

AUSTRALIAN MARKETS WEEKLY

How accommodative is Australian monetary policy?



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Analysis – How accommodative is Australian monetary policy? Assessing the stance of policy given a lower neutral cash rate

- With the cash rate at a record low of 0.75%, short-term interest rates broadly match the all-time low reached in the 1950s. Variable home loan rates are also at their lowest level since the 1950s, while business rates are likely at a new record low.
- Adjusting interest rates for inflation, which is what matters for the economy, the real cash rate is -0.9%, which is low compared with most economic slowdowns, but not at the extremes reached in past recessions. However, the current real mortgage rate is only in the middle of the pack compared with previous downturns and well above that reached in past recessions.
- More importantly, policy is not quite as stimulatory as past downturns when judged against a lower neutral real cash rate, which looks to have fallen further from the Reserve Bank's end-2017 estimate of 0.8%.
- With conventional monetary policy near exhaustion, we think unconventional policy is on the table next year unless the Commonwealth government delivers meaningful additional fiscal stimulus, easing up on its objective of returning the budget to surplus. That said, we note that Governor Lowe remains positive about the economy and repeated over the weekend that unconventional policy was unlikely.

The week ahead – Brexit approaches; flash PMIS due in Europe and the US

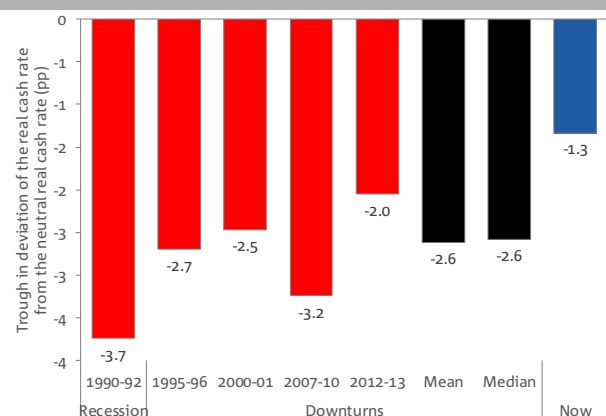
- No major data are due in either Australia or New Zealand.
- Globally, Brexit dominates in Europe with PM Johnson sending an unsigned letter to the EU requiring an extension to the 31 October deadline, as required by law, along with a signed letter arguing that he will continue his efforts to pass the revised Brexit deal. PMIs are due in both Europe and the US and will be examined to see the extent to which manufacturing activity continues to wane and in the US, whether there is any spillover slowing into the much larger services sector. No change in policy is expected at the ECB meeting on Wednesday.

Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.6847	1.1	RBA cash	0.75	0
AUD/CNY	4.85	0.4	3y swap	0.82	10
AUD/JPY	74.2	1.0	ASX 200	6,650	0.6
AUD/EUR	0.614	-0.1	Iron ore	83	-4.4
AUD/NZD	1.073	-0.3	WTI oil	53.6	0.0

Source: Bloomberg

Chart of the week: Policy is not particularly stimulatory



How accommodative is Australian monetary policy? Assessing the stance of policy given a lower neutral cash rate

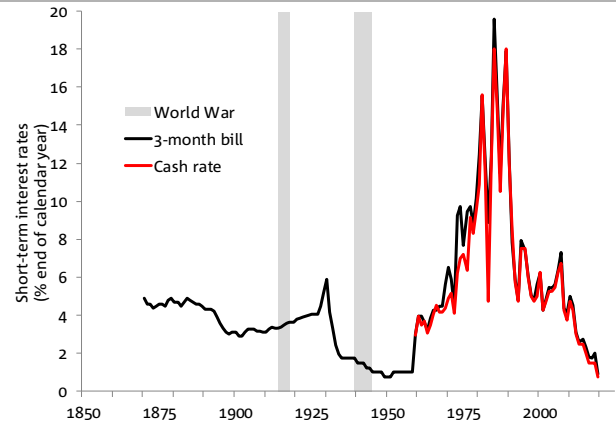
- With the cash rate at a record low of 0.75%, short-term interest rates broadly match the all-time low reached in the 1950s. Variable home loan rates are also at their lowest level since the 1950s, while business rates are likely at a new record low.
- Adjusting interest rates for inflation, which is what matters for the economy, the real cash rate is -0.9%, which is low compared with most economic slowdowns, but not at the extremes reached in past recessions. However, the current real mortgage rate is only in the middle of the pack compared with previous downturns and well above that reached in past recessions.
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With the cash rate at a record low, lending rates are extremely low

