NAB Monetary Policy Update 15 May 2023

Cash rate likely to pass 4% in the coming months

NAB Group Economics

Key points

- After a sequence of surprises from the RBA in recent months, we are reverting to our baseline expectation from February that the cash rate will rise to a peak of at least 4.1% – which we pencil in for July, though we see some risk the RBA could wait till August.
- Our February call of a likely 4.1% peak in the cash rate was based on three fundamentals: that inflation would remain well above target in the near term; that the economy was displaying considerable resilience; and that a tight labour market would continue to support a pickup in wage growth. These fundamentals all remain evident.
- The key uncertainty for our rate expectations has been the reaction function of the RBA, and monetary policy strategy of the RBA been marked by some mixed signals in 2023. However, it is clear that the near-term balance of risks on inflation remain to the upside, and the RBA is forecasting inflation to only return to the top of the target band by mid-2025. At least one additional rate rise is likely to be necessary to limit the risk this timeline slips any further. We wouldn't rule out the prospect of an additional rise to 4.35% if the data stays stronger for longer.
- Importantly, our rate call is not a response to the recent Federal Budget, which we judge to be broadly neutral in terms of its effects on inflation and implications for monetary policy.
- It remains our view that, as higher rates pass through to household cash flows and the wider economy, the economy will begin to slow more noticeably in the second half of 2023 and into 2024, seeing annual GDP growth slow to below 1% and the unemployment rate begin to rise, reaching around 4.7% in 2024. This makes it an increasingly difficult balancing act for the RBA to manage inflation lower without slowing the economy too much. We continue to expect the cash rate to return to a more neutral setting of 3.1% by mid-2024 as this slowdown takes hold.

Economy resilient despite looming turning point

Strong population growth and rebounding services consumption continue to support the economy despite the growing pressure from higher interest rates and inflation on consumer spending. Retail trade has continued to grow in nominal terms, and the decline in retail volumes in Q1 was contained to goods with cafes & restaurants up 1%. Conditions in the NAB Business Survey are easing but remained well above average as of and capacity utilisation is very high.

This resilience has also been reflected in the strength of labour demand which has seen strong employment growth, and the unemployment rate hover at very low levels since mid 2022. This is supporting incomes with hourly wage growth already running at over 3% in 2022 and set to strengthen this year, with additional wage pressure likely to come from ongoing tightness in the labour market as well as the next minimum and award wage increase.

There are some signs that consumption is softening, including recent soft readings in NAB's internal transaction data. This is consistent with our expectation that the economy will slow this year as higher rates weigh on households. Our full updated economic forecasts will be released on Tuesday 16 May.

Inflation not forecast to return to target until 2025

The RBA's most recent Statement on Monetary Policy (SMP), released following the May Board meeting, forecast inflation to slow from its current 7% y/y (6.6% trimmed mean) to 4.5% (4%) by end-2023, before

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reaching 3% on both measures by June 2025 – implying a further two years of above-target inflation. These forecasts were based on an assumed interest rate peak of around the current 3.85%.

Our own inflation forecasts follow a similar profile. A large part of the near-term moderation is likely to come from easing global goods inflation, as well as easing building costs. However, achieving further progress towards the target in 2024 and 2025 will depend on the services side where the outlook for wages growth, inflation expectations and the resilience of demand will be increasingly important.

For now, inflation expectations remain reasonably well anchored. On wages, we expect hourly wage growth to rise as high as 4% y/y across 2022, before softening as the economy slows and labour market pressures ease. However, there is considerable uncertainty around these forecasts.

RBA's reaction function a key source of uncertainty

Ultimately, the question for the RBA Board is whether they are comfortable with inflation remaining above the target for a further two years. In his most recent speech, the Governor stated that:

> "…the Board is resolute in its commitment to returning inflation to target within a reasonable timeframe. We don't need to get inflation back to target straight away, but nor can we take too long. We are taking a bit more time than some other countries, on the basis that doing so can preserve some of the gains in the labour market. But there is a limit here. If we take too long to get inflation back to target, expectations will adjust and life will become more difficult."

In our view, inflation above target for a further two years is likely to be the very limit of what the Board would consider a "reasonable timeframe". Indeed, given the recent RBA Review recommended the Board focus on achieving the mid-point of the target (2.5%), it may be that reaching only 3% by the end of the forecast period is outside what is reasonable. On this basis, the cash rate would need to be higher than the current level to ensure inflation moderates sufficiently quickly, especially if there are any unwanted surprises on the wages front.

As we articulated in February, a cash rate of 4.1% would be clearly in restrictive territory and would have a material impact on household cash flow. However, assessing the restrictiveness of monetary policy in real time is difficult, and it is a real possibility that an even higher cash rate of 4.35% is necessary to balance the risks on inflation. For now, we see a rate peak of 4.1% as most likely, including because of the RBA's signalled willingness to tolerate a more gradual return to target inflation.

It remains possible the Board will choose to keep rates on hold at 3.85%, accepting a more protracted return to target in return for preserving gains in the labour market and minimising the impacts of higher rates on households. However, such an approach would leave the RBA exposed to considerable risk if the economy is more resilient, wages more responsive or services inflation stickier than expected.

Data flow to shape the timing of decisions

A further rate increase to 4.1% could come as soon as the next Board meeting in June, especially if this week's Q1 WPI release exceeds expectations. However, since April the RBA has shown a preference to move away from monthly moves and accumulate data over larger intervals given it is now a matter of fine-tuning how restrictive policy is under heightened uncertainty.

As such, we see a pause in June as most likely, with a 25bp rise to follow in July when the RBA will have the benefit of both the Q1 WPI and National Accounts releases as well as additional labour force and monthly CPI indicator prints and the National Wage Case decision. Indeed, the Board may choose to hold off on further moves until August, when it will be armed with the full Q2 CPI release and another round of staff updates.

As we have previously said, the longer the RBA chooses to wait the more likely they will begin to see evidence of slowing activity, which may limit the impetus for rates to rise. However, as demonstrated by recent RBA staff scenario exercises revealed through FOI, the trade-off for keeping rates lower is likely to be that rates need to remain restrictive for longer – an outcome the Board would want to avoid.

Rates to return to more neutral level in 2024

It remains our view that, as higher rates pass through to household cash flows and the wider economy, the economy will slow noticeably in the second half of 2023 and into 2024, with annual GDP growth below 1% and the unemployment rate to rise, reaching around 4.7% in 2024. We continue to expect the cash rate to return to a more neutral rate as this slowdown takes hold. Our view is that neutral should involve a small positive real rate. That could be a cash rate of around 3% in nominal terms and we expect to see the RBA cutting to around this level from mid-2024.

Table 1: Updated cash rate profile

	2023						2024			
	May	**June**	**July**	**Aug**	**Sep**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Cash Rate	3.85	3.85	4.1	4.1	4.1	4.1	4.1	3.35	3.10	3.10

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