Economic Insights

Economics | June 7, 2022

Shock & awe: biggest interest rate hike in 22 years

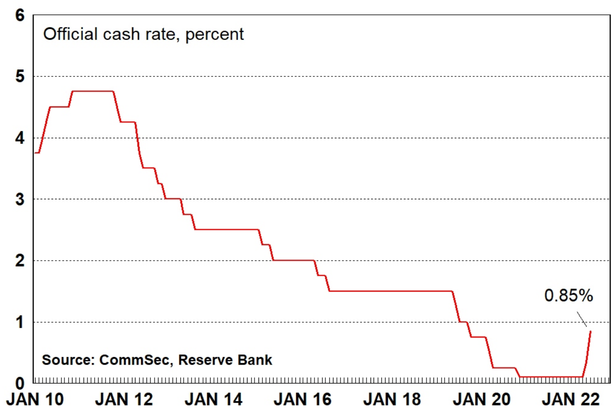
Reserve Bank Board meeting

- **The Reserve Bank (RBA) Board has lifted the target rate for the cash rate by 50 basis points (0.50 per cent) to 0.85 per cent, the biggest rate hike in 22 years and the first back-to-back rate hike since May 2010. The RBA increased the interest rate on Exchange Settlement balances from 25 basis points to 75 basis points.**
- **The Board said that it *"is committed to doing what is necessary to ensure that inflation in Australia returns to target over time."***

What does it all mean?

- The 'normalisation' process continues. Clearly, 'emergency' level interest rates are no longer required for an economy in good shape with above-average economic growth, generational-low unemployment, record profitability and solid spending growth. And the RBA notes *"inflation has increased significantly."*
- Apart from the 'normalisation' process, the Reserve Bank faces the same problem as other central banks in addressing the global inflation problem. The Covid-induced supply-chain issues, strong consumer demand for goods during lockdowns and the war in Ukraine are the key influences in pushing prices higher across the globe. There is not much central banks can do about those influences. But what they can do is try to slow down spending (demand) until production (supply) catches up.
- Most people would like to know the timing and size of future rate hikes well in advance, as well as how many rate hikes are likely to be necessary to slow down the economy. Unfortunately it is not as simple as that. The Reserve Bank is monitoring a broad array of domestic and global factors in determining the size and timing of interest rate hikes. This is more 'art' rather than science – hopefully it has mastered the art of rate hiking, but we have doubts.
- RBA Governor Lowe has said in the past that interest rates are not on a pre-determined path. The RBA knows that rates have to rise, but the size and timing of moves is not known with certainty. But the Reserve Bank implicitly acknowledges that it is fallen *'behind the curve'* – it now needs to lift rates quickly to get ahead of the inflation threat, but the risk is that the economy slumps as a result.
- Commonwealth Bank (CBA) Group economists expect the cash rate to rise further in coming months: 50bp in July and then 25bp moves in August, September and November, taking the cash rate to 2.10 per cent by year-end.
- Given the significant lift in household debt taken on by Aussie consumers over the last few years, it will only take a few more interest rate increases to slow the economy to a pace consistent with inflation holding in the 2-3 per cent target band.

Short, sharp shock



The assessment

- On the inflation challenge, the Reserve Bank said: *"Inflation is expected to increase further, but then decline back towards the 2–3 per cent range next year."*

Craig James, Chief Economist
Twitter: @CommSec

But the RBA notes that inflation is likely to be higher than was expected a month ago. The Reserve Bank has also again shifted to the 'outlook' for inflation and wages as opposed to looking at current data.

- On wage pressures the Reserve Bank said: *"The Bank's business liaison program continues to point to a lift in wages growth from the low rates of recent years as firms compete for staff in a tight labour market."*

Perspectives on interest rates

- The RBA lifted the cash rate by 0.50 percentage points to 0.85 per cent. This follows a 25bp increase on May 3, 2022. The RBA last cut the cash rate from 0.25 per cent to 0.10 per cent on November 3, 2020. Before the Covid-19 health and economic crisis, the official cash rate was 0.75 per cent on February 5, 2020.

Implications

- The RBA says that it *"is committed to doing what is necessary to ensure that inflation in Australia returns to target over time."* Expect similar statements to be made by the Reserve Bank Board at future rate meetings. The RBA will use a combination of 'jawboning' and interest rate hikes to ensure that inflation target returns to the 2-3 per cent target band.
- Before the pandemic, the cash rate was 0.75 per cent. With today's rate hike, the cash rate is now back at pre-pandemic levels.
- It's important to remember that household deposits have risen 28 per cent or $280 billion since Covid hit in February 2022. If the 50bp rate is fully passed on, it will add more than $6 billion to household incomes – providing a welcome boost especially to the incomes of retirees.

The Statement

- Below is the statement from today's June 7, 2022 meeting.

Media Release

No: 2022-14
Date: 7 June 2022

Statement by Philip Lowe, Governor:
Monetary Policy Decision

At its meeting today, the Board decided to increase the cash rate target by 50 basis points to 85 basis points. It also increased the interest rate on Exchange Settlement balances by 50 basis points to 75 basis points.

