MONETARY POLICY

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Monetary policy differs from other aspects of economic and social policy because it is not directly under the control of the federal government: it is managed by the Reserve Bank of Australia (RBA), which operates on the principle of central bank independence, at 'arm's length' from the government. Although the Bank is operationally independent, its aims and powers are set out in legislation, and interpreted in the Statement on the Conduct of Monetary Policy, all of which can be changed by the government of the day. Moreover, because the monetary policy that the Bank pursues impacts on macroeconomic conditions, it constrains what any government can effectively do in other policy areas. Currently, the wave of inflation over the last two years has loomed large among the economic challenges facing both the Bank and the Albanese government. This ongoing inflation – together with the report of the review of the Bank established by Treasurer Jim Chalmers – make it opportune now to assess the role of monetary policy in Australia.

For many years the Reserve Bank of Australia basked in success. The monetary policy framework has been stable for a generation. In 1995, two years into the 'inflation targeting' era – then seen as an experiment – Bank economists Guy Debelle and Glenn Stevens set out how success should be judged: 'if, some years hence, we can look back and observe that the average rate of inflation has a "2" in front of the decimal place, that will be regarded as a success' (Debelle and Stevens 1995: 3). Just over two decades later, in 2018, the Bank's annual conference looked back on 'Twenty-five Years of Inflation Targeting in Australia'. Debelle, then Deputy Governor, could happily report that the main thing that had changed was 'the degree of confidence that the regime might actually work […] The proof of the pudding has been in the eating' (Debelle 2018: 53).

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Since then, history has come rapidly to the RBA. The notion of having an independent review of the central bank gained prominence in September 2021, following a recommendation of the OECD's *Economic Survey* of Australia. Its main concern was underlying inflation *undershooting* the 2-3% target since 2015, and it mentioned 'overly tight monetary policy settings' in the pre-pandemic years (OECD 2021: 27). Both the Coalition government and Labor in Opposition flagged a review to take place after the election (Mizen and Kehoe 2021). By the time the new Labor Treasurer officially announced the Review in July 2022, inflation had decidedly burst out the *other* side of the target zone, with the consumer price index rising 7.1% over the previous 12 months. When the Review's report was released in March 2023, inflation had fallen back from its peak but remained above 6% according to the ABS's monthly indicator. The Bank had sharply raised the cash rate from the near-zero it had been since the pandemic emergency: it went from 0.10 to 1.35 in three steps between May and July, and then steadily to 3.60 by the time of the review.

This is a time of unpredictability: actual inflation in mid-2023 was running far above even the upside estimates made two years earlier.[1] In late 2023, the inflation rate remains well above 5%. The Bank expects it to continue to decline back into the target range by mid-2025, while unemployment rises to 4.5%. But its 90% confidence interval for consumer price inflation in mid-2025 stretches from below 1% to above 5% (RBA 2023d; 61). After a few months' pause, the Bank again raised the cash rate in November 2023, with inflation 'more persistent than expected' (Bullock 2023).[2]

This article uses the Review and recent commentary by the Reserve Bank itself to consider whether the post-pandemic inflation and policy response mark a turning point for Australian monetary policy, after a long period of relative stability. Its first section discusses the effect of the recent inflation on real wages, and the way in which the monetary policy response has further hit the disposable incomes of typical wage-earners. The following

[1] The Bank did not report confidence intervals for its CPI projections in its 2021 surveys but did give 'upside' and 'downside' estimates around its central forecasts. In August 2021, its baseline forecast for trimmed mean inflation for the year ending in June 2023 was 2 %, and its upside forecast about 2.7% (RBA 2021: 70, 76). Actual trimmed mean inflation for the year ended June 2023 was 5.9% (RBA 2023c: 66).

[2] The Bank's October *Financial Stability Review* and November *Statement on Monetary Policy* arrived too late to fully discuss them here, but they do not seem to call for any revision to the points made below.

section puts the response of wages into historical context, arguing that the success of the 'inflation-targeting' regime should be understood in a broader context – including its freedom from responsibility for income distribution. Then comes a section discussing the difficulties a supply shock poses for the policy framework, because of its distributional effects and its aggravation of a dilemma between the Bank's statutory goals of price stability and full employment. The article concludes that, although the current inflation has revealed problems with the current monetary policy framework, it is likely to survive while there are no alternatives on the political horizon.[3]

Wages and interest rates: The double hit

Recent inflation has seriously eroded real wage rates (see: Greenwell 2024, figure sixteen in this issue). Measured by the wage price index, real wage rates fell by 5.5% between the June quarter of 2021 and the June quarter of 2023, reversing gains made since 2009. As measured by average weekly ordinary time earnings, real wage rates fell by 6.0% over the two-year period, returning to a level first passed in 2013.[4] This is a historically large and rapid decline in real wage rates, coming soon after years of slow real wage growth.

