

Appendix only: RBA cash rate scenarios following its hawkish tilt

AUTHOR: TRENT SAUNDERS, QTC PRINCIPAL ECONOMIST

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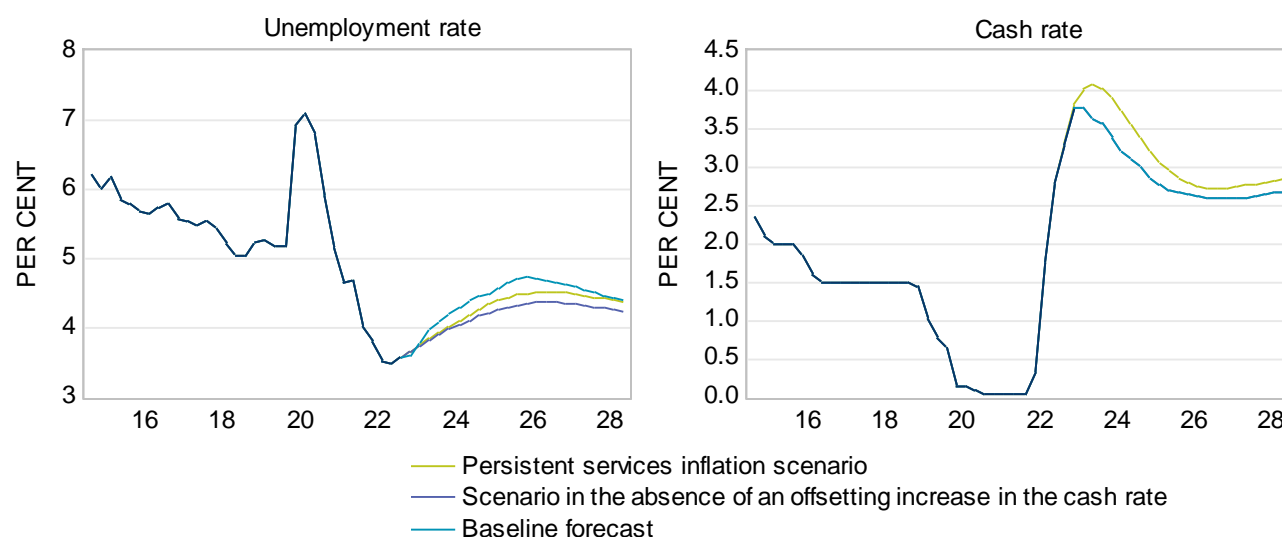
This appendix provides further detail on the scenarios described by Saunders (2023).

Persistent services inflation

There are several reasons why services inflation might be more persistent than expected. For example, inflation expectations could be higher than expected, tight housing market conditions could result in a large and persistent contribution of rents to inflation, or the strength in the labour market could prove to be more resilient than expected.

For this scenario, I assume that the persistence of services inflation reflects ongoing resilience in the labour market. To do this, I shock the unemployment rate so that in the absence of any offsetting increase in the cash rate, the unemployment rate is 0.4 percentage points below its baseline by mid-2026 and 0.25 percentage points lower on average over the forecast horizon (shown as the purple line in Graph A1). The unemployment rate is a bit higher than this in the scenario discussed in the article (green line), due to the cash rate increasing in response to the lower unemployment rate and higher inflation.

GRAPH A1: ASSUMPTION FOR PERSISTENT SERVICES INFLATION SCENARIO

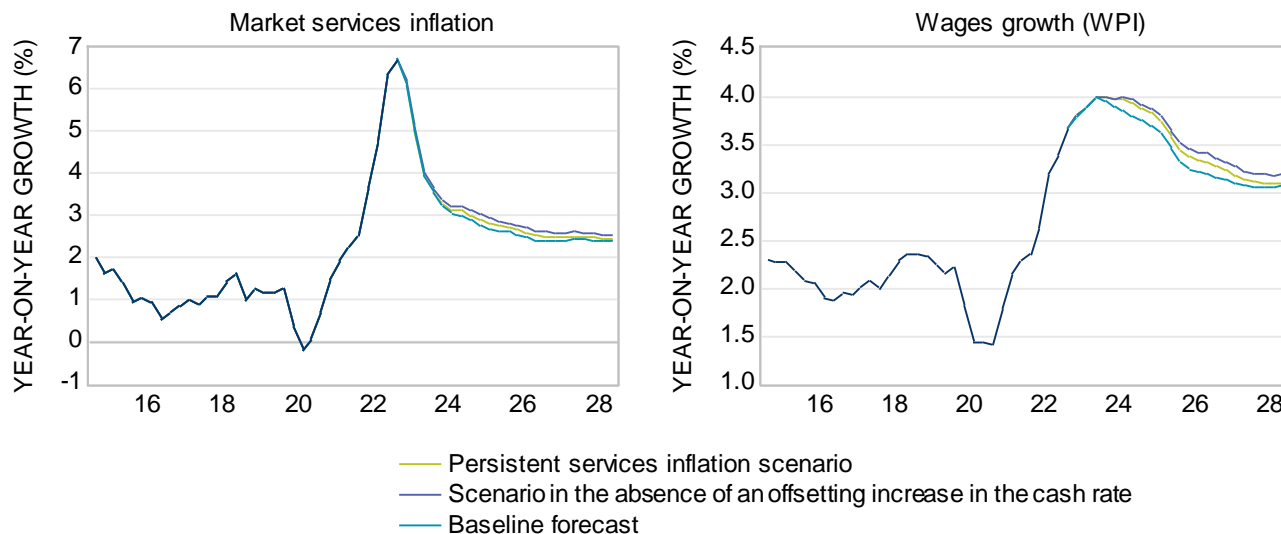


Source: Macrobond, QTC, RBA

The 'persistent services inflation scenario' sees market services inflation and wages growth increase to be around 0.1 percentage points above its baseline (this shown by the differences between the green and light blue lines in

Graph A2).¹ If the cash rate did not respond to this strength in the labour market, then these projections would be 0.2 percentage point above their baseline (purple lines).

GRAPH A2: RESPONSES OF MARKET SERVICES INFLATION AND WAGES

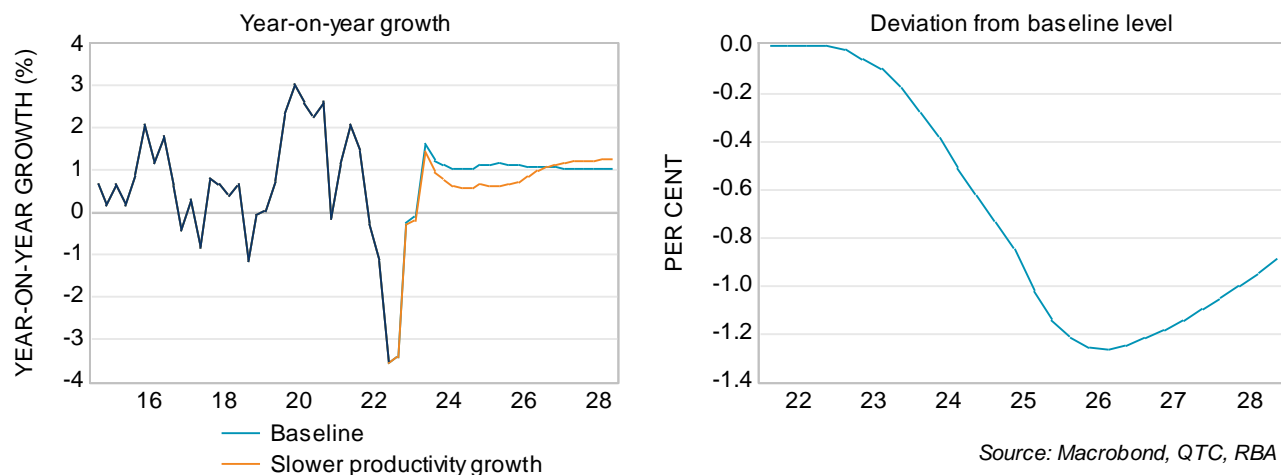


Source: Macrobond, QTC, RBA

Slower labour productivity growth

In the 'slower productivity growth' scenario, I have assumed that productivity growth increases to around 0.5 per cent over the next couple of years, compared to 1 per cent in the baseline scenario (Graph A3). This sees output per hour worked fall to be 1.3 per cent below its baseline level by mid-2026. Productivity growth picks up towards the end of the projection period, though its level remains around 1 per cent below its baseline by 2028.

GRAPH A3: ASSUMPTION FOR SLOWER LABOUR PRODUCTIVITY GROWTH SCENARIO



Source: Macrobond, QTC, RBA

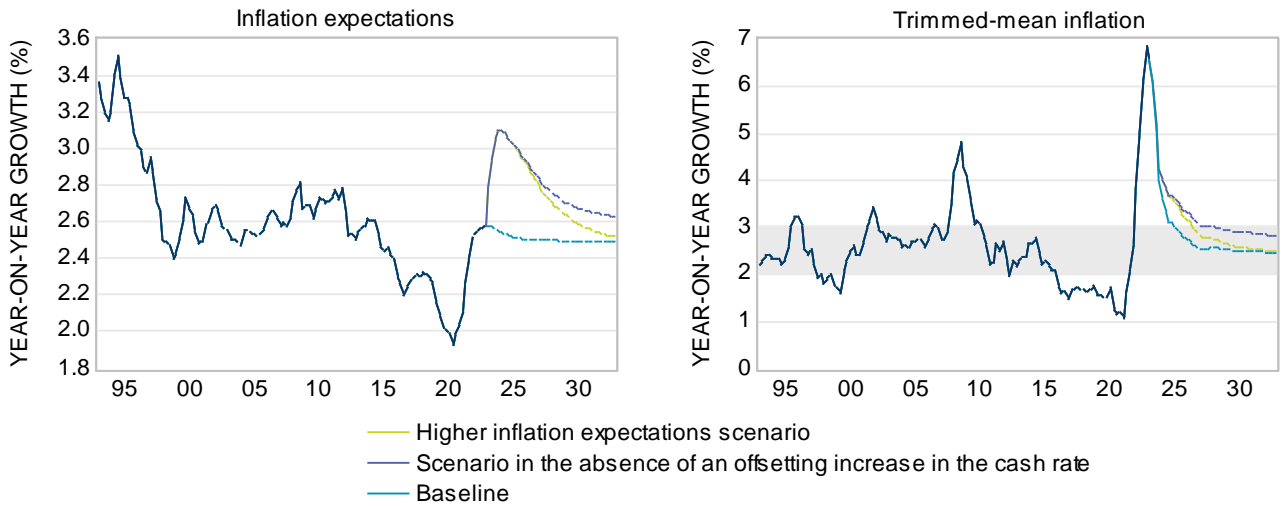
Higher inflation expectations

In this scenario, I assume that inflation expectations respond to higher inflation, which results in expectations increasing to slightly above 3 per cent by early 2024 (the green line in Graph A4). Inflation expectations then gradually decline, reaching the middle of the target band by 2032.

In the absence of higher interest rates, it would take even longer for inflation expectations to return to 2.5 per cent (purple line). This results in a slower return of trimmed-mean inflation to its target, with it reaching the top of the RBA's target band in 2027 and remaining at 2.8 per cent a decade from now.

¹ The RBA's MARTIN model does not include services inflation, so I have included it in QTC's amended version of the model by using a similar specification to that used for trimmed-mean inflation.

GRAPH A4: HIGHER INFLATION EXPECTATIONS SCENARIO



Source: Macrobond, QTC, RBA

I have used a measure of inflation expectations that is similar to that discussed by [Cusbert \(2017\)](#).

To generate these projections, I have estimated inflation expectations as:

$$pi_expected_t = 0.85 * pi_expected_{t-1} + 0.05 * pi_{t-1} + 0.1 * 2.5$$

Where $pi_expected$ is inflation expectations and pi is year-ended trimmed-mean inflation. This assumption for inflation expectations is somewhat ad hoc. If I instead estimated the parameters using a regression, the weight placed on both actual inflation and the centre of the RBA’s target band would be noticeably lower (with the coefficient on actual inflation being 0.01 and that on the inflation target being 0.04).

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