Should the Reserve Bank Cut Interest Rates?

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ABSTRACT

Nine leading economists acknowledge that the state of the labour market is currently the critical factor determining price inflation and, consequently, the decision to adjust the cash rate. The main point of contention is how high unemployment, and other measures of labour surplus, need to be, to ensure wages do not fuel further inflation. Five economists agree that current conditions (January 2025) are not stimulating inflation and delaying a rate cut could risk a low growth, low productivity outcome; two have a conditional view, and two would like to see rates maintained.

1 | Introduction

The genesis of inflation outbreaks has historically been varied, but in the early 2020s, there is consensus that it was instigated by a combination of pandemic-induced supply chain disruptions, heightened public sector spending during the COVID years, and disruptions due to the Ukraine war.[1] According to the Australian Bureau of Statistics, increases in the prices in both tradeable and non-tradable goods contributed to recent inflation (ABS Consumer Price Index, Australia).

Excessive inflation can damage the economy through superfluous price and wage adjustments (minor inflation); capricious changes to the distribution of wealth and income (moderate inflation)[2]; and the breakdown of the exchange system (hyper-inflation). The experience during the 1970s and 1980s created a view that unchecked minor inflation can rapidly lead to uncontrollable moderate inflation. Public sector agencies around the world accordingly now target inflation to stabilise expectations and keep the growth in nominal prices stable and low. In Australia, the target is for inflation to stay within the 2%–3% range.

One compelling reason for concern about high inflation and high interest rates is that it has differential effects on households. For example in Figure 1, we show the year-ended changes in the cost of living for two household types – employees and self-funded retirees. According to the ABS, the increase in the cost of living for employees between 2022/Q3 and 2023/Q3 was 9.0% compared with an increase of only 5.7% for self-funded retirees. Figure 1 shows the year-ended gaps, on a monthly basis, and how mortgages have been a significant contributing factor in affecting the expenditures of employees and self-funded retirees over those years.

The problem facing the RBA now is how to lower the inflation rate that currently exceeds the official 2%–3% range without plunging the economy into recession.[3] Governments rely on their central banks to vary their cash lending rate to affect aggregate demand and consequently businesses' ability to charge higher product prices and to pay higher wages to attract and retain labour. Essentially, more slack in the product market makes price and profit rises riskier, and more spare capacity in the labour market reduces the pressure for wage rises.

The Reserve Bank of Australia has increased the cash rate by 4.25% points since underlying inflation rose above the target

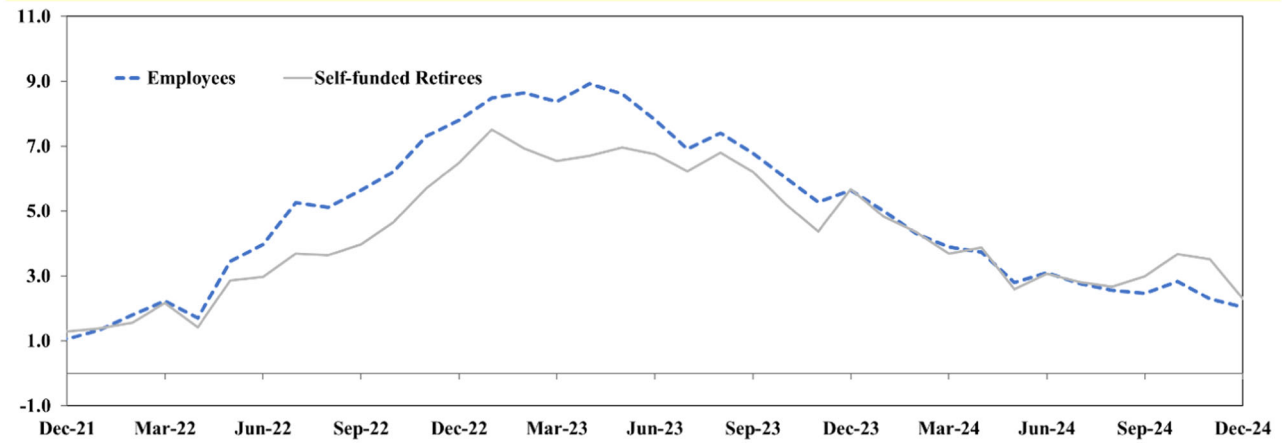

FIGURE 1 | Changes in the cost of living (year-ended, %). *Source:* Based on data collected for the Melbourne Institute Inflation Gauge and Cost of Living Indexes.

band of 3% in the first quarter of 2022. Headline inflation peaked in December 2022 at 7.8%. As of September 2024, the trimmed mean inflation has fallen to 3.5% and the headline CPI to 2.8%. At the same time, by late 2024, the rate of unemployment had risen to 3.9% from its low of 3.5% in mid-2023. The combination of falling inflation and higher unemployment has focused attention on the question of when the RBA should begin to cut the cash rate.

