NAB MONETARY POLICY UPDATE 27 JANUARY 2022

RBA TO HIKE IN NOVEMBER, QE TO END IN FEB AS EXPECTED

NAB Economics

Key points

- We now see the first RBA rate hike occurring in November, with follow up hikes in December 2022 and February 2023. A likely move of 15bps followed by 25bp hikes at each of the next two meetings will take the target cash rate to 0.75% by February 2023, while the actual cash rate will trade between 50-75bps.
- The economy has continued to surprise to the upside, with the labour market now 6-12 months ahead of our prior forecasts – and significantly ahead of the RBA's – alongside two consecutive inflation surprises.
- From here we see underlying inflation tracking at least in the upper half of the target band with the possibility it will be above the band in Q1 and Q2. As a result, there is the risk the RBA hikes earlier and we think every meeting should be considered 'live' from August 2022.
- For the RBA's timing, a pickup wage growth will remain an important factor. While it will be difficult to have assessed the breadth and passthrough of wage growth completely by November, the RBA will have two additional reads on the WPI.
- No change to our view of QE ending in February 2022.

With the economy continuing to outperform and upside surprises to the labour market and inflation we now see the RBA beginning to normalise policy from November 2022. We expect a first hike in the cash rate target of 15bps to 25bps in November, followed by 25bps at each of the next two meetings taking the cash rate target to 0.75% by February 2022. This would take the target cash rate back to where it was prior to the pandemic. From there we expect a steady series of quarterly hikes – which would see the cash rate reach 2.5% by end 2024.

While economic activity will be impacted in the short-term by ongoing virus disruptions, we do not expect the recovery to be derailed, with a strong rebound in Q2 and growth of 3.6% overall in 2022. More important for policy is the fall in the unemployment rate to 4.2% in December 2022 – around 6 months ahead of our previous forecast and 12 months ahead of the RBA's November Statement of Monetary Policy. Indicators of labour demand remain strong despite the disruption caused by the Omicron outbreak. This suggests that upward pressure on wages growth will build over the next 6 months also – albeit with a recovery in migration providing some relief. While still early days, a labour market that is tighter for longer will see wage pressures build more quickly than previously expected despite inertia in wage setting.

By November, the RBA will have seen underlying inflation within (and potentially above) the target band for four successive quarters and have observed that the recent labour market gains have been sustained – we forecast unemployment will be below 4% by year's end. While the inflation outlook will remain uncertain at that point - as the impact of transitory virus impacts likely begin to wane - the RBA should have confidence that wage pressure will begin to flow through in 2023 and 2024 and thus sustain inflation at target.

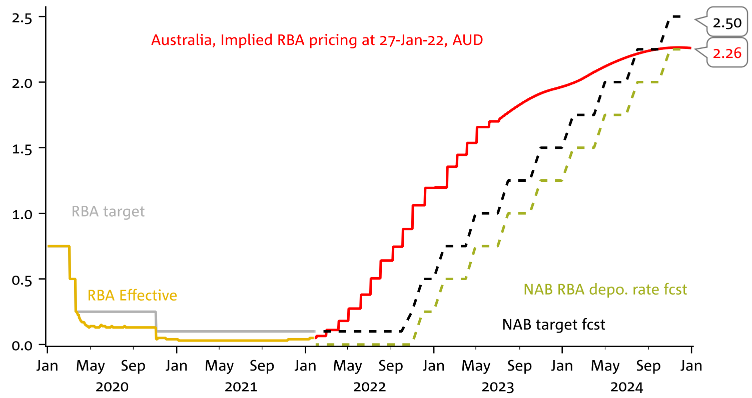
In the near term, the RBA will continue to focus on actual rather than forecast outcomes, especially given the key uncertainties around ongoing virus impacts on activity and the speed and passthrough of a tighter labour market to wages and then inflation. Therefore, we think the upcoming February SMP and Governor's speech will emphasise a central case for rate hikes in early 2023, alongside a significant upgrade to labour market and inflation forecasts. The RBA's central wage forecast will likely be pushed to 3% in early 2023 (was Dec 2023).

However, given the starting point for inflation, moving to a central forecast of early 2023 will necessarily mean earlier hikes if wages surprise to the upside. There is also the risk that the RBA's tolerance for inflation overshooting the band may evolve depending on how high CPI prints in the interim. Given the unexpected nature of the RBA's prior two changes to its framework (maximum employment in late 2020 and YCC guidance in 2021), a change to a more limited toleration for overshooting the inflation target cannot be ruled out. In this vein we should consider every meeting 'live' from August 2022.

If we take the RBA at their word, November is most probable with two more wages prints and three more inflation prints by then. It is unlikely that the RBA will have had the opportunity to have assessed a broadening in wage growth and a flow through to inflation before November. On the other hand, if wage and especially price pressures start to moderate in the second half of 2022 the RBA may well form a view that the current upward surprises in price pressures was temporary. As a result, there is a risk that the RBA start date is actually in 2023. In any event, we do not see hikes occurring as rapidly as implied by current market pricing (110bps of tightening by December).

Ultimately, the key risks now lie around how quickly wages pickup in the absence of any further shocks to activity. The experience prior to the pandemic suggests that unemployment around 5% implied significant spare capacity in the labour market with wage growth and short-term measures of inflation expectations softening. Recent estimates by the RBA suggest unemployment of closer to 4% will be required for upward pressure on wage growth, though this is difficult to assess in real time. Further, inertia in the wage setting process implies only a gradual pass-through to broader inflationary pressure and for the RBA to be forward looking in setting policy to move as early as November. Offsetting this risk in the near term is the strength in demand and overall health in the economy which has seen firms able to pass on a degree of the supply-side cost pressures in play.

CASH RATE FORECASTS



Source: National Australia Bank, Macrobond

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