Economic Analysis RBA Monetary Policy Decision Dec 2022

At its meeting today, the Reserve Bank of Australia (RBA) decided to lift its interest rates by 25 basis points, increasing:

- the cash rate target to 3.10%,
- the interest rate on Exchange Settlement balances to 3.00%.

The decision was in line with the market expectations.

A separate dataset shows that RBA's bond holdings declined by A$2.1b to A$350.4b in October, due to the maturing of the November 2022 Commonwealth bond.

Justification of the Decision

The post-meeting statement by RBA Governor Philip Lowe was re-shuffled a bit compared with the previous month. However, the overall assessment of current economic conditions remained broadly unchanged:

- Governor Lowe again stressed that inflation is too high in Australia, though he also dropped the reference to inflation in other countries,
- inflation expectations remain well anchored,
- economic growth remains solid,
- the labour market is very tight, despite some slowdown in employment growth over the previous months,
- wages growth is accelerating, and it is important that a wage-price spiral is avoided.

The assessment of the economic outlook was also unchanged from the previous statement:

- inflation is anticipated to peak at 8.0% in Q4, before gradually declining towards the upper bound of the target range in the following two years,
- household spending is expected to slow, though the timing and scale of that slowdown is uncertain.

The new elements of the statement concerned mainly the assessment of the current monetary policy stance and the forward guidance. Most notably, the Governor:

- underscored that there has been a "substantial cumulative increase in interest rates" in the current tightening cycle,
- stressed that the Board's priority is to "re-establish low inflation and return inflation to the 2-3% range over time",
- said that further interest rate increases should be expected "in the period ahead" but re-instated the phrase that the Board is "not on a pre-set course".

Philip Lowe again mentioned the lags in monetary policy transmission, assessing that the full impact of tightening is yet to be reflected in mortgage rates. He continued to pledge that the RBA is trying to re-establish price stability while keeping the economy "on an even keel" but cautioned "there are a range of potential scenarios".

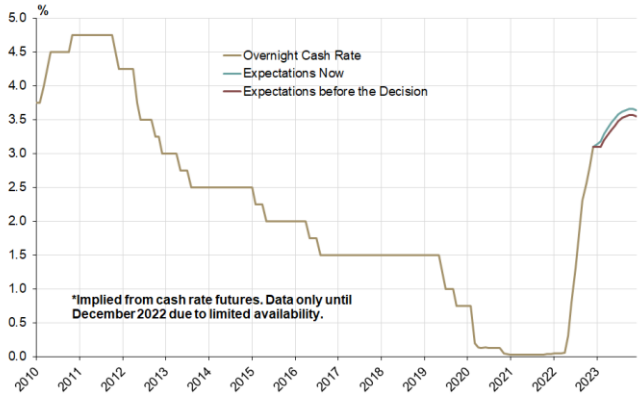
Market Impact

The 25bps hike was less than fully priced in, which was reflected in the market reaction:

- the AUD/USD rose from 0.6716 to 0.6733 just after the announcement, before falling to 0.6724 at the time of writing,
- the ASX 200 declined from 7315 points to 7291 points at the close,
- 3-year Commonwealth bond yields rose from 3.02% to 3.09%,
- 10-year yields picked up from 3.34% to 3.40%.

Despite a marginal increase in cash rate expectations after the RBA decision, a 25bps increase is only around 50% priced in for February. The cash rate is expected to peak at 3.60% in mid-2023.

RBA Historical and Expected Cash Rate*



Comment

As expected, the RBA decided to deliver another 25bps rate increase. The RBA is trying to walk a fine line between bringing inflation back to the target range while not derailing domestic economic growth nor adding too much to pressure to household finances.

The RBA signalled that the rates will increase further, with the pace and timing being data dependent. Similar to the FOMC in early November, the Governor pointed to the substantial cumulative tightening already in place and, again, to the lags in monetary policy transmission mechanism. Some caution regarding future rate increases was added to the statement, but the language regarding restoring price stability was tightened a bit.

We think that the RBA is approaching the end of the tightening cycle but prefers not to be explicit in its forward guidance, as inflation has not peaked yet and there are multiple risks about the outlook. We expect another 25bps increase at the next meeting in February 2023.

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