NAB CHANGE IN CASH RATE CALL

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By Group Economics

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NAB ECONOMICS CHANGE CASH RATE VIEW TO INCLUDE TWO 25BP CUTS IN 2017, WITH THE POSSIBILITY OF UNCONVENTIONAL MONETARY POLICY THEREAFTER

At its August meeting, the RBA cut the cash rate by 25bps to 1.5% (against our expectations) following a similarly-sized 25bp cut in May. Major banks have since passed on some, but not all, of the easing through to lending rates. The RBA Board concluded that “prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy at this meeting”. This suggests:

- That the Board believes that monetary policy continues to be effective in Australia (although it is unclear whether the RBA expected banks to pass on the cut in full or not),
- That house price risks have diminished (there was a large paragraph to this end despite what we consider to be very strong house price growth recently), and most importantly, and
- That the Bank preferred to take out some extra insurance on the inflation target front.

The outlook for inflation remains very subdued. Underlying inflation is expected to remain below the bottom of the target band until mid-2018. Most of the factors currently suppressing inflation are likely to persist, including low wages growth, strong retail competition both domestically and offshore, low commodity prices globally and slow growth in rents as dwelling supply picks up. The RBA outlook for CPI is similar, expecting inflation of 1½ - 2½% out to 2018 (below the 2% lower band of the target for much of this period). With inflation forecasts still very low and the RBA showing its hand as a committed ‘inflation targeter’, it is seemingly less worried than we thought about using up some of its valuable remaining monetary policy ammunition, the case for further cuts from the RBA appears to be mounting.

Backing up the case for additional monetary policy support, in its recent Statement on Monetary Policy the RBA re-emphasised that house price risks had become less of a constraint on the decision to cut rates. At the same time they appeared to be much more focussed on highlighting the downside risks to the outlook, particularly in relation to uncertainty around the likely direction and the degree of spare capacity in the labour market. Yet, despite the focus on downside risks, the RBA maintained its expectation for economic growth to lift to well above trend by 2018 – counter to NAB’s longer-term view.

NAB continues to see a reasonably solid economy in the near-term, supported by an improved non-mining economy (particularly with strong growth in residential construction) and increased hard commodity production. This is evidenced by the NAB Business Survey, which has consistently shown very high levels of business conditions and positive confidence, despite some large external shocks (such as the Brexit vote). However, the risks to the outlook going into 2018 are becoming increasingly apparent, as LNG exports flatten off at a high level and the dwelling construction cycle turns down. Consequently, NAB’s forecasts for GDP growth are factoring in more headwinds going forward, widening the spread between NAB and RBA forecasts to around 1½ ppts by late 2018 (NAB forecast 2.2% over 2018 vs RBA’s 3-4%).

In essence, CPI inflation is expected to remain below the target band for an extended period, while structural shifts in the economy and modest economic growth put pressure on the labour market in the longer-term. Although we are not as quiescent as the RBA with respect to house prices, nor are we convinced lower rates will have a material impact on inflation, we do expect the RBA will react by providing further support. This will include two more 25bp cuts in May and August 2017 (to a new low of 1%), which should be enough to stabilise the unemployment rate (which is currently a concern for the RBA) at just over 5½% and prevent economic growth from dropping below our forecast of 2.6% (average) in 2018. Monetary policy deliberations may then turn to the possible use of non-conventional policy measures if the outlook deteriorates further. Additionally, persistent weakness in CPI inflation could potentially trigger a rate cut even sooner than expected.

	Jun-16	Dec-16		Jun-17		Dec-17		Jun-18		Dec-18	
	RBA	RBA	NAB	RBA	NAB	RBA	NAB	RBA	NAB	RBA	NAB
GDP growth	3¼	2½-3½	2.7	2½-3½	3.0	2½-3½	3.1	3-4	2.7	3-4	2.2
CPI inflation	1.0	1½	1.7	1½-2½	2.9	1½-2½	2.6	1½-2½	2.5	1½-2½	2.6
Underlying inflation	1½	1½	1.7	1½-2½	1.9	1½-2½	1.8	1½-2½	1.8	1½-2½	2.0
	2015/16	2016		2016/17		2017		2017/18		2018	
GDP growth	3	2½-3½	2.9	2½-3½	2.7	2½-3½	2.9	2½-3½	3.0	3-4	2.6

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