

Key points

- **As expected, the RBA raised the cash rate by 0.5 percentage points in July;**
- **That takes the cash rate to 1.35%, the highest level since May 2019;**
- **The RBA made it clear that there are further cash rate increases to come;**
- **I look for another 0.5 percentage point rise in August following a big Q2 inflation read;**
- **I think the cash rate in this cycle will peak at around 3%. This is higher than current median economist views but under financial market projections.**

RBA July Board meeting

As expected the RBA increased the cash rate by 0.5 percentage points following the July meeting (the cash rate is now 1.35%). The cash rate increased for the reasons you would expect. Inflation is well above the 2-3% target and the labour market is very strong.

Next Moves in 2022

Unless something unexpected happens the RBA made it clear that there are more rate hikes to come. The RBA will want to get to at least a 2% cash rate relatively quickly. That suggests another big move (most probably 0.5 percentage points, but a 0.4 percentage point move is a possibility) at the August meeting. Given that the Q2 CPI (released 26 July) is likely to show another big quarterly rise such a big move will be easy to justify.

Thereafter I think the RBA will start to slow the pace of interest rate rises in order to get a better idea of what impact the rate hikes to date have had. A 0.25 percentage point move at either the September or October meeting would take the cash rate to 2% (or a bit over). A final 0.25 percentage point move (taking the cash rate to 2.25-2.35%) for the year is then likely at the November meeting following what is likely to be another large Q3 CPI number (released 26 October). At the time of writing financial market pricing is for the cash rate to be 3% by end 2022. The median economist forecast is 2.35%.

On the announcement government bond yields declined and the \$A fell. I thought the RBA's statement was relatively balanced (emphasising the need to fight inflation but also the downside economic risks). Other central banks have been more aggressive in talking about higher interest rates in recent times.

The RBA thinks that inflation will hit 7% this year before declining back towards the 2-3% band next year. Maybe that will be the case although inflation has been higher than expected and supply problems have lasted longer than anticipated. This suggests that the risks for the RBA's inflation forecasts are probably still to the upside.

House prices and the consumer

The rate hikes that have already occurred is impacting sentiment about house prices although growth had begun to decline at the start of this year reflecting concerns about affordability. The first monthly decline in major city house prices took place in May (the first rate hike) although that was mainly in Sydney and Melbourne.

That house prices will decline as interest rates rise would not surprise the RBA (although they might be surprised how quick that decline has started). In their April Financial Stability Review the RBA noted that historically a 2 percentage point increase in interest rates has typically led to a 15% decline in real house prices (ie, house price growth after allowing for inflation) over a two-year period. The interest rate rise in this cycle will almost certainly be more than 2%. But inflation could be up 10% over 2022 and 2023. This means it is possible that real house prices might decline by 20-25% by end 2023 but actual house prices fall by 'only' 10-15%.

Falling house prices impact the economy in various ways. People are less likely to build or buy a house when their value is falling. Small businesses borrow against the value of their home, so a declining price reduces how much they can borrow. Consistent reminders that the value of your house is going down can't be a good thing for consumer confidence.

ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

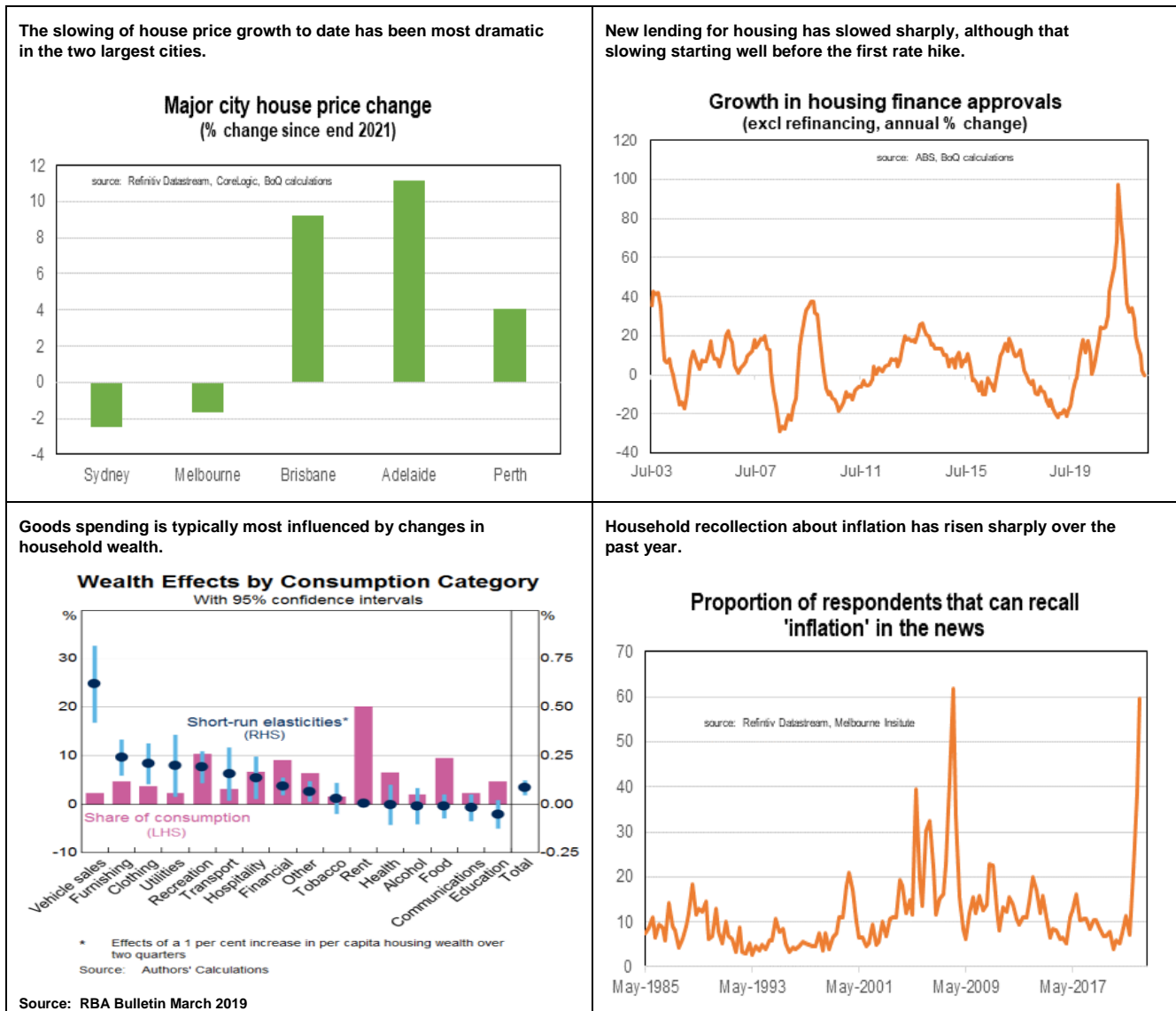
WEEK ENDING 8 JULY 2022



More directly there has been plenty of research indicating that falling house prices (and therefore a drop in household wealth) leads to lower consumer spending (and the wider economy). How big a negative is less certain, as it depends upon the state of the economy and what is happening with monetary and fiscal policy.

Currently the economy is in good shape, with the unemployment rate around fifty-year lows. Household have socked away a mountain of saving over the past couple of years although they are currently being hit with a significant inflation tax. The type of spending typically impacted by changes in wealth (the RBA found that spending on cars, furnishings and clothing are the most strongly impacted by wealth changes) is the spending that has been strongest during COVID and would be expected to slow anyway.

Most surveys indicate that consumer sentiment is currently extremely negative. Higher interest rates have played a role but higher inflation is the biggest issue. The May retail sales data highlights that consumer spending so far has remained strong. But declining house prices, rising interest rates and negative real wages growth means the risks are that consumer spending may be slower than anticipated sooner. And is the reason why the RBA is keeping a careful eye on developments on what households are doing with their money.

