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Growth narrative needed to rescue monetary policy

THE AFR VIEW

Thankfully, as we foreshadowed, the Reserve Bank of Australia was not foolish enough to sit on its record low 1.5 per cent cash rate at every monthly board meeting since September 2016, only to cut it just over a week before a federal election. But after its May board meeting, Australia's central bank worryingly has taken on more of the burden of sustaining economic growth. Governor Philip Lowe began 2019 with a stated bias toward normalising his ultra cheap money policy. But this position continued to unravel following the weak GDP reading for the last three months of 2018 and then the below-target inflation result for the first quarter of 2019.

With inflation stubbornly below the central bank's 2-3 per cent target, Dr Lowe now has set a lower hurdle for easing monetary policy even further. He now suggests that "a further improvement in the labour market" will be required to push inflation back up into its target band. In other words, the Reserve Bank will cut its cash rate to 1.25 per cent, or less, unless the jobless rate falls below the current 5 per cent.

In the low inflation world of the smartphone, trying to force up inflation risks over-extending a monetary policy framework.

With support from other policy settings, that would be achievable. In Donald Trump's America, the jobless pool has shrunk to a half century low of 3.6 per cent. Even amid Brexit, the Bank of England forecasts a jobless rate falling to 3.5 per cent, again the lowest since 1973, when the first OPEC oil

shock collapsed the entire post-war Keynesian consensus. Australia's jobless rate fell to 4 per cent during the resources boom but has scarcely been below 5 per cent since. It may happen over the next few months given the external stimulus from stronger iron ore and coal export prices. But as the chief executives of two of the big four banks have warned, making ultra cheap money even cheaper wouldn't provide much of a stimulus. At these extremes, monetary policy simply loses its potency, warned the National Australia Bank's Phil Chironic. Rather than even cheaper money, what's needed are policies "that make people want to take risk and invest and grow their business", suggests Westpac's Brian Hartzler.

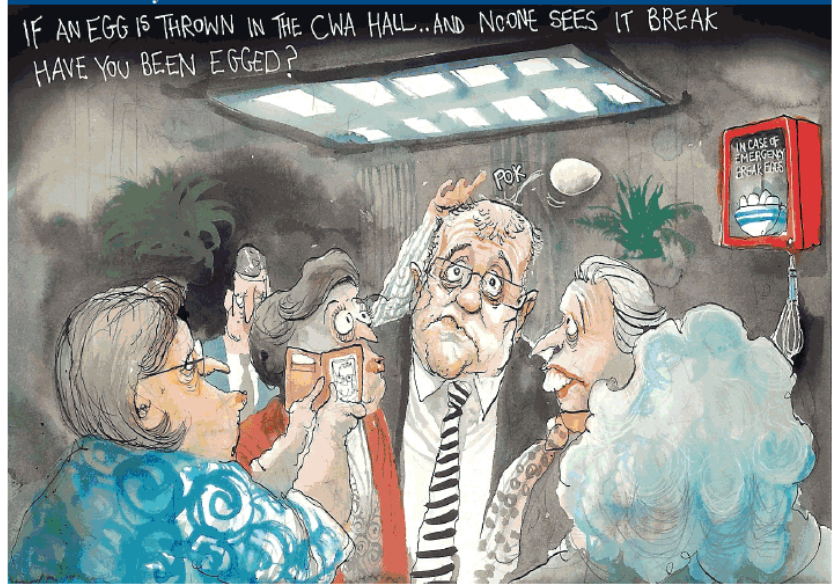
Some suggest that cutting the cash rate would help by weakening the Australian dollar. But the floating exchange rate is not supposed to require extreme monetary policy to play its swing role. Without any substantial growth agenda coming out of the federal election contest, even cheaper money would instead encourage retirees to take the wrong sort of risks with their money in search of higher returns. And with deposit rates approaching the zero lower bound, cheaper mortgage rates would further squeeze bank margins, profits and dividends.

By the time of the next Reserve Bank board meeting in June, Australia is likely to be ruled by a Labor government committed to a higher taxing, bigger spending, heavier regulation and more redistribution agenda. Without a clear growth narrative to support it, monetary policy would likely further lose its grip, as then Reserve Bank governor Glenn Stevens warned in 2015, while building up instability elsewhere in the economy. Yet the Reserve Bank is on the verge of mechanically cutting its cash rate to try to push up inflation into its 2-3 per cent target band amid an election being fought over reducing the cost of living. No wonder no-one gets the narrative.

Dr Lowe could be fortunate. The established laws of economics might start operating again as the jobless rate falls further and wages growth picks up pace. But as debated in the pages of *The Australian Financial Review*, the problem instead could be the 2-3 per cent inflation target calibrated for the lingering high inflation memories of the pre-internet age. In the low inflation world of the smartphone, trying to force up inflation risks over-extending a monetary policy framework that has been a foundation of Australian prosperity for the past quarter of a century. Ultimately, that would reflect policy failures elsewhere. The Reserve Bank simply does not have the policy tools to accelerate the economy's growth potential or to sustainably engineer a lower jobless rate.

From the Gallery

David Rowe



Vale RBA inflation targeting regime

Interest rates

The bank had to cut if it wanted markets to believe that inflation targeting was still alive. It didn't. And it isn't.



Richard Holden

After 33 months of seeming inaction, the Reserve Bank of Australia finally took action yesterday.

No, it did not cut short-term interest rates. It left the cash rate unchanged, again, at 1.5 per cent.

What it did do was effectively abandon its inflation-targeting regime that has been in place since the early 1990s.

Mark it in your calendars, May 7, 2019 was the last best chance the RBA had to save confidence and belief in inflation targeting.

Having not been in the 2-3 per cent target band for the entire term of the current governor, with headline inflation last quarter at literally zero, and with annual inflation pushing toward 1 per cent, the bank had to cut if it wanted markets to believe that inflation targeting was still alive.

It didn't. And it isn't.

It's worth reminding ourselves of the rationale behind inflation targeting by central banks.

It is about setting stable expectations for consumers, businesses and markets and trading off the costs and benefits of inflation.

The Reserve Bank put it this way: *The Governor and the Treasurer have agreed that the appropriate target for monetary policy in Australia is to achieve an inflation rate of 2-3 per cent, on average, over time. This is a rate of inflation sufficiently low that it does not materially distort economic decisions in the community. Seeking to achieve this rate, on average, provides discipline for monetary policy decision-making, and serves as an anchor for private sector inflation expectations.*

But all of this depends on market participants believing that a central bank will stick to the target. Once they lose that faith in the central bank's commitment to the target, inflation expectations become unmoored. This is what led to the wage-price spirals of the 1970s and 1980s, and to deflationary episodes in Japan.

And let's not forget about the underlying economics of the present situation. Real wage growth has been extremely sluggish for the past six years. House prices have fallen from their peaks thanks to an unprecedented contraction in credit availability. Consumer confidence is shaky and household spending, which accounts for about 60 per cent of GDP, is anaemic.

An unemployment rate of 5 per cent used to be good enough to get wages moving, but it isn't any more. And judging by the US and UK experience – where unemployment rates are 3.6 per cent and 4 per cent respectively – our unemployment rate will need to be closer to 4 per cent than 5 per cent to get wages moving again.

The Australian economy needs to be

stimulated. Monetary policy is one way to do that, and we have some room to do so.

Those who say "it hasn't done much good thus far so what use is a bit more" ignore the counterfactual of where the economy might well have been if not for past cuts.

Fiscal stimulus is an option, although the balanced-budget fetishism of both sides of politics largely precludes significant investments in physical and social infrastructure. Tax cuts might help, too, but neither side is committed to doing anything meaningful in any reasonable timeframe.

The most notable change to taxation in Australia in recent times was to slug five big banks with a massive ad hoc tax increase for being unpopular.

On this front the RBA could act in the future, but it will need to develop and explain a new framework for monetary policy.

What that regime looks like is up for debate. In the US context former Treasury Secretary Larry Summers has argued persuasively for a nominal GDP target of say 5-6 per cent, and that may prove attractive here too. Summers emphasises how the inflation trade-off has changed:

"I do not see much that has changed that bears on the cost of higher inflation in making it harder for economic agents to plan. On the other hand there are compelling reasons to believe that the risks of deflation have increased.

"First, the world has seen a substantial amount of deflation or very low inflation over the last 20 years. In Japan and significant parts of Europe, deflation has taken place over several year periods. And there were moments during the financial crisis when deflation appeared a real risk for the United States.

"Second, deflation scenarios occur when the economy falls into the liquidity trap where short-term safe nominal rates cannot be reduced any further even though there is economic slack and inflation rates are declining. "On any reasonable calculation this is a much greater risk than it could have appeared in the mid-1990s."

Maybe the old 2-3 per cent inflation target was out of date, maybe it wasn't. In any case, it's gone. The RBA had ample opportunity to defend it, and in the end did nothing. Governor Lowe would do well to remember the words of Bob Dylan: "They may call you doctor, they may call you chief, but you're gonna have to serve somebody ... it may be the devil or it may be the Lord, but you're gonna have to serve somebody."

Governor Lowe needs to fully commit to a monetary policy regime, and then use his policy instruments to serve it. Now.

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