ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 6TH MAY 2022

Key points

- **The RBA hiked rates by 0.25 percentage points at its May meeting;**
- **The move was higher than what financial markets had anticipated;**
- **This move will almost certainly not be an orphan with another rate increase likely next month;**
- **Financial market pricing of the amount of rate hikes is aggressive compared with economist forecasts and the history of moves in the low inflation era.**

Inflation in the March quarter

Going into the May RBA Board meeting economists thought the three possible scenarios were possible: no move, a 0.15 rise or a 0.4 percentage point hike. Financial Markets were fully priced for a 0.15 percentage point move. By moving by 0.25 percentage points (to 0.35%) the RBA obviously wanted to do something different for its first move in over one year.

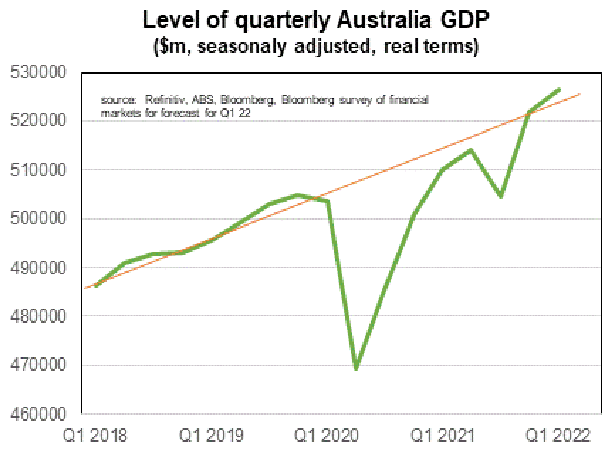
The reason given about why interest rates have gone up is what you would expect: the economy is doing so well it doesn't need more help and inflation is rising strongly. The RBA appears comfortable about the economic growth outlook although they acknowledge the various risks (China and COVID, Russia-Ukraine the impact of higher inflation). The RBA are forecasting that the unemployment rate will decline to 3.5% by early next year and remain there. The RBA suggested that much of the recent rise of inflation has been down to global factors although they noted that domestic factors are playing an increasing role. A further rise in the annual inflation rate is expected over the next 3-6 months (although I think the largest quarterly rise may have already happened). Inflation is then expected to moderate, with 3% the forecast by mid-2024. Using as evidence their liaison program and business surveys the RBA feels confident that wages growth is rising despite it not yet been evidence in the economy-wide data.

The statement released post the Board meeting made it evident that there are more rate hikes to come. I would expect the next move to be at the June meeting. In both the past two tightening cycles the RBA moved at back-to-back meetings at the beginning of its tightening cycle. In a subsequent press conference the RBA Governor indicated that 0.25 percentage point was chosen as the RBA wanted to give the impression that 'things were returning to normal'. This suggests that future rises of 0.25 percentage points is the most likely outcome. The RBA has also historically focussed upon moving the cash rate quickly back to a particular level at the beginning of a rate hike cycle.

In his press conference the RBA Governor nominated 2.50% as the sort of level that the cash rate might be heading towards without any promises that level will actually be achieved. At the time of writing, financial market pricing was substantially more aggressive.

As expected the RBA also decide to reduce the size of its balance sheet. It will do this by not re-investing the bonds as they mature and allowing the term funding facility (cheap funding to banks) to come to an end.

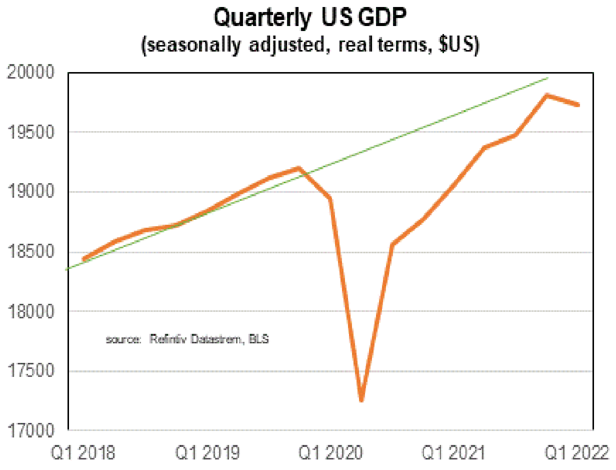
Australia's GDP is likely to be above its pre-pandemic trend in the March quarter.



