***[All the reasons interest rates are a bad way to manage the economy](https://www.smh.com.au/business/the-economy/all-the-reasons-interest-rates-are-a-bad-way-to-manage-the-economy-20230914-p5e4to.html)***

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In outgoing Reserve Bank governor [Dr Philip Lowe’s last speech](https://www.smh.com.au/link/follow-20170101-p5e2l4), he made a striking acknowledgement: monetary policy – the manipulation of interest rates to encourage or discourage spending – “has its limitations, and its effects are felt unevenly across the community”. We should “aspire to something better”.

He’s right. So, here’s my full list of monetary policy’s limitations.

When the economy’s growing strongly, and the demand for goods and services exceeds the economy’s ability to supply them thus pushing up prices, the need is for all of us to reduce our demand – aka our spending.

Raising interest rates is intended mainly to leave people with less money to spend on other things. But obviously, it only has this effect on people who’ve borrowed a lot, meaning its main effect is on people with big home loans.

Trouble is, only about a third of all households have a mortgage. The rest own their home outright or are renting. And some proportion of those with mortgages have had them for years and by now don’t owe much.

This is what Lowe means by saying monetary policy’s effects are felt unevenly across the community. Younger people with super-sized mortgages really feel it, while the rest of us don’t feel much.

So, using interest rates to discourage spending can be seen as unfair: it picks on only those who happen to have big mortgages.

[**Which generation has it the worst in the cost-of-living crisis?**](https://www.smh.com.au/national/which-generation-has-it-the-worst-in-the-cost-of-living-crisis-20230809-p5dv4q.html)

But the unfairness is multiplied because monetary policy’s selectivity limits its effectiveness. To achieve the desired slowdown in *total* spending, the 25 per cent or so of households with big mortgages have to be hit all the harder.

But that’s just the most obvious of monetary policy’s “limitations”. Another is its effect not on the people who borrow from banks, but on those who lend to them, aka depositors.

These people – many of whom are retired and depending on interest earnings for their livelihood – should be getting a steady income. Instead, their income bounces around, depending on whether the central bank is trying to encourage or discourage spending.

*Using interest rates to discourage spending can be seen as unfair: it picks on only those who happen to have big mortgages.*

How is this fair to depositors? And remember this: in principle, when the central bank obliges the banks to increase mortgage interest rates by, say, 4 percentage points, that increase should be passed through to the interest rates on deposits.

In practice, however, this rarely happens in full. With just four big banks dominating the mortgage market, their pricing power lets them widen their interest rate margin between what they pay for deposits and what they charge borrowers.

So, part of the pain the central bank imposes on people with mortgages ends up fattening the pay of bank executives and the dividends of bank shareholders. How is this fair?

**Former Reserve Bank governor Philip Lowe is right to say monetary policy isn’t primarily to blame for the high cost of housing.**

Remember the failure of the [Silicon Valley Bank](https://www.smh.com.au/link/follow-20170101-p5csol) in America? It had a lot of money parked in US government bonds, but was wrong-footed by the US Federal Reserve’s sudden move to jack up interest rates.

Central banks are responsible for ensuring the stability of the banking system. But their use of interest rates to manage demand can add to banking instability in a way that other means of influencing demand wouldn’t.

It hasn’t been a problem in Australia, however, because our much more oligopolised banking system means our banks are hugely profitable and so less likely to fall over.

On the other hand, whereas in the US and elsewhere home loans have an interest rate that’s fixed over the long life of the loan, most of our home loans have rates that can be changed as often as the bank thinks necessarily.

It’s this that makes monetary policy more immediately effective – and painful – in Australia than in other economies. A reason we should start the move away from monetary policy.

Lowe is right to say that monetary policy isn’t primarily to blame for the high cost of housing. It is, as he says, the result of the way we’ve encouraged our politicians to bias the system in favour of those who already own a home, to the disadvantage of those who’d *like* to own one.

[Global debt reaches $367 trillion as calls grow for restraint](https://www.smh.com.au/politics/federal/global-debt-reaches-367-trillion-as-calls-grow-for-restraint-20230913-p5e4cx.html)

Even so, watching all those young people signing up for massive loans while interest rates were at unprecedented lows during the pandemic made me wonder if the Reserve’s moving of interest rates up and down doesn’t create a FOMO effect: when rates are low, first-home buyers load up with debt – and bid up house prices – for “fear of missing out” when rates go back up.

As Lowe acknowledged after his speech, the continued use of monetary policy as pretty much our only means of slowing demand is threatened by another, quite different development: the slow disappearance of the world long-term *real* interest rate, which has had the lasting effect of lowering world *nominal* interest rate by about 3 percentage points, and so bringing them much closer to the “zero lower bound”, known to normal people as just zero.

This means monetary policy can still be *raised* to discourage borrowing and spending but – as we’ve witnessed over the past decade – often can’t be *cut* very far to encourage borrowing and spending.

At the time of the global financial crisis in 2008, and again during the pandemic, the US Federal Reserve and the other big central banks sought to overcome this barrier by resorting to unconventional “quantitative easing” (QE) – mainly, buying shed loads of second-hand government bonds to force down longer-term interest rates.

One of the main effects of this has been to lower the country’s exchange rate at the expense of its trading partners. Which is why, once the Fed starts doing it, other central banks feel they have to do it too, in self-defence.

But while “QE” seems quite effective in raises the prices of assets such as shares, it’s not very effective in boosting demand for goods and services and thus encouraging economic growth.

I think history will judge QE to have been a bad idea. It will be another reason we’ll need to become much less reliant on interest rates to manage the economy.

I thought that the primary reason the US has embarked on QE is because the Fed Govt is brok