

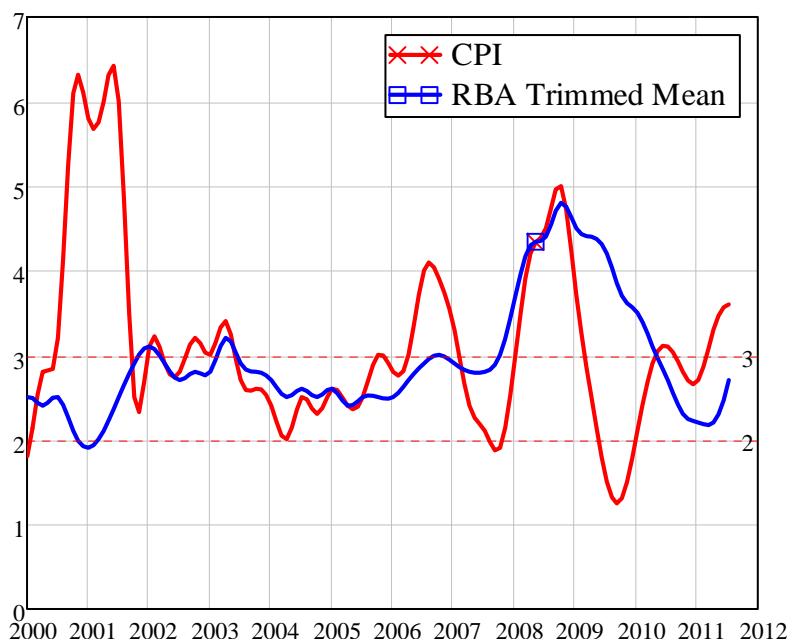
High Noon Tuesday at the RBA

In a Nutshell: I have a hunch that the RBA will follow its conventional “neoclassical” models and raise rates tomorrow, even though the economy is locked in “two speed” mode, and the global economy is racked by uncertainty. This would be a mistake: given unprecedented private debt levels and deleveraging by households and businesses, a rate rise would accelerate the economy’s decline into recession.

The RBA meets 11 times a year to set the cash rate. At only 4 of those meetings—February, May, August and November—does it know the most recent CPI figures before the meeting. When the Board meets tomorrow morning, it knows that consumer price inflation was 3.6% for the year. Even the RBA’s preferred trimmed mean, which shows a lower annual rate of 2.7%, has had two consecutive quarters of 0.9%. Inflation is thus above the RBA’s target zone of 2-3% on one measure, and heading that way on another.

On inflation alone, the RBA is therefore under strong pressure to raise rates. As a very conventional Central Bank, the RBA’s policy decisions before the “Global Financial Crisis” (as Australians call the Great Recession) generally followed what is known as the [Taylor Rule](#). This rule argues that when the economy is at full employment and inflation exceeds 2 percent, the Central Bank should respond to an increase in inflation by raising rates 1.5 times as much.

Figure 1: Consumer Price Inflation in Australia



According to the Taylor Rule, the RBA should raise its rate to 5 percent if it uses its trimmed mean as the measure of inflation, and to a whopping 6.4 percent if it uses the standard CPI. It's inflation [High Noon](#), the Price Rise Gang is in town, and the Sheriff has to kill them with his anti-inflation Colt 45. As the Gary Cooper of Central Banks, the RBA therefore simply has to raise rates tomorrow: to do otherwise would be cowardice.

That's if you believe that the Taylor Rule actually describes reality—I categorically don't. The only arguments in the Taylor Rule are the policy interest rate, the inflation rate (actual and target) and the growth rate (actual and target). Like all neoclassical models, it ignores the role of private debt in the economy. Now that private debt is falling from unprecedented levels in Australia, two factors that aren't even considered by the RBA's exclusively neoclassical economic models are really determining the economy's direction: the level of debt that is constraining consumers, and deleveraging by both households and firms that is reducing aggregate demand. Pulling the interest rate trigger may blow the economy's (and the Sheriff's) brains out.

