

FactFile

Interest rates:

what you need to know

Interest rates are the cost of money or credit, and are used to control inflation and economic growth. This fact file explores the reasons why interest rates rise and fall, and how they affect your finances.

Who controls interest rates?

Movements in official interest rates are principally determined by the Reserve Bank of Australia (RBA), not by the Federal Government as is often thought. The RBA's objective is to ensure that price rises across the board do not get out of control and it uses 'monetary policy' to do this. Monetary policy involves either increasing the cost of money to slow the economy down, or lowering the cost of money to encourage people to invest and spend, leading to economic growth.

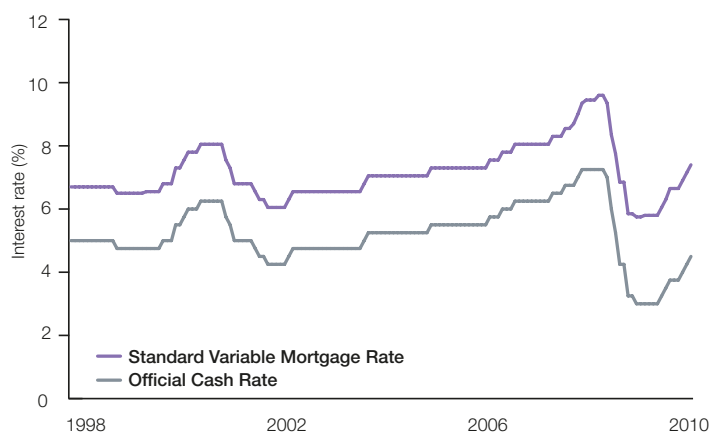
The RBA's function is vitally important because if the economy is growing too fast it can lead to high inflation, while weak economic growth can lead to unemployment, reduced incomes and lower living standards.

The official cash rate

One of the ways the RBA manages the long term growth of the economy is by making changes to the interest rate it charges financial institutions, commonly referred to as the official cash rate.

This cash rate feeds through to financial products which have variable interest rates, such as cash management trusts, variable rate mortgages and personal loans.

The graph below shows the official cash rate and standard variable mortgage rate movements over the past 18 years.



Source: RBA, Source: RBA. Data to 5 May 2010

What drives interest rate changes?

Changes to the official cash rate are based on a number of economic indicators such as employment, inflation, the housing market and the overall strength of the economy.

For example, if the demand for housing is too strong and leads to sharp gains in house prices, this can cause inflation expectations to rise and lead to inflation pressures. Increasing interest rates can curb housing activity, as fewer people can afford to buy or build.

An increase in unemployment generally points to a slowing economy, which may lead the RBA to cut rates. On the other hand, strong growth in employment can fuel inflation by creating wages growth, in which case an interest rate rise may be necessary.

The RBA looks at important international factors that will drive the performance of the Australian economy, in particular demand for and price of Australia's natural resources. If Australia's trading partners are growing strongly and demand and prices of raw materials are rising, this can lead to strong economic growth in Australia and place upward pressure on interest rates.

The RBA will also look at the Consumer Price Index (CPI) which measures price changes on a basket of goods and services that a typical consumer would buy. The CPI is considered the benchmark for changes in inflation. A rise in CPI often leads to a rise in interest rates. The RBA targets inflation to be between 2% and 3% over the economic cycle. If inflation is towards the top end of this band or above and rising, this is a signal that the RBA may lift the official cash rate.

In general, if these indicators are rising, the RBA is more likely to raise rates and if they are falling, rates are more likely to be cut.

How do interest rate changes affect investments?

Interest rates rises are generally good news for people with savings. For investors looking to commence a term deposit or similar investment in bonds, an increase in interest rates will mean higher rates of return on offer. Term deposits usually offer higher returns in a rising interest rate environment.

However, for those holding fixed interest investments such as government and corporate bonds, interest rate increases may mean the value of these bonds will decrease. This is because the capital value of a bond falls as interest rates rise.

Also, as Australian interest rates rise, the Australian dollar strengthens against other currencies. This can reduce the returns from global shares for Australian investors.

Of course, the opposite applies to each of these situations when interest rates fall.

It's worthwhile regularly reviewing how the latest interest rates affect your investments to make sure you are still on track with your investment strategy.

Managing your money as interest rates change

For many Australians a rise in interest rates will mean increased repayments on debt from mortgages, loans and credit cards. With less disposable income, many people may need to tighten their belts.

Interest rate rises can be tough for families and small businesses, as increased mortgage and debt repayments can make life more difficult and expensive.

Conversely, declining interest rates can help ease debt repayments.

When reviewing your finances make sure you look at how interest rates are tracking and if necessary, plan for further increases or decreases that might affect your repayments or returns. It may also be worth looking at consolidating your debts and renegotiating your current interest rates to protect yourself from future increases.

General impacts of interest rate changes

It is important to understand the effects interest rate changes can have on your personal finances. The table below summarises some of the economic consequences of interest rate changes.

Increase in interest rates	Decrease in interest rates
Raises interest payments on borrowings	Reduces the cost of debt repayments
Increases the cost of mortgage interest payments	Makes mortgage interest payments more affordable
Reduces personal disposable income	Increases personal disposable income
Increases incentive to save rather than spend	Encourages spending
Strengthens the value of the Australian dollar	Weakens the value of the Australian dollar
Reduces consumption and investment	Encourages investment in bonds and property

The RBA meets 11 times a year, on the first Tuesday of each month, except in January. When they meet, they will either raise the cash rate, reduce it or keep it the same.

The official cash rate as at 5 May 2010 is 4.5%.

Speak to us for more information

If you would like to know more about interest rates and the effect on your mortgage and investments, contact us. We can give you more detailed information on the best approach for your situation.

Important Information

This general advice has been prepared without taking into account your particular financial needs, circumstances or objectives, and is based on Financial Wisdom Limited's understanding of the economic situation as at 15 April 2010. While every effort has been made to ensure the accuracy of the information, it is not guaranteed. All investments are subject to risk, including loss of income and capital invested. Past performance is no guarantee of future performance. You should obtain professional advice before acting on the information contained in this publication.

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