Friday, 10 February 2023

RBA Statement on Monetary Policy

Wages and Inflation Up, RBA Has More To Do

- **The Reserve Bank (RBA) Governor's shift to a more hawkish tone on Tuesday came as a surprise to many. Today's release of the February 2023 Statement on Monetary Policy (SoMP) confirms that the RBA has become more concerned by the stronger than expected wages growth and shift in inflation psychology.**
- **The SoMP includes updated forecasts for the economy. The outlook for economic activity remains broadly unchanged. The RBA is still expecting a soft landing and the unemployment rate is expected to increase but remain well below where it sat before the pandemic.**
- **What did change was the outlook for underlying inflation (the inflation measure which dampens the impact of volatile items) and wages growth. The RBA is now expecting annual wages growth to be around ½ per cent higher in December quarter 2022 and June quarter 2023. This is feeding into higher underlying inflation, which is now around ¾ percentage points higher for June quarter 2023. By 2025, underlying inflation and wages growth are broadly in line with what was expected in November.**
- **These forecasts are based on the cash rate reaching 3¾ per cent in mid-2023, up from the 3½ per cent expected in November 2022. In other words, the RBA believes the economy can withstand a cash rate of 3¾ per cent without slowing down too sharply.**
- **We expect the RBA has more work to do to sustainably bring inflation back down. Our long-held view was that the cash rate would rise and peak at 3.85 per cent and we remain comfortable with this position.**

The RBA raised the cash rate on Tuesday by 25 basis points to 3.35 per cent, the highest level since September 2012. While this was widely expected, the Governor's stronger resolve to fight inflation took the market by surprise. The RBA clearly signalled that at least two more rate hikes were likely when it stated in its final paragraph that it "expects that further increases in interest rates will be needed over the months ahead".

Economic Growth and Unemployment

The economy is expected to have grown solidly in the second half of 2022. From there, growth is expected to step down over the first half of 2023, before really slowing to below trend growth over the second half of 2023 and into 2024. Increasing interest rates, declining dwelling prices and ongoing cost-of-living pressures are expected to weigh on household spending and economic activity.

The RBA forecasts economic growth to be 2¾ per cent over 2022 and then 1½ per cent over the 2023 and 2024 calendar years. The RBA continues to expect that the unemployment rate will increase to 3¾ per cent over 2023 and 4¼ per cent over 2024.

Table 5.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	Dec 2022	June 2023	Dec 2023	June 2024	Dec 2024	June 2025
GDP growth	2¾	2¼	1½	1½	1½	1¾
(previous)	(3)	(2)	(1½)	(1½)	(1½)	(n/a)
Unemployment rate(b)	3.5	3½	3¾	4	4¼	4½
(previous)	(3½)	(3½)	(3¾)	(4)	(4¼)	(n/a)
CPI inflation	7.8	6¾	4¾	3½	3¼	3
(previous)	(8)	(6¼)	(4¾)	(4¼)	(3¼)	(n/a)
Trimmed mean inflation	6.9	6¼	4¼	3¼	3	3
(previous)	(6½)	(5½)	(3¾)	(3½)	(3¼)	(n/a)
	Year-average					
	2022	2022/23	2023	2023/24	2024	2024/25
GDP growth	3¾	3½	2¼	1½	1½	1¾
(previous)	(4)	(3½)	(2)	(1½)	(1½)	(n/a)

(a) Forecasts finalised 8 February. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing. Other forecast assumptions (assumptions as of November *Statement* in parenthesis): TWI at 62 (62); A$ at US$0.69 (US$0.64); Brent crude oil price at US$82bbl (US$89bbl). The rate of population growth is assumed to be in line with its pre-pandemic average. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.
(b) Average rate in the quarter.

Sources: ABS; RBA

Inflation and Wages Growth

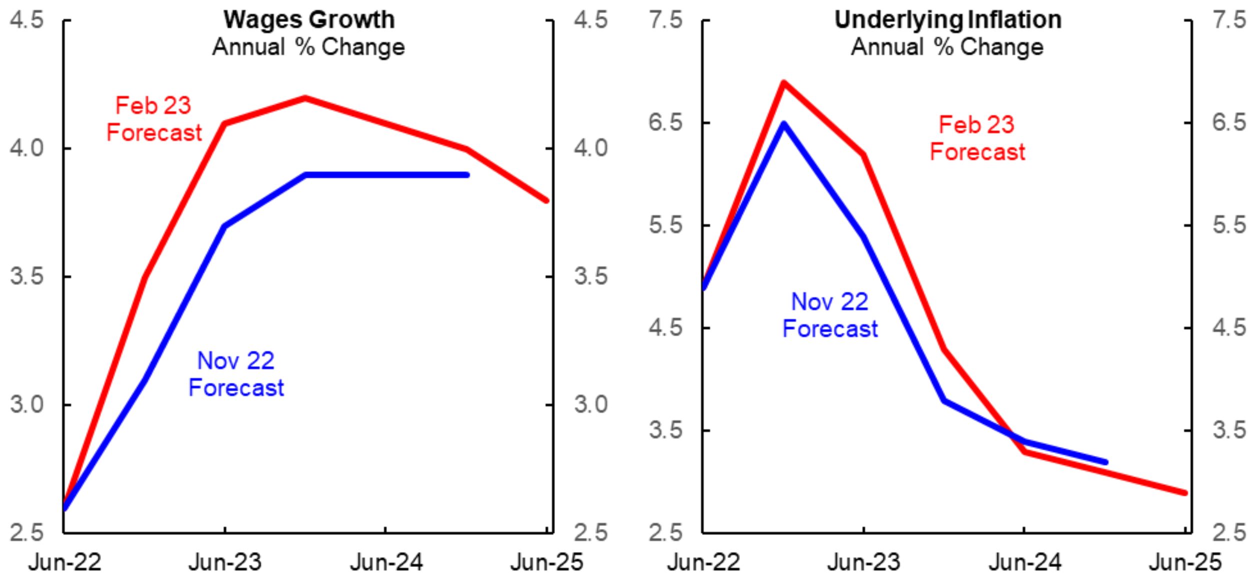
The SoMP's fresh forecasts and commentary highlight that the RBA's strengthened language about future rate hikes was prompted by the recent inflation report. Whilst the headline annual inflation rate printed below the RBA's forecasts, the central bank's key inflation measure– the underlying (trimmed mean) – did not! In fact, it printed at 6.9% per annum, above the RBA's expectation for a 6.5% outcome.

In today's SoMP, the RBA has revised up its forecasts for the underlying inflation profile in 2023. The December quarter 2023 result sits at 41/4 per cent, up from 3¾ per cent. The inflation profile for 2024 was downgraded with underlying inflation now reaching the 2-3% target band sooner – in the second half of 2024.

The headline inflation profile was only upgraded for the first half of this year.

Encouragingly, for both headline and underlying inflation, the RBA still anticipates the peak occurred late last year. The "immaculate goods disinflation", which we have seen in the US and elsewhere is expected to lead to an easing in goods inflation. In the US, five of the last six months have seen goods prices fall. But the risks are tilted to the upside for 2023 and 2024, as the more elevated profile for inflation in the near term means there is a risk of inflation proving stickier.

So, why is inflation expected to be higher? The Reserve Bank is forecasting wages growth to be higher based on more timely indicators of wages growth and their internal liaison. Firms in the Bank's liaison program report that the higher-than-expected wages outcomes have been driven by strong labour demand in a tight labour market, elevated staff turnover, higher inflation outcomes and pass-through to wages from the Fair Work Commission's minimum wage decision announced in June. Wages growth is expected to ease in the second half of the forecast period as the unemployment rate rises and labour market capacity constraints become less binding.



Monetary Policy Outlook

The SoMP released today suggests that the RBA still expects to achieve a soft landing with growth forecasts unchanged except for a modest tweak in the very short term. Yet inflation is expected to be higher in 2024 than previously thought.

Inflation in underlying terms reaches the top of the target band sooner, in December 2024. But 3% is still eighteen months away and as the last twelve months proved – a lot can happen.

What we do know is that the longer inflation is elevated, the harder it can be to bring down as prices become stickier and the inflation psychology shifts. With the inflation outlook upgraded in the nearer term, the risks are, therefore, arguably biased towards inflation being stickier for longer. If inflation continues to be stronger than expected, the cash rate may need to go higher or stay higher for longer.

However, markets will see downgrades to the underlying inflation profile and faster progress towards the inflation target, as further proof that rate cuts in 2024 are a possibility. Rate cuts also remain our core view for the first half of 2024, but there is a lot of water to flow under the bridge between now and 2024.

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