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Banks' response to RBA rate cut doesn't warrant inquisition

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Perhaps the best that can be said for hauling the banks before the House of Representatives' Standing Committee on Economics is that it is unlikely to do much harm. But rather than being dragged behind Labor's populism, isn't it time the government moved to reset the economic agenda?

There is, for sure, more than a slight irony in cries for the banks to explain themselves. In 2010, when the outrage that follows each change in the Reserve Bank's cash rate reached Olympian heights, the Coalition urged the Gillard government to prevent firms from engaging in "price signalling", with the claim being that public pronouncements on pricing strategies could facilitate tacit collusion by allowing rivals to predict each others' future competitive responses.

Labor, which didn't need much encouragement to indulge in a bit of bank bashing, promptly passed an appallingly drafted amendment to the competition laws, prohibiting banks (and banks alone) from engaging in any form of communication that might disclose how prices were set.

Well, now our villainous financiers will be forced to do precisely that, with their CEOs being required to lift the kimono on those most private of parts, "the costs of funds, the impacts on margins and the basis for bank interest rate pricing decisions".

Yet the banks' response to the RBA's latest rate cut is scarcely so mysterious as to warrant a parliamentary inquisition.

As Mark Sheppard, a partner in the fintech venture mCD Exchange, has observed, while lower cash rates have reduced banks' funding costs locally, they are at least partially offset by imminent changes to the US regulation of money market funds which have pushed US inter-bank rates to new post-crisis highs, raising the costs Australian banks incur when they finance their operations by borrowing overseas.

That would, in itself, lead the banks to compete more vigorously in the local market for term deposits, since those deposits could replace the now more expensive foreign sources of finance. But the pressures on them to do so have been greatly intensified by regulators, with Wayne Byres, who chairs the Australian Prudential Regulatory Authority, identifying short-term foreign finance as "the form of funding most likely and able to run in a crisis" and so as a major source of systemic risk.

With APRA introducing regulations that will require the banks to boost the share of their funding sources that are "stable", the banks' response to the latest rate cut has therefore focused on making term deposits more attractive, rather than on reducing mortgage rates.

As far as the banks are concerned, this should have been a case of "move on, there's nothing to see". That hardly means, however, that the RBA's rate cut does not raise important concerns.

As best one can tell, the RBA's aim was, at least in part, to keep a lid on the value of the dollar, with the need to do so being all the more pressing as interest rates continue to fall, often into negative territory, overseas. The reality, however, is that central banks in other countries are also seeking to reduce their exchange rates — and not all exchange rates can decline at once. Relying on monetary policy alone to preserve our international competitiveness is therefore a dangerous proposition.

That is especially the case as our competitiveness problems have little to do with monetary policy. The persistent budget deficit puts upward pressure on the exchange rate, as it is largely financed through foreign borrowing. Achieving genuine progress in bringing the deficit under control would consequently yield a double dividend, improving competitiveness in the immediate term while reducing the burden that public debt imposes on future generations over the longer term.

Every bit as important are the labour market distortions that have limited the gains from the substantial depreciation that has occurred to date. In principle, that depreciation should have improved competitiveness by reducing labour costs, while cushioning the effect of falling export prices on the profitability of our export industries. In practice, the opposite has occurred: virtually all the impact of the reduction in the terms of trade has been borne by profits, with the

real rate of return in the market sector 30 per cent lower than it was in 2008-09, while real wages are 8 per cent higher measured in terms of consumer prices and 12 per cent higher when measured relative to producer prices.

In other words, far from being bolstered, the internationally traded parts of our economy are being squeezed, with ill-judged energy policies, which are increasing electricity costs, aggravating the problems.

It would be foolish to believe any amount of monetary easing could address those issues. And as the cash rate approaches zero, the risks involved in further cuts only become more acute. The RBA already seems to be laying the ground for a round of "quantitative easing", with Bloomberg reporting that having studied "the examples of unorthodox policy conducted by its peers", the RBA "would favour a multi-pronged stimulus if economic conditions unexpectedly deteriorated".

Yet as former Bank of England governor Mervyn King puts it in his important new book, *The End of Alchemy*, the short-term stimulus those policies provide "reinforces the misallocation of investment and its impact peters out when households and businesses come to realise that the pattern of spending is unsustainable".

It is a mature consideration of those risks, rather than yet more childish bank bashing, that we require. And it is explaining those risks to the public, rather than caving in to Labor's contrived rage, that deserves to be the government's priority.