

Tuesday, 7 June 2022

Reserve Bank's Cash Rate Decision Going Harder in Fight Against Inflation

- The RBA delivered a rate hike of 50 basis points today, taking the cash rate to 0.85%. It is the biggest move in 22 years. It follows a 25 basis point rate hike in May, which kicked off the RBA's tightening cycle after headline inflation cracked 5.1% per annum in the March quarter.
- The consecutive rate rises more than fully unwind the 65 basis points of emergency rate cuts the RBA implemented at the start of the pandemic. And these back-to-back rate hikes, totalling 75 basis points, are the biggest in a two-month window since December 1994.
- It's a strong signal that the RBA is prepared to move harder in the fight against inflation.
- Moreover, it's also consistent with the recent 50 basis point moves from other major central banks, including the US Federal Reserve, the Bank of England and the Reserve Bank of New Zealand.
- Since the RBA's meeting in May, data has revealed a further drop in the unemployment rate to a 48-year low and an uplift in inflation expectations to a record rate. Moreover, national accounts data last week confirmed a robust economic expansion is underway.
- The RBA appears more concerned about inflation. It stated in its board statement today that it expects near-term inflation to be higher than expected a month ago.
- We've also recently upgraded our inflation trajectory. We expect annual headline inflation to peak at around 6.5% late this year, before easing over 2023. And we continue to expect inflation won't return to the RBA's inflation target band before late next year.
- So, what's next? The RBA's more aggressive stance and the revised outlook for inflation opens the door for another 50 basis point hike at the RBA's next meeting in July. Indeed, at 0.85%, the cash rate is still providing stimulus to the economy and further hikes will be needed to tame inflation.
- Our end-of-year forecast for the cash rate is 2.10%. In comparison, interest-rate markets are expecting a cash rate of around 3.10% by the end of 2022 – 100 basis points higher!
- We see the peak in the cash rate occurring in the first half of next year. Rate hikes have greater potency than in the past due to the high level of household indebtedness, but many households have built up buffers.

The Reserve Bank of Australia (RBA) has joined other major central banks, including the US Federal Reserve and the Reserve Bank of New Zealand, in going harder in the fight against inflation.

The RBA delivered a rate hike of 50 basis points today, taking the cash rate to 0.85%. It follows a

25 basis point rate hike in May, which kicked off the RBA’s tightening cycle after headline inflation cracked 5.1% per annum in the March quarter. Today’s rate hike is the biggest in 22 years.

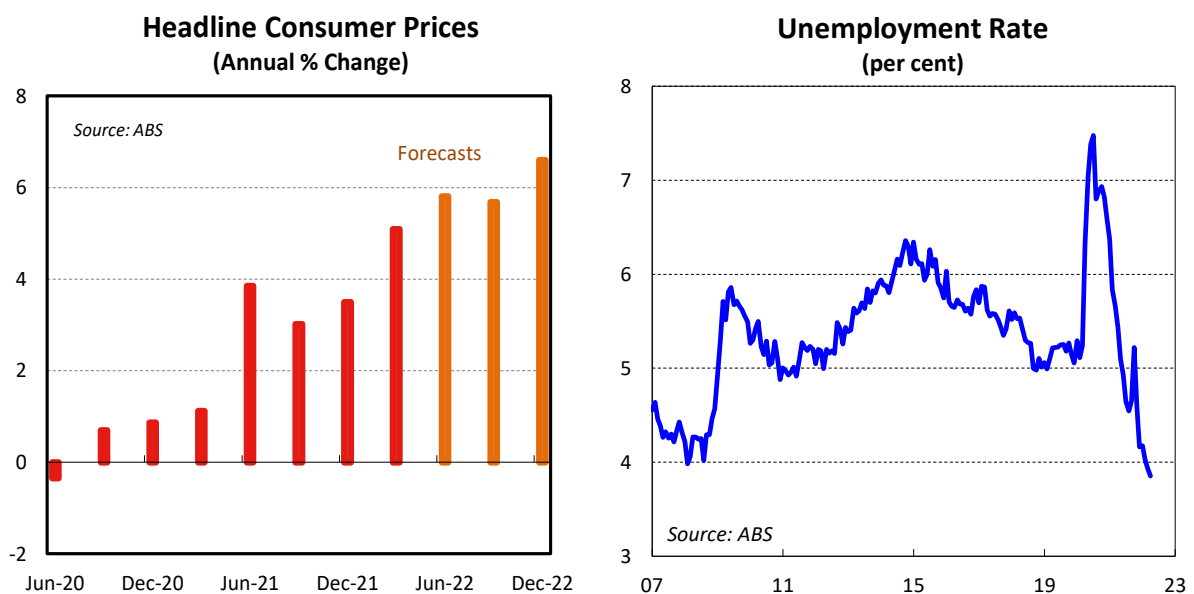
The consecutive monthly rate rises more than fully unwind the 65 basis points of emergency rate cuts the RBA implemented at the start of the pandemic. And these back-to-back rate hikes, totalling 75 basis points, are the biggest in a two-month window since December 1994.

