ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 10TH JUNE 2022

BOQ GROUP

Key points

- **The RBA increased the cash rate by 0.5 percentage points at its June meeting;**
- **The RBA indicated that inflation in coming months could be higher than they anticipated as recently as last month;**
- **Economists widely agree that the current level of inflation and the unemployment rate will require further rate rises;**
- **But how high the cash rate needs to get in this cycle, and how long it takes to get there, is the key point of debate.**

RBA announcement

For the second meeting in a row the RBA surprised financial markets and increased interest rates by a larger than expected amount (0.5 percentage points). The size of such a move is the same as what other central banks (US, Canada, New Zealand) have recently delivered. I had thought they would raise rates by 0.4 percentage points, in part to take the cash rate back to an even quarter amount (following the June move the cash rate is 0.85%). Clearly that argument did not rate with the RBA.

The analysis contained in the monetary policy statement did not surprise. The RBA thinks economic growth is strong, with further declines in the unemployment rate likely. Inflation could head even higher than was envisaged even one month ago, reflecting movements in electricity and gas prices.

They noted the significant uncertainty about the outlook, notably about household spending (and how it is influenced by higher inflation and falling house prices). Other concerns included high commodity prices and how that would impact global economies as well the uncertainties associated with COVID (notably in China).

Barring some unforeseen development, the statement following the meeting made it clear that the move in June will not be the last. An economy with an unemployment rate in the 3's and an inflation rate in the 5's does not need a cash rate of under 1%. In March, the cash rate after allowing for inflation ('real cash rate') was at its lowest level in at least forty years. Using RBA inflation forecasts and financial market pricing of future cash rate movements, the real cash rate would still be at historically low levels by the end of next year.

That the cash rate will be heading higher is widely agreed amongst economists and financial markets. The big disagreement is how high the cash rate will need to go and how long it will take to get there. Before the June meeting the expectations for the cash rate by the end of this year ranged between 1 - 2.6%, with 1.75% the most popular projection.

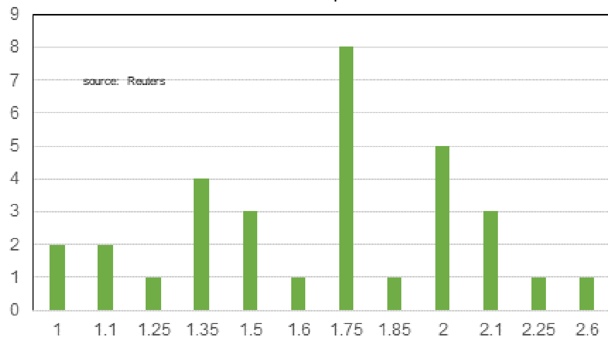
If the RBA does take the opportunity to raise the cash rate by 0.4 percentage points (to get the cash rate level at a quarter percentage point) at its July meeting, then they might take a meeting off to see how higher interest rates are impacting the economy. Otherwise, another 25bp at the July meeting, followed by a further 25bp at its August meeting, is a real possibility.

Where does the cash rate get to by the end of this year? I had been thinking 1.5%, as this was the level that might start to impact household spending. They would then give themselves the summer to see how higher interest rates were impacting the economy before moving again. But the RBA has mentioned that a more neutral (or typical) cash rate is somewhere around 2-3%. And other central banks (such as the Federal Reserve, Bank of Canada and Reserve Bank of New Zealand) are either at 2%, or will shortly be there.

Bank of Queensland Limited ABN 32 009 656 740 (BOQ).

There is widespread views on where the cash rate will be at the end of this year.

Financial market economist cash rate expectations for Dec 2022
(nos of forecasts per interest rate, forecast as at 2 June)



The cash rate after inflation is currently at a historically low level.

Real cash rate
(cash rate minus annual % change headline CPI, quarterly)

How monetary policy impacts the economy

The current high level of inflation reflects very strong demand at a time of a remarkable number of supply problems. Some of these problems are getting fixed (shortage of some manufacturing goods), others are temporary (problems with coal electricity generation plants). But some (food and energy shortages due to the Russia-Ukraine war and labour shortages) will be with us for some time.

Higher interest rates will do nothing to solve the many supply problems. But they do slow demand. Monetary policy impacts the economy through a number of different ‘channels’.

