18 August 2023

ECONOMIC UPDATE

The lower cash rate in Australia

Key Points

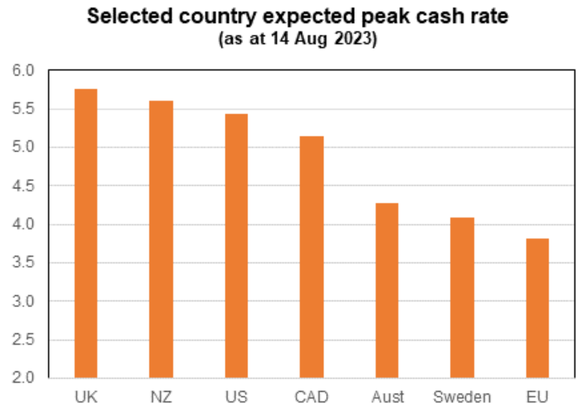
- **The Australian cash rate is likely to peak below that of most peer countries;**
- **This is unusual in a historical context;**
- **High household debt at a time of negative real disposable income growth are the most likely cause;**
- **There is likely to be an improvement in consumers' real disposable income growth over the next year;**
- **What households do with that extra income will play a big role in the economic outlook.**

The peak in the Australian cash rate will be lower than in peer countries

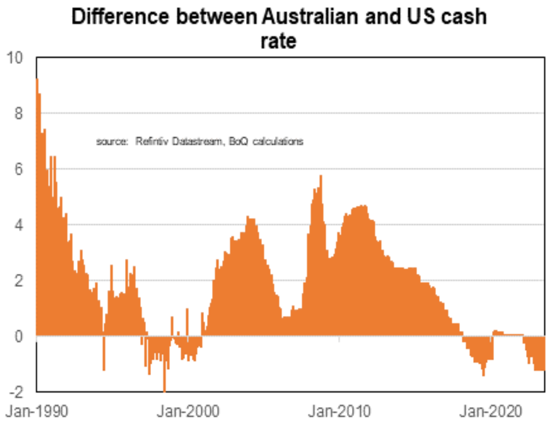
Ever since thoughts first turned to rate hikes at the beginning of 2022, financial markets have believed that the peak in Australia's cash rate would be below that of the US. That has also been the case for financial markets views about the peak in the cash rate relative to New Zealand. Expectations that Australia's peak cash rate would be below that of the UK and Canada though is something that has only happened this year.

Historically Australia having a lower cash rate than the US is not typical but is also not unusual. The Australian cash rate was higher around the turn of the century at a time when the US economy was feeling the fallout from the equity market 'Tech Crash'. It was again lower prior to the pandemic when the Australian economy was still feeling the pinch of the end of the mining boom and the US economy was powering ahead boosted by fiscal policy.

The cash rate in Australia is expected to peak below that of peer countries.



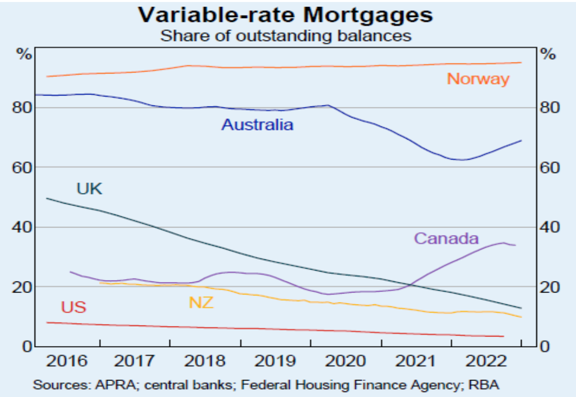
The Australian cash rate is typically above the US.



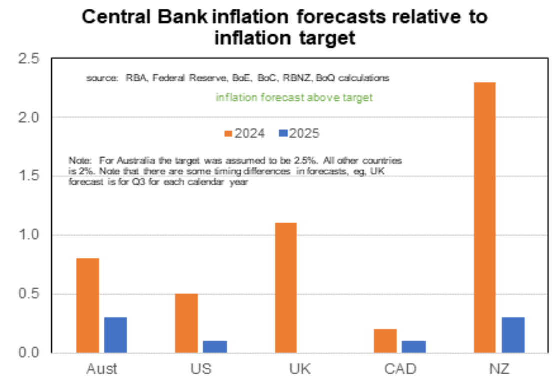
This time though there is no obvious difference in economic cycles to explain why the Australian cash rate will peak under that of the US. According to RBA figures, the growth of GDP per capita (per person) has been about the same in Australia and the US (it has been slightly higher in the US). The unemployment rate in both countries is around 3.5%. Core inflation in both countries peaked at around 6%.

