30 June 2023

We confirm our call for 0.25% increase in the cash rate next week

The Reserve Bank Board meets next week on July 4. We confirm our view that the Board will decide to lift the cash rate by 0.25% to 4.35% at the July meeting with a further 0.25% increase to follow in August.

With core inflation holding above 6%; the unemployment rate holding nearly 1 ppt below the NAIRU (RBA's estimate) and the cash rate only around 1 ppt into contractionary territory (we see neutral around 3%) the cash rate will need to go higher. A second pause, to gather further information, seems unnecessary and only risks the need for the cycle to extend even further into 2023 when the prospects for damage to the economy increase substantially.

A terminal cash rate of 4.6% is likely to be sufficient to achieve the Bank's inflation objectives, although growth is forecast to slow to a crawl this year and next. Westpac's forecasts, which are based on a 4.6% terminal rate, point to very weak growth in both 2023 (0.6%) and 2024 (1.0%) and an earlier achievement of the inflation target than currently forecast by the RBA.

The case for a further rate increase has strengthened since the last Board meeting on June 6.

Of most importance are indications that the Board has, appropriately, adjusted its reaction function at the June meeting to prioritise containing inflationary expectations and addressing the risk (admittedly low) of a 1970s-style extended period of high inflation. Specifically, the minutes to the meeting noted that: "Members discussed the possibility of implicit indexation of wages to past high inflation and the potential for this to become widespread."

The objective of "preserving as many of the gains in employment as possible" is still noted by the Board in the minutes but other communication suggests it is taking a more cautious approach to safeguarding employment gains. Deputy Governor Bullock in a speech on June 20 indicated that the Board's inflation objective could not be achieved without the unemployment rate rising to 4.5%. Recall that the unemployment rate was around 5% before the pandemic, so an unemployment rate objective of 4.5% only represents a modest 0.5% net gain.

There have been some the key developments in the economy since that last Board meeting.

- The unemployment rate fell from 3.7% to 3.6% in May, – remaining near recent lows despite the 4% tightening cycle.
- Jobs growth printed 76,000 in May – well above market consensus of 15,000 and Westpac's forecast of 40,000, meaning that the monthly pace of jobs growth has hardly slowed since the tightening cycle began.
- Business surveys continue to point to intense labour shortages. Official job vacancies fell a modest 2% between February and May – a slightly slower pace than the 2.2% fall we saw between November and February with the vacancy-to-unemployed ratio still 0.83 compared to 0.27 before the pandemic.
- The May CPI indicator showed a sharp fall in headline inflation to 5.6% in May from 6.8% in April but was largely due to volatile items (fruit, vegetables and fuel) and holiday travel. The Reserve Bank typically strips out these items when assessing inflation trends. Annual inflation in the CPI excluding volatile items and holiday travel fell from 6.5% to 6.4%, while the monthly increase in this measure lifted from 0.2% in April to 0.5% in May. Fuel provides a clear example of the risks involved with relying on monthly moves without adjusting for volatile items. Fuel prices fell 7.6% in May but are already up 6.4% over the June month to date.
- The measure for the trimmed mean inflation fell from 6.7% to 6.1%. Even if the fall is confirmed by the much more reliable June quarter CPI, annual underlying inflation at over 6% at a time when the unemployment rate is holding well below full employment is not consistent with pausing.
- the RBA should be unnerved by dwelling prices which have continued to post gains despite recent rate hikes – an unwelcome 1.4% rise in May has been followed by what looks to be a further 1.3% lift in June.
- A surprise 0.7% lift in nominal retail sales in May suggests consumer demand has retained some momentum in the second quarter, albeit with volumes still tracking a subdued pace.
- The March quarter national accounts reported a further lift in annual unit labour costs growth, surging to 7.9%yr, up from 7%yr in December and just 4%yr in June last year. Unit labour costs, which are closely linked to market services inflation, have become a particular source of concern for the Board.
- The surprise 50 basis point lift by the Bank of England, last week, highlights the general mood overseas that central banks expect that their tightening cycles have further to run.

What are the arguments against a move?

The July decision comes one month before the Board can assess the staff's revised inflation and growth forecasts, which are refreshed in February, May, August and November. This will include an extension of the forecasting horizon out to the end of 2025.

The minutes to the June meeting show there is already unease on the Board about the time being taken to reach the inflation target. Specifically: "… members noted that a more prolonged period of above-target inflation would increase the risk that firms' and households' expectations for inflation rise." Waiting for the refreshed forecasts is always a respectable reason not to move. It seems unlikely that they will entail any change in the 'timetable' and should include the expectation that inflation will be in the centre of the target band by end 2025.

The Board minutes describe the arguments for and against the June tightening as 'finely balanced'. My view is that arguments will always be 'finely balanced' near the peak of a tightening cycle.

But from the perspective of our forecast for July, a much more troubling aspect of the minutes is the absence of the comment that "some further tightening of monetary policy may be required". This was used by the Governor in his statement following the decision and repeated in his speech the following day, which the Board minutes noted "would provide an opportunity to explain the decision in more detail."

It would be extraordinary if the omission of this sentence was a basic oversight, especially when used twice by the Governor in other communication.

With the Governor nearing the end of his tenure, the spectre of the recommendations of the recent Review of the Reserve Bank, and some turnover at Board level the current task of forecasting monetary policy has become even more challenging.

We can only promote what we think is the appropriate decision given the issues outlined above.

Last month the Board had two high profile triggers to move – the award wage agreements and the increase in the monthly inflation gauge.

A more tentative Board than we think should be appropriate at this stage of the cycle which does not have the high profile "trigger" of the wage agreements and the temporary boost from the monthly Inflation Indicator could choose to pause pending more information.

Given the issues, which are clearly pointing to the need for higher rates, a second pause in this cycle seems inappropriate and unnecessarily complicates the central task of bringing inflation back into line.

Bill Evans, Chief Economist (WestpacGroup)

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