



Macroeconomic policies for inflation: lessons learned from COVID-19

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Overview of recent inflation episode

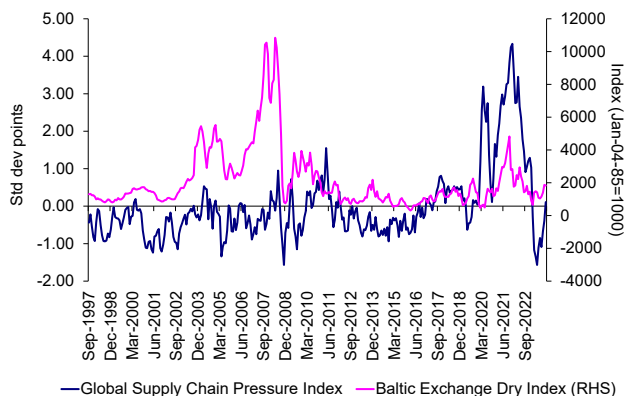
Lockdown caused both demand and supply shocks

In the face of a global pandemic, the like not seen for 100 years, governments around the world implemented measures to help stem the transmission of the coronavirus, including lockdowns. These actions shut down many sectors of the economy, especially those sectors involving human contact, such as accommodation and food services, arts and recreation services. Many businesses were forced to close, causing workers to lose their jobs and receive lower income, pushing down aggregate demand in the process. This act of stopping an economy from functioning normally – by restricting business activities and the movement of people – resulted in a multitude of shocks to both the demand and supply sides of the economy.

The supply shocks reduced the capacity of economies around the world to produce goods and services at given prices, while the demand shock lowered consumers' ability or willingness to purchase goods and services at given prices.

For most countries, the lockdowns imposed on their own domestic industries were exacerbated by lockdowns in other nations. They disrupted production of both intermediate inputs and final goods, ultimately causing global supply chains to grind to a virtual halt, while international transport costs associated with goods and commodities rocketed. In Australia, during the initial period of COVID-19, some manufacturers and food processors had difficulty securing packaging materials, and the agriculture sector faced shortages of fertiliser and pesticides due to factory shutdowns in China.¹

Figure 1: Global Supply Chain Pressure Index and Baltic Exchange Dry Index



Source: NYFEDLSE, The Baltic Exchange, Haver, KPMG

The early phase of the pandemic, especially in the period prior to the development of the COVID-19 vaccine, was a period of heightened uncertainty. Businesses experienced constrained cash flows, and at a macro level, this translated to increased volatility in financial markets across the globe.

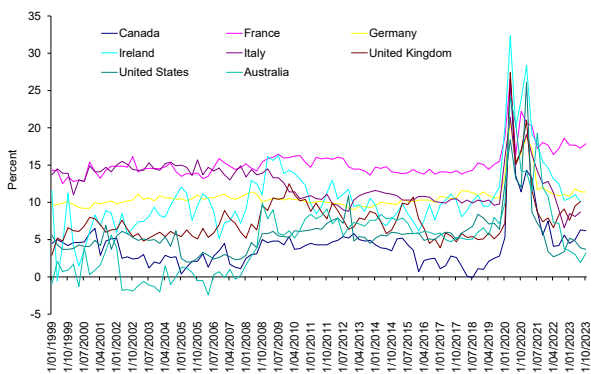
Australia entered a technical recession for the first time in almost three decades as its GDP contracted in the March and June quarters 2020, with household consumption falling by 12.7 percent over the year to June 2020. The seasonally adjusted unemployment rate jumped sharply from 5.2 percent in March 2020 to 7.5 percent in June 2020, with hundreds of thousands of workers laid off and unable to find alternative employment.²

¹Parliament of Australia (2020), Inquiry into the implications of the COVID-19 pandemic for Australia's foreign affairs, defence and trade, https://www.apf.gov.au/Parliamentary_Business/Committees/Joint/Foreign_Affairs_Defence_and_Trade/FADTandglobalpandemic/Report.

² ibid

Central banks and governments around the world responded with large stimulatory policies to underpin demand and inject liquidity into the economy. Ultimately, many of these policies supported household income which, given that the physical capacity to consume had diminished due to lockdowns, resulted in higher saving rates across most advanced economies. These increased by a factor of two or more during the pandemic, putting households in a strong position to spend at a future point in time.

Figure 2: Household saving rate in selected advanced economies



Source: National sources, Macrobond, KPMG

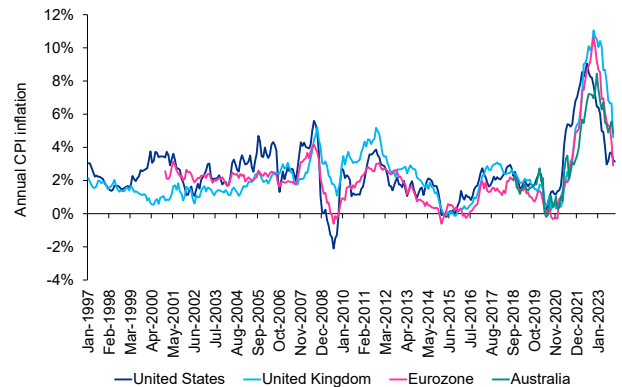
Post-lockdown surges in inflation

One of the greatest human achievements we have seen in decades was the mobilisation and collaboration of the world’s science community to develop, test and mass produce a vaccine for COVID-19 within 12 months; an amazing time frame given the ‘normal’ time frame for developing a new vaccine is usually between 10 and 15 years. While economic activity normalised after the vaccine became more widely available, allowing production to ramp up and services to recommence, problems associated with integrated global supply chains and transportation took much longer to resolve.

The uncertainty, and to some extent, hysteria associated with the pandemic, created the impetus for governments and central banks to adopt a range of policy measures aimed at stabilising businesses and households. Some of these policy initiatives were new and novel, and therefore untried, while some were from the standard fiscal and monetary policy playbooks adopted in previous crises.

This imbalance between demand and supply led to a rapid rise in inflation, particularly in developed economies, from mid-2021. This was exacerbated by supply chain problems in early 2022 caused by the commencement of the Russia–Ukraine war, which pushed up the prices of oil, natural gas, fertiliser, and food.

Figure 3: Annual headline inflation in advanced economies



Source: ECB, ONS, ABS, BLS, Haver, KPMG

In some major emerging market economies, including Brazil, South Korea, Mexico, and South Africa, policy rates began to be raised in response to the surges in inflation sooner than in advanced economies. In December 2021, the Bank of England was the first of the major central banks in advanced economies to raise rates, increasing its Bank Rate from 0.1 percent to 0.25 percent. The US Federal Reserve soon followed, increasing the Fed Funds Rate (FFR) by 25 basis points in March 2022. The European Central Bank started raising rates in July 2022 in response to eurozone annual inflation increasing to 8.6 percent in June.

The initial rise in inflation was delayed in Australia compared to its global counterparts, largely as a consequence of lower domestic wages growth compared to other advanced economies. In addition, the rise in energy prices in late 2021 due to energy supply issues and the Russia–Ukraine war impacted the United States and Europe but took longer to flow through to electricity and gas prices in Australia, which is a net exporter of gas and less dependent on international energy supply.³ Nonetheless, global energy pricing eventually flowed through, and domestic supply issues also arose, with coal plants being offline and affected by flooding. These factors pushed up energy prices in Australia in 2022.

Wholesale electricity prices in Australia reached a peak in mid-June 2022, leading the Australian Energy Market Operator (AEMO) to implement a price cap for several days in some states. High-cost generators whose production cost was above the cap then ceased supplying electricity until directed to do so by AEMO. As a result, the National Electricity Market became difficult to operate, and AEMO suspended the NEM between 15 and 24 June.⁴

Price inflation of agricultural products, particularly wheat, corn and fertiliser started to lift in 2021 and rose sharply in 2022 following the onset of the Russia–Ukraine conflict. In Australia, inflation of food prices picked up later in 2022 and were exacerbated by the flooding on the east coast.

