BULLETIN

28 July 2023

RBA Board to raise the cash rate by 25 basis points at the August meeting – maintain tightening bias

The Reserve Bank Board meets next week on August 1.

Westpac has consistently argued that a further increase in the cash rate should be the appropriate policy response at the August meeting and we confirm that view.

We also believe that the Board should maintain its tightening bias, repeating the sentence: "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe."

Previously we had a firm view that a follow-up increase in September would be required. We are now comfortable that maintenance of the tightening bias beyond August should be sufficient.

Markets and most commentators have concluded that the better print on headline inflation for the June quarter will be sufficient for the Board to extend the pause that it began in July for another month.

That is a quite reasonable position to take given the policy approach taken by the Board at the June and July meetings. For both meetings the key factor behind the decision to hike in June and pause in July centred around the monthly headline inflation reports.

In June the annual headline from the monthly indicator lifted from 6.3% to 6.8%, prompting an increase of 0.25%; whereas in July the monthly indicator slowed from 6.8% to 5.6% prompting the decision to pause.

In both months other developments, particularly around the labour market and services inflation, were arguably consistent with a different decision (the most notable exception being the minimum wage decision delivered just prior to the June Board meeting).

So, how can we possibly not go with the market for August when the quarterly headline Inflation report was softer than expected and the monthly indicator showed a further modest reduction from 5.6% to 5.4%?

Headline inflation printed 6.0% for the year to June compared to the RBA's forecast of 6.3% when it released its forecasts in the May Statement on Monetary Policy, and down from 7.0% in the year to March.

The RBA Board will undoubtedly look more deeply into the June quarterly report for inflation than is possible with the monthly indicator.

It will find that the 5.9% print for core inflation (trimmed mean) compared to the RBA's forecast of 6.0% – a much closer result. That print was down from 6.6% in the year to March.

Annual goods inflation fell from 7.6% to 5.8%. On the other hand, annual services inflation lifted from 6.1% to 6.3%.

The ABS calculated that quarterly services inflation slowed from 1.7% in March to 0.8% in June. June is a low seasonal quarter for services – June 2023 was in fact higher than the gain in June 2022 (0.6%).

A more reliable measure of services inflation is "market services ex volatile items". This measure excludes the government administered prices therefore capturing the economic cycle. The quarterly increase in this measure lifted from 0.9% to 1.2%, while annual growth held steady at 6.8%.

The detail around services inflation and core inflation is less encouraging than the headline result.

Central banks favour the core number because it is a more reliable indicator of ongoing inflation momentum.

While the decision at the last two meetings was reliant on the monthly Indicator the decision at the August meeting can draw on the much more reliable and detailed information from the quarterly report.

We had a similar situation at the May Board meeting.

Following a material fall in annual headline inflation in the March inflation report, markets dismissed the possibility of a rate increase in May. After all, headline inflation had fallen from 7.8% to 7.0% in a single quarter.

But the Board surprised with a hike, having the benefit of the more detailed quarterly report, which showed a further lift in services inflation (5.5% to 6.1%).

The theme behind much of the Board's concern around its inflation challenge, at the May meeting and continuing, has been that "inflation was not expected to reach the top of the target band until mid-2025 … although this was consistent with the Bank's mandate and objectives, it left little room for upside surprises to inflation given that inflation would have been above target for around four years by that time." (May minutes).

This explanation was given as a central reason for the surprise rate hike in May.

Notably also, despite the March result, the staff did not lower its forecast track for inflation – with underlying inflation still projected to reach 2.9% by June 2025.

The key to the August policy decision is whether the Board and staff feel comfortable enough to lower their inflation forecasts following the June inflation result.

The Bank' refreshed forecasts in August – to be published in Fridays' Statement on Monetary Policy – will be extended out to December 2025. It would be very difficult for the Board if the forecasts still did not have inflation reaching the 2.5% mid-point of the target by end 2025.

During my recent trip to the East Coast of the US; Europe; and London I noted consistent criticism of the Board's approach of being comfortable to reach the top of the target band after being outside the band for so long.

