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10 February 2023

INTEREST RATE UPDATE

Closer to the peak

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Key Points

- **As widely anticipated, the RBA raised the cash rate by 0.25% at its February meeting;**
- **High inflation was a key driver of the rate hike;**
- **The RBA made minimal changes to its economic forecasts;**
- **The Statement released following the meeting suggested that there are more rate hikes to come.**

What happened at the February meeting

As expected, the RBA increased the cash rate by 0.25% at its February meeting (taking it to 3.35%). The reasoning was expected: the economy is doing OK, and inflation is too high partly driven by domestic demand.

The headline economic forecasts have not been changed significantly (a full update will be released with the February Monetary Policy Statement). Inflation is expected to be 4.75% by end 2023 and 3% by end-2024. GDP growth is forecast to be around 1.5% both this year and next. The unemployment rate is expected to rise only a touch by the end of this year (to 3.75%) and to 4.5% by mid-2025. My forecasts are pretty close to those of the RBA for this year, although I think the economy might be weaker (and therefore the unemployment rate higher and inflation lower) by the end of next year.

The RBA changed its outlook paragraph from saying it 'expects to increase interest rates further but is not on a pre-set course' in December, to 'expects further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target, and this period of high inflation is only temporary' following its latest meeting. I take this as a signal that another rate rise next month is very likely, with a good chance of at least one more a month or two after.

The main reason for the change would have been that the underlying inflation measure in the December quarter was clearly higher than the RBA anticipated. They are concerned that if inflation stays too high for too long then it will become difficult for them to reduce it back to their 2-3% inflation target.

If the RBA forecast of inflation of almost 5% and only a modest rise in the unemployment rate come true, there is little chance of a rate cut this year. Indeed, an inflation forecast of 3% by mid-2025 suggests minimal chance of a rate cut prior to 2025.

Key economic questions

The answers to a number of key questions will determine the economic (and therefore interest rate) outlook.

Inflation will almost certainly decline from here. But how quickly will it decline, particularly 'underlying' inflation?

Both the headline and 'underlying' Q4 CPI data were higher than financial market expectations, with the underlying number also higher than the most recent RBA forecast (headline inflation was lower). While it is probable that goods inflation has peaked, service-sector inflation will most likely move higher this year. On six of the nine occasions that inflation has been higher than 5% over the past one hundred years, it has taken more than one year for inflation to fall back below 5%. The decline of global inflation though

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has been quicker than expected over the past couple of months, although it is not yet clear whether it will be enough to get inflation back towards 2% quickly.

How quickly will rising interest rates slow the economy?

The economy has already slowed. Partly, that reflects spending patterns returning to 'normal' (resulting in higher demand for services, lower for goods). But declining real wages growth and rising interest rates has made its mark on household spending (evidenced in the decline in retail trade spending after allowing for inflation in Q4). There was also some moderation of business investment in the December quarter as firms grew a little more cautious about the economic outlook. The impact of the 'fixed-rate mortgage cliff' will become increasingly evident over the next six months. But households without mortgages and/or those with higher-incomes are still spending. Many consumers have built up substantial saving. The jobs market remains strong. The anecdotal evidence from the start of the year suggests that consumer spending growth remained reasonable, notably on travel and entertainment.

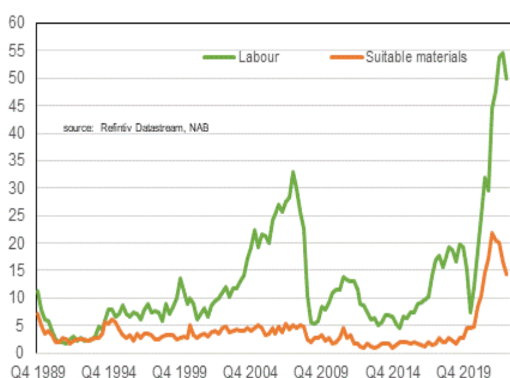
How long will it take the unemployment rate to rise?

Rate cuts are unlikely to take place unless there is a rise in the unemployment rate. The jobs market has clearly turned. Vacancies have declined from their peak and worker confidence in the jobs market has softened a little. The supply of workers (immigration) has risen. Nonetheless, the feedback from firms was that it remained significantly harder at the end of last year to find workers than it was during the peak of the mining boom. Even with a substantial slowing of the economy, a rise in the unemployment rate is unlikely until well into the second half of the year (in line with the RBA's forecast). The unemployment rate in the US remains near decade-lows despite a weakening economy.

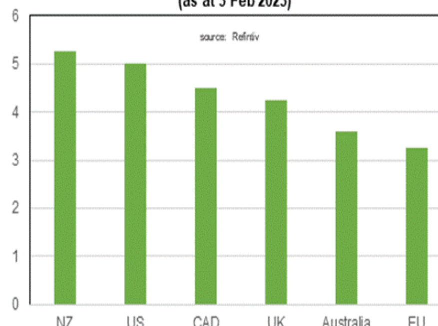
What is the outlook for wages growth?