Second-hand vehicle prices in Australia rose sharply through 2021 and 2022 as demand lifted amid backlogs in the new car market, which were caused by disruptions in car production due to the concurrent shortage of semiconductors.

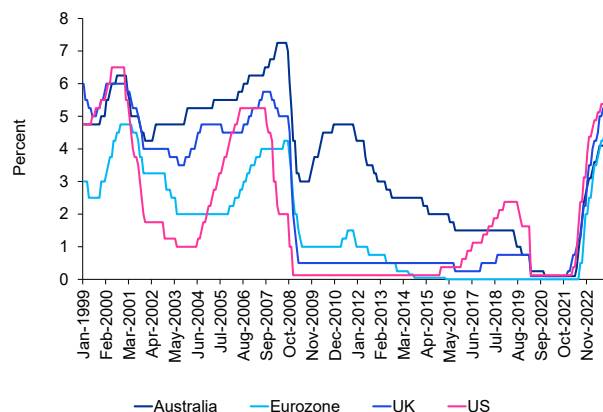
Annual inflation for tradeables (goods and services that are highly exposed to international trade) lifted from 3.1 percent in September quarter 2021 to 4.9 percent in December quarter 2021, before rising sharply to the peak of 8.7 percent in December quarter 2022.

The development in non-tradables inflation, driven by domestic factors, lagged that of tradables by about a quarter, with its peak of 7.5 percent occurring in March quarter 2023.

Annual inflation for tradables came down significantly from its peak to 1.5 percent in December quarter 2023 as prices were lower compared to 12 months earlier for some components, including imported goods of clothing, footwear, furniture and household appliances. Meanwhile, annual inflation for non-tradables in December quarter 2023 remained elevated at 5.4 percent owing to price increases for new dwellings, rents, insurance, and electricity.

The Consumer Price Index (CPI) annual inflation accelerated from 3.5 percent in December quarter 2021 to 5.1 percent in March quarter 2022. The Reserve Bank of Australia (RBA) initially believed the situation in Australia was ‘different’⁵ and delayed raising interest rates (see more detailed discussion in Section 2.1). They eventually raised the cash rate in May 2022 for the first time since November 2010, marking the start of one of the most aggressive nominal cash rate tightening cycles in Australian economic history.

Figure 4: Policy rates in advanced economies



Source: BoE, ECB, FRB, RBA, Haver, KPMG

³ Macdonald-Smith, A & Ludlow, M (2021), Australia ‘not immune’ to energy price crisis, Australian Financial Review.

⁴ Reserve Bank of Australia (2022), Statement on Monetary Policy, August 2022.

⁵ Philip Lowe (2021), Today’s Monetary Policy Decision, RBA, <https://www.rba.gov.au/speeches/2021/sp-gov-2021-11-02.html>.

Macroeconomic policies adopted in Australia in response to the COVID-19 pandemic

This section of the report provides a summary of the monetary and fiscal policies enacted in Australia that were aimed at stabilising the domestic economy during the Covid pandemic.

Monetary policy measures

During the pandemic, central banks in advanced economies employed a range of monetary tools to support their economies and financial systems, decreasing their standard policy rates to historical lows and reactivating facilities introduced during the Global Financial Crisis (GFC). The objectives of these responses adhered to the traditional mandates of central banks, which were to meet their employment and inflation targets by easing financial conditions to support the economy when facing a demand shock.⁶

At the start of the pandemic, many financial markets became dislocated due to a large increase in the demand for cash by banks, other financial entities, non-financial businesses and households, and constraints on the ability of dealers to intermediate markets.⁷ This led to a significant tightening in financial conditions across economies, with sharp rises in transaction and funding costs, as well as the beginning of (self-perpetuating) asset fire sales.⁸

Central banks implemented their measures over two overlapping phases. The first phase was focused on restoring market functionality by reversing the tightening in financial conditions, which was deemed necessary for the effective transmission of monetary policy. The second phase was targeted at cushioning economies amid a sharp demand shock by reducing interest rates and providing support for the flow of credit to borrowers.⁹

The RBA was no exception – the tables below show the range of tools it employed during the pandemic to support the economy and the functioning of financial markets.¹⁰

⁶ Vallence, C & Wallis, P (2020), The response by central banks in advanced economies to COVID-19, RBA, <https://www.rba.gov.au/publications/bulletin/2020/dec/pdf/the-response-by-central-banks-in-advanced-economies-to-covid-19.pdf>.

⁷ ibid

⁸ ibid

⁹ ibid

¹⁰ Reserve Bank of Australia (2024), Supporting the economy and financial system in response to COVID-19, <https://www.rba.gov.au/covid-19/#:~:text=In%20response%20to%20the%20COVID,of%20credit%20to%20the%20economy.>

Table 1: Monetary policy measures employed to support the economy

Monetary policy measures	Objectives
<p>Lowering the cash rate target to 0.1 percent: The cash rate was reduced twice in March 2020 from 0.75 percent to 0.25 percent, and once more in November 2020 to an ultra-low rate of 0.1 percent.</p>	<ul style="list-style-type: none"> - To boost the cash flow of businesses and households - To assist trade-exposed industries through the exchange rate
<p>Government Bond Purchase Program (Quantitative Easing): In November 2020, the Bank introduced its Bond Purchase Program (BPP), involving the planned purchase of \$100 billion of bonds issued by the Australian Government and states and territories over six months. The BPP was extended several times: a further \$100 billion was deployed from April to September 2021 at a rate of \$5 billion a week; then, from September to November 2021 at a rate of \$4 billion a week; and finally, purchases of \$4 billion a week until mid-February 2022 when the Bank decided to discontinue the program. In total, the BPP led to the purchase of \$281 billion of Australian, state and territory bonds.¹¹</p>	<ul style="list-style-type: none"> - To lower the whole domestic structure of interest rates - To lower borrowing costs and exchange rate (the normal transmission mechanisms of monetary policy)
<p>Term Funding Facility (TFF): The TFF was announced in March 2020, with an increase and extension announced in September 2020. The interest rate on the TFF was reduced from 0.25 percent to 0.1 percent in November. In June 2021, the TFF closed to new drawdowns as scheduled, at which time \$188 billion of funding was outstanding, but the facility will continue to support low borrowing costs until mid-2024 as it has provided low-cost fixed-rate funding for three years.</p>	<ul style="list-style-type: none"> - To lower funding costs for the entire banking system, thus lowering the cost of credit to households and businesses - To provide an incentive for lenders to extend credit to businesses
<p>Australian Government bond yield target: In addition to targeting the cash rate, to respond to the pandemic, the RBA also targeted a risk-free interest rate further out along the yield curve by purchasing government bonds. In March 2020, the Bank introduced a target for the yield on three-year Australian Government bonds of around 0.25 percent. In November 2020, the target was lowered to around 0.1 percent. In November 2021, the Bank announced the target on the April 2024 bond had been discontinued.¹² This measure is different from the BPP in that the BPP did not target a particular level of yields, but rather set a quantity of bonds to be purchased over a set time period.¹³</p>	<ul style="list-style-type: none"> - To lower funding costs across the economy

¹¹ Michelle Bullock (2022), Review of the Bond Purchase Program, RBA, <https://www.rba.gov.au/speeches/2022/sp-dg-2022-09-21.html>.

¹² Reserve Bank of Australia (2023), Review of the Yield Target, <https://www.rba.gov.au/monetary-policy/reviews/yield-target/index.html>.

¹³ Bullock, M (2022), Review of the Bond Purchase Program, <https://www.bis.org/review/r220921b.pdf>.

Table 2: Monetary policy measures employed to support the functioning of financial markets

Monetary policy measures	Objectives
<p>Expansion of liquidity operations: In March 2020, the RBA announced it would conduct regular one-month, three-month and six-month maturity repurchase operations, which were later scaled down given the existing substantial liquidity in the system and the commencement of the TFF.</p> <p>In May 2020, the RBA also decided to broaden the range of eligible collateral for the Bank’s domestic market operations to include Australian dollar securities issued by non-bank corporations with an investment grade credit rating.</p>	<ul style="list-style-type: none"> - To provide extra liquidity to the financial system
<p>Purchase of government bonds in the secondary market: The RBA purchased Australian government bonds and semi-government securities in the secondary market to support its smooth functioning.</p>	<ul style="list-style-type: none"> - To provide liquidity to the government bond market, a key market for Australian financial system providing the pricing benchmark for many financial assets
<p>USD FX swap line: The RBA and the US Federal Reserve established a temporary swap line for the provision of US dollar liquidity, allowing the RBA to access up to US\$60 billion in exchange for Australian dollars. The US dollars were made available to financial institutions operating in Australian via repos with the RBA. The swap line expired on 31 December 2021.</p>	<ul style="list-style-type: none"> - To support US dollar funding

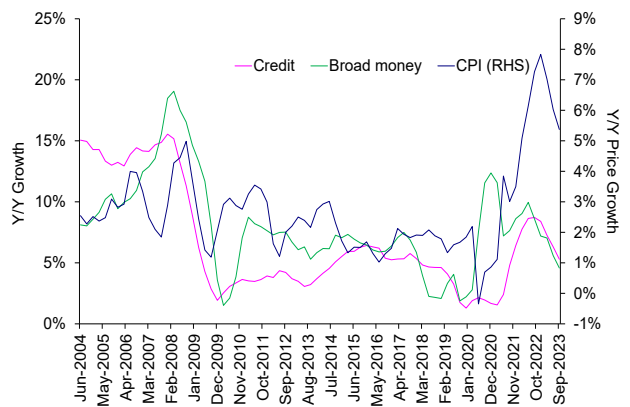
Most of the policy settings were in place until at least the end of 2021. As inflation around the world began to surge from mid-2021 the RBA joined other central banks and embarked on a rapid tightening cycle from mid-2022 onwards. The cash rate was raised by 25 basis points in May 2022, followed by four consecutive 50 basis point increases from June to September and eight 25 basis point increases from October to November 2023 (with a break in April 2023 and from July to October 2023).

The bond purchase program introduced in 2020 was the first time Quantitative Easing (QE) was formally applied by the RBA. Prior to the pandemic the then-Governor Philip Lowe outlined three reasons behind his reluctance towards using QE in Australia. Firstly, it created unhelpful incentives for banks to take more risk and for governments to spend. Secondly, ultra-low rates hurt the banks' profitability and lowered their capacity to lend, as well as allowed zombie firms to continue to operate. The third reason was the blurring of lines between monetary and fiscal authorities, and the view that asset price inflation resulting from QE worsens inequality.¹⁴

However, by October the following year, concerned about the severe impacts of the downturn and economic scarring from entrenched unemployment, the Bank commenced a \$100 billion formal QE program.

In Australia, measures of money grew strongly from the onset of COVID-19 to the first half of 2022, well beyond the liquidity crisis period. Broad money annual growth climbed from 2.1 percent in February 2020 to reach a first peak of 12.6 percent in February 2021 and a second peak of 10.4 percent in May 2022 before slowing down from late 2022. This reflected strong growth in deposits at authorised deposit-taking institutions (ADIs), driven by new credit provided by the banking sector, changes to the mix of banks' funding pertaining to changes in preferences of investors, and a contribution from the RBA's purchases of government bonds.¹⁵

Figure 5: Credit and broad money growth (quarterly)



Source: Reserve Bank of Australia, KPMG

¹⁴ Lowe, P (2019) Unconventional monetary policy: some lessons from overseas, Reserve Bank of Australia, <https://www.rba.gov.au/speeches/2019/sp-gov-2019-11-26.html>.

¹⁵ Reserve Bank of Australia (2020), Statement on Monetary Policy – August 2020, Box D: Recent growth in the money supply and deposits, <https://www.rba.gov.au/publications/smp/2020/aug/box-d-recent-growth-in-the-money-supply-and-deposits.html>.

Fiscal policy measures

The Australian Government and state and territory governments also implemented large fiscal stimulus packages in response to the pandemic. At the federal level, fiscal stimulus, consisting of expenditure and revenue measures worth A\$312 billion, equivalent to 15 percent of 2020 GDP, was authorised through to FY25, with nearly two-thirds of the stimulus occurring by the end of FY21. These measures included the JobKeeper wage subsidy program (A\$89 billion) and the health response package (A\$20 billion).

The timeline of fiscal stimulus provided by the Australian Government during the pandemic is as follows:

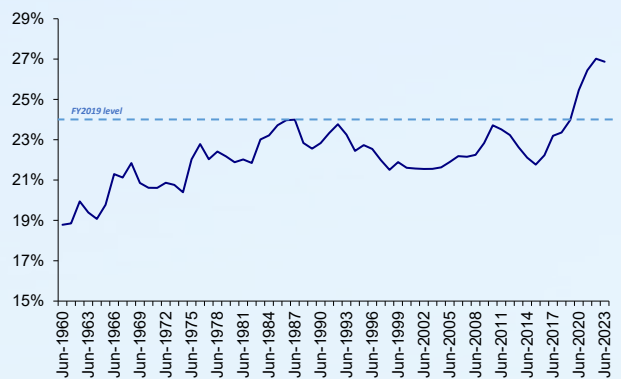
Time	Fiscal policy measures
March 2020	<p>The Australian Government introduced a series of economic and health packages, totalling A\$217.1 billion (11 percent of GDP) through FY24 over two rounds.</p> <p>The first round (A\$17.6 billion) included a one-off stimulus payment to welfare recipients, accelerated depreciation deductions, expansion of applicable eligibility criteria for instant asset write-offs, cash flow assistance for businesses, and financial support to sectors, regions, and communities disproportionately affected by the pandemic.</p> <p>The second round (A\$66 billion) included the Coronavirus Supplement (a top-up payment to JobSeeker unemployment benefits and welfare recipients) and additional economic support for households and businesses. The flagship JobKeeper wage subsidy program (A\$130 billion) was then introduced near the end of March to help Australians maintain their jobs.</p>
July 2020	<p>The July update to Australia's Economic and Fiscal Outlook revised down the cost estimate of the JobKeeper wage subsidy program to A\$85.7 billion, including an extension at a tapered level for six months to the end of March 2021.</p> <p>A new JobTrainer Skills package – a training program for job seekers – was introduced, along with additional health support to boost the testing capacity.</p>
October 2020	<p>An additional stimulus package (A\$98.2 billion) was announced in the FY21 budget, including a new JobMaker program (A\$73 billion), new measures (such as loss carry-backs and a personal income tax cut), as well as the extension of existing measures (the temporary Coronavirus Supplement, other income support measures, full expensing, and infrastructure investment, among others).</p>
December 2020	<p>Additional funding (A\$7 billion, 0.4 percent of GDP) was introduced in the Mid-Year Economic and Fiscal Outlook (MYEFO) to strengthen the national vaccination program and extend the Coronavirus Supplement and other income support measures for another three months through to the end of March 2021.</p>
May 2021	<p>Further stimulus measures amounting to A\$48.4 billion were then provided in the FY22 budget, including additional tax reliefs for low and middle-income earners, extending temporary full expensing and loss carry-backs for businesses, and more spending on infrastructure investment and training programs.</p>

In addition to the above measures, the Australian Government authorised up to A\$15 billion to be invested in asset-backed securities to assist funding for small banks and non-bank financial institutions, as well as A\$20 billion for loan guarantees with participating banks to cover the immediate cash flow needs of small to medium sized enterprises (SMEs). The latter scheme was renamed as the SME Recovery Loan Scheme in March 2021 and extended through to the end of December 2021.

State and territory governments also provided their own stimulus packages, totalling A\$50 billion, including payroll tax relief for businesses and relief for households, support for health spending, construction, and infrastructure.

