Economic Analysis RBA Monetary Policy Decision Sep 2022

At its meeting today, the Reserve Bank of Australia (RBA) decided to lift its interest rates by 50 basis points, increasing:

- the cash rate target to 2.35%,
- the interest rate on Exchange Settlement balances to 2.25%.

The decision to deliver a fourth consecutive 50bps hike was in line with market expectations. The cash rate target is now 225bps higher than before the start of the tightening cycle in May.

A separate dataset shows that RBA's bond holdings were unchanged at A$353.1b in August, after shrinking by A$2.6b in July due to maturities in its portfolio.

Justification of the Decision

The key elements of the post-meeting statement by RBA Governor Philip Lowe were largely unchanged from the previous month. Most notably, the statement:

- emphasised that the Bank is committed to returning inflation to the 2-3% target band while keeping the economy balanced ("on an even keel");
- repeated that, while high inflation is largely due to external factors, it is also being driven by domestic determinants (strong demand, a tight labour market and capacity constraints);
- pointed to downside risks related to the reaction of Australian households to higher costs of living and interest rates.

At the same time, the statement included several minor modifications, which made it slightly more hawkish:

- the statement stressed that the labour market is "very tight" (rather than "tighter than it has been for many years");
- it had a newly added paragraph that underscored the pick-up in wages growth and pockets of "brisk" labour cost growth in the economy;
- there was an RBA pledge to pay close attention not only to the evolution of labour costs, but also to the price setting behaviours of businesses;
- the statement also included a new sentence, stressing that "price stability is a prerequisite for a strong economy and sustained full employment".

In addition, while discussing the recent and upcoming interest rate hikes, Governor Lowe no longer used the term "normalisation" but simply "increases". This could mean the RBA considers the cash rate to be around neutral and that it is prepared to take policy into restrictive territory in the months ahead if needed. However, Governor Lowe still stressed that the RBA Board is not "on a pre-set path" in relation to the future decisions.

Market Impact

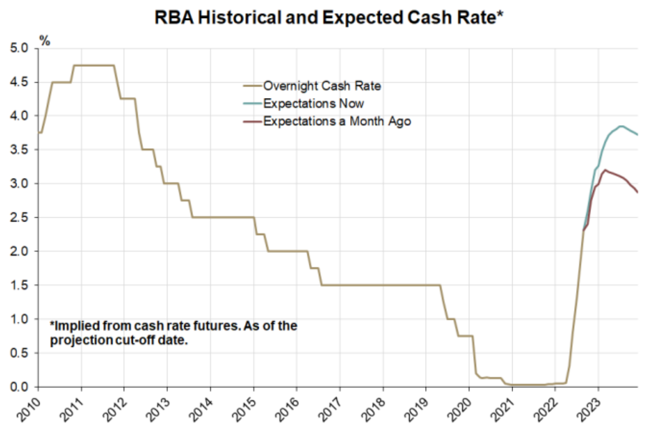
A 50bps hike was expected by the market participants and almost fully priced in. However, the market reaction suggests that the communication about the cash rate increases was indeed perceived as slightly hawkish.

3-year Commonwealth bond yields rose from 3.27% to 3.32%, while 10-year yields picked up from 3.64% to 3.67%.

There was also an increase in cash rate expectations. Futures market pricing for another 50bps hike to 2.85% in October is currently above 50%. The peak of the interest rate hike cycle is now expected at around 3.85% in mid-2023.

The ASX 200 reversed its gains from earlier in the trading day, to close 0.4% lower.

At the same time, however, the AUD depreciated slightly after the decision, from US$0.6802 to US$0.6790 at the time of writing.



Comment

The RBA continues its swift monetary policy tightening, with 225bps in hikes in just five months. The cash rate is now the highest it has been since 2014.

The task is challenging. On the one hand, domestic inflation is high and is expected to climb further. On the other hand, there are mounting downside risks to the global economic outlook, with our main trading partner China facing multiple headwinds.

In addition, it remains uncertain to what extent the high costs of living and the increased mortgage rates will impact spending of Australian households. That said, slightly weaker private consumption growth would be a desired outcome for the RBA, helping to contain demand pressure in the economy.

Cash rate expectations point to further rapid cash rate hikes ahead. The terminal cash rate at 3.85% in mid-2023 would be the highest in over a decade.

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