NARROW ROAD
CAPITAL

The RBA’s mistake was cutting the Cash Rate

It has become fashionable in recent months to criticise the RBA for raising the cash rate too quickly and causing financial pain for highly leveraged borrowers. A vocal cohort of economists and market commentators, abetted by attention seeking media outlets, would have you believe that the RBA is completely unaware of the impact of higher interest rates. Common arguments include that it is unfair to punish borrowers for high inflation, that inflation is being caused by supply chain issues and should therefore be ignored, and that high inflation isn’t a big deal anyway.

These myopic arguments are typically left to run without counterarguments being given airtime. The most obvious counterpoint is that we shouldn’t be in this position because the RBA (and other central banks) should never have cut rates as far as they did.

The current round of rate increases hasn’t taken the overnight interest rate back to a normal level (think 4-5% if inflation is within the 2-3% target range), let alone to a level that ensures that real interest rates are positive. Unless inflation collapses soon, the RBA still has a way to go.

There is a common misconception that central bank rate increases cause recessions, with central banks seen as pushing increases too far when inflation ramps up. History, especially in recent decades shows that the opposite is true, with excessive rate cuts promoting speculative behaviour. The US housing collapse after the onset of the Financial Crisis is a classic example, with cheap debt leading to stupid risk taking. This inflated economic growth for a time before becoming a drag on GDP when the bubble inevitably burst.

Cutting interest rates pulls forward demand and promotes speculative economic activity. Normalising interest rates unwinds those impacts, which often results in a recession.

There is a two-pronged impact of low interest rates; cheap debt encourages investors to leverage their assets and it discourages them from pursuing lower risk investments where prospective returns have been forced down. The activities of speculative investors rarely increase productivity. Cryptocurrencies, options/day trading, mergers and acquisitions, and debt funded purchases of residential property are some recent examples.

This understanding of how investors respond to low interest rates raises some obvious questions. Without the tailwind of ultra-low interest rates, how much more affordable would Australian housing be? How many people are underwater on their recent property purchases due to rates being cut too far and now being normalised? How many borrowers are or will soon be struggling with their repayments after borrowing based on servicing calculations when rates were low? Why did the RBA and other central banks repeat the mistakes of the Federal Reserve in the lead up to the Financial Crisis? Did they expect that this time would be different?

Other sectors that have seen pain from rising interest rates are UK pension funds and mid-tier American banks with their mismanaged interest rate positions, venture capital and unprofitable “high growth” companies, emerging market borrowers and open-ended property funds. The list of potential trouble spots includes commercial property, high yield and leveraged loan investors and their borrowers, as well as highly indebted sovereigns such as Greece, Italy and the states of Illinois and New Jersey.

The sources of the current inflation outbreak

The primary drivers of the recent outbreak of inflation include:

- Global supply chain issues (now fading)
- Excessive monetary stimulus
- Excessive fiscal stimulus
- Wage inflation (higher in the US but building in Australia)
- Governments avoiding productivity reforms
- Inflation within the housing component of CPI (primarily government mismanagement of migration, taxation, and zoning restrictions, but also the above five factors)

While I have no sympathy for central banks that cut rates too far and helped spark inflation, I have some sympathy for the overreaction to their attempts to bring down inflation. Central banks are correcting their excessive monetary stimulus, but their job would be much easier if governments got their budgets back into surplus. This would remove spending from the economy, thus reducing overall demand.

Peter Costello delivered a decade of surpluses when unemployment was higher and commodity prices were lower. Since his time as Treasurer there has been solid growth in tax revenues, partly due to strong population growth, but successive governments have failed to exercise spending discipline.

The massive wave of migration to Australia, (driving population growth of around 2% per annum), will be a substantial tailwind that probably helps Australia avoid a technical recession, though a GDP per capita recession is more likely. However, this deliberate policy of high population growth is neither sustainable nor costless.

The migration wave puts enormous strain on the rental market, which is currently seeing the average rent increase by at least 10% per annum. This is particularly painful for the lowest income households who typically spend a large proportion of their income on rent. The cost of building and renovations is also high with Australia's construction industry unable to keep up with the demand for infrastructure and housing that a surging population requires. The unnecessary migration wave is another factor the RBA has no control over.

An often-forgotten inflation factor is the paltry growth in productivity. Goods and services that are cheaper and better naturally push inflation down. It's difficult to avoid the elephant in the room on this topic.

Governments are increasingly looking to populist advice (higher spending, higher taxation) from think tanks, rather than the economically sound advice from the Productivity Commission. The Productivity Commission continues to deliver good advice that would advance the prosperity of Australia, but governments lack the courage to act on it.

Getting back to normal

The RBA normalising the Cash Rate is a key part of dealing with high inflation. The RBA has rightly been pointing out that high inflation is a scourge. It is a subtle form of taxation that disproportionately impacts the poorest citizens. This is a message that governments also need to accept. Australian governments need to respond by getting back to a surplus position, undertaking productivity and tax reforms, and slashing the migration rate. These changes would be a normalisation of government economic policies. Normalising interest rates will hurt some in the short term, but we must keep our eyes on the long term prize.

A natural outcome of higher interest rates is that it incentivises saving, which leads to long term investment and economic growth, rather than incentivising borrowing which temporarily brings forward unproductive demand.

Written by Jonathan Rochford for Narrow Road Capital on 15 March 2023. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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