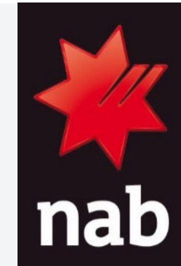
NAB MONETARY POLICY UPDATE 22 JULY 2022

NAB NOW EXPECTS RATES TO REACH 2.85% BY YEAR-END

NAB Economics



Key points

- The recent drop in the unemployment rate to 3.5% is too large to ignore, particularly given the expectation that next week's Q2 CPI release will show further very elevated inflation. We now expect the RBA to lift rates to 2.85% by the end of the year, which we consider to be around neutral if not mildly restrictive, and then to pause. Previously we had expected a Cash Rate of 2.35% by end 2022, with rates peaking at 2.6% in early 2023.
- The path towards this level is difficult to pin down – with the RBA still suggesting "the pace and size of increases will be determined by data" but also that we will likely see a "steady" series of rate increases.
- With the cash rate still well below "neutral" this points to an ongoing rapid normalisation in coming months, but given the speed there will need to be a pause to assess the impact of rate increases. That sees 50 bps at each of the next two meetings but a slowing to 25bp increments in October/November.
- Current high inflation risks a material rise in inflation expectations which could feed into the wage-bargaining process given the very tight labour market. If this were to eventuate this would pressure the RBA to move even higher.
- While we formally expect a pause in rate hikes once the RBA has lifted rates to a level it considers is consistent with inflation returning to within their target, the current high level of uncertainty around any point forecast and estimates of the neutral interest rate, means the RBA will be sensitive to material incoming data surprises as well as overseas developments.
- We have also brought forward our track for the US Fed; we now expect them to reach a (peak) fed funds rate target range of 3.25-3.50% by end 2022 (previously early 2023).

Cash rate to now reach 2.85% by year-end and then pause

The immediate path of monetary policy in a broad sense seems quite clear and hasn't changed. The RBA is in hiking mode with a view to 'normalise' rates relatively quickly. Incoming data, and the balance of risks to inflation – will determine the speed of this adjustment and whether just normalising rates is sufficient. But the current 1.35% cash rate is still an accommodative policy stance by any measure.

While the June unemployment rate at 3.5% (a 48-year low) didn't tell us anything we didn't already know – the labour market is very tight, it was still 'eye catching' to borrow an expression used by the US Federal Reserve Chair recently. Such a tight labour market – and other indicators of domestic capacity constraints from NAB's business survey – points to ongoing domestic inflation pressures. The RBA can't just hope that the (long-delayed and still uncertain) unwinding of global inflationary pressures will return inflation to target.

It also feeds into the RBA's underlying concern that inflation expectations could become unanchored from the RBA's 2-3% inflation target, due to the potential feed through to wages. Given this, and with rates still well below neutral, there are strong reasons for the RBA to continue to move rates quickly in the near term.

Moreover, the RBA is unlikely to get any relief from the Q2 CPI to be released next week. We expect CPI growth of 6.3% y/y which would be the highest rate since 1990. Trimmed-mean CPI is also expected to be very high – at +1.5% q/q (+4.7%y/y) illustrating the breadth of inflationary pressures.

Normalising policy means bringing the policy rate back to its (long-run) neutral level. As the RBA has noted there is a lot of uncertainty around what the neutral rate actually is, and there are a range of estimates. However, it considers that it is at least positive in real terms which, if inflation expectations are anchored at the mid-point of the RBA's target, suggests that the neutral (nominal) cash rate is at least 2.5%. We broadly concur with this but acknowledge the risk that it is lower - rates have not moved up for a decade, housing debt is high and the impact of the recent very quick speed of the adjustment remains uncertain.

Normally, a combination of well above target inflation and domestic capacity constraints – would lead to a central bank adopting a clearly restrictive policy setting – i.e. rates above neutral. Central banks historically have tended to look through the impact of supply shocks (particularly in energy markets) but that is not the only factor behind current elevated inflation. It is difficult to ignore high inflation, whatever the cause, in a situation where there are concerns around inflation expectations becoming unanchored and where the labour market is so tight.

