bank SA

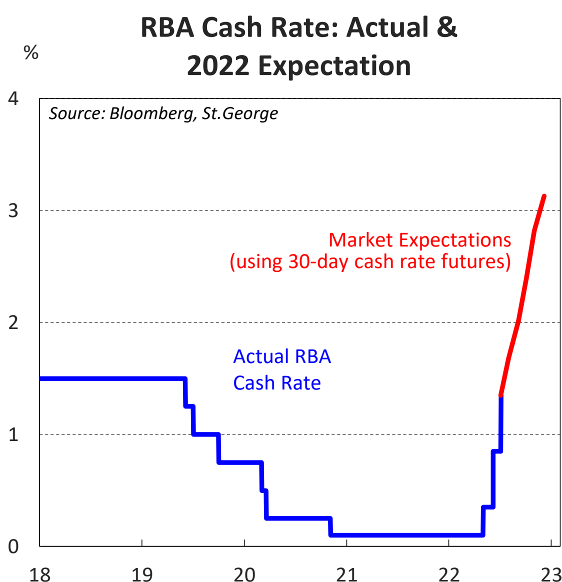
Interest Rate Outlook

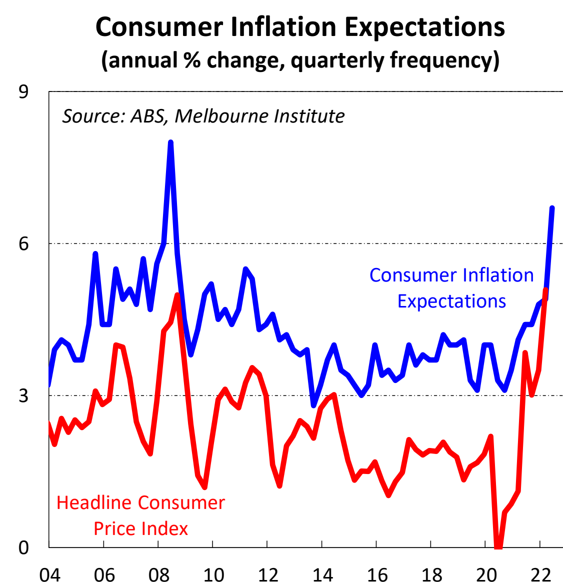
Tuesday, 5 July 2022

Reserve Bank's Cash Rate Decision

Biggest Tightening in 3 Months Since 1994

- **The Reserve Bank (RBA) hiked for the third consecutive month today, lifting the cash rate by 50 basis points to 1.35% – the highest cash rate since May 2019.**
- **This marks the most aggressive tightening in a 3-month window since 1994 when the RBA hiked by 200 basis points in the three months to December.**
- **Inflation is running hot, and the reading out later this month is likely to print even higher, with a possible '6' handle on the annual rate. Unemployment is very low and economic activity, so far, remains robust.**
- **There were only subtle changes in the statement from June. These changes included a strengthening in the language around the jobs market.**
- **The cash rate needs to keep rising, it is just a matter of how quickly it increases and how high it peaks. We remain comfortable with our view that the RBA will hike another 50 basis points in August, but we cannot fully rule out a 25-basis-point move next month.**
- **The upcoming data, in particular another inflation print out later this month, will be important in guiding the Board's decision.**
- **By the end of 2022, we expect the cash rate to increase to 2-2.50%, with a peak a bit above 2.50% early next year. This remains well below financial market expectations, which have a cash rate of around 3.10% priced and a peak of over 4% factored in for next year.**





The Decision

The Reserve Bank (RBA) hiked for the third consecutive month today, lifting the cash rate by 50 basis points to 1.35% - the highest cash rate since May 2019, before the pandemic struck.

