Philip Lowe: Investing in a low interest rate world

Address by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Commonwealth Bank of Australia's 7th Annual Australasian Fixed Income Conference, Sydney, 21 October 2014.

*   *   *

Thank you very much for the invitation to speak tonight at the Commonwealth Bank's 7th Annual Australasian Conference. I would like to extend a particularly warm welcome to those of you who are visiting Australia to gain first-hand knowledge of our economy and our financial markets. Welcome to our shores.

The general topic that I would like to speak about this evening is investing in a low interest rate world.

No doubt this is an issue that you have all pondered over recent times. No doubt you have all thought about which assets offer the most attractive returns in the post-crisis world in which interest rates in many countries are extraordinary low. And no doubt you have thought about the risks that come with those assets.

I am not a financial advisor, so I will refrain from giving you advice on how to grapple with these difficult issues. But I would like to talk about a couple of the general challenges that we face in this world of low interest rates.

The first issue has an international dimension and it has been the focus of many of the discussions around the G20 table this year – and that is, how do we translate greater risk-taking on the financial side of the economy into greater risk-taking on the real side. The second issue, which has a more domestic focus, is recent developments in the Australian housing market.

The international challenge

It is useful to start with a reminder of just how unusual the current global environment is. Interest rates are as low as they have ever been in most advanced economies. In the United States, the euro area, Japan and the United Kingdom official interest rates are essentially zero. In Germany, investors actually pay the government for the privilege of lending to it for terms of three years or so. And in the euro area, banks are now faced with negative interest rates on their deposits at the European Central Bank (ECB), and the ECB is prepared to lend money to banks for terms of up to four years at just 15 basis points.

A number of the major central banks have also engaged in very substantial money creation to buy large quantities of assets from the private sector, including government bonds, asset-backed securities and equities. As a result, financial institutions are holding record balances at central banks and central banks have become very large managers of assets themselves.

While it is easy to lose track of time, global monetary affairs have been in this very unusual territory for quite some time. It is now six years since the financial crisis was at its peak. Even with the knowledge that the recovery from financial crises can be frustratingly slow, few observers predicted that the crisis would throw such a long and enduring shadow over monetary and financial conditions in so many countries.

This shadow has created a difficult environment for savers and those managing savings. Perhaps at the risk of over-simplifying things, they have three basic choices:

1. They can leave the savings in the bank and earn zero (or less).
2. They can use the savings to purchase *existing* assets from other investors in the hope of earning a positive return.

3. They can use the savings to finance the development and creation of *new* assets, for example a new piece of capital equipment, a new building or some new intellectual property.

It is this third use of savings that is critical to the resumption of strong growth in the global economy.

When the crisis hit in 2008, the first of these three savings choices dominated. Investors were intent on preserving their capital and remaining as liquid as possible. Many sold their more risky *existing* assets and the prices of these assets declined, in some cases significantly. There was an even more precipitous decline in the demand for *new* assets, with aggregate investment in many countries dropping to very low levels as a share of GDP.

As we gradually climbed out of the crisis, attitudes to investing evolved. Faced with very low interest rates on safe assets and evidence that the global economy has been on a recovery track of sorts, investors have been prepared to move out along the risk spectrum and purchase existing assets as they search for yield. In response, the prices of these assets have risen again.

This rise in the prices of existing assets is understandable. Indeed, it is one of the channels through which stimulatory monetary policy works. Low interest rates make it less attractive to hold savings in bank deposits and more attractive to hold other existing assets – and prices respond. The higher asset prices should then both encourage, and make it easier for, firms to increase their investment spending – that is, to use their savings to finance the creation of new assets.

It is this latter part of the transmission channel that is proving frustratingly slow in many countries. The strong demand for many *existing* assets has not yet generated a strong appetite for the creation of *new* assets. Many investors remain very cautious when considering funding business expansion and aggregate investment remains low. In response, central banks have felt that they have had no choice but to continue with very expansionary policies and, in some cases, to add yet further stimulus. The hope is that in so doing they will eventually induce a shift from the world of strong demand for existing assets to one in which there is strong demand for the new assets that will create the growth and jobs that are so badly needed.

This slow transition has been one of the central issues that we have discussed around the G20 table over the past year under Australia's presidency. A key question we have been asking ourselves is what can be done to speed up this transition.

One perspective is that it is just a matter of time. It takes time for demand to recover, for excess capacity to be wound back and for business confidence to return. Time also leads to the depreciation of the existing capital stock. So, maybe we just need to wait a bit longer. In the United States, we are, perhaps, getting close to the point where things will turn. But in Europe and Japan, it is difficult to have the same degree of optimism.

The obvious problem with waiting is that it can be very costly in terms of jobs and overall economic growth. It can also generate new risks. In particular, the prolonged highly stimulatory monetary policy that is required during the waiting period can lead to the development of new financial vulnerabilities. Indeed, this appears to be occurring at the moment. The search for yield, the low volatility, the elevated prices of some assets, the compressed credit spreads and the pockets of higher leverage that we have witnessed recently has made the system more vulnerable to unexpected events.

So what can be done to promote healthy growth and reduce financial risk?

The G20 discussions have highlighted two broad lines of attack.

The first is the promotion of structural policies that encourage real investment, not just financial investment. This is, of course, easier to say than to do. But policies that promote trade and competition, and that promote innovation and entrepreneurship, must surely be at the heart of the solution. Globally, policymakers need once again to create an environment where savers feel that it is worth taking a risk developing a new asset. Higher prices for existing assets can help in this regard, but only so far. It is reform-focused government policy, rather than monetary policy, that is the key.

The second response is increased spending on infrastructure, which creates new assets directly.

From a number of perspectives now is a favourable time to undertake such investment. In many countries, the infrastructure is ageing and/or underdeveloped and there is a growing likelihood that this will inhibit future economic growth. The record low interest rates and limited recent investment mean that there are likely to be many projects that yield risk-adjusted social rates of return greater than the cost of finance. There is also plenty of spare capacity to undertake such investment. In addition, higher levels of infrastructure spending could take some of the pressure off monetary policy globally, ultimately reducing some of the risk in the financial system that I referred to a moment ago. So, there is much to commend it.

One of the main stumbling blocks continues to be financing. Typically, building infrastructure requires somebody to borrow. At the moment, few entities want to do this. Many private investors remain wary of borrowing given the construction and patronage risks often associated with infrastructure investments. In earlier eras, governments might have been prepared to step in and use their own balance sheets to boost demand. But today, many governments remain very wary of doing this, given the need to put public finances on a more sustainable footing. The end result is that investment in infrastructure remains low despite record low interest rates, a deficiency of global aggregate demand and infrastructure shortfalls in many countries. This is hardly an ideal situation.

As the G20 has identified, finding solutions here is important to the health of the global economy. In Australia, the federal government's asset recycling program is one way of increasing infrastructure investment without increasing government net debt. More generally, better balance sheet accounting by the public sector would also be helpful. Borrowing to build assets can be thought of quite differently from borrowing to finance current expenditure provided – and this is important – that one can have a degree of confidence that the asset will deliver a reasonable return. So, more rigorous processes around project selection and governance are important. The G20 has also been working on ways of improving contracting and the private-sector financing of infrastructure investment, including through appropriate pricing, as well as sharing experiences across countries.

Both of these elements – the promotion of real risk-taking and increased spending on infrastructure – are central in delivering on the G20 commitment to lift global GDP by an additional 2 per cent by 2018. They are both important in creating a stronger global economy where investors look for new opportunities rather than simply seeking out existing assets. Progress has been made on delivering on this commitment, although more is needed and effective implementation is clearly required.

Australian developments

I would now like to turn my focus more directly to domestic issues.

For reasons that I expect you already understand, Australia has found itself in a different position from that of many other advanced economies over recent years. Our banking system came through the international crisis quite well. Aggregate investment has been high, not low. Interest rates are positive, and the Reserve Bank has not had to buy large quantities of assets from the private sector.

But we do live in an interconnected world. So what is happening elsewhere does have an effect here. While our interest rates are positive, they are at record lows. While aggregate investment has been very high, investment outside the boom in the resources sector has been very subdued. And as we have seen elsewhere around the world, many companies have preferred to hold cash or distribute profits back to their shareholders rather than invest themselves.

So we face some of the same issues as other countries. This means that the discussion about the promotion of entrepreneurship and increased spending on infrastructure is not just relevant to the global economy, but to Australia too. Over the period ahead, higher infrastructure spending can help with the transition from the mining investment boom to other forms of activity. It can also help strengthen the foundations for future growth in the economy. And, as I have spoken about on previous occasions, policies that promote innovation and entrepreneurship are likely to hold us in good stead not just in the short term, but over the long term as well.

In terms of the financial side, it is in the housing market where the strong demand for existing assets is most evident. Many investors, including those in self-managed superannuation funds, have decided that investment in residential property is an attractive option, partly given the low level of interest rates. Prices have risen as a result. Nationwide, they are up by around 10 per cent over the past year, and in Sydney they are up by around 13 per cent. Auction clearance rates have been high and loan approvals for the purchase of residential property have risen very strongly.

The good news is that this increased demand for *existing* housing assets is translating into increased demand for *new* housing construction. This is a very welcome development. Investment in residential construction has increased by 9 per cent over the past year and further increases are expected.

So this part of the monetary transmission mechanism is working in Australia, and working more effectively than it is in some other countries. The higher construction activity is adding to jobs and assisting with the rebalancing of demand in the economy as mining investment declines.

But recent developments do raise some of the same general questions that are being discussed internationally. In particular, a question that has a strong echo in the international discussions is whether the recent increases in the prices of the existing housing stock, together with pockets of higher borrowing, is generating increased financial and macroeconomic risk? And if it is, what, if anything, should be done?

Questions about how risk is evolving are often difficult to answer and one can never be completely confident that the conclusion reached is exactly right. But, it is possible to make informed judgements based on the balance of probabilities. And, the judgment that we have reached over recent times is that at least some aspects of the housing market have become somewhat unbalanced and that this has generated some increase in overall risk.

The area that has attracted most attention is the very strong demand by investors to buy housing for the purposes of renting. Currently, loan approvals to investors buying properties to rent out account for nearly 45 per cent of total loan approvals, with most of the investment properties being existing properties. Perhaps not surprisingly, the biggest increases in housing prices have occurred in the city where investor demand has been strongest – namely Sydney. Overall, investor credit outstanding is growing at an annual rate of close to 10 per cent, around twice the rate of increase in household income. A fairly high and increasing share of these investor loans do not require the repayment of any principal during the life of the loan. And this is all occurring in an environment in which growth in rents has slowed and the ratio of housing prices to income is at the top end of the range experienced over the past decade or so.

Now as I said, one cannot draw conclusions with absolute confidence, but I contend that a reasonable interpretation of these events is that they are leading to some increase in overall risk.

It is important to make clear that I am not saying that this will end badly, or even that is likely to end badly – just that, on average, recent loans are probably a bit more risky than those made earlier. One reason this might be the case is that the likelihood of some type of painful household balance adjustment in the event that there is a correction in the housing market, while still not high, has probably increased. Given this, it is prudent for both borrowers and lenders to be careful.

Quite appropriately, the Australian Prudential Regulation Authority (APRA) has been discussing this evolution of risk with financial institutions for some time, and there has been a strong focus on maintaining appropriate lending and risk-management standards. As has been well publicised, the members of the Council of Financial Regulators, including the Bank and APRA, have also held discussions regarding the merits of additional measures within the existing prudential framework. If risk has increased, then it might be appropriate to adjust one or more of the elements within that framework to reflect that change in risk.

It is also important to point out that the fact that the Bank and APRA are talking about these issues does not mean that a return to the type of heavy regulation we saw in earlier decades is on the agenda. That earlier experience demonstrated all too clearly the distorting effects of such regulation as well as the ability of financial institutions to circumvent it, including by activities outside the regulatory net. As it turns out, the financial system is very good at finding ways of getting money from the people who have it to those who want to borrow it, although perhaps less good at containing aggregate risk. All this means that we need to be realistic about what can be achieved through changes in the regulatory parameters alone. This realism, however, need not preclude consideration of modest and sensible changes within the existing prudential framework.

Obviously, another relevant issue is the overall level of interest rates. As I have said, low rates have boosted asset prices globally, including in our own housing market. The judgement that the Reserve Bank Board has reached is that in Australia these low rates are entirely appropriate. They are required to assist in the necessary balancing of the Australian economy following the once-in-a-century boom in resources sector investment. This is especially so when the exchange rate has not been providing the degree of support that might normally have been expected. The low interest rates are helping boost construction activity and spending more broadly in the economy. This is the transmission mechanism at work.

But just like the situation internationally, as the period of very low interest rates continues to run on, we all need to be cognisant of how risk is changing. Lenders need to ensure that their lending standards remain sound and that they hold the appropriate amount of capital against the risks they face. And investors need to evaluate developments in the broader market, including how their investments might turn out in less benign scenarios. Careful attention to these issues will help ensure that in getting the economic benefits of low interest rates we do not generate unacceptable risks on the financial side.

Concluding remarks

Let me conclude by trying to tie these various strands together.

Very low global interest rates have been with us for some time. And it is likely that they will stay with us for some time yet.

Fundamentally, this reflects the low appetite for real investment relative to the appetite for saving.

These low rates are encouraging investors to buy existing assets as they seek alternatives to bank deposits earning very low or zero rates. Asset prices have increased in response.

Some of this is, of course, desirable and, indeed, intended. But the longer it runs on without a pickup in the appetite for real investment, the greater is the potential for new risks to develop. During this period, while we wait for the investment environment to improve, we need to be cognisant of potential risks of asset prices running too far ahead of real activity. This is true in Australia, as it is elsewhere around the world.

The underlying solution is for an improvement in the investment climate. Monetary policy can, and is, playing an important role here. But ultimately, monetary policy cannot drive the higher ongoing expected returns on capital that are required for sustained economic growth and for reasonable long-term returns to savers. It is instead government policy – including in some countries, increased spending on infrastructure – that has perhaps the more important role to play here.

Thank you very much for listening this evening.