The decline has hit real wages across the spectrum, albeit those on lower wages have been shielded to some extent by the Fair Work Commission's recent decisions to increase award minimum wages, by 4.6 to 5.2% in 2022 and 5.75% in 2023. Though below inflation, this is much closer than has so-far been secured in most enterprise and individual agreements: for the lowest quintile, real wage rates fell only 3% in the year to December 2022 (RBA 2023b: 66). Continued strong demand for labour has also helped. In spite of the fall in real wage rates, real income from employment rose over the year, especially in the lowest quintile. This is because hours worked

[3] The extraordinary role of the central bank in facilitating stimulus during the pandemic emergency is warrants analysis in a separate paper.

[4] The wage price index tracks movements in pay for the same work, giving a pure measure of wage changes but without registering shifts in the composition of jobs. The index of average weekly ordinary time earnings captures changes in the (ordinary, full-time) pay people get, which does capture the effects of shifts in the composition of jobs.

increased substantially, perhaps also due to overtime, bonuses and job switching in a tight labour market (RBA 2023b: 66).[5]

The fact that some workers have recovered lost real income by selling more hours of labour does not reverse the conclusion that they have lost badly from its declining real value. It is difficult to disentangle labour demand and supply, which have both been high, but part of the reason for near-record participation rates and increased hours surely involves households responding to the higher cost of living and rising mortgage rates by seeking more hours.[6] On average, workers who did not change hours or jobs 'will have seen their real incomes decline significantly' (RBA 2023b: 66).

Moreover, those with mortgages have seen disposable incomes eroded further by rising interest rates. Mortgage rates are not included in the consumer price index, but the ABS produces broader cost-of-living indices in which it is included. The 'Employee' living cost index – using a basket of expenses typical for households whose income comes primarily from employment – has been rising much faster than the consumer price index. In the year to June 2023, this index increased by 9.6%, compared with consumer price inflation of 7.0%, with the difference primarily explained by the increase in mortgage interest (ABS 2023b). Measured by the wage price index, the fall in real wage rates since the June quarter of 2021 is 7.3%; measured by average ordinary time weekly earnings, 7.8%.[7]

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[5] This information comes from the ABS's Single Touch Payroll data, derived from automatic employer reporting to the tax office. It reports total labour income per worker, but not hours worked or the composition of that income. It is not possible to disaggregate changes into their contributing factors (Australian Bureau of Statistics 2021). Data from the ABS Labour Force surveys show monthly hours worked growing strongly in 2022 but with serious volatility early on during the wave of the Omicron variant of COVID-19 – another factor complicating interpretation (ABS 2023a).

[6] Over the last quarter of 2021, underemployment – the proportion of employed people reporting they would prefer to be working more hours – fell sharply to its lowest level since 2008, and has remained flat since, suggesting that demand roughly accommodated supply of increased hours for those employed over 2022.

[7] Note, though, that real wages had risen higher in terms of the Employee living cost index earlier in the decade when interest rates were falling – the falls returned real wages to the levels of 2012 (WPI) and 2015 (AWOTE). All figures are given to June 2023, the latest data available at time of writing.

Australia is unusual in the extent to which monetary policy works quickly and directly through mortgage rates.[8] Variable-rate loans comprise about 70% of outstanding mortgage balances in Australia, compared with around a third in Canada, 15% in the UK and less than 5% in the US. Further, fixed-rate loan rates tend to be fixed for a shorter period: two years is typical, compared with five in Canada and the UK and 30 in the US. Thus, policy rates pass through to mortgage rates in Australia much faster and more fully than elsewhere (RBA 2023a: 19-22). Though the RBA believes (with some uncertainty) that 'the effect of Australian monetary policy on activity and inflation is similar to that in other comparable advanced countries,' the transmission channels are different (p. 21). The ratio of household debt to disposable income is more than twice as high today as it was in the early years of inflation targeting. Scheduled payments of mortgage interest and principal are already as large a share of household disposable income as they were when the cash rate was much higher in 2008; and are projected to rise sharply higher (RBA 2023e: 38).

After years of slow growth before the pandemic, real wage rates are not materially above their level of a decade or more ago. Rising interest rates are further squeezing the disposable incomes of mortgage borrowers. Whereas the RBA projects that real wage rates will soon reach their trough, the effects of interest rate rises are only beginning to be felt on spending and the labour market. The projections – and policy strategy – depend on the labour market loosening. The latest forecasts project nominal wages returning by 2025 to the 4% growth rate they last saw in the 2000s as unemployment rises to 4.25% and inflation returns to 3% (RBA 2023d: 60, 64). At that pace it will take years for real wage rates to recover the ground they have lost in the last two (p. 65). But if wages look like they might rise appreciably faster, policy will tighten further, in the absence of a productivity miracle.

Inflation as a distributional phenomenon

Wage-earners were able to maintain the real value of their pay in some other major inflationary episodes in Australian history. During the wool boom inflation of 1950-51, real wages were protected by automatic

[8] This is contrast to the postwar decades, when housing finance was sometimes deliberately shielded from monetary policy (Beggs 2015: 118).

quarterly cost-of-living adjustments that had been built into the Commonwealth arbitration system since the 1920s. Through the early years of the 1970s inflation, average wages outpaced inflation until 1976/77 (Beggs 2015: 198). The failure of wages to keep up with prices is a striking feature of the current inflation. It has greatly simplified the policy problem that there is no longer any real political expectation that wages *should* keep up with living costs, and that labour has little leverage for pursuing such an expectation anyway.

