

RBA is stabilising the economy. Next job is to reform it

Policy
The rate cut is essential insurance against financial instability. But only reform clarity will bring real recovery.



Warwick McKibbin

Australia's public health and economic policy responses to the COVID-19 pandemic are the envy of much of the world. The public health responses have been based on scientific evidence, and most Australians have accepted the tough decisions to make short-term behavioural changes and the costs of lockdowns to enable the emergence of a recovering economy.

The fiscal and monetary packages that were quickly put in place played a critical role in stabilising a sharp economic contraction. Now that the public health crisis appears to be under control, there is still a great deal yet to be done to produce a sustainable economic recovery.

The initial policy responses had many dimensions and an even more comprehensive array of policies that will be needed to manage our economic recovery. The Reserve Bank of Australia has played an essential role in stabilising the financial system, in managing low interest rates and in providing a term finance facility for banks to cover the financing costs of lending.

The RBA reduced the policy rate from 0.25 per cent to 0.1 per cent, in addition to lowering the three-year bond target rate and the interest rate on the TFF to 0.1 per cent. The policy also included the additional purchase of \$100 billion of five- to 10-year government bonds.

The reduction in the policy rate alone might have been counterproductive in current circumstances. But in combination with the full set of announcements, it does everything the RBA could do.

The RBA policy change alone does not provide anywhere near the stimulus to the economy that is needed. It is essential insurance to stabilise the economy while implementing the real policy interventions that will be required to kickstart the Australian economy. The most critical role of the RBA is to maintain the stability of the financial system.

Volatility is to be expected due to possible resurgent spikes in COVID-19 in Australia but also in response to the global economic shocks caused by the COVID-19 pandemic.

As shown in McKibbin and Fernando (2020), the economic impact of COVID-19 on the Australian economy depends on policy responses in Australia but also the public health responses and macroeconomic policies in the rest of the world.



Philip Lowe's RBA bought an additional \$100 billion in government bonds. PHOTO: LOUIE DOUVIS

Low interest rates enable stressed borrowers to remain liquid and low rates along the yield tends to weaken the Australian dollar, which provides support through competitiveness for exports.

A fundamental dilemma still to be faced is how to continue to fund illiquid but solvent firms to aid their survival while insolvent firms exit the economy. A lesson from the long period of quantitative easing in Europe and Japan is the survival of zombie companies that continue to absorb valuable resources that otherwise would boost more productive firms.

Much of the burden of the economic recovery will be borne by fiscal policy and fundamental economic reforms.

In the near term, it is essential to maintain demand through incomes policies and to prevent a financial crisis from emerging. While the scale of the fiscal response in the recent budget is appropriate to tackle the economic fallout from COVID-19, the composition of the package could have been better targeted.

For example, income transfers would be a better way to stimulate the economy than tax cuts in the short term. And support for child care would maintain labour supply as well as an income support mechanism.

The specific lack of support for some

Income transfers would be a better way to stimulate the economy than tax cuts.

sectors based on ideology rather than economic reality contributes to the poor targeting. Over time, the key policies that are needed are substantial economic reform and other policies that increase productivity while maintaining domestic demand.

A vital part of the recovery plan should be policy clarity. The ideal economic policy framework for a sustained recovery would be a bipartisan approach with support across the government and the opposition on the critical policy platforms.

Bipartisan support for the core drivers of economic growth reduces policy uncertainty and gives a less uncertain environment for firms to invest in and for households to save and invest.

A key driver of policy uncertainty is the state of climate and energy policy in Australia. While the technology road map was a good outline of the available technologies that would enable us to reach a

low emissions future, there's nothing in the road map that would drive adoption of technologies by the private sector.

The last thing needed in the current fiscal environment is for governments to add further pressure on the budget by paying for a technology transition. The adjustment to a low emissions future needs to be undertaken by companies and households in response to clear market signals.

A well-designed carbon market can drive the adoption of existing technologies and innovation in new technologies. The urgency of an energy transition in Australia has risen substantially with the announcements by China to reach zero net emissions by 2060 and by Japan and Korea to have zero net emissions by 2050.

These announcements have important implications for Australia's economy. Chapter 3 of the October IMF World Economic Outlook (which I co-authored) examines the mix of green infrastructure and other energy and climate strategies that can both stimulate the economy in the short term and provide economic growth in the medium to long term.

The key is how to transition from a fossil fuel-intensive economy but also a reliance on fossil fuel-intensive income through our exports to a different economy as the world transitions away from fossil fuels.

Australia has a significant advantage in this space in the sense that new industries such as renewable energy, hydrogen and a range of other technologies have enormous potential within Australia.

One option that is consistent with the technology road map but focuses on fairness and economic efficiency is the Climate Asset and Liability Mechanism, recently published by the Australian Academy of Social Sciences.

There has never been a better or more critical time to reopen the debate on how to create a world-leading framework for climate and energy policy in Australia. As with the COVID-19 response, this can be done well if it is based on science.

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Did Lowe do the right thing on rates? It's very hard to tell

Big guns
Imagining that central bankers have magical powers obscures a lot of other important policy conversations.



Richard Holden



Greg Kaplan

The Reserve Bank of Australia did exactly as it signalled and what markets expected by cutting the cash rate to 0.1 per cent and expanding its bond-buying program yesterday.

Now that the RBA is getting close to having no ammunition left, it's a good time to reflect on what it can achieve, and, more importantly, what we should expect from it.

A little perspective. Central banks are incredibly important in stabilising economies.

This was nicely put by the governor and later chairman of the US Federal Reserve, Ben Bernanke, in celebrating Milton Friedman's 90th birthday. Bernanke said: "Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again".

That is what central bankers can do—they can inject liquidity to avoid massive economic downturns from bank failures or a collapse in aggregate demand. This was most notably on display during the 2008 financial crisis when the US Fed and the RBA acted quickly and decisively.

And central bankers also have a hugely important role to play in anchoring long-run inflation expectations, which ended the self-fulfilling prophecies of wage-price spirals from the 1970s.

When they have a lot of room to cut rates, central bankers have big guns, even if right now they're armed with little more than a slingshot.

The idea that central banks can fine tune inflation or output is pretty hard to see in the data.

But what central bankers are not cut out for is fine-tuning inflation and output. Even at the best of times, their weapons have pretty poor sights on them.

This was pointed out by the RBA last year when, seemingly out of nowhere, it cut its estimate of the "non-accelerating inflation rate of unemployment" to 4.5 per cent and noted how wide its confidence interval was: a 95 per cent chance of being between 3.5 and 5.5 per cent. That's quite a range.

Moreover, innocent bystanders are frequently collateral damage when central banks fire their guns. It's easy for central banks to fuel asset-price bubbles, and the distributional consequences implicitly favour current versus future home owners.

An enduring part of the difficulty central banks face is that they typically have one instrument (the cash rate), or maybe a couple now with quantitative easing, but we expect them to aim at many things: inflation, unemployment, asset prices, and the exchange rate, to name a few.

The reality is that it's hard enough for the RBA to influence even inflation, which is the one target it should, at least in theory, have the most control over.

This is why the RBA is at great pains to point out how wide its target band is. And even if one does get inflation to move back up into the target of 2 per cent to 3 per cent, then it is still far from clear this will have a big impact on output or unemployment.

In fact, ascribing magic powers to central bankers obscures broader policy conversations. With the coronavirus pandemic serving as motivation, earlier this year we began a national conversation about how to get unemployment down. So far, the results of that conversation are non-existent. For instance, nothing was announced in the budget last month.

And it's really not all that surprising. Policy reform is hard, but if the good folks in Martin Place can take care of everything with monetary policy, then why bother with tough discussions about the labour market or housing affordability.

To his credit, RBA governor Philip Lowe has repeatedly emphasised the importance of fiscal policy, saying that there's only so much that monetary policy can do. Of course, that might have been more credible if he hadn't left the cash rate at 1.5 per cent until mid-2019, despite repeated calls to react to a prolonged period of anaemic growth and low inflation.

The history of central banking from the

1970s in countries like the US and Australia is distinguished. Bankers learnt the lessons of the Great Depression, and inflation was tamed by credibly anchoring expectations about its future path. This has led to much greater economic stability and prosperity than could easily have been imagined.

But let's not get carried away with what central banks can do. The idea that they can fine-tune inflation or output is pretty hard to see in the data, or in modern economic models for that matter.

What central banks can do is to avoid financial crises, prevent hyperinflation and be mindful of Friedman's admonition: "The first and most important lesson that history teaches about what monetary policy can do ... is that monetary policy can prevent money itself from being a major source of economic disturbance."

That's no easy task, but well-trained central bankers in advanced economies have become very good at it. For that, we should all be very grateful.

But we shouldn't expect too much from central banks. As another economist, the late, great Zvi Griliches was fond of saying: "There's only so much lemon juice one can get out of a lemon."

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