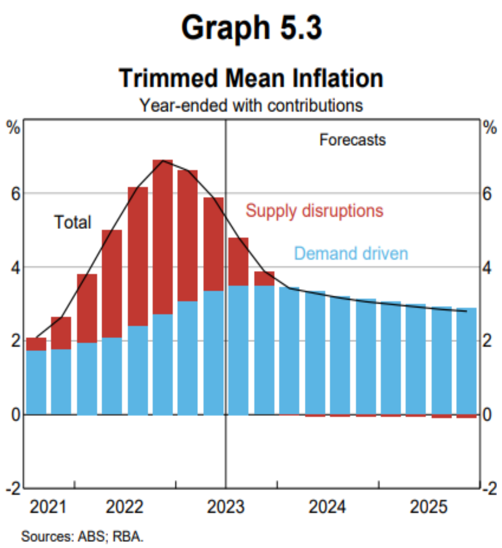
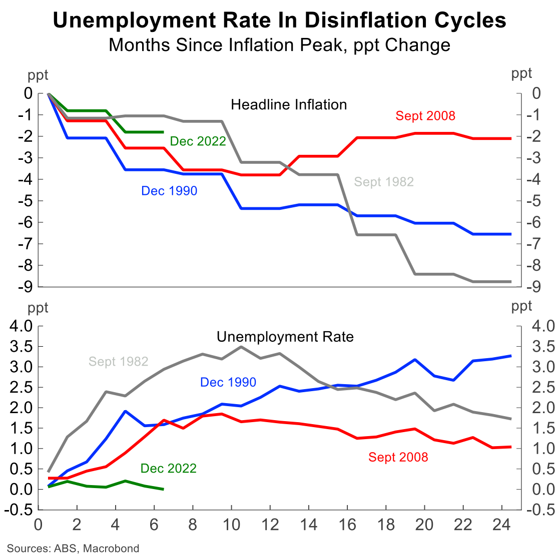
RBA Statement on Monetary Policy

RBA Forecasting Goldilocks Disinflation

- **The Reserve Bank (RBA) is forecasting inflation to be back within the 2-3% target by the end of 2025. To achieve this, the unemployment rate is forecast to increase from its current rate of 3.5%, to 4.5% by the end of 2024 and remain at this level through 2025 - or from an extremely low to a very low rate.**
- **This would be a truly remarkable achievement. It would mean successfully navigating the narrow path of returning inflation to target while preserving the gains in the labour market.**
- **But the historical experience suggests that the RBA may be a little too optimistic. In previous disinflationary cycles the unemployment rate has increased by significantly more to get inflation back to target – indeed using the average over the past three cycles, the unemployment rate would need to increase to around 6% to get inflation back down.**
- **Why the optimism? A key assumption is that the global supply curve will revert to where it was before the pandemic. We are seeing evidence that this is happening – shipping costs are back to 2019 levels and headline inflation is falling globally as the prices of energy commodities and food items come off their peaks.**
- **Additionally, the RBA expects that the cumulative 400 basis points of cash rate hikes (and potentially one more) will be enough to prevent a wage price spiral but not enough to slow demand to the extent that will induce mass job shedding.**
- **Is the Goldilocks finish possible? It hasn't happened before, but this doesn't mean it's impossible. We believe the RBA can achieve its soft landing. But given the tightening that has occurred, we think the unemployment rate will increase by slightly more.**





The Reserve Bank's (RBA) latest forecasts were little changed from last quarter, with the RBA continuing to forecast a soft economic landing. The economy is expected to grow below trend and unemployment is expected to drift higher. But the historical experience suggests that the RBA may be a little too optimistic.

The forecasts see inflation returning to the top of the target band by the middle of 2025 and drifting more comfortably within the band by the end of 2025. Over the same period the RBA expects the unemployment rate to lift from its current rate of 3.5% to 4.5% - or from an extremely low to a very low rate.

At 4.5% the unemployment rate would still be below pre-pandemic levels and not far off estimates of where the 'neutral unemployment' rate might currently be – the 'neutral unemployment' rate neither adds nor subtracts from inflationary pressures.

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

Per cent

	Year-ended					
	June 2023	Dec 2023	June 2024	Dec 2024	June 2025	Dec 2025
GDP growth	1½	1	1¼	1¾	2	2¼
(previous)	(1¾)	(1¼)	(1½)	(1¾)	(2)	(n/a)
Unemployment rate[(b)]	3.6	4	4¼	4½	4½	4½
(previous)	(3½)	(4)	(4¼)	(4½)	(4½)	(n/a)
CPI inflation	6.0	4¼	3½	3¼	3	2¾
(previous)	(6¼)	(4½)	(3½)	(3¼)	(3)	(n/a)
Trimmed mean inflation	5.9	4	3¼	3	3	2¾
(previous)	(6)	(4)	(3¼)	(3)	(3)	(n/a)
	Year-average					
	2022/23	2023	2023/24	2024	2024/25	2025
GDP growth	3	1½	1	1¼	1¾	2
(previous)	(3¼)	(1¾)	(1¼)	(1½)	(1¾)	(n/a)

(a) Forecasts finalised 2 August. 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. The cash rate is assumed to peak at around 4¼ per cent before declining to around 3¼ per cent by the end of 2025. Other forecast assumptions (assumptions as of May *Statement* in parenthesis): TWI at 61 (60); A$ at US$0.66 (US$0.66); Brent crude oil price at US$80bbl (US$78bbl). The rate of population growth has been revised higher in the near term but is expected to gradually decline to around 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.

There are two key takeaways from this.

Firstly, the RBA expects almost all the disinflationary impulse to come from the supply side of the economy. This process is already underway and has driven the fall in inflation we have seen to date.

Secondly, the cumulative 400 basis points of cash rate hikes (and potentially one more) will reduce demand sufficiently to ensure that a wage price spiral does not emerge, and expectations remain well anchored. But it will not slow demand to the extent that will induce mass job shedding. This is an interesting assessment given the RBA has indicated that the current level of the cash rate is contractionary.

Nevertheless, this would be a fantastic achievement for the Australian economy if realised. It would mean locking in the best part of the gains in the labour market from the pandemic while also restoring price stability. It would mean the RBA had almost perfectly navigated the narrow path it set out to traverse at the beginning of the hiking cycle back in May last year.

The RBA appears confident in achieving this goal, but the historical experience suggests it will be difficult.

In other words, the RBA is not expecting domestic inflationary pressures to accelerate far beyond levels that are consistent with the inflation target. If it were, the unemployment rate would need to be well above neutral. This is a bold assumption given it does not expect inflation to brush the top of the target band for almost two years.

Since records began, Australia has experienced three major disinflationary cycles – in the early 80's, the early 90's and in the midst of the GFC. During these three cycles inflation fell on average by 6.6 percentage points, more than required to wrangle in the peak rates of inflation experienced during this cycle. This task took an average of 19 months to complete. At the same time, the unemployment rate jumped on average by 3.5 percentage points in the space of around 16 months. This was the cost of such a large disinflationary task.

In contrast, the RBA is expecting that it can trim inflation by 5 percentage points over the course of 26 months and only see the unemployment rate jump by 1.1 percentage points. This would be a truly remarkable achievement.

Australian Disinflation Cycles

Inflation	**Cycle 1**	**Cycle 2**	**Cycle 3**	**Average**	**Implied by RBA Forecasts**
Inflation Peak Date	Sep-82	Dec-90	Sep-08	N/A	N/A
Inflation Peak (y/y%)	12.4	8.7	5.0	8.7	7.8
Peak to Through Chg. (ppt)	-8.8	-7.2	-3.8	-6.6	-5.0
Peak to Trough Time (months)	24	21	12	19.0	36
Unemployment					
Unemployment Trough Date	Mar-82	Jan-90	Aug-08	N/A	N/A
Unemployment Rate Trough	6.3	6.1	4.0	5.5	3.4
Trough to Peak Chg. (ppt)	4.2	4.4	1.8	3.5	1.1
Trough to Peak Time (months)	16	23	10	16.3	32.0

Now, the historical experience isn't reason to say it is not possible. But it does support our expectations that a more significant loosening in the labour market will be necessary to bring inflation back under control.

We too think inflation can be reined in without the increase in unemployment experienced in the past. The key reason for this is the large contribution of the supply side of the economy to the disinflation cycle.

Where we differ from the RBA is the extent and persistence of demand pressures and the impacts of the current levels of the cash rate on the economy. We believe that demand will slow by more to bring inflation back to the target band. And we see this being achieved by the current level of the cash rate. This additional hit to demand will require a more significant hit to the labour market – we see the unemployment rate increasing to 4.8% by the end of 2025. This would still be a great outcome for the Australian economy and would still see the economy navigate the narrow path.

Monetary Policy Outlook

The RBA's Statement on Monetary Policy suggests that the upside risks to inflation and downside risks to growth are finely balanced. This is consistent with the Board's decision to leave interest rates on hold in July and August to further assess the impact of rate hikes and the progress on inflation. The Statement also explicitly notes that the Board responded to an upside shift in the balance of these risks by hiking at the May and June meetings.

The balance of risks is therefore the number one consideration for the future trajectory of the cash rate. The Board recently considered an additional hike as a form of insurance to protect against the balance of risks shifting to the upside but concluded that it was not justified by the potential cost to the labour market.

The RBA will therefore only hike again if this balance of risks tilts to the upside or incoming data surprises and suggests we have gone of the disinflation path. This could still happen, but it is not our central view. We therefore expect the RBA to remain on hold for a prolonged period until these risks tilt to the downside and we see a cutting bias.

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