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Monetary policy is spent: Its fiscal policy or bust

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Summary

Monetary policy is recognised as being less effective as official interest rates approach zero. There are two main reasons. First, spending in Australia on investment is not very responsive to reductions in interest rates. Second, any reduction in official interest rates is mediated by the banks and other financial institutions. For practical reasons deposit rates cannot go below zero so, in order to maintain interest margins banks have to resist reductions in lending rates and that effectively nullifies any impact of reductions in official interest rates.

Discussion

Philip Lowe, the Governor of the Reserve Bank of Australia (RBA), has virtually said that monetary policy in Australia is no longer effective and the burden should be taken up by a more active fiscal policy. Fiscal policy refers to taxing and spending arrangements so a more active fiscal policy would mean more spending, such as through increases in Newstart, spending more on health, education, building roads, bridges and the like.

By contrast monetary policy is the sort of things the Reserve Bank does such as reducing short-term interest rates, buying and selling in the wholesale government bond market and encouraging the banks to tighten or loosen their rates. In July Dr Lowe said that while 'Monetary policy does have a significant role to play and our decisions are helping support the Australian economy… we should not rely on monetary policy alone' (cited in Cranston 2019). The journalist covering this story was left in no doubt that Governor Lowe was flagging 'weakening monetary policy effectiveness'.

There are a number of aspects to the 'weakening monetary policy effectiveness'. First we note that the RBA has published research that shows corporate decision-makers do not take account of the incentives implied by different interest rates and decisions are dominated by other criteria. The RBA recently published a paper that pursued the topic and found that businesses used investment decision-making criteria that were crude and demanded very high rates of return that are much higher than the cost of capital in Australia (Lane and Rosewall 2015). This is reinforced by the OECD which said:

> *For some reason the 'hurdle' rate of return required to undertake new capital spending is so high that, despite historically low interest rates, economic growth is stagnating in many regions due in part to the lack of investment (OECD 2015).*

When we think about it these results make sense. On 6 September 2019 the 10-year government bond rate was 1.06 per cent. If a business made an investment with that yield it would take 92 years to get

its money back. So common sense says there is more than just the opportunity cost of capital, the alternative rate available on safe assets, that is relevant to the investment decision.

The RBA article also makes the point that business decision-makers are also interested in lots more than just the price and that demand is crucial. The National Australia Bank Monthly business surveys use the change in forward orders as their proxy for demand which then feeds into their forecasting. Research in the rest of the world is demonstrating that it is not price incentives so much as demand for products that are driving investment. In his famous limits-of-monetary-policy speech the former head of the Reserve Bank, Glen Stevens said 'the apparent opportunities for profitable investment [are] so weak, that real interest rates cannot equilibrate saving and investment for the system at positive rates of interest and full employment'. The Reserve Bank of Australia (RBA) has been concerned that in fact investment has not responded to successive reductions in the 'cost of capital' flowing from official interest rate changes.

When we think about this a bit further it is clear that the RBA is going to have trouble lowering interest rates in the private sector when rates are already so low. The RBA can only control conditions in the official money market which is closed to most people and companies. However, the official market is used by the private banks to manage their short-term liquidity and so the official market is used to influence the private banks. Hence the RBA wields its influence through influencing the private banks.

