ECONOMIC UPDATE
PETER MUNCKTON – CHIEF ECONOMIST
WEEK ENDING 8TH OCTOBER 2021

BOQ GROUP

Key points

- **There has been a forty-year downtrend of the cash rate in Australia;**
- **This has been caused by both a decline of inflation and 'real' interest rates'**
- **And most likely the cash rate will remain at its current level for the next couple of years;**
- **But the groundwork is being laid for a (modest) shift higher of interest rates.**

Summary

For forty years interest rates have been on a declining trend. That decline has mainly reflected two factors: slowing inflation and falling 'real' interest rates.

Most of the trends for lower inflation have been in place for some time. But in combination with the weakness of global economic growth post GFC it has resulted in global central banks (and most economists') to overestimate inflation and wages growth outcomes for much of the past decade. The result has been lower interest rates.

There has also been a substantial decline in 'real' rates. A fair bit of the discussion has revolved around a fall in the demand for funds (which would drive interest rates lower). But I think it is more likely to have been a result of a rise in global saving (increasing the supply of funds). That rise started in the late 1990's. In more recent years central banks' QE policies have played a role.

It can't yet be ruled out that the forty-year trend decline in interest rates has further to run. One clear possibility is that the recovery from COVID ends up being slower and more prolonged. A bigger risk for rates heading lower in my view is the significant amount of global debt. High debt levels means that Governments and central banks can't let 'real' interest rates get too high otherwise there would be a large number of defaults.

But the bigger picture is that many of the things that you would need to see to get a change in the interest rate trend are now getting in place (with the exception of high debt levels). A growing number of Governments around the world are getting less worried about budget deficits. Many central banks (including the RBA) are explicitly aiming for stronger growth, lower unemployment, higher wages and higher inflation. There are cracks appearing in the global trading and financial market systems. Global investment spending will continue to be strong, driven by infrastructure demands and a need to de-carbonise economies.

A change in the interest rate trend may not be obvious for the next 1-3 years as we move through the final stages of COVID, the debate about whether price rises are temporary or permanent and the impact of Central Banks' reducing has on asset prices (such as equities).

The very long-run trend of interest rates has been down (due to improvements in communication and transport). But around that long-run trend there has been cycles where interest rates head up, as well as down. It looks increasingly likely that the groundwork for a trend shift towards (modestly) higher rates is starting to be laid.

Interest rates – The end of the line

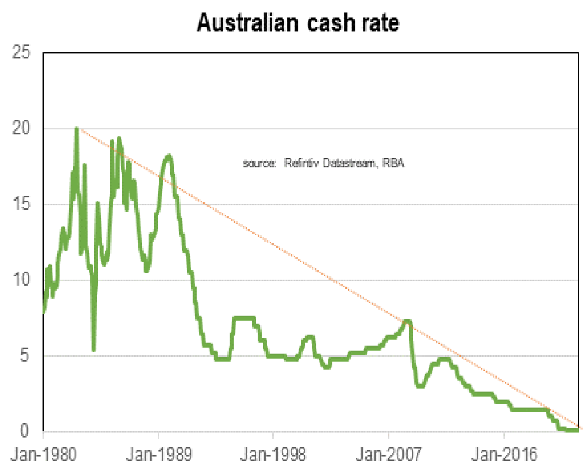
For forty years interest rates have been on a declining trend. Much of the economic discussion that takes place in Australia tends to focus upon domestic developments. But the declining trend of interest rates has been a global one. That decline has mainly reflected two factors: slowing inflation and falling 'real' interest rates.

The trend decline of inflation has reflected a variety of factors. Developments in technology has not only meant that things could be built cheaper, it has made it easier for consumers and businesses to compare prices. It also has enabled outsourcing. Technology has led to a massive reduction in transport and communication costs. A globally integrated trading system (particularly the entry of China) allowed for goods (and increasingly services) to be produced in the most efficient locations. Globalisation also increased competition for domestic firms making them more reluctant to raise prices.

