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AUSTRALIAN CONSTRUCTION INSIGHTS
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Construction Brief

5 March 2018

Australia is marching to a different beat

A rate rise of 10 basis points this year?

Insight: What happens to wages growth is a key to interest rate expectations this year. The rate of growth in wages may start to accelerate in the second half of this year leading to a rise in rates, perhaps as early as late 2018.

Background*: A* decade ago Australia escaped the worst of the 'Great Recession' for two primary reasons. Firstly, on a per capita basis Australia implemented the second largest stimulus package in the world. Secondly, China – Australia's King Kong of trading partners – implemented the largest stimulus policy in the world.

The result was a housing-led domestic economic recovery and a China-led resumption of the largest resources investment boom Australia has ever experienced.

Australia's narrow escape from the jaws of the largest global economic downturn since the great depression did put our economic cycle at odds with the rest of the world.

The most telling example the Reserve Bank of Australia embarking on a tightening interest rate cycle from late 2009 (a starting date that in hindsight was too soon) in contrast to the rest of the developed world.

One of the key factors to determine interest rate expectations this year is wages growth. The rate of growth in wages has been falling for a number of years. The reasons for this include: a correction for Australia as our wages growth was disproportionally high post the GFC and they are now coming back in line with our trading partners; the end of the resources boom leading to a share of the workforce remaining engaged but at lower rates of pay; underemployment; and lower economic activity.

As household savings have also fallen in recent years this tells us that the boom in household expenditure over the same timeframe was at the expense of savings. Or in other words, households have been selling of the silverware to pay for the groceries.

If wages growth accelerates, leading to a growth in consumer confidence, an acceleration of activity will increase the pressure on rates.

We have been in unprecedented territory with respect to interest rates for some time – not only are they lower than ever before, but they have also demonstrated a degree of stability that is unrivalled by historic standards. The RBA had gone for over 20 months without changing its benchmark official cash rate. This is the longest interval without change since at least the 1980s.

The low interest rates of recent years have helped guide unemployment downwards (it's now around 5.5 per cent) and fuel very substantial job creation across the economy.

We have also seen new home building reach record levels thanks to the low cost of borrowing, a development which has partly addressed the gap between housing supply and demand.

It is difficult to sustain an argument that the next change to the OCR will be negative, in the absence of a major unforeseen exogenous shock to the economy.

The outlook then is that if the next move is to increase the OCR then the first of these moves will be a shock to the housing market. Throughout the 1980s and 1990s the RBA adjusted the OCR by quantum's as large as 100 basis points. More recently the market has become accustomed to more modest changes of 25 basis points.

Since the beginning of the 1990s the most dramatic change in interest rates occurred in late 1994, when the RBA raised interest rates by 275 basis points over a period of just four months in response to developments on international financial markets and an acceleration in economic growth at home.

A more orderly situation occurred in the late 1990s involving a 1.50 percentage point uplift in interest rates spread out over nine months. During the 2000s, the official cash rate was raised from 4.25 per cent to 7.25 per cent but this involved 12 separate rate increases being stretched out over a six-year period.

One of the most interesting features of the RBA's approach to raising interest rates is that their modus operandi has become more fine-tuned. On every occasion when it has raised rates since April 2000 (which is 22 times), the RBA has opted for a 25 basis point rise (that's one quarter of one per cent). Compare this December 1994 when we were whacked with a full 1 per cent increase in the cash rate only days before Christmas! The point is that the RBA came to recognise the prudence of tightening monetary policy in a graduated manner over an extended period rather than hitting markets and borrowers with 'big bang' type changes.

A lot has changed since 2010.

When rates last increased in 2010, a rise of 25 basis points added $95 dollars to the monthly repayments on a typical house in Sydney. If a similar rate increase happened tomorrow, mortgage payers in Sydney would need to come up with an additional $132 per month.

Were the RBA to instead start by increasing interest rates by just 10 basis points, mortgage repayments would rise by a more manageable $52 per month?

In the current context, testing the ground with a rate move from 1.50 per cent to 1.60 per cent would seem far more sensible than a change by a full 25 basis points.

Update: Private capital expenditure (Capex) results released by the ABS last week showed that non-mining capital expenditure at the end of 2017 was over 10 per cent higher than at the end of 2016.

This is an encouraging sign that the cycle of mining investment has embarked on a slow recovery. This trend should continue as maintenance, repairs and upgrades to sunk capital are necessary to supply the growing demand for resources.

This also will add to expectations of future GDP by the RBA.

The fortnight ahead – key dates and releases (AEDST)

Monday 5 March

ABS Building Approvals, January 2018, 11:30am

Tuesday 6 March

RBA Interest rate decision 11.30am

Wednesday 7 March

ABS National Accounts, Dec qtr 2017, 11:30am

Tuesday 13 March

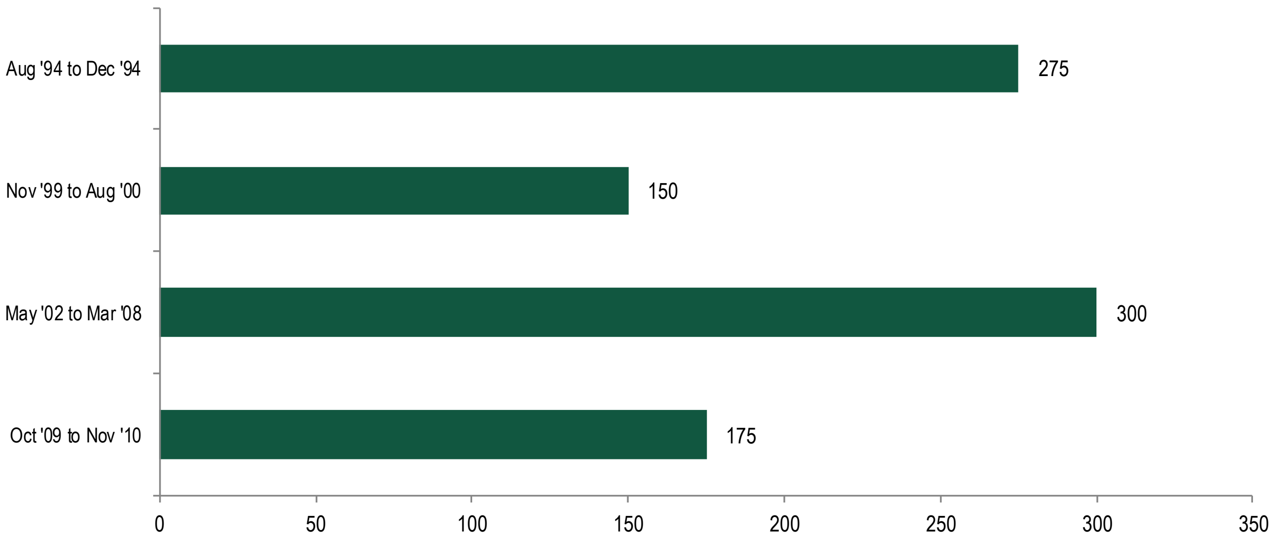
ABS Housing Finance, January 2018, 11.30am

ABS Regional Building Approvals, January 2018, 11.30am

Wednesday 14 March

ABS Lending Finance, January 2018, 11:30am

Magnitude of Previous RBA Official Cash Rate Increases (Basis Point Change)



Source: RBA

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