Was keeping rates on hold a mistake?
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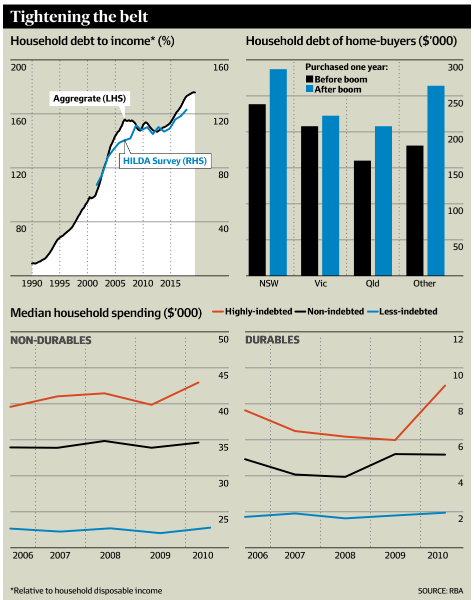

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The Reserve Bank's focus on financial stability over inflation may prove to be three times more costly than it is worth, according to the bank's own researchers.

Keeping interest rates higher than macroeconomic conditions would warrant because of concerns about financial instability, otherwise known as "leaning against the wind", is widely seen as a costly move.

"We estimate the costs of leaning against the wind to be three to eight times larger than the benefit of avoiding financial crises," the central bank's Trent Saunders and Peter Tulip write in a paper published on Thursday. "Most of the international research finds that interest rates have too small an effect on the probability of a crisis for this benefit to be worth higher unemployment."

The Reserve Bank had kept interest rates on hold for almost three years until June this year in what some economists say was a sign that the central bank itself had been leaning against the wind.

The paper says the policy of leaning against the wind was not necessarily inappropriate. "Leaning against the wind might have benefits that are not apparent to researchers," it says. "In particular, the Reserve Bank has emphasised that low interest rates increase households' indebtedness and that this may have deleterious macroeconomic effects."

Economist at the University of Sydney's United States Studies Centre, Stephen Kirchner argues the central bank left cutting rates too late because it was more concerned about financial stability than inflation, after having the mandate changed in 2016. "When Philip Lowe became governor of the Reserve Bank of Australia in 2016, the Australian government agreed to a change in the Statement on the Conduct of Monetary Policy that inverted the relationship between the Reserve Bank's price and financial stability mandates," Mr Kirchner said.

"Whereas a previous agreement had made financial stability explicitly subordinate to the price stability objective, the 2016 agreement specifically allowed for temporary deviations from the inflation target in pursuit of financial stability.

"I argue this change led the Reserve Bank to overly condition monetary policy on apprehended financial stability risks at the expense of achieving the inflation target, explaining a prolonged undershoot of the central tendency of the RBA's 2 per cent–3 per cent inflation target range."

Before the federal election Treasurer Josh Frydenberg said he would stay well out of the RBA's monetary policy decisions – the primary goals for which were to maintain stability of the currency, full employment and economic welfare of Australians.

"The Coalition government respects the independence of the Reserve Bank of Australia and has no intention to change the current arrangements of how monetary policy is conducted," Mr Frydenberg said.

He reconfirmed the government's commitment to keeping the 2-3 per cent inflation targeting band.

The number of central banks with financial stability mandates has increased from around two-thirds before the financial crisis of 2008 to around four-fifths post-crisis.

Dr Kirchner argues that the Reserve Bank, in not lowering interest rates as much as it could have, has been undershooting its inflation target.

The central bank then excuses itself by suggesting that inflation is missing the target because of non-monetary phenomenon such as globalisation. "Non-monetary explanations for inflation divert attention from the RBA's responsibility for undershooting its inflation target."

Dr Kirchner is less in favour of holding back rate cuts just to prevent asset bubbles and potential financial stability risks.

"The issue is whether monetary policy should take a more pre-emptive approach to financial stability risks by 'leaning against' growth in asset prices and credit aggregates, potentially at the expense of the inflation target, rather than responding to financial instability after the fact," Dr Kirchner said.

The debate he notes is now characterised as one between "leaners" versus "cleaners" or "poppers" versus "moppers".