Economics | March 3 2015

Interest rates: Where do we go from here?

Reserve Bank Board meeting

- **The cash rate has left at a record low of 2.25 per cent. There is a clear bias to cut rates again.**

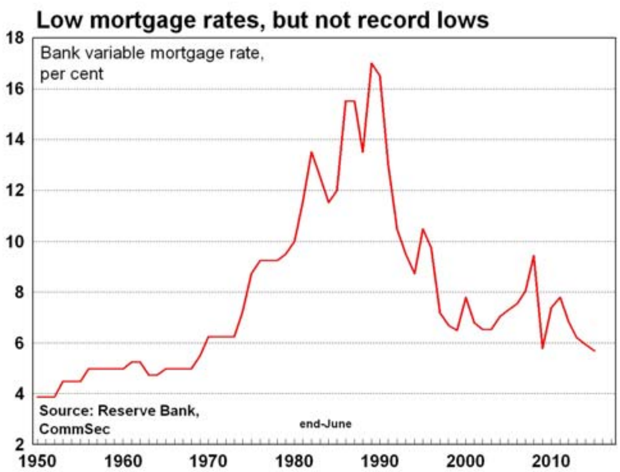
What does it all mean?

- The Reserve Bank has made a strategic decision and is conserving its ammunition. Rates may be cut again if the economy needs a bit more help. But there is no urgency, no panic. The statement is short, sharp and to the point. And that's why the decision can be applauded. Consumers won't be spooked by successive rate cuts. But rates are still low, and can fall further. So the decision is positive for confidence and hopefully causes more consumers and businesses to spend, invest and employ.
- **There is a clear bias to cut rates again:** *"At today's meeting the Board judged that, having eased monetary policy at the previous meeting, it was appropriate to hold interest rates steady for the time being. Further easing of policy may be appropriate over the period ahead, in order to foster sustainable growth in demand and inflation consistent with the target. The Board will further assess the case for such action at forthcoming meetings."*
- But with interest rates at generational lows (not record lows – housing rates in the 1950s were lower) the question is where do we go from here. And there are so many questions to be answered.
  - What are 'normal' rates?
  - Do rate cuts still work?
  - Are negative interest rates the new 'norm'?
  - If rate cuts don't work as well as in the past, what other tools can be applied?
- Certainly the global financial crisis changed things, particularly attitudes towards debt. Now even low interest rates are failing to entice consumers and businesses to take on debt. At the same time, global financial troubles have weighed on confidence levels, restraining economic growth and inflation, and thus justifying lower interest rates. And advances in technology and online shopping have increased competitive pressures on businesses,

Selected Policy Rates (%)

Norway	1.25
Canada	0.75
UK	0.50
US	0.25
Japan	0.10
Israel	0.10
Denmark	0.05
Euro zone	0.05
Czech	0.05
Sweden	-0.10
Switzerland	-0.75

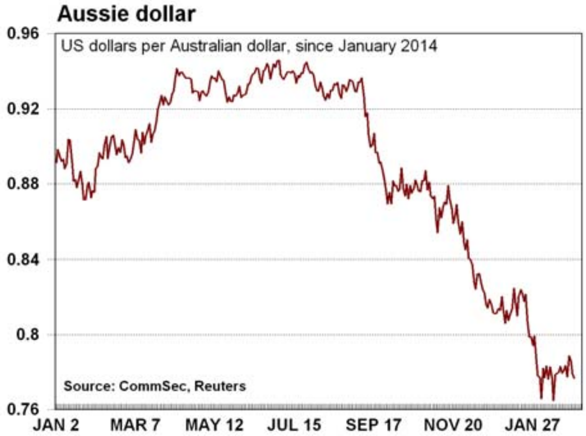
Source: global-rates.com, CommSec



Craig James – Chief Economist (Author)
(612) 9118 1806 (work); Twitter: @CommSec

restraining prices and inflation. Simply, people can buy goods from anywhere, adding new competitive pressures to pricing.

- While the current generation may think that the era of super-low interest rates are amazing, it's important to note that rates were even lower in the 1950s. Bank mortgage rates stood at 3.88 per cent in June 1950, whereas the current variable mortgage rate from the major banks is today around 5.65 per cent (fixed rates around 4.70 per cent).

