NAB Monetary Policy Update 2 Aug 2023

RBA on hold for now but one more rise still likely

NAB Group Economics

Key points

- Following the RBA's decision to keep rates on hold at 4.1% for a second consecutive month, we now see only one more increase this cycle, taking the cash rate target to a peak of 4.35% (previously 4.6%). In terms of timing, we see this as likely at the November meeting, following the release of the Q3 CPI.
- With recent data showing a clear trend of easing inflation and slower demand growth, the probability that 4.1% is the peak for the cycle is growing – particularly given the RBA's stated intention to seek to maintain the pandemic-era gains in the labour market.
- However, a number of near-term upside pressures remain likely to challenge the RBA's risk tolerance around inflation – particularly on the services side. On balance, we still see the RBA as likely to take out some additional insurance to ensure inflation remains on track to return to target by mid-2025. That RBA forecast remains a very important anchor for policy movements.
- We continue to forecast very slow economic growth in the second half of 2023 and into 2024, alongside a pickup in unemployment. With rates peaking slightly lower, we have pushed back our expectation for the beginning of rate cuts to August 2024, with the cash rate to return to around 3% in early 2025.

Recent data have shown inflation easing and demand softening.

The recent Q2 CPI release showed inflation continued to moderate to June, exceeding expectations with headline inflation running at 0.8% q/q, down from 1.4% in Q1. Trimmed mean inflation also slowed to 0.9% q/q, down from 1.2% in Q1 (and 1.9% at its peak). While the quarterly growth rate of both the goods and services components eased, market sector measures rose suggesting pressure from an underlying supply and demand imbalance remains.

That said, while some of the moderation in inflation likely reflects the unwind of supply side impacts, there are also clear signs that the past year's rapid tightening in monetary policy is working to slow demand. Nominal retail trade fell 0.8% in June, likely foreshadowing weak Q2 consumption growth in real terms. Dwelling approvals have also fallen (though strong population growth is supporting house prices and rents) and building activity has weakened.

So far the labour market has remained resilient with vacancies still very elevated, jobs growth strong enough to absorb the rebound in population growth and unemployment holding at very low levels as a result. However, labour demand growth typically lags activity and we see unemployment rising over the next year or so.

Upside pressures are still likely to challenge the RBA's inflation tolerance in Q3.

While the Q2 CPI came in slightly below expectations, the post meeting statement indicated this has had little impact on the RBA staff's forecast path for inflation to return to the top of the target band by mid-2025 (and within the band in the latter part of 2025, with the regular extension of the forecast horizon to end-2025). The full staff forecasts will be released in the *Statement on Monetary Policy* on Friday.

Importantly, we continue to expect a strong Q3 CPI print and see ongoing upside pressures, particularly on the services side. Large price rises are expected to take effect in telcos, insurance, council rates and postal services, and significant minimum and award wage increases also took effect on July 1. Rents will also continue to rise strongly as market prices are passed through, while increases in consumer energy bills will initially be offset by government subsidies but will eventually be reflected when these subsidies unwind.

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

Should these pressures see Q3 inflation exceed the RBA's expectations – either in the monthly or the full quarterly CPI prints – this would likely challenge the current forecast path for inflation. This is more likely from the August Monthly CPI print in late September, which has more services components than the July Monthly CPI indicator in late August, which is "goods heavy". Outgoing Governor Phillip Lowe has previously stated that this forecast path represents the limit of what the Board is willing to tolerate and we see no reason for this to change under incoming Governor Michele Bullock.

Only scope for one more rate rise this cycle, most likely in November.

Given the upside pressures on inflation, the near-term risk on rates remains clearly to the upside. Indeed, the August post-meeting statement maintained the warning that "some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe". Nonetheless, with the cash rate now in clearly restrictive territory and the data flow beginning to head in the right direction it is likely that rates are near their peak for this cycle.

Inflation aside, we expect data on economic activity and the labour market to show the economy slowing further over coming months, and the RBA has previously stated an intention to maintain the pandemic-era gains in the labour market as much as possible. As such, the longer the RBA remains on hold, the greater the probability that the current rate of 4.1% is the peak.

On balance, we still see the RBA as likely to take out some additional insurance to ensure inflation remains on track to return to target by mid-2025 as currently forecast. However, the activity data flow is unlikely to provide scope for more than 25bps of rate increases and as such, we now see one further hike to a peak of 4.35%. While the timing will depend on the data, we see November as most likely after the full Q3 CPI release.

Rate cuts to begin in the second half of 2024.

We continue to forecast very slow economic growth in the second half of 2023 and into 2024, with GDP growth likely to be below 1% for both years overall. We also expect a pickup in the unemployment rate to as high as 5% by end-2024. This would represent a significant rise but would still leave unemployment around its pre-COVID level.

With rates now expected to peak slightly lower than our previous forecasts, we have pushed back our expectation for the beginning of rate cuts to August 2024. From there we see gradual cuts of 25bps at each meeting which, due to the RBA's revised schedule of eight meetings per year, should see the cash rate to return to around 3% in early 2025.

Table 1: Updated cash rate profile

	2023						2024				2025
	July	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
Cash Rate	4.10	4.10	4.10	4.10	4.35	4.35	4.35	4.35	3.85	3.35	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

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

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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