Australian central bank cuts base interest rate to record low

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The Reserve Bank of Australia yesterday cut its cash rate to the lowest level in history in a clear indication that the country is becoming rapidly embroiled in the global currency wars.

Lowering the benchmark rate from 3 percent to 2.75 percent, it indicated that there could be further reductions in the months ahead.

Announcing the decision, RBA governor Glenn Stevens pointed to the impact on the value of the Australian dollar as a result of the flooding of liquidity into global financial markets as a result of the so-called "quantitative easing" policies of the central banks of the US, Europe and Japan.

Last month's decision by the Bank of Japan (BoJ) to undertake the doubling of the country's money supply in a bid to combat deflation appears to have been a significant factor in the decision. The value of the Japanese yen has fallen by 20 percent in recent months against the currencies of the major economies—much of it the result of the BoJ's actions.

The central banks insist that their quantitative easing programs are not aimed at devaluing their currencies but merely at stimulating their domestic economies. But the fall in currency values is the inevitable result of these policies.

While he did not directly attribute the RBA's decision to the expansion of global liquidity—official statements are couched in diplomatic language—Stevens did point to the "historically high level" of the Australian dollar over the past 18 months which was "unusual given the decline in export prices and interest rates during that time."

The escalation of the Australian currency was initially triggered by the rapid increases in 2010-2011 in the prices of the country's major exports—iron ore, coal and liquefied natural gas. But it has remained at historically high levels in face of the fall of prices in these commodities in 2012, which reduced the terms of trade—the ratio of export to import prices.

Previously, such a fall would have brought a reduction in the dollar's value but not on this occasion.

According to the RBA's trade-weighted index, which measures the value of the Australian dollar against the currencies of its major trading partners, the dollar has appreciated by 27 percent since early 2007, before the onset of the global financial crisis.

Even though the RBA has cut its benchmark rate by 2 percentage points since November 2011, the dollar has continued to remain above parity against the US dollar because interest rates remain close to zero in other major economies, prompting a flood of money seeking higher rates of return from Australian financial assets.

The high dollar value has severely impacted on a swathe of industries, especially in manufacturing, with employers announcing major "restructuring" and job cuts in order to try to reduce costs and maintain or increase profits.

However, the reduction in interest rates will do nothing to boost the economy. Rather, its major consequence will be the development of bubbles in a series of financial assets.

Writing in the *Australian Financial Review*, columnist Christopher Joye pointed to the unprecedented conditions that now exist in global financial markets.

There was clear evidence, he noted, that the combination of the lowest interest rates in history combined with "government money printing on an unheralded scale" was creating "serious financial market distortions." Bond prices and share values normally move in opposite directions, but now were both rising. This was because the money injected into the financial system by central banks as a result of the global financial crisis was being used to buy all manner of assets and “blow even bigger and possibly more destructive new bubbles.”

While the rate cuts will bring a reduction in home mortgage rates, it will not bring relief to families trying to put together the finances to buy a house. On the contrary, the effect of the rate cut will be to increase house prices, already at some of the highest levels in the world, even further.

The housing industry has been experiencing a downturn with layoffs in both construction firms and building supply firms. Figures published last week showed that building approvals fell 5.5 percent in March.

The major building supplies firm Boral, which has announced the axing of more than 1,000 jobs in the past two months, has indicated that demand for new housing might even be going backwards. Indicating that further cuts could be on the way, the company’s chief executive said that despite the RBA’s round of rate cuts there was little or no increase in demand for his company’s products. “We just haven’t seen any green shoots in terms of demand,” he said.

The downturn in construction is being replicated across a range of industries.

In its latest business expectations survey, the Australian Chamber of Commerce and Industry found that conditions had flatlined in the first three months of the year at weak levels. The business conditions index stood at 42.1, well below the level of 50 separating contraction and growth.

ACCI chief economist Greg Evans said there was “little evidence to date” of the broad-based growth that had been expected by the Labor government and the Reserve Bank as a result of previous interest rate cuts.

In a clear indication of a further downturn, Australian companies are cutting their spending on investment. A survey conducted by the global business information company, Dun and Bradstreet, found that Australian companies were set to cut their investment to a three-year low in the coming months. And actual spending had gone into reverse as well with an investment index for the March quarter falling to its lowest level since early 2009 when the global financial crisis was making its initial impact.

Over the longer term, investment is also expected to contract as major construction projects in the mining industry are completed.

The chief beneficiaries of the RBA decision will be the four major Australian banks which last year pulled in profits of $25 billion.

Westpac chief executive Gail Kelly was among those who called for the RBA to make a rate cut saying it was needed to boost business confidence.

Kelly also pointed to what she called “the wall of money” that has been unleashed by central banks around the world and voiced concerns about what would happen when it came time to turn off the tap. In the meantime, however, Westpac will join its counterparts in Australia and around the world in seeking to boost its profits as fast as possible from the availability of cheap money.