7 April 2023

ECONOMIC UPDATE

A pause before another (final?) climb

Key Points

- **The RBA kept the cash rate unchanged at 3.6% following its April meeting;**
- **The main reason for the pause was to gauge how the rate hikes to date are impacting the economy;**
- **But they gave a clear indication that interest rates may need to rise further;**
- **The key piece of data will be the Q1 CPI released on 26 April;**
- **Development in the global economy and financial markets, as well as household spending, will also be important.**

The RBA decided to keep the cash rate unchanged for the first time since April 2022. I agree with its read on the economy. Economic growth is slowing but still decent. Inflation has peaked but remains too high. Despite the better data over recent weeks the outlook is for a weaker global economy over the next year. Global inflation has not declined as quickly as expected. The recent financial market instability is likely to lead to some weakening of the global economy.

After the March meeting, the RBA nominated four pieces of data that would help it determine whether there should be another rate hike in April. One was the labour market numbers that had shown a (modest) rise in the unemployment rate in December-January. The February jobs number was undeniably strong. The RBA though expected a sharp bounce back in jobs growth (for technical reasons associated with changing seasonal patterns influencing the economy).

A second bit of data was business surveys. They indicated that in February firms thought that conditions remained solid, with order books growing at an above-average clip. Firms reported that while price growth was slowing it remained high. That message of slowing but still high inflation was confirmed in the February CPI (the third piece of data).

The fourth was the retail sales figures that indicated that spending rose only modestly in February. Given the backdrop of high inflation much of that rise in spending almost certainly was a result of higher prices (implying a decline in volumes). A slowing of spending on goods has been expected as consumers switch more of their spending towards services post lockdowns. But growth in spending at restaurants also appears to be weakening. This suggests that rising cost of living and increasing interest rates is taking a toll on households.

On balance, those numbers might have argued for another quarter percentage point rate hike in April. This is particularly the case given that Australia's cash rate is currently comfortably below that of comparable countries (such as the US, UK, New Zealand and Canada).

Interest rates in this cycle both domestically and globally have risen at its most aggressive pace since the early 1990s. The aggressive rate hikes followed a decade of low (and declining) rates. This sudden change in the direction of interest rates was always going to have some impact. Most recently it was the turmoil in financial markets from issues surrounding banks in the US and Europe. Last year it was problems in the UK bond market (exacerbated by a controversial budget). To date there have been few problems in the domestic economy or financial market. But we are 6 -12 months away from understanding what the full impact of the rise of interest rates to date will have on the domestic economy.

One impact of the recent turmoil in the US banking system is that it could lead to tighter lending standards by smaller and medium sized banks as they are being more heavily hit by the recent turmoil. In turn this could lead to slower credit growth in the US. This is the key reason why the Federal Reserve and financial markets are now expecting less rate hikes in the US than they were at the start of March.

Some tightening of lending standards is probable in the US, but bank lending standards always tighten as the US economy weakens. In anticipation of a weaker economy lending standards have already tightened a fair bit. The larger US banks could fill some of the credit growth gap.

What happens to interest rates from here? I suspect concerns about global banks will settle down given the recent announcements in the US and Europe. If that is right the outlook for interest rates will return to the inflation outlook.

On that count the risks are that (as the RBA noted in its post meeting-statement) interest rates may need to go higher. The rise of inflation has mainly reflected global factors. In other countries further advanced in the rate hike cycle inflation has declined from its peak but remains too high. The economic numbers have surprised to the high side in many countries over recent months. While the inflation numbers have been more mixed, they also have not declined as fast as central banks had hoped. And as noted in previous research historically, it usually has taken at least a couple of years for inflation to decline back under 5% once it goes above that mark.

The uptick of house prices over the past couple of months may have taken away one economic negative from the impact of rising interest rates. We will see whether that bounce in house prices is maintained. The recent global turmoil did not stop other central banks (such as the Federal Reserve, ECB and BoE) increasing interest rates when financial market volatility was even higher.

But rising interest rates has already had notable global economic and financial market impacts. As the RBA noted, we have yet to see the full impact of the rate hikes that have taken place. And the higher interest rates go, the bigger the possible economic and financial market impact.

