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SOME UNINTENDED CONSEQUENCES OF THE RBA'S PIVOT

The Westpac Melbourne Institute Index of Consumer Sentiment only fell by 0.9% from 84.4 to 83.7 in the October Survey.

The Index remains in deeply pessimistic territory but could have been much weaker.

As discussed when we released the results of the survey we examined the two samples over the four day period.

The first sample (covering the responses on day 1 of the survey) preceded the RBA's decision to raise the cash rate by 25 basis points. The second sample covered responses which followed the rate decision.

The first sample (sample of 476) showed a Sentiment Index of 77.4 – down 8.3% from the September print of 84.4.

But the Index for the second sample (a sample of 724) printed an Index of 88.7 (up 5.1% on the September print). The difference between the two surveys represented a turnaround of 14.7%.

The turnaround in housing market confidence was even more spectacular. The first sample measure for the Westpac Melbourne Institute Index of House Price Expectations showed a 16% fall in the Index while the second sample showed a lift of around 8% relative to the September print.

This spectacular change in the Index is very likely attributable to the Reserve Bank's decision to raise the cash rate by "only" 25 basis points despite market pricing that gave a probability of around 90% to an increase of 50 basis points.

In my 30 years following RBA policy and markets I cannot recall the RBA moving against market expectations when the probabilities have been so high.

The key indicator for the Sentiment survey was the media reports which took the lead from market pricing and signalled a very confident expectation to the public that a further 50 basis point move was to be expected.

We can congratulate the Board for a courageous decision while pointing out some likely unintended consequences.

Westpac had expected a 25 basis point move until we were obliged to lift our forecast for the terminal federal funds rate by 125 basis points to accommodate a much more aggressive guidance from the FOMC and upside surprises on US inflation.

In lifting our forecast for "global rates" by 125 basis points we lifted our terminal rate for the RBA cash rate by 25 basis points to 3.6%, with the upward adjustment coming in October – a 50 basis point move instead of our earlier preference for 25 basis points.

Because the Australian economy is much more sensitive to the cash rate than is the US economy to the federal funds rate it is not appropriate to follow the full lift in FOMC pricing.

The major adjustment came in our AUD/USD forecast with a US7¢ cut in the likely exchange rate by end 2022 to USD0.65.

With the surprise 25 basis point move the market lowered its terminal cash rate by around 50 basis points. Central banks like to see the markets doing their job for them so a fall in the fixed rates only adds to the task of easing demand pressures.

From our perspective that price response was a surprising reaction to the decision from the RBA and an unintended consequence of the decision.

We observe from the confidence turnaround in the Sentiment survey the RBA decision has provided a short term boost to confidence that is likely to delay the slowdown in demand which will be necessary to constrain demand and inflation pressures.

The key for central banks at this stage of the inflation cycle is to slow demand overall including the demand for labour so that businesses question whether their recent successes in raising their prices, particularly to restore margins, can be sustained or whether they can proceed with plans to increase prices.

Without that hesitation the RBA will fail to wring the inflation pressures out of the system.

Questioning the sustainability of demand will also be consistent with questioning the need to boost employment plans – this is at a time when the labour market is the tightest in 50 years. Currently, labour supply cannot adjust quickly enough to contain wages pressures – thus labour demand needs to slow.

Tight labour market conditions emerged during the pandemic, associated with the national border "closure" – with restrictions on the inflow of people (labour supply) more stringent than those for the outflow. Net immigration averaged around plus 240,000 before Covid and over the two years during the pandemic Australia experienced outflows of around 120,000 – a net loss of around 600,000 people. This was at a time when fiscal and monetary stimulus was boosting demand exacerbating the employment shortfall.

The third unintended consequence of the RBA surprise has been an unexpected further collapse in the AUD to around USD0.625 from USD0.65 before the announcement.

That can be expected to heap further pressure on inflation, adding upside risks to the RBA's current forecast of 7.75% by end 2022 and, potentially, its 2023 forecast.

And the fourth unintended consequence is that a decision to speed up rate increases back to 50 basis points would now be particularly dangerous.

Just as we saw an overreaction in confidence from a positive shock the impact of a larger tightening than expected is likely to be too damaging from the RBA's perspective.

The RBA has not ruled out returning to “50’s” should the data so demand although we think the hurdle to going by 50 now will be very high.

At the time of the announcement, we interpreted these likely unintended consequences as justifying no change to our terminal rate of 3.6% but extending the length of the tightening cycle.

We have extended our estimate of the end of the tightening cycle from February to March.

As discussed, that would be consistent with activity holding up for longer given the boost to confidence of the policy pivot.

Consequently, we now expect 25 basis point moves in November; December; February (no meeting in January) and March.

We still expect that achieving a terminal rate of 3.6% will be sufficient to slow growth in the economy from 3.4% for 2022 to 1.0% in 2023.

Activity may hold up a little better in the first half of 2023, given a little more momentum in 2022, resulting from the lower rate profile, to be followed by a more rapid slowdown in the second half.

Any risks of consecutive negative growth quarters would centre on the second half of 2023 rather than the first half, although that “recession” scenario is not our central case.

If our four percentage point down swing in inflation in 2023 does not appear to be materialising (and that has to be a central risk) then we expect that the RBA will have to raise the terminal rate even further – certainly a more likely scenario than trying to fine tune inflation with a more benign rate cycle and a stronger growth outcome.

The Role of the Neutral Rate

Our view has been that the “handbook” for central banking is, when it becomes necessary to contain an inflation shock at the same time policy is clearly stimulatory the strategy is to quickly return the cash rate to “neutral” and then move more slowly.

In previous speeches the RBA Governor has identified “neutral” to be at least zero real, where the nominal component is best assessed as long term inflationary expectations- around the policy target of 2.5%.

The guideline we have been working with is minimum neutral is 2.5%.

The cash rate is now 2.6% so policy is just now in the neutral region.

On October 12, RBA Assistant Governor (Economic) Ellis delivered an important speech on measures of neutral.

She nominates a range of “neutral” from negative 0.5% real to positive 2.0% real - with her various models indicating a central tendency of around 1% real, (or 3.5% nominal).

But neutral is described in terms of the long term. It is the rate which is consistent with the economy holding at trend growth and inflation at the inflation target.

Ellis concludes “The neutral rate is an important guide rail for thinking about the effect policy might be having. It is not necessarily a prescription for what policy should do.”

This indicates that neutral is a long term concept whereas actual policy will be buffeted by short term shocks.

It is a similar approach to when Chairman Greenspan was asked where he saw neutral. He answered along the lines of “I will tell you when we are there” or even after we have been there.

Nevertheless, it does now seem that the Bank has a concept of neutral that is likely to be around where we are today if not a little higher.

For other reasons we discussed above that points to the shift to 25 basis point moves being the most likely outcome.

Bill Evans, Chief Economist

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