Australia’s Cost of Living Crisis has reached a Critical Juncture

Australian Financial Review

10 June 2024

The Australian economy is at a critical juncture. Inflation is above the RBA’s target range, and the GDP growth in the March quarter of 2024 was minimal. Per capita GDP has declined for five consecutive quarters. The RBA's estimate of unemployment being below the rate consistent with putting downward pressure on inflation adds to the complexity. Given current policies, some, including myself, argue for higher interest rates to combat inflation, while others propose fiscal policy to stimulate the economy without inflating prices.

The root cause of inflation in Australia is an imbalance between aggregate demand and supply where there is excess demand. This imbalance can occur when demand outpaces supply, supply falls short of demand, or a combination of both. In the case of Australia, inflation is a result of both imported and domestic factors. The disruption to supply from the COVID-19 pandemic and the implementation of loose monetary and fiscal policies in Australia have also contributed to inflationary pressures.

Persistent inflation causes cumulative economic losses (particularly impacting low-income households). There is substantial evidence that the more entrenched inflation is within an economy, the more costly it is to reduce inflation back to a less regressive rate over time. That is why temporary inflation surges (especially if demand drives) should be met with aggressive monetary policy to remove the inflationary impulse.

The cost-of-living crisis in Australia is not only because inflation is high but because inflation is higher than the growth in nominal incomes, in which case real incomes are falling. The cost-of-living crisis is fundamentally caused by a lack of productivity growth, which causes a lack of real income growth. Australia is facing a productivity crisis and has been doing so for many years. Increasing fiscal spending to increase demand without any policy to increase aggregate supply will increase inflation, especially given the current unemployment rate in the economy. There are capacity constraints throughout the Australian economy. Without policies to raise productivity, fiscal spending will increase inflation and require higher interest rates or higher inflation if interest rates do not respond. A new way of economic thinking or manipulating data measurement does not solve this fundamental problem.

Australia’s economic challenges will likely continue until economic policy focuses on dealing with large structural changes due to the energy transition, the surge in artificial intelligence, a possible loss of the terms of trade surge, and global geopolitical uncertainty.

The 2024 budget contains too much spending and distortionary taxation, which can only be sustained if the terms of trade boom continue. The budget focuses on “A Future Made in Australia,” which is partly a speculative focus on production network resilience. If productivity doesn’t rise due to the policies and therefore doesn’t generate higher future revenue due to this policy, then taxpayers will pay the bill. Producing a range of goods in Australia at a higher cost than importing from cheaper suppliers implies higher overall costs, which is the same as reducing national productivity. Thus, the budget trades off higher speculative production chain resilience in Australia with lower macroeconomic resilience. Does that matter? We have more historical evidence of the importance of macroeconomic resilience to an economy than the benefits of making supply chains more resilient.

Given the magnitude of the problems the Australian economy is grappling with, what should be done? The most significant obstacle to overcome is the lack of bipartisan political consensus on crucial issues, stifling private investment. It's crucial to prioritize a collaborative approach, engaging with the opposition to develop a bipartisan strategy for tackling these major issues. Any other approach would be a more costly solution.

With or without bipartisan cooperation, the first step should be to focus on raising productivity. The government needs to address the market failures and/or government failures that have hindered the economy from adapting sufficiently to the major global risks that are glaringly apparent. The policies should then zero in on rectifying the issues at the lowest possible adjustment cost. The government has a pivotal role in rectifying distortionary government policies and tackling real problems when markets fail.

Without any consensus on Australia's problems and how to solve them, most budget policies will be reversed when there is a change of government. This policy reversal will waste taxpayers' money while delaying inevitable major adjustments. The 2024 budget fails to capitalize on potential opportunities. It overlooks the potential benefits of substantial tax reform, labor market reforms to enhance flexibility, and major investments in education to equip future workers to adapt to rapidly changing circumstances. These reforms could have a significant positive impact on the Australian economy. The good news is that the budget could have been much worse given the role of corporate lobbyists, union officials, and foreign intellectuals in promoting "a new exciting role for government" from countries that have failed "third-way" policies in setting the government's agenda.

Australia's cost-of-living crisis is far from being solved, while the debate focuses on the symptoms rather than the cause.

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This piece was first published by the Australian Financial Review.