The RBA has put the likelihood of a lower cash rate in Australia down to three possibilities. The first is that the RBA is happy to have a slower return to their inflation target than other central banks to (hopefully) keep the unemployment rate relatively low. That is a noble aim, one that hopefully can be achieved. But an examination of the RBA's inflation forecasts for the next two years suggests that their forecast inflation path is not too different from peer economies.

Australia has a high proportion of variable rate mortgages.

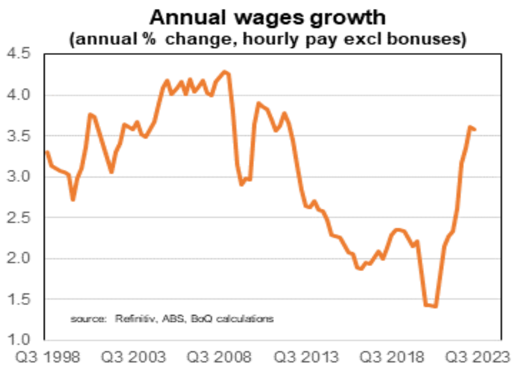


The RBA's projected inflation path does not look too dissimilar to that of peer central banks.

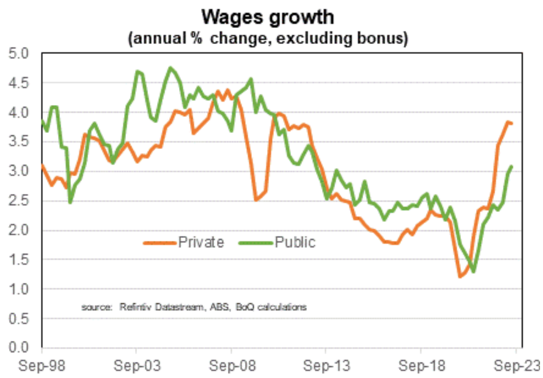


A second factor is that wages growth in Australia has been below peer countries. This has been the case. And it may remain the case. But the Wages Price Index data showed that for those in the private sector that received a pay rise, wages growth in the June quarter (at 4.5%) hit a record high (the reason for the modest total quarterly increase was the seasonally low number of workers that received a pay rise). We know that wages growth is likely to get a bump in the second half of the year from the increase in the minimum wage. Public-sector wage growth is at a decade high, with further increases likely.

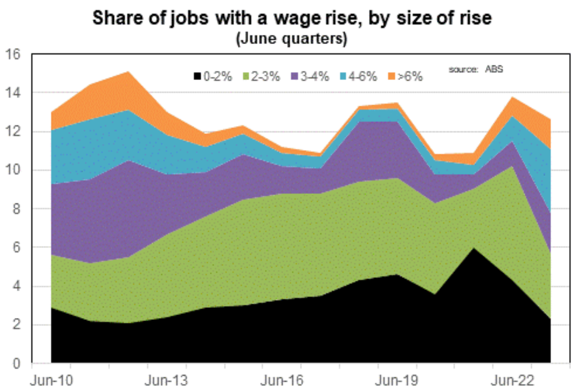
Wages growth has been modest compared to the 2000's despite the strength of the jobs market.



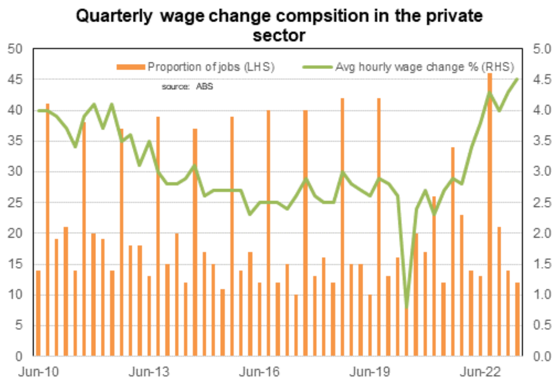
Both private and public-sector wages growth is near a decade high.



The proportion of pay rises over 4% was at its highest since at least 2010.

