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August 2009

Understanding cash rates and how they shape the economy

Insights

A look behind the Reserve Bank of Australia's (RBA's) target cash rate, its impact on commercial lending rates, the $A, and what interest rate changes mean for the economy.

From September 2008 to March 2009 the Reserve Bank of Australia reduced cash rates from a high of 7.25% to 3.00%. One of the main aims of these uncharacteristically rapid cuts was to lower commercial lending rates and avoid an impending recession by stimulating growth in the Australian economy. However commercial lending rates have not fallen by nearly as much and in some cases are on the rise.

How the cash rate is set

As its starting point, monetary policy in Australia is established via the official cash rate, which is the interest rate the RBA pays on overnight loans between banks. The cash rate is determined by the RBA Board and announced in its monthly meetings. It is controlled by utilising the money supply of commercial banks in their exchange settlement accounts held with the RBA. For example, to change the cash rate, the RBA engages in open market operations. To lower interest rates, the RBA sells its reserves of securities and other financial market instruments, putting the proceeds into the settlement accounts of commercial banks. This excess cash then needs to be lent by the banks to maintain the target balance of their settlement accounts. The excess liquidity in the market leads to a fall in the target cash rate. The opposite occurs when the RBA raises the cash rate.

Changes in commercial lending rates

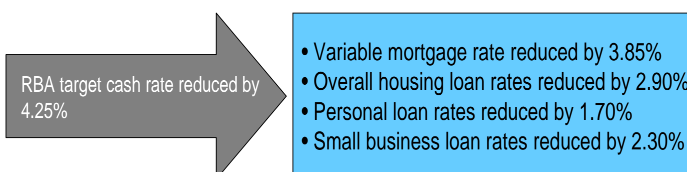
A rise in bank funding costs

Commercial lending rates are influenced by the major banks' overall cost of funding. Banks can draw on multiple sources of funding including deposits (which typically represent over half of their funding), short term capital market debt (approximately a quarter of their funding) and long term capital market debt (the remaining quarter). The target cash rate has an influence over capital market lending rates, bond yields and retail deposit rates.

Short term capital market lending rates have as their starting point, the bank bill rate, while long term capital market lending rates take their lead from the swap rate. Historically, both these reference rates decrease as cash rates fall. However increases in the risk premium due to the global financial crisis have raised commercial bank funding costs in this area. This risk premium is defined as the extra return required by lenders to compensate them for additional liquidity and credit quality concerns. The cost of funding sourced from deposits has also risen due to increased competition as banks seek to source more of their funding from this relatively stable source.

Maintaining profit margins

The additional costs faced by banks have meant that not every rate decrease from the RBA has flowed through to commercial banks' loan books. The RBA estimates that the interest rate on major banks' outstanding funding liabilities has declined by an average of 3.30% since the first reduction of the cash rate in September 2008. The table below illustrates the fall in the different types of commercial lending rates compared to the fall in bank funding costs and the official cash rate.



Source: Data sourced from the Reserve Bank of Australia as at 31 March 2009

A key driver of a commercial bank's profitability is its net interest margin. This margin is the difference between the commercial lending rates received from its portfolio of loans less the cost of funding. In the diagram above, the 3.85% reduction on the variable mortgage rate is more than the total funding cost reduction (3.30%). The result is a decrease in the net interest margin or a loss for the bank.

However housing loan rates overall have fallen by just 2.90%, representing an increase in the net interest margin or a profit on home loan portfolios. Similarly, personal loan and small business loan rates have fallen considerably less than both variable rates and housing rates overall (1.70% and 2.30% respectively), as commercial banks reduce the supply of credit, penalising loans with lesser underlying asset values.

According to the RBA's data, the total net interest margin by the banks on their loan portfolios rose by 0.09% over the six months to March 2009, an amount the banks will feasibly want to increase further.

How interest rate changes affect the economy

Adjustment of spending patterns

As a general rule, consumers and businesses adjust their spending patterns by either increasing savings when interest rates rise or spending more when interest rates fall. A secondary effect of cheaper and more available debt is that businesses are more able to invest in future projects, helping to create jobs and subsequently increase domestic consumption.

Over the last year and with the onset of the global financial crisis, the RBA dramatically reduced interest rates to stimulate consumption and support economic growth. Given the nature of the crisis, the Federal Government decided it wasn't enough to lower interest rates and proceeded to inject cash into the economy via one–off payments to eligible consumers plus implement a range of other fiscal stimulus programs. Both the lower interest rates and the fiscal stimulus have encouraged people to spend more, which is reflected in recent retail sales data and consumer sentiment survey results. Whether this sentiment continues as the stimulus is withdrawn from the economy remains to be seen.

Changes to export and imports

Lower interest rates also reduce foreign investment due to the lower rate of return available on their investment. As offshore capital investment falls, the demand for Australian dollars decreases, lowering its relative value in comparison to other major currencies. The lower Australian dollar increases the cost of imports (which detracts from GDP). However Australian exports which are denominated in foreign currency have greater value as the amount of Australian dollars received increases (a positive impact on GDP).

In the very early stages of the global financial crisis, foreign investors moved away from what they perceived as risky currencies such as the Australian dollar into safe haven currencies such as the US dollar. This caused a relatively rapid depreciation in the Australian dollar in late 2008 not helped by the rapid drop in the official cash rate at the same time. However, the lower Australian dollar acted like an income cushion, adding value to commodity exports to emerging Asian countries like China. Further, as China's domestic demand increased, so did the price of commodities which provided a further boost to GDP.

As the financial crisis eased in mid 2009, foreign investors began to invest in riskier assets again, leading the Australian dollar to rise back to pre-crisis levels. Not only was the Australian dollar attractively cheap at that time but the overall interest rate of three percent was still significantly higher than rates offered in other developed economies including the US. In this case, while interest rates were comparatively lower than they had been earlier in 2008, they were still attractive in relative terms, helping attract foreign investment in Australia.

Inflation

Rising inflation occurs when demand exceeds supply of goods and services, leading to increase in prices. When the economy is close to full employment, the cost of hiring additional workers to meet excess demand can soar. This so-called wage inflation leads to an increase in consumption which in turn increases the demand for imports, reducing net income. Such conditions typically call for higher rates to curb both demand and inflation.

Currently, with interest rates at historic lows and following government stimulus, the RBA is remaining balanced on whether the economy could over-heat and lead to a pick up in inflation. The RBA is beginning to alert people that low interest rates cannot be sustained indefinitely, and the next move may well be up.

How low can rates go?

Financial markets, especially in the fixed interest area are 'pricing in' an expected increase in the cash rate to more normal levels by the end of the year, with further increases over 2010. Expectations are based on an improvement in economic conditions from the lows of six months ago, coupled with inflation concerns generated from significant government stimulus which could eventually push interest rates upwards.

However, at present, the Australian economy is in a period of falling inflation against a backdrop of rising unemployment. Economic data indicates that, while improving, output levels and conditions remain significantly lower in absolute terms to levels seen in the last several years. This implies that economic recovery will be a slow grind rather than the "V-shape" recovery some commentators have suggested. Chief Economist and Head of Investment Strategy, Dr Shane Oliver, maintains the view that the RBA will not be changing the official cash rate in the short term.

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