BULLETIN

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Preserving the gains and timing the turning points

Labour markets in both Australia and the United States have clearly turned. As Westpac colleague Economist Ryan Wells reported yesterday, the unemployment rate ticked back up to 3.7% in October and total hours worked seems to be levelling out. In the United States, the unemployment rate has risen ½ppt since the beginning of the year. While some of this reflects the belated return of US labour supply, jobs growth has also slowed.

These developments have led market participants to focus on the question of when central banks will reverse course and start cutting policy rates. Yet for Australia, the question remains whether the RBA still has further to go with rate increases. We are often asked why Australia seems likely to be later to reach the rate-cutting phase of the cycle than some other advanced countries. Relatedly, we are also often asked why – even if the RBA were to raise rates further – the peak level seems likely to be materially lower than in the United States, New Zealand and several other peer countries.

Part of the reason for the later peak is simply that Australia has been later to the inflation surge and reversal than many other advanced economies. We were later to open up after the pandemic, thanks to the hard lockdowns during the 2021 Delta wave. We were therefore later to see a mismatch emerge between rebounding demand and a supply side that needed to be reconfigured to recover. Given the extraordinary circumstances, it could not be assumed that Australia would follow the path of countries like the United States. Not every economy followed that path as it opened up. Much depended on whether the policy support during the pandemic phase was enough to fill the income hole created by lockdowns and other health-related restrictions on activity. This couldn't be assessed in advance. Japan and many other Asian economies are clear counterexamples to the US case, with domestic inflation not taking hold in the same way. (See Westpac colleague Economist Illiana Jain's note on 8 November.) So it would not have been reasonable to tighten policy in anticipation of an inflation surge that had not yet occurred and was not certain to do so.

Framed in this way, Australia can be viewed as being six or so months behind some other countries in its disinflation journey. Like the United States earlier in the year, Australia is still in the phase of being surprised how slow services inflation declines at first. A further wrinkle here is that the shock to energy prices following Russia's invasion of Ukraine last year only flowed through to domestic retail electricity costs in July this year. In this sense, the dynamics of the inflation cycle can also be a little slower.

The other main driver of the later expected turning point for rates is that the RBA has, for a variety of reasons, seemingly chosen a 'not quite as high for longer' strategy. Foremost among these reasons is the RBA's stated desire to preserve, as much as possible, the recent decline in unemployment. This had been clearly stated by the previous Governor, and Governor Michele Bullock has continued using similar language.

At 3.7% in October, Australia's unemployment rate is around 1½ppts below pre-pandemic levels. The RBA does not want to undo these gains. Other countries' central banks presumably do not feel the same sense of urgency on this, even if they have full employment mandates. The United States, euro area and Canada all achieved multi-decade lows for their unemployment rates in the years leading up to the pandemic. So perhaps they are less worried about not being able to do so again.

There is of course a risk involved in the RBA's strategy, in that a longer return to the inflation target raises the chance that inflation expectations will increase, making it harder to get inflation down. That gamble appears to have paid off so far. Measures of medium-term inflation expectations have largely remained in line with target. In addition, wages growth has not taken off in the same way as it did in the United States, Canada and some other countries. The September quarter read for the Wage Price Index was very high because of the flow-through of award wage increases. But as Westpac colleague Senior Economist Justin Smirk reported on Wednesday, outcomes outside the award system suggest that growth has peaked.

This relatively modest response of wages to the tight labour market contrasts with the experience in other countries. It also connects with some of the other reasons the RBA has been able to adopt this more drawn-out strategy.

The first and best-known of these is that, unlike the United States and Canada, most mortgages in Australia are variable-rate. Monetary tightening therefore passes through to lending rates faster here and affects the incomes of more households earlier. Even if the endpoint for inflation is the same as elsewhere, the costs are different. It is therefore understandable that the RBA might seek to balance the trade-off differently while still meeting its target.

A less well-known difference is that fiscal policy is working in the same direction as monetary policy here, to a greater extent than elsewhere, especially as it pertains to the household sector. As has been noted in the media recently, Australia is one of the countries that does not routinely index tax brackets for inflation. In the United States and Canada, at least, federal tax brackets are indexed. (State/provincial tax rates are a different story.) A consequence of the arrangements in Australia is that higher tax payments are currently dragging more on household incomes than net interest payments are. The RBA routinely publishes graphs in the Statement on Monetary Policy that show this, so they are surely aware of the issue.

The upshot of both differences is that real household disposable income is contracting at present and is likely to do so for a while, despite strong population growth. The household sector is being squeezed in a way we are not seeing elsewhere. It is therefore understandable that policymakers here would make different choices.

Finally, the Board will be aware that there is not much benefit to a more aggressive path for rates. Documents released under FOI in May showed that RBA staff regularly model the likely outcome of different paths for the cash rate. A note written in

January, included in that release, modelled the effects of paths for the cash rate based on the actions of the RBNZ and Bank of Canada. It turns out that in the current situation, where much of the inflation surge reflects supply shocks, a more aggressive path does not buy much in terms of an earlier return of inflation to target. It does, however, involve noticeably higher unemployment.

What that note also showed was that market pricing at the time implied that both the RBNZ and Bank of Canada would be cutting rates by now. Obviously things have changed since then. But it does highlight that the success of an aggressive tightening depends on the policymaker being able to reverse course at the right moment. Otherwise, you would end up keeping policy tight for too long and undershooting the inflation target for no real benefit. If you are sufficiently humble about your ability to forecast, you would not bank on getting the timing right on that turning point. That context lends further weight to a strategy more like the one the RBA has chosen. While the February and subsequent meetings are still live, depending on inflation outcomes, it should be understood that the RBA is not following the template set out by other countries.

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