BULLETIN

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A low-tolerance RBA won't yet have seen enough to move

The main domestic data this week was the September labour force release. As colleague Westpac Economist Ryan Wells noted yesterday, the data were a mixed bag. Looking through the monthly noise, the labour market is continuing to cool gradually from its earlier tightness. There was nothing in the data to nudge the RBA in the direction of raising rates.

The Reserve Bank minutes released this week show a Board that has no appetite to let inflation stay high for any longer than their current forecasts imply. If the inflation outlook remains on its current trajectory, the Board will keep the cash rate where it is. If the data start pointing to material risks of higher outcomes than that, though, they are very willing to move.

Governor Bullock's fireside chat earlier this week had nothing in it to change our views about the path of policy. The Governor did take pains to emphasise that the Bank is aware that the policy tightening is making things difficult for some parts of the community. Ms Bullock will be speaking twice more between now and the November Board meeting. The event on Tuesday could be an opportunity to set out her thinking about the outlook or the framework for policy, given it is her first set-piece speech since becoming Governor. The appearance before Senate Estimates on Thursday is likely to cover a wider range of issues, though some senators might want to probe Ms Bullock and Assistant Governor Kent about any implications for policy of the CPI release the day before.

The RBA's four near-term inflation worries

Today we released the Westpac Economics preview for the September quarter inflation release. Senior Economist Justin Smirk notes that we are expecting both headline and trimmed mean inflation to print a 1.1% quarterly increase. It would have to be a significant upside surprise from this to dislodge the RBA Board from an unchanged rates decision in November. That said, there are several upside risks to inflation that would have the Bank's attention.

- Goods prices not unwinding quickly enough (receding risk). Much of the surge in inflation globally reflected the demand shifts and supply chain issues induced by the pandemic. This is now receding and, in some countries, core goods prices are outright falling. The Bank has from time to time flagged a risk that this reversal in prices would happen too slowly, but so far this risk doesn't seem to be materialising.

- Domestic demand and services price inflation remaining too high (steady, concerning). Even though consumer demand in Australia is weak overall, there are pockets of strong demand and cashed-up households. In these areas, services businesses are managing to raise prices noticeably. Services inflation is still uncomfortably high, and the experience overseas has been that it can be quite sticky and slow to come down.

- Labour costs (receding). If domestic demand were to remain strong enough, this would tend to boost both services prices and wages growth. Heightened risks to the inflation outlook from this source was one of the factors the Bank cited to explain its decision to raise rates in June. But the October minutes show that the Board is now less worried about this possibility, noting "...that there were few signs of the risk of a price-wage spiral materialising". It also pointed to non-award wages growth moderating. Poor productivity outcomes are still a concern given their influence on unit labour costs. Overall though, the Bank is sounding more sanguine about wages recently, in light of the data flow on both wages themselves and the labour market.

- Energy costs (electricity receding, oil increasing). The Bank took some comfort from the smaller pass-through from default offers to actual electricity prices. In contrast, the Middle East conflict means oil prices have increased again. Short-term fluctuations in petrol prices would not induce the Board to shift policy. But sustained increases in energy costs, whether for geopolitical reasons or related to climate transition, would involve a more difficult trade-off.

Three broader risks

On top of these proximate risks to the inflation outlook, there are a range of more medium-term risks. Three of these are particularly front of mind currently.

First, housing prices have picked up, which is not what you would have expected given higher interest rate and weak income growth. Australia is not alone in this; it has been seen in a range of economies where population growth has picked up sharply, such as Canada. In principle, the resulting higher wealth would boost consumption and so domestic demand and inflation. But as the RBA minutes noted, this effect partly depends on housing turnover picking up. And further rapid price increases would be hard to square with the recent step down in auction clearance rates.

Second, the outlook for China is beset by headwinds. While activity has gained some momentum after an initially slow recovery from COVID lockdowns (despite problems in the property market), the medium-term outlook is more clouded. It is no longer in the phase of fast catch-up to the rest of the world or the most obvious destination for foreign investment into low-cost production. Its population is already ageing and shrinking and the policy environment is geared more to control than to growth. The implications for Australia's export base are material and we can expect markets to mark down the Australian dollar whenever these concerns come to the fore.

Third, long bond yields have risen to levels last seen more than a decade ago. In the short term, markets have been unsettled by the US congressional dramas and the conflict in the Middle East. But there is a longer-term element to this: if fiscal policy globally is less contractionary than it was in the period between the GFC and the pandemic, monetary policy does not have to offset this with lower interest rates. So it is possible that the structure of global interest rates will be a bit higher in future than it was in that period. To the extent that this is a risk rather than market participants' solid expectation, this could be one contributor to higher term premia.

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