Higher Saving

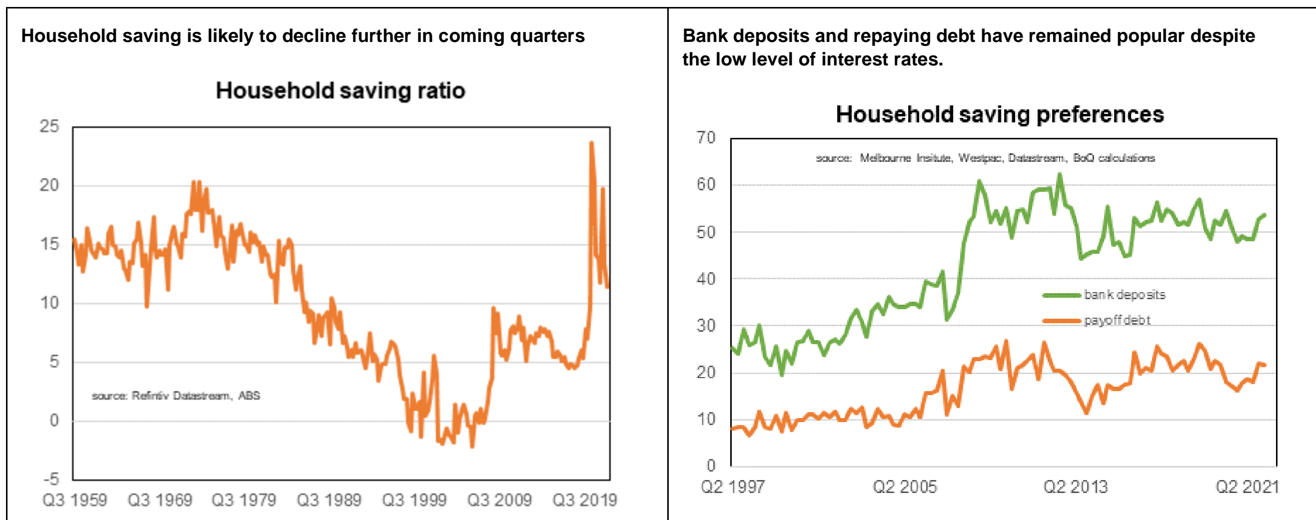
In theory higher interest rates provides an incentive for households to increase saving and reduce consumption. The real world outcomes are less persuasive. Saving behaviour is notoriously difficult to predict as it depends upon a variety of factors including the age distribution of the population, income distribution (richer people save more), income growth and confidence about the economic outlook.

There is a good chance that the saving ratio may actually decline despite higher interest rates. The saving ratio is currently at a high level by historical standards mainly reflecting an inability to spend due to lockdowns and fear of the virus. Government are reducing COVID regulations and household concerns about the virus are declining. Consumers have a high level of confidence in the strength of the jobs market. Declining real wages growth will mean households are likely to need to dip into their saving to maintain their standard of living.

Interest rates may have a bigger impact on the type of saving than the level. For example, there was a big rise in the proportion of households preferring to put their money into the bank or to repay debt when interest rates were rising in the 2000’s. And the decline of interest rates in the early 2010’s saw reduced preference for deposits or repaying debt.

But even here the impact of interest rates is not clear. The proportion of households nominating deposits and repaying debt to put additional saving has been high over the past ten years despite declining interest rates.

BOQ GROUP



Lower Investment

Higher interest rates (and the fear of higher interest rates) makes it more expensive for households and firms to borrow, reducing their investment spending. In this cycle borrowing by households has begun to slow even before the cash rate had risen. Partly that may reflect rising fixed rates as financial markets anticipating a higher cash rate. Affordability due to the high level of house prices is another concern. And Government incentives (notably the HomeBuilder program) had finished.

The reduction of home buying that has started to occur will directly reduce GDP growth (in the GDP terminology it is known as 'ownership transfers' that includes items such as estate agent and legal fees).

