The Very Last Thing We Need Is Radical Reserve Bank Action

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The Reserve Bank of Australia has used the coronavirus threat to accelerate its move toward radical monetary policy. To prevent further distortions to the Australian economy the government should lower the RBA's inflation target that is driving economically harmful intervention.

Last year, RBA Governor Philip Lowe tested the waters with talk of quantitative easing and negative interest rates with the proviso, "our current thinking is that QE becomes an option to be considered at a cash rate of 0.25 per cent, but not before that." With last week's decision to cut the cash rate to 0.5 per cent, the RBA is now just one cut away from what it has termed "unconventional monetary policy". At the Australian Financial Review Business Summit on Wednesday, RBA Deputy Governor Guy Debelle increased expectations of QE stating, "there are scenarios in which we are certainly going to have to consider that – absolutely."

Quantitative easing would involve the RBA buying long term government debt and other financial assets in a bid to lower long term interest rates and inject more money into the economy. This measure will inflate asset prices, expand Australia's debt bubble, and further harm savers by lowering their interest income, forcing them into greater risk exposure and diluting the value of their savings through higher price inflation.

The inevitability of QE was clear long before the coronavirus outbreak, which was mentioned nine times in a Lowe’s short seven paragraph ‘Monetary Policy Decision’ statement last week. The economic shock may have brought forward the cut, but the response to the coronavirus should not be divorced from an already well established trajectory.

Despite holding interest rates at record lows for the past seven years, the RBA has only managed to meet its inflation target twice in the last 21 quarters. If a future cash rate cut to 0.25 per cent is anything like the previous 15 consecutive cuts, it too will fail to generate inflation. The next step, as Lowe has admitted, will be for the RBA to spend money into existence through the purchase of financial assets.

The risk of QE can be mitigated by lowering and expanding the inflation target. All this would require is a straightforward agreement between the Treasurer and the RBA Governor to lower and widen the inflation target band, shifting it from between two and three per cent to between one and three per cent. This would allow the RBA to refrain from further expansionary policy.

The current trajectory in monetary policy has been a failure. The economy’s current predicament comes on the back of a decade of unconventional policy. There is nothing conventional about holding interest rates at record lows for multiple years on end in the absence of a recession. The solution cannot be to double down.

Experiments with QE and negative interest rates by central banks around the world have failed to produce empirical support for the RBA to follow. Moreover, the RBA lacks a proven policy track record. Reading through the last decade of monetary policy statements will not fill anyone with confidence that the RBA has any special knowledge or skill for forecasting the effectiveness of their policies.

The first step in righting the ship is to reconsider the pursuit of an arbitrary inflation goal. Central banks across the world have been tripping over each other trying to generate price inflation with increasingly destructive policies. The end result has been economic stagnation and the inflation of asset markets that are addicted to easy money.

Instead of fearing deflation, downward pressure on prices should be recognised as beneficial when resulting from productivity gains. If the amount of goods produced in the economy grows at a faster rate than the amount of money, prices will fall. This means lower living expenses and an increase in the purchasing power of accumulated savings.

Deflation is feared because extended easy monetary policy has created an economy dependent on continual monetary expansion. This means that low rates of inflation and the slowing of monetary expansion are often associated with pricking bubbles in the economy. But accelerating monetary expansion to maintain asset bubbles can only make the problem worse.

It makes no sense to maintain an inflation target that if enforced would require the RBA to engage in economically harmful policy tools. Widening and lowering the inflation target to between one and three per cent is a necessary and prudent first step to avoid undermining the Australian economy with radical monetary policy experiments.

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