BULLETIN

29 July 2022

RBA Board to Raise the Cash Rate by 0.5% next week

The Reserve Bank Board meets next week on August 2.

For some time we have been forecasting that the Board will decide to lift the cash rate by a further 0.5% to 1.85% and we remain confident of that outcome next week.

Last week we lifted our forecast for the RBA's terminal rate in this cycle to 3.35%, up from 2.6%, with the timing for reaching the terminal rate remaining the February Board meeting next year.

Because we now see an extended period of rates holding well into the contractionary zone (our own estimate of neutral is 1.5-2.0%) with a sudden associated slowdown in economic growth we are now anticipating a series of rate cuts in 2024 to restore the cash rate to the RBA's neutral zone (total cuts of 100 basis points).

The revised profile sees the Board raising the cash rate by a further 0.5% in September to 2.35% - near the Governor's estimate of neutral which is "at least 2.5%".

Just as we saw Chairman Powell, during the post FOMC Press Conference this week, imply that having reached the neutral zone (around 2.5%) with the federal funds rate (now 2.375%) it would be appropriate to slow the pace of tightening we expect that following the 0.5% increase in September the RBA Board will move back to 0.25% increments from October as policy moves into the contractionary zone.

Because the RBA Governor will not hold a Press Conference after the September meeting, we expect some signal in the Governor's written Statement or the Minutes for the meeting that policy can change gear to a slower tightening pace at the next meeting with the cash rate now in the neutral zone.

For August, the Governor will continue to make the case for justifying a third consecutive 0.5% move therefore laying the foundation for the expected move in September.

Next week will not only be about the decision on August 2 but the Bank will also publish its revised growth and inflation forecasts in the August Statement on Monetary Policy that will print on Friday August 5.

Readers will be aware that the Government has just released a new set of forecasts from Commonwealth Treasury that represents an update from the forecasts in the Pre-Election Economic and Fiscal Outlook – a document that provided the updated fiscal estimates for the recent campaign that culminated in the Federal election on May 21.

Last week Westpac released its revised forecasts in conjunction with the upward revisions to the interest rate outlook.

Westpac's Forecasts Compared to Treasury's Revised Forecasts

Our key revisions were: GDP growth (through the year) were revised from 4.0% to 4.4% in 2022; down from 2% to 1% in 2023; and down from 2.5% to 2.0% in 2023.

With this growth slowdown in 2023 we lifted our end 2023 unemployment rate forecast from 3.5% to 4.2% and lifted the end of 2024 forecast for the unemployment rate to 5%.

While our forecasts for the June quarter Inflation Report were in line with the actuals there were some developments in the Report (particularly around home building costs and durables) that have lifted our end 2022 inflation forecast from 7.1% to 7.5%, with the trimmed mean annual rate upgraded from 5.0% to 5.5%.

For 2023 we have also lifted our inflation forecasts from 3.0% to 3.1% with the trimmed mean forecast holding at 3%.

These inflation forecasts through 2023 strengthen our case that the RBA will be committed to maintaining the cash rate at 3.35% throughout 2023.

Treasury has revised its GDP growth forecasts for 2021/2022 (Year average) to 3.75% (from 4.25%); for 2022/23 to 3% (from 3.5%) and for 2023/24 to 2% (from 2.5%).

On the "year average fiscal year" basis our own growth forecasts are: 4.1% (2021/22); 4.5% (2022/23); and 1.1% (2023/24).

On a "through the year calendar basis" we estimate the Treasury forecasts are likely to be around: 2.7% (2022); 1.8% (2023); and 2.4% (2024).

As noted there are some big differences between our own forecasts and the revised Treasury forecasts.

In effect, we expect 2022 to be much stronger than Treasury while the slowdown in 2023 will be much more severe as the rate hikes bite.

We expect GDP growth in the June quarter of 2022 to be 2% (we estimate Treasury are factoring in around 0.9%); 1% in the September quarter (an estimated 0.6% by Treasury) and 0.6% in the December quarter (Treasury around 0.4%).

Our differences with Treasury in 2022 are quite significant. Hours worked from the Labour Force survey increased by 4.6% in the June quarter consistent with a strong outcome in that quarter as households freed up more spending , particularly on services, by further lowering their savings rate from the "high" starting point of 11.4% and NSW and Victoria benefitted from the reopening effect we saw in the March quarter.

