BULLETIN

11 August 2023

Consumers not convinced rate hikes are over but RBA looks to be more firmly on hold

Inflation may be off its peaks and the RBA on hold but the 'inflation lockdown' continues to weigh heavily on Australian consumers.

The Westpac-Melbourne Institute Consumer Sentiment survey continues to show only a muted response to the RBA Board's decision to leave the cash rate on hold in recent meetings, up only 2.3% in the two months since June, and slightly lower for the mortgage belt. Continued pressures on family finances from sharp rises in the cost of living, fears of further rate hikes to come and concerns about the near-term economic outlook continue to weigh heavily on confidence.

Around living costs, the easing in reported headline inflation is likely being offset by continued strong rises in a range of essentials, most notably around rents, fuel, and electricity. On the last two: petrol prices have lifted 10% in the last month as a rally in global oil prices has combined with a lower AUD; while electricity costs rose significantly from July 1 with 'benchmark maximum' rates up 20-25% across the major eastern states and expected to be up 7% on average national in the September quarter.

On interest rates, consumer fears partly relate to the RBA's continued warnings that further tightening may still be required. Our survey shows most consumers are still bracing for further rate rises with over two thirds of those surveyed after the RBA's August decision expecting rates to move higher over the year ahead, nearly half of this group expecting a rise of over 1ppt. That is about the same hawkish mix of responses we saw when the RBA first actively paused its rate rise cycle back in April.

Westpac's view is that the RBA tightening cycle is now over. While there are still clear risks, particularly around the tight labour market, these are unlikely to form a strong enough case for the RBA to tighten further in coming months, particularly with inflation continuing to ease and growth outcomes confirming a sharp economic slowdown. The RBA's recent commentary has shown increased confidence in achieving a reasonably timely return to low inflation and that it is also comfortable with inflation 'only' returning to the 2-3% range by late 2025 rather than being more intent on hitting the mid-point of that range.

The RBA Governor's testimony to the House of Representatives Standing Committee on Economics gave some further articulation to the Bank's views. Within this long and wide-ranging Q&A was a particularly notable discussion of the RBA's 'reaction function' – how it is assessing the risks and trade-offs involved with different policy approaches. Governor Lowe described two alternatives: one in which the RBA set out to achieve an earlier return to low inflation by the end of 2024 (in line with many other central banks overseas); and another in which inflation was allowed to run higher for longer, only returning to target some time in 2026.

His assessment was that, given the strong inflation already locked-in around rents and electricity near term, achieving the inflation target in 2024 would require a substantial additional tightening in interest rates – in the order of as "at least a further 1ppt" – delivering a significantly larger shock to the economy that would result in a significantly higher unemployment rate. This trade-off was not one the Board was willing to make (presumably partly on the notion that rent and electricity cost inflation would become less of an issue beyond 2024).

On a slower return to target, the Governor's key concern was that such a prolonged return, which would see inflation above target for over four years in a row, risked losing public confidence that the Bank was serious about achieving its inflation goals.

Separately, the Governor's discussion of the evolution of the return to low inflation also provides some clues to how risks may play out from here – in our view, more as a constraint on prospective policy easing rather than additional tightening.

The Governor described the 'next phase' of the return to low inflation as one that requires slower growth in unit labour costs. That in turn relies on the extent to which labour costs rise and the degree to which we see a lift in labour productivity – output per unit of labour. Unit labour costs have surged 7.9% over the year to March, well above the 2.5% average seen over the inflation-targeting period. However, measures have been heavily impacted by COVID disruptions, making identifying shifts in underlying trends extremely difficult, particularly for what was already a volatile measure. Productivity and unit labour cost updates are only available quarterly with the national accounts figures on GDP. Going by the Governor's testimony, it could take several quarters for a definitive shift to emerge.

Assessing the extent to which productivity is normalising and the rate of inflation in the 'cost base' of the economy is easing will clearly not be easy – inflation updates may well give more clues before the productivity data does. These uncertain and slow dynamics will make it difficult to make a case for further policy tightening. Instead, the main implications from 'unit labour cost' risks are likely to be for the timing and extent to which the RBA can ease policy. We expect scope for easing to emerge in the second half of 2024 with a rate cut cycle beginning in the September quarter. But that scope could be challenged if unit labour cost growth looks likely staying well above the 2.5%yr pace seen in the past.

For now, however, the main message is still of an RBA that is comfortable with policy settings as they are, more confident of achieving the 'narrow path' back to low inflation over a reasonable time-frame without doing too much damage along the way in terms of unemployment, and sees the requirement for further policy tightening as a 'possibility' but as part of a more balanced range of risks. Next week's wage and labour force updates will be important, as will the monthly CPI indicator release later in the month but given the high hurdle for any further rate increases another 'on hold' decision at the RBA's September meeting looks very likely at this stage.

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