BULLETIN

1 September 2023

RBA Board on hold next week – next move will be down

The Reserve Bank Board meets next week on September 5.

We are confident that the Board will decide to keep rates on hold at the meeting.

Following the Board's decision to hold rates steady at the August meeting we concluded that rates would remain on hold until the September quarter next year when the first rate cut of 0.25% can be expected.

Since we released that forecast the data flow and the Minutes from the August meeting have provided further support to the view that rates have peaked at 4.1%.

The **Minutes** once again highlighted that the Board had considered the two options of holding rates steady or raising the cash rate by 0.25%. While in previous Minutes the cases for both options were represented in an even – handed way the preferred case in August seemed to be more clearly favoured than we have seen in past meetings (no reference to "finely balanced").

The Minutes note " the Board had already tightened monetary policy significantly, there were signs that this was working as intended and the Board had time to wait and see how the economy evolves… full effects of the earlier tightening were yet to be recorded… consumption had already slowed significantly, there were early signs that the labour market might be at a turning point and inflation was heading in the right direction."

The Wage Price Index for the June quarter lifted by 0.8% - the same increase we saw in the December and March quarters despite the ongoing record low unemployment rate. There was no significant evidence of an ongoing lift in pressures in either the individual or enterprise bargaining components. Annual growth will increase from the current 3.6% to 3.9% in the September quarter when the 5.9% lift in the minimum wage flows through to the Index but we now expect that 3.9% will be the peak, down from our previous forecast of 4.1%.

The **monthly Inflation Indicator** showed annual inflation easing to 4.9%yr in July from 5.4%yr in June and 6.7%yr in April. There is volatility in these monthly prints, and we do expect a lift next month due to a greater focus on quarterly services price surveys.

We are forecasting a 0.5% print for the update in August, but this will be offset by a –0.1% decline in September as the new Federal Government child-care rebate kicks in.

Overall, the trend in inflation is clearly "in the right direction." Our current annual growth rate forecast for the CPI in the September quarter is 5.1% down from 6.0% in June and likely to finish the year at 3.9%.

While there was a sharp jump in the unemployment rate in July from 3.5% to 3.7% the ABS points out the effects of school holidays which are becoming a key issue in determining when people take their leave and start or leave a job. We are expecting a significant lift in jobs growth in August just as we saw in May following the similar lift in the unemployment rate in April (the April survey was conducted during school holidays). Although adding to our case, we don't think the July jobs report will be a swing factor in the Board's decision at the September meeting.

We have argued for some time that the August meeting was likely to be the last opportunity the Board would have to take further insurance against the risk of inflation not reaching the target band by the end of 2025.

Going forward from here the evidence around an ongoing weak economy and slowing inflation will encourage the Board to extend its pause through to the end of the year and into 2024.

So, we expect the debate is now going to evolve towards the timing of the first rate cut.

That does not mean that the Board will abandon the policy of considering "on hold" or "25 bp hike" as the two options but, as we saw in August, the "on hold" case will progressively become dominant.

The Board will also be mindful of the weak AUD – largely a function of the unusual negative yield differential with the US and some market concerns that the policy target of 2.8% inflation by 2025 is too "soft". The recommendations of the RBA Review advocated targeting the middle of the band. That approach may well be adopted by the new Board although, given the better than expected progress on inflation, a revised in the target is unlikely to be a game changer for policy.

One approach to contain some of this AUD negativity is to persist with "members agreed it was possible some further tightening of monetary policy might be required", although markets are likely to become increasingly more dismissive of this practice as we move ahead.

The timing of the first rate cut.

In the note following the August Board meeting we have targeted the September quarter, 2024, for the first cut in this cycle.

Our estimate is that by the time of the August meeting next year the Board will be confronted with unemployment rate of 4.5%; inflation having fallen to 3.4%yr; and GDP growth of 0.8% for the year to the June quarter 2024. By the time of the August 5–6 meeting, the board will have a good idea of growth to the June quarter. However, it would need to wait until the 2023–24 September board meeting before the official growth rate for the June quarter will have printed.

While inflation will not have fully returned to the target band of 2–3%, policy will be assessed as being clearly contractionary; the unemployment rate will have risen 1ppt over the previous year with the prospect of further deterioration in the second half of 2024; the economy will be growing at the parlous pace of 0.8% and confidence that inflation will reach the target earlier than the current forecast will be building.

While the RBA will have been hold since June of 2023 the lagged impact of borrowers transitioning from low fixed rate mortgages to much higher floating mortgages, which will intensify in the second half of 2023, leading toa cumulative automatic increase in average mortgage rates right out to the first quarter of 2024 of up to 1 ppt.

After having already slowed to 3.6%yr in June 2023, wages growth is set to peak at 3.9%yr in the September quarter before easing through 2024.

Pressure will have eased on the AUD as we expect the Federal Reserve to have begun its easing cycle by March or June at the absolute latest. Falling US rates will also boost global confidence providing some support for the "risk" currencies, including the AUD.

It is unlikely that the rate cuts can come earlier.

In the first half of 2024 the Board will be facing a tight labour market; potential delays in the beginning of the Fed's easing cycle; and ongoing momentum in house prices. While still falling, inflation will be stickier in the first half of 2024 as the contraction in goods inflation eases and services inflation remains elevated.

That combination is likely to preclude the prospect of rate cuts in the first half of 2024 despite the ongoing evidence that spending remains lack lustre.

Conclusion

2023 has been a difficult year for gauging monthly movements in the cash rate. The Board has varied the weights it gives to the two key themes: risk of not achieving the inflation target on time; and needing to pause to assess the cumulative impact of this very rapid tightening cycle. There has been no clear lead indicator as to how these weights have evolved.

With inflation slowing more rapidly than the Board, and other central banks had expected; evidence of an easing in wage pressures; household spending struggling; and further effective mortgage increases embedded in the system, the policy of moving to the sidelines is now clearly the favoured approach.

We think this should remain the case until the September quarter next year when inflation; growth; and unemployment have established a very clear message that will allow the Board to begin the process of unwinding the rate hikes.

Bill Evans, Chief Economist Westpac Group

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