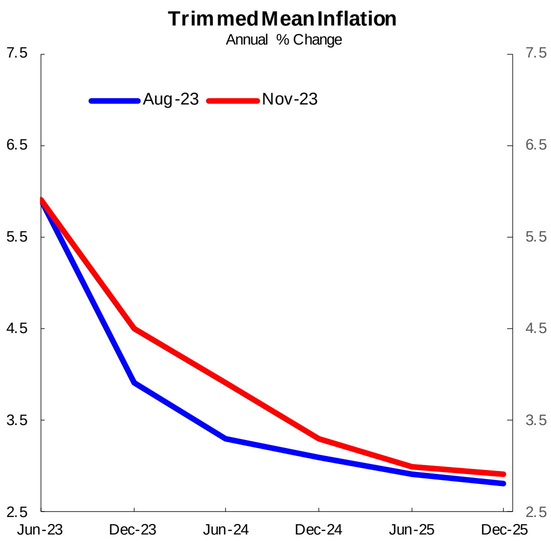
Friday, 10 November 2023

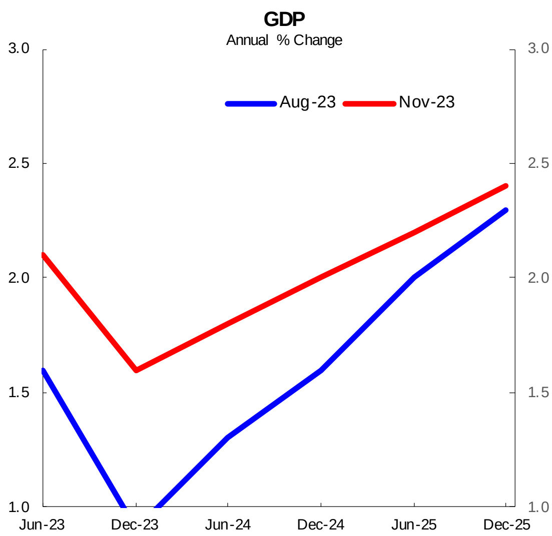
RBA Statement on Monetary Policy

RBA Wrestling With Resilience

- **The November Statement on Monetary Policy (SoMP) confirms that the Reserve Bank (RBA) perceives the underlying resilience of the Australian economy as the key source of the inflation 'surprise' which prompted a 25-basis point hike from the Board in November.**
- **The outlook for inflation has been revised higher, particularly in the near term, as inflation has proved to be stickier than the RBA previously expected. The story is a familiar one – goods inflation continues to moderate as supply-chain disruptions ease. However, services prices, which are more impacted by domestic factors, are showing signs of being sticky.**
- **The RBA's forecasts reflect a more optimistic outlook for the Australian economy. This is partly a mechanical upgrade from the current resilience of the economy but the RBA has also carried this momentum forward, expecting stronger growth in both 2023 and 2024.**
- **Employment growth has been revised higher in line with a stronger-than-expected economy and faster population growth. The unemployment rate is expected to rise by less than in the previous SoMP, slowly rising to 4.3% by the end of 2025, from its current rate of 3.6%.**
- **A gradual easing in the labour market is expected to be evident in broader measures of slack, including underutilisation and hours worked. Average hours are expected to fall as employers demand fewer hours from their employees to adjust to weaker demand, rather than through outright job losses. This adjustment is consistent with our expectation.**
- **There remains very little leeway for inflation to surprise to the upside if the RBA is to succeed in its objective of bringing inflation back to target by the end of 2025. As a result, another interest rate hike cannot be ruled out if an upside surprise materialises.**



Source: RBA



Source: RBA

The Reserve Bank's (RBA) Statement on Monetary Policy (SoMP) provides a detailed assessment of the Australian economy and the Bank's updated economic forecasts which were relied upon in the November policy meeting.

The SoMP confirms that the RBA perceives the underlying resilience of the Australian economy, rather than global factors such as the price of oil, as the key source of the inflation 'surprise' which prompted a 25-basis point hike from the Board in November. Importantly, the resilience underpinning the stickiness in inflation means it's difficult to rule out another hike – November may not have been just 'one and done'.

Crucially, the RBA's fresh forecasts are predicated on the assumption that the cash rate will peak at around 4½%, this is half a percentage point higher than was assumed in the August SoMP and slightly higher than the current rate. Even after increasing its cash rate assumption, the RBA has upgraded its expectation for economic growth and inflation. There is now very little leeway for inflation to surprise to the upside if the RBA is to succeed in its objective of bringing inflation back to target by the end of 2025. An objective which the Governor says the Board has a "low tolerance" for extending out further. In other words, the threshold for another rate hike might be lower than suggested in the November statement's newly tweaked forward guidance.

Inflation

The outlook for inflation has been revised higher, particularly in the near term, as inflation has proved to be stickier than the RBA previously expected. The story here is one that our readers would be familiar with. Goods inflation continues to moderate as supply-chain disruptions ease. However, services prices, which are more impacted by domestic factors, are showing signs of being sticky, as has been the case overseas. This was made clear by the September quarter inflation result, which printed at 1.2% in quarterly terms, well above the RBA's implied forecast from August of 0.9%.

The RBA now expects headline inflation to finish 2023 at 4.5% (up from 4.1%), and for prices to rise by 3.5% in 2024 (up from 3.3%). Underlying inflation, as measured by the trimmed mean, has been revised higher by slightly more than headline inflation in the near term – to 4.5% for 2023 compared to 3.9%.

Further out, the RBA expects inflation to moderate, but it only expects inflation to just scrape into the top of the 2-3% band (at 2.9%) by the end of 2025 – slightly above its previous expectation of 2.8%.

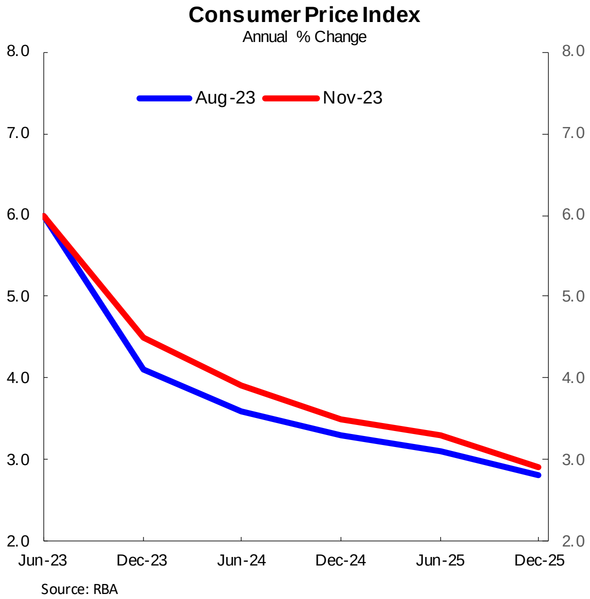
Inflation is proving to be stickier than the RBA was previously expecting and the Board has emphasised that they have a low tolerance for inflation remaining outside of the band for longer than currently expected (i.e. beyond the 2025 timeframe). November's rate hike was hoped to give the Board more confidence that they would achieve this target. But the forecasts suggest that there might still be some way to go to build this confidence.

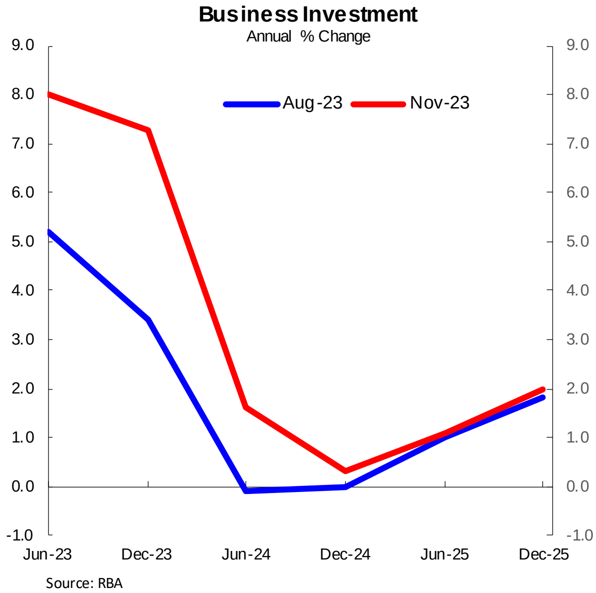
Based on the forecasts, the RBA's implied expectation for the December quarter inflation print is quarterly growth of 1.0% for headline inflation and 1.1% for underlying inflation. These will be important numbers to watch come late January, when the data will be released ahead of the RBA's February meeting.

Economic Growth

The RBA's revised forecasts reflect a more optimistic outlook for the Australian economy. This is partly a mechanical upgrade from the current resilience of the economy but the RBA has also carried this momentum forward, expecting stronger growth in both 2023 and 2024.

The RBA now expects the economy to expand 1.6% in 2023, up from 0.9% previously. In 2024, the economy is expected to grow 2.0%, up from 1.6% in August's SoMP. In 2025, the economic growth forecasts were notched up to 2.4% from 2.3% but were broadly unchanged.





Interestingly, the composition of growth has also been updated. The RBA has downgraded its expectations for household consumption in both 2023 and 2024, this is despite population growth continuing to surprise to the upside. The RBA is now expecting inflation, tax and interest rates to have a deeper drag on household disposable income than previously expected.

More than offsetting this change were large upgrades to business investment, particularly in 2023 but also in 2024. Weak per capita household consumption is being buffeted by surging population growth, which is slowing the usual passthrough from households to businesses. Resilient business conditions, elevated capacity utilisation and the easing of supply snarls have been supporting business investment and it looks like the RBA expects this to continue in the near term. Interestingly, this implies that the limited spillover from weak households to businesses is also expected to persist.

While the RBA is endeavouring to get on top of inflation while keeping the economy on an even keel, too much resilience poses an upside risk to inflation. Additionally, the RBA would be more concerned by inflation risks stemming from resilient demand compared to overseas shocks such as the price of oil, as domestic drivers of inflation can be stickier and more difficult to curb.

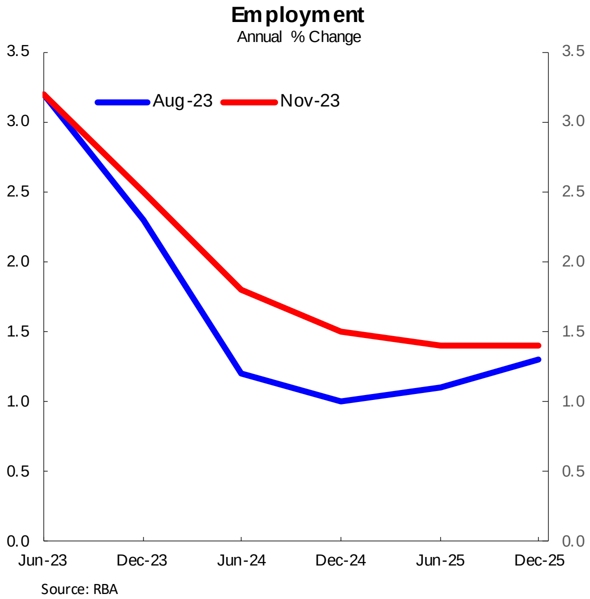
Unemployment and the Labour Market

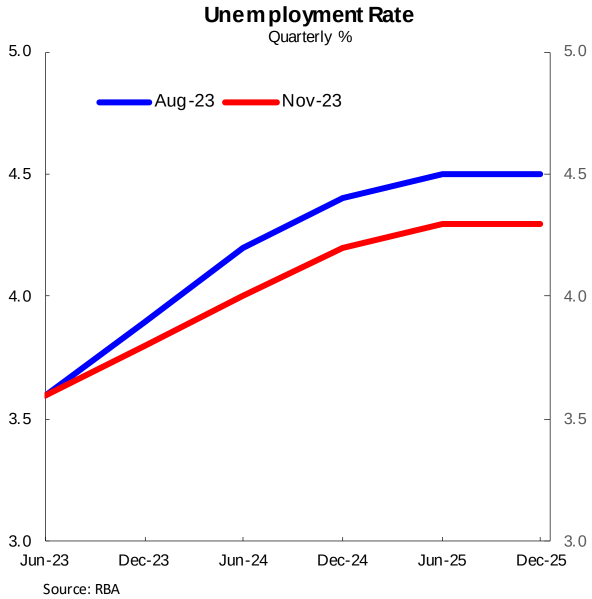
The profile for employment growth has been revised higher in line with a stronger-than-expected economy and faster population growth. Additionally, the unemployment rate is expected to rise only gradually as the labour market remains tight. Indeed, the unemployment rate has been revised lower compared to the previous SoMP. The RBA expects the unemployment rate to slowly rise to 4.3% by the end of 2025, from its current rate of 3.6%.

This begs the question, where is the required easing in the labour market coming from if the unemployment rate has been revised lower and employment growth has been revised higher?

The answer lies in broader measures of labour market slack, including underutilisation and hours worked.

As the growth in the working age population is expected to outpace growth in employment, spare capacity in the labour market rises, leading to higher unemployment rate. But another way that space capacity can increase is through employers demanding fewer hours from their employees, rather than through outright reductions of employment.





The RBA expects this to occur as it predicts that total hours will grow more slowly than total employment, resulting in average hours declining over time. This is a reasonable expectation given the recent environment where businesses struggled to hire workers meaning they may now be more reluctant to let go of employees.

This dynamic emphasise why economists look at several indicators to get a sense of how tight the labour market is. The unemployment rate isn't necessarily the best measure of spare capacity. Other measures, including underemployment, underutilisation, and hours worked, help provide a fuller picture.

The wages picture is expected to be broadly unchanged from the previous SoMP, as nominal wages growth is supported by a still relatively tight labour market. The RBA expects the wage price index to grow by 4.0% in 2023, 3.7% in 2024, and 3.5% in 2025.

Monetary Policy Outlook

The RBA remains vigilant to domestic drivers of inflation and perceives the resilience of the economy as the key source of the recent inflation surprise. They expect some of this resilience to continue and its forecasts leave little wriggle room for inflation to land to the upside. This means the RBA will remain highly attentive to upside inflation risks and may react to any further inflation surprises. Such a response would be in line with the Board's 'low tolerance' to jeopardise its goal of returning inflation to target by the end of 2025.

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