Level of quarterly Australia GDP
($m, seasonaly adjusted, real terms)

source: Refinitiv, ABS, Bloomberg, Bloomberg survey of financial markets for forecast for Q1 22

The US economy though was a little below its pre-pandemic trend.



Quarterly US GDP
(seasonally adjusted, real terms, $US)

source: Refintiv Datastrem, BLS

Demand is expected to remain strong, there is greater uncertainty about supply

It is hard to argue that the cash rate should be at 0.1%. Inflation is at its highest level in over two decades and the unemployment rate is at its lowest level in almost five decades. I had thought they might have delayed moving until June until stronger wages growth was more evident. But the RBA clearly had decided it has seen enough evidence on that front.

Higher interest rates work by reducing demand. Higher interest rates reduces the incentive to borrow as well as reducing the cash flow of existing borrowers. They can reduce asset prices (such as house and equity prices) and encourage households to increase saving. It can also result in a higher exchange rate.

There is disagreement as to how much current inflation is caused by excess demand and how much by problems with supply. The short answer it is both. When the March quarter data is released in June we are likely to find out that Australian GDP has moved to be above its pre-pandemic trend (in contrast to the US). The strength of demand (until recently) has been more skewed towards goods over services.

On the supply side COVID has resulted in a sizeable reduction in the number of hours worked over the past couple of years reducing the amount of goods that could be produced. And there are substantially less workers than there would have been if immigration was remained at pre-pandemic levels. The Russia-Ukraine conflict further boosted commodity prices that had already been rising reflecting under investment and strong global demand.

Some of the excess demand and supply shortages are unwinding. Goods spending is slowing, spending on services is increasing. This has meant a slowing of new orders for goods (more noticeable overseas). Reduced concerns about COVID has seen more people return to work, leading to an increase in deliveries and reduction in the backlog of orders. Financial markets appear comfortable about the scope of the Russia-Ukraine War with many commodity prices down from their highs.

But some of the supply problems will last longer. There is a reasonable chance that chunks of the Chinese economy could be closed for periods in coming months as they continue to follow a zero-COVID strategy. While financial markets are not looking for energy prices to head higher they are also not expecting energy prices to declines. And Treasury is not expecting a return to pre-pandemic rates of population growth for some time.

Even if the supply problems are not permanent the longer they last the more likely that households and firms will expect them to last. Which is why the evolution of wages growth is so important. The RBA has previously indicated that a move of wages growth up towards 3-3.5% will be necessary for inflation to stay sustainably within the 2-3% inflation target band. If wages growth were to move towards 4% (or higher) without higher productivity growth that increases the risk of inflation staying too high (without a fall in the share of national income going to profits).

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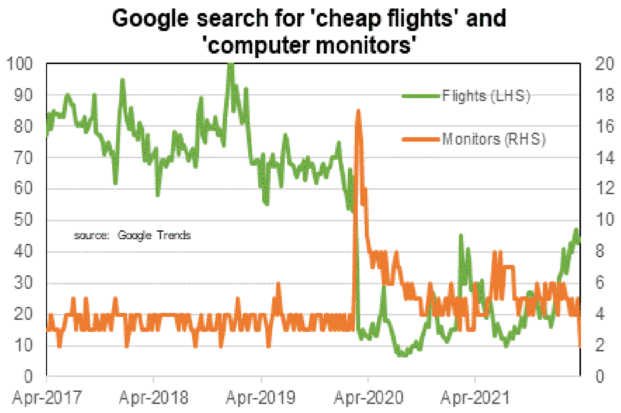
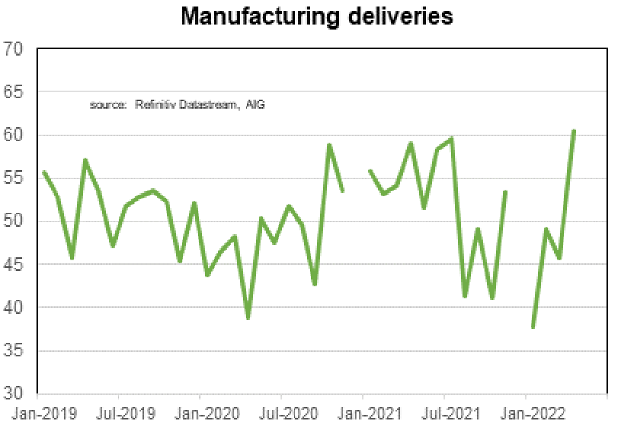
The uncertainties on the demand side is how much will consumers spend as they face declining real wages growth (wages growth less than inflation) and how higher interest rates given the level of household debt. The evidence to date is that consumers in aggregate are still spending although some households are starting to find the going tough. How that evolves will play an important role in terms of how high and how fast interest rates will rise over the next year.

