WESTERN AUSTRALIAN
TREASURY CORPORATION

Economic Analysis RBA Monetary Policy Decision Feb 2023

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 3.35%,
- the interest rate on Exchange Settlement balances to 3.25%.

The decision was in line with the market expectations.

A separate dataset shows that RBA's bond holdings was broadly unchanged at A$350.5b.

Justification of the Decision

The post meeting statement was again reshuffled from the previous month, striking a bit more hawkish tone.

First, on inflation, Governor Philip Lowe stressed that underlying inflation surprised to the upside. He also said that strong domestic demand is adding to price pressures (which is a step up from just saying that they "also play a role" in the past statements). He assessed that inflation is to decline to 4.75% this year, from 7.8% in Q4 2022, before falling to around 3% in mid-2025.

Second, Governor Lowe continued to stress that wage growth is expected to pick-up further and that the RBA will monitor the evolution of labour costs closely. The RBA expects the unemployment rate to pick up to 3.75% by the end of this year and 4.5% by the end of projection horizon. Both levels are very low by historical standards.

Third, the statement contained a new paragraph emphasising that returning inflation to target is "the Board's priority". Governor Lowe continued to pledge that the RBA is trying to re-establish price stability while keeping the economy "on an even keel" but cautioned that "the path to achieving a soft landing remains a narrow one". The reference to "not being on a pre-set path" regarding monetary policy outlook was removed.

Looking ahead, the RBA Board expects further interest rate increases, which would help inflation return to target and remain elevated for only a "temporary" period. The magnitude of those increases will depend on the global economy and household spending, as well as inflation and the labour market outlook. This wording suggests the probability of a pause at the next meeting is low.

The statement also contained three new minor dovish elements. More specifically, Governor Lowe said that:

- global inflation is moderating, but will likely remain above the central bank targets for some time (this echoes the comments by Fed Chair Jerome Powell last week),
- global economic outlook remains subdued and GDP growth is expected to slow down in Australia as well,
- some Australian firms report a recent easing in labour shortages.

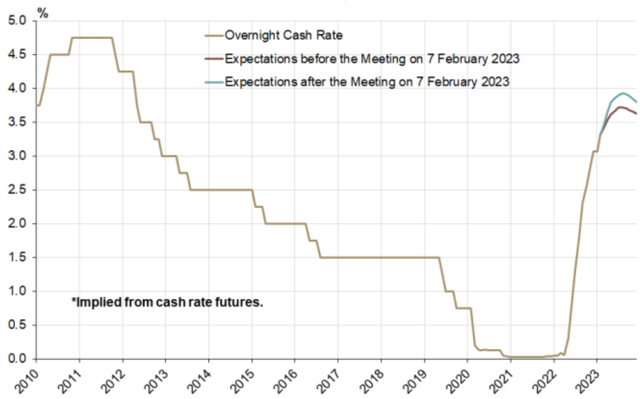
Market Impact

The 25bps hike was less than fully priced in and the markets were after some reference to an upcoming pause in the cycle. As no reference to the pause was made and the statement overall read as hawkish, cash rate expectations increased, with a rise above 3.85% now priced in by the futures.

As a result of higher cash rate expectations:

- the AUD/USD rose from 0.6919 to 0.6950 just after the announcement, before falling to 0.6929 at the time of writing,
- the ASX 200 declined from 7548 points just before the decision to 7504 points at the close,
- 3-year Commonwealth bond yields rose from 3.120% to 3.262%, before declining to 3.225%
- 10-year yields picked up from 3.521% to 3.626%, to decline back to 3.591%.

RBA Historical and Expected Cash Rate*



Comment

As expected, the RBA decided to deliver another 25bps rate increase. However, in contrast to speculation, the RBA did not signal any pause in tightening. To the contrary, they said that increases will continue while citing projection numbers, which suggest inflation is to remain elevated and will only touch the upper bound of the target band in more than two years.

Following today's statement, RBA cash rate market expectations rose substantially, and some commercial banks also revised their rate forecasts upwards, expecting a terminal rate at 3.85%.

Another 25bps hike is largely priced in for March, and we also expect such a move at the next meeting. However, the timing of any further increases will depend on upcoming data, particularly on the labour market and inflation. The January labour force survey is due next Thursday, while the monthly CPI indicator is scheduled for 1 March.

7 February 2023

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