Non-technical summary for 'The Consequences of Low Interest Rates for the Australian Banking Sector'

By Anthony Brassil

Although interest rates are expected to continue rising in the short-term, the long-term trends that led to more than a decade of low global interest rates after the global financial crisis are not expected to materially reverse. Therefore, there is benefit in learning from the recent period of low interest rates given the high probability that they will return at some point in the future.

To that end, I seek to understand the consequences of low interest rates for the Australian banking sector. This is not a straightforward question to answer because modern banking is complex. Not only do banks lend money and take deposits, they also borrow from overseas, hold government bonds, and hold deposits at the RBA. Banks also need to manage the losses that arise from their loans not being repaid and ensure they meet regulatory requirements. So there are many channels through which low interest rates could affect how banks operate.

Answering this question is further complicated by the fact that the Australian banking sector operates differently from the banking sectors in other countries. So we should not treat the vast international literature that explores the consequences of low interest rates as being a precise description of how low rates affect Australian banks.

For example, the international literature predicts that the difference between banks' lending rates and their costs of funding those loans (known as the net interest spread) will shrink as interest rates fall. This occurs for two main reasons. First, international banks are typically more reliant on deposit funding than their competitors such that their costs of funds do not fall as much as their competitors when interest rates fall – small deposit account interest rates tend to have a lower bound around zero due to the possibility of holding physical currency instead. And second, international banks earn profits from the difference between long-term and short-term interest rates and this difference tends to shrink as interest rates approach zero.

Conversely, I find that Australia's major banks maintained a fairly stable interest spread as the level of interest rates fell towards zero. Therefore, in the face of low interest rates, Australian banks' profitability likely did not declined as much as the international literature would predict.

A corollary of this finding is that the extent to which cash rate changes were passed through to lending rates in Australia may have been more muted than what would be predicted by the international literature (which already predicts falling pass-through as the level of interest rates fall).

With pass-through falling, a key question for central banks has been whether pass-through could ever turn negative – the so called 'reversal rate'. Famously theorised by Brunnermeier and Koby (2018), the reversal rate is the point at which any further reduction in the central bank's policy rate will cause banks to increase their lending rates, such that policy rate reductions become counterproductive.

To answer this question for Australia, I use a recent advance in modelling the interactions between the banking sector and the Australian economy – the new banking sector addition to the RBA's macroeconometric model (Brassil, Major and Rickards 2022). I find that the way Australian banks operate is sufficiently different from what is assumed in the international literature that a reversal rate is highly unlikely to exist in Australia.

References

Brassil A, M Major and P Rickards (2022), 'MARTIN Gets a Bank Account: Adding a Banking Sector to the RBA's Macroeconometric Model', RBA Research Discussion Paper No 2022-01.

Brunnermeier MK and Y Koby (2018), 'The Reversal Interest Rate', NBER Working Paper No 25406.