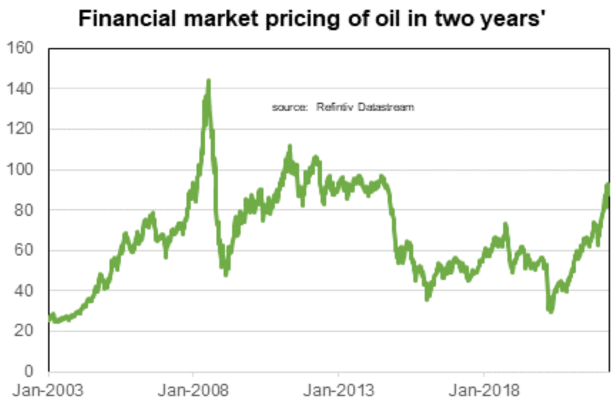
Spending on goods has been stronger than services. But that is starting to change.



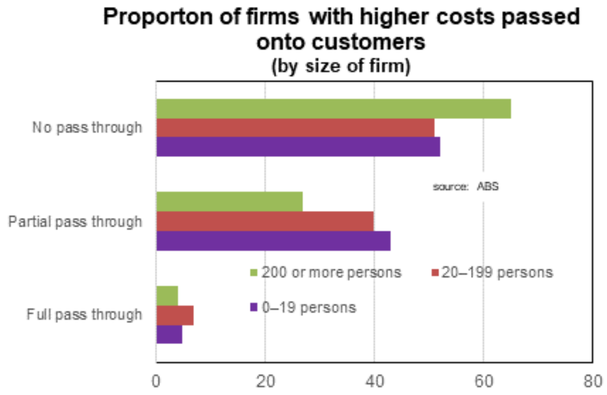
Supply chain issues is starting to ease.



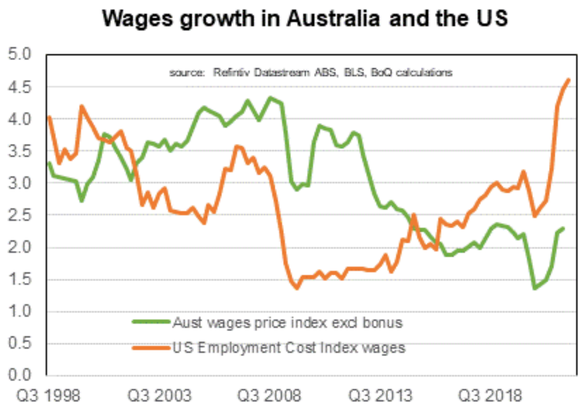
Financial markets are pricing a high oil price in two years' time.



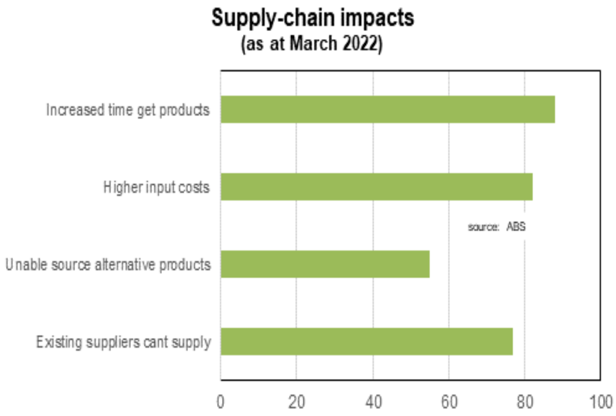
To date firms have absorbed much of the increase in costs.



