NAB MONETARY POLICY UPDATE 12 JULY 2022
NAB NOW EXPECTS RATES TO REACH 2.35% BY YEAR-END
NAB Economics

Key points

- We have further front-loaded our rate track, and now see the cash rate target at 2.35% by November (was 2.1%) and peaking at 2.6% in February (previously mid 2023).
- Our view is that the RBA will continue to rapidly adjust rates towards neutral (around 2.5%), hiking by another 50bps in August and following up with 25bp in increases in September, November and February.
- The rapid increase in rates and higher prices faced by households will begin to moderate consumer demand and we now see below-trend GDP growth of 1.8% in 2023 and 2024.
- We see inflation peaking in both headline and trimmed-mean terms in Q4 at 7.2% and 5.4%, respectively. Inflation is then expected to ease in 2023 as growth slows globally and the impact of supply shocks begin to wane.
- High inflation in the near-term, however, risks a more material rise in inflation expectations and potentially the need to move more quickly or to a more restrictive stance should these expectations begin to feed back into the wage-bargaining process.

Cash rate to now reach 2.35% by year-end and 2.6% in early 2023

The RBA's post meeting statement for July continued to communicate further rate rises in coming months, stating that "The Board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead" but noted that the RBA will be both data dependent and forward-looking in future policy deliberations. Notably, the RBA continues to assess the current level of rates as stimulatory - it is still using the word "normalisation" and stated that the July move was a "further step in the withdrawal of the extraordinary monetary support" that it had put in place during the pandemic.

The RBA also emphasised the importance of both inflation outcomes and the outlook for the labour market in the statement. The post meeting statement and our outlook for the labour market do not change our view that the RBA will lift rates by a further 50bp at the August meeting, taking the cash rate target to 1.85%. The August meeting will also follow what is looking like a very strong Q2 print for underlying inflation of around 1.5% (to be released in late July).

To further front-load our rate track, we now also see the RBA moving 25bp in September. From there, we expect two further 25bp hikes in November and February 2023, taking the cash rate to 2.6% - three months earlier than previously expected. Pausing there would give the RBA comfort that it has moved away from a stimulatory setting while allowing for an assessment of the impact of higher rates on the economy and the evolution of inflation based on incoming data.

Normalisation of rates is the focus for now

We have not fundamentally changed our view of the dynamics at play. The economy has rebounded strongly as the impacts of lockdowns fade and is expected to grow at around trend pace this year. Alongside the recovery in activity, the labour market has been strong with employment now well above pre-pandemic levels, participation at record highs and the unemployment rate at five-decade lows.

As a result, an exceptionally easy policy stance is no longer appropriate, and we see the RBA continuing to normalise rates to avoid overheating the economy. In addition, inflation is expected to track well above target for an extended period, and although it has been in large part driven by global factors, domestic demand has also been strong. While we expect the impact of these shocks will begin to unwind and inflation will begin to moderate, they pose a risk to inflation expectations, particularly in the wage-bargaining process in an already tight labour market.

Indeed, wage growth has begun to increase as the labour market has tightened but remains soft by historical standards. We expect wage growth to continue to rise, reaching around 3.5% by the end of 2023 – a rate that is likely to be consistent with inflation within the 2-3% target band. Therefore, as the impact of supply side factors and other global shocks wanes, we expect inflation to trend towards the target band.

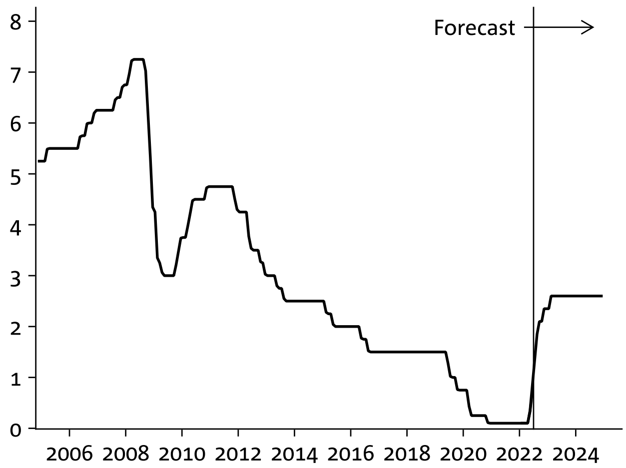
We also see easy policy has having been a significant support to the consumer with a low interest burden supporting both consumption and the savings rate via higher disposable income over the past couple of years. As rates rise, this impact will begin to unwind while the impact of higher prices also weighs on household budgets – ultimately seeing a slow-down in consumer spending growth going forward. This sees below trend growth in 2023 and the unemployment beginning to tick up (but remain broadly consistent with full employment) further moderating the pressure on wages and inflation. Global growth is also being impacted by policy tightening and other disruptions and we have revised down our expectations for global growth. Our full set of updated economic forecasts for Australia will be released tomorrow.

This means we do not expect the RBA will need to go deep into restrictive territory but will remained focused on inflation expectations and the risk that current high inflation feeds back into the wage bargaining process entrenching higher rates of inflation. For now, the RBA notes that medium-term inflation expectations remain anchored, but we expect they will be closely monitored as inflation continues to rise and then peak in the near term, amidst an already tight labour market.

Risks to the outlook

We see the risks around our rate profile as evenly balanced. There is a risk the RBA will want to further front-load rate hikes to get to neutral more quickly, given the tight labour market and large inflation shock risking a sharp rise in inflation expectations. Further to the upside, the wage response to a tight labour market remains uncertain, with these levels of unemployment not seen during the inflation targeting regime. A more rapid increase in wage growth may warrant both the RBA moving more quickly and into restrictive territory.

Chart 1: NAB's cash rate target forecast



Source: Macrobond, NAB Economics

However, these factors need to be weighed against the potential impact on household balance sheets as higher prices erode real incomes and a sharp increase in debt servicing costs over recent months reduces disposable incomes. While households have built up a large buffer of saving during the pandemic consumer confidence has already fallen sharply and the speed at which rates have risen may provide an additional challenge.

Global developments will also be important and again there are risks on either side. A more aggressive tightening by the major overseas central banks than we expect could lead to downwards pressure on the dollar, adding further pressure on imported inflation in Australia. Against that, in such a scenario there is the likelihood of a more severe global slowdown which could lower global inflation, weaken demand for Australian exports and therefore reduce the need for the RBA to raise rates.

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