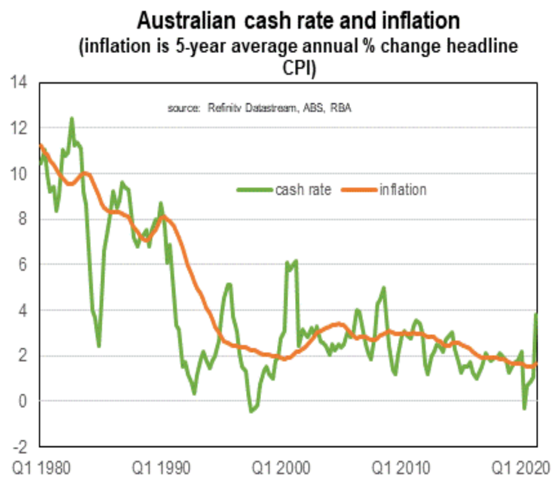
The tougher competition from globalisation for Australian firms meant that wage rises needed to be largely funded by higher productivity (otherwise firms' would lose competitiveness). The RBA Governor has noted that high immigration increased the supply of labour, putting downward pressure on wages growth. Independent central banks were given a mandate to keep inflation low.

Most of these trends have been in place for some time. But in combination with the weakness of global economic growth post GFC it has resulted in global central banks (and most economists') to overestimate inflation and wages growth outcomes for much of the past decade. The result of lower inflation has been lower interest rates.

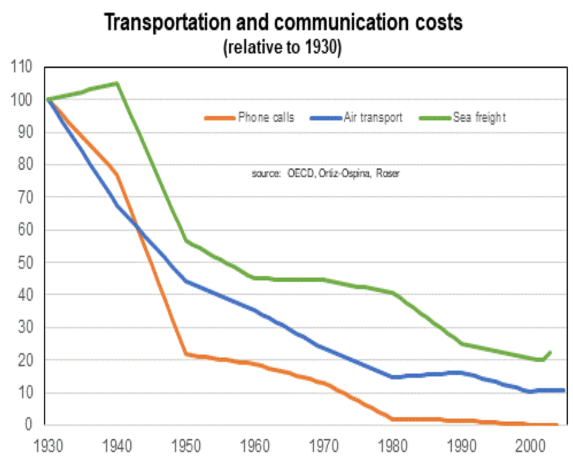
There has been a four-decade downtrend of interest rates.



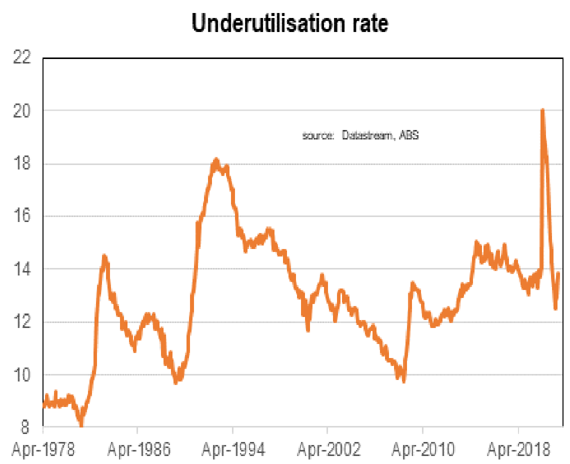
An important driver has been the decline of inflation.



There has been a dramatic fall in transportation and communication costs over the past century.



Over the past decade the Australian (and global) economies have not been strong enough for long enough.