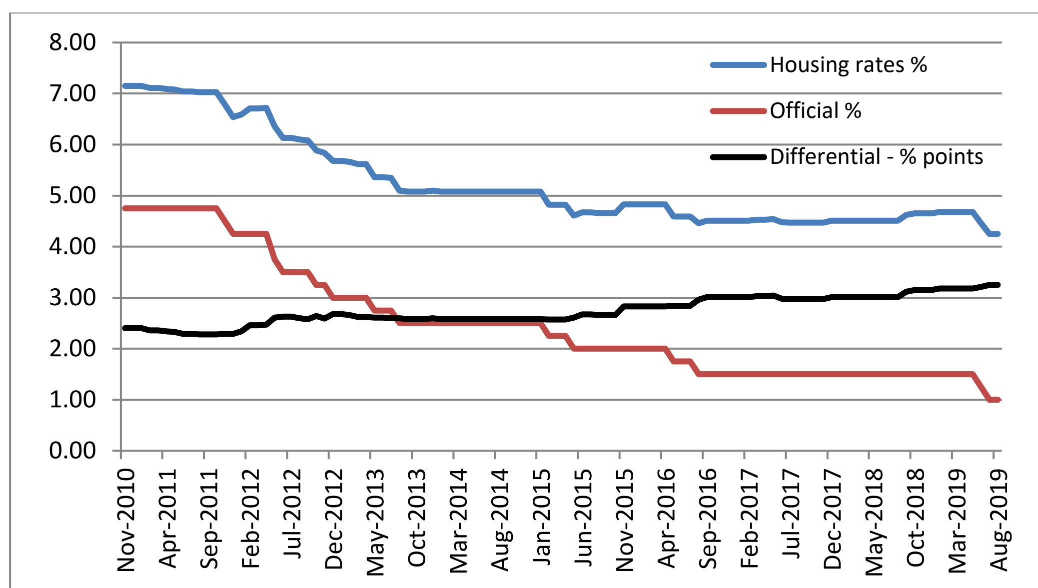
The private banks control most of the lending in Australia and these are going to resist any cut to their interest margins in various parts of their business when official rates are as low as they are now. Hence for example, banks and other deposit-accepting institutions[1] hold 70 per cent of the liabilities of the household sector and 90 per cent of the Australian loans of the non-financial corporate sector (ABS 5232.0).

An inspection of the data bank published by the RBA shows that interest rates on bank deposits are even zero on large deposits at call. That is of course below the 1 per cent official cash rate. The banks have to price above zero to get you to part with money in a term deposit, so they now offer around 1.5 per cent pa on $10,000 or so locked away for three years. If the official rate goes lower the interest rate on at-call bank deposits cannot really go down any further and the banks will still have to pay some premium to get you to part with $10,000 for 3 years. So it is difficult to see deposit rates going down much further.

In this environment and in order to maintain interest margins banks are going to be loathe to reduce lending rates. We can already see what has happened as official interest rates have been reduced over recent years by examining figure 1. Figure 1 uses housing interest rates (bank lending rates on housing loans; the variable, discounted rate for owner-occupation). Other lending rates show similar patterns.

[1] Credit unions, building societies in particular.

Figure 1: Housing loan rates, official interest rates and the difference.



Source: Author's calculations based on RBA data.

It is easy to see from the graph in figure 1 that the banks have increased the housing rate relative to the official rate as they tried to preserve interest margins. Since late 2011 the margin over the official rate was around 100 basis points. Around September 2018 the banks increased rates in a deliberate attempt to offset the zero lower bound effect. The banks used excuses such as increasing costs and seem to have held off increasing rates while under the gaze of the Hayne Royal Commission into banking (Janda 2018). Nevertheless the zero lower bound effect has been important.

Of course the graph also shows that when the RBA changes official rates the banks follow. This has been the pattern since 1990 when the RBA first started to post official interest rates. (Prior to that the RBA's intentions had to be guessed by looking at trades in the short-term money market.) Nobody ever suggested that changes in official rates should justify the exact same movement in banks' deposit and lending rates, but that is what tended to happen with rare exceptions. The RBA tended to act as the market setter in an oligopolistic market.

But now attempts to maintain margins on the part of the banks will see increasing departures from the automatic changes in line with the RBA changes. There are also likely to be other changes such as tightening up lending criteria so that a given interest margin produces a higher profit with fewer defaults on loans.

We saw official rates fall in 2016 and mortgage rates followed automatically. However, soon thereafter the banks acted to restore margins so that by early 2019 the 2016 rate reductions were almost completely offset with margin increases. One might expect those blowbacks to be quicker in the future. All of this increasingly means that reductions in the official rate will be less potent because the banks will increasingly resist passing on any reductions to their own customers.

We have made the point that the banks, especially the big four banks, make huge monopoly profits and if governments could reduce the monopoly profits, substantial savings could be passed on to

borrowers (see for example Richardson 2010). That remains true of course but it is unlikely we are going to witness any effective control over banks' monopoly profits soon.

We cannot be sure but the above is certainly the type of thinking Dr Lowe may have had in mind when he suggested monetary policy was becoming ineffective. Given less effective monetary policy then the Government only has one arrow left in its quiver. It must use fiscal policy to stimulate the economy.

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