Jumping off the currency rollercoaster: the argument against lowering interest rates

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Abstract
The rollercoaster ride of our Australian dollar reminds us how crucial it is to our export competitiveness. Our dollar is inextricably linked to commodity prices as well as the interest rate differentials between Australia and other countries.

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interest, off, lowering, rates, against, jumping, argument, rollercoaster, currency

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The rollercoaster ride of our Australian dollar reminds us how crucial it is to our export competitiveness. Our dollar is inextricably linked to commodity prices as well as the interest rate differentials between Australia and other countries.

Whether the strong link to commodity prices is technically justified is not the issue – the fact is many large money movers around the globe perceive Australia’s fortunes linked explicitly to the commodity price cycle and therefore sell the Australian dollar when commodity prices are in decline. This is happening now.

The lower dollar will alleviate pressures on our exporters; however given its volatility, can our export manufacturing and mining industries rely on the dollar remaining low to justify further investment?

And what happens to their investment strategies when the dollar climbs to historically high levels again? It seems our export industries, their profitability, the level of employment and furthermore our country’s prosperity no longer rides on the sheep’s back but largely on the volatile commodity price cycle. So how do we jump off this rollercoaster?
The “liquidity trap”

Many economic commentators are currently advocating a massive reduction in interest rates and look to the monetary policy lever of the RBA to initiate this tactic.

Common wisdom is that a lower interest rate will stimulate the economy by lowering the cost of borrowing and this should encourage exporters by lowering their overall costs and render new projects profitable which were previously economically unviable.

There is no denying that the RBA’s monetary easing during the height of the global financial crisis provided some economic stimulus and helped Australia avoid a recession.

However when an economy is in a slump and interest rates are very low and close to zero, no matter how much the RBA reduces the cash rate target, cash stays relatively trapped in financial institutions.

This is known as a “liquidity trap” – a concept developed by Keynes where any reduction in interest rates from a position of very low or negative real interest rates does not sufficiently induce companies to borrow and invest in productive projects until the economy recovers and aggregate demand increases. This problem is further compounded when consumer and investor confidence are low. We can therefore say that investment demand is inelastic based on pessimistic expectations.

Therefore the question for Australia presently is whether any further reduction in interest rates from an already historical low level will be beneficial.

If we take a look at Japan which has had interest rates close to zero for almost 20 years we find that even following the height of the global financial crisis (GFC) in 2007/2008 when the Bank of Japan returned interest rates to zero, there was a negligible impact on loans to the private sector and GDP growth.

Furthermore, the US Federal Reserve’s strategy of quantitative easing (QE) following the onset of the GFC has also had a benign effect on credit growth and GDP growth.
Instead it seems to have further fuelled the US equity markets where the S&P 500 index has increased by over 100% from 797 in January 2009 to 1669 in May this year. There are also signs that the US housing market is also on the increase.

Therefore we can see how quantitative easing policies have had minimal impact on credit growth of these advanced economies which are experiencing a combination of recessionary conditions and low interest rate environments.

Is this the case for Australia?

Since November 2011, the cash rate has declined 2%, from 4.75% to 2.75%. While inflation in Australia is 2.5%, our real rate of interest is a meagre 0.25% - very close to zero. In the meantime credit growth in the business sector measured by the RBA as a percentage of GDP has in fact been in decline since this period of monetary easing. So how can economists prescribe further monetary easing with this background?

In fact while business credit has been in decline, personal credit has been growing and GDP has been relatively static. Personal credit (excluding home mortgages) is often used for personal consumption, which is a non-productive purpose and does little to improve our export
Keeping our powder dry

Are we going to reignite the conditions that brought us to the precipice of the global financial crisis? An additional argument against a massive decrease in interest rates is the notion of keeping one’s powder dry. That is, to reserve any further reductions in interest rates for future crises. Not that the RBA has much to play with given our low level of real interest rates mentioned previously.

So what policy levers are left? It seems the government can play a major role here. Australia’s problem is related to its international competitiveness. If we wish to generate sustainable prosperity, a priority should be to diversify our export revenues away from the resources industry.

The only problem with this idea is that we are a high wage country and generally uncompetitive in many traditional manufacturing industries when competing with countries like China and India. One solution is to foster innovative industries based on technology, innovation and know-how. This requires industries which can develop products and services which cannot be easily replicated.

This means we grow businesses in industries with high technological barriers to entry. Government could direct policy to assist this transition by a variety of means including further research and development incentives for example. Apart from ensuring an industrial relations policy which can mediate in an over inflationary wages culture or traverse a more radical industrial relations reform program using the Netherlands or Irish models, it could offer other fiscal based support.

Encouraging productivity

This support should be targeted towards innovation and technology-based industries which can offer products or services with significant value add. Profits for businesses offering high competitive...
value add products and services would be relatively insulated from foreign exchange shocks such as a major appreciation of the Australian dollar which could render other industries uncompetitive. The ability to absorb these shocks will protect jobs and help avoid the large bankruptcies this country has been experiencing lately in our manufacturing sector.

It seems to me that the place to start is with research and education in our tertiary institutions and research and development laboratories around the country where new ideas and innovation are nurtured and the genesis of new products and services are likely to emerge. What is our government doing in this sector? Well in the most recent budget announcements funding in our tertiary sector was targeted, which is not only short-sighted but contrary to our long term national interest.

Any other policy aimed at improving competitiveness should also be encouraged. This could cover Australia’s ageing infrastructure which over recent years has not kept pace with our production capacity. Here we are referring to transport including rail and road, communication, ports, energy and water supply. Government’s investment in Infrastructure Australia is commendable, however policy initiatives need to accelerate, and funding models need to be refined and implemented without delay to attract necessary funding from private as well as public sources. A closer look at ways to encourage superannuation funds to participate to a greater extent should be expedited for example.

Avoid the quick fix

Therefore, taking aim at the RBA for a quick monetary policy fix may not be the best answer. Rather a long hard look at government fiscal policy and strategies, which seems like hard work, may be a better answer. A little more wisdom in fiscal policy, a little less “quick fix” monetarism and a lot more research and education seems right.

Australia used to be known as the “lucky country”, a characterisation on which we can no longer rely. With government and industry co-operation, I'm confident we can truly become the “clever country”.