NAB Monetary Policy Update 14 Feb 2023

Three further hikes to come, cash rate to hit 4.1%

NAB Group Economics

Key points

- Following the first RBA meeting of the year and the release of the February SoMP, NAB now sees the RBA lifting rates to a peak of 4.1% in May, including 25bp increases at each of the next three meetings.
- Since we upped our call to 3.6% last October, the economy has remained resilient to both higher inflation and interest rates. Our business survey (out today) and consumer transaction data (tomorrow) indicate this resilience continued in January, and we continue to expect strong prints for wages and inflation to continue in the near term.
- We still see a strong case for the RBA to look to pause the current hiking cycle soon given the considerable tightening put in place, the 'long and variable lags' and the need to look through some unusual features of the post-COVID normalisation period. However, the RBA's framing of domestic inflationary pressures has clearly changed and as such, we judge it to be unlikely the Board will feel comfortable pausing before May.
- A cash rate peak above 4% will have a significant impact on economic growth, and we expect GDP to be below 1% over both 2023 and 2024 despite the more optimistic near-term outlook. We also expect the RBA will need to cut interest rates in 2024 to closer to neutral to support growth as inflation moderates. Our full economic forecasts will be released next Tuesday.

The RBA has signalled further rate increases to come

Taken together, last week's post-meeting statement and the SoMP project a more hawkish approach by the RBA than suggested by their communication in December. The statement emphasises that the "Board's priority is to return inflation to target" (unchanged) and that the Board "expect further increases in interest rates will be needed over the months ahead".

Importantly, the RBA's updated set of forecasts revised up the inflation track in the near-term and the bank continues to see inflation only declining to the top of the 2-3% band by mid-2025. The RBA's GDP forecasts see growth of 1.5% over each of the next two years and while unemployment is expected to rise, wage growth is now forecast to peak above 4%.

Based on the RBA's forecasts – which are conditioned on a cash rate peak of around 3.75% in early 2023 and an easing from early 2024 – it is likely they see scope to take rates higher and return inflation to target more quickly, particularly given the risk to domestic inflationary pressure remains to the upside.

The RBA does acknowledge that the full impact of policy is yet to flow through, and more broadly that uncertainty remains high around the economy's response to higher rates. However, both the SMP and the post-meeting statement also point to an economy that has remained more resilient than expected. Further, while the RBA does continue to note that it wishes to keep the economy on an "even keel", ensuring inflation expectations remain well anchored seems to be increasing in importance given strong wages indications.

A string of strong data prints will likely push the RBA

While it is likely that headline inflation has peaked, a significant unknown for 2023 is how quickly inflation moderates. Indeed, the Q4 CPI showed that price increases remain broad-based, and despite the expectation of an easing in goods inflation, the easing in upstream cost pressures is yet to flow through to consumer prices. Our business survey measures of costs and prices appear to have peaked but remain very high with strength evident across all industries.

More timely activity data show the economy has remained resilient. Our internal transaction data – to be released in our *Monthly Data Insights* note tomorrow – suggests that nominal retail sales rose by 2.0% in

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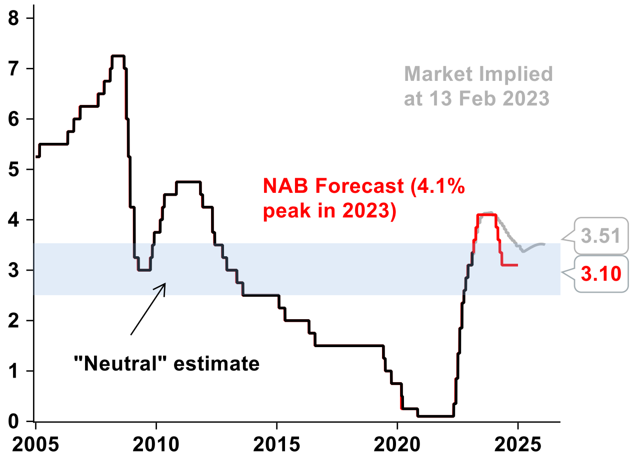
January, and broader household consumption rose by a similar amount. This suggests that the dip in December was likely a result of moving seasonality and that the underlying strength in spending remains strong, despite the ongoing pass-through of higher rates.

