Australian central bank cites US slowdown in interest rate cut

Nick Beams
9 February 2001

The decision by the Reserve Bank of Australia to cut interest rates by 0.5 percentage points, following last month's 1 percentage point cut by the US Federal Reserve Board, is a further example of how central banks and financial authorities worldwide have been caught unawares by the rapid slide in the US economy.

The rate cut, which was announced on Wednesday, comes just six months after the RBA lifted rates by 0.25 percentage points—the shortest interval on record between a rate rise and a cut.

Announcing last August's increase, the RBA said gross domestic product and employment growth "point to an economy that continues to perform strongly" and that the "robust world economy will assist further growth."

In its statement announcing the rate cut decision, the RBA said: "Economic conditions abroad have deteriorated noticeably since last year. The United States economy has slowed more quickly than expected, after several years of exceptional strength. This has prompted a significant decline in US interest rates. Notwithstanding this, a slowing US economy can be expected to dampen growth in the world economy in 2001."

Turning to Australian conditions, the RBA pointed to a decline in business confidence in recent months and a softening of the labour market.

The rate cut, which has led to an immediate across-the-board reduction in home-loan rates, was carried out amidst pressure from the Howard Liberal government which has been looking for an economic boost prior to the federal election, due later this year.

In the lead-up to the RBA board meeting, federal treasurer Peter Costello warned that the economic situation facing Australia was the greatest challenge since the Asian financial crisis of 1998. Inflation, which had been cited by the RBA as one of the reasons for the August rise, was "not providing the problem that some people thought it would through the course of last year."

While pointing to the downturn in the US and its implications for the world economy, the RBA statement nevertheless insisted that "the Australian economy still exhibits extraordinary resilience."

Profits remained strong, corporate balance sheets were in good shape, there was no sign of overinvestment or overcapacity, credit remained readily available, conditions in capital markets had not deteriorated in the way they had in the US and the low exchange rate of the Australian dollar "has made exporters and import-competing sectors very competitive."

While not openly stated, the implication of these remarks is that the Australian economy is well placed to withstand the effects of a sharp downturn or even a recession in the US.

Such views were the subject of some caustic criticism by the editor of *The Bulletin* magazine, Max Walsh, in a column published in the week before the RBA decision.

Walsh, a long-time economics commentator, began by warning that the "success with which Australia had sailed through the Asian crisis" had created "an extraordinary degree of complacency" about its ability to "negotiate the slowdown-cum-recession gathering momentum in the US."

It seemed, he wrote, that the adage that "when the US catches cold we get pneumonia" had been consigned to the "dustbin of history." But this was "too premature by half."

Australia had "powered through" the Asian crisis on the back of US monetary policy which was considerably eased in 1998 and 1999, in response to the Asian crisis and the Russian default, and again at the end of 1999 as the Federal Reserve Board pumped liquidity into the economy, fearing that Y2K computer problems could spark a recession.

He pointed out that while Australia had been able to diversify its exports in the wake of the Asian crisis, its major customers were still in the region and were dependent on exports to the US market. But with the slowdown in the US these economies “are about to take a heavy hit.”

Under these conditions, he warned, export markets would become much more competitive.

“Instead of looking at our performance through the Asian crisis as evidence of our ability to ignore external shocks,” he wrote, “we should look at the reality which is that it underlined our interdependence not our independence. Should the US move into a full-blown recession the strength of our export expansion and the narrowing of our current account deficit would soon evaporate.”

A recession in the US would also bring a considerable exodus of capital from equity markets in Australia. In conclusion, Walsh remarked that “the line presently being peddled by most economic commentators” that Australia would “comfortably weather an American recession is utter rubbish.”

However, from an examination of its statement on the interest rate cut, citing the “extraordinary resilience” of the Australian economy, it seems that at least some of this “rubbish” is emanating from the board of the Reserve Bank of Australia.