The Treasury forecasts for headline inflation have been revised up to 7.75% by end 2022 falling to 3.5% by end 2023 and 2.75% by mid-2024. (Treasury has not provided any trimmed mean forecasts).

Westpac's forecasts are: 7.6% in 2022; 3.1% in 2023; and 3.0% in mid-2024.

Treasury forecasts the unemployment rate in June 2023 at 3.75% and 4.0% by June 2024.

What Does this Mean for the RBA's Forecasts in the August Statement on Monetary Policy?

Some very important points to note about the RBA's forecasts are that the forecasts in the May Statement on Monetary Policy were based on "expectations derived from surveys of professional economists and financial market pricing" while the Brent crude oil price is fixed at US$101bbl (as at 4 May) for the entire forecast period.

Since May 4 market pricing has scaled back significantly – at that time markets had the cash rate rising from 0.35% to 4% by May 2023 peaking around 4.5% by May 2024.

Economists were much more cautious with peaks in the 2.25%-2.75% range generally assessed.

Now markets have repriced the peak in the cash rate to mid-2023 at around 3.5% while economists have generally lifted their peak rate forecasts to be around 3%.

Overall it is reasonable that the RBA would be using a somewhat lower expected profile for the cash rate than was the case in May although, because it is a "mix" of two quite different assessments, it is not at all clear exactly how far the rate forecasts will have been reduced.

Perhaps the best approach is to assume a broadly unchanged path for interest rates for the August forecasts. Note that the forecasts for the August Statement will be extended from mid-2024 to end 2024.

In May the key forecasts from the RBA (through the year growth) were: for GDP: 4.25% (2022); 2% (2023); and 2% (to June 2024); for headline inflation: 6% (end 2022); 3.25% (end 2023); and 3% (mid 2024).

Trimmed mean inflation was: 4.75% (2022); 3.25 (2023); and 3% (mid 2024) while the unemployment rate was forecast at 3.75% (end 2022); 3.5% (end 2023); and 3.5% (June 2024).

On growth, we expect the RBA will be much closer to our estimate of 4.4% for 2022; and more upbeat in 2023 than our 1% (perhaps 1.75%) and retain the 2% growth forecast in 2024.

On inflation, the RBA is likely to lift the forecast for 2022 from 6% to 7.5%; retain the 3.25% forecast for 2023 but lower the 2024 forecast to 2.75%.

The RBA's forecast for the unemployment rate is likely to hold at 3.5% in both 2023 and 2024 – lower than Treasury's forecast.

RBA's "year average – fiscal year" growth forecasts in May were: 3.75% (2021/22); 4.5% (2022/23); 2% (2023/24). Those compare with Treasury's numbers of 3.75%; 3%; and 2%. Our own forecasts are 4.1%; 4.5%; and 1.1%. We do not think that the RBA will follow Treasury with such a sharp downgrade of 2022/23 but believe the 2023/24 forecast will be much closer to the Treasury forecast than our own.

Conclusion

Apart from the 2022 inflation forecast we do not expect any significant forecast changes from the RBA in the August Statement on Monetary Policy despite a downgrading of growth by the Treasury.

However, in particular, we do not expect the RBA to forecast the sharp slowdown in 2023 in line with our own views.

That slowdown is linked with a higher unemployment profile than we expect from the RBA which, we believe, will pave the way for rate cuts in 2024.

The Australian Dollar

Readers will be aware that we have consistently argued for a higher AUD through the second half of 2022 and through 2023.

We have "tweaked" our target profile from USD0.75 (end 2022) and USD0.80 (end 2023) to USD 0.73 (end 2022) and 0.78 (end 2023).

That adjustment mainly reflects the sharper forecast slowdown in Australia's growth rate in 2023 from 2% to 1% and greater uncertainty in the world economy, particularly around China.

However the key principles which continue to underpin the AUD remain, namely: a sharp slowdown in the US economy - undermining the USD; an eventual clear out-performance by China; expected resilience among the prices of a number of Australia's commodity exports; and, most importantly, a clear signal that the risk aversion that undermined the AUD in 2022 H1 (where markets were progressively more nervous about the ability of central banks to contain inflation) will subside in 2023 as inflation slows; markets confidently anticipate lower rates; and risk aversion fades.

Bill Evans, Chief Economist

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