AUSTRALIAN MARKETS WEEKLY

The impact of lower interest rates on household cash flows

National Australia Bank

In this issue

Analysis – The impact of lower interest rates on household cash flows

- Reserve Bank research suggests that the two rate cuts to date will boost growth by 0.25-0.4pp over two years and lift inflation by only 0.1pp over two to three years. Part of the transmission mechanism of lower interest rates is via the cash flow channel, where lower rates boost household income given households are a significant net debtor (liabilities are 201% of annual income versus interest-bearing assets at 93%).
- The transmission of lower interest rates to household cash flows changed during the global financial crisis, with a structural increase in the spread between mortgage rates and the cash rate reflecting higher bank funding costs. Since that break, cash flows have broadly reflected the cash rate and we expect the recent rate cuts will boost household income by about 0.3-0.4%.
- This is helpful considering growth in incomes remains sluggish, but is still only a modest boost. This suggests to us that further stimulus will be needed to lift spending and we continue to factor in another rate cut by November along with fiscal stimulus beyond the legislated personal income tax cuts.

The week ahead – Governor Lowe speaks on "inflation targeting and economic welfare"

- Governor Lowe speaks on "Inflation targeting and economic welfare" at lunch-time on Thursday (1:05pm AEST). We think the governor will highlight that the Reserve Bank's broad mandate means that it can deliver average inflation of between 2 and 3% "in a way that supports sustainable growth in the economy and that bests serves the public interest". This flexibility allows the bank to take into account the impact of its decisions on financial stability, as was the case in recent years, and the labour market, where the bank now emphasises the desirability of lower unemployment. Assistant Governor (Financial markets) Chris Kent will elaborate on changes to the committed liquidity facility on Tuesday.
- Internationally, Q2 US GDP on Friday is expected to show a slowing US economy, with the consensus expecting annualized growth of 1.8%, which would be the smallest quarterly increase since 2016. The ECB meets on Thursday, where a 49% chance of a 10bp cut to -0.5% is priced by markets. Draghi's press conference is likely to signal a dovish outlook and a willingness to enact further stimulus. The new UK Prime Minister and leader of the conservative party will be announced on Tuesday.

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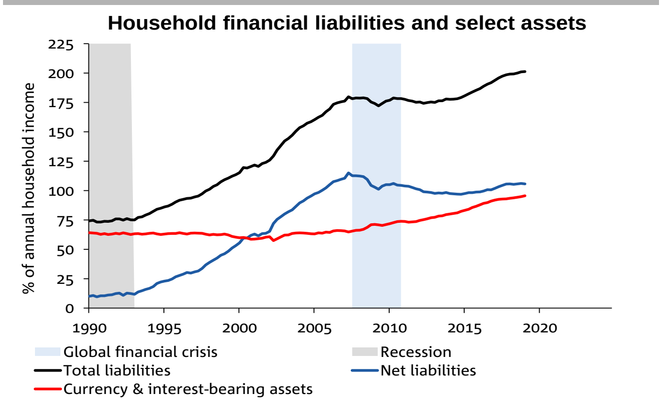
Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.7041	0.0	RBA cash	1.00	0
AUD/CNY	4.84	0.2	3y swap	1.00	-3
AUD/JPY	76.0	0.1	ASX 200	6,681	0.4
AUD/EUR	0.628	0.4	Iron ore	114	-1.8
AUD/NZD	1.039	-0.8	WTI oil	56.1	-5.9

Source: Bloomberg

Chart of the week: H'hold debt greatly exceeds deposits



Kieran Davies

The impact of lower interest rates on household cash flows

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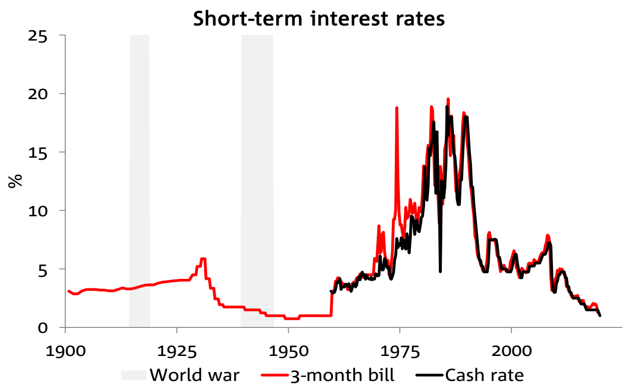
- This is helpful considering growth in incomes remains sluggish, but is still only a modest boost. This suggests to us that further stimulus will be needed to lift spending and we continue to factor in another rate cut by November along with fiscal stimulus beyond the legislated personal income tax cuts.

