7 November 2023

INTEREST RATE UPDATE

The Last Dance

Key Points

- **The RBA increased the cash rate by a quarter percentage point at its November meeting (taking the cash rate to 4.35%);**
- **The rise was widely anticipated by economists (less so by financial markets);**
- **While another rate rise is possible, I think we have hit peak cash rate for this cycle;**
- **Based on the RBA's updated forecasts a rate cut is very much a 2025 question.**

RBA decision

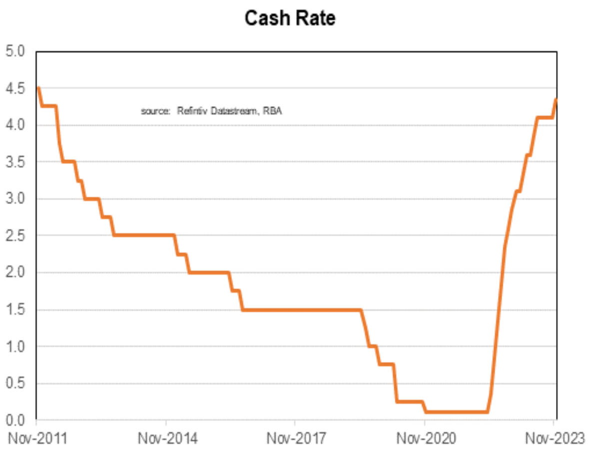
As widely anticipated by economists, the RBA raised the cash rate by a quarter percentage point at its November meeting. The cash rate is now at its highest level since November 2011. The explanation for the increase in interest rates was straight forward. The RBA noted that the economy is slowing due to weaker consumer spending and lower dwelling investment. And that the full impact of previous monetary tightening has yet to be felt. Although, the Q3 CPI figure was higher than anticipated and the economy this year has done a little better than expected.

Based on how the economy has developed over the past 3 months, the RBA has made some (modest) changes to its forecasts. Inflation (presumably headline) is now expected to be 3.5% at the end of next year, a little above the previous forecast. The strength of the jobs market has meant that the unemployment rate next year is projected to be a little lower.

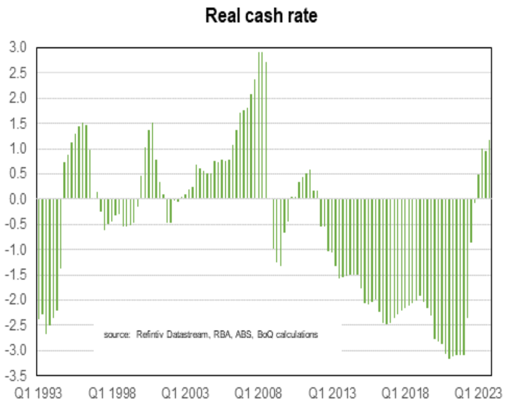
Going into the meeting financial markets were priced a bit over 50% for a rate change. Accordingly, it would be expected that money market yields would have risen and the $A appreciated following the announcement of a rate rise. The reverse happened. I put financial market reaction to a slight (but apparently important) change to the first sentence of the last paragraph in the announcement. Instead of ‘Some further tightening might be required", the new sentence starts off with "Whether further tightening of monetary policy is required".

At face value that change is suggestive that we could be at the peak of the cash rate in this cycle, and if there are any more rate hikes to come, there are unlikely to be many of them. Such a change is consistent with the evolving views of global central banks. As discussed further below, I also think it is the right call.

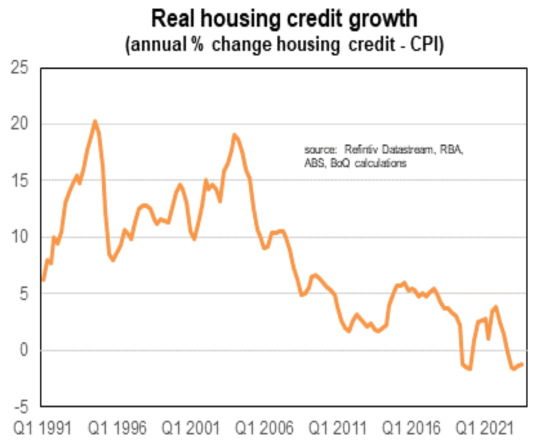
The cash rate is at its highest level in 12 years.



