Interest Rates: How High Will They Go?

An estimated $150 million was bet on the 2009 Melbourne Cup. The well-backed Shocking winning the race wasn't the best result for bookies but, roughly, punters probably lost something in the order of $15 million. That's big money for a horse race, but small change when compared with the damage RBA Governor Glenn Stevens did on the same day.

The latest RBA statistics show $865 billion of homes loans outstanding in Australia. An estimated 85% of those are variable rate. So, when the Governor puts interest rates up 0.25%, the cost to Australia's homeowners is $1.8 billion a year.

Now that's big bikkies. Still, the cup day rate rise shouldn't have come as a surprise. It had been well flagged by the RBA and expected by financial markets. The big question now is: how high will they go?

All the official talk is about keeping inflation under wraps. But, for a guy who has sensed the need to start applying the monetary brakes before any other central bank around the world, Stevens seems remarkably sanguine about the risk of inflation: 'Both CPI and underlying inflation are expected to be consistent with the target in 2010.'

Of course, he may be worried about beyond 2010. The economy is, Stevens pointed out in a recent speech to The Melbourne Institute, coming out of this recession with less 'spare capacity' than previous recessions. That's good news if you're looking for a job, but also means inflation could rare its ugly head much sooner than we all would like.

But I think the RBA is also pursuing a different agenda. Stevens has been at pains to point out that the 3% benchmark rate we've seen over the past 6 months was an 'emergency' rate. Now that we've seen off the emergency, the RBA wants to get back to a level that it considers 'normal' sooner rather than later.

Official interest rates are a tool that the RBA uses to regulate the economy. When things get a bit heated, they put rates up, which reduces the demand for loans and takes a bit of cash out of people's pockets. When the economy hits the skids, like it has during the past year or so, the RBA can slash rates, making it easier for people to borrow and giving them more cash so that demand can be maintained.

The problem is that you can't have rates less than zero (Well, that's not quite true. Sweden's Riksbank did make its deposit rates negative at one point. Generally, though, this rule holds. Why would you put your money in the bank if you get less back once you take it out?). Japan has been hard up against this limit for more than a decade. Interest rates are zero, the economy remains moribund and there's nothing the central bank can do about it. The US is also at zero, has been there for almost a year and shows no signs of raising rates soon. So what happens the next time a recession rolls around? Ben Bernanke, Chairman of the US's Federal Reserve, will have nothing to play with.

That and not inflation is, I believe, why Glenn Stevens is so keen to get interest rates back up before Australia gets used to 3%. He’s trying to rebuild his ammunition pile so that, next time trouble rolls around, he has plenty to play with again. I’d guess his target is somewhere between 5% and 6%. Whether our highly leveraged economy can handle it or not is another question, but that’s where Stevens would like to be.