

Vital Signs: only the banks know how low rates can go

Written by The Conversation

Vital Signs is a weekly economic wrap from UNSW economics professor and Harvard PhD Richard Holden (@profholden). Vital Signs aims to contextualise weekly economic events and cut through the noise of the data impacting global economies.

This week: gloomy data isn't helped by the big 4 banks holding back on interest rate cuts.

The big, but completely unsurprising, news this week was the Reserve Bank of Australia cutting the cash rate to an historic low 1.50%.

As Vital Signs has been saying for some time, this month was a likely candidate for a cut, once second-quarter inflation was confirmed to be disturbingly low – as it was last week.

Australia is faced with extremely low inflation, low effective growth, a squishy labour market, and prudential regulation measures enacted last year partially reigning in the housing market. Given this, it was almost inevitable Glenn Stevens would engineer another cut.

But there were some other figures of note this week. Australian retail trade rose 0.1% in June, compared to market expectations of 0.3% – further underlining the weak domestic economy.

Adding to that story of gloom, private sector building approvals were down in June, both in absolute terms and relative to expectations. House approvals fell 2.3% implying a 5.9% drop compared to a year earlier. Apartment approvals fell 2.4%, implying a 4.8% drop year-on-year.

Chinese manufacturing data was mixed – or perhaps just confusing – with the official Purchasing Managers' Index (PMI) down to 49.9, from 50.0 the month before. Recall that 50 is the break even between expansion and contraction. Meanwhile, the private Caixin index came in at 50.6 in July, up from 48.6 in June. This was the first jump above 50 since February 2015.

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Why the difference? The likely answer is that the official government PMI is more relevant for large, state-owned enterprises, while the Caixin index is a better gauge of smaller and medium-size companies.

In the US, payroll processing firm ADP's latest data revealed a 179,000 increase in non-farm payrolls in July. This was essentially confirmation of the official Bureau of Labor Statistics figures (though on a slightly different scale) of strong job creation in the US. This is further evidence of the likelihood of a rise in official rates by the Fed in the next month or two.

Now, back to Australian interest rates. Lower rates only have a potential stimulatory effect if they are passed on to borrowers by (largely) the big 4 banks. About half of Tuesday's cut was passed on – with the rest “kept” for bank shareholders.

On Thursday afternoon, Prime Minister Malcolm Turnbull and Treasurer Scott Morrison [announced at a press conference](#) that the big 4 banks would have to front the House Economics Committee annually to “explain” their interest rate decisions.

Populist nonsense? Interventionist joke? Meaningless charade? Those are all phrases that come to mind. Turnbull grinned like a Cheshire cat as he described it as a “great opportunity” for the banks. Ho, ho, ho.

I'm no apologist for the banks, but they do have a legitimate argument that their funding costs have been rising. The US money market funds are much harder to tap as they have become significantly more conservative after the Primary Reserve Fund [“broke the buck”](#) during the financial crisis. Deposits now make up about 60% of bank funding, compared to 40% in 2007-08 – and those rates have been rising.

Nonetheless, the banks do have a good deal of market power. It's legitimate for them to use that, unless they are violating competition law. That's a matter for the Australian Competition and Consumer Commission, not the House Economics Committee.

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One final note. To all those people who keep saying “rates have been cut a lot and it hasn’t done any good”: please search my name and the word “counterfactual”.

Richard Holden is an ARC Future Fellow.

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