The latest national accounts show government spending representing 27.5 percent of GDP in the September and December quarters of 2023; a proportionate level of spending only seen previously in Australia in the June quarter 2020 (27.4 percent) and September quarter 2021 (27.5 percent) – periods when the economy shrank by 6.9 percent and 1.9 percent respectively.

Figure 6: Real government spending (federal and state combined) as a share of GDP – annual



Source: Australian Bureau of Statistics, KPMG

Evaluation of policy responses adopted during Covid and in reaction to rising inflation

Introduction

Hindsight is 20/20.

The challenge with considering if and how domestic inflation was materially impacted by the adoption of excessive monetary and fiscal policy support packages during Covid is understanding the social and political environment in which decision-making was being undertaken.

It is not an exaggeration to say that at the beginning of the pandemic, world leaders did not know how bad the negative health consequences – and therefore any economic downturn – would be. There was genuine concern the world was looking down the barrel of another Spanish flu pandemic in terms of the number of potential deaths, while the economic dislocation was being talked about on a scale similar to the Great Depression.

It was this prospect of a dual health and economic catastrophe that faced politicians and public officials in early 2020 that shaped policy responses. The nearest previous equivalent was the GFC, where the ‘battle cry’ from the government of the day was ‘go early, go hard, go households’. Arguably, Australia navigated the GFC as well as any country could, and this policy response framework of ‘throwing the kitchen sink’ at the problem took hold across all levels of government and our central bank.

In other post-crisis evaluations undertaken by global and state economic agencies, it would seem there is a consensus that the broad policy responses adopted by central banks during the pandemic were correct.¹⁶ But with the benefit of hindsight, it can also be reasonably argued that the totality of measures that were implemented were ultimately too stimulatory, leading to a higher than necessary increase in money supply, which materially contributed to the inflationary pressures experienced in the post-Covid economic environment.

This assessment may be slightly harsh given the context of policy decision-making, but the consequence of the excessive stimulation has been economies operating with aggregate demand above potential GDP, which invariably stokes inflation.

Even though the policy decisions being made at the time were done so under extreme uncertainty and in response to what *hopefully* was a once-in-a-generation event, there is still benefit in evaluating this episode to understand whether any lessons can be learned and adopted across a normal policy environment.

¹⁶ International Monetary Fund (2023), Regional Economic Outlook: Asia and Pacific, Challenges to sustaining growth and disinflation.

Consideration of the monetary policy measures taken in Australia

Overarching assessment

KPMG believes the RBA adopted a series of policy responses that were necessary and appropriate under the circumstances to rapidly stabilise the system and resolve severe financial market stress when access to these markets by businesses and governments was important.

By alleviating market dysfunction, the Bank enabled the transmission of monetary policy to the economy and allowed the system to accommodate government policies, which arguably prevented long-term scarring to economies and financial systems.^{17 18}

Forward guidance

At the beginning of the pandemic, the RBA applied a 'state-based' approach to forward guidance, meaning that it committed to keeping the cash rate unchanged until particular economic conditions were met; specifically the cash rate would be maintained at extraordinarily accommodative levels until progress was made towards full employment and inflation could be sustainably within the target band.

Later, the Bank added a 'calendar-based' element in October 2020 and November 2020, indicating a time horizon of three years over which the cash rate would be unlikely to change. In February 2021, the guidance was updated to: 'The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 percent target range... The Board does not expect these conditions to be met until 2024 at the earliest'.

The adoption of this calendar-based component immediately placed the Bank in a difficult position, even if it was just from a perception perspective. The suggestion that the RBA would hold the cash rate firm over the coming three years even under changing circumstances and economic developments was a misstep; simply put, three years is a long period of time in the world of economics and to commit to a policy option that far into the future provided the RBA little room to adjust for changing circumstances.

The Australian Government Review of the RBA in 2023 found other central banks also used calendar-based forward guidance during the pandemic,¹⁹ yet the RBA, and only one other central bank,²⁰ gave guidance over an extended time horizon and did not update its guidance frequently enough when the economic outlook changed.²¹

The Reserve Bank Board's associated documentation also provided relatively little recognition of international experience where guidance had been misunderstood, nor was there evidence of discussion about how to pivot the guidance should upside risks to inflation materialise.²² The Bank has acknowledged they could have paid more attention to upside scenarios, which may have helped them alter the calendar-based component of forward guidance earlier.²³

¹⁷ Vallence, C & Wallis, P (2020), The response by central banks in advanced economies to COVID-19, RBA, <https://www.rba.gov.au/publications/bulletin/2020/dec/pdf/the-response-by-central-banks-in-advanced-economies-to-covid-19.pdf>.

¹⁸ Ramos-Francia, M & Garcia-Verdu, S (2022), Central bank response to COVID-19, <https://www.sciencedirect.com/science/article/pii/S2666143822000199>.

¹⁹ See page 50 of the Review of the Reserve Bank of Australia for the approach of calendar-based forward guidance in other advanced economies: https://rbareview.gov.au/sites/rbareview.gov.au/files/2023-06/rbareview-report-at_0.pdf.

²⁰ Sveriges Riksbank offered guidance out to 2024 for a similar length of time as the RBA. From April 2020 until November 2021, they forecast their policy rate to remain at zero for a 3-year forecast period. In February 2022, the rate was forecast to not increase until H2 2024. The central bank however raised its policy rate in late April 2022.

²¹ Australian Government (2023), Review of the Reserve Bank of Australia: an RBA fit for the future, https://rbareview.gov.au/sites/rbareview.gov.au/files/2023-06/rbareview-report-at_0.pdf.

²² Ibid

²³ Reserve Bank of Australia (2023), Review of the RBA's approach to forward guidance, <https://www.rba.gov.au/monetary-policy/reviews/approach-to-forward-guidance/index.html>.

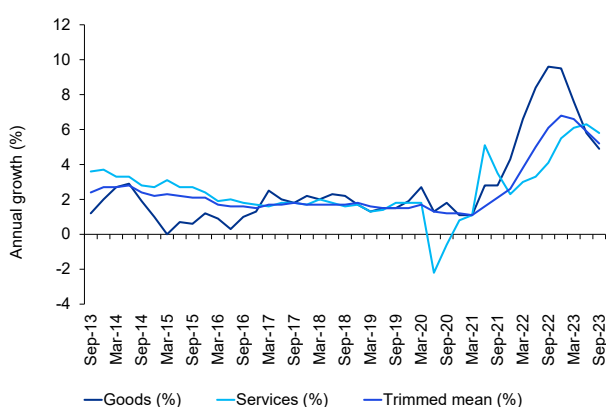
Timing of monetary support

In late 2021, although inflation had already surged and stayed higher for longer than expected, most central banks were still hopeful that the shift in prices was transitory. The Federal Reserve anticipated inflation to ease in mid-2022, and the RBA believed it was a temporary result of supply-side pressures. This belief that the surge in inflation would largely self-correct led to a delay in the normalisation of policy settings by central banks, including the RBA.

As inflation continued to rise globally and it became increasingly apparent that the surge in prices was not all transitory, Australia's economic policy settings may not have been sufficiently influenced by the contemporaneous macroeconomic environment in other comparable developed countries. At the time, Governor Lowe argued the situation in Australia was different for a variety of reasons, including:²⁴

- Australia did not face similar labour shortages to the United States
- our wages growth remained more contained than other countries due to Australia's wage-setting process
- there remained a strong cost control mindset by businesses.

Figure 7: Annual movement of goods, services, and trimmed mean CPI



Source: Australian Bureau of Statistics

Part of the RBA's policy rationale at the time was the belief that consumers would revert to spending more on services as economies reopened, unwinding the demand pressures on goods amid supply-side issues.

