Economic Insights

Economics | July 5, 2022

Interest rate hikes: Harder and faster

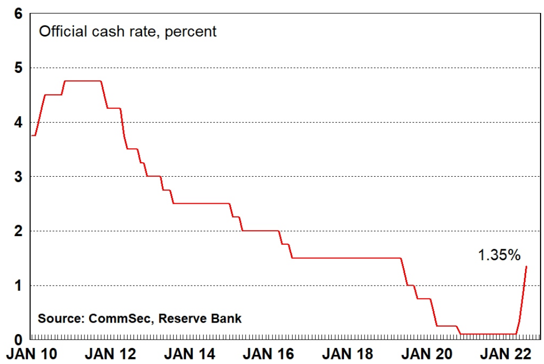
Reserve Bank Board meeting

- The Reserve Bank (RBA) Board has lifted the cash rate by 50 basis points (half of a percent) for a second straight month, taking the cash rate to 1.35 per cent. This represents the biggest back-to-back rate hikes since the cash rate was first targeted in 1990. The RBA increased the interest rate on Exchange Settlement balances from 50 basis points to 1.25 per cent.
- 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?

- There are two important points to consider when evaluating the latest Reserve Bank decision to lift interest rates. The first, is that rate hikes are happening across the globe. Nearly all central banks across the globe are lifting rates from 'emergency' levels to reflect more 'normal' functioning economies. The second point is that rates are being lifted to slow down economies and bring supply (production) and demand (spending) back into balance to address soaring inflation rates.
- Central banks are 'front loading' rate hikes to try and get on top of inflationary pressures. That is, rates are being lifted quicker and more aggressively than usual. The fear is that if higher rates of inflation take hold – become cemented in people's consciousness – then it will take longer to bring the inflation rates back to preferred levels.
- One factor driving inflation higher is Covid-19. Workers are continuing to contract the virus and forced to stay at home, resulting in fewer goods and services being produced. But economies are continuing to recover from the virus, with spending lifting. Unfortunately spending is recovering more quickly than production.
- The other key factor is the war in Ukraine, driving up energy and food prices across the globe.
- The risk with 'harder and faster' rate hikes is that they could cause economies to go into recession. Recessions are differently defined across the globe, but in Australia the general definition of recession is two consecutive quarters of economic contraction (declines in gross domestic product).
- Commonwealth Bank (CBA) Group economists expect the cash rate to rise further in coming months: a rate hike of at least 25bp is expected in August, then 25bp moves in September and November, taking the cash rate to 2.10 per cent by year-end. The risk is that rates rise a little higher than currently expected, to 2.35 per cent.
- Commonwealth Bank (CBA) Group economists expect the Australian economy to slow, not stall. In calendar 2022 the economy is tipped to grow by 3.5 per cent and then grow a further 2.1 per cent in calendar 2023.

Short, sharp shock



The assessment

- On the inflation challenge, the Reserve Bank expresses some confidence: *"Inflation is forecast to peak later this year and*

Craig James, Chief Economist
Twitter: @CommSec

then decline back towards the 2–3 per cent range next year." Further the RBA notes *"Medium-term inflation expectations remain well anchored and it is important that this remains the case."*

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

Perspectives on interest rates

- The RBA lifted the cash rate by 50 basis points (bp) or half a per cent to 1.35 per cent. This follows a 50bp increase on June 7 and 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

- Higher borrowing costs should lead to slower demand for houses. But as home prices ease, they will actually become more affordable for home buyers – especially those buyers with higher deposits or greater equity.
- Higher interest rates are also positive for savers. It's important to remember that household deposits have risen 28 per cent or $283 billion since Covid hit in February 2022. If the 50bp rate is fully passed on, it will add more than $6.4 billion to household incomes – providing a welcome boost especially to the incomes of retirees.

The Statement

- Below is the statement from today's July 5, 2022 meeting (emphasis added by CommSec).

Media Release

No: 2022-20
Date: 5 July 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 1.35 per cent. It also increased the interest rate on Exchange Settlement balances by 50 basis points to 1.25 per cent.

Global inflation is high. It is being boosted by COVID-related disruptions to supply chains, the war in Ukraine and strong demand which is putting pressure on productive capacity. Monetary policy globally is responding to this higher inflation, although it will be some time yet before inflation returns to target in most countries.

