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The Reserve Bank of Australia (RBA) is making an explicit trade-off between inflation and financial stability concerns. And this could be weighing on Australians' wages.

In the past, the RBA focused more on keeping inflation in check, the usual role of the central bank. But now the bank is playing more into concerns about financial stability risks in explaining why it is persistently undershooting the middle of its inflation target.

In the wake of the global financial crisis, the federal Treasurer and Reserve Bank governor signed an updated agreement on what the bank should focus on in setting interest rates. This included a new section on financial stability.

That statement made clear that financial stability was to be pursued without compromising the RBA's traditional focus on inflation.

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The latest agreement , adopted when Philip Lowe became governor of the bank in 2016, means the bank can pursue the financial stability objective even at the expense of the inflation target, at least in the short-term.

While the RBA board has explained its recent steady interest rate decisions partly on the basis of risks to financial stability, this sits uneasily with what the RBA otherwise has to say about underlying fundamentals of our economy.

It correctly blames trends in house prices and household debt on a lack of supply of housing, and not on excessive borrowing. These supply restrictions amplify the response of house prices to changes in demand for housing. RBA research estimates that zoning alone adds 73% to the marginal cost of houses in Sydney.

Restrictions on lending growth by the Australian Prudential Regulation Authority since the end of 2014 have been designed to give housing supply a chance to catch-up with demand and to maintain the resilience of households against future shocks.

The RBA argues that it needs to balance financial stability risks against the need to stimulate the economy through lower interest rates. But this has left inflation running below the middle of its target range and helps explain why wages growth has been weak.

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The official cash rate has been left unchanged since August 2016, the longest period of steady policy rates on record. The fact that inflation has undershot its target of 2-3% is the most straightforward evidence that monetary policy has been too restrictive.

While long-term interest rates in the US continue to rise, reflecting expectations for stronger economic growth and higher inflation, Australia’s long-term interest rates have languished.

Australian long-term interest rates are below those in the US by the largest margin since the early 1980s. This implies the Australian economy is expected to underperform that of the US in the years ahead.

Inflation expectations (implied by Australia’s long-term interest rates) have been stuck around 2% in recent years, below the Reserve Bank’s desired average for inflation of 2.5%.

Financial markets can be forgiven for thinking the RBA will not hit the middle of its 2-3% target range any time soon. The RBA doesn't believe it will either, with its deputy governor Guy Debelle repeating the word "gradual" no less than 12 times in a speech when describing the outlook for inflation and wages.

Inflation has been below the midpoint of the target range since the December quarter in 2014. On the RBA's own forecasts inflation isn't expected to return to the middle of the target range over the next two years.

The Reserve Bank blames low inflation on slow wages growth, claiming in its most recent statement on monetary policy that "labour costs are a key driver of inflationary pressure". But this is putting the cart before the horse.

In fact, recently published research shows that it is low inflation expectations that are largely to blame for low wages growth.

Workers and employers look at likely inflation outcomes when negotiating over wages. These expectations are in turn driven by perceptions of monetary policy.

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Below target inflation makes Australia less resilient to economic shocks, not least because it works against the objective of stabilising the household debt to income ratio. Subdued economic growth and inflation also gives the economy a weaker starting point if and when an actual shock does occur, potentially exacerbating a future downturn.

When the RBA governor and the federal treasurer renegotiate their agreement on monetary policy after the next election, the treasurer should insist on reinstating the wording of the 2010 statement that explicitly prioritised the inflation target over financial stability risks.

If the RBA continues to sacrifice its inflation target on the altar of financial stability risks, inflation expectations and wages growth will continue to languish and the economy underperform its potential.

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