



Thinking about Interest Rates and the RBA

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It is with some dismay to realise the RBA met yesterday to consider whether or not to raise rates on the very day the National Accounts were released showing a quarterly growth rate of a minuscule 0.1 percent.

And not only has there been a slowdown in growth, full-time employment has fallen – not slowed, but fallen – for the past five months.

In addition, expectations data provided by the ABS show a slowing in private investment growth for the present financial year. Expected growth is now forecast to be 5.0 percent, one third of the increase of the past twelve months.

And there is the drought which has not yet broken in many parts of Australia. And there is still an international slowdown across the developed world. And there are, as there always are, impenetrable uncertainties about the future.

Yet rate increases are still widely seen as more likely than reductions with many analysts arguing they should go up. And although the consensus is that there will be no change on this occasion, which is indeed the most likely outcome, if there is any change at all, it will be upwards. Now how strange is that in the midst of all of this?

Why rate increases are even on the RBA agenda in spite of everything is because the Bank has decided to look at whether rising house prices are creating a bubble that will eventually burst. It is this that so concerns the Bank that it is prepared to consider raising rates even though the economy came to a virtual standstill in June and there is no likelihood of its overheating any time soon.

Somehow the notion has gotten around that Australia is protected by raising rates every time the economy gets up a bit of steam. It seems all but forgotten now, but in May and June last year, when the economy was growing more than twice as fast as it is now, rates were pushed up with the very clear implication that they would rise by another one percentage point before the year was out.

The expressed intent of the RBA in raising rates was to slow growth. Well growth is now substantially slower but is this really what we want?

The problem is that the RBA can know nothing with certainty in the present that it can reliably use to gauge the state of the economy twelve months ahead. It therefore should not act as aggressively as it routinely does to slow growth. Twelve months ago it was wrong about how economic conditions would be today, and this is the kind of error that costs this economy dearly.

The Bank would achieve more by trying to do less. As long as the budget is in surplus, public spending growth remains moderate, wages growth is contained and financial institutions are not lending to people unlikely to repay their debts, it seems clear that rate adjustments should not be designed to slow the economy down.