FINANCIAL REVIEW

Zero interest rates fan inflation flame

by Hugh Giddy | 8-Mar-21

Rising inflation mean retirees may need to accumulate more assets at retirement than they are expecting, and zero interest rates are exacerbating the problem.

Targeting a low level of inflation is a key goal of monetary policy in Australia and elsewhere. In recent years, and particularly amid COVID, central bankers have lowered interest rates to zero and below. They have faith in monetary easing boosting growth and therefore consumer prices to reach inflation targets.

Evidence that low interest rates have not boosted either with any reliability is ignored, or dismissed as a lagging response, or expressed as “things would have been much worse without monetary easing”, an unscientific contention that can never be disproven.

The surprisingly sharp recovery in the Australian economy after the initial lockdowns may have been assisted by easy money but almost certainly relates more to extreme fiscal stimulus and government payments, no leakage of spending offshore by Australian travellers, better rains for farmers, and extraordinarily high iron ore prices following supply constraints at Vale.

Inflation targeting became a central tenet of monetary policy for the RBA in the early 1990s. At the time, inflation as measured by the CPI had been well above 5 per cent almost continually since the early 1970s.

Setting a targeted band of 2 to 3 per cent over the medium term no doubt seemed appropriately conservative in that context. According to the RBA’s website: “This is a rate of inflation sufficiently low that it does not materially distort economic decisions in the community.”

In the context of the preceding high inflation, was it the intention of Bernie Fraser, then Governor of the RBA, and the government led by Hawke and Keating, that inflation should actually be boosted if it fell below the target for a reasonable period of time?

Effects of inflation on saving for retirement

Inflation is equivalent to a devaluation of money. Inflation of 2.5 per cent, however innocuously low a number that may seem, would mean the purchasing power of a dollar would halve in 28 years and that a dollar would lose a third of its value in 17 years.

This means that saving for retirement is a challenging endeavour – you may need to accumulate more than double the assets at retirement that you currently think you may need to fund your living expenses. Zero interest rates exacerbate the problem.

For the RBA to target increasing inflation from a low level, they should surely have to justify why Australians’ hard-earned savings should be gradually eroded. As demonstrated in David Fischer’s excellent book, *The Great Wave*, long periods of prosperity (such as Victorian England) occurred when prices overall did not increase for as long as a century.

Inflation is not inevitable, and periods of stable prices can coincide with great advances and prosperity. Technology and innovation are often contributors to lower prices; targeting 2 to 3 per cent inflation explicitly indicates a curious wish for other prices to increase materially.

Comparing low with moderate inflation countries does not suggest that higher inflation generates greater prosperity.

It is hard to reconcile zero interest rates and attempts to gee up prices with the RBA's stated aim to "not materially distort economic decisions".

Pensioners and savers are reluctantly being pushed into riskier investments from safe term deposits in order to receive *any* meaningful income, when many cannot afford the significant capital drawdown that such risk might entail.

Abandoning traditional jobs, some people have decided to trade speculative stocks and cryptocurrencies which have flourished amid the liquidity sloshing around. Insurance companies and life insurers are scratching around for ways to make reasonable returns in order to pay future claims.

Zero interest rates also push up financial asset prices more than the prices captured in the CPI.

State and federal governments repeatedly provide incentives and grants for home ownership, which in combination with low interest rates, easy credit from banks, and longer mortgage terms, have pushed housing prices up at a far greater rate than incomes.

Australian Bureau of Statistics and Stapledon data shows constant quality real house prices did not increase from 1880 to 1950, but have subsequently risen more than fourfold.

While housing may be seen as both an investment and a consumer item, it does represent the biggest purchase most people will ever make.

Policies aimed at underpinning a rising housing market may find favour with existing homeowners but not with the many who feel they may never be able to buy a home.

Australia has one of the highest household debt levels in the world as mortgage debt has risen much faster than incomes, a statistic that policymakers should not be proud of.