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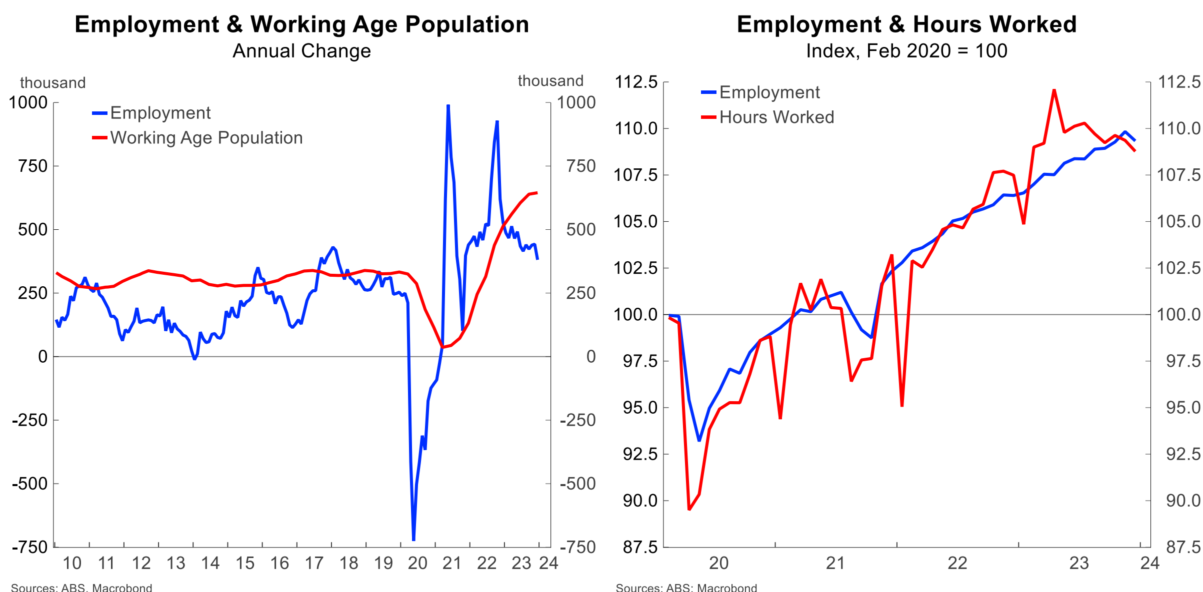
Shifting Supply Still a Risk

Last week the Reserve Bank (RBA) dominated the news cycle. As expected, the RBA Board left the cash rate unchanged at 4.35% – its highest level in 12 years. The Board's policy statement, and the Governor's remarks at the press conference, left the possibility of another rate hike on the table. During her appearance before the House of Representatives Economics Committee on Friday, the Governor outlined the threshold for the Board to pivot to a less restrictive stance – essentially, the Board needs to be confident that inflation is moving sustainably towards target.

Analysis presented in the Statement on Monetary Policy, also released last week, concluded that the level of demand remains higher than supply, notwithstanding the recent pull back in spending. The gap is closing but we are not quite there. The RBA's view remains that key indicators, such as the unemployment rate, remain below the level that is consistent with inflation returning to target.

An orderly loosening in conditions is expected – labour demand will slow while labour supply continues to increase. Throughout this adjustment, employment is forecast to continue to grow. When the labour force survey is released this Thursday, we expect an outcome consistent with this outlook. We expect that employment grew by 15k over January, which means that some new entrants into the labour market were unable to find jobs, leading to a tick up in the unemployment rate from 3.9% to 4.0%. Average hours worked are also expected to ease as employers adjust to the pull back in demand.



Risks to the outlook: Supply continues to adjust.

While we expect an orderly loosening in labour market conditions, there is a risk that a disorderly adjustment occurs. Why? <u>The supply side of the economy continues to adjust, independently of</u>

monetary policy, and this may see demand for labour fall more quickly than would otherwise be the case.

Since the reopening of the economy, businesses have been trying to keep up with elevated demand. During times of severe supply disruptions and bottlenecks, businesses couldn't access the intermediate and capital goods needed to expand supply. Instead, they turned to labour, hiring more workers to boost output. While boosting labour without capital generally reduces productivity, it satisfied the immediate need.

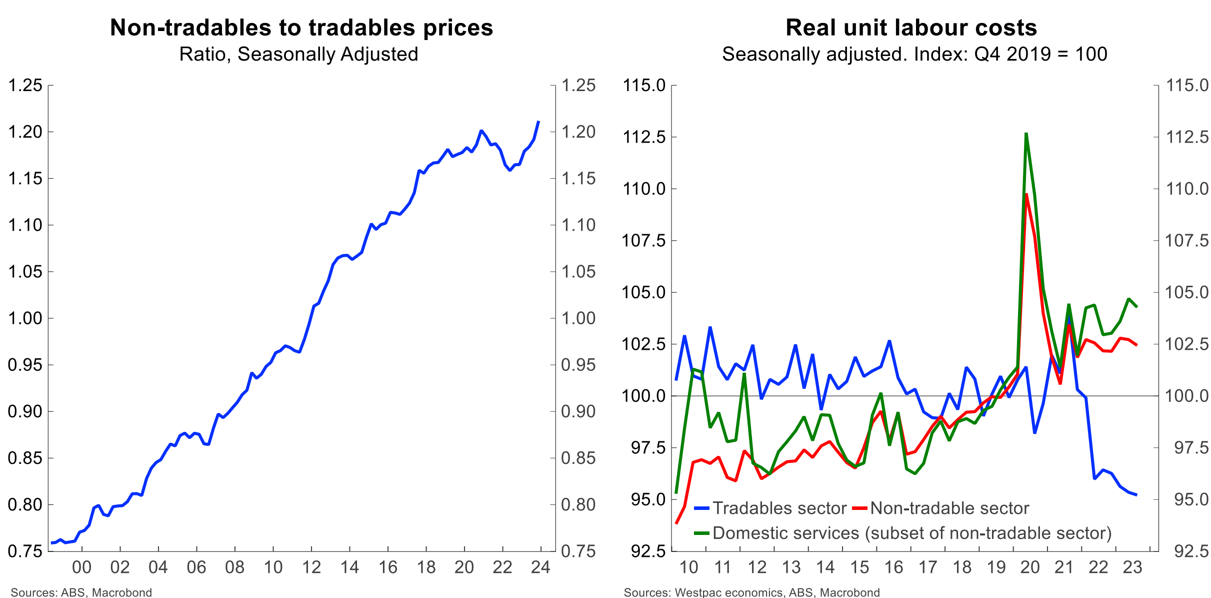
Demand for domestically produced goods and services was supported by revenge spending, particularly as consumers responded to the higher prices of traded goods and switched to domestic substitutes. Underlying strength in demand meant businesses had little trouble passing higher costs on to consumers. This has contributed to the tightness of the labour market, supported wages growth, and added to inflation.

But these supply disruptions are unwinding, meaning businesses can now access the intermediate and capital goods needed to boost supply. At the same time, slowing demand and moderating inflation for globally traded goods means that it is becoming harder for businesses to pass on costs. The RBA's business liaison noted this difficulty and found that businesses are instead trying to optimise their costs and boost productivity.

In this environment businesses may be more inclined to substitute capital for labour to boost productivity and reduce costs. This could see demand for labour fall more quickly than would otherwise be the case.

At the same time, as capital catches up to the growth in labour, the supply side of the economy could expand on the back of the bounce back in labour productivity. By assuming the supply side of the economy is largely static, there's a risk demand slows by more than is required to bring demand and supply into better balance.

The recent evolution of real unit labour costs (RULCs), which measure the labour costs relative to sales prices (i.e. an increase in RULCs means labour costs are increasing faster than sales prices and it's becoming less profitable to employ workers), shows that some of these adjustments are continuing to play out.



RULCs in the traded sector of the economy continue to be below pre pandemic levels, supporting jobs for the time being. As the prices of tradable goods continue to ease, this will turn. At the same time, RULCs for the non-tradable or domestic sector have increased, pointing to a fall in labour demand.

Other domestic news

Tomorrow we will receive a fresh consumer sentiment read for February. We expect consumers remained gloomy, given the ongoing cost of living pressures. Sentiment is only likely to turn in the second half of the year when household finances improve on the back of tax cuts, moderating inflation, and the possibility of lower interest rates. However, we could see a short-term bounce from the RBA's decision to leave rates unchanged and from the announced changes to Stage 3 tax cuts, which will see low- and middle-income earners receive a larger tax cut than previously legislated.

We will also receive an updated read on business confidence and conditions. Business conditions have started to ease, particularly in consumer facing industries. This has led to a deterioration in business confidence. We have also seen clear signs that cost pressures, including labour costs, are moderating. The next instalment will give us a read on whether these dynamics continued over January.

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Group Forecasts

	2024					2025	
End Period:	**Close (09 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.35	4.35	4.35	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.34	4.55	4.47	4.22	3.97	3.72	3.47
3 Year Swap, %	3.96	4.15	4.10	4.05	4.00	3.90	3.70
10 Year Bond, %	4.13	4.35	4.30	4.20	4.15	4.10	4.05
US Interest Rates:							
Fed Funds Rate, %	5.375	5.125	4.875	4.625	4.375	4.125	3.875
US 10 Year Bond, %	4.15	4.25	4.20	4.15	4.10	4.05	4.05
USD Exchange Rates:							
AUD-USD	0.6524	0.67	0.68	0.69	0.70	0.71	0.72
USD-JPY	149.29	145	144	141	138	135	132
EUR-USD	1.0784	1.09	1.11	1.13	1.14	1.15	1.16
GBP-USD	1.2628	1.26	1.27	1.28	1.29	1.30	1.30
NZD-USD	0.6150	0.62	0.62	0.62	0.63	0.63	0.63
AUD Exchange Rates:							
AUD-USD	0.6524	0.67	0.68	0.69	0.70	0.71	0.72
AUD-EUR	0.6050	0.61	0.61	0.61	0.61	0.62	0.62
AUD-JPY	97.39	97.2	97.9	97.3	96.6	95.9	95.0
AUD-GBP	0.5166	0.53	0.54	0.54	0.54	0.55	0.55
AUD-NZD	1.0606	1.08	1.11	1.11	1.11	1.13	1.14

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	5.4	2.3	1.4	1.6
CPI (Headline), %	3.5	7.8	4.3	3.2
CPI (Trimmed mean), %	2.6	6.8	4.4	3.2
Unemployment Rate, %	4.7	3.5	3.8	4.5
Wages Growth, %	2.4	3.3	4.1	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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