AUSTRALIA'S RESERVE BANK GOVERNOR

GLEN STEVENS

Raising Interest Rates to Fight Inflation?

Copyright June 15th, 2011

This document may be freely distributed as a public service
ArmstrongEconomics.COM & MartinArmstrong.ORG

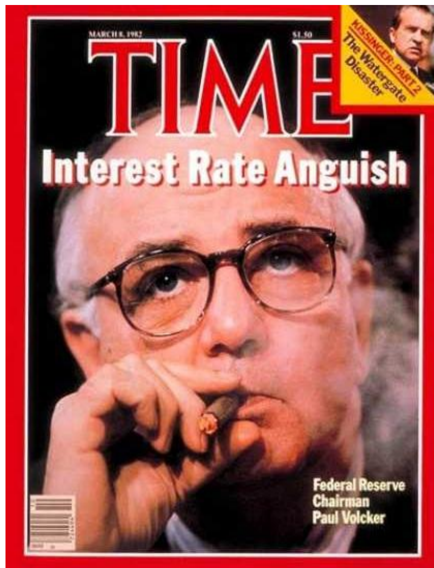
Glen Stevens hints at August rate rise

Copyright June 15th, 2011

By: Martin A. Armstrong
former Chairman of Princeton Economics International, Ltd.

Copyright all rights reserved throughout the world

LD theories die hard, for the doorway to knowledge seems often nailed shut. Like an actor on stage, central bankers memorize their lines and repeat them with each performance. They are not the author, but just the actor. Unfortunately, we are in desperate need of revising the economic theories but we lack men of actual experience such as **Adam Smith** and **David Riccardo** to make the observations necessary. Everything is academic and that is the role of the actor – repeat the mantra perfectly memorized, but there is nobody going out to see if this stuff really works. The **Australia Reserve Bank Governor**, **Glenn Stevens** says inflation data at the end of July will be important in deciding interest rate hikes come August. He will raise interest rates thinking this will contain inflation.



Time Magazine - March 1982

However, in this new global age, he will make the same mistake as **Paul Volcker** who raised rates so high, going into 1981, he sent the US dollar to record highs for the century into 1985, cut off exports, set in motion the need to then manipulate the currency to try to create jobs lost, and in the process gave birth to the 1987 Crash, the flight of capital back to Japan that culminated in the bubble of 1989. The rest is history.

Mr. **Glen Stevens** has hinted that interest rates are likely to rise in August if inflation continues edging higher when he spoke at an economist lunch in Brisbane. **Glen Stevens** says the sharp slide in Australia's economic output during the March quarter was "***more than fully explained***" by the fall in coal and iron ore production due to flooding. While fruit and vegetable prices are returning to normal in Australia after farmers got back to full production in the aftermath of the devastating floods helping to reduce immediate inflation, we are in a 7 year drought in the US and Europe-Russia that no change in interest rates will cure. This will drive food prices higher regardless of the domestic policies in Australia. Raising interest rates will have no disinflationary effect and more likely than not, this will add to the upward spiral in food prices.

There is so little attention paid to the difference between an across the board **STRUCTURAL INFLATION** and a **SPECULATIVE BUBBLE** that might be fueled by cheap money. **Governor Stevens** recognized the shift in the Australian economy towards greater income from the mining sector as China continues to boom over the next 4.3 years. He stated:

> ***"Let me be clear here: there is a cyclical dimension to the China story, and it is important that we remember that. But there is also a structural dimension…"***