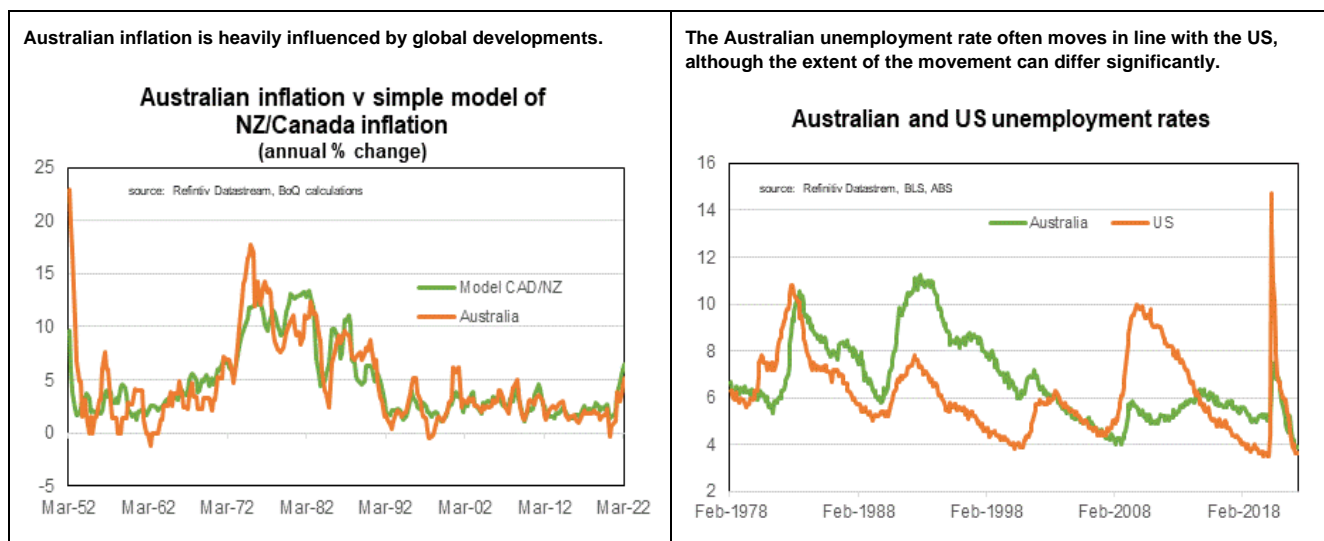


Global developments

The RBA has noted that inflation is lower in Australia than in a number of peer countries. This reflected a variety of factors, from what drives electricity prices, a lower impact of rising global food and energy prices and a record high participation rate (in contrast to the US and the UK) increasing the supply of labour and reducing pressure on wages growth.

Nonetheless, inflation is on the rise in Australia. The RBA's forecast of 7% is not that much lower than the numbers being recorded in other developed countries. One ray of hope is that historically Australia's inflation has moved in line with Canada and New Zealand (two countries that have similar economic structures to Australia). The Reuters surveys suggest that inflation will peak at 6% in Canada and 7% in New Zealand

The RBA also noted the growing uncertainty about the global economy (notably in the US). Financial markets have been getting worried that the likelihood of aggressive cash rate rises will lead to slowing economic activity. This view has recently received support from economic data coming in increasingly weaker than expected in the US and Europe. Financial markets appear to date to be less concerned about a slowdown of the Australian economy despite pricing a peak in the cash rate a bit above the US. Perhaps that is because the RBA has yet to show any signs of concern about a potential slowdown. Or that the economic data in recent weeks has been stronger than analyst expectations. But history does indicate that a rise in the Australian unemployment rate often takes place when the US unemployment rate increases.



