BULLETIN

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Weak consumer, restrictive policies, but easing in cost pressures is not assured

The week began with the tragic news out of Israel. As well as the human cost, there are important geopolitical implications and impacts on oil prices. Our current assessment is that there is enough spare capacity on the sidelines to keep oil supply flowing and prevent prices from spiking too far. As with all geopolitical risks, though, further escalation can't be ruled out.

In domestic news, we saw the October release of the Westpac–Melbourne Institute Survey of Consumer Sentiment. As my Westpac Economics colleague, senior economist Matthew Hassan commented, Australian consumers are still very gloomy: they are being squeezed by high inflation, a rising tax take and escalating housing costs – both rents and rising mortgage payments. There are some glimmers of hope, especially for households with interest income, but the overall picture remains very weak.

Given weak consumer sentiment, it is no surprise that business surveys are also showing a moderation recently. This was the message of the ACCI–Westpac survey earlier, and as Westpac Economics colleague, senior economist Andrew Hanlan reported this week, it is also the message of the September NAB survey. An important theme from both surveys is that cost pressures are starting to ease.

The Reserve Bank will need to see those signs of easing cost pressures translate into an actual easing in inflation. One area to watch is whether falls in global prices of some goods flow through to falls in retail prices here in Australia, or whether prices instead stabilise and margins expand. The RBA has been alluding to this issue for a while. The August Statement on Monetary Policy noted that prices of furniture and home furnishings were still rising strongly in the June quarter and included a graph showing that audiovisual prices have been trending up since 2021, counter to the historical trend. RBA Head of Economic Analysis Marion Kohler also called out the delayed turning point in audiovisual goods prices in her speech in May.

Also relevant to the inflation outlook was the tick up in consumer inflation expectations reported this week. The trimmed mean measure increased from 4.6% in September to 4.8% in October. At least some of the move can be attributed to the well-known sensitivity of these measures to movements in petrol prices. The developments in the Middle East this week will therefore have a bearing on future releases. But the RBA's communication continues to focus on the need for medium-term inflation expectations to remain anchored, not so much the shorter-term expectations. So far, they have done so. More important to the RBA's view (though not the only thing they will be watching) will be the September quarter inflation data due out later this month. A surprise there could spur a revision to their forecasts in November and – if it is a big enough surprise – be a consideration at the November Board meeting.

In other RBA news, Assistant Governor (Financial Markets) Chris Kent spoke on the transmission mechanism of monetary policy. This speech read as an educational piece, not one intended to convey a change in policy messages. It provided a useful reminder that monetary policy works through more channels than the effects on the cash flows of households with mortgages. This effect does come through a bit faster here in Australia than in other countries, but it does not mean that monetary policy is more powerful overall here than elsewhere. Other things adjust.

There were some interesting points in the Q&A after the speech as well. Kent reiterated that the RBA thinks that monetary policy is restrictive now. This is another indication that they see real (inflation-adjusted) interest rates in terms of longer-term measures of inflation; if you were to calculate a real interest rate using current inflation or short-term expectations, you would get a negative number and be misled into thinking policy is still expansionary. Nothing about current borrowing behaviour and credit growth would support that conclusion.

Perhaps of more interest to those with a market bent was the question on the RBA's bond holdings. Some might have interpreted Assistant Governor Kent's answer as suggesting that the RBA is more open to active selling of bonds ('active QT') than it was before. A more likely interpretation is that this was a restatement of their earlier position that it is not something they are ruling out forever, but nor are they actively planning to embark on a program of sales. Look to the Annual Report, which should be out soon, or an official communication before concluding that there has been a change in view. While Kent pointed to the interest rate risk on the RBA's balance sheet as a consideration, a broader issue is the fiscal implications of any losses crystallised by such sales. The Annual Report would be the normal vehicle to provide more detail on the balance sheet implications, but based on earlier information, Commonwealth revenue will go without the benefit of a dividend from the RBA for a few years while its capital levels are rebuilt. This might seem less of an issue in a time of budget surpluses, but there are scenarios where that strategy becomes less comfortable for fiscal policymakers.

Another thing that caught my eye over the past week was the release of the Financial Stability Board's report into the failures of Credit Suisse, as well as Silicon Valley Bank, Signature Bank and First Republic Bank in the United States. While this report will mostly be of interest to regulatory aficionados (or recovering ones), it highlighted the potential for losses on bond holdings when long interest rates rise as quickly as they have in recent times. For certain portfolios, banks aren't required to mark to market in real time, leaving them vulnerable to large unrealised losses crystallising if rates move sharply.

In Australia, though, the large banks are required to hold capital against this so-called interest rate risk in the banking book. This is not the case in other major jurisdictions, where the international standards that apply are much more principles-based and designed around measurement and disclosure. A result of these different supervisory incentives is that Australian banks have less incentive to engage in those risks, and in particular to 'borrow short, lend long' (or in the case of the US banks that got into trouble, hold long). If while reading Chris Kent's speech, you wondered why Australia's mortgage market and monetary transmission mechanism are so geared towards variable-rate lending compared with some other jurisdictions, this difference in regulatory approach is one of the reasons.

Luci Ellis, Chief Economist Westpac Group

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