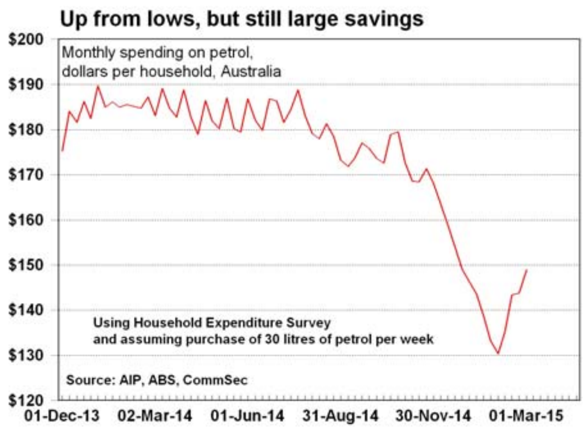


Perspectives on interest rates

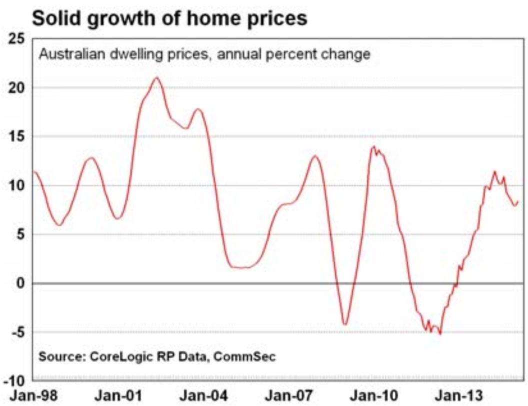
- The last rate cut was in February 2015 (25 basis points), taking the cash rate to a record low of 2.25 per cent.
- There have been nine rate cuts since November 2011.
- The Reserve Bank had previously lifted rates seven times from October 2009 to November 2010 – a total of 1.75 percentage points, from 3.00 per cent to 4.75 per cent.

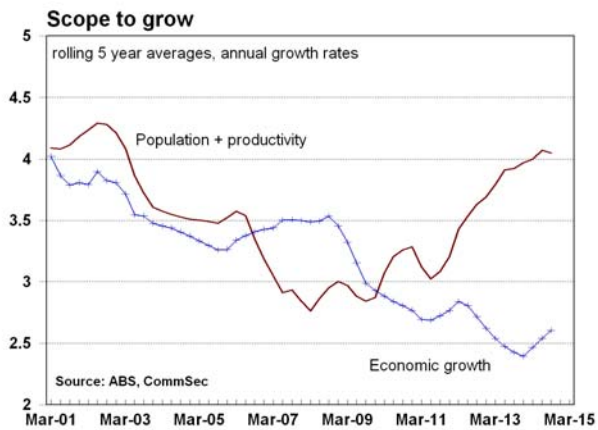
What are the implications of today's decision?

- Savers should have got the message by now – low interest rates are here to stay – at least for the next year, and possibly longer. As a result, savers need to secure the best possible returns, given the level of risk that they are comfortable with.
- Listed companies certainly have adjusted to the new environment, maintaining or lifting dividends to attract new investors. In the recent profit-reporting season, 86 per cent of all ASX 200 companies that reporting half-year results issued a dividend, above the long-term average of 83.7 per cent. Of all companies issuing dividend, 68 per cent lifted dividends, 24 per cent maintained dividends while only 8 per cent cut dividends.
- This is a new era for interest rates. The Reserve Bank will no doubt openly discuss the new environment over coming months, questioning whether rates can stay at current levels or fall further and provide a judgement about whether future rate cuts can still be effective in boosting economic activity.
- The fundamental factor holding back the Australian economy is confidence. Broadly, so-called economic fundamentals remain favourable. Inflation is low, interest rates are low, the budget deficit is still only around 2.5-3.0 per cent of GDP and home building is at record highs. Consumers and businesses just need more confidence to spend, invest and employ.
- The Reserve Bank may not have finished cutting rates. But Reserve Bank researchers, senior officials and Board members alike will do some soul searching in coming months to determine the best strategy to adopt in the new low rate era. CommSec continues to factor in one more rate cut with timing still an open question.



Craig James, Chief Economist, CommSec
Work: (612) 9118 1806; Twitter: @CommSec





Comparing the two most recent statements

- The statement from the February 2015 meeting is on the left; the statement from today's March 2015 meeting is on the right. Emphasis has been added to significant changes in the wording in the statements.

Media Release

No: 2015-01
Date: 3 February 2015
Embargo: For Immediate Release

Statement by Glenn Stevens, Governor: Monetary Policy Decision

At its meeting today, the Board decided to lower the cash rate by 25 basis points to 2.25 per cent, effective 4 February 2015.

Growth in the global economy continued at a moderate pace in 2014. China's growth was in line with policymakers' objectives. The US economy continued to strengthen, but the euro area and Japanese economies were both weaker than expected. Forecasts for global growth in 2015 envisage continued moderate growth.

