Monday, 19 June 2023

Grim Growth As Economic Engine Stalls

The Australian economy is facing a range of challenges. From still elevated inflation and the risk that it remains sticky, to a rapid slowdown in growth as aggressive cash rate increases from the Reserve Bank (RBA) bite. The recipe is one for a difficult environment and for weak growth as policy makers work to get on top of the greatest inflation challenge in decades.

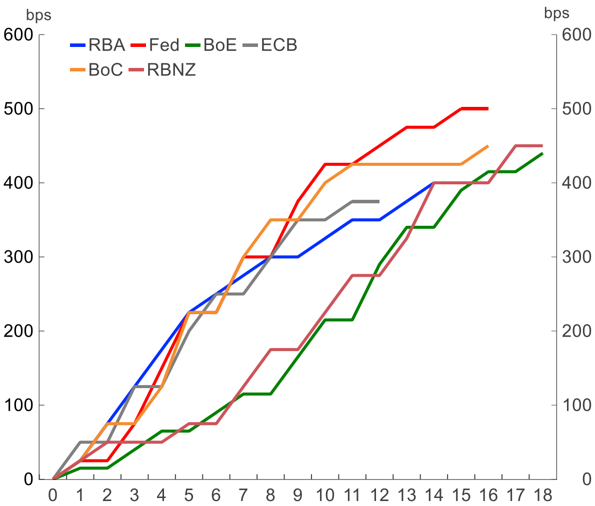
Incorporating the latest economic data and guidance from the RBA, we have upgraded our expectation for the path of the cash rate. We expect the cash rate to increase two more times, to a peak of 4.60%, from the current 4.10%. This is expected to occur via 25-basis-point hikes in July and August. Financial markets are broadly in agreement about the peak in the cash rate but seem uncertain around the timing. Interest-rate markets are currently pricing a 4.60% peak by November. Risks appear broadly balanced to this view, but there is a risk that the RBA may need to go even further.

As always, there is uncertainty. Globally, some central banks are pausing to take stock while others continue to charge ahead. The Federal Reserve recently decided to ‘skip’ a rate hike as it awaits more information on how hikes to date have impacted the economy, while also remaining firm that more needs to be done. The Reserve Bank of New Zealand, which has been quite hawkish through this cycle, may be done with hikes as the New Zealand economy slipped into a technical recession.

On the other hand, the European Central Bank continued raising rates and all but confirmed that another hike was on the cards in July. The Bank of England is expected to continue hiking as inflation remains persistently higher than expected. The Bank of Canada also recently started raising rates again after being on pause for much of 2023.

Major Central Bank Policy Rates

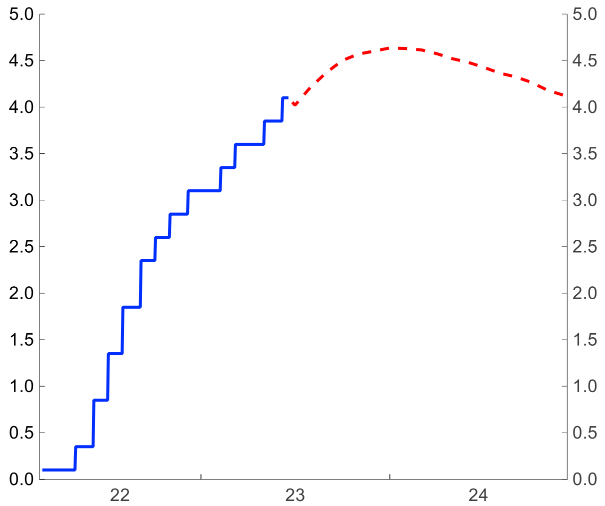
Cumulative Rate Increases, Months Following First Hike



