Bank of Melbourne

Friday, 5 August 2022

RBA Statement on Monetary Policy

Inflation to be Higher for Longer

- **The Reserve Bank (RBA) has today released its quarterly Statement on Monetary Policy (SoMP) providing a full breakdown of the Bank's revised forecasts, some of which were previewed in the monetary-policy decision earlier this week.**
- **The RBA upgraded its inflation forecasts for this year and next year. It expects headline inflation to peak at 7¾ per cent in the December quarter of this year, up from 5.9 per cent previously and the 7 per cent suggested in recent speeches.**
- **The RBA also now expects inflation to be elevated for longer. Indeed, it doesn't expect headline inflation to return to the 2-3 per cent target band until the end of 2024.**
- **The RBA also cut its growth forecasts for this year and 2023. Growth is expected to remain above trend this year, but slow considerably in 2023 to just 1¾ per cent, driven by weaker consumer spending and slowing growth in public demand.**
- **The unemployment rate is expected to trough earlier and lower than previously anticipated, at 3¼ per cent by the end of 2022. However, as economic activity begins to slow over 2023 and into 2024 the unemployment rate is expected to rise, albeit only gradually.**
- **Despite an expected uptick in nominal wages, real wages are projected to go backwards until at least 2024 as inflation moves higher and remains elevated for longer.**
- **We continue to expect the RBA to hike to cash rate to 3.10% by the end of this year. And we expect the cash rate to peak at 3.35 per cent in early 2023, as a stream of weaker data halts the RBA's hiking agenda. We expect the RBA will have to turn to cutting rates within twelve months of the end of its tightening cycle.**

After delivering the most aggressive monetary tightening in a four-meeting window since inflation targeting commenced in 1993, the Reserve Bank (RBA) has today released its quarterly Statement on Monetary Policy. The statement provides a full breakdown of the Bank's revised forecasts, some of which were previewed in the monetary-policy decision earlier this week. The Statement also provides further details on the RBA's assessment of global and international economic conditions, which can sometimes provide us with further clues on the Bank's assessment of the likely path of interest rates.

Economic Growth

The RBA cut its growth outlook for this year and next year. The RBA still expects the Australian economy to grow strongly in 2022, albeit less strongly than in May. Growth this year is expected to be supported by robust household consumption and a recovery in services exports. The economy is forecast to grow by 3¼ per cent in 2022, compared to the RBA's previous projection of 4¼ per cent.

From there, the RBA expects growth will slow to a below trend rate of 1¾ per cent in 2023 and 2024, as a combination of weaker private spending and slowing growth in public demand weigh on activity. Elevated consumer prices, rising interest rates and declining dwelling prices are expected to underpin a slowing in private spending, as real incomes erode, and household wealth takes a hit. Meanwhile, growth in public demand will be curtailed after the recent rapid growth alongside the COVID-19 response and subsequent recovery.

Our own forecasts for growth are stronger for this year, but notably weaker for next year and 2024. It is why we see a real risk the RBA will be cutting the cash rate by 2024.

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

Per cent

	Year-ended					
	Jun 2022	Dec 2022	Jun 2023	Dec 2023	Jun 2024	Dec 2024
GDP growth	3½	3¼	2¼	1¾	1¾	1¾
(previous)	(3½)	(4¼)	(3)	(2)	(2)	(n/a)
Unemployment rate[(b)]	3.8	3¼	3½	3½	3¾	4
(previous)		(3¾)	(3½)	(3½)	(3½)	(n/a)
CPI inflation	6.1	7¾	6¼	4¼	3½	3
(previous)		(6)	(4¼)	(3¼)	(3)	(n/a)
Trimmed mean inflation	4.9	6	5	3¾	3¼	3
(previous)		(4¾)	(3½)	(3¼)	(3)	(n/a)
	Year-average					
	2021/22	2022	2022/23	2023	2023/24	2024
GDP growth	3¾	4	3½	2¼	1¾	1¾
(previous)	(3¾)	(4½)	(4½)	(2¾)	(2)	(n/a)

(a) Forecasts finalised on 3 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. Other forecast assumptions (assumptions as of May *Statement* in parenthesis): TWI at 63 (63); A$ at US$0.69 (US$0.71); Brent crude oil price at US$94bbl (US$101bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government Budget 2022–23. 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

Labour Market

In June, the unemployment rate dropped to a near 50-year low of 3½ per cent. In its previous SoMP in May, the RBA did not expect unemployment to reach such a low level until mid way through 2023. In addition, the RBA expected the unemployment rate to bottom out at 3½ per cent, alongside its expectation that no more slack could be extracted from the market.

In light of the recent labour market outperformance and adjustments to its growth profile, the RBA has revised its unemployment forecasts. The unemployment rate is now expected to trough earlier and lower than previously anticipated at 3¼ per cent by the end of 2022. The RBA also expects that the record level of labour force participation will be sustained alongside strong market conditions and the longer-term improvement in participation among females and older Australians.

However, as economic activity begins to slow over 2023 and into 2024, the unemployment rate is expected to rise, albeit only gradually. The RBA expects the unemployment rate will edge up to 3½ per cent through 2023 and reach 4 per cent by the end of 2024. It's important to note that the

RBA's own estimate of full employment is an unemployment rate between the high 3's and the low 4's. The unemployment rate is, therefore, expected to remain within the vicinity of full employment, suggesting the labour market will remain tight despite some easing of employment conditions.

Consistent with a further tightening in labour market conditions, the RBA has also upgraded the near term outlook for nominal wages growth. The wage price index (WPI) is expected to rise by 3 per cent in 2022, 3½ per cent in 2023 and to reach almost 4 per cent by the end of 2024. If this were to come to fruition it would represent the fastest growth in the WPI since 2012.

Broader measures of wages are expected to rise more rapidly as employers raise non-wage remuneration to attract and retain talent and employees increasingly job-hop for a better deal. Indeed, around 60% of the firms in the RBA's liaison program expect that wages growth will be higher over the next year compared to current rates. This expectation is underpinned by higher voluntary turnover, higher inflation outcomes being used in wage negotiations and the recent decision from the Fair Work Commission to raise minimum and award wages.

Despite an expected uptick in nominal wages, real wages are projected to go backwards until at least 2024 as inflation moves higher and remains elevated for longer.

Inflation

As detailed in the RBA's monetary policy decision, the RBA has sharply upgraded its expectation for the peak in headline inflation. Additionally, inflation is now expected to moderate less quickly, meaning inflation is forecast to remain above the RBA's 2-3 per cent target band for longer. Inflation higher for longer highlights the inflation challenge facing the RBA.

The RBA is expecting headline inflation to peak at 7¾ per cent in the December quarter of 2022. This is up from a previously projected peak of 5.9 per cent in May's SoMP and 7 per cent indicated in recent speeches. Headline inflation is not expected to return to the top of the 2-3 per cent target band until the end of 2024, after declining steadily over the course of 2023 and 2024. The RBA had previously expected inflation to return to the top of its target band by mid way through 2024.

Higher utilities prices largely account for the RBA's forecast upgrade. Wholesale electricity and gas prices have jumped sharply over recent months, as domestic supply disruptions collided with strong demand and elevated international coal and gas prices. This is expected to lead to a 10-15% increase in retail electricity and gas prices in the September quarter. However, much of the increase in utilities prices will not show up in the consumer price index (CPI) until the December quarter, as state government rebates will largely offset the increases.

Rising energy prices are not the only factor driving the revision to the RBA's headline inflation forecasts. The Bank is also expecting inflation to broaden, that is, prices are expected to rise faster across a larger range of items. Reflecting this, the RBA has also lifted its forecasts for trimmed mean inflation. Trimmed mean inflation is expected to peak at 6 per cent at the end of 2022 and to ease to 3 per cent by the end of 2024. This compares to the RBA's previous forecasts which projected a peak in trimmed mean inflation of 4¾ per cent later this year.

Monetary Policy Outlook

Changes to the RBA's forecasts mean the Bank's expectations for the evolution of the Australian economy are now more closely aligned with our own and reinforce our forecast for the cash rate profile.

We continue to expect the RBA to hike to cash rate to 3.10% by the end of this year in response to a further escalation in inflationary pressures. We expect the cash rate to peak at 3.35 per cent in early 2023, as a stream of weaker data halts the RBA's hiking agenda.

As the RBA moves to contractionary monetary-policy settings in coming months, we expect growth to slow materially in 2023 to an annual pace of just 1 per cent. It is on this backdrop and with evidence that inflation pressures are starting to ease, that we expect the RBA to begin cutting rates. Our group view is for this to begin at the start of 2024, however, there is a growing risk that rate cuts commence in late 2023.

Jameson Coombs, Economist
Ph: 0401 102 789

Contact Listing

Chief Economist
Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist
Jarek Kowcza
jarek.kowcza@bankofmelbourne.com.au
0481 476 436

Economist
Jameson Coombs
jameson.coombs@bankofmelbourne.com.au
0401 102 789

The Detail

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 Bank of Melbourne has a contract to supply Information, the supply of the Information is made under that contract and Bank of Melbourne's agreed terms of supply apply. Bank of Melbourne does not represent or guarantee that the Information is accurate or free from errors or omissions and Bank of Melbourne 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 Bank of Melbourne products and details are available. Bank of Melbourne 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. Bank of Melbourne owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of Bank of Melbourne.

Any unauthorised use or dissemination is prohibited. Neither Bank of Melbourne- 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.