Figure 2: The Taylor Rule in a Debt-constrained economy

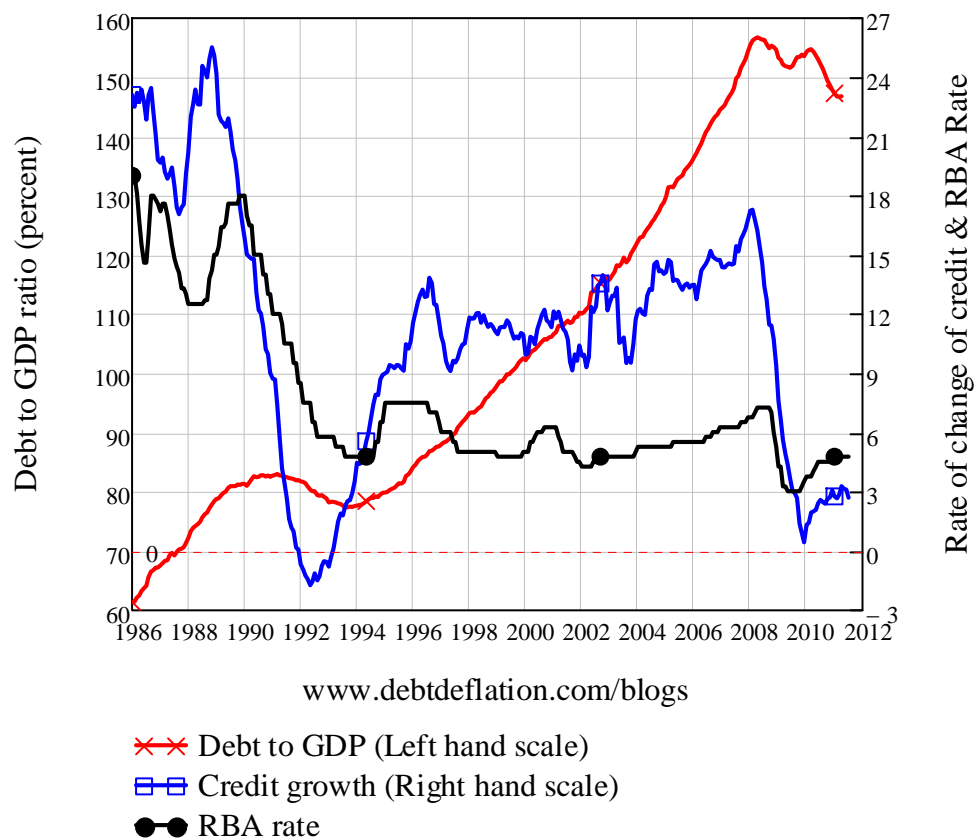


The RBA thus faces a dilemma: if it sticks with its “fight inflation first” motto, it could trigger a much sharper slowdown in the economy than its models predict.

This isn't the first time the RBA has faced this dilemma. Back in the late 1980s, credit growth was astronomical, and the economy was going gangbusters. After dropping rates in the aftermath to the Stock Market Crash of 1987—and introducing the First Home Owners Scheme which kick-started a property bubble—the policy makers (interest rate setting wasn't the exclusive domain of the RBA back then) put up interest rates to constrain the boom.

Their timing was bad: the boom in credit ended at the start of 1989 when the cash rate was 15 percent, but they kept increasing the rate to a high of 18 percent by 1990. A year later, credit growth was negative on a monthly basis (though still positive year-on-year), and the RBA was in serious backpedal mode, dropping interest rates as the economy fell away beneath it in “The Recession We Had To Have”. During the Recession itself, annual credit growth actually turned negative, and not merely coincidentally, unemployment rose to a post-WWII peak of 11.2 percent.

