April 28, 2017

Economics Group

WELLS FARGO SECURITIES

Special Commentary

Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Erik Nelson, Currency Strategist
erik.f.nelson@wellsfargo.com • (212) 214-5652

Catch-22

The RBA's Policy Dilemma and Implications for the Australian Dollar

Executive Summary

The Reserve Bank of Australia (RBA) has found itself in something of a bind recently. After a series of gradual rate cuts over the past several years aimed at cushioning the Australian economy's adjustment to slower growth and lower inflation, debt imbalances among Australian households have steadily grown as low interest rates have fueled a sharp rise in house prices. Burdened by this growing pile of liabilities, consumers are also facing rising unemployment and a still-weak economy and thus could benefit from lower rates; however, additional rate cuts risk even more piling-on of debt.

Growth and inflation have slowed, while debt risks have risen.

In this special report, we review how the Australian economy and the RBA got to this point and what the RBA's likely next course of action could be in addressing its conflicting concerns. In all, while we do not necessarily expect further rate cuts from the RBA at this time, we also do not believe Australian economic fundamentals currently justify an increase in interest rates any time soon. With the RBA likely to be on hold until well into 2018 and the Fed expected to continue raising rates, we see downside risk for the value of the Australian dollar against the greenback.

RBA's Paradox: Stave Off Debt Risks While Supporting Soft Economy

The Australian economy fared better than most advanced economies during the global slowdown of 2009 due mostly to Australia's trade ties to China's economy, to which it sends around a third of its exports. Real GDP in China continued to grow at a respectable pace in 2009 and 2010 even as growth in much of the rest of the world struggled. Since 2011, however, the moderation in China's GDP growth, particularly in the past couple of years, has translated into a generally weaker profile for export growth in Australia. In turn, this has had negative knock-on effects for its mining sector and raw material exporters, which has fed into weakness in overall Australian economic growth more broadly.

To be sure, Australia's economy remains bifurcated, with the resource-dependent states still trying to recover even as the rest of the country is faring pretty well. Final domestic demand, or the sum of total final consumption and investment, in the resource-rich states of Queensland and Western Australia is roughly 8 percent below its peak in Q4 2013, while final domestic demand in the rest of the country has grown 10 percent since then. In aggregate, however, Australian final private demand is soft, while public spending is pulling a good bit of the weight at present (Figure 1). Since 2015, for example, government spending growth has averaged 5.1 percent, while the average growth rate for consumer spending was only 2.8 percent and business fixed investment growth was negative for that same period. Thus, despite the somewhat divergent fates of resource and non-resource rich states in Australia, aggregate growth figures clearly point to an economy in which overall demand is subdued.

Weakness in Australia's external sector has fed through to the domestic economy.

Together we'll go far

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Figure 1

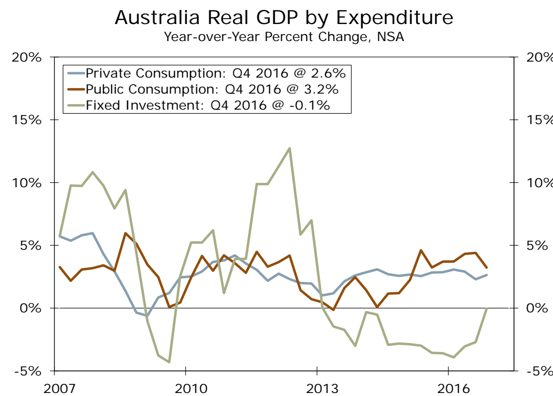
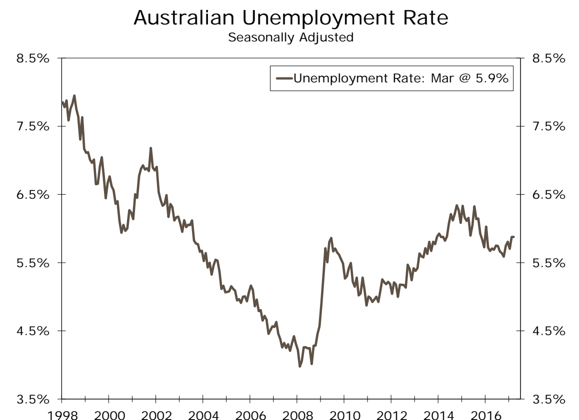


Figure 2



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

The RBA's playbook has thus far been simple: cut rates.

