9 October 2023

ECONOMIC UPDATE

The extended pause

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Key Points

- **The RBA kept the cash rate at 4.1% at its October meeting;**
- **That was not a surprise given the run of economic data;**
- **There remain good reasons to think another rate hike may yet be on the way;**
- **The Q3 CPI data released on 25 October will play a crucial role in determining whether there will be a rate rise in November.**

The jobs market has been strong

There was no surprise in the RBA decision to keep the cash rate at 4.1% following its October Board meeting. It would have been slightly embarrassing for the previous Deputy Governor in her first meeting as Governor to have hiked rates after two weeks in the job, given that she was part of the decision-making process that had kept the cash rate unchanged at the preceding two meetings.

Concerns about optics though would not have stopped the Board raising the cash rate. But not enough had happened in the domestic and global economy to change the RBA's view that inflation was on track to hit the 2-3% inflation target by their end-2025 forecast. Economic growth is at a reasonable, but below trend pace. In aggregate both the domestic economic activity and inflation numbers have been coming in a little below consensus views.

There have been interesting trends developing beneath the aggregate movements. A notable feature of the current economy is the very different views both between and within the household and business sectors about the state of their finances.

The jobs market has weakened modestly highlighted by the rise in the underutilisation rate. In my view, that increase mainly reflects the big rise in the supply of workers (record high participation rate, record high number of people working multiple jobs, strong immigration growth). The demand for workers while down from its highs in 2022 remains at historically high levels.

We will find out the quarterly CPI towards the end of October (25th), but the August monthly number and survey data suggests price pressures remain in the economy. House prices continue their rise despite the financial constraints facing a good portion of households.

The US economy continues to surprise with strength, the Japanese economy is in a good place and some of the economic news out of China has been a bit better in recent weeks. Europe is the prime economic region of concern (notably Germany). Commodity prices rose through much of September, although they began to decline towards the end of the month. That most likely reflected concerns about the impact of the rapid rise of bond yields on global economic growth. In turn the rise in bond yields reflected better-than-expected economic growth.

The AUD/USD exchange rate declined a little over the course of the preceding month, largely reflecting the strength of the $US. The AUD was broadly unchanged when measured against the currencies of all our major trading partners.

Despite the Federal Budget surplus, fiscal policy (as measured by the federal and state non-financial public sector cash balance) is projected to contribute a little more than it usually would at this time of the economic cycle. Mostly this reflects the large infrastructure programs of many states (although a number of states are running larger-than-usual operating budget deficits). By my (and the RBA's) calculations, monetary policy is acting to constrain domestic demand (although current bond market pricing suggests something different).

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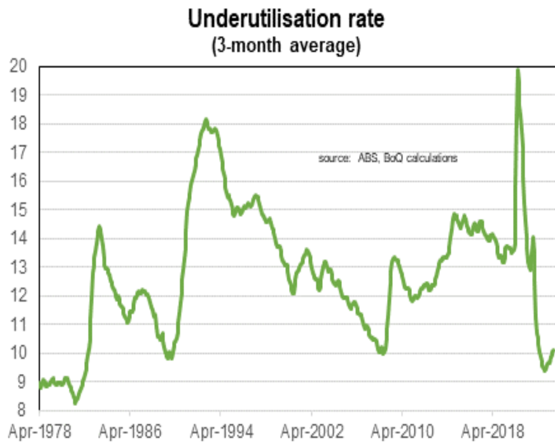
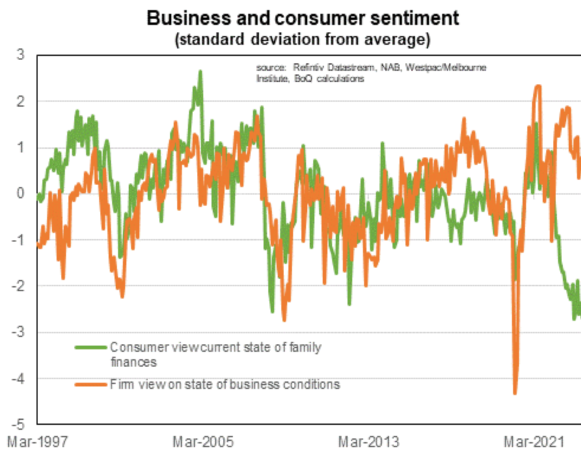
There has been a pickup in the underutilisation rate.

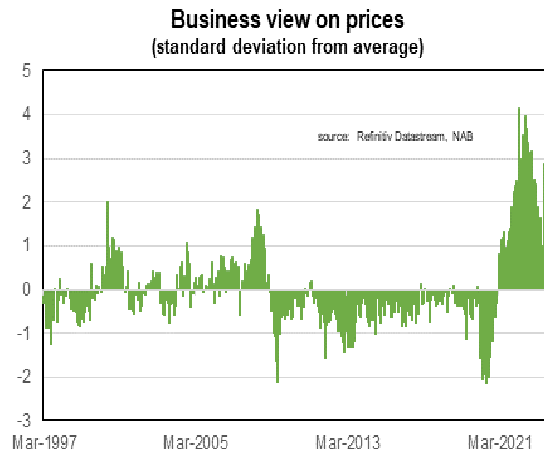


The demand for labour slowed but remains strong.

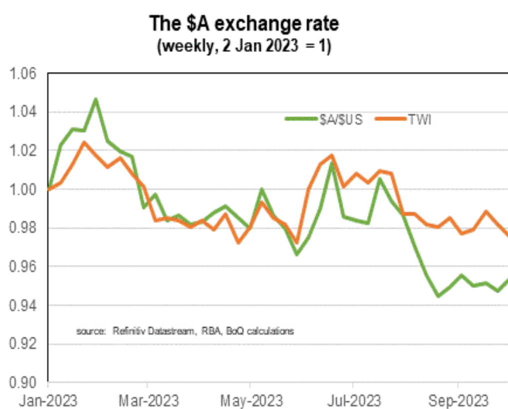
There is a big difference in sentiment between the business and household sectors.



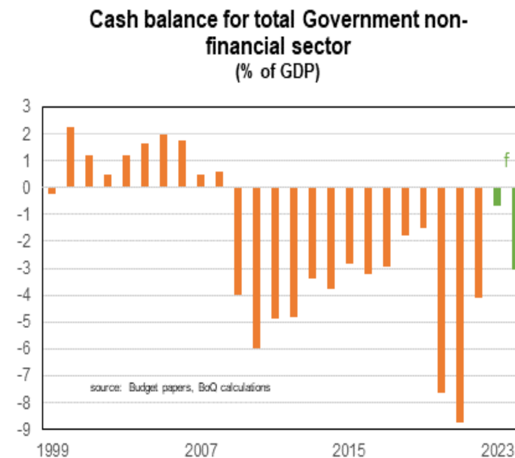
The feedback from firms is that there is still plenty of pricing pressure in the economy.



The recent decline in the AUD mainly reflected a strong $US.



Fiscal policy is contributing a little more to the economy than it did in the pre-GFC boom.



With the domestic and global economy slowing but still OK, a strong jobs market and price pressures still evident, there remains a strong chance that the RBA will feel the need to raise rates again.

Views on whether another rate hike is needed is mixed. In recent months, financial markets have flip-flopped from fully pricing in another quarter percentage point move to fully pricing in no chance of another move (at the time of writing, there was just over a 50% chance priced for one more quarter percentage point rate rise). Financial-market economists are evenly split as to whether another rate rise will be required.

I have been of the view that the most likely timing of another move would either be in November (following the Q3 CPI release) or in December (after the Q3 wages data). The thinking is that those pieces of data would indicate that inflation pressures were still uncomfortably high. With the unemployment rate near fifty-year lows and Australia's cash rate below that of peer countries, another rate rise would be necessary. A rate rise in 2024 was considered a less likely possibility. The thinking was that if a rate rise had not happened by end-2023 it was because economic growth had slowed enough to be confident that inflation was on track to hit 2-3%.

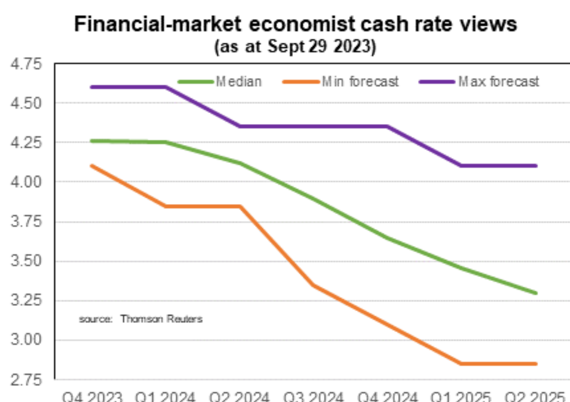
I am not alone in this view. Virtually all financial market economists who have pencilled in another rate hike expect the move to come in either November or December.

But at the time of writing financial markets are priced for a different outcome. A decent chance of a rate change in November/December is priced. But financial markets expect the most likely timing of the next rate rise will be in February-August next year. One interpretation of financial market pricing is that the last one percentage point (or so) decline of inflation will be hard to achieve. Service-sector inflation might prove to be 'sticky' (as it has been in a number of other economies). The ongoing strong demand for workers could minimise any rise in the unemployment rate in the first half of the year. This view has gained support from the growing 'higher for longer' mantra for global cash rates.

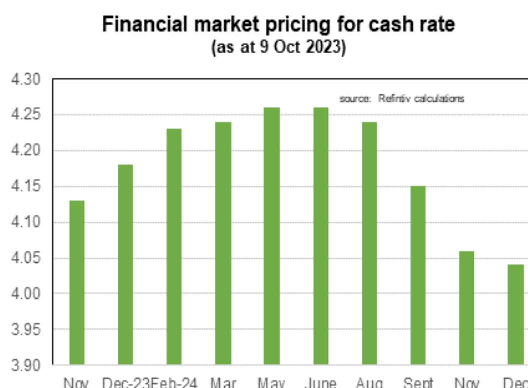
This scenario is not unreasonable and can't be ruled out. There have been times historically when there has been a gap between the bulk of the cash rate moves and the final one or two rate changes in a monetary policy cycle. For example, in the mid-1990s the cash rate was cut by 2.5% between July 1996 to July 1997. A final quarter percentage point rate reduction then took place in December 1998 (admittedly as a result of the Asian debt crisis).

For now, I am keeping with my view that the most likely timing of a rate hike will be November/December. The Q3 CPI number (released 25 October) is the main piece of data that will determine whether a November rate change is likely.

Economists more likely expect a cash rate rise at the end of 2023.



But financial markets are indicating that if a move happens it will be in the first half of 2024.



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One thing all this discussion about the potential for more rate hikes is to reduce thoughts about the possibility of imminent rate cuts. Financial markets have removed any chance of a cash rate decline in Australia in 2024. No rate cuts until 2025 is consistent with the current RBA inflation forecasts (as well as that of most other central banks). By contrast all but one economist expects a rate cut before the end of next year, with two-thirds predicting multiple cash-rate reductions.

I think the first rate cut will be in Q4 2024. This reflects that I have a lower economic growth forecast than the RBA (as well as the consensus) and therefore a lower inflation forecast for 2024. If the economy though turns out to be stronger than I expect (and more in line with RBA thinking) then the chance is that inflation will turn out to be higher than my current projections. And the timing of any rate reduction almost certainly would be pushed into 2025. Good news for the economy would mean bad news for borrowers.

We really do live in interesting times.

Regards

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