THE AUSTRALIAN

EVEN ECONOMISTS MUST KEEP AN OPEN MIND

Inflation rethink does not take the pressure off

THE Australian's economic columnist Henry Thornton is fond of the anonymous quote that consistency is the sign of a middle-class mind and this is not the time for middle-class thinking. The debate over whether the Reserve Bank of Australia should rethink its response to inflation being driven by higher global oil and food prices has certainly unmasked some middle-class thinking by economic commentators troubled by the notion of change. But this is not a debate about whether inflation is such a bad thing after all, as Terry McCrann seems to suggest. Of course it is. Unchecked inflation, as many correspondents to this newspaper have pointed out, saps the value of retirement savings and forces wage earners to work harder to stand still. But recognising the odious nature of inflation is a different thing entirely from knowing how to combat it in all circumstances.

The conversion of well-known inflation hawk Thornton is a wake-up call for RBA governor Glenn Stevens. Thornton has adopted a position first put by *The Australian* in November, when we asked whether the "solution to the pressure that comes from higher world oil prices, the drought and the conversion of two billion people in Asia from poverty into the First World really is to penalise people who are struggling to pay their home mortgage in the outer suburbs of Sydney or Melbourne". Since then, there have been two 25-basis-point rises in official interest rates, compounded by independent rises from retail banks facing a global credit squeeze.

Consumer and business confidence measures have plunged but inflation has remained stubbornly high. Those economists who now question whether a rethink is necessary have accepted the lessons of history. This includes the inflationary spike that accompanied earlier booms in Australia's terms of trade such as the post-war wool boom. They also acknowledge the certainty that economic policy must ultimately accommodate political reality. This is why Thornton says that, if they get it wrong, Wayne Swan risks being part of a one-term government and Mr Stevens risks squandering the prized "independence" of the RBA. Rather than accept Labor's argument that the Howard government is responsible for the current inflation problem, Thornton puts the blame at the feet of easy monetary policy at the start of the century. This caused a surge of asset prices, which are now refusing to fall to compensate for the rising cost of oil and food. The result of "sticky" asset prices is inflation. Thornton has identified the difficult question for central banks as being whether to hang on to firm monetary policy to try to force down those other prices, or put up with a bit of inflation as the repricing of food and oil works its way through the system. If central banks try to hold on to tight monetary policy and other prices don't adjust, the economy risks slowing into recession.

That is the point at which many believe the RBA now finds itself. A growing number of economists concede it may be wise to suspend or relax inflation targets, at least for the time being. This is effectively an argument to lengthen the cycle over which an interest rate average should be considered. The reality is that it will produce higher average interest rates over the cycle. But the alternative may well be an unnecessary recession.

To admit that the present approach is not the best one for current circumstances is in keeping with the ultimate failure of both the Gold Standard and monetary targeting. There is evidence that the Australian economy is slowing, and the RBA may yet just get away with it this time. But for credibility it would be wise for the RBA to keep an open mind. Mr Stevens appears more concerned with staying "on message" to wring the maximum benefit from the interest rate hikes already in the system.

Meanwhile, having emphasised the RBA's independence, the Rudd Government has a lot riding on the bank's continued credibility as it wrestles with fiscal policy challenges of its own. The Treasurer has already turned his attention from the inflation threat to the likely impact of the global economic slowdown, something *The Australian* has urged. But this should not be seen as a get-out-of-jail-free card on handing down a tough budget. The Government has already made the biggest inflation mistake possible by scrapping the Howard government's Work Choices industrial relations reforms. A flexible labour market with controlled wages has been the best defence to date to stop the imported oil-price inflation spiralling into more worrying wage-push inflation. With Work Choices gone, it will be interesting to see if we now get industrywide pay claims and a wages-led inflation breakout. It also remains to be seen how Labor will balance its rhetoric in favour of a productivity revolution with new flexibility clauses in workplace awards announced by Julia Gillard yesterday to allow employees to achieve a greater balance between work and home life.

The Government says it wants to put downward pressure on inflation but is shying away from sorting out generous non-means-tested welfare payments. It has proposed "root and branch" tax reform but excluded the GST from the mix. However, it has not been shy about introducing an ad hoc tax increase on one type of alcoholic drink or on tobacco to suit its social-policy agenda. As John Durie has written, the most likely outcome will be inflationary pressures from higher beer prices. The Government's mixed signals are far more worrying than an admission from the RBA that it may need to rethink its approach to inflation targeting, or lengthen the cycle over which average rates are measured, to take account of extraordinary circumstances.