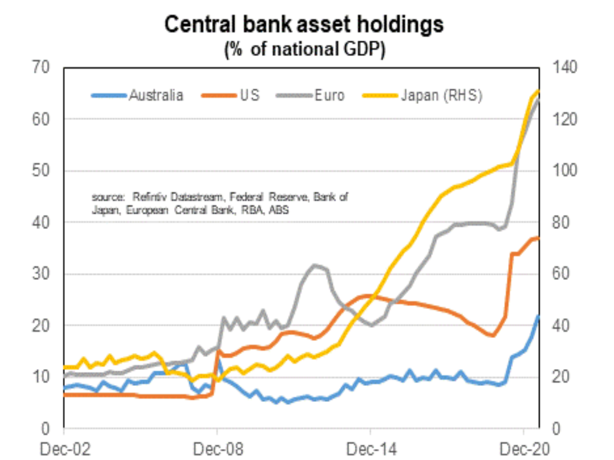


There has also been a substantial decline in 'real' rates. This is measured as the level of interest rates after taking into account inflation and is impacted by the demand and supply of funds. A fair bit of the discussion has revolved around a fall in the demand for funds (which would drive interest rates lower). Analysts making this argument point to a decline of GDP growth (due to both slowing population and productivity growth). Certainly slowing GDP growth has been a fact of life for developed (OCED) countries. But it has not been true for the world economy where (according to the IMF) growth has averaged about 3% for forty years (underpinned by the strong growth of the Chinese and Indian economies). A related suggestion is that declining investment has led to a lower demand for funds. Again that is true in the developed world where lower investment has been a factor behind weak GDP growth. But that has not been true for the world economy for the past twenty years where (again according to the IMF) the global investment rate has actually been increasing (China again playing a crucial role).

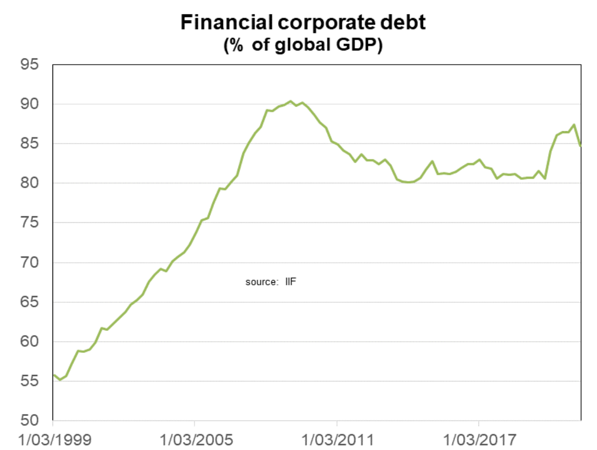
This suggests that the decline of 'real' rates is more likely to have been driven by a rise in global saving (increasing the supply of funds). That rise started in the late 1990's as Asian countries increased their saving by building big foreign exchange reserves to support their currencies after their torrid experiences during the Asian Crisis. Global saving got a further boost when the Chinese economy started cranking up big time in the late 1990's into the 2000's, leading to a big rise in Chinese income and therefore saving (partially offset in the 2000's by a fall in US saving as US consumers' went on a spending binge on cheap goods).

In recent years there has been two other additional sources of saving. First, the large run-up of debt that caused the GFC led central banks to drastically reduce interest rates and start quantitative easing (QE, where central banks buy large amounts of government bonds and other financial assets). When COVID hit rates fell further. But because the cash rate in most economies was already so low central banks massively expanded their QE programs. Second, the change in bank regulations post GFC meant that not only did banks have to de-leverage (removing a source of borrowing) but they became big buyers of government debt. Also, for much of the period governments (apart from the US) were focussed upon minimising debt and deficits. Finally, the significant reduction in communication and computing costs (as well as the de-regulation of financial markets) made it easier for saving to flow to countries providing the best returns.

Central bank buying has become a substantial force in financial markets over the past decade.



The amount of bank debt outstanding is lower now than it was pre-GFC.

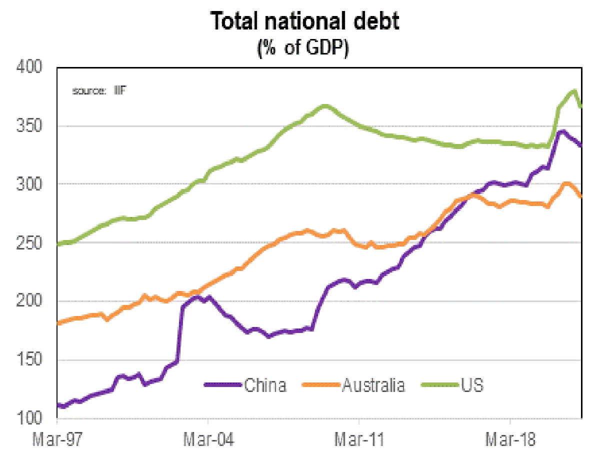


So that was then. But what will happen.

