# Why it’s getting harder to dismiss the possibility of rate hikes in Australia

Sticky inflation means the Reserve Bank of Australia will struggle to justify rate cuts this year – indeed, the chance of a further increase in rates is growing


Inflation's not only proving sticky in Australia, it's actually on the rise again - and we're not convinced the path to getting it fully under control is going to be smooth sailing

## After a good start, inflation is now going back up

Much like the Federal Reserve, expectations for easing from the Reserve Bank of Australia (RBA) were strong at the beginning of this year. But after an initially impressive decline from the 8.4% year-on-year December 2022 peak, progress in getting inflation lower has ground to a halt and even reversed in recent months. As it has done so, market expectations for rate cuts have evaporated.

Following the latest set of inflation data for April – where the CPI index rose 0.7% month-on-month, lifting the inflation rate from 3.5% to 3.6% YoY – we also bit the bullet and chopped out our last remaining rate cut forecast for 2024.

What has concerned us is the lack of any apparent slowdown in the run-rate for inflation in Australia, without which any prospect of inflation dropping back within the RBA’s 2-3% target range looks elusive. A reasonable question is, did the RBA ever raise rates far enough to bring inflation back to target? At 4.35%, Australia’s cash rate target is more than 100bp lower than the equivalent US rate. While at its peak, Australian inflation was not much lower than that in the US

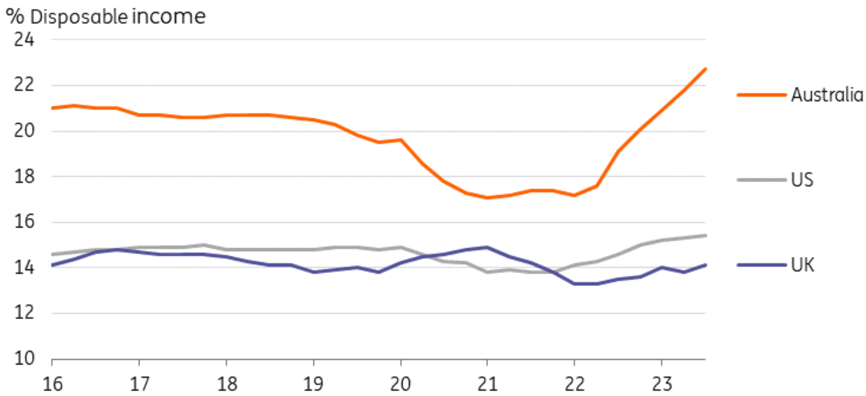
(US inflation peaked at 9.1% YoY in June 2022).

## The arguments for a lower peak rate in Australia are good…

Differences in the mortgage structure between the US and Australia (in particular, shorter fixed-rate mortgage products) may mean that Australian households have less insulation against policy rate hikes than their US counterparts. If so, that should show up as a larger increase in debt service costs, justifying lower peak policy rates.

This is certainly confirmed by evidence from the Bank for International Settlements (BIS), which shows a much sharper rise in debt service costs for Australian households than either their US or UK counterparts. It is also reflected in a much weaker profile for Australian household spending in GDP data since rates started to go up than in the US, where consumer spending has been the bulwark of GDP growth until recently.

## Debt service costs (% disposable incomes)




Source: Bank for International Settlements

## … but inflation is still rising

Still, despite weaker growth, Australian inflation is not only sticky, but rising again. The CPI price level increases in the last three months have averaged more than 0.5% MoM – more than twice what is needed to bring inflation back within the RBA's target. May data could get some help from lower crude oil and retail gasoline prices, which could weigh on the price level. But the May 2023 price level change was -0.4% MoM, and undershooting that is going to be very hard. So a further increase in inflation next month looks possible even with lower oil prices.

With little evidence that the momentum of CPI is slowing enough, or even at all, whatever the debt service data and household spending show, it is becoming harder and harder to dismiss the possibility that rates in Australia may not have peaked after all.

We removed the final rate cut from our 2024 forecast this month. A further increase in inflation next month may force us to consider adding in an additional rate hike and pushing back the start date of the easing cycle much later into 2025.

In fairness to the RBA, it has been clear that it did not see inflation returning to target until later in 2025. Nevertheless, even with a very slow adjustment to target, you'd be hard pressed to argue that the central bank will be content seeing inflation moving higher for much longer.

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