

Australia Should Keep its “Goldilocks” Interest Rates

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The Governor of the Reserve Bank of Australia has recently stated that interest rates may be cut unless there is a change for the better in overseas economic conditions. Confirmed leaks from the RBA's June meeting indicate that the Treasury Department representative on the RBA board wanted a rate cut. On 25 June 2003, the US Federal Reserve cut rates to 1%, a 45 year low.

Only a year earlier, the RBA raised rates, by 0.25% in each of May and June 2002, and stated that rates were likely to rise further – but they did not.

Despite having interest rates that are high by comparison with other countries, our domestic economy is growing much faster than those countries. If Australia follows Japan, the US, and the Euro area down the path of ultra low interest rates then we expose our economy to very serious risk of stagnation.

In this article, I examine the reasons for low interest rates overseas; the consequences of low interest rates; and the dangers Australia faces if interest rates are cut.

Reasons for Low Interest Rates Overseas

US interest rates started falling in January 2001, when the Federal Reserve detected a sudden slowing of the economy. The official interest rate has fallen 13 times from 6.5% in December 2000 to 1% in June 2003. Despite this steady fall, the US economy shows no clear sign of bouncing back.

Recently, the Federal Reserve has mentioned the dreaded “D” word – deflation. The Chairman of the US Federal Reserve, Alan Greenspan, has reportedly (Australian Financial Review, June 28-29 2003) been influenced by a research paper by Fed staff entitled “Preventing Deflation: Lessons from Japan’s experience in the 1990’s.” It concluded that economists and financial markets failed to forecast Japan’s deflationary slump in the early 1990’s and thus failed to act in a timely manner. The policy prescription was that when inflation is low and there is the faintest chance of deflation, insurance should be taken out by cutting interest rates by more than they would otherwise.

Official interest rates started falling in Japan in mid 1991, from 6% to zero by early 2001.

Interestingly, US interest rates have been cut faster than Japan’s since the respective downward cycles began (Chart 1).

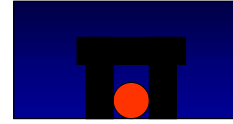
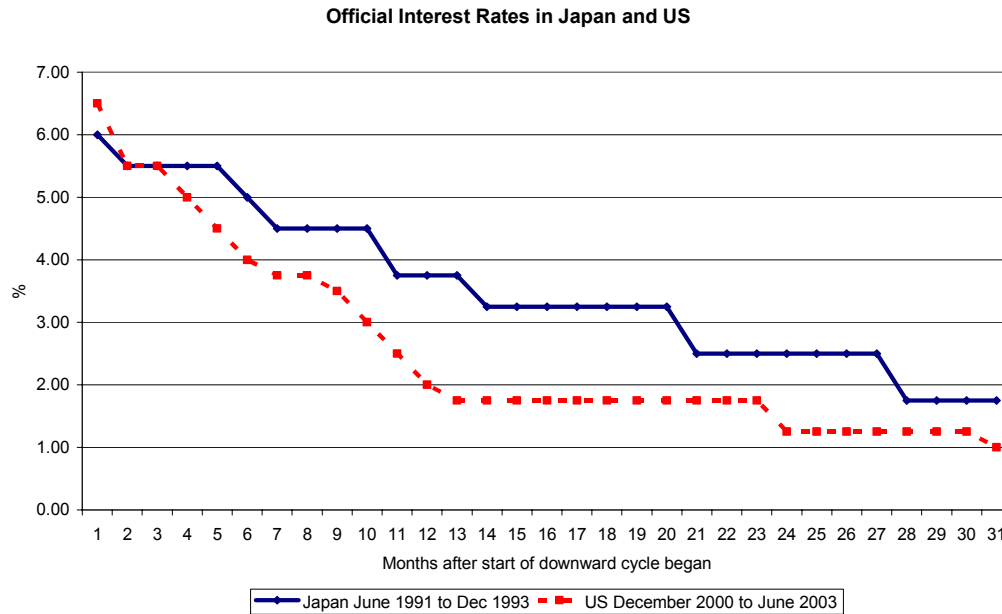


Chart 1



The Causes and Consequences of Deflation

There are two causes of falling prices:

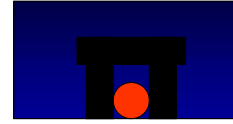
1. Productivity improvements caused by technological or other developments. The price of computing power has been falling since computers were invented.
2. Excess productive capacity, caused either by overinvestment or lack of demand. The price of motor vehicles has fallen since the mid-1990's because of overcapacity rather than lack of demand

Falling prices are a good thing, especially if brought about by increased productivity. However, if there is widespread excess productive capacity this can spill over into income cuts for both employers and employees (mostly through loss of jobs).

