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From monetary policy addiction to fiscal rehab and beyond

Everyone, it seems, has a welter of advice for economic policymakers, including (ahem!) humble financial market scribblers.

In a break from that practice, I am going out on a limb and suggesting both the RBA and the Federal Government deserve commendation for the way in which they have managed the fallout from the COVID-19 pandemic.

Despite criticism from former Prime Minister Keating for "indolence", I think the RBA has, by and large, acted with an appropriate balance of alacrity and caution. In so doing, it has avoided lurching into "doing something for the sake of doing something" and potentially exacerbating current problems with an over-reliance on monetary policy at a time when its efficacy is surely under question.

It has always been a source of some wonderment to me that for much of this century it has been an excess of private leverage that has been the clearest area of financial imbalance, yet the policy response has always been to encourage more private leverage. Yes, that has acted as a palliative to financial markets, but it has had an arguably limited impact on the real economy and has fuelled inequality concerns. In this context, there are obvious limitations to what monetary policy can achieve and the gentle nudging from the RBA for a greater emphasis on fiscal measures makes considerable sense.

The Federal Government for its part (maybe with some encouragement from the RBA) pragmatically jettisoned its fixation with budget balance and relatively quickly enacted a series of mostly well-constructed and mostly well-calibrated fiscal measures that have been, and will be, important in mitigating the economic fall-out from the COVID-19 pandemic.

It is a testament to previous governments – both Coalition and Labor – that Australia was in a position where it had plenty of fiscal room to manoeuvre. In this regard, the institutional make-up of the Australian polity was helpful in allowing a reasonably prompt fiscal response. This is certainly the case compared with the Eurozone or the US.

This is not to say that with the benefit of hindsight things may have been done differently or that what has been enacted is impervious to criticism. Rather that the response in Australia is as good, if not better, than what we have seen elsewhere.

However, the policy journey is not over. And as good a job as the Australian authorities may have done, we are in some sense a hostage to the capacity of the global policy complex in negotiating that journey.

One could be forgiven for thinking that the journey might not be too difficult. After all, risk assets are close enough to historic highs. That ebullience would appear to indicate that markets are sanguine about the future. Yes, there are 'second wave' issues but the vaccine news is encouraging.

However, the consequence of an over-reliance on monetary policy is that financial markets are now essentially ‘nationalised’. Risk market pricing is now set by virtual central bank fiat rather than any ‘fundamentals’ reflecting the current or prospective performance of the economy. Central banks have been like the proverbial ‘boiling frog’ – slowly and unwittingly been drawn into adopting a policy aimed at directly supporting equity markets, rather than creating the conditions for their organic growth.

Is that sustainable? Maybe in the short-term – the equity markets are not short of professional boosters - but not in the medium-term. Or at least not without potentially significant costs. Every now and then the consequences of unbridled and undisciplined risk-taking need to be visited on markets.

The ‘moral hazard’ consequences of the ‘central bank put’ and attendant easy liquidity will be difficult to shake. Easy liquidity debilitates future economic performance by allowing ‘zombie’ companies to persist, ultimately delaying necessary economic adjustment. In this way it might ultimately lower the economy’s growth path by inhibiting its productivity, flexibility and dynamism.

Easy liquidity appears to simply inflate financial asset prices without discernible increases in economic performance (a decline in the ‘velocity of money’) fuelling concerns about growing inequality.

Fiscal policy too has potential pitfalls not least in its ability to be compromised by execution error. But it would seem to be a more effective means of support for the economy going forward than monetary policy, and more importantly can support the implementation of structural economic policy measures.

These include policies aimed at maximising the operational flexibility of goods and labour markets and resisting the siren call of protectionist measures.

In the Australian context, Governor Lowe has urged movement on IR, responsible lending laws, digital initiatives in the payments area, health and government service delivery and infrastructure.

State governments have a role to play. The NSW government’s decision to look at replacing stamp duty with a land tax is a welcome small step forward.

Fiscal policy can help via the provision of lower personal and corporate taxes together with the addition of productive infrastructure. Policies that benefit the ‘real economy’ rather than one that simply inflates financial asset prices ultimately generating financial stability concerns.

In short, it is time for policymakers to get markets over their monetary addiction and into fiscal rehab and, more importantly, beyond.

And if the result is a flat equity market for a time, or even a meaningful correction, that may be a price worth paying. Avoidance of that scenario may lead to even worse outcomes down the track.

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