After a long period of stability, where the Reserve Bank Board had warned as recently as the end of last year that the next move in interest rates was likely to be up, the bank has embarked on a new easing cycle, cutting the cash rate three times since June to 0.75%.¹ This marks the lowest level of the cash rate since the Reserve Bank was established in 1960, broadly matching the all-time low in short-term interest rates in 1949 to 1951.

¹ For example, the Reserve Bank Board said as late as the end of last year that “members continued to agree that the next move in interest rates was more likely to be an increase than a decrease, but that there was no strong case for a near-term

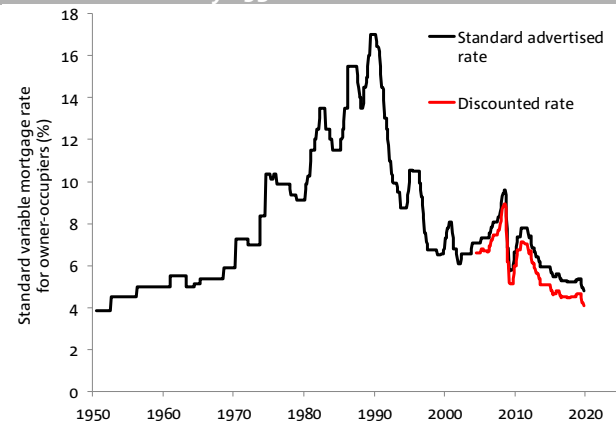
Chart 1: The current cash rate broadly matches the record low in short-term rates reached around 1950



Note: The observations for 2019 are as at October 2019.
Source: Jorda-Schularick-Taylor Macroeconomy database, Reserve Bank of Australia, National Australia Bank

Similarly, lending rates are at an extremely low level. For example, the variable interest rate on residential mortgages for owner-occupiers is now at its lowest level since the 1950s. Variable lending rates for large business are published with a long delay by the Reserve Bank, but are likely also at a new record low.

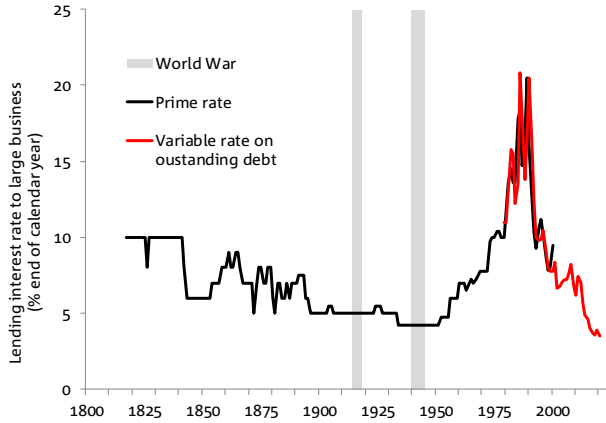
Chart 2: Residential mortgage rates are at their lowest level since the early 1950s



Note: The October 2019 observations are estimates.
Source: Reserve Bank of Australia, National Australia Bank

adjustment in monetary policy”. See Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board*, Sydney, 4 December 2018.