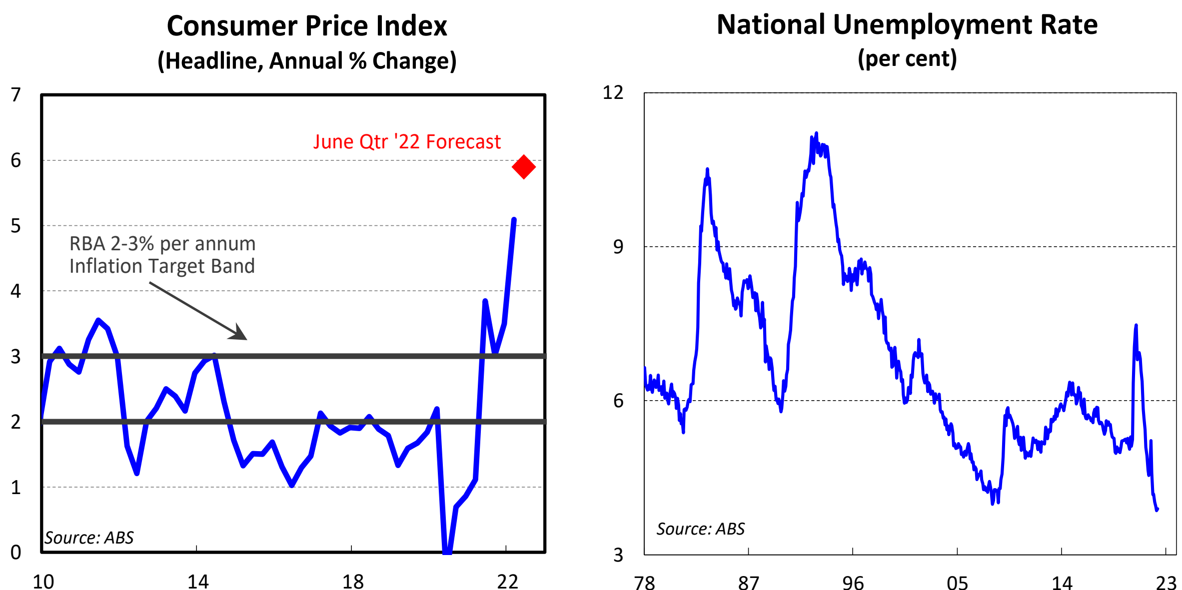
Today's decision follows a 25 basis point hike in May and a 50 basis point hike in June. The central bank has now lifted the cash rate by 125 basis points in three months. This marks the most aggressive tightening in a three-month window since 1994, when the RBA hiked by 200 basis points in the three months to December, with 100-basis-point moves in both October and December.

Why?

A cash rate of 0.85% was still very stimulatory amid a backdrop coloured by elevated and rising inflation, an unemployment rate near a 50-year low and an economy firmly in expansion mode.

The annual inflation rate was 5.1% in the March quarter. We expect the annual rate to move higher over this year. The next inflation report is out later this month. It's possible that it will print with a '6' in front of it. Unemployment is at 3.9% and likely to push lower in coming months. The RBA estimates that full employment is when the unemployment rate is in the high 3s to the low 4's. Based on that, the unemployment rate may already be around or below the level of full employment and is likely to move below that of full employment. And economic activity remains robust, although some loss of momentum is likely to emerge later this year.

We judge the neutral cash rate to be between 1.50% and 2.00%. The neutral rate can be thought of in much the same way as coasting in a car. It is the rate that is not braking on economic activity or tapping on the accelerator to stimulate activity. As the cash rate approaches this level, the RBA's decisions will become more finely balanced as it weighs up taming inflation with supporting growth.



Some of the inflation shocks moving through the economy are outside of the RBA's control – as Chris Richardson aptly said – the RBA is fighting inflation with one hand tied behind its back. These include the war in Ukraine and sanctions on Russia pushing up energy prices, and China's zero-COVID strategy contributing to supply-chain disruptions and pricing pressures. Floods earlier this year, and now again, are also part of the story. However, domestic demand-side factors are also strong, as evidenced by very low unemployment. But the biggest story – one we have not seen in

contemporary times – is a supply-side driven inflation story.

What's Next?

The biggest immediate question is what the RBA will do when it next meets on 2 August. We remain comfortable with our existing house view that they will deliver another 50-basis-point hike in August to take the cash rate to 1.85%. The market is more convinced the RBA will move by 50 basis points in August after today's decision, with the probability of a 50 basis point move in August moving from 63% before the meeting to almost 80% at the time of writing this report.

The RBA is unlikely to be locked into a predetermined path for August and will examine the economic data, both here and overseas, closely. For this reason, we cannot fully rule out the RBA starting the process of scaling the size of its rate hikes back to 25 basis points.

One central reason why we expect the RBA to move again by 50 basis points is that the RBA will receive another inflation report (later this month). This report is likely to show a deterioration in the inflation outlook and maintain the pressure on the RBA to try and get in front of the inflation curve.

How High Will The Cash Rate Go?

By the end of this year, we expect the RBA will have a cash rate of 2-2.50%, with a peak in the cash rate a bit above 2.50% early next year.

This remains well below market expectations that have a cash rate of around 3.10% priced and a peak of over 4% factored in for next year.

Expectations for RBA tightening remain far more aggressive than that of any other major economy. Indeed, the table below demonstrates that interest-rate markets expect around 275 basis points of tightening from the RBA over the next year compared with 175 basis points for the US for example.

	NZ	US	Canada	Australia	UK
Current Policy Rate	2.00%	1.50% - 1.75%	1.50%	1.35%	1.25%
Total Tightening Over Next Year According to Interest-Rate Markets	174bp	175bp	190bp	274bp	171bp

Notably, in the RBA's statement today, the RBA inserted "it will be some time yet before inflation returns to target in most countries", perhaps acknowledging that supply-side factors driving inflation could prove peskier than preferred. The RBA stated that it does not expect inflation in Australia to return towards the 2-3% band until next year.

Explicit Clues on the Outlook for the Cash Rate from the RBA's Statement

There have been major changes to the monthly statement in the past couple of months as the RBA outlined the framework they will be considering when deciding the cash rate through this hiking cycle. There were less significant changes to the statement between June and July. Inflation remains high, and the jobs market remains tight. Clearly, the cash rate needs to keep rising. And the RBA has established their approach to deciding the cash rate in the coming months. Now they need to see how the data evolves.

However, there were four notable, albeit subtle, changes in today's statement.

Firstly, the statement flagged "medium-term inflation expectations remain well-anchored and it is important that this remains the case". This builds on comments from the Governor in his recent speech. If medium-term inflation expectations increase, this could mean high inflation becomes more entrenched and more difficult to return to the target band, necessitating the RBA to hold the

cash rate higher for longer. Nervousness around inflation expectations adds to the urgency of central banks in getting on top of inflation pressures.

Second, the statement strengthened the language around the jobs market. The characterisation of the jobs market was changed from “strong” in June to “tighter than it has been for some time” in July. Further, job vacancies were described as “very high” in July, upgraded from “high” in June. And a sentence around underemployment having fallen “significantly” was inserted.

Third, the RBA dropped the central case scenario from last month where it expects “strong household consumption”. However, the RBA added “recent spending data has been positive” and the consumer is “benefitting from stronger income growth”. Dropping the forward-looking commentary on spending could imply that RBA is expecting weaker household consumption than previously, as higher rates begin to impact households.

Finally, in the final paragraph, the RBA dropped a reference to the current level of interest rates as being “very low”. This could possibly point to less need for 50-basis-point hikes now that the cash rate is approaching neutral. It arguably leans in favour of the possibility that the RBA opts to slow down the pace of tightening in August, and only move by 25 basis points.

One other nuance is that the July statement focused slightly more on global inflation than the June statement. This underscores the importance of global developments in determining the path of the cash rate over the coming period.

Where do the balance of these changes in the statement leave us? It leaves us with a clear guide that more rate hikes are likely from the RBA. Next month the decision could be 25 basis points or 50 basis points – the data will be very important in guiding the Board’s decision.

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