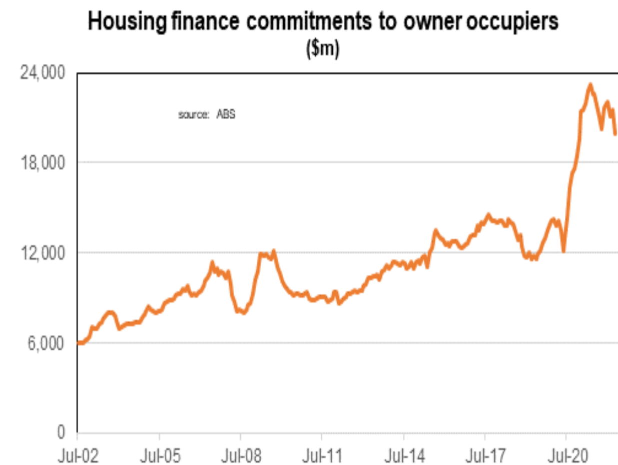
Building approvals have also declined from their highs. But this decline in approvals will not lead to weaker activity for some time. Supply-chain problems and worker shortages means that there is a huge backlog of work. It is possible that the large jump in costs that have hit the construction sector might see some orders not be filled. The size of the backlog of orders means that residential construction will be a significant part of economic activity until well into next year.

Business investment is typically less impacted by the cost of borrowing and more by the indirect impact (interest rates impacting economic growth and therefore the profit outlook). Currently firms are indicating they expect to increase their capex budgets. That is consistent with their view that business conditions for many sectors are good and capacity utilisation is high. In time as interest rates slow the economy the growth of business investment spending will also likely slow.

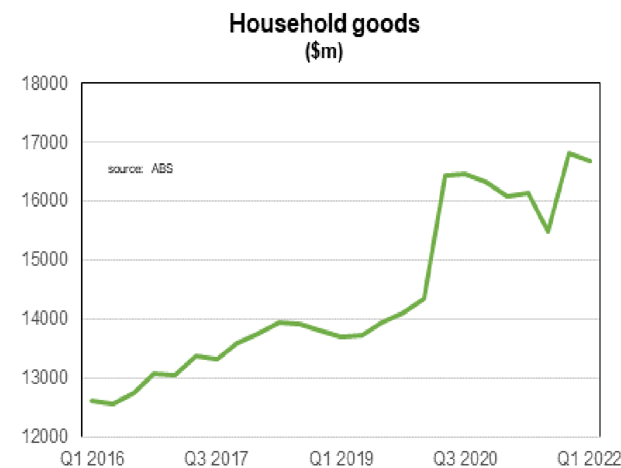
Rising costs has led to some firms cutting capex budgets. This will be more noticeable for firms in sectors that are either unable or unwilling to increase prices to offset higher costs or don't have high enough volume to offset any decline in margins. Smaller firms are more likely to be vulnerable.

Government investment decisions are less impacted by interest rate movements. Currently there is a high level of infrastructure spending in the pipeline. Indeed, the NSW Government is looking to postpone a number of projects given the material and worker shortages.

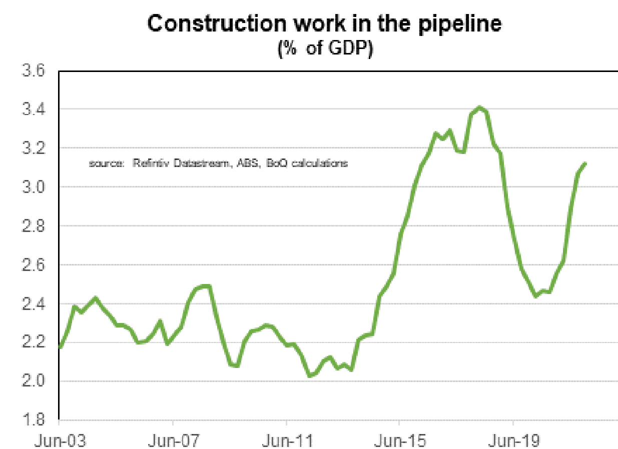
There is starting to be a slowdown in lending to the housing sector.



