

Key points

- Stronger growth and higher inflation led the RBA to revise its economic forecasts;
- They are now open to the possibility of increasing the cash rate this year;
- I look for two cash rate increases in Q4 2022 (taking the cash rate to 0.5%);
- An earlier move in Q3 is possible depending upon wages growth;
- The big focus will be on the peak of the cash rate.

Summary

Views on the economic outlook have changed quickly over the course of the pandemic. The RBA thinks that the unemployment rate will be in the 3's by end-2022 (so apparently does Federal Treasury). The RBA has also dramatically increased their inflation forecasts that are now consistent with rate rises occurring this year (and certainly well before the end of next year). The timing of rate rises will be substantially (but not wholly) determined by wages growth. The RBA believes rising wages growth will be a slow burner, with the fabled 3% figure not hit until towards the end of next year. I think it will be earlier.

For much of last year the prevailing view was that higher prices was largely a supply problem. These supply problems would prove temporary once the economy fully re-opened. There has been improvement in supply in recent weeks. People working in the global logistics industry think it might take the best part of this year for them to be fully resolved. Worker shortages might be around longer because of lack of immigration and very strong demand workers.

Strong demand has played a role in rising prices. And the fundamentals for further strong spending look good. The problem is we cannot be certain about the future path of the virus. Another COVID wave(s) would complicate matters for the RBA. Spending would slow again, as would the number of hours worked. The virus is having at least as big an impact on the supply side of the economy than demand. And COVID has had a very uneven impact on the economy.

The other issue that may complicate things is developments in the financial sector and movements in overseas interest rates. Currently financial markets are pricing in a higher cash rate not only in Australia but for many of the major global economies. Concerns about rising interest rates are impacting asset markets and has led to some rise in borrowing costs. To date the fall in equity markets and the rise in borrowing costs have been modest. Some further weakness in equity and housing markets would not be enough to stop central banks starting to hike interest rates. But sustained weakness in asset markets might be a bigger worry.

At its February meeting the RBA announced that it would end Quantitative Easing (QE). The RBA believes that its QE program reduced interest rates by 0.2-0.3 percentage points lower than it otherwise would have traded. The ending of QE and the shift to QT (quantitative tightening, when the RBA reduces the size of its balance sheet) will likely have some impact on financial markets and therefore the general economy. This will be happening at the same time as other central banks also undertake QT. It adds to the upside risk for longer-term interest rates.

In the most likely scenario I expect the first rate increase to be in Q4 (of 0.15%), quickly followed by a second (0.25%) in the same quarter. An earlier move in the third quarter is possible depending upon wage outcomes. I would expect that the cash rate to get to 1% quite quickly (in the first half of 2023). Thereafter increases in the cash rate are likely to be slower. A number of analysts think the peak in the cash rate will be 1-1.5%. Financial Markets are currently pricing in a peak of 2-2.25%. I think the risks are that the peak could be closer to 3%.

Changing times

Views on the economic outlook have changed quickly over the course of the pandemic. When the virus first arrived there were forecasts that the unemployment rate in Australia would be well into the double figures. Not only did we not get there but the unemployment rate looks to be on track to fall to its lowest level in almost fifty years.

Over that time Governments in the developed countries have been very good at maintaining household and business incomes. Government restrictions and caution about COVID have at times limited spending. The spending that has taken place has been more focussed on goods than services. The virus has had a significant impact upon supply. The result has been higher inflation, a macroeconomic concern that has not raised its head since the GFC.

This is the backdrop that the RBA faced entering its first meeting for this year. The big changes in economic views has led to a big change in view about the outlook for interest rates. Namely, the cash rate could rise later in 2022.

Change view on economy

The impact of the Omicron wave led the RBA to downgrade its Q1 GDP growth view (and therefore its forecast for 2022). They remain confident that growth will pickup as this virus wave subsides. I agree with the RBA's projected pattern of economic growth (see below on a discussion about uncertainties). But I am more optimistic about the level of growth (4.75% v RBA 4.25% in 2022, and 2.5% v RBA 2% in 2023). We shall see who is right.

