Getting Real on Interest Rates

9 Aug 2006

Bananas and petrol are convenient distractions, but they don't hide the fact that Australian interest rates have been among the highest in the developed world for years, writes Ian McAuley.

During his time in office, Paul Keating talked about 'raising the speed limit' that is, ensuring Australia's economy was structurally robust enough to enjoy high growth without incurring inflation.

The metaphor is clear. A winding, poorly aligned and narrow road requires a low speed limit; once it is straightened and widened, the speed limit can be raised.

So too with the economy. A structurally weak economy one in which there is a shortage of skills and infrastructure runs into capacity constraints, and inflation occurs. Its rate of growth has to be slowed, and the role of traffic cop is assigned to the Reserve Bank.

The big news last week was that inflation is back. The contribution to the Consumer Price Index (CPI) of the high price of bananas and petrol has made it easy for the Reserve Bank to lift interest rates, and it has allowed the Government to conveniently blame external factors even the most fervent Howard hater does not blame him for cyclones or crude oil prices.

But, as Reserve Bank Governor Ian Macfarlane points out, there are more basic inflationary pressures at work. Those high commodity prices, which are promoting a boom in Western Australia, are starting to have an effect through our national economy as prices of steel, aluminium, and other inputs rise. There has been particularly high inflation in child care, health care and education the results of successive waves of government cost-shifting and privatisation. Most of all, there has been high asset inflation not measured in the CPI, but anyone who has tried to buy a house is well aware of it.

For years, we have gotten away with speeding on a narrow road; luck has saved us from an accident.

The Howard Government inherited an economy that was starting to enjoy the fruits of painful structural reform over the 1980s, and was pulling out of a recession. Our luck was extended by China's boom economy, on two counts. China has deliberately kept its exchange rate low, providing us with low-priced clothing, appliances and electronic goods so that, until now, falls in these prices have masked other price rises in the CPI. The second benefit has been China's demand for our mineral commodities.

That is why most Australians have enjoyed rising consumption, even while the Government has neglected economic reform. Apart from replacing our ramshackle sales tax regime with the GST, the Howard Government has not attended to any basic structural reform. (It may claim its workplace legislation as 'reform,' but if anything these changes will reduce productivity and economic growth.) Many of us have boosted our living standards with debt, drawn in by the illusion of wealth as the value of our houses went up an illusion because the rise in value has simply been a form of price inflation.

Our temporary prosperity, and the Government's claims of economic competence, is diverting attention from fundamental economic weaknesses. Our economic structure resembles that of an oil-rich sheikdom, rather than one that can compete in a world where prosperity is based on competition in skills-intensive industries.

The Reserve Bank knows this. In fact, it has deliberately maintained high interest rates for many years. Yes as you can see from the attached graph Australia has had some of the highest interest rates of all developed countries, and continues to be at or near the top of the pack. Howard and Costello didn't tell us this during the 2004 election campaign, and neither did Labor which, on economic issues, froze like a rabbit in the headlights.

The Reserve Bank has had to sustain high interest rates for a number of reasons: to quell the speculative housing boom (a boom aided by the Government's changes in capital gains tax); to prop up the Australian dollar's exchange rate (which, because of our high foreign debt, would otherwise have plummeted, setting off a round of stagflation); to wean us off unsustainable household debt; and to soak up the liquidity caused by a Government spending on tax breaks rather than investing in the nation's productive capacity.

'But wait,' one might say, 'wasn't Howard right in 2004 when he said that interest rates were higher under the Hawke/Keating Government?'

It's a disingenuous claim, because it is based on nominal rates, rather than real rates. The distinction requires explanation, because the Government has no incentive to offer it, and the mainstream press has been remiss in enlightening the debate.

In the late 1980s, nominal rates the rates posted by banks and other financial institutions were high. (The short-term cash rate hit 17 per cent at one stage.) At the time, however, inflation was running at about 10 per cent. So, provided one's income kept up with inflation, the pain of a 17 per cent interest burden was offset by regular 10 per cent rises in income. In the 1980s, mortgages imposed a high initial burden, but for most borrowers nominal wage rises soon lessened that burden. Today, because of much higher house prices and lower inflation, the interest burden is no lighter but is more enduring.

This is not to suggest that inflation is desirable, but it does blunt the pain of high nominal interest rates. And for financial systems to work, the interest rate must be at least equal to inflation preferably higher.

As every Economics 101 student knows, it's the 'real' rate (the nominal rate minus inflation) that measures the pain on borrowers and the return to lenders. This is the rate to watch. Australia's real short-term rates since 1980, through many changes in government, have been in the range of zero to 10 per cent, hovering around a mean of 5 per cent. Neither main political Party can look back with pride on its history of monetary management, which is perhaps why there has never been a well-informed debate on interest rates.

In comparison with other countries, Australia has high real interest rates, and as long as we have a structurally weak economy with a chronic current account deficit, we will have to put up with high rates.

It will take many years of rebuilding our assets of skills and infrastructure, and establishing a competitive export base, before we can raise our speed limit.