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We have seen enough for RBA's next move to be an increase

Last week we noted that the RBA would leave rates unchanged so long as they saw inflation coming down as they had expected. But if the data flow showed inflation declining slower than that, they would raise rates. This message was reinforced in the Governor's first speech, on Tuesday, where she said "The Board will not hesitate to raise the cash rate further if there is a material upward revision to the outlook for inflation." The September quarter CPI release was always going to be crucial.

Has the RBA seen enough to move? At 1.2% in the quarter, both headline and trimmed mean inflation was a little higher than the Westpac team expected (see Westpac Senior Economist Justin Smirk's note). We assessed that it would take a significant upside surprise to induce the RBA Board to raise rates at the November meeting. A 0.1% difference might not seem like a lot, but the underlying detail was sobering.

So yes, I've seen enough to make my first-ever rate call to be a prediction of a hike.

In August, the RBA expected that the trimmed mean rate of inflation would reach 3.9% over 2023. That seems a long way out of reach now: the December quarterly result would have to print at 0.5% for this to happen. The higher result also cannot be attributed solely to volatile components that will reverse out soon. Fuel inflation was stronger in the quarter, but so were vehicle price inflation, homebuilding cost inflation and inflation in a range of services components such as meals out and takeaway, dental fees and transport fares. Recreational services more broadly were also strong. And a significant fraction of the index saw quarterly changes moderating by less than expected.

Looking at some of the risks we called out last week, it is noteworthy that some traded goods prices are still holding up, even as similar prices decline in other economies; see the graph in Justin Smirk's inflation note for more detail. The cumulative difference in price movements is too large to explain as an exchange rate effect. A sequence of above average inflation outcomes is also evident in the related services series, which includes things like streaming services. Along with strong services inflation more broadly, these outcomes suggest that domestic demand pressures are still driving domestic inflation, even though consumer spending growth more broadly is very weak. Strong population growth is a factor here, and recent arrivals data suggest it will remain so.

Another risk that will remain front of the Board's mind is that housing prices continue to rise. Related to this, the material in the Financial Stability Review and the Governor's speech this week highlighted that the household sector has been resilient to the tightening in monetary policy so far. So although the household sector is currently facing a squeeze on real incomes, and household spending is weak, the Board could conclude that the risk that domestic demand remains stronger than expected has increased. The recent resurgence in US retail sales is a salutary example of what can happen, though it should be emphasised that the US consumer sector is in a very different position to Australia's.

That said, we do not think that a decision to increase rates at the November meeting is entirely clear cut. There is an argument that bygones are bygones, and the upside surprise on the September quarter data will not carry through to subsequent quarters. If the RBA did not want to raise rates this month, it could upgrade its 2023 forecast for inflation but not the forecast for 2024 and beyond. It could then argue that there had been no material upward revision to the *outlook* for inflation, only to the history.

As an aside, we do not take any signal from the Governor's parliamentary testimony this morning on the interpretation of the CPI data. Having spelled out so clearly that a material surprise to the outlook would warrant a rate increase, she simply had to be equivocal to avoid front-running the Board's decision, which is still more than a week away.

The Board could point to the reduced risk of a price-wage spiral and the turning in the labour market as evidence in support of a decision to keep rates on hold. The Board might also want to reference the current uncertainty generated by the conflict in the Middle East and the tightening in global financial conditions. Some of the near-term strength in services inflation could be a passing through of award wage increases that probably won't be repeated, as well as non-standard timing of increases in health insurance. Business services have been showing cost pressures easing, and growth in the real economy is relatively weak.

But this seems like a hard case to make. It is going to be a finely balanced decision and a decision to hold still can't be ruled out entirely. An increase this month won't be the outcome the RBA had hoped for. But given the strength of their rhetoric around upside surprises, I don't think they will try to craft a rates-on-hold story. Nor will they wait until the following month. There is not enough in the way of new data between the November and December meetings, and waiting would be inconsistent with the clear language from the Governor's speech this week about not hesitating if the outlook changes.

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