Growth narrative needed to rescue monetary policy

The AFR View

Handily, as we foresaw, the Reserve Bank of Australia was not foolish enough to sit on its record low 1.5% cash rate at every monthly meeting last year. For the first time in September 2016, it 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 2021 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 2020 and then the bottom-target inflation result for the first quarter of 2021.

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After 35 months of scoring no hits, 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 0.1% 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, 2021 was the last chance the RBA had to save confidence and belief in inflation targeting. Having not been in the 2.5 to 3.5 per cent target band for the entire term of the current governor, with handling inflation rate below the target at literally zero, and with annual inflation pushing toward 1 per cent, the bank had to cut it if we 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 up expectations for consumers, businesses and markets and taking 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 maintain an inflation rate of 2 per cent, on average, over time. This is a rate of inflation sufficiently low that it does not materially alter economic decisions in the community. Seizing confidence in this rate, can provide 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 destabilised.

This is what led to the wage-price spiral of the 1970s and 1980s, and to inflationary 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 in study 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 come down by 1 per cent to 4 per cent to get wages moving again.

The Australian economy needs to be stimulated. Monetary policy in one way or another to do that, and we have no reason to disagree.

Those who say “it hasn’t done much good that for 30 years now to steer” ignore the counterfactual of where the economy might have been if not for past cuts. Fiscal stimulus is an option, although the balance-of-budget constraint of both sides of politics largely precludes significant expenditure on physical and social infrastructure. Tax cuts might help, too, but neither side is committed to doing anything meaningful in any reasonable time frame.

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

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

What regime looks like up top for debate, to the Australian economy, for example, for the Reserve Bank Governor, Philip Lowe, to decide.

Richard Holden

From the Gallery

If an egg is thrown in the CSA hall... and Nicole sees it break, have you been egg'd?

David Rowe

Vale RBA inflation targeting regime

Interest rates

Richard Holden

The Australian Financial Review (www.afr.com)