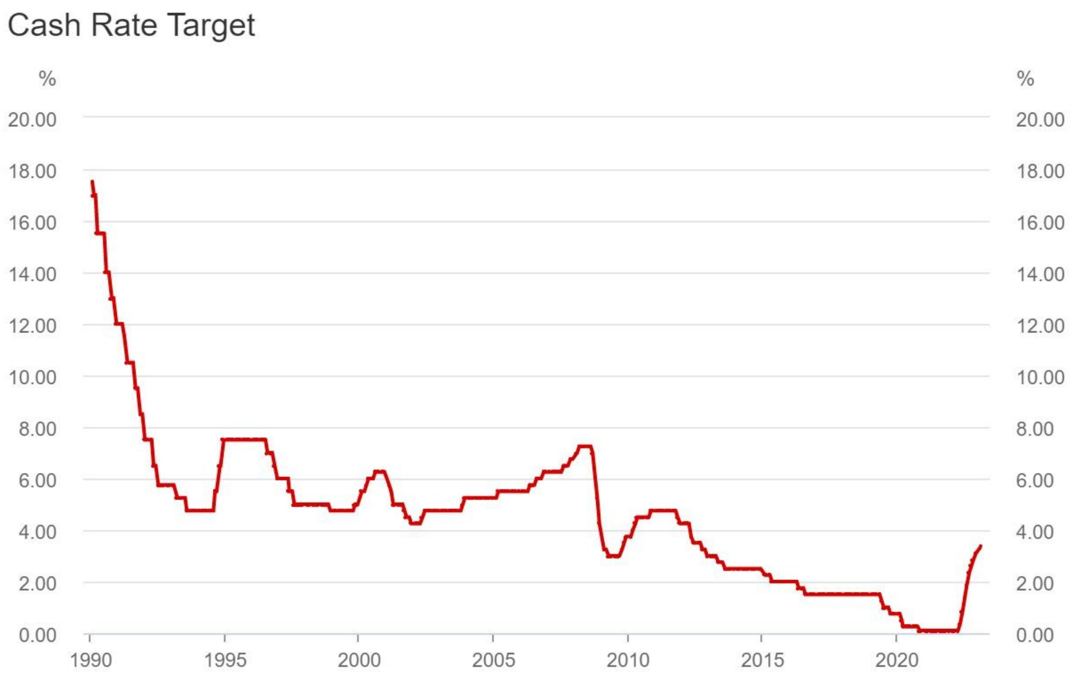
The impact of rising inflation and interest rates on businesses

The pandemic era of 2020 to 2022 delivered countless challenges to everyone, some of which are now behind us. But in its wake, we are left with a unique environment: sharply higher interest rates, rampant inflation, stressed supply chains and falling property prices. It's a very different situation to 2019, and to anything we've seen in decades. The impact on households is clear: budgets are under pressure not just from rising interest rates but more broadly from inflation lifting the cost of almost all goods and services. The impact on businesses however may be more nuanced.

The RBA have now lifted rates in nine consecutive meetings, with the February rise taking us to 3.35 %. As the chart shows, this is the sharpest incline since the 80's, but has still only taken us to near the long-term average. I am factoring in another hike to 3.6 % over the coming months, although I'm not convinced that there are more than one or two hikes ahead of us in 2023. One question for businesses is how quickly household consumption of products in their sector is likely to contract after this ninth-rate hike, and how sensitive to further price increases consumers will be.



Source: RBA

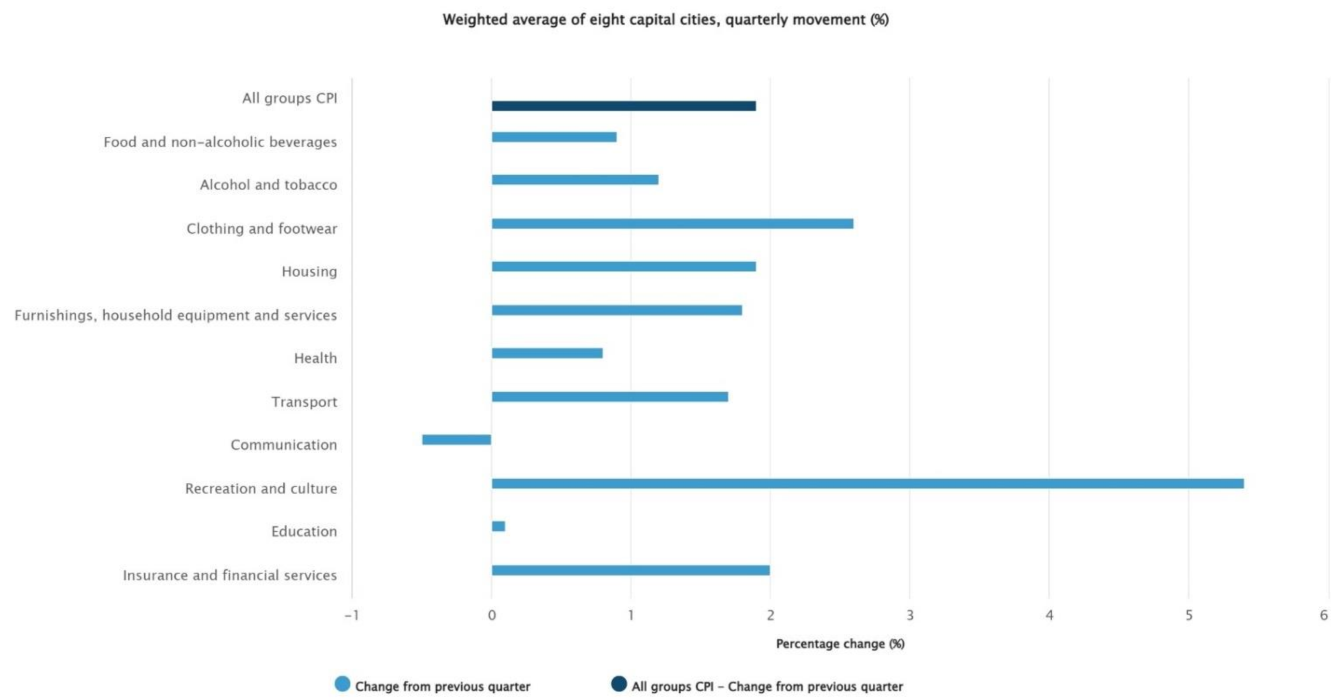
Despite the RBA cash rate still being 'relatively' low compared to the last three decades, the pace of rate hikes has surprised everyone, and so adjusting from record low rates to a more neutral rate remains challenging.

On top of this, the level of household debt (with a near record ratio of debt-to-income) means our economy is more sensitive to rate hikes than in the past; but fortunately government stimulus during the pandemic has built many household balance sheets, and we are still sitting at around a fifty year low for unemployment. Until recently, consumers have been seemingly understanding of rising costs and have maintained retail spending, but we are likely to be near a tipping point- especially as the jobs market starts to lose some of its momentum, as it inevitably will with tighter RBA policy settings.

Why beating inflation is the end goal

The RBA have been relentless with their attack on inflation and stated last week that the Board "remains resolute in its determination to return inflation to target". Inflation left unchecked is much more damaging than an economic contraction or even a recession because inflation eats into real wages, it undermines asset values and destroys wealth. So the RBA are choosing the lesser of two evils- slowing the economy down and discouraging spending with higher interest rates instead of losing control of inflation - even if that choice costs thousands of jobs this year and next.

Inflation has been broad-based, peaking in the fourth quarter of 2022 at 7.8 %. In the wake of the pandemic as economies reopened, we were always going to face a period of reflation; but the war in Ukraine and its impact on energy and commodity prices (and supply chains) turbo charged the inflationary shock. Prices have also been impacted by weather-related disruptions locally, and by tight labour markets. Consumers are paying more for almost everything and businesses have had to pass on higher input costs as temporary pandemic stimulus support has run off.

