Why fix the cash rate?

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Australia's official interest rate is known as the overnight cash rate, or just the cash rate for short. It is the rate at which banks and other financial institutions which have accounts at the RBA borrow from and lend to each other on an overnight basis. However, it also forms the basis for interest rates in the wider economy due to the ability of banks and other institutions to borrow from or lend to the RBA.

In the past, Australia had no official cash rate, or at least none which the RBA disclosed publicly. The rate of interest banks charged each other on overnight loans was a function of demand and supply of cash, with the RBA supplying additional cash or soaking it up whenever it thought necessary. This changed in 1983 when the dollar was floated and the RBA began to target the cash rate instead of the exchange rate. The RBA only began to publish publicly its target in 1990.

The practice of the RBA setting the cash rate is, at best, ineffective and, at worst, counterproductive.

The future direction of interest rates is at least as important to an investment decision as the current level of rates. A reduction in interest rates can be read as a signal of future interest rate reductions.

If the decision is whether to borrow now to expand or wait until later, then the current interest rate is only part of the reason. A more important question is, "What is the likely level of interest rates in the next three to six months?"

If interest rates are going to fall, then logic dictates that I should wait to take advantage of the lower rates. The corollary is also true that if rates are going to be higher in the future I should borrow now.

Falling interest rates are only an advantage (to a borrower) when they have finished falling.

So, the positive effect of the RBA's rate drop may be more than offset by an expectation that rates will fall further in the near future.

Fixed cash rates also have some undesirable effects.

Currency Speculation

Fixed cash rates encourage currency speculation by providing unlimited liquidity to a bank wanting to sell the currency. The RBA is prepared to enter into as many repurchase agreements ("repos") as necessary to maintain the cash rate at its target rate. The same repos also provide unlimited investment opportunities to those wishing to purchase the currency. If rates were allowed to float to some extent then they would tend to rise when there is a run on the currency. This should help to stem the fall.

No Premium for Liquidity

A fixed cash rate mean that the Reserve Bank guarantees liquidity at all times. This means that most of the time a 10-year mortgage-backed security will just as easily produce cash as a 10-day Treasury note. Both can be used to undertake a repo with the Reserve Bank. This has the effect of narrowing liquidity spreads and credit spreads which were particularly evident prior to the GFC.

In effect, a moral hazard is created as borrowers can rely on a lender of last resort which will bail them out of a poor investment decision. The RBA must accept at least some of the blame for the GFC along with most other central banks which maintain a similar system.

We should not confuse the price of money (its interest rate) with its availability (its liquidity). APRA's recent moves show that money can become very tight even when interest rates are historically low.

Effect on Pensioners

Pensioners at the moment have no incentive to consume. Low-interest rates together with an expectation of even-lower rates is a major incentive to save.

In conclusion, setting the cash rate comes with problems. It promotes currency speculation and it creates a moral hazard among bankers. Cash rate targeting has not delivered the promised results.

I believe letting the cash rate fluctuate within a defined band which will average out over some short time period, such as a month, for instance, will provide a better outcome. Lenders will not have an incentive to become over-leveraged.