BULLETIN

27 January 2023

Inflation picture supports higher rates

The December Inflation Report provides more support for our view that the Reserve Bank will continue raising the cash rate in 2023 from 3.1% to a peak in May of 3.85%.

Last week we discussed the outlook for inflation.

We highlighted that global supply pressures were likely to ease markedly in 2023 allowing Australia's headline inflation to fall to 3.7% by end 2023.

That was based on our estimate that inflation in 2022 would be 7.4%.

Inflation for 2022 has printed 7.8% – an upside surprise raising the risk that our 3.7% target for 2023 could also be a little higher. But we do not believe that any upward revision will be sufficient to delay the first rate cut which we expect in the March quarter of 2024.

The analysis we used to highlight the important role that global supply factors would play pointed out that the unwinding of these pressures was already underway in the US and that Australia is following suit (goods inflation eased a little from 9.6% in June to 9.5% in December).

Demand forces in the US, typically proxied by services inflation, have already begun to ease in the second half of 2022. Headline inflation in the US has fallen from 9.1% in June 2022 to 6.5% in December 2022. The US measure of services inflation has fallen from a contribution of 1.2ppts to annual inflation in June 2022 to 0.8ppts in December.

That slowing is likely to be associated with the peaking in wage pressures in the US in 2022.

But wage pressures in Australia still have some way to run.

We are forecasting wage inflation to lift from 3.1% in the year to the September quarter 2022 to 4.5% in the year to June 2023.

The persistence of services inflation in Australia has been highlighted by the December quarter inflation report. Annual services inflation lifted from 3.3% in the year to June 2022 to 5.5% in the year to December 2022. Major contributors were: holiday travel; meals out; and takeaway food although there was evidence of other widespread pressures.

Inflation pressures were widespread more generally, with nearly 80% of items in the CPI printing at gains in the quarter running above a 3% annualised pace.

These pressures, especially in services, highlight that businesses are responding to strong demand and cost pressures by raising prices and that households are accepting the increases and expecting them to continue, near term inflationary expectations still high.

We argued that the desynchronisation of the US and Australia with respect to services inflation and wages would mean that the RBA tightening cycle is likely to extend beyond the cycle for the Federal Reserve.

We currently expect the Federal Reserve to lift the federal funds rate by 25bps at the meeting next week prior to a final 25bp increase at the meeting on March 21–22.

If lower inflation is reflecting easing supply side pressures but price pressures, associated with domestic demand, remain strong then central banks will accept that there is more work to do.

A disturbing aspect of the December inflation report for the Reserve Bank was that while the headline print of 7.8% was a little lower than their most recent forecast of 8.0%, the 6.9%yr gain in the trimmed mean, which the Board uses to gauge sustained inflation pressures, significantly exceeded their forecast of 6.5%.

The December inflation report almost certainly ensures that the Reserve Bank Board lifts the cash rate by 25bps at its next meeting on February 7.

But it is what follows that holds the most interest.

We expect that the Board will leave its options open in the Governor's Statement after the February meeting to allow scope to raise rates at the March meeting.

A central bank is unlikely to pause when there the evidence of demand pressures and firms seizing some pricing power associated with rising services inflation as we saw in the December inflation report.

Prior to the March Board meeting (March 7) we will see important updates on wages for the December quarter, both from the wage price index on February 22, and the December quarter national accounts on March 1.

With services inflation pressures accelerating (5.5% in December; up from 3.3% in June) the Board should be particularly focussed on the wages report.

We expect it will show a marked increase in wage inflation, from 3.1% in the year to September to 3.6% in the year to December.

There will be a monthly inflation report for January (March 1) although with the ABS choosing to exclude the trimmed mean from the monthly series there will be no further updates of this key underlying measure.

Rising wage inflation in the context of intensifying demand-related inflation in the December inflation report will make a convincing case for a further 25bp rate increase at the March Board meeting.

With the cash rate at 3.6% – arguably 0.5–1.0ppt above neutral – and the ongoing need to monitor the accumulated impact of the of the series of rate increases since May 2022 there will be a case for the Board to pause in April, pending further information on inflation in the March quarter inflation report.

That report will be available for the May Board meeting. While we expect that overall inflation pressures will have eased further in the goods sector, upward pressure will still be apparent in services and other wage-related components of the Index.

The meeting will occur on May 2 only two days before the Federal Reserve meeting where a pause will be confidently expected.

An RBA hike in May coinciding with an FOMC pause will be consistent with our view that the RBA tightening cycle has lagged the FOMC cycle.

The decision to go on hold after the increase in May will not reflect a peaking in wage pressures.

But demand conditions are likely to have eased sufficiently for the RBA, with rates firmly in the restrictive zone, to anticipate real difficulties for businesses to continue to pass on higher costs while costs associated with supply chains and even wages (from the second half of 2023) continue to ease.

Conclusion

Persistent inflation pressures will see RBA Board raising the cash rate in February and March. After a pause in April we expect a final move at the May meeting, in recognition of the persistence of demand-related inflation in the first half of 2023.

Bill Evans, Chief Economist (WestpacGroup)

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