While all these considerations put forward by the RBA were reasonable and considered, demand for goods did not adjust quickly enough or sufficiently to alleviate the market pressures brought about by the pandemic-induced supply-side constraints, resulting in goods inflation peaking in the September quarter of 2022. Specifically:

- The RBA expectation that consumers would transfer spending from the goods sector to the services sector once lockdowns ceased and restrictions relating to personal contact ended did eventuate.
- This shift in consumer demand also occurred at a time of constrained domestic labour markets and challenges in processing the backlog of visa applications for foreign workers who had been shut out of Australia when border controls were put in place as part of the government's pandemic responses.
- The consequence of this tightness in the labour market was higher wage growth, most notably in accommodation and food services, which combined with higher non-wage input prices saw services inflation start to escalate. However, it is important to note that the large influx of immigrants from 2022 also fuelled inflation by increasing demand for goods and services, especially housing, given the existing constraints in the economy's capacity.

KPMG understands why the RBA took the view that 'Australia is different'. However, adopting this position publicly during a largely synchronous global inflation surge created a policy environment where the RBA may have been perceived to be less agile and open to alternative positions.

²⁴ Lowe, P (2021) Recent trends in inflation, Reserve Bank of Australia, <https://www.rba.gov.au/speeches/2021/sp-gov-2021-11-16.html>.

Evaluation of fiscal policy measures

Overarching assessment

KPMG appreciates that the ratcheting up of public spending during the pandemic was necessary to support large parts of the economy that were negatively impacted by the restrictions adopted by governments to minimise the health risk associated with COVID-19.

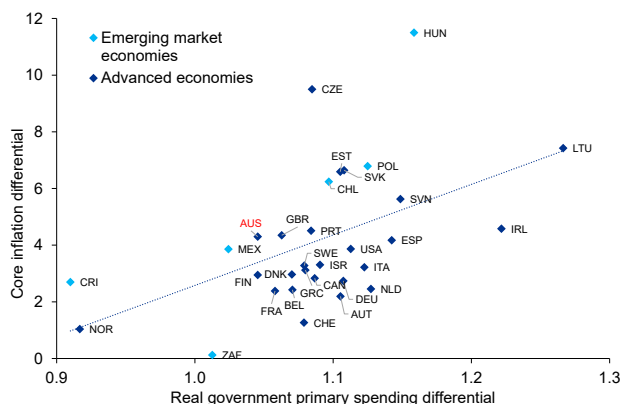
Fiscal policy measures implemented during the pandemic helped limit long-term economic scarring, while providing a strong foundation for recovery.²⁵ Nonetheless, it remains unclear whether the magnitude of fiscal support was appropriate and also how the pandemic-related stimulus contributed to the recent inflation pulse.

Relative size of fiscal support

The IMF conducted a cross-country analysis comparing the relationship between changes in government spending and changes in core inflation between 2019 and 2022.²⁶ The analysis found there was a positive relationship between higher than 'normal' government spending and stronger levels of core inflation (Figure 8).

The IMF database of country fiscal measures in response to COVID-19 showed that compared to other countries, Australia's discretionary fiscal support during COVID-19 was slightly lower than the average in advanced economies (20.2 percent of GDP in Australia as opposed to 23 percent of GDP in advanced economies), but higher than emerging market economies and developing countries. However, Australia's fiscal responses were predominantly in the form of additional spending and foregone revenue as compared to the average observed in advanced economies (Figure 9).

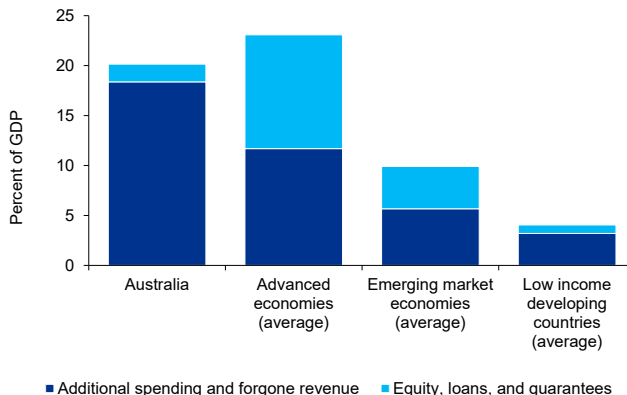
Figure 8: Correlation between 2022 changes in fiscal policy and core inflation since 2019



Source: International Monetary Fund, KPMG

Note: Core inflation differential is core inflation in 2022 minus core inflation in 2019. Real primary spending differential is real primary spending in 2022 divided by real primary spending in 2019.

Figure 9: Discretionary fiscal response to COVID-19 (percent of GDP) in selected economies as of September 2021



Source: International Monetary Fund, KPMG

²⁵ Hudson, C et al (2021), The global fiscal response to COVID-19, <https://www.rba.gov.au/publications/bulletin/2021/jun/pdf/the-global-fiscal-response-to-covid-19.pdf>.

²⁶ Empirical studies indicate that before 1985, a rise in government spending equivalent to 1 percent of GDP led to an average increase in inflation of almost 1 percentage point in the same year, which then phased out slowly. After 1985, the same shock led to an average hike in inflation of half that size, which flattened out after 3 to 4 years.

Composition of fiscal support

Figure 8 also shows that Australia’s resultant increase in core inflation was higher than most other advanced countries, suggesting that:

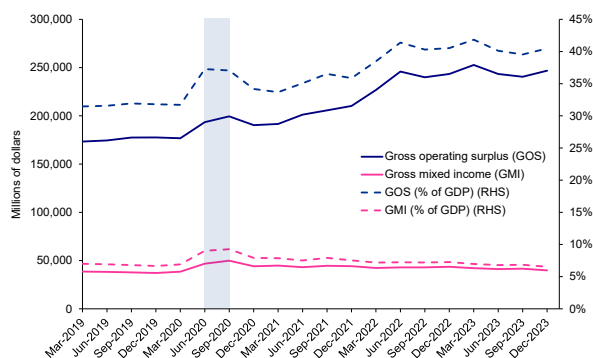
- Our domestic price adjustment processes are more sensitive to government expenditures than most other advanced economies; and/or
- The composition of government support implemented in Australia had a more potent impact on aggregate demand than the mix of fiscal programs adopted in most other jurisdictions; and/or
- Other factors impacting the domestic economy have influenced core inflation in a stronger way in Australia.

Given the quantum of Australia’s fiscal stimulus was slightly lower (as a proportion of GDP) than the average implemented in other advanced economies and we achieved stronger growth in core inflation than most other advanced economies, then of the three possibilities noted above, it would seem that the compositional mix of the stimulus package was the most likely explanation of Australia’s higher core inflation differential outcome.

The single largest fiscal support measure implemented by the Commonwealth Government was the JobKeeper payment; a wage subsidy scheme which cost A\$89 billion, representing about 22.4 percent of all forms of fiscal stimulus provided by Commonwealth and state governments during the pandemic. A defining feature of the program was that it paid eligible recipients a flat A\$1,500 per fortnight, with Treasury acknowledging this resulted in around 11 percent of recipients earning more through JobKeeper than their pre-pandemic earnings.²⁷

A counterintuitive consequence of the JobKeeper program was a substantial lift in gross operating surplus (GOS) and gross mixed income (GMI) during the June and September quarters in 2020. These were the two primary quarters where the majority of the JobKeeper package was spent (A\$70 billion out of A\$89 billion) and also the two quarters most disrupted by lockdowns.

Figure 10: Australia – Gross Operating Surplus and Gross Mixed Income



Source: Australian Bureau of Statistics, KPMG

In comparison to Germany, which utilised its Short-Time Work (STW) program during Covid as its primary labour market support mechanism, company profits fell below pre-Covid levels in 2020 Q2 and 2020 Q3 before steadying in the following two quarters.²⁸ The key differential between these two outcomes across Australia and Germany is largely due to the design variations in the wage subsidy policies adopted in the two countries.²⁹ The STW only funded 60 percent of the pay associated with the hours not worked, with the business still being responsible for paying each worker for the hours they did work.

²⁷ Australian Treasury (2023), Independent Evaluation of the JobKeeper Payment – Final Report, <https://treasury.gov.au/sites/default/files/2023-10/p2023-455038.pdf>.

²⁸ As a share of GDP.

²⁹ It is possible to infer this due to the fact that GOS and GMI (adjusted for inflation) spiked during the June 2020 and September 2020 quarters whereas compensation of employees (COE) remained flat.

A consequence of the 'generosity' of JobKeeper in maintaining workers' incomes and flowing through to higher profits and mixed incomes across the economy, was the accumulation of excess savings that allowed aggregate demand to pent up rather than naturally dissipate given the economic circumstances.

The fiscal backstop combined with temporary relief measures for financially distressed businesses and the physical limitations around households' and businesses' ability to spend, helped stabilise national savings during the early part of the pandemic.

This suite of policy measures also appears to have given confidence to consumers and investors that the government can and will underwrite the economy when needed, so that the pressure on the private sector to manage risks may have been less than in jurisdictions where less comprehensive support was provided.

This confidence, combined with other factors such as largely unaffected household incomes, higher profits and strong levels of national savings, underpinned aggregate demand in the post-lockdown period – the same time period where disrupted goods production and global supply chain problems meant aggregate supply was struggling to recover back to pre-pandemic levels. Again, this mismatch in aggregate demand and aggregate supply provided the environment for inflation to start ramping up.

Lessons learned for the future

This section of the report seeks to draw together our assessment of the monetary and fiscal policy responses to the pandemic that contributed to the current inflation pulse and to consider lessons that should be learned for the future.

Supply-side shocks should not be taken lightly

Monetary policy is usually triggered when an inflation shock occurs due to a change in aggregate demand. For supply-side shocks, such as commodity price shocks or transportation disruptions, the standard monetary policy approach is to look through the shocks if they are assessed to not leave a lasting impact on potential output.

However, if the inflation shock persistently lowers potential output, thereby creating sustained excess demand, monetary policy needs to be tightened to bring demand back into alignment with the economy's productive capacity. Separately, monetary policy should respond strongly if inflation expectations are at risk of being de-anchored due to supply shocks.

Recent research into the post-Covid inflation surge shows that supply plays a dominant role in driving inflation. This research highlights the importance of monitoring the supply side of the economy closely and not discounting the possibility of a supply shock persisting.

Managing money supply

Research by the ECB on money and inflation, particularly on the relationship between money growth and inflation, sought to understand whether the rise of money growth that occurred during the pandemic was a causal factor in the subsequent surge in inflation.³⁰

Broadly, the ECB found that the quantity theory of money remained an important economic concept that could inform central banks about the risk of higher and sustained inflation as a consequence of any surge in money growth. However, the ECB noted this conclusion was different to suggesting a causal relationship, and that the impact of QE is 'state-dependent' with a strong linkage to the strength (or otherwise) of banks, firms and households' balance sheets at the commencement of any episode of active policy response involving growing money supply.

The difference between the inflation consequences from using QE during the GFC versus the COVID-19 pandemic was that large-scale asset purchases associated with the global financial and sovereign debt crisis were used to repair the balance sheets of banks and replenish public finances. Simply, the QE funds were largely not lent out by banks during the GFC, whereas because private sector balance sheets were in a reasonable state at the onset of the pandemic, the additional funds from the recent episode of QE were taken up by businesses and households as new borrowings.

The ECB research allows us to conclude that QE on its own is not inflationary, but it can become so if agents in the economy, including banks, households, firms, and governments are able and willing to respond to lower interest rates. That is, depending on the economic state in which QE is being deployed then it has the capacity to strengthen the transmission of monetary policies, boosting growth of money supply, economic activity, and therefore inflation.³¹

³⁰ Schnabel, I (2023), Money and inflation, Speech at the annual conference of the Verein für Socialpolitik, https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230925_1~7ad8ef22e2.en.html.

³¹ *ibid*

Distributional impacts of extraordinary monetary policy

The unconventional monetary policy settings used to facilitate economic activity during Covid lowered the cost of borrowing for home ownership, causing an increase in demand for residential property, and with no corresponding rise in housing supply, average house prices increased about 40 percent between the start of 2020 and March 2022.

While this outcome occurred at the aggregate level, it is important to understand how these asset gains were distributed across the Australian population.

To do this, KPMG has analysed changes in asset values by major asset classes for Australian households disaggregated into wealth quintiles between 2018 and 2022 using data collected in the Melbourne Institute's Household, Income and Labour Dynamics in Australia (HILDA) survey.³²

As shown in the table and charts below, year-to-year growth in wealth across household quintiles varied considerably between years, obviously impacted by macroeconomic conditions, including external shocks such as the Global Financial Crisis which caused increased volatility in household wealth.

Figure 11: Equivalised household wealth by quintile (real 2022 dollars, '000)

Wealth quintile	2002	2006	2010	2014	2018	2022	2002-18 CAGR	2018-22 CAGR
1	\$ 4.9	\$ 9.8	\$ 5.3	\$ 6.0	\$ 10.3	\$ 21.2	4.8%	19.8%
2	\$ 94.3	\$ 131.5	\$ 130.7	\$ 108.0	\$ 136.5	\$ 192.9	2.3%	9.0%
3	\$ 218.8	\$ 290.9	\$ 296.4	\$ 274.6	\$ 332.3	\$ 433.4	2.6%	6.9%
4	\$ 399.2	\$ 508.7	\$ 527.4	\$ 531.2	\$ 635.9	\$ 801.7	3.0%	6.0%
5	\$1,193.6	\$1,632.7	\$1,596.3	\$1,592.0	\$1,871.6	\$2,183.1	2.9%	3.9%

Source: HILDA, KPMG analysis

³² Arguably, it would be ideal to compare data for the year immediately prior to the onset of the Covid pandemic against the year immediately following the cessation of any unconventional monetary policy settings (in this instance 2019 versus 2023). Unfortunately, wealth data in HILDA is only available every 4 years, starting from 2002.

However, given the RBA QE bond purchase program ceased in early February 2022, the TFF closed new drawdowns at the end of June 2021, and the RBA started lifting the cash rate from extraordinarily low levels from May 2022, and the HILDA survey process for 2022 commenced in July of that year and stretched into February 2023, KPMG considers this is a reasonable time period to consider on a simple first principle basis whether these policy measures collectively impacted on asset values, and also whether there were any associated unusual distributional impacts.

Despite the COVID-19 pandemic occurring during the 2018–2022 timespan, this four-year period experienced exceptional growth in asset values across all households.³³

The greatest increase in wealth occurred for those households that owned property assets, either their own home or other property. The HILDA data also confirms those households in the bottom 20 percent quintile have not lifted their wealth associated with home equity values over the whole history of the survey (Figure 12).

These findings suggest that the conventional and unconventional monetary policy responses enacted during the pandemic did have wealth distribution consequences that further exacerbated inequality in Australia largely based on property ownership.

Figure 12: Equivalised household wealth by quintile and asset class (real 2022 dollars, '000)

Asset class	Year	Wealth quintiles				
		1	2	3	4	5
Home equity	2002	\$ 3.2	\$ 45.6	\$ 122.4	\$ 208.7	\$ 411.6
	2018	\$ 1.2	\$ 50.8	\$ 160.4	\$ 326.2	\$ 698.9
	2022	\$ 1.4	\$ 78.0	\$ 214.4	\$ 396.0	\$ 799.1
Other wealth	2002	-\$ 5.7	\$ 24.1	\$ 51.4	\$ 105.7	\$ 548.0
	2018	-\$ 8.7	\$ 29.8	\$ 72.7	\$ 153.1	\$ 738.2
	2022	-\$ 1.5	\$ 48.9	\$ 104.2	\$ 224.0	\$ 901.3
Superannuation	2002	\$ 7.4	\$ 24.6	\$ 45.0	\$ 84.7	\$ 234.0
	2018	\$ 17.9	\$ 55.8	\$ 99.1	\$ 156.6	\$ 434.5
	2022	\$ 21.3	\$ 66.0	\$ 114.8	\$ 181.6	\$ 482.6
Total	2002	\$ 4.9	\$ 94.3	\$ 218.8	\$ 399.2	\$ 1,193.6
	2018	\$ 10.3	\$ 136.5	\$ 332.3	\$ 635.9	\$ 1,871.6
	2022	\$ 21.2	\$ 192.9	\$ 433.4	\$ 801.7	\$ 2,183.1

Source: HILDA, KPMG analysis

³³ The absolute growth by quintile in wealth occurred in reverse order to percentage growth by quintile, reflecting base effects in the return calculations.

Monetary policy does more than just influence housing investment and property prices

In the recent episode of high inflation and the subsequent corrective tightening in the cash rate from its extraordinarily low levels, it would be reasonable for the average person on the street to think that the sole purpose of monetary policy was to influence house prices.

Analysis of speeches made by the new Governor Bullock since her appointment reveals that for every comment or response to a question she made regarding business investment, the Governor made nine on housing, house prices or the housing market. Even in the final public speech by Governor Lowe at the Anika Foundation lunch in early September 2023, for every comment he made on business investment, he made three on housing.

This focus on housing market responsiveness to movements in the cash rate is unsurprising given strong interest from the public and media. In addition, research by the RBA back in 2008 found housing investment and business investment in machinery and equipment were the components of GDP expenditure most sensitive to changes in monetary policy.³⁴ However, research by the RBA – Hambur and Cava (2018) – also acknowledged in their 2018 paper:³⁵

'Modern macroeconomic textbooks typically suggest that there is an inverse relationship between interest rates and business investment (e.g. Mankiw 2007; Blanchard 2017). In the textbook description, this inverse relationship is essential to understanding how changes in monetary policy affect the economy. Despite its theoretical importance [...] empirical evidence for this inverse relationship is difficult to establish.'

Using a sample of 100 non-financial, non-mining, and publicly listed companies, Hambur and Cava (2018) show the low level of both the cash rate and average business lending rates may not have translated to lower borrowing rates for all companies. The research, however, finds a strong and robust negative relationship between company-specific interest rates and their investments – a relationship that is hard to identify using aggregate time series data.

A more recent analysis by the RBA in 2023, which uses almost the complete universe of Australian firms from September 2001 to June 2017 from ABS BLADE that includes non-listed firms, finds evidence that monetary policy has a large effect on investment, both on the intensive and extensive margins.³⁶ The research indicates contractionary monetary policy decreases both the likelihood that firms invest (extensive margin) and the amount of investment (intensive margin). The paper also shows financially constrained firms and sectors that are more reliant on external finance are more responsive to monetary policy, which emphasises the crucial role of cash flow and financing constraints in the transmission of monetary policy.

³⁴ Lawson, J and Rees, D (2008) A sectoral model of the Australian economy, RBA research discussion paper.

³⁵ Hambur, J and Cava, GL (2018), Do Interest Rates Affect Business Investment? Evidence from Australian Company-level Data, RBA research discussion paper.

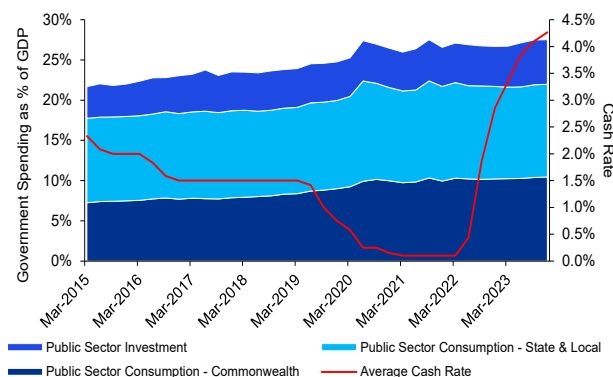
³⁶ Nolan, G, Hambur, J and Vermeulen, P (2023) Does monetary policy affect non-mining business investment in Australia? Evidence from BLADE, RBA research discussion paper.

Fiscal policies should align with and provide support for monetary policy

In ordinary economic times, let alone extraordinary ones like a pandemic, it is now well understood that in order to bring credibility to a country’s overall macroeconomic management, fiscal policies should align with and provide support for monetary policy.³⁷

There was a high degree of policy alignment, both timing and extent, and a consistency of messaging to the public by government and the RBA during the early and middle stages of the pandemic. As outlined in Section 2, between the end of March 2020 and November 2020, the RBA reduced the cash rate by 65 basis points and kept it at 0.1 percent until April 2022; during which time annual public sector spending also ramped up by an additional \$90 billion.

Figure 13: Public sector spending as a share of GDP and the cash rate



Source: Australian Bureau of Statistics, Reserve Bank of Australia, KPMG

Once the RBA started lifting interest rates in response to a ‘more than expected’ pick-up in inflation in May 2022,³⁸ with a recognition by the Governor that ‘it is appropriate to start the process of normalising monetary conditions’,³⁹ it would have also been prudent for fiscal policy to also start withdrawing some of the extraordinary fiscal support that was put in place during the pandemic.

It is clear the RBA did appreciate the need for more fiscal restraint to help reduce aggregate demand and fight inflation, but it also appreciated the practical (and political) challenges both of publicly saying that message, and in seeing that outcome eventuate. In a Senate Estimates hearing of the Economics Legislation Committee on 31 May 2023, Governor Lowe noted:

‘... decisions that are made by the parliament can affect inflation in at least three broad ways. A more restrictive policy stance – let me be clear about that; that involves higher taxes or less government spending – would mean less aggregate demand in the economy and less inflation.’

and

‘... there was additional spending in the Budget, and that’s at the margin expansionary... The extra spending from the government this year is \$3 billion or \$4 billion, in a \$2 trillion economy. That doesn’t shift the needle in terms of macroeconomic outcomes. It might be important in helping some groups, but it doesn’t shift the needle in terms of macroeconomic outcomes. It’s not something that’s shifted the dial for us at all.’

The marginal expansion of public sector spending was materially greater than quoted by the Governor in the Senate Estimates, both in terms of absolute (real) spend proportion of incremental GDP. In 2022–23, real government consumption spending increased by \$8.2 billion over the previous financial year, while government investment spending rose by \$6.9 billion over 2021–22; this represented nearly 21 percent of the incremental GDP for FY23. However, real government spending in FY23 was \$88 billion higher compared to FY20, which represented about 41 percent of the incremental GDP recorded between those two years.

³⁷ International Monetary Fund (2023), Fiscal monitor: On the path to policy normalisation.

³⁸ RBA 2022, Statement by Philip Lowe, Governor: Monetary Policy Decision, May 2022

³⁹ Ibid.

This analysis of marginal government spending suggests that at the time monetary policy was ‘stomping on the brake’, fiscal policy remained ‘planted on the accelerator’.

Australia’s response to managing the recent inflation pulse therefore has been one where coordination between the RBA and government could have been better. This disconnect between monetary and fiscal policy in the current tightening cycle has also been identified as an issue by the IMF, who noted in its recent Country Report on Australia:

‘Policy coordination will be critical ... A tighter fiscal policy is needed to support disinflation. Fiscal policy must strike an appropriate balance between supporting monetary policy – by not adding to inflation pressures – in the near term and the necessary structural transformation over the long term.’⁴⁰

Fiscal policy matters in fighting inflation. Fiscal support should be ‘temporary’, so that it does not add to demand over the medium term; targeted, so that the support benefits those most vulnerable; and tailored, so that it does not weaken incentives to cut demand.⁴¹ Several fiscal responses implemented in some countries to curb inflation have been ineffective while being costly to the budget and leading to shortages and rationing, including price controls or subsidies, or tax cuts to limit price increases.⁴² These policies potentially risk making inflation more persistent.

The scenarios in Auclert et al (2021) analysis show a fiscal contraction across the board helps reduce inflation, while impacting private consumption by less than in the monetary policy scenario. In the real world, fiscal support that is aligned with monetary policy stance can help avoid interest rates being too high and output going into deep contraction.

Disinflation through different policy tightening options⁴³

Auclert et al (2021) investigates three combinations of policies to slash inflation. In the first scenario, monetary policy is tightened, while there is no further action from fiscal policy than required for a gradual return to its debt target of 90 percent. In the second scenario, a fiscal restraint is employed, with a reduction in overall spending across all budget items amounting to 1 percent of GDP. In the third scenario, a fiscal restraint of the same overall size is employed, but with a different composition – spending in other items is cut by 1.5 percent of GDP, but targeted transfers to families in the lowest 10 percent of the income distribution are increased by 0.5 percent of GDP.

In the first scenario, nominal interest rates are raised by 2.5 percentage points to bring inflation down by 2 percent in two years. Output and consumption fall throughout the period, with the poorest families decreasing their consumption the most.

In the second scenario, inflation fell by a total of 2 percentage points in eight quarters – this means central banks are able to raise interest rates by less. Aggregate demand and output contracts, affecting everyone, but the impact on higher income families is smaller due to the decline in taxation.

In the third scenario, while both GDP and inflation go down, aggregate consumption decreases by less than in the other scenarios as the poor households receiving transfers consume a high share of their extra income.

⁴⁰ IMF 2023, 2023 ARTICLE IV CONSULTATION, IMF Country Report No. 24/11, January 2024

⁴¹ Lagarde, C (2022), Monetary policy in a new environment, Speech at the European Banking Congress, <https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221118-639420cee0.en.html>.

⁴² Ibid.

⁴³ International Monetary Fund (2023), Fiscal monitor: On the path to policy normalisation.

Conclusion

The COVID-19 health crisis was unprecedented, leading to immediate policy responses that tried to limit economic scarring and support economic recovery. Decisions made by government at all levels and the RBA were done in a highly charged environment of public fear and uncertainty, and with limited information on the health, economic and social ramifications of these decisions.

Overall, the policy decisions made by government and the RBA enabled the Australian economy to traverse the pandemic and come out the other side in very good shape. Inflation in Australia did not reach the heights of other developed economies, and consequently neither did our policy rate need to lift to levels adopted in other countries. Simply put, KPMG finds it hard to point to any one policy decision or associated issue made during the depth of the crisis that could now be construed as being an obvious mistake. Even high-profile forward guidance statements made by Governor Lowe that subsequently proved to be incorrect should be assessed for their intention; which was an attempt to underpin confidence in the economy and to encourage households and businesses to remain engaged with normal economic activities in the face of serious uncertainty.

Nonetheless, with the benefit of hindsight there are a number of key learnings that policymakers should recognise in planning for how fiscal and monetary policy should react to the next economic crisis in order to try to at least minimise, or at best avoid, an accompanying surge in inflation.

In hindsight, the critical driver of inflation was the scale, timing and to some extent the design of support being provided by policy rather than the overall policy measures. Factors that policymakers should therefore be cognisant of in preparing any future responses to economic crises specifically in relation to trying to manage a potential accompanying surge in inflation, include:

- The possibility of a supply shock persisting should not be discounted. Monetary policy needs to react quickly when a supply shock persistently lowers the productive capacity of an economy, leading to a large and sustained imbalance between aggregate demand and aggregate supply.
- The impact of adopting QE is state-dependent and it has the potential to be inflationary in those circumstances where households, businesses and banks are able to apply the incremental supply towards consumption and investment activities. This finding means the RBA needs to critically assess the state of the balance sheets of economic agents at the time of any future QE.
- If calendar-based forward guidance needs to be adopted to provide surety to households and businesses, it should have relatively short horizons and be accompanied by an acknowledgement that it is subject to change given the emergence of state-based criteria being met.
- Fiscal policy should avoid overcompensating for income losses during future economic downturns. Policies, such as short-time work programs and mechanisms that allow business support to be treated as debt or equity, should be designed today and be ready to be rolled out when the next crisis is triggered.
- Monetary policy has a distributional impact. The recent crisis shows that Australians, given the opportunity, will invest heavily in assets when confronted with very low interest rates, especially if there is the prospect of those interest rates remaining low for an extended period. However, the opportunity to invest in assets is not uniform across the spectrum of household income. The divide between those that have assets and those that do not can be exacerbated by policy. Low interest rates encourage those with the means to purchase assets like property. High inflation that erodes real incomes and increases the price of assets makes it harder for those without assets to acquire them.

There is, however, one area in the recent policy environment that KPMG believe requires a rethink, and that is the coordination of monetary and fiscal policy, which also implies coordination in fiscal policy between the Commonwealth and state governments, during periods of surging inflation. To date, we have seen monetary policy do all the ‘heavy lifting’ in trying to bring domestic inflation back within the target band. At the same time, we have seen government expenditures materially add to aggregate demand when monetary policy has been seeking to reduce it. Monetary policy and fiscal policy should be aligned during periods where inflation is significantly outside of the target range.

Government spending as a proportion of GDP now sits substantially higher than it did prior to the pandemic and represents about 40 percent of the incremental increase in real GDP between the start of the pandemic and last financial year. While the optimal share of the government in the economy is one for society to determine, an immediate challenge for government to consider is whether the pre-pandemic share (around 24 percent of GDP) is more appropriate than the current share. The answer to this question has important ramifications for the setting of fiscal policy over the coming years.

Appendix 1

Money supply and inflation

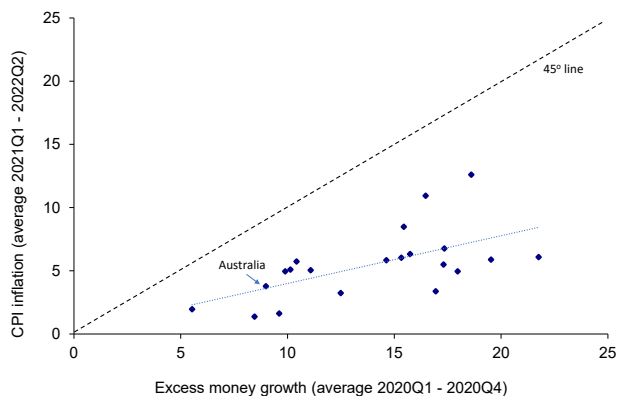
The monetary theory of inflation asserts that money supply growth is the cause of inflation. The theory is often stated in terms of the following equation: $MV=PY$, where M is the money supply, V is the velocity of money (i.e. the number of times a unit of currency is used to purchase goods and services within a given time period), P is the overall price level, and Y is the amount of goods and services produced.

Assuming that Y and V remain stable, and M is under the control of the central bank, then increasing M will raise P. In other words, growth in the money supply will result in growth in price levels (inflation) if real output grows at a constant rate.

More intuitively, an increase in the money supply raises consumers' demand for products and tends to stoke inflation unless the supply of goods and services has also risen in the meantime.⁴⁴

With the recent inflation episode, the large amounts of money pumped into the economy for households and businesses during the pandemic spurred demand for goods when there were supply chain disruptions and labour shortages, raising inflation.

Figure 14: Excess month growth and CPI inflation (annual growth)



Source: European Central Bank

The size of the inflation surge in recent years was found to be positively correlated with excess month growth across a sample of advanced and emerging market economies (Figure 14), although the relationship was lower than one-to-one as predicted by the monetary theory's equation given the short time horizon involved.⁴⁵ Researchers from the Bank for International Settlements (BIS) also found including money growth would have helped improve post-pandemic inflation forecasts, providing further evidence of linkage between money growth and inflation, albeit being inconclusive about causality.

⁴⁴ Frick, W (2022), What causes inflation?, Harvard Business Review, <https://hbr.org/2022/12/what-causes-inflation>.

⁴⁵ Schnabel, I (2023), Money and inflation, Speech at the annual conference of the Verein für Socialpolitik, https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230925_1~7ad8ef22e2.en.html.



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