Inflation is always and everywhere a distributional phenomenon. That is the case because the trajectory of a person's real income depends on the extent to which they can keep their nominal income claims moving in line with the prices that matter to them. But it is also because attempts to defend (or improve) one's real income in the face of inflation can further feed inflation. Inflation has both distributional consequences and distributional causes.

Income distribution was central to the politics of inflation in Australia from the 1950s to the 1980s because Australia had an industrial arbitration system whose decisions had a large impact on the wage structure – making it both a point of leverage and a venue for debate. In the post-war decades, close to 90% of workers were covered by federal or State industry awards setting minimum hourly wages and additional margins for skill, experience and other features of their jobs.[9] For those workers, these centrally bargained ordinary-time wage rates accounted for the bulk of their actual pay.[10]

In contrast to the 'safety net' awards of today, the arbitration system directly determined most pay, though 'over-award' payments could be negotiated on top. The decisions of the tribunals were therefore of major macroeconomic importance. As a foundational minimum referred to by the rest of the award wage structure, the Basic Wage hearings at the national tribunal (later, Total or National wage cases) became a critical point of influence over wages and their response to inflation.

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[9] In 1954, 10.6% were uncovered; by 1963 this number had risen slightly to 12.3% (Vernon *et al.* 1965: 133, using gender workforce composition figures from p. 80).

[10] The Commonwealth Statistician's 1960 Survey of Wage Rates and Earnings, covering adult male private sector workers, found that mandated ordinary time award wages made up 81.1% of the average pay packet, overtime earnings 9.9%, and other earnings just 9%.

The tribunal decisions thus had a major impact on the pace of wage growth. How they responded to inflation mattered to both the distributional consequences – to what extent wages would keep up – and to further inflationary impulses from wage costs. The tribunals were judicial in form and so not exactly a branch of policy: the judges heard government submissions alongside those of unions and employers. Legislation and precedent established norms for the tribunals – involving fairness and maintenance of living standards – that could clash with macroeconomic 'rationality' as perceived by economists and government officials.

After the wool boom, macroeconomic arguments became more prominent and often decisive in the hearings. The 1953 Basic Wage decision was a watershed, ending automatic quarterly indexation of the Basic Wage to consumer prices, which had been in place since the 1920s. But there was no singular 'macroeconomic rationality' to follow, and no side had a monopoly on macroeconomic argument. The importance and volatility of international commodity prices upset the seemingly simple rule for price stability of tying nominal wage growth to labour productivity growth. With Australian conditions so susceptible to disturbances on world commodity markets, suppressing the response of wages would have meant wild swings in the distribution of national income. Unions began to call economists as expert witnesses, and a distinctive labour approach to incomes policy developed, which would culminate in the Prices and Incomes Accord of the 1980s.[11]

Macroeconomic policy was about more than demand management because neither price stability nor full employment were seen as negotiable. While the government was committed by the Bretton Woods Agreement to a fixed exchange rate, the balance of payments constraint limited how far policy could let domestic inflation outpace that abroad. Later, the possibility of an exchange rate spiral had the same effect (Beggs 2015: 31-71, 139-75; Beggs 2021). But the idea that macroeconomic policy should deliberately induce or allow unemployment to choke off wage growth was politically poisonous.

Tensions between the goals of full employment and price stability were widely recognised. The possibility was discussed in the Full Employment

[11] I discuss the intersection of macroeconomic policy and arbitration in the 1950s in Beggs (2021).

White Paper of 1945 (paragraphs 74-79) and was a central theme of the 1965 *Report of the Committee of Economic Enquiry* (Vernon *et al.* 1965: esp. 43-6). There were always sceptics, including in Treasury, who believed a looser labour market would be necessary, but usually only for brief periods – the 'short sharp shock' to cool overheating. Even most of these would accept that this would be unnecessary if income claims could be negotiated – they were simply pessimistic about the prospects. The notion of permanently abandoning full employment had few proponents, well into the 1970s. Early econometric estimates of the 'natural rate of unemployment' (theoretical precursor to the NAIRU) found it to be around or below 2% – which was unsurprising since this level had been sustained on average for decades with no apparent tendency to accelerating inflation (Beggs 2018: 261-2).

Managed incomes policy proposals flourished on both sides of politics and, as of 1974, 'Australian economists appear to have reached an impressive consensus on prices and incomes policy' (Hagger 1978: 175). The arbitration system was at the core of the proposals, but it was recognised that wage restraint alone would be inadequate and lack legitimacy. Union consent would be necessary. Controls on prices and non-wage incomes would be part of the story, along with fiscal compensation.