Wage growth in the US has been substantially stronger than in Australia.



Supply chain problems have had a range of impacts including increasing input costs.



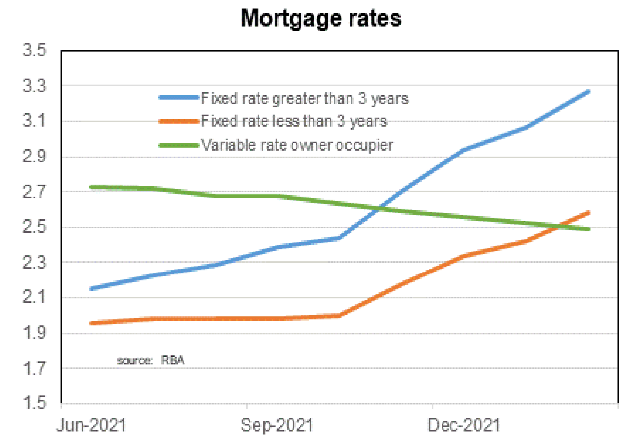
The cash rate is not the only financial variable that moves the economy

Much of the focus is on the cash rate. But other variables can also have a strong influence on the economy. The cash rate typically has a significant impact upon the variable mortgage rate. But fixed mortgage rates are driven more by financial market views of future cash rate movements. And with financial markets now expecting significant rises in the cash rate over the next couple of years there has been a notably jump in fixed mortgage rates over the past couple of months (particularly longer than 3 years').

Movements in asset prices (such as housing prices and equity markets) can also influence the economy. House price growth has moderated noticeably in recent months partly reflecting rising fixed mortgage rates. The rising number of homes for sale and affordability concerns though have probably played a bigger role. Worries about rising global interest rates has certainly played a role in the recent weakness of equity markets.

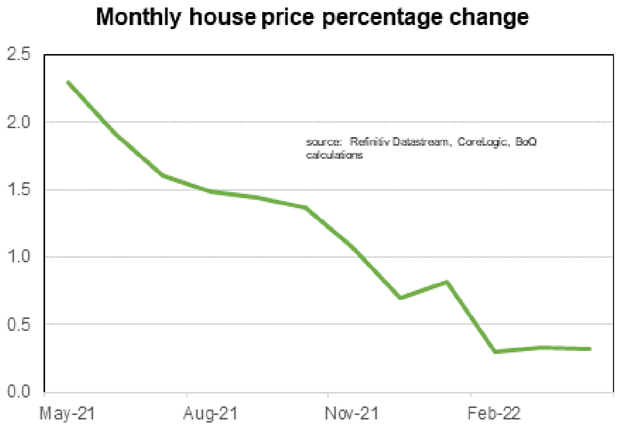
One positive for the economy is that the terms of trade (export prices against import prices) is near a record high reflecting the strength of commodity prices. Often a very high terms of trade coincides with a strong AUD. But not this time, mainly because of the strength of the $US (a result of the expectations of very aggressive rate hikes by the Federal Reserve). Fiscal policy remains very supportive of the economy for the next financial year although some tightening of policy is projected for next year.

Fixed mortgage rates have already risen from their lows.