Inflation in Australia is also high, but not as high as it is in many other countries. Global factors account for much of the increase in inflation in Australia, but domestic factors are also playing a role. Strong demand, a tight labour market and capacity constraints in some sectors are contributing to the upward pressure on prices. The floods are also affecting some prices.

Inflation is forecast to peak later this year and then decline back towards the 2–3 per cent range next year. As global supply-side problems continue to ease and commodity prices stabilise, even if at a high level, inflation is expected to moderate. Higher interest rates will also help establish a more sustainable balance between the demand for and the supply of goods and services. Medium-term inflation expectations remain well anchored and it is important that this remains the case. A full set of updated forecasts will be published next month following the release of the June quarter CPI.

The Australian economy remains resilient and the labour market is tighter than it has been for some time. The unemployment rate was steady at 3.9 per cent in May, the lowest rate in almost 50 years. Underemployment has also fallen significantly. Job vacancies and job ads are both at very high levels and **a further decline in unemployment and underemployment is expected over the months ahead. The Bank's business liaison program and business surveys continue to point to a lift in wages growth from the low rates of recent years as firms compete for staff in the tight labour market.**

One source of ongoing uncertainty about the economic outlook is the behaviour of **household spending**. The recent spending data have been positive, although household budgets are under pressure from higher prices and higher interest rates. Housing prices have also declined in some markets over recent months after the large increases of recent years. The household saving rate remains higher than it was before the pandemic and many households have built up large financial buffers and are benefiting from stronger income growth. The Board will be paying close attention to these various influences on household spending 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 increase interest rates. **There are also ongoing uncertainties related to COVID, especially in China.**

Today's increase in interest rates is a further step in the withdrawal of the extraordinary monetary support that was put in place to help insure the Australian economy against the worst possible effects of the pandemic. **The resilience of the economy and the higher inflation mean that this extraordinary support is no longer needed.** 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 5.27 per cent. And the Banks Discounted Variable owner-occupier rate is currently 4.20 per cent.

MORTGAGE CALCULATOR (Monthly repayments, 30 years)

Mortgage		Change in Interest Rates					
		+0.25%	0.50%	0.75%	1.00%	1.25%	1.50%
	5.27	5.52	5.77	6.02	6.27	6.52	6.77
$300,000	$1,660.33	$1,707.13	$1,754.53	$1,802.51	$1,851.06	$1,900.15	$1,949.78
$350,000	$1,937.05	$1,991.66	$2,046.95	$2,102.93	$2,159.56	$2,216.84	$2,274.75
$400,000	$2,213.77	$2,276.18	$2,339.38	$2,403.35	$2,468.07	$2,533.54	$2,599.71
$450,000	$2,490.49	$2,560.70	$2,631.80	$2,703.77	$2,776.58	$2,850.23	$2,924.68
$500,000	$2,767.22	$2,845.22	$2,924.22	$3,004.18	$3,085.09	$3,166.92	$3,249.64
$550,000	$3,043.94	$3,129.74	$3,216.64	$3,304.60	$3,393.60	$3,483.61	$3,574.60
$600,000	$3,320.66	$3,414.27	$3,509.06	$3,605.02	$3,702.11	$3,800.30	$3,899.57
$650,000	$3,597.38	$3,698.79	$3,801.49	$3,905.44	$4,010.62	$4,117.00	$4,224.53
$700,000	$3,874.10	$3,983.31	$4,093.91	$4,205.86	$4,319.13	$4,433.69	$4,549.50
		Change in repayments per month					
$300,000		$46.80	$94.20	$142.18	$190.73	$239.82	$289.45
$350,000		$54.60	$109.90	$165.88	$222.51	$279.79	$337.70
$400,000		$62.41	$125.60	$189.58	$254.30	$319.76	$385.94
$450,000		$70.21	$141.30	$213.27	$286.09	$359.73	$434.18
$500,000		$78.01	$157.00	$236.97	$317.88	$399.70	$482.42
$550,000		$85.81	$172.70	$260.67	$349.66	$439.67	$530.67
$600,000		$93.61	$188.41	$284.36	$381.45	$479.64	$578.91
$650,000		$101.41	$204.11	$308.06	$413.24	$519.62	$627.15
$700,000		$109.21	$219.81	$331.76	$445.03	$559.59	$675.39

Source: CommSec

Selected charts