The Reserve Bank’s Great Gamble On Interest Rates

Publish Date:

October 2020

The fiscal path outlined in the federal budget will constrain monetary policy and undermine the stability of the Australian economy. The Reserve Bank of Australia will be forced to pursue expansionary monetary policy that will leave it impotent in the event of future economic headwinds.

The RBA’s decade-long experiment with record low interest rates has created an economy that is dependent on low borrowing costs and has emboldened the Federal government to dramatically blow the government debt out to $1.7 trillion over the next decade.

High levels of government and private debt has committed the RBA to a policy of continual monetary expansion that will trap it between a rock and a hard place should price inflation set in.

The dramatic expansion in deficit spending will require the RBA to increase money creation to purchase government debt if it is to maintain low interest rates. The RBA has already doubled its balance sheet since January to over $300 billion which has contributed to record growth in the m oney base. The money base measure, which includes currency held by the private sector and bank deposits with the RBA, is up 48% on this time last year.

In the event that continual growth in the money supply flows through to price inflation, the RBA will be forced to either allow inflation to wreak economic havoc or fight inflation by restraining monetary growth and allowing interest rates to rise.

Increased borrowing costs would reveal the instability of the Australian economy. Government interest payments would shoot to the top of the budget expenditure list, and Australian households, which have the second highest household debt to GDP ratio in the world behind Switzerland, would quickly go underwater with mortgage defaults causing a housing market decl ine that could undermine the balance sheets of Australian banks.

The expansion of government debt combined with the RBA's mandates has severely constrained the central bank. The *Reserve Bank Act (1959)* charges the RBA with conducting monetary policy to best contribute to "the stability of the currency", "the maintenance of full employment", and "the economic prosperity and welfare of the people of Australia".

For the foreseeable future, the economic prosperity and welfare of Australians depends on low b orrowing costs, but achieving this will require continual monetary expansion that risks undermining the stability of the currency. Given the RBA's charter, it has little option but to attempt to hold the line with low interest rates, hope for modest inflation to assist the indebted economy, and pray that inflation doesn't get out of control.

This shows that the RBA is independent in name only. For all intents and purposes, its decisions are constrained by the need to accommodate fiscal policy and the rapid expansion of government debt.

However, the RBA's current predicament also reflects a long-term failure of its own monetary policy. In the wake of the Global Financial Crisis the RBA slashed the cash rate from 7.25% to 3%. In November 2011, after an attempt to normalise rates, the RBA began a rate cutting cycle that culminated in March this year with the cash rate target being set at 0.25%. Never before have we had a decade-long period of record low interest rates. This has facilitated a record level of household debt and enticed governments into deficit spending. Instead of having a stimulating effect, myopic monetary policy has severely undermined the stability of the Australian economy.

Low interest rates cannot be assumed in the long-term as debt is repaid. The timeline of repaying the national debt has shifted out decades with the Institute of Public Affairs estimating that it could take until 2080 before gross debt is repaid with favourable conditions. A host of not unlikely scenarios over the next half a century – including rising interest rates, increased price inflation, and future economic shocks – could see the Australian economy enter a deep and debilitating depression.

This is not a position of strength to leave to our children and grandchildren. Pursuing the status quo will not improve Australia's economic resilience. Governments must recommit to reducing debt by implementing pro-growth reforms, such as cutting red tape and inefficient taxes, reducing the size of government and restraining government spending.

Originally published in:
The Spectator Australia
Original Link:
https://www.spectator.com.au/2020/10/the-reserve-banks-great-gamble-on-interest-rates/