21 October 2019

Policy debate hinges around risks of ultra low rates

The employment report for September printed a modest fall in the unemployment rate from 5.26% to 5.20%. Further, the underemployment rate fell from 8.53% to 8.35%.

That will be sufficient to avert another rate cut from the RBA in November.

Westpac has consistently argued that a cut in November was unlikely and the Employment Report strengthened our case.

The October RBA meeting minutes made an important point that had not been part of earlier commentaries:

"Members also discussed the possibility that policy stimulus might be less effective than past experience suggests. They recognised that some transmission channels, such as a pick-up in borrowing or the effect on the home-building sector, may not be operating in the same way as in the past, and that the negative effect of low interest rates on the income and confidence of savers might be more significant. Notwithstanding this, transmission through the exchange rate channel was still considered likely to work effectively, and evidence suggested that the positive effects of lower interest rates on aggregate household cash flows via lower debt repayments was likely to support household spending, given that household interest payments exceed receipts by more than two to one".

This point is highly relevant for any discussion around the Effective Lower Bound (ELB) for the cash rate in this cycle.

Certainly, with the Board targeting full employment (currently assessed by the RBA as 4.5% compared to the actual of 5.2%) and a move into the 2–3% target zone for underlying inflation, it seems certain that the RBA will reach its ELB before it achieves its objectives.

Westpac's current forecast (first set out on July 24) is that the ELB is 0.5% and will be reached at the February Board meeting.

However this process is different to the normal process for forecasting the end point of any policy cycle. That forecast typically hinges around forecasting how far below (or above) neutral (or R*) the cash rate will need to be pushed before the authorities can be comfortable of achieving the objectives of full employment and inflation sustainably in the 2–3% target range.

So the policy around choosing the ELB will likely be determined by the trade-off between the expected impact of further cuts and unanticipated consequences of ultra-low interest rates.

The minutes have already highlighted one risk – the impact of ultra-low rates on confidence. That effect was further emphasised by the 5.5% fall in the Westpac-MI Consumer Sentiment Index in October to its lowest level for four years. The survey was conducted during the week of the announcement of the 0.25% cut in the cash rate from 1% to 0.75%.

We also assess that the announcement from the banks that the standard variable home loan rate was "only" being reduced by 13–15 basis points would, following highly critical media coverage, have also undermined confidence.

This partial pass through from the banks would have been interpreted by the RBA as limiting the impact of the rate cut on the household sector's cash flow – one of the two channels of monetary policy (along with the exchange rate) which was identified by the Board in the minutes.

While we are not aware of any definitive remarks from the RBA, other central banks, such as the BOE, recognise that as rates fall below certain levels only partial pass through can be expected.

"Evidence from a number of economies suggests that, as the level of interest rates set by the central bank becomes lower, the extent to which further cuts are passed on by commercial banks and building societies to other interest rates in the economy decreases, making monetary policy less effective… The potential difficulty, from a monetary policy transmission perspective, arises when interest rates are close to zero because it is likely to be difficult for banks and building societies to reduce deposit rates much further. This constraint means that lenders may then face a choice between reducing the pass through of lower official rates to those they charge on loans — in particular rates on new loans — or a period of lower profitability, which, were it to persist, could reduce the supply of lending". (Bank of England Quarterly Bulletin, 2018 Q4)

Combined with the impact on confidence of low rates and partial pass through it is reasonable to expect that the RBA will see the ELB as a positive level consistent with the 0.5% which we currently envisage.

However, risks to that view are that the RBA will still see the transmission mechanism through the currency as operating effectively at ultra-low rates.

We expect that the confidence effects of negative or zero rates are likely to be profound while transmission would be affected by banks' unwillingness to set negative retail deposit rates.

Central banks are obsessed with avoiding the deflationary trap experienced by Japan. The signal from a move to negative or even zero rates might risk the onset of deflationary expectations by implying that the central bank held such views.

Even the European banks (ECB 2014; SNB; DNB; Riksbank in early 2015), that have been dealing with negative policy rates for years have generally held their retail deposit rates in positive territory.

Overnight comments from the Governor of the Reserve Bank, Philip Lowe, "Negative interest rates are extraordinarily unlikely in my country", further cement the conclusion that the RBA sees the ELB in positive territory and, most likely, above zero.

As discussed, our current forecast for the ELB is 0.5%, to be reached by February next year. We cannot entirely dismiss the possibility that it will fall to 0.25%. That decision will be determined by the RBA's assessment of the likely effectiveness of moving to 0.25% on household cash flows and the currency, contrasted with any concerns around unintended consequences, particularly associated with the stability of the financial system; the impact on confidence; and whether such a move might have negative implications for inflationary expectations.

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If, as we expect, the move to the ELB will not provide the RBA with sufficient evidence that the economy is on the path to full employment and attaining its inflation target, it may have to consider other policies.

Indeed, the decision to push the ELB to 0.25% might also be affected by an assessment that other policies would be more effective than further lowering the ELB. With negative interest rates being ruled out, asset purchases or loans to banks seem to be the policies that would attract consideration.

In particular, if the RBA signals no further action, having reached the ELB, with underlying inflation still below the 2–3% target zone, it might risk lowering inflationary expectations as agents assume, with no further action pending, it is resigned to missing its target.

In recent speeches the Governor has signalled that any move to unconventional policies would likely take the form of asset purchases. We are somewhat surprised given the success of the bank loan program adopted by the Bank of England in 2016 (see Westpac Weekly, July 29). So, at this stage, we should not dismiss that as an option. However, for now, it makes sense to focus on asset purchase alternatives.

Asset purchase programs explicitly aimed at monetary accommodation were announced by central banks globally with about 18 programs launched between 2009 and 2016. Six central banks purchased mostly public sector issued securities, although in some cases, programs also encompassed corporate and covered bonds, commercial paper, agency MBS and other asset backed securities, real estate investment trusts, and exchange traded funds (equities).

The RBA will be studying these programs and, given that they are very close to the ELB, is likely to be prepared to adopt some form of asset purchase program, if needed, over the course of 2020.

Bill Evans, Chief Economist

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