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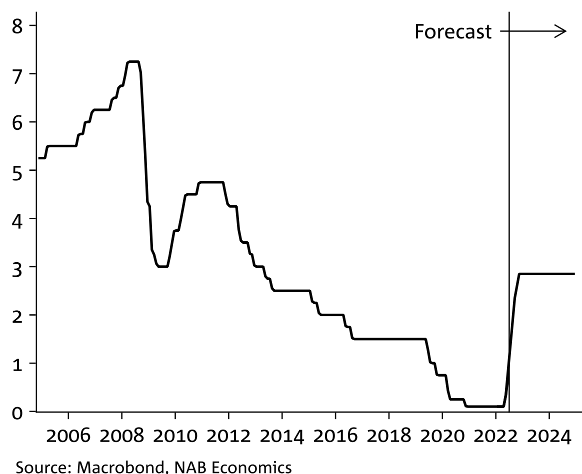
However, we need to recognise that there are a range of external shocks and price rises that are weighing on the economy and are likely to take growth below trend even if rates are at neutral. These include the war in Ukraine (and the global energy and food supply shock), the possibility of ongoing rolling lockdowns in China due to its zero-COVID policy, and the rapid tightening of monetary policy by overseas central banks.

The RBA Governor, in a speech this week, indicated that the RBA sees a 'narrow path' to bringing inflation back to target while keeping the economy growing and unemployment low. (We would add that some rise in the unemployment rate from 3.5% would still be considered low.) He also indicated that the Bank does not need to bring inflation back to target immediately but does need to set policy to deliver a credible path back to 2-3% inflation.

This suggests a strategy of lifting rates to a level that is considered consistent with inflation returning to target over time and then pausing to assess whether this is the case or not given the lags between monetary policy changes and their impact on the economy along with the other extraneous factors impacting on growth and inflation at the present time.

Against this backdrop, we have brought forward our expectations of how quickly the RBA will move. We now expect a higher peak for the Cash Rate over our forecast period - 2.85% - and for this to be reached by the end of this year, with the RBA then going on hold. This would be consistent with rates around neutral or mildly restrictive. Previously we had expected rates to peak at 2.6% in early 2023. It is hard to pin down the exact path to 2.85% with any great confidence. We tentatively have 50bp in August and September, followed by 25bp in the following two meetings, in part referencing the RBA Governor's recent reference to 'steady' increases. However, we acknowledge a 75bp hike in August is possible (particularly if the Q2 CPI surprises to the upside) as part of a more rapid path to 2.85%. It seems very unlikely that a 25bps increase at the August meeting will be given any serious consideration.

Chart 1: NAB's cash rate target forecast



Source: Macrobond, NAB Economics

A combination of below trend growth and inflation moving back to target over 2023 and into 2024, as in our forecasts, raises the possibility of rate cuts at some point in 2023 or 2024. With rates close to neutral whether the RBA would feel the need to do so will in part depend on global developments and prospects, as well as domestic fiscal policy settings.

Risks

The economic environment remains highly uncertain. The evolution and impact of global developments will be key – and could see further inflationary pressure (e.g. from Russian energy supply cutbacks or because broader inflation has become entrenched at a high level) or deflationary pressure (if commodity prices fall or if broader goods prices were to decline with restocked inventory and a pull-back in demand, which seems to be now occurring in the US).

A key risk is around how much (and how quickly) the economy slows from here, including the degree to which the labour market remains tight and how this then feeds into inflation. While our most recent forecasts see inflation coming back to within target over 2023, there is a risk that current elevated inflation – and the likelihood of further strong readings in coming quarters – lifts inflation expectations or adds to the RBA's assessment of the risk they will become unanchored. One way this could play out is through wages growth – our forecasts incorporate only a modest strengthening in wages growth over time. But with the labour market very tight (and near-term labour demand indicators remain strong), coupled with the desire to make up for real wage falls caused by high inflation, it is easy to see a scenario where wages accelerate more quickly. Indeed, the Q2 NAB Quarterly Business Survey released this week indicates that businesses are reporting growing wage pressures.

On balance these considerations suggest that the risks around our RBA track remain tilted to the upside. Higher rates (above 2.85%) would risk seeing the 'narrow path' - of inflation back to target while the economy still grows enough to keep unemployment low - the RBA is aiming for, become non-existent. However, it is clear that the RBA sees failing to deliver on its inflation target now would come at even a greater cost to economic activity (and employment) down the track so this would not stop the RBA moving rates higher if it considered it necessary to get inflation under control.

Change to Fed track

We are also bringing forward our expectations of Fed rate hikes. We had factored in 100bp of rate hikes in Q3 and, at the time, thought there was little to choose between the Fed going 50bp in each of the July and September meetings or 75/25bp. However, the recent debate around the July meeting has been whether the Fed would do 75bp or 100bp, with the former the more likely. In this context, it is hard to see the Fed slowing the pace down to a 25bp rate hike in September. So we now expect a 75bp hike in July, followed by 50bp in September and 25bp in each of the Q4 meetings. We have removed our expectation of a rate hike in Q1 2023 so our view of the peak is unchanged (target range of 3.25% to 3.50%). We still expect that rates at this level will lead to a (mild) US recession during 2023.

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