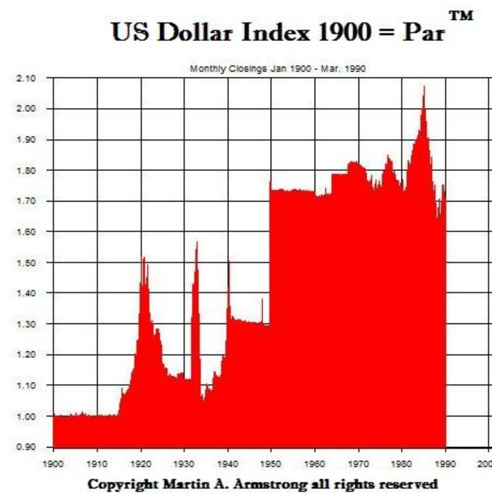
Nevertheless, it is rare to find central bankers willing to drop that script and try something new. Indeed, since nobody has done so, it is beyond rare and just plain unknown. **Volcker** did not make this distinction between **speculation** and **structural** changes. Back in late 1977, protests against the regime of the **Shah of Iran** culminated in his overthrow in January, 1979. It is true that this disruption of Iranian oil production was used as the excuse to send oil prices sharply higher reaching the $40 level a barrel. From an average of 5.75 million barrels of oil a day, Iranian production declined catastrophically because the Western oil companies were effectively kicked out. Production briefly fell to zero. Oil had already risen during the first shock by the formation of OPEC. Where oil had been under $2 a barrel, it had risen to $15 per barrel in 1978 on average and continued higher reaching $25 per barrel in 1979. This had a profound impact on structural inflation throughout the USA and Europe as companies had to now deal with a sharply higher energy costs. The US Consumer Price Index (CPI) averaged 6.5% during all of 1977 and for the first third of 1978. Thereafter, the **structural** impact of raising oil all at once began to filter into every sector of the economy and the CPI then touched 8.13% by March of 1979. The Iranian Revolution altered the dynamics and within just two months thereafter, inflation climbed to over 10% annually. By the end of 1979, average inflation for the year was 11.22%, and by March of 1980, inflation was now reaching nearly 15%. Raising interest rates in theory lowers demand but not **structural** shifts.

Unemployment was now rising to 5.9% when the **Shah** was overthrown in January of 1979. This was a **structural shift** and that always leads to rising unemployment as the work force has to readjust to the new conditions within the economy. By 1980, unemployment rose further to 6.9%. Under these conditions, raising interest rates would have no impact upon preventing **structural** changes. Why anyone would think so is beyond me. It is like the government threatening to imprison your wife if she does not get you to take out the trash. There is no direct relationship between a **structural inflation shift** and excess demand. The entire economy had to change. Cheap energy was a thing of the past.

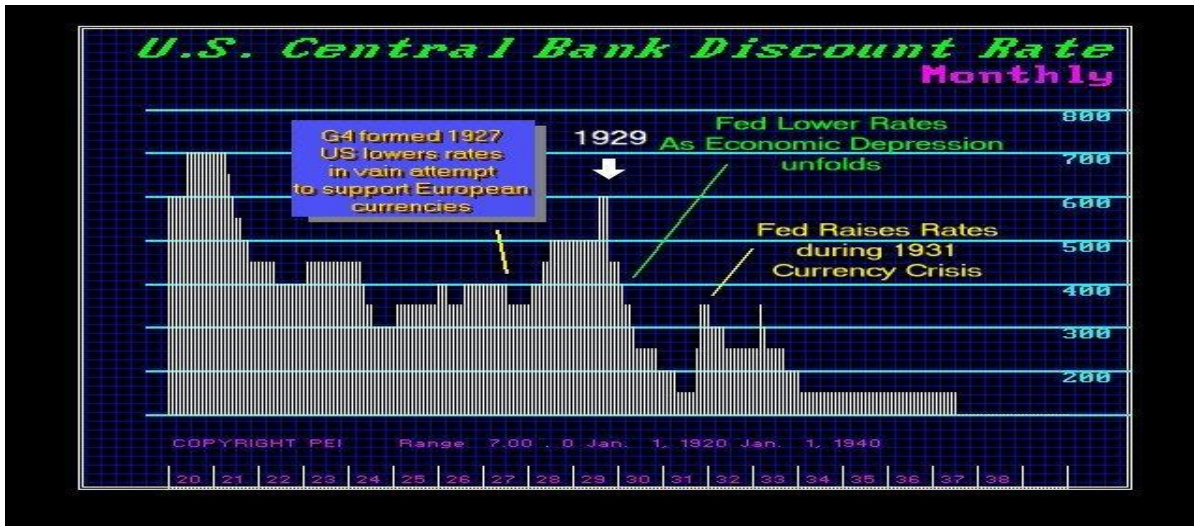
President Carter appointed **Paul Volcker** as the new **Chairman of the Federal Reserve** in August of 1979. By October of 1979, **Volcker** raised the Fed funds rate to 12% in the so-called "***Saturday Night Special.***" Thereafter, **Volcker** kept the Fed funds rate moving up above 15% for most of 1980 and 1981, peaking at last at 19.1%. Unemployment would eventually reach a plateau of 10%, and remain there until June 1983. The actual peak arrived at 10.8% in November of 1982. Unemployment remained structurally high, giving rise to the justification to create the G5 at the **Plaza Accord** in 1985. It took until just before the 1987 Crash in September of 1987 to fall back to the pre-Oil Shock level of 5.9%. This illustrates the **structural** changes required to readjust the economy. This took about 10 years to accomplish and raising interest rates adversely affected small business reducing employment as a consequence of fighting inflation. These things are just **NEVER** thought out very carefully anymore.

U.S. Money Supply, 1974–1986

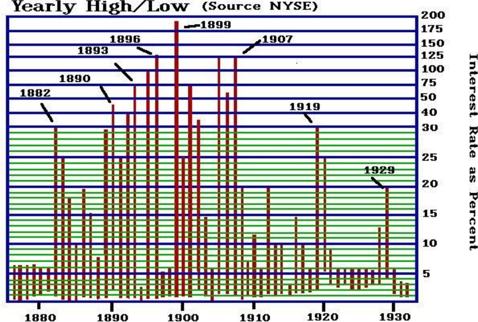
Date	M2	Y-to-Y diff.	As percentage
Jan-74	$861		
Jan-75	$908	$47	5.46%
Jan-76	$1,028	$120	13.22%
Jan-77	$1,167	$139	13.52%
Jan-78	$1,282	$115	9.85%
Jan-79	$1,375	$93	7.25%
Jan-80	$1,486	$111	8.07%
Jan-81	$1,610	$124	8.34%
Jan-82	$1,772	$162	10.06%
Jan-83	$1,966	$194	10.95%
Jan-84	$2,147	$181	9.21%
Jan-85	$2,342	$195	9.08%
Jan-86	$2,513	$171	7.30%



Based upon the statistics of the Federal Reserve itself, we can see that money supply played no role in creating inflation between 1977 and 1981 going into the peak of interest rates. The sharply rising money supply clearly begins in 1982 caused by the high interest rates attracting cash on an international level. This is when foreign capital was pouring into the US because of these extremely high interest rates. Once there was a perception the US would not default, everyone was buying US debt at such high rates of interest locking it in for a decade or more that the capital inflows were driving the dollar up giving rise to the stupid idea of the **Plaza Accord** to manipulate the dollar lower to affect the trade deficit i.e. jobs!



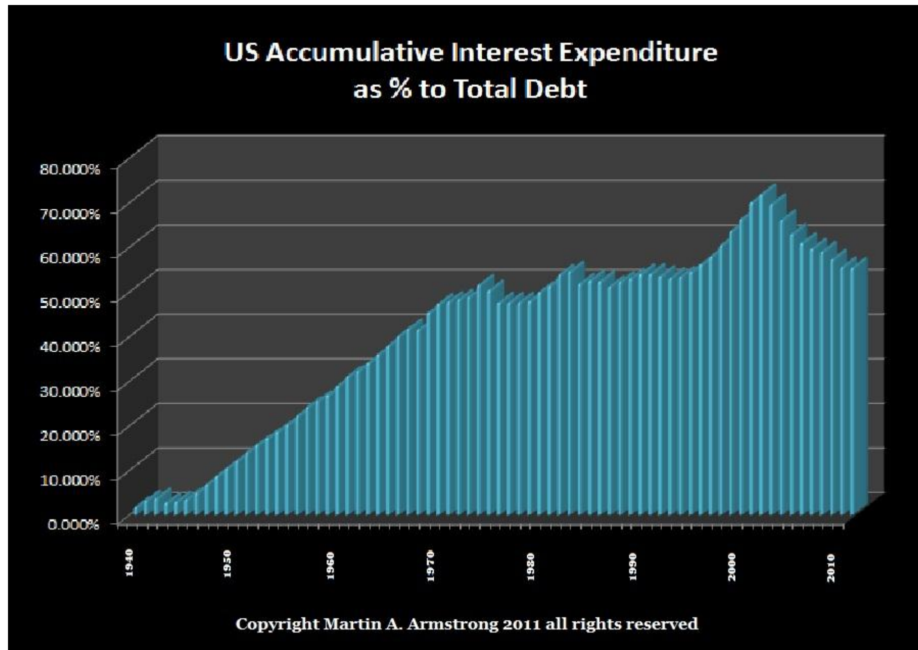
The mistake **Stevens** is about to make stems from his reading the same script from a fixed exchange rate world that no longer exists. In the good old days, a central bank could raise interest rates to attract capital in times of need, or in theory, to raise interest rates to increase the cost of borrowing to reduce demand. There is **NO** empirical evidence whatsoever that this policy has **EVER** worked even once. Above is a chart of the Federal Reserve discount rate for the Great Depression. There was back then a **G4** type deal where the US cut its interest rates to try to deflect the foreign capital that was flowing into the country to help out Europe. That was seen by the markets as a confirmation that there was a problem in Europe. The US stock market soared. As you can see, the Fed kept raising interest rates. Note that the discount rate peaked at 6%. The Fed cut interest rates with **NO EFFECT** whatsoever. This was the worst collapse in modern history and lowering interest rates had no more effect than the virtual zero interest rates in Japan. Zero interest rates in Japan caused capital to flee to higher interest rate nations. The opposite is true by raising rates when the currency is seen positively by international capital.



Now look at this chart of call money rates from the **New York Stock Exchange**. The theory is that raising interest rates will suppress the inflation and the stock market lowering demand. Note that the worst economic event of 1929 took place with the lowest interest rates, not the highest. There is **NO** empirical evidence showing **ANY** direct relationship between interest rates and inflation no less the stock market because demand is affected by other factors as well including international capital comparisons.

There are simply many more factors involved and for whatever reason society keeps trying to reduce everything to a single cause and effect. As long as we keep this up, there is no hope whatsoever of advancing society at all. The future appears no different than the past. So what will Mr. Stevens create?

Unlike the US and Europe, the socialists in Australia did one thing right. They demanded that the pension funds be actually funded. The **SUPERANNUATION** Fund in Australia is a model for the world. There is no ticking time bomb as there is in the US, and now he will raise interest rates as did **Volcker** and create a huge magnet that will draw in capital to Australia like never before.



There are major banks that are starting to quietly reduce US Treasury exposure. Some are concerned about the confrontational posture building over this stupid debt ceiling debate in Congress. There is no effort to review the system at all. They just want to cut spending ignoring the fact that interest rate expenditure will eventually consume all spending and then what? Pictured above is a chart since 1940 showing the accumulative interest expenditures as a percent of the total national debt. What they cannot see right before their eyes is that cutting every program and destroying "***Obama-Care***" as the Republicans call it, will do **ABSOLUTELY** nothing to stop the crisis on the horizon. They cannot address the interest expenditures that are not negotiable without default. On a real basis, accumulative interest expenditure stands currently at about 55.49% of total debt levels based upon **Bureau of Public Debt** numbers. The accumulative interest costs of constantly rolling over the debt will bankrupt the nation certainly by 2032 no matter what they cut even if the New York Investment Bankers don't blow themselves up again guaranteeing sovereign debt in countries like Greece with their CDOs forcing taxpayers to bail them out again. Hello! Why did Congress not put CDOs on an exchange?

Stevens is playing precisely in line with the **Economic Confidence Model**. I have never met him and I doubt that he is even aware of its existence. Nevertheless, he will raise interest rates because that is what the script says to do with "***inflation***" that will rise especially in the Asian sector. The higher he raises the rates, the more capital he will attract from around the world increasing domestic money supply, and there will be a danger of a future Australian bubble ahead.

I don't know what it will take to get rid of these brain-dead theories of yester-year. **Steven**s will fulfill precisely what the model is forecasting for Australia. He will **<u>ATTRACT FOREIGN CAPITAL TO BUY THE A$ AND AS DEBT CONCERNS GROW OVER EUROPE AND THE US, CAPITAL WILL DIVERSIFY BUYING CANADA AND AUSTRALIAN DEBT!</u>** So for those who were wondering WHY the A$ will do well in the years ahead, try this one on for size ***mate! – The Land Downunder looking good!***