Do We Have Inflation Licked?

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The economy's purring along and the Coalition's scaremongering about the carbon tax has been debunked. It's now time to focus on the real challenges facing Australia - like inflation, writes Ian MacAuley.

The September quarter Consumer Price Index was the first official measure of household price inflation since the carbon tax came into effect in July. As expected there was a jump in electricity prices, of 15.3 per cent over the quarter, or 18.5 per cent over the year, but this was not much more than the rises over the previous five years — from June 2007 to June 2012 electricity prices had risen by 73 per cent. Overall, the CPI remained benign, at 2.0 per cent over the year.

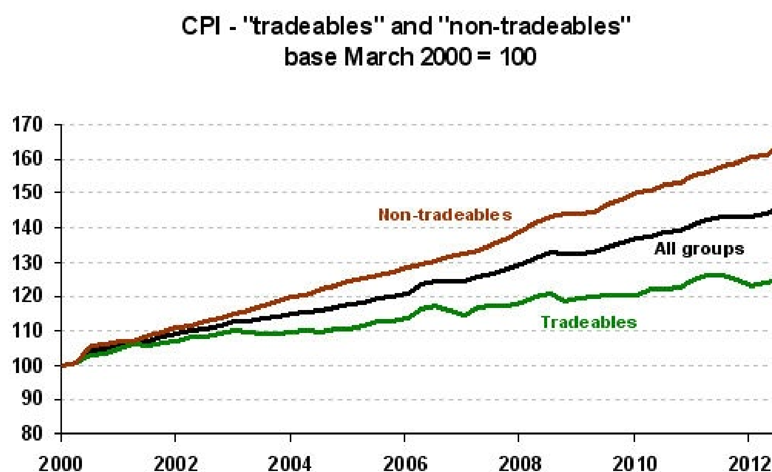
A few days before the ABS released the CPI, the Productivity Commission had released its draft report on electricity networks, clearly sheeting most of the blame for rising prices on permissive regulation of electricity networks ("poles and wires"), along with technological backwardness in electricity pricing and metering. This report finally put the carbon tax issue to rest, rendering Tony Abbott's fear campaign about the "big new tax" as credible as the warnings by astrological and religious freaks about the end of the world. (The current end of the world prediction is 21 December this year).

But does this mean we have inflation licked? Perhaps we have been too sidetracked by Abbott's prophecies and Barnaby Joyce's warnings of a $100 Sunday roast to notice some other trends. (A reminder to Barnaby: lamb prices fell by 4.3 per cent over the quarter.)

Our CPI has been kept low by two related phenomena — a high exchange rate and the falling price of many of the goods we import.

Because the ABS deconstructs the CPI into two components — "tradeables" and "non-tradeables" — we can get a reasonably good idea of the extent to which low-cost imports have kept our cost-of-living in check. "Tradeables", as the name suggests, relates to goods and services which can cross national borders. Imports such as clothing, cars, household appliances, computing and entertainment equipment are the obvious examples. There are also domestic goods which compete with imports, such as many foods (think of the range of imports on supermarket shelves) and household goods such as furniture. "Non-tradeables" refers mainly to services which we do not import, such as education, household utilities and health care.

The graph below shows the CPI since the turn of the century — roughly corresponding to the time over which Chinese imports have risen in prominence (now accounting for a fifth of our merchandise imports). Since 2000, while the CPI has risen on average by 2.9 per cent a year (within the Reserve Bank's comfort range), the "tradeable" component has risen on average by only 1.6 per cent a year, while the "non-tradeable" component has risen on average by 3.8 per cent a year. This divergence has become even more marked over the last three years.



In short, China has protected us from inflation, not only because it is a source of low-cost imports, but also because its demand for our minerals has lifted our exchange rate over recent years — which means goods and services from all over the world are more competitive.

What for the future? I suggest that future inflation will be more driven by those domestic factors which are driving our "non-tradeables" inflation. We have a particular problem of poor productivity which stems from under-investment in infrastructure and human capital, poor management, and a tax system discouraging patient investment.

There are four reasons why that offsetting benefit of low inflation in "tradeables" will probably be lost.

First, the Australian dollar exchange rate is unlikely to stay at its current level. As any visitor to Australia can affirm, it's seriously over-valued. It has tended to rise and fall with the commodity cycle, but in recent times, even as commodity prices have softened, it has stayed high because of "hot" money seeking a haven in a country with reasonable short-term interest rates and conservative economic management.

If Europe finds a way out of its fiscal and monetary mess, and if Americans have the good sense not to choose Romney's fiscal path of tax cuts, confidence will return to these major financial markets, and if we elect Abbott with his promises of tax cuts and increases in welfare, we could see a major flight of capital.

Even if we simply revert to a commodity cycle link, our exchange rate will fall, because that's the nature of the cycle — rapid price rises over a few years followed by 20 or more years of slowly falling prices. And if the bottom falls out of the thermal coal market because of global greenhouse gas concerns there could be an even sharper fall. The US east coast storms could be a turning point in that country's awareness of climate issues.

Second, tariff reductions by now have gone about as far as they can go. There is still a small scheduled reduction in the duty on clothing — from 10 per cent down to 5 per cent — in January 2015. Otherwise most tariffs have fallen to a base rate of 5 per cent, a rate which seems to be politically locked in. Much of the fall in the price of cars and clothing has been due to tariff reductions.

Third, some imported items which have kept the CPI low have become so cheap that even if they fall further in price they will have little influence on the overall prices. The ABS has already re-weighted the CPI to reflect lower outlays on household goods and audio visual equipment. In less technical terms, it is clear that once we get a flat screen TV with every $100 of groceries, flat screen TVs will have done all they can to keep our prices down.

Fourth, and related to the above, China's manufacturing costs from here on will probably rise. As Chinese wages rise the manufacture of some labour-intensive items such as clothing and toys will probably move offshore to low labour-cost countries. That has been a general pattern of global economic development. But for technologically sophisticated goods, production will probably remain in China, or in other countries at a similarly advanced stage of technological development.

A return to an environment in which inflation is present or threatened is not necessarily all bad. It may protect borrowers from being sucked into high debt because of the illusion of low nominal interest rates. And it may shake us out of our complacency and partisan blindness about productivity.