

***Money too tight to mention:  
Interest rates, investment and financial stability  
in Australia and the United States***

**Dr Stephen Kirchner**  
Program Director, Trade and Investment  
United States Studies Centre  
at the University of Sydney

# Outline

- Monetary policy, interest rates and investment
- Investment and policy uncertainty
- Financial and price stability mandates in the conduct of monetary policy

# Post-Crisis Macro Story

- Low inflation and interest rates, alongside subdued economic performance, including investment spending
- Monetary policy ‘ultra-loose’, ‘unconventional’, ‘unorthodox’
- Some say monetary policy ineffective, need new targets, greater reliance on fiscal policy

# Financial Market Story

- Market-determined interest rates ‘artificially low’
- Higher asset prices
- ‘Suppressed’ asset price volatility
- ‘Suppressed’ cross-asset price dispersion
- ‘Financial repression’
- ‘Currency wars’

# Problems with this Story

- If monetary policy is so easy, why is inflation so low?
- If monetary policy is so potent in influencing interest rates and asset prices, why is monetary policy transmission to investment seemingly so weak?

# Alternative Story

- Monetary policy has not been easy
- Accommodated an increased demand to sold safe assets (money and bonds), not resulted in excess liquidity
- Monetary policy has to work harder
- Monetary policy under-utilised rather than ineffective
- Post-crisis macro/financial market experience no longer puzzling or surprising

# QE Effectiveness in US

- QE a tool, not a policy
- Consensus estimates around -100 bp
- Static effect to lower interest rates
- Dynamic effect to raise interest rates
- Announcement effect seems to raise rates (eg, Greenlaw et al, 2018)

# QE Effectiveness in US



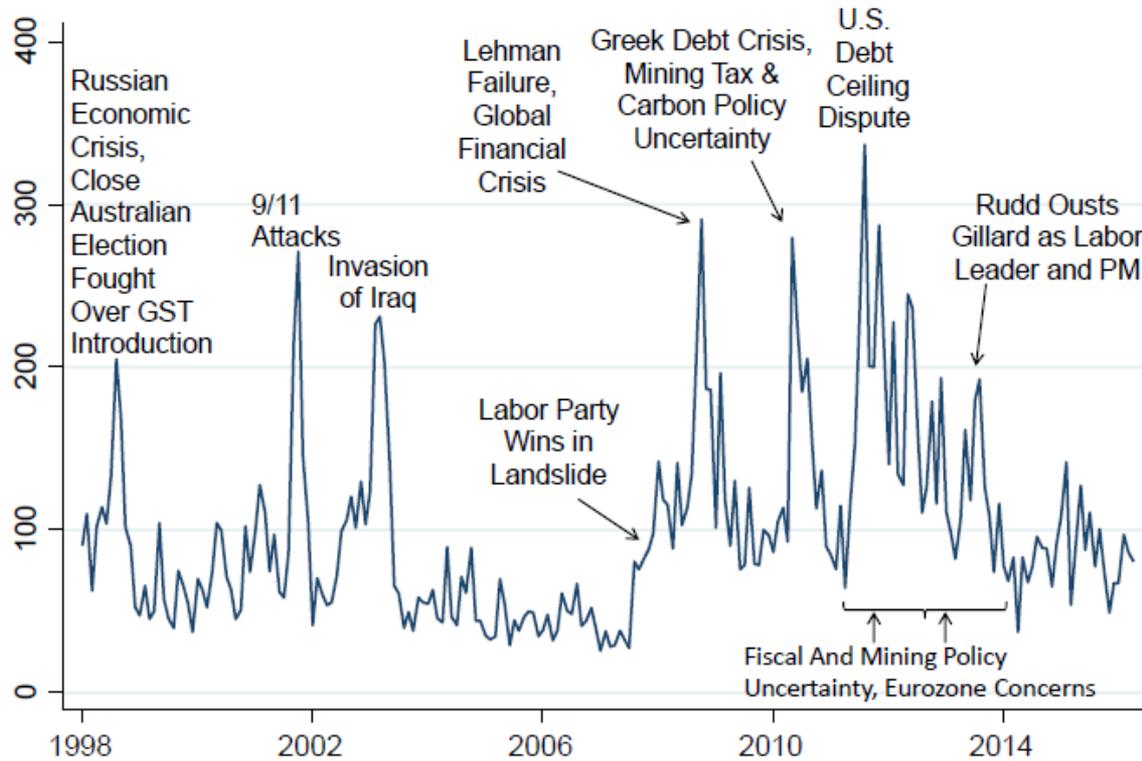
# Investment and Interest Rates

- Expected negative relationship hard to establish empirically
- Options theory of investment, effect of interest rates on investment theoretically ambiguous
- Large role for uncertainty
- Uncertainty increases the value of maintaining rather than exercising the option to invest
- Bernanke (1983) uncertainty-driven investment cycle

