Weekly Economic Outlook

Bank of Melbourne

Monday, 11 April 2022

RBA Turns A Corner, Rates to Rise in June

The Reserve Bank's (RBA) April board meeting quickly regathered the attention of economists and headlines last week, following the Government's time in the spotlight during the Federal Budget.

Monetary policy settings were left unchanged at the April meeting, as widely expected. However, there were several critical changes to the RBA's guidance in the statement accompanying the decision. The RBA tweaked the language used in the statement, including dropping the word "patient", which has a been a key part of the bank's communication surrounding the cash rate for some time. The statement was also missing previous references to "uncertainty" surrounding the persistence of inflation and the boards commitment to "maintaining highly supportive monetary conditions". The change in tone may seem minor to the common eye, however, these are big shifts in central bank language.

The RBA has turned a corner and has laid the groundwork for its first cash rate hike in over a decade, making the question of 'when' all the more important. The RBA's statement provided some clues on the Board's thinking, highlighting upcoming wages and inflation data released "over the coming months".

We have adjusted our cash rate forecasts in light of the RBA's renewed stance and now expect the RBA to begin hiking the cash rate in June. We expect the RBA will be quick to unwind the emergency rate cuts (65 basis points) made in response to the pandemic, before taking the cash rate to 1.25% by the end of 2022. We expect further increases in the cash rate in the first half of 2023 and expect the cash rate to peak at 2.00%.

Alongside our revised expectation for the path of interest rates, we have also upgraded our forecasts for the labour market, which has so far proved to be the backbone of the economic recovery. The unemployment rate fell to 4.0% in February, the lowest level in 13½ years and we expect it will head below 3.5% by the end of this year. In fact, we expect the unemployment rate to bottom out at around 3.2% by the end of 2022. The unemployment rate hasn't been consistently below 4% since the 1970s. In line with a further strengthening in the labour market, we have raised our forecast for wages growth to peak at 4.0% in 2023, compared to 3.5% previously.

Federal Election

The RBA stole the show last week, although the Government wrestled some of the focus back over the weekend. Prime Minister Scott Morrison announced yesterday that the federal election will be held on 21 May, setting up a 6-week election campaign. Morrison kicked off the campaign with promises to manage the economy, national security, and the pandemic recovery. Opposition Leader Anthony Albanese countered with pledges for higher wages and climate change.

Financial Stability

The RBA's semi-annual financial stability review was released on Friday and provided an update on the health of Australia's financial system, including discussion of any potential risks identified by the bank.

The RBA said the Australian financial system remains resilient despite recent global developments, highlighting strong business and household balance sheets and low loan arrears rates.

The RBA flagged several key risks to the Australian and global financial systems, including falls in property or financial asset prices. This could be triggered by larger-than-expected increases in interest rates, an increase in risk aversion and/or weak income growth. Household debt levels are high in Australia and around the world. These high levels of debt may impact the ability of borrowers to repay loans as interest rates increase. Additionally, the RBA also identified elevated cyber security risks for Australian financial institutions, noting the increasing prevalence of cyber-attacks.

The RBA provided insights surrounding possible scenarios for Australian borrowers as interest rates begin to rise. The RBA estimates that the median borrower has the equivalent of around 21 months' worth of mortgage repayments in excess savings. This is estimated to fall to 19 months if interest rates were to rise by 200 basis points. This buffer is considerably larger than the prior to the pandemic, where households were estimated to have approximately 10 months' worth of mortgage repayments in excess savings.

The RBA also noted that while debt-to-income ratios have increased from already high levels, loan-to-valuation ratios (LVRs) haven't increased as much. Only around 5% of loans have an outstanding LVR greater than 75%. This compares to almost 25% at the start of 2020. The incidence of household financial stress has also been in decline and is lower than before the pandemic. The share of non-performing housing loans was just 0.9% at the end of 2021, with almost all borrowers who exited from COVID-19 loan deferral arrangements now up to date on repayments. Notwithstanding the overall strength of borrowers' balance sheets, the RBA expects that a small share of borrowers could struggle to service their debts as a result of higher interest rates and/or inflation. This is especially the case for borrowers with high LVR and high debt-to-income ratios or households who are susceptible to potential reductions in income.

The RBA estimates that a 200 basis point increase in interest rates could lower the value of real house prices (i.e. adjusted for inflation) by around 15% over a two-year period, compared to if interest rates remained unchanged. However, given only a small share of borrowers have high LVR ratios, the RBA doesn't expect this to cause major financial stress for borrowers.

Week Ahead

Looking ahead to this week. Tomorrow we will receive a fresh update on business confidence for March, followed by the results from April Westpac Melbourne-Institute consumer sentiment survey on Wednesday.

Business confidence improved for a second consecutive month in February. However, the survey was undertaken from 21 February to 28 February, meaning that the impact of the war in Ukraine and severe flooding across parts of Queensland and NSW wasn't fully captured. Confidence is likely to be impacted by these factors in the March survey.

Consumer confidence has softened recently on the back of global developments, rising cost-of-living pressures and expectations of upcoming interest rate increases. Additionally, flooding across the east coast of the country also impacted consumer confidence in March. We expect that these factors will continue to weigh on confidence in April. However, the release of the Federal Budget, which included measures to address rising cost-of-living pressures, may offset some of these downside factors.

On Thursday, the ABS will release the Labour Force survey results for March, providing us with a timely read on the state of the labour market. Consistent with our expectation of a tightening jobs market, we expect employment to have increased by 25,000 jobs in March. We also expect the participation rate to move from 66.4% to 66.5%, a new record high. The increase in jobs, combined with a higher participation rate, is expected to result in the unemployment rate remaining at a 13½ year low of 4.0%.

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Forecasts

		2022			2023		
End Period:	**Close (8 Apr)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.25	0.75	1.25	1.50	2.00	2.00
90 Day BBSW, %	0.30	0.45	0.95	1.45	1.70	2.20	2.20
3 Year Swap, %	2.79	2.80	2.80	2.80	2.70	2.60	2.55
10 Year Bond, %	2.96	3.00	3.00	2.70	2.50	2.35	2.25
US Interest Rates:							
Fed Funds Rate, %	0.375	1.375	1.875	2.375	2.375	2.375	2.375
US 10 Year Bond, %	2.70	2.60	2.60	2.30	2.20	2.15	2.10
USD Exchange Rates:							
AUD-USD	0.7458	0.74	0.75	0.76	0.77	0.78	0.79
USD-JPY	124.34	124	123	122	121	120	119
EUR-USD	1.0877	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3025	1.33	1.34	1.35	1.36	1.37	1.37
NZD-USD	0.6849	0.69	0.70	0.71	0.72	0.72	0.73
AUD Exchange Rates:							
AUD-USD	0.7458	0.74	0.75	0.76	0.77	0.78	0.79
AUD-EUR	0.6859	0.67	0.68	0.68	0.68	0.68	0.69
AUD-JPY	92.71	91.8	92.3	92.7	93.2	93.6	94.0
AUD-GBP	0.5721	0.56	0.56	0.56	0.57	0.57	0.58
AUD-NZD	1.0888	1.07	1.07	1.07	1.08	1.08	1.09

	2020	**2021**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	4.2	5.5	2.7
CPI (Headline), %	0.9	3.5	4.3	2.3
CPI (Trimmed mean), %	1.2	2.6	3.5	2.9
Unemployment Rate, %	6.8	4.7	3.2	3.4
Wages Growth, %	1.4	2.3	3.4	4.0

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

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

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