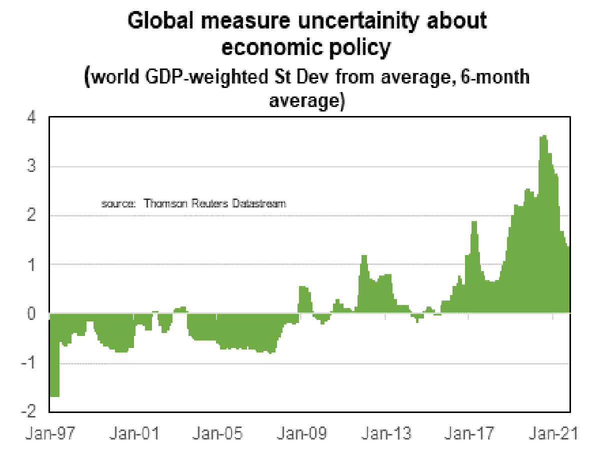
It can't yet be ruled out that the forty-year trend decline in interest rates has further to run. One clear possibility is that the recovery from COVID ends up being slower and more prolonged. And until case numbers (and hospitalisations) stabilise at a lower level that can't be ruled out. But to date the evidence suggests that the vaccines developed have remained effective about preventing serious illness against all the strains of COVID.

A bigger risk for rates heading lower in my view is the significant amount of global debt. Most economies have at least one part of their economy that has 'high' debt (household debt in Australia, Canada and New Zealand, government debt in the US). The biggest risk is probably in China where corporate debt is very high for its stage of economic development (highlighted by the recent problems of Evergrande and other property developers). There are good reasons to think the Chinese government will be able to contain the problem. China has a closed financial system which means there is little foreign debt. And their regulators have plenty of power to ensure there is a resolution to any problems. But high debt levels means that globally Governments and central banks can't let 'real' interest rates get too high otherwise there would be a large number of defaults.

China has seen a significant rise in debt over the past twenty five years.



There has been a substantial rise in uncertainty about the global economic outlook over recent years.



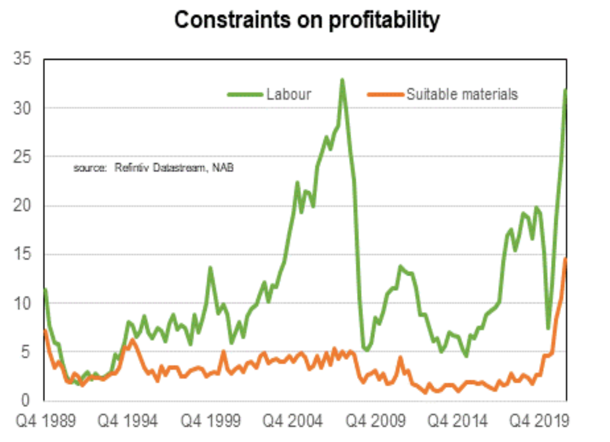
The no surprise RBA

Following its October meeting the RBA announced that it would keep the cash rate unchanged, as well as continuing to buy $4b of Federal and State Government debt every week until February when the bond-buying policy will be reviewed. The decision was not a surprise. The RBA believe that once the Lockdowns end there will be a substantial bounce in economic growth. But the course of the Pandemic and how Governments', firms and consumers react are a major unknown.

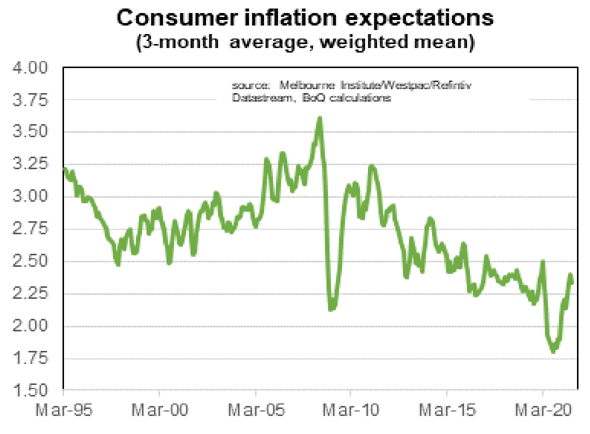
There are good reasons to think the RBA is right that economic growth will strengthen. But the virus will still be around and will likely still have some impact upon demand. As with now some sectors and regions of the economy will be harder hit than others. But as many overseas economies are currently finding out it will also have a significant impact upon supply.

