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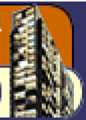

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Inflation rate is critical in RBA strategy

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With interest rates in the US dangerously close to zero, surely this provides pause for thought for the Reserve Bank of Australia.

What happens if the economy slows and the central bank has no further room for activist policy? Deflation may set in.

Generations of Australians have been schooled to believe that inflation can never fall far enough and that deflation is an affliction too exotic to contemplate seriously.

Japan has skewered that perception. Japanese interest rates stand at 0.1 per cent, yet growth remains anaemic. The problem is that nominal interest rates cannot be forced below zero, yet falling prices have raised the real interest rate. In turn, higher real interest rates have further stymied growth.

There is increasing fear that similar recessionary dynamics may hit the US. Yet, paradoxically, the Federal Reserve's strongest ally is the fact that inflation expectations remain high.

With inflation expectations around 2 per cent, the US already has something the Japanese cannot get: negative real interest rates. Fed chairman Alan Greenspan has 125 basis points of room to move, but inflation effectively adds another 200 points of stimulus and he may need them all.

What about Australia? With reasonable growth and the cash rate at 4.75 per cent, the **RBA** is blessed with both less need to stimulate, and more room to move than its US counterpart. But to declare that the possibility of a liquidity trap does not exist in Australia would be foolish.

The **RBA** can shift nominal interest rates down as far as zero if recession hits. But, as with the US and Japan, the extent to which this is stimulatory depends crucially on inflation expectations.

Further, the Howard government's fiscal irresponsibility during good times limits the scope for further fiscal stimulus during bad times.

Australia, of course, has an inflation target of 2 to 3 per cent. The key is whether this target is policed symmetrically.

Is the **RBA** as committed to cutting rates to boost inflation when it falls below 2 per cent as it is to raising rates when it breaches the 3per cent ceiling? Current bond market returns suggest that the **RBA** is erring on the hawkish side.

By comparing rates of return on nominal and inflation-indexed 10-year bonds, we can estimate the market's inflation expectations. The two yields now differ by about 2.25 per cent. But this cannot simply be read as the expected rate of inflation nominal bonds incorporate a risk premium of about half a percentage point to account for the risk that inflation will erode their purchasing power.

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Hence the market expects inflation to average 1.75 per cent over the next decade.

Apparently the market does not believe the **RBA** is committed to its inflation target.

Allowing the perception to spread that the actual target is simply ``less than 3 per cent" may have been a useful tactic to establish the bank's credibility in a high inflation era. But when deflation is stalking the global economy, insisting on a rate above 2per cent becomes just as critical.

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