yieldreport %

SUBSCRIBE HERE FOR WEEKLY NEWSLETTER

TOP STORY FOR THE WEEK 14 Dec - 18 Dec 2020

Reserve Bank management of interest rates

Melbourne, Australia 22 Dec 2020.

By Ken Atchison, principal, Atchison Consultants

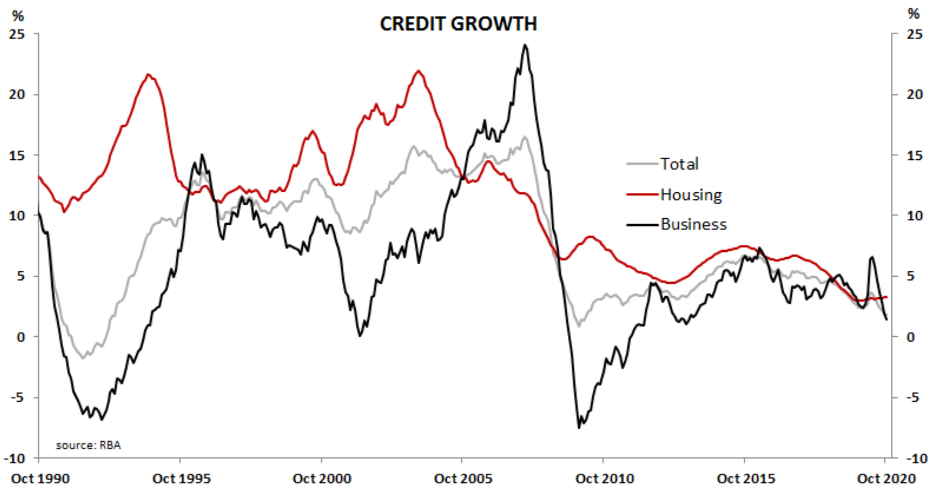
How fiscal and monetary policy is conducted in Australia will be critical for its recovery from recession, which itself was driven by Australia's response to dealing with the coronavirus. While a health crisis and an economic crisis were almost inevitable, avoidance of a financial crisis was a key policy of the Federal government and the Reserve Bank of Australia (RBA). However, the RBA's policy thrust has extended well beyond monetary policy.

In part, the Reserve Bank has been trapped into following the Federal Reserve, ECB and other central banks in keeping interest rates very low. If it I did not, the Australian dollar would have appreciated significantly. The notorious "Greenspan/Bernanke put", the practice of the Federal Reserve cutting interest rates whenever US equity markets quivered, has had wide ramifications for more than two decades, and not just for the US.

Extreme actions have been adopted by the RBA as it imposes alternative policies. Having reached zero bound, lowering interest rates is no longer an effective policy tool. RBA Governor Lowe has stated:

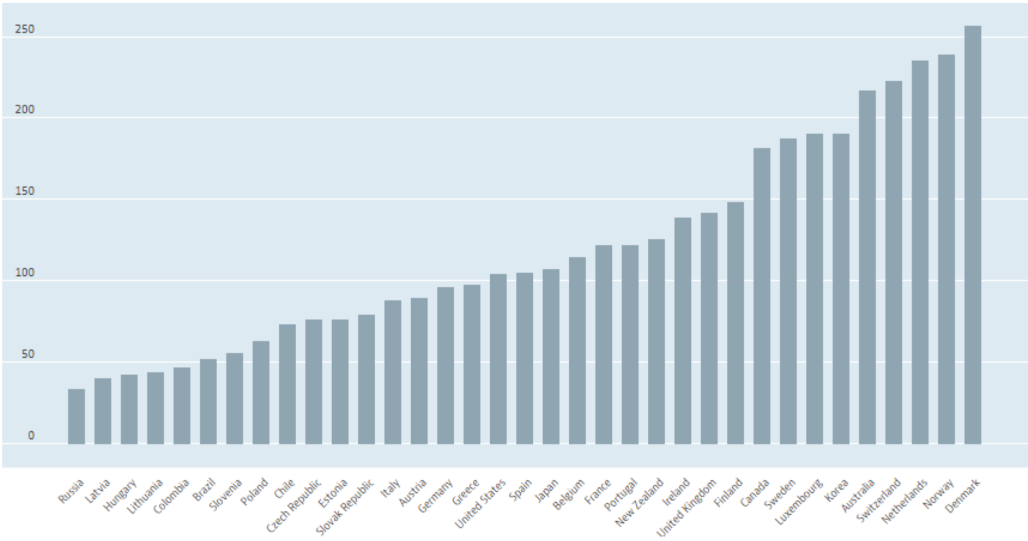
- that the cash rate will stay at the low of 0.1% for at least the next three years.
- that preservation of states' credit ratings is not particularly important. Creating jobs is much more important.
- that he has no concerns at all about state governments being able to borrow more money at low interest rates.
- that $100 billion of long-term federal and state government bonds will be bought over six months.
- that a $200 billion funding line of credit will be offered to banks to offer cheap money to business.

The RBA's actions have only had a cushioning effect. Data to October 2020 indicates private sector credit rose only 1.6% in the year. Drastically lower interest rates have resulted in a minor increase in total borrowing for housing. Business credit is still contracting as survival is currently the business sector's sole focus.



Click here to this week's other latest stories

Lower interest rates and liquidity into the financial system has instead flowed into investment markets with housing prices not only stabilising but rising. Australia already has one of the highest levels of household debt-to-income ratios in the world; only four European countries have higher ratios.



Source: OECD (2020), household debt

And yet the RBA appears keen to advocate for more debt. Officials have explicitly called for governments to spend more and finance that spending through borrowing. These statements have been used to justify rising debt in the public sector, adding to the very high level of household debt in Australia. Credit standing does matter. A lower credit rating indicates uncertainty about the ability of the borrower to service the loan. It is a statement about financial management competence. For example, when S&P downgraded the credit rating of the Victorian Government, it said, “Victoria’s operating and after-capital accounts deficits and debt burden had deteriorated sharply …”

The RBA also decided that it has a role beyond stability of the currency. Lower interest rates have meant that the currency has remained low. Now the RBA wants to suppress longer-term bond rates until 2023, thus minimising their attractiveness to offshore buyers and preventing the exchange rate from rising. If prudent financial management by an elected government results in a rising exchange rate, then that is an acceptable outcome. Imprudent financial management may not suffer consequences immediately but it is invariably punished. Austerity will be imposed with reduced government services and employment.

The RBA has a clear purpose, being the “stability of the currency, full employment and the economic prosperity and welfare of the Australian people.”

William White, former chief economist of the Bank for International Settlements, has stated “Central banks have pursued the wrong policies over the past three decades which have caused ever-higher debt and ever-greater instability in the financial system”.

Is the Reserve Bank of Australia now encouraging an even greater failure by increased government debt without regard to financial prudence?

If the RBA were to act in the economic prosperity and welfare of the Australian people it would Immediately cease purchasing long term federal and state government bonds, as well as its encouragement of financial imprudence by state governments.

Click here to this week’s other latest stories