bankSA

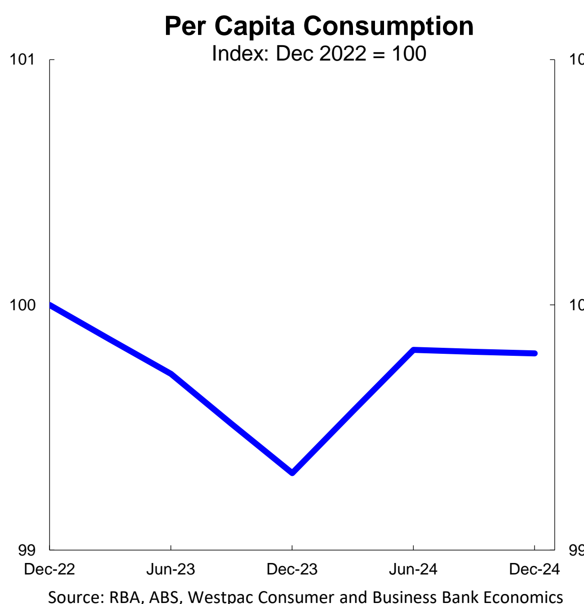
Interest Rate Outlook

Friday, 5 May 2023

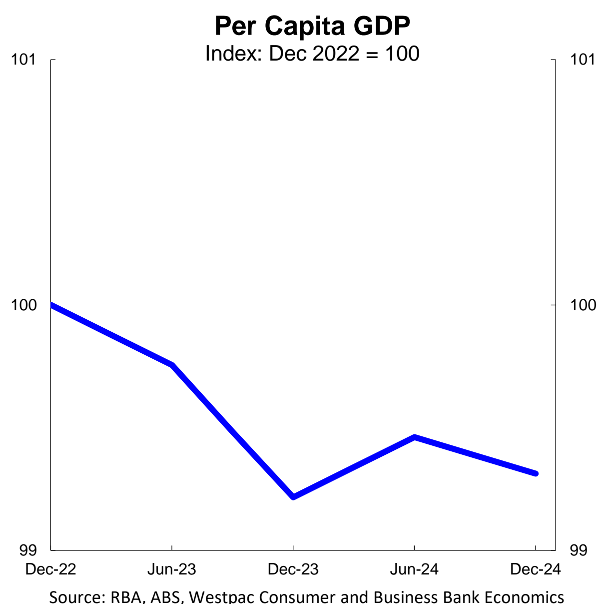
RBA Statement on Monetary Policy

Inflation High, Despite Per Capita Recession

- **The May 2023 Statement on Monetary Policy (SoMP) includes updated economic forecasts. While the growth outlook remains broadly unchanged, there is a change in the composition. Some of the near-term softness we are seeing in partial economic indicators (such as retail trade) is expected to be partly offset by stronger expected growth in population.**
- **As a result, the Reserve Bank (RBA) is implicitly forecasting per capita consumption and per capita GDP to go backwards, implying a per capita recession. In fact, per capita consumption and per capita GDP are both expected to be lower through 2023 and 2024, compared to the December quarter of 2022. In other words, the RBA expects individuals to spend less per period over the next two years, compared to the December quarter 2022.**
- **This is significant. It highlights the tension in the RBA's deliberation. The economy is slowing and slowing quickly. This is because households faced with mounting cost of living pressures, elevated rents and higher interest rates are cutting back. However, the record influx of migrants has offset this drag and is adding to short run inflationary pressures.**
- **At some point the drag from households cutting back on spending will to a large extent offset the boost to demand coming from migrants. Based on the RBA's forecasts, this is likely to occur in the second half of 2023, where activity is expected to slow significantly.**
- **Inflation has been downgraded in 2023, but unchanged in later years. The CPI is expected to return to the top of the 2-3% band by mid 2025. The composition of inflation is expected to shift as rent inflation strengthens, while non-housing inflation is expected to be weaker.**



Source: RBA, ABS, Westpac Consumer and Business Bank Economics



Source: RBA, ABS, Westpac Consumer and Business Bank Economics

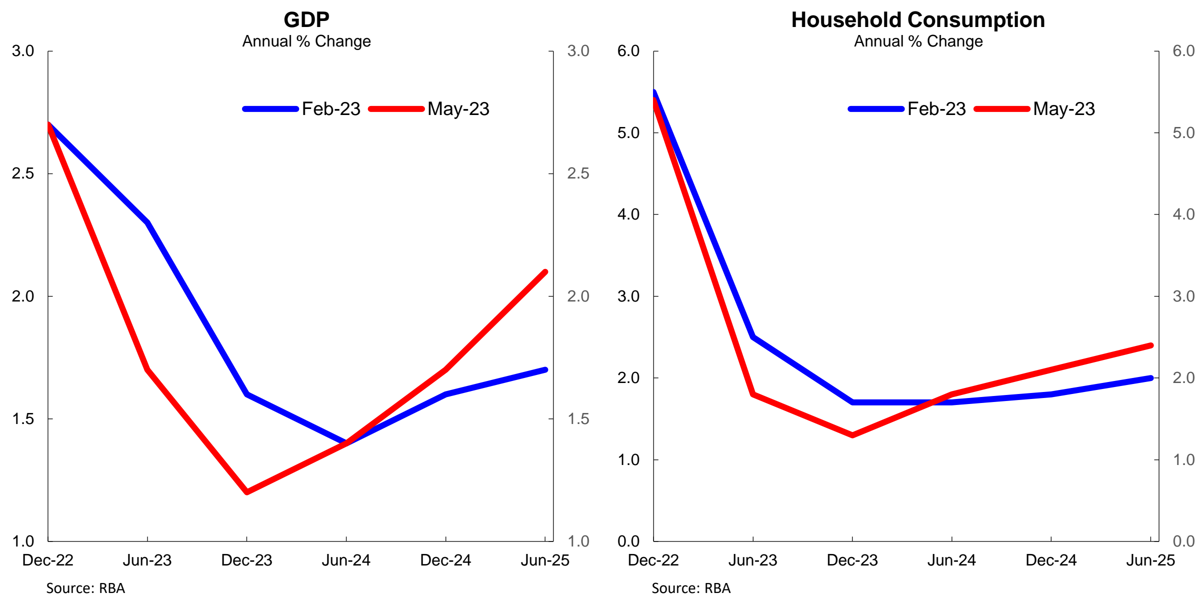
Economic Growth and Unemployment

Gross Domestic Product (GDP), or economic activity, expanded by 2.7% over 2022, slightly above average or trend for the Australian economy. Activity was supported by the reopening impulse over the first half of 2022. Strong population growth drove activity in the second half of 2022. With activity growing in line with population, the RBA notes that there was "little growth in GDP per capita".

Consistent with the outlook presented in February, the RBA is expecting activity to slow sharply over the forecast period. Activity is expected to grow at 1.2% over 2023 and 1.7% over 2024 – this compares to long-run growth of a bit under 2.5%. While these numbers remain broadly consistent with the RBA's February forecasts, the near-term outlook has weakened on the back of softness in recent data. This was partly offset by an upward revision to the RBA's population growth forecasts.

A slowdown in household spending is the main reason why the RBA is expecting the economy to slow. Household spending accounts for around 55% of total demand in the economy. It is expected to slow to 1.3% over 2023 and 2.1% over 2024 – well down from the strong 5.4% recorded over 2022. Increasing interest rates, higher rents and ongoing cost-of-living pressures are all expected to weigh on household spending.

As a result of the slowdown in economic activity, the RBA continues to expect the unemployment rate to increase from the 3.5% recorded in March, to 4.0% by the end of 2023 and 4.4% by the end of 2024.



These forecasts are based on the cash rate reaching 3¾ per cent in mid-2023, and then falling to around 3 per cent by June 2025. In other words, the RBA believes the economy can withstand a cash rate of 3¾ per cent without causing a recession.

Is the RBA forecasting a recession?

The RBA is forecasting a sharp slowdown in activity but not a technical recession. Implied quarter on quarter growth of around ¼ per cent over the second half of 2023 is low by historical standards. A negative shock in either of those quarters could potentially result in the economy going backwards – this is not the RBA's central forecast.

However, per capita consumption and per capita GDP are implicitly forecast to go backwards this year and next by the RBA. This implies that the RBA is expecting a so-called per capita recession.

In fact, based on the forecasts presented, per capita GDP and per capita consumption will be lower by the end of 2024 than it is today – in other words over the next two years the RBA is expecting individuals to consume less per period, compared to the December quarter of 2022.

On the back of the record surge in overseas migration, annual population growth is expected to peak at around 2 per cent this year and then ease to be around 1½ per cent by the end of the forecasts period (June 2025).

At the same time, economic activity is only expected to grow by 1.2% and 1.7% in 2023 and 2024, respectively. Household consumption is expected to grow by 1.3% and 2.1% in 2023 and 2024, respectively.

Based on these numbers per capita GDP is expected to be around ¾ percentage point lower in the December quarter 2023, compared with the December quarter 2022, and then go sideways to remain at around ¾ percentage point lower by the end of 2024, compared with the December quarter 2022.

Consumption per capita is expected to be around ¾ percentage point lower in the December quarter 2023, compared with the December quarter 2022, and make a slight recovery to be ¼ percentage point lower by the end of 2024, compared with the December quarter 2022.

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	2.7	1¾	1¼	1½	1¾	2
(previous)	(2¾)	(2¼)	(1½)	(1½)	(1½)	(1¾)
Unemployment rate[(b)]	3.5	3½	4	4¼	4½	4½
(previous)		(3½)	(3¾)	(4)	(4¼)	(4½)
CPI inflation	7.8	6¼	4½	3½	3¼	3
(previous)		(6¾)	(4¾)	(3½)	(3¼)	(3)
Trimmed mean inflation	6.9	6	4	3¼	3	3
(previous)		(6¼)	(4¼)	(3¼)	(3)	(3)
	Year-average					
	2022	2022/23	2023	2023/24	2024	2024/25
GDP growth	3.7	3¼	1¾	1¼	1½	1¾
(previous)	(3¾)	(3½)	(2¼)	(1½)	(1½)	(1¾)

(a) Forecasts finalised 1 May. 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 3¾ per cent before declining to around 3 per cent by mid-2025. Other forecast assumptions (assumptions as of February *Statement* in parenthesis): TWI at 60 (62); A$ at US$0.66 (US$0.69); Brent crude oil price at US$78bbl (US$82bbl). The rate of population growth is assumed to be in line with forecasts from the Australian Government's Centre for Population. 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

What are the implications?

Without strong population growth aggregate activity and consumption would go backwards, and significantly so. This highlights the tension in the RBA's deliberation.

The economy is slowing and slowing quickly. This is because households faced with mounting cost of living pressures, elevated rents and higher interest rates are cutting back. We are seeing this through lower per capita spending and the fall in per capita GDP.

However, the record influx of overseas arrivals has offset some of this drag. It is supporting demand while at the same time helping to meet our critical skills shortages. At some point the drag from the households that are cutting back on spending will to a large extent offset the boost to demand coming from overseas arrivals. Based on the RBA's forecasts, this is likely to occur in the second half of 2023, where activity is expected to slow significantly.

Additionally, given the incredible pace of migration, it appears that pressure is being placed on certain parts of the economy. This is most clear in the rental market, as the supply of housing is fixed in the near term. It is also reflected across other areas, including essentials such as food and other key products and services, adding to short run inflationary pressures.

Inflation

We received evidence of positive developments on the inflation front when the March quarter inflation report confirmed that inflation had peaked in the December quarter. However, the inflation fight is far from over and the RBA remains conscious of the risks.

In the near term, the RBA has downgraded its inflation profile due to the "slightly weaker-than-expected March quarter outcome". However, inflation is only expected to return to the top of the 2-3% band by mid 2025 – unchanged from the February SoMP.

By the end of 2023, headline inflation is expected to be 4.0% (revised down from 4.3%) and underlying inflation is expected to be 4.5% (revised down from 4.8%). Beyond this point, the profile is unchanged, with headline and underlying inflation expected to be 3.1% and 3.2%, respectively in 2024, before falling further to 3.0% and 2.9%, respectively by mid 2025.

Over the forecast period, a continued moderation in goods prices is expected to contribute to the decline in inflationary pressures. This reflects the unwinding of supply-chain disruptions and a reduction in goods demand. However, the RBA does point out that this process is happening slower in Australia than in other countries.

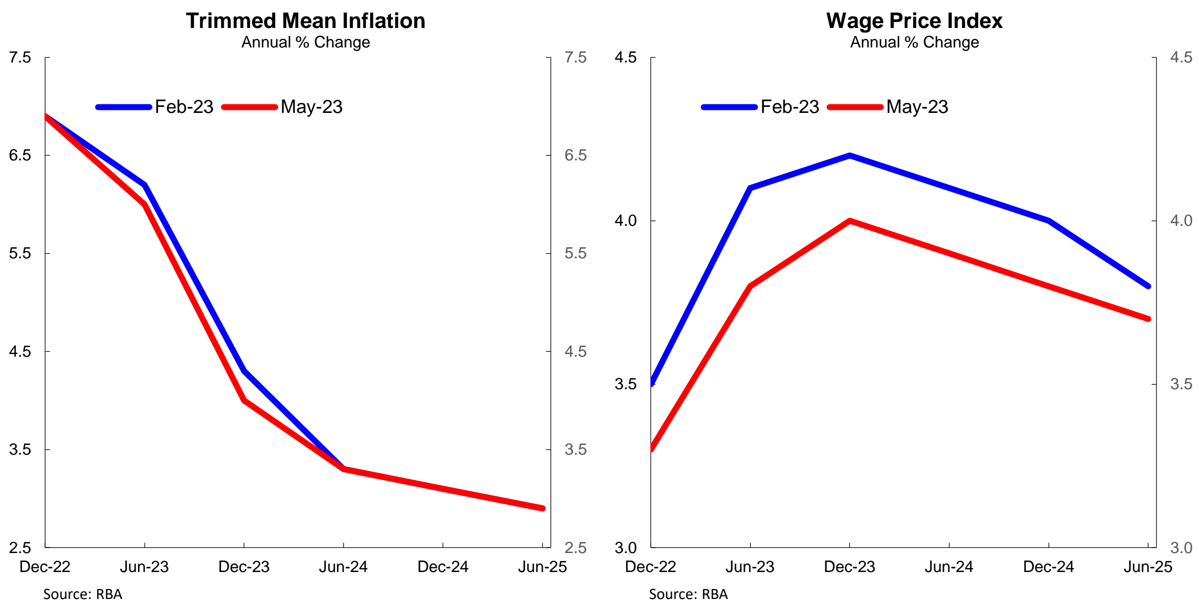
But services inflation is expected to be a tougher nut to crack. We have seen this to be the case internationally, where services inflation is proving to be somewhat sticky. The RBA expects services inflation to be more persistent in the near term, before easing later in the forecast period as growth slows, higher interest rates weigh on household spending, and growth in unit labour costs eases. Energy costs and rents are also expected to rise and contribute to inflationary pressures.

While the inflation profile has not changed beyond 2023, the RBA expects the composition of inflation to shift relative to their previous forecasts. This reflects the dynamics present across the housing category (e.g. skyrocketing rents and elevated energy costs) and record levels of population growth, in addition to a weaker growth outlook. Namely, rent inflation is expected to be stronger than previously thought. On the other hand, non-housing related inflation (e.g. discretionary goods and services), is expected to be weaker due to slower economic growth, weaker wages growth, and a higher unemployment rate.

The RBA is also mindful of the risks around the inflation outlook and outlined the key risks, on the upside and downside. On the upside, the RBA notes that inflation could be more persistent if "productivity growth remains weak, the high inflation environment leads to firms expanding margins as their costs ease, there is greater feedback between higher prices and wages than

expected, or if rents increase by more than expected."

On the downside, the RBA points out that inflation could subside more quickly if "the easing in goods inflation is faster or more widespread than anticipated, including because consumer spending is weaker."



Wages Growth

The RBA has been keeping on close eye on wages growth for some time. Indeed, with such a tight labour market, there were concerns that wages growth could pick up more rapidly to levels that are inconsistent with the inflation target. Wages pressures have been evident across certain sectors of the economy and wages growth has picked up materially from very low levels over the past decade. However, in aggregate, wages growth has not been inconsistent with the inflation target, wages pressures haven't been a driver of inflation, and there appears to be little risk of a prices-wages spiral at this stage. Indeed, recent wages growth outcomes have been weaker than expected and RBA liaison contacts also indicate that they expect wages growth between 3.75%-4% over 2023, before moderating beyond that point.

Accordingly, the RBA has downgraded their wages forecasts and expect the Wage Price Index (WPI) to peak at 4.0% (down from 4.2% previously) in 2023. Later in the forecast period, it expects wages growth to slow, in line with weaker economic growth and higher unemployment. In 2024, it expects wages growth to slow to 3.8% (down from 4.0% previously).

However, for the inflation outlook, productivity growth, not just nominal wages growth is also important. One thing underpinning the points around wages growth not being inconsistent with the inflation target is the assumption that productivity growth runs at around levels that prevailed prior to the pandemic (or ideally higher).

Recently, the RBA has been turning its attention to measures of wages growth which account for changes in productivity to get a better sense of wage pressures across the economy. Unit labour costs (ULC) are an indicator of the average cost of labour per unit of output produced in the economy and provide a measure of labour costs accounting for productivity. This measure can be very volatile in the near term and can be affected by compositional changes in the labour force, such as those that occurred during the pandemic. As a result, the measure needs to be considered with caution.

The RBA notes that growth in ULC has been around "multi-decade highs" and they expect growth

over the forecast period to be "solid". The evolution of ULC is clearly something the RBA is watching closely and is worth keeping a closer eye on going forward.

Monetary Policy Outlook

During this hiking cycle, the RBA has emphasised that they are on a narrow path to getting inflation down over time, while achieving a soft landing and not having undue impacts on growth and employment. RBA communication has at times implied that the relative emphasis the Board is placing on these somewhat competing objectives has shifted from month to month as the data has come in.

In May, the Board surprised markets and most economists with a 25-basis-point hike after it paused in April to assess the impact of the aggressive monetary policy tightening to date. The May SoMP demonstrates that the RBA maintains a hiking bias and is prepared to hike again, if necessary. However, this will depend on the evolution of the data and of inflationary pressures.

Indeed, the cash rate, at 3.85%, is now around the peak level assumed in the SoMP. This means that the forecasts have the current level of the cash rate built into them. Going forward, the SoMP assumes that the cash rate will gradually decline to around 3% by mid 2025. This suggests that if the economic and inflation outcomes are in line with the RBA's forecasts, we have likely seen the final hike in this cycle. Financial markets think so and expect 3.85% to be the peak. Our house view is also for a 3.85% peak and that cuts are likely to come in early 2024.

However, there are risks to both the upside and downside on inflation and we can't yet rule out the possibility that further hikes may be needed down the line. For the RBA, they will continue to walk their narrow path.

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