Sources: RBA, BoC, ECB, BoE, RBNZ, Fed; Macrobond

Cash Rate Market Pricing

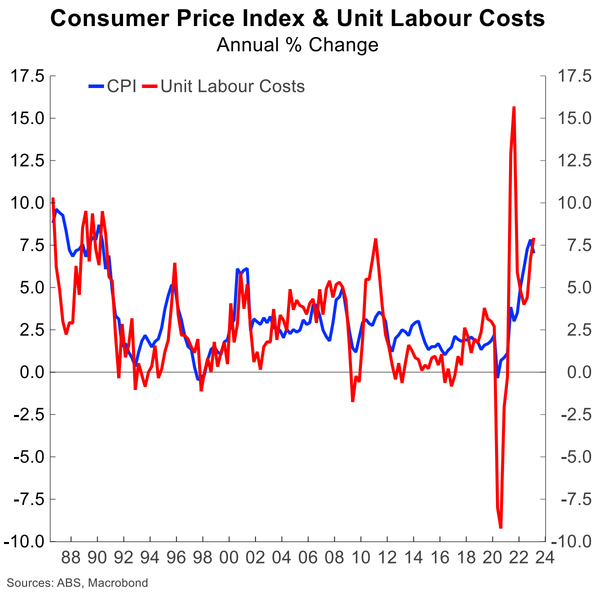
30-Day Interbank Cash Rate Futures

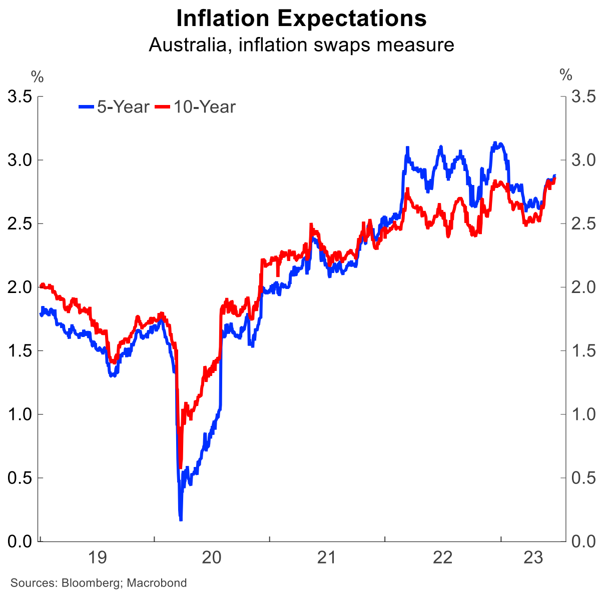


Sources: Bloomberg; RBA; Macrobond

The increase in the terminal cash rate expectation reflects a range of factors, including economic data showing that parts of the economy remain resilient and that risks to inflation are skewed to the upside. For example, the latest labour market update showed that the jobs market remains extremely resilient. Employment rose by 75.9k in May, well above the range of market expectations. The unemployment rate also declined to 3.6% in the month, not far above the near 50-year low of 3.4% seen earlier in the cycle.

While the labour market is expected to slow over the remainder of 2023 and through 2024, this slowing is taking some time to materialise. Additionally, jobs demand has so far remained hot and been able to absorb the record increase in migration and addition to the labour force. However, this dynamic is expected to turn over coming months and quarters, contributing to a slowing in the labour market and an increase in the unemployment rate.

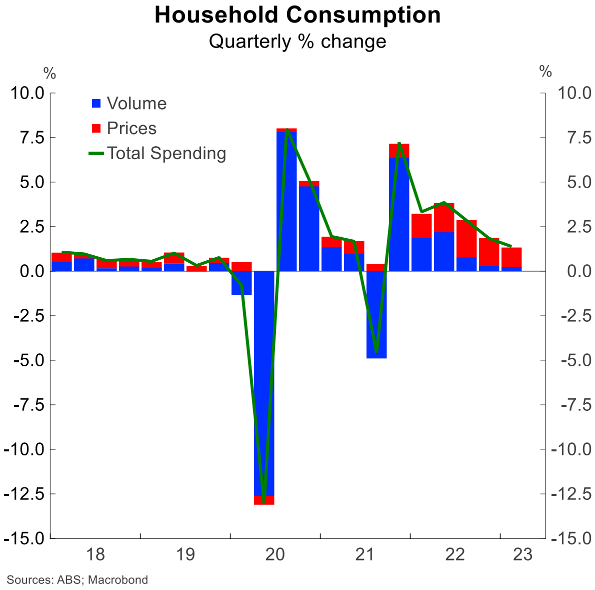


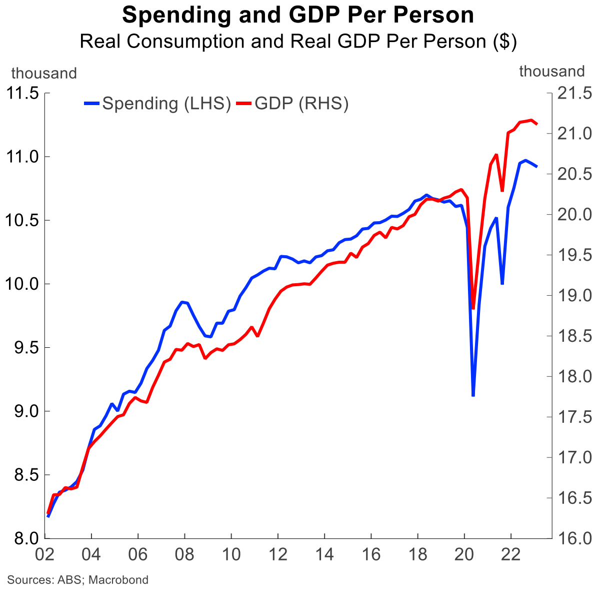


The March quarter national accounts showed that unit labour costs (ULCs) continue to run hot. This measure adjusts nominal labour costs for productivity. Nominal unit labour costs have a very strong relationship with inflation and the RBA has noted on several occasions that there is a risk that wages grow at a rate that is inconsistent with the inflation target. This is made more difficult if productivity growth is weak, as the level of wages growth that would be consistent with the inflation target would be lower in a scenario of prolonged weak productivity growth. These dynamics are picked up by the ULC measure. However, it is also important to note that there can be a lot of volatility in productivity estimates in the near term, making the data more difficult to assess and interpret.

Inflation expectations are another important component that is watched closely by the RBA. Expectations of future inflation can impact consumer and firm behaviour and contribute to the risk that inflation remains more persistent. Over recent weeks, measures of inflation expectations have been creeping higher. Indeed, 5- and 10-year inflation swaps are currently trading near the top of the RBA's 2-3% band and 5-year inflation swaps have not been at the middle of the band since January 2022.

While risks to inflation appear to be skewed to the upside, the real economy is slowing rapidly under the weight of higher interest rates and elevated inflationary pressures. In the March quarter, the economy grew at a tepid 0.2%. Additionally, once this number was adjusted for rapid population growth, per capita GDP contracted by 0.2%. This weak growth largely reflects a brisk slowing in household spending, as budgets continue to be squeezed. Real household spending (i.e. adjusted for price changes) is barely growing in aggregate terms and has gone backwards for the past two quarters in per capita terms.





We have been forecasting weak economic growth through 2023 and 2024 for some time. This reflects the slowing in consumer spending. We now expect growth to be even weaker and for weakness to extend for longer as the cash rate is anticipated to rise further. We predict growth to slow to a crawl of 0.6% in 2023, before rebounding slightly to 1.0% over 2024.

While we are not forecasting a recession as our base case, the risk of one has risen materially and it certainly cannot be ruled out. Our expectation is that we will see one quarter of negative GDP growth in early 2024. While this wouldn't meet the definition of a 'technical recession' of two quarters of contraction in real GDP, it is certainly teetering mighty close.

Another key theme that is expected to continue through the rest of 2023 and 2024 is rapid population growth, driven by net overseas migration. This is expected to result in per capita numbers looking much worse than the aggregate totals suggest. Indeed, we predict a prolonged per capita recession through 2023 and 2024 as population growth runs far ahead of GDP growth. The RBA also predicted a prolonged per capita recession in its most recent set of forecasts in May.

Data Releases

Minutes of the June Reserve Bank Board Meeting

After several busy weeks with a raft of economic data, there are few domestic economic releases this week. The key area of focus will be the minutes of the June Reserve Bank Board meeting. At its June meeting, the Board decided to increase the cash rate by 25-basis-points, to 4.10%. This took the market and most economists by surprise. Prior to the meeting, only 10 of 30 economists surveyed by Bloomberg expected the RBA to hike. The remaining 20 expected the RBA to remain on hold. Financial markets were also largely positioned for a hold decision. On the Monday before the hike, markets were pricing around a 26% chance of a 25-basis-point move.

The RBA Governor delivered a speech the day after the June meeting. During that speech, he noted that the decision to hike again was "taken to provide greater confidence that inflation will return to target within a reasonable timeframe". He also added that "it follows recent information that has suggested greater upside risks to the Bank's inflation outlook".

The Governor has previously noted that the RBA was more willing than other central banks to tolerate inflation being above target for longer to retain as many of the labour market gains as possible. However, in this speech, he emphasised that this patience had a limit, stating: "I want to make it clear, though, that the desire to preserve the gains in the labour market does not mean that the Board will tolerate higher inflation persisting."

Additionally, he went into some detail around the factors the Board will be paying close attention to over coming months. The four factors discussed were: the global economy, household spending, the growth in unit labour costs, and inflation expectations.

While the speech provided key information on how the Governor and the Board are assessing the risks around inflation, the minutes will still be examined closely for any additional clues into the Board's thinking and how they may respond in future months.

Jarek Kowcza, Senior Economist
Ph: +61 481 476 436

Group Forecasts

End Period:	Close (16 Jun)	2023 Q3 (f)	2023 Q4 (f)	2024 Q1 (f)	2024 Q2 (f)	2024 Q3 (f)	2024 Q4 (f)
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.60	4.60	4.60	4.35	4.10	3.85
90 Day BBSW, %	4.30	4.80	4.80	4.63	4.38	4.13	3.88
3 Year Swap, %	4.31	4.30	4.15	4.00	3.80	3.60	3.50
10 Year Bond, %	4.03	3.80	3.70	3.50	3.30	3.20	3.10
US Interest Rates:							
Fed Funds Rate, %	5.125	5.375	5.375	4.875	4.375	3.875	3.375
US 10 Year Bond, %	3.76	3.60	3.50	3.30	3.10	3.00	2.90
USD Exchange Rates:							
AUD-USD	0.6875	0.69	0.69	0.71	0.72	0.73	0.74
USD-JPY	141.82	138	136	134	132	130	128
EUR-USD	1.0937	1.11	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2817	1.27	1.27	1.28	1.28	1.29	1.29
NZD-USD	0.6236	0.62	0.62	0.63	0.64	0.65	0.66
AUD Exchange Rates:							
AUD-USD	0.6875	0.69	0.69	0.71	0.72	0.73	0.74
AUD-EUR	0.6286	0.62	0.62	0.63	0.64	0.64	0.64
AUD-JPY	97.6	95.2	93.8	95.1	95.0	94.9	94.7
AUD-GBP	0.54	0.54	0.54	0.55	0.56	0.57	0.57
AUD-NZD	1.10	1.11	1.11	1.13	1.13	1.12	1.12

	2021	2022	2023 (f)	2024 (f)
GDP, %	4.6	2.6	0.6	1.0
CPI (Headline), %	3.5	7.8	4.2	3.2
CPI (Trimmed mean), %	2.7	6.9	4.1	3.2
Unemployment Rate, %	4.7	3.5	4.2	5.3
Wages Growth, %	2.3	3.4	4.1	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

Contact Listing

Chief Economist
Besa Deda
dedab@banksa.com.au
+61 404 844 817

Senior Economist
Pat Bustamante
pat.bustamante@banksa.com.au
+61 468 571 786

Senior Economist
Jarek Kowcza
jarek.kowcza@banksa.com.au
+61 481 476 436

Economist
Jameson Coombs
jameson.cooombs@banksa.com.au
+61 401 102 789