Chart 3: Lending rates to large business are likely at a new record low



Note: The latest reading is for June 2019.
Source: Reserve Bank of Australia, National Australia Bank

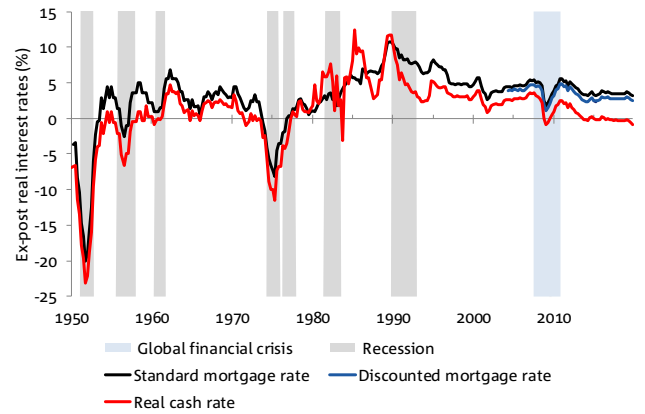
However, lending rates adjusted for inflation are not at an extreme

Although nominal interest rates are plumbing the depths, ex-post real interest rates – which are a better measure of the stance of monetary policy – are not at an extreme relative to history.²

- **The current real cash rate is low compared with most downturns and is higher than the experience of past recessions.** The current real cash rate of -0.9% is much lower than the troughs reached in most downturns, where the average low-point is 0.6% and the median low is -0.3%, and on a par with the early 1970s downturn and the global financial crisis. However, the real cash rate is well above the lows reached in past recessions, where the average trough was -6.7% with a median low of -4.3%.
- **The current real mortgage rate is in the middle of the pack compared with previous downturns and is well above the lows of past recessions.**³ The current real mortgage rate of 2.5% matches the average low-point of past downturns and is close to the median trough of 2.3%. This places it well above both the average and median troughs of post-WW2 recessions of -3.4% and -1.9%, respectively.

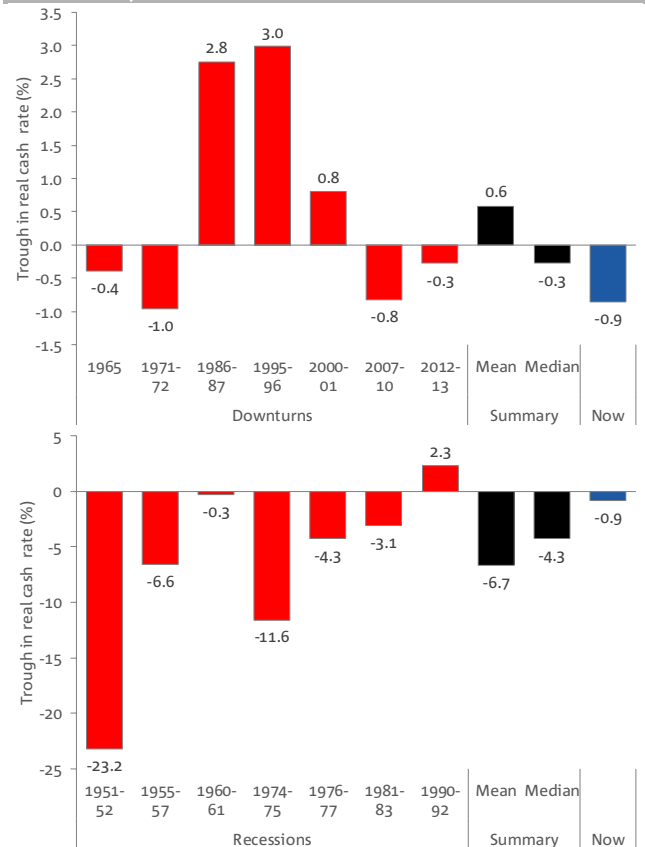
That said, real interest rates have been low for an extended period, while the troughs reached in past downturns and recessions interest rates were relatively short lived.