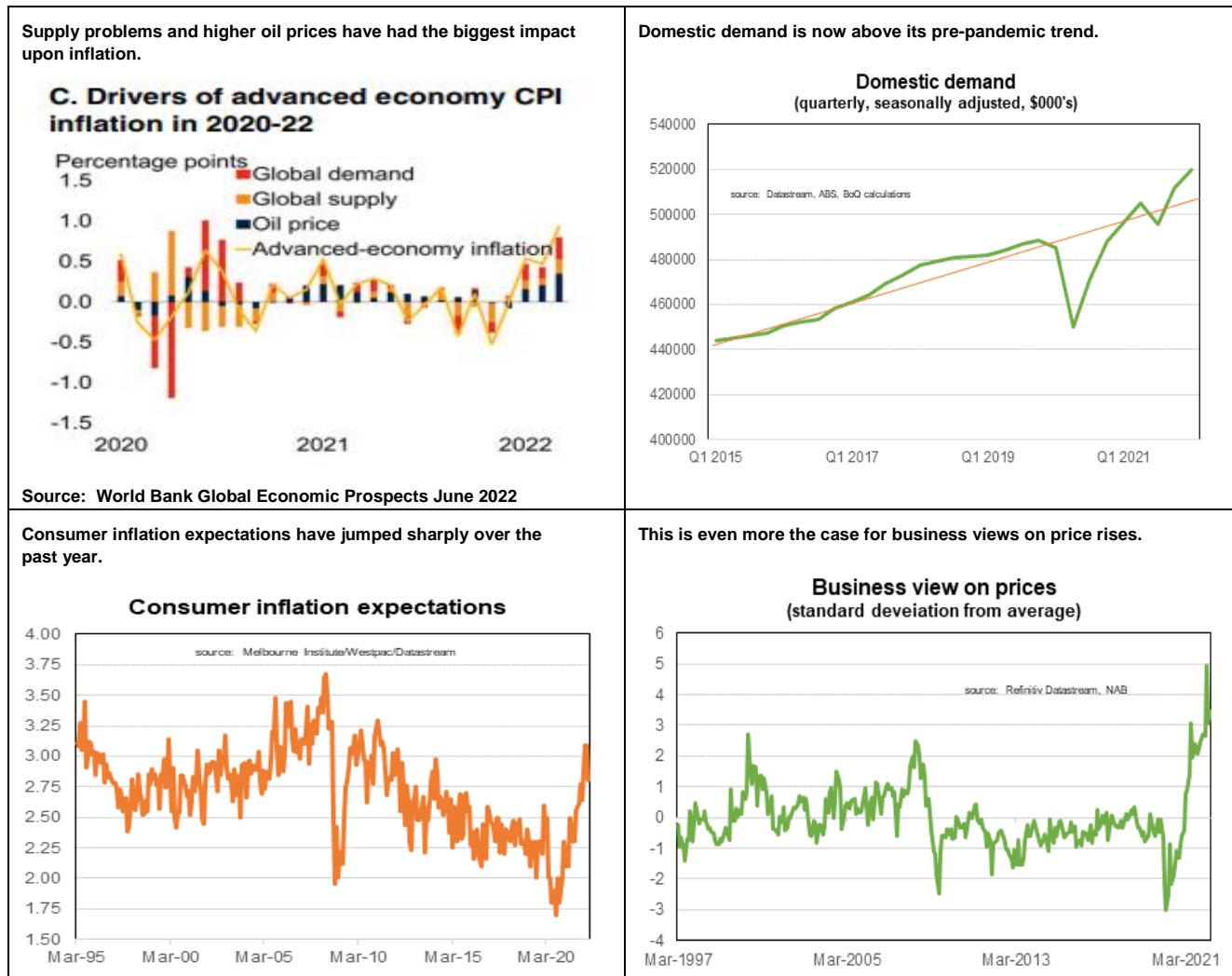
Inflation and expectations

How much inflation has been caused by supply and demand factors is a matter for debate although my read is that most economists think that the majority of the rise of inflation has reflected supply-side factors. The World Bank for example found that supply chain problems and the sharp jump in oil prices have been the most significant drivers of higher inflation in developed economies.

I think there is a lot to that argument. But demand has also been a driver, as acknowledged by the RBA. Domestic demand in the Australian economy was above its pre-pandemic trend by the March quarter of this year. And a cash rate of under 2% is inconsistent with unemployment rate under 4% and inflation forecast to be 7%.

But even if demand played no role, if inflation stays high enough for long enough then this itself can lead to higher inflation. That is because households and businesses price and wage behaviour begins to be based on expectations of higher prices. To date financial markets are not that concerned, with their medium-term inflation expectations consistent with the RBA's 2-3% target. While consumer inflation expectations have moved to around their highest level in around a decade that level has historically been consistent with outcomes in line with the RBA's inflation target. Business pricing views have picked up more strongly probably reflecting the high prices they are paying for input costs.

