

Non-technical summary for 'Shifts in Australian Price-setting Behaviour around Large Shocks'

By Matthew Fink and Jonathan Hambur

What did we set out to do?

After the COVID-19 pandemic, inflation rose much faster than many economists expected. The extent of the increase was greater than many standard economic models would have predicted. Understanding why these models got it wrong is important, as it can help central banks to make better inflation forecasts and interest rate decisions in the future.

One reason standard models may have struggled to explain the pick-up in inflation is that they assume that businesses change their prices at the same pace – regardless of what is happening in the economy. However, when costs jump suddenly during a major shock – like they did during the pandemic and in the years that followed – businesses might adjust their prices more often. In these circumstances inflation should increase faster than otherwise.

To test this hypothesis, we use a new dataset of product prices from the websites of around 60 major retailers, collected every few days between 2018 and 2023. We examine how often firms changed prices and whether this behaviour changed during the inflation surge in 2022 and 2023. We then examine how these changes may have contributed to higher inflation in this period.

What are our key findings?

1. Businesses adjusted their prices more frequently during the inflation surge. This suggests that businesses change how frequently they reset prices depending on what's happening in the economy.
2. Standard economic models could have materially underpredicted inflation during the post-pandemic inflation surge because they didn't account for businesses changing prices more often at this time. Using one model, we found that the underprediction could have been as large as 1.2 percentage points.
3. Central banks typically face a trade-off between reducing high inflation and supporting employment and economic activity. When businesses change their prices more frequently, this trade-off becomes smaller because inflation responds more quickly to shifts in economic activity and business costs. As a result, policymakers can bring inflation down without needing to slow the economy as much as they would in normal times. This means they can put more emphasis on fighting inflation with fewer harmful effects on employment.

What are the key policy implications of our findings?

The results show that economic models that assume stable price-setting behaviour can be misleading when the economy experiences a big shock. To make better forecasts and policy at such times, policymakers should use models that allow price-setting behaviour to change over time or apply judgement when interpreting models that assume prices always change at the same pace.

Doing so will help central banks respond more effectively to future economic shocks and strengthen the resilience of monetary policy frameworks.