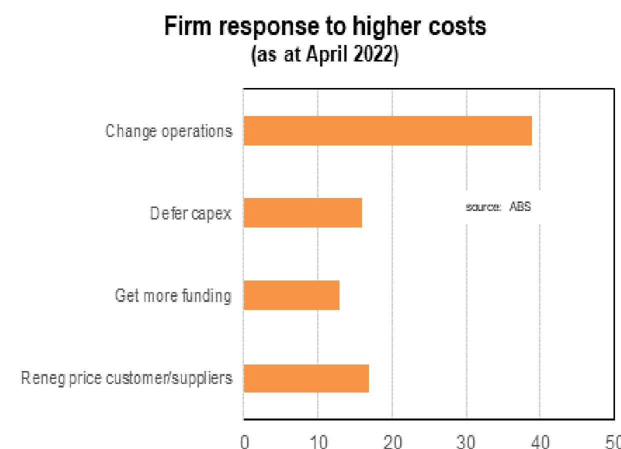
There already has been a big jump in buying of households goods.



There is plenty of construction work still to be done.



Higher costs has led to some firms to postpone capex spending.



Reduces cash flow

Higher interest rates increases debt repayments, reducing the amount of spending on other goods and services. This is partially offset by higher interest rates increasing the income for households and firms that receive income from deposits.

A number of analysts believe that reduced cash flow will be a particularly effective channel in this economic cycle reflecting the high level of household debt in Australia. The psychological impact of higher interest rates could be magnified with a generation of homeowners have not experienced an interest rate hiking cycle.

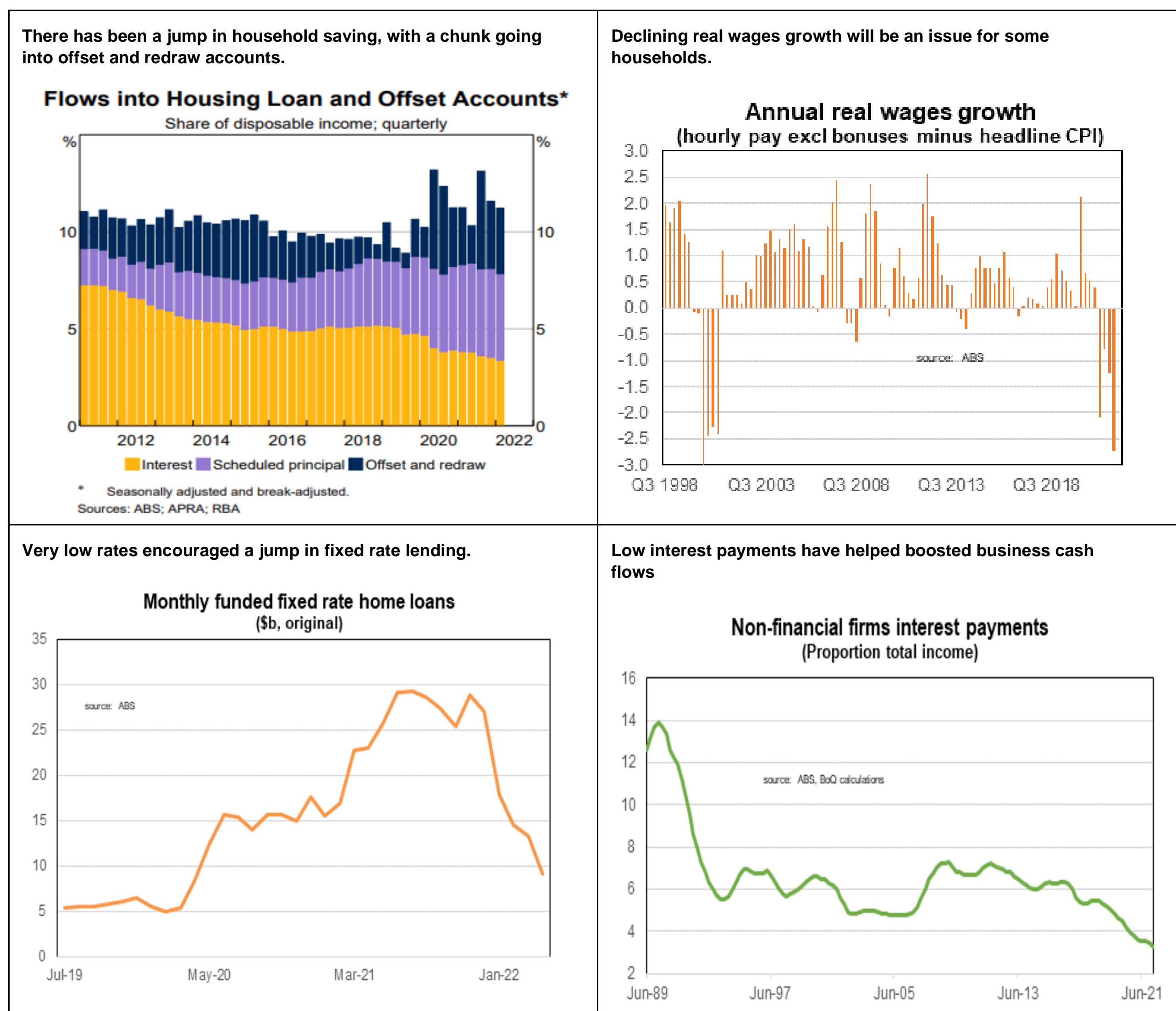
This will be an issue for some borrowers. But there are offsetting factors. Many households have built up a high level of saving, with a substantial proportion of saving put into offset and redraw accounts. A large number of borrowers took advantage of extremely attractive offers by fixing their home loans rates. Those borrowers will initially be protected from higher interest rates although will be exposed to interest rate movements once their fixed loan period ends.

