



# New questions over Lowe road to inflation target range

Some challenge the governor's focus on financial stability

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The failure of the Reserve Bank to get inflation back to its target band in the two years since its last rate cut is leading some economists to challenge governor Philip Lowe's priority on financial stability.

The September quarter consumer price index, to be published this week, is expected to show further weakness in both headline and the Reserve Bank's preferred underlying measures of inflation.

The headline measure has averaged just 1.6 per cent since the end of 2014, while underlying inflation, which removes the influence of large price moves, dropped below 2 per cent in the March quarter of 2016 and has averaged 1.7 per cent since then.

The Reserve Bank itself cautioned that further weakness was likely in the September quarter because of a number of one-off cuts to government-influenced prices including child care and energy.

Shortly after his appointment as governor in September 2016, Lowe commented that the Reserve Bank monetary policy staff believed rates should be cut further to return inflation to its target band more rapidly. However, he was concerned that the main effect would be to encourage more borrowing for housing at a time when household debt was already very high.

Lowe had won agreement from then-treasurer Scott Morrison to change the wording of the Reserve Bank's agreement with the government to include a specific provision for temporary devia-

tions from the inflation target in the interests of financial stability.

During his time at the Bank for International Settlements in the early 2000s, Lowe was co-author, together with BIS's now head of monetary policy and economics, Claudio Borio, of the pioneering paper canvassing using monetary policy to curb excessive credit growth, an approach that has be-

come known as "leaning against the wind".

The paper was hailed as the most prescient warning of the dangers that otherwise went unheeded leading up to the global financial crisis, when the absence of inflation encouraged central banks to keep rates low despite soaring debt-fuelled asset prices.

However, a new paper by the University of Sydney's Stephen Kirchner argues the Reserve Bank must take responsibility for inflation undershooting the target and says the bank's own commentary suggests the risks to financial stability are slight.

"According to the Reserve Bank, financial stability risks are low, rising housing prices and debt-to-income ratios reflect structural fundamentals and borrowing is not the underlying cause of higher house prices," it says.

"This suggests that conditioning monetary policy on financial stability risks is likely to yield few benefits while incurring costs in terms of undershooting the inflation target and may even weaken

resilience to future shocks." The paper says that, like its peer central banks around the world, the Reserve Bank has been resorting to non-monetary explanations for low inflation.

Lowe has referred to the persistence of low wage growth. "If wages growth were to continue around its current rate for an extended period, it is unlikely that inflation would average around the midpoint of the inflation target in the period ahead," he says.

With productivity of around

1 per cent, it would need wage growth of 3.5 per cent to get inflation back to the middle of the target band (with the implication that the Reserve Bank would be unlikely to lift rates until wage growth was back to at least 3 per cent).

Kirchner contends that the Reserve Bank has the relationship between inflation and wages backwards, arguing that maintaining rates that are too high is resulting in low inflationary expectations, which are conditioning wage growth.

Similar arguments have been made by independent economist Nicholas Gruen. He contends that the Reserve Bank's forecasts of flat inflation and unemployment into the distant future have encouraged investors to believe that rates would remain low for years and has done more to fuel speculative investment than would a more aggressive approach to getting inflation back to the target band.

Both Kirchner and Gruen cite analysis by former deputy governor of Sweden's central bank, Lars

Svensson, who has assessed the costs and benefits of "leaning against the wind", by keeping rates higher than called for by inflation dynamics for financial stability reasons.

Following the GFC, the Swedish central bank cut its benchmark rate to 0.25 per cent, but then lifted it to 2 per cent over 2011 and 2012 as housing prices soared. It was a move dubbed "sado-monetarism" by Nobel-winning economist Paul Krugman.

Svensson opposed the rate hikes, which were dramatically reversed as the Swedish economy stalled, and taken to negative levels by 2016. Svensson left the bank in 2013, publishing research to substantiate his dissent.

He argues that while keeping interest rates higher than required to lift inflation does lower debt, it also lowers income, so the effect on debt-to-income ratios — which is the key variable for financial stability — is small and may



even be in the opposite direction.

He used the Swedish central bank's internal model to estimate

the impact if the benchmark rate had been kept at 0.25 per cent rather than 2 per cent in 2010, calculating that unemployment would have been 1.2 percentage points lower and inflation would have reached its 2 per cent target.

He then estimated the impact on the debt-to-income ratio showing it would have been fractionally lower, at 170 per cent, instead of the actual 173 per cent. His paper showed that the effect of higher rates on the probability of a financial crisis was "completely insignificant". He says the likelihood of benefits of "leaning against the wind" exceeding the costs is vanishingly small.

Kirchner calls on the RBA to publish research using Svensson's framework to show what assumptions would have to be made in order for the Reserve Bank's policy of holding its cash rate at 1.5 per cent to yield net benefits.

While acknowledging that staff have urged for rates to be lower, Lowe has not directly addressed the costs of keeping them stable. He would probably be sceptical about the ability of the bank's economic models to produce accurate assessments of the impact of marginally higher or lower rates when rates are already at a low level. He has expressed doubts that additional rate cuts from a low level would induce much greater spending.

The impact of rates on borrowing is not linear but is influenced by other market conditions. The Reserve Bank's rate cuts in 2016 had an explosive impact on borrowing for investment housing. Investor loan approvals had been falling at an annual rate of 6 per cent in August, when rates were cut to 1.5 per cent. By the end of the year, they were soaring at a rate of 26 per cent, fired by a speculative boom in Sydney.

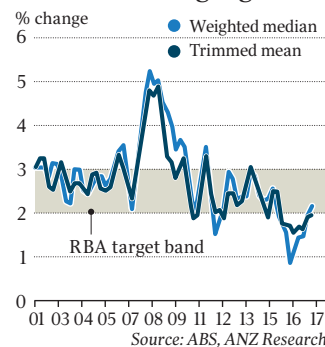
The Reserve Bank has highlighted the effectiveness of banking regulator APRA's macroprudential measures limiting growth in investor loan portfolios and interest-only loans.

However, there is also a view in the bank that they only work for a limited period.

For the moment, the Reserve Bank is happy enough to see the economy growing strongly and unemployment falling. It sees no reason why the next move in rates shouldn't be an increase, although it expects this will take some time.

Lowe says keeping rates on hold is a force for stability and confidence.

### Inflation drifting higher





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**Reserve Bank governor Philip Lowe says keeping rates on hold is a force for stability and confidence**