Interest rates are at their lowest level since the 1950s

With the Reserve Bank delivering back-to-back rate cuts in June and July, the cash rate is now at 1%, which is the lowest level since the Reserve Bank was established in 1960. The 3-month bank bill rate is slightly higher at 1.1%, such that short-term interest rates are at their lowest level since the 1950s.

Chart 1: ST interest rates at lowest level since the 1950s



Note: The Q4 2019 estimates are as at July 2019 to date.
Source: Australian Bureau of Statistics, Jorda-Shularick-Taylor Macrohistory Database, Reserve Bank of Australia, National Australia Bank

Lower rates should provide a modest boost to growth and a small boost to inflation

The Reserve Bank estimates that a 1pp reduction in the cash rate boosts GDP growth by about 0.5-0.75pp over two years and lifts inflation by a "bit less" than 0.25pp over two to three years.[1]

With the bank cutting interest rates by 0.5pp to date, this suggests that growth will be boosted by 0.25-0.4pp over two years and inflation will be increased by only 0.1pp over two to three years.

This assumes that the reduction in the nominal cash rate is fully reflected in a lower real cash rate. That assumption appears unrealistic to us, as both past and market estimates of expected inflation have both fallen by 0.2pp since late last year. As such, the real cash rate is likely to have only declined by 0.3pp.

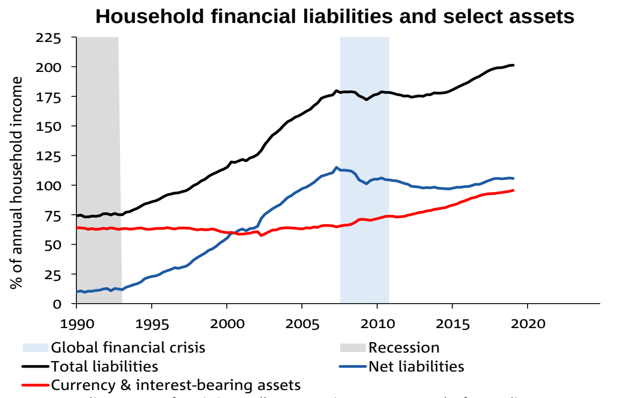
Lower interest rates can boost the cash flow of households and hence spending

Part of the transmission mechanism of lower interest rates to growth and eventually inflation is via the cash flow channel. Lower interest rates alter cash flows by reducing both interest payments and interest income, which makes borrowers better off than savers.

The net effect on spending of these opposing forces is positive because:

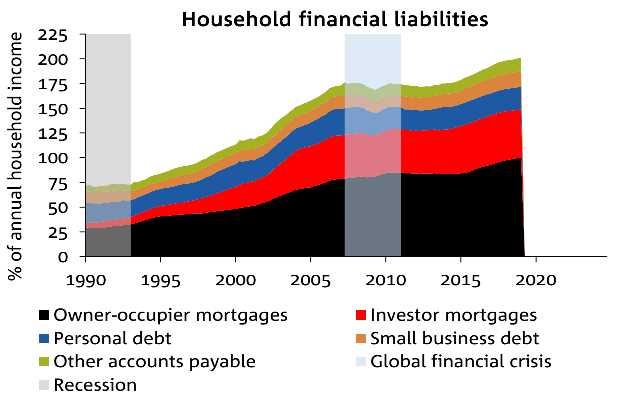
- The household sector is a substantial net debtor, where household financial liabilities greatly exceed household holdings of currency and interest-bearing deposits.
  - At present, household financial liabilities are more than double the value of household cash and interest-bearing assets, at 201% and 93% of annual household income, respectively.
- Spending by debtors is more sensitive to lower interest rates than spending by savers because borrowers are more likely to be cash-constrained.

