NAB Monetary Policy Update 5 Apr 2023

The cash rate at a peak, but upside risks remain

NAB Group Economics

Key points

- On balance we now expect the RBA to hold the cash rate at 3.6%, meaning we are now at the peak cash rate in this cycle. We expect the RBA to remain on hold until the first half of 2024 before the cash rate is cut back to 3.1%.
- The RBA justified the "pause" at 3.6% in the month on the need for more time to assess the ongoing impact of previous rate rises and the evolution of the outlook for the domestic and global economies. In our view, waiting for more than a few months would see the RBA overrun by slowing consumption data and a deteriorating labour market outlook meaning the RBA will remain on hold as inflation moderates.
- Nonetheless, a rate rise in May or June remains a real possibility. The RBA is now very data dependent, and the key risk to our view in the near term is that the RBA reads inflation or wage growth as sufficient to do more before the full impact of rates fully flows through - which would see a slightly higher peak of 3.85%. Which is where we previously expected the peak to be (and to an extent where we think it should be).
- Further out, the key risks are more balanced. To the upside, a stronger wage response and stickier domestic inflation could push the RBA higher - though this scenario would likely involve more than just small tweaks to the cash rate. To the downside, a more significant deterioration in global growth due to a tightening in financial conditions could see a faster moderation in inflation.

A 3.6% cash rate peak is likely now the peak

Looking forward, the RBA will likely become increasingly focused on the outlook for both the domestic and global economies, while calibrating the impact of previous increases in real time based on key data points for consumer spending, wage growth and inflation.

Yesterday's post meeting statement continued to emphasise the RBA remains "resolute" in returning inflation to target and will continue "to do what is necessary to achieve that". However, the Board also remains conscious of the cumulative 350bp increase in the cash rate over the past year and the lags in the transmission of monetary policy, justifying a pause in the month to "provide additional time to assess the impact of the increase in interest rates to date and the economic outlook" while aiming for a "soft landing".

Usually such a pause would last for 2-3 months to accumulate the evidence based on the data flow while the outlook continues to evolve in an environment of uncertainty. In our view waiting three months will see the RBA (which to date has had more optimistic forecasts than us) overrun by slowing activity data, a turning point in the unemployment rate and the ongoing moderation in inflation.

Further out, the RBA will need to return interest rates to a more neutral setting as inflation moderates and they gain confidence that inflation will settle back within the target band. On our outlook for a sharp slowing in consumption in H2 2023, the unemployment rate rising to around 4% by year's end and inflation continuing to moderate – ending 2023 at around 4.5% (down from a peak of almost 8%) we see the RBA easing the cash rate back to 3.1% in H1 2024.

Upcoming inflation and wage data prints present a key upside risk

In our view, stopping at 3.6% leaves some upside risk in the near term ahead of the Q1 CPI (late April) and Q1 WPI (late May). The upcoming release of the Q1 quarterly CPI in late April will likely confirm the peak in year-ended inflation while also providing greater detail at the component level and an update on the underlying measures of inflation.

Alan Oster (Group Chief Economist), M: +(61 0) 414 444 652
Alt: Gareth Spence (Senior Economist); Brody Viney (Senior Economist)

Importantly, the read on the magnitude and persistence of domestic pressures gleaned at the component level will be important in assessing the trajectory of inflation as global factors wane. Goods inflation is expected to moderate (or even see deflation) while other components will likely see ongoing volatility – for example fuel and household energy prices – though even then the RBA will be on the lookout for second round effects. The RBA is likely to look through these transitory factors somewhat. Services inflation and other components driven by domestic pass-through of cost pressure and wage pressure will likely remain the focus.

Wage growth will also be important. While the Q4 WPI showed a moderation in the pace of quarterly growth from the strong Q3 data this could be related to some unusual volatility in the measure. Ongoing tightness in the labour market has seen wages pressure continue to build.

Further out, the risks are more balanced

Further out, we see the risk around the RBA holding the cash rate steady until H1 2024 as more balanced. To the upside, a stronger wage response and stickier domestic inflation could push the RBA higher. Though this scenario would likely involve more than just small tweaks to the cash rate. Key drivers of this scenario would likely be a stronger wage response over time in a still tight labour market (with job vacancies still elevated), ongoing strength in rents growth, delayed passthrough from previous cost pressures in the business sector and ultimately stronger inflation expectations.

Downside risk could come from a more significant deterioration in global growth due to a tightening in financial conditions as well as a larger than expected consumer spending response to ongoing pressures to household balance sheets. Slower growth would ultimately see a larger and faster deterioration in the labour market, slower wage growth and a likely faster return of inflation to target.

Table 1: Updated cash rate profile

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

Authors

Alan Oster, Group Chief Economist
Ivan Colhoun, Chief Economist, C&IB
Gareth Spence, Senior Economist
Tapas Strickland, Markets Economist
Taylor Nugent, Markets Economist
Brody Viney, Senior Economist

Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Jacqui Brand
Executive Assistant
+(61 0) 477 716 540

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0) 422 081 046

Brody Viney
Senior Economist
+(61 0) 452 673 400

Phin Ziebell
Senior Economist
+(61 0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Senior Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

International Economics

Tony Kelly
Senior Economist
+(61 0) 477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

Global Markets Research

Ivan Colhoun
Chief Economist
Corporate & Institutional Banking
+(61 2) 9293 7168

Skye Masters
Head of Markets Strategy
Markets, Corporate & Institutional Banking
+(61 2) 9295 1196

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