Tuesday, 1 November 2022

RBA Board Meeting
‘Business-As-Usual’ Despite Inflation Jump

- **Today the Reserve Bank (RBA) Board increased the cash rate by 25 basis points to 2.85% - the highest rate since April 2013. The RBA Board has now raised the cash rate by 275 basis points since May, the most rapid tightening cycle since 1994.**
- **The move follows a stronger-than-expected inflation report last week, which showed that inflation surged to its highest level in over 32 years.**
- **The Board decided to stick with a “business-as-usual” sized hike of 25 basis points in November. As in October, the choice between a 25 and 50 basis point move was a close call.**
- **Key to the decision to stick with a 25-basis-point hike was the desire for the RBA to engineer a soft landing – i.e. gradually return inflation to its 2-3% target band while keeping the economy on an “even keel”.**
- **Nobel Prize winning economist Milton Friedman observed that monetary policy acts with “long and variable lags”. The RBA Board is well aware of this and acknowledged that the “full effect of the increase in interest rates is yet to be felt in mortgage payments”. It is also made note of the pressure that many households are under following the rate hikes to date.**
- **But this approach has its risks. The key one being inflationary expectations becoming unanchored if households and businesses form the view that the Board is not resolute in its desire to get inflation back within the 2-3% band.**
- **This approach is also likely to result in inflation being higher for longer. Such an outcome would prolong the RBA’s tightening cycle and increases the risks of further rate hikes being necessary down the track.**
- **Indeed, the RBA Board has more work to do as additional hikes are needed to sustainably bring inflation back down. Interest-rate markets expect the cash rate to increase to almost 4% by the end of 2023.**

Today, the Reserve Bank (RBA) Board increased the cash rate by 25 basis points to 2.85% - the highest rate since April 2013. The RBA Board has now raised the cash rate by 275 basis points since May, the most rapid tightening cycle since 1994.

The move follows a stronger-than-expected inflation report last week, which showed that inflation in Australia has surged to its highest level in over 32 years. Headline inflation jumped to 7.3% over the year to the September quarter. Trimmed mean inflation, which removes some of the more volatile components and provides a better measure underlying inflationary pressures, also surged to 6.1%, the highest annual rate in the history of the series.

The Board decided to stick with a "business-as-usual" hike of 25 basis points in November. As in October, the choice between a 25 and 50 basis point move was a close call, particularly given the need to respond to a faster-than-expected inflation print, while accounting for the long and variable lags in the action of monetary policy.

The Board acknowledged that inflation in Australia is too high and that "returning inflation to target requires a more sustainable balance between demand and supply". However, it continues to expect inflation to decline next year "due to the ongoing resolution of global supply-side problems".

Monetary policy acts with considerable lags and households have not yet felt the full impact of the interest rate hikes to date. It typically takes two to three months for interest rate hikes to be fully reflected in the cash flow of households on variable rate mortgages. Additionally, a higher-than-average number of households are on fixed rate mortgages and will not feel the effects of higher interest rates until their fixed rate period ends. The RBA expects around two thirds of these households will roll off fixed rates by the end of 2023. The Board again made note of this point in its statement today and these lags have had a large impact on its decision making.

The Board continues to walk a narrow path as it seeks to engineer a soft landing – i.e. keeping the economy on an "even keel". This is becoming a more challenging task as inflationary pressures continue to rise. Tackling inflation requires reducing demand in the economy, which has negative consequences for growth in the near term.

Many global central banks have previously noted a willingness to significantly impact growth to bring inflation back to target. By shunning this approach, the RBA risks inflationary expectations becoming unanchored if households and businesses form the view that the Board is not resolute in its desire to get inflation back within the 2-3% band. This approach is also likely to result in inflation being higher for longer. Such an outcome would prolong the RBA's tightening cycle and increases the risks of further rate hikes being necessary down the track.

Another important factor in thinking about monetary policy settings is the relative stance of monetary policy. The Governor on previous occasions has noted that the neutral level of the cash rate, where it is not providing stimulatory or contractionary pressure on the economy is "at least" 0% in real terms. This implies a nominal rate of "at least" 2.5% when inflation expectations are well anchored. Assistant Governor Luci Ellis also recently spoke about the neutral level of the cash rate and noted that the average estimate from the nine models the RBA uses to estimate the level was "just under 1%" in real terms, implying a neutral rate of around 3.5% in nominal terms.

The increase today takes the cash rate further into the RBA's estimates of the neutral range. As the cash rate increases towards its neutral level, and moves beyond, it enacts more contractionary pressure on the economy.

RBA Statement

There were a few key take aways from the RBA Board's statement today.

Firstly, last week's stronger than expected inflation read did not fundamentally change the RBA's view on the future direction of the Australian economy. The RBA again noted that the main underlying drivers of high inflation are temporary in nature and originate from global factors. The Board continues to expect that inflation will "decline next year due to the ongoing resolution of global supply-side problems".

Indeed, the Board again noted that the global economy has "deteriorated over recent months", presumably adding downward pressure to supply-side problems and subsequently, prices.

However, domestic factors are also playing a role and the Statement added that “returning inflation to target requires a more sustainable balance between demand and supply”.

The RBA still hopes to achieve a soft landing, noting that the path to “achieving this balance remains a narrow one and it is clouded in uncertainty”. The RBA seems to take comfort in the fact that inflation expectations remain well anchored and that nominal wages, while ticking up, are lower than in other comparable nations.

The RBA now thinks that inflation will remain higher for longer. Importantly, the RBA notes that higher inflation means that the risk of a price-wage spiral increases. At its extreme, a spiral could lead to stagflation (a situation where inflation and unemployment are simultaneously elevated). The Statement makes the addition “given the importance of avoiding a prices-wages spiral, the Board will continue to pay close attention to both the evolution of labour costs and the price-setting behaviour of firms in the period ahead”.

The key uncertainty remains how households respond to “materially” higher interest rates that are yet to fully hit the economy. Higher rates combined with cost-of-living pressures are offsetting some of the upside from the stronger labour market and savings buffers accumulated during the pandemic. While acknowledging that the labour market remains tight, the RBA makes the point that “employment growth has slowed over recent months as spare capacity in the labour market has been absorbed”.

Updated forecasts

Today’s decision included a sneak peak into some of the RBA’s forecast revisions ahead of its quarterly Statement on Monetary Policy (SoMP) on Friday. The SoMP will include a full suite of updated economic forecasts.

RBA Economic Forecasts: August SoMP vs November SoMP*

	Dec 2022		**Dec 2023**		**Dec 2024**	
	Aug SoMP	**Nov SoMP**	**Aug SoMP**	**Nov SoMP**	**Aug SoMP**	**Nov SoMP**
GDP, y/y%	3.2	~3	1.8	1½	1.7	1½
Consumer Price Index, y/y%	7.8	~8	4.3	4¾	3	~3
Unemployment, %	3.4	~3½	3.5	-	4	~4

*Based on forecasts included in the November Monetary Policy Decision

The most notable change comes to the RBA’s inflation forecast profile. After inflation hit a more than 32-year high in the September quarter, the RBA has upgraded its forecast for the peak in inflation. The RBA now expects inflation to peak at around 8 per cent in the December quarter of this year, compared to 7.8 per cent previously.

But the RBA doesn’t just expect inflation to peak at a higher level, it also expects inflation to be higher for longer. The RBA forecasts inflation will fall to 4¾ per cent by the end of 2023, up from 4.3 per cent previously. Importantly, the RBA now expects inflation to settle “a little over 3 per cent” at the end of its forecast horizon in December 2024. That means that the RBA does not expect inflation to return to the top of its 2-3% target band until at least 2025.

The RBA also revised down its forecasts for economic growth, reflecting the impact of “materially” higher rates since May which are yet to fully flow through to households and businesses, and its sour outlook for the global economy. GDP growth in 2022 is expected to be around 3 per cent, down slightly from the 3.2 per cent increase published in the August SoMP. Similarly, growth is

forecast to be 1½ per cent in 2023 and 2024, down from 1.8 per cent and 1.7 per cent, respectively.

The RBA maintained its expectation for the labour market to remain tight over the months ahead but now expects unemployment will settle marginally higher at the end of 2024 on the back of weaker economic growth. The Bank makes the point that "employment growth has slowed over recent months as spare capacity in the labour market has been absorbed".

Outlook

Today's decision reaffirms the RBA Board's focus on a achieving a soft landing. However, this does not mean that the rate cycle is nearing an end. The Board still "expects to increase interest rates further over the period ahead" and last week's inflation report proves that there is more work to be done.

By treading lightly, the Board is giving itself the best opportunity to achieve its objective of "keeping the economy on an even keel" while bringing inflation back to the target "over time". However, this approach risks higher inflation becoming entrenched in inflation expectations and the inflation psychology and could mean the Board will have to take further action at a later stage in this cycle.

Indeed, financial markets currently expect the cash rate to peak at almost 4% by the end of next year.

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