The hike today means the cash rate is back above its pre-COVID level. The cash rate was sitting at 0.75% in February of 2020, just before the pandemic swept the country. On a backdrop of persistent high inflation, a strong labour market and solid economic growth, the Reserve Bank is clearly eager to wind back emergency policy settings quickly.

A rate hike today was no surprise. The RBA had clearly flagged more rate rises are likely last month. The surprise came in the size of the hike. Our Group house view was 40 basis points, although in recent weeks we had been flagging to customers the risk was of 50 basis points. The consensus view of economists was for 40 basis points and interest-rate markets only had a 54% probability attached to a 50-basis-point hike.

We see the rate hike of 50 basis points as the appropriate decision, given the potent backdrop of elevated inflation, strong economic growth and an extremely low rate of unemployment. The danger is inflation remains sticky. Inflation would have been harder to tame if the RBA failed to take strong action today.

The RBA is nervous about elevated inflation pushing up inflation expectations, noting in the minutes from the May meeting that “it would be more difficult to return inflation to the target if the inflation psychology were to shift in an enduring way”.

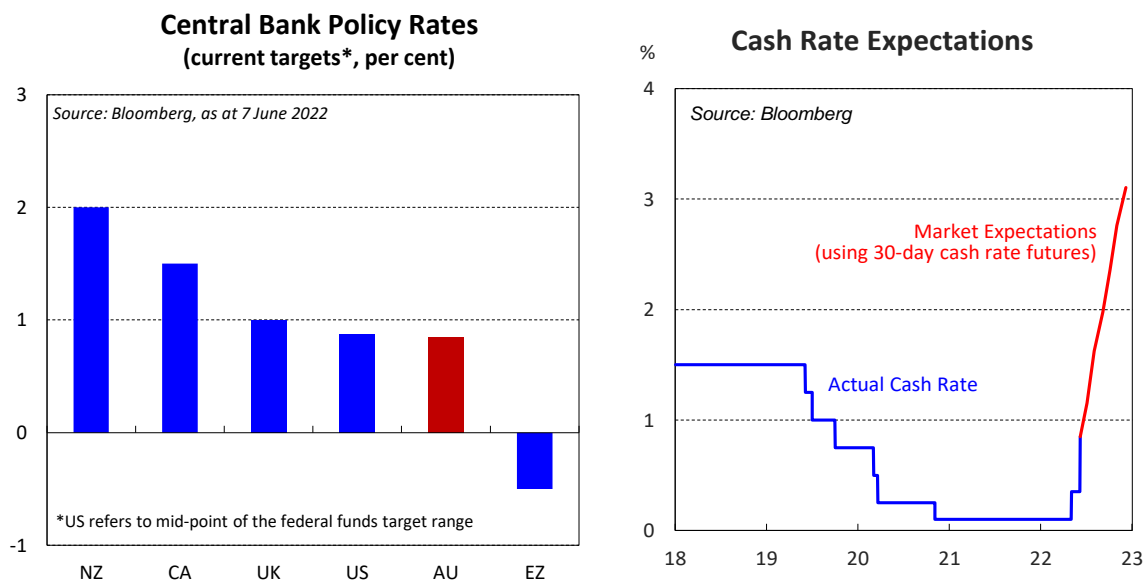


Since the RBA last met, jobs data has revealed the unemployment rate has fallen further to its lowest level in almost 48 years at 3.9%. Inflation expectations have ramped up again to a record pace of just under 5%. And economic activity data has revealed an economic expansion continued solidly in the March quarter, despite the Omicron wave and weather disruptions. Official wages data has remained slow to accelerate. But wages barely got a mention today in the RBA statement. Moreover, a consideration of other information sources, such as the trends in business surveys and feedback from liaison surveys, suggests it is only a matter of time before the premier measure of wages growth (the wage price index) picks up considerably.

The need to act harder via the larger-than-expected move and the details in the statement suggest

the RBA is becoming more worried about the strength of inflation. The statement explains that near-term inflation is “likely to be higher than expected a month ago” because of higher electricity, gas and petrol prices. In the May Statement on Monetary Policy, the RBA forecast a peak in annual headline inflation at 5.9% later this year. Underlying inflation was forecast to peak at 4.6% later this year. Today’s statement suggests the RBA now expects inflation to peak even higher.

We’ve also recently upgraded our inflation trajectory for this year and next; we expect the peak in the annual inflation rate will occur late this year at around 6.5% before it gradually declines over next year. The RBA expects inflation will “decline back towards the 2-3% target range” in 2023, as “the global supply-side problems are resolved and commodity prices stabilise”. We don’t expect inflation to return to the band until late 2023.



So, what’s next? The RBA’s more aggressive stance and the revised outlook for inflation opens the door for another 50 basis point hike at the RBA’s next meeting in July. Indeed, at 0.85%, the cash rate is still providing stimulus to the economy and further hikes will be needed to bring inflation back under control.

We also expect several more rate hikes before the end of the year, albeit 25 basis points in size, will follow the move in July. The cash rate is likely to end this year at just over 2%.

Interest-rate markets remain convinced the RBA will need to be more aggressive; 30-day cash rate futures have a cash rate of 3.11% by year’s end – up from around 2.70% before today’s cash rate announcement. That is, markets expect the RBA to deliver a further 226 basis points of tightening before the conclusion of 2022.

These expectations are also reflected in swap and bond rates, especially shorter-dated bond and swap rates. It will take a run, perhaps somewhat prolonged run, of weaker economic data to convince the market that their expectations are too aggressive for 2022. That run of data may not materialise until late this year or next year.

How high can the cash rate go? That is a difficult but important question. And one we need to consider and forecast amid heightened uncertainty. As the RBA gets closer to a cash rate that is no longer stimulatory, it will become trickier for the RBA to navigate cash rate policy. At a cash rate of 0.85%, the cash rate is still arguably very stimulatory. We think that when the cash rate crosses over 1.50% (in August 2022), the RBA decisions will become more finely balanced.

Each successive rate hike will become more restrictive for households, given the level of household indebtedness in Australia. However, as the RBA highlighted today many households have built up large buffers, including paying off their mortgage faster than needed. The household savings ratio is also above the long-run average. It is not to say there won't be households that will start feeling stress.

Our preliminary forecast is for the cash rate to peak at 2.35% in the first half of 2023 – a rate that would see the household debt servicing ratio peak above previous peaks but there is greater variability around the peak in the cash rate at this early stage of the hiking cycle. Much will depend on the transmission mechanism of monetary policy to the economy, including via the impact on dwelling prices and share markets.

Interestingly, the annual rates of inflation in NZ and Australia are closely correlated historically. The Reserve Bank of New Zealand (RBNZ) recently hiked back-to-back in 50 basis point moves – something that has not happened since the introduction of the Official Cash Rate in 1999. When the RBNZ started hiking rates in October last year, their inflation rate was lower than the inflation rate in Australia when the RBA started hiking in May 2022. The economies are not identical but one wonders whether the risks are that inflation proves peskier than the RBA would like. More tightening will slow growth, but because some of the key drivers of inflation are exogenous to Australia (i.e. war in Ukraine and China's zero-covid strategy), inflation may still take some time to come back into the RBA's band.

Besa Deda, Chief Economist
Ph: 0404 844 817

Contact Listing

Chief Economist

Besa Deda
dedab@banksa.com.au
(02) 8254 3251

Economist

Matthew Bunny
matthew.bunny@banksa.com.au
(02) 8254 0023

Senior Economist

Jarek Kowcza
jarek.kowcza@banksa.com.au
0481 476 436

Associate Economist

Jameson Coombs
jameson.coombs@banksa.com.au
0401 102 789

The information contained in this report (.the Information.) is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom BankSA has a contract to supply Information, the supply of the Information is made under that contract and BankSA's agreed terms of supply apply. BankSA does not represent or guarantee that the Information is accurate or free from errors or omissions and BankSA disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to BankSA products and details are available. BankSA or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. BankSA owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of BankSA.

Any unauthorized use or dissemination is prohibited. Neither BankSA- A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.