TRANSCRIPT – PHILIP LOWE – ABC 730 – 14 JUNE 2022

Leigh Sales: Governor, welcome to the program.

Philip Lowe: Thanks Leigh. It's great to be with you.

Leigh Sales: These are your first public remarks since the 50 basis point rise. I wanted to immediately ask therefore, why did the Reserve Bank go so hard? It was a little bit unexpected.

Philip Lowe: Well I think Australians need to prepare for higher interest rates. We had emergency settings during the pandemic – that was the right thing to do – but the emergency is over and it's time to remove the emergency settings and move to more normal settings for monetary policy. The other consideration was that inflation is high – it's too high. At the moment it's 5 per cent, and by the end of the year I expect inflation to get to 7 per cent. That's a very high number and we need to be able to chart a course back to 2 to 3 per cent inflation. I'm confident that we can do that, but it's going to take time. And with inflation being as high as it is and when interest rates are as low as they are, we felt it was important to take a decisive step to normalise monetary conditions and we did that at the last meeting.

Leigh Sales: I'll ask about inflation in a bit more detail in a second. But I think the key question a lot of viewers would have is how far are rates going to rise and how quickly?

Philip Lowe: Well it's going to be determined by events, isn't it. I think it's reasonable that the cash rate gets to 2½ per cent at some point. And I say that because the midpoint of our inflation target is 2½ per cent. So an interest rate of 2½ per cent in inflation-adjusted terms is a real interest rate of zero, which in historical terms is a very low number. And I would expect that over time we want an average inflation-adjusted interest rate to be more than zero.

How fast we get to 2½ per cent, and indeed whether we get to 2½ per cent, is going to be determined by events. The Reserve Bank Board meets every month. We have at our disposal a huge wealth of data to analyse at each of our meetings when we decide how fast we need to go and how far we need to go.

Leigh Sales: After the RBA October Board meeting last year you said that rates would not rise before 2024. In May the RBA lifted rates by 25 basis points and this month by 50. What changed from last October?

Philip Lowe: What we've said right through the last two years was, and this is important, if the economy evolved as we expected, interest rates were unlikely to increase until 2024. So for most of the past two years, we thought that growth would be slow to recover, that inflation would stay fairly low, and that there'd be a long tail from the pandemic. And given that, we thought interest rates would need to stay where they were until 2024. So sometimes my comments get interpreted as me having made a promise or a very strong statement that interest rates would stay where they were to 2024. In our own communication, our own way of thinking, it was very much a conditional statement – if the economy evolved as we'd expected, we'd keep rates where they were until 2024. But the economy didn't evolve as we expected. It's been much more resilient and inflation has been higher. And we needed to respond to that.

Leigh Sales: What would you say to people watching who feel rattled because they think 'well, I made borrowing decisions based on what was said last October and now it's changed so I feel stressed, I feel worried about where it's going'?

Philip Lowe: I understand that people will make borrowing decisions based on our communication, and people took out loans that they may not have otherwise taken out. I also point to the fact that the economy's done remarkably well. The unemployment rate is at a 50 year low, a higher share of the population has a job than ever before, households have built up very large financial buffers. Over the past couple of years people have put away an extra $250 billion – it's a lot of money, and the saving rate is still high, and the number of people who've fallen behind in their mortgages is actually declining, not rising.

So there's a lot of resilience in the household sector. At the individual level, some people have taken out loans that they may not have wanted to take in retrospect, but the overall picture, which is really very much the focus of the Reserve Bank, is of a pretty resilient economy.

Leigh Sales: When the RBA makes decisions about whether to raise rates – I know of course, you're looking at the big picture about cooling down inflation and so on – are you also thinking about things like how many households are going to struggle to meet their mortgage repayments if you rise by say 25 or 50 basis points?

Philip Lowe: We certainly are and we spend a lot of time looking at the disaggregated data because we know that even the increases in interest rates so far are putting pressure on some families' budgets. They're coping with higher interest rates, higher fuel prices, higher food prices, so we know already for some households they are finding it difficult.