Loss of jobs is particularly damaging for those with debt. If prices and incomes are rising then the real level of a given debt falls quickly. But if prices and incomes are falling then the burden of a given debt increases.

There has been little or no discussion in the media about the impact of deflation on retirees – a rapidly growing consumer segment. Falling prices are a good thing for pensioners, so long as pensions do not fall. For self-funded retirees, falling prices are a good thing so long as investment income does not fall.

Retirees tend to have little or no debt, so deflation has no fears on that score. But with rapidly falling interest rates in USA, Japan, and Europe, those self-funded retirees with cash investments have experienced a large cut in income. Those with



investments in shares have seen their nest-egg shrink. Either way, they will have retrenched spending.

It is sometimes claimed that in an environment where most prices are falling, and expectations are formed that prices will continue to fall, consumers will defer spending in the hope of buying at a lower price. This is unlikely to happen for an extended period.

There are counter examples:

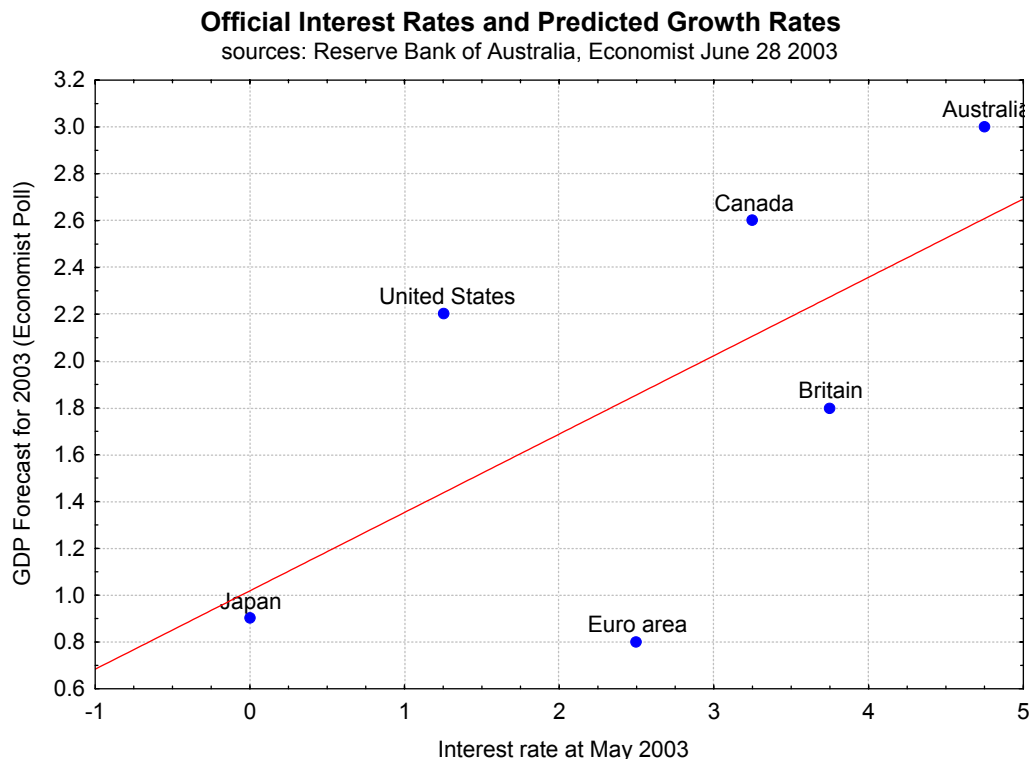
- The price of computing power has fallen continuously - and this is widely expected to continue – but firms and consumers still buy computers;
- There are no reports from Japan, where prices have been falling for several years, of people dying of starvation while they wait for a cheaper sushi – people will eat eventually.

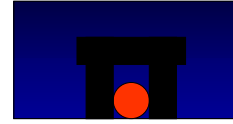
Deflation is only a problem when incomes fall – and this includes income on savings in the bank.

The Danger of Very Low Interest Rates

Chart 2 compares official interest rates for six selected countries/regions with their expected economic growth rates for 2003 (Economist Poll).

Chart 2



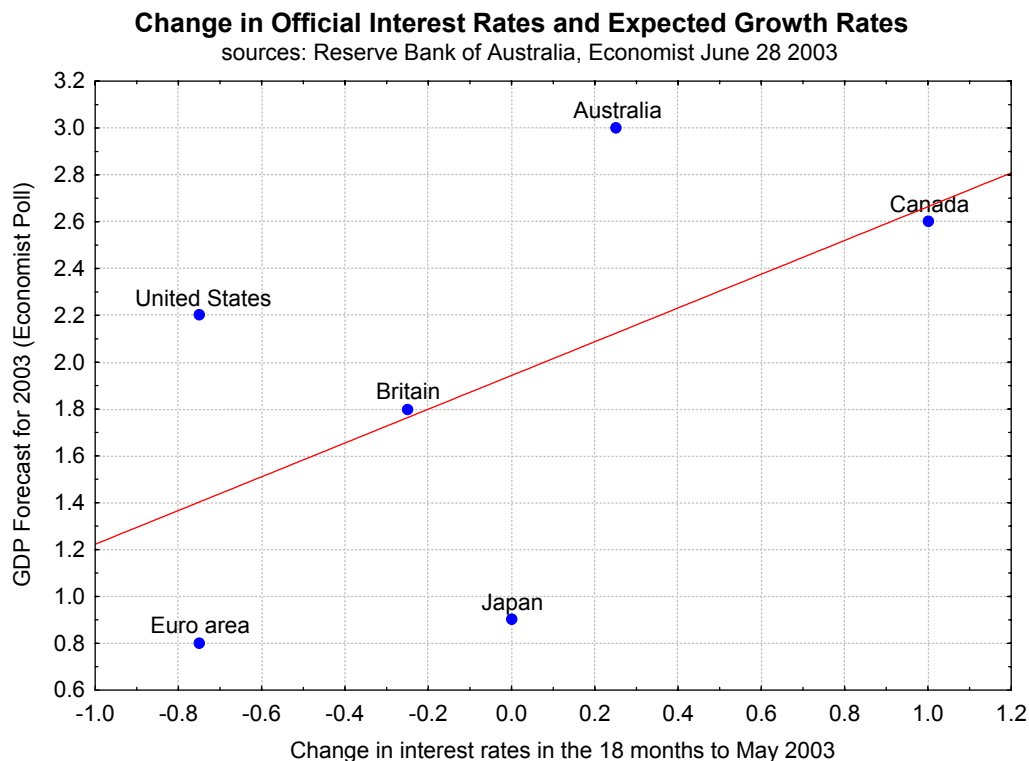


The chart shows that the country with the highest interest rate, Australia, is expected to have the highest growth rate while the country with the lowest interest rates, Japan, is expected to have the second lowest growth rate, marginally ahead of the Euro area. Canada has higher interest rates than USA but is expected to enjoy higher growth. Similarly Britain has higher interest rates than the Euro area but is expected to have much higher growth.

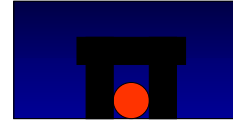
Surely this is contrary to what economists always tell us? Lower interest rates are supposed to boost economic growth.

It could be argued that interest rates are reduced when the economy slows so that Chart 2 simply reflects the policy reaction. Interest rates do take time to have an impact on the economy so Chart 3 compares the change in interest rates in the 18 months to May 2003 with expected economic growth rates. It does not support the theory that lowering interest rates boosts economic growth. The two countries that have raised rates over 18 months have the highest expected growth rates.

Chart 3



It can be argued that there are a number of special circumstances, especially in USA and Japan. Also, the forecasts for 2003 may not be accurate. In addition, there are not enough countries/regions in this analysis to reach any statistically significant conclusions.



There is no doubt that there is the expected **negative** relationship between interest rates and GDP when analysed on a time-series basis for Australia and other countries. In Australia, for example, there is a statistically significant negative relationship between interest rates and:

- Investment, with a lag of 9 months;
- Household consumption, with a lag of 15 months.

However, in Australia there is also a statistically significant **positive** relationship between interest rates and discretionary consumer spending with a lag of one quarter.

These reactions in different directions and with different lags is explained by different consumer segments:

- Net payers of interest, especially households with mortgages, boost spending when interest rates fall, but only after a lag of 15 months during which time they repair their balance sheets by maintaining lifestyle while paying off debt (when rates are rising, they maintain lifestyle by saving less and/or borrowing more for 15 months);
- Net receivers of interest (mostly people over 50) depend on interest for some or all of their discretionary spending. They cut spending when interest rates are falling and they do it quickly because they will not use debt and they will not eat into their nest egg for consumption. When rates are rising, they quickly boost discretionary spending.

For full details of our research on this topic, our paper can be downloaded at www.foreseechange.com/perverse.pdf. For more on the distribution of debt and wealth by age group, download www.foreseechange.com/debtwealth.pdf.

Chart 3 shows the proportion of Australian adults who prefer interest rates to rise, fall, or stay the same. Consistent with 27% of households paying off their home, 30% want lower interest rates. But 20% want higher interest rates. As shown in Chart 4, these are mostly older people and this is consistent with research by NATSEM, based on ABS household expenditure survey data, which shows that in 1998/99 each person over the age of 65 had an average of \$40,000 on deposit in addition to other investments and superannuation. It is the segment that wants higher interest rates which is increasing more quickly because of the rapid ageing of the population.

This line of argument is often dismissed by economists because there are more people with mortgages than with significant deposits. But this ignores the subtlety of the faster reaction time of net receivers of interest, which can result in policy errors and could result in snowball effects. For example, if consumer spending is slowing central banks may cut interest rates and expect to see a recovery. But initially spending slows further due to the quick reaction of receivers of interest and the slow reaction of payers of interest. This could lead to unnecessary further cuts in interest rates and possibly layoffs by affected retailers and their suppliers. In an extreme case this could result in a self-reinforcing downward spiral.

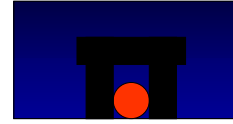


Chart 3

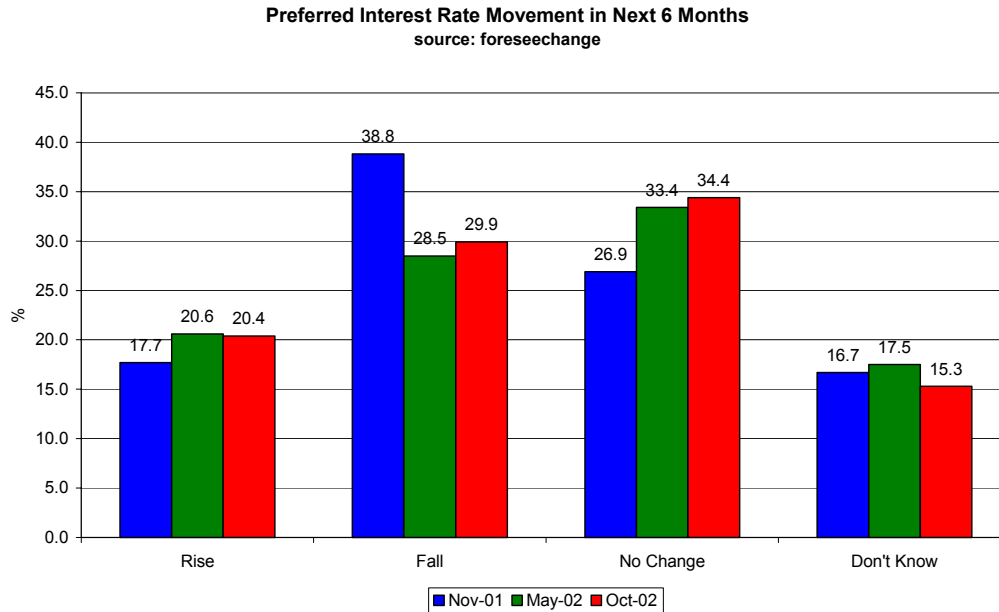
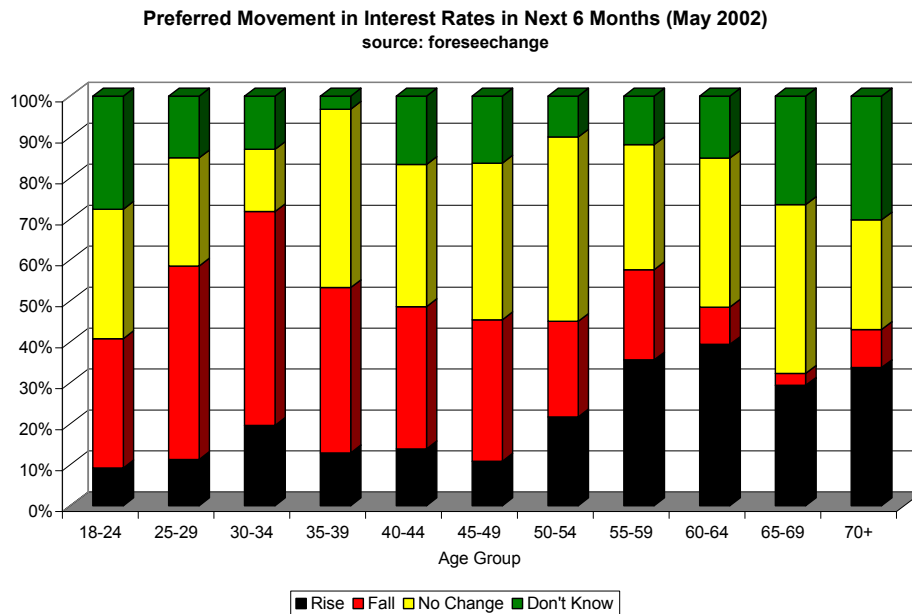
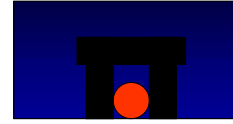


Chart 4

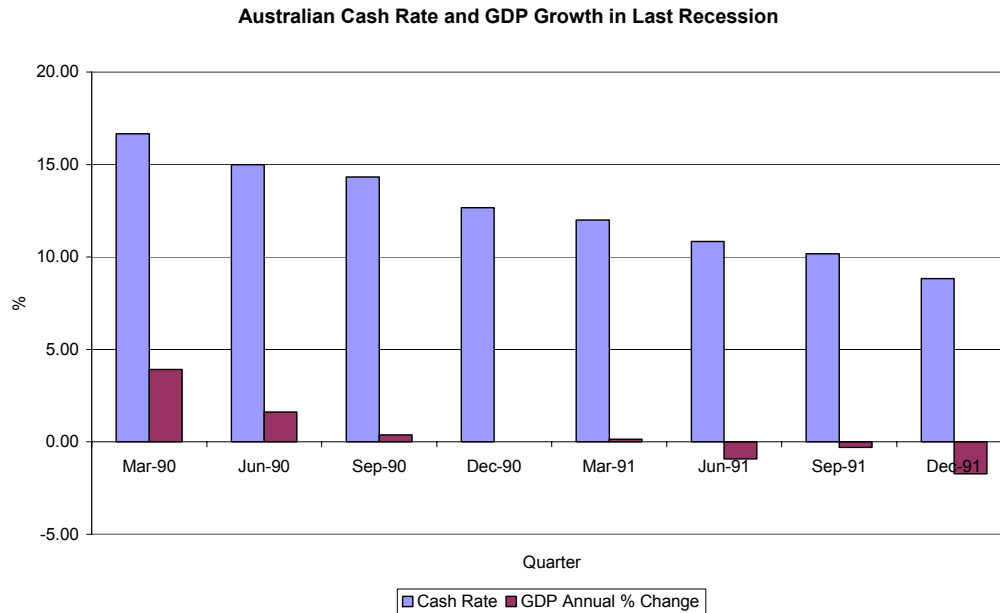


The last recession in Australia was associated with rapidly falling interest rates (Chart 5). Of course, the Reserve Bank would argue that the last recession was caused by interest rates being kept too high for too long in the late 1990's. But if they knew precisely how interest rates influenced economic growth, they would not have made such a mistake. Perhaps the boom before the recession was, in part, caused by high



interest rates fuelling spending by retirees. Almost certainly, the quick descent into recession was caused by interest rates falling too quickly.

Chart 5



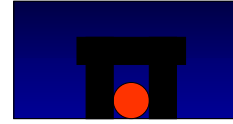
There are at least three case studies of countries falling into recession when interest rates are falling rapidly. Australia in the early 1990's, Japan in the 1990's, and now USA in the early 2000's.

Japan is a country with a much higher proportion of older people than Australia and they have a lot of savings which pay virtually zero interest. The Japanese stockmarket is down by over 75% from its peak in the late 1990's and the property boom has burst. How has a self-funded retiree been able to earn an income over the past decade? Perhaps the fall in interest rates combined with the fall in the stockmarket has led to a self-reinforcing downward spiral as described above.

Perhaps such a spiral is now in place in America too. The stockmarket is off its 2000 peak by more than 20% and interest rates are close to zero. If the property bubble bursts, self-funded retirees will put their savings under the mattress rather than having them eroded by fees that exceed interest.

The only way out of such a spiral is to raise interest rates.

Virtually nowhere in the extensive reporting of the economic situation in America, Japan, and Europe is there any discussion about the spending behaviour of partially and fully self-funded retirees and the impact of monetary policy on that spending. No mention of this issue is made in the official statements by central banks.



This negligence could be very costly in economic and social terms. Monetary policy is very blunt and central banks make policy on the basis of the “average” consumer. However this is the fallacy of averages – there are few, if any, average consumers and the response of consumers to policy changes does not resemble that of the hypothetical average.

Risks Faced by Australia if Rates Fall

I have pointed out one risk of cutting interest rates too much – there is the potential for a self-reinforcing downward spiral in economic growth. The likelihood of such a spiral may be increased when stockmarkets are well down from their peaks.

Another possibility is that already present imbalances in our economy will be worsened with potentially dire consequences.

Chart 6 shows the growth in housing and personal debt since 1990. The current growth rate of 17.2% is approaching the late 1994 peak of 18.0%. That bubble was burst by the Reserve Bank lifting rates by 2.75% in the space of five months.

The Reserve Bank has expressed concern about the recent rapid buildup of debt but it is a problem that they created by keeping interest rates low. Cutting interest rates now runs the risk of further stimulating this unsustainable boom. The bigger the boom, the bigger the ultimate bust when interest rates inevitably rise in the future.

The household saving ratio has been falling since the mid-1970's and has now turned negative (Chart 7). Lower interest rates, by encouraging further borrowing, would reinforce this trend. The long-term consequences could be slower economic growth due to lower future retirement incomes and further deterioration in our international debt as more investment funds are sourced from overseas rather than domestically.

Exporters are baying for rate cuts to slow the appreciation of the Australian dollar. But many factors influence the value of the local currency, including commodity prices, the value of the \$US, and investment opportunities (download our paper www.futuretoolkit.com/currency.pdf). There is no guarantee that a cut in interest rates will lower the value of the currency. Australia does have a problem with export growth and this has been influenced by drought, SARS, and complacency regarding the development of more diverse export opportunities. Exports have been falling for two years and this predates both drought and the recovery in the Australian dollar.

Interest rates are a very blunt instrument and it would be dangerous to ease purely to encourage export growth. Indeed, the sole goal of monetary policy in Australia (whether rightly or wrongly) is to keep price inflation in the band of 2% to 3% over the course of the economic cycle. Inflation was towards the top end of that band and the appreciation of the Australian dollar will help to reduce inflation towards the middle of the target band.