Inflation in Australia has increased significantly. While inflation is lower than in most other advanced economies, it is higher than earlier expected. Global factors, including COVID-related disruptions to supply chains and the war in Ukraine, account for much of this increase in inflation. But domestic factors are playing a role too, with capacity constraints in some sectors and the tight labour market contributing to the upward pressure on prices. The floods earlier this year have also affected some prices.

Inflation is expected to increase further, but then decline back towards the 2–3 per cent range next year. Higher prices for electricity and gas and recent increases in petrol prices mean that, in the near term, inflation is likely to be higher than was expected a month ago. As the global supply-side problems are resolved and commodity prices stabilise, even if at a high level, inflation is expected to moderate. Today's increase in interest rates will assist with the return of inflation to target over time.

The Australian economy is resilient, growing by 0.8 per cent in the March quarter and 3.3 per cent over the year. Household and business balance sheets are generally in good shape, an upswing in business investment is underway and there is a large pipeline of construction work to be completed. Macroeconomic policy settings are supportive of growth and national income is being boosted by higher commodity prices. The terms of trade are at a record high.

The labour market is also strong. Employment has grown significantly and the unemployment rate is 3.9 per cent, which is the lowest rate in almost 50 years. Job vacancies and job ads are at high levels and a further decline in unemployment and underemployment is expected. The Bank's business liaison program continues to point to a lift in wages growth from the low rates of recent years as firms compete for staff in a tight labour market.

One source of uncertainty about the economic outlook is how household spending evolves, given the increasing pressure on Australian households' budgets from higher inflation. Interest rates are also increasing. Housing prices have declined in some markets over recent months but remain more than 25 per cent higher than prior to the pandemic, supporting household wealth and spending. The household saving rate also remains higher than it was before the pandemic and many households have built up large financial buffers. While the central scenario is for strong household consumption growth this year, the Board will be paying close attention to these various influences on consumption as it assesses the appropriate setting of monetary policy.

The Board will also be paying close attention to the global outlook, which remains clouded by the war in Ukraine and its effect on the prices for energy and agricultural commodities. Real household incomes are under pressure in many economies and financial conditions are tightening, as central banks withdraw monetary policy support in response to broad-based inflation. There are also ongoing uncertainties related to COVID, especially in China.

Today's increase in interest rates by the Board is a further step in the withdrawal of the extraordinary monetary support that was put in place to help the Australian economy during the pandemic. The resilience of the economy and the higher inflation mean that this extraordinary support is no longer needed. Given the current inflation pressures in the economy, and the still very low level of interest rates, the Board decided to move by 50 basis points today. The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market. The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time.

Implications for home buyers

- The following table shows current monthly repayments on a range of mortgages and projections if rates are increased by major lenders in response to the lower cash rate. The Reserve Bank notes that the Banks Standard Variable owner-occupier rate is currently 4.77 per cent. And the Banks Discounted Variable owner-occupier rate is currently 3.70 per cent.

MORTGAGE CALCULATOR (Monthly repayments, 30 years)

Mortgage	Change in Interest Rates						
		+0.50%	+0.75%	+1.00%	+1.25%	+1.50%	+1.75%
	4.77	5.27	5.52	5.77	6.02	6.27	6.52
$300,000	$1,568.56	$1,660.33	$1,707.13	$1,754.53	$1,802.51	$1,851.06	$1,900.15
$350,000	$1,829.99	$1,937.05	$1,991.66	$2,046.95	$2,102.93	$2,159.56	$2,216.84
$400,000	$2,091.41	$2,213.77	$2,276.18	$2,339.38	$2,403.35	$2,468.07	$2,533.54
$450,000	$2,352.84	$2,490.49	$2,560.70	$2,631.80	$2,703.77	$2,776.58	$2,850.23
$500,000	$2,614.27	$2,767.22	$2,845.22	$2,924.22	$3,004.18	$3,085.09	$3,166.92
$550,000	$2,875.69	$3,043.94	$3,129.74	$3,216.64	$3,304.60	$3,393.60	$3,483.61
$600,000	$3,137.12	$3,320.66	$3,414.27	$3,509.06	$3,605.02	$3,702.11	$3,800.30
$650,000	$3,398.55	$3,597.38	$3,698.79	$3,801.49	$3,905.44	$4,010.62	$4,117.00
$700,000	$3,659.97	$3,874.10	$3,983.31	$4,093.91	$4,205.86	$4,319.13	$4,433.69
	Change in repayments per month						
$300,000		$91.77	$138.57	$185.97	$233.95	$282.50	$331.59
$350,000		$107.06	$161.67	$216.97	$272.94	$329.58	$386.86
$400,000		$122.36	$184.76	$247.96	$311.93	$376.66	$442.12
$450,000		$137.65	$207.86	$278.96	$350.93	$423.74	$497.39
$500,000		$152.95	$230.95	$309.95	$389.92	$470.83	$552.65
$550,000		$168.24	$254.05	$340.95	$428.91	$517.91	$607.92
$600,000		$183.54	$277.15	$371.94	$467.90	$564.99	$663.18
$650,000		$198.83	$300.24	$402.94	$506.89	$612.07	$718.45
$700,000		$214.13	$323.34	$433.93	$545.88	$659.16	$773.71

Source: CommSec

Selected charts