The RBA Has Lost Its Way

The RBA's description of its monetary policy mandate states that it "has a duty to maintain price stability, full employment, and the economic prosperity and welfare of the Australian people". Based on its decisions to cut the RBA Cash Rate since 2011 and the explanation given by Philip Lowe for the June rate cut, the RBA is ignoring its own mandate. The RBA, like many other central banks around the world, has become solely focussed on the short term impact of its decisions on narrow parts of the economy. The RBA is ignoring the mounting evidence of the damage caused by low interest rates and the counterproductive outcomes from its actions. This article uses economic analysis and principles to debunk the RBA's arguments, and lays out the alternative course of action for Australia to increase its economic health and prosperity.

Low inflation is not a problem

There is broad agreement that the high levels of inflation, as seen in the 1970s and 1980s, are a problem and can be addressed with monetary policy. The introduction of an inflation target of 2-3% in Australia (the US, Europe, UK and Japan simply use 2%) was a correct response to the menace of high inflation. However, there isn't agreement that monetary policy is an effective tool in lifting inflation levels moderately or that central banks should even be concerned with low inflation. Despite this, the RBA remains a slave to its existing target for no good reason.

In the 200 years preceding World War One, inflation in the US was fairly close to zero. People expected that in the long term prices would barely change, and this lack of change was regarded as a good thing. During this period enormous technology improvements occurred, urbanisation took hold and the standard of living greatly improved. The onset of costly world wars and the removal of the gold standard brought in the modern era of higher inflation levels. The modern embrace of the idea that governments should have an ongoing level of debt provided a reason for governments to want inflation. Whilst the population doesn't want inflation, governments now do as it is a way to reduce the real (after inflation) cost of servicing government debts.

The arguments made to justify the need for inflation above 2% are profoundly weak. Some argue that low inflation expectations would cause consumers to delay purchasing goods and services. Who would put off buying groceries, white goods, accommodation or transportation merely because it was going to be 1% cheaper in year's time? If there is any meaningful delay of consumer purchases it would be small and temporary.

The second main argument against low inflation is to merely point at Japan and say that we don't want to end up like them. Japan's low GDP and inflation growth has many causes. Japan's malinvestment in the 1980s, an ageing and declining population, a failure to implement productivity reforms and the failure to clear banks of their bad debts are all partly to blame. As Europe has been facing the exact same issues since the financial crisis, it is no surprise that its last decade looks much like Japan's last 30 years. Japan should serve as an example of what not to do and what doesn't work, rather than an example of the need to pursue even more aggressive monetary and fiscal stimulus.

Better models aren't the answer

The financial crisis was a huge embarrassment to establishment economists. Academic and central bank economists were blind-sided by the severity of the downturn. Their reliance on DSGE models, which typically ignore credit and asset bubbles, has not been reduced by the clear failure of these models to predict the future. Many have doubled down arguing that if only the models were tweaked the output would be more accurate.

The Phillips curve is another area of theory that central banks cling to despite its inaccurate output. The combination of low unemployment and low inflation in the US should cause academic economists to end their belief that these positive outcomes cannot coexist. It should also serve as a lesson that economies are far harder to control and predict than most economists choose to admit.

Low interest rates create boom-bust cycles

The evidence that low interest rates create credit and asset price bubbles is increasingly coming from central banks themselves. It started with the Bank for International Settlements in the years after the financial crisis and has spread more recently to central banks in Europe and the US. The RBA's recent working paper linking rising house prices to lower interest rates was its first major admission of this obvious relationship. The possibility that buyers of property might compare the yield it generates to other potential investment sectors (particularly bond yields) took a long time to dawn on the RBA despite it being an industry standard point of reference.

The impact of low interest rates spreads far beyond housing affecting shares, infrastructure investments, commercial property and fixed income yields. Every additional rate cut unleashes another wave of selling of safe assets to purchase riskier assets. Often these purchases involve explicit or embedded leverage, for instance residential investment properties are typically geared as are listed and unlisted property trusts. Purchasers of bank preference shares (hybrids) are taking on substantial embedded leverage with around 92% of bank liabilities ranking senior to their position. This process makes the Australian financial system substantially more unstable, in direct contradiction of the RBA's mandate to enhance the stability of the financial system.