Chart 2: Household debt is more than double the holdings of interest-bearing assets



Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, NAB Australia Bank

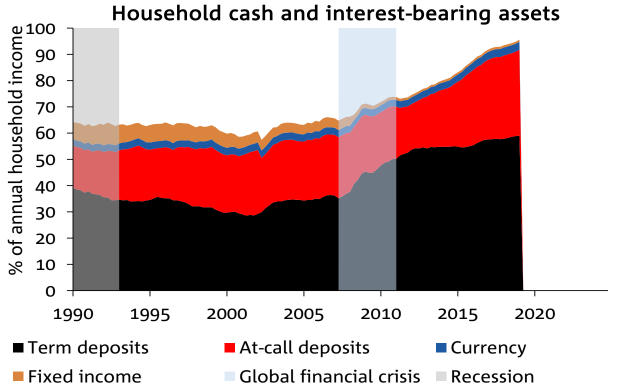
Chart 3: Mortgages account for bulk of household debt



Note: Owner-occupier and investor mortgages are home loans. Small business debt refers to debt held by unincorporated enterprises.
Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

[1] See Tim Atkin and Gianna La Cava, *The transmission of monetary policy: How does it work?*, Reserve Bank of Australia Bulletin, September quarter 2017.

Chart 4: Deposits dominate interest-bearing assets

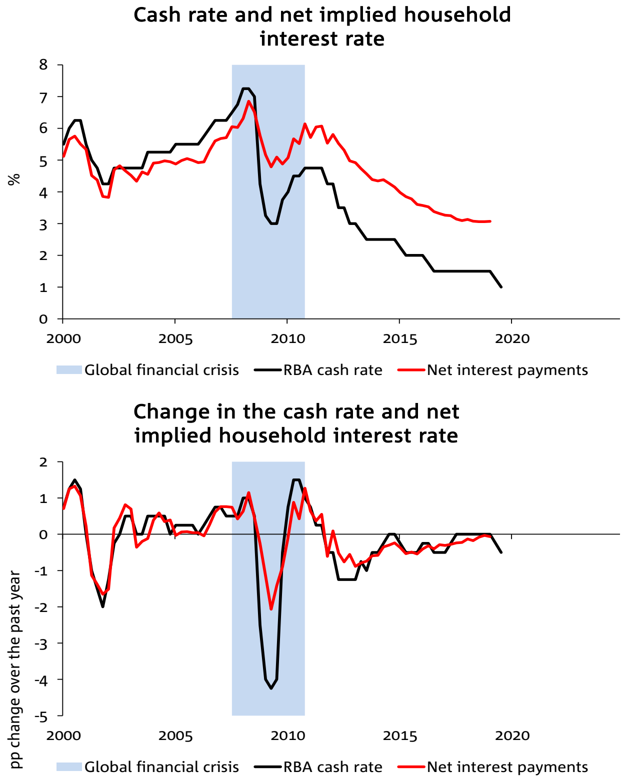


Note: Fixed income = bonds, bank bills and loans and placements.
Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

Interest flows have broadly tracked the cash rate over recent years after a large break during the global financial crisis

Analysing interest flows suggests the transmission of lower interest rates to household cash flows remains strong, although there was a change during the global financial crisis. The global financial crisis saw a structural increase in the spread between mortgage rates and the cash rate, reflecting higher bank funding costs.

