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Economic Analysis RBA Monetary Policy Decision June 2023

At its meeting today, the Reserve Bank of Australia (RBA) decided to increase its interest rates by 25bps. After this decision, the cash rate target rose to 4.10% and the interest rate on Exchange Settlement balances rose to 4.00%.

The decision was a surprise to many market participants, though it had been anticipated by others.

A separate dataset shows that the RBA's bond holdings were roughly unchanged at A$337.2b in May.

Justification of the Decision

In the post-meeting statement, RBA Governor Philip Lowe explained the decision to increase the interest rates was triggered by:

- inflation remaining high, particularly for services, despite passing its peak,
- upside risks to inflation and interest rates stemming from higher inflation expectations becoming entrenched in decisions made by economic agents,
- a "brisk" increase in unit labour costs, with productivity remaining subdued and wages responding to the tight labour market as well as, more importantly, inflation,
- forecasts of a further pick up of public sector wages and the annual increase in award wages being higher than a year ago,
- limited spare capacity of the economy and the very low level of unemployment,
- the renewed rise in house prices.

As much as the statement reads hawkish judging from the above, it also contained some dovish elements, such as that:

- wage growth remains in line with the inflation target, provided that productivity growth picks up,
- domestic economic growth has slowed, with household spending hit by higher interest rates and cost of living pressures,
- Aussie labour market conditions have eased (but remain very tight),
- global economic growth is expected to slow this year.

Governor Lowe also acknowledged that, while some households have substantial buffers to withstand the rise in mortgage rates, others are experiencing "a painful squeeze on their finances." He reiterated that the RBA is seeking to keep the economy "on an even keel" while returning inflation to its target range of 2-3%, but the "path to achieving the soft landing" is "a narrow one."

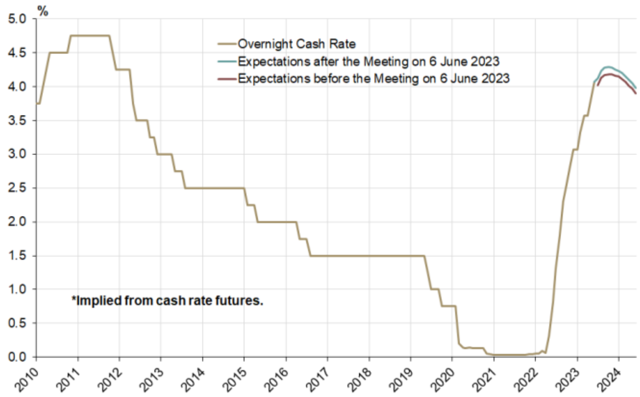
The forward guidance was unchanged, with the Board still expecting that some further tightening may be required, but also that decisions will continue to be data dependent.

Market Impact

The decision to increase the cash rate and retain the hawkish tilt was a surprise to some market participants. As a result of this:

- 3-year Commonwealth bond yields jumped from 3.56% to 3.68% after the decision, before declining to 3.65% at the time of writing,
- 10-year yields rose from 3.77% to 3.81%, having briefly reached 3.83%,
- the AUD/USD rose from $0.6626 to $0.6679,
- the ASX 200, which was trading at 7,176 just ahead of the decision, closed at 7,142.

RBA Historical and Expected Cash Rate*



Comment

The RBA's decision to deliver another cash rate hike was expected by some market participants, while others, thought the RBA would keep the cash rate unchanged. but still saw a high risk of an increase.

The RBA Board meeting was pretty much alive? with recent news such as the upside surprise to the April CPI indicator, the larger-than-estimated award wage hike for 2023-24, the faster annual wage growth in Q1 and the acceleration in home price growth in May all favouring a hike. In addition, while the April labour force survey was somewhat weaker than expected, the unemployment rate of 3.7% remained very low and labour demand high.

With the RBA continuing to signal that it remains "resolute" in its determination to bring down inflation, cash rate expectations have picked up, with another 25bps hike around 50% priced in for the next meeting. Further tightening appears likely if disinflation remains slow and labour market conditions are still tight.

The RBA is still trying to walk a fine line between cooling inflation towards the target range and avoiding a recession. However, with inflation remaining stubbornly high, the task is increasingly more challenging, and the risk of overshooting and a hard landing is on the rise.

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