Opinion

No, prime minister, higher inflation was home-grown

Government forecasts are overly optimistic. The CPI peaking at about 6 per cent until mid-2023 is the legacy of the fiscal overcompensation for COVID-19.

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Detailed economic modelling that I have been undertaking over the past year foreshadowed an inflation outbreak [https://www.afr.com/topic/inflation-1mph], and predicts that the outbreak will get worse before it gets better.

While labour supply disruptions from COVID-19 and the war in Ukraine have played a role, in Australia and the United States some of the inflation is home-grown from the overreaction of national fiscal policy to the COVID-19 recession.

Josh Frydenberg and Scott Morrison at the JobKeeper announcement on March 30, 2020. **Alex Ellinghausen**

Underlying inflation is not yet as high as the headline consumer price index increase of 5.1 per cent in the year to the March quarter suggests. Stripping out regulated prices and the volatile items of fruit and vegetables and automotive fuel, the underlying CPI rose by 4.2 per cent.

The latest version of my paper on fiscal policy and COVID-19 [https://taxpolicy.crawford.anu.edu.au/publication/ttpi-working-papers/20109/fiscal-policy-covid-19-era] was published at the Australian National University before the recent federal budget. It confirms the prediction made last October, in an early ANU seminar version of the paper, that underlying CPI inflation will eventually reach a peak of about 6 per cent.

I expect CPI inflation to reach that rate in the December quarter and then hold around that level until the June quarter 2023.
In contrast, government forecasters have been optimistic on inflation. In its February Statement on Monetary Policy [https://www.rba.gov.au/publications/smp/2022/feb/], the Reserve Bank forecast that inflation would be only 2.75 per cent in the June quarter of 2023. The Treasury’s latest forecast in the pre-election economic and fiscal outlook was only slightly higher at 3 per cent.

The Coalition and Labor should change tack by campaigning on near-term budget savings measures.

It was good fiscal policy for governments in advanced economies to compensate the private sector for its income losses. The income losses in the industries restricted by COVID-19 could have led the affected workers and business owners to reduce their consumption, causing the weakness in economic activity to spread to other industries.

Further, it would have been inequitable to expect participants in the restricted industries to carry more than their share of the economic burden in slowing the spread of COVID-19. Thus, compensation for COVID-19 income losses was the right principle.

Levels of compensation

Generally, governments in advanced economies achieved that. A recent economic letter from the Federal Reserve Bank of San Francisco shows that, on average, in a sample of OECD countries (Canada, Denmark, Finland, France, Germany, the Netherlands, Norway, Sweden and the UK) governments provided about the right amount of compensation. That is, government compensation was enough to maintain real personal disposable income close to its trend path, despite the COVID-19 recession in GDP.

The US government went further and overcompensated the private sector for its COVID-19 losses. So much so that real personal disposable income was an average of 7 per cent *above* trend during the COVID-19 years of 2020 and 2021, despite the GDP recession. The San Francisco Fed finds that this bloating of incomes caused the US economy to run too hot on the exit from COVID-19 restrictions, contributing an estimated 3 percentage points to core CPI inflation in 2021.

Other studies have made lower estimates of the inflation impact, but there is a growing consensus that fiscal overcompensation for COVID-19 is contributing to the US inflation outbreak.

The outliers: US and Australia

My detailed economic modelling for Australia shows a similar level of government overcompensation to the US. Compared with normal, real private income was up by an average of 6 per cent in 2020 and 2021, similar to the US boost of 7 per cent. As in the US, we should expect this will contribute to inflation this year, following the lifting of COVID-19 restrictions.

Of course, if the government had done nothing, private incomes would have been weaker than normal under COVID-19. Specifically, real private income would have been 5 per cent below normal instead of 6 per cent above normal. Thus, the Australian fiscal response conferred on the private sector about $2 in compensation for every $1 of income lost to COVID-19.

This fiscal overcompensation arose from COVID-19 and non-COVID policy measures announced in 2020 and 2021 that had a large total budget cost of $429 billion, or the equivalent of 21 per cent of last financial year’s GDP.

The largest COVID-19 measure, JobKeeper [https://www.afr.com/policy/economy/here-s-a-jobkeeper-economics-lesson-for-joe-aston-20210901-p58nxu], cost $90 billion and illustrates the overcompensation. While some businesses and workers were undercompensated, there were three types of overcompensation.

First, some businesses were eligible to receive JobKeeper payments for up to three months after their operations had recovered from COVID-19; second, many stood down part-time workers were overcompensated for lost wages; and third, businesses that only narrowly qualified for the program were often overcompensated for lost profits.

JobKeeper deserved support, but it should have been better targeted to reduce overcompensation, not broadened and extended, as suggested by Labor.

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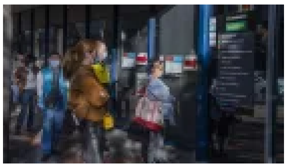

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In my forecast, government overcompensation for COVID-19 and the lifting of restrictions leads to a jump of 9.5 per cent in real household consumption in 2022-23. This boom in consumer demand drives the forecast of consumer price inflation of 5.7 per cent.

The much lower inflation of 3 per cent forecast in the budget assumes a dive in commodity prices (reflected in a 21 per cent decline in the terms of trade in 2022-23) yet a steady Australian dollar, a combination not seen since the Australian dollar was floated in 1983. It also assumes that consumers continue to save at above-normal rates for a further two years, despite being highly cashed up.

To help contain the developing outbreak of inflation, the Coalition and Labor should change tack by campaigning on near-term budget savings measures. A post-election mini-budget with savings of at least $30 billion in 2022-23 would help. Further, they should draw the lesson that they should compensate, but not overcompensate, for private income losses in any future pandemic.

Finally, the Reserve Bank should decide at its Tuesday meeting to have a path to lift the cash interest rate from 0.1 per cent to a neutral rate of around 3 per cent by year's end, if that turns out to be necessary to fight inflation. That path would be out of reach with rate rises as low as 0.25 per cent at each monthly meeting.

Chris Murphy is a developer of economic models who has been a regular economic modelling consultant to the Australian Treasury and the Monetary Authority of

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