This is not to say that there was a systematic incomes policy at any point. The arbitration system always only set minima, not maxima, and over the long run actual average wages tended to drift further above the award rates – especially when the tribunals attempted restraint. They had no power over prices, profits, or non-wage incomes, and attempts to restrain these were always half-hearted and politically difficult. This and fiscal compensation had to be negotiated in a separate political domain, making coordination difficult. But the importance of the arbitration system forced distribution to the heart of the politics of price stability, even if it could not resolve the resulting tensions. Macroeconomic policy could not be a technocratic question of demand management alone so long as so much of the workforce's incomes depended on centralised negotiations. The Prices and Incomes Accord of the 1980s was both the culmination and last gasp of the incomes policy alternative, combining negotiated wage restraint with fiscal compensation via the 'social wage' and more progressivity in taxation. The prices and non-wage income controls envisioned at its beginning developed only in the weakest forms, and the fiscal aspects were a hostage to broader macroeconomic policy restraint (Beggs 2015, 206-10; 260-76).

Inflation stabilised, but at a stubbornly high rate, while unemployment declined only slowly across the decade. When recession at the turn of the 1990s sent unemployment back into double digits, but finally brought inflation back below 2%, the Labor government and central bank took advantage of 'the recession Australia had to have' to 'snap the stick of inflation' (both lines of then-Treasurer Paul Keating). Unemployment would be accepted as the price of price stability. It was the end of an era, though in retrospect we remember it as the birth of 'inflation targeting'.

From distributional politics to technocratic policy

How does the 2023 RBA Review understand the history of the policy regime it investigates? Simply that, in the 1990s, Australia finally emerged out of a hazy murk of bad policymaking, in which it had been wandering aimlessly for some decades:

> Australia experimented with various monetary policy frameworks before adopting inflation targeting in the early 1990s […] Throughout most of the 1970s and 1980s, the lack of a credible and coherent monetary policy framework, structural changes in the economy, and perceptions of fiscal and monetary ill-discipline led to serious bouts of inflation and a high unemployment rate (*Review*: 31).

This is a Whig view of policy history, treating it simply as the triumph of good policy over bad, showing no recognition of the political economic tensions behind the policy instability.

When the RBA Review considers a list of possible 'alternative monetary policy frameworks', it is considering a narrow question – the choice of monetary policy target (*Review*: 247-9). But the 'inflation targeting framework' is a metonym: a whole approach to monetary policy is named for one of its components, the target. Labels given to earlier approaches have referred to its instruments – the 'banking policy' period of the 1950s (Rowan 1980: 120-1), its theoretical framework (the 'Radcliffe period' of the 1960s (Rowan 1980: 122-3), or an intermediate target (the 'monetary targeting' of the late 1970s and early 1980s).

The regime inaugurated in 1993 could have been named for any or all of these features. Its main instrument is the cash rate; and its theoretical framework built around the expectations-augmented Phillips curve and the non-accelerating inflation rate of unemployment (NAIRU). Its intermediate targets include keeping a lid on expectations of inflation; and

leaving enough slack in the labour market to keep the pace of nominal wage growth within certain bounds. The former is served by maintaining the credibility of policy itself: showing the Bank is prepared to do what it takes in pursuit of the latter.

But even this is too narrow. To understand the distinctiveness of the 'inflation targeting' period of monetary policy, we need to consider not only the strategy of the central bank, but also its context as one branch of policy among others. In the early years of inflation targeting, Gruen and Stevens recognised that it was not only a shift in monetary policy strategy but also represented a transfer of responsibility *to* monetary policy. They noted that just ten years before, inflation was typically discussed as a product of wage-setting, and 'in this view of the world, the wages Accords of the 1980s […] determined the rate of wage and price expectations'. They acknowledged that the view that 'wages outcomes were the proximate determinant of prices' was a 'long-standing tradition in Australian economic policymaking and many academic circles.' But it had in the space of a few years come to seem old-fashioned, as Australia joined 'the global policy shift towards inflation targeting' (Gruen and Stevens 2000: 52-3).[12]

The distinctiveness of the 'inflation targeting' period is thus about much more than the selection of policy target for the central bank. It is also about the framing of inflation as a problem of monetary policy alone: a problem calling for the management of demand and not of income distribution.

How did distributional conflict fall out of the frame, in which it had been central so long? Gruen and Stevens give a clue: in support of their claim that inflation was now a matter for the RBA and not the then Industrial Relations Commission, they quote the Commission explaining in 1997 why it was limiting its increase to award wages:

> We have noted the Reserve Bank's intimations of the order of increase which, in its view, accords with its inflation target. Any increase greater than the amount which we grant carries a risk […] of leading to a rise in interest rates. In the current state of the economy […] we are unwilling to take that risk. (Industrial Relations Commission, quoted in Gruen and Stevens 2000: 53).

[12] I have elaborated on this transition and discussed the continuing centrality of wages to monetary policy in the 2000s in Beggs (2018).

This is not evidence of a decline in the view that 'wages outcomes were the proximate determinant of prices,' but rather of a shift in the order of policy responsibility for wages outcomes.

