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How high will the Australian cash rate go?

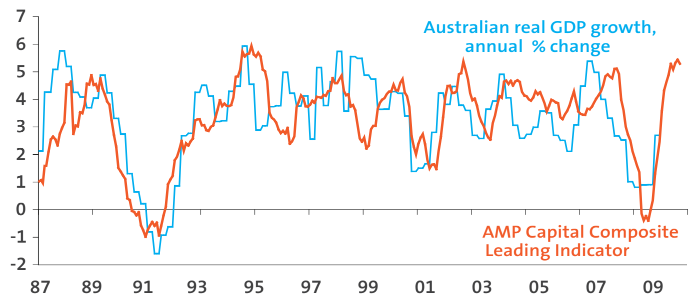
Key points

- The Reserve Bank of Australia is continuing to warn of further interest rate increases as interest rates are returned to 'more normal levels'.
- Although wider bank lending spreads have reduced the normal level for the official cash rate, probably to around 4.75%, strong immigration levels and structurally higher commodity prices are likely pushing it back up to around 5.5%.
- It's highly likely the cash rate will rise above this level in 2011-12. However, the heightened interest rate sensitivity of the household sector as a result of high debt levels will likely see the cash rate top out at around 6% or just above in 2012.

The Reserve Bank of Australia (RBA) has increased the cash rate five times from its low of 3%, taking it to 4.25%. The consistent message from the RBA has been that more interest rate increases are likely. In simple terms, the RBA cut the official cash rate to generational lows of 3% early last year to minimise the impact of the global financial crisis on the Australian economy. However, with the economy having avoided recession and growth now back around trend, it's hard to justify interest rates below normal levels.

There is little doubt Australia's economic growth has improved and the need for abnormally low interest rates has passed. Although housing finance data and retail sales have recently been soft, indicators for job advertisements, employment, car sales, house prices, auction clearance rates, business investment and export earnings are all pointing to strong growth ahead. This is summarised in our leading growth indicator for Australia which is pointing to strong 5% growth ahead.

Strong growth on the way for Australia



Source: Thomson Financial, AMP Capital Investors

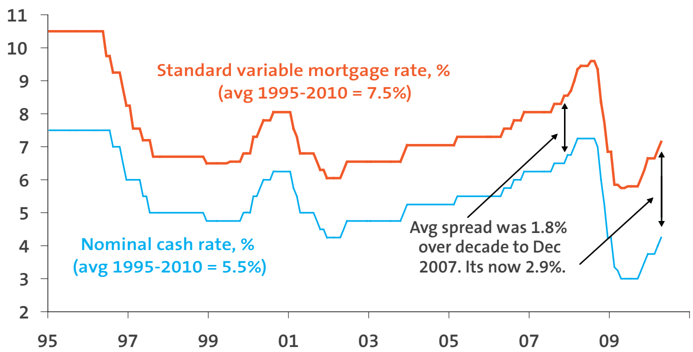
However, although growth may be back at trend and probably heading higher, the key questions are what is the 'normal' level for interest rates and secondly, what is the risk we will go beyond this level some time in the next few years?

The normal or neutral interest rate

Most economists regard the normal or neutral rate of interest (above which monetary policy bears down on growth and below which it stimulates growth) as being roughly in line with the economy's long-term nominal growth rate. So with an inflation target of 2.5% and real potential growth thought to be around 3.25%, the neutral rate was generally thought to be around 5.75%.

However, **last year there was increasing talk of a 'new normal' rate, subsequently given credence by the RBA itself.** This stemmed from the fact it is actual borrowing rates that matter. Due to increased bank funding costs, the banks' borrowing rates are running at an above normal margin relative to the cash rate. For example, over the decade prior to 2008, the standard variable mortgage rate averaged around 1.8 percentage points above the official cash rate, whereas it is now about 2.9 percentage points above the cash rate.

Australian mortgage rate vs cash rate



Source: Thomson Financial, AMP Capital Investors

This would suggest that the normal cash rate has fallen by 1 percentage point or so, taking it to around 4.75%. With the cash rate now at 4.25% this would suggest there is not far to go in terms of returning the cash rate to normal. Similarly, the average standard variable mortgage rate of 7.15% is now not far below the average of 7.5% over the last decade and a half. **All this would suggest interest rates are now close to normal with only another 0.25% or 0.5% increase required.**

The new, new normal interest rate

However, a counter view is starting to emerge suggesting the normal level for the cash rate is actually still around 5.5%. This view accepts that the spread between bank lending rates and the cash rate has widened but argues the potential real economic growth rate of the economy is actually around 4%. Over the last few decades, Australia's real growth rate averaged around 3.25% per annum (pa) and it was thought that this represented the longer-term potential growth rate of the economy reflecting labour force growth of around 1.7% pa and productivity growth of around 1.5% pa. However, several factors may be working to push Australia's potential growth rate up towards 4% pa:

- A large increase in immigration levels is driving an acceleration in labour force growth. The increase in the working age population in Australia is now running at 2.2% pa. Even allowing for some scaling back in immigration levels, labour force growth could be running at around 2% pa over the next few years.
- The super cycle in commodity prices is providing a big boost to national income, and hence the economy, that is likely to continue for many years to come. For example the 90% increase in iron ore prices and the 50% increase in coking coal prices will provide a $35-40 billion boost to national income (equal to 3% of gross domestic product [GDP]).
- The boost to national income from the mining sector combined with strong public-sector infrastructure spending has pushed growth in the capital stock (i.e. the stock of factories, machinery, commercial buildings and infrastructure) to its fastest pace in almost 40 years. This is likely to boost productivity growth.

If potential real economic growth has been boosted to 4%, then allowing for 2.5% inflation would suggest the normal cash rate (before allowance for wider spreads on bank rates) has increased from 5.75% to now 6.5%. Allowing for wider bank spreads brings the normal rate back to 5.5%.

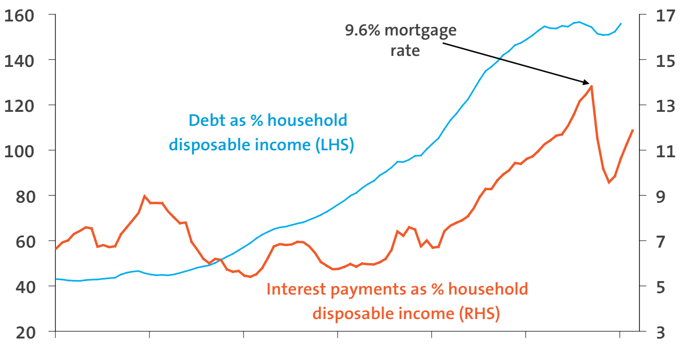
The bottom line is that on this basis, the RBA still has quite a bit more work to do to return interest rates to normal levels. **Rather than one or two more 0.25% rate hikes, this would suggest that there might be another five to go, just to get back to normal.**

So how high will the cash rate go?

Regardless of what the normal level is, the experience in past cycles suggests at some point the cash rate will likely rise above normal. In the last tightening cycle the cash rate peaked at 7.25% in 2008. As in any cyclical upswing, the reason this time around will be simple – if growth rises above the potential for a while (as our leading indicator on the first page suggests is possible) this would be likely to push inflation above target levels.

On this basis, some are now suggesting the cash rate could rise to its 2008 high of 7.25% some time in the next two years. However, there is good reason to believe this won't be necessary as it would likely create significant problems for the Australian household sector. While the ratio of household debt to income has stabilised at around 155% over the last few years, it remains extremely high (well above that of other countries) and it has recently started to increase again. Similarly, the proportion of household disposable income used for debt interest payments is starting to rapidly increase again (see the next chart). In fact, the vulnerability of the household sector may have increased as the aggregate debt figures may mask faster repayments by older households but high average debt levels for borrowers who recently entered the market due to the first home owners boost. This group is likely to be highly sensitive to rate hikes.

Higher household debt means greater interest rate sensitivity



Source: RBA, AMP Capital Investors

The 2008 experience highlighted the vulnerability of the household sector – essentially when rates started to push above 9%, real consumer spending slowed sharply in early 2008, indicating that the RBA had gone too far. As a result, the Australian economy slowed to a virtual crawl in 2008 even before the global financial crisis hit in the December quarter. The pressure on households was only relieved when the RBA started slashing interest rates from October 2008.

A move back to a 7.25% cash rate would be far more negative for household cash flows this time around as it would imply a standard variable mortgage rate of 10.1% which is well above the 2008 peak and would take the proportion of interest payments to household income well above the 2008 high. This is why it won't be necessary and most likely won't occur. If the economy was already slowing significantly in 2008 when mortgage rates went above 9%, the same will likely happen this time around.

This all suggests the cash rate is more likely to peak around 6%, or just above, probably in 2012, rather than rise to its previous highs. This would imply that mortgage rates will likely peak at around 9%.

Concluding comments

Although wider bank lending spreads have reduced the normal level for the official cash rate, possibly to 4.75%, strong immigration levels and structurally higher commodity prices are likely pushing it back up to around 5.5%. On this basis, the RBA still has more work to do to get the cash rate back to normal.

What's more, it's likely the cash rate will rise above this level in 2011-12. However, the heightened sensitivity of the household sector due to high debt levels will likely see the cash rate top out at around 6%.

We are allowing for another 0.25% cash rate hike in either May or June and the cash rate rising to 5% by year end, before moving up to a peak of around 6%, or just above, in 2012.

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Contact us

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