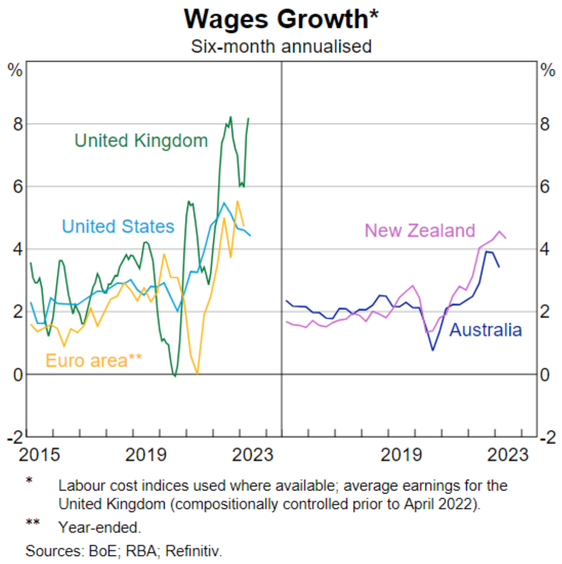


But the proportion of workers that received a pay rise in the June quarter was near a seasonal low.

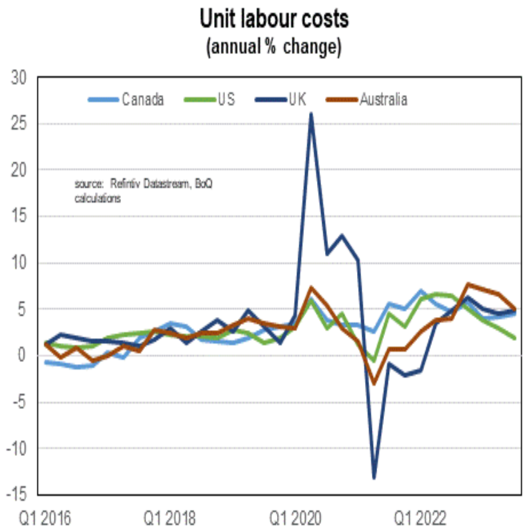


Wages growth matters because it is the key cost for firms' particularly for a large part of the services industry. But as the RBA themselves emphasise what really matters for the inflation outlook is not so much wages growth but the growth of unit labour costs (the increase in labour costs, which includes wages growth, adjusted for the growth in productivity). Australia's low productivity growth has meant that unit labour costs are rising faster than in peer countries. The RBA is not yet concerned about this fact, assuming that productivity growth is likely to rise (or the higher labour costs can be absorbed within profit margins).

Wages growth in Australia has been below that of peer countries.



But unit labour cost growth has been higher reflecting weak productivity outcomes.



The other possibility flagged is that the higher proportion of variable rate mortgages in Australia means the transmission of interest rates impacts the Australian economy quicker than other economies (most notably the US where the most common form of mortgage is a 30-year fixed rate). This is true although Australia has had a higher proportion of variable-rate mortgages for a long time. And the proportion of fixed rate mortgages written in Australia between 2020-22 was higher than usual.

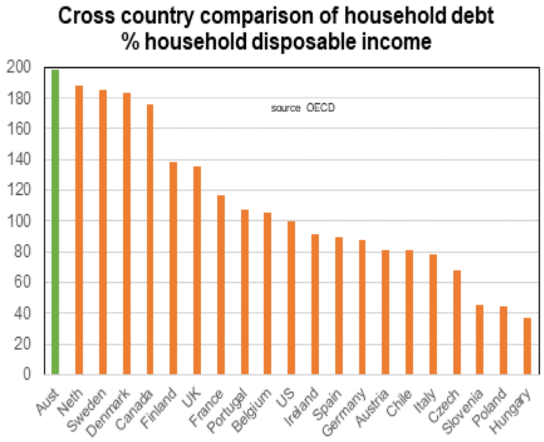
But it is the high ratio of household debt to disposable income in Australia as to why the large proportion of variable rate mortgages matter. That high debt ratio is the reason why the RBA expects scheduled interest payments (as proportion of disposable income) to hit a record high in coming quarters.

In one respect that should not be an issue as actual mortgage payments have been this high (or higher) relative to disposable incomes over the past dozen years reflecting voluntary additional payments. But the last time that household budgets came under financial stress (in the years after the end of the mining boom in the 2010's) households reduced the amount of voluntary additional payments (and therefore total mortgage payments) they made. They will not have that choice on this occasion.

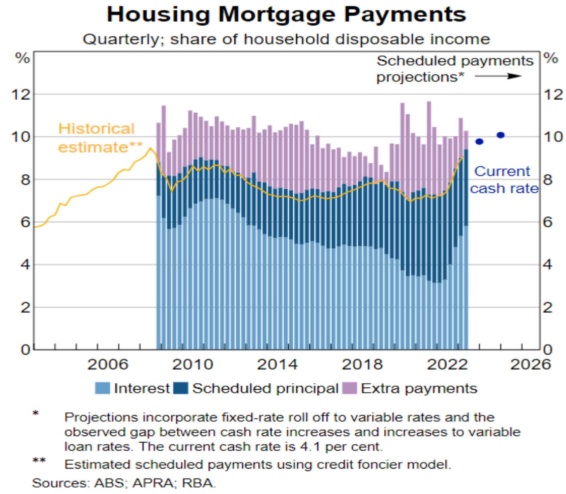
The high household debt ratio can explain why the cash rate in Australia will peak below that of the US. But it does not explain why the cash rate in Canada is expected to peak at a high level given that Canada also has a high household debt ratio.

The best explanation I have is based upon a couple of interesting charts from the RBA's August Monetary Policy Statement. Those charts show that while real household disposable income growth (household income growth after inflation) has been around flat in peer countries (and is now on the rise in the US and to a less extent France), it has been negative in Australia. Partly the weaker disposable income growth reflects the quicker impact of higher interest rates on mortgage payments in Australia. But according to RBA calculations, it also reflects that the combination of ‘other’ income (such as government payments and dividends) and tax payments has been a bigger negative factor on Australian household incomes than for peer countries.

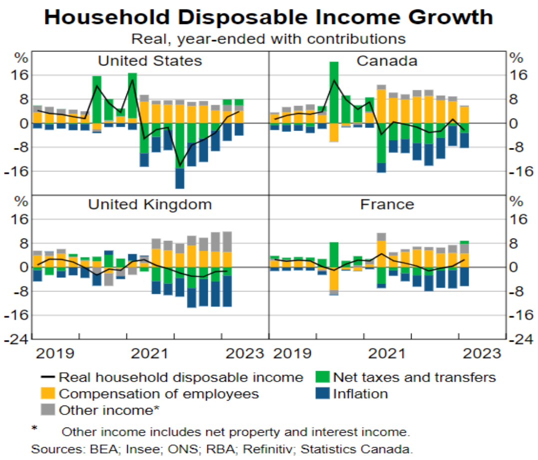
Australia’s household debt ratio is high by global standards.



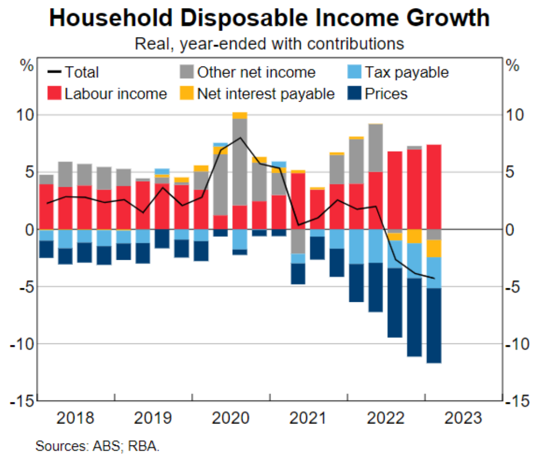
High debt means scheduled interest payments will be a record amount of disposable income.



Household disposable income growth has been flat in most countries although it is picking up in the US.



But household disposable income growth has been even weaker in Australia.



In coming quarters real household disposable income growth will be hit by conflicting forces. Interest payments will take a bigger chunk out of incomes while inflation will become less of a negative. Wages growth is likely to head a little higher. Most forecasters expect a rise in the unemployment rate (particularly in 2024) although Australia’s jobs market still looks strong by peer country standards (even despite the surprising monthly fall in jobs in July). Income tax cuts are due to be delivered in the second half of next year.

In net terms it is likely that real disposable income growth will improve in coming quarters. The question then will be how much of that improvement will be spent. Recent surveys suggest that rising interest rates has led to a growing proportion of households indicating they will use their additional funds to repay debt (or rebuild saving).

