NAB MONETARY POLICY UPDATE 8 JUNE 2022

RBA RUSHING TO NEUTRAL, RATES TO REACH 2.10% BY YEAR-END

NAB Economics

Key points

- In light of the RBA's 50bp June rate rise and newly revealed preference to quickly normalise policy – as well as expected high inflation prints in Q2 and Q3 – we have revised up our cash rate profile. We expect additional 50bp rises in July and August to take the target to 1.85%, with a further 25bp November rise to 2.10% by year-end.
- Yesterday's rate increase to 0.85% came on the back of robust Q1 GDP growth data, a low unemployment rate, and further signs that inflation will remain elevated. We see unemployment falling further below 4% in coming months and now expect trimmed mean inflation to reach 5% y/y later in 2022.
- Importantly, the Board signalled it now intends to quickly withdraw the extraordinary monetary support provided during the pandemic. Given this approach, yesterday's 50bp rise is unlikely to be a one-off as the Board seeks to shift the level of rates closer to the 2-2.5% range.
- From 2023, the pace of hikes is likely to slow as policy approaches neutral. We see two further 25bp increases in 2023, taking the target to 2.60% and remaining there, with our end 2024 forecast unchanged.

Outsized June rise signals rush to a more neutral setting

The RBA yesterday raised the cash rate target by 50bps to 0.85%, exceeding our expectations for a 25bp move. The increase followed confirmation of robust Q1 GDP growth – despite headwinds from Omicron and floods – and an April unemployment rate of 3.9%, as well as modest signs of wage growth in the Q1 WPI and National Accounts.

There has been limited new inflation data since May, but the Board noted that inflation is "higher than earlier expected" due to global supply chain issues, the war in Ukraine, and domestic capacity constraints. That suggests a clearer forward-looking focus on the balance of risks, and a further step away from the data-driven search for evidence of higher wages growth that the Bank had been emphasising. Despite the supply-side nature of the challenges driving inflation, the Board stated that it expected higher rates to assist in returning inflation to target over time.

Importantly, the Board is of the view that "the resilience of the economy and the higher inflation mean that…extraordinary support is no longer needed". We interpret that to mean the Board now wants to shift the cash rate closer to neutral as soon as possible. Governor Lowe has previously indicated a view that the neutral rate should be around 2.50%.

Cash rate to reach 2.10% by year-end

Given the RBA's revised approach, yesterday's 50bp rise is unlikely to be a one-off and as such we expect another 50bp increase in July, taking the cash rate to 1.35%. While this would be around the pre-pandemic level, it is likely to still be considered well short of neutral given the pickup in inflation relative to pre-pandemic levels.

Moreover, we expect another very high inflation print when Q2 CPI is released later in July. Along with ongoing strength in the labour market, which should see unemployment fall further below 4% over coming months, the Board is likely to have enough ammunition for a third consecutive 50bp rise at its August meeting, taking the cash rate to 1.85%.

After such a rapid adjustment to rates over a four-month period – the fastest since the tightening cycle in the mid-1990s – a pause is likely to be necessary to assess the initial effects of tighter monetary policy on households and businesses, as well as the evolution of inflation and the global economy. However, with energy prices rising we expect another strong inflation print when Q3 CPI is released in October, taking trimmed mean CPI as high as 5% y/y. In response, a further 25bp hike in November is likely, taking the cash rate target to 2.10% by year-end.

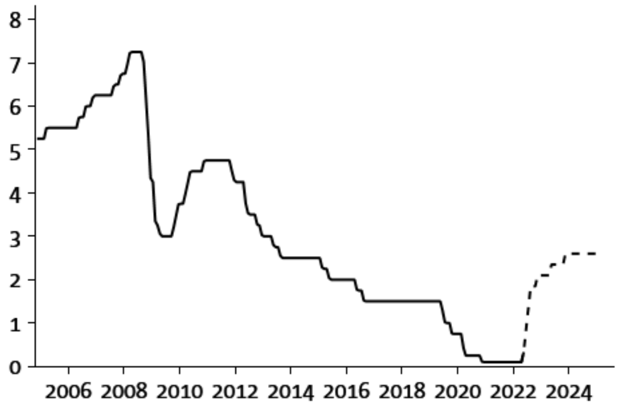
While a cash rate of 2.10% remains at the lower end of our (and the RBA's) estimates of neutral, such a significant adjustment to rates will substantially affect the economy heading into 2023. Currently high household savings rates are likely to fall and, eventually, consumption growth will slow as mortgage payments increase. We still expect above-trend growth in 2022 and but below-trend growth in 2023. Our full updated forecasts will be released as usual next week.

RBA to take a cautious approach from 2023

With our revised profile in 2022 bringing the cash rate much closer to neutral by year-end, the pace of rate rises is likely to be much slower in 2023. The RBA will need to take a cautious approach as most of the 2022 rate rises will have their impact in early-to-mid 2023, alongside a roll-off of current fixed rate loans.

We see two further 25bp increases in 2023, consistent with our forecasts for unemployment to remain historically low and wage growth to continue to pick up, taking the target rate to a roughly neutral level of 2.60%. We also expect some supply side pressures to ease through this period, helping to bring inflation back to the top of the RBA's target band. We expect rates to remain around that level through 2024 with GDP growth around or slightly below trend.

Chart 1: NAB's cash rate target forecast



Source: Macrobond, NAB Economics

In contrast to markets, which currently price the cash rate reaching 3.85% in 2023, at this stage we don't expect rates to move into more clearly contractionary territory. While the RBA has largely abandoned its prior commitment not to raise rates until wage growth was closer to 3%, the Board would likely need evidence of a much more long-term inflation challenge to raise rates above neutral, which would depend on high inflation feeding back into much higher wage growth and higher medium-term inflation expectations. Such a scenario is possible and could see rates rise above neutral but, for now, we see only a gradual pickup in wage growth across 2022 and 2023 and expect inflation to start to ease next year.

It also remains possible that the speed and size of rate rises in coming months will be more modest, for example if the labour market softens or a global downturn materialises. However, the pace at which the Board is now likely to move will mean there will be little time to change course before the level of rates passes 1½%. balance, we see a cash rate around 2% by the end of 2022 and 2½% by the end of 2023 as the most likely profile for monetary policy.

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