Westpac now expects the Reserve Bank to cut the cash rate by 25bps in both August and November this year. We have revised down our GDP growth forecasts for 2019 and 2020 from 2.6% to 2.2%. With the slower growth profile we now expect to see the unemployment rate lift to 5.5% by late 2019. That makes a strong case for official rate cuts to cushion the downturn and, in turn, meet the RBA’s medium term objectives.

The Reserve Bank recently revised down its growth forecasts for 2019 and 2020 to 2.25% and 3.0% respectively. It also cut its estimate for 2018 from 3.5% to 2.75%. Momentum in 2018 slowed dramatically through the year. The annualised growth rate in the first half was 4% whereas in the second half we estimate that the pace slowed to 1.5%. Moving from a 1.5% pace to a 3% pace in 2019 seems to be a very large stretch.

Westpac’s growth forecast in 2019 and 2020 has been a much weaker 2.6% in each year but even that number now appears too high. Our new forecast for GDP growth in 2019 and 2020 is 2.2%.

In particular, we have been expecting only a modest impact on consumer spending from the likely negative wealth effect associated with falling house prices in Sydney and Melbourne. Our growth forecasts have assumed a lift in the savings rate across 2019 from 2.4% to 2.9%. That would be consistent with consumption growth of 2.4%. Note that we expect momentum in consumption growth in the second half of 2018 to be closer to 1.5%.

A more reasonable assessment of the lift in the savings rate in 2019 is from 2.4% to 3.5% with a lift towards 5.0% expected in 2020. Those savings rates imply consumer spending growth around 2%.

That lift assumes that house prices in Sydney and Melbourne will continue to fall through 2019. Our estimates of the need to restore affordability and the impact of tighter lending standards on prices point to falls of around 5%-10% in Sydney and Melbourne over the course of 2019 complemented by softness in other markets.

Absent any policy response from the RBA we expect that further falls will be necessary in 2020 before stability in these markets will be achieved.

These headwinds for the housing market and activity are also apparent in developments around credit. In the second half of 2018 new lending for housing fell by 14.9% with both investors (-15.5%) and owner occupiers (-14.7%) being affected. This is a sharper correction than we had anticipated. These falls are a combination of both demand (concerns around falling prices and stretched affordability) and supply (new regulations and caution from some lenders in a falling market).

We expect these falls, albeit at a much slower pace, to continue through 2019 representing a negative feedback loop to prices.

That negative wealth effect is therefore likely to persist through 2020 with a further extension of the soft profile for consumer spending.

Other important dynamics will be around the sharp downturn in residential housing construction. We have revised down our forecast for residential housing construction in 2019 to -10% from -7% and -5% in 2020 from -3%. We also envisage a weaker profile for business equipment investment as businesses adjust their plans to a softening growth environment.

Overall we have revised down our GDP growth rates in 2019 and 2020 from 2.6% in both years to 2.2% respectively.

Consumer spending; residential housing construction and equipment investment are all key to the outlook for jobs growth.

With reasonable estimates for the participation rate our weaker jobs growth profile has the unemployment rate lifting to 5.5% in the second half of 2019 and further by end 2020.

Our process for forecasting monetary policy has always been to assume that the economy will evolve as we expect and then to anticipate the policy response once the authorities react to the new reality.

The decision by the Reserve Bank Board to accept the possibility that interest rates could fall further, despite the current record low levels, is profoundly important.

We can now be confident that if our growth profile does evolve the Reserve Bank will be prepared to act. Prior to this more balanced approach to rates it was reasonable to assume that it was most reluctant to lower rates. The view seemed to be that the adjustment in the housing market was a necessary development with limited spillover effects on the rest of the economy.

Lowering rates, as we last saw in 2016, would only disrupt that adjustment while the rest of the economy was not in need of further stimulus.

The approach now seems to be that the spill over effects to the rest of the economy are real and the “adjustment” process may be more substantial than earlier anticipated. Certainly the collapse in new lending and sharp falls in house prices would be attracting considerable attention.

That negative effect is therefore likely to persist through 2020. We do not anticipate that this will be enough to reverse the economy’s negative trajectory. At some stage we envisage the RBA cutting rates to the level of around 25bps in August and 50bps in November.

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deterioration in the overnight cash rate differential. That puts downside risks to our current target of USD 0.68 for the AUD in the second half of 2019 particularly if the expected cuts from the Reserve Bank are ineffective in settling markets.

The Risks to This Rate Outlook

Housing markets may stabilise more quickly than we anticipate and the extended negative wealth effect may not materialise.

The labour market may hold up more strongly than we expect. (note the January Employment Report showing 39,000 new jobs). Certainly evidence from other countries points to unusually strong labour markets despite other less constructive developments in these countries. A relative improvement in the cost of labour may hold up labour markets despite soft demand conditions. Unit labour costs in Australia have been flat for many years.

We may be overestimating the appetite of the RBA to respond to the environment we are describing.

Wages growth may lift more quickly than we expect, boosting household incomes and supporting spending despite a negative wealth effect. That lift may be supplemented by unexpected increases in the terms of trade as China boosts its own growth through housing and infrastructure. On the other hand while this is a perfectly reasonable scenario, there is still likely to be little flow through from higher commodity prices to household incomes as mining companies remain cautious. Mining wages continue to languish highlighting the limited effect a strong terms of trade has on the broader economy.

There is mixed evidence around wealth effects in other countries although the scale of the adjustment in house prices in Sydney and Melbourne is too large to downplay.

Conclusion

Since the last rate cut in August 2016 Westpac has consistently held the line that the RBA cash rate would remain on hold for the foreseeable future (a standard 2-3 year window). That has been despite markets, the RBA and most economists expecting higher rates.

To an extent this view was influenced by the perception that the Bank welcomed the adjustment in the housing markets and saw insignificant spill over effects to the rest of the economy.

The recent change of rhetoric from the Bank on that issue is important.

Our revised growth, inflation and unemployment forecasts now make a convincing case for lower rates.

Bill Evans, Chief Economist
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