Impacts of rate cuts on borrowers

In the speech given by Philip Lowe justifying the June rate cut he pointed out that households pay around two dollars of interest for each dollar of interest they receive. Given that interest rates for home loans, car loans, personal loans and credit cards are far higher than deposit rates this shouldn't be a surprise to anyone. This statistic on its own merely points to households (as a group) having a roughly similar level of deposits and loans. A rate cut applied equally is simply robbing Peter to pay Paul.

There is also a deeper level to this discussion that Lowe chose to leave out of the speech – the impact that low interest rates have had on the ratio of deposits to loans. By repeatedly cutting rates the RBA has strongly incentivised households to switch from being savers to borrowers, primarily through the residential property market. Household debt levels and property prices have surged since 2011 as the RBA slashed 3.50% off the cash rate. There is no doubt that had the RBA left rates at a neutral level Australian banks would be sourcing more of their funding from "sticky" Australian depositors and would be far less reliant on the "fast money" of international bondholders.

Even if the above factors are ignored, the impact of rate cuts on borrowers is less than many expect. Less than a quarter of residential borrowing is interest only. For this minority, a rate cut does have an immediate cash flow impact as the amount taken out via direct debit each month reduces. However, the majority of borrowers who are making principal and interest repayments see no immediate impact. Their 25 year loan will be repaid one year earlier. The impact of rate cuts for borrowers is predominantly back ended, resulting in little short term stimulus for the economy.

Where rate cuts have a much larger impact for borrowers is on the maximum amount that a loan applicant can be approved for. Now that APRA has removed a hard 7% serviceability test, every rate cut increases the amount that an applicant will be able to borrow. As the pool of potential property buyers are all receiving a similar loan size increase the result is higher property prices and more household debt. Bizarrely, whilst rate cuts have largely caused the explosion in household debt, the RBA now points to the mountain of household debt as a reason it can't raise rates back to a neutral level. To unwind its excessive monetary stimulus would cause a recession, hence rates can't be raised.

Impacts of rate cuts on savers

Unlike the impact on borrowers, the impact on savers of rate cuts has a much higher flow through to immediate consumption. Wealth is concentrated amongst older Australians, many of whom have de-risked their portfolios as they no longer earn material income from work. This group has seen the yields on their term deposits, bonds and other low risk assets slump, reducing a large part of their income. Many are adamant they will not increase their investment risk or increase the pace of running down their assets to maintain their spending levels. They have chosen to reduce their spending in response to rate cuts.

For those saving to buy a house or build assets for their retirement prospective returns have fallen, making their goals harder to achieve. These groups also make choices to reduce their current lifestyle spending, deferring spending now to ensure that they will have the lifestyle they want in the future.

Impacts of rate cuts on business investment and entrepreneurship

For years the RBA was perplexed by the lack of increase in business investment in response to the rate cuts. Why don't businesses take advantage of lower rates to buy more equipment and hire more staff? This obvious answer to this question illustrates the lack of real world experience within the RBA. Businesses buy more equipment and hire more staff when they can profitably put them to work. If the demand isn't there to utilise the increased capacity the vast majority of business owners won't risk insolvency on a punt that the economy will magically improve.

The growing body of evidence now points to the survival of zombie companies as the biggest impact on businesses from low interest rates. Entrepreneurship and innovation have fallen as zombie companies take up space that should be left open for new businesses offering better and cheaper products. Japan and Europe are textbook examples, their lower interest rates, barriers to entry and government bailouts have allowed poorly capitalised and poorly managed businesses to stagger on.

