NAB CHANGE IN CASH RATE CALL MAY 2019

RBA TO CUT IN JUNE WITH A RISK IT EVENTUALLY CUTS BELOW 1%

NAB Group Economics

Table 1: NAB Cash Rate Forecast

	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Current	1.50	1.50	1.25	1.25	1.25	1.25	1.00	1.00
Previous	1.50	1.25	1.25	1.00	1.00	1.00	1.00	1.00

Source: RBA, NAB

- **We have changed our view on the cash rate, bringing forward the timing of forecast rate cuts to start in June. Previously, we had forecast the RBA to cut the cash rate by 25bp in July and again in November, taking the cash rate to 1%. We now expect the RBA to cut at the 4 June Board meeting and again in August. We also see a risk that the RBA delivers additional policy stimulus by early 2020, either by cutting again or opting for an alternative policy measure.**
- **Yesterday's labour force data provided further evidence that the economy is weaker than the RBA had expected. The unemployment rate has risen from an eight-year low of 4.9% in February to 5.2% in April. Although employment has remained strong, other measures point to increased spare capacity over recent months, while forward indicators of the demand for labour have turned down, except for the less timely ABS job vacancies series.**
- **With underlying inflation almost back at the multi-decade low reached in 2016, the RBA said in its May cash rate decision that "a further improvement in the labour market was likely to be needed for inflation to be consistent with the target", where the Board would be "paying close attention to developments in the labour market at its upcoming meetings". Given low inflation, continued weakness in the NAB business survey – where NAB's internal indicators point to the weakness in spending becoming entrenched – and now higher unemployment, we think the Board will now act in June and that this is likely to be signalled in the May Board minutes and Governor Lowe's speech on Tuesday.**
- **The timing of a follow-up cut will depend on the flow of the data, but we have now brought forward the second cut to August, taking the cash rate to 1%. This will allow the Board to gauge the initial reaction to the first cut, while the RBA will update its outlook based on Q1 GDP (released 5 June), the Q2 CPI (31 July), two more labour force surveys and further reads on the economy from the NAB business survey.**
- **We have previously noted that further policy adjustment may be required and we highlight the risk the RBA will deliver additional policy stimulus by early 2020. This could be in the form of a further rate cut, taking the cash rate below 1%, or consideration of an alternative policy measure to support the economy. The case for additional stimulus stems from the RBA's need to reduce real interest rates, an objective that is frustrated by low actual and underlying inflation. This view is reinforced by our updated outlook, where we think that the RBA is overly optimistic on growth with a weaker labour market likely to see inflation undershoot the 2-3% target band until mid 2021 (see *The Forward View – Australia*, 15 May).**

The Reserve Bank recently marked down its outlook in the May Statement on Monetary Policy and adopted an easing bias, with the Board noting in the May policy press release that "a further improvement in the labour market was likely to be needed for inflation to be consistent with the target", such that it would be "paying close attention to developments in the labour market at its upcoming meetings".

With unemployment now picking up to 5.2%, inflation well below the RBA's expectation and wage growth stuck at a low level, we think that the Board will act on its easing bias at the 4 June Board meeting. We think that this is justified given that the NAB business survey shows that the slowdown in the economy that began in the second half of 2018 has continued in 2019 and where NAB's more timely internal indicators point to further weakness in spending. Surveyed business conditions are now just below average as employment has fallen sharply, while confidence and other forward-looking indicators are even weaker. Lower capacity utilisation also suggests a less positive outlook for capex and employment.

We look for this to be signalled in the May Board minutes, which are due next Tuesday (21 May). Governor Lowe is speaking shortly after the release of the minutes on "The economic outlook and monetary policy" and he is likely to reinforce this message, outlining that the economy is weaker than the Bank had anticipated,

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inflation is lower, and the labour market is deteriorating rather than improving in line with its recently revised forecasts.

After June, we have brought forward our second forecast rate cut to August, which would take the cash rate to 1%. The timing of the second cut will depend on how the upcoming data play out, but by the August meeting the Board will have revised forecasts based on Q1 GDP, the Q2 CPI, two additional labour market reports and further readings on the economy from the monthly and quarterly NAB business survey (they will also have an update on the ABS measure of job vacancies, which we think will start to turn as it catches up with the weakness in more timely measures of the demand for labour).

Longer term, we think the RBA could deliver additional stimulus by early 2020. This could be in the form of a further rate cut, which would take the cash rate below 1% or an alternative policy action, depending on the state of the economy at the time. For example, it may consider action that could place downward pressure on the exchange rate or it may recommend that APRA reduces the serviceability buffer on residential mortgages (note that the RBA is chair of the Council of Financial Regulators, which is the co-ordinating body for financial regulation). Substantial fiscal stimulus would also be helpful, although that seems unlikely at the present given both sides of politics remain committed to budget surpluses.

We think the case for additional stimulus rests with the need to make policy more accommodative by lowering the level of real interest rates, which is frustrated by the recent decline in actual and expected inflation. There is also the risk that rate cuts are less effective at a low level of interest rates, a point recently made by the Board in the minutes of its April meeting. This view is reinforced by our economic outlook, which suggests that the Reserve Bank is overestimating prospects for growth over the next couple of years and that inflation will continue to undershoot the 2-3% target band until mid 2021 given a weaker labour market.

There remains uncertainty about our call on policy in that we think the Reserve Bank will further revise its forecasts given our weaker outlook and this could take more time than we anticipate. It may also be hesitant to cut further at a low level of interest rates. The global backdrop will also influence the Bank's views, where trade tensions between China, our largest trading partner, and the US remain unresolved.

Table 2: RBA and NAB Economic Forecasts

	RBA Forecasts				NAB Forecasts		
	Dec-18	Dec-19	Dec-20	Jun-21	Dec-19	Dec-20	Jun-21
Unemployment Rate (%)	5.0	5.0	4.9	4.8	5.0	5.1	5.3
Core Inflation (y/y %)	1.8	1.7	2.0	2.1	1.3	1.8	2.0
GDP (y/y %)	2.3	2.6	2.7	2.8	2.5	2.1	2.3

Source: RBA, NAB

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