The current forecasts only have the core inflation rate falling from 3.1% to 2.9% (–0.2ppts) over the first six months of 2025. Arguing for a much faster fall in the second half of 2025 is not credible given that growth is forecast to be picking up in 2025.

So, to justify an earlier achievement of the target, the progress will need to be in 2023 H2 and 2024.

Following the analysis of the June quarter report, particularly taking account of the stickiness of services inflation, we see some moderation in the pace of inflation in the second half of 2023 as goods inflation unwinds at a faster pace but the services story still holds inflation at an elevated pace in 2024 – our forecasts for both headline and trimmed mean inflation in that year remain unchanged at 3.2%yr and 3.3% respectively.

Other factors create inertia for inflation in 2023H2 and 2024.

This inertia in inflation, particularly in 2024, is due to the range of other factors that have become more apparent in recent months and the market appears to be overlooking. These include:

- The continued strength of labour markets – we have recently upgraded our forecasts for employment growth and lowered our unemployment rate forecasts, to reflect the consistent upside surprises on jobs and the persistence of 50-year lows in the unemployment rate. The strength reflects the extraordinary backlog of unfilled jobs with job vacancies remaining at extreme highs. This is another direct legacy from the pandemic – and an issue being faced by many developed economies coming out of COVID. This resilience in labour market outcomes boosts incomes and demand adding to pressure on wages growth.

- Slow productivity growth – the ‘productivity challenge’ has been at the top of the Board’s considerations consistently in the meeting minutes. This was most clearly identified in the minutes to the meeting in May, which noted: “Members observed that the forecast for inflation to return to the top of the target band by mid-2025 was predicated on productivity growth returning to around the modest pace recorded prior to the pandemic. If this did not occur, growth in unit labour costs would be uncomfortably fast.” The latest update on unit labour costs – wages adjusted for productivity – saw annual growth lift 7.0%yr to a very strong 7.9%yr in the March quarter.

- A resurgent housing market – nationally house prices have lifted by around 5% since February, and the Westpac MI House Price Expectations Index showing consumers expect gains to continue over the next year, which will anchor and support current momentum. Activity, inflation and wealth effects resulting from the improving housing market will tend to make it more difficult for the RBA to achieve its inflation target. The May Board meeting minutes picked up on some of these concerns: “Members also reviewed recent developments in asset markets – in particular, they noted the depreciation of the exchange rate and the increase in house prices … the decision to hold rates steady in April was likely to have contributed”.

- Emerging risks around commodities – oil prices are lifting and electricity costs already look like being a persistent source of high inflation; global food prices are being impacted by Russia’s blockade of Ukraine’s agricultural exports and are at risk of more weather-related impacts as an El Nino forms.

The RBA’s forecasts of reaching the top of the band by mid-2025 already envisage a very significant fall in inflation through the remainder of 2023. Underlying inflation is forecast to fall from 6% in June to 4% in December. That entails a slowdown in semi-annual inflation from 2.2% in 2023 H1 to 1.8% in 2023 H2 – we think that is achievable but expect progress in 2024 to be much slower as goods disinflation runs its course, and the emphasis moves to more persistent services inflation.

Conclusion

Markets are convinced that the slowdown in inflation apparent in the June quarter inflation report will see an extension of the Board’s July pause.

The headline inflation picture has been the key driver of recent decisions in both June and July. But that was not the case in May when the detailed quarterly report allowed for deeper and more reliable insights that were more concerning.

This time around, the June quarter report highlights the stickiness of services inflation while other information around the labour market and productivity pose questions about whether the staff can credibly lower the inflation profile to allow for an earlier achievement of the inflation target. Most importantly it needs to reach the mid-point of the target range by the extended forecast end-point of December 2025.

If, as we consider likely, the RBA’s revised forecasts show little progress in this regard then the Board should take out more ‘insurance’ with an additional 25bp rate hike at its August meeting.

A combination of one last hike in August complemented with the ongoing ‘soft’ tightening bias seems to be the best approach to a difficult challenge.

Bill Evans, Chief Economist (WestpacGroup)

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