3 March 2023

RBA on track for hike in March

The Reserve Bank Board meets next week on March 7.

We expect the Board will decide to lift the cash rate by a further 0.25% from 3.35% to 3.6%.

Most interest will be in the guidance the Governor provides in his Statement announcing the decision.

In February he changed the wording from the December Statement which noted that "The Board expects to increase interest rates further over the period ahead, but is not on a pre-set course" to "The Board expects that further increases in interest rates will be needed over the months ahead …"

The term "not on a pre-set course" allowed for the possibility of an imminent pause before resuming hikes later in the cycle. By choosing to leave that term out of the guidance a reasonable assumption was that the Board had decided to continue the steady 25 basis points per meeting before deciding on a permanent pause.

The Minutes from the February meeting confirmed that a change of approach had been adopted by noting that a pause had not even been considered at the meeting.

For these reasons we would be very surprised if the Board decided to pause in March.

The issue will be whether the Board chooses to revert back to language that accommodates a possible pause in April or decides to confirm the guidance from February ("further increases in interest rates") with a statement like, "The Board expects to increase interest rates further over the period ahead." (The December statement without the "not on a pre-set path").

Such an approach would be consistent with the "further increases" wording in February.

A further hike in April, which is Westpac's view, seems the logical extension of the February statement.

But since the February Board meeting, we have seen downside surprises on both the Wage Price Index and economic activity in the December national accounts.

The Wage Price Index printed an increase of 0.8% in the December quarter compared to market forecasts of 1%; economic activity lifted by 0.5% in the December quarter compared to market forecasts of 0.8%.

The measures of wage pressures in the national accounts also confirmed the slow down signal from the WPI, although a sharp deterioration in productivity saw unit labour costs surge by 7% for the year – highlighting the risk from wages growth for inflation.

On the other hand, inflation indicators in the national accounts were strong while the outlook for US Federal Reserve policy has been boosted – Westpac has lifted its forecast for the peak in the federal funds rate from 4.75-5.0% to 5.25- 5.5% and some analysts have gone even further.

In the Parliamentary hearings the RBA Governor attended recently he emphasised the importance of a steady policy approach.

Having signalled multiple rate hikes at the February Board it seems that the prudent approach for the Board at the March meeting will be to remain consistent with that guidance while certainly not committing to a move in May.

The best way to achieve that will be for the Governor to simply note that "The Board expects to increase interest rates over the period ahead."

That will send a clear signal for April while keeping options open for May.

Any policy change to take the recent data into account should be contemplated for May.

National Accounts raise alarm bells about the household balance sheet

The Governor has talked about the narrow path that would keep the economy on an even keel.

The national accounts that printed this week for the December quarter highlighted the risks associated with the narrow path.

Domestic demand was flat in the quarter with consumer spending growth slowing from 1% in the September quarter to 0.3% in the December quarter. That was despite a significant fall in the household savings rate from 7.1% to 4.5%, freeing up around $9 billion of spending capacity – compared to around $6 billion of actual spending.

The household sector faced some extraordinary pressures during the December quarter. Nominal disposable income contracted by 0.7% weighed down by a 7.4% lift in income tax payments and a 22.4% increase in interest payments – an all time high in absolute dollar terms ($25.2 billion).

The increase in tax payments partly reflects rising employment and rising wages but there is a considerable base effect coming from an unusually small increase in tax payments in the September quarter (partly affected by the Low and Middle Income Offset which lowered tax payments in the September quarter).

The fall in real wages (inflation at 7.8% in 2022 compared to wages growth of 3.3%) contributed to a record (outside the volatile pandemic period) fall in real disposable income of 2.2%.

The interaction between negative real wages growth; rising tax and interest payments; labour income growth; and the drawdown in excess savings will dictate household incomes and spending over the course of 2023 and 2024. In turn that process will dictate the path of growth in the overall economy.

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Sharp Deterioration in Line with Westpac's Forecasts – only minor downward revisions.

While Westpac was surprised by the sharp contraction in real incomes in the December quarter, we see this development as broadly consistent with our outlook for consumer spending in 2023 and 2024.

We expect wages growth in 2023 of 4% and inflation of 4% ending the contraction in real wages that was apparent in 2022 while in 2024 wages growth and inflation slow to 3.2% and 3% respectively.

However with slower employment growth and lower wages growth in 2023 and 2024 labour income growth will also be much weaker.

We expect three more rate hikes from the RBA through 2023 while rates are forecast to fall by 100 basis points in 2024.

Consumer spending is likely to be boosted by further freeing up of spare capacity as the savings rate continues to fall – settling at around 2% by the end of 2024.

Over the course of the two years we expect that households will draw down around $50 billion in 2023 and $70 billion in 2024 out of the $300 billion in excess savings that have been accumulated.

Slowing employment growth; low confidence; drags from higher tax payments and interest costs will weigh on the household sector over 2023 and 2024.

Cyclical offsets to these negative forces as we move through 2023 and 2024 will be stability in real wages and capacity to drawdown excess savings balances.

We have not materially lowered our growth forecasts for consumer spending in 2023 and 2024 despite the alarming signal around the household balance sheet from the December national accounts.

We have lowered our already very modest forecasts for consumer spending growth from 1% to 0.7% in 2023 and 2% to 1.5% in 2024.

Those adjustments see our GDP growth forecast hold at 1% for 2023 and trimmed to 1.5% for 2024 (marked down from 2%).

Other important developments remain largely unchanged – equipment investment down by 6.5% in 2023 and 3% in 2024; dwelling investment down 3.2% in 2023 and 2024; while net exports contribute 1.2ppts to growth in 2023 (upgraded from 1ppt) and 0.1ppt in 2024.

Note that we have not changed our RBA call that the cash rate will peak at 4.1% in May while the easing cycle will begin in the March quarter 2024, while we recognise that the RBA will be even more challenged to keep the economy on that even keel.

Bill Evans, Chief Economist (WestpacGroup)

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