Offsetting these positives is that the increase in interest rates is taking place at the same time that many households are facing a period of declining real wages (wages growth is not keeping up with inflation). This will make it more difficult for low-income households that have borrowing but with minimal saving.

Firms are currently benefitting from rock-bottom interest rates. According to my calculations interest payments were at a record low relative to their income in the March quarter. Firms with narrow profit margins and minimal

cash buffers will be more impacted by higher interest rates. This will particularly be the case for firms that are facing big cost rises, and without the ability to pass them onto customers. Many firms though have built up strong cash buffers.

Higher interest rates tends to have little impact upon government spending. Government consumption spending (such as more spending on NDIS and aged care) has been growing faster than the wider economy for some years. The current budget settings are generous given the current state of the economy. It will be interesting to see whether the new government decides to change fiscal settings later this year, particularly given the cost of living pressures.

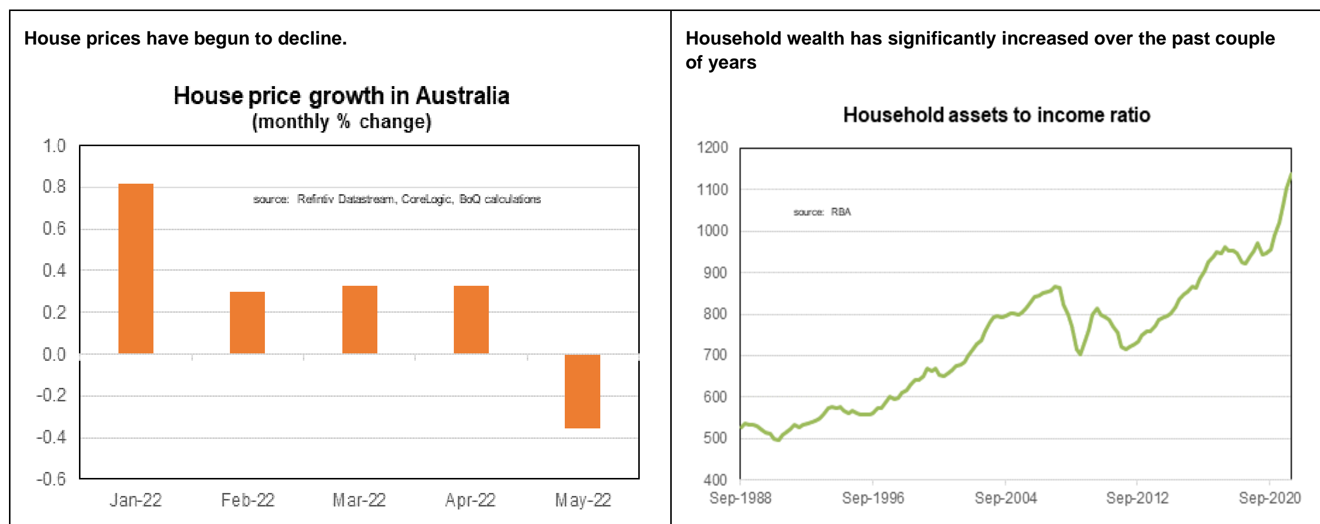


Falling asset prices

Higher interest rates reduce the value of many asset prices (including house prices). Weaker house prices could lead to households to become more cautious in their spending. Lower housing values can also limit how much money households (or businesses) can borrow. This can be an issue for SME's.

