Speech

The Costs of High Inflation

RESERVE BANK OF AUSTRALIA

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Governor

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I am very pleased to be here at the Anika Foundation fundraising luncheon. It is a tradition for the Governor of the Reserve Bank to give this annual address and I am very happy to continue it. As you know, the Foundation supports research into adolescent depression and suicide, a widespread issue and I suspect one that many of us in this room have been touched by. I am therefore very pleased to be speaking at an event in support of such an important cause.

The monetary policy environment

I want to start by explaining the Board's most recent policy decision and summarising our central outlook for the Australian economy as set out in our August *Statement on Monetary Policy*. To a large extent, I will be reinforcing many of the points I made following the August Board meeting.

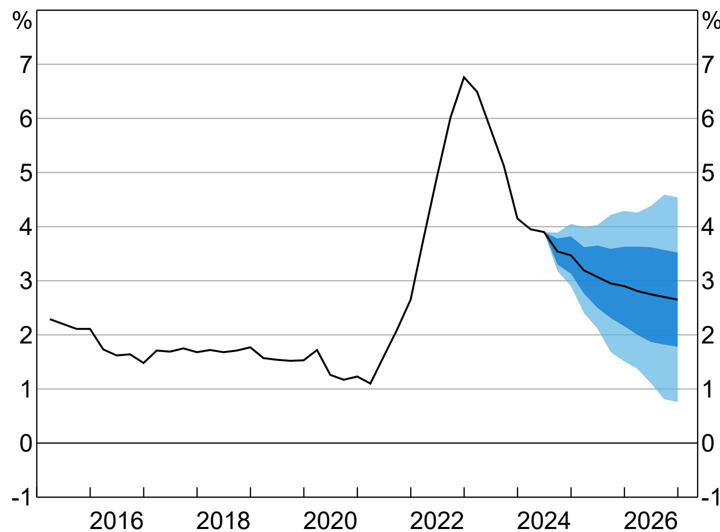
As I'm sure you know, at its meeting in early August, the Board decided to leave the cash rate unchanged at 4.35 per cent. While inflation has fallen substantially since its peak, it is still some way above the midpoint of the 2–3 per cent target range, with underlying inflation – as measured by the trimmed mean – at 3.9 per cent in June.

The Board is trying to bring inflation back to target in a reasonable timeframe while preserving as many of the gains in the labour market that we have seen in the past few years as possible. This is the so-called narrow path.

In our central August forecast, underlying inflation is expected to be back in the target range by the end of next year, and to approach the midpoint in 2026 (Graph 1). That is a slightly slower return to target than our forecast in May. Meanwhile, the labour market remains relatively tight but is expected to continue to ease gradually over the next couple of years.

Graph 1

Trimmed Mean Inflation Forecast*



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

There is substantial uncertainty around this central outlook, however, with risks on both sides. One way to think about this is to consider the historical errors around our central forecasts – represented as fan charts in the *Statement on Monetary Policy*. There are many things that could happen that could result in inflation being above or below the central forecast. The *Statement* also provided some specific scenarios under which consumption and employment could be stronger or weaker than implied by our central forecasts. These illustrate that outcomes for inflation could be quite different if the economy follows an alternative path. The Board needs to be alert to these possibilities in thinking about the future path of interest rates.

In setting policy, the Board is looking to strike an appropriate balance between the RBA's inflation and full employment objectives. Given the starting point of high inflation and a relatively tight labour market, and that low and stable inflation ultimately supports our full employment objective, our highest priority has been and remains to bring inflation down – I will come back to say a bit more about why later. The Board remains vigilant to upside risks to inflation and has noted that monetary policy will need to remain sufficiently restrictive until it is confident that inflation is moving sustainably towards the target range.

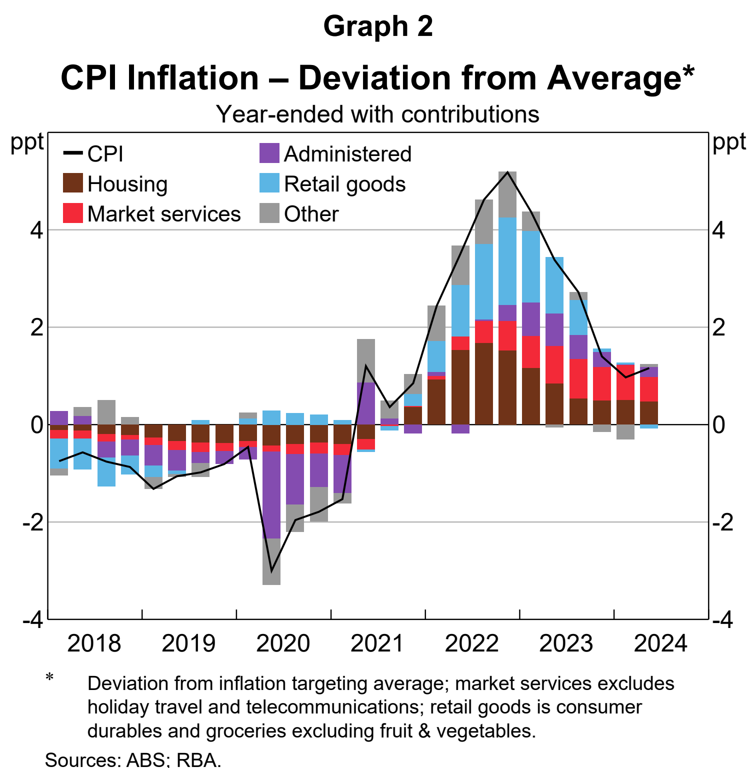
Moreover, the forecasts I've described were predicated – as usual – on the technical assumption that the cash rate follows the path implied by the market. This meant that the central forecast for inflation was based on cuts in the cash rate starting early next year.

Accordingly, the Board's message following its meeting only a few weeks ago was that it is premature to be thinking about rate cuts. Circumstances may change, of course, and if economic conditions don't evolve as expected, the Board will respond accordingly. But if the economy evolves broadly as anticipated, the Board does not expect that it will be in a position to cut rates in the near term.

I now want to talk through recent developments in inflation in a bit more detail; explain why it is so important to complete the job of getting inflation down; and say a bit about the resilience of household finances to high inflation and the tightening in monetary policy that has occurred in response.

Recent developments in inflation

So, what is driving inflation now? The chart below shows the contributions of various parts of the consumer price inflation (CPI) basket compared to their average contribution over the entire inflation targeting period (Graph 2). This helps identify which parts of the CPI basket drove the rise in inflation in 2022 and the subsequent easing.



Graph 2

CPI Inflation – Deviation from Average*

* Deviation from inflation targeting average; market services excludes holiday travel and telecommunications; retail goods is consumer durables and groceries excluding fruit & vegetables.

Sources: ABS; RBA.

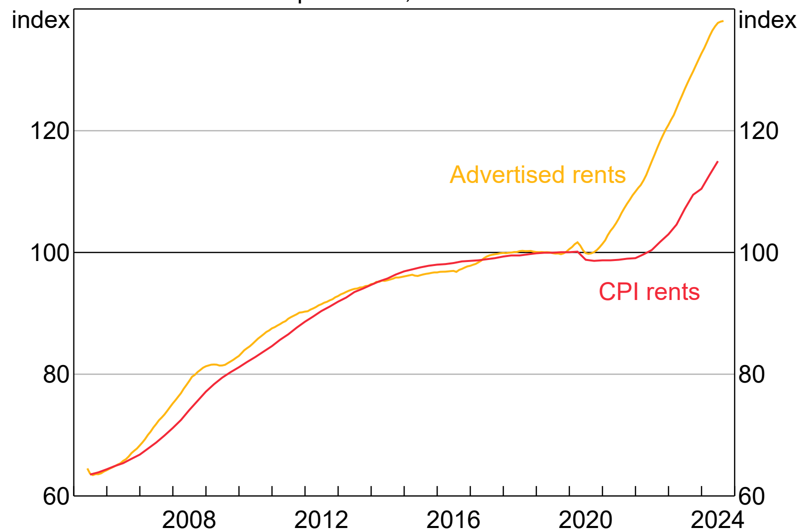
You can see that through 2022 and 2023, most components of the CPI basket were growing faster than usual. Inflation in housing and goods prices was particularly high over that period. But over the past 18 months, goods price inflation has declined substantially as supply disruptions associated with the COVID-19 pandemic and war in Ukraine have subsided and global demand for goods has eased. Inflation for retail goods – consumer durables and groceries – is now close to its historical average.

Inflation for administered prices – which are at least partly regulated or relate to items for which the public sector is a significant provider – is only a little above its long-run average.

The key drivers of elevated inflation at the moment are housing costs and market services inflation, which remain above their average levels and have been easing only gradually.

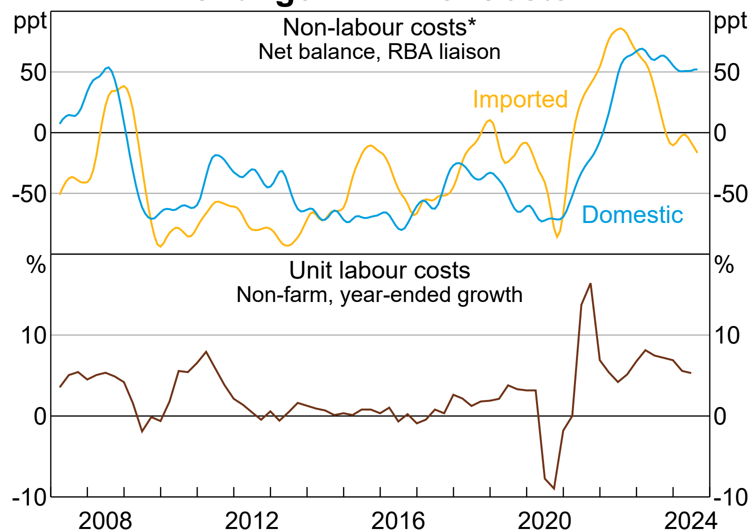
On the housing side, this reflects both construction cost growth and strong increases in rents. Year-ended growth in advertised rents is still high, reflecting pressure from a rebound in housing demand and limited supply response.[1] Rents on new leases take time to impact overall CPI rents because only a small share of the stock of rental properties update leases in a given month and so CPI rents inflation is likely to be high for some time (Graph 3). New dwelling inflation has declined from its earlier peak as materials costs have eased, but it remains elevated. There is still a large pipeline of work and ongoing labour shortages for certain trades.

Graph 3



Market services is making the largest contribution to above-target inflation. While year-ended inflation has been moderating across most market services – particularly those that are more discretionary, such as eating out and recreational activities – inflation in this category remains high at 5.3 per cent over the year to the June quarter. We typically think of market services inflation as reflecting overall domestic inflationary pressures – a combination of costs and margins. Domestic non-labour costs (including, for example, electricity, insurance and warehousing and logistics rents) continue to increase strongly, and labour cost growth is also strong, reflecting both wage increases and weak productivity growth (Graph 4).

Graph 4



* Share of firms reporting above-average increases less share reporting decreases, no change or below-average increases; average increase indexed to 0; smoothed with a 13-month Henderson trend.

Sources: ABS; RBA.

Survey measures, including in the RBA's liaison program, suggest that firms are continuing to pass through some of this cost growth to prices, although softer consumer demand has made pass-through more difficult in some industries.

The key takeaway here is that domestic capacity pressures, in both housing and market services, are contributing to above-target inflation. Despite a gradual easing over the past 18 months, the labour market remains relatively tight, with labour availability still a constraint for some businesses and job vacancies elevated. We also continue to observe tightness across product markets, and firms report high capacity utilisation.

Restrictive monetary policy has been working to bring demand and supply more into balance and this has contributed to the easing in aggregate CPI inflation. It is true that inflation in some components of the CPI has eased more than others. But it is not unusual for different components of inflation to behave differently at any point in time. And at an aggregate level, there is further to go. With underlying inflation having fallen very little over the past year in quarterly terms, the Board is vigilant to upside risks. That is why, as the Board has said, policy will need to be sufficiently restrictive until we are confident that inflation is moving sustainably towards the target range.

Why is bringing inflation down so important?

We know the restrictive monetary policy settings that are necessary to bring inflation down are causing hardship to some households and businesses. We are very conscious of that. In fact, we spend a lot of time trying to understand how interest rates settings are affecting households and businesses – and I will say more about that later.

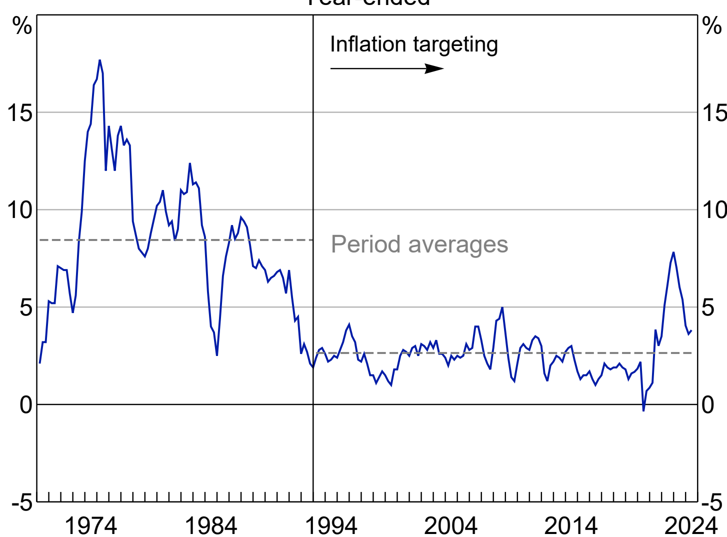
But inflation causes hardship too, for all Australians and particularly for the more vulnerable in our community. Our experience of how costly inflation can be is the reason that getting inflation back to the target range is our priority.

There are two ways to come at this. The first, taking a longer view, is to remind ourselves why we have a flexible inflation targeting framework, which goes back to the experience with high inflation in the 1970s and 1980s. Inflation – as measured by the year-ended change in the CPI – reached 17.7 per cent in March 1975 and it remained around 10 per cent on average for the rest of the 1970s and early 1980s (Graph 5).

Graph 5

CPI Inflation*

Year-ended



* Excludes interest charges prior to the September quarter of 1998; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

For those who experienced it, memories of that period may have faded – and for many younger people it probably seems like ancient history. But institutions can preserve the lessons of the past. The move to flexible inflation targeting by many central banks in the 1990s embodied the strong consensus at the time that inflation was harmful and that the way monetary policy had operated in the 1980s had not been sufficient for many central banks to bring inflation down.[2]

High and variable inflation is harmful because it raises uncertainty and makes it harder to plan for the future. It can distort economic activity, affecting decisions about investment and employment and ultimately hurting productivity and household incomes. For example, it might be hard for a firm to lock in a supply contract if it doesn't know what prices are going to be over the next year. In turn, this might make it harder to make expansion plans. High and variable inflation can also cause shifts in people's wealth and spending power. Agreeing to a new contract, or making saving plans, is harder if you don't know how expensive things will be in the future. Moreover, high inflation eventually requires disinflation, which can have long-lasting costs for households through higher unemployment.[3]

Setting a clear and transparent inflation target helped guide the Reserve Bank Board's decision-making. But it also provided a clear anchor for inflation expectations, resulting in lower and more stable inflation. Over the inflation targeting period well-anchored inflation expectations have enabled monetary policy to more effectively respond to the ups and downs of the economic cycle, stabilising the economy and creating the conditions for steady growth and job creation.

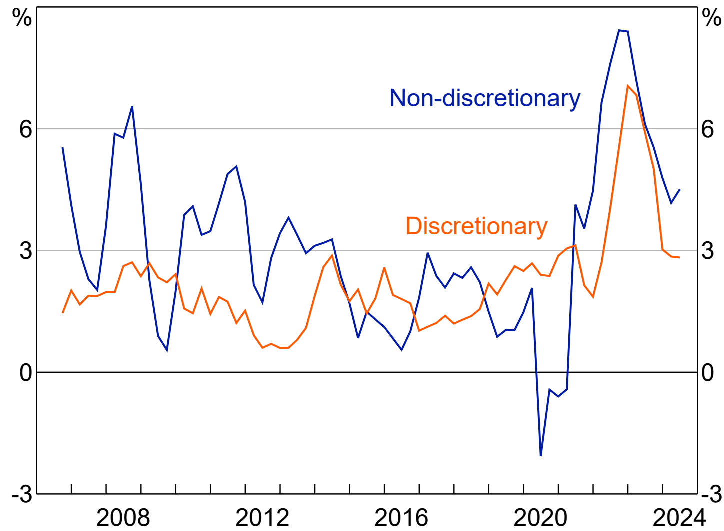
The anchor has held through the recent inflation episode – but we do not and cannot take that for granted. Over time, inflation expectations will only remain aligned with the target if we continually work to return inflation there when it moves too far up or down. The timeframe over which we do so can (and does) vary as we take account of our full employment objective. But, over the medium term, our full employment goal is best served by achieving the inflation target.

The second way to come at the question of why getting inflation down is the Board's priority is to look at the effects that high inflation has had on people over the past three years.

Every Australian feels the effects of inflation, but people have different patterns of spending and incomes, and so their experience of cost-of-living pressures varies. Lower income households tend to allocate more of their spending towards essentials, including food, utility bills and rent. Higher income households tend to spend more on owner-occupied housing as well as discretionary items such as consumer durables.

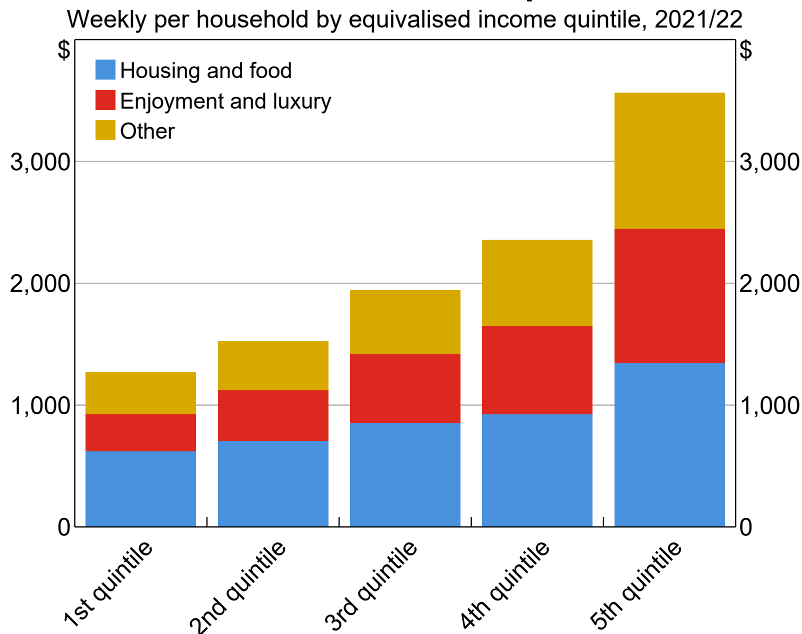
Through most of the recent inflationary period, inflation has been broadly based across most components in the CPI basket. So, most people have experienced similar rates of increase in inflation. However, inflation for non-discretionary items has eased but remains elevated in recent quarters. This partly reflects housing inflation. Lower income households tend to spend a larger share of their income on rents, and so this is likely to be a greater challenge for this segment of our community (Graph 6).

Graph 6



The experience of individual households varies widely, but younger households and lower income households have been particularly affected by cost-of-living pressures overall.[4] They are often budget-constrained and have less scope to reduce their spending on discretionary items to balance their budgets (Graph 7). They may also have less scope to reduce spending via trading down to cheaper items within the same category if they were already purchasing lower cost items. Moreover, they typically have smaller savings buffers and so less scope to use savings to maintain their current standard of living.

Graph 7



We know that if high inflation becomes entrenched in the expectations of firms and households it would be more difficult and costly to reduce. If businesses and workers come to expect that prices and wages will continue rising quickly this adds to inflationary pressures, requiring even higher interest rates to bring inflation down. Ultimately, we would need to slow the economy down by more, which would result in a larger rise in unemployment and higher risk of recession.

The costs of job loss are very high to individual workers and lead to persistent earnings losses. This experience is consistent across groups of workers. But job losses tend to be disproportionately borne by some members of the community – the young, those who are less educated, and people on lower incomes and with less wealth (including renters).[5] A weak labour market also hurts those who keep their jobs, whether through a reduction in hours worked or lower wages growth. So the future costs to not taming inflation would be borne by all Australians, but disproportionately by lower income households.

How resilient have household finances been to high inflation and tighter monetary policy?

I have noted on a number of occasions that monetary policy needs to be set for aggregate economic conditions. We only have one instrument – the interest rate – to impact demand and it is blunt. But just as inflation is felt differently by various groups in the community, so too are interest rate moves. We therefore need to pay close attention to conditions facing different parts of the community, including the most vulnerable. That is true when thinking about monetary policy and also in thinking about financial stability. The RBA's forthcoming September *Financial Stability Review* (FSR) will provide an overall assessment of the health of household and business finances. While I don't want to steal the FSR's thunder, I do want to conclude today by previewing a few key messages on how household finances are faring.

The first thing to say is that I understand that the Board's message on interest rates is not what many borrowers want to hear. Those with mortgages are feeling the squeeze on their cash flows not just from high inflation, but also from the increase in interest rates that has occurred in response to it. And as labour market conditions ease, more households will experience a strain on their finances from unemployment or reduced working hours. Information received through the RBA's liaison program indicates that more people than usual are seeking support from community organisations, and often for the first time.

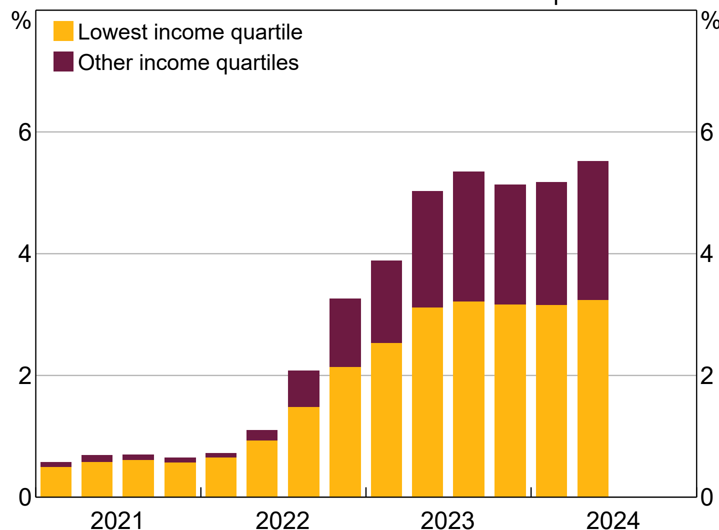
In the FSR we tend to focus on households with mortgages, because debt has the potential to amplify and transmit stress across the financial system. A key point to make here is that despite the pressure on household budgets, only a small share of borrowers is currently at risk of falling behind on their mortgage repayments. Key reasons for this are that the labour market has been strong, people have been able to find and stay in work and many have been making adjustments to their spending, particularly on discretionary items.

For owner-occupiers with variable-rate loans (which is a subset of all borrowers), we estimate that around 5 per cent are in a particularly challenging situation, where the combined total of their essential spending and scheduled mortgage repayments is more than their income – that is, they have a 'cash flow shortfall' (Graph 8). Although this group is fairly small overall, those in it have had to make quite painful adjustments to avoid falling behind on their mortgage repayments. This includes things like cutting back on their spending to the more essential items, trading down to lower quality goods and services, dipping into their savings or working extra hours. Some may ultimately make the difficult decision to sell their homes. A really important point to note here, is that lower income borrowers are over-represented in the group of people who are really struggling.

Graph 8

Borrowers with Cash Flow Shortfall*

Estimated share of variable-rate owner-occupier loans



* Estimates of borrowers with minimum scheduled mortgage payments and essential expenses (proxied by the Household Expenditure Measure) exceeding their income. Excludes borrowers in arrears, which accounted for around 0.6 per cent of loans in June 2024.

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Should inflation remain high for longer than the RBA is forecasting, the share of borrowers most at risk of being unable to service their debts would increase a little further.[6] While the numbers are not large enough to pose a material risk to the stability of the financial system, it would have a material impact on those households who end up in this situation. And we know that lower income borrowers are most at risk of this, because they typically have smaller financial buffers.

Conclusion

Inflation has not been as high as it has been recently for a few decades and I think many people have forgotten how bad it is – people under the age of 40 will not have experienced high inflation until the last few years. There is a reason why there is so much talk about the cost of living – high inflation hurts everyone, and especially the most vulnerable. It reduces what people can buy with their wages, erodes the value of savings, and it disproportionately hurts those on low or fixed incomes. This is why it is imperative that we return inflation to levels that mean it is in the background again – at which point it will no longer be distorting our economy.

We see achieving our inflation target as going hand in hand with our full employment objective, as it lays the foundations for economic growth and jobs creation. The Board is seeking to balance reducing inflation in a reasonable timeframe and maintaining as many of the gains in the labour market that we have seen in the past few years as possible. Ultimately, though, it is crucial to remember that our full employment goal is not served by letting inflation stay above target indefinitely.

Endnotes

[*] Thank you to Michelle Bergmann, Callum Hudson, Tim Taylor and Michelle Wright for excellent assistance with this speech.

[1] See Hunter S (2024), 'Housing Market Cycles and Fundamentals', Address to the REIA Centennial Congress, Hobart, 16 May.

[2] One of my predecessors as Governor, Bernie Fraser, put it like this in 1990: 'That inflation is a bad thing and should be eradicated is about as close to a consensus as you are likely to get on any economic or political issue.' See McTaggart D (1992), 'The Cost of Inflation in Australia', Paper delivered at the RBA Annual Conference, 10–11 July.

[3] The 1992 RBA Annual Conference, which took place just prior to the introduction of inflation targeting in Australia was dedicated to the costs of high inflation. See Blundell-Wignall A (ed) (1992), 'Inflation, Disinflation and Monetary Policy', RBA Annual Conference, 10–11 July.

[4] See Wood D, I Chan and B Coates (2023), 'Inflation and Inequality: How High Inflation Is Affecting Different Australian Households', Working paper prepared for the RBA Annual Conference, Sydney, 25–26 September 2023; Beckers, A Clarke, A Gao, M James and R Morgan (2024), 'Developments in Income and Consumption Across Household Groups', RBA *Bulletin*, January.

[5] See Lancaster D (2021), 'The Financial Cost of Job Loss in Australia', RBA *Bulletin*, September; Coates B and A Ballantyne (2022), 'No One Left Behind: Why Australia Should Lock in Full Employment', Grattan Institute; RBA (2023), 'Box B: Scenario Analysis on Indebted Households' Spare Cash Flows and Prepayment Buffers', *Financial Stability Review*, April.

[6] This scenario was illustrated in the March 2024 *Financial Stability Review*. See RBA (2024), '4.1 Focus Topic: Scenario Analysis of the Resilience of Mortgagors and Businesses to Higher Inflation and Interest Rates', *Financial Stability Review*, March.