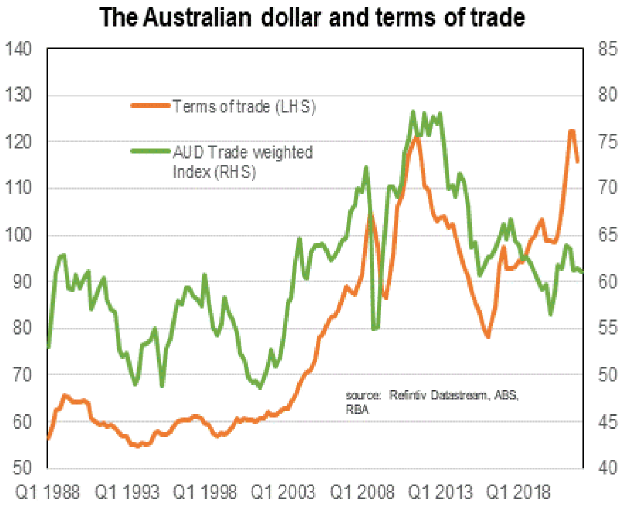
source: RBA

This has played a part in the slowing house price growth although affordability and rising supply have been bigger factors.



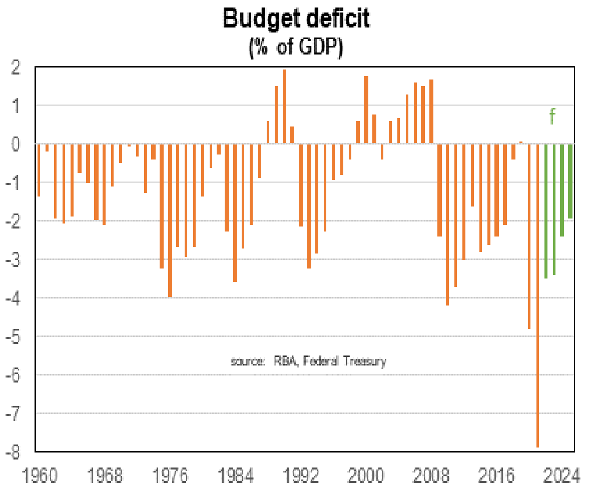
source: Refinitiv Datastream, CoreLogic, BoQ calculations

The AUD is low given the high level of commodity prices.



source: Refinitiv Datastream, ABS, RBA

Fiscal policy is very supportive given the state of the economy.



source: RBA, Federal Treasury

What history tell us about this interest rate cycle

There is a big disagreement amongst economists as to how high the cash rate should head in this cycle. A recent Reuters' poll indicated that economist expectations for the cash rate by the end of 2023 range between 0.75-3% (with a median of 2%). Financial markets are more aggressive, with the cash rate expected to be 3.5% by end-2023 (pricing as at 2 May). As a comparison, financial markets are pricing 3.25% in the US and 2.5% in the UK by the end of 2023.

What can history tell us about where the cash rate is heading? In the four monetary policy tightening cycles in Australia (and the US) the cash rates rose by between 1.50 to 3.25 percentage points. So the amount of tightening currently priced in by financial markets is higher than each of the preceding four tightening cycles. The starting cash rate is (substantially) lower. There are a number of reasons (notably higher debt levels) why interest rates are unlikely to quickly rise back to where they were in the preceding cycles.

Three of the previous cash rate cycles were short (5-13 months). The other cycle was substantially longer reflecting the surprising strength and duration of the largest mining boom in Australia's history as well as a global credit boom in financial markets (that resulted in the GFC).

Monetary policy tightening cycles in Australia and the US since 1990
(Projected rate changes from May 21 are based upon financial market pricing as at 3 May)

Australia				US			
Date	Time taken (months)	Amount rate rises (percentage ponts)	Starting cash rate	Date	Time taken (months)	Amount rate rises (percentage ponts)	Starting cash rate
Aug–Dec 94	5	2.75	4.75	Jan 94 – Feb 95	13	2.50	3.0
Nov 99-Aug 00	9	1.50	4.75	May 99 – May 00	12	1.75	4.75
May 02–Mar 08	70	3.00	4.25	June 04 – June 06	24	3.25	1.0
Oct 09–Nov 2010	13	1.75	3.00	Dec 15 – Dec 18	36	2.25	0.125
May 21–Nov 22	18	3.50	0.1	Mar 21 – Mar 23	24	3.25	0.125