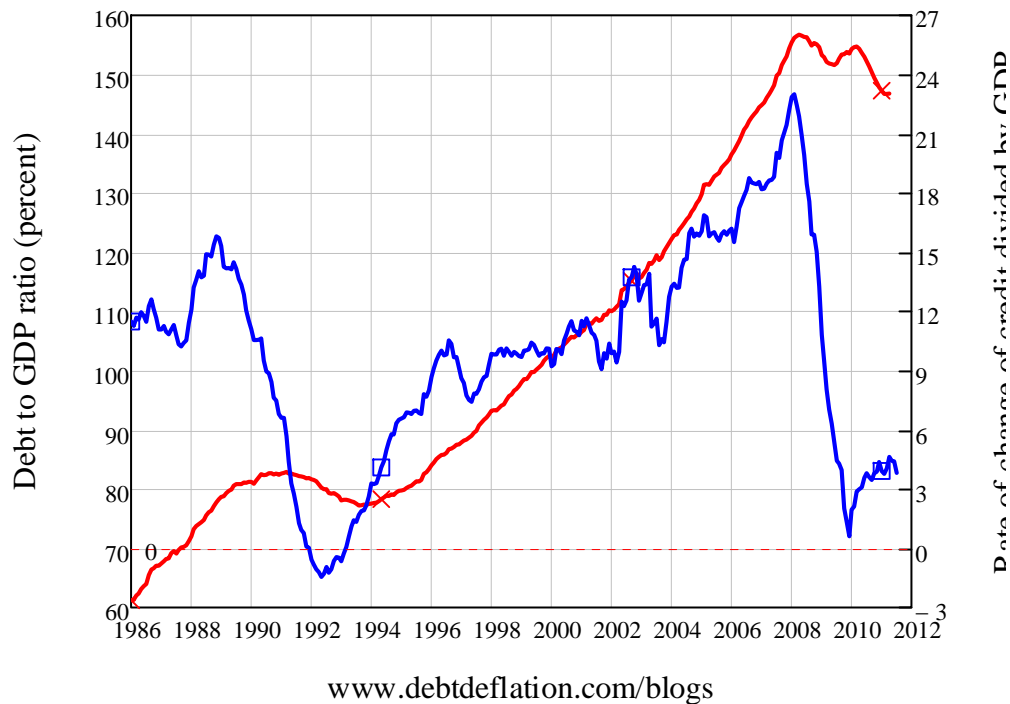
Figure 3: Debt to GDP and Credit Growth



A cursory look at Figure 3 might make you think that the RBA has less of a problem this time. Credit growth is lower, and though it approached zero back in 2010, it had bounced from that level; and interest rates now are substantially lower than in 1989.

But that is misleading, because though credit growth is lower, credit growth is much larger *compared to GDP* than it was then—because debt has grown so much more than GDP. Though the rate of growth of credit was much lower in the last decade than it was in the 1980s—a peak growth rate of under 18%, versus an average of over 18% for 1980-1990—the contribution that credit growth makes to aggregate demand is much larger today, because private debt is so much higher. Credit growth averaged 9.5% of GDP in the 1980s, versus 13.5 percent from 1998 till 2008 (see Figure 4).

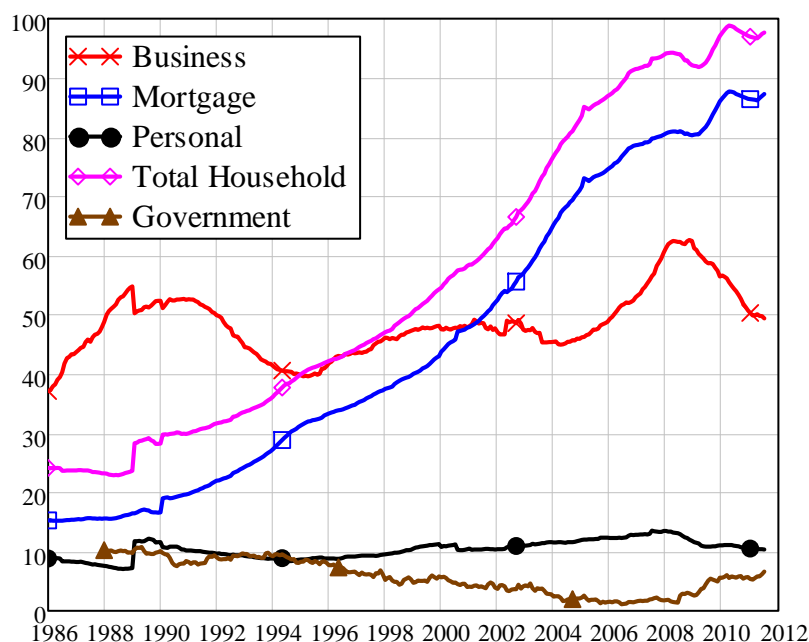
Figure 4: Debt to GDP level and growth rate



- ×× Debt to GDP (Left hand scale)
- Credit growth as percent of GDP (Right hand scale)

This has two implications. The first, relatively obvious one, is that consumers are debt-constrained as never before, and are therefore not spending. Household debt was less than 25 percent of GDP back when the cash rate was 15 percent in the late 1980s (see Figure 5). It is now almost 100% of GDP—four times as high. Therefore, even ignoring the impact of repaying principal, an RBA rate of 4.75% today equates to 19% back then. Households are thus even more strained today than they were when the cash rate was 18 percent in 1990—and inflation today is a lot lower than it was in 1990, which makes the real debt service burden today even worse. So the level of household debt is a major factor in the subdued level of household consumption.

Figure 5: Debt by sector as a percentage of GDP



Glen Stevens seemed to acknowledge this point in his speech "[The Cautious Consumer](#)" last week, when he said that:

"The period from the early 1990s to the mid 2000s was characterised by a drawn-out, but one-time, adjustment to a set of powerful forces. Households started the period with relatively little leverage, in large part a legacy of the effect of very high nominal interest rates in the long period of high inflation. But then, inflation and interest rates came down to generational lows. Financial liberalisation and innovation increased the availability of credit. And reasonably stable economic conditions – part of the so-called 'great moderation' internationally – made a certain higher degree of leverage seem safe. The result was a lengthy period of rising household leverage, rising housing prices, high levels of confidence, a strong sense of generally rising prosperity, declining saving from current income and strong growth in consumption.

I was not one of those who felt that this was bound to end in tears. But it was bound to end. Even if one holds a benign view of higher levels of household debt, at a certain point, people will have increased their leverage to its new equilibrium level (or, if you are a pessimist, beyond that point). At that stage, debt growth will slow to be more in line with income, the rate of saving from current income will rise to be more like historical norms, and the financial source of upward pressure on housing values will abate..."

This is a welcome acknowledgement that changes in private debt have some macroeconomic impacts, as Rob Burgess pointed out recently in *Business Spectator* (see "[Steve Keen's RBA Convert](#)"). But it is not enough: Stevens is still thinking in neoclassical terms, where everything settles down to "equilibrium", and he has not integrated credit into his thinking. Though he obliquely acknowledges that rising debt boosted aggregate demand, he doesn't make the leap to see that aggregate demand is the sum of GDP *plus the change in debt*.

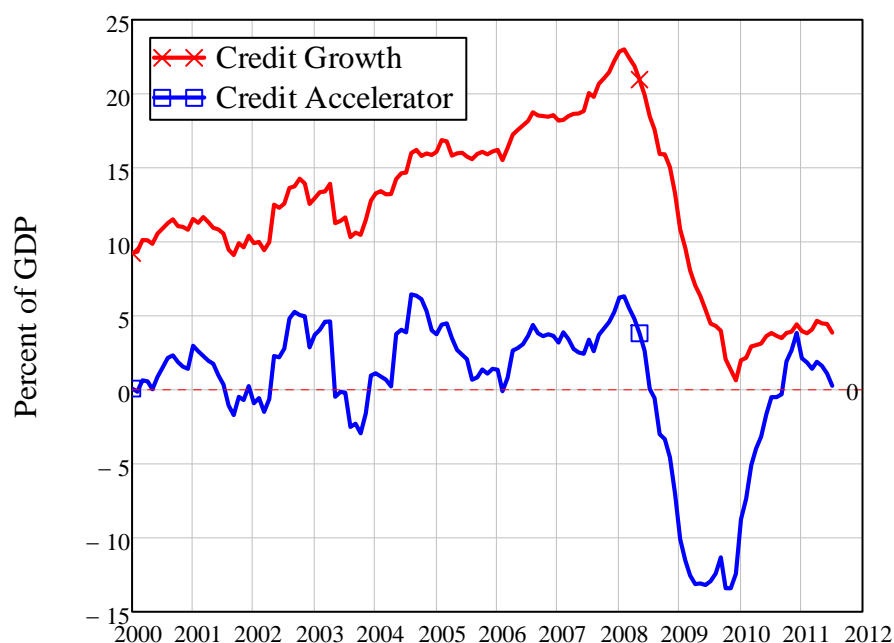
Stevens is hoping that once the “drawn-out, but one-time” change in household leverage settles down, tranquil growth in income and consumption will return:

“Can we look forward to a time when these adjustments to household saving and balance sheets have been completed? We can... the saving rate, debt burdens and wealth will at some stage reach levels at which people are more comfortable, and consumption (and probably debt) will grow in line with income... We could then reasonably expect to see consumption record more growth than it has in the past few years.”

But this can only happen if aggregate demand grows smoothly, which it can't do *unless debt not merely grows, but accelerates*. This is so because, since aggregate demand is GDP plus the change in debt, the change in aggregate demand is the change in GDP *plus the acceleration of debt*. Accelerating debt is thus necessary for a constant rate of growth of aggregate demand, but if debt continually accelerates, it must ultimately grow faster than GDP.

This is what happened in the period from 1993 till 2008—when the RBA, like Central Banks around the globe, ignored the role of private debt even as the biggest debt bubble in history developed, because their neoclassical models of the world ignored the role of credit. The acceleration in debt averaged over 2 percent of GDP in Australia between 1993 and 2008, so much of the recorded 3.8% growth in output over that period—and most of the growth in asset prices—was driven by accelerating debt.

