

Financial Insights

with Australian Unity Personal Financial Services

6 February 2012

Why central banking is becoming increasingly challenging

By Macquarie Research Team

The past four years have presented the greatest challenge to central banks in a generation. Indeed, not since the shift to explicit inflation targeting 20 years ago has the entire modus operandi of central bankers been questioned.

It is understandable that central bankers have taken some unprecedented steps over the past four years - from the Federal Reserve's implementation of quantitative easing and purchase of mortgage backed securities, to the European Central Bank's provision of an unlimited three year lending facility. While economic historians Carmen Reinhart and Kenneth Rogoff have shown that the current financial turmoil is not a new phenomenon, the response of central banks certainly is.

Unscathed Australia...

The Reserve Bank of Australia has come through the turmoil relatively unscathed. Unlike most developed countries, where policy rates are close to zero (and savings rates for household deposits also near zero), the RBA's official cash rate finished 2011 at a neutral setting of 4.25 per cent. Nor has the RBA had to resort to extraordinary monetary policy measures.

And inflation targeting remains firmly in tact in Australia – with the RBA's target of underlying inflation between 2-3 per cent over the medium term. This compares to other regions where central banks have become increasingly concerned about metrics such as employment, exchange rates, and long-term interest rates. That is not to suggest no relationship between these metrics and inflation, merely that the pre-2008 era of basing monetary policy off the medium-term inflation outlook has been considerably complicated since that time, and possibly for the long term.

A loosening bias is taking hold

Interest rates in Australia remain in neutral territory. This is despite increasing evidence of weakness in the domestic economy, with the manufacturing (and tourism) sectors struggling under the strength of the Australian dollar, and households becoming increasingly cautious in spending

and investment behaviour as an expected multi-year deleveraging cycle gets underway. With businesses struggling to increase sales and retain profitability, employment conditions have also deteriorated over recent months, with employment growth failing to keep pace with population growth and the unemployment rate rising to 5.25 per cent.

With the domestic economy slowing, concerns over capacity constraints in resource operations now on the back-burner, and revised inflation data indicating that underlying inflation – at 2.5 per cent - is comfortably within the RBA's target band, the official cash rate was lowered by 25bp in both November and December 2011 on intensifying concerns over the downside risks from global events. This saw rates move from a tight to a neutral setting. Moreover, economists and interest rate futures markets both suggest that a further 50bp of rate cuts are likely over the next 6 months.

Breaking the nexus on monetary policy

However the benefits may not be entirely felt by households, with several factors aligning to break the nexus between monetary policy and domestic interest rates.

Indeed, the first signal of this was the decision of ANZ, in early December 2011, to announce changes to its lending rates on the second Friday of each month, up to 10 days after the policy announcement by the RBA. And the first risk is that this dampens the signal of monetary policy. For the past 20 years, whenever the RBA decided to shift interest rates settings at its monthly Board meeting on the first Tuesday of each month, the outcome would be broadcast on the evening news that night and on the front page of newspapers the following day. Of course, this was relevant for the one third of households with a mortgage, as well as those households thinking about entering the housing market. But it was also a clear signal for businesses, from struggling home-builders deciding whether to lay off staff, or retailers deciding to hire more part-time workers.

1

Hence the effectiveness of monetary policy – both in terms of the magnitude of its effect and its timeliness – increased because of its impact on expectations. And this is now at risk. Mortgage holders will not only have to focus on what the RBA does, but then monitor their own bank. And the message is even less clear for businesses. Hence the 'signal' element of monetary policy is at risk of being lost.

The second risk is that the link between the RBA's policy rate and market interest rates gets disrupted. Funding costs for Australian banks have increased substantially over the past three months due to the European sovereign debt crisis. And hence it would be unsurprising if the Australian banks opt not to pass through the full extent of any policy rate cuts by the RBA. Of course the RBA still has plenty of room to move, and can simply continue to lower rates to achieve the desired decline in market rates that it considers necessary. However the time taken to achieve this is extended.

Finally, an increasing proportion of Australian households are opting for fixed rate mortgages. While typically a small proportion of the mortgage market in Australia, fixed rate mortgages have the disadvantage of muting the policy transmission mechanism as lower variable rates do not automatically translate to lower interest repayments.

Indeed, given the standard two year fixed rate term, this can equate to some households not receiving the benefit of lower interest rates for almost 24 months following a lowering of the official cash rate. And by this time, the economic outlook may have changed substantially.

Nonetheless, Australia remains in an enviable position relative to global peers. And monetary policy is unlikely to become completely ineffective. Merely, it is possible that it will become less effective than it was prior to the financial crisis. And that this will result in a more volatile cash rate cycle in Australia.

Who is Australian Unity Personal Financial Services?

We specialise in providing professional strategic advice to help you improve your current financial position and ultimately achieve your long term lifestyle goals.

Importantly, our initial advice isn't a 'set and forget' service. Instead we offer you regular financial mentoring and ongoing guidance – in all aspects of your personal finances – to set you, and keep you, on the path to financial wellbeing.

Our team of experienced financial professionals can provide you with a detailed and totally tailored blueprint for financial success in any or all of the following areas:

- Financial advice
- Wealth creation
- Retirement planning
- Investments
- Superannuation
- Home loans
- Commercial loans
- Investment loans
- Equipment finance
- Car finance
- Personal estate planning
- Business estate planning
- Personal risk insurance
- Business risk insurance

Australian Unity has a proud 170 year heritage of helping Australians create secure financial futures. This pedigree and experience, combined with our corporate strength and leading edge strategic advice capability, means we are uniquely placed to offer you high quality personal financial services... each finely tuned to your particular needs to ensure you achieve your vision of a secure financial future.

After all, your financial wellbeing is at the heart of everything we do.

MoneyInsights[®]
with Australian Unity Personal Financial Services

Australian Unity Personal Financial Services is committed to providing Australians with a genuine understanding of their investment options. This is achieved via our comprehensive investor education program called Money Insights.
Because knowledge is the first step to creating a secure financial future.

Disclaimer: Unless otherwise indicated, the information in this newsletter is provided by Australian Unity Personal Financial Services Limited ABN 26 098 725 145 AFSL & ACL 234459. This information has been prepared without taking into account the investment objectives, financial situation, tax position or particular needs of any individual person. Because of this you should, before acting on it, consider its appropriateness, having regard to your objectives, financial situation and needs. You should obtain a copy of the Product Disclosure Statement before making any decisions about any product. Reasonable care has been taken to ensure that information in this newsletter is derived from sources believed to be accurate, and that examples are fair and reasonable. However, it should not be considered a comprehensive statement on any matter nor relied upon as such and Australian Unity Personal Financial Services Limited does not guarantee the accuracy or completeness of the information. Any taxation or legal position described is a general statement and should only be used as a guide. It does not constitute tax or legal advice and is based on current laws and their interpretation. We recommended that you speak with an Australian Unity Adviser to review your individual situation. This document produced in February 2012. © Copyright 2012

If you no longer wish to receive 'Financial Insights' please send an 'Unsubscribe' email to the person who sent it to you.