BULLETIN

10 June 2022

Some more thoughts on the RBA

The RBA Board decided to raise the cash rate by 50 basis points at its meeting on June 7.

The bold decision came as quite a surprise to many analysts. Even the decidedly hawkish market was priced for a more modest move.

In our latest preview on June 3, we noted that "The arguments set out above would also be consistent with a 50 basis point move. However, given that the Board actively considered 40 basis points at the May meeting we think it more likely that the 40 basis point option will be taken."

Readers will be aware that since the Board raised the cash rate by 0.25% on May 2 and the Governor indicated that 25 basis point moves would be business as usual Westpac took a different view. We argued at the time that while the guidance seemed to be consistent with a 25 basis point move in June such a decision would be the wrong policy. We argued that the right policy would be a "large" move and opted for 40 basis points.

Over the 5 weeks leading to the June 7 decision we consistently made the case for a large move in June. That was supported by the May minutes; aspects of the WPI report; the surge in hours worked in the April employment report; a sharp increase in domestic inflation and average wage inflation in the national accounts. We also pointed out that inflationary expectations, particularly amongst trade unions, had been significantly boosted in recent surveys.

Consistent with our analysis was the key observation in the Governor's statement, "Inflation… is higher than earlier expected. Global factors account for much of the increase. But domestic factors are playing a role too, with capacity constraints in some sectors and the tight labour market contributing to upward pressure on prices."

That statement clearly signals that the Bank now recognises that it has a significant challenge to contain inflation and Tuesday's decision points to it now being prepared to act decisively. That decisive action will, in particular, assist with the important objective of containing those inflationary expectations we referred to above.

For those reasons, we predicted on June 7, following the RBA announcement, that the next move in July will also be a 50 basis point increase.

That would push the cash rate to 135 basis points. Having eliminated the emergency policy settings of 2020, the next move would be to take back the 75 basis points of cuts from 1.5% to 0.75% seen in 2019 when the Bank was frustrated at the consistently low inflation prints.

A slowdown in the pace of hikes in August can be expected but a response will still be necessary to the likely strong inflation print for the June quarter with a further 25 basis point move required.

With the cash rate having reached 160 basis points by August it will be prudent for the Bank to pause. Our analysis of the leverage in household balance sheets points to a cash rate of around 160 basis points being "in the neighbourhood" of neutral – better to pause at that point to assess the impact on household consumption; house prices; the labour market; consumer and business confidence; and the response of wages growth to these inflation pressures.

In the Governor's statement he highlighted the uncertainties around these issues indicating to us that they such thinking would at least justify a pause.

The Board has pointed to other central banks wanting to quickly return to neutral. A total of 150 basis points in only three months (May to August) by the RBA is a very solid pace even compared to the FOMC; the BOC; and the RBNZ.

This is partly because the RBA meets more frequently than those central banks. The RBA meets eleven times per year compared to FOMC and BOC at eight times and RBNZ at seven times.

RBNZ has taken nine months to raise the OCR by 175 basis points; we expect that the FOMC will take four months to increase the federal funds rate by 175 basis points; and the BOC has taken three months to move by 125 basis points.

After that pause we expect further increases of 25 basis points will be required in November and December in response to another disturbing inflation print for the September quarter.

That would see 200 basis points of rate increases in seven months for the RBA.

Even with the expected pause in September/October the RBA would have taken seven months to tighten by 200 basis points; we expect the FOMC will take nine months to tighten by 250 basis points.

2022 would end with a cash rate of 2.1% – a policy stance that we would assess to be in the contractionary zone.

Readers will be aware that we expect that the FOMC will have paused following its December rate move (total of 250 basis points) and the RBA is likely to take some guidance from that decision. We expect that the 25 basis point increase from the RBA in February, following another high inflation report, will be the last in this tightening cycle with the terminal rate settling at 2.35%.

That terminal rate is only slightly higher than the 2.25% terminal rate we forecast following the May Board meeting, mainly because we anticipated an outsize move in June.

Even though the RBA's forecasts and our own forecasts point to a larger inflation task than expected in May the decision to front end load the hikes (we expected one hike of 40 basis points in June to be followed by 25's) will prove to be much more effective in meeting the inflation challenge by signalling clearly to economic agents that the RBA is very serious about its role in returning inflation to within the band by 2024.

Containing inflationary expectations must be the most urgent task of a central bank and front loaded moves assist in that regard.

Critical to our "on hold" view for the RBA and FOMC for the bulk of 2023 is our forecast for inflation in 2023 which relies upon a flattening of some key prices, admittedly at high absolute levels.

Our forecast slowing in inflation in Australia from 6.6% in 2022 to 3.0% in 2023 will be largely achieved by a reduction in the contribution to inflation from house building costs from 1.11 ppt's to 0.23 ppt's (a global slump in building activities); a reduction in the contribution from fuel from 1.16 ppt's to – 0.76 ppt's (supply increases and demand slowdown to see oil prices fall through 2023); a reduction in the contribution from electricity from 1.45 ppt's to 0.63 ppt's (prices still rising but at a slower pace); and a reduction in the contribution from food from 0.70 ppt's to 0.43 ppt's (improved conditions in Ukraine/domestic weather).

Readers will notice that these numbers are reliant on the fuel price forecast in particular. We are forecasting the oil price (Brent) to fall from USD110/bbl. to USD85/bbl. over the course of 2023 with a modest improvement in refinery costs. On those numbers fuel subtracts 0.76 ppt's from inflation in 2023. Without that fall, headline inflation would only fall from 6.6% to 3.8% and pose some challenges for policy.

The combined turnaround in those supply related factors is forecast to lower inflation by 4.00 ppt's. That allows some room for a boost in the pressures from the labour intensive sectors such services as wages growth (WPI) lifts to 4% to reflect the tight labour market.

Critically, an easing in inflation from the supply side and the slowdown in demand, will be sufficient for a boost in real wages in 2023 taking pressure off a damaging wage/ price spiral.

Our rate profile is consistent with the revised growth forecasts we released on June 3 (which were predicated on the outsize move in June).

Growth in the June and September quarters of 2022 is expected to be resilient reflecting the ongoing opening of the economy; the release of additional funds from a continuing fall in the savings rate, and the confidence associated with a 48 year low in the unemployment rate.

But as we move into the December quarter; the cash rate moves above 1.6% and policy pivots into the contractionary zone; the near term boost to spending in the June and September quarters fades with growth momentum slowing appreciably.

The December quarter will be much weaker than the earlier quarters in 2022.

We are forecasting growth in 2023 to slow from 4% in 2022 to a below trend 2% in 2023. A contraction in dwelling investment in the second half; a slump in consumer spending; a step up in the pace of falls in dwelling prices; softer business investment; prospects of a rise in the unemployment rate during the year and a marked easing in inflation will all be sufficient to signal to the RBA that, having paused after February, policy can go on hold for the remainder of the year.

The lagged effect of a lift in the cash rate from 0.1% to 2.35% in the space of only nine months will take its toll.

Bill Evans, Chief Economist

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