If the supply problems were truly ‘transitory’ then the RBA could afford to be conservative when raising interest rates. But the supply problems continue to last substantially longer than most expected. I agree with the RBA that household and business medium-term inflation expectations are consistent with the 2-3% inflation target. After all that has been their experience of inflation for much of the past twenty five years. But the RBA can’t be certain when high inflation outcomes lead to a shift upward of inflation expectations.



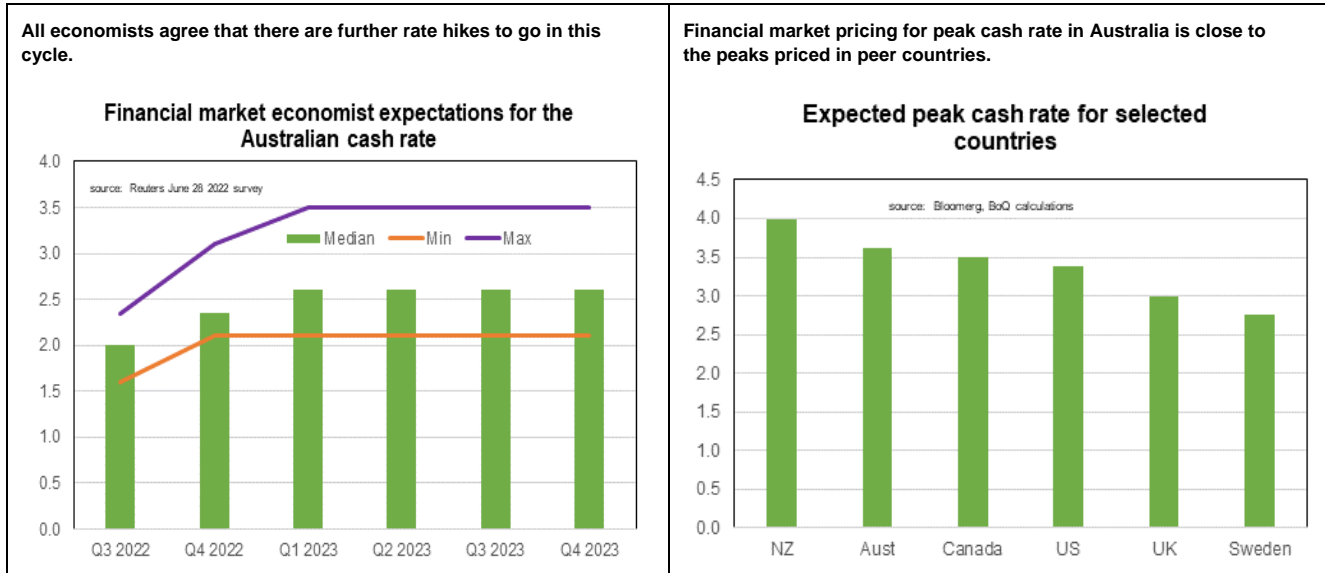
Financial Markets

Financial markets have recently reduced their expected peak of the cash rate in this cycle. This usually happens once central banks begin increasing interest rates. The combination of signs of slower economic growth and rising interest rates is why cash rate views get marked down.

The one exception was during the 2000’s when financial markets had to consistently revise up their view on how many rate hikes were needed. This reflected the benefits the Australian economy received from a terms of trade boom that lasted substantially longer than expected. This time a more likely cause of upward revisions on the peak cash rate would be if inflation continued to surprise to the high side. This could be because of ongoing supply chain worries or stronger wages growth. The RBA noted that its business liaison and surveys both point to a pickup of wages growth although it has not yet shown through in the official data.

According to a survey conducted by Reuters at the end of June, financial market economists think the peak in the cash rate in Australia will be somewhere between 2-3.5% in this cycle (median expectation is 2.6%). Financial markets themselves are pricing a peak of 3.5-3.75% (as at 5 July). This compares with a 2.75% peak in Sweden,

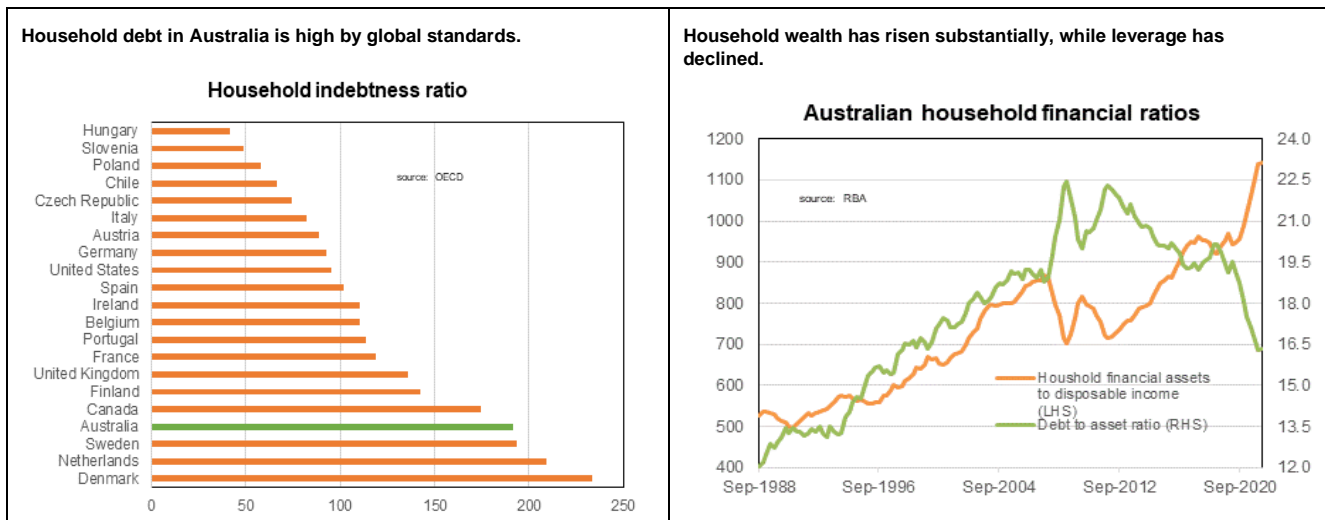
3% in the UK, around 3.25% in the US, 3.5% in Canada and almost 4% in New Zealand. These international comparisons would suggest that the peak of the cash rate could be higher than the median economist expectation although possibly lower than current market expectations.



The cash rate and household debt

The main reason why economists don't expect the cash rate to rise as significantly as financial markets are pricing is that the level of household debt (relative to disposable income) is high in Australia. The high level of debt would be expected to make households more vulnerable to higher interest rates (particularly at a time of negative real wages growth).

But there are important offsets. The labour market is the strongest it has been in fifty years. Household wealth has risen substantially (although could well decline further given potential further falls in house and equity prices). The high level of household saving and large proportion of fixed-rate lending that occurred in 2020 and 2021 means that we may not see the full impact of rising interest rates on households until the second half of next year. Household debt is also high in New Zealand and Canada where the expectations for the peak in the cash rate is around current (or higher) financial market pricing for Australia.



Summary

The RBA has made it clear that the rate hike in July is unlikely to be the last. And all economists agree. The strength of the labour market and probable inflation outcomes all suggest that higher interest rates are needed.

The most important question for the economy over the next 12-18 months will be how high and fast interest rates rise. The current strength of the labour market and global financial market pricing would suggest a higher cash rate than the current median financial market economist prediction. But concerns about the level of household debt and the potential for a slowdown of global economic growth in 2023-24 means maybe not as high as current market pricing.

My view is that the cash rate will peak at close to 3% in this economic cycle sometime next year. By the second half of next year the impact of higher interest rates, the inflation tax, declining wealth and weaker global economic growth could see financial markets begin to think about the timing of the first rate cut. But before we get there the RBA will look to ensure that the inflation dragon remains slayed.

We live in interesting times.

Regards

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