

AUSTRALIAN MARKETS WEEKLY

Funding pressures, BBSW/Y and monetary policy



In this issue

Funding pressures, BBSW/Y and monetary policy	2
Calendar of economic releases	5
Forecasts	6

- In today's weekly we consider the implications of the recent increases in Australian money market rates for the RBA/monetary policy. We conclude that before the RBA considered lowering interest rates to offset this phenomenon, first the rise in money market rates would need to be seen as persistent and would need to lead to a significant rise in broader lending rates across all borrowers. Only the latter would likely impact the RBA's forecasts for growth and inflation.
- The Bank would likely also consider whether there were any changes to its market operations that might be implemented to assist in any persistent change in how money markets are functioning, though we suspect that for now, the RBA believes the situation in time will right itself.
- This week starts with a higher AUD, on the back of the emergence of Friday's agreement on migration by EU leaders after a marathon negotiation. It's an important victory for Chancellor Merkel – the deal is expected to appeal to both sides of the rift in her coalition government – and markets will watch how Merkel holds together her government in the week ahead.
- For the week ahead, trade tensions continue to dominate market sentiment globally, with the 25% US tariffs on \$34bn of Chinese goods set to begin on Friday. Markets will also be watching emerging markets (EM), which have been rocked by trade war fears, a stronger USD and higher US yields.
- US ISM data, for Manufacturing on Monday and Non-manufacturing on Thursday, will be analyzed for any trade-related negative spillovers. Markets are not expecting a significant impact, but recent Fed anecdotes indicate growing concerns among businesses, which are considering deferring spending and investment.
- Brexit talks will also be a focus this week, as PM May summons her cabinet for a meeting on 6 July ahead of a key Brexit white paper scheduled for Monday 9 July. There is an increased urgency to Brexit discussions given the March 2019 deadline is coming closer and the Pound has fallen sharply in recent weeks.
- Domestically, the RBA meets on Tuesday, and May data is released for: Building Approvals (Tuesday), Retail Sales and Trade (both Wednesday). The RBA's post-meeting Statement is likely to reiterate that the Bank is happy to wait for wages and inflation to pick up, while it is also worried about trade tensions.
- Data wise, Retail Sales on Wednesday and Building Approvals on Tuesday are the focus. We expect Retail Sales to be soft, with NAB's Cashless Retail Sales Index indicating no change in ABS Retail Sales in May. Tomorrow's Building Approvals will also be monitored for any signs apartment approvals are softening further.

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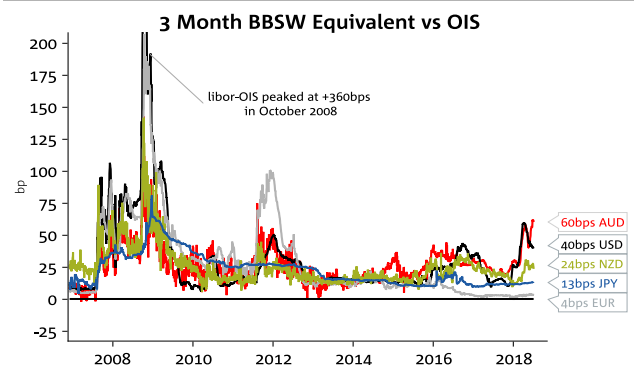
[Ask the Interest Rate Strategists](#)

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7391	-0.3	RBA cash	1.50	0
AUD/CNY	4.90	1.2	3y swap	2.15	-3
AUD/JPY	82.0	0.8	ASX 200	6,205	-0.1
AUD/EUR	0.634	0.0	Iron ore	65.02	-0.5
AUD/NZD	1.091	1.6	WTI oil	73.3	7.7

Source: Bloomberg

Chart 1: Funding pressures again prevalent at qtr end



Source: National Australia Bank, Macrobond

Ivan Colhoun, Chief Economist, Markets

Pressure in money markets into quarter end has been evident year-to-date and has resulted in higher BBSW/Y rates in Australia – a rate many business and mortgage rates are either directly or indirectly set against. These pressures have been evident in both US and Australian money markets, though leading into June quarter end, the Australian market was impacted while US markets were not (Chart 1).

NAB's rate strategists have published a good deal of research on this topic, attributing the pressure to a combination of market and regulatory developments in both the US and Australia. [Please contact Skye.Masters@nab.com.au or Alex.Stanley@nab.com.au if you would like to understand more about the situation]. This note however deals with the implications of these developments for the economy and how the RBA might consider this in relation to monetary policy.

To date, the RBA has only acknowledged developments in US and Australian short-term markets but has not expressed or shown particular concern about the developments. In part, this likely reflects: (i) that this is a relatively recent phenomenon, the reasons for which are not fully understood; (ii) that the issue was expected to be temporary (though has now persisted for some months); and (iii) the increase in BBSW/Y rates has yet to have a significant impact on the politically-sensitive and highly visible mortgage rate for major lenders, though of course many corporate/business borrowing rates have been impacted.

This leads to a number of questions from a policy perspective:

- Should the RBA respond to these developments?;
- How should the RBA respond?; and
- Under what conditions might the RBA need to respond by moving its official cash rate?

The conceptual answers to these questions have a number of dimensions. In terms of the first question, the RBA will want to fully understand what is happening, as that would obviously condition the response. And importantly – for how long might these developments persist – is it a temporary phenomenon or something that might be more structural or permanent in nature. This would also guide the policy response.

The policy options available to the Bank would include attempting to fix the problem by regulation or open market operations, if for example the functioning of the market had changed for some reason. Or the Bank could look to offset the impact of the development, which could be achieved either via its market operations or by lowering its cash rate target. The latter policy response would likely be appropriate, in the circumstance where the change was deemed permanent, there was no regulatory or market operation change that could be made to resolve the issue in the short-term and the lift in mortgage and business lending rates was sufficiently large to impact the general economy and thereby result in changes to the RBA's forecasts for growth and inflation.

There is of course precedent for the RBA altering its monetary policy as a result of changes in funding costs. In May 2012, the RBA cut the policy rate by a larger-than-expected 50 basis points, 25 basis points of which was to

offset recently tighter financial conditions relating to increased funding costs, which had seen lending rates increase out-of-cycle. Then of course it was term-funding markets that were impacted as a result of global credit concerns, so it is quite a different consideration.

So how does the current situation stack up in terms of what the RBA might do?

The main factor that is likely to determine **whether** the RBA responds is the extent to which mortgage and other interest rates rise as a result of higher funding costs as this would, all other things being equal, lower the Bank's forecast for growth and result in a slower decline in unemployment and pick-up in wages and therefore a slower return of inflation to target. (How long funding pressures are expected to persist is also of course relevant).

The RBA Governor has of course been willing to accept a slower return of inflation to target recently for financial stability reasons. However, it's hard to argue that reversing a funding pressure driven increase in borrowing rates is the same situation. This would not add to current financial stability concerns, as it would presumably only return rates to the previous setting of policy.

So conclusion one is to look at how significantly mortgage and other interest rates are affected and to determine how permanent the change in funding costs might be. At this stage, none of the major lenders has moved mortgage rates higher.

Market participants also generally do not expect any potential out-of-cycle mortgage rate increase to be large, Citibank analysts recently predicting an 8bps increase in mortgage rates by the major lenders by September. The RBA has also noted an increased prevalence of discounting, which also would be taken into account by the RBA. We expect it would likely take a lift in mortgage and business rates close if not above a full 25bps hike, before the RBA considered reducing the target cash rate by a similar amount.

However, it's also worth considering what other policy options might be available to the RBA? To the extent that the change in funding pressures reflects changes to the nature of money markets in Australia, the RBA could seek to offset the impact of the current situation. It could, for example, alter its daily money market operations. Over the past few months the RBA has dabbled here, thereby acknowledging they are sensitive to the developments. However, their reluctance to do more than dabble likely reflects that the RBA thinks that the actions of borrowers and investors in Australia's money market should be able to correct the situation over time.

Our conclusion is that should the situation in Australian short-term funding markets persistent and lead to significant rises in borrowing rates, including mortgage rates, it would likely bring about a response by the RBA. In the extreme, this could include an official interest rate cut to reverse any rise in interest rates due to funding pressures (as in May 2012). However, we're not near that situation as yet.

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CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Monday, 6 August 2018								
AU	AiG Perf of Mfg Index	Jun				57.5	21.30	8.30
JN	Tankan Large Mfg Index/ Outlook	2Q		22/20		24/20	22.50	9.50
JN	Tankan Large All Industry Capex	2Q		9.3		2.3	22.50	9.50
AU	CoreLogic House Px MoM	Jun				-0.2	23.00	10.00
JN	Nikkei Japan PMI Mfg	Jun F				52.8	23.30	10.30
AU	Melbourne Institute Inflation MoM/YoY	Jun		/		0/2.1	0.00	11.00
AU	ANZ Job Advertisements MoM	Jun				1.5	0.30	11.30
CH	Caixin China PMI Mfg	Jun		51.1		51.1	0.45	11.45
AU	Commodity Index SDR YoY	Jun				3.6	5.30	16.30
EC	Markit Eurozone Manufacturing PMI	Jun F		55		55	7.00	18.00
EC	PPI MoM/YoY	May		0.5		0	8.00	19.00
EC	Unemployment Rate	May		8.5		8.5	8.00	19.00
US	Markit US Manufacturing PMI	Jun F		54.7		54.6	12.45	23.45
US	Construction Spending MoM	May		0.5		1.8	13.00	0.00
US	ISM Manufacturing	Jun		58.5		58.7	13.00	0.00
Tuesday, 3 July 2018								
NZ	Dairy Auction Avg. Winning Price MT	3 July				3481	early am	
JN	Monetary Base YoY	Jun				8.1	22.50	9.50
AU	Building Approvals MoM/YoY	May	3/12.7	0/9.9		-5/1.9	0.30	11.30
AU	RBA Cash Rate Target	3 July	1.5	1.5		1.5	3.30	14.30
UK	Markit/CIPS UK Construction PMI	Jun		52.5		52.5	7.30	18.30
EC	Retail Sales MoM/YoY	May		0.1/1.6		0.1/1.7	8.00	19.00
CA	Markit Canada Manufacturing PMI	Jun				56.2	12.30	23.30
US	Durable Goods Orders	May F		-0.5		-0.6	13.00	0.00
US	Cap Goods Orders Nondef Ex Air	May F				-0.2	13.00	0.00
Wednesday, 4 July 2018								
NZ	QV House Prices YoY	Jun				6.9	16.00	3.00
NZ	ANZ Job Advertisements MoM	Jun				2.2	21.00	8.00
AU	AiG Perf of Services Index	Jun				59	21.30	8.30
JN	Nikkei Japan PMI Composite	Jun				51.7	23.30	10.30
NZ	ANZ Commodity Price	Jun				1.5	0.00	11.00
AU	Trade Balance	May	\$600m	1200		977	0.30	11.30
AU	Retail Sales MoM	May	0	0.3		0.4	0.30	11.30
JN	BOJ Harada speaks in Kanazawa						0.30	11.30
CH	Caixin China PMI Services/Composite	Jun		52.7/		52.9/52.3	0.45	11.45
EC	Markit Eurozone Composite PMI	Jun F		54.8		54.8	7.00	18.00
UK	BOE Deputy Governor for Prudential Regulation Sam Woods speaks						7.05	18.05
UK	Markit/CIPS UK Composite PMI	Jun		54.5		54.5	7.30	18.30
US	MBA Mortgage Applications	47270				-4.9	10.00	21.00
Thursday, 5 July 2018								
NZ	N.Z. Government 11-Month Financial Statements						21.00	8.00
JN	BOJ Masai speaks in Matsumoro						0.30	11.30
GE	Factory Orders MoM/WDA YoY	May		1.1/1.7		-2.5/-0.1	5.00	16.00
UK	BOE Governor Carney speaks in Newcastle						9.00	20.00
US	ADP Employment Change	Jun		190		178	11.15	22.15
US	Initial Jobless Claims	30 Jul		225		227	11.30	22.30
US	Markit US Composite PMI	Jun F				56	12.45	23.45
US	ISM Non-Manf. Composite	Jun		58.2		58.6	13.00	0.00
US	FOMC Meeting Minutes	13 June					17.00	4.00
Friday, 6 July 2018								
AU	AiG Perf of Construction Index	Jun				54	21.30	8.30
JN	Leading Index CI	May P		106.6		106.2	4.00	15.00
GE	Industrial Production SA MoM/YoY	May		0.3/1.5		-1/2	5.00	16.00
UK	Halifax House Prices MoM	Jun		0.2		1.5	6.30	17.30
CA	Unemployment Rate	Jun		5.8		5.8	11.30	22.30
CA	Net Change in Employment/ Hourly earnings YoY	Jun		20/3.7		-7.5/3.9	11.30	22.30
US	Trade Balance	May		-43.6		-46.2	11.30	22.30
US	Change in Nonfarm Payrolls	Jun		195		223	11.30	22.30
US	Unemployment Rate	Jun		3.8		3.8	11.30	22.30
US	Average Hourly Earnings MoM/YoY	Jun		0.3/2.8		0.3/2.7	11.30	22.30
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		3-Jul	1.5%	1.5%		1.5%		
Canada, BoC		11-Jul	1.5%	1.5%		1.25%		
Europe, ECB		26-Jul	-0.4%	-0.4%		-0.4%		
Japan, BoJ		31-Jul	-0.1%	-0.1%		-0.1%		
US, Federal Reserve		1-Aug	1.75-2%	1.75-2%		1.75-2%		
UK, BOE		2-Aug	0.75%	0.75%		0.5%		
New Zealand, RBNZ		9-Aug	1.75%	1.75%		1.75%		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

FORECASTS

Economic Forecasts		Annual % change				Quarterly % change															
	2016	2017	2018	2019	2016				2017				2018				2019				
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Australia Forecasts																					
Household Consumption	2.9	2.7	2.5	2.5	0.9	0.6	0.5	0.8	0.3	1.0	0.6	1.0	0.3	0.5	0.6	0.6	0.6	0.6	0.7	0.7	0.7
Underlying Business Investment	-11.8	3.0	3.3	6.6	-3.4	-2.6	-5.6	2.2	3.1	0.0	3.7	-0.5	-0.1	1.3	1.6	0.9	2.1	1.6	2.2	1.2	1.2
Residential Construction	8.7	-2.2	-1.4	-2.6	4.3	1.7	-0.7	2.4	-3.2	0.3	-2.1	-0.1	0.9	-1.1	-0.6	-0.7	-1.0	-0.5	-0.2	-0.2	-0.2
Underlying Public Spending	5.2	4.5	4.8	4.3	1.8	1.9	1.1	0.6	1.0	1.3	1.4	1.2	1.5	0.8	0.9	1.0	1.1	1.1	1.1	1.1	1.1
Exports	6.8	3.5	4.4	4.9	2.1	1.4	0.8	3.4	-1.9	2.9	0.7	-1.5	2.4	1.1	1.5	1.4	1.3	1.2	0.7	0.6	0.6
Imports	0.2	7.8	4.2	4.4	-0.8	2.1	0.9	2.5	3.1	-0.1	2.6	1.6	0.5	0.7	0.9	0.8	1.1	1.3	1.5	1.3	1.3
Net Exports (a)	1.2	-1.0	-0.1	0.0	0.9	-0.2	0.0	0.1	-1.1	0.6	-0.4	-0.7	0.3	0.1	0.1	0.1	0.0	0.0	-0.2	-0.2	-0.2
Inventories (a)	0.1	-0.1	0.0	-0.1	0.0	0.4	0.2	-0.4	0.4	-0.5	0.1	0.0	0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand - qtr%					0.1	0.6	-0.1	1.1	0.7	0.9	0.9	0.8	0.6	0.6	0.7	0.6	0.8	0.8	0.9	0.8	0.8
Dom Demand - ann %	1.9	3.0	2.8	3.0	1.5	1.8	1.7	2.5	2.3	2.6	3.6	3.3	3.2	2.8	2.6	2.5	2.6	2.9	3.1	3.3	3.3
Real GDP - qtr %					0.9	0.9	-0.2	1.1	0.3	1.0	0.5	0.5	1.0	0.5	0.7	0.7	0.8	0.7	0.7	0.6	0.6
Real GDP - ann %	2.6	2.2	2.9	3.0	2.7	3.3	2.0	2.4	1.8	2.0	2.8	2.4	3.1	2.6	2.8	3.0	2.8	3.0	3.0	2.9	2.9
CPI headline - qtr %					-0.2	0.4	0.7	0.5	0.5	0.2	0.6	0.6	0.4	0.7	0.4	0.7	0.4	0.5	0.6	0.8	0.8
CPI headline - ann %	1.3	1.9	2.2	2.2	1.3	1.0	1.3	1.5	2.1	1.9	1.8	1.9	1.9	2.4	2.2	2.3	2.2	2.0	2.2	2.2	2.2
CPI underlying - qtr %					0.2	0.5	0.3	0.5	0.4	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6
CPI underlying - ann %	1.6	1.8	2.0	2.1	1.6	1.6	1.5	1.5	1.7	1.8	1.9	1.9	2.0	1.9	2.0	2.0	2.0	2.0	2.1	2.2	2.2
Wages (Pvte WPI - qtr %)					0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Wages (Pvte WPI - ann %)	1.9	1.8	2.1	2.5	2.0	2.0	1.9	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.1	2.2	2.4	2.5	2.5	2.6	2.6
Unemployment Rate (%)	5.7	5.6	5.4	5.0	5.8	5.8	5.7	5.7	5.9	5.6	5.5	5.4	5.5	5.5	5.4	5.3	5.2	5.1	5.0	5.0	5.0
Terms of trade	0.6	12.3	-0.4	-0.8	-1.9	2.4	4.0	11.3	5.4	-6.0	-0.1	0.4	3.3	-1.4	-3.4	-0.2	-1.9	-1.4	-0.1	0.2	0.2
G&S trade balance, \$Abn	-14.3	10.2	8.4	-11.2	-8.7	-7.4	-4.3	6.0	6.4	3.4	1.4	-1.0	4.1	3.2	0.4	0.8	-0.9	-2.5	-3.6	-4.2	-4.2
% of GDP	-0.8	0.6	0.4	-0.6	-2.1	-1.8	-1.0	1.4	1.4	0.8	0.3	-0.2	0.9	0.7	0.1	0.2	-0.2	-0.5	-0.7	-0.8	-0.8
Current Account (% GDP)	-3.1	-2.5	-2.7	-3.7	-3.8	-3.9	-3.4	-1.4	-1.6	-2.4	-2.6	-3.2	-2.3	-2.4	-3.0	-2.9	-3.3	-3.6	-3.8	-3.9	-3.9

