Inflation rate is critical in RBA strategy

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With interest rates in the US dangerously close to zero, surely this provides pause for thought for the Reserve Bank of Australia.

What happens if the economy slows and the central bank has no further room for activist policy? Deflation may set in.

Generations of Australians have been schooled to believe that inflation can never fall far enough and that deflation is an affliction too exotic to contemplate seriously.

There is increasing fear that similar recessionary dynamics may hit the US. Yet, paradoxically, the Federal Reserve's strongest ally is the fact that inflation expectations remain high.

What about Australia? With reasonable growth and the cash rate at 4.75 per cent, the RBA is blessed with both less need to stimulate, and more room to move than its US counterpart. But to declare that the possibility of a liquidity trap does not exist in Australia would be foolish.

Australia, of course, has an inflation target of 2 to 3 per cent. The key is whether this target is policed symmetrically.

Is the RBA as committed to cutting rates to boost inflation when it falls below 2 per cent as it is to raising rates when it breaches the 3per cent ceiling? Current bond market returns suggest that the RBA is erring on the hawkish side.

By comparing rates of return on nominal and inflation-indexed 10-year bonds, we can estimate the market's inflation expectations. The two yields now differ by about 2.25 per cent. But this cannot simply be read as the expected rate of inflation nominal bonds incorporate a risk premium of about half a percentage point to account for the risk that inflation will erode their purchasing power.
Hence the market expects inflation to average 1.75 per cent over the next decade.

Apparently the market does not believe the RBA is committed to its inflation target.

Allowing the perception to spread that the actual target is simply "less than 3 per cent" may have been a useful tactic to establish the bank's credibility in a high inflation era. But when deflation is stalking the global economy, insisting on a rate above 2 per cent becomes just as critical.

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