

Friday, 6 May 2022

RBA Statement on Monetary Policy Higher Inflation Outlook as Hikes Begin

- The Reserve Bank (RBA) followed up its first interest rate hike in 11½ years with its quarterly Statement of Monetary Policy (SoMP), released this morning.
- The RBA has quelled the question of when the first hike will occur, turning attention to the future path of interest rates. This shift places further emphasis on the RBA's forecasts, as they provide insights into the RBA's thinking around the evolution of monetary policy.
- The RBA forecasts headline inflation to surge to a peak of almost 6 per cent in 2022 (previously 3¼ per cent), before easing over 2023 and 2024. Underlying inflation was also revised significantly higher. The RBA does not expect inflation to return to the top end of its target band until midway through 2024.
- The unemployment rate is forecast to fall to around 3½ per cent by the middle of 2023 and remain there for the rest of the forecast period. An unemployment rate this low has not been observed in Australia since 1974!
- The RBA also upgraded its outlook for wages growth. The RBA expects wages to grow by 3 per cent over 2022 and for growth to accelerate to 3¾ per cent by mid 2024.
- We expect the RBA to hike the cash rate by 40 basis points at its June meeting quickly unwinding the pandemic emergency rate settings. We expect this to be followed by several more rate hikes this year, lifting the cash rate to 1.75% by the end of 2022.

The Reserve Bank (RBA) followed up its first interest rate hike in 11½ years with its quarterly Statement of Monetary Policy (SoMP), released this morning. The statement provides deeper insights into the RBA's assessment of the domestic and global economy, and critically, further information around the RBA's thinking on the future path of inflation. The statement also includes a full set of updated economic forecasts, adding to the projections released alongside the Board's monetary policy decision earlier this week.

By getting the tightening cycle underway the RBA has quelled the question of when the first rate hike will occur, turning the attention to the future path of interest rate moves. This shift places further emphasis on the RBA's forecasts, as they provide the clearest insight into the RBA's thinking around the potential evolution of monetary policy.

Economic Growth

The RBA forecasts Australian economic growth to remain strong, despite an expected slowdown in global growth caused by higher-than-expected inflation, the war in Ukraine, and widespread lockdowns in China to control the spread of COVID-19.

The Australian economy is expected to grow by 4¼ per cent over 2022 (unchanged from the February SoMP), underpinned by growth in private consumption and investment. This is broadly

consistent with our expectation that GDP will rise by 4½ per cent over 2022.

Growth is expected to slow to 2 per cent in 2023 (unchanged) as policy support provided by governments and the RBA during the peak of the pandemic is unwound and the recovery matures.

Output Growth and Inflation Forecasts^(a)

Per cent

	Year-ended					
	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023	June 2024
GDP growth	4.2	3½	4¼	3	2	2
(previous)		(5)	(4¼)	(2½)	(2)	(2)
Unemployment rate ^(b)	4.7	3¾	3¾	3½	3½	3½
(previous)		(4)	(3¾)	(3¾)	(3¾)	(3¾)
CPI inflation	3.5	5½	6	4¼	3¼	3
(previous)		(3¾)	(3¾)	(2¾)	(2¾)	(2¾)
Trimmed mean inflation	2.6	4½	4¾	3½	3¼	3
(previous)		(3¼)	(2¾)	(2¾)	(2¾)	(2¾)
Year-average						
	2021	2021/22	2022	2022/23	2023	2023/24
GDP growth	4.7	3¾	4½	4½	2¾	2
(previous)		(4½)	(5½)	(4¾)	(2½)	(2)

(a) Forecasts finalised on 4 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, and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the May 2022 Board meeting. Other forecast assumptions (February *Statement* forecasts in parenthesis): TWI at 63 (60); A\$ at US\$0.71 (US\$0.71); Brent crude oil price at US\$101/bbl (US\$85/bbl). 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.

Source: RBA

Labour Market

The RBA foresees the labour market tightening faster and further than previously expected. The unemployment rate is forecast to fall below 4 per cent over the first half of this year (previously 4 per cent), before reaching 3½ per cent midway through next year (previously 3¾ per cent). An unemployment rate this low has not been observed in Australia since 1974!

At such a low level of unemployment the economy is likely to be below the level of full employment, which the RBA estimates is somewhere in the 'high 3's to low 4's'. As the labour market tightens and spare capacity is reduced, wages are expected to grow more quickly as businesses compete for workers in a tight labour market.

While the most recent wage price index (WPI) print revealed wages had only returned to the historically low levels preceding the pandemic, businesses in the RBA's liaison program are reporting that labour costs have picked up over the course of this year and the use of bonuses, allowances and other non-base wage payments are on the rise. In fact, more than 40% of firms in the RBA's liaison program reported wages growth of 3 per cent or higher for 2022 to date and more than 50% expect wages growth of 3 per cent or higher for the year ahead.

As the labour market continues to tighten, the RBA has been shifting its focus away from the WPI towards other measures of wages pressure. The WPI provides a lagged reading of wage developments as it includes award and enterprise bargaining agreements, which are typically agreed for multiple years and only gradually reflect emerging wage pressures.

Reflecting this, and its fresh set of labour market forecasts, the RBA has also upgraded its outlook

for wages growth (as measured by the WPI). The RBA expects wages to grow by 3 per cent over 2022 (previously 2¾ per cent) and for growth to accelerate to 3¾ per cent by mid-2024 (previously 3¼ per cent).

The RBA expects the lift in base wages to be gradual, led by individual arrangements in the private sector. However, as multi-year enterprise agreements expire and private sector benchmarks flow through to the public sector, wages growth is expected to broaden.

Inflation

The much hotter-than-expected first quarter inflation print blew the RBA's previous forecasts out of the water. The RBA now expects price pressures to be higher and more persistent than previously anticipated. Although inflation in Australia remains lower than in many other advanced economies.

The RBA's renewed assessment of inflation has driven a stark change in the Bank's forecast for the consumer price index (CPI). The RBA forecasts headline CPI inflation will surge to a peak of almost 6 per cent in 2022 (previously 3¾ per cent), before easing over 2023 and 2024. The RBA does not expect headline inflation to return to the top end of its target band until midway through 2024.

Inflation is expected to decline over the forecast period as supply-chain disruptions and high commodity prices ease over time. However, the war in Ukraine and lockdowns in China mean that this transition is likely to take longer than the RBA previously expected. Additionally, inflationary pressures from a tight domestic labour market and increasing wages are expected to flow through sooner than the RBA previously forecast.

Forecasts for underlying inflation have undergone a similar revision. Underlying inflation is forecast to peak around 4¾ per cent in 2022 (previously 2¾ per cent), before falling to around 3 per cent by June 2024.

It is important to note, that underlying the RBA's inflation forecasts is the assumption that the cash rate will increase to around 1.75% by the end of 2022 and peak at 2.5% at the end of 2023. Accordingly, the forecast trajectory for inflation incorporates the expected impact of increasing interest rates on economic activity.

Monetary Policy Outlook

The RBA Governor recently stressed the "need to normalise interest rates" because the economy doesn't "need these emergency settings anymore". Today's SoMP noted that "the Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time" and flagged that this "will require a further lift in interest rates over the period ahead".

The cash rate is expected to continue to normalise over the remainder of 2022 and into the start of 2023. Governor Lowe suggested during a Q&A session earlier this week that he considered a cash rate of 2.5% to be "a more normal level", providing some guidance on where the RBA expects rates to peak in the longer-run.

We expect the RBA to hike the cash rate by 40 basis points at its next meeting in June, fully unwinding the 65 basis points of emergency cuts at the start of the pandemic. We then expect several more rate hikes over the remainder of the year, lifting the cash rate to 1.75% by the end of 2022. An additional two 25 basis point hikes in the start of 2023 are expected to take the cash rate to a peak of 2.25% by mid-2023.

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