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Economic Analysis — RBA Monetary Policy Decision Nov 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 2.85%,
- the interest rate on Exchange Settlement balances to 2.75%.

The market was split in half between a 25- and 50bps hike.

A separate dataset shows that RBA's bond holdings declined by A$0.5b to A$352.5b in October, due to the maturing of some Semis, including WATC bonds.

Justification of the Decision

In the post-meeting statement, RBA Governor Philip Lowe reiterated that inflation returning to the 2-3% target range remains the RBA Board's priority, but they seek to achieve it while keeping the economy balanced ("on an even keel"). He again stressed that returning inflation to target will require a "more sustainable balance between demand and supply".

The assessment of the current state of the economy was unchanged from the previous statement and noted:

- higher inflation is largely explained by global factors, but domestic factors are also playing a role,
- inflation expectations remain well anchored,
- economic growth remains solid,
- the labour market is very tight, which is reflected in faster wage growth; the Bank expects that this acceleration will continue.

The statement contained some information about the new RBA projection. Most importantly:

- inflation is now expected to peak at around 8% later this year, before declining to 4.75% in 2023 and 3% in 2024 amid abating supply disruptions, lower commodity prices and slower demand growth,
- GDP growth forecasts were revised down to 3% this year and 1.5% in the following two years; the slower growth is mainly due to weaker global economic conditions,
- the unemployment rate is to remain around the current 3.5% in the coming months, but then it is forecast to increase gradually to slightly above 4% in 2024.

The Governor again stressed that there are many risks around the above scenario, including the uncertainty about the global economic outlook and the reaction of households to the tighter conditions.

Looking ahead, the interest rates are set to be increased further, with the size and timing still being data dependent. Particular attention will be paid to the global economy and household spending, as well as wage and price setting behaviour of companies.

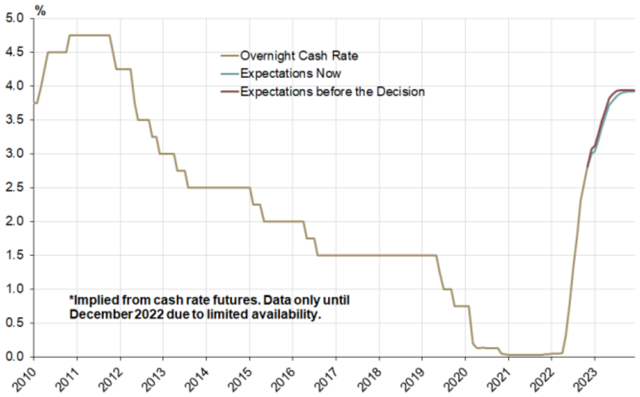
Market Impact

The 25bps hike was smaller than expected by many market participants, which was reflected in the market reaction. Most notably:

- the AUD/USD declined from 0.6441 to 0.6408 just after the announcement, before recovering to 0.6440,
- the ASX 200 increased from 6930 points to 6977 points at the close,
- 3-year Commonwealth bond yields fell from 3.383% to 3.261%,
- 10-year yields declined from 3.800% to 3.771%.

The decline in government bond yields came amid a slight adjustment in near-term cash rate expectations. The probability of a 25bps hike in December has declined slightly, but such a move is still around 70% priced in. The cash rate is still expected to peak at 3.85%, yet in Q3 2023 rather than Q2 2023.

RBA Historical and Expected Cash Rate*



Comment

As we expected, the RBA decided to maintain the 25bps pace of its rate increases, 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 still expects inflation not to return to the target range of 2-3% before 2024. At the same time, the central projection path is for growth to slow down. However, the balance of risks to growth is clearly to the downside.

The RBA continues to stress that interest rates have increased materially since the start of the cycle in May and that monetary policy operates with a lag. The RBA has increased the cash rate by 275bps so far, which is same as in the entire 1994 tightening cycle in terms of magnitude and pace.

Governor Philip Lowe, who will speak later today, will likely give additional explanation on this and upcoming decisions, as well as the most recent projection data.

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