Chart 4: Real lending rates are not at an extreme relative to history



Note: Ex-post real interest rate = end-quarter nominal interest rate – annual trimmed mean inflation. Annual trimmed mean inflation was estimated prior to 1976. Inflation in Q3 and Q4 2019 was based on the Reserve Bank's latest forecasts. The cash rate prior to 1959 was proxied by the 3-month bill rate. Q4 2019 nominal interest rates are as at October 2019.
Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

Chart 5: The current real cash rate is lower than most downturns, but is not at a recession-like level

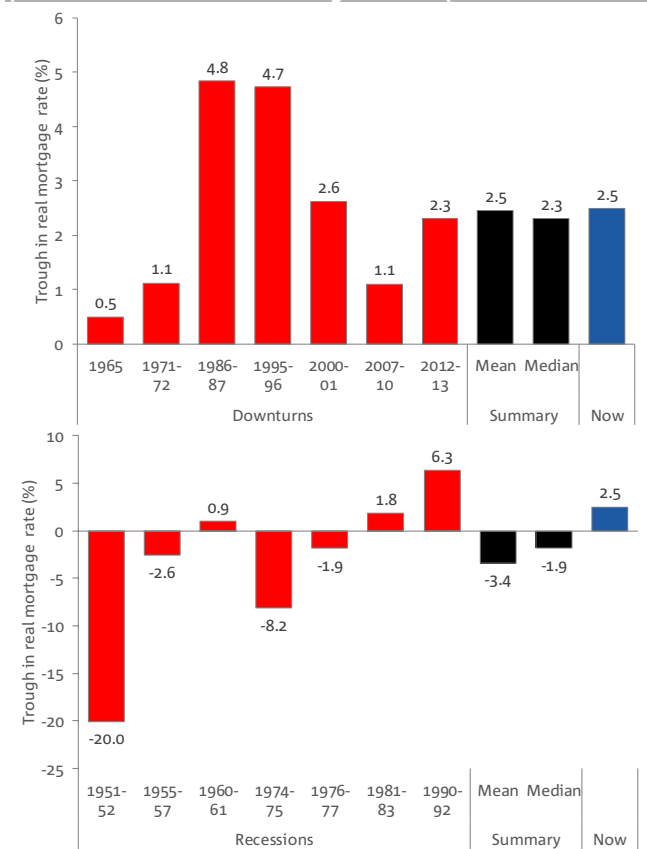


Note: The cash rate prior to 1959 was proxied by the 3-month bill rate. Downturns were based on the broad peak in the annual change in the unemployment rate.
Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

² Ideally, we would have used ex-ante real interest rates, but there is only a relatively short history of inflation expectations. Also, the Reserve Bank often uses ex-post real interest rates when analysing the impact of monetary policy on the economy.

³ The real mortgage rate was constructed using the discounted variable mortgage rate for owner-occupiers, spliced with the standard variable mortgage rate prior to 2004.

Chart 6: The current real mortgage rate is in line with past downturns and much higher than past recessions



Note: The variable mortgage rate is the discounted rate for owner-occupiers spliced with the standard variable rate prior to 2004. Downturns were based on the annual change in the unemployment rate. Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

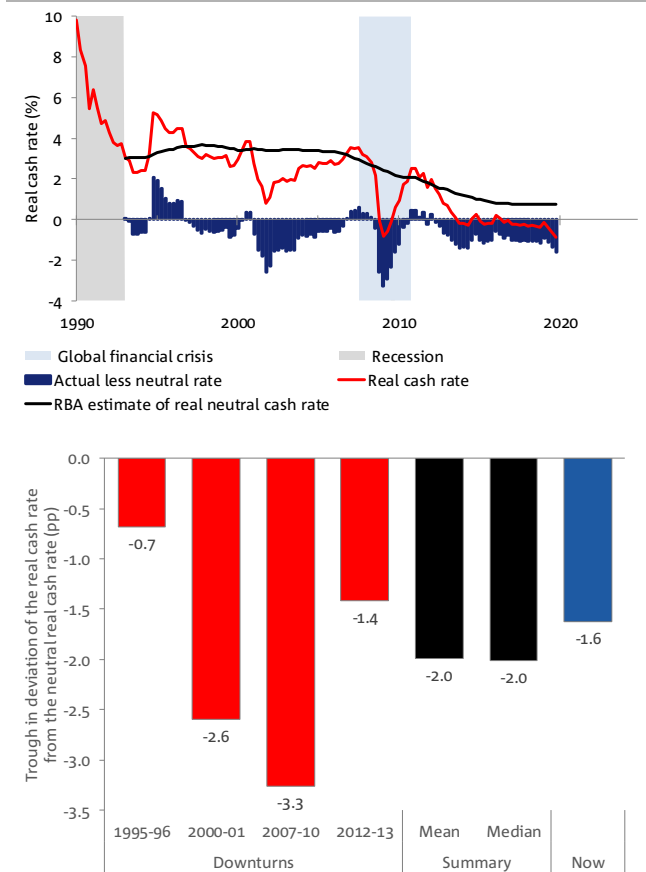
Policy is not quite as stimulatory as past downturns when judged against a lower neutral cash rate

