NAB MONETARY POLICY UPDATE 8 MARCH 2022

NAB NOW SEES THE FIRST RBA HIKE COMING IN AUGUST; GRADUAL NORMALISATION TO FOLLOW THROUGH 2023 AND 2024

NAB Economics

Key points

- We now see the first RBA rate rise occurring in August (15bps) with further increases in September (25bps) and November (25bps) with the corridor left unchanged (with the ES rate kept at 10bps below the target). This will see the cash rate target back to pre-pandemic levels of 0.75% by the end of 2022.
- The change in our view comes alongside an upgrade to our domestic forecasts. We now see the unemployment rate below 4% by March – well ahead of RBA expectations – and around 3.5% in the second half of 2022.
- We also expect higher quarterly trimmed-mean inflation of around 1% in Q1 and Q2 (still with some upside risk), putting core inflation at around 3¾% by mid-year (compared to the RBA's 3¼% forecast).
- We expect the RBA will continue to gradually normalise policy through 2023 and 2024, assessing financial conditions in real time as the TFF ends and RBA bond holdings begin to mature. We see a further six hikes over two years – which sees the cash rate around 2.25% by the end of 2024.
- The RBA is unlikely to reinvest its bond holdings as they mature, instead allowing maturities to roll off the balance sheet in 2022 and subsequent years, subject to economic conditions remaining favourable.

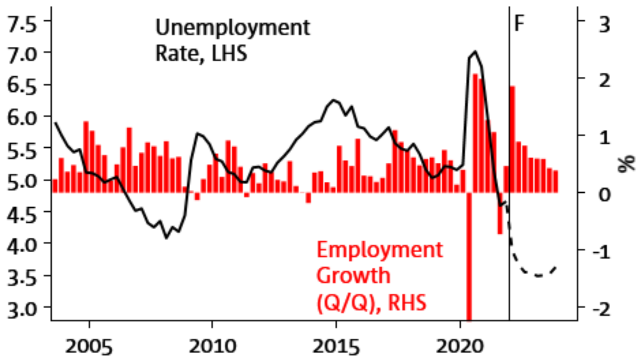
August call comes on the back of an updated near-term outlook

Our revised monetary policy call reflects upgraded near-term forecasts as the economy continues to outperform our expectations. The recent national accounts confirmed that activity rebounded rapidly in Q4 of 2021, and our internal data suggests that while Omicron impacted consumption in early January, the effect was short-lived and consumer spending rebounded in February (as did our NAB Monthly Business Survey). We expect GDP growth of around 3.5% during 2022, easing to around-trend growth of 2.1% during 2023. A full set of updated forecasts will be released tomorrow.

Similarly, the labour market has continued to strengthen. Omicron caused disruptions to hours worked but the unemployment rate remained low in January. Our internal data on the number of benefit recipients suggest the situation continued to improve in February. We now expect the unemployment rate to fall below 4% by March and reach around 3.5% in the second half of 2022 – well ahead of RBA expectations in the most recent Statement of Monetary Policy, which saw the unemployment rate at 4% in June and 3.75% in December.

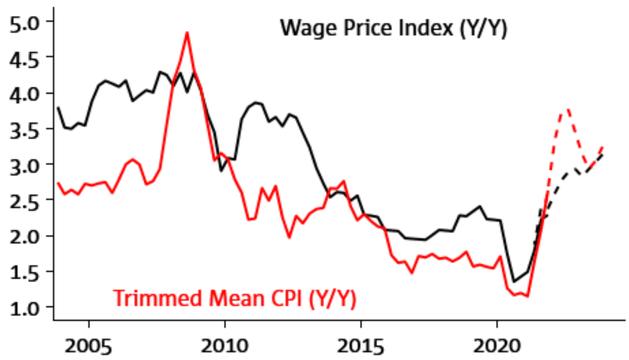
Such a tight labour market will focus attention squarely on the nominal side of the economy. Supply-side pressures pushed annual trimmed-mean inflation into the top half of the RBA's target band in Q4, and today's NAB Business Survey results indicate purchase costs and retail price growth have only strengthened in January and February. We now expect quarterly trimmed-mean CPI to print around 1% again in both Q1 (released in April) and Q2 (released in July), putting core inflation at around 3¾% by mid-year.

