

The CommBank View: Higher rates, harder choices

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Key points

- Australia's economy is slowing, with growth expected to moderate through the rest of 2026 before gradually picking up in 2027.
- Inflation is proving more persistent than expected, making the RBA's task of balancing inflation and economic growth increasingly difficult.
- CommBank expects one final RBA rate hike in November, taking the cash rate to 4.60%, with little rate relief expected for households in the near term.
- Household spending is slowing amid higher interest rates, falling home prices and cost-of-living pressures, although high savings provide households with some buffer.

The Big Picture View: The world is adjusting to the new economic reality

We have consistently argued that we are now in a new, more complex economic era. There is clear evidence of this across the current economic landscape. The ongoing wars in Ukraine and the Middle East are complicating the near-term outlook, inflation is proving stubborn and hard to tame, the AI investment boom is in full swing, drawing in vast amounts of capital, materials and skills, and global bond markets are becoming increasingly skittish, with longer-term borrowing costs rising around the world. We are in the early stages of adjusting to this new economic reality and it will be no easy task.

It will not be easy for central banks. We are seeing this play out globally and here at home. A key feature of this new era is structurally higher inflation and rising neutral interest rates, with more intense competition for global capital than we have seen for decades. To keep inflation contained, interest rates will need to be kept higher than in the past, but estimates of neutral interest rates are imprecise, increasing the reliance on real-time data and the risk of policy mistakes. The credibility of central banks is also moving into the spotlight, with bond markets watching closely to see whether authorities will act quickly enough and decisively enough to keep inflation contained or instead drag their feet due to political and public pressure.

The RBA is currently grappling with this new reality and what it means for monetary policy here at home. On the one hand, there is clear evidence that the Australian economy has moved into a cyclical downturn. National house prices are falling sharply, consumer spending is slowing, and government expenditure has eased from its post-COVID highs. Over the past six months, real economic activity has grown at just 1.4% in annualised terms, and the unemployment rate has drifted higher. This type of cyclical downturn would normally see inflation fall back inside the official 2-3% target range and official interest rates move lower.

So why then, does underlying inflation remain too high, and the RBA remain on edge? As outlined below, we expect the RBA Board to again hike interest rates in November, or possibly as early as late

September.

Part of the answer lies in the normal cyclical factors. Firms have taken some time to pass on higher oil, diesel, fertiliser and other input costs to protect or rebuild their margins, and this is only now showing up in inflation measures. However, deeper structural factors are also at play. First, the RBA is increasingly worried about a potential lift in inflation expectations. In an era of increasing strategic competition, where global rules are abandoned and conflict is normalised, we expect to see far more global supply shocks. As these push prices up, firms may become more willing to pass on costs, and households are more likely to demand higher wages as compensation for falling real living standards. Left unchecked, this could see inflation expectations drift higher, making the RBA's job much harder. In the past, the central bank textbook suggested 'looking-through' these 'one-off' inflation spikes, but that strategy is under pressure and starting to splinter.

Secondly, the labour market in Australia is structurally tighter than it has been in decades, even considering the steady rise in unemployment over the past year. For much of the past few decades, Australia had an unemployment rate closer to 6%, wages growth was anaemic and inflation consistently undershot the 2-3% target band. The RBA was reluctant to drive the economy harder for fear of stoking inflation or triggering a house price bubble. Instead, it took the large post-COVID fiscal stimulus to drive the economy beyond full employment. Today, at an unemployment rate of 4.5%, the labour market is, at best, close to balance.

The RBA regularly cites labour market tightness and difficulty finding skilled workers as a key watchpoint.

Thirdly (and relatedly), productivity growth is too low and the supply side of the economy is too constrained to permit private demand to grow materially faster without stoking inflation. This is especially the case given high levels of investment into AI, defence, renewables, transport and housing, along with structurally higher government spending at both federal and state levels. The RBA learnt this lesson the hard way last year. After cutting interest rates three times, the RBA saw household demand and house prices surge, quickly stretching the economy beyond its speed limit. The RBA will be wary of repeating this pattern and reluctant to provide too much support to private demand while there is such little spare capacity.

The economic cycle still matters. We expect the cyclical slowdown to exert an influence on inflation and steadily bring it back under control over the next 12 months. We also expect the RBA Board to do what is necessary to keep inflation contained and maintain its inflation-fighting credibility. However, the task is now materially harder and the RBA knows it. As a result, we expect the RBA to remain very cautious and on 'high alert' for the foreseeable future. This means the slowing economy will not bring much in the way of immediate or major rate relief for Australian households.

Adjusting to this new economic reality will also pose major challenges for governments around the world. Over the past few decades, households have become accustomed to rising real incomes and wealth, stable inflation and low interest rates. More recently, they have experienced higher inflation, higher interest rates and falling real wages. This is driving community frustration and, in some cases, calls for more public intervention and support measures to shield households.

At the same time, global bond markets are focussing more sharply on unsustainable government spending and rising debt levels across developed countries. Across Europe, Japan and the US, we have seen several recent episodes where bond markets have reacted badly to a perceived lack of fiscal discipline, driving up debt-servicing costs. Australia's overall fiscal position is unquestionably strong compared to most of our peer countries. Nevertheless, in this new economic era, it would be wrong to

assume that our cost of borrowing will remain low and stable into the future, particularly with the level of global investment starting to exceed the level of global savings, driving more competition for capital.

Finally, as central banks are forced to keep interest rates higher, governments will come under more acute pressure to lift productivity and cut government spending to free-up private sector capacity and keep pressure off interest rates. Central banks around the world (including in Australia) are calling on governments to take stronger steps in this direction, to avoid having to do all the heavy lifting themselves through the blunt interest rate lever. To date, we haven't seen any major step-change in these areas. However, as we move further into this new economic era, governments will increasingly need to balance pressure from communities for more structural spending and support, with pressure from global debt markets.

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