One indicator that all central banks are watching in determining their view of the inflation outlook is wages growth. The official data indicates that wages growth has picked up although so far it remains consistent with the RBA's inflation target. Other indicators (such as the Seek index) show a higher level of wages growth although that growth has not got noticeably faster over the past year despite the very tight jobs market. Growth in the ABS total wages index (a proxy for firms' wages bill) slowed in Q4 (at least partly reflecting slowing jobs growth). The next big wages data will be released on the 22nd February (Wages Price Index).

Labour shortages are starting to ease but will be some time before they return to pre-COVID levels



Financial markets believe that the peak of the cash rate in Australia will be below that of peer countries.



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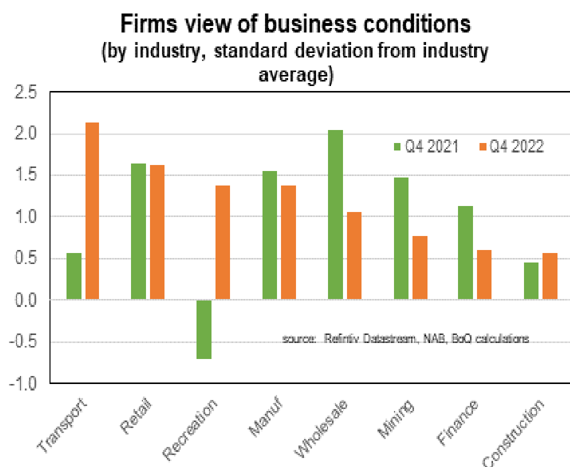
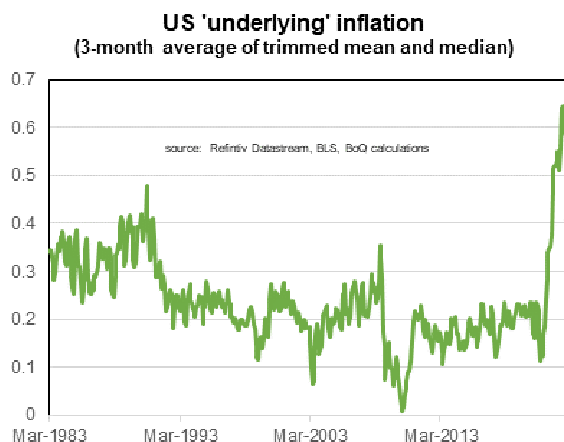
Business conditions have improved for most sectors over the course of 2022.



Inflation in the US has dropped sharply in recent months.



The growth of firms' wages bills slowed in the last quarter of 2022.

The pace of wages growth to date is consistent with the RBA's inflation target.

The bottom line

I had been thinking that the RBA would sit back and keep rates on hold at its March meeting to see how the economy had absorbed the rate hikes to date. But the Statement released following its February meeting strongly suggests that another rate rise is probable at the March meeting. And that there could be further rate hike(s) in following months.

As a result, I have bought forward the quarter percentage point rate hike that I had pencilled in for April to March. For now, I have not changed my view that 3.6% will be the peak in the cash rate in this cycle. I say that on the view that global inflation is slowing, and so the global pace of rate hikes will continue to moderate in coming months. Domestic economic growth is also slowing, and I don't expect wages growth

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to be a medium-term inflation concern. If those assumptions are wrong then at least another rate rise becomes likely.

Clearly the higher that interest rates go, the more likely there will be a sharper slowing of economic growth. Indeed, after the interest rate announcement financial markets began pricing a bigger chance of a rate cut before the end of this year. If Australia's economy slows very sharply (as well as inflation) then that is a possible scenario. But I agree with the RBA that the strength of the labour market means that any rise in the unemployment rate this year is likely to be modest. And inflation will probably still be too high.

Australia's cash rate has been priced to be lower than peer countries in this cycle. The cash rate peak is seen to be higher in both New Zealand and Canada despite both those countries having similar economic vulnerabilities to Australia (high household debt ratio and high house prices). The cash rate is also projected to be higher in the UK despite the consensus view that the UK will enter recession this year and Australia won't (the UK does have a bigger inflation problem). The European cash rate is expected to be only a notch lower than for Australia despite being a low economic growth/low inflation economy for the past decade (they also have a higher inflation rate than Australia). Hence the risks that the peak Australian cash rate could be higher.

The relatively low peak of the Australian cash rate also suggests the risk that any domestic rate cut could lag those in other countries. Also, after getting their inflation forecast wrong last year the RBA (and other central banks) will want to be certain that inflation is within 2-3% before thinking about easing monetary policy. All of this suggests that rate cuts are unlikely this year, and probably won't take place until at least the middle of next year.

Before we can talk seriously about rate cuts, we have to be certain that interest rates have peaked. And that will only occur once it is clear that inflation is back within 2-3%.

We live in interesting times.
Regards

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