Tuesday, 6 June 2023

RBA Board Meeting

RBA Veers Off The Narrow Path

- **The Reserve Bank (RBA) increased the cash rate by 25 basis points at today's Board meeting. This takes the cash rate up to an 11-year high of 4.10%. We flagged the strong risk of a rate hike last week in the wake of the Fair Work Commission's (FWC) minimum and award wage decision and the stronger-than-expected monthly inflation report.**
- **The upside risk to inflation, the rapid rise in unit labour costs and the implicit omission this month around well-anchored inflation expectations suggests to us that the RBA has more tightening to do. We are now expecting at least one more rate hike in July.**
- **On the RBA's inflation forecasts, it does not have inflation returning to its target band until mid 2025 and, even then, it is just brushing the top of the band. With inflation outcomes surprising on the upside and wages growth expected to be stronger, the RBA has more to do to ensure inflation returns to the band in that time frame. Last week, the Governor explicitly said he was not prepared to accept a later return to the target band.**
- **The Governor has spent a lot of time discussing the rapid rise in unit labour costs (ULCs). The RBA Board appears very concerned about the rise in ULCs given the strong relationship with inflation. Lifting productivity growth is complex and takes time. Productivity growth estimates can be volatile and in the short term it would be difficult to see a material pick up. Trying to restrain wages growth via rate rises would be the more obvious channel.**
- **The accompanying statement maintained the sentences referring to keeping the economy on an even keel and being on a narrow path. During his Senate Estimates appearance, the Governor said the RBA was still "hoping" they could tread the narrow path. However, he also added that "if it's not possible to do that, we will do what's necessary to make sure inflation comes back within the target range in the next few years."**
- **The higher cash rate and the high possibility of more tightening means economic activity should slow further. Tomorrow's national accounts should confirm this slowdown, led by weaker household spending.**
- **The idea that the Board could bring down inflation while keeping the economy on an even keel seems less likely now. The risk of a recession has risen. The Australian 2-10-year bond yield curve notably inverted at the close of trade on Friday for the first time since 2008 – typically an inversion is a reliable indicator of recessions, although a sustained and extended inversion is usually required.**

The possibility of more rate hikes was always a risk with inflation still elevated and well above the Reserve Bank's 2-3% target band. On the RBA's forecasts, headline inflation is not expected to

return to the target band until the middle of 2025 and, even then, inflation would be just brushing the top of the band.

Towards the front of its statement today, the RBA said “this further increase in interest rates is to provide greater confidence that inflation will return to target within a reasonable timeframe”. Ensuring they get inflation to the target band by mid 2025 is imperative. Last week, in front of Senate Estimates, the Governor made it clear there was no tolerance for the return to the inflation target to take any longer than mid 2025.

Goods inflation is clearly moderating due to supply-chain disruptions easing, delivery times improving and the price of energy commodities well down from their peaks. However, services inflation has been called out by the RBA as being still “very high” and they are concerned by the “persistence” or stickiness that services inflation has demonstrated in other major economies.

Last week’s stronger-than-expected monthly inflation report suggested that inflation might have some stickiness with the annual trimmed mean measure unexpectedly rising in April.

The minimum wage decision on Friday was also stronger than policymakers expected and there’s some upside risk to inflationary pressures from this decision. The RBA explicitly notes “that the annual increase in award wages was higher than it was last year” notwithstanding the fact that inflation has peaked and is moderating.

Since the start of the rate-hike cycle, the RBA has stressed the importance of keeping inflation expectations in check. Today’s statement removed the previous wording that medium-term inflation expectations “remain well anchored” and the RBA added that the “upside risks to inflation have increased”. It is these upside risks that the RBA has responded to.

Last month’s rate hike and this month’s rate hike were largely unexpected. Financial markets had partially priced in a chance of a rate hike today but weren’t fully pricing a rate move until August.

It begs the question, will there be more tightening?

More tightening appears likely, despite signs of household spending slowing and a slight possibility of a contraction in economic activity for the March quarter (when GDP is published tomorrow).

There are three big clues which inform why we expect at least one more hike (timing being July).

1. The Governor in front of Senate Estimates last week and in more recent remarks has spent a lot of time discussing the rapid rise in unit labour costs (ULCs).

   The Governor has stated that nominal wages growth of 3.7% per annum (most recent reading) ordinarily would not be an issue. However, against a backdrop of flat productivity growth, it means ULCs are rising fast. The RBA Board appears very concerned about the rise in ULCs given the strong relationship with inflation over time.

   Lifting productivity growth is complex and takes time. In the RBA’s statement, the Board noted that wages growth is still consistent with the inflation target, provided productivity growth picks up. Productivity growth estimates can be volatile and in the short term and it would be difficult to see a material pick up. As a result, trying to restrain wages growth via rate rises (slowing demand in the economy) would be the more obvious channel.

2. Restraining wages growth has become tougher. The FWC’s minimum and award wage decision was higher than expected by policy makers, including the RBA. The minimum wage was raised by 5.75% and there was also a level shift in the minimum wage. Allowing for the shift, means the minimum wage rose by 8.60% (for around 184,000 people) and for those on awards it rose by 5.75% (around 2.4 million people). The higher-than-average increase comes on the back of

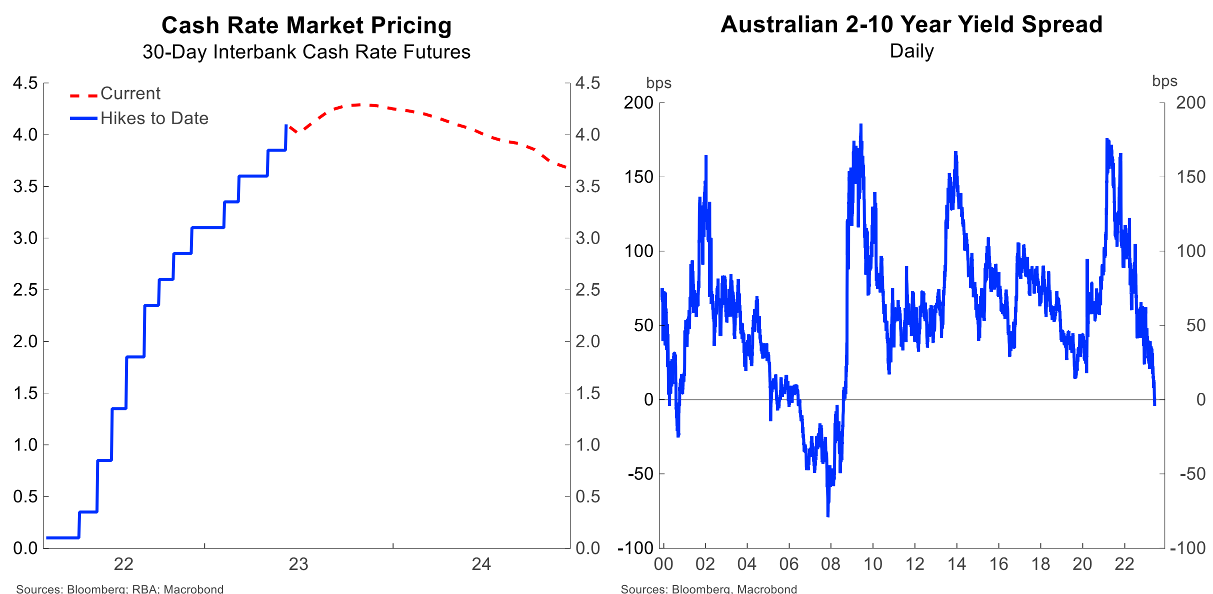
elevated inflation.

There's a risk that more workers in the economy use this rise of 5.75% and 8.60% as an anchor to bargain for higher wages. Awards span across a range of occupations, from nurses, police officers, banking experts to pilots. Many of these occupations are part of the public service and are having enterprise agreements renegotiated. There may be a temptation to use the FWC outcomes as a baseline. If this were to be the case, it could lead to stronger wages growth and fan inflation pressures beyond what the RBA is comfortable with.

These wage increases are more likely to come through in 2023-24, so it could also mean we have a higher cash rate for longer and rate cuts could take longer to flow through.

3. Removing the remark that inflation expectations remain well anchored implicitly suggests there are concerns that expectations around inflation have become de-anchored – suggesting upside risk to inflation.

Today's rate hike now takes the number of cash rate hikes from the RBA to twelve in 14 meetings (or 13 calendar months); they began hiking in May last year, did not meet in January this year and paused in April this year. The cash rate has lifted by 400 basis points or 4 percentage points in total in this cycle. It is the most aggressive tightening cycle since before the 1990s.



Household spending has slowed. Retail spending volumes have contracted for two straight quarters (December and March quarters). Consumer confidence remains very downbeat. The unemployment rate has turned a corner from the low point of last year, but remains incredibly low at 3.7% – below the estimated full employment rate of 4-4.5%.

The Governor has spoken at great lengths about staying on a narrow path – that is, bringing down inflation whilst keeping the economy on an even keel. Keeping the economy on an even keel implicitly comes with a low unemployment rate.

Today, the RBA has likely taken its first step towards veering off this path. Though, this might be the necessary cost of reigning in inflation. Last week, the Governor said he was prepared to "do what's necessary" if needed. The higher cash rate and the possibility of more tightening means it will be harder to avoid a hard landing.

The Australian 2-10-year generic government yield curve inverted at the close on Friday for the first time since the Global Financial Crisis in 2008, implying a greater risk of a recession. Typically, a

sustained and extended inversion is required, but it perhaps is an early sign that there is now a greater risk of a hard downturn.

Besa Deda, Chief Economist
+61 404 844 817

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
+61 404 844 817

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
+61 481 476 436

Senior Economist
Pat Bustamante
pat.bustamante@stgeorge.com.au
+61 468 571 786

Economist
Jameson Coombs
jameson.coombs@stgeorge.com.au
+61 401 102 789

The information contained in this report ("the Information") is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom St.George has a contract to supply Information, the supply of the Information is made under that contract and St.George's agreed terms of supply apply. St.George does not represent or guarantee that the Information is accurate or free from errors or omissions and St.George disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to St.George products and details are available. St.George or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. St.George owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of St.George.

Any unauthorised use or dissemination is prohibited. Neither St.George Bank - A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.