Figure 6: Credit Growth and Acceleration in Australia

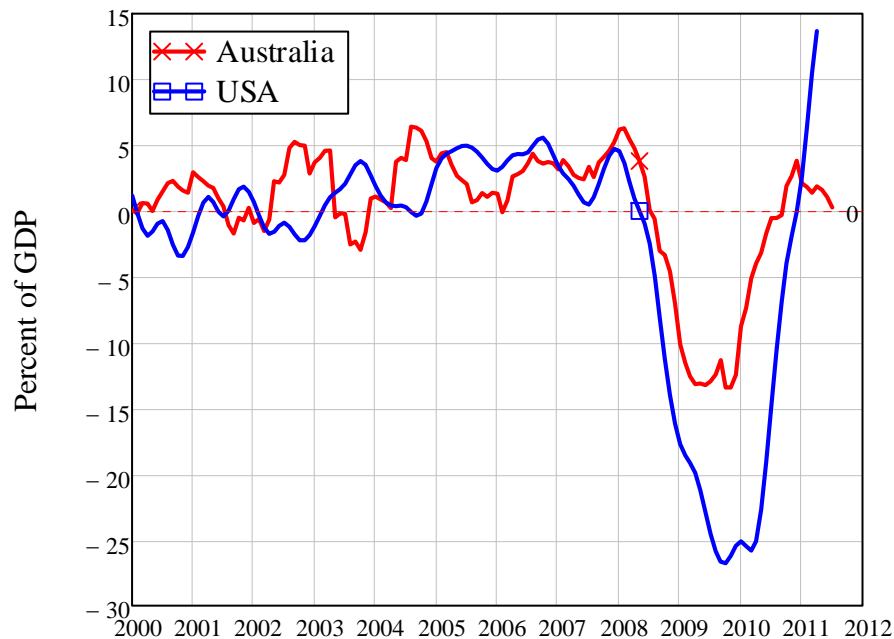


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The GFC began when accelerating debt rapidly turned into decelerating debt. Australia attenuated the severity of the downturn partly by encouraging households back into debt with what I call the

First Home Vendors Boost, so that even though the deceleration in debt was severe, it wasn't nearly as severe as in the USA. Our peak negative from the Credit Accelerator came in at minus 13%, whereas the USA's maxed out at minus 27%--which is why the downturn in the USA was so much worse than in Australia. Secondly, again under the influence of the First Home Vendors Boost, our Credit Accelerator turned positive again before it did in America--so the USA spent two years in a severe recession while Australia recorded only one quarter of negative growth.

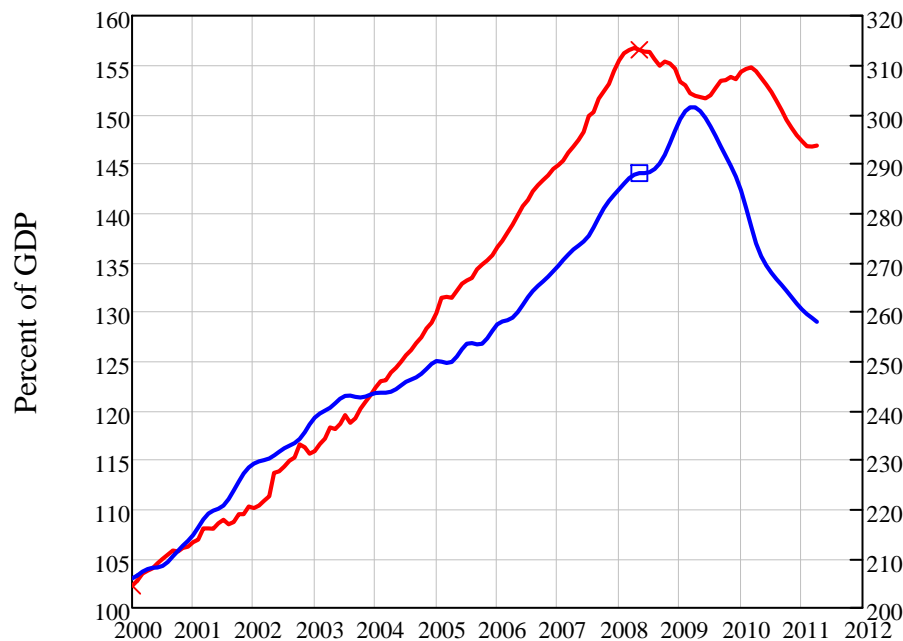
Figure 7: Credit Accelerators for Australia and the USA



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But herein lies the rub. Both countries now face the same problem that, with private debt levels at unprecedented highs, debt will normally tend to decelerate rather than accelerate, and this deceleration could go on for a very long time. America's level has already fallen by 40% of GDP since its peak in early 2009, and the current massive increase in the Credit Accelerator is due to a slowdown in the rate of growth of debt *while debt is still falling*.

Figure 8: Private debt levels for Australia and the USA



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Having delayed its deleveraging via the First Home Vendors Boost, Australia is only just starting to delever—and its Credit Accelerator is now turning negative after an anaemic rise till the end of 2010. This is the major cause of the “two-speed” economy—with the retail sector and non-mining States stuck in reverse—and it won’t end until private debt levels fall substantially from today’s levels.

For this reason, I don’t share Stevens’ optimism that this downturn in consumer spending will prove to be brief:

We cannot really know, of course, when that might happen.... the rise in the saving rate over the past five years ... was ... the biggest adjustment of its kind we have had in the history of quarterly national accounts data... That in turn means that the time when more ‘normal’ patterns of consumption growth recur is closer than it would have been with a more drawn-out adjustment.... It is entirely possible that, were some of the current raft of uncertainties to lessen, the mood could lift noticeably, so I don't think we need to be totally gloomy.

However I do agree that the “new normal” won’t be as strong as the “old normal”:

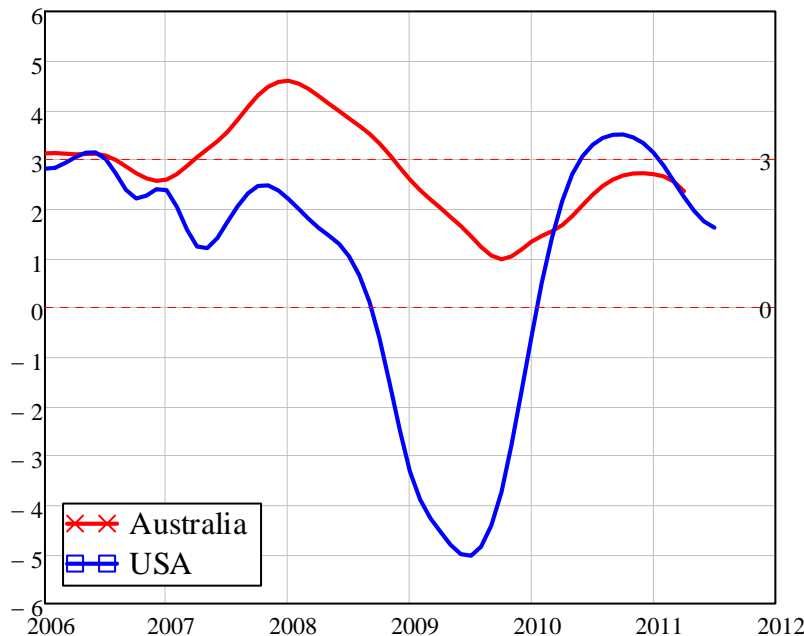
But what is ‘normal’? Will the ‘good old days’ for consumption growth of the 1995 -2005 period be seen again?

I don't think they can be, at least not if the growth depends on spending growth outpacing growth in income and leverage increasing over a lengthy period...

To that reason, I add the probability that the Credit Accelerator will remain negative for most of the next decade, with the consequence that the economy will not benefit from the legitimate role that expanding credit plays in a growing economy—when that credit is used to finance investment rather than Ponzi Schemes. Consequently both Australia and America are likely to return

"disappointing" growth figures: growth will tend to be below the 3% level that is needed to reduce unemployment. This is already firmly the case in the USA, where growth has fallen well below the "Okun's Law" level of 3 percent and unemployment is once more on the rise.

Figure 9: Real growth rates in Australia and the USA



Thus the "Taylor Rule" advice that the RBA should raise rates is extremely bad advice—but there are reasonable odds that the RBA will follow it and raise rates tomorrow.

The impact of such an increase will be dramatic, and will amplify the case I have been making for a year now, that the RBA will be forced by economic circumstances to abandon its "fight inflation first" obsession, and cut rates to stimulate a flagging economy.

Sky News emails on interest rates

I was very glad to have [Westpac's Bill Evans agreeing with me that rates should fall](#). This is a case I've been making for a year now, as evidenced by the Sky News poll on rates that I've contributed to irregularly for the last year. Sky couldn't locate a database of its programs on the topic, but here is a selection of my emails to Sky since mid-2010. I expected rate cuts to begin before now—which clearly didn't happen—but this is in contrast to all other commentators who thought rates would **and should** rise. I thought they might—but that such a move would be a policy mistake.

July 2010

Hi Steve

Can't reach you on the mobile/landline ...

Compiling our rates poll ahead of tomorrow's decision. Let me know yr call on:

- *Tomorrow*
- *December 2010*
- *July 2011*

Flat mate--I'm in NY right now BTW, and the global roaming works about as well as the global economy.

By December, 0.25 to 0.5 below now.

July 2011, 0.5 to 1.0 below now.

October 2010

We're conducting our Sky News interest rate poll for November, hope you can help out again.

Will we see an interest rate rise in November/how much?

Rates by end March quarter?

Year from now?

Anything you're particularly watching out for Tuesday?

Thanks for your time in advance,

Again it's the old Changi game--betting which cockroach will cross a line first--but I think the RBA will hold off again because of the "unexpectedly low" inflation numbers this week (incidentally I'm one of the few expecting such numbers because I think we're headed for deflation globally, not inflation).

The RBA is itching to put rates up though, and they may well make up a reason for putting rates up by 0.25 at some time between now and February.

However I'll go with rates at 4.5% in March (unchanged) and below 4% in a year from now--not 3% as I have been calling for a while, but lower rather than higher.

February 2011

Good afternoon,

Time for our monthly interest rate poll, hope you can spare us a moment.

Will the RBA move on interest rates/by how much?

No.

Where will rates stand the end of June quarter?

Same as now: 4.75%

One year from now?

Lower: of the order of 4%.

What comment are you most looking forward to in the statement?

Surprise about the failure of inflation to hit the levels they were expecting. The last few CPI figures have come in below their expectations, meaning that the tightenings they did in the anticipation of higher inflation have not been justified by the actual performance of the CPI.

May 2011

Hello,

Hard to believe it's almost May – I hope you don't mind taking a few moments to complete this month's survey.

Will we see a rate change on Tuesday/by how much?

Where will rates sit by the end of the September quarter?

May next year?

What are you looking for in the statement?

Many thanks again,

No change, though if they're spooked by the recent CPI they might raise by 0.25.

September: 0.25 lower than now

May next year: below 4%

The statement: Some puzzlement about the low rate of growth of credit; continued euphoric expectations about China; more neglect of the "Dutch Disease" dangers posed to manufacturing and tourism from the high dollar.

June 2010

Hello,

Hope you can spare a moment to answer our monthly interest rate poll.

Will the RBA hike OCR tomorrow/by how much?

Where will rates be at the end of the September quarter?

June next year?

What will you be looking out for in the statement?

I expect them to keep rates on hold, but they could be brazen and increase them because their models tell them they have to "strike first" to fight the inflation their models predict.

It would be a mistake for them to do so, but far be it from me to argue that the RBA doesn't make mistakes!

I think rates might be at 5% by September and 4% or lower by this time next year.

July 2011

Hello,

Interesting times – hopefully you can spare a moment to complete this month's interest rate poll by Monday afternoon.

Will there be an interest rate rise in August/by how much?

OCR by the end December?

OCR in August (post meeting) next year?

What's the main point you'll be looking for in accompanying statement?

I'll write a post this weekend called "Blue Moon Tuesday at the RBA" because it's only once in a blue moon that their decision comes soon after the CPI change is known, rather than before.

I think they'll hike 25 points on Tuesday--not because they should but because their "Taylor equation" model tells them they should to stop inflation in its tracks.

The trouble is they also know that house prices are falling and growth is slowing in the US and Europe. So I think they'd rather not put them up, but for their own credibility as "inflation fighters" they're almost forced to.

I see that as an error, but it's one I think they'll make.

For the future, I think the economy will go further backwards--accelerated by the .25 rate increase's effect on house prices and households--and they'll be forced into reverse.

So a 5% cash rate by Tuesday, 4.5% by December and below 4% by next August.

In the statement I expect a confused international outlook, recognition of the 2 speed economy, and a "balance of probabilities" call that the uptick in inflation justifies the rate hike.