Strong economic growth and much stronger than expected labour market numbers has the RBA thinking that the unemployment rate will be in the 3's by end-2022 (so apparently does Federal Treasury). I agree with that view. It is possible that the unemployment rate may rise a tick or two early this year as a result of the current Omicron wave. But the extraordinary high level of vacancies and already high participation rate means it is highly likely that the unemployment rate will be under 4% before year-end. The only catch will be whether the unemployed workers have the skills for the jobs advertised.

The stronger economy, longer-lasting supply problems and high CPI numbers has led the RBA to dramatically increase their inflation forecasts. From November forecasts for of 2.25% and 2.5% at end 2022 and 2023, respectively, underlying inflation is now expected to be 3.25% and 2.75%. These numbers are consistent with my forecast. And the RBA inflation forecasts are consistent with rate rises occurring this year, and certainly well before the end of next year.

The timing of rate rises will be substantially (but not wholly) be determined by wages growth. The RBA rightly note that wages growth is not currently very strong, and a further pickup will be required for inflation to sustainably stay within the 2-3% target. The RBA believes rising wages growth will be a slow burner, with the fabled 3% figure not hit until towards the end of next year. I think it will be earlier. Recent experience highlights the uncertainty about any economic forecast.

The RBA has also attempted to move attention away solely from the Wage Cost index data when thinking about wages growth. The best measure is unit labour costs. That measure takes into account not only wages growth but also other labour costs such as superannuation. It also explicitly takes into account productivity growth. That measure has risen by 3.6% since end 2019, consistent with a sustained inflation rate of under 2%. But like all data the quarterly movements contain plenty of noise (particularly over the past couple of years). Hence the RBA focus on more than one indicator.

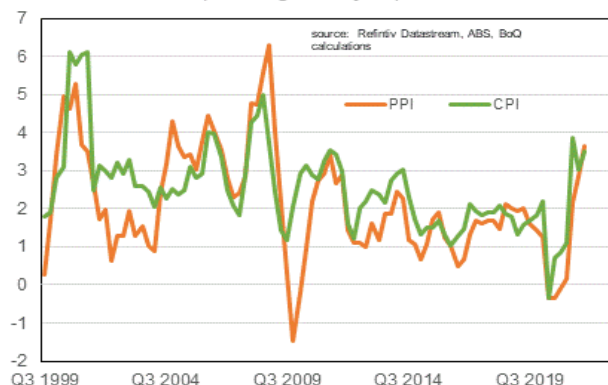
ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 4TH FEBRUARY 2022

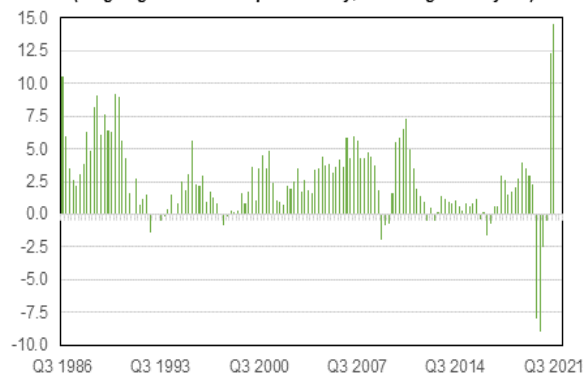
Firms are increasing passing on higher costs to customers.

Australian inflation
(% change over year)



Movements in labour costs are a key driver of price rises.

Unit labour costs
(wages growth minus productivity, % change over year)



Is higher inflation due to a lack of supply or higher demand?

For much of last year the prevailing view was that higher prices was largely a supply problem. These supply problems would prove temporary once the economy fully re-opened. The thinking went that there was nothing a central bank can do to fix supply problems. Certainly business surveys indicate that a lack of materials and workers are major problems. Costs are on the rise and are increasingly being passed onto customers.