Labor market dynamics do not look particularly favorable either. Although the mix of part-time and full-time employment is improving at the margin, the unemployment rate is elevated relative to recent years, which has had predictable effects on wages—most measures of wage growth are at or near multi-year lows, while data for Q4 2016 showed a sequential decline in employee compensation. With slack in the labor market and growth below potential, inflation remains low. Indeed, while headline CPI in Australia climbed slightly above 2 percent, the lower bound of the RBA's target range, in Q1 2017, the RBA's core measures of CPI inflation remained below 2 percent.

For the RBA, the playbook for dealing with softer growth, slowing inflation and the rise in unemployment was, for many years, fairly simple: cut rates. The RBA cut the cash rate twice in 2016, the latest in a series of cuts that began in the autumn of 2011. Over that time, the cash rate in Australia has come down from 4.75 percent to just 1.50 percent at present—the lowest rate on record (Figure 3).

Figure 3

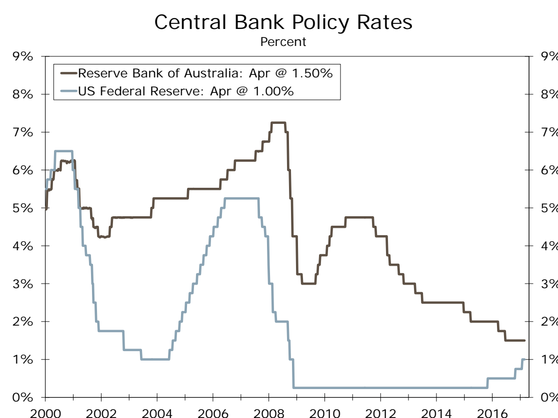
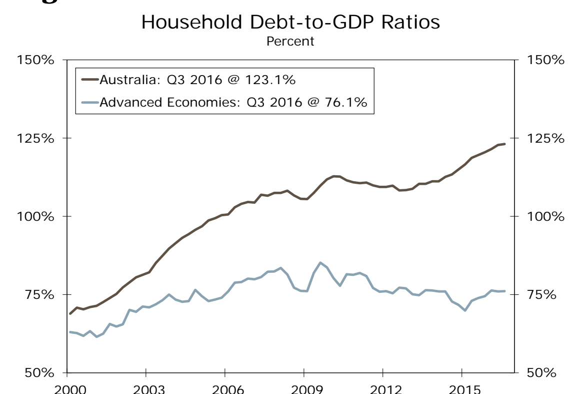


Figure 4



Source: IHS Global Insight, Bank for International Settlements and Wells Fargo Securities

Yet, rising debt has changed the balance of risks.

However, as the RBA has continued to cut interest rates over the past few years, imbalances have been steadily growing for Australian households. Indeed, the debt-to-GDP ratio for Australian households has risen roughly 15 percentage points since 2012 to nearly 125 percent currently (Figure 4), with much of that increase concentrated in household mortgage debt. This likely reflects the sharp increase in house prices in Australia, which have risen nearly 50 percent over that same time period. With the rise in house prices showing few signs of abating, and with low interest rates fueling further expansion in mortgage credit, the RBA is facing something of a

paradox: if it raises rates to guard against the risk of rising debt imbalances, it could squeeze Australian consumer finances and contribute to a pullback in broader consumer spending. Meanwhile, if it cuts rates further to support inflation, it runs the risk of adding further fuel to the rising debt imbalances.

Joseph Heller's acclaimed 1961 WWII novel *Catch-22* featured a number of paradoxical situations in which an individual is constrained by contradictory rules or constraints in which the solution to a problem is the cause of the problem thus precluding any solution. The "Catch-22" concept is introduced by an Army doctor who describes the paradox that exists when a pilot, claiming insanity as an exemption from flying dangerous bombing runs, effectively demonstrates his own sanity in making the request thus nullifying the grounds for the exemption:

> *"You mean there's a catch?"*
>
> *"Sure there's a catch," Doc Daneeka replied. "Catch-22. Anyone who wants to get out of combat duty isn't really crazy."*
>
> *There was only one catch and that was Catch-22, which specified that a concern for one's own safety in the face of dangers that were real and immediate was the process of a rational mind. Orr was crazy and could be grounded. All he had to do was ask; and as soon as he did, he would no longer be crazy and would have to fly more missions. [...] Yossarian was moved very deeply by the absolute simplicity of this clause of Catch-22 and let out a respectful whistle.*[1]

The RBA is likely to remain on hold until well into 2018.

