16 June 2023

Growth forecasts lower – RBA to hike in both July and August

In March, when we last revised our economic forecasts, we expected growth of 1% in 2023 to be followed by a tepid 1.5% in 2024.

That was based on an RBA cash rate peak of 4.1% in May with an easing in the cash rate beginning in February 2024.

Those growth forecasts were well below consensus at the time (the RBA had 1.6% growth for 2023) while the cash rate outlook was also above consensus.

Westpac has now lowered its growth forecasts to 0.6% in 2023 and 1.0% in 2024.

The key driver of this insipid growth outlook is household consumption which we now expect to grow by just 0.3% in 2023 and 0.6% in 2024 (the latter consisting of a -0.3% contraction in H1 and +0.9% lift in H2). This consumption profile is consistent with the very weak measures of Consumer Sentiment we have seen since the onset of high inflation and rising interest rates in 2022.

The forecasts mean per capita spending recessions in both 2023 and 2024 of -1.5% in 2023 followed by -1.0% in 2024. It also implies GDP per capita recessions of -1.2% in 2023 and -0.6% in 2024.

This consumption profile is decidedly weaker than consumption growth during the deep recession years of the early 1990s when annual growth remained positive (+1.2% in 1990 and +1.9% in 1991).

The main difference between the outlook for 2023 and 2024 and the deep recession of 1990 and 1991 is around business investment which contracted by 13.3% in 1990 and 16.7% in 1991 compared to our forecasts of +4.7% and -3.9% for 2023 and 2024 respectively.

The difference in the business investment profile is attributed mainly to forecasts of solid investment growth in infrastructure; renewables; and mining investment. However, we do expect businesses to respond to the weakening sales outlook with a 15% reduction in equipment investment in the year to June 2024.

Consumer spending prospects, in the face of high inflation and sharply higher interest rates, would be even weaker were it not for the substantial savings buffer that households accumulated during the pandemic and the strong starting point for jobs. The tightest labour market conditions in 50 years and still elevated job vacancies are providing clear support to household incomes and spending, but also give those households coming under more intense financial pressure more scope to make adjustments.

Following the RBA's decision to raise the cash rate to 4.1% in June we lifted our forecast for the cash rate peak to 4.35% on the expectation of a further immediate 0.25% increase in July while noting that there was "considerable risk" of a follow-on move in August.

The May Labour Force Survey tips the balance on our August call. It showed an increase in employment of 76,000, outstripping even our top-of-the range forecast for a 40,000 bounce from a small decrease in April that looked to be mainly due to an Easter-related seasonal anomaly. The stronger rebound means we now have average growth of 36,000 jobs over the two months – around the monthly pace we have seen over the past year, indicating no significant slowing of jobs growth despite the RBA's 400 basis points of tightening over the same period. The evidence of strong ongoing momentum in the labour market is sufficient to trigger the "considerable risk" of an August rate hike in our central forecast.

We now expect a further final increase in the cash rate of 0.25% to 4.6% at the August Board meeting, for a peak in the cycle of 4.6%.

This extension of the tightening cycle to August, with the ongoing evidence of a tight labour market, now indicates that the beginning of the easing cycle which we anticipated for February will be delayed to May.

Next year, with labour markets remaining tight for longer than we expected back in March, the RBA Board will require further convincing that the inflation path will land within the 2-3% target zone by June 2025. They will have little choice but to hold-off on the much-needed rate relief by three months. Accordingly, we now expect 25 basis point rate cuts in May; August and November 2024 prior to further cuts in 2025 eventually bringing the cash rate below 3%, our estimate of 'neutral', by year-end.

Given the higher interest rate path than we expected in March it is reasonable to have considered an even larger downside revision to our growth forecasts. But a number of offsetting factors are at play including: higher population growth than expected back in March; a much lower AUD (now forecast to be at USD0.69 by year's end compared to March forecast of USD0.74); stability in the housing market rather than a further year of house price falls; and upsides to household income growth as labour markets remain tighter for longer, wage setting arrangements are adjusted in favour of higher wage outcomes, and fiscal measures provide some additional support.

Consistent with our views in March, our forecasts are based on an additional gradual increase in average mortgage rates over the next year coming from 'fixed rate roll-offs' as up to 30% of fixed-rate loans transition to much higher floating rates (increases generally from 2% to 5.5-6.0%). With the RBA's rate increases from May, June, and (expected) July and August also being passed on, the average mortgage rate over the next year or so will rise by at least 150 basis points – nearly 40% of the current tightening cycle of 400 basis points.

This weaker growth profile has also seen us raise our target unemployment rate for end 2024 from 5% to 5.3%.

Do these growth adjustments constitute a recession?

The standard definition of a 'technical recession' is two consecutive negative quarters of GDP growth. Our forecasts

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now contain one negative quarter – the March quarter of 2024 (–0.2%) while our forecasts for the adjacent quarters – December quarter 2023 (+0.1%) and June quarter 2024 (+0.2%) – are still positive although well within the range of forecast error. Consequently, on this definition, we are not forecasting a technical recession but recognise the high degree of uncertainty.

There are a range of other ways to define a recession. An increase in the unemployment rate from 3.5% at the beginning of 2023 to 5.3% at the end of 2024 might fit an alternative definition of a recession although we are unaware of any formal definition.

Note that our forecasts also imply per capita spending and GDP recessions in 2023 and 2024, which is sometimes used as an alternative measure definition of recession (see above).

Risks

The significant change in the emphasis of priorities delivered by the Governor in his June decision statement – from staying on the 'narrow path' of protecting post pandemic employment gains to containing inflationary expectations and worrying about rising unit labour costs pointed to those further near-term rate increases.

Our down-beat growth forecasts reflect that policy outlook.

Given the notable resilience of the labour market to date; the prospect of adjustments to industrial relations arrangements that will add pressure to wages growth; and the lift to wage expectations from recent award wage decisions we cannot dismiss prospects of even further increases in the cash rate.

For now, we will bow to the prospect of ongoing tepid growth eventually containing these inflation pressures, expecting rates to go on hold beyond August. But we cannot entirely dismiss these risks and the inevitable implications for the state of the economy in 2024.

Bill Evans, Chief Economist (WestpacGroup)

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