The RBA's outdated exchange rate manipulation play

Currency
The RBA's mercantilist attempt to shift the exchange rate is outdated, ignoring the importance of cheap imports to our cost base.

Richard Holden

Last week the Reserve Bank did what most economists and capital markets thought they would do, and cut the cash rate to a record low 1.5 per cent.

The move was met with much rolling of eyes, with many commentators and market participants essentially saying: "They've cut rates a lot already and it hasn't done much good."

This put the prospect of less conventional monetary measures on the table.

Like Japan, the US, the UK, and Europe before us, large bond buying programs, so-called "quantitative easing" (QE), are squarely on the horizon.

According to reports, the RBA has recently begun planning for this contingency.

Disturbingly, though, the RBA (and numerous market economists) see the benefit of this as lowering the Australian dollar. It was reported in this paper that the internal RBA study on QE highlighted the fall in the Australian dollar that could result from buying out foreign investors, who own around 60 per cent of the government bonds on issue.

The RBA seems obsessed with trying to lower the Australian dollar to give a boost to the export sector. Are we really now pinning our hopes for economic recovery to some quasi-mercantilist attempt at back-door exchange rate manipulation? I sure hope it hasn't come to that.

I've said repeatedly that focusing on the benefit to exporters from a lower Australian dollar fails to appreciate how large effective US dollar imports now are: from large machinery to physical technology to cloud computing, like Amazon Web Services, that power surprisingly large chunks of the service economy.

The RBA, and others, are operating with an out-of-date model of the economy in which most inputs are domestic and thus the benefits to exporters of a lower dollar dominates.

Reserve Bank governor Glenn Stevens has little wriggle room left. PHOTO: BEN RUSHTON

But the world has changed since those intuitions and heuristics were formed.

Sure, a lower dollar helps on the export side, but hurts on the import side.

And the latter has become much more important as the nature of economic inputs has changed in the technology-driven economy, and as the world economy has radically globalised.

I think the rate cut was prudent, and more will be needed. I also think that QE may be needed. But it's the fact that after all these cuts the economy is still sputtering, and what it means for what might come, that we should really be focused on.

I have been saying for some time now (particularly in this paper) that the Australian economy, while doing better than most, is suffering from "secular stagnation" – a protracted reduction in the potential stable rate of economic growth because of a global shift in the supply of, and demand for, savings.

The RBA's need to cut rates, and the fact that the economy hasn't rebounded as a result, is further evidence of this.

An obvious reason to be worried about the possibility of QE is what it signals about the state of the economy.

We have been consistently told, by both sides of politics, and especially RBA governor Glenn Stevens, that the transition away from the mining boom is going smoothly. Actually, it's closer to the truth to say "we've got low inflation, low interest rates, low wages growth and low levels of business investment," as Scott Morrison did last week.

Whoever gave the Treasurer the shot of truth serum prior to those remarks might remind him that his budget forecasts 4.25 per cent nominal GDP growth in 2016-17, and 5 per cent for the following three years. In light of the radical monetary policy we are already witnessing – let alone the prospect of QE – those numbers look fanciful. And that, of course, means big budget deficits, rising debt-to-GDP, and a looming credit rating downgrade.

And then there's the QE policy itself. The RBA buying up some portion of roughly $450 billion of Commonwealth government securities raises a whole host of thorny questions. Is it only going to be government bonds, or also other, riskier securities, as has occurred overseas?

What maturities are going to be purchased? How quickly would the RBA's balance sheet expand? From whom are these securities to be purchased?

Finally, there's the exit strategy to consider. It's no overstatement to say that nobody in the world really knows what unwinding a major central bank bond-buying program involves, precisely.

In particular, how does the upward pressure on long term yields, as happens when QE rolls off, interact with rising short-term rates – as would occur in the event of recovery? This is unchartered territory.

What should happen – even if it is in conjunction with QE – is large-scale infrastructure spending.

The government can borrow at historically low levels and has a unique opportunity to both renew our critical infrastructure and also help combat secular stagnation..

The RBA now has 150 basis points of wiggle room left before it needs to embark upon a program of extraordinary measures.

That prospect alone should shake us out of our complacency.

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Xi's technocrat crackdown risks China's growth

Politics
China's leadership is undermining its own policy program in order to protect the political system.

Brian Toohey

Former Australian diplomat Philippa Jones is tapping into an unlikely niche market in China. Jones, the managing director of the research firm China Policy, takes advantage of how policy formation in the one-party state is far less monolithic than often portrayed. The large volume of publicly available policy deliberations in Chinese allows her firm to provide a detailed analysis to clients

Jones told this writer in Beijing recently, "licenced policy contention" exists for broad economic and social policy, and issues that don't directly affect the Party's power.

She said: "Money flows in substantial quantities to the policy community in universities and think tanks who continue to debate and comment on policy as it develops." Jones says the number of interested parties giving advice has often been a natural check and balance to government.

The Party also uses extensive polling to keep in tune with public sentiment.

However, Jones is concerned that intra-party panels, called "Leading Groups", set up by President Xi Jinping "threaten to overtake the role of the technocratic agencies in decision making.

Many Chinese are now saying this reminds them of how Mao ran the country under the Cultural Revolution.

"We wait for the cycle to turn."

China Policy's research director, David Kelly, says the country's reform agenda confronts deep troubles blocking many policy solutions. He says: "The legacy issue of 'national unity' gives rise to a highly centralised government locked in dependency with local administrations, adept at playing by their own rules.

"The result is endless cycling between re- and de-centralising."

Kelly says difficulties in implementing the 2013 reform program to level the playing field between private and state-owned enterprises are unresolved and solutions to the rural-urban divide face "daunting costs".

However, the consultative policy process has served the leadership's core goal of building support to avoid the collapse of the existing political system.

A collapse would wreck China's drive to shift its economy further up the value chain. But the strong consensus encountered during this writer's recent trip, sponsored by the Australia China Relations Institute at UTS, is that a political collapse is highly unlikely.

A collapse would wreck China's drive to shift its economy further up the value chain.

There is more concern that conventional economic factors will slow growth below the official annual target of 6.5 per cent. Some argue excessive credit creation will produce a hard landing. Others disagree, noting China has no net external debt and over $3US trillion in foreign reserves.

The ex-RBA director John Edwards says that if the Chinese government took the "at risk" component of the State Owned Enterprises' debt onto its own balance sheet, government debt would rise from 40 per cent of GDP to manageable 65 per cent.

The keen interest in the growth outlook is understandable. The IMF estimates China accounts for over a third of global growth: double the US contribution.

No one can be certain, but the prevailing view is any recession generated within China would be short lived – unlike the consequences of a major political collapse or a war.

Xiang Bing, founding Dean of the privately owned Cheung Kong Graduate Business School, is an unswerving optimist. He told this writer the estimated 850 million people in China's middle class by 2030 "will be like a new continent rising from the sea and calling 'Come sell to us'".

Already UTS economist James Laurenceson says Chinese tourists are expected to spend $11.5 billion in Australia in 2016-17 – triple that of second-placed US visitors.

Four economics professors at the Chinese Academy of Social Sciences said reforms should include steadily eliminating excess capacity in steel, cement and coal.

They strongly supported the massive government and private sector investment in R&D reported in this column last Monday. They said the January 1 change to allow families to have two children could help alleviate China's ageing population problem, but no baby-boom is expected.

One economist was encouraged by how rapidly Didi Chuxing, Uber's competitor in China, had created 3.8 million jobs in 19 provinces.

Didi's performance is a reminder of the abundance of talented entrepreneurs in China. This is one reason Platinum Fund Management remains positive about the China in its latest quarterly report. It notes China leads the world in e-commerce with sales of over $US600 billion, as well as "innovative platforms offering a great selection of products with cheaper prices and same-day delivery".

The Australia China Relations Institute at UTS sponsored the writer's trip.

China could help clean up Olympics

Adam Minter

When the Olympic torch was lit on Friday in Rio de Janeiro, there were 416 Chinese athletes in attendance, the largest contingent the country has sent abroad. It's a hopeful symbol amid an unprecedented whirlwind of doping and corruption charges. And seems a pretty apt metaphor.

For three decades, China has embraced the Olympics as a proxy for national greatness. Winning more medals – and China wins a lot of them – seemed to equate with its rising status in the world. It even seemed to boost racial self-confidence: In 2004, hurdler Liu Xiang told the press his unexpected gold medal proved "athletes with yellow skin can run as fast as those with black and white skins."

Yet as China's political and financial investment in the Olympics has grown, the games themselves have only become more tarnished: Revelations of widespread cheating by Russia at the 2014 Olympics in Sochi are just the latest to undermine the integrity of competition that the Chinese government so esteems.

China has had its share of doping problems, of course.

In recent years, China has gained a lot of influence over the Olympics.

Few countries have China's attachment to sport as a symbol of national greatness. If nothing else, standing up against cheating would be a way to enhance its status in the world – regardless of how many athletes it sends to the medal platform.

Adam Minter is a Bloomberg View columnist based in Asia.

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