The Reserve Bank of Australia faces a similar paradox at this stage of the economic cycle. In our view, Australian economic fundamentals do not necessarily suggest that the RBA is likely to cut rates further at this time, but they certainly suggest sustained accommodation for quite some time. After assessing on all these factors, our baseline expectation is that the RBA remains stuck in its "Catch-22" situation and will therefore make no changes to the cash rate anytime this year and likely well into next year, a consideration which should have key implications for the Australian currency.

Monetary Policy Dynamics Portend Australian Dollar Weakness

In assessing the medium-term outlook for the Australian dollar, we view relative monetary policy as the most relevant factor influencing the currency's prospects. In that regard, we see the relative monetary policy outlook for the United States and Australia as favoring a steady decline in the Australian currency against the greenback throughout the remainder of 2017 and into 2018. As described above, we expect the RBA to maintain its current policy stance until well into 2018, at which point it could begin the gradual process of raising interest rates. Meanwhile, we expect the Federal Reserve to raise interest rates an additional two times this year and three next year, suggesting that the evolution of expected rates in the United States relative to Australia are likely to favor a softer Australian currency against the greenback over the medium term. For further insight into how monetary policy dynamics could lead to weakness in the Australian dollar, we also examine how these factors could affect Australian capital flows.

Australia's external balances have worsened.

Recent trends in Australian external balances and capital flows have become somewhat less favorable. Indeed, long-term capital flows, or the sum of portfolio and direct investment flows, slowed to 1.5 percent of GDP in 2016 from an inflow of more than 6 percent of GDP in 2015. During that same time, the current account deficit has also narrowed, but the slowdown in capital flows has outpaced the narrowing in Australia's current account deficit (Figure 5). Accordingly, the basic balance, or the sum of the current account balance and long-term capital flows, worsened to a deficit of 1.1 percent of GDP in 2016, an indication that Australia's external deficit is not currently being fully financed by long-term capital flows.

[1] **Heller, J. (1961).** ***Catch-22.***

Figure 5

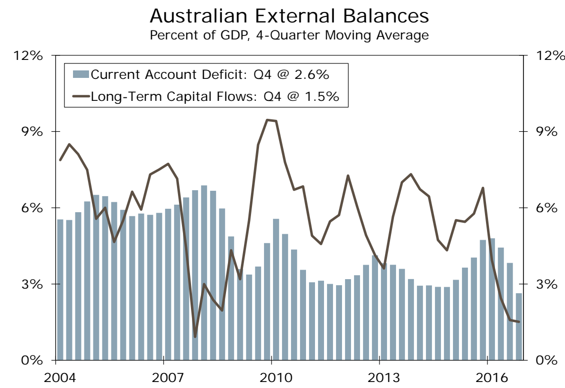
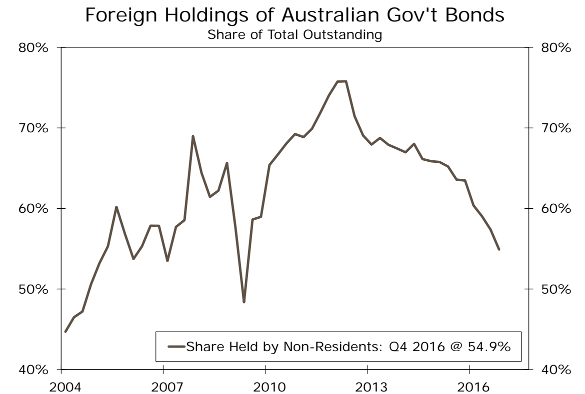


Figure 6



Source: Datastream, Australian Bureau of Statistics and Wells Fargo Securities

Australia saw record portfolio outflows in 2016.

