BULLETIN

23 June 2023

Central banks have more work ahead

Over the last four weeks I have been travelling to US (East Coast); Canada (Toronto); Europe (including Paris and Frankfurt) and London visiting customers and officials.

Just as we have seen the RBA step up its tightening agenda following the pause in April we have seen similar themes in other countries. The BOC paused and restarted and BOE has accelerated its cycle. Today we see that the BOE has surprised markets with a 50 basis point increase.

The FOMC paused in June but expects to resume tightening twice more by year's end.

My take on the current challenges of central banks is that they have been responding to the surprising resilience of asset markets; services inflation; labour markets; and, in some cases, household spending due to the unusual legacies of the pandemic.

I see those legacies in three categories.

The first is the imbalance between the demand and supply of labour. During the pandemic households were provided generous income support from governments while being restrained in their ability to spend. Once they were "released" a sharp lift in demand for services, boosted labour demand while simultaneously labour supply was being constrained by border closures; early retirements; and "pandemic caution." That imbalance which is measured by the gap between job vacancies or openings and available labour has been slow to close. This issue was raised only this week by the deputy Governor of the Reserve bank in a speech in Newcastle.

The second imbalance is the accumulation of excess savings by households and businesses. In the case of Australia, the RBA estimates that excess savings balances reached 20% of disposable income at their peak. These excess balances made household spending more resilient to central bank tightening than normally and blunted a key transmission mechanism through asset markets. Housing markets have stabilised in UK; Canada; and Australia while the US equity market has been remarkably resilient to the FOMC's aggressive tightening cycle. The higher income groups have been the dominant beneficiaries of this liquidity build up boosting investment in housing and equity assets. The lower income groups initially used the savings as buffers but are now quickly running down their holdings.

The third imbalance has been the build- up in fixed rate borrowings in Australia; Canada; UK and NZ in response to the long run of low fixed rates in the years leading up to and particularly during the pandemic. This has, to some extent, "blunted" the traditional key transmission mechanism for monetary policy through the cash flow of the household sector. In the February Statement on Monetary Policy, the RBA calculated that to December 2022 the average mortgage rate for Australia had lifted by around 1.8% despite the cash rate rising by 3.25%. That compared with Canada – 4.2% tightening and the average mortgage rate rising by around 1.4%; the UK 4% and 0.5% and New Zealand 4% and 1.5% respectively.

This transmission mechanism is never a factor for the US where nearly all mortgages are written with 20–30 year fixed terms. Consequently, the average mortgage rate for the US hardly lifted despite the federal funds rate increasing by 4.5% by end 2022. A rising federal funds rate affects the US economy primarily through its impact on the cost of unsecured borrowing; small business funding costs; the equity market as discussed above; bond rates and the USD.

Evidence of this "frustration" shows with the actions of the BOE, which expected to be on hold earlier in the year only to have to accelerate hiking as inflation; labour markets and spending remained resilient. We saw a similar response from the BOC which paused earlier this year only to have to resume tightening recently. The RBNZ has indicated it expects to be on hold going forward although the Westpac economists anticipate another move. The FOMC has paused but expects to raise the federal funds rate by a further 50 basis points.

The most likely outcome of this global dynamic is that central banks push rates to levels that would not have been necessary if not for the "pandemic legacies"; hold them there for longer; but reach a non-linear point where the accumulated increases have a much larger than anticipated impact, including an earlier than expected slowdown in inflation. Our consistent view has been that markets have been too early in their estimates of the beginning of the easing cycles. Markets have now made that adjustment but are not sufficiently "ambitious" about the extent to which rates can fall through 2024.

This brings us to the RBA.

The RBA paused in April and markets and most commentators expected an extension to the pause in May. But the Board surprised with increases in both May and June. Resilience of the jobs market; structural changes in the labour market, which support higher wages growth; concerns around sticky services inflation and a recovery in the housing market all conspired to elevate concerns around inflation, particularly at the June Board meeting.

The Governor noted following the June decision that "upside risks to the inflation outlook have increased".

This response is consistent with the positions taken in other countries where risks are assessed to have increased despite aggressive tightening cycles.

Despite some curious "softening" in patches of the rhetoric in the June Board Minutes that key theme was still consistently conveyed.

And that was before the Employment Report registered 76,000 new jobs in May (well above the Consensus of 15,000 and Westpac's forecast of 40,000) and as the housing market has sustained its upward momentum in June – current daily data points to a further 1% plus lift in house prices in June, following 1.4% in May.

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The Governor's Statement following the June Board meeting, which elevated concerns around rising inflationary expectations and the signals to labour markets from the award wage and minimum wage decisions, pointed to a change in the Board's reaction function to be more urgent around the need to contain inflation risks.

After the May decision there was genuine concern raised about the current target of only reaching the top of the band by mid-2025.

That rebalancing of the reaction function signalled to Westpac that a further move can be expected in July with considerable risk for August. The employment and housing data triggered that "considerable risk" pushing us to forecast both July and August.

The Reserve Bank Deputy Governor clarified the Bank's position on the labour market in a speech during the week. Essentially, she noted that "full employment" was estimated by the Bank as an unemployment rate of around 4.5%. That unemployment rate was consistent with inflation reaching the top of the range by 2025.

That revelation is consistent with our view that the Bank's reaction function has been evolving – targeting a 1% increase in the unemployment rate has a different tone to aiming to preserve the post pandemic employment gains as far as possible. In 2019, the year before the pandemic, the unemployment rate hovered around 5% - targeting an unemployment rate of 4.5% (with likely further increases in 2025) means that the "preservation" is only around a 0.5% improvement in the unemployment rate relative to pre pandemic.

The Bank's current forecast is for the unemployment rate to reach 4.5% by mid -2025. Westpac expects a higher rate of 5.5% by mid-2025. Evidence like the recent Employment Report which showed the unemployment rate falling from 3.7% to 3.55% will not be welcomed in the context of achieving that 4.5% "target".

Conclusion

Central banks have extended expected tightening cycles due to the unusual legacies of the pandemic, including the RBA. They can be expected to continue on this path in the near future.

The impact of the tightening cycles has been delayed rather than neutralised – that points to, eventually, more aggressive easing cycles, than currently factored into market pricing, which are likely to begin during 2024.

Bill Evans, Chief Economist (WestpacGroup)

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