1 September 2022

RBA to raise the cash rate by 50 basis points next week

The Reserve Bank Board meets next week on September 6.

We are confident that the Board will decide to raise the cash rate by a further 50 basis points to 2.35%.

The Statement from the Governor following the meeting will be closely scrutinised. In the note below we discuss a range of issues that will be relevant to that issue.

In summary, **"The best approach will be to strengthen the rhetoric we saw in the August Statement; maintain the term "not on a pre set path"; and, following Chair Powell, note that at "some point" it will be appropriate to slow the pace of tightening while emphasising that the cycle may have considerably further to run."**

Raising the cash rate by 50 basis points will move the cash rate into the "neutral zone".

In recent speeches (19 and 20 July) the Governor and Deputy Governor assessed "neutral" is at least 2.5%.

Having quickly moved policy into that neutral zone (225 basis points in four months – five meetings) we expect the Board will decide to slow the pace of increases to 25 basis points from the October meeting.

This second stage of the tightening process, with consecutive 25 basis point increments, is expected to extend out to February next year with the rate peaking at 3.35%.

At that point we expect that it will become evident that the Australian economy is clearly slowing with clear evidence of continuing deterioration as the series of rate hikes and high inflation weigh on households and business. Furthermore, although both headline and underlying inflation will be rising on an annual basis the quarterly increase in underlying inflation will have slowed from 1.5% (September quarter) to 1.2% (December quarter) with the prospect of a further slowing to 0.8% in the March quarter.

Our assessment of "neutral" is lower than the RBA's. We view neutral in the Australian economy to be around 2% (partly relying on comparisons with previous peak debt servicing ratios in earlier cycles).

The 2.5% estimate from the RBA assumes a zero real rate and a nominal component equal to long term inflationary expectations which are judged to be 2.5%.

We accept that the challenge to contain inflationary expectations in this cycle will be formidable given the current evidence that both businesses and households are becoming accustomed to rising prices and short-term inflationary expectations are rising quickly.

Holding the cash rate at 3.35% through 2023, well above the neutral setting of 2.0%, is a necessary condition for the Bank to bring inflation down close to the 3% target – the top of the 2-3% range.

But there will be a price to pay for such success – we forecast the economy to grow by only 1% in 2023 – well below the trend rate of growth of around 2.5%.

This growth forecast is more pessimistic than the Bank's forecast of 1.8% while our forecast for inflation (Trimmed Mean) by end 2023 is 3.1%, well below the RBA's forecast of 3.8%.

Indeed, the RBA's forecast for headline inflation by end 2023 is 4.3% (3.8% underlying) - well above the 2-3% target.

The RBA's economic growth forecast for 2023 is 1.8% – significantly above our 1% forecast.

But the RBA uses a different interest rate profile in its forecasts, "the cash rate assumed to increase to around 3% by end of 2024" – a lower profile than our expectations. This profile is not a policy driven choice but rather "expectations derived from professional economists and financial market pricing".

So, although the Bank has a very clear policy objective, its forecasts use the estimates provided by others for the profile of its policy instrument.

There is a strong case for this approach to be reviewed in the current circumstances. It hardly signals the decisive "whatever it takes" commitment we see from US Fed Chairman Powell's Jackson Hole speech.

In the case of the RBA, the outcome is a set of forecasts that does not emphasise the Bank's commitment to returning inflation to the target zone in a reasonable time.

Consider the two policy approaches of the RBA and the Federal Reserve as indicated by the most recent Statements.

Governor Lowe, "The Board places a high priority on the return of inflation to the 2-3% per cent range over time, while keeping the economy on an even keel." (August Board)

Chairman Powell, "The FOMC's overarching focus right now is to bring inflation back down to our 2% goal.... Reducing inflation is likely to require a sustained period of below trend growth ... will bring some pain to households and business." (Jackson Hole).

The Jackson Hole speech was clearly aimed at convincing business and households that the FOMC is absolutely committed to containing inflationary expectations, whatever the cost.

The Governor's Statement refers to "the path to achieve this balance is a narrow one and clouded in uncertainty."

The much more cautious, softer rhetoric along with the cautious forecasts risks the RBA losing control of inflationary expectations.

Chairman Powell emphasises that risk by invoking Chairman Volker, "Inflation feeds on itself, so part of the job ... must be to break the grip of inflationary expectations."

That is compounded by a set of forecasts from the RBA that projects a "leisurely" two and a half years to reach the top of the 2-3% target zone.

So, the question is whether the powerful Jackson Hole speech will spur the RBA into stronger words after the September meeting than we saw in August.

I believe that would be the right approach although it should not commit to extending the 50 basis point increases into October.

Even the robust Chairman Powell noted, "At some point, as the stance of monetary policy tightens further it likely will become appropriate to slow the pace of increases."

The best approach will be to strengthen the rhetoric by strongly emphasising the inflation priority; maintain the term "not on a pre set path"; and, following Chair Powell, note that at "some point" it will be appropriate to slow the pace of tightening while emphasising that the cycle may have considerably further to run."

The Bigger Picture for Central Banks

Chairman Powell has emphasised his 2% inflation target.

It seems clear that he is prepared to impose considerable pain on the US economy to achieve that objective.

We forecast that growth in the US economy will be only 0.7% in 2023; a necessary development to squeeze inflation out of the system.

Consider the structural changes in the global economy in recent years:

- There has been ample supply in global labour markets, due to the rise of China and Eastern Europe. Through ageing; geo-political tensions; health shocks and mobility restrictions the excess supply of global labour has reverted into global shortages.
- The transition from fossil fuels to renewables, as the world deals with the realities of climate change, has quickly transformed into global shortages of fossil fuels which is pressuring energy prices.
- Food supplies are regularly disrupted by extreme climate developments.
- Globalisation and the resulting cost savings is reverting to deglobalisation as businesses that have suffered through supply chain disruptions are reassessing their supply chain policy – moving the mantra from "just in time" to "just in case".
- In response to the major shocks of the GFC and COVID central banks aggressively expanded their balance sheets. We cannot be sure exactly how this massive boost to liquidity will affect inflation, although the uncertainty is about the extent rather than the direction.

Central banks are likely to be able to restore inflation to their pre COVID targets through aggressively slowing demand over the course of the next few years. But, in facing these major structural changes to the global economy, they may have to accept higher inflation targets once they rebalance policy settings to revitalise demand and restore their economies to potential growth in the future.

With the key current objective for central banks being to contain inflationary expectations there will be no immediate move to address this challenge.

As we move beyond 2023, and into 2024 when we expect central banks to be easing policy settings to restore demand, upward pressures on inflation may emerge more quickly than is currently expected.

Bill Evans, Chief Economist

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