NAB Monetary Policy Update 26-Oct 2022

Series of 25bp rises ahead; peak rate of 3.6%

NAB Group Economics

Key points

- NAB continues to see two more 25bp cash rate increases in 2022 taking the cash rate to 3.1% by year-end, and now expects two further increases in February and March 2023 taking the peak (terminal) rate to 3.6%.
- Today's Q3 CPI release confirmed inflation has continued to escalate over recent months and the RBA is likely to revise up its peak inflation figures by 0.75ppts next week. The labour market remains very tight, consumption has held up longer than we expected, and conditions in the business survey remain strong.
- In these circumstances, the RBA will need to move monetary policy into more clearly restrictive territory to ensure inflation returns to target, and as such we have revised up our terminal rate expectation to 3.6% (from 3.1%). We see 25bp moves as likely, but a 50bp rise in November is possible, given today's CPI print.
- We expect higher interest rates to materially weigh on consumption and GDP growth in 2023 and 2024 and while we don't expect a recession, annual growth will likely fall below 1% and unemployment rise to 4.5%. Full forecasts will be released in our next forecast update in November.
- Slow growth, rising unemployment and easing global inflation pressures are likely to see the RBA begin to ease policy back towards a more neutral setting in 2024, with the cash rate expected to fall back below 3%.

Consumption holding up despite headwinds

Today's Q3 CPI release showed inflation has continued to escalate over recent months, with trimmed-mean CPI at 1.8% q/q and 6.1% y/y. While much of the current inflation pressure has been driven by global forces, there are signs that domestic pressures are also growing with services CPI picking up to 4.1% y/y and further gains likely from rent rises and domestic airfares. The resumption of full fuel excise, unwind of some electricity subsidies, rising rents and flood effects on food prices mean another very strong print is likely for Q4. Inflation is now likely to peak 0.75 percentage points higher than the RBA's August SoMP forecast of 7.8% in Q4.

The labour market remains very tight, with the unemployment rate around 3.5% over successive months and job vacancies still elevated, indicating some labour demand remains unmet. So far there have only been tentative signs of easing in employment demand – though these might more reflect additional labour supply rather than demand. There are also indications that wage growth is picking up, with wage growth expected to reach a level consistent with at-target inflation in 2023.

The impact of recent interest rate rises has been evident in the housing market – the most interest sensitive sector. For households, while we are conscious the direct effects are yet to fully flow through to mortgage repayments, so far consumption has held up better than expected. Conditions in the NAB Business Survey are above their pre-COVID peak and our consumer spending data for September showed a 1% increase in monthly spending in nominal terms. Accordingly, we recently revised up our consumption growth forecasts for Q3.

RBA will need to head further into restrictive territory

The strength in inflation, tightness in the labour market and resilience of demand all indicate that further rate increases are needed as the RBA Board has been signalling. In addition, while yesterday's Federal Budget reflected that fiscal and monetary policy are broadly aligned, it is clear that monetary policy will be the active policy lever in cooling demand and ensuring inflation returns to target.

In light of these factors, we are now of the view that the RBA needs to move monetary policy into more clearly restrictive territory. That sees us revise up our view of the terminal rate for this hiking cycle, from 3.1% to 3.6%, materially above most current estimates of the long-run neutral rate.

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The RBA has indicated in recent communications that a series of 25bp increases is likely. While the strength in today's CPI release will see the Board actively debate the possibility of a 50bp hike in November, we see a 25bp hike as being slightly more probable given recent communications and the fact that monthly meetings provide scope for the Board to continue to adjust rates relatively quickly, while also monitoring incoming data.

As such, we continue to see two more 25bp increases in November and December taking the cash rate to 3.1% by year-end. We then expect two additional 25bp increases in February and March 2023, which would follow the release of the Q4 CPI in January and WPI data in February – both of which are likely to be strong.

This would take the cash rate to 3.6%, its highest level since mid-2012, and see a cumulative increase of 3.5ppts in just under a year. At this point, it remains our view that the RBA will need to pause to allow the effects of this adjustment to flow through to the economy and observe the evolution of the data.

Higher rates will slow the economy

A more clearly restrictive monetary policy track will weigh materially on consumption and GDP growth in 2023 and 2024. Higher interest payments will increasingly impact households' cash flow and higher rates will also continue to affect house prices, weighing on household wealth.

While we don't see a 3.6% rate as causing a recession, our revised rates path will likely see annual GDP growth fall below 1% in both 2023 and 2024 with the possibility of some quarters of near-zero growth. Unemployment is likely to rise to around 4.5% - marginally above estimates of full employment and 1ppt above its current level (but still below pre-COVID levels). Full forecasts will be released with our next forecast update in November.

Importantly, we continue to see global inflation pressures easing in 2023 and while wage growth will pick up, we see it remaining at around 3.5%, a level consistent with at-target inflation. As such, by 2024 the RBA is likely to face inflation edging back towards 3% alongside slow growth and rising unemployment. In this environment, we would expect some easing in monetary policy with the cash rate expected to return to 2.85% by mid-2024.

Risks remain finely balanced

Considerable uncertainty continues to surround the outlook. Globally, we expect key economies to be in recession in 2023. Should the global economy deteriorate more sharply than expected, this would further weigh on Australia's growth outlook and could give the RBA reason to pause before reaching 3.6%. Likewise, if there are clearer signs domestically that consumption is materially slowing by the end of the year, this could signal rates are already sufficiently high to curb demand – though we see this as unlikely.

Conversely, additional commodity price spikes or other global shocks that extend the period of supply chain disruption would challenge our expectation that inflation begins to ease in 2023. Domestically, it is difficult to know how wages will respond to an unemployment rate below 4% and a more rapid wage lift-off could prompt the RBA to continue raising rates beyond 3.6%. As ever, inflation expectations will be a major focus with any sign of de-anchoring likely to meet a strong response.

Further out, our expectation for Australia to experience slow but positive annual growth in 2023 and 2024 could be challenged if the eventual impact of higher rates on household spending behaviour is more severe than we anticipate, or if other headwinds emerge. For now, the RBA remains committed to tackling inflation while limiting the damage to the real economy – but balancing these trade-offs will be immensely difficult.

Table: Updated cash rate profile

	2022			2023				2024			
	Oct	**Nov**	**Dec**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Cash Rate	2.60	2.85	3.10	3.60	3.60	3.60	3.60	3.10	2.85	2.85	2.85

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