NAB CHANGE IN CASH RATE CALL

February 2018

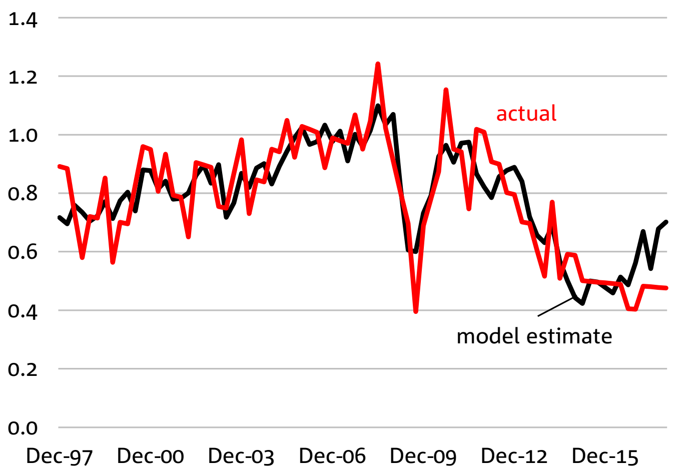
By Group Economics

NAB ECONOMICS CHANGES CASH RATE VIEW TO ONE 25BP INCREASE IN LATE 2018

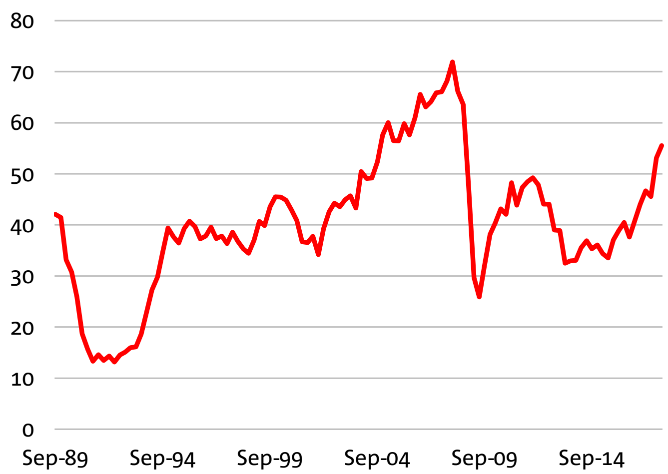
- **Weak wages growth and slow progress reducing unemployment means it is now less likely that the RBA will raise rates twice in 2018 (our previous forecast).**
- **We now see the RBA raising rates only once in late 2018 – with November 2018 as the most likely start date for a gradual RBA rate hiking cycle.**
- **By late 2018 growth should be near 3% and the unemployment rate approaching 5%. That, together with increasing tightness in employers' ability to find suitable labour, may finally see private sector wages start to moderately edge up.**
- **Inflation by that time should also be approaching the bottom of the 2-3% target range.**
- **That said, much will still depend on the data flow – it is not impossible that the RBA stays on hold for all of 2018 and raises rates in early 2019.**

For some time NAB has been forecasting that if the economy continues to improve as we expect, then the RBA's confidence that inflation will return to their 2-3% target band would grow and with that they would begin to lift the cash rate from its current low level of 1½%. We have emphasised that the key data that will give the RBA this confidence is a turn in the recent depressing trend on wages growth. Last week's Q4 2017 wage numbers were in that sense a little disappointing. While total wages did increase a touch (to 0.55% unrounded) there was no acceleration in private wages growth. That stands in contrast to traditional models that suggest wage increases are overdue and runs counter to employers' reports that it is getting more difficult to find suitable labour (see below).

Private Sector Wage Price Index (QoQ%)



Employers Reporting Difficulty in Finding Suitable Labour - NAB QBS Q4 2017



In recent RBA communications (including the Statement on Monetary Policy and the Governor's testimony to the House Standing Committee on Economics) the RBA has emphasised that they expect to make further progress reducing unemployment with some uptick in wages and inflation likely as a result. But the Bank has emphasised that this progress is expected to be "gradual".

It is also worth noting that the Australian labour market remains in a somewhat different state than the US labour market. In the US, most estimates of the NAIRU are significantly higher than the current level of unemployment (4.1%). In contrast most estimates of the Australian NAIRU are around 5% (or possibly lower). That is lower than the current unemployment rate which has been stuck around 5.5% in recent times. In addition, Australia's labour underutilisation rate is nearer 14% and hence there is some more slack in the labour market than is implied by purely focussing on the unemployment rate. That said, underutilisation in now falling, and usually declines when firms report rising difficulty finding suitable labour.

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Our wages model (above) uses underutilisation of labour (as well as inflationary expectations, productivity and the terms of trade – the latter as a proxy for mining wages). The model supports the RBA's expectation that wages should begin to increase.

The outlook for wages is important not just for its implications for inflation but also its ramifications for private sector consumption. With increased utility prices consumers are still cautious about discretionary retail spending and there are of course ultimately limits as to how far savings can be run down. Our current forecasts see the broader economy still growing at around 2.9% in 2018 and 2.8% in 2019. While we will review these forecasts after next week's national accounts and the February Monthly NAB Business Survey, our general view is that better business investment and infrastructure spending will offset a still cautious consumer (with delayed LNG exports also helping in 2018). That said, we remain a little more cautious on the consumption outlook than the RBA in 2019.

The RBA comments on the housing market (and financial stability) seem more relaxed recently given the success of APRA in slowing investor credit and house prices- especially in Sydney - however that too will do little to encourage consumption.

Based on current data, August 2018 (our previous forecast start point for rate hikes) now appears too soon for the RBA to make a start despite the better global picture, which will see other central banks tighten further.

Finally while price competition (especially online retailing) will keep inflation relatively low for some time, our judgement remains that by late 2018 the RBA will feel sufficiently relaxed on the domestic fundamentals to cautiously start withdrawing the stimulatory policy stance it is currently running. Again however, the data flow will be critical with key determinants including: the strength of wages and consumer spending, unemployment and obviously core inflation. For 2019 we still have another two rate rises but well spread (May and November).

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