Debate about banks' lending rates misses the point

(by Saul Eslake, Program Director, the Grattan Institute; originally published in the business pages of the Melbourne Age*, 3rd November 2010)*

Yesterday's decision by the Reserve Bank to lift its official cash rate by another 25 basis points to 4.75% - at which level the stance of monetary policy is now unambiguously restrictive – adds new bite to the debate re-started by Shadow Treasurer Joe Hockey about the extent of competition in Australia's financial services market and the degree to which governments should be involved in determining the interest rates actually paid by household and business borrowers.

This debate has actually been running for more than a decade. Needless to say, in the mid- and late 1990s, when banks absorbed increases in the official cash rate into their lending margins, or lowered their lending rates by more than reductions in the official cash rate, under competitive pressure from the newly-emerging mortgage originators, there was no debate at all about banks' pricing behaviour.

But when, in late 1999 and early 2000, ANZ's then Chief Executive Officer John McFarlane several times mused out loud about the possibility of raising ANZ's mortgage rate independently of movements in the Reserve Bank's official cash rate, he was soundly rebuked by then Treasurer Peter Costello, who on each occasion said that "if ANZ puts up people's interest rates then people should change their bank". This was around the time that the Howard Government was introducing the GST, so after the third such public rebuke, I sent John McFarlane an email suggesting that the next time the Treasurer repeated that remark, he should say, "so does that mean if the government puts up people's taxes, people should change their government?".

John McFarlane was of course mindful of ANZ's need to maintain good relations with a government that didn't take too kindly to criticism of it from business (as I was to find out myself a few years later), and to be fair the introduction of the GST was accompanied by a reduction in the overall tax burden, so my suggestion didn't go any further.

When interest rates subsequently began falling, during 2001 and 2002, the then Treasurer's office would routinely call each of the major banks on the day of the Reserve Bank's decision, demanding to know when they would be lowering their mortgage rates, and implicitly or explicitly suggesting that any bank which failed to make an announcement to that effect before Question Time that afternoon could expect some unfavourable commentary in Parliament. Funnily enough, similar calls were never made after the Reserve Bank began raising interest rates from mid-2002 onwards.

For his part, Wayne Swan as Treasurer has been equally vociferous in criticizing banks for raising lending rates independently of, or by more than, movements in the Reserve Bank cash rate, or for failing to pass on in full reductions in the cash rate.

But he has not, to the best of my knowledge, ever sought to use arcane powers granted to the Treasurer more than six decades ago to direct the banks as to how they should price their products. Nor has Joe Hockey said that he should. The only suggestions to that effect have come from a Liberal Senator, and the Greens (a curious alliance, if ever there were one).

Some of the elements of Joe Hockey's 'nine point plan' are worth supporting. It's undeniable that the major banks now face less competition than they did before the financial crisis, thanks to the absorption of two of the smaller banks into the majors and the dramatic shrinkage in the securitization business (although it is still difficult to name many significant sectors of the Australian economy in which there are four home-grown competitors). So anything that can be done to enhance competition in lending markets, or to make it easier for customers to change their allegiances, merits serious consideration.

Similarly, there's a good case for another inquiry into Australia's financial system, nearly 15 years after the last one, with a view to ensuring that the weaknesses exposed by the financial crisis (and there were some) are addressed effectively.

There is also room for argument as to whether the banks still have a 'case' for raising their rates independently of, or by more than, movements in the official cash rate. The banks argue that as they replace short-term borrowings in the wholesale money markets with more expensive longer-term funds or retail deposits, their cost of funds is still rising. The Reserve Bank argues that the major banks' net interest margin (between their borrowing and lending rates) for their Australian operations is now about 35 basis points higher than it was just before the onset of the financial crisis (although the same analysis also shows that this margin is still around 50 basis points lower than it was a decade ago).

However it seems unfair to suggest that banks should be precluded from making their case in public, lest they be accused of 'signalling' some intention about pricing to their competitors potentially in breach of the Trade Practices Act.

And the whole debate about whether the banks have some obligation to tie the timing and magnitude of movements in their lending rates to changes in the Reserve Bank's cash rate entirely misses the crucial point that the Reserve Bank is now targeting the interest rates that borrowers actually pay when it sets the cash rate, and thus takes account of any change in the spread between the cash rate and the rates that borrowers pay.

If the banks were to raise their lending rates by an average of, say, 50 basis points following yesterday's 25 basis point increase in the cash rate, then the Reserve Bank would simply remove one of the series of further 25 basis point increases in the cash rate it is clearly contemplating between now and the peak of the current mining boom.

Preventing the banks from raising their rates by more than the cash rate would not result in borrowers paying lower interest rates. All it would do would be to alter the distribution of the stream of interest payments made by borrowers between bank shareholders, bank depositors, and other sources of bank funds. And why that should be the subject of government intervention – especially by those who, as a general proposition, say that they favour less rather than more government intervention in business decision-making – continues to elude me.