Credit Research
General

Australian QE – Pushing Against The Same Monetary Policy String

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Summary

- With interest rates priced to fall lower in the near term, an increasing dialogue is taking place about the effectiveness of a further lowering in interest rates and whether other, so-called unconventional monetary policy measures, should be considered.
- Some market participants contend the efficacy of easing monetary policy is being stymied by the unwillingness of commercial banks to pass on in full recent changes to the official cash rate. This is only likely to intensify as the official cash rate moves lower. We would suggest the supply of money is not the problem, but rather the demand is, with both households and businesses reluctant to respond more positively to falling rates.
- We believe monetary policy alone is unlikely to be sufficient to achieve the Reserve Bank of Australia (RBA's) mandate. Even the central bank Governor is not convinced, recently stating "monetary policy cannot deliver medium-term growth…we risk just pushing up asset prices."
- With the government appearing reluctant to embrace further fiscal measures in the near term--instead seemingly hoping tax cuts and higher assets prices will stimulate demand--we believe the probability of the RBA employing unconventional monetary policy measures, such as quantitative easing in some form, is increasingly likely in the short-term (within the next one-two years).
- The pursuit of quantitative easing effectively pushes against the same monetary policy string the RBA has been for a number of years. Ultimately, it will be wealth and asset prices that emerge as the main beneficiary of quantitative easing, in our view, with higher risk asset prices feeding into increased spending. However, this effect is also premised on those with risk assets--generally the well-off--spending their new-found wealth.
- Although the RBA believes it is unlikely it will need to employ unconventional monetary policy measures, it has indicated a preference for reducing the cash rate to a very low level and possibly further out the curve. For bondholders, rates should drift lower across the curve, although depending on the degree of 'signalling' from the central bank, much of the movement may be priced.
- The effectiveness of quantitative easing in lifting growth and inflation expectations will take some time to materialise. We currently prefer fixed-rate bonds (more so at the shorter-end of the curve), although we continue to encourage a diversified portfolio given the unprecedented (and unpredictable) nature of monetary policy in Australia (and the rest of the world).

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Monetary policy, interest rates and the role of quantitative easing

The Reserve Bank of Australia (RBA) conducts monetary policy by using interest rates to influence economic activity (basically the gross domestic product of a country), employment and inflation. The most effective tool to manage inflation is the cash rate as it influences the broader interest rate structure in the domestic financial system (the cost of funds of financial institutions), which is a considerable (but not sole) determinant in the cost and availability of money for households and businesses. This is the first stage of monetary policy transmission. The second stage is the effect those changing interest rates have on economic activity, employment and inflation. This occurs through a range of different channels (source: RBA):

- Savings and investment channel: A reduction in deposit rates reduces the incentive for households to save their money. Lower lending rates can encourage households and business to increase their borrowing as they face lower repayments, and in the case of business, the returns on investment are now more likely to be higher than the cost of borrowing.
- Cash flow channel: A reduction in lending rates reduces interest repayments on debt, increasing the amount of cash available for households and businesses to spend on goods and services. At the same time, a reduction in interest rates reduces the amount of income that households and businesses get from deposits, and some may choose to restrict their spending. These two effects work in opposite directions, but a reduction in interest rates can be expected to increase spending in the Australian economy through this channel (with the first effect larger than the second).
- Asset price and wealth channel: Lower interest rates support asset prices (such as housing and equities) by encouraging demand for assets. An increase in asset prices increases people's wealth. This can lead to higher consumption and housing investment as households generally spend some share of any increase in their wealth.
- Exchange rate channel: A reduction in interest rates (compared with the rest of the world) typically results in a lower exchange rate. This leads to an increase in exports and domestic activity. A lower exchange rate also adds to inflation because imports become more expensive in Australian dollars.

In summary then, an easing in monetary policy (lower interest rates) is designed to stimulate spending and business investment, increasing economic activity and ultimately, higher employment, wage and inflation growth.

In theory, as interest rates approach zero, the effectiveness of easing monetary policy is assumed to diminish, and that a central bank can no longer influence economic growth. The events surrounding the financial crisis in 2008 and in subsequent years have severely questioned this theory as central banks embarked on numerous rounds of unconventional monetary policy measures. This includes the application of negative interest rates in Europe. Given central banks also have a responsibility to promote financial stability, the use of negative interest rates, in particular--placing bank margins under increasing pressure--highlights the increasing aggressiveness of monetary policy.

The underlying practice of quantitative easing--a central bank purchasing assets including government and other securities in order to increase the supply of money, thus reducing its cost--is common. Central banks buy and sell securities from the banking system to maintain the cash rate at its target. Unconventional forms of quantitative easing involve a larger-scale purchase of securities. Its application is more recent and its effectiveness (including downside risks) yet to be fully assessed given the measures are still yet to be unwound.

The central bank can influence interest rates across the yield curve by either buying or selling bonds of a particular maturity. For example, if a central bank embarks on a large-scale purchase of 10-year government bonds, it will push the price of those bonds up and the yields (interest rates) on those bonds down. This has the effect of lowering the risk-free rate, which in-turn should lower the cost of money for borrowers (recall that the coupon on a corporate bond comprises the risk free rate plus a premium for the credit risk of that particular entity). A central bank could also intervene more directly by purchasing other assets such as mortgage-backed securities or corporate bonds. Other options include forward guidance and direct foreign exchange intervention. In Europe, as noted above, more extreme measures include the adoption of negative interest rates.

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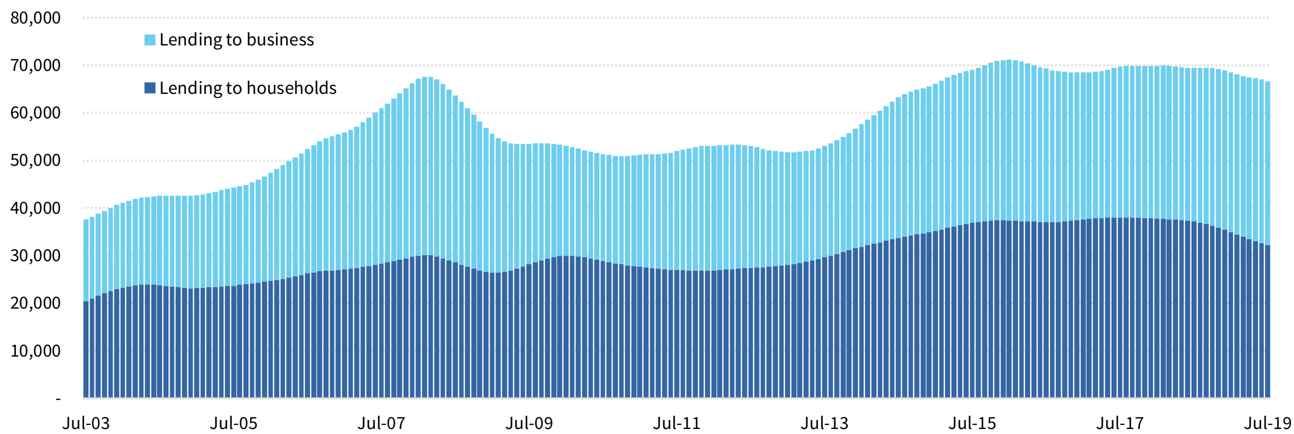
Supply of money is not the problem -- demand and allocation is

One of the primary objectives of quantitative easing is to help unlock liquidity and encourage the flow of money. This was one of the main reasons behind the success of the first round of quantitative easing in the US (QE1) in November 2008, when global credit markets literally froze and credit spreads erupted, even for investment grade credit. The Bank of International Settlements (the bank for central banks) has averaged the various estimates of the effectiveness of QE1, with long-term interest rates falling by 76 basis points.

In Australia, the circumstances are vastly different. Some market participants contend the efficacy of easing monetary policy is being stymied by the unwillingness of commercial banks to pass on in full recent changes to the official cash rate. This reluctance is only likely to intensify as the official cash rate moves lower (which we explore here). The increased prevalence of discriminate pricing and capital requirements across different product sets, as well as increased preparedness of commercial banks to adjust rates out of cycle, complicates this view, in our opinion.

Flow of new credit has shown little sign of a deficiency in its availability in the latter part of the last decade since the financial crisis (see Figure 1). Refinancing activity remains particularly resilient. As such, it's not overwhelmingly conclusive in our view that the efficacy of monetary policy is currently being hampered by the actions of our commercial banks. Rather, it would appear a lack of demand for credit is negating the demand-side effects of easing monetary policy.

Figure 1: New lending to business and households (12-month moving average, AUDm)*



*Source: RBA. *Includes refinance*

Richard Koo, chief economist at the Nomura Research Institute and author of *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and its Global Implications,* writes that when the private sector is preoccupied with debt overhang, extended periods of slow growth and inflation result from the disappearance of borrowers--not by the lack of lenders. Monetary policy, which controls the availability of financing, does not work well when there is no appetite for debt. We would suggest Australia is no different in this sense. Household debt is amongst the highest in the developed world (see Figure 2).

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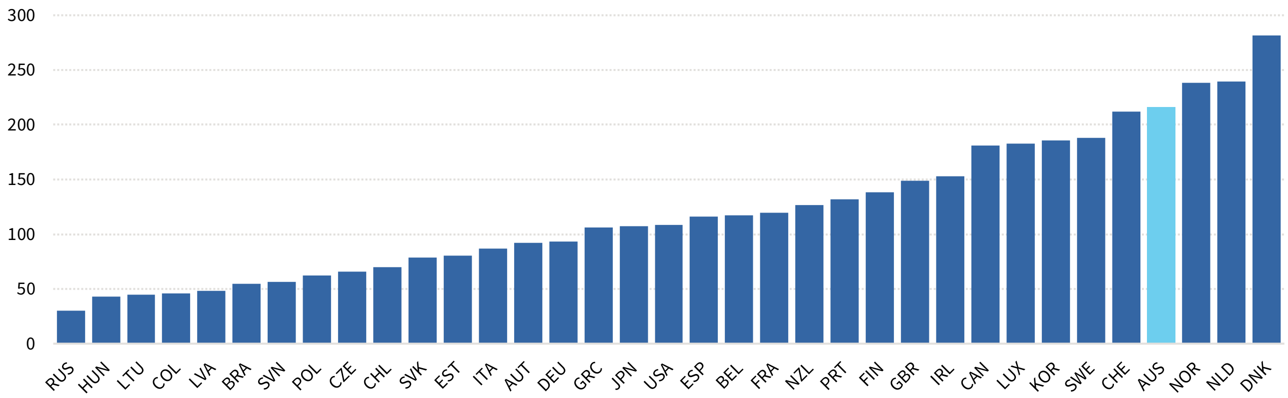
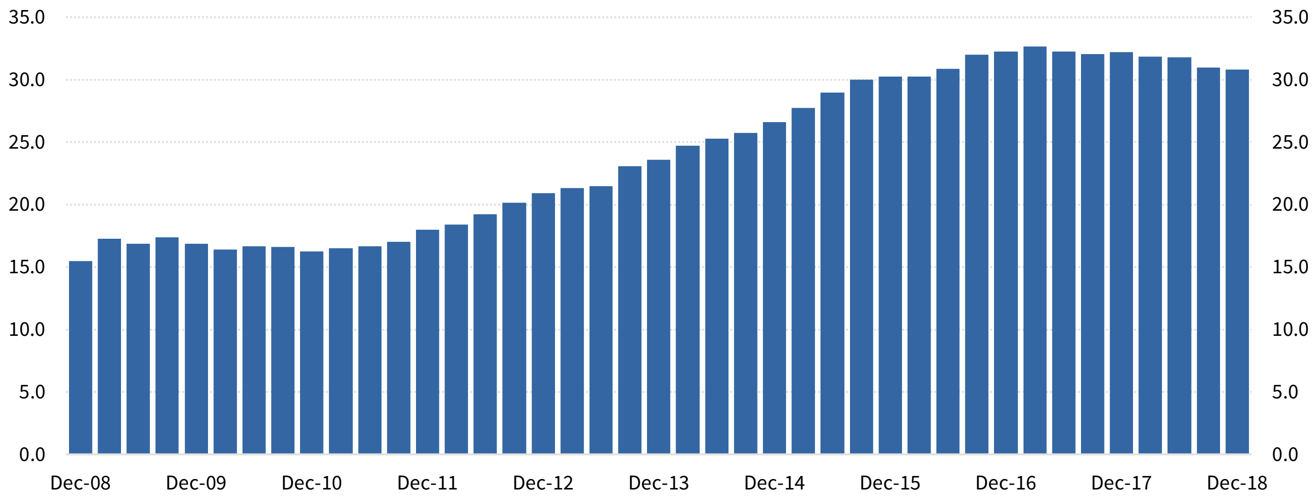
Figure 2: Household debt (% of net disposable income)



Source: OECD

Since the financial crisis, the propensity of households to use excess savings to pay down debt remains elevated. According to the RBA, 'the stock of prepayments (the sum of balances in offset accounts and redraw facilities) accounts for 16½ per cent of the gross stock of housing credit or a bit over 2½ years of repayments at current interest rates' (from just over 1 year worth back in 2009) (see Figure 3). The response of households should come as little surprise. With falling interest rates also eroding the interest earnt on interest-bearing assets--primarily deposits in this country--its arguable that easing monetary policy is suppressing demand from certain cohorts, particularly at the wider-ends of the population spectrum.

Figure 3: Household mortgage prepayments (number of months)



Source: RBA

The RBA recently observed that business is also not responding positively to lower costs of borrowing (or costs of capital) by lowering their internal rates of return (an estimate of the profitability) of their investments. But interest rates are low because the outlook is uncertain--why would business invest into an uncertain environment when consumption is soft and households are responding to easing monetary conditions by saving or paying down debt?

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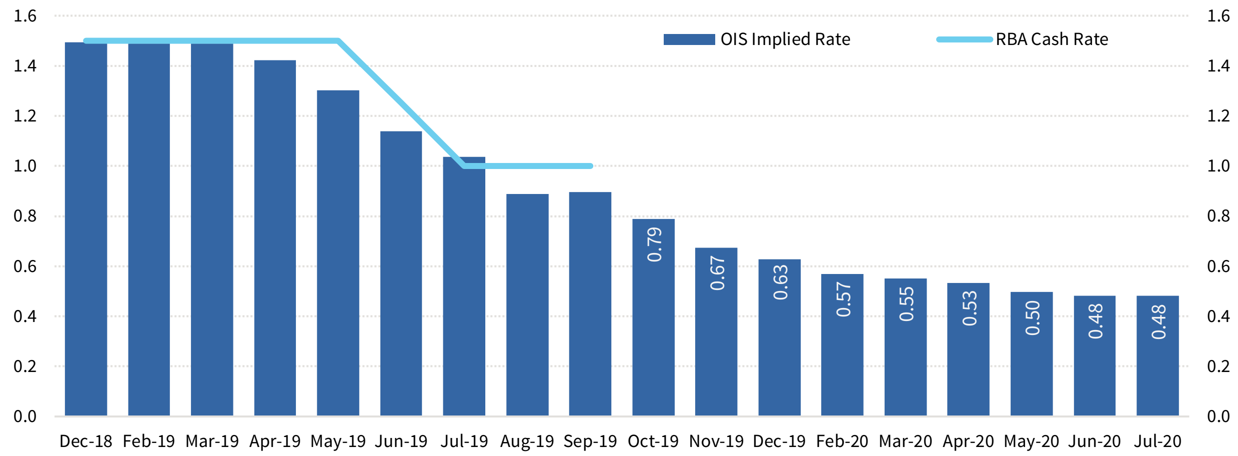
Australian quantitative easing -- higher asset prices, lower yields, and more of the same

The RBA stated it was unlikely to need to employ unconventional policy measures[1]. It has however elaborated on this point, confirming that any measures employed would focus on reducing the risk-free interest rate. 'This would involve reducing the cash rate to a very low level and possibly purchasing government securities to lower the risk-free rate further out along the term spectrum.'

Markets are currently pricing in up to two rate cuts through to mid-2020, taking the cash rate to 0.50% (see Figure 4). It has remained broadly unchanged in recent months despite deteriorating economic conditions, suggesting an increasing acceptance that unconventional measures will be adopted before interest rates reach their theoretical zero bound. With the government appearing reluctant to embrace further fiscal measures in the near term--instead seemingly hoping fiscal reform in the form of tax cuts will stimulate demand--we believe the probability of the RBA employing quantitative easing will become increasingly likely in the short-term. Unfortunately, albeit predictably, monetary policy has become increasingly politicised, although Australia is not unique here.

Figure 4: OIS (Implied Rate) per RBA Meeting Date (%, %)



Source: Refinitiv (Reuters), ICAP, FIIG Securities

The pursuit of quantitative easing effectively pushes against the same monetary policy string the RBA has been for a number of years. There is also the question of the effectiveness of lower long-term rates given banks generally borrow and lend on terms less than five years (more than three-quarters of all mortgages are on variable terms). Admittedly, monetary policy is subject to a lag effect--according to the RBA, estimates suggest that it takes between one and two years for changes in the cash rate to have their maximum effect on economic activity and inflation. As such, the recent lowering of the cash rate in June and July this year are probably still to take full effect; these cuts will have a positive impact on both economic activity and inflation, although it is unlikely to be significant. The RBA suggests lowering the cash rate by 100 basis points increases GDP by ½ to ¾ percentage points and inflation by a bit less than ¼ percentage points (per year) over the course of the next two to three years[2]. The number of employed persons should theoretically increase as a result.

However, with population growth (and the participation rate) at record levels, and the non-accelerating inflation rate of unemployment (a theoretical level of unemployment below which inflation would be expected to rise) at 4.5% (compared with 5.3% currently, and more likely to rise than fall in the near term, in our view [see Figure 5]), we believe monetary policy alone is unlikely to lift employment to a sufficiently high enough level to put upward pressure on wages (see Figure 6) and ultimately inflation. Even the central bank Governor is not convinced, recently stating "monetary policy cannot deliver medium-term growth…we risk just pushing up asset prices."

[1] *RBA, Responses to Questions in Writing from the House of Representatives Standing Committee on Economics, 11 September 2019*

[2] *RBA, The Transmission of Monetary Policy: How Does It Work?, September Quarter 2017 Bulletin*

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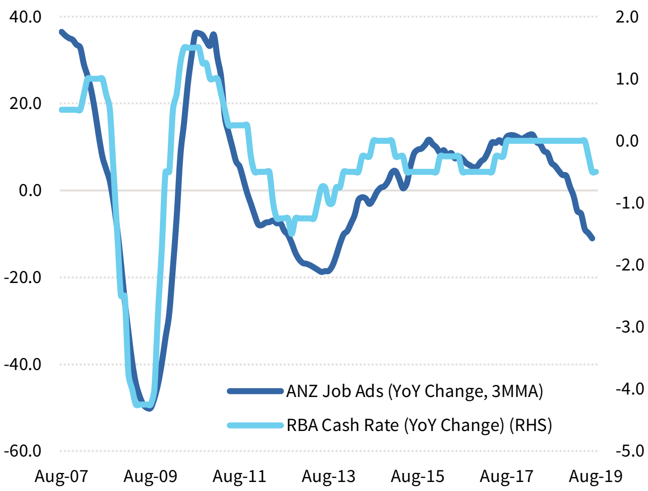
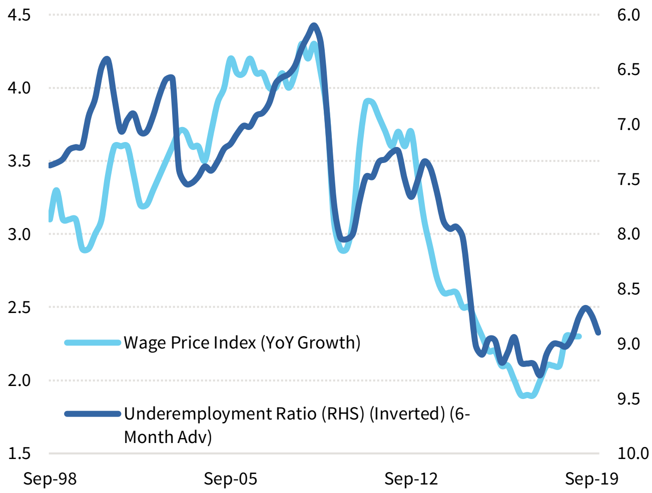
Figure 5: Job Ads v RBA Cash Rate (%, pts)



Source: Refinitiv (Reuters), JPMorgan

Figure 6: Wages v Underemployment Rate (%, %)



Source: ABS, Macrobusiness

Quantitative easing targeted toward reducing the risk-free interest rate should lower funding costs. This increases the capacity of commercial banks to lend, increasing investment and discouraging savings. However, businesses have yet to respond positively to already lower costs of borrowing. There is also the psychological impact for both households and business. After all, sustained monetary easing does not depict a strong economy. This feeds into uncertainty and higher saving and repayment rates. The external and export sectors should also respond favourably to a lower exchange rate, although it's unclear whether current settings are overly prohibitive. Ultimately, allocation of capital is a matter for the private sector and to a lesser extent, the government and regulatory authorities, rather than the central bank.

It will be the 'asset price and wealth channel' that emerges as the main beneficiary of quantitative easing, in our view. The government also appears to favour this approach given their unwavering commitment to preserving a surplus budget--for the tougher times, it would seem. Higher house prices (along with higher prices of other risk assets, including bonds and equities), feeding into increased discretionary spending (also explained here). However, this effect is also premised on those with risk assets--generally the well-off--spending their new-found wealth.

For bondholders, if we draw on theory and the recent experience in the US with QE2 and QE3 (we ignore QE1 as the circumstances then were vastly different to what we could conceivably imagine in Australia in the near term), rates should drift lower across the curve (see Figure 7 and 8), although depending on the degree of 'signalling' from the central bank, much of the movement may be priced in. It is also clear in our view that central banks have less control over long-term rates.

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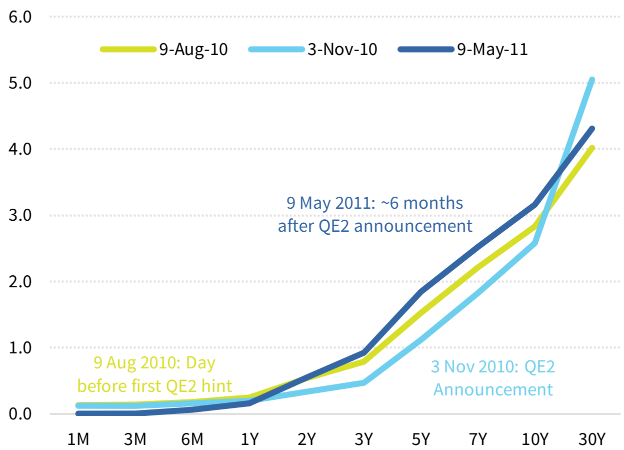
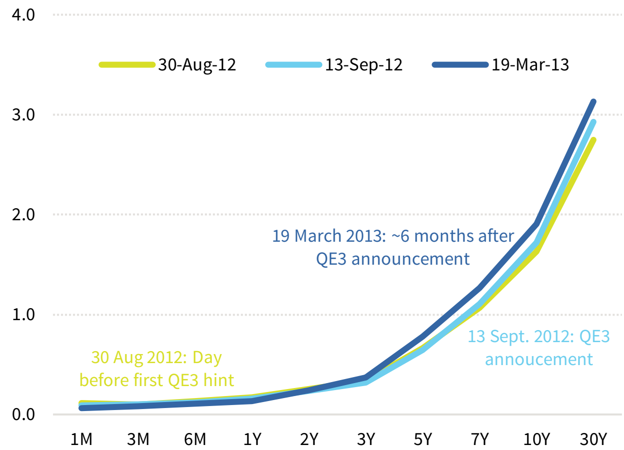
Figure 7: QE2 (Constant Maturity Treasury Yields [%])



Source: Federal Reserve Bank of St Louis, U.S. Treasury Department

Figure 8: QE3 (Constant Maturity Treasury Yields [%])



Source: Federal Reserve Bank of St Louis, U.S. Treasury Department

The impact is generally greatest on the particular rate at which the central bank intervenes. The RBA has indicated a preference for reducing the cash rate to a very low level and possibly further out the curve. The main beneficiary of this would be fixed-rate bonds (price of the bond rises as yields fall). Coupons on floating rate-notes will fall in response to falling rates, although prices on high-yield issues should remain resilient given the dearth of income on offer.

Initially, longer-dated fixed rate bonds should respond positively (a function of lower rates and investors locking in fixed coupons for longer). Longer-dated bonds are also more sensitive to changes in interest rate expectations (see Figure 5 in particular). Recall however that the general purpose of easing monetary policy is to raise expectations for long-term economic growth and inflation, which is reflected in longer-term interest rates (i.e., an upward-sloping yield curve). The longer-end of the curve is also influenced by other factors, including fiscal policy and global market developments. If the market interprets central bank intervention will be sufficiently successful in lifting growth and inflation expectations, inflation-linked bonds and floating rate notes should respond positively (and longer-dated fixed rate bonds will fall in value).

The effectiveness of quantitative easing in lifting growth and inflation expectations will take some time to materialise. We currently prefer fixed-rate bonds (more so at the shorter-end end of the curve), although we continue to encourage a diversified portfolio given the unprecedented (and unpredictable) nature of monetary policy in Australia (and the rest of the world).

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