Reining-in debt without using policy rates

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29 March 2019

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Australian official interest rates are set by the Reserve Bank of Australia (RBA), an independent body established in 1959. It operates within an inflation-targeting regime which seeks price stability in the 2%-3% consumer price index band. Originally, the RBA also governed prudential policy but, as a result of several large scandals and bankruptcies in the late 1990s, that role was transferred to a discrete entity titled the Australian Prudential Regulation Authority (APRA).

The RBA's role is set out in the *Reserve Bank Act 1959*. The Bank conducts the nation's monetary policy and issues its currency. It seeks to maintain a stable financial system in which financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors.

In late 1989, Australian official rates hit a cyclical peak at 19%. Afterwards, in what came to be known as the "Great Moderation" (this term was put forward in 2002 by James Stock and Mark Watson to describe the decline in the volatility of business cycles), official interest rates consistently fell alongside inflation and then oscillated in a band between 1.5% and 7.5%.

Australia remains a beneficiary of a rich endowment of resources which proved very attractive to China during the Global Financial Crisis. Consequently, Australian interest rates did not fall to the lows experienced in other developed markets. Indeed, Australia was the first developed market to raise interest rates after the crisis, though it subsequently had to lower them again as the commodity boom subsided.

During the 2000s, Australian interest rates began to be influenced by external economic pressures much more than in the past. This process was driven by the huge offshore borrowing of Australia's "big four" banks in wholesale markets. As their offshore liabilities ballooned, these banks were increasingly exposed to the fluctuations of far-flung markets and investors. This reached a head in the global financial crisis of 2008 when banks faced much higher demands from offshore investors for better risk-adjusted returns, forcing them to break with the Australian cash rate in setting local interest rates.

Ever since Australian banks have regularly adjusted lending and deposit rates unilaterally and independently around the target "cash rate" (the "official" interest rate on unsecured overnight loans between banks) set by the RBA. These interest rates moves are a constant source of political friction as politicians desperately seek to protect the Australian property bubble.

In 2015, the Australian interest rate policy returned to a shared responsibility arrangement between the RBA and APRA. The RBA has responsibility for monetary policy, overall financial system stability and regulation of the payments system. APRA has the responsibility for prudential supervision of deposit-taking institutions (banks, building societies and credit unions) as well as friendly societies, life and general insurance and superannuation.

With the lowest interest rates in fifty years, Australia experienced an asset price bubble and, if prices got out of line and there was a subsequent bust, problems could develop for the financial sector, particularly where such inflated assets are financed with debt. Should asset prices fall, financial institution solvency could be seriously undermined, leading to systemic difficulties for the banking sector. The solution found was to apply a macro-prudential policy to some mortgage lending so that interest rates could be lowered to take pressure off the currency.

There is a range of macro-prudential policy tools such as changing the tax treatment of ownership of investment properties (and mortgage interest), transaction taxes and property taxes. There are also specific macro-prudential tools such as higher capital requirements on either a sector-specific or general basis, dynamic provisioning and loan-to-value and debt-to-income restrictions. Other potential macro-prudential policy tools identified, and sometimes used internationally, include levies on foreign bank funding, so as to increase the costs of offshore borrowing that might be used to fund increased housing lending and increases to required liquidity levels.

The Australia housing bubble has burst even where new borrowers can get mortgage rates under 4%, unemployment is at 5% and has been falling for the past few years and the latest official GDP figures show the economy growing moderately. How is this possible? It can be argued that the single most important factor that determines home prices is not the rate of interest but the availability of credit i.e. how much you borrow determines how much you pay. Easy credit has been turned off through the intervention of APRA into the banking sector and subsequently by ASIC enforcement of responsible lending laws pushed along by the royal commission. In June 1989, interest rates were around 17%, people couldn't afford to borrow (or many cases repay debt). This time around, rather than pushing people into default with high-interest rates, as the RBA did in the late 1980s, APRA, ASIC and the royal commission into banking are simply forcing banks to lend more responsibly.