Tuesday, 2 August 2022

Reserve Bank's Cash Rate Decision

Fighting Inflation a High Priority

- **The Reserve Bank (RBA) hiked for the fourth consecutive month today, lifting the cash rate by 50 basis points to 1.85% - the highest cash rate since April 2016.**
- **The RBA has increased the cash rate by 175 basis points since it began a tightening cycle on May 3. It represents the most tightening in a four-meeting window since the inflation targeting regime began in 1993 and is not the last in this cycle.**
- **More rate hikes are on the way. The RBA stressed returning inflation to the target band was a "high priority". It upgraded its inflation forecasts. It also said it expects to take "further steps to normalise policy" and reiterated its commitment to doing what is necessary to ensure inflation returns to target over time.**
- **We forecast the RBA to continue tightening at its remaining meetings this year, taking the cash rate to 3.10%. This includes another 50 basis point hike next month, which would take the cash rate near neutral and allow the RBA to slow the hikes to 25 basis points thereafter.**
- **We see the peak in the cash rate occurring early 2023 and the RBA turning to cutting rates in 2024, although the odds are shortening that rate cuts will need to occur sooner in late 2023.**
- **The upgrades to inflation see the RBA expecting inflation to be above its 2-3% target band for longer, which speaks to the inflation challenge facing the RBA.**
- **Inflation is now forecast to be 7.75% this year, up from around 7% suggested more recently. Next year, it's projected to be a bit over 4% rather than 3.1% previously.**
- **Growth forecasts for this year and next year were cut. The RBA expects the economy to grow below trend in 2023 and 2024. The jobs market is expected to loosen only modestly to 2024.**
- **We see next year's growth forecasts as too optimistic, especially as consumer spending feels the impact of higher rates. The RBA recognises the path of monetary policy will be shaped by the outlook for household spending, which they highlight as a "key" source of uncertainty.**
- **The RBA acknowledges that higher inflation and higher interest rates are putting pressure on household budgets. We expect this pressure to result in a slowing of momentum in consumer spending, weighing on economic growth over the rest of this year and next year.**
- **In the final paragraph, the statement says the "Board expects to take further steps in the process of normalising monetary conditions over the months ahead, but it is not on a pre-set path." That's a clear signal that more rate hikes are coming. But the insertion of the qualifier that policy is not on a pre-set path perhaps suggests there's some risk that the size of rate hikes falls to 25 basis points sooner than we expect. We note the Governor has flagged policy isn't on a pre-set path at other times. The data, as always, will be the north star.**

The Decision:

The RBA hiked for the fourth consecutive month today, lifting the cash rate by 50 basis points to 1.85% - the highest cash rate since April 2016.

The RBA has increased the cash rate by 175 basis points since it began a tightening cycle on May 3. It represents the most tightening in a four-meeting window since the inflation targeting regime began in 1993.

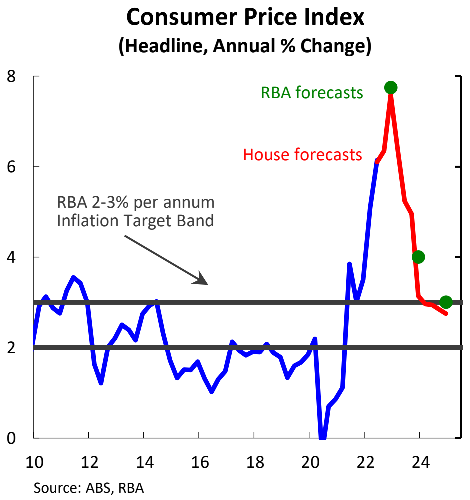
Outlook for the Cash Rate:

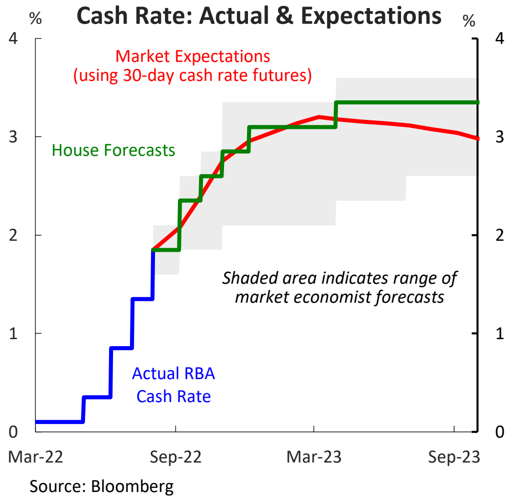
This latest hike is not the last in the cycle. More rate hikes are likely, especially after the Reserve Bank today stressed returning inflation to the target band of 2-3% is a “high priority” and its inflation forecasts for this year and next year were upgraded.

Furthermore, the RBA said it expects to take “further steps to normalise policy” and reiterated the Board’s commitment to doing what is necessary to ensure that inflation returns to target over time.

The RBA says the size and timing of further policy tightening will be determined by the data and the bank’s assessment of the outlook for inflation and the labour market.

We expect the RBA will again hike by 50 basis points next month to take the cash rate to 2.35%. This move would take the cash rate closer to what the RBA has estimated as the neutral rate using a range of models. The Governor has recently suggested that the neutral rate was when the cash rate was “at least 2.5%”. Therefore, after next month’s Board meeting, we expect the size of subsequent rate hikes to be scaled back to 25 basis points. As the cash rate nears the neutral rate, each additional hike is more contractionary for the economy and the RBA can afford to slow the pace of tightening.





More broadly, we continue to expect the RBA to hike at each of its meetings to the end of the year, which means a cash rate of 3.10% by year’s end if our forecasts come to fruition. At this stage, the economic data and the RBA’s statement today support our expectations on where the cash rate will land at the end of this year.

We also have maintained our view that the cash rate will peak at 3.35% early next year. The impact on economic growth from this significant tightening in less than twelve months means we expect the RBA to turn to cutting rates quickly. Our house view is that a rate-cutting cycle will start in 2024, but the rising risk is that it kicks off in late 2023.

Key Changes in the Statement:

Growth-inflation tension

The first key change is in the opening of the statement where it stated that the "Board places a high priority on the return of inflation to the 2-3% range over time, while keeping the economy on an even keel". This statement appears to signal that the RBA is mindful of the tension between inflation and growth, but the priority for now is firmly on fighting inflation. It reminds us of remarks from other central bank heads, like the US Federal Reserve, where inflation remains the focus. Indeed, Jerome Powell last week reiterated that failure was not an option in achieving price stability.

Inflation pressures widening

The second notable change is that the RBA characterises the inflation pressures as "widespread", including from "strong demand" and not only supply-chain disruptions and other global factors. The broadening of inflationary pressures could signal the RBA's job in fighting inflation is tougher and suggests that the cash rate still needs to move a lot higher from here – consistent with our view.

Changes to economic forecasts

The RBA has upgraded its inflation forecasts for both 2022 and 2023. The RBA now expects headline inflation to increase to around 7.75% over 2022 and be a little above 4% over 2023. The forecasts have also been extended to include the full year of 2024. Inflation for 2024 is slated to be around 3%. These forecasts demonstrate the inflation challenge facing the RBA, as inflation is expected to remain above the 2-3% band until 2024.

The updated inflation forecast for 2022 has been revised higher from around 6% at the RBA's latest full forecast update in May and from 3.25% in February. In fact, it is even higher than the "around 7%" number suggested by the Governor in more recent speeches. These are substantial revisions over a period of six months. The forecast over 2023 has been upgraded from 3.1% in May, the RBA's most recent forecasts.

Our forecasts are for inflation to peak at 7.60% in 2022, which is only modestly below the RBA's new forecast. For 2023, we have headline inflation easing, but remaining at an annual growth rate of above 3%.

The expectation that inflation will be above the RBA's band for longer could mean the RBA expects inflation to be stickier on the way down. The upgrade to the 2023 forecast could also reflect the higher-than-expected inflation outcome over the first half of 2022.

What can be said is that there remains a high degree of uncertainty attached to the RBA's forecasts. This uncertainty is reflected in how much inflation forecasts have changed this year, as more data has come to light. The next inflation report is due in late October and more changes to the forecasts we suspect are likely after that.

The forecasts for growth have also been altered. Growth has been downgraded for both this year and next. Instead of 4.2% growth for 2022, growth is now expected to be 3.25%. For 2023, GDP growth has been cut from 2% to 1.75%. Growth is expected to stay at 1.75% in 2024. These forecasts indicate that the RBA expects the economy to grow below trend in 2023 and 2024.

The shifts in the growth forecasts could result in changes to the unemployment forecasts when the quarterly Statement of Monetary Policy is published on Friday. It will contain the full, detailed set of forecasts. Today, the RBA revealed they anticipate the unemployment rate would be around

4% at the end of 2024.

The RBA estimates that the economy is at full employment when unemployment rate is in the high 3s to low 4s, so a 4% rate of unemployment at the end of 2024 suggests a tight labour market will remain. Such an unemployment rate implies only a small weakening in the labour market is foreseen over the next two and a half years.

Uncertainty and the consumer

The RBA has elevated the consumer as the key source of uncertainty. Last month, “one source” of uncertainty was the behaviour of household spending. But this month, it has been elevated to the “key source” of uncertainty. The RBA has also deleted the sentence about recent spending being positive. The RBA flags it will be paying close attention to how the various factors impacting household spending balance out as it assesses the appropriate setting for the cash rate.

The factors include falling consumer spending and dwelling prices on the one hand and more people finding jobs and a build up of large financial buffers during the pandemic on the other.

The RBA acknowledges that higher inflation and higher interest rates are putting pressure on household budgets. We expect this pressure to result in a slowing of momentum in consumer spending, weighing on economic growth over the rest of this year and next year.

Future Rate-Hike Path Not Set

The final paragraph tends to receive more attention than the rest of the statement. In this final paragraph, the RBA statement says the “Board expects to take further steps in the process of normalising monetary conditions over the months ahead, but it is not on a pre-set path.” That is a clear signal that more rate hikes are coming. However, this month’s insertion of the qualifier “but it is not on a pre-set path” perhaps suggests that there is some risk that the size of rate hikes reduces to 25 basis points sooner than we expect (i.e. moves to 25 basis points in September rather than October). However, we note that the RBA Governor has indicated policy is not on a pre-set path at other times recently. The data, as always, will be the north star.

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