NAB CHANGE IN CASH RATE CALL JUNE 2019

RBA TO CUT TO 0.75% IN NOVEMBER

NAB Group Economics

Table 1: Cash rate forecasts

(%)	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
NAB:							
Previous	1.25	1.25	1.00	1.00	1.00	1.00	1.00
Current	1.25	1.25	1.00	1.00	1.00	0.75	0.75
Consensus:							
Current	1.25	1.25	1.00	1.00	1.00	1.00	1.00

Source: Bloomberg, RBA, NAB

- **We have changed our view on the cash rate, to include an extra cut in late 2019 – while heavily data dependent we have tentatively placed the cut in November. We also think that lower interest rates will be supported by fiscal stimulus later this year. We would not rule out the possibility of alternative monetary action in early 2020, in addition to further rate cuts, if the economy remains very subdued, but have not put it into our projections.**
- **The forecast of a larger reduction in interest rates reflects our judgment that the economy is losing momentum and is weaker than reflected in the Reserve Bank's recently downgraded near-term growth outlook. The loss of momentum is apparent in private demand, which has barely grown over the past year, and more timely indicators, such as the NAB business survey and internal data, which point to a weaker labour market and entrenched weakness in spending.**
- **The Reserve Bank Board said when cutting rates earlier this month that the lower cash rate would help make further inroads into spare capacity and "achieve more assured progress towards the inflation target", with Governor Lowe emphasising that the cut did not reflect a weaker outlook for the economy. However, the loss of momentum means that the unemployment rate is likely to rise further, reaching 5.5% next year, adding to already considerable spare capacity in the economy given the Reserve Bank now puts the NAIRU at 4.5% and possibly lower. More spare capacity will means inflation is likely to undershoot the 2-3% target band until mid-2021.**
- **On the question of a July or August cut that is very hard – and to a large extent is less relevant for the economic outlook. On the one hand given a starting point problem (i.e. the economy is weaker than the RBA expected and continues to lose momentum) the RBA should probably get on with the cutting cycle. On the other hand, there does seem to have been a post- election boost to confidence and it is too early to assess if that has flowed into activity in any sustained way. Also back to back cuts could send a strong signal that the economy has bigger problems than we thought. On balance we have opted to stay with our August cut forecast – but would not at all be surprised by a July move. It is in short a very finely balanced judgement. And it will probably be the case that Governor Lowe will talk about the need for more action when he speaks on "The labour market and spare capacity" on 20 June.**
- **We think action to combat the slowdown in the economy and reduce unemployment will involve a third rate cut and fiscal stimulus, with possible consideration of other options down the track if these polices fail to have much effect. This is more than the one additional rate cut embedded in the Bank's current forecasts, but we think that the Bank's optimism has been further challenged by weaker-than-expected Q1 GDP, likely weak Q2 GDP and the trend deterioration in the NAB business survey. We expect the Bank will be forced to change its narrative as the year progresses, downgrading its forecasts to bring them closer to our own outlook of subpar growth, rising unemployment and persistently low inflation.**

The Reserve Bank has embarked on a new easing cycle, reducing the cash rate from 1.5% to 1.25% earlier this month. This is a significant change from last year, when the Bank was suggesting that the next move in interest rates was likely to be up. The Bank said the rate cut was directed at reducing unemployment towards a lower NAIRU of 4.5% in order to return inflation to the 2-3% target band, with the Governor characterising the economic outlook as "reasonable".

Although the Reserve Bank made significant downgrades to its growth outlook in the February and May Statements on Monetary Policy, we think that the Bank's forecasts are still too optimistic. Q1 GDP was weaker

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than the Bank forecast, while partials for Q2 have been weak and there has been a trend decline in key indicators from the NAB business survey. We expect the incoming data will trigger further downgrades by the Bank as the year progresses, bringing it more into line with our own outlook of below-trend growth, rising unemployment and stubbornly low inflation.

Beyond August, we have pencilled in a third rate cut to 0.75% in November and fiscal stimulus by late this year. Alternative monetary policy options might be considered next year if these measures fail to have much effect. A third rate cut is needed to reduce the real cash rate, where expected inflation, as proxied by the 10-year breakeven inflation rate has fallen back to its multi-decade low of 1.4%. The Bank may be reluctant to cut a third time given that the Governor said in 2012 that the effective lower bound for the cash rate was 1%, plus or minus a bit, although he recently cited the experience of much lower interest rates in the US, UK and Canada.

On fiscal policy, we think that the weaker economy will lead to additional fiscal stimulus, likely announced later this year. Governor Lowe has called for increased infrastructure spending and structural reform, which we think would be helpful because they would boost both demand and supply in the economy. The downside is that even the most “shovel-ready” projects take time to boost growth.

The lag involved with infrastructure spending and structural reform could see the government bring forward future personal income tax cuts. That would hinge on securing the support of the senate, perhaps leading the government to consider cash handouts as an alternative. While that would put at risk a return to surplus next year the impact would be temporarily offset by unexpectedly high iron ore prices. In our view a better trade off “than the surplus at all costs” would be a better performing private sector economy.

There remains uncertainty about our call on policy given such low levels of interest rates are unchartered territory for the Reserve Bank and when policy-makers have been slow to acknowledge the slowdown to date and the need for policy support. As always, the global backdrop will also influence the RBA’s views, where trade tensions between China, our largest trading partner, and the US remain unresolved and the Federal Reserve is now forecast to cut rates this year.

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