I also know there are some households who welcome higher interest rates. For the past four or five years, each week I would get letters from people complaining that interest rates were so low it was hurting their finances. So different households are in different positions, and the Reserve Bank staff spend a lot of time trying to understand that. At each of our Board meetings we discuss the various experiences of households.

At the end of the day, though, our responsibility is a national one. We want to make sure that inflation is low and stable, the country gets to full employment, the financial stability of the country is preserved, the country has high quality banknotes, and we provide high quality banking services to the government. So that's our big picture. Against that big picture, we have to look at the individual households and we spend a lot of time, as I said, looking at the disaggregated data and I understand that it's not easy for many people at the moment.

Leigh Sales: Financial markets are factoring in a $1,000 increase per month in mortgage repayments by the end of next year. Would the RBA really raise rates that high and put households under that much stress?

Philip Lowe: We'll do what's necessary to get inflation back to 2 to 3 per cent. As I said, I think by the end of the year inflation will get to close to 7 per cent, and we need to chart a course to bring it back down. We don't need to get it back down straight away. We've long had a flexible inflation target in Australia – we can look through the swings in inflation – but what we've got to do is make sure inflation comes back to 2 to 3 per cent. And it's unclear at the moment how far interest rates will need to go up to get that. I'm confident inflation will come down over time but we'll have to have higher interest rates to get that outcome and how much higher remains to be determined.

Leigh Sales: The RBA has noted that there are external factors helping drive inflation such as the war in Ukraine, global supply issues. What happens if you raise interest rates and inflation doesn't come down?

Philip Lowe: I think eventually it will come down and partly it will come down because of the global factors. Over the past year, the petrol price in Australia has gone up more than 30 per cent, so even if the current level of petrol prices stays where it is, the rate of change goes from 30 per cent to zero. And that will help bring down the headline rate of inflation.

Another thing that's going to help is that the supply side problems in the global economy are being resolved. We've seen just recently a big pick-up in production of cars around the world, and chip producers are responding so computer chip prices are coming down. So we're seeing the global economy respond to some of the supply-side problems – that will help bring prices down, at least the rate of inflation down, and if oil prices don't keep going up the inflation rate goes to zero for those commodities.

So inflation will come down for those reasons but it will also come down because of the higher interest rates. At the moment, the spending pressure in the economy is putting pressure on capacity. You see this in lots of areas in the labour market at the moment. Almost every business that I speak to says it's very hard to hire workers. We've seen in the infrastructure space, state governments delay some spending because they can't find the resources and, in construction, many firms are at full capacity. So the current rate of spending in the economy is putting pressure on the capacity of the economy – the ability of the economy to provide the goods and services. Over time, higher interest rates will get a better balance there. And when there's a lot of pressure on capacity, prices go up and higher interest rates will establish a better balance between spending and the ability of the economy to produce goods and services.

Leigh Sales: I think you said earlier that you would anticipate inflation would be at about 7 per cent cent in the back half of the year. When do you anticipate that it would start to come off?

Philip Lowe: By the first quarter of next year. The peak will be in the December quarter this year and by the time we get into the second half of next year, inflation will clearly be coming down, but in the first quarter, we'll see lower rates of headline inflation.

Leigh Sales: Other than interest rates, what other factors are likely to drive the Reserve Bank's thinking on interest rates? For example, if housing prices fall significantly, would that play a role in what you decide to do?

Philip Lowe: Not directly. We don't target housing prices, nor would it make sense to do so. But we know that swings in housing prices affect people's consumption decisions. For many people, if the value of the house is falling, they're going to spend a bit less. So that's the prism we look at this through. We don't target housing prices and I think ... I know the banking system's very strong at the moment. So we're not worried that declines in housing prices will affect the banking system. So it's really what effect does it have on household consumption.

So we've got declining housing prices, but we've got to remember as well that households have saved this extra $250 billion and the current rate of saving is very high. And unemployment is low and the number of job vacancies at the moment is extraordinarily high. So there are a lot of other factors that are influencing consumption other than housing prices and our job is to work out what the balance is amongst all those factors.