More importantly, the real cash rate is not low relative to the Reserve Bank’s estimate of the neutral cash rate (aka r-star), which declined to 0.8% at the end of 2017.⁴ Assuming the neutral rate has remained unchanged since then, this puts the current gap between the real cash rate and r-star at -1.6pp, which compares with the average and median low-points in the gap in past downturns of -2.0pp.

Even allowing for the uncertainty surrounding estimates of the neutral real rate, this comparison suggests that policy is not quite as loose as past downturns, although the three recent interest rate reductions have eased policy. It also suggests that the current stance of policy is a long way from the dire experience of the global financial crisis when the gap reached -3.3pp.

⁴ The Reserve Bank characterised the real neutral cash rate as 1% at the time, although the published analysis shows it around 0.8%. See Rachael McCrick and Daniel Rees, *The neutral interest rate*, Reserve Bank of Australia Bulletin, September quarter 2017.

Chart 7: Real interest rates are not at an extreme relative to the neutral real cash rate



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

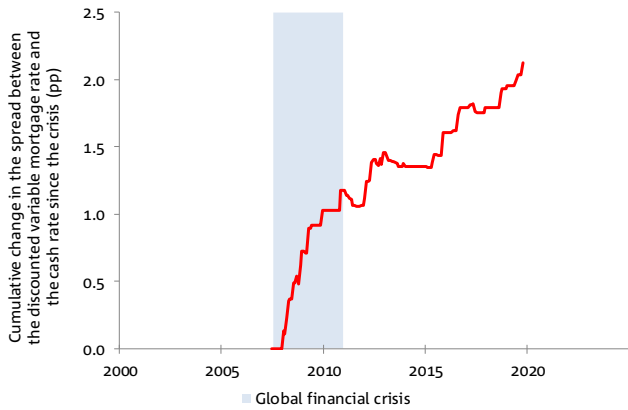
The neutral interest rate has likely declined further this year

With the Reserve Bank estimating the neutral real interest rate reached about 0.8% at the end of 2017, we think it likely that the neutral rate has edged lower to about 0.5% this year. This reflects a roughly 30bp increase in the spread between the discounted variable mortgage rate and the cash rate since the end of 2017, which, as Deputy Governor Debelle has remarked, “should have a roughly one-for-one effect on the neutral interest rate”.⁵

The decline in the real 10-year bond yield, which has fallen from 0.8% at the end of 2018 to -0.1%, also suggests that the neutral rate has fallen given the loose relationship between the two series.

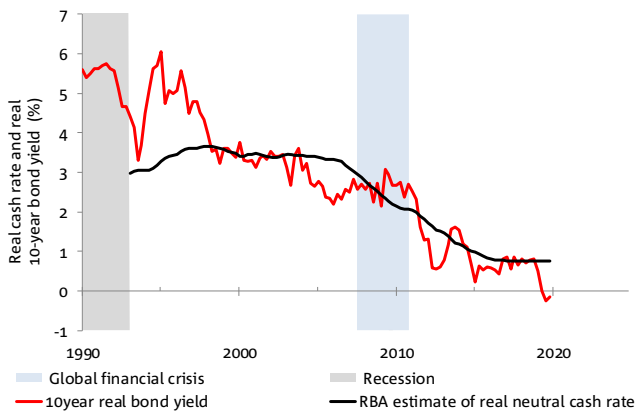
⁵ See Reserve Bank of Australia Deputy Governor Debelle, *Global influences on domestic monetary policy*, Adelaide, 21 July 2017.