Chart 5: The net implied interest rate has tracked the cash rate post its break during the global financial crisis



Note: Net interest payments are as at Q1 2019, while the cash rate is as at Q3 to date.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

We calculated an implied net interest rate by dividing net interest payments less income by household liabilities less interest-bearing assets.[2]

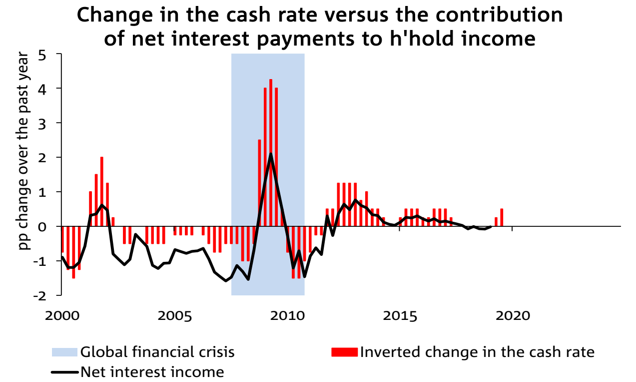
This calculation shows the global financial crisis drove a wedge between the *level* of the cash rate and the implied net interest rate, but that the two series resumed tracking each other closely over recent years.

More stimulus will be needed as recent rate cuts provide only a modest boost to household income

The relatively close relationship between the implied net interest rate and the cash rate suggests that the two recent rate cuts should be reflected in a roughly 0.3-0.4pp boost to growth in household income.

This is a welcome boost to income considering that growth has been sluggish over recent years, but is still comparatively modest. This reinforces our view that further stimulus will be needed to support the economy, in the form of another rate cut by November and fiscal stimulus beyond the legislated personal income tax cuts.

Chart 6: The lower cash rate should boost growth in household income by about 03-0.4pp



Note: Net interest payments are as at Q1 2019, while the cash rate is as at Q3 to date.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

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[2] The implied interest rates on liabilities and interest-bearing assets are adjusted for imputed service charges estimates by the Bureau of Statistics. Given that these charges are not published, we hoped to minimise their effect on the data by calculating a net implied interest rate.

CALENDAR OF ECONOMIC RELEASES

Monday, 22 July 2019							
US	Chicago Fed Nat Activity Index	Jun		0.1	-0.05	12.30	22.30
CA	Wholesale Trade Sales MoM	May		0.5	1.7	12.30	22.30
Tuesday, 23 July 2019							
AU	RBA's Kent Gives Speech on The Committed Liquidity Facility, Sydney					22.30	8.30
JN	Machine Tool Orders YoY	Jun F			-38	6.00	16.00
US	FHFA House Price Index MoM	May		0.3	0.4	13.00	23.00
US	Richmond Fed Manufact. Index	Jul		5	3	14.00	0.00
EC	Consumer Confidence	Jul A		-7.2	-7.2	14.00	0.00
Wednesday, 24 July 2019							
NZ	Trade Balance NZD	Jun	105	100	264	22.45	8.45
JN	Jibun Bank Japan PMI Mfg	Jul P			49.3	0.30	10.30
GE	Markit/BME Germany Manufacturing PMI	Jul P		45.2	45	7.30	17.30
EC	Markit Eurozone Manufacturing PMI	Jul P		47.6	47.6	8.00	18.00
EC	M3 Money Supply YoY	Jun		4.6	4.8	8.00	18.00
US	Markit US Manufacturing PMI / Services PMI	Jul P		51/51.8	50.6/51.5	13.45	23.45
US	New Home Sales	Jun		659.5	626	14.00	0.00
Thursday, 25 July 2019							
AU	RBA's Lowe Gives Speech on Inflation Targeting and Economic Welfare in Sydney					3.05	13.05
GE	IFO Business Climate	Jul		97	97.4	8.00	18.00
GE	IFO Current Assessment	Jul		100.4	100.8	8.00	18.00
EC	ECB Main Refinancing Rate / Marginal lending facility	25 Jul		0/0.25	0/0.25	11.45	21.45
EC	ECB Deposit Facility Rate	25 Jul		-0.4	-0.4	11.45	21.45
EC	ECB's Draghi Speaks in Frankfurt After Policy Decision					12.30	22.30
US	Wholesale Inventories MoM	Jun P		0.5	0.4	12.30	22.30
US	Durable Goods Orders	Jun P		0.7	-1.3	12.30	22.30
US	Initial Jobless Claims	20 Jul		218.5	216	12.30	22.30
Friday, 26 July 2019							
JN	Tokyo CPI YoY	Jul		1	1.1	23.30	9.30
US	GDP Annualized QoQ	2Q A		1.8	3.1	12.30	22.30
US	Core PCE QoQ	2Q A		2	1.2	12.30	22.30
Upcoming Central Bank Interest Rate Announcements							
Europe, ECB		25-Jul	-0.4%	-0.4%	-0.4%		
Japan, BoJ		30-Jul	-0.1%	-0.1%	-0.1%		
US, Federal Reserve		31-Jul	2-2.25%	2-2.25%	2.25-2.5%		
UK, BOE		1-Aug	0.75%	0.75%	0.75%		
Australia, RBA		6-Aug	1.00%	1%	1%		
New Zealand, RBNZ		7-Aug	1.25%	1.25%	1.5%		
Canada, BoC		4-Sep	1.75%	1.75%	1.75%		