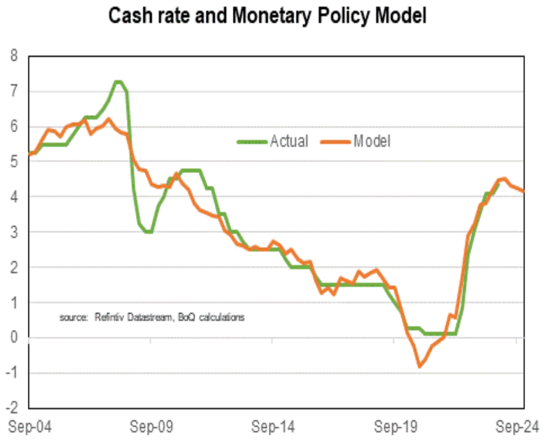
My measure suggests that the ‘real' cash rate is at its highest level since pre-GFC days.



This is the reason why housing credit is negative in ‘real’ terms.



The cash rate is about where it should be given the ‘fundamentals’.



Decent economic growth has played a role in higher inflation

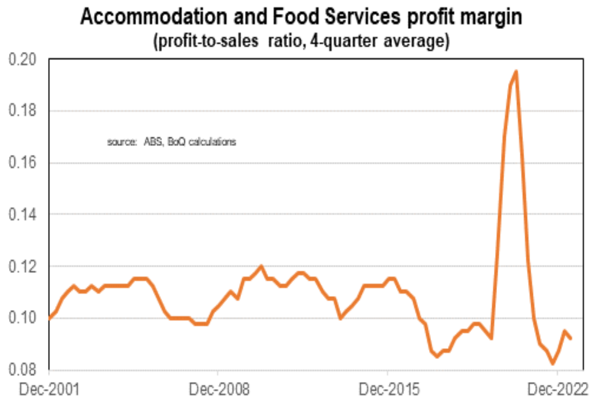
The increase in interest rates is working to reduce demand in the economy. This is most obvious in the decline in consumer spending per person, the reduction in demand for workers (declining job vacancies) and the fall in building approvals.

Nonetheless, demand in the economy has held up a little better than expected and has played a role in the recent upward inflation surprise. The recent retail sales report indicates that consumer spending hasn’t fallen off a cliff despite the high cost of living and rising mortgage payments. Firms’ report that conditions remain above their long-run average.

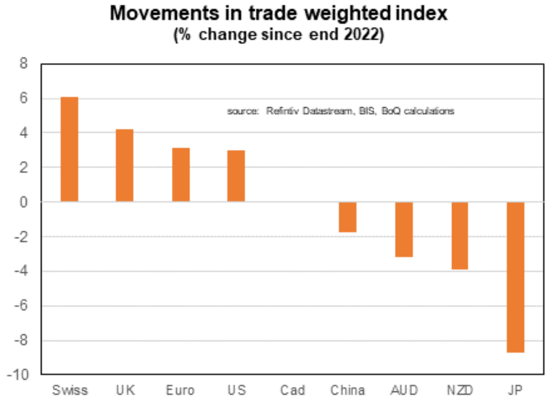
Factors that have underpinned the economy include:

- population growth has not only been strong but faster than what had been expected. This has boosted demand for housing as well as putting a floor under household spending;
- service-sector spending (notably restaurants and travel) continues to benefit from a mountain of saving and a catch-up spending from COVID lockdowns;
- high levels of capacity utilisation and above average profit growth has underpinned strong business investment;
- fiscal policy has been a lot more supportive of the economy in this cycle. This has been particularly the case in the states. Operating budget deficits are larger than usual in some states and significant infrastructure programs are taking place in virtually all states;
- interest rates have been lower than in comparable countries leading to a decline in the $A;

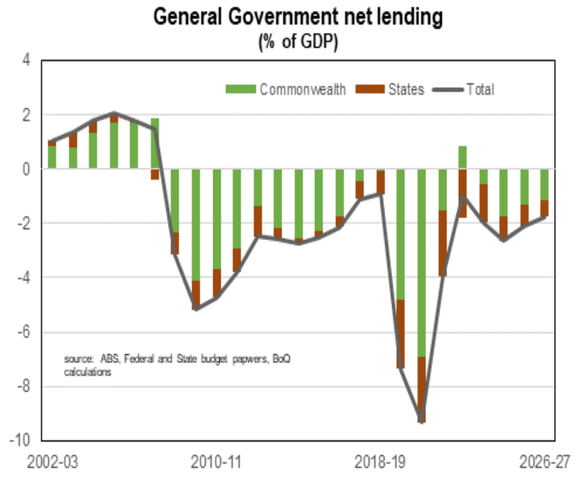
Margins in hospitality are low, with firms unable to absorb higher labour costs.



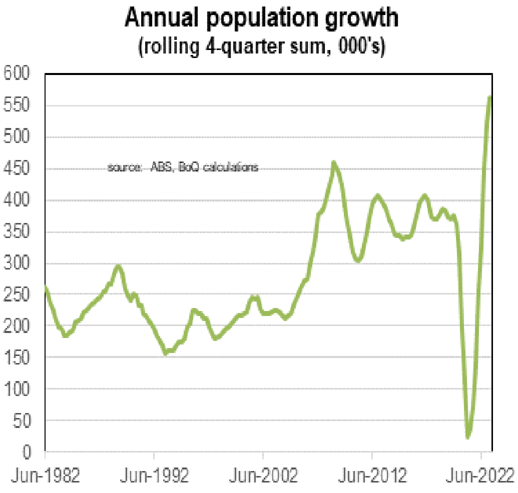
Low Australian interest rates has weakened the $A.



Fiscal policy is more accommodative than the last time the unemployment rate was low, particularly the states.



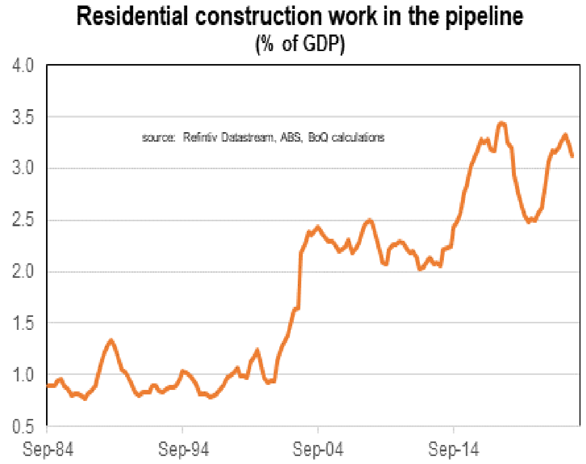
Population growth has been a lot stronger than expected.



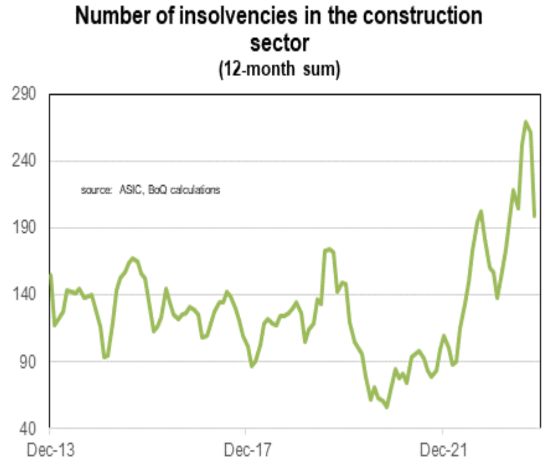
Supply issues are also still playing a role in driving inflation:

- oil prices have risen by around 1.5% this year, mainly as a result of OPEC countries reducing supply;
- material shortages in Australia have not declined as quickly as they have globally;
- despite big increase in the supply of workers, strong demand for labour means a shortage of skilled workers remains the number one issue for firms;
- in aggregate wages growth has not played a significant role driving inflation in this cycle. But sectors with low profit margins (such as Accommodation and Food Services) would have found it difficult to absorb the rise in labour costs (including the recent Minimum Wage increase);
- high insolvencies amongst builders has been a factor in the slower-than-usual rate of housing completions (driving up rents);
- electricity prices are still playing catch-up to the boost to energy commodity prices principally caused by the Russia-Ukraine War;
- a shortage of airline flights at a time of strong demand for tourism.

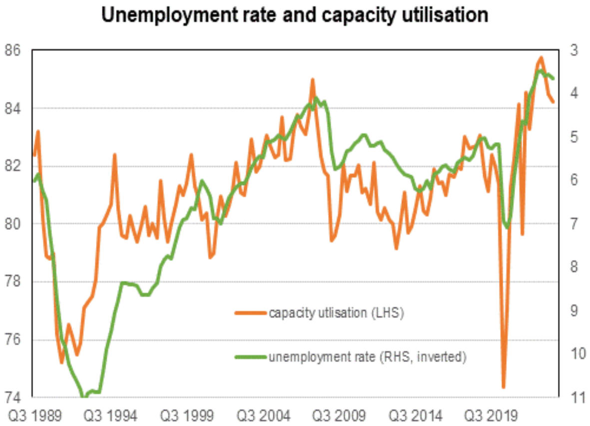
Supply-chain problems and worker shortages have held up supply of new homes.



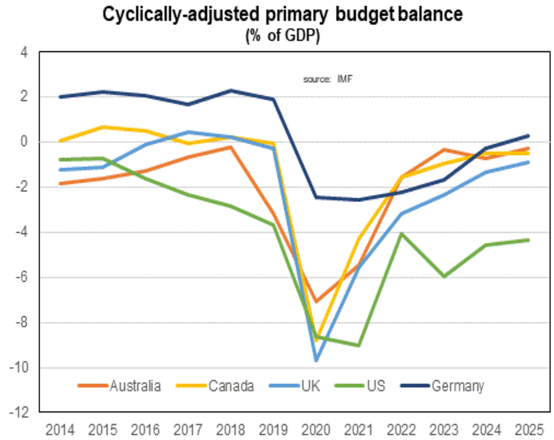
As have the high number of builder insolvencies.



The economy is operating at a high level of capacity although growth is slowing.



Fiscal policy has been less supportive in Australia than many other countries (notably the US).



Outlook

The RBA changing interest rates will do little to improve supply (indeed in areas such as residential construction it is a negative). The key questions are how important is supply factors relative to demand in driving inflation and how long will the supply problems last?

Clearly if demand is the biggest driver of inflation, then interest rates need to go higher. If the supply problems are the key driver of higher prices and are expected to last only a little longer (6-12 months) then no change in rates is probably the right decision. But if the supply problems are viewed as longer-lasting (longer than 18 months) then to ensure that inflation remains sustainably low demand must decline to match the lower level of supply.

According to RBA analysis, the majority of the original increase in inflation was due to supply problems. Also, the majority of the decline of inflation so far this year has been due to the resolution to some of those supply problems. The RBA analysis suggested that supply problems will be largely resolved by end-2023 leaving much of inflation forecast at that point (around 4%) to be largely driven by demand factors.

Clearly the housing shortage (which is caused by a mix of very strong demand and not enough supply) won't be resolved any time soon. But I agree many of the other supply problems should be resolved by this time next year. Even without the additional rate hike after the November meeting, I think it is probable that demand would have slowed enough to ensure that inflation returns to 2-3% by 2025.

But the RBA can't be certain. The Q3 CPI number was higher than they had forecast. Population growth has been stronger than anticipated. The biggest hit to consumer disposable incomes from higher inflation will be in the rear-view mirror next year. Most concerningly, inflation expectations are not consistent with the 2-3% target band. For all of these reasons it was understandable that the RBA hiked rates again.

In my view there will be three determinants of the cash rate outlook from here: is inflation coming down in line with (the updated) RBA forecasts, what is happening with the unemployment rate and what are the movements in global cash rates (particularly in the US).

Historically it has been a multi-year fight to get inflation down once it has been this high for this long. In that historical context central bank forecasts (including those of the RBA) of inflation returning to the 2-3% band in 2025 look about right. Given how long inflation has been above 3% if inflation again moves notably above RBA forecasts another rate hike could be on the cards.

Global inflation movements in recent months provides some comfort that there are further notable declines in the domestic inflation rate to come. I also think a rate hike is more necessary when forecasts are missed when inflation is well above the target band (say, above 4%). I think the RBA might be more comfortable to be patient with inflation misses when (underlying) inflation is in the 3's given that it is much closer to target (although it would depend upon the size of the miss).

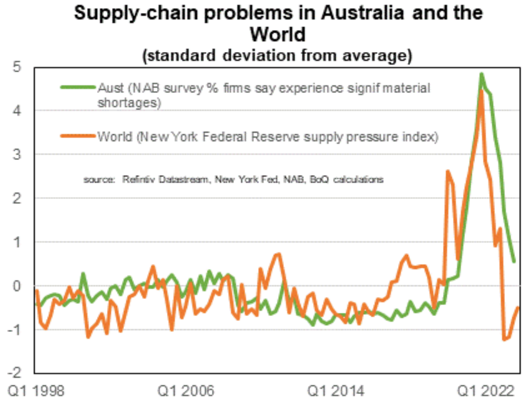
In my view the unemployment rate will need to top at least 4% before the RBA may even start to think the economy could do with monetary policy support. The way the economy is currently performing suggests that this is unlikely to happen until at least H2 2024. Although slowing, the demand for labour remains strong. The unemployment rate remains close to fifty-year lows despite the big rise in the supply of workers.

The global economy is in better shape than expected given the very aggressive rate hike cycle. A big factor has been the performance of the US economy that has been boosted by extremely strong fiscal support. But there are reasons to think the US economy may slow next year (e.g., there has been a notable tightening in bank lending standards). The European economy is struggling. The Chinese Government is actively trying to get its economy to do better.

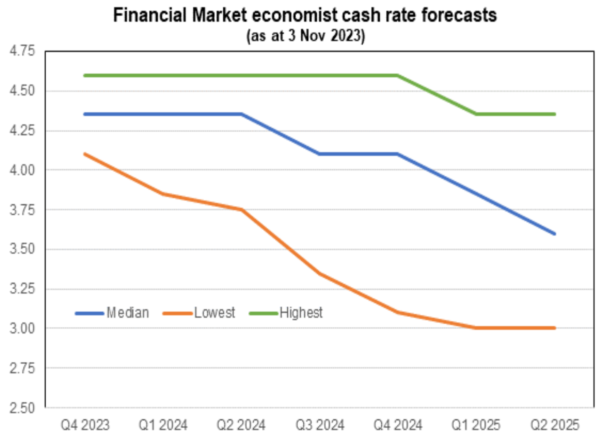
Financial markets are currently pricing rate cuts in major markets to start in Q2 next year (Europe). We are unlikely to be hiking rates if cash rates are declining in the rest of the world. But the Australian cash rate lagged the rest of the world on the way up and is likely to do the same on the way down. We opened our borders later than most others. And both the level and change in the cash rate has been lower than for global peers.

Financial market long-term inflation expectations are their highest in ten years.

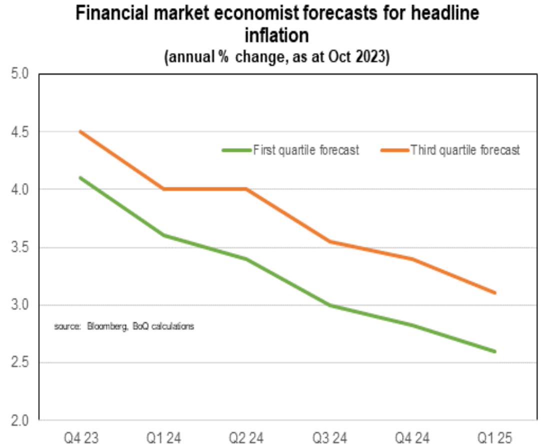
Supply chain problems have taken longer to resolve in Australia than in major economies.



Before the November meeting, almost all economists expect one more rate hike. The median expectation is for rate cuts to start in Q3 2024.



Inflation is unlikely to be at the RBA's target until well into the second half of next year.



Bottom line

Most economists think we have hit the peak in cash rates although there is the risk of one more at some stage in the first half of next year. No economist has a rate cut pencilled in before the second half of next year. Financial markets agree with economists about the cash rate outlook for H1 2024 (i.e., a bias for another rate hike). But investors' have not priced any rate cuts as far as the eye can see.

I think the RBA is done (although I have said that before). Until inflation moves below 4% the risks remain tilted towards another rate hike. The inflation rate will also be the major constraint on the timing of rate cuts. I now think rate cuts are most likely to start in H1 2025. It is only by then that I think we will have seen at least two consecutive quarters of 'underlying' inflation readings consistent with the 2-3% inflation target.

We really do live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | 255 George Street Sydney NSW 2000

Twitter: @petermunckton