Chart 8: The spread between the mortgage rate and the cash rate suggests the neutral rate has fallen further



Note: The October 2019 observation is an estimate.
Source: Reserve Bank of Australia, National Australia Bank

Chart 9: The decline in the 10-year real bond yield also suggests that the neutral rate has fallen further



Note: The Q4 2019 observation for the real bond yield is as at October 2019.
Source: Australian Bureau of Statistics, Melbourne Institute, Reserve Bank of Australia, National Australia Bank

Unconventional monetary policy is possible unless there is meaningful fiscal stimulus

With conventional monetary policy nearing exhaustion as the official cash rate approaches zero and the real cash rate not particularly low relative to a declining neutral interest rate, further stimulus to support the economy will likely require action from the Commonwealth government and/or the adoption of unconventional monetary policy.

Commonwealth action would be desirable given the record low level of bond yields and the scale of the Commonwealth’s balance sheet, but at this point the government seems committed to returning the budget to surplus, which constrains any additional stimulus to a small share of GDP. That said, the Commonwealth could change its view by the May budget should the unemployment rate begin to trend higher.

The focus on the budget surplus matters for monetary policy, as we think that without a meaningful additional fiscal stimulus the Reserve Bank could cut the cash rate as low as 0.25% and adopt unconventional policy measures by mid 2020.

The Reserve Bank would clearly prefer to avoid unconventional measures, as Governor Lowe made clear in his remarks at the weekend IMF meetings. However, without fiscal support the Reserve Bank is likely to find it hard to achieve full employment and return inflation to the 2-3% target, when it has estimated the NAIRU at 4.5%.

Kieran Davies

CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Monday 21 October 2019								
CA	Canada federal election							
JN	All Industry Activity Index MoM	Aug		0.1		0.2	4.30	15.30
Tuesday 22 October 2019								
JN	Public Holiday - Enthronement Ceremony							
CA	Retail Sales MoM	Aug		--		0.4	12.30	23.30
Wednesday 23 October 2019								
NZ	Trade Balance NZD	Sep	-1320	-1350		-1565	21.45	8.45
AU	RBA's Kent takes part in Sydney Panel						22.20	9.20
EC	Consumer Confidence	Oct A		-6.5		-6.5	14.00	1.00
Thursday 24 October 2019								
JN	Jibun Bank Japan PMI Mfg	Oct P		--		48.9	0.30	11.30
GE	Markit/BME Germany Manufacturing PMI	Oct P		42		41.7	7.30	18.30
GE	Markit Germany Services PMI	Oct P		51.7		51.4	7.30	18.30
EC	Markit Eurozone Manufacturing PMI	Oct P		46		45.7	8.00	19.00
EC	ECB Main Refinancing Rate	Oct 24		0		0	11.45	22.45
EC	ECB Marginal Lending Facility	Oct 24		0.25		0.25	11.45	22.45
EC	ECB Deposit Facility Rate	Oct 24		-0.5		-0.5	11.45	22.45
EC	ECB's Draghi speaks in Frankfurt after policy decision						12.30	23.30
US	Durable Goods Orders	Sep P		-0.6		0.2	12.30	23.30
US	Markit US Services PMI	Oct P		--		50.9	13.45	0.45
US	Markit US Manufacturing PMI	Oct P		--		51.1	13.45	0.45
US	New Home Sales	Sep		710		713	14.00	1.00
Friday 25 October 2019								
GE	Ifo Business Climate	Oct		94.6		94.6	8.00	19.00
GE	Ifo Current Assessment	Oct		98.1		98.5	8.00	19.00
US	U. of Mich. Sentiment	Oct F		96		96	14.00	1.00
Upcoming Central Bank Interest Rate Announcements								
Europe, ECB		Oct 24	-0.50	-0.50		-0.50		
Japan, BoJ		Oct 31	-0.10	-0.10		-0.10		
Canada, BoC		Oct 30	1.75	1.75		1.75		
US, Federal Reserve		Oct 30	1.75/2	1.75/2		1.75/2		
Australia, RBA		Nov 5	0.75	0.75		0.75		
UK, BOE		Nov 7	0.75	0.75		0.75		
New Zealand, RBNZ		Nov 13	0.75	1.00		1.00		