Everyone agrees that higher demand and supply constraints gets you higher prices. The difference of view comes down to how long the supply constraints will last. I think they will last for 12-24 months. And with the economy likely to remain strong that will put pressure on interest rates to go up earlier than the RBA's current view of the first half of 2024 (my forecast is the second half of 2023).

Constraints on materials and workers are likely to be an issue for the economy for much of next year.



To date higher prices has not changed consumers' inflation expectations.



The trend decline of interest rates is likely over

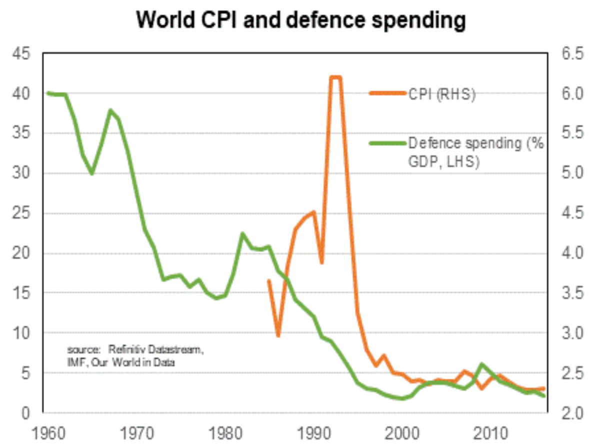
Leaving aside developments over the next year or two the bigger picture is that many of the things that you would need to see to get a change in the interest rate trend are now getting in place (with the exception of high debt levels).

A growing number of Governments around the world are getting less worried about budget deficits. Governments' are also spending more on defence that has less direct productivity benefits for the economy (but can be a good source of R&D). Many central banks (including the RBA) are explicitly aiming for stronger growth, lower unemployment, higher wages and higher inflation. There are cracks appearing in the global trading and financial market systems, with the world looking to be splitting into US-China (and maybe European) sphere's. This could lead to reduced flow of goods, services, capital (and potentially people). China is looking to boost consumer spending (reducing saving), and could do so by running larger fiscal deficits to finance higher social spending. Global investment spending will continue to be strong, driven by infrastructure demands and a need to de-carbonise economies.

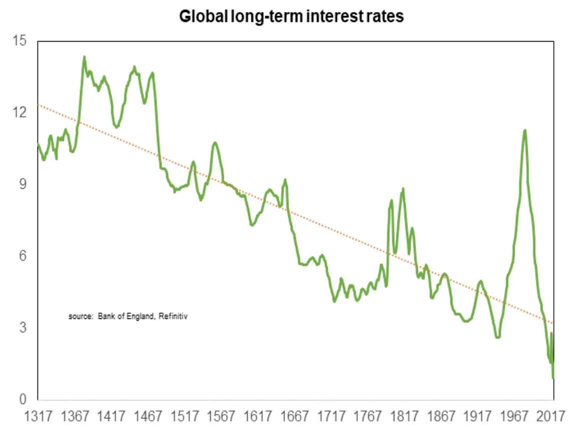
It is possible that growth worries, large-scale debt defaults or heightened financial market volatility leads to another step down in global interest rates. But more likely is that the trend decline in rates is coming to an end. That may not be obvious for the next 1-3 years as we move through the final stages of COVID, the debate about whether price rises are temporary or permanent and the impact of Central Banks' reducing has on asset prices (such as equities).

The very long-run trend of interest rates has been down (due to improvements in communication and transport). But around that long-run trend there has been cycles where interest rates head up, as well as down. It looks increasingly likely that the groundwork for a trend shift towards (modestly) higher rates is starting to be laid.

Falling defence spending and low inflation: coincidence or causation.



The very long-term trend of interest rates has been down. But there has also been plenty of cycles.



We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland