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Inflation ain't what it used to be

For much of the past thirty years, central banking has been built around a relatively straightforward proposition. If demand in the economy grows faster than supply, inflation rises. Raise interest rates, slow spending, and inflation eventually comes back under control. Conveniently, the vice versa also holds. Easy peasy.

That framework still holds. The problem is that today's inflation increasingly comes from places that interest rates have little influence over.

Think about the past few years. We've seen inflation driven by disrupted supply chains, wars, higher oil prices, tariffs, weather events and, more recently, significant increases in administered prices such as local authority rates, electricity charges and insurance costs. None of these reflect households suddenly deciding to spend too much, yet they all show up in exactly the same CPI number.

The diagnosis has become harder

That, I think, is where the challenge for central banks has fundamentally changed. The CPI is a measure of inflation. It tells us how much prices have risen, but not why. A surge in oil prices, a sharp increase in council rates and accelerating wage growth all contribute to exactly the same inflation outcome. Yet each has very different implications for monetary policy.

That means the first task for a central bank is no longer measuring inflation. It is diagnosing it. To be fair, this is not a new idea. The Reserve Bank of New Zealand, like most inflation-targeting central banks, has never responded mechanically to headline inflation. It spends considerable effort assessing a wide range of underlying inflation measures, inflation expectations, wage growth and other indicators in an attempt to distinguish temporary price shocks from more persistent inflation pressures. The challenge is that this diagnosis is becoming progressively more difficult.

The effectiveness of monetary policy depends not just on the level of inflation, but on where that inflation is coming from. Monetary policy is at its most effective when inflation originates in interest rate-sensitive parts of the economy. The more inflation shifts towards administered prices and supply-side shocks, the weaker that transmission mechanism becomes.

Some inflation reflects excessive demand and should be met with tighter monetary policy. Some reflects temporary supply disruptions that monetary policy can do little to influence. Other price increases originate in regulated or administered sectors where higher interest rates have almost no direct effect. The task is no longer simply identifying whether inflation is above target. It is understanding what is driving it.

The diagnosis matters

Why does that matter? Because different causes of inflation require different policy responses.

If inflation is being driven by excessive demand, tighter monetary policy is entirely appropriate. But if inflation primarily reflects temporary supply disruptions or administered price increases, the same policy response risks unnecessarily weakening growth and employment while having only a limited impact on the source of the inflation itself.

That doesn't mean central banks can simply ignore supply shocks. Headline inflation still matters because households and businesses respond to the prices they actually pay, not the inflation measures economists prefer. A sustained rise in fuel, food or electricity prices can alter inflation expectations, influence wage negotiations and change business pricing behaviour. What begins as a temporary supply shock can ultimately become persistent domestic inflation. That is precisely why diagnosis matters so much. If the diagnosis is wrong, the policy prescription risks being wrong as well.

The changing composition of inflation is important here. Historically, some of the most persistent inflation pressures came from the housing sector. Strong demand pushed up residential construction costs and, over time, rental inflation. Monetary policy was relatively well suited to leaning against those pressures by cooling credit growth and housing activity. Today, that transmission mechanism appears less dominant. Residential construction inflation has moderated, rental inflation has eased, yet inflationary pressures have increasingly shifted towards administered prices and other supply-side influences. That doesn't make today's inflation any less important, but it does make it less responsive to interest rates.

A changing inflation environment

In many respects, this reflects a broader change in the global economy. The era of globalisation delivered relatively stable supply chains, expanding productive capacity and low, predictable inflation. The world we appear to be moving into is rather different. Geopolitical tensions, trade fragmentation, climate events, energy security, demographic pressures and more frequent supply disruptions are all likely to make inflation more volatile than we became accustomed to over previous decades.

That uncertainty matters. Thirty years ago, an inflation surprise was more likely to reflect excessive demand. Today, the same inflation surprise could equally reflect a geopolitical event, an energy shock, a weather disruption, a tariff increase or an administered price change. The information content of inflation has become less clear, making policy mistakes more likely.

That doesn't diminish the importance of data, but it increases the importance of judgement.

A broader policy challenge

Central banks still have the same policy instrument they had thirty years ago, but the inflation they are being asked to control has changed. And that points to a much bigger shift in the way we think about economic policy.

If an increasing share of inflation originates from supply shocks, administered prices and structural constraints rather than interest rate-sensitive sectors of the economy, then monetary policy inevitably becomes a progressively less precise instrument. Interest rates remain an essential tool, but they cannot generate more electricity, build infrastructure, improve logistics, lift productivity or make global supply chains more resilient.

That doesn't make monetary policy less important, but it does make it less sufficient.

The burden of macroeconomic management may gradually be shifting. Rather than expecting central banks to solve every inflation problem, governments will need to play a larger role in strengthening the supply side of the economy. Productivity, infrastructure, energy security, planning reform, competition, education and investment are no longer simply long-term growth policies. Increasingly, they are inflation policies as well.

That doesn't diminish the importance of central bank independence or inflation targeting. If anything, it reinforces it. But it does suggest that achieving price stability in the future will require a broader policy toolkit than the one that served us so well over the past thirty years.