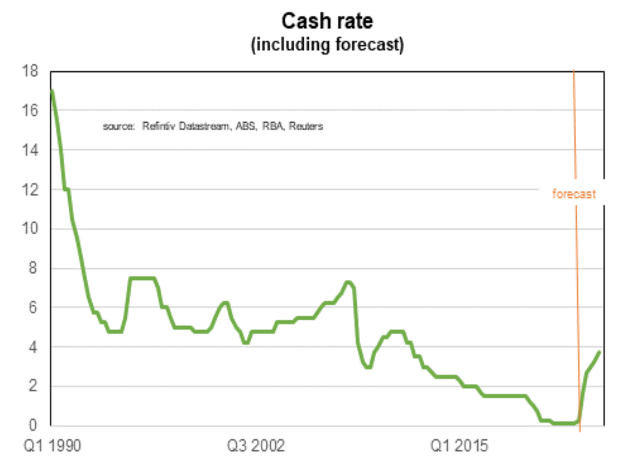
Could this tightening cycle be substantially longer than currently anticipated by financial markets? A possible scenario is that inflation remains higher for longer. Ongoing COVID problems in China could be one cause. But a more likely one is that wages growth picks up strongly, and without productivity offsets leads to a wage-price spiral. To date Australia's wages data has been very subdued (particularly compared with the US). The RBA (and most forecasters) expect wages growth to rise further over the coming year.

The main reason I think this could be an elongated rate rise cycle is that after an initial spurt the RBA might want to be cautious about raising interest rates too quickly given concerns about high levels of household debt. A slower pace of rate hikes would allow time for household disposable incomes to grow to enable them to meet debt repayments. A slow pace of rate rises though will be dependent upon inflation moderating in line with the RBA's forecasts.

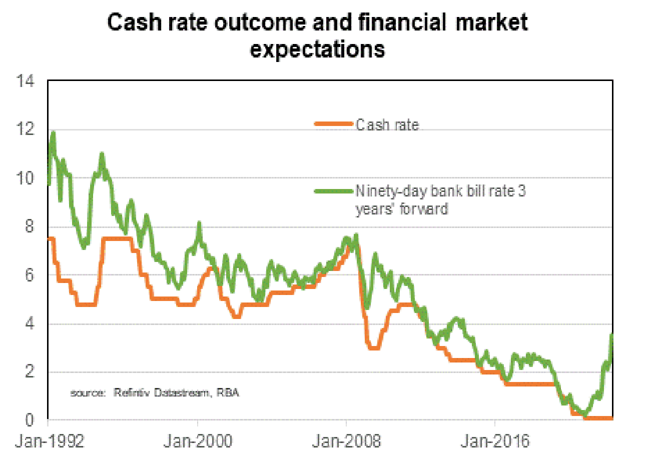
Historically it has been common for financial markets to have overestimated the amount of rate hikes by the RBA. That probably reflects that before rate hikes have started investors want to add a risk premium for how much the RBA might increase interest rates given the uncertainty about the economic and inflation outlook. But as interest rate rises start investors' become more confident that the RBA will keep inflation under control and reduce rate hike expectations. The exception was in the noughties when strong economic growth due to the mining boom and the credit boom in financial markets lasted longer than investors' had anticipated.

Finally it is worth noting that a rate cut cycle has started within 6-18 months at the end of each of the preceding four rate hike cycles. Clearly the RBA (and other central banks) do not aim to cut rates within 2 years of finishing raising interest rates. But that it has happened after each cycle highlights how difficult it is to set interest rates at the right level. It also highlights how quickly economic conditions can change. And of course we do not know how long this current rate hike cycle will last

The peak in the cash rate cycle is low by historical standards (forecasts based on financial market expectations).



Financial markets typically overestimate the size of the cash rate cycle.



The cash rate is heading higher. And so it should. The big questions from here is how high does the cash rate head in this cycle and how quickly will it get there. Financial markets appear to be pricing an aggressive amount of rate increases in this cycle compared with previous occasions. The higher than expected move at the May meeting will only add to financial market confidence about their views about the size and pace of future RBA moves.

Given the inflation outlook and extremely low level of the cash rate financial markets could be right. I think in time the cash rate could hit 3%. But virtually all economists' and the history of the past thirty years say that the pace of cash rate rises in this cycle appears too quick and probably too high. Time will tell who is right.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland