but when wages growth is charted over time, instead of plotting it against the unemployment rate, then a pattern of sorts emerges. It seems that time itself and not the unemployment rate can better explain what determines wages growth. Time or rather what else was happening in the economy at that time does show distinct patterns of wages growth. Moreover it is the institutional arrangements which condition inflationary expectations during each period that appears more dominant. The behaviour of wages growth appears to be more due to the prevailing institutional structure of the economy during different eras than the unemployment rate prevailing at the time (see the second chart).

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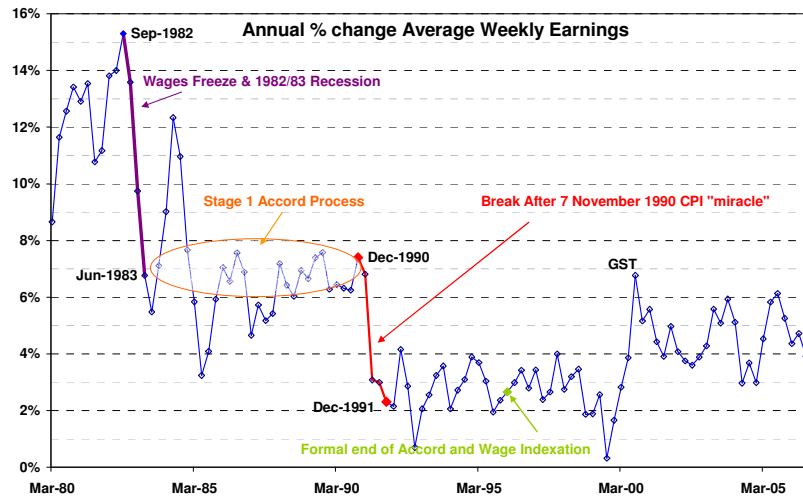


Chart 2

In the 1970s, inflation had averaged about 10%, and in the 1980s about 8½%. Wages growth showed similar patterns in the decades when wages growth and rising consumer prices were locked together. Back then big institutions dominated the economy and worked together in a feather-bedded economy: big unions, big companies and big government which regulated vast aspects of the economy. In the mid 1980s 43% of all employees were members of unions (a decade later the proportion of employees in unions fell by a third to 31% in 1996; and another decade later the proportion fell by another third to 20% in 2006). High wages growth and high inflation rates were locked together: high inflation begat expectations of future high inflation which resulted in high wage increases under a centralised system which were then passed on to consumers which confirmed the earlier expectations of high inflation and that started the cycle all over again. In the early 1980s entrenched inflationary expectations led the economy to have an ‘inflation bias’¹.

In the closing months of the Fraser government an agreed “wages freeze” as well as the 1982/83 recession helped reduced wages and prices from double-digit rates to just under 10%. Yet with any “freeze” comes a thaw and the impact was temporary. The Hawke government tried a different approach, “the Accord”. The Prices and Incomes Accord process which began in April 1983 was designed to reduce wages growth and inflation to improve Australia’s international competitiveness; it did help a bit. By the end of the 80’s with the Accord process in place, inflation averaged around 7½% and wages growth had shifted down to a lower range. However the Accord also introduced a new rigidity into the system through wage indexation and that seemed to have put a floor of about 7% under the inflation rate. Not even high interest rates at the end of 1980s could break the cycle and the new decade seemed destined to be a repeat of the past. I observed at the end of 1989 “*the outlook for inflation is for a continuation of Australia’s poor record compared to its major trading partners*”². Indeed the 90s began in the same manner as the past. In August 1990 after the June quarter CPI recorded yet another high reading I noted that “*this shows how sticky inflation is in Australia even after almost two years of high interest rates and tumbling economic*

¹ R.N. Woods, “Wages and Inflation”, Unpublished Note, School of Economics, Curtin University of Technology, 1987.

² R.N. Woods, December 1989 Economic Outlook, prepared for IOPG Investments

activity. *The RBA's high interest rate policy alone is insufficient to eradicate inflation.*³ Something else was needed to break the inflation mentality in Australia.

Then it happened at the end of 1990. Something happened that was almost magical. It became, I would argue the most important day in Australia's economic history since 1973⁴. On the 7th November 1990 an ultra-low quarterly CPI was released (for the September quarter). It appeared at first that the "one" had disappeared before the decimal point. Up until then the average quarterly rise in the CPI since 1980 had been just over 2% per quarter. Likewise, that quarter was also expected to be around 2% or a high 1-point something. Yet when it was released there was universal disbelief that the published number was the lowest in around twenty years at just 0.7%⁵; everyone thought the "1" before the decimal point had been misplaced but it hadn't. The low result was a genuine quirk in the data but it was the trigger to initiate a miraculous change in the Institutional arrangements in the economy which have continued to this day. It led to a sustained push by the then powerful union movement the ACTU, the Reserve Bank, Government and the Wages Indexation System to get on board the push to lock in low inflation. It provided a chance to break the prevailing inflation psychology.

In response to that low figure the ACTU agreed among other measures to forgo that quarter's automatic wage indexation. Forgoing one quarter's indexation would help lop around 200 points off annual wages growth and help to permanently lower the size of automatic wage increases and slash wages growth (see the red line in chart 1 where annual wages growth fell from just under 7% in March 1991 to under 3% pa the following quarter). That in turn would help curb prices growth which back then was almost mechanically tied to wages growth. The low CPI helped introduce a new stage in the Accord process: the Accord Mark VI was initially agreed to 21 February 1990 but was revised on 20 November 1990 after the low CPI was announced. The revised Accord imposed a 14-month deferral on general wage increases in return for promises of tax cuts and improved superannuation. Moreover it also announced the shift away from centralised wage fixing to "enterprise bargaining" the benefits of which the economy continues to reap today.

A few weeks after that CPI data I was lucky enough to be among a group of investors to hear then ACTU secretary and Reserve Bank of Australia Director Bill Kelty⁶ tell us that as a result of the low quarterly result the unions were fair dinkum in getting behind the push to break the back of high inflation expectations. The ultra low CPI was also the trigger for a second revolution too. It led the Reserve Bank Governor Bernie Fraser to get on board to achieve a structural shift down in inflation, and for the RBA to abandon its old objectives and become a 'fight inflation first' central bank. Until that time the RBA was trying work within its 1959 charter which required them to maintain "the stability of the currency [keep inflation under control, and] the maintenance of full employment in Australia".

³ R.N. Woods, August 1990 Economic Outlook, prepared for IOPG Investments.

⁴ The internationalisation of the Australian economy began with the Whitlam government's 25% across-the-board tariff cut of 18th July 1973; it ended an ethos of protection all-round for Australian industry.

⁵ After the CPI was rebased June quarter 1998 = 100 this number is now 0.8%

⁶ Bill Kelty served on the board of the Reserve Bank from 29 July 1987 to 4 March 1996, resigning the Monday after that weekend's defeat of Paul Keating's Labor Government.

One year earlier Bernie Fraser observed that *“fighting inflation might be what monetary policy does best but, however good it is at that, monetary policy alone will not beat inflation in Australia”*⁷. I echoed those remarks in my report noted above *“that the RBA’s high interest rate policy alone is insufficient to eradicate inflation”*; institutional change was also necessary and in November 1990 the opportunity was within grasp. In a speech three weeks after the CPI Governor Bernie Fraser observed that this statistical quirk was the chance to knock out high inflation. In a speech titled *“A Proper Role for Monetary Policy”* he noted that *“there is now the very real prospect of Australia joining the ranks of the low inflation countries. We must not allow this once-in-a-decade opportunity to slip through our fingers... We are not yet there...but we are knocking on the door”*⁸. This marks the starting point when the RBA switched focus primarily onto inflation. As the Reserve Bank’s 1991 Annual Report notes *“policy should focus, much more sharply than before, on inflation”*⁹.

Following that meeting with Mr. Kelty and Mr. Fraser’s speech, I was convinced that we were witnessing a revolutionary change in the country’s institutional fabric which would render the old economic model obsolete. One month after that incredible CPI data I wrote in a monthly economic outlook: *“the most significant development of recent times has been the commitment by the Government and the ACTU to ensuring a low wages and hence prices outcome over the next few years. I was entirely due to the fortuitous low September quarter CPI but the seizing of this opportunity to buy-back wage increases at a relatively low cost was a major achievement”*¹⁰. In the New Year, February 1991, and now a stockbroker, I was more optimistic than many and predicted inflation would plunge through the old floor level and reach 6% by mid year and 5½ % by year end. As it turned out, the CPI tumbled even more to just under 3½% by mid-year and just 1½ % at the end of that year. The severity of the recession vanquished any residual inflation.

The once-in-a-decade opportunity was more of a once in a generation chance. It was seized upon and by the middle of 1992, the RBA were able to note in their Annual Report that: *“Inflation has declined in periods of cyclically weak economic activity in the past. On this occasion, however, there are good grounds for believing that a critical threshold has been breached and that Australia can sustain a low inflation environment... All indicators of inflationary expectations suggest that there has been a real breakthrough over the past two years”*¹¹. The 7th November 1990 was a watershed for inflation in Australia, with the high rates of the previous two decades quickly being replaced by an average of 2 to 3% that we still enjoy today. For the past 15 years (excluding the four quarters when the GST was introduced) underlying inflation has averaged 2½% while the unemployment rate has ranged from 10.7% to 4.6% (see chart 3 below).

⁷ B.W. Fraser, “Reserve Bank Independence and All That”, RBA Bulletin, December 1989

⁸ B.W. Fraser, “A Proper Role for Monetary Policy”, Melbourne, 28 November 1990.

⁹ Reserve Bank of Australia 1991 Annual Report, page 3.

¹⁰ R.N. Woods, December 1990, Economic Outlook, prepared for IOPG CBA Investments

¹¹ Reserve Bank of Australia 1992 Annual Report, page 2.

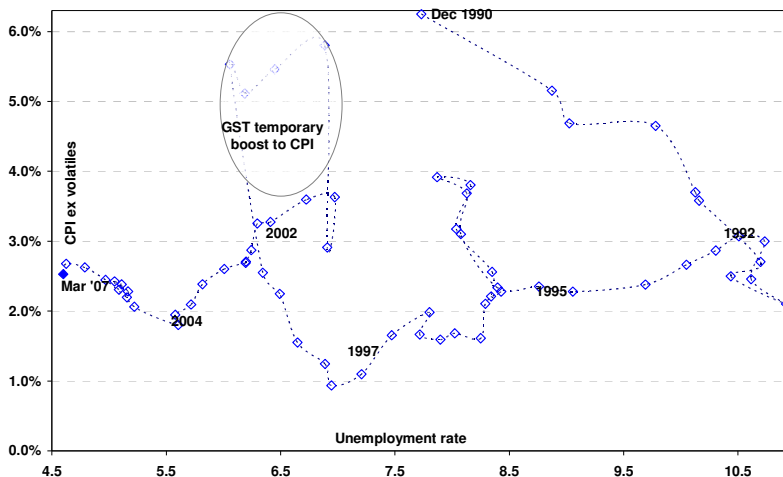


Chart 3

Not only did this opportunity break the back of inflation but it also led to the breakdown of the old institutional model of the Australian economy, dismantling centralised wage setting, and automatic indexation, introduced enterprise bargaining and eradicating the economy's inflationary bias. Without centralised wage fixing when wages go up in a growing sector (that's how you attract workers to where demand is greatest) it doesn't flow on to all other sectors. Also the market for labour is not like the market for oranges: we are all different with different skills and not all jobs are the same. The theory that says the unemployment rate measures labour supply and determines wages wrongly assumes we are all the same kind of oranges. Relative wages can and should go up in an industry that is growing but that does not lead to a general wage rise across the economy. There is not one market for labour which is why it doesn't make sense to expect a relationship between the unemployment rate across the economy and aggregate wages growth. The reality is that the unemployment rate or "capacity utilisation" has not been a key determinant of aggregate wages and neither is the unemployment rate a key determinant of inflation either.

In addition the economy is now open to imports of all kinds of goods and services such that "capacity" is not restricted to just the local economy. What you can't make at home you buy from outside. In an open competitive economy companies have to be careful not to lose market share to other local companies or imports. Consumers can also use the internet for cheaper prices. Even if some prices do rise it is difficult for prices to rise everywhere. The result of these and other changes has established the primary cause of future inflation is current expectations of inflation, not wages nor the unemployment rate. The old structure of the Australian economy had a history of high inflation; that locked in expectations of high inflation continuing in the future resulting in high wage increases; and under a centralised system it was spread throughout the economy and then passed on to consumers, thus confirming earlier expectations of high inflation only for the cycle to start all over again. That structure has gone and the myth that low unemployment causes inflation should disappear too. Instead the main determinant of future inflation is current expectations of inflation. Provided inflationary expectations remain as well anchored as they currently are, this should stop any drift in actual inflation. This is the "new" model for the Australian economy and why the focus is on gauging changes to inflationary expectations not the unemployment rate.

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