Op-Ed Commentary

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The Poverty of Macroeconomic policy revealed once more

By Professor William Mitchell, Director of CofFEE

What is the logic and what will be the impact of the Reserve Bank's (RBA) decision to raise the cash rate 25 basis points to 5 per cent. Speculating, this signals a series of increases over the next year with the next rise of around 25 basis points predicted in December leading to a total of around 1 per cent.

The RBA decision reflects their thinking on two trends. First, they believe the improving international outlook will help us enjoy continued growth. This is largely due to the growth of our major trading partner Japan after nearly a decade of sloth. However, the U.S. and the Euroland economies are still weak. The major Euro engines of Germany and France are struggling to increase production and hold down unemployment. My view is that the international economy is slightly stronger but the recovery is very uncertain and hardly robust.

Second, the RBA now realises that the growth of credit in Australia is excessive and unsustainable with Australian households and businesses holding record levels of debt. The RBA should know that interest rates hikes will drive a large number of Australians insolvent. Some economists, in typical fashion, see this as an advantage because they claim it just means that the interest rates will bite earlier and the overall rise needed to discipline spending will thus be less than in the past when household debt levels were considerably lower. But that is cold comfort for those who lose their homes.

The rise will mean that for the average home loan of $161,500 over 30 years mortgage holders will have to pay about $27 per month extra and by December this could rise to $54 per month. How many Hunter families will this cause hardship for? The indication is that it will be many.

The government is caught in a bind of its own making. The Treasurer says that historically the 6.8 per cent mortgage rate is relatively low but in the same breath has warned households to reign in their borrowing. The fact is that the pursuit of budget surpluses and the strategies of banks and other lending agencies to push as much credit on us that they can has meant that the household balance sheets are now very fragile. So mortgage rates of yesteryear when debt levels were insignificant are irrelevant when appraising the consequences of rising interest rates now.

Business in general and exporters in particular will not be happy. The higher rates not only dampen domestic demand but they also push up the exchange rate because they our financial assets are more attractive to foreigners. This reduces our international competitiveness and makes it harder for exporters. The rising exchange rate is somewhat offset by the rather robust recent productivity growth but on balance the traders will suffer.

What of the regional impact? It is clear that housing prices in the major capital cities are too hot. Using interest rates to dampen demand will impact on all regions whether they are booming or not. The Hunter is hardly booming and we will be damaged by the reduced spending and I expect higher unemployment to result. In general, there is a poverty of economic policy in Australia at present that eschews net government spending, can only see lower taxes, and relies almost exclusively on the blunt interest rate instrument to stabilise the business cycle. We need to tackle the housing boom with targetted policies that do not damage other less affluent sectors and regions.

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