BULLETIN

10 March 2023

RBA Governor wants to pause in April; we are not yet convinced

The Reserve Bank Board lifted the cash rate by 25 basis points from 3.35% to 3.6% at the March meeting.

While this decision was widely expected the real issue was the guidance the Governor would provide for the future.

He chose to use the words, "The Board expects that further tightening of monetary policy will be needed to ensure inflation returns to target …. In assessing when and how much further interest rates need to increase, the Board will be paying close attention to developments in the global economy, trends in household spending and the outlook for inflation and the labour market."

The compares to the February Statement which noted, "The Board expects that further increases in interest rates will be needed over the months ahead … in assessing how much further interest rates need to increase."

Note that in February the issue was around "how much" whereas in March it has become "when and how much."

The revised assessments (from the February Statement) of those issues that the Board is following with respect to future policy are:

- The monthly CPI suggests that inflation has peaked.
- At the aggregate level wages growth is still consistent with the inflation target and recent data suggest a lower risk of a cycle in which prices and wages chase one another.
- The Board remains alert to the risk of a price-wage spiral given the limited spare capacity in the economy.
- Household consumption growth has slowed. But in contrast, the outlook for business investment remains positive.
- Rents are increasing at the fastest rate for some years.
- Employment fell in January but that reflects changing seasonal patterns.

These observations were based on lower than expected prints for the Wage Price Index; GDP growth in the December quarter; a significant fall in annual inflation in the monthly series; and a fall in employment in January.

These insights indicate that, as should be expected, the accumulation of ten consecutive rate hikes is having an impact on the economy.

We had been expecting that the Board would continue to point to higher rates with 'guidance' along the lines of "The Board expects to increase interest rates further over the period ahead."

In referring to monetary tightening rather than interest rates the case could be made for a very different message but the second line in the paragraph – "when and how much further interest rates need to increase" – returns the theme to interest rates as the monetary policy instrument but adds the notable "when" to earlier guidance.

For these reasons the case can be made for a pause in April.

We should not overlook that the Board still has a very strong tightening bias and, by April, will still not be forecasting that inflation will return to the 2–3% target zone before mid-2025. The forecasts will not be refreshed until the May Board meeting.

Recall a key reason for dismissing a pause at the December meeting was that "inflation was expected to take several years to return to the target range."

Since then, markets have also lifted the profile for the US federal funds rate by 50–75bps required to support the FOMC's forecasts to lower inflation to 3.3% in 2023.

In contrast the RBA's "target" of 4.75% by end 2023 seems quite leisurely.

We continue to expect rate increases in both April and May.

On the day following the March Decision Statement, the Governor spoke at a Business Conference. He noted that "before our next Board meeting, we'll have important data on employment, … monthly inflation indicator… retail spending and business surveys…. If collectively they suggest that the right thing to do is pause, then we'll do that."

That statement indicates that he would like to pause but will continue to be data dependent.

The employment and monthly inflation indicator are both volatile particularly in the first two months of the year due to changing seasonal patterns.

In the January Labour Force Survey not only was there a larger-than-usual increase in unemployment (3.5% to 3.7%) there was a larger-than-usual rise in the number of unemployed who had a job to go to.

January is the most seasonal month of the year (employment fell 343k in original terms) with people not just leaving jobs but also getting ready to start new jobs or return from extended leave.

In his speech the Governor pointed out, "In early January there were around 100,000 more people than usual indicating they had a firm offer to start a job within the next four weeks."

Our February 2023 forecast for the increase in original employment is 276k. If we add, say, a further 60k to that estimate, this boosts our seasonally adjusted estimate for jobs growth from 50k to around 100k. This points to a clear upside risk to our current February forecast of a 50k rise in employment.

Justin Smirk who forecasts our labour market statistics notes that, "This may not lower the unemployment rate. A large proportion of those unemployed with a job to go to would not have been looking for work, it is the summer holidays, so they would not have been counted as unemployed as they were not included in the labour force. Not only will they boost employment in February, but they will also boost the participation rate as they return to the labour force."

All this is uncertain, but if there is a big jump in jobs without a pull back in the unemployment rate the Governor might see that as consistent with the need to pause.

The monthly CPI is a useful additional source of information on how inflationary pressures may be evolving.

While the ABS collects a lot of monthly price data a large proportion of the CPI is still only available on a quarterly, or even an annual, basis. This is also why the ABS has discontinued the monthly measure of the Trimmed Mean. And recall that the biggest shock the RBA received from the December quarter Inflation Report was that the Trimmed Mean inflation had lifted to 6.9% compared to the forecast of 6.5%.

The monthly CPI fell 0.4% in January; we had been looking for a flat print but saw a risk of a larger than expected fall in holiday travel costs. In the end this did occur (-7.2%) but there was broader softness in prices with food -0.1%, clothing -3.6% and household contents -1.6% – these were all weaker than we had expected."

The RBA will be analysing the February Inflation Report to assess that the downturn in inflation pressures which abruptly emerged in the January Report remains intact.

Since the March Board meeting an additional source of uncertainty has emerged in the US. Market pricing now gives a 50% probability to the FOMC lifting the federal funds rate by 50 basis points on the morning of March 23 – less than two weeks before the April RBA Board – pausing in the face of a 50 by the FED would be a brave move indeed.

Conclusion

There is ample evidence that the Governor favours a pause in April – his Statement; speech; Q and A. But the task is reliant on a series of highly volatile data reports and overseas developments.

In that context Westpac has not changed its call for rate hikes in both April and May, assessing that more needs to be done to tame inflation.

Bill Evans, Chief Economist (WestpacGroup)

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