Leigh Sales: We've seen financial markets here today and in the US tank on fears of an aggressive US interest rate rise when the Federal Reserve meets later this week. There's also fears of a global recession. What are you anticipating the Australian economy in the context of the world economy is going to look like in the next six to 12 months?

Philip Lowe: We're expecting the Australian economy to continue to grow pretty strongly over the next six to 12 months. There's still a bounce back from all the COVID restrictions. People are spending in a way that they weren't able to do last year. People have got their savings that I've talked about to draw on and the current rate of saving is still quite high. So it's quite plausible that saving patterns return to where they were before, so even if income growth is a bit weaker people have the financial capacity to keep spending.

There's a big backlog of construction work to be undertaken and the number of job vacancies is extraordinarily high, so people can be confident the jobs will be there and in that environment people will keep spending.

Leigh Sales: Did the Federal Government with its welfare support during the pandemic and the RBA with its rate cuts overstimulate the economy and is that why you're now being compelled to raise interest rates so fast and so far?

Philip Lowe: It's a really good question and one we've been thinking a lot about, particularly in terms of monetary policy, but perhaps I can take you back to the dark days of the pandemic. Back in February and March 2020, there were credible predictions that tens of thousands of Australians would be dead within a few months, that our hospitals will be overfull, that the unemployment rate would reach 15 per cent, that there'd be deep economic and social scarring in the society, and there'd be a generation of lost opportunity. That was the environment in which we were making decisions. And sometimes it's easy to forget that given that the economy is doing well at the moment. But that was the environment in which we're operating.

The Reserve Bank strategy at the time was twofold. First, to build a bridge to the other side. We were looking into the chasm and that was very scary. We wanted to build a bridge to the other side. And the other thing we wanted to do was provide some insurance, some economic insurance for the country, that if the really bad outcomes were going to eventuate, that we would be there and we would be able to support people.

So we wanted to provide insurance. And it's an open question – the one that you ask – did we provide too much insurance? It's hard to know. But that's the nature of insurance, isn't it? You take out insurance against a very bad event. A very bad event occurs, and you're very glad you took out the insurance. But the bad event doesn't occur and then you think 'well, I could have saved some money here, I didn't need all this insurance'. My view is that broadly the country got it right.

We were facing incredibly scary, damaging times. We took out a lot of insurance. I think it was the right thing to do, but I accept that others will have a different view and the Reserve Bank is committed to learning from that experience. We're undertaking a series of reviews about how we responded through that period and we'll publish those over coming months.

We took out insurance. Maybe we took out too much but in the time that we faced and the decisions that we had to take, I think was the right thing to do.

Leigh Sales: I appreciate that you don't want to be a political commentator, but what kind of government policy settings would put fiscal policy in line with what the RBA is trying to do with monetary policy?

Philip Lowe: I'm not particularly concerned about a lack of alignment between monetary and fiscal policy. I've already had a couple of meetings with the new Treasurer. I know he is as committed as I am to bringing inflation back to the 2–3 per cent range. So I think over the next little while there'll be close alignment between fiscal and monetary policy. I have no concerns there.

The issue that I think is more important for us to focus on is not one for monetary policy, it's how as a society we're going to pay for the increasing demands on the public purse. Understandably, the society wants the government to finance spending on a whole range of social services including disability, aged care, education and defence. So there are increasing demands on the public purse. It's harder to find out how are we going to pay for that.

So the options, as Stephen Kennedy, the Treasury Secretary, talked about last week, we can make sure the economy grows very strongly, so that the pie is bigger and so there is more funding for everything. That's the best option. Another option is to cut back in some other areas, but that's pretty hard, isn't it? And the third option is to raise more revenue through higher taxes and that comes with complications as well. So that's the bigger fiscal issue. How do we meet the demands that society is putting on the public purse to provide the services that many of us want. In the short run I'm are not so much worried about the lack of alignment between fiscal and monetary policy - that can be worked out.

Leigh Sales: Governor, we appreciate your time today. Thank you very much.

Philip Lowe: Thank you very much.