Chart 1: NAB's labour market forecasts



Source: National Australia Bank, Australian Bureau of Statistics

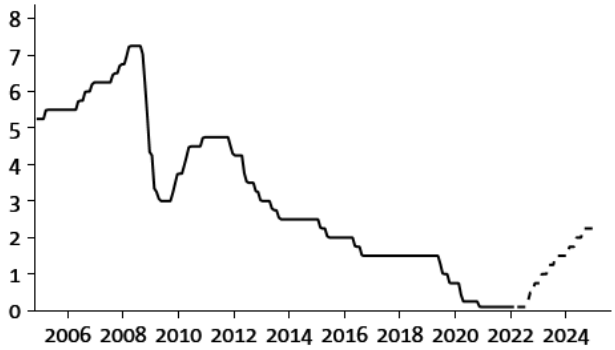
Chart 2: NAB's WPI and CPI forecasts



Source: Macrobond, NAB Economics

The RBA has reiterated that it is prepared to be patient and wait for evidence that inflation is sustainably within the target band, with labour costs growth – of which wages make up the bulk – a key factor. The Q4 WPI annualised to 2.8%, indicating wage growth has strengthened though remains historically soft in year-ended terms at 2.3%. We expect further gradual progress on wages over the course of 2022. In addition, while easing supply chain issues and normalising goods demand may reduce one source of pressure on inflation later in the year, several more quarters of inflation at the current rate are likely to increasingly feed into inflation expectations and wage bargaining, building the case for the RBA to respond.

Chart 3: NAB's cash rate target forecast



Source: Macrobond, NAB Economics

We expect that by August – after the release of the Q2 CPI data – the RBA will have sufficient evidence of very low unemployment, strong inflation, and progress on wages to begin the process of normalising rates, starting with a 15bp increase to lift the cash rate target to 0.25%. The ES rate will most likely move in tandem, maintaining a cash rate corridor of 10bpts.

Risks remain with Russia/Ukraine a key uncertainty

The Russia/Ukraine conflict is a key uncertainty, with the potential for higher commodity prices to weigh on the global economy or see a dampening in both consumer and business confidence. This backdrop supports a gradual normalisation of policy in the near-term and the RBA could choose to wait longer to see how the situation plays out and how inflation and wages evolve. The RBA could also choose to experiment by running the economy hotter for longer with the goal of seeing the unemployment rate fall even lower.

On the other hand, it is clear the RBA will be tested by strong inflation prints in the near term – with some upside risks to our forecasts – and there is a chance the Bank shifts its strategy and moves on rates sooner. However, given the timing of official data releases, the Federal Election expected in May, and the uncertainty around the Russia/Ukraine conflict we see this as a small risk, with meetings likely to be live from August.

Cautious approach will lead to gradual normalisation through 2023 and 2024

Our expectation is for the RBA to take a cautious approach to normalising monetary policy, with interest rates to rise gradually over an extended period as occurred in the first phase of the mining boom. Policy makers will be wary of the impact of higher rates on cash flows, and a gradual approach will ensure low unemployment and strong income growth allow households and businesses to deal with higher interest rates.

We see a further two hikes in September and November this year, taking the cash rate back to the level in effect before the COVID pandemic struck, around 0.75%. From there, we expect six further rises spread across 2023 and 2024, taking the cash rate to around 2.25% by the end of 2024. This pace of rate rises is considerably slower than current market expectations but reflects that the end of the TFF will be adding to bank funding costs in parallel, and bond holdings from QE will also be beginning to mature (see below).

RBA unlikely to reinvest bond holdings as they mature

When the RBA Board announced the end of QE in February, it flagged a May decision on whether it would reinvest bond maturities, which will be relatively small in the next 12 months but larger in 2023 and beyond. We expect the RBA will allow the 2022 maturities to roll off the balance sheet and likely allow the maturities in 2023 to also roll off. This will see some upward pressure on the exchange rate and higher government yields to the extent that markets expect a degree of reinvestment.

These impacts will represent a tightening in financial conditions over and above the cash rate (which will remain the primary tool of monetary policy) and the impact will be closely monitored by the bank. This will be an important reason for a gradual approach to normalising the cash rate over the next three years.

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