GMT: Greenwich Mean Time; AEDT: Australian Eastern Daylight Time

FORECASTS

Economic Forecasts																				
	Annual % change				Quarterly % change															
	2018	2019	2020	2021	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	1.4	1.7	2.3	0.5	0.8	0.3	0.4	0.3	0.4	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.6	0.6	0.6
Underlying Business Investment	1.2	-2.1	0.2	1.9	0.7	-0.8	-2.1	0.1	-0.2	-0.6	-0.3	-0.5	0.1	0.1	1.1	0.5	0.4	0.4	0.2	0.4
Residential Construction	4.8	-8.6	-8.1	-0.9	3.3	2.8	0.1	-2.8	-2.2	-4.4	-2.7	-2.4	-2.1	-1.3	-1.7	-0.5	0.1	0.2	0.5	0.8
Underlying Public Spending	4.3	4.2	3.8	3.6	1.4	-0.1	2.1	0.8	1.1	1.4	0.4	0.8	1.1	1.1	0.9	0.9	0.8	0.8	0.8	0.9
Net Exports (a)	0.8	1.6	-0.1	-0.2	0.6	0.0	0.4	-0.2	0.4	0.6	0.3	0.3	0.0	0.0	-0.1	0.0	0.0	0.0	-0.1	0.0
Inventories (a)	0.1	-0.4	0.1	0.1	0.0	0.2	-0.3	0.2	-0.1	-0.5	0.0	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand (q/q %)	-	-	-	-	0.9	0.5	0.4	0.2	0.1	0.3	0.2	0.2	0.5	0.5	0.6	0.6	0.7	0.7	0.7	0.7
Dom Demand (y/y %)	2.8	0.9	1.7	2.6	3.5	3.3	2.5	2.0	1.2	1.0	0.8	0.8	1.2	1.4	1.9	2.2	2.5	2.6	2.7	2.8
Real GDP (q/q %)	-	-	-	-	1.0	0.7	0.3	0.1	0.5	0.5	0.5	0.5	0.6	0.5	0.7	0.6	0.6	0.6	0.6	0.7
Real GDP (y/y %)	2.7	1.7	2.2	2.5	3.1	3.1	2.6	2.2	1.7	1.4	1.6	2.0	2.1	2.1	2.3	2.4	2.4	2.6	2.5	2.6
CPI headline (q/q %)	-	-	-	-	0.4	0.4	0.4	0.5	0.0	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	1.5	1.8	2.2	1.9	2.1	1.9	1.8	1.3	1.6	1.6	1.6	2.0	1.7	1.8	1.9	2.0	2.1	2.3	2.3
CPI underlying (q/q %)	-	-	-	-	0.5	0.5	0.4	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 %)	1.9	1.4	1.5	1.9	1.9	1.9	1.8	1.8	1.5	1.4	1.4	1.3	1.5	1.5	1.5	1.6	1.7	1.9	2.0	2.0
Private wages (q/q %)	-	-	-	-	0.5	0.6	0.5	0.6	0.5	0.5	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	2.1	2.3	2.4	2.3	2.3	2.3	2.4	2.5	2.6	2.6	2.7	2.7	2.8	2.8
Unemployment Rate (%)	5.3	5.2	5.4	5.5	5.5	5.6	5.1	5.0	5.0	5.2	5.2	5.3	5.3	5.4	5.5	5.5	5.5	5.4	5.5	5.4
Terms of trade	2.0	3.2	-7.9	1.8	3.3	-1.3	1.1	3.0	3.1	1.5	-4.4	-4.7	-2.6	-0.6	0.9	-0.2	1.2	0.6	-0.1	-0.1
Current Account (% GDP)	-2.1	0.3	-1.0	-0.8	-2.2	-2.7	-2.2	-1.4	-0.2	1.2	0.5	-0.3	-0.9	-1.1	-1.0	-1.0	-0.8	-0.7	-0.8	-0.9

