No need to tighten monetary policy after last week's inflation figures – and no need to abandon or modify the inflation target either

Last week's March quarter CPI figures, showing that on both of the Reserve Bank's preferred measures the annual rate of 'underlying' inflation had topped 4% for the first time since 1991, was an unpleasant surprise. No less surprising, however, have been some of the reactions which these figures prompted.

Among these was the knee-jerk reaction of financial markets. At the end of the week before last, financial markets were giving no chance to the prospect of another rate rise this year, and indeed were flirting with the possibility that rates could be coming down before Christmas. By the end of last week, the markets were giving slightly-better-than even odds on another rate hike by August, and no chance of a rate cut this year.

It is undeniable that the Reserve Bank lifted the cash rate at the first opportunity after the release of each of the three previous CPI releases, each of which was higher than expected. But the circumstances in which the Reserve Bank Board will be interpreting the latest CPI release is rather different from those in which it decided to lift official interest rates over the past nine months. Not only are interest rates now considerably higher than at the time of each of the previous three CPI releases, but there is now (as Governor Glenn Stevens has acknowledged) growing evidence that the tightening of financial conditions over the past nine months is beginning to have its intended effect in slowing the growth of domestic demand.

To be sure, the Reserve Bank staff will need to revise their inflation forecast upwards; they may need to step back a little from the advice they gave to the April Board meeting that 'inflation on both a CPI and underlying basis would fall by a little more than earlier thought over the next two to three years'. But given that, as they also acknowledged at the April meeting, 'a considerable degree of uncertainty continued to surround the outlook for both demand and inflation', there has been no compelling reason to alter the conclusion that inflation will fall over the next two to three years.

That conclusion will only change if the recent signs that the economy is slowing turn out to be a 'false dawn'. And it would take some months of data pointing in the opposite direction to the tenor of recent information to warrant drawing that inference.

Hence, the most plausible assessment of the outlook for official interest rates would seem to be that they are 'on hold' for at least the remainder of the year. That's a difficult prospect for financial markets to entertain, since markets tend to think that if rates aren't about to go down then the only alternative is that they must be going up, and vice versa. Nonetheless, given where we appear to be in the business cycle, and assuming that fiscal policy will at long last begin making some contribution to restraining growth in domestic demand, an extended period of stability in monetary policy would seem to be both warranted and likely.

The second surprise prompted by last week's CPI figures has been the spate of suggestions in its wake that the Reserve Bank should either move its inflation target to, say, 4-5%, or suspend it altogether, on the grounds that the acceleration in inflation over the past year or so has been largely attributable to the rapid growth and industrialization of China and other large emerging economies over which actions by the Reserve Bank can have no influence.

These suggestions are all the more surprising given that they have come from some of the earliest proponents of inflation-targeting in Australia.

Peter Jonson (who now writes under the pseudonym of 'Henry Thornton') used to argue when he was Head of Research at the Reserve Bank that inflation was not only an economic issue but a moral one. In 1990 he wrote that 'the evident decline of standards of morality in some segments of our business community and in aspects of private behaviour can be traced partly to the incentives and distortions created by inflation'. John Hewson, as Leader of the Opposition, used to argue that the inflation target should have been 0-2% (as it was at the time in New Zealand), rather than 2-3%. And Bernie Fraser, who as Governor of the Reserve Bank presided over the introduction of inflation targeting in the early 1990s, was once sufficiently persuaded of his predecessor Nugget Coombs' assertion that 'a persistent tendency for prices to rise may, like the housemaid's baby, be very small at first – but once people get used to it being around, they may well be astonished at how rapidly it will grow' that he had it featured in big bold type on a full page of the Bank's 1989-90 Annual Report.

Better than most, these distinguished economists would surely recollect that the reason why Australia adopted inflation targeting, and chose 2-3% (rather than some other range) as the inflation target, was in order to provide a sustainable and stable 'anchor' for expectations about inflation. A target of 2-3% allows for the unavoidable upward bias in statistical measures of inflation, whilst keeping inflation below most people's intuitive radar screens. Once inflation gets above 3%, people start to notice it, as indeed they have done since the middle of last year. And once they start to notice it, they start to behave in ways that make it more likely than not that inflation will continue to accelerate – most obviously, by seeking wage increases to 'compensate' for actual or expected inflation.

That's why an inflation target of, say, 4-5% is not sustainable in the way that one of 2-3% is (provided, of course, that the central bank sticks to it, rather than abandoning it when it becomes more difficult to attain).

And while there may be some truth in the assertions that rising food and energy prices have contributed to the acceleration in inflation over the past year, and that the increases in food and energy prices are in turn partly attributable to global influences (including, but not limited to, the rapid growth of large developing economies), that does not detract from the fact that most of the rise in inflation over the past year has been domestically generated, not imported from overseas. Prices of 'tradeable' items rose by 3.3% over the year to the March quarter, while prices of 'non-tradeables' rose by 5.0%.

That, in turn, largely reflects the fact that over the past three years, growth in domestic demand has outpaced growth in supply by a factor of roughly half, in circumstances of diminishing spare capacity within the Australian economy to be drawn down to meet 'excess demand'. That's why domestic demand has to slow in order to bring inflation back within the target range, as the Reserve Bank has been seeking to accomplish. That task will ultimately become more costly, not avoided, by modifying or suspending the inflation target now.

(An edited version of the above was published as an op-ed article in The Australian Financial Review *on Wednesday 30th April 2008)*

- *Saul Eslake*
Chief Economist, ANZ