There's No Good Case For Another Rate Cut

After consecutive 0.25% rate cuts in June and July, the market is now pricing in another rate cut on October 1st. Philip Lowe's speech in Armidale on Tuesday laid out the case for another rate cut, but it is a particularly weak case at best. Lowe pulled out his usual reasons for a rate cut; a global savings glut, the currency war, inflation is too low and the desire to decrease the unemployment rate. I've touched on the faulty logic of these arguments in two longer pieces recently (The RBA Has Lost Its Way and Central Banks Are Fighting Economic Fundamentals) so I'll keep the responses short this time.

The Savings Glut Fallacy

This sleight of hand appeals to the natural demand and supply dynamics that is taught in elementary economics courses. The price (interest rates) is low therefore there must be too great a supply of savings. The problem is that there isn't an independent market for setting interest rates, the rate is controlled by central banks. The proof of this is simple enough, there is a near perfect correlation between the rate paid on savings by banks and the movements in the overnight rate set by central banks. Long term government bond yields are merely an extrapolation by the market of what the future central bank rate is expected to be, with a small adjustment for a term premium.

For those who are struggling with this consider another incongruency. Central banks claim there is a savings glut, but at the same time the European Central Bank and the Bank of Japan are pursuing quantitative easing. Surely if there is a glut of excess savings, there is no need for central banks to buy government bonds. Rather, they should allow the government bonds they own to mature and not be replaced, with the supposed savings glut filling the gap.

The Currency War Justification

It is now clear that central banks are engaged in a currency war, with a race to the bottom underway. There are two problems with this; like using steroids it is short term gain but long term pain and it doesn't work nearly as well as expected once the countereffects are included.

There is another option, however. Rather than joining all of the other lemmings in jumping off the cliff, the RBA can step out of the pack and reduce systemic risk by not cutting rates further beyond normal levels. This is likely to lead to a higher exchange rate, which may be accompanied by a shallow recession. That outcome is far better than a deeper recession that occurs after debt and asset price bubbles are allowed to inflate.

The False Fear of Low Inflation

The continued argument that inflation must return to the target band is a case of forgetting the reason why the target band exists. Inflation targeting was implemented to ensure that inflation is not too high, it was never about stopping it from going too low. For those who are worried about deflation, try taking a survey of consumers asking whether they would prefer inflation of 0% or 2.5% per annum for the medium term. When the results come back that consumers overwhelmingly favour no inflation on the goods and services they buy, ask yourself who's wrong? Inflation is the enemy of consumers and savers, but the friend of governments that want to collect more taxes (through the menace of bracket creep) and deflate away their debts.

More Jobs Now, Less Jobs Later

As touched on in the currency war section, lower rates will have a short term stimulatory effect but bring negative consequences in the long term. This is particularly acute for employment, with the massive spike in unemployment during deep recessions (which occur after debt and asset price bubbles) carrying long lasting damage for workers and the economy. More frequent, shallower recessions are much more palatable than less frequent, deeper ones.

The battle to reduce unemployment is better left to the Federal Government guided by the Productivity Commission. Changes that would boost employment would include; fixing the tax and welfare systems (welfare cliff/trap) to incentivise work, simplifying the minimum wage and other basic employment conditions, and testing the willingness of the unemployed to work.

Conclusion

The markets are pricing in a 78% chance of a rate cut and when the confidence level is that high the RBA has a history of delivering. Whilst it is very likely that the RBA will cut again, it has failed to put forward a good reason to do so. The four reasons given by Philip Low in his speech this week don't stack up, and he has again failed to mention the negative long term consequences that come with excessive monetary stimulus. We can continue to kick the can down the road for a while, but eventually the road train named "Recession" will catch up and squash us all.

Written by Jonathan Rochford for Narrow Road Capital on September 26, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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