Even before the cash rate had risen significantly house prices had started to decline (most notably in Sydney, Melbourne and Canberra). Global equity markets have also had a tougher time reflecting concerns about the impact of higher interest rates.

Declining asset prices is likely to have some impact. But this decline comes after many households have enjoyed a significant rise in wealth over recent years. How much this channel impacts the economy will depend upon how much house (and equity) prices decline. Over the past forty years' house prices have typically declined by 10-15% (from peak-to-trough) during rate hike cycles. A 15% decline from the peak would take house prices back to the level prevalent at the start of 2021.



Higher exchange rate

Higher interest rates can lead to a stronger $A. Whether the currency does strengthen though depends upon other factors, including what is also happening with interest rates in other countries.

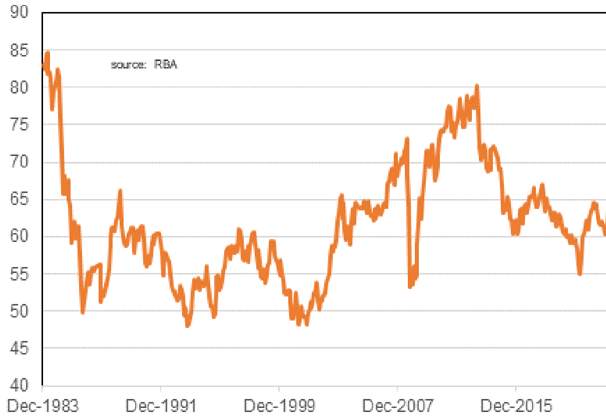
The $A/$US rate has been trading below its long-term average of about 75c for much of the past couple of months despite the cash rate starting to rise. Mostly that is a reflection of the strength of the $US. On a trade weighted basis (currencies of our major trading partners) the $A is currently around its long-term average, and is up a bit under 10% from its lows of earlier this year.

For the currency what matters is where financial markets expect the cash rate to get to (and the time it takes to get there), not the current cash rate level. Investors' are already pricing in a significant rate hike schedule for the RBA. At the start of June financial markets were only pricing in a higher cash rate higher in NZ.

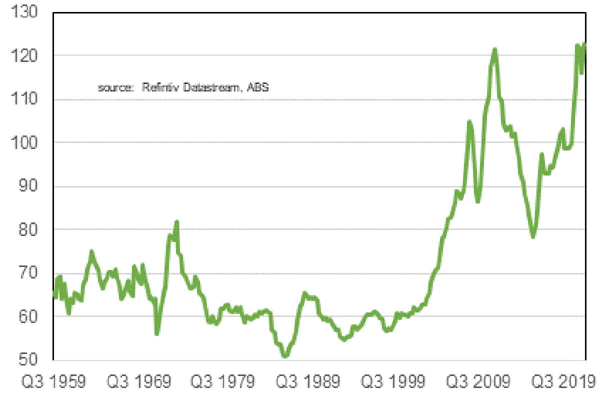
But the relatively bigger set of rate hikes priced for the RBA is not reflected in the current level of the $A. That indicates that there are more factors than just interest rates that drive the $A. Typically a current account surplus and higher commodity prices would thought to be positive factors for the $A. That is not so much the case right now. One reason is that the uncertainty caused by higher interest rates and high inflation has meant that investors are less willing to put their money into smaller economies such as Australia (and New Zealand). Another is that there has been a constant flow of capital outside of Australia as superannuation funds looks to diversify their investments offshore.

BOQ GROUP

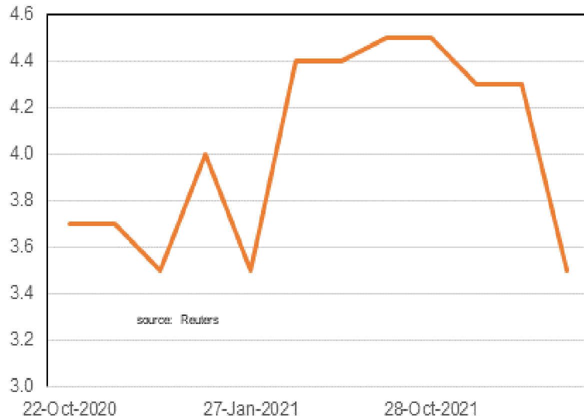
The $A is currently trading around its long-term average against the currencies of all major trading partners.



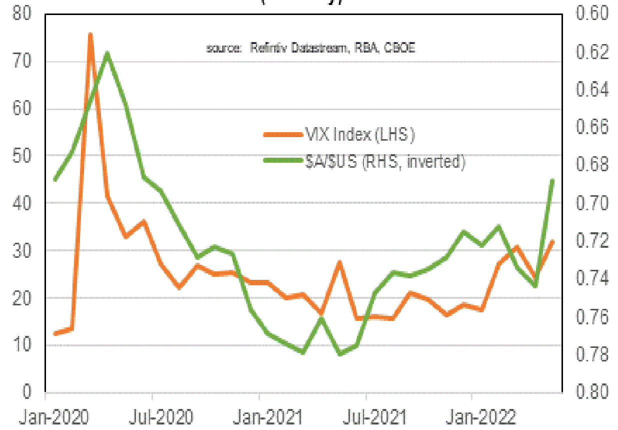
High commodity prices are significantly boosting Australia's national income.



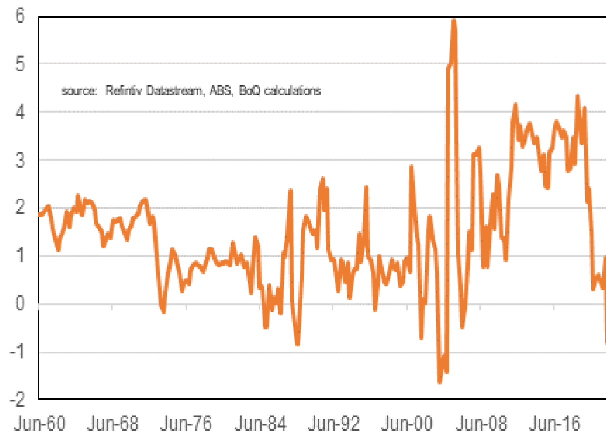
Higher interest rates and rising inflation has seen a mark down in global growth forecasts.



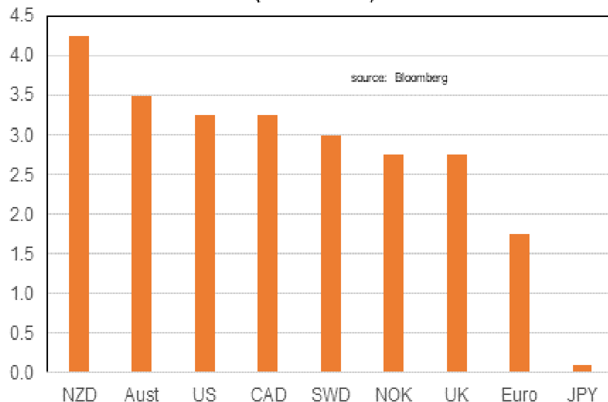
Financial market and economic uncertainty has weighed on the $A.



Capital has been flowing out of Australia as super funds looks to diversify their investments.



The expected peak in the cash rate in Australia is higher than most other developed economies.



BOQ GROUP

Summary

In some respects the higher cash rate is good news. It is a reflection that the economy is doing well, underlined by an unemployment rate of 3.9% (and likely to go lower). But a higher cash rate is also due to some bad news, namely that inflation is substantially higher than had been expected. Much of the rise of inflation has been down to global supply factors that are out of the RBA's control. But some of the rise of inflation has been down to domestic demand factors, something that the RBA has some responsibility.

It is uncertain as to how quickly higher interest rates will impact the economy. Some of the impact is already being felt (lower asset prices). Some of the usual ways that higher interest rate influences the economy (lower investment and reduced cash flows) may take some time to have their usual impact. And some of the other channels (higher saving) may not work in this cycle.

Given the uncertainty as to how households will respond to higher interest rates, the RBA at some stage will likely pause to get a gauge of how its monetary policy changes have been working. But we are not there yet. And this means there are more interest rate rises on the way.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | 255 George Street Sydney NSW 2000

Twitter: @petermunckton