Opinion

Beware the threat of reaccelerating inflation in 2025

It is awfully hard beating inflation out of the system without a real recession. Most soft landings have ended up triggering even higher interest rates.

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Pity all those poor Victorians living in the only state in Australia where house prices are falling. They seem to be truly cursed. Talking to Kiwi mates in the construction game during the week, they blindsided me when they blamed Victoria, of all places, for New Zealand's labour shortages. And this is coming from a country that is in a full-blown recession and which has had one of the largest increases in unemployment – from 3.2 per cent to 4.6 per cent – in the developed world.

My Kiwi building buddies claimed the change in the Victorian government's gross debt outstanding – exploding from below $50 billion in 2019 to almost $300 billion today – was sucking tradies from their homeland.

Nobody appears to be contemplating a reacceleration of inflation in the years ahead. **David Rowe**

The Kiwis relayed that in Australia, lollipop ladies earn more than $200,000 a year. They explained how the Aussie firm retained to build Christchurch's 30,000-seat rugby stadium were astonished to learn that Kiwi labourers do not clock off work when it rains. My pals chortled that in the relatively de-unionised New Zealand employment market, workers simply put their raincoats on.

In the same way that few folks are seriously talking about politicians matching revenues with expenses and balancing their burgeoning budget deficits, it is surprising that nobody appears to be contemplating a reacceleration of inflation in the years ahead.

At least in the United States, markets seem convinced that the inflation genie is being shoved back into its bottle [https://www.afr.com/link/follow-20180101-p5k2iw]. It reminds me of how six to 12 months ago, nobody genuinely thought we would get a hard landing, unless you lived in New Zealand. Soft landings were the overwhelmingly dominant meme of the day.

Yet the catalyst for the enormous volatility shock this month was the sudden realisation that the rise in the US jobless rate from 3.3 per cent to 4.3 per cent had triggered this column's preferred real-time recession indicator, known as the Sahm Rule. This implied that a US hard landing might be afoot. Not a catastrophic recession, mind you – just the run-of-the-mill variety characterised by a normalisation of the unemployment rate.

The savage draw-down in equity valuations has nevertheless been superseded by far calmer – even ebullient – price action in the ensuing weeks. And this appears to have been galvanised by feverish anticipation around the world's most important central bank slashing interest rates in September. The tightening cycle is over!

History teaches us that the dual-mandated Federal Reserve will move assertively to reduce rates if it thinks unemployment is going to climb sharply due to the advent of a bona fide recession.

Statistically unlikely

And this brings us to an important rub for those still longing for soft landings: they are extraordinarily rare in the US, and when they do materialise, they typically presage a potentially cataclysmic policy failing. A further wrinkle is that it can take years to figure this out.

Our economics team has studied every US cycle since World War II. Whereas there have been 13 recessions over this eight-decade period, there were just three soft landings. The latter are defined as an event where the Fed raising rates does not precipitate a significant increase in unemployment, which is precisely what the Fed and the similarly dual-mandated Reserve Bank are hoping to achieve. Hope is emphasised here precisely because this contingency is so statistically unlikely.

Applying this definition, there have been only three soft landings, and just one that could be classified as a success. They are the first half of the 1960s, the mid-1980s, and during the mid-1990s. In two of these three episodes, the Fed failed. That is to say, there was no durable landing per se.

In the 1960s case study, core inflation did decline to a benign level in the first half of the decade after the Fed had raised rates from about 1.2 per cent in 1961 to 5.8 per cent in 1966. But after the central bank lowered rates to 3.8 per cent, inflation reaccelerated aggressively again over the remainder of the decade.

The same pattern asserted itself in the mid-1980s soft landing: rate increases from about 8.5 per cent to 11.5 per cent initially crushed inflation for a time, only for subsequent cuts down to 5.9 per cent to leave a legacy of reaccelerating inflation in the latter part of that decade.

The one success was the restrictive measures applied during the mid-1990s, wherein rates rose from 3 per cent to 6 per cent, which did eventually help the Fed

hit its 2 per cent inflation target.

The lesson here is that it is awfully hard beating inflation out of the system without a real recession: over the past 75 years, the US has endured 13 recessions relative to one tractable soft landing. The need for a cathartic realignment is particularly important when one experiences excess demand that drives high productivity-adjusted wage growth, which in turn bleeds into elevated services inflation.

The challenge during these cycles is not just how much businesses have to pay people as proxied by wage growth; it is just as equally a function of how many folks they have to hire to get a job done. And in Australia and New Zealand, productivity-adjusted wage growth has been running at between 6 per cent and 7 per cent annually, more than double the pace required [https://www.afr.com/link/follow-20180101-p5k5l4] to get inflation sustainably back to the central banks' targets.

In this respect, there is a case that New Zealand is streets ahead of its Antipodean sibling. The Reserve Bank of New Zealand is seeking to lift unemployment to 5.4 per cent, and crystallise its current recession, in the name of dampening rampant labour cost growth. And the data signals that it is well progressed on this mission, which is exactly why the RBNZ can now start easing its cost of capital.

The risk for investors is that central banks ease monetary policy too quickly based on their notoriously rubbery forecasts.

Back in sleepy hollow, however, we are petrified about any increase in our historically very low 4.2 per cent unemployment rate despite it being well below the RBA's 4.75 per cent full-employment estimate and, therefore, inflationary. This is because Martin Place appears not to want to ruffle political feathers. So we are, for now, tolerating globally high inflation in the hope that it will magically mean-revert by some time in 2027.

Concurrently, our spendthrift politicians keep pumping the economy full of additional cash in the name of buying votes.

The risk for investors is that central banks ease monetary policy too quickly based on their notoriously rubbery forecasts. The worry is that we see a reacceleration of inflation in 2025 and/or 2026 because money is too cheap and politicians have developed a persistent propensity for spending it.

While markets are now myopically focusing on near-term interest rate relief, which is what they are best at doing (handicapping the present), the risk is they wake up next year and face a very different world to the one they imagined.

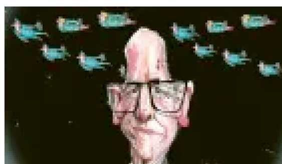
At a lunch during the week, a very smart billionaire's consigliere, who went by the self-appointed title of the "no surprises guy", cautioned that we should watch for the seemingly never-ending supply shocks wrought by our changing geo-polity.

Whether it is war in Europe, conflict in the Middle East, the threat of major powers clashing over Taiwan, or a plague, these financial asteroid strikes seem to be becoming a constant of sorts.

As it transpired, this polymath was yet another Kiwi. And while he was zealous about the coming technology revolution in the US, which could be disinflationary in the medium term, he was clearly exercised about reaccelerating inflation in the meantime.

And he cautioned that the superior productivity growth unleased by innovations such as artificial intelligence could also bequeath us loftier neutral interest rates.

In the one soft landing since World War II, the Fed lowered interest rates by only 75 basis points. Many roads, therefore, could lead us towards higher-for-longer "states of nature", which could slowly asphyxiate the sub-prime and zombie borrowers that have been financed by the rapidly growing non-bank lending sector, as some super funds are discovering as their private credit exposures blow up [https://www.afr.com/link/follow-20180101-p5k5h1].



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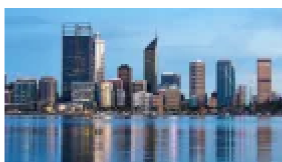

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