# Economic note

**By TCorp Chief Economist, Brian Redican**

The American humourist, H.L. Mencken wrote that "for every complex problem there is a solution that is simple, neat and wrong." This certainly applies to the problem of inflation and the belief that central banks control it precisely like a remote-control car.

Not only is it a waste of time arguing over the minutiae of monetary policy movements, an unrealistic belief in the omnipotence of central banks leads to misguided policy recommendations that do more harm than good. Moreover, these arid debates distract attention away from more productive discussions about policy changes that could make the economy less inflation prone in the long term. I will come back to this point.

It is now well understood how soaring energy prices, supply chain disruptions and cashed-up consumers combined to deliver the perfect inflationary storm in recent years. Inflation soared into the high-single digits around the world and almost reached 8% in Australia. While inflation has fallen sharply, it is still above 3% which informs the debate about whether the Reserve Bank of Australia (RBA) has tightened policy enough.

This is why it is important to understand the limits of what central banks can do. When oil prices double, it directly injects an inflationary impulse into the economy as petrol and diesel prices rise sharply. Then, this price shock works its way through the economy as every firm that uses petrol or diesel – which is most – responds to the jump in input costs.

Obviously, the RBA cannot do anything about surging oil prices. The best they can hope to do is limit the extent to which firms pass on those higher costs by keeping inflation expectations anchored. That is, while they can influence inflation, they cannot control it at all times, which is why the RBA has highlighted the advantages of 'flexible' inflation targets.

The other consideration is the way an inflationary shock is propagated through the economy, and the mechanisms that amplify, or dampen, the initial impulse. For example, tax excise rates on tobacco and alcohol are indexed to inflation. This means that there is an additional increase in consumer prices when the indexation takes place. And, again, the RBA cannot do anything to prevent this.

Similarly, in 2023 the Fair Work Commission gave a very large increase to Minimum Wage and Award workers to ensure that real wages did not fall. This is another example of a mechanism that amplifies an initial inflationary shock as firms pass on those higher costs. It also takes time for these effects to materialise as some organisations – such as schools – have to wait for the new calendar year before they can change prices.

But even though central banks cannot perfectly control inflation, we can still hold them accountable for ensuring that the pre-conditions for low inflation remain in place. This means that people believe inflation will return to target and wages will grow at a pace that is consistent with sustained low inflation. Even with the large increase in the minimum wage last year, this remains the case in

Australia. And while that is so, it makes sense for the RBA to display patience as the previous inflationary impulses eventually fade.

People arguing that the RBA should do more to fight inflation might concede that although the Bank is powerless to prevent surging oil prices or supply-chain disruptions, it could make room for those unavoidable price rises by crushing the economy to ensure that other prices fall.

This is theoretically possible but impractical in the real world. The deflationary impact of very tight policy would appear just as the initial inflationary impulse was receding. Rather than smoothing inflation it would make it more volatile; the exact opposite of effective counter-cyclical policy.

Thinking about inflation in this way – as a series of impulses that either get amplified or dampened as they make their way through the economy – provides a more nuanced view of what central banks can and cannot do to influence the path of inflation. It also highlights something very practical that governments could do to help keep inflation low, which is to ensure that inflation propagation mechanisms dampen, rather than amplify, inflationary impulses.

In this regard, Westpac's Chief Economist, Luci Ellis, argues that excise rates, for example, should be indexed to 2.5% rather than the actual inflation rate. Along similar lines, why not increase the minimum wage by 3 or 3.5% every year rather than deliver large wage increases when inflation is high and small wage rises when inflation is low? More stable energy prices are another area that would make Australia less inflation prone. Focusing on these issues is more helpful in ensuring that Australia remains a low-inflation country, rather than wishfully thinking that our inflation problems would have disappeared if only the RBA had lifted rates another 25 or 50bps.

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