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

Exchange Rate Forecasts						
	21-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Majors						
AUD/USD	0.686	0.65	0.66	0.67	0.69	0.70
NZD/USD	0.64	0.62	0.62	0.63	0.65	0.65
USD/JPY	108.5	104	104	105	106	106
EUR/USD	1.12	1.12	1.11	1.13	1.14	1.15
GBP/USD	1.29	1.20	1.18	1.20	1.22	1.24
USD/CNY	7.07	7.40	7.40	7.30	7.20	7.10
USD/CAD	1.31	1.36	1.38	1.38	1.36	1.35
USD/CHF	0.99	0.97	0.95	0.96	0.96	0.96

Australian Cross Rates						
	21-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/NZD	1.07	1.05	1.06	1.06	1.06	1.08
AUD/JPY	74.4	68	69	70	73	74
AUD/EUR	0.61	0.58	0.59	0.59	0.61	0.61
AUD/GBP	0.53	0.54	0.56	0.56	0.57	0.56
AUD/CNY	4.85	4.81	4.88	4.89	4.97	4.97
AUD/CAD	0.90	0.88	0.91	0.92	0.94	0.95
AUD/CHF	0.68	0.63	0.63	0.64	0.66	0.67

Interest Rate Forecasts						
	21-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australian Rates						
RBA cash rate	0.75	0.50	0.50	0.50	0.50	0.50
3 month bill rate	0.90	0.60	0.60	0.60	0.60	0.60
3 Year Swap Rate	0.83	0.70	0.70	0.85	0.95	1.00
10 Year Swap Rate	1.31	1.05	1.05	1.20	1.35	1.45
Offshore Policy Rates						
US Fed funds	2.00	1.75	1.75	1.75	1.75	1.75
ECB deposit rate	-0.50	-0.60	-0.70	-0.70	-0.70	-0.70
BoE repo rate	0.75	0.75	0.75	0.75	0.75	1.00
BoJ excess reserves rate	-0.10	-0.20	-0.20	-0.30	-0.30	-0.30
RBNZ OCR	1.00	0.75	0.50	0.50	0.50	0.50
China 1yr lending rate	4.35	4.10	4.10	4.10	4.10	4.10
China Reserve Ratio	13.0	12.50	12.00	12.00	12.00	12.00
10-year Bond Yields						
Australia	1.13	0.90	0.90	1.00	1.10	1.20
United States	1.75	1.50	1.50	1.60	1.70	1.80
New Zealand	1.26	0.95	0.95	1.05	1.10	1.30

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP				
	2018	2019	2020	2021
Australia	2.7	1.7	2.2	2.5
United States	2.9	2.2	1.6	1.8
Eurozone	1.9	1.1	1.1	1.4
United Kingdom	1.4	1.2	1.2	1.5
Japan	0.8	1.0	0.2	0.9
China	6.6	6.3	6.0	5.8
India	6.8	5.7	6.8	7.1
New Zealand	2.9	2.1	2.4	2.0
World	3.6	3.1	3.2	3.5

Commodity prices (\$US)					
	21-Oct	Dec-19	Mar-20	Jun-20	Sep-20
Brent oil	59.2	70	70	75	75
Gold	1490	1450	1483	1518	1547
Iron ore	na	76	72	68	71
Hard coking coal*	150	170	165	160	155
Thermal coal	69	90	93	90	88
Copper	5785	6300	6225	6150	6125
Aus LNG**	10	12	12	12	12

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

** Implied Australian LNG export prices

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