Impact of rate cuts on construction

The impact of rate cuts on construction is another area where the RBA gives too much prominence to short term impacts whilst ignoring long term fundamentals. The RBA is correct in its view that lower interest rates stimulate housing construction in the short term. Some builders and buyers will be willing to speculate on future house price growth as rates fall. However, the RBA has failed to recognise that ultimately the amount of housing required reflects population growth. Having an excessive stock of empty houses, as occurred in the US, Ireland and Spain prior to the financial crisis, will eventually result in a collapse in house prices. A combination of collapsing house prices, increasing unemployment and high levels of household debt are a sure-fire way to bring on a deep recession.

Impact of rate cuts on the Australian dollar

The RBA's best argument for rate cuts is that it will push down the Australian dollar, giving a boost to exporters and our service industries (e.g. tourism and education). This is an undeniably positive impact. The main cost of a lower Australian dollar is a higher cost of imported goods, which is a substantial portion of goods consumed as Australia has a narrow manufacturing base. This counter effect flows through to less consumption (as imported goods now cost more) and higher costs in producing goods and services reducing export competitiveness. Overall a lower Australian dollar is positive, but not as much as is commonly thought once the countereffects are considered.

Impact of rate cuts on employment

Taking into account the impacts detailed in the previous sections, rate cuts are likely to make a small positive contribution to employment in the short term. However, in the medium term almost all of this impact will be lost as construction reverts to normal levels and the impact on the Australia dollar fades. In the long term, the impact of rate cuts on employment is decidedly negative. Rate cuts well beyond normal levels increase financial instability creating the risk of a 1990s level of recession. Such a rapid reduction in demand across businesses and consumers would see unemployment soar. By cutting rates too far the RBA has created the conditions for it to badly fail on its full employment and economic prosperity aims in the future.

Monetary policy isn't the answer

The previous sections have laid out the case that monetary policy is now the part of the problem and not the answer. Further cuts in interest rates will exhaust the firepower that might be useful if a recession begins as well as increasing the likelihood of a recession brought on by excessive debt and speculative investment. Had interest rates been left at their 2011 levels, house prices and household debt levels would be far lower today and the Australian financial system would be on a much firmer footing.

Fiscal policy isn't the answer

Philip Lowe's speech called on governments to increase fiscal stimulus, particularly infrastructure spending. I'm all for increasing infrastructure spending where the project will be a net positive in the long term. The one proviso is that it must come from within a balanced budget, with inefficient expenses cut to cover the cost of productive infrastructure investment. Like monetary policy, most fiscal stimulus is merely a short term measure akin to a sugar hit that quickly fades. Both have negative long term consequences that outweigh their limited short term benefits.

Population growth isn't the answer

Population growth has been the saviour for Australian politicians, allowing them to boast of having avoided a recession since 1992. However, this covers up the fact that Australia is currently in a per capita recession and had another per capita recession in 2008. Australia's abnormally high population growth reduces the quality of life for existing residents. It is also enormously expensive, particularly for state governments that need to spend tens of billions on the infrastructure required to meet the additional demand. A much smaller migration intake, targeted at increasing the wealth and skillset of Australia, would be a net positive but the current number and segmentation of migrants is not the answer.

Tax reform and productivity reform are the answers

The most agreeable part of Philip Lowe's speech is right at the end. The need for "productivity growth that is the main source of improvement in our living standards" is a recognized doctrine amongst economists of all stripes. Giving businesses greater opportunity to innovate and compete, through deregulation and the removal of subsidies, drove Australia's last great wave of GDP and income growth. Tax reform that shifts the burden from income taxes to land taxes and consumption taxes incentivises individuals to work and invest more. This shift in the tax burden is inevitable as the population ages and the percentage of the population working declines.

Conclusion

This month's RBA decision to cut the Cash Rate has further increased the risks to Australia's financial stability. High household debt levels, low productivity growth and inflated asset prices are obvious, yet the RBA continues to cut rates hoping that the same actions will bring about a different outcome. It's time for the RBA to breakout of its groupthink and go back to evidence based economic decision making focussed on how people and businesses react to changes in interest rates and inflation. Australia should quit the sugar hit of monetary and fiscal stimulus, replacing stimulus measures with tax reform and productivity reform.

Written by Jonathan Rochford for Narrow Road Capital on June 25, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.