

## **Leading economist slams the RBA's irresponsible monetary policy**

Posted by [LC Team](#), Monday, September 15, 2008

Dr Peter Brain, Executive Director, National Institute of Economic and Industry Research maintains that the Reserve Bank is sitting on a knife's edge and that it's only got itself to blame.

Brain admits that his outlook is pessimistic; his concern being underlying inflation.

He says the prudent move would have been to keep interest rates on hold on 2 September and not lower the cash rate until there was certainty that the underlying inflation rate is trending down.

Brain's quarrel with the RBA is its "privatised" money policy regime. "Where no intermediate target for credit growth has been set (as is the case in the monetary policy of the European Union) and where credit growth in excess of desired nominal GDP growth is taken as a sign of a healthy economy."

"I don't have any sympathy for the Reserve Bank," he says. "They've created this mess because they've relied on debt for so long, which meant they've had to cut interest rates and they're not sure that the underlying inflation is going to track down to a satisfactory level."

According to Brain the RBA cut interest rates this month because it was more fearful of the economy falling off a precipice (as in 1991) than inflation becoming entrenched in the system. With consumption being driven at around 5% of net borrowings if households suddenly stopped borrowing for consumption (as in 1991) the savings ratio would increase by about 3 percentage points, which would mean zero consumption growth for a year, which is a recession outcome.

Brain argues that the reliance on debt to drive the economy means that even a small decline in household appetite for debt can create very large demand-side consequences.

"Running the economy and growth by debt acquisitions rather than fundamentals produces all sorts of problems," he says.

"More and more households become debt saturated and the elasticity goes out of the economy and you end up with the sort of financial shocks that we've seen in the US.

"There's a real risk of this occurring. The problem is we have to get productivity up if the RBA's scenario is going to be successful and there are only limited signs that this is happening. If we can't get productivity up and we've got wages tracking at 5 percent-plus the underlying inflation is going to be running at 3.5 percent, which is unsatisfactory."

He says that the RBA is hoping that shocks such as US investment bank, Lehman Brothers' record loss this week will continue to suppress demand and act as an additional anti-inflationary factor.

Brain gives this strategy a 50/50 chance of success. He says the RBA will be counting on commodity prices tracking down, no political upheaval in the Middle East, oil prices staying within bounds and enough of a rise in unemployment to keep wages under control.

He declares that if the alternative scenario occurs, and there is evidence that it still could - the economy grows faster than the RBA is anticipating, wages start accelerating from the long-term 5% benchmark, an oil price shock in the Middle East occurs or confidence in the US dollar suddenly turns up - "then they've stuffed it".

"You can't run a debt driven gross without things starting to weaken in the system and anyway there is no point," he says.

"Yes, you can cut interest rates and confidence returns to housing markets but prices just go up and rents go up and you're just increasing proportions of households with higher levels of debt. Yes, you get higher short-term growth but where is society and the economy going?

"Credit is like a drug. It gives you a great upfront hit and then you have to pay for it and suffer the withdrawals over a long period. That's why in Germany the banks won't lend more than 60% of the house value."

Brain maintains that by 2018 on current conservative trends (an increase in the household debt to income of 30% from current levels and interest rates declining from current levels), it is estimated that at least 22% of households will be paying more than 35% of income in debt service and rent costs, or a doubling since 1996 levels. This excludes the high debt of fully owned households.