Economic Analysis — RBA Monetary Policy Decision Oct 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 2.60%,
- the interest rate on Exchange Settlement balances to 2.50%.

The interest rate hike was less decisive than the 50bps expected by the markets.

A separate dataset shows that RBA's bond holdings were broadly unchanged at A$353.0b in September.

Justification of the Decision

In the post-meeting statement, RBA Governor Philip Lowe justified the lower-than-expected increase by stressing that the cash rate had been hiked substantially in a short period of time. He assessed that the October decision will help inflation return to the 2-3% target range, but also judged further increases will be likely needed.

The statement was slightly reshuffled, but contained the key hawkish elements present in the previous months. Most notably, it:

- emphasised that the Bank is committed to returning inflation to the 2-3% target band while keeping the economy balanced ("on an even keel");
- further underpinned the above commitment by keeping the sentence added last month that "price stability is a prerequisite for a strong economy and sustained full employment";
- repeated that, while high inflation is largely due to external factors, it is also being driven by domestic determinants ("strong domestic demand relative to the ability of the economy to meet that demand");
- again pledged that the RBA will continue to pay close attention to the evolution of labour costs and price-setting behaviour of companies.

At the same time, the statement included several minor modifications, making it sound slightly more dovish:

- the statement stressed that, despite the continued increase, wages growth remains lower than in other economies, and the reference to pockets of "brisk" labour cost growth in the economy was removed;
- it mentioned a bleaker global economic outlook as an extra risk factor to domestic growth ahead and pledged to follow it closely (the reaction of households to monetary tightening remained the other major source of uncertainty);
- it continued to say future interest rate increases will be determined by the incoming data but removed the reservation that the RBA is not "on a pre-set path".

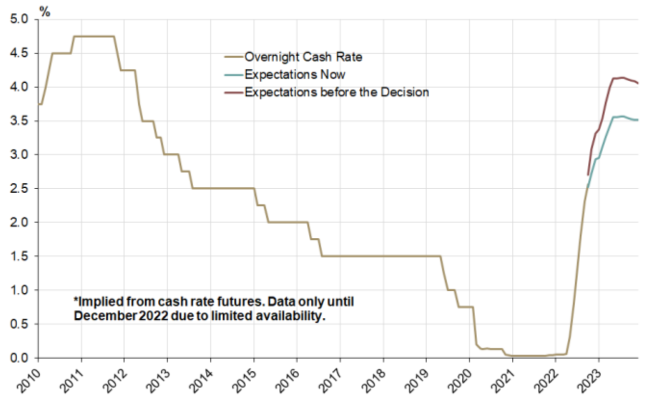
Market Impact

The downside surprise to the interest rate increase immediately generated a significant market reaction. Most notably:

- the AUD/USD dropped from 0.6504 to 0.6459 just after the announcement, before recovering to 0.6471;
- the ASX 200 jumped from 6619.6 points to 6663.4 points just after the decision and continued to rise; reaching 6688.4 points at the time of writing;
- 3-year Commonwealth bond yields fell from 3.431% to 3.180%, but have since risen to 3.238%;
- 10-year yields declined from 3.769% to 3.660%, before picking up to 3.695%.

The fall in government bond yields came amid a decline in cash rate expectations. At the time of writing, the market is pricing in a 25bps hike for the next meeting in November, down from a 50bps increase this time yesterday. The cash rate is now expected to peak at around 3.50%, which compares to slightly above 4.00% before today's announcement.

RBA Historical and Expected Cash Rate*



Comment

After bringing interest rates to their estimate of neutral territory, the RBA has decided to slow the pace of tightening and soften the language on the monetary policy outlook.

While we saw the risk of a larger, 50bps hike, the move reflects the rapid tightening already in the system, as well as the large and increasing level of uncertainty around the global growth outlook.

The RBA is trying to walk a fine line between bringing inflation back down to the target range while not derailing domestic economic growth. Given that inflation is still high, we will see further cash rate increases in the coming months, but their pace will be slower than earlier in the tightening cycle.

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