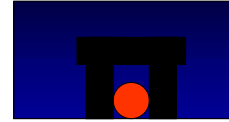


Chart 6

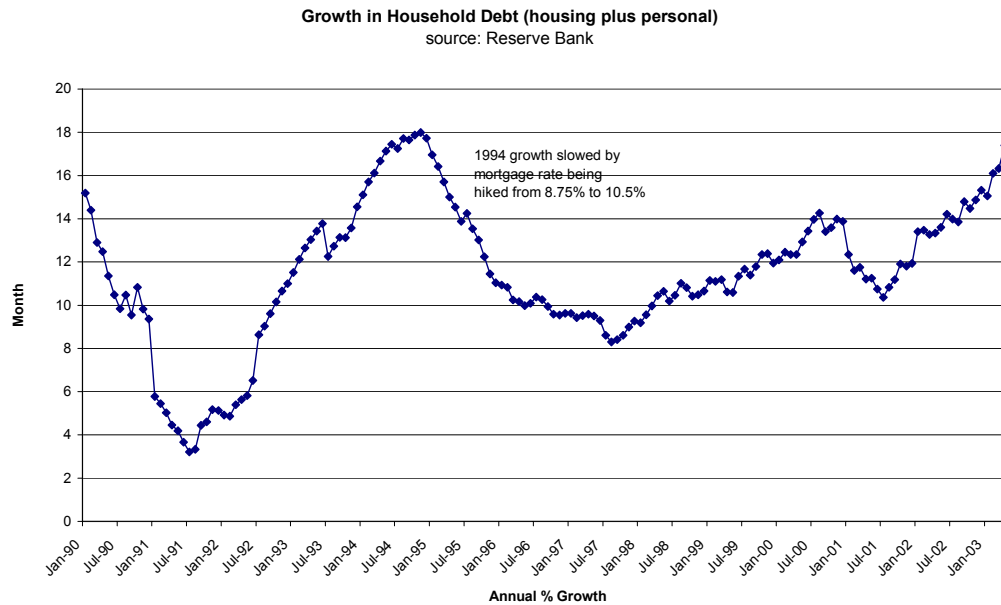
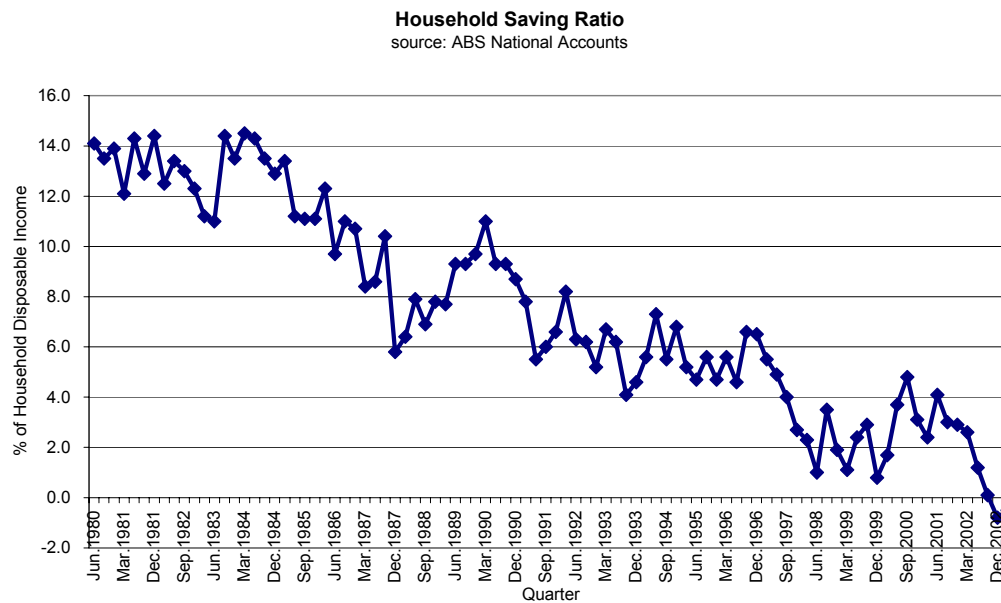


Chart 7

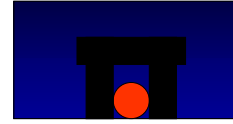


Conclusions

Australia's domestic economy is strong relative to the rest of the world and there is no case for a rate cut on purely domestic factors. A cut in interest rates risks a Japan (and perhaps USA) style low growth economy despite, indeed because of, very low interest rates. Even if that outcome were to be avoided, we risk a ballooning debt problem that will cause significant pain when interest rates eventually rise.

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Given the lags in the working of interest rates, there is also a danger that we may cut rates only to see a recovery in the US economy and a booming Australian economy with little we can do to control it in the short term.

Australia should keep its “Goldilocks” interest rates:

- Not too high to hurt borrowers; and
- Not too low to hurt net recipients of interest too badly.