BULLETIN

8 July 2022

Why we expect another 50 basis points in August and then a pause

The Reserve Bank Board decided to increase the cash rate target by 50 basis points to 1.35% at its July Board meeting. The decision was expected by Westpac and widely anticipated by the market and other analysts.

The Governor's July decision Statement provides ample flexibility for the next Board meeting on August 2. From our perspective the key objective of scrutinising the Statement is to detect whether there appeared to be any clear signal that the Board planned to scale back the sequence of 50 basis point moves which we have now seen for two consecutive months. Since the RBA began announcing the cash rate publicly in 1990 it has never raised the cash rate in two consecutive meetings by 50 basis points each. However, the Governor's statement made no reference to that historical precedent, something that may have been done if he was signalling the intention to scale back the moves. Neither did he assess that the stance of policy had moved from stimulatory to the neutral range.

He sounded more confident about the inflation outlook, noting that the Bank expected that the inflation rate would peak later in 2022. On the other hand, he did observe that the real time data on the labour market and household spending had lifted. We note that this has been despite the sharp deterioration in consumer confidence. However, the resilience of household spending to date has relied upon a strong reopening effect and the release of spending capacity as the savings rate returns to more normal levels. We see those effects fading through 2022 with spending in the December quarter and 2023 falling well short of long run trend.

The Governor stopped referring to rates as "very low" but did not substitute that term with a more moderate assessment. Of some significance was the strong emphasis in the Statement on the importance of inflationary expectations. And most importantly he implied that the June quarter Inflation Report would be pivotal to future decisions. With all this in mind and given our upbeat forecast for the June inflation report (5.8% headline; 4.5% trimmed mean), we remain comfortable with our expectation that the Board will decide on a further 50 basis point lift at the August 2 meeting. In light of that significant expected lift in inflation both headline and underlying it is appropriate for the Board to lift rates by a further 50 basis points , while the policy setting is still stimulatory, to emphasise its commitment to returning inflation to the target range of 2–3%.

However, we are expecting the Board to pause in September and October. A key to that decision to pause will be the RBA's assessment of the level of rates that constitutes a neutral policy stance. We assess that stance as being in the 1.5–2.0% range. Neutral is the rate at which policy is neither stimulatory nor contractionary.

Given the powerful transmission from the cash rate to the household sector (we assess that 90% of borrowers will be directly affected by the RBA's cash rate policy by end 2023), "neutral" has been falling as households have lifted their leverage.

But we cannot be certain of the level of neutral and many central banks have followed the Greenspan example (paraphrased), "I will tell you where neutral is when we get there!" That is the right approach and argues for a near-term pause in the RBA's tightening cycle to assess the cumulative impact of a series of out sized rate increases.

The concept that neutral is "zero real" when inflation is back at the middle of the target band might be an interesting theoretical approach for a steady state analysis but "zero real" is hardly relevant when annual inflation is trending towards 7%.

For example, if inflation was back at 2.5% the dampening impact on the economy of inflation (through the squeeze on household budgets) would be much weaker than the current situation where inflation is more than double 2.5% and rising. With inflation playing a much more prominent role in restraining real activity the level of interest rates required to align demand with supply is appropriately lower – not higher which would be the result of targeting zero real as "neutral".

Consequently, some notion that "neutral" should be 2.5% (zero real) seems misplaced in this extraordinary cycle. There have been some reports that the RBA sees neutral as 2.5% but that is likely to be a theoretical "steady state" assessment – not an approach which is relevant to the current situation.

But to support our expectation that the Board will pause in September we will need to see a significant change in the wording in the August Statement, highlighting some if not all of: how far rates have moved in such a short time; describing the rate of 1.85% as in the neutral zone; noting the much higher frequency of RBA meetings than other central banks: while firmly indicating that further increases will be required.

It will also be important to assess the Bank's revised forecasts which print on August 5, three days after the Board meeting, with the August Statement on Monetary Policy.

As we have done quite successfully through this current cycle, we have chosen to forecast the best policy rather than follow any implied guidelines from the RBA. For September, having firmly established the RBA's inflation targeting credentials over the previous four meetings, the Board's best policy option will be to pause to assess the high frequency response (confidence; house prices; new lending; housing related spending such as durables) and global developments before resuming the cycle following the September quarter Inflation Report. That Report is likely to see underlying inflation lift further to around 4.8% requiring a further, but scaled back, response of 25 basis points to emphasise that the Board remains focussed on its inflation objectives.

Our expected peak in the cycle (2.6%) is likely to be reached in February 2023, although the Board is unlikely to be able to indicate such an expectation.

A further pause in March in recognition that policy is firmly in the contractionary zone would be appropriate to again observe developments in the economy. By then we expect the very clear indications that the economy has slowed substantially with consumer spending growth well below trend; house prices well on the way to our 14% contraction target by end 2023; housing activity signalling an imminent contraction; the FOMC on hold; and the US economy losing all momentum.

But the key will be the March quarter Inflation Report where we expect to see annual inflation, both headline and underlying showing the first signs of falling (headline 6.6% to 5.6%; underlying 4.8% to 4.2%). Although annual inflation will still not be within the target band the Board will be observing a significant easing in supply side inflation pressures which are likely to continue as global demand slows and supply adjusts to elevated prices. The obvious easing in demand in the economy supplemented by increasing overseas arrivals will be closing the demand/supply gap in the labour market and provide the Board with ample justification to maintain its pause.

Bill Evans, Chief Economist

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