A defining feature of the 'inflation targeting' era, setting it off from what came before, is widespread acceptance of the notion that demand management alone is sufficient for price stability. Wage growth is a proximate determinant of price growth, but both are claimed to have a predictable relationship to the level (and rate of change) of unemployment. The possibility of spiralling income claims is still recognised and appears in the model via expectations: once people come to expect a given rate of inflation, it becomes the baseline. Changes in the inflation rate from that baseline can be predicted from the unemployment rate.

The central bank has no way of intervening directly in wage or price setting. What it can do is signal that it will use the instrument at its disposal – monetary policy – to restrain demand as necessary to keep inflation in the target band, and to return it to the band if it does exceed it. The idea is that as long as this commitment is *credible*, the agents involved in wage and price setting will anchor their expectations to the target, and this will dampen spirals. This makes maintaining credibility an absolute policy priority.

Framing distribution in the recent inflation

The great shift in context – the movement towards enterprise and individual bargaining over wages – is as important a feature of today's macroeconomic policy regime as the internal shift in central bank strategy. Award wages are now a 'safety net' directly relevant to only around a fifth of workers, and there is no question of using the arbitration system as a powerful point of leverage over wages in general.

Though this is the loss of what was once seen as an important instrument (at least potentially), it has also simplified the policy problem. Because the arbitration system also had goals of equity and wellbeing, it complicated and politicised the pursuit of price stability. From the 1950s to the 1980s, policymakers could not ignore the question of whose incomes must adjust in pursuit of price stability. It had to be negotiated. That this is no longer the case reframes inflation as a technocratic problem. This can be seen in the tepid response to the distributional effects of the recent inflation. Nevertheless, the Reserve Bank has been drawn into some debate, framed

by the question of whether business profits and price-setting could be considered an independent cause of inflation. Its response illustrates how questions of price stability have been isolated from concerns with income distribution.

The Reserve Bank devoted a section of its May 2023 *Statement* to the question 'Have business profits contributed to inflation?' Though the only Australian version of the charge it responds to is an analysis from the Australia Institute (Stanford 2023), its researchers may also have been sensitive to the newly-released report of the RBA Review, which suggests that the Bank was late to respond to the post-pandemic inflation in part because it was not paying enough attention to inflationary impulses from non-wage sources (Review 2023: 58).

The Bank's analysis acknowledges that the aggregate profit share of private income (excluding the finance sector and dwellings) has risen sharply since 2021, but emphasises that the rise disappears if the mining sector is excluded.[13] Its rationale for excluding that sector is (1) that it was 'driven by commodities prices set in global markets, based on the balance of global supply and demand'; (2) that much of it was due to rises in prices of iron ore and base metals, which are mostly exported rather than used as domestic inputs; and (3) the profits will not have contributed much to domestic demand because much of what was not taxed went to foreign shareholders (RBA 2023b: 37-8). That is, the rise in the mining profit share was not fed by *domestic* dynamics and did not much contribute to them. Energy price increases were an exception, in that they did contribute to the recent inflation, but 'the primary underlying cause is global energy market conditions rather than higher markups in the energy sector independently driving prices'.

There has been no change in the labour and profit shares of national non-mining income. Looking at firm-level data, the RBA finds that – again outside mining – operating profit margins for large non-financial firms were roughly the same in September 2022 as they had been in 2019, though some of the largest firms widened margins (RBA 2023b: 39). The Bank concludes that 'these observations are consistent with firms having generally passed on higher costs to maintain their profit margins, and aggregate inflation having been driven by the balance of demand and

[13] As also discussed by Jericho and Stanford (2023).

supply factors, rather than changes in firms' pricing power' (RBA 2023b: 37).

Elsewhere, the Bank presented another dataset, including smaller firms, showing that median operating margin had in fact increased substantially over 2021 and 2022. It reports that 'most businesses were able to pass on higher input costs to rebuild their profit margins after the pandemic' (RBA 2023e: 44). This was not universal – margins were reduced in the construction sector, for example, because companies faced rising costs while operating under fixed-price contracts, and smaller businesses in general were less able to pass on cost increases (p. 45).

To summarise the argument: mining sector firms (and their owners) benefited from price increases but did not cause them, because commodity producers are price-takers. Firms outside the mining sector – on average – did not gain from price increases and did not cause them, although they have some price-setting power, because in raising prices they were simply maintaining their margins (on average).

This does not exonerate firms from a role in propagating inflation. It is not necessary for firms in general to increase their profit margins for their pricing strategies to propagate inflation beginning in the commodity sector. Price-taking mining firms may enjoy windfalls from rising prices on world commodity markets, while firms in other sectors then maintain their margins by raising prices in response to rising costs, in the knowledge that competitors are likely to follow suit (Weber and Wasner 2023). This is 'passive' only in the sense that the firms are behaving as they are expected (or modelled) to behave. It then seems a double-standard to treat attempts by workers to 'pass on' higher costs by getting wage increases that match inflation. But this has been the attitude expressed by Reserve Bank leadership, for example, in Governor Philip Lowe's response to questions at the National Press Club in April 2023. He remarked:

> [R]ising profits are not the source of the inflation pressures we have. Outside the resources sector, the share of national income that goes to profits is basically unchanged. I think what's been happening is demand is strong enough to allow firms to pass on the higher input costs into prices, so the firms have not suffered a decline in their profits as their costs have gone up, with the exception of the construction sector. But most sectors have been able to pass on the higher input costs into higher prices and have kept their profit margins the same.

