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Interest rate cuts

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August began with super-cuts in interest rate.

Reserve Bank of Australia (RBA) started the round, with cut on August 2 and Bank of England (BOE) on August 3. We have the latest by Reserve Bank of New Zealand (RBNZ) on August 11.

The most sensational of all is the cut by BOE, the mother of central banks.

The BOE cut its interest rate to the lowest ever, from 0.5% to 0.25%.

The cut is part of a package to meet the aftermath of the dreadful decision to leave the European Union. The other components of the package are: a new Term Funding Scheme of £100 billion to reinforce the pass-through of the cut in interest rate; purchase of up to £10 billion of UK corporate bonds; and an expansion of the asset purchase scheme for UK government bonds of £60 billion, taking the total stock of these asset purchases to £435 billion.

All are aimed at flooding the market with money and boosting economic activities. That is to fight the likely emergence of recession, following the BREXIT decision.

It is feared Britain would shrink, 2.5% smaller in three years' time.

For 2017, the growth forecast is just 0.8%. The economy would grow only at 1.8% in 2018 against the earlier forecast of 2.3%. Unemployment would rise to 5.4% in 2017 and 5.6% in 2018.

Regime change to growth change

Following the exit from European Union, a regime change, Britain has to “redefine its openness to the movements of goods, services, people and capital".

The exit decision is indeed a growth game change for the worst.

The four freedoms enjoyed by Britain; freedom of movement of goods, freedom of movement of services, freedom of movement of capital and freedom of movement of labour in search of jobs and educational opportunities in a single market of about 500 million of 27 countries would all end.

No mercy has been shown by EU: “Better hurry up and get out soon”.

The BOE expects that by acting early and comprehensively, it can “reduce uncertainty, bolster confidence, blunt the slowdown, and support the necessary adjustments in the UK economy."

Critics are arguing BOE is over-hasty. Its over-confidence in its ability to make a difference to the economy by such hasty steps is not justified. They warn that following the interest rate cut, the already weakened British pound would fall further and a weaker pound would render imported goods more expensive. That would only increase inflation. They were not incorrect. The pound indeed fell by one percent soon after the cut.

BOE measures have now to be matched by Government’s fiscal policy measures. It has to cut tax rate including VAT and take advantage of low interest rate environment to undertake new investments through public borrowing. It has to lessen its dependence on property market as the savior of the economy. It has to improve skills and efficiency of labour towards raising productivity and promoting exports.

Australia’s super cut

There are reasons behind RBA’s cut on August 2 in its interest rate to 1.5% from 1.75%. One was low inflation, a 17- year low at one percent, well below the target rate of 3%. The RBA attributed the low inflation to subdued growth in labour costs as well as low cost pressures elsewhere in the rest of the world and to a large decline in business investment.

Is it a sign of a struggling economy?

“No!”, says the Treasurer. The economy is growing at 3.1%. Low rates, further cuts to record lows and low investor confidence and low investments are all part of alarming global phenomena.

The RBA Governor, Glenn Stevens in his farewell speech on August 10 after ten years on the job made it clear that monetary authorities cannot just “dial up growth”. Monetary policy’s role is limited: low interest rate encouraged private debt going up to 125% of GDP while government debt is just 40% of GDP and the private sector cannot take on any more debt.

He wanted government to play a greater role: not for welfare payouts and salaries and wages, but for “long lived assets that yield an economic return.”

Central banks have been overburdened since the 2008 financial crisis. They were expected to do the tricks: cuts in interest rates; followed by pumping in money by purchasing bad debts; push long-term interest rates down; and force banks through “carrot and sticks” to lend. Governments went on a “pipe dreaming” trip that economy would grow and tax revenue would begin to roll-in.

That did not happen.

On Thursday August 11, Reserve Bank of New Zealand joined the low interest rate club cutting its rate by 0.25% to 2%. Remember its peak interest rate at 3.5% in 2015?

RBNZ does not want the kiwi dollar to climb up, rendering kiwi exports of dairy products, lamb chops and beef becoming more expensive.

A competitive devaluation process would begin soon?

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