There has been improvement in supply in recent weeks (test kits are more widely available, there is more food on the shelves). This should continue as supply chains look to be working better. For example, the backlog of orders for US manufacturers is declining. Freight costs have fallen. But people working in the global logistics industry think it might take the best part of this year to be fully resolved (assuming a decent run with the virus).

Worker shortages might be around longer because of lack of immigration and very strong demand workers. Even immigration may not be the full answer given that very low unemployment rates are a feature of most developed economies.

In recent decades central banks have not worried about price rises caused by supply problems as these have largely proven to be temporary. But the supply shortages on this occasion have lasted longer and are leading to a more sustained rise in prices. The RBA acknowledges the possibility that these supply problems might last for some time yet.

The rise in prices has led to an increase of inflation expectations. To date expectations have risen from being below the 2-3% target to now being consistent with the inflation objective. But the longer price rises remain too high the more likely that expectations move too high. And the more likely that price rises will stay too high.

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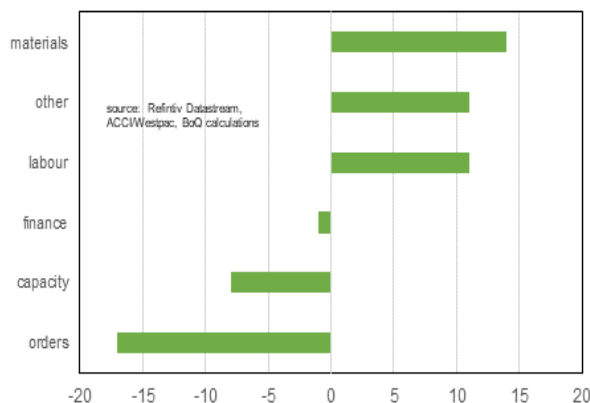
Global supply chains are starting to work better.

US manufacturing backlog of orders (index)



Materials and workers remains major worries for firms.

Factors limiting production (Dec qtr 2021 outcome relative to long-term average)

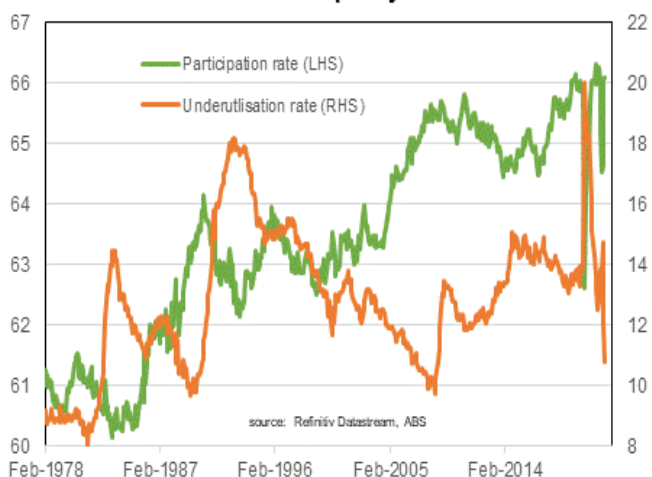


Demand has also played a role

But it is also clear that strong demand has played a role in rising prices. The level of GDP growth at the end of 2021 is likely to be about 2% above end 2019 levels (although it is below where the economy would have been if it kept growing at its pre-pandemic growth rate). The domestic economic data has consistently surprised with strength over the past couple of months. The participation rate is near record highs, the underutilisation rate at its lowest level in over a decade. The demand for labour (job vacancies) is extremely strong.

