Forget intervention, let the correction do its job

Economics & Deregulation and The Global Financial Crisis | Alan Moran Bookmark
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The Reserve Bank of Australia has proven itself unable to comprehend, still less to control, the nation's money supply. Like the US Federal Reserve, the RBA is trying to address the market meltdown with the tools that analysts consider would have worked in previous crises.

The problem is that, like wars, no two financial breakdowns are identical. And they are seldom due to a single cause.

The trigger for the current crisis was lax monetary policy in the US and elsewhere combined with regulatory pressure on US banks to widen the basis of their lending guidelines to cover poorer people, who were previously considered to be bad risks.

Underscoring these monetary and regulatory causes are shortfalls of savings in the US and other wealthy economies, shortfalls that were offset by huge capital inflows from oil states and poorer countries like China. Australia has been one of the world's largest borrowers in relation to income levels. And while capital inflow is to be welcomed when it supplements national savings, when it simply substitutes for inadequate domestic savings it is masking deep seated problems.

Australia appeared to be controlling the monetary repercussions of its undersupply of domestic savings liquidity until early 2006. Interest rate rises seemed to reining in excessive liquidity. Raising the official interest rate from 5.5 per cent to 7.25 per cent between 2006 and the middle of this year kept a lid on money growth. Even so, monetary growth was excessive and was bringing inflation, though this was reflected in assets - especially houses - rather than in the normal goods and services measured by the consumer price index.

Cutting interest rates by 1.25 percentage points in the past couple of months in spite of rising levels of monetary growth smacks of panic. In boosting money supply further, this will bring increased inflation and a need to take sterner remedial action later.

The fact is that Australia, like the US, has been on a consumption spree. For a long time we have been spending more than we have been earning, and allowing ourselves to be fooled into thinking that our nest eggs were safe. But those nest eggs, mainly housing, were artificially inflated by demand feeding on itself in a context of a casino underpinned by government-created housing land shortages.

This is now unravelling in the credit crunch. An early area of vulnerability was real estate that smaller businesses used as collateral to obtain finance. Once the US sub-prime crisis hit and raised the worldwide cost of wholesale finance, assets had to be liquidated. Small businesses in particular have had to find more equity to support their borrowings. This has meant selling real estate bringing softer prices, a process that is snowballing and amplifying the downturn.

No action by the Reserve Bank can arrest this process. Borrowers are in hock and must reduce the size of their operations and liquidate assets. The downward spiral is in place and hence, in the hackneyed phrases used in the US election parlance, the Wall Street meltdown is hitting Main Street. This will soon be translated into a headlong retreat of house prices, a reduction in economic activity and a rise in unemployment.

Right now, state governments are seeking federal assistance to offset reduced demand. And Prime Minister Kevin Rudd, who appears to see government as the answer to all travails, is eager to man

the pump.

State governments are facing lower tax revenue from the housing downturn. But Canberra too will have fewer resources to prime the pump. And if Canberra raids community savings in the Future Fund, it is a certain bet that the expenditure will be on the trendy and unproductive. This is already being foreshadowed in the criteria being set for spending, criteria which include measures to reduce greenhouse gas emissions and to ‘‘improve our quality of life”.

Queensland and NSW are pitching for public transport upgrades to tap into the commonwealth’s $20 billion infrastructure fund. Victoria will doubtless seek an opportunity to finance its white elephant desalination proposal.

Australia’s major savings and consumption imbalance must be addressed. Individuals need to restore the real level of their savings. And as a nation there is now an even greater urgency to ensure that our inadequate national savings are not misallocated into politically motivated investments with suboptimal economic returns. This requires less, not more, government spending.

A major economic downturn is inevitable and essential to allow a correction of the inflated values and inadequate savings that have characterised the economy. Energetic government intervention, which is second nature to Rudd, will aggravate the situation and could lead to a very prolonged period of instability and economic decline.

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