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	2-Jul	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Majors						
AUD/USD	0.7385	0.73	0.75	0.75	0.75	0.75
NZD/USD	0.6773	0.69	0.70	0.70	0.71	0.71
USD/JPY	110.96	109.0	110.0	108.0	106.0	104.0
EUR/USD	1.1660	1.15	1.18	1.22	1.22	1.25
GBP/USD	1.3181	1.32	1.38	1.45	1.47	1.53
USD/CHF	0.9919	1.02	1.00	0.98	0.98	0.97
USD/CAD	1.3166	1.32	1.28	1.26	1.25	1.25
USD/CNY	6.6335	6.50	6.40	6.30	6.23	6.23

Australian Cross Rates

	2-Jul	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/NZD	1.0904	1.06	1.07	1.07	1.06	1.06
AUD/JPY	81.9	80	83	81	80	78
AUD/EUR	0.6334	0.63	0.64	0.61	0.61	0.60
AUD/GBP	0.5603	0.55	0.54	0.52	0.51	0.49
AUD/CNY	4.8988	4.75	4.80	4.73	4.67	4.67
AUD/CAD	0.9723	0.96	0.96	0.95	0.94	0.94
AUD/CHF	0.7325	0.74	0.75	0.74	0.74	0.73

Interest Rate Forecasts

	2-Jul	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Australia Rates						
RBA Cash rate	1.50	1.50	1.50	1.50	1.75	1.75
3 month bill rate	2.10	1.95	1.95	1.95	2.15	2.15
3 Year Swap Rate	2.14	2.15	2.35	2.50	2.80	3.00
10 Year Swap Rate	2.81	2.95	3.20	3.30	3.60	3.70
Offshore Policy Rates						
US Fed funds	2.00	2.25	2.50	2.75	3.00	3.25
ECB deposit rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20
BoE repo rate	0.50	0.50	0.75	0.75	1.00	1.00
BoJ excess reserves rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
RBNZ OCR	1.75	1.75	1.75	1.75	2.00	2.25
China 1yr lending rate	4.35	4.35	4.35	4.35	4.35	4.35
China Reserve Ratio	16.0	16.0	16.0	16.0	16.0	16.0
10-year Benchmark Bond Yields						
Australia	2.61	2.80	3.00	3.05	3.30	3.40
United States	2.86	3.10	3.25	3.25	3.50	3.50
New Zealand	2.84	2.95	3.10	3.20	3.45	3.60

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

Dec year	2015	2016	2017	2018	2019	2020	20 Yr Avg
Australia	2.5	2.6	2.2	2.9	3.0	2.7	3.4
US	2.9	1.5	2.3	2.7	2.3	1.7	2.6
Eurozone	2.1	1.8	2.6	2.1	2.0	1.8	1.5
UK	2.3	1.9	1.8	1.5	1.7	1.5	2.4
Japan	1.4	0.9	1.7	0.9	1.0	0.7	0.8
China	6.9	6.7	6.9	6.5	6.3	6.0	9.2
India	8.2	7.1	6.7	6.8	7.2	6.9	6.6
New Zealand	3.5	4.0	2.9	2.9	3.0	2.4	3.0
World	3.5	3.2	3.8	3.8	3.7	3.5	3.5
MTP Top 5	4.1	3.7	4.2	3.9	3.7	3.1	5.0

Commodity prices (\$US)

	2-Jul	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Brent oil	73.2	67	66	65	66	67	68
Gold	1252	1320	1350	1365	1370	1380	1390
Iron ore	65.0	63	61	60	58	60	62
Hard coking coal	186	130	110	101	99	100	100
Thermal coal	114	90	90	90	65	65	65
Copper	6638	6630	6630	6630	6630	6630	6630
Aust LNG (*)	13.1	11.5	11.8	11.7	11.3	11.7	11.8

(*) Implied Australian LNG export prices.

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