However, regarding wages, Lowe (2023) said:

> It's really important that we don't develop a pattern here where wages and prices chase one another. If they do, inflation will get entrenched and we'll have to have higher interest rates.

To exclude the resources sector, however, is to exclude a large proportion of the corporate profits made in Australia – just over half in 2022, as Jericho and Stanford note (Jericho and Stanford 2023: 4-5). This makes them relevant to any consideration of the distributional *effects* of inflation, even apart from any question of corporate agency or the role of minerals prices in the *propagation* of inflation.

However, the basis for the central bank's seeming double standard can be understood as coming from a distinction between what it can influence and what it cannot, given the limited instruments at the Bank's disposal. Monetary policy has no way to influence firm price-setting strategy, or the supply-side conditions. It can only influence the demand side and labour market conditions. This restricted capacity influences not only its strategy but its very framing of inflation. The fact that wage growth did not initially spark the current inflation is immaterial to the inflation-targeting strategy: the Bank has one tool and must use it to restrain demand, cool the labour market, and maintain the credibility of its commitment to the target so that expectations do not become unanchored and fuel further rounds of inflation.

This policy strategy is made possible by the fact that there is now neither a general expectation that nominal wages should keep up with prices, nor an institutional framework for defending real wages – except, to some extent, for those still covered by industrial awards. It would not have been possible under the broader-based arbitration system of earlier decades, so its demise is a crucial feature of the current regime. It depends on wages bearing the brunt of adjustment to supply shocks.

Supply shocks, the NAIRU, and the future of the dual mandate

The RBA Review recognises the importance of unfavourable supply shocks to the current inflation and notes the 'risk that the Australian economy will experience more frequent supply disruptions in future' (Review 2023: 138). It recognises that this poses serious problems for the framework, but ultimately does not present a solution, except to

recommend building the Bank's capacity to model and forecast supply disruptions; and to engage in research about them. The Bank's own statements have consistently treated the current inflation not as a policy failure, but as sparked in large part by a supply shock over which monetary policy has little control. It claims that most of the models used in the Bank's forecasts:

> are designed to capture demand-driven inflationary pressures in the economy, which have been the most important drivers of inflation over recent decades. These models (like most forecasting models) were not well equipped to capture supply-driven inflation, the signal from global inflation surprises, a change in firms' pricing behaviour or shocks that are highly uneven across sectors. This is because it is difficult to capture the inflation signal from unusual drivers or unprecedented events in a forecasting framework, which relies on the statistical relationships that prevailed on average in the past. (RBA 2022: 79)

Supply chain disruptions and commodity price increases were global phenomena – hangovers from the pandemic and the Russian invasion of Ukraine. Australia had been further unlucky in suffering severe flooding on the east coast. All these 'were unpredictable or seemed too unlikely to include in the central forecasts' (p. 77).

It is not a simple matter to separate out supply from demand factors. The RBA has presented the results of three methods. One uses a simple rule tracking whether price and quantity changed in the same or different directions in each expenditure category of the consumer basket. This attributes about half of the increase in inflation over the year ended September 2022 to supply-side issues. A second uses the Bank's structural general equilibrium model, which captures relations between sectors rather than treating them in isolation. This method attributes three-quarters of the inflation increase to supply (RBA 2023a: 66-7). A third approach compares actual inflation to that predicted by the Bank's other major in-house model, a Phillips curve/'non-accelerating inflation rate of unemployment' (NAIRU) model, and attributes the error to 'implied supply disruptions'. By this measure, supply-side disruptions were responsible for 'around one-half to two-thirds of inflation' over the previous year (Beckers, Hambur and Williams 2023: 41). Had inflation moved in line with the central prediction of the NAIRU model, it would have only just exceeded the Bank's target zone: 3.1% over the year to March 2023.

Supply shocks of this magnitude raise a difficult problem for the inflation targeting framework. As the Bank explained, 'monetary policy primarily affects the economy by influencing demand' (RBA 2023a: 66): there is not much it can do about supply chain disruptions, global commodity prices, or natural disasters. But it cannot ignore them either unless it is 'expected to be short lived and inflation expectations remain anchored' (p. 66). Neither is the response as straightforward as adjusting aggregate demand downward to meet diminished aggregate supply. The capacity constraints tightened by supply problems are in specific parts of the economy, and there is no monetary policy tool that allows for fine-grained redirection of demand away from bottlenecks.[14] The central bank can aim only at a broad reduction in demand to dampen the transmission of inflationary dynamics outward from its origins, and the development of wage-price spirals.

