Tuesday, 2 May 2023

RBA Board Meeting

Surprise Hike As Inflation "Still Too High"

- **The Reserve Bank (RBA) surprised markets and most economist by increasing the cash rate by a further 25 basis points at today's Board meeting. This takes the cash rate up to 3.85%, the highest since April 2012.**
- **This takes the cumulative amount of tightening to 375 basis points since the RBA began lifting the cash rate in May 2022.**
- **Returning inflation to target remained a top priority. With that in mind, the RBA expressed concerns around the stickiness of services inflation, the pick up in until labour costs and the need to keep inflation expectations well anchored.**
- **The RBA drew on the inflation experience of other major economies, referencing that the experience overseas regarding services inflation points to upside risks. This suggests perhaps the RBA no longer sees Australia as that different. Australia may be just lagging. This would represent a change from previous comments made by the RBA.**
- **The big question is where to next for the cash rate? Our central group view is that the rate-hike cycle is over, however, we cannot rule out further tightening. Indeed, a tightening bias remains part of the statement. The RBA has not ruled out further tightening but has tied it to the data. Data is the king!**

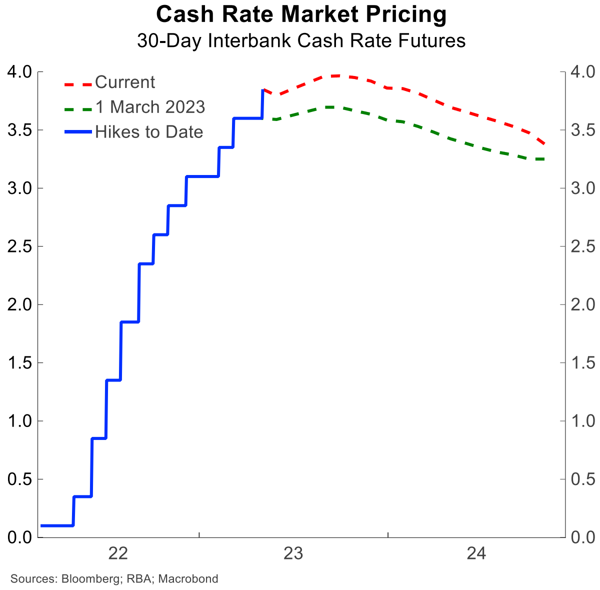
The Reserve Bank (RBA) surprised markets and most economist by increasing the cash rate by a further 25 basis points at today's Board meeting. This takes the cash rate up to 3.85%, the highest since April 2012 and the number of rate rises in this cycle to eleven. The cash rate has now increased by 375 basis points since this hiking cycle began.

We flagged the decision would be a close call. However, we thought it would be another pause. The latest inflation report suggested inflation was heading in the right direction, although remained elevated. Moreover, the RBA's view was that a return to the band was not likely until mid 2025 – some time away, which carries a risk that the path of inflation does not materialise as planned. The further out a forecast, the more variability there is attached to that forecast.

The outcome also surprised financial markets, which were expecting a pause. The move has resulted in a repricing of future interest rate moves, with markets now pricing in the possibility of further hikes. A peak rate of just under 4% is currently priced for later this year.

The RBA expressed concern around the outlook for services inflation, which is "still very high and broadly based". The annual pace of services inflation growth did step up in the last quarter and it is the component of inflation that can be stickier and trickier to bring down.

Another factor noted was around "unit labour costs… rising briskly, with productivity growth remaining subdued." The suggests that the RBA remains vigilant of higher labour costs, particularly if they are not accompanied by higher productivity growth.



The RBA pointed to the international experience on these factors. However, in recent times the RBA has been more at pains to single out Australia as different to the rest of the world. Perhaps there's a realisation forming that Australia is not that different, it just lags other major economies.

The RBA's decision was also centred on keeping inflation expectations in check. Rising inflation expectations are a risk to the strategy the RBA has undertaken of tolerating a slower return to target to achieve a soft landing. The statement noted that "medium-term inflation expectations remain well anchored, and it is important that this remains the case." Today's further adjustment in interest rates will help in this regard and reduce this risk.

On wages growth, they repeated that they remain "alert to the risk of a prices-wages spiral". However, the labour market is showing signs of easing, albeit from an extremely tight level. They conceded there are some reports of an easing in labour shortages. The massive ramp up in net overseas migration is providing an injection of much needed labour supply. Forward-looking indicators of employment are also softening, for example, candidates per vacancy are rising and job ads are declining. Furthermore, there are increasing reports of redundancies and increased outsourcing offshore from our own customer liaison.

The statement noted the pressures households are under regarding their balance sheets, stating that "the combination of higher interest rates, cost-of-living pressures and the earlier decline in housing prices is leading to a substantial slowing in household spending. While some households have substantial savings buffers, others are experiencing a painful squeeze on their finances."

Updated forecasts

The RBA provided updated forecasts around growth and inflation. These are a sneak peek into the full update, published in the May Statement on Monetary Policy on Friday this week.

Unemployment was left unchanged. GDP growth was downgraded in the near term to 1¼% for this year (from 1.6% previously), but upgraded for 2024. Concerns will deepen after today's decision that the path to bringing down inflation and avoiding a recession will be too narrow. Inflation was also downgraded modestly to 4½% in 2023, from 4.8% previously. The forecast of 3%

for mid 2025 remains unchanged.

RBA Economic Forecasts: February SoMP vs May SoMP*

	Dec 2023		Jun 2025	
	Feb SoMP	May SoMP	Feb SoMP	May SoMP
GDP, y/y%	1.6	1¼	1.7	~2
Consumer Price Index, y/y%	4.8	4½	3.0	3
Unemployment Rate, %	3.8	-	4.4	~4½

*Based on forecasts included in the May Monetary Policy Decision statement

Impact on households

The latest hike will take time to flow through the economy. Indeed, the full effect of monetary policy changes takes around 12 to 18 months to be felt. However, variable rate mortgage holders will feel the impacts over coming months. Since the hiking cycle began, monthly repayments have lifted by around $500 to $4,500 per month for those with loans between $250,000 and $2 million. This assumes the entire 375 basis point increase is passed through. However, competition in the mortgage market is strong and refinancing has been around record levels. As a result, the full impact is likely to be smaller for households that have refinanced.

Cumulative Change in Monthly Repayments ($)		
	Date	As at May 23
	Change since May 2022	375 basis points
Loan Size ($)	**250,000**	565
	500,000	1,125
	1,000,000	2,250
	1,500,000	3,380
	2,000,000	4,505

Outlook

The big question is where to now. Is this the peak or is another hike coming, and, if so, when? These are all valid questions and what today's meeting demonstrated is that there is some fluidity attached to the outlook, especially given it will be very dependant on how the data evolves.

Indeed, the key final paragraph of the statement suggested that further tightening can't be ruled out and maintained a hiking bias. However, it is conditional on data developments: "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve."

This compares to last month, which stated that "the Board expects that some further tightening of monetary policy may well be needed to ensure that inflation returns to target."

Looking forward, the key areas the Board will focus on remain "developments in the global economy, trends in household spending and the outlook for inflation and the labour market."

Our central group view is that the peak is at 3.85%, but there's some risk of further tightening, especially if the trajectory of inflation is slower to return to the band than the RBA expects.

On the RBA's own forecasts, inflation does not return to the top of the band until mid 2025. This is still some time off, meaning elevated inflation will be with us for an extended time.

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