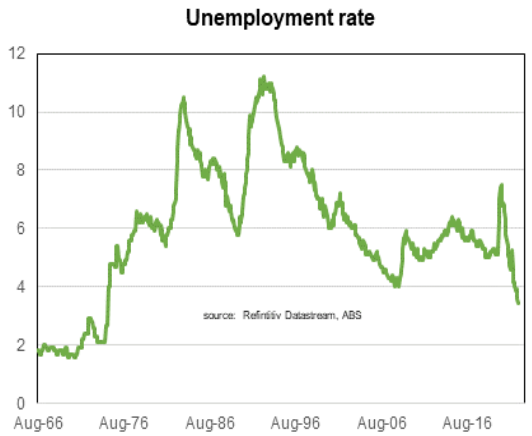
I think that domestic and global interest rates are already high enough. But I can understand that the RBA could be more risk averse than me on the inflation outlook. This means that while interest rates may have peaked, borrowers (and savers) should be prepared for the possibility for another 1-2 quarter percentage point rate hike in the coming months. The recent financial market turmoil though is a signal that interest rates do not need to go substantially higher.

Thereafter I think that the RBA would prefer that the cash rate remain at its peak level for some time (12-18 months) to ensure that inflation returns towards 2-3. The current high level of job vacancies suggests that there is unlikely to be any imminent rise in the unemployment rate.

At the time of writing financial markets had a different view. They think there is some chance that there could be one more quarter percentage point rate hike in coming months but that is far from a done deal. Indeed, financial markets central-case view is that we have already hit ‘peak cash rate’ and think there could be 1-2 quarter percentage point rate cuts by early in the second half of next year.

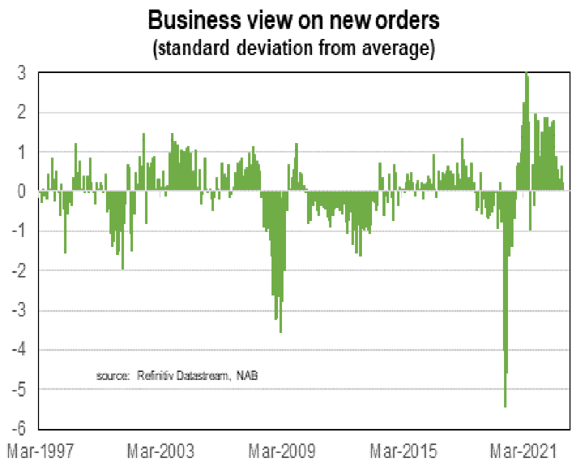
It should be noted that financial market views on the interest rate outlook have turned on a dime this year. Following an unexpectedly aggressive statement about the need for higher rates from the RBA in February, markets had priced a peak cash rate of 4 - 4.5%. At the peak of concerns about global banks markets had priced in the potential for 2 - 3 rate cuts by the first half of next year. Now investors’ views are somewhere between the 2. Where the cash rate lands will depend upon the economic data and financial market performance in coming months.

The unemployment rate remains extremely low.

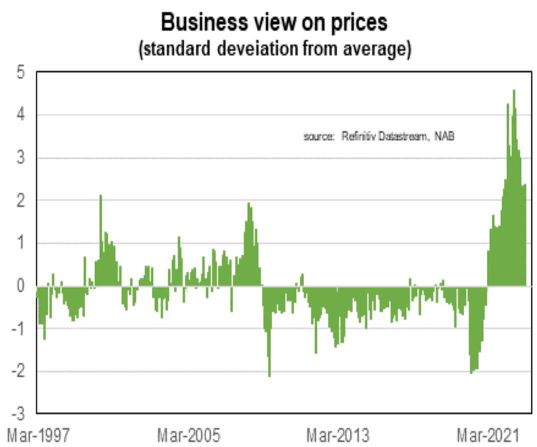


Job vacancies while declining remain very high.

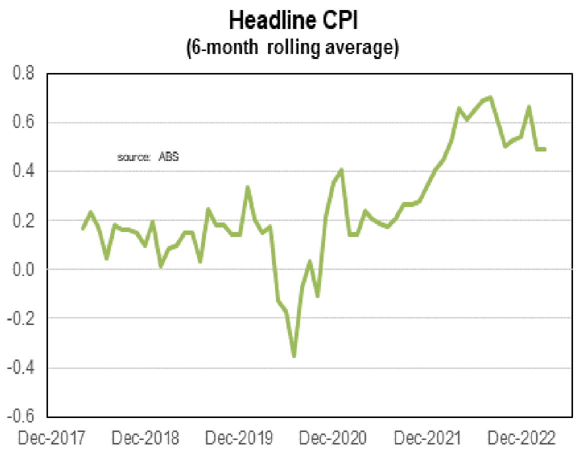
Order books continue to grow at an above rate.



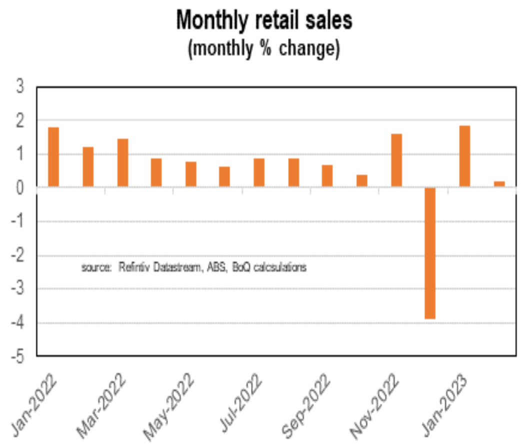
Firms report that price growth is slowing but remains too high.



This is consistent with inflation in the wider economy.

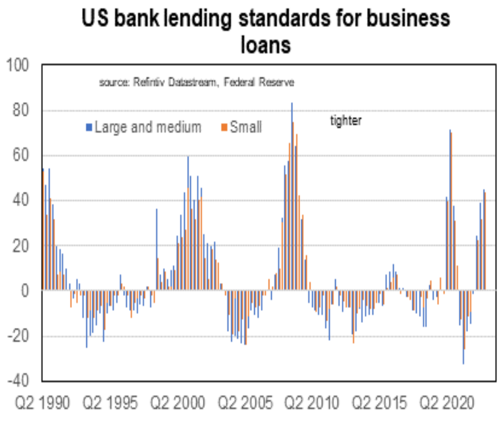


Retail spending growth has been slowing over the past year.

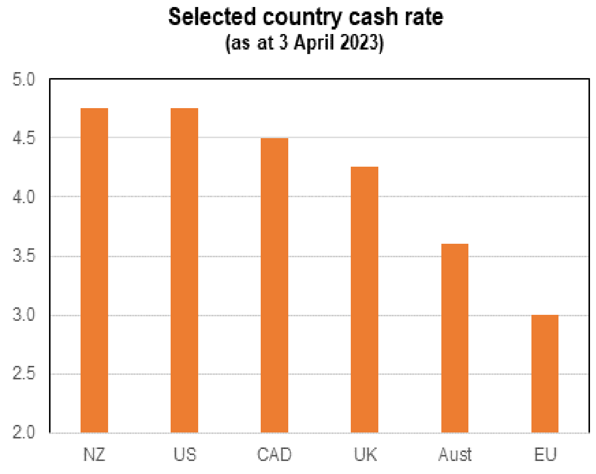


There has also been a softening of the growth in spending at restaurants.

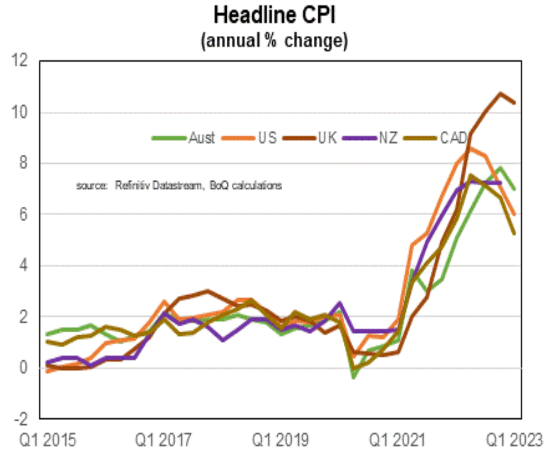
US bank lending standards had been tightening even before the recent market turmoil.



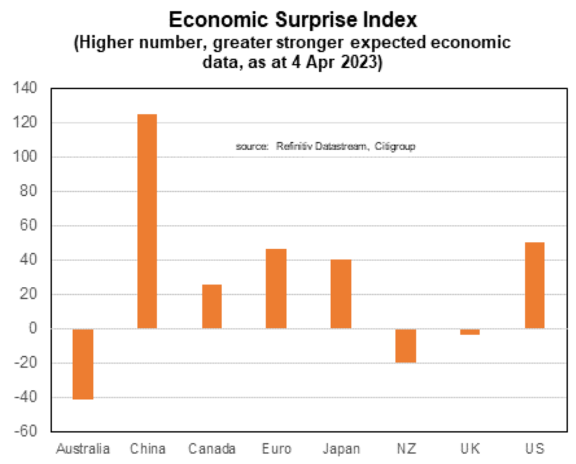
Australia's cash rate is low by peer country standards.



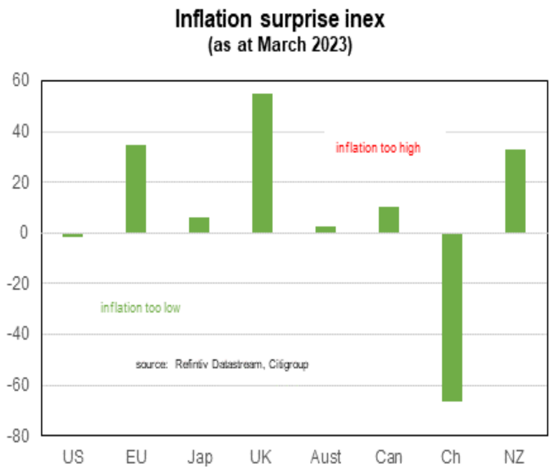
Inflation is declining globally but remains well above central bank targets.



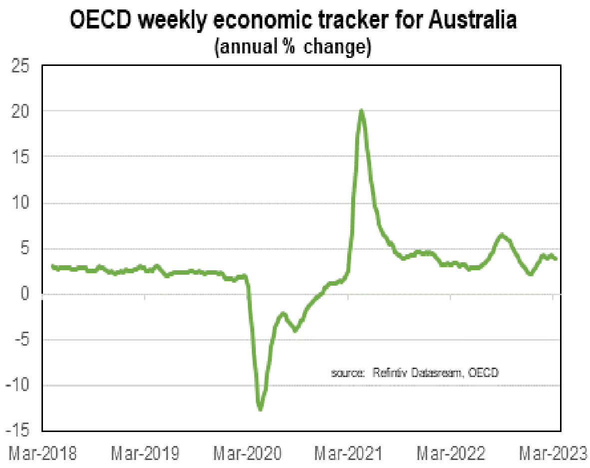
The economic data has been stronger than anticipated in most major economies.



The inflation data has been a little more mixed relative to expectations.

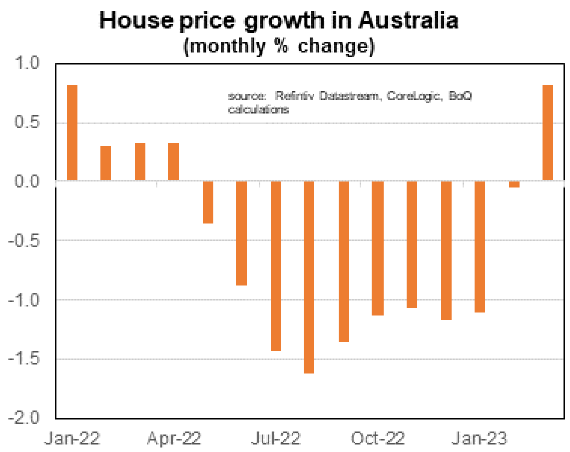


OECD data suggests that domestic economic growth remains solid.

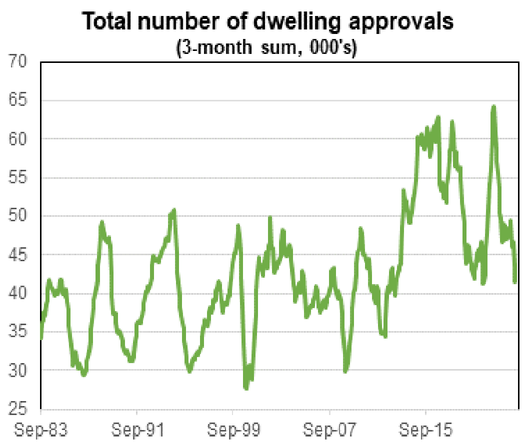


Financial market volatility is elevated albeit a step down from the level of a couple of weeks ago.

House price growth has picked up over the past couple of months despite the rise of interest rates.



High interest rates is one factor impacting the supply of new dwellings.



We really do live in interesting times.

Regards

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