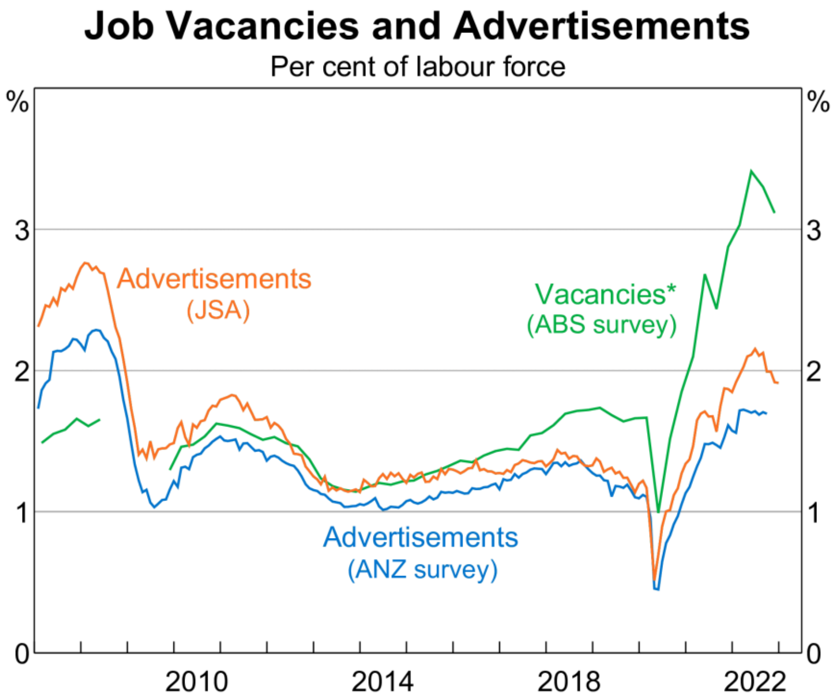


Source: Australian Bureau of Statistics, Consumer Price Index, Australia December Quarter 2022

From here the inflation rate should fall steadily with core inflation (currently 6.9 %) expected to be around 5 % by mid-year and 3 ½ % by year end: lower, but not yet back in the 2-3 % target band. As a result, the RBA are unlikely to have the option of being able to cut rates; but for businesses the key issue isn't necessarily the cost of debt, but more-so the impact that higher rates are having on consumer demand, and the extent of any further increases of input costs.

While household spending will certainly be lower, the reopening of China and its likely impact on tourism and international student numbers (and other export demand) will soften the blow. These are likely to be the two prominent but opposing forces this year: higher rates discouraging domestic demand, but a return to pre-pandemic levels of tourism, net migration and offshore demand from Asia.

Another consideration for businesses in this vastly different environment will be access to labour: as the chart shows job vacancies have already begun to fall, which should continue through 2023. The shortage of potential labour here on working visas is improving, and more international students back in Australia will all help with shortages- but at the same time the demand for goods and services will continue to be impacted by higher interest rates while (hopefully) easing inflationary pressures.



* This survey was suspended between May 2008 and November 2009.
Sources: ABS; ANZ; Jobs and Skills Australia (JSA); RBA

Periods of rising interest rates are always a challenge for businesses but overlaying an inflation shock amplifies the impact. Fortunately, the reopening of China and a brighter outlook for South-East Asia than the North Atlantic economies should offer some relief, and while I expect the unemployment rate to gradually trend to back above 4 % this year, labour shortages will be much less of an issue than they were in 2022. Another one or two rate hikes will dampen confidence further, but some of the RBA rhetoric from the latest policy meeting may be intentionally 'hawkish' to lower inflation expectations, rather than being predictive.

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