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

FORECASTS

Economic Forecasts

	Annual % change				Quarterly % change															
					2018				2019				2020				2021			
Australia Forecasts	**2018**	**2019**	**2020**	**2021**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Household Consumption	2.6	1.5	2.2	2.3	0.4	0.8	0.3	0.4	0.3	0.3	0.4	0.7	0.6	0.5	0.5	0.5	0.6	0.6	0.5	0.6
Underlying Business Investment	0.9	0.9	4.3	3.6	0.6	-1.0	-2.1	0.0	0.6	1.0	0.8	1.8	0.3	1.8	0.4	1.4	0.4	1.0	0.8	1.4
Residential Construction	4.7	-8.2	-8.3	-1.6	4.1	1.7	0.7	-2.9	-2.5	-3.3	-3.0	-2.2	-2.0	-1.8	-1.9	-0.8	-0.2	0.5	0.2	0.8
Underlying Public Spending	5.0	5.4	4.5	4.1	1.4	0.4	2.5	1.6	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Net Exports (a)	0.7	0.6	-0.3	-0.4	0.5	0.2	0.3	-0.2	0.2	0.3	0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Inventories (a)	0.1	-0.2	-0.1	0.0	-0.1	0.2	-0.3	0.2	-0.1	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand (q/q %)	--	--	--	--	0.9	0.6	0.5	0.4	0.1	0.3	0.4	0.7	0.6	0.7	0.5	0.7	0.6	0.7	0.7	0.8
Dom Demand (y/y %)	2.9	1.4	2.3	2.7	3.4	3.2	2.8	2.4	1.6	1.3	1.2	1.6	2.0	2.4	2.5	2.5	2.5	2.6	2.7	2.8
Real GDP (q/q %)	--	--	--	--	1.0	0.9	0.3	0.2	0.4	0.4	0.4	0.8	0.5	0.6	0.5	0.6	0.5	0.6	0.5	0.7
Real GDP (y/y %)	2.8	1.7	2.3	2.3	3.1	3.1	2.8	2.4	1.8	1.3	1.5	2.1	2.2	2.3	2.4	2.2	2.2	2.3	2.3	2.4
CPI headline (q/q %)	--	--	--	--	0.4	0.4	0.4	0.5	0.1	0.6	0.4	0.6	0.4	0.4	0.5	0.7	0.5	0.5	0.6	0.7
CPI headline (y/y %)	1.9	1.6	1.8	2.2	1.9	2.1	1.9	1.8	1.4	1.7	1.6	1.6	1.9	1.7	1.8	1.9	2.0	2.2	2.3	2.3
CPI underlying (q/q %)	--	--	--	--	0.5	0.5	0.3	0.4	0.2	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
CPI underlying (y/y %)	1.8	1.4	1.5	1.9	1.9	1.7	1.7	1.7	1.4	1.4	1.4	1.3	1.5	1.4	1.5	1.6	1.8	1.9	2.0	2.0
Private wages (q/q %)	--	--	--	--	0.5	0.6	0.6	0.5	0.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Private wages (y/y %)	2.1	2.3	2.5	2.8	1.9	2.1	2.2	2.3	2.4	2.3	2.3	2.4	2.5	2.5	2.6	2.6	2.7	2.7	2.8	2.8
Unemployment Rate (%)	5.3	5.2	5.3	5.4	5.5	5.5	5.1	5.0	5.1	5.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.4	5.5	5.5
Terms of trade	1.8	2.9	-3.8	-1.5	3.2	-1.2	1.1	2.9	3.1	-1.1	-2.6	-1.4	-0.6	-1.0	0.4	-0.2	-0.2	-0.8	-0.8	-0.5
Current Account (% GDP)	-2.0	-0.9	-1.8	-2.4	-2.2	-2.5	-2.1	-1.3	-0.6	-0.5	-1.1	-1.4	-1.5	-1.8	-1.8	-1.9	-2.0	-2.3	-2.6	-2.8