In this article, we discuss the views of nine leading Australian economists: Professor Jeff Borland,[4,5] Professor Emeritus Peter Dawkins AO,[6] Professor Emeritus Ross Garnaut AC,[7] Dr Isaac Gross,[8] Dr Warren Hogan,[9] Professor Guay Lim,[10] Dr Michael Keating AC,[11,12] Dr Peter Tulip,[13] and Professor Emeritus David Vines,[14] presented at a forum at University of Melbourne in December 2024.

2 | What Are the Points We Can Agree On?

A target rate of annual inflation of 2%–3% alongside full employment is widely accepted as the goal for Australian monetary policy. Although the aim is to stabilise all prices in the CPI basket, economists generally focus on measures of inflation that exclude items that had large price movements in either direction to obtain a more accurate read on the underlying rate of inflation. The most common method of removing these outlier price movements is known as the 'trimmed mean' inflation rate. The Australian Bureau of Statistics calculates this by trimming the top and bottom 15% outliers (usually temporary price items) and averaging the inflation rate over the remaining 70% of price changes.

All nine economists acknowledge that the labour market outcomes are currently *a* (and some argue, *the*) critical factor determining price inflation and, consequently, the decision to adjust the cash rate.[15] This therefore made the state of the labour market the focus of most presentations. Specifically, what matters for price inflation is the rate of growth in labour costs, reflecting both wage growth in the market economy (i.e. those not determined by government regulations) and productivity growth. In turn, wage growth is seen as depending on the degree of tightness in the labour market. Hence, there was much discussion of trends in wage growth and the extent of tightness in the labour market.

Lim cites survey data (CASiE) on price and wage inflationary expectations to show that expectations are in line with central bank policy of bringing inflation down.[16] As can be seen from Figure 2, survey respondents tend to overestimate the percentage change in prices and underestimate the percentage change in their wages. Nevertheless, the data shows that price expectations have been trending down since 2023,[17] whereas wage expectations have been steadier but at a higher expected rate of change (commensurate with higher inflation).

All economists appreciate that the Reserve Bank's cash rate, which drives commercial lending rates, plays an important role in changing demand for labour. However, within our group of nine, there was a point of difference between those who sought to identify the main impact of policy as being on the market sector and those whose analysis considered aggregate outcomes. In addition, Keating contends that as much of the current round of inflation is due to insurance, housing, medical and dental price rises, interest rate rises will have a limited impact on the CPI. These price increases are not driven by wage increases, and in the case of house rents, higher interest rates could exacerbate the situation by reducing housing investment. Tulip suggested that these inflationary pressures could be offset by lower increases elsewhere.

3 | What Is the Key Concept of Interest?

A measure of labour market tightness is therefore the key focus. The cash rate should return to 'neutral' when we are confident that inflation is on track to fall within the target range. However, this is where the consensus ends.

The NAIRU (the non-accelerating inflation rate of unemployment) is the prime measure used by the Reserve Bank and is commonly cited in the (financial) media. If the current rate of unemployment is below the NAIRU, then, it follows that there is still inflationary pressure in the economy and

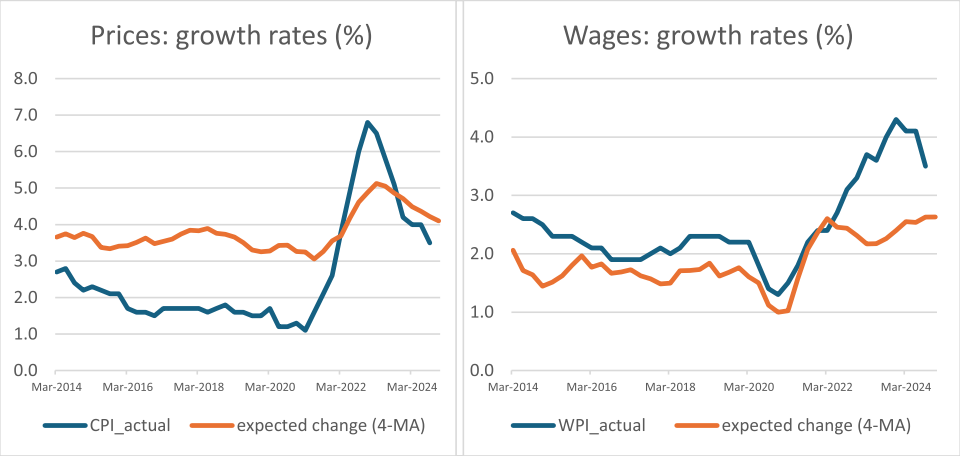

FIGURE 2 | Annualised growth rates in actual and expected prices and wages, 2014–2024. *Source:* Melbourne Institute CASiE survey and ABS CPI and WPI.

compensating high interest rates should remain. And vice versa. The RBA does not publish many details about how it estimates the NAIRU, but a recent Freedom-of-Information request revealed that they estimate 6 different time-varying NAIRU models. The estimated NAIRUs will drift over time as new data appears, and they are averaged to provide a single-point estimate of the NAIRU for Australia.

A major (arguably, the main) point of disagreement was over how to measure the NAIRU – do we rely on the multivariate econometric models or use single but contemporary indices? Tulip and Gross rely on the extensive econometric modelling by analysts in the Reserve Bank. By end 2024, the NAIRUs were estimated by the RBA in the 4.5%–5.0% range compared with the actual unemployment rate of 3.9%. Although they recognise the slow drift of the NAIRUs to current conditions, they point out that the drift in the various NAIRU estimates have not all been downward. This suggests inflationary pressure remains in the economy.

Others – Borland, Garnaut, Dawkins, Vines and Keating – draw attention to the divergence between the estimated NAIRUs derived from RBA's econometric modelling and actual behaviour in the labour market over the past decade and today. They argue that RBA models have been consistently misleading in projections of wage outcomes over the past decade and therefore favour analysis based on observation of recent and contemporary behaviour in the labour market. Among their criticisms of the RBA's NAIRU modelling is its large confidence intervals (although Tulip notes that this does not imply bias) and its instability over time.

Vines predicts that the recent reductions in real wages will be transitory, as supply chain difficulties are progressively resolved and prices of energy revert to pre-Ukraine-war levels, along with prices of other primary commodities. These things will – of themselves – lead to a temporary reduction in the NAIRU, enabling unemployment to be kept at a somewhat lower level without engendering inflationary pressure.

Dawkins reminds us that estimates of the full employment level of unemployment have varied between 2% and 7% since the 1950s. He argues that the NAIRU has been falling since the 1990s due to structural changes in the economy including declining union power.

In particular, Dawkins and Garnaut point out that after the outbreak of COVID, the Reserve Bank adopted a highly expansionary monetary policy and indicated that it would maintain that level until sustained wages growth above the inflation rate was accompanied by sustained general inflation going above the target range. This brought the unemployment rate down to 3.4%, without causing a wages breakout.

Dawkins points out that following the major outbreak of price inflation in 2022, triggered by supply shocks, average annual wages measured by the Wage-Price Index reached a maximum of 4.2% in December 2023, well below the rate of price inflation, and have since turned downwards in the same way that the CPI has turned down, the September quarter Wage Price index was running at 3.5% on an annual basis with the last three quarterly increases being 0.8%. No evidence of a wage-price spiral has developed, and the data are suggestive of the level of unemployment being above the NAIRU, not below it.

Tulip by contrast feels the sophisticated multivariate modelling by the Reserve Bank should be preferred to the descriptive analysis of single measures such as the Wage- Price Index and wage setting data. Keating, however, highlighted that the RBA persistently over-estimated annual wage growth by about 1% between 2011 and 2019.

The neutral real rate of interest is a companion to the NAIRU and can be defined as the rate of interest that delivers full employment within the target range of inflation in the medium term. The Reserve Bank undertakes extensive modelling on the neutral interest rate (estimated as 0.5%–2.0% with a mean of 1.0%). Lim and Hogan prefer this measure. Lim notes that if inflation is 2.5%, the neutral (nominal) interest rate lies between 3.0% and 4.5%. The current rate (as of January 2025), 4.35%, would therefore be at the upper bound. Garnaut points out that the neutral rate varies with factors influencing propensities to save and to invest and has been much lower over the past decade than in earlier times.

Borland, Garnaut and Keating argue that interest rates primarily affect the private sector markets, and these have been weakening since early 2023. The main growth in employment has been in the public sector which has in-built protections against wage spirals. Borland, Garnaut, Dawkins, Vines and Keating believe that the NAIRU can best be determined authoritatively by observing upward pressures on real prices from wages in the market economy.

4 | What Are Secondary Factors?

Unpredictable time lags between monetary settings and the 'real' economy make Keating worry that current high rates of interest will overshoot and push the economy into recession. Policy settings need to be based on forecasts for inflation and action taken before waiting to reach the target zone, both on the way up and the way down. The US Federal Reserve, for example, started cutting interest rates in September 2024 before inflation was all the way back to its target.

Hogan takes a longer perspective and argues that the demographic shift in dependent residents (from under 18 s to over 65 s) is causing a massive shift in the welfare state that will manifest in inflationary pressure for the next 15 years.

Garnaut notes that it is erroneous to see fiscal and monetary policy as substitute policies for stimulating aggregate demand. Monetary and fiscal settings *jointly* determine whether aggregate demand is set at levels that keep inflation within the target range, while securing full employment with the right amount of debt. Whether expanding or contracting demand to achieve macro-economic objectives is better, secured through changes in the setting of fiscal or of monetary policy, depends on the context. Sometimes simultaneously securing multiple objectives requires one to be tightened while the other is eased.

Keating argues that an important secondary consideration is the effect of high interest rates on investment (including innovation, upskilling and training) and industry transformation, and therefore productivity. Productivity growth can break the link from higher wages to higher prices and, therefore, speaks to the longer-term effect of interest rates on inflation. Dawkins and Garnaut add that reducing unemployment by moving to and sustaining full employment also helps grow productivity in the medium to long term, due partly to its effect on investments in physical and human capital.

Vines cautions us that Australia is not an island, and we need to consider the situation overseas. US President Trump's announced policies are likely to lead to upward pressures on the neutral interest rate, at the global level, in the short run, but they will likely be reversed. Furthermore, the neutral (real) interest rate is likely to remain at historically low levels in the longer term – higher than after the GFC but nevertheless lower than 20 or 30 years ago. The US, Canada and NZ are cutting rates and the French, Chinese and German economies are slowing down and therefore likely to cut rates in the near future.

Garnaut notes that the second, third and fourth largest monetary systems in the world (the European, Chinese and Japanese) now have policy interest rates far below Australia. The largest, the US, is heading down from above the Australian rate to somewhere below our current rate.

5 | What Are the Recommendations for February 2025?

Garnaut argues that the Reserve Bank has failed to see that the neutral rate of interest has declined, especially following the global financial crisis and is below their interest rate. He is comfortable with use of the NAIRU in setting monetary policy and sees the evidence as suggesting that the NAIRU is well below the current unemployment rate. He is concerned that the Bank kept interest rates too low in 2021 but too high since international inflation rates began to ease in 2023. He would have preferred cuts in 2024, but as early as possible in 2025 is better than later.

Hogan views non-mining private sector investment as strengthening and believes the unemployment rate at 3.9% is not far enough away from the range of estimates for NAIRU to justify a rate cut, while underlying inflation pressures remain above the RBA's target band.

Gross believes that the cash rate should return to the neutral rate of 3.5% when it is confident that inflationary pressure is on track to fall. A quarterly trimmed mean rate of 0.7% or lower for the December 2024 quarter would be a clear indicator.

Dawkins argues that the recent data on unemployment, wage inflation and price inflation, suggests that the labour market is not putting upward pressure on inflation and that there is now a case for reducing interest rates to increase economic activity, reduce unemployment and help raise productivity.

Keating believes that the NAIRU is lower than the Reserve Bank estimates, and the balance of risks is that we are currently heading for a recession unless we start dropping interest rates.

Borland argues that interest rates primarily affect the private sector markets and as these are currently weak and depressed, and wage growth in low, the Reserve Bank should reduce rates. Moreover, while growth in real unit labour costs has been high in recent times, he argues it is important to consider that this has mainly been due to what is likely to be a transitory drop in labour productivity.

Lim is more cautious and would prefer to wait for more data, but on balance, she can see the case for a rate cut.

Vines recommends cutting rates for both domestic and international reasons.

Tulip notes that inflation and unemployment are forecast to converge to their targets, so the cash rate is about right. The Reserve Bank should not react to overseas rates, concerns about private sector growth or the level of household consumption beyond their effect on the forecasts for inflation and unemployment.

6 | Conclusion

The perspectives of the nine experts reveal significant divergence on the optimal monetary policy path for 2025, highlighting the inherent challenges in striking a balance between managing inflation and sustaining economic growth. Although there is consensus on key principles – such as the importance of avoiding a wage-price flareup and targeting inflation within the 2%–3% range – their disagreements centre around critical variables like the sustainable level of unemployment (NAIRU), the neutral interest rate and the appropriate indicators of inflationary pressure.

These disagreements will ultimately be resolved through a combination of more data and new research on the topic of Australian monetary policy and the causes of inflation. This debate suggests several areas of useful research including the impact of government subsidies on inflation, how price growth interacts with the state of the labour market and alternative policy levels to bring down inflation. Those who emphasise the econometric NAIRU estimations would like sceptics to express their objections more precisely and provide statistical evidence on alternatives.

Ultimately, the path forward requires balancing the risks of doing too much versus too little. By prioritizing data transparency, robust modelling and deeper inquiry into the nuances of inflation and labour market dynamics, policymakers can navigate these challenges and maintain credibility in their commitment to stable and sustainable economic growth.

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Data Availability Statement

The authors have nothing to report.

Endnotes

[1] Inflation is defined as a persistent increase in the prices of goods and services.

[2] Social security recipients are protected from inflation by CPI-related indexation; low-income wage earners are protected if the Fair Work Commission indexes low wage, but low incomes above this are less well protected against inflation. As the CPI includes house prices but not mortgage payments, the impact on different households will vary according to whether one rents, owns a home outright or has a mortgage. Modelling by Ben Phillips and Matthew Gray from the ANU (https://theconversation.com/whos-better-off-and-whos-worse-off-4-years-on-from-the-outbreak-of-covid-the-financial-picture-might-surprise-you-231172) shows that over the 5 years from December 2019 to December 2024 the living standard of mortgagee households fell by 5.6%, whereas the living standard of renters and owners increased.

[3] The Monetarists' advice during the 1970s and 1980s for containing aggregate demand via limiting the money supply was largely unworkable as money – foremost a medium of exchange – proved to be endogenous to business demand.

[4] See https://sites.google.com/site/borlandjum/labour-market-snapshots.

[5] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0009/5184711/Jeff-Borland-notes.pdf.

[6] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0004/5184715/Peter-Dawkins-notes.pdf.

[7] See https://www.afr.com/policy/economy/there-s-a-compelling-case-for-rba-reducing-interest-rates-on-tuesday-20241209-p5kwte.

[8] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0010/5187475/Dr-Isaac-Grosss-key-points.pdf.

[9] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0007/5184718/Warren-Hogan-context-slides.pdf.

[10] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0008/5184710/Guay-Lim-notes.pdf.

[11] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0003/5184714/Michael-Keating-notes.pdf.

[12] See https://johnmenadue.com/to-avoid-recession-cut-interest-rates-next-week/.

[13] https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0005/5184716/Peter-Tulip-notes.pdf.

[14] See https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0007/5184709/David-Vines-notes.pdf.

[15] This is in contrast to the initial period of inflation with COVID-19 when the main source of inflation was from internationally transmitted supply shocks.

[16] The expectations data is based on our survey of Consumer Attitudes, Sentiments and Expectations (CASiE). The wage expectations data is the sample average of the expected change in the pay of respondents who are employed, and the price expectation is the trimmed mean value of what these respondents say is the change in the prices of goods they buy. The figure shows the 4-quarter moving average (4-MA) mainly to smooth out quarterly variations and hence to provide an indication of the overall trend.

[17] Though not down to the pre-pandemic levels.