A Virtue Signalling Rate Cut

Like a private jet flying celebrity lecturing the world about climate change, the RBA's decision to cut rates yesterday seems more about appearances than cold economic logic. A cursory understanding of the economic impact of the Coronavirus, the relatively minor sell-off last week and the RBA's own research on debt and asset bubbles created a strong case for no action. Instead, the RBA chose to reflexively give markets the rate cut they had only just priced in.

The Coronavirus will pass eventually, likely in the next 6-12 months. Expectations are that it will either peter out (by containment or after it becomes widespread) or that a vaccine will be developed and distributed. The economic impact now is substantial and will likely drag several major economies into recession that were mostly on the brink of recession already. China too may see a recession, depending on the size and speed of government fiscal stimulus. On its own, the economic impacts of Coronavirus are likely to be temporary, but they could also be the trigger that starts a global Minsky downcycle.

Either way, the initial textbook economic response would be fiscal stimulus aimed at filling the demand drop-off. Monetary stimulus will impact asset prices positively, but it will do almost nothing for an education, travel, retail or commodity based business that has seen a substantial drop-off in demand for its goods and services. A rate cut might be seen as a demonstration that the RBA cares about the economic issues, but it does little to fix them.

If the biggest positive outcome of a rate cut is to calm markets, it ignores the fact that the recent sell-off has so far been small compared to run-up in asset prices over the last decade. Prior to the sell-off last week, asset prices were widely seen as over-valued by almost all historical benchmarks with clear signs of speculative excess. Even after the nearly 10% drop last week, the ASX 200 Accumulation Index is still up over 15% since 1 January 2019. This relatively minor sell-off should have been recognised as an overdue and healthy correction with no need for intervention.

Whilst the stimulus and market issues focus on short term impacts, in the long term the continuation of rates cuts builds the bonfire of financial instability. Philip Lowe's recent comments on rate cuts "that it is possible to have too much of a good thing" were seen by some as a sign that the RBA had seen the light on debt and asset price bubbles. However, the comment that immediately followed pointed to these problems being something for others to worry about.

I've written several times about the long term economic damage done by low interest rates, it's a problem that is increasingly acknowledged as the evidence mounts. Philip Lowe also wrote about similar issues earlier in his career but seems to have disowned his previous conclusions on credit and property price bubbles. Now that he is RBA Governor, he seems intent on using monetary policy to extend a bubble, rather than bringing forward its collapse and minimising the consequences as he advised in a 1997 research paper. In a second paper that year, he co-wrote that "low inflation increases the importance of monetary policy responding relatively early in the life of a bubble".

The Prime Minister joined in the virtue signalling calling on banks to pass on the full RBA rate cut, extending a tradition Australian politicians have long engaged in. The four major banks obliged for home loans; it will be interesting to see whether business borrowers and credit card holders see the full benefit. Savers are no doubt going to be punished further for their prudence, they are increasingly becoming extinct as the RBA attempts to convert them all to being leveraged property owners and yield chasing investors. Perhaps after the next crisis the RBA will realise that they need a conversion, going back to normal monetary policy and evidence based economic decision making.

Written by Jonathan Rochford for Narrow Road Capital on 4 March 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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