# Economic Policy Uncertainty

- Baker, Bloom, Davis measure of economic policy uncertainty (QJE, 2016)

## Economic Policy Uncertainty Index for Australia



Notes: Index reflects scaled monthly counts of articles in eight Australian newspapers containing "uncertain" or "uncertainty", "economic" or "economy", and one or more policy-relevant terms: regulation, "Reserve Bank of Australia", RBA, deficit, tax, taxation, taxes, parliament, senate, "cash rate", legislation, tariff, war. Normalized to a mean of 100 from 1998 to 2013. Index methods follow "Measuring Economic Policy Uncertainty" by Baker, Bloom and Davis. Data available at [www.PolicyUncertainty.com](http://www.PolicyUncertainty.com).

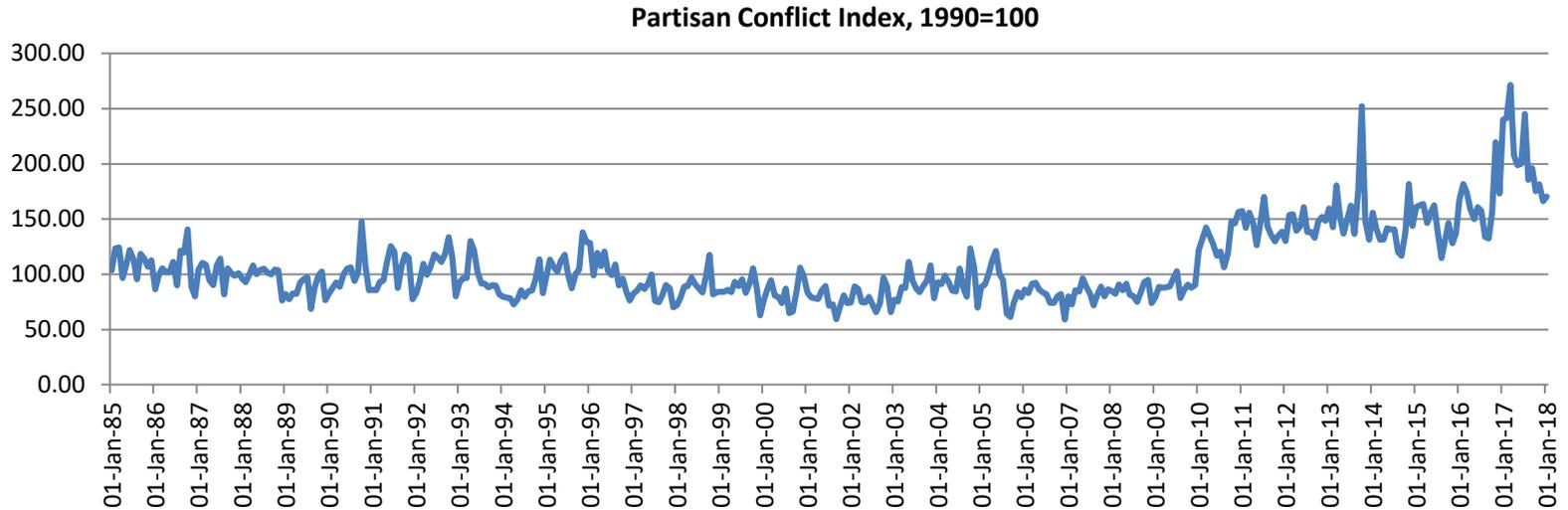
# RBA Measure of Economic Uncertainty (Moore, 2016)

- Negatively related to investment and employment growth, positively related to household saving
- Statistically significant positive correlation of 0.49 with monetary policy surprises

# Partisan Political Conflict Index

- Azzimonti (2017) US PCI
  - Increased partisan conflict has negative effect on aggregate and firm-level investment in the US
  - Positively correlated with EPU (coefficient 0.34 for 1985-2015)

# US Partisan Conflict Index



# Investment and Monetary Policy

- Elevated political, economic and policy uncertainty helps explain subdued investment in a low interest rate environment
- Framework and conduct of monetary policy may influence uncertainty, separate transmission mechanism from monetary policy to investment spending independent of interest rates

# Constraints on Monetary Policy

- (1) Inflation target (how flexible?)
- (2) Long-run neutrality of money
- (3) Central bank solvency
- (4) Financial stability concerns
  - Is there a price-financial stability trade-off?

# Financial Stability Mandate

- RBA does not have an explicit statutory mandate for financial stability
- Quasi-statutory mandate in second-reading speech to the APRA Act 1998, post-Wallis regulatory framework

# Second Reading Speech to APRA Act 1998

*There are three fundamental regulatory objectives for government intervention in the financial system. The first is the maintenance of **financial stability**, including through ensuring a safe and reliable payments system. This goal, which has **close links with the price stability objective of monetary policy**, is to be the regulatory focus of the Reserve Bank of Australia.*

# Statements on the Conduct of Monetary Policy

- First four agreements (1996, 2003, 2006, 2007) make no mention of financial stability
- 2010 agreement, first post-GFC, included a new section on financial stability

# 2010 Statement on the Conduct of Monetary Policy

*Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system.*

# 2016 Statement on the Conduct of Monetary Policy

*They agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. This formulation allows for the natural short-run variation in inflation over the economic cycle and the medium-term focus provides the flexibility for the Reserve Bank to set its policy so as best to achieve its broad objectives, **including financial stability.***

# Inflation Realisations and Forecasts, Australia and US

	Australia headline CPI	Australia statistical core	US personal consumption expenditures deflator
Actual Q4 2011-Q4 2017	1.9	2.1	1.4
Forecast 2018-2020	2.2	1.9	2.0

**Table 1: Average Inflation Rate, Australia and the United States, %**

Notes: Australia statistical core inflation is the average of the trimmed mean and weighted median inflation rates.

Forecasts are taken from RBA Statement on Monetary Policy, February 2018 and FOMC members' median projections as at 13 December 2017.

# Australian Monetary Policy Explicitly Conditioned on Financial Stability Risks

Governor Lowe testimony before the House of Representatives Economics Committee February 2018:

*the [RBA] Board has sought to strike a balance between these benefits of monetary stimulus and the medium-term risks associated with the increase in the already high level of household debt. We have sought to steer a middle course, promoting sustainable growth in the economy.*

# Macroprudential Policy

- Enhanced prudential and supervisory measures since end 2014
- Seen as complement to monetary policy
- Also at cross-purposes to the extent that macropru tightens credit conditions

# RBA on House Prices, Household Debt, Financial Stability Risks

- Driven by fundamentals, supply-side rigidities in housing market
- Structural/secular not cyclical, not a 'bubble'
- House prices not driven by borrowing
- Macropru and monetary policy are leaning against fundamentals
- Macropru policies temporary measures to allow housing supply to catch-up to demand, not a long-run solution
- Financial stability risks low

# Financial/Price Stability Trade-Off

- If financial stability risks are low, what is the benefit from trading-off the inflation target against financial stability risks?
- Lars Svensson suggests costs of 'leaning against the wind' (LAW) higher than benefits
- Swedish experience 2010-15

# Undershooting the Inflation Target May Reduce Resilience to Shocks

- LAW gives the economy a weaker starting point if there is a shock/crisis
- Works against the objective of stabilising income/debt ratio
- Tighter credit conditions inhibits financing of new dwelling supply
- May increase policy uncertainty

# Inflation/Financial Stability Trade-Off

- Rigidities on the supply-side of the housing market mean that the RBA cannot reconcile its inflation and price stability mandates as currently interpreted
- Need to go back to subordinating financial stability objective to price stability
- Fed ironically much more cautious about conditioning monetary policy on financial stability risks
- Government needs to own the problem of fixing the supply-side of the housing market
- Conditioning monetary policy and immigration policy on housing supply, compounding a public policy failure with second-best policy responses