The dual objectives, supply shocks, and the NAIRU

This opens the biggest potential political problem for the monetary policy framework. It remains politically uncomfortable to increase unemployment deliberately. It might be thought especially so when part of the aim is to ensure that wages do not keep up with inflation, after a decade of slow wage growth. The RBA Review calls for full employment to have equal priority with price stability among the central bank's aims, which some have interpreted as a departure from a status quo in which the Bank prioritises price stability. However, it also predicts that supply shocks may become more frequent – and does not suggest how the Bank can deal with that without facing a dilemma.

Even disregarding the supply shock situation, the Review's supposed elevation of 'full employment' should not be exaggerated. It recommends that 'The RBA should have dual monetary policy objectives of price stability and full employment, with equal consideration given to each' (p. iv). But everything there hangs on how 'full employment' is defined. The Reserve Bank Act has always formally committed the Board to using monetary policy to 'best contribute to' both 'the stability of the currency' and 'the maintenance of full employment,' as well as 'the economic prosperity and welfare of the people of Australia'. Successive Statements

[14] In the immediate postwar period, some Australian economists and policymakers did envision an integration of macroeconomic and industrial policy (Jones 2021).

on the Conduct of Monetary Policy since the first in 1996 have reiterated the three objectives, but also interpreted them in a hierarchical way. The 1996 wording still appears almost verbatim in this most recent Statement of 2016:

> These objectives allow the Reserve Bank Board to focus on price (currency) stability, which is a crucial precondition for long-term economic growth and employment, while taking account of the implications of monetary policy for activity and levels of employment in the short term.

In other words, the Bank's role is to focus on price stability; by doing that it also aims at full employment and prosperity. There is no sense of tension between the objectives, at least in the long run.

The Review seems to make explicit what is usually left implicit, defining 'full employment' as the unemployment rate compatible with price stability – the 'non-accelerating inflation rate of unemployment' or NAIRU. It describes the NAIRU as '*a measure of full employment* commonly used by central banks that represents the lowest rate of unemployment that can be sustained without fuelling excessive inflation' (Review 2023: 32, emphasis added). Elsewhere, it notes that 'full employment is not directly measurable and changes over time' (p. 75) – which is exactly how the RBA has long described the NAIRU.

The Review's call for 'equal consideration' to both price stability and full employment is therefore not a departure from the Bank's standard practice. There is no conflict between price stability and full employment if full employment is defined as the level of unemployment compatible with price stability. If the Review leads the government and/or the Bank to define 'full employment' more explicitly in terms of the NAIRU, this will be not a strengthening but a weakening of the Act's full employment aim. Though, again, this will be a confirmation of a longstanding implicit interpretation rather than a new departure.[15]

Meanwhile, the government's recent 'White Paper on Jobs and Opportunities' gives an old-fashioned, common-sense definition of 'full employment': 'everyone who wants a job should be able to find one without having to search for too long,' and explicitly contrasts this with the NAIRU (Commonwealth of Australia 2023: 17-8). It does also define

[15] It seems possible, though, that the Bank may be asked to publicly estimate multiple indicators of full employment.

'sustained full employment' as a rate 'consistent with low and stable inflation,' but acknowledges that there may be a divergence between this 'sustainable' rate and what it calls 'inclusive full employment,' and that macroeconomic policy alone is not enough to reach the latter.

This also is a familiar trope in policy discussions of unemployment: At any point in time, there is a NAIRU representing the best macroeconomic policy can hope to sustain without provoking accelerating inflation. But this NAIRU is subject to change and lowering it can be a policy project over longer periods of time. This would resolve any tension within macroeconomic policy *if* the level of the NAIRU depended entirely on things outside the purview of demand management. There can then be a neat division of labour, with the central bank targeting the NAIRU, and other branches of policy aiming at lowering the NAIRU through microeconomic and labour market reforms.[16] But if the NAIRU is subject to hysteresis, with feedback loops from higher actual unemployment, this neat division disappears.

The RBA's use of the NAIRU is not mechanistic, and it has downplayed the concept since the pandemic. It does not routinely make those estimates public in real time. We have two main recent sources on how Bank economists think about the NAIRU, both pre-pandemic: a paper from 2017 by Tom Cusbert presenting the in-house NAIRU model; and a 2019 speech by Luci Ellis discussing how the Bank interprets it. Both emphasise that the NAIRU is the artefact of a model, and that there are major uncertainties in estimating it even assuming the model is specified to capture the relevant aspects of reality.

The Bank puts wide confidence intervals around the central estimate, especially its estimates for the most recent periods, which must be used for forecasting. Writing in mid-2017, Cusbert reported the recent central estimate for the NAIRU as 5.0%, but with the 70% confidence interval stretching from 3.9 to 6.0 %, and the 90 % confidence interval more than three percentage points wide, from 3.3 to 6.6 (Cusbert 2017: 15). The central estimates are often substantially revised in retrospect—not uncommonly by half a percentage point or more (Cusbert 2017: 17).

[16] I discuss interpretations of the 'time-varying NAIRU' in Beggs (2018). As noted there, the 1990s-vintage view that lowering the NAIRU was largely a matter of labour market deregulation has not been borne out in later literature. This should not have come as a surprise in Australia, given that it sustained very low unemployment for decades without any tendency to accelerating inflation, under a system of centralised bargaining.

By the time of Ellis's speech two years later, the Bank had modified the model to allow for 'the possibility that the data have become less volatile since the 1980s' (Ellis 2019: 10). But the confidence intervals are still wide, and clearly the NAIRU cannot be used by policymakers in a mechanical way to guide policy. The indicator is one among others, and the Bank and its Board refer to it alongside other indicators of wage and price pressure.

Given the degree of uncertainty, and the view that the NAIRU tends to move towards actual unemployment (hysteresis) (Cusbert 2017: 15), it might seem worthwhile for monetary policy to push and test the lower reaches in pursuit of full employment. Instead, the Bank is cautious, because of the risks of unleashing inflationary expectations if credibility slips. Some models suggest that undershooting the NAIRU will raise inflation faster than overshooting will bring it back down (Debelle and Vickery 1997: 26; Borland and McDonald 2000: 22). Combine this with the lags between policy decisions and their effects, and the implication is that policy must be ready to shoot first and ask questions later.[17]

The Review claims Bank NAIRU overestimates as one reason why 'monetary policy did not sufficiently support the economy between 2016 and 2019' (Review 2023: 35). In this period, consumer price inflation remained below the 2% lower bound of the target, while 'the RBA consistently expected a tighter labour market and a pick-up in wage growth to lift trimmed mean inflation back to the target range' (Review 2023: 34). For most of the 2010s the Bank's forecasts for wage price index growth repeatedly projected pickups that never came. The Bank has retrospectively revised downward its NAIRU estimates for that period. But a bias towards caution is built into the framework because there is no longer a venue for managing income claims down the track: it is a matter for countless decentralised wage bargains, which can only be managed via labour market slackness.

Finally, the Bank's NAIRU model is simply not designed to deal with supply shocks. There have not been any serious ones for most of the period over which the model has been estimated. It deals with the oil shock of the 1970s in an ad hoc way, using a dummy variable to incorporate an oil price term only for quarters before 1977 (Cusbert 2017: 20). The model relates unit wage cost and price inflation to the level and rate of change of

[17] I elaborate on this point in Beggs (2018).

unemployment, to import prices, and to expectations. Supply shocks will appear initially through the error terms and import prices, and then through any effect on expectations. The model itself is unenlightening about the process of adaptation; and there is little past experience to go on. This is surely why the Bank has only rarely talked in terms of the NAIRU, or published estimates, since 2019: the pandemic and other shocks since have made it much less relevant to understanding recent inflationary dynamics.

Conclusion

If the RBA Review is right in expecting more frequent supply shocks, the recent inflation and response may foreshadow future difficulties. The possibility of a supply shock was not entirely an unanticipated problem. Debelle and Stevens, in the early years of inflation targeting, noted that monetary policy could reduce inflation arising from a supply shock only by further restraining output, which 'leaves the policy maker with difficult choices' (1995: 15). They raised the possibility of 'escape clauses' in the target, arguing that 'major, identifiable supply-side shocks may be a sufficient condition for the suspension of a target,' though suspending too often would undermine the credibility on which the regime depended.

For a long time, policy was not tested by this dilemma. Looking back from 2003, Stevens acknowledged that luck had played some role in monetary policy's success:

> For most of its history, inflation targeting has coincided with, if anything, favourable supply shocks. We have had positive surprises on productivity, and in the supply-enhancing effects of internationalisation of production. These surprises tended to push output up and prices down. This has been, we have to admit, a very benign environment in which to operate monetary policy. It may not always be this way in future (Stevens 2003: 24).

That 'good weather' on the supply side continued for the better part of another two decades – although monetary policy faced other challenges. Some policymakers may not have taken this for granted, but the political culture and media fell out of the habit of considering the possible ramifications of serious supply-side-generated inflation. Stevens himself was confident about what the Bank should do in such an event – hope that inflation expectations remain anchored, and 'focus on gradually bringing inflation down again' (2003: 24). But policy strategy does not happen in a

vacuum, and how the political environment would react was an open question, especially given the distributional consequences.

It is only now for the first time that the framework is facing the nemesis of stable policy in earlier decades: major shocks upending distributional stability. The question is whether wage-earners will now remain more sanguine about bearing the burden of adjustment than they were in those earlier episodes; and/or whether they are now more defenceless. The framework may be saved by the ease with which real wages absorb the shock. But this places the burden of adjustment to supply-side inflation on workers, and particularly those with variable-rate mortgages. The resulting social stresses and political consequences bear heavily on the political economic environment in which the current Labor government must operate.

While this article has made a case for bringing distribution back into consideration in macroeconomic policy, there is a big difficulty in giving it practical effect in the present circumstances. This is the marginalisation of the arbitration system, once a point of leverage and venue for politicisation: it was much easier to let wither away into a vestige than it would be to rebuild. But there may be 'lower hanging fruit' in other aspects of the incomes policy tradition. These include fiscal mechanisms – such as deferred income, the 'social wage', and redistributive transfers – that the government can use to deal with inflation while managing and counteracting the distributional consequences.

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