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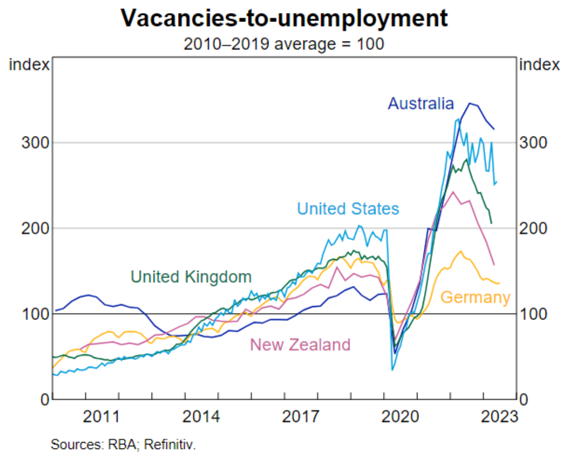
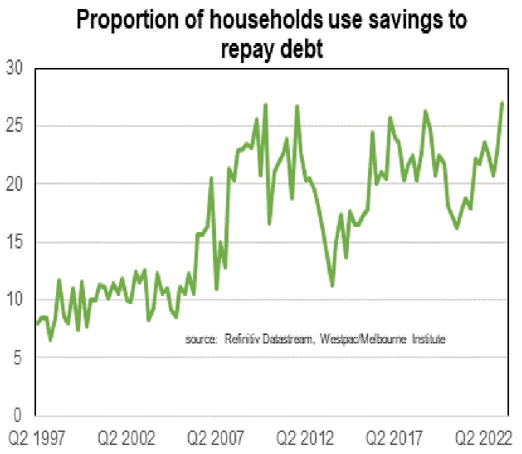
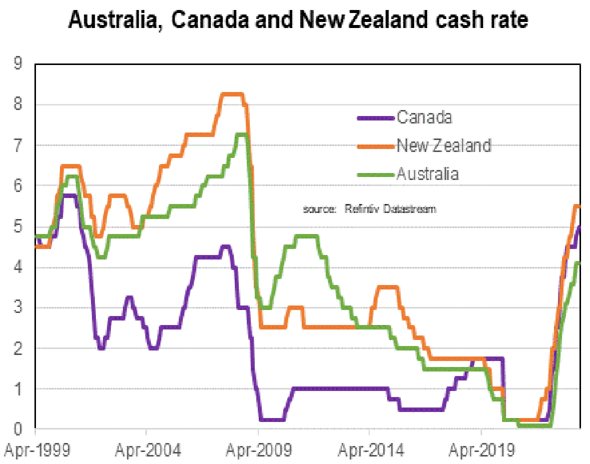
Australia's jobs market is in a stronger state than peer countries.



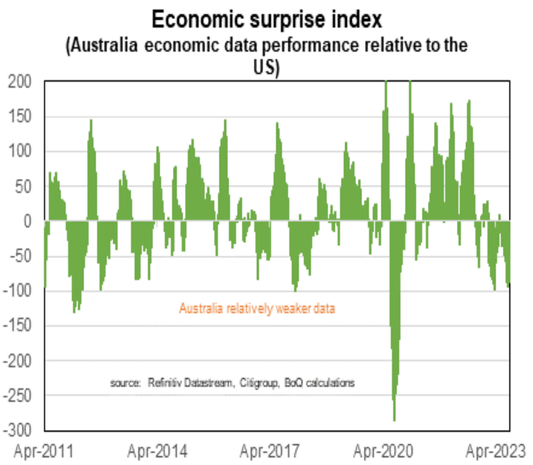
Surveys indicate a growing proportion of households wish to repay debt.



The NZ cash rate has mainly been higher than Australia's. That hasn't usually been the case with Canada.



US economic data has been stronger than Australian data for much of this year.



The Australian cash rate looks likely to peak below that of peer countries. That likelihood will be of scant consolation to many mortgage owners. The good news is that pressure on household budgets should improve as inflation declines over the next year (providing consumers can keep their full-time job). I believe that households are likely to save a fair slice of that extra income, particularly given the probable weakening of the jobs market. We will see. The answer to that question will play an important part in determining how the economic and inflation outlook evolves over the next year.

We really do live in interesting times.

Regards

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