

Explainer: what is reflation and is Australia experiencing it?

Written by Lee Smales, Associate Professor, Finance, Curtin Graduate School of Business, Curtin University

Since the 2007 global financial crisis, policy makers have been fighting deflationary (falling prices) and disinflationary (prices rising at slow rate) pressures. But the global economy finally [appears](#) to be entering reflation – a period of higher prices together with stronger growth.

This is good news for households, businesses and governments around the world.

Reflation means the end of below trend growth, and this has widespread benefits. As demand grows, firms will expand production and will require more staff. This is good for job seekers, but ultimately it should also lead to higher wages. Although there is [scant evidence](#) of that so far in Australia.

The federal government will also benefit from reflation via increased tax revenue, as corporate profits increase and individuals return to the workforce. Meanwhile, government spending should reduce as benefit payments fall.

Seeing reflation

In its recent update on the [World Economic Outlook](#), the International Monetary Fund (IMF) increased growth expectations both globally and in Australia.

The IMF noted there has been a recovery in investment, manufacturing, and trade. This is [consistent with recent manufacturing data](#) that signals there will be solid growth in the coming months.

The manufacturing data also noted that [costs are increasing](#), largely thanks to rising prices for raw materials. Indications are that consumer prices are [also turning upwards](#).

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The [latest figures](#) show Australian inflation creeping into the lower end of the Reserve Bank of Australia's target range, but smoothed underlying inflation (which takes out extreme price fluctuations) is still just 1.8%.

This pick up in economic activity has occurred at the same time as [corporate earnings have improved](#). This is [a global phenomenon](#), but Australia is able to benefit from this via trade, particularly in the resource sector.

Investors have been taking advantage of the “reflation trade”, by piling into assets that benefit from rising growth and inflation - companies in emerging markets and who sell discretionary items, such as cars and jewellery, to consumers.

In the 6-month period since the US election, stock markets in the [US](#) and [Australia](#) have each increased around 11%.

What's causing reflation?

Following the financial crisis, central bankers [slashed interest rates](#) to [all-time lows](#), and [greatly expanded their balance sheets](#) by purchasing assets, in a bid to stimulate their economies. Until recently this had failed to stimulate global demand, but that appears to be changing.

The White House has [moved](#) to [deregulate](#) industries, and has [promised](#) to increase infrastructure spending in the US.

As the world's largest economy, reflation in the US results in economic growth elsewhere, particularly in countries [like Australia](#) that sell goods and raw materials into the US.

Finally, the political uncertainty of the Brexit referendum and US Presidential election have passed. Both [consumers](#) and [producers](#) are confident, and this is feeding into other decisions.

Will reflation keep going?

Whether reflation continues is far from guaranteed.

For starters central bankers could raise interest rates more quickly than expected if they think inflation will get out of hand. Already, the US Federal Reserve has indicated [discomfort with high share prices](#).

Increasing interest rates, or [selling some of its recent asset purchases](#), could impact demand.

Second, there are [already questions](#) about the Trump administration's ability to enact legislation. The prospects of tax reform and infrastructure spending are fading. The infrastructure package, especially, had potential to increase inflation.

Finally, there are new sources of political uncertainty. Trump appears to have [reversed course](#) on engagement in the Middle East and North Korea. The UK faces a [surprise general election](#) and Marine Le Pen is [still in the running](#) in the French Presidential election.

More uncertainty inhibits firms making investment and employment decisions.

At present, the economic signs are good for a continued reflation of the global economy. This will benefit households as well as investors and corporations. However, this recovery is still fragile and may be thrown off course by policymakers and further increases in geopolitical tensions.

Lee Smales does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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