Commodity prices have continued to decline, in some cases sharply. The price of oil in particular has fallen significantly over the past few months. These trends appear to reflect a combination of lower growth in demand and, more importantly, significant increases in supply. The much lower levels of energy prices will act to strengthen global output and temporarily to lower CPI inflation rates.

Financial conditions are very accommodative globally, with long-term borrowing rates for several major sovereigns reaching new all-time lows over recent months. Some risk spreads have widened a little but overall financing costs for creditworthy borrowers remain remarkably low.

In Australia the available information suggests that growth is continuing at a below-trend pace, with **domestic demand growth overall quite weak**. As a result, the unemployment rate has gradually moved higher over the past year. The fall in energy prices can be expected to offer significant support to consumer spending, but at the same time the decline in the terms of trade is reducing income growth. Overall, the Bank's assessment is that output growth will probably remain a little below trend for somewhat longer, and the rate of unemployment peak a little higher, than earlier expected. The economy is likely to be operating with a degree of spare capacity for some time yet.

The CPI recorded the lowest increase for several years in 2014. This was affected by the sharp decline in oil prices at the end of the year and the removal of the price on carbon. Measures of underlying inflation also declined a little, to around 2¼ per cent over the year. With growth in labour costs subdued, it appears likely that inflation will remain consistent with the target over the next one to two years, even with a lower exchange rate.

Credit growth picked up to moderate rates in 2014, with stronger growth in lending to investors in housing assets. Dwelling prices have continued to rise strongly in Sydney, though trends have been more varied in a number of other cities over recent months. The Bank is working with other regulators to assess and contain economic risks that may arise from the housing market.

The Australian dollar has declined noticeably against a rising US dollar over recent months, though less so against a basket of currencies. It remains above most estimates of its fundamental value, particularly given the significant declines in key commodity prices. A lower exchange rate is likely to be needed to achieve balanced growth in the economy.

For the past year and a half, the cash rate has been stable, as the Board has taken time to assess the effects of the substantial easing in policy that had already been put in place and monitored developments in Australia and abroad. At today's meeting, taking into account the flow of recent information and updated forecasts, the Board judged that, on balance, a further reduction in the cash rate was appropriate. This action is expected to add some further support to demand, so as to foster sustainable growth and inflation outcomes consistent with the target.

Media Release

No: 2015-03
Date: 3 March 2015
Embargo: For Immediate Release

Statement by Glenn Stevens, Governor: Monetary Policy Decision

At its meeting today, the Board decided to leave the cash rate unchanged at 2.25 per cent.

Growth in the global economy continued at a moderate pace in 2014. A similar performance is expected by most observers in 2015, with the US economy continuing to strengthen, even as China's growth slows a little from last year's outcome.

Commodity prices have declined over the past year, in some cases sharply. The price of oil in particular has fallen significantly. These trends appear to reflect a combination of lower growth in demand and, more importantly, significant increases in supply. The much lower levels of energy prices will act to strengthen global output and temporarily to lower CPI inflation rates.

Financial conditions are very accommodative globally, with long-term borrowing rates for several major sovereigns at all-time lows over recent months. Some risk spreads have widened a little but overall financing costs for creditworthy borrowers remain remarkably low.

In Australia the available information suggests that growth is continuing at a below-trend pace, with **domestic demand growth overall quite weak**. As a result, the unemployment rate has gradually moved higher over the past year. The economy is likely to be operating with a degree of spare capacity for some time yet. With growth in labour costs subdued, it appears likely that inflation will remain consistent with the target over the next one to two years, even with a lower exchange rate.

Credit is recording moderate growth overall, with stronger growth in lending to investors in housing assets. Dwelling prices continue to rise strongly in Sydney, though trends have been more varied in a number of other cities over recent months. The Bank is working with other regulators to assess and contain risks that may arise from the housing market. In other asset markets, prices for equities and commercial property have risen, in part as a result of declining long-term interest rates.

The Australian dollar has declined noticeably against a rising US dollar, though less so against a basket of currencies. It remains above most estimates of its fundamental value, particularly given the significant declines in key commodity prices. A lower exchange rate is likely to be needed to achieve balanced growth in the economy.

At today's meeting the Board judged that, having eased monetary policy at the previous meeting, it was appropriate to hold interest rates steady for the time being. Further easing of policy may be appropriate over the period ahead, in order to foster sustainable growth in demand and inflation consistent with the target. The Board will further assess the case for such action at forthcoming meetings.