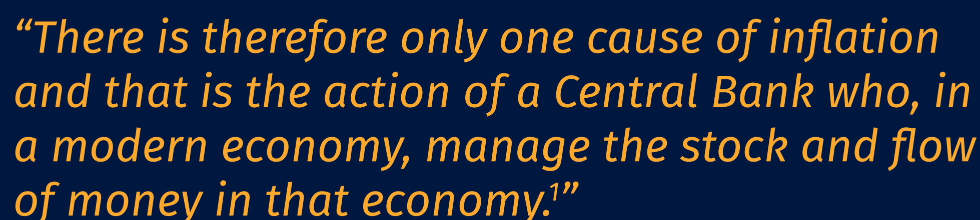
ECONOMIC INDICATORS

Edition 8



Daniel Lacalle
PhD Economist, Global Economy Expert and Fund Manager

SLAYING THE INFLATION DRAGON

Treasurer Jim Chalmers released the Albanese Government's first budget on Tuesday 25 October 2022. On page 1 of the Budget Overview Chalmers notes that "the global economic outlook has deteriorated rapidly. Advanced economies are facing the challenges of high inflation, rising energy prices, strained supply chains, and the fastest synchronised monetary policy tightening in decades".[2]

With inflation forecast to hit 8% in December 2022, the highest level it has been in over 30 years, and the resulting inflationary rise in cost-of-living impacts being felt mainly by low- and middle-income earners, it is worthwhile examining what causes inflation. Chalmers infers in his Budget Overview that "high global energy prices and floods" are the main causes of inflation.[2] However, rising prices are just a symptom of inflation and not the cause. According to Dan Richards, Manzur Rashid and Peter Antonioni, the authors of Macroeconomics for Dummies, there are really just 2 underlying causes of inflation. One is that the monetary authorities print too much money so that its supply becomes relatively abundant, such that money loses its value. The second cause is the expectations mechanism. If everyone expects money to lose value, everyone will try to get rid of it quickly, and the easiest way to do that is to spend it.[3]

PhD economist, global economy expert and fund manager, Daniel Lacalle suggests that "inflation is the destruction of the purchasing power of a currency, not 'rising prices.' Prices do not rise in unison due to an exogenous factor like a war unless the quantity of currency issued is higher than the growth in the productive sector".[4] Stanford economist, John Taylor agrees with Lacalle's assessment and suggests that "the biggest misunderstanding is that people do not realise that monetary policy is a major cause of the increase in inflation".[5] Taylor also states that "the Ukraine conflict and supply bottlenecks are not reasons for the large rise in inflation".[5]

In Australia, the Government is responsible for Fiscal Policy and the Reserve Bank of Australia (RBA) is responsible for Monetary Policy and these 2 areas are supposed to operate independently of each other.

In November 2020, the RBA first introduced unconventional monetary policy, in the form of a government bond purchase program (also known as quantitative easing), into the Australian economy totalling $100 billion with a further commitment of another $100 billion made in February 2021.[6] Quantitative easing is a monetary policy tool that central banks can use to inject money into the economy through the purchase of 'financial assets', usually government bonds.[7] Quantitative easing is also known as 'asset purchasing'.[8] It has also been referred to as currency printing.[7]

It is important to note the Australian Government will ultimately need to raise additional funds to repay the RBA once the bonds that were purchased reach maturity. The government can do this either by issuing new Australian Government Securities (i.e. bonds) to the private sector or via increased revenue (i.e. higher taxes) and/or reduced government expenditure.[9]

Since 2020, the Reserve Bank of Australia (RBA) reports that its outright holdings of government bonds has risen by around $230 billion, and now make up around half its total assets. Prior to 2020, the RBA's holdings of government bonds were much smaller, typically making up between 5 and 10 per cent of its total assets.[9]

PhD economist, global economy expert and fund manager, Daniel Lacalle explains that government bond purchase programs/quantitative easing/currency printing "is not neutral, and it never is. It disproportionately benefits government and massively hurts real salaries and deposit savings. It is a massive transfer of wealth from savers to the indebted."[4] Currently, Australian wages are not keeping up with inflation, which in real terms is effectively like experiencing a salary/pay cut and according to the recent budget forecast, real wages are not expected to start to grow until 2024.[10]

When addressing the National Press Club, a day after handing down the budget, Treasurer Chalmers declared that "whether it's food, whether it's electricity, whether it's rent, inflation is public enemy number one. Inflation is the dragon we need to slay."[10]

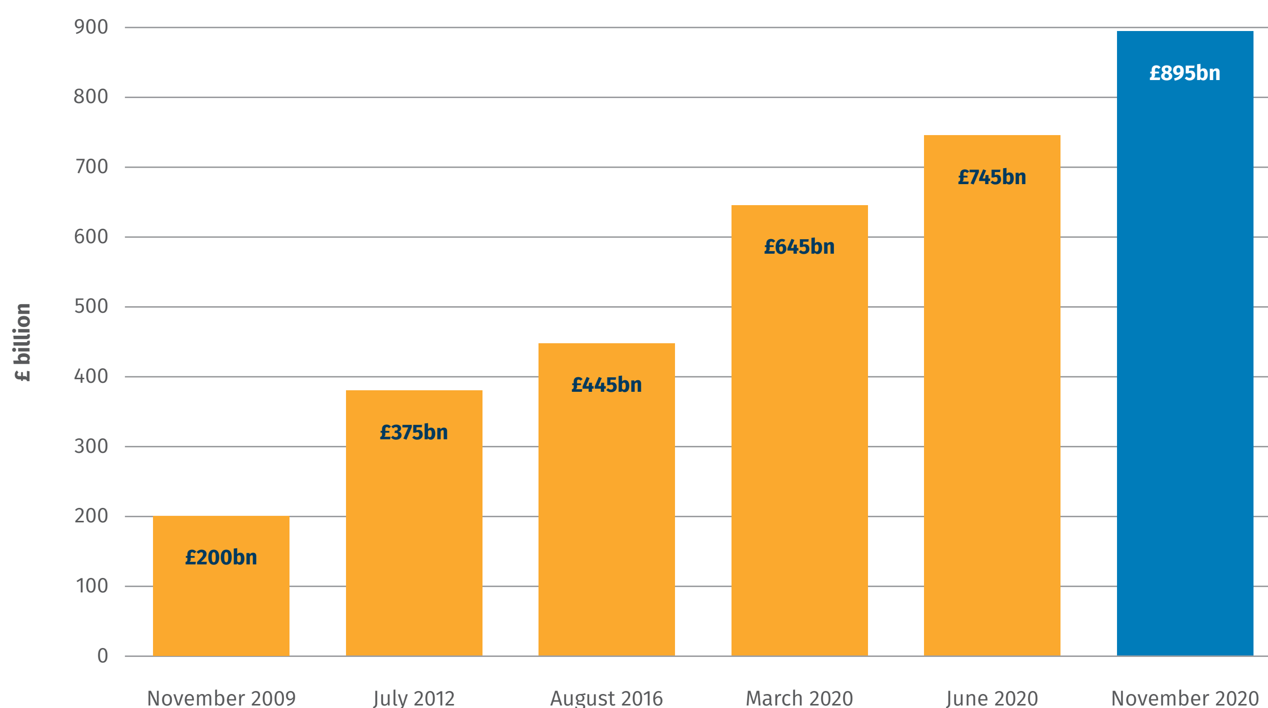
GLOBAL PERSPECTIVE

It is interesting to note that record high inflation appears to be a global trend impacting many advanced economies at the moment. So, is it monetary policy or the expectation mechanism that is the underlying cause of this high inflation trend?

In the UK, unconventional monetary policy (quantitative easing) was first introduced in 2009 as a short-term measure to support the economy through the global financial crisis. However, over the last decade or so, the program has expanded substantially, and it has become the Bank of England's main monetary policy tool. In total, the Bank of England had bought £875 billion of Government bonds and £20 billion of corporate bonds, totalling £895 billion in assets by the end of 2021.[7]

The below graph sets out how the value of bond assets purchased by the Bank of England has grown since the introduction of unconventional monetary policy (quantitative easing) in 2009.[7]

Bank of England bond purchases by the month that new purchases were announced



Source: Bank of England, 'What is quantitative easing?': https://www.bankofengland.co.uk/monetary-policy/quantitative-easing [accessed 6 July 2021]

The UK's Economic Affairs Committee (EAC) conducted an inquiry into the use of quantitative easing by the Bank of England with findings published on the UK Parliament website. In summary this inquiry concluded:

- The effects of quantitative easing remain poorly understood and in recent years, particularly during the COVID-19 pandemic, the Bank of England has struggled to explain why it was the appropriate response to particular economic circumstances.[7]
- While the EAC recognises that quantitative easing has prevented economic crises from spiralling downwards, its effect on inflation and output is uncertain, and it may also have increased wealth inequality by raising the price of certain assets, benefitting those who own them.[7]
- Quantitative easing has also made the Bank of England and HM Treasury policymaking more interdependent, blurring monetary and fiscal policy, and this has started to erode the perception that the Bank has acted wholly independently of political considerations.[7]
- The design of the quantitative easing program and the size of the Bank's balance sheet—now equivalent to 40% of GDP—has increased the sensitivity of the public finances to a substantial rise in debt servicing costs if the Bank needs to raise interest rates to control inflation.[7]

AUSTRALIAN INSIGHTS

As noted in the Reserve Bank of Australia's (RBA) Annual Report 2022, lessons can also be drawn from Australia's newly evolving experience with using various unconventional monetary policy measures (including bond purchasing/quantitative easing). In summary, the RBA concluded:

- Time-based forward guidance implied in the yield target helped to ease financial conditions at the height of the pandemic, this feature meant the yield target was not well-suited to respond to changing conditions and eventually became ineffective as the economic recovery progressed.[11]
- The RBA discontinued the yield target when it was assessed to be inconsistent with the RBA's policy aims. The exit was disorderly and associated with bond market volatility and some dislocation in the market.[11]
- The bond purchase program is expected to entail a sizeable financial cost to the Bank, although there are some offsetting financial benefits for the broader public sector balance sheet.[11]
- The RBA noted the importance of evaluating any potential future use of a bond purchase program against other policy options at the time, taking into account the costs of the bond purchase program under a full range of scenarios.[11]
- A review of the RBA's bond purchase (quantitative easing) program is published on the Reserve Bank's website.[12]

FEDERAL BUDGET OCTOBER 2022/2023

Key Economic Indicators

- Inflation is expected to peak at 8 per cent in the December quarter 2022, before moderating gradually over the next 2 years.[1]
- Economic activity is forecast to slow from 3¼ per cent in 2022–23 to 1½ per cent in 2023–24.[1]
- Unemployment rate forecast to rise to 4½ per cent by the June quarter of 2024.[1]
- Budget deficits projected for a decade and gross debt as a share of GDP at its highest level in over 70 years.[1]
- Underlying cash deficit is estimated to be $36.9 billion (1.5 per cent of GDP) in 2022–23.[1]
- Projected rises in gross debt as a share of GDP, stabilising at 46.9 per cent of GDP in the last 3 years of the medium term.[1]

Superannuation Specific Plans - Budget October 2022/2023

- The Government has set a goal of building 1 million new homes over five years from 2024. Homes are expected to be built under a new national Housing Accord under which the Government will seek to facilitate investment by superannuation funds (amongst other institutional investors) into affordable housing by providing funding to make more projects commercially viable.[13]

- AustralianSuper, the Australian Retirement Trust, Aware Super and CareSuper have publicly backed the Accord but the challenge ahead will be how to translate the goal into financing new investments in ways which also meet super fund's primary obligation to invest for the best financial interest of members. The next step in the discussions will be the Treasurer's Investor Roundtable on November 25, 2022 which will include various representatives from the super fund sector.[14]
- The age for downsizer contributions to superannuation is proposed to be reduced from age 60 to age 55. An individual can make a downsizer contribution of up to $300,000 of proceeds from the sale of their home as a one-off, post tax contribution to superannuation. Downsizer contributions do not count towards non-concessional caps.[13]

CONTACT AXIS

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Give us a call on **1800 111 299** or email **super@axisfg.com.au**

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