RBA Board Meeting Minutes

Steering Australia's 'Inflation Psychology'

- **In August, the Reserve Bank (RBA) Board raised the cash rate target by 50 basis points, taking the benchmark rate to 1.85% - its highest level since April 2016.**
- **At 175 basis points, the cumulative tightening represents the most rapid increase in the cash rate over a four-meeting window since the inflation target was introduced in 1993.**
- **The minutes from August meeting did not make a case for a 25-basis-point hike, nor did they lay out arguments in favour of a larger 75-basis-point hike. It appears a 50-basis-point hike may have been the only option on the table.**
- **The minutes note the Board's focus on ensuring that inflation expectations and the general inflation psychology remain well anchored. If these shifted higher, inflation would be more persistent and more difficult to reign in. This will play a role in the cash rate decisions in upcoming meetings.**
- **Household spending is the "key source of uncertainty" as households are currently being squeezed by two competing forces. For the time being, the tailwinds outweigh the headwinds, however, and the speed at which these forces counteract each other is the key uncertainty of interest for the RBA.**
- **The minutes reinforce that a further normalisation of monetary policy is required but note that policy is not on a pre-set path. The RBA emphasise that the size and timing of future rate hikes will be guided by the incoming data and their assessment of the inflation and labour market outlook.**
- **We anticipate a further 50 basis point hike at the Board's September meeting. This will take the cash rate to 2.35% and within the vicinity of the RBA's estimated neutral rate.**

At its policy meeting earlier this month, the Reserve Bank (RBA) Board raised the cash rate target by 50 basis points, taking the benchmark rate to 1.85% - its highest level since April 2016. This was the fourth consecutive rate hike from the RBA and the third in a row of that size. At 175 basis points, the cumulative tightening represents the most rapid increase in the cash rate over a four-meeting window since the inflation target was introduced in 1993.

In the days following the policy statement, the RBA also released its quarterly Statement on Monetary Policy. This included its full arsenal of updated economic forecasts, upon which the policy decision relied. The revisions included a downgrade to the Bank's growth forecasts and an upgrade to the outlook for jobs and wages. However, the main story was that the RBA expects inflation to be higher for longer.

Today, the minutes from the RBA's August Board meeting were released. The minutes provide further insights into the August decision, along with some additional colour on the assessment of the global and domestic economic landscape.

The size of cash rate hikes

Given elevated inflation, the strength of the economy and the tightness of the labour market, expectations going into the meeting were for a 50-basis-point hike. This is what the RBA delivered.

During previous meetings, the Board largely considered two options for the size of rate hikes, being 25 or 50 basis points. However, the minutes of the August Board meeting did not make a case for a 25-basis-point hike, nor did they lay out arguments in favour of a larger 75-basispoint hike. Instead, it appears a 50-basis-point hike may have been the only option on the table. The minutes note “The Board decided to increase the cash rate by a further 50 basis points” while providing no additional detail on the consideration of each option. This perhaps reflects that the cash rate remains some way off the RBA’s estimate of the neutral rate of “at least 2.5%”, and therefore, a more expeditious approach to normalising policy is warranted. Indeed, the minutes noted that the move was appropriate “given high inflation, the resilient economy and the tight labour market”. However, the RBA did drop its reference to the level of the cash rate as “remaining low”.

Inflation Psychology

Anchoring inflation expectations and steering the inflation psychology is also an important objective of the RBA and should bear some serious consideration when determining the timing and size of future rate hikes. The minutes appear to echo this sentiment, noting that “if inflation expectations and the general inflation psychology shifted, higher inflation would be more persistent”.

According to the RBA’s own forecasts, inflation is expected to continue to rise over the course of 2022 and peak at the end of the year. The driving forces behind the expected rise are largely out of the RBA’s control, as they primarily relate to developments in the Australian and international energy markets. Accordingly, rate hikes are not likely to have much influence on peak headline inflation, but rather, how quickly inflation normalises once supply issues and the energy shock abate and domestic factors become the primary driver of inflation.

One of the domestic inflationary drivers will be inflation expectations and the inflation psychology. As the minutes highlight, if higher inflation expectations become entrenched in wage setting practices and businesses pass on price rises more readily, it will take longer for inflation to normalise. Information from the RBA’s business liaison program suggests that “recent high inflation outcomes were a factor in current wage negotiations”. This is a potential sign that the inflation psychology is beginning to shift and heightens the importance of the RBA’s role in influencing inflation expectations and the inflation psychology via movements in the cash rate.

Household Uncertainty

Adding complexity to the RBA’s inflation fight, is the trade-off between inflation and growth. The RBA has only a small runway to normalise inflation, while maintaining steady economic growth. As Governor Lowe put it, the RBA is on a “narrow path”.

Household consumption is the powerhouse of the Australian economy and is therefore essential to maintaining growth. However, as the minutes highlight, there is considerable uncertainty around how household consumption will react to interest rate hikes and the RBA is becoming increasingly focused on these uncertainties.

The minutes identify household spending as the “key source of uncertainty for the domestic growth outlook” as households are currently being squeezed by two competing forces, being high inflation and rising interest rates. High inflation and rising rates are eating into household disposable incomes and reducing the share of household income available for discretionary spending. However, there are also tailwinds to spending offsetting these factors. The labour market is exceptionally strong and household incomes are expected to be boosted by an uptick in nominal wages growth. Households have also accumulated a substantial pool of aggregate savings and the savings ratio remains at around double its long-run average.

For the time being, the tailwinds outweigh the headwinds and household consumption is growing strongly. However, this is not expected to last and the speed at which these forces counteract each other is the key uncertainty of interest for the RBA. If households prove more resilient, the RBA will have more headway to raise rates to combat inflation. However, if households are more sensitive to rate rises, growth will slow more rapidly and the trade-off between inflation and growth will become more apparent.

The minutes also highlight the potential for a further decline in housing prices and a larger than expected wealth effect to weigh more heavily on household consumption.

Monetary Policy Outlook

Inflation is at its highest level since the early 1990's and the peak is still ahead of us. The Australian economy is growing strongly, owing largely to the resilience of consumer spending, the labour market is incredibly strong, the economy is pushing against capacity constraints, and the outlook for investment remains positive. Against this backdrop, a further normalisation of monetary policy is required. The minutes from the August Board meeting reinforce this view but note that policy is not on a pre-set path. Instead, the size and timing of future rate hikes will likely be guided by incoming data and the RBA's assessment of the outlook for inflation and the labour market.

We continue to expect the RBA to move rates to a neutral setting expeditiously and anticipate a further 50 basis point hike at the Board's September meeting. This will take the cash rate to 2.35% and within the vicinity of the RBA's estimated neutral rate. A 50-basis-point hike will have the dual effect of withdrawing monetary stimulus rapidly, while also sending a strong message that the RBA is committed to bringing inflation back towards its target band. Such a message will be key to reinforcing inflation expectations and shaping the inflation psychology, a priority objective highlighted within the minutes.

Having hiked rates to within neutral territory, we expect the RBA will exercise caution as it endeavours to move rates into the contractionary zone. Accordingly, expect the RBA to slow the pace of rate hikes to 25 basis point increments from the October Board meeting onwards.

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