Respecting the constraints

> *"If you don't respect the basic constraints of situations, you find yourself doing things that are counterproductive and that in the long-run prove to be harmful."*

- Larry Summers (March 2022)[1]

The month of March was all about one thing, and one thing only: Russia's invasion of Ukraine, which is now in its sixth week. But if you were to look at the performance of our daily indicators over the month you wouldn't know it – it was a sea of green, which perhaps reflects the late-February plunge (reducing the base from which these figures are calculated) more than market optimism.

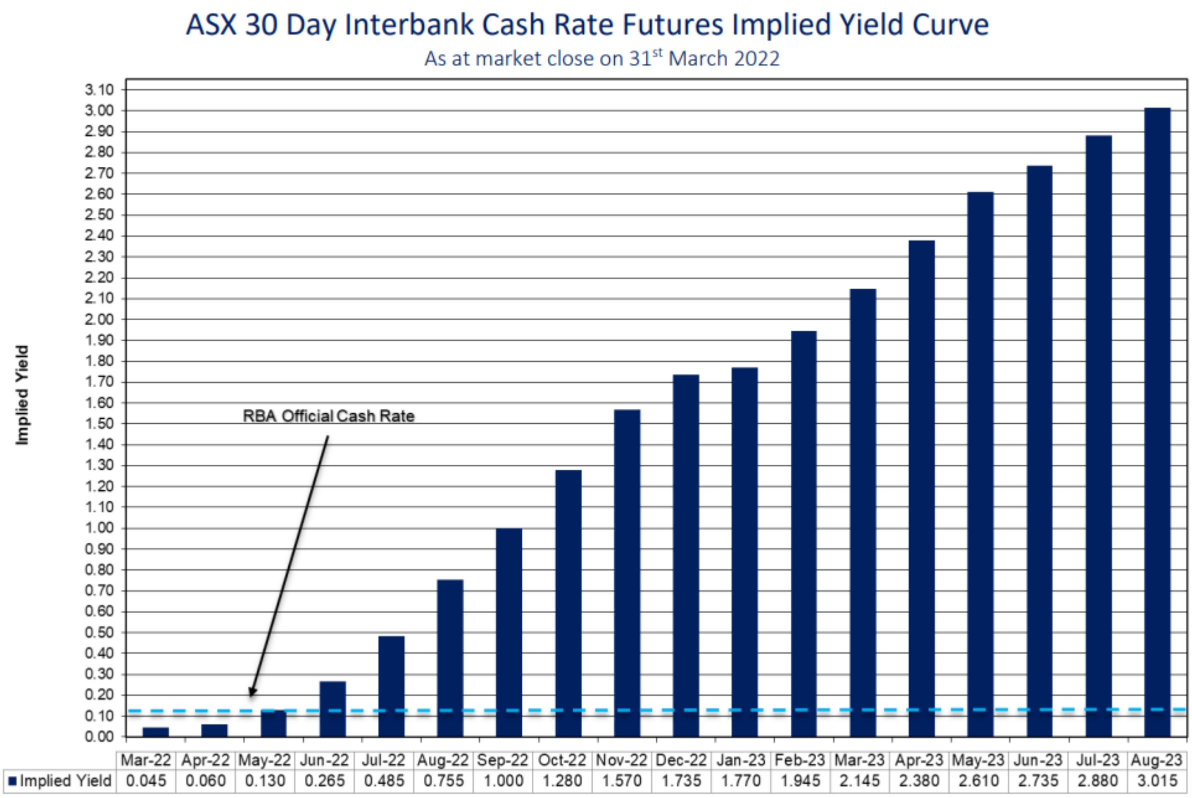
The following table shows all the monthly movements in more detail:

		Monthly % change
AUD/USD	74.9	+4.2%
AUD/CNY	4.74	+5.1%
AU Bond	2.80	+28.7%
US Bond	2.33	+26.5%
ASX200	7,500	+6.4%
S&P500	4,530	+3.6%
Brent (bbl)	107.8	+6.7%
Gold (oz)	1,942	+2.2%
Iron ore (t)	159.7	+13.6%
Bitcoin	45,725	+5.9%
Ethereum	3,295	+12.9%

Note: Brent oil, gold bullion and iron ore prices are the second futures contract. Bond yields are 10-year Treasuries.

[1] https://brekkywrap.com/2022/what-if-hes-right/

The most notable mover was bonds, with yields soaring nearly 30% as investors started pricing in interest rate hikes from the world's central banks. Even the most dovish amongst a sea of doves, the Reserve Bank of Australia (RBA), is set to hike rates as soon as June this year[2], despite as recently as November 2021 insisting that "the first increase in the cash rate" wouldn't be until 2024.[3]



Central bankers have truly been asleep at the wheel over the past two years, including our very own RBA. Faced with a global pandemic, the RBA slashed the cash rate to an emergency low. Perhaps that was appropriate given the uncertainty at the time; it could well be that the situation justified cutting the cash rate to 0.1%, monetising around half a trillion dollars' worth of government debt and helping to inflate house prices by more than 20% in a single year.

[2] https://www.asx.com.au/data/trt/ib_expectation_curve_graph.pdf
[3] https://www.rba.gov.au/publications/smp/2021/nov/overview.html

But that argument vanished as soon as it became apparent that the vaccines were effective and that maintaining ultra-easy monetary policy in the face of the highest ever post-war fiscal stimulus would unleash enough demand to trigger inflationary pressures, requiring the *opposite* stance.

By holding rates low the RBA held real interest rates heavily negative last year, lighting a fire under asset prices. Nominal GDP – a broader indicator of monetary policy-induced inflation given it includes *all* prices in the economy, rather than a narrow basket of consumer goods – increased at over 10% annually in the June, September and December quarters last year (there's no 2022 data at present).

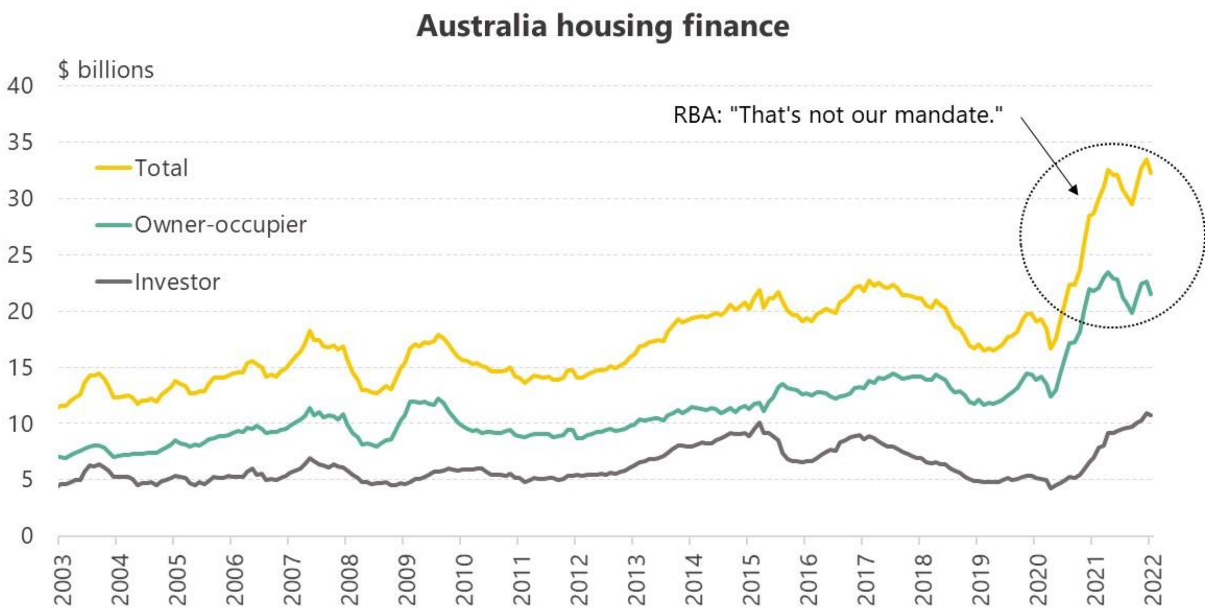
Admittedly that was off a pandemic-affected base, but quarter-on-quarter growth has averaged over 3% since September 2020, or around 13% on an annualised basis. The only blip was during September 2021 when half of the country entered a hard lockdown, but those days are now well and truly behind us. For context, Australia's nominal GDP usually grows at a rate of around 4-5% annually.

By not offsetting the federal government's unprecedented fiscal stimulus the RBA set in motion an inflationary wave (monetary policy has long lags) that will require policy tightening far beyond what would have been necessary, had it been paying attention to something other than its New Keynesian models, populated as they are with lagged historical data and correlations that cannot account for something as dynamic as a modern pandemic.

But we shouldn't be surprised: cutting rates is all RBA Governor Philip Lowe knows. Since Lowe was appointed deputy Governor in 2012 and then Governor in 2016, the RBA has never raised the cash rate. Over that same period Australian house prices have increased 83.5%, while those in Sydney (where Lowe lives) have jumped 116.7%.[4]

For those who prefer to conceptualise things annually, that equates to a compound annual growth rate of around 7.0% for Australia and 9.0% for Sydney.

Supply issues that the RBA can't do anything about (e.g., zoning) also contributed to that increase, along with Australia's population growth of ~1.5% each year over that period. But the amount of credit flowing into housing is something the RBA can regulate; it just decided to turn a blind eye to it, deflecting responsibility by stating: "That's not our mandate".[5]



[4] https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/residential-property-price-indexes-eight-capital-cities/latest-release
[5] https://www.afr.com/policy/economy/asset-prices-not-our-mandate-rba-20210205-p56zyx

The reason the RBA tolerated rapid housing credit growth was because overheating the economy allowed it to get closer to another of its mandates, the constantly moving target that is full employment. According to Governor Lowe (9 March 2022):[6]

> *"Australia has the opportunity to secure a lower rate of unemployment than has been the case for some decades. Moving too early could put this at risk. There are benefits to the economic welfare of Australia of a period of relatively steady growth in which people get jobs, have training and develop skills. This is one path to sustaining a lower unemployment rate than was thought possible just a short while ago – not as low as was thought possible back in 1963, but lower than was thought possible just five years ago."*

It's a well-meaning goal but as the proverb goes, "the road to hell is paved with good intentions". By not respecting the constraints of the situation – that excessively expansionary monetary policy begets more contractionary than otherwise policy in the future – the RBA attempted to hit a short-run outcome that in the longer-run may well result in hardship for the very people Lowe is trying to help.

Which brings us to the outlook. There is no question that last week's federal budget will juice the Australian economy even more in the coming months. By some estimates it will add new spending worth more than 1% of GDP to the economy this calendar year alone.[7] If that fiscal shock is not offset by sufficiently tight monetary policy – and we're almost certain it won't be, unless the attitude of those within the RBA quickly changes – then it will contribute to even greater inflationary pressures this year.

Ultimately, inflation will continue to climb until the point that even the RBA can no longer ignore it. When that time comes – barring another exogenous shock, of course – the RBA, which is already over year too late in tightening policy, will be faced with the

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[6] https://www.rba.gov.au/speeches/2022/sp-gov-2022-03-09.html
[7] https://www.firstlinks.com.au/federal-budget-2022-23-magic-election-pudding

difficult dilemma of triggering a relatively hard landing or living with something akin to stagflation (low or negative real growth, high inflation).

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