NAB Monetary Policy Update 30 Mar 2023

Line-ball April meeting to take rates to 3.85% peak

NAB Group Economics

Key points

- We continue to expect the RBA to raise the cash rate by 25bps in April, though we now see the resulting 3.85% rate as the peak (previously 4.1%). Further out, we continue to see rate cuts in H1 2024 bringing the cash rate back to 3.1% as the economy slows and unemployment rises.
- It has become increasingly clear that interest rates are nearing their peak, and the April meeting is a line-ball decision. The labour market remains very tight, inflation is well above target and the risks on wage growth remain to the upside. However, activity is also slowing as post-COVID momentum fades and the monthly CPI appears to confirm RBA and market expectations that inflation has passed its peak.
- The key question for the RBA Board is whether the current level of interest rates is now sufficiently high to ensure inflation sustainably returns to target in a reasonable time frame. In part, this depends on wage pressures remaining contained and expectations for inflation staying anchored. Based on the RBA's statements and forecasts, a peak cash rate of 3.6% is unlikely to be seen as sufficiently restrictive by the Board, necessitating one more increase before a pause to assess how the effects of prior monetary policy tightening flow through.
- The risk to our forecast is that the Board chooses to pause in April, as floated in the minutes, if a strong signal is taken from the monthly CPI indicator. Alternatively, rates could still rise to 4.1% if either of the full Q1 CPI or Q1 WPI releases surprise to the upside relative to the RBA's forecasts. On balance, a 3.85% peak appears more likely. Any early reduction in Australian interest rates, however, seems very unlikely barring a significant shock or deterioration in economic conditions.

A 3.85% cash rate peak is now the most likely scenario

In the February *Statement on Monetary Policy* (SoMP), the RBA forecasts continued to see reasonable growth of 1.5% over each of the next two years, wage growth rising to over 4% and inflation only declining to the top of the 2-3% target band by mid-2025. These forecasts were conditioned on a cash rate peak of around 3¾%.

At the time, and reflecting resilience in the NAB Survey data, consumer spending, and our expectations for the evolution of wages and inflation over the early part of the year, we assessed the RBA would ultimately be pushed to continue raising rates through to May, to a slightly higher peak of 4.1%.

Since then, the Q4 WPI and National Accounts releases have surprised to the downside – albeit only slightly – with the March board minutes showing the RBA see the case for a pause in the near future. More recently, events in the financial sector in the US and Europe have shaken confidence and are expected to contribute to generally tighter financial conditions and slower growth globally. Both of these factors have served to somewhat rebalance the risks on inflation and, as such, we now see a peak cash rate of 3.85% as the most likely scenario.

Data still supportive of a rise at the April meeting

With rates now closer to their peak, it is unsurprising that the outcome of the next meeting is line-ball. In the March meeting minutes, the RBA Board agreed to consider a pause at the April meeting, and specifically noted that data releases on "employment, inflation, retail trade and business surveys would provide important additional information".

While these data have provided somewhat mixed signals, in our view they remain in line with the RBA's central forecasts and as such are supportive of a further 25bp increase. On the labour market, employment rebounded strongly in February and the unemployment rate fell back to 3.5% - still broadly at the same near 50-year lows

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seen in mid-2022. Nominal retail spending growth slowed to 0.2% in February but remains at a very high level, and business conditions and capacity utilisation in the NAB Business Survey remain well above-average.

The February monthly CPI Indicator slowed to 6.8% y/y from 7.4% but this remains an incomplete inflation measure and still well above target. It should provide some confirmation that inflation has begun to ease from its Q4 peak, and will likely suggest to the RBA that Q1 inflation is unlikely to exceed their February forecasts, which saw trimmed mean inflation at 1.4% q/q. However, in our view it is not on its own sufficient to drive an early pause, especially as the full Q1 CPI will be available ahead of the May Board meeting.

Uncertainty remains elevated, and there are risks both ways

The risk to our forecast is the Board chooses to pause in April if a strong signal is taken from the monthly CPI indicator. This could simply be a case of delaying the inevitable if the Q1 CPI ultimately confirms that a hike is necessary in May. However, whenever the RBA does choose to pause, we expect they would prefer to do so for some time to assess how the effects of monetary policy flow through and how the global economy evolves. This in itself should support the case for an April rise, avoiding the potential confusion of a one-month pause.

Alternatively, rates could still rise to 4.1% if either of the full Q1 CPI or Q1 WPI releases surprise to the upside relative to the RBA's forecasts. While we see the RBA as likely to become more forward-looking given the significant lags in the effects of monetary policy, a higher-than-expected CPI or WPI print could serve to push out their forecast inflation moderation profile, which may test the Board's risk appetite. If the economy outperforms over coming months, if inflation fails to ease as expected, or if current emerging elevated wages demands are successful, there is also a possibility that rates rise again after a pause.

On balance, a 3.85% peak after the April meeting appears likely. We continue to see the higher level of rates weighing more materially on real household consumption as the year goes on, with GDP growth likely to be <1% as a result and the unemployment rate to rise to around 4% by the end of the year.

Given this slowing and the likely further easing of inflation as global supply-side pressures unwind, we expect the RBA will cut rates over the course of H1 2024 to bring the cash rate back to a more 'neutral' level of 3.1%. This will require an important moderation in services inflation, which to date remains elevated in Australia and much of the world. Any early reduction in Australian interest rates, however, seems very unlikely barring a significant shock or deterioration in economic conditions.

Table 1: Updated cash rate profile

	2023						2024			
	Mar	**Apr**	**May**	**Jun**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Cash Rate	3.60	3.85	3.85	3.85	3.85	3.85	3.35	3.10	3.10	3.10

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