A closer investigation of Australian capital flows figures reveals that most of the slowing in net long-term capital flows into Australia has been the result of swings in portfolio capital flows, which have turned from net *inflows* to net *outflows* in recent quarters. In fact, net portfolio capital *outflows* from Australia totaled A$31.1 billion in 2016, the largest annual outflow on record. While an increase in Australian purchases of foreign portfolio securities has contributed to this trend at the margin, data suggest that lessening net purchases of Australian portfolio assets by foreigners have been a much more significant driver of the deterioration in these net portfolio flows.

In particular, foreign investors have sharply reduced their purchases of Australian debt securities over the past several years and have in fact become net sellers of Australian debt. An important driver of this trend and of Australian capital flow cycles more broadly has been foreign demand for debt issued by Australian banks, which is likely influenced by interest rate factors as well as by sector-specific issues relating to the banking sector. However, the evolution of foreign demand for debt issued by the Australian government has also been a relevant driver of broader swings in capital flows.

As shown in Figure 6, the share of Australian government bonds held by non-residents has been on a steady decline since 2012, and that decline has in fact gathered pace since 2015. In assessing the outlook for the Australian dollar, we view it as relevant and important to consider how this trend could evolve going forward. To address this issue, we note that the share of foreign ownership of Australian government securities has not yet reached especially low levels, such as those seen during the global financial crisis. Indeed, non-residents currently hold around 55 percent of Australian government debt, while that share fell as low as 48 percent in 2009, so there could arguably be further downside for the share of foreign ownership. However, perhaps the more important consideration is whether Australian economic fundamentals justify further subdued foreign demand for Australian government securities, or even outright selling of those securities.

Monetary policy dynamics favor a weaker Australian dollar in the coming months.

As we mentioned, Australian interest rates are likely to remain steady at low levels (by Australian standards) for a relatively long time, with growth and inflation expected to stay low and gradual policy normalization from the RBA unlikely to begin until well into 2018. Meanwhile, with the Fed set to continue its gradual tightening cycle, the relative attractiveness of U.S. interest rates for foreign investors should rise further in the months ahead. In fact, if the monetary policy actions of the RBA and Federal Reserve evolve as we expect, then the federal funds rate could match or exceed the RBA's cash rate by 2018 for the first time in around 20 years, and relative government bond yields in the two countries could follow suit. The last period during which the rate gap moved in favor of the United States versus Australia coincided with a decline in the Australian dollar to its lowest level against the greenback during the floating exchange rate period of the past

several decades. Based on these expected dynamics, we believe foreign demand for Australian government debt could remain subdued, which could restrain or soften the Australian dollar in the months and quarters ahead.

Later in 2018, the Australian dollar could be stabilizing.

However, despite our overall negative view on the Australian dollar against the greenback throughout the balance of 2017 and into 2018, by the middle of next year, the Australian currency may be stabilizing and indeed beginning to stage a mild recovery against the greenback. Our view of a more favorable backdrop for the Australian dollar as 2018 progresses is primarily informed by the relative monetary policy outlooks for the United States and Australia. While we expect U.S. and Australian monetary policy to *diverge* in the coming months, that divergence should come to an end in 2018, and we may even begin to see the emergence of monetary policy *convergence* some time next year. However, we would not expect a significant and sudden turn from trend weakness to trend strength in the Australian dollar against the greenback, as eventual tightening from the RBA is likely to be gradual in nature.

Bottom Line: RBA on Hold for Now, Australian Dollar Heading Lower

The RBA is facing somewhat conflicting concerns at present, with a soft domestic economy supporting the case for a maintenance of accommodative policy, while mounting debt imbalances could perhaps be curbed by tighter policy. In all, the RBA is likely to hold policy steady well into next year, at which point it may begin the gradual process of normalizing interest rates. Given the outlook for further policy tightening from the Federal Reserve, and considering recent dynamics and trends in Australian capital flows, we see trend weakness ahead for the Australian dollar against the greenback.

Wells Fargo Securities Economics Group

Name	Title	Phone	Email
Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(212) 214-8543	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
E. Harry Pershing	Economic Analyst	(704) 410-3034	edward.h.pershing@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Advisors, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2017 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE