Tuesday, 4 October 2022

RBA Board Meeting

RBA Slows Hikes but Job Far From Over

- **Today the Reserve Bank (RBA) Board decided to increase the cash rate by 25 basis points to 2.60% - the highest rate since July 2013. The RBA Board has now raised the cash rate by 250 basis points since May, the largest increase over a six-month period in the post inflation targeting era.**
- **The rapid increase in the cash rate to date, along with the long and variable lags associated with these increases, has been enough to sway the Reserve Bank (RBA) Board to step down the pace of interest rate hikes. The market had factored in a 40-basis point increase at today's meeting.**
- **The RBA has now embarked on a more gradual hiking path to allow it to assess the impact of previous rate hikes on the economy before stepping on the breaks further.**
- **The RBA Governor's Statement makes it clear that further rate hikes are expected "over the period ahead" with the size and timing "to be determined by the incoming data."**
- **The Statement also makes clear that the RBA is closely monitoring the inflation psychology of households and businesses, but for the time being are comfortable that inflationary expectation remains well anchored.**
- **The RBA is focused on achieving a soft landing and has scaled back the size of its rate hikes as it moves beyond 'neutral' to ensure it doesn't make a policy mistake in overtightening. However, stepping down the pace of tightening increases a risk of a policy mistake in the other direction. For the time being, the risks are finely balanced and only time will tell if the RBA has selected the right course.**
- **Our view is that the cash rate is now back at its "neutral" level, the RBA will increase interest rates by the traditional 25 basis points. An inflation surprise on the upside may mean that the RBA Board increases rates for longer. We do not think they will go back to increasing by 50 basis points unless there is a significant shock to domestic inflationary pressures.**
- **It is still our view that the RBA will need to increase the cash rate further to get inflation down to the target band of 2-3%. We expect the terminal cash rate to be reached in the first half of 2023 and be around 3.50%**

Today the Reserve Bank (RBA) Board decided to increase the cash rate by 25 basis points to 2.60% - the highest rate since July 2013. The RBA Board has now raised the cash rate by 250 basis points since May, the largest increase over a six-month period in the post inflation targeting era.

The rapid increase in the cash rate to date, along with the long and variable lags associated with these increases, has been enough to sway the Reserve Bank (RBA) Board to step down the pace of interest rate hikes and increase the cash rate by 25 basis points today.

However, the RBA Board has said it expects to hike rates further over the period ahead as it focuses on returning inflation to the 2-3% range, while keeping the economy on an even keel.

In the wake of the September meeting, RBA Governor Lowe stressed on several occasions that as the cash rate increases further the case for slowing the pace of rate hikes will grow. The only question was whether we had reached that stage yet or if another 50-basis point hike was in order before pulling back the pace.

We always maintained that it would be a close call between a 25 and 50 basis point hike today. The minutes from the September meeting revealed that the Board considered both a 25 and 50 basis point hike in September, however, opted to increase by 50 basis points given the cash rate was "still relatively low" and the risks to inflation were skewed undoubtably to the upside.

However, the October statement notes that the "cash rate has increased substantially in a short period of time" and Board now believes it is time to take a step back and assess the impact of such a rapid increase in interest rates. Slowing the size of rate hikes to 25 basis point increments allows the RBA to do this, while also continuing to take steps to tackle inflation that is "too high".

Although not explicitly noted in the RBA's statement, it is clear that Board assessed a cash rate of 2.60% as sufficiently restrictive to justify a gentler approach and to prevent any potential 'over-tightening' as the RBA moves policy settings into contractionary territory. In other words, the RBA believes it is now moving beyond its estimate of the neutral rate and is paying more attention to the impact this may have on economic growth.

This was made especially apparent in the RBA Board's assessment of the global economy. The statement noted that the task of keeping the economy on an even keel has been made more difficult due to the growing uncertainty over the deteriorating global outlook. Skyrocketing energy prices in Europe and supersized interest rate increase in the largest economies in the world, including the US, Canada and ECB, are starting to bite. We have seen several indicators point to a significant contraction in the US and eurozone manufacturing sectors. This will reduce demand for Australian goods making it harder for the RBA to achieve a soft landing.

Scaling back the pace of rate hikes has the key benefit of allowing the RBA to assess the impact of previous rate hikes on the economy before stepping on the breaks further and will help the Board fine tune the impact of rate hikes on economic growth. However, this comes at a cost and elevates the risk that inflation expectations becoming unanchored.

Other central banks, including the US Fed, have tried eliminating this risk by maintaining a more aggressive approach with a risk of more adverse consequences for growth. The RBA has wavered from this path in its quest for a soft-landing. Only time will tell if this was the right call, or if the RBA will need to take further steps later in the cycle than would have otherwise been necessary.

The RBA is cognisant of this risk and has highlighted inflation expectations, along with the global outlook, and household consumption behaviour as the key risks to the domestic economy and the interest rate outlook. But for the time being, the Board appears comfortable that inflation expectations and the inflation psychology remain well anchored.

Outlook

The RBA is focused on achieving a soft landing and has scaled back the size of its rate hikes as it moves beyond 'neutral' to ensure it doesn't make a policy mistake in overtightening. However, stepping down the pace of tightening increases a risk of a policy mistake in the other direction if inflation expectations become unanchored and inflation proves more persistent. For the time being, the risks are finely balanced and only time will tell if the RBA has selected the right course.

The RBA has pivoted, but its job is far from over. Our view is that the cash rate is now back at its "neutral" level. We expect the RBA to continue hiking over the coming meetings in the traditional 25 basis point increments. An inflation surprise on the upside may mean that the RBA Board increases rates for longer. We do not think they will go back to increasing by 50 basis points unless there is a significant shock to domestic inflationary pressures. We foresee a peak in the cash rate of around 3.50% in first half of next year.

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