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The RBA exposes the poverty of macroeconomic policy in Australia!

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On Monday, the Reserve Bank of Australia (RBA) released their “Statement on Monetary Policy”. The Statement reveals the RBA’s current thinking about the economy and exposes the poverty of the Federal Government’s macroeconomic policy. Yet, when a change in the conduct of policy is so urgently needed, financial market commentators were content to speculate on what the Statement meant for interest rates.

As an academic economist, I think we need to understand why the Reserve is ringing the alarm bells. The “chickens are coming home to roost” and while the blame for the coming crunch will lie deservedly with the Federal Government, the losers will be the unemployed.

So what is going on? For several years, the financial markets have been offering consumers innovative forms of credit. Able to spend far in excess of our income, the private sector is now holding record levels of debt. The financial ‘experts’ reassure us that our assets are also increasing but they also make huge commissions as our debt levels rise so are hardly neutral. The RBA is belatedly realising that many households are in a very precarious financial position. A moderate interest rate rise will now send many households insolvent.

In Monday’s Statement the RBA warned that monetary policy decisions have been complicated by household credit growth “...well in excess of what could be considered sustainable in the medium to longer term”. It noted the rise of worrying financial practices such as households borrowing against rising housing values to fund other forms of spending. What is the risk associated with these trends? In the RBA’s words: “the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn”.

Put simply, when the household sector finally becomes worried about its financial position and starts saving to reduce debt levels, consumption spending must fall. When that happens we will see a sequence of bankruptcies and wealth write-downs and the R word of consequence will be ‘recession’ not ‘rugby’.

So why should the finger be pointed at Peter Costello? The Treasurer boasts that persistent Federal budget surpluses are the exemplar of sound financial and economic

management. They allegedly allow private sector saving and keep interest rates down. In fact, nothing could be further from the truth. When the budget surplus grows, private sector debt must increase as a matter of accounting.

When the government runs a budget surplus it rips more dollars out of the economy than it injects via spending. It is spending that creates demand for goods and services and generates both jobs and incomes for the private sector. If the non-government sector wishes to increase its savings then continuing economic growth depends on the government spending more than it raises in revenue. As the monopoly issuer of its own currency, the government can increase net spending to the level required for a high growth, fully employed economy.

The Federal Government may choose to accompany a deficit position by issuing government bonds, to provide a highly liquid non-government sector with an interest-bearing asset and ensuring the RBA can maintain its target cash rate. But note it is the Federal budget deficit that provides the funds and the opportunity for the private sector to purchase government bonds as a store of wealth. So not only does a budget deficit increase demand and employment, but it allows the private sector to increase its savings and to hold these in the form of government bonds. A win-win situation! A public deficit is mirrored as the savings of the private sector.

Claims that the issue of public debt in these circumstances will drive up interest rates reflect a misunderstanding of how financial markets work. The supply of government bonds is necessarily equivalent to the newly created funds (the deficit) and the interest rate, in this case, is set by the RBA to reflect its monetary policy. Economists who scaremonger about rising interest rates must explain why Japan - which has the highest public debt recorded and repeated downgrades from the rating agencies - can issue its debt, day in and day out, at an interest rate of 0.0001%, and has done so for years.

So why do persistent budget surpluses force the private sector into higher levels of debt? When the government runs a surplus (taxes exceed spending) then more dollars are transferred from the private to the public sector than the other way round. To find the cash to pay its net tax liability, the private sector either draws down its savings or the government may offer to buy back government bonds the sector holds. Either way, the government surplus reduces the net income of the private sector and requires an equal reduction in private wealth (and savings).

As the government continues to withdraw spending via the surplus, the economy can only keep growing if the private sector can keep borrowing. Private sector deficits and debt have to rise. While the Treasurer claims that budget surpluses reflect prudent financial management and allow a reduction in government debt, they are in fact systematically destroying private wealth and sowing the seeds for a major economic downturn.

When the private sector starts to save again, the fiscal drag embodied in the surpluses will strike hard and falling tax revenue and rising unemployment will drive the budget into deficit, where it should have been all along. But in this case, it will be accompanied by a poorer and weaker private sector.