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

Exchange Rate Forecasts

	22-Jul	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Majors						
AUD/USD	0.704	0.71	0.73	0.74	0.75	0.75
NZD/USD	0.68	0.67	0.68	0.69	0.70	0.70
USD/JPY	108.0	107	108	107	106	105
EUR/USD	1.12	1.12	1.13	1.13	1.13	1.14
GBP/USD	1.25	1.22	1.24	1.24	1.25	1.27
USD/CNY	6.88	6.96	6.95	6.92	6.90	6.85
USD/CAD	1.31	1.33	1.30	1.29	1.27	1.28
USD/CHF	0.98	0.98	0.98	1.02	1.02	1.00
Australian Cross Rates						
AUD/NZD	1.04	1.06	1.07	1.07	1.07	1.07
AUD/JPY	76.0	76	79	79	80	79
AUD/EUR	0.63	0.63	0.65	0.65	0.66	0.66
AUD/GBP	0.56	0.58	0.59	0.60	0.60	0.59
AUD/CNY	4.84	4.94	5.07	5.12	5.18	5.14
AUD/CAD	0.92	0.94	0.95	0.95	0.95	0.96
AUD/CHF	0.69	0.70	0.72	0.75	0.77	0.75

Interest Rate Forecasts

	22-Jul	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Australian Rates						
RBA cash rate	1.00	1.00	0.75	0.75	0.75	0.75
3 month bill rate	1.11	1.10	0.85	0.85	0.85	0.85
3 Year Swap Rate	1.00	0.80	0.80	1.10	1.25	1.40
10 Year Swap Rate	1.55	1.38	1.38	1.53	1.63	1.73
Offshore Policy Rates						
US Fed funds	2.50	2.00	2.00	2.00	2.00	2.00
ECB deposit rate	-0.40	-0.60	-0.60	-0.60	-0.60	-0.60
BoE repo rate	0.75	0.75	0.75	0.75	0.75	0.75
BoJ excess reserves rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
RBNZ OCR	1.50	1.25	1.25	1.25	1.25	1.25
China 1yr lending rate	4.35	4.10	4.10	4.10	4.10	4.10
China Reserve Ratio	13.5	13.00	12.50	12.00	12.00	12.00
10-year Bond Yields						
Australia	1.33	1.20	1.20	1.35	1.45	1.55
United States	2.05	1.90	1.90	2.00	2.10	2.20
New Zealand	1.57	1.60	1.65	1.85	2.00	2.20

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

	2018	2019	2020	2021
Australia	2.8	1.7	2.3	2.3
United States	2.9	2.4	1.7	1.7
Eurozone	1.8	1.2	1.3	1.4
United Kingdom	1.4	1.5	1.4	1.5
Japan	0.8	0.7	0.4	0.9
China	6.6	6.3	6.0	5.8
India	7.1	6.7	7.2	7.1
New Zealand	2.8	2.4	2.6	2.5
World	3.6	3.2	3.3	3.5

Commodity prices ($US)

	22-Jul	Sep-19	Dec-19	Mar-20	Jun-20
Brent oil	63.5	68	70	70	75
Gold	1428	1334	1382	1393	1398
Iron ore	122	79	76	72	68
Hard coking coal*	183	178	170	165	160
Thermal coal	75	85	90	93	90
Copper	6055	6400	6300	6225	6150
Aus LNG**	10	12	12	12	12

** FOB quarterly contract prices (thermal coal is JFY contract)*

*** Implied Australian LNG export prices*

CONTACT DETAILS

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