Further, a string of upcoming data prints are likely to continue to push the RBA with the Q4 WPI (released in February ahead of the March meeting) likely to see another strong result – particularly for the private sector measure which is expected to annualise in the high 4% range. The subsequent prints of monthly and quarterly CPI measures for Q1 are likely to show some easing but will remain elevated, motivating the RBA Board to respond with further rate rises in April and May to take the cash rate to 4.1%.

Chart 1: NAB rate forecast and market pricing



Source: Macrobond, NAB Economics

In our view, a strong case remains for the RBA to pause or slow down the current hiking cycle soon to allow time for the rapid adjustments made over the past year to flow though. Such an approach would leave open the possibility of raising rates further later in the year if inflation did not moderate sufficiently. However, given the Board's recent statements, its continuing reactiveness to recent inflation data and our expectations for the near-term data flow, we judge it to be unlikely the Board will feel comfortable pausing before May – and indeed there remains a possibility that rates rise further.

Rates rising into more restrictive territory will have growth implications

With rates now expected to peak above 4%, we see policy as moving deeper into restrictive territory. Assessing neutral in real time is difficult, and momentum in the labour market, rebounding population growth, savings buffers and the strength in the terms of trade have weighed against the effects of policy tightening so far. Nonetheless, the interest burden is rising sharply (and further pass through is expected in H1 2023) and the savings rate has already returned to pre-COVID levels.

We expect consumption growth to slow sharply as 2023 progresses and likely fall slightly in real terms in the back end of the year. This will weigh on GDP growth, alongside a weaker outlook for both dwelling and business investment. Overall, we see growth of around 0. 7% during 2023 and 0.9% during 2024 – well below trend growth of 2¼ -2½. The labour market typically lags activity by around 6 months, and consequently we expect the unemployment rate to begin drifting higher through H2 2023 with slowing labour demand unable to fully absorb the rebound in population growth. Our full forecasts will be released next Tuesday.

Risks remain finely balanced

The speed and magnitude of the tightening so far, combined with ongoing delayed pass through and uncertainty over how consumers react (with confidence already very low) poses the risk of a sharper than expected slowdown. We still don't expect a technical recession in Australia – but with rates rising above 4%, it is becoming more of a possibility. Ultimately, a more significant downturn would see rates cut more quickly in early 2024.

Still, there are also upside risks for growth including a possible near-term improvement in the global outlook, the rebound in population growth and the strong buffers built up on household balance sheets. Indeed, as noted above, notwithstanding the expected lags, the economy has so far remained resilient as the rebound from lockdowns has passed.

For inflation, it is clear that some global pressures are moderating – supply chains continue to heal, freight costs have fallen sharply and commodity prices have broadly levelled off. However, how quickly this is passed through to consumers domestically is uncertain. At the same time, services inflation remains elevated pressure, in part due to reopening and continuing tight labour markets.

Ultimately, the wage response to a tight labour market remains key to where inflation eventually settles. Recent wage growth remains strong, but likely incorporates the larger than usual minimum wage decision. That said, the labour market has been extremely tight and experience with unemployment at such low levels is limited. For the RBA, the longer the labour market remains tight and headline inflation high, the greater the risk that the two become mutually reinforcing.

Table 1: 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	4.10	4.10	4.10	3.60	3.10	3.10	3.10

Table 1: Key Forecasts

	2021	2022-F	2023-F	2024-F
Domestic Demand (a)	6.3	5.0	1.1	-0.2
Real GDP (annual average)	**5.2**	**3.7**	**1.7**	**0.6**
Real GDP (year-ended to Dec)	**4.6**	**2.8**	**0.7**	**0.9**
Terms of Trade (a)	17.2	5.1	-6.7	-2.9
Employment (a)	3.4	4.0	2.0	0.6
Unemployment Rate (b)	4.7	3.5	4.0	4.7
Headline CPI (b)	3.5	7.8	4.4	2.9
Core CPI (b)	2.5	6.3	4.5	3.0
RBA Cash Rate (b)	0.10	3.10	4.10	3.10
$A/US cents (b)	0.73	0.68	0.78	0.80

(a) annual average growth, (b) end-period, (c) through the year inflation

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