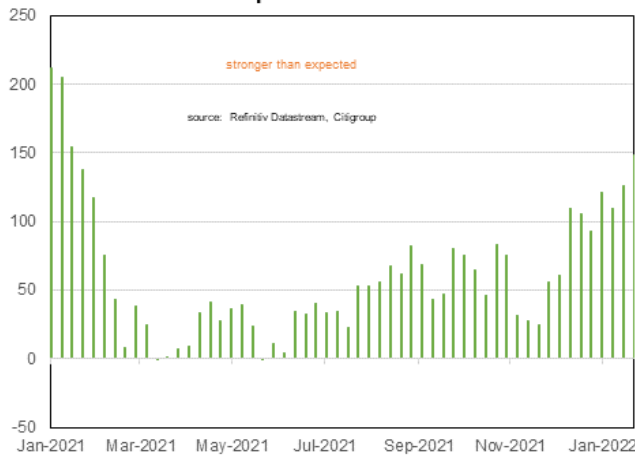
The jobs market is currently very strong.

Labour market capacity measures



Australian economic data has consistently been stronger than expected over the past year.

Economic Surprise Indicator for Australia



The RBA central case is that spending will pickup strongly as the current wave declines. That is a reasonable assumption. Demand has bounced back after each preceding virus wave. Consumer confidence has started to improve, household mobility is rising.

And the fundamentals look good. Income growth has been strong, savings high, company's cash flow has been largely good. Household confidence about the economic outlook and their own finances is good. There is plenty of construction and infrastructure work still to be done. Despite the uncertainty, firms' capex intentions are elevated. High commodity prices are helping our farmers and miners. The Chinese Government is acting to boost its economy that should underpin demand for key Australian minerals.

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The problem is we cannot be certain about the future path of the virus. A future Omicron wave is possible, particularly in the winter months when immunity from the third booster shot begins to wane. There remains the possibility of further variants. Government restrictions have only modestly tightened restrictions during this wave. Rising consumer and business caution has been a bigger issue.

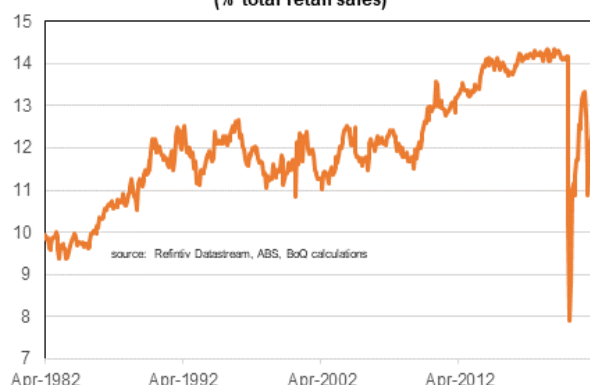
Another COVID wave(s) would complicate matters for the RBA. Spending would slow again, as would the number of hours worked. The virus is having at least as big an impact on the supply side of the economy than demand meaning inflation could remain a problem. Household income growth is likely to be supported by strong jobs growth and rising wages. The economy might require further government income support in the event of further COVID interruptions, particularly smaller firms.

And COVID has had a very uneven impact on the economy. Areas of the economy not impacted by consumer caution and government regulations (agriculture, mining, manufacturing, construction, wholesale trade, logistics, and professional services) are doing well and are the areas where prices are rising the fastest. But the impacted sectors (recreation, hospitality, parts of retail, transport) are doing it tough.

As demand switches back towards services and the supply of goods increases this will play a role in reducing inflation. But we cannot be certain when that switch will occur or whether there has been a structural shift higher in the demand for goods. A tight labour market is likely to lead to stronger wages growth. And in time wages growth is the key determinant of service sector inflation.

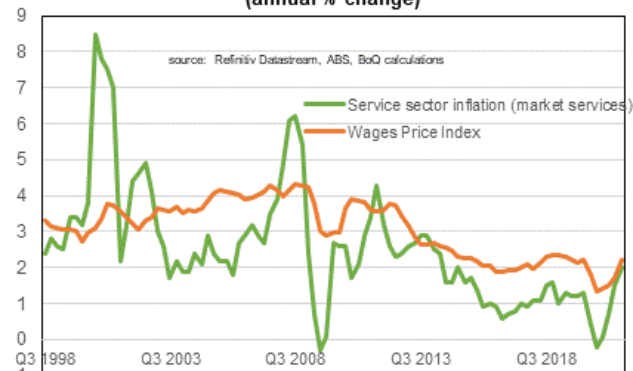
There is still some distance to go before consumer spending has returned to pre-COVID patterns.

Cafe and Restaurant sales
(% total retail sales)



Wages growth influences service sector prices.

Service sector inflation and wages growth
(annual % change)



Impact of global developments

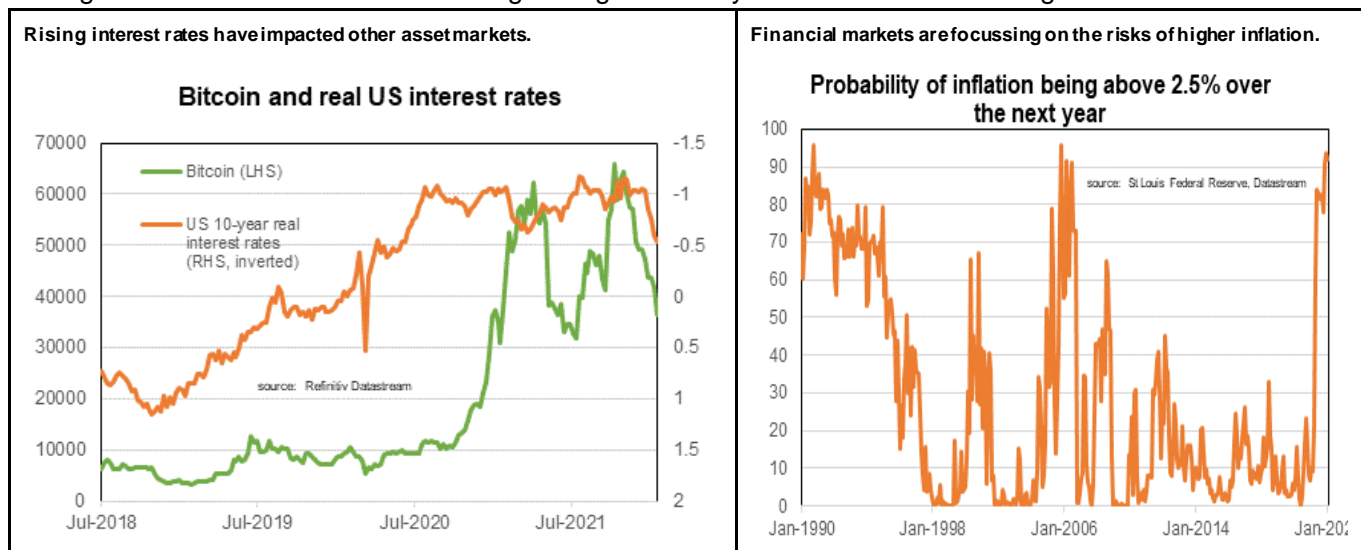
The other issue that may complicate things for the RBA is developments in the financial sector and movements in overseas interest rates. Currently financial markets are pricing in a higher cash rate not only in Australia but for many of the major global economies (with the exception of China and Japan). In Australia, markets are pricing almost a one percentage point rate hike for the remainder of this year. In the US it is almost 1.25 percentage points and the UK, and over 1.5 percentage points in New Zealand. Rate hikes are even expected in Europe later in the year.

But concerns about rising interest rates are impacting asset markets. Year to date both the Australian and US equity market are down almost 5%, with the Nasdaq down over 8%. Bitcoin has been hit even harder (down by 45% from its October peak). There are forecasts for potential declines in house prices this year based on the premise of higher interest rates. Concerns about rising interest rates has started to see borrowing costs in financial markets rise.

To date the fall in equity markets and the rise in borrowing costs have been modest. House prices have actually started the year on a tear. Even if household wealth did take a bigger hit, a very strong jobs market, rising wages and a mountain of saving should provide plenty of support to consumer spending.

A weaker performance in equity and housing markets would not be enough to stop central banks starting to hike interest rates. But sustained weakness in asset markets might be a bigger worry.

The other concern is that global central banks hike interest rates aggressively fearing they are behind the inflation curve leading to a slowdown in the global economy. Currently financial markets are pricing neither high inflation nor interest rates heading too high. But they note that the risks of higher inflation have risen.



Putting the tools back in the toolbox

It used to be that changing the cash rate was the only game in the monetary policy town. But with interest rates essentially at zero the RBA (like other central banks) dived into their toolbox to see what else they could use to help repair the economy. Some of those tools have already been put away (cheap bank funding and yield curve control).

At its February meeting the RBA announced that it would put away another of those tools (Quantitative Easing, or QE). QE is when the RBA buys federal and state government bonds to help drive down interest rates for all borrowers. The RBA said that they will announce in May what they will do with the bonds they have bought. They have essentially three options. Reinvest bonds as they mature to keep the size of their balance sheet unchanged. Reduce the size of their balance sheet as bonds mature by not investing the bonds that mature. Or more aggressively reduce their balance sheet by selling bonds.

It is most likely they will initially take the second option. There is no reason to keep their balance sheet so big given the current inflation and unemployment rate. But they may not want to drastically reduce the size of their balance sheet at least in the initial stages of any interest rate rises. What path they follow thereafter will depend upon how the economic and inflation data evolve and what other central banks do. Many other central banks have already stopped their QE programs. And some (such as the Federal Reserve and the Bank of England) are discussing whether and when to begin selling bonds.

Conceptually, having a significant buyer (or seller) in the financial markets should influence prices. The RBA believes that its QE program reduced interest rates by 0.2-0.3 percentage points lower than it otherwise would have traded. Practically though it is very difficult know how QE works. QE programs are often implemented during periods of changing views on economic growth and inflation as well as the interest rate outlook.

The ending of QE and the shift to QT (quantitative tightening, when the RBA reduces the size of its balance sheet) will likely have some impact on financial markets and therefore the general economy. This will be happening at the same time as other central banks also undertake QT. It will be difficult to know in advance how big an impact QT will have, particularly given there is also dramatic changes in views about the outlook for the cash rate. But it adds to the upside risk for longer-term interest rates. And therefore adds to the downside risk for equity markets and higher financial market volatility.

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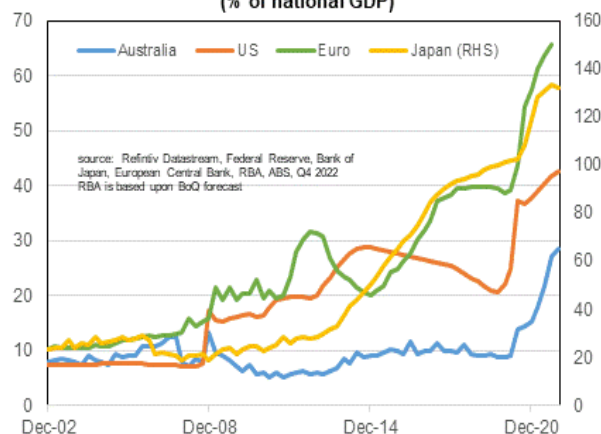
Financial market expectations of inflation have risen, but to date they have not moved too high.

Australia financial market inflation expectations
(5-year, 5-year forward)



Globally, central banks are discussing about what to do with the size of their balance sheets.

Central bank asset holdings
(% of national GDP)



What this means for monetary policy

In the most likely scenario, COVID cases further reduce in coming weeks and there are no further waves. Demand picks up and the unemployment rate declines into the 3's in the second half of the year. Supply problems last for much of this year, albeit reducing as we enter the second half. Pricing pressures remain high. Wages growth picks up, although not approaching 3% until at least Q2 (that Wages Cost data will be released in late August). Cash rates increase across most large economies, with the exception of China, Japan and Europe.

Given the above I would expect the first rate increase to be in Q4 (of 0.15%), quickly followed by a second (0.25%) in the same quarter. An earlier move in the third quarter is possible depending upon wage outcomes. If the first rate hike occurs in the September quarter I would expect the cash rate to end the year at 0.75%.

I would expect that the cash rate to get to 1% cash rate quite quickly (in the first half of 2023). A cash rate of 1% is still very low given that inflation is expected to be in top half of 2-3% target band, wages are likely to be rising and the unemployment rate is likely to be at multi-decade lows.

Thereafter increases in the cash rate are likely to be slower. There is a high degree of uncertainty as to what the peak in the cash rate should be in this cycle. In particular there is a view that high debt levels increases household sensitivity to rate rises. Financial Market valuations are reliant upon the maintenance of very low rates. Financial markets will no longer be getting any support from central banks QE policies.

On this basis a number of analysts think the peak in the cash rate will be 1-1.5% (mainly due to high debt). Financial Markets are currently pricing in a peak of 2-2.25%. I think the risks are that the peak could be closer to 3%. Wages growth next year is likely to be at its strongest in 10 years. There are further income tax cuts on the way. Household debt to disposable income has been declining. The interest payments to income ratio is at a record low. Fixed rate lending has been strong over the past couple of years providing initial protection for many borrowers against higher interest rates (those borrowers would feel the impact of higher interest rates when the fixed term ends). Household saving rates have been high. Plenty of excess saving has gone in offset mortgage accounts.

This is against a backdrop where the global demand for funds is rising reflecting strong capex spending and mortgage lending. At the same time central banks ending QE means a lower supply of funds.

But there is plenty of uncertainty as to what the peak in the cash rate should be, how the virus will evolve and how financial markets react to global central banks tightening monetary policy. This is why the pace of interest rate rises might be cautious past 1%. The key proviso is that inflation does not stay too high.

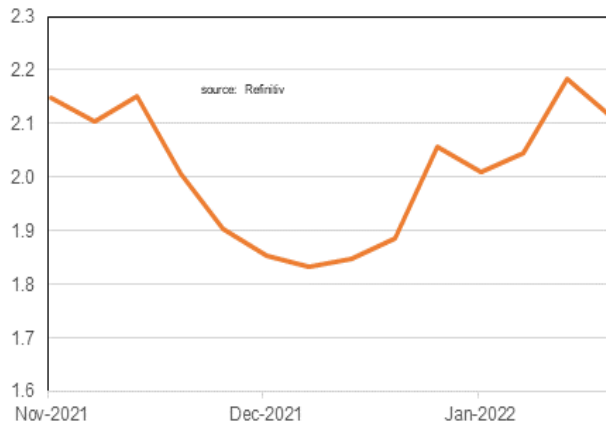
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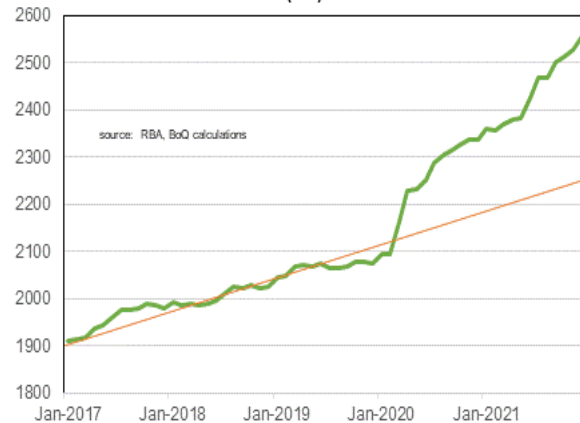
The peak in the cash rate is a key issue for financial markets.

Financial market pricing peak of the cash rate